Merrimack Valley Chamber of Commerce Annual Meeting

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Merrimack Valley Chamber of Commerce, Andover, Massachusetts
April 25, 2001

Thank you. It is a pleasure to be here tonight to participate in your Annual Dinner. And it is a particular pleasure to see Jane Walsh and her husband Michael. Jane, as you all probably know, served as a director of the Federal Reserve Bank of Boston. She provided wise counsel to us on policy matters and, particularly, on matters associated with the management of the Bank. I also want to say a formal hello to Len Wilson. We share an interest in workforce development; Len chairs the statewide Workforce Investment Board and I am the chair of the Boston Private Industry Council -- the local workforce development investment board.

As the Chinese curse goes "May you live in interesting times". Well, these times are certainly interesting for you, I can well imagine, and for us in the Federal Reserve. I've spoken to some of you at the reception and dinner about your sense of economic conditions here in the Merrimack Valley and more broadly. As Jane can confirm, one of the vital roles I play as a Reserve Bank president is to inform national policy making with regional insights -- and these are particularly important during times of rapid change in the economy.

Tonight I want to provide you with my perspective on the national economy and recent Fed policy moves. I also want to talk a bit about the region -- New England generally, and Massachusetts specifically. Finally, I want to conclude my comments with a few perspectives on a longer-run issue of vital importance both nationally and regionally -- creating a more skilled workforce.

It goes without saying that the national economy is in the midst of a sharp deceleration in growth. Debate abounds over whether or not we are in a recession. Personally, I think that is the wrong question. Whether or not the economy is still growing -- and likely it is, albeit slowly --the deceleration has been so swift from the last half of 1999 into 2000 to now, that this period has been truly painful, particularly for the manufacturing and high tech sectors that, to date, have been the hardest hit. But to an important extent, the pain we are feeling now arises not just from the speed of the slowdown, but from the necessary return to normalcy in key sectors of the economy that got seriously overextended a year and a half or so ago. Let me give you some perspective on this.

During the last half of 1999 and into the first half of 2000, GDP grew at a rate of 6.1 percent. To sense how remarkable this was, over the previous 3+ years, GDP had grown at 4.0 percent. The expansion, the longest in U.S. economic history, was gaining rather than losing speed. It is almost a universal law that expansions, like people, lose speed with advanced age. This expansion broke the rules. Unemployment dropped to a 30-year low, and inflation remained low as well. Great strides in U.S. productivity made much of this possible; from 1996 on the rate at which productivity grew was double that of the '70s, '80s, and early '90s. Productivity was accelerating during this latter period as well, helping to curb inflationary pressures. Also helping to restrain inflation was the fact that world growth was hit hard by the 1997-98 Asian and Russian crises. Worldwide excess capacity kept competitive pressures high, and commodity prices -- like oil -- low.

To paraphrase Herb Stein -- when things simply can't continue, they don't. Oil prices could not continue to be 1/3 to 1/2 of their usual level, and when worldwide demand picked up in late '98 and 1999, oil prices tripled. Labor markets could not continue to be so tight that the U.S. was literally running out of people to work at any job, skilled or not, without wages rising, and they did. Consumers could not continue to buy automobiles at the almost 19 million units a year pace of early 2000 -- at some point we had to run out of drivers and driveways. Homes could not continue to be built faster

than households were being formed -- that can continue for a while with increased household wealth fed by an ever-growing stock market, but it has to slow when financing and other market conditions tighten. Foreign economies cannot continue export driven growth when the largest customer for their goods -- the U.S. economy -- begins to slow. Finally, with hindsight, perhaps a 40+ percent annual pace of business investment in computers was not sustainable as well.

In the middle of 1999, the FOMC began tightening interest rates in recognition of the growing constraints on resources. But financial markets were not far behind in acknowledging an environment of increased risk as well. The NASDAQ tumbled for the first time in early 2000, and credit spreads widened as well, first in the spring, and then in the fall. Consumers and businesses reevaluated their spending in light of increased energy costs, higher borrowing costs, rising wages, and ultimately slowing demand. Did consumers really need that extra SUV or did businesses need that expansion to their corporate network? Maybe not. In short, things had to slow down and they did.

The slowdown showed up first in manufacturing -- automobiles in particular. In general, this took the shape of an inventory correction. With slowing demand, wholesale and retail inventories grew, orders to manufacturers dropped, and manufacturing activity came to a sudden pause. A lot of this inventory problem seems to have worked its way out, however. In first quarter 2001, inventories accumulated at a pace well below that of fourth quarter, though some imbalances remain. In addition, key indices of factory production, like the NAPM survey, the industrial production index, and capacity utilization data, while not robust, indicate a pickup at the end of first quarter.

