Remarks by Governor Susan Schmidt Bies

At the Canisius College Richard J. Wehle School of Business Community Business Luncheon, Buffalo, New York
April 18, 2005

The Economy and Managing Personal Finances

I am very pleased to join you. Today I want to begin with a brief assessment of the economic outlook before discussing financial conditions of businesses and households in more detail. Then, I will turn to some issues related to the management of personal credit and savings and the greater need that consumers have to improve their understanding of financial services and providers as the financial marketplace has expanded.

I also need to add that I am expressing my own opinions, which are not necessarily those of my colleagues on the Board of Governors or on the Federal Open Market Committee.

The Economic Outlook
As you know, the economy has been expanding at a solid pace lately. Real gross domestic product grew at an annual rate of 3-3/4 percent in the fourth quarter and growth in the first quarter looks to have remained solid. Labor markets have continued to improve, albeit at a slow pace, with private nonfarm payroll employment posting moderate gains in 2004 and in the first three months of this year. Business outlays for capital equipment grew robustly in the past two quarters. Consumer spending also has continued to expand, although higher energy prices may be crimping household purchases recently. Consumer and business confidence remain favorable, despite a slight dip in consumer sentiment in early April, and, with accommodative financial conditions, I expect that the economy will continue to expand at a solid pace this year.

On the inflation front, broad measures of consumer inflation have risen somewhat faster than they did in the year-earlier period, boosted by higher energy prices. Focusing on the core price index, which excludes food and energy, it too has been a bit higher than it was the year before, likely reflecting the indirect effects of rising energy prices and the falling dollar. Productivity is slowing from its exceptional pace of the past couple years and unit labor costs are again increasing. Though inflation pressures have risen somewhat in recent months, longer-term inflation expectations appear to have remained well contained. I believe that, while underlying inflation is expected to continue to be low, the Federal Reserve must be more alert to monitoring incoming data, and continue to remove policy accommodation at a measured pace, consistent with the incoming data and its commitment to maintain price stability.

Financial Conditions of Businesses
Business expansion solidified last year and continued growth by businesses will depend in part on their financial conditions. So let me take a few minutes to review the financial position of the business sector, and especially the dramatic improvement from a few years ago. Since 2001, firms have improved their balance sheet liquidity, reduced leverage, and

restructured their liabilities, responding in part to investors' concerns arising from some high-profile unanticipated meltdowns in the early part of this decade. In addition, firms have significantly cut costs through dramatic gains in productivity, which has boosted profits. In my view, even with a rise in interest rates and some moderation in profit growth, the business sector should remain financially strong and continue to expand.

The improvement in corporate balance sheets in the past few years has been substantial. Most noteworthy are the gains achieved in balance sheet liquidity. Firms have taken advantage of low long-term interest rates to pay down short-term debt with longer-maturity debt. At the same time, firms have built up their cash positions to extraordinary levels. At the end of last year, the ratio of cash and equivalents to short-term debt at nonfinancial corporations stood at about twice its average level since the 1950s.

In addition, many firms have taken advantage of low long-term interest rates to refinance high-cost debt, and others have used profits from operations or asset sales to retire debt. As a result, interest expense burdens have declined on balance and nonfinancial corporate debt has grown only modestly in recent years, 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 staff suggests that firms that rely more on floating-rate debt, and for that reason might be more vulnerable to rising rates, have in recent years tended to use derivatives to hedge some of their exposure to interest rate risk. Thus, for many firms, the effect of rising interest rates will be mitigated and spread out over time.

Also, as we learned from the episode of policy tightening in 1994, 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. Indeed, corporate credit quality improved on balance after 1994 with the pickup in economic activity and corporate profits.

Some of the improvement in financial conditions among businesses is due to 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.

The pickup in revenue growth since mid-2002, combined with outsized productivity gains, has produced a dramatic recovery in overall corporate profitability. The profits of nonfinancial corporations as a share of sector output continued to climb and reached almost 12 percent in the fourth quarter of last year, up from its cyclical trough of 7 percent in 2001. This share lies well above its long-run average over the past few decades. To be sure, the profit share likely will slip a bit from its high level as the expansion gains steam and businesses hire new workers more aggressively. But some decline in the profit share is to be expected and will not, in my view, significantly impair the financial health of companies. This favorable view is reflected in risk spreads on corporate bonds and credit default swaps, which have dropped dramatically from their historic highs in the fall of 2002.

Household Financial Conditions

In the household sector, some analysts have expressed concern about the rapid growth in household debt in recent years and the decline in the household saving rate. 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 pockets of financial stress exist among households, the sector as a whole appears to be in good shape.

