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Presentation to

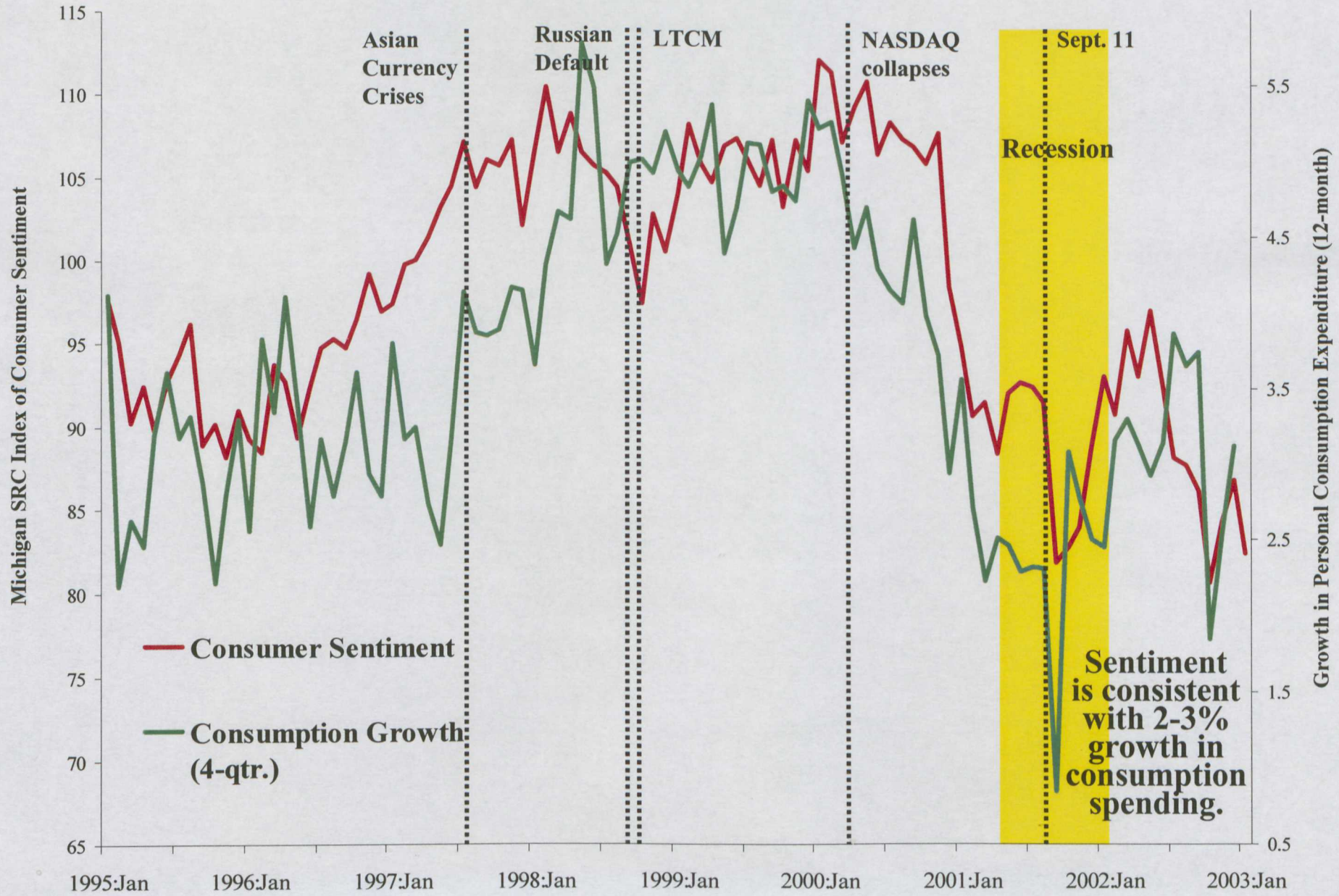
Vanderbilt University
Monetary and Fiscal Policy Seminar

February 12, 2003

Summary

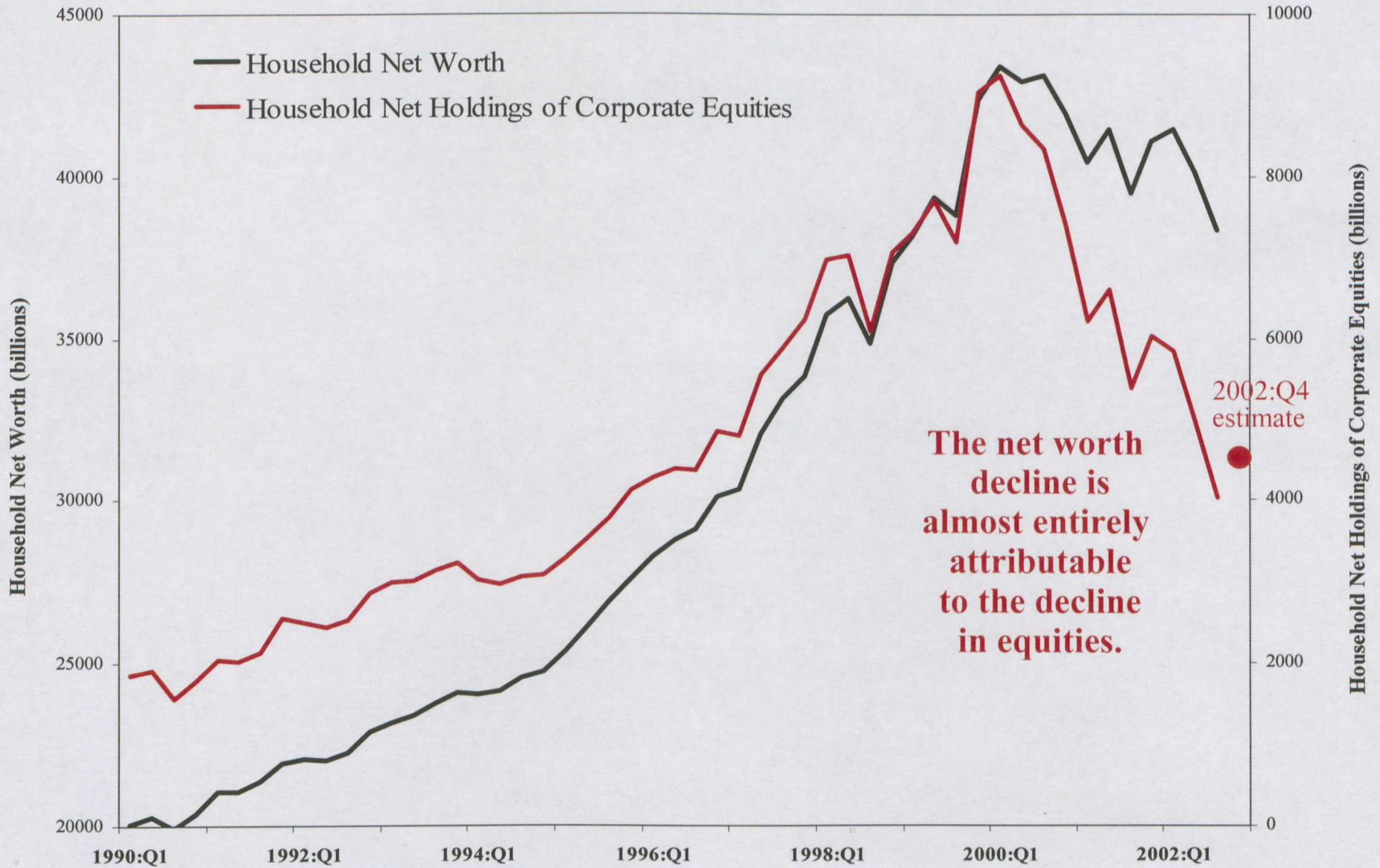
- The recovery continues, but slowly
 - Consumers have held up;
 - Business investment is increasing, but slowly;
 - Federal stimulus may be partly offset by state and local fiscal problems.
- Considerable uncertainty remains

