The Federal Reserve Board

Remarks by Governor Susan Schmidt Bies

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The Federal Reserve System and the Economy

Good morning. I'm certainly pleased to be here with you. The programs of the American Association of Individual Investors play an important role in advancing the financial education of its members. Folks like you--individual investors--are important participants in our economic system. As financial services firms and their products continue to evolve, people are continually challenged to improve their ability to evaluate alternative consumer and investor services. The great strength of our financial markets is that they efficiently weigh and sort the judgments of literally millions of investors, large and small, as economic conditions evolve, channeling investment dollars, at least ideally, to where they can best be used. Programs such as this morning's event doubtless help keep your members informed about where they may seek the highest risk-adjusted returns on their investments.

I know that because you have a Federal Reserve policymaker here, you will want to hear how my own views of where our economy stands compare with yours. I'll get to that. But first, let me offer the customary caution that the views I'll express are my own and don't necessarily reflect those of other policymakers or staff members of the Federal Reserve. And second, I want to spend some time offering you a broader perspective on the Federal Reserve's purposes and functions, of which monetary policy is just one part, albeit a very important part, of the larger whole. At the Board, we sometimes nickname this topic "Fed 101." In fact, the Fed has a wonderful website with just that name. You can find it at www.federalreserveeducation.org.[1]

The Federal Reserve System is generically described as the central bank of the United States. It represents our nation's third, and I trust final, attempt to establish a central bank. You may well recall learning in school that, in the late eighteenth and early nineteenth centuries, the Congress chartered the First Bank of the United States and the Second Bank of the United States, but neither institution lasted more than twenty years. The Banks' very existence was controversial and went to the heart of the great national debate, which continues to this day, over which responsibilities and powers should be handled at the federal level and which should be left to the states. Suffice it to say that, after the charter of the Second Bank of the United States expired in 1836, we went without a central bank for nearly eighty years.

A series of financial panics in the late nineteenth and early twentieth centuries, most notably the Panic of 1907, revived the idea of creating a central bank to provide the nation with a safer, more flexible, and more stable monetary and financial system. But suspicion of centralized power remained at the core of the American psyche, and so the institution that the Federal Reserve Act established in 1913 was a central bank that assigned significant responsibilities for monetary-policy-making to regional Federal Reserve Banks. The System that resulted consists of a governmental agency--the Board of Governors--in Washington and, in twelve major cities, the regional Federal Reserve Banks, which combine public and private elements. The role of the Board vis-a-vis the regional Banks was elevated in the aftermath of the stock market crash of 1929 and in the early years of the Great Depression, but the combination of centralized and regional responsibilities remains an important strength of the the Federal Reserve System, as I'll explain shortly when I discuss the formulation of monetary policy.

The role that the Fed's founders envisioned for the central bank was narrower, and more passive, than the role that the Fed plays today. The emphasis was on providing currency and reserves to meet seasonal demands and on assisting banks in accommodating the credit needs of commerce and business. Indeed, until the 1920s, it wasn't clearly understood that the Reserve Banks' purchases and sales of government securities influenced the supply of money and credit in the economy.

Today, the Federal Reserve's duties fall into four general areas--some that would have been familiar to the central bankers in the Fed's early years and some that would have been unfamiliar:

- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- supervising and regulating banking organizations to ensure the safety and soundness of the nation's banking and financial system and to protect consumers from harm in their use of credit and banking services
- playing a major role in operating and overseeing the nation's payment system, including providing certain financial services to financial institutions, the U.S. government, and foreign official institutions
- conducting monetary policy in pursuit of stable prices and maximum sustainable employment

We have an all-too-recent example of the Fed as a source of financial stability in its response to the financial aftermath of the terrorist attacks of September 11, 2001, which occurred just before I joined the Board in December 2001. As a commercial bank executive, I was impressed with the speed at which the Fed responded when the normal settlement and information systems in check and securities markets were interrupted. The Fed worked immediately through discount window lending, open market operations, and other means to provide the financial and banking systems with sufficient liquidity.

