

Economic Outlook

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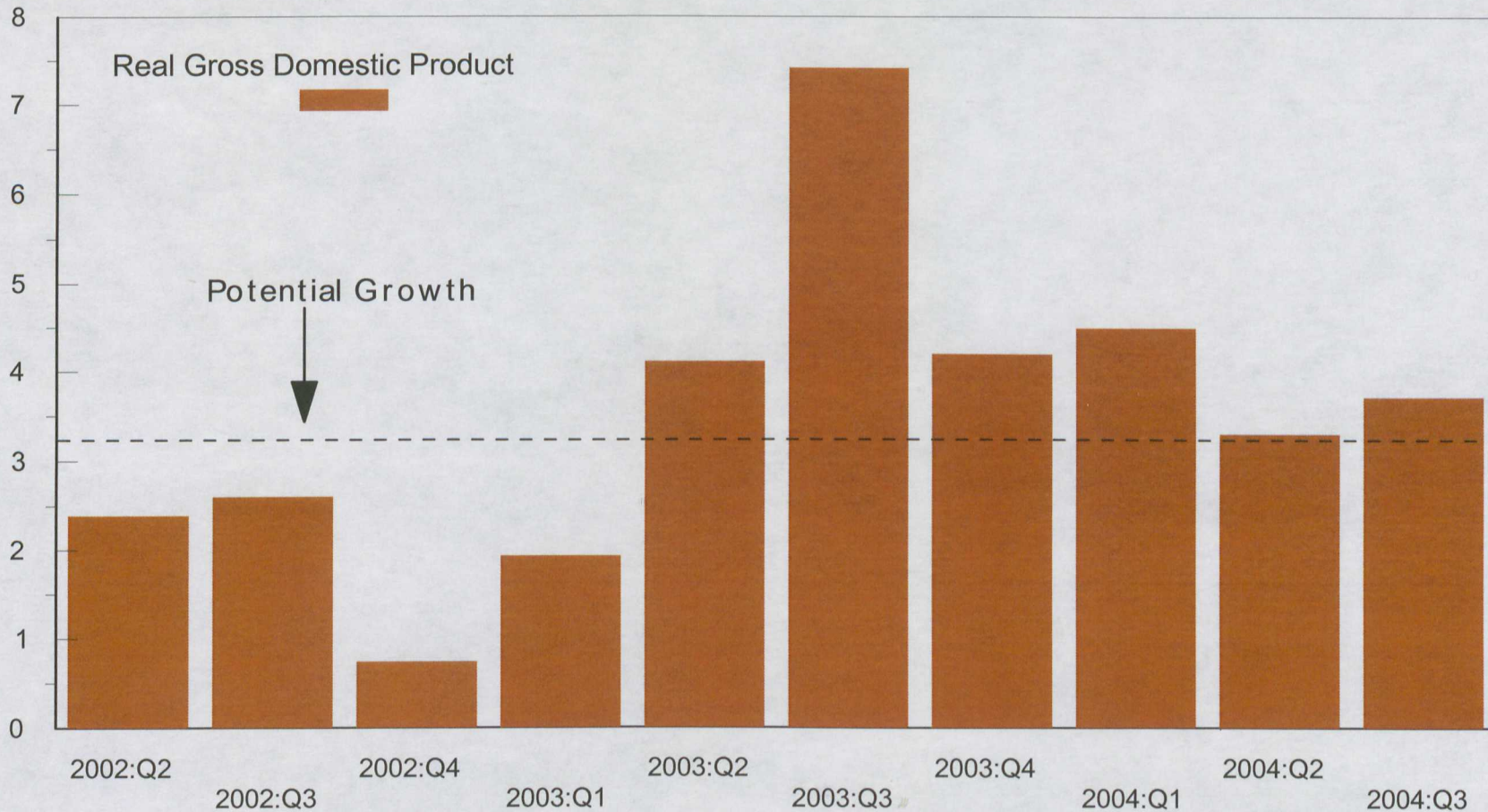
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A Turbulent Ride, But a Soft-Landing?

- The long awaited soft-landing – where output grows at potential and the economy is at full-employment appears to be within our grasp.
- Certainly, GDP growth over the past two years looks like a recovery.
- But the slow employment growth prevented any talk of a soft-landing.
- The recent employment data, along with most forecasts of economic growth, suggest we may very well be on course for a three-point landing.

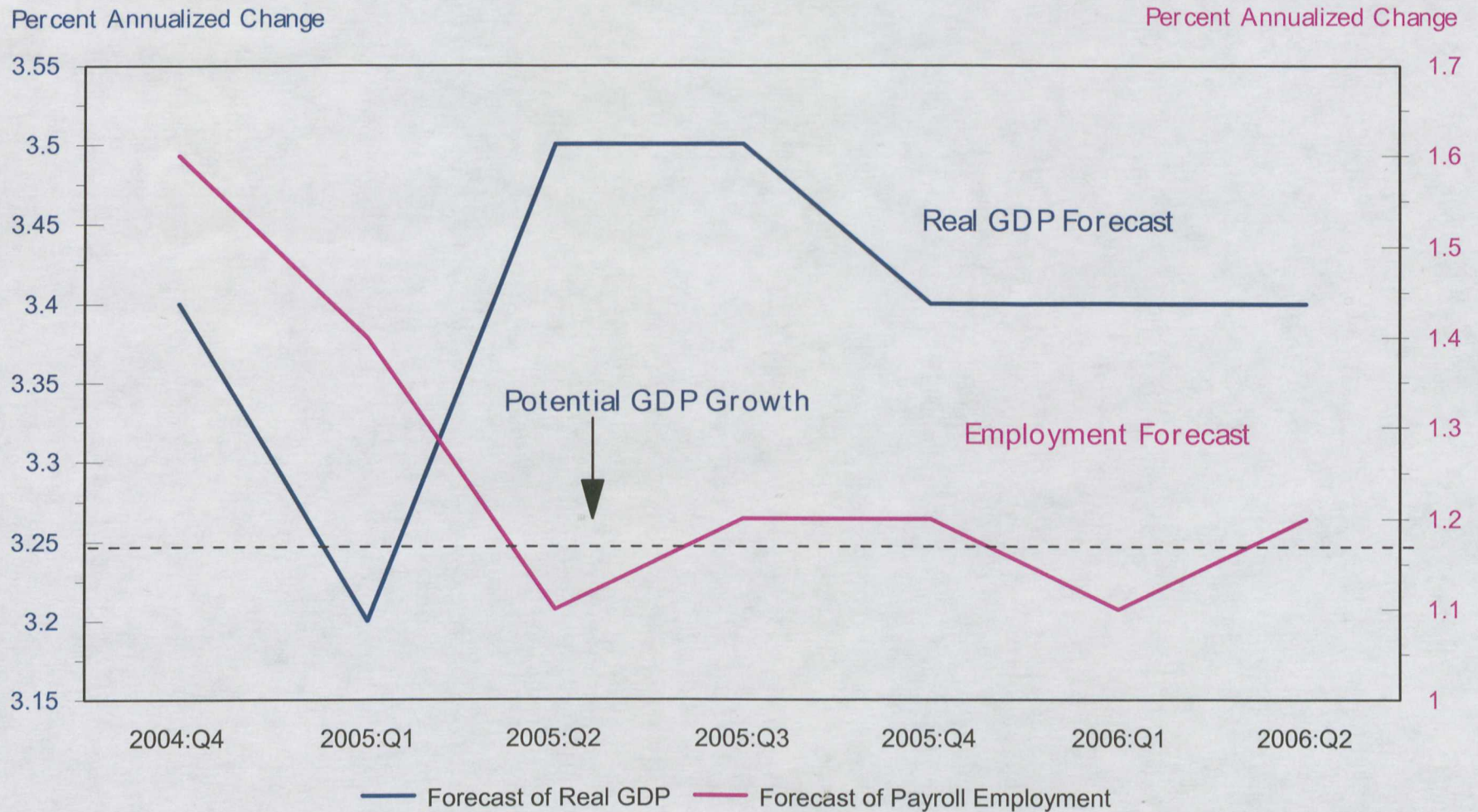
For the past 2 years, GDP has grown at, or above, potential – a recovery.

Percent Annualized Change



Source: Bureau of Economic Analysis.

And the consensus forecast calls for more of the same - a soft-landing.

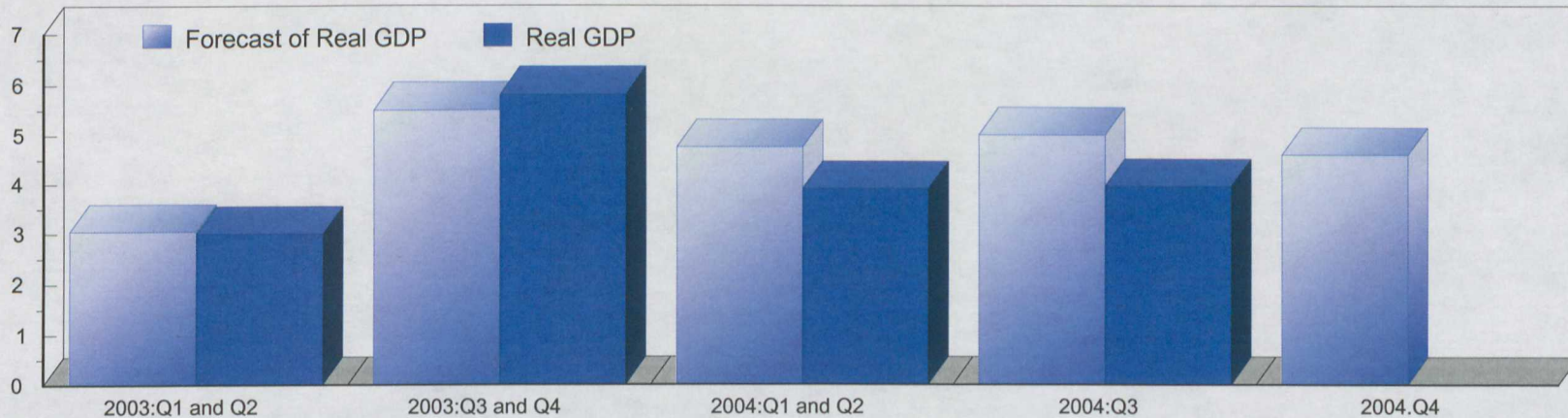


Source: Consensus Forecasts.

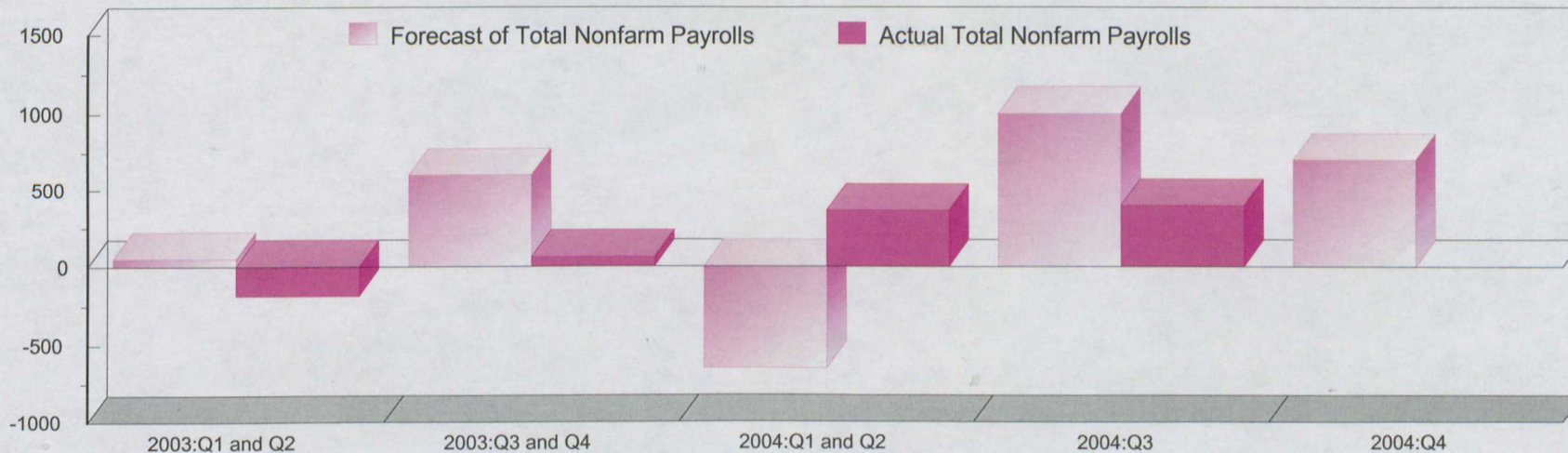
But we have seen this forecast for the past two years, and it was only half right.

