Commercial bank earnings soared to a record high of $13.8 billion in the third quarter, spurred by strong loan growth, stable net interest margins, and reduced deposit insurance premiums. Bank earnings have now surpassed $10 billion for 11 consecutive quarters.

The industry’s return on assets rose to a record 1.32% in 1995:IIIQ, bringing the average for the first three quarters of the year to 1.19%—more than twice the level seen only four years ago. Although the net interest margin has declined from its 1994 average, it has not fallen since the first quarter of 1995 and remains above pre-1992 levels. Banks have increased the fraction of loans in their portfolios, allowing higher returns even though the net interest margin has remained flat.

Growth of unused loan commitments continues to outpace the rise in bank loans. This suggests that lending standards are relatively relaxed and that changes in demand may be the prevailing factor for changes in credit.

The quality of commercial bank assets remained strong in 1995:IIIQ, as the ratio of troubled assets to total assets continued to decline. Net charge-offs as a share of loans and leases increased slightly in the July-to-September period, but the average for the first three quarters of 1995 remained below 1994's.

(continued on next page)
level. The banking industry's return on equity set a new record of 16.30% in the third quarter. The previous high—16.13%—was set in the third quarter of 1993. The ratio of equity capital to assets continued to firm during the first nine months of the year, with a 10.4% increase in equity capital overshadowing a 7.8% rise in assets.

The quality of commercial bank loans remained strong in the third quarter, although delinquency and net charge-off rates picked up slightly. More than half of the $57.4 billion increase in loans was traceable to real estate loans and loans to consumers. Loans to commercial and industrial (C&I) borrowers showed their smallest quarterly rise in two years.

Noncurrent loans (those 90 days or more past due) continued to decline. At the end of the third quarter, noncurrent loans stood at $31.5 million, $1.9 billion below the year-ago level. However, delinquent loans (those 30 to 89 days past due) increased during the third quarter, possibly suggesting higher future levels of noncurrent loans.

Despite sluggish third-quarter growth, C&I borrowing in September was up 12.5% over year-ago levels, with strong loan growth in every region of the country. Only four states saw a decrease in these types of loans.
When the Bundesbank cut official interest rates on December 14, other European central banks quickly followed suit. Observers, noting below-target German money growth and low inflation, anticipate further German interest-rate cuts.

The Bundesbank Act requires the German central bank to maintain the "stability of the currency." The monetary authorities traditionally seem to interpret an inflation rate below 2% as being consistent with this mandate. Germany's inflation rate, which rose sharply following unification, dropped below 2% early this year and has continued to moderate. In November, consumer prices were up 1.7% over year-ago levels.

Real German GDP growth slowed over the first three quarters of 1995, but remained fairly strong. Many economists, however, fear that real economic activity will stall or possibly contract in 1995:IVQ. Real manufacturing orders fell sharply in October, and industrial production has been weak. December's disruptions in shipments—stemming from French rail strikes—further darkened the business outlook. Business confidence has ebbed, suggesting that capital spending may slow. A substantial weakening in German economic activity could dampen growth throughout Europe.
The Mexican Economy

A year after Mexico's disastrous peso depreciation, the worst of the matter may be over. Mexico's prospects—particularly its access to international capital markets—will depend on the government's capacity to sustain a stabilization program in the face of weak economic activity and a shaky financial sector. Financial market jitters in October and November (which have since calmed) quickly sent Mexican interest rates higher and the peso lower.

Mexico's GDP has contracted sharply since 1994:IVQ. More moderate declines in real economic activity since 1995:IIQ, coupled with improvements in the nation's export industry, offer some hope that the recession has hit bottom. Nevertheless, the prospects for a rapid recovery this year remain few.

The peso's depreciation and the recession have eliminated Mexico's current account deficit. In October, imports stood 6.7% below year-ago levels, while exports were 35.7% higher. The current account shifted from a $29 billion (annual rate) deficit in 1994:IVQ to a $2 billion surplus in 1995:IIIQ. International reserves, which fell to $6.3 billion by the end of 1994, have since risen to $14.5 billion, although largely from inflows of official funds.

Mexico probably will not sustain a current account surplus once the recent crisis has passed. Countries importing foreign capital for development typically run current account deficits.