It is true that 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 1999 and 2004; in comparison, after-tax household income increased at a rate of about 5 percent over this period. This rapid growth in household debt largely reflects a surge in mortgage borrowing, which has been fueled by historically low mortgage interest rates, strong growth in house prices, and an increasing share of households owning their home rather than renting.

Indeed, many homeowners have taken advantage of low interest rates to refinance their mortgages, some having done so several times over the past couple 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 2002. Since then, however, the debt-service ratio has been stable and the financial obligations ratio has receded a bit, an indication that households, in the aggregate, have been keeping an eye on their financial commitments. Consistent with these patterns, delinquency rates for a wide range of household loans either have drifted down over the past year or held about steady at levels below recent highs.

The low interest rates of the past few years, however, will give way as the economy continues to expand, and we have already seen an increase in mortgage rates and on some other consumer loans during this past year. To be sure, some households will be pressured by the higher rates, but I believe that concerns about their effect on repayment burdens 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 occur rather slowly. For example, many adjustable-rate mortgages start off with a fixed rate for several years, providing households with some protection from rising rates.

Another concern is that house prices will reverse and erase a considerable amount of home equity built up in recent years. Recent gains in house prices have been notable: the average house price rose 11 percent in 2004, and cumulative gains since 1997 now top 65 percent.[1] Despite a rise in mortgage debt, the current loan-to-value ratio for outstanding mortgages is estimated to be around 45 percent, roughly the level that has prevailed since the mid-1990s. It is true that some households have considerably less equity in their homes, and these households tend to have lower income and fewer other financial assets to cushion shocks. Based on the 2001 Survey of Consumer Finances (SCF), a small share, 7 percent, of households had a loan-to-value ratio of 90 percent or more. Unfortunately, we cannot characterize the current share as accurately, at least not until the 2004 survey becomes available later this year, but it is unlikely that the share has risen by a lot. While new originations of mortgages with high loan-to-value ratios in recent years would push this share up, the substantial house price appreciation in that same period likely improved the financial positions of the households with high loan-to-value ratios in 2001.

However, we are beginning to see signs that housing prices may be reaching a peak in some markets. An increasing share of new mortgages is being taken out by investors rather than by occupants of the property. Some borrowers are stretching to buy their new homes using adjustable-rate, interest-only mortgages. Not only will these households face higher monthly payments as interest rates rise, they are also not building equity in their homes as quickly as they would with a traditional amortizing mortgage.

Some analysts have also expressed concerns about the decline in the personal saving rate. Aggregate personal saving, measured by the Bureau of Economic Analysis, averaged just above 1 percent of disposable income in 2004, more than 6 percentage points lower than the average that has prevailed since the early 1960s. The saving rate, measured by the Board's flow of funds accounts, is higher, at 4 percent of disposable income, though it, too, is significantly lower than its average level in the past. Analysis by Board staff using data from the SCF indicate that households in the top income quintile can account for nearly all of the decline in the aggregate saving rate since 1989. Given that these higher-income households have more financial resources to weather shocks, the significant decline in savings is less troublesome than if it had occurred in the lower part of the income distribution.

This comparison points out two different perspectives on household financial health. While analysts usually focus on the saving rate as a share of current income and funds flow, some argue that a more relevant measure of saving adequacy is not the portion of current income set aside for saving but rather the change in net worth. And in this regard, the picture of household saving looks more favorable than suggested by the saving rate. The ratio of net worth-to-disposable income has come down from its peak in 2000, but remains at a high level relative to the past few decades, because capital appreciation on household assets, such as equities and real estate, has considerably outpaced income gains. This is a passive perspective on savings, though, where households rely on the markets to raise the value of their assets over time. But, to create these assets, households need to consistently set aside some of their current earnings to invest for their future needs. While the experience of the past few years of exceptionally low interest rates and lower expected stock returns encouraged a rational consumer to spend and not save, as the markets return to more long-term trends, we should see consumers moderate their behavior as well.

Managing Personal Finances

I now want to turn from an aggregate view of household finances to savings and credit at the individual level. In particular, I want to discuss issues relating to managing personal finances, including managing personal credit and saving for retirement, and the special importance of financial education.

College graduates preparing to enter the labor force will soon assume a new level of responsibility for managing their finances. Personal financial management includes the strategic use of both credit and savings to enhance asset accumulation and financial well being. Just as the choices that students have made regarding their education play a vital role in determining career opportunities, the decisions they make and behaviors they establish regarding financial management in the coming years will also impact future opportunities and their ability to capitalize on them.

