INDIANA CORPORATE CREDIT UNION (INDICORP) ANNUAL ECONOMIC FORUM

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I. Introduction

A. Good morning. I'm pleased to be here and appreciate the invitation.

- Conferences like this provide me with a chance to discuss some issues related to the Fed, but more importantly they give me a chance to hear your ideas and questions.
- The importance of soliciting and responding to feedback from our customers and stakeholders is something we're stressing at the Chicago Fed.

B. This morning I'd like to discuss three areas where we work together — financial services, Year 2000 preparations, and the economy. But first, let me give you a little background about the Federal Reserve.

C. As the nation's central bank, our mission is to foster a safe and sound financial system and a healthy, growing economy. We have three main responsibilities

- providing financial services to depository institutions and the U.S. government;
- supervising and regulating state member banks and bank holding companies;
- and formulating national monetary policy.

D. The Chicago Fed is one of 12 regional Reserve Banks and serves a five-state area consisting of most of Indiana, Illinois, Michigan, and Wisconsin, and all of Iowa.

- We have a head office in Chicago as well as offices in Detroit, Des Moines, Milwaukee, Peoria, and Indianapolis.

II. Electronic Banking

A. Turning now to financial services, I'd like to discuss electronic payments. Let me read you a prediction.

- "In banking…the advances of yesterday are merely a faint prologue to the marvels of tomorrow. In our lifetime we may see electronic transactions virtually eliminate the need for cash."

- Many people would agree with that statement today. However, that prediction was made back in 1965, by Thomas J. Watson, then president of IBM.

B. We're still not close to a paperless or even a checkless society. But there is growing momentum in the electronic payments area. Electronic payments seem to be tantalizingly close to achieving critical mass. Consider the following statistics:

- The dollar value of ACH transactions last year was more than $11 trillion — almost a 10 [9.9] percent increase from 1996.

- Over 200 million debit cards were issued by U.S financial institutions last year.

- On-line business transactions totaled an estimated $7.5 billion in the U.S. last year. Many project a dramatic increase during the next four years.

- A very small percentage of U.S. households used Internet banking last year — no more that 1 or 2 percent. But some estimate usage will accelerate quickly in the next two years.

C. But Americans still wrote about 63 billion checks and share drafts, last year. According to one study, the average American signs about 270 checks each year; the average German signs 10.

D. Why is it important to use electronic payments?

- I know I don't have to convince you about the importance of electronics payments. You're already moving full speed ahead with your recent agreement with the EFT network, Magic Line (R). This is clearly the direction to be moving.

- I firmly believe our financial system is enhanced by the use of more efficient, cost-effective electronic payments.

- So a shift to electronics is very much in keeping with the Fed's mission to foster a healthy economy and a stable financial system.

E. I say that even though check services provide the Fed's main source of service revenue.

- Ideally, I'd like to see our check service evaporate as electronic payments become more popular. But, as I said, we don't expect that any time soon.

- According to one estimate at a recent Chicago Fed conference, the share of noncash, electronic transactions is expected to rise from 23 percent in 1995 to nearly 50 percent by 2010.

- That's a dramatic increase in electronics, but we'll still have a lot of checks.

F. So why do checks remain so popular?

- From a check services provider's perspective, checks can have a significant impact on profits.
- The check product can add to an institution's revenue stream by encouraging the use of other services and can actually be a cash cow.

G. There's also the network problem.

- The value of signing on to a new electronic payment network depends on a lot of people and businesses being able and willing to accept the payment.
- At the same time, people and businesses are unwilling to invest in new payment processing equipment unless they are sure a lot of payors will use it.

H. From the perspective of customers, checks are a good deal since institutions tend to bundle checks with other services.

- As a result, customers don't always pay the actual costs of processing. This has reduced the incentive to move to a more efficient alternative.
- The experience in Norway offers an interesting example. After unbundling its prices ten years ago, Norway went from having only 10 percent of noncash payments in electronic form to 60 percent today.

I. The Federal Reserve is working with depository institutions to encourage the use of electronic payments.

- As you may know, a committee of Fed officials, headed by Alice Rivlin, Vice Chair of the Federal Reserve, examined the role of the Fed in the payments system.
- One of their key recommendations was that the Fed work closely with depository institutions on ways to expand electronics.
- For example, we're exploring ways to encourage greater use of the ACH network to reduce the total number of checks and improve the efficiency of the payments system.

J. Can credit unions play a role in encouraging electronic payments? Yes, they certainly can.

- In a recent Federal Reserve study, we found that consumers rely primarily on their financial institution for information on electronic services.
- The message here is clear — You have the power to influence your customers' attitudes about electronic payments.
- The study also found that direct deposit has the greatest potential for attracting customers to electronics. Many consumers expressed an interest in direct deposit, but fewer than half receive their payroll by direct deposit.

K. The study also showed that consumers are not the only ones with misunderstandings about electronic payments.

- Many businesses consider direct deposit an employee benefit, rather that a cost saver for the business.

