

Remarks by Cathy E. Minehan
at the
South Shore Chamber of Commerce
Breakfast Forum

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It is a pleasure and an honor to be here this morning with you.

As some of you are aware, I bring a somewhat different background to my current position than my immediate predecessors at the Federal Reserve Bank of Boston. I have spent most of my career on the operations side of the Fed dealing with the payments system. In that role, I spent lots of time working with bankers and market participants both in solving crises and in developing operational approaches and products that served the needs of payments system participants.

I've found that's a useful approach to my new job as well. That is, I've been spending a lot of time with the data, and with the Bank's fine economists, but also considerable time talking to as many bankers, business people and community groups as I can about economic conditions in the District. In that regard, I am told this is one of the largest suburban Chambers of Commerce in the United States. Thus,

you should be a great source of information and I look forward to your comments and questions later.

Another aspect of life that changed when I became the Bank's President in July is that groups I meet with now no longer include mostly satisfied customers as in my former operations job. No, it's hard to find those who truly are satisfied with the economy, or with regulatory policy. I should also note that being a Reserve Bank President in a time of rising interest rates is not the preferred route to winning an award for humanitarianism. I'm reminded of that old joke about lawyers--what's 10,000 lawyers at the bottom of the East River--a start! I haven't heard it applied to Central Bankers yet but it may only be a matter of time.

I would like to start this morning with an overview of current economic conditions nationally and in our region. I will also talk about the key issues involved in the formation of monetary policy as we move forward. We have some longer term structural issues facing us regionally as we continue to move away from manufacturing jobs toward a heavier reliance on service jobs, and I will comment on those. Finally, I'll conclude with some thoughts about trends in bank lending

here in New England, which I expect is of interest to most of the people in this room.

Any doubts about the continuing strength of the national economy have been diminished by recent data, including the report of 3.4 percent GDP growth in the third quarter. Industrial capacity utilization rates are at a 15-year high; retail sales continue on a solid upward trend and by any measure we are at or very close to the rate of unemployment that analysts believe is the best we can do without putting upward pressure on prices. We also have been successful on the price front; based on the CPI it would appear inflationary pressures remain reasonably contained.

This comparatively rosy set of economic circumstances has met surprisingly mixed reviews in recent months. The bears in the bond markets seem last week to have finally begun to believe inflation can be contained; unfortunately that same news comes as a shock to the stock markets after a period of euphoria with rising corporate profits. Away from Wall Street, consumers worry about layoffs at large manufacturers, and are suspicious about the nature of job growth and declining unemployment. However, these uncertainties have not

prevented them from spending and borrowing anyway. Clearly, depending on where you sit, things can look very different.

Over the past year, the Fed has tightened short-term interest rates by 250 basis points. Each tightening action has rattled screens on Wall Street, but rising rates seem to have disturbed Main Street comparatively little. Despite interest rate increases, consumer spending, and sales of durable goods, particularly computers, remain vigorous. In turn, the continued strong data keep Wall Street wary that the Fed's program for tightening monetary policy may not be complete.

So where do we stand? Obviously, there is a great deal of debate, not to mention uncertainty, but I would like to give you a sense of how we at the Boston Fed are analyzing the current picture.

Even though each business cycle is to a large extent unique, it is helpful to start by reviewing the sequence of events in a "normal" economic cycle. At the beginning of a recovery, the pent-up demand from the preceding recession in combination with lower interest rates bring a surge in spending on long-lived, postponable goods like homebuilding and consumer durables. These increases set off self-

reinforcing rounds of increases in employment and income. Eventually, households and businesses rebuild their stocks of durable goods and interest rates rise, driven up partly by strong demand but also by at least the prospect, if not the reality, of rising inflationary pressure, as labor and product markets tighten. To be fair, I should also acknowledge that when the Federal Reserve starts to scent the signs of an inflationary build-up, we provide reserves less generously, thereby contributing to the market forces that are already at work raising rates. Once we reach a certain point--and that point is terribly difficult to recognize, let alone to predict in advance--the markets for postponable goods are saturated and this fact, along with the effects of lower demand due to higher interest rates, lead to a slowdown, if not an actual downturn, in the economy. From the looks of the recent data, we haven't yet reached that point, though I think it's something we have to be vigilant about.

Looking at home building so far in the current recovery, the demand for new houses remains strong. Permits for single unit homes have leveled off at fairly high rates, and the median price of homes sold has risen about 5 percent since last February.

The picture for consumer purchases of durable goods is much the same. Retail sales for the third quarter were stronger than in the second, led by both automotive sales and by sales of computers and other durable goods. Recently, new factory orders fell, but most of this drop was accounted for by the notoriously volatile transportation sector and orders for defense goods. Orders for durable goods other than cars and airplanes grew at a healthy rate.

There is also no sign of incipient weakness in capital spending by businesses, and growth abroad is exceeding most expectations. Government spending, while surprisingly strong in the third quarter estimates, likely will continue to be a drag as progress is made in reducing the deficit.

