Economic Outlook

Cathy E. Minehan
President and CEO
Federal Reserve Bank of Boston

Presented to
Regional and Community Bankers
June 7, 2005

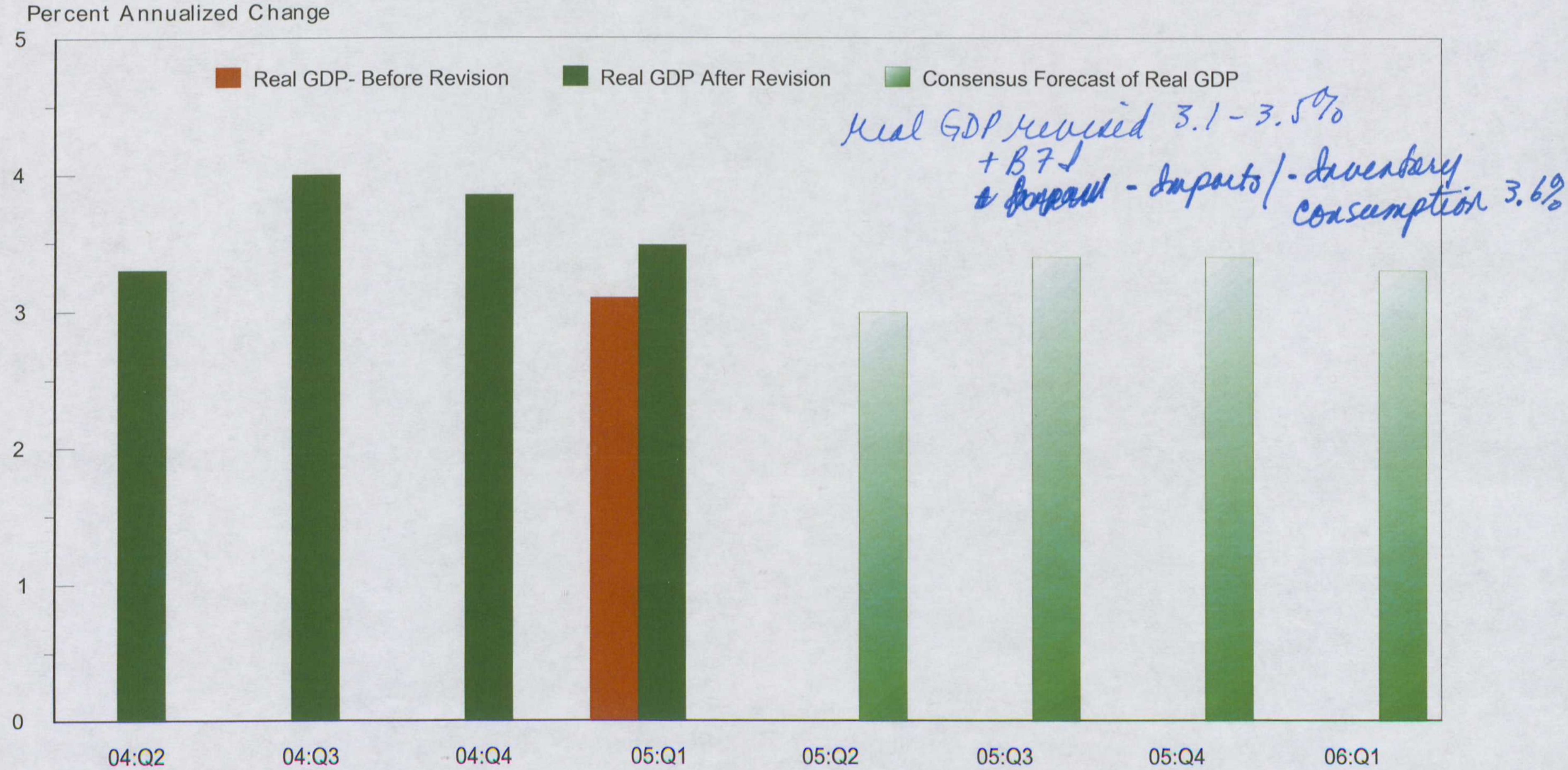
• Welcome to FRBB - we're very happy to see all of you once again
• One of the best programs we offer - I know we all look forward to your reactions & comments on material we're discussing
• Want to do a couple of things
- cover near term horizon nationally & N.E.
- talk about some medium term challenges

So —

Overview of the US Economy

- Over the near-term, the expansion appears to be on a solid footing - perhaps not as strong as we might have expected in Q4, but quite solid
- Risks on the downside:
  - Will businesses and consumers stay the course? w/ policy accommodation being removed → need private demand to stay the course
  - Is there a housing bubble? - • biggest ? and there, at least domestically • can find a variety of opinions I'll share mine
- Inflation risks:
  - The effect of oil and other input price increases are likely to moderate. - assuming no major jumps (futures market doesn't expect) uptick in both headline & core inflation should moderate
- New England continues to grow along with the nation
  Mass in particular hard hit on job growth but ~~recovery as~~ expansion proceeds
- In the longer run, national savings needs to increase.
  key area for medium to longer term

Much of the recent "Soft Patch" was revised away



Source: Bureau of Economic Analysis.
Consensus Forecast.

Looking forward, businesses and consumers will be the key to the continued expansion - ? is - will they stay the course?

Seems some spending strength here

Firms' demand for capital equipment rebounded in April after two months of weak numbers,

new orders for capital equipment rose as well

However, ISM & regional Purchasing Manager data as well as industrial prod & capital spending off a bit

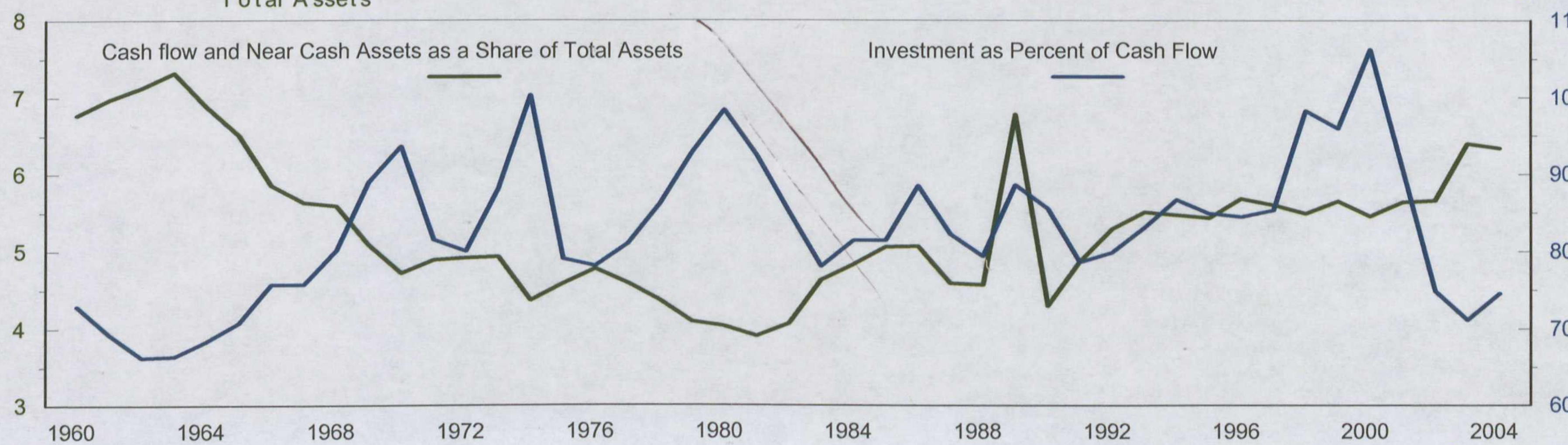
but the expansion of profits and the buildup of cash should support investment in the future.

But build up of cash suggests support for spending is there

Cash Flow and Near Cash Assets as a Share of Total Assets

Investment as a Percent of Cash Flow

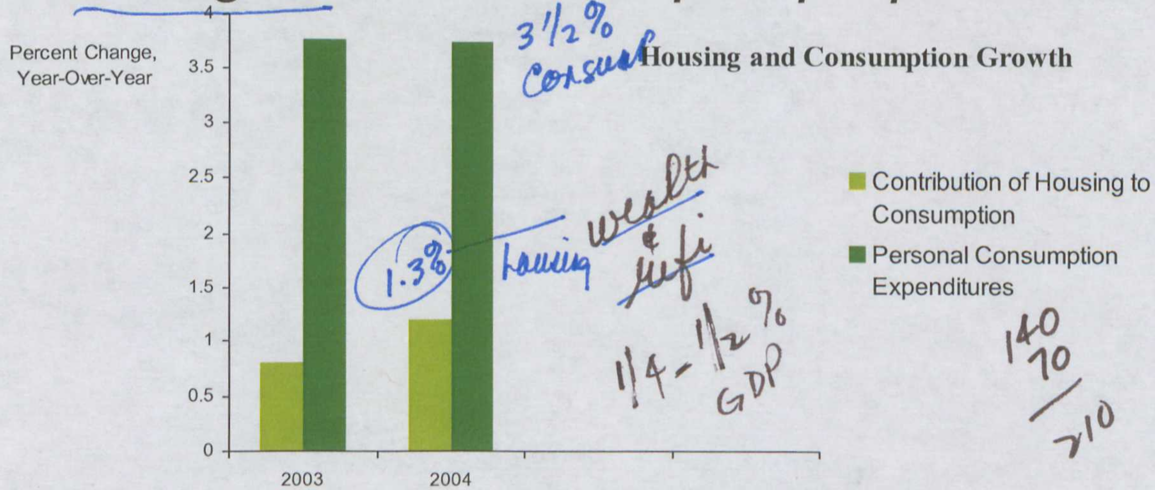
+



So businesses may not be charging ahead, but there is strength — consensus?

