

**THE ECONOMIC ENVIRONMENT FOR THRIFT MANAGEMENT**  
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Good evening! It is an honor for me to participate in this conference on issues in thrift financial management. The interrelationship between the economy and the work of depository institutions occupies my thoughts a good deal these days, and I am pleased to have the opportunity to share some of my ideas on that subject this evening. I think it is significant that a central banker should be asked to speak to thrift managers on how changes in the economic environment affect their jobs. It reaffirms the growing similarities between two industries that have traveled in separate but parallel courses for much of the nation's history. Those paths have moved closer together in the past decade or so, and, looking ahead, I think we would all agree that they are likely to converge even more.

The convergence of purpose and function between banks and thrifts is taking place at a moment when both industries are experiencing greater difficulties than at any time in recent memory. Stories of troubled thrifts are all too familiar to everyone here. Meanwhile, among banks we have seen more failures in recent years than at any time since the 1930s. Even among the vast majority of institutions that have remained open, a pattern of declining profitability has persisted for most of this decade. Research at the Atlanta Fed shows that throughout the 1980s bank profitability has fallen among institutions of all sizes. The trend toward flagging profits has been more dramatic among the smallest institutions. Over the last five years percentage return on assets for banks in the \$100 million to \$500 million range, which is the size comparable to most thrifts, has fallen off to some degree, especially at the lower end of the range. All this is taking place at a time when the economy in general is in the sixth year of expansion. Obviously, banks and thrifts should, in principle, thrive as other sectors of the economy

prosper. So what is going wrong?

There are probably two basic reasons why depository institutions perform poorly. On the one hand, many argue that banks and thrifts fall victim to the economies of the areas they serve. A glance at the map certainly shows a concentration of failed institutions in areas that have been hardest hit by economic reversals, especially in farming and energy. Others suggest that weak management is as much to blame as economics. Of course, there are always going to be instances of bad management in any industry. However, it is possible that in the current environment the two criticisms bear an increasingly close relationship to one another. That is, to some extent weak management as measured by poor performance may indicate a deficient understanding of and adjustment to the general economic environment in which an institution operates.

You might well ask if it is reasonable to expect thrift managers to foresee developments that even professional economists are unable to predict. However, I am not asking thrift managers to become economic forecasters. Rather, I am suggesting that you need to become more attuned to the fluctuations in today's economic system and adjust your management methods to protect yourselves. In part, this entails doing the kinds of things that protect you from both known and unknown dangers--prudent measures like ensuring adequate margins on your collateral and diversifying your assets.

Later I will give you my outlook for the coming 6 to 18 months and suggest how the developments I foresee might affect your business. Before I do that, however, I would like to take a brief historical digression to emphasize how much the economic environment in which thrifts operate has changed over the last two decades and how this has affected your work as thrift managers.

### **Depository Institutions in a Changing Economy**

The last 10 to 15 years have brought banks and thrifts to a rather rude awakening

regarding economics. For 30 years or so after the Second World War, the financial services industry enjoyed a period of remarkable stability. The banking legislation of the 1930s separated banks and S&Ls from each other and shielded both from outside competition. The spreads between interest income and costs were adequate to ensure profitability for nearly all institutions, and financial intermediaries settled into a relatively comfortable mold.

Conditions in the economy outside supported this stability. The United States had emerged from the war as the only major industrialized nation with its physical plant undamaged and its economy intact. As the leader of the world's postwar economic expansion, we found other countries coming to us for financial and industrial support. Inflation settled down to low levels--something in the range of 1 to 3 percent annually--after an initial postwar spurt, and a long period of more or less steady economic growth ensued. As families formed and expanded in the early years of the baby boom, the home-mortgage market bore new fruit.

There was a hint that all this was changing in the credit crunch of 1966 when deposit rate ceilings were first applied to thrifts. Then in the 1970s the economy changed radically. One of the predominant economic forces of that decade was the oil-price shocks of 1974 and 1979 orchestrated by the oil-producing cartel. These price hikes spread rapidly from the gasoline pump to just about every sector of the economy. Higher energy costs, along with worldwide food shortages, caused inflation to accelerate. Lenders demanded higher and higher inflationary premia, and some borrowers were willing to pay. Interest rates ratcheted up, inflation persisted at unusually high rates, and the expectation grew that it would continue indefinitely.

As the difference between market interest rates and Reg Q ceilings widened, old standbys like U.S. government securities and innovative products like money market accounts offered by nonbank financial institutions began capturing a significant share of

the deposit base that had once been the uncontested domain of banks and thrifts. The Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 helped level the playing field by deregulating interest rates and opening the way for depository institutions to bring new products onto the market. There were still quirks in market structure that could not be addressed by legislation, though. Accustomed to looking at the 20-year income streams of average individuals and administering an interest rate over which he had little control, the thrift manager in particular was put at a disadvantage by the volatility in interest rates that inflation was fueling. The switch from fixed and adjustable-rate mortgages has been one symptom of the uncomfortable adjustment required of S&Ls and their customers.