It worked with public- and private-sector participants to keep markets open or, if circumstances forced markets to close, to return them quickly to normal operations. As the operator and overseer of key payment systems, it had to ensure that its own systems, as well as those of the private sector, were operational. And on the Monday after September 11, it lowered the target federal funds rate to help cushion the economic fallout of the blow to consumers' and businesses' confidence. Because the Fed worked so effectively, bankers throughout the country could serve their consumer and business customers and thereby help to minimize the economic effect of the terrorist attacks.

The Fed's role as the supervisor of banking organizations--both as the federal supervisor of the roughly one thousand state-chartered banks that have joined the Federal Reserve System and as the umbrella overseer of financial and bank holding companies--gives the Fed's staff and policymakers the kind of hands-on experience and knowledge that is essential for a central bank during a financial crisis.

The Fed's examiners and supervisors seek to ensure not only the safety and soundness of the banking system but also the strength of banking organizations, systems for complying with anti-money-laundering, consumer-protection, and other laws. In fact, the Congress charged the Federal Reserve Board with writing the rules that implement consumer protection laws such as the Truth in Savings Act and the Truth in Lending Act, though each of the various federal banking agencies enforces the regulations for the institutions within its purview.

Given all the attention paid to the Board and its Chairman, you may be surprised to learn that more than 21,000 of the Federal Reserve System's roughly 23,000 employees work not in Washington but at the twelve regional Federal Reserve Banks. A substantial portion of these employees work in vital but often unsung jobs, keeping the payment system operating smoothly. The System's employees handle the distribution of U.S. currency and coin throughout the nation and the world. They also clear and process checks and electronic payments, such as the direct deposit of paychecks and they facilitate the electronic transfer of huge sums between large financial institutions.

But it is monetary policy--and the Fed's principal monetary lever, the federal funds rate, which is the interest rate on overnight loans of reserves between depository institutions--that earns the Federal Reserve all that ink and airtime. Deciding on the appropriate policy from among the various options keeps nineteen policymakers and a staff of more than four hundred Ph.D. economists at the Board and the Reserve Banks quite busy.

The chief monetary-policy-making body within the Federal Reserve is the Federal Open Market Committee, or FOMC. It meets eight times a year but can confer by telephone more often if necessary, as it did in 2001 as it responded to incoming economic information as well as economic shocks from terrorism, and as it did again in 2003 as policymakers sought to understand the economic effect of the war in Iraq. The FOMC has nineteen members. Although all members actively participate in discussions at the meetings, only twelve have votes at any one time on the Committee. Each of the seven members of the Board wields a vote, as does the president of the Federal Reserve Bank of New York by virtue of that Bank's unique responsibility for implementing monetary policy decisions through the open market operations of its Domestic Trading Desk. The responsibility for casting the remaining four votes alternates among the remaining eleven Reserve Bank presidents: Two vote every other year, and the other nine vote every third year.

But the important point to remember is that, in a consensus-driven body such as the FOMC, the identity of a member who casts a vote in any given year is less significant than the fact that each member of the FOMC participates fully in the deliberations. The presidents, in particular, bring to the table analyses of economic and business conditions in their districts. The boards of the Reserve Banks also contribute a wealth of anecdotal information to supplement the torrent of hard economic data the Fed analyzes. Moreover, they make recommendations to the Board on the discount rate, the rate the Fed charges on its own loans to financial institutions. The information from the Reserve Bank boards, along with other economic intelligence, is summarized in a report known as the Beige Book, which is publicly released about two weeks before each FOMC meeting. The FOMC also consults other books of other colors. But I'm getting ahead of myself.

Let me describe the routine at a typical FOMC meeting. After seating ourselves around the twenty-seven-foot-long, polished mahogany-and-black-granite Board table, we begin punctually at nine o'clock. After approving the minutes of the previous meeting, our first order of business is a report from the Manager of the System Open Market Account at the New York Fed, who focuses on conditions in domestic and international financial markets. That report is followed by a presentation from the directors of the Board's Divisions of Research and Statistics and International Finance, who deliver the Board staffs' economic forecast as represented in the Greenbook, which FOMC members have usually had the weekend to study. The Greenbook contains the staffs' summary of recent economic information, a baseline economic forecast, which is the staff's best estimate, and scenarios based on possible alternative future events. Then comes the first "go-round," in which every member of the Committee offers his or her assessment of current economic conditions.

