Fifth Annual Conference of International Treasury Management

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It is a pleasure to be with you this morning to kick-off of your timely conference. I'd like to thank Gian Camuzzi, treasurer of Gillette, for asking me to speak to this international group. As it turns out, you are a perfect audience to engage in thinking about a topic of some interest to us in the Federal Reserve -- what does the prospect, or at least the possibility, of significant U.S. fiscal surpluses in the next decade, and a related decrease in the value of U.S. Treasury securities outstanding, mean for how money markets here in the U.S. and worldwide deal with issues of liquidity and risk. But before we get into that, let me first give you my perspective on the prospects for the U.S. economy.

It goes without saying that, after four barn-burner years and a decade of rising rates of expansion, the US economy slowed significantly at the end of last year. In many ways, this slowdown is not surprising--most forecasters had seen a less severe version of it coming, albeit incorrectly, at the beginning of each of the previous three years. And, as each year, and especially 1999, proved better than the last, an eventual slowing in growth seemed more likely. In fact, some deceleration was necessary. From the second half of 1999 through the first half of 2000, U.S. GDP grew at better than a 6 percent pace. That rate of expansion was rapidly straining capacity, as evidenced by the decline in the unemployment rate over this period. In fact, labor markets were getting so tight that it was nearly impossible to find the workers needed to sustain that rate of growth. It is in just such an environment that inflation tends to rise.

I think most would agree that this rapid expansion of demand was simply unsustainable. One need look no further than motor vehicles to find a market in which the growth in demand had outstripped previous concepts of long-run sustainability. In the first quarter of last year, motor vehicle sales hit the unprecedented rate of over 18 million units a year-a few million over the recent average. At that pace, I wonder if the U.S. was about to run out of driveway space. This largely reflected an adjustment to the increased level of wealth and income of U.S. households at the end of the millennium, the confidence they had as a result of higher wealth and income, and their willingness to save less out of disposable income than ever before. Inevitably, these trends had to slow.

The investment boom of the 1990s was also unsustainable. Until the second half of this year, business fixed investment had grown at solid double digit rates for at least the previous 4 years, and spending on computer equipment and software had grown at an amazing 45 percent. Although most expansions have spurts in overall investment of a similar magnitude, not since the 1960s have we had a burst that lasted as long. Technological improvements in computing power, software, and telecommunications increased firms' demand for these goods. And, no doubt, continued technological improvements will help propel such investment in the future. But the rates of investment in the late '90s, fed by ebullient consumer demand and accommodating financial markets, could not continue when demand flattened, and markets became more discriminating.

Residential investment also outpaced its long-run fundamentals at the beginning of last year. Starts and permits hit their cyclical peaks at the beginning of 1999 - a level roughly equal to past cyclical highs. At that pace, the stock of homes was increasing significantly faster than households were being formed. Again, a trend supported for a time by rising consumer wealth and confidence, but not sustainable over the longer run.

At the beginning of last year, I believed that the question was not whether the economy was going to slow down, but what the environment would look like when it did. The slowdown could occur with a glut of new homes, high office vacancy rates, and significant over-investment in unused business equipment and consumer durables, or it could occur

when these stocks were closer to their desired levels. Obviously the latter case is preferred.

To help attain this better-balanced environment, the Federal Reserve began tightening monetary policy in the middle of 1999. By the beginning of 2000, other sources of increasing restraint became evident as well. Financial markets became far less expansionary. Uncertainty about profit projections resulted in declines in asset values, particularly in the high tech sector. Credit markets, which had never returned to the headiness of the 1997 global pre-crisis period, became even more discriminating in early 2000. Yield spreads, particularly for lower-rated securities, widened considerably in the spring and again in the fall. Lending standards at major commercial banks tightened as well. The increase in the price of oil, which continued through much of 2000, and, more importantly, price increases in natural gas, began to bite into the real incomes of consumers, and the profits of businesses. These events both signaled and helped cause the second half slowdown.

However, the suddenness and intensity of the deceleration took almost everyone by surprise. Growth averaged 1.7 percent in the second half of last year, less than one-third the 6 percent average in the 4 quarters prior to that. Some ask whether or not the economy is or will be in recession, but in many ways that is the wrong question. The economy may well be growing, albeit quite slowly, but for those hard hit by this sudden slowdown--the manufacturing sector especially--this deceleration clearly is painful.

A number of explanations for the intensity of this slowdown have been highlighted in the press. Consumer demand slowed more sharply than anyone expected, driven in part by the effect on confidence of sharp drops in the NASDAQ. Moreover, since the consumption of durable goods, especially motor vehicles, declined most significantly, it may be that consumers finally reached their "saturation" levels of these goods. Finally, stormy weather throughout most of the country in December and early January had an effect as well.

