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The Economy in Perspective

My dinner with André…On my way to the restaurant, I realized that I hadn't seen André in nearly 18 months, although I'd heard plenty about him. My old friend, the former finance minister of Nedlaw, had quit politics and founded his own "New Economy" company at the height of the dot-com craze. Everyone was certain André had lost his shirt, but I suspected otherwise. I knew he was too clever by half.

He had commandeered the best table at the hottest new restaurant in town, the Random Walk. Tanned and fit, he embraced me warmly. As we caught up on one another's recent activities and spoke about mutual friends, I couldn't help but wonder what was happening in fabulous Nedlaw, his cherished homeland. Although most people regarded it as a poor, backward country, hearing André's tales over the years had convinced me that this image of Nedlaw was a calculated ruse.

I asked how he was enjoying private life and personal wealth, after being a humble public servant for so long. He popped a forkful of tuna escabêche into his mouth, his eyes twinkled, and smiling broadly, he said, "I'm going back to politics." He could see that his answer astonished me.

"As we say in Nedlaw, 'You can't grow corn on the ceiling.' I miss politics. Besides, since I left office the opposition party has been ruining the economy. They have let the façado float freely in the international currency market; it has appreciated 25% in the last year. My new wealth is suddenly in jeopardy."

"But André," I protested, "I thought that floating exchange rates were beneficial for countries like Nedlaw. You have many trading partners and a well-developed financial system. If the façado has appreciated so much, perhaps it is because people from other countries found your exports very cheap, or because they wanted to invest in Nedlaw's companies. Either way, it sounds like a vote of confidence in your country's economy."

André turned his gaze from me to his Chateaubriand with asparagus in Mornay sauce. After a long pause and a few swallows, he resumed the conversation. "If it sounds too good to be true, *mon ami*, it generally is. The façado is now very strong, which makes our exports quite expensive. The manufacturers of Nedlaw are very upset, and rightly so. They are being priced out of world markets. When I was finance minister, I followed what is commonly called a 'weak façado' policy, which is really anything but weak. During my regime, Nedlaw's goods were always cheap and in demand. And there were plenty of manufacturing jobs."

"André," I ventured, "how did you keep up with all the demand from foreign companies to acquire the façados they needed to buy your merchandise? And what did you do with all the foreign currency that was coming into Nedlaw?"

André motioned me to move my salmon en brochette within his reach. "Managing foreign currency was easy. I simply required Nedlawians to exchange their foreign currency holdings for façados. The central bank is holding them in a lock box—mere entries in a ledger. We discouraged imports, which just take jobs away from our people. To keep up with the domestic and foreign demand for façados, we had the central bank buy more Nedlaw debt and pay for it with newly created façados. And believe me, there was plenty of Nedlaw debt to acquire. Do you know how much debt it takes to run a country these days?"

"Forgive me," I pleaded, "but I'm still confused. I understand that your policy created jobs and enabled Nedlaw's companies to sell more merchandise abroad. But it seems that in the end, your people were just holding more façados. The few imports you permitted to enter Nedlaw must have been expensive, and if you were constantly printing new façados, inflation must have been high. I'm sure people were working hard, but what were they able to purchase and consume? How does it help all your countrymen to have a policy that mostly favors exporters? Doesn't everyone else pay for that policy one way or another? Wouldn't the opposition party's free-floating-façado policy tend to discipline the government to reduce both debt and inflation? Wouldn't most people be better off?"

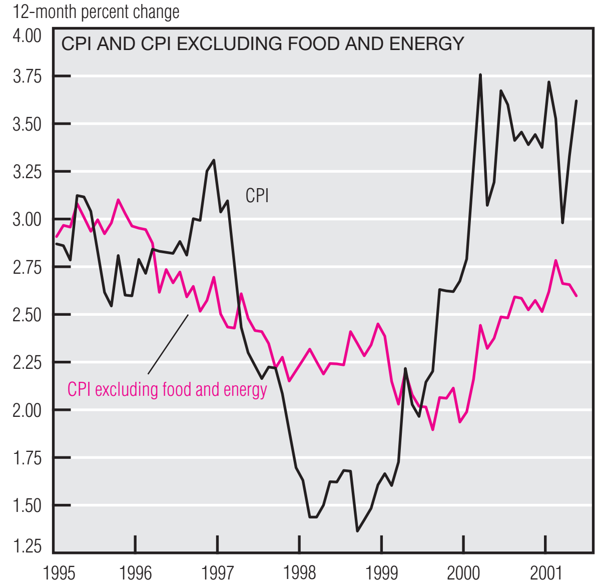
Confronting André in this manner, I thought, might be going too far. But the politico-turned-financier just shook his head in disappointment as a spoonful of Grand Marnier soufflé slid down his throat.

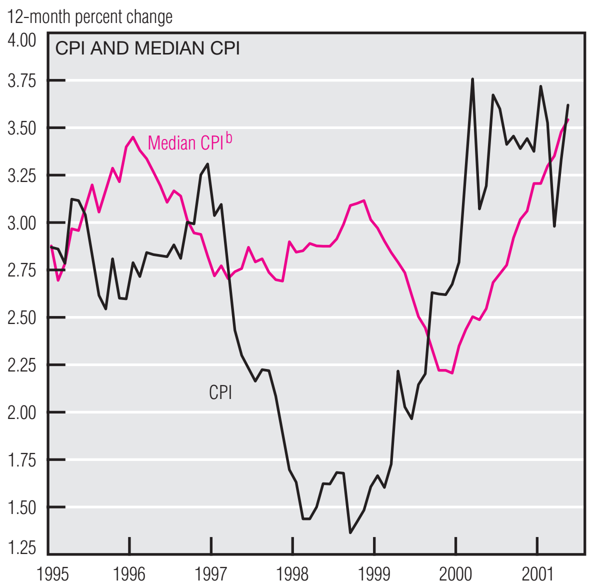
"Like the rest of my critics, you are starting in the wrong place. Decades ago, 50% of Nedlaw's jobs were in manufacturing industries; today that figure is 10%. Obviously, each manufacturing job creates nine others! Furthermore, exports used to make up only 5% of GDP; today they amount to 20%. The trend lines are clear and, as economists like to remark, where two lines intersect something important must be happening. It reminds me of the old proverb, 'You can't make cheesecake out of snow.' Exports of manufactured goods are the true source of wealth—the mercantilists proved that more than 200 years ago. And as you know, *mon ami*, those who are ignorant of history are bound to repeat it."

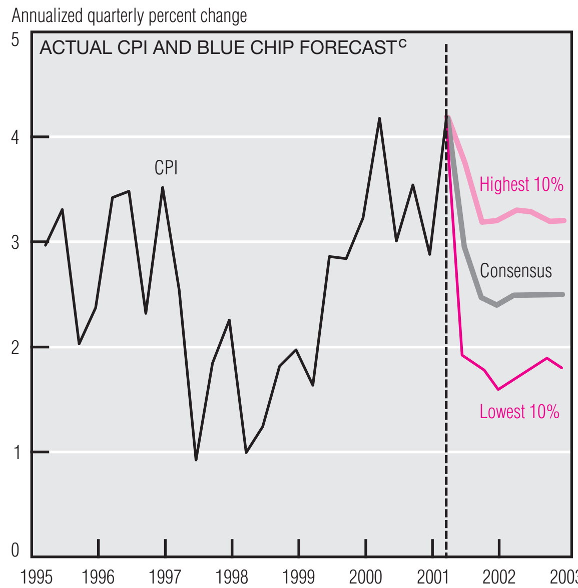
Inflation and Prices

May Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2000 avg.
Consumer prices					
All items	4.9	3.0	3.6	2.6	3.4
Less food and energy	1.3	2.2	2.6	2.4	2.5
Median[b]	3.9	3.9	3.5	2.9	3.2
Producer prices					
Finished goods	0.8	1.1	3.7	1.7	3.6
Less food and energy	2.4	2.2	1.6	1.1	1.3







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*, June 10, 2001.

Retail price growth seems to have accelerated slightly in May. The Consumer Price Index (CPI) jumped an annualized 4.9% during the month; after subtracting out the highly volatile food and energy components, however, the increase was a much more modest 1.3%. Still, price pressures are being felt across a broad range of retail goods, as evidenced by a 3.9% increase in the Federal Reserve Bank of Cleveland's median CPI. Indeed, this measure of inflation has been trending steadily upward since early 2000; its recent 12-month increase of 3.5% is the highest in about nine years.

Most economists see retail price pressures easing over the remainder of this year and next, as the upward pressure on energy prices felt in the past several years subsides. However, the magnitude of the "disinflationary" process is in some dispute. Some economists project the CPI growth trend to fall back under a 2% threshold, probably because they expect that a moderation in domestic spending will combine with a resumption of strong productivity growth and will put downward pressure on prices. Other economists, however, expect the CPI to continue growing at a rate above 3%. The inflation pessimists' view has no doubt been reinforced by the surge in money growth over the past year or so.

The behavior of U.S. retail prices has been roughly similar to that seen elsewhere around the world. For example, after following a largely downward trend in the latter half of the last decade, consumer prices in Europe have been rising since 1999—in tandem with the U.S. CPI.

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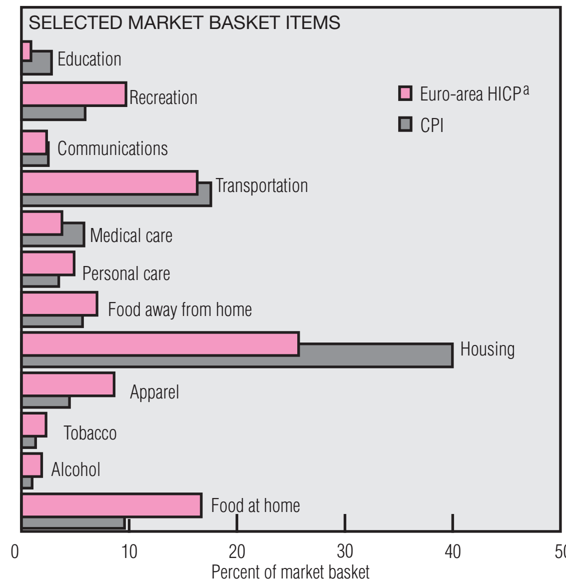
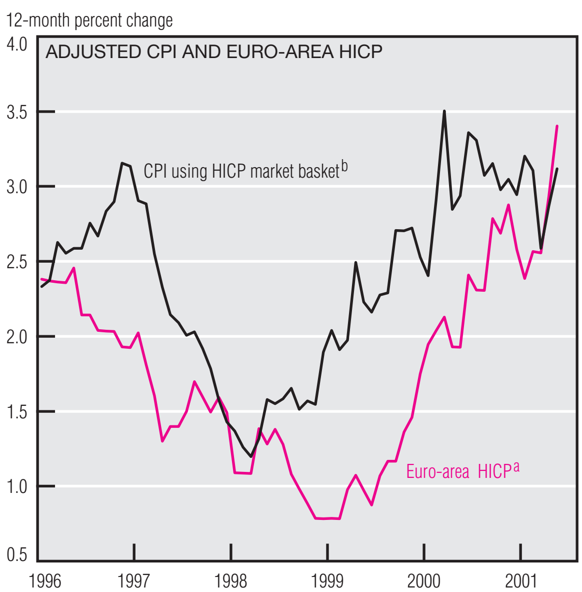
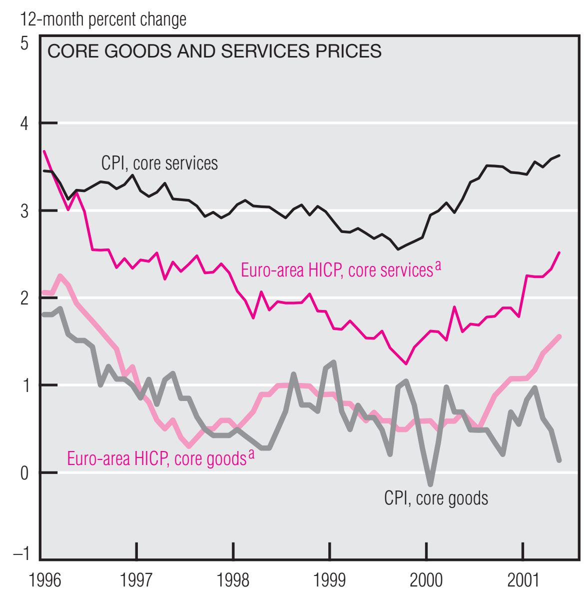
Inflation and Prices (cont.)