GDP and Employment: Forecast and Actuals (2003 and 2004)

Percent Annualized Change



Monthly Change, Thousands

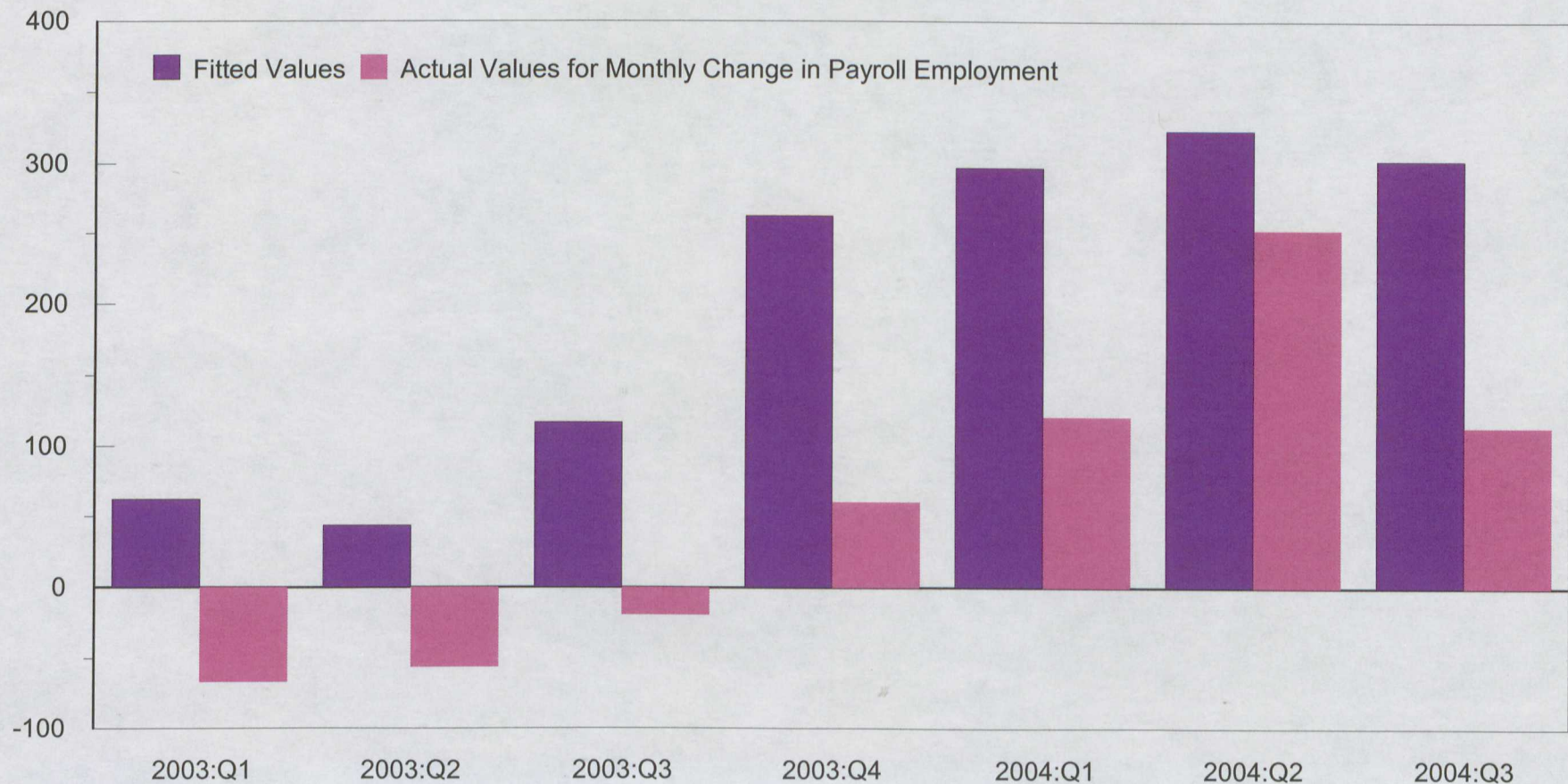


Source: Global Insight.
Bureau of Economic Analysis.

*The lack of employment growth has been a puzzle;
given actual expansion in GDP we would have
expected much more job creation.*

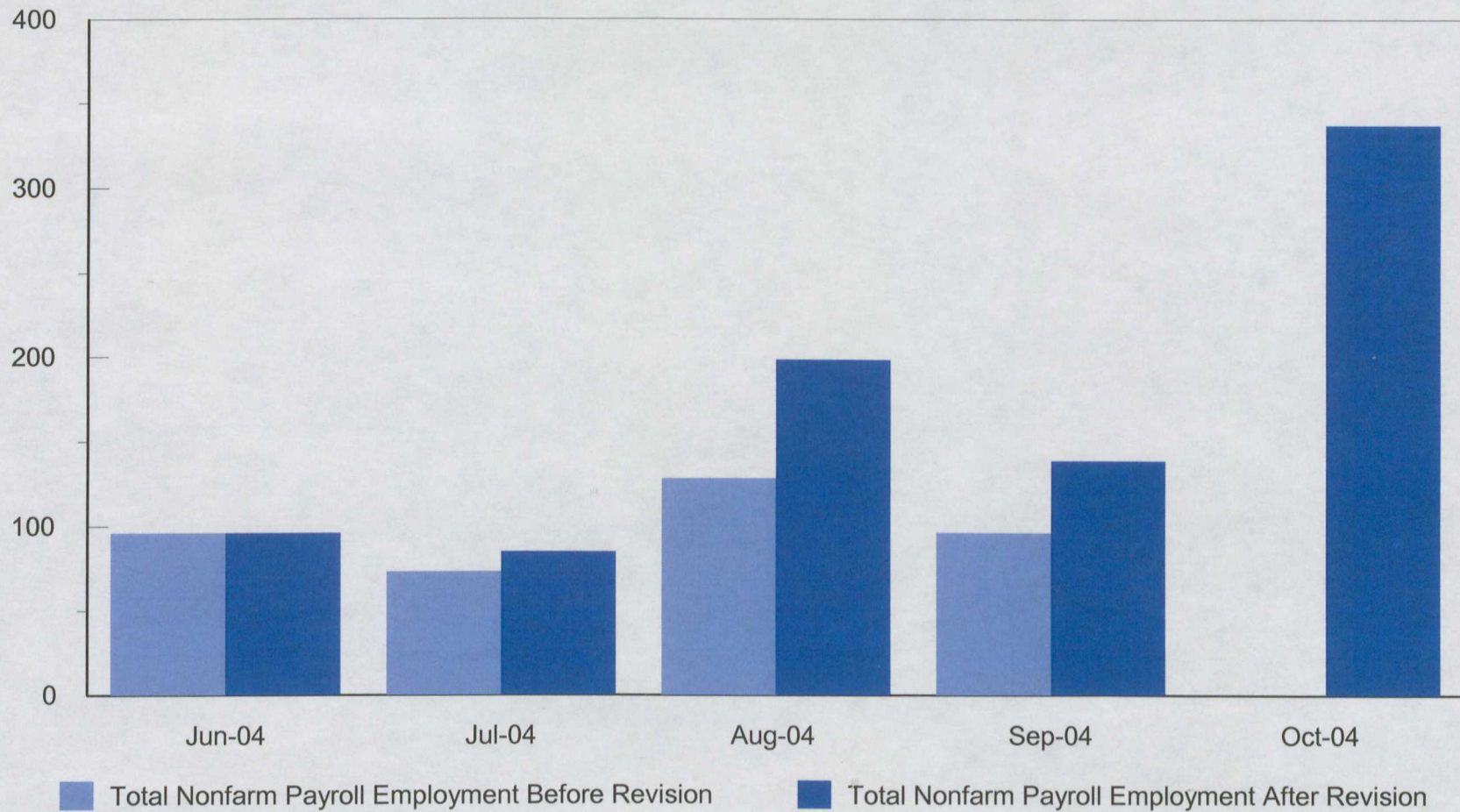
Monthly Change, Thousands

Nonfarm Payroll Employment



However, the recent employment numbers suggest this puzzle may be at an end.

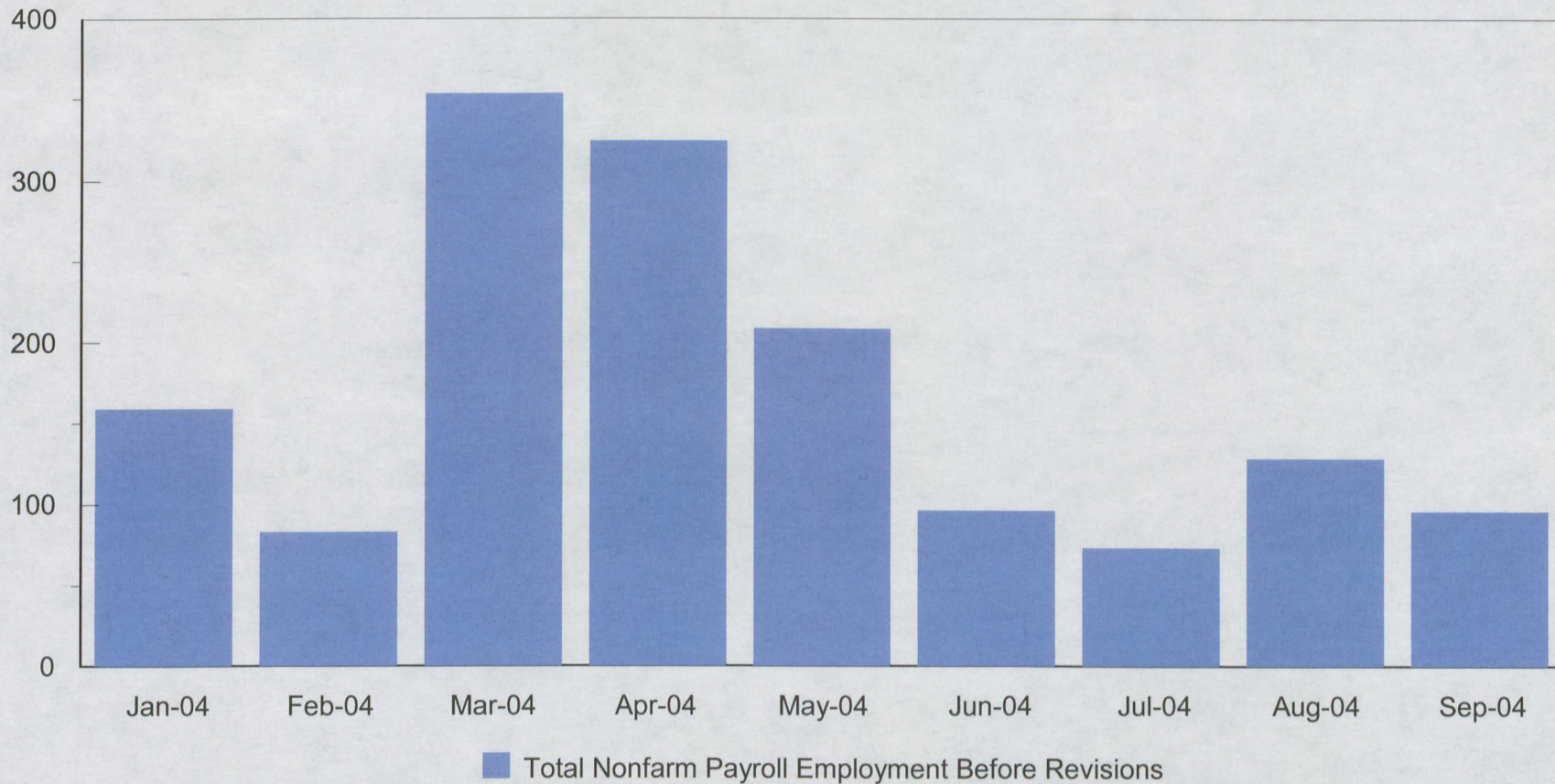
Monthly Change, Thousands



Source: Bureau of Labor Statistics.

Although employment has sent us false signals before.

