

Testimony on the Third District Economy and Monetary Policy

*Edward G. Boehne**

Thank you for the opportunity to appear before this Committee to discuss District economic conditions and monetary policy.

BACKGROUND ON THE THIRD DISTRICT

The Third Federal Reserve District, headquartered in Philadelphia, includes the state of

Delaware, the southern half of New Jersey, and roughly two-thirds of the state of Pennsylvania. About one-third of New Jersey's population and more than 70 percent of Pennsylvania's population are in the District. The three states that are either wholly or partially in the District represent more than 8 percent of the U.S. population, employment, and income. The District itself, although small in size geographically, represents about 5 percent of the U.S. economy in terms of population, employment, and personal income. More than 25 of the Fortune 500 companies are headquartered within the District boundaries.

The largest concentration of economic activ-

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ity in the District is in the Philadelphia metropolitan area. The Philadelphia area is the fourth most populous metropolitan area in the country, with almost 5 million residents. It ranks among the 10 largest U.S. markets in both industrial and commercial office space. The City of Philadelphia is the fifth largest city in the country and has the nation's sixth largest downtown office market.

In general, the economy in the three states of the District is quite diversified and could be described as a microcosm of the U.S. economy, since the nonfarm economy in the three states mirrors the nation quite closely. The proportions of jobs in most nonfarm categories differ little from the proportions at the national level. The two major nonfarm sectors in which the percentage of jobs diverges significantly from the national average are business and personal services and government services. Compared with the nation, about 2 percent more of the jobs in the tri-state area are in the private service industries (including accounting, private education, and health care), and about 2 percent fewer jobs are in the government sector. Agriculture and agricultural services contribute about 1 percent to the total output of the three states—somewhat less than the U.S. average. But agriculture remains a major industry in parts of south Jersey, southern Delaware, and south central Pennsylvania.

The District used to have a high proportion of its jobs in manufacturing, but that has changed. In the early 1970s more than one-third of the jobs in the three states were in manufacturing—about 7 percent more than at the national level. As late as 1980 more than one-quarter of the jobs were in manufacturing, still higher than the national average. Today the percentage of jobs in manufacturing in the Third District states is less than 20 percent and very close to the national average.

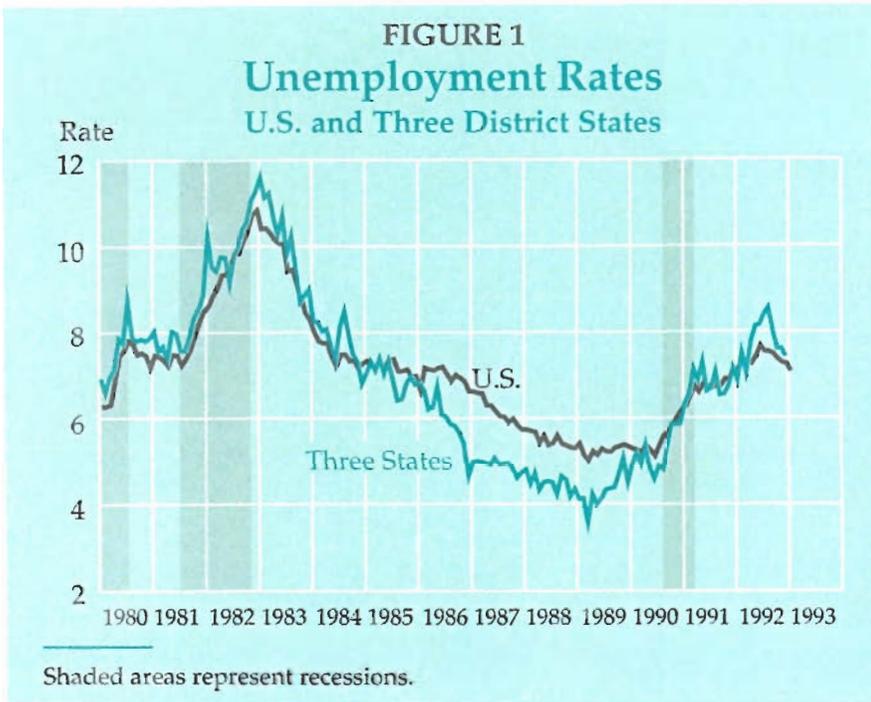
The chemical industry and health services are more heavily represented in the District than in the nation. The production of industrial

chemicals in the District is concentrated in Delaware. Pharmaceutical research and production, also classified among the chemical industries, is concentrated in central New Jersey and in the Philadelphia area. The higher-than-average number of jobs in health services in the District is the result of two factors: the average age of the population in the District is higher than that in the nation, and there are many large medical schools, hospitals, and health research facilities in the District.

