

DOMESTIC ECONOMIC CONDITIONS

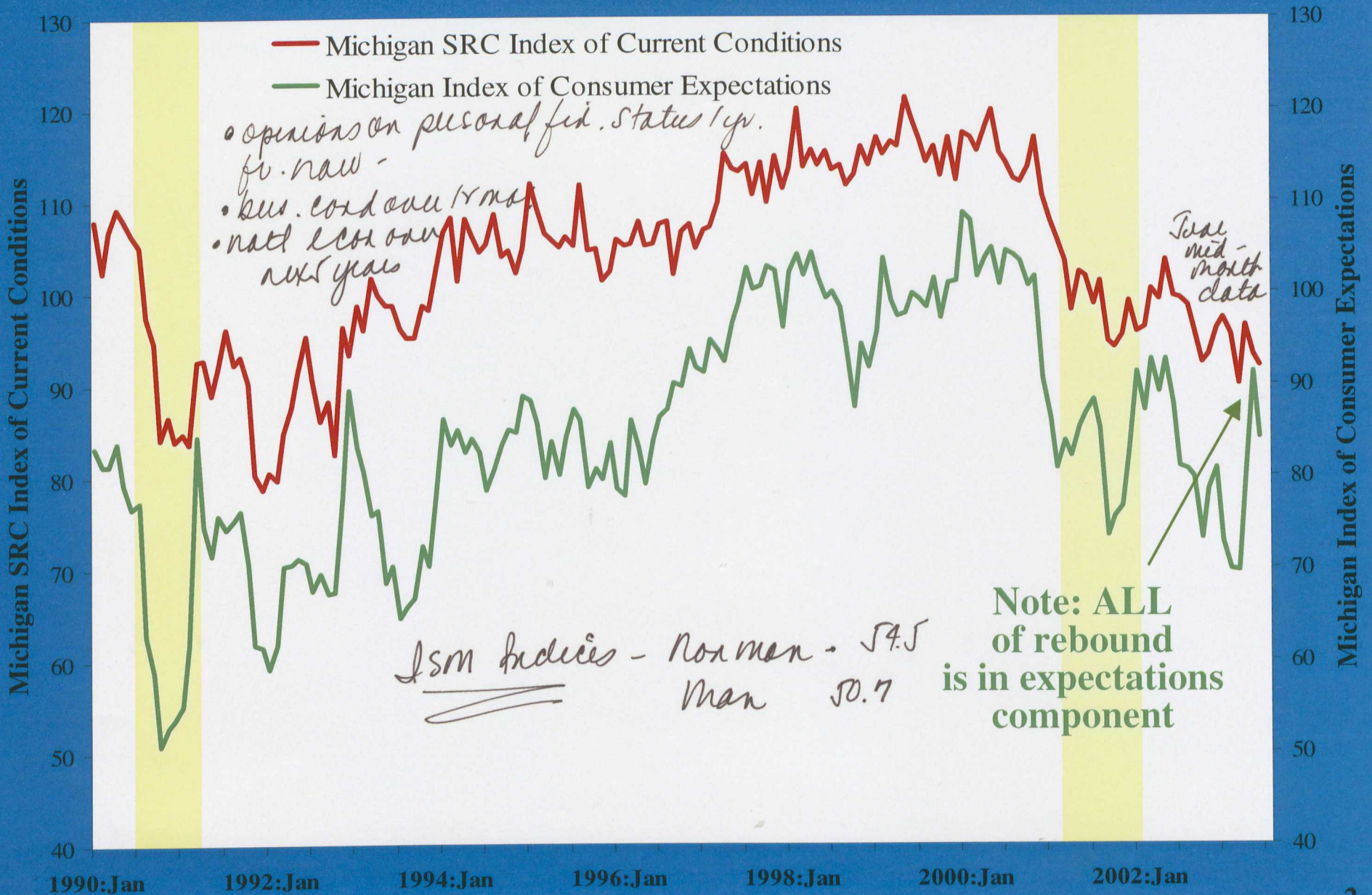
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Federal Reserve Bank of Boston

Presented to
The Global Business Alliance
June 16, 2003

The Spirit is Willing, But the Flesh?

- Some encouraging data from financial markets and consumer confidence readings
- Less encouraging real-side data
- Slack expected to continue through 2004
- Deflation?
 - Not a pressing current concern
 - But lingering slack suggests continued *disinflation*

The Spirit is Willing: Consumer Confidence has rebounded recently



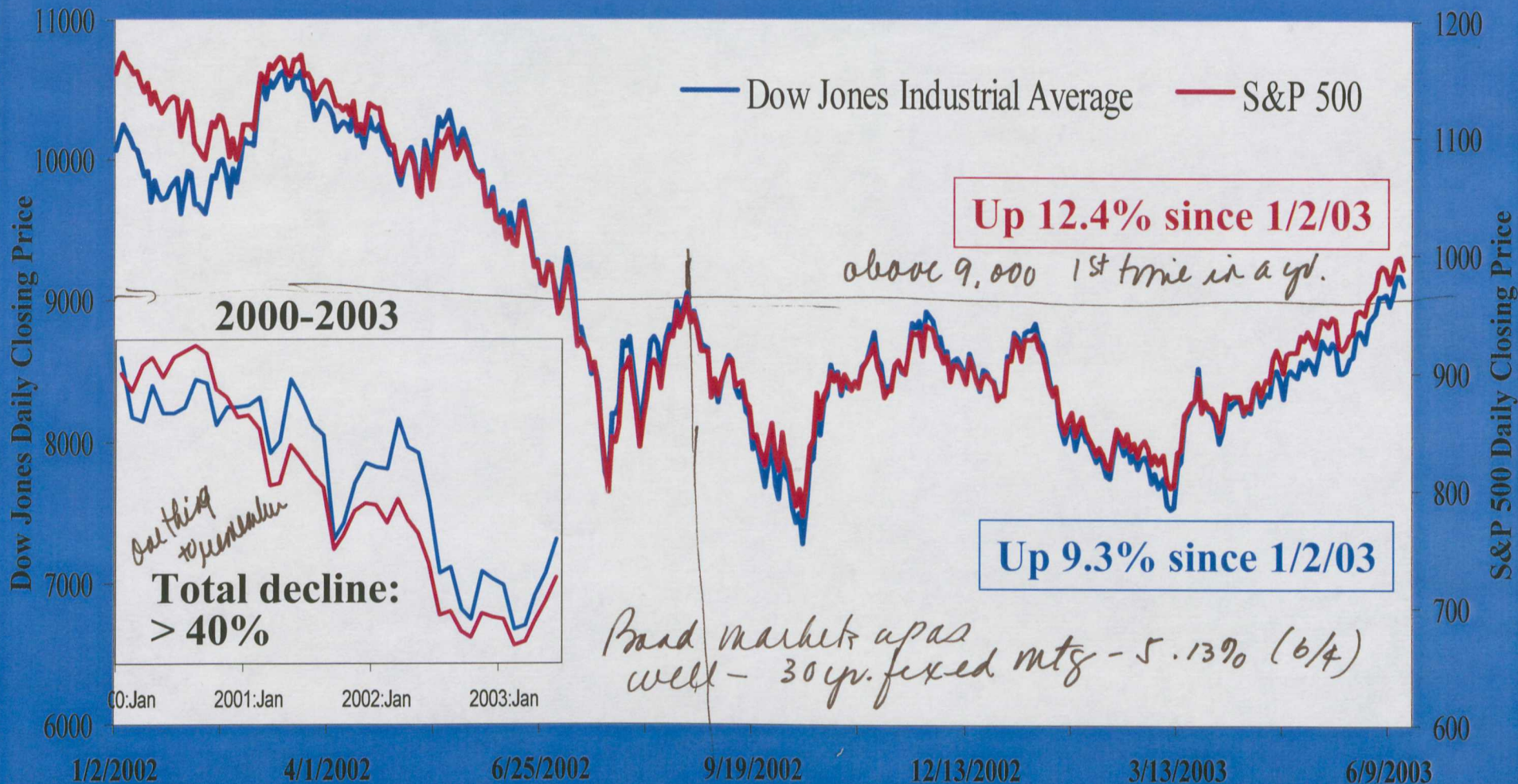
Source: Current Conditions and Consumer Expectations (NSA, 1966:Q1 = 100); University of Michigan.

Data through End of Sept - Back up was in wet - future as well - similar to 90-91 → after Gulf war

The Spirit: Equity prices have rebounded this year.

