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Comments on the Economy and Banking

Remarks by

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It is a pleasure to be with you this morning, and I am honored by your invitation to address this Convention once again. When Jack Benny was honored in some way back during his career, he said he didn't deserve the honor. He added, however, that he had arthritis, and he didn't deserve that either. So you accept honors when they come your way, and I appreciate the one you are extending to me via this invitation.

I'm getting to be a short-timer at the Fed, and as I approach my retirement at the end of July, I've been reflecting on some of the lessons I've learned over the years. One lesson is that there have been certain keys to doing particular things in my job reasonably successfully, or at least not unsuccessfully. For example, the key to success in making remarks in the business sessions of conventions at places like the Greenbrier, where golf awaits, is to keep one's remarks brief. I've been allotted 15 minutes here this morning, and I'll respect that. I'm probably already down to 13½ minutes.

Let me offer a few observations about the current condition of the U.S. economy as I see it, and the outlook for the remainder of the year and the first half or so of next year. As always, these are my own views and not necessarily those of my colleagues on the Federal Open Market Committee.

Obviously, the first point to make about the economy's condition is that it's a lot better now than it was not very long ago. The recovery from the recession back in 2001 was pretty sluggish in its early stages. GDP growth picked up, however, in the second half of last year and has remained strong — 4.2 percent at an annual rate, to be precise — in the first quarter of this year according to a preliminary report. This acceleration has been driven by stronger final demand for goods and services. Consumer spending and housing construction had held up remarkably well during the recession and the early recovery, due in no small part to the tax cuts and highly accommodative monetary policy put in place in 2001. What sparked the acceleration in overall activity last year — in addition to further tax cuts — was renewed business spending for new equipment and software. Business investment in equipment and software rose 10 percent in 2003, the strongest performance for this category of expenditures since 1999. It rose at an even stronger 11½ percent rate in the first quarter of this year.

Despite this acceleration in the growth of aggregate demand, though, until very recently job growth remained remarkably soft. Payroll employment did finally turn up last summer after an extended period of persistent monthly declines. But the pickup was gradual through February, probably because many business firms were hesitant to incur the cost of hiring and rehiring workers until they were more confident that the expansion would continue — a strategy enabled by continuing robust growth in productivity, which permitted many firms to meet increased demand without increasing their workforces.

As I'm sure you know, job growth finally accelerated — sharply — in March and April to an average monthly increase of 312,000 jobs, compared to an average increase of only 81,000 jobs in the six months ending in February. This firming has been encouragingly broad-based across various sectors of the economy and industries. Of special interest in our Fifth Federal Reserve District, where manufacturing is an important part of the regional economic base, factory jobs have increased at least modestly over the last three months after several years of uninterrupted monthly declines. Other recent monthly data reinforce the consensus view that the economy has remained strong so far in the current, second quarter. Industrial production rose solidly in April. And the widely followed composite index of manufacturing activity published by the Institute for Supply Management — formerly called the Purchasing Managers' Survey — stayed above the historically high level of 60 in April for the sixth consecutive month.

This quite robust recent economic performance, especially the pickup — finally — in job growth, has raised both business and household confidence that the expansion will be sustained in the months ahead. One obviously must be cautious in evaluating economic forecasts. There's some safety in numbers, however, and the latest monthly Blue Chip consensus of about 50 professional forecasters is projecting GDP growth at or above 4 percent in the final three quarters of 2004, followed by a mild deceleration to about 3½ percent in the first half of 2005 due to reduced fiscal stimulus and recent and expected future increases in longer-term interest rates. Beyond professional forecasts, I can tell you that the anecdotal comments on business conditions and the outlook I am hearing from my directors and other business contacts have brightened considerably in recent months.

Expectations, then, about our near-term economic prospects are pretty favorable, which seems reasonable enough to me given what we know now. What could go wrong? Well, as always there are risks in the outlook. A growing concern currently, as I'm sure you're aware, is the possibility of rising inflation in the months ahead. Back last December — not very long ago — many economists, including this one, were worried about the risk of a further <u>decline</u> in inflation from an already historically low rate. The core personal consumption expenditures (PCE) inflation index, which may be the best indicator of underlying inflation trends, rose only 0.8 percent in the 12 months from December 2002 to December 2003.

Since then, however, the inflation picture has changed significantly. Prices of many commodities, including crude oil and gasoline, have risen sharply in recent months due to the pickup in activity in the U.S. and the boom in China. Most recently, some of these prices have backed down from their peaks, but they remain at high levels. More importantly, core PCE inflation rose from the 0.8 percent rate I mentioned a minute ago in the 12 months ending in December of last year to almost 1½ percent in the 12 months ending in March. Many economists would consider a 1½ percent core PCE inflation rate comfortable, especially since this index probably has an upward bias of about half a percentage point. But the rapidity of the apparent bottoming out of core inflation, and its subsequent upswing, has naturally gotten the attention of all of us who are determined to contain inflation and preserve the price stability it took almost 20 years to achieve.

