WISCONSIN BANKERS ASSOCIATION

Phoenix, Arizona
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I. Introduction

A. Thank you, Alan [Langeteig, senior vice president, First Business Bank, and chair of WBA Bank Management Committee] It's a pleasure to be here. Judging from the weather, it's clear we're not in Wisconsin. I assume you scheduled this seminar here because all the hotels in Green Bay were booked.

B. I've been interested in speaking before the Wisconsin Bankers Association (WBA) for a number of years, but I wasn't able to avoid conflicts on my calendar until this year. So I'm truly pleased to have this opportunity.

   1. I was interested to learn that the WBA is the recipient of the Personal Economics Program Award from the American Bankers Association for outstanding achievement in teaching children the basics of financial management and saving.

   2. This is truly an important task and an achievement to be proud of.

C. As Alan said, I'm an economist by trade. One task economists are called upon to do is make forecasts — a very dangerous undertaking.

   1. Just think of all the unusual things that happened in the last 12 months, including the warm weather in Wisconsin. Who would have forecast that?

   2. If someone told you a year ago that we'd have near 70 degree temperatures in Wisconsin in February or that the Cubs would make the playoffs, or that a former pro wrestler would be elected a state governor, you probably would have written off that person as member of the lunatic fringe.

3. The economy is about as unpredictable as the weather, sports, and politics. That's why the old rule of thumb for economic forecasters is to give a number or a date, but never both.

D. I'll break that rule in a few minutes, when I discuss the current outlook for the national economy. But first, I'd like to give you a little background about the Fed and then discuss the state of banking in Wisconsin and a topic of great concern to all of us — Y2K.

II. Federal Reserve System

A. As you know, the Fed is 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—

1. providing financial services such as check processing and electronic payments to depository institutions and the U.S. government;

2. supervising and regulating state member banks and bank holding companies;

3. and formulating national monetary policy.

B. 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, Indianapolis, Peoria, and Milwaukee.

III. Wisconsin Economy and Banking

A. As I said, one of the Chicago Fed's responsibilities is supervising banks and, from our perspective, Wisconsin banks are in excellent shape.

1. Earnings are solid. In 1998 Wisconsin banks earned $780 million, a 4.6 percent increase in net income from the previous year.

2. The Return on Assets was 1.09 percent, about the same as 1997, and roughly equal to the U.S. average [1.14%].

B. Wisconsin banks have enjoyed strong loan growth of almost 11 percent [10.63%] in 1998. This exceeds the U.S. average of about 9 percent [8.89 %].

C. The percentage of nonperforming loans to total loans remained stable [0.76%] in 1998, below the national average [0.94%] for the first nine months of 1998 — the latest number we have. Wisconsin has a low level of problem commercial and industrial loans when compared to the other Midwestern states and to the U.S. average.

D. So, as I said, Wisconsin banking is in good shape. That's important, because we have a critical challenge coming up—Y2K.

IV. Year 2000 preparations

A. Y2K is the top priority for the Fed, and the topic of the year for the financial sector and the public at large. Between now and January 1st, all of us — the public, banks, and the Fed — have important roles to play.

B. The public's role is to maintain perspective, use common sense, and not overreact. As a country, we've worked together to meet important challenges in the past. I'm confident that the public will keep the Year 2000 in perspective, realizing it's one more challenge we will meet.

  1. To meet this challenge, however, we need to provide the public with reliable, accurate information. Lately we've seen that consumers are getting conflicting messages about steps they should take to prepare themselves for Year 2000 — often these messages include information related to the banking industry.

  2. It's important that the industry aggressively combat misinformation that confuses the public.

C. I'm pleased to see that the WBA is taking the initiative to help prepare its members and the public. I was particularly impressed with the "Y2K and other patches" site on your Web page.

  1. At the Fed we're also doing our part to get the message out about our preparations and the readiness of the banking system. Like the WBA, we have Y2K information on our Web site.

