FDIC
Speeches

Economic outlook:

Remarks By

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

Before

The Conference Board
New York

February 24, 1988

It gives me a great deal of pleasure to address this gathering of the Conference Board.

It's been said that if one could fully understand the nature of the economic forces in the world, one could foretell the future. It has also been said that the predictive record of economists has given astrology a good name.

Popular interest in discovering an economic soothsayer has never been higher. The state of business, and our economy, is no longer something thought about only by economists and public policy makers.

Just look at the books on the Best Seller list. A year or so ago you could find many titles that concerned exercise and diet.

But now it seems that Americans are concerned with a different kind of health.

Economics has replaced aerobics. Budget has replaced diet.

Recently four books on The Washington Post's Best Seller list dealt with some aspect of economic disaster: "The Panic of '89"; "The Depression of '92"; "The Rise and Fall of the Great Powers"; and "Secrets of the Temple."

Some forecast a "Great Recession" in the near future. That's understandable because forecasts of economic Armageddon have always sold books. One sees a number of statements using banking system statistics to support these predictions.

These dire predictions of the dismal science remind me of a story that's told about Sir Winston Churchill.

Long after he retired, when he was in his eighties, he still used to enjoy visits to the House of Commons.

Once, when the elderly Sir Winston was being helped down the aisle by a friend, two young Members of Parliament began to whisper.

"They say he won't be with us much longer," said one young M.P.

"They say he's going soft in the head," his colleague replied.

Sir Winston turned and faced them from almost 30 feet away. "They also say," he boomed ". . . that he's getting hard of hearing!"

As the insurer of 14,000 banks, the FDIC has a keen interest in the direction of the economy. We do our best to sift through the different economic data to discern where we believe the economy is headed, but our primary interest is in the financial system and where it is going.

Banking is what we at the FDIC know best. Information on its condition can be useful when you are peering into your economic crystal ball.

Recent headlines are used to support the conclusion that the state of the banking system is bad, and getting worse. There is some apparent support for this view:

1) In 1987, the FDIC handled a record 184 failed banks, and assisted 19 banks that otherwise would have failed. That is 1/3 higher than in any year since the FDIC was founded in 1933. To that can be added the $13 billion assistance transaction involving the near-failure of First City Bancorporation of Texas, which was handled, in part, in 1987, and will be finalized in 1988.

2) Recently the major credit rating services downgraded several of the largest bank holding companies and banks. No major bank <u>holding</u> company has a triple A rating. On the other hand, at least one money center bank retains its triple A rating, and banks generally retain higher ratings than their holding companies. Perhaps this is a reflection of the FDIC message that we stand behind the banks, not the holding companies.

3) The FDIC's Quarterly Banking Profile report on bank results for 1987 will be published next week, but I'll give you a special sneak preview. In 1987, banks as a whole made just 3.7 billion dollars. This translates into a return on book equity of about 2.5 percent. Not since the Great Depression have the nation's banks performed so poorly.

What are the reasons for the sad results in 1987? Profitability in the banking industry was especially low in 1987 primarily for three reasons: <u>competition</u> from other parts of the financial services industry, economic problems in the <u>Southwest</u> and <u>farm belt</u> areas, and increased reserving for <u>LDC debt</u>.

The first reason is systemic and the last two are, hopefully, less fundamental.

First, problems in the regulatory system under which banks operate have contributed to these results. The rate of profitability of commercial banks has been dropping steadily throughout the 80's and reached .13 percent of assets in 1987. The number of UNPROFITABLE banks is three times higher than it was in 1981.

To a substantial extent, this trend reflects increased competition from other non-banking financial institutions and regulatory restraints on the ability of banks to respond. The result has been the slow erosion of profits and the increase of risk in bank portfolios. Banks are moving toward riskier real estate lending, and away from more conservative commercial lending, which actually shrank two percent last year. Banks are also being forced to add increasing amounts of non-interest income to support flagging returns from traditional lines of business.

Since 1980 the annual asset growth rates of banks have been lower than for all other types of financial institutions During the period 1980-1986, banks grew approximately eight percent. During this same period, mutual funds grew around 33 percent. Securities firms grew 28 percent. Finance companies and credit unions grew at rates nearly twice that of banks.

A second reason for 1987's poor results: The Southwest and farm belt "recession/depression" heavily influenced overall statistics. These localized economic problems played an even more pronounced role than competition in the low profitability of the industry.