Recent improvement puts us above the level at start of 2003

Daily closing prices for the DJIA and the S&P 500

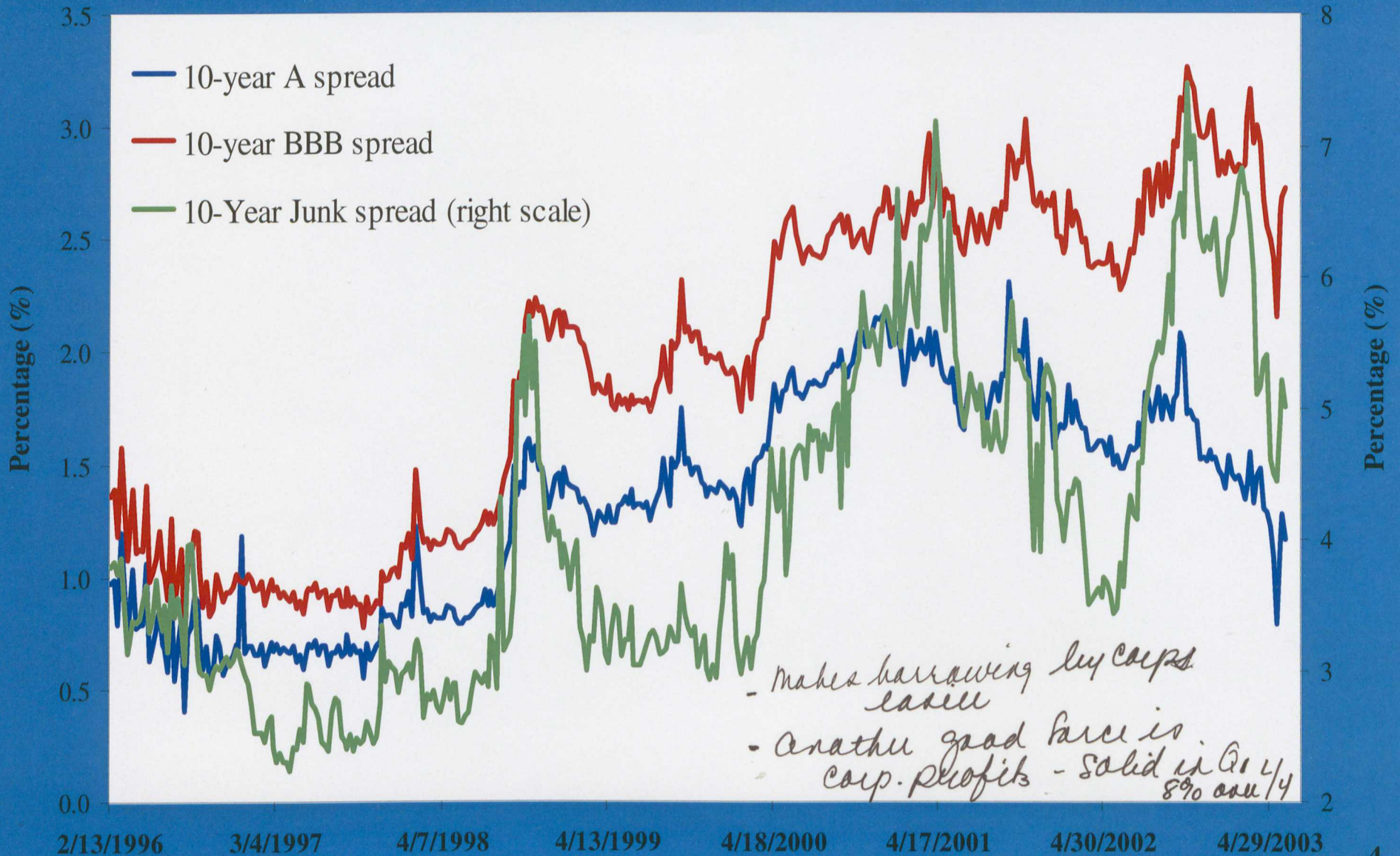


Source: S&P 500 Composite Index, Wilshire 5000 Stock Index, Dow Jones Industrial Average (Daily Closing Price); Bloomberg; Final closing price on 6/13/03.

6/13/03

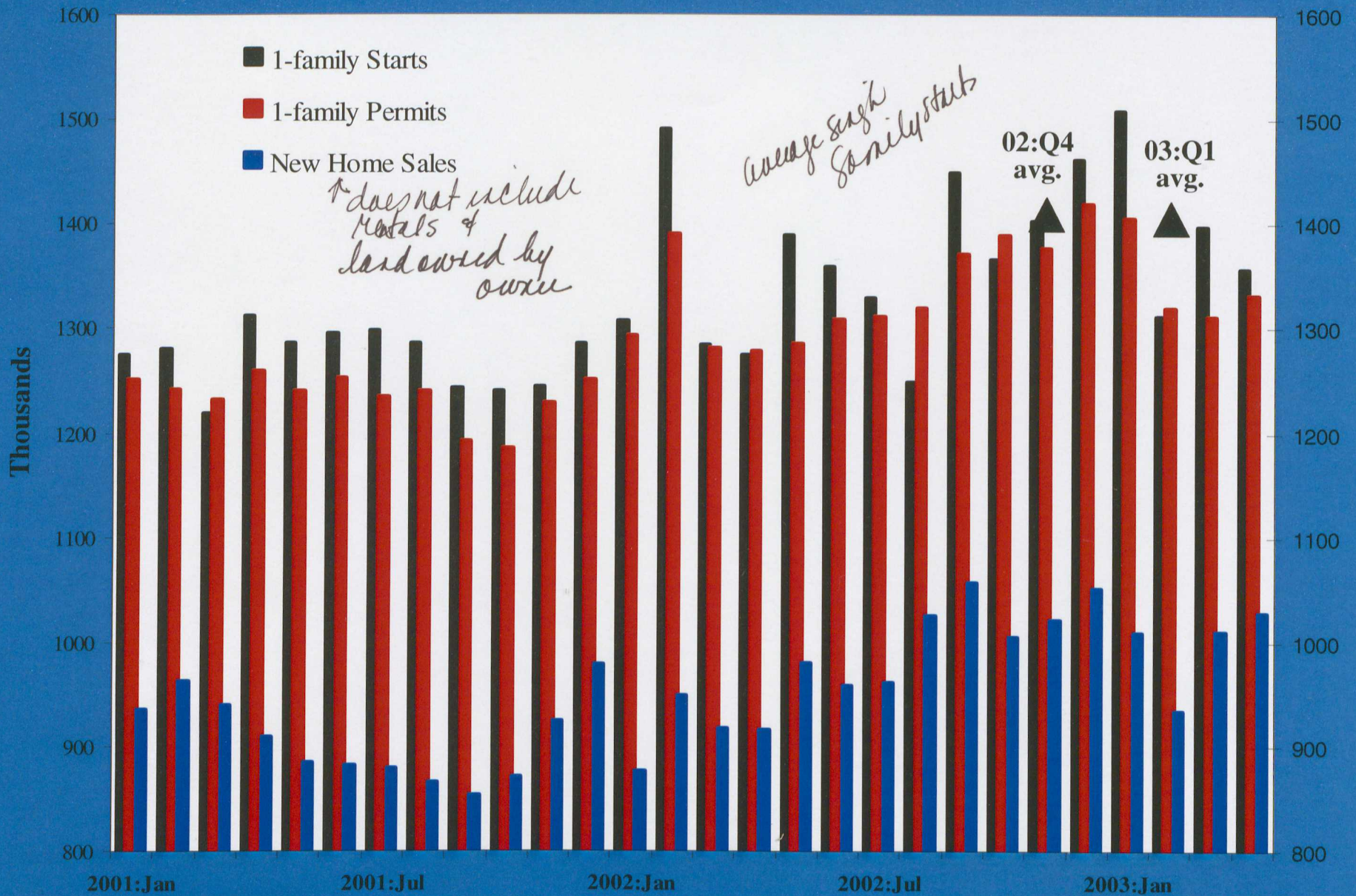
The Spirit: Yield spreads have improved, although they remain at somewhat elevated levels

