

**Remarks by Cathy E. Minehan
President, Federal Reserve Bank of Boston**

to the

**Cape Ann Chamber of Commerce
June 19, 1995**

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Gloucester, MA
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Thank you for inviting me to speak with you today. I really value the opportunity to speak with District business people and hear what is on their minds. That interchange forms a critical part of my presentation at the Open Market Committee, and at times has been a key element in setting national economic policy.

What I'd like to do this afternoon is provide an overview of economic conditions and the current outlook for Massachusetts and the United States. Of course, you should take this all with a grain of salt. I'm reminded of the story about the economist who finds a magic lantern in a solitary walk on the beach. He rubs the lantern 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."

The Massachusetts economy has come a long way in the last few years. While some clouds are on the horizon, the local disadvantages and imbalances in the region's economic prospects have diminished considerably from the late 1980s. As I'm sure all of you (and your businesses' bottom lines) know, it was late 1988 and early 1989 - more than a year before the rest of the nation - when Massachusetts and the other New England states began the most severe economic downturn to hit the region in the post-World War II era. At the recession's low point at the end of 1991, one out of every nine Massachusetts jobs had been lost and one in ten for the New England region as a whole, a much greater job loss than any other U.S. region.

Since then, New England and Massachusetts have been gaining jobs fairly steadily. While the regional recovery has fallen short of the national pace of job growth, the rate of growth of population and labor force are typically slower in Massachusetts than in the nation as a whole. As a result, the Commonwealth's slower-than-national job gains have been substantial enough to bring unemployment down in

line with the nation. Although state unemployment rates show much greater month-to-month volatility, Massachusetts' jobless rate has been roughly on par with the national rate for over a year.

A variety of other indicators also indicate the progress the region has made. For example, given the depth of the real estate bust that followed the 1980s boom, and the key role that crash played in impairing the region's banking system and deepening the general downturn, the real estate recovery we've seen and the current health of banks in the region are very reassuring. Commercial vacancy rates have come down and the housing market remains active; housing prices have picked up at the upper end. Indexes of consumer and business confidence in the region have risen markedly from their recession depths.

Looking forward, the near term clouds on the regional horizon relate to the national economy. For any region or state, the national economy is always a critical determinant of growth. Many Massachusetts businesses sell in national markets; so a more buoyant national economy is likely to mean stronger demand for these companies' products. For example, although Massachusetts no longer has an auto assembly plant, we have a number of companies that

supply machine tools, upholstery and plastic parts to the Big 3 automakers; so Massachusetts as well as Michigan benefits when cars and trucks are selling well.

In addition, Massachusetts consumers and businesses respond to the same forces affecting consumers and businesses nationwide - interest rates, exchange rates, opportunities for productivity-enhancing investments. This is not to say that states and regions move in lock step with the nation, as changes in interest rates or exchange rates may have a greater impact on some areas than others. And events may take place that affect only part of the country. Certainly, Massachusetts' experience in the mid 1980s, when a real estate boom caused it to perform better than the nation, and in the early 1990s when the ensuing bust - as well as other problems - caused it to fare much worse, prove that the deviations between the state and national experience can be substantial. But the nation is always an important influence.

Last year, the U.S. economy was a powerful engine. Real GDP, the primary indicator of activity at the national level, grew 4 percent in 1994. Industrial capacity utilization reached its highest level since the late 1970s and the U.S. unemployment rate fell from about 6 1/2

percent at the start of the year to 5 1/2 percent at the end. This is a critical area. It is well below the average rate of unemployment over the past 25 years. More importantly, it is below the level that historically has been associated with a pick-up in inflation.

Historically, inflation has increased whenever the unemployment rate has stayed below 6 percent or so for any length of time. And while there are some people who argue that more intense global competition and reduced employee bargaining power have reduced the unemployment rate at which inflation starts to pick up, as recently as the late 1980s the traditional relationships between inflation and the unemployment rates were working in textbook fashion. Thus, for inflation to remain at acceptable rates, it was necessary for the U.S. economy to grow more slowly and for the U.S. unemployment rate to stop falling. To this end the Federal Reserve raised short-term interest rates 7 times over the period from early '94 to early '95.

The anticipated slowdown has now happened. Since the turn of the year, the economic news has consistently pointed towards slower growth. Housing, retail sales, and orders for durable goods have all come in on the weak side. U.S. payroll employment actually declined by 100,000 jobs in May, following a small loss in April.

Although most forecasters had predicted that growth would slow in 1995, the slowdown has come perhaps faster than expected. The result is that people are starting to wonder whether the economy might experience negative growth trends. Just a few months ago, the greater concern was that the economy would not slow down enough. At the Boston Fed, we believe that while the current and third quarters will undoubtedly be slow, a more permanent downturn is not the most likely scenario, at least based on what we see right now in terms of personal income and business spending plans, the level of long-term interest rates, and the more competitive position of U.S. exports. Although the risks have definitely shifted toward slower growth, we believe the most probable outcome is that we will experience that "soft landing" the media all talk about. Actually, the metaphor is a difficult one. We would not define a soft landing as a halt in forward momentum--rather it is a leveling off from a previous fast upward trajectory. In light of this, we still see the lower end of the central tendency of the of the System's Humphrey-Hawkins forecast of last February as reasonable for the year as a whole. That is, it still seems reasonable that the economy will grow at a real rate of about 2 percent or perhaps a little less in 1995, and the U.S. unemployment rate will

settle around 6 percent by year-end. Inflation would come in a little higher than last year, but would still be well behaved at 3 1/4 - 3 1/2 percent.

