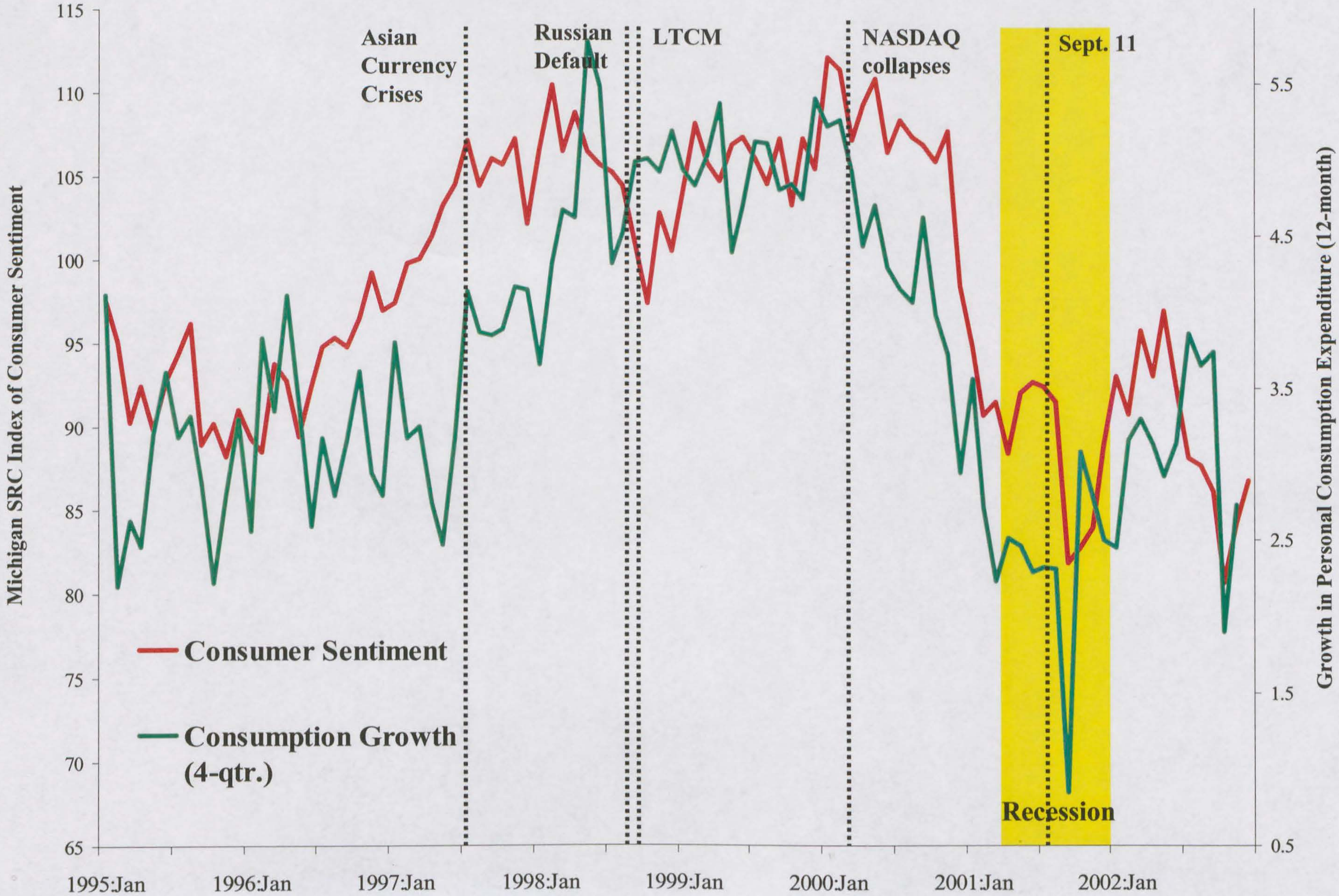
Summary

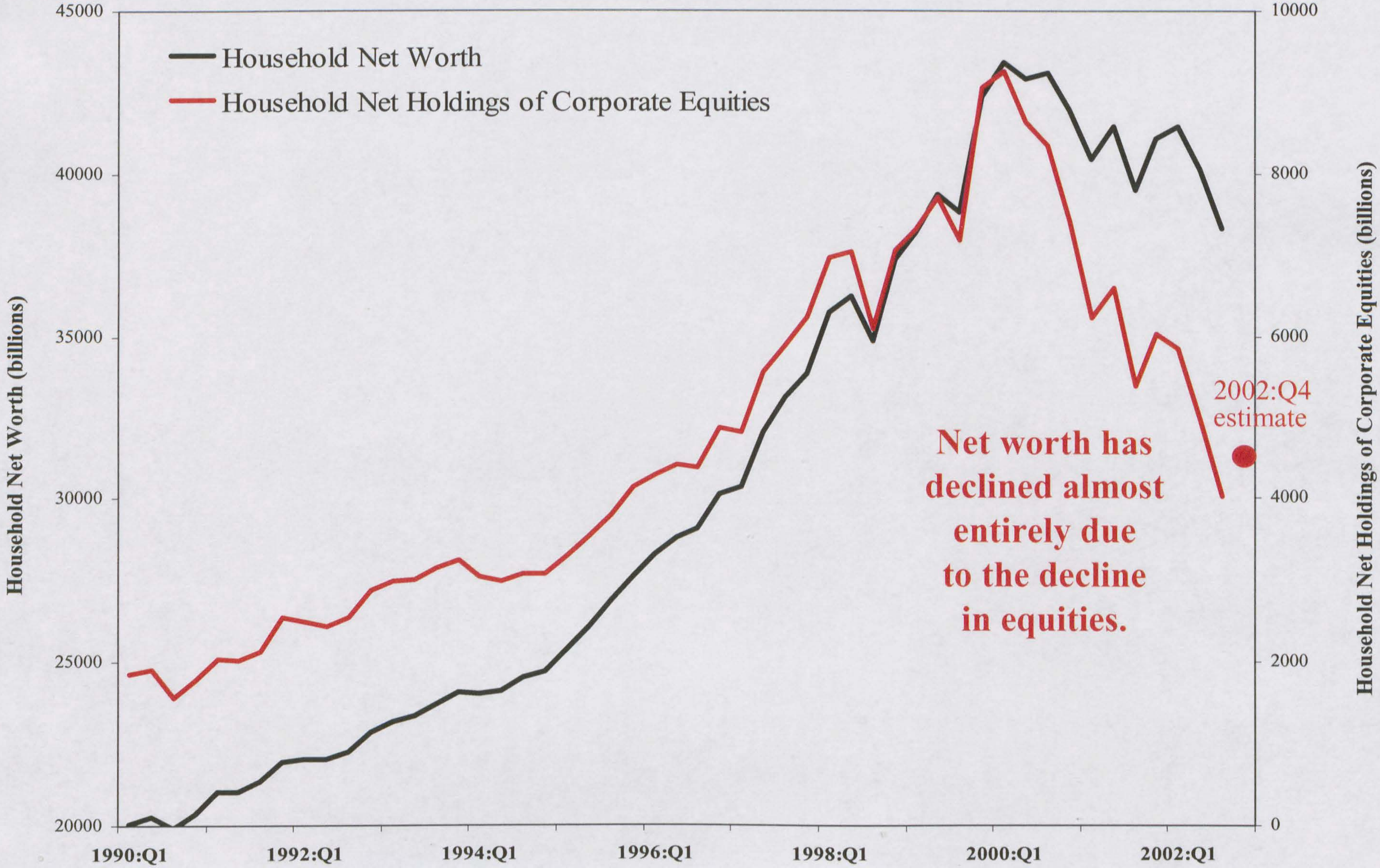
- The economy is going through a soft patch
  - Consumers have held up well, although slowing wealth growth and sluggish labor markets will probably limit spending increases in 2003
  - Business investment is increasing, but at a slow pace
  - State and local fiscal problems will be partly offset by federal fiscal stimulus
- Consumers and businesses are rebuilding wealth and repairing their balance sheets
  - Households' savings are increasing
  - Investment is about in line with cash flow
- Considerable uncertainty remains
  - Policy is stimulative but downside risks are real

Resilience: Consumer sentiment and spending have remained a source of strength through many crises