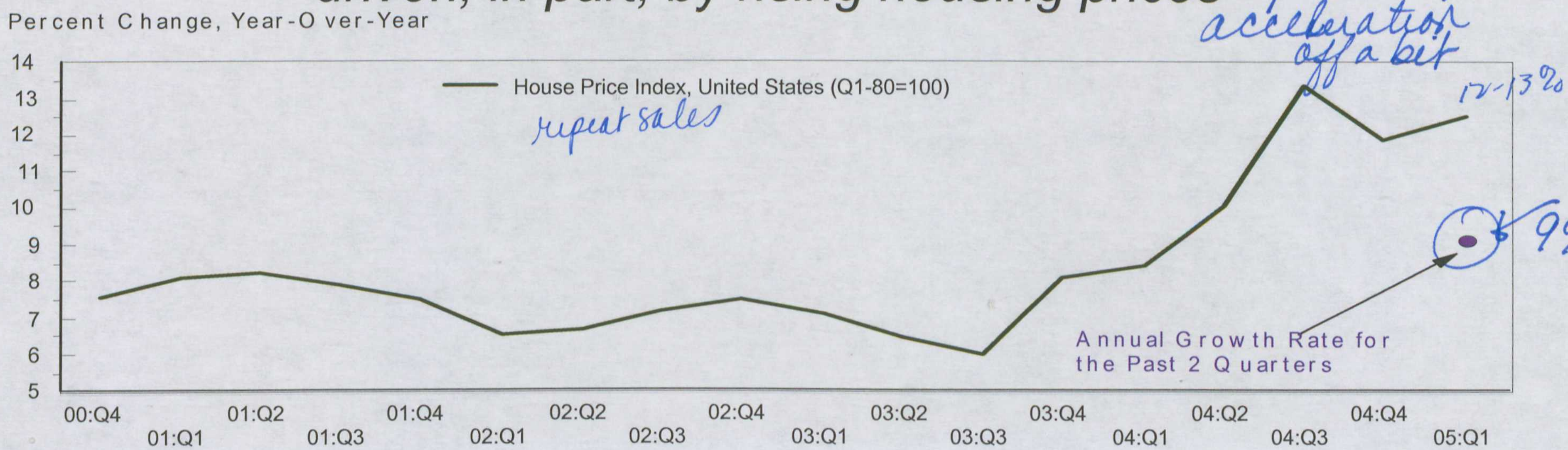
Housing has been major key to consumer spending

Increasing housing wealth has helped propel the consumer



Source: OFHEO, Bureau of Economic Analysis and author's calcuations

driven, in part, by rising housing prices - price acceleration off a bit

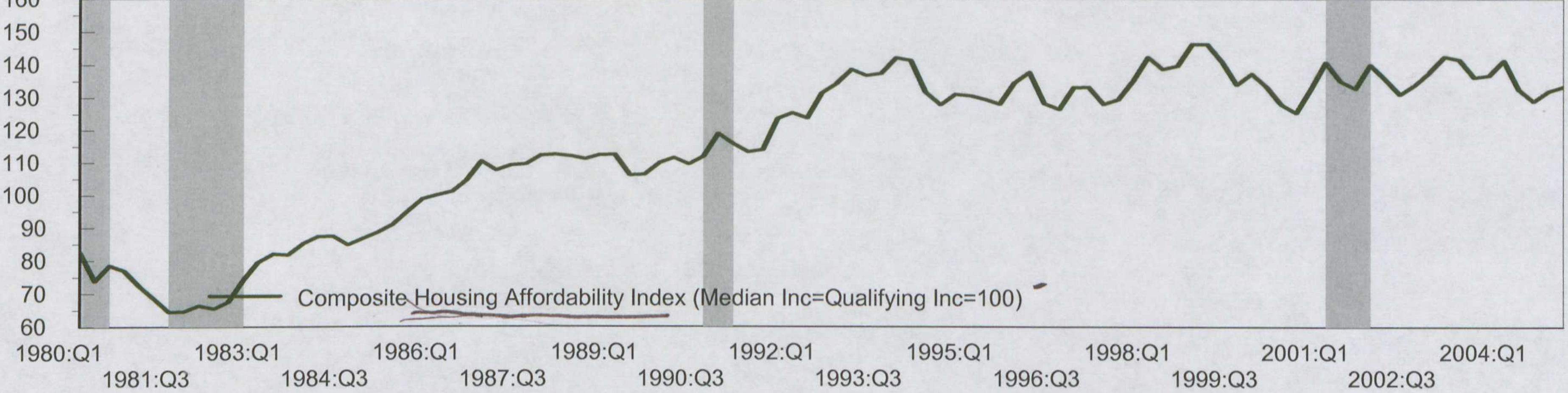


Source: Office of Federal Housing Enterprise Oversight.

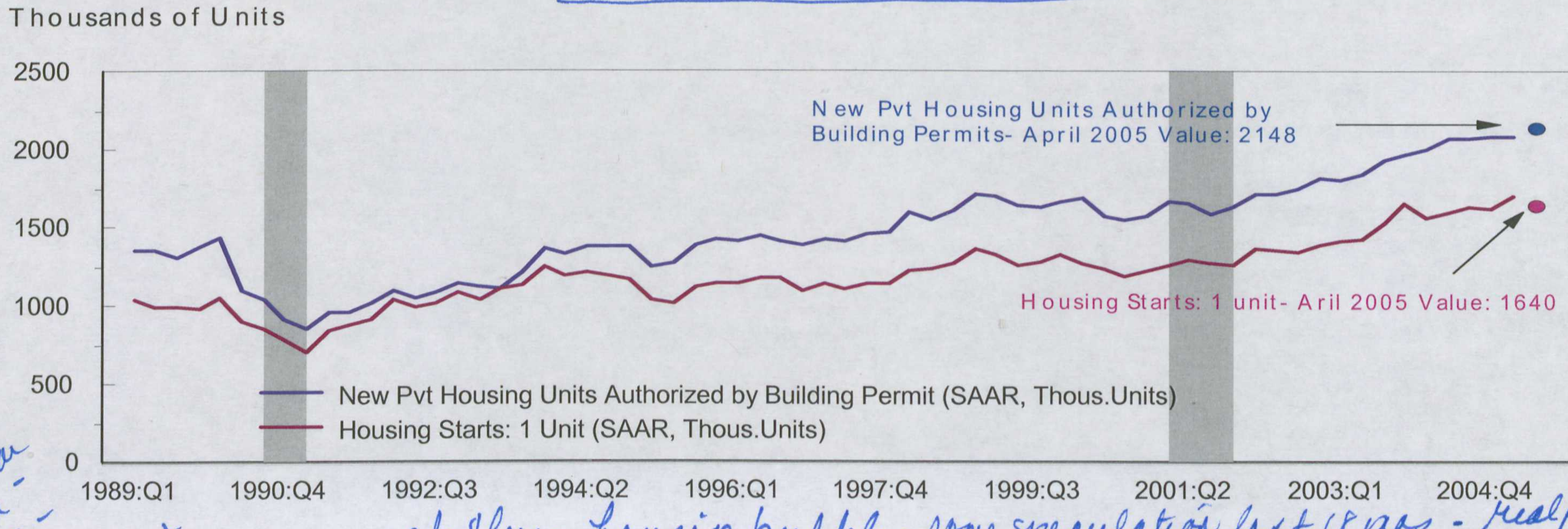
which

Rising real estate prices have decreased affordability, but low interest rates and strong employment growth have left overall affordability high.