A similar story may apply to the decline in firms' investment in plant and equipment. In the wake of extraordinary spending growth on equipment, and reflecting tighter credit and financial markets, firms may have grown concerned about over-investment. Reports of sharp curtailment in the motor vehicle industry may have triggered the reassessment of consumer attitudes in December. In turn, this may have spread the narrow weakness in motor vehicles to broader spending categories. Finally, the rapid change from very strong to slumping sales growth likely led to an unexpected overstocking of inventories.

This inventory overhang and the related retrenchment in business and consumer attitudes pose challenges for the U.S. economy in the short run. But in many ways, the economy is better positioned to weather these short-run adjustments than it was in previous periods of weakness.

First, the major positive force that has propelled this historic expansion is still with us--the amazing acceleration in U.S. productivity. The development of and investment in new technologies to enhance business processes has provided a tremendous spur to productivity growth. Even as such investment slowed in late 2000, productivity remained surprisingly strong. This gives further evidence to the assessment that the underlying, or structural, growth rate of U.S. productivity has stepped up significantly over its pace of the '80s and early '90s. Reflecting this, the sheer determination on the part of U.S. businesses to work harder and smarter in the face of domestic and global competition seems, if anything, stronger now.

Another imbalance that has preceded almost all post-war recessions has been significantly rising inflation. However, inflation has been well behaved recently even in the face of continued, tight labor markets. Labor costs have accelerated, but core inflation has remained at a relatively low, stable level. Fluctuations in oil and natural gas prices will have a transitory effect on both the headline and core CPIs, but the potential for broader price increases seems small at present. Thus, containing inflation is not an immediate concern.

Third, although an inventory overhang exists in some sectors, just-in-time inventory processes and rapid production adjustments have probably limited the buildup. These processes should help reverse the overhang more quickly than is usual.

Long expansions often spawn imbalances in real estate markets. Certainly, significant overbuilding in commercial real estate was evident by the end of the 1980s. Vacancy rates for commercial properties were high and rising before the

recession of the early '90s. Currently, however, vacancy rates in many markets are low and prices for commercial and residential buildings are solid. These facts seem inconsistent with significant overbuilding.

Assets in the banking sector remain reasonably healthy, especially relative to capital, despite problems in particular sectors like telecommunications. Loan standards tightened in 2000, and credit markets discriminated sharply between investment grade and other credits, for the most part a desirable and prudent response to heightened uncertainty about current and future loan quality.

Unlike the late 1980s as well, large government budget deficits are not crowding out private investment, or creating the need for fiscal austerity. On the contrary, government budgets at both the national and local level remain supportive.

Finally, of course, the economy now has 100 basis points of easing in the pipeline. This may help shore up confidence, creating some rebound in spending by both firms and consumers. Recent signs are at least somewhat encouraging here. In these circumstances, it goes without saying vigilance on the part of the Federal Reserve is necessary.

Thus, in my view, the economy is likely to continue feeling the effects this quarter of a significant but relatively short-lived inventory correction. The correction is the result of an unexpectedly rapid adjustment toward more sustainable growth in demand. The longer-run underpinnings-technology-driven productivity growth, benign inflation, bank balance sheets, fiscal balance sheets-appear sound. There are risks for sure, the level of private savings and the softness in domestic demand in many foreign economies, to name two. Nonetheless, I expect activity to increase later in the year, and growth for the year to average around 2 percent.

One of the major underpinnings to the decade of expansion in the '90s was the gradual decline, and eventual elimination, of the U.S. federal deficit. I don't need to explain the benefits of reduced government deficits to this audience. For one thing, lower long term interest rates made possible by a declining demand by the government for funding figured prominently in the capital investment boom of the '90s. But it is easy to forget how hard it was to get to this favorable situation, and how hard we should work to ensure it remains .

Not so long ago, the performance of the U.S. economy was distinctly subpar, particularly when compared with today. The late '60s to the early '80s saw four recessions, slow productivity growth, episodes of double-digit inflation and unemployment, and a chronic federal deficit which hit a new place-time high in 1983. After peaking at 6 percent of GDP, the deficit remained high until 1994. By that year, U.S. public debt had risen to 67 percent of GDP, also a peace-time record high.

This build up of deficit and debt produced a series of legislative efforts to discipline the budget process. Of particular importance in this effort was the Budget Enforcement Act of 1990, passed during the previous Bush Administration. This legislation set caps on three categories of discretionary spending, it established "pay-as-you-go" procedures requiring that increases in direct spending or decreases in revenues due to legislative action be either budget neutral or reduce the deficit. It also provided some enforcement mechanisms for both the discretionary caps and "pay-go" provisions. The Omnibus Budget Reconciliation Act of 1993 extended these provisions through FY 1998.