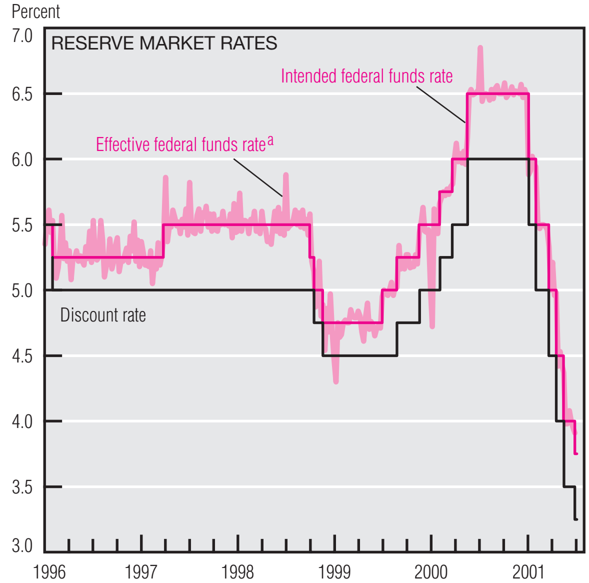


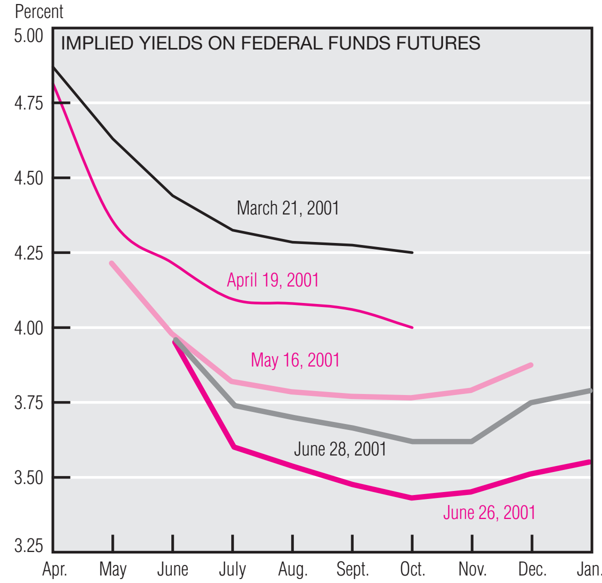
a. Harmonized Index of Consumer Prices.
b. This adjustment applies euro-area HICP market basket shares for 2000 throughout the entire time series of CPI data. Data limitations make this adjustment only approximate.
NOTE: Data are not seasonally adjusted, except the PCE price index.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Eurostat.

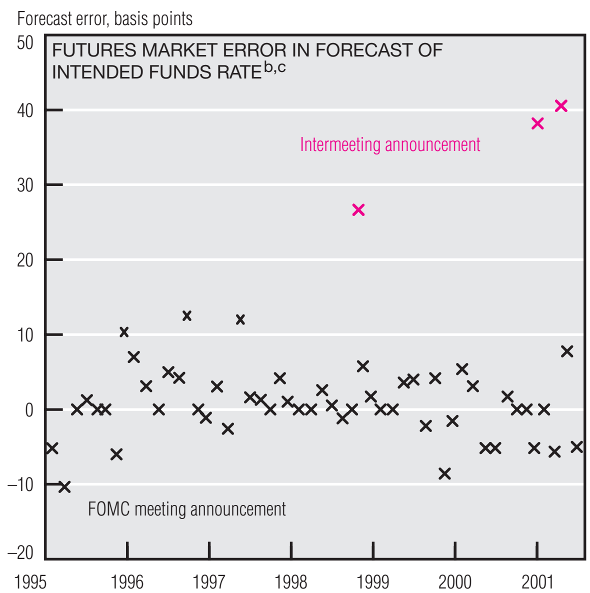
However, the U.S. CPI has been tracking about ½ to 1 percentage point above the euro-area Harmonized Index of Consumer Prices (HICP), a measure of retail price increases constructed for the 12 European nations with a common currency. A direct comparison of the U.S. CPI to the euro-area HICP is somewhat problematic, however, as the two indexes track fundamentally different bundles (or "baskets") of goods and services. The U.S. CPI puts a higher weight on housing costs, while the HICP is more heavily weighted toward food, apparel, and recreation. Indeed, the composition of the HICP corresponds more closely with another measure of U.S. retail prices—the Chain-Type Price Index for personal consumption expenditures, which also puts a smaller weight on housing.

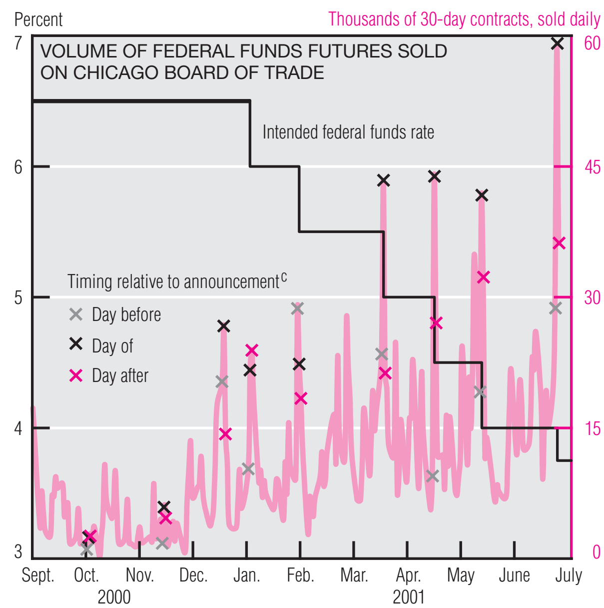
Adjusting U.S. CPI data to a market basket more consistent with the euro-area HICP suggests that retail prices have tended to rise more rapidly in the U.S. than in the euro area over the past five years or so. However, the gap between the two has narrowed substantially in the past two years, when inflation apparently accelerated even more rapidly in the euro area than in the U.S. Much of the euro-area price surge (relative to the U.S.) has come from "core" (nonfood, nonenergy) goods. This may reflect a change in the relative terms of trade between the U.S. dollar and euro. With the dollar strengthening against the euro, U.S. consumers have found euro-area imports relatively less expensive to buy—while euro-area residents have seen a rise in their cost of U.S. goods.

Monetary Policy









a. Weekly average.

b. The forecast error is taken as the negative of the unanticipated change in the target rate as described in Kenneth N. Kuttner, *Monetary Policy Surprises and Interest Rates: Evidence from the Fed Funds Futures Market*, Federal Reserve Bank of New York, Staff Report no. 99, February 2000.

c. Announcements occur on scheduled FOMC meeting dates and on intermeeting dates when a change in the target rate is announced. When a scheduled meeting lasts two days, the second day is taken as the meeting date.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of New York; Chicago Board of Trade; and Bloomberg Financial Information Services.

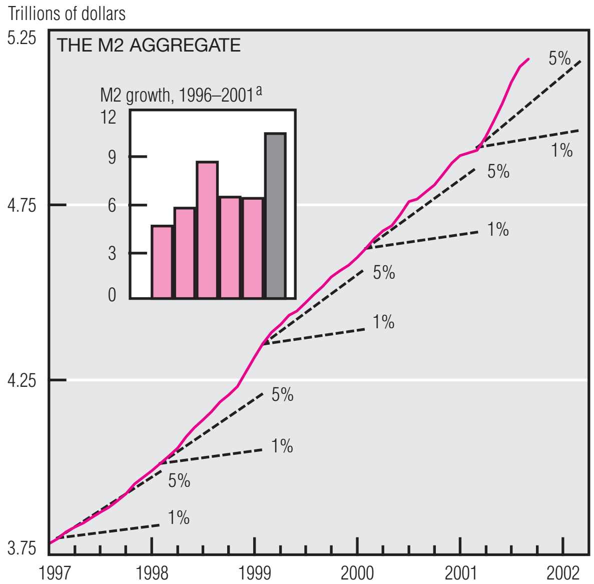
On June 27, the Federal Open Market Committee (FOMC) lowered the intended federal funds rate 25 basis points (bp) to 3.75%, citing "declining profitability and business capital spending, weak expansion of consumption, and slowing growth abroad" as reasons for the rate cut. In a related action, the Board of Governors approved Reserve Bank requests to reduce the discount rate 25 bp to 3.25%.

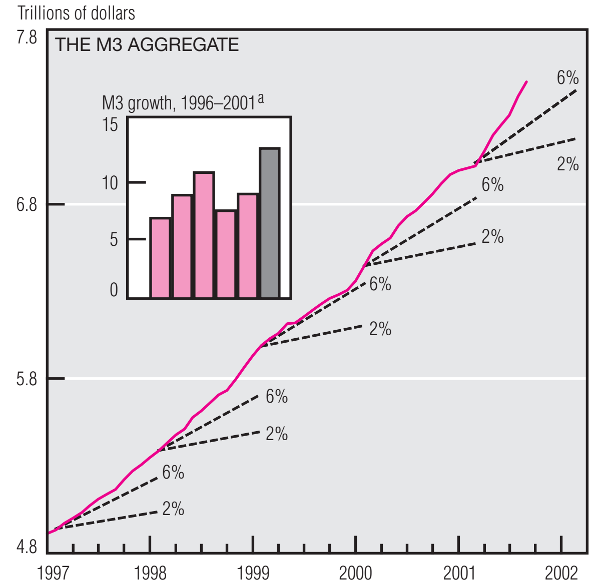
Implied yields on federal funds futures often are used to gauge the expected course of monetary policy actions. Just after the recent rate cut, implied yields rose 13 bp–24 bp across the various maturities. Previous 2001 rate cuts were followed by decreases in implied yields. As of July 2, the September contract implied a yield of 3.66%.

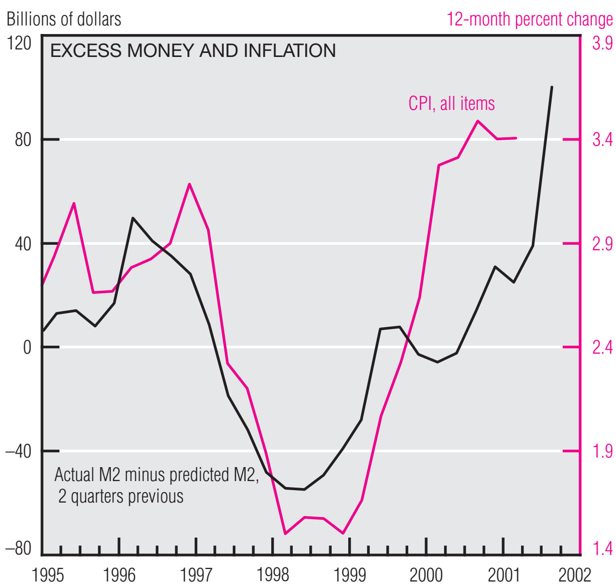
Fed funds futures predict short-term movements in the intended rate fairly well, typically within 10 bp of rate actions at FOMC meetings. Market participants tend to underestimate the extent of rate changes in both directions. Intermeeting actions, however, catch them off guard, with errors close to the size of the rate changes.

