

The Economy in Perspective

One step back, two steps onward... Last month, the National Bureau of Economic Research's Business Cycle Dating Committee announced that U.S. economic activity peaked in March. The NBER arrived at this conclusion after determining that business conditions had subsequently deteriorated in production, inventories, and employment among a broad range of industries. That the peak is now being dated in March came as a surprise to those who thought that the September 11 tragedy pushed the economy over the edge. To others, especially those who follow manufacturing conditions, March seems too late: Many manufacturers date the peak in their activity sometime in the last quarter of 2000.

Recessions occur when total demand for goods and services unexpectedly falls short of what has been produced. Economic activity declines, and several months or more elapse before total spending growth resumes. Since manufactured goods are readily storable, the inventory management process often plays a prominent role in determining business cycle dynamics. As undesired inventories accumulate throughout the supply chain, firms scale back orders and production until the imbalances are corrected. The longer demand is expected to remain depressed, the more forcefully will companies curtail their inventory positions and production schedules. Moreover, earnings losses associated with the first-round effects of this process have the potential to spill over into other economic sectors, retarding spending even further.

During the long business cycle expansion that recently ended, the fortunes of U.S. manufacturers varied considerably because of two fundamental forces, international trade and technology. By now the story is a familiar one. When the Berlin Wall came down, trade barriers tumbled immediately after. Trade flourished in the 1990s as a consequence of liberal trade policies and global economic expansion. From 1992 to 2000, the sum of all U.S. exports and imports as a share of GDP expanded from 20 percent to 30 percent. Trade in manufactured goods accounted for the greatest part of that increase.

At the same time, the U.S. economy was booming, led by extremely vigorous capital spending, especially for high-tech goods. In the last half of the 1990s, trade in capital goods expanded more rapidly than in any other category of trade; within that sector, high-tech equipment set the pace. When the high-tech sector turned around, it did so abruptly, collapsing seemingly overnight. Although

the long-term prospects of the high-tech sector appear to be bright, an adjustment period of unknown dimensions still lies ahead.

Long-term prospects for the steel, apparel, lumber products, and textile industries seem less certain. Total U.S. industrial production increased roughly 50 percent during the recent economic expansion, but steel output rose only 30 percent and lumber products just 15 percent. Textile output did not expand at all, and apparel products' production fell 10 percent. Even though there are some well-run U.S. firms in these industries, the sectors as a whole have struggled to compete with highly efficient foreign facilities. In many cases, lower labor costs abroad make the difference.

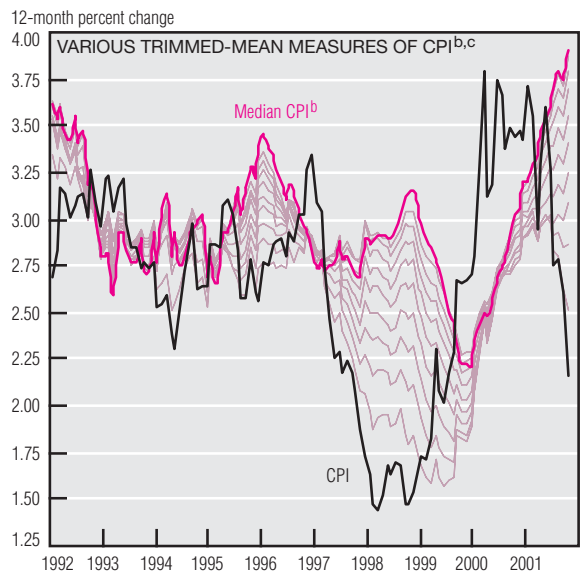
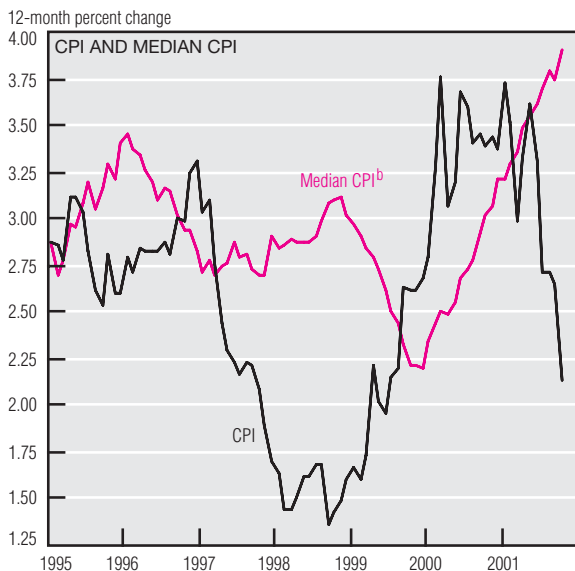
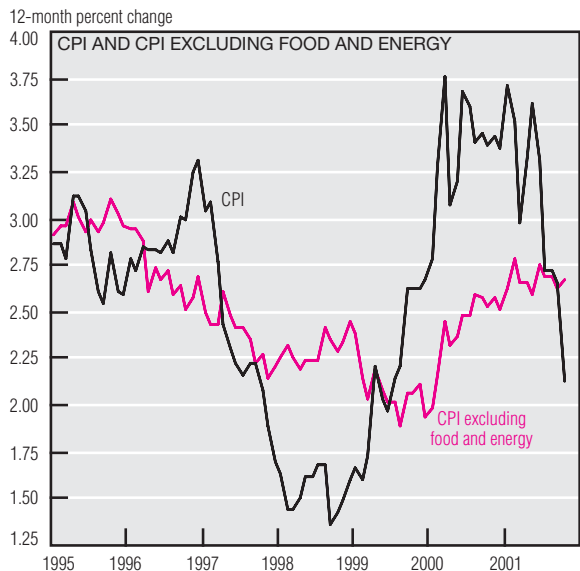
At the macroeconomic level, the rise and fall of various industries over time is driven by the comparative advantages of nations, and leads to a reallocation of resources around the world. In the United States during the past few decades, relatively more capital has been channeled to companies using sophisticated technology and highly educated employees than to low-tech firms with unskilled workers. The U.S. comparative advantage has become based in knowledge; it is the knowledge-based companies in both the manufacturing and service sectors that are absorbing resources and growing. And as this evolution slowly unfolds, the proportion of U.S. employment devoted to services, rather than goods production, continues to creep upward.

Most economists describe U.S. recessions as being of relatively short duration, and—compared with the long periods of expansion we have enjoyed during the past 20 years—recessions are indeed brief. Activity declines for roughly six months, on average, and then growth resumes. Economic activity generally takes much longer, however, to return to the level it had attained at its prior business cycle peak. Real GDP and personal income, for example, typically take about 18 months to attain this benchmark, and industrial production and employment require about two years.

Even as the United States learns it is in recession, we know that the seeds of the recovery are already being sown. Optimism for the future is more than a matter of faith—it is based on past experience. That same experience, however, informs us that our future will not look the same as our past. When we have reached the next summit, the landscape will have changed.

Inflation and Prices

	Percent change, last:				2000 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	-4.0	0.5	2.1	2.3	3.4
Less food and energy	1.9	2.4	2.7	2.4	2.5
Median ^b	5.1	4.1	3.9	3.0	3.2
Producer prices					
Finished goods	-17.9	-3.7	-0.4	1.0	3.6
Less food and energy	-6.2	-1.3	0.8	1.0	1.3



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 c. A trimmed mean is calculated by discarding a certain percent of the lowest and highest price changes and then computing the mean of the rest. For example, a mean trimmed 10% is computed by discarding the lowest 5% and the highest 5% of price changes and taking the mean of the remaining price-change observations.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The consumer price index (CPI) fell an annualized 4% in October, largely because of a sharp (53% annualized) decline in energy prices. The drop in gasoline prices was particularly steep (about 74% annualized). Core CPI, a measure of retail inflation that excludes the volatile food and energy components, has shown a steadier trend. By this measure, inflation has averaged slightly less than 2¾% (annualized) since 2000.

There are many months, however, when food and energy price changes are not particularly volatile, but other

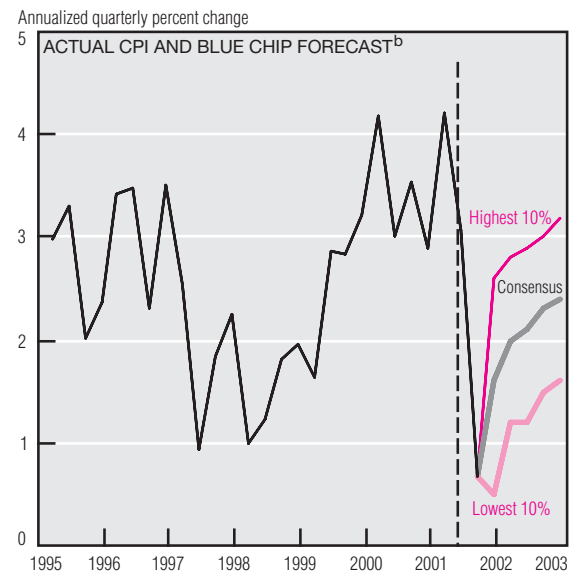
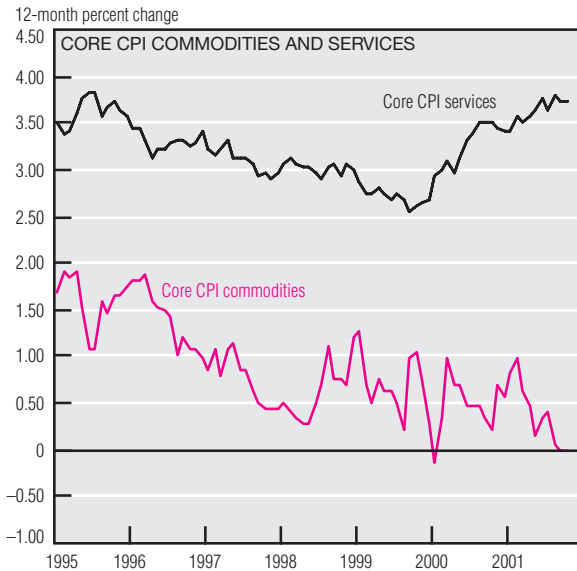
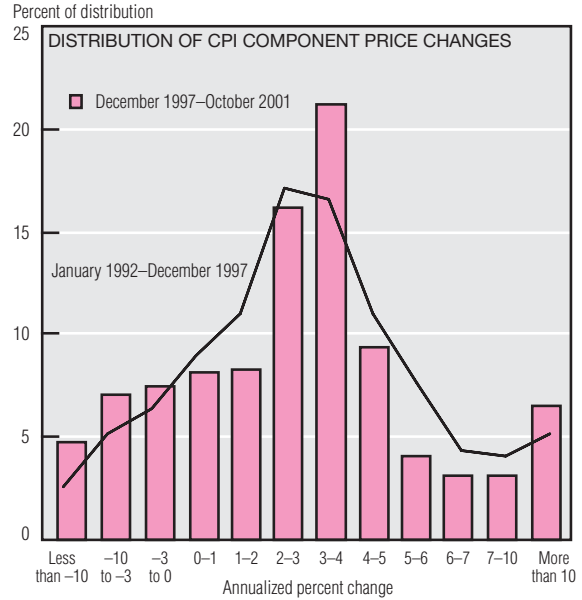
CPI components experience wide, presumably temporary, price swings. For these months, excluding food and energy prices from the calculation is not likely to yield a more reliable estimate of the economy's underlying inflation trend. A less arbitrary approach involves eliminating the observations at both ends (tails) of the price-change distribution and averaging the observations that remain. Such a statistic is a *trimmed mean*. The bottom right chart shows a set of these measures, which are trimmed by amounts ranging from 10% to 90% of observations.

An extreme example of this approach is a median. When constructing the median CPI, we eliminate every observation in the price-change distribution except the one that lies in the middle. Eliminating fewer and fewer observations, of course, produces inflation estimators that are less and less trimmed, until—at the other extreme from the median—we leave the entire price-change distribution intact. This mean statistic is the official CPI. Since 1997, the growth trends of the CPI and the median CPI have diverged

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Inflation and Prices (cont.)

