

The Economy in Perspective

Money talks... Many analysts have been projecting a decline in the dollar's foreign exchange value for years now. Their logic seems to be that the U.S. trade balance, which has been in considerable deficit lately, "should" move toward zero, or surplus, and that dollar depreciation is a necessary part of this process. U.S. manufacturing companies, in particular, have been complaining that the "strong dollar" is an obstacle to profitability and that the U.S. government should take steps to weaken the dollar's value.

Considering that its exchange value is determined in international currency markets, it is no more meaningful to label the dollar strong or weak than to attach that label to wheat, copper, or semiconductors. Dollars become more expensive to purchase when people become more willing to exchange other foreign currencies for them than the other way around. It doesn't really matter why. One reason might be the purchase of U.S.-made goods; another might be the purchase of dollar-denominated assets. Regardless, the relative supply of, and demand for, a currency is what determines its exchange valuation.

Capital inflows accompany trade deficits. For every U.S.-based exporter whose products are more expensive abroad because of the dollar's exchange value, some U.S. firm or consumer is benefiting from lower interest rates. Arguably, U.S. exporters benefit from the strong dollar on the financing side of their operations at the same time as they suffer from the foreign price of their merchandise. For years, large capital flows into the United States enabled firms here to invest and households to consume at a brisk pace without having to generate a commensurate amount of domestic savings. For a share of the investment returns, the rest of the world has been bankrolling our consumption.

The U.S. manufacturing sector's long-term prospects will not be determined exclusively by its own managerial prowess, labor quality, or productivity; the rest of the world matters as well. U.S. industry, which has become increasingly efficient over time, contributes heavily to the nation's economy. But in a relative sense, the rest of the world is improving its manufacturing capabilities faster than the United States. This trend favors production of foreign goods and, by itself, reduces the demand for U.S. dollars. At the same time—as good as it already is—the United States seems to be improving its service-producing capabilities faster than the rest of the world. Among these are financial

services, which derive value from the integrity, reliability, and efficiency of the entire U.S. financial system. This comparative advantage strengthens demand for U.S. dollars. If both these trends continue, the U.S. manufacturing sector will probably shrink further over time, just as service-producing industries will probably continue to expand.

Even as countries debate dollarization, it has become a *fait accompli* in international liquidity and risk management circles. During the last decade, U.S.-based financial institutions filled the void created when Japan's financial institutions retreated from their formerly strong position and when the proposed European currency's success was problematic. In the 1990s, each time a currency crisis beset a regionally important country anywhere in the world, it became more evident that the U.S. dollar and U.S. financial markets play a pivotal role in global financial stability. We cannot know how much "demand for dollars" remains unfilled throughout the world, but if it is considerable, the dollar's exchange value could remain in its current range for a while. Immediate dollar depreciation is not inevitable.

Another point that advocates of a weak dollar often fail to recognize is that for the dollar to depreciate, the currencies of some other countries must appreciate. Which are the likely candidates? Without naming names, they would have to be countries with "undeservedly weak" currencies, presumably running trade surpluses, that would not mind watching their export sectors slow down. Very few countries are likely to volunteer.

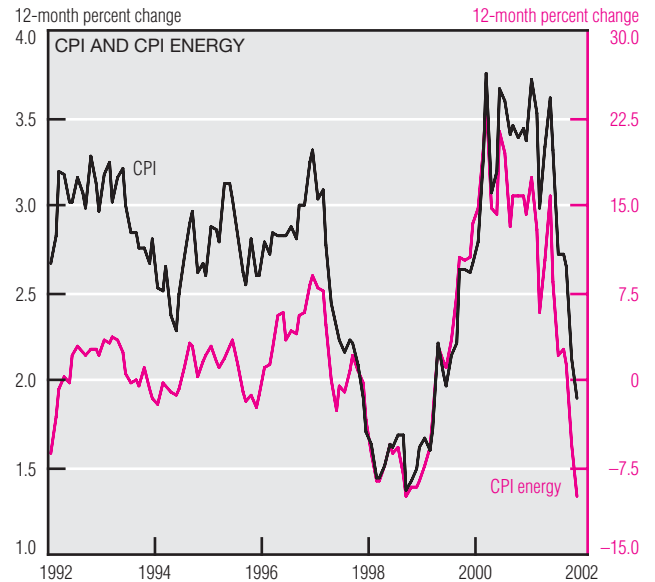
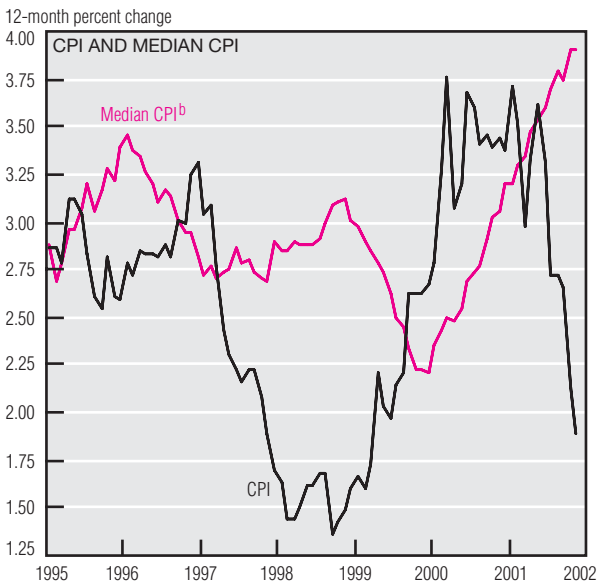
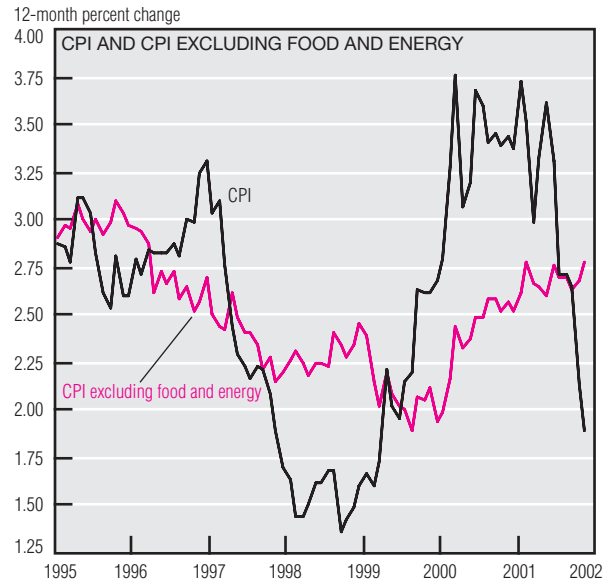
Come to think of it, how could a country go about influencing its currency's exchange value? It would have to do something to affect demand for its currency, such as alter its inflation rate; its legal, accounting, and financial environment; its trade policies; or its productivity growth rate. Economic policies that alter a country's nominal exchange rate do not necessarily alter its real exchange rate in any meaningful way. History demonstrates that policies designed to reduce the foreign attractiveness of a nation's currency inevitably lower the living standards of its citizens. If and when dollar depreciation occurs, let's hope that it is driven by improvement in our competitors' economic circumstances and not by deterioration in our own fundamentals.

