

**Remarks by Cathy E. Minehan  
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**to the**

**Massachusetts Mayors Association  
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**June 21, 1995**

**Westfield, MA**

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before  
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Thank you for inviting me to speak with you today. I really value the opportunity to speak with government leaders to hear what is on their minds. This group is particularly unique, as it seems that every corner of Massachusetts is represented. In that regard, I look forward to your questions following my remarks.

What I'd like to do this morning is provide an overview of economic conditions and the current outlook for Massachusetts and the United States. I'd like to finish up with some discussion of regional cooperation as a means to enhancing New England's competitive position, a subject of increasing importance in our ever-increasing global economy.

Of course, you should take the outlook for the economy with a grain of salt, owing to the well-known inexactitude of the science of economics. 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 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.

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 and 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 while a few months ago there was concern the economy might not slow down enough now people are starting to wonder

whether the economy might slow too fast, or go down too far. It's our best guess, however, that while the current quarter will undoubtedly be slow, the rest of the year may well slowly bounce back, 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 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 in the defense industry, in health care, and in banking and computer equipment is one that we will have to deal with over the long run. I will return to this point a little bit later.

Over the 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. Thus, manufacturing employment is not playing its historic role as engine of

growth in Massachusetts. 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. Most of the industries in retail trade and, especially, the services sector are dominated by small businesses, i.e., those employing 500 or fewer employees. Massachusetts' job growth has been concentrated in trade and services so by implication it would seem fair to say 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).

This list in itself is a pretty good microcosm of our recovery--service led but in a number of diverse businesses.

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.

As I mentioned earlier, 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, while continuing to be positive, is likely to continue to be slower here than nationally.

Could anything be done with national monetary policy that would somehow cure this slow growth rate? Well, if national growth slows enough, monetary policy will undoubtedly address that problem, but this alone would not cure our longer-run structural problem. Instead, I believe the real solution to our problem lies in addressing these major structural issues, including focusing on school-to-work, training and retraining programs, public school funding, and the many private/public partnerships we participate in that are focused on community development. 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. We must find a way for all the youngsters graduating from our public schools to hold down a job that exists, rather than one that has gone away, and to insure that we have a skilled labor pool. In my visits around the region, I have made a point of asking business people about their experience in finding skilled

workers. Many told me that there is a shortage of workers to fill their needs, despite the fact that New England as a whole, and Massachusetts specifically, has one of the most educated workforces in the U.S. What I heard underscored my long-held conviction that quality public education is essential to economic progress. Moreover, I have come to believe that the organization of educational opportunity for those of working age is crucial and the joint responsibility of the public schools, community colleges, and the private sector.

Further, the commitment of banks to provide capital is key to the success of any economic development plan. Nowhere is this more true than in low- and moderate-income communities. We all know that the wider community has a very large stake in rejuvenating or developing communities. The future of our local economy depends on the solution to these real world problems.

That is the perspective that I am trying to incorporate in the ongoing role of the Federal Reserve Bank of Boston. We will continue to be ever vigilant over the region's banking system, and we will continue to closely monitor the regional and national economy as we formulate monetary policy recommendations. But at the same time we will expand our role as facilitator and catalyst for economic initiatives

that address other fundamental components of our economy. We believe, as I know you do, that it is part of our mission to make our region a better place in which to live, to work, and to prosper.