Spread of indicated rate over 10-year Treasury rate



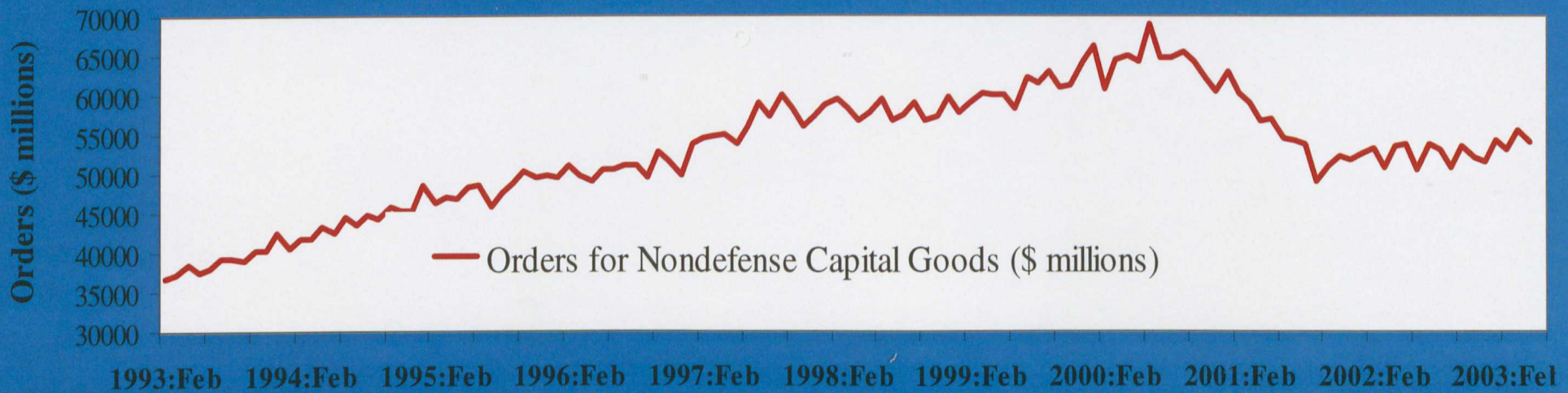
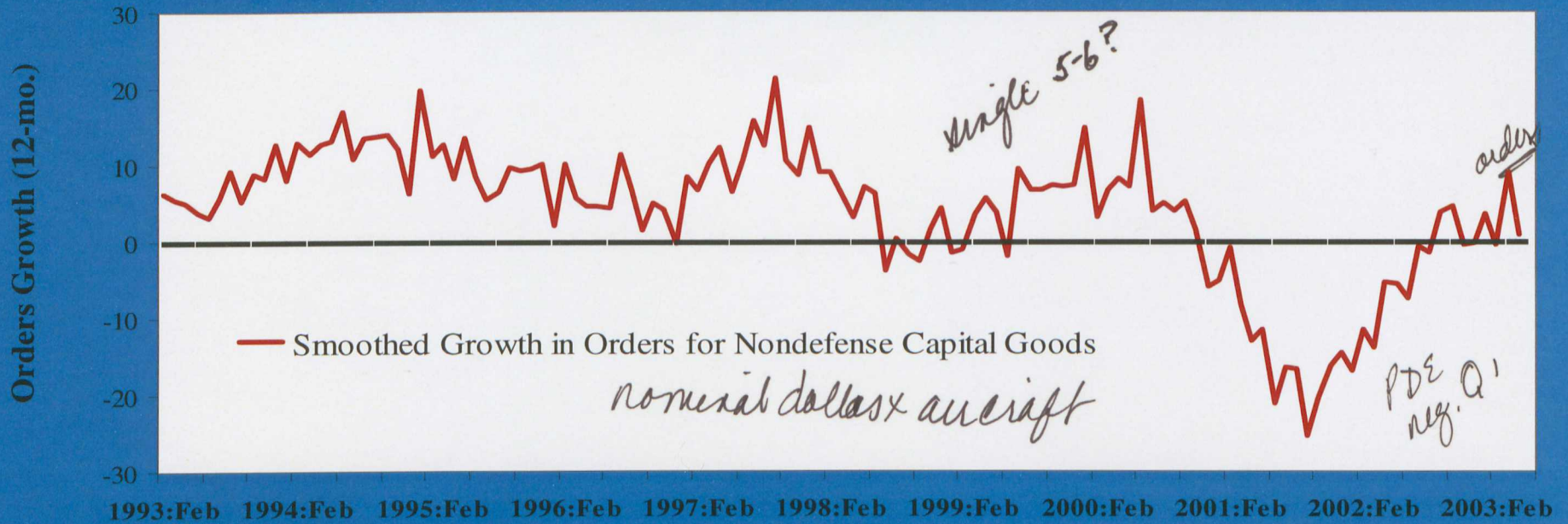
Sources: 10-year Treasury Bond Yield at Constant Maturity: Federal Reserve Board. 10-year Industrial Corporate Bond Yields: Standard & Poor's.

The Flesh: Housing Remains Strong, But Not Growing



Source: Single-family Housing Starts, Housing Units Authorized, and New Houses Sold (SAAR, Thousands): Bureau of the Census.

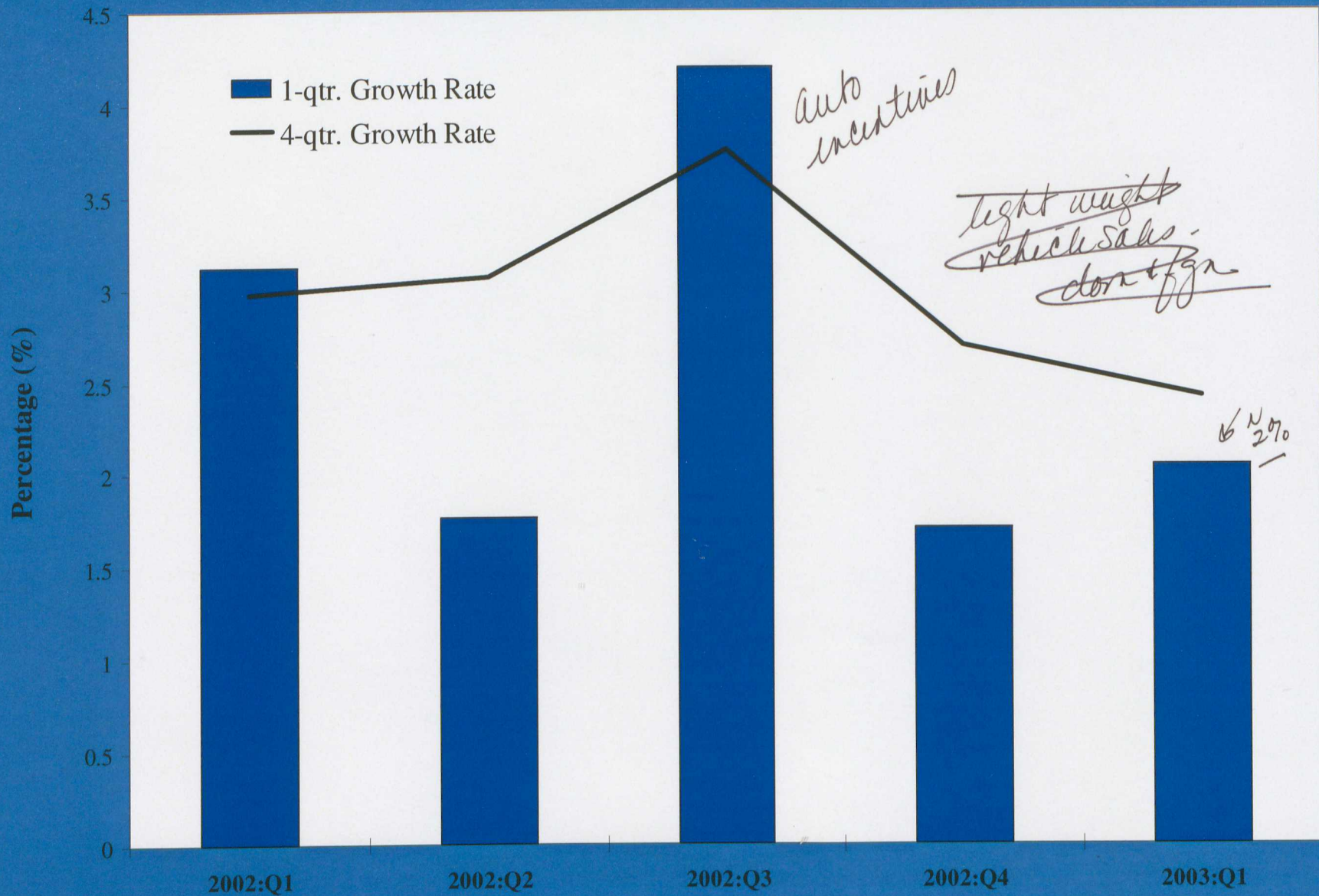
The Flesh: Recent orders growth is consistent with only modest PDE growth this year ...