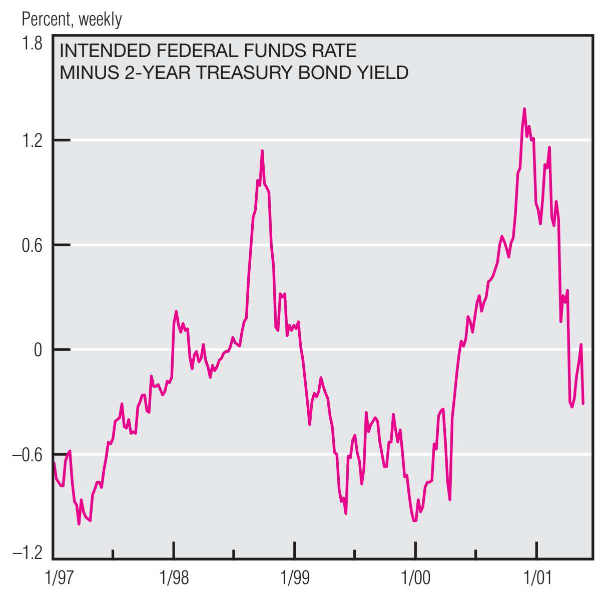
Trading in fed funds futures began in 1988 at the Chicago Board of Trade. Trading volume so far this year already exceeds all of last year's, perhaps because of the increased number of FOMC actions. Volume picks up on days surrounding FOMC actions. This may come from speculators trading contracts immediately before and after FOMC actions and from hedgers adjusting positions in other short-term financial instruments. Increased futures-price volatility (around meeting dates) may have driven up volume as well, as it has in other futures markets.

Money and Financial Markets









a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2001 growth rates for M2 and M3 are calculated on a May over 2000:IVQ basis. Data are seasonally adjusted.

NOTE: Last plots for M2 and M3 are May 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.

SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Cleveland; and Bloomberg Financial Information Services.

Have we gone too far? Or is this just a beginning? Some consider the actions of the Federal Open Market Committee (FOMC) during the current economic slowdown fully consistent with the quest for maximum long-term real growth through low inflation. Others question whether the possibility of recession has become the focus of undue attention so that the FOMC is ignoring potential consequences for more rapid inflation.

From the perspective of the broad monetary aggregates, annualized growth of M2 and M3 so far in 2001 has outpaced that of the past five years. What may be more informative is excess money, defined as actual money minus predicted money demand. Historically, excess M2 (lagged two quarters) follows a pattern similar to that of consumer price inflation. Excess M2 has escalated sharply based on GDP for 2001:IQ and the most recent M2 levels.

The spread between market rates (here, two-year Treasuries) and the FOMC-controlled federal funds rate provides a different perspective. This spread has fallen sharply since the beginning of the year, mostly because the FOMC made five consecutive cuts of 50 basis points (bp) each in the intended federal funds rate. The additional 25 bp cut on June 27 reversed a recent uptick, so the spread remains near its five-year

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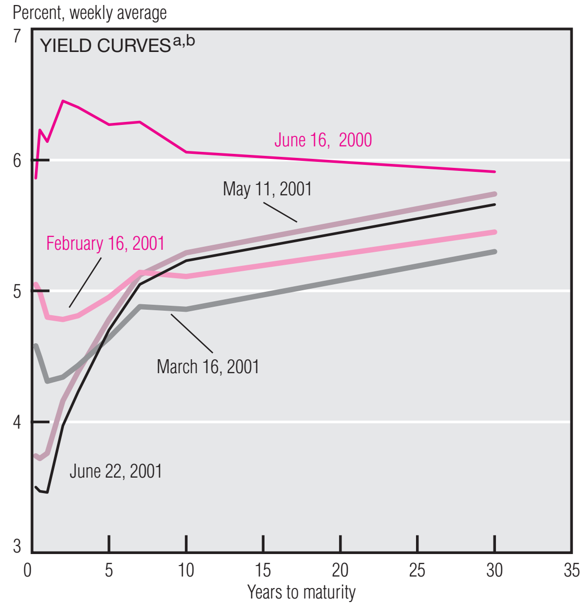
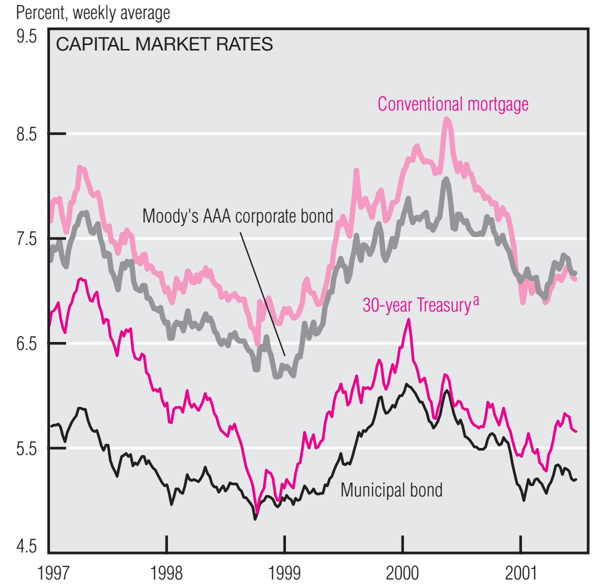
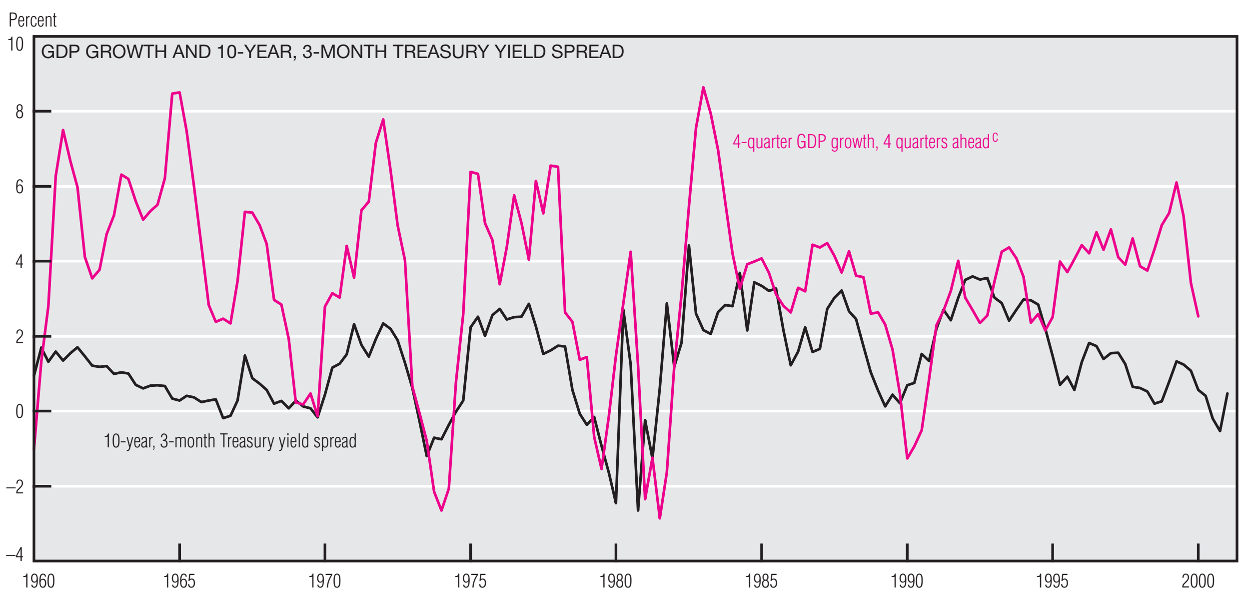
Money and Financial Markets *(cont.)*







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

average, perhaps suggesting that policy has not gone too far.

The yield curve has not changed appreciably in the past month. Last June’s inversion has disappeared almost totally. The shortest maturities, closely tracking FOMC rate cuts, are down to about 3.6%. Longer maturities have not declined as much and have backed up about 40 bp since mid-March. The overall steep positive slope at the short end seems consistent with future economic growth. Other long-term rates—on mortgages and on municipal and corporate bonds—have followed the same pattern as the benchmark 30-year Treasury bond, falling until April and rising somewhat since then.

The spread between 10-year and 3-month Treasuries, which contains much the same information as the yield curve, historically has been correlated with the level and direction of real GDP growth four quarters ahead. Although in certain periods this relationship has not been clear, the recent uptick in the spread might be interpreted as a good sign of future growth.

The spread between yields at different maturities may signal investors’ expectations of yields in different time periods of the future. In addition to these so-called term spreads, risk spreads compare yields on a security to that on a safe benchmark, usually a Treasury security. Both short- and long-term risk spreads have declined

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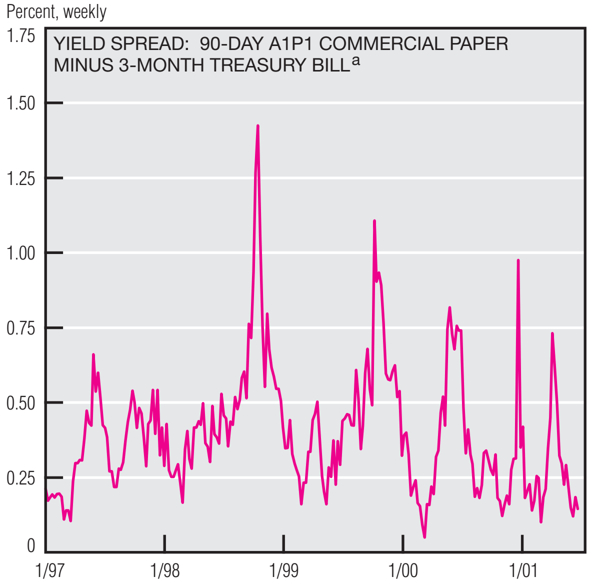
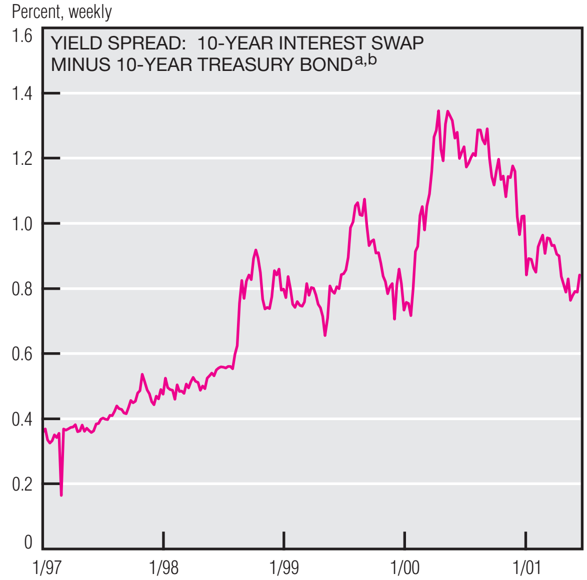
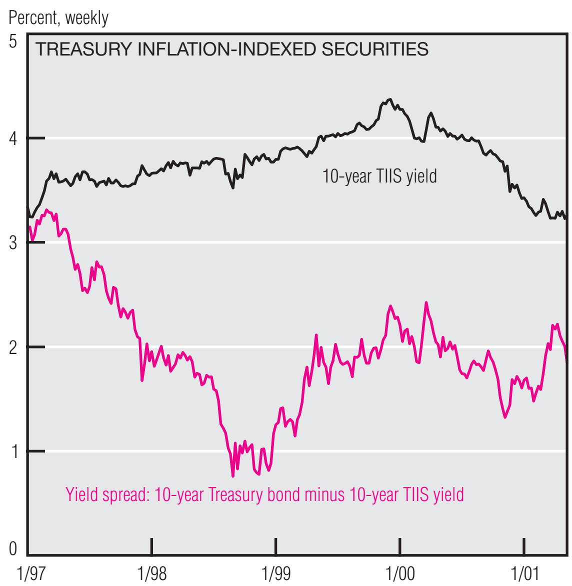
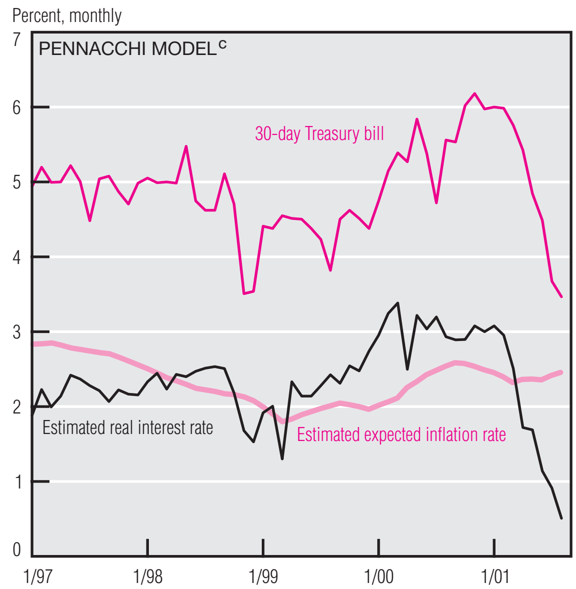
Money and Financial Markets *(cont.)*









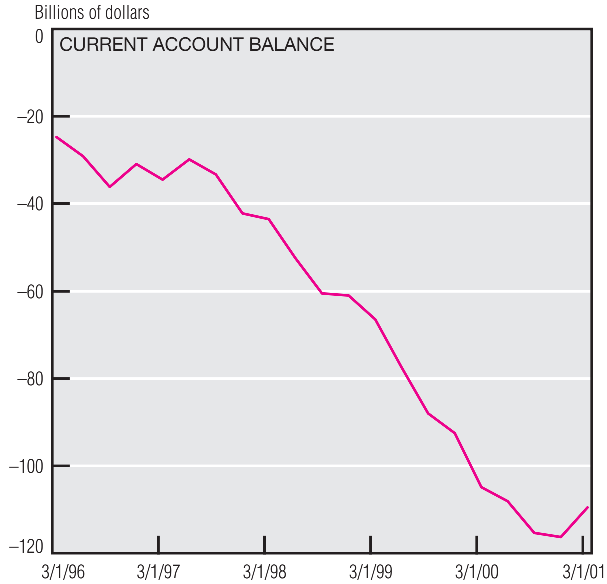
a. Bloomberg generic series.
b. Quote for semiannually fixed rate versus the U.S. dollar's 3-month London interbank offered rate (LIBOR).
c. The estimated expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the 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.