We may usefully digress here to consider how the Board staff arrives at its forecast and to describe what role the forecast plays in policymakers' deliberations. An important, perhaps obvious, point to make is that it is not--I repeat, not--the FOMC's forecast. The economic staff of each Reserve Bank independently advises its president. And the economic staffs of the Reserve Banks and the individual members of the FOMC may or may not agree with elements of the Board staff's forecast. Indeed, FOMC members sometimes couch the presentation of their economic views in terms of where those views coincide with and diverge from the Greenbook's forecast. That description, in and of itself, gives you some sense of the staff's influence of the forecast. It sets the parameters of the discussion.

So what kind of forecast is it? It is a forecast based on human judgment. But this judgmental forecast is informed by sophisticated econometric models. The staff's core, large-scale structural model has been dubbed FRB/US--pronounced "ferbus." But that model is not the only one the staff uses. Indeed, the staff uses its suite of smaller-scale models to probe the vulnerabilities of the core model. But as seductive as modeling is to us economists, we must remember that no model can fully capture a dynamic, ever-evolving economy such as ours. Thus, the staff's forecast, and I'm sure the individual forecasts of each FOMC member, are in the end judgmental assessments.

After the Greenbook session, the director of the Board's Division of Monetary Affairs briefs the committee on the Bluebook, a document that presents policy options, usually two or three, for the Committee's consideration and that offers arguments for and against each course of action. Not a recommendation from the staff, the briefing is instead a vehicle against which FOMC members can test their own thinking.

Finally, after hours of discussion and analysis, the Chairman speaks on the policy choice for the first time. Until this point, his participation in the meeting has usually been limited to questions and to comments aimed at keeping the meeting moving. After the Chairman makes his recommendation, FOMC members react in the second go-round. Then we vote, and by then it is usually about one o'clock and time for lunch. About an hour later, at around quarter after two, a statement publicly announces our decision. As currently formulated, the announcement has four parts: the first states the target for the federal funds rate; the second briefly explains the Committee's analysis of current economic conditions; the third provides the Committee's assessment of the risks to price stability and economic growth; and the last provides Committee members' votes.

The statement is a relatively recent innovation; it is about a decade old and, over that period, it has evolved from a quite terse missive to the almost loquacious form it takes today. Before the advent of FOMC statements, market observers had to infer shifts in monetary policy by watching the New York Fed's open market operations. The FOMC statement, as well as more-detailed minutes released about six to seven weeks after each meeting, twice-a-year reports to the Congress on monetary policy, and audits by outside auditors and the Government Accountability Office (formerly the General Accounting Office), are all important elements of the transparency necessary for an independent central bank to function within a democracy. As I mentioned, our goals--price stability and maximum sustainable employment--are set by law, but we are afforded the political independence to make the sometimes unpopular decisions required to achieve those goals. Appropriate transparency and accountability offer a necessary counterbalance to that independence.

Now, as promised, let me turn to the state of the economy and the prospects ahead.

The Economic Outlook
As you know, real gross domestic product grew at an annual rate of 3.3 percent in the second quarter, building on larger increases since the middle of 2003. After having moderated a bit in late spring, partly in response to a substantial rise in energy prices, aggregate demand appears to have regained some traction. Consumer spending has begun expanding at a faster pace and housing activity remains strong. Business outlays for capital equipment also appear to be on an upward trend, continuing to rebound from their weakness of the past several years. And with financial conditions still accommodative, I expect that economic activity will continue to expand at a solid pace for the remainder of the year.

Despite the continued expansion of output, the pace of job creation has been disappointing in recent months. Nonfarm payrolls have grown an average of only 101,000 jobs per month from June through September, after growing at nearly triple that pace in the prior three months.