With this in mind, it would be fair to say that the greatest foreign exchange threat facing the U.S. economy is not the trending of the buck, but the bucking of the trend.

Inflation and Prices

November Price Statistics

	Percent change, last:				
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	2000 avg.
Consumer prices					
All items	0.0	0.2	1.9	2.3	3.4
Less food and energy	4.6	3.0	2.8	2.4	2.5
Median ^b	3.5	3.8	3.9	3.0	3.2
Producer prices					
Finished goods	-6.7	-7.2	-1.1	0.9	3.6
Less food and energy	2.4	-0.3	0.9	1.1	1.3



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

After declining in October, the Consumer Price Index (CPI) remained unchanged in November. Energy prices posted another significant decline after falling more than 6.0% in October. Food prices also fell in November (0.1%). These price movements helped dampen the overall rate of change in consumer prices for the month. Over the past 12 months, the CPI rose at a rate of only 1.9%. By comparison, in the previous November the index's 12-month percent change was almost 3.5%.

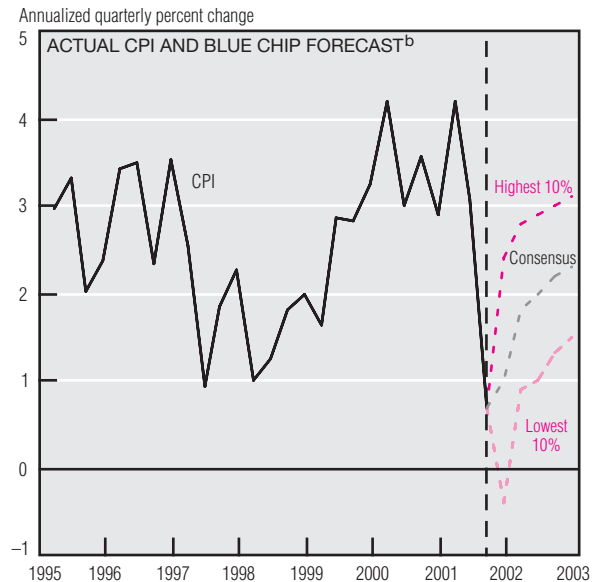
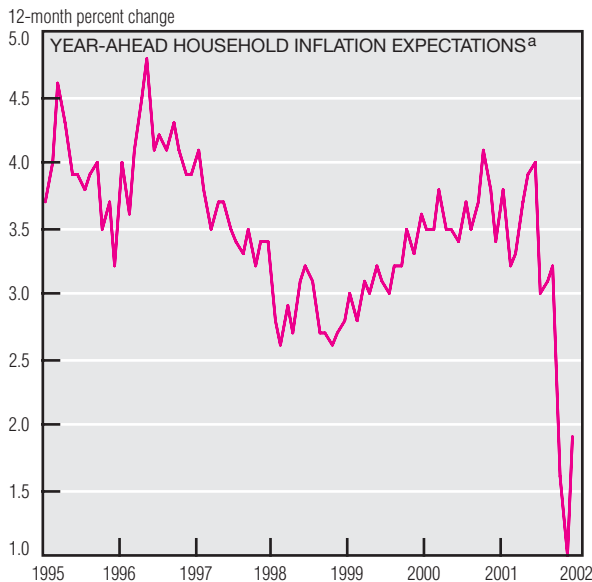
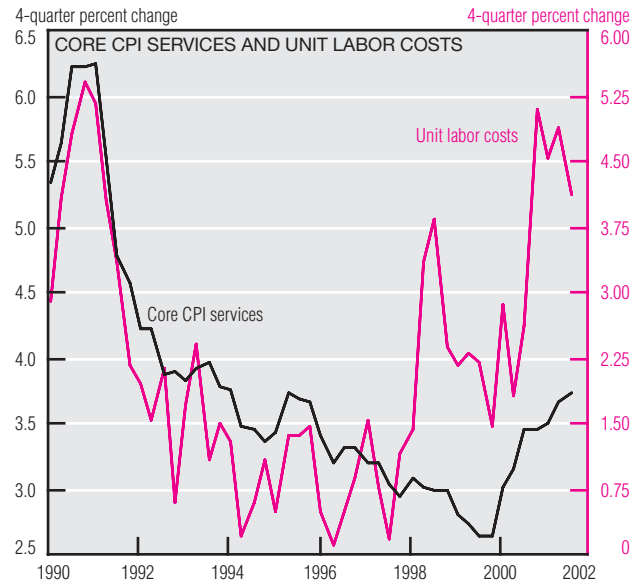
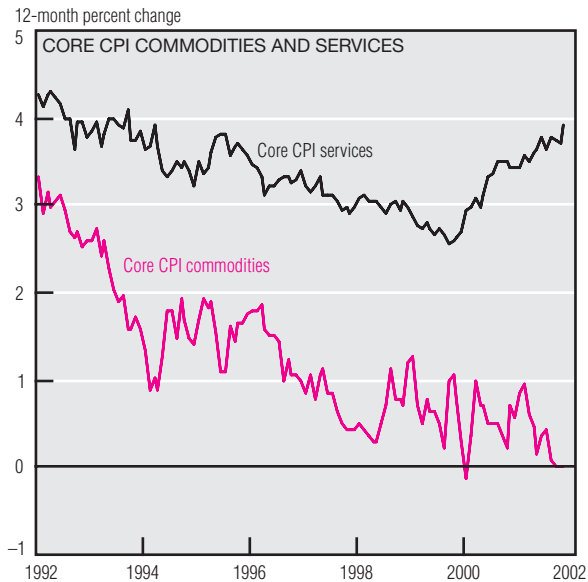
Excluding food and energy, however, consumer prices rose more sharply in November than in any month since January 1996. The monthly increase in the so-called core CPI was led by a sizeable jump (3.9%) in prices for tobacco and smoking products. Two travel-related components, car and truck rental and lodging away from home, also posted large monthly price increases, snapping back from the unusually large price drops these goods showed in the aftermath of September 11. Over the last 12 months, the CPI

excluding food and energy has risen at a rate of 2.8%, similar to its growth rate for 2000.