↳ and related income growth



Which explains the continued strength in the housing market



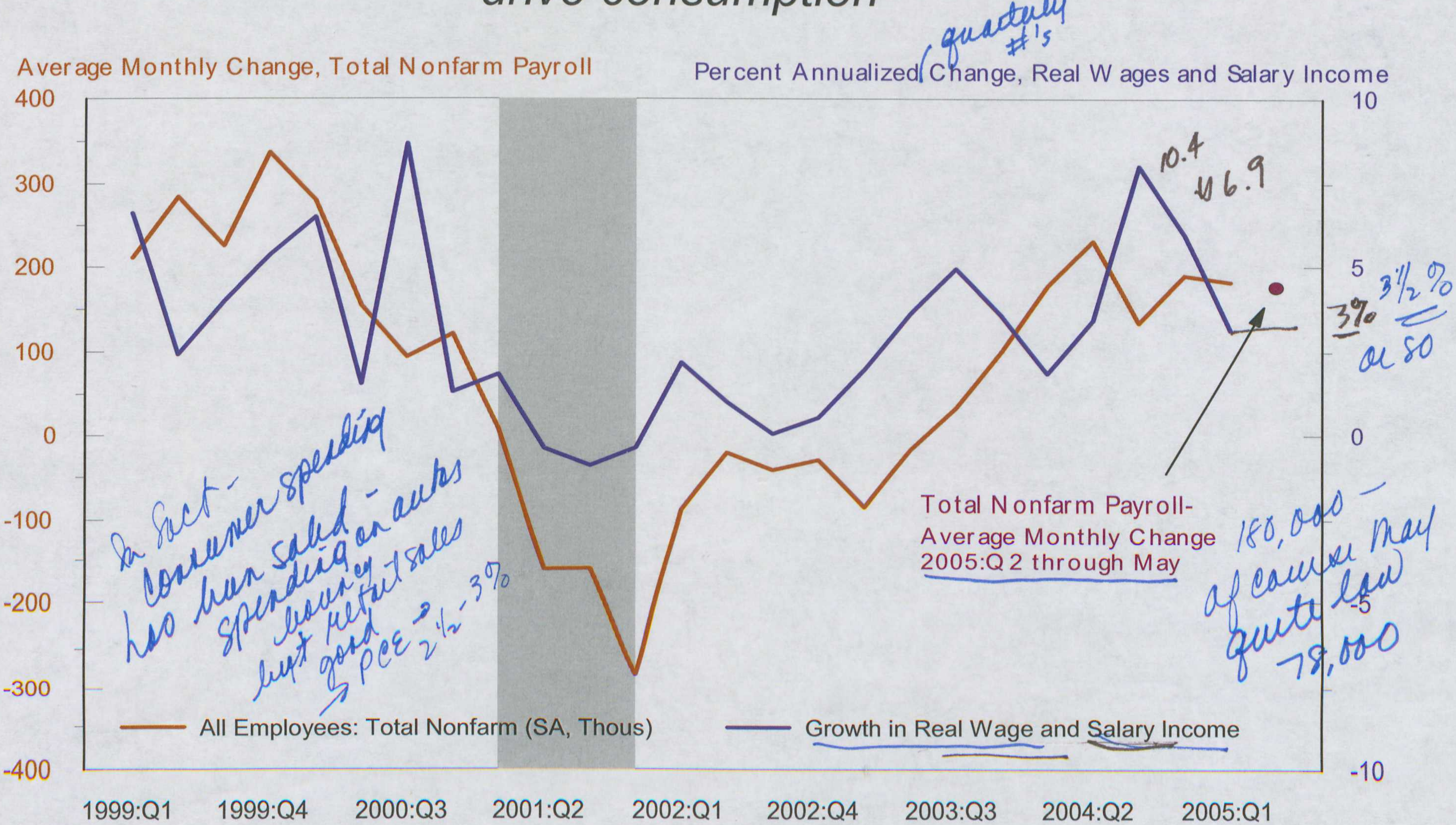
But for near-term - housing still a

Source: Census Bureau.

- Is there a housing bubble - some speculation last 18 mos - real price
- Economic fundamentals strong, at least until recently - affordable, credit accessible; demographics → 2nd homes, 1/3 all homes 04
- Risks → consumption is several, over-extended consumers in part.

But only if people are working

Improving employment and wage and salary growth should drive consumption

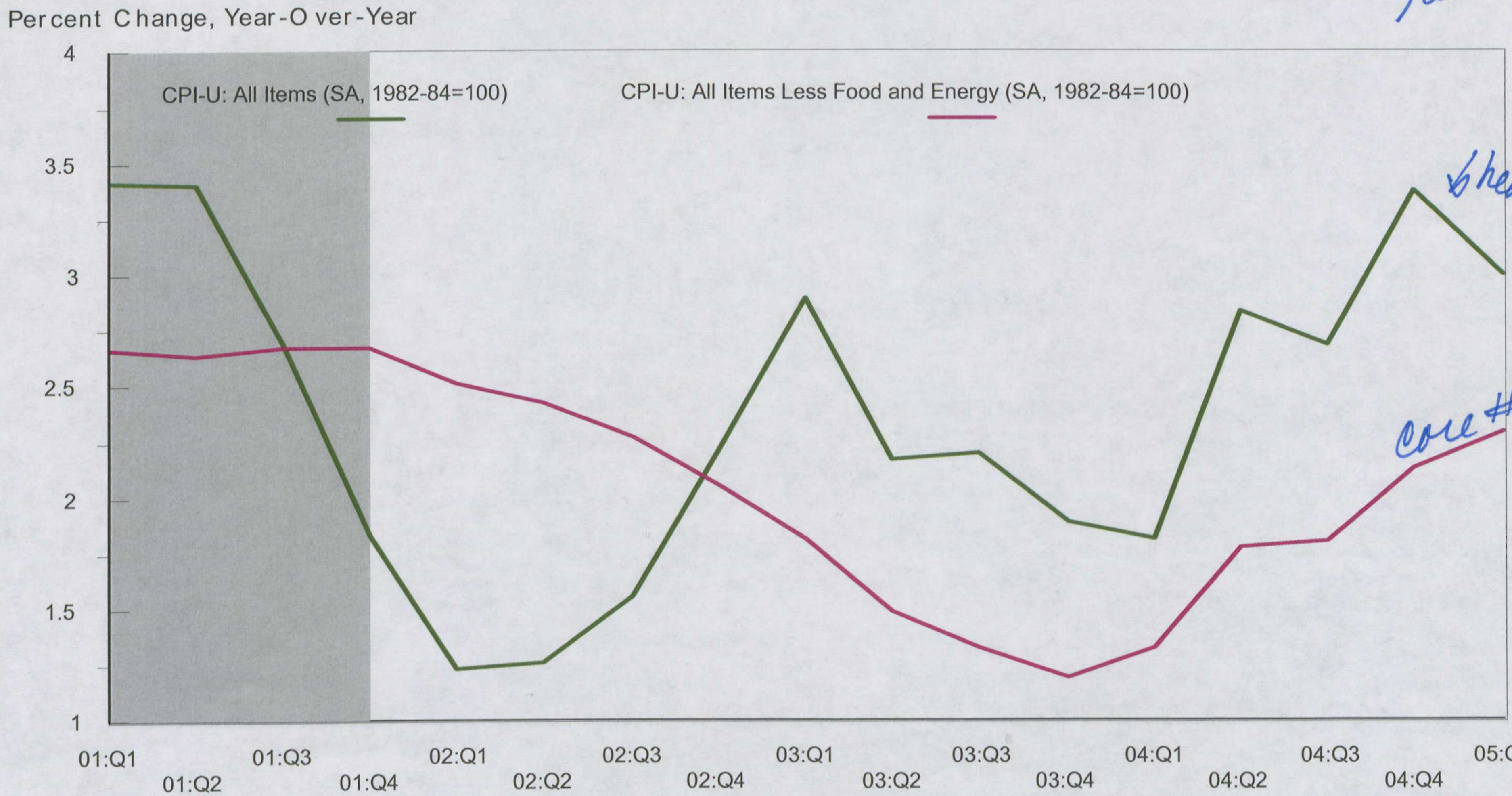


Source: Bureau of Labor Statistics.
Bureau of Economic Analysis.

So it seems likely businesses & consumers on a solid growth path - jumpy #'s mo/T/mo ⇒ but annual picture is + ⟶ inflation