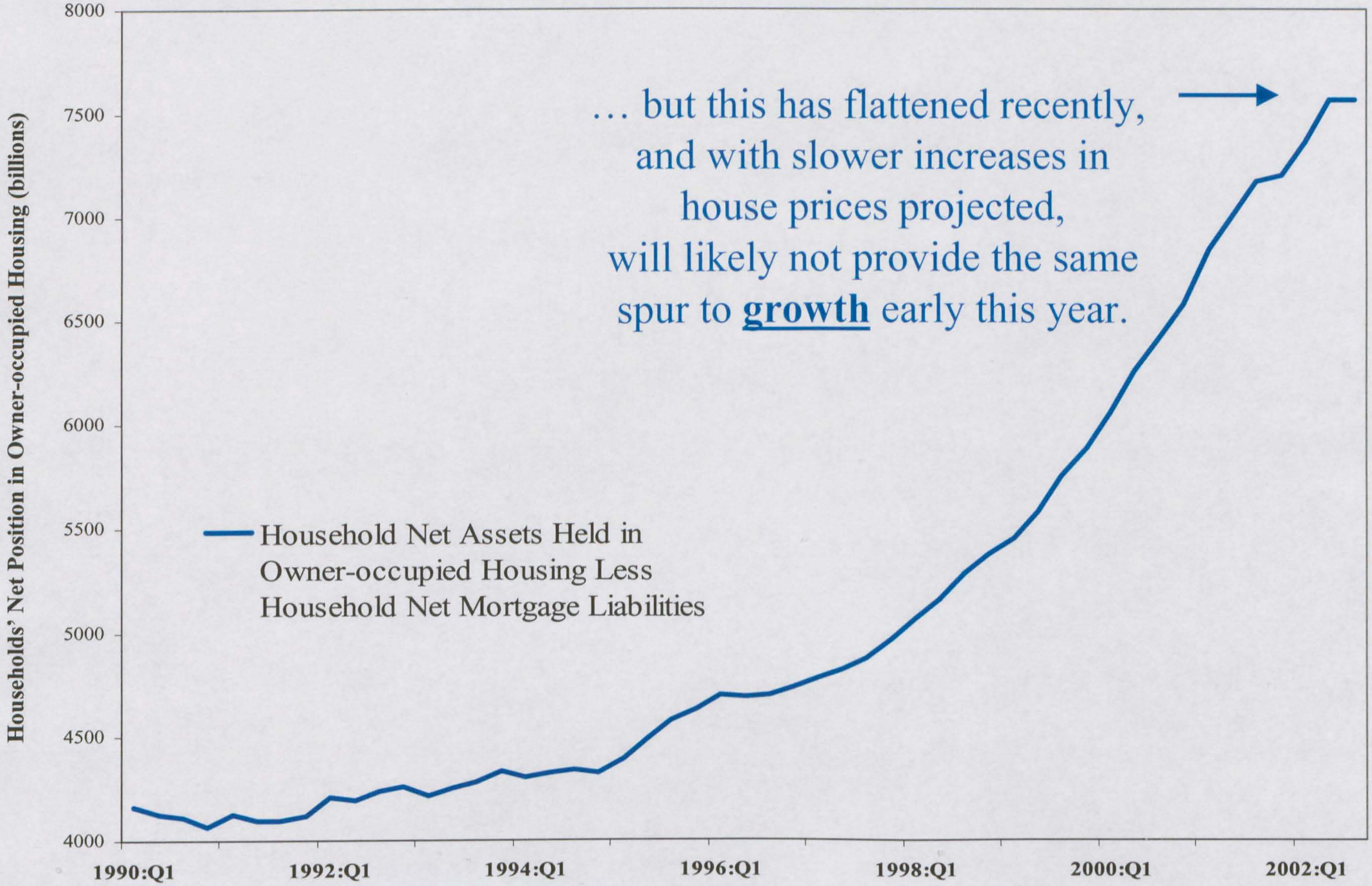
Sources: Consumer Sentiment (NSA, 1966:Q1 = 100): University of Michigan. Personal Consumption Expenditures (SAAR, Chained 1996$): Bureau of Economic Analysis.

Consumers have spent even as household net worth has slid over the past two+ years



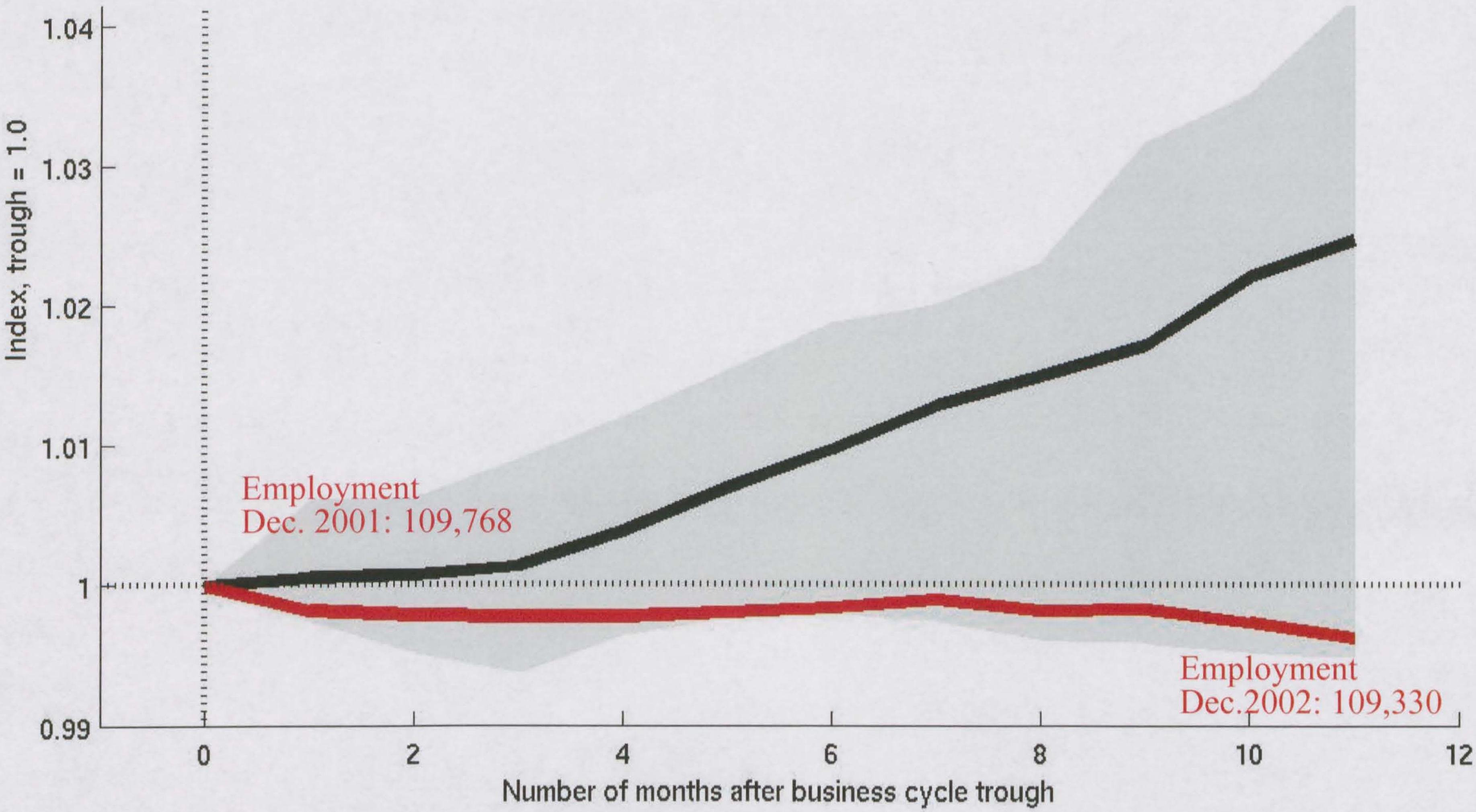
Source: Net Worth of Households and Nonprofit Organizations, Household Net Holdings of Corporate Equities excluding Mutual Fund Shares (Billions $): Federal Reserve Board.

Offsetting the decline in equity prices has been the improvement in households' net position in owner-occupied housing ...



Source: Household Assets, Total Owner-Occupied Real Estate and Household Liabilities, Home Mortgages (Billions $): Federal Reserve Board.

