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The Economy in Perspective

*Monetary policy in a box…*The Federal Open Market Committee has reduced its policy-controlled interest rates—the federal funds rate target and the discount rate—three times already this year, and if the majority of Fedwatchers are right, more rate cuts are in the offing. Why are commentators so convinced? There are at least two reasons.

Judging from the way they discuss monetary policy, many journalists, talking heads, and ordinary citizens believe that the Federal Reserve should keep cutting the federal funds rate until continued economic expansion is demonstrably assured. News of weak economic conditions, like the March labor report of further layoffs in manufacturing industries, convinces this audience that additional monetary stimulus makes sense. Many economists adopt a different framework but still reach the same conclusion.

Experienced economists recognize that during a period when excess inventory needs to be worked down, manufacturing output and employment will be curtailed temporarily. Since monetary policy begins to affect economic conditions only after a lag, experts know that at some point an aggressive reaction to current economic conditions may turn out to be an over-reaction in the broader scheme of things. With 150 basis points of policy-induced declines in short-term interest rates only recently initiated, one could argue that a wait-and-see approach is just as valid as another cut in the funds rate. Why, then, are some of the pros still impatient?

Those advocating hurried additional action cite signals that, in their opinion, suggest continuing weakness. Many business firms have been reporting lower-than-expected earnings. Corporate profits in high-tech sectors have been particularly disappointing, and these industries were so important during the economy's long expansion phase that it is sensible to question how vigorous the future can be unless they get back on their feet. Investors have not yet shown confidence in these industries, fearing that it may take a while for demand to firm up and stabilize at higher levels.

Finally, the stock market itself continues to be an important factor. The "wealth effect" on consumption is not always reliable, but the size of the market's decline obliges us to take it into account. Many people lost a significant share of their wealth in the past year, so households might cut back on purchases they otherwise would have made. Firms, for their part, no longer have such liberal access to funds, so capital investment is more costly and difficult to support. Arithmetic tells the story: Economic growth will remain feeble as long as consumption and investment spending are below par.

The focus on immediate prospects for growth is what preoccupies many Fedwatchers, leading them to advocate further quick policy actions. They evaluate the case for funds rate movements in terms of the "Taylor rule," a deceptively simple relationship between the funds rate, inflation, and real growth. A central bank that followed the Taylor rule would pay attention to two gaps: the gap between inflation and the bank's inflation target, and the gap between actual output and the economy's growth capacity. Conventional wisdom places the inflation target for the PCE price index at 2%, fairly close to inflation's actual performance for the past year.

Estimates of the economy's growth potential are more problematic and contentious, but most economists consider its current growth rate to be far below reasonable estimates. For example, if potential growth falls in the 3%–4% range, the current shortfall is somewhere between two and three percentage points. Since the Taylor rule suggests that the funds rate should decline in response to significant output gaps, many analysts call for further reductions.

Rules offer several advantages over pure discretion. In particular, the Taylor approach to monetary policy is attractive because it limits the number of variables to be considered, it offers a simple method for balancing inflation concerns with concerns about economic growth, and it yields a numerical setting for the funds rate. Some analysts seem to regard such rules of thumb as "monetary policy in a box" and use them as a do-it-yourself kit. But the old warning still applies: "Don't try this at home!"

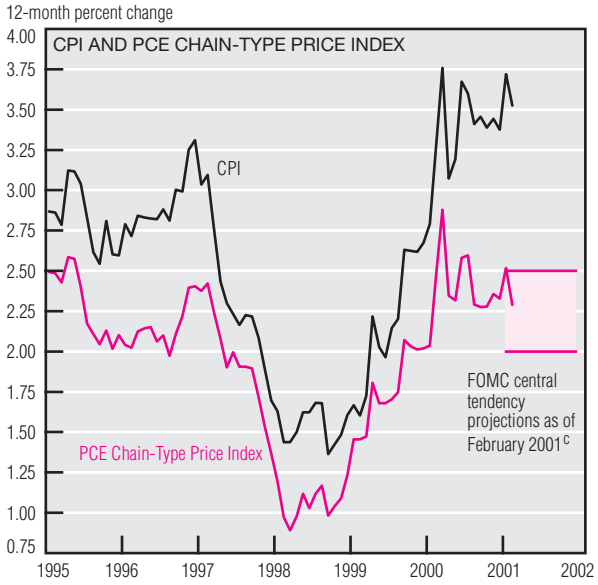
Output gaps may be illusory because potential output cannot be estimated with confidence. Instead of gauging gaps in output, they may merely betray gaps in our knowledge. If the economy is currently growing more slowly than someone's idea of potential, it might well be because certain sectors are undergoing adjustments that simply need more time to work through. In some previous business cycles, policymakers exacerbated inflation by mistakenly responding to output gaps that subsequently proved insubstantial.

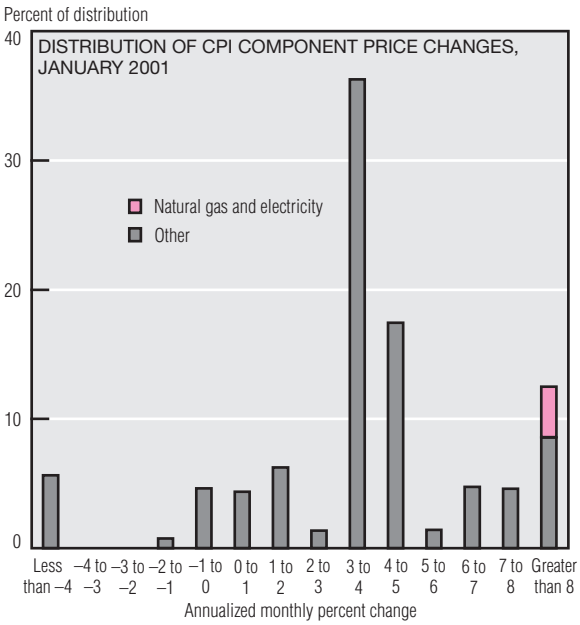
As for inflation, although several core measures have been escalating steadily during the last six months, few analysts seem worried. After all, when output grows slowly, inflation is not supposed to be a threat. That combination of outcomes just doesn't fit into a handy box.

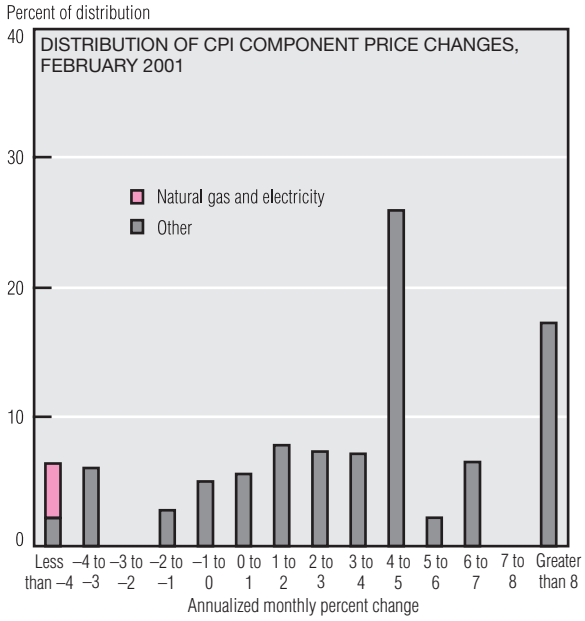
Inflation and Prices

February Price Statistics

	Annualized percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2000 avg.
Consumer prices					
All items	3.5	4.4	3.5	2.6	3.4
Less food and energy	4.0	3.1	2.8	2.4	2.5
Median[b]	4.2	3.8	3.3	2.9	3.2
Producer prices					
Finished goods	1.7	6.1	4.0	1.8	3.6
Less food and energy	–3.9	1.9	1.3	1.1	1.2







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. Upper and lower bounds for inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The recent acceleration in energy price increases reversed course in February, after a January in which the Consumer Price Index (CPI) posted its largest monthly increase in more than a decade. The sharp January rise was largely the result of an outsized increase in the CPI's energy subindex; according to the Labor Department, this measure rose an annualized 57.6%, accounting for over half of the overall increase in the CPI. The energy subindex itself was propelled by a record increase in the index for utility natural gas, which rose 17.4% in the month.

In February, by contrast, retail price increases settled down to a more familiar pace. After an annualized increase of 7.8% in January, the CPI rose an annualized 3.5% in February. Not surprisingly, this more moderate increase was also the result, in large measure, of the CPI's energy components. In particular, natural gas prices rose a much more modest 2.4% in February, while the energy subindex as a whole fell an annualized 2.7%.

These marked fluctuations in the prices of energy goods and services—and their impact on the unadjusted measures of inflation—are almost certainly distorting our sense of inflation's current state. A look at the so-called core measures of inflation may, therefore, be more instructive. Both the CPI excluding food and energy and the median CPI have shown similar rates of change thus far in 2001. The CPI excluding food and energy rose an annualized 4.0% in February, just as it did in January, while the median CPI rose an annualized 4.2% in

