

Remarks of Cathy E. Minehan
at
Economic Outlook Conference
Connecticut Business & Industry Association & Northeast Utilities
January 4, 1995

Thank you, Bill (William Ellis, Northeast Utilities). Thanks also to CBIA Director of Research Peter Gioia (Joya) for inviting me to join you. It is an honor and pleasure to be here this morning.

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. 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. Regionally, we have some

longer term structural issues facing us 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 many people in this room.

Any doubts about the continuing strength of the national economy have been diminished by recent data, including the report of 4 percent GDP growth in the third quarter. Through most of this year, private sector forecasters have been continually surprised by this economic strength. They have underestimated the consumer, misjudged how much firms might want to build inventories, and have been startled by the economic growth of our major trading partners abroad. These factors have brought industrial capacity utilization rates to their highest levels since 1989, have kept retail sales growth strong; and reduced the national unemployment rate to its lowest level since July 1990 (which is when the recession began). Moreover, inflationary pressures have remained reasonably contained. All in all, 1994

was a remarkable year, the fourth year of the recovery and one in which things kept picking up, instead of slowing down, as forecast.

During 1994, the Fed tightened bank reserves, raising short-term interest rates by 250 basis points in an effort to stay ahead of the inevitable inflationary pressures that can occur with the level of economic growth we've experienced. Each tightening action has rattled screens on Wall Street, but rising rates seem to have disturbed the overall economy comparatively little so far. Perhaps a more general perspective on 1994 would be helpful not only in understanding the past year, but also in assessing what is likely in 1995.

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 and producer

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 raising rates. Once we reach a certain point--and that point is terribly difficult to recognize, let alone to predict in advance--the pent-up demand for postponable goods is satisfied and this, 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 have not yet reached that unpredictable point. Several weeks ago we saw the nation's unemployment rate drop to 5.6 percent, reflecting a very strong

increase of 350,000 non-farm jobs in November. For over two years now, the unemployment rate has declined, and more than 5 million new jobs have been created. We are now at or below the unemployment rate that most analysts associate with accelerating rates of inflation, though thankfully we have not seen this in consumer prices or in wage growth as of yet.

The demand for new houses remains fairly strong though last week did witness a decline in new home sales. Permits for single unit homes, however, 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. Consumption for the third quarter was stronger than the second, with strong growth in furniture and appliances, as well as nondurable goods and services. Spending on motor vehicles also remained high. Nor are there signs of incipient weakness in capital spending. Business investment in equipment, including computers, was very strong in the third quarter.

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?

Some 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 and 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 two months ago, the proportion of home mortgages written as adjustable-rate loans has reduced borrowers' effective cost of funds, at least for the time being.

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, consumers 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 full effect.

So what can we expect for 1995? Without making any predictions as to interest rates - which, of course, I cannot do -- I think it's safe to say that the long awaited economic slowing will

start to take effect in 1995. Most private forecasters expect that by mid-year the economy's growth rate will slow to about half the rate experienced in 1994. Inflation may well tick up. This could be a momentary cyclical blip, or an acceleration brought about by the very high rate of economic growth and full capacity conditions of 1994. The Fed's task in 1995 is a particularly delicate one. On the one hand, we need to avoid accelerating inflationary trends; the progress we've made on the inflationary front in the last decade or so is too valuable to our current economic health to be relinquished. On the other hand we need to be careful about overdoing it and slowing things too much when the full effects of higher interest rates kick in. To say this is an interesting time to be a voting member of the FOMC is, in my view anyway, a vast understatement.

Turning to the regional 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 - 240,000 net new jobs have been added. This is good news for sure but it pales by comparison with the rest of the country. For the U.S. as a whole, all the jobs lost in the recession have been replaced, and over two times that many jobs have been added since. New England, however, has only regained about one-third of the 650,000 jobs it lost in the recession, and Connecticut has created just 13,000 net new jobs since its trough. Clearly, the nation is much further along in job recovery than this region.

Moreover, in 1994 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 over the last year in Massachusetts has been virtually the same as the U.S. figure, while Connecticut

and Rhode Island have had much slower growth rates.