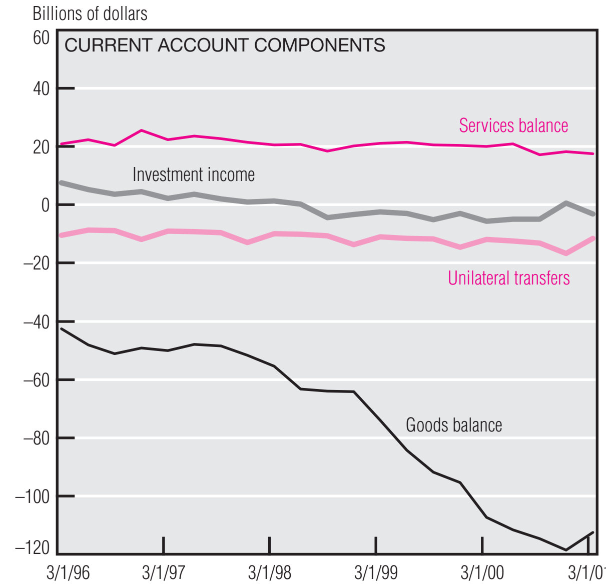
recently. However, the longer-term spread is still at the level it reached just after the Russian default and the Long Term Capital Management crisis. The spread between 90-day A1/P1 commercial paper and the 3-month Treasury yield, however, is quite low—only a bit above the levels of spring 2000.

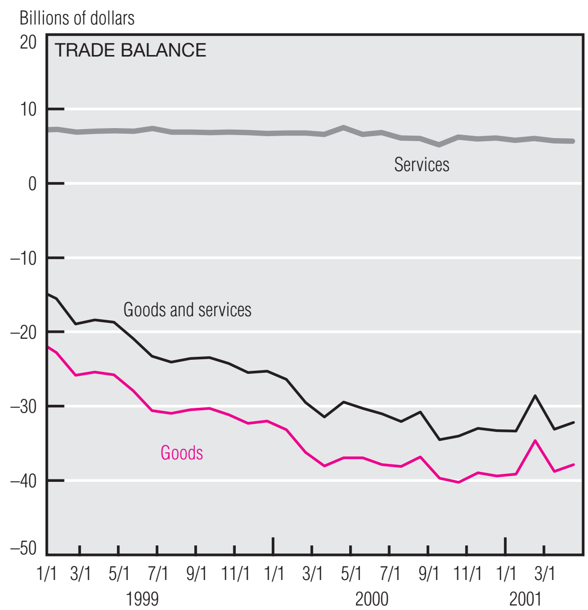
Treasury inflation-indexed securities (TIIS), first issued in 1997, offer a yield indexed to the Consumer Price Index. Initially, public interest in TIIS was slight, perhaps because inflation was quite low. Then, as TIIS's inflation protection became more widely appreciated, they were incorporated into more portfolios. The spread between yields on nonindexed Treasuries and on TIIS is a potential measure of investors' inflation expectations. This spread started rising in February but more recently receded a bit. Pennacchi model estimates indicate only very slowly rising inflation expectations over the past year and steeply declining real short-term rates.

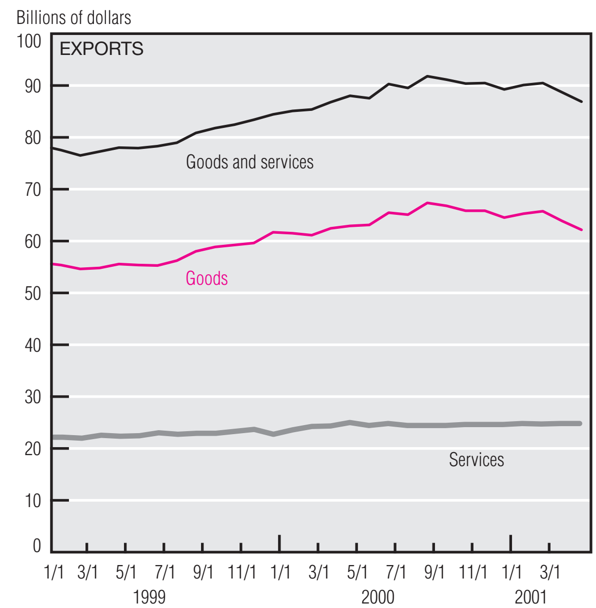
Rapid growth of the monetary aggregates and recent increases in the Consumer Price Index suggest a potential risk of rising inflation. However, the behavior of the intended federal funds rate and various other market rates seem consistent with the FOMC's most recent policy statement, suggesting that easing pressures in producer and labor markets will keep inflation contained.

International Developments









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

The U.S. current account is measured quarterly. In 2001:IQ, the current account deficit decreased to $109.6 (from $116.3 billion in 2000:IVQ). This decrease represents the first reversal in four years of the decade-long deterioration in the current account balance. Of the four components that constitute the current account—trade in goods, trade in services, income, and net unilateral current transfers—three components are in deficit positions and one, trade in services, is in a surplus position. The deterioration of the current account balance is closely related to trade in goods. Consistent with movements in the current account as a whole, the goods balance has deteriorated since mid-1997, with the deficit decreasing between 2000:IVQ and 2001:IQ. The other three components have remained fairly flat since 1997.

Trade balances are measured monthly. The service balance is in a surplus position. Its level has remained stable since at least the beginning of 1999. The goods balance is negative. After declining throughout 1999 and in the first part of 2000, the goods balance has hovered around a deficit position of $40 billion.

Both exports and imports of services have been stable since the beginning of 2000. Exports and imports of goods increased throughout 1999 and in the first part of 2000; since then, they have shown little

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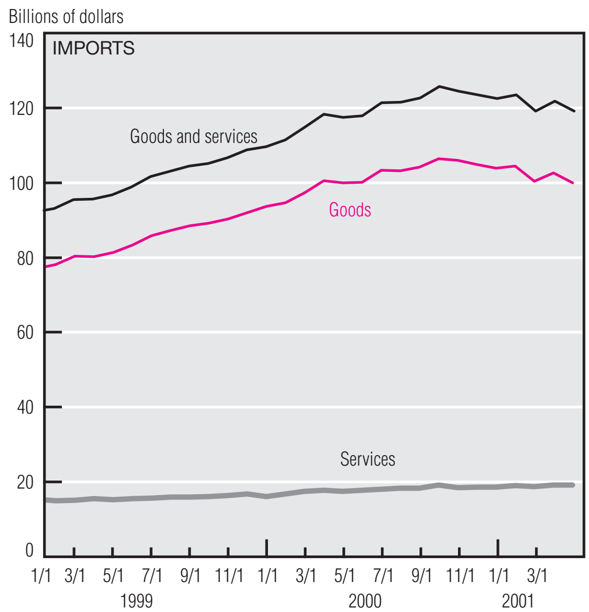
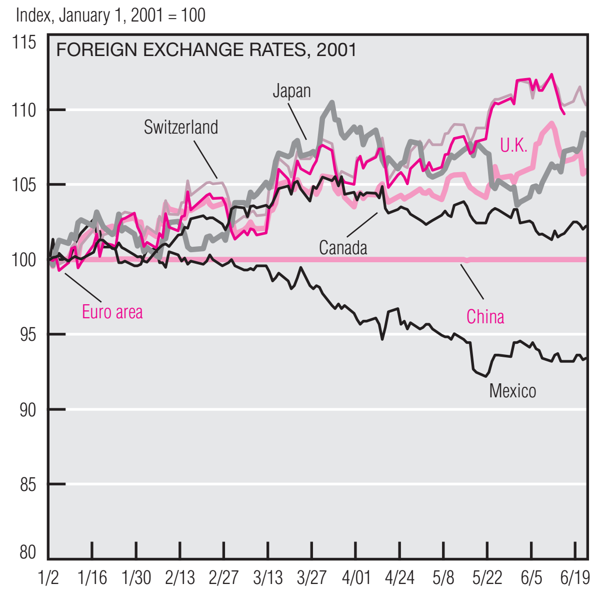
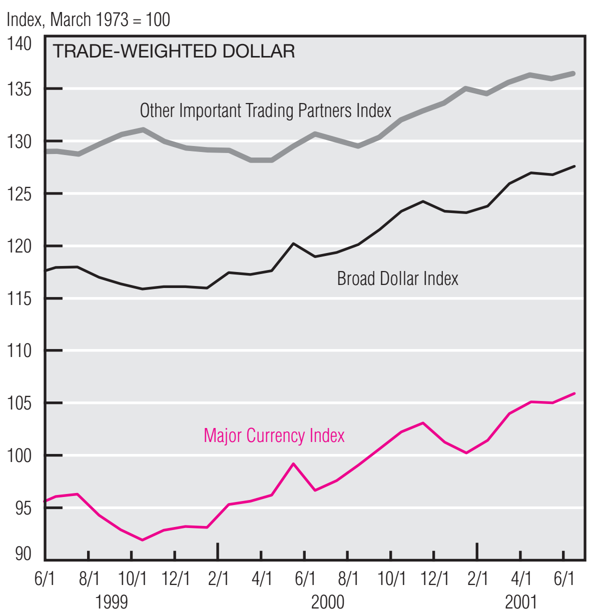
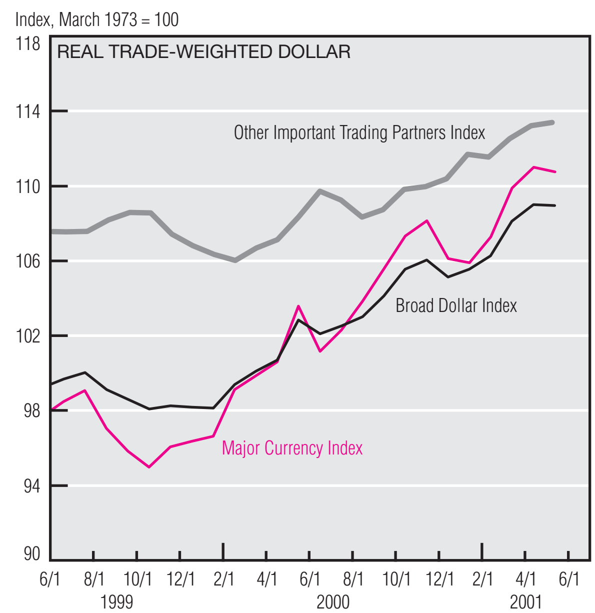
International Developments (cont.)









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

movement in either direction. What is puzzling is that although both imports and exports of goods leveled off after the middle of 2000, the current account continued to deteriorate throughout 2000.