Source: Manufacturers' New Orders for Nondefense Capital Goods excluding Aircraft (SA, \$ Millions); Bureau of the Census.

modest growth also encouraged by sto

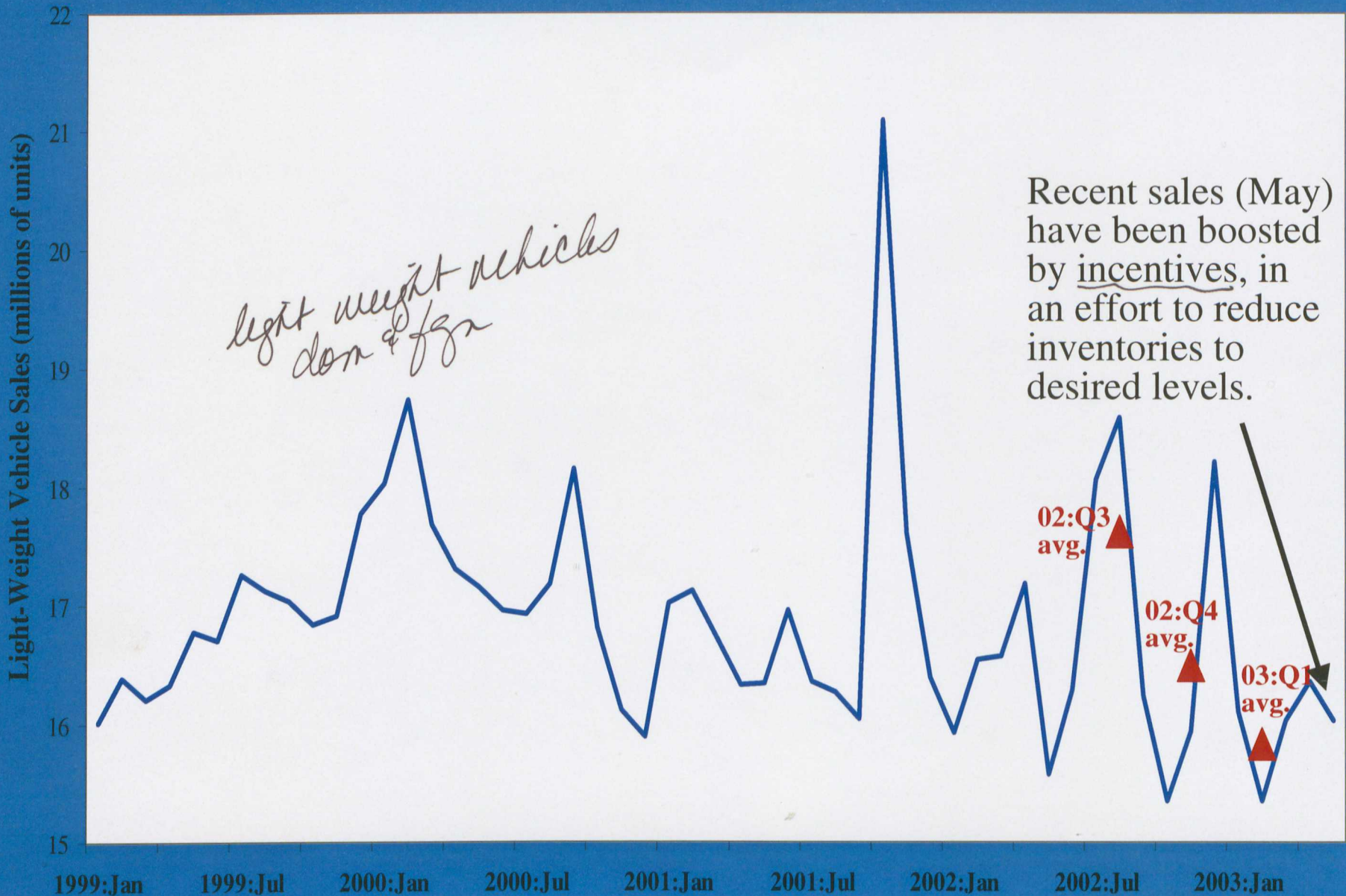
The Flesh: Consumption growth has been uneven, and weaker of late



Source: Personal Consumption Expenditures (SAAR, Chained 1996\$): Bureau of Economic Analysis.

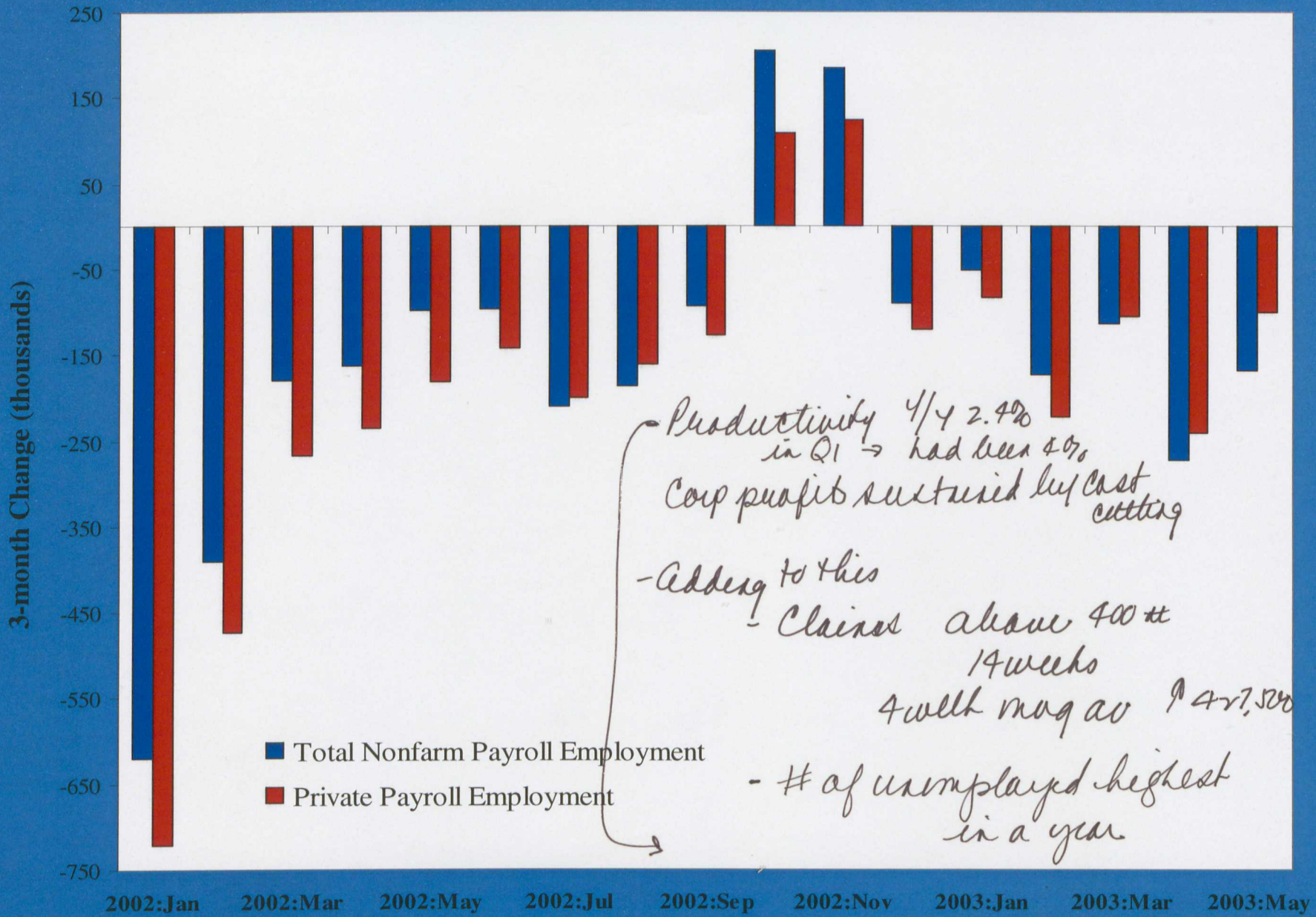
Auto Sales

Total light-weight vehicle sales have been tailing off since mid-2002 ...



Source: Light-Weight Vehicle Sales (SAAR, Autos & Light Trucks, Millions of Units); Bureau of Economic Analysis.