The median CPI, by contrast, has shown an almost uninterrupted upward trend in its 12-month rate of change since the beginning of 2000. Over the last 12 months, the median CPI has risen at a rate of 3.9%. With the exception of the 12 months ending in October 2001, this marks the most rapid 12-month increase in the index since December 1991.

Clearly, the CPI's ups and downs in recent years have followed wide *(continued on next page)*

Inflation and Prices (cont.)



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

b. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; and *Blue Chip Economic Indicators*, December 10, 2001.

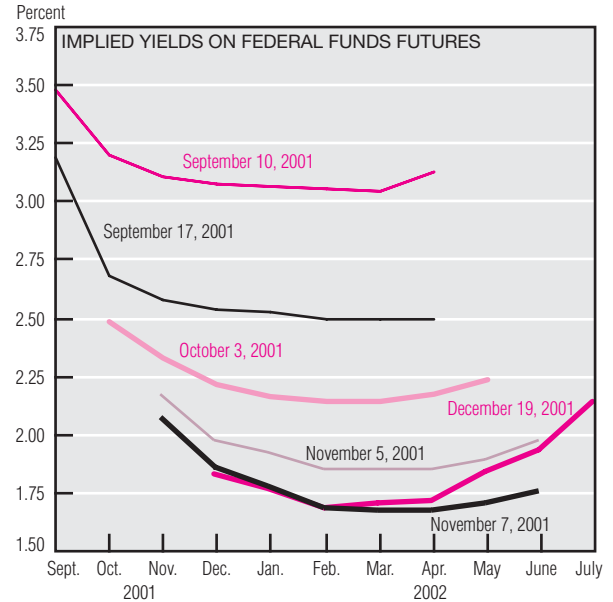
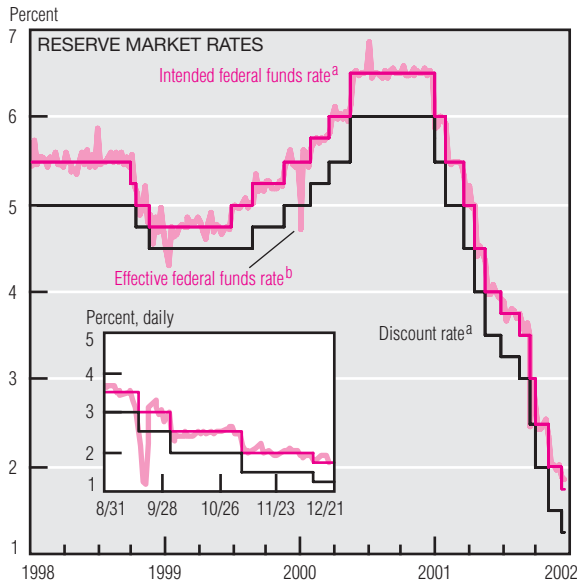
swings in energy prices. While energy costs are an important component of household expenses, their highly unstable behavior may mask the underlying movement in all prices, which the central bank hopes to keep under control. This supports the argument for excluding these items when monitoring inflation.

Of course, transitory movements can be recorded in other goods as well (this month's surge in tobacco prices, for example). More generally, however, the divergence in recent years between the CPI less food and

energy and the median CPI results from the widening gap between the behavior of retail goods prices and services prices. Not surprisingly, the upward trend in core services prices roughly matches the pattern shown by unit labor costs (the difference between labor compensation growth and labor productivity growth). Whether those wage increases can continue, especially in light of continued deterioration in U.S. labor markets, is a key unknown in assessing the economy's 2002 inflation performance.

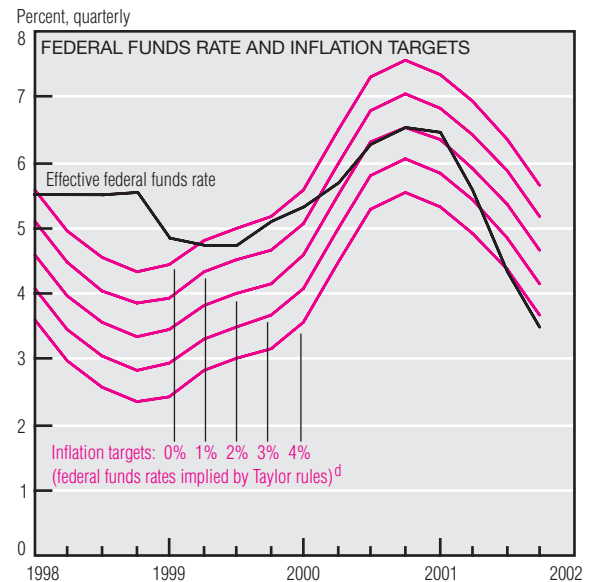
Recent survey data from households show a sharply lower expectation of price changes over the next 12 months—roughly half the inflation households were anticipating just a few months ago. However, economists' outlook is a bit less optimistic. They expect little or no price growth in 2002:1Q, followed by higher growth during the rest of the year. The pessimists among them project that inflation (as measured by the CPI) will return to its trend (about 3%) by year's end.

Monetary Policy



Bias in FOMC Statements as an Indicator of Monetary Policy^c

Risk cited in FOMC statement	Number of federal funds rate changes at meeting following FOMC statement				
	-50 bp	-25 bp	0 bp	+25 bp	+50 bp
Conditions that may generate economic weakness	8	3	0	0	0
Neutral	0	0	2	2	0
Conditions that may generate heightened inflation pressures	0	0	5	3	1



a. Daily.

b. Weekly average of daily figures.

c. Includes all scheduled and unscheduled FOMC meetings with accompanying statements, from May 18, 1999 until November 6, 2001.

d. The formula for the implied funds rate is taken from the Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, vol. 39 (1993), pp. 195-214.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Congressional Budget Office; Chicago Board of Trade; Haver Analytics; and Bloomberg Financial Information Services.

On December 11, 2001, the Federal Open Market Committee (FOMC) lowered the target federal funds rate 25 basis points (bp) to 1.75%. This was the eleventh decrease in 2001, the Committee having reduced the rate at each of its eight regularly scheduled meetings and three times at unscheduled (telephone) meetings. At one unscheduled meeting in April, the Committee held rates constant. The moves have reduced the target federal funds rate 475 bp from 6.5%, where it stood at the beginning of 2001.

