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Current Economic Conditions

- Welcome
- Pleasure to greet you again
- See many familiar faces - Boston's forums

Regional and Community Bankers
 Conference
 May 18, 2004

- Want to cover two things
- National Economy
- Some regional comments

Cathy Minehan
 President & CEO,
 Federal Reserve Bank of Boston

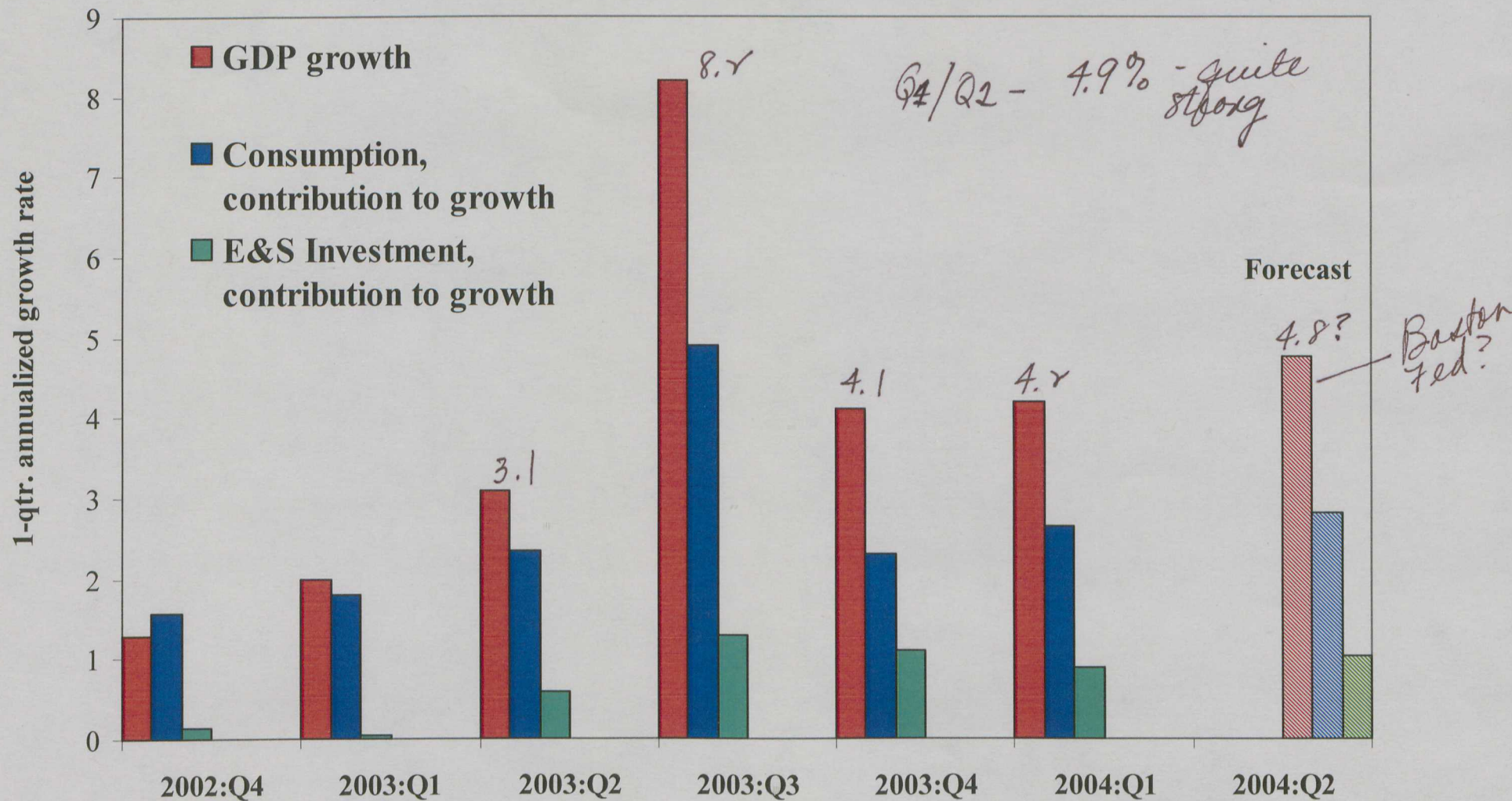
Overview

- **U.S. recovery is now on a solid footing**
 - Self-generated private growth is substituting for policy-induced growth
 - Employment growth has picked up, while productivity growth remains strong
 - Inflation requires watching, but likely to remain well-behaved
- **New England fared worse than the nation, but the regional outlook is improving**

The recovery has gained steam

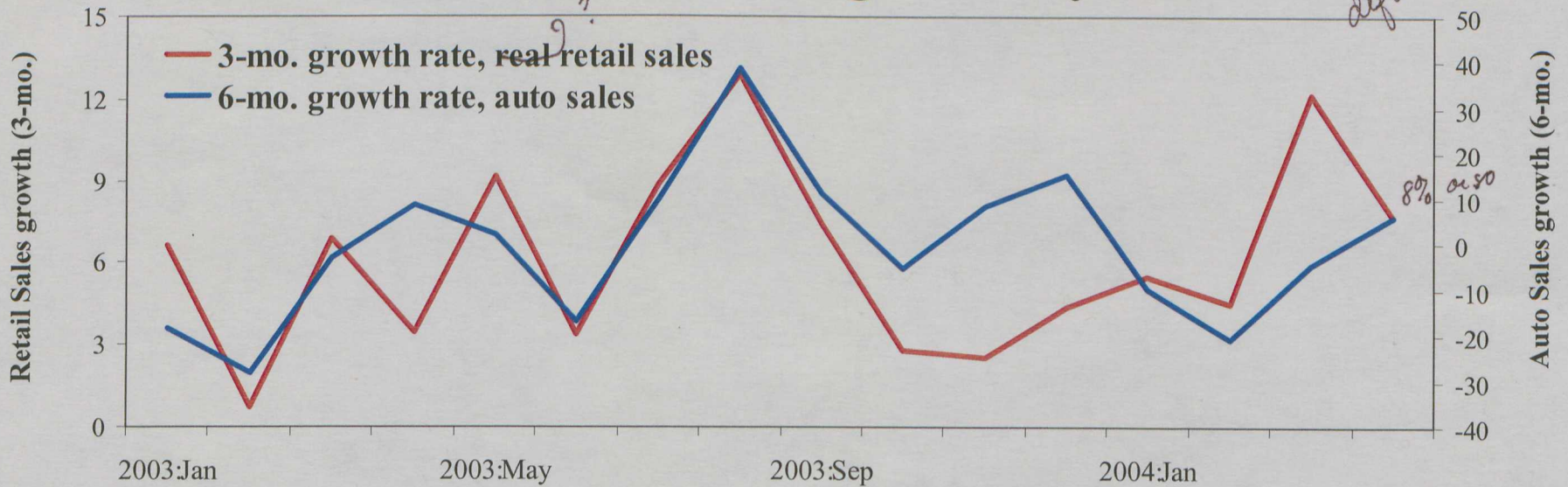
- Consumption spending has been strong
- Investment in equipment and software has picked up
- And recent data point to continued strength in both consumption and investment

The recovery has gained steam, and has featured strong private spending

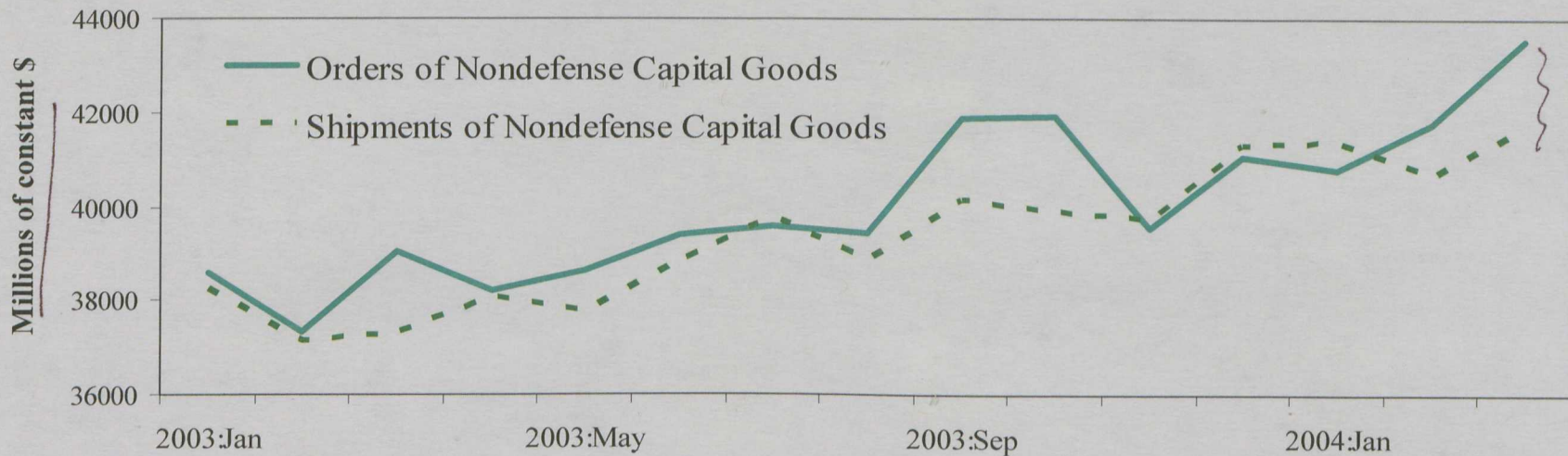


Source: Real Gross Domestic Product, Real Personal Consumption Expenditure: Contribution to Real GDP Change, Real Investment in Nonresidential Equipment & Software: Contribution to Real GDP Change, (SAAR): Bureau of Economic Analysis.

