

## **New Jersey's Economy and Banking Developments**

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### **New Jersey's Economy**

Both New Jersey's economy and the nation's are showing a great deal of resilience as we begin the ninth year of this economic expansion--the longest peacetime expansion in the nation's history.

The best gauge of the strength of New Jersey's economy is the solid growth in jobs that we have seen in the last few years and the tightening of the labor market. After being well above the national average in the early years of this expansion, the state's unemployment rate has now declined to 4.1 percent—slightly below the national unemployment rate.

The largest job gains, percentage-wise, in New Jersey last year were in business and personal services and in construction. The construction industry was spurred by increased home building and continuing high levels of nonresidential construction. Despite the high level of activity, the New Jersey building cycle does not seem headed for a boom-bust scenario like the one experienced in the mid- to late-1980s. In fact, so far, this expansion has been characterized by noninflationary growth rather than the overheating that has been the death-knell of so many past expansions. Rapid productivity growth is one factor that has helped keep inflation low. But this expansion has also avoided some of the excesses of previous expansions, such as the real estate speculation that New Jersey and other states experienced in the 1980s.

1998 marked the third consecutive year of increased homebuilding in New Jersey. But while contractors have been very busy, New Jersey housing permits are still only about one-half their 1980s peak, in part because of the limited availability of suitable land in prime markets. Despite strong home sales, we also are not seeing the sharp increases in home prices that we saw in the mid-1980s -- increases that were too often fueled by speculation. Increases in existing home prices have been quite modest in New Jersey and the entire Northeast.

The lack of significant speculation is also evident in nonresidential construction. Although the state's commercial real estate markets are the strongest they have been in a decade, nonresidential contracts are only about two-thirds what they were in the mid-1980s. Caution in capital markets has kept a lid on expanded development. Nevertheless, office vacancy rates have come down and rental rates have stabilized or turned up in most parts of the state. One important development during the past year has been the improvement in the southern New Jersey markets, where the office vacancy rate fell to about the same level as in the northern and central markets.

Industrial properties, especially warehouse and distribution facilities, have also been in demand, and construction of these types of buildings has increased markedly.

For the most part the economic news for New Jersey is very positive, but there has been one notable weak spot -- manufacturing. The state's producers felt the impact of the recent turmoil overseas, which dampened exports and increased competition from imports. More recent indicators, however, point to improvement in manufacturing going forward in 1999. In fact, since the beginning of this year, manufacturers in our Third District *Business Outlook Survey* have been telling us that they have seen improved activity and are expecting more. And a broad base of firms that we contact in our *South Jersey Business Survey*, including manufacturers, retailers, and service providers, are reporting increases in overall activity or sales and are adding workers. They expect business to continue moving up this year, and they plan to increase capital spending and payrolls. The biggest worry among most businesses seems to be finding qualified workers.

### **Banking**

The performance of the banking industry, like that of the overall economy, has been quite remarkable for some time as well. During the current economic expansion, profitability has risen substantially, cost ratios have improved significantly, and the ratio of nonperforming loans has fallen dramatically. New Jersey banks have shared in the industry's prosperity, and their ratio of nonperforming loans is much lower than the national average.

While this dramatic improvement in bank performance has been occurring, the banking industry has been undergoing a tremendous transformation. Banks have been consolidating into fewer and larger organizations, and more recently, they have begun to expand into new product areas. Over the past 10 years, the number of banks in the U.S. has fallen 30 percent, and the share of domestic banking assets held by the 10 largest banking organizations in the country has doubled, from about 20 percent to about 40 percent.

New Jersey has experienced its share of consolidation as well. Ten years ago, 126 commercial banks were headquartered in New Jersey. Today, there are only 70. Just over the past four years, there have been 36 mergers and acquisitions involving banks and bank holding companies in the state. These combinations are partially responsible for the higher concentration of New Jersey's banking market compared to the nation's. The 10 largest banking organizations operating in New Jersey hold over 80 percent of New Jersey banking assets, about twice that of the nation.

In addition to consolidation, which is concentrating banking resources into fewer but larger institutions, banks have also been expanding into other financial services. Several bank holding companies have acquired investment banking firms, and today 51 bank holding companies have subsidiaries authorized to underwrite securities -- so-called, Section 20 subsidiaries. Banks are also "partnering" with investment management firms. And many states, including New Jersey, have authorized banks to sell insurance.

Is it just a coincidence that bank performance has improved at the same time the industry has been consolidating and restructuring? Much of the improvement in performance reflects, of course, the favorable economic climate, with low interest rates and strong borrower balance sheets. The banking industry is similar to other cyclically sensitive industries in this respect, although banking is probably more sensitive to the interest rate cycle than other industries. But recent evidence also suggests that consolidation may have played an important role in the dramatic changes in bank performance. Indeed, while merging banks appear to have experienced some increased costs, they have more than made up for this with increased revenues.

