FUTURES INDUSTRY ASSOCIATION
CHICAGO LUNCHEON

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U.S. Economic Outlook

Good afternoon and thank you for inviting me to this luncheon. Last week all of us were shocked and moved by the events unfolding in the wake of Hurricane Katrina. I know that all of you will join me in expressing sympathy to the families and friends of those who lost their lives in this tragic event. Going forward, we express our support and best wishes to the people of New Orleans and other areas of the Gulf Coast who now face significant personal and economic challenges because of the enormous upheaval to their way of life.

Like many other organizations, the Federal Reserve has been affected by the hurricane. Our thoughts are with the staff of the New Orleans branch and their families. The Atlanta Fed, working with other Federal Reserve Banks and the Board of Governors, has implemented contingency plans to serve the payments needs of financial institutions serving the Gulf Coast region.

For today, I'd like to make some comments about your derivatives industry and the U.S. economic outlook.

It should come as no surprise to the Futures Industry Association's Chicago Division that the Chicago Fed is keenly interested in our local derivatives markets. And like you, the Chicago Fed is interested in the economic affairs of this city, the Midwest, and the country as a whole.

The Chicago derivatives industry is more than just a business sector that is important to our local and regional economy. The exchanges, clearing organizations, FCMs (futures commission merchants), and other market-related businesses you have built here in Chicago are special. As the late Merton Miller noted at a conference on derivatives sponsored by the Chicago Fed, futures exchanges rank among the major technological inventions of the 19th century." Those 19th century commodities markets have since become the standard for today's modern derivatives exchanges. Thus, what has happened here in Chicago in the past century or so has had an important role in the modernization and continuous improvement of the financial system, not only in the U.S. but around the world as well.

One key element of the derivatives industry's support infrastructure is the Fedwire funds and securities transfer systems, operated by the Federal Reserve. These systems are used by your industry to transfer margin and settlement payments, move derivatives-related collateral in the form of U.S. government securities, and for related purposes. The Fedwire funds transfer system is a real-time gross settlement system for U.S. dollar payments. The Fedwire securities transfer system is a real-time delivery vs. payment (DVP) system which facilitates the immediate, final, and simultaneous transfer of U.S. government securities against final and irrevocable payment in central bank funds. In the first quarter 2005, the average daily value of funds transfers over Fedwire was over $2 trillion and the average daily value of securities transfers was over $1.5 trillion. It is essential that those transfers be made in a timely and secure manner and that the public has confidence that the financial system works.

Of course, Fedwire is just one component of the clearing and settlements system that supports these markets. Billions in daily settlements are generated by the clearing business of the three largest Chicago exchanges, and those settlements can skyrocket on a particularly volatile day. Those time-critical payments are essential to the economic functions performed by Chicago's derivatives markets. Indeed, the clearing and settlements system can be described as the "plumbing" of the financial system.

In addition to the operational infrastructure, we are also interested in the legal and regulatory structure of the derivatives industry. When we feel it's appropriate, we respond to requests for public comment on proposed legislative or regulatory changes.

For example, the Chicago Fed has publicly commented on a number of policy developments relating to the derivatives industry, such as the reauthorization of the CFTC, where in 1999 we argued against a "one size fits all" regulatory structure for derivatives. As you may know, we instead supported a principles-based and streamlined structure for derivatives regulation, and we were pleased to see that Congress enacted such a structure in the Commodity Futures Modernization Act of 2000.

We also commented on the recent "Recommendations for Central Counterparties" (CCPs), which is a joint effort of the Group of Ten countries and the International Organization of Securities Commissions (IOSCO). In that comment letter, we expressed our support for the efforts to formulate "flexible, risk-focused recommendations for securities settlement systems that utilize a central counterparty." Furthermore, we argued that the recommendations should be applied broadly to cover other clearing arrangements that do not formally use a CCP structure. The European Central Bank and the Chicago Fed are jointly sponsoring a conference in Frankfurt next April to further discuss "Issues Related to Central Counterparty Clearing." More information about that event, as well as copies of our public comment letters, can be found on the ChicagoFed.org web site.

There are many other ways that the Chicago Fed is actively involved in matters concerning the derivatives markets in Chicago. Some of those efforts are oriented toward economic theory and research. Others are more "hands on," such as the contingency planning efforts under way in the Chicago financial community to assure that we are resilient in the face of unforeseen events. For example, we are pleased to be a strategic partner of the Chicago FIRST initiative, which is addressing the business continuity and disaster recovery needs of Chicago's financial community. All of these activities, I hope, are valuable to you, your industry, and the nation as a whole.