  2. In addition, Fed officials have discussed Y2K at Congressional hearings, industry conferences, and public meetings.

  3. And we're working with the media to help disseminate accurate information. The public has a strong need for accurate information. That's why the Fed is taking an active role in Y2K communications. We believe it's important and in the best interests of each bank to do the same.

D. No one can say there won't be any glitches, but we're confident that the financial system will be prepared. The Federal Reserve is committed to doing all we can to safeguard the stability of the U.S. financial system.

  1. As you know, the Fed and financial institutions are making extensive preparations and things are going well. The Fed has set some very ambitious goals for certifying our internal systems and we've met all of them so far.

  2. Our most important systems are compliant and are now in daily use. Our remaining systems are on target to be fully compliant by March 31st. We're also developing detailed contingency plans to handle any glitches that occur in the early days of 2000. We expect that any Y2K problems will be of limited duration.

  3. The Federal Reserve has vast experience in handling disruptions such as national disasters. We've learned how to keep banks open and critical systems going.

E. We've also made significant progress in working with banks that use our financial services. We began testing with banks and thrifts last June. More than 6,000 of the Fed's customers across the nation have already conducted tests with the 12 Federal Reserve Banks.

F. Regarding the readiness of banks, we're working closely with the other regulators to review the preparedness of the financial institutions we supervise.

1. Ultimately, it's up to the banks to ensure that they are ready, but the results of our Y2K exams so far indicate that the vast majority of institutions are making satisfactory progress.

2. We don't have any institutions that are seriously behind. In fact, only a very small number of the banks we supervise are not in full compliance with our guidelines.

G. The final phase in our examination program will begin in April.

1. We're taking a risk-focused approach with an emphasis on ensuring that Y2K compliance is completed and that banks have effective contingency plans in place. We don't expect any major obstacles in meeting the final milestones.

2. We're encouraging banks to assess their customer risk exposures for both borrowers and major depositors, and test their contingency plans to assure they'll work.

H. Banks should also project their needs for cash.

1. As you probably know, the Fed has acted to ensure that more than sufficient cash will be available throughout 1999 and 2000. As a precaution, the Fed will increase the currency in circulation and in our vaults to about $700 billion in late 1999—that provides a cushion of about $200 billion to meet any increase in demand.

2. Additionally, the Fed is taking steps to ensure that banks are able to obtain currency quickly to meet their customers' needs. Of course, we also stand ready to lend through the discount window to satisfy extraordinary liquidity needs. It's important that you make appropriate arrangements as early as possible. I strongly encourage you to start thinking about this.

I. To sum up, we've all devoted a lot of time and effort to preparing for Y2K. I'm confident that our work is going to pay off and that our nation's banking system will be prepared for the century rollover.

V. National Economy

A. Let me move to another topic now — our national economy. We're coming off a remarkable year for our economy. As Phil Jackson commented after the Bulls won one of their championships—"It's been a long, strange journey." And, like the Bulls, we ended up last year with a happy result—an excellent year for the economy. The outlook for the economy is still good. Unfortunately, the outlook for the Bulls is more dubious. But then again, maybe the Bulls' outlook isn't unfortunate for Bucks fans.

B. The 1998 economic numbers speak for themselves.

1. Real GDP growth averaged 4.3 percent over the four quarters of 1998.

2. The unemployment rate was 4.5 percent—the lowest level since '69.

3. And inflation, as measured by the Consumer Price Index (CPI), was 1.5 percent — the first time in more than 30 years that CPI inflation has been below 2 percent for two consecutive years.

C. Wisconsin did more than its share in contributing to this strong performance.

   1. The state's average unemployment rate for 1998 was under 3.4 percent [3.4%], the lowest in almost three decades.

   2. The Madison metro area continues to have one of the lowest unemployment rates in the country — was just over 1½ percent at the end of 1998 [1.6%].

   3. When the final 1998 numbers are in, Wisconsin is expected to show solid personal income growth of about 4½ percent [4.4%].

D. So what do I see for the national economy in '99? I'd like to highlight three questions that should have a lot to do with how things shape up this year.