These data may appear to question the efficacy of monetary policy. Why haven't rising rates prevented the rise in consumer and business spending on durables and depressed home borrowing?

At least part of the answer can be found in the actual cost of funds. Consumer spending on durables and their borrowing to finance these purchases are rising rapidly partly because the cost of funds remains relatively low. Auto loan rates, which did not rise significantly

at banks until late summer, still remain low compared to yields on Treasury notes. Also, for the past year some lenders have been promoting their credit cards by offering below-market rates for six months to a year on new borrowing.

Similarly, the increase in effective mortgage interest rates has been less than the increase in Treasury yields. With the teaser rates on adjustable rate loans below bill yields as recently as last month, the proportion of home mortgages written as adjustable-rate loans has reduced borrowers' effective cost of funds, at least for the time being.

Banks are offering their loan customers relatively good deals because their cost of funds is relatively cheap. During the recession, partly for want of demand, banks bought Treasury securities, while they cut their deposit rates. Some banks also issued substantial amounts of fixed-rate debt as interest rates fell last year. Now that loan demand is increasing, but not yet so much that banks must seek new funding, banks' lending rates tend to reflect their relatively cheap cost of funds.

So where does the Fed's tightening fit into all of this?

Analysts have long remarked that monetary policy works with a

lag - it may not achieve even half its ultimate effect on spending until six to nine months have elapsed. It not only takes time to brake the momentum of spending; sometimes it also takes time to raise the cost of funds for many borrowers.

Currently, those on Main Street who are financing their spending with bank loans or with their cash flows do not feel the consequences of rising rates as greatly as bond traders on Wall Street. This will begin to change once the demands for mortgage loans, consumer loans, and business working capital take up the slack and force banks to bid more aggressively for funds.

As this slack diminishes, interest rates paid by borrowers will continue to rise and the tightening desired by the Fed's actions will take the full effect.

We have seen the other side of this lag in the economy's response to policy before. After the Fed cut interest rates during the early nineties, many people despaired that Fed policy was not working - that we were pushing on a string - when the rebound in spending lagged the reduction in interest rates by several quarters. However, ultimately that interest rate reduction did work, and the recovery

began.

So that is where we stand at the moment - on the horns of a dilemma as one of our economists at the Fed is fond of saying. On the one hand, we have to avoid the build up of inflationary pressures during the first half of next year; on the other, we need to be careful about overdoing it and slowing things too much when the full effects of higher interest rates kick in. This is a delicate balancing act, to be sure.

As we proceed, we will no doubt continue to face on almost a daily basis, another aspect of the Wall Street vs. Main Street perceptions about our local economy. With data suggesting solid economic growth both nationally and here in New England, why is it that some people sense things are not as good as they might be? I'd like to suggest that the structural shifts in our regional economy are generating certain labor market dynamics that are quite difficult to deal with from a public policy standpoint--and certainly from the standpoint of monetary policy.

Over the past two and a half years - since New England employment hit its trough - 230,000 jobs have been added. This is

good news. However, this job growth is only about one-third of the 650,000 jobs lost during the recession. For the U.S. as a whole, all the jobs lost in the recession have been replaced. Moreover, over the last year jobs were created in New England at a rate that is only about two-thirds as fast as for the nation as a whole, though there is a lot of variability among the states. For example, employment growth in Massachusetts has been virtually the same as the U.S. figure, while Connecticut has barely shown any growth. Regional unemployment rates bounce around a lot, but for most of the year, they've been about at the U.S. average, while most other measures also track moderate growth. Retail sales have been bright and I must admit that most anecdotes I've heard from businessmen and bankers suggest optimism and increasing confidence that the New England recovery is here to stay. I'll be interested in your comments on that topic later.

We have had considerable structural change in this recovery that is not unlike that taking place for the U.S. as a whole. Our region's manufacturing sector continues the employment decline that started in the mid-80's, while job expansion is concentrated in service-producing sectors.

Two years into the recovery, we continue to hear reports of layoffs at our largest employers. Job creation is real, but it is scattered and diffuse.

In Massachusetts we've added 155,000 net new jobs over the past two years. Like the rest of New England, the bulk of this growth has come in services, retail trade, and construction. Most of these industries have been expanding at a fast rate, in addition to adding a lot of jobs. Other rapidly-growing but smaller industries include nonbank credit institutions and mutual fund companies, furniture retailing (which has been helped by the housing recovery), and plastics manufacturing (which is benefitting from higher demand for autos and electronics products).

At the other end of the spectrum, some industries are continuing to shrink-- must notably computers and transportation equipment. The decline in transportation equipment largely means defense and civilian aircraft engine production.

As service jobs steadily replace manufacturing jobs, both locally and nationally, debate has heated up about the impact of this shift on workers, and what public policy measures ought to be taken as the

shift progresses.

Nationwide average hourly wages have been rising slightly in real terms, but there is concern that those who are laid off from high paid manufacturing jobs are moving to lower paid service jobs, and that those already employed in the low paid service jobs are seeing a stagnation or erosion of their earnings.