Regional unemployment rates bounce around a lot, but for most of the year the New England rate has been about at the U.S. average. State rates bounce around even more, especially those of small states like Connecticut. Connecticut's rate, after peaking at 8.1 percent during the recession, is now down to 5.1 percent, which is below the U.S. average. This would seem to indicate a healthy labor market here. In fact, Connecticut's low rate is attributable to a net population outflow, which reduced both the number of state residents unemployed and the number in the labor force over the last four years. The recession was simply so severe that it drove workers out of the state.

Aside from employment, most other indicators suggest that New England is well-entrenched in its recovery, and that Connecticut is improving steadily, although much more slowly than the nation. Nationally, consumer confidence is high and rising, while confidence of New Englanders remains strong despite a small drop in December. Help-wanted advertising, in the

nation, New England, and recently in Hartford, has also been trending upward.

I mentioned earlier that homebuilding in the nation has leveled off in response to higher interest rates, but at a reasonably strong level. More of a slowdown has occurred in New England and Connecticut, but activity is still at levels well above those experienced during the recession. On the residential side, rising interest rates will reduce home purchases, but commercial real estate activity depends more on job growth than interest rate trends, at least in the near term. We are seeing some commercial construction, and more importantly, the overhang of office space that plagued the region when I arrived here in 1991 has been greatly reduced.

So the statistics look fairly good in New England. Why is it then that everywhere I go I'm asked about whether job growth is real, whether large fractions of our population are getting poorer, and why many people just don't feel as good about things as the data would indicate. At least one explanation is that this recovery

has come during a period of considerable structural change that has been underway since the mid-1980s both in New England and the U.S. as a whole. The region's and the nation's manufacturing sector began shrinking in the mid-80's, and for New England as a whole manufacturing employment continued to drop until quite recently. Connecticut is *still* reducing manufacturing employment, and is expected to continue doing so in the next few years. Most of these manufacturing jobs will not be coming back. Rather, the job recovery is concentrated in service-producing sectors.

Of all the New England states, Connecticut was perhaps most hard-hit by this structural change. Connecticut's recession lasted the longest of the New England states, ending nearly two years after the official trough for the U.S., and firms are still reacting to the prolonged contraction. Most of the state's largest employers - Pratt and Whitney, Aetna, Hamilton Standard - announced layoffs in 1994, and many plan to cut more jobs in 1995. Job creation *is* real, but it is occurring largely in service industries that may be new and are often smaller, more scattered

and diffuse.

One well-documented boost to services employment has come from the Foxwoods casino facility in Ledyard. Foxwoods added 9,500 jobs since opening in early 1992, and its success has sparked plans for other casinos in Connecticut and Rhode Island, though one wonders how many casinos can be supported in New England without each new one simply taking the business from the last one opened.

Growth in Connecticut's business and health services industries is another source of new jobs. In business services, job growth is in part a result of downsizing by manufacturers. As these firms get smaller, their need to outsource increases, creating opportunities for small companies providing accounting, legal and temporary help services, to name a few.

But despite these bright spots in Connecticut's employment picture, the fact remains that the pace of job growth in Connecticut is painfully slow. The end of the cold war and subsequent defense cuts have taken a toll on the state's

manufacturers, who rely heavily on military contracts. Jobs that are being created in services can be both low-wage and high-wage, but at the high end they often require more skills and education than the old manufacturing jobs. There may not be an easy transition from old job to new for workers laid off in manufacturing, and it's tough to come up with prospects for near-term quick fixes for this structural situation. In short, while Connecticut's recovery is real, many people don't have as much to feel good about as their brethren in the rest of New England, or in the U.S. as a whole.

Looking forward, structural change in the Connecticut economy will certainly continue. It is unlikely that there will be any kind of manufacturing rebound, but we can expect the trend towards higher service industry employment to continue. As the state catches up to the rest of the country in terms of overall economic health, activity in the trade sector should increase, boosting employment there. Overall, Connecticut should return to its pre-recession employment level by the end of the decade-

slow to be sure but steady.