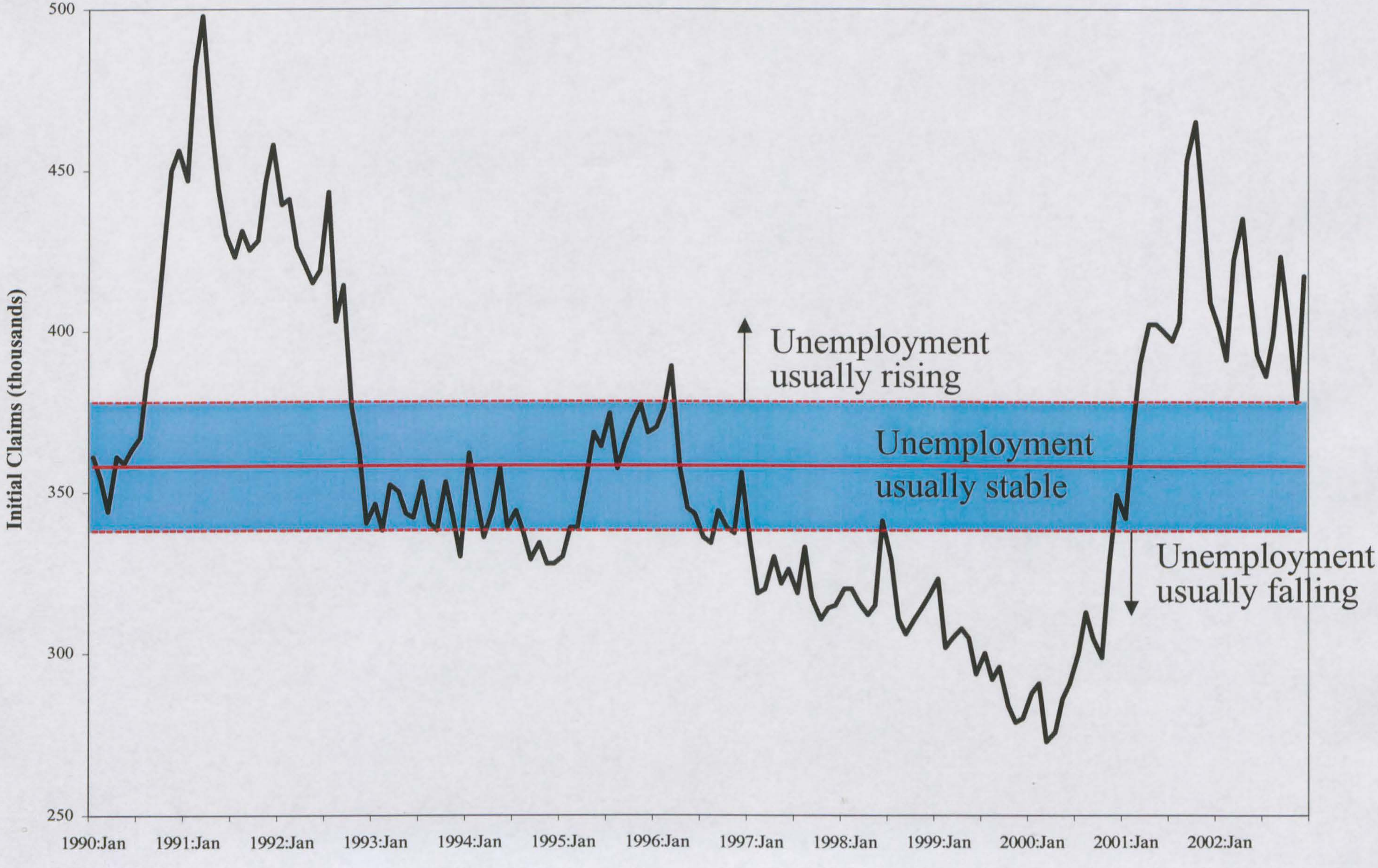
In addition, the employment outlook has yet to brighten ...



Heavy black line represents average of recessions
Heavy red line represents current experience
Shaded area shows range of outcomes across all business cycles

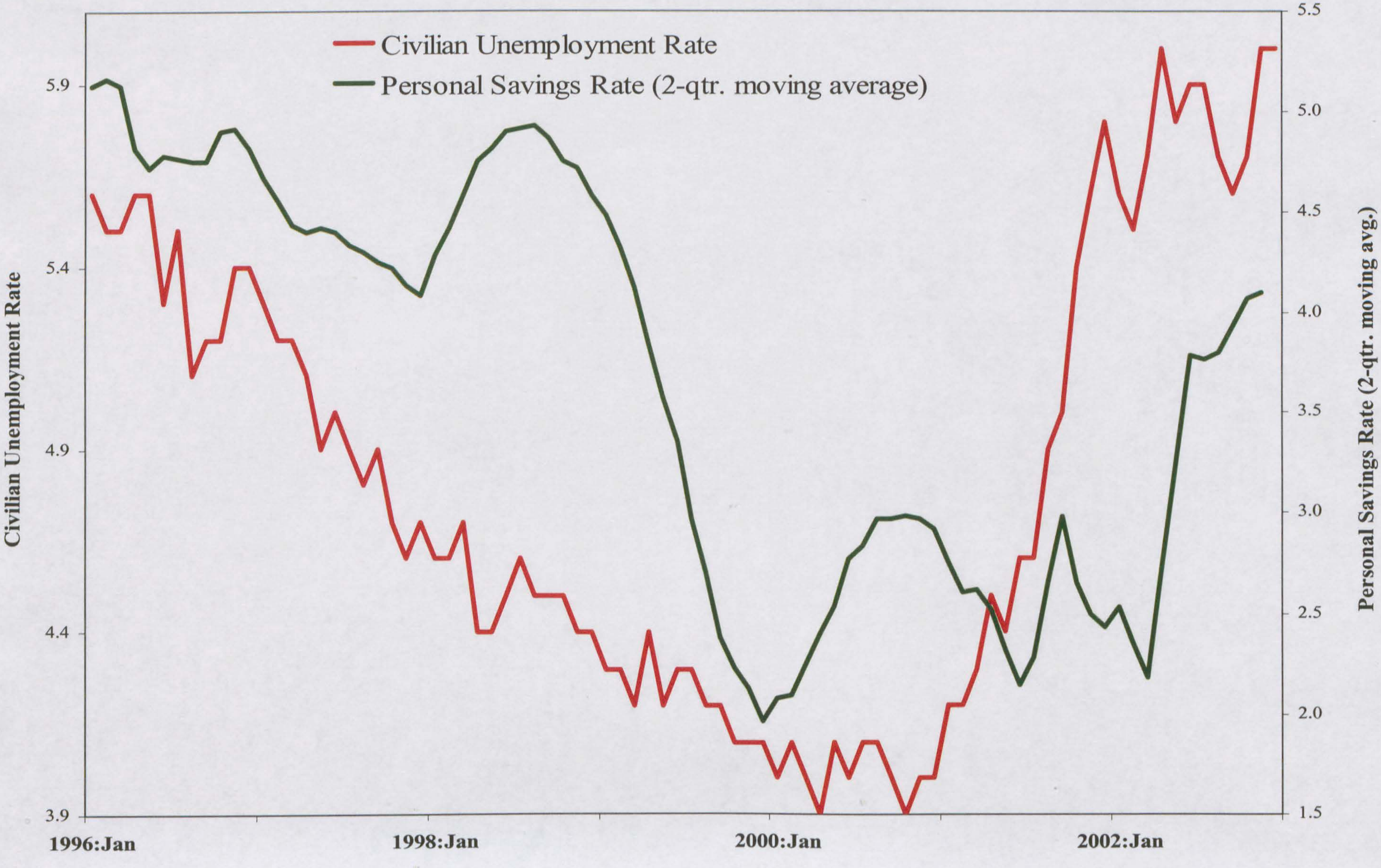
Source: Employment at Private Non-farm Establishments (SA, Thousands): Bureau of Labor Statistics.

And the most recent initial claims data suggest no improvement in the unemployment rate



Source: Initial Claims for Unemployment Insurance, State Programs, Weekly Average (SA, Thousands): Department of Labor.

...With employment uncertain, households are increasing their saving rate



Sources: Civilian Unemployment Rate, 16yr.+ (SA): Bureau of Labor Statistics. Personal Savings Rate (SAAR): Bureau of Economic Analysis.

