For release on delivery

10 a.m. EST

Wednesday

March 10, 1993

Testimony by

Thomas C. Melzer

President

Federal Reserve Bank of St. Louis

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

March 10, 1993

Recent Economic Performance in the Eighth District

Though the 1990-91 recession and restructuring have affected both the national and Eighth District economies, the District has fared somewhat better than the nation.

Pockets of Strength

One of the characteristics of a diverse economy is that, even when an economy slows, some regions or sectors may moderate the slowdown. This situation has been observed in our area in recent years, as certain pockets within the District have grown rapidly, bolstering the economic fortunes of our District. As examples,

- Northern Arkansas has experienced substantial economic growth in the past few years. The northwestern part is home to some of the nation's fastest-growing companies: Wal-Mart, Tyson Foods and J.B. Hunt Transport Services. Nucor, as well as several small steel manufacturers, have located in northeastern Arkansas.
- Bowling Green, Kentucky, has attracted major industrial plants, including International Paper and the James River Corporation.
- Memphis, already a significant transportation and distribution center, has exhibited substantial real growth. In December, total payroll employment was 1.8 percent higher than a year earlier, real retail sales were up 31 percent, and the area unemployment rate stood at 5.5 percent, well below the 7 percent national average.

Employment, Unemployment and Restructuring

Payroll employment data provide a useful measure with which to compare the Eighth District and the nation during the recession and the recovery to date. As figure 1 shows, U.S. payroll employment fell at a 2.2 percent annual rate during the recession from July 1990 to March 1991. District employment declined as well, but at half the national rate. Figure 1 also shows that, in contrast to previous recovery periods, U.S. payroll employment has essentially remained unchanged since the

March 1991 recession trough, whereas Eighth District payroll employment has grown, though only at a 0.5 percent annual rate.

The employment growth comparison for the District and the United States is repeated in unemployment data. Table 2 shows that the increase in the District unemployment rate in the 1990-91 recession was only two-thirds that in the nation. In the recovery, the unemployment rate for the District fell to 5.8 percent by the end of 1992 — its prerecession level — while the unemployment rate for the United States remained well above its pre-recession level.

Figure 1 further illustrates that increases in District service sector employment in the aftermath of the recent recession more than offset the continued job losses in the goods-producing sector. District goods-producing employment, after decreasing at a 6.4 percent rate during the recession, has continued to fall in the recovery, though at a significantly reduced 0.1 percent annual rate. In contrast to the District experience, national job growth in services has not been enough to make up for job losses in manufacturing.

The Eighth District has not escaped employment restructuring. Figure 2 illustrates the substantial employment changes in transportation equipment, including both automobile and aerospace manufacturers. Many of the changes in the District aerospace industry are directly related to reductions in spending on national defense. During the 1990-91 recession, employment in transportation equipment declined at an annual rate of 15.3 percent in the District and 8.9 percent nationally. Since the March 1991 recession trough, employment in this industrial classification has declined 3.4 percent in the nation but increased 0.4 percent in the District, an increase that is, nonetheless, below the norm for previous recoveries. Since mid-1990, McDonnell Douglas, the nation's largest defense contractor, has cut back employment in St. Louis by roughly 13,000. While many of those laid off have found jobs in St. Louis and elsewhere, manufacturing employment in St. Louis in 1992 was 5,000 below its level for 1991 and 21,200 below its level for 1990.

lower nonperforming and loss rates than other types of real estate loans. Currently, nonperforming ratios for all types of real estate loans are lower at District banks than at national peer banks (see table 4).

- Over the last five years, District banks have consistently had capital ratios that exceed regulatory minimums (see table 5). At the end of the third quarter of 1992, only one of the District's 1,200 banks failed to meet the "adequately capitalized" requirement under the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Even more impressive is the fact that only 12 District banks failed to meet the tougher "well capitalized" standards under FDICIA. Because District banks generally have capital ratios that exceed regulatory minimums, they are well-positioned to meet demands for loans and other banking services.

All in all, it is fair to say that the economy of the Eighth District has been relatively stable in light of national developments. The diverse nature of the District economy has contributed to this stability, with pockets of strength more than offsetting areas of weakness. Such overall stability is backed up by the strength of the banking sector. This optimistic evaluation does not ignore the significant structural adjustments that are occurring in certain sectors and regions. Nevertheless, in my judgment, were it not for these unusually large structural adjustments, economic growth in the District would be comparable with that of earlier recoveries.