Monthly Change, Thousands

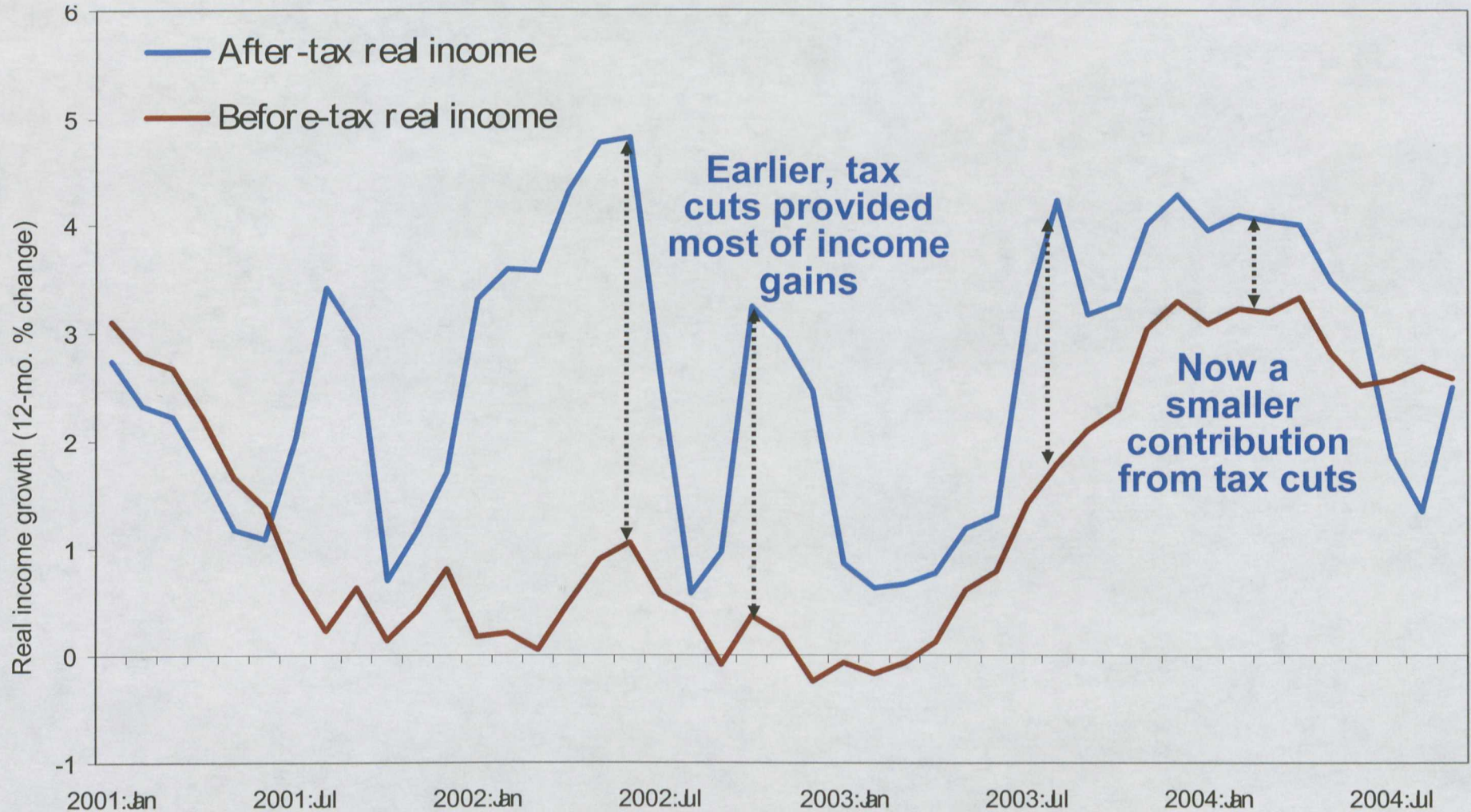


Source: Bureau of Labor Statistics.

When will the employment puzzle disappear?

- Which was the false signal, the low employment growth of the summer, or the higher growth of the fall?
- Although employment has failed to grow as GDP growth would have expected, it is still our best bet that the two will move together in the future.
- Thus, job creation will be strong if GDP growth is robust. But how sure are we that the economy will continue to expand as it has over the past two years?

We've progressed from a policy-supported to a privately-supported recovery

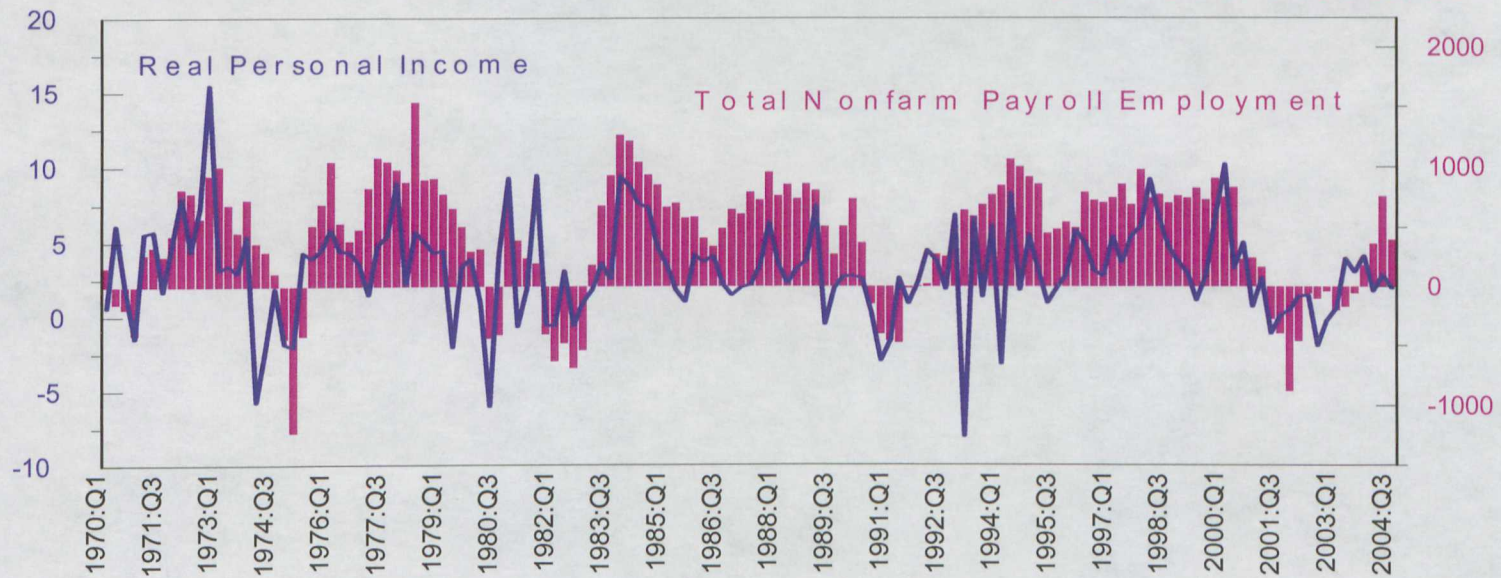


As tax cuts fade, continued household income growth depends on solid employment growth

Source: Real Disposable Personal Income, Real Personal Income (SAAR, Billions Chn, 2000P), Bureau of Economic Analysis.

Percent Annualized Change

Difference: Quarter to Quarter, in Thousands

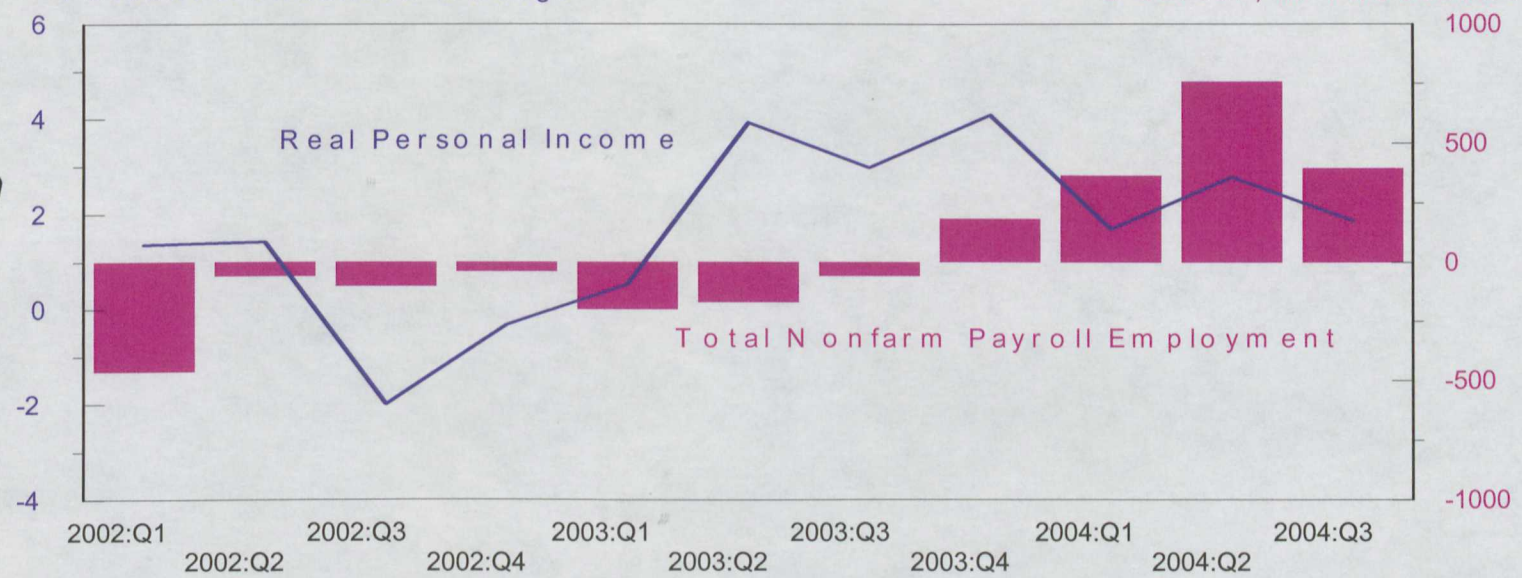


Privately-driven income growth depends on employment growth.

Recently employment growth has propelled income.

Percent Annualized Change

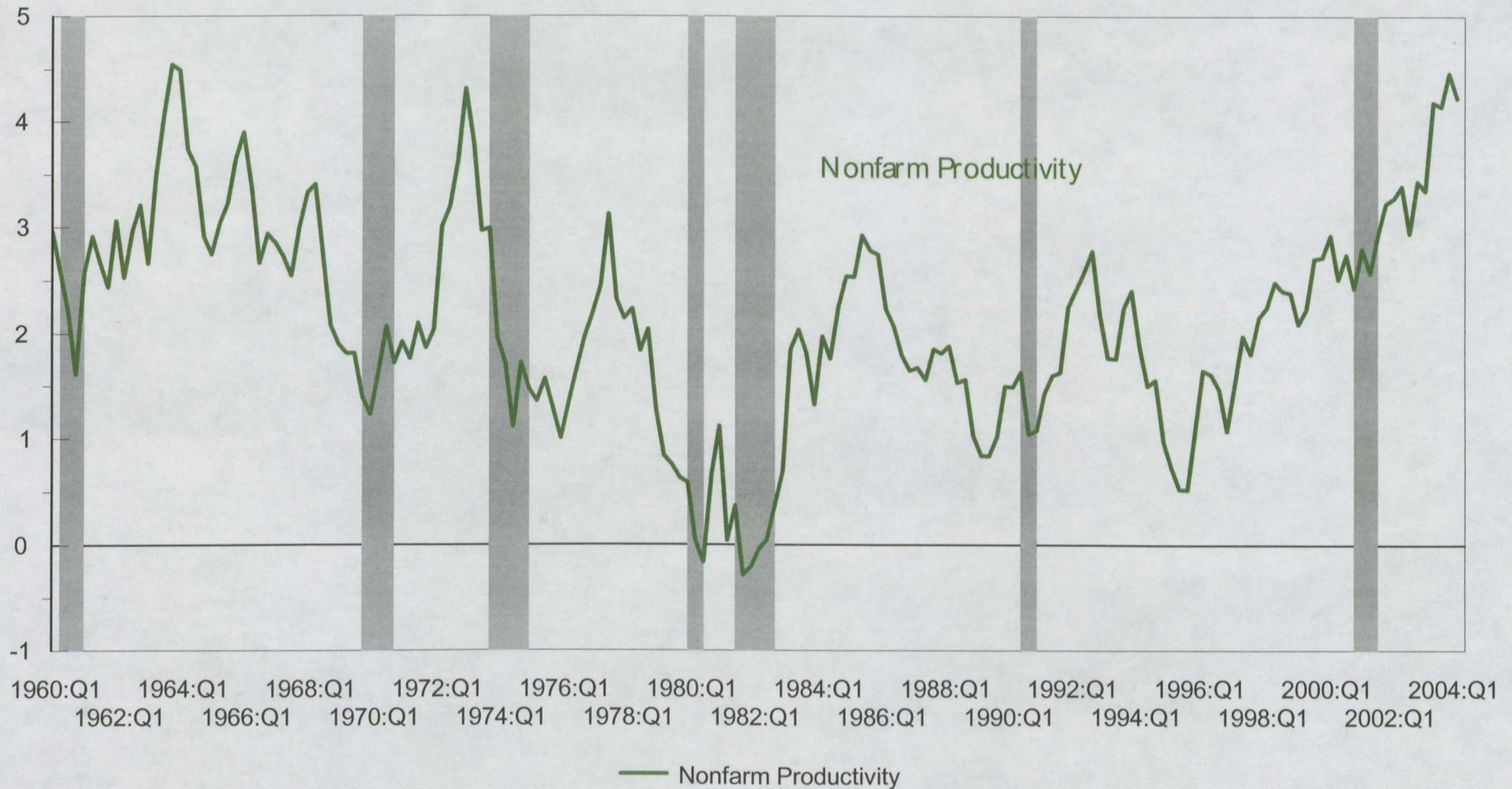
Difference: Quarter to Quarter, in Thousands



Source: The Conference Board.
Bureau of Labor Statistics.

