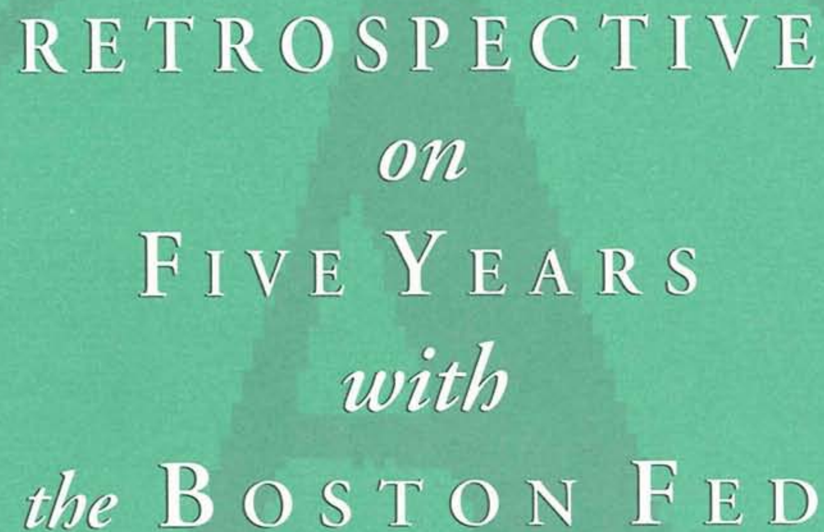
RETROSPECTIVE *on* FIVE YEARS *with* *the* BOSTON FED



RICHARD F. SYRON

AFTER MORE THAN TWENTY YEARS WORKING IN THE FEDERAL RESERVE SYSTEM — THE LAST FIVE AS PRESIDENT OF THE BOSTON BANK — I AM DEPARTING TO TAKE ON A NEW CHALLENGE. I LEAVE WITH SOME SADNESS, AS I TAKE GREAT PRIDE IN HAVING BEEN A PART OF THIS ORGANIZATION.

RICHARD F. SYRON
PRESIDENT AND CHIEF EXECUTIVE OFFICER

The Federal Reserve System is a remarkable body in many ways, but a particular strength is its decentralized structure, consisting of twelve regional Reserve Banks and a Board of Governors. This structure allows for a diversity of experiences, analytical approaches, and viewpoints. In the conduct of monetary policy, this structure provides both an early warning system for detecting potential economic problems and a consensus-building forum. Purists may be frustrated that the resulting policies do not adhere to a single school of thought, but in my judgment the System's intellectual give-and-take gives rise to the most prudent policies.

This diversity has been a great asset as the Fed has coped with the financial and economic changes of the past quarter century. We have seen the deregulation and globalization of financial markets, and we have suffered through oil shocks and debt crises among the less developed countries. We have enjoyed the fruits of expanded world trade, but we also wrestled with employment losses from import competition. The federal budget deficit ballooned during the 1980s — and stayed there.

These developments have posed new challenges for the Federal Reserve System. Thus, the large federal deficits of the 1980s, by crippling fiscal policy, shifted much of the burden of achieving economic growth and price stability onto the Fed. Just a few years after the Fed adopted monetary targets to combat the high inflation rates of the late 1970s, the relationship between different measures of money and economic activity broke down.

Not all the challenges have involved monetary policy. During the 1980s, the Federal Reserve began to charge for the payments services it provides, services that have had to adapt to an increasingly electronic and international financial market. Increased competition in banking and financial markets has fostered innovation but also increased risk and complexity,

requiring greater vigilance in banking supervision. Passage of the Community Reinvestment Act (CRA) in 1977 and amendments to CRA and the Home Mortgage Disclosure Act in 1989 have resulted in intensified interest in fair lending and community reinvestment.

While the past twenty-five years have posed many challenges to the Federal Reserve System, this annual report focuses on the five years during which I was president of the Boston Fed and on three issues in which Boston's experience illustrates the important role played by regional Reserve Banks: monetary policy, banking regulation, and fair lending.

