ILLINOIS MORTGAGE BANKERS ASSOCIATION BREAKFAST

Chicago, Illinois
December 2, 1997

Overview of the Economy

I'd like to discuss two topics that are directly related to the interests of mortgage lenders. One is what you might expect from a Fed Bank president and, probably the reason you're here this morning — an overview of the economy.
The other may surprise you. You may not think it's a responsibility of the Fed. But it is. In fact, it's one of our most important responsibilities — promoting fair access to credit, including mortgages.

First, let me take a couple of minutes to provide some background on the Fed. The Fed's mission as the nation's central bank, of course, is to foster a safe and sound financial system and a healthy, growing economy: We formulate monetary policy. We supervise and regulate banks. And we provide financial services to the U.S. government and banks and thrifts.

The Fed consists of 12 regional Reserve Banks, which are overseen by the Board of Governors in Washington, D.C. The Chicago Fed serves a five-state region consisting of most of Illinois, Indiana, Michigan, and Wisconsin, and all of Iowa. Our head office is in Chicago. We have a branch in Detroit and offices in Des Moines, Indianapolis, Milwaukee, and Peoria.

The Fed's job that gets the most headlines, of course, is formulating monetary policy. The Federal Open Market Committee, or FOMC, is the Fed's key policymaking body, which determines the course of monetary policy. The FOMC is made up of the seven members of the Board of Governors and five of the twelve Reserve Bank Presidents, who vote on a rotating basis. However, regardless of their voting status, all of the presidents attend the meetings and take part in the discussions. This year, I'm the voting member from the Midwest. Our next meeting is December 16.

One of the advantages of the Fed System is its regional orientation. Each of the Reserve Banks has a certain amount of freedom to develop new ways of accomplishing its goals. I'd like to briefly discuss an innovative project initiated by the Chicago Fed to help ensure fair access to credit. Fair access is a topic I'm sure everyone in this room is interested in. And one that the Fed has advocated for years. In fact, promoting fair access was a basic concern when the Fed System was established in 1913. And it still is. We have responsibility for administering many of the housing-related and fair-credit laws such as the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Community Reinvestment Act.

However, the project I'd like to discuss isn't a regulatory initiative. As you know, barriers to fair access can develop anywhere in the home-buying process. So the Chicago Fed organized a partnership of everyone involved in the mortgage lending process. We call it the Mortgage Credit Access Partnership, or MCAP, for short. Its purpose is to achieve fair access to mortgage credit and housing in the Chicago area. You may have read about it a couple of weeks ago in the real estate section in the Sunday Tribune.

It's a partnership in the truest sense of the word. We brought together a wide range of people involved with home buying—realtors, appraisers, lenders, insurers, secondary market participants, mortgage brokers, community group leaders, and, of course, mortgage bankers. To bring these people together, we worked with over a hundred organizations ñ including the City of Chicago, the Urban League, the Latino Institute, the Woodstock Institute, the Commercial Club of Chicago, and the Illinois Mortgage Bankers Association. All these organizations came together — on a voluntary basis — to address issues important to all of us. I appreciate the willingness of organizations such as the IMBA to take part in this effort.

The MCAP group didn't just discuss housing problems. It's doing something to help resolve them ñ to help eliminate barriers that limit people's access to credit. Let me give you a couple of examples. One initiative was developed in response to the perception that low-and moderate-income consumers have more inaccurate information in their credit files. The partners recommended taking a closer look at the information that credit bureaus receive from their subscribers—the retail outlets and other businesses that use credit bureau services. As you know, the information subscribers provide on a credit problem can be challenged by the consumer involved. The partners developed procedures to identify subscribers that had a large number of challenges in low-income neighborhoods. One partner, a major credit bureau, is now analyzing whether subscribers in certain low-income areas report inaccurate information more often than average.

In another example, the partners addressed the problem of the high rate of foreclosures in low-income and minority neighborhoods. As you know, nobody wins in a foreclosure. Not the family that's loses the home, and not the lender who has to write off the loan. The biggest loser is the community because foreclosures can lead to abandoned buildings and deteriorating neighborhoods. Two of the MCAP partners — the Neighborhood Housing Services of Chicago and the Consumer Credit Counseling Services of Greater Chicago — took the initiative and are working to turn the lose/lose situation of a foreclosure into a win/win situation.