Tails of the CPI Price-Change Distribution			
	Market basket weight ^a	12-month percent change	Annualized 3-year percent change
<i>Low</i>			
Motor fuel	3.3	-12.6	8.6
Fuel oil and other fuels	0.3	-11.7	12.0
Car and truck rental	0.1	-6.6	-1.3
Women's and girls' apparel	1.7	-4.5	-1.8
Lodging away from home	2.3	-3.4	1.3
<i>High</i>			
Miscellaneous personal services	1.5	4.7	4.1
Dairy and related products	1.1	5.5	3.3
Motor vehicle insurance	2.5	5.7	2.4
Education	2.9	5.9	5.4
Tobacco and smoking products	1.4	8.4	14.7



a. Relative importance of component, October 2001.
 b. Blue Chip panel of economists.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Blue Chip Economic Indicators*, November 10, 2001.

substantially, with the various trimmed-mean measures falling between the two. But even eliminating only the most extreme observations can make a considerable difference in the inflation estimate. Since 2000, eliminating only the most extreme 5% from each end of the price-change distribution produced a statistic that typically showed a closer resemblance to the median CPI than to the CPI.

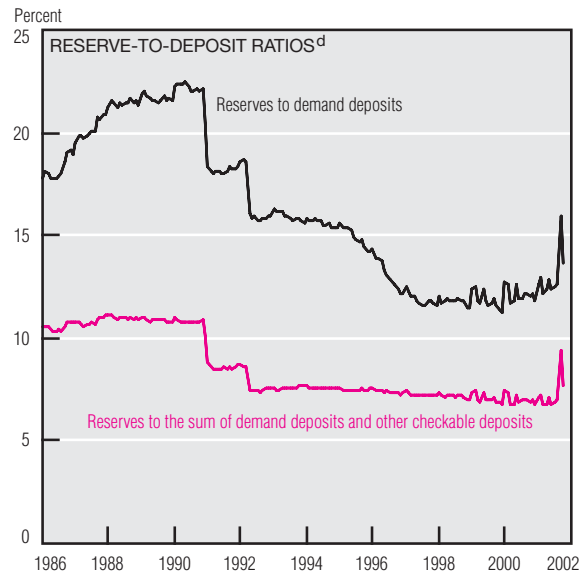
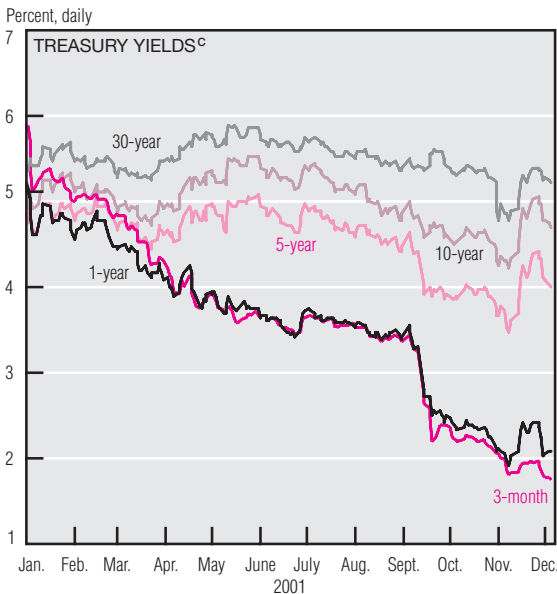
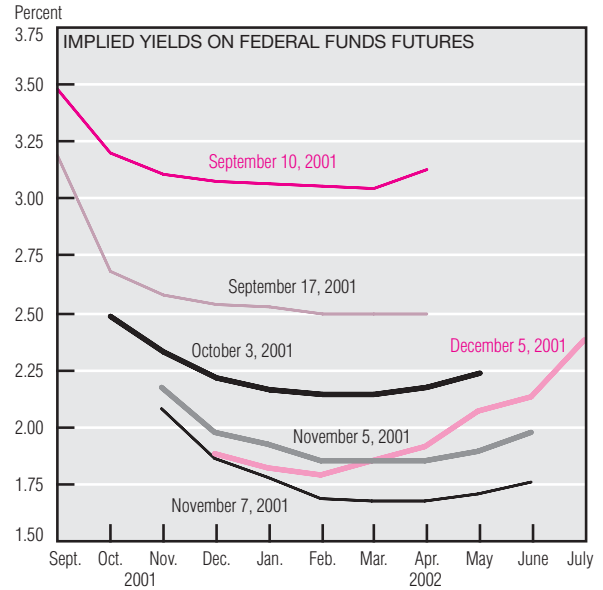
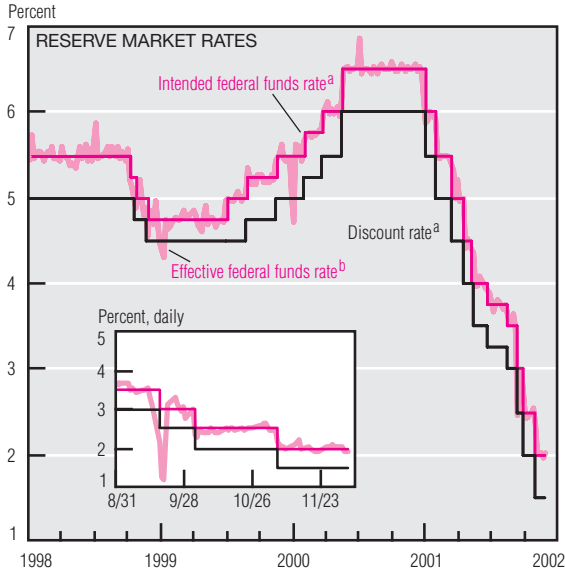
Indeed, for much of the post-1997 period, the price-change distribution has been exceptionally peaked and skewed. That is, substantial price

declines in a number of CPI components have been only partially offset by price increases in an even broader set of components. As a result of this asymmetry, the 12-month percent changes of all trimmed-mean estimators persistently exceeded the 12-month percent change in the CPI from 1997 to 1999, and have again risen far more than the CPI in 2001.

Over the most recent 12 months, energy and apparel prices and prices associated with travel have declined very sharply, while several services and a few goods such as tobacco and dairy

products have shown pronounced price increases. This pattern can easily be seen in the recently increasing divergence between the price increases for non-food, non-energy consumer goods compared to services. Such mixed signals from the price data probably explain much of the difference between professional economists' most optimistic and most pessimistic inflation forecasts. The consensus forecast sees an abrupt uptick in inflation as energy price declines subside, followed by a gradual increase in inflation over the course of 2002.

Monetary Policy



- a. Daily.
 b. Weekly average of daily figures.
 c. Constant maturity.
 d. Monthly data, not seasonally adjusted. Total reserves are not adjusted for changes in reserve requirements.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Selected Interest Rates," H.15, "Factors Affecting Reserve Balances," H.4.1, and "Money Stock and Debt Measures," H.6; Chicago Board of Trade; and Bloomberg Financial Information Services.

At its November 6 meeting, the Federal Open Market Committee lowered the intended federal funds rate 50 basis points (bp) to 2%. Its press release stated that the "necessary reallocation of resources to enhance security may restrain advances in productivity for a time." Separately, the Board of Governors approved Reserve Bank requests for a 50 bp reduction in the discount rate to 1.5%.

From November 5 to November 7, implied yields on federal funds futures fell between 8 bp and 21 bp across maturities. Market participants now

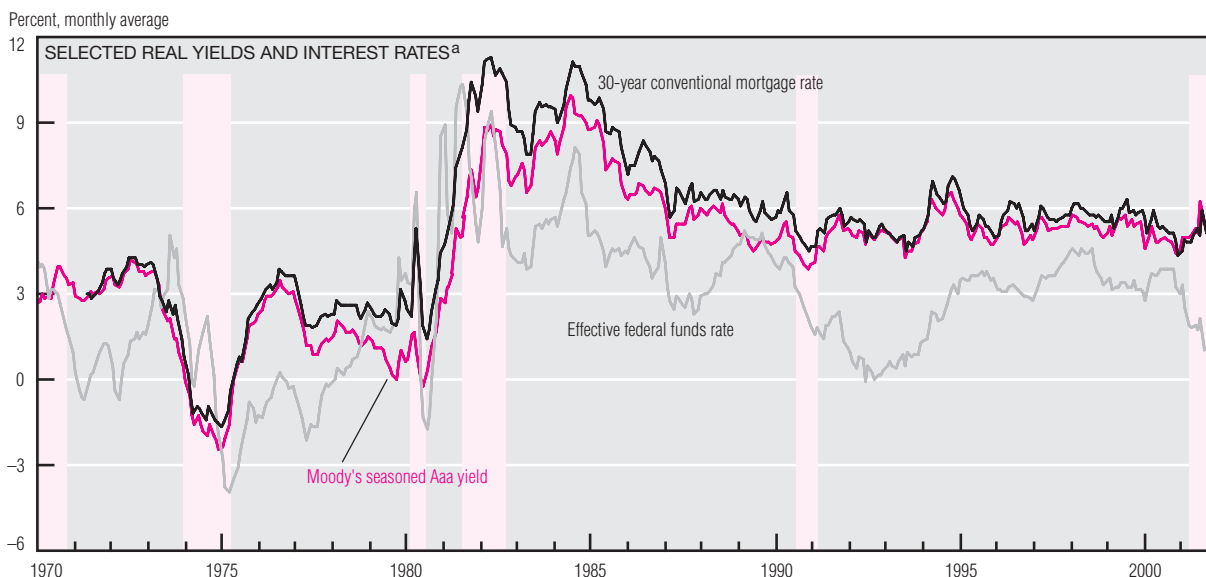
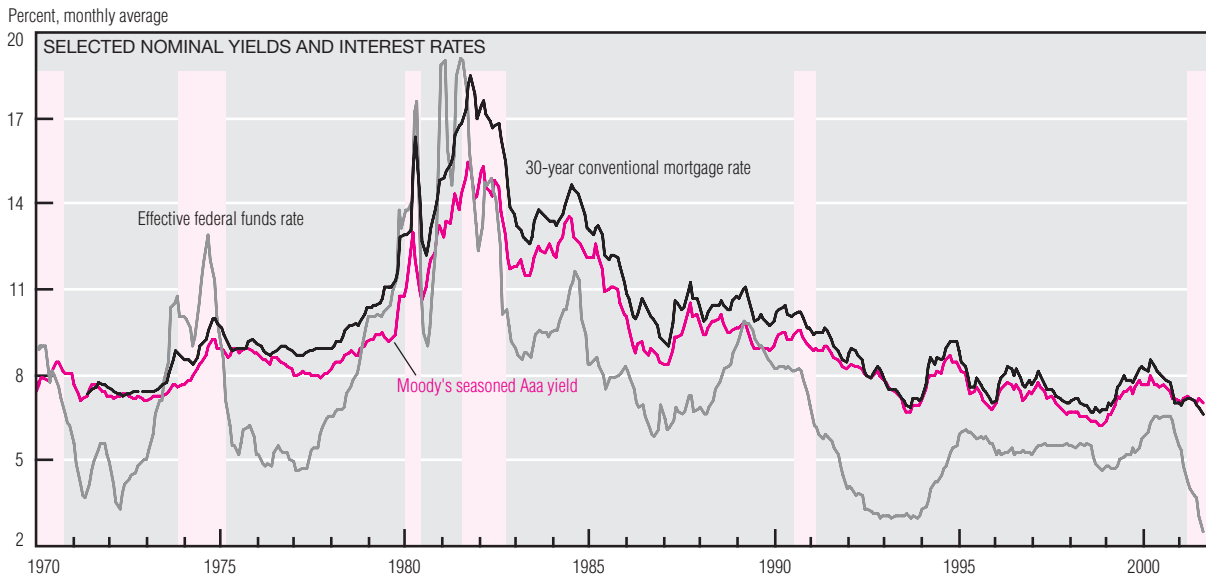
expect a funds rate cut of no more than 25 bp at the December meeting. Current implied yields suggest that they also expect a round of policy tightening to begin early next year.

On October 31, the U.S. Treasury announced that it would no longer issue 30-year Treasury bonds, setting off a yield drop of more than 40 bp in the days that followed. Treasury yields rebounded in the first part of November, only to decline later in the month.