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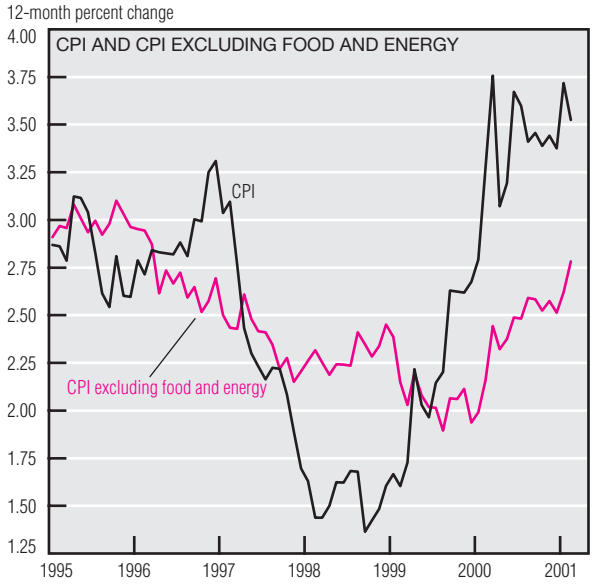
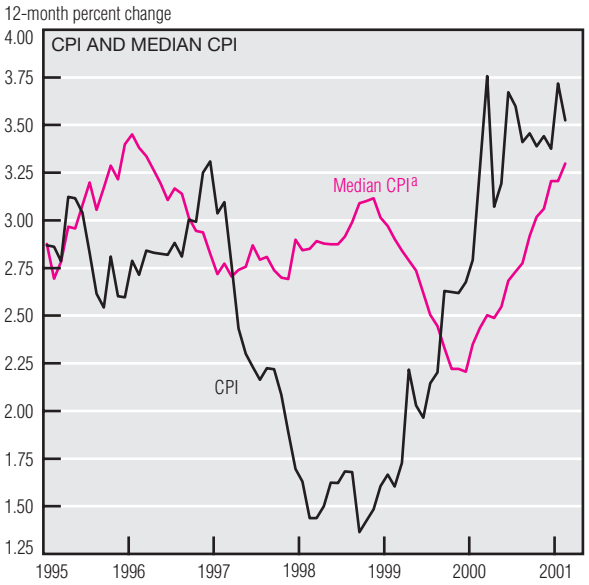
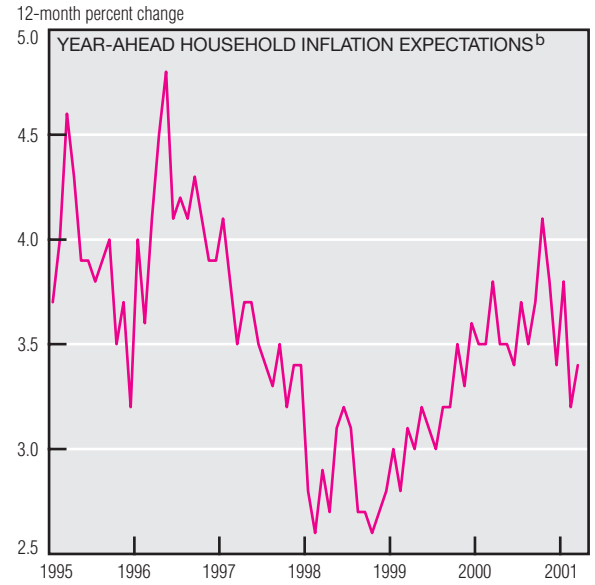
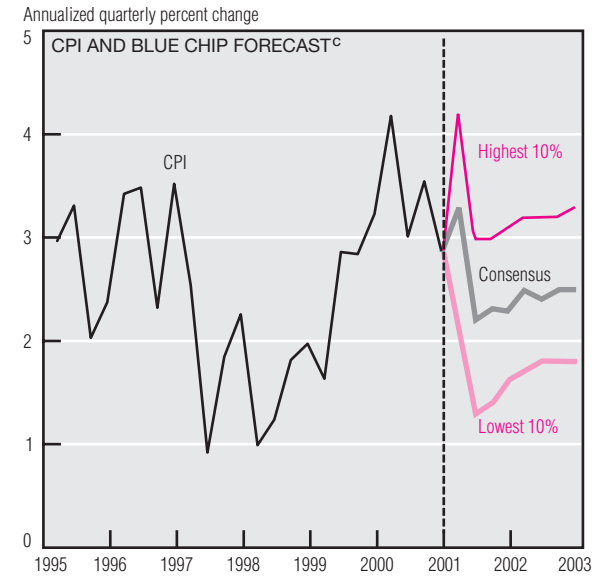
Inflation and Prices (cont.)









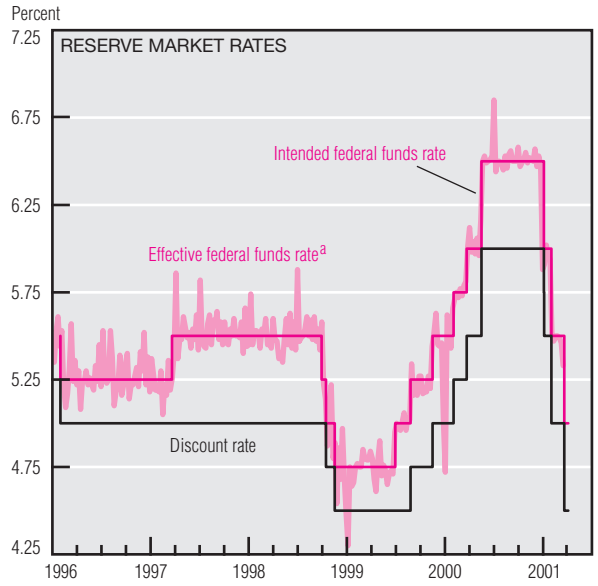
a. Calculated by the Federal Reserve Bank of Cleveland.
b. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
c. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; University of Michigan; and *Blue Chip Economic Indicators*, March 10, 2001.

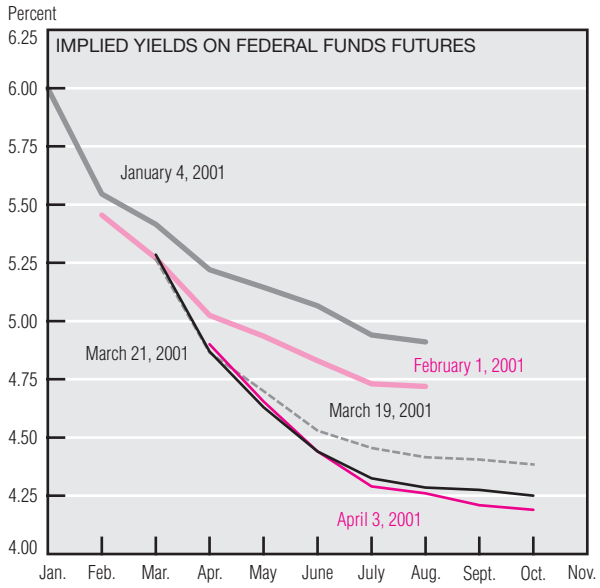
February after rising an annualized 3.6% in January. Taken together, these measures suggest that the underlying inflation rate is currently about 4%.

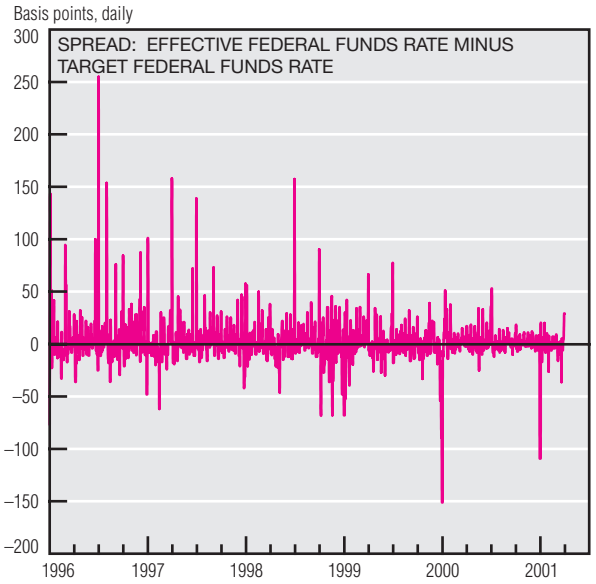
Despite the decidedly upward trend in both core and non-core measures of inflation over the last several quarters, households' expectations of future inflation have actually fallen in recent months. After peaking at just above 4% in late 2000, expectations fell to 3.2% in February. For March, they rebounded somewhat to just below 3.5%. This recent decline is important, because achieving price stability is less a matter of limiting actual inflation than of keeping inflationary expectations in check. This is because inflation's corrosive influence on the economy results from inefficient reallocation of the nation's resources as businesses and households attempt to protect themselves from an unknown future price level. In other words, economic prosperity is jeopardized by the anticipation of rising prices, not by realized price increases, so the observed decline in the public's expectation of inflation may be more significant than the recent upturn in retail prices.

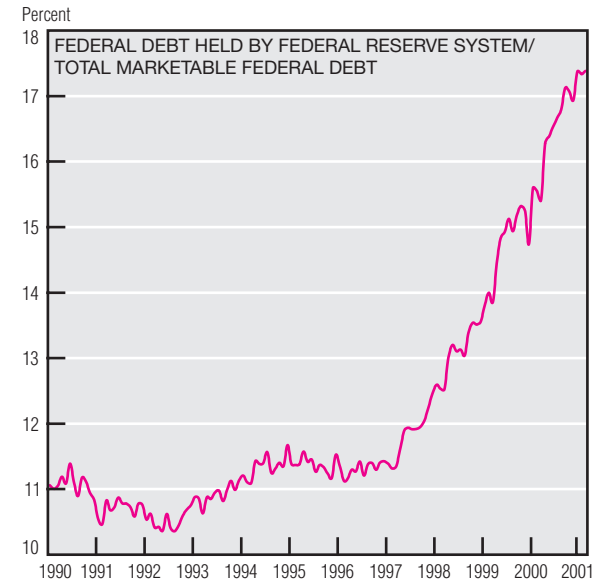
Like households, professional forecasters also see inflation falling in the near future. After a slight increase in early 2001, the consensus forecast has the CPI settling at about 2.5% by late 2001 and staying there through 2002. Even the most pessimistic forecasters do not anticipate that inflation by year's end will be much above current levels; their expectation for the CPI in late 2001 and through 2002 is about 3%.

Monetary Policy









a. Weekly average.
SOURCES: U.S. Department of the Treasury; Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

