

The Economy in Perspective

Learning to live with the New Economy. . . The tangible manifestations of the current U.S. economic slump have reinvigorated the Old Economy/New Economy debate. The Old Economy's champions, pointing to stock market woes, consumer sentiment worries, declining manufacturing activity, and corporate layoffs, see familiar patterns at work. New Economy advocates argue that even as the economy endures an adjustment period, it does so in different ways and will emerge in a different place than it used to.

Does this Old Economy/New Economy dichotomy offer us anything useful from which to learn, or is it a distinction without a difference?

First, let's define the Old Economy paradigm. In this world, business cycles are endemic to the economy's operations because it is so hard to coordinate production and sales. Inventory buffers are stockpiled at links in the supply chain between manufacturers and consumers to smooth out normal imbalances between supply and demand, but these same stockpiles can create large disturbances if they swell just before demand shrinks. When that happens, manufacturers are forced to scale back sharply or shut down completely while the stockpiles are worked off, usually at deep price discounts.

The resulting declines in profitability feed back through financial markets, impairing firms' ability to raise funds when they need them most. Labor markets slacken, the unemployment rate rises, and hiring cost pressures ease. Economic activity remains at low ebb until excess inventories are cleared out, marginally profitable operations are sold or improved, and balance sheets are repaired. Hiring and investment spending resume only after firms are forced to expand capacity once again, and when banks are able to finance more projects.

The New Economy, its advocates say, is less fragile. Where the Old Economy was rooted in manufacturing industries constrained by decreasing returns to scale in production, the New Economy is built on information and technology industries that show increasing returns to scale in production and positive externalities. Waves of innovation guarantee that firms can constantly lower their cost structure and promise consumers a continuously improving array of choices. Living standards tangibly rise, as does the quality of life. The dynamism associated with these innovations also ensures new and profitable investment opportunities and a steady supply of rewarding jobs. People accept change because they see it as a bridge to a better future.

The New Economy is also free of the boom-and-bust pattern that plagues the Old Economy. Inventory rebalancing, such a prominent source of transmission in the Old Economy paradigm, is far less important in the New Economy of advanced supply-chain management. New Economy firms directly tie their information systems together, enabling them to continuously match orders to sales.

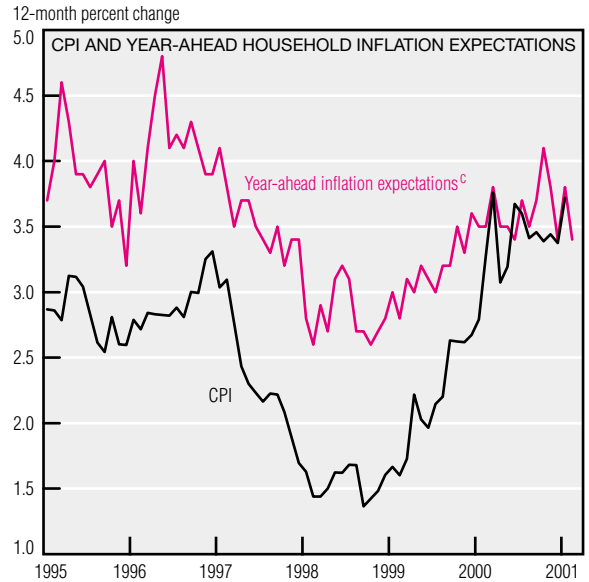
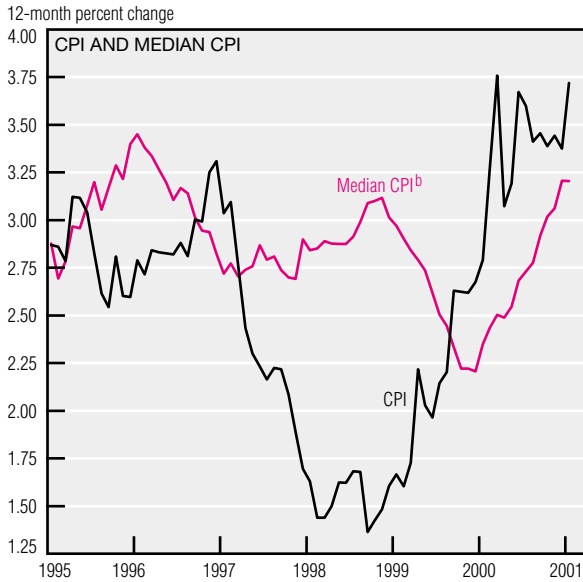
Moreover, New Economy firms and their investors have long planning horizons. They see the merits of increasing market share, expanding globally, and acquiring smaller competitors. With new technologies to power their businesses and sell to others, the entire New Economy has a solid underpinning that is impervious to cyclical fluctuations. Its financing comes not just from banks, but from global capital markets. While the Old Economy was about job security and Social Security, the New Economy is about creative destruction and the privatization of retirement wealth.

But just how profound is the change? High-tech investment, the lynchpin of our decade-long expansion, has nearly stopped growing, while the NASDAQ's much-vaunted invincibility has crumbled. One Blue Chip firm after another has fallen short of its earnings projections. An old-fashioned inventory correction seems to be under way, with especially severe repercussions echoing through the transportation equipment industry. Lenders are applying tighter credit standards to their customers. Consumer and business sentiment has been poor. Certainly none of these conditions fit with the beguiling portrait that ardent New Economy advocates have been painting. Yet, something does seem different.

Productivity has improved significantly during the past several decades, especially in manufacturing industries. New technologies are surely important, but there are other important factors to consider. Businesses invest in new technologies when they can put them to use profitably. Those circumstances are far more likely to prevail in an environment of low inflation and increasingly open borders—conditions that have prevailed for the last decade. Competition and property rights are just as important to intellectual property as they are to physical assets. The New Economy is new, not only because of its application of new ideas, but because it relies on some sound old ideas as well.

Inflation and Prices

| | Percent change, last: | | | | 2000 avg. |
|-------------------------|-----------------------|--------------------|--------|--------------------|--------------|
| | 1 mo. ^a | 3 mo. ^a | 12 mo. | 5 yr. ^a | |
| Consumer prices | | | | | |
| All items | 7.8 | 4.2 | 3.7 | 2.6 | 3.4 |
| Less food and energy | 4.0 | 2.9 | 2.6 | 2.4 | 2.5 |
| Median ^b | 3.6 | 3.6 | 3.2 | 2.8 | 3.2 |
| Producer prices | | | | | |
| Finished goods | 14.6 | 6.2 | 4.8 | 1.8 | 3.6 |
| Less food and energy | 8.4 | 3.3 | 2.0 | 1.1 | 1.2 |



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 c. Mean expected change in consumer prices as measured by the University of Michigan's Survey of Consumers.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

Inflation worsened unexpectedly in January. The Consumer Price Index (CPI) rose at a decade-high 7.8% annual rate, helping to push its 12-month growth trend to 3.7%, the highest level in nearly nine years. Likewise, price increases at the factory level were much larger in January, up a whopping 14.6% (annual rate). Energy and tobacco price increases were especially prominent, building on a year-long sequence of large advances in these items.

Still, the breadth of recent price increases clearly has extended well beyond a few volatile components, as

shown by core measures of inflation. The CPI excluding food and energy, for instance, was up 4.0% (annual rate) in January, while the median CPI rose 3.6% (annual rate). The median CPI corresponds to the price increase in a consumer's market basket where half the items show larger price increases and half show smaller ones. The 12-month percent change in the median CPI has risen sharply since the beginning of 2000.

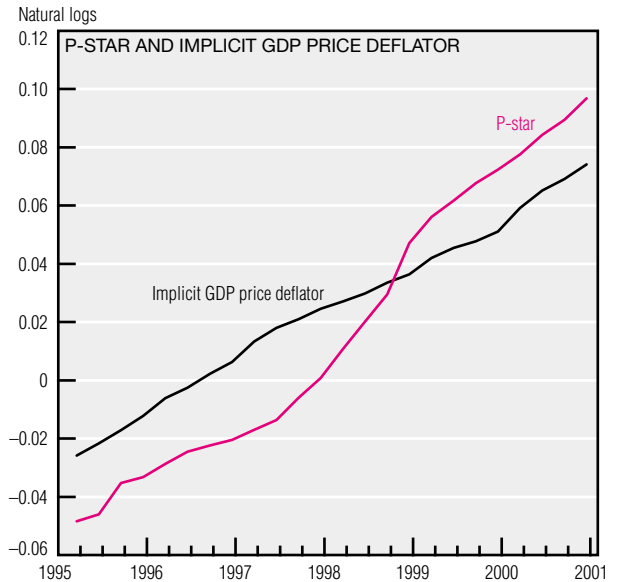
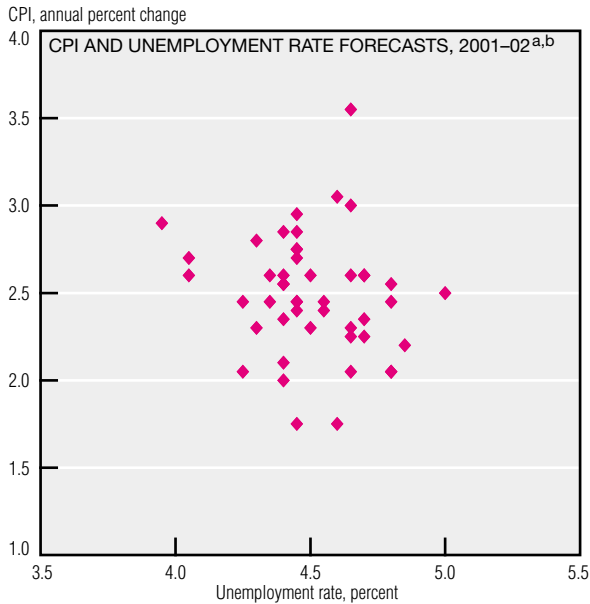
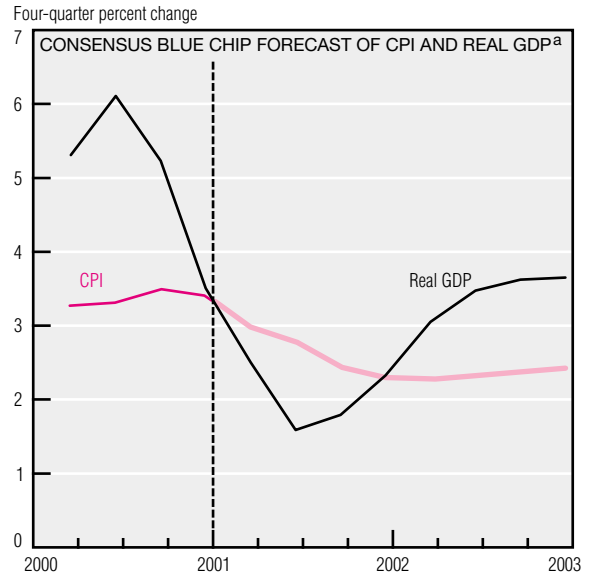
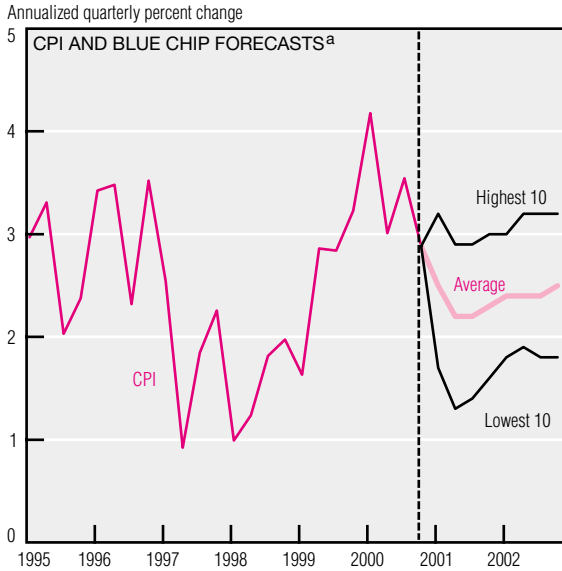
Nevertheless, while the recent upward inflation trend was accompanied by deteriorating household inflation expectations early in the process (1999), the pub-

lic's inflationary sentiments seemingly leveled off in 2000 and, so far, in 2001. In other words, the higher inflation rates recorded in recent months have apparently not fueled an inflation scare among U.S. households.

The central bank faces an especially difficult decision on how to respond to these higher inflation estimates, given the recent deceleration in the rate of economic growth. The Federal Reserve's stated ultimate objective is to eliminate inflation's corrosive influence on the economy. A key ques-

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Inflation and Prices (cont.)



a. Blue Chip Panel of economists.

b. Individual economists' forecasts, average for 2001 and 2002.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Blue Chip Economic Indicators, February 10, 2001.

tion, then, is whether recent data are an aberration or suggestive of a persistent upward trend in the inflation rate.

