

Economic Outlook and the Role of Bank Directors

Presented by Anthony M. Santomero, President
Federal Reserve Bank of Philadelphia

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It is a pleasure to join you today for the Spring Directors Conference. This is a kind of reunion for me with members of both the Pennsylvania Association of Community Bankers (PACB) and the American Association of Bank Directors (AABD), as I have long had ties with both of your organizations. As far as the PACB is concerned, my relationship dates back many years. In fact, my very first official speech as a Reserve Bank president was at your annual meeting nearly five years ago. It is good to be back among friends, and I look forward to seeing many of you at your upcoming annual meeting in Banff this September. As for the AABD, some of you might recall that in my former life as a Wharton professor, I served on the advisory board of your organization. I believed in the goals of your organization then, and I support them now. So, I am glad to be here and to exchange views with members of both organizations.

This afternoon, I will share with you my perspectives on the progress of the economic expansion in our nation and its impact on you as community bank directors. These two topics — namely, the state of our national economy and the role of directors in our banking community — are ones I know well. And they are topics central to the interests of this group. They are also intertwined, as I will indicate shortly.

I will begin today by offering my views on both the history and likely future course of the national economic expansion. In this process I will also spotlight some risks associated with the outlook. Along the way I will include some observations on monetary policy, both how it has been playing out this cycle and its likely future path. Then I will address the implications of the economy's dynamics for the performance of your institutions. Here I will offer you my thoughts on some issues I think are particularly relevant to your role as bank directors given today's economic climate.

The Outlook for the U.S. Economy

I believe the U.S. economy is embarked upon a period of sustained expansion. As you will recall, the recession of 2001 was followed by an unusually attenuated recovery. But economic performance improved noticeably after mid-2003, and 2004 was a year of solid real growth. And after a mild scare of another "soft patch" earlier this year, the economy looks to be expanding at a moderate pace.

Looking forward, I expect **real GDP** to grow at a rate of 3-1/2 to 4 percent through 2005. Earlier this year I would have favored the upper end of this range, but recent events have dampened that forecast somewhat. Of course, a factor that will play a role in determining the exact magnitude of growth is the course of the price for oil. I will have some more to say on this a little later.

On what do I base this forecasted growth? Well, let's look at the fundamentals. As always, **consumers** will do the bulk of the new spending. They always do and always will. During the past recession and recent recovery, consumer spending held up unusually well. In the earlier phase of the expansion this growth in spending was fueled by hope in the future and aggressive monetary and fiscal policy. Now job growth and rising household incomes have been and will continue to support growth in consumer spending overall. However, in the current rising interest rate environment; growth in big ticket items — such as cars, houses, and other durables — should stabilize and therefore play a less significant role than in past quarters in consumer spending's contribution to economic growth.

Going forward, **businesses** too will make a substantial contribution to new spending. Swings in business investment spending have driven the pattern of this past business cycle. Firms have now begun investing again in everything from high-tech equipment and software to warehouses and machinery. In this way, firms are positioning themselves for greater efficiency and greater productive capacity. The numbers here were

surprisingly strong at the end of last year. However, the last number we received on business investment from the first quarter GDP figures was lower than some expected, though clearly positive. Nonetheless, going forward, I anticipate that robust growth in business investment spending will continue to play a major role in our growth through the remainder of the year.

Next, add to this pattern of private-sector spending the growth in **government spending** on goods and services. Here, there is little evidence of either a decline or an appetite for a dramatic increase in spending at either the state or federal level. So looking forward, moderate growth in government spending appears to be a reasonable guess.

Adding up all of these components of demand suggests that we should have solid growth in what economists call domestic final sales. Of course, as we have all become aware, how much of that domestic **demand** translates into domestic **production** depends on what happens to our **international trade balance**.

Indeed, the widening **trade deficit** of the past decade has sapped growth in demand for domestic production. Over the past several years, economists have been expecting the decline in the value of the dollar to bring stability to the trade picture. This began in earnest in the second half of last year. Now, however, disappointing growth among our trade partners, the increased world price of oil, and the pattern of exchange rate movements since the beginning of this year, all suggest that the deficit may continue to widen.

Together, these factors suggest that GDP growth this year will more likely settle in the lower end of my projected growth range of 3-1/2 to 4 percent.