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



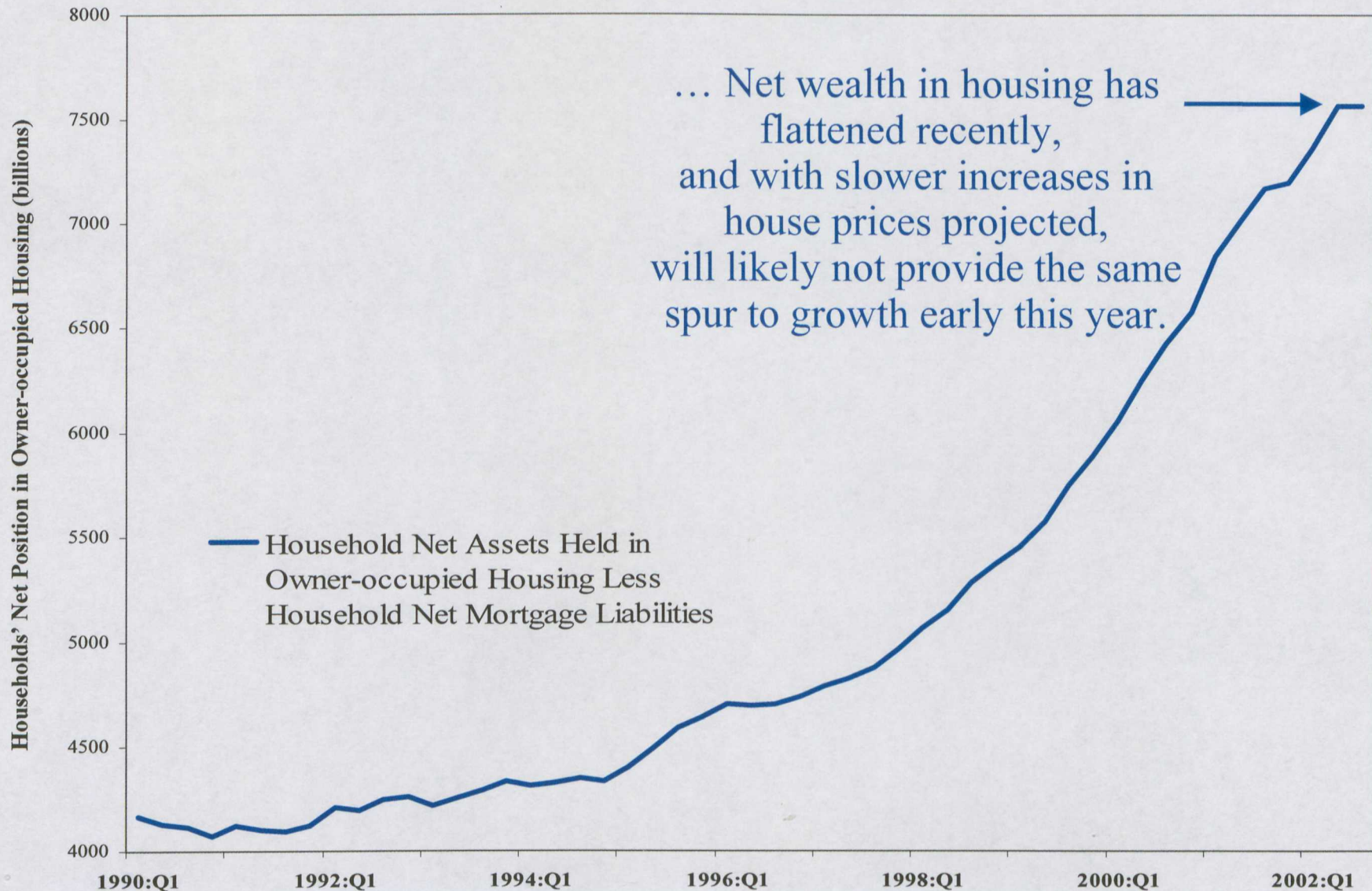
Sources: Consumer Sentiment (NSA, 1966:Q1 = 100): University of Michigan. Personal Consumption Expenditures (SAAR, Chained 1996\$): Bureau of Economic Analysis.

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



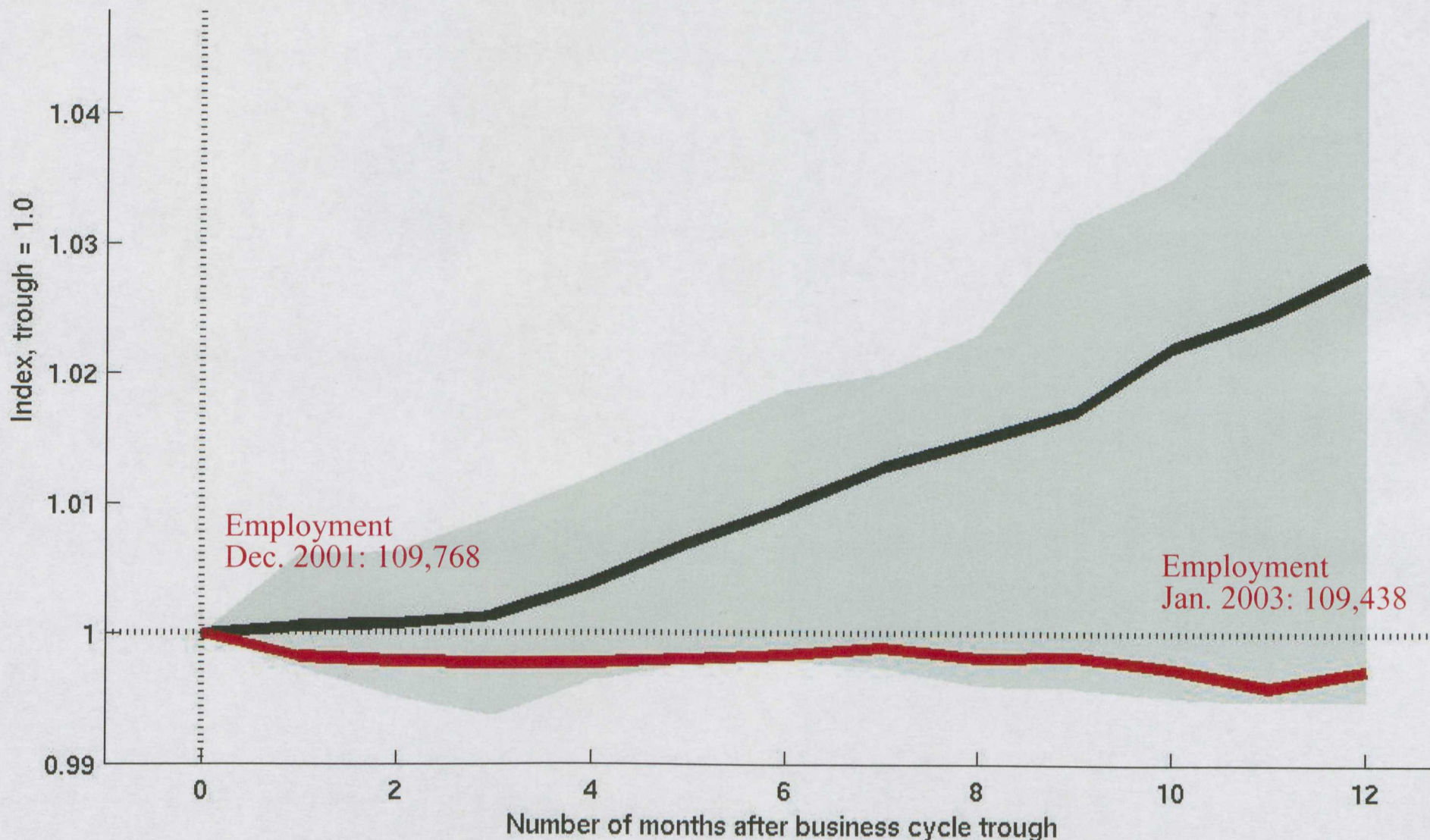
Source: Net Worth of Households and Nonprofit Organizations, Household Net Holdings of Corporate Equities excluding Mutual Fund Shares (Billions \$): Federal Reserve Board.