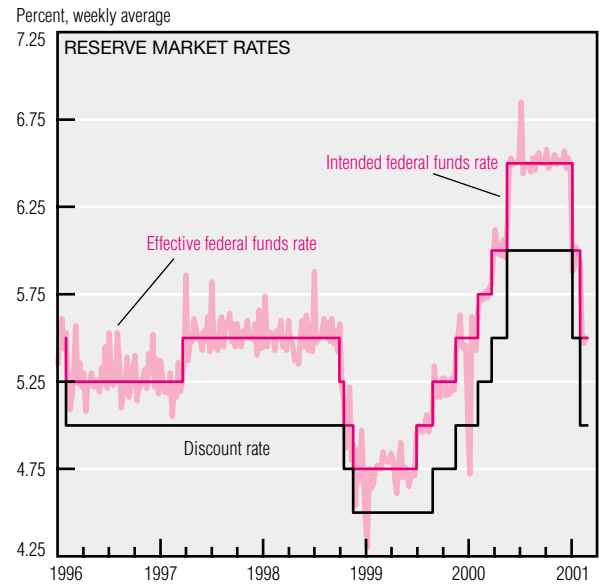
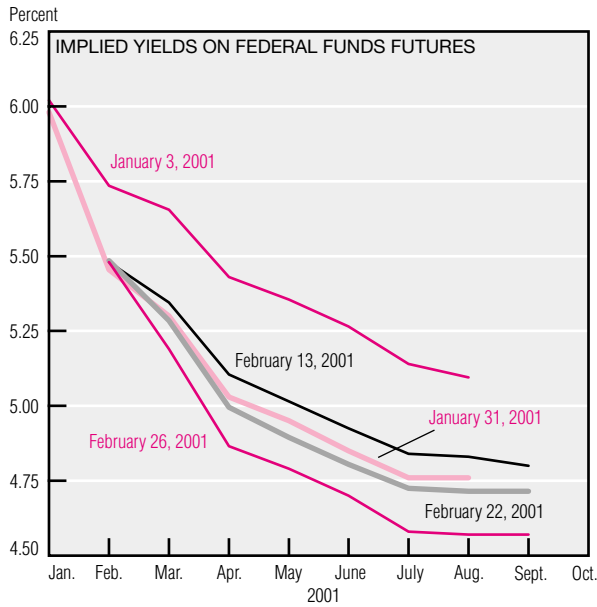
Economists are divided on the outlook for the next few years. Pessimists are projecting the rate of inflation to remain at or slightly above 3% through the end of 2002; optimists see it falling back below a fairly benign 2% during the same period.

An argument for the optimists' view is that energy prices, which doubtless are

being incorporated into a wide range of goods and services this year, will not keep rising indefinitely. Slower growth in economic activity might also relieve some of the price pressure. Indeed, the consensus forecast of economists shows a pattern in which inflation is projected to follow the economy's growth rate downward. But economists who use such models have been unable to measure precisely the connection between inflation and growth (witness the widely scattered unemployment and inflation rate expectations charted above).

The more pessimistic inflation outlook is buttressed by an above-average growth rate in the money supply (as measured by M2) relative to estimates of potential GDP, a model of future inflation that economists call P-star. When P-star exceeds the price level (as it has done since late 1998), inflation will likely accelerate. Unfortunately, this model of the inflation process has also proven highly imprecise in recent practice.

Monetary Policy



| Economic Indicators (percent) | Projections for 2001 ^a | | |
|---|-----------------------------------|-------|------------------|
| | 2000 Actual | Range | Central tendency |
| Nominal GDP ^b | 5.9 | 3¾–5¼ | 4–5 |
| Real GDP ^c | 3.5 | 2–2¾ | 2–2½ |
| PCE Chain-type Price Index ^b | 2.4 | 1¾–2½ | 1¾–2¼ |
| Civilian unemployment rate ^d | 4.0 | 4½–5 | About 4½ |

a. By Federal Reserve governors and Reserve Bank presidents.

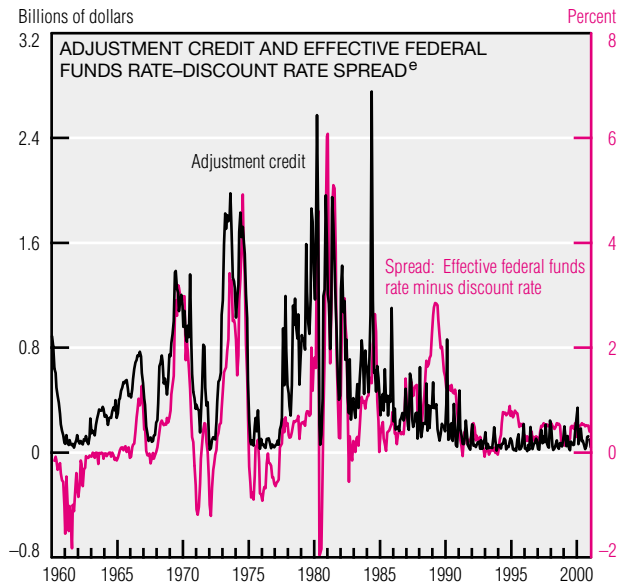
b. Change, fourth quarter to fourth quarter.

c. Change, fourth quarter to fourth quarter, chain weighted.

d. Average level, fourth quarter.

e. Monthly, not seasonally adjusted.

SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.



On February 13, the Board of Governors of the Federal Reserve System submitted its semiannual Monetary Policy Report to Congress, and Federal Reserve Chairman Alan Greenspan testified before the Senate Committee on Banking, Housing, and Urban Affairs. Chairman Greenspan expressed optimism about “the prospects for sustaining strong advances in productivity in the years ahead,” but also noted that “downside risks predominate” over a shorter horizon. Implied yields on federal funds futures did not react strongly to his testimony. Market participants continue to

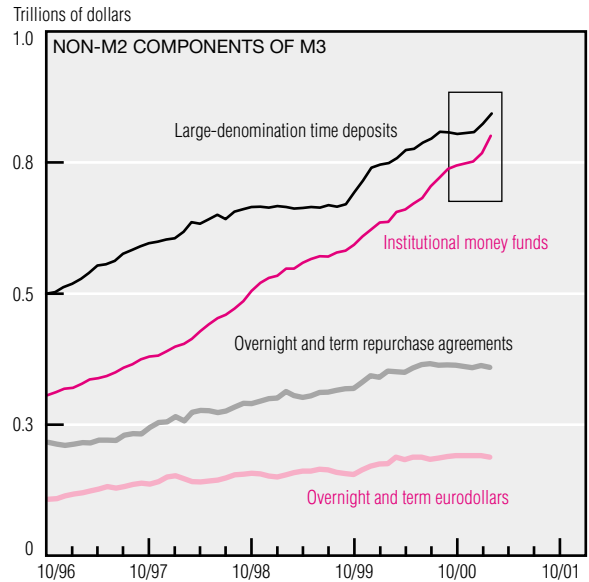
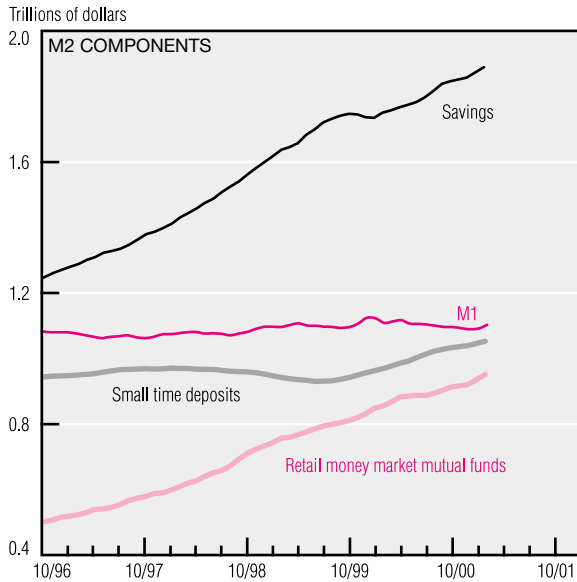
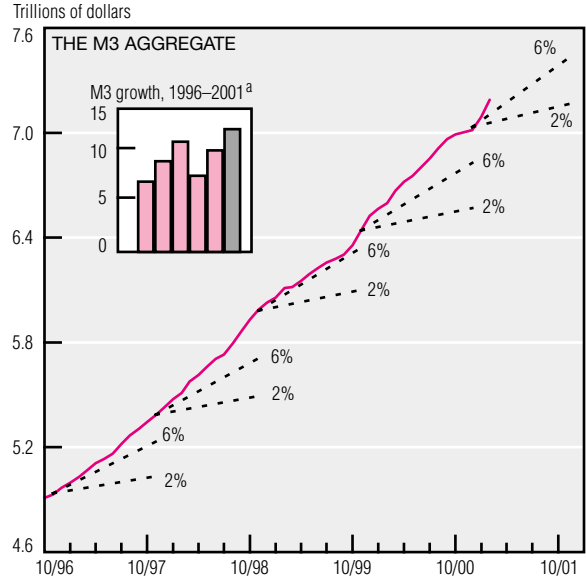
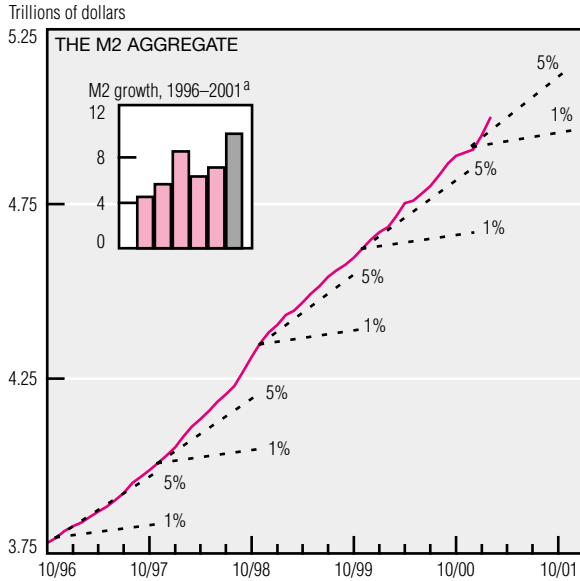
place a high probability on a further cut of 50 basis points in the federal funds rate by the end of March.

The report’s 2001 central tendencies of projections for real GDP growth and inflation (the Personal Consumption Expenditure Chain-type Price Index) were revised downward from the July report’s 3¼–3¾% and 2–2½% to 2–2½% and 1¾–2¼%, respectively. Fourth-quarter civilian unemployment rate projections rose from 4–4¼% to about 4½%.

Banks’ borrowing through the Federal Reserve’s discount window has fallen significantly in recent years. One

might expect a positive relationship between discount window borrowing and the spread between the federal funds rate and the discount rate. A larger spread presumably would encourage banks to exploit arbitrage possibilities by borrowing more heavily from the Fed. Before 1985, about 70% of changes in adjustment credit could be accounted for by changes in the federal funds–discount rate spread; since 1985, it is only 10%. Bank failures in the late 1980s may have made banks hesitant to visit the discount window lest market participants perceive its use as a sign of weakness.

Money and Financial Markets



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for M2 and M3 are calculated on a January over 2000:IVQ basis. Data are seasonally adjusted.
 NOTE: Last plots for M2 and M3 are January 2001. Prior to November 2000, dotted lines for M2 and M3 are FOMC-determined provisional ranges. Subsequent dotted lines represent growth rates and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

Growth in the broad monetary aggregates accelerated sharply in January. Annualized year-to-date M2 growth reached 10.2% and annualized year-to-date M3 growth hit a remarkable 13.2%. The annualized monthly changes for these aggregates were the largest posted in the last 10 years (13.1% and 17.9%, respectively).

The components of M2 reveal that about 8.5 percentage points of the 13.1% January increase can be attributed equally to demand deposits and retail

money market mutual funds. The recent buildup in these components, however, results primarily from transitory factors. Much of the increase in demand deposits, for example, reflects a surge in mortgage refinancings, which in turn enlarge custodial balances between the time old mortgages are extinguished and the time when payment is made to mortgage-backed securities holders.

