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WHAT'S AHEAD FOR 1993? A POLICYMAKER'S PERSPECTIVE

Today I want to talk about three issues that I think are especially important to California and its banking industry, and to the Fed. The first issue is the banking industry's performance both nationally and here in California. In particular, I want to look at the link between bank performance the strength of the economy.

The second issue is the economy itself—namely, whether the recovery is going to pick up more steam. The NBER finally has dated the start of the recovery as March 1991. Since then, we've been "pulling out of the station" pretty slowly. I do think we'll pick up some steam in 1993, but I also think we've got some steep terrain ahead, so I don't expect the pace of the recovery to be rapid.

The third issue is, what will moderate growth mean for the inflation outlook and for monetary policy? Keeping inflation low is the main way the Fed can contribute to the economy's long-term growth. But the Fed also is concerned about the performance of the economy in the short run. So finding the right balance between growth and inflation will be a key consideration for monetary policy in 1993.

Let me start with the good news about the banking industry. We saw a dramatic turnaround in bank earnings nationally over the first three quarters of 1992, with after-tax profits of $24.1 billion. This pushed ROA at commercial banks to a 0.94 percent annual rate, an excellent level for the industry, and led bank stocks to outperform the overall

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market. The Salomon Brothers 50-bank stock index, for example, rose close to 29 percent last year, compared to about a 4½ percent increase in the S&P 500.

One factor that's helped turn banks around is the reduction in troubled loans. Even more important are the wide interest margins that are related in part to the unusually steep yield curve. The increase of 24 basis points in net interest margin for U.S. banks during 1992 boosted industry earnings by around $3 billion in the third quarter alone. These wide interest margins help explain why banks have performed so well while the economy has been chugging along at a fairly sluggish pace during the past year. But, it's important to remember that we can't expect the steep yield curve to persist. More important, we shouldn't let it mask the fact that the vitality of our financial institutions depends on the vitality of the economy itself.

The situation here in California, where we are in a long and deep recession, is a perfect illustration of this point. According to the BLS, California has lost over 760,000 jobs since employment peaked in May 1990. The most recent data indicate that California is still losing jobs. The state's unemployment rate is 9.7 percent. In fact, if you exclude California, the unemployment rate for the rest of the nation is just under 7 percent.

This economic stress shows up plainly in the banking statistics. California banks registered a rather modest 0.6 percent (annual rate) ROA in the first three quarters of 1992, and 28 percent of the banks in the state lost money. While asset quality outside the state improved, it fell for California banks last year. Capitalization, however, is one

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area where California banks did make progress. The total equity capital to assets ratio for the state rose to 7.4 percent, slightly above the national average.

The relationship between economic stress and bank performance is just as clear when we focus more closely on regions within the state. In research done at the Fed in San Francisco, we compared the performance of community banks in three major regions of California: Southern California, the San Francisco Bay area, and the Central Valley. As you probably know, the recession has hit Southern California much harder than other parts of the state; this area accounts for about 85 percent of the job loss in the state. And, as you might expect, the area's economic troubles are reflected in the performance of community banks. In the first three quarters of 1992, the ROA for community banks in Southern California was a dismal 0.06 percent (annual rate). 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. In the same vein, problem loan ratios are appreciably higher for community banks in Southern California than for their counterparts in the other regions of the state.

The performance of the banks in California clearly suggests that the future financial health of commercial banks rests to a large degree on the outlook for the economy. In California, and Southern California especially, the outlook, continues to be dimmed by the depressed commercial real estate sector and cutbacks in defense spending. However, the basic links between California and the nation are still there, and the performance of the national economy will spill over to our state.

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So now let me turn to the national economy. Since growth in the economy began to slow in the spring of 1989, the Fed has eased monetary policy substantially. The federal funds rate and other short-term rates are now about a third of what they were in early 1989. And the discount rate now stands at 3 percent, its lowest level in nearly three decades.

Though it was hard to see the effects of this easing for a while, some of the most recent numbers *have* had a rosier glow. The unemployment statistics have improved, falling from a high of 7.7 percent in June to 7.3 percent in November and December. 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. This is a substantial improvement over 1991's virtual standstill. Retail sales and consumer confidence improved markedly in recent months.

Do statistics like these mean we're ready to go "full steam ahead"? I am more confident that the expansion will be sustained. But I also think we'll see only a moderate expansion, probably in the neighborhood of 3 percent both this year and next.

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. First, a number of our most important trading partners are going through slowdowns themselves, so their purchases of U.S. products aren't growing as fast as in earlier cyclical upturns. Second, we've been importing foreign goods, especially computers, at a rapid pace in recent years, and we expect this trend to

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continue. This cuts into demand for domestic products. Then, there's trouble in the commercial real estate market in many places. The vacancy rate nationally is high, at about 20 percent. And it will probably take years to work off this much overhang. Finally, and perhaps most importantly, budget deficits have constrained government spending at all levels. In particular, the large federal budget deficits and the end of the cold war have made the government cut back, especially for defense. And recent budget projections suggest that these constraints will be with us for some time to come.

Each of these factors taken alone would have only a modest impact on the economy as a whole. 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. Of course, this forecast could change once we know more about what to expect from the Clinton White House. For example, one of the major items of discussion at the two-day economic conference in Little Rock was an investment tax credit. But at this point it's too soon to tell what kind of fiscal program the new administration will propose.

Now, let me give you my outlook for inflation. 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. And I think we'll probably see continued downward pressure on inflation for a couple of reasons. First, as I mentioned, the economy is likely to pick up only gradually, so this will keep inflationary pressures from building up. Second, we've seen stronger increases in worker productivity over the

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

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, and I expect to see it decline to about 2¾ percent this year and to be lower in 1994. These numbers represent significant progress over the 4½ percent core rate of consumer inflation in 1991.

What does this mean for monetary policy? 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. That is really the most important way the Fed can contribute to long-run growth in the economy. So the downward trend in inflation that I expect is very much in keeping with our long-term goal. 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. But I want to emphasize that while we'll continue to do what we can to help sustain economic recovery, we also must be careful to preserve and advance hard-won gains against inflation. I think our efforts in both areas ultimately will pay off.

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