One gauge of future policy is the implied yields on federal funds futures

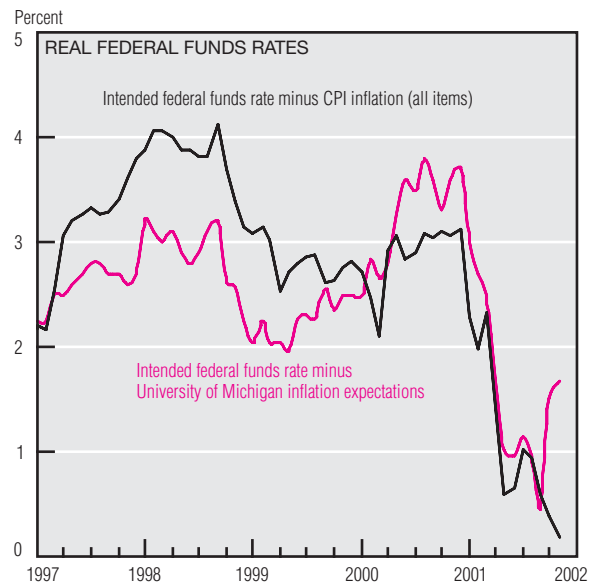
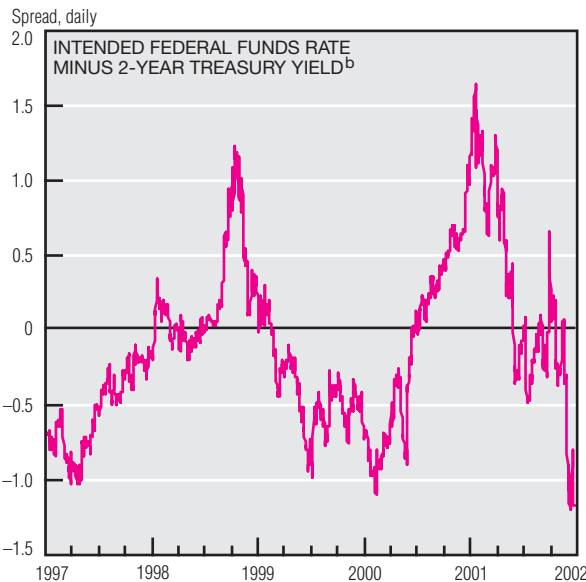
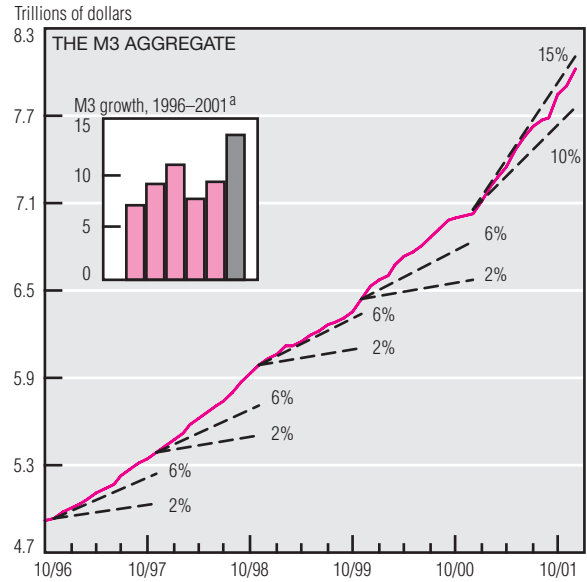
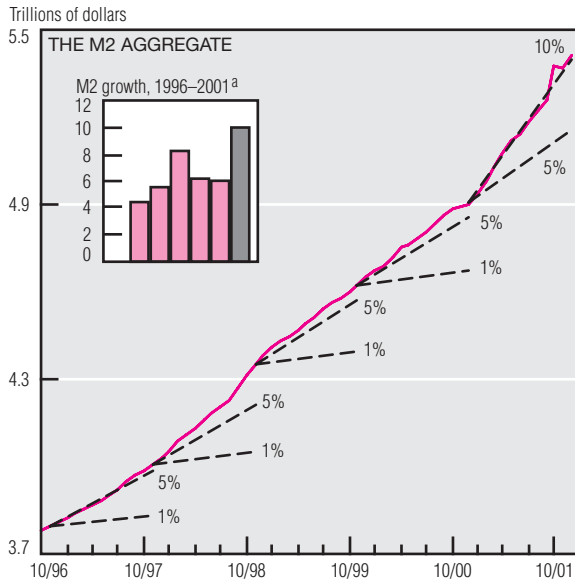
contracts. Market participants apparently expect the rate reductions to stop fairly soon; the minimum rate of 1.68% in February further suggests that they see only a partial probability of further downward cuts. Rates are expected to rebound quickly, with a rise to 2.25% by July considered a distinct possibility.

Another popular gauge is the discussion of the weighting of risks in the FOMC statement, sometimes called the "tilt" or "bias." Since the middle of 1999, when it began to announce this weighting at all meetings, the FOMC has always followed a statement of

weakness by lowering the federal funds rate at the next meeting, although a statement of inflationary pressures has not always preceded a rate increase.

A third gauge, the Taylor rule, posits that the FOMC chooses the target rate as a balanced response to economic weakness and inflation. The form of the Taylor rule depends on the weights given to deviations of inflation and output from their target values. While the rule recently has predicted correctly the direction in which the federal funds rate would move, it has missed on magnitude.

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

b. Constant maturity.

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

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6, and "Selected Interest Rates," H.15; and University of Michigan Survey of Consumers.

Although headlines about monetary policy mostly announce changes in the target federal funds rate, the nature of those changes cannot be appreciated without looking at their effect on the money supply. Similarly, changes in the fed funds rate may indicate very different policy stances, depending on the course of market interest rates.

In the case of money, the broad aggregates have been growing quickly: Both M2 and M3 increased at rates exceeding 10% during 2001.