Obviously, the inventory situation could improve only in the context of some strength in consumer demand. Here the resilience has been surprising, with purchases of automobiles, homes, and other durables either picking up in first quarter, or staying at relatively high rates. However, one key risk going forward lies in the continuing strength of consumer demand. With employment weaker, stock market wealth diminished, and confidence up and down, but mostly down recently, can spending continue? It's hard to answer that question definitively, but the diminishing pace of retail sales growth during the months of the first quarter suggests a rather weak trajectory of spending into the second quarter.

The other area hard hit during this slowdown has been high-tech businesses, particularly telecommunications. My own view is that two related things are going on here. First, an inventory adjustment has occurred in the face of slowing demand, not unlike the situation faced by automobile manufacturers. Orders slowed, and inventories of chips and finished equipment backed up. In addition to this, businesses seemed to have begun a fundamental reassessment of their own technology spending. Perhaps they are considering how to best use all the computers, routers, networks and software they've purchased over the past four years, both in view of declining demand and profit pressures and in view of their own continuing desire to be ever more productive and competitive. One thing seems clear -- this period of retrenchment in technology spending has the potential to be longer than a simple inventory correction.

It is these two risks to the economy -- the level of consumer spending and business investment -- combined with the slowing picture worldwide that the FOMC recognized when it began easing policy in January, and particularly when policy eased last week. To quote the Committee's statement from last week, "capital investment has continued to soften and the persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook seems poised to dampen capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, threatens to keep the pace of economic activity unacceptably weak".

As the statement indicates, looking forward, risks on the downside seem to predominate. However, for some time I have been cautiously optimistic about the underlying strength of the U.S. economy and I remain so. Clearly, the strong impetus to be ever more productive is a theme I hear from all my business contacts. The banking system, though clearly undergoing some challenge in this slowdown, remains relatively strong. Cooling labor markets may, at least for a time, help some businesses to grow in areas where they were constrained a year or so ago. And last but not least, inflation growth remains relatively benign. So with 200 basis points of ease in the pipeline, perhaps some optimism is warranted. But it is important to take this sense of optimism with a large grain of salt -- even if the U.S. economy achieves the growth rate of 1½-2% or so this year that is the consensus of most forecasters at present, that rate of growth will be half or less than any year since 1996. In short, the need for heightened vigilance on the part of the FOMC remains.

Speaking of interesting times, how "interesting" will things be here in New England? Well, I don't think we are going to

see the region experience this slowdown much differently than the nation as a whole. That is, unlike the late '80s, there do not seem to be regional imbalances that will make New England an outlier in terms of growth. Indeed, the region has fared a bit better over the last year than the nation. Employment growth -- which is just about the only timely comparative measure of growth that we have -- actually has been a bit stronger here in New England than for the nation, and unemployment lower. Manufacturing employment, while declining, has not declined as much as the nation's and manufactured exports have risen. Some of this is because the region's manufacturing base is not so oriented toward automobiles and steel, which led the national downturn.

But the region does have a distinct bent toward high-tech, and toward financial services. Aren't these being hard hit in the slowdown?

Certainly they are. I would expect that a continued slowdown in business technology spending will hit New England, and perhaps has started to already with the pullback in local operations of some major national high-tech firms. In financial services, growth in transaction volume -- in rising or falling markets -- buoys some income streams, but capital market financing and investment banking results are likely well off recent levels. In addition, New England is a high-income, high-wealth area. To the extent that these high income consumers feel less wealthy, regional spending may well suffer; though as yet we have not seen that happen to any great degree. In sum, if the nation's growth continues to be quite slow, New England will feel the pain though likely not in a disproportionate way.

Turning to my last topic, whether economic cycles are on the upswing or on the downswing, one factor that is critical to continued growth and productivity improvement is workforce development. New England is blessed with the most well educated workforce in the nation. But it is not an area to which workers naturally immigrate, whether because of higher costs, housing availability or even the weather. We have to grow our own workforce by and large, though immigrants from foreign countries do help.

We grow our own from the network of premier colleges and universities in the region, but this could become more challenging. Recently the annual share of college grads from New England as a percentage of the whole has declined, in part because the pool of students has grown. New England colleges and universities tend to be relatively small and expensive, and colleges and universities in other regions have become more competitive both in price and quality.

