

Lakes Region Chamber of Commerce

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

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Good evening. It's a pleasure to be here with you tonight. I'd like to thank Bruce Clow for inviting me to meet with you. Chambers of Commerce have an important role to play in facilitating the interaction of business and government. They often help to marshal the business community to close the gaps in public services that government cannot address, such as summer jobs. Equally important, Chambers often bring a private sector perspective to issues of public importance. This is a quintessentially American form of private collaboration toward public ends and, in my view, is key to a well-functioning town or city. Chambers also provide forums for discussion of issues of importance to the political body, whether they be transportation, education, tax levels, or development issues. Thus, I feel honored that you have asked me to speak, and I look forward to hearing what's on your mind after I finish my intentionally brief remarks.

In considering the recent evolution and current state of the national and regional economies, I am drawn to literary metaphors. It seems to me that over the past several years we've moved from an economic environment that could be characterized by the fairy tale of "Goldilocks," to one resembling Dickens' "A Tale of Two Cities." More

recently, however, things have been so volatile financially but strong domestically that I'm torn between "The Iceman Cometh" and "Atlas Shrugged." Let me provide some insight into why those particular literary titles seem appropriate.

First, the Goldilocks economy. From 1993 to the early part of 1998 the economy grew at an average annual rate just a bit above 3 percent. During the same period, well over 16 million jobs were created, bringing the unemployment rate to its lowest level in 25 years. Yet even with this strain on labor capacity, the rate of inflationary growth dropped, from around 3.5 percent in 1993, to its current rate of below 2 percent overall, and about 2.5 percent excluding the volatile food and energy sectors. By the end of this period, workers' wages were rising faster than inflation, after barely keeping pace for many years, reflecting productivity increases that were most obvious from the data in nonfinancial businesses, but probably existed more broadly.

This era of prosperity fueled, and was fueled by, a stock market that nearly tripled in value regardless of the index. At the same time, long-term interest rates reached 25 year lows, making credit relatively inexpensive. Banks added to their capital, strengthened their balance

sheets, and fought with each other to meet the borrowing needs of customers. Business' ample cash flows, coupled with the reduction in the cost of equity, fueled spending on capital equipment that dramatically expanded their capacity to produce goods and services. Relatively lower interest rates helped propel the economy by fostering a low nominal debt burden for firms and consumers alike.

For the first year since 1960, the federal government registered a budget surplus--a seeming impossibility only five years before the start of this period. The only cloud on the horizon was a widening trade deficit, which while worrisome for the long run, was largely a reflection of the strength of our economy relative to that of many of our trading partners.

That was our "Goldilocks" economy--not too cold, not too hot, just about right. The only question was whether we could keep it that way.

That brings us to the "Tale of Two Cities", or more accurately, continents--the United States and the developing world. Starting in 1997 with the currency crisis in Thailand, it began to be very clear that much of Southeast Asia was unraveling, economically if not politically

and socially as well. Currency, and equity values plummeted, banking systems carrying a heavy load of foreign-denominated liabilities collapsed, and interest rates rose to levels that brought economic activity to a screeching halt. These areas, comprising 17% of world trade, and 19% of U.S. trade, ground to an economic standstill.

Here in the U.S., the surface of economic activity barely rippled. It was easy to see the problems in Asia, while tragic for the countries involved, as a necessary brake on U.S. economic activity. After five years of above trend growth, almost every forecaster saw inflation on the horizon, and many were worried about the speculative activity that could so easily be the outcome of the country's expansive financial markets.

But even as Asia slowed, the U.S. remained strong. Despite sharp drops in exports to Asia, the U.S. GDP grew at a rate of about 3.7 percent in the first half of 1998. Employment continued to grow, adding 240,000 jobs per month in the first half of the year, and just under 200,000 per month in the third quarter. Unemployment remained low, and inflation by almost any measure either stabilized or declined. Readings on the real economy were complicated by the GM strike,

which shifted employment and production from July to August, but indicators of consumer spending, housing, and business investment remained strong, and the overall economy vibrant.