   1. First—and this is one that's always important—Will consumers continue to spend at a rapid rate?

   2. Second—Will businesses continue to invest at a rapid rate?

   3. And third—How will overseas developments affect the U.S.?

E. Let's look at consumer spending first. Last year the major driver of the surprisingly strong economy was the unexpectedly high growth in consumer spending.

   1. Why the spending spree? Some of the key factors were strong employment growth, healthy gains in income, high consumer confidence, and low interest rates.

   2. For example, fixed-rate mortgages averaged below 7 percent for the year—that's the first time that's happened in three decades.

F. A factor that's been in the news a lot is the stock market. The effect of the rise in the stock market on consumer spending is hard to pin down. But it certainly raised the value of household assets and probably increased peoples' comfort level in making major purchases last year.

G. What do we see for consumer spending in '99?

   1. We anticipate that growth in consumer spending will continue at a solid pace, but not as fast as last year.

   2. It looks as though employment growth will not be as strong as the 2.8 million new jobs we created in '98.

   3. This means income gains will moderate and therefore spending growth will slow as well.

   4. In short, consumer spending growth will be very respectable, but slower than last year.

H. The second key question is the pace of business investment.

   1. Like consumers, businesses were heavy spenders last year, increasing their investment at a strong rate of 12¼ percent.

2. But the pace of business investment varied over the course of the year. It started strong in the first half, but was more moderate on average in the second half.

I. One of the reasons for this trend is continued pressure on business profits because of slower growth overseas, higher labor costs, and intense competition, which makes it difficult for firms to increase prices. Overall, growth in business investment should continue at a respectable pace, but not at the high levels of '98.

J. That brings me to my third and toughest question: how will developments overseas affect the U.S.? It didn't take long for the shock wave from Asia to have an effect on the U.S. economy. In 1998 the sharp drop in net exports knocked off more than 1 (verified by Research) percentage point from GDP growth.

K. As expected, some U.S. industries have been hit hard by the reduced demand and lower prices from overseas. Steel and agriculture are notable examples. That's something that's particularly important for the Midwest because we have such a heavy concentration here of these two industries.

L. The ag industry has been hurt by weak prices for corn, soybeans, and hogs.

1. Prices have been weak because of strong domestic production, lackluster foreign demand, and greater competition overseas. Those declines have had a strong effect on farm operations in the Chicago Fed's Midwestern district, particularly in Illinois, Indiana, and Iowa. Wisconsin has been the bright spot in the Midwest because of the state's concentration in milk production.

2. Even as other commodity prices have declined sharply, milk prices have been high by historical standards. Milk prices did drop in February, but were still 9 percent higher than a year ago. Most experts anticipate that milk prices will come down from their current high levels as milk production increases.

M. The relative strength of Wisconsin is indicated by a Chicago Fed survey of Midwestern ag bankers.

1. The survey showed that farmland values in the Midwest increased by only one percent last year, the smallest annual increase since 1991. But there was considerable variation among the states. While Illinois and Iowa decreased by 4 percent and 5 percent, respectively, Wisconsin increased by 12 percent.

2. Our survey of ag bankers shows some potential problems in farm loan portfolios in Illinois, Indiana and Iowa, but it's still too early to know if there is a serious problem. However, ag bankers in Wisconsin have not experienced those problems.

N. In addition to their effect on industries such as agriculture and steel, overseas developments had a dramatic impact on U.S. financial markets.

1. Around the middle of 1998, the problems in East Asia, combined with financial difficulties in Russia and uncertainty in Brazil and other Latin American countries, had a pronounced effect on U.S. markets.

2. There was a dramatic flight to quality and liquidity, a strong aversion to risk. Some pulling back from risk was a rational response. But the extent of the reaction was extraordinary.

O. As a result, the Federal Open Market Committee took action last fall to cushion prospective U.S. economic growth from the effects of increasing weakness overseas and unsettled financial markets at home. Since then we've seen signs of a return to calmer market conditions, but some risk spreads are still high by historical standards.