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

In the early 1990s, large loan losses and very weak capital positions caused most New England banking institutions to shrink. Total bank loans declined 30 percent from their peak in the third quarter of 1989 to the trough in the first quarter of 1993. Shrinkage of this magnitude, particularly in loans to business, caused widespread complaints of a credit crunch. Particularly vocal were small businesses, which frequently depend on banks as their sole source of external credit. Research done at the Federal Reserve Bank of Boston has shown that broad-based tightening of capital requirements at a time of cyclical downturn exacerbated capital losses at many New England banks and was a major factor in the credit crunch.

Now that's not to say that attention to capital requirements wasn't necessary. Since 1960, bank capital ratios had steadily

declined both nationally and locally. The decade of the 80's brought stresses associated with third-world debt restructuring, and the rapid proliferation of new financial instruments. Valid concerns were raised that the riskiness of bank assets should be reflected in higher capital ratios. But, bank capital ratios in New England continued to decline, reflecting more rapid bank loan growth than the nation as a whole, particularly in real estate loans. With the decline in real estate values here in New England in the late 80's, bank capital positions were hit badly. Attempts by regulators to address this situation, however, required banks to restrict their lending, as increasing capital at a time of financial stress was not feasible. In fact, the particularly sharp initial rise in capital ratios in New England in the early 90's was accomplished in part through reductions in assets. In effect what started as a capital crunch became the credit crunch.

Most banks have now restored their capital ratios to comfortable levels and are once again ready to resume lending. Over the past year, total loans have been growing in both New

England and the United States; not surprisingly, given local economic conditions, loans in New England are growing more slowly than the U.S. as a whole across all categories--business, real estate and consumer.

Where do we expect lending to go in the future? 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.

In closing, the economic trends both nationally and locally give cause for much optimism and confidence about the future. Challenges for New England remain, but with a healthy growing national economy--and we at the Federal Reserve hope to

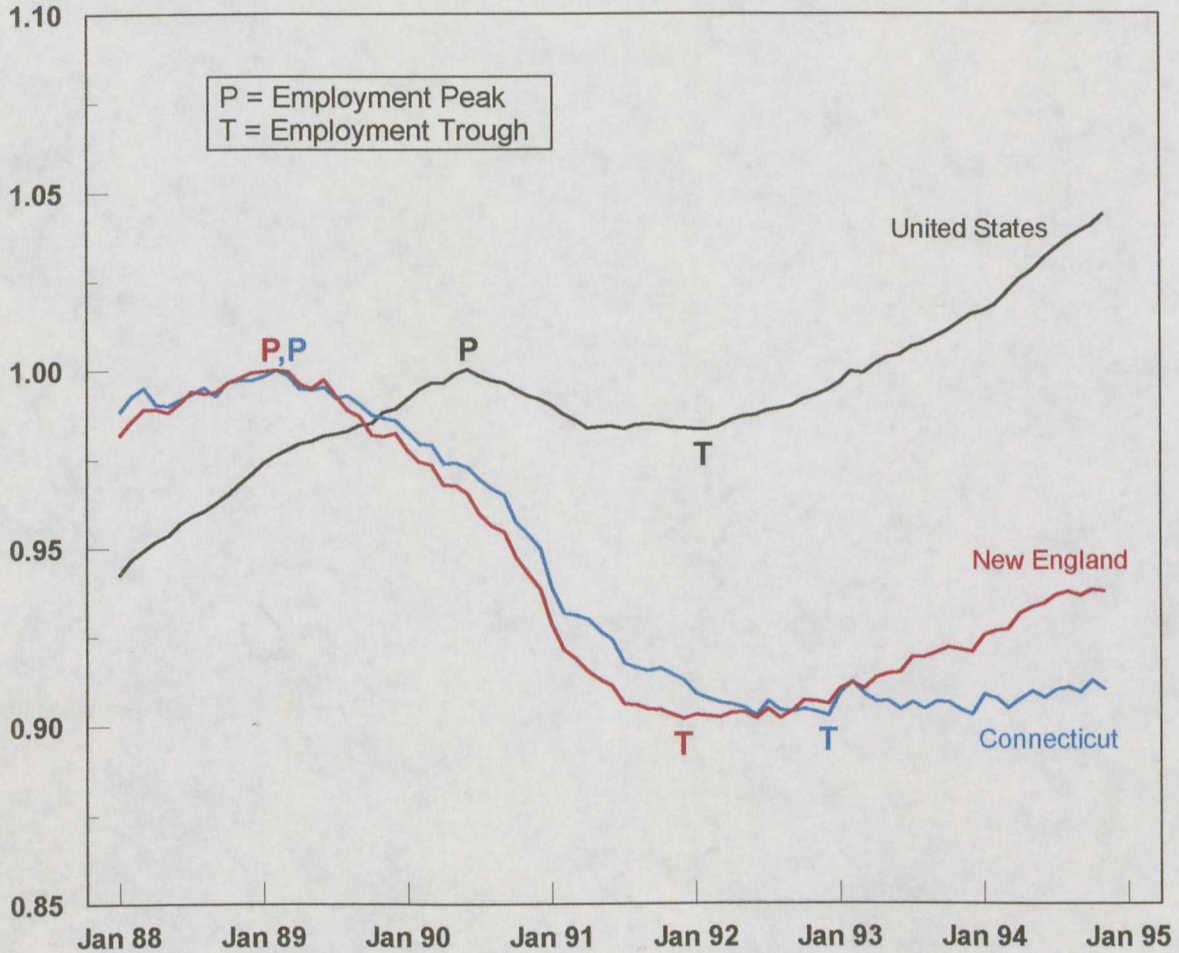
encourage that--our own regional success seems a greater certainty. I'd like to thank the Connecticut Business & Industry Association and each of you for this opportunity to share some thoughts with you. I would be pleased to hear your questions or comments.

