

# Domestic Economic Conditions

Mass Software Council

January 14, 2005

Cathy Minehan

President & Chief Executive Officer

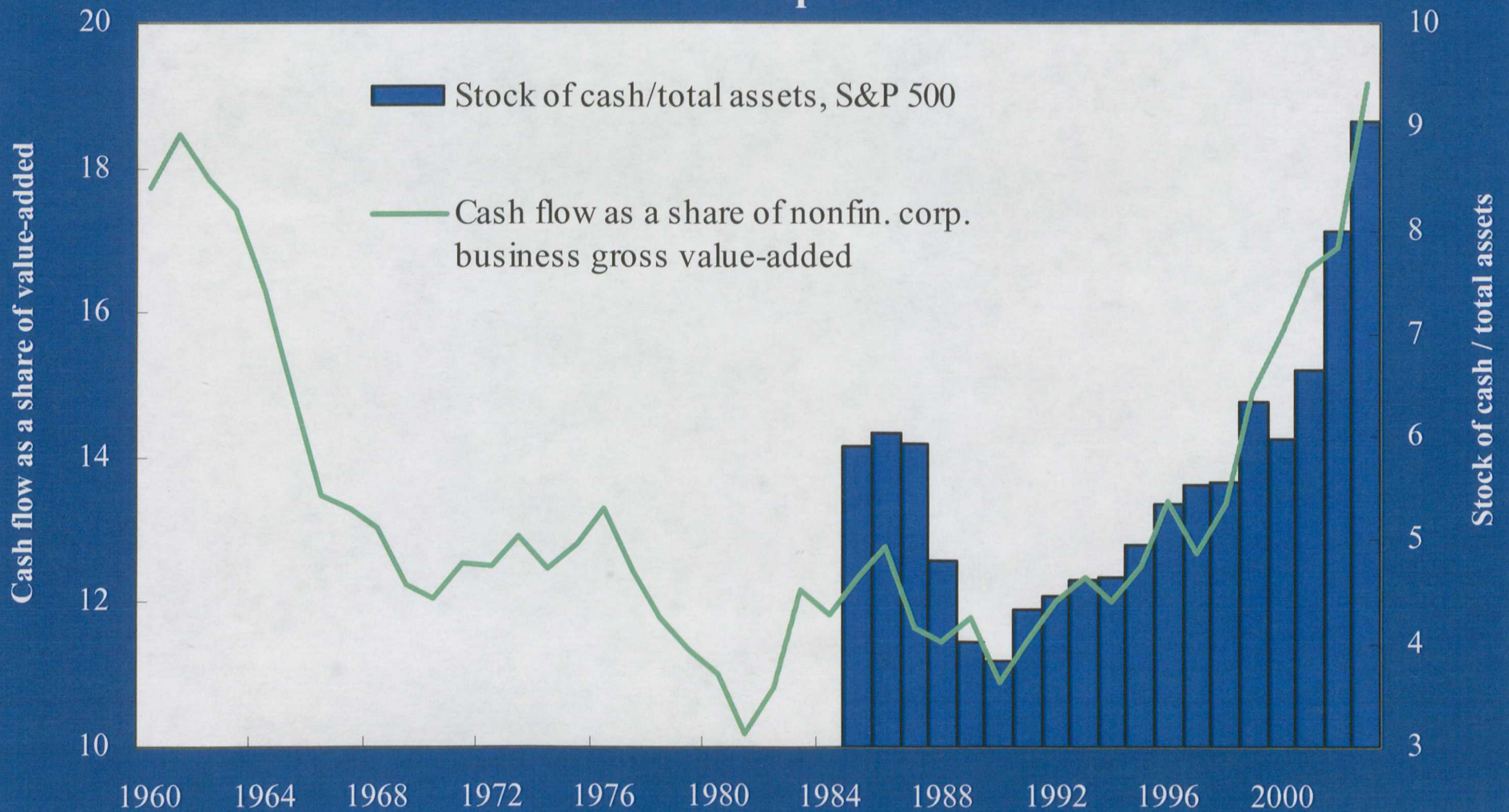
Federal Reserve Bank of Boston

# Investment Spending: orders solid, shipments weaker



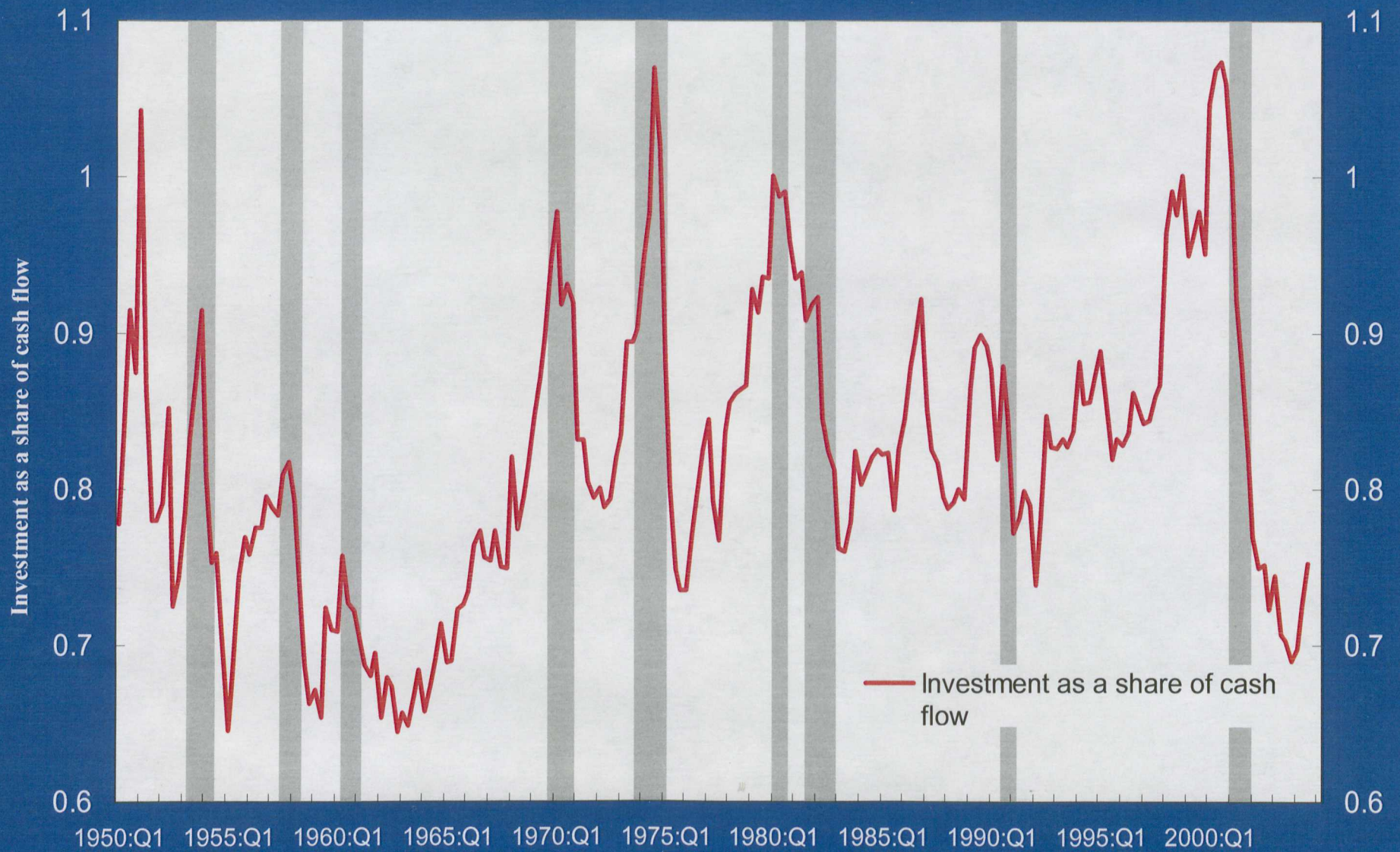
Sources: Manufacturers' New Orders and Shipments, Nondefense Capital Goods ex Aircraft, (SA, Millions \$): Census Bureau. Real Private Nonresidential Investment in Equipment & Software (SAAR): Bureau of Economic Analysis.