... And still no growth in payroll employment



Productivity 4/4 2.4%
 in Q1 → had been 4%
 Corp profits sustained by cost cutting

- Address to this
 - Claims above 400 #
 14 weeks
 4 week mag av \$427,500

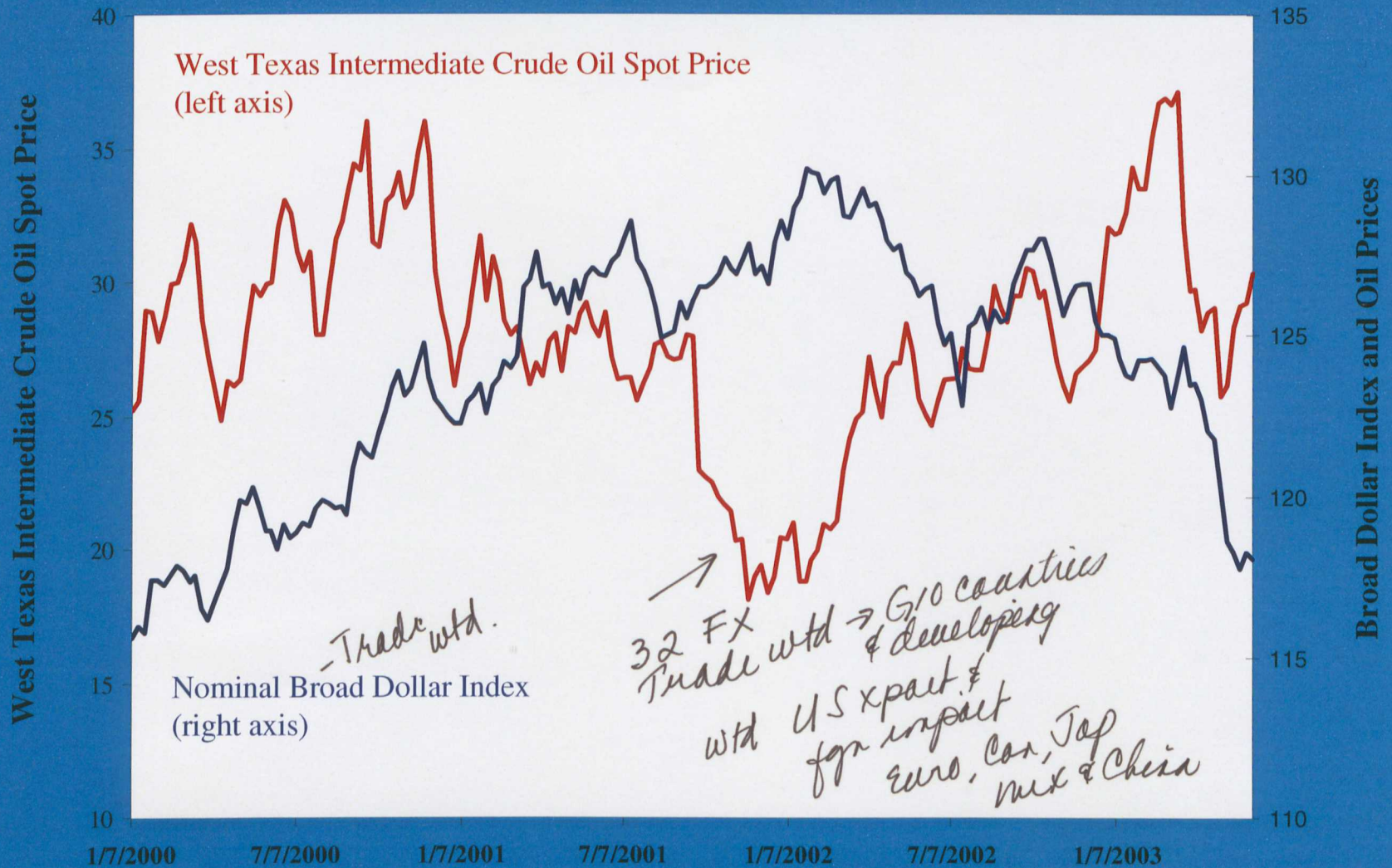
- # of unemployed highest
 in a year

Source: Total Employees on Nonfarm Payrolls and Total Employees on Private Nonfarm Payrolls (SA, Thousands): Bureau of Labor Statistics.

→ Things that should help

Th

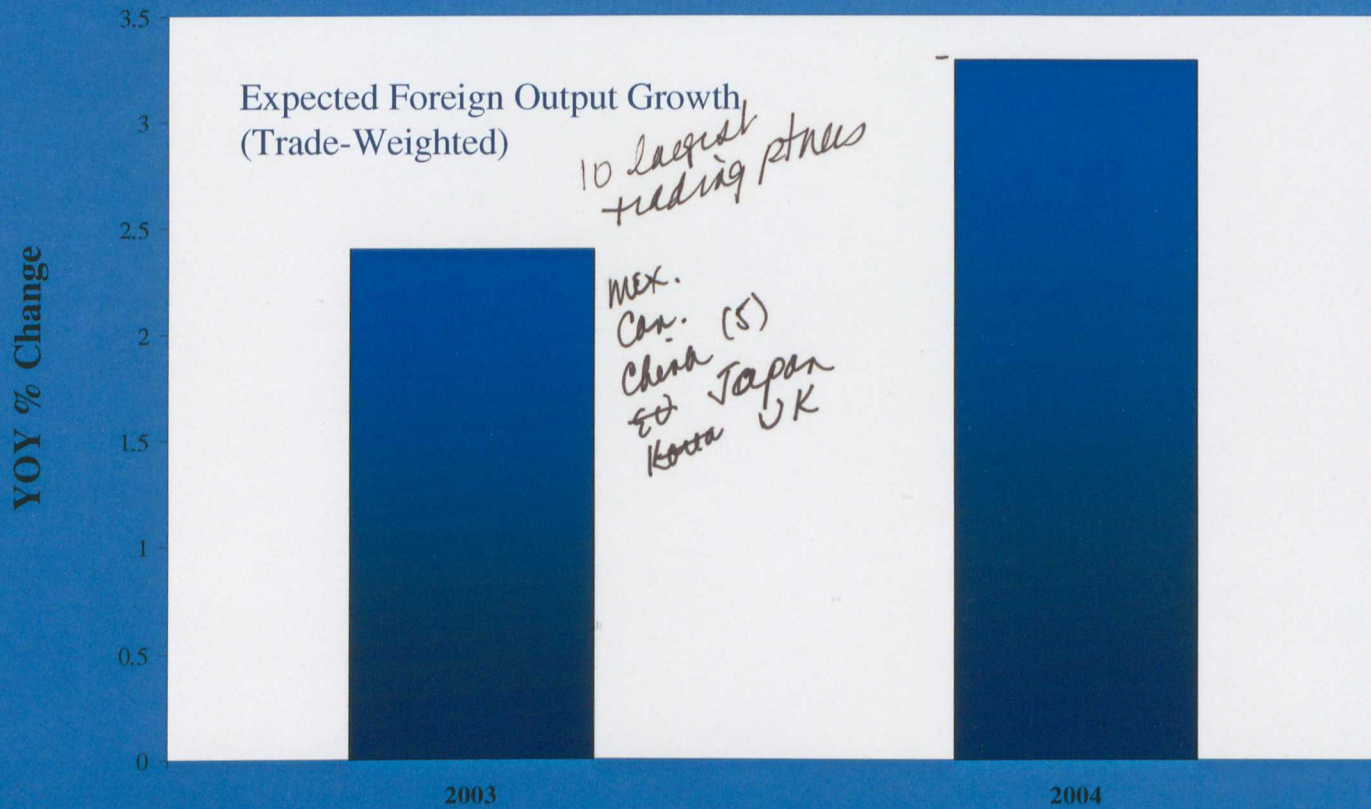
The recent decline in oil prices should help the consumer



And the weakening dollar should help improve exports...

Sources: West Texas Intermediate, Crude Oil, Spot Price: DRI. Nominal Broad Dollar Index: FAME.