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Chart 1

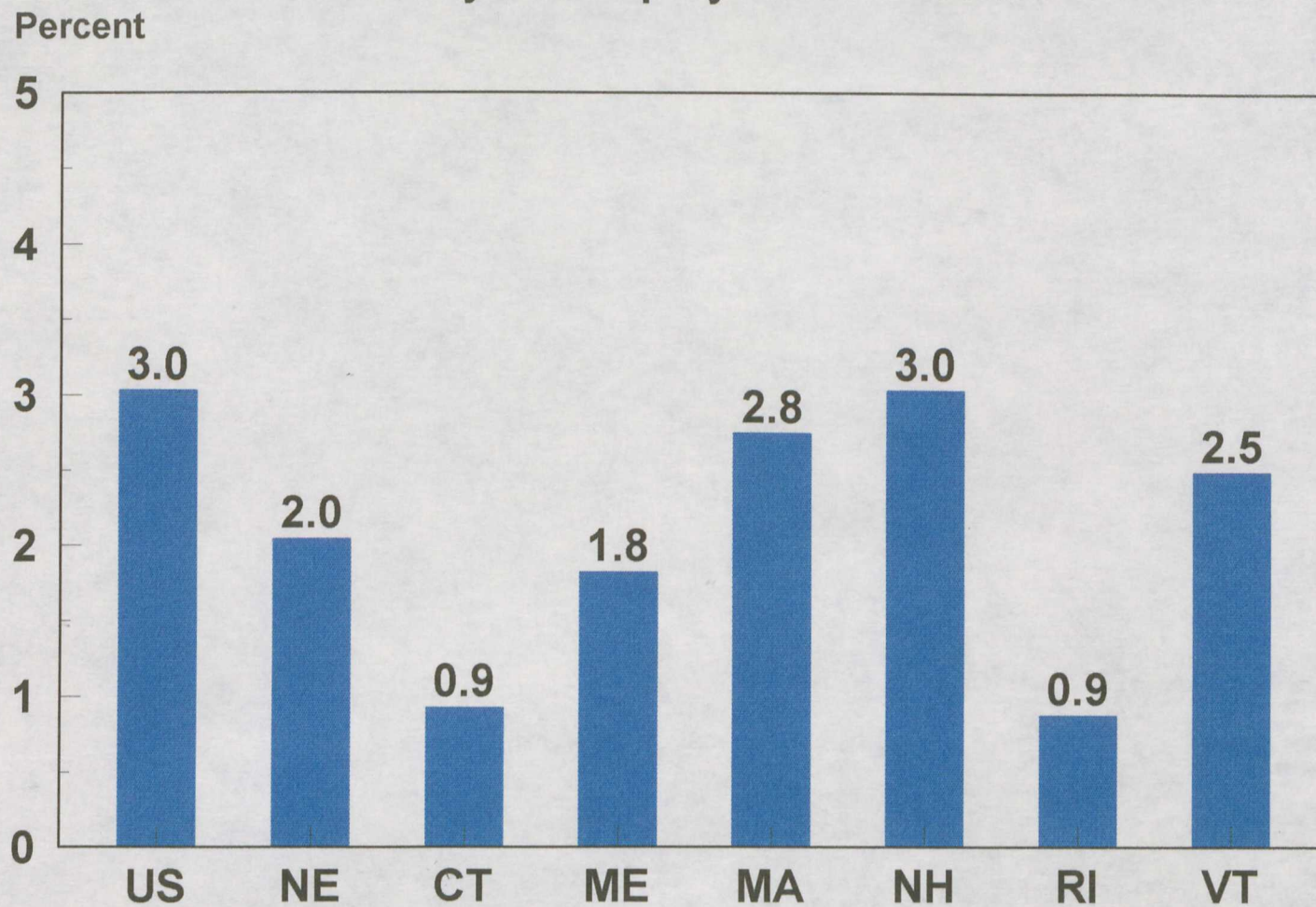
Nonfarm Payroll Employment