Views on Monetary Policy

I would now like to turn to my views on monetary policy. As I stated initially, the monitoring of regional economic conditions provides useful insights that contribute to the monetary policymaking process. The input of Reserve Bank presidents, who are briefed on a broad range of economic viewpoints, enriches Federal Open Market Committee discussions of national economic conditions. Such deliberations

provide the backdrop for formulating monetary policy. Nonetheless, monetary policy decisions necessarily must be made for the nation as a whole, regardless of the conditions in any one district.

In reaching judgments on policy, I try to keep several factors in mind. They include the goals of economic policy; the role of monetary policy in achieving such goals; the usefulness and limitations of countercyclical monetary policy actions; and the importance of an indicator to gauge the thrust of monetary policy actions over time. I will discuss each of these issues briefly.

Goals

The goals of economic policy include maximum sustainable growth of the economy, a high level of employment, and stability in the purchasing power of the dollar. At one time there was thought to be a tradeoff between policies pursuing growth and those aimed at price stability. We now know that maximum sustainable economic growth is achieved when changes in the price level cease to be a factor in economic decision making. It is no accident that the most advanced industrial countries and the newly industrialized and fast-growing Asian economies have been comparatively successful in keeping price levels stable.

It cannot be emphasized too strongly that reasonably stable prices create an environment conducive to long-range planning, as resources are used productively and not expended on inflation hedges. Removing the distorting effects of inflation from real price signals enhances market efficiency. Low and stable inflation also helps to keep interest rates low by removing the premium that investors require to compensate themselves both for expected losses due to rising prices and for the risks of making long-term commitments in a world with price-level uncertainty.

Role of Monetary Policy

In the long run, monetary policy only affects prices. Stimulative monetary policy

actions cannot increase the economy's long-run growth. The potential for economic growth is determined by real factors such as the growth in the labor force, capital investment and increases in productivity. Accordingly, the role of monetary policy in achieving our long-run economic goals is limited.

Countercyclical Policy

Countercyclical monetary policy, however, may be appropriate in the short run. Monetary policy actions can lay the foundation for recovery by bolstering sagging monetary growth rates during a recession and can avoid an upward spiral in inflation and interest rates by moderating excessive monetary growth during an economic expansion. But monetary policy is a blunt tool. Both the magnitude and timing of the effects of countercyclical monetary policy actions on the real economy are uncertain. Excessive countercyclical monetary policy actions are destabilizing because they necessitate policy reversals down the road. Consequently, one must avoid sowing the seeds for the next inflation when fighting recession or sowing the seeds for the next recession when fighting inflation.

Monetary Policy Indicators

Finally, it is essential to have indicators of the thrust of monetary policy actions to gauge whether monetary policy has been excessively tight or easy. Such indicators should be tied closely to Federal Reserve actions, which primarily involve adding or draining reserves available to the banking system. This approach leads me to monitor the behavior of total reserves, the monetary base and the M1 monetary aggregate. These variables, observed over relatively long periods, provide a reasonable gauge of the stance of monetary policy.

The behavior of broader monetary and credit aggregates, such as M2, can also be useful in formulating and evaluating monetary policy. Averaged over three- to five-year intervals, M2 growth has been an indicator of the growth of nominal spending,

although this relationship is now being re-evaluated. But monetary policy is too complex to be described solely by the behavior of a single variable, especially one over which the Federal Reserve has only limited control.

