



## Letter from the President

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In times of rapid change, experience teaches that good management involves doing two things simultaneously: performing at a high level in the current environment and preparing for the future – a future that may differ from the present in significant ways. This dual focus on present performance and looking ahead was a hallmark of our work in 2004 – in economic analysis and monetary policy, in bank supervision and regulation, in financial services, and in all aspects of our organization.

Economic conditions in 2004 highlight the challenge of managing in the present while preparing for the future. On balance, 2004 was a good year for the U.S. economy and the near-term outlook is promising. Economic conditions also brightened in New England. Longer term, however, our economy faces serious challenges.

The U.S. economy performed quite well in 2004, both in comparison with the rest of the industrialized world and in light of our own recent record. Real GDP was up 4.4 percent from the previous year, a rate of growth above the average for the past 50 years or so and, even after recent surges in productivity, above what some would view as sustainable over the long run. Employment finally began to increase after several years of stagnation, and the unemployment rate drifted down. Moreover, the outlook for 2005 is encouraging. Relatively vigorous job growth should sustain consumption, even though fiscal and monetary policy have become less accommodative. Businesses enjoyed very strong profits in 2004, and balance sheets are in excellent

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shape, creating conditions favorable to investment. There are risks to the 2005 outlook – in particular, core inflation has picked up modestly. But with continued strong productivity growth, near-term prospects for solid economic growth and continued low inflation are good.

Yet there are clouds on the economic horizon. In particular, the low rate of saving in the United States confronts policymakers with serious challenges down the road. Households' saving in this country has fallen to extremely low levels, below one percent of disposable income. At the same time, the federal government has moved from a budget surplus in the late 1990s to a sizable deficit. While strong consumption, supported by federal tax cuts, increased government spending, and accommodative monetary policy, helped sustain the economy through the recession of 2001 and the tentative early years of recovery, their legacy has been a very large federal government deficit and an external deficit of unprecedented size. We are in uncharted territory and the way out is not clear. National saving must increase, but how and when?

The essay in this year's Annual Report explores the implications of these "twin deficits," describing how they are linked, the risks they pose, and the challenges for policymakers. The message of the essay is that we must take action to increase national savings if we are to enjoy a prosperous future.

Within the Bank, the year demanded intense focus on our current performance. Many of our operations met significant challenges most admirably, and we succeeded in achieving some very formidable goals. For example, while the decline in paper check payments is a good development for U.S. consumers and businesses, it has challenged our check-clearing operation to reduce costs and infrastructure to keep pace with lower volumes. We successfully met that challenge in 2004, exceeding very demanding operational and revenue targets – all while promoting next-generation electronic check-image services to assist our customers. And in our high-speed currency-processing operations, years of innovation bore fruit in dramatic productivity gains.

Without question, the hallmark of recent years has been the increasing pace of change. With hindsight, we are likely to look back on the past few years as a period in which many longstanding activities evolved in significant ways, and a range of important new responsibilities emerged. In check, we will be consolidating all our processing activities at the site in Windsor Locks, Connecticut. We also learned that TreasuryDirect call center responsibilities will wind down this year. At the same time, the U.S. Treasury asked the Bank to establish an internet payments platform that will allow federal agencies to reduce the

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cumbersome paperwork and costs of their transactions with suppliers. Meanwhile, four additional New England institutions opted for membership in the Federal Reserve System, increasing our community bank supervision responsibilities. Our supervisory staff contributed nationally and internationally, playing a valuable role in the development of Basel II capital standards, particularly as they relate to operational risk. We also established three new research efforts to focus our expertise and advance our policy contributions – the Behavioral Economics Center, an emerging payments research group, and the New England Public Policy Center. And, in its first full year of operation, our New England Economic Adventure proved quite successful, becoming part of the economics and financial literacy curriculum of nearly 5,000 students and affecting many more through our innovative web site.

The Bank also devoted considerable effort to developing a vision for the future. Although the Bank's core mission of fostering sound growth and financial stability is unchanged, we know that many of the particulars of our activities will be very different. And we recognize that we need to be aggressive in responding to the continuing changes in technology, banking structure, the payments system, and the economy, if we are to remain a dynamic and vital organization effectively serving the public interest.

We looked ahead and assessed the opportunities and the risks. We developed a vision of a Bank that is sought after for its expertise and policy contributions, that is recognized for the effectiveness of its services and its use of state-of-the art technologies and organizational approaches, and that engenders pride among its employees. And we are moving forward to achieve this vision, with particular emphasis on helping our staff develop the skills necessary to take on new and challenging responsibilities. Our new research centers, our work with the U.S. Treasury, our contributions to monetary and supervisory policy, and new initiatives in economic and consumer education are all examples of how we are moving to fulfill our vision.

We also took time to look back, at our past. The Bank reached its 90th birthday in November 2004, as did all of our sister Federal Reserve Banks. As an organization we reflected on nine decades of service, and we were reminded again that the Bank's work has always been shaped by technological change and customer needs. Nine decades ago, the Bank opened for business in two rooms below street level. In our first decade, Morse code messages replaced the movement of currency or gold as the primary means of funds transfers. In our fourth decade, the Federal Reserve and the banking industry developed magnetic ink character recognition (MICR) encoding, allowing automated check processing. In



our seventh decade, the Bank moved into its current home at 600 Atlantic Avenue, and the Reserve Banks began nationwide processing of Automated Clearing House electronic payments.

Today, we are doing things like serving the U.S. Treasury with stored-value-card services for soldiers in far-flung places like Qatar, running internet firewall services for the entire Federal Reserve System, contributing to supervision policy nationally and internationally, and organizing economic conferences on issues ranging from the effectiveness of fiscal policy to the workplace challenges facing high-achieving women. We also are refurbishing the property surrounding our building, creating a beautiful and secure setting that will serve us many decades in the future.

Last but far from least, I must acknowledge all the officers and staff who made these achievements possible. We will miss the many valued colleagues and friends who retired in 2004. I am also grateful to all those who served on the Bank's advisory groups; their insights have been most helpful in discerning the course of the economy and identifying emerging issues. The Bank's board of directors has been a valuable source of guidance, support, and energy in these challenging times. We especially thank Larry Fish, Chairman, President and Chief Executive Officer of Citizens Financial Group, who completed his three-year service as a director.

The Bank has always played a crucial role in the financial and economic fabric of New England and the nation. By continuing to assess and improve our present policy contributions and services, and looking out towards the future, we are confident that we will meet the present and future needs of the public we are here to serve.

Cathy E. Minehan