

## *The Economy in Perspective*

*The gravity of the situation...* This morning the Bureau of Labor Statistics reported that payroll employment declined by more than 200,000 people in April, a much larger number than private analysts had expected. Not only had employment weakened further in the already beleaguered manufacturing sector, but it had also softened in the service sector. The unemployment rate drifted up from 4.3% to 4.5%. Market opinion cheered this development, sensing that it would spur the Federal Reserve to reduce the federal funds rate another 50 basis points at its May 15 meeting. Market sentiment had already anticipated a funds rate cut because the FOMC had reduced the funds rate 50 basis points in a surprise intermeeting move on April 18, and market participants reckoned that such an action signaled a predisposition to move again if economic data continued to be weak. The employment report was the coup de grace.

We've gotten used to talking heads and do not begrudge them their pulpit. Someone, after all, has to supply "content" to an industry awash in bandwidth and column inches. Nor does the business public seem to mind the inaccuracy of economic forecasts. In fact, listening to some analysts is like watching WWF wrestling: You sense that the performers are winking at you as they launch a body slam against their opponent. Many analysts—though often wrong—are never in doubt. Humility doesn't sell.

We've also grown accustomed to analysts who base their policy recommendations on the difference between the economy's actual and "potential" output. During the 1996–2000 period, most analysts confidently intoned that the U.S. economy was exceeding its potential and would generate inflation; this afternoon a radio show sound bite delivered the equally confident message that the economy was now operating far below its potential and carried no inflation threat. Terminology can get even more sophisticated in the major media markets. When the level of output is below potential but expanding rapidly, the Fed is asked to engineer a "soft landing"; when the level of output is above potential but its growth rate is slower than that of potential, the Fed is urged to perform a "reverse soft landing." Close your eyes and you will see Alan Greenspan out on the ice, with Scott Hamilton commenting on his triple Lutz/double toe loop combination.

We've even become inured to the market's apparently perverse response to macroeconomic news, in which investors buy claims to earnings

streams (stocks) after they find that earnings are likely to be poorer than they had thought. The attraction seems to arise from their belief that weakness begets easier monetary policy, which begets lower interest rates, which begets a smaller discount rate applied to the earnings stream, which begets greater willingness to pay for the stock. Hence, bad news is good news. Never mind that bad news may be the beginning of more bad news, including bankruptcy of the firm itself.

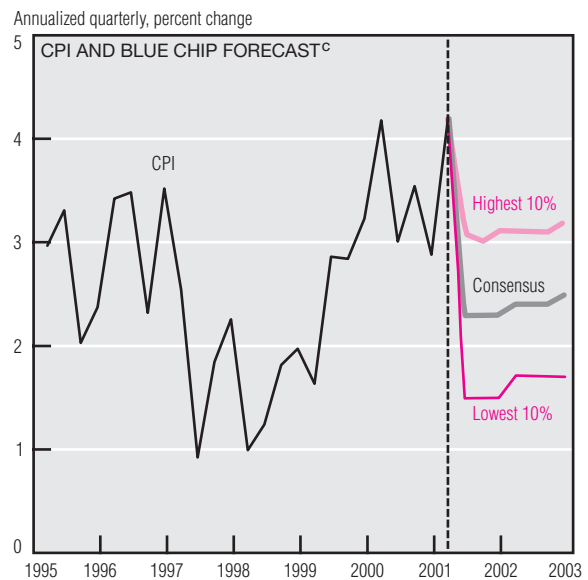
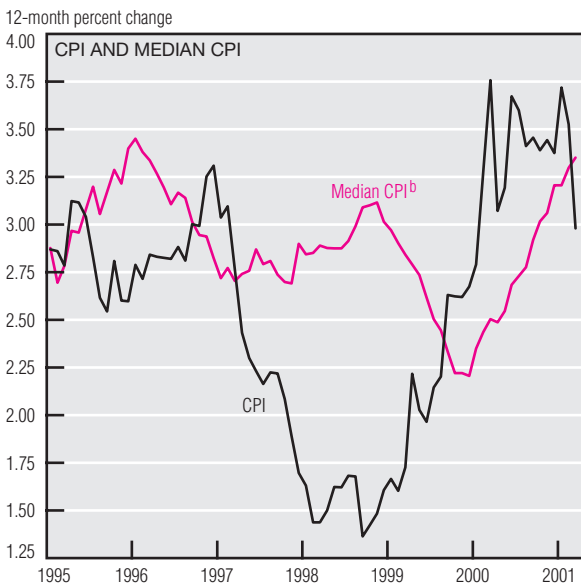
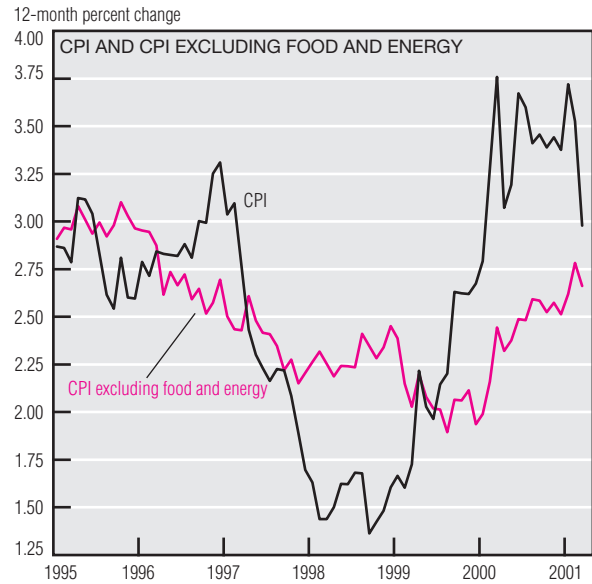
What we can't get used to, however, is people's inability—or unwillingness—to differentiate between easier monetary conditions and inflationary monetary policy. The U.S. economy has sustained two shocks: an energy supply shock and a capital-goods demand shock. Firms are slowing production and employment; inventories must be financed until they are liquidated. Firms and households still want credit, but many now are finding it more expensive if they can get it at all. The FOMC has provided the financial system with more liquidity, but markets are channeling these funds into short-term credit instruments because creditors have become more cautious about making loans with more than a few years' maturity. Not surprisingly, then, the Fed's actions have had little effect on long-term interest rates.

Easier monetary conditions play the very positive role of aiding the financial restructuring of households and firms as they adjust to new circumstances. Creditworthy individuals and firms benefit from access to short-term loans as they pare current expenses and realign their spending with their income. But easier monetary conditions can neither correct nonviable business plans nor revive nonviable businesses. People who based their plans on the continuing value of those businesses must now make new plans. Monetary policy can facilitate this restructuring but not prevent it. History suggests that attempting to do otherwise could eventually promote inflation. One might as well try to defy gravity.

It's uncertain how much lower the FOMC will take the federal funds rate before it pauses or stops. This afternoon one analyst told a financial newscaster that the Fed is prepared to ease monetary conditions until all risks of a recession disappear. Policymakers who recognize the lags between actions and effects won't wait that long; those who do not may press too hard. One thing seems certain: Performing the triple Lutz/double toe loop combination is much more difficult while weightless and in a vacuum.

# Inflation and Prices

	Annualized percent change, last:				
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	2000 avg.
<b>Consumer prices</b>					
All items	0.7	4.0	3.0	2.5	3.4
Less food and energy	2.6	3.5	2.7	2.4	2.5
Median <sup>b</sup>	4.0	4.0	3.4	2.9	3.2
<b>Producer prices</b>					
Finished goods	-0.8	4.9	3.1	1.7	3.6
Less food and energy	1.6	1.9	1.4	1.1	1.2



a. Annualized.  
 b. Calculated by the Federal Reserve Bank of Cleveland.  
 c. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, April 10, 2001.

After large increases in the first two months of 2001, the Consumer Price Index (CPI) rose a very modest 0.1% (0.7% annualized) in March. Energy prices declined for the second straight month (-22.4% annualized), as the prices of household fuels fell 8.4% and motor fuel prices dropped 36.4% (both annualized). Food prices (up an annualized 2.8% in March, compared to 5.8% in February) also contributed to March's slower CPI growth.

Still, even after excluding food and energy prices, the CPI's March increase was less pronounced than

earlier this year (an annualized rate of 2.6% versus 4.0% in each of the previous two months). Smaller price increases for apparel and medical care, along with price declines in tobacco, recreation, and household furnishings and operations, contributed to a slowdown in retail prices' advance.

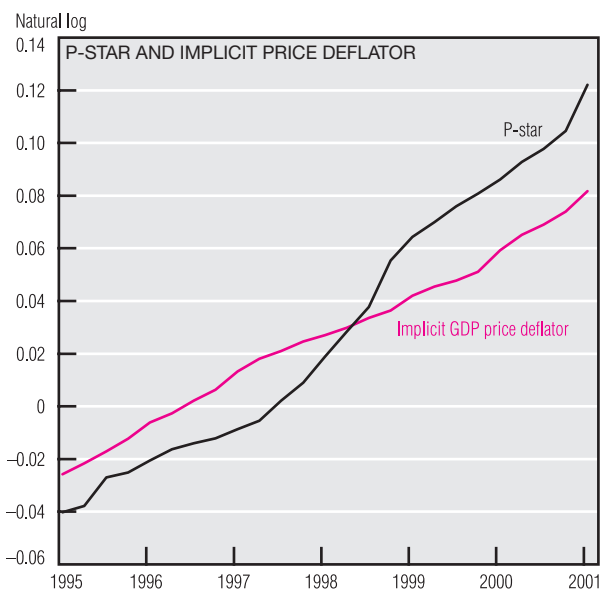
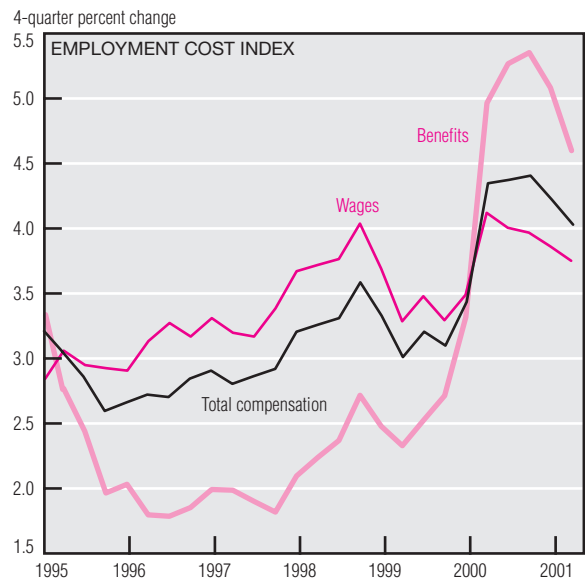
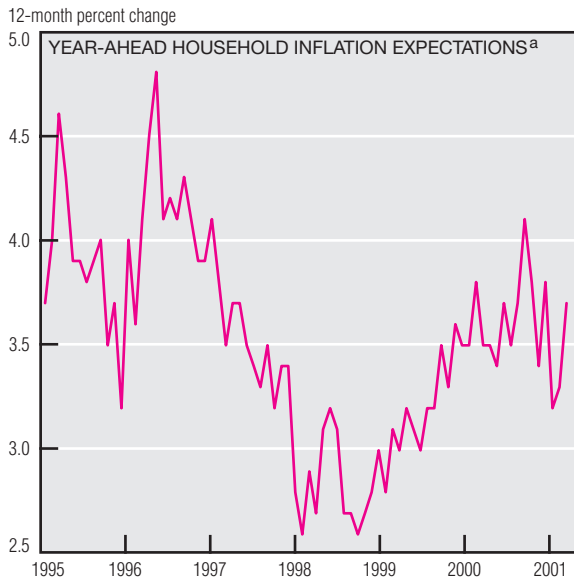
Although these data suggest an improving inflation outlook, the median CPI provides a less sanguine reading. While a subset of items in the CPI helped restrain retail price growth, prices for a large share of goods con-

tinued to advance strongly. In March, the median CPI rose at a 4.0% annualized pace—equal to its average increase for 2001 and up from the 3.2% average in 2000.

Mixed signals from the price data help explain the wide range of opinions regarding the inflation outlook. The consensus forecast by the Blue Chip panel of economists shows the CPI rising about 2½% (annualized) through 2002. However, the most pessimistic of these forecasters expect inflation to hold at around a 3% rate over the next

*(continued on next page)*

## Inflation and Prices (cont.)



a. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.

b. Finance, insurance, and real estate.

c. Transportation and public utilities.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and University of Michigan.

seven quarters, while their more optimistic counterparts see inflation of only about half that amount. Households' inflation expectations rose to 3.7% in the most recent month, but remain marginally below the four-year high of 4.1% they set last October.