Spending has been supported by rising equity in housing, but this effect may be diminishing ...



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

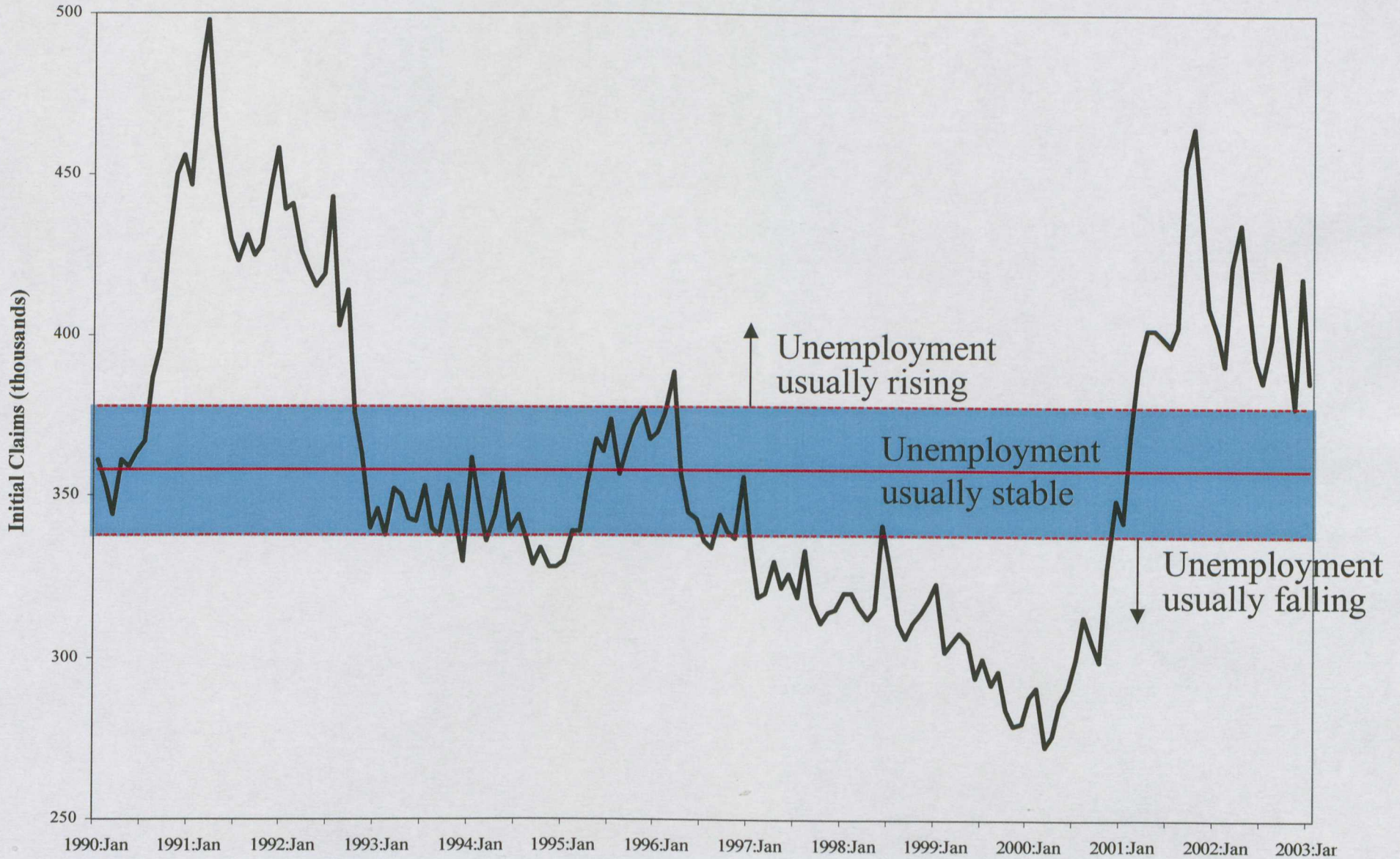
In addition, the employment outlook has yet to brighten ...



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

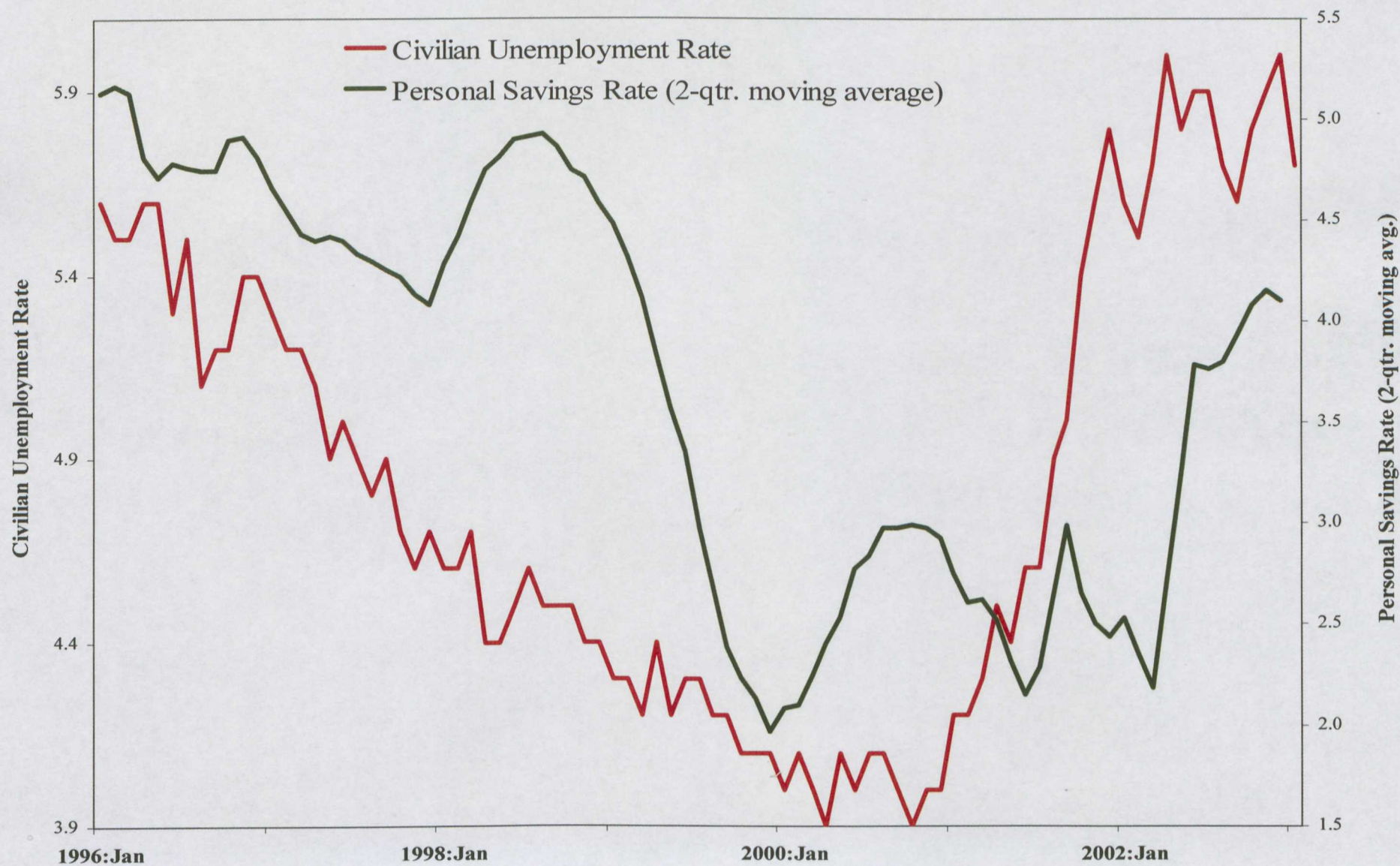
Source: Employment at Private Non-farm Establishments (SA, Thousands): Bureau of Labor Statistics.

