

## The Implications of a Consumer-Driven Expansion

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### Introduction

Good morning, everyone. It is a pleasure to be here at your annual Retail Risk Management Conference to share my views on the economy and the near-term economic outlook. In my remarks today I will take some time to focus on the behavior of the consumer sector. Indeed, as you will see, many of today's macroeconomic issues revolve around consumers and their spending patterns in this cycle. At the same time, the evolution of consumer spending also has important implications for retail risk management within your industry. So, I hope I will pique your interest by shedding some light on the behavior of your customers and by offering you some insights into managing your risks in the current environment. In short, in this speech you are getting two views for the price of one!

### The Outlook for the U.S. Economy

The U.S. economy is embarked upon a period of sustained expansion. 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 toward the lower end of this band. Of course, the price of oil is one factor that will play a role in determining the exact magnitude of this number.

Here is how I arrive at this prognosis. As usual, the consumer will contribute significantly to the expansion. **Consumers** will do the bulk of the new spending. They always do and always will. In fact, 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, it is job growth and rising household incomes that have been supporting growth in consumer spending overall. Of course, as interest rates rise, growth in the sales of big ticket items — cars, houses, and other durables — should stabilize and return to more normal levels. Therefore, such purchases will play a less significant role than in past quarters in consumer spending's contribution to economic growth.

**Businesses** too will contribute significantly to spending growth. Looking back, swings in business investment spending have driven the pattern of this past business cycle. Now, with the expansion firmly in place, businesses are 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. Going forward, I anticipate that growth in business investment spending will continue to play a major role through the remainder of the year.

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

Adding up all of these components of demand suggests a scenario of solid sustainable 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**.

For the past decade, a **widening trade** deficit has been sapping growth in demand for domestic production. For the past several years, economists had been expecting the decline in the value of the dollar to bring stability to the trade picture. The decline began in earnest in the second half of last year. Now, however,

disappointing growth of our trading partners' economies, the increased world price of oil, and the pattern of exchange rate movements since the beginning of this year, all suggest the deficit may continue to widen.

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

Let me next turn 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. Admittedly, the labor market signals we have been receiving this cycle have been surprisingly uneven. And, I expect the pace of employment growth will continue to vary considerably from month to month. But, let us not lose sight of the long-term pattern. Over the past 12 months, non-farm payrolls gains have averaged 180,000 per month, slightly above the figure that many economists believe is necessary to keep pace with growth in the labor force. So, with these kinds of employment gains, the **unemployment rate** should remain close to its current 5 percent level.

On the price front, I 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, combined with 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 remains focused on its goal of price stability and engages in monetary policy supportive of that goal. Let me explain.

I think we would all agree that as the economy continues on its path of expansion, price dynamics are prone to shift. As productivity growth returns to trend and labor markets firm, 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 its long-run trend and unit labor costs have been increasing. 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. All this makes me a bit more concerned about inflationary pressures than I would have been a year or so ago. So, while the recent inflation numbers have been good, and I share the general view that inflation is unlikely to be a problem in the near term, I believe that we must stay ahead of the curve to ensure that it does not become a problem in the long term.

## Monetary Policy

For that reason I emphasize that it is incumbent upon the Federal Reserve to continue to take the steps necessary to keep price pressures well contained. Just about a year ago, we began the transition from an accommodative policy stance to a neutral one more conducive to sustaining noninflationary economic growth. That process continues.

The task here is to move the interest rate back to a more neutral level without dampening growth in real output, but it is essential for us to ensure our goal of long-term price stability. If the economy evolves as I expect over the next year or so, it is likely we will continue to move the federal funds rate toward neutrality at what we have described as a measured pace. But, the precise course the Fed takes will very much depend on the precise course the economy takes. We all have our own lists of risks to the outlook that may alter the economy's course. These must be monitored over the remainder of the year, and no doubt, they will play an important role in determining the course of actual policy.

## Implications of a Consumer-Driven Expansion

As I said at the outset, given the purpose that brings us together today, I think it is appropriate for me to highlight the extraordinary part the consumer has played in the dynamics of this cycle. In fact, the consumer has been a vital source of strength and consistency in an otherwise tumultuous time.