Even though the District as a whole is not highly dependent on defense spending, certain parts of the District, such as the areas around Dover Air Force Base in Delaware and McGuire Air Force Base in New Jersey, are heavily dependent on defense. In Philadelphia, the Navy Yard and the Personnel Support and Industrial Supply Centers employ a large number of workers. In addition, the District has some major defense contractors, such as Boeing Helicopter and GE Aerospace (which is currently in the process of being sold to Martin Marietta).

DISTRICT EMPLOYMENT AND UNEMPLOYMENT

The Third District economy enjoyed solid growth during the expansion of the 1980s even as it continued to shift away from manufacturing and toward services. The history of state unemployment rates illustrates how the region's economy performed during most of the 1980s (Figure 1). In the late 1970s and early 1980s, unemployment rates in all three states in the District were regularly at or above the national average. During the long expansion in the 1980s, unemployment rates in all three states fell below the national average. By the end of the decade Pennsylvania's rate was a percentage point below the nation's in some months, and the rates in Delaware and New Jersey were even further below the national rate. For a time, Delaware's unemployment rate was below 3 percent, and the rate in New Jersey was between 3.5 and 4 percent.



Job growth in our District was very good in the last decade, but not quite as good as the drop in unemployment rates would suggest. Combined job growth in the three states of the District was slower than job growth at the national level, although some labor markets were notable exceptions. Jobs in Atlantic City and Monmouth/Ocean counties in New Jersey, in Lancaster and State College in Pennsylvania, and in the state of Delaware, all grew appreciably faster than the national average. In Delaware, jobs grew more than one-and-a-half times the national rate. Some of these fast-growing areas benefited from special circumstances.

The introduction of casino gambling in Atlantic City in the late 1970s, for example, resulted in very rapid job growth. Atlantic City was the fastest growing labor market in our District in the 1980s; jobs increased by more than 35 percent. Delaware experienced a major boom as financial service firms moved in to take advantage of the state’s 1981 Financial Center Development Act. Jobs in the financial service sector more than doubled in the state

during the 1980s.

Unemployment rates in the District came down relative to the national unemployment rate during the 1980s, despite overall job growth that was slower than the national average, because the District’s labor force generally grew more slowly than that in the nation. With the exception of Delaware, labor force growth in the three states in the District lagged growth in the nation. This slower growth was partly a function of the age distribution in our District: fewer young people entered the labor

force than in earlier decades. The number of jobs in the three states of the District increased about twice as fast as the slowly growing labor force during the expansion of the 1980s, so many labor markets became very tight near the end of the expansion.

By the late 1980s, the economy in several parts of the District was showing signs of becoming overheated. Wages and prices were rising faster in the Northeast than in the nation as a whole. The rate of increase in the regional Consumer Price Index for the Philadelphia-Wilmington-Trenton area, for example, was 0.5 to 1.5 percentage points higher than the CPI inflation rate for the nation as a whole during the latter part of the 1980s. The region’s inflation rate is now close to the national average. Inflation and wage costs are not a concern I hear much about now in the District.