We also grow our own through incumbent worker training and, as you know, Massachusetts has set aside a Workforce Training fund to finance worker training. This program was slow to start but now is gaining some momentum. In addition, the one-stop career centers set up prior to the recent Federal workforce investment legislation seem to be working well. However, at least according to one study, Massachusetts ranks near the bottom of all states in terms of public funding for incumbent worker training even after the new fund was set aside. Clearly, all of us involved in workforce investment need to be focused on this issue.

Finally, we grow our own workforce in Massachusetts by having a strong public education system. Indeed, Massachusetts students rank relatively well against others in the U.S. in national tests and SAT scores. Boston students -- you may be surprised to find out -- when surveyed nine months after high school graduation are much more likely than their inner city peers elsewhere to be in two- or four-year post secondary education, or working.

But everyone knows that U.S. students don't compare well with their peers internationally, particularly in science and math, and, for Boston and other Massachusetts cities, performance on standards-based tests like the Stanford 9 or the MCAS is sadly lacking. More than half of 10th grade students cannot score above level 1 on both the math and English language portions of the MCAS -- that's a failing score -- but equally as important in my view, that's a score that is inconsistent with the needs of employers for competence even at entry-level.

Now the MCAS test is not without its controversy. Some believe it will cause teachers and schools to "teach to the test" rather than encouraging creative thinking and problem-solving. Others believe that it is unfair to urban students who, to date, have failed the test with greater frequency than their suburban peers. I have a different take on this subject.

I have followed the evolution of the 10th grade MCAS tests since they began, partially out of self interest since my son was in the first class of 10th graders to take the test. I have also reviewed the material distributed by the Department of Education describing what separates passing answers from failing on that test. This material makes it clear that much of

the MCAS test, unlike many others, looks at both whether a specific answer is right, and how the answer, right or wrong, was developed. Passing the test, as you know, requires scoring only one point above failure and involves only the math and English language portions, unlike high stakes tests elsewhere. Over time, I have come to the view that the MCAS, while challenging, does a good job of evaluating and measuring critical thinking skills. These are exactly the skills that are needed in the real world.

Now, tell me this. Is it fair to allow students to graduate without the ability necessary to address real-world questions at least partially successfully? How are they prepared for the future if teachers have not "taught to the test" at least for basic skills? And how are we as employers going to find, and afford, the entry-level workers we all need to grow and prosper in the future if the public schools can't at least ensure a basic level of quality?

Putting high standards into public education was what the Massachusetts education reform of the early '90s was all about. Much progress has been made bringing under funded school districts up to more reasonable levels, and increasing funding for all public schools. Progress has been made in defining standards, in developing curricula that meet the standards, and, for Boston anyway, finding even more help in whole school change, coaching and professional development through major foundation grants and private fund raising. However, the time has come to start showing results in terms of better student outcomes -- and it is these results that will help to produce the workforce we all need.

Employers large and small have a role to play in this final push toward realizing the promise of education reform. For one, all of us should be communicating with our staffs about the value of MCAS in measuring the results of the education reform effort. We need to be persuasive in telling employees about the importance, and ultimate fairness, of holding high school graduates to reasonable standards.

Second, as you all know, 10th graders who took, but did not pass, the MCAS this spring, will have at least four more chances to do so. The state has committed $40 million to support remedial efforts for students at risk of failure, but employers can help as well. For example, at the Federal Reserve Bank of Boston, our summer interns were given 90 minutes of remedial literacy instruction each day for seven weeks. The results were impressive. In both of two consecutive years, the students averaged a literacy gain of 1-1/2 academic years.

Why did this instruction work when the previous year may not have? Well, the classes were small, taught by very enthusiastic public school teachers at the workplace as part of the work day. The instruction was fun; it used technology efficiently and it was linked to a paid summer job. How about that -- a learning experience that's both intellectually and monetarily rewarding! And the supervisors on the job also believed these summer interns were better workers as well.

Finally, employers should be involved during the school year. Many of us have partnerships with local schools. These should involve more than just "feel good" programs and lunches for teachers. We all need to refocus our efforts on mentoring students likely to be left behind and making the most effective use of the time our employees spend on partnership activities. This is an area I know Fed employees love -- getting involved with helping schools. We as senior management need to be sure those efforts are focused on student success.

Conclusion

In closing, the national and regional economies face clear challenges, and policy makers must be focused and vigilant. By the same token, the challenge of ensuring we have the skilled workforce Massachusetts employers need to grow over the long run is considerable as well. And that is a matter over which we must all be vigilant.

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