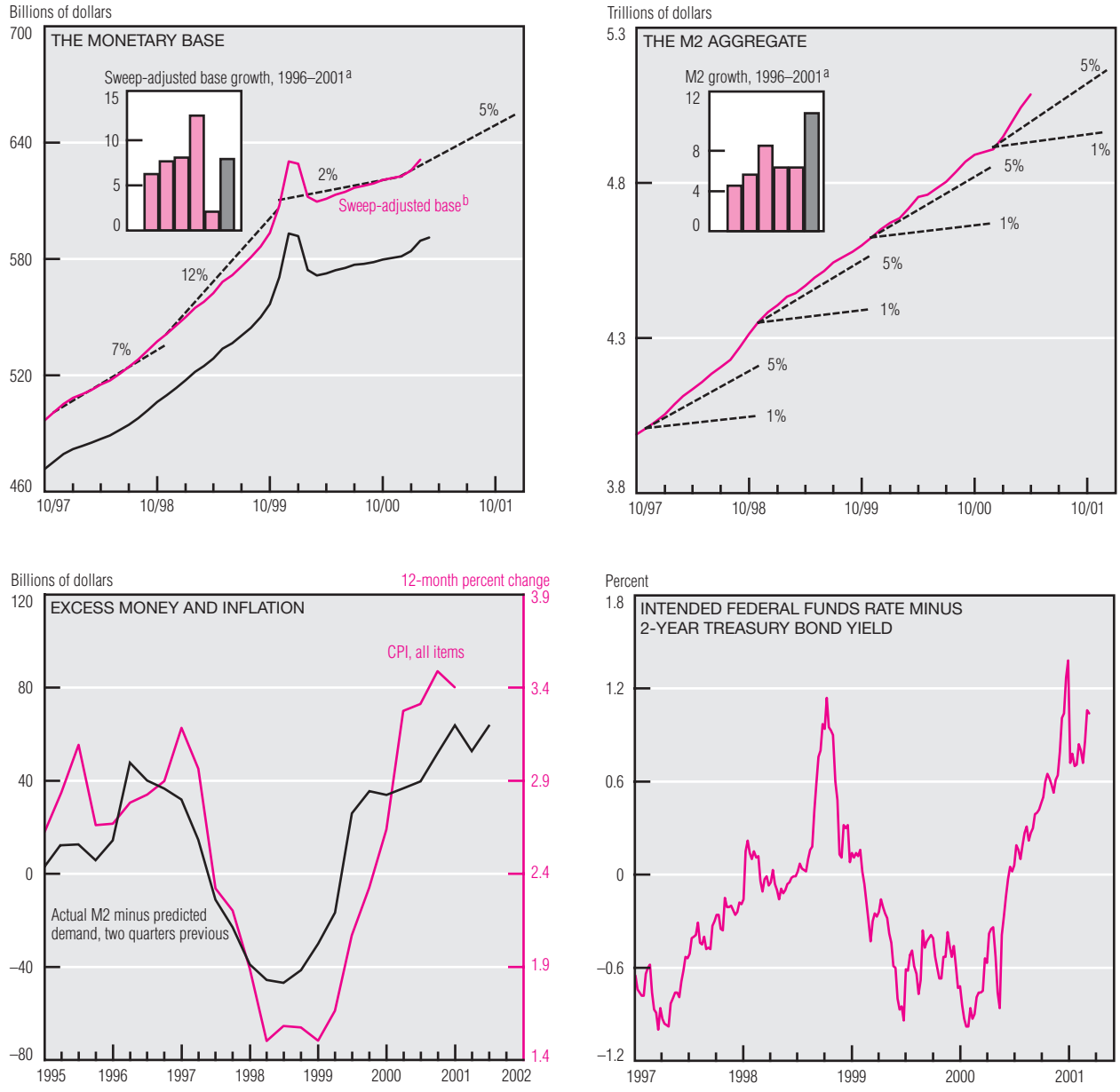
At its March 20 meeting, the Federal Open Market Committee (FOMC) lowered the target federal funds rate 50 basis points (bp) to 5.0%, the third 50-bp cut in 2001. Its press release cited "substantial risks that demand and production could remain soft." Separately, the Board of Governors approved a 50 bp reduction in the discount rate to 4.5%.

Implied yields on federal funds futures, often used to predict monetary policy's future path, declined moderately after the meeting. Market participants place a significant probability on a further rate cut by the end of May. As of April 3, the October contract traded at 4.19%, 81 bp below the current federal funds rate target.

By altering the supply of bank reserves through open market operations, the Federal Reserve attempts to maintain the federal funds rate near its intended level. Typically, the effective funds rate is close to the target rate; since 1996, the average daily absolute deviation from target has been less than 12 bp. However, the effective rate deviates significantly from target at times, missing it by 100 bp or more on several days.

The New York Fed's trading desk conducts most of its open market operations in the form of U.S. Treasury securities. Since 1992, the Federal Reserve's share of these securities has trended upward, partially due to Treasury debt reduction. As of February 2001, this share exceeded 17%. There is some concern that if the Fed holds too large a proportion of Treasury securities, it may disrupt Treasury markets and impede open market operations. Currently, the Federal Reserve is studying the impact on its operations of further expected declines in the quantity of Treasury debt.

Money and Financial Markets



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for the monetary base, sweep-adjusted base, and M2 are calculated on a February, January, and estimated March over 2000:IVQ basis, respectively. Data are seasonally adjusted.
b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts.
NOTE: Last plots for the monetary base and the sweep-adjusted base are February and January, respectively. Last plot for M2 is estimated for March 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.

The March 20 reduction of the federal funds rate target (from 5.50% to 5.00%) has not quelled discussion on the appropriateness of monetary policy. Debate about interest rates, however, tends to ignore a crucial aspect of the question—the money supply. Monetary aggregates have continued to grow at substantial rates and might lead to the suggestion that monetary policy has, if anything, become too loose.

The broad money aggregate, M2, has grown at a year-to-date annualized rate of 11.7%, faster than in 2000 and well above the average rates for 1996–2000. Only part of this increase can be attributed to the monetary base, whose year-to-date growth rate is just 7.9%. Monetary aggregates must be treated with caution at this time of year because of tax payments and rebates, but the year-to-date numbers are not encouraging.

Money growth by itself is only half the picture: Money supply will not be excessive if real money demand is also growing briskly—and that demand depends on the influence of overall real economic growth and interest rates. A plot of the difference between actual M2 and an econometric estimate of M2 demand shows that M2 has been growing faster than the economy can absorb it, given real GDP growth and current interest rates. In the past, this condition has often predicted an increase in inflation correctly and it appears to be doing so now.

One key interest rate measure, however, does not reflect such

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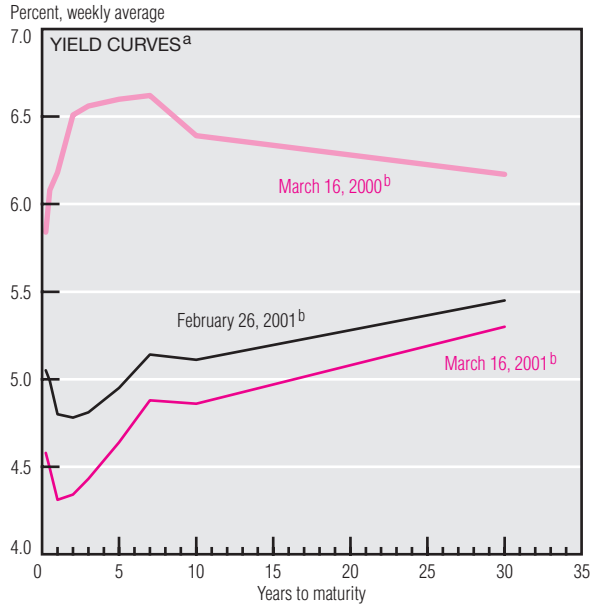
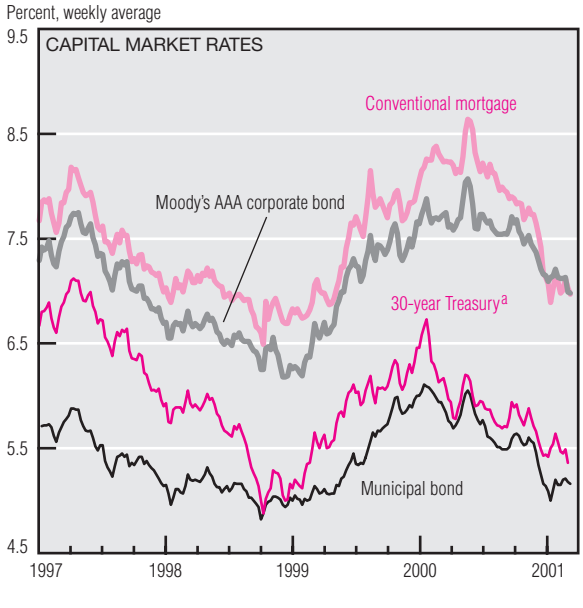
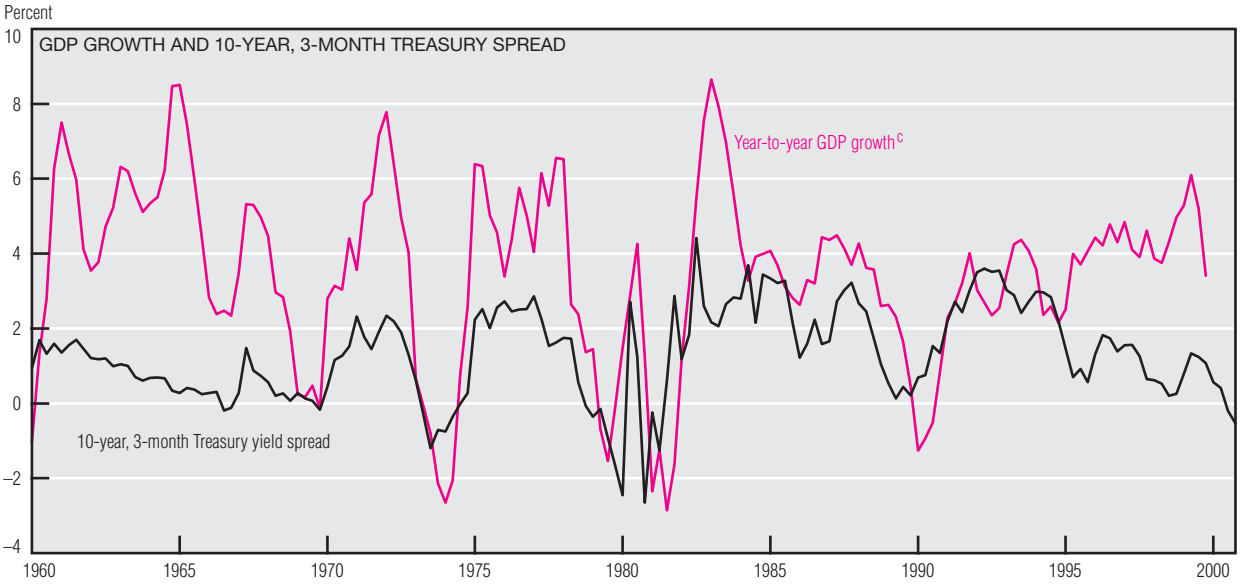
Money and Financial Markets (cont.)







a. All yields are from constant-maturity series.
b. Average for the week ending on this date.
c. Real GDP growth leads four quarters.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15; and Bloomberg Financial Information Services.

excess money growth. The spread between the target federal funds rate and the yield on 2-year Treasury bonds has increased dramatically over the past year because interest rates have generally been decreasing. Of course, the 150 basis point reduction in the federal funds target rate since January 3 seems to have reduced the spread somewhat.

The yield curve has shifted downward since last month. While the curve remains inverted at the short end, the low point of the curve is moving toward earlier maturities (the current minimum is the 1-year yield), suggesting an incipient unbending. The 3-year, 3-month spread stands at –15 basis points (bp) and the 10-year, 3-month spread stands at 28 bp. Longer-term rates generally have also come down, as have long-term Treasuries, but the recent picture is a bit more mixed. Municipal bond yields have actually increased so far in 2001. In an unusual move, conventional mortgage rates have dropped below AAA corporate bond yields.

One reason the yield curve receives so much attention is its history as a predictor of future economic performance. A steep yield curve usually indicates high future growth, and an inverted yield curve indicates a recession. While this pattern is apparent in the plots for the 10-year, 3-month spread, as well as in GDP growth for the following year, both the 1960s and the 1990s show long periods in which low spreads were associated with high growth. Does this mean the recession suggested by the recent yield-curve inversion should also be discounted? Time will tell.