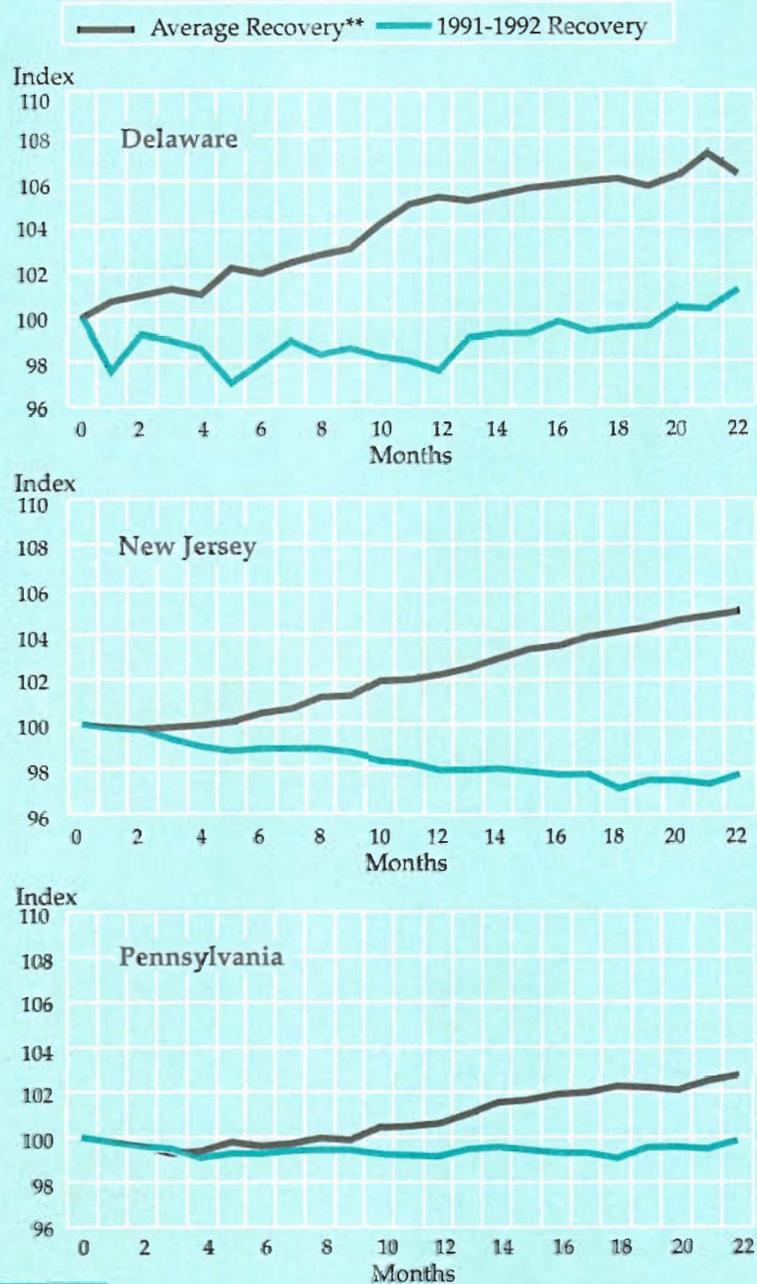
In contrast to the District’s better-than-average performance during much of the 1980s, the District has suffered a more serious recession and slower recovery than has the nation in the 1990s. One of the most frequent complaints I heard in the late 1980s when I met with business

people was their inability to find qualified workers. Now I hear from people who cannot find jobs. The job situation turned around dramatically in the District, especially in New Jersey. As measured by the period in which jobs were generally declining, the recession lasted longer in most parts of our District than in the nation. Jobs began to decline in our region before they did in the nation. In New Jersey the general decline began in early 1989—more than a year before the onset of the national recession. In Pennsylvania the general decline began three months before the official beginning of the recession. Mirroring the national pattern, jobs continued to decline in the District beyond the official end of the recession. In New Jersey, there has not yet been any sustained job growth.

The job picture following this most recent recession stands in marked contrast to the average job growth after the other recessions since 1970. I have included a set of charts comparing the job growth in each state in our District following this recession with the average growth following the recessions of 1970, 1974-75, and 1981-82 (Figure 2).

Twenty-two months

FIGURE 2
Job Growth in Recoveries*



* Job growth is measured by payroll employment, indexed at 100 in the last month of the official recession.

** Average of recoveries from business cycle troughs of November 1970, March 1975, and November 1982. The recovery following 1980 is not used because it did not last 22 months.

into the national recovery, only Delaware has more jobs than it did at the end of the recession. The net increase is slightly more than 1 percent, far short of the more than 6 percent average for earlier recoveries. In New Jersey jobs are more than 2 percent *below* their levels at the official end of the recession, and in Pennsylvania they are still slightly below their levels at that time. By this time in earlier recoveries, jobs in these two states averaged 2.5 to 5 percent *above* their levels at the trough of the business cycle.