Compared to a generation ago, the financial marketplace of today is significantly more complex. There is now an extensive range of consumer financial products and services, and providers of these goods and services. Advances in communications technologies and other technological tools have dramatically broadened the provision of financial services. For example, the development of sophisticated credit-scoring models permits lenders to more efficiently evaluate credit risk and underwrite loans and thus provide a broader array of loans to more closely meet the specific financial needs of different consumers. In addition, as workers have become more mobile and more likely to change jobs several times over the course of their careers, they have increased their demand for retirement savings vehicles that are portable and have benefits that are less tied to longevity at a single firm. These developments have increased the opportunity for consumers to build their asset base through education and home ownership, exercise greater control over their retirement savings, as well as acquire at lower cost the goods and services that enhance daily life.

With this increased access and availability of financial products, consumers also have to assume greater personal responsibility for managing the use of credit and their financial outcomes. As I have already noted, in the aggregate, household debt has grown more rapidly than income in recent years. Of special relevance to this audience is that the increase in consumer debt loads in recent years is particularly apparent among younger adults. The majority of this increase is attributable to student loans, with a 2002 survey by Nellie Mae indicating a 66 percent increase in the average undergraduate student loan debt from 1997.[2] Credit card debt is another factor contributing to the increased level of debt among young adults. The Survey of Consumer Finances (SCF) data shows that 18-to-24 year olds experienced on average about a 100 percent increase in credit card debt between 1992 and 2001, albeit from a small base, but still substantially higher than the rate for other households.[3] Moreover, there are indications that some of these younger households are having difficulty managing their debt successfully. The 2001 SCF indicates that delinquency rates (one debt payment more than 60 days past due) were twice as high among households headed by someone less than 35 years old than for households in the 35-to-44-year age group.[4] Finally, surveys continue to indicate that many workers are not currently saving for retirement, and many that are saving, by their own calculations, are not saving enough.[5]

Clearly, these statistics are sobering and raise some concerns about financial security. In recognition of the reality of both the promises and pitfalls of the consumer finance market, there has been a heightened appreciation for consumer protection. Lawmakers and regulators are mindful of the possibility of abusive and fraudulent credit practices, commonly known as predatory lending, and have undertaken efforts to thwart such activity. In addition, employers have adopted strategies through plan design and education programs to encourage retirement savings of its workers. But consumers cannot rely solely on the efforts of others for financial security. They need to develop an understanding of the available options and be able to comprehend the implications of their financing and savings decisions. Indeed, lawmakers, regulators, and employers look to consumer savvy to promote efficiency in the consumer financial services industry.

In recent years, surveys and other studies that evaluate the understanding of financial concepts have demonstrated the need for improved financial education, especially among younger consumers. One nonprofit organization dedicated to increasing financial education for youth, the Jump$tart Coalition, has conducted a survey of financial literacy of high school seniors every two years since 1997. Overall, the results have been disappointing: Results from the 2004 survey showed more than 65 percent of students failed the survey's questionnaire, with only 6 percent scoring a "C" or better. In terms of credit card usage by college students, a Government Accountability Office (GAO) study found that students were more likely than other borrowers to run up debts they could not pay because of financial inexperience. In recognition of this behavior, many credit card issuers provided access to financial education materials, and debt counseling services for students who faced repayment difficulties, but the GAO did not try to determine the effectiveness of these education efforts.[6] Some preliminary research by others suggests some possible benefits from online credit education tutorials to college student cardholders, but it is possible that more responsible usage only reflects the type of student who would participate in the tutorial.[7] Clearly, more research is needed to assess the efficacy of consumer education, and the Federal Reserve System has been an active promoter. In fact, the System hosted a conference in early April on consumer financial awareness, including a session on the efficiency of delivering financial education to consumers.

So what resources are available to consumers to help them become sufficiently familiar with financial concepts to make sound financial decisions? Many public, private, and nonprofit organizations have developed a variety of financial education programs, and many are available on the Internet. These educational materials address the full range of personal financial management, from the essential fundamentals of creating a budget and defining specific savings plans to understanding more complex transactions, such as applying for mortgage credit. Valuable information on consumer protection matters is also available, concerning the rights of consumers if a credit or ATM card is stolen or if they are a victim of identity theft. Similarly, many federal agencies publish a variety of consumer protection and financial education materials. In fact, the Federal Reserve System offers a wide variety of consumer information relating to financial services on its web site. In addition, the Federal Reserve launched a national personal financial education campaign in 2001 to promote the importance of financial education, as well as to provide support for the wide variety of resources committed to this topic.