Recent indicators of consumer spending suggest continued strength this year



Investment spending will likely grow at a solid double-digit pace

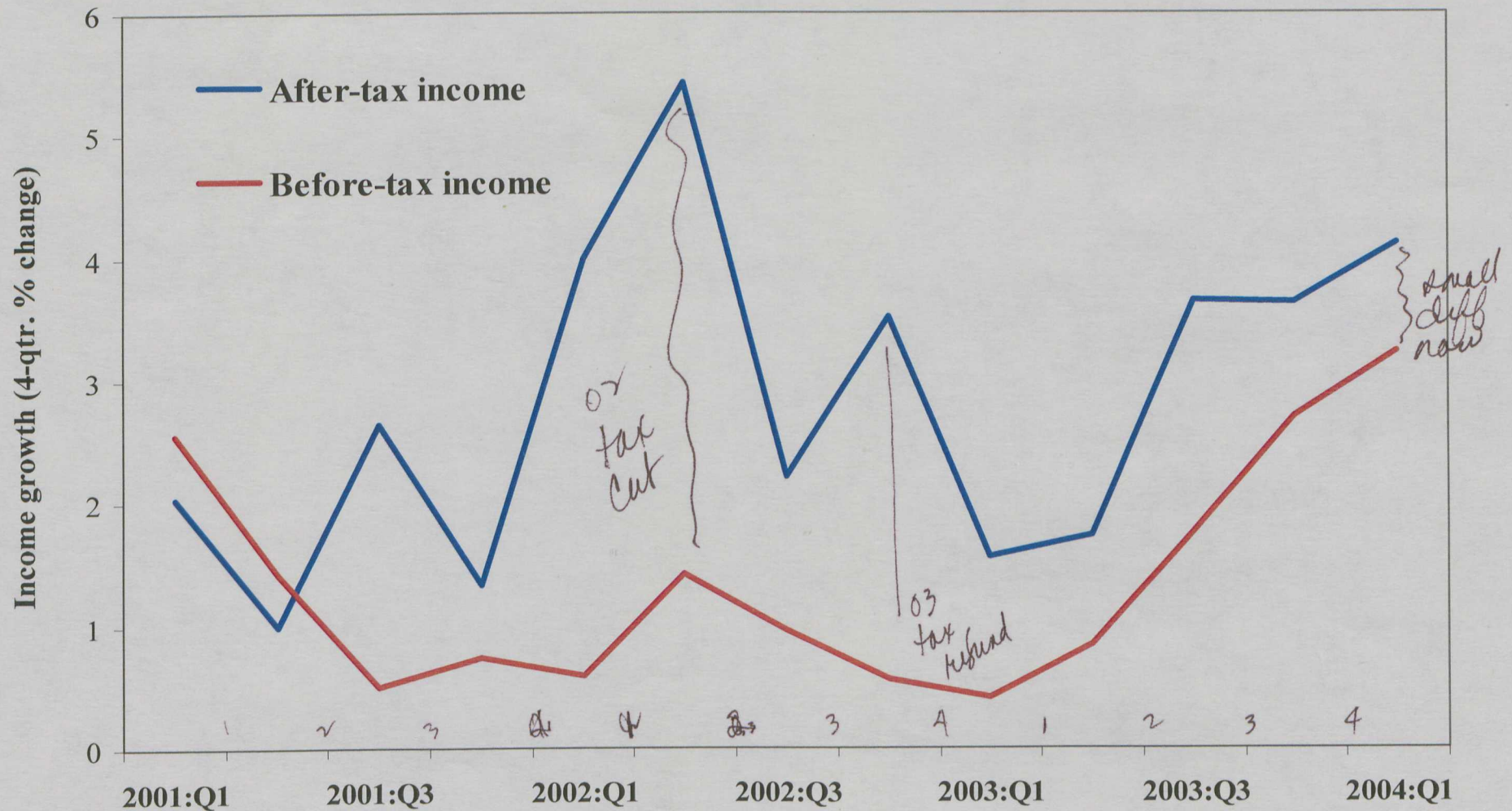


Sources: Total Light Weight Vehicle Sales, (SAAR, millions): Bureau of Economic Analysis. Retail Sales & Food Services, New Orders and Shipments for Nondefense Capital Goods ex Aircraft, (SA, millions \$): Census Bureau.

Consumption is supported by rising income growth

- Consumption depends upon “disposable” or after-tax income
- Earlier, tax cuts were responsible for most of the growth in disposable income
- Now, income is growing on its own

Earlier tax cuts spurred growth in household income. Now pre-tax income is improving.

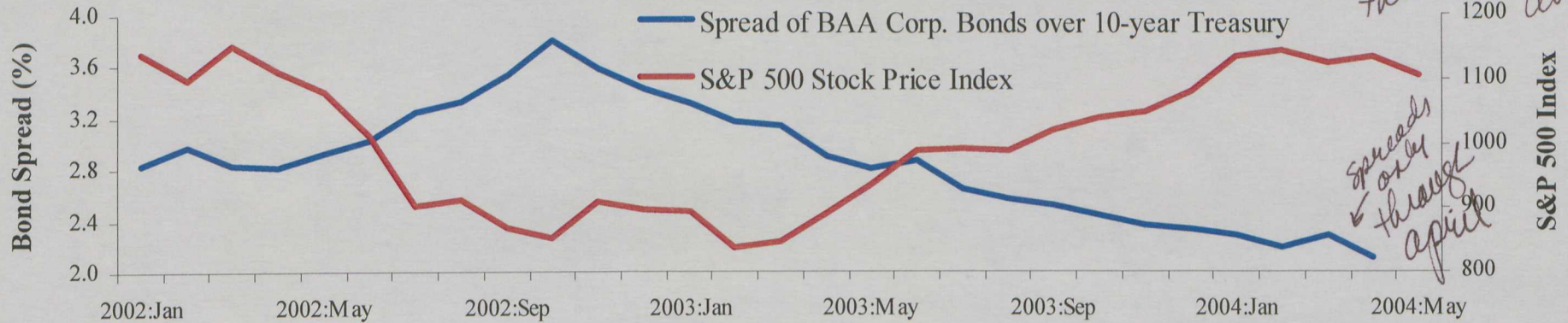


Source: Real Disposable Personal Income, Real Personal Income, (SAAR, Bil. Chn. 2000\$): Bureau of Economic Analysis.

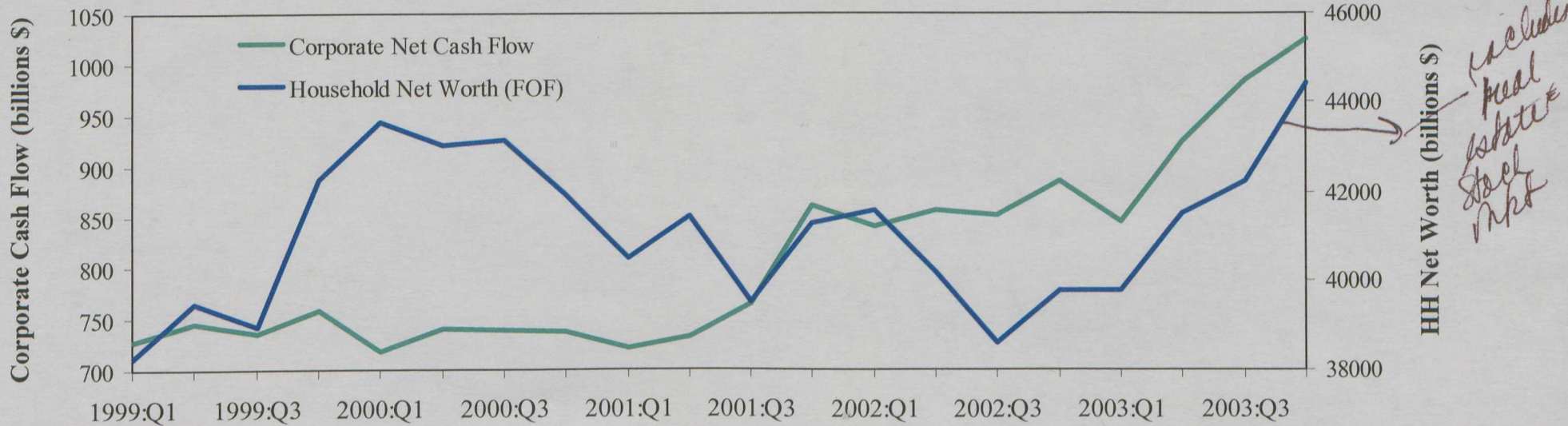
Household net worth is also improving

- *Well mostly* Improving financial markets and rising home prices have boosted households' net worth
- Corporate cash flow is also growing strongly, providing support to business investment

Financial markets have provided support ...

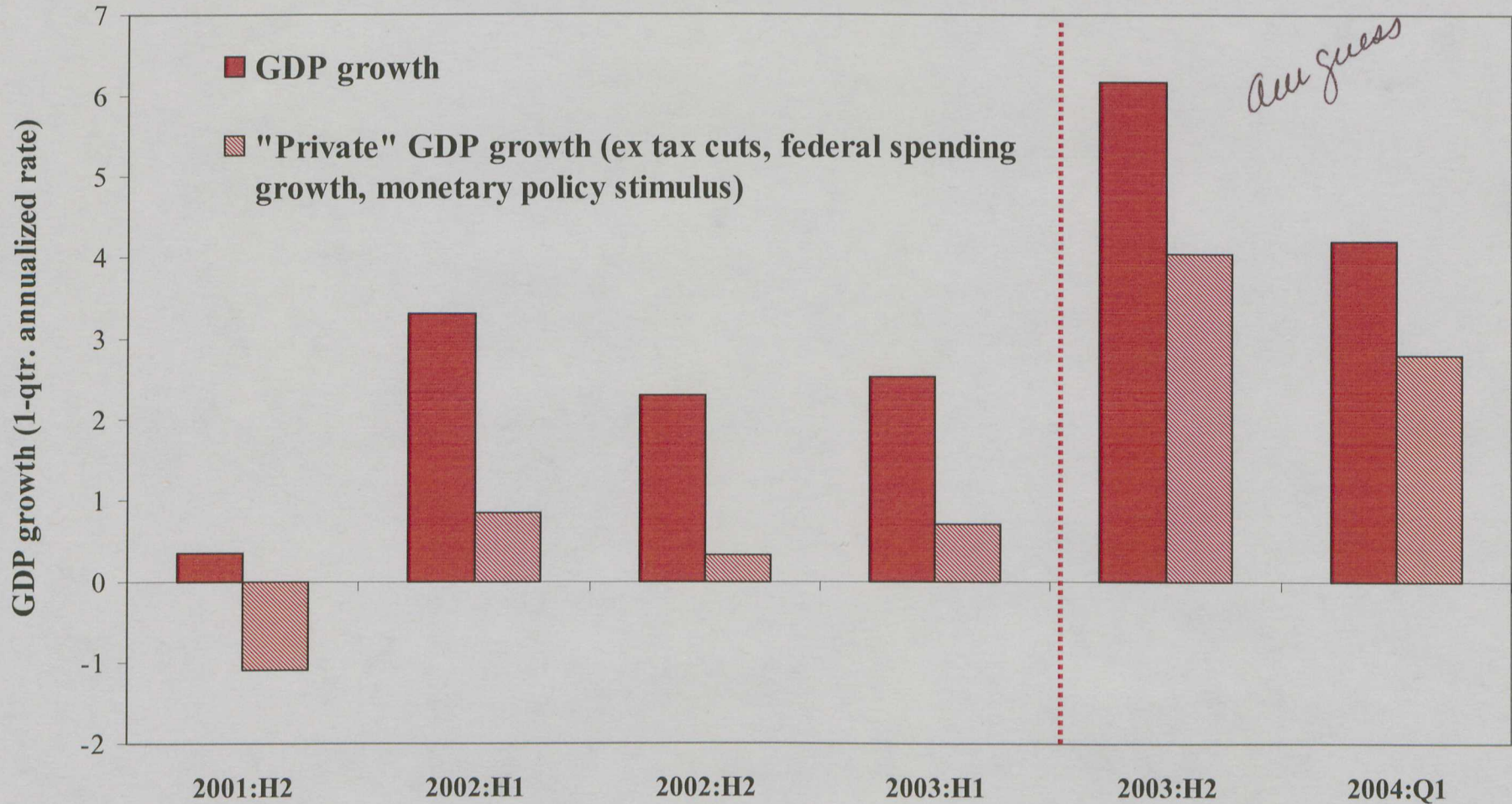


... Boosting Household Net Worth and Improving Corporate Cash Flow



Sources: 10-year Treasury Bond Yield at Constant Maturity, Moody's Yield on Seasoned BAA Corporate Bonds, Nonfinancial Corporate Business Total Internal Funds + IVA (SAAR, Billions \$), Households Net Worth (Billions \$): Federal Reserve Board. S&P 500 Composite Index, (Monthly Average): Wall Street Journal.