Given the extended period of job declines in most of our District, it is not surprising that the percentage loss of jobs has been deeper than the loss at the national level. Recently revised numbers show that the job declines in the District were not as severe as earlier numbers suggested, but District losses were still steeper than the national decline. While the U.S. lost less than 2 percent of its jobs, Pennsylvania and Delaware lost 2.4 percent and 2.7 percent, respectively. New Jersey had the highest percentage of job losses; the state lost almost one out of every 14 jobs between 1989 and 1992.

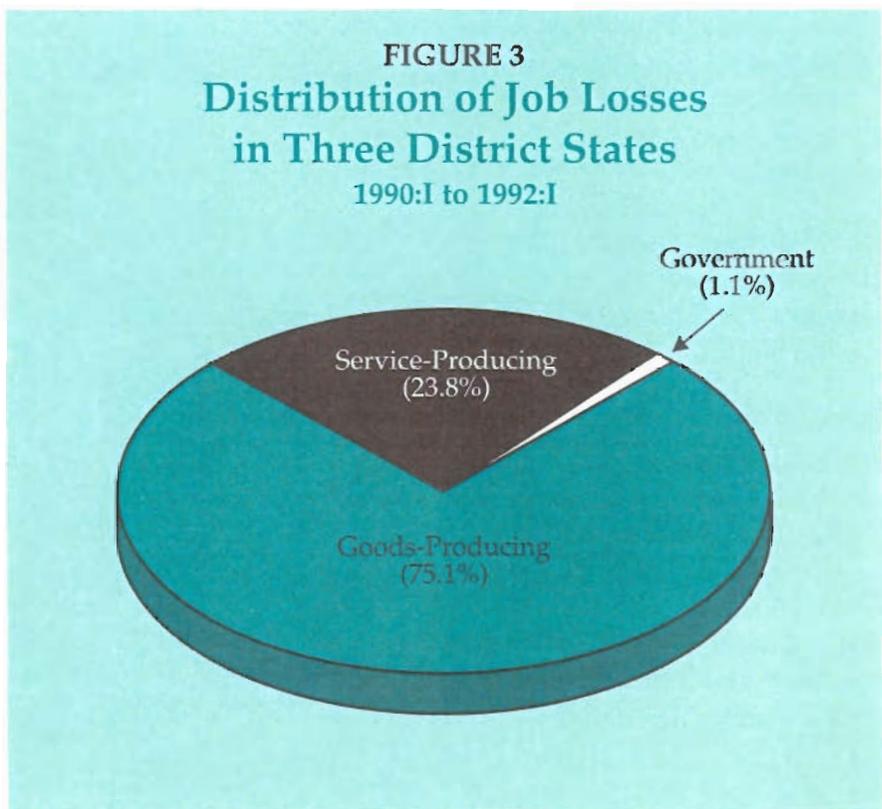
Job losses in the District were spread across every sector of the economy (Figure 3). The goods-producing industries took the biggest hit, as they typically do in any recession. More than three-quarters of the jobs lost in our states were in construction and manufacturing, even though they account for less than one-fourth of the jobs. A larger than usual percentage of the job losses in this recession, however, were in the service-producing industries. In every other recession during the last 20 years, the

private service-producing industries suffered little or no net job loss. This time almost 25 percent of the job losses in our region (between first quarter 1990 and first quarter 1992) were in the private service-producing industries.

Whether in the goods sector or the service sector, the job losses this time seem to be more permanent, as many firms have undergone major restructuring. Our District has suffered, or is about to suffer, cutbacks by several large employers. DuPont has gone through a major restructuring that has reduced its work force by 6000 in Delaware alone. Last year, Bell Atlantic announced reductions of over 1000 positions in New Jersey and almost 1000 in Pennsylvania. GM is slated to close an auto parts plant in Trenton, New Jersey, and an assembly plant in Wilmington, Delaware; Sears closed a distribution facility in Philadelphia; and Bethlehem Steel closed its division in Johnstown, Pennsylvania, eliminating 1900 jobs.

The continuing job losses beyond the end of

FIGURE 3
Distribution of Job Losses
in Three District States
 1990:I to 1992:I



the national recession meant that unemployment rates in most of the District did not peak until mid-1992. Except for Delaware, the state unemployment rates in the District are again higher than the national average, as they were in the 1970s and early 1980s. Pennsylvania did not quite have the boom times in the 1980s that New Jersey did, and Pennsylvania hasn't fallen as far during the past two years either. Pennsylvania's unemployment rate, which had been quite a bit below the national average during the late 1980s, has more recently been very close to the national average. Within Pennsylvania and New Jersey we have a wide range of unemployment rates. Some are in the 5 to 6 percent range; others are over 10 percent. These differences across the states represent differences in the mix of industries in these geographical areas.