To understand the connection between consolidation and performance, ask the basic question: What's driving consolidation and the expansion of activities? The answer, in a nutshell, is that banks must reinvent themselves to stay competitive in a changing marketplace. And regulators must allow this to happen, all the while ensuring that the safety and soundness of the industry remains intact as the transformation occurs.

On the deposit side, money market mutual funds and stock and bond funds are aggressively competing with bank deposits. Given recent legislation, credit unions have the potential to become stronger competitors with banks as well.

On the loan side, the growth of the commercial paper market and the entry of nonbank firms into the market for middle market borrowers and now even for small business loans have changed the face of commercial lending. Technological innovations have enabled the development of credit scoring and automated loan application processing, for example. Thus, although new, powerful tools have been put into the hands of bankers, these same tools have also been put into the hands of their nonbank competitors. Twenty-five years ago, commercial banks provided almost 35 percent of nonmortgage borrowings by nonfinancial firms; today, they provide only about 20 percent. In the Philadelphia Federal Reserve District, American Express is one of the top granters of credit lines to small businesses, especially lines with face values under \$100,000.

Facing these increasing pressures to become more competitive, banks have stood up to the challenge, partly through consolidation and partly through finding new activities to generate revenue. But deregulation of banking is still incomplete. I hope Congress will move further this year to deregulate the asset side of banks' balance sheets and further expand permissible powers.

As you probably know, I generally favor allowing banks to expand their powers in securities and many aspects of insurance, but I have serious reservations about the mixing of commerce and banking. I think that any steps in this direction should be evolutionary, not revolutionary, until we gain more experience with mixing the two -- comparable to what was done with securities underwriting.

I am generally quite positive about the banking industry, but it's important for both the industry and regulators not to become complacent in the midst of good times. At this stage of the business cycle, we often see a deterioration in underwriting standards. Last summer's financial market problems were a wake-up call to lenders' in response, bankers tightened underwriting standards. In the current environment, many people who have been in banking even five to 10 years have very limited experience with the performance of loan portfolios during economic downturns. We have had only one recession during the past 15 years. So unless a banker studies history, he or she may not appreciate what happens when the economy sours. Not that I expect a downturn in the economy this year or next-I don't. But we haven't repealed the business cycle either, and the profitable loans of today can perform a lot differently under less favorable economic circumstances. So, in the competition for loans, know the level of risk you are getting into, and structure and price the loans accordingly. Prudence now can avoid major loan losses later.

### **Century Date Change**

Technology is also a near-term issue for banks, which have to deal with the century date change. This year began with many news stories about potential problems with computer systems when the year 2000 arrives. So-called Y2K problems will receive even more attention as we move through the year. Many of the scarier stories being told about Y2K involve the banking and financial system. The impression one gets from some of these stories is that the banking industry is the one most likely to suffer from Y2K problems. In fact, the banking industry is doing one of the best jobs to ensure that the arrival of the year 2000 is a manageable event.

We at the Federal Reserve have tested, updated, and re-tested our own major systems and made sure they will work in the year 2000. Now we are working to test the interaction of our automated systems with those of banks-not just large banks, but community banks as well. Our objective is for banks to have tested with us, or to be scheduled to test with us, by the end of this month. All banks should have tested with us by the end of June. Bank regulators have been raising the heat on banks about preparing for the year 2000 for more than a year now. Regulators are also pushing banks to make sure that their business customers are ready for Y2K.

We are also preparing for the possibility that some individuals may decide to hold extra cash during the century rollover. And we will make sure our cash operations are staffed around the turn of the year so that banks can obtain currency on a timely basis. For that matter, we will have a lot of staff from many of our departments available around the turn of the year, just to handle any unusual developments in the payments system. Furthermore, we will be prepared to lend funds to financial institutions under appropriate circumstances.

Beyond the technical side of fixing the century date change problem lies the issue of educating the public and the media about what the true situation is rather than letting anxiety build through a lack of knowledge.

You can expect media attention about this issue to intensify as the year progresses. It would be wise for all of us to be prepared to answer reporters' questions about Y2K preparedness honestly and reassuringly. No one can guarantee a perfect rollover into the millennium-in fact, I believe it would be unwise to do so-but through Y2K preparedness, the financial industry can do its part to maintain confidence in our economy and keep glitches manageable. We should strive to give the public confidence that banks are on top of Y2K issues.

### **Conclusion**

To close, the banking industry has been enjoying strong performance in recent years. This reflects the tremendously good economic environment in which banks are operating and also the consolidation trend, which has driven banks to become more efficient in their production and more profit-oriented in their

selection of bank products. It is important going forward for banks and their regulators not to become too complacent about the health of the banking industry. Banks need to stay alert to the risks they are undertaking, and remain prudent even as they enjoy the current good times.