Depository institutions must hold reserves equal to a specified fraction of certain classes of deposits. From December 1990 to January 1991, the

reserve requirement on nonpersonal time deposits was eliminated. In April 1992, the highest tier of reserve requirements on transaction deposits was reduced from 12% to 10%. Increased volatility in the measured reserve-to-deposit ratio, beginning in 1998, probably results from the shift to a system of lagged reserve accounting, which loosened the link between deposits and the contemporaneous level of reserves. After September 11, the reserve-to-deposit ratio spiked as disruptions caused banks to increase holdings of excess reserves.

Money and Financial Markets



NOTE: Shaded areas mark NBER-defined recessions.

a. Nominal rates and yields minus the 12-month percent change in the Personal Consumption Expenditure Chain-type Price Index.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Selected Interest Rates," H.15; and National Bureau of Economic Research, Inc.

Many interest rates have fallen to their lowest levels in 30 years (except for a brief period in 1998 after the Asian financial crises and the Russian default). The benchmark effective federal funds rate averaged just 2.49% in October. After the Federal Open Market Committee's November 6 decision to cut the intended federal funds rate 50 basis points (bp) to 2%, the fed funds rate fell even further, averaging just 2.01% for the week ending November 21. Likewise, financing costs for both individuals

and corporations have dropped: The average 30-year conventional mortgage rate was 6.62% in October, and the Aaa-rated corporate bond yield dropped to 7.03%. In November, despite a rate cut, the 30-year mortgage rate and Aaa yield moved upward, averaging 6.75% and 7.16% for the week ending November 21.

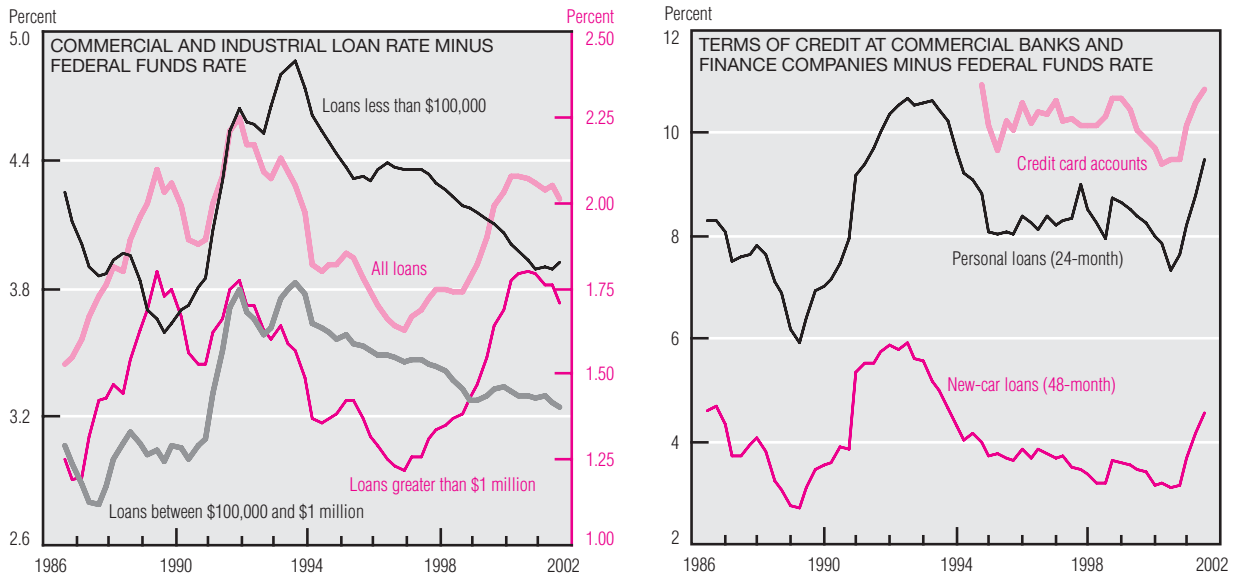
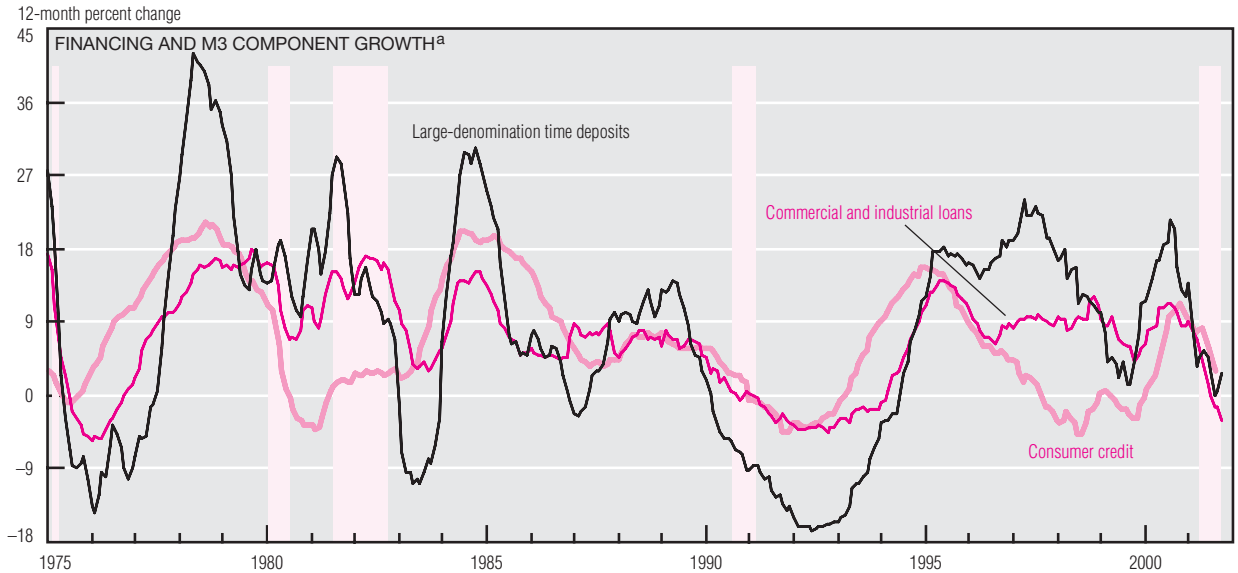
None of this should be terribly surprising. During periods of economic weakness, the Fed characteristically pursues an aggressive policy of rate cutting to avoid retarding recovery.

Although most private-sector yields are not tied directly to the fed funds rate, they tend to follow a similar pattern over longer periods. On November 26, the National Bureau of Economic Research's (NBER) Business Cycle Dating Committee announced that the longest economic expansion in U.S. history ended early this year, confirming many analysts' contention that the U.S. economy is experiencing a recession.

What may seem surprising is that the real costs of borrowing have not

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Money and Financial Markets (cont.)



a. Shaded areas mark NBER-defined recessions.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Survey of Terms of Business Lending," E.2, "Consumer Credit," G.19, "Money Stock and Debt Measures," H.6, and "Assets and Liabilities of Commercial Banks in the United States," H.8; and National Bureau of Economic Research, Inc.

reached historical lows comparable to the nominal costs. Estimates of real interest rates subtract from nominal interest rates the portion that lenders may demand to cover inflation. The real effective fed funds rate, while lower than in recent years, has yet to dip below levels experienced in the early 1990s and is far from the lows of the mid-1970s and early 1980s. Real 30-year mortgage rates and Aaa yields have risen in the course of this year, behavior that is consistent with a belief that long-term prospects have

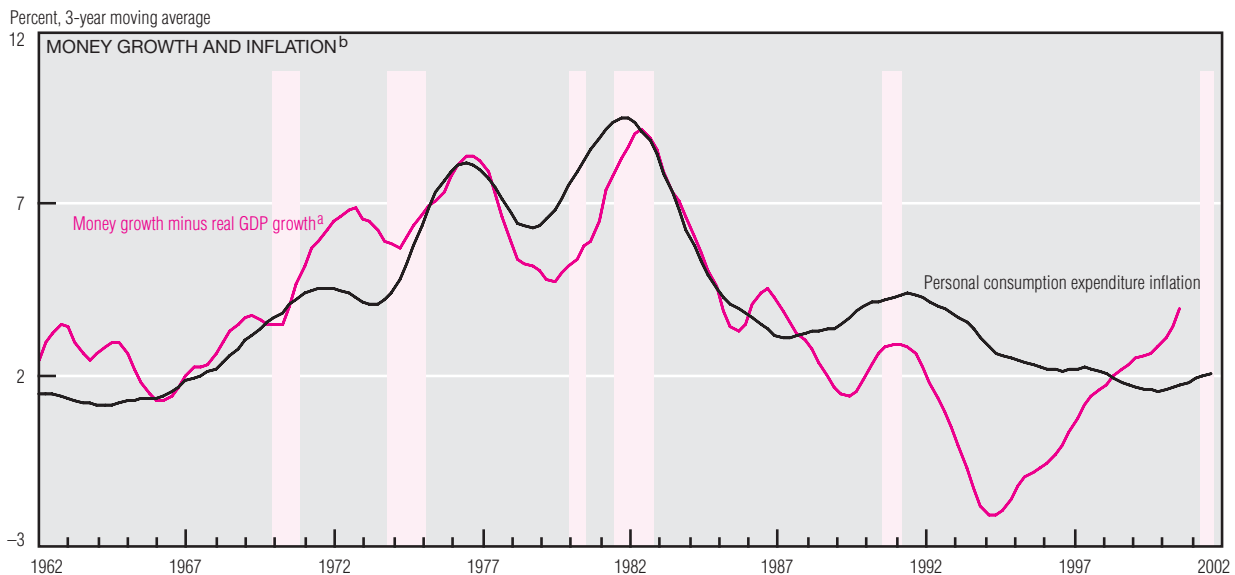
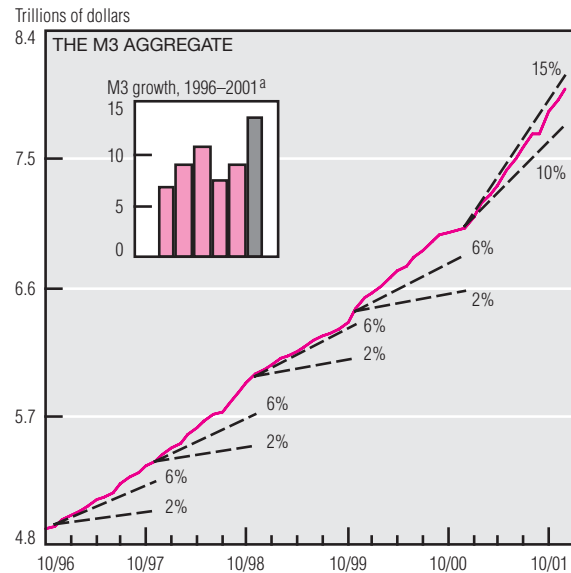
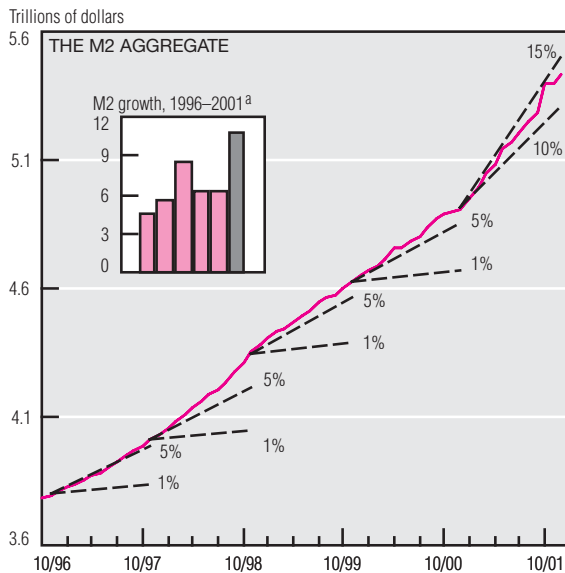
improved and the economy may be headed for recovery. Ultimately, real rates should reflect the economy's long-term growth potential.