The emerging recovery from the recession is uneven across the District. So far the low point for jobs in the District's three states combined was September 1992. Employment was up slightly in the fourth quarter for the District as a whole. I must caution, however, that we have had temporary improvements in the job picture earlier in the national recovery only to see the gains evaporate, so we continue to closely monitor the job picture in the region.

OTHER DISTRICT INDICATORS

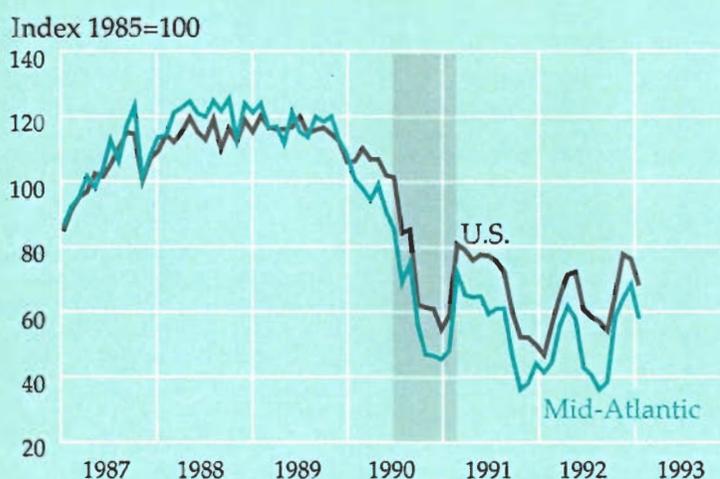
Other indicators give some evidence of a pickup in economic activity in several sectors in the District. The index of current activity from the Philadelphia Fed's monthly *Business Outlook Survey* of manufacturers rose from close to zero

in October 1992 to almost 39 percent in February of this year. That means that 39 percent more manufacturing firms reported increases in current business activity than reported decreases in activity. A similar index from our quarterly survey of all types of firms in southern New Jersey rose from 12 percent in the third quarter to 34 percent in the fourth quarter.

Consumers in our region are also showing more faith in the recovery. The Conference Board's Consumer Confidence Index for the mid-Atlantic region was up in the fourth quarter of last year and again in January, but fell back a bit in February. This bears close watching because confidence in the region rose twice before in this recovery before falling back to low levels (Figure 4).

Retail sales in the region have increased since their cyclical low in early 1991. The improvement has not been as strong in New Jersey as it has been in Pennsylvania. Moreover, the advance has been uneven over the past two years.

FIGURE 4
Consumer Confidence



Source: Conference Board

Shaded area represents recession.

DISTRICT REAL ESTATE

The real estate sector in the District deserves special mention because a full recovery in that sector is probably still several years away. There is no sign yet of a real recovery in the commercial office market. In the mid-Atlantic region, office construction, measured in square feet, is down more than 75 percent from its peak in 1987. In dollar terms it is down more than 60 percent. Office vacancy rates in the Philadelphia market remained high in 1992 despite the lack of any new construction. Quoted rental rates in the downtown Philadelphia market were down in 1992 and were unchanged in the suburbs.

High vacancy rates, lower rental rates, and sales of some distressed properties have meant that purchase prices per square foot in the Philadelphia area have dropped dramatically. The average price per square foot for properties sold dropped from \$94 per square foot in 1990

to \$43 per square foot in 1992. Many of these recent sales, however, are distress sales.

On the residential side, in contrast, a recovery has been going on for some time, at least in parts of the District. However, the increase in housing starts has been neither steady nor evenly distributed (Figure 5). The housing recovery in New Jersey has been particularly weak; housing starts there are only about 40 percent of their 1987 level. Although some of the builders in southern New Jersey have recently indicated improvement in activity, they have also expressed concern that rising lumber prices (which have gone up 40 to 50 percent in a few months) could choke off the recent rise in housing demand in the area. Most of the improvement in housing has been in the single-family market. With high vacancies and falling real rents, there has been little incentive to invest in rental housing. But there are some signs that the rental market is stabilizing. In

1992 landlords offered fewer incentives, such as one-month's free rent or free parking, to renters.