At the same time, despite the recent volatility in oil markets, inflation, on balance, remains subdued. The core consumer price index, which excludes food and energy, edged up only 0.1 percent in each of the three months from June through August and rose at a faster 0.3 percent in September. Last month's increases occurred in varying sectors, including used cars and lodging. We will continue to monitor the pass through effect from energy and import prices on inflation, but I expect underlying inflation to remain relatively low. In my view, under these circumstances the Federal Reserve can remove its policy accommodation at a measured pace, consistent with its commitment to maintain price stability as a necessary condition for maximum sustainable economic growth.

Household Financial Conditions
Continued vigorous expansion depends importantly on consumer spending, so let me spend a few minutes on the financial condition of the household sector. Some commentators have expressed concern about the rapid growth in household debt in recent years. They fear that households have become overextended and will need to rein in their spending to keep their debt burdens under control. My view is considerably more sanguine. Although there are pockets of financial stress among households, the sector as a whole appears to be in good shape.

Households have taken on quite a bit of debt over the past several years. According to the latest available data, total household debt grew at an annual rate of about 10 percent between the end of 1999 and the second quarter of 2004; in comparison, after-tax household income increased at a rate of about 5 percent. But looking below the aggregate data, we must understand that the rapid growth in household debt reflects largely a surge in mortgage borrowing, which has been fueled by historically low mortgage interest rates and strong growth in house prices.

Indeed, many homeowners have taken advantage of low interest rates to refinance their mortgages, and some have done so several times over the past couple of years. Survey data suggest that homeowners took out cash in more than one-half of these "refis," often to pay down loans having higher interest rates. On net, the resulting drop in the average interest rate on household borrowings, combined with the lengthening maturity of their total debt, has damped the monthly payments made by homeowners on their growing stock of outstanding debt.

The Federal Reserve publishes two data series that quantify the burden of household obligations. The first series, the debt service ratio, measures the required payments on mortgage and consumer debt as a share of after-tax personal income. The second series, the financial obligations ratio, is a broader version of the debt service ratio that includes required household payments on rent, auto leases, homeowners insurance, and property taxes. Both ratios rose during the 1990s, and both reached a peak in late 2001. Since then, however, they have receded slightly on net, an indication that households, in the aggregate, have been keeping an eye on repayment burdens. Moreover, delinquency rates for a wide range of household loans have continued to drift down this year and lie below recent highs in 2001.

To be sure, mortgage rates and other consumer loan rates have come off the lows reached early this year, and concerns have been heightened about interest payment burdens for households. Although some households will be pressured by the higher rates, I believe the concerns can be overstated. First, most household debt--mortgage and consumer debt combined--carries a fixed interest rate, which slows the adjustment of interest costs to rising rates. Second, although interest rates on some variable-rate loans will rise quickly, the adjustment for a large number of variable-rate loans could be a good deal slower. For example, many adjustable-rate mortgages start off with a fixed rate for several years, providing households with some protection from rising rates.

This relatively upbeat assessment of household credit quality seems to be shared by lenders and by investors in securities backed by consumer debt. According to the Federal Reserve's survey of senior loan officers, the number of banks tightening their standards on consumer loans has fallen over the past year. Moreover, credit spreads on securities backed by auto loans and credit card receivables have narrowed in recent months. These indicators do not point to much concern about household loan performance.

Thus far, I have focused on the liability side of the household balance sheet. Favorable developments have occurred on the asset side as well. Equity prices rallied strongly last year and have held their ground this year; as a result, they have reversed a good portion of the losses sustained over the previous three years. In addition, home prices have appreciated sharply since 1997. All told, the ratio of household net worth to disposable income--a useful summary of the sector's financial position--has climbed in the past couple of years and currently stands at a high level relative to the past decade.

Financial Conditions of Businesses

Businesses are also in good financial shape, having experienced a dramatic improvement in recent years. Indeed, starting last year, many firms found themselves in the unusual position of being able to finance a pickup in spending entirely out of rapidly rising cash flow, and those that turned to external markets generally found the financing environment to be quite accommodative.

This improvement in financial conditions reflects a number of factors, namely low interest rates, a widespread restructuring of corporate liabilities, and significant cost-cutting and productivity gains that boosted profitability. In my view, even with an expected rise in interest rates and some moderation in profit growth, the financial condition of the business sector should remain strong and able to support continued expansion. I will address each factor in turn.