# Attention to the bottom line has left businesses sitting on a pile of cash. Poised to spend?



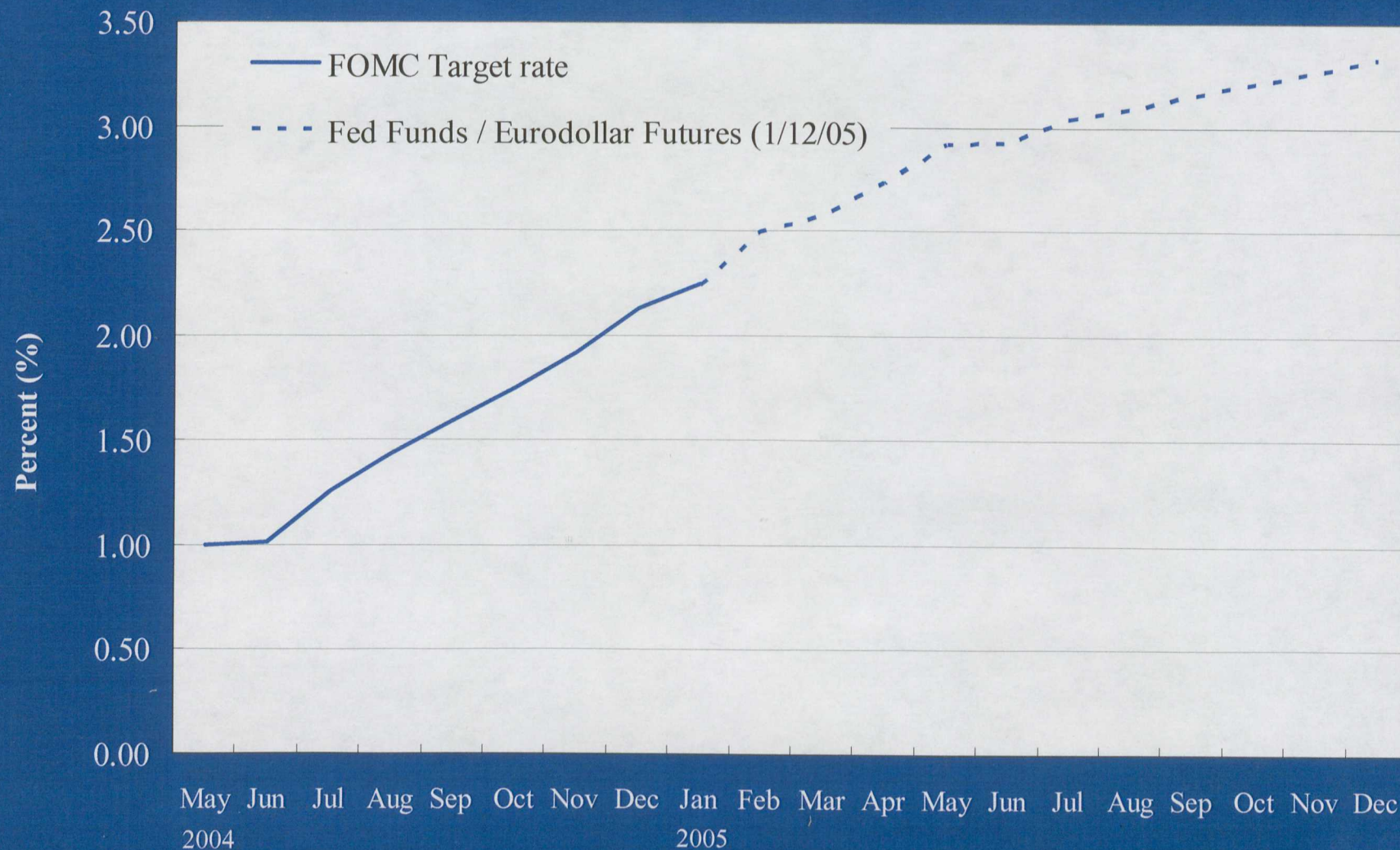
Sources: Gross Value Added for Nonfinancial Corporate Business (SAAR, Billions \$): Bureau of Economic Analysis. Cash and near-cash assets as a share of total assets: Flow of Funds.

## Businesses have not spent profits on investment as expected



# The market still expects gradual increases in the funds rate

About one-quarter point per quarter in 2005



Sources: Federal Funds Target Rate: Federal Reserve Board. 30-Day Federal Funds Futures: Chicago Board of Trade. Eurodollar Future Contracts: Bloomberg.