Inflation risks have risen along with oil prices

certainly risks have risen



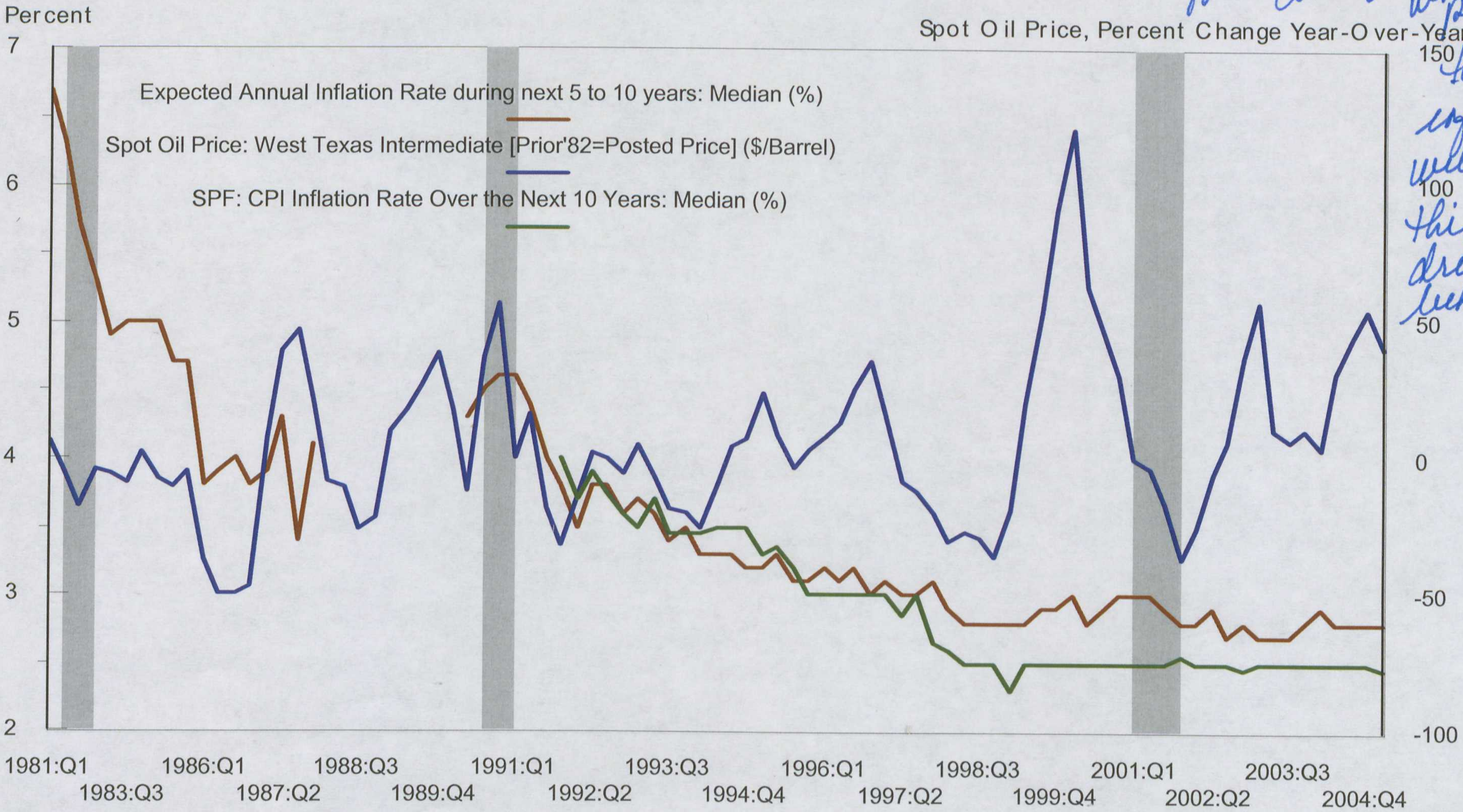
↓ headline

core ↑

Source: Bureau of Labor Statistics.

Yet oil price increases have not had a lasting effect on survey expectations of inflation.

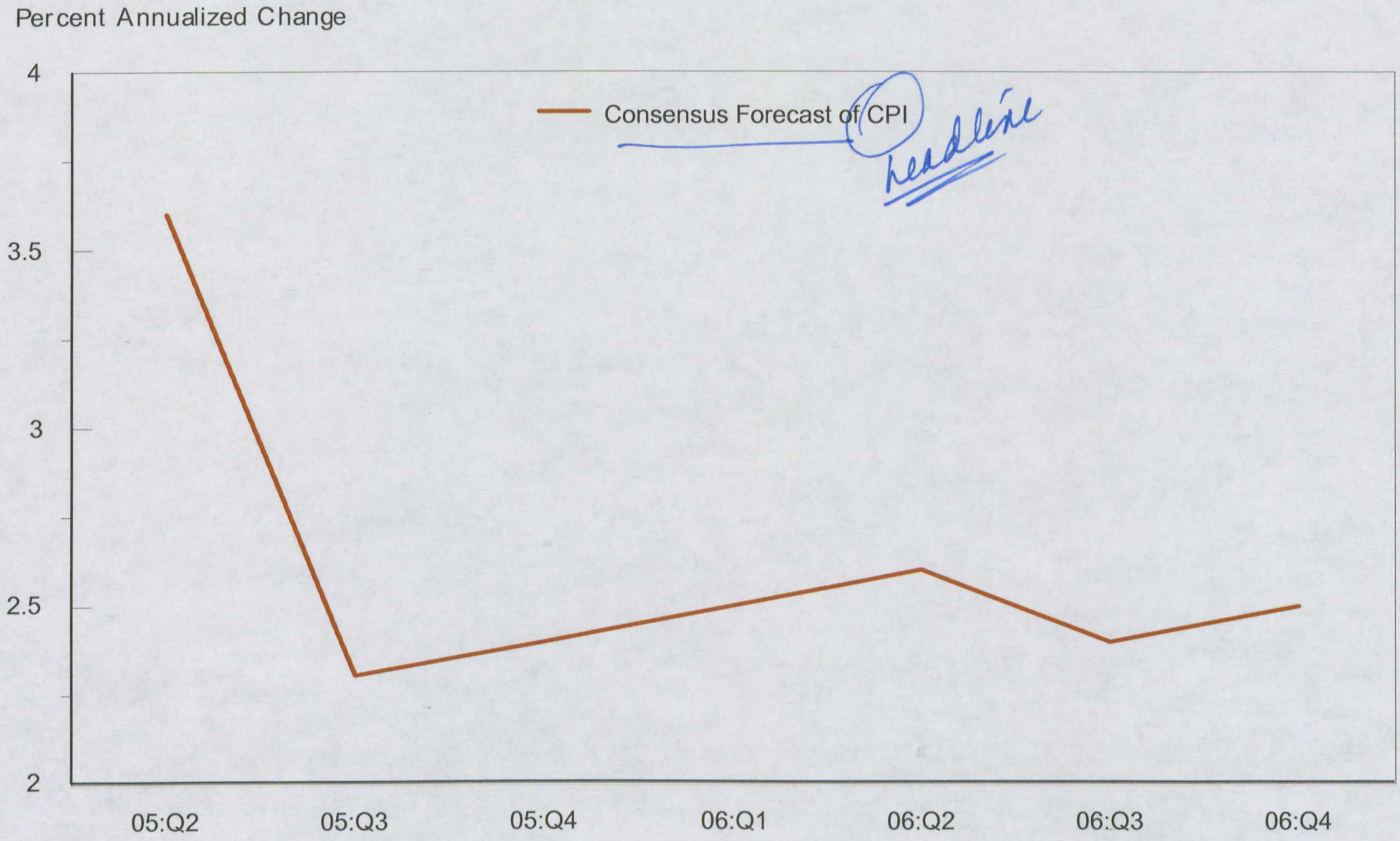
But looking forward - most concerned about what people think inflation will be this drives behavior



Source: Survey of Consumers (University of Michigan).
SPF: FRB Philadelphia.
Wall Street Journal.