More recently, the already capital-starved industry has been battered by economic disturbances affecting customers' ability to service their debt. First in agricultural areas and then in energy-producing regions, entire communities experienced massive setbacks. Both the agricultural and energy contractions developed rather quickly. There was little warning that those two industries in particular, both of which had been prospering, would begin to fold. The fact was, however, that the very forces that had contributed to their prosperity--high prices on world commodity markets--turned on them with a vengeance.

Strong demand both at home and from overseas and favorable exchange rates led to a boom in U.S. agriculture in the late 1970s and early 1980s. Betting that good times would continue, farmers secured loans with relatively highly-valued farmland and invested in more land and machinery. They lost their wager when countries like India and China suddenly became net exporters of grain at the same time the dollar soared to record heights against foreign currencies and made U.S. crops more expensive to foreign purchasers. The drop in farmers' income had ripple effects in their communities. Incomes, demand for housing and other goods, and ability to repay loans in existence declined in areas where farming was an important activity.

Likewise, the domestic oil industry shared the fate of oil-dependent countries like Mexico when world prices fell by half over the course of a year. Oil users had learned to switch to other sources of energy or conserve enough to foster serious erosion of the cartel which had kept prices artificially high. OPEC members violated their own self-imposed production quotas, and boom turned to bust, destroying real estate values along with companies and jobs in areas that only shortly before were riding high.

Could S&L managers in energy-producing or agricultural regions have anticipated these great shifts in the world's economy? Though there were straws in the wind, the answer is probably no. These events took many people by surprise, including economists who make their living by analyzing macroeconomic trends. However, even if foreknowledge is discounted, the lesson in the examples I have been discussing is clear. In the global marketplace where all of us from the smallest S&L to the largest money-center bank now do business, diversification is the best insurance against localized economic reversals.

Thrifts need to continue broadening their portfolios to encompass a mix of investments. That way, if a portion goes bad, the remainder can keep the business afloat. This is essentially the reason why banks have fared a bit better in the aggregate. They have had more avenues for investing and as an industry have been better equipped to weather recent storms.

Banks are not immune to local problems, though. The lesson of oil prices over the last decade and a half should make this clear. Their rise in the middle 1970s contributed to rampant inflation. Their collapse in the 1980s led to ruin in several of our own states, not to mention a few foreign countries. The aftershocks of these oil-price gyrations demonstrate that credit decisions which once could be confidently made on the basis of local experience are affected more and more by circumstances on the other side of the globe. Survival demands that managers in all industries raise our levels of awareness to

include global events. It is also incumbent on financial institutions to diversify activities to guard against downturns concentrated in specific industries and regions.

I might add that to enhance competitiveness, the thrift industry also needs to overcome the public relations problem arising from the tactics of those managers who yielded to the moral hazard posed by deposit insurance. The pressures of the late 1970s and early 1980s tempted some in decision-making positions to "bet the bank" on risky investments, secure in the knowledge that deposit insurance would cover possible losses. In other cases, unscrupulous financiers bought thrifts with the intention of exploiting insurance coverage in this way. These shenanigans have not only added to the woes of the FSLIC; they have tarnished the industry's image in the eyes of potential customers. I think it is important for you to emphasize the kind of service that will keep customers coming back and promote good word-of-mouth advertising. One way to do this, of course, is to work toward a high degree of loyalty among your staff. An employee's positive attitude shows through at the teller's window, the loan desk, and over the telephone and is one of those "little things" that play major roles in customers' business decisions.

Having drawn what I hope are some useful insights from economic changes of the recent past, I would like to turn now to current conditions and the direction in which they are leading the economy of our state and the nation.

### **The Economic Outlook**

Happily, Georgia thrifts operate in local economies that have for the most part been healthy. For just that reason we have avoided the worst effects of several economic problems. Led by Atlanta's vibrant growth, the state's economy has consistently outperformed the nation's on average. It will likely continue to do so, although our growth will slow somewhat. Our excellent performance is largely the result

of new jobs and the rapid population growth associated with this phenomenon. We have seen a continuous stream of profitable companies--domestic and foreign--locate here to serve a growing market in the Southeast. They seek the advantages of a labor force recognized for its strong work ethic, a good climate, and a transportation network having as its centerpiece a first-class international airport. What is more, Atlanta is not the only growth area in the state. Cities like Augusta also exceed the national average in the rate of job growth. This fact is often overlooked because Atlanta's expansion has been so extraordinary.