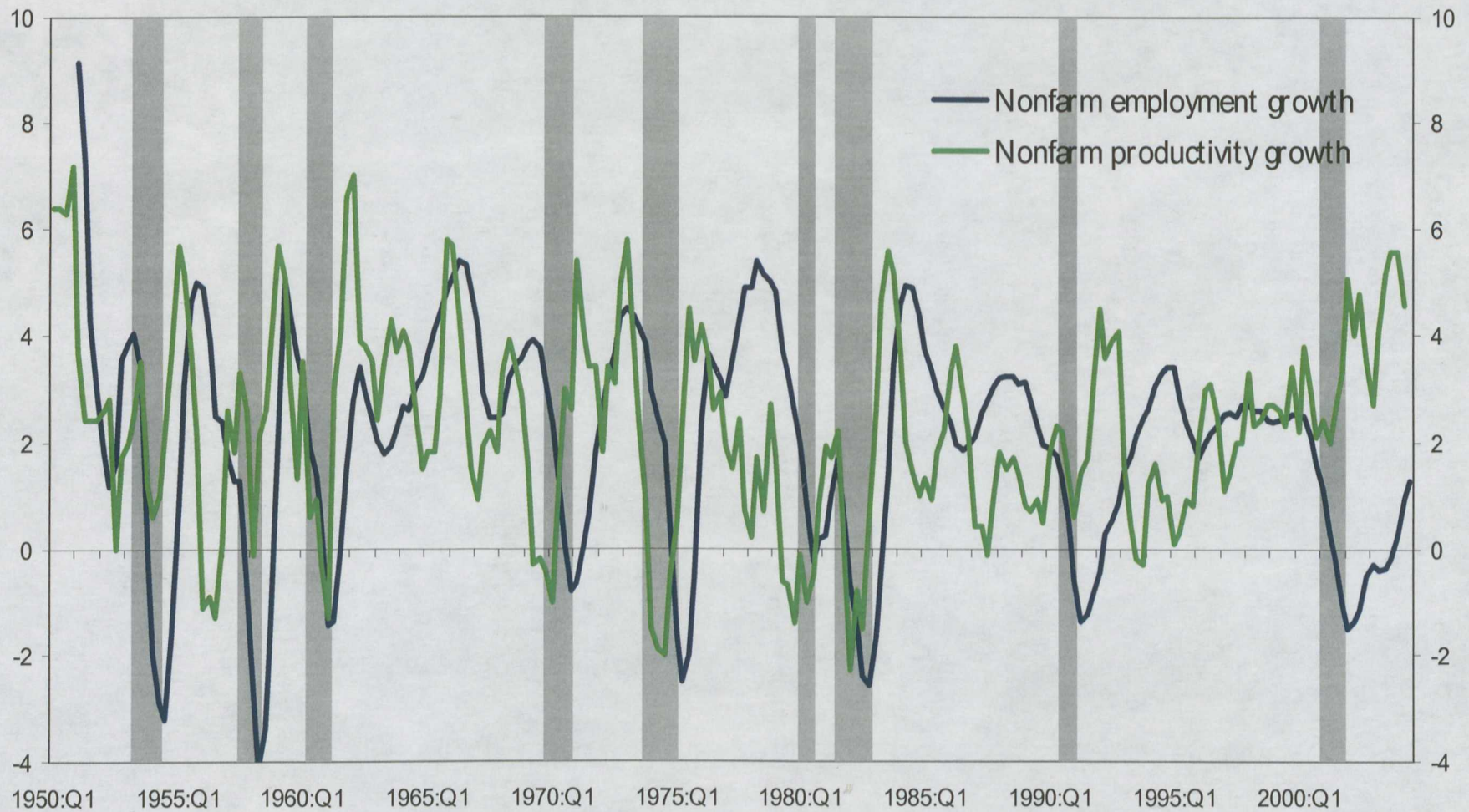
Why might this hiring continue in the future? The increase in productivity could help sustain the private recovery.

Percent Change, Year-Over-Year

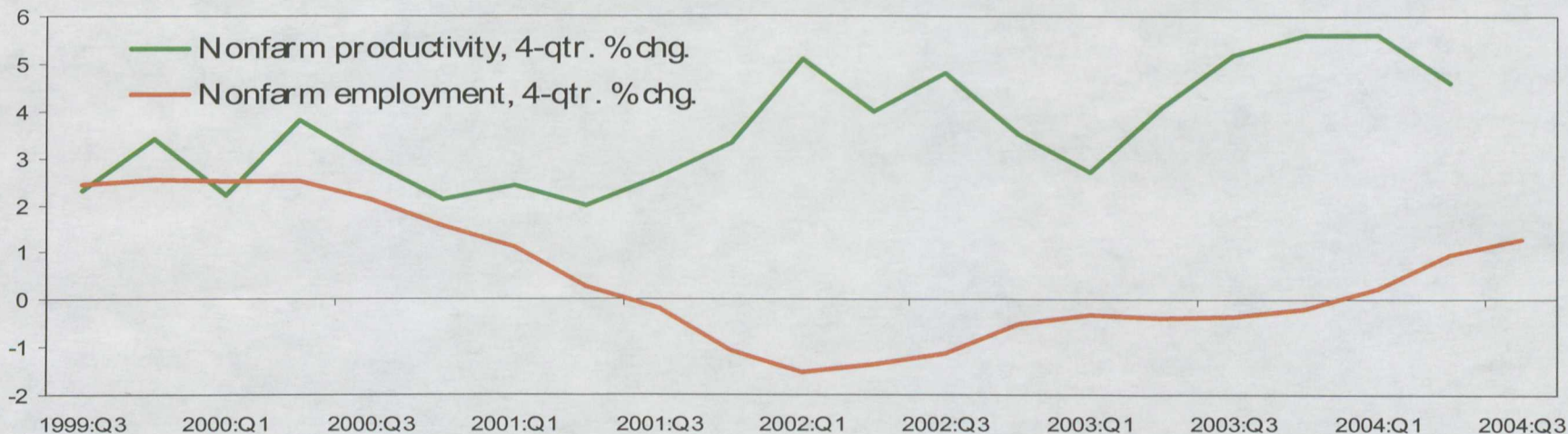


Source: Nonfarm Business Sector: Output per Hour of All Persons (SA); Bureau of Labor Statistics.

Strong productivity growth generally precedes employment growth.



Although It has only recently begun to increase employment,

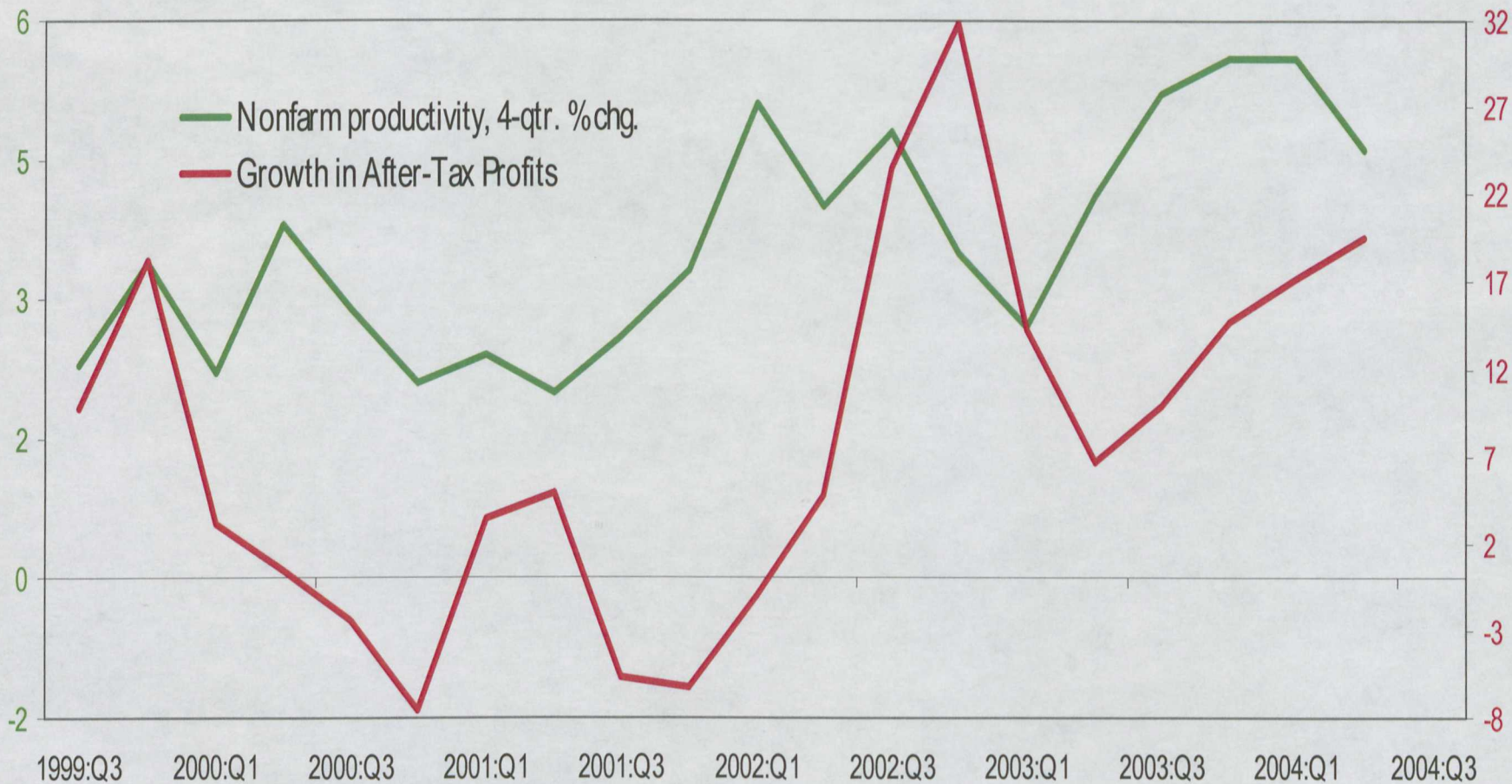


and has yet to increase

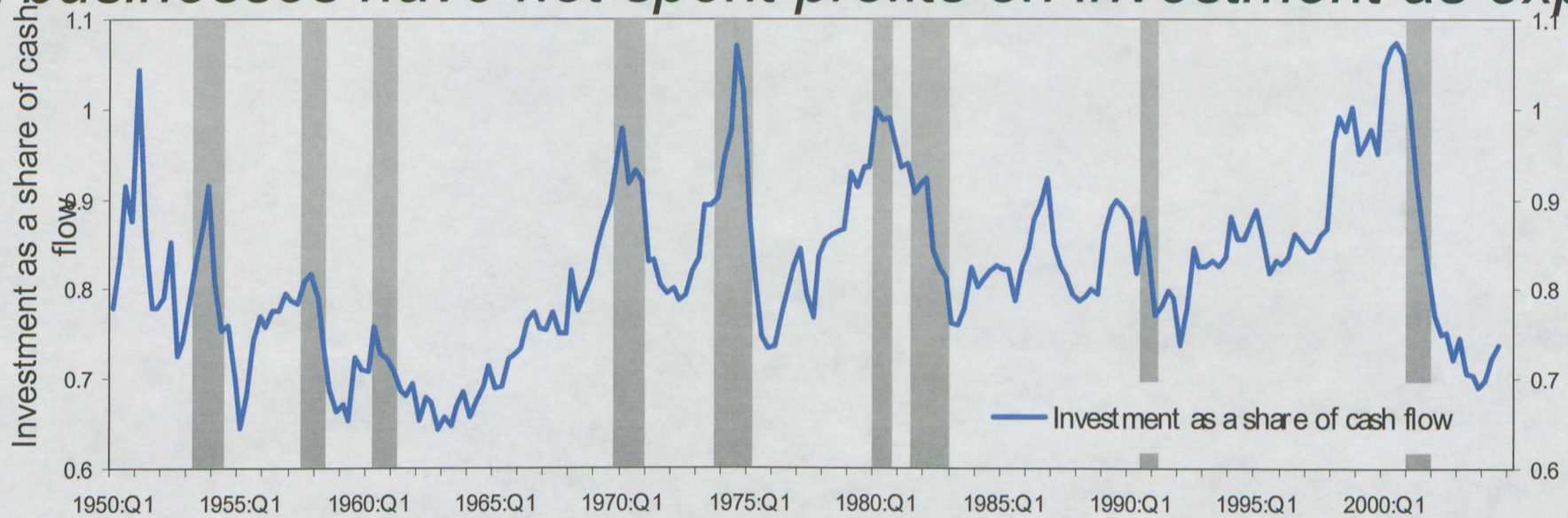
wages,



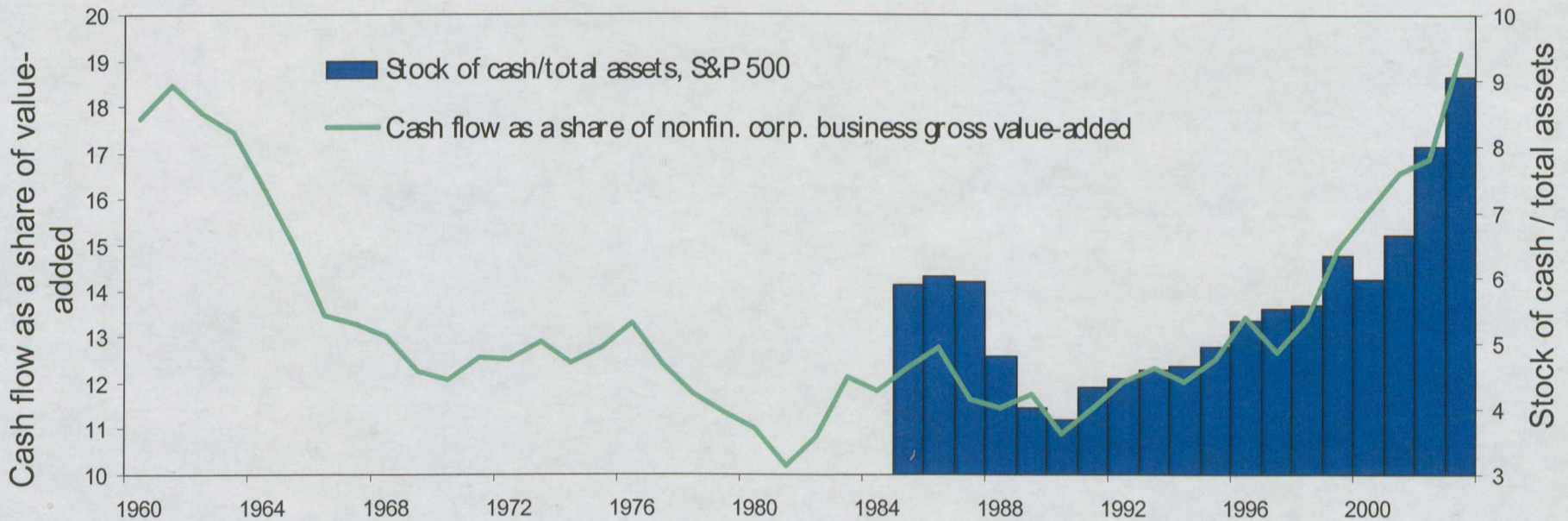
... it has made its way into profits.