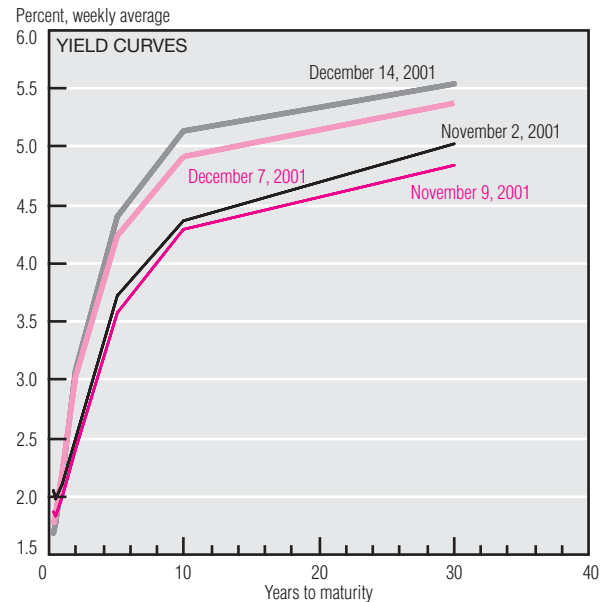
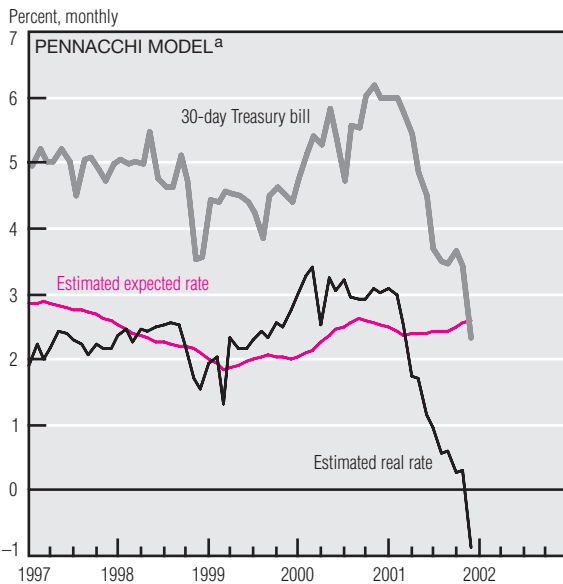
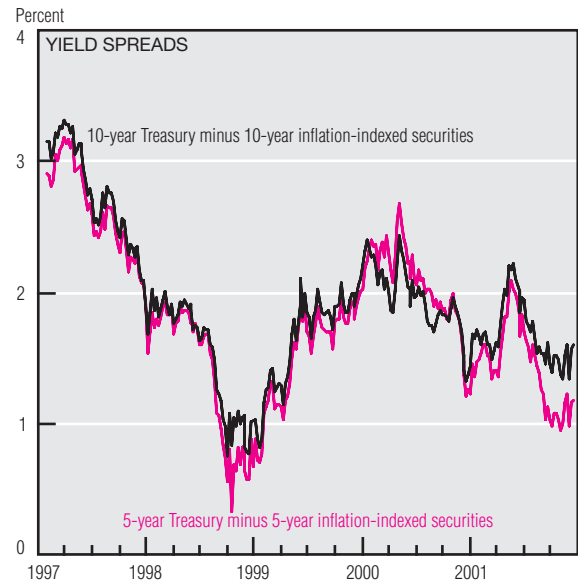
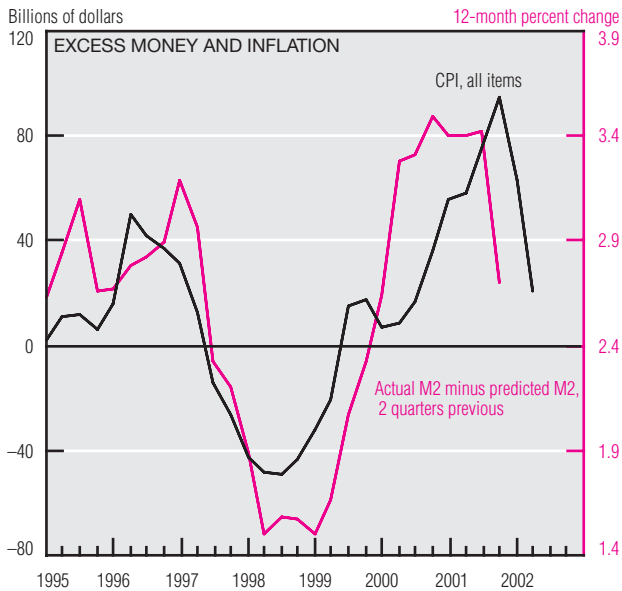
Describing the rate reductions as an easing of monetary policy is validated by the response of money.

A similar validation of the easing concept comes from looking at the fed funds rate relative to market rates. The reductions shrank the difference between the fed funds rate and the 2-year Treasury bond yield more than 2½ percentage points in 2001. The spread fell noticeably (41 basis points) after the November 6 meeting, but it continued to drop a further 85 bp over the next three weeks, even without a change in the target rate.

Another rate that declined steeply in 2001 was the real (inflation-adjusted) federal funds rate. One simple measure of this, the fed funds rate less CPI inflation, fell nearly 300 bp on the year. A more forward measure of expectations, from the University of Michigan survey, shows a drop over the year but a sizeable increase since August: While the target has decreased, inflationary expectations have fallen faster, from 2.8% in August to 0.4% in November.

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Money and Financial Markets (cont.)



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

While it may not be apparent in the Michigan survey, worries about higher inflation are a traditional accompaniment to faster monetary growth. Money supply is only half the analysis, however, because money demand also matters: To the extent that inflation is too much money chasing too few goods, "too much money" must be defined relative to the amount that people want to hold. A simple model that tracks the difference between supply and demand for M2 captures the broad outlines of

inflation over the past several years, though it appears to be lagging the recent downturn in inflation.

Other inflation measures have been holding fairly steady. The difference between yields on nominal and real Treasury bonds, which has been fluctuating between 1.3% and 1.6% since mid-August, shows no discernible trend. A shorter-term measure from a more complicated model, using 30-day T-bill rates and survey measures of inflation, increased slightly (from 2.48% to 2.60%) in 2001. It pays to note that the real

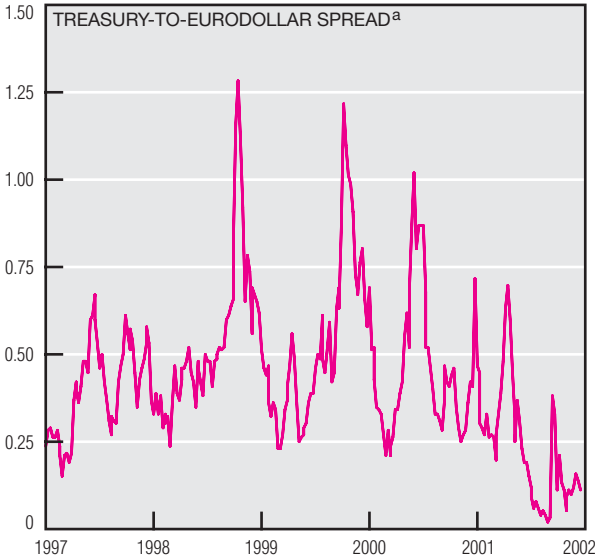
interest rate derived from this model went negative in December.