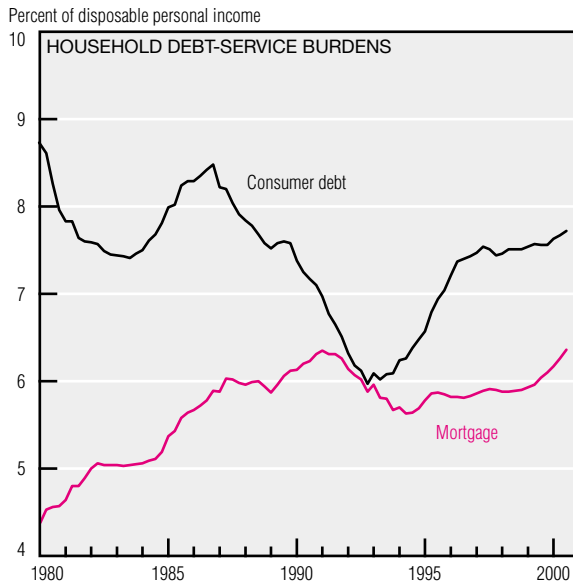
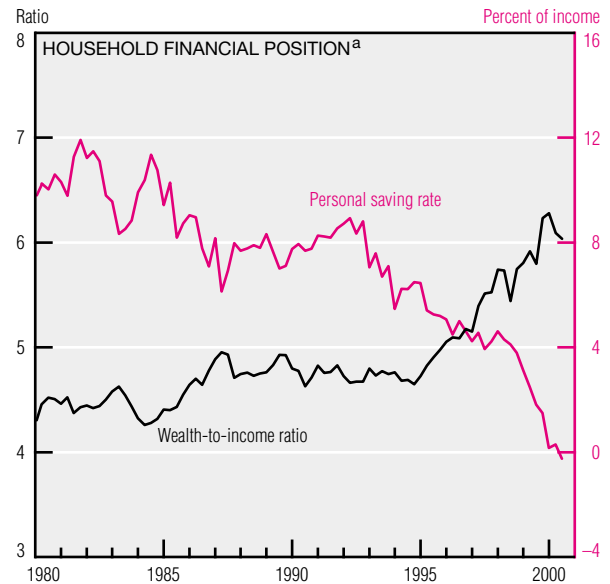
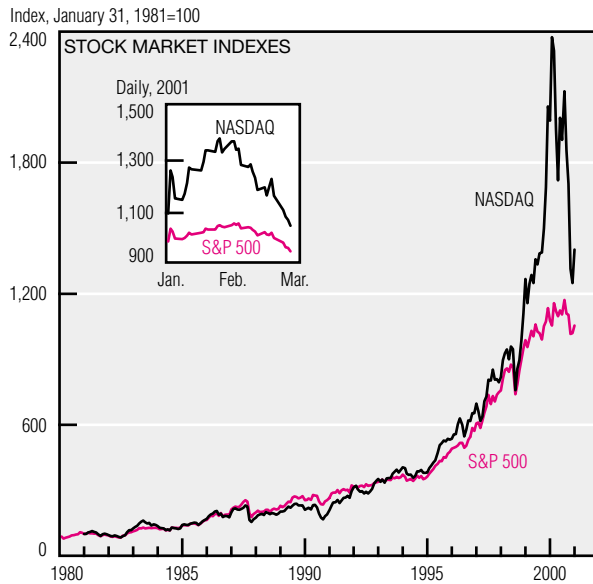
Acceleration in retail money funds, on the other hand, reflects the recent increase in stock market uncertainty.

Money market mutual funds give tentative investors a temporary parking lot for funds. Even as temporary factors abate, however, M2 growth will be sustained by recent declines in interest rates, which lower the opportunity cost of holding money.

As for M3, about 11 percentage points of its nearly 18% January increase comes from institutional money market mutual funds and large-denomination certificates of deposit (CDs), with most

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Money and Financial Markets (cont.)



a. Wealth is defined as household net worth. Income is defined as personal disposable income. Data are not seasonally adjusted.

b. Constant maturity.

SOURCES: Board of Governors of the Federal Reserve System; Bloomberg Financial Information Services; and Wall Street Journal.

of the rest accounted for by the increase in M2. Institutional money funds, like retail funds, swelled as many investors headed for the sidelines. The increase in large CDs mirrors the sudden January rise in commercial and industrial loans, for which CDs are a convenient source of funding.

The stock market remains the big story. The sharp ascent of equity prices, especially in the late 1990s, greatly increased household wealth, pushing up the ratio of wealth to income almost

50%. With stock prices four times their 1990 levels, many households have seen less reason to save part of their current income. Indeed, the personal saving rate has dropped below zero as wealth-induced spending grew faster than income.

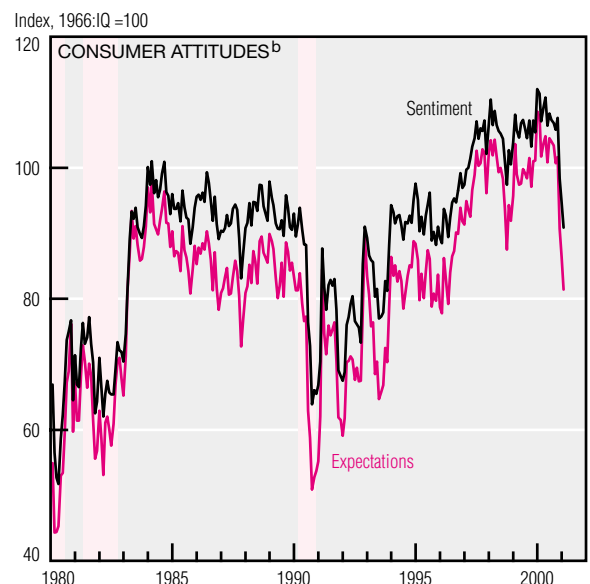
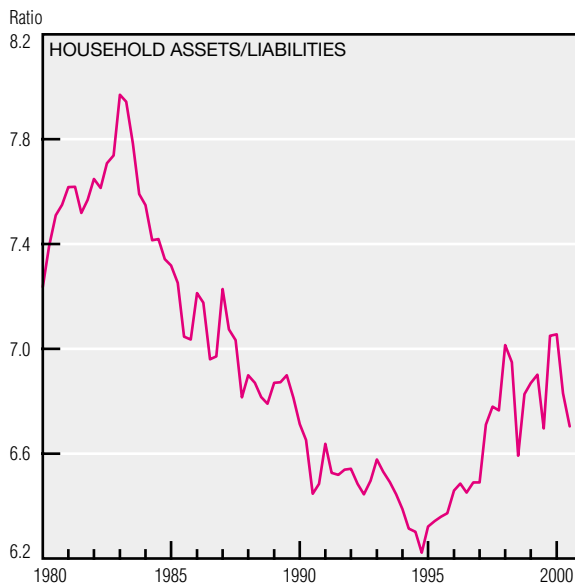
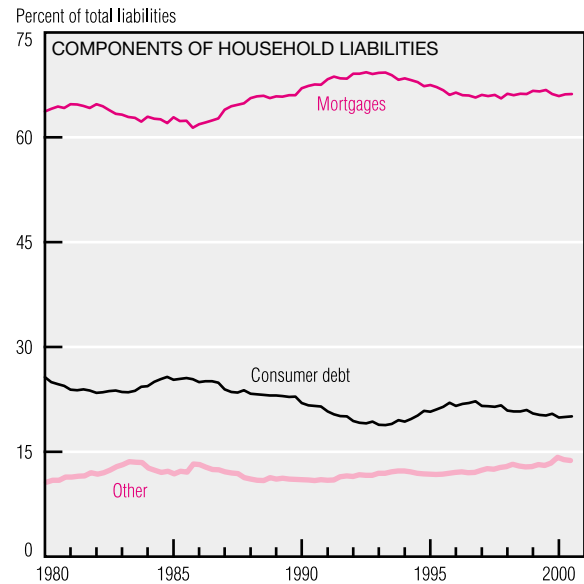
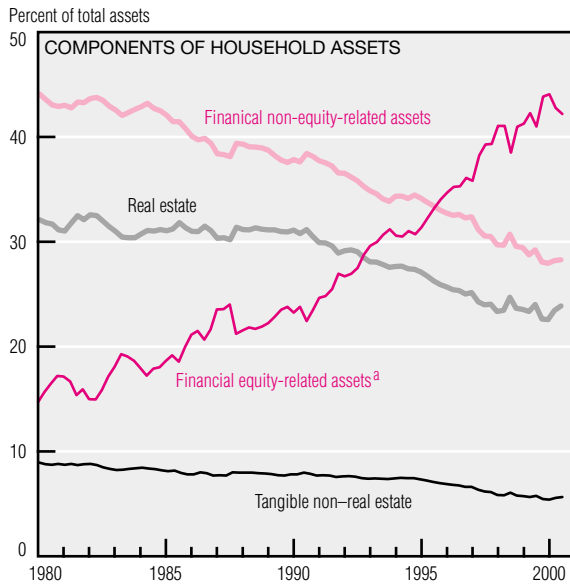
After rallying in January, stock prices drifted downward in February, erasing all gains on the year. A key element is participants' uncertainty about the seriousness of the current economic slowdown. Private economic projections—such as those of the Reserve Bank presidents

and Board of Governors—anticipate weakness in the first half of this year, with economic activity beginning to accelerate again about midyear.

The major impetus for this projected rebound in growth is a cessation of inventory rebalancing. Higher energy prices, another dampening factor, could also abate. The recent decline in both spot and futures energy prices, if sustained, could boost purchasing power and thereby become a key support for recovering demand over the rest of the year.

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Money and Financial Markets (cont.)



a. Equity-related assets are defined as corporate equities, mutual fund shares, and pension fund reserves.

b. Shaded areas indicate recessions.

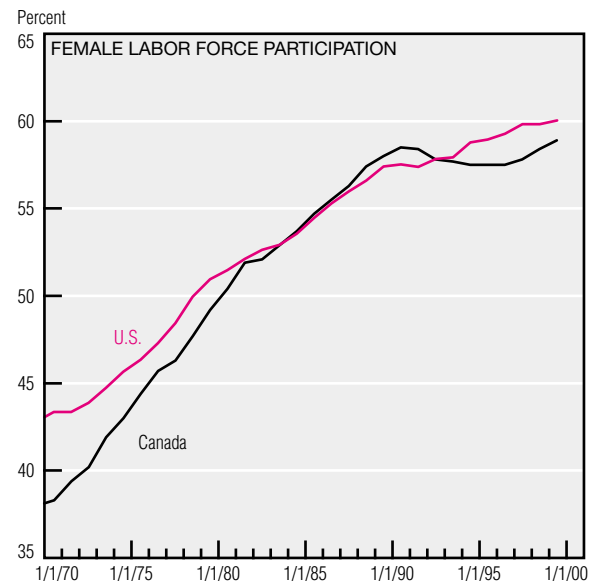
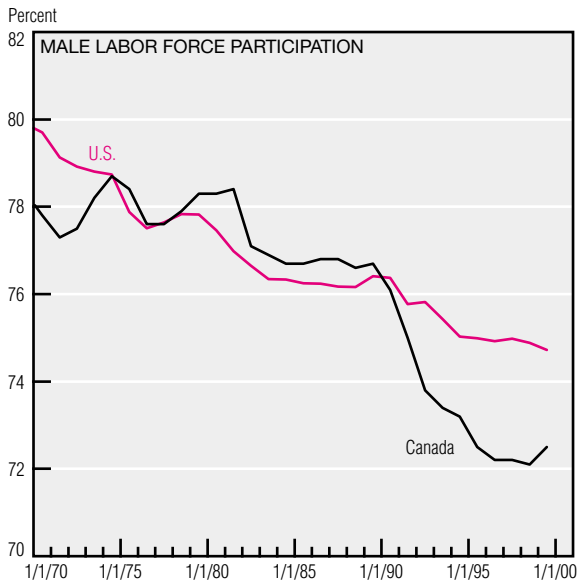
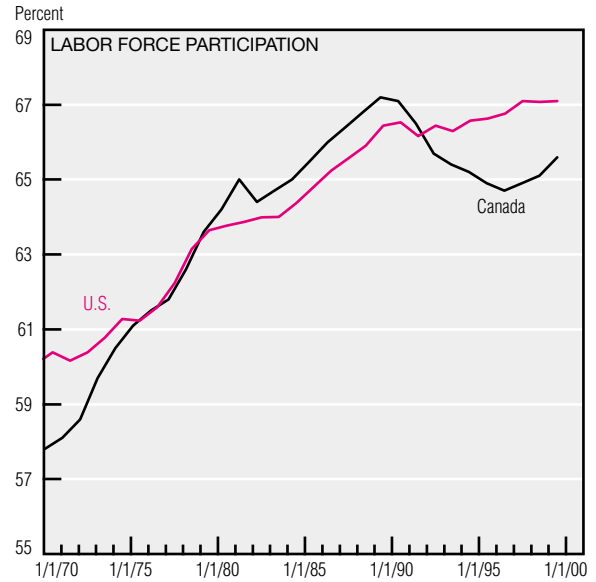
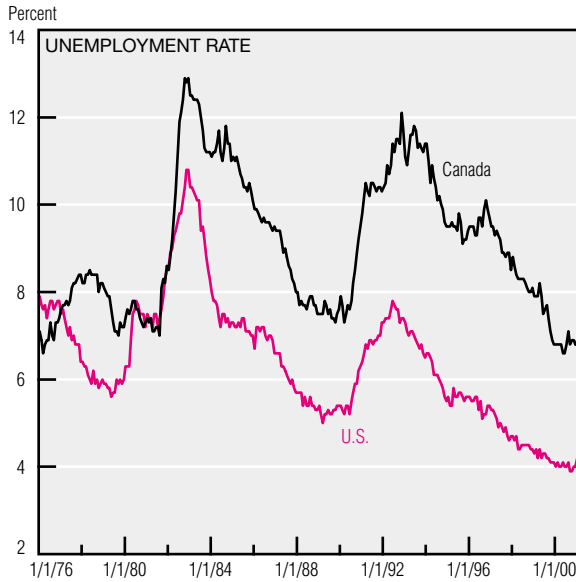
SOURCES: Board of Governors of the Federal Reserve System; and University of Michigan, Survey of Consumers.