This is a pretty good outcome. Growth would be sufficient to hold the unemployment rate below its average of the past 25 years and to allow for productivity gains, which are the key to a rising standard of living over the long run.

What would such an outcome mean for Massachusetts? Some observers have expressed concern that a national slowdown will have particularly adverse effects on parts of the country such as New England that were flying closer to the ground before this soft landing was attempted. I believe, however, that while Massachusetts and the rest of New England are likely to continue growing more slowly than the nation, our local economy will not be disproportionately hurt by slower national growth. Rather, the issue of structural change is one that we will have to deal with over the long run.

Sharing this view is the New England Economic Project (known as NEEP), a regional forecasting group composed of banks, utilities, universities and government agencies, as well as the Boston Fed. NEEP expects New England to continue growing somewhat more slowly than

the nation, but not to a greater degree than has occurred in the last few years. NEEP forecasters expect services to provide most of the net increase in jobs over the next few years, with wholesale and retail trade also adding to employment growth in the region. Thus the basic near-term forecast is for a continuation of what we've seen over the last few years.

Longer term, the region's prospects have improved because the imbalances of the late 1980s have begun to diminish. Certainly, weakness in the banking system is not the hindrance to economic growth that it was during the 1989-91 period; the credit crunch is now over - many banks are eagerly courting borrowers.

Another drag that's beginning to lessen is the region's cost disadvantage that developed during the boom. For most of the 1980s and even through the recession, the cost of living rose faster here than nationally and such business costs as manufacturing wages also outpaced national trends. In the last year or two, however, this situation has begun to move the other way, with costs rising more slowly here. While we're very far from our relative cost position of a decade ago, current movements are in the direction of reducing the disadvantage.

Just as these disadvantages contributed to our more severe downturn and below-average recovery pace to date, their diminution should improve our prospects over the longer term. Our competitive disadvantages have affected manufacturing in particular. Prior recoveries have seen faster overall employment growth, with manufacturing industries adding the most jobs. This time, manufacturing in Massachusetts has been beset not only by the general cyclical downturn, but by federal defense cutbacks and the ongoing restructuring of the state's computer industry. In addition, manufacturers in Massachusetts, like those elsewhere, have been aggressively trying to increase productivity and avoid hiring commitments through use of overtime and contract workers.

In contrast to defense cuts and the problems besetting some of our computer companies, efforts to boost productivity and expanded use of overtime and temporary workers are not negatives from the standpoint of the individual firm. Indeed, if one excludes the defense contractors and the large computer companies, anecdotal evidence suggests that many Massachusetts manufacturers have been doing well. In some cases, very well - much better than one would expect from looking at the job counts. Nevertheless, manufacturing

employment is not playing its historic role as engine of growth in Massachusetts. Thus, the slow pace of our job recovery can be blamed to a large degree on the absence of any boost, indeed a continuing drag, from the manufacturing sector.

The job growth to date has been generated primarily by two sectors of the economy: services and wholesale and retail trade. Firms in these sectors have accounted for over three-quarters of employment growth since the end of the recession. With the increasing dominance of nonmanufacturing industries in the Massachusetts economy, particularly services, have come new challenges and opportunities for the region. From the standpoint of the worker, the growing importance of services has led the job market to place a higher premium on education and interaction-related skills.

Another implication of this shift in the industry composition of job growth is an increased role for small businesses in the economy. From census data on establishments nationwide, we know that most of the industries in retail trade and, especially, the services sector are dominated by small businesses. Specifically, over 60 percent of the workers in most trade and services industries are employed by small firms, defined as having 500 or fewer employees. Conversely, a

majority of firms in most manufacturing industries employ over 500 people. Since trade and services are the sectors where Massachusetts' job growth has been concentrated, it's reasonable to assume that small businesses in Massachusetts have been the cornerstone of the state's job recovery.

Last month, Business Week magazine compiled a list of the 100 hottest growth companies in the nation, based on three-year results in sales growth, earnings growth, and return on invested capital.

Massachusetts is home to six of the top 25 companies on that list - almost one-quarter is not bad for a state with only 2½ percent of the nation's jobs. Of those six hot growth firms in Massachusetts, three were in software (recall that software is a services industry), a fourth was in another business services area (direct-marketing mailing lists), and one each were in retailing (direct mail wine marketing) and manufacturing (of golf clubs and woodworking tools for hobbyists).

In sum, the economic progress the region has experienced over the last few years returns us to a more normal relationship with the national economy. As a result, the near-term prospects for regional growth remain good but certainly depend on how smoothly the national economy comes into its landing. We think the odds are good

that a national recession will be avoided. Compared with the nation, however, Massachusetts faces some clear structural minuses in the form of defense cutbacks, consolidation of the health and banking industries, and reorganization of our local computer industry. At present, no one industry or sector can be counted on to propel the region's economy reliably into the 21st century, or if one can, it's not clearly visible yet. Thus growth is likely to continue to be slower here than nationally.

Thank you. I'd be pleased to take your questions.