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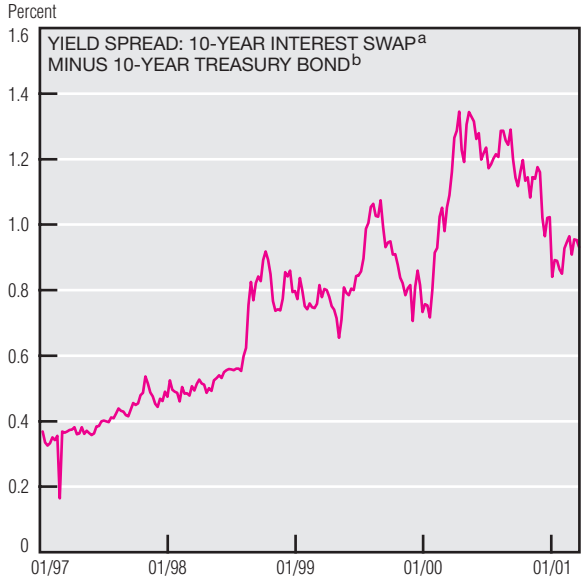
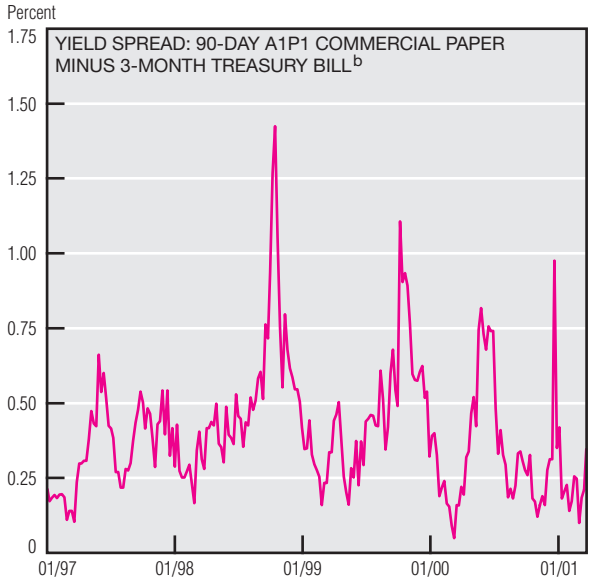
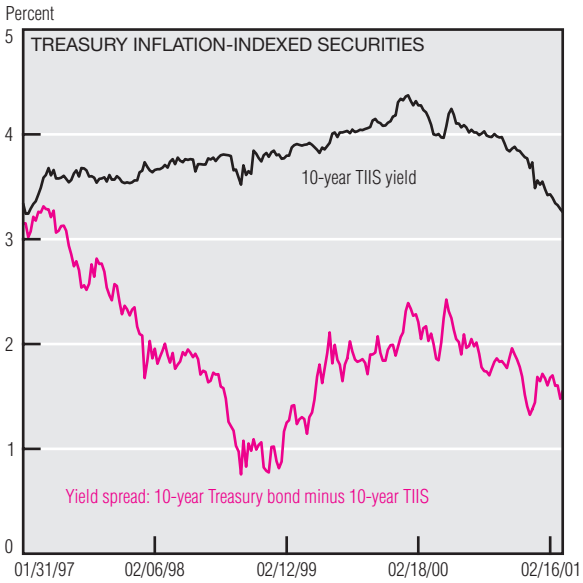
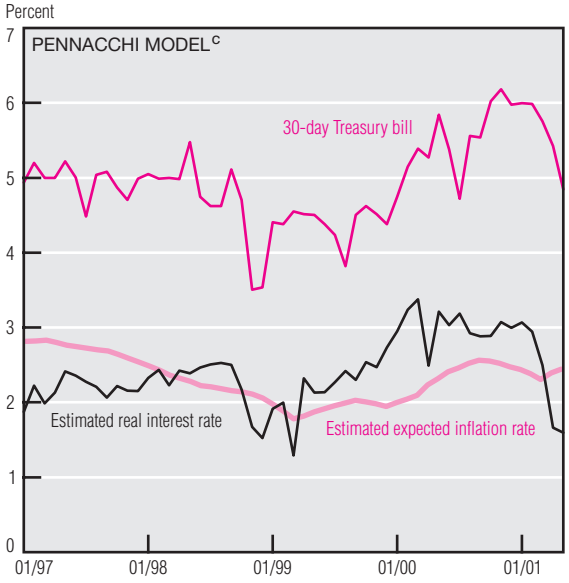
Money and Financial Markets (cont.)









a. Quote for semiannually fixed rate versus the U.S. dollar's 3-month London interbank offered rate (LIBOR).
b. Bloomberg generic series.
c. The estimated expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; and Bloomberg Financial Information Services.

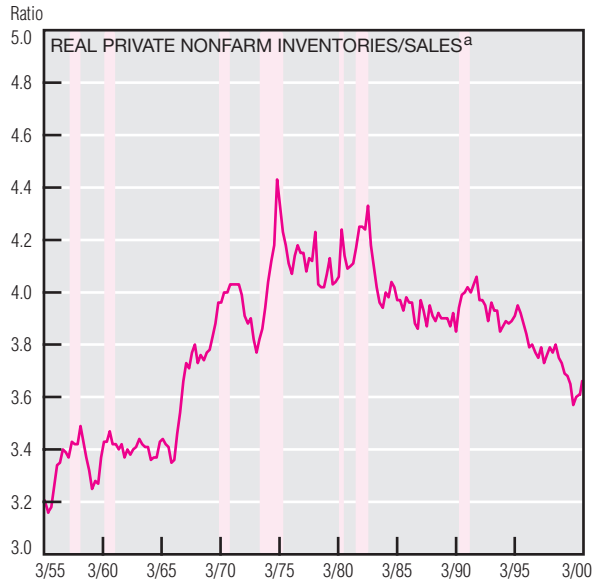
The spread between long- and short-term yields, often called the term spread, has a counterpart in the spread between risky and safe bonds, often called the risk spread. This can sometimes be interpreted as a predictor of future growth—under the assumption that risk increases in a recession—but it can also be seen as a more contemporaneous indicator of uncertainty. If so, then bond markets are having a rather tranquil time. At longer maturities, the spread between 10-year interest rate swaps and 10-year Treasuries has decreased 42 bp since May 2000, although it remains above the levels seen in 1997 and 1998. On the short end, the spread between 90-day commercial paper and 3-month Treasury bills has eliminated the spike seen around the turn of the year and resumed a value on the low side of its range for 1997–2001.

Yet another sort of spread may provide information about future inflation. The spread between nominal Treasury bond yields and yields on Treasury inflation-indexed securities (TIIS) measures the difference between real and nominal interest rates, of which inflation is an important component. Another approach is to estimate inflation and real rates from nominal rates and survey measures of inflation. Although both of these measures indicate that real rates have fallen in 2001, they differ as to the prospects for inflation.

Inventories and Imports

Real GDP and Components
(Billions of chained 1996 dollars)

	2000:IIIQ	2000:IVQ	Change
Real GDP	9,369.5	9,393.7	24.2
Personal consumption	6,329.8	6,373.3	43.5
Business fixed investment	1,438.8	1,438.3	–0.5
Residential investment	362.3	359.0	–3.3
Change in business inventories	72.5	55.7	–16.8
Government spending	1,578.2	1,589.6	11.4
Net exports	–427.7	–441.7	–14.0



Percentage Change in Imports Resulting from a 1% Increase in Inventories[c]

	Point estimate	Confidence range 95%	Confidence range 90%
1956–79	1.3	0.3 to 2.3	0.5 to 2.1
1980–89	1.8	0.5 to 3.1	0.7 to 2.8
1990–2000	1.2	0.3 to 2.2	0.4 to 2.0

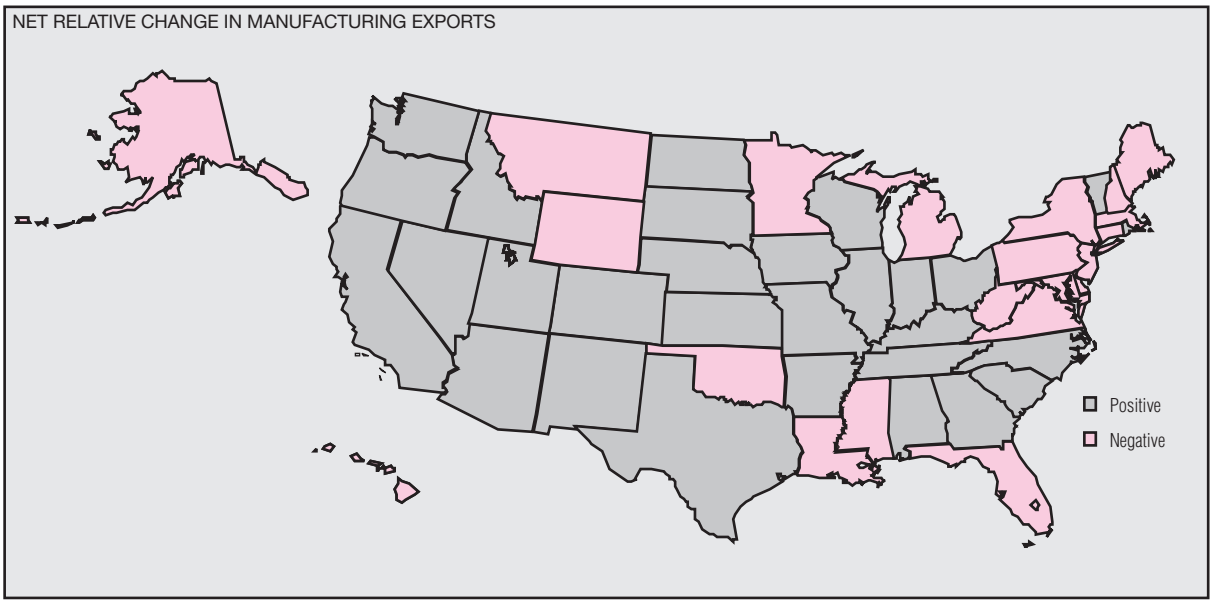
a. Shaded areas indicate recessions.
b. Real imports plus exports, divided by GDP.
c. Calculations are based on quarterly data for imports of goods and nonfarm inventories.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Many economists believe that the current cooling in economic activity largely reflects an inventory correction that will pass fairly quickly and painlessly. Two observations support this prognosis. First, businesses have managed their inventories closely, fostering a general decline in the ratio of inventories to sales since the early 1980s. Because manufacturers reacted quickly when the ratio began to rise last year, the necessary correction might be less extensive than it often has been in the past.

The second reason for optimism is the increasingly global nature of production. International trade (exports plus imports) equaled 29% of GDP in 2000, up from 7% in 1960. As businesses rely more heavily on imports to manage their inventories—so the story goes—corrections have less impact on their domestic production and employment than they had 20 or 30 years ago.