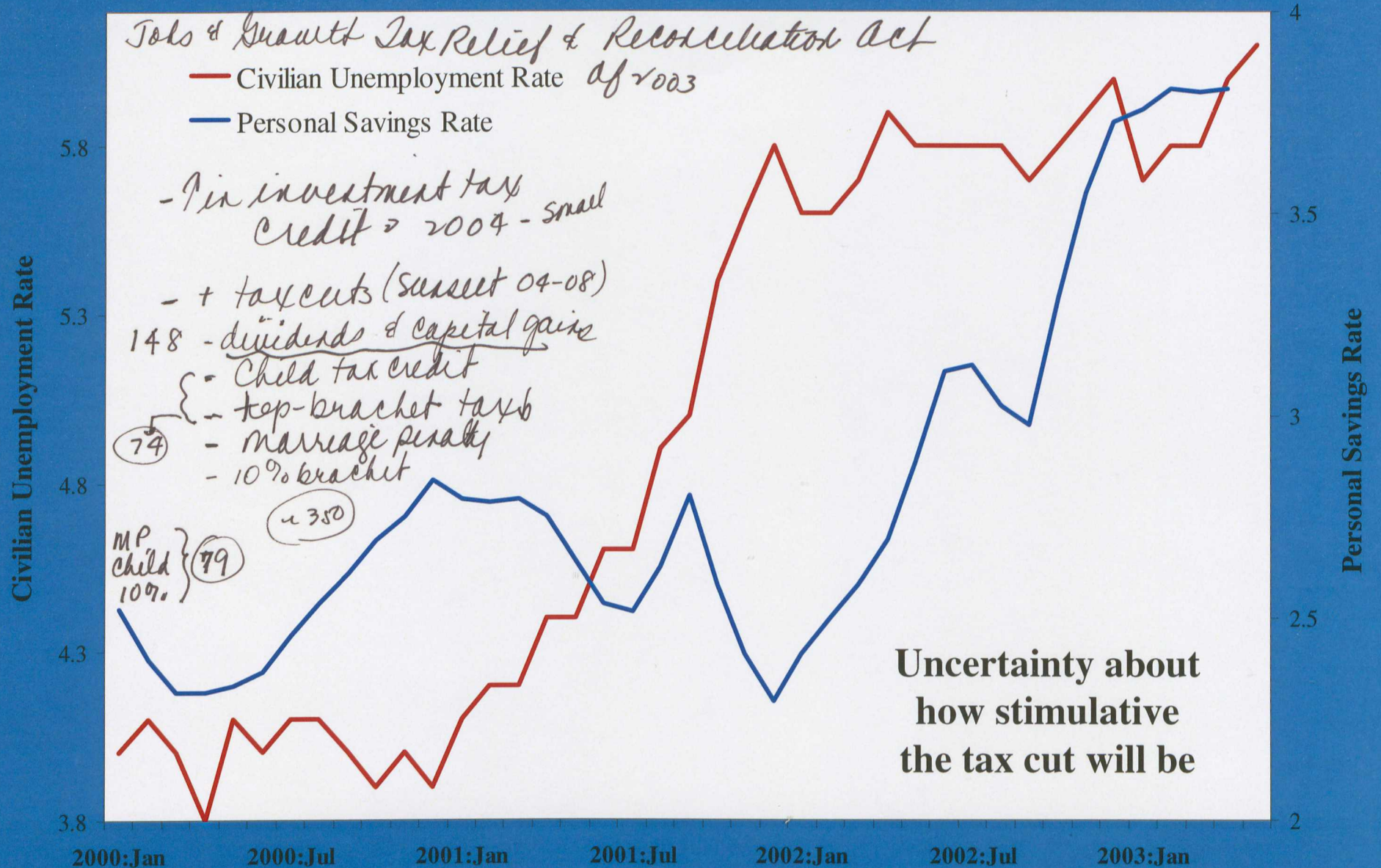
the rest of the world
...as will growth abroad *only moderate*



Both MP & FP Stimulative

Fiscal Policy Is Stimulative

~~We Have a Tax Cut!~~

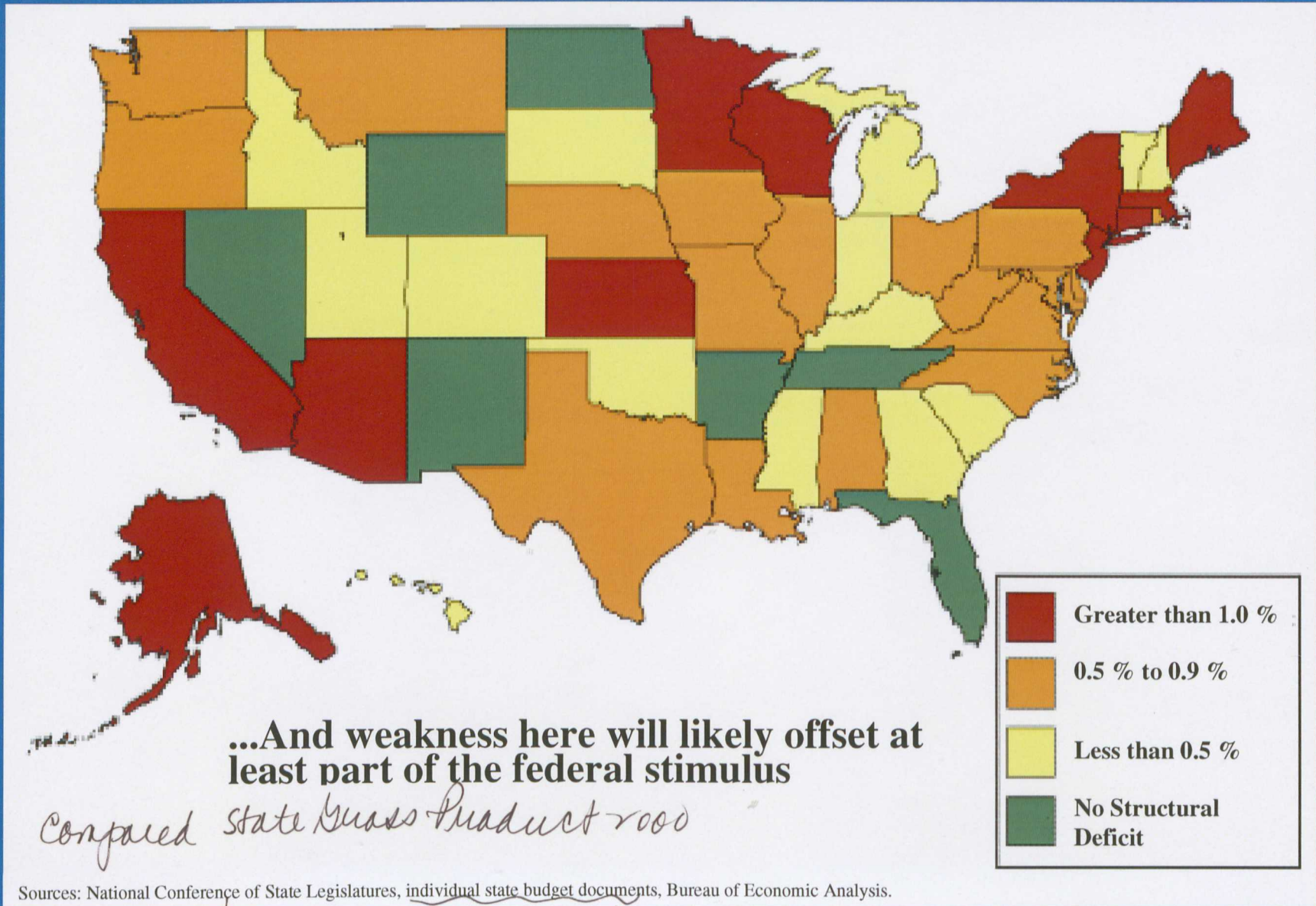


Sources: Civilian Unemployment Rate, 16yr. + (SA); Bureau of Labor Statistics. Personal Savings Rate (SAAR): Bureau of Economic Analysis.

- 20 B to help states

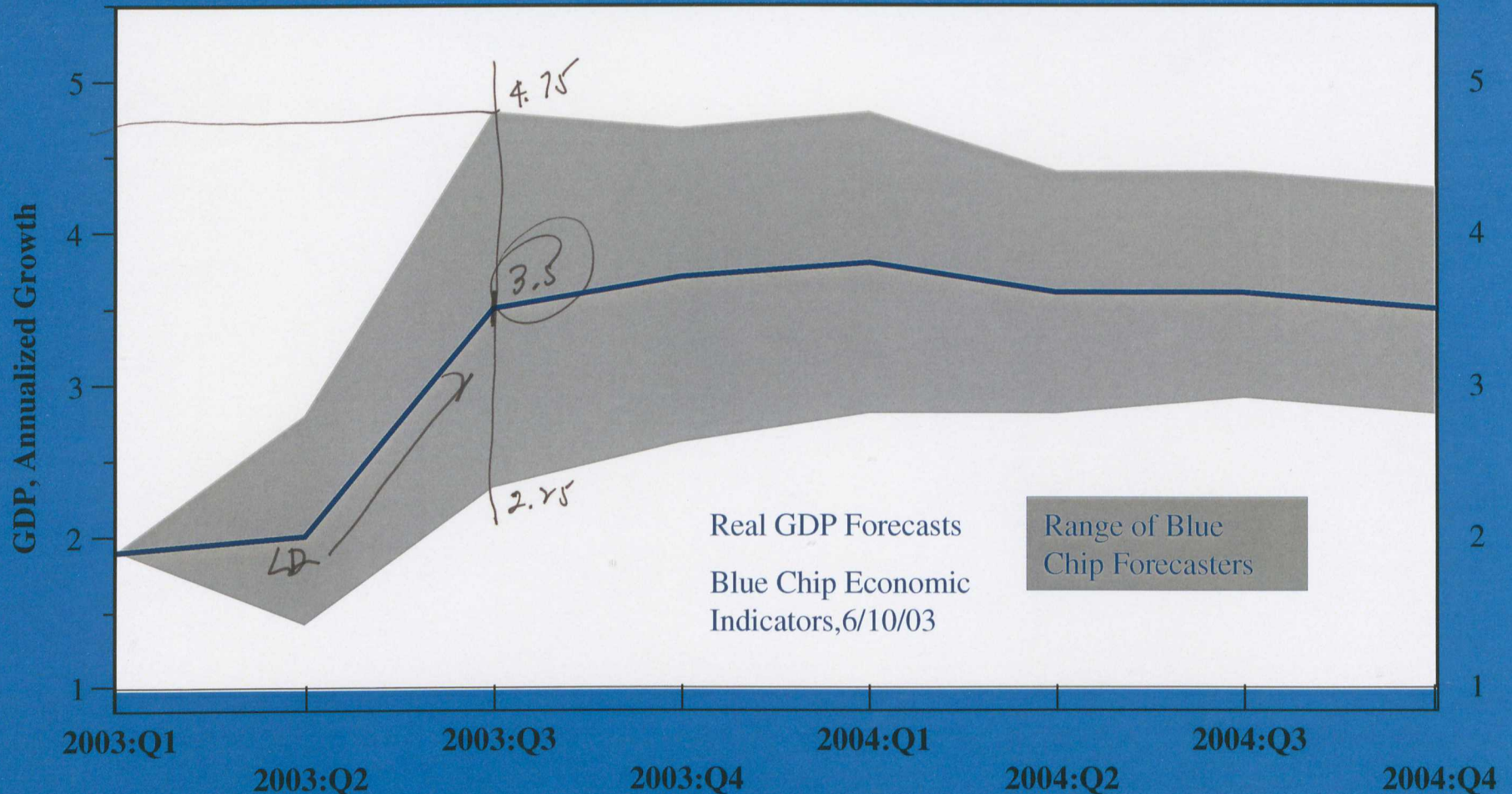
State and Local Governments Continue to Confront Budget Problems . . .