MONETARY POLICY

Of all the Federal Reserve System's responsibilities, the most important are the implementation of monetary policy and the closely related goal of financial stability. Monetary policy is a joint responsibility of the Board of Governors and the twelve Reserve Banks. The actual policy-making body is the Federal Open Market Committee (FOMC). All the governors and Reserve Bank presidents participate in monetary policy deliberations, although only the governors and five presidents — the New York president and, on a rotating basis, four others — vote at any one time.

In my experience, this system has worked well. An important advantage is the active participation of the Reserve Bank presidents, who represent a variety of schools of economic thought. The St. Louis Fed, for example, has long been a champion of the "monetarist" approach, which holds that inflation is "always and everywhere a monetary phenomenon" and looks primarily to the monetary aggregates for signs of inflation. Boston follows more of a "real sector" approach that associates movements in inflation to changes in the slack in the economy, especially in labor markets. This approach has been more influential in recent years, during which the relationship between the monetary aggregates and the economy has been very unstable.

Whatever their analytical approach, the Reserve Bank presidents all bring to the FOMC deliberations an in-depth knowledge of their regions. New England's recent recession provides an example of the "early warning" potential of regional information. This region began to decline much earlier than the rest of the nation, and problems in commercial real estate and disruptions in credit appeared sooner and more severely here. Thus, New England's misfortunes helped sensitize the FOMC to

dangers that later threatened the national economy. Monetary policy over the past five years can be characterized as a well-executed balancing act, in which the Fed sought to achieve the dual goals of price stability and full employment. Each goal took precedence at different times, but never was one pursued to the exclusion of the other.

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At the start of the period, inflation was the primary concern. In the late 1980s, the unemployment rate approached 5 percent, a rate that most economists associate with upward pressure on inflation. And inflation had, indeed, started to rise.

The Fed was determined not to lose ground to inflation. Lowering inflation in the early 1980s had been very costly in lost jobs and income. It was critical, therefore, to stop rising inflation before it became embedded in the expectations of business and the public and locked into wage and price contracts. Between the spring of 1988 and the spring of 1989, the FOMC repeatedly voted to increase the federal funds rate, pulling up credit market rates. The incipient rise in inflation was quelled.

The FOMC had hoped that inflation could be lowered without serious job loss. A soft landing proved elusive, however. The economy began sliding into recession in 1990 as consumers, perhaps fearing hostilities in the Persian Gulf, unexpectedly and sharply retrenched. Real estate markets also began to show signs of weakness, first in New England, and later in commercial real estate throughout the country, and still later around the globe. Banks tightened lending standards. This most immediately affected real estate, but in some regions small and medium-sized businesses found themselves cut off from bank credit.

The FOMC responded with a series of rate cuts, lowering the federal funds rate from 8 1/4 percent in mid-1990 to 3 percent by September 1992. Credit market rates followed suit, dipping to 30-year lows. Eventually the economy began a modest recovery.

Job gains were quite muted in the early stages of the recovery. Growth was hampered by a number of "headwinds." Cuts in defense and other government spending supplanted the

fiscal stimulus that had helped fuel previous recoveries. Exports grew slowly as major U.S. trading partners fell into recession. Banks, under internal as well as regulatory pressure, tightened lending standards. And the combination of tighter credit and overbuilding left investment in office and other commercial buildings dead in the water. Finally, the necessary efforts of employers in a host of industries to become more productive resulted in round after round of layoffs.

Almost all of these headwinds hit New England earlier and more severely than the rest of the country. Thus, New England's experience highlighted the impediments to recovery and the importance of a stimulative monetary policy. For a time, the force of these headwinds led some analysts to suggest that monetary policy had lost its effectiveness. But housing, consumer durables, and business equipment investment all responded eventually to lower interest rates, just as the textbooks say they should. All picked up strongly, and these economic engines propelled the economy along an uneven, but enduring, course of recovery. Growth in the latter part of 1993 was especially strong.

ALTHOUGH THE NATION SUFFERED THROUGH DISAPPOINTING ECONOMIC GROWTH IN THE EARLY RECOVERY, THE UNITED STATES HAS OUTPERFORMED A NUMBER OF COUNTRIES COMMONLY REGARDED AS MODELS. MOREOVER, IT DID SO DESPITE CONSUMERS' BROAD-BASED CONCERNS ABOUT THE FUTURE, AND DESPITE HEADWINDS IMPEDING ITS RECOVERY.

