

Remarks of Cathy E. Minehan
at
Fourth Annual Vermont Economic Outlook Conference
January 13, 1995

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Good afternoon. I'd like to thank Art Woolf for inviting me to be here with you today. The Vermont Economic Outlook Conference has become an important tradition, and I appreciate the opportunity to be part of it.

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. I will also talk about the key issues involved in the formation of monetary policy as we move forward. Then, since we've heard many excellent speakers

this morning talk about the economies of New England and Vermont, I thought I would instead turn from the national to the international. 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). The December producer price data show that wholesale prices are up just 1.7 percent from

a year ago, and the latest CPI increase of 0.2 percent suggests inflationary pressures remain reasonably contained -- though with the degree of tightness we now see in labor markets, upward pressure on wages could emerge. 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. The national unemployment rate continued its downward trend, reaching 5.4 percent in December, while 256,000 new jobs were added to the country's payrolls. November saw an increase of 488,000 non-farm jobs. 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~~ ^{recently we see} did witness a decline in new home sales. Existing home sales ^{however} are on a pace to match -- if not exceed -- the highest level on record. 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. 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.

At this point I'd like to turn to a discussion of a couple of relevant international developments. But first, so you don't think I'm neglecting Vermont or New England in general, I'd like to mention the chart packages at the back of the room which I invite you to take home with you. As I noted before, rather than repeat the regional analysis you heard earlier, we thought we'd simply provide you with some charts which highlight the recoveries in Vermont and New England in the context of the country as a whole. The final chart illustrates a key factor in both the national and regional recoveries -- the dramatic shift in employment away from manufacturing jobs toward a heavier reliance on service jobs, in Vermont, New England, and the U.S. In summary, the charts show what you already know -- that Vermont has recovered relatively faster than its neighboring states, but that longer-term structural issues remain..

Internationally, economic recovery has spread to all the major industrialized countries and is becoming increasingly well

established even in Japan. The OECD (The Organization for Economic Cooperation and Development) characterizes prospects for its members as better than they have been for several years, with unemployment declining in most countries and inflation low and likely to remain so over the near term. Growth also continues robust in many Asian and some Latin American countries and has resumed in some of the transitional economies of Central Europe and the Baltic--though not in Russia and other members of the old Soviet Union. The outlook has even begun to improve for individual countries in Africa, as a result of rising commodity prices and reform efforts. In total, the IMF expects real world output to grow at a 3.6 percent pace in 1995, a faster rate than any in the 90's.

This boom in world economic growth is coinciding with what will likely be the fifth year of economic recovery in the United States. Reflecting this, the IMF projects overall growth in world trade at 6 percent for 1995--a rate slightly behind the pace of 1994 but well ahead of earlier years in the decade. Indeed, U.S.

export growth has been a major unexpected surprise in our domestic economy this year, and some analysts expect exports to be even stronger next year. This will be a major source of buoyancy for the U.S. economy, which, in turn, will have spillover effects on countries that are major suppliers for goods that we export.

There is no doubt in my mind that NAFTA, and, more importantly, the successful conclusion of the Uruguay Round reinforces these favorable prospects. The GATT Agreement will greatly enhance trading opportunities for all countries over the long term and should bolster confidence and investment incentives even now. Conservative estimates indicate that over time the GATT agreement should bolster world trade by 10 percent and raise world income by \$250 billion or 1 percent, as a result of efficiency gains.

The confluence of world and national economic recovery augurs well for Vermont's continued growth. Between 1987 and 1993 Vermont's export share of Gross State Product grew

from 8 percent to 23.5 percent, and is now the largest of any New England state. That this growth occurred despite the weaker Canadian economy and dollar indicates the potential boost available from global markets. It also suggests one reason that the Vermont recovery outpaced that of neighboring states early on. Renewed economic strength of Vermont's trading partners can only continue this trend.

The international prospects for 1995 are bright. We are in the midst of a world-wide cyclical upturn, and meaningful structural change in the openness and competitiveness of markets provides many opportunities for financial returns. Important challenges exist both in meeting the world's burgeoning demands for capital and in the risks associated with doing so. But I think we in the Federal Reserve, and the major U.S. financial institutions are well positioned to deal with these challenges.