Projected FY2004 Structural Deficits as a Percentage of 2000 GSP



Budget update 2/03 *nonresponders*

All in all, most forecasters anticipate a solid recovery as the year progresses.



Note: Gray shading indicates range between top ten average and bottom ten average forecasts.
Source: Blue Chip Economic Indicators, 6/10/03.

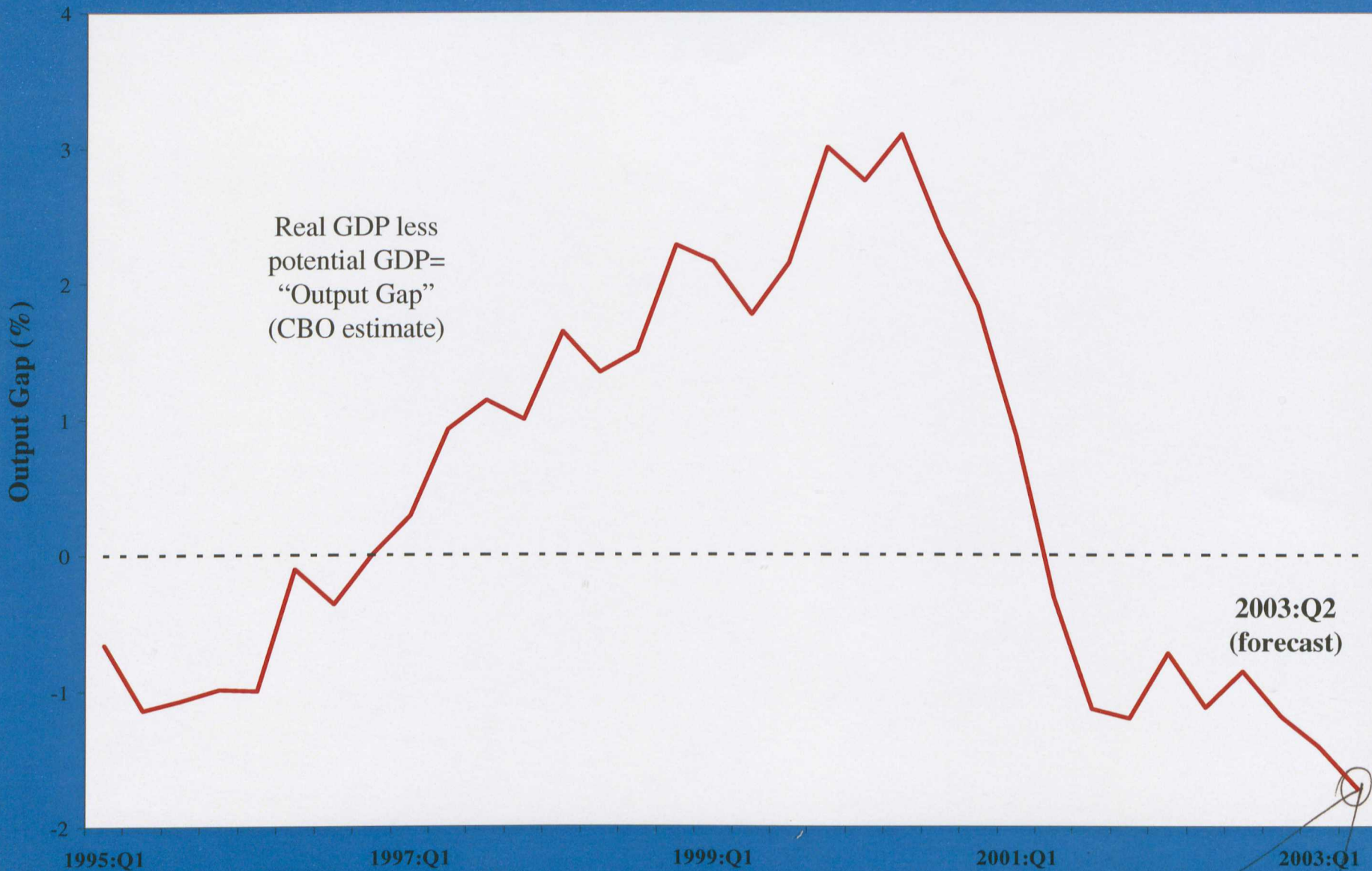
mainly the result of fiscal stimulus

but even this

will leave

The modest recovery has left excess capacity/slack

We are producing below our full-employment potential



2003:Q2 (forecast)

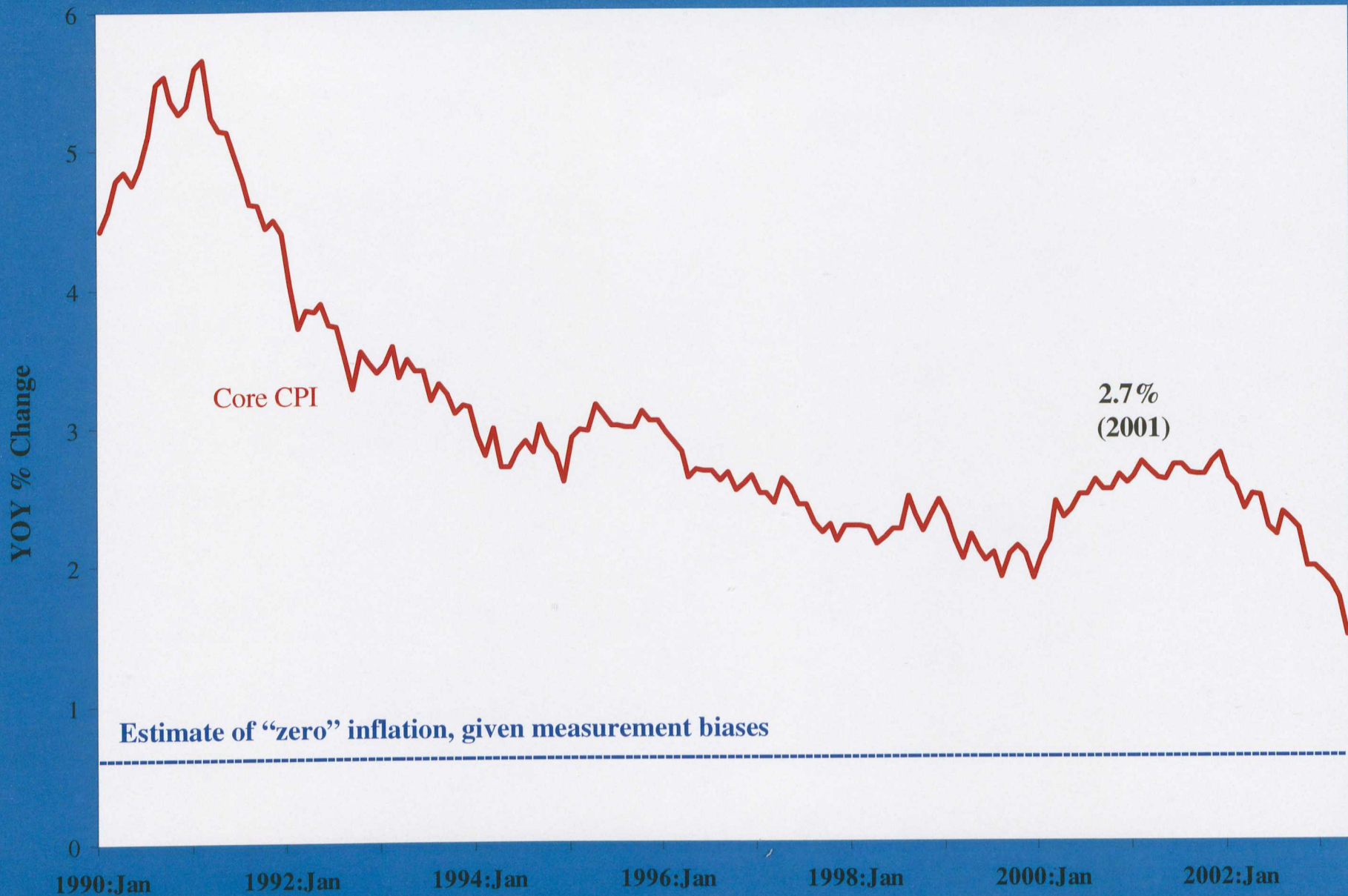
Sources: Real Gross Domestic Product (SAAR, Chained 1996\$): Bureau of Economic Analysis. Real Potential Gross Domestic Product, (Chained 1996\$): Congressional Budget Office.