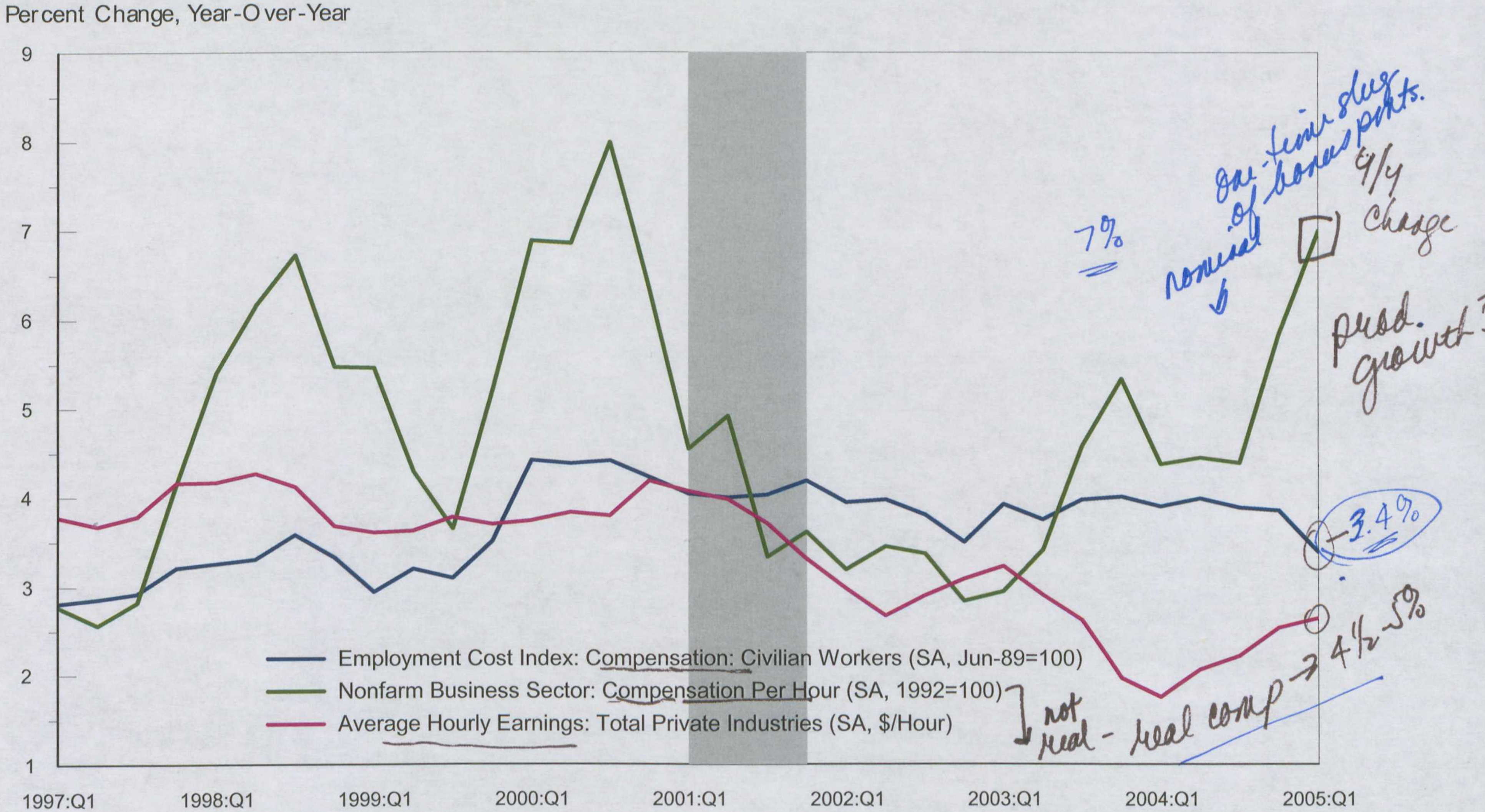
Given expectations, and futures markets

As most forecasters anticipate moderation in inflation



Source: Consensus Forecast.

And most measures of labor costs have yet to accelerate.



Source: Bureau of Labor Statistics.

So - while comp P/hr #s jumped - as did unit labor costs - probably one-time impact → ECI & average hrly earnings more moderate

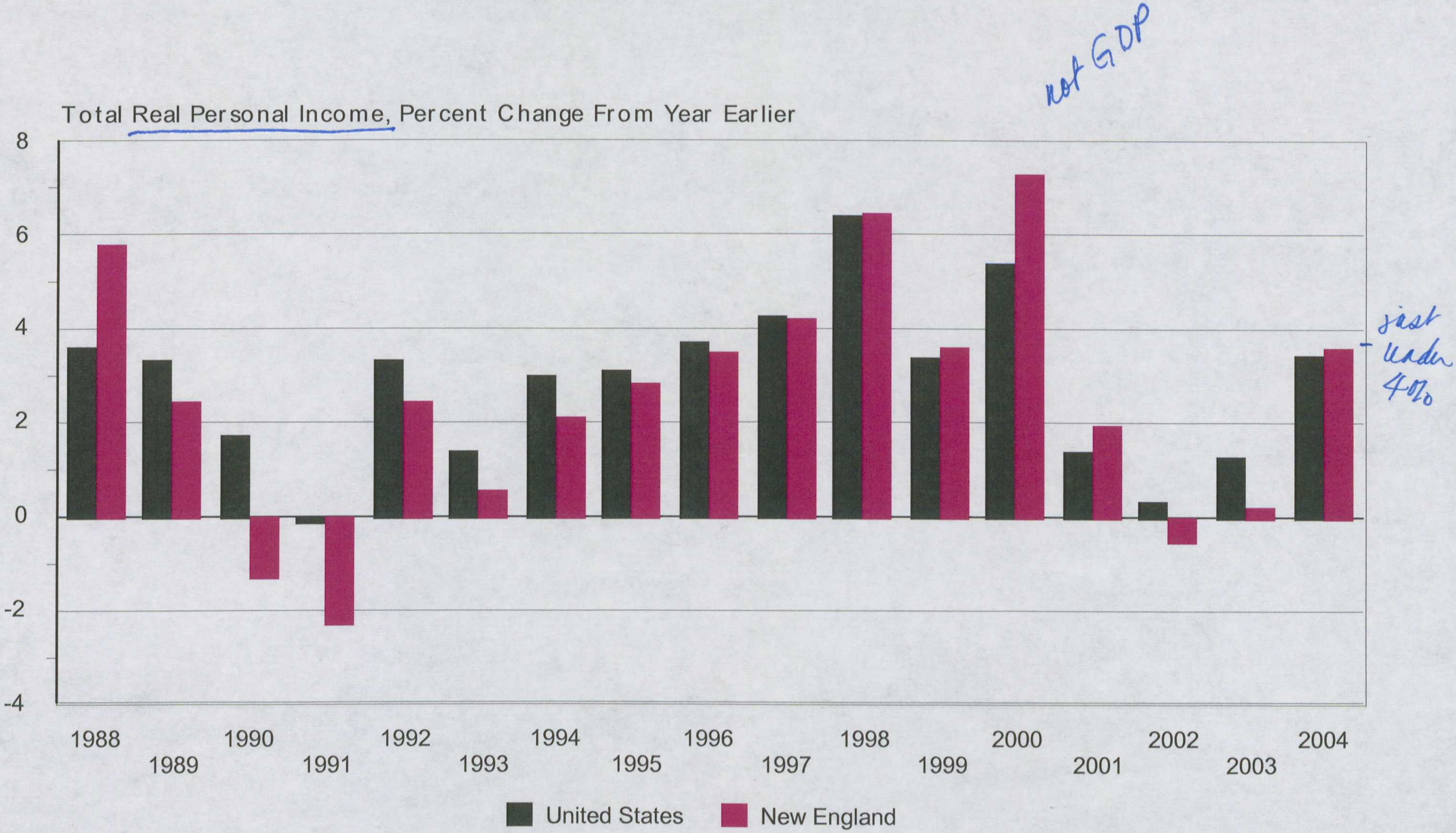
New England Economy

Turning to N England

Business Cycle Update

- New England's economic growth caught up with the nation's in 2004.
- Job counts remain below peak in the two largest New England states, Massachusetts and Connecticut.
- Indicators for early 2005 signal continued expansion.
- … and their homes appreciate more moderately than those in certain other regions of the country.

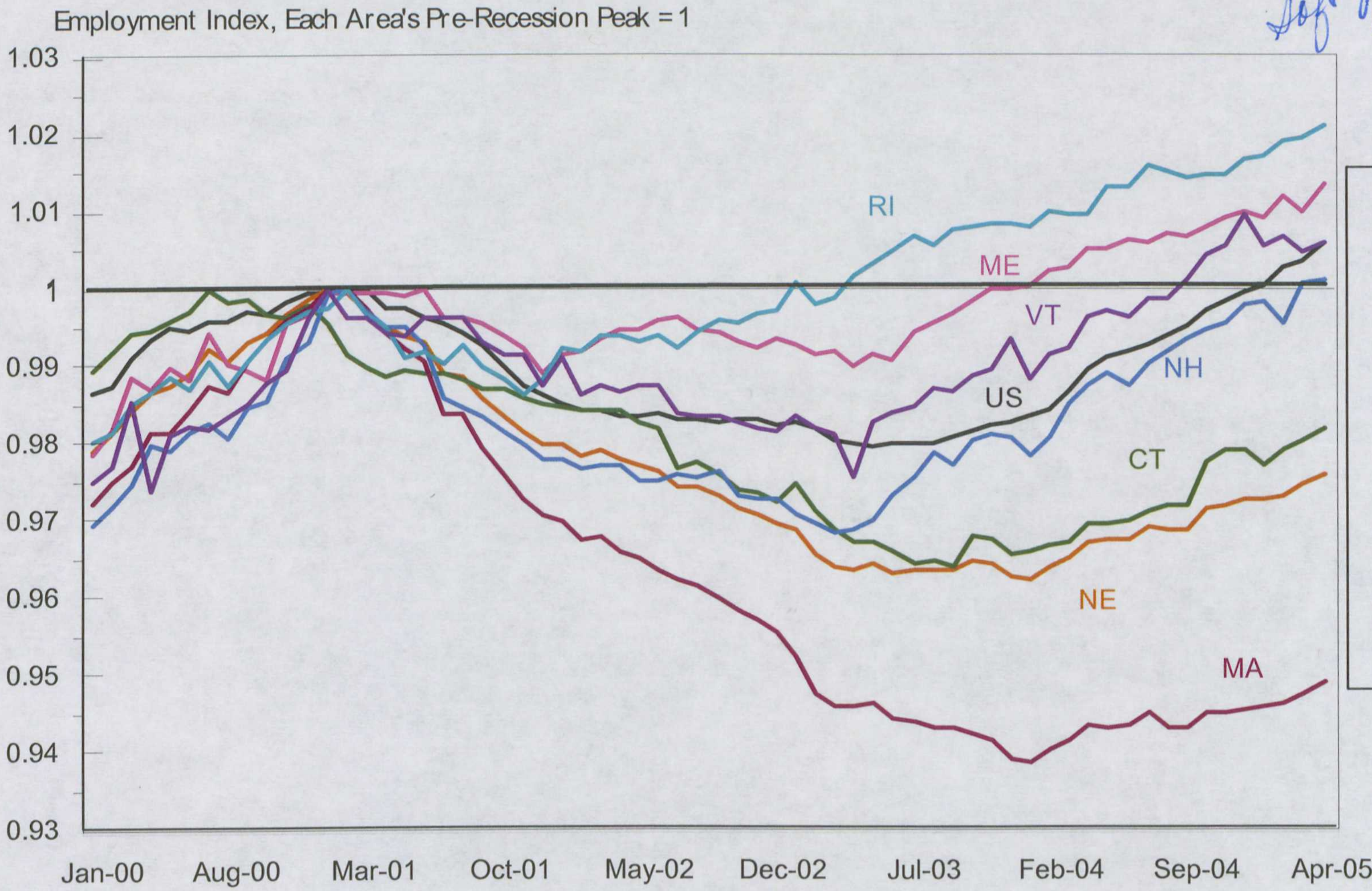
After a slow pickup, the New England economy grew at the same rate as the nation in 2004.