By early 1994, the unemployment rate, which had previously exceeded 7 1/2 percent, where it exerted substantial downward pressure on inflation, was heading towards 6 percent. Similarly, rising industrial production had pushed capacity utilization to within striking distance of previous peaks, raising the possibility of bottlenecks and shortages in the not too distant future.

Soon, unless growth took a more moderate course, the rising demand for labor and capital would start to push up wages and prices. Recognizing that changes in interest rates affect the economy and inflation only with a delay, the FOMC at its February and March meetings voted to forestall an emergence of inflationary pressures, and raised the federal funds rate. In doing so, the Fed sent a signal reaffirming its commitment to preserve the

ground it had gained in lowering inflation over the last 14 years.

In my view, the FOMC has followed a wise course over the past five years. The Consumer Price Index (CPI) increased only 2.7 percent in 1993 and remains subdued. The unemployment rate is expected to fall in 1994 to a rate that is roughly consistent with full employment. Although the nation suffered through disappointing economic growth in the early recovery, the United States has outperformed a number of countries commonly regarded as models. Moreover, it did so despite consumers' broad-based concerns about the future, and despite headwinds impeding its recovery.

Such intricate balancing, which involves complex, constantly changing factors, relies heavily on the information and insights of the regional Reserve Banks. The economic gale that battered New England helped the FOMC recognize and respond to the headwinds facing the nation. The success of the Federal Reserve System rests on local, concrete foundations.

BANKING AND CREDIT

The interplay between region and nation contributes to regulatory as well as monetary policy and enabled the Fed to keep the recent credit crunch from becoming more severe and widespread. Once again, New England's experience was crucial. Because the recession hit earlier and harder in this region than in others, the Federal Reserve Bank of Boston was among the first in the System to realize the severity of the problems caused by falling real estate values and declining bank capital.

Although these problems later became characterized as a "credit crunch," a more apt phrase might be a "capital crunch." Banks, particularly in New England, had their capital depleted by falling collateral values and rising numbers of nonperforming loans. This loss of bank capital occurred at a most inopportune time, just when regulators throughout the world were placing greater emphasis on banks

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maintaining higher levels of capital. To make matters worse, the deepening New England recession made the capital markets very doubtful about the ability of the region's banks to return to health.

Falling capital, inability to raise new capital readily, and a stream of losses left New England's banks with only one way to boost their capital-to-asset ratios: by shrinking their assets. And the assets most banks chose to shrink were commercial and industrial loans, which fell from a peak of $41 billion in the first quarter of 1990 to $34 billion by the first quarter of 1993. Banks raised their lending standards, took on no new borrowers, and chose not to renew loans that had been rolled over routinely in the past. Some existing borrowers even had loans called. The shrinking pool of available credit particularly hurt small and medium-sized businesses, which rely much more heavily on bank credit than do larger companies.

Word of the emerging problem first reached the Boston Fed when a few business contacts reported more difficulty borrowing money than in the past. Economists — even those at the Boston Fed — viewed these early complaints skeptically, however. Their reflex reaction was that if these loans were so good, other banks would step in to pick up those that had not been renewed.

But the complaints kept coming. Soon it became apparent that almost all New England banks were doing the same thing. All were experiencing capital problems, and most were responding by cutting loans. Moreover, banks in other regions, which in better times might have considered entering the New England market, were discouraged both by the severity of the New England downturn and by signs of similar problems emerging in their own markets. A capital crunch was in progress, and it was causing the entire regional economy to contract.

Again, the Fed's structure was key to both recognizing the problem and responding. Only the Federal Reserve, in its roles as bank regulator, bank supervisor, and monetary policymaker, was positioned to sound the alarm. Our contacts with members of the business and banking communities, as well as our expertise in both bank

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supervision and economic monitoring, enabled the Boston Fed to understand early the nature of this economic setback.

was to avoid widespread loss of confidence in New England's depository institutions while minimizing payments problems.

