

Opening question/ Ms. Minehan

Despite relatively low inflation, the Federal Reserve Bank has raised short-term interest rates six times this year. Many economists and businesspeople believe the Fed has overreacted to the threat of inflation, creating fears of renewed recession which recently have shaken the confidence of investors who seem to be moving from stocks into bonds. What is the rationale for the Fed's actions this year?

Answer to opening question

When discussing the Fed tightenings over the last 9 months, it must be remembered that interest rates were unusually low in the beginning of this year, roughly equal to the rate of inflation. As Chairman Greenspan explained at the time, keeping short-term interest rates equal to inflation is a highly stimulative monetary policy, suitable only when the economy is in recession.

In fact, the economy has moved from recession and slow growth in 1991 to very rapid growth over the last year. The unemployment rate has fallen steadily for more than two years and more than 5 million new jobs have been created. Over the past year real GDP increased 4.3 percent, well above any estimate of the rate that could be sustained over the long run; growth in

the last quarter was still ^{3.9}3.4 percent, also well above the growth of productive capacity. The latest Blue Chip survey of professional forecasters expects the economy to grow at a rate of 2.5 percent next year and the unemployment rate to remain below 6 percent throughout the year. All of this suggests that the Fed is tightening because the economy is so strong; the tightening has not resulted in "stifled" growth as the question I am asked to address suggests.

Having seen the consequences of New England's excessive boom in the late 1980s, we should all hope that the pace of economic activity will slow along the lines suggested in the Blue Chip forecast. The reason we hope and expect economic growth to slow is that economic conditions, especially labor market conditions, are now starting to resemble those that prevailed in previous periods when the inflation rate started to rise. Inflation has a lot of momentum so that, if it were to start to rise, the only way to stop it would be to raise rates enough to slow economic growth to a crawl. That is what we all hope to avoid by the policy we have been pursuing this year.

The policy is designed to prevent an increase in inflation. If the policy succeeds--that is no increase in inflation occurs--I think the prospects for continuing economic growth will be improved substantially.

Question

In a recent interview, you said, "I recognize the importance of the Fed as a corporate citizen and as a catalyst in developing answers to issues of local economic development." How can the Boston Fed work with the business community to help develop the New England economy to its fullest potential?

Answer

The Fed can help New England by helping the business community and public officials understand the challenges and opportunities facing New England. It is difficult to develop answers if one does not really understand the question. Thus, the Boston Fed back in 1990 helped diffuse some of the tension arising from Massachusetts' budget difficulties by publishing an analysis of the forces driving up spending levels. In the spring of this year, the Bank held a conference exploring what health care reform might mean for the region. A forthcoming article in our publication, done in conjunction with a Bank of Boston economist,

will look at New England's export patterns, showing among other things, that New England has not been as active in the fast growing markets of the Far East and Latin America as other parts of the country. The Fed can also help dispel unfavorable myths about New England and can promote the region's virtues, both through our research and through public appearances. We can and do lend our expertise on numerous task forces examining New England's problems. I personally am a member of many such organizations, but so too are many of my senior staff. Not only do we make a direct contribution in this way, but more importantly our visibility as the Fed enables us to set an example.

Finally, I would like to emphasize that New England's fortunes are closely tied to those of the national economy. Thus, New England benefits from sound monetary policy. At the same time, New England business men and women can contribute to the formulation of monetary policy by sharing their experiences with us. As some of you know, the Fed puts out a "Beigebook" which is based on informal surveys of local businesses. The

Boston Fed also has a New England Advisory Council which provides us with the perspective of small and medium-sized businesses.

Question

Have we finally reached the end of the so-called "credit crunch", and what are your observations about bank lending patterns in New England now?

Answer

Yes. The credit crunch was in large part a result of banks having insufficient equity capital to maintain their level of loans. Inadequate capital was a significant problem in 1990 and 1991, however, most banks in New England have restored their capital ratios well above their regulatory requirements. While equity capital is no longer constraining banks from lending, the increase in bank loans has been modest, lagging that of banks elsewhere in the country. Given that most New England banks have only just recovered from their loan losses earlier in the decade, it is not surprising that they may want to avoid the mistakes of the past and avoid competing by lowering credit

standards. And just as the banks have needed to restore the financial health of their balance sheets, so too have many businesses needed to improve their financial position. Now most banks and many businesses are once again able to expand, and given the economic recovery in the region, further increases in bank lending in New England are likely.

Question

In 1992, the Boston Fed issued a landmark study on racial discrimination in mortgage lending in the inner city. Do you believe that progress has been made in establishing equality in lending practices?

Answer

Yes. In part because of the Boston study, lenders have become more willing to face up to the possibility of discrimination in the mortgage lending, with senior bank management and even directors seeing this as an issue that warrants their personal attention. Accordingly, many lenders have adopted second review and other practices to ensure fair treatment. They have also launched more aggressive programs of outreach to minority communities to encourage more minority mortgage applications. It

short-run stabilization objective always aware of the long-run level of inflation, because high rates of inflation interfere with economic decisionmaking and can lead to inefficient use of resources. Apart from this, however, job creation in the long run, or the long-run rate of growth of the economy, depends on factors unrelated to Fed policy, such as population growth and the pace of innovation.

Question

As we move to a global economy with increased trade to previously closed world markets and a possible unified currency in Western Europe, will the Fed need to develop new monetary policies to help the United States be as competitive as possible on the world stage?

Answer

No. As world markets become increasingly open, the Fed does not need to develop new monetary policies. The U.S. competitive position depends on the costs of our goods and services relative to those produced in other countries. These relative costs in turn depend on long-run productivity growth, relative price movements, and the level of the exchange rate. The foreign exchange value of the dollar is determined in the long run

by factors like savings and investment rates here and abroad, over which the Fed has little control. The Fed also has little control over productivity growth. Thus, monetary policy cannot be manipulated to increase competitiveness in the long run. Perhaps a more interesting question is whether the increased openness of trade and mobility of capital reduces the Fed's ability to perform its stabilization function. The short answer to this question is that it complicates the task but does not preclude it.