Source: Bureau of Economic Analysis.

The regional job count remains below its pre-recession peak.

Soft spot remains jobs



Shortfalls from Peak (numbers of jobs)

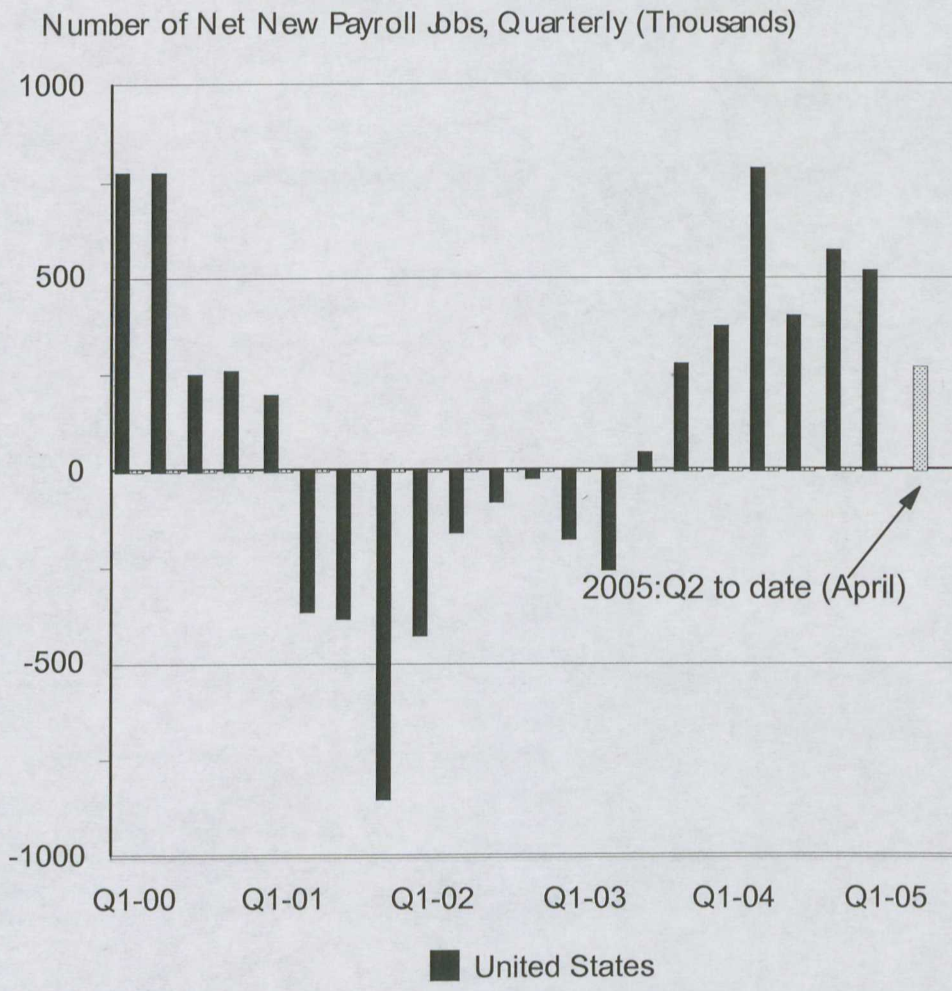
NE: 170,700

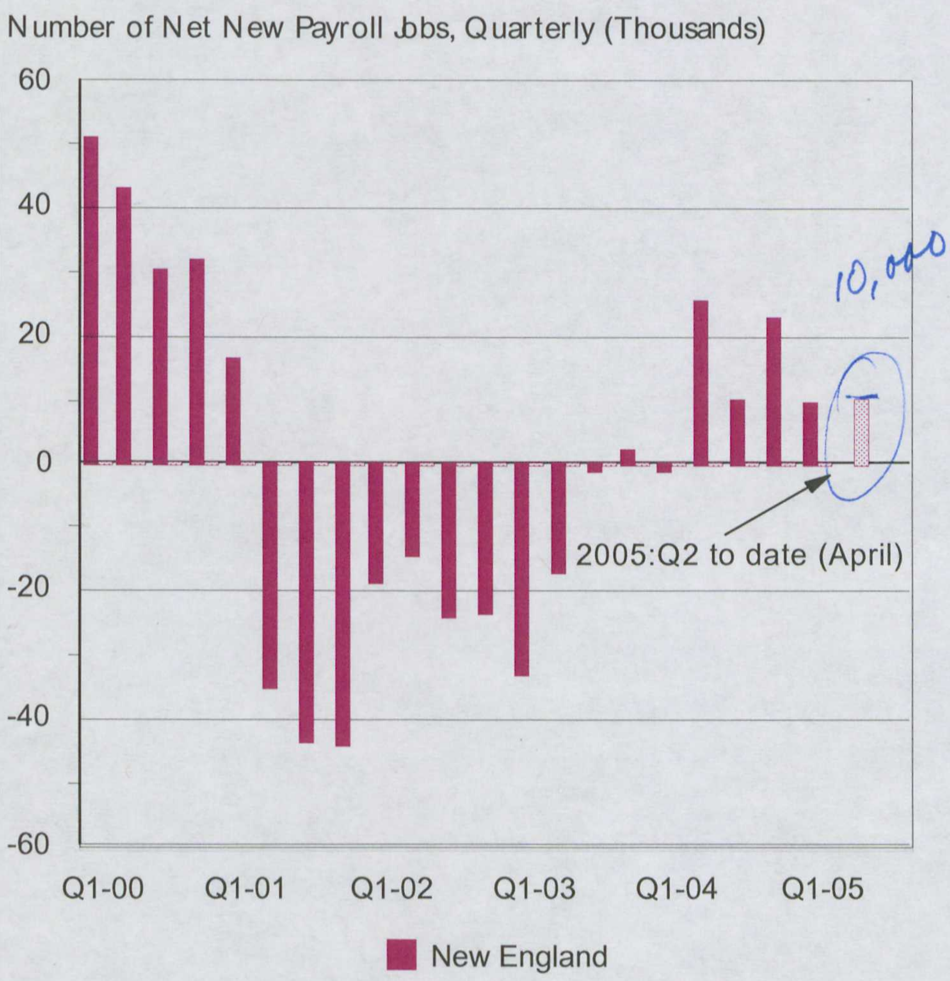
MA: 172,200

CT: 31,000

Source: Bureau of Labor Statistics.