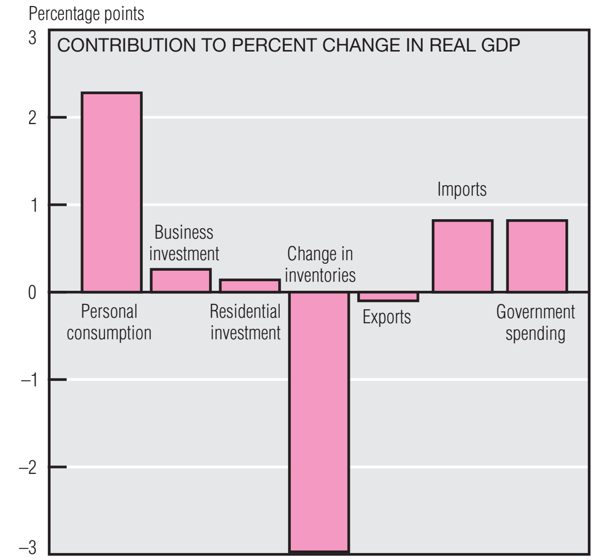
The U.S. dollar continues to gain strength against the currencies of many other nations. Since the beginning of this year, the U.S. dollar has appreciated against the Swiss franc (10%), the euro (10%), the Japanese yen (8%), the British pound (6%), and the Canadian dollar (2%). Against the Mexican peso, however, the value of the U.S. dollar has depreciated almost 7%.

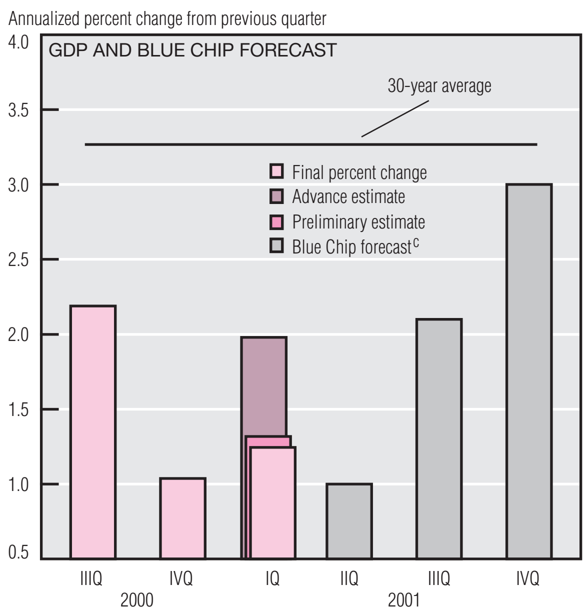
The Major Currency Index, which is a weighted average of the exchange rates of seven industrialized nations plus the euro area, has appreciated approximately 6% since the beginning of the year. The Broad Dollar Index, which includes the currencies of the most important U.S. trading partners, has appreciated about 3.5% since the year began, and the Other Important Trading Partners Index has appreciated about 1%. Real trade-weighted indexes take account of differences in the inflation rates between countries. Since the beginning of 2001, the real indexes have broadly mirrored the nominal indexes. With the general strengthening of the U.S. dollar since at least the beginning of the year, it is surprising to note that the current account position improved in the first quarter of the year.

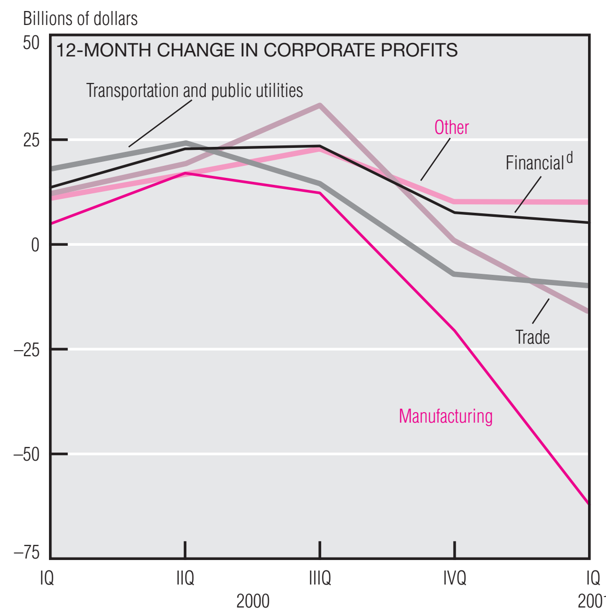
Economic Activity

Real GDP and Components, 2001:IQ[a,b]
(Final estimate)

	Change, billions of 1996 $	Percent change, last: Quarter	Percent change, last: Four quarters
Real GDP	29.1	1.2	2.5
Personal consumption	53.3	3.4	3.4
Durables	27.2	12.7	2.8
Nondurables	14.2	3.0	3.1
Services	15.7	1.8	3.8
Business fixed investment	6.8	1.9	5.8
Equipment	–6.6	–2.3	4.2
Structures	10.7	15.4	11.1
Residential investment	3.1	3.5	–2.5
Government spending	18.6	4.8	2.8
National defense	4.7	5.4	4.9
Net exports	19.1	—	—
Exports	–2.7	–0.9	4.8
Imports	–21.7	–5.4	6.7
Change in business inventories	–74.9	—	—







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 panel of economists.
d. Does not include Federal Reserve Banks.
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*, June 10, 2001.

The final estimate from the National Income and Product Accounts for 2001:IQ reveals that real GDP grew at an annual rate of 1.2% in that quarter, down slightly from the preliminary estimate of 1.3%. Personal consumption expenditures made the largest positive contribution to output growth. Government spending and imports also made substantial positive contributions. Inventory investment, on the other hand, exerted a heavy negative drag on first-quarter GDP growth.

GDP growth for 2001:IQ was up 0.2% relative to 2000:IVQ. Looking ahead, the Blue Chip forecast sees output growth falling back to 1% in 2001:IIQ, but anticipates considerably stronger growth in 2001:IIIQ and 2001:IVQ, albeit somewhat below the U.S. economy's long-term growth trend.

The National Income and Product Accounts also showed further deterioration in corporate profits. The decline in profits has been fairly broadly based, although the manufacturing sector has been particularly hard hit over the past two quarters. The transportation and trade sectors have also experienced substantial declines.

Health expenditures have risen precipitously over the past 40 years, from less than $400 per capita to more than $1,500 (all measured in constant 1996 prices). While health service expenditures may have increased in step with real income, this explanation cannot account for the rise in health services' share of

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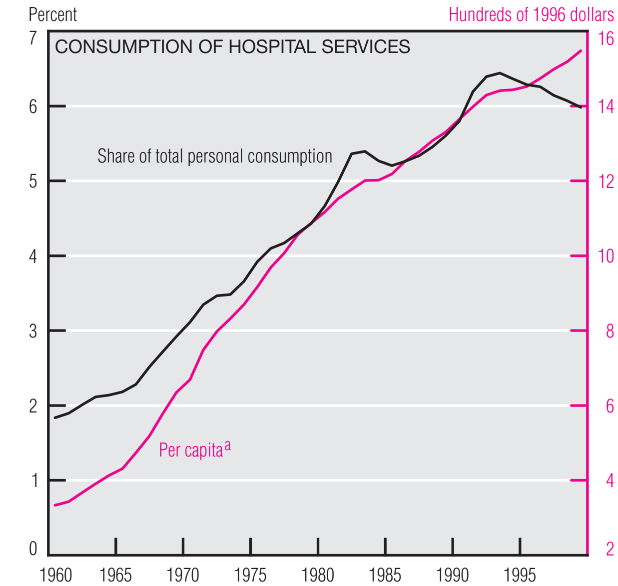
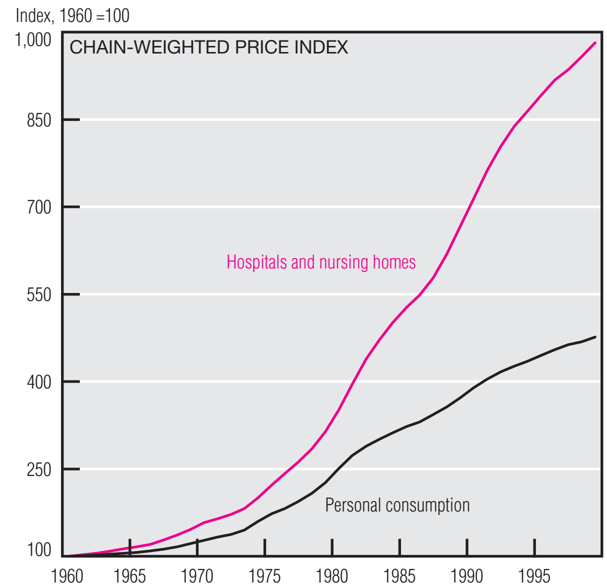
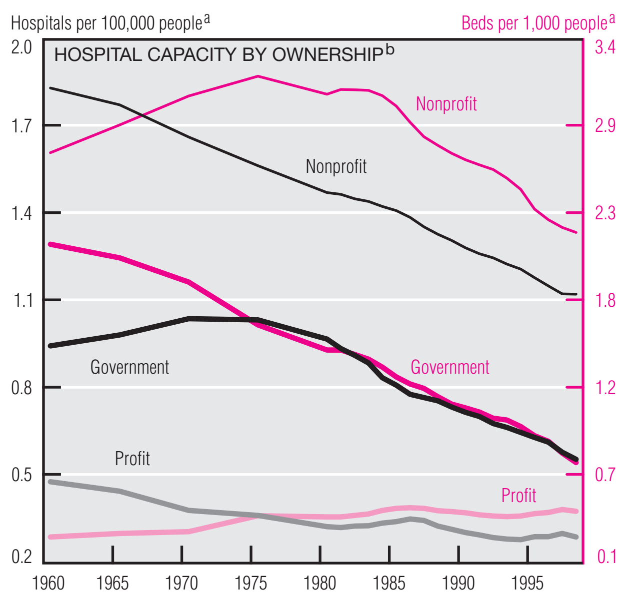
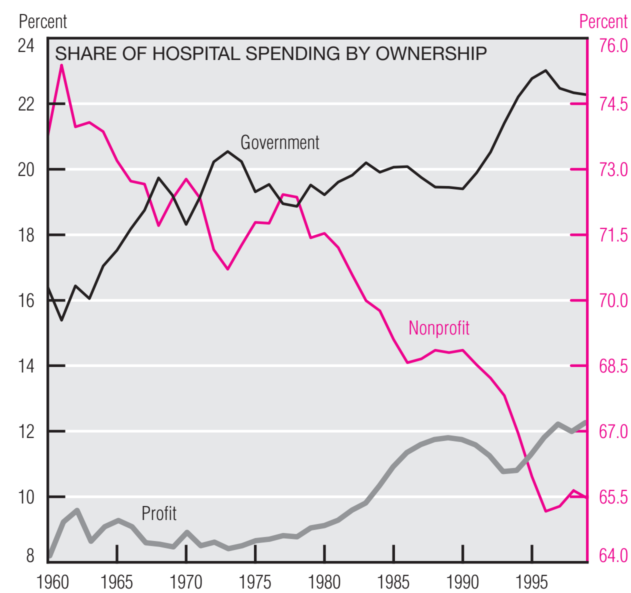
Economic Activity (cont.)









a. Based on annual estimates of U.S. resident population.
b. Does not include long-term, psychiatric, or tuberculosis hospitals.
NOTE: All data are seasonally adjusted and annualized.
SOURCES: SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Board of Governors of the Federal Reserve System; and *Hospital Statistics*, through 2000 edition.

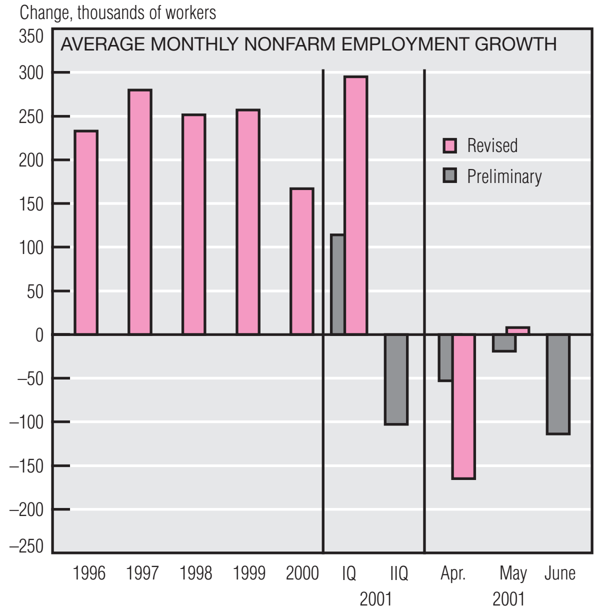
consumption spending from less than 2% to more than 6%.

