

Credit Union Distinguished Lecture Series

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It is a great pleasure to have the opportunity to talk with you today. I would like to start by extending congratulations for your success in the transition through the century date change. Many may consider Y2K a "non-event," but I know that it was the extensive preparation by financial institutions such as yours that allowed us to make such a successful step into the new millenium. I thank you for your careful and thorough preparation.

The current U.S. economic expansion can be considered nothing short of remarkable. We are now experiencing the longest expansion in our nation's history, with exceptional GDP growth, near-record-low levels of unemployment, and little evidence of inflationary pressures. While several contributing factors have led to such a favorable environment, my talk today will focus on a group that I know is close to your hearts – consumers.

The strength of consumer spending over the past year has been phenomenal; the consumer is the driving force behind our strong economic growth. Real consumer spending in 1999 grew 5.6 percent, much faster than in any other year in the past decade. Of course, such

brisk consumer spending could not occur if not for financial institutions, such as credit unions, providing the necessary credit. In that respect, credit unions have played an important role in this expansion; but what goes up often comes down as I will note a bit later.

Much of consumer spending has been strong in areas that are part of the core business of credit unions. With your focus of supplying credit to consumers who have a "common bond," credit unions have been a major source of financing consumer durables, one of the strongest sectors of the economy. Purchases of new and used cars, homes, and other durable goods have far surpassed the forecasts of many economists, who had assumed that demand for such durable goods would have been satiated long ago.

The motor vehicle sector provides a good example of how credit unions have contributed to our strong economic growth. Consumers, buoyed by the low unemployment rate, the booming stock market, and relatively low nominal interest rates, have had a voracious appetite for purchasing cars. Motor vehicle sales surpassed 16 million units in 1999, far above the level in previous years. With auto loans

accounting for approximately 40 percent of credit union loans, clearly, credit unions were important contributors to the growth in this sector.

Similarly, credit unions have played an important role in the housing sector. Credit unions have focused increasingly on mortgage products, with first mortgages, second mortgages, and home equity lines accounting for another large part of credit unions' loan portfolios. Despite the rise in interest rates over the past year, housing starts in 1999 surpassed 1.6 million units, more than in any other year in the past decade. And as I'm sure you are all well aware, particularly if you tried to build a new house or tried to get contractors to bid on an extension, the housing market in many parts of New England seems more constrained by supply than by demand.

The beneficial economic trends occurring nationwide are magnified in the New England economy. The three states represented in this room, Rhode Island, Massachusetts, and New Hampshire, have all experienced impressive economic growth. Their unemployment rates at the end of 1999 were 3.8 percent, 3.2 percent, and 2.5 percent, respectively – all below the 4.1 percent unemployment rate

*between
.6 and
1.6%*

nationwide. These conditions are reminiscent of the unemployment rates that occurred during the economic boom of the 1980s.

With such a strong local economy, it is not surprising that housing prices in the region are accelerating at a somewhat faster pace than the national average. As a drive through any new subdivision will show, the wealth effect generated by the stock and housing markets not only is affecting activity in general, but also has particularly stimulated growth in the construction of higher-end homes.

Favorable factors such as the booming stock market and the ability to tap into our highly educated work force have allowed firms in the region to develop new technologies and enhance their productivity. These factors, along with the important part the financial services industry plays in the region, have provided the necessary environment for our remarkably strong economic growth.

New England's credit unions, along with other financial intermediaries focused on consumer lending, have been in the right place at the right time in this expansion. While most firms have benefited from the unusually strong growth, unusually low inflation, and substantial increases in productivity, credit unions have been

especially well situated to benefit from the favorable economic environment. This good fortune comes from an abundance of consumers "ready, able, and willing" to finance the purchase of homes and cars. Equally important, the good fortune comes from a decline in the financial distress among borrowers who have already purchased their home or car. Delinquency rates remain at very low levels by historical standards. Credit unions, like other financial intermediaries, have seen delinquency rates at dramatically lower levels than they were through much of the 1980s and early 1990s.

Low delinquency rates and strong demand for housing and auto loans should translate into a favorable environment for financial intermediaries and, indeed, it has. For credit unions, this environment has benefited its members in the form of higher rates paid on savings and lower rates on loans. In addition, and potentially of great importance as we go forward, credit union profitability has allowed the industry to continue to build its capital base. This build-up also comes at a good time for credit unions, since it should make it easier for most institutions to comply with new capital standards required by the Credit Union Membership Access Act of 1998 (CUMAA).

As we reflect on the past, it is probably safe to say that we have been operating in the best of all possible worlds – strong growth, low unemployment, and low inflation. But, we cannot and must not assume that such favorable economic conditions will continue indefinitely. To date, our economy has been able to satisfy the incredible demand of consumers without economic stress largely because slow world growth outside the U.S. and rising domestic productivity have acted to bring strong demand into balance with supply. Increasingly, however, this matching of supply and demand is threatened by a series of imbalances largely driven by the consumer sector. Consumers have been the life of this expansion, but they could be its death as well.

