

Remarks by
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I am pleased to be with you this evening. The Federal Reserve Bank of Boston has an ongoing and strong relationship with the New England Chapter of Robert Morris Associates, both through the membership of our Vice President and Credit Officer Curt Turner, and through our hosting of the periodic "Breakfast at the Fed" meetings with RMA-associated credit analysts. My predecessors have spoken at RMA meetings, and I am delighted to join in this tradition.

I am also delighted to speak to you tonight about the region's economy and developments in the banking industry. As you may know, I have been President of the Boston Fed for just over a year now. Many times when I am asked to speak the desired topic is monetary policy. While I find that an endlessly fascinating subject, it is a rather tricky talk to give, and of course more so when the media is present. But I have learned the technique, which is to say something when there's nothing to say, and to say nothing when there is something to say. No easy task.

Of equal importance and less hazardous is the subject of the region's economy. Tonight I'd like to give you an overview of economic conditions in New England, discuss the forces at work that continue to pull us out of the depths of the early 90s recession, and make some projections about that all-important determinant of New England growth - the national economy.

We've seen some ups and downs in economic activity in New England this year, but the general picture is one of continued growth, albeit at a slower pace: slower than a year ago and slower than the nation. Throughout this recovery the region has expanded more slowly than the nation, so it's not surprising that as the pace of the national expansion has abated, we've followed suit.

The U.S. economy has slowed noticeably this year. The slowdown was on the abrupt side, but on balance, it was a good thing, because growth last year was faster than is sustainable without accelerating inflation. While the slowdown is needed, some remain nervous about whether the economy is achieving a "soft landing" - that is, slowing to a sustainable rate of growth but not stalling into a recession.

An additional concern locally is whether the 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. In partial answer to this concern, the specific sectors most affected by the national slowdown - construction, autos - are not particularly concentrated in New England, so it seems unlikely that the region's economy will be disproportionately hurt by more moderate national growth. Thus, in the near term, New England can expect recent patterns to continue: as long as the national economy continues to grow at a reasonable pace - and I'll come back to the issue of the national economic outlook toward the end of my presentation - there is every reason to think we will keep growing too.

New England has been gaining jobs for three-and-a-half years. To many people, the fact that we've been recovering for over three years comes as a bit of a surprise. That surprise is partly attributable to the fact that the recession was very severe here and partly to the fact that the local recovery has all along been quite modest.

Since the region's employment trough in December 1991, not quite half of the jobs lost during the downturn have been replaced. In most of the other regions of the country and the nation as a whole, payroll employment is well above its pre-recession peak. Within New

England, we have a tale of two places - the northern states are about back to the employment levels they enjoyed before the recession, while Massachusetts, Rhode Island, and Connecticut still have quite a ways to go.

Massachusetts is still less than 50 percent of the way back, but in recent months it has looked the steadiest of all the New England states, continuing to add jobs while the "downs" outweighed the "ups" in the other five states. Connecticut and Rhode Island, unfortunately, after beginning to gain jobs several years ago, tallied fewer jobs in July 1995 than a year earlier.

Unemployment shows a slightly different picture of New England compared with the nation - a picture in which we're generally tracking the national performance rather than lagging behind. After coming down from recession highs, the region's jobless rate has centered around the national rate over the last few years.

This apparent discrepancy between two key indicators of the region's economic health - employment growth lagging the U.S. but unemployment tracking - largely reflects the fact that the labor force has been stagnant or declining in New England over the last several years. With fewer people in the region looking for work, reflecting, in

part, outmigration during the recession, the unemployment rate can improve even with modest job growth. Thus, some caution is needed when looking at regional unemployment rates as signs of strength.

Another interesting aspect of this recovery is the industry mix of jobs being added, which is both quite different from those jobs lost, and a departure from the typical pattern in recoveries. The great bulk of the job additions in the region's recovery has come in services industries covering occupations from software to legal services, window washers to engineers.

At the top of the list of services industries, in terms of jobs added locally, is business services. This category includes temporary help - which has been responsible for large numbers of new jobs nationally in the recovery. If you hire someone on a temporary basis through a personnel supply agency, that person shows up as part of the services industry, regardless of where he or she is working. Business services also includes computer and data processing services, telemarketing, and services to buildings. Another services industry that's added many new jobs in New England's recovery is health services other than hospitals; this too has been a fast-growth industry nationally.

Expansion has also taken place in the region's construction and retail

trade industries.

On the other side is manufacturing. A sizable fraction of the recession job losses were in manufacturing, but manufacturing jobs have been conspicuous by their absence in the recovery. Usually, manufacturing helps propel a recovery, especially in its early stages. In Massachusetts, the top three job-losing industries, since the employment total began to grow, are in the areas of manufacturing, computers, office equipment, transportation equipment, and instruments other than measuring and control devices. These losses reflect ongoing restructuring in the computer industry as well as cuts in defense spending.