Other things being equal, low real interest rates and bond yields favor borrowers. However, commercial and industrial (C&I) loans and consumer loans have fallen sharply in 2001. C&I loan growth averaged 9.4% (12-month percent change) in 2000 but only 2.8% during the first 10 months of 2001. Banks may finance C&I loans by issuing certificates of deposit, which are counted within

the large (greater than \$100,000) time deposit component of the M3 monetary aggregate. (C&I loans and large time deposits show a high correlation—0.86 since 1975.) Large time deposits' growth rate has fallen almost exactly in step with C&I loans, from a 15.9% average last year to 4.7% in the first 10 months of this year. Although consumer credit growth increased slightly over the same horizon, from an average of 6.1% in 2000 to 6.8% so far this year, consumer loan growth peaked in

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Money and Financial Markets (cont.)



NOTE: Last plots for M2 and M3 are estimated for November 2001. Dotted lines for M2 and M3 are FOMC-determined provisional ranges. Prior to November 2000, dotted lines are FOMC-determined provisional ranges. Subsequent dotted lines represent growth in levels and are for reference only.

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 an estimated November over 2000:IVQ basis. Data are seasonally adjusted.

b. Shaded areas mark NBER-defined recessions.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6; and National Bureau of Economic Research, Inc.

October 2000 and has been declining steadily ever since.

The spread between C&I loan rates and the fed funds rate—a measure of the premium that business borrowers must pay—has been nearly flat, while the spread between the fed funds rate and various types of consumer loan rates has increased markedly. From 2000:IVQ to 2001:IIIQ, spreads on new car loans, personal loans, and credit card accounts rose 1.43, 1.88, and 1.36 percentage points, respectively. It seems plausible that the decline in commercial lending reflects economic

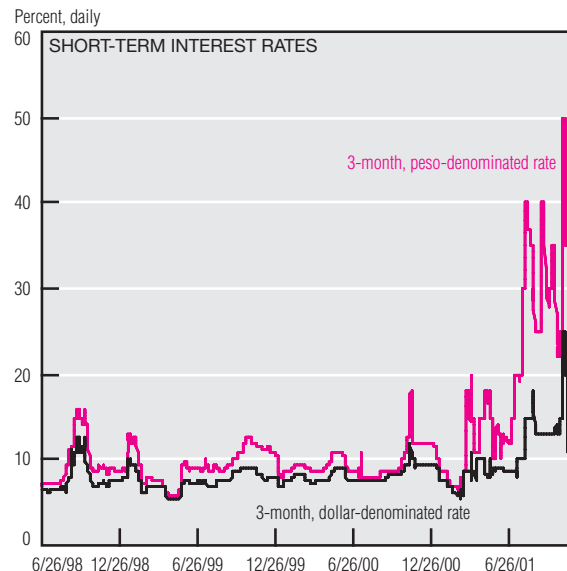
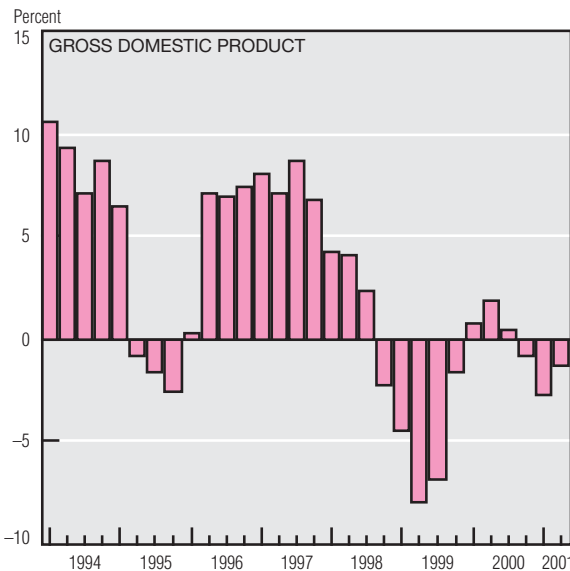
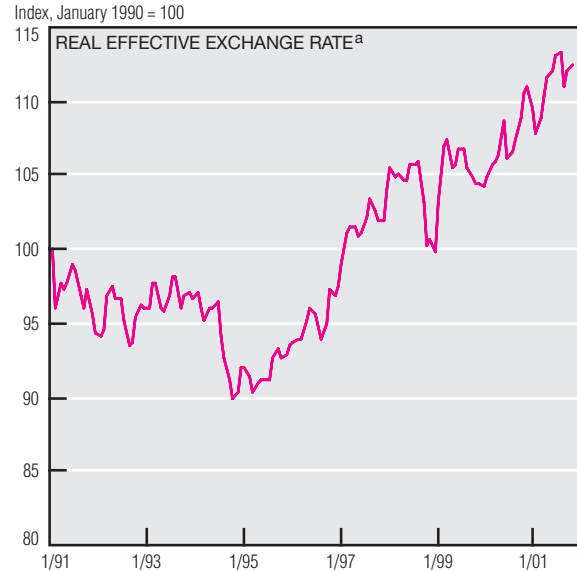
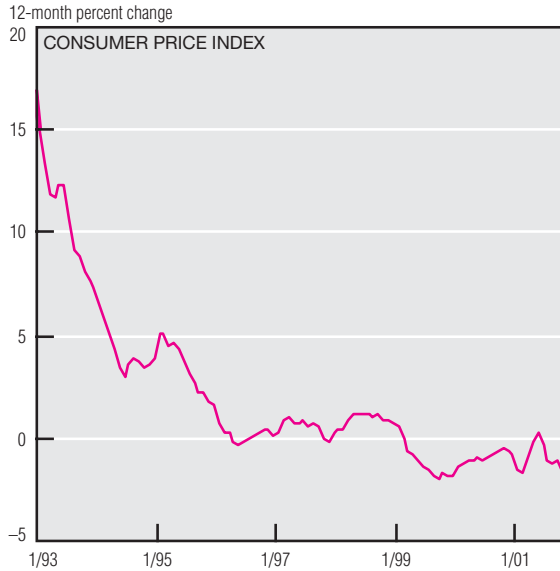
uncertainty, while the drop in consumer borrowing may be related more directly to increases in the real cost of borrowing.

Changes in the real cost of borrowing and lending are eventually reflected in the growth of monetary aggregates through their opportunity cost. As nominal interest rates fall, it is less costly to own non-interest-bearing financial assets, and individuals often prefer to hold safer, more liquid assets. The broad monetary aggregates (M2 and M3) are growing faster now than at any time in the last 15 years. Esti-

ated November year-to-date growth is 10.7% for M2 and 13.9% for M3.

The Quantity Theory says that inflation will reflect the excess of money growth over real GDP growth when velocity is reasonably stable. Velocity was almost trendless for the three decades prior to the 1990s, but then drifted upward, allowing money growth to decelerate relative to inflation. If velocity were to stabilize around the higher levels of the late 1990s, the recent breakneck pace of money growth could bring a fresh bout of inflation.

Argentine Monetary Policy



a. The real effective exchange rate is a trade-weighted average of bilateral exchange rates between Argentina's peso and the currencies of its major trading partners. Because it also adjusts for inflation patterns in each country, it provides a good indication of Argentina's international competitive position. An increase in the index represents an appreciation.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund; J.P. Morgan Securities, Inc.; and Bloomberg Financial Information Services.

Many commentators blame Argentina's current economic problems on its decision to peg the peso one-for-one to the U.S. dollar. This policy has caused the peso to appreciate on a real effective basis, eroding Argentina's international competitiveness and weakening its economic growth. Without exchange rate flexibility, adjustment can come only through wage and price declines, which proceed slowly. Many believe that devaluing the peso could lift the country from its economic malaise,

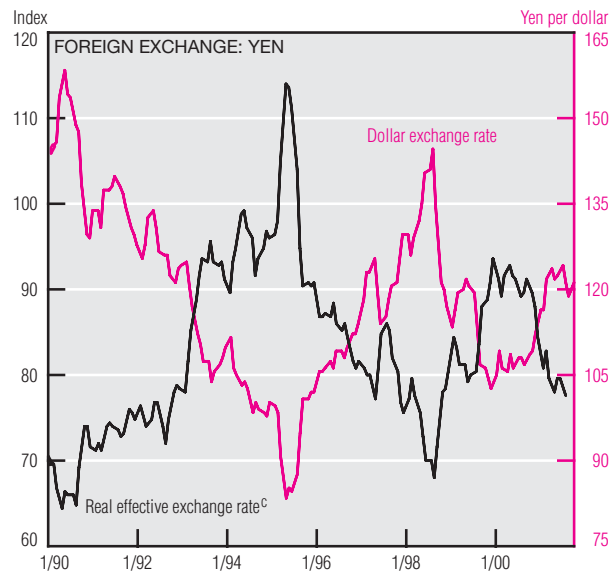
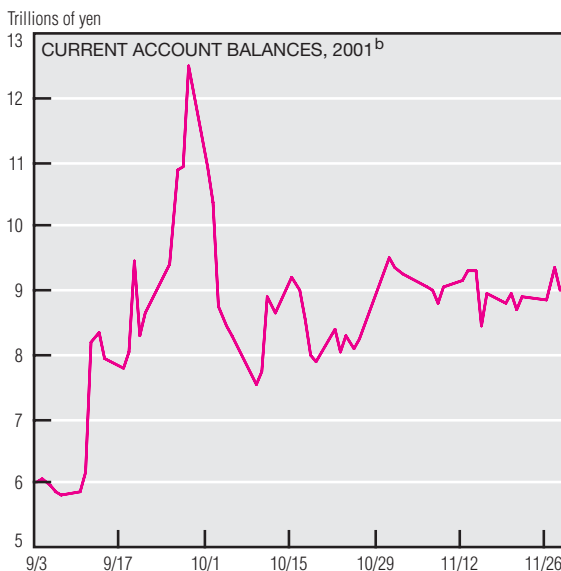
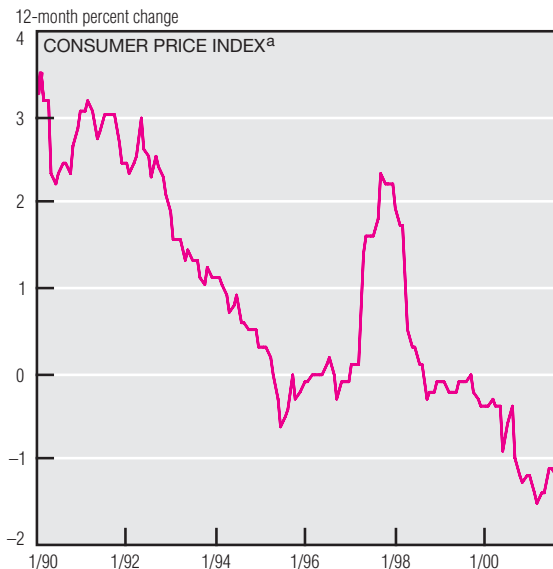
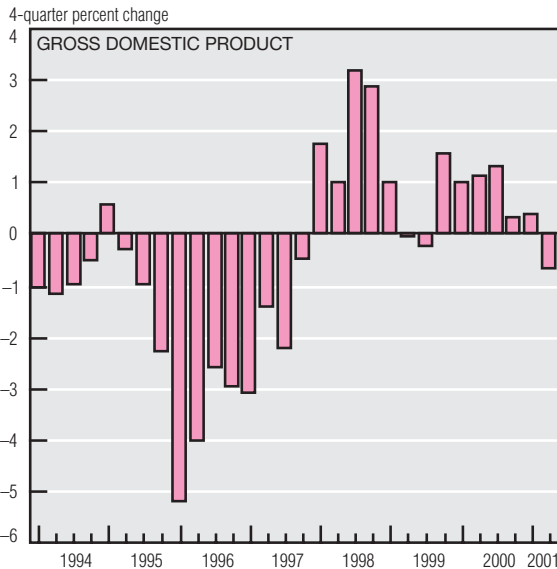
but devaluation could seriously scar Argentina's credibility.

Despite the peso-dollar peg, Argentina remains highly dollarized. This results partly from lingering doubts about the currency peg's permanence, which stem from Argentina's recurrent, worsening fiscal problems. Spreads between peso and dollar interest rates also reflect these doubts. Only recently has the country taken steps to rationalize a fiscal process that formerly promoted deficit spending and saddled the country with large public debts.

Argentina further rattled markets in early November with a debt-restructure plan that would require investors to accept lower-yielding bonds. Some viewed the plan as tantamount to default.