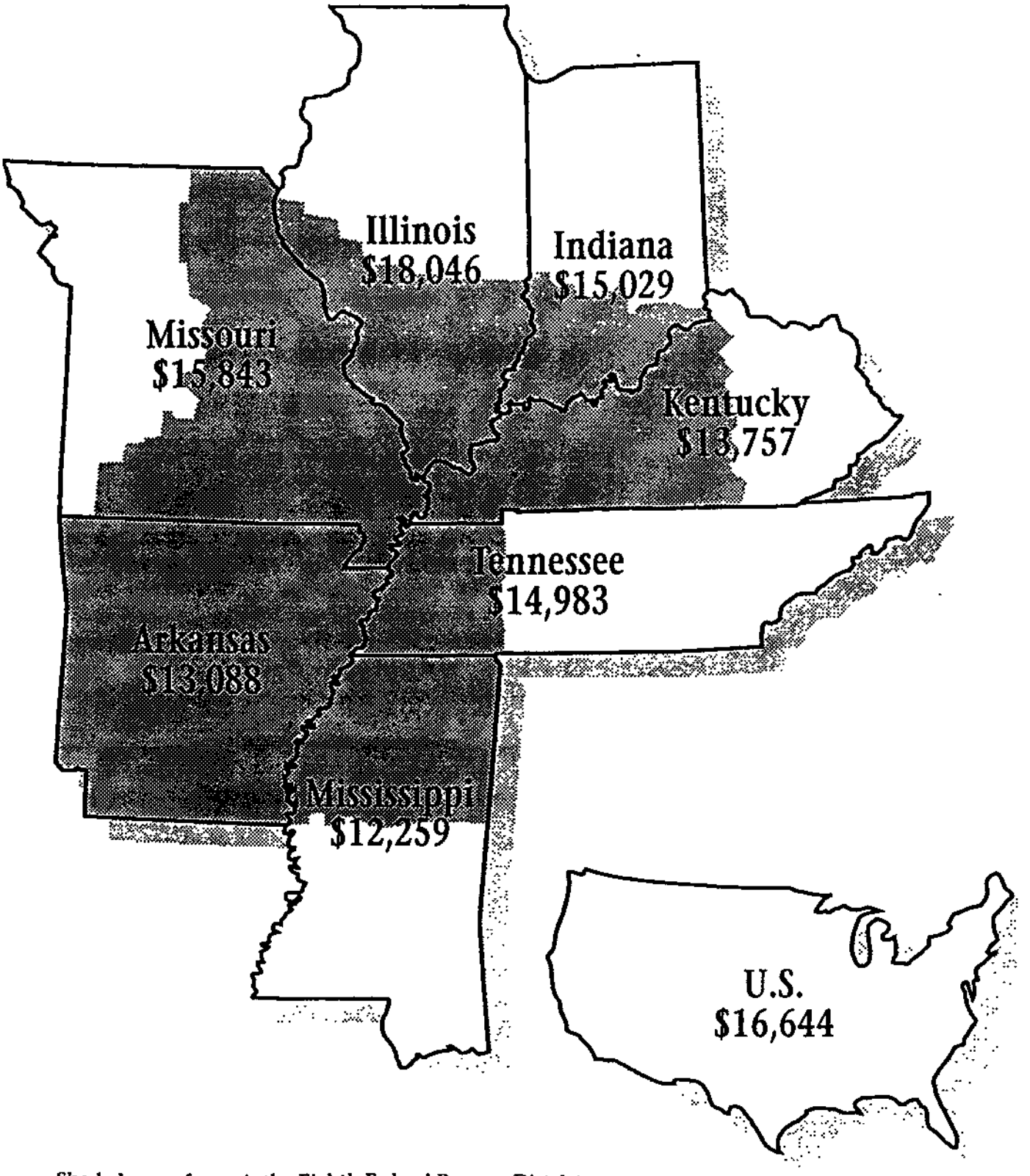
The portion of M2 that is most directly affected by Federal Reserve actions, M1, has risen at double-digit rates during the last two years, as have total reserves and the adjusted monetary base. The slow overall growth of M2 has been due entirely to its non-M1 components, which Federal Reserve actions affect only indirectly. The growth of these components has been affected by the very steep yield curve, the rise in deposit insurance premiums, the need for higher capital ratios, increased regulatory oversight, weak credit demand, and continuation of the longer-run trend channeling credit away from depository intermediaries. Consequently, M2 growth has slowed despite the Federal Reserve's considerable efforts to raise it.

Conclusion

There is no simple rule for assessing the appropriateness of monetary policy at each point in time. Considerable judgment is required in setting policy. Thus, the Federal Open Market Committee benefits greatly from the diversity of views that are advanced under its current structure. Ultimately, the effectiveness of monetary policy must be evaluated based on results — and the record of the past decade is reasonably good. Despite unusually large federal budget deficits, complicated international developments and significant financial market restructuring and disruptions, monetary policy has been successful in reducing inflation during a long period of moderate economic growth. Though set back by the recession and a slow recovery, monetary policy has made substantial progress in regaining credibility with respect to controlling inflation and has laid the foundation for a sustainable, low-inflationary expansion in the 1990s. No one can know what the future holds, but if accelerating inflation is behind us, the real economy will be on a firm footing for genuine progress in the years ahead.

U.S. and Eighth Federal Reserve District Disposable Personal Income, 1991

Thousands of Dollars per Person



Shaded area of map is the Eighth Federal Reserve District.

