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A POLICYMAKER'S PERSPECTIVE ON THE U.S. ECONOMY

I. Thank you. I'm delighted to be here.

II. Today I'd like to focus on the outlook for the economy over the next year or so.

  A. And I'd also like to draw out some of the implications of the outlook for savings institutions and community banks,

  B. as well as for the conduct of monetary policy.

III. Let me begin by taking a quick look at the performance of depository institutions,

  A. which in many respects has been very encouraging.

  B. Of course, we still have some problems to deal with.

    1. We'll continue to see an elevated rate of bank failures.

    2. Furthermore, a portion of the assets in the thrift industry remains in institutions with weak earnings and capital positions.

      a. This situation calls for giving the highest priority to providing the RTC with appropriate funding,

      b. so that the healthier part of the industry can finally get out from under the cloud cast by the weaker savings institutions.

  C. Nevertheless, banks and thrifts have done relatively well in the face of an otherwise lackluster economy.

    1. Earnings at savings institutions and banks have been positive for several quarters.

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(1) For example, ROA was a respectable 0.6 percent in the second quarter of this year for the SAIF-insured private sector savings institutions,

(2) with 93 percent of them showing positive earnings.

2. We're also seeing improvement in capitalization for banks and thrifts.

   a. This is very encouraging since strong capital positions are fundamental to the long-run viability of savings institutions and commercial banks alike.

D. Why have banks and thrifts done so well in these sluggish times?

1. The main reason is the wide interest margins that are related in part to the usually steep yield curve.

2. But it's important to remember that we can't depend on the steep yield curve and favorable interest rate margins to persist.

3. Moreover, we shouldn't let them mask the fact that the underlying vitality of our financial institutions depends on the vitality of the economy itself.

E. I'd like to illustrate the importance of the economy for profitability by telling you about some research done at the San Francisco Fed.

1. This research compares the performance of community banks in three major regions of California: Southern California, the San Francisco Bay area, and the Central Valley.

2. As you probably know, the recession has been much more pronounced in Southern California than elsewhere in the state.

   a. Of the more than 650,000 jobs that have been lost statewide since the Spring of 1990, about 85 percent were in Southern California.

3. And the troubles in Southern California are reflected in the performance of community banks in the area.

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a. Despite favorable interest margins, in the first half of this year, the ROA for community banks was a dismal .26 percent in Southern California.

b. By comparison, earnings rates were two to three times higher in the San Francisco Bay Area and the Central Valley, where job losses have been less severe.

4. In the same vein, in June, problem loan ratios were appreciably higher for community banks in Southern California than they were for their counterparts in the other regions of the state.

F. I think this clearly suggests that the future financial health of savings institutions and commercial banks rests to a large degree on the outlook for the economy.

G. Now, one of the issues in the outlook for the national economy is the role that banks and thrifts themselves are playing.

1. Some analysts argue that we're seeing a slow recovery *because* of sluggish lending by banks and thrifts.

2. But I think the far more dominant causal relationship runs the other way—that banks and thrifts are making fewer loans largely because of the slow economy.

3. That is, the weakness in the overall economy and problems in the real estate sector explain a lot of the sluggishness in lending, not just by banks and thrifts, but by virtually *all* lenders.

IV. Well, just how weak has the economy been?

A. As a matter of fact, the last three and a half years have been one of the longest periods of slow growth in this country's postwar history.

B. And though we're out of the recession, the recovery has been disappointing.

1. As a result, national unemployment remains at a high 7½ percent.

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2. We may be able to take some small comfort in the preliminary data for the fall quarter.

   a. It showed real GDP growth at a 2¾ percent rate.

   b. This brings the growth rate for the first three quarters of the year to an average of 2½ percent,

      (1) a definite improvement over last year's virtual standstill.

3. But it still leaves the economy running far below the robust pace of expansion we've typically seen in prior recoveries.

C. In order to revitalize the economy, the Fed has eased monetary policy substantially.

1. The federal funds rate and other short-term rates are now about a third of what they were in early 1989.

2. The discount rate now stands at 3 percent, its lowest level in nearly three decades.

D. This easing works to stimulate spending on goods and services, and therefore, economic activity.

1. First of all, lower interest rates boost spending on business equipment and consumer durables, like autos, furniture, and appliances.

2. We've also seen the effects of dramatically lower rates on the housing market.

   a. Residential investment has grown at an average rate of close to 11 percent for over a year and half, with most of the increases in single-family units.

   b. Although housing activity slowed in the late spring and summer, it has picked up in the last few months, and I

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expect to see fairly strong figures in the year ahead.

E. Still, there are a number of reasons why this low-interest-rate environment in the U.S. will probably produce only a modest expansion.

1. First, even though lower interest rates tend to lower the value of the dollar, and therefore make prices for U.S. goods cheaper abroad, we're not seeing much action in exports.

   a. The problem is that a number of our most important trading partners are going through slowdowns themselves, so they're not buying as many U.S. products, even though exchange rates make our products relatively less expensive.

2. Second, we've been importing foreign goods, especially computers, at a rapid pace in recent years, and we expect this trend to continue.

   a. This cuts into demand for domestically produced goods and services.

3. Then there's fiscal policy.

   a. In view of large federal budget deficits and the end of the cold war, the government has cut back spending, especially for defense.

   b. Fiscal policy could become more expansive, but the effect may not be very great in 1993.

      (1) First, President-elect Clinton's concern over the budget deficit and the need to keep inflation low should have a moderating effect on any fiscal policy proposals.

      (2) Second, the effect of any added fiscal stimulus probably would be slow in developing.

4. Finally, I don't need to tell you that there's trouble in the commercial real estate market in many places, not just California.

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a. The national vacancy rate is high, at about 20%.

b. And in some areas

(1) like Dallas, Phoenix, and Miami, the vacancy rates are even four to five percentage points higher.

c. Normally, lower interest rates tend to stimulate spending on commercial real estate.

(1) In fact, this is one of the channels monetary policymakers traditionally rely on to pull the economy out of a recession.

d. But, with this much "overhang" in the commercial real estate market, it's unlikely that this channel will work the way it has in the past.

V. Now, let me give you my outlook for inflation.

A. During the past three years of recession and slow growth, labor and product markets slackened, and this restrained growth in labor compensation and product prices.

B. Moreover, since the pick-up in the economy will probably be gradual over the next year or so, we're likely to see continued downward pressure on inflation.

1. So far this year, core consumer inflation -- which excludes the volatile food and energy component from the consumer price index -- has risen at around a 3¼ percent rate, and I expect to see it decline to about 3 percent for this year as a whole and 2½ percent in 1993.

2. Compared to the 4½ percent core rate of consumer inflation in 1991, 2½ percent next year definitely would represent progress.

VI. This downward trend in inflation is in keeping with the Federal Reserve's main long-term goal of moving gradually toward price stability—a crucial element to achieving maximum economic growth in the long run.

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A. Our progress on this front in recent years is important because it gives us greater latitude to respond to weakness in the economy if it's necessary.

B. Given our expectations of only a modest expansion, we can't rule out the possibility that further action will be needed.

C. But I want to emphasize that while we're doing what we can to help sustain economic recovery,

    1. we're also being careful to preserve and advance hard-won gains against inflation.

D. I think our efforts in both areas ultimately will pay off.

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