Real expenditures on health care can rise in two ways: an increase in the relative price of health care or an increase in the quantity of health care services consumed. It turns out that both factors have been at work. Since 1960, the relative price of health care has roughly doubled while its share of consumption spending has tripled.

Services in the health care industry are offered by government, nonprofit, and for-profit institutions. Over the past 40 years, the nonprofit sector has been declining in relative importance, whether measured by its share of hospital spending, number of hospitals, or number of beds.

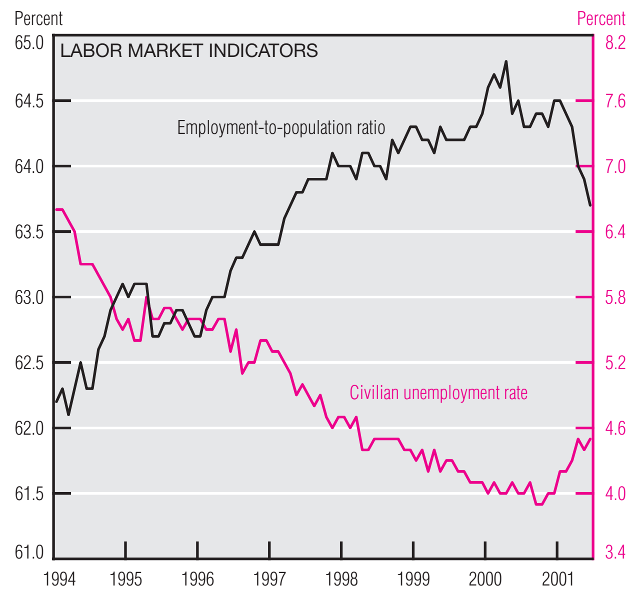
Measuring the quantity of health care services is difficult. For example, it would be wrong to look at the smaller number of hospitals and hospital beds and conclude that the quantity of health services has fallen, since hospital and bed numbers measure inputs, not outputs. Many procedures that used to require a hospital stay are now handled on an outpatient basis. The resulting fall in hospital bed use may be thought of as an increase in health services, since patients return to their normal lives more quickly.

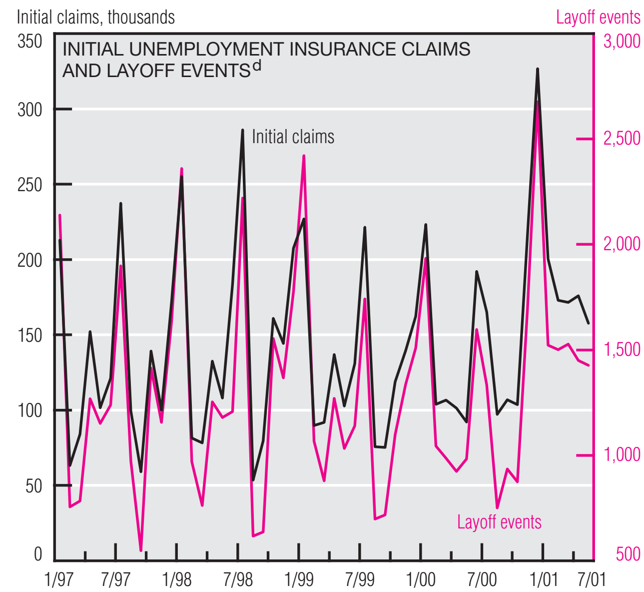
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1997	1998	1999	2000	June 2001
Payroll employment	280	251	257	167	–114
Goods-producing	47	22	7	8	–119
Mining	2	–3	–3	1	1
Construction	21	37	26	18	–7
Manufacturing	25	–13	–16	–12	–113
Durable goods	26	–2	–5	1	–81
Nondurable goods	–2	–11	–11	–13	–32
Service-producing	232	230	250	159	5
TPU[a]	16	20	18	14	–11
Retail trade	24	30	49	26	18
FIRE[b]	21	22	7	0	–5
Services[c]	141	120	131	93	–6
Government	17	28	35	18	24
	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. Not seasonally adjusted
NOTE: All data are seasonally adjusted unless otherwise noted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

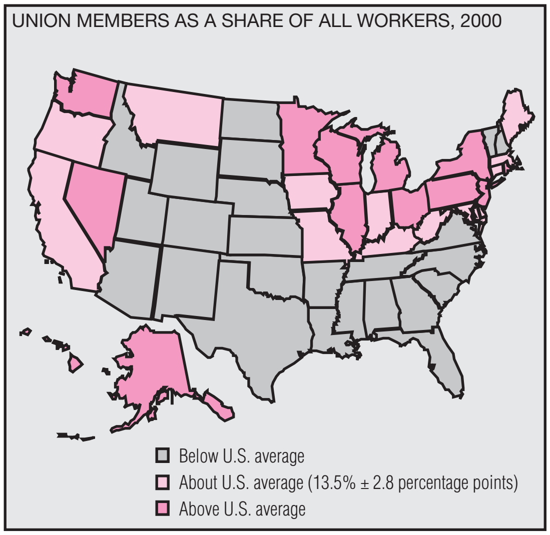
Nonfarm payroll employment posted a net loss of 114,000 jobs in June, a dramatic reversal of May's (revised) net gain of 8,000 jobs. June's preliminary figure shows the second considerable loss in the last three months. Average payroll employment showed a net loss of 103,000 jobs from 2001:IQ to 2001:IIQ.

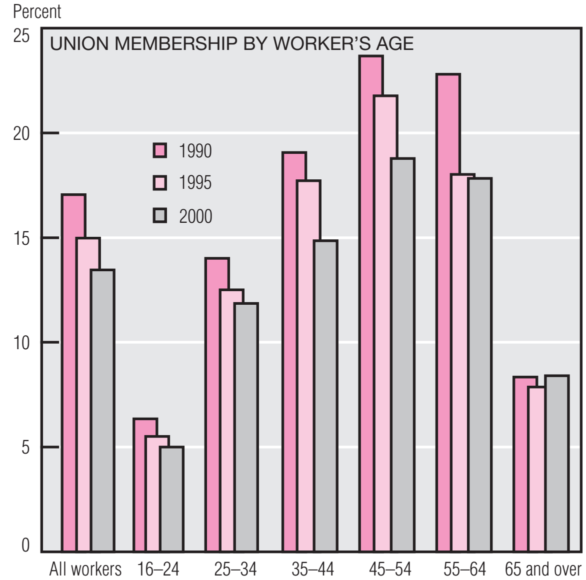
Goods-producing industries once again reported substantial net losses (another 113,000 jobs in manufacturing and 7,000 in construction). On the other hand, growth in retail trade (up 18,000) and government employment (up 24,000) contributed to a net gain of 5,000 jobs in the service-producing jobs, a relatively small gain for that sector. The decline in service industry jobs between the ends of calendar quarters (a net loss of 19,000 from March 31 to June 30) marked the first such period in 40 years that the industry failed to add jobs.

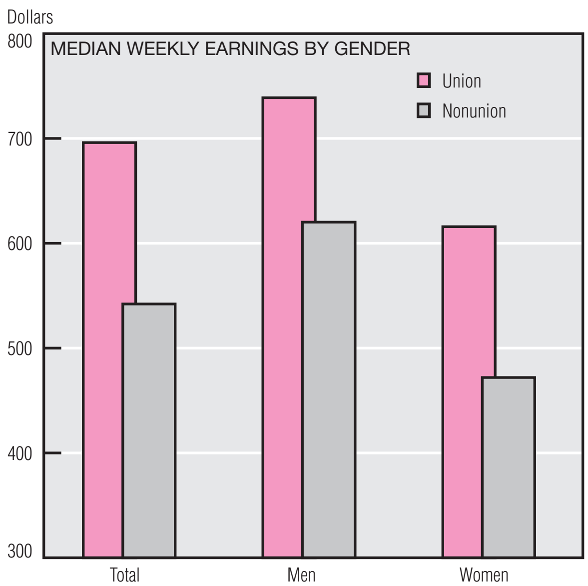
The June unemployment rate of 4.5% held steady; the rate has equaled either 4.4% or 4.5% in each of the last three months. The rate is a slight increase over the average of 4.2% for 2001:IQ. The employment-to-population ratio has continued its slow but steady decline, falling to 63.7% in June.

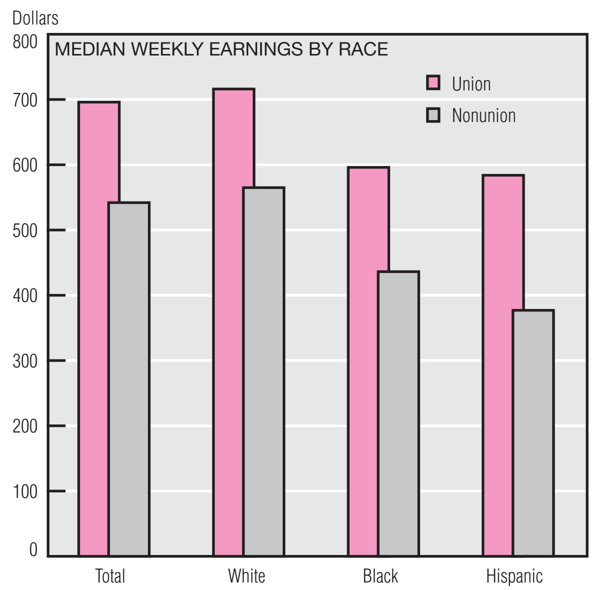
The numbers of initial unemployment insurance claims and layoff events over the past four months have been higher than in previous years. While seasonality contributes to December job-loss peaks, last year's were higher than usual (326,743 claimants and 2,677 events) due to layoffs in auto manufacturing, motion pictures, and department stores.

Union Membership









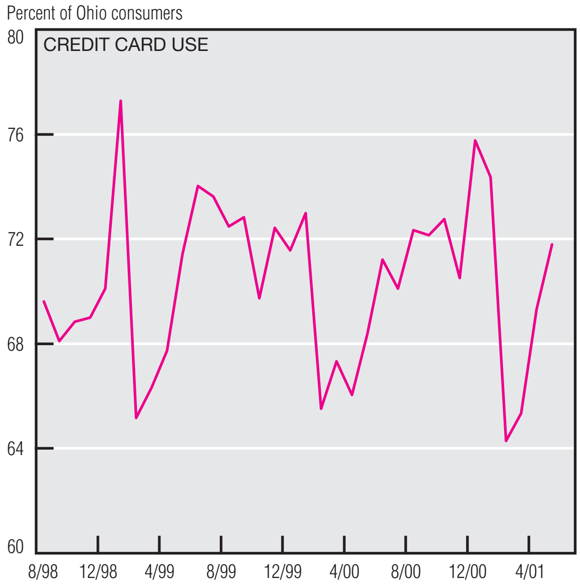
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, *Current Population Survey*, March, various years.

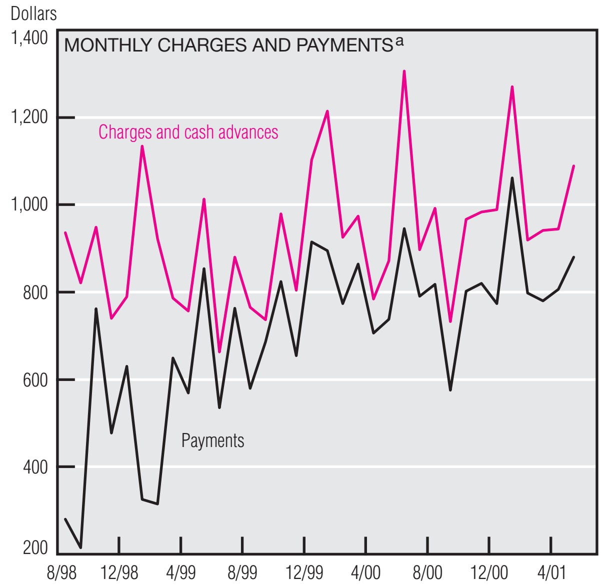
This country's 16.3 million labor union members accounted for only 13.5% of all workers in 2000, continuing the downward trend from the 20.1% membership rate reported in 1983 (the first year in which comparable data were available). Today, union membership is highest in protective services (39.4%) and government (37.5%). Geographically, higher membership rates are concentrated in the Midwest, Northeast, and Pacific regions, where rates are far above the national average of 13.5%.