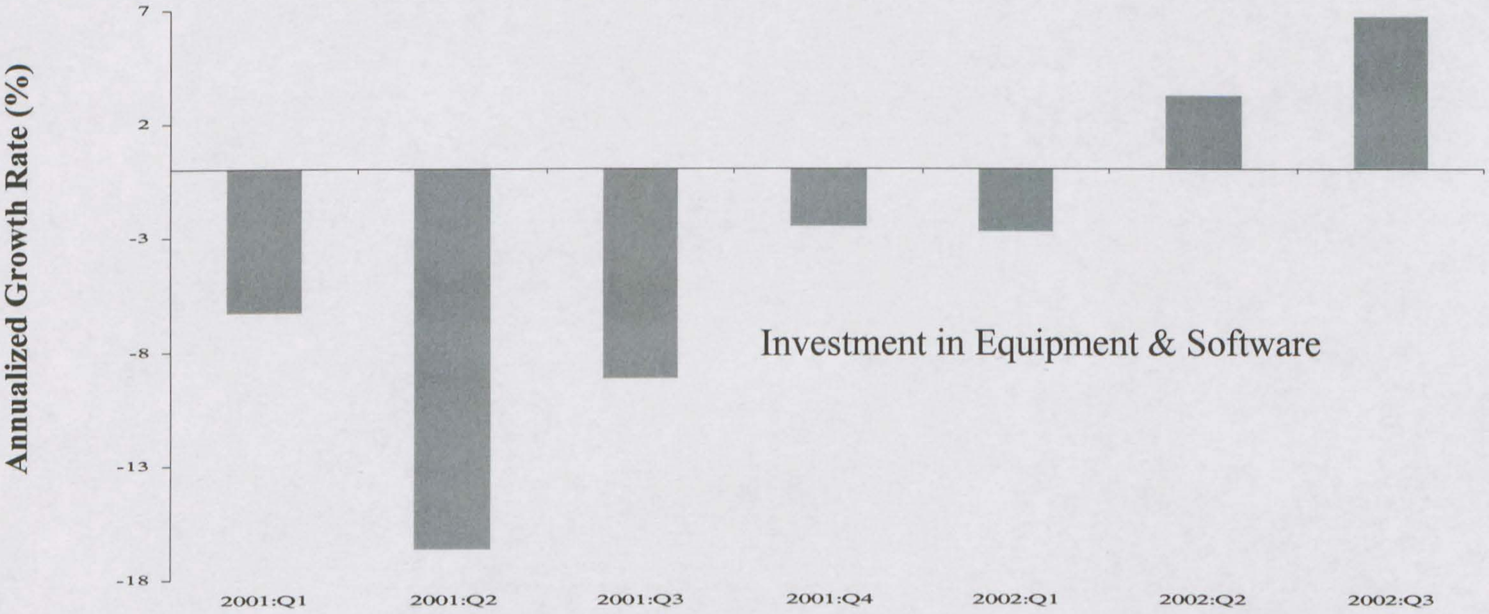
- Which implies that consumption will grow slowly--perhaps 2.5 to 3%--in 2003

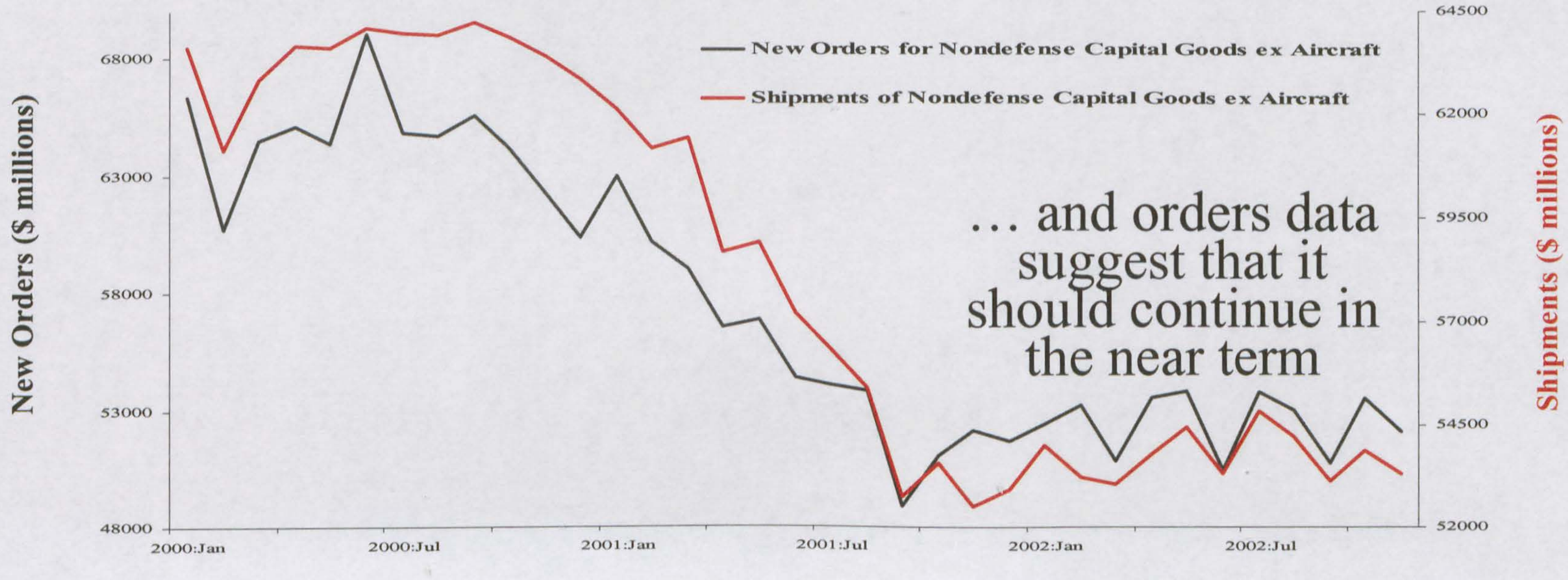
- But investment in equipment and software should exceed that pace

  - Not *fast* growth, but faster than the rest of GDP

  - Investment in equipment and software is projected to rise to 10-plus percent growth late in 2003/2004

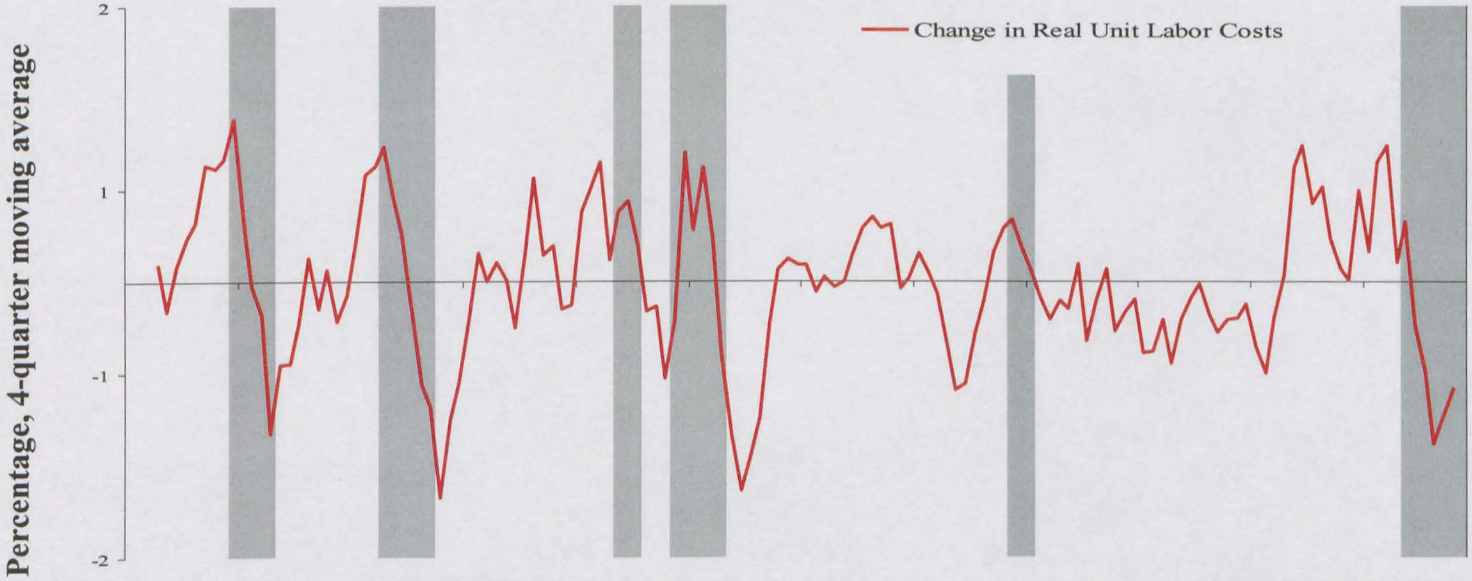
There has been some positive growth in investment lately…