- I find that particularly curious since the cost savings of not producing and distributing paper checks seems so obvious.

III. Year 2000

A. Let me move to another important area where we're working closely with you — Y2K. By now all of you know that Y2K is not a droid in the new Star Wars movie, but a computer problem we're all facing.

B. The main responsibility for resolving the problem rests with individual depository institutions, including the Federal Reserve. To this end, we're giving the highest priority to preparing all our computer systems.

C. We've begun testing interfaces with customers and vendors.

- These tests have been available 19 hours a day since July and will be available through 1999.

- If you need to test with us, I urge you to schedule your test as soon as possible. We'd all like to avoid a last-minute rush during the 4th quarter of 1999.

D. In addition to renovating our own systems, the Fed, the National Credit Union Administration, and the other supervisors are working to help the financial community prepare.

E. First, it's important to clarify that federal regulators can't solve the problem for the industry. Each institution must complete its own renovation program, test its own applications, and manage the additional risk.

- Ultimately, each institution's board of directors and senior management is responsible for assuring that their institution is compliant.

- For this reason, the Fed and the other federal regulators strongly encourage regular reporting to the board of directors on Year 2000 renovation efforts.

F. The Fed and the other supervisors have taken a two pronged approach: education and guidance, on the one hand, and strong incentives on the other.

- The education program consists of coordinated advisory statements from all federal regulators, supervisory letters from the Federal Reserve, and an extensive series of seminars and conferences sponsored by regulators.
  - At the Chicago Fed we've had over 60 seminars attended by a cross section of the financial community. We have almost 30 more sessions planned through November.

- On the incentive side, the Fed and other federal supervisors are monitoring and enforcing Year 2000 readiness for depository institutions.

G. What are we looking for? Each institution must have a written testing strategy and plan in place. At this stage, they should have almost completed renovation of their mission-critical systems and should be testing interfaces.

- By June 30, 1999, mission-critical testing must be complete and non-critical systems renovated and into compliance testing.

- Unfortunately, even the federal regulators can't change the date of the millenium, and we can't grant any extensions.

H. There are several areas of particular concern.

- One is whether hardware and software products from third-party vendors are Year 2000 compliant.

- More than 90 percent of depository institutions use service providers or vendor software to process critical information.

- These institutions can't take the vendor's word that products are compliant. All vendor software must be tested in the institution's operating environment.

- There have unfortunately been too many cases of supposedly renovated software that failed when tested in the institution' operating systems.

I. It's also essential to ensure that any Y2K risk from customers is well-controlled.

- All depository institutions were required to implement a risk management process to assess the Year 2000 risks posed by customers by June 30th of this year.

- The emphasis here is on controlling risk, not managing the borrower's compliance of Y2K. Our goal is to help avoid business interruption.

J. Another issue I'd like to mention is liquidity. The Federal Reserve is prepared to meet any unusual demands.

- As one of our customers, you can check your balances with us, through regular channels at any time during the day.

- Our discount window is available to lend to institutions with adequate collateral, under appropriate circumstances, and with proper documentation.

- As always, we will work with you to ensure that you have enough currency on hand to meet your customer demands.

IV. Economy

A. Finally, I'd like to say a few words about the economy.

B. On the national level, as I'm sure you know, the FOMC recently eased the stance of monetary policy somewhat, reducing the intended federal funds rate from about 5½ percent to 5 percent in a period of just over two weeks.

- As the FOMC noted on September 29th when it announced the first policy change, the action was taken to cushion prospective U.S. economic growth from the effects of increasing weakness overseas and less accommodative financial conditions domestically.

- On October 15th, the Fed announced a second policy action. The intended Fed funds rate was reduced another 25 basis points, and the discount rate was lowered from 5 percent to 4? percent.

- At that time, the Federal Reserve noted that growing caution by lenders and unsettled conditions in financial markets are likely to restrain aggregate demand in the future.

- These actions are expected to contribute to sustaining economic growth in the future with inflation remaining contained.

    B. To understand where the U.S. economy is going and these changes in monetary policy today, I think you have to consider where we've been. In the last few years, inflation and unemployment rates have been quite low.

- The Consumer Price Index (CPI) last year increased only 1.9 percent—the lowest since 1986. During the first nine months of 1998, the CPI has risen at a 1.4 percent annual rate.

- At the same time, the unemployment rate has fluctuated between 4? percent and 4 ? percent during the past twelve months. The last time unemployment rates were consistently this low was nearly three decades ago.

C. Given this experience in 1997 and earlier this year, a paramount concern of the FOMC was a possible rekindling of future inflationary pressures.

- Although inflation is currently low, monetary policy must always be forward-looking. Our concern about future inflation was generated in part by strong growth in real GDP during the last two years—3.9 percent in 1996 and 3.8 percent in 1997.

- During this period, consumer confidence was very high, employment and personal income were growing strongly, and financial wealth increased due to surging stock market values.

