

THOUGHTS ON GLOBAL ISSUES:
PRESIDENT'S ECONOMIC COMMENTARY

The favorable economic progress made in the United States in 1995 can only be viewed as positive for us domestically and for the world as a whole. As I look around the world, certainly there are pockets of problems — some of them severe — but in general, the macroeconomic data are reasonable. These include decent rates of real growth, clear progress against inflation, and the recognition of and commitment to solve the twin problems of domestic budget and foreign trade deficits. All of these areas of progress augur well and reflect, to greater or lesser degrees, not just a cyclical upturn but, even more importantly, sustained patterns of solid economic performance amid a series of worldwide trends.

I'd like to address three of these trends: the growth and pervasiveness of technology, the global integration of markets, and the consolidation of the financial services industry, broadly defined. These trends are tightly linked: technology promotes the global integration of markets, and both technology and market integration have hastened consolidation in financial services.

These developments, if properly managed, promise greater economic growth and improved living standards worldwide. They also have the potential to create financial instability on a global basis and, for individual countries to widen income disparity among workers, with all that could imply about the potential for social instability. In the midst of rapid change and appropriate worldwide fiscal constraints, there is a need to be careful that the primary function of government — to ensure the continuing welfare of all its citizens — can be met.

It goes without saying that technology is an increasingly vital part of everything we do. Transactions that were impossible 10 years ago can now be accomplished in minutes, if not seconds, and the potential exists to reap great benefits in efficiency and productivity for individual firms and for society as a whole. Strides in telecommunications in particular have accelerated the global integration of markets. Such technology has broadened the range of financial instruments — derivatives, for example — that can help the financial services industry minimize and redistribute risk. And last, but certainly not least,

technology has allowed the expansion and proliferation of payments, clearance, and settlement systems designed to provide assurance of liquidity and financial stability to global markets.

Not long ago, U.S. pension and mutual funds largely invested in domestic securities. Today, a growing portion of this money is invested abroad, a shift made attractive by higher rates of return, but made possible by technology. Information on foreign investments is now available on-line; trading in global markets can be accomplished around the clock; and worldwide, both securities and funds settlement increasingly take place electronically and in rapidly growing volumes and values. Businesses and economies not only must compete for customers and funding locally, but also must stand up to foreign competition that can, with increasing ease, supply products formerly made only locally and attract previously secure sources of investment.

Global integration has reinforced the need for all countries to shape policies in ways that are credible to foreign investors. This has meant attention to achieving long-run economic goals of low inflation and high rates of saving, and in most countries this has meant attention to deficit reduction.

The realities of ever-changing technology and global integration have spawned the need for increasing consolidation in the financial services industry. No longer can any single type of financial services provider lay sole claim to a product; technology has created commodity-like products and services with low profit margins. Global integration has increased competition. This combination has driven home the need for efficiency. In response, financial services providers have consolidated into larger entities which can spread the costs of technology and global reach over a broad base. These institutions then seek to diversify geographic risk in order to deal profitably with global businesses that need support in many markets.

All three trends — technology, global integration, and financial consolidation — hold great promise both for increasing the size of the world's economic pie and for generating broad-based increases in living standards. Combined with a basically solid worldwide economic outlook, the

promise is great indeed. However, there is also much about which a central banker can worry.

In a highly technological and global financial environment where volumes and values of transactions are growing rapidly, it is all too easy to forget the basics: the simple, unalterable truths that, if neglected, come home to roost just as they did 100 years ago. When we look at any of the financial debacles of recent times—Drexel, Kidder Peabody, Orange County, Barings, to name just a few—it's not the complex nature of derivatives or foreign exchange markets that has been the heart of the problem; it's the lack of attention to basics. High rewards are the result of higher risks; internal controls do matter; leverage can be overdone; and most importantly, never invest in anything the logic of which is not readily apparent.

With the benefits of increasing technical capabilities and a smaller world comes an increasing potential for bouts of financial instability. One has only to consider the phenomenon of the swift and violent "run-on-a-country" that occurred in Mexico to realize the potential for problems in the combination of technology and highly sophisticated global investors. Fortunately, in each case where global financial instability has threatened, financial markets and institutions have shown remarkable resiliency. The global economy has managed to dodge the bullet, even though those most directly involved have paid dearly. However, there is always the danger, albeit remote, that one of these disturbances could be bigger in size, affect more countries, bring gridlock to national and international payments systems, and occur faster than ever before.