rest of year - 3-3.75 start est into 2004 -

2070 source

CBO - potential

And not surprisingly, inflation is trending down



Sources: CPI-U, All Items Less Food and Energy (SA, 1982-84=100): Bureau of Labor Statistics. PCE Less Food and Energy, Chain Price Index (SA, 1996=100): Bureau of Economic Analysis.

Summary of Economic Conditions

- Pluses

- Sentiment, financial market improvements
- Federal spending and tax cut stimulus
- Ongoing monetary stimulus
- Oil prices settled down (although still high)
- Lower exchange rate (helps exports)

- Corporate profits

- Minuses

- Real data on spending, employment weak
- State and local weakness offsets federal strength
- Monetary policy perhaps not as stimulative as it was
- Excess capacity remains, inflation slipping down
- Weakening outlook for EU, Asia

About Deflation

- What is it?

- A sustained general decline in the prices of all goods and services

*- But mainly now that this
- asset prices decline → add banking/fin
system has
problem
- 2008
- Japan*

- Compare to **disinflation**: a decrease in the rate of inflation of goods and services

- Currently, we run a risk of further **disinflation**

- The risk of deflation is smaller and farther off

- Of course, the risk increases as we approach zero inflation

About Deflation

- How Big a Risk?

- Not that likely: most prices still rising

- Services prices still rising $> 3\%$ in 2003

- Services are 60% of consumption

- Nondurable goods prices still rising at nearly 3%

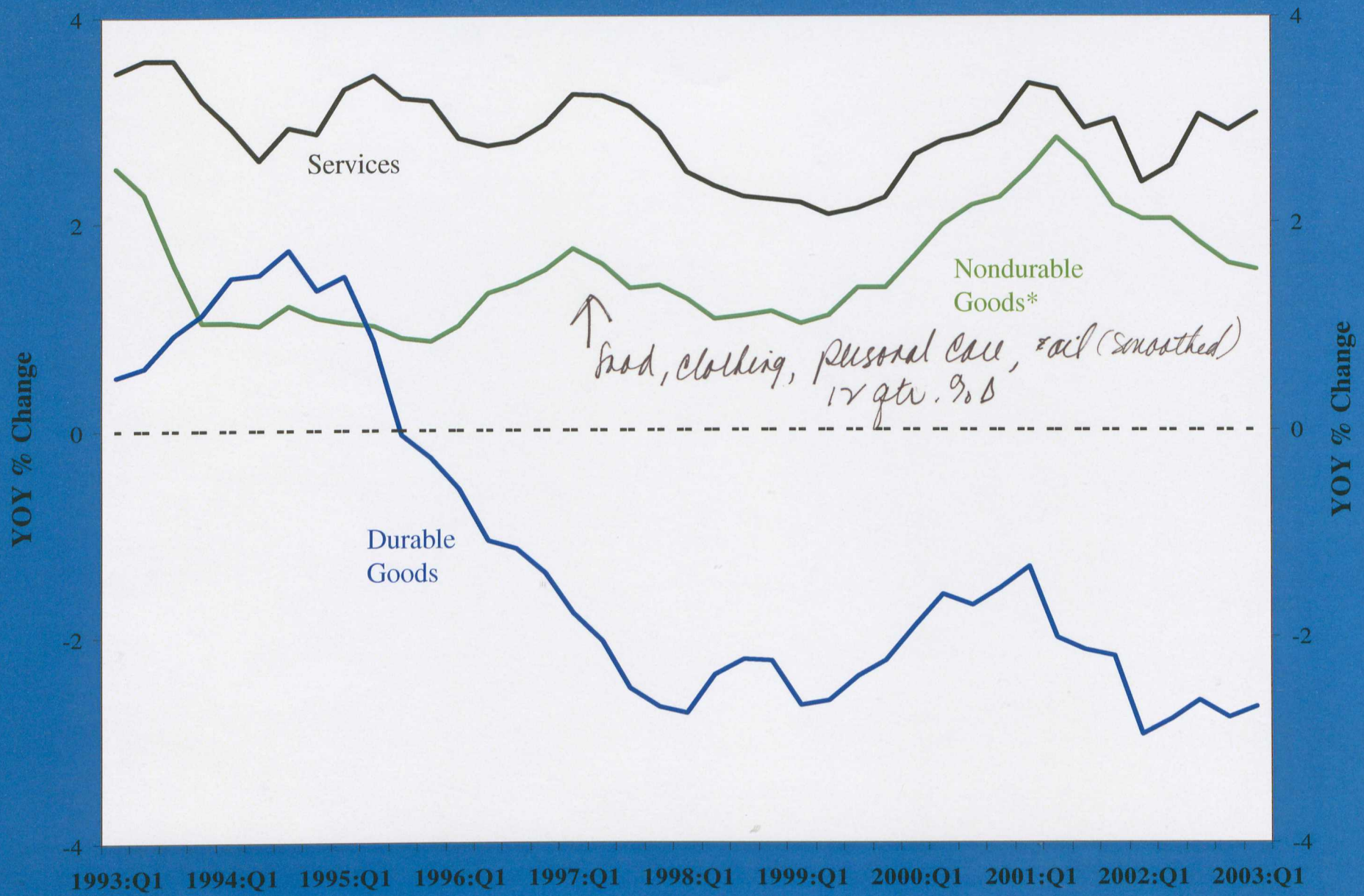
- It's really only durable goods prices that are falling

- Because the efficiency with which we manufacture them is high and rising faster than other goods and services

- In general, always a mix of price movements, with some rising faster, some rising slower, some falling

- In the long run the Fed determines the *overall* rate of price increase--which probably should be a positive number

Most Consumer Prices Are Still Rising at 2 to 3%



* Represents 12 quarter % change.
 Source: Personal Consumption Expenditures Chain-Type Price Indices (SA, 1996=100): Bureau of Economic Analysis.

Deflation, continued

- Why is deflation a problem?
 - An indication of serious economic weakness *l*
 - That's how the economy would get to deflation
 - Could include falling asset prices--stocks, houses
 - Reduces collateral values, possibly limiting loan growth
 - Makes inflation-adjusted interest rates high

- “Zero bound” on nominal interest rates -

- This would be an enduring problem, not just a transition issue.

Hard to use monetary policy to take i rates below 0 - they don't go there easily - at the thing cards - can buy longer term bonds - return i rates & long end

Deflation, continued

- Why is deflation a problem (continued)?
 - Debtors pay back loans whose payments grow in real terms (reverse of situation with inflation)
 - Particularly difficult adjustment for long-term contracts such as pensions
 - Would increase default, non-performing loans
 - Wages may not adjust downward easily
 - Implies real wages “too high,” at least temporarily
 - higher unemployment
 - ^{could}Engenders more general financial instability
 - In all cases, may be only a “transition” problem--but transition could take a while!

Conclusions

- The economy is still weak, and increasing vigor is a forecast, not yet a reality
 - Risks to growth are on the downside – *This is the real economic start.*
- Excess capacity persists, which means
- Inflation is trending down, gradually
- The risk of rising inflation is minuscule
- The risk of deflation is relatively small, but not zero, and increases with falling inflation