Knowing this — and in view of the firming of general economic activity I reviewed a minute ago — financial market participants now expect the Federal Open Market Committee to shift to a less accommodative monetary policy stance in the months ahead. The benchmark 10-year Treasury bond rate has increased a full percentage point from its low point earlier this year to its present level of about 4¾ percent, and the futures market in federal funds has now fully priced in a quarter-point increase in the funds rate at the Committee's meeting in late June. Some observers are concerned about these actual and prospective increases in interest rates. They worry that the increases may undermine the economic expansion just as it seems to be gaining momentum.

Let me offer a few observations about all this. The growing concern about inflation is certainly understandable. Indeed, I have to confess that after being in the unfamiliar mode of worrying about inflation falling too low, I'm dusting off my old inflation hawk feathers in case I have to flap my wings one more time before I leave the Fed.

It's important, though, to keep our perspective here. Productivity — remarkably — is still rising solidly. It was up at a 3½ percent annual rate in the first quarter and an extraordinary 5.3 percent in the four quarters ending in the first quarter. With labor markets still far from tight, and wage growth therefore restrained, high productivity growth helps restrain price increases by holding unit labor costs down. And while the decline in the dollar over the last two years as a whole has put some upward pressure on import prices, increased global competition in the context of sizable price markups currently in many U.S. industries will likely discourage aggressive price increases, despite strengthening demand. Beyond this, there is still considerable excess capacity in many industries. All of these conditions will tend to restrain inflation pressures in the period immediately ahead.

Let me be very clear here. I am not dismissing the risk of an unwelcome further increase in inflation. Given what we know now, there is no question that this risk is greater now than it was as recently as three months ago. Taking account of the factors I just cited that are likely to help contain inflation, however, I think the risk is manageable. Consequently, the FOMC's expectation — reported in its policy statement released after its meeting May 4 — that it will likely be able to transition to a less accommodative policy at a "measured" pace, strikes me as reasonable.

I would add one other point in this regard. Some analysts and commentators have compared the current situation to 1994, when the FOMC tightened policy aggressively as the economy strengthened and inflation expectations rose. I recall that year vividly. It was my first year as an FOMC voter, and I dissented several times from the Committee's decisions because I didn't think we were tightening promptly enough. There may be some parallels between 2004 and 1994, but there are also significant differences. In 1994 we had not yet achieved price stability; today, in 2004, we have enjoyed reasonable price stability for several years. Most importantly, in 1994 we had not yet established the full credibility for our low inflation strategy that I believe we have today. It is appropriate, in my view, for the Committee to take these differences into account as it addresses the present inflation risk.

Having said all this, rest assured that the Federal Reserve will monitor incoming information on pricing developments especially carefully in the weeks ahead. As I indicated earlier, it required almost 20 years to bring inflation down from its dangerous, double-digit rates in the late 1970s and early 1980s. The process was painful. We don't want to go there again, and I am confident we won't.

Finally on the economy, I mentioned the concern in some quarters that rising rates might undermine the expansion's increased momentum. Rising mortgage rates, for example, have already reduced refinancing activity, which has been an important factor sustaining consumer spending throughout the recovery. The strengthening in demand that underlies the increase in rates, however, is now finally creating significant additional employment, and therefore increased income, that will support spending going forward. Rising rates would become a problem if an inflation scare developed in bond markets, but there is no evidence of such a scare at this point. And as I just indicated, the Federal Reserve is committed to preventing one from emerging.

I hope this brief overview of current and prospective economic conditions will be useful to you. Let me close with just a quick comment on banking conditions. In a word, they're good. Based on FDIC data for all insured banks and thrifts, profitability, as measured by returns on assets and equity, was high in 2003, due largely to sizable increases in noninterest income. Business loan demand was weak, as many corporations took advantage of the historically low longer-term interest rates in capital markets. But consumer lending and mortgage demand remained robust. Moreover, this high profitability was broad-based across different size categories of banks. At the same time, banks were — and still are — well capitalized, and problem assets are at historically low levels in relation to total assets. As Chairman Greenspan indicated in testimony to the Senate Banking Committee last month, our sense at the Fed is that the industry is managing its interest rate risk effectively, and is well prepared to deal with the further increases in interest rates now widely expected. These favorable banking conditions are expected to continue over the remainder of 2004. Indeed, profitability could increase further as net interest margins widen, and some corporate borrowers turn back to their banks to meet their credit needs as corporate bond rates and commercial paper rates rise.

All of this is comforting. But regulators and supervisors aren't paid to be comfortable. So I will remind you of the old adage that most bad loans are made in good times. Fortunately for all of us, risk management tools and techniques have improved significantly in recent years, enabled by advances in information technology. It is particularly encouraging to note that many mid-sized and community banks, as well as large banks, are investing in these tools. I hope this trend will continue.

Many thanks for your attention. It has been my great privilege and pleasure to work with this Association over the years, and I will miss you.