Whatever its macro benefits, devaluation would impose a harsh burden on the many Argentinians who have net dollar obligations. By raising doubts about the peso's future value, devaluation would probably encourage further dollarization.

Japanese Monetary Policy



a. The temporary rise in Japan's CPI between mid-1997 and mid-1998 reflects the imposition of a broad-based 2% sales tax in 1997.

b. Current account balances are mostly commercial bank required and excess reserves held on deposit at the Bank of Japan.

c. The real effective exchange rate is a trade-weighted average of bilateral exchange rates between Japan's yen and the currencies of its major trading partners. Because it also adjusts for inflation patterns in each country, it provides a good indication of Japan's international competitive position. An increase in the index represents an appreciation.

SOURCES: Board of Governors of the Federal Reserve System; and Bank of Japan.

Japan's economy has contracted, and the price level there has fallen for much of the last decade. Prospects for a quick turnaround seem dim. Some economists believe that near-zero short-term interest rates and falling aggregate price levels have stymied monetary policy. They call on the Bank of Japan (BOJ) to announce an inflation target a few percentage points above zero and to pursue it aggressively, perhaps by financing a further fiscal expansion. The expectation of higher future inflation, these observers contend, would spur consumption and investment today.

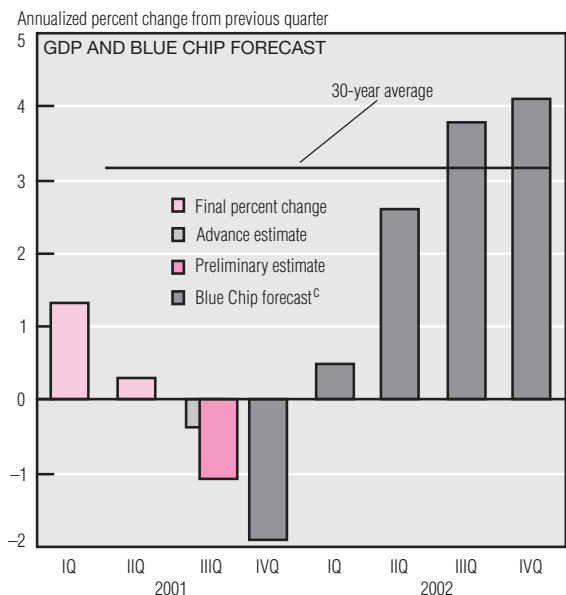
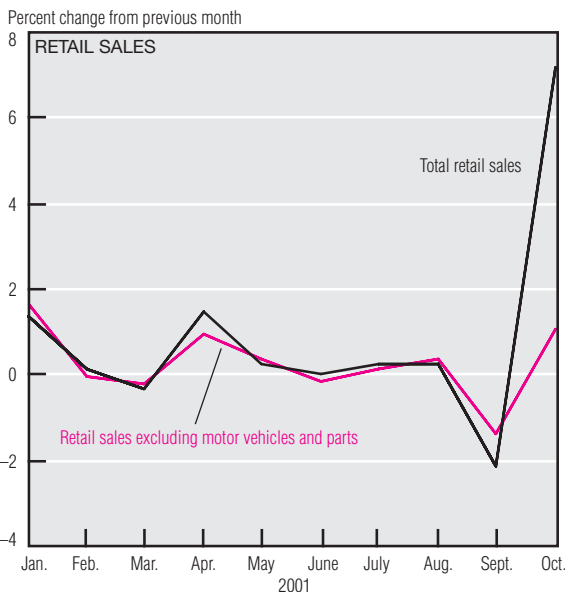
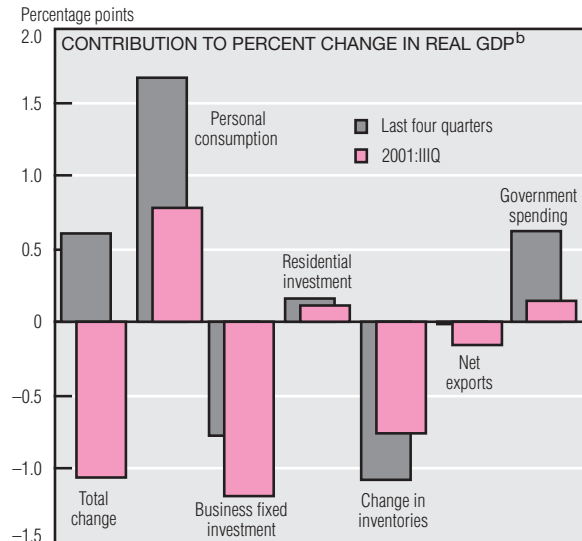
They applauded the BOJ's decision last March to focus policy on the quantity of bank reserves it supplies instead of on short-term interest rates and to increase its holdings of government securities to achieve that target. Since September 11, the level of current account balances has jumped from Y6 trillion to about Y9 trillion.

Other economists contend that in an open economy with floating exchange rates, near-zero interest rates need not neutralize monetary policy. They want the BOJ to focus monetary policy on an exchange rate target and expand bank reserves by

buying foreign exchange (for example, dollars) instead of government debt. They believe that this would promote a yen depreciation, spur Japanese exports, and induce the nation's consumers to shift from imports to domestically produced goods. The Bank of Japan temporarily increased its current account balance to Y12.5 trillion in late September through foreign exchange interventions. Although the yen has depreciated recently, on a real effective basis it has appreciated since 1990.

Economic Activity

Real GDP and Components, 2001:IIIQ ^{a,b} (Preliminary estimate)	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	-24.9	-1.1	0.6
Personal consumption	18.1	1.1	2.5
Durables	1.7	0.7	3.9
Nondurables	2.4	0.5	0.9
Services	13.7	1.5	2.9
Business fixed investment	-31.8	-9.3	-6.0
Equipment	-25.1	-9.3	-7.6
Structures	-6.8	-9.3	-1.0
Residential investment	2.3	2.5	3.9
Government spending	3.2	0.8	3.6
National defense	2.3	2.6	5.7
Net exports	-1.4	—	—
Exports	-52.8	-17.7	-9.0
Imports	-51.3	-12.9	-6.8
Change in business inventories	-21.8	—	—



a. Chain-weighted data in billions of 1996 dollars. 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.

b. All data are seasonally adjusted and annualized.

c. Blue Chip panel of economists.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and *Blue Chip Economic Indicators*, November 10, 2001.

Preliminary gross domestic product (GDP) was revised downward 0.7 percentage point from the advance estimate; it fell at a 1.1% annualized rate in 2001:IIIQ. The preliminary estimate of personal consumption growth was positive but slightly lower than the advance estimate; it grew at a paltry 1.1%, less than half its growth rate for 2001:IIQ. Business fixed investment fell 9.3%, although that figure represented an upward revision of more than 2.5 percentage points from the advance estimate. Changes in private inventories contributed

-0.8 percentage points to real GDP growth. For 2001:IIIQ, growth in both residential investment and government spending was weaker than the last year. The trade balance deteriorated further: Although the drop in imports was steep, the slide in exports exceeded it by nearly 5 percentage points.

November's headlines celebrated a 7.1% gain in retail sales in October, the biggest monthly percent gain ever, but this increase undoubtedly reflected the zero-percent financing offered by several automobile manufacturers. Excluding motor vehicles and parts

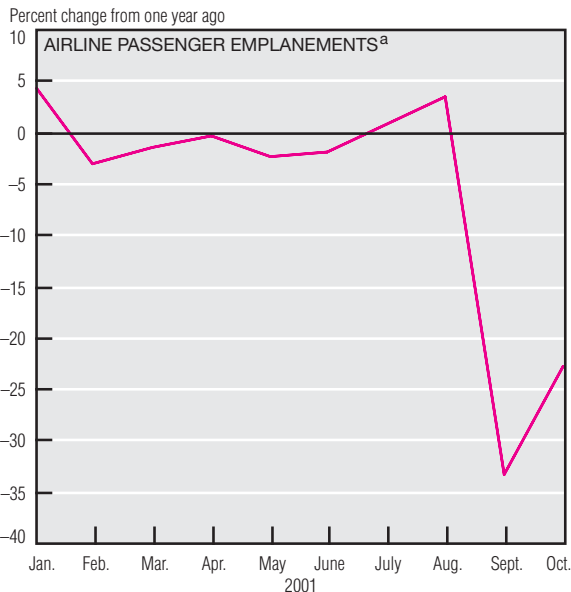
dealers, retail sales rose a modest 1% from September's anemic levels.

In late November, the National Bureau of Economic Research announced that the economy entered a recession this March, ending a 10-year expansion, the longest on record. Blue Chip forecasters expect GDP growth to decrease further in 2001:IVQ before it begins to recover in 2002:IQ; they do not see the quarterly growth rate surpassing its 30-year average until 2002:IIIQ.

Predicting how long a recession will last or how severe it will be is always a

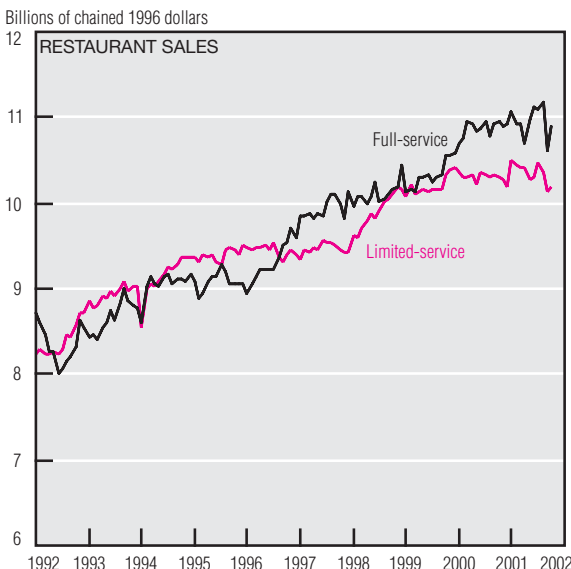
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Economic Activity (cont.)



Lodging				
Revenue per available room (percent change)				
	Actual		Forecast	
	1999	2000	2001	2002
U.S. total	3.5	5.8	-7.1	0.5
Upper upscale	4.3	7.0	-12.8	1.1
Upscale	0.2	5.1	-7.3	-2.7
Midscale with food and beverage	2.4	4.5	-6.7	0.8
Midscale without food and beverage	2.2	4.6	-1.9	3.4
Economy	2.8	3.4	-3.6	0.4

Occupancy rate (percent)				
	Actual		Forecast	
	1999	2000	2001	2002
U.S. total	63.3	63.7	60.7	60.3



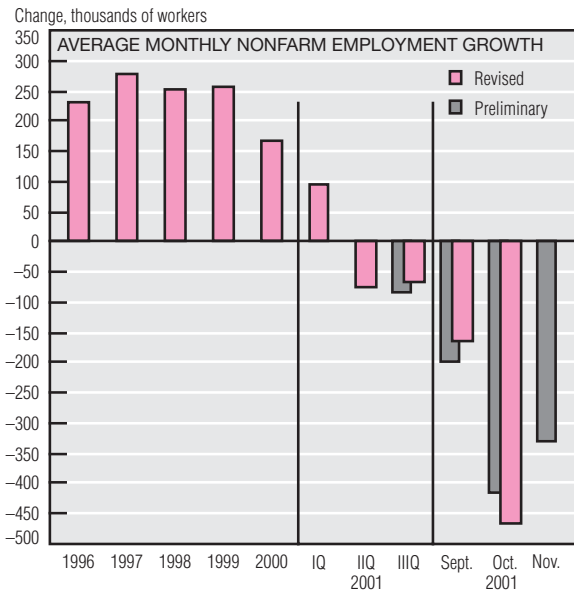
a. One passenger emplanement represents one paying customer boarding an aircraft in scheduled service, including originations, stopovers, and connections.
 b. Adjusted for seasonal, holiday, and trading-day differences. Total restaurant sales include full- and limited-service restaurants as well as special food services and drinking establishments.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Air Transport Association; PricewaterhouseCoopers; and Smith Travel Research.