But it's not just the payments system that concerns us and is strongly influenced by the derivatives markets. The Chicago Fed is part of our nation's central bank and in that capacity has responsibility for conducting monetary policy, which requires a careful assessment of regional, national, and international economic conditions. To do this, we sift through the relevant data, including signals about economic performance that are generated by Chicago's derivatives markets.

The truth, however, is that monetary policy is still more of an art than a science. Therefore, we have to make substantial judgments when setting policy, judgments that are supported, in part, by our familiarity with the financial, commercial, and agricultural institutions that are a part of our community. We regularly are in contact with representatives of the financial markets and other business organizations that serve the five states in our District and, in many cases, also have an important presence in the national economy. These contacts help us keep a finger on the pulse of the markets and stay aware of the developments affecting the outlooks for the regional and national economies.

In that regard, we are going to face a number of judgment calls in trying to assess the impact of Hurricane Katrina on the national economy. Clearly, this is a horrible disaster in terms of lost lives and property destruction. And it's a big loss to the local economies. But at this time it's very difficult to say how the national economy will be affected.

For example, Hurricane Andrew was a large, destructive storm that hit the East Coast in August 1992. Though it was devastating in terms of personal losses and its effect on the local economies, it did not have a large impact on national economic activity. By one estimate, property damage to housing alone from Andrew ran in the neighborhood of $15 billion in today's dollars. While this is a large number, particularly for a region, it is not so large relative to the size of the national economy. In fact, it's difficult to say that it had much more than a tenth or two effect on overall GDP growth.

By all appearances, however, Hurricane Katrina is different. The scale of destruction clearly is larger. Furthermore, the hurricane has damaged portions of our nation's energy and transportation infrastructures. The impact on the economy will depend on the extent of the damage to the energy refining and distribution systems, shipping infrastructure, and other critical components that affect the national economy. An important aspect of this is the time dimension—how long it will take to make the repairs needed to resume operations. We also need to keep in mind that the economic effects can be mitigated by how businesses outside of the area adapt to the disruptions—by finding alternative transportation routes and resorting more to goods produced elsewhere.

Of course, we have little if any data available yet to help guide these assessments. An exception is energy prices—the futures industry has given us a better idea of what markets expect about these prices. Spot gasoline prices have spiked, but near-term gasoline futures have not moved up that much, nor have crude oil prices moved a great deal. So, at least for now, markets think that the disruptions to energy markets as a whole will largely be transitory.

So what's this all mean for the national economy? Some forecasters have made early attempts to grapple with these uncertainties and have lowered their projections for real GDP growth in the second half of this year by around 0.3 to 0.5 percentage points. To put this in perspective, before the hurricane, the consensus forecasts were for growth to be a bit above 3½ percent in the second half.

Our assessments of the risks facing the economy after Hurricane Katrina will continue to evolve. Even before the hurricane, however, I saw three notable risks to the near-term forecast: risks of increasing energy prices, higher core inflation, and the potential for a decline in housing prices.

With respect to the energy price risk, oil prices have more than doubled since 2002, driven by increases in world demand combined with smaller increases in supply capacity. Furthermore, futures markets see crude oil prices remaining high for some time—although not continuing to increase. As I noted, these prices have not changed a great deal after Katrina, but we'll have to monitor unfolding developments closely.

Rising oil prices may reduce economic growth. The increased amount we spend on imported oil represents a transfer of income from U.S. energy consumers to foreign producers of oil. To date, we think the higher prices have had some effect on growth in the U.S., but it's been relatively modest. Why hasn't the effect been more noticeable? First, solid productivity growth and accommodative monetary policy have offset some of the negative effect of rising oil prices on growth. Second, in real terms, the increase in crude prices is smaller than during the 1970s, and the level remains well below the peak reached in 1980 of $86 per barrel in 2005 dollars. And third, the U.S. economy is less dependent on oil today. Twenty-five years ago, it took more than 15,000 BTUs of energy to produce one real dollar of GDP; in 2003, it took just under 9,500 BTUs. Of course, if prices continue to rise, we could see some more troublesome effects on growth.

In addition to the potential negative effect on growth, rising oil prices, like other unfavorable cost shocks, can also feed through and raise underlying core inflation. So there is also a risk on the inflation front, and the risk is higher now than it was a year ago. Because the economy is running nearer to potential, unfavorable cost developments are more likely to pass through to core inflation. And we've seen another source of potential cost shocks—hurricane-related distribution disruptions. But as I mentioned earlier, futures prices for gasoline suggest that markets expect the Katrina disruptions to be transitory; hopefully they are right, and this should be less of an inflation risk.

Putting it all together, I'm concerned about core inflation running at the upper end of the range that I feel is consistent with price stability. If we indeed start to see a string of higher inflation numbers, people may begin to expect permanently higher inflation. Such expectations could become self-fulfilling if they become built into the behavior of households and businesses. And this would have adverse effects on longer term economic performance. If this occurred, the Fed would need to respond accordingly in order to restore price stability.