P. We've also seen some stabilization in the world economic outlook. However, the prospects vary quite a bit from country to country. Canada, Mexico, and Europe are expected to have respectable growth, although slower than in 1998. This is important to the Midwest, which trades heavily with these regions.

Q. The outlook for Latin America, of course, has been the subject of much discussion in recent weeks. Brazil will play a large role in determining the region's economic success. And, as you know, Brazil has experienced some problems.

R. It's still too early to know how this situation will turn out, but it's very important that Brazil make progress in addressing its fiscal deficit problems.

1. Brazil accounts for only about 2 percent of U.S. trade. But it's an important trading partner with other Latin American countries.

2. The health and stability of the Brazilian economy is critical to the economic well being of the whole of Latin America. And Latin America is very important to U.S. trade, accounting for more than 9 percent [9.3 %] of our exports and 5½ percent of our imports.

3. Clearly it's a situation that bears close watching.

S. In Asia, it appears that the worst may be over, but there will be continued economic weakness in the region. Japan is the key factor.

1. Japan has announced programs to stimulate its economy and reform its banking system, but they're unlikely to boost economic growth appreciably in the near term.

2.In fact, most forecasters expect the Japanese economy to contract again in '99.

T. Putting this all together, U.S. export growth will continue to be held back by the weak global economy. But as Asia improves, we should see exports starting to recover during 1999.

U. Perhaps the most notable accomplishment last year for the U.S. economy was that we achieved very low inflation in an environment of strong growth and low unemployment rates. The good inflation results were due in part to temporary factors such as lower oil prices and the strength of the U.S. dollar. So far inflation continues to be benign. But we can't expect temporary factors to dampen inflation indefinitely.

V. We expect that U.S. economic growth will decelerate a bit during '99, but we'll continue to see tight labor markets. All this highlights the need for the Fed to continue to be vigilant about emerging inflationary pressures. It's possible that such pressures may build during 1999, especially if corporate profit margins continue to be squeezed and companies respond by increasing prices.

W. To sum up, the strong economic fundamentals of the U.S. economy propelled growth last year and more than offset the significant shock of the Asian crisis. We experienced a dichotomy between the strong domestic economy and the weak international economy.

X. Looking forward to 1999, I anticipate that growth in consumer spending and business investment will moderate, but so will the negative effects of the Asian crisis.

1. Last fall, the Federal Reserve was primarily concerned that growth could be unduly slowed by unsettled international and financial conditions.

2. Today, I see the risks of slower growth versus inflationary pressures as more in balance than was the case last fall.

Y. Overall, I expect that U.S. real GDP growth will be in the range of 2½ to 3 percent on a fourth-quarter to fourth-quarter basis. We anticipate that inflation as measured by the Consumer Price Index will be 2 to 2½ percent and that the unemployment rate at the end of the year will be about 4½ percent. In other words, we should experience solid economic growth, with continued low inflation and a low unemployment rate.

Z. Unfortunately we run the risk of what you might call the Sammy Sosa syndrome. For years Sosa hit 30 to 40 home runs, a very good performance for a star player. Last year, he hit 66—an extraordinary performance. If he hits 40 this year, some will say he had a bad year. It's a case of unrealistically high expectations.

AA. We don't expect the U.S. economy to have another extraordinary year like 1998. But it certainly won't be a "bad" year. We expect a very solid economic performance — a year in which the economy will grow at a pace that's more sustainable over the long run.

BB. In conclusion, I'd say I'm cautiously optimistic about the national economy. That's not a surprising stance from a central banker and an economist.

1. I recently heard about the tombstone of a famous economist. The inscription on the tombstone read: "I'm guardedly optimistic about the next world but remain cognizant of the downside risks."

2. Our economy is facing an unusual number of unknown factors — potential risks on both the upside and the downside. But I'm guardedly optimistic that we'll successfully navigate the various crosscurrents in the economy, and have another winning economic performance.