Index, Each Region's Employment Peak = 1



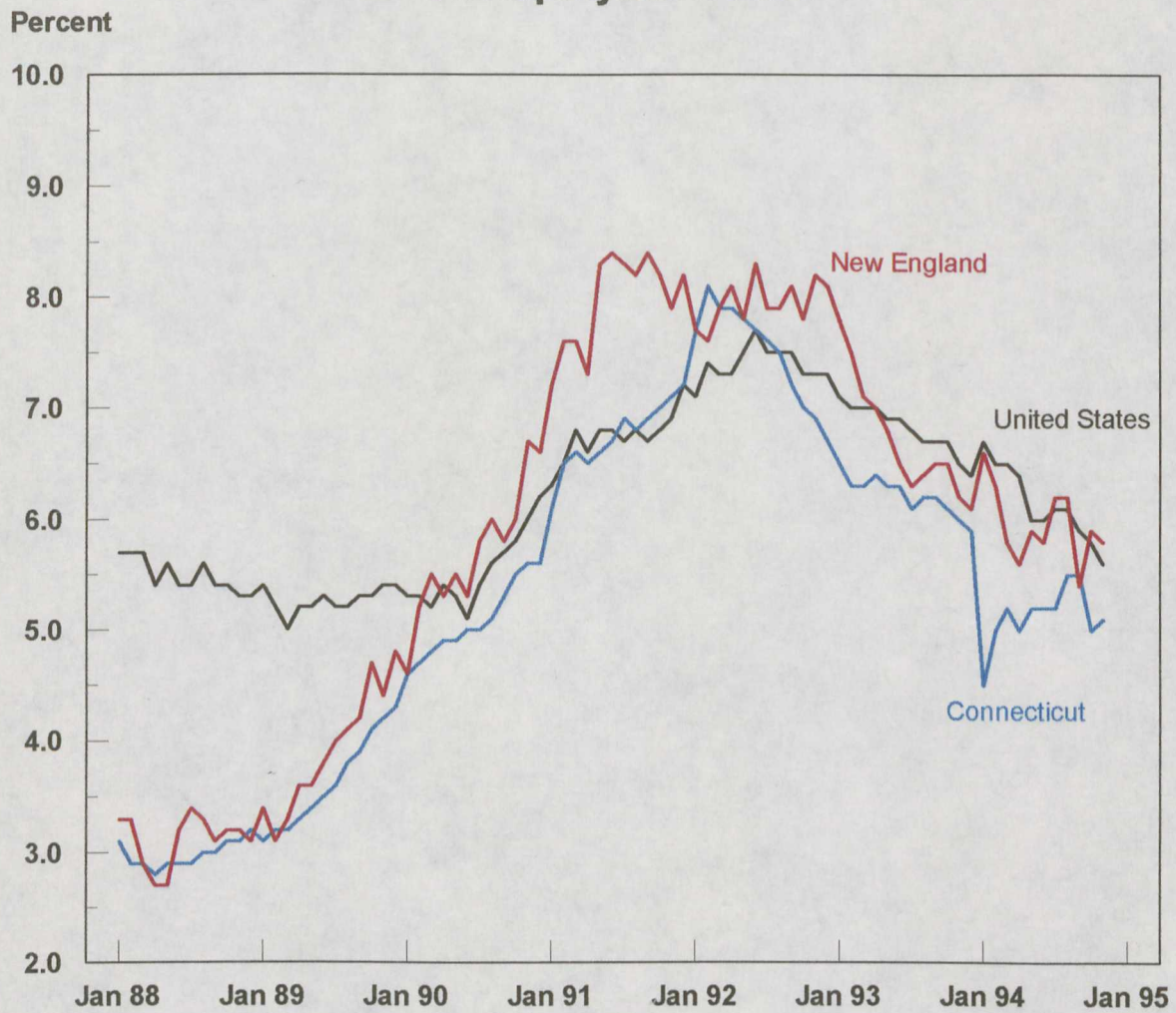
Source: U.S. Bureau of Labor Statistics.