Businesses have not spent profits on investment as expected

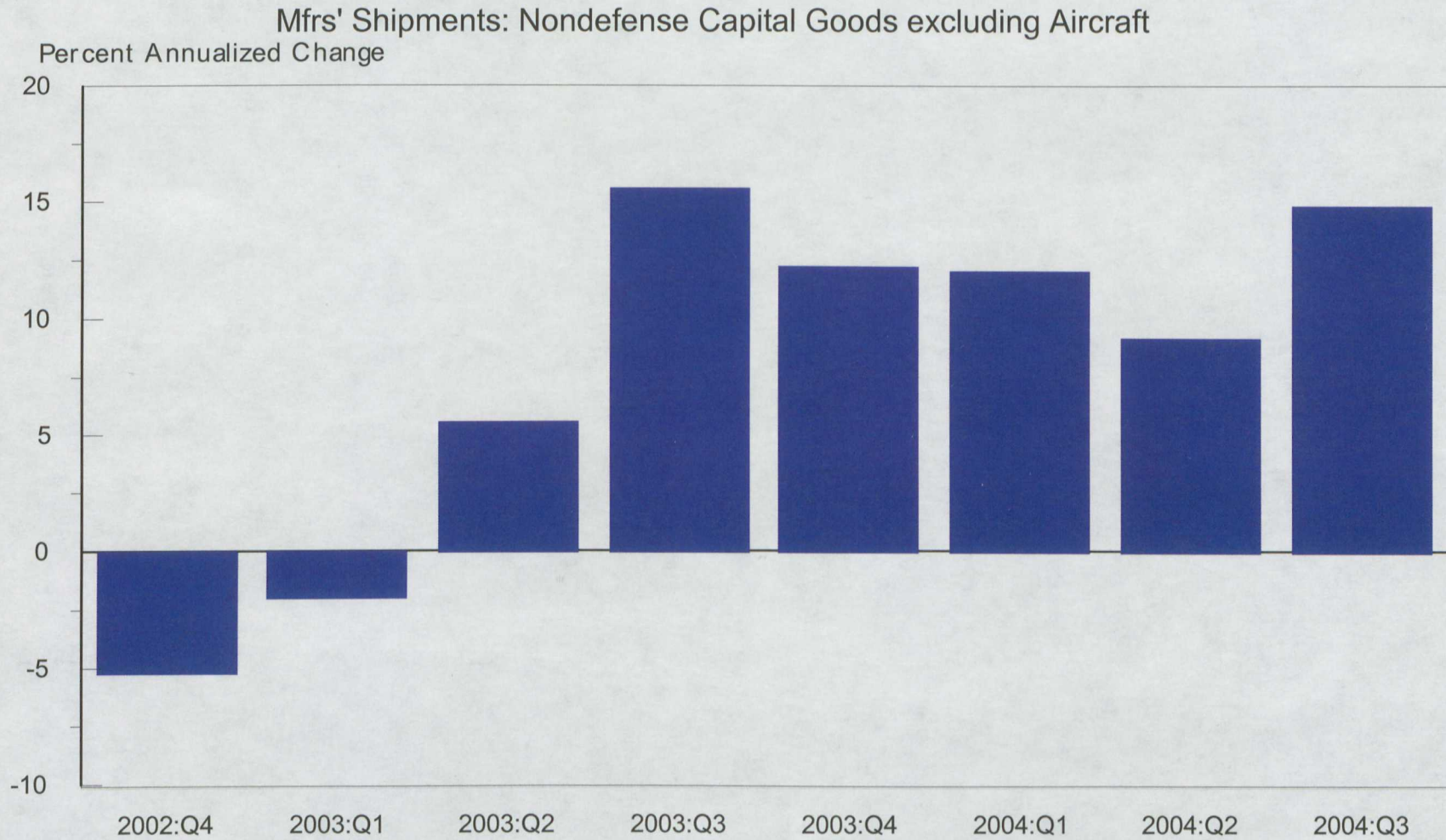


Meanwhile, high productivity has left businesses sitting on a pile of cash



Source: Private Nonresidential Investment in Equipment & Software, Gross Value Added for Nonfinancial Corporate Business, (SAAR, Billions \$): Bureau of Economic Analysis. Cash and near-cash assets as a share of total assets: Flow

The most recent data suggest that firms are investing more.



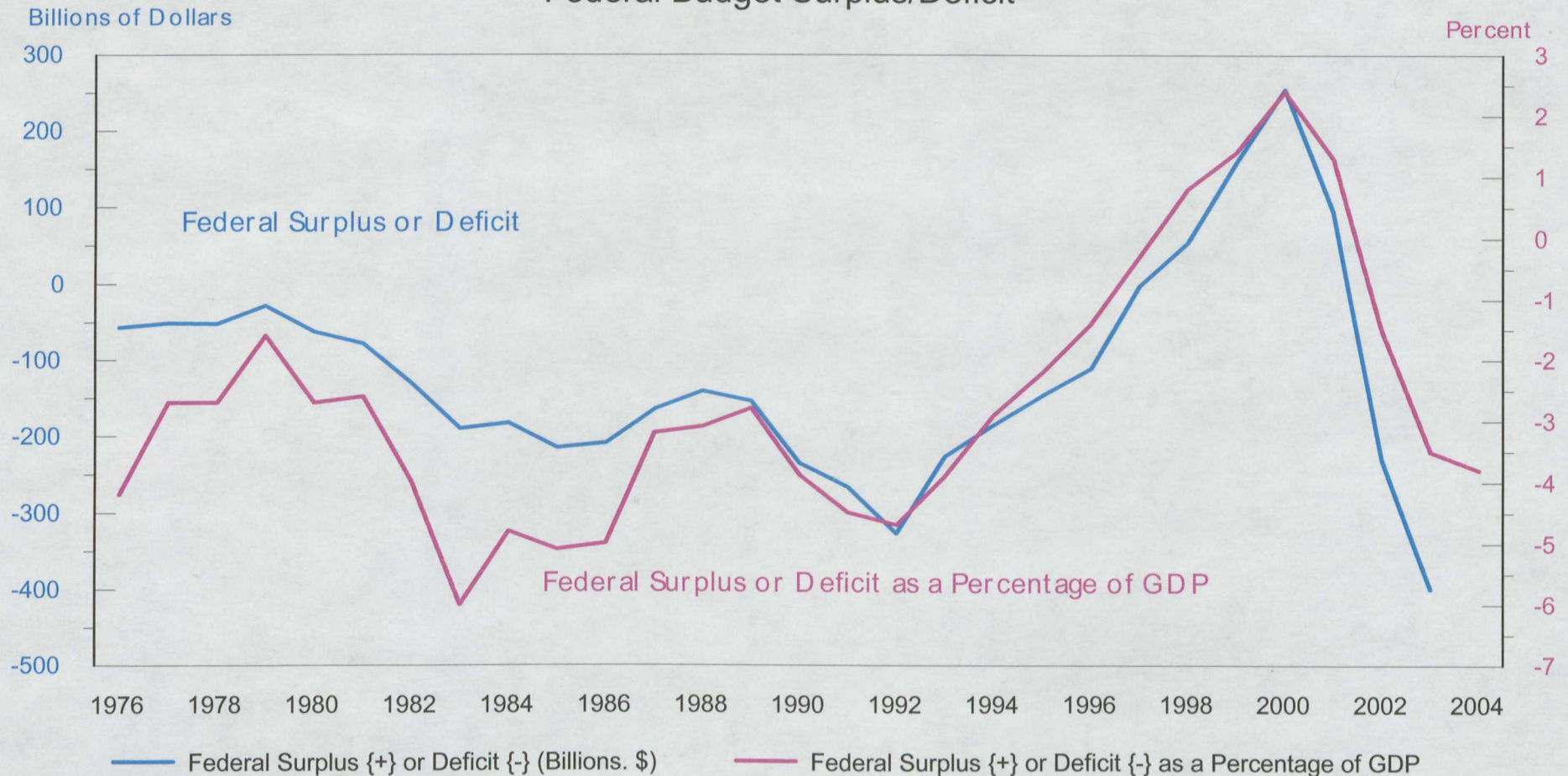
Source: Census Bureau.

If firms regain their confidence, they have the resources to finance the recovery.

- Recent employment and investment data suggest firms have begun to spend.
 - At some point, they could spend it on labor and capital
 - To satisfy investors—alternatively, pay more dividends and boost consumption?
 - To earn a decent return vs. cash (short-term liquid assets)
 - When they are convinced that the investment will pay off.
- The soft-landing looks to be in the works, but there are still imbalances that could upset the applecart.

The Savings Imbalance: The federal budget imbalance is large, even when measured as a percent of GDP.

Federal Budget Surplus/Deficit

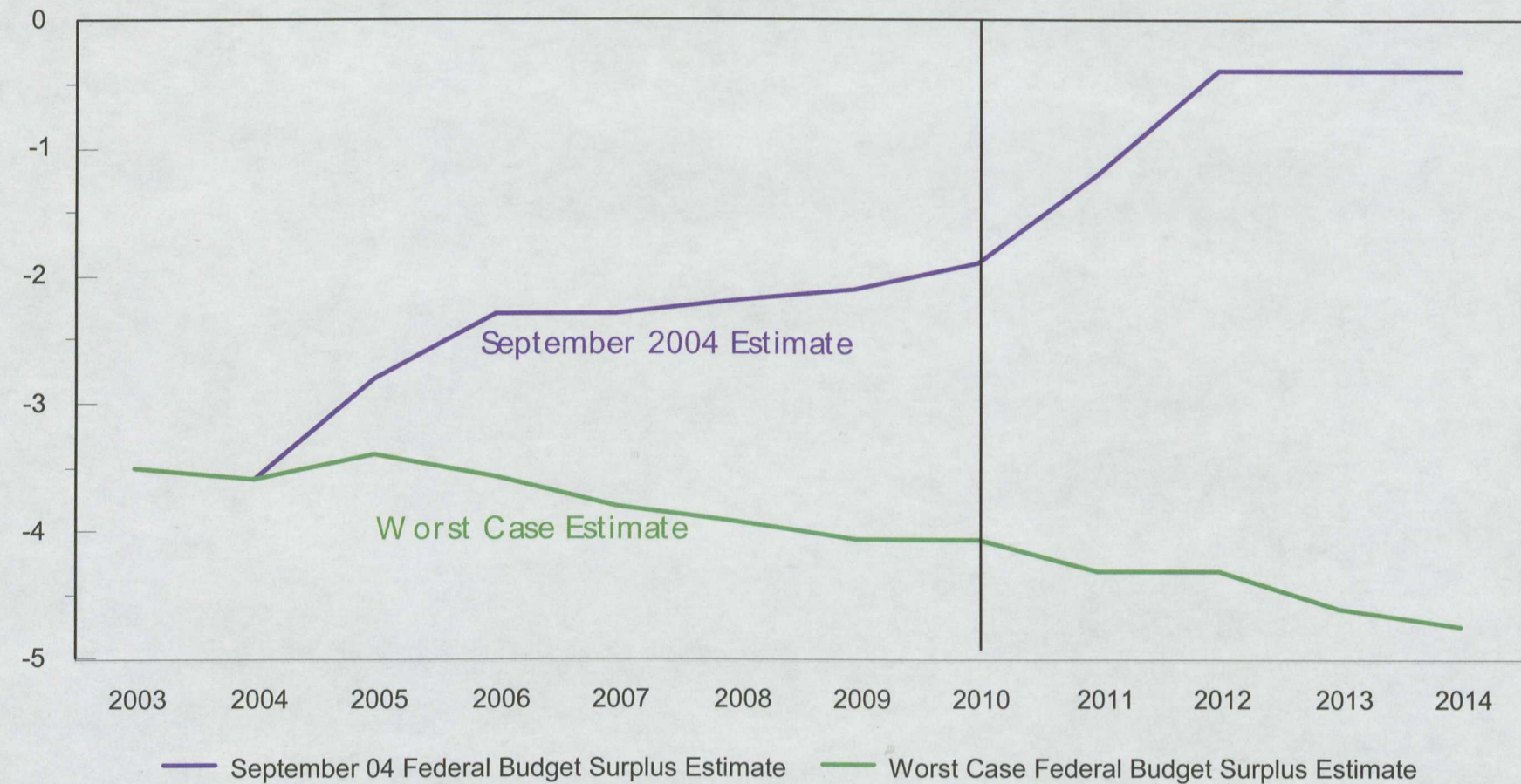


Source: U.S. Treasury.
Office of Management and Budget.