First, firms are continuing to benefit from the accommodative stance of monetary policy. Even with the recent increase by the FOMC in the target funds rate to 1.75 percent, short-term borrowing costs remain low. For longer-term debt, the combination of low yields on benchmark Treasury securities and sharply reduced risk spreads from those of a couple of years ago has kept borrowing costs quite attractive. The reduced risk spreads reflect the improved financial positions and more positive investor sentiment, perhaps as accounting and corporate governance scandals have receded.

Second, in response to low long-term rates and to investors' concerns arising from some high-profile, unanticipated meltdowns, firms have greatly strengthened their balance sheets. Many firms have refinanced high-cost debt, a move that has reduced the average interest rate on the debt of nonfinancial corporations by about 1 percentage point on net since the end of 2000. Businesses have also substituted long-term debt for short-maturity debt to improve their balance sheet liquidity and to reduce the risk of rolling over funds. In addition, many firms--especially in the most troubled industries--have retired debt through equity offerings and asset sales, while others have used their growing profits to retire debt. As a result, the growth of nonfinancial corporate debt in the past two and a half years has been limited to its slowest pace since the early 1990s.

These repairs to balance sheets have also reduced the exposure of many firms to rising interest rates, especially in the near term. In particular, the replacement of short-term debt by long-term bonds means that less debt will have to be rolled over in the near term at higher rates. In addition, because much of the long-term debt has a fixed rate, interest payments typically are unaffected over the life of the bond. Moreover, research by the Board's staff suggests that firms that are more likely to rely on floating-rate debt, and for that reason might be more vulnerable to rising rates, have tended to use derivatives in recent years to hedge their exposure to interest rate risk.[2] Thus, for many firms, the effect of rising interest rates will be mitigated and stretched out over time.

In addition, a lesson we can take from the episode of policy tightening in 1994 is that rising interest rates have little detrimental effect on the financial health of the corporate sector when the rate increases occur in the context of an expanding economy. Specifically, corporate credit quality improved on balance after 1994 with the pickup in economic activity and corporate profits.

Third, the improvement in financial conditions among businesses is due partly to some significant belt-tightening by many firms. Over the past few years, the drive to cut costs and boost efficiency has generated rapid productivity gains. Fuller utilization of the capabilities of capital already in place, ongoing improvements in inventory management, and streamlined production processes requiring fewer workers, to name but a few examples of efficiency enhancements, have boosted corporate profitability even when revenue growth was tepid.

With the pickup in revenue growth in the second half of last year, companies were able to leverage the productivity gains and produce a dramatic recovery in overall corporate profitability. The profits of nonfinancial corporations as a share of sector output rose to almost 11 percent in the second quarter of this year. This share lies above its long-run average over the past few decades and well above the cyclical trough of 7 percent in 2001. To be sure, the profit share will likely slip a bit from its high level as the expansion gains steam and businesses are less able to keep a lid on their labor costs. Moreover, because cyclical factors likely contributed to the recent dramatic advances in productivity, we should expect productivity gains to moderate.

But these developments and the decline in profit share are to be expected and will not, in my view, lead to a meaningful impairment of the financial health of companies. The improvements that businesses have made to their financial strength and profitability have been substantial and should help to support sustained, solid growth of the U.S. economy.

Footnotes

1. These remarks draw from the following sources: Laurence H. Meyer (1998), "Come with Me to the FOMC," speech delivered at Willamette University, April 2; Mark W. Olson (2004), "The Federal Open Market Committee and the Formulation of Monetary Policy," speech delivered at the Twenty-sixth Conference of the American Council on Gift Annuities, May 5; and David J. Stockton (2002), "What Makes a Good Model for the Central Bank to Use?" speech delivered at the Federal Reserve Bank of San Francisco, March 2. Return to text

2. Covitz, Daniel and Steven A. Sharpe, "Which Firms use Interest Rate Derivatives to Hedge? An Analysis of Debt Structure and Derivative Positions at Nonfinancial Corporations," Working paper, July 2004. Return to text