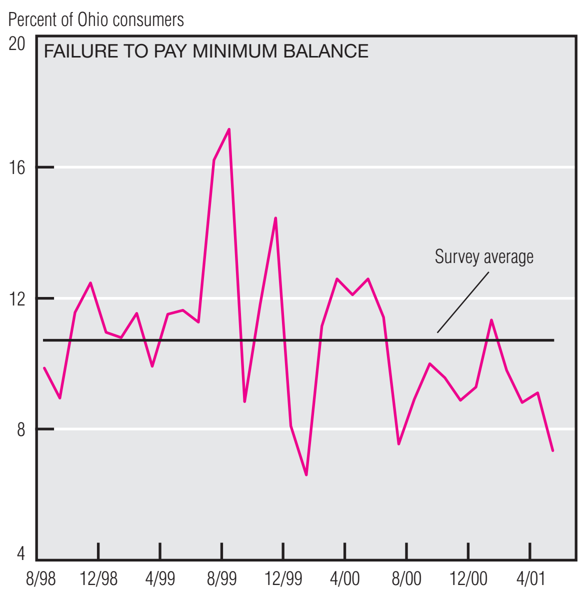
Except for workers 65 and older, union membership dropped in all age groups throughout the 1990s, but the largest drop occurred in the 55–64 group between 1990 and 1995. This presumably resulted from workforce reductions, since companies that wish to downsize frequently offer early retirement to employees in this age group.

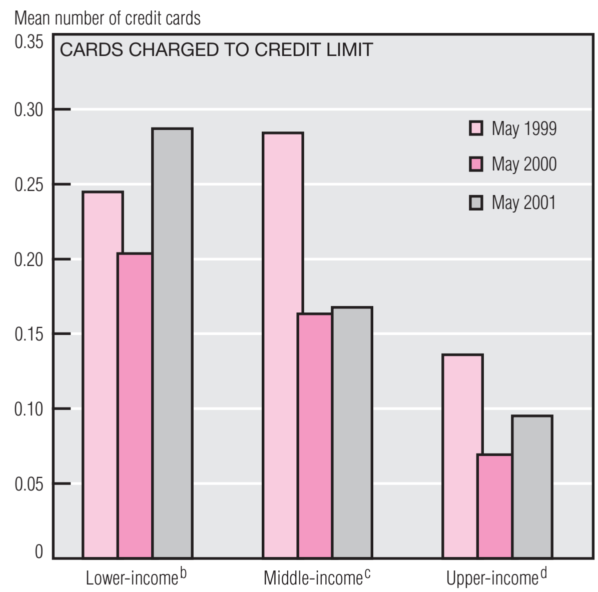
Union members' median weekly earnings consistently outpace those of nonunion workers. In general, workers who are unionized earn $154 per week more than those who are not. In every category of gender or race, union members earn more than their nonunion counterparts. Women and Hispanics seem to benefit the most from union membership, with female members earning an average of $144 more each week than female nonmembers, and Hispanics gaining an average of $207 per week with union membership.

Credit Card Use in Ohio









a. Data plotted for each month refer to expenditures and payments in the previous month. For example, the amounts reported in January 2000 refer to the amounts charged/paid on cards during the December 1999 billing cycle.
b. Annual household income of less than $30,000.
c. Annual household income of more than $30,000 but less than $75,000.
d. Annual household income of more than $75,000.
SOURCE: Federal Reserve Bank of Cleveland calculations, based on data from the Buckeye State Poll, which is conducted by The Ohio State University's Center for Survey Research.

The Buckeye State Poll is a monthly telephone survey that queries Ohio residents on a range of political, economic, and religious topics. The survey, started in September 1998, has a short history, but even within the 34 months of data accumulated so far, patterns of credit card use and indebtedness are starting to emerge.

Roughly 70% of Ohio consumers use credit cards in an average month, with annual peaks in December (the holiday shopping season) and lows in February. Data on monthly charges and cash advances, both peaking in December, also hint at seasonality.

While charges and cash advances have drifted only slowly upward, monthly payments on credit cards have climbed more rapidly since the survey began. The gap between how much consumers charge on their cards and how much they pay on them each month has been closing. In August–October 1998 (the first three months of the survey) the gap averaged $483. For the same period in 2000, the gap was roughly two-thirds smaller, at $165. (The three-month period ending in May 2001 showed a gap of $169.) Throughout 2001, survey data have shown general improvement in consumers' ability to pay down their debts. The percent failing to pay the minimum balance on their cards has declined throughout this year.

The mean number of cards that consumers have charged to their limit varies by income level. Not surprisingly, the number is highest among lower-income cardholders. Between May 2000 and May 2001, the average number of maxed-out cards rose across all income levels, although the increase in the middle-income group was negligible. While the number of

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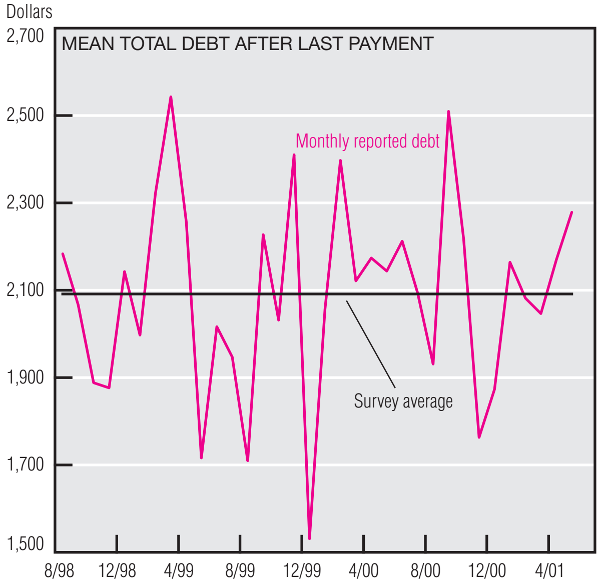
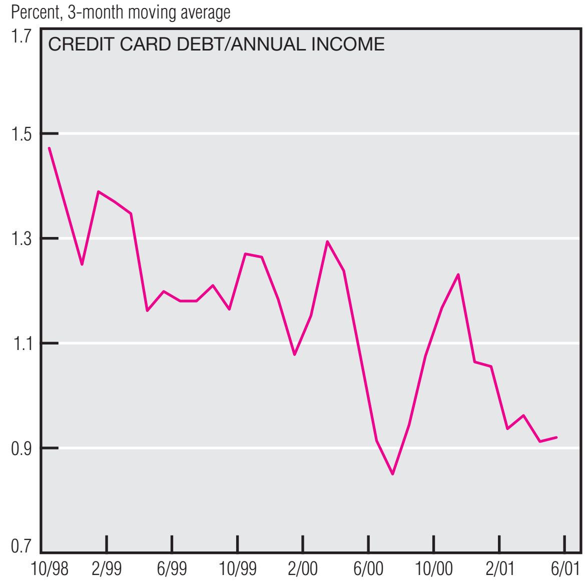
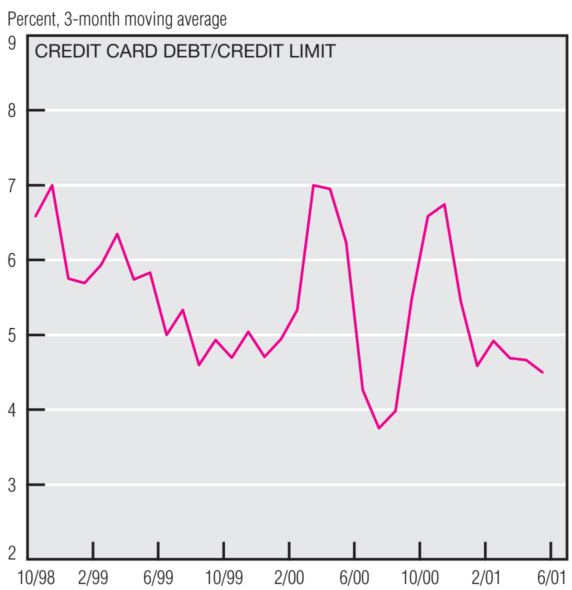
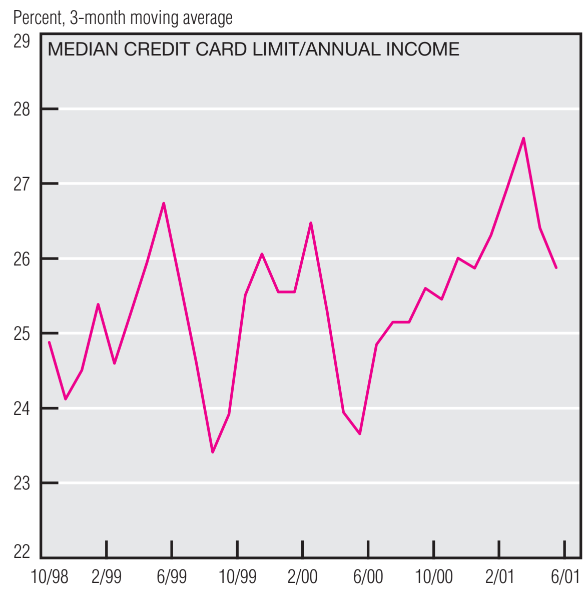
Credit Card Use in Ohio (cont.)









SOURCE: Federal Reserve Bank of Cleveland calculations, based on data from the Buckeye State Poll, which is conducted by The Ohio State University's Center for Survey Research.

cards charged to their limit has dropped since 1999 for middle- and upper-income consumers, it has increased for lower-income individuals. Whether this results from increased spending or a change in credit standards for lower-income cardholders is unclear.

The amount of debt that consumers hold on their credit cards is highly volatile; through the survey's history, debt has fluctuated around an average of about $2,100. Since November 2000, however, debt has grown notably, creating the longest period of rising debt in the survey's brief history. It is too soon to say whether this effect is seasonal or not; a similar effect occurred between November 1998 and March 1999.

Although the absolute amount of credit card debt has been drifting upward, debt as a share of income has been trending down throughout 2001, suggesting that respondents' average annual income has been growing. Similarly, credit card debt as a share of consumers' credit limit has remained fairly level since January, suggesting that credit limits have risen slightly. While consumers are using only about 4.5% of their available credit this year (an amount that, on average, accounts for less than 1% of their annual income), a look at the ratio of credit limit to annual income suggests that if consumers used all the credit available to them, they could take on debt exceeding 25% of their household income. This figure rose dramatically from June 2000 through March 2001, suggesting an increase in the amount of credit available to consumers. The drop in April and May could be the result of tightening standards, increasing incomes, or both.