THE VALUE OF A CENTRAL BANK WITH A STRONG REGIONAL PRESENCE WAS FURTHER REINFORCED BY THE BOSTON FED'S MANAGEMENT OF NEW ENGLAND'S RECENT BANKING CRISIS. THE CHALLENGE WAS TO AVOID WIDESPREAD LOSS OF CONFIDENCE IN NEW ENGLAND'S DEPOSITORY INSTITUTIONS WHILE MINIMIZING PAYMENTS PROBLEMS.

We recognized that the capital crunch and its distressing effects were the result of a regulatory approach that focused on individual banks rather than the banking system as a whole. This understanding not only contributed to the FOMC's monetary policy deliberations, but was also disseminated through appearances before Congressional committees; discussions with other regulators on possible regulatory reforms; and policy papers distributed to academic, business, and government leaders. A number of regulatory actions to encourage bank lending were adopted. Recognition of the systemic implications of bank regulation also increased.

The value of a central bank with a strong regional presence was further reinforced by the Boston Fed's management of New England's recent banking crisis. The challenge

This was no small task, given the list of failures between 1989 and 1992: Rhode Island's privately insured credit unions; the Bank of New England, holder of the most deposits in the region; and the failure of more than one hundred of New England's small and medium-sized banks. This grim list was prevented from growing even longer by the Boston Fed's providing hundreds of millions of dollars in emergency cash shipments, warehousing billions of dollars in collateral for emergency loans, and setting up entirely new payments mechanisms for electronic transfers of funds.

While the crisis in banking in New England is now over, the presence of a strong central bank in the region remains essential. The Boston Fed continues to provide a critical link between bank supervision, crisis

management, maintenance of the payments system, and overall economic policy.

Fair Lending and Community Reinvestment

The Boston Fed's experience with the Community Reinvestment Act and fair lending is a reminder that a regional Federal Reserve System also exists to help improve opportunities for all of us. These two closely related issues have been among the most controversial in which the Boston Fed has been involved, but also among the most rewarding.

Both issues have been major concerns in the City of Boston for many years. In fact, redlining in Boston contributed to the passage of the Community Reinvestment Act (CRA), which requires federal supervisory agencies to consider an institution's record in helping meet the credit needs of its entire community when evaluating bank merger proposals and other applications. Then, during the 1980s, a wave of mergers and acquisitions involving Boston banks provided the opportunity for community organizations to utilize CRA to voice complaints alleging bank neglect and unfair treatment. Because of its location, its role as banking supervisor, and its concern for the economic well-being of all New Englanders, the Boston Fed paid attention.

The best known of the Boston Fed's activities was its 1992 study of mortgage lending in the Boston area. Data newly available under an amended Home Mortgage Disclosure Act showed that black and Hispanic mortgage applicants in the metro area were turned down much more frequently than white applicants. Although earlier studies of mortgage lending in various cities — including one by the Boston Fed in 1989 — had found that fewer loans were made in minority neighborhoods than in white, these studies were generally unable to disentangle lenders' role in this outcome from that of realtors, insurers, and other actors in the housing and mortgage markets. With the release of new data on mortgage applications, however, it was clear that minority mortgage applicants were turned down more frequently than white applicants.

Community representatives saw this as proof of discrimination. Lenders, however, pointed out that without information on applicants' loan-to-value ratios, credit histories, and other characteristics important to the mortgage decision, the figures said little. Hoping to end a rancorous debate, Boston Fed researchers went back to the lenders and collected data on a host of applicant characteristics said to affect the mortgage decision.

Our researchers found that the explanations lenders gave for minorities' high denial rates did indeed account for much of the difference. But race still mattered. Boston's black and Hispanic mortgage applicants were more likely to be turned down than white applicants with the same economic characteristics.

The study attracted widespread attention. Lenders and community groups in other cities with large disparities between minority and white mortgage denial rates wondered whether the Boston findings applied to them. Moreover, the study provided an important insight that has rung true among many observers within both the banking industry and the regulatory agencies: that discretion plays a major role in mortgage approvals.

Prior to the study, something of a myth had developed that the mortgage decision was dictated entirely by unbending secondary market guidelines. The study, however, found that many approved mortgage applicants did not meet every guideline. Lenders exercise judgment. This use of discretion means that more people, both minorities and whites, are approved for mortgages than a strict application of the guidelines would permit. But it also creates an environment in which discrimination, and the perception of discrimination, can exist.