The relationship between inventories and imports is not wholly inconsistent with this account. Over the past 10 years, a 1% increase in private nonfarm inventories has been associated with a 1.2% increase in goods imports. Nevertheless, the story falls short. After allowing for the inherent randomness of any such estimate, it appears that the relationship between inventories and imports has not changed in 45 years. Imports are no more an inventory escape valve today than they were in the past.

Fourth District Export Growth



Shift-Share Results
(Percent)

	Net relative change	Industry-mix effect	Competitive effect	Destination effect
Ohio	1.7	0.1	2.2	–0.6
Kentucky	44.1	–4.4	51.1	–2.7
Pennsylvania	–0.8	3.5	–4.6	0.4
West Virginia	–33.2	–12.7	–17.8	–2.8
Illinois	19.6	0.8	21.3	–2.6
Indiana	22.7	–0.4	23.7	–0.6
New York	–31.2	3.2	–31.1	–3.3
Michigan	–35.0	1.9	–46.3	9.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Cletus C. Coughlin and Patricia S. Pollard, "Comparing Manufacturing Export Growth across States: What Accounts for the Difference?" Federal Reserve Bank of St. Louis, *Review,* vol. 83, no. 1 (January/February 2001), pp. 25–40.

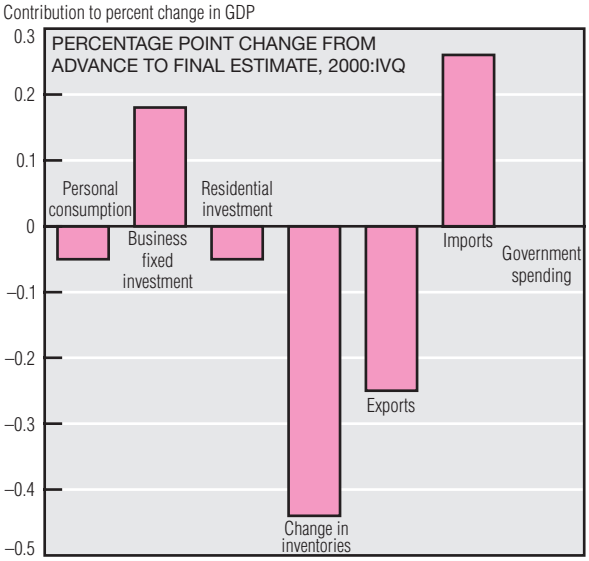
Since the mid-1980s, overall U.S. manufacturing exports have increased sharply as a share of gross domestic product, but their state-by-state performance has been uneven. In the Fourth Federal Reserve District, Ohio's and Kentucky's manufacturing exports grew faster than the national average, while Pennsylvania's and West Virginia's lagged behind it.

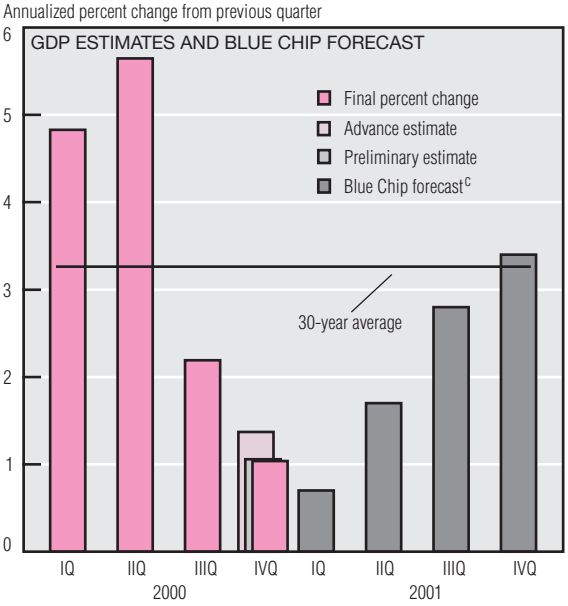
Cletus Coughlin and Patricia Pollard, economists at the St. Louis Federal Reserve Bank, recently examined relative export growth by splitting the change in each state's net manufacturing exports into three constituent effects. The industry-mix effect indicates that a state contains a higher concentration of industries whose exports expanded faster than the U.S. average. The competitive effect indicates that exports from a state's industries are leading or lagging export growth among similar industries nationwide. The destination effect attributes a state's differential export performance to whether its manufacturers predominantly serve faster- or slower-growing foreign markets.

A consistent pattern does not emerge in the Fourth District. Kentucky, which showed solid relative export growth, benefited from a strong competitive effect. Ohio's relative export growth stemmed from modest competitive and industrial-mix effects. Pennsylvania's exports benefited from a favorable industrial mix and fast-growing foreign customers, but its competitive effect held Pennsylvania back. West Virginia lost ground on all counts.

Real GDP and Components, 2000:IVQ[a,b]
(Final percent change)

	Change, billions of 1996 $	Percent change, last: Quarter	Four quarters
Real GDP	24.2	1.0	3.4
Personal consumption	43.5	2.8	4.5
Durables	–7.2	–3.2	5.2
Nondurables	4.8	1.0	3.8
Services	43.2	4.9	4.6
Business fixed investment	–0.5	–0.1	10.5
Equipment	–9.7	–3.3	9.8
Structures	7.2	10.4	12.7
Residential investment	–3.3	–3.6	–2.6
Government spending	11.4	2.9	1.3
National defense	7.5	9.0	–2.0
Net exports	–14.0	—	—
Exports	–19.0	–6.4	6.7
Imports	–4.9	–1.2	11.3
Change in business inventories	–16.8	—	—





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 are based on *Blue Chip Economic Indicators*, March 10, 2001.
NOTE: All data are seasonally adjusted and annualized.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis, and *Blue Chip Economic Indicators*, March 10, 2001.

Gross domestic product (GDP) grew at a 1.0% annual rate in 2000:IVQ. Consumer spending was revised downward but remained healthy, with nearly 3% growth. Business fixed investment fell only slightly this quarter, the drop in equipment and software purchases being offset by strong growth in business structures. Residential investment and exports were also off modestly, while greater government spending added to fourth-quarter growth.

The final estimate for 2000:IVQ, released late in March, is 0.1 percentage point below the preliminary estimate of a month earlier and 0.4 percentage point below the advance estimate. The most recent revision resulted primarily from business inventory accumulations that were slower than originally estimated. Adjustments to inventory accumulation can account for the entire –0.4 percentage point revision in quarterly GDP growth, with revisions in the other components offsetting one another.

Despite much slower inventory accumulation, inventory-to-sales ratios remain above their recent lows. Ratios for both trade and manufacturing broke trend and began to rise in 2000:IQ. While the trade ratio has begun to fall again, manufacturers' inventories continue to accumulate faster than sales.

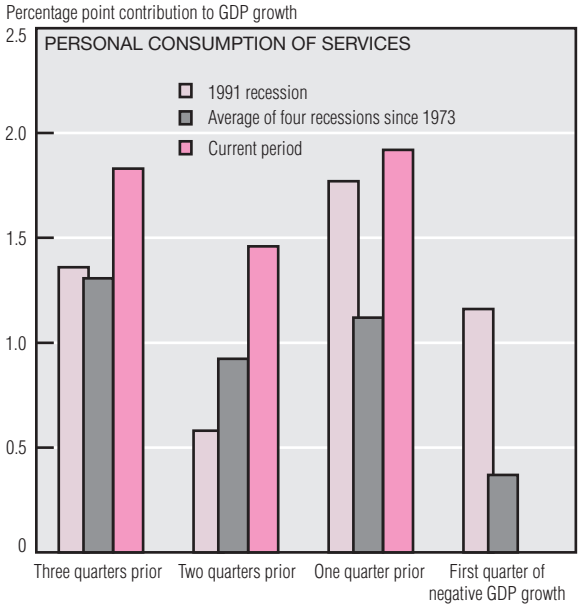
Quarterly real GDP growth is slower than at any time since 1995:IIQ, and Blue Chip forecasters

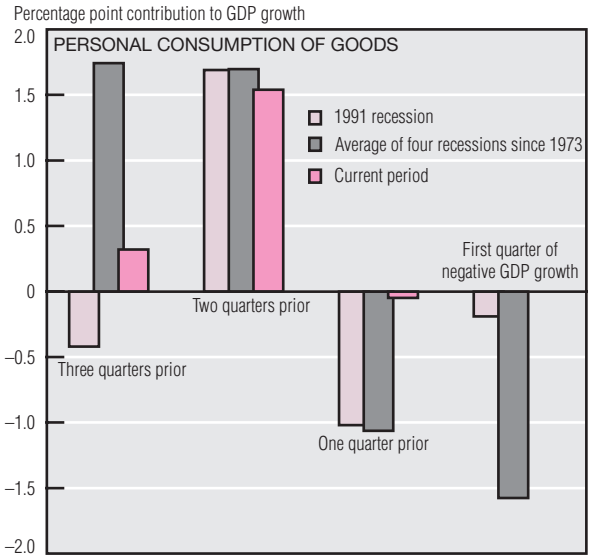
(continued on next page)

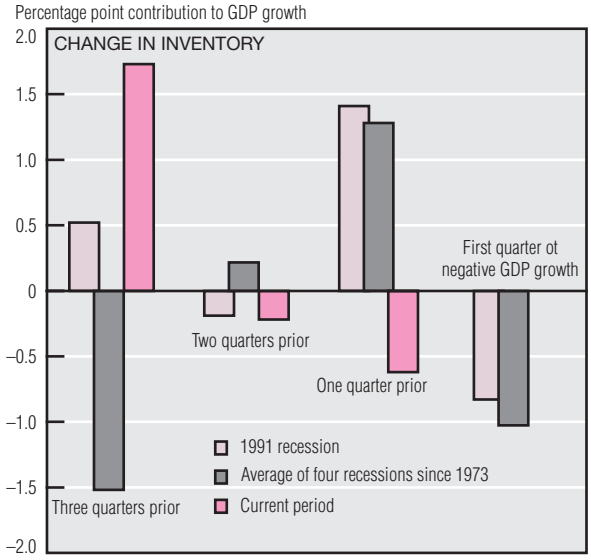
Economic Activity (cont.)

Contribution to Change in Real GDP Growth

	Last Four Recessions, Peak to Trough			
	1973–75	1979–80	1981–82	1990–91
Change in GDP growth[a]	–15.6	–10.8	–14.5	–8.3
Percent contribution to change in GDP growth[b,c]				
Personal consumption	16.7	73.4	–2.5	54.3
Durables	10.6	42.0	–0.3	28.7
Nondurables	4.2	21.2	5.7	15.5
Services	2.0	10.1	–7.8	10.1
Investment	104.6	47.9	98.2	57.8
Structures	8.5	12.3	5.1	11.2
Equipment and software	21.7	27.9	8.5	6.5
Change in inventory	63.1	–24.7	81.2	23.4
Government spending	–4.6	–1.2	7.9	5.3
Net exports	–16.5	–20.4	–4.0	–17.3







a. Annualized quarterly growth rates.
b. Components of personal consumption, investment, government spending, and net exports sum to 100.
c. Negative numbers indicate an offset to GDP contraction.
NOTE: All data are seasonally adjusted and annualized.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis, the Census Bureau, and National Bureau of Economic Research.

expect it to slow further before rebounding later this year. Forecasters predict that real GDP growth for 2001:IQ will be less than 1% but expect it to reach its long-term average by 2001:IVQ.