In addition, in recognition of the importance of financial education, Congress established the Financial Literacy and Education Commission in 2003. This Commission, headed by the Treasury Department, is composed of the heads of twenty federal agencies, including the Federal Reserve Board, to encourage collaboration and coordination of government and private-sector efforts to promote financial literacy. The Commission is also charged with establishing a web site and toll-free number for obtaining financial education resources offered by the government resources, as well as for developing a national strategy for promoting financial literacy and education. Under the direction of the Treasury Department, interagency task forces have worked to streamline access to the wide variety of consumer information and financial education materials offered by government agencies. These resources are available on the Internet at www.mymoney.gov. Consumers can also call 1-888-MYMONEY to obtain a tool kit of financial education information that can assist them in understanding credit, savings, and investment products before they become obligated, and provide a foundation for shopping for financial products and providers that are most appropriate for their circumstances and needs. By obtaining a firm grasp of the fundamentals of financial management, consumers can create savings and spending plans that are compatible with their earnings throughout their lives and that help them meet their short- and long-term life goals.

Turning to retirement savings in particular, workers entering the labor force today will bear more of the risk of financial security later in life than workers of a generation ago. Far fewer workers will be covered by defined-benefit pension plans established by their employers, which provide pre-set benefits after retirement. Data from the SCF indicate that among workers with a retirement savings plan, nearly 60 percent of workers aged 25 to 34 were covered by a defined-benefit plan in 1989; by 2001, this share had declined to 31 percent. Instead the vast majority of employees with retirement benefits will be offered the opportunity to contribute to a defined-contribution pension plan, most likely a 401(k) plan, which allows workers to take their retirement assets with them as they change jobs over the course of their careers. Under a typical 401(k) plan, retirement wealth will depend primarily on workers' own contributions, often supplemented with some matching contributions by the employer, returns realized on the investments chosen, and what workers choose to do with balances when they change jobs.

However, studies have found some troubling patterns related to individual savings in 401(k) plans that suggest that workers may not be giving adequate attention to their retirement savings. First, despite the tax advantages of 401(k) contributions, one-quarter of workers eligible for 401(k) plans do not participate at all, even if the employer would match a portion of their own contributions.[8] These workers are effectively giving up a pay raise. And among those that contribute, many save just a little. In a survey last year, one-quarter of firms reported that their rank-and-file 401(k) participants saved an average of less than 4 percent of pay.[9]

Another concern relates to the way employees manage their 401(k) plans. Some participants simply invest contributions equally across the investment options or according to plan defaults, which in many cases is a low-risk, low-return money market fund.[10] And, as has been publicized widely in recent years, many 401(k) participants invest heavily in employer stock. Among companies that offer company stock as an investment option, more than one-quarter of 401(k) balances are in company stock.[11] This high concentration cannot be attributed entirely to an employer match that is required to be held in company stock. Instead, employees appear to voluntarily purchase and hold abundant amounts of company stock, despite the obvious risk of linking their current income and retirement wealth to the financial health of their employer.

These patterns are troubling because they raise doubts about the financial security of workers in later life. Fortunately, new research in the discipline of behavioral finance provides some important insights into the behavior of 401(k) participants and suggests some promising changes that can lead workers to make savings choices that will leave them better prepared for retirement. Contrary to predictions of traditional finance theory, the way the retirement-plan options are framed affects the choices made by participants. Researchers have found that "opt-out" plans--those that automatically enroll workers unless they actively choose not to enroll--have substantially higher participation rates than plans in which employees must take the initiative to opt in.[12] Moreover, when defaults are designated, many workers tend to enroll using the default contribution rates and investment options and to leave these in place for many years after enrollment, even though the default may be set too low to allow for the accumulation of sufficient retirement assets.[13]

If workers are influenced by how choices are offered, then employers can make changes to the plans to help participants make better decisions. For example, employers might set default contribution rates to rise as workers receive pay raises, or set the default investment option to a diversified portfolio that adjusts as the worker ages.[14] In addition, employees have increasingly expressed interest in employer-provided financial education, and firms and lawmakers are responding. Congress has passed legislation that makes it easier for firms to provide investment advice with less fear of being held liable should such advice lead to losses. Some firms have started to provide access to a third-party who will advise employees about how much to contribute and how to invest their contributions. Moreover, a recent study by the Employee Benefit Research Institute (EBRI) suggests that education about retirement planning provided by employers led to a substantial portion of employees altering their retirement savings.

In closing, as credit availability and financial alternatives continue to expand, it has become ever-more important for consumers to develop the skills necessary to make informed financial choices. I encourage prospective graduates to place the same priority and attention to managing their personal finances as they do to developing their careers. Beginning early and remaining committed to thoughtful management of personal finances throughout one's life is an essential element to long-term financial success.

Footnotes

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