They set up a program in which they work with lenders to identify early delinquencies and then work with borrowers to help them avoid foreclosures. I expect the program will help reduce foreclosures in neighborhoods that need the stability of homeownership. Everybody wins ñ the homeowners, the lenders, and the community.

This is the way we hoped it would work. People taking action to bring about meaningful change in the home-buying process.

I'm very excited about the partnership and think there'll be other initiatives as people see more and more successes coming from the program. By the way, the full report of the MCAP recommendations is available in the back of the room. I encourage you to take a copy.

Let me turn to my second topic this morning, the economy. Overall, the economy has performed remarkably well this year. Real GDP increased at an annual rate of 3.8 percent during the first three quarters of the year. The unemployment rate fell to 4.7 percent in October, its lowest level in 24 years. And the core Consumer Price Index, which excludes food and energy prices, is up only 2¼ percent from a year ago. That's the lowest inflation rate in over three decades. This is an impressive performance, especially since we're in the seventh year of expansion.

A key issue during the course of the year has been the potential for inflationary pressures. In the past, of course, inflation usually started to accelerate when growth was so strong and the unemployment rate fell to such a low level. Instead, we've seen inflation move lower.

Why haven't we seen history repeating itself? There's a number of factors that seem to have played a role. A few are temporary; some may be more permanent.

One of the temporary factors is the strong dollar, which has contributed to a fall in import prices. That's helped to keep inflation down. But of course, we can't count on import prices reducing our inflation rate forever.

Another temporary factor is slower growth in benefits costs for many businesses, particularly health care costs. Again, this trend could continue for a while. But we're beginning to see reports that employer costs for health benefits may rise more rapidly next year. For example, one report indicated that firms will face HMO rate increases that are twice what they were in 1997.

There's another factor that may not be temporary. It's possible that trend productivity growth may have risen to a higher level as a result of strong investment in computers and other high-tech equipment. Such investments have increased at double-digit rates for the past five years. The U.S. may finally be getting the return on that investment in the form of higher productivity growth.

Productivity growth, of course, is essential because it's one of the key elements that determines how fast our economy can grow without triggering inflation. Has trend productivity growth increased? The evidence is mixed. The strong business profits in recent years are certainly consistent with higher productivity. But until recently, the official statistics didn't show any change from the 1.1 percent average annual increase we've seen over the past 25 years. However, the latest data indicate that productivity was up at twice the trend rate in the second quarter and four times the trend rate in the third quarter.

Is this recent pickup a temporary, cyclical phenomenon? Or does it reflect a more permanent increase—an increase that could reduce the potential inflationary pressures generated by tightness in the labor markets? We don't know yet. It'll be some time before we'll know the extent of any lasting improvement in productivity and its effect the economy.

So what are our expectations for 1998? Overall, we expect that the economy will continue to grow at a healthy rate in 1998, though at a slower, more sustainable pace than in 1997. We anticipate that the rate of inflation will accelerate slightly and that the unemployment rate will be similar to what we experienced in 1997. We forecast the national economy on a regular basis and we'll be refining our thinking on the1998 economy in the coming weeks as we prepare for the Fed System's monetary policy report to Congress in February.

As part of our information-gathering process, the Chicago Fed holds an economic outlook symposium, which brings together more than 50 analysts and economists from business, government, and academia in our five-state Federal Reserve district. Each year, we ask participants to submit a forecast prior to the annual meeting. The conference won't take place until Friday, but here's an advance look at the forecasts we've received thus far. Participants expect that real GDP growth for the nation will be 2.6 percent during 1998, with the Consumer Price Index increasing 2.4 percent and the unemployment rate averaging 4.9 percent. The group expects that housing starts will continue at a healthy clip next year, only slightly below 1997 levels. Car and light truck sales are also expected to continue at a healthy pace, decreasing only slightly to 14.8 million units during 1998.

Of course, a central banker is paid to worry and there are some potential concerns. Let me mention two. First, some consumers have accumulated quite a bit of debt and we continue to monitor debt servicing burdens and the level of delinquencies and bankruptcies. We're also monitoring credit underwriting standards at banks. As you know, there's sometimes a tendency to loosen standards during good economic times.

Second, recent events in Asian financial markets have complicated the task of economic forecasting. It's too early to fully evaluate the impact of the turbulence in the Asian markets. Clearly, though, it highlights the importance of a sound banking and financial system. Problems in a nation's financial system have a ripple effect on the rest of the domestic economy. And serious problems in one nation's economy and financial system can't be ignored by other countries in today's interconnected world.