challenge, but forecasting is even more uncertain now, as Americans struggle to understand the economic consequences of September 11. If the damage to certain sectors proves long lasting, it will influence the recession's course and severity. Three interconnected sectors—airline travel, lodging, and restaurants—have been hit especially hard. The airline industry has received the most attention because the terrorist attacks involved it directly: Airline travel in September dropped a whopping 33% from the same month last year, which is especially remarkable because the attacks occurred

almost mid-month. October remained bleak, with travel down nearly 23% from a year before. This damage will necessarily spill over into other industries, such as lodging. Revenue per available hotel room in 2001 is expected to fall 7.1% from its 2000 levels and to improve only 0.5% in 2002. This contrasts markedly with forecasts made in July, when the industry was expected to contract only 0.3% in 2001. The discrepancy between then and now results from a weaker macroeconomic forecast as well as the impact of September 11. Upper-scale chains are

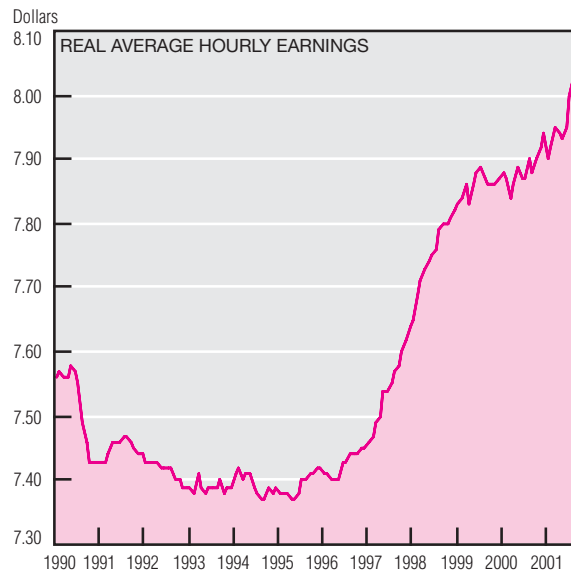
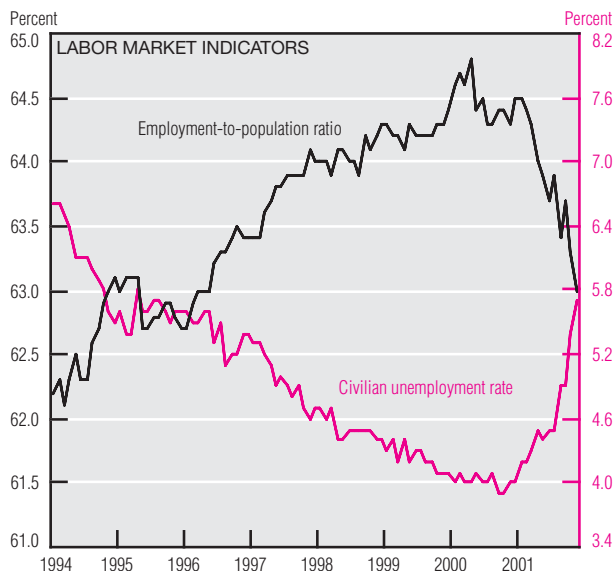
expected to be hit hardest, while economy and midscale chains should fare better. The restaurant business has also suffered. In September, full-service restaurant sales fell 5.0% from August levels, while sales at limited-service restaurants dropped 2.3%. Overall, restaurant sales fell 2.5% in September. By October, the industry had recovered only partially, suggesting that not all of the previous month's drop resulted from the "CNN effect"—potential restaurant-goers' decision to stay at home and watch breaking news stories.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1997	1998	1999	2000	Nov. 2001
Payroll employment	280	251	257	167	-331
Goods-producing	47	22	7	8	-167
Mining	2	-3	-3	1	-2
Construction	21	37	26	18	-2
Manufacturing	25	-13	-16	-12	-163
Durables	26	-2	-5	1	-116
Nondurable goods	-2	-11	-11	-13	-47
Service-producing	232	230	250	159	-164
TPU ^a	16	20	18	14	-58
Retail trade	24	30	49	26	-14
FIRE ^b	21	22	7	0	9
Services ^c	141	120	131	93	-70
Government	17	28	35	18	-6
	Average for period (percent)				
Civilian unemployment rate	4.9	4.5	4.2	4.0	5.7



NOTE: All data are seasonally adjusted.

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.

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Further labor market deterioration was evidenced by another drop in nonfarm payroll employment (331,000 jobs) in November. In addition, revisions to the October data show that month's decline to have been larger than previously reported (468,000 rather than 415,000). Nonfarm payroll employment peaked this March and has been declining steadily since.

Every industry experienced job losses in November with the exception of finance, insurance, and real estate, which posted a net gain of 9,000 jobs, buoyed by low interest rates increasing the demand for banking and

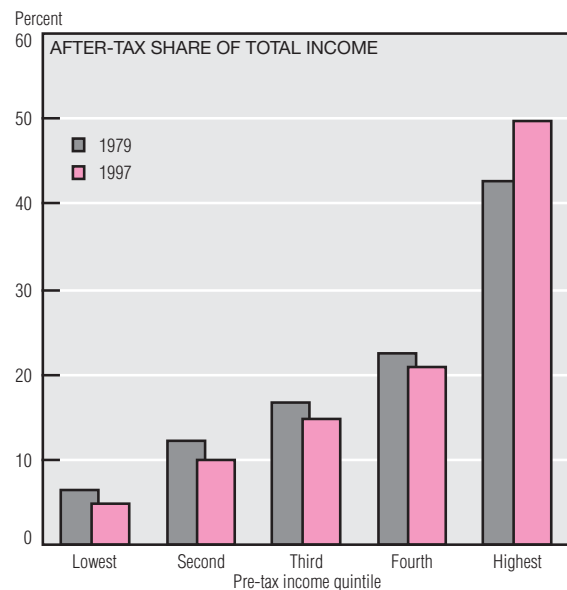
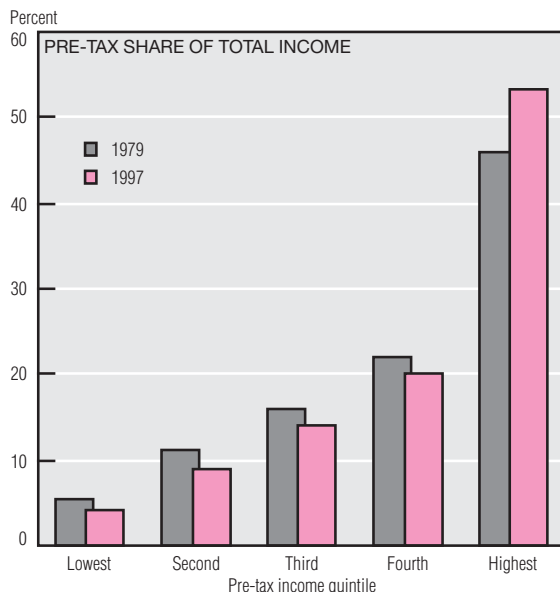
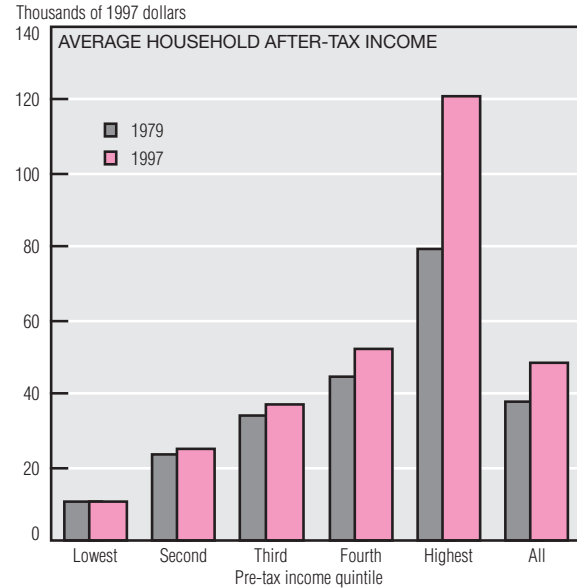
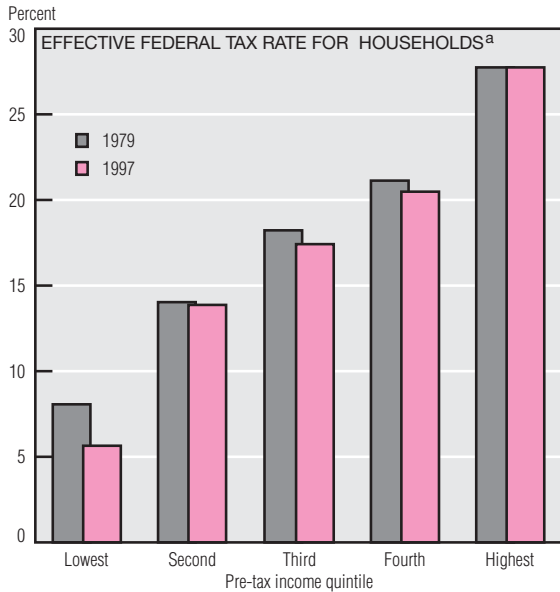
mortgage brokering services. Net job losses were nearly equal in goods-producing sectors (167,000) and service-producing sectors (164,000), which is uncommon for the usually strong service-producing industries. Among specific industries, manufacturing was hardest hit, with a net loss of 163,000 jobs, followed by services and then transportation and public utilities.

The unemployment rate has reached 5.7%, its highest level since August 1995. It has risen nearly 2 percentage points since October 2000, when it reached its lowest point since

January 1970. The last time the unemployment rate increased this quickly was the period between the summers of 1990 and 1991. The employment-to-population ratio has declined again to 63%, its lowest level since May 1996.

After declining and then stagnating during the first half of the 1990s, real hourly earnings showed strong gains in 1996-99. Hourly earnings growth paused in 1999-2000, but has since rebounded. Hourly earnings generally move in tandem with underlying productivity, which suggests that productivity growth may continue faster than its pre-1996 rate.

Effective Federal Tax Rates and Income Distribution



NOTE: Household classification by quintiles is based on comprehensive (pre-tax) income adjusted for household size. Comprehensive income includes earnings, asset income, welfare and retirement transfers, employer-paid payroll taxes, retirement plan contributions, health insurance premiums, and receipts of in-kind benefits, including health benefits.

a. Calculations of the effective tax rate include only the four major sources of federal tax revenue: income, social insurance, corporate income, and excise. Corporate income taxes are allocated in proportion to households' income from interest, dividends, rents, and capital gains. Excise taxes are allocated in proportion to households' purchases of taxed items.

SOURCES: Congressional Budget Office, *Effective Federal Tax Rates, 1979-1997*, October 2001; and the Urban Institute.

Between 1979 and 1997, effective tax rates dropped for all income levels. During this period, 15 legislative changes were enacted, affecting both tax rates and tax bases; income grew rapidly, especially at the upper end of the distribution. Demographic changes in household composition, notably the increasing share of childless non-elderly households, was another major cause of shifts in effective tax rates across income groups.