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 internationally, 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 Northern Economic Consulting and Vermont Magazine for asking me to join you today, and I would be pleased to hear your questions or comments.

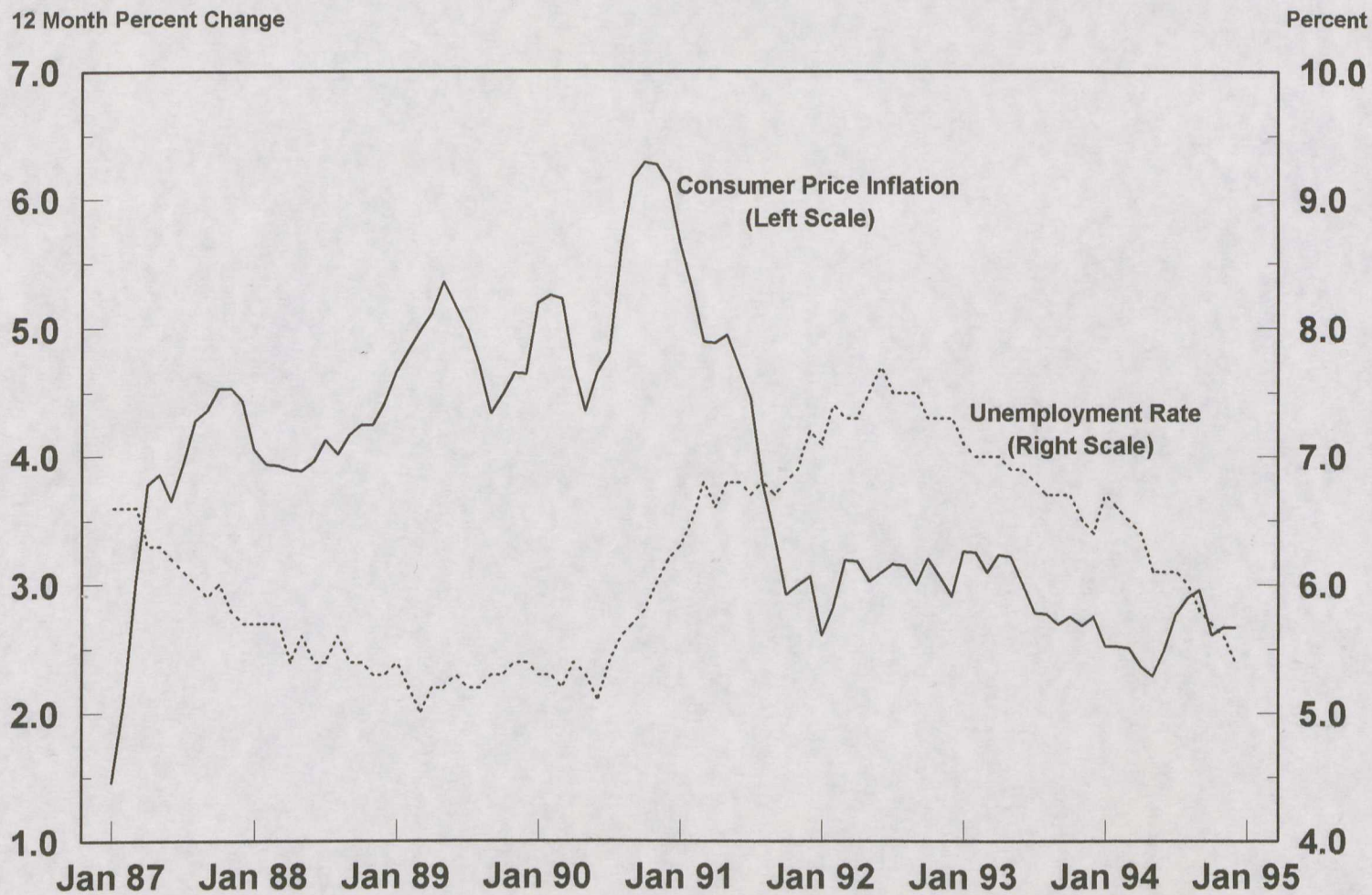
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**Charts Prepared by:
Federal Reserve Bank of Boston**