The New York Times added fuel to the debate last month with a front page article highlighting the increase in average earnings resulting from expansion of high paying service jobs. The Times article cited Bureau of Labor Statistics figures showing almost three million new managerial and professional jobs created in the service sector in the past five years. During the same period, there has been a decline of about 1.8 million skilled and semi-skilled jobs in the manufacturing side of the economy, and an increase of about the same number of lower paid service jobs. Workers at the low end actually saw their real wages decline over the period.

It appears at this time that although the average wage earned is increasing slowly, there are many manufacturing workers who are experiencing real reductions in pay as they move from skilled or semi-

skilled manufacturing jobs to low skilled service jobs. On the other hand, newly created professional and managerial service jobs are providing well paid jobs for those with sufficient education and training to fill these positions. The well paid service jobs are bringing up the average wages, but we cannot ignore those who are being left behind.

For them, it is critical to provide training and educational opportunities to make the transition to the growing service economy. In that vein, I must put in a plug for the work of regional employment boards and the Mass. Jobs Council. Their efforts to match up the skills of workers to the changing labor demands is vitally important to the future competitiveness of our local economy.

Before we turn to your questions and comments, I would like to briefly discuss how bank lending in New England is shaping up in comparison to the nation as a whole.

At the risk of dredging up painful memories, many of you will recall that just a couple of years ago New England was in the grips of a credit crunch--banks were restricting credit availability as regulators hiked capital standards and closely monitored exposure to risk, especially risk stemming from real estate loans.

Well, I can report to you that the credit crunch is definitely over. Bank lending is growing but like the rest of the New England economy it's growing more slowly than the Nation as a whole. Lending for U.S. commercial banks is currently growing in excess of 10% on an annual basis, survey data from our 9 largest New England banks have had markedly slower growth overall.

Looking at loan categories, a strong but recently tapering-off growth continues nationally for commercial and industrial loans. Annual growth rates have been in the 10% range since last spring. This growth is consistent with the recovery and with reports of building-up of inventories. But in New England, commercial and industrial loans by our large banks have been almost flat for the past few months, and sluggish all year.

Real estate lending saw a strong acceleration nationally beginning last May and June, peaking at close to 12% growth on an annualized basis in September, and now continuing to exceed 10%. Call report data suggests that growth has come in all categories of real estate except construction and land development lending.

The exception to this dichotomy between national and regional

lending data has been consumer loans which have grown in New England at a rate consistent with the nation as a whole. This is consistent with employment gains, with strong contributions from both credit card and installment categories of consumer loans.

So what is going on and why should we care? I don't have a single answer here, but let me share a few hypotheses. Clearly the absence of credit availability during the credit crunch exacerbated the recession so we've gotten pretty sensitive to trends in loan data.

First of all, as I've already outlined, the New England economy has been growing less rapidly than the nation as a whole, so the demand side of the bank lending market has most likely been weaker. Although the regional economy clearly has strengthened, it has not been up to the national pace. In addition, most of the jobs created in New England have been in the service area--businesses that by and large don't need as much financing for large capital purchases. Of course, if this is to explain rates of bank lending growth, that would assume that our large banks are lending solely to New England customers, which we know to be only partially true.

A second explanation could be that large bank lending standards

are somewhat different in New England than they are elsewhere in the country. After the very difficult period of bank failures we experienced here, it would not be surprising if bankers remained a bit shy in easing lending standards--memories of the not-so-distant past may still be influencing loan policies.

A third phenomenon we are looking at is the possibility that New England's large banks are selling loans into the secondary market at a relatively higher rate than banks nationwide. This would explain a lower level of reported loans from our banks.

Finally, we have known for many years now that many corporations are finding advantages in accessing capital markets directly through corporate bonds and commercial paper. If you look at the debt structure of U.S. nonfarm, nonfinancial corporations, you see that in 1965 53% of the debt was bank loans. By 1975, it was 46%. By 1985, it was 36%. And last year bank loans comprised only 28% of that corporate debt. That is almost a 50% reduction in the reliance on banks by nonfarm, nonfinancial corporations in America. If you combine this trend with the fact that even small borrowers in New England may be leery of bank borrowing after the credit crunch, it

could suggest that demands for credit specifically from banks are more moderate in New England than nationally.

Looking forward, this matter likely will correct itself. Most forecasters expect New England to continue growing over the 5 year horizon at rates only slightly less than the U.S. If this happens, large bank lending will certainly grow. Moreover, with the increasing health of smaller banking organizations and savings banks, I expect we will see a continued and vibrant role for bank lending in New England.

In the meantime, there are some very far-reaching proposals under discussion in Washington to restructure the financial services industry. It is possible that the landscape will be dramatically altered in the years ahead and the role of banks in financing American industry will be substantially reshaped. But I do firmly believe we will see a continued and vibrant role for banks in our economy.

Again, I'd like to thank the South Shore Chamber of Commerce and each of you for this opportunity to share some thoughts with you. I would be pleased to hear your questions or comments.