Table 1

U.S. Eighth District Industrial Composition and District Concentration Index, 1989

MANUFACTURING

Sector	Percent of U.S. Total	Percent of District Total	District Index
Total	**22.5%**	**27.2%**	**121**
Nondurable Goods	**8.4**	**10.9**	**130**
Rubber and plastic products	0.7	1.3	186
Apparel and other textile products	0.9	1.2	180
Food and kindred products	1.7	2.8	165
Paper and allied products	0.8	1.2	150
Chemicals and allied products	1.8	2.4	133
Printing and publishing	1.1	1.1	100
Tobacco products	0.1	0.1	100
Petroleum and coal products	1.1	0.5	45
Durable Goods	**14.1**	**16.3**	**116**
Transportation equipment	2.6	4.3	162
Motor vehicles	1.1	2.4	218
Other	1.5	1.9	127
Fabricated metals	1.6	1.9	119
Lumber and wood products	0.6	0.7	117
Electrical machinery	2.2	2.4	109
Primary metals	0.9	0.9	100
Nonelectrical machinery	4.2	4.1	98

NONMANUFACTURING AND AGRICULTURE

Sector	Percent of U.S. Total	Percent of District Total	District Index
Agriculture, Forestry, Fisheries	**2.4%**	**3.2%**	**133**
Transportation, Communications, Pub. Util.	**9.7**	**10.7**	**110**
Transportation	3.8	5.1	134
Communications	2.6	2.8	108
Public utilities	3.3	2.8	85
Retail Trade	**10.0**	**10.5**	**105**
Government	**10.1**	**9.5**	**94**
Federal civilian	2.2	2.7	123
State and local	6.8	5.9	87
Wholesale Trade	**7.4**	**6.9**	**93**
Finance, Insurance, Real Estate	**14.6**	**12.4**	**85**
Banking	1.5	1.9	127
Insurance carriers	0.9	0.7	78
Real estate	10.3	8.3	81
Services	**15.8**	**13.3**	**84**
Health services	4.0	4.3	108
Business services	3.8	2.8	74
Legal services	1.0	0.7	70
Mining	**3.1**	**2.5**	**81**
Coal mining	0.5	1.9	380
Oil and gas extraction	2.3	0.4	17

NOTE: The most current Gross State Product data are from 1989. The percentages listed for the United States represent the fraction of total output in the United States the sector represents. Similarly, the percentages listed for the Eighth District represent the fraction of total output in the District the sector represents. A concentration index number for the District represents the ratio of the sector's share in the District over the sector's share in the United States. Therefore, a concentration index number of 100 implies that the shares of the sector are the same in both the national and District economies. As an example, Total Manufacturing was 22.5 percent of national output in 1989. The District's concentration index number of 121 means that Total Manufacturing's share in the District economy was 21 percent greater than its share in the national economy. The sectors are listed in descending order of importance by sector and subsector for the District.

Table 2

Unemployment Rates for the United States and the Eighth District

Period 1: Peak and Trough of Last Recession

	July 1990 (Peak)	**March 1991** (Trough)
United States	5.4%	6.8%
Eighth District	5.7	6.6

Period 2: Trough of Last Recession to December 1992

	March 1991 (Trough)	**December 1992**
United States	6.8%	7.0%[1]
Eighth District	6.6	5.8

[1] Measured as of February 1993.

Table 3
U.S. and District Bank Performance Ratios

Ratio	All U.S.	U.S. <$15B[1]	District	AR	IL[2]	IN[2]	KY[2]	MS[2]	MO[2]	TN[2]
Return on Average Assets (Annualized)										
3rd quarter 1992	0.94%	1.06%	1.17%	1.39%	1.21%	1.06%	1.07%	1.25%	1.11%	1.16%
3rd quarter 1991	0.59	0.69	0.97	1.19	1.00	0.96	1.00	1.10	0.84	0.86
Return on Average Equity (Annualized)										
3rd quarter 1992	13.38	13.59	14.39	16.10	13.59	12.01	13.29	13.87	14.42	16.10
3rd quarter 1991	8.78	9.33	12.24	13.95	11.50	10.99	12.48	12.78	11.58	12.12
Net Interest Margin (Annualized)										
3rd quarter 1992	4.47	4.82	4.47	4.60	4.60	4.61	4.22	5.06	4.27	4.67
3rd quarter 1991	4.15	4.51	4.23	4.40	4.17	4.23	4.05	4.72	4.03	4.58
Nonperforming Loans as a percent of Total Loans[3]										
3rd quarter 1992	3.43	2.60	1.43	1.27	1.74	1.06	1.39	1.34	1.53	1.45
3rd quarter 1991	3.94	3.12	1.84	1.80	2.05	1.50	1.91	1.40	1.93	1.74
Net Loan Losses as a percent of Average Total Loans (Annualized)										
3rd quarter 1992	1.22	1.02	0.56	0.34	0.75	0.52	0.67	0.51	0.45	0.81
3rd quarter 1991	1.49	1.22	0.66	0.36	0.69	0.49	0.64	0.61	0.65	1.16

[1] U.S. banks with average assets of less than $15 billion are shown separately to make comparisons with District banks more meaningful, as there are no District banks with average assets greater than $15 billion.
[2] Includes only that portion of the state within the Eighth District boundaries.
[3] Includes loans 90 days or more past due and nonaccrual loans.