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Chart 1

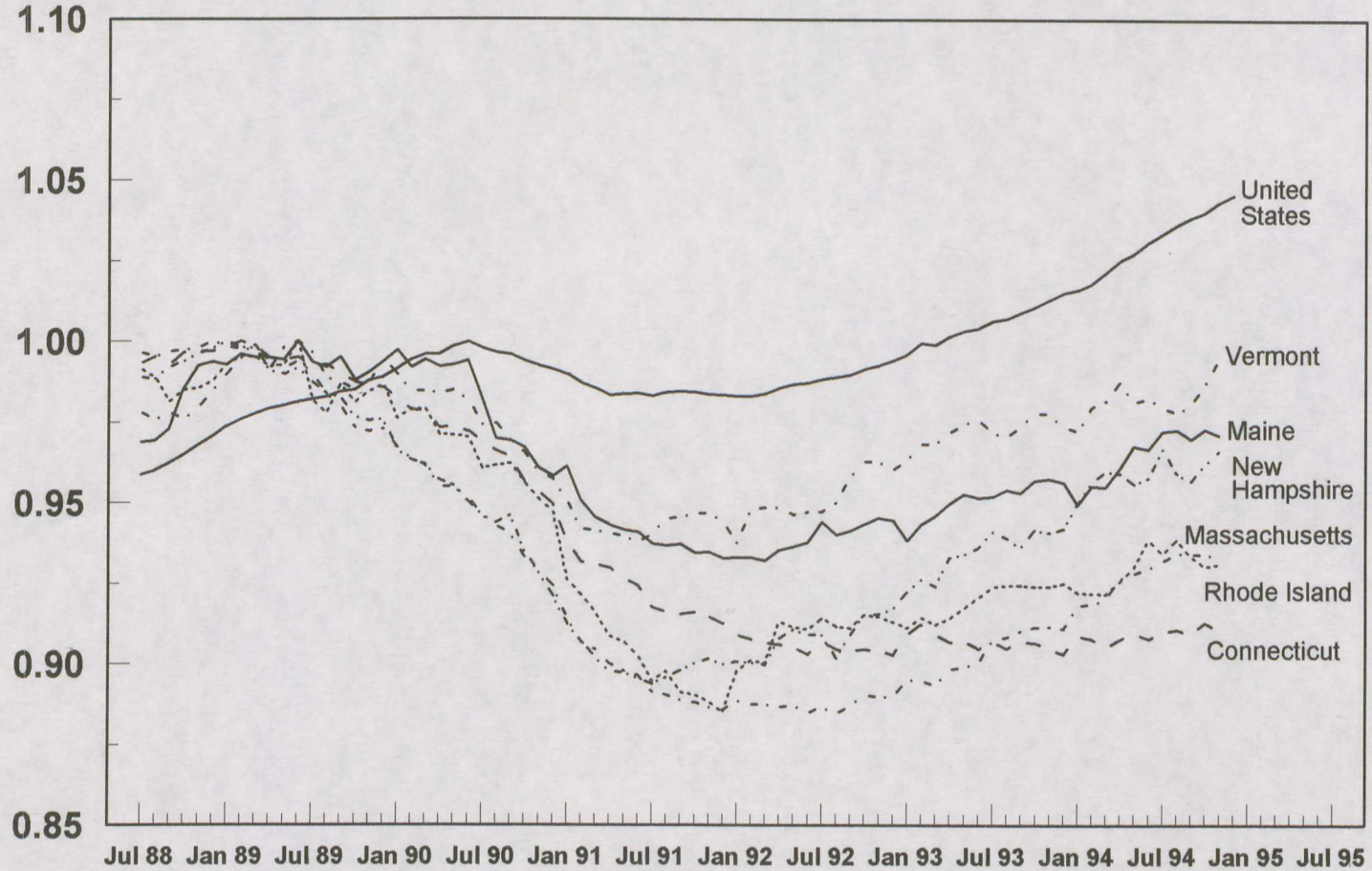
Consumer Price Inflation and the U.S. Unemployment Rate



Source: U.S. Bureau of Labor Statistics.