Another likely contributor to household purchasing power in 2001 is the recent surge in mortgage refinancing. Refinancing reduces households' debt-service burdens, freeing up funds for spending on other goods and services. Moreover, home equity financing has given households an important means of consolidating consumer debt. Because home equity loan rates are substantially lower than rates paid on credit card debt, such consolidation offers households another way to reduce their overall debt burden.

As stock prices soared in the late 1990s, equity-related assets approached 45% of total household assets, up from about 15% in 1980. During the same period, the ratio of household assets to liabilities declined. This raises concerns about households' financial vulnerability to the vagaries of the stock market. And, as Chairman Greenspan noted in his February 13 testimony, changes in stock market wealth have become more important than changes in current household income when it comes to determining shifts in consumer spending.

Sharply lower equity prices seem to affect consumer confidence as well. The University of Michigan's indexes on consumer sentiment and expectations both fell in February but were revised up from preliminary estimates. Although all measures of consumer confidence have fallen precipitously in recent months, their levels nonetheless remain higher than those that formerly have been consistent with economic growth.

Unemployment in Canada and the U.S.



SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, International Financial Statistics; Bank of Canada; and Statistics Canada.

Since the early 1980s, the U.S. unemployment rate has been about two percentage points lower than Canada's. Before that time, the two countries' unemployment rates were almost identical. The relative strength of the U.S. economy can account for its lower unemployment in the 1990s, but what might explain the differences in the previous decade?

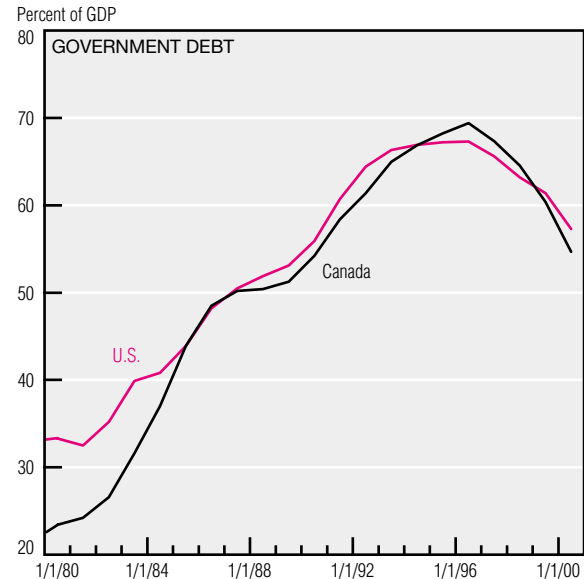
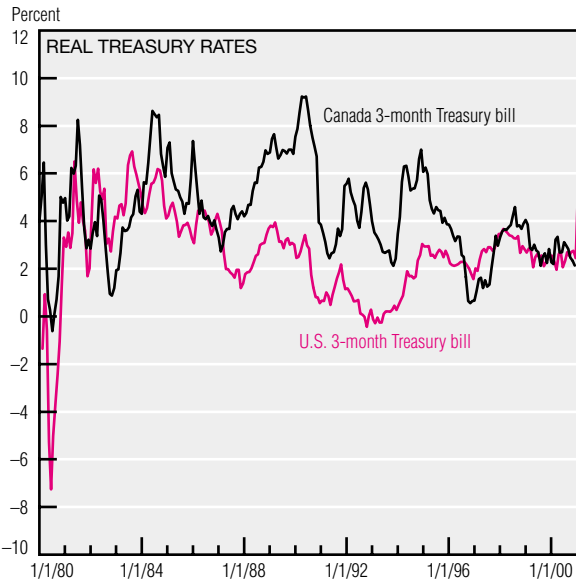
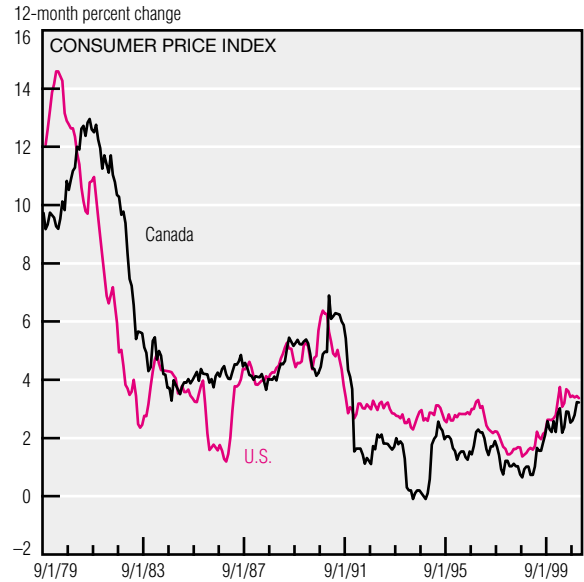
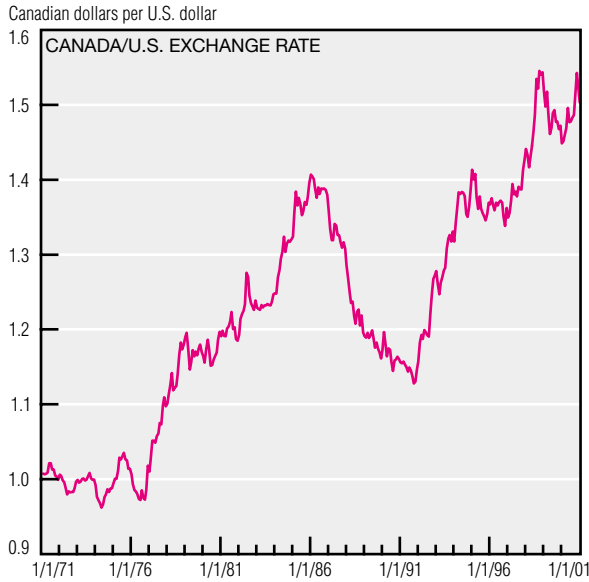
U.S. unemployment insurance benefits became taxable in the 1980s, while eligibility requirements became tougher and benefits shrank. Over the same period, Canada's unemployment insurance system changed little, if at all. As a result,

the U.S. system became relatively less generous. A less generous system gave some unemployed U.S. workers an incentive to take jobs that were previously unacceptable, thus lowering the country's unemployment rate. But the story does not end there. Other workers had an incentive to exit the labor market in the 1980s because of changes in the U.S. system, lowering U.S. participation rates relative to Canada's.

The difference in the two countries' participation rates did, in fact, narrow. Before the 1980s, the U.S. rate was higher than Canada's but their positions reversed over the decade.

U.S. participation rates for both men and women fell relative to Canada's. Participation rates for males have generally fallen over the past 30 years. During the 1980s, however, men's rates fell to a lesser degree in Canada than in the U.S. Participation rates for females have generally risen over the past 30 years. Until the early 1980s, U.S. females' participation rates exceeded Canadian females'. During the 1980s, female participation rates were about the same for both countries, implying a relative decline for U.S. women during that decade.

The Canada/U.S. Exchange Rate



SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, International Financial Statistics; Bank of Canada; and Statistics Canada.

Before 1976, the exchange rate between the U.S. and Canadian dollar was typically not far from one. The U.S. dollar appreciated significantly against Canada's in 1976–85 and again between 1991 and the present. The reasons behind these appreciations, especially the present one, are a puzzle.

Currencies may appreciate or depreciate relative to one another for several reasons. If one country's inflation rate is higher than another's, then one might expect the currency of the higher-inflation country to depreciate because its real value is eroding faster. Although in-

flation rate differentials may explain the initial run-up in the exchange rate, they do a poor job of explaining the run-up after 1991—Canada's inflation rate has been consistently *lower* than that of the U.S. during this period.

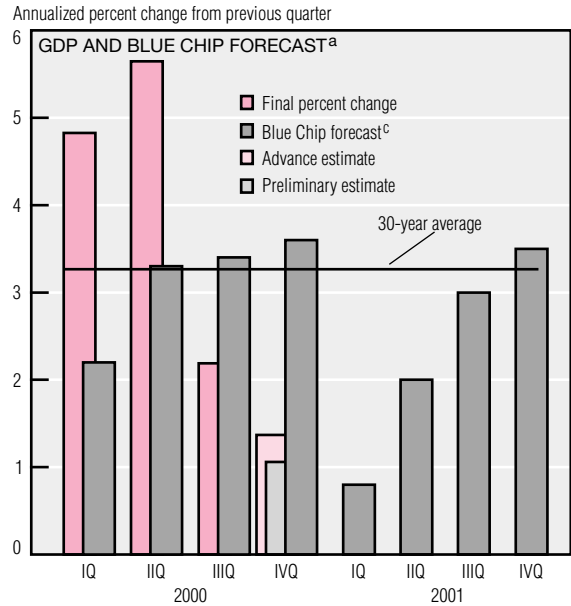
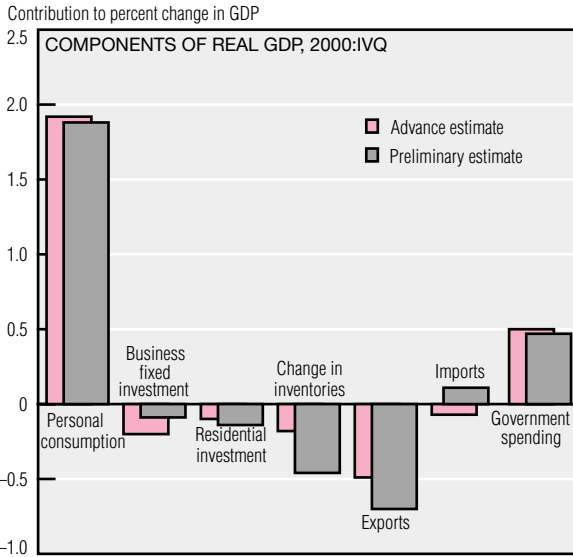
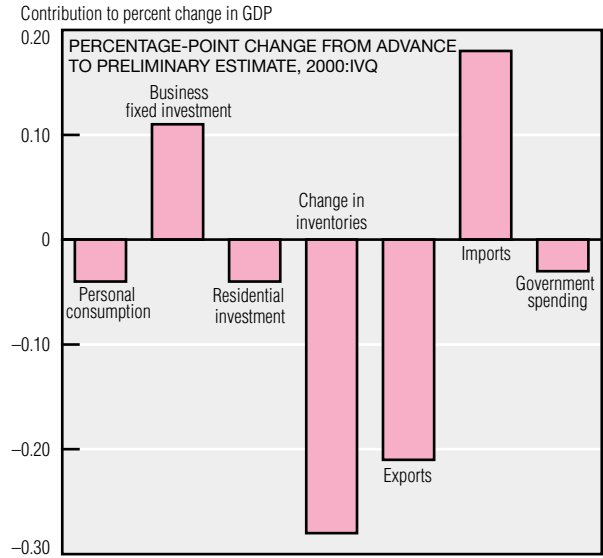
If one country's real interest rate is lower than another's, the currency associated with the lower rate would be expected to depreciate. Real interest rate differentials in Canada and the U.S., measured by real Treasury bill rate differentials, cannot explain exchange rate movements. Canada's real interest rate was *higher* than the U.S.'s in 1984–86 and

from 1991 to the mid-1990s, periods when the exchange rate appreciated.

A country with consistently higher government deficits than another may experience a currency depreciation, possibly because of fear that it will pay off its debt by the inflationary method of simply printing money. As a percent of GDP, federal government debt in Canada has closely tracked that of the U.S. for the past 15 years. Hence, levels of federal debt, like inflation and real interest rate differentials, fail to explain Canada/U.S. exchange rate movements after 1991.