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



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

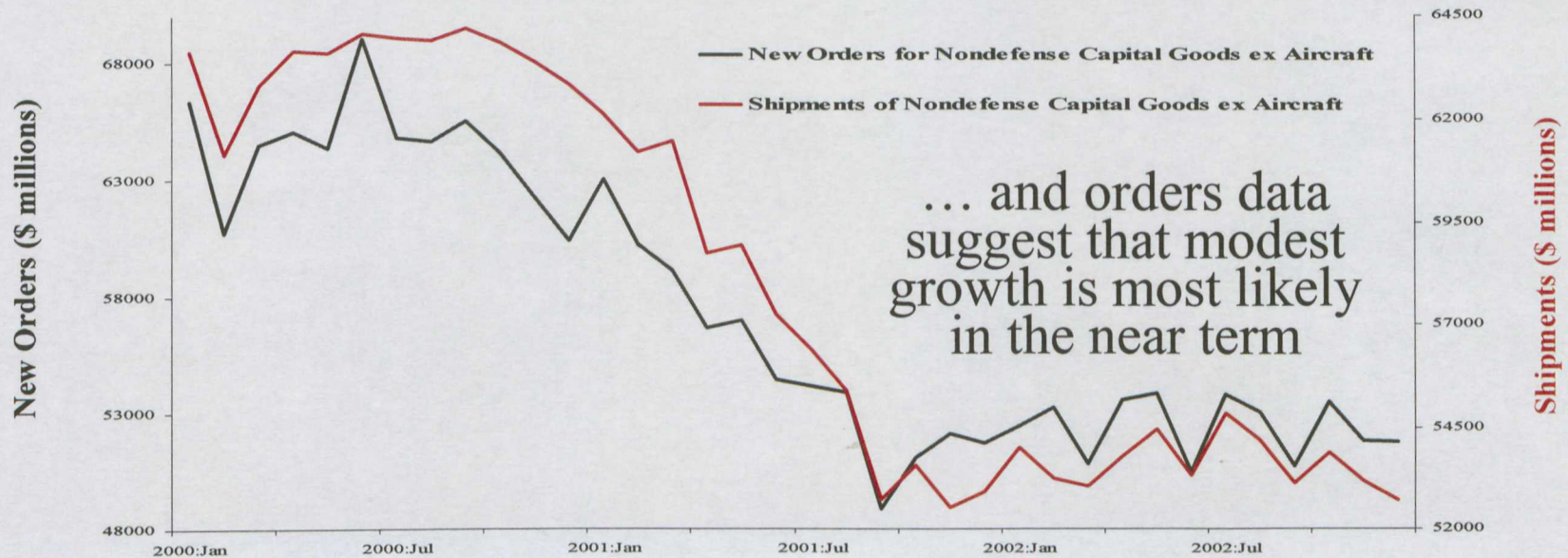
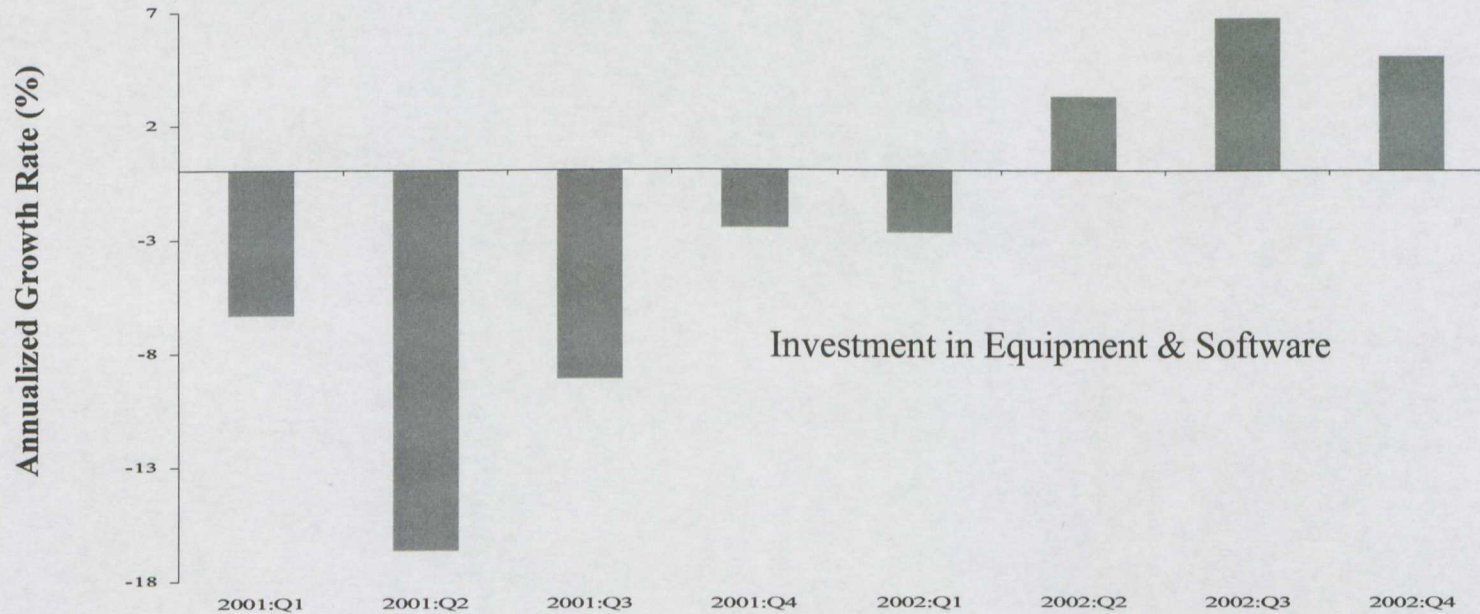
...With employment uncertain, households are increasing their saving rate



