IOWA INDEPENDENT BANKERS ASSOCIATION

Lake Okoboji, Iowa
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Perspectives From the Federal Reserve and an Economic Outlook — Where To From Here?

Thank you Dick. Let me begin by thanking you for inviting me here today. I'm glad to continue the Chicago Fed's involvement with the annual conference of the Iowa Independent Bankers. I plan to take part in many of the activities, and it looks like Charlie Walsh, Dick Berglund and Diane Gibbs have an interesting couple of days in store for us.

We have a number of people affiliated with the Chicago Fed here today. First and foremost, I want to mention two of our directors. As many of you know, three of the nine members of a Reserve Bank's board of directors must be bankers — one each from a small, medium-size and large bank. Over the past 80 years, the community banker seat on our board of directors has by-and-large been filled by an Iowa banker. Currently, that person is Arnie Schultz, who's here with us today. Arnie's a former president of the IIB and is current chairman and president of Grundy National Bank in Grundy Center. Arnie's joined by Thomas Dorr, president and chief executive officer of Dorr's Pine Grove Farm Company in Marcus, Iowa. I've had the opportunity and pleasure to work closely with Arnie and Tom since I joined the Federal Reserve, and I can attest to the fact that our board's deliberations are significantly enhanced by their input and experience. Arnie and Tom provide terrific insight about Iowa, and come this September they're taking it one step further by helping to bring our board meeting here. The meeting will focus on agriculture, and we'll have a chance to tour some special facilities.

We also have two former directors with us today: O.J. Tomson, chairman of the board of First Citizens National Bank of Charles City, and John Spies, president and chief executive officer of Iowa Trust and Savings Bank in Emmetsburg. And we have three key people from our Des Moines regional processing office — Ed Ketchmark, the assistant vice president in charge of the office; Dick Jung, manager in charge of customer service; and Fred Berkey, customer service representative.

Importance of communication

Today, I'd like to discuss two general topics. I have a notion you might feel shortchanged if, coming from the Federal Reserve, I didn't discuss the economic outlook, especially in light of our recent monetary policy decisions. This is an interesting time from a policy perspective, and I'll share my thoughts on where I see the economy headed.

First of all though, I'd like to say a few words about the importance of encouraging a flow of communication among us. Ultimately, we all share the same goal: an efficient, stable financial system and a growing economy. Even with that being the case, I suspect many of you wouldn't believe me if I were to say I'm from the Fed, and I'm here to help. I hope, however, you'll believe that I'm from the Fed, and I'm asking for your help. We're in a very challenging industry, undergoing significant change. We can all benefit from continuous and open communication. For me to do my job, I need to know as much as possible about the challenges you face in your job. I plan to have more and more opportunities to meet with you and other bankers in the Midwest on a frequent basis. In this way, we can share ideas and concerns, and work together to shape the changes that confront us.

With this thought in mind, I'd like to briefly highlight some of our activities and how we're trying to work more closely with our constituents, or stakeholders, if you will. As you may recall, the Federal Reserve has three primary activities: formulating monetary policy, supervising and regulating banks, and providing financial services. To carry out these activities in our five-state region, we have a head office in Chicago, a branch in Detroit, and offices in Milwaukee, Indianapolis, and, as I mentioned, in Des Moines.

Given our involvement in all of these areas, we have a fairly complex and diverse organization. Our activities range from the analytical and abstract study of the economy to the high-volume, time-critical processing of checks. This makes for an interesting combination, with elements of the private sector, government, and academia all in one organization.

Because we have such diverse responsibilities, it's essential that we communicate effectively with our stakeholders. Community banks provide a good model. We hear so much about consolidation and mergers within the banking industry. True, consolidation is a fact of life. But I maintain that community banks will always be a vital segment of the banking industry. Why? Because they continue to provide solid customer service and display an ability to identify new markets and tailor services to those markets. Community bankers are close to their customers. They know their market. Community bankers innovate. They compete successfully.

Iowa community banks are no exception. They're active and vital participants in the community. The response to the Great Flood of 1993 is a good example. Following the flood, Iowa banks lowered loan rates and deferred payments. In fact, business failures in Iowa declined by a third in 1993 despite the flood. To me, that highlights the close working relationship between banks and the local business community. This type of partnership is good business. It's good for the community.

I like to think that some of the strengths of community banks are present at the Chicago Fed. Certainly, the Federal Reserve's regional structure allows us to be closer to you and tailor our services to your needs.

Financial Services

Our Des Moines Office is a good example of the advantages of a regional structure. The office is one of the most proficient in the Federal Reserve. Part of the reason why is a willingness to innovate. For example, later this year we're going to be rolling out a new check-imaging product here. The Iowa office has an outstanding record for achieving and surpassing quality goals established by the System.