Economic Activity

| Real GDP and Components, 2000:IVQ ^{a,b} (Preliminary estimate) | | | |
|--|-----------------------------|-----------------------|---------------|
| | Change, billions of 1996 \$ | Percent change, last: | |
| | | Quarter | Four quarters |
| Real GDP | 24.7 | 1.1 | 3.4 |
| Personal consumption | 43.9 | 2.8 | 4.5 |
| Durables | -6.5 | -2.8 | 5.3 |
| Nondurables | 3.8 | 0.8 | 3.8 |
| Services | 44.0 | 5.0 | 4.7 |
| Business fixed investment | -2.3 | -0.6 | 10.3 |
| Equipment | -10.3 | -3.5 | 9.7 |
| Structures | 6.1 | 8.8 | 12.3 |
| Residential investment | -3.2 | -3.5 | -2.6 |
| Government spending | 10.7 | 2.7 | 1.2 |
| National defense | 7.4 | 8.8 | -2.0 |
| Net exports | -15.2 | - | - |
| Exports | -18.1 | -6.1 | 6.8 |
| Imports | -2.8 | -0.7 | 11.5 |
| Change in business inventories | -13.0 | - | - |



a. Chain-weighted data in billions of 1996 dollars.
 b. Components of real GDP need not add to totals because current dollar values are deflated at the most detailed level for which all required data are available.
 c. Blue Chip forecasts for current and future periods are based on Blue Chip Economic Indicators, February 10, 2001. Past-quarter predictions are based on Blue Chip Economic Indicators three months prior to the end of a quarter.
 NOTE: All data are seasonally adjusted and annualized.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Blue Chip Economic Indicators, February 10, 2001.

According to the recently released preliminary estimate, real GDP growth in 2000:IVQ was somewhat weaker than reported in the advance estimate—1.1% compared to 1.4%. Growth in inventory investment and exports was revised downward substantially, while growth in business investment and imports increased.

Declining exports and inventory investment were the largest contributors to relatively weak output growth in 2000:IVQ. Residential investment, traditionally a leading indicator, also declined, albeit by less than in the previous quarter. Business

fixed investment fell slightly, a result of the first outright decline in the equipment and software component in almost a decade. One explanation for the U.S. economy's remarkable growth during the 1990s is that it reaped the benefits of previous investments in information technology. If this is true, the decline in equipment and software investment may foreshadow slower growth. Personal consumption grew at a slower pace than in previous quarters, and growth in government spending increased relative to past quarters. The decline in exports accounted for

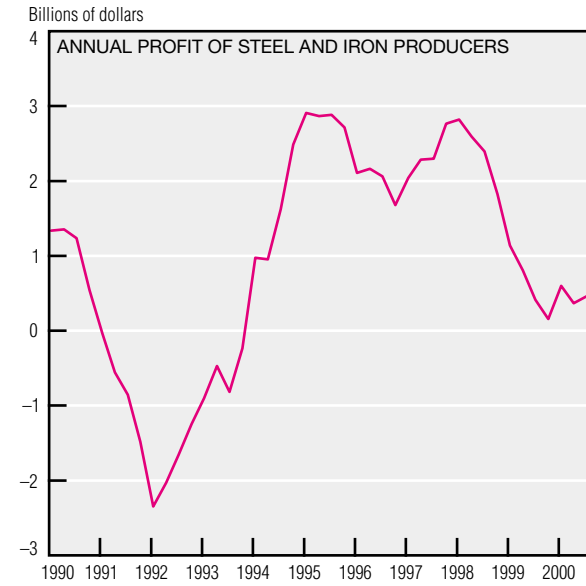
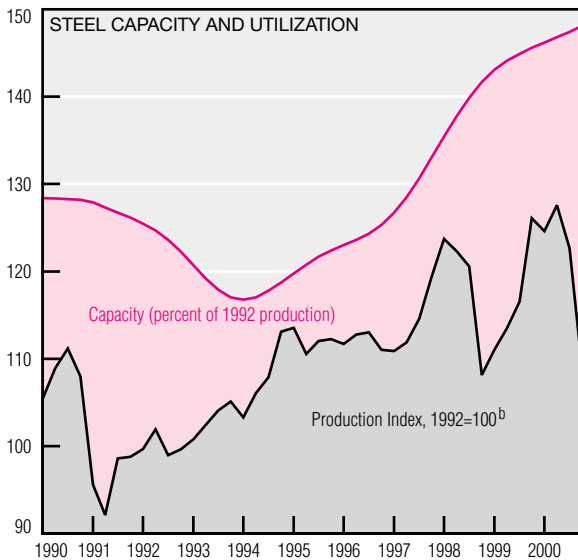
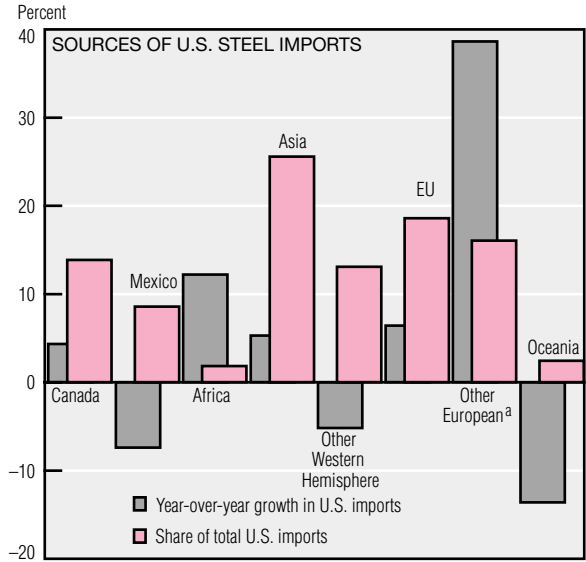
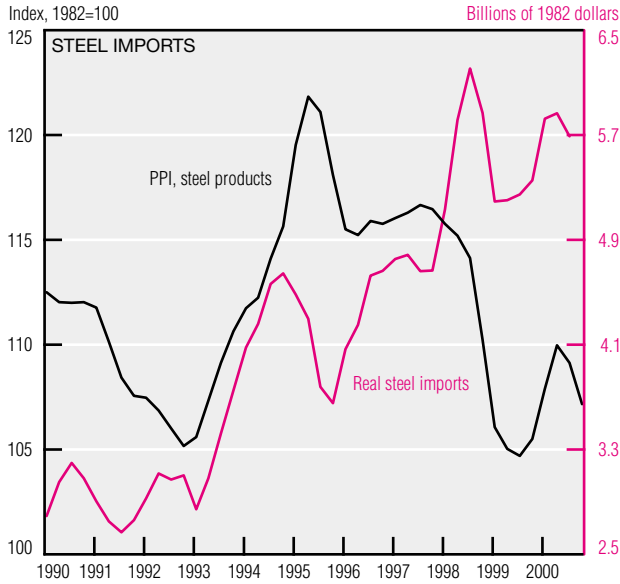
much of the fall in output growth.

The Blue Chip forecast suggests that GDP may weaken further in 2001:IQ, but it is expected to regain strength later in the year. By the end of 2001, forecasters predict output growth will return to its historical average. Forecasters, however, have tended to predict a reversion to the historical mean output growth: They were surprised on the upside in the first half of 2000 and on the downside in the last half of that year.

One of the major industries in the Fourth District is steel production. Accord-

(continued on next page)

Economic Activity (cont.)



a. Includes Russia.
 b. Product of capacity-utilization rate and steel capacity.
 NOTE: All data are seasonally adjusted and annualized.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and American Iron and Steel Institute.

ing to the American Iron and Steel Institute, the U.S. industry “has been severely weakened by high levels of dumped, subsidized and disruptive steel imports.” Recently, the Institute called for temporary import quotas to stabilize the industry.

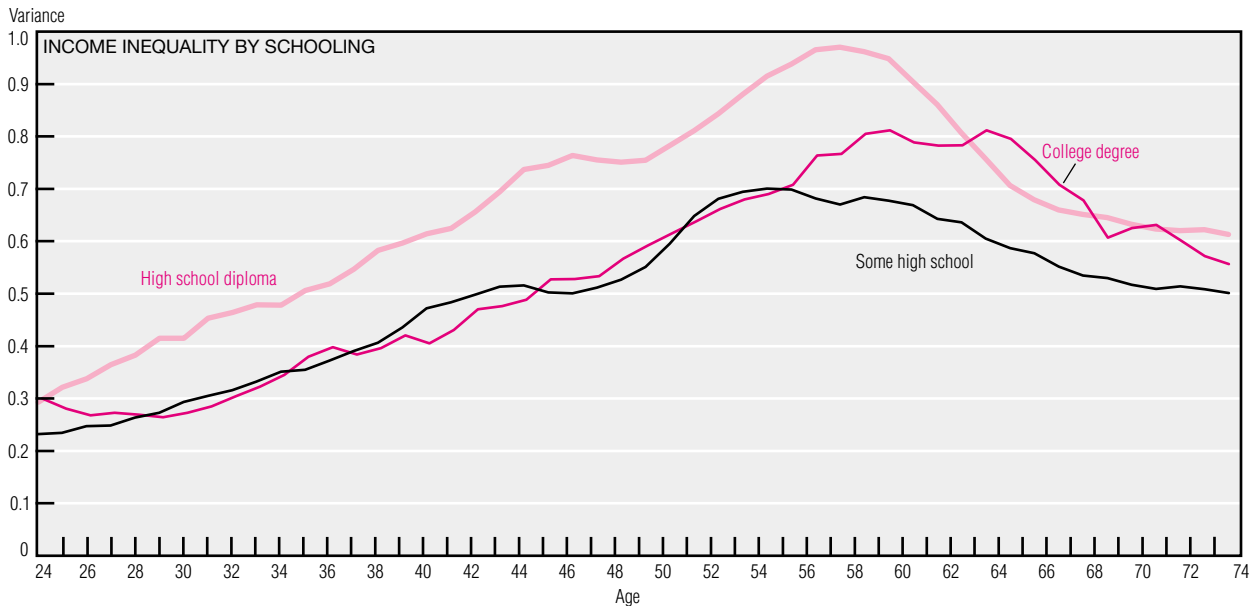
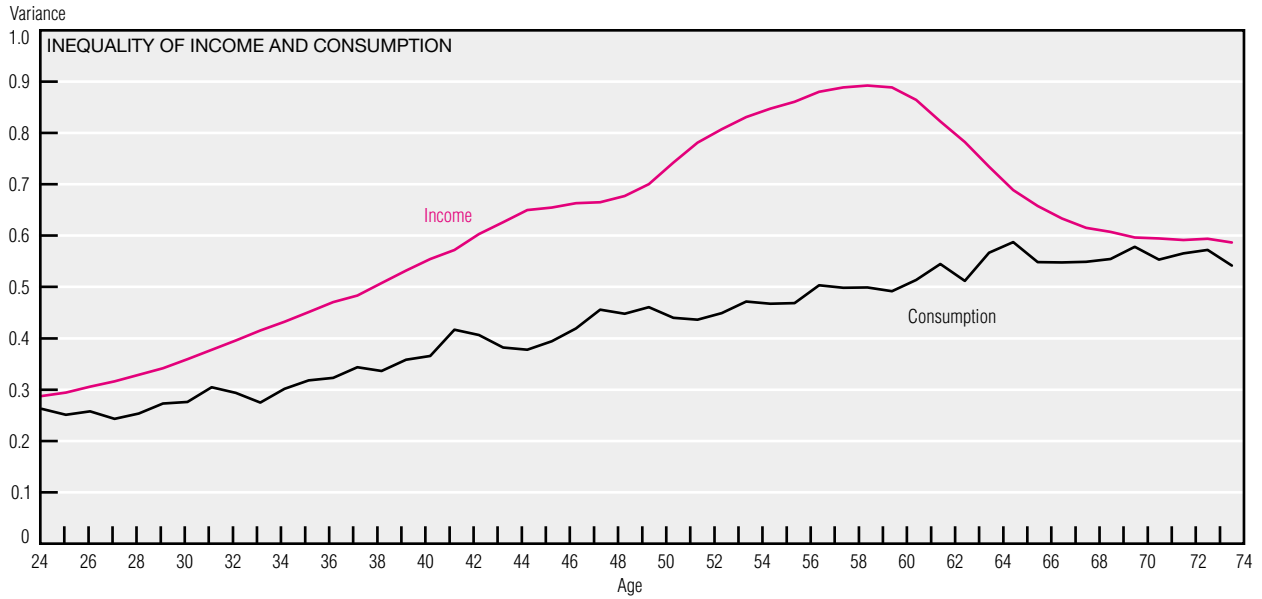
Presumably, imports of foreign steel drive down U.S. steel prices. Experience in the 1990s lends some credibility to this story: Steel prices rose sharply in 1995–96 as steel imports fell, and prices fell in 1997–99 as steel imports rose. There must be more to the story, though, because prices also increased in 1994–95, a period when imports rose.