For the global economy or for any individual nation or financial institution, the only way to ensure against the potential for crisis is to practice financial discipline. Conservative national macroeconomic policies maximize the attractiveness of a country for stable foreign direct investment. Increased international regulatory cooperation can anticipate a global weak link before the crisis. And increased investment and coordinated central bank attention to the payments and settlement systems that underpin global markets are necessary. Efforts to these ends are under way, but they must be stepped up to keep pace with advances in technology and global integration—no easy task, but a necessary one.

There is no doubt that increasing the level of private savings while diminishing public dissaving

is a critical economic priority in every developed country. High domestic savings rates reduce dependence on foreign savings, in effect reducing vulnerability to the problems inherent in technology and global integration. Promoting high savings rates means keeping inflation low, providing attractive savings vehicles—for example, pension reforms—and addressing chronic government budget deficits. In this regard, the G-7 countries must redouble their efforts at deficit reduction, since such deficits collectively are a huge drain on savings and an ongoing source of congestion and pressure in global capital markets.

However, in the global rush to better balance government income statements, it is important not to forget that governments exist for a reason. They exist to address the fact that the invisible hand simply cannot do the job by itself. There are needs, whether in the area of national security or in the elements of a social safety net, for which only governments can and should provide.

Balancing this inherent role of government with fiscal discipline is a challenge of some dimension. I have the uneasy thought that just as countries all over the world are making headway in deficit reduction, the very public investments in human and physical infrastructure that are needed to cope with the challenges of technology, integration, and industry consolidation may have difficulty being funded. How, for example, will our public education systems turn out the highly skilled workers needed for the more technologically intense industries and services of the present and future? A real worry is that just when we need them the most, the funding for these so-called public goods will dry up, with all that implies about the potential for a permanent underclass and social instability.

U.S. and worldwide economic health is encouraging both for the present and for the immediate future. But beneath the surface are problems that must be addressed. I have touched on only a few, and while I recognize that the probability of serious difficulty is low, the assumption that these issues will go away if unattended is both myopic and dangerous. Central bankers, policymakers, and business leaders must work together to establish sound, conservative macroeconomic policies, emphasize basic financial controls, and ensure that enough investment can be made in the human and physical infrastructure to sustain growth in this challenging and ever-changing world.



In the crunch of global competition and instantaneous decision-making, it's easy to forget the principles of sound financial management. Forums provided by the Bank, such as the one on derivative risk management, are services aimed at educating the region on financial issues.



At the request of public leaders from several New England states, the Boston Reserve Bank held a conference at which District leaders from all sectors, including Native American tribes, were able to discuss with national experts the economic implications – pro and con – of casino gambling.

MONETARY POLICY AND THE NEW ENGLAND ECONOMY

The Boston Reserve Bank participates in the formulation of monetary policy and in the promotion of sound economic growth and financial stability both here in New England and throughout the country. The quality of the Bank's research and its reputation for impartial policy analysis also enable us to contribute information and provide forums for discussion of a wide range of issues important to decision-makers and communities in the First District and beyond.

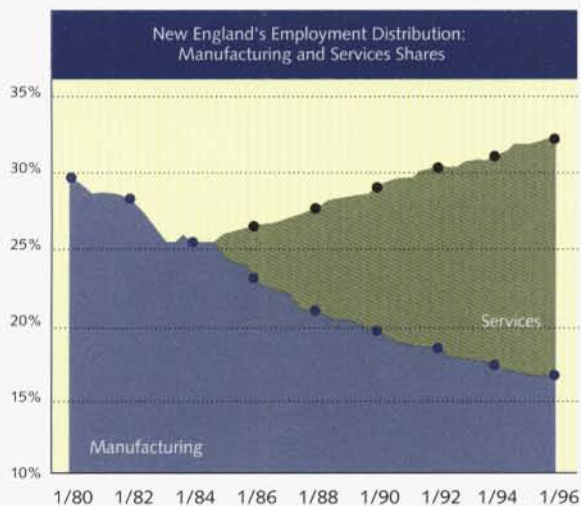
Monetary Policy

Inflation averaged under 3 percent in 1995, the fourth year in a row of such low rates and the best performance since the early 1960s. Unemployment for the year was 5.6 percent, well under its 20-year average of 7 percent. The continued expansion of the economy demonstrates that we have achieved a "soft landing." The economy did not slide into recession, despite the advanced age of the recovery. Nor did growth accelerate into an unsustainable inflationary boom, as has often happened in the past.

