Speeches

The Outlook for the Economy and the Banking Industry

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Thanks, Bill. I always wondered why you moved here to Middle Tennessee, but I understand you shortened your commute, and, besides that, something tells me this is the only day this week you've had to wear your pinstripe suit. Oh, the life of an academic. . . .

It's great to see a full house here today. Bill told me that we'd be meeting in the new Chamber of Commerce building, so I don't know whether to attribute the good attendance to curiosity about me or about the building, but I'll take what I can get. In fact, with all the construction I see going on in this area, I begin to understand why you needed a new building. It wouldn't surprise me to hear that the president of the chamber and your chairman are already putting their heads together to try to figure out how to add a new wing just to keep up with the growth you are obviously experiencing.

A big part of my job is to help people understand what the Fed is thinking and doing, and why--and to be out with real business people and community leaders, to understand what you are thinking and what you are expecting from the economy. That's why I was particularly pleased that Bill asked me to come speak at this Sixth Annual Financial Industry Conference. Let me also say a big thank you to Waymon Hickman, chairman and chief executive officer of First Farmers and Merchants National Bank, who is helping to host today's luncheon. Waymon is a director of our Bank, and I hope you will use him as an ongoing conduit to me and my people by giving him your thoughts on the economy from time to time to bring to the discussions we have at our monthly Board of Directors meetings.

What I want to do with you with my time today is to reflect a little bit on where the national economy has been over the past five to six years and then discuss where I think it's headed. After that, I plan to talk briefly about how the banking industry is doing, and then I'd like to tell a couple of stories--one true and one not--that I hope will help to explain the Federal Reserve's recent monetary policy action that has gotten so much press attention and is being talked about most everywhere I go. And finally, if there's time, I'd be delighted to see if I can respond to your questions on things I've talked about or other things you know we're involved with at the Fed.

Economic Outlook

These last six years, since the recession in 1990-91, have been extraordinary. Actually, as economists measure economic expansions, we're into the seventh year of this expansion, the third-longest since World War II. Real GDP growth since this expansion began in 1991 has averaged almost 3 percent annually. The current unemployment rate of 5.2 percent is the lowest since 1989, and we've been around this very low level for some while now. We've had inflation at or below 3 percent (as measured by the CPI) for four consecutive years--or as some of the broader measures would have it, around 2 percent. These broader measures are consistent with the recent conclusions of the Boskin Commission, Fed economists, and others, who suggest that the actual inflation rate may be as much as 1 percentage point lower than currently reported by the CPI.

I and my Fed colleagues, and others who talk about the economy, describe current economic performance as a Cinderella economy, or a Goldilocks economy (not too hot, not too cold, but just right), or compare it with the Energizer bunny, as it just keeps on going. Economic expansions don't have to die of old age, but more often than not inflation and resource constraints of one kind or another eventually begin to bring trouble. We're now nearly one-third of the way through 1997, and most of us expect to see continued moderate growth--with low inflation and low unemployment. But most of us also expect to begin seeing some slowing in the pace of activity as we move through 1997. Although we won't get the first official report on GDP growth in the first quarter until next week, the economy seems to be growing faster than expected. It now looks like 1997 is likely to exceed last year's 2-1/2 percent annualized growth. Where's the strength behind this growth?

Consumer spending is leading the way. We've all seen the reports of month-after-month strong job growth--and income growth has been strong as well. Although the volatility of the stock market in recent weeks has probably had some impact, the "wealth effect" (as economists call it) from the run-up in stocks and other assets is thought to have added to consumers' willingness to spend. We haven't really seen an imbalance in consumer spending, and, in fact, spending is currently growing somewhat less than income, and the savings rate is increasing. Debt burdens are somewhat higher, but not at the level of past peaks yet. Needless to say, if the savings rate falls again, or we see consumers starting to spend more on the basis of their perceived wealth, this would be a concern.

Housing, which is particularly important to the economy of the Southeast because of our various industries that feed off of it, has been slightly stronger longer than we had forecast. Nonetheless, we are still expecting some slowing in housing over the rest of 1997 and into 1998, not only because of the slightly higher long-term interest rates, but also more fundamentally because of demographic trends. There simply aren't as many new families looking for apartments and houses as there were in the 1970s and 1980s.

