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Financial Community Lunch
Salt Lake City
For Delivery January 7, 1993 - 12:00 Noon MST

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

I. Thank you. It's a pleasure to be here.

A. My topic today is the outlook for the national economy. As you know, for almost four years, we've had sluggish growth followed by an actual contraction followed by more sluggish growth.

1. Now, a lot of issues about this economic performance were discussed during the seminar President-elect Clinton held in Little Rock last month.

2. About 350 people talked about the economy for two solid days.

B. Well, I'm just one policymaker, with about 20 minutes here at the podium, so I'm going to focus on just three issues.

1. But these are issues that are especially important to you in the banking community and to us at the Fed.

C. The first issue is the importance of a healthy economy to the banking industry's performance.

D. The second issue is whether the economy has finally turned the corner.

1. My short answer is: yes, I think it has, and I expect growth to continue for at least the next year or so,

a. but I also don't expect it to be rapid.

E. Finally, what will moderate growth mean for the inflation outlook and for monetary policy?

1. As you know, keeping inflation low is the main way the Fed can contribute to the economy's long-term growth.

2. But the Fed also is concerned about the performance of the economy in the short run.

3. So finding the right balance between growth and inflation will be a key consideration for monetary policy in 1993.

II. Let me start with the banking industry.

A. In many parts of the country banks certainly have had some tough sledding.

1. And we're not out of the woods yet.

a. We have close to a thousand institutions on the FDIC's problem list,

b. and we haven't seen the last of the bank failures.

B. But, commercial banks over the past year generally have posted strong earnings and improved capitalization, despite a lackluster economy.

1. In the first three quarters of last year, banks in the U.S. registered a healthy 0.94 percent ROA, up sharply from a year earlier.

2. The improvement in earnings has led to meaningful improvement in bank capitalization.

a. This is encouraging because strong capital positions are fundamental to the long-run viability of banks.

C. Why have banks' earnings been strong?

1. The main reason is the wider interest margins that are related in part to the unusually 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.

D. Let me illustrate why the economy is important for banks' profitability by telling you about some research done at the San Francisco Fed.

1. In that research, we compared 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 may know, the recession has hit Southern California especially hard.

   a. Of the more than 700,000 jobs that have been lost statewide since the Spring of 1990, about 85 percent were in Southern California.

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

   a. Despite favorable interest margins, in the first three quarters of last year, the ROA for community banks in Southern California was a dismal 0.06 percent (annual rate).

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

4. In the same vein, in September, 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.

E. The situation here in Utah also shows the link between the economy and the health of banks.

   1. Throughout the national recession and sluggish recovery, Utah's economy has been relatively strong.

   2. That strength is reflected in a high ROA and high asset quality.

      a. For the first three quarters of 1992, banks in Utah registered a very impressive ROA of 1.45 percent.

b. And problem real estate and consumer loan ratios for the state are about half as large as for banks nationally.

F. I think the performance of the Utah banks and the evidence on community banks in California clearly suggest that the future financial health of 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 are playing.

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

2. But I think the far more dominant causal relationship runs the other way—that banks 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 but by virtually *all* lenders.

III. So now let me turn to the national economy.

A. Since growth in the economy began to slow in the spring of 1989, 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. And the discount rate now stands at 3 percent, its lowest level in nearly three decades.

B. And though for some time it was hard to see the effects of this easing, some of the most recent numbers *have* had a rosier glow.

1. The unemployment statistics have improved,

a. falling from a high of 7.8 percent in June to 7.2 percent in November.

2. The third quarter growth rate of almost 3½ percent in real GDP brings growth for the first three quarters of 1992 to an average of 2½ percent.

   a. This is a substantial improvement over 1991's virtual standstill.

3. Retail sales and consumer confidence improved markedly in October and November.

   a. And early reports suggest this improvement continued in December.

C. Do statistics like these mean we've turned the corner? Is the recovery finally taking hold?

   1. I <u>am</u> more confident that the expansion will be sustained.

D. At the same time, I think we'll see only a <u>moderate</u> expansion, probably in the neighborhood of 3 percent both this year and next.

IV. There are a number of reasons why modest growth is likely—weak economies abroad, heavy imports, an overbuilt commercial real estate market, and fiscal constraints. Let me take them one at a time.

A. First, a number of our most important trading partners are going through slowdowns themselves,

   1. so their purchases of U.S. products aren't growing as fast as in earlier cyclical upturns.

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

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

C. Then, there's trouble in the commercial real estate market in many places.

   1. The vacancy rate nationally is high, at about 20 percent.

2. And it will probably take years to work off this much overhang.

D. Finally, and perhaps most importantly, budget deficits have constrained government spending at all levels.

1. In particular, the large federal budget deficits and the end of the cold war have made the government cut back, especially for defense.

E. Each of these factors taken alone would have only a modest impact on the economy as a whole.

1. But taken together, they probably mean that growth will be around 3 percent for 1993, rather than the 4-5 percent that would be normal early in an economic recovery.

F. Of course, this forecast could change once we know more about what to expect from the Clinton White House.

1. For example, one of the major items of discussion at the two-day economic conference in Little Rock was an investment tax credit.

2. But at this point it's too soon to tell what kind of fiscal program the new administration will propose.

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

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

B. And I think we'll probably see continued downward pressure on inflation for a couple of reasons.

1. First, as I mentioned, the economy is likely to pick up only gradually, so this will keep inflationary pressures from building up.

2. Second, we've seen stronger increases in worker productivity over the last four quarters.

   a. So long as these continue, firms will have a better chance of meeting increased demand without having to increase prices.

C. During 1992, core consumer inflation—which excludes the volatile food and energy component from the consumer price index—rose at around a 3½ percent rate,

   1. and I expect to see it decline to about 2¾ percent this year and to be lower in 1994.

   2. Compared to the 4½ percent core rate of consumer inflation in 1991, 2¾ percent in 1993 definitely would represent progress.

VI. What does this mean for monetary policy?

A. As I said at the outset, the Federal Reserve's main long-term goal is to keep inflation low and move gradually toward price stability.

   1. That is really the most important way the Fed can contribute to long-run growth in the economy.

   2. So the downward trend in inflation that I expect is very much in keeping with our long-term goal.

B. Our progress in lowering inflation in recent years is important also because it gives us greater latitude to respond to weakness in the economy if it's necessary.

C. But I want to emphasize that while we'll continue to do what we can to help sustain economic recovery,

   1. we also must be 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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