

Remarks by Cathy E. Minehan  
before  
The Bostonian Club  
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Good afternoon. I'd like to thank Pam McDermott and Laddy Brank (Lardy Brahnk) for inviting me to be with you today. The Bostonian Club Forum has a tradition of having very distinguished speakers, and I am honored and pleased to be in such company.

Today I would like to speak to you about what I believe are the significant challenges facing the Federal Reserve and more particularly the Federal Reserve Bank of Boston. I'd like to do this within the context of the structure of the Federal Reserve, and hope that perhaps you will come away with an enhanced understanding of our Central Bank and its many responsibilities. By doing so, I also hope to give you some insight into what it's like to be the President of a Federal Reserve Bank.

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.

In both my old operations job and now as the Bank's President, I must confess that not a day goes by I'm not impressed, if not awed, not only by the breadth of responsibility that is the Federal Reserve's, but also by the wisdom of the founders of the System.

The creation of the Federal Reserve System in 1913 involved a grand compromise between those in Congress who favored a purely private central bank and those that believed that the nation's central bank should be purely governmental. At that time there had built up an aversion to concentrations of economic power. There was considerable concern that a purely governmental central bank would become too powerful. The compromise that was reached was to combine, within a single system, a central governmental authority in Washington, the Federal Reserve Board, and essentially private regional Reserve Banks located in important centers of the country. Each Reserve Bank is a separate corporation chartered under the Federal Reserve Act and subject to the control of its local Board of Directors, but also subject to the general oversight of the Board of Governors. Each Reserve Bank has jurisdiction over a particular section of the

country with the Boston Reserve Bank covering virtually all of New England.

The intent back in 1913, which still holds true today, is that separate Reserve Banks with deep roots in their individual Districts are in the best position to know the complexities of the local economy. They can bring that knowledge and expertise to the table when the Federal Reserve considers national economic priorities. Each Reserve Bank has a unique perspective on the economy of its District and on the health of its banking institutions; possesses a unique understanding of the complex nature of the financial structure of its District, and is in the position to act as an active intermediary in processing transactions between depository institutions within its region and outside of it. These competencies are important given the statutory role of the Federal Reserve--a role that is often visualized as a three-legged stool--a unified whole having an overriding mission with three separate functions that work together.

The overriding mission of the Federal Reserve is this country's financial stability. The System pursues this goal by addressing the three major areas that form the legs of the stool. The first leg is

participation in the formulation of the nation's monetary policy, which involves expanding and contracting bank reserves to effect short-term credit conditions and control the value of the nation's currency. The second leg is the supervision and regulation of banks and bank holding companies in a fashion that both promotes financial stability and protects the transmission of monetary policy. Finally, the Fed is responsible for participating in and overseeing the nation's payments system--the glue that holds everything else together.

While each of these responsibilities is equally important, participation in the conduct of monetary policy is the most important role of a President of a Reserve Bank. Beginning this month I am a voting member of the Federal Open Market Committee, the Fed's 12 member Committee which sets monetary policy. To handle this rather awesome responsibility, I am served by a fine staff of economists and draw heavily on outside panels of academic economists and market participants. Equally important, however, is the anecdotal information that I gather from regular meetings with business leaders such as yourself. While a Fed president represents his or her individual District at the Open Market Committee, we must

consider the impact of monetary policy on the national economy, rather than strictly on how it will affect our region. Nonetheless, as evidenced in the early 1990s by the credit crunch and the particularly severe recession experienced in New England, the regional perspective is extremely important and must be ably represented.

I should also mention that from time to time the unique private/public, regional/central organization of the Federal Reserve is questioned by Congress. This is, of course, appropriate in that the Federal Reserve is a creature of Congress, but those of us in the System have to admit to some bias that the current structure works quite well. For example, as we speak, there is draft legislation to make Reserve Bank Presidents appointed by the Board of Governors rather than selected by their own regional boards of directors after consultation with Washington. In my view, this creates a real change both in the attachment of the Reserve Bank to its District, and in the relationships on the Open Market Committee. Again, I'm biased but I would leave well enough alone here.

Right now we are at a particularly interesting, and challenging, time for monetary policy. 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 and expectations of better than that in the fourth 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 1990. At the same time, price pressures have been restrained. 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 brought the year-over-year rate of growth in at less than 1993. 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, thereby 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. Most of the interest sensitive sectors seem to be holding their own while capital spending, particularly business investment in equipment, especially computers has been very strong. Why haven't we seen more of a slowdown?

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 change more dramatically 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.

The theme of 1995 as a particularly interesting and challenging year extends beyond the monetary policy arena into bank supervision as well. As you know, Congress enacted legislation last year which will permit nationwide banking by 1997. We don't expect this legislation will have as much of an impact on New England as in some other areas of the country, largely because we have already experienced significant consolidation of the banking industry in this region. We do expect some further consolidation as our large financial institutions round out their market areas and as our regional economy continues to improve. I also expect that when the dust settles on interstate banking we will continue to have some large regional institutions headquartered here, though I think we must be sensitive to areas that may make Massachusetts less desirable as a bank headquarters. One that comes to mind is bank taxation, which needs to be a top agenda item for the state legislature this year.

We must also consider effects interstate banking may have on the regional economy and we have been doing research on the effects of interstate banking on credit availability in the region. A principal concern is the availability of credit to small and medium sized

businesses traditionally served by small community-oriented banks .