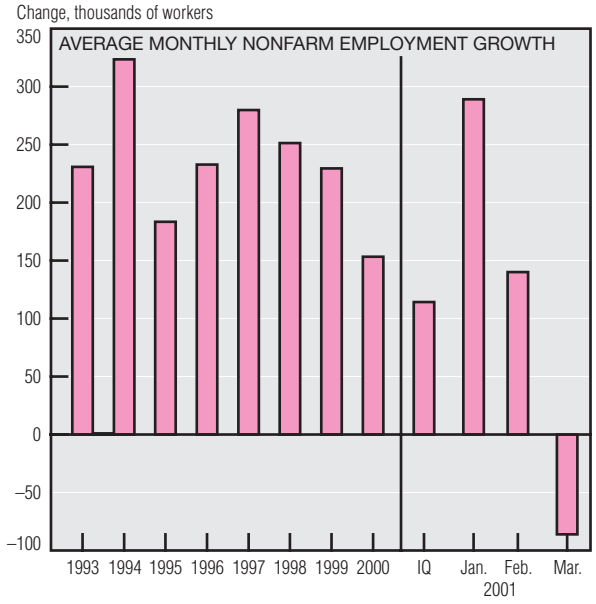
Over the last 30 years, the U.S. has undergone four periods of economic contraction. By comparing current patterns of consumption and investment with historical trends, one may gain insight about the likelihood of a recession.

Some argue that the risk of a recession is minimal because services growth has accelerated over the last three quarters. If history is any teacher, however, this does not necessarily mean that a recession can be avoided. Personal consumption of services has remained strong going into each contraction, particularly the last one.

Personal consumption of goods has proven a better predictor of looming contractions. In each of the last four, goods consumption fell in the quarter immediately preceding a drop in real GDP. Thus far, goods consumption has remained flat, suggesting that a recession is not necessarily imminent.

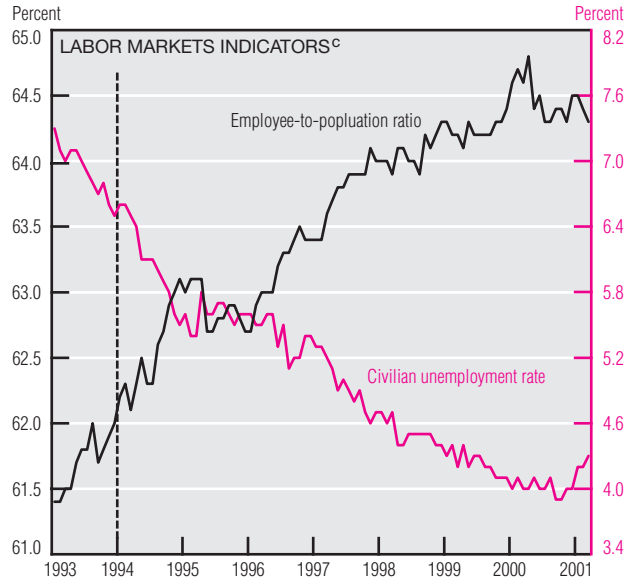
Past inventory changes may also provide some insight into the current situation. Changes in inventory usually spike one quarter before a drop in GDP and then decline the following quarter. Changes in inventory spiked during 2000:IIQ and then fell slightly in 2000:IIIQ. That spike probably portended the slow growth that occurred in 2000:IVQ rather than the beginning of an actual recession.

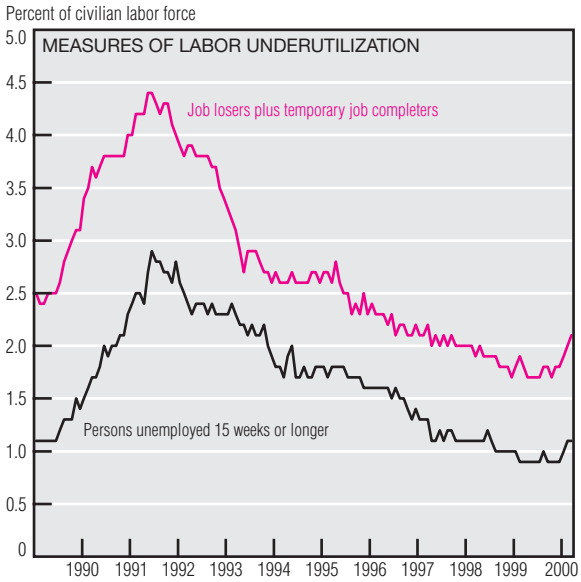
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1997	1998	1999	2000	Mar. 2001
Payroll employment	280	251	229	153	–86
Goods-producing	48	22	4	1	–67
Mining	1	–3	–3	1	2
Construction	21	37	25	14	12
Manufacturing	25	–12	–18	–14	–81
Durable goods	27	–2	–6	–4	–59
Nondurable goods	–2	–11	–12	–10	–22
Service-producing	232	229	225	153	–19
TPU[a]	16	20	16	15	5
Retail trade	24	30	36	26	–46
FIRE[b]	21	22	10	4	17
Services	141	120	124	91	11
Government	17	28	28	11	–4
	Average for period				
Civilian unemployment rate (%)	4.9	4.5	4.2	4.0	4.3





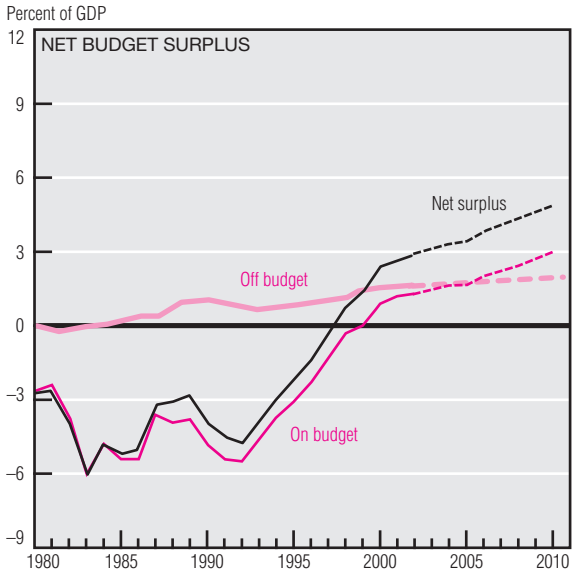
a. Transportation and public utilities.
b. Finance, insurance, and real estate.
c. Vertical line indicates break in data series due to survey redesign.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

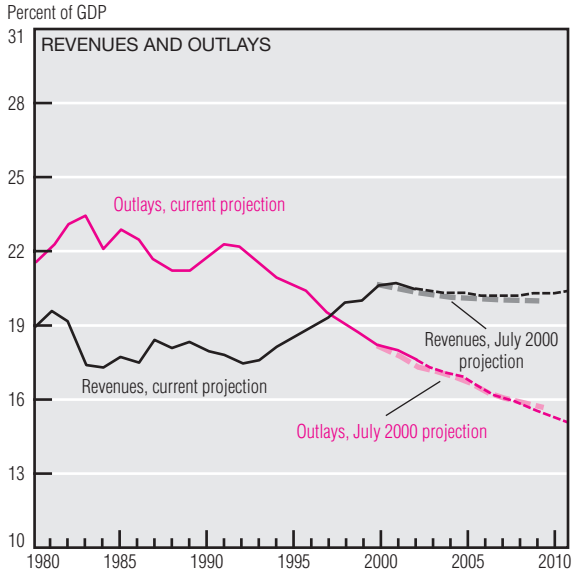
In March, manufacturing and help-supply services (temporary help) posted large employment losses, which combined with below-average gains in most service industries to cause a net decrease of 86,000 in total nonfarm payrolls.

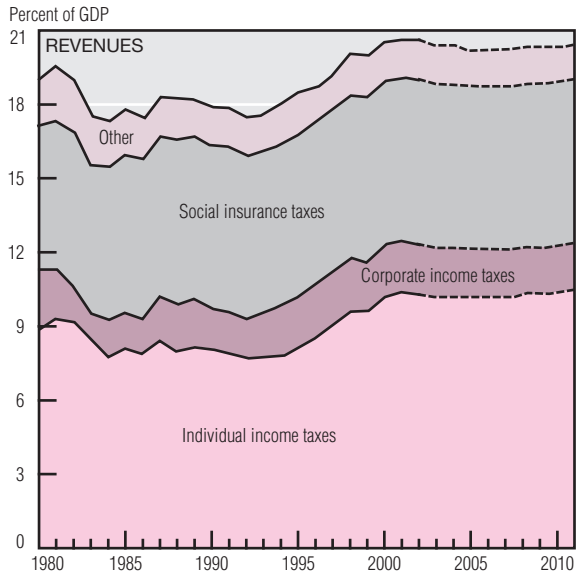
Manufacturing continues to struggle mightily; it shed another 81,000 jobs in March, bringing its losses to 451,000 since June. Similarly, help-supply services decreased by 86,000 jobs in March, for total losses of 273,000 jobs in the last six months. Labor conditions in both industries are considered leading indicators and may portend more widespread employment declines. The large job losses in help-supply services, as well as in retail trade, more than offset gains in other industries, such as health services (23,000) and computer services (11,000); as a result, service-producing industries posted a rare overall monthly employment decline.

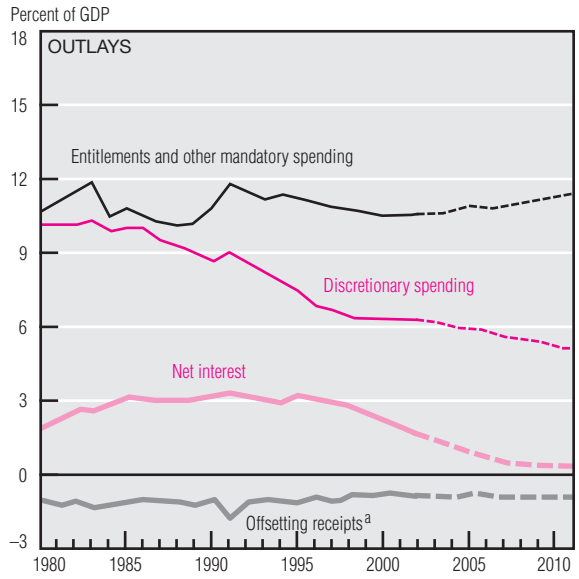
Other labor market indicators also deteriorated slightly in March. The unemployment rate edged up 0.1% to 4.3%; since last October, when it reached a 30-year low of 3.9%, it has risen 0.4%. The employment-to-population ratio fell 0.1% to 64.3%. The percent of the civilian labor force unemployed for 15 weeks or longer recently increased, albeit slightly. Similarly, the percent of the civilian labor force that recently has lost a job or completed a temporary job rose slightly. While variations in these series are common, even during periods of robust economic growth, their recent simultaneous movements seem atypically strong and suggest that first-quarter economic activity slowed considerably.