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

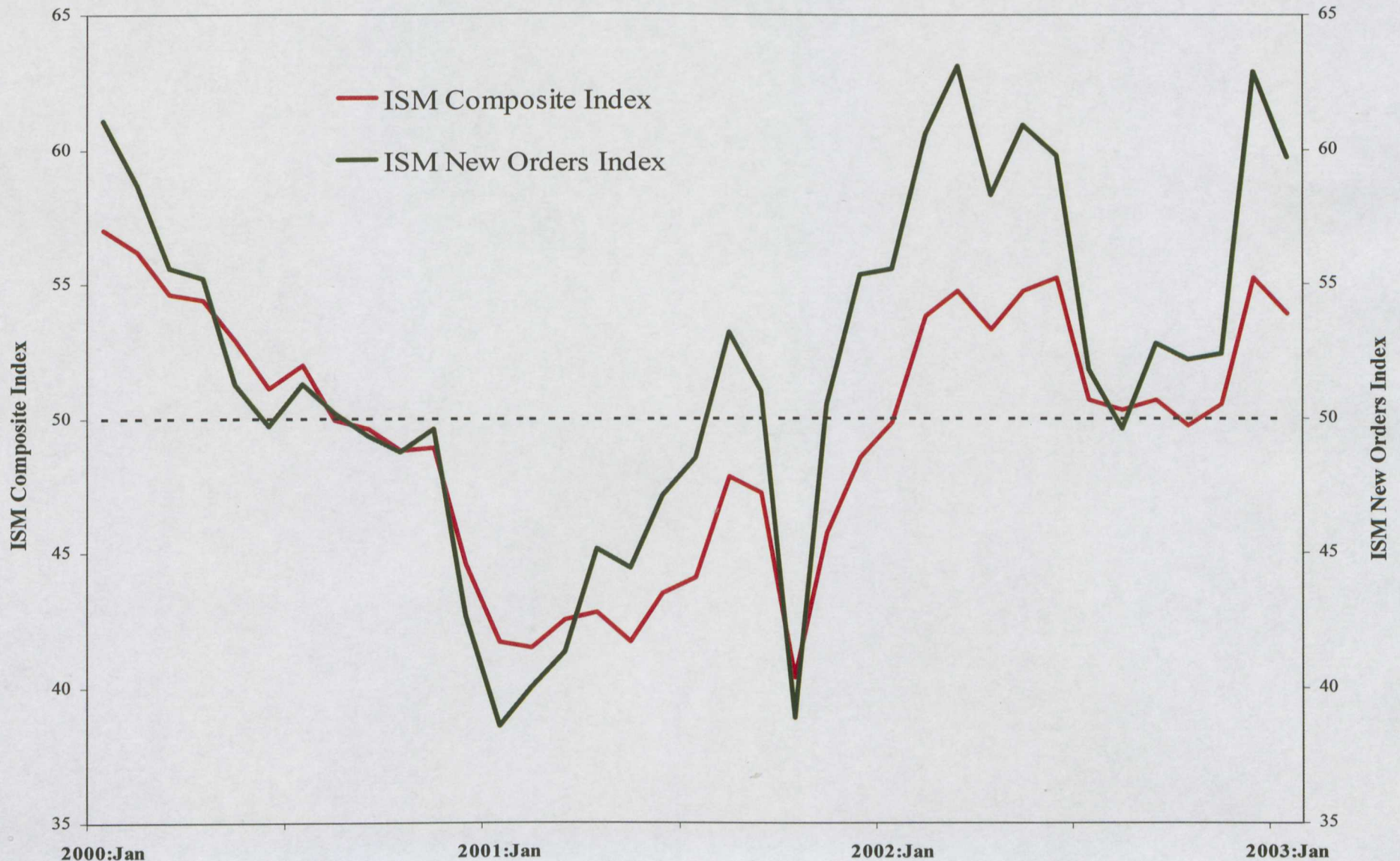
- Consumption growth at 2-3% won't do the job alone (would leave unused capacity).
- Many forecast that investment in equipment and software will grow faster than that
 - Why do they say that?
 - Capital spending has grown about 5% over the past three quarters, an improvement over the recession;
 - Orders growth is consistent with continued growth;
 - Firms have made improvements in efficiency, balance sheets;
 - Overall financial environment has improved somewhat
 - But there remains considerably uncertainty about that outlook
 - Is it “geopolitical” uncertainty that holds back investment and employment?
 - Or is it uncertainty about the robustness of the recovery and prospects for strong sales?

We have seen modest 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.

ISM manufacturing indicators for overall activity and new orders also show some improvement.

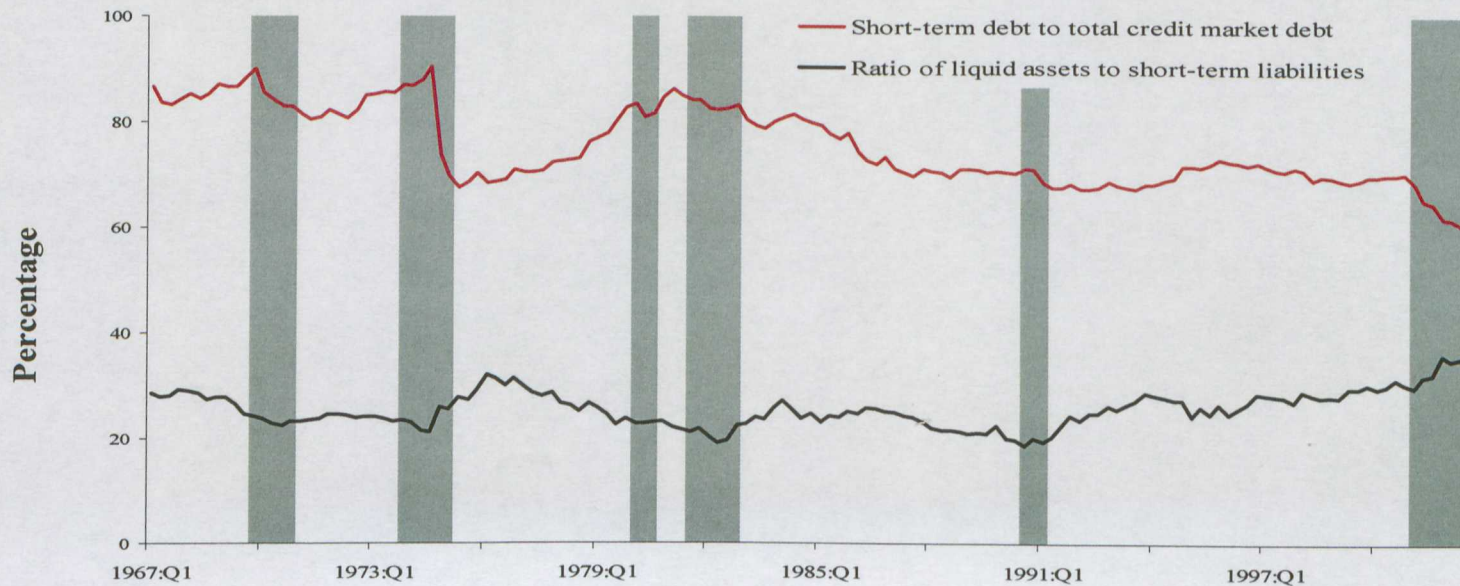


Source: ISM Manufacturing, PMI Composite Index and New Orders Index, 50+ = economic expansion (SA): Institute for Supply Management.

Firms are taking steps to improve efficiency and rebuild balance sheets, as evidenced by productivity growth ...