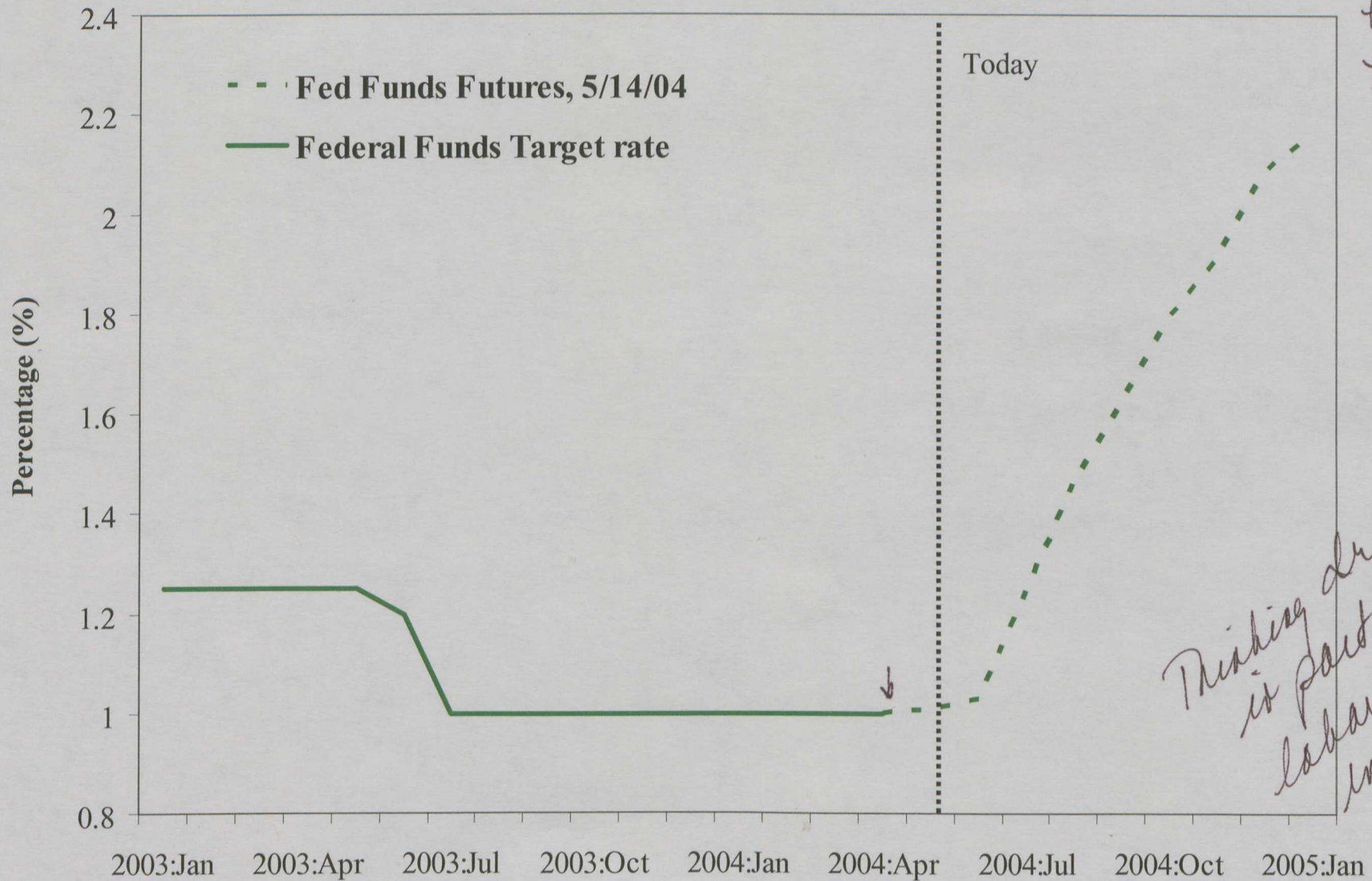
More broadly, policy-induced growth is being replaced by private spending



Source: Real Gross Domestic Product, (SAAR, Bil. Chn. 2000\$): Bureau of Economic Analysis. Federal Reserve Bank of Boston estimates.

We expect the recovery to be increasingly privately-driven !

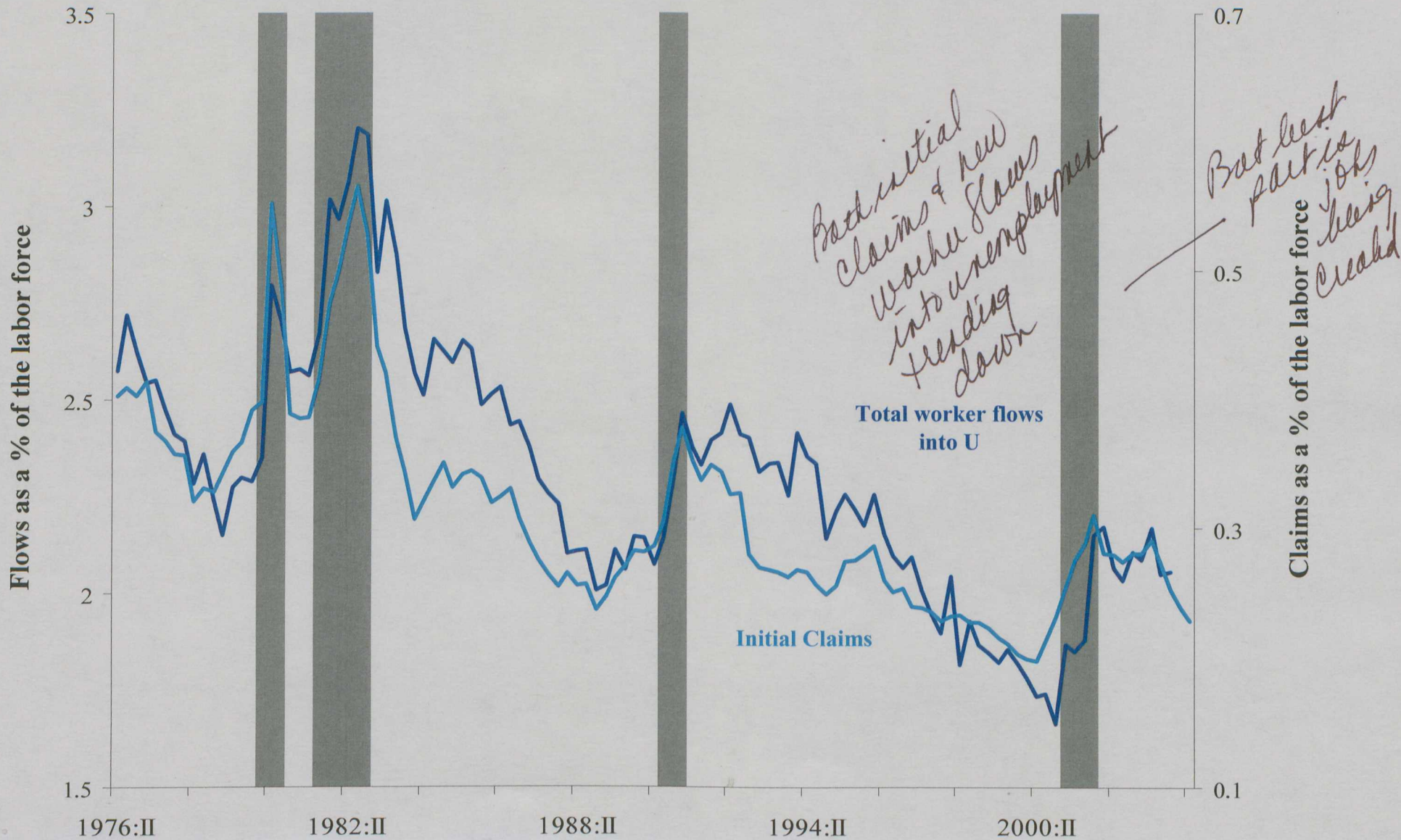
The effect of tax refunds will wane later this year, and financial markets see the Fed raising rates soon



Source: Federal Funds Target Rate (%): Federal Reserve Board.

Labor Markets are Improving

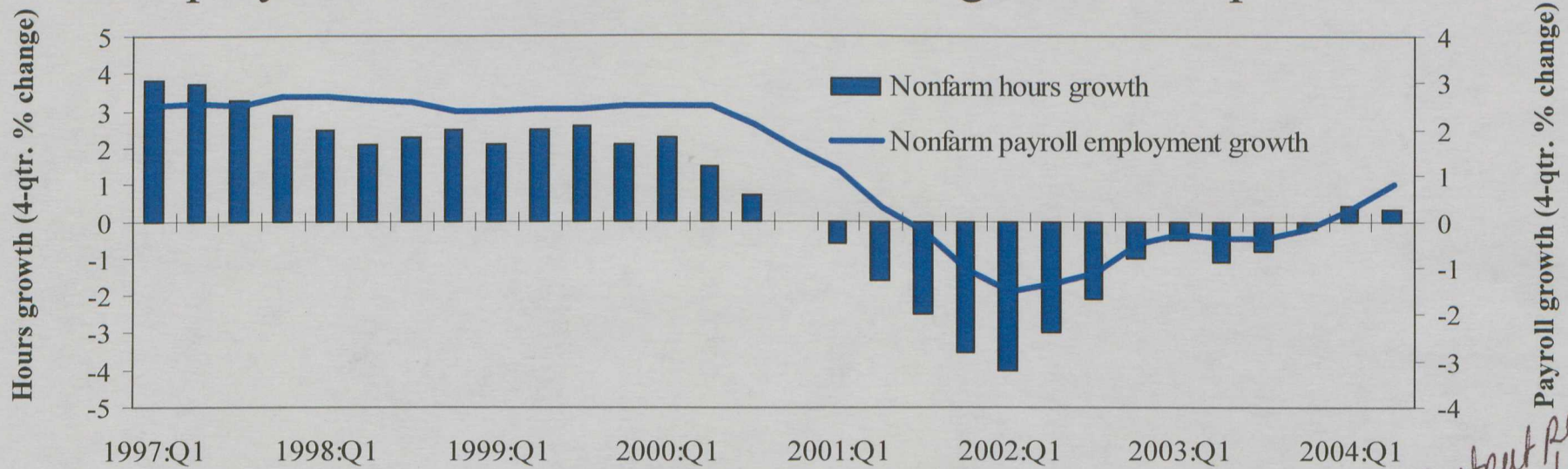
Layoffs have been declining for a while



Sources: Initial Claims for Unemployment Insurance, State Programs, (Wkly Average, SA): Department of Labor. Employment flows based upon Current Population Survey data along with author's calculations.