Thus, globally, it was "the best of times (here), and the worst of times (there)". But it soon became evident that while the U.S. seemed impervious, it might not be. As Chairman Greenspan warned, it might not be possible for the world's largest economy to remain "an oasis of prosperity in a wider sea of global turmoil."

The wisdom of these remarks became evident in the aftermath of the simultaneous default and devaluation in Russia. Beginning in early August, domestic financial markets here in the U.S. were roiled by an almost overnight reappraisal of risk by participants, and fears of a major negative effect on the real economy grew. Deflation, recession--the economic equivalent of the literary "Iceman"--began to dominate some discussions of the economy. Now, however, we seem to be seeing the continued strength of the consumer, the "Atlas" of this growth period, "shrugging" off potentially bad news and continuing to bolster the economy's strength, at least for now. The speed with which this has happened, however, has been unsettling to say the least.

What happened to credit markets in the early fall and what are we to make of it? Well, to start with, in September, in the wake of the Russian default, a reappraisal of the risk in foreign positions and U.S. equities propelled a flight to safety and liquidity. The safest and most liquid of securities available are U.S. Treasuries. This surge in demand for U.S. government issues caused a substantial decline in their yields, which had several disruptive effects.

First, a number of bank and nonbank financial institutions that had positions that depended on the stability of Treasury yields were caught short as prices rose rapidly and yields fell. They soon found themselves unable to unwind those positions in a market on a risk diet, but with a heightened appetite for liquidity.

At the same time, the fall in Treasury yields made corporate debt issuance less attractive, both to firms wishing to raise funds and to underwriters. The potential issuers took rising spreads of debt over Treasuries as a signal to look elsewhere for financing, and they did so (largely at banks). Underwriters were uncomfortable with taking on the increased risk of placing corporate securities even as rising Treasury prices increased their cost of financing such deals.

As a result, for a month or so in October, corporate debt issuance slowed markedly, and many feared that we were finally seeing the influence of the rest of the world on the previously impervious U.S. The flight to liquidity had initiated a drought of credit supply, and the real economy might soon suffer as a result.

In fact, as the story I just told suggests, conditions were not quite as dire as that. Some of the upheaval reflected the natural response of the debt market to changes brought about by the flight to U.S. Treasuries. Some of the retreat from risk as well was a healthy reaction to spreads that were at historically low levels early in the summer. But there was also a potential for significant damage to the real economy, and recognizing that, the Fed cut interest rates three times from late September to mid-November.

Recently, Treasuries have risen back to their pre-panic levels, spreads have narrowed, and corporate debt issuance appears to have resumed. While we are probably not entirely out of the woods, the debt markets seem to have calmed, and with some luck, are well-positioned for a more orderly conclusion to the year. Even more surprising is the fact that the stock market is back to its early summer

highs. The consumer apparently never stopped spending during the turmoil, so that GDP for third quarter came in just below 4%, and forecasters have been busy adjusting their 4th quarter and 1999 numbers upward. Most still see a slowdown, but certainly not a halt to economic growth in 1999. On the plus side, unemployment remains low, conditions for housing investment are strong, businesses are challenged by competing imported goods to invest, to improve efficiency, and to keep price increases in check. On the minus side, lingering uncertainty about financial market health, a relatively poor outlook for corporate profits, slower job growth and a possible retrenchment in consumer spending seem the biggest risks.

In sum, we have moved from the almost too good to be true "Goldilocks" state, through a period of seeming invincibility in the face of external turmoil, to a time of continued domestic strength but uncertainty about the future. Certainly this is a period that demands central bank vigilance and caution. But, I believe it also requires an

intensified outreach to understand just how this uncertainty plays out in the real economy. That's my reason for being here today--to hear from you about how you see things. So let me stop there, and open the floor for comments and questions.

Thank you.