Business spending looks like it will continue to be a source of strength again this year. While investment in plant and equipment is not now quite as robust as it was earlier in this period of expansion, everything I see and hear suggests businesses will continue to spend on productivity-enhancing equipment. When the history of this period of economic expansion is written, I think one of the big stories that will be told is how a new era of competition (some of it global) has pushed businesses of all kinds to invest in more and more technology to produce their products or services at a lower unit cost.

Another source of balance is **inventories**, which appear to be about in line with desired levels--although they are at much lower levels than we have seen in the past, due to new inventory management techniques, such as just-in-time inventory, which is now used in almost all industries.

Government spending should remain flat overall if Congress comes up with a plan to reach a balanced federal budget--which will reduce the upward push of federal spending, but will be offset by spending at the state level.

Demand from abroad is not likely to change dramatically in the period immediately ahead and should continue to be a moderating force, given that the prospect for economic growth of our major trading partners remains only moderate.

So you see, we do continue to have a pretty balanced economy, although I would point out that the largest upside risk is in the area of consumer demand, which accounts for about two-thirds of GDP. As I mentioned earlier, job growth continues to be quite strong, and with it has come good growth in spendable income. And with consumer confidence at very high levels, it doesn't appear that demand is going to slack off. A quick review of past economic expansions tells us that most expansions don't quit because consumers as a whole decide to slow down their spending, but instead what usually happens is that consumers want to spend even more. And, as they do, aggregate demand continues to increase until it outstrips supply--and if such an expansion is fueled by accommodative Fed monetary policy, eventually we get an overheated economy and an accelerating rate of inflation.

It was a fresh assessment of this risk, and others that my colleagues on the Fed Open Market Committee saw, that caused us to make a modest monetary policy tightening move at our FOMC meeting four weeks ago. And, in the aftermath of that policy move, the Fed is getting even more attention (and press). Before I go on to talk about this interesting topic, let me briefly take a look the outlook for the banking industry, which has certainly been having a good run in the current economic climate.

Outlook for the Banking Industry

I would like to pull out just a few numbers to remind you how well the banking industry is doing. Profitability for banks, as measured by return on assets, is at one of the highest levels ever. In fact, 1996 was the second most profitable year in the recorded history of banking. About three-quarters of all banks reported higher earnings in 1996 than in 1995, and nearly two-thirds reported return on assets of 1 percent or higher, a number that may sound low to other businesses but which is considered to be a very good number for banks. Other profitability measures also indicate that, clearly, the bottom line for the banking industry is in good shape. This performance bears out what we have seen previously--that is, banks tend to do well when interest rates are low, not when they are high.

But the other big story in banking, obviously, is consolidation, which has had a large influence, as it has in other industries as well. Most of you are probably familiar with the fact that we've been losing banks to mergers and acquisitions, but let me give you a few numbers. Twenty years ago, we had nearly 15,000 banks in the United States, most of them small banks. Today, we have fewer than 10,000, a decrease of one-third. Tennessee has followed the same pattern of one-third attrition, starting with about 350 banks 20 years ago, and down to 230 today.

In the Southeast, most of this merger and acquisition activity has been in Georgia and Florida. About two-thirds of the banking assets acquired from 1994 to 1996 were in Georgia and Florida. Tennessee accounted for only about one-twelfth. A little more than half of the assets acquired in the Southeast were bought by banks from outside of the region. That's not too surprising in that the Southeast has a vibrant economy--the kind of economy most banks would like to be active in--and because there are some attractive target markets.

There are two kinds of consolidation going on: (1) consolidation of individual banking institutions across state lines to get down to one charter and (2) mergers of different banks. Here in this Federal Reserve district, we thought that banks might wait to start their charter consolidations until June 1, when the interstate branching laws generally go into effect. But instead, almost one-third of the 20 banks in our region that operate in more than one state have already collapsed their charters into one master charter.

Some projections on the future of the industry suggest even more declines to come in the total number of banks, particularly in smaller banks of $500 million or less. Our best guess is that we'll probably lose about half of these banks over the next few years. A basic reason for the decline in the smaller banks is simply that most of the banks in the industry are smaller banks. On the flip side, we should see an increasing concentration of industry assets in the largest banks. So, the short story is that consolidation has been under way, and it will continue.

But a longer-run view of what the banking industry will look like includes, in my mind, the fact that small banks are not going to disappear. In fact, we get new applications every month from groups wanting to start new banks. I've been told you just had a new bank open its doors here in Murfreesboro. I think part of what drives this phenomenon is that small, well-run community banks will always have a place in their communities and that as big banks move in on some of their business, community banks continue to find niches that serve the needs of their local customers. Looking farther into the future of consolidation in the industry, I might also point out that it's possible that the largest banks might become more interested in merging with non-banks or other financial services firms, similar to the proposed Bankers Trust acquisition of Alex. Brown, now that the Fed has relaxed some of the restraints on this kind of merger. If this scenario were to become a trend, it might take some pressure off small banks.