The Federal Budget









a. Offsetting receipts result from market-oriented public transactions that are not authorized to be credited to expenditure account.
NOTE: Dotted lines indicate projections.
SOURCE: U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002–2011* (baseline budget projections).

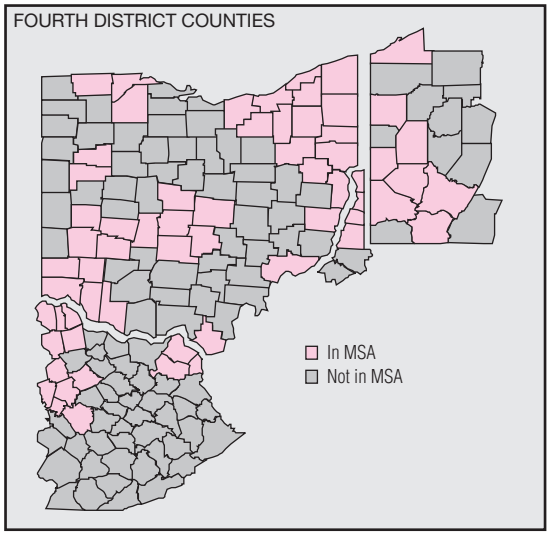
Recent projections by the Congressional Budget Office place the cumulative 10-year (FY2002–11) surplus at $5.6 trillion. This figure is more than $1 trillion higher than the estimate given last July for FY2001–10, primarily because the projection window was shifted forward a year.

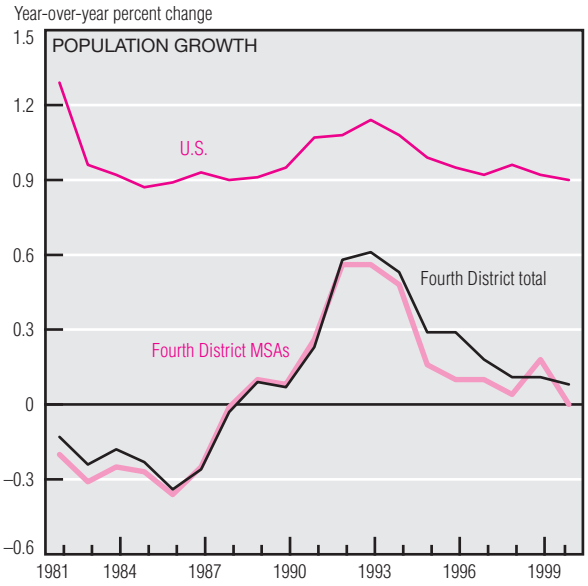
Of the 10-year total, $3.1 trillion accrues on budget and $2.5 trillion off budget—which includes the Social Security and Postal Service accounts. The improved budgetary projections depend on several economic assumptions—that the recent economic weakness will be short-lived; real GDP growth will average 3% annually in FY2002–11; and interest rates will be slightly lower relative to the Congressional Budget Office's July assumptions, implying lower debt-service costs.

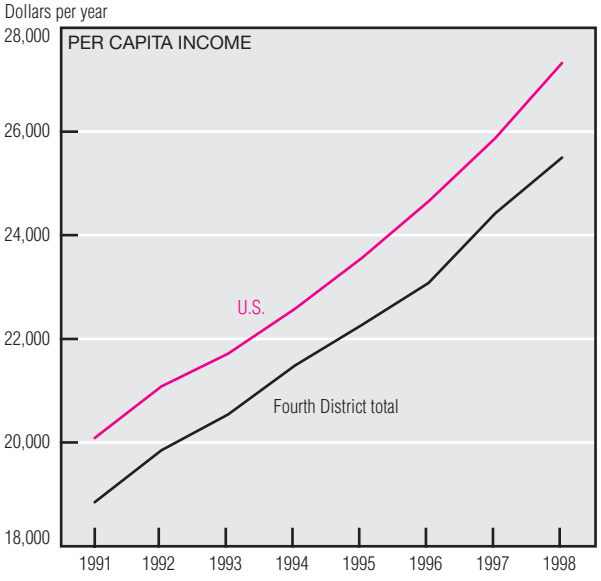
Almost all ($808 billion) of the increase in the projected 10-year surplus comes from higher revenue projections, which assume an improved economic outlook. Individual income taxes are expected to contribute the most revenue growth as a percent of GDP, especially in the later years of the projection horizon, as the recent increase continues and accelerates. This upsurge in revenue has resulted from rapid growth in several categories: taxable personal income, capital gains realizations, taxable withdrawals from 401(k) plans and individual retirement accounts, and a higher effective tax rate because a greater proportion of Americans are in higher marginal income-tax-rate brackets.

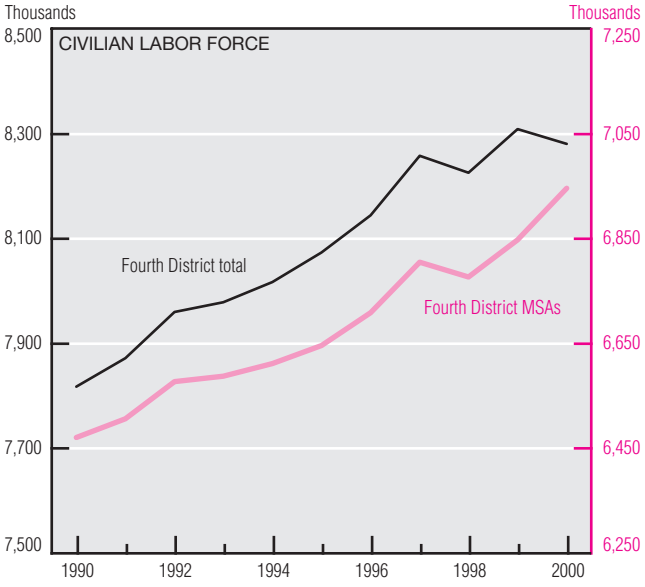
On the outlay side, discretionary spending as a percent of GDP continues its downward trend, primarily because of slower growth in defense expenditures.

The Fourth District in Focus









SOURCES: Analysis by the Federal Reserve Bank of Cleveland, based on data from U.S. Department of Labor, Bureau of Labor Statistics; and from U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

The Fourth District is an unwieldy entity, composed of 169 counties in four states, but its composition is important for understanding its evolving economy. New figures indicate that the District's population now stands at 16.6 million, 13.4 million of whom live in counties that the Census Bureau classifies as part of a metropolitan statistical area (17 MSAs are located at least partly in the District). Only 68 of 169 counties (40%) are located in MSAs, yet they account for 81% of the District's population, 83% of its labor force, and 85% of its income.

The District's population grew at a decreasing rate throughout the 1990s, lagging national growth trends considerably. The story is similar for District MSAs.

In 1996, the District's per capita income fell relative to the U.S. average (that is, the gap between national and District figures widened), and that gap has remained relatively larger than it was when the expansion began. In 1991, annual per capita income in the Fourth District was $1,784 less than the U.S. average; by 1998, the gap had nearly doubled. In that year, per capita income in the District was $25,496, compared to the U.S. average of $28,542 (a difference of $3,046).

Although the District's population growth was relatively low throughout the 1990s, its labor force grew because of rising labor force participation rates. (Bureau of Labor Statistics data show that the District's labor force declined in 1998, perhaps reflecting the Bureau's switch from using a direct counting method for the 10 largest states to using a standardized sampling method for all 50 states). Throughout the 1990s, labor

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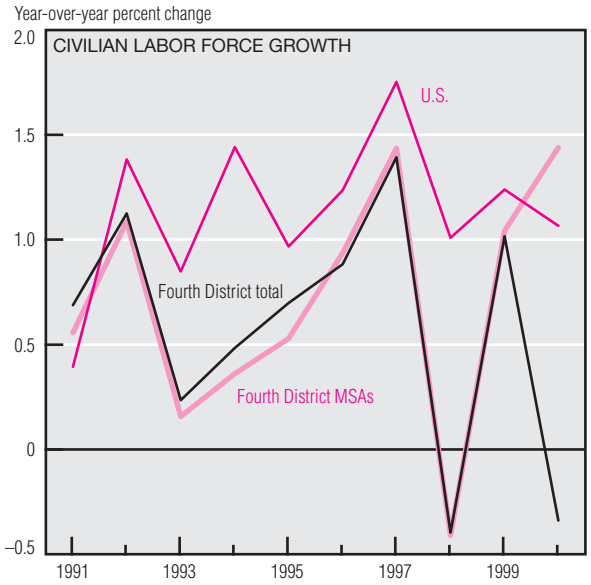
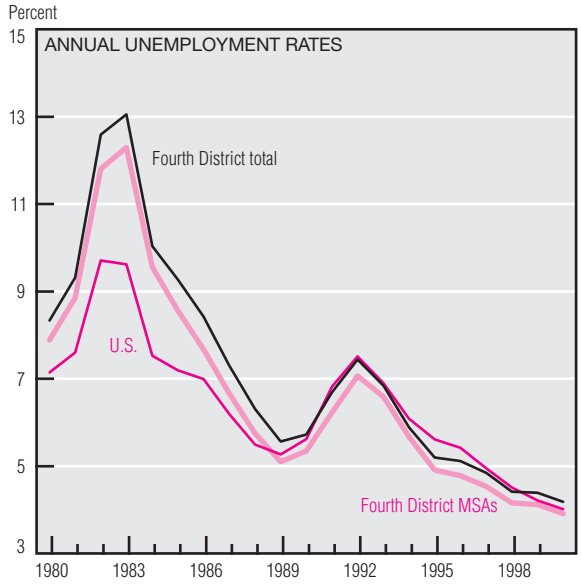
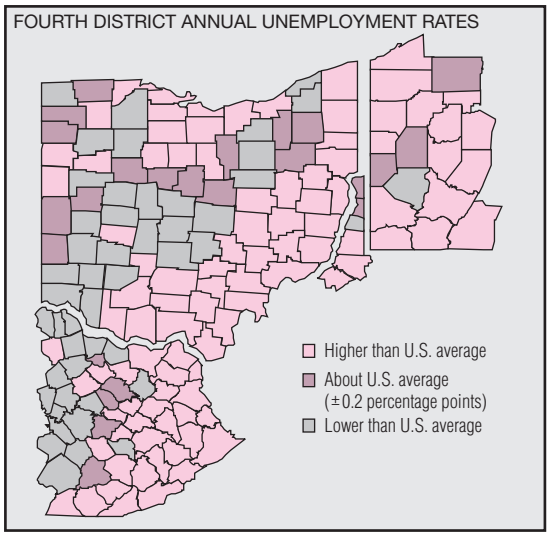
The Fourth District in Focus (cont.)