Some people also look to the yield curve as a measure of inflationary expectations. Though not always accurate because of liquidity effects, risk factors, and the like, some component of the spread between long and short rates is attributable to inflation expectations. Over the past six weeks, the yield curve has gotten steeper, with 30-year rates rising from 5.02% on November 2 to 5.54% on December 14.

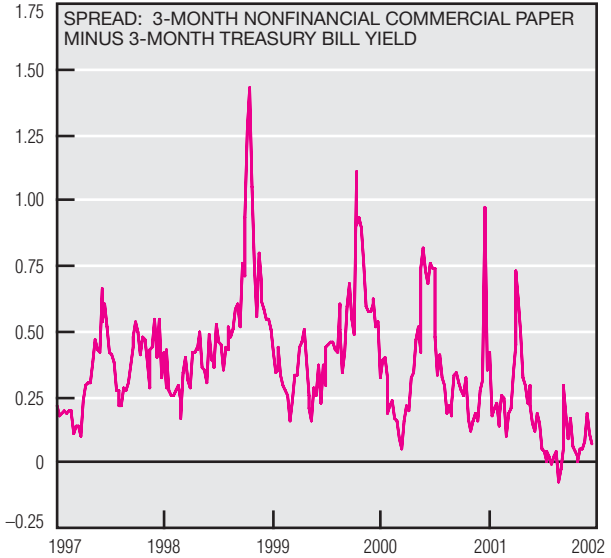
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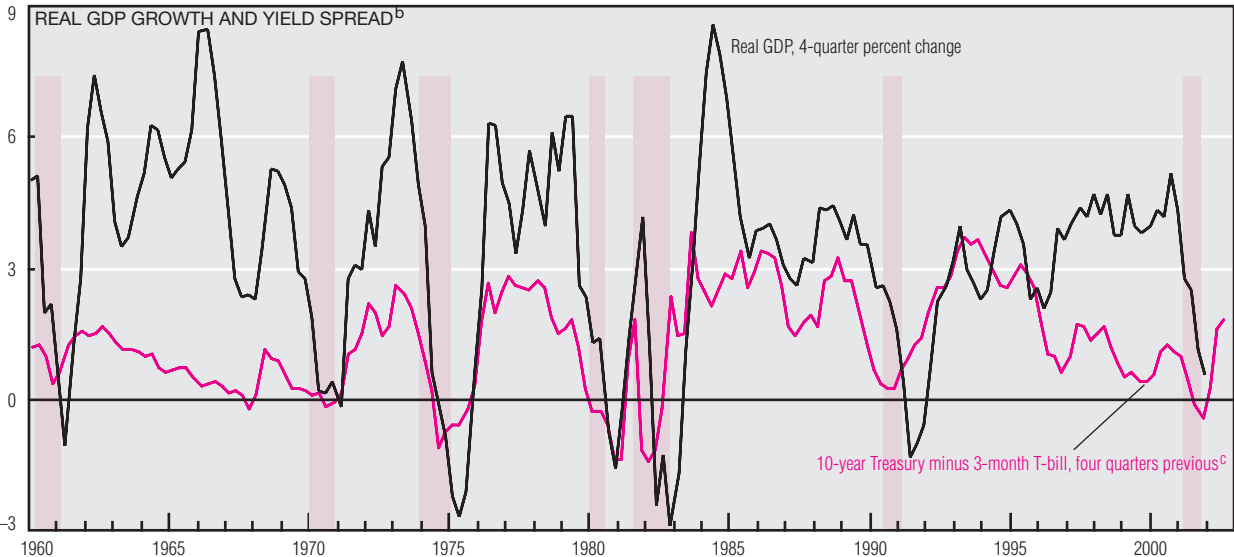
Percent, weekly average



Percent



Percent



a. Three-month eurodollar minus 3-month constant maturity T-bill yield.

b. Shaded areas mark NBER-defined recessions.

c. Ten-year constant maturity Treasury minus 3-month, second-market T-bill yield.

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.

Monetary policy is also made in the context of the real economy of recessions and recoveries. Do the financial markets provide any hint of what is to come? Two traditional measures of risk, at least, show smoother sailing ahead. The Treasury-to-eurodollar (TED) spread measures the difference between the rate on eurodollar deposits and Treasury notes. It is thought to reflect traders' worries about international problems because it is a way to arbitrage rates between the U.S. and the rest of the

