[Economic outlook - Stock market crash]

Remarks By

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When I accepted this invitation, my thought was that I should take this opportunity to convince you that the banking system was sound despite the worst second quarter in history and an estimated 200 failures this year--including First City in Houston--the second largest in history. My view was that banking's losses and failures were regional and one-time events; and the system was sound and viable. And this view would encourage you to see banks as a source of strength for the economy and for real estate and home building in the year ahead. Our FDIC continues to be able to handle record failures while breaking even, with $18 billion in resources.

But, I didn't know they would be making a show in Miami called, "Rambo Gets a Margin Call,"--or that you would find people thinking of investment bankers when they saw a sign for "lost dog,"--or that things would get to the point where Shearson Lehman and Paine Webber would merge under the name, "Shear Paine."

As Professor Galbraith has so beautifully put it: "All that is required for genius on Wall Street is a bull market and a short memory." No, unlike some other new-found prophet, I didn't predict the market's fall was to arrive prior to this meeting.

Actually, I was going to say that the real threat to housing and the financial system was rapidly rising interest rates. The question was why they were going up. It was the question being asked by most observers, including the Chairman of the Federal Reserve. Chairman Greenspan said that the interest rate rise was not warranted by fear of inflation. Wage rates were not rising, and the auto contracts just signed did not appear inflationary under current conditions. Commodity prices were rising--only from "abnormally low" to "low"; unemployment was under six percent, and that was considered full employment a few years ago; but this too was changing as the make-up of the labor force changed; the "Baby Boomers" are getting middle-aged, which probably indicates a lower number for full employment as turnover is reduced by a more stable work force. And, of course, the Fed couldn't be pushing interest rates up--or they wouldn't be wondering why they were going up.

My thought was that interest rates were going up because we were experiencing a very strong economy with a potential G.N.P. growth rate of over four percent. Interest rates usually increase with economic activity.

At the same time, the security markets were booming to historically record highs, and corporate buy-outs also were at record levels. Both were creating large demands for credit. And, of course, the Federal Government deficits demanded financing. Demand for credit raises rates. Then came "BLACK MONDAY", and the markets retreated--rather rapidly from their historic high.

What about the economic outlook--given the dramatic activity on Wall Street? At the FDIC we have an insurer's interest in these events. Over the last two years, the FDIC has seen in the Southwestern United States what near-depression conditions can do to the banking system, and to our deposit insurance costs. Three quarters of all of the record 200 bank failures expected this year will be in the Southwest.

Are we looking at a nationwide recession now? While, of course, it is too early to tell, looking at the question through the window of the banking system, we don't see the crash of '87 or '88 accompanying the panic of '87. While I don't think it is prudent to offer theories on market behavior before the numerous committees report on what happened, it does seem prudent to weigh the recent volatility on Wall Street against the number of positive indicators we had in our economy before the market upset--and try to evaluate how they have been affected by Wall Street.

The near term outlook for the economy has been remarkably strong. Let me point out ten reasons for that statement and suggest--no guess--how recent events will affect them.

1. As I have said, renewed inflation is nowhere to be found. Note the last wholesale price report, which was essentially flat. The Labor Department says that consumer prices rose a scant 0.2 percent in September, down from an already low 0.5 percent rise in August, and the underlying rate seem to be about four to five percent, as it has been for the last five years. Certainly, the market upset does not seem likely to increase the fear of inflation in the near term.

2. Weekly unemployment claims (one of the best early warning signals of trouble in the economy) have fallen sharply from 350,000 to 250,000--a more than 25 percent drop in the last report.

3. The Commerce Department's leading indicators had been moving up. The September report showed a marginal decline of one tenth of one percent--mainly due to the date of Labor Day and stock prices and an upward adjustment in August.

4. Columbia University's "long leading index" signals growth through next year.

5. The National Association of Purchasing Agents just released its report predicting strong growth in the manufacturing sector of the economy (At almost a 4 percent GNP growth rate with no inventory build up and a strong increase in new orders.)

6. Capital spending by business showed a 22 percent increase in corporate appropriations for new capital spending over the last two quarters. (One thousand of the largest manufacturers lifted capital appropriations for last quarter to $26.2 billion.) This is one to watch for change--too early to tell at this point, but certainly okay prior to market problems.

7. Industrial production is up, and productivity in the manufacturing sector is above the three percent level--just like the good old days in the 1960s.

8. Consumer confidence was at its highest level in 15 years, according to the Conference Board, and it took a small but <u>not significant drop</u> after October 19 (116.9 to 110.4).

9. The U.S. Budget deficit was down by $73 billion in the year just ended (from $221 billion in fiscal '86 to $148 billion this year.) As the President said at his last news conference, this change occurred not only because of a one time improvement in revenues, <u>but also because of reduced spending</u>. Of course, the market crisis has brought action on this very real problem--as crisis usually does in Washington.

10. While the dollar trade balance remains stubbornly high, in real value terms, the situation is improving. Exports were up 15 percent over the last year. As William Lilley III of the American Business Conference said: "The current rate reports should cause neither celebration <u>nor</u> dispair." The deficit appears subject to a Murphy's Law--particularly the problems with oil in the Mid-East and the long term impossibility of governments stabilizing exchange rates.

While there are some good reasons why we should believe our economy will remain reasonably strong over the near term, a change in <u>Main Street's</u> view would make a difference--a big difference. You go to Omaha and people there say, 'those cats on Wall Street had it coming.' People aren't that worried yet. A real downturn in consumer and business confidence, of course, would cause problems for the economy. Our discussions with the bankers throughout the country does not support the view that the fundamentals have changed. Why? Because <u>interest rates are going down</u>. Money is flowing into the banks, consumers can obtain credit at lower rates to borrow and buy. So far, the banking industry, though certainly not every bank, including our own Continental Illinois, shows little adverse effect from the market's behavior.

As former Federal Reserve Board member Lyle Gramley said: "Such fragments of anecdotal evidence as I have are heartening. We all know that Maseratis and Ferraris are selling slower, but other than that there's no sign of collapsing consumer markets."

If Main Street remains steady, housing should benefit from (1) declining interest rates, (2) a strong job market, and (3) real estate as the traditional haven from uncertainty. With the price of existing homes increasing, on the average, of five to seven percent each year over the last five years, home ownership <u>still</u> provides an excellent tax shelter, hedge against inflation, and against volatility in values. The latest report shows September sales at our unreal rate of 656,000--down about 5 percent from August--and that's not bad with rapidly raising mortgage rates.

Some are predicting serious trouble: Pierre Rinfret, a former Economic Advisor to President Kennedy, says: "Get ready for a savage recession, which will produce GNP declines of 5 percent in the first and second quarters of 1988 after a 2 percent drop in the current quarter. Christmas business will be a disaster. Ditto capital spending: it'll be down 10 percent to 15 percent next year."

We don't see any evidence on Main Street to support that kind of talk at this point. Lester Thurow, Dean of the Management School at MIT, has noted that: "The end of the world plays well, and has for more than 2,000 years," and it certainly sells books.

Fortunately, it has not happened recently. But, as they say: "Few complaints are heard from parachute jumpers who drew a bad chute."

It's not that the U.S. economy doesn't have its problems--primarily very high debt levels, governmental and private. At home and abroad the question is whether the market's warning blast will help us solve those excesses.

Nothing is certain, except that we cannot predict the future with certainty. But, so far, so good--and that's not bad, considering the market's record. In fact, for banking, increasing deposits and less speculation should be good news for the months ahead.

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