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Testimony by

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Mr. Chairman, I am pleased to present the views of the Federal Reserve Bank of Boston on the important issues you have raised on the cost of credit to consumers and small business in New England. These issues are especially important given this region's recent economic history.

The Massachusetts economy continues in a pattern of slow, steady growth. Since the bottom of the recession--two years ago--some 155,000 net new jobs have been created and our recent rate of employment growth is virtually the same as the nation as a whole. A variety of other indicators also signal respectable growth--expanded help-wanted sections in newspapers, overtime work in the manufacturing sector, rising business incorporations, higher consumer spending, more housing activity, increasing per capita income. And I'm pleased to note that while the economy is growing, local inflation has been kept under control and real income growth has been stronger than that for the nation as a whole.

These signs of improvement deserve more attention than they have received. They are tangible indicators of economic progress. But I recognize that the purpose of this hearing is not necessarily to detail the economic recovery in Massachusetts or New England more broadly, but to address certain concerns as to the breadth and durability of that recovery. I will address three issues in this regard. First, what have the trends been as to the affordability and availability of credit to small businesses and consumers in New England? Second, if the indicators suggest growth is solid and credit is both affordable

and available, why don't residents feel better about the economy? And finally, what is the effect of rising interest rates on the prospects for continuing economic recovery?

First, it should be noted that both the affordability and availability of credit to consumers and small businesses have national and local components. Consumers typically borrow using credit cards, mortgage and home equity loans, and auto loans. Consumers may enter into these debt arrangements with local banking or financial institutions, but national secondary markets exist for all these types of credits. Increasingly larger shares of auto loan, credit card receivables and, of course, mortgage loans are securitized. This process has enabled banks and other traditional lenders to households to continue to originate consumer loans even when they are unable to profitably fund these credits themselves. In addition, the securitization process has meant that the rates available to consumers are based on national markets. Rates on auto loans and credit cards have come down since the early '90s, as documented in Governor Lindsey's testimony to you on this matter in June.

As he noted then--and this continues to be the case--consumer spending has fueled the national economic recovery. Favorable borrowing conditions have contributed to this growth in spending, which has been accompanied by growth in consumer installment and mortgage debt. Borrowing conditions should remain sufficiently favorable to maintain continued expansion in consumer spending, but the pace will moderate and the composition

will shift. Some consumer rates respond more rapidly to general market rates than others and some forms of spending are more sensitive to interest rates than others. Rates on credit cards are especially sticky. Mortgage rates, in contrast, are responsive; and higher mortgage rates have resulted in a levelling off of housing activity both nationally and in Massachusetts.

For small businesses both the cost and availability of debt is more locally determined. However, since the "credit crunch" of the last recession which severely restricted small business lending in New England, markets for such credit have become more competitive. Larger institutions have announced an increased focus on small business loans; smaller banks appear to be quite active; and we hear numerous anecdotes indicating that lending terms are increasingly competitive. Interestingly, we also hear that small business borrowers are not coming to the banks in the numbers expected, although we do not know whether this is because they are reluctant to take on debt after surviving the credit crunch or whether they have found alternative lending sources. Nevertheless, in Massachusetts, small business lending has grown about ten percent over the past year despite increases in the prime rate to which rates on many small business loans are tied.

Thus, both the broader economic data, and data on consumer and business borrowing, suggest solid economic growth in New England. Why is it that some people sense things are not as good as they might be? An improvement definitely has taken place

over the last two years in how people in New England rate current economic conditions, but, over this same time period, national consumer confidence has risen nearly twice as sharply.

Organizations like the University of Massachusetts at Lowell and the Bank of Boston take polls of local businesses. These barometers continue to show improvement, and, if anything, they indicate that business leaders are more confident than those polled in the consumer surveys.

Consumer reticence undoubtedly relates to the fact that the recession here was long and deep. In Massachusetts, payroll employment started falling in early 1989, more than a year ahead of the nation. Between the end of 1988 and the summer of 1992, payroll employment in our state fell by 11 percent. Nationally, the decline was less than 2 percent. So while we have had a reasonably good recovery in Massachusetts, payroll employment remains below its previous peak. In contrast, the national economy has fully recovered, and is now in an expansionary phase.

