Letter from the President

As many of you know, I have decided that this year will mark the end of my nearly 40 years with the Federal Reserve System, and 16 years here at the Federal Reserve Bank of Boston. It has been an incredible journey from management trainee in New York to President in Boston, and one for which I am more grateful than I can say. In particular, having the opportunity to lead the outstanding staff at the Boston Bank, to meet the many challenges we have successfully faced, and to see the Bank and its work remain a vital part of the New England community and the Federal Reserve System has been deeply satisfying. I am confident the Bank will continue in its tradition of excellence going forward, and I am proud to have helped make this possible.

It has been a tradition in our Annual Report letters from the President to provide a short sketch of the economy over the past year and some highlights of Bank operations. I see no reason to depart from that tradition, as it has indeed been a challenging and interesting year of transition for the economy and for the Bank.

In 2006, the U.S. economy made a difficult downshift in tempo – a transition from above-trend growth at the start of the year to more moderate growth at the end. But this transition was hardly smooth, as the outlook was buffeted by a rapid deterioration in housing markets and volatile energy prices. However, as has been the case through many challenges over the past decade or more, the economy's underlying resilience shone through. Employment trends were solid, consumption remained strong, business profits surprised on the upside, and foreign demand grew in strength. Through all of this, inflation – stoked by higher energy costs – increased, and then declined toward year-end as oil prices moderated. Taken together, the pattern of solid underlying demand, low unemployment, and rising prices pointed to the need for policy action. In four steps in the first half of the year, the key monetary policy rate moved to 5.25 percent, where it remained at year-end. This increase was necessary to manage the risks to the economic outlook, which became both more balanced and deeper as the year ended.

Economic activity in New England continued to expand at a pace that was slower than that of the nation, at least measured by job growth. Overall, though, regional

Cathy E. Minehan, President
Paul M. Connolly, First Vice President

businesses showed signs of health, with manufactured exports growing and both downtown and suburban office vacancy rates in the Boston market declining below national levels. Indeed, both business and consumer confidence remained relatively high, even in the face of deterioration in housing markets that mirrored the nation's. Residential construction fell sharply in all New England states, and the pace of housing appreciation slowed. More important for New England's families and communities, delinquencies and home foreclosures began to rise, particularly for certain types of mortgages. Clearly, this will be a challenge in 2007.

Within the Bank, we managed many transitions in 2006. We met the challenge of successfully combining our two check-processing operations into one, at Windsor Locks, Connecticut. This supports the shift of the U.S. retail payments system from paper to electronics and reflects the Bank's commitment to providing financial services in the most efficient, effective, and forward-looking ways possible. And on the other side of the globe, our staff installed stored value card software and kiosks at 13 military bases in Iraq and Kuwait – a high-profile example of the innovative work we are doing to support the U.S. Treasury's transformation of its payments services.

At the Boston office, after 11 years of "Big Dig" construction, and our own renovation efforts, we cut the ribbon on a brand-new plaza, both attractive and highly secure. We are a premier site located at a major gateway to the city, and along the new Rose Kennedy Greenway that marks a major transformation of the city of Boston. Both our staff and our tenants have reason to be proud of the building and its place in the city.

Our 51st research conference focused on transitions, too, under the theme "Global Imbalances – as Giants Evolve." Economists, business leaders, and policy makers from around the world explored the structural changes underlying today's large global imbalances; considered the pressures and opportunities presented by the recent emergence of China and India in the global economy; and examined how demographic change and the evolution of advanced economies affect international resource flows. These are critical issues facing this country and the world. As we have done in the past, the essay in this Annual Report is devoted to the major themes of the conference, and we hope that this will enable a wider audience to learn from the conference experts.

A critical effort across the Bank last year focused on developing a Vision for our operations in 2010 and planning how to achieve that Vision. Bringing this to fruition will present dynamic and exciting challenges in the years to come. The many activities of the Bank and the ways we pursued our Vision in 2006 are noted in the Bank Highlights section of this report.

Leadership transitions also characterized 2006. The Federal Reserve System experienced an historic transition in 2006, as the chairmanship of the Board of Governors passed from Alan Greenspan to Ben Bernanke. Chairman Bernanke visited with us in June and engaged everyone with his insights and understanding of all that we do. Within our Bank, three members of our board of directors completed their service – Peter Blyberg, President and CEO of Union Trust Company; Kirk Pond, Chairman of the Board of Fairfield Semiconductor International; and our chair, Dr. Blenda Wilson, President and CEO of the Nellie Mae Education Foundation. All of our directors and members of the Bank's advisory groups provide the Bank with invaluable insights and leadership, and we thank them for their service in 2006.

Transitions bring with them a sense of sadness as well as anticipation. I am looking forward to new ways to continue to serve the region and the nation, but I will miss everyone involved with the Bank and the Federal Reserve System. It has been a joy to work with the staff of the Bank and our directors and to develop relationships with so many around the region, in banking, business, government, community organizations, academia, and the nonprofit world. As all of us make the transition to 2007 and beyond, I know we will continue to work together to make the Bank, the region, and the nation stronger.