Since a good many of you in the audience today are business people, you might be asking yourself, What does all this change in the banking industry mean to me? Well, first of all, competition is always going to help you. In this technological era, you will not ever be left with only one bank to take your business to. Even without technology, you can look around this community of about 50,000 and find at least a dozen banks you can walk into and do business with. But there are some interesting issues that are changing the shape of banking due to technology and changing demographics that I also think might affect you.

Aside from consolidation, there's the whole issue of banks getting the ability to offer new services to their customers that now only non-banks can offer. Certainly, it's been the bigger banks who've "pushed the envelope" in many respects. Over time, though, I think the ability to offer such new services will be high on every banker's agenda. Why? The answer in one word is "demographics."

It all comes down to the baby boomers and the major shift we're going to see as they reach that point in their lives when their kids are out of college. I'm a living example of this since I've recently had my youngest child graduate from college and then get married one week later. In addition, as an age group, the boomers are going to start to inherit large sums of money from their parents' generation. Statistics show that they will inherit some $7 trillion by the year 2008--and this windfall will come at a time when they are also entering the prime period in their lives for accumulating assets. Those items are on the plus side of the ledger.

On the minus side, however, is that this large group of people has to be concerned about how much of a cushion it's going to get from Social Security when it's time to retire. The upshot is that these folks are not about to be satisfied to just drive to their nearest bank and buy a CD to secure their retirement years. They're going to want financial advice and brokerage services. They're going to want to invest their money, and the big question for banks is, then, How will they get this business if they are not prepared to offer the services baby boomers will be looking for?

Another big change I sense is that the industry will continue to move away from bricks and mortar--that is, building new branches. There was a banker in our region (whose bank has since been merged with another) who used to say that the next big charge-off for banks will be their branches. As I shop at my local supermarket and see the new kind of branch that banks are operating in such locations, I believe this astute banker had a point. And, if I correctly remember the history of supermarket branches, it's a Tennessee bank that we need to thank for that new way of serving customers.

What all of these changes point to is the need for legislation to expand allowable activities for banks. Specifically, that means repealing the Glass-Steagall Act. It also means allowing banks to continue to choose the type of charter and regulator that is best for their individual situation, as they have been able to do for years in our so-called dual banking system. Representatives Roukema, Leach, and LaFalce have introduced legislation to amend the interstate branching law to make it easier for banks to continue with a state charter rather than having to switch to a national charter. While I've not reviewed this particular proposal, I think its motivation rests on a vital principle, that is, providing the kind of regulatory choice for banks that has helped the industry to stay creative and competitive and, in turn, provide the best level of service to businesses and consumers.

Inflation Stories

Now, I'd like to turn from those thoughts on the banking industry back to the economy and to the larger issue of how the Fed is handling monetary policy. When I was a young father, some years ago now, one of the greatest pleasures in life was to crawl up in the bed beside my young-'uns and read them stories until they fell off to sleep. As my children have grown up and left home to start their own careers (and have their own babies), I'm being exposed to a new form of story telling--that's when the economists on my staff tell me stories to support their interpretation of the current economic data and economic developments. And believe me, those stories aren't nearly as interesting as those children's bedtime stories were.

But, having said that, let me engage in a little economic story telling myself.

Story No. 1

Here's the story the Fed told at 2:15 p.m. on the afternoon of March 25--after we had agreed to slightly tighten monetary policy at our latest FOMC meeting.

> "This action was taken in light of persisting strength in demand, which is progressively increasing the risk of inflationary imbalances developing in the economy that would eventually undermine the longexpansion."

In talking about the risks to the economy earlier, I have already told part of this story more informally--the old Economics 101 relationship between supply and demand. Excessive demand pressures show themselves in different ways in different economic cycles. Sometimes it's capacity utilization that moves beyond its practical limits, and we begin to see delays in deliveries and, eventually, prices being bid up. This time around, it's been the availability of labor that has been under the most pressure as we've been seeing it in the statistics and in the anecdotal reports we've been getting from around the country that tell us the task of finding the next 10 or the next 100 workers has become more and more difficult. You see it every month when the employment numbers come out.