Asia, the European Union, and the rest of Europe are the largest exporters of steel to the U.S. Our NAFTA partners, Canada and Mexico, are also important sources. Growth of exports to the U.S. was strongest in Europe, exclusive of the European Union.

After declining in the early 1990s, the U.S. steel industry’s capacity has risen. Capacity utilization fluctuated throughout the decade and appears to be positively correlated with steel prices. For the most part, total U.S. steel production rose during the 1990s.

Profits in the steel industry appear to move fairly closely with the price of steel. Undoubtedly, the U.S. steel industry was pleased when a U.S. trade panel recently voted 6–0 to allow the Commerce Department to continue its investigations of “dumping” (selling below cost) of hot-rolled steel exports by 11 nations. The European Union, Brazil, Chile, India, Indonesia, Japan, South Korea, and Thailand have disputed these charges as being illegal under international trade rules.

Labor Markets



SOURCE: Kjetil Storesletten, Chris I. Telmer, and Amir Yaron, "Consumption and Risk Sharing over the Life Cycle," unpublished manuscript, September 2000.

In the U.S., inequality among individuals in both consumption and income increases with age, although it is unclear how large a role income inequality plays in consumption inequality. The question is important because the design of public policy programs, such as welfare reform and unemployment insurance, could benefit greatly from identifying the sources of individuals' risk and uncertainty.

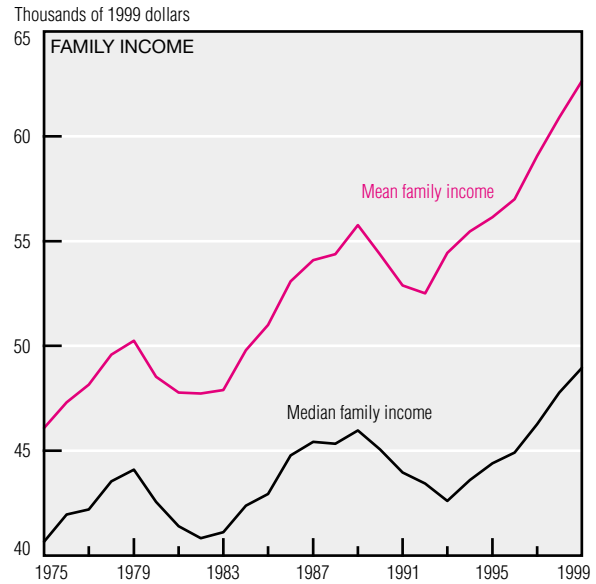
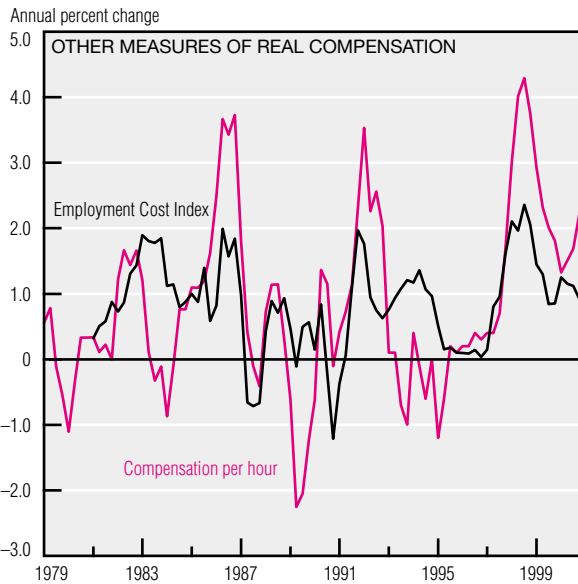
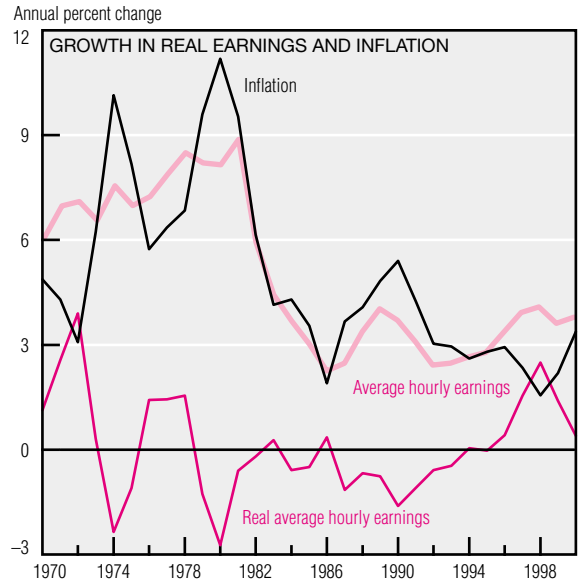
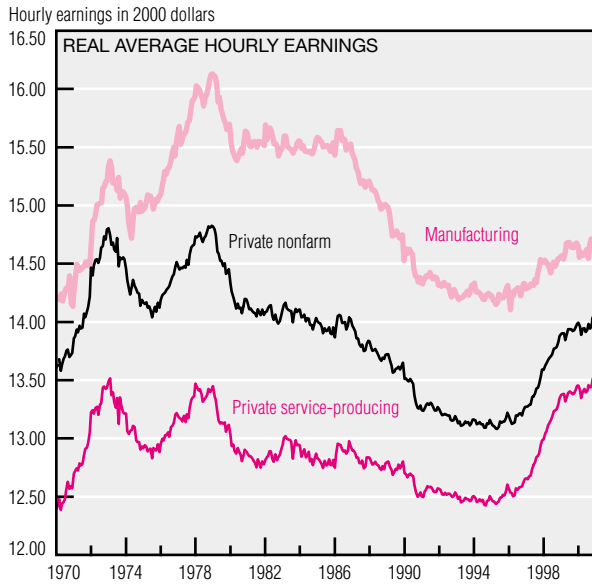
At least some progress is being made in narrowing the range of explanations for age-related income inequality. Some

inequality, predictable even before a person is old enough to enter the labor market, is determined by preconditions, like family background and schooling, that affect individuals' incomes throughout their working lives. Programs like unemployment insurance would have only a minor effect if the dominant sources of inequality were fixed early in life.

Evidently, such preconditions do not loom large in explaining why income inequality increases with age;

variations among individuals at a given age do not differ substantially across schooling groups, leaving little variance to be explained by preconditions. It appears that random but persistent shocks over workers' lifetimes, perhaps from plant closings, technological change, and so on, must lead to the observed increase in inequality with age. Recent research suggests that roughly 40% of the age-related increase in income inequality can be explained by such shocks.

Production Workers' Earnings



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census.

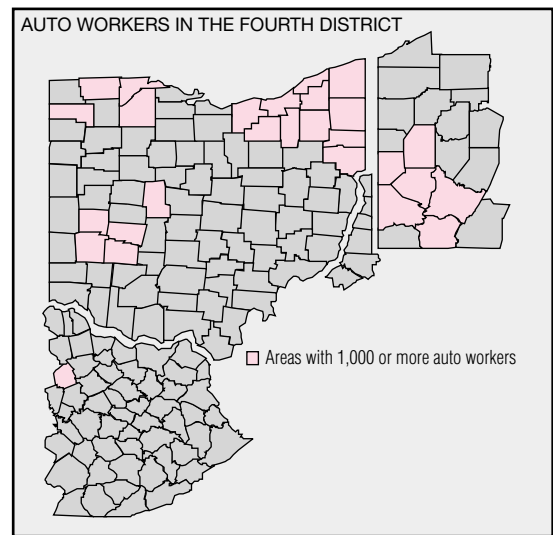
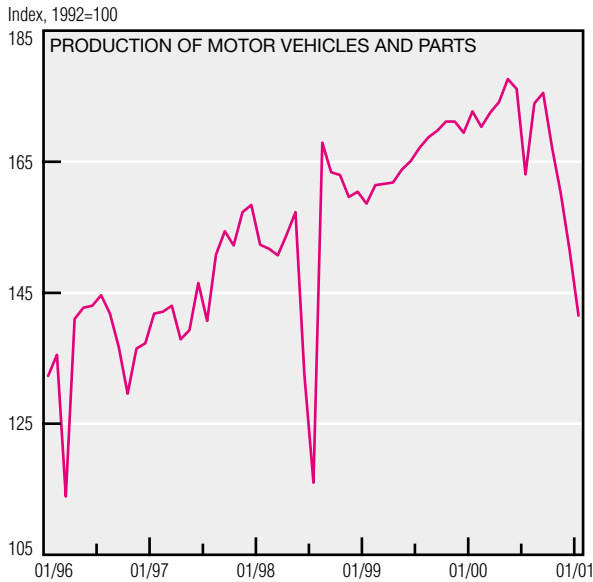
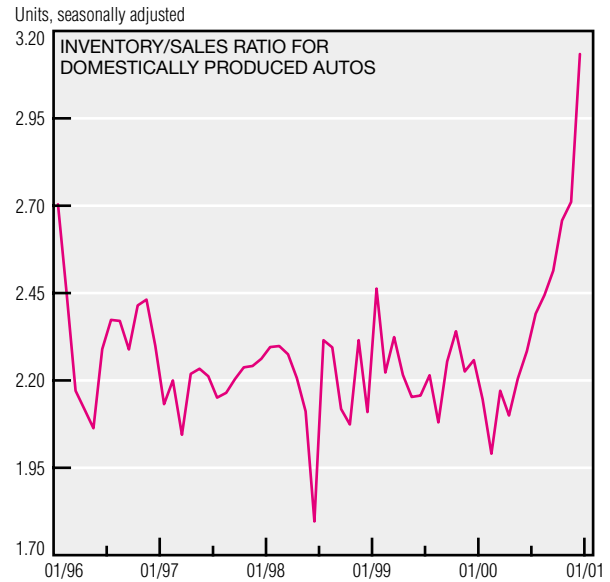
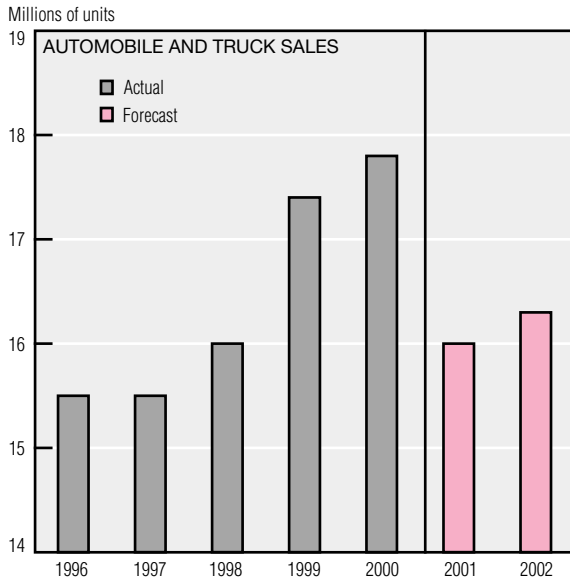
The American economy has experienced a 60% increase in real per capita output since 1970. However, this has not translated into large gains in private production workers' real average hourly earnings, which consist of their hourly compensation (wages and benefits) as reported by employers. In fact, private production workers' real hourly earnings, after falling nearly \$2 an hour between 1972 and the mid-1990s, only recently returned to the mid-1980s level (about \$14 an hour in 2000 dollars). Production

(or nonsupervisory) workers, as defined here, comprise slightly more than 80% of the private labor force, a share that has remained roughly constant for 30 years.

Much research has focused on explaining why production workers' average real hourly earnings have fallen in an expanding economy. Measurement flaws with this series is one such explanation. But there is little doubt that the three major spikes in the inflation rate in the 1970s and 1980s contributed to erosion in hourly earnings.

Other measures of compensation, however, such as total compensation from the Employment Cost Index and real compensation per hour from productivity data, which cover a different subset of the labor force and employ different methodologies, have shown overall growth since the late 1970s. In addition, despite some intermittent declines, overall family income has risen since 1975. Much of this growth, however, may result from the increasing number of two-worker families.

The Automobile Industry



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Board of Governors of the Federal Reserve System; and Blue Chip Economic Indicators.

U.S. motor vehicle sales reached new highs in 1999 and 2000, but forecasters do not expect this trend to continue. The February 2001 edition of *Blue Chip Economic Indicators* reported a consensus forecast that sales would fall to 16.0 million in 2001 (a drop of roughly 10%) and rebound slightly to 16.3 million in 2002.