Distribution of pre-tax income became more unequal over the past two decades. The highest quintile's

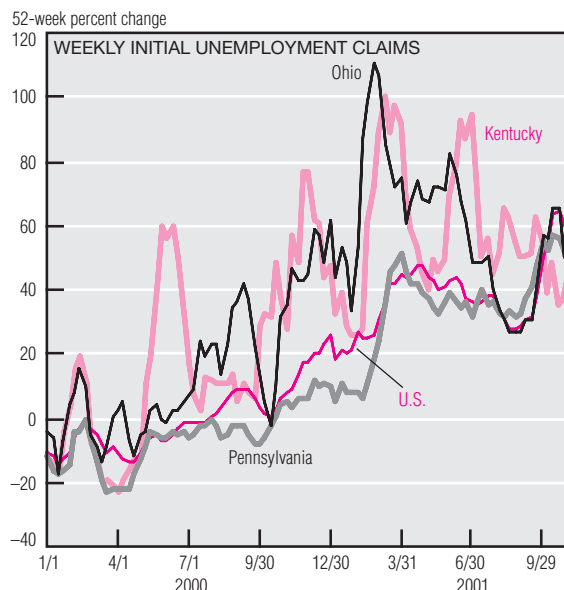
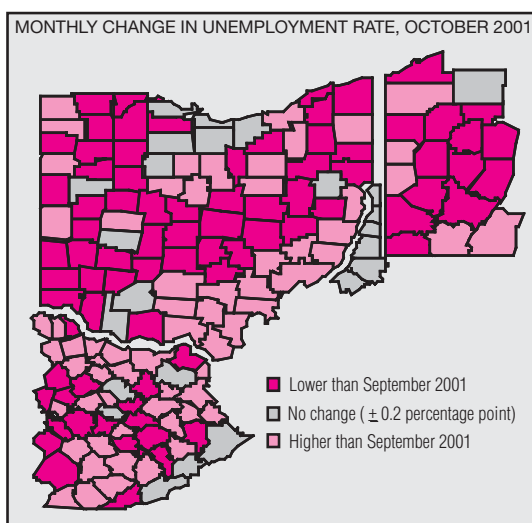
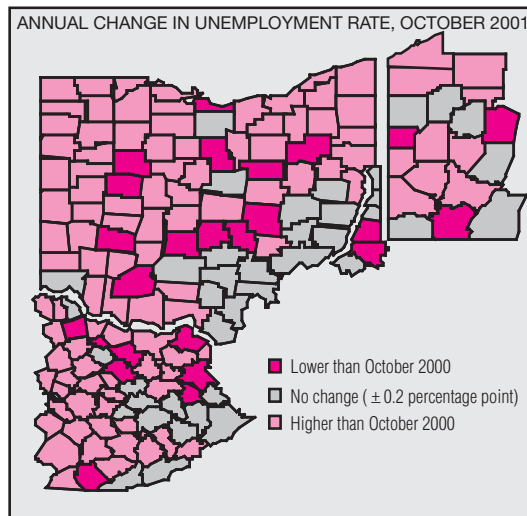
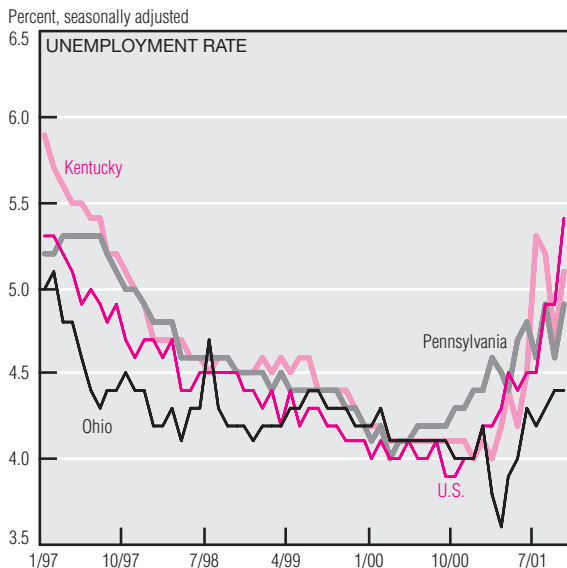
share of income rose from 46% of total income to 53%. For the two lowest income quintiles taken together, in contrast, the share declined from 16% of total income in 1979 to 13% in 1997.

Although the share of pre-tax income for the middle three quintiles declined, lower effective tax rates and robust income growth resulted in higher average after-tax income in 1997 than in 1979. However, despite the sizable drop in the effective tax rate, average after-tax income for the lowest income quintile did not increase and overall

after-tax income inequality grew during the last two decades.

These numbers do not tell us whether any particular household became richer or poorer during this period. Because of life-cycle changes in composition, demographic status, and earning ability, most households do not stay in the same income quintile throughout their lives. One study suggests that only about half of the households in either the highest or the lowest income quintile in the 1970s and 1980s remained in the same quintile after 10 years.

Unemployment in the Fourth District



NOTE: Data are not seasonally adjusted unless otherwise noted.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics and Employment Training Administration; Kentucky Department for Employment Services; Ohio Department of Job and Family Services; Pennsylvania Department of Labor and Industry; and West Virginia Bureau of Employment Programs.

Unemployment rates for the Fourth District states of Kentucky, Ohio, and Pennsylvania were already on the rise before September 11. A lagging indicator of economic performance, the unemployment rate began rising for all three states in March 2001, which suggests that an economic slowdown was under way in the Fourth District before the onset of a national recession during that month. Year-over-year comparison of October unemployment rates also displays widespread evidence of a regional recession.

October 2001 local area unemployment statistics would be the first to register the terrorist attacks' effects on local labor markets. Kentucky and Pennsylvania showed steep jumps in unemployment, similar to that of the U.S. as a whole. Surprisingly, Ohio's October unemployment rate showed no change, which suggests that the attacks did not affect Ohio's labor markets directly. This is consistent with reports in the Federal Reserve's Beige Book; for example, Fourth District companies in travel and tourism (an industry devastated by the attacks at the national level) noted

that they had been relatively insulated from the attacks' negative impact.

Examining the change in unemployment at the county level between September and October yields unexpected results: Unemployment increases were not concentrated in areas within the District that rely heavily on travel and tourism or financial companies. For example, only two of the 10 counties in the Cincinnati-Hamilton metropolitan statistical area showed increased unemployment, but part of the reason is that excess labor capacity in the area's travel and tourism industry had already been shed:

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Unemployment in the Fourth District (cont.)



NOTE: Data are not seasonally adjusted.
 SOURCE: U.S. Department of Labor, Employment Training Administration.

A poor economy, riots in April and September, a regional airline strike, and disappointing performances by local professional athletic teams had caused a serious decline in the area's tourist industry long before September 11.

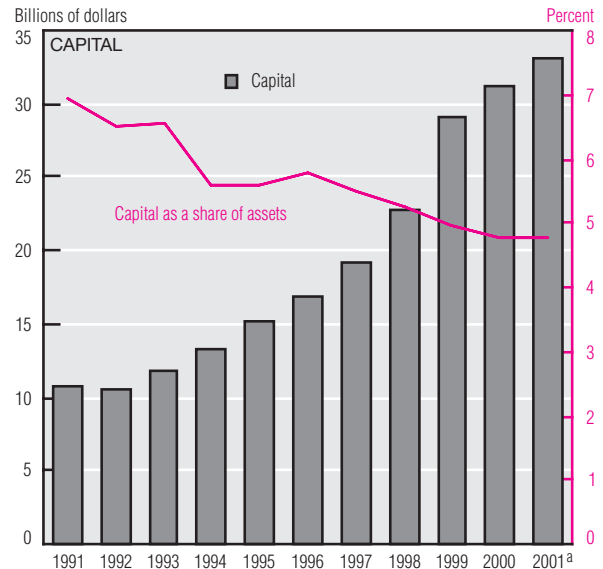
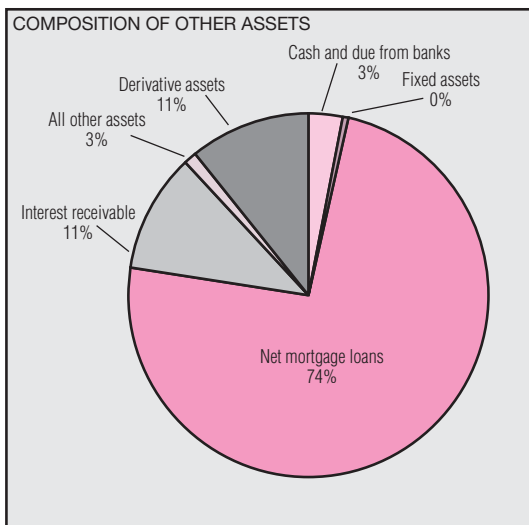
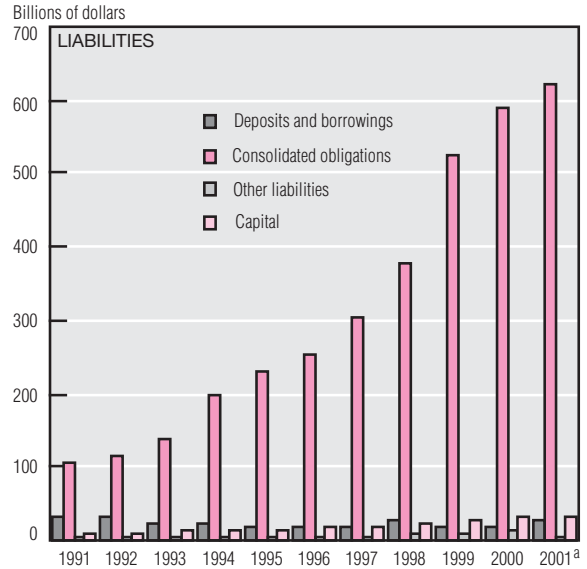
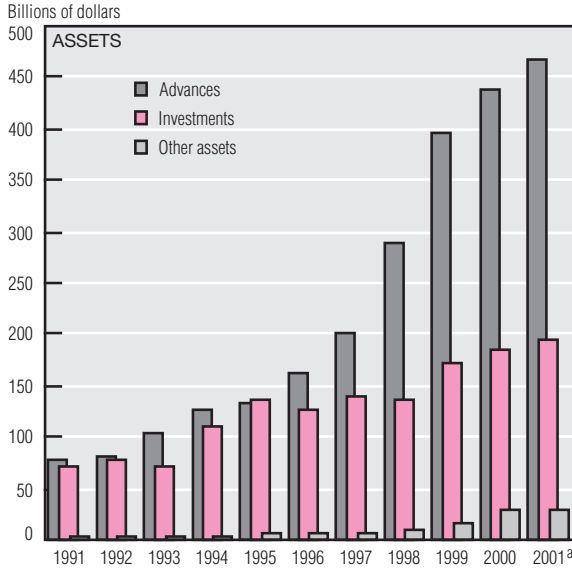
Weekly initial unemployment claims offer another look at the possible effects of the terrorist attacks. In the weeks after September 11, the U.S. recorded its largest year-over-year percent change in initial claims for 2001. Ohio and Kentucky, however, did not. Ohio saw its highest percent increase in March: The month's claims were double those of

the previous March because steel companies such as LTV laid off workers to contain costs in an industry that continued spiraling downward. In Kentucky, the year-over-year doubling in layoffs that occurred near the end of March resulted from a broader-based, economywide shedding of excess labor capacity.

A breakdown of the initial claims data for each of these Fourth District states in the weeks surrounding September 11 resembles the data for the U.S. as a whole. The last half of August showed general improvement in the level of initial claims, which fell week to week, but claims started

to rise again at the beginning of September. Slower processing of claims in a workweek shortened by state offices' closings on September 11 and the following days, as well as decreased worker productivity, may explain the curious decline Fourth District states' initial claims for the week of September 15, which runs counter to the national trend. While the U.S., Ohio, and Pennsylvania showed an overall trend of year-over-year increases in initial claims during the period charted, Kentucky's trend was flat to slightly declining, which suggests that the area's labor market situation is improving.

Federal Home Loan Banks



a. Data through the third quarter.
 SOURCES: Federal Home Loan Bank System, annual reports and *Quarterly Financial Report*, September 30, 2001.

The 12 Federal Home Loan Banks (FHLBs) are stock-chartered, government-sponsored enterprises whose original mission was to provide short-term advances to member institutions, funded by deposits from those institutions. Membership initially was open to specialized housing finance lenders, mostly savings and loan associations and mutual savings banks. As their traditional clientele has shrunk and the financial system has consolidated, FHLBs have re-invented their role in financial markets. FHLB advances, which are now an important source of funding for member

institutions' mortgage portfolios, rose to \$466.77 billion by the end of 2001:IIIQ, far outstripping all other FHLB investments and assets.

