American Banks are pillars of Recovery

By Paul Erdman

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HEALDSBURG, Calif. (CBS.MW) -- This week in an op-ed piece in the Financial Times, Chicago-based economist, David Hale pointed out that the economy of the United States is separated from much of the rest of the world by the extraordinary strength of its banking system.

For the most part, this has been ignored, especially by the doom and gloomers who would like to convince us that we are headed for a decade-long downturn similar to that which has occurred in post-bubble Japan, or to what happened here in the 1930's.
The fact is that American banks have performed remarkably well during these most recent difficult years, far better, Hale points out, than during the recession of 1990-91 and after previous periods of great stock market weakness. Whereas 205 American banks failed in 1989, 160 in 1990, and 109 in 1991, there were only seven such failures in 2000, 11 in 2001 and just 2 so far this year.

The extraordinary resilience of the banking system during the most recent down phase in the business cycle can be explained by four factors, Hale, one of the best in the business, says.

First, there was far less margin borrowing during the recent stock market bubble than during the bubble of
1929.

875 NORTH DEARBORN, SUITE 206, CHICAGO, ILLINOIS 60610 USA
phone 1.312.664.8882 *fax* 1.312.787.0993

Second, banks did not finance the speculative capital spending boom that propelled economic growth in the final years of the 1990's.

Third, American banks had far less exposure as a result of property lending that during previous cycles.

And finally, because of the strength of balance sheets in the corporate sector in the United States, the overall level of loan delinquency was only 3.99 percent in the most recent quarter, as compared with 5.38 percent in the early 1990's.

By contrast, Japan's banks are still carrying probably a half trillion dollars of bad loans on their books, while in Germany the write-off of bad loans in recent years has been so great and resulted in such huge losses that, as Hale puts it, the market capitalization of German banks has fallen to pitiful levels.

One reason why the weakness of the banks in Japan is having such a negative effect on that country's overall economic performance is due to the fact that, as Federal Reserve Vice Chairman Roger Ferguson pointed out in a recent speech, Japan has a bank-centered financial system. So does Germany. By contrast, the United States has highly developed and integrated financial markets that operate outside the banking system.

This allows our banks, through the process of securitization, to transfer a good proportion of their risks to insurance companies, mutual funds and pension funds, and to thus remain healthy even during difficult times. Hale concludes that the strength and power of the American banking system will inevitably help stimulate economic recovery.

As Japan has learned, even zero interest rates cannot promote recovery if a country's banks are riddled with bad debts. If, however, a country's banking

system is well capitalized and profitable, as is true today for the United States, the odds are high that monetary policy will be effective.

It is, therefore, the resilience of American banks combined with an aggressive Federal Reserve's monetary policy that is setting the stage for economic recovery in the United States later this year.

Economist and author Paul Erdman is a CBS.MarketWatch.com columnist

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