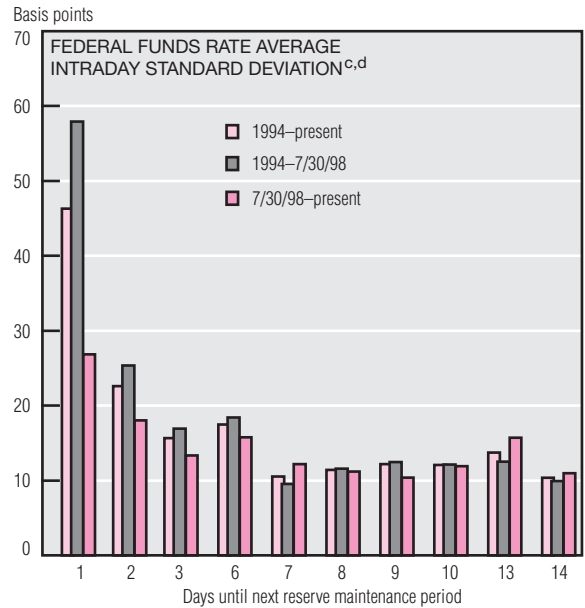
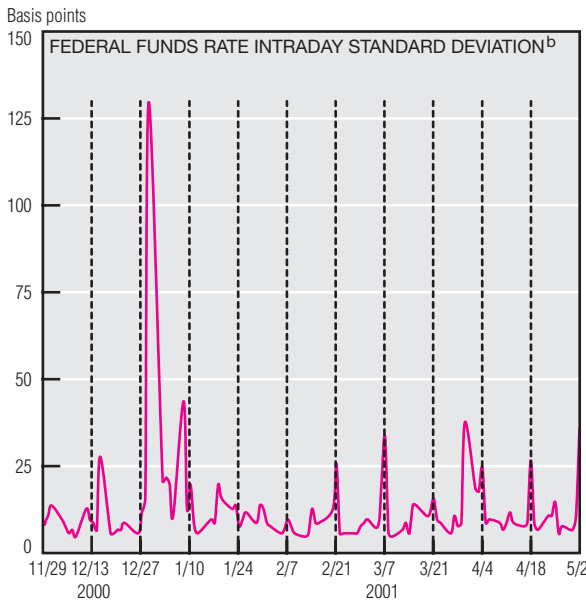
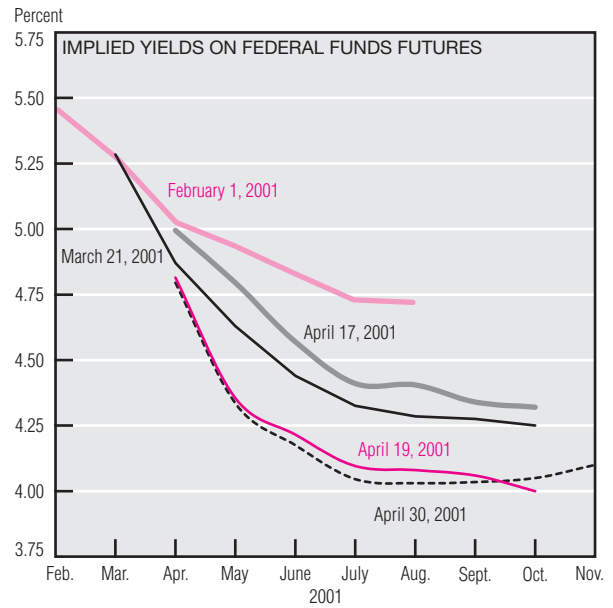
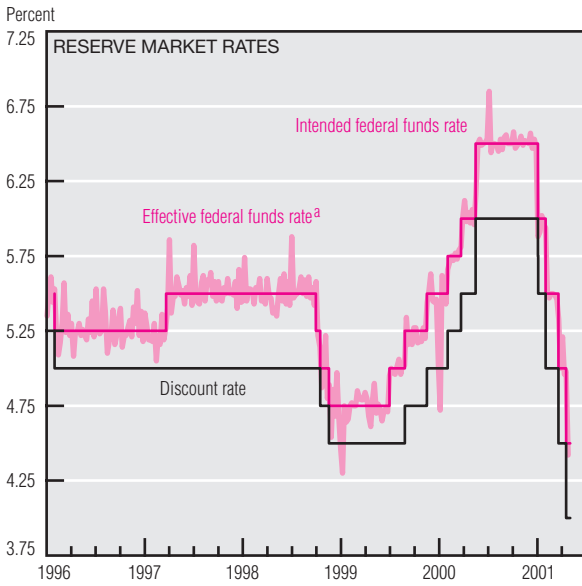
Those who gauge the economy's inflationary momentum by the patterns of wage growth are also receiving mixed signals. Overall, the trend in compensation growth has slowed slightly compared with 2000

for both wages and benefits. Still, that slowdown has been heavily concentrated in industries where business conditions were unusually soft—finance, trade, and durable goods manufacturing. In areas where business conditions are stronger, including general services, construction, and transportation, workers' compensation growth has picked up since last year.

But for economists who believe that inflation is ultimately caused by "too much money chasing too few

goods," the inflationary signs are more ominous. The P-star statistic is one gauge of the inflationary potential of money growth. This statistic shows the long-run price level implied by the trend rate of M2 growth relative to the economy's long-run growth rate (among other things). Since 1998, the price level as measured by the implicit GDP price deflator has been below P-star, which means that this inflation predictor foretells acceleration.

# Monetary Policy



a. Weekly average.  
 b. Dashed lines indicate the final day of a reserve maintenance period.  
 c. Averages are taken from January 3, 1994 to April 30, 2001 and exclude nontrading days.  
 d. Required reserves are based on an average of transaction account balances over a two-week period. Before July 30, 1998, this period ended the Monday before the reserve maintenance period ended. Since that date, the two-week period has ended the Monday before the end of the preceding maintenance period.  
 SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of New York; and Chicago Board of Trade.

In an intermeeting action on April 18, 2001, the Federal Open Market Committee (FOMC) lowered the intended federal funds rate 50 basis points (bp) to 4.5%, its lowest level since August 1994. Its April 18 press release noted that lower capital spending and other factors threaten "to keep the pace of economic activity unacceptably weak."

Immediately after the April 18 action, implied yields on fed funds futures dropped 18–44 bp across the various maturity dates. As of April 30,

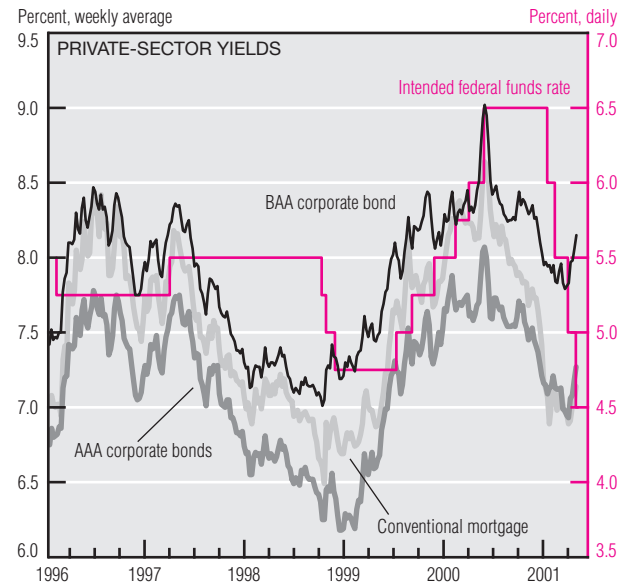
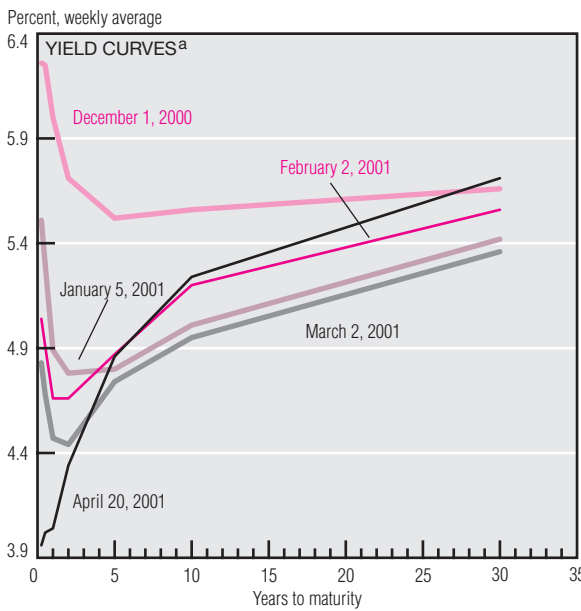
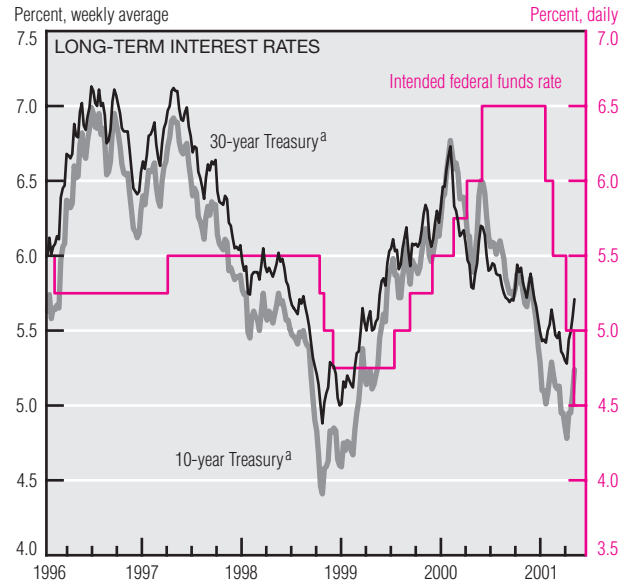
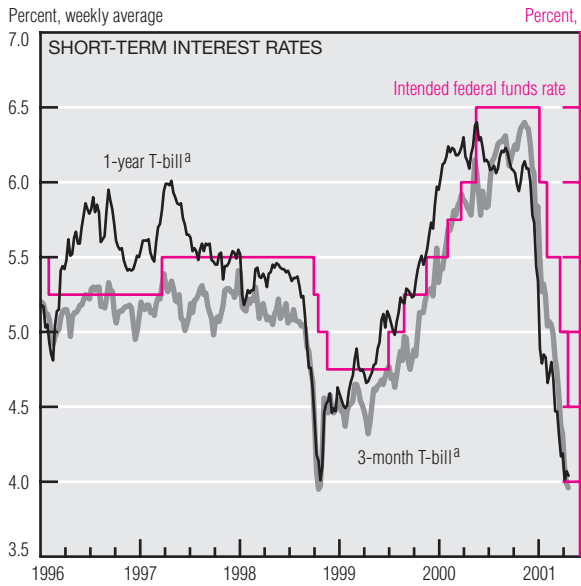
the November contract traded at 4.1%, 40 bp below the current intended federal funds rate.

The federal funds rate typically varies over the course of a day, even though the daily average ("effective") rate tends to remain fairly close to its intended level. The rate's intraday standard deviation rises markedly toward the end of a two-week reserve maintenance period.

A bank satisfies its reserve requirement by averaging its end-of-day balances at a Federal Reserve Bank

over a maintenance period. Intraday funds rate variations increase during a period as reserve managers enjoy less and less freedom in adjusting actual balances to meet their requirements. This effect lessened when the Fed switched to a system of lagged reserve accounting in July 1998, eliminating banks' uncertainty about required balances. Intraday volatility also tends to rise at the end of each quarter and on corporate tax dates, when banks may have to scramble for balances to cover large payments flows.

# Money and Financial Markets



a. Constant maturity.  
SOURCE: Board of Governors of the Federal Reserve System.

