OPENING STATEMENT

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Chairman Garn, Senator Proxmire, Senator Riegel from my home state, and other Members of the Committee.

Thanks so much for giving me a chance to take a few minutes to share with you my views on the economy, monetary policy and some regulatory matters.

After a slowdown in overall economic activity last summer and early fall, business strengthened in late 1984, wrapping up the second year of our Nation's recovery. To be specific, growth in real GNP picked up to an annual rate of 4-1/4% from about 1-1/2% in the third quarter. Although this pattern was influenced by the auto strike in September and the resumption of output in October, the reduction in the current account deficit with foreign countries had a greater impact. Other measures of performance—such as the industrial production index, housing starts and retail sales—also showed a pause followed by a rebound.

Today—a cursory view of the American scene suggests that things look quite good. Total employment, personal income, and retail sales are all (using February data) at record high levels while popular price indices suggest that inflation remains rather subdued. And on the financial side, interest rates are far below their 1981-82 record highs.

But as March draws to a close, new signs are appearing that the growth of domestic output is slowing once again. The "flash" estimate of real GNP growth for the first quarter was a modest 2.1% SAAR, roughly half that of the previous quarter. While "flash" estimates are very tentative and subject to substantial revision over the next few months, recent behavior of the industrial
production index also suggests some weakness. Indeed, output of the Nation's factories and mines declined 1/2% in February, following three small monthly gains, and now is below the levels of last summer. Unemployment also is no better than its June 1984 rate. Domestic spending especially by consumers, has not shown a comparable slowdown but has continued robust as foreign imports replace more and more domestically-produced goods. Monetary policy makers must carefully monitor the economy's overall performance to detect further signs of deterioration and to prevent a "slowdown" from becoming a "downturn."

There are, however, some specific sectors of the economy already faced with big problems, and I want to assure you that I am not only aware of them but also concerned about them. First, the Nation's thrift industry is very fragile. Although the news from Ohio the last few weeks concerned some 71 small institutions in a single state, the plight of the thrifts is far more general and widespread. In 1981 and 1982 most U.S. thrifts lost money because of a mismatch between maturities of assets and liabilities, the so-called gap problem. As interest rates and cost of funds fell, the institutions that survived that period experienced some turnaround. But not enough time has been allowed for the healing process to be completed; net worth positions are on average very skimpy; some gap problems still exist; and, for the first time in decades, problems with credit quality are cropping up. As the number one provider of funds to our Nation's housing industry, S&Ls are worth preserving in a viable form.

Another sector I'm deeply concerned about is agriculture. Farmers with heavy indebtedness are having a difficult time meeting their obligations in the face of depressed commodity prices, weak export demand, and a deflation in farm real estate values. As
more and more default on their debt obligations, small towns in rural areas feel the tremors and farm lenders are weakened. In fact, about a dozen ag banks have failed so far this year.

Numerous non-ag banks are also experiencing asset quality problems. Those who had been active lenders to energy-related companies, real estate, and Third World Nations have reported surges in nonperforming loans and big loan write-offs.

Speaking of Third World debt, significant progress has been made by commercial banks during the past year in restructuring a large chunk of this debt, but the job is not yet finished, and the IMF is still working with individual countries to get their financial houses in order. The numbers are huge and, since the rates tend to float, even a one percentage point rise in interest rates has a tremendous effect on borrowers. In the case of Brazil, that uptick would add roughly $1 billion a year to debt service requirements.

Moreover, the so-called American "super dollar" is challenging policy makers and making life difficult for numerous companies in various industries. The cumulative rise of the dollar—roughly 75%—over the past four years has priced more and more American exporters out of the world markets. The group includes such diverse entities as farmers, machine tool builders, auto parts makers, construction machinery producers and others. At the same time, the strong dollar has led to a surge of imports and tremendous competition for American firms in domestic markets. I have heard these stories first hand from people in Cincinnati, Ohio; Racine, Wisconsin; Detroit, Kalamazoo and Muskegon, Michigan; Louisville, Kentucky; Pittsburgh, Pennsylvania; and, Peoria, Illinois.
Given the economic conditions mentioned earlier and the long list of specific challenges, what has been going on in the realm of monetary policy? Monetary policy was eased late last summer following a dramatic slowdown in monetary growth and substantial evidence of weakness in economic activity. Interest rates declined rather generally from summer until January with the drop in short rates a significant 2 to 3 percentage points and in long rates a more moderate 1+ points.

By November, monetary aggregates were expanding rapidly once again and the economic pause seemed to be coming to an end. Thus, as Chairman Volcker reported to Congress last month, the Fed's easing moves ceased in late January. The Chairman also reported on the Fed's monetary targets for 1985—a set not much different from those for 1984 and designed to be consistent with further sustainable economic growth and progress toward reasonable price stability over time.

It is my personal view that the Fed must strive to keep the recovery going at a reasonable pace of 3 to 4%--because a recession at this time would make our already gigantic budget deficits even more gigantic; because the serious problems of our financial institutions could reach crisis proportions; because the Third World Nations would experience trade deterioration as their major market becomes weak and this in turn would impair their ability to service their outstanding debt; and, because protectionist actions would become all the more likely, risking retaliatory moves and a world-wide recession.

At the same time, the Fed certainly has to be on the lookout for signs of a resurgence of inflation. But we also cannot overlook signs of deflation today. Most industrial commodity prices are actually
below a year by an average of nearly 15%. Other commodity prices are also down—lumber by 24%, soybeans and broilers by 23%. Farm land has dropped 25 to 40% and there are reports of selected deflation in housing. This is a rather new challenge to policy makers because we have to go back many decades to find a period of declining prices. Also, most of today's businessmen and financiers have not had experience doing business without inflation to influence decision-making. Therefore, it is imperative that we proceed cautiously and weigh carefully the potential impact of higher interest rates on the value of the dollar and the other special trouble spots I described earlier.

Finally, let me say a few words about regulatory matters. Because of my interest in supervision and regulation of financial institutions and my two-year experience as a regulator of all State-chartered institutions in Michigan, Chairman Volcker selected me for the Board's Supervision and Regulation Committee. In this role, I've tried to increase contact with the Exam Council and to improve cooperation among the Federal regulatory agencies. The problems today are so critical that we have to cooperate and coordinate our activities better in order to get prompt solutions.

This reminds me of the need for legislation to simplify and streamline the whole regulatory structure to reduce overlap and make accountability more clear.

Since I'm a supporter of the dual banking system, I've made an effort to meet with some State regulators and to work on ways to increase Fed cooperation with them—primarily in areas of examination and training. This is a part of a bigger interest—namely, studying the whole approach to supervision in order to more promptly discover problems in financial institutions and to deal
with them swiftly and smoothly. As a member of the Board's Committee on Federal Reserve Bank Activities, I've pushed for additional resources for Super-Reg, primarily for hiring, training and equipping examiners for today's challenges.

Thank you very much for giving me time to present some of my views on issues and recent activities.

Now I'd be glad to try to answer your questions.