Trying to understand and anticipate the path of the economy is one of the primary functions of the research staff at the Boston Reserve Bank. Gathering information on economic activity in New England for the System's periodic Beige Book entails a regular survey of firms in the region. Throughout the year, the staff prepared briefings for the Bank's Board of Directors on current conditions in the region, the nation, and among our major trading partners; advised the Bank president before Federal Open Market Committee meetings; and engaged in research on the complex issues related to monetary policy.

The interaction between regulatory policy and monetary policy and their effect on economic activity are much-debated issues to which we in New England are especially sensitive, having suffered through the credit crunch that followed the real estate collapse here in the late 1980s. Over the past year, the Boston Reserve Bank produced a number of conceptual and empirical articles exploring these relationships and showing the pitfalls of a mechanistic approach to capital regulation. In part because of New England's experience, economists and policy-makers have been debating whether bank lending has a special role in the economy; and our conference on the role of banks in the transmission of monetary policy brought together researchers from across the nation to explore whether bank lending affects economic activity, independent of the effects of interest rates and changes in the money supply.

*Services industries
dominated job growth
in 1995 while manu-
facturing employment
bottomed out.*



Business executives and municipal officials attended our conference on the benefits and risks associated with use of derivatives. The opportunity to hear from prominent experts in the field led, we hope, to a better understanding by those who make investment decisions. This advice was also published in the Bank's economic journal, as was research examining banks' use of derivatives which showed that many derivatives are conceptually equivalent to more familiar traditional securities. One theme of this research is that regulation should focus on institutions' overall risk management rather than on a particular class of financial instruments.

The Regional Economy

Although the nation enjoys moderate growth, with low unemployment and low inflation, this prosperity has not been shared evenly by all regions, industries, or individuals. New England still has not recovered all the jobs lost in the deep recession of the early 1990s. Nevertheless, it seems likely that this unfortunate episode was a one-time occurrence rather than the beginning of a prolonged period of economic difficulty. While the rate of growth in 1995 was slightly lower than in 1994, it was consistent with historic trends. Among the six New England states, New Hampshire and Vermont continued to experience the most rapid growth.

The recovery has been characterized by pronounced industrial shifts. Services industries have accounted for most of the new jobs and have continued to dominate job growth in 1995. Construction employment also rose. Manufacturing employment, on the other hand, has fallen throughout most of the recovery. Our contacts with manufacturers, however, reveal that the employment figures give a misleading impression of the health of the industry. Large productivity gains are enabling manufacturers to do more with less, and when they do need to expand, they look increasingly to outside sources

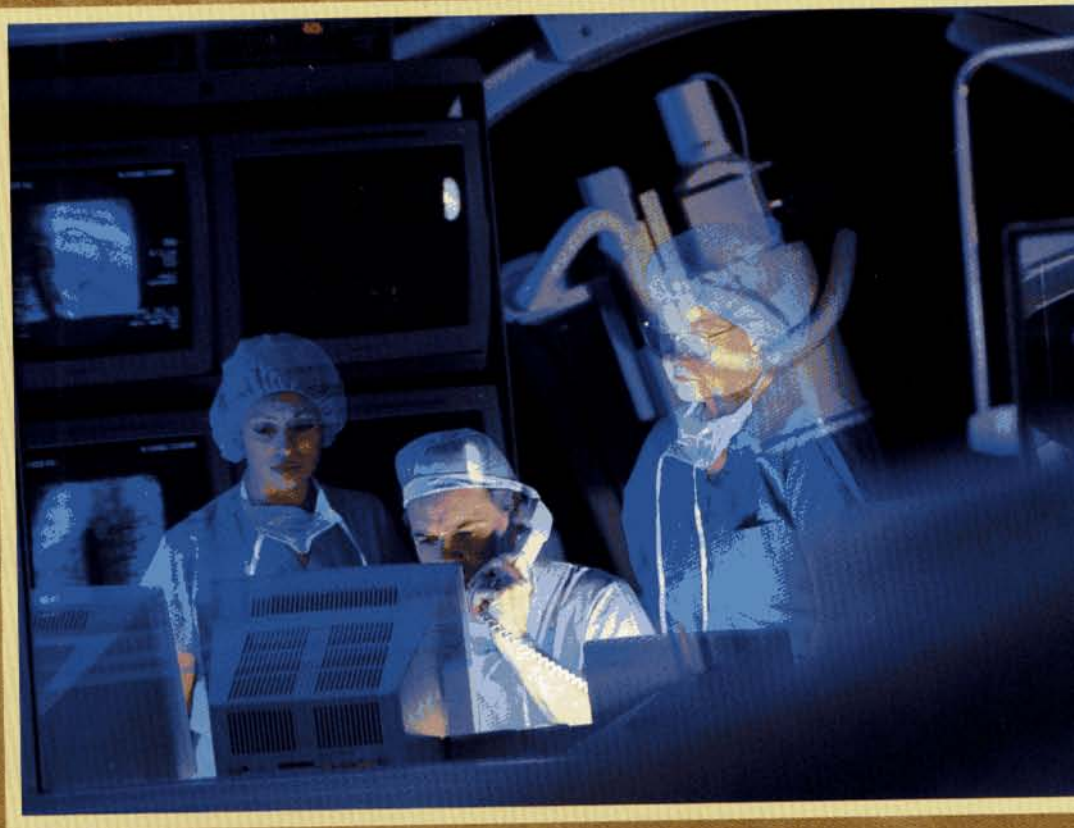
and temporary help agencies to supply staff, rather than adding to their own payrolls. In 1995, moreover, manufacturing employment appears to have bottomed out. Several traditional manufacturing industries such as metals, once dismissed as uncompetitive in New England, are expanding. High-tech employment, meanwhile, appears to be stabilizing.