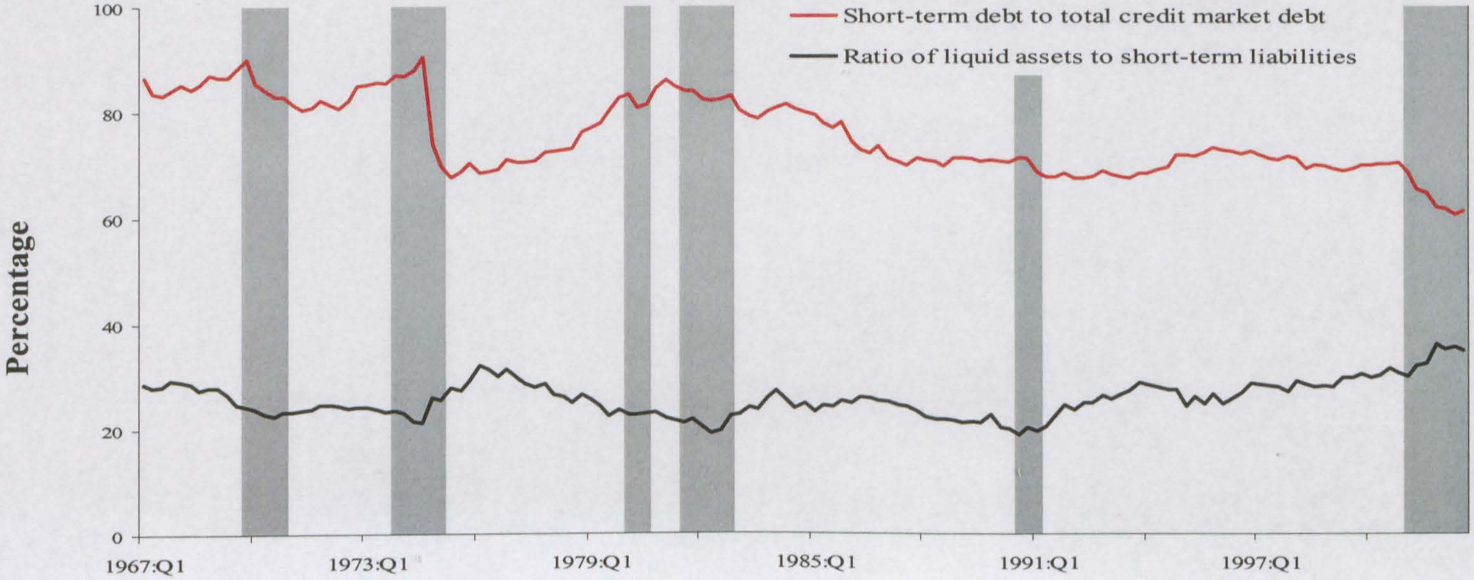


Sources: Gross Private Domestic Investment in Nonresidential Equipment and Software (SAAR,Chained 1996$): Bureau of Economic Analysis. Manufacturers' New Orders and Shipments for Nondefense Capital Goods ex Aircraft (SA, $ Millions): Bureau of the Census.

High productivity is keeping costs low...

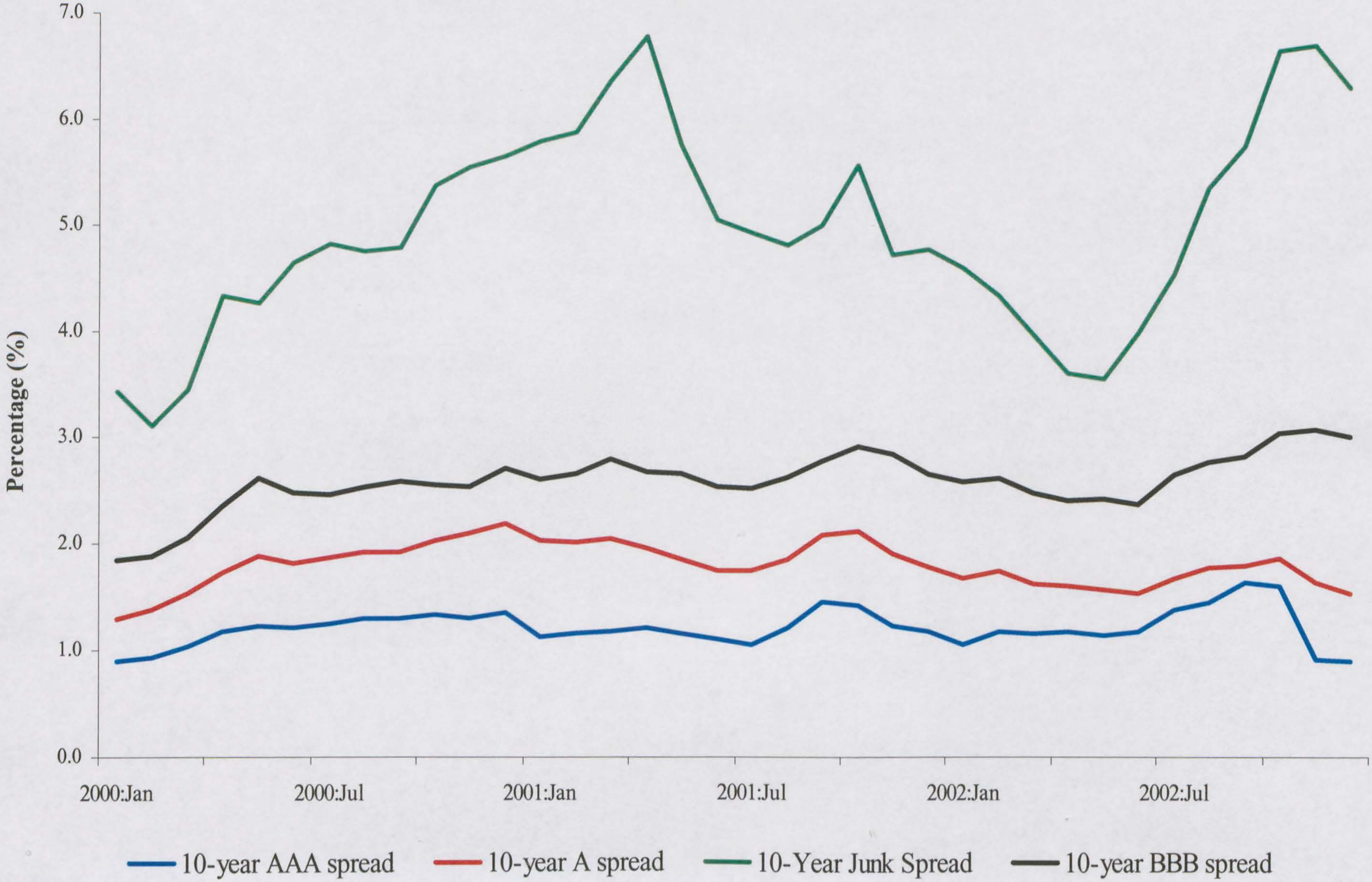


... and helping firms to make progress in rebuilding their balance sheets ...