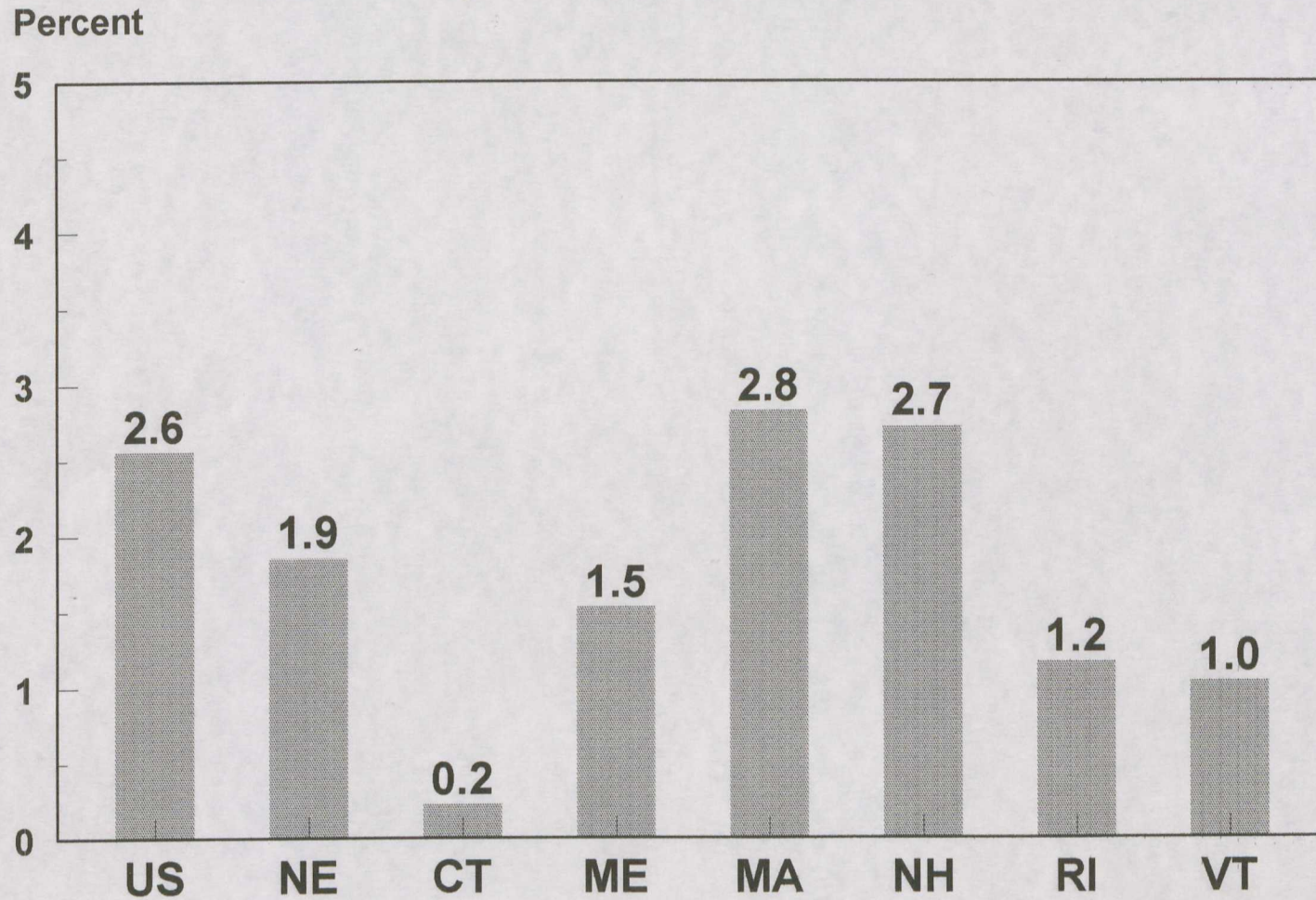
Chart 2 Total Nonfarm Employment in the U.S. and New England

Index, Each Area's Employment Peak = 1



Source: U.S. Bureau of Labor Statistics.