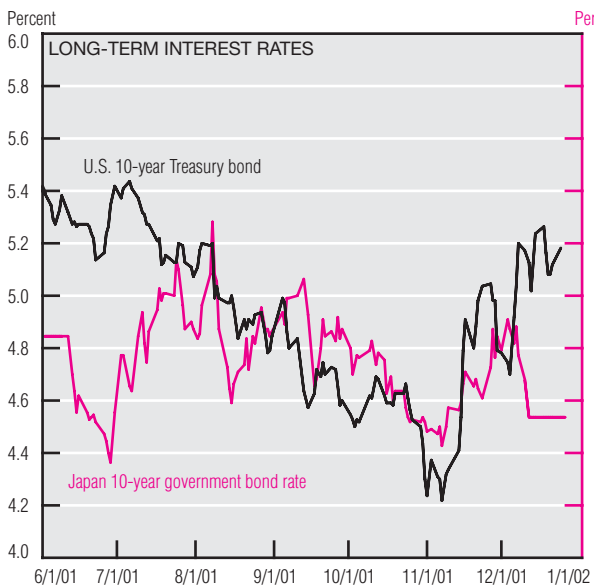
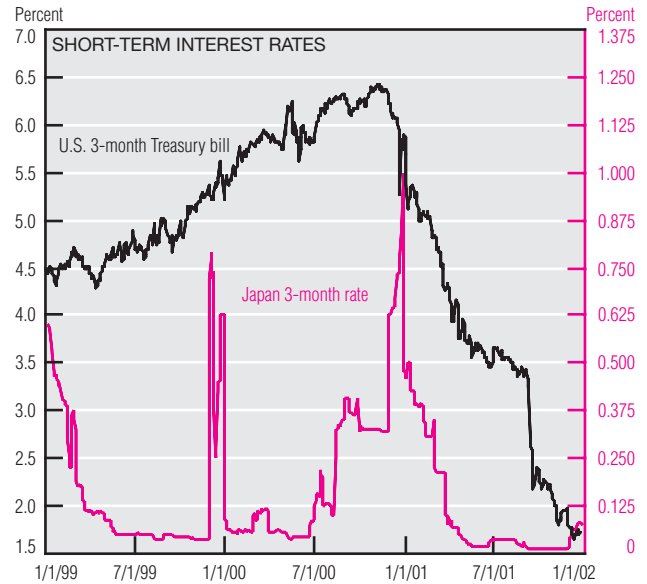
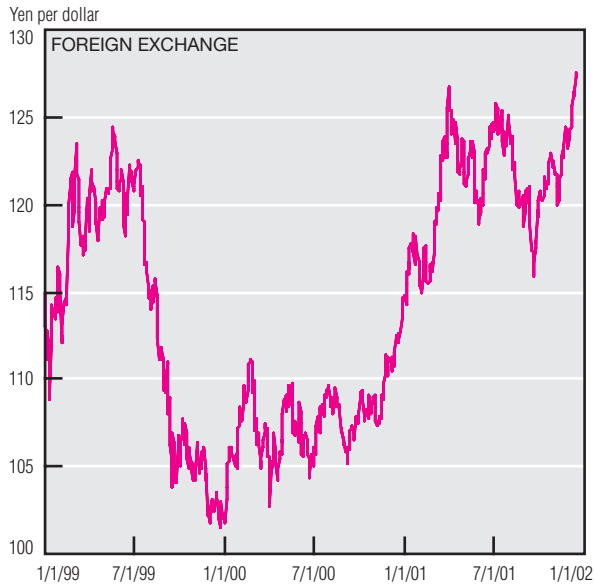
world without bearing any currency risk. The spread remains quite low by historical standards. This most likely means that market participants were not spooked by the introduction of the euro, which the TED spread suggested would be less of an event than Y2K.

Another, purely domestic, risk spread, between 3-month commercial paper and the 3-month T-bill, is also low by historical standards, suggesting that credit is readily available to most firms in the commercial

paper market, and no major risks are seen on the horizon.

A final measure of future economic performance, and perhaps the most venerable of the lot, is the spread between 10-year and 3-month Treasuries. The slope of the yield curve tends to predict economic activity four quarters into the future; it has an enviable record of picking up recessions when it inverts (goes negative). It is predicting robust growth for 2002.

Japan's Economy



SOURCES: Board of Governors of the Federal Reserve System; Japan Securities Dealers Association; Association of Call and Discount Companies/Nihon Keizai Shinbun; Japan Ministry of Public Management, Home Affairs, Post, and Telecommunications.

In mid-December, the Japanese yen began another bout of weakening against the dollar. In analyzing exchange rate movements, one important concept is uncovered interest rate parity (UIP), by which the movement in the exchange rate expected by the market must equal the interest rate differential between the two countries. While U.S. short-term interest rates have continued to decline, Japan's short-term interest rates have shown little movement since mid-2001. In this case, UIP would imply that the market now

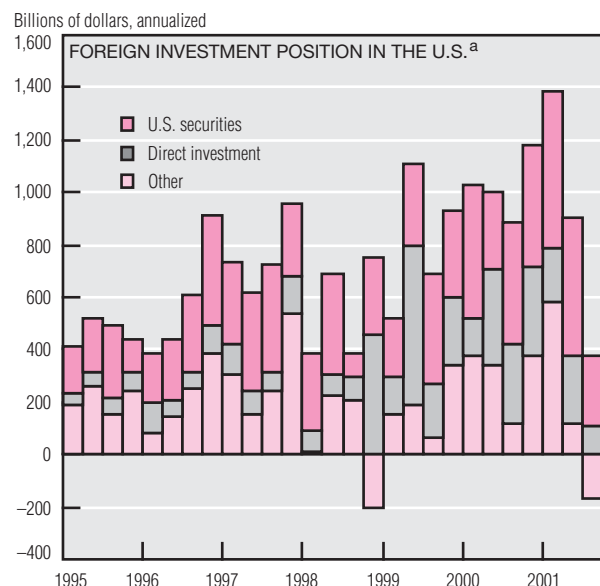
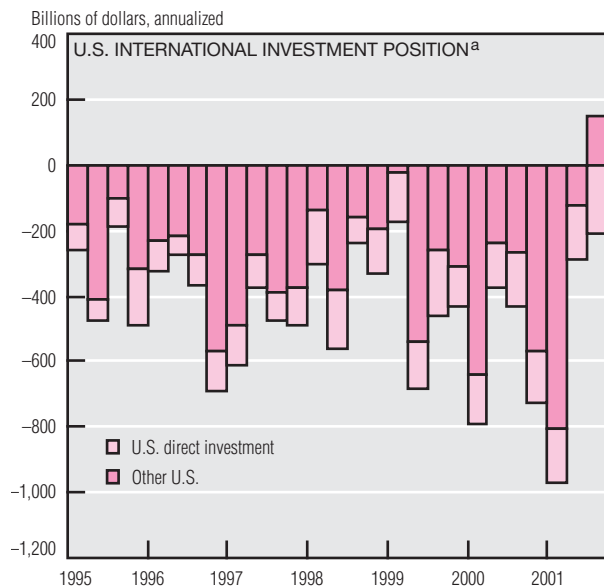
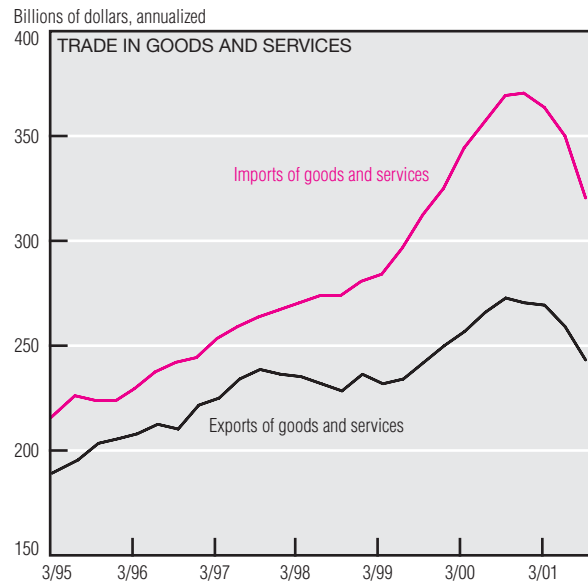
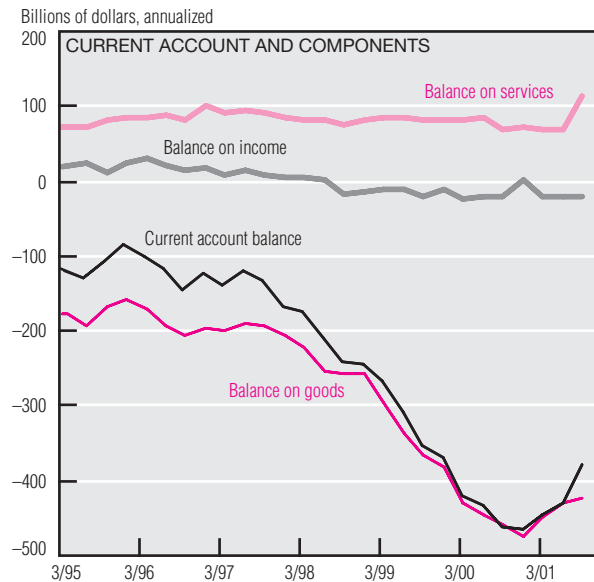
must expect a smaller movement in the yen-to-dollar exchange rate. Many studies, however, have failed to provide evidence that supports the UIP concept. One possible explanation for this contradiction lies in the movement of risk premiums.