Restructuring in the face of competition has prompted downsizing among utilities and in financial services. Despite employment declines, however, the banking industry in the region is healthy once again. Consolidations have reduced the number of institutions, but the industry's return to health removes a significant drag on the regional economy.

Small and medium-sized businesses are particularly dependent upon bank financing. Thus, a healthier banking sector bodes well for the availability of credit. At the same time, the increasing concentration of the industry raises concerns, since large banks devote a smaller fraction of their resources to small business lending than do their smaller counterparts. Boston Reserve Bank economists addressed this issue in several articles on the availability of bank loans to small businesses and the implications of the changing structure of the New England banking industry.

Adding to the ongoing debate over reform of the health care system, the Bank published the proceedings of our 1994 health care conference. That forum gathered prominent experts from diverse sectors to explore the impact of mergers on the health service industry, the con-

In New England one in ten jobs is directly tied to the health care industry. In 1995 the Boston Reserve Bank published the proceedings of its conference on health reform at which experts, policy-makers and consumers explored the difficult challenges and practical responses.



sequences of reform for the region's medical research, and the requirements for market-based health care.

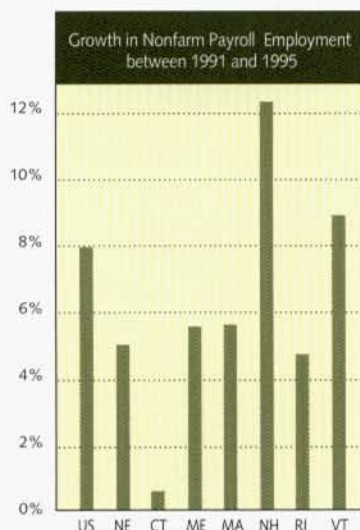
The Bank also looked at the fallout from the shift from manufacturing to services and from the downsizing of major corporations. One project examined the experience of laid-off New England defense workers and found that they typically experience substantial pay cuts in their new jobs, with older workers faring the worst. Another study looked at the effect of changes in health benefits on the inequality of incomes. The study concluded that less educated workers are even more disadvantaged by recent labor market shifts when health benefits data are taken into account than when only wage data are included.

Indeed, income inequality is a serious and growing problem. To stimulate new thinking, the Boston Reserve Bank organized a symposium that brought together two groups of researchers who address the inequality issue from quite different perspectives. By mixing those who focus on location and isolation from mainstream economic activity with those who stress mismatches between the demand and supply of labor, we

hoped to generate fresh ideas and set in motion new collaborations. The conference focused attention on possible institutional and neighborhood factors that might be amenable to policy action. We trust that the true measure of its success will be apparent over time, as researchers take advantage of their exposure to new colleagues and fresh approaches.

The disruptions arising from the changing character of the economy have intensified the pressure on elected officials and business and community leaders to adopt policies that stimulate local growth. Casino gambling is seen by some as an important economic development tool. At the request of public officials from several New England states, the Boston Reserve Bank held a conference that brought together policy-makers and experts from around the country to explore the costs and benefits of casino gambling. Although opinion was divided on the net outcome, agreement was widespread that, like it or not, gambling is on the upswing.

Looking ahead, the Bank's research staff will continue to seek a better understanding of the forces responsible for economic growth and contribute to policies that enhance economic well-being, with attention to the special needs of New England. The Boston Reserve Bank strives to be an impartial source of information and expertise by providing a common ground for citizens, researchers, and policy-makers to share their concerns and insights.



Unemployment rates in New England followed the national downward trend.

