

Remarks by Cathy E. Minehan
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Good afternoon. It's a pleasure to speak before this very impressive group. Since being named President of the Boston Fed in July 1994, I have had my share of press attention, and I can tell you that my respect for the power of journalism and the newspaper industry has become quite keen. However, I'm not sure I'd go so far as Thomas Jefferson did in 1787, when he said: "The basis of our government being the opinion of the people, the very first objective should be to keep that right, and were it left to me to decide whether we should have a government without newspapers, or newspapers without a government, I should not hesitate a moment to prefer the latter." I'm pleased that he did not have to make that difficult choice. Personally, I think there's room for both of us.

I'd like to cover three topics in my comments this afternoon. First, I'll give you a few perspectives on the national economic scene and discuss the background of and environment for monetary policy in

1995. Second, I want to focus specifically on the issue of job creation, both locally and nationally, and what opportunities are presented for the nation's workers. Finally, on the same general theme, I want to spend some time on aspects of equal credit opportunity which, as you likely know, seems to be a cottage industry at the Boston Fed.

On the national scene, the economy in 1994 seemed almost "too good to be true." Inflation and unemployment both low, output growing rapidly, and our major trading partners all regaining economic health together. Unfortunately, this could be too much of a good thing. As 1994 progressed, stronger economic growth than expected by many if not most economic observers brought us to what many consider to be the limits of our productive capacity. In reaction to this, we at the Federal Reserve raised short-term interest rates 6 times, essentially to let off the steam from a potentially overheated economy. Many have complained that we've engaged in overkill; others say we should have acted sooner in the face of very easy monetary conditions in late 1993. The proof of who's right will be in how the economy adjusts during the first half of 1995.

Economic expansions have a certain life cycle that is often

compared to a plane taking off and landing. Coming out of a recession, we would normally experience a fast acceleration in economic growth just as a plane would need to take off. This level of growth eats into excess capacity in labor markets and in productive resources, until all the unused capacity is gone. At this point, the plane is cruising. Further growth acceleration at this point can lead to inflation, as the demand for goods outstrips our ability to produce them. Thus, what we do at the Fed is try to slow growth sufficiently so that our economic plane gently cruises down into a soft, safe landing--with the economy still growing but inflation risks diminished. Unfortunately, if we pull on the throttle too sharply--i.e., raise interest rates too far--our plane will crash into a recession. And if we don't pull hard enough, the resulting inflationary trends will require even harder tugs on the throttle later.

This economic expansion has followed a somewhat different course than earlier ones--complicating the task of engineering a soft landing even further. Instead of accelerating quickly at the beginning of the expansion, our plane tried to glide out, and only began rapid acceleration about two years into the recovery. This has led to all sorts of conjecture about economic capacity, the effects of increasing

globalization, the impact of rising productivity growth, and on and on. At this point, however, I think we would be kidding ourselves if we thought there was a safe way out of the current situation that did not involve economic slowdown.

Whether the economy will achieve that desired soft landing is not yet known. If the hikes in interest rates to date have succeeded in slowing growth sufficiently this year, then success is likely. If, however, growth continues at anywhere near last year's pace, inflation will rise. The question now is: Will the slowdown occur in time?

One must look to the sectors of the economy that produced last year's growth for the answer to that question: durable goods consumption, investment, exports, and inventory accumulation will have to slow down soon if we are to achieve the soft-landing. Some very preliminary evidence suggests that the required slowdown may be beginning but I must say this has been mixed.

On one hand, retail sales did slow over the last three months, and auto sales flattened in January and February. On the other, it's hard to see a real fall-off in demand occurring in the face of continued reasonably strong job and personal income growth. Residential investment shows some signs of slowdown, with the housing sector a

drag on GDP growth in the second half of last year. Foreign demand for our goods will also likely subside and net-net I would think that exports will not spur GDP growth in 1995 as much as they did in 1994.

Finally, inventory investment remains a significant uncertainty. Inventories grew at a rapid pace in 1994, though inventory to sales ratios remained low. With the initial release of 4th quarter GDP data, it appeared there might be an inventory overhang to slow production in early 1995. That data was revised, and now the amount of inventory induced drag is uncertain, though it's clear that if sales continue to lag, inventory production will decline.

So, its possible that we've pulled the throttle just enough to begin to produce a soft landing. Still, I think the risks remain slanted toward the upside, toward rising inflation.

Inflation results when the economy exceeds its long-run level of capacity. The economy is currently at full employment by almost anyone's definition, and below that level by some estimates. Industrial capacity utilization is above its pre-recession peak in 1989, a time when inflation was rising. The current unemployment rate of 5.4% is almost as low as the level in the late 1980s, but that unemployment

rate also produced significant inflationary pressures. We have not yet seen the rising wage levels that are the harbinger of CPI increases, but everything we think we know about these economic processes suggests increased labor costs cannot be far away. It may be that what the Fed has done to date is enough, and after a small cyclical uptick, inflation will remain well behaved. But I also think it's by no means certain this is the case, so we must continue to be vigilant.

We are all familiar with the problems that occur when the economy overheats. Rising inflation increases nominal interest rates, shrinks the real earnings of those on fixed incomes, and adds uncertainty to the economic environment. In the late 1970s and early 1980s inflation hit double digit levels. Since then, monetary policy has been remarkably successful in both taming inflation and creating an economic environment in which periods of sustainable growth are longer and longer, interest rates even at peaks are generally lower, and economic players are focused to a greater degree on productive versus speculative activity. The costs of taming inflation are high; we paid the price and I for one would not like to sacrifice the progress we've made. This is a particularly tricky time, and one that offers no small challenge for a first-time voter on the Open Market Committee.

Now let me turn to the issue of jobs. The last two years of the expansion have been strong, and we are at or even below some estimates of full employment, yet some people argue that the current level of unemployment overstates the strength of the recovery. They assert that many of the 5.5 million jobs created since the trough of the recession are inferior, so-called "MacJobs." Much of the basis for this claim arises from the loss of manufacturing jobs and the resulting increase in service sector employment during this recovery. The assumption clearly is that manufacturing jobs are superior to service sector jobs. I wonder if there was the same nostalgia about farm life during the Industrial Revolution?

Employment in manufacturing is not intrinsically better than employment in the service sector. Obviously, many manufacturing jobs are low-wage, while many service sector occupations are high-wage. And, in fact, many of the manufacturing jobs leaving this country are not necessarily the high-wage "good" ones. A TV assembly job that moves to Mexico where the hourly wage is equivalent to \$5 is not a good job; it is precisely because it is a low-wage job that it is leaving.

The service sector jobs this economy has been producing are, in

general, not MacJobs. In fact, employment creation in the service sector is generally following its historical pattern. Retail trade, transportation, and government all have produced roughly the same proportion of jobs in this recovery as they have produced in the last 30 years. The only major differences occur in two service sectors--health services and help supply firms.

Employment in the Health Services industry has grown faster in the last 5 years than in the past. This should come as no surprise since the relative demand for health services has risen consistently over the last 30 years, in part because of the aging of the population. Jobs are growing in this sector not because they are the only ones we can create but because they are the ones consumers want created. And many of these jobs are relatively good.

The other sector of the economy where employment grew surprisingly fast, accounting for almost one-sixth of the employment growth in this recovery, was in Help Supply services: firms where the employee is contracted out to work temporarily in another firm. Growth in this industry has been interpreted as a sign of weakness in the economy because these jobs are assumed to provide only temporary employment. Some assert that the recovery has been

unsatisfactory because the many jobs created in this sector have been temporary rather than permanent. Several points are relevant here, however. First, these jobs are, in many cases, good jobs; managers, office workers, clerical help, accountants, programmers, registered nurses, and a host of other professionals are a large part of this industry. Second, not all of these jobs are temporary. They include, for example, accountants and engineers who are leased out to firms temporarily but who work full-time with the manpower firm. Finally, this sector has been growing relatively quickly for some time, perhaps because the increased numbers of retirees and working parents in the labor market demand more work flexibility. Surprisingly also while average wages in this sector are lower than those for the economy as a whole, they are rising faster than the national average, perhaps reflecting growth in high wage occupations. Again, it may be not just that these temporary jobs are the ones available--they may be the ones that workers want as well.

Now before any of you get the wrong idea, I'm not a total Pollyanna about job creation during this economic expansion, particularly here in New England. Locally we face some very significant challenges as major local industries--defense, health care,

banking, insurance, and high-tech manufacturing--have all managed to fall on hard times or at least recognized some challenges together.

There have been major dislocations for many families. There is widespread recognition that high-end jobs in the service sector require much more in the way of education and skill than the jobs that may have disappeared. These are major structural issues that need to occupy our thoughts as we consider school-to-work, training and retraining programs, public school funding, and the many private/public partnerships we participate in that are focused on economic and community development. We must find a way for all the youngsters graduating from our public schools to be able to hold down a job that exists, rather than one that has gone away. It's tempting to point to the economy and interest rates and say that if only rapid growth would continue, the job problem would go away. Unfortunately such a policy would only take us back to the boom of the 80's, and undoubtedly a repeat of the bust as well.

We at the Boston Fed are concerned, not only about the employment opportunities generated by macro policies, but also about the borrowing opportunities that result from the enforcement of the fair lending laws. Equal access to credit markets is crucial to ensuring

equal economic opportunity in our society. This is why we take our role as one of the regulators entrusted with policing the Equal Credit Opportunity Act very seriously.

The Federal Reserve Bank of Boston undertook one of the most ambitious investigations to date of fair lending in the mortgage market. As I'm sure most of you are aware, before our study, the existing Home Mortgage Disclosure Act data revealed that minorities were almost three times as likely to be rejected for a mortgage as were whites. These data were at best only suggestive, since they did not control for the variables lenders consider when deciding whether to grant a mortgage. The purpose of the Boston Fed study was to include all these variables, in order to determine if race were still important in the mortgage lending decision. To choose which information to collect, we interviewed loan officers from many of the major lenders in the region. They specified a handful of personal and financial variables; we collected those variables plus another 30, to ensure completeness.

Our study found that these variables explained about half of the difference in the rejection rates of minorities and whites. A significant difference remained, however, that was explained by the race of the

applicant. A little-publicized follow-up study also revealed that it was the race of the applicant that accounted for the higher rejection rate for minorities, not the fact that minorities lived in different neighborhoods from non-minorities; redlining did not appear to be the problem, racial discrimination did. These two studies provide the most serious and thorough evidence to date that society's goal of fair lending is not being realized.

The extensiveness of the variables examined by our Bank initially produced a consensus view that a problem existed. Once the solutions to that problem began to be considered, however, the study came under very intense scrutiny. I want to say right off the bat that the Boston Fed welcomes scholarly scrutiny and has facilitated this in every possible way. A few of the ensuing criticisms, however, were much more rhetorical than substantive and, unfortunately, these few rhetorical attacks were and are the ones that keep getting repeated in the press. These obscure and arcane disputes over the methodology used in the study and the quality of the data have only served to mislead the public. The methodology used in the study has a long tradition in the economics literature. Any problems with the data are relatively trivial. We have verified that neither changing the

methodology nor altering the data as these critics suggest has a significant effect on the results; race still plays an important role in the mortgage lending decision, at least based on the data in our study.

The debate over this study can be reduced to one simple question: Is the Boston Fed study still missing an important variable that is related to minority status? This question returns the debate to where it was when the original HMDA data were released but with one major difference. Then we knew important variables were missing from the analysis; now the critics of the study have a great deal of difficulty naming even one. In fact, no economic study has proven that an important variable was omitted. Why, then, has this study been so vociferously attacked in the press?

I believe this has two explanations. Some people believe that discrimination cannot occur in any market, while others attack our findings because they dislike some of the policies advocated to rectify the problem. Some economists argue that discrimination cannot occur because profitable lending opportunities would be overlooked if it did. If one believes that lenders continually maximize profits, then discrimination is difficult, though not impossible, to explain. No amount of evidence can convince these people that discrimination is

occurring; by definition, they say, if race still appears to play a role in the mortgage lending decision, then an important variable related to race must have been omitted from the analysis, no matter how complete the list of variables appears to be. Economic theory is driven by logic and evidence; some of these arguments, however, seem driven more by a form of economic theology.

Anecdotally, lenders that I have talked to do, in fact, find profitable lending opportunities in the minority market once they enter. Perhaps it wasn't that they were intentionally ignoring profit opportunities, but were simply unaware that these opportunities existed.

I also believe a lot of the controversy over our study stems from concerns about some of the proposed solutions to the findings, rather than from the finding themselves. These critics tend to discuss the study in the context of what, for example, the Justice Department did today or the OCC is considering in the future. The Boston Fed study takes no stand about policy. Attacking our study because you find some of the policy prescriptions that have been discussed distasteful is like shooting the proverbial messenger because you dislike the message. The validity of these policy prescriptions have little to do

with the quality of the study, just as Willie Horton's furlough had little to do with Michael Dukakis' ability to govern, but it has, unfortunately, played a large role in the motivation of many of the criticisms.

Much of the argument, particularly that carried on in the press, has obscured the purpose and benefits of the study. It is important that the Fed play an active role in ensuring equal access to credit, regardless of one's race. The study was the most recent, and an important, step toward reaching that goal. It brought about a realization by lenders that extra care must be taken to ensure that race is not playing an independent role in mortgage lending. To assist in these efforts, the Boston Fed has published a book entitled *Closing the Gap*, which helps lenders objectively analyze any differences in treatment that may be occurring. Its been a best seller; 80,000 copies have been distributed nationwide. There's also a video on the subject though I can assure you we are not in competition for an Oscar on this one. Moreover, as I noted earlier, we believe there has been a sea change in attitude among bankers and many are willing to say that low and moderate income lending is good business. I think this augurs well for our communities and for future economic growth that is broad-based.

In closing, I want to thank you for the opportunity to speak with you today. It's a challenging time for monetary policy, for local job creation and economic development, and certainly for low and moderate income borrowers. I hope my remarks have helped you understand better how we look at these things at the Federal Reserve Bank of Boston. This is also an opportunity for me to learn while listening to you speak. I'd be happy to take questions or comments that you have.