Even without an increase in inflation expectations, it will take appropriate monetary policy to keep inflation well contained. I should also note that some indicators from markets that you are all very familiar with support the view that inflation will remain well-contained. Notably, TIPS data and surveys suggest that the private sector's long-run inflation expectations remain stable.

A final risk to the short-run outlook that analysts have been talking a lot about is a drop in housing prices. Housing has been an area of strength in the economy throughout this business cycle. But there is concern that housing is overvalued and that prices may decline, adversely affecting residential construction and household spending on other goods and services.

The largest price increases, however, have occurred in cities on the East and West Coasts, and prices have risen much less in Chicago and most other Midwestern cities. These differences highlight the local nature of housing markets. So, unlike many financial markets, there is much less of a tendency for a house price decline in a particular region spilling over to a more general drop in prices at the national level. Furthermore, it's not clear what will happen to house prices. Financial innovations in mortgage markets, which improve the liquidity of housing investments, and lower capital gains taxes have likely increased the value of residential investment relative to other types of investment.

If house prices do fall, however, the change in wealth and related spending adjustments likely would be slow. This would give policymakers time to formulate appropriate policy responses and for those actions to affect economic activity.

The risks I've talked about so far primarily relate to the near-term economic outlook. But in the long term, we face a different set of challenges. In order to support productivity growth and maintain a solid trend in economic growth, we need to continue to invest in plant and equipment and human capital at sufficiently high rates.

In the case of physical investment in plant and equipment, the challenge will be financing. Spending on physical capital must be financed by our national savings—which includes saving by households, businesses, and the government, as well as capital inflows from abroad. Saving by households is quite low, a fact that gets a lot of attention in the media. And, of course, current federal budget deficits mean that government saving is negative. Even when the higher rate of corporate saving is included, overall national saving has fallen in recent years.

Fortunately, the rest of the world has so far viewed the United States as a good place to invest. They have supplied us with enough capital to allow our investment to exceed our own national saving. But this also reflects the fact that our current account deficit—mainly, the difference between our imports and exports—has been rising and is now more than 6 percent of GDP.

Unfortunately, for a number of reasons, such deficits are not sustainable indefinitely. Eventually, our current account deficit must fall and capital inflows will slow. This means that if we are to maintain our current rates of capital investment, national saving will have to rise to make up for this adjustment. This will be happening at the same time that the aging of our population will put increasing pressure on our Social Security and Medicare spending. Without changes in spending or taxes or both, this increased demand for social insurance will further increase government deficits and decrease net national saving.

Finally, another factor that can affect our future economic growth is our ability to maintain an educated workforce—a main element of what economists like to call investment in human capital. Historically, this has been a strength of the United States, but some current trends are worrisome. While measures of primary school achievement have improved over time, secondary school achievement levels have not. This indicates that too many teenagers are not getting the education they need while in high school in order to be successful in a more competitive workplace.

Among more highly educated individuals, the trends may also be troublesome. The percentage of 25- to 29-year-olds who have completed a bachelor's degree or higher has increased nearly 18 percentage points since 1960. However, this percentage has stagnated since 2000. And foreign students—many of whom stay in the U.S. and enhance our workforce—are having a greater difficulty getting visas to study in our graduate schools. Together, these trends indicate a danger that our pool of highly educated individuals in the workforce will not be sufficient in the future.

How we generate increases in national savings and improve education are important long-term issues for our nation. I think it's encouraging that Social Security reform is being discussed at the national level and that we're seeing education reforms, such as those currently being made in Chicago. But we can't just talk about possible reforms or implement a few pilot programs—we must keep addressing these issues in a meaningful way. Although there will be some obstacles, we must not lose sight of the long-term challenges we need to overcome to reach our future potential. Thank you.

1. “The futures exchanges with their centralized trading floors, clearinghouses, and daily settlement rules rank among the telegraph, the telephone, and electricity generation as among the major technological inventions of the 19th century.” Merton Miller, “The Future of Futures,” Conference on Derivatives and Public Policy. Federal Reserve Bank of Chicago (1996).

2. Chairman Greenspan noted in his 1999 address to the FIA that the “extraordinary development and expansion of financial derivatives .... is [b]y far the most significant event in finance during the past decade.” Alan Greenspan, Remarks before the Futures Industry Association, Boca Raton, Florida (March 19, 1999) (available online at: http://www.federalreserve.gov).

3. “Recommendations for Central Counterparties.” Committee on Payment and Settlement Systems, Central Banks of the Group of Ten countries, and International Organization of Securities Commissions (2004).