Over the past cycle, we have weathered a wide variety of economic events and, as we economists call them, economic shocks. In 2000, the U.S. stock market declined precipitously, and the tech bubble burst. This led to a decrease in national wealth and had a negative effect on the economy as a whole. Then came

the terrorist attacks of September 11, 2001. These events too had an immediate and profound contractionary effect on the demand side of the economy. Already left with an overhang of equipment from the investment boom of the late 1990s, businesses confronted these new uncertainties about the future and saw new reasons to defer and delay investment spending. The events that followed — the anthrax attacks and then the wars in Afghanistan and Iraq — only served to heighten these uncertainties.

Then, as the U.S. economy began a slow recovery, accounting scandals and corporate governance issues created new uncertainties and what some referred to as another “soft spot” in the economy. Scandals surrounding Enron and WorldCom, to name just two of the largest, undermined confidence and created mistrust of large corporations in the U.S. psyche. This further heightened investor uncertainty and weakened both households’ and businesses’ willingness to spend. For businesses, this rise in investor skepticism increased risk spreads in credit markets, raising — at least for a time — the cost of capital.

Finally, completing the list of disturbances buffeting our economy, we were hit with another shock — a sharp increase in the price of oil. The international benchmark jumped from roughly \$30 per barrel through 2003, to over \$50 per barrel by the fall of 2004, to its current level near \$60.

Yet, in spite of all this, consumers continue to spend. Since the beginning of 2000, consumer spending has grown at an annual rate of 3.4 percent. We see evidence of this spending everywhere — on nondurables and services, on durables like automobiles, and on housing. Consumers are like the Energizer bunny: their spending growth goes on and on.

Aggressive tax policy made some of this possible. The Bush administration came into office intending to permanently reduce tax rates as a strategy for fostering stronger economic performance over the long term. As events unfolded, the tax reductions were accelerated and enhanced in order to provide the economy, and the household sector, a much needed stimulus in the short term. Without a doubt, this application of counter-cyclical fiscal policy was extraordinarily well timed and effective.

Stimulative monetary policy also played an important role, inducing the consumer to continue to spend despite the general weakness in economic conditions. In fact, I would argue, and few would doubt, that monetary policy has been a defining part of this recent business cycle. The Federal Reserve reduced its target federal funds rate by 475 basis points — from 6.50 percent to 1.75 percent — in the recession year of 2001. When the recovery threatened to stall, the Fed once again reacted, dropping the target fed funds rate to just 1 percent, its lowest level since the 1950s.

This counter-cyclical monetary policy gave consumers the opportunity to borrow at low interest rates, and they certainly seized it. Households increased their purchases of durables and homes at record rates, dampening the breadth and depth of the recession. And consumers sustained that growth thereafter, giving business both time to recover and a reason to invest.

But there was another part of the economy that facilitated ever higher consumer spending. The financial markets supported consumers’ appetites for higher consumption by increasing the availability of credit. Over the past two decades, financial innovations as well as the rapid growth in consumers’ wealth have introduced households to many more financial options. Consumers today have access to unprecedented levels of credit.

Several long-term trends in consumer lending have given consumers progressively greater command over their economic resources. Deregulation of consumer lending began in earnest in the late 1970s and early 1980s. The 1990s brought advances in risk-based pricing, which have allowed lenders to better estimate risk and therefore price loans accordingly; and securitization, through which credit card advances, mortgages and other receivables are financed through bonds sold around the world. Add innovations in consumer credit modeling, new pricing strategies for consumer loans, expanded funding options, and changes in regulations governing consumer lending, and we have seen a revolution in consumer banking that has given consumers greater access to credit and banking services than ever before.

And so credit availability gave consumer spending the resilience it showed over this most recent cycle. Despite job woes and stock market volatility, consumers were both willing to finance purchases at

historically low interest rates and able to bear the heavier debt burden they represent. As a result we have seen a surge in consumer borrowing that has, in turn, financed record levels of auto sales and an ongoing housing boom. Indeed, as a consequence of the latter, consumers have been able to refinance and restructure debt to reduce their debt burden by tapping accumulated home equity.