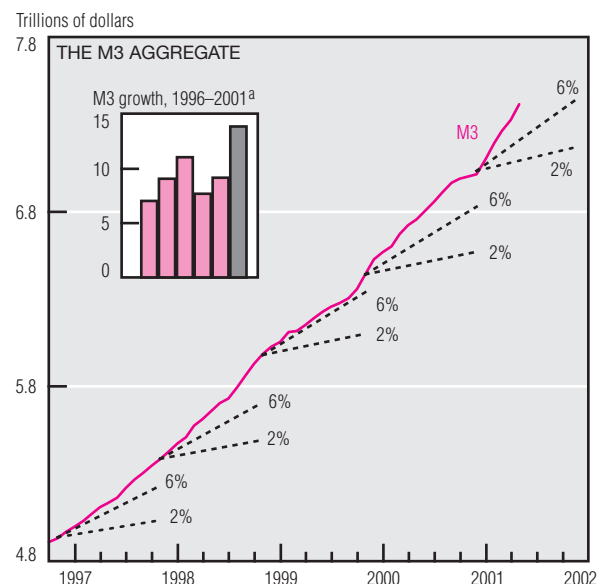
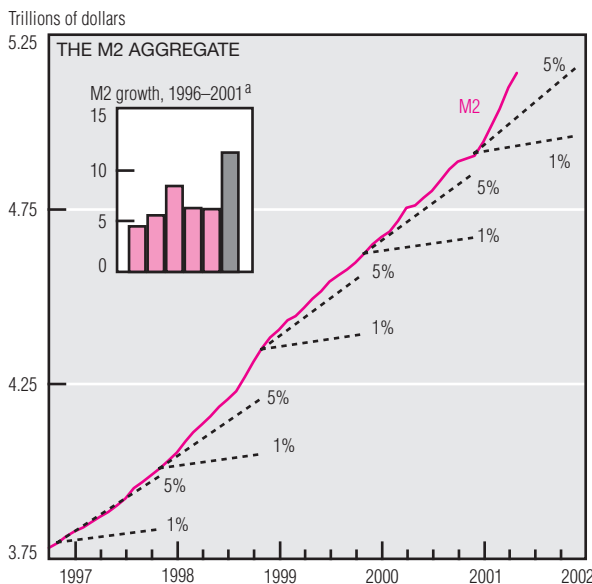
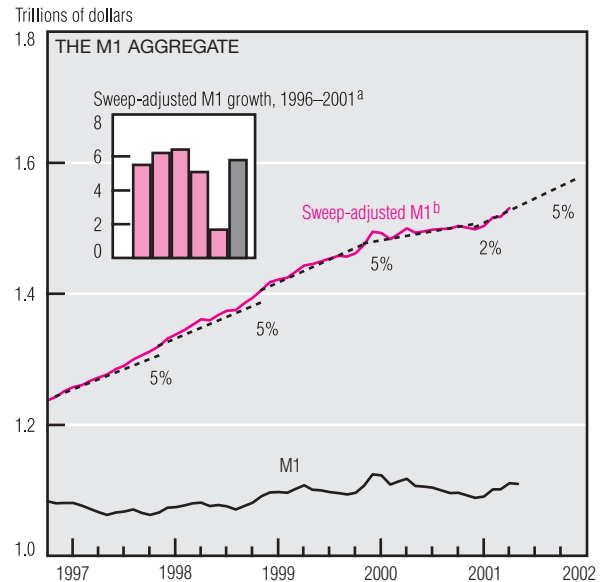
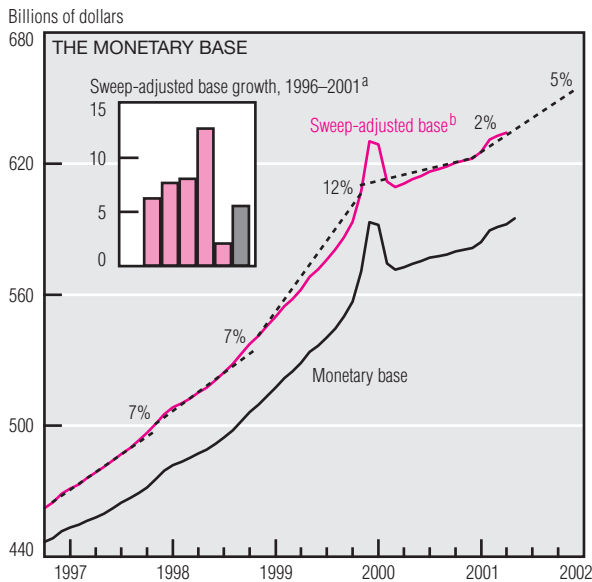
Starting in mid-1999, the intended federal funds rate first was raised from 4.75% to 6.5% in six steps and then was cut sharply to 4.5% in four moves of 50 basis points (bp) each. When the FOMC changes the intended fed funds rate—the rate at which banks can borrow reserve balances from each other overnight—it is often said simply to be “lowering interest rates.” In fact, the entire array of other interest rates is determined by participants (lenders and borrowers) in a wide variety of financial markets, and individual rates can move with or opposite to the target

rate. It is true that the intended funds rate and market interest rates, especially short-term rates, tend to follow the same general pattern. However, it is not uncommon to see some market rates moving in the opposite direction from the policy rate, even over fairly long periods. The 200 bp decline in the intended funds rate, which began on January 3, 2000, has been accompanied by a similar decline in 3-month and 1-year T-bill yields, which have fallen 188 bp and 171 bp to 3.96% and 4.02%, respectively, since the end of last year. However, this

pattern does not hold for long-term interest rates. Since year's end, yields on the 10-year and 30-year Treasury have risen 14 bp and 27 bp to 5.24% and 5.71%, respectively. The decline in short-term rates has completely eliminated the yield curve's inversion for the first time since January 2000; we now have a traditional, upward-sloping yield curve. An inverted yield curve is often seen as a predictor of an economic slowdown or recession, presumably making yield curves with the current shape harbingers of future growth.

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## Money and Financial Markets (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for the sweep-adjusted base and sweep-adjusted M1 are calculated on a March over 2000:IVQ basis. The 2001 growth rates for M2 and M3 are calculated on an estimated April over 2000:IVQ basis. 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. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.

NOTE: Last plots for the monetary base, M1, M2, and M3 are estimated for April 2001. Last plots for the sweep-adjusted base and sweep-adjusted M1 are March 2001. Prior to November 2000, dotted lines for M2 and M3 are FOMC-determined provisional ranges. All other dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

Yields on AAA and the slightly lower-quality BAA corporate bonds also have risen somewhat over the course of the year, while conventional 30-year mortgage rates have been virtually unchanged.

At first blush, money growth appears to be expanding rapidly across the spectrum of monetary aggregates. On closer inspection, however, a plausible case can be made that the narrow aggregates are not too far out of line with recent history after Y2K effects are

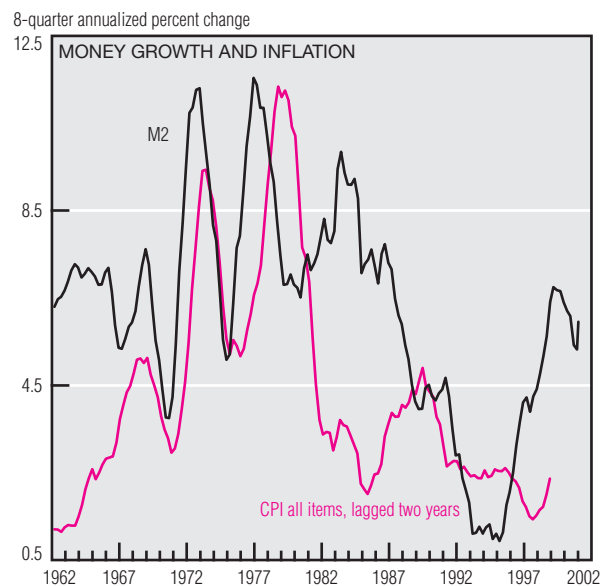
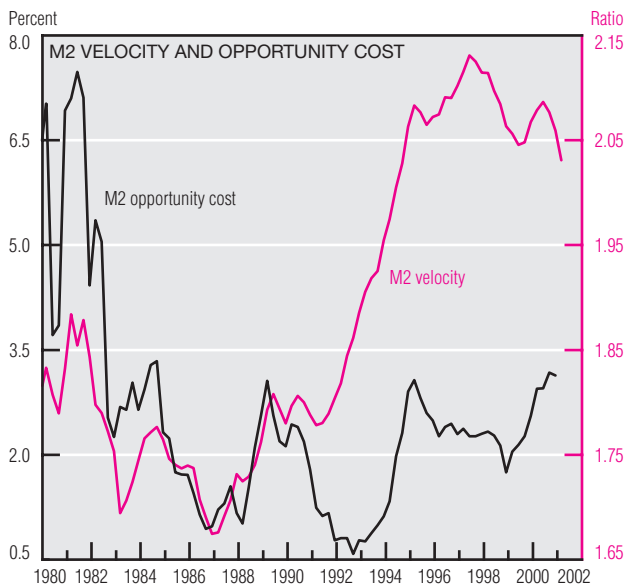
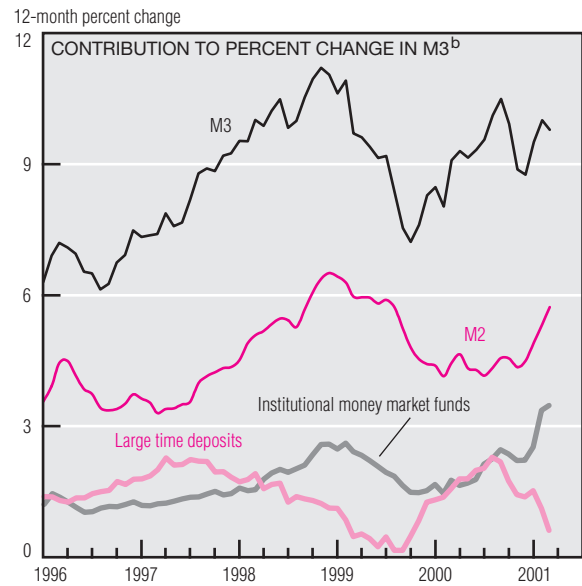
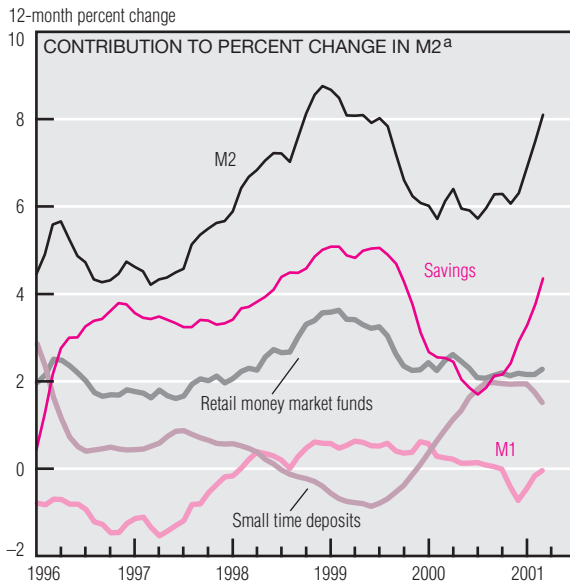
accounted for, while much of the growth in the broad aggregates can be attributed to a few sources.

Year-to-date growth of the sweep-adjusted monetary base reached 5.5% and sweep-adjusted M1 hit 5.8% at annual rates through March (the most recent sweeps data available). Compared to last year's annual growth, these rates appear very rapid indeed, but a longer view eliminates Y2K-related volatility and reveals that rates are consistent with the growth experienced during the latter half of the current expansion.

Although the broad monetary aggregates were largely insulated from Y2K-related fluctuations, they currently depict growth that is well above recent annual rates. Estimated year-to-date annual growth rates for April are 11.8% for M2 and 13.9% for M3. Keep in mind that uncertainty surrounding tax receipts and payments makes definitive interpretation of the broad aggregates difficult at this time of year. Transitory factors such as increased mortgage refinancing and stock market volatility can lead to temporary increases as

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## Money and Financial Markets (cont.)



a. Weighted by share of M2.

b. Weighted by share of M3. Overnight and term repurchases and overnight and term eurodollars not shown.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

funds are “parked” in savings and money market mutual funds. Examining individual components’ contributions to the growth rates of the broader aggregates supports this interpretation. The recent surge in M2 growth is due almost entirely to growth in savings deposits (1.4 of the 1.8 percentage point increase in year-over-year M2 growth between December 2000 and March 2001). In turn, M2 growth contributed 1.2 percentage points—and institutional money market mutual funds

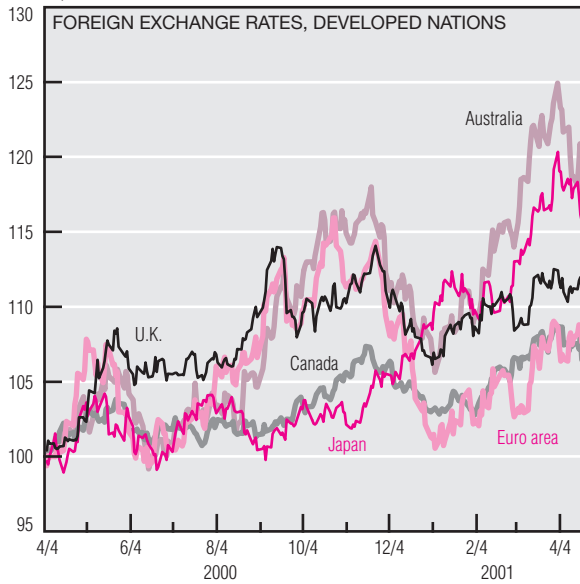
1.3 percentage points—to the 1.0 percentage point increase in M3 growth, offsetting total declines of 1.5 percentage points concentrated in large time deposits.