The composition of employment growth also differs from that in a normal New England recovery, and this difference has contributed to skepticism about the recovery. Growth has been dominated by services. Manufacturing, which historically played a major role in powering recoveries, has not on net been a source of new jobs in Massachusetts. Manufacturing employment certainly declined in the recession, and while it has grown a little over the past five months, some of our companies are still cutting their work forces.

This pattern has a number of implications. First, it raises questions about job quality. Some of the very highest paying jobs are in services. But there are also a lot of low paying jobs. Moreover, the skills needed to earn high wages in services are not necessarily the ones that led to high pay in manufacturing; so even if the jobs are equally good, the people who get the good jobs may not be the same.

Additionally, manufacturing firms tend to be larger than services companies. Thus, employment cuts at manufacturing firms involve large numbers of people and tend to be widely publicized. Indeed, at least in New England, some of the companies that have been cutting back were, in the past, beacons of technical progress or innovation. Their continued difficulties are a blow to the collective self-confidence of the region. Moreover, Massachusetts residents are also aware that cuts in defense spending and market pressures on health costs have been and will continue to be more strongly felt here in terms of permanent job losses. In contrast, the growth that is occurring is highly dispersed and not very visible--a few jobs here, a few jobs there. As a consequence, people are acutely conscious of what is going wrong but not of what is going right.

Let me now turn to the role of interest rates and economic growth. Back in January, the federal funds rate was 3.0 percent; the prime was 6.0 percent; and the rate on fixed rate mortgages was about 7.0 percent. Today those rates are 4.75; 7.75; and roughly 9.0 percent respectively. The economies of Massachusetts

and the nation have had sufficient momentum to move forward despite the interest rate increases. And if the national economy continues to expand--as most analysts believe it will in 1995--the Massachusetts economy and the economies of the other New England states should follow. Moreover, to the extent that national monetary policy is successful in promoting solid, non-inflationary growth for the nation as a whole, addressing the region's long-term structural trends may be easier.

These trends can only be addressed by solutions that look to building an employment base with the skills that are needed for the jobs now being created.

And make no mistake those jobs are there -- over the past two weeks, I have met personally with small businessmen, corporate executives, university administrators and public service providers all over Massachusetts. About 30-40 percent of them plan to hire over the coming months. And some reported labor shortages, particularly in skilled labor such as auto technicians, truck drivers, computer specialists and the like. In Springfield last week, I had the opportunity to tour the Springboard facility which typifies much of what is going on in Massachusetts today. Located in a former Digital manufacturing facility, Springboard repairs computer hard drives, and has doubled its small service firm from 75 to 150 employees. While the 75 new service jobs alone will not offset the loss of the Digital plant, many firms each following the Springboard model may do just that. Springboard reports it is doing its own

training now, but for the future New England needs programs to train and retrain workers for the skilled jobs that are available now and will become available in the future.

We also know that while stronger growth feels better in the short run, it can have damaging consequences over time. New England of the 1980s in fact provides an extreme, but useful, example of the dangers of too rapid growth. During that time, the unemployment rate fell to 3 percent in the region. Wages and other costs rose faster in the region than elsewhere, undermining the competitive position of New England businesses and setting us up for problems in the long run. Real estate prices soared, encouraging speculation and further price increases. It may have been great while it lasted, but the aftermath was devastating. It is possible to have too much of a good thing.

In closing, let me note that we at the Boston Federal Reserve Bank are aware that economic progress in Massachusetts has been uneven. While the overall unemployment rate is quite low, pockets of high unemployment exist in certain parts of the state, and in certain neighborhoods within more prosperous metropolitan areas. We remain committed to expanding economic opportunities in these locations, whether it be through our own powers and responsibilities, or through our cooperation with national, state, and local government agencies and private organizations.