Expectations are that it will improve significantly once the tax cut sunset provisions take place.

Federal Budget Surplus Estimates

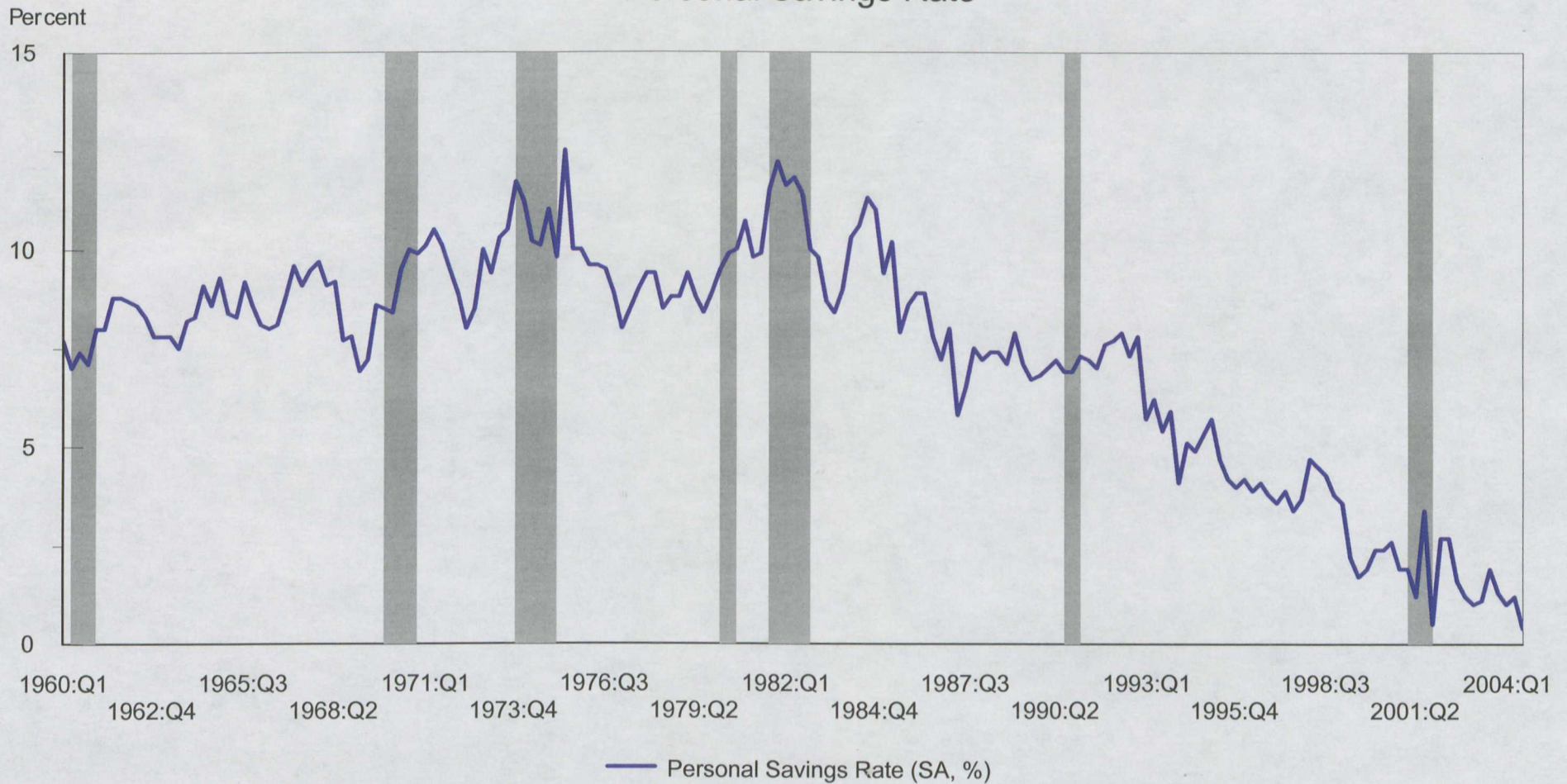
Percent of GDP



Source: Congressional Budget Office

In the near term, however, the shortfall in public savings is not being made up with private savings.

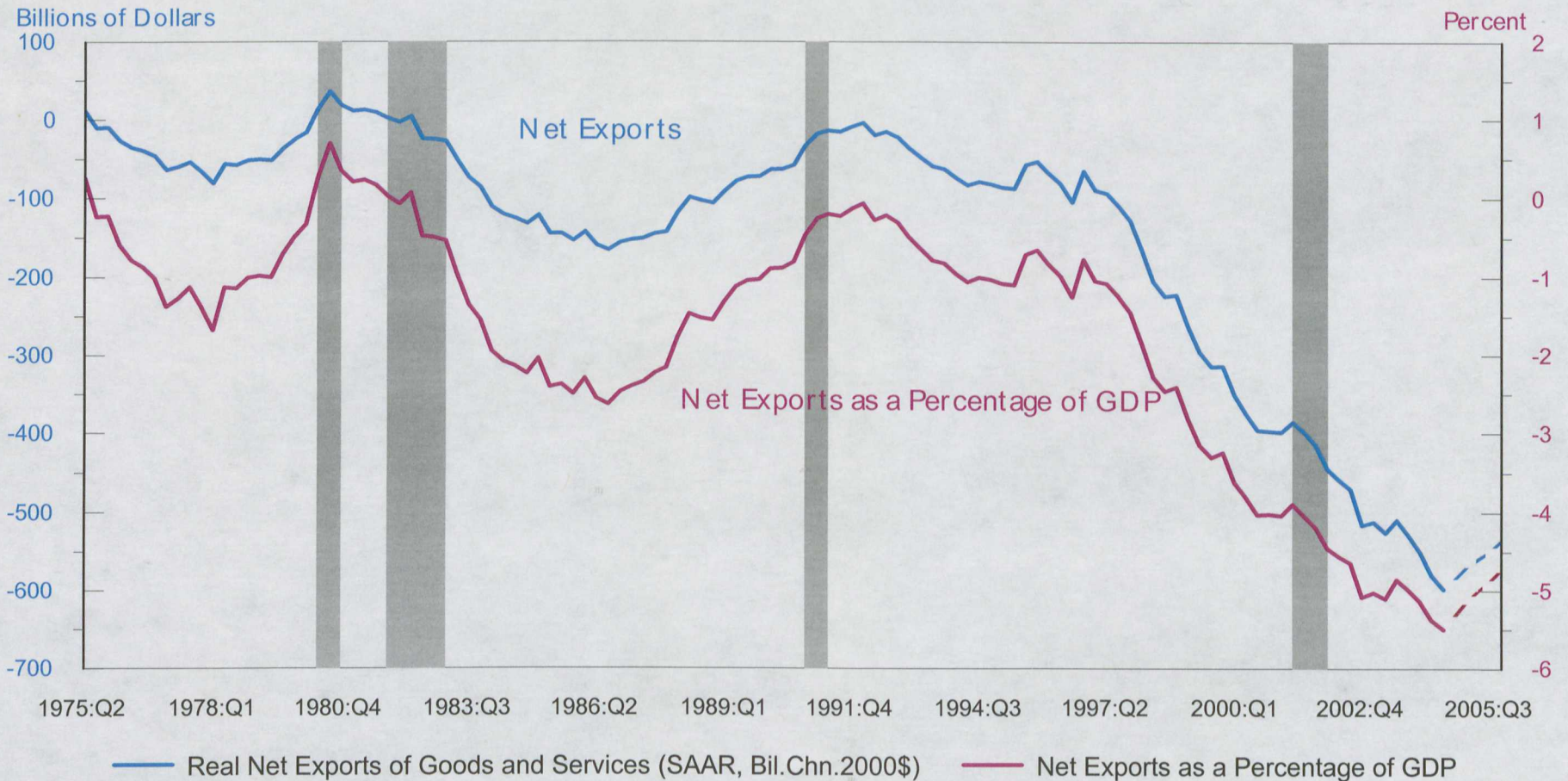
Personal Savings Rate



Source: Bureau of Economic Analysis.

Which has left foreign savings to take up the slack.

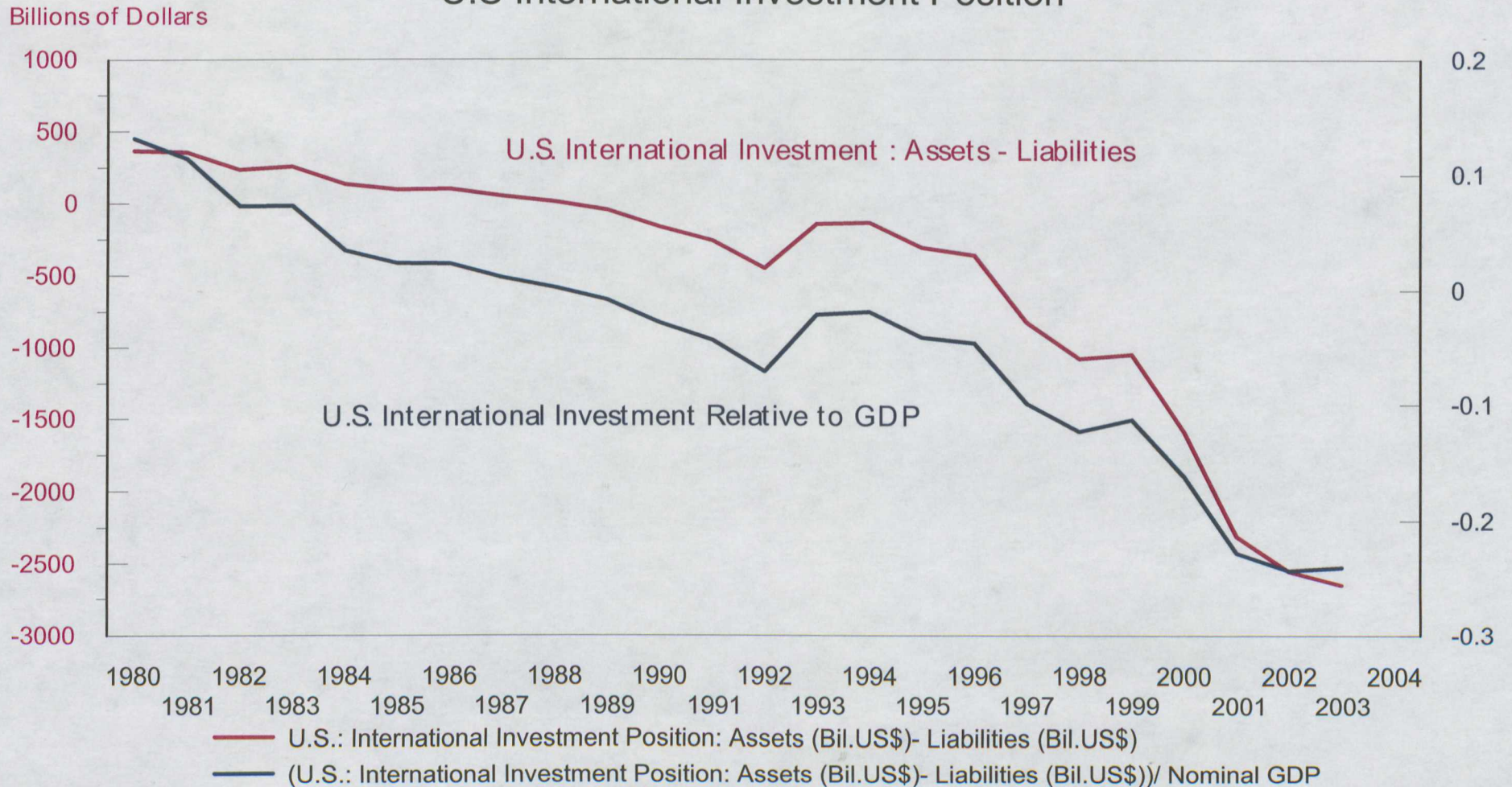
Net Exports of Goods and Services



Source: Bureau of Economic Analysis.