The monetary aggregates have featured less prominently in monetary policy since the widely recognized breakdown in many money-demand models during the early 1990s. An enduring shift in velocity (the ratio of economic activity to money) during this time made it hard to determine the quantity of money demanded.

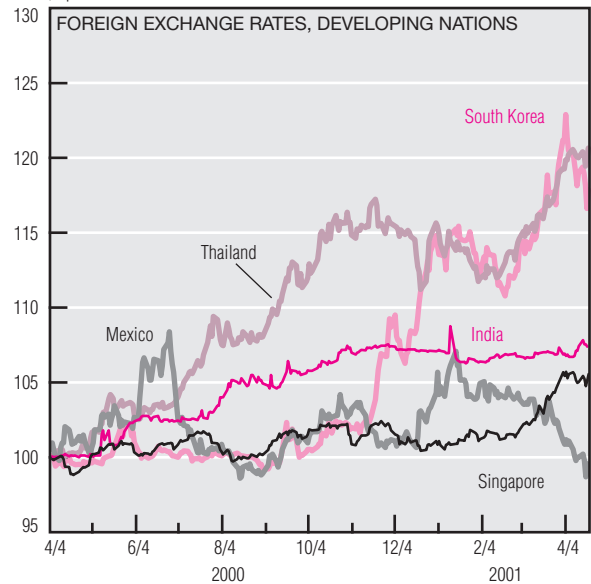
Thus, it was difficult to know whether observed money-supply growth exceeded the unpredictable noninflationary money-demand growth. Over long periods, however, inflation undoubtedly is related to money growth. Given the substantial lags associated with monetary policy, the 200 bp cut in the intended federal funds rate might result in continued rapid money growth, which could cause inflationary pressures.

## Foreign Exchange Rates

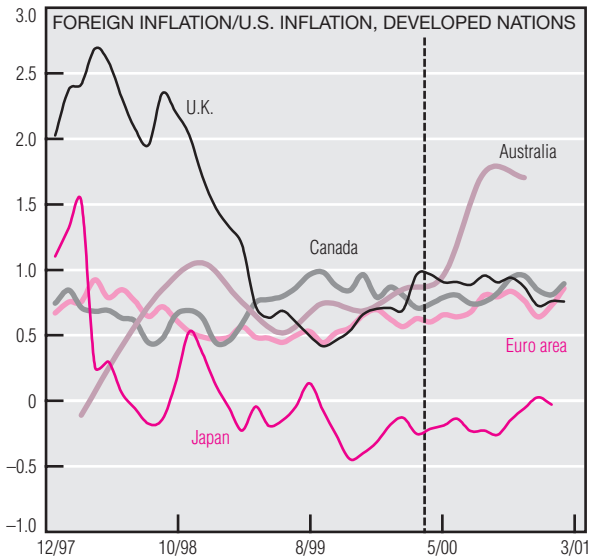
Index, April 2000 = 100



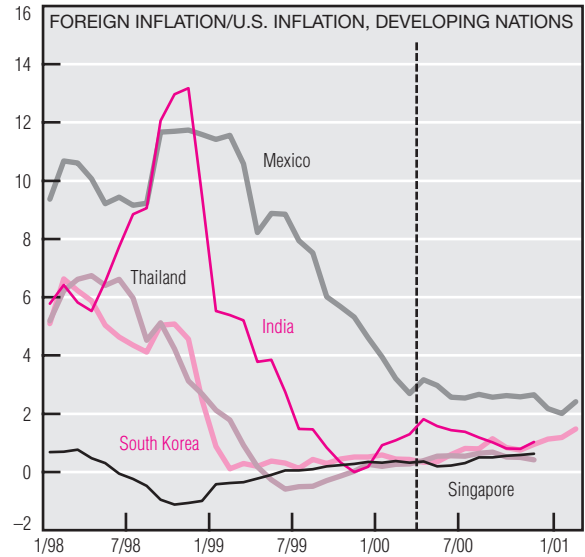
Index, April 2000 = 100



Ratio



Ratio



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Banco de México; Bank Negara Malaysia; Bank of Japan; European Central Bank; Japan Ministry of Public Management, Home Affairs, Post, and Telecommunications; National Statistics Office of Korea; Organisation for Economic Co-operation and Development; Office for National Statistics U.K.; Reserve Bank of India; Singapore Department of Statistics; Statistical Office of the European Communities; Statistics Canada; and Thailand Ministry of Commerce.

The S&P 500 has declined 18% in the past year, and the NASDAQ has fallen 52%. One might expect foreign investors to have liquidated some of their U.S. holdings and reinvested the proceeds abroad; such reinvestment would cause the U.S. dollar to depreciate against other national currencies. With the exception of the Hong Kong (Hang Seng) index, however, which dropped more than 90%, most major international stock markets significantly outperformed the NASDAQ and performed comparably to other

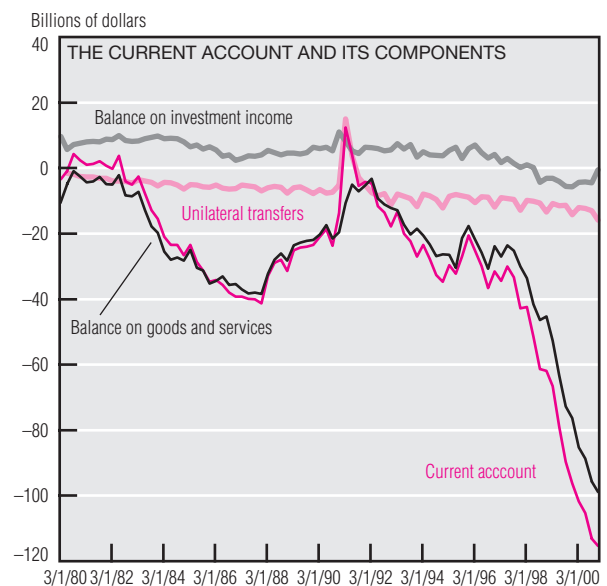
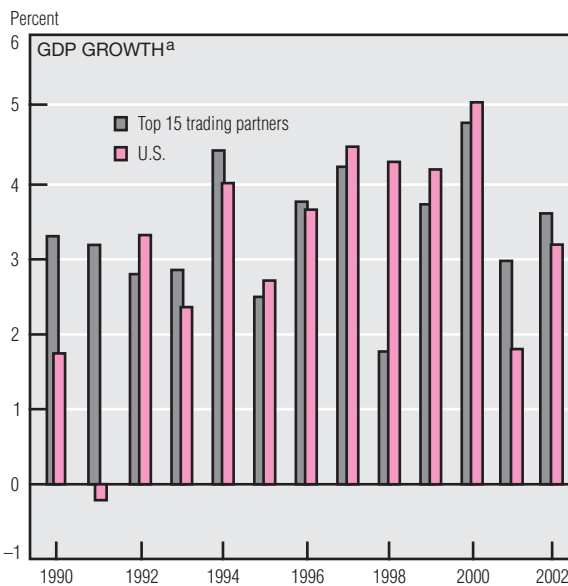
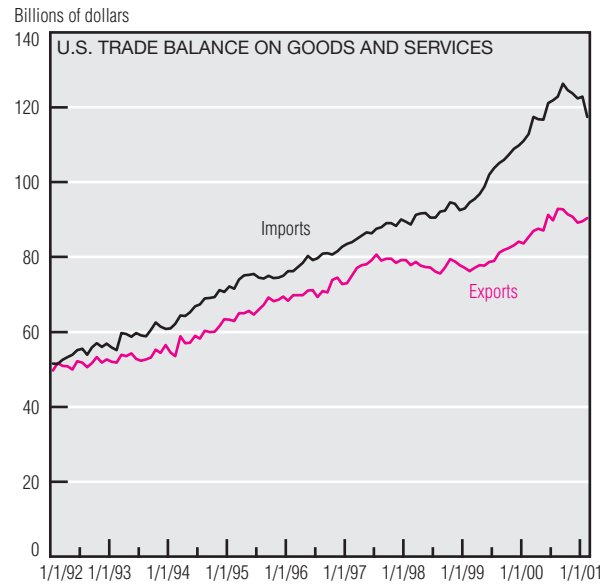
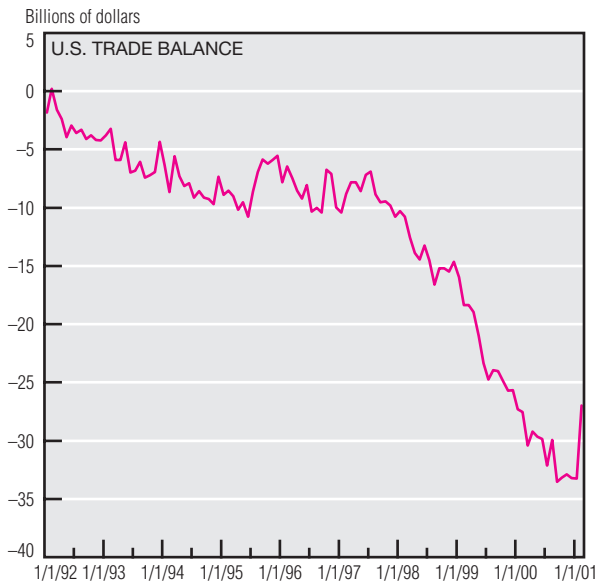
U.S. stock indexes. Moreover, the U.S. dollar has appreciated greatly against most of the world's currencies.

The U.S. dollar has gained against a large set of developed nations' currencies (Australia, Canada, euro area, Japan, and the U.K.). The Canadian dollar and the euro depreciated the least (slightly more than 5%) during this period, while the Australian dollar depreciated more than 15%. The story is similar for developing nations (India, Mexico, Singapore, South Korea, and Thailand), of which only Mexico's currency did not depreciate.

Comparative inflation rates cannot explain exchange rate movements over the past year. Since April 2000 (the dashed vertical line in the lower charts), the U.S. inflation rate has been comparable to or higher than most other countries, except Australia and Mexico. (In these charts, a higher U.S. inflation rate is associated with a number less than one.) Perhaps our strong fiscal position and prospects for future growth relative to other countries account for continued foreign capital inflows over the past year and a consequent appreciation.



# The U.S. Trade Balance



a. Data for 2000, 2001, and 2002 are forecasts.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics*; *Blue Chip Economic Indicators*, April 10, 2001; Organisation for Economic Co-operation and Development, *World Economic Outlook*, May 2000; and *Economist*, April 14–20, 2001.

The U.S. trade deficit in goods and services fell \$6.3 billion in February to \$27 billion as the result of a \$0.9 billion increase in exports and a \$5.4 billion decline in imports. The trade deficit (exports minus imports) rose rapidly between March 1998 and September 2000, then held steady at around \$33 billion until January 2001. February's trade deficit is the smallest since December 1999.

Exports of goods rose \$0.6 billion; goods imports fell \$5.5 billion (the largest monthly drop on record), reflecting a weak domestic economy.