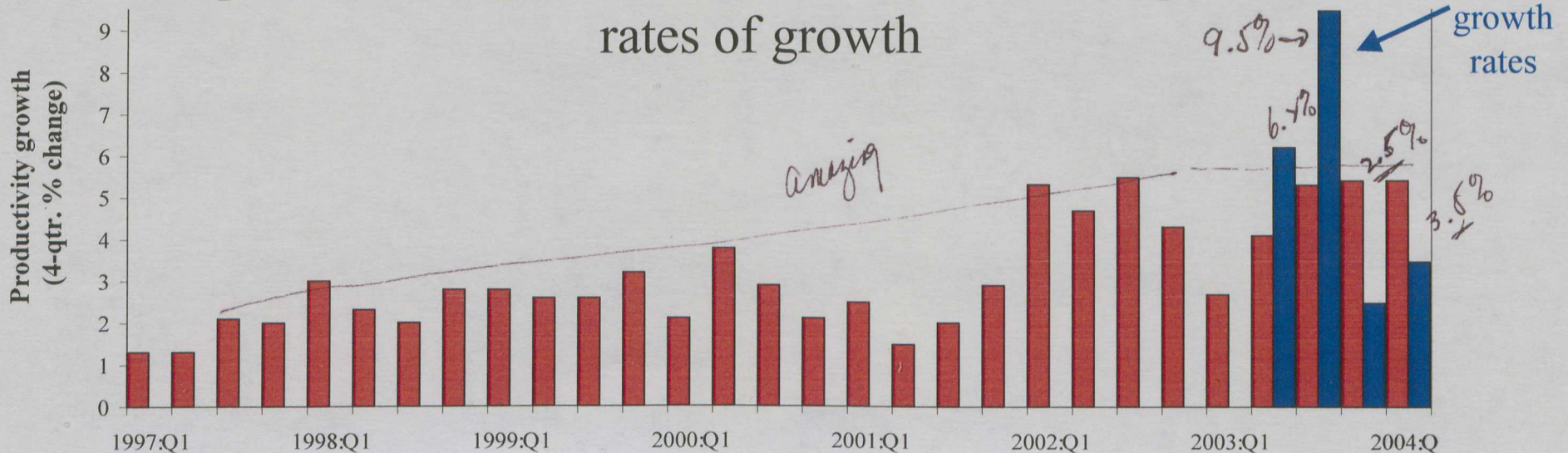
And Now Hiring Appears to Have Turned the Corner

Employment and hours have shown significant improvement



*output per hour
Q1/Q1
Qtly. 5.3%*

As productivity growth has receded to merely spectacular rates of growth

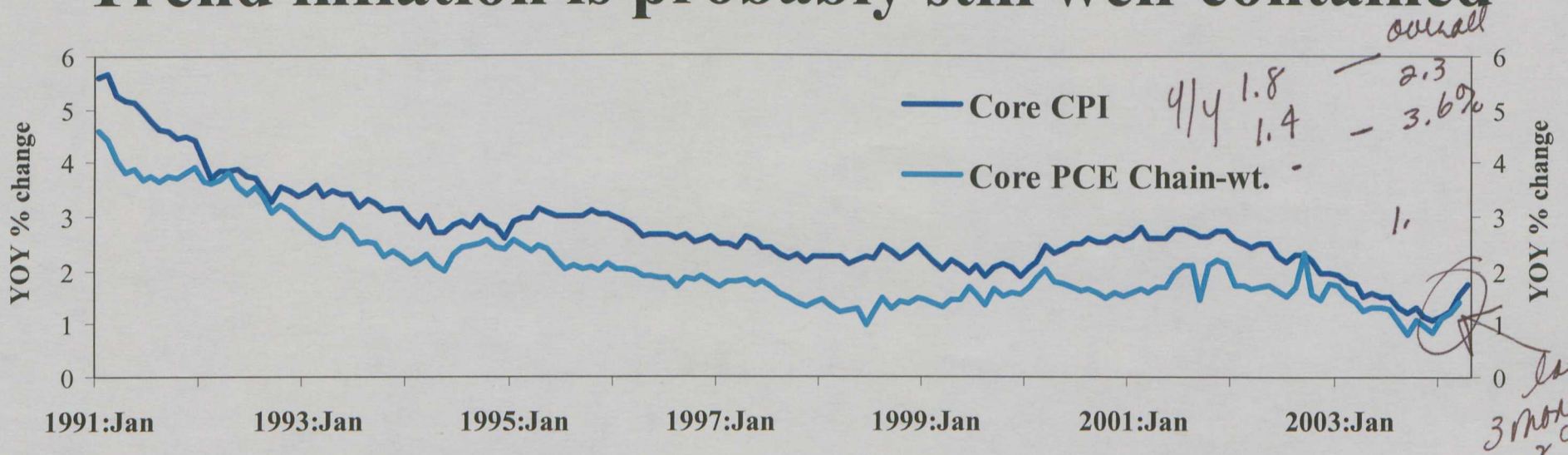


Source: Nonfarm Business Sector: Output per Hour, Hours of All Persons, Total Nonfarm Employment, (SA): Bureau of Labor Statistics.

Is inflation an issue?

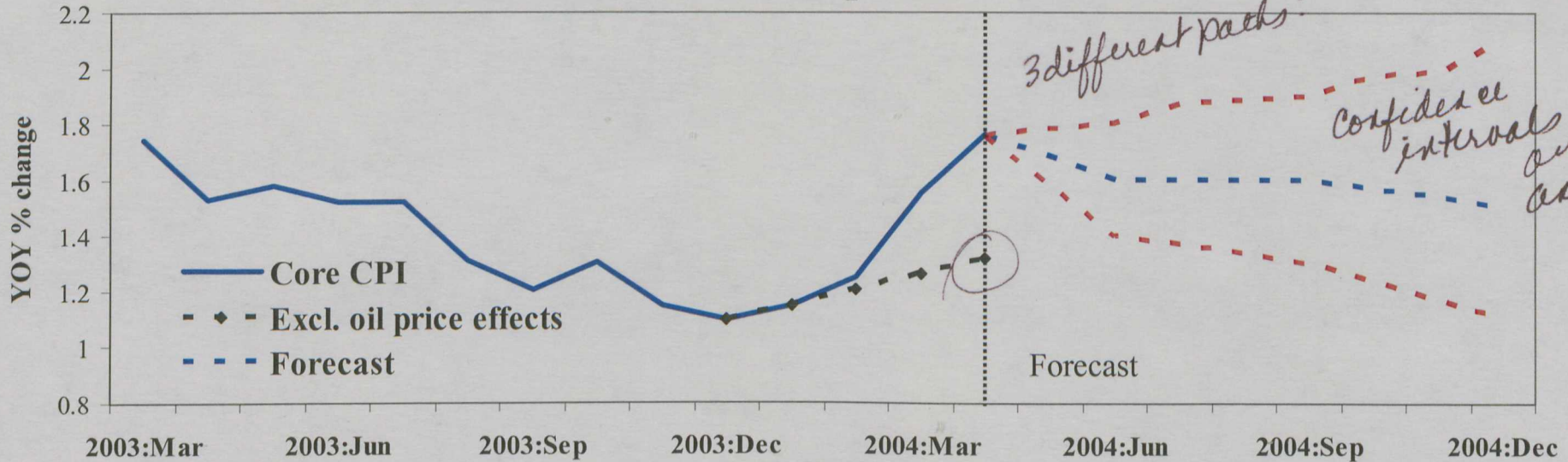
- Some commodity prices have risen sharply
- Core inflation has edged up, although still low
- Is this cause for worry? Probably not

Trend inflation is probably still well-contained



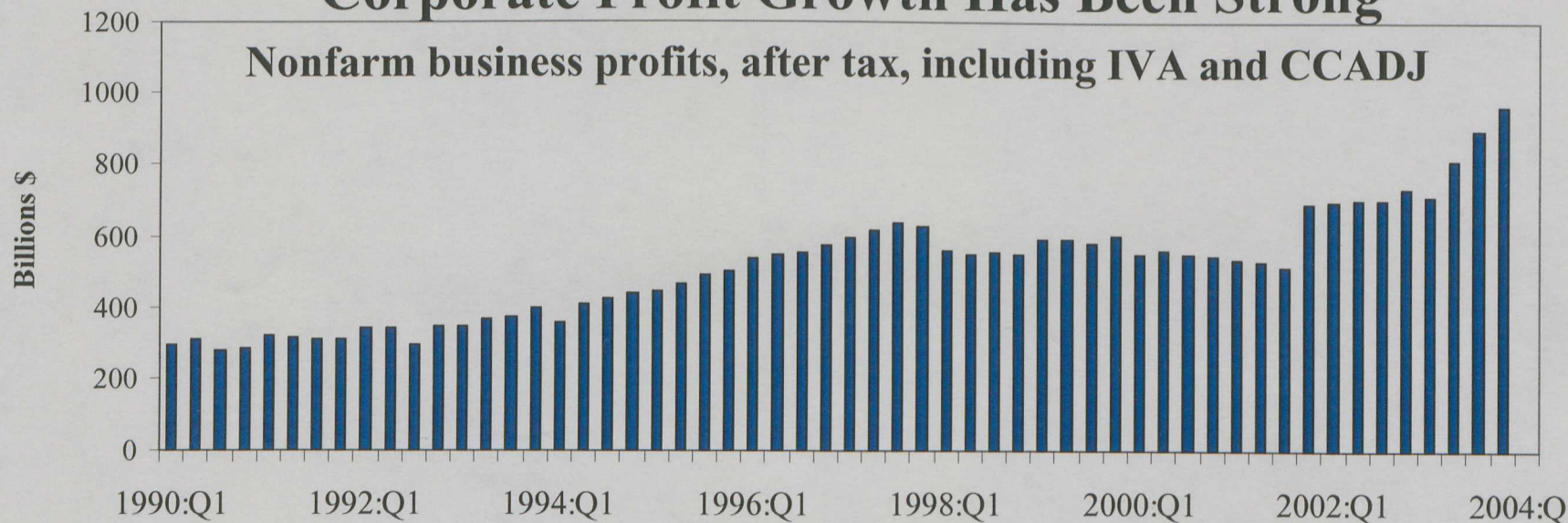
last 3 months - core
 .7
 .3
 .9 x 4
 3.6%
 overall 4%
 1.0 = 4%