Over 90 percent of the failed banks, as well as almost 80 percent of the banks with losses, were located west of the Mississippi. Roughly 85 percent of last year's bank failures were caused, at least in part, by troubles in the farm and energy economies. In 1987, 24 percent of banks located west of the Mississippi had losses, versus only 8.5 percent of the banks in the east.

It might be said that some of our banking friends in these areas have learned, "Good judgment comes from experience. But experience comes from poor judgment."

I can give you an idea of the significance of the energy-related problems on overall industry profitability. Thirty-six percent of the banks in the Southwest reported net losses in 1987. If the banks in the Southwest are backed out of last year's numbers, industry profitability moved up from about .13 percent of total assets to .21 percent.

A third reason for 1987's dismal record is the significant reserving for losses on Latin America and other LDC country debt. In the second quarter of 1987 alone, commercial banks lost almost 10.6 billion dollars, most of that owing to this reserving process. The reserves attributable to international operations in 1987 were 20.6 billion dollars, up 18 billion dollars from 1986. This increase accounts for the entire reduction in aggregate operating income from 1986.

Given that banking had a forgettable year in 1987, what does 1988 look like for the banking industry. I'm pleased to report that 1988 looks better. Bank profits should move upward and regain 1986 levels, but not 1985 levels.

So, it looks a lot better, but it doesn't look great.

In all three problems areas just mentioned -- banking regulatory restraints, regional economic conditions, and LDC debt losses -- one can see some signs of better days.

First, while anyone who predicts what Congress will do should be suspect, it does look like there is a 50-50 chance that some kind of a bill may pass giving banks additional ways to meet the competition. Even if no legislation is forthcoming, the courts and the regulators have responded to the call to "let banks compete."

Competition from securities firms, credit unions, S&L's, nonbank banks and finance companies will certainly continue unabated. But it looks like there is a real chance for banks to broaden their product lines through a modernized regulatory system.

Nothing too dramatic in the legislative arena, but the outlook is certainly more favorable than it has been for an improved environment for bank profits.

Second, with respect to economic conditions west of the Mississippi, our people are seeing a mixed picture. There is nothing too encouraging in the Southwest. Nonperforming asset levels continue to rise, having climbed to nearly six percent of total assets by the end of 1987. Even a sudden turnaround in these economies could do little to help some beleaguered banks. It takes time for such improvements to be reflected in the banking system, so bank failures will continue in this region at much the same high rate as in 1987.

In contrast, the farm belt economy is clearly improving and will provide a much stronger profit picture in 1988. Banks in the Midwest experienced a 22 percent decline in loan charge-offs in 1987. At the same time, their asset-quality improved significantly, particularly in the fourth quarter. At year-end less than two percent of assets were nonperforming. Midwestern bankers have strengthened their balance sheets, and are positioned for a profitable 1988.

Third, with respect to LDC debt, most large holders now have created reserves equal to 30% to 50% of book value. We do not see substantial increases in reserves being made in this area in 1988. This will have a strong positive effort on money center bank profitability. For example, if there had been no major LDC reserving in 1987, aggregate bank net operating income would have been over 13 billion dollars, close to 1986's level. LDC debt continues to be a matter of long term concern, but the medicine taken in 1987 will mean lower reserving and thus higher profits in 1988.

So, the outlook for 1988 should be for an improved year in banking profitability unless the U.S. or world economy falters. Do we see anything ahead that indicates real problems for 1988?

I'll use what we call our "red and green" charts to help in this analysis. We have a few samples available for you after the talk if you are interested.

In our chart system, Green lines on the chart indicate a commonly accepted view that the trend indicates increased economic activity. Red indicates the commonly accepted view that the trend is toward reduced economic activity. When I was in the White House as President Ford's Economic Assistant, we used these simple trend lines to check on the many fancy econometric models on hand, and found them very useful.

Let me give you a look at today's charts.

--INFLATION. Subtracting out the period when prices were actually declining, the trend is slightly increasing, and sharply down from 12.4 percent in 1980. It's a GREEN.

--MI is up. That's GREEN.

-- Our UNEMPLOYMENT trend line is sharply DOWN. It stands at 5.8 percent -- the lowest level of the DECADE. In December ALONE, the economy created 325,000 NEW jobs. It's GREEN.

-- INDUSTRIAL OUTPUT. The Federal Reserve says OUTPUT last year at the nation's factories, mines and utilities made the BEST ANNUAL SHOWING since 1984. It's GREEN.

-- BUSINESS CONFIDENCE, as measured by the National Association of Manufacturers in a survey of top CEOs, is up. Eight out of ten predicted both that exports and profits would be up this year. Nineteen percent of the CEOs thought profits would be SUBSTANTIALLY higher. It's GREEN.