BANK LENDING IN THE DISTRICT

Bank lending was very weak in the District in 1990 and 1991, as it was in the nation as a whole, as the recession reduced loan demand and as deteriorating asset quality led banks (and regulators) to be more conservative in evaluating lending opportunities. Real estate lending was especially limited in the face of declining property values. The cost of financial intermediation rose because of increased capital requirements and higher deposit

FIGURE 5
Housing Starts
U.S. and Three District States



Data are three-month moving averages.
Source: U.S. Dept of Commerce for U.S. data; F.W. Dodge for state data
Shaded area represents recession.

insurance premiums, and the deterioration in loan quality increased the perceived risk of default. These factors led, despite weak loan demand, to a widening of spreads between loan rates charged by banks and their cost of funds.

I believe that we have started to see signs of an improved environment for bank lending in the District. We seem to be moving from a credit crunch to credit caution. Banks have increased their capital positions and reduced their net charge-offs during the past two years, and nonperforming loans as a percent of total loans declined last year. Consequently, the region's banks are now in a better position to increase their lending as loan demand picks up.

Loans by banks in our region have, in fact, increased somewhat during the past year in all categories of lending: real estate, consumer, and commercial and industrial. Banks also reported at the beginning of this year that they are beginning to see stronger loan demand from middle-market firms and small businesses. What's more, banks are becoming more active in seeking out lending opportunities. For example, at a recent meeting of builders in southern New Jersey, some bank loan officers attended the meeting—something we had not seen during the previous two years. (In another region of the District, one developer even reported receiving a phone call from a banker asking if the developer was interested in borrowing money!) Banks in the region also are no longer tightening credit standards, and some banks reported an easing of their loan terms. I expect to see further increases in lending over the next year.

Nonetheless, there remain obstacles to the resumption of normal borrowing relationships, especially for small and medium-size businesses. In particular, we must find ways to facilitate the so-called "character" loan by easing up, where prudent, on excessive documentation and other costs that fall disproportionately on small businesses.

SUMMARY OF DISTRICT ECONOMY

Overall, District economic activity has shown improvement since September of last year. The unemployment rate has declined in each of the District's three states, and employment levels are up in the District as a whole. Unfortunately, employment has not risen very much since the end of the national recession. What's more, some large firms have announced major layoffs that will affect our District. The District's growth has lagged the rest of the nation during most of the past two years, and I expect this situation to continue during 1993. Even though I expect employment to increase in each of the District's three states, the improvement is likely to lag behind gains in the nation as a whole. Among the states in our District, growth in New Jersey is likely to be weaker than in Delaware and Pennsylvania.

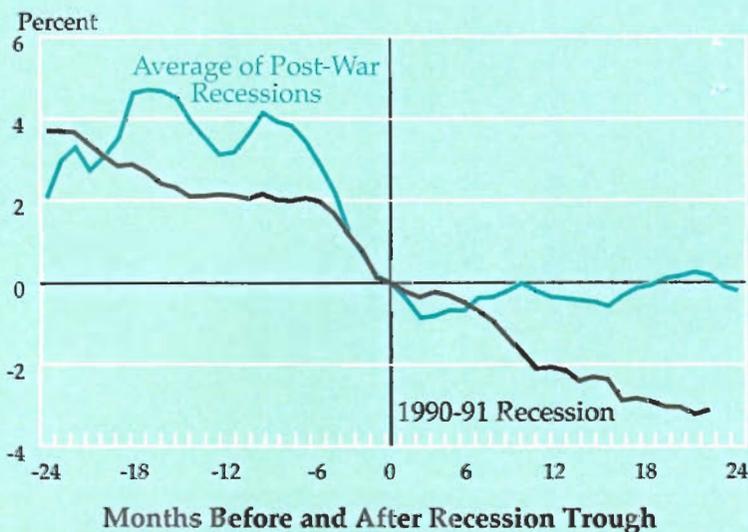
MONETARY POLICY

Let me now turn from the District to monetary policy. The Federal Reserve, against a background of weak economic growth and lessening inflationary pressures, has brought short-term rates down to their lowest levels in about 30 years. The federal funds rate has declined by almost 7 percentage points since early 1989 (Figure 6). Monetary policy began to ease more than a year before the onset of the 1990 recession; it eased substantially during the recession; and it continued to ease during the sluggish recovery. By this point in past recession/recovery periods, the federal funds rate had, on average, risen from its low point a few months after the trough of the business cycle (Figure 7). In contrast, in this most recent recession/recovery period the federal funds rate has continued to decline since the trough of the recession in March of 1991. This further decline of short-term interest rates reflects a continued easing of monetary policy that has been entirely appropriate given the weak growth of employment and real GDP through much of this recovery. Because employment