Evidence of this slowdown in automobile and truck sales has already appeared in auto industry data. Although sales were strong for last year as a whole, the inventory-to-sales ratio

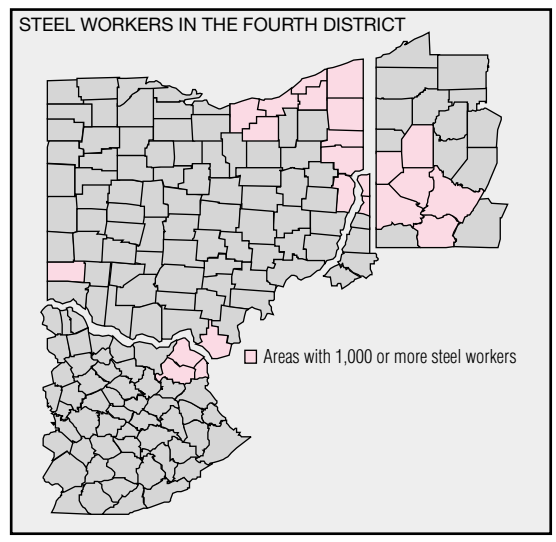
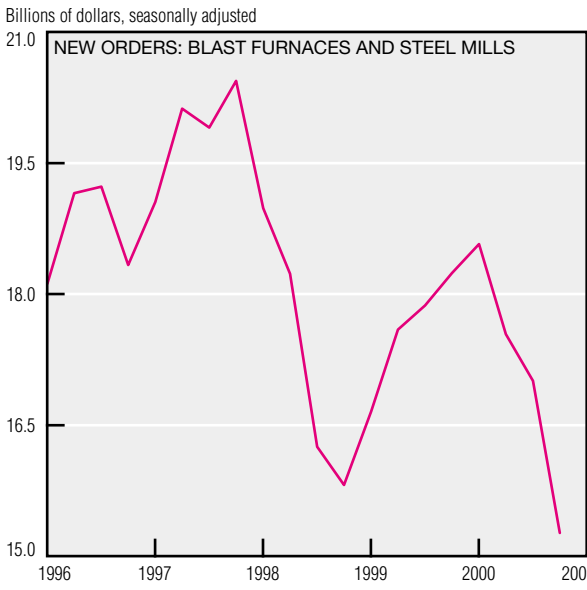
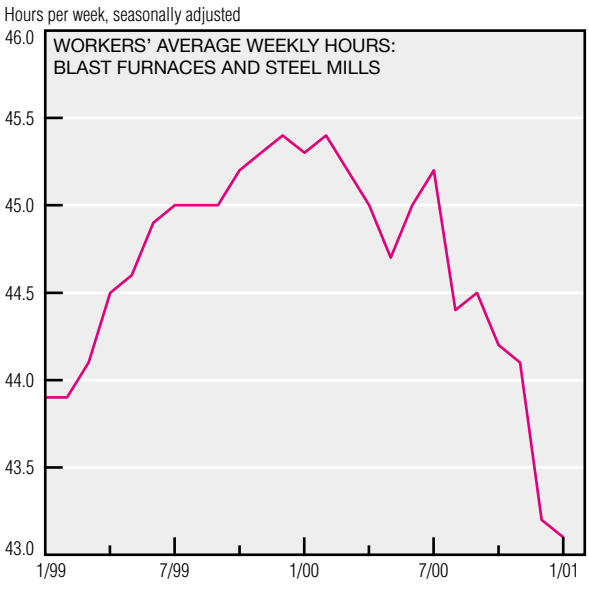
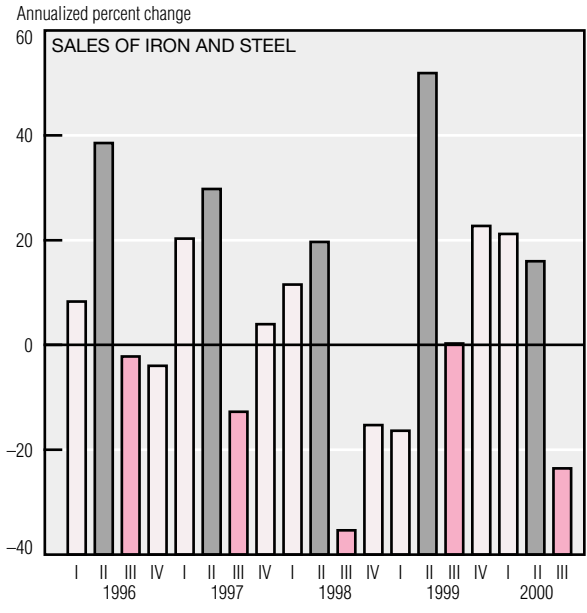
for domestically produced autos rose fairly steadily from April to November and then jumped precipitously in December.

As unit sales of domestic automobiles fell from a seasonally adjusted annual rate of 6.8 million in August 2000 to 5.7 million in December (a drop of 16%), manufacturers of motor vehicles and parts cut production to keep their inventories from rising further. In December 2000, production of motor vehicles and parts hit the lowest level seen since June and July 1998, when work stoppages at

two General Motors plants in Flint, Michigan, idled more than 71,000 workers at assembly plants across the country.

The slowdown in the auto industry will have a noticeable effect on the economy of the Fourth District; in the metropolitan statistical areas of Cleveland-Akron, Dayton-Springfield, Pittsburgh, Toledo, and Youngstown-Warren, large numbers of workers are employed by auto makers or suppliers.

The Steel Industry



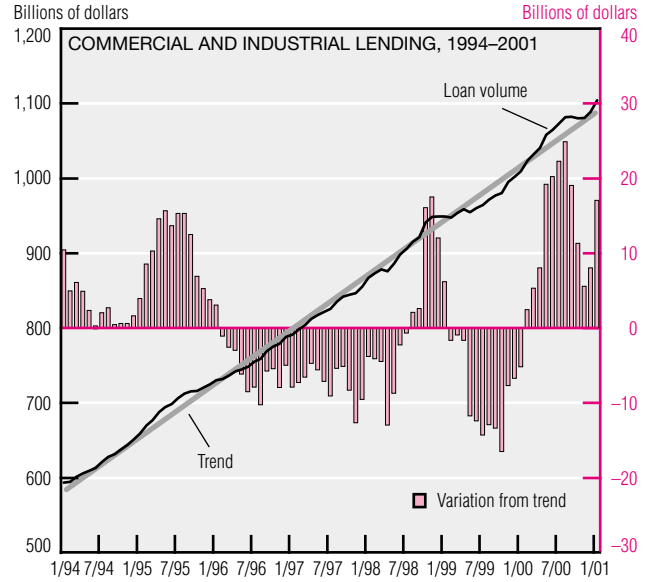
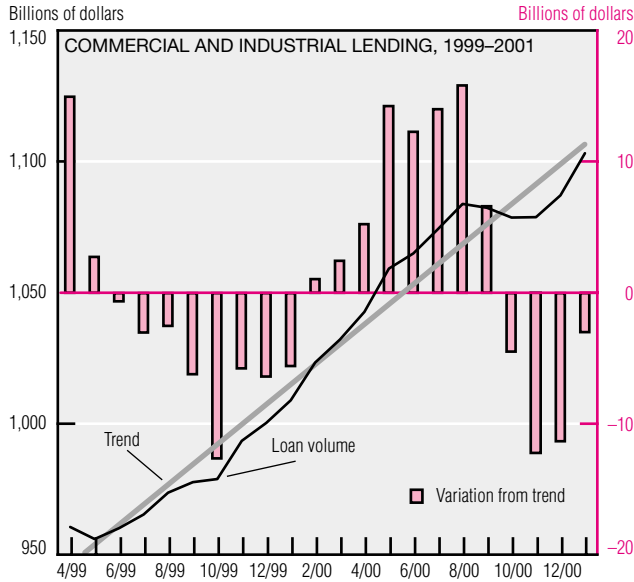
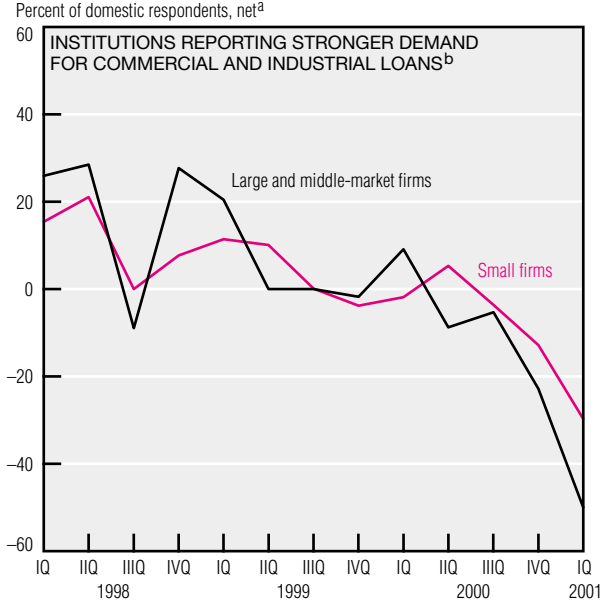
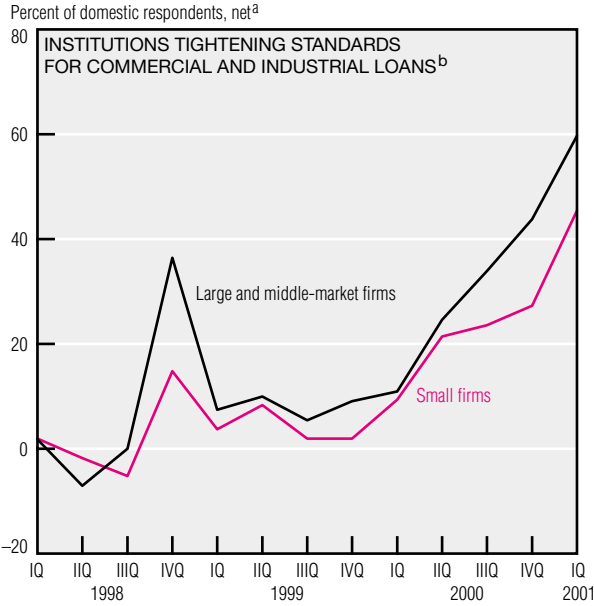
SOURCE: U.S. Department of Commerce, Bureau of the Census and Bureau of Labor Statistics.

The recent troubles of Cleveland's LTV Steel Corporation have brought regional focus to the health of the U.S. steel industry. Sales of iron and steel decelerated steadily in terms of annualized growth rates during the first two quarters of 2000, then declined abruptly in the third quarter. Although the third-quarter decline in growth was not remarkable, having become a regular feature of iron and steel sales in recent years, the second-quarter growth decline was. Even during the last recession, growth in the iron and steel industry accelerated during the sec-

ond quarter. The industry has not experienced a second-quarter slowdown in growth since 1989. Decelerating sales have been accompanied by a decline in the average weekly hours of workers at blast furnaces and steel mills: Except for a very small increase in September (0.1 hours), workers' average hours have been falling since July 2000. The decrease in sales and average weekly hours, not surprisingly, coincides with a decline in new orders for blast furnaces and steel mills, which began after

2000:1Q and persisted through the end of the year. New orders declined from June to December of last year, with only a modest increase (0.7%) in September. The industry's slowdown will affect several Fourth District areas where large numbers of workers are employed in producing iron and steel. Areas that are sensitive to changes in the industry include the Cleveland-Akron, Huntington-Ashland, Pittsburgh, Steubenville-Weirton, and Youngstown-Warren metropolitan statistical areas.

Lending by Depository Institutions



a. Net percent, excluding respondents reporting no change.

b. The quarters indicated correspond to the publication dates of the survey and include data from the previous quarter.

SOURCES: Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices," Federal Reserve Surveys and Reports; and "Assets and Liabilities of Commercial Banks in the United States," Federal Reserve Statistical Release, H.8.

In the last quarter of 2000, the net share of commercial banks' senior loan officers (domestic and foreign) who reported tightening their lending standards on commercial and industrial loans reached 60% for loans to large and middle-market firms and 45% for loans to small firms. This is the latest and largest addition to the tightening trend that loan officers have been reporting since 1998:IVQ. Parallel to tighter standards, senior loan officers reported declining demand for commercial and industrial loans; 50% (net) reported weaker loan

demand from large and middle-market firms and 30% reported weaker demand from small firms.