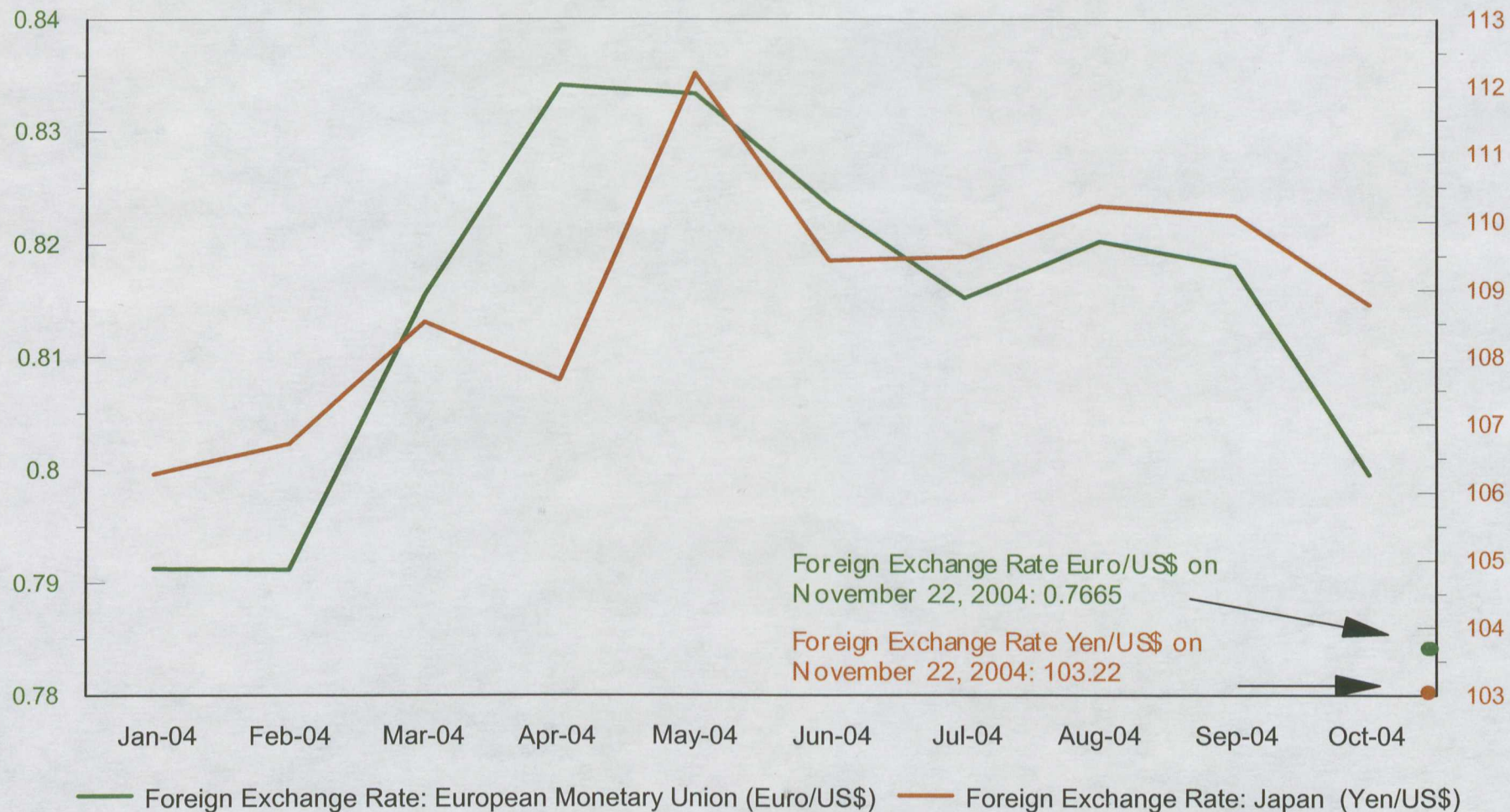
How long this borrowing can continue at this pace is uncertain.

U.S International Investment Position



Source: International Monetary Fund/ Haver Analytics.

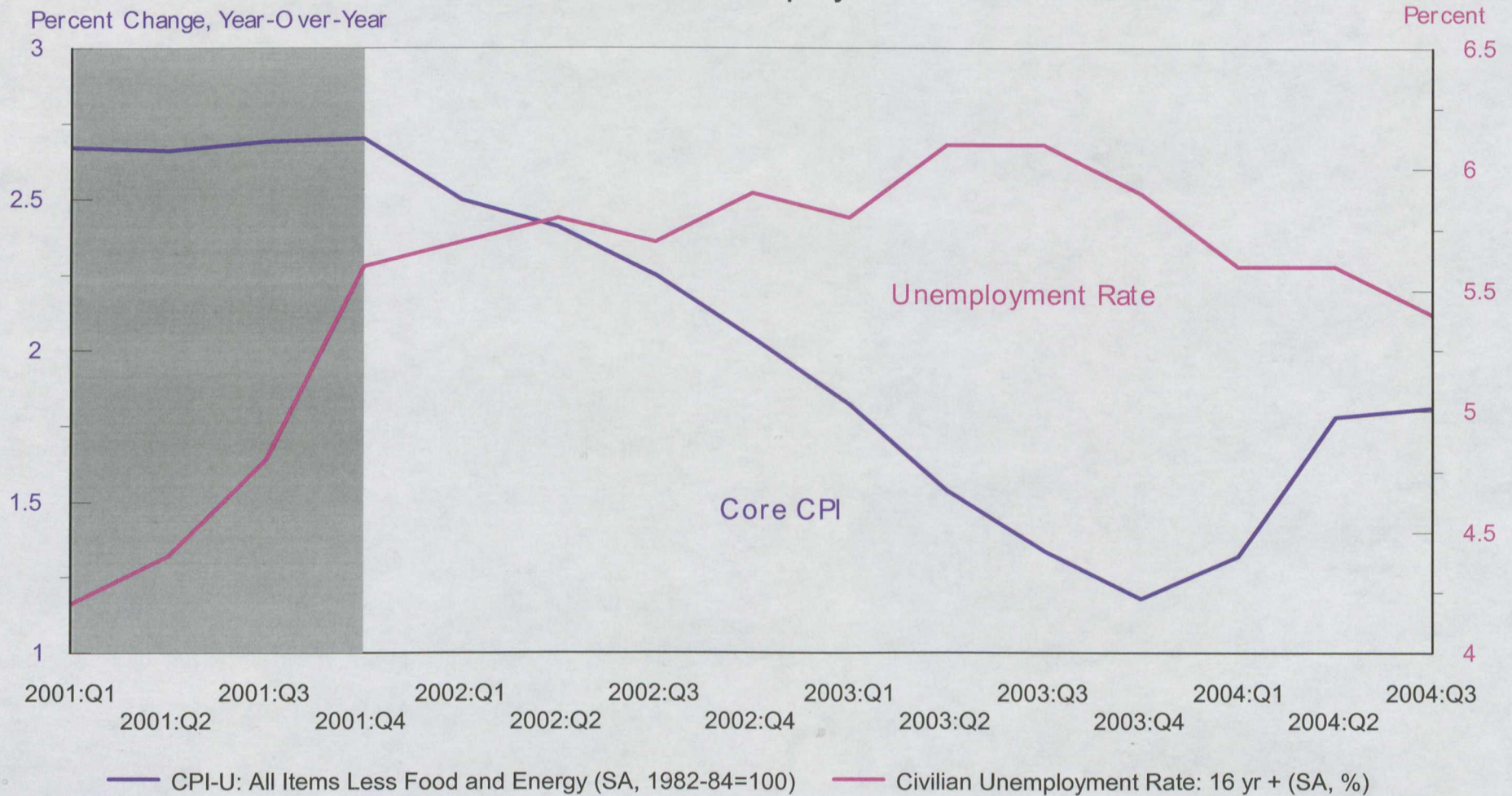
The savings imbalance will be rectified by increased savings one way or the other.



Source: Federal Reserve Board.

A Potential Labor Market Imbalance: Some worry about an acceleration in inflation.

Core CPI and Unemployment Rate



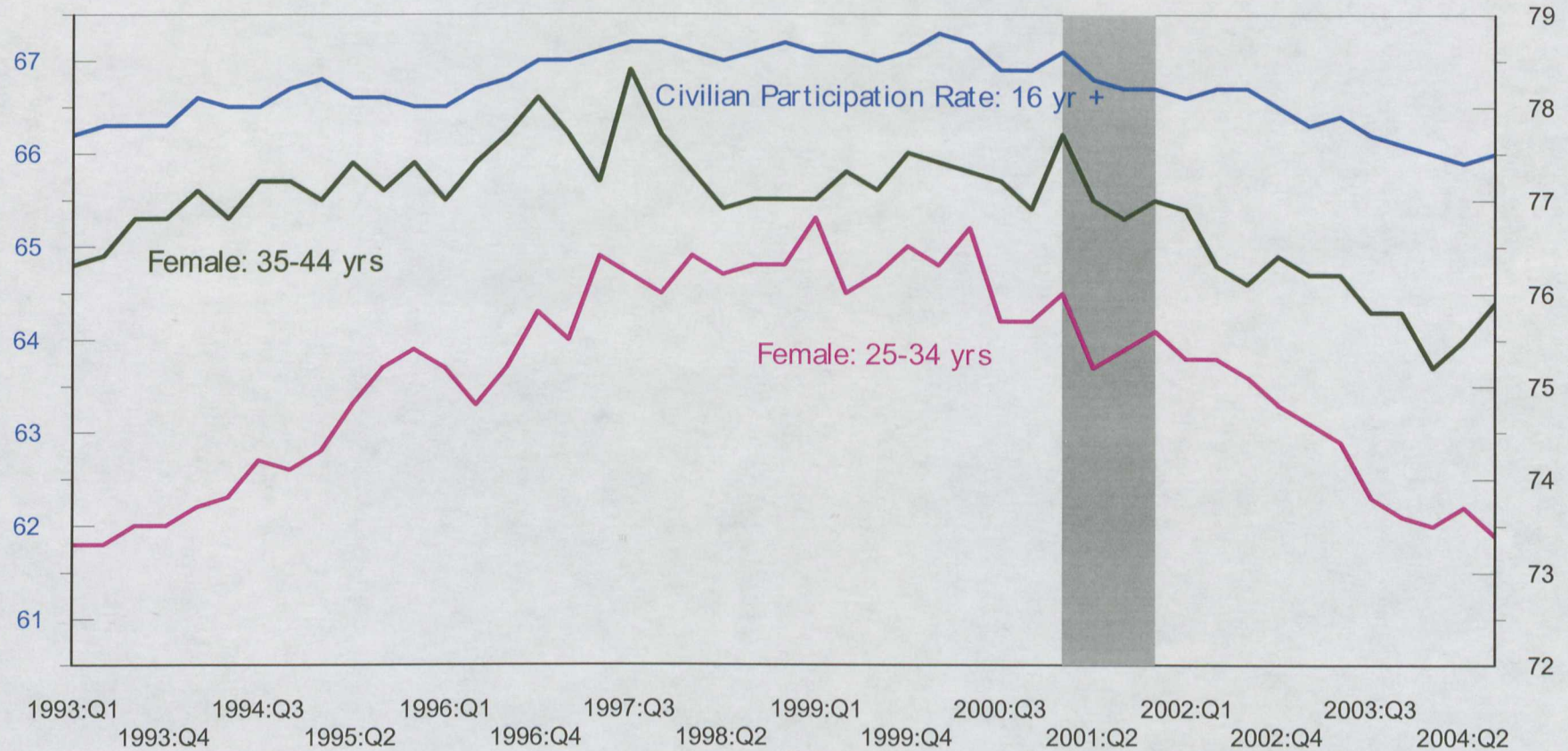
Source: Bureau of Labor Statistics.

But is the unemployment rate too low?

Percent

Labor Force Participation Rate: Females

Percent



— Civilian Participation Rate: 16 yr +

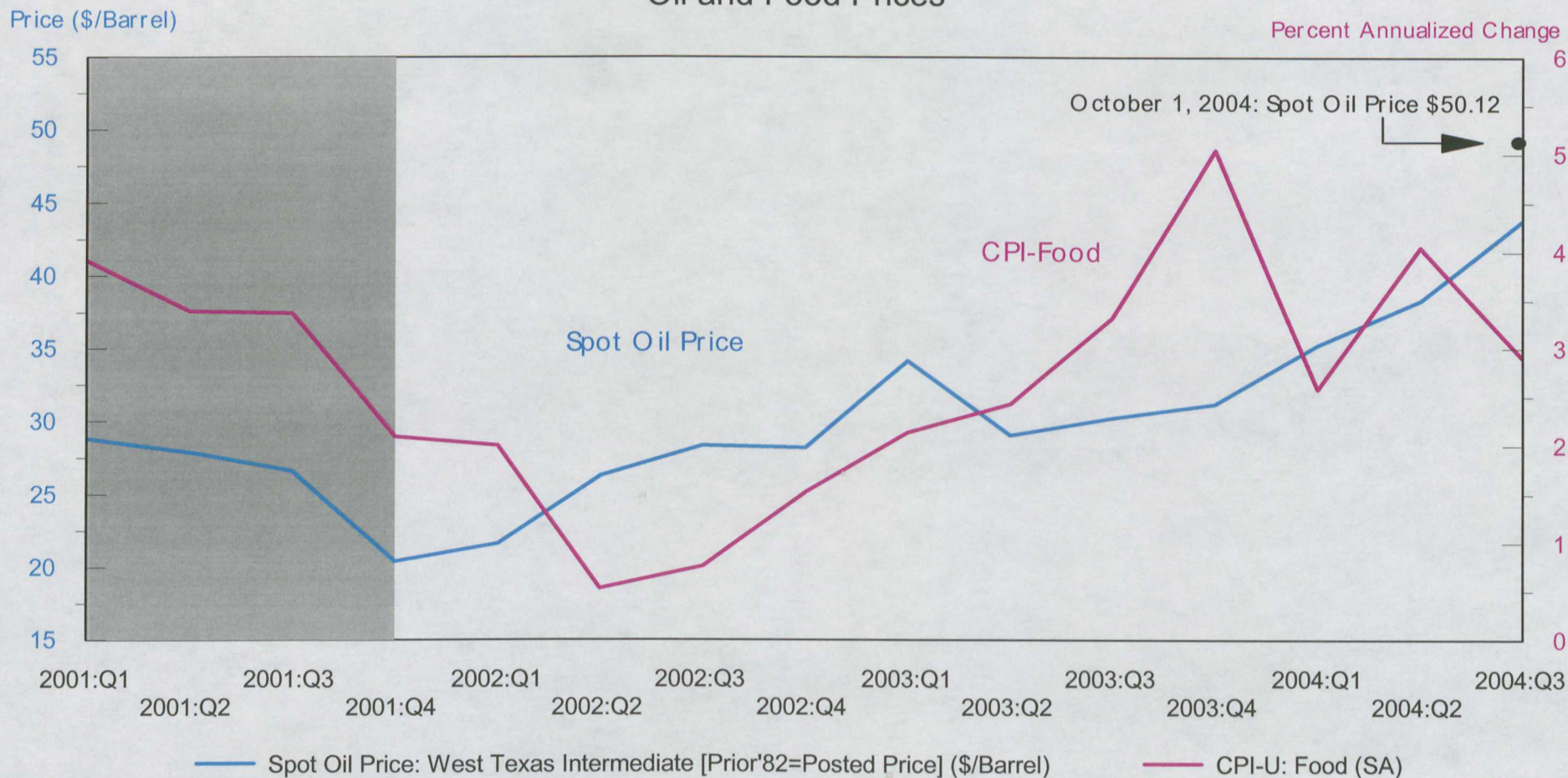
— Civilian Labor Force Participation Rate: 35-44 Yrs, Female

— Civilian Labor Force Participation Rate: 25-34 Yrs, Female

Source: Bureau of Labor Statistics.