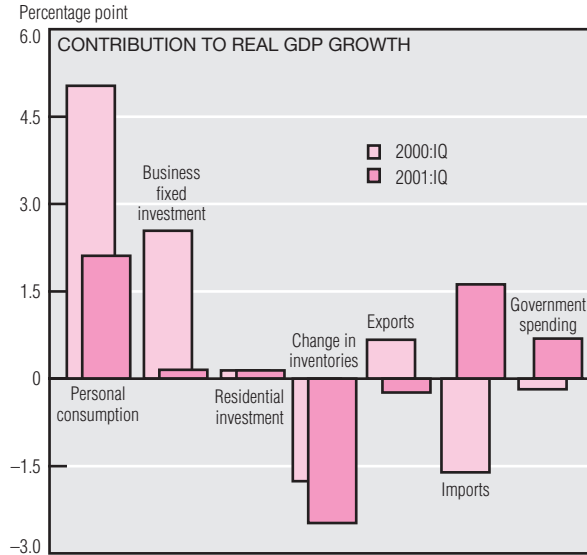
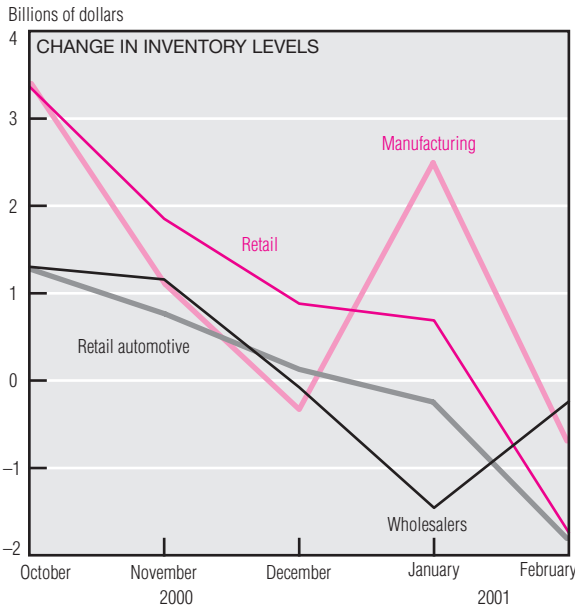
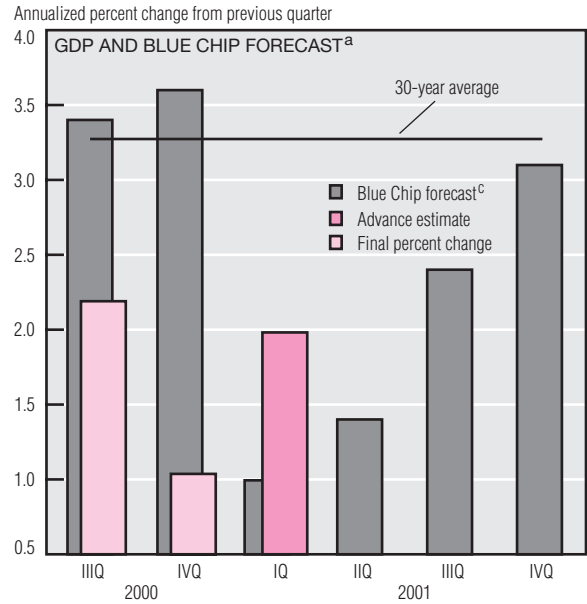
U.S. imports declined most significantly in consumer goods (\$1.9 billion), industrial supplies and materials (\$1.8 billion), and capital goods (\$1.3 billion). Autos and auto parts, energy-related crude and petroleum products, and imports of food and beverages also contributed to the decline.

The 2000 trade deficit exceeded that of 1999 by 39%. If monthly deficits stay at the current level for the rest of this year, the annual deficit will be 10.5% less than it was in 2000. Since 1997, the trade deficit has largely reflected a

divergence between U.S. and foreign economic growth. Forecasters have been expecting foreign growth to be about 3% in 2001—one percentage point or so more than in the U.S. Such an outcome could trim some of the trade gap of the past four years and begin to correct the massive U.S. current account deficit. However, continued shading of foreign growth forecasts and the surprising strength of U.S. GDP growth in 2001:1Q caution against premature optimism about such an outcome.

# Economic Activity

Real GDP and Components, 2000:IVQ <sup>a,b</sup> (Advance estimate)	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	46.2	2.0	2.7
Personal consumption	49.3	3.1	3.4
Durables	25.5	11.9	2.6
Nondurables	12.2	2.6	3.0
Services	15.1	1.7	3.7
Business fixed investment	3.9	1.1	5.6
Equipment	-6.0	-2.1	4.2
Structures	7.8	11.0	10.1
Residential investment	2.9	3.3	-2.6
Government spending	15.5	4.0	2.6
National defense	4.2	4.8	4.8
Net exports	36.8	—	—
Exports	-6.2	-2.2	4.5
Imports	-43.0	-10.4	5.3
Change in business inventories	-62.8	—	—



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. Projections for 2001:IQ–2001:IVQ are based on the issue of *Blue Chip Economic Indicators* dated April 10, 2001. Forecasts for previous quarters are based on the issues dated 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 Bureau of the Census; and *Blue Chip Economic Indicators*, various issues.

The advance estimate for the National Income and Product Accounts, released April 27, reported output growth of 2.0% in 2000:IVQ—much stronger than had been expected. (The Blue Chip forecast for the first quarter was for less than 1% growth.) Some might interpret this surprising strength as a sign that further reductions in the Federal Open Market Committee’s intended federal funds rate will be unnecessary, or even that the target should be raised. More realistically, only time will tell whether

the quarter was merely a pause or in fact was the floor of the recent economic slowdown.

Given the unexpected strength of the first quarter, it will be interesting to see whether the Blue Chip forecast for the rest of the year is revised upward. The path previously projected was a gradual rise over the rest of the year to a trend growth rate of just over 3%.

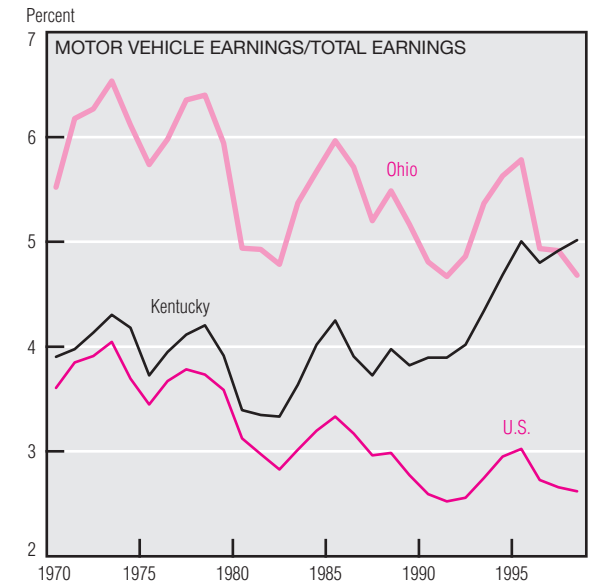
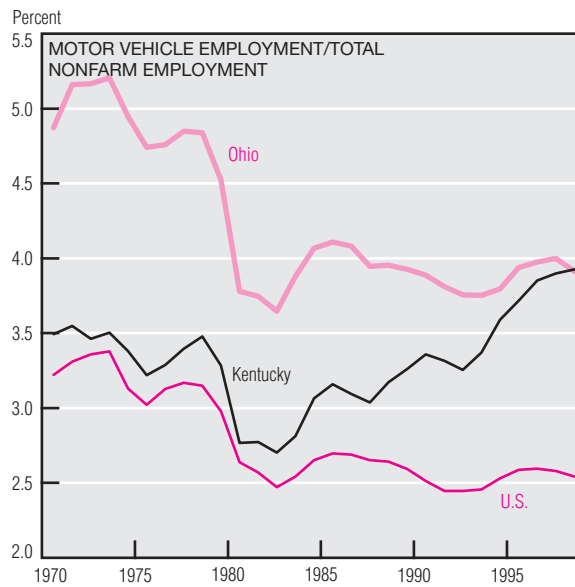
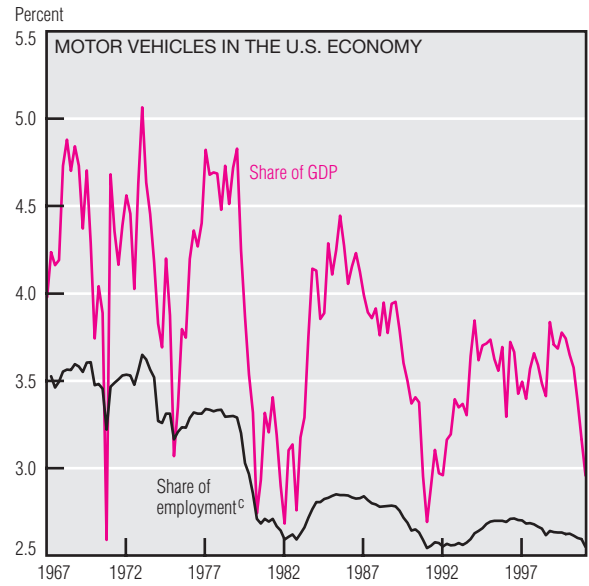
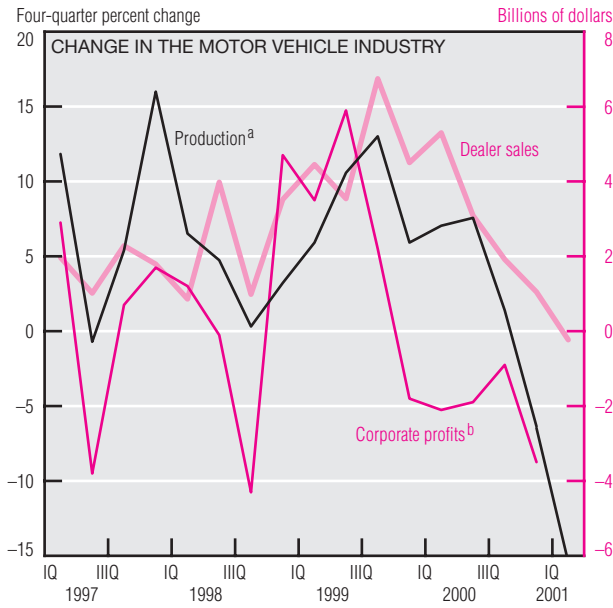
The first-quarter growth rate of 2% was higher than expected. It also was higher than in 2000:IVQ, but a year ago the economy was growing robustly at

about 5% in 2000:IQ. Three major factors account for this year’s slowdown: personal consumption, business investment, and imports. Growth rates for all categories of consumer spending have declined relative to a year ago, while the decline in business investment growth is concentrated primarily in equipment and software.

A widespread drop in inventories (negative inventory investment) also contributed to the economy’s weak performance over the past couple of quarters. Retail inventory investment

(continued on next page)

Economic Activity (cont.)



a. Industrial production of motor vehicles and parts.  
 b. Corporate profits, adjusted for inventory valuation and capital consumption.  
 c. Employment by motor vehicle manufacturers and retailers as a share of total nonfarm employment.

NOTE: All data are seasonally adjusted and annualized.

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

has been on a downward path for several months.

The assertion that “what’s good for General Motors is good for the U.S.A.” has been scoffed at for many years. Nonetheless, it remains true that the automotive industry is an important feature of the U.S. economy. For example, the drop in auto inventories and production is responsible for a substantial proportion of the fall in output growth over the past two quarters.

While the auto industry’s share of total U.S. nonfarm employment has

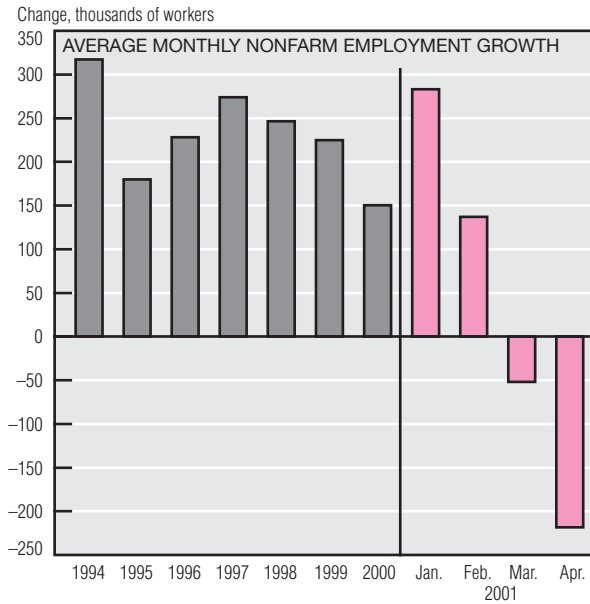
fallen since the 1970s, it is still about 2.5%. For the states of the Fourth District, the auto industry is somewhat more important; in Ohio and Kentucky, for example, automotive jobs account for about 3.5% of the total. Moreover, employment share may understate the importance of this sector, since automotive jobs tend to pay better than average. In Ohio and Kentucky, around 5% of total earnings, compared to 3.5% of all jobs, are due to the motor vehicle industry.

Likewise, for the U.S. as a whole, the auto industry’s share of output is

higher than its employment share. In the mid-1990s, the motor vehicle sector generated around 3.5% of total GDP, compared to 2.5% of total employment.

For many communities, like the Toledo area, these figures understate the industry’s importance. Furthermore, these figures measure only the direct effects of the automotive sector, missing the indirect effects of autoworkers’ spending in their local communities.