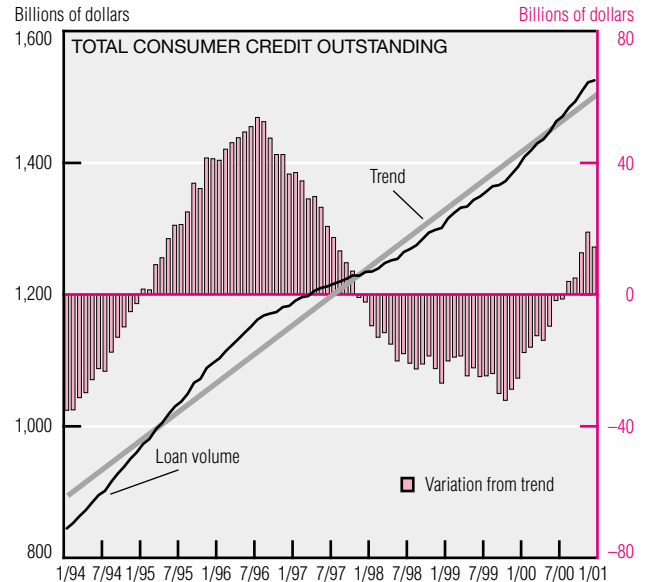
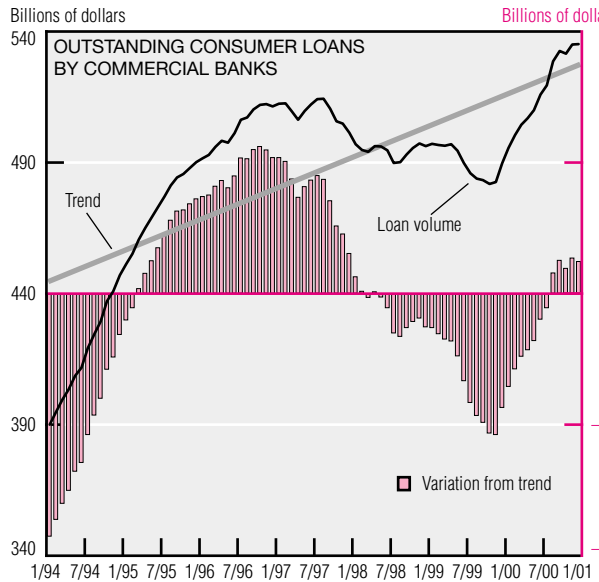
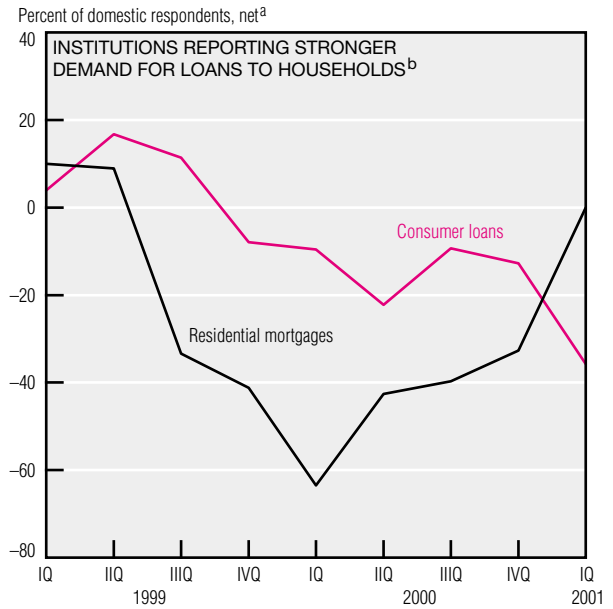
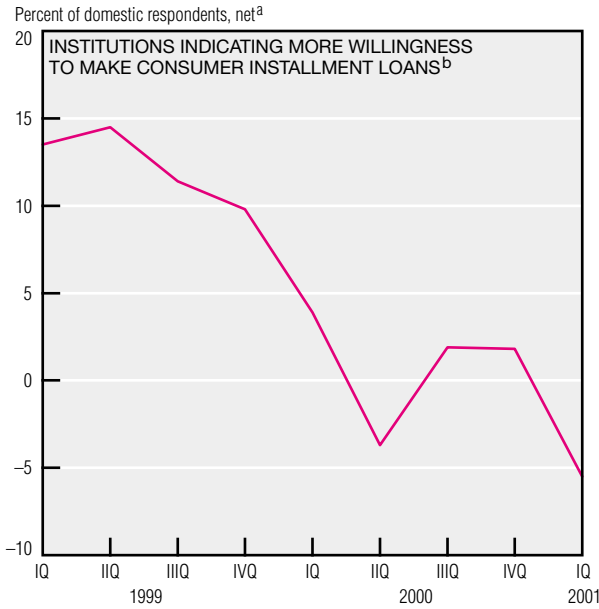
Commercial and industrial lending data for 1999-2001 seem to support the declining-demand argument. Although the dollar volume of commercial and industrial loans reached its highest-ever level of \$1,104 billion in January 2001, it has been below trend since October 2000. The shortfall was \$11 billion in December 2000 and is currently about \$3 billion.

However, it is not clear whether these

facts should be interpreted as signs of weak bank lending or merely a myopic comparison of current performance to the most recent data. When we compare the commercial and industrial loan volume in January 2001 to the trend over a longer period of time (1994-2001, for example) rather than just the last two years, the current volume is \$17 billion above trend. From this longer-range perspective, the decline in loan demand in 2000:IVQ may

(continued on next page)

Lending by Depository Institutions (cont.)



a. Net percent, excluding respondents reporting no change.

b. The quarters indicated correspond to the publication dates of the survey and include data from the previous quarter.

SOURCES: Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices," Federal Reserve Surveys and Reports; and "Consumer Credit," Federal Reserve Statistical Release, G.19.

be interpreted as a return to trend from the exuberance of early 2000.

On the consumer lending side, 6% (net) of senior loan officers surveyed in January 2001 reported that they are less willing to make consumer loans than they were in previous quarters. Their pessimism parallels the weakness in consumer loan demand that they have been reporting since 1999:IVQ. In 2000:IVQ, 36% (net) of the senior loan officers surveyed said that they faced a weaker consumer loan market. There has been no

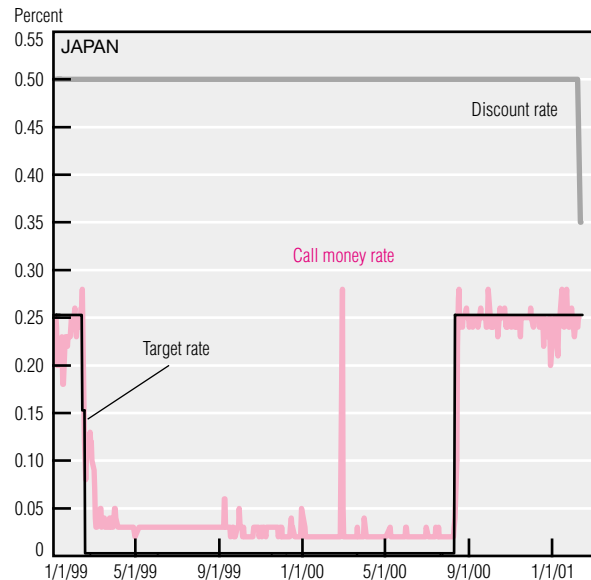
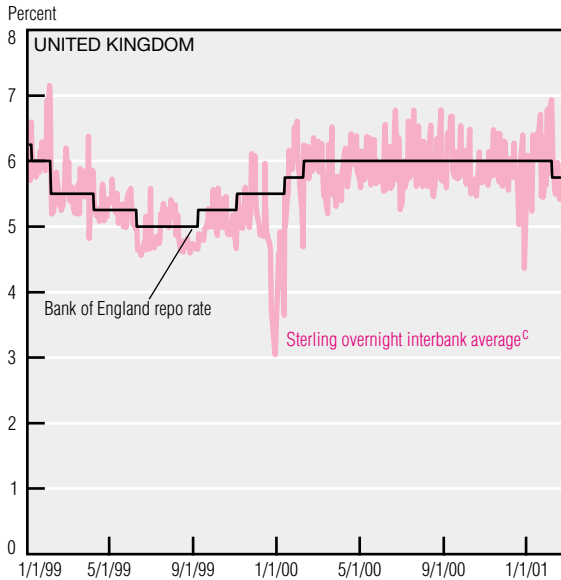
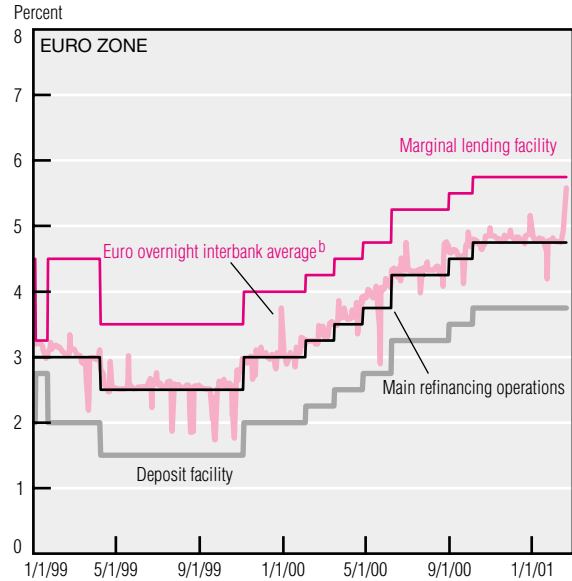
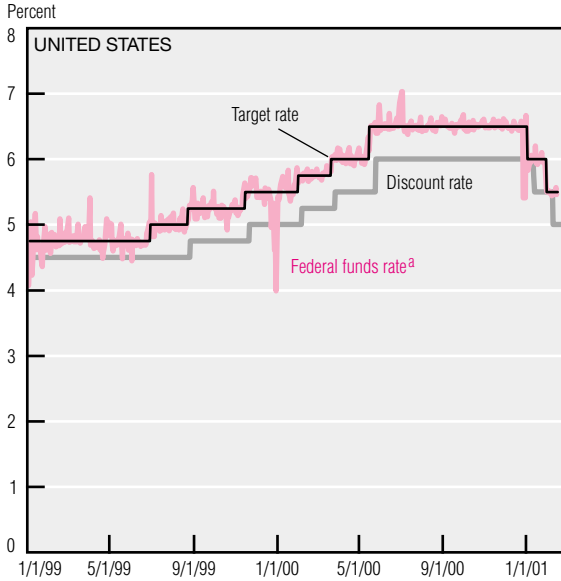
change in the demand for residential mortgages.

Supporting the reported decline in consumer loan demand, the dollar volume of consumer lending by commercial banks declined steadily from a high of \$514 billion in August 1997 to a low of \$482 billion in October 1999. The good news is that the volume of outstanding consumer loans by commercial banks has been increasing ever since. As of December 2000, commercial banks had \$535 billion in outstanding con-

sumer loans, which was \$7 billion above trend.

It may be helpful to look at the size of the entire consumer loan market (such as commercial banks, finance companies, and credit unions) to understand why consumer lending by commercial banks dropped in 1998 and 1999. The data show that the size of outstanding loans has been increasing steadily in recent years. Therefore, the decline in commercial bank lending may be partly attributable to a loss of market share. As of December 2000, the dollar volume of total outstanding consumer loans was \$15 billion above trend.

International Monetary Policy Rates



a. The weighted average rate on trades made through New York City brokers.

b. The weighted average rate on all overnight, unsecured lending transactions in the interbank market, initiated within the euro area by contributing panel banks.

c. The weighted average rate of all brokered, unsecured sterling overnight deals between money market institutions and their overseas branches, transacted between midnight and 3:30 p.m. GMT.

SOURCES: Board of Governors of the Federal Reserve System; and Wholesale Markets Brokers Association.

The central banks of other major countries have not imitated the Federal Open Market Committee's 100 basis point (bp) easing of the federal funds rate target in January. The Governing Council of the European Central Bank kept rates unchanged at its February 1 meeting, but acknowledged that "risks to price stability in the medium term now appear more balanced than at the end of last year."

At its February 8 meeting, the Bank of England's Monetary Policy Committee, seeing "inflation most likely to continue below the 2.5% target for quite a while," adopted a precautionary or grad-

ualist reduction of 25 bp in the Bank's repo (repurchase) rate. The inflation rate of 1.8% for the year ending in January remained within the allowable symmetrical 1.0% band around the 2.5% target. An inflation rate below this band would trigger a compulsory letter to the Chancellor of the Exchequer explaining the divergence from target.

The Bank of Japan left the overnight call rate target (0.25%) unchanged at its February 9 meeting. While maintaining its scenario of "moderate recovery led by private demand," the Bank noted more pronounced risk elements

"involving U.S. economic developments and stock markets." The Bank did adopt a new Lombard-type lending facility, designed to help stabilize short-term interest rates. Starting in March 2001, overnight loans will be extended at the request of eligible counterparties (banks, securities companies, *tanshi* money market dealers, and securities finance dealers) at the basic discount rate, which was reduced from 0.50% to 0.35%. The intention is to cap the overnight call loan rate when market disturbances otherwise would push it more than 10 bp above the current target.