Much of the recent rise in core inflation is pass-through of oil prices and other one-time price increases

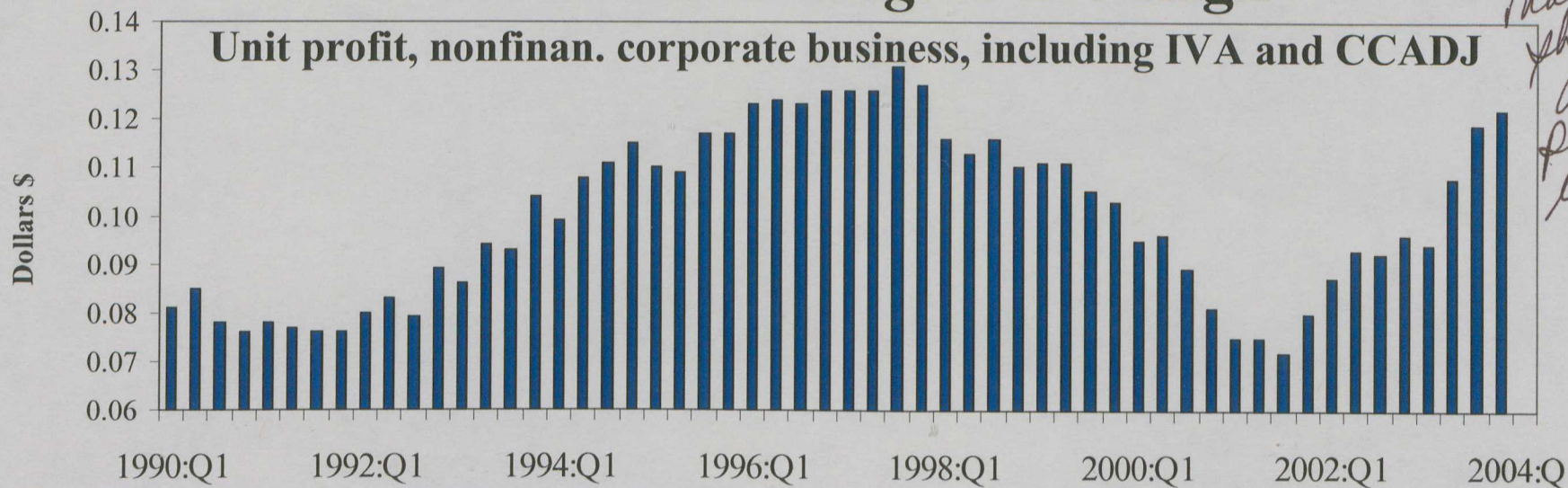


Sources: CPI-U All Items Less Food & Energy, (SA, 1982-84=100): Bureau of Labor Statistics. PCE Less Food & Energy Chain Price Index, (SA, 2000=100): Bureau of Economic Analysis.

Restraining forces on inflation: Corporate Profit Growth Has Been Strong



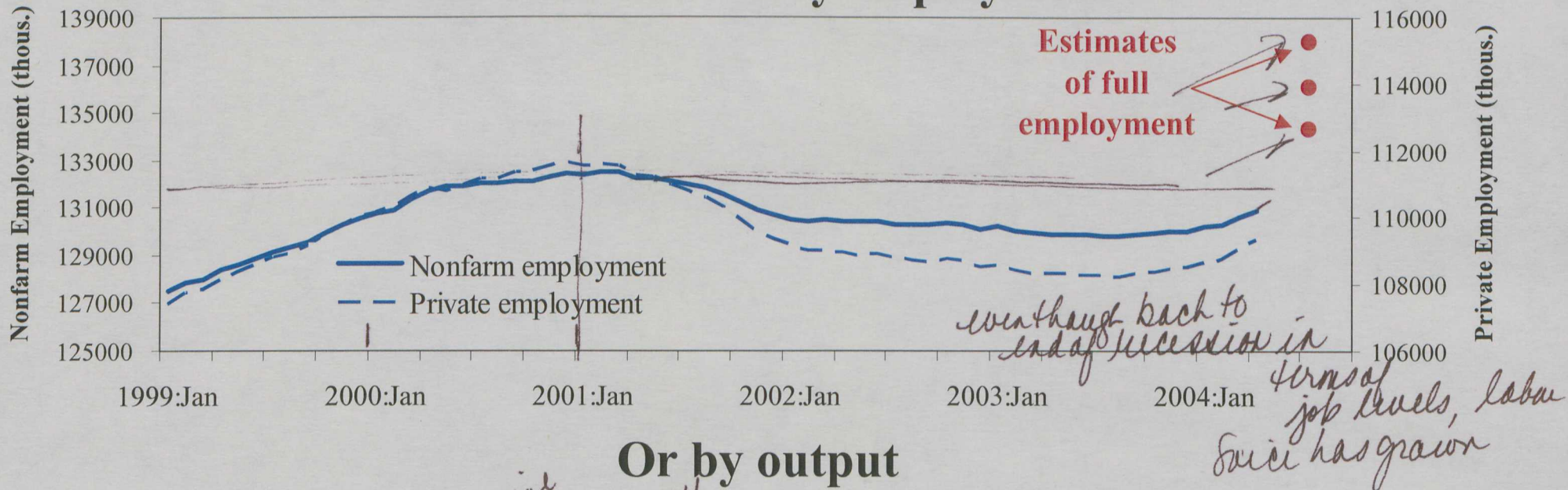
And Profit Margins are High



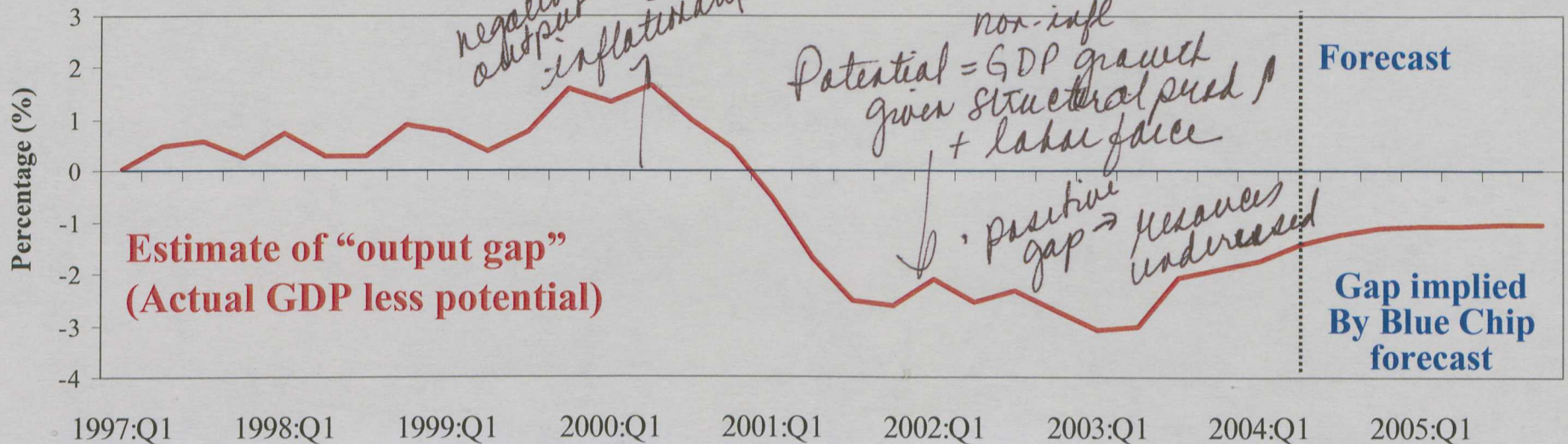
Profit margins should accommodate price increases

Source: Corporate Profits After Tax with IVA and CCAdj (SAAR, Billions \$), Corporate Profits with IVA and CCAdj per Unit of Real Gross Value Added of Nonfinancial Corporate Business (SA): Bureau of Economic Analysis.

Restraining forces on inflation: Economic slack is likely to persist for another year or so, whether measured by employment