-- The National Association of Purchasing Management reported recently that the economy had entered its NINETEENTH STRAIGHT MONTH of expansion. It's GREEN.

-- CONSUMER CONFIDENCE is also up. The Sindlinger consumer confidence index was up 1.4 percent last week. It's GREEN.

-- U.S. manufacturing CAPACITY UTILIZATION is UP. Utilization neared 83 percent for the last quarter of 1987. Another GREEN.

-- TRADE BALANCE deficit was down in November and December. Exports, including farm products, rose at a 37 percent annual pace in the last quarter of 1987. The deficit is moving down for the right reason -- more exports. It's a GREEN, at last!

-- The FEDERAL BUDGET DEFICIT is going down, especially when compared to GNP. Frank Carlucci is well on his way to earning his predecessor's former nick name as "The Knife." I'll let you decide if this is Keynesian or a Friedman green. But I score it as a GREEN.

-- INTEREST RATES are down. That has to be a GREEN.

-- PRODUCTIVITY in manufacturing is up. It is reaching post-World War II highs. That's a big GREEN.

-- REVISED figures on RETAIL SALES show a rise in January.

The Commerce Department now says that retail sales IN FACT ROSE half a percent in January, the highest monthly rise since last August -- AND the third CONSECUTIVE monthly increase. It's GREEN.

-- UNEMPLOYMENT CLAIMS have risen in the past two months. These claims appeared to level off at the end of January and were down 4.8 percent in the first week of February. So the line is barely a GREEN.

-- BANK LOAN DEMAND is still high and climbing. A GREEN.

Of course, not all of the news is GREEN. A few of the trend lines are RED.

-- <u>HOUSING STARTS</u>. This just turned <u>RED</u>.

-- <u>GNP GROWTH</u>. Our economy grew at an inflation-adjusted rate of 3.7 percent in 1987 -- giving us the longest sustained period of peacetime growth in U.S. history. However, the fourth quarter is down slightly. It's marginally <u>RED</u>, but closer to <u>YELLOW</u>.

-- Commerce's LEADING INDICATORS were off slightly at the end of the year, and were definitely <u>RED</u>.

That gives us 15 GREEN, and 4 RED.

So we have a mostly green picture for increased economic activity near term. But while trend lines are helpful, like income statements, they don't tell all. They state where we're going near term, but we still need balance sheet items to tell us where we are. Here there are definitely <u>RED</u> indicators.

America's debt levels in all sectors are at or near record levels when compared to repayment ability. Americans and their government are spending by the motto, "Always live within your income, even if you have to borrow to do so."

George Washington described the danger of this situation long ago. "[Y]ou may be assured that there is no practice more dangerous than that of borrowing money . . . . For when money can be had in this way -- it comes easy and is spent freely; and many things indulged in that would never be thought of, if to be purchased by the sweat of the brow."

The NY Fed's President Gerald Corrigan in an excellent presentation on the long term economic imbalance in the economy said, "the harsh reality [is], that for too long we in the United States have been borrowing more than we save and consuming more than we produce in an environment in which debt, deficits and leveraging have become a way of life for government, for business and for individuals. Fortunately, we have both the underlying economic strength and the opportunity to remedy these problems -- but only if we heed the warnings of the recent past and get on with the task now."

The balance sheet indicates that for the longer term the U.S. will have to do all those good things we learned as kids: save, work hard, and be <u>ready for a rainy day</u>.

Our hope is to use what Paul Samuelson has called our current "Window of opportunity": <u>We must produce more, export more, save more, and continue to keep the trend lines GREEN</u>.

Some contend that although the signals look green now, fundamental problems in the economy, like the trade and budget deficits, will mean the bubble could burst at any moment and we will move into recession. As is clear from my speech I disagree with such forecasts. If Black Monday with its 25 percent decline in stock prices didn't burst that bubble, it's a mighty hard bubble to deflate!

In closing I'd like to quote from a new book to be published soon -- and probably eventually made into a full length motion picture -- which discusses America's competitive strengths. It's titled "Competitiveness: An Executive Handbook." In the last chapter, titled the "American Advantage," the author states that America's economic freedom, educational resources, technological base, vast capital markets, and entrepreneurial spirit are good reasons to believe the U.S. will be a winner in the competitive world economy of tomorrow. By the way, the author is otherwise known as the banks' insurance fund chairman. So you now know where I'm coming from.

Thank you.