# Summary of Outlook

- 3.5% to 4% GDP growth in 2005
  - A bit above potential growth
  - Gradual decline in unused resources
  - Assumes a gradual increase in the federal funds rate
- Employment growth of ~200,000 per month
  - Still some risk to this part of the outlook
  - Last two months averaged 147,000
- Stable core inflation of 1.5% (PCE) to 2% (CPI)
  - Risks not asymmetric, but some upside as well as downside risks
    - Some uncertainty about the size of the output gap
    - Possibility of additional shocks to oil prices, the dollar

*Greg  
Paul  
Deb  
Joyce*

Massachusetts Software Council  
Presentation  
January 14, 2005

- Pleasure to be here with you
- Want to cover two things
  - Some reflections on 2004
  - What I see for 2005
    - Particular focus on business investment spending on equipment and software
    - Longer term challenge, low national savings
- 2004
  - In a nutshell, quite a good year
  - Latest data GDP 4% growth over 4 qtrs., unemployment down, inflation more of a concern but moderating at year end
  - Consumer was the mainstay - consumption grew 3.5% - take out 2nd quarter when oil prices acted as a tax, consumption 4.5%
  - Housing sales, autos strong, and consumers seemed confident about the future
  - Business investment strong as well - E&S 13% over 4 quarters; info processing quite strong 1st half, less strong second half
  - Payroll employment picked up as well - bouncy, but last 3 months averaged 200,000
  - Inflation - rose considerably with increases in oil and gas prices - about 5 percent 2nd quarter - core prices rose as well (2.6 percent first half) but moderated by year end

- Still hear anecdotes about excess capacity, so while may have the finances, may still be hesitant
  
- Finally - have to say something about inflation
  - Core inflation increased 1% point 2003-2004
  - Moderated at year-end, but will it escalate again?
    - Oil prices
    - Dollar depreciation
    - Productivity slowdown
    - Above trend economic growth
  - Possible - don't think so
    - Impact of oil price escalation likely transient; core inflation moderates at year end
    - Dollar feed thru not large near as we can tell
    - Underlying productivity growth strong - 3 percent on a 4 quarter basis
    - Other things say resources still available
  - So expect core 2% or so depending on how you measure
  - Upside risk here
  - Moreover, even if economy performs as expected & inflation stays low, policy has to become less accommodative as excess capacity is used up - can't get behind the inflation curve
  - **SLIDE 4** - So market expects Fed will continue to tighten at a pace of about .25 basis points per quarter in 2005
  - **SLIDE 5** - Summary

- 2005

- Expect more of the same - growth 3.5+ percent, growing employment, well-balanced inflation
- Questions:
  - Strength of the consumer: 2004 spending has wealth effect component, not likely in 2005 with moderating house prices - will consumers decide to save, not spend?
  - Answer is jobs - if jobs and wages grow, consumers will spend - continued 200,000 new jobs would give assurance here
  - Strength of business - spending quite strong this year - will it continue? **SLIDE 1**
  - See shipments in Q4 off, orders pretty good
  - Suggests green line will come down in Q4, bounce back in Q1
  - Issues:
    - Tax change - move from 2005 back to 2004
    - Continued uncertainty **SLIDE 2**
    - See businesses have accumulated a pile of cash, despite recent investment spending - clearly some part of this is keen focus on putting accounting and compliance houses in order under Sarbanes-Oxley, and an extra premium on "making their numbers"
    - **SLIDE 3** - Thus, while investment spending grows pretty strongly, not close to its usual share of cash flow
    - Thus, businesses have funds - will they spend?

- Longer-term concern
  - National savings too low - 1-2% of GDP
  - As a result, borrow from rest of the world in increasing amounts
  - Savings - two courses; households & federal govt.
  - Both are problems - savings as % of real disposable income at an all-time low; federal deficit at 3.5% GDP
  - With reasonable assumptions about tax revenues and discretionary spending, deficit as % of GDP will grow
  - Twin deficits - CAD now 6% GDP - Share DNA
  - Adjustment - will come sooner or later - others surplus down our deficit down
  - Question is how; gradually or not
  - Dollar could fall precipitously, increasing interest rates, affecting equity markets, slowing growth - clearly that would have impact on trade deficit
  - Better way: other industrial countries increase domestic spending & U.S. increase savings
  - Household spending down - fiscal deficit down - not cost free; time to start is now
  - Better for world & for U.S.