Let me turn next to the labor market. **Nonfarm payrolls** have been growing for some time now, and I expect them to continue increasing at an average rate of 150,000 to 200,000 jobs per month this year. But as I have said before, the pace will vary from month to month. In fact, the labor market signals we have been receiving this cycle have been surprisingly uneven, as the most recent employment data have clearly illustrated.

That said, let us not lose sight of the long-term pattern, namely, that monthly job growth for the past 12 months has averaged 165,000. This is above the 150,000 jobs per month that many economists believe is necessary to keep pace with the growth in productivity and the labor force. With these kinds of employment gains, the **unemployment rate** should continue its gradual decline.

Furthermore, [research](#) done at the Federal Reserve Bank of Philadelphia suggests that job growth in high-wage industries will account for a large portion of total job growth going forward.

I also expect **inflation** to remain well contained in 2005, both overall and by core measures that exclude food and energy prices. My scenario of solid output growth, at or just slightly above the economy's long-run potential, and steady job gains, which gradually bring the labor market into better balance, is consistent with a relatively stable price environment. This is true as long as the central bank focuses on its goal of price stability and engages in a monetary policy that supports that goal. I will say more about this in a moment.

Nonetheless, I think we must all recognize that as the economy continues on its path of expansion, price dynamics are prone to shift. As productivity growth returns to trend, unit labor costs may start to rise, potentially putting pressure on prices. We have already seen some indications of this, since measured productivity growth has been shifting down toward long-run productivity growth and unit labor costs have been increasing recently. In addition, the very continuation of the expansion, now in its fourth year, may lessen the competitive pressure on domestic producers and permit them to exert some pricing power.

We have all heard anecdotes about some increased incidence of pricing power across various business sectors. Around my District, reports from business leaders of pricing power have been somewhat more frequent. Moreover, reports and surveys such as the Philadelphia Fed's recently released [Livingston Survey](#) have indicated some increase in short-term inflation expectations. All this leads me to become somewhat more concerned about inflation than I was a year ago.

Monetary Policy

It is incumbent upon the Fed to make every effort to keep these price pressures well contained. Toward this end the Federal Reserve has been committed to making the transition from an accommodative policy stance to a neutral one, more conducive to sustained noninflationary economic growth. This process began about a year ago and is ongoing. The challenge here is to move the interest rate back to a more neutral level without dampening growth in real output or generating undue negative sentiment.

If the economy evolves as I anticipate over the next year or so, I expect we will continue to move the federal funds rate toward neutrality at a measured pace. But the precise course the Fed takes very much depends on the precise course the economy takes. I have listed several risks to the outlook that must be monitored over the remainder of the year, and these will play important roles in determining the course of monetary policy.

As I have said before, if signs emanating from the economy suggest that the economy is veering off its most likely course, we will need to consider altering the pace at which we move toward policy neutrality. At the moment, however, this does not seem to be the case.

Issues Facing the Industry

So overall, I expect the economic expansion to move ahead at a moderate, sustainable pace, with inflation under control, and the Fed moving short-term interest rates to a neutral position over time. Yet risks exist, as I have indicated, and they will have an effect on both the national economy and your own institution. The risks surrounding the dynamics of this cycle ought to be the focus of attention not only for me as a central banker but also for you as a bank director — and bank management as well.

Indeed, even in the most benign environment, the banking industry faces some significant challenges. In today's marketplace, however, volatility in financial markets and uncertainty in the geopolitical environment have created a business climate in which everyone must manage smarter and analyze risks more carefully.

We can take some solace in the fact that the performance of this sector over the last decade has been remarkably robust. Returns have been strong and relatively stable in an environment of considerable turmoil. However, that was the past. Going forward, the macroeconomic risks we face will present a challenge for all firms, but most notably for financial firms. With this in mind, I would like to mention several areas that may be worthy of particular care as we look into the future.

The first of these is a standard worry for any banker: the reality that **interest rate risk** can never be ignored. We all know that the FOMC has moved the fed funds rate upward by 2 percent over the last year in a series of eight quarter-point adjustments. Yet over this same period, long-term interest rates have fallen.

It is incumbent upon management to position its balance sheet so as to protect the institution from the vicissitudes of the long bond market, whether long rates remain low or revert to a more common historical pattern. A key bank responsibility is to manage this risk and establish some clear boundaries on bank interest rate risk-taking. Prudence and good banking practice dictate that you manage your portfolio's exposure to weather various rate environments.