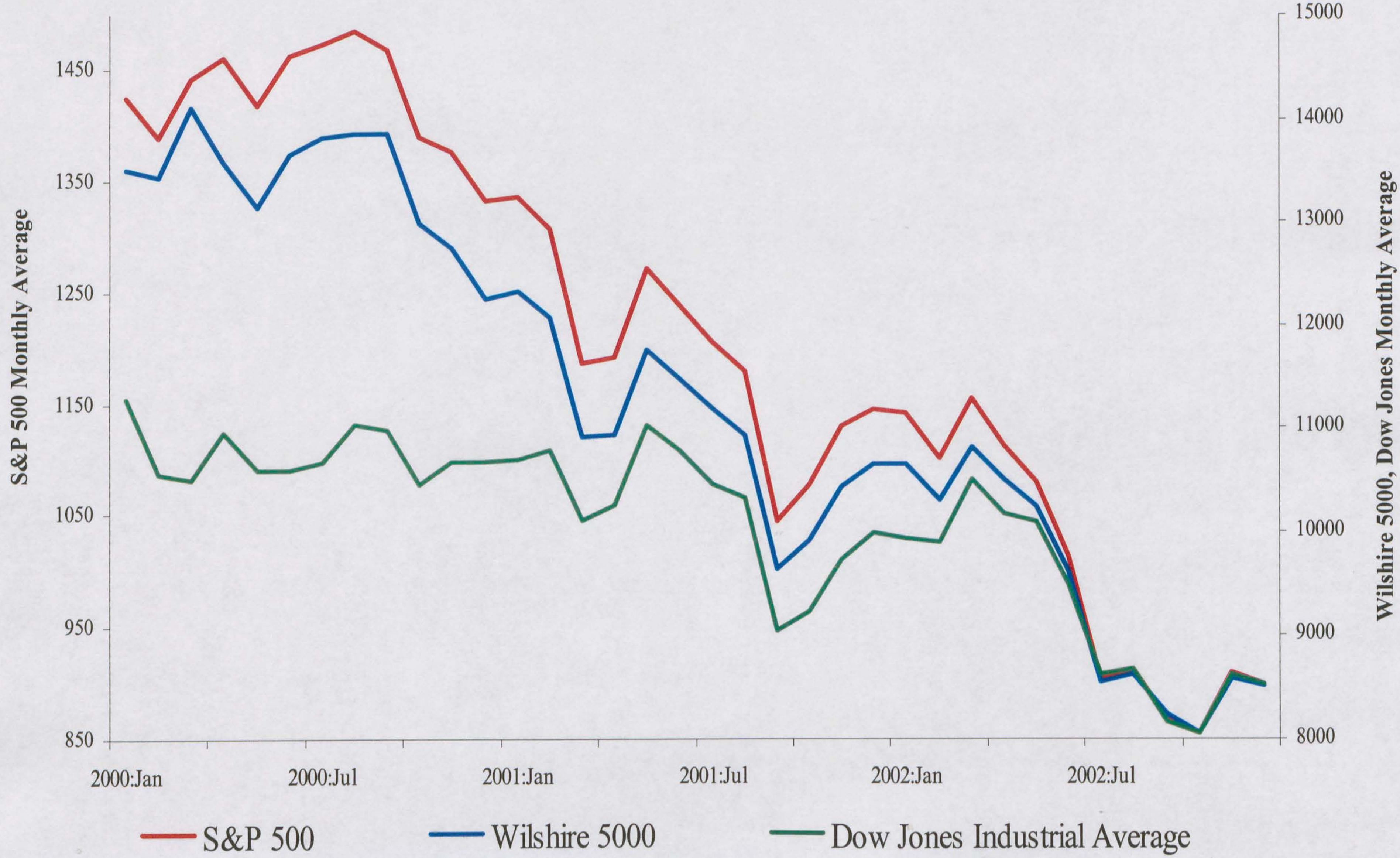
Source: Nonfinancial Corporate Business, Flow of Funds: Federal Reserve Board and Bureau of Labor Statistics.

Yield spreads are improving somewhat ...



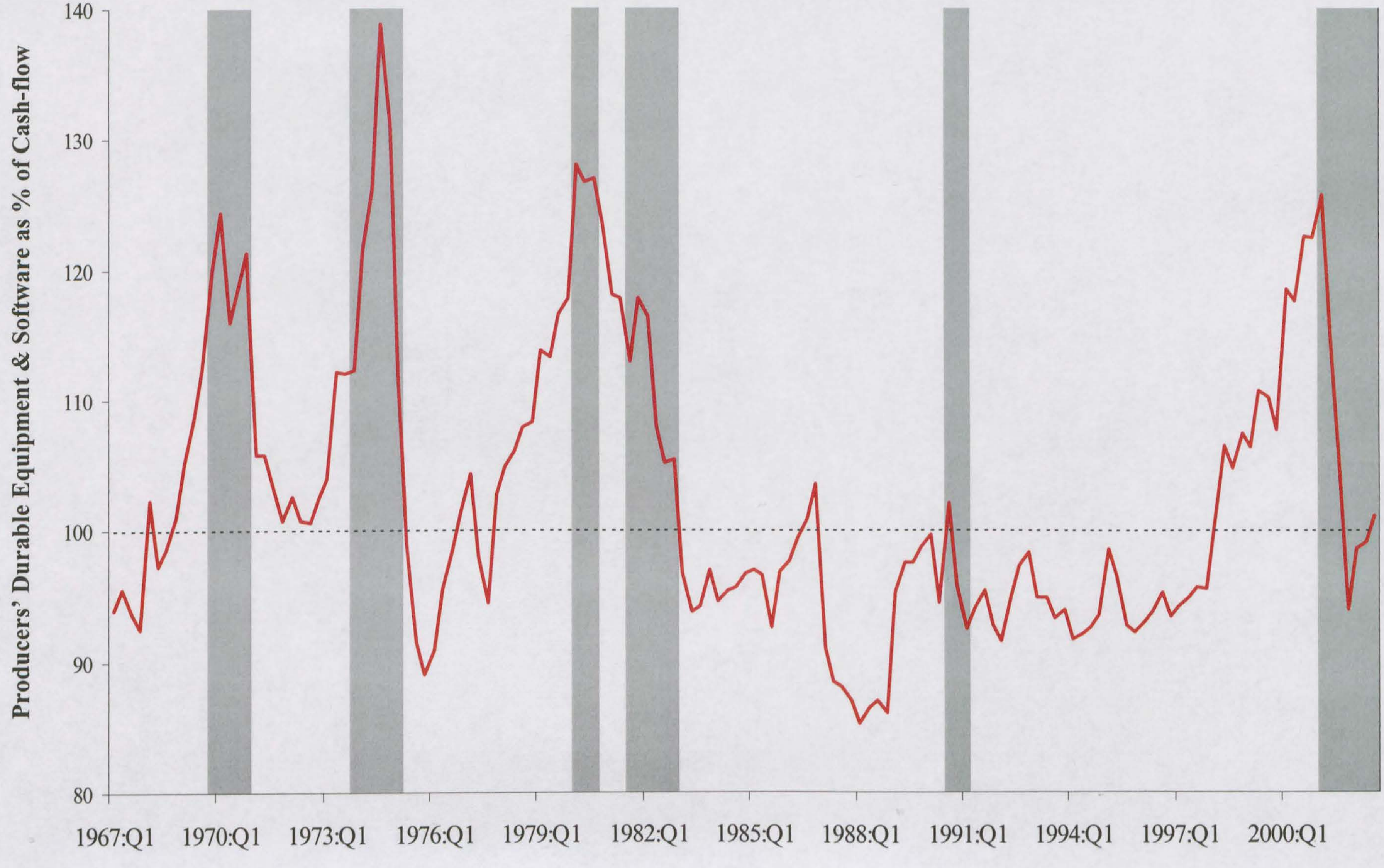
Sources: 10-year Treasury Bond Yield at Constant Maturity: U.S. Treasury. 10-year Industrial Corporate Bond Yields: S&P Global Fixed Income Research.

And equity markets have stabilized recently...



Source: S&P 500 Composite Index, Wilshire 5000 Stock Index, Dow Jones Industrial Average (Monthly Average): Wall Street Journal.

A stronger rebound in investment is in the making, but not yet entirely in place



Source: Nonfinancial Corporate Business, Flow of Funds: Federal Reserve Board.