We hope to do even better in the future. We're now finalizing plans to locate the Des Moines office at a new facility at a business park near the Des Moines airport. We expect the facility to be in operation in early 1997. As you can probably guess, the location is significant because it's close to major interstate highways as well as the airport. We'll be able to provide quicker, more efficient service. I think this new facility represents a commitment not only to you, but to the economic well-being of Iowa. I think it's also indicative of our commitment to providing financial services to community banks and to ensuring that all banks have access to the payments system.

We've made a similar commitment in other parts of our Federal Reserve district. We're now in the process of establishing a check-processing operation in central Illinois near Peoria. This won't replace an existing office, but will be an entirely new operation in a new location. When it opens in September, the Peoria facility will be the first new Federal Reserve office in some twenty years.

Why establish a new office during a period of consolidation in the banking industry? That's a question we considered carefully. We felt it was essential to move aggressively to provide the best possible service, given the increased competition. The new facility will enable us to be closer to our customers. A key consideration was the availability of new technology, which will enable us to use computers in Chicago to drive the check sorters and printers at the Peoria office. So we had a winning combination — the advantages of being closer to the customer combined with the efficiencies of this new technology.

The bottom line is that both of these facilities will let us provide better, less expensive service to our customers, and, most importantly, contribute to a more efficient payments system.

Supervision and Regulation

I'd like to turn now to our regulatory duties. As you know, the goal of supervision and regulation is a banking system that's safe and sound. That's a goal we all share. An important component of that, it seems to me, is working together, finding common ground.

I think we'd all agree that we should try to reduce the burden of regulation. The key, of course, is to reduce the regulatory burden and maintain high supervision standards. I don't think the two are mutually exclusive; ideally, they should work hand-in-hand. I spent a number of years in the private sector. I know that regulation can be burdensome. So I was pleased to learn that the Bank has embarked on a number of projects to reduce the supervisory burden. Certainly, we can do more. But I think we've made progress in this area.

For example, last year the Bank developed and tested a Federal Reserve System project to increase efficiency in the examination process. As with most good ideas, the concept is straightforward — to perform a larger portion of examination work at our Reserve Bank office. This reduces the supervisory burden for banks. This allows examiners increased access to in-house analytical tools. And this reduces examination costs. I should add that our examiners stationed in Des Moines are pioneers in this effort.

In keeping with my theme of working together, I'd also like to comment briefly on the Community Reinvestment Act (CRA). From my point of view, this is an area where it's absolutely essential that we work together. As you know, the CRA regulation has just been re-written from top-to-bottom. It wasn't an easy process. Fortunately, we weren't lacking for input. We received over 7,000 letters of comment from bankers, community organizers and others. In my discussions with bankers and community organizations alike, there seems to be widespread agreement: The new regulation may not be ideal, but it does represent a reasonable compromise and a big step forward. We all share similar goals. We want results, not reports — loans, not lip service. To accomplish this, we must work together.

Monetary Policy

Now, turning to the economic update I promised. Evaluating the state of the national economy is clearly another area where we benefit from good communication. One of the strengths of the Federal Reserve System is that we have access to timely, grass-roots information on the state of the economy, region by region. Our board of directors plays an important role in providing this regional intelligence. Our advisory councils on agriculture and small business also provide us with valuable information.

This grass-roots input is more important than ever because the economy is at such an interesting juncture. Two weeks ago I was in Washington for a meeting of the Federal Open Market Committee, which formulates national monetary policy. As you probably know, the FOMC decided at that meeting that inflationary pressures had receded enough to accommodate a modest adjustment in monetary conditions. More specifically, the federal funds rate was allowed to decline by 25 basis points, from 6 percent to 5¾ percent. I'd like to bring you up-to-date on how we reached this point, and let you know how things look for the future.

First, let's look back to the start of 1994. The economy had picked up steam after the doldrums of the early '90s. It was expanding rapidly. We had very legitimate concerns about an unsustainable pace of expansion and mounting inflationary pressures. The goal at the start of 1994 was to eliminate inflationary pressures before they had a chance to build. So in February of last year, we started to take action. There was some controversy at the time as to whether the shift was appropriate, whether we were jumping the gun. I wasn't there at the time, but I think the Fed did the right thing.

As it turned out, we had unusually strong growth during 1994. Real GDP grew at 4.1 percent. You might ask why we didn't just let the economy keep rolling along at that pace. The answer is because 4.1 percent growth is simply not sustainable. The economy's real potential is closer to 2½ percent. Growth much beyond that really can't be sustained without accelerating inflation. That's why we took action.

So much for 1994. Let's take a look at this year. Our 1994 actions clearly had an impact on the economy in 1995. We've definitely seen signs of moderation. And while there is some uncertainty, in general I'm optimistic about the future. The key point I'd like to highlight is that, despite the difficulty in forecasting economic turning points, the economy does not appear to have any significant imbalances that might lead to a recession. The economy needs to be on an even keel to operate at full efficiency — like a massive schooner with just the right amount of wind in its sails to cut through the water at a steady clip.