In addition, manufacturers have been aggressively trying to increase productivity and avoid hiring commitments through the use of overtime and contract workers. In contrast to defense cuts and the problems besetting some of the computer companies, efforts to boost productivity and use 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 New England manufacturers have been doing well, in some cases, very well - much better than one would

expect from looking at the job counts. Due to restructuring, output and profit gains are not translating into as many jobs as has historically been the case. As a result, manufacturing employment is not playing its historic role as engine of growth in New England, but there is some reason to believe it is reengineering itself to be a competitive force over the long run.

Speaking of engines of growth, we are pleased with the continued strong performance of the region's commercial and savings banks, which reported their fourteenth consecutive quarterly profit in the second quarter of this year. Earnings of \$1.5 billion for the first half of 1995 produced a return on average assets topping 100 basis points. Early on in the banking industry's recovery in the region, improved profitability was attributable to transitory sources -- reduced loan loss provisions, securities gains, and extraordinary gains related to accounting rule changes. Today, profits stem from more encouraging and sustainable sources, from core banking operations.

Despite healthy profits, the New England banking industry is still awaiting a more vigorous pickup in loan activity. Loan growth in the region lags the national average by a considerable margin. While the banking industry nationwide reported loans and leases outstanding at

12.5 percent above year-ago levels at the close of the second quarter, New England commercial and savings banks reported loan growth of 5.2 percent -- less than half the national average. More modest loan growth, however, is consistent with the more modest growth of the regional economy.

New England bankers, though eager to lend, have vivid memories of the real estate downturn. Loan quality remains of foremost concern. At the present time, Fed survey information at the national level as well as call report data on delinquencies and modest loan growth suggest that credit standards are holding up and that most bankers expect loan quality to remain the same or improve.

What about the role of small business in the region's expansion? Small business and banks have a mutually sustaining relationship that is particularly important for us in New England. We don't have data that allow us to know for sure what's going on in firms of different sizes in New England, but we can put together some pieces of the puzzle to gain some understanding. Some industries are more concentrated at the small business end of the scale than others. Construction, services, and wholesale and retail trade are the broad industry groups that tend to be dominated by small firms; by contrast, manufacturing

and finance/insurance/and real estate tend to be more at the large-firm end of the scale. These differences are quite striking according to the Census Bureau's "enterprise statistics." In construction, for example, three-quarters of employment nationally is in firms with fewer than 100 employees, while less than one-quarter of manufacturing jobs are in such small firms.

Since New England's job growth in the recovery has been concentrated in the services, wholesale and retail trade, and construction industries - and these are the small-firm dominated industries nationwide - we can infer that small firms have played an important role in the region's job growth in the last few years. By the same token, manufacturing - a big-firm industry - has been shrinking in the region, tilting us further in the small-firm direction.

Given this, bank lending to small businesses is a special concern for us in New England. We know small and medium-sized firms rely heavily on bank lending. At the same time, small business lending is important to the health of our banks. Many banks, particularly smaller ones, look to small business lending to build their loan portfolios and enhance their profitability. Finally, there has been speculation that the trend toward consolidation among banks may endanger small business lending.

Fortunately, some data are available so that we can take a look at trends in bank lending to small businesses. For the past three years, banks have reported on small business loans once a year in their June call report. What is reported are business loans under \$1 million, so that the size of the loan, rather than the size of the borrower, is used to define "small business lending." Figures for June 1995 have just been released, and tell an interesting story.

Small business loans at New England commercial and savings banks stood at \$21 billion as of June 30, 1995, up 2 percent from the previous June. At the same time, large business loans grew at a much faster pace (9.0 percent), resulting in a decline in the small business loan share of total business loans at New England banks. Nationally, while both small and large business loan growth outstripped New England's, the same pattern of faster large loan growth evidenced itself, though for the nation as a whole, the small business share of lending declined more modestly than in New England. In addition, overall, small business loans are a smaller share of overall lending here than in the nation as a whole.

Growth in small business lending over the past year varied widely among the different bank asset size categories, more or less confirming

our expectations. Small business loans declined at New England's largest banks (with assets over \$5 billion). Medium-sized banks (with assets between \$1 and \$5 billion) reported a very slight (0.5 percent) increase in small business loans, while the region's smallest banks saw fairly sharp growth in small business lending. Clearly, while larger banks may, as feared, be pulling away from smaller loans, the medium- and smallest-sized banks see a niche to be filled.

So, besides bank lending, what will be the key factors in the unfolding of this expansion and its impact on New England?

We're gaining jobs now because at least some of the negative factors that brought on the recession are no longer in force. The credit crunch is now over, and real estate markets also made a marked recovery, although they've slowed somewhat this year. Declining office rents and a period of virtually no office construction have brought down vacancy rates.

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 in New England than nationally and such business costs as manufacturing wages also outpaced national trends. In the last one to two years,

however, this situation has begun to move the other way, with costs rising more slowly here.