The banking community in Boston was galvanized by the study. Rather than attack the results, Boston banks have re-examined how they conduct business. They have stepped up efforts to increase lending to minorities by adopting a broad approach, emphasizing outreach to attract minority borrowers as well as instituting second reviews and other steps to ensure that borrowers are treated fairly.

Boston's mortgage-lending study also triggered a reassessment by secondary mar-

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ket agencies. Discussion surrounding the study revealed that some credit standards used by lenders and the secondary market are based as much on tradition as on analysis of loan performance. Federal supervisory agencies responded to the problem as well, supplementing their traditional case-by-case analysis with more sophisticated analytical techniques that look at patterns over many loans.

Our study has not been universally praised. Criticism has been fierce, some seemingly based on the rather naive assumption that, ipso facto, discrimination simply cannot occur in lending despite its presence in so many other markets. Underlying some of these criticisms may be fears that the study's findings will lead to overregulation, quotas, and credit allocation. Such fears are understandable, and it would be most unfortunate if they proved correct. A much more desirable outcome would be if the study prompted lending institutions across the country to recognize that minorities constitute a large and growing market that warrants more attention.

Serving this market may require innovative methods. Language and cultural barriers must be overcome, and new approaches to assessing creditworthiness may have to be developed. But serving any new market requires an investment. Banks, for example, do not lend overseas without assessing the economic and political climate of their target countries, and they should be carefully studying the risks associated with derivatives and mutual funds. Work up front is necessary to success in any new venture, and serving minority customers is no exception.

The 1992 Boston Fed study, as well as earlier research on mortgage-lending patterns and second mortgages in minority communities, was a logical outcome of the Bank's responsibilities for educating banks about their obligations and opportunities in helping meet community credit needs and for evaluating protests of merger proposals under the provisions of CRA. Contacts with community organizations arising from these functions made the Boston Fed aware of a festering sense of injustice on the part of minority and low-income borrowers.

Conclusion

The past five years have been a time of challenge, especially here in New England. But for me these years have also been enormously rewarding. During this time, the Boston Fed was able to play an important role in monetary policy by bringing to the attention of the FOMC the dangers of the commercial real

estate collapse and the attendant disruptions in bank credit supply. Boston's experience with the credit crunch has also influenced the regulatory policy debate.

At the same time, the Boston Fed's supervisory and payments responsibilities enabled us to help maintain confidence in New England financial markets when many of our banks and thrifts failed and, thus, helped to limit the damage to the New England economy. Finally, our work on mortgage lending has brought an underserved market to the attention of banks and other lending institutions and increased opportunities for minorities and residents of lower-income communities.

LASTLY, COMMUNITY LEADERS IN NEW ENGLAND AND IN BOSTON IN PARTICULAR DESERVE CREDIT FOR THEIR WILLINGNESS TO WORK COOPERATIVELY WITH BANKING INDUSTRY REPRESENTATIVES TO ACHIEVE THEIR GOALS OF FAIR TREATMENT OF MINORITY AND LOW-INCOME BORROWERS.

The past five years also demonstrated the resiliency and ingenuity that are trademarks of New England's history. Despite the devastating job losses of the recent recession and despite continuing cutbacks at the region's large defense firms, New England in the spring of 1994 was on the road to recovery. Remarkably, the region's unemployment rate was down to the national average. The turnaround of the region's banking industry, like that of the general business community, has also been little short of remarkable. An improving economy and the low cost of funds in 1992 and 1993 were critical to this improvement, but they would not have been sufficient without a lot of energy and resourcefulness on the part of the New England banking industry.

Lastly, community leaders in New England and in Boston in particular deserve credit for their willingness to work cooperatively with banking industry representatives to achieve their goals of fair treatment of minority and low-income borrowers. These exchanges between the banking industry and community representatives have opened many eyes to the opportunities that exist in serving minority and low-income customers.

The Boston Fed can be proud of its accomplishments in the past five years. However, we were only a small part of very extensive efforts in support of the regional economy by New England's business, banking, political and community leadership. I am honored to have had the chance to play a role.