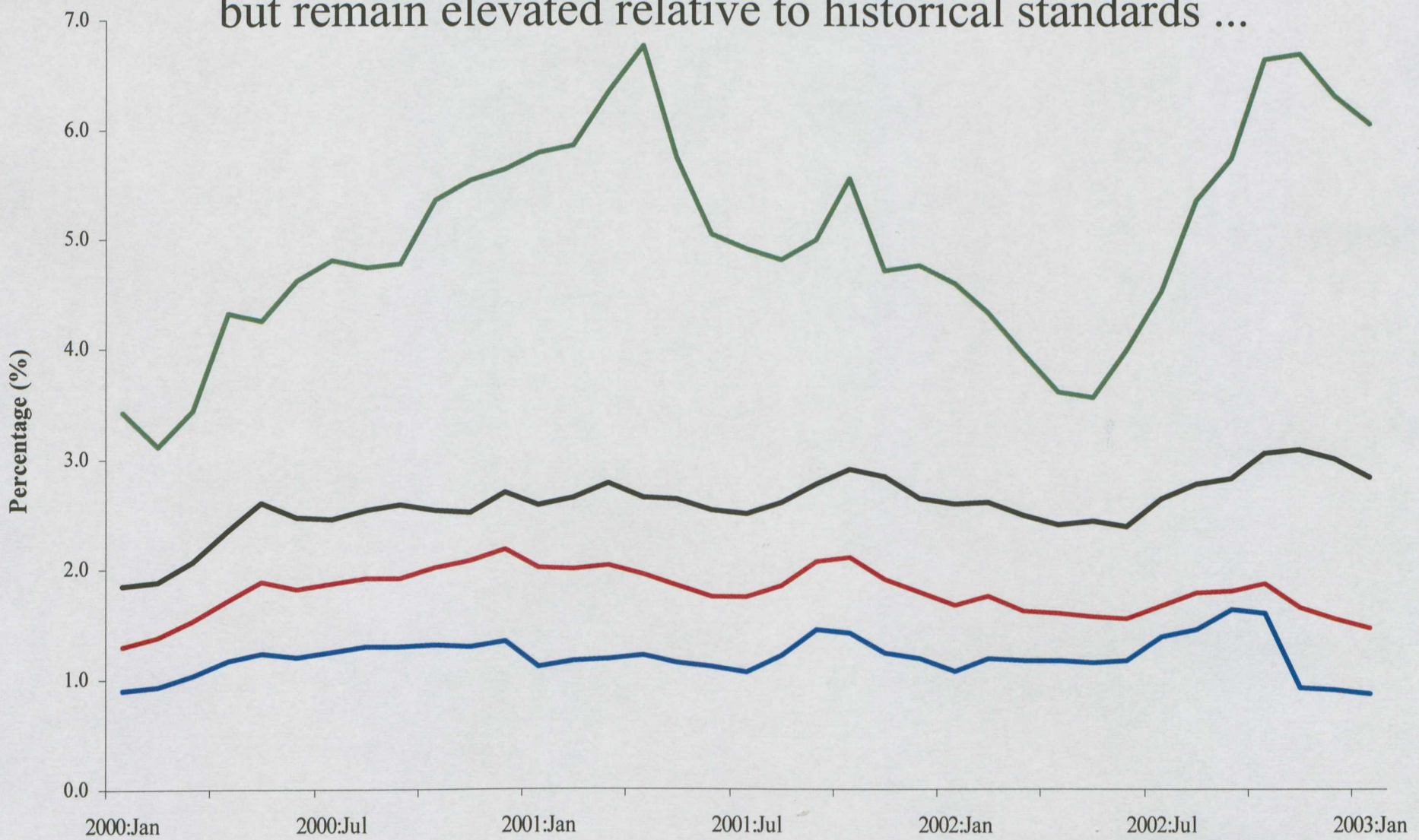


... and key balance sheet ratios.



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

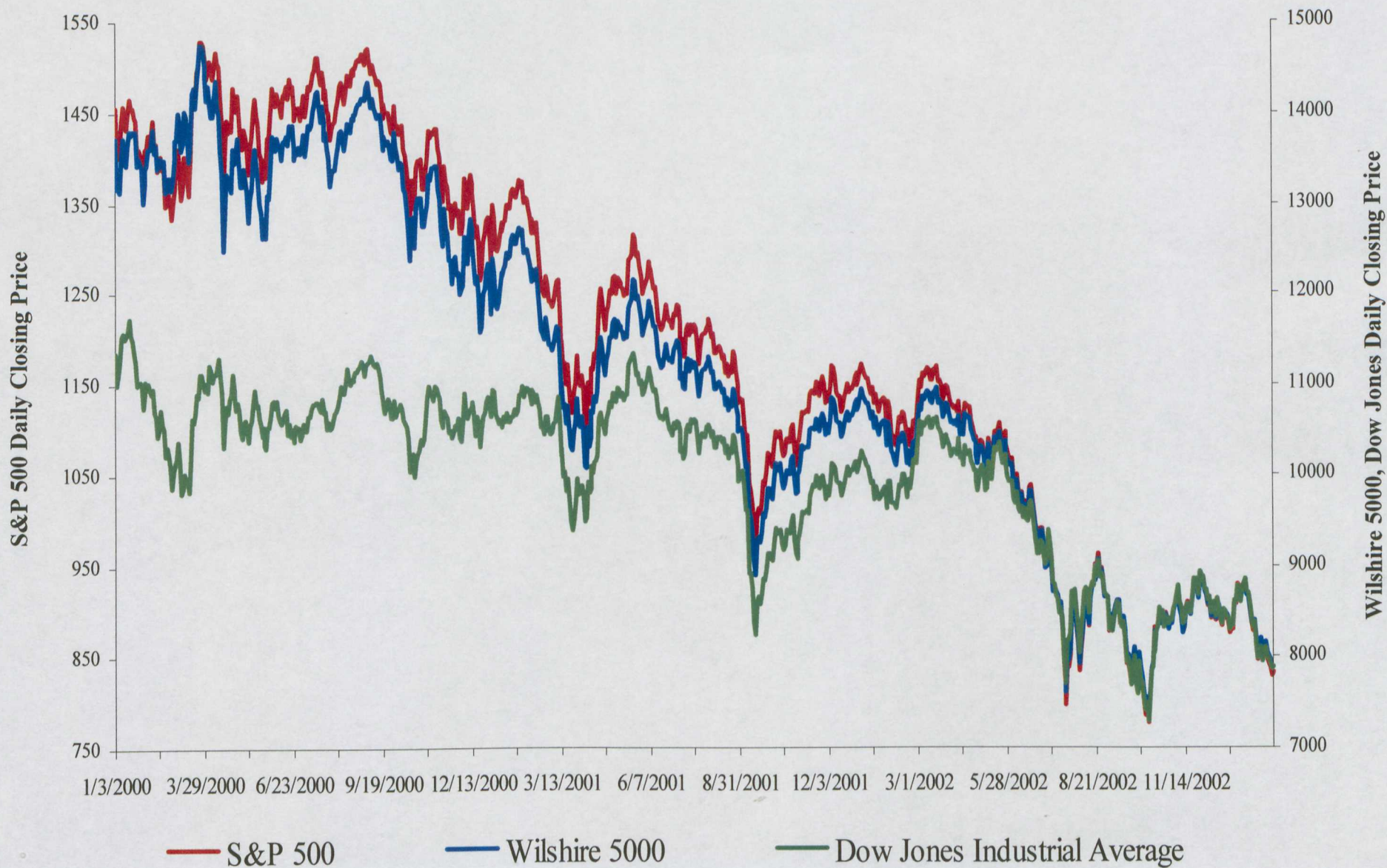
But considerable uncertainty remains:
Yield spreads have improved somewhat,
but remain elevated relative to historical standards ...



— 10-year AAA spread — 10-year A spread — 10-Year Junk Spread — 10-year BBB spread

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 remain shaky.



Source: S&P 500 Composite Index, Wilshire 5000 Stock Index, Dow Jones Industrial Average (Daily Closing Price): Bloomberg.