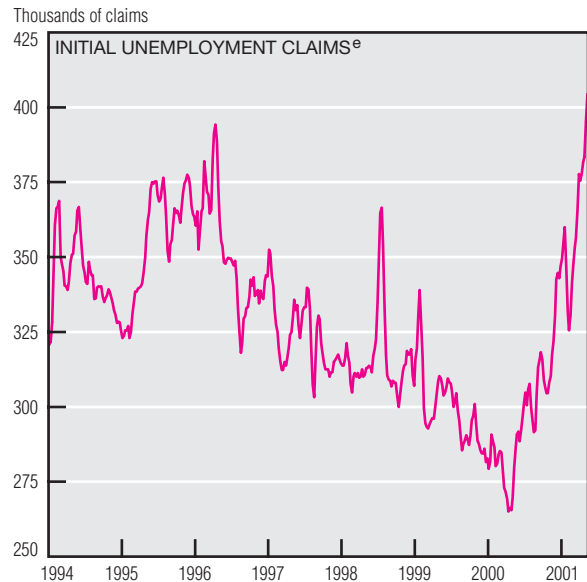
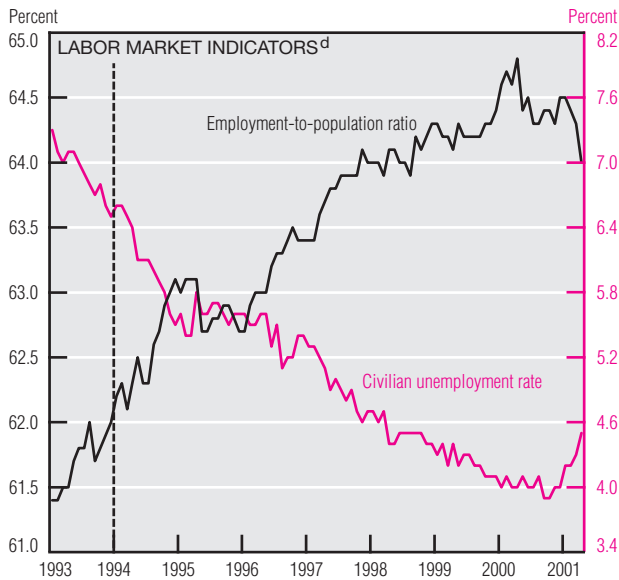
# Labor Markets



	Average monthly change (thousands of employees)				
	1997	1998	1999	2000	April 2001
Payroll employment	280	251	229	153	-223
Goods-producing	48	22	4	1	-164
Mining	1	-3	-3	1	4
Construction	21	37	25	14	-64
Manufacturing	25	-12	-18	-14	-104
Durable goods	27	-2	-6	-4	-73
Nondurable goods	-2	-11	-12	-10	-31
Service-producing	232	229	225	153	-59
TPU <sup>a</sup>	16	20	16	15	-2
Retail trade	24	30	36	26	22
FIRE <sup>b</sup>	21	22	10	4	8
Services <sup>c</sup>	141	120	124	91	-121
Government	17	28	28	11	38

	Average for period (percent)				
Civilian unemployment rate	4.9	4.5	4.2	4.0	4.5



a. Transportation and public utilities  
 b. Finance, insurance, and real estate.  
 c. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.  
 d. Dotted vertical line indicates break in data series due to survey redesign.  
 e. Four-week moving average.  
 NOTE: All data are seasonally adjusted.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The downward trend in payroll employment continued in April, with a net loss of 223,000 jobs. As in March, large job losses occurred in manufacturing and help supply services. In a notable departure from previous trends, however, the overall service-producing sector lost 59,000 jobs; more specifically, the services industry lost more than 120,000 jobs. Construction also sustained large employment losses.

The unemployment rate rose 0.2 percentage points in April, bringing the total increase over the last six

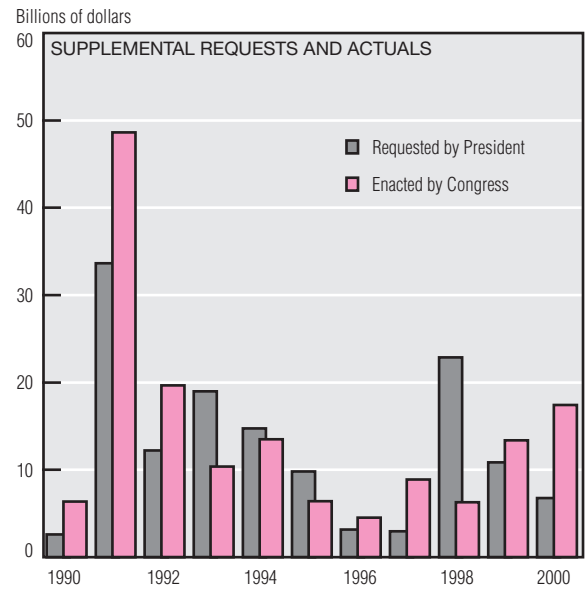
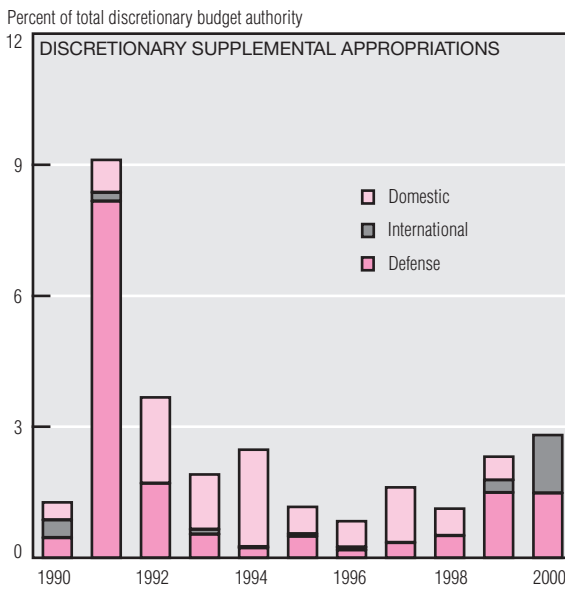
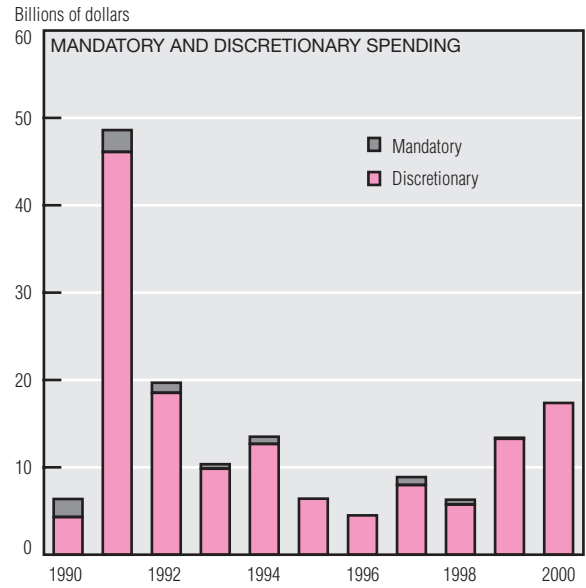
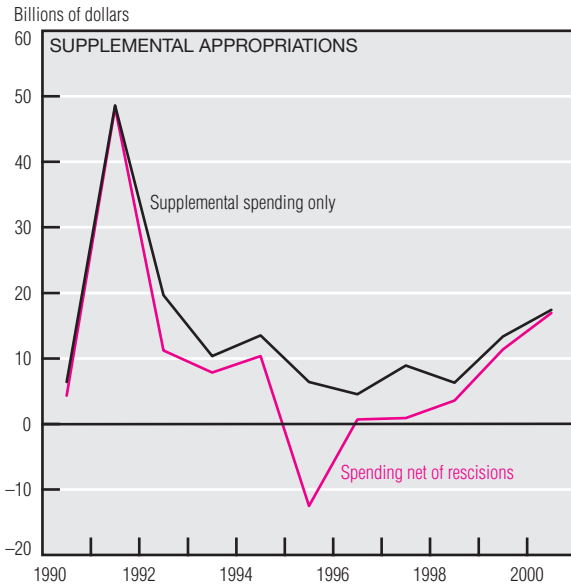
months to 0.6 percentage points. Jobless rates for adult women (3.8%) and whites (4.0%) both registered a monthly increase, while unemployment rates for other major worker groups (adult men, teenagers, blacks, and Hispanics) remained relatively unchanged from March. Since October 2000, however, unemployment rates for all major worker groups have increased significantly.

The employment-to-population ratio declined again in April. The civilian labor force remained about constant at 141.8 million, so the labor

force participation rate stayed fairly stable at 67.1%.

Initial unemployment claims, considered a leading economic indicator, continued to climb during the last week of April, with the four-week moving average (404,500) rising above 400,000 claims for the first time since August 1992. Since April 2000, when initial claims reached the lowest level in more than 25 years, there has been an increase of nearly 140,000 claims.

# Supplemental Appropriations



SOURCE: Congressional Budget Office, *Supplemental Appropriations in the 1990s*. Washington, D.C.: Government Printing Office, 2001.

Although budget authority for discretionary federal outlays is established annually through the budgeting process, Congress enacts supplemental appropriations bills outside of the budget cycle. Attempts to offset supplemental spending by enacting coincident rescissions (downward revisions of budgeted monies for specified agencies or programs) were made throughout the 1990s, but only in 1995 was supplemental spending completely offset by rescissions.

Supplemental appropriations for mandatory outlays are designed to accommodate revenue shortfalls in specific trust funds. Throughout the

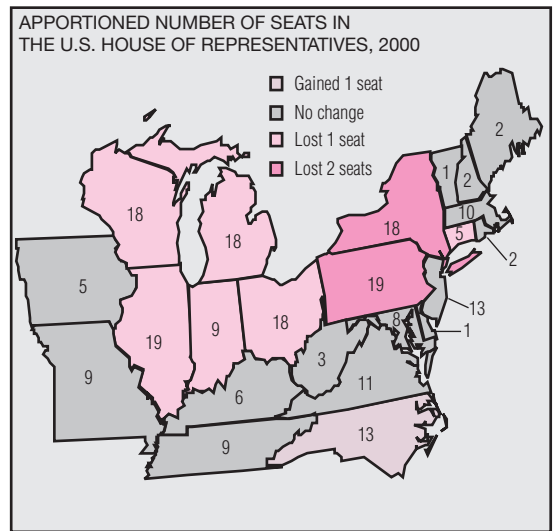
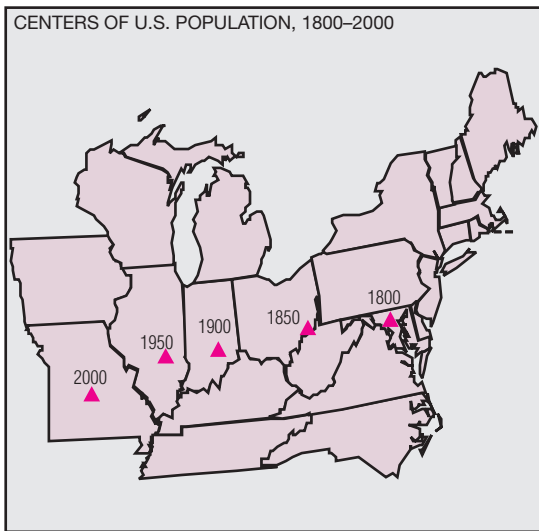
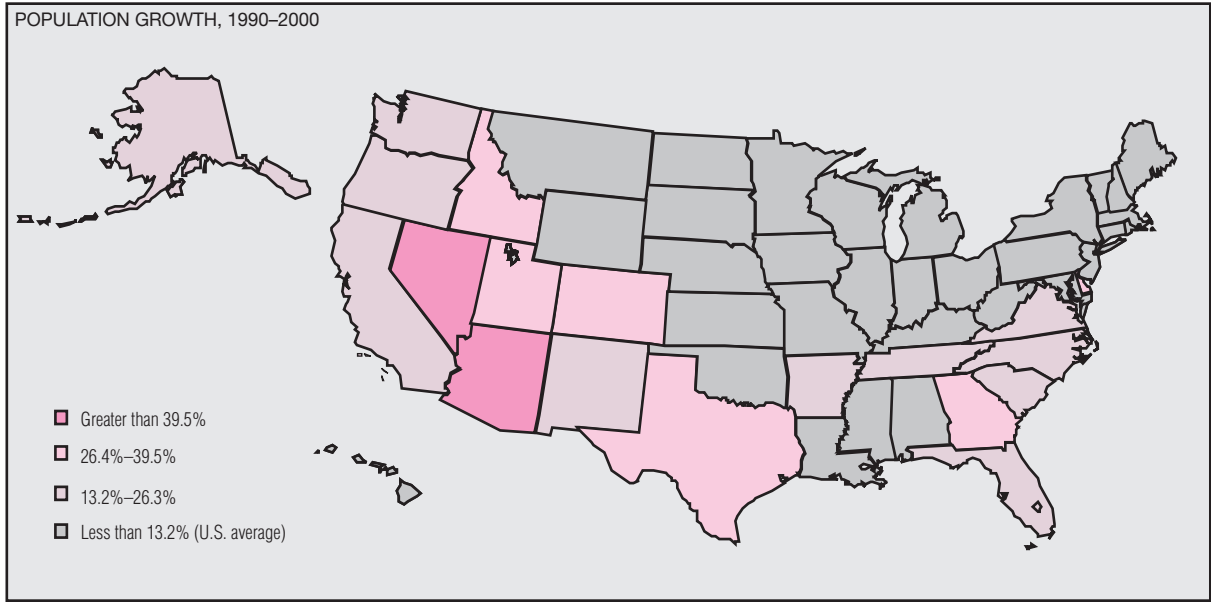
1990s, only 9% of all supplemental appropriations were mandatory, whereas in the previous two decades, supplemental mandatory and discretionary spending were distributed fairly evenly.