SOURCE: FFIEC, Reports of Condition and Income for Insured Commercial Banks, 1991-92.

Table 4

Nonperforming Real Estate Loans as a Percent of Real Estate Loans by Type, as of September 30, 1992[1]

Loan Type	District Banks	U.S. Peer Banks[2]
Residential		
One-to-four family	0.49%	0.67%
Home equity lines of credit	0.47	0.68
Multi-family	2.96	3.46
Commercial		
Construction and land development	2.53	10.32
Nonfarm, nonresidential	2.25	4.23
Agricultural	1.98	2.41
Total	1.54	3.15

[1] Nonperforming loans include loans 90 days or more past due and nonaccrual loans. Each ratio measures the portion of that loan type that is nonperforming.

[2] Includes only those banks of comparable size to District banks.

Table 5

Proportion of Banks with Deficient Regulatory Capital Ratios[1]

	1992[2]	1991	1990	1989	1988
District banks	1.17%	1.45%	1.60%	0.88%	0.47%
U.S. peer banks[3]	3.11	4.21	3.52	2.87	3.86

---

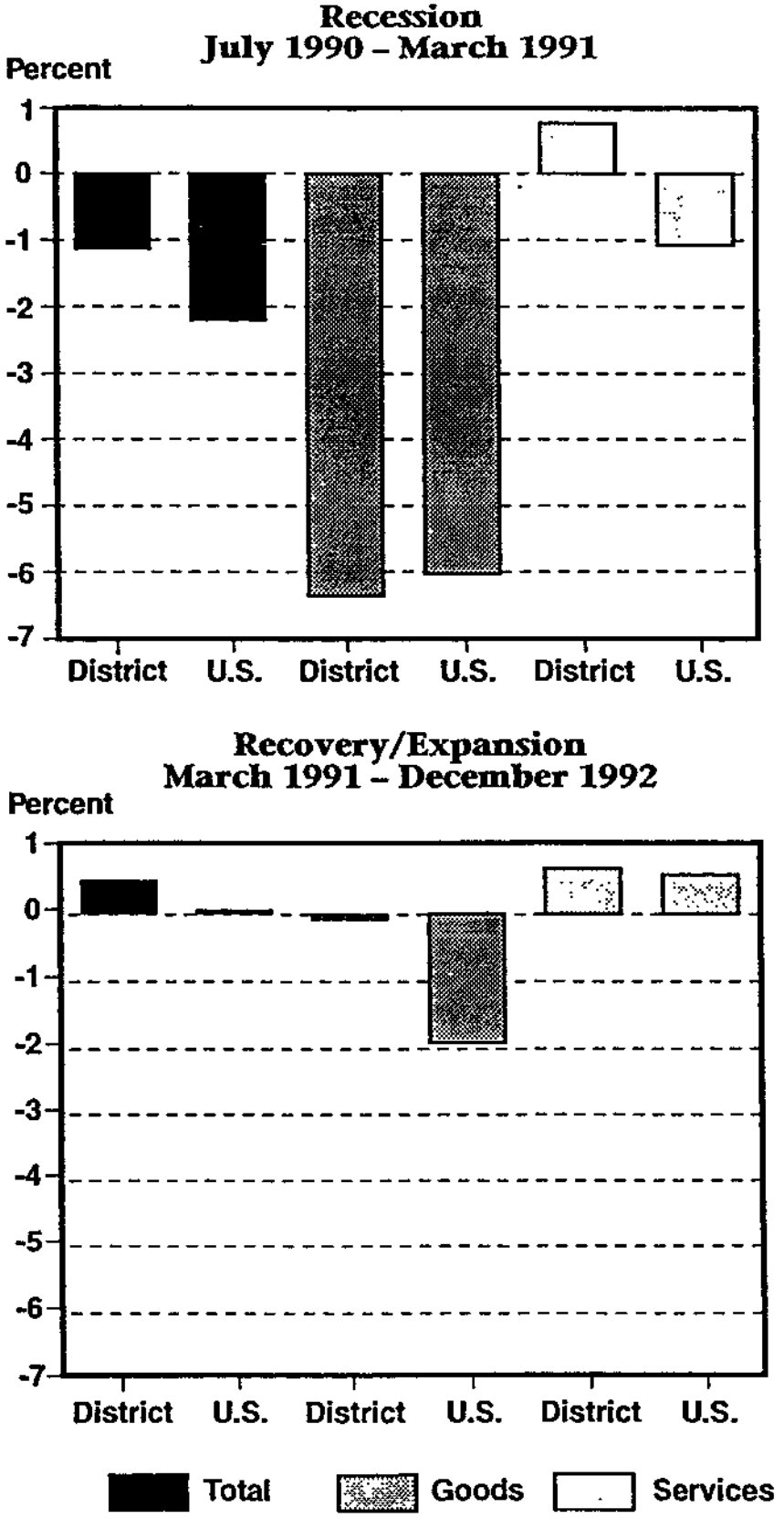
[1] For 1990, 1991 and 1992, the binding regulatory capital constraint used is total capital to risk-adjusted assets; for 1988 and 1989, the primary capital ratio is the binding capital constraint used.

