UTAH'S ECONOMY

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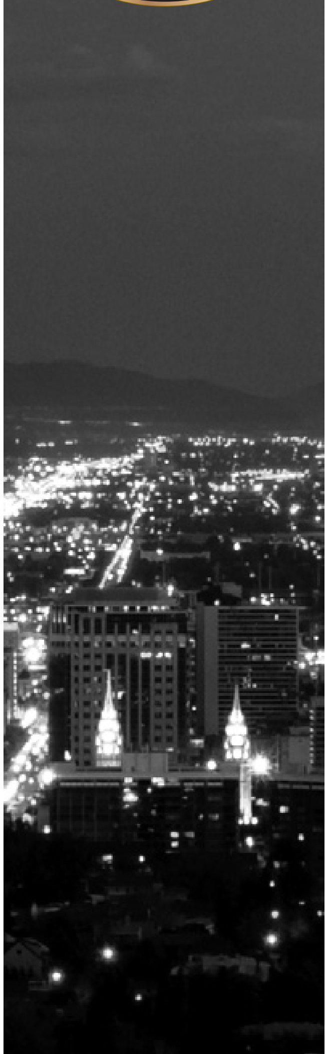
INFLATION, INTEREST RATES AND UTAH BANKS



In conversations with business owners, most express serious concern that the U.S. economy is on the threshold of high rates of inflation, but at the same time they almost unanimously report lower prices and wages for their business. Indeed the average wage in Utah in the past year has increased less than one percent. Despite lower costs they worry that the projected record federal deficits, and the expansion of the Federal Reserve balance sheet, means that price instability is just over the horizon. Trillion dollar deficits and the historic intervention by the Federal Reserve to pump up the financial system will surely lead to high rates of inflation.

The long-term inflationary threat, however, depends in part on the cause of the deficit. Of the projected $1.6 trillion deficit in 2009 about $850 billion is due to a loss in revenue and increase in expenditures due to the recession. Federal tax revenues have dropped 17 percent in the past year while expenditures are up 24 percent. In both cases the percent change is the greatest since World War II. No doubt the impact on the federal budget of the 2008-2009 recession has been harmful, but nevertheless temporary. Antirecessionary fiscal policy and Fed action was key to preventing a depression and even greater budget deficits, higher rates of unemployment and lost output. As the US economy recovers the deficits will shrink significantly, but not be eliminated. There are on-going "structural" deficits which stretch out indefinitely and are not sustainable. These "structural" rather than temporary deficits reflect the impact of an aging population and rapidly rising health-care costs.

The threat of these long-term deficits, however, relate to productivity and living standards not inflation. Large budget deficits do not automatically lead to high rates of inflation. Since World War II, large deficits and high rates of inflation have been associated almost exclusively with developing countries, not developed countries like the U.S., which have advanced financial systems and independent central banks.

For example, in the 1980s large budget deficits coincided with declines in the rate of inflation. Over the five year period from 1982-1986 the budget deficits averaged 5.0 percent of GDP, the highest share since World War II, but the average rate of inflation during the period was 3.8 percent. Japan has run huge deficits relative to GDP for a number of years without provoking inflation. In fact, Japan's problem has been deflation in the face of budget deficits. And most recently the U.S. ran large deficits between 2003-2005—due to recession, tax cuts and the Iraq war—and inflation remained around 3.0 percent.

In the U.S. the problem is not that large deficits automatically lead to inflation, but rather that they can produce increases in long-term interest rates. Higher long-

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lcutler@commercecrg.com

COMMERCE CRG
175 East 400 South, Suite 700
Salt Lake City, Utah 84111
Tel (801) 322-2000
www.commercecrg.com

term rates are caused by rising public and private demand for credit. As the Federal government competes with the private sector for credit there occurs a "crowding out" of credit thereby restricting and increasing the cost of credit for the private sector, which in turn reduces productivity rates and dampens increases in living standards. But currently the private sector's demand for debt is very weak, so financing government debt does not cause a problem for the private sector and living standards. Long-term interest rates are expected to remain low despite the heavy presence of the Federal Government in the credit markets.

Will the purchase of debt (mortgage backed securities, commercial paper, credit card debt) by the Federal Reserve generate high rates of inflation? Over the past 18 months the balance sheet of the Federal Reserve has increased from $900 billion to $2.6 trillion. But most of this expansion has been increased reserves that member banks deposit with the Fed. The expansion of credit and bank reserves by the Fed would create inflation if it generated excess demand for goods and services, but the chance of this is remote. The U.S. economy is currently suffering from a massive loss of demand from the private sector. The economy needs more demand to offset the underutilization and slack demand in most markets.

Budget deficits in the near-term will have minimal impact on inflation and interest rates. Rather, availability and cost of credit for Utah businesses will be much more vulnerable to the liquidity of the financial sector. The anecdotes are numerous. Purported viable projects stalled or thwarted due to the loss of financing and the reluctance of banks to make loans.

Credit availability has been constricted by the weak financial conditions of banks. Utah's banks do not fare well in comparisons to those in surrounding states or the nation. State banking profiles produced by the San Francisco Federal Reserve for the nine banks in the 12th district show troubled balance sheets for Utah financial institutions. Utah banks rank highest in the west in noncurrent loan rates, average net charge-off rates and loan concentrations in construction and land development loans, *Table 1*. In the first quarter of 2009, Utah banks not only ranked number one in the district but also number one in the country in the concentration of construction and land development loans (C&LD loans). These loans in Utah banks accounted for 27 percent of total loans. Utah banks had an average net charge-off rate of 2.41 percent and a noncurrent loan rate of 6.9 percent, nearly double the average of 3.8 percent for the 12th district banks.

It appears that over the next few years the financial condition of Utah's banks will be more troublesome for Utah businesses than deficits, inflation or interest rates.

Table 1
Selected Bank Data for States in the Twelfth District of the Federal Reserve System

	Noncurrent Loan as % of Total Loans	Avg. Net Charge-Off as % of Total Loans	C&LD** Loans as % of Total Loans
Utah*	6.9%	2.41%	27%
Alaska	3.2%	0.34%	13%
Arizona	5.6%	2.30%	20%
California	3.1%	1.23%	12%
Hawaii	1.9%	0.71%	8%
Idaho	2.9%	0.71%	20%
Nevada	5.3%	2.01%	24%
Oregon	4.0%	1.07%	16%
Washington	4.4%	1.36%	19%
12th District	3.8%	1.42%	16%

*Only a few states have industrial loan banks. Utah has the highest umber of industrial loan banks of any state therefore to standardized the comparisons Utah's information excludes industrial loan bank data.
**Construction and Land Development.
Source: Federal Reserve Bank San Francisco.

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