Most discretionary supplemental appropriations in 1991 were for military operations Desert Storm and Desert Shield. Domestic spending dominated discretionary supplemental appropriations from 1993 to 1998, but defense spending re-emerged as the largest category in 1999 and 2000 because of peacekeeping missions in Bosnia and Kosovo. Humanitarian relief for refugees of these crises also

raised discretionary supplemental spending for international causes to the highest levels of the decade.

Congress was unwilling to grant the full amount of supplemental appropriations requested by the President between 1993 and 1995, but the reverse held in all but one year since 1996. While Congress's overall supplemental spending in the 1990s (\$138 billion) was slightly larger than the President's requests (\$132 billion), the amount of total rescissions enacted by Congress was almost three times that requested by the President (\$52 billion compared to \$18 billion).

The 2000 Census



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

Preliminary data from Census 2000 show that the U.S. population grew 13.2% between 1990 and 2000. Every state's population increased, but rapid growth was concentrated in the South and West. Growth rates in the Midwest and Northeast lagged the national trend. Kentucky posted the highest growth rate among Fourth District states (9.7%), while West Virginia reported the second-lowest growth rate in the nation (0.8%, slower than all but North Dakota). Ohio's population growth over the decade was 4.7% and Pennsylvania's was 3.4%.

Following the fastest growth, the center of U.S. population continued its pattern of south- and westward movement since the previous census (in fact, the nation's population center has shifted southwest in every census since the first). Calculated as the point of balance if the U.S. were a perfectly flat plane and each of its 281,421,906 residents weighed exactly the same, the current U.S. population center is in Phelps County, Missouri.

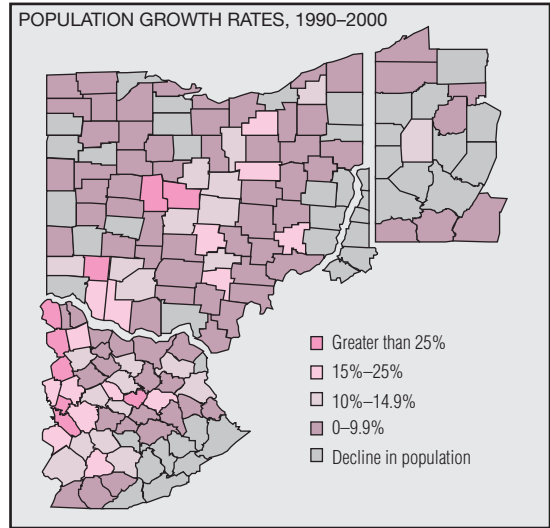
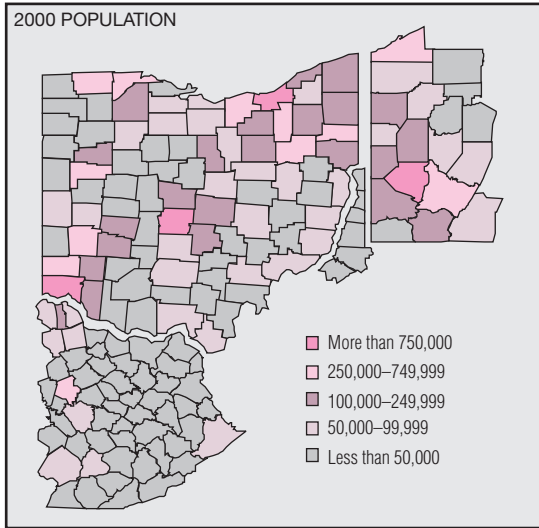
Reflecting this southwesterly movement, Fourth District states'

populations, while increased, lagged growth rates of states such as California and Texas. As a result, the District lost three apportioned seats in the U.S. House of Representatives—two from Pennsylvania and one from Ohio—forcing these states' congressional district lines to be redrawn sometime this year. For Kentucky and West Virginia, representation in the House was unchanged.

Newly released county data confirm that the Fourth District's population is concentrated around Cleveland, Cincinnati, Columbus, and

*(continued on next page)*

The 2000 Census (cont.)



**Fastest-Growing County Populations in the Fourth District**

National growth rate ranking	County	2000 population	1990-2000 growth rate (percent)
40	Delaware, OH	109,989	64.3
90	Boone, KY	85,991	49.3
137	Grant, KY	22,384	42.2
161	Warren, OH	158,383	39.0
167	Scott, KY	33,061	38.5

**Most Populous Metropolitan Statistical Areas in the Fourth District**

National population ranking	Metropolitan area	2000 population	1990-2000 growth (percent)	National growth-rate ranking
16	Cleveland-Akron CMSA	2,945,831	3.0	233
22	Pittsburgh MSA	2,394,811	-1.5	265
24	Cincinnati-Hamilton CMSA	1,979,202	8.9	172
33	Columbus MSA	1,540,157	14.5	109
53	Dayton-Springfield MSA	950,588	-0.1	257

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

Pittsburgh. Northeast Ohio has the highest density of people, while counties in the northwest corner of the state and in Kentucky, which are largely agricultural, have the lowest density.

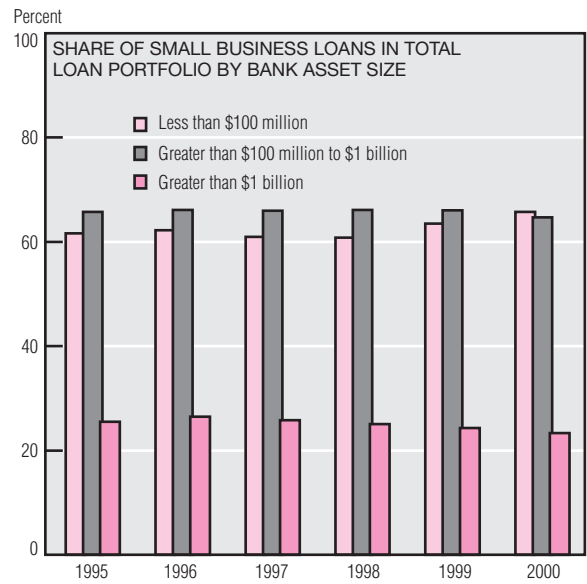
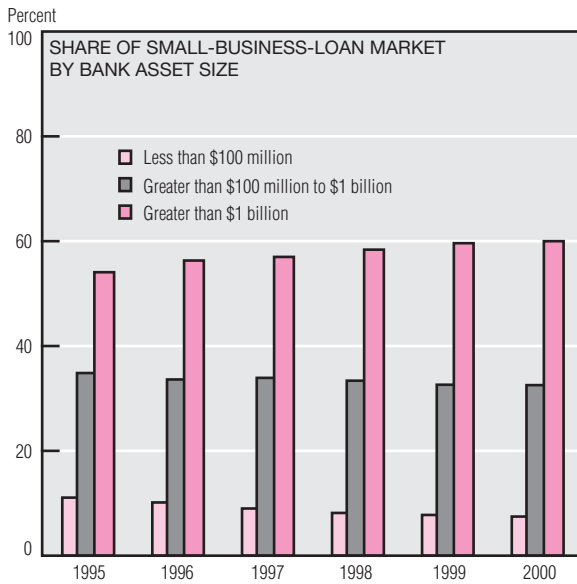
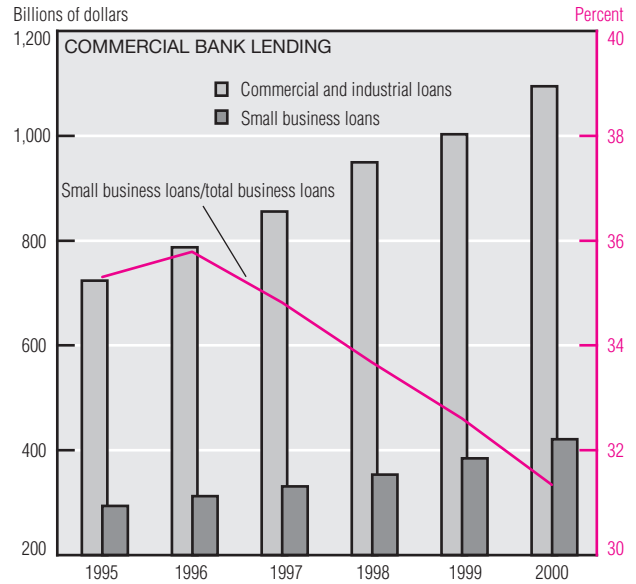
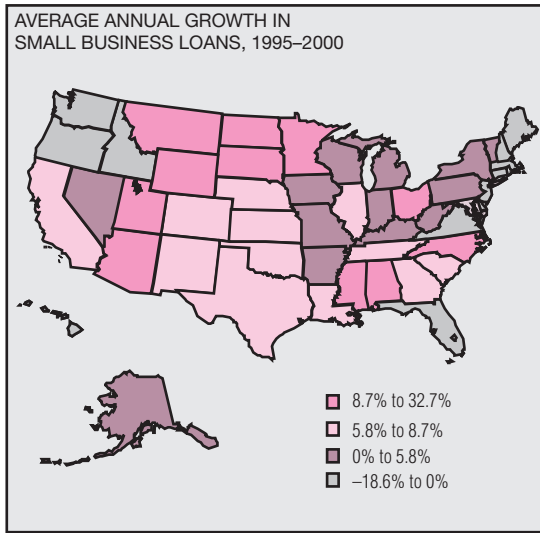
Counties with the fastest-growing populations are located along the western Kentucky boundary of the District and north of Columbus. Population in most counties in the eastern part of the District declined, with all District counties in West Virginia reporting losses and all but one District county in Pennsylvania

reporting either losses or modest growth that lagged the national trend.

Population growth rates in the District suggest continued migration from central cities in metropolitan statistical areas to surrounding counties. With few exceptions, the District's fastest growth occurred in counties adjacent to a county containing an MSA's central city. (The District's five fastest-growing counties fall into this category.) Population in Cuyahoga, Allegheny, and Hamilton counties (containing central cities Cleveland, Pittsburgh, and Cincinnati, respectively) fell during the last decade.

Among the District's metropolitan statistical areas, Cleveland-Akron remained the largest, although its national rank fell from 13 to 16 between 1990 and 2000. Population growth rates in District MSAs were low compared to other MSAs: The highest-ranking MSA was Columbus (109 out of 280). With the exception of Columbus and Cincinnati, all of the District's MSAs fell into the lowest third when ranked nationally according to population growth.

# Commercial Bank Lending to Small Businesses



SOURCE: Federal Financial Institutions Examination Council, *Report of Condition and Income*, various issues.

The U.S. Small Business Administration Office of Advocacy reports that in 1999, small businesses with fewer than 500 workers employed 53% of the private nonfarm workforce, made 47% of all sales in the U.S., and were responsible for 51% of the private gross domestic product. Lending by commercial banks reflects small businesses' importance in the economy. With the exception of Florida and the northern parts of both coasts (11 states and the District of Columbia), small business lending (loans less than \$1 million) grew at an average annual rate of 10.3% in 1995–2000. Within

Fourth District states, growth rates reached 16.9% in Ohio, 5.0% in West Virginia, 4.4% in Kentucky, and 2.3% in Pennsylvania.

Small business lending grew at a 7.4% rate nationwide in 1995–2000, but this figure is lower than the 8.6% growth rate in commercial and industrial lending. Consequently, the share of small business loans in commercial banks' business loan portfolios fell from 36% to 31% over this period.