[2] As of the end of the third quarter.

[3] Includes only those banks of comparable size to District banks. For 1991 and 1992, the peer group is those U.S. banks with average assets of less than $15 billion; for 1988-90, the asset cutoff is $10 billion.

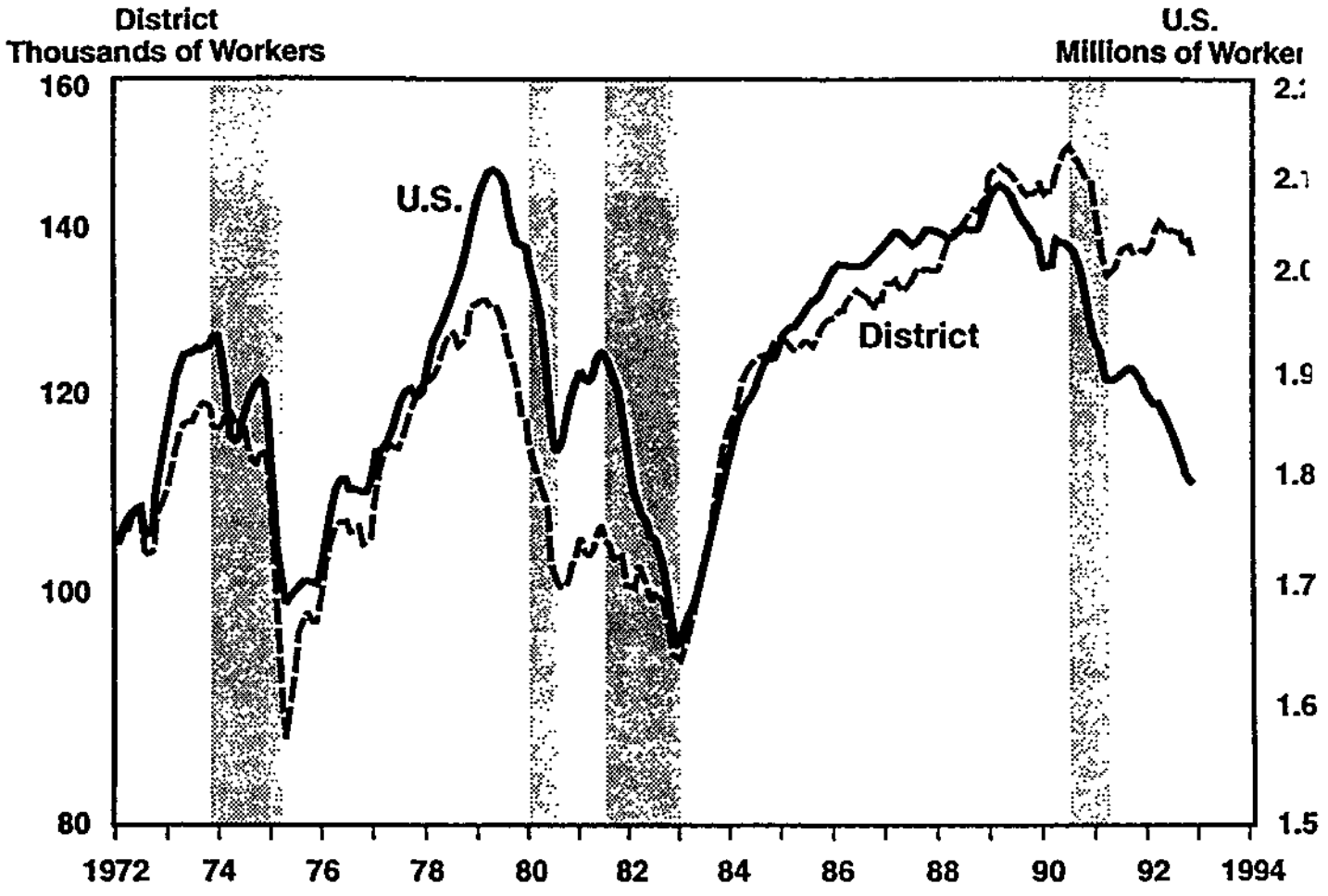
Figure 1

U.S. and Eighth District Employment Growth



NOTE: Growth rates are compounded annual rates calculated from three-month moving average data. Because of state data limitations, the sample period ends in December 1992.