Policy stimulus: A key source of strength

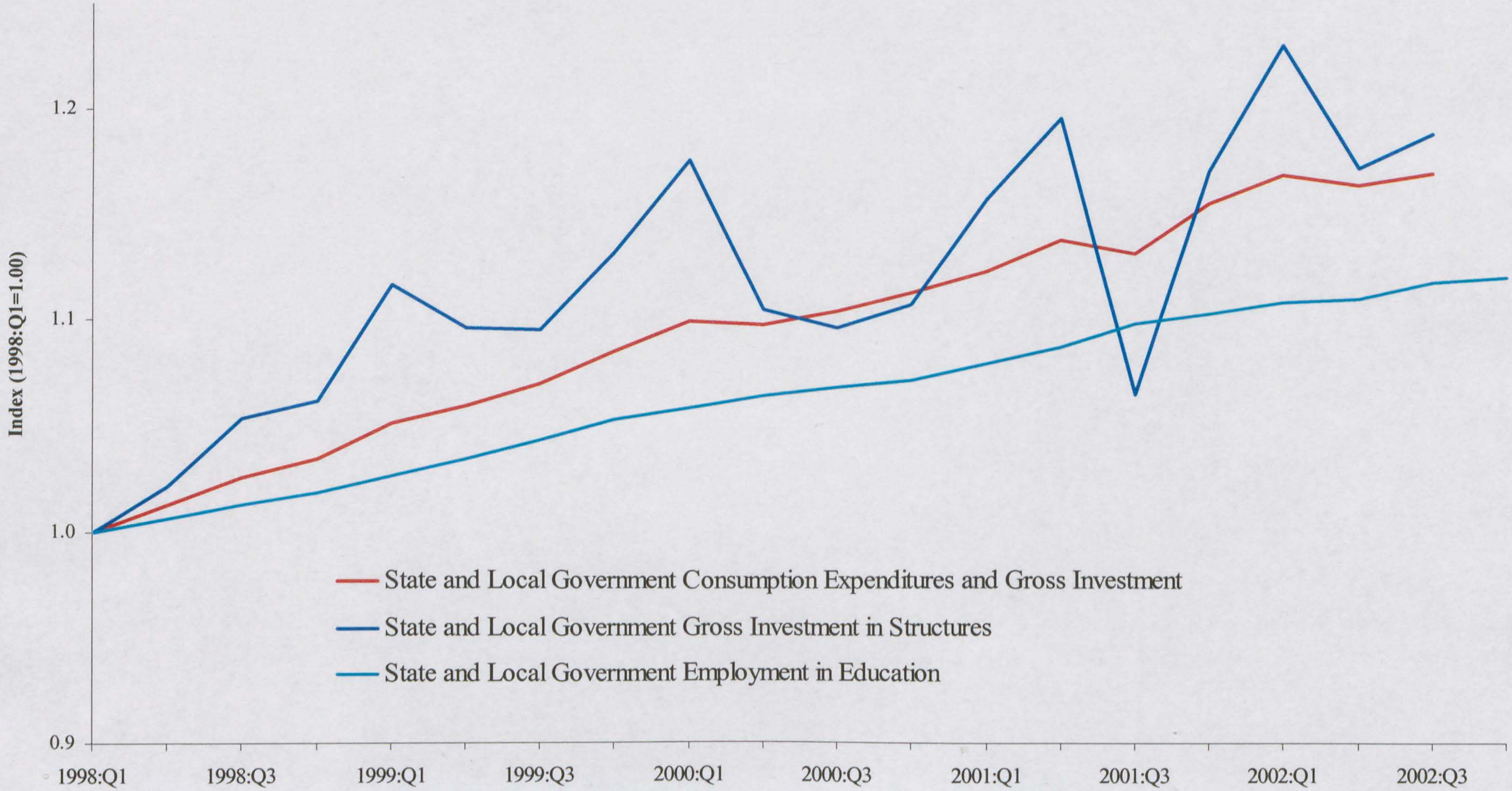
- Monetary Policy
  - 12 reductions in interest rates since early 2001
  - Latest 50 basis points in November 2002
  - Rates at lowest point in 60 years
  - Less headwind from financial markets

Policy stimulus: A key source of strength

- Fiscal Policy: The Administration's fiscal stimulus package
  - Move 2004, 2006 tax rate cuts forward; increase tax credit for children; lower "marriage penalty"
  - Eliminate double-taxation of dividend income
  - Extend emergency unemployment insurance benefits
  - Provide direct aid to states (in Democratic proposal)
  - Tax rebates (Democratic proposal)
- Don't know yet what will be passed, or how stimulative different provisions will be

Some Federal stimulus is needed to offset weakness at the State and Local level

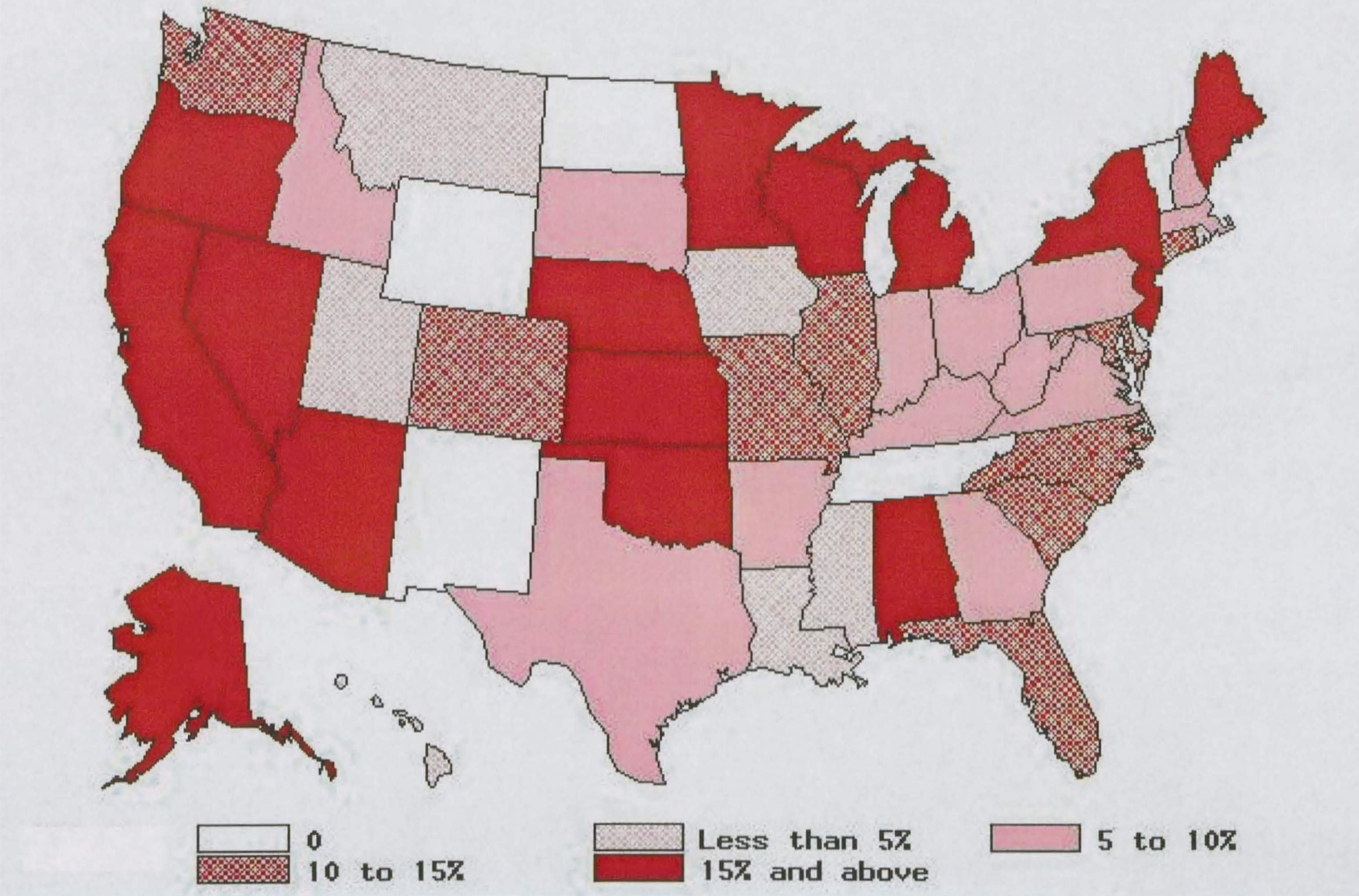
Spending has held up, buoyed by construction spending and education employment



Sources: Bureau of Economic Analysis and Bureau of Labor Statistics.