Policy stimulus: A key source of strength

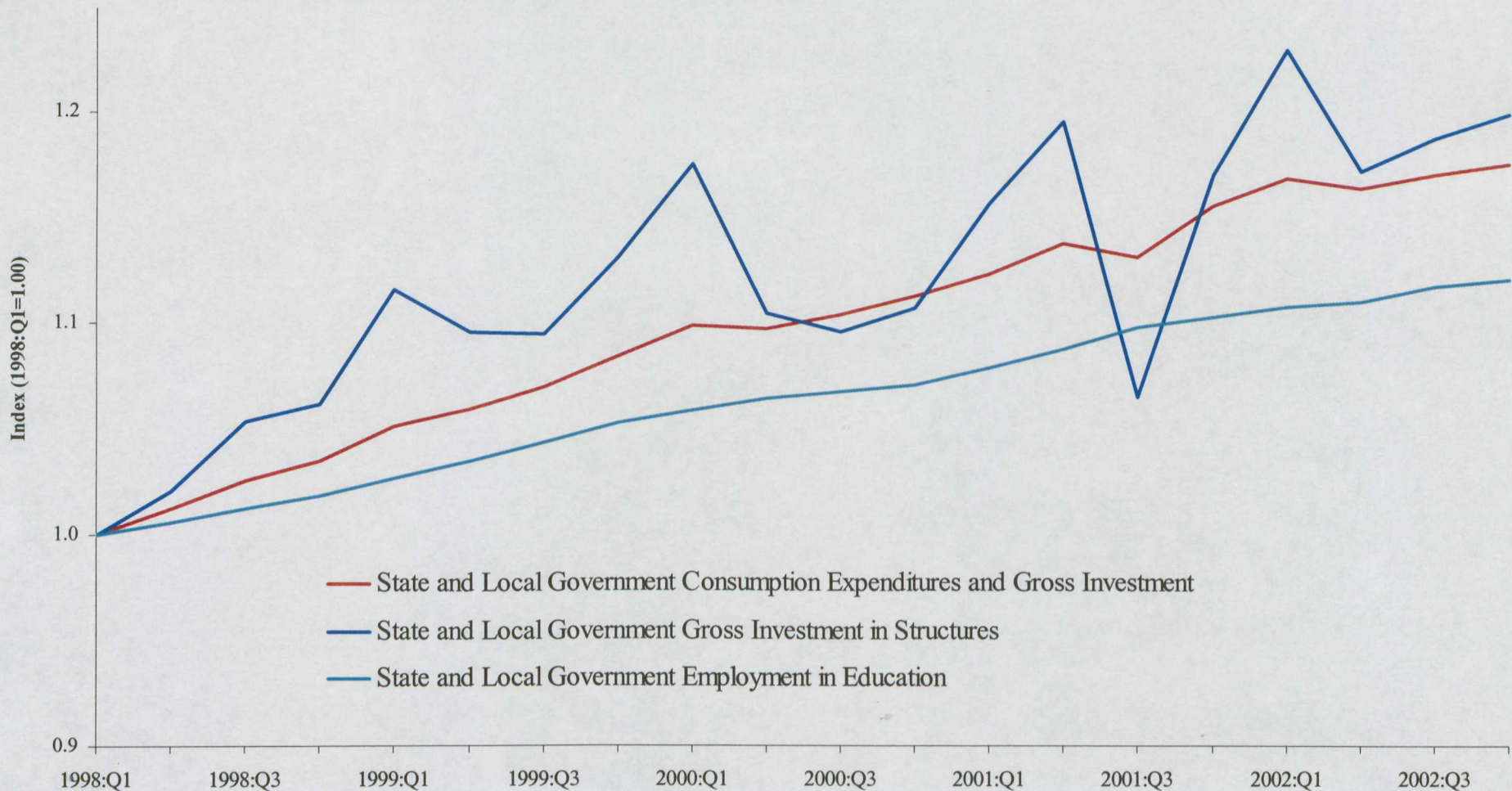
- Monetary Policy

- 12 reductions in interest rates since early 2001
- Latest 50 basis points in November 2002
- Rates at lowest point in 60 years
- Has supported growth in housing and consumer durables
- And helped to reduce headwinds from financial markets

- **Fiscal Policy:** could be a source of strength, but considerable uncertainty remains.
- **Proposed fiscal stimulus packages:**
 - 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 the combination of federal and state and local policies will be

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

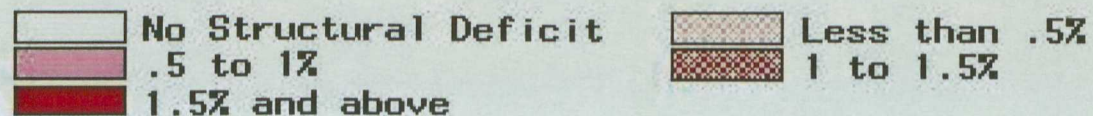
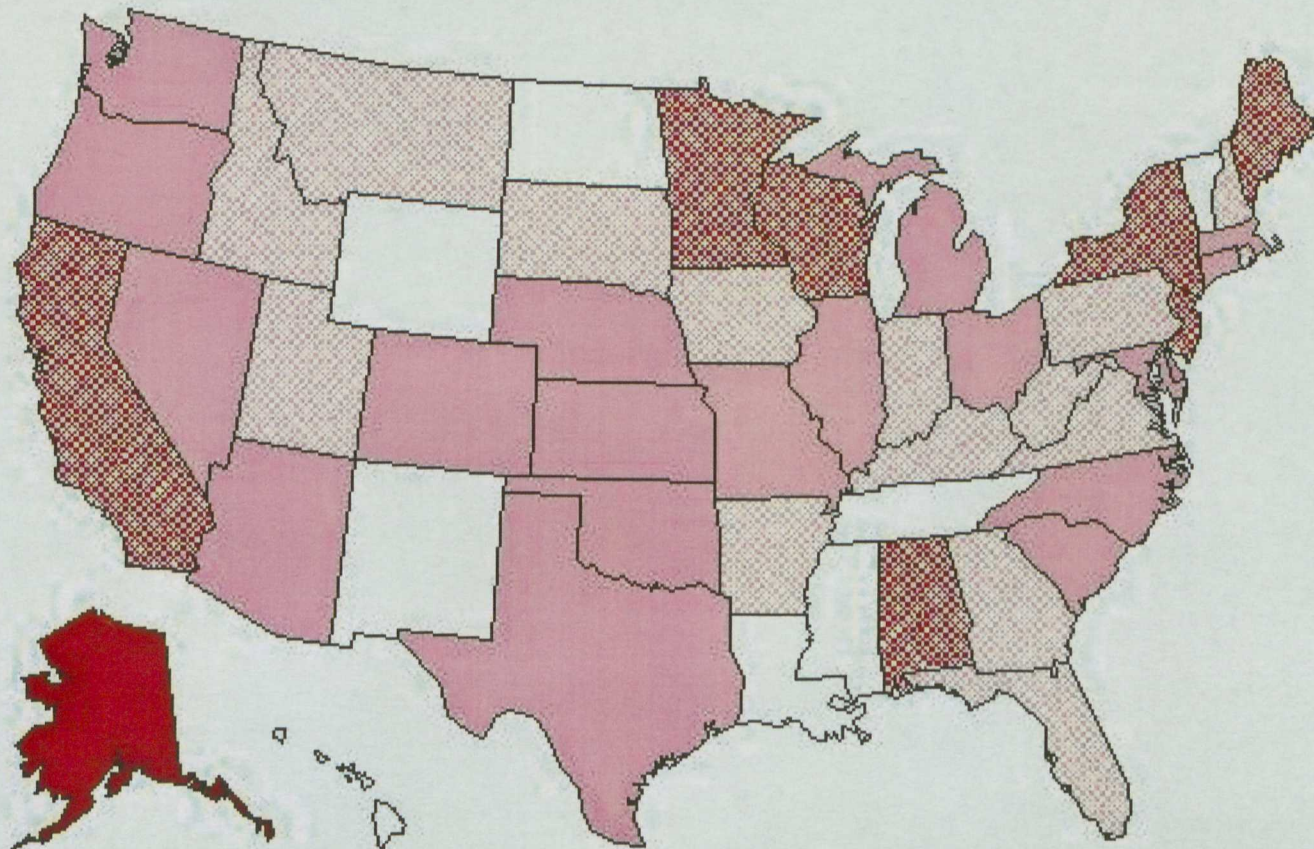
Spending has grown, buoyed by construction spending and education employment