Strong consumer spending reflects the fact that the vast majority of people who really want jobs have them. Labor markets are extremely tight. To date, the ability of employers to tap into the pool of available workers to meet consumer demand for their products, without a rapid increase in wages, has been remarkable. This pool consists of those officially unemployed, as well as those considered not

to be in the labor force. Perhaps surprising to many, employers have been successful in attracting workers back into the labor force, helping them satisfy their employment needs. In addition, strong productivity growth has effectively acted to augment the supply of labor and keep wage pressures from escalating. But the pool of available workers both in the labor force and out of it is becoming ever smaller and productivity cannot continue to grow at faster and faster rates indefinitely. The risk facing us is that in the face of booming consumer demand, labor will dwindle further, pushing wages and salary costs up and creating inflationary pressures.

A second imbalance involves consumers continuing to spend as much or more than they earn. Despite strong growth in disposable income, the personal saving rate of individuals has been declining. By the end of 1999, consumers were spending an ever-higher percentage of their disposable income, causing their saving rate to be at an all-time low of just 2 percent of disposable income. Apparently, the substantial gains in recent years in the value of our houses and our stock portfolios have made us comfortable consuming more of our current disposable income. The wealth gains we have experienced are a natural reflection

of the surprisingly strong productivity gains in the U.S. economy. As firms produce more goods with the same resources, stock prices have risen. As consumer wealth increases, in part the result of changes in stock valuations, more is consumed. These effects have a tendency to be reinforcing. During boom times, consumer confidence reaches high levels, and consumers are willing to not only purchase more consumer goods, but also to pay higher prices for assets purchased for investment purposes.

However, there is a growing risk that we will experience the other side of this virtuous cycle, the vicious side. Consumers are not only spending more, and saving less, but they are borrowing at high levels relative to income as well. So far this borrowing is affordable but this is a trend that cannot continue forever. Sooner or later stock prices will level off or fall to a point that consumers will not feel so wealthy. Spending will drop, savings may rise, but levels of consumer debt may well become a problem. High consumer debt burdens may not have a major impact on consumer demand, consumer delinquency rates, or financial institutions health during periods of rapidly rising personal income, sharp increases in wealth, and relatively low nominal interest

rates. However, when wealth and current incomes decline, debt service payments could become a more serious impediment to ~~continued consumption, and~~ to the health of both household and financial institution balance sheets.

Finally, the balance of trade poses yet another consumer-related ~~imbalance~~ ^{problem}. To satisfy their demand for goods and services, consumers have increasingly turned to foreign-produced products. Part of the explanation for this trend is that many foreign firms, suffering through the Asian crisis, priced their products aggressively with depreciated currencies and exported their way out of recent economic problems. The supply of cheap imports eased the demands placed on ^{U.S.} domestic producers and helped reduce price pressures domestically. In addition, with many foreign economies struggling, weak demand for many raw materials also kept price pressures minimal. Together, these factors contributed to the country's favorable inflationary environment.

However, this favorable impact from abroad also can't continue indefinitely. Many struggling economies are fully in recovery, putting pressure on the prices of raw materials and imports; the rising price of oil is just one aspect of this. Also, a continued deterioration in our

current account, which requires an increasing amount of foreign investment in the United States, would be difficult to maintain without eventually putting pressure on the U.S. dollar.

The Fed's primary goal is to provide an environment in which the country can continue to have strong economic growth while maintaining low inflation. With this goal in mind, it is becoming increasingly clear that the imbalances generated by rate of growth in consumer spending could threaten this expansion. They pose the risk of increasing rates of inflation, of excessive consumer debt, and of an unsustainable trade deficit. Clearly, consumer spending needs to moderate. The most recent data, however, show an acceleration in consumer spending rather than a moderation, even in the face of rising interest rates.

~~To the extent that~~ ^{as} the economy ^{continues to} grows at a pace that becomes unsustainable and inflationary pressures ^{are a potential} ~~become a~~ problem, monetary policy will have to continue to respond. Unfortunately, monetary policy only has a fairly blunt tool for slowing the economy. Raising interest rates sufficiently to restore the economy to a more sustainable path clearly has risks for stock valuations, but it also is likely to have a

disproportionate impact on interest-sensitive sectors of the economy. Consumer spending is most likely to be affected, especially spending in the housing and auto sectors – two sectors that are important to financial services firms, especially the credit union industry.

Should the economy slow down to a more sustainable pace and avoid exacerbating some of the emerging imbalances in the economy, consumption of durable goods and housing should continue, but at a more subdued rate than in the past several years. We must hope that this will occur without any sharp revision in equity prices.

Nonetheless, the economic environment, looking forward, is likely to be less favorable than it has been in the past few years. We cannot expect consumption to grow at the pace of the second half of 1999. Just as a good central banker should always remain watchful for emerging inflationary pressures, a good credit union executive should remain alert to emerging risks in the loan portfolio. The past several years have not penalized institutions that have relaxed their lending standards, as unemployment has been driven ever lower, the stock market has moved ever higher, residential property values have risen, and consumers remain ebullient. However, such periods are exactly

the time when it pays to weigh the risks of the impact that a slower economy, with less favorable personal income and wealth growth, might have on your credit union's loan portfolio.

In sum, I spent about half our time this morning talking about how good things have been. This period has left credit unions and financial institutions ^{better} ~~more~~ generally armed against adversity through their ^{never} ~~better~~ focus on risk management and capital adequacy. The coming year or two may well test these preparations as economic growth slows and consumer ebullience turns to a bit of retrenchment.

I think it is possible for us all to weather this period if we are vigilant and proactive, ^{It is my hope, and my expectation, that working together we can} and extend this unprecedented period of expansion.