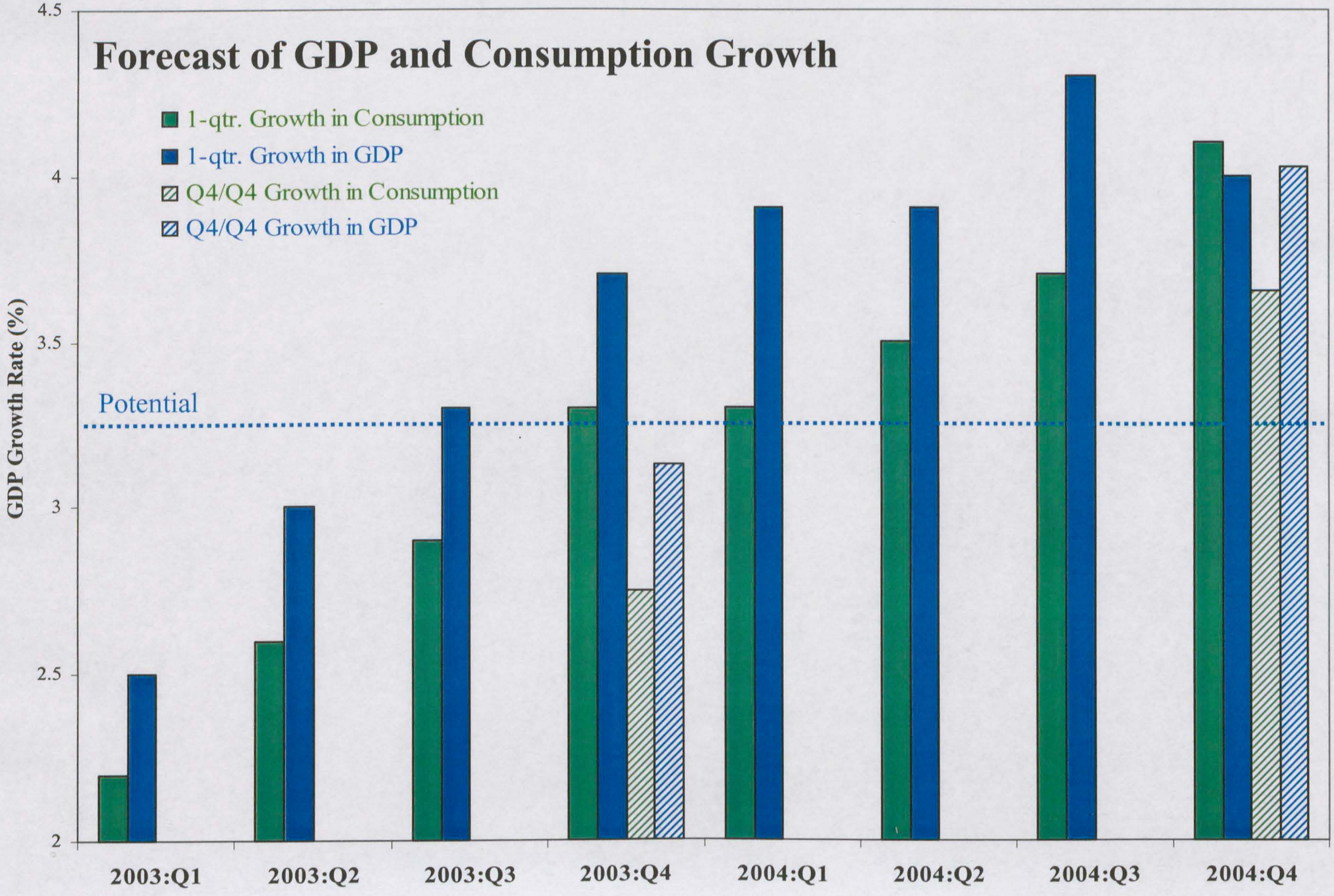
But deficits for fiscal year 2004 still loom, and will likely constrain State and Local spending

Projected FY 2004 Budget Gaps as a Percent of General Fund Expenditures



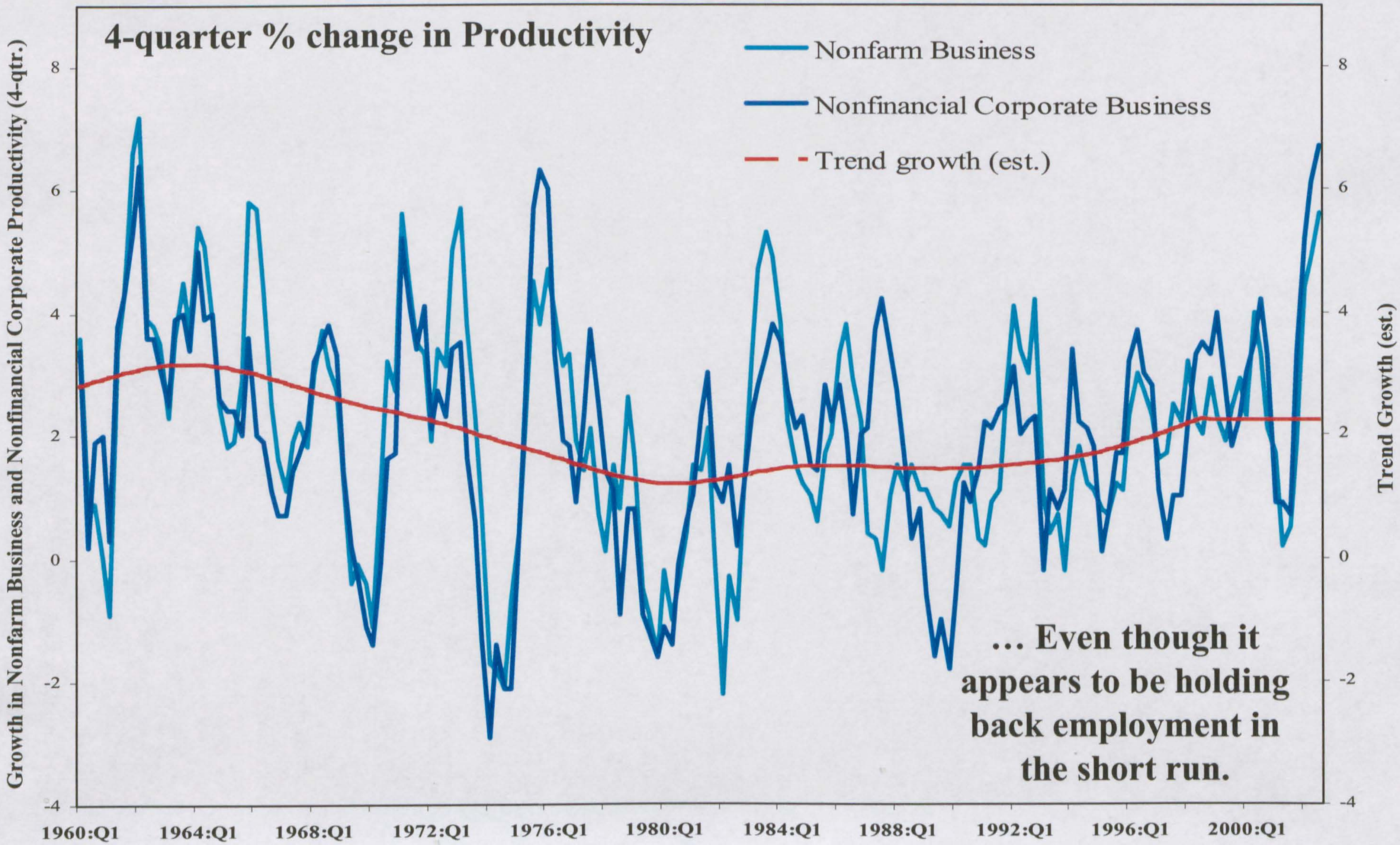
Sources: Projections of public officials, National Conference of State Legislatures, and Center on Budget and Policy Priorities.

All of which implies a forecast of modest growth in 2003-2004, with consumption growth lagging a bit behind GDP



Source: Forecasts based upon Federal Reserve Bank of Boston staff estimates.

The longer-run prospects are good: Looking forward, strong trend productivity growth will support real incomes for consumers and investment payoffs for firms...



Source: Nonfarm Business Sector and Nonfinancial Corporations: Output per Hour of All Persons (SA): Bureau of Labor Statistics.

Summary and Outlook

- With the ongoing balance-sheet restructuring, the short-term outlook calls for modest spending increases in both the household and business sectors.
  - Consumption growing slower than GDP for the reasons discussed, savings rate rising a bit
  - Investment faster than consumption, but still relatively modest
    - Considerable reliance on this component, and considerable uncertainty about its contours
  - Some excess capacity remains at least through 2003 (thus, inflation not a problem)

- Considerable uncertainty remains
  - But more symmetric than earlier

- The foundations are being laid for a meaningful upturn in the second half of next year.