Commercial Banks

a. The net interest margin equals interest income less interest expenses, both divided by average earning assets.
NOTE: Observations are annual except the last one, which is 2001:IQ in all charts.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

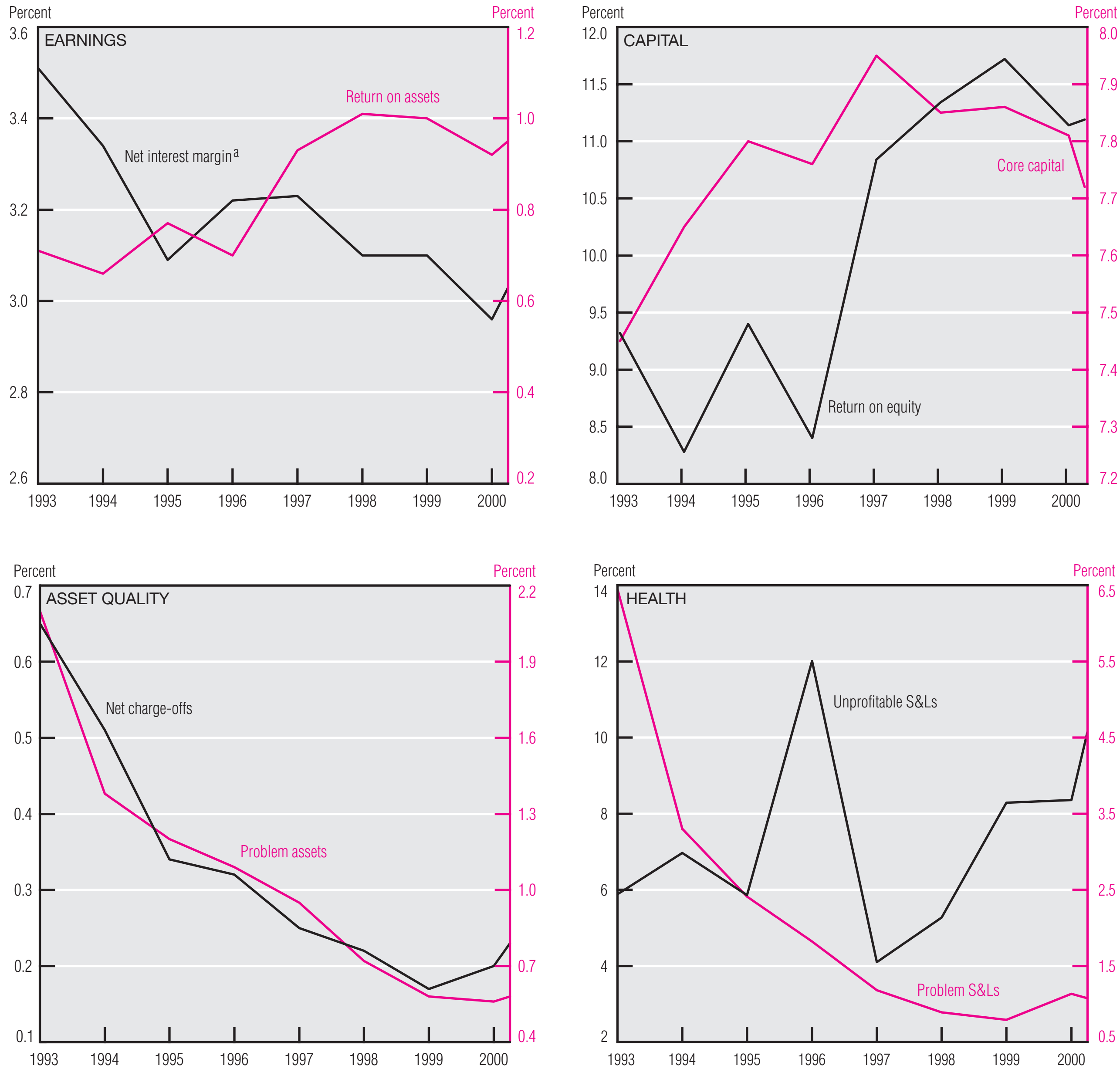
Commercial banks' quarterly earnings ($19.9 billion for 2001:IQ) surpassed the record of $19.4 billion reported for 2000:IQ. These profits translate into an annualized return on assets of 1.27% for 2001:IQ, up slightly from 1.19% for the year 2000. On the down side, capital gains realized through security sales accounted for more than 6% of first-quarter profits. Downward pressure on core earnings continued as the net interest margin for 2001:IQ fell to 3.83%, its lowest level in more than 10 years.

Return on equity for 2001:IQ was 14.78%, compared to 14.07% for the year 2000. This improvement results from the rebound in return on assets and a slight increase in leverage as core capital fell from 7.71% of total assets at year-end 2000 to 7.68% at the end of 2001:IQ. The slower economy of the past 12 months is not yet manifest as asset-quality problems in bank portfolios: Problem assets remained less than 1% of total assets. And, despite an increase of nearly 10 basis points, net charge-offs remain below the early 1990s' levels.

While first-quarter earnings improved from year-end 2000, the share of problem banks—those with substandard examination ratings—rose slightly in 2001:IQ to 0.95%. On the other hand, the share of banks that are unprofitable fell from 7.06% in 2000 to 6.86% in 2001:IQ.

Thus, while most performance indicators seem consistent with a strong banking sector, others may not be. There does appear to be continued deterioration, albeit minimal, in asset quality. Moreover, it remains to be seen whether noninterest sources of income can continue to offset declines in net interest margins.

Savings and Loan Associations



a. The net interest margin equals interest income less interest expenses, both divided by average earning assets.
NOTE: Observations are annual except the last one, which is 2001:IQ in all charts.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

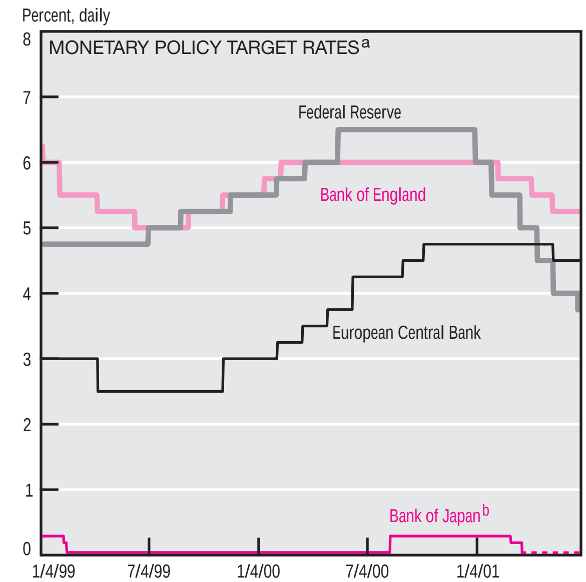
In many ways, savings associations performed like commercial banks, with first-quarter earnings of $2.9 billion (up from $2.6 billion in 2000:IVQ and unchanged from 2000:IQ). Their annualized 0.95% return on assets for 2001:IQ was marginally higher than the 0.92% posted for 2000. Like banks, they used lower interest rates to boost their first-quarter earnings $761 million through capital gains on the sale of assets. But unlike banks, savings associations benefited from a slightly wider net interest margin (3.03%).

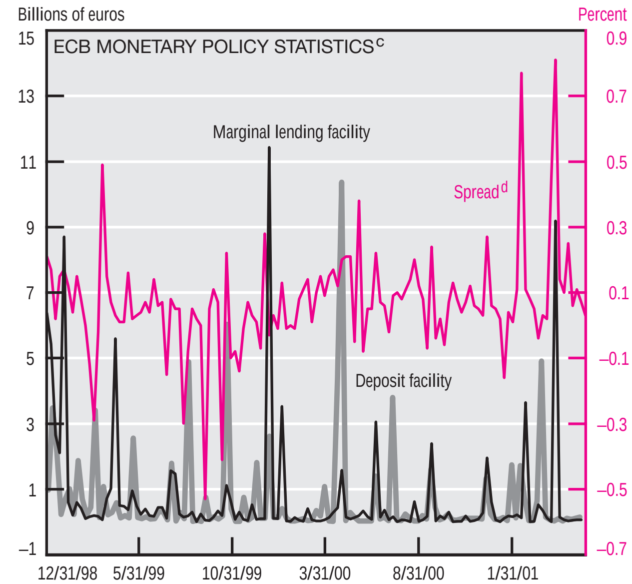
Return on equity rose from 11.14% in 2000 to 11.9% for 2001:IQ. This rise was apparently driven by the higher return on assets and a slight increase in leverage as core capital fell from 7.81% to 7.72% of total assets. Savings associations' asset-quality indicators are mixed. At the end of 2001:IQ, nonperforming assets rose slightly to 0.58% of total assets, still the second-lowest share in more than a decade, but net charge-offs rose slightly to 0.23%.

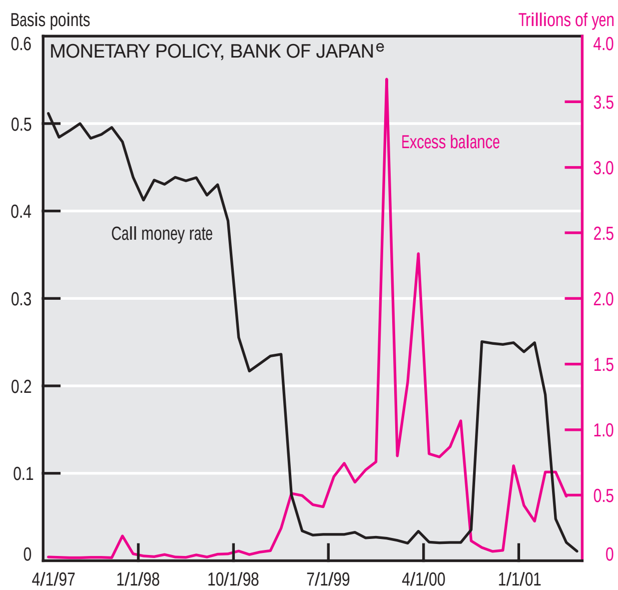
Other signs are mixed as well. Like banks, savings associations' steady or growing profits have been accompanied by a higher number of unprofitable institutions. More than 10% reported losses in 2001:IQ, the largest share since 1996. However, the share with substandard examination ratings was 1.07% at the end of 2001:IQ, down from 1.13% at the end of 2000.

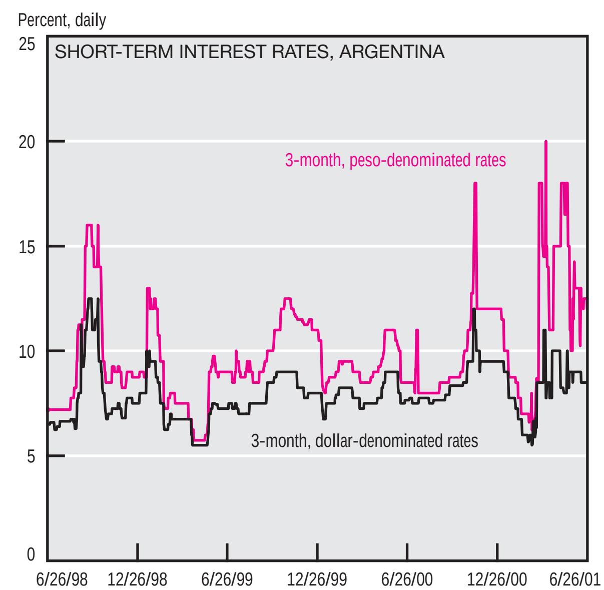
Most performance indicators suggest little change in the health of savings associations. Like commercial banks, they currently show only minor effects of the slowing economy.

Foreign Central Banks









a. Overnight interbank rates for U.S. and Japan. Two-week repo rates for the euro area and the U.K.
b. On March 19, the Bank of Japan shifted to a target for the quantity of current account balances at BOJ that is expected to be consistent with a zero rate.
c. Weekly averages.
d. Spread between euro overnight interbank average index and main refinancing operations rate.
e. One-month averages for reserve maintenance period ending June 15.
SOURCES: Board of Governors of the Federal Reserve System; European Central Bank; Bank of Japan; and Wholesale Markets Brokers Association.

Major central banks made no changes in operating targets in June until the Federal Reserve announced a rate cut of 25 basis points (bp) on June 27.

Lombard facilities give banks relatively unimpeded access to central bank loans, but at a substantial spread above a central bank's operating target rate. This suggests that Lombard borrowing would be minimal unless the overnight rate were to rise close to the Lombard rate. For the European Central Bank, weekly average data obscure any relationship that might be apparent on a daily basis. But even weekly data show a positive correlation of 0.26 between borrowing and the rate spread.

The Bank of Japan's current monetary policy focuses on supplying far more reserves than its banking system needs to meet reserve requirements. Excess balances were large when the call-rate operating target was zero, but declined briefly last year with a higher (25 bp) call-rate target.

Argentina has struggled with currency risk, evident in the gap between dollar and peso interest rates. Its Currency Board, created in 1991, pegged the peso to the U.S. dollar, one for one. Newly approved legislation pegs the peso to the average value of the dollar and the euro at the time when those two currencies next reach parity. Meanwhile, non-energy importers must pay a variable premium when converting pesos to dollars, while non-energy exporters will receive the same premium when converting dollars to pesos. The premium, currently about 7%, diminishes (increases) as the euro moves toward (away from) parity with the dollar.