Most of the acceleration has come from food and energy prices.

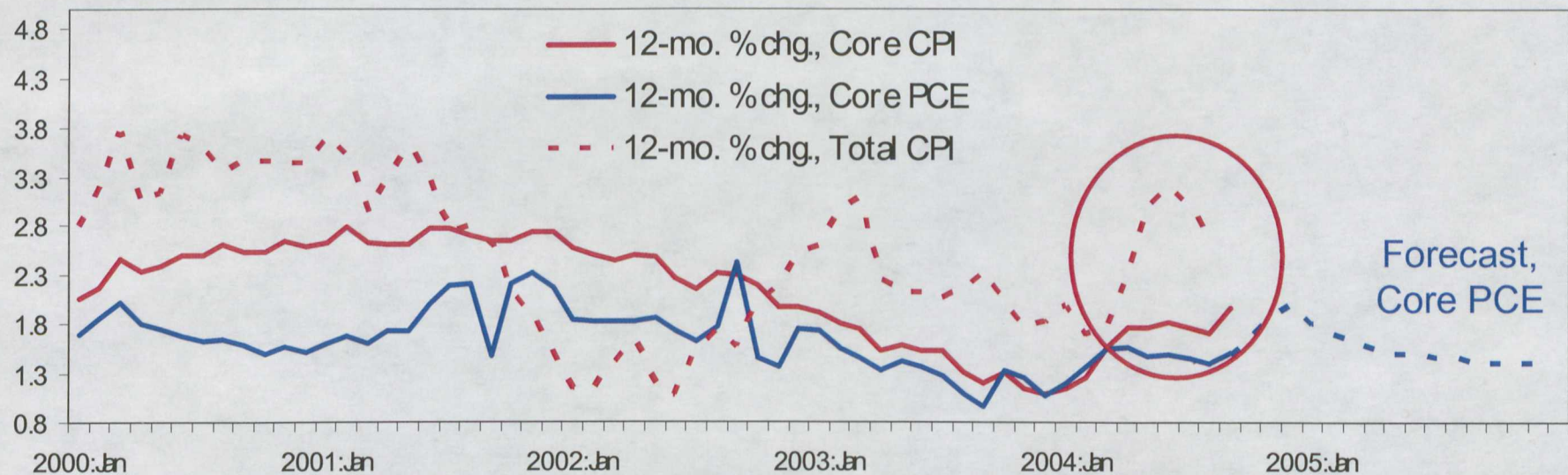
Oil and Food Prices



Source: Wall Street Journal.
Bureau of Labor Statistics.

Effects of oil prices on inflation: so far, modest and temporary

Percent Change, Year-Over-Year



Oil price pressures on inflation offset by:

- Remaining excess capacity
 - Excess capacity of about 1.5%
- Near-record profit margins
- Moderate labor costs
 - Overall compensation growth is subdued by most measures, especially relative to productivity and inflation. Unit labor costs stable.
- We expect inflation to remain moderate, but of course vigilance is required here

Another risk to the recovery: Oil prices will affect spending

Good news: Energy share of consumptions has halved since 1980.



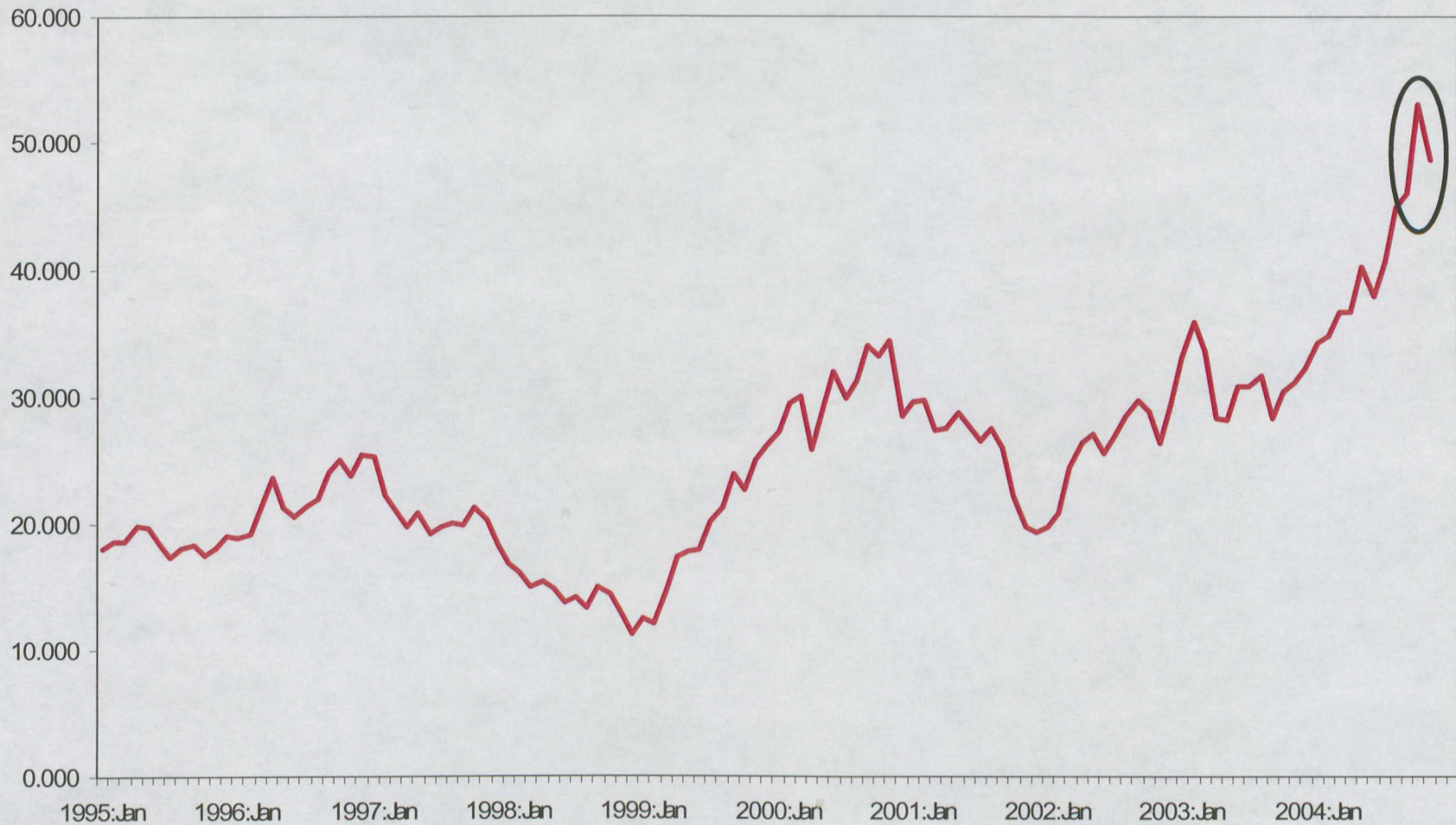
How much of a tax has oil imposed on consumers?

Spending category	Increase over past year (billions \$)	As a percentage of disposable personal income
Gasoline, fuel oil	\$40.2	0.6
Electricity and gas	\$8.2	0.1

Source: Personal Consumption Expenditures; PCE: Gasoline, Fuel Oil, & Other Energy Goods; PCE: Household Operation Services---Electricity & Gas, (SAAR, Billions \$): Bureau of Economic Analysis.

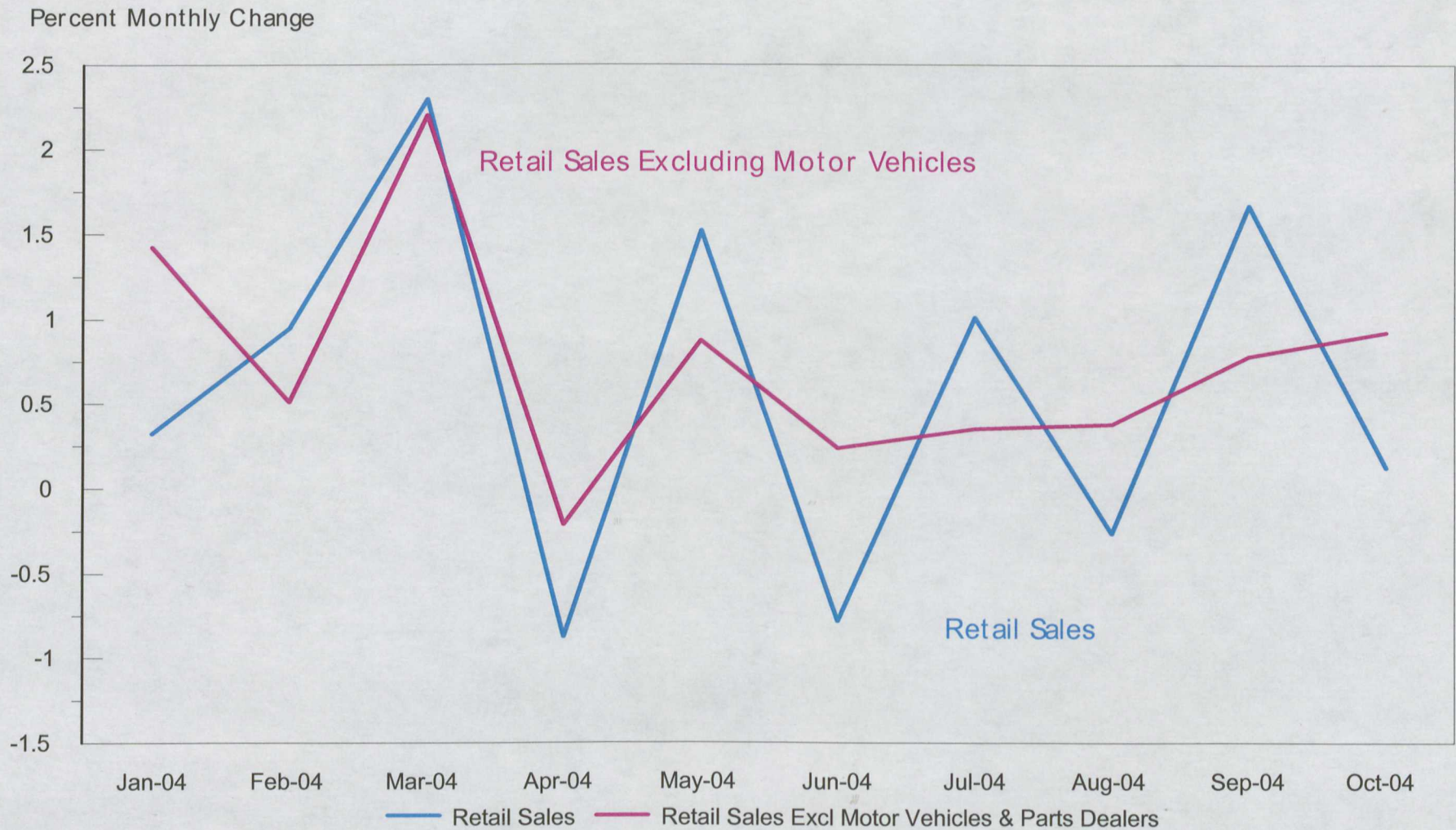
*Some good news in this regard:
Oil prices have receded recently*

West Texas Intermediate Crude Oil, Price per barrel



Source: West Texas Intermediate Crude Oil, \$/bbl: Haver Analytics

And recent data on consumption remain strong



Source: Census Bureau.

Summary

- The outlook is for 3-4% real GDP growth
 - Which implies gradual absorption of excess capacity
- The fundamentals on the consumer and business side are generally encouraging
 - Some risks, especially to household spending:
 - Strong employment growth is critical to ongoing income creation—some recent good news here
 - Low household savings
 - Further oil price shocks
- Inflation remains well controlled
 - Most likely outcome: about 1-1/2% in 2005