Chart 2
Average Annual Growth of Nonfarm
Payroll Employment in 1994



Note: Calculations do not include December 1994 data.

Chart 3
Unemployment Rate

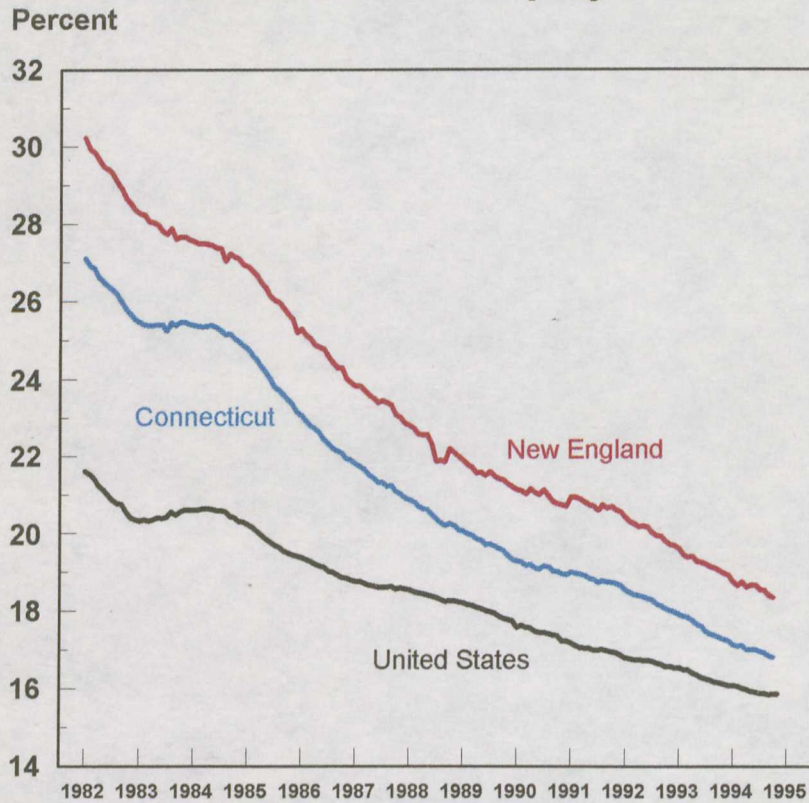


Note: Data beginning January 1994 reflect the redesigned CPS survey and are not strictly comparable to data for 1993 and earlier years.