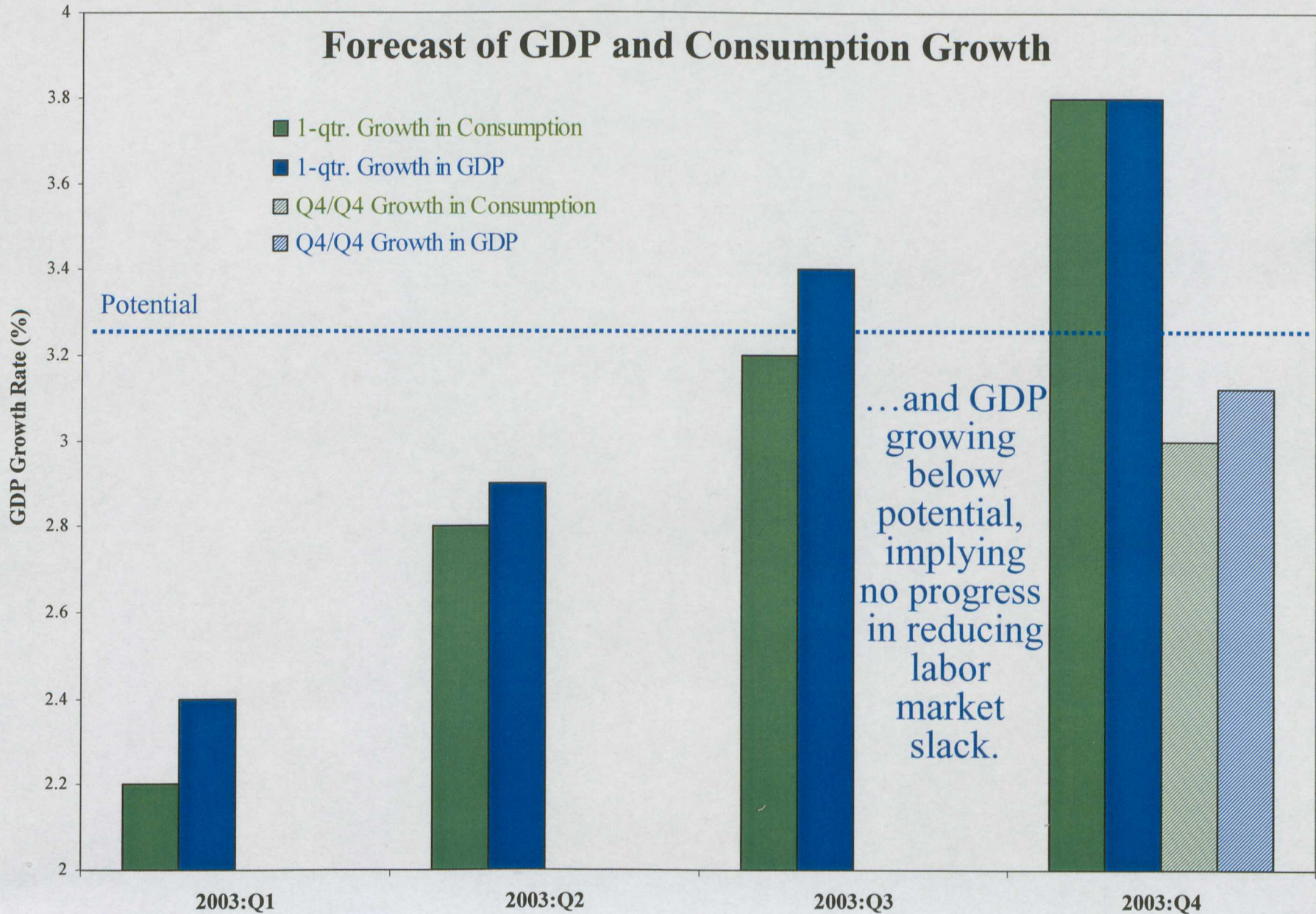
Sources: Bureau of Economic Analysis and Bureau of Labor Statistics.

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

Projected FY 2004 Structural Deficits as a Percent of 2000 GSP

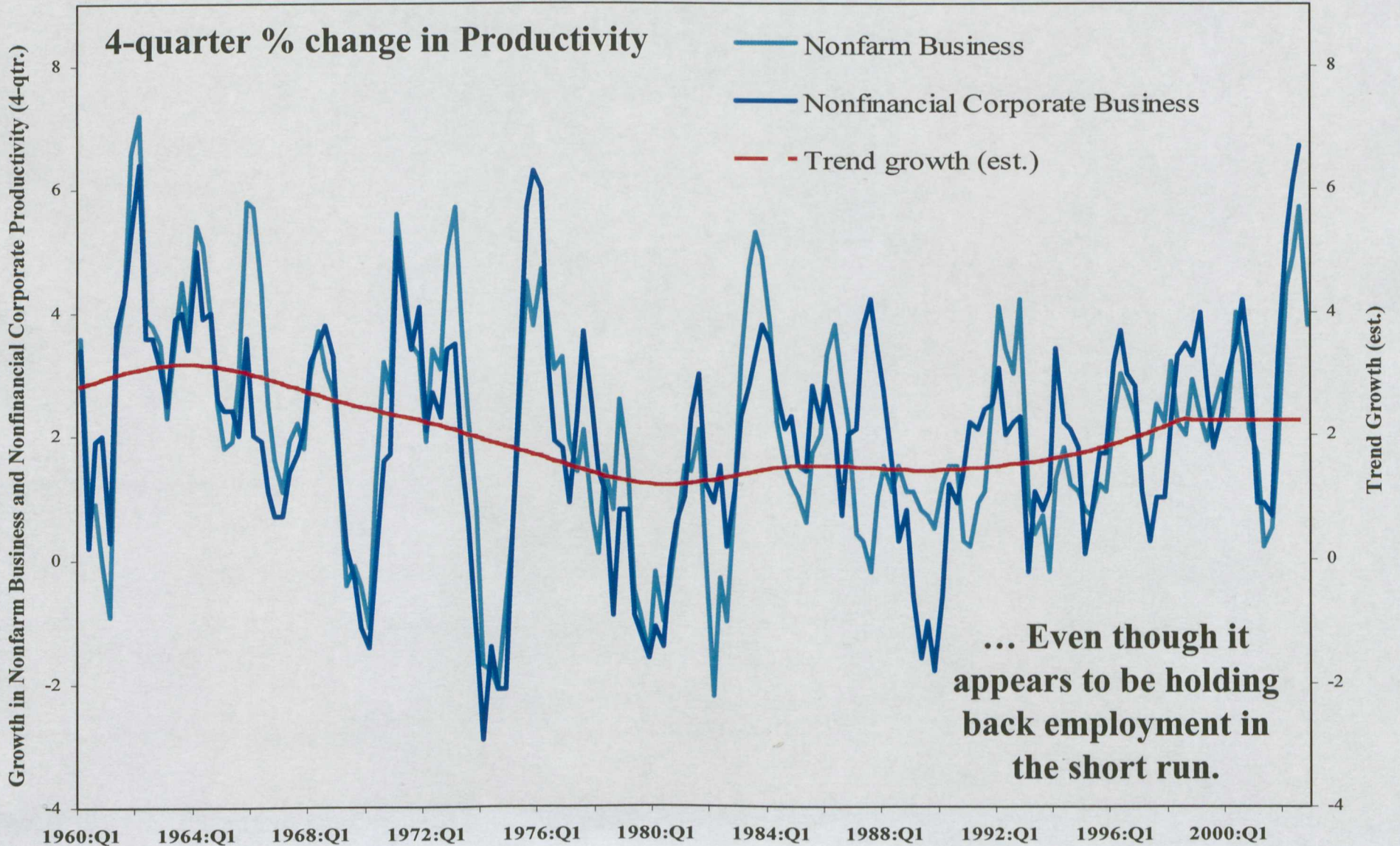


All of which implies a forecast of modest growth in 2003, with consumption growth lagging a bit behind GDP ...



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

The longer-run prospects are good:
 Looking forward, strong trend productivity growth should 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 ongoing balance sheet restructuring, the near-term outlook calls for modest spending increases in both the household and business sectors.
 - Consumption will grow slower than GDP for the reasons discussed; the savings rate will rise a bit
 - Investment will grow 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
 - Geopolitical uncertainty
 - War more likely now than a few weeks ago
 - Effects on oil prices? Terrorism?
 - But also economic uncertainty
 - Will overall policy stimulus spur spending?
 - Will businesses then see justification for hiring and investment?