In early December, selling pressure against the yen appeared to be strong. Continued news of Japan's economic weakness did not seem to be undermining its currency, but the possibility that U.S. rate declines might soon come to an end may have been weighing against the yen. The November increase in the U.S.

10-year interest rate could be taken to indicate an expected increase in U.S. short-term rates.

Despite a relatively sharp increase in Japanese M1 over the course of 2001, the Bank of Japan has continued to be under pressure either to provide further monetary easing or to purchase foreign assets. From the market's point of view, the likelihood of such policy moves seemed to increase in mid-December, when Japanese officials made statements that could be viewed as encouraging the yen's decline.

U.S. International Transactions



a. The sum of the bars is equal to the net investment position.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The U.S. current account deficit decreased from \$107.6 billion in 2001:IIQ to \$95 billion in 2001:IIIQ, mainly because of a decline in the deficit on goods and services. The U.S. continues to run a large deficit on goods (which decreased), along with a much smaller surplus on services (which increased). A sizeable portion of the decrease in service payments, related to the September 11 terrorist attacks, took the form of increased claims received abroad by reinsurance companies and decreased transportation payments.

The net financial outflow associated with changes in the total of U.S.-owned assets abroad fell from an annualized \$288.7 billion in 2001:IIQ to \$61.5 billion in 2001:IIIQ, largely because economic conditions abroad weakened and thus slowed demand for U.S. bank credit. U.S. purchases of foreign stock also dropped sharply.

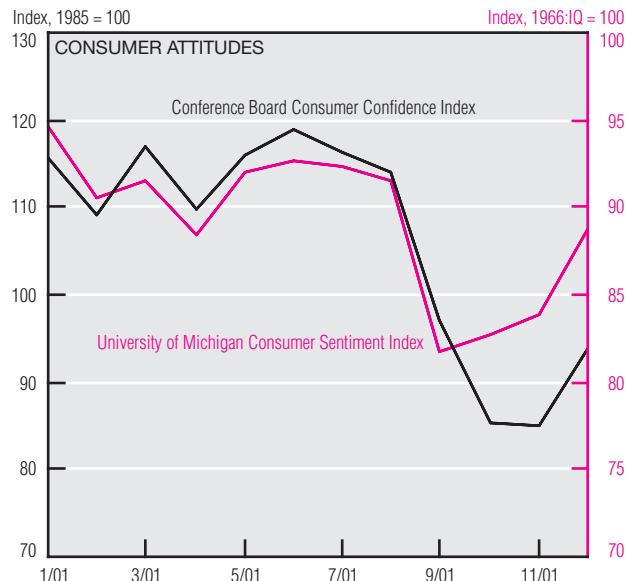
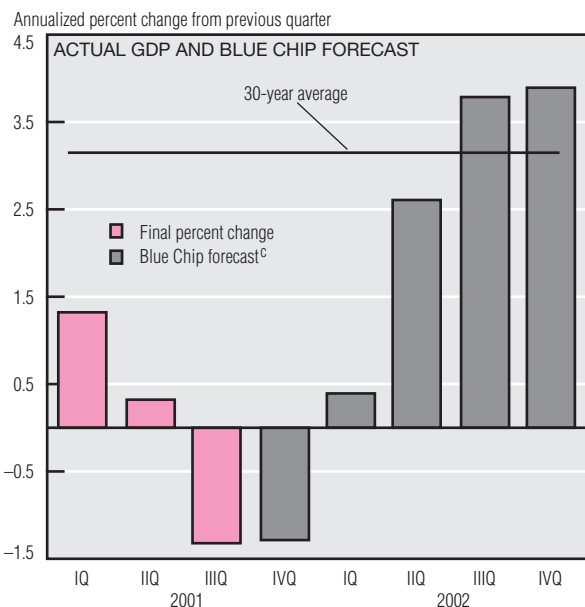
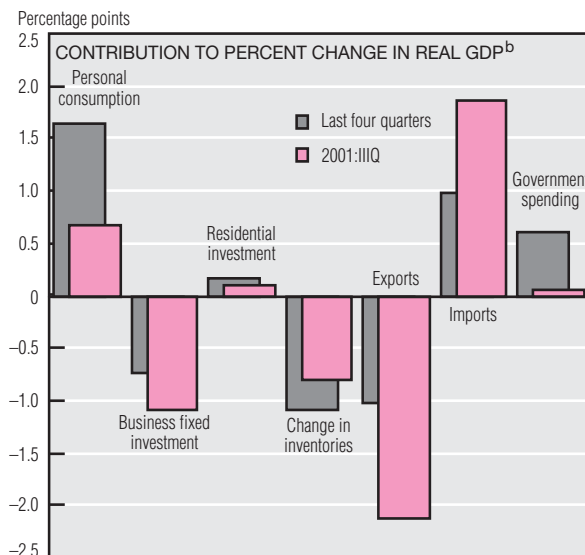
The financial inflow associated with changes in foreign-owned assets in the U.S. also slowed in 2001:IIIQ, primarily because of a large drop in net foreign purchases of U.S. securities (excