Remarks by Cathy Minehan
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Good morning. I'd like to thank Jeb Bachman for inviting to speak to you this morning. I'm delighted to be here for a couple of reasons, one of which is the focus on our interaction at the end of my talk. Second, as CFOs, you bring an insight into financial markets that I will also find very useful. As you know, the markets are perhaps the most unpredictable actors in the economy, more so, I think, than consumers. This unpredictability is one of the main reasons why economics can never be a perfect science, and why some people have some very strong ideas about how well anyone can forecast the economy:

An economist is walking along a beach and comes upon a magic lantern. He rubs it and sure enough a genie appears. The genie hadn't been in the lantern that long so he only offered the economist one wish. Being a profit maximizer, the economist wished for $10 million. The genie replied it would be too hard to get that much money. "What is your back-up wish?" The economist replied he would like each and everyone of his forecasts of national economic growth, employment and inflation to be absolutely accurate. The genie paused and then said, "Wait a minute--I'll be right back with the money."

I'd like to begin with an overview of the New England economy, giving you my assessment of the region's recovery, and then tie that into the broader policy concerns that face the Federal Reserve.

Compared to when I first came to the Boston Fed in 1991 from New York, there is a good story to tell about New England. The region is on a solid, though not spectacular, growth path. Solid is the key word here -- a word that consumers and businesses in the region should feel good about. With the cost of spectacular growth sometimes being deep recession, I think we've learned the lesson that spectacular may be something we want to avoid.

However, while we should feel good about the region's economy, many people in New England are still cautiously, if not overtly, pessimistic. Perhaps this is because in contrast to the last growth period, this upturn seems anemic. There is no question that 1995 is a tortoise, in contrast to 1985's hare. Aesop's fable is a fitting metaphor for New England's economic experience over the last decade. We should take comfort in remembering that slow and steady wins the race.

Another factor that dampens our enthusiasm is that New England lags the nation and other regions in this recovery. A key component is the relatively lackluster job recovery and some concern about the nature of the new jobs being created.

The fact is, however, New England <u>is</u> on a solid growth path. Since payroll employment bottomed out in December of 1991, the region has been expanding slowly, but respectably.

With employment on the rise, we've seen both national and regional labor markets tighten in the last year. New England's unemployment rate fell to 5.4 percent in March, a shade under the national rate of 5.5.%. Recognizing that monthly regional unemployment rates are typically more volatile than national rates, over the longer term, unemployment was noticeably higher in the region than in the nation during the recession, but since early 1993 it's been about in line with the national rate.

Other indicators confirm this sense of a region in recovery, but moving more slowly than the nation. Consumer confidence, helpwanted advertising and retail sales have all been trending up for a few years, both in New England and the nation, but in each case the U.S. data are slightly stronger. Wages in the region have been on the rise, but haven't moved as quickly as the national average. This might explain in part why inflation - as measured by the Boston CPI - appears to be rising more slowly in New England than the U.S.

Now to what is contributing to this lingering pessimism. You may recall that at the recession's low point, one in ten New England jobs had disappeared. A total of 656,000 jobs were lost during the downturn, and to date we have recovered just 282,000 -- or 43 percent -- of these. In contrast to New England, the U.S. and most of the other regions have surpassed their late 1980s employment peaks and continue to create new jobs. Notwithstanding our late start in job recovery, the job count in New England in February was up 1.9 percent from a year ago, as compared with 3.3 percent job growth in the nation over the same period.

Given our relatively slower pace of recovery, the region will require several more years of expansion and job formation to fully recoup all the losses associated with the recession. Forecasts currently predict a full job recovery in New England by the end of 1998.

As I mentioned earlier, a distinctive aspect in both the nation's and New England's current recovery is the composition of its employment growth. In previous recoveries, we typically witnessed a cyclical upswing in manufacturing employment, accompanied by growth in other sectors. In the present case, however, job cuts at manufacturers have continued, and the burden of job creation has fallen primarily on service and trade industries. Specifically, between the December 1991 low point and February 1995, services grew by 196,000 jobs and trade by 78,000 jobs, while manufacturing lost about 60,000 jobs.

The services-oriented nature of this recovery has made it more difficult to pinpoint specifically what industry is propelling the expansion. Usually, one measures regional performance by looking at the activity of specific industries. It's more useful to know that growth is being driven by the auto industry, as in Michigan, or the oil industry, as in Texas, or mini-computers, as not so long ago in Massachusetts, but in the case of New England such precision eludes us. The services industry encompasses many diverse activities like software, engineering, janitorial services, social services and health care, and at times it seems that no matter how finely one breaks down the categories, a clear source of strength is hard to find.

If one cannot look to specific industries, how can one explain the recovery in New England? One answer is that the after-effects of the region's real estate bust are gone. In the residential sector, home prices have stabilized and in some locales are edging up. New construction has definitely picked up in the last year. In the commercial real estate area, vacancy rates are moving down, and some markets are fairly tight. Another explanation is the absence of the credit crunch, which inhibited the flow of credit to small and medium-size businesses. We believe these businesses have been the major sources of job growth during this recovery.

The other key force in the New England recovery is the strength of the national expansion. Clearly, business in this region does not operate in a vacuum. New England companies sell in national markets and New England consumers and businesses are affected by the same forces that affect consumers and businesses nationwide - interest rates, exchange rates, and opportunities for productivity enhancing investments. Fueled by the low interest rate environment of the early 1990s, U.S. economic growth in 1993 and 1994 was quite strong, and this helped bolster our recovery.

However, for over a year now the Fed has recognized that the same strong growth which aided New England is unsustainable in the long run without a corresponding acceleration in inflation. Fed policy over the last year has been geared to prevent the U.S. economy from overheating, and based on recent statistics, it appears that the elusive "soft-landing" may be in sight. Retail sales have slowed in recent months and the national pace of job growth has moderated. Some interest-sensitive sectors of the economy are also slowing -- auto production has slipped in past months and activity in the nation's housing sector is more subdued.

We in New England realize that slower U.S. growth will not help speed our regional recovery. Moreover, over the long term 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 recognize some challenges together. There have been major dislocations for many families. There is widespread recognition that high-end jobs in services 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 national economy and interest rates and say that if only rapid growth would continue, the job problem would go away. Regrettably, policy actions that fostered such economic growth at this point would be both wrong for the nation and bad for New England. It would not cure our longer-run structural issues, and it might also stimulate a repeat of the boom/bust cycle of the late 80's early 90's.

This raises an interesting and important question: what role does the regional Reserve Bank play in the formation of monetary policy? Or, to cast the same question as it has been asked of me: on what do you base your decisions about monetary policy -- on economic conditions in the Nation, or in New England? Since becoming a voting member of the Federal Open Market Committee in January, this is a question I have thought long and hard about.

As you know, at any one time, there are 12 voting members of the FOMC -- seven Governors, including Chairman Greenspan, and five of the Federal Reserve Bank Presidents. The remaining seven Reserve Bank presidents attend the meetings and contribute their insights to the deliberations, they just don't actually vote on policy actions. Thus, economic activity in the various regions -- twelve in all -- is an important factor in the policy-making process, and a Reserve Bank president is expected to have considerable expertise and knowledge about his or her region's performance. Part of what helps me become an expert is the time I spend meeting with business leaders like yourselves, to gather anecdotal information which is, in my estimation, of tremendous value, and which often precedes or illuminates what the statistics are telling us.

You may also know from Economics 101, that Reserve Banks are unique creatures within the overall structure of U.S. Government. They are banks for banks that are privately incorporated financial institutions within the city and state in which they are located. Their shareholders are the banks which are required to buy stock but have no rights of ownership. Each Reserve Bank has a 9 person board of directors--3 bankers, 3 business people elected by bankers, and 3 representatives of broad community interests, who are appointed by the Board of

Governors in Washington. My own board of directors is a terrific source of information and input to me on both national and regional matters, and I often communicate their views in my FOMC presentations.

When the Federal Reserve System was formed in 1914, the regional nature of the System was specifically intended as a counter-balance to what was perceived as the potential evil of a truly central- (i.e., Washington) based central bank. In those days, regional Banks set their own District interest rate through the Discount Rate mechanism. Over time, monetary policy became much more, if not entirely, a function of national open market operations and even regional Discount Rates are set by Washington. Still the regional influence is strong, and the support for the System that comes from the interaction between regional business leaders like yourselves, and Reserve Bank presidents like me, is vital to the credibility of the central bank in this country.

From time to time, this 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.

In any event, the decision to change short-term interest rates - or not - is a Committee decision; and participants in FOMC deliberations bring to the table different insights into the economy. As we in New England well know, the regional experience can differ quite markedly from the national average and these differences can provide an "early warning" of developments that could affect the nation as a whole. A case in point is the New England credit crunch in the last recession. The recession started earlier in New England and was much deeper than the national downturn; the combination of a declining economy and a collapsing real estate market led to severe problems at the region's banks. As banks struggled to survive, they cut back their lending, which further exacerbated the regional recession.

New England's problems were later echoed elsewhere; but because of New England's earlier experience, the FOMC was already sensitized to the contractionary effect of disruptions to the availability of bank credit. This was one of the headwinds to which Chairman Greenspan referred frequently during the early stages of the national recovery and which contributed to the FOMC's reducing short term interest rates to their lowest levels in 30 years.

Although the Reserve Bank presidents bring regional input to the FOMC deliberations, they must adopt a national perspective in their policy recommendations. At the same time, our thinking is undoubtedly influenced by regional economic conditions. Thus, reconciling the needs of the nation as a whole with the needs of this District is indeed one of the most challenging aspects of my job. Knowing that New England remains in the midst of job recovery, I am as concerned with the human and economic costs of our unutilized resources as I am with the potential for wage and price pressures nationally.

Of course, I am not alone in this experience. To varying extents, each president has to compromise a District agenda for what is perceived to be the greater good of the nation. Although this may cause FOMC members to differ in how they see the economy, the diversity of represented viewpoints remains a virtue of the FOMC, and of the Federal Reserve System more generally.

In closing, New England's recovery is continuing to chug along at a decent rate. Furthermore, this recovery, perhaps more than any prior one, represents a transitional period for the region. It is clear that the economy is becoming increasingly services-oriented, and this has presented special challenges to a region like ours with a long history of manufacturing. The resulting shifts in employment have made it particularly difficult to identify the underpinnings of the regional recovery in detail, but we know for certain that the national economy has been a big factor. The fact that we must slow the pace of national growth at this point is not surprising, but we will miss the boost it provided us over the last year. Looking forward, the future holds some uncertainties. We on the FOMC are keenly aware of the risks associated with trying to engineer a soft landing for the national economy, and while current indicators suggest that the runway is in sight, we haven't touched down yet. To the extent that the U.S. economy does slow down, New England will have to draw on other sources to sustain its recovery, including increased use of foreign markets, a return to our traditional strengths of innovation and entrepreneurialism, and attention to structural issues and the needs of all our workers for better training and educational opportunities.

Thank you. I'd be pleased to answer any questions you might have.