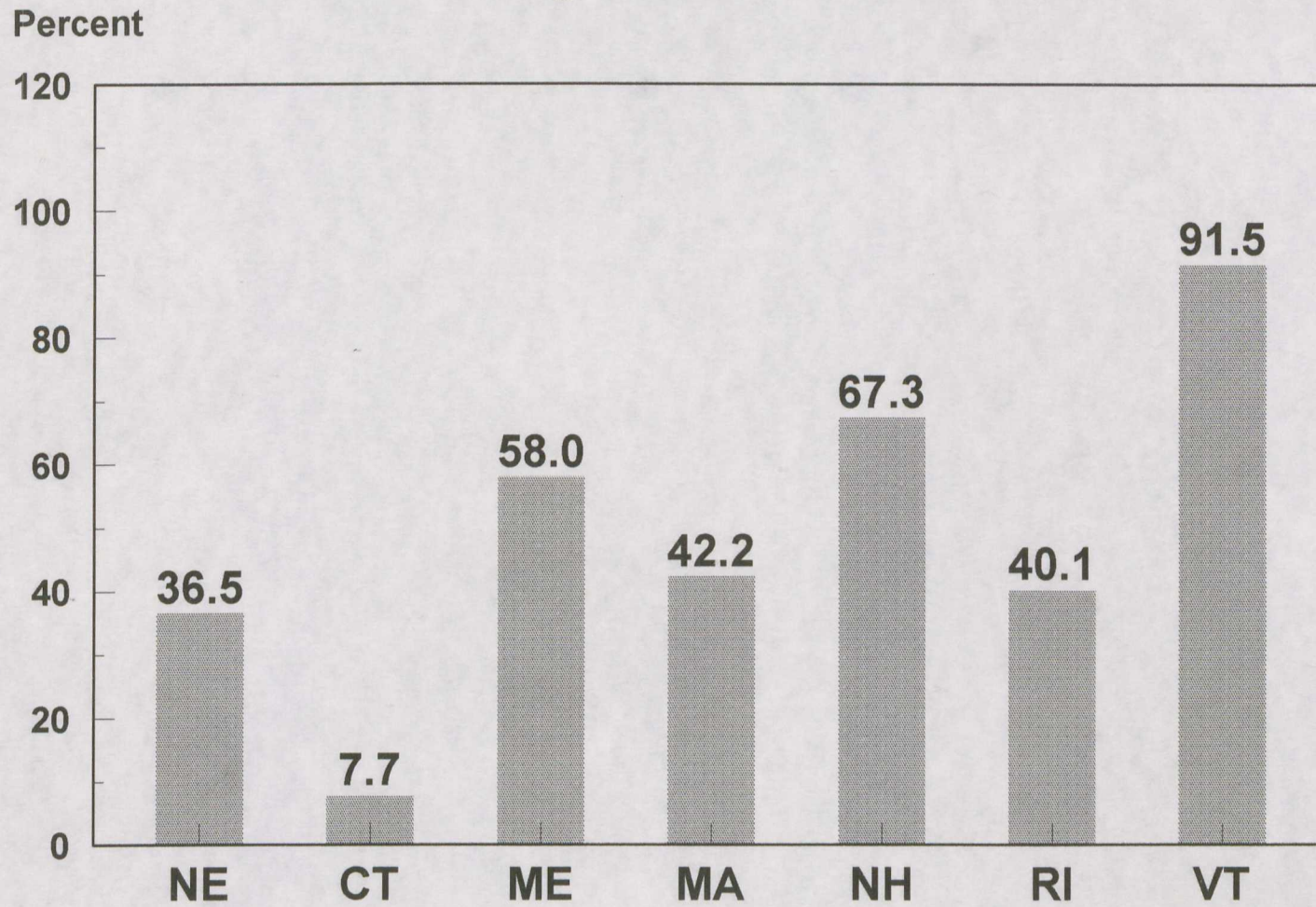
Chart 3
Average Twelve Month Growth of Nonfarm
Payroll Employment in 1994



Note: Calculations do not include December 1994 data.