## The Consumer Balance Sheet

But now recession and the period of extraordinarily low interest rates lie behind us. Expansion and a return to more normal interest rate levels lie ahead. And in this context, the greater access to, and greater use of, credit by consumers raises some important questions. Among them are: Just how sustainable is growth in consumer spending going forward? And how vulnerable is the consumer to an economic shock? Have people become so sophisticated that they are willing and able to continue spending through any economic circumstance, or have they been naïve and overburdened themselves with debt? And, importantly, how will developments in the consumer sector affect retail lending portfolios, both in the financial markets in general, and on bank balance sheets in particular? A look at the data provides some perspective.

Every quarter the Fed publishes a measure of households' debt burden called the household Financial Obligation Ratio. I am sure most of you are familiar with it. The financial obligation ratio is the ratio of households' debt payments to disposable personal income. It includes debt payments on outstanding mortgage and consumer debt, including automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments. While this ratio is at a historically high level, it appears to be down slightly from its peak. It rose to over 18 percent in the fourth quarter of 2000, peaking at 18.8 percent in the fourth quarter of 2002. In the first quarter of 2005, this ratio came in just under 18.5 percent.

This debt-payments ratio can be broken down in several ways that are quite interesting, given the housing market boom. First, we can break out the financial obligation ratio of homeowners and renters. Looking at just the homeowners, we can then break down the ratio into the homeowner mortgage ratio — which includes payments on mortgage debt, homeowners' insurance, and property taxes — and the homeowner consumer ratio — which includes payments on consumer debt and automobile leases.

If we examine these data, it appears that consumers have been increasing their mortgage financial obligations while decreasing their consumer financial obligations. This suggests that consumers have been keeping a watch on their balance sheet. They are capitalizing on low mortgage rates by increasing their mortgage debt, while at the same time reducing other debt obligations. And, although households could feel some pressure from interest rate increases, most consumer debt carries a fixed interest rate, which will slow the adjustment of interest costs to rising rates. So, all in all, the consumer sector's financial situation appears to be reasonably sound and should provide a firm base for continued growth in consumer spending as incomes and employment expand.

However, I do not want to give the impression we should not be watchful of the financial situation of the consumer. The data I just reported are averages over the entire consumer sector, and averages miss a lot of detail. The details suggest that we should not be complacent about the consumer sector but, instead, make sure we understand where the risks lie and take some precautions.

The democratization of credit has increased access to many who must learn how to properly use it. Here we all should care about financial literacy and the need for consumer credit education. Then there is the reality that a small number of the operators in this industry are less than honest; indeed, they are predatory in their credit advances. You as an industry must take up the mantle and root out such people and practices. They hurt the consumer; they hurt the reputation of the industry; and they ultimately erode the viability of a long-term goal of all those here, namely the expansion of consumer credit to its largest possible market size.

Beyond those concerns, the increased availability of credit to a broader market poses some natural challenges to all lenders. Credit extended to weaker borrowers has associated with it higher delinquencies and higher costs. This is a natural consequence of broadening the market and it will continue to drive average delinquency and loss rates higher over time. Moreover, interest rates charged on credit cards now

can be adjusted faster than in the past, so there is now the potential for a rapid deterioration in credit quality should the economy or the consumer's situation change unexpectedly. In this new environment, perhaps more so than ever before, lenders must carefully monitor their retail portfolios.

The mortgage market has also seen innovation. While I noted that a large percentage of the stock of mortgage debt outstanding is financed at a fixed rate, there has been an increase in the use of variable rate mortgages, in particular option ARMs and interest-only mortgages in the market. At the moment these account for only a small portion of the outstanding volume and they have tended to be offered to the more creditworthy portion of the market. Nonetheless, we may find that as short-term rates continue to rise, a larger number of households than in the past will be exposed to interest rate risk. That said, the balance sheets of consumers are quite healthy, and most consumers understand they face this risk, so I do expect most will be able to handle this exposure.

Staying on the housing issues, much has recently been made of the sharp revaluation of residential real estate in the current cycle. I guess that no speech would be complete without some mention of this feature of the current expansion. So what do I think about this phenomenon?

Economists traditionally view housing as a type of durable good rather than a purely financial investment. In this vein demographers assure us that aging baby boomers, a positive rate of family formation, and continued immigration into the U.S. are at least partially responsible for the relative rise in residential real estate prices. Economists' best guess is that the underlying fundamentals indicate that housing markets and housing prices should begin to stabilize as the so-called conundrum fades and mortgage interest rates rise.