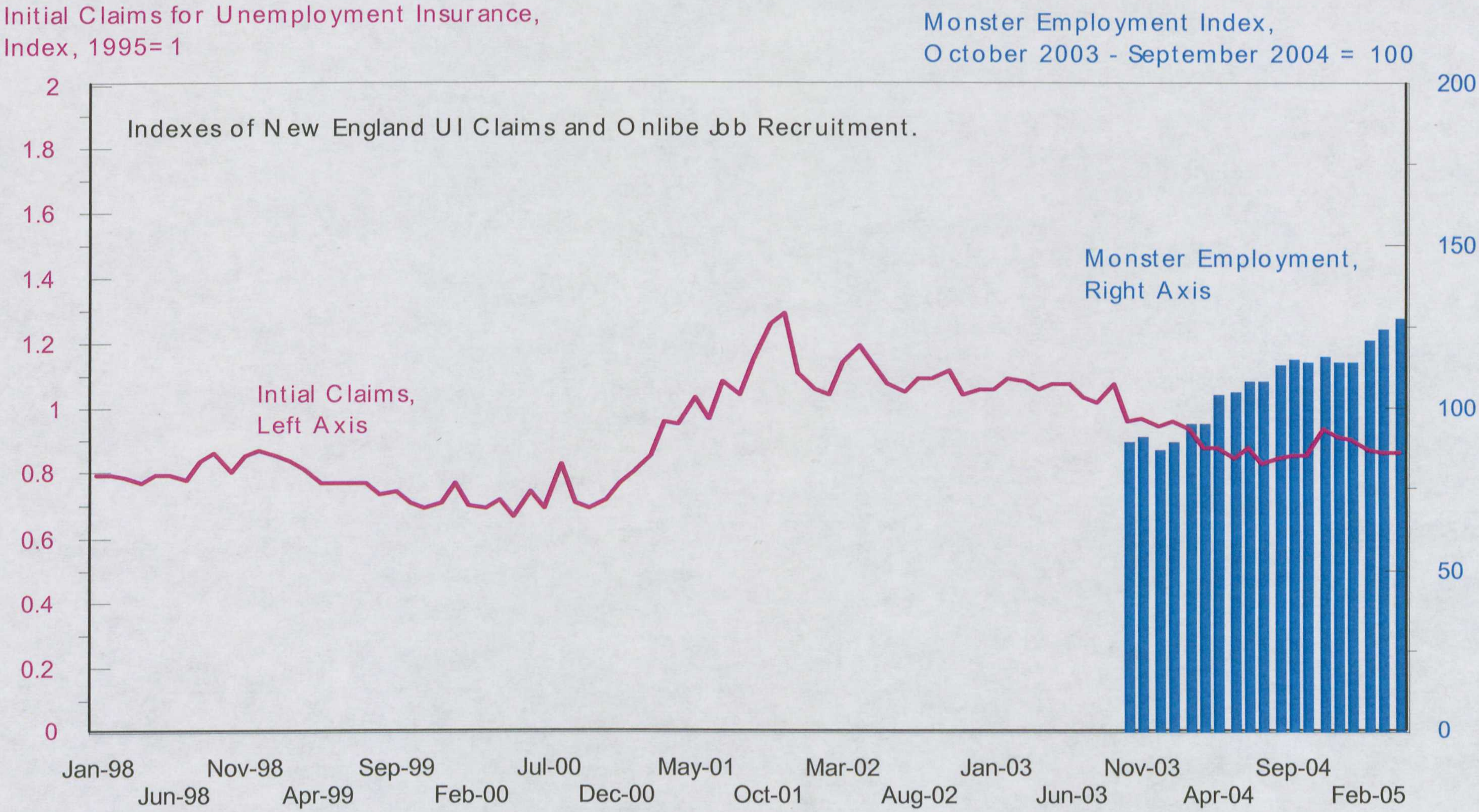
The New England economy is continuing to grow; job gains strengthened in April.





Source: Bureau of Labor Statistics.

Most forward-looking regional economic indicators continue to look positive.

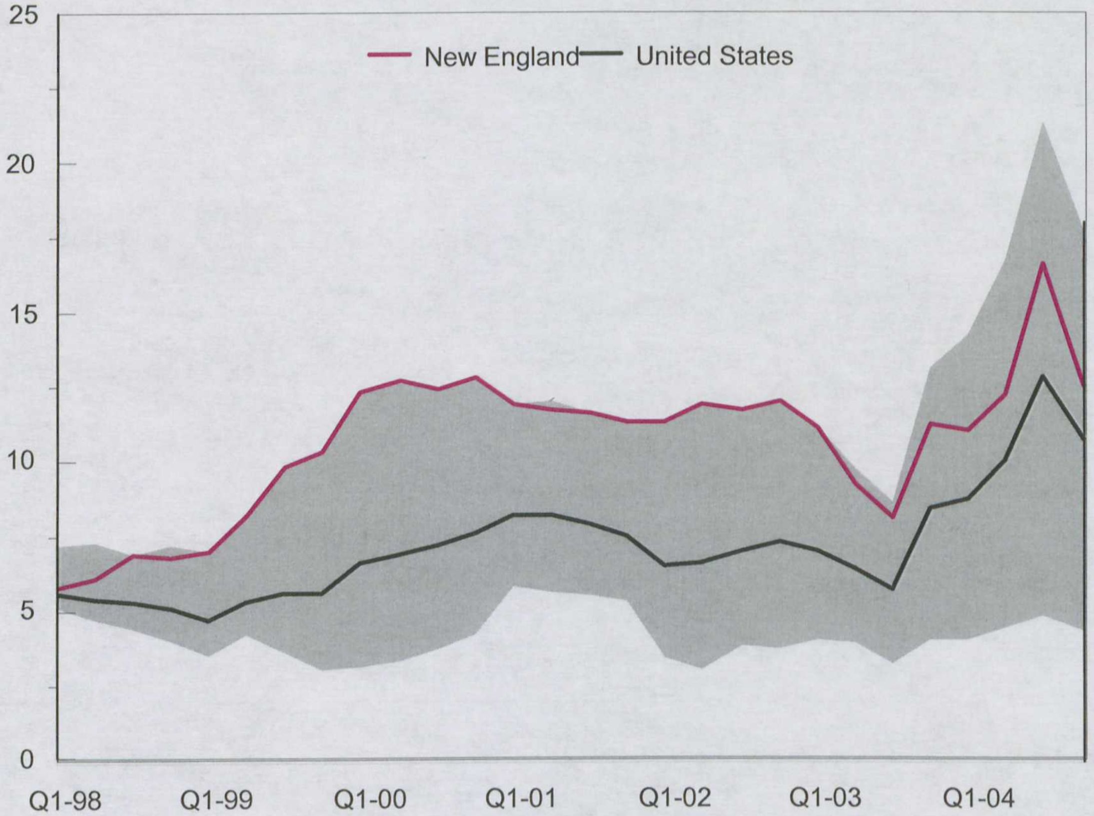


Source: U.S. Bureau of Labor Statistics and Federal Reserve Bank of Boston; Monster Worldwide.

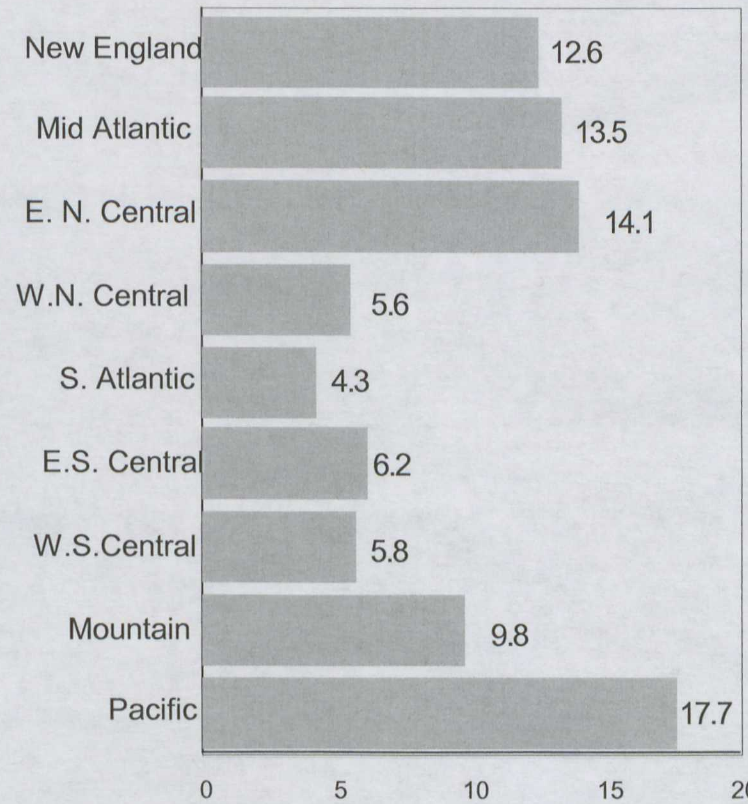
bubble
issue

New England homeowners continue to see their properties increase in value, but several other regions are now experiencing greater rates of home price appreciation.

Conventional Mortgage Home Price Index, Percent Change From Year Earlier



Percent Change,
2003 Q4 – 2004 Q4



Note: Shaded area indicates range of values among the nine U.S. Census divisions.
Source: Freddie Mac.