Real housing prices, for example, soared in New England in the boom, in stark contrast to U.S. house prices, which barely grew over the same time period. New England's prices have since come part of the way back down. Similarly, average hourly earnings of manufacturing production workers rose sharply during the boom even as they fell steadily in the nation as a whole; in recent years this wage gap has stopped growing but not really narrowed. Thus, for both these cost measures, the movements are currently in the direction of reducing the disadvantage, although we're very far from our relative cost position of a decade ago.

These cost adjustments reflect a response to the region's marked cost disadvantages of the late 1980s. That is, costs fall or grow more slowly when markets, in this case for housing or labor, get softer because of business location and population migration decisions that reduce demand. The fact that the bust did not return us to our pre-boom cost position relative to the nation probably indicates that there's more adjustment still to come, and also that there's been a change in our relative attractiveness or productivity.

One indication that the region's residents are doing all right is the fact that the New England states have managed to keep a large portion of the gains in per capita income they achieved in the 1980s. The region's per capita income is currently 116 percent of the national average - down from the late 1980s but well above where we were in the early 1980s.

One reason for these continued income gains is that our historically better educated work force has become more so - New England had a larger gain from 1980 to 1990 in the percentage of adult residents with a college degree than any other region of the country. Thus, some of our workers have moved more toward the top of the salary scale by becoming better prepared for the ongoing shift toward knowledge-based industries. The challenge remains to ensure more of our region's young people are well-educated - even at 25 percent of our work force with a college education or better, 75 percent remain without. The evolving economy has fewer and fewer jobs for those lacking technical skills. Those of us with a stake in New England need to work on ensuring our public education systems can deliver the employees we need for the future.

Looking forward, the other major economic driver for New

England is the national expansion. 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, opportunities for productivity-enhancing investments. This is not to say that states and regions move in lock step with the nation. For example, interest rate changes may be especially important to construction-dependent states. And events may take place that affect only part of the country. We need only look at New England's recent experience - performing better than the nation in the boom and much worse in the bust - to know that deviations between the regional and national experience can be substantial. But the nation is always an important influence, and the U.S. economy was a powerful engine last year, a more moderate one this year and presumably next.

The U.S. economy grew very briskly at the end of 1994; then slowed in early 1995. Rather than the momentum of 1994 building on itself, as often happens, some of the strength in late 1994 seems to have come at the expense of early 1995. In particular, consumers seem to have purchased motor vehicles and other durable goods in late 1994 that they would otherwise have bought in early 1995. The auto

industry, however, interpreted the strength in late 1994 as a sign of better things to come and increased production. When the expected demand failed to materialize, inventories accumulated. And when these inventories went unsold in first quarter, producers cut back, putting the brakes on economic growth.

Also contributing importantly to the slowdown was a slower growth in exports, due in part to difficulties in Mexico, which had been a big purchaser of U.S. products. Housing activity also weakened in response to high interest rates.

The result was a fairly pronounced slowing in economic activity. Real GDP, which had grown at an annual rate in excess of 5 percent at the end of 1994, slowed to 2.7 percent in the first quarter and to 1.3 percent in the second quarter of 1995.

Some slowing was necessary. Labor markets had tightened, and in general, capacity was strained to points historically associated with an acceleration in inflation. And inflation had indeed, started to pick up. Were it not for favorable food and energy numbers, the growth in the CPI would have risen from roughly 3 percent in 1994 to 3.5 percent in the first half of 1995.

The suddenness and extent of the slowing in the first and second

quarters surprised most forecasters. Over night, the indicators went from uniformly robust to uniformly weak. But just as concerns about a possible recession started to emerge, the economy perked up. In particular, payroll employment, which was very weak in the spring, increased substantially this summer. Housing appears to be coming back. Motor vehicle sales were very strong in August, although some of that reflects sales to the rental fleets. Business investment has been strong, and while net exports continue to be a drag, prospects for an improving Mexico and growth in other foreign countries bodes well for these areas as sources of strength.

The Bank's expectations for 1995 concur with those of most analysts; we expect the economy to grow about at potential (or somewhere between 2 and 3 percent real GDP) in the second half of this year, with close to full employment and with an inflation rate that is essentially stable and at a level unlikely to distort business decisions. Thus, I expect that the slightly better than one percent growth in real GDP was a pause rather than a trend, and that growth will pick up noticeably in the last half of the year. I also expect good news on the inflation front to continue, as slow growth in benefits results in restrained growth in employee compensation. With low labor costs,

reduced pressure on input costs, and strong competitive pressures in most industries, firms may have little incentive to raise prices, though from the central bank perspective, that is a situation that requires close and rigorous vigilance. Overall, our chances of achieving that equivalent of economic nirvana - "a soft landing" - seem pretty good to me, and that augers well for both the nation and for New England.

In sum, we've faced some tough challenges locally over the last several years. Structural change in the types of industries dominating New England, and the severe cyclical downturn created a recession that was worse here than anywhere else. The saving grace appears to be the growth of small businesses, with all that implies about the continuation of New England's historical claim to predominance in entrepreneurialism and ingenuity. Moving forward, we must tackle issues of regional cost disadvantage and carefully nurture and expand our highly educated work force. If we do so, my view is that our prospects are good.

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