The last six years of strong growth, combined with this concerted attention to deficit reduction by policymakers, changed the federal government's fiscal balance dramatically. By 1998, the deficit had vanished. Now the United States is running a surplus that is nearly 2 percent of GDP, and the ratio of public debt to GDP has fallen substantially.

Looking ahead, the Congressional Budget Office projects the U.S. surplus to rise above 5 percent of GDP over the next 10 years. The Social Security trust fund accounts for just under half of the coming surpluses, and the on-budget programs account for the remainder. These projections, by the way, do not depend on the rate of U.S. economic growth remaining at the record-breaking pace of the last two years. The CBO assumes that U.S. growth will average about 3 percent, inflation (measured by the CPI) will average just below 3 percent, and unemployment will rise to over 5 percent over the 10-year interval.

If these projected surpluses are realized, the ratio of public debt to GDP would continue to fall rapidly. Over the next five years, the debt could fall below 20 percent of GDP, setting a new post war record low, and continue to set new records after that.

As debt falls, so do the outstanding amounts of marketable U.S. government securities. Indeed, if the CBO projections are realized, outstanding marketable Treasury securities could literally be at negligible levels by 2010.

These projections assume that the federal government changes neither its existing spending programs nor tax laws. It may be more realistic to assume that new fiscal initiatives authorize more spending, or lower taxes and on-budget surpluses are exhausted. Nonetheless, substantial Social Security surpluses remain and the supply of marketable debt falls substantially even by mid decade. This is, of course, a near-term situation. As the full baby-boom generation retires, Social Security and Medicare surpluses disappear rapidly, but for the next ten or fifteen years, projections of falling or disappearing levels of debt seem plausible.

Now I should sound a note of caution here. Projections over periods as long as 10 to 15 years of necessity are surrounded by a wide band of uncertainty. Many things have to fall just right for them to be realized. Nonetheless, the possibility of a shrinking supply of Treasuries must be taken seriously by all market participants.

This possibility has important implications for the Federal Reserve. U.S. monetary policy is implemented largely by buying and selling Treasury securities. Such securities, of course, pose no credit risk. But, equally important, trades in these securities, in the amounts necessary to effect short-term interest rates, can be made without disrupting activity or producing substantial increases in bid-asked spreads. This is because open market desk trades are small relative to a market that trades hundreds of billions of dollars of securities each day. Moreover, SOMA holdings of Treasuries are not large compared to the outstanding supply. Currently, the System's portfolio of just under $600 billion represents less than one-sixth of the outstanding supply of marketable Treasury debt.

But growing surpluses may make reconsideration of how monetary policy operations are conducted necessary within the next few years. If the CBO's projections are realized, in three years the System's portfolio of Treasuries could absorb about 30 percent of the marketable debt. Even if the surplus is only half as big as the CBO projects, within five years the Fed's holdings could amount to an uncomfortably large share.

Current conditions in financial markets already foreshadow the consequences of the shrinking supply of Treasuries. The levels of U.S. government debt recently raises issues about the adequacy of the supply of collateral in markets for repurchase agreements. These concerns have contributed to a sharp rise in the prices of longer-term Treasuries and to the inversion of the yield curve for Treasuries at a time when other curves remained upward sloping. In so doing, the use of the 30-year Treasury as a benchmark has been undermined.

These facts suggest that the breadth, depth, and resiliency of the market for Treasuries already are affected. In the next few years, the Treasury market may become too shallow to handle the customary needs of money managers, investors, and the Fed.

Obviously this is an issue for the Federal Reserve, but the challenges facing U.S. monetary authorities are only a small part of a larger concern. U.S. Treasuries form the backbone not just of domestic monetary policy, but of liquidity and value in money markets worldwide. Foreign ownership of Treasury securities reached 34 percent last year, and daily market trading in U.S. government securities is a mainstay of global money management. The System Open Market Account is only a small player on a daily basis in these markets. If SOMA needs to change, so will all the players in these markets--so will all of you as you manage funds for corporate treasuries. And as you change, so will the markets themselves.

In that regard, let me pose some of the same questions to you that the System has begun to confront. How will you manage your need to place funds easily and securely overnight? What new instruments will be needed to serve the needs of risk-averse customers and money managers? What security will be used as a benchmark for building and pricing portfolios? Will the emerging practice of using Government Agency Securities and SWAP transactions as benchmarks be sufficient? And what new, or modified clearing and settlement systems will be needed to replicate the size, liquidity and finality of the current Treasury market? As participants in the markets, we will need to work together to answer these questions. And we should not forget, demanding as it might be, the need to address these questions reflects good things--fiscal discipline, some success in monetary policy, a measure of good fortune, and the underlying strength of the U.S. economy in recent years.

In closing, let me reiterate my belief in that strength and in the inherent resiliency of the U.S. economy. The short run may challenge all of us but with wise policy choices and considerable vigilance these challenges can be met.

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