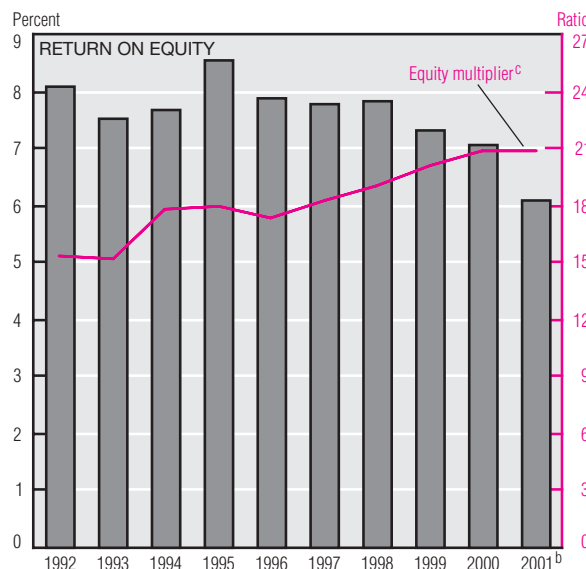
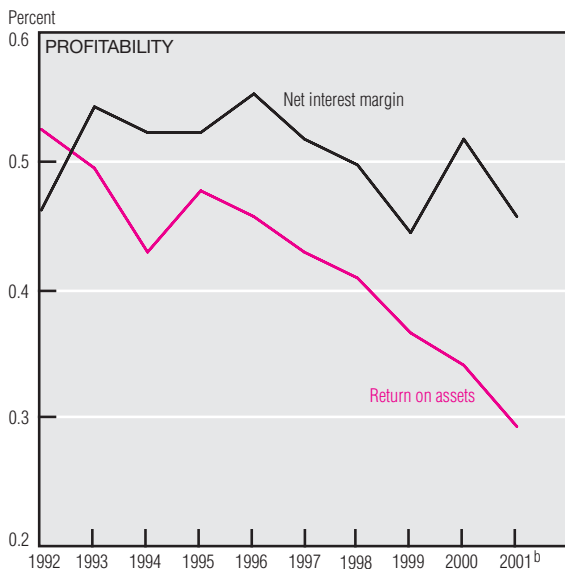
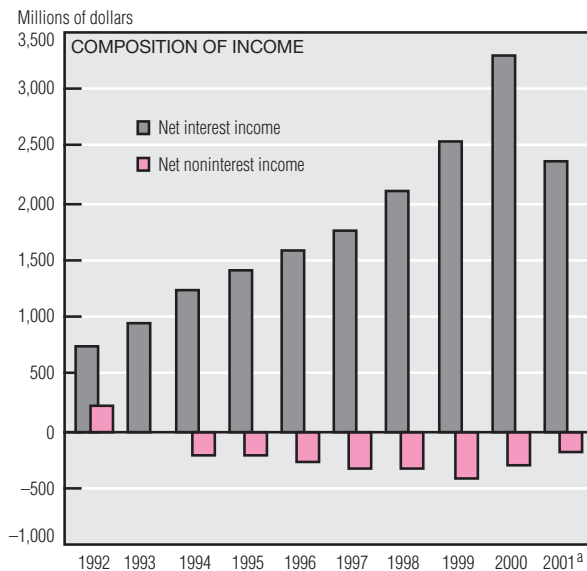
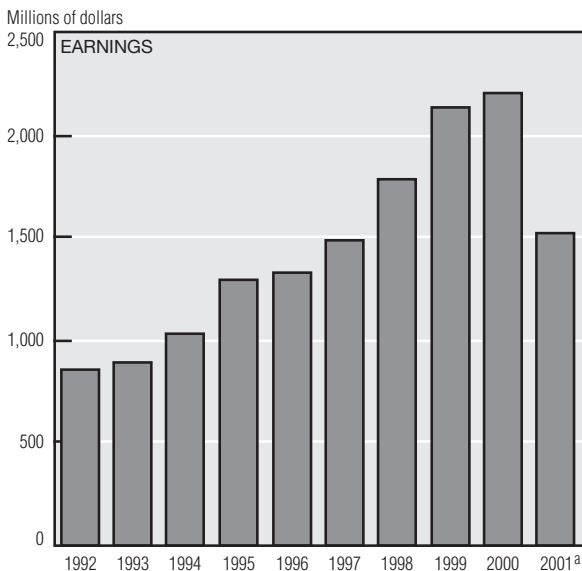
Most of the funding for assets comes from \$622.34 billion of consolidated FHLB System obligations—bonds issued on behalf of the 12 FHLBs collectively. Market participants view these bonds as implicitly backed by the U.S. government, so FHLBs can raise funds at much lower rates than those that AAA-rated corporations pay. Member institutions' deposits, short-term borrowings, and other liabilities are only a miniscule

source of funds. FHLBs have added capital as they have grown, although the asset growth rate has outstripped the capital growth rate since 1996, and the capital-to-asset ratio fell to 4.79% at the end of 2001:IIIQ.

In 1997, the Chicago FHLB initiated a mortgage partnership finance program, by which it began investing directly in mortgages in addition to supporting members' own mortgage portfolios through advances. Currently, all 12 FHLBs purchase mortgages directly from member institutions. The \$22.64 billion of

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Federal Home Loan Banks (cont.)



a. Data through the third quarter.
 b. Data for 2001:IIIQ are annualized.
 c. The equity multiplier is the ratio of total assets to equity.
 SOURCES: Federal Home Loan Bank System, annual reports and *Quarterly Financial Report*, September 30, 2001.

mortgages that FHLBs hold represents almost three-fourths of their other assets and is projected to be a major source of future asset growth.

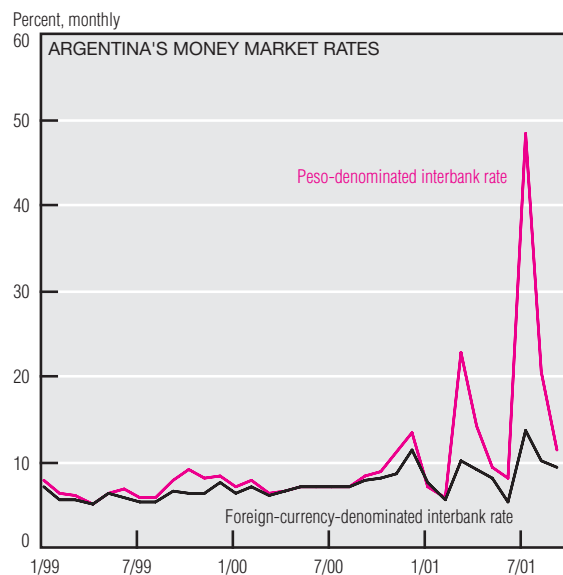
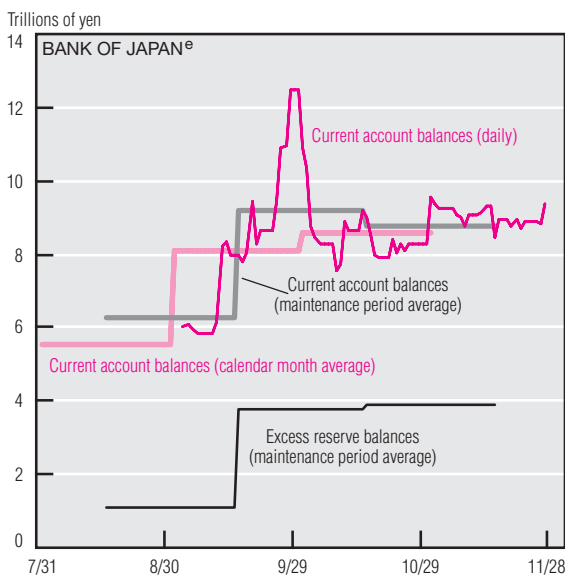
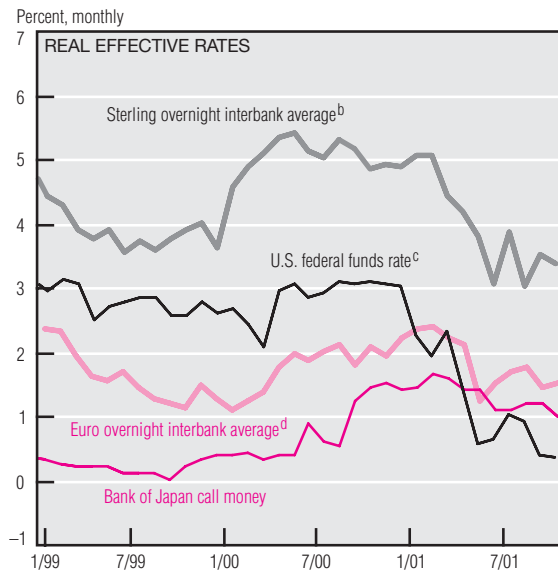
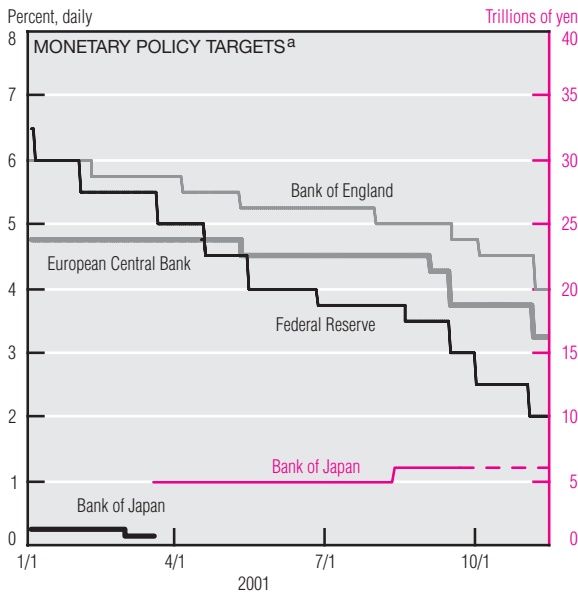
FHLBs' earnings grew each year from 1992 through 2000. Their net income was lower for the first nine months of 2001 than for the same period in 2000 (\$1,515 million compared to \$1,634 million). Net interest income (interest income less interest expense) grew from \$735 million in 1992 to \$3,311 million at the end of 2000. Net interest income of \$2,358 million for the first nine months of

2001 was down from \$2,437 million for the same period in 2000.

The increasingly negative spread between noninterest income and non-interest expenses after 1993 resulted primarily from the steady increase in FHLBs' operating expenses, especially employee compensation and benefits. Unfortunately, improvements in earnings and net interest income resulted from strong asset growth rather than improvements in underlying profitability. Return on assets declined from 52 basis points (bp) in 1992 to 34 bp at the end of 2000. Annualized return on assets through 2001:IIIQ was 29 bp.

Profitability suffered from a decline in the net interest margin from 52 bp at the end of 2000 to an annualized 46 bp for the first nine months of 2001. Moreover, FHLBs' net interest margins are small compared to the 300–400 bp typical of depository institutions. Finally, despite continued increases in leverage since 1996, return on equity fell slightly during the first nine months of 2001 (from 7.07% to 6.10%). These persistently weak returns on assets and equity oblige FHLBs to undertake further nontraditional lines of business in search of higher returns.

Foreign Central Banks



a. Federal Reserve and Bank of Japan: overnight interbank rates (since March 19, 2001, the Bank of Japan has targeted a quantity of current account balances). Bank of England and European Central Bank: two-week repo rate.

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

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

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

e. Current account balances at the Bank of Japan are required and excess reserve balances at depository institutions subject to reserve requirements plus the balances of certain financial institutions not subject to reserve requirements. Reserve requirements are satisfied on the basis of the average of a bank's daily balances at the Bank of Japan starting the sixteenth of one month and ending the fifteenth of the next.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; and International Monetary Fund.

In the second week of November, the Federal Reserve, the Bank of England, and the European Central Bank each cut its target interest rate 50 basis points (bp) for a total reduction of 450, 200, and 150 bp, respectively, in policy rates this year.

After adjusting for changes in measured consumer price inflation, rough indicators of real effective overnight interbank lending rates may have declined less than nominal policy rates. Including a 50 bp reduction in November, real rates have dropped

about 315 bp in the U.S., 200 bp in the U.K., and 120 bp in the euro area.

A 40 bp reduction in Japan's real effective overnight interbank rate came early this year as the Bank of Japan cut its policy rate to zero. Deflation creates a real effective rate of about 1%, higher than in the U.S. Further attempts to ease monetary policy have focused on raising the Bank's target for the quantity of its current account balance liabilities, stated as "above Y6 trillion" since September 18. In fact, the Bank has

increased the supply of current account balances about Y3 trillion (50%) over the past two reserve maintenance periods. So far, this effort has increased banks' holdings of excess reserves—idle current account balances—without any appreciable expansion in their loans and investments.

Markets' pessimism this year about Argentina's ability to maintain parity between the peso and the U.S. dollar has created substantial differences between peso- and foreign-currency-denominated Argentine interest rates.