Or by output



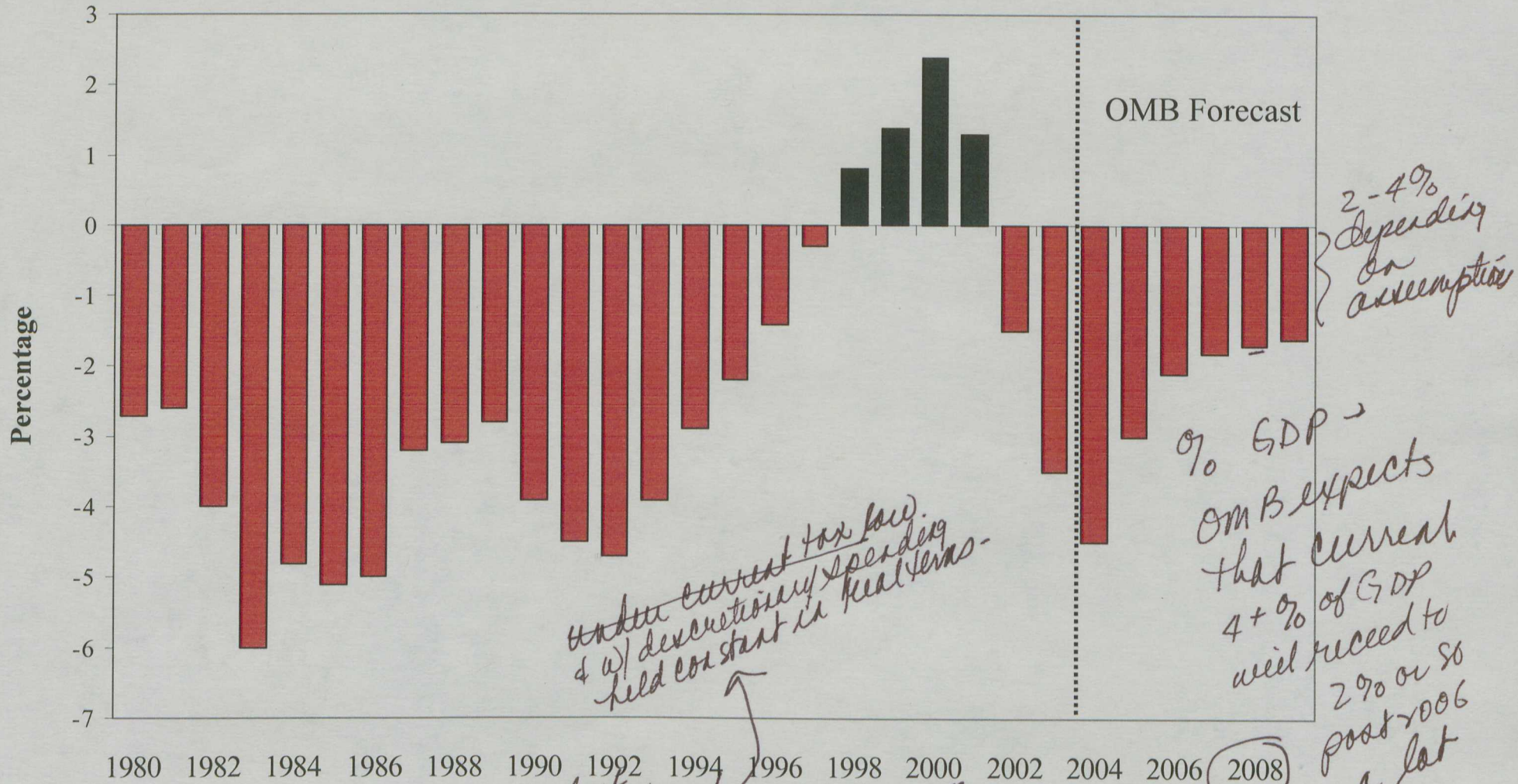
Sources: Total Nonfarm and Total Private Nonfarm Employment (SA, Thousands): Bureau of Labor Statistics. Real Gross Domestic Product (SAAR, Chained 2000\$): Bureau of Economic Analysis. Real Potential Gross Domestic Product, (Chained 2000\$): Congressional Budget Office. Forecast: Blue Chip Economic Indicators.

Risks

- **Inflation – likely to remain low; risks fairly balanced**
 - Recent increases largely due to one-time factors
 - Significant economic slack remains
- **Real growth – likely to remain solid; risks fairly balanced**
 - As tax cuts fade, we expect strong employment growth to create income, support spending
 - Some uncertainty about employment forecast
 - Some uncertainty about geopolitical situation

What About Deficits?

Federal budget deficit/surplus as % of GDP, with OMB projections



Source: Federal Deficit/Surplus as a Percent of GDP (Fiscal year, %): Office of Management and Budget.

President's budget - tax cuts permanent

under current tax law & w/ discretionary spending held constant in real terms

*another scenario
July 08 - 4% -
Reform AMT &
Disc Spending =
GDP growth*

2-4% depending on assumption

% GDP - OMB expects that current 4+ % of GDP will succeed to 2% or so post 2006

depends on a lot of assumptions

*Real action 01/21/19
Balance - (-5%)*

Deficits are a long run concern, not a near term problem

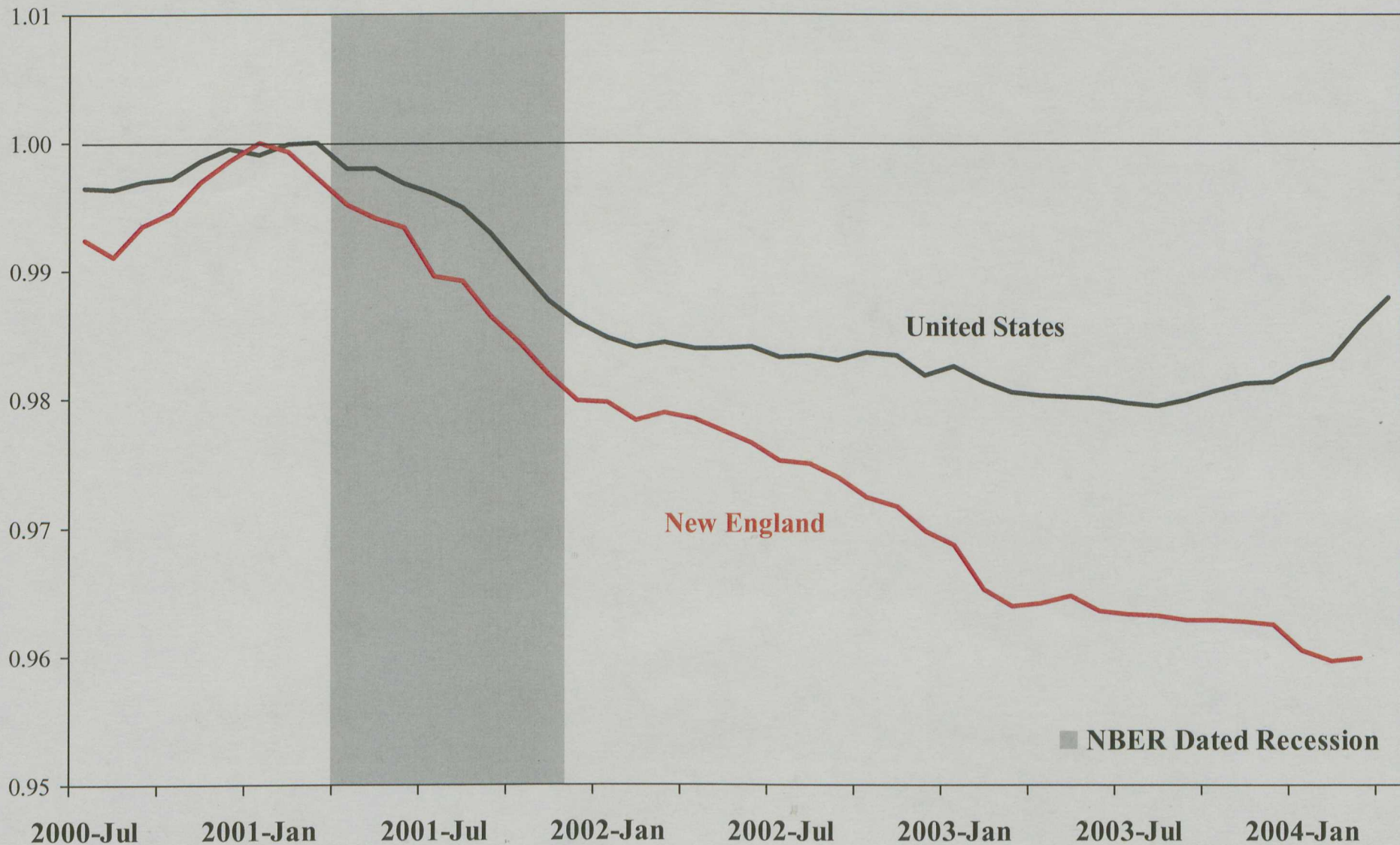
- **Will deficits cause inflation?**
 - Still have some economic slack despite growth in federal spending
 - Our forecasts for next few years indicate solid growth, fairly stable inflation, and a declining deficit/GDP ratio
- **Will deficits crowd out investment?** - Maybe
 - Long term interest rates should already reflect what we know about the path of deficits
 - Near-term outlook for investment is positive

How is New England faring?

- Suffered greater employment losses than the nation in the recession; losses continued in the “recovery”
- Turnaround is beginning – slower than nationally
- Within the region, some states are doing much better than others

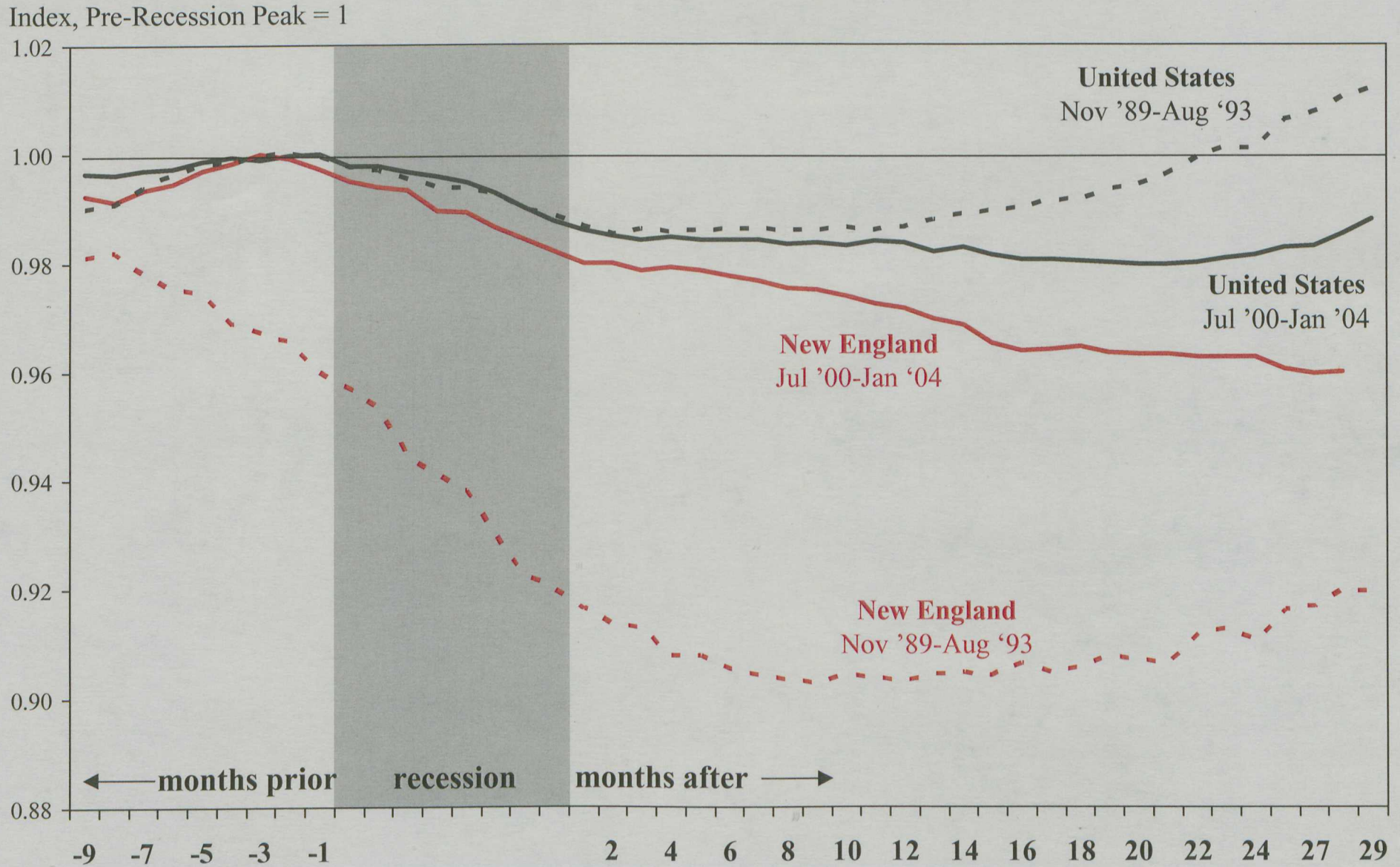
Employment has fallen more in New England than the Nation

Index, Pre-Recession Peak = 1



Source: U.S. Bureau of Labor Statistics, seasonally adjusted data.