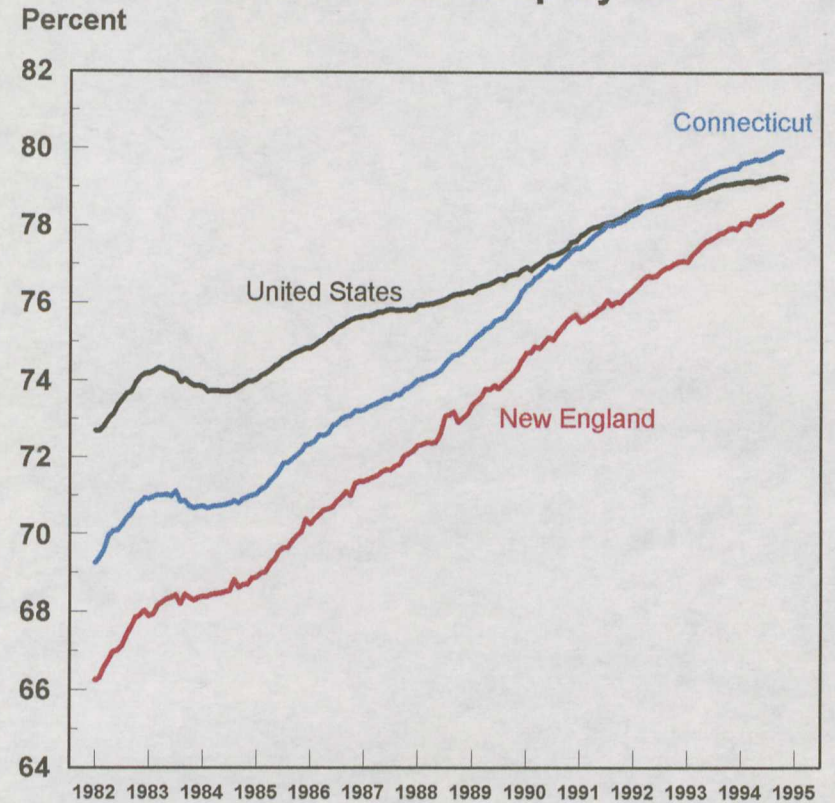
Source: U.S. Bureau of Labor Statistics.