As for the moderation I just mentioned, we had economic growth of 2.7 percent in the first quarter of this year, compared with 5.1 percent in the last quarter of '94. The numbers are not available yet, but it looks as though growth slowed appreciably again in the second quarter of this year. This slowdown was most noticeable in areas sensitive to interest rates, such as autos and housing. It eventually spread into other areas such as appliances and other durable goods. Some stores and factories were caught with excessive inventories, particularly in the auto industry. Now, with the second quarter over, we're seeing signs that the economy might be picking up again.

Other recent signs indicate that inflationary pressures have receded. We're not seeing symptoms of an overheated economy, which could spark inflation. For example, capacity utilization rates have declined. At the same time, there's been a speed-up in the delivery of materials to factories, indicating a slowing in demand and possibly less upward pressure on prices. Fewer purchasing managers are reporting increases in what they pay for materials used in production. We're also hearing anecdotal evidence here in the Seventh Federal Reserve District that pressures are fading. There are reports that some price increases for steel are being renegotiated. Auto-part makers are reporting pressure from the Big Three to cut prices. Freight haulers report that increased competition is pushing shipping rates down.

Now it's true that the core Consumer Price Index (CPI) increased 3.6 percent in the first half of 1995. That's higher than the 2.6 percent rate we had last year, but the positive news is that there has been a gradual reduction so far this year from month-to-month. Some of the underlying cost structure that was generated last year had carried through into early 1995, but it appears that our actions during 1994 are taking effect.

On the employment side, the nation's jobless rate has fluctuated between 5.4 percent and 5.8 percent all this year. The Midwest continues to perform well compared with other regions. Labor markets here are still relatively tight, with unemployment numbers generally well below the national average. In May, for example, Iowa was at 3.3 percent — a 20-year low.

Let's take a look now at what's ahead. Let's look at four key areas: the consumer sector, the business sector, government and the international arena.

- **Number one –** the consumer sector. We're seeing new life in this area. Retail sales data for June was stronger than expected, and we're not experiencing widespread pessimism. We expect consumer spending to continue rising in the second half of the year, but at a moderate pace. Lower interest rates should stimulate the housing and auto sectors. In terms of residential investment, we expect a modest rebound in the second half of 1995 as a result of lower mortgage rates. Thirty-year, fixed-rate loans have dropped from about 9¼ percent in early January to around 7½ percent.

- **Number two –** the business sector. Capital spending is expected to continue to be strong, although the pace of growth will slow from the double-digit rates we had last year. Competitive pressures are encouraging firms to continue spending for equipment that enhances productivity — even in the face of moderating demand for their products. With no large build-up in debt and lower long-term interest rates, firms are in a good financial position to undertake additional capital spending. As I mentioned, there's been an excess build-up in inventories, especially in the auto industry. Factories have been trimming production to bring inventories back in line with sales. Most 1995 forecasts have this modest inventory correction decreasing our 1995 rate of growth by one or two percentage points.

- **Number three –** government. The government sector, at all levels, continues to face fiscal constraints. As for the federal government, momentum for deficit reduction is strong. In the short term, less government spending might mean less stimulus to economic activity, but that should not be a significant problem. If a meaningful deficit reduction can be accomplished, that would have a positive impact on the economy overall. Long term, a smaller deficit will be a major plus because the government will be borrowing less. That will tend to lower interest rates and stimulate private investment. And that will set the stage for higher productivity and a better standard of living in the future.

- **Number four –** the international arena. At the start of 1995, we were expecting solid growth abroad. The Mexican crisis took some of the wind out of our sails, but that situation is stabilizing. However, Japan's economy has stalled, and Canada's growth has slowed more than expected. So, in general our forecasts for growth abroad have had to be scaled back. That will have an impact on exports and this country's overall economic growth. Exactly how much is difficult to say.

In summary, while we've experienced slowing, we're still seeing no significant imbalances. We've had some softening, but coming out of the second quarter, improvement has been fairly solid. With inflation likely to be lower than expected, the reduction we provided in short-term interest rates was appropriate. Will we need to take further action? No one could answer that question with complete certainty. We will, of course, continue to keep a close watch on the economy. It appears that businesses are adjusting their inventory levels to the desired slower pace of the economy. It seems unlikely that the U.S. economy will move into recession in the near future. That's reflected in our outlook for 1995. We anticipate real GDP growth of approximately 1½ percent or slightly higher for the year. The increase in the CPI is expected to be about 3 percent or slightly higher. And we see a year-end unemployment rate of about 6 percent.

To conclude, I'd like to reiterate the importance of a healthy communication flow, whether it's within the realm of financial services, supervision and regulation, or monetary policy. Ultimately, we all share the same goal: an efficient, stable financial system and a healthy, growing economy. Current conditions will vary, and we must respond accordingly. In the long run, however, our actions must be consistent with the Federal Reserve's goal of price stability. High inflation distorts incentives to save and invest. Low inflation allows for efficient savings and investment decisions. For this reason, price stability is a goal we should all share. Working together toward this is the best way that we can help ensure a healthy, vibrant economy.

Thank you very much.