    D. Not surprisingly, rising consumer expenditures were an important part of the increase in real GDP. At the same time, business investment was growing smartly for many similar reasons: financing was available, and growth prospects were strong.

E. Strong real GDP growth through 1997 suggested that the growth in aggregate demand couldn't be sustained at that pace over the long term. Unfortunately, excessive growth in aggregate demand is often accompanied by increasing rates of inflation.

- For this reason, as Chairman Greenspan has testified, the FOMC kept the inflation-adjusted real federal funds rate at a relatively high level in 1997.

- The goal of this moderately restrictive monetary policy was to have the economy gently return to its sustainable growth path, which economists generally estimate to be around 2 ? percent.

F. Beginning in mid-1997, however, other economic events began to unfold, these have since accumulated to the point of potentially restraining U.S. aggregate demand more than desired.

- The financial crisis that began in Thailand spread throughout East Asia.

- As expected as recently as the fall of 1997, U.S. export growth slowed due to lower demand in Asian countries and a strong dollar against Asian currencies.

G. Last year, the U.S. shipped 28 percent of its exports to Asia. That figure dropped to 24 percent during the first half of 1998.

- On the import side, we've seen an increase in Asian imports of about 6 percent in dollar terms compared to a year ago.

- The prices of these imports are well below year-ago levels. So the developments in Asia have helped to dampen inflationary pressures here in the U.S.

H. Even with this international drag on the U.S. economy, it was unclear as recently as this summer whether the Asian crisis would offset the strong economic fundamentals propelling the U.S. consumer and business sector forward. In some ways the Asian crisis has actually boosted domestic spending.

- The flow of international capital seeking a safe haven in the U.S. has contributed to a decline in medium- and long-term interest rates.

- The low rates have helped fuel buying of homes, consumer durables and business equipment.

- Consequently, the moderately restrictive monetary policy in place this past summer could still be viewed as balancing the economic risks facing our economy.

I. However, further developments overseas have added risks to our economy.

- The developments in East Asia were accompanied by further financial problems in Russia in August. The current situation in Brazil and other Latin American countries further added to the uncertainty.

- One indication of the increased risks in the global economy was the change in the world economic outlook by the International Monetary Fund.
  - Last May, the IMF forecast 3.1 percent world GDP growth during 1998. On September 30, The IMF revised its forecast to 2 percent.
  - The downward revision for world growth during 1999 was even more dramatic—from 3.7 percent to 2.5 percent.
  - And frankly, these projections are a bit optimistic compared to other business analysts' forecasts.

J. The full extent of the after-shocks to our domestic economy is hard to gauge.

- Financial developments have quickly turned investors away from additional risk-taking investments. Investors' appetite for risk has clearly declined.
- As managers of financial funds reweighted their portfolios towards less risky assets, market volatility increased.
- A world-wide financial flight to quality increased spreads between private bonds relative to U.S. Treasury securities, which are considered a safe haven.
- In this environment, there are growing concerns that credit-worthy borrowers may find it difficult to obtain credit for productive investment opportunities in the coming months. Some companies have cut back on their borrowing in the capital markets.
- And Federal Reserve surveys and other sources indicate that banks are less willing to lend to some borrowers.
- Although the jury is still out on these questions, the risks to the U.S. economy seem to have swung towards slower growth in aggregate demand.

K. Looking forward into 1999, the FOMC's monetary policy stance has evolved with these risks in mind.

- Financial market volatilities have already reduced consumer wealth substantially, and continuing pressures on corporate profit margins and widening risk spreads have increased the costs of capital investment.
- It will be difficult for the components of aggregate demand that strongly propelled the U.S. economy in 1996, 1997, and the first half of 1998, to continue to drive growth rates of spending at their previous extraordinarily high rates of increase.

L. Of course, everyone has been expecting consumer and business spending to slow in 1999. The risk, and it's only a risk at this point, is that this slowing will be too quick. In any event, these factors most likely will offset some of the potential inflationary consequences from tight labor markets.

M. For these reasons, in late September and again last week, the FOMC moved to ease monetary policy somewhat.

- The Fed acted to cushion the effects on prospective economic growth. Monetary policy works like a time-release capsule, with a lag of a year or even longer. So it's necessary to anticipate developments rather than wait until after the fact.

- Given this background, the FOMC felt that events overseas and the resulting adjustments in U.S. financial markets meant that a moderate change in policy would be consistent with achieving the Fed's goal of low inflation and sustainable economic growth.

V. Conclusion

A. In conclusion, I'd like to stress the Chicago Fed's commitment in being responsive to the needs and concerns of our customers and stakeholders. I hope that was a recurring theme in each of the areas that I covered.

- Whether it's working with depository institutions to develop more efficient electronic services, helping them resolve the Y2K problem, or formulating monetary policy that fosters long-term sustainable growth, the Fed can profit by soliciting and responding to our stakeholders.

- One of the advantages of a regional central banking system is the increased opportunity to hear directly from people affected by monetary policy, and the services we provide.

B. So I thank you for your attention and I look forward to hearing your comments and suggestions.