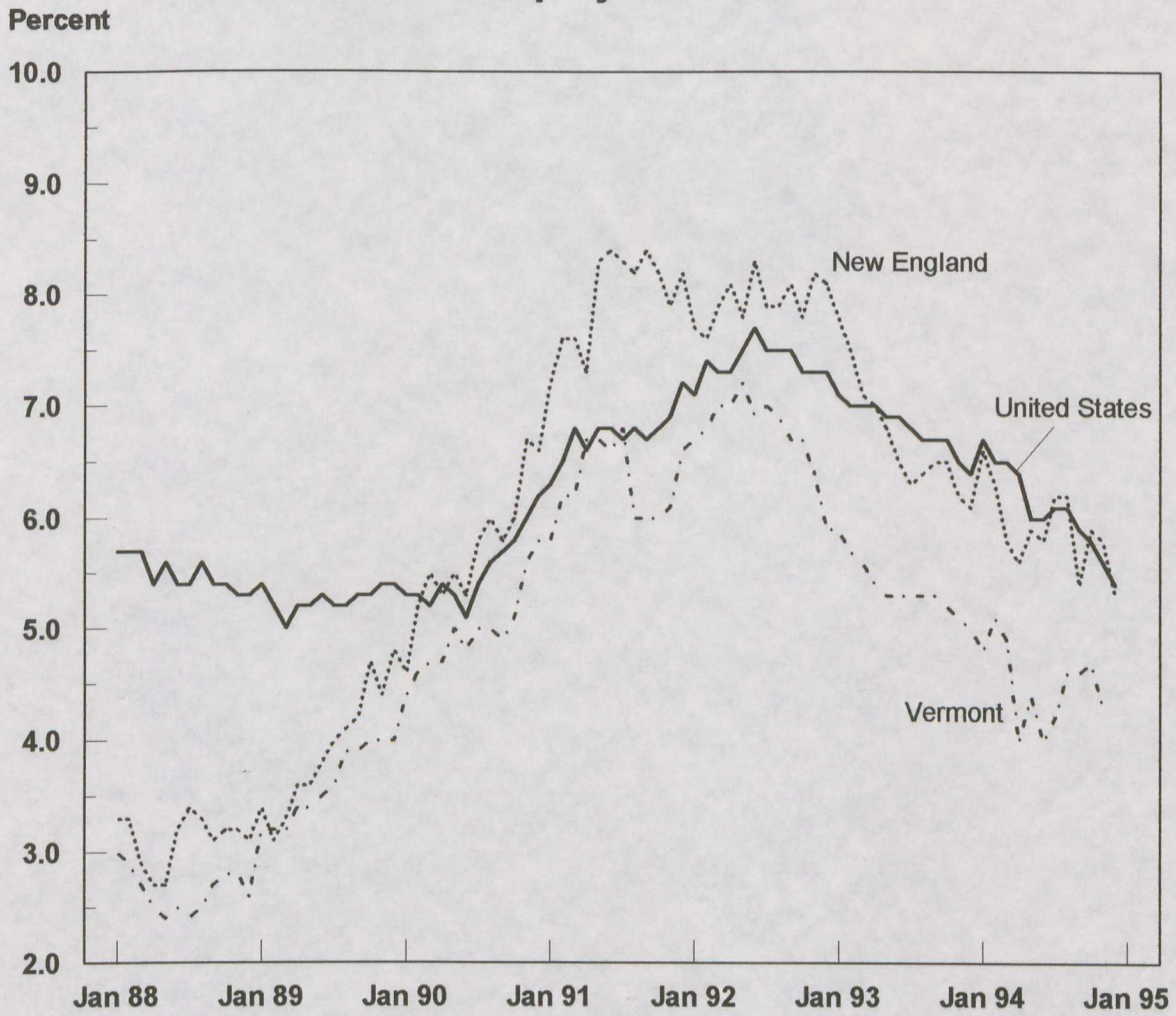
Source: U.S. Bureau of Labor Statistics.

Chart 4
Jobs Recovered as a Share of Total Jobs
Lost During Each Area's Recession



Source: U.S. Bureau of Labor Statistics.