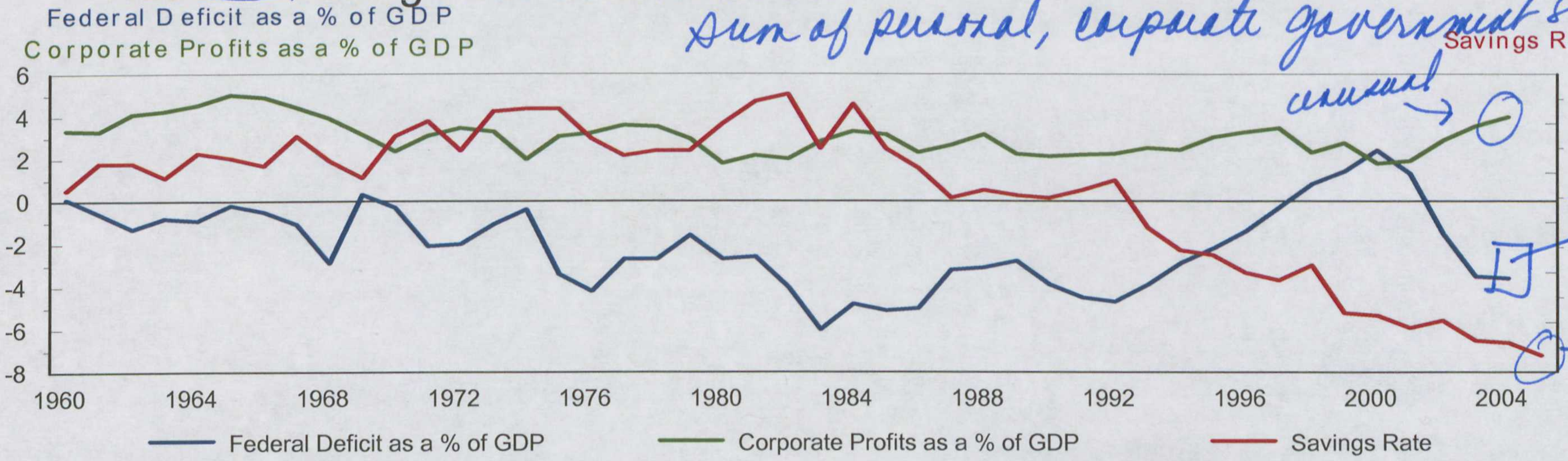
So far the near term - U.S. okay
Region does expanding
Bu housing bubble real in some
places → but maybe lacking
a bit here - what about
long run

Longer-run Concerns

"Twin Deficit" Concerns
Fiscal Deficit / Trade Deficit
Share DNA

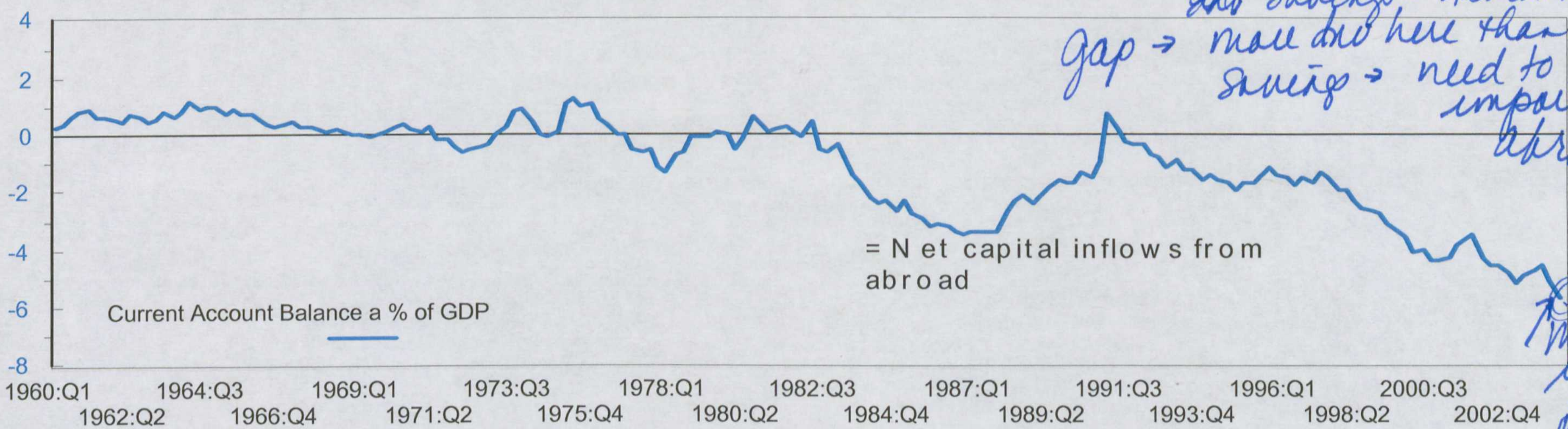
National savings has deteriorated…

Sum of personal, corporate government savings disappear



Which requires that we import savings from abroad

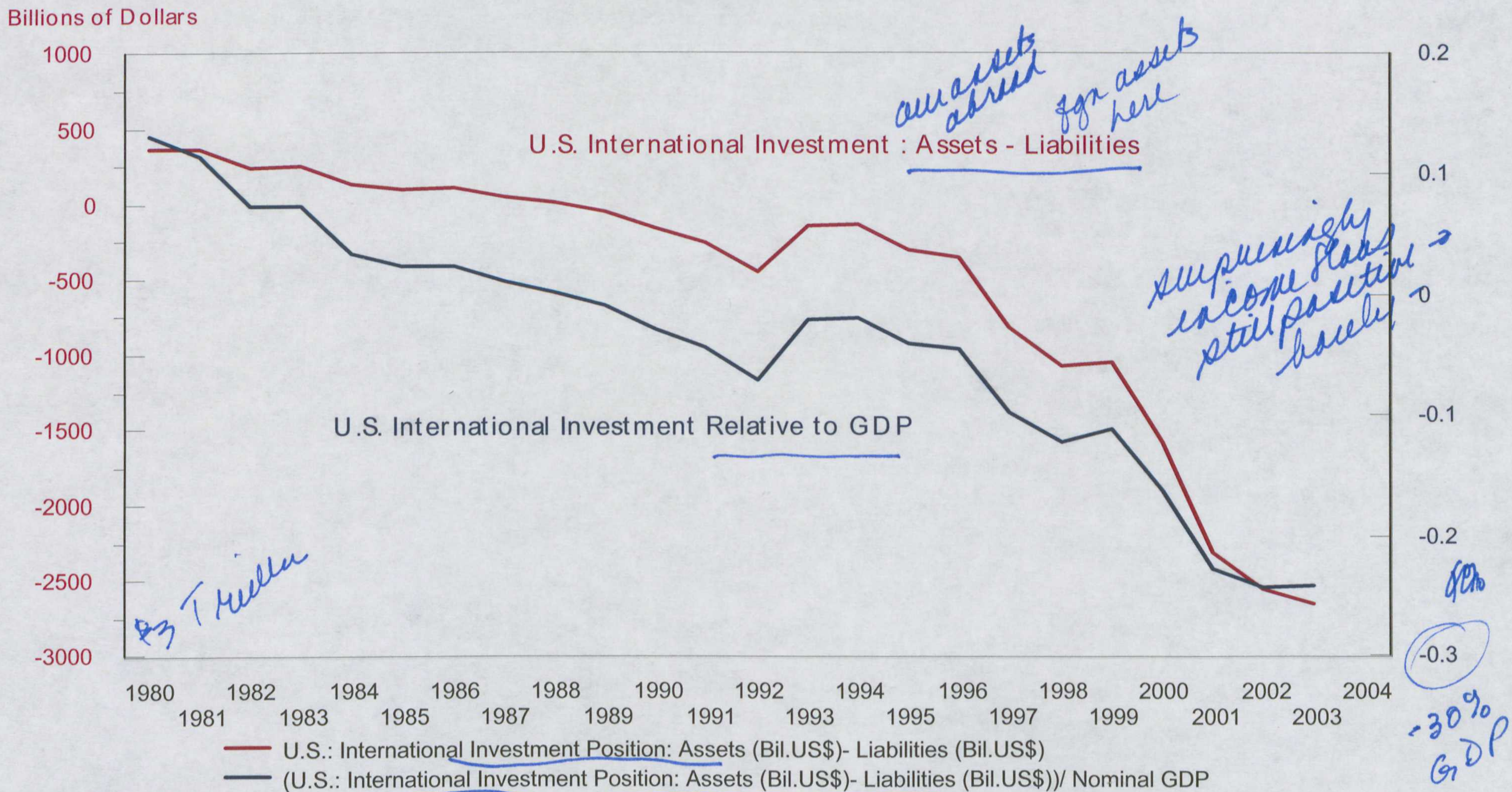
Gross Savings = Investment
Gap → more invested here than savings → need to import from abroad



Source: Federal Surplus/Deficit as a % of GDP (FY): Office of Management and Budget. Personal Savings as a % of Disposable Personal Income, Balance on Current Account as a % of GDP (SAAR): Bureau of Economic Analysis. Corporate Profits as % of GDP: Bureau of Economic Analysis.

This continuing borrowing from abroad turned us from creditor to debtor nation

And our indebtedness relative to the rest of the world limits how long this can continue.



Source: International Monetary Fund/ Haver Analytics.

Investment/Savings Imbalances

- How to re-balance?
  - Depreciating currency, which could result in rising interest rates and financial market instability
  - Increased government or private savings
- Problems with those solutions:
  - We may not like it in the short run
    - Increased govt. savings means less stimulus
    - Weakens recovery in short run
    - Does not yield 1-for-1 decline in trade deficit
  - The rest of the world might not like it
    - Depreciating currency makes *their* goods more expensive
    - If we save more (spend less), the "engine of world growth" slows down—so do they
- 1 Economic logic says deficits can't grow indefinitely. - for both fiscal & trade deficit increasing levels of debt -> create ↑ costs both in principle & interest - eats into std of liv

#sustainable 2-3% - Trade marginal fiscal