While it's hard to sort out all of the causes and consequences of the Asian situation at this point, there are some lessons from the past that are useful to review. As you all know, this isn't the first time we've had such financial disturbances. So how can we prevent bank crises?

The Chicago Fed co-sponsored a conference with the World Bank last June in which we looked at that very question. Leading researchers and regulators from countries that had experienced problems took part in the conference. We had participants from Europe, Asia, and Latin America. Participants agreed that in almost all cases a bank crisis can be traced to large credit losses, which are usually triggered by instability in the macro economy. This is true in highly developed countries as well as developing countries with untested supervisory systems. Those taking part in the conference generally agreed on what needs to be done.

First, it's essential that banks provide accurate and truthful information on their current condition. A transparent accounting system is perhaps the most basic requirement for efficient financial markets. The rules for preparing financial statements must be clearly specified. These statements communicate vital information to creditors, investors, commercial counterparts, and regulators. This is particularly true of banking where there's a need for better information on hidden reserves, loan loss provisions, nonperforming loans, and off-balance sheet commitments. The recent problems in Asia clearly show how important it is to have a consistent set of standards to monitor and control risk-taking. Market values don't change overnight. Better, more timely information will help prevent the type of surprise that can trigger a crisis.

A second key factor is market discipline. Accurate, timely information fosters market discipline. And market discipline is often more effective than regulation. I should note that using market discipline requires having an appropriate infrastructure, such as laws covering bankruptcy and the rights of creditors in seizing or disposing of assets. But market discipline is invaluable, assuming that the basic infrastructure is in place. The major advantage of market discipline is that it helps to prevent a crisis from happening in the first place. That's obviously preferable to a regulator coming in after the-fact to clean up a problem.

That brings me to a third issue discussed at our conference. In many cases banks have made lending decisions based on politics rather than economics. This was true for state-owned banks as well as private banks. In effect, these banks existed to allocate credit to sectors favored by the government. You can guess the results. A growing economy can hide poor lending practices for a while. But eventually the economy slows and loans turn sour.

A fourth issue is shielding regulators from political influence. During our conference, participants cited several examples in which there were appropriate rules and regulations but they weren't enforced. In each of these cases, regulatory enforcement was lax or non-existent. The inability or unwillingness to enforce necessary regulation has been costly in a number of situations.

Finally, if a crisis does occur it's essential for regulators to act in a timely and decisive manner. Regulators have to meet the problem head-on. And the markets must know that the regulators are serious. Governments and regulators are usually under political pressure to delay a necessary action that they know will be painful and unpopular. However, the longer the delay, the more serious the problem.

These periods of financial stress also highlight the importance of maintaining effective monetary policy in conjunction with sound fiscal policy and efficient financial systems. One recurring theme is that banking crises usually can be traced to large credit losses triggered by instability in the macro economy.

How can the Fed help ensure a stable, growing U.S. economy? Focus on price stability. This conclusion is hardly surprising coming from a central banker. Some people see a trade-off. They're willing to accept higher inflation in exchange for faster economic growth. I wish it were that easy. In the long run, there's no trade-off. High inflation leads to lower growth.

We need to keep in mind that the economy's real potential is determined by two factors:

- Labor force growth, and
- Productivity growth.

These two factors determine how fast the economy can grow. They are the nutrients of our economic diet.

Inflation, on the other hand, is junk food. It's a sugar high. Once people anticipate inflation, they act to protect themselves from higher prices. With prices rising, they make fewer long-term investments, and — instead of saving — they spend more on consumer goods today to beat higher prices tomorrow. Sure, some people profit when inflation skyrockets. But many others are hurt, especially those on the lowest rungs of the economic ladder.

An economy that grows at a solid, sustainable pace may not be exciting. But a roller-coaster economy is a losing proposition in the long run. As the great tennis instructor Vic Braden once said, "Losers hit a wide variety of shots, but champions keep hitting the same old boring winners." That's what I want to see — the same, old boring winners.

Ignoring inflation may seem to be an easy way to boost growth — in the short term. But in the long term, it's a prescription for low employment and stagnant growth. The cure is painful and is best avoided — prevention is the best medicine. In the long run you need a foundation of stable prices to achieve maximum sustainable growth — that's the best way we can assure a healthy, vibrant economy for many decades to come.

Thank you.