Chart 5
Unemployment Rate



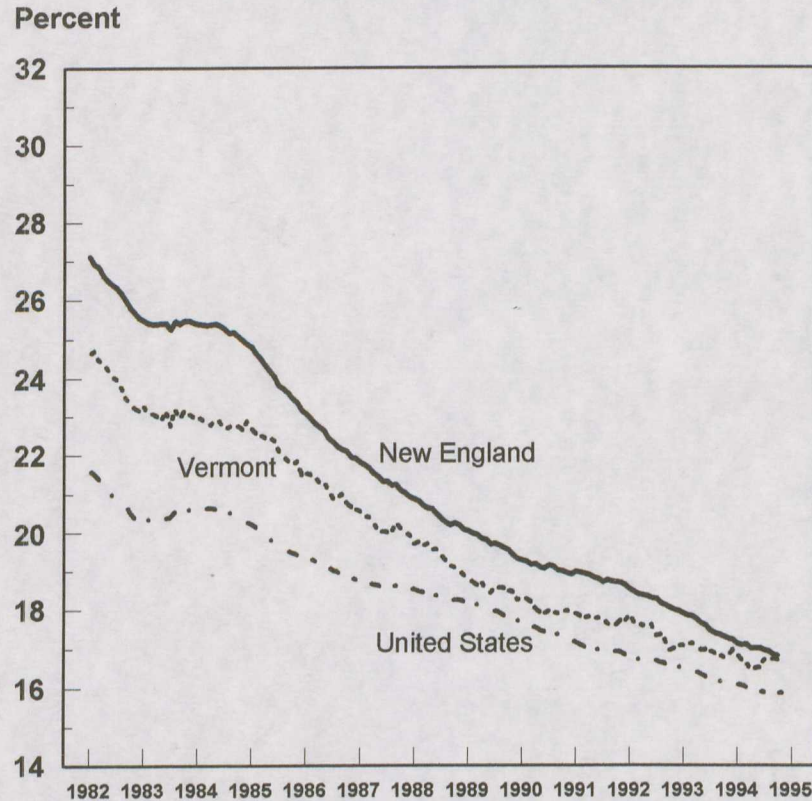
Note: Data beginning January 1994 reflect the redesigned CPS survey and are not strictly comparable to data for 1993 and earlier years.

Source: U.S. Bureau of Labor Statistics.

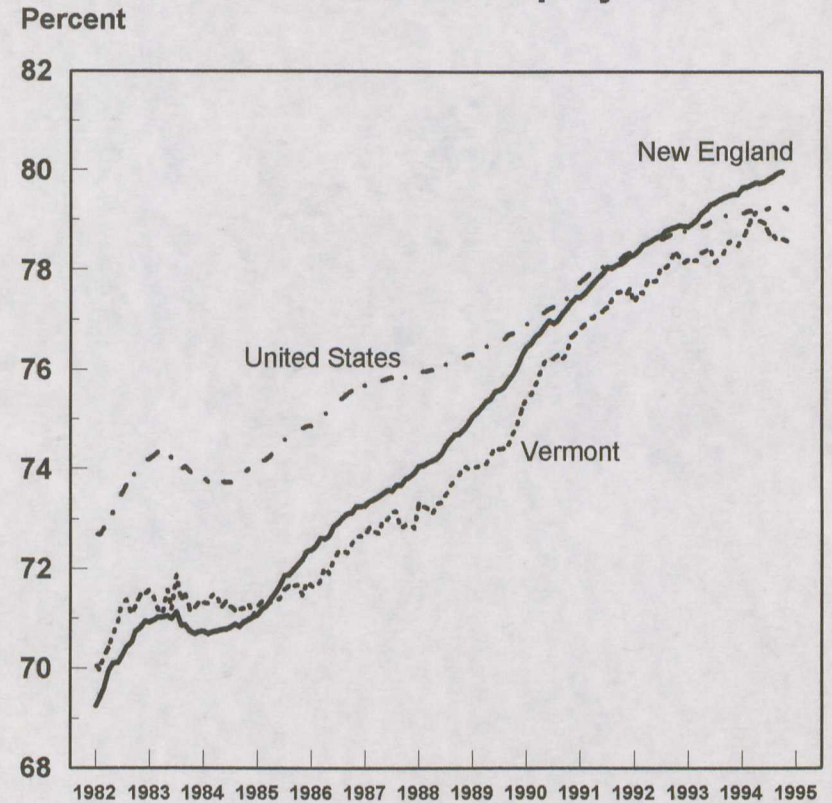
Chart 6

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.