FIGURE 6
Discount Rate and Federal Funds Rate
 1989-1993



FIGURE 7
Federal Funds Rate Relative to Its Levels
at Recession Troughs
 1990-91 Recession vs. Post-War Recessions*



*Average of recessions from 1960 to 1989, excluding 1980 recession.

and real GDP growth have been weaker during this recovery than in previous ones, monetary policy has been unusually accommodative in continuing to bring down short-term rates to try to get the economy growing at a more sustainable pace. With core inflation (that is, the CPI excluding food and energy) somewhat above 3 percent during the past two years and short-term rates falling to around 3 percent, short-term real rates (that is, short-term rates adjusted for core inflation) have been close to or a little below 0 percent since the trough of the recession, whereas in previous recessions the real federal funds rate has typically risen by now and become positive.

The pattern of declining short-term interest rates during this recession/recovery period has been in marked contrast to the behavior of M2 money growth. M2 growth has been very sluggish in comparison to past recoveries despite the continued easing of monetary policy. Since M2's relationship to economic growth has been changing in ways that we do not fully understand, M2 has become a less reliable guide for monetary policy. Indeed, the pace of economic activity in 1992 was much faster than could have been anticipated

using the historical relationship between M2, income, and interest rates.

The pace of economic activity improved substantially over the last two quarters of 1992, and, as noted in Chairman Greenspan's testimony to this Committee on February 19, the central tendency of the governors' and Reserve Bank presidents' forecasts is for real GDP to grow 3 to 3.25 percent during 1993, with the unemployment rate continuing to decline to around 6.75 to 7 percent. In light of the still substantial degree of slack in the economy, I would not be concerned by somewhat faster growth than this.

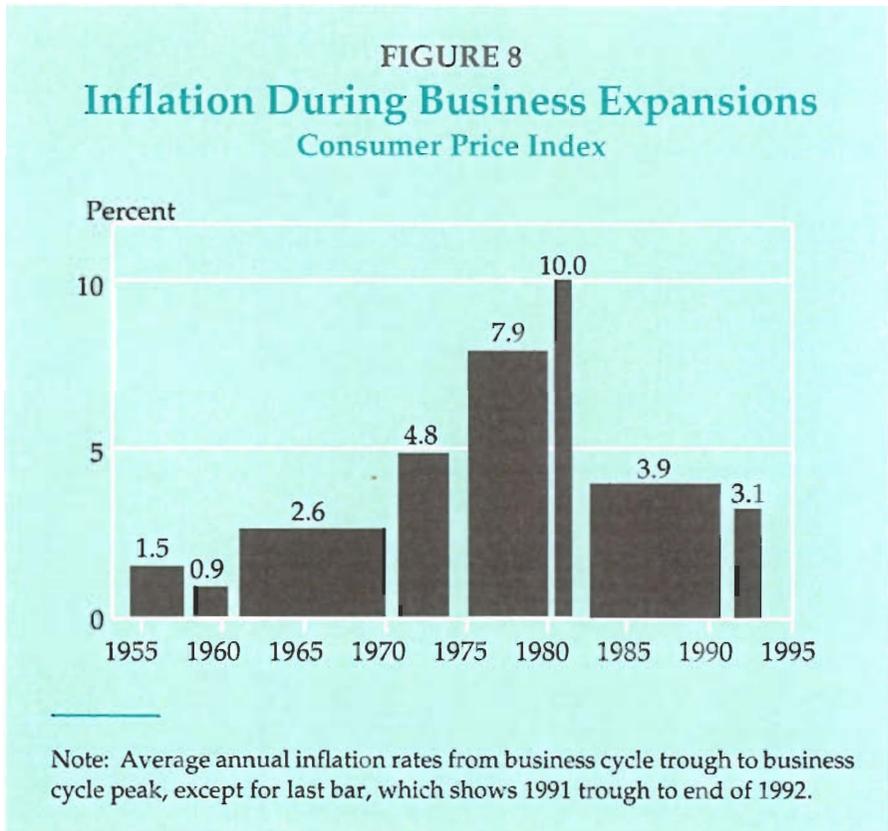
Much of the growth in output during 1992 reflected sharp gains in productivity rather than gains in labor input. This high rate of productivity growth is welcome news in one sense, in that it improves our nation's competitive position in world markets. But these productivity gains over the past two years have meant that employment has not risen very much so far during this recovery. Productivity gains as large as those in 1992 are unlikely to persist in 1993, and consequently I expect that employment growth will be more substantial this year than last.