We do have weaknesses, of course. The southern areas of the state in particular have suffered from the general agricultural decline. In addition, our rural areas remain overly dependent on low-wage, low-skill jobs that are vulnerable to being displaced by workers in countries like China, where far lower wages prevail. In those areas as in our region generally we have to find ways to raise the quality of the work force through greater educational efforts. Nonetheless, Georgia is strong, and through initiatives like Quality Basic Education the state is working on its weaknesses. These efforts translate into prospects for an even more solid economic environment for your industry.

Looking at the nation's economy in general, in fact, the past few years have presented a good opportunity for S&Ls to improve portfolio balance and to diversify. Economic growth has been good, inflation has been moderate, and interest rates have come down overall. It is true that residential real estate has not exactly boomed in the past couple of years. Except in the areas I have mentioned, though, it has not been a sufficient drag on its own to bring down otherwise healthy S&Ls. I look for the nation's economy to grow at a rate of about 3 1/2 percent in 1988 as expressed in real GNP figures. That will probably be better than next year's performance. In fact, my outlook implies that growth will slow in the last two quarters of this year, since the first six months' growth has been above 3 percent. Inflation should be about the same as last

year--about 4 1/2 or 5 percent--and persist in that range through 1989. I expect unemployment to fluctuate around 5 to 5 1/2 percent for the coming 18 months.

Underlying these statistics are some important fundamental changes--in consumption and borrowing patterns, in price levels, and in foreign trade. From the beginning of the current expansion in 1982 through the first part of last year economic growth in the United States was driven by consumer spending growth. Both the federal government and individual consumers bought goods and services at a prodigious rate, and many of us borrowed heavily to do so. That tendency has slowed, in part because government purchases have entered a downward slope that I fervently hope will be maintained. Curbing the deficit is crucial to the continued health of this country's economy. In addition, a good portion of the baby boom has passed through its household-formation stage, when large, long-term credit purchases are made. This age cohort is entering a period when its members will begin to increase saving. This return to a higher rate of saving should help correct some of the imbalances that have led to record fiscal and trade deficits in recent years. The decline of the dollar from heights which kept the prices of foreign-made goods low and encouraged our national spending binge is also beginning to show up in sticker prices. While overall inflation has been in the 4 to 5 percent range over the past two years, the prices of foreign items, excluding oil, have jumped 8 to 9 percent. This, too, will contribute to slowing consumption.

Price shifts in favor of U.S. products are also boosting our sales overseas. The weak dollar has made our goods and services more attractive to foreigners, and we see the results in the increased exports that are bolstering our manufacturing sector. After languishing during the high-dollar days of the mid-1980s, manufacturing has become the leading growth sector, stimulating increased investment in capital goods. We have also begun to notice some signs of strength in both residential and nonresidential construction of late, though I do not look for a major upturn any time soon.

### **Policy Concerns**

All this growth is certainly a good thing, but it carries the seeds of potential dangers as well. Capacity utilization in industries such as steel and paper is almost at full throttle. This suggests nascent bottlenecks in the delivery of material inputs. If supplies get short, the high-level of demand could push prices up. Similarly, unemployment is at a 14-year low. Again, limited supplies--in this case of available workers--could push costs up.

These incipient inflationary pressures are the major concern of most Fed policymakers and other economic analysts. We have acted on that concern by tightening the availability of money and credit since February. It is not difficult to guess that the rising interest rates that have accompanied this policy stance probably do not make you very happy. However, most thrift institutions are in a stronger position now because you have become better at adjusting your portfolios. These moves serve to lessen the potentially adverse impact of rising rates. Moreover, the increase in rates so far has been relatively small. Our hope is that if we act before inflation actually begins to accelerate, we can avoid the truly high interest rates that plagued all of us earlier in this decade. There is a precedent on which to base this belief. The tightening for which the Fed was roundly criticized in 1984 seems to have been effective at slowing an overheating economy and the inflation that threatened. This was done without the painful costs of a recession.

### **Conclusion**

Let me conclude by reemphasizing that I believe the economic environment will remain favorable for the thrift industry over the coming 6 to 18 months, with overall growth close to this country's potential and moderate inflation. Nonetheless, market forces combining local, national, and international dynamics will continue to influence

your local business climates and demand heightened vigilance from each of you. One consequence of the rapid globalization of financial markets is the need to broaden your horizons to include an understanding of developments in Tokyo and London even if your customers are in Waycross or Gainesville. A second consequence is the necessity of adopting a long-term strategy of portfolio diversification, maturity matching, and other sound funds-management practices. Yet another demand placed on you by rapidly changing conditions is to increase your attentiveness to the requirements of your staff and customers. By doing these things, you can sharpen your own competitive edge and at the same time help bolster public confidence in the thrift industry. Your industry offers products and services that remain vital to the functioning of our economy. I am confident that those who adapt to current challenges with sound management are sure to reap the benefits of their foresight.