Employment in Transportation Equipment

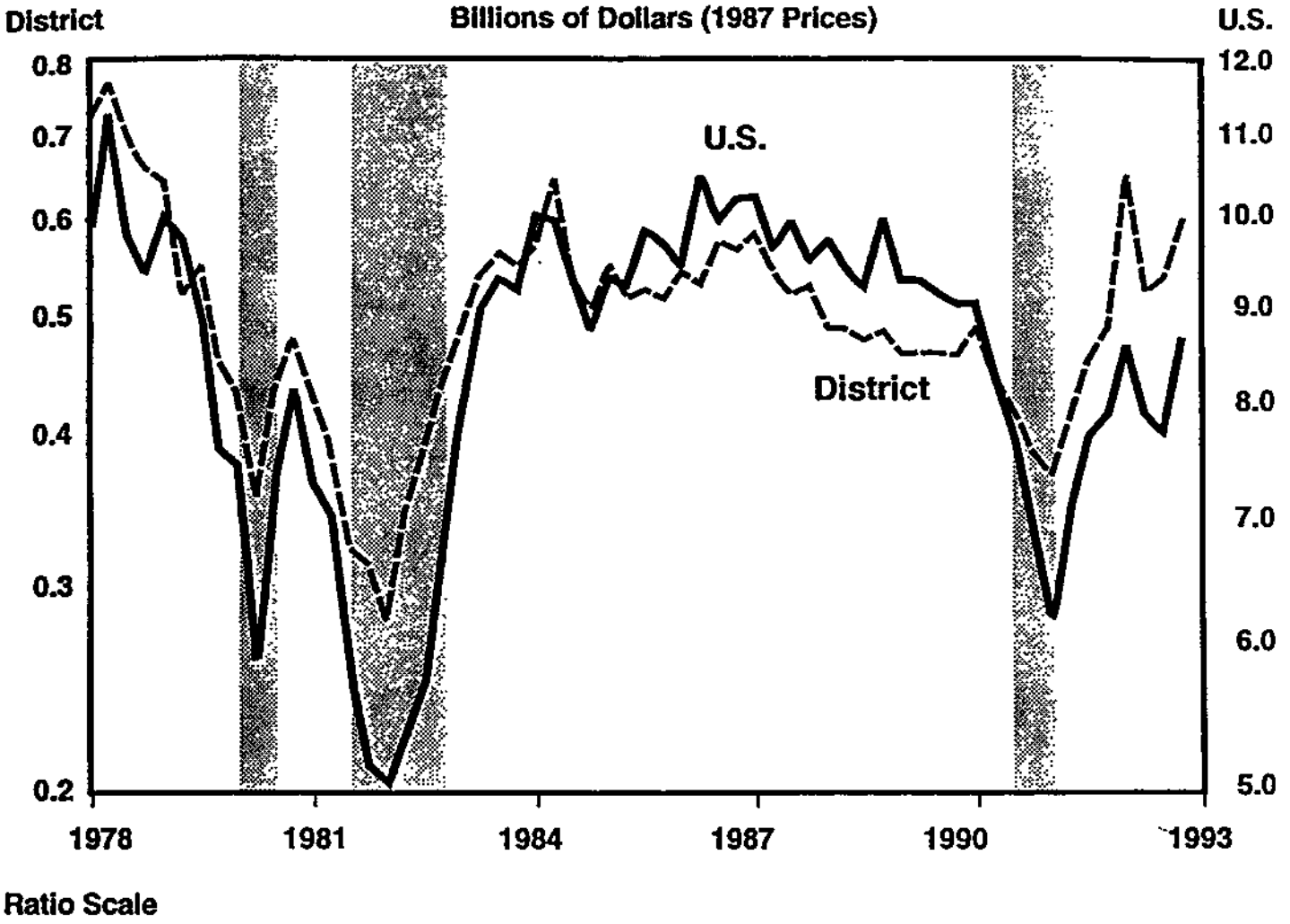


Ratio Scale
3-month moving average

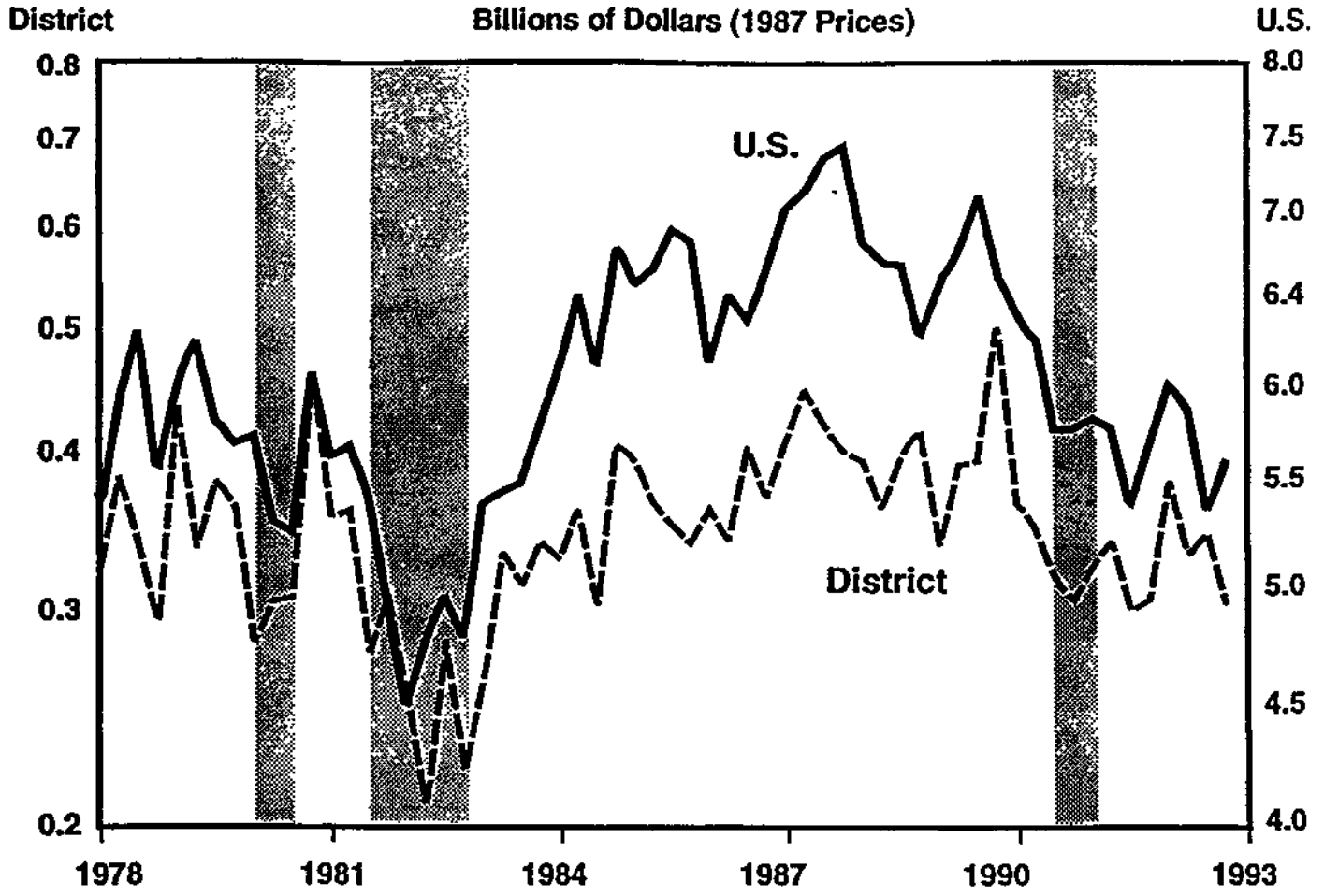
Shaded areas are periods of business recession.

Figure 3

Real U.S. and District Residential Construction



Real U.S. and District Nonresidential Construction



Shaded areas are periods of business recession.