The second area of special emphasis is the area of **credit risk**. As I mentioned in my outlook, the business sector and business investment spending have been strengthening as the expectation of further growth has permeated the marketplace. In this environment, the demand for commercial loans has begun to accelerate. This is, of course, good for the national economy and good for your business.

Nonetheless, I offer a note of caution here. My sense is that there is keen competition among banks to make these loans. Under these circumstances in the past, banks tended to underprice risk. It is particularly important to guard against this temptation, particularly because slackening growth in deposit inflows may put upward pressure on funding costs as the expansion progresses.

Another issue related to credit risk, which I believe worthy of some consideration, concerns credit quality issues in the consumer portfolio, particularly in the area of residential lending. We have all witnessed the recent run-up in housing prices. This has been greater in some areas than others, but the price of the stock

of residential housing has certainly risen over the past several years. This phenomenon clearly warrants careful scrutiny.

Economists traditionally view housing as a type of durable good rather than a purely financial investment. But when markets turn speculative, activity in the sector can impose broader risks on our economy and considerable risks on the lending institutions involved. Economists' best guess is that the underlying fundamentals indicate that housing markets and housing prices should begin to stabilize as interest rates adjust upward and the so-called conundrum fades. As this occurs, the speculation present in some markets will eventually dissipate and prices will stabilize.

In the meantime, banks would do well to carefully manage their exposure to the associated credit risk. Prudent bankers, here too, would be wise to review underwriting standards and be sure that they are adequately enforced. This is important because despite historically low delinquency and loss rates, lending activity has involved products with higher embedded risk. Consequently, the Federal Reserve recently distributed to banking organizations under its supervision a letter warning of the rapid growth in home equity lending and offering guidance on sound risk management practices.

Issues Faced by Bank Directors

So where, in my opinion, do you fit into all this? As all in this room are keenly aware, a well-functioning board of directors is the nucleus of any organization. It is the directors who ensure that the institution's management keeps those goals and interests in focus as it goes about the business of running a bank. In the banking industry, the role of the director is of particular importance, since it is this industry that underpins the very foundation of the complex network that makes up our nation's financial system. The public too depends upon their financial institution to represent their interests and serve their financial needs.

Bank directors are the first line of defense for ensuring a bank is run safely, soundly, and efficiently. Ultimately, it is the director's mandate to ensure that the organization recognizes and manages risks so as to maintain the utmost public trust in the institution. Indeed, American capitalism relies heavily on the fiduciary duty concept to protect those who entrust their money to large, and often distant, corporations.

While service on any board entails hefty demands, serving on the board of a financial institution should prove particularly rewarding, since it serves both a private and public purpose. Far beyond the stewardship of a single company, your responsibilities can be thought about more broadly — as the stewardship of the health and prosperity of your community, America's banking system, and without hyperbole, the entire U.S. economy .

We at the Federal Reserve recognize all this. In fact, to provide a better understanding of your role in today's ever-changing legal and economic climate, we have designed an online training course for bank directors. Called "[Insights for Bank Directors](#)," this free online resource provides a comprehensive look at evaluating bank financial performance and methods for managing the risks to a bank's portfolio. It also reviews regulatory issues and other topics related to board responsibilities. I think it is worth your attention; it can be accessed through the St. Louis Fed's web site.

Conclusion

With that, let me end. By way of summary, our nation's economy appears to be on a path of sustained expansion. I expect 2005 to be another year of healthy growth in output, steady gains in employment, and well-contained inflation. At the Federal Reserve, we are committed to pursuing monetary policy that supports sustained growth by fostering public confidence and stable prices for the long term.

As this expansion proceeds, there will be risks along the way. As a central banker I must be prepared to respond to those risks. Our banking system too must be prepared for the unexpected by establishing a risk management environment that identifies, limits, and manages the risks that are all around us.

As directors of banking institutions, you must oversee that process and the managers who bear the bulk of the responsibility for running their organizations. This is a substantial responsibility.

I commend you all for accepting the role of bank director. You ensure the fiduciary well-being of your institution. Your work is essential to the functioning of our nation's banking system. Ultimately, you make a genuine contribution to the health and strength of the American economy.

I have enjoyed spending time with you today, and I will be happy to take your questions.