One factor that will be especially important in contributing to continued, and perhaps even stronger, growth during 1993 is the recent decline in long-term interest rates. By the end of last year, long-term interest rates had already declined substantially from their peak in early 1989. The continued easing of monetary policy in 1990, 1991, and 1992, along with

reduced private sector credit demands as the economy went into recession, contributed to these reductions in long-term interest rates.

The decline in actual inflation and in expectations of future inflation was another very important contributor to the decline in long-term interest rates over the past several years. Unlike the expansions of the 1970s, when the rate of inflation rose in stepwise fashion from one business cycle to the next, average inflation rates have not exhibited a tendency to accelerate during the long expansion of the 1980s and the recovery so far in the 1990s (Figure 8).

Not only did actual inflation remain relatively low in 1991 and 1992, but expectations of long-term inflation fell as market analysts came to believe that the economy would not experience a resurgence of inflationary pressures. Based on a survey of economic forecasters in business and academia, the rate of inflation expected to prevail over the next 10 years fell



nearly a full percentage point from about 4.4 percent in early 1990 to 3.5 percent last month (Figure 9). This reduction in expected inflation undoubtedly has been a major factor in helping to reduce long-term bond and mortgage rates.

But at the current 3.5 percent level, long-term expected inflation is still somewhat above the actual rate of 3 percent CPI inflation experienced over the past two years. I expect inflation will decline below 3 percent in 1993 and 1994, helping to bring expected inflation down further and helping to keep long-term interest rates low.

Proposed changes in fiscal policy also have contributed to low long-term rates. The Administration's long-term deficit reduction proposal has received a generally favorable reaction in financial markets. Evidently, the markets view it as a credible plan to reduce the federal government's future demands for credit.

This has resulted in a significant reduction in long-term interest rates in recent weeks. This reduction should be a big help to the housing market and other interest-sensitive sectors of the economy during 1993. Consequently, I am more optimistic about the future path of economic growth and employment than I was at the beginning of the year.

Nonetheless, the economy continues to face some serious obstacles to growth. A major concern is that employment is not rising commensurately with the rise in economic activity. Further increases in employment would help ensure that an expansion in the economy will be self-sustaining. In addition, several structural impediments to the economy remain with us. The overhang of commercial office space, still high debt burdens of some households and firms, substantial cutbacks in defense spending, and the continued restructuring and lay-

offs of workers by some firms, all will continue to hold back the growth of the economy to some extent in 1993. Keeping long-term interest rates low will continue to be important in helping to ease the debt burdens of firms and households and in offsetting some of these other impediments to economic growth.

The objective of monetary policy is to help maximize sustainable growth in output, jobs, and living standards. Keeping inflation low is a necessary ingredient for maximizing sustainable economic and job growth. Low inflation promotes long-term planning and investment by keeping long-term interest rates low. We now have inflation rates

FIGURE 9
Long-Term Expected Inflation



Source: Expected CPI inflation rate over next 10 years, based on survey of business and academic forecasters. Prior to 1991/Q2, Richard Hoey's Decision-Makers Poll; 1991/Q2-1991/Q3, Livingston Survey; 1991/Q4-1993/Q1, Survey of Professional Forecasters (Federal Reserve Bank of Philadelphia).

back to levels of the 1960s, and these levels will help to keep long-term interest rates low. Reducing the federal budget deficit is another critical ingredient to achieving low long-term interest rates. For that reason, the current focus of fiscal policy on deficit reduction is a welcome

development. In combination, these policies—both fiscal and monetary—will help to support expansion of the economy while also supporting improved living standards and low inflation over the long term.