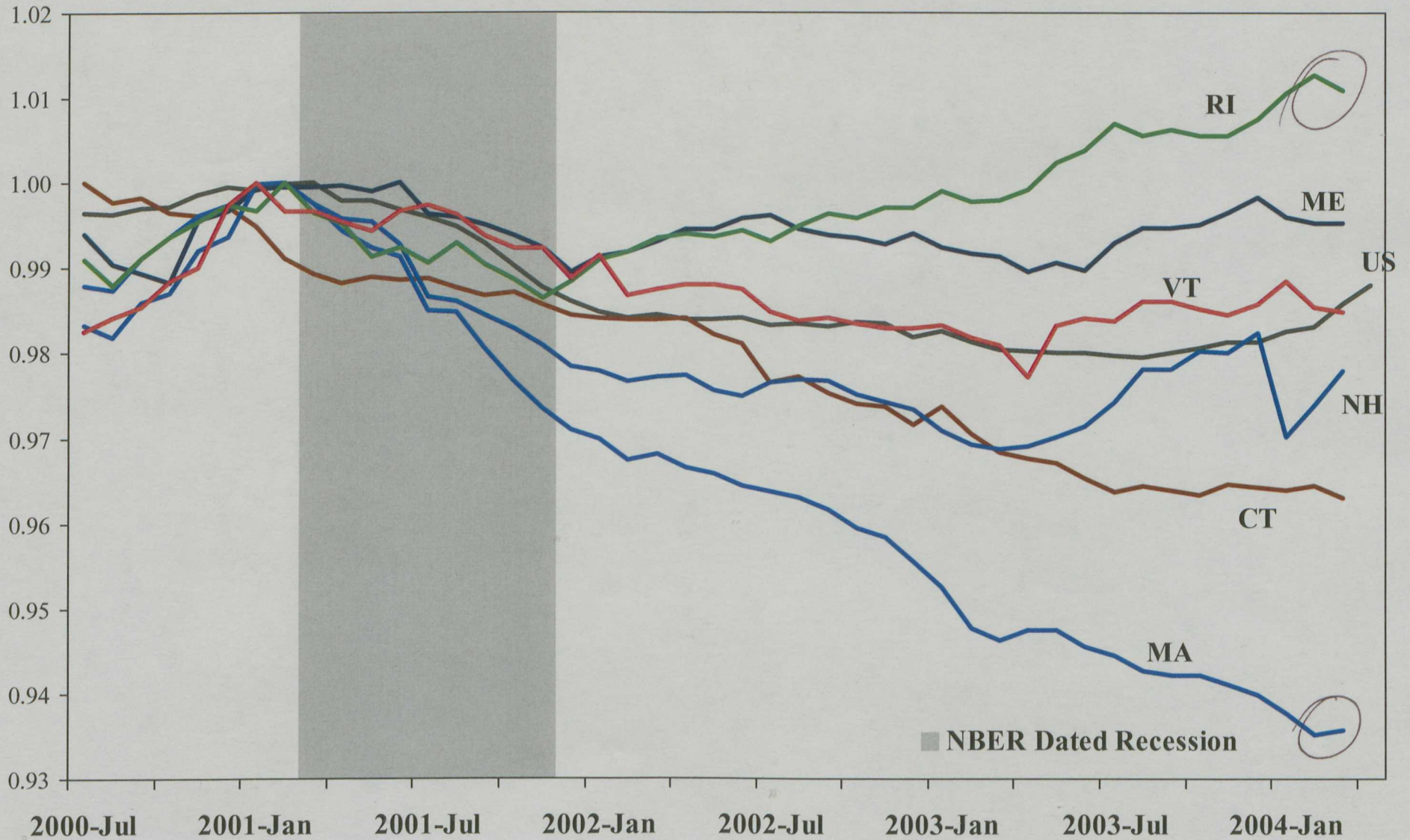
But weakness is much less severe than early 1990s (dotted lines)



Source: U.S. Bureau of Labor Statistics.

Considerable variation among the New England states – Massachusetts hit hardest, Rhode Island showing minimal job losses

Index, Pre-Recession Peak = 1



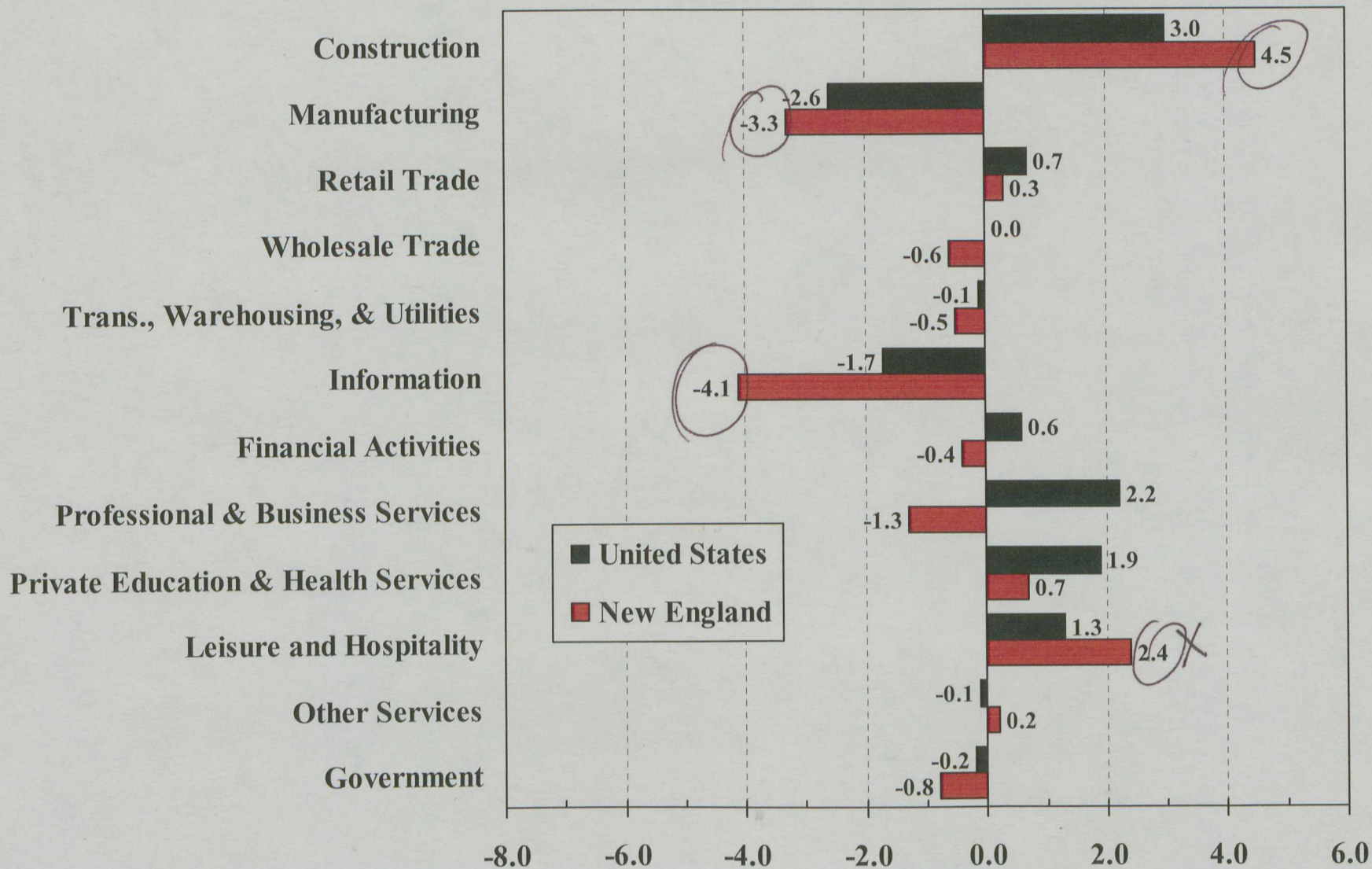
Source: U.S. Bureau of Labor Statistics.

Why is New England faring worse?

- Steeper losses in recession attributable to national weakness in key regional industries:
 - software and other technology services
 - communications
 - computers and other capital goods
- Steadier sectors important in New England, such as private education and health services, not strong enough to offset

In past year, manufacturing, information and professional services lost jobs; Gains in construction and hospitality