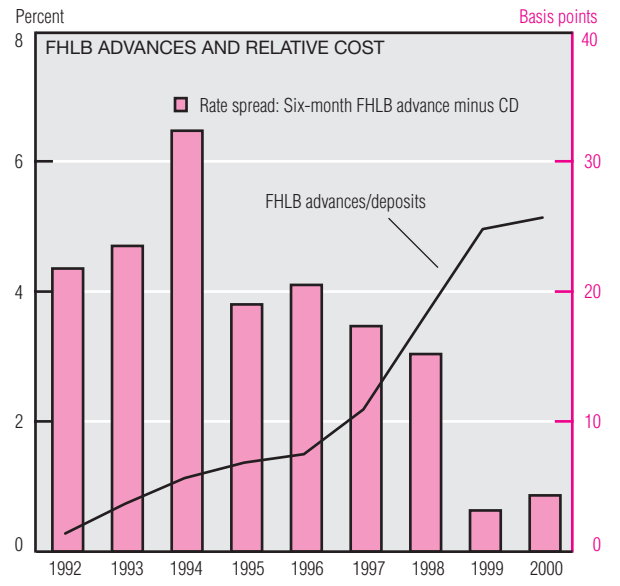
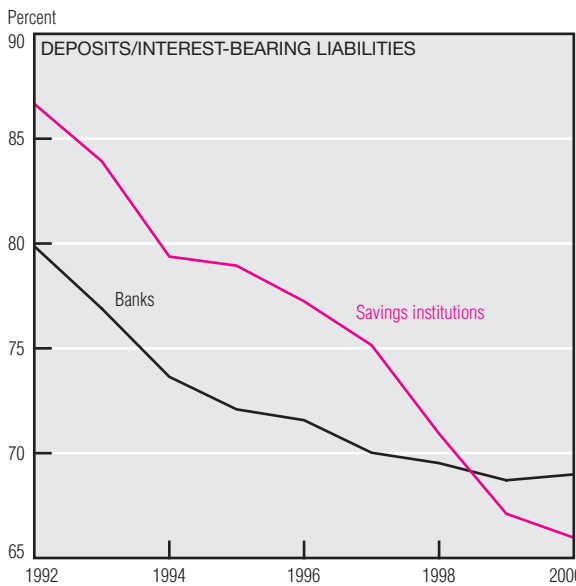
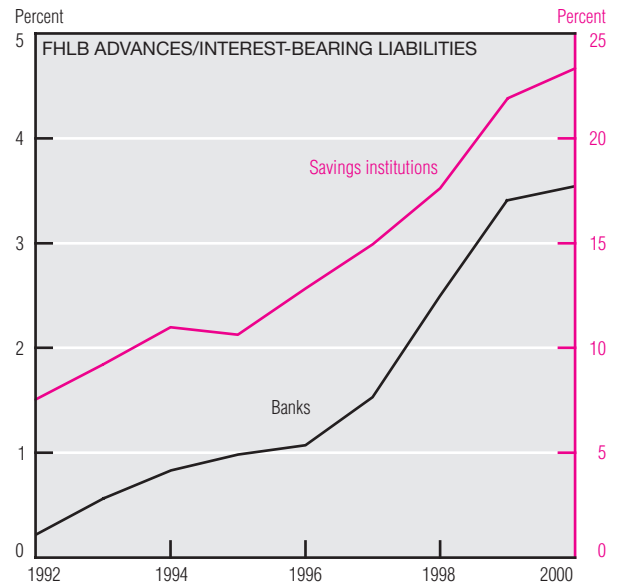
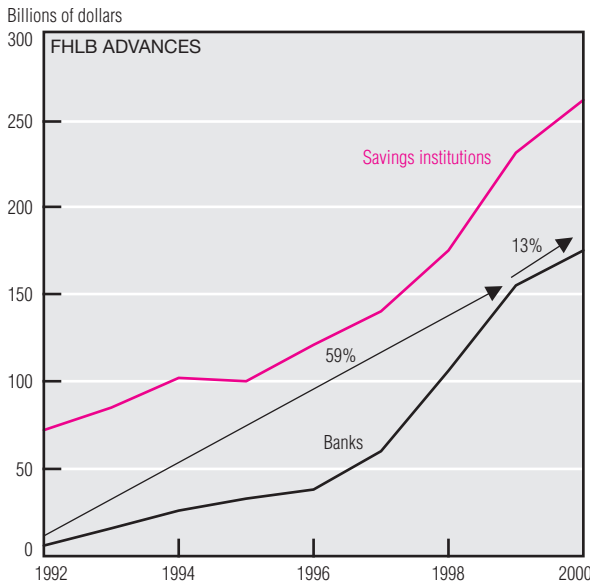
Commercial banks with assets greater than \$1 billion control over half the market for loans to small businesses. In 1995–2000, their market

share grew from 54% to more than 60%. One-third of this gain came at the expense of midsize banks with assets of \$100 million to \$1 billion, whose market share dropped from 35% to 33% in the course of five years. Small banks with assets less than \$100 million suffered the biggest loss in market share—from 11% to 7%.

Although large banks dominate the small business market, in 2000 the share of small business loans in large banks' total business loan portfolio was less than 25% and declining. Small banks, however, remained heavily engaged in this market.



## FHLB Advances to Depository Institutions



SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues; and Bloomberg Financial Information Services.

Federal Home Loan Banks (FHLBs) were established to lend to federally chartered thrift institutions and member banks having at least 10% of their assets in mortgages. FHLB advances had to be collateralized by borrowing institutions' mortgage portfolios. The Financial Modernization Act of 1999 enabled FHLBs to depart from their traditional role of providing housing finance. They now can lend outside the housing sector to community banks, accepting banks' loans to small businesses, small farms, and small agribusinesses as collateral.

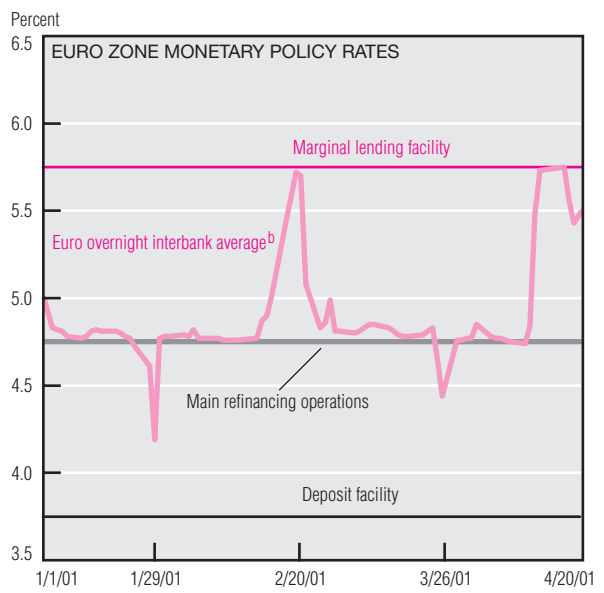
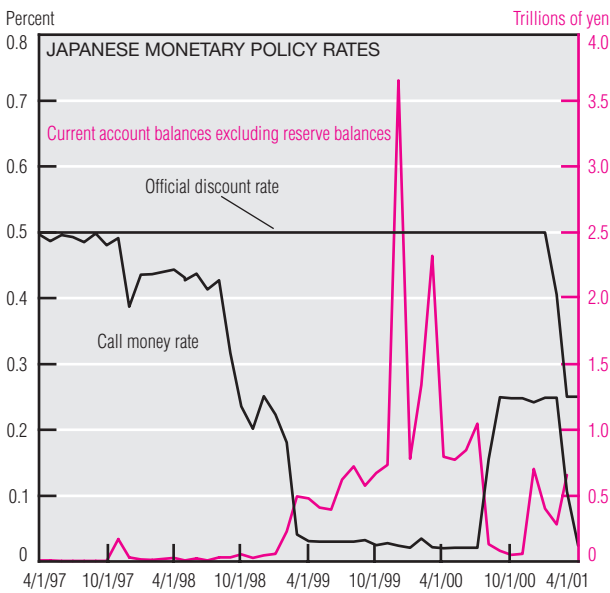
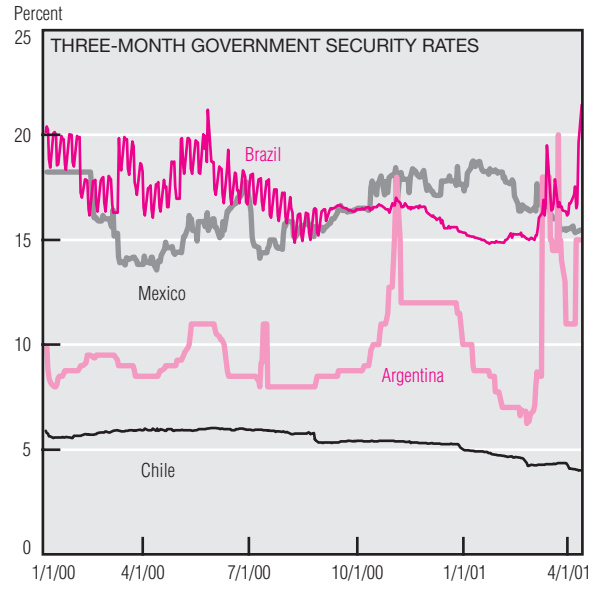
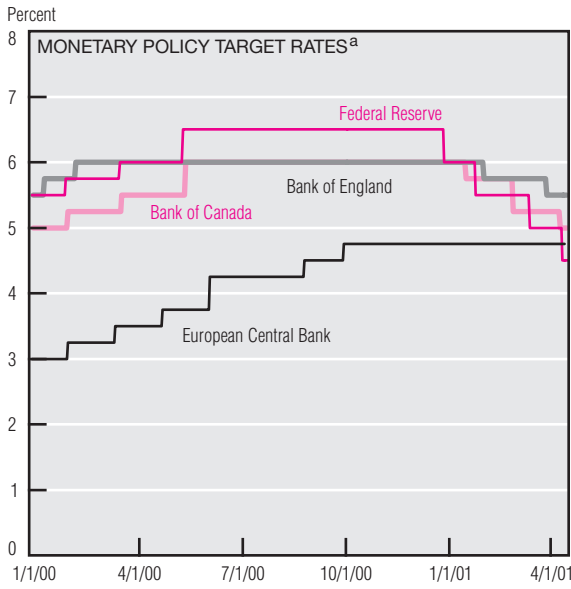
FHLB advances to commercial banks increased from almost zero in the early 1990s to \$175 billion in 2000. However, advances' growth rate declined from 59% (annualized) in 1992–99 to 13% in 2000. During the same period, FHLB advances to savings institutions rose from \$72 billion to \$261 billion. As of 2000, these FHLB advances constituted 3.5% of banks' and 23% of savings institutions' interest-bearing liabilities.

Banks and savings institutions increased the share of FHLB advances in their liabilities at the expense of interest-bearing deposits. In 1992,

deposits constituted 87% of savings institutions' liabilities, but this share fell to 66% in 2000. Similarly, commercial banks' deposit-to-liability ratio dropped from 80% in 1992 to 69% in 2000.

One explanation for this shift from deposits to FHLB advances is the decline in advances' cost relative to deposit rates. The average rate spread between the six-month FHLB (New York) advance and the CD fell from 32 basis points (bp) in 1994 to 4 bp in 2000. Including the cost of deposit insurance, which varies between zero and 27 bp, the FHLB advance is clearly a lower-cost funding alternative.

Foreign Central Banks



a. Overnight interbank rates except for the European Central Bank, whose main refinancing rate is shown.  
 b. The weighted average rate on all overnight unsecured lending transactions in the interbank market, initiated within the euro area by contributing panel banks.  
 SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; and International Monetary Fund, *International Financial Statistics*.

Reductions in the Federal Open Market Committee's interest rate target this year have been paralleled by three other central banks of the G7, but not by the European Central Bank (ECB). While the economic outlook for all the G7 nations has dimmed at least somewhat, concern about above-target inflation has restrained the ECB from adjusting its policy rates.

Experience in Latin and South America has been less uniform. Short-term interest rates in Chile and Mexico have drifted down with those of the G7. Argentina and Brazil, however, have faced special challenges to monetary stability that have

engendered substantial variations in their money market interest rates.

In March, the Bank of Japan shifted its operating policy target from an overnight call rate "around 0.15%" to a quantity of current account balances on deposit with the bank "around Y5 trillion." This quantity target (about Y1 trillion above required reserves) distinguishes current policy from the so-called zero interest rate target that prevailed between February 1999 and August 2000. The recent rough correspondence between the level of the call rate and the level of current account balances in excess of required reserves suggests that the call rate

should average close to zero, as the Bank of Japan expects.

Recent European experience illustrates the operation of a Lombard-type central bank lending facility, embodied in the ECB's marginal lending facility. The ECB stands ready to make collateralized loans to approved institutions at a rate 100 basis points above the policy target. Normally, little borrowing takes place, but when the supply of base money is restricted relative to demand (as in February and April 2001) the lending facility serves to cap the market rate for overnight loans.