At the same time, real estate values seem to have escalated beyond fundamentals in some areas, and there is evidence of speculation in some markets. When markets turn speculative, activity in this sector can impose broader risks on our economy and considerable risks on the lending institutions involved. Survey data suggests that in 2001 less than 5 percent of homes purchased were purchased as investments. By 2004 that figure had jumped to over 20 percent. Admittedly, the figures vary considerably from city to city, but this is quite a large change in the aggregate number over a relatively short period of time. In all likelihood, this investment cycle will unwind too with the arrival of higher rates. As this occurs the speculation present in some markets will eventually dissipate and prices will stabilize. However, the dynamic here is worth watching, as such cycles of speculation do not always come to an end in an orderly fashion.

This whole issue of the state of consumer balance sheets is of interest to me from two different vantage points. As a macro policymaker, I watch to see if the acceleration in debt and unrealized home equity wealth can be sustained by the economy's growth going forward. As a regulator, I wonder if it can be sustained to ensure adequate returns and continued stability to the banking sector.

I can forgive you for ignoring the first set of concerns — you are, after all, bankers, not policymakers. But I cannot allow you to ignore the second set of issues, nor as a regulator can I fail to seek assurances of your ability to manage the risks apparent in the consumer sector.

Of course, you have not ignored these risks. In fact your industry, your profession, has developed various methodologies to help analyze and manage these risks. In the current environment of rising interest rates and a booming real estate market, it is nonetheless imperative that we keep an eye on these risks even as the expansion continues. I have laid out some of the issues facing the consumer and pointed out several implications of the consumer-driven expansion. These are all things that you as risk managers must keep an eye on.

## **Challenges to Retail Risk Modeling**

The people assembled here have dedicated their careers to understanding these retail risks. This joint conference is a tribute to the banking industry's attempts to bring retail experts and risk managers together so that you can build on each other's expertise and improve your capacity for consumer risk management. But this task is by no means complete.

Risk management itself is not a mature discipline, and the robustness of its models and systems continue to be questioned. To some, risk management systems simply have not been in existence long enough to generate reliable results on risk trends and assessments, and so the very newness of the profession itself can be considered a disadvantage.

There is some truth to this. The models used have yet to be tested through an entire business cycle. And they have not been faced with systematic risk arising from economic change. Accordingly, it is critical that we do not become complacent or overconfident in the models as they currently exist.

However, this is not the only open issue. As one who has labored in your field as a researcher for many years, I know that you have a number of more specific challenges to face going forward. For example, the need to figure out how to allocate capital within the firm so as to create the incentives that foster proper attitudes toward risk-taking. This will affect risk appetites across the firm and ultimately determine the nature of the risk that resides on the institution's balance sheet.

In any risk-based capital allocation system, there is also a need to address the pro-cyclicality of risk. This is a difficult challenge. Exactly how stable should capital allocation algorithms be over a business cycle?

Still another open issue is how organizations should be structured so as to manage firm level risk and reflect risk management priorities.

These are complex issues, and they raise questions we are still trying to answer. All of this suggests the status quo will not be good enough for tomorrow — indeed, it is probably not good enough for today. But as industry professionals involved in the realm of risk management, you know it never is.

## **Conclusion**

With that, let me close. 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 modest inflation. At the Federal Reserve, we are committed to pursuing monetary policy that supports sustained growth by fostering public confidence in stable prices for the long term.

But this expansion, indeed this entire business cycle, has been greatly affected by consumer behavior — consumer spending, consumer wealth accumulation, and consumer debt accumulation. This has all been made possible by the advances in risk management in the industry.

Improvement in risk management practices is a necessary component of good banking in a world of increasing complexity and evolution in the financial services industry. We can take pride in the fact that we have come such a long way in a relatively short time.

Yet, as the expansion unfolds, the world of risk management is shifting under our feet. New and better advances in technology will afford us opportunities to create ever more robust risk management systems in our organizations. We do not have all the answers, but this conference is an important step forward as it sets the stage for further advances in the science and art of retail credit risk management.

The topics discussed, answers provided, and analysis offered are important inputs into the evolution of the industry and its regulation, thus ensuring that this important sector of our financial system continues to effectively meet the needs of the people it was designed to serve.