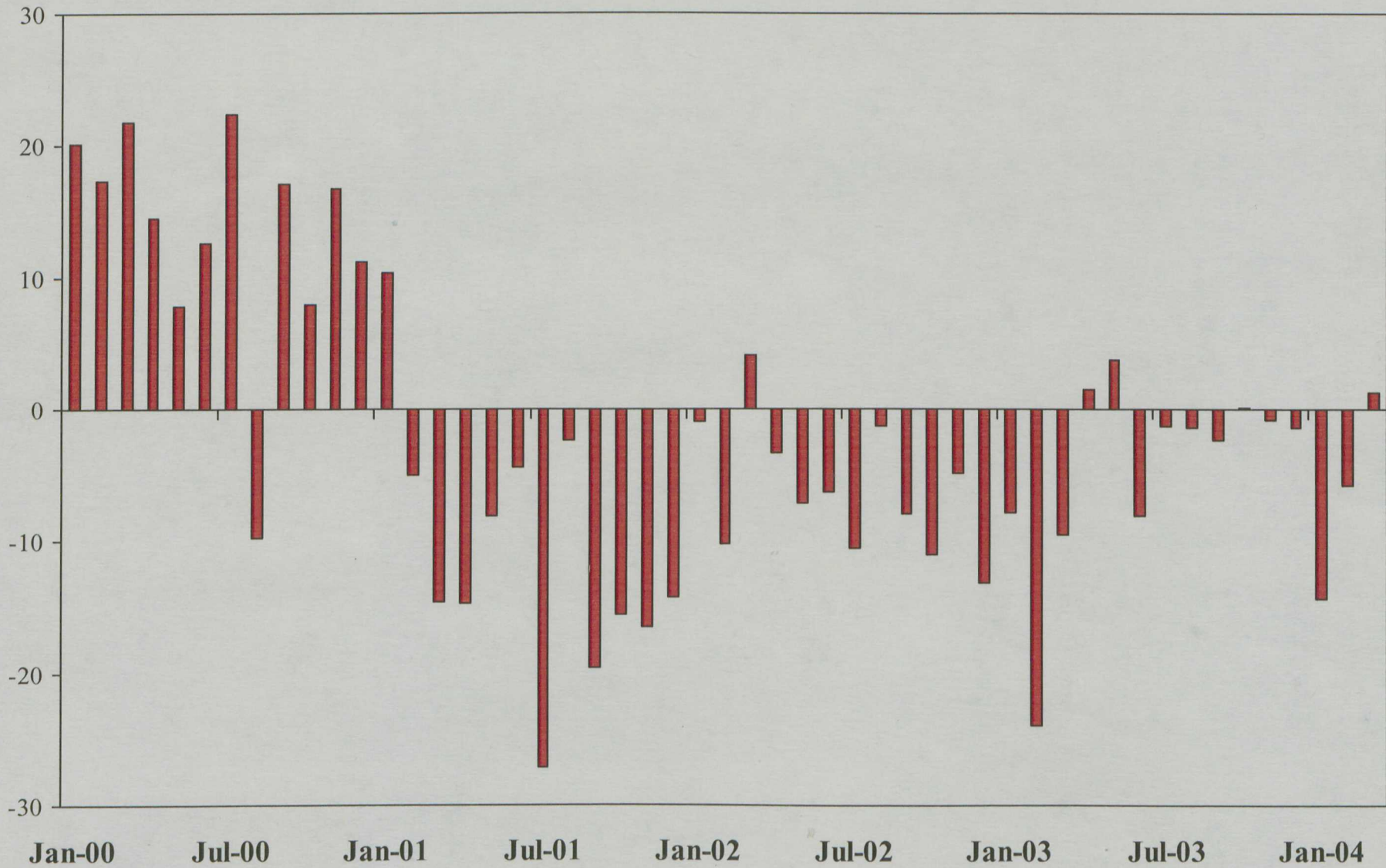
Percent Change, March 2003 – March 2004



Source: U.S. Bureau of Labor Statistics.

For all New England, job losses have moderated

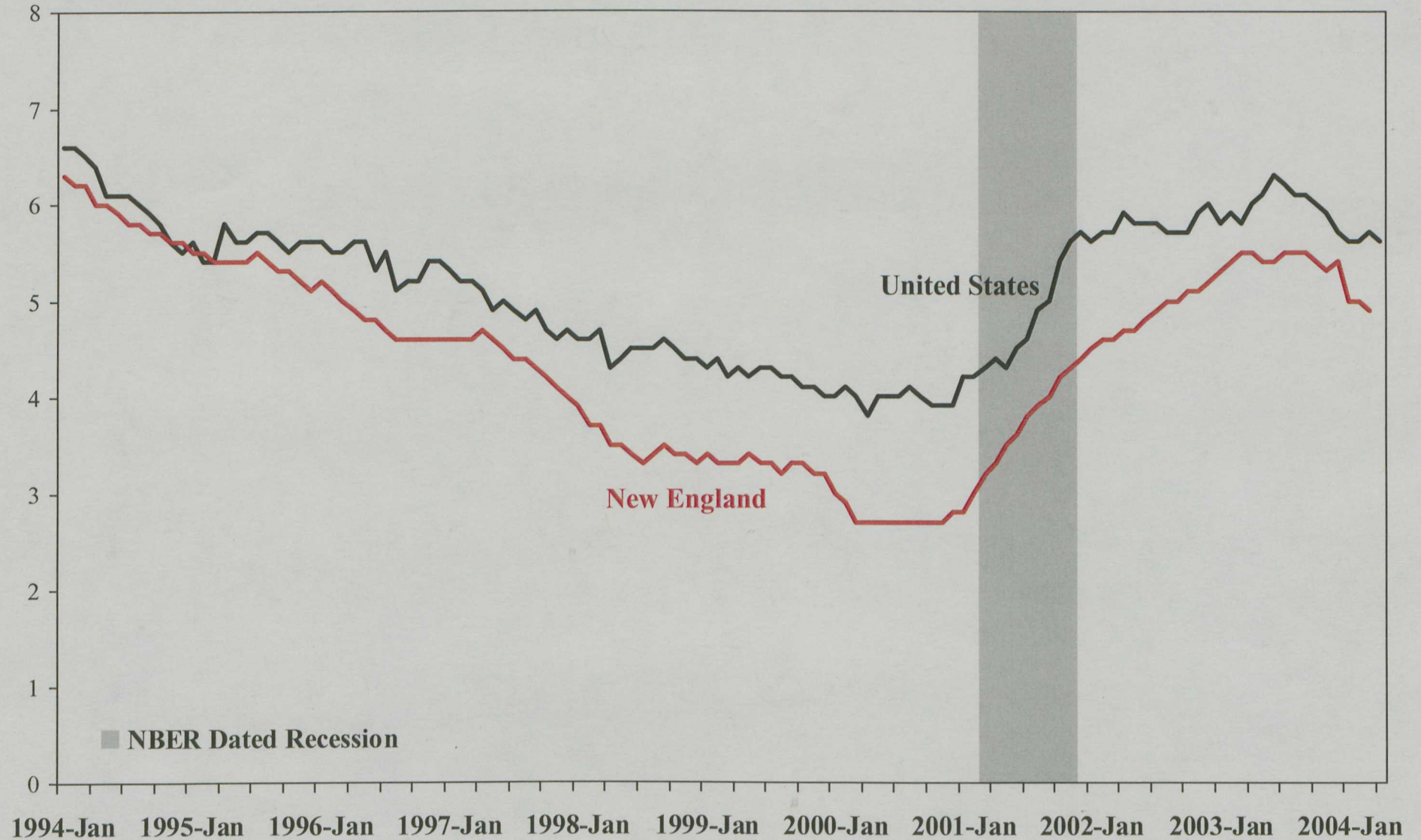
Thousands of Jobs



Source: U.S. Bureau of Labor Statistics.

Unemployment is coming down in the region

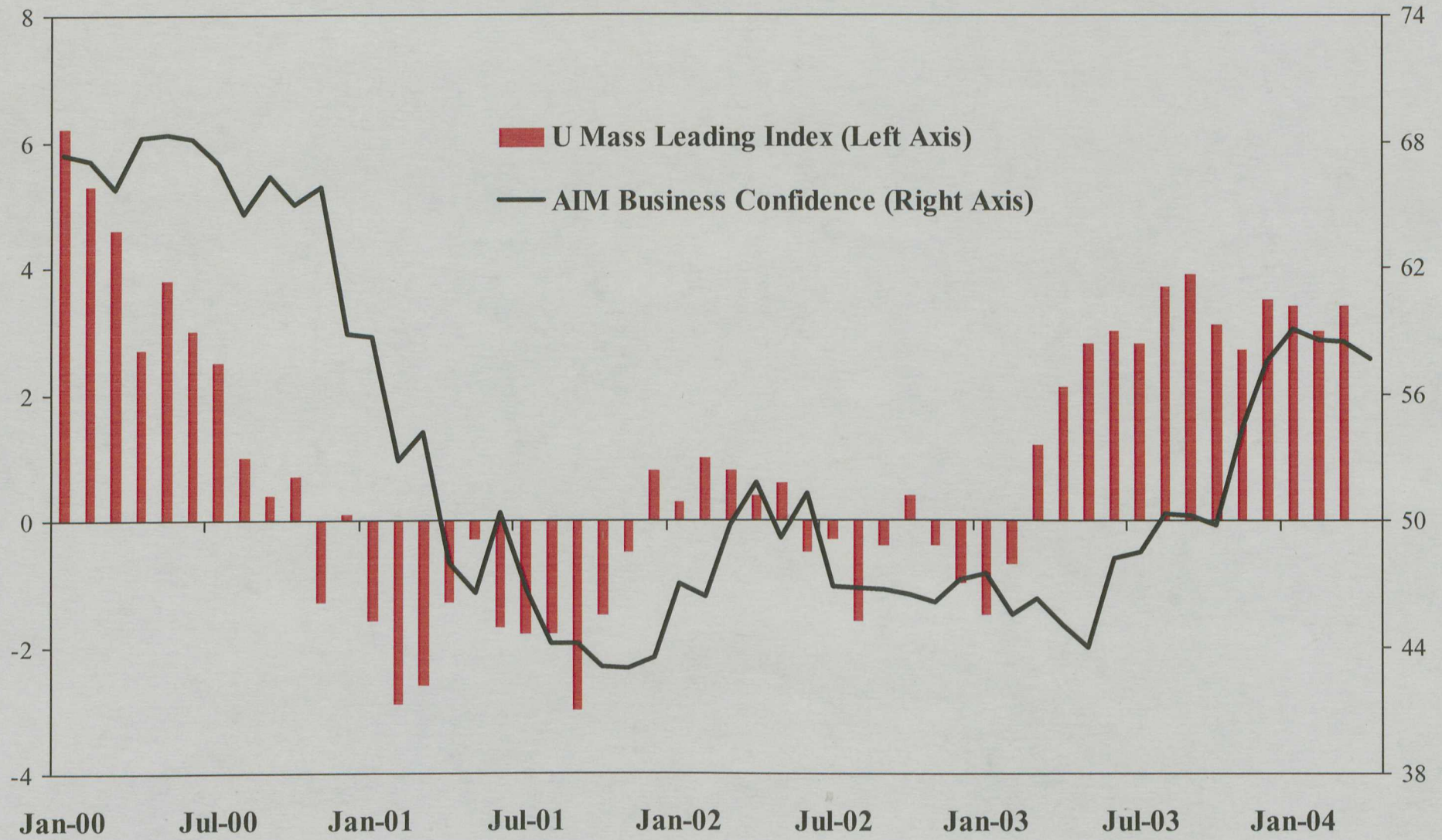
Percent, Seasonally Adjusted



Source: U.S. Bureau of Labor Statistics.

Confidence is rising in New England

Index of leading indicators for Massachusetts points to growth



Source: Associated Industries of Massachusetts and the University of Massachusetts.

Key factor in regional outlook continues to be national economy, but New England lags

- Regional recovery will continue, following nation
- Pace of region's recovery is contingent on national (and global) economy → hence regional pace likely to speed up

Boston Fed Experience

- According to our own HR department,
 - recent falloff in job applicants
 - less desperation, more negotiation
 - counter-offers and turndowns
- “The tide is turning”