Chart 4 Structural Change in Progress

Manufacturing Employment as a Share of Total Employment



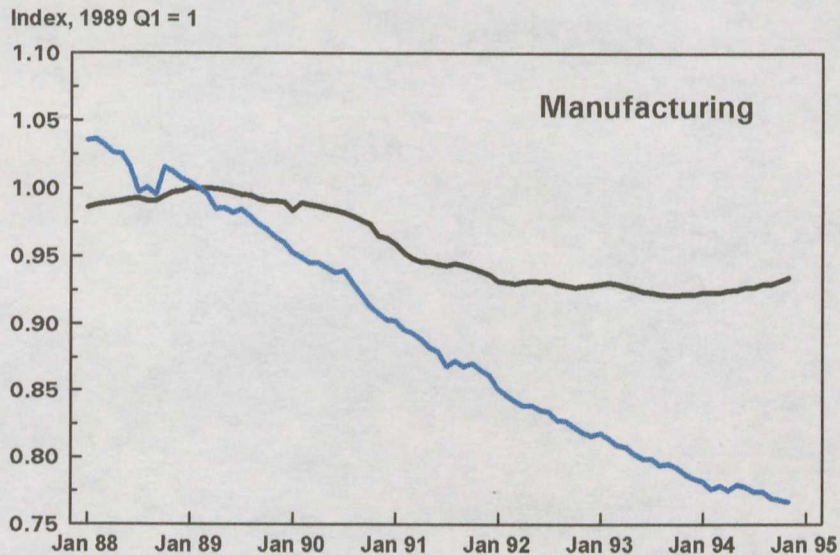
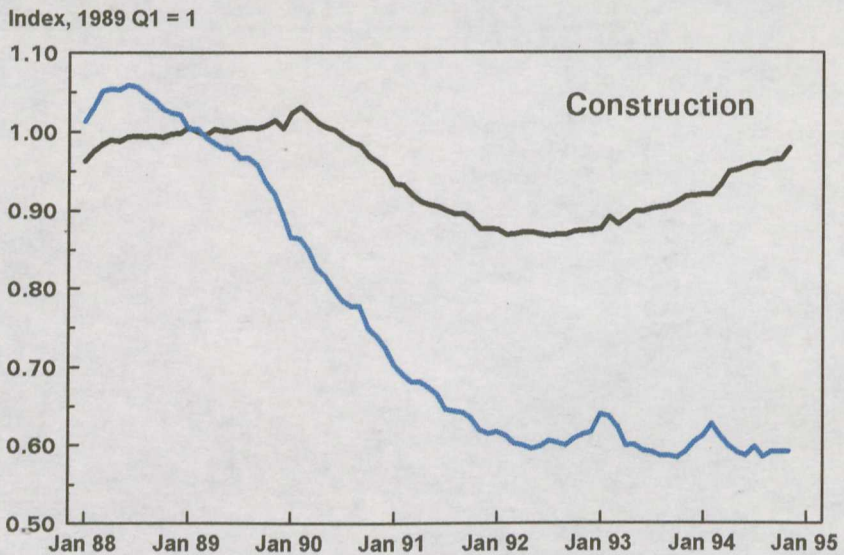
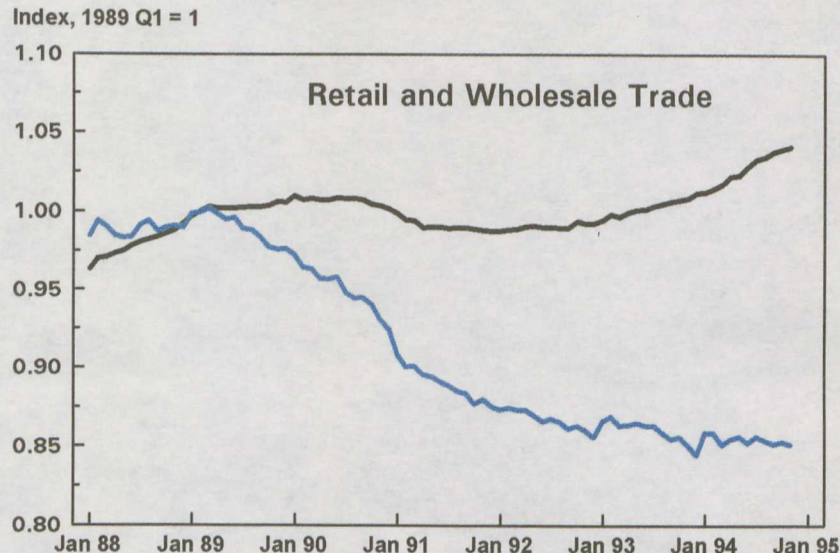
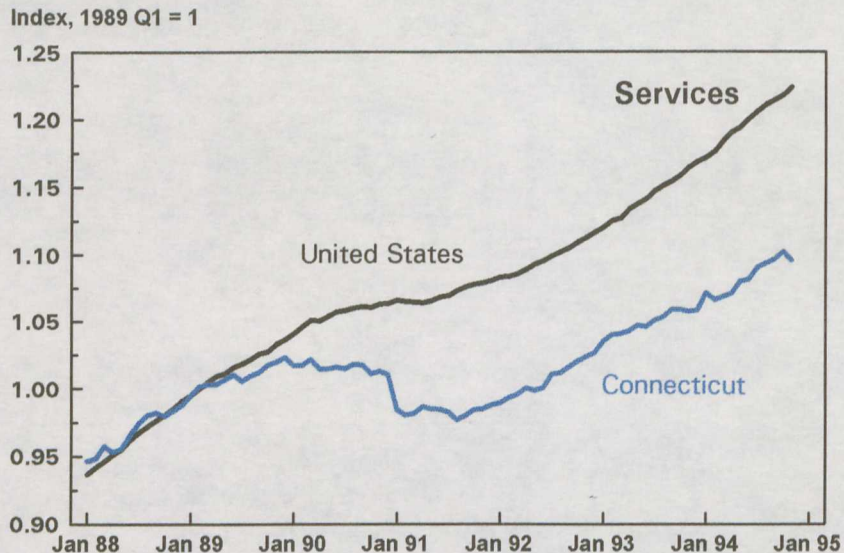
Service-producing Employment as a Share of Total Employment



Source: U.S. Bureau of Labor Statistics.

Chart 5

Sources of Employment Growth by Sector



Source: U.S. Bureau of Labor Statistics.