Let me take a few seconds to talk briefly about the idea that there is a link between unemployment and inflation. There is a fairly common argument that runs like this: as unemployment declines, labor resources become scarce. Wages then get bid up, and these increased labor costs get passed through to consumers in the form of higher prices--all of which results in accelerating inflation. Although this line of reasoning may sound logical, it's off the mark for at least two reasons. **First**, wage increases and prices aren't necessarily linked. For example, if labor productivity is increasing, then companies can pay workers more and still not affect their profit margins--in fact, they may even be able to increase their profits. **Second**, higher costs can only be passed through if customers are willing and able to pay the higher prices.

The only situation where wage increases can result in higher prices is if there is too much money chasing too few goods, as the old saying goes. That usually means that the stance of monetary policy is so accommodative that it actually **encourages** wages to be bid up and passed on to consumers. If this is the case, then rather than wage increases leading to accelerating inflation, they actually follow from accelerating inflation.

That's why the Fed must always keep its eye on the "inflation ball." The problem we face today as policymakers is to sort out whether the increases in labor productivity can justify wage increases and are consistent with robust and balanced demand for goods and services--or whether they are an indicator that monetary policy is too easy and inflation is accelerating.

As a final note, I think it bears repeating that this kind of vigilance regarding inflation is essential to realizing the economy's fullest growth potential. It comes down to the notion that when businesses and individuals have confidence that inflation will remain low, we all are more willing to make the kinds of investment decisions that raise productivity and growth over time.

Story No. 2

What I've just told you is the story I want you to remember, and believe. But, there's another story, or stories, that are being told by some in the popular press, and others. They have a very different view of what's going on in the economy. That story takes different forms, but often goes something like this:

> "We've got a vibrant economy with strong job growth and no measurable increase in inflation. The Fed is supposed to worry about things other than inflation--like job growth -- so, dadgummit, we like things the way they are. The Fed should keep its hands off and let things go."

This is a very understandable way of looking at the world, and even my own characterization of the current economy could lead one to honestly believe we've made it to the Promised Land and can live happily ever after. In fact, I hear from a lot of business people--including a few at a recent meeting of my recent Small Business, Agriculture, and Labor Advisory Council--that they can't understand why we seem to be so anxious to take action against something they can't see.

To those who would have us wait until we "see the whites of inflation's eyes," (and by that I mean wait until we've had several months of deteriorating inflation data) before we begin to move to a more restrictive policy, to those people I would only say, look at what our past experience has been under such an approach (and we've certainly tried that before--knowingly and unknowingly). We have learned from experience that when we wait till the "inflation cat is out of the bag," it takes a bigger dose of medicine of higher interest rates to bring things back to a sustainable rate of growth--and such greater swings in the economy do not engender the kind of confidence I talked about earlier when business people invest in job-creating plants and equipment and when consumers stay on a steady course of spending. Indeed, because of the lags in the way monetary policy decisions are played out in the economy at large, waiting for concrete evidence virtually guarantees that we will always be behind the curve, acting too late.

Essentially, the Federal Reserve has to do its best to look months ahead and take pre-emptive actions against the possibility of accelerating inflation. While I think we do get some immediate "psychological reaction" to a Fed policy move--easing or tightening--the major effect of any interest rate change takes months and months to work its way through the economy--lags that are thought to be at least nine months, or a year or more. Clearly, our action a month ago reflects what we think the economy will look like later this year and into next year.

The other notion embedded in this popular story about the economy and appropriate Fed behavior is the belief that somehow the Fed can directly control the creation of jobs and some higher rate of economic growth. The truth of the matter is that the only direct contribution the Fed and Fed policy can make is to help create an environment of low and predictable inflation. Such an environment, in turn, creates the business confidence I have already talked about, which does then create jobs and fuel sustainable growth. In that sense, it's not a choice between low inflation on the one hand and job growth and good economic growth on the other. Low inflation brings with it the other good things that all of us (these second storytellers included) want out of our economy. And. let me reassure you that I as much as anyone want to see this expansion continue until it beats our last record of just over 100 months--we're at 73 months and counting right now.

That's enough stories and general economic talk for now. Let me stop with the expressed hope that when the final chapters of the current economic story are told that we have managed to extend the current economic expansion for more years--and that any future swings in the level of economic growth in this country were more modest than if we had simply let nature run its course.

Bill, again, thanks for the invitation to be with you and share these thoughts this afternoon.

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