As consolidations occur and small banks are merged into large regional banks, some people are afraid that credit may not be as readily available to smaller firms.

Another regulatory area that our Bank will continue to focus on and one that I feel very strongly about is ensuring that equal credit is available to all. Even subtle forms of discrimination in the credit granting process need to be addressed. We have worked very hard here in Boston with the banking industry and community groups to try and determine what prevents individuals from obtaining equal access to credit. We have developed training programs and other tools to educate lenders and the borrowers about discrimination in the provision of credit. While significant progress has been made, we realize that much needs to be done in this important area and we want to work in cooperation with the banking industry, community groups and the business community to insure we obtain the desired goal of equal access to credit.

Hands-on involvement in bank supervision and regulation is extremely important to the effective functioning of the Federal Reserve

System as it is the primary mechanism for the transmission of monetary policy to the real economy. This hands-on involvement was key to our understanding the ramifications of the rapidly declining real estate prices on banks in our district in the early 1990s, in turn helping us to identify the credit crunch and its effect on the regional economy. An understanding of how important this function is to the Federal Reserve is apparently shared by Congressman Leach of Iowa, the new Chairman of the House Banking Committee, who has recently sponsored a regulatory consolidation bill that would keep the Fed active in the bank regulation area. This is in contrast to a proposal put forward by the Treasury last year, which would have drastically reduced the Fed's involvement in supervision and regulation.

Recent developments concerning the use of derivative instruments add to the supervisory and regulatory challenge. In order for the Fed to manage risk to the financial system, it must remain vigilant about those risks. The expanded use of derivative financial instruments has created both opportunities to manage risks and potential new exposures to private and public investment portfolios. We have all read about the problems in Orange County, California

stemming from derivatives. Here in New England, the City of Auburn, Maine received publicity recently when some of its investments were sharply devalued due to rising interest rates. We are in the process of planning a seminar for end users of derivative products in the first District -- municipalities, counties, states, as well as corporations and thrift institutions -- to help them focus on the appropriate uses and risk of derivatives in managing money and hedging risks.

Emerging technologies, global financial markets, and new financial instruments all require continued vigilance on our part. The traditional business of banking has changed and a number of activities that were unique to banks are now available in varying degrees from other nonbank providers of financial services or directly from the capital markets. Insurance companies provide an array of funding sources for corporations and mutual funds provide alternatives for individuals to invest their savings, to name just a few. New England has a high concentration of insurance and mutual fund companies and financial services companies that provide investment advice to mutual funds. One of our key priorities at the Boston Fed is to be expert in these non-bank critical financial institutions, how they effect monetary

policy transmission, and the nation's financial stability in times of crisis.

Turning to the third leg of the stool, I have spent a significant amount of time over the last two decades managing payments system operations. You may not be aware of it, but just about 1/3 of all the checks written are processed by Reserve Banks (that's about 55 billion pieces of paper annually), and more importantly, better than \$2 trillion in electronic transfers are handled each day. Despite this, I know from experience, that just saying the term payments system can cause eyes to glaze over. Like the plumbing that brings us fresh water, however, our financial system cannot work without an efficient way to transfer value from one market player to another. Or, to use another metaphor, just as an effective transportation and distribution system is essential for the efficient movement of goods to market, so, too, is an effective payments system essential for the efficient transfer of value. If money and capital markets are to gather and allocate their resources efficiently they *must* have access to an effective payments system. And to follow this reasoning one step further, as market activities become increasingly international in scope, an effective *international*

payments system is required -- with all of the additional complexities implied by different currencies, different operating hours and different regulatory environments.

In response both to anticipated changes in the structure of the banking system in the U.S., and to the need to continually improve the payment system infrastructure, the Federal Reserve has recently restructured its financial services operations. Four Reserve Banks, with support from the System as a whole, will each manage a portion of the planning for Reserve Bank efforts in the payments system. The Boston Fed has been honored by being named to manage retail payments products, which include the mundane areas of check collection and the automated clearinghouse functions for the entire country. Our challenge here will be to set a strategic plan together with the banking industry and major payment system users that will move this country away from a dependence on paper checks and toward a fully electronic system. There are major efficiencies to be gained that will accrue to our nation and make our financial services sector more competitive globally. This is a tall order for us, so if we go around boring you to tears with our efforts in the payment system

arena, please excuse us. The stakes are high and we are determined to make a difference in this technical but highly important area.

In closing, I hope I've given you some idea of the breadth of what we do over at 600 Atlantic Avenue, and the challenges we see in 1995. I must say I have found the first six months in this job the most incredibly intellectually challenging period of my life. Throughout my career, I have sought to occupy positions where intellectual growth is a prerequisite, and I've learned to be a practical, focused decision-maker. In that regard, I bring skills to the table in Washington that are not unlike a couple of the members of the Board of Governors with backgrounds in banking or business, and at least one other Reserve Bank President. Just as the Federal Reserve Act brings together regional and central perspectives within the Federal Reserve System, so too the joining of economists and practitioners at the FOMC table brings theory and reality into clearer focus, and, I hope anyway, makes for better economic judgements. I face this year with a sincere sense of awe at the challenging tasks that face us in 1995 and beyond, and a deep commitment to continuing and broadening the role the Boston Reserve Bank plays in our local community. I view the opportunity to speak to you today as part of that role. Thank you.