Unemployment Rates

	Dec. 2000	Nov. 2000	Dec. 1999	Year/ year change
Fourth District total	3.9	3.9	3.8	0.1
Fourth District MSAs	3.6	3.7	3.6	0
Ohio	3.7	3.7	3.9	–0.2
Pennsylvania	3.8	4.1	3.7	0.1
Kentucky	3.7	3.8	3.9	–0.2
U.S. average	3.7	3.8	3.7	0

SOURCES: Analysis by the Federal Reserve Bank of Cleveland, based on data from U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

force growth in District MSAs closely followed changes in the District as a whole. The year 2000 appears to be an exception: Although the labor force shrank in the District overall, it grew in District MSAs. In fact, labor force growth in District MSAs even outpaced the U.S. average in 2000.

Unlike population growth rates, the District's unemployment rate generally followed the national trend over the last decade. During the 1980s, the District—as well as its MSAs—reported unemployment rates considerably higher than the nation's; starting with the current expansion, however, it has enjoyed lower unemployment rates than the U.S. as a whole. Over the last two years, the figures have fluctuated around the U.S. average. These varying relationships to the national unemployment trend can likely be explained by the District's heavier-than-average dependence on manufacturing as a source of employment. When manufacturing unemployment is high, the District's rate tends to be high.

The eastern part of the District tends to have higher unemployment rates than the nation as a whole, while the western part reports figures below or at national rates. (The western counties are more heavily concentrated in agriculture, which generally has lower unemployment.) In December 2000, the District's non–seasonally adjusted unemployment rate was slightly higher than the rate reported by District states and the U.S., but year-over-year changes for the District and its MSAs were comparable to the nation's.

Commercial Banks

a. The net interest margin equals interest income less interest expenses, both divided by average earning assets.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

Commercial banks showed negligible deterioration in 2000, with earnings of $71.176 billion, off slightly from 1999. Return on assets also declined somewhat (1.19% in 2000, compared to 1.31% in 1999). Downward pressure on profits was apparent in the net interest margin, which dropped from 4.07% at the end of 1999 to a 10-year low of 3.95% at year-end 2000.

Return on equity for 2000 was 14.07%, compared to 15.31% the previous year. This drop must have been due primarily to a lower return on assets, since core capital remained a healthy 7.71% of total assets, only a small decrease from 1999. Asset quality continued strong, with problem assets still less than 1.00% of the total. However, the increase in this share (from 0.63% in 1999 to 0.74% in 2000) could indicate some weakness in asset quality. This bears watching, especially as the economy slows down. In addition, net charge-offs increased slightly (from 0.61% of loans at year-end 1999 to 0.64% at year-end 2000, but still below the 1998 peak of 0.67%).

While earnings have slowed somewhat, the share of unprofitable banks fell from 7.47% of all banks at year-end 1999 to 7.06% in 2000:IVQ. On the other hand, the share of problem banks (those with substandard examination ratings) rose slightly to 0.91% at year-end 2000.

Although these changes in performance indicators are consistent with some weakening in the banking sector, they do not suggest significant deterioration. However, the current economic slowdown raises the question of whether the deterioration observed in 2000 will remain negligible in 2001.

Savings Associations

a. The net interest margin equals interest income less interest expenses, both divided by average earning assets.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

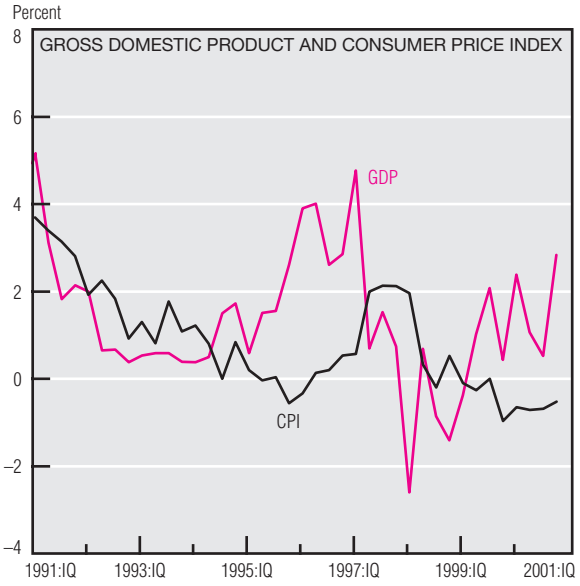
In many ways, savings associations' performance mirrored commercial banks' in 2000. Savings associations' earnings were $10.7 billion, slightly below the 1999 record of $10.826 billion. Return on assets was 0.92%, down from 1.00% in 1999—its second consecutive annual decrease. The earnings slowdown is also reflected in the net interest margin's drop below 2.96% to its lowest level since 1991.

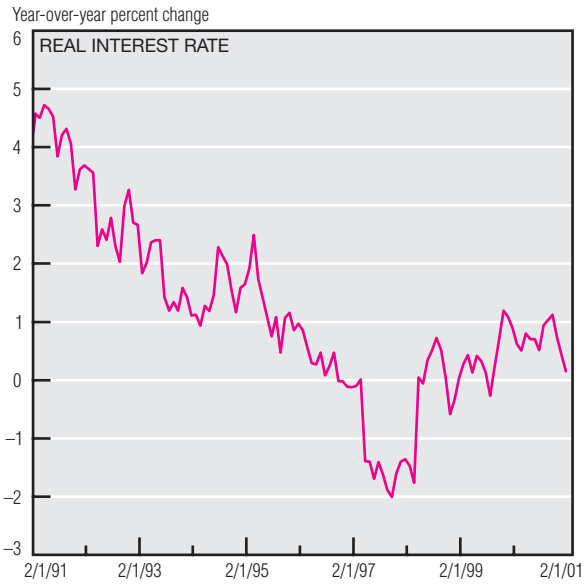
Return on equity's fall (from 11.72% at year-end 1999 to 11.14% at year-end 2000) was apparently driven by a lower return on assets; core capital remained a healthy 7.81% of total assets, only a small decrease from 1999. Further signs of weakening include a greater number of problem institutions and more savings associations reporting losses. The share of savings associations reporting losses rose steadily from 4.1% in 1997 to 8.36% at year-end 2000. In addition, 1.13% of savings associations received substandard examination ratings in 2000, the largest share since 1997.

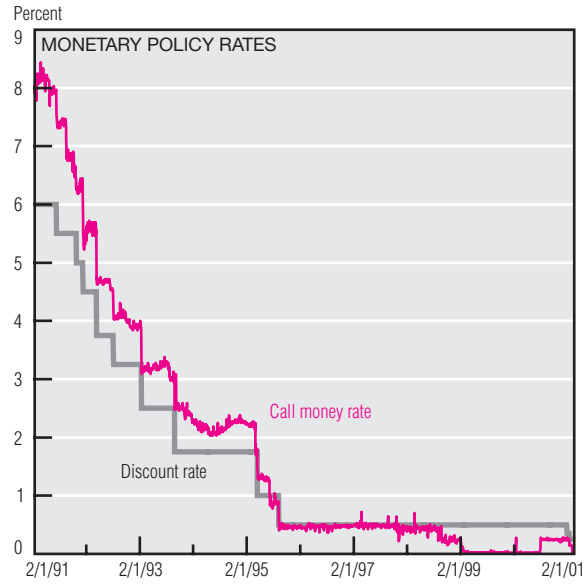
Asset-quality indicators are mixed. At year-end 2000, problem assets fell to 0.56% of total assets, the smallest share in over a decade. On the other hand, net charge-offs rose slightly to 0.20%.

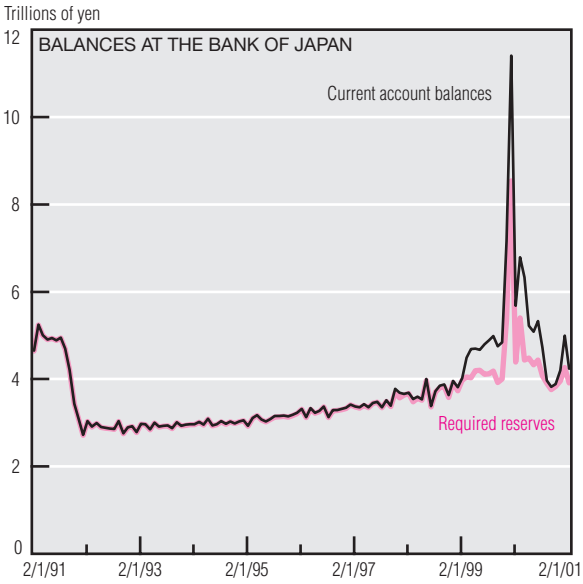
Most changes in performance indicators are consistent with some weakening in housing finance, but the latest data do not suggest significant deterioration in savings associations' health. As with banks, the question for savings associations is whether the deterioration noted in 2000 will remain negligible this year.

Japan's Monetary Policy









SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; and International Monetary Fund, *International Financial Statistics*.

Deflation and relatively weak economic growth have bedeviled the Japanese economy for more than two years. Sharp declines in real growth and inflation during the early 1990s were followed by several years of advancing growth rates and very low measured inflation. This recovery was cut short during the Asian crisis, which brought plummeting growth rates and a year of rising prices, followed by the current deflation.

Over the past decade, the Bank of Japan has reduced both the overnight call loan rate and its own lending rate through a steady succession of cuts. The real call loan rate (the actual rate minus the annual rate of inflation) reached a low of –2% during the 1997 period of rising prices, but then averaged about zero in 1998 and 1999 before moving up slightly further to average closer to 1% in 2000. This occurred despite a monetary policy that brought the nominal call loan rate close to zero. The Bank, perhaps encouraged by the halting pickup in real growth, modified the zero-rate policy slightly in August 2000 to maintain a target of 0.25%, which it reduced to 0.15% in early March of this year.

On March 19, the Bank of Japan adopted a new policy strategy, abandoning interest rate targets to achieve a drastic easing "unlikely to be taken under ordinary circumstances." The new policy target is the quantity of current account deposit balances at the Bank. Initially, by ensuring a surplus of balances over required levels, this approach is expected to keep the call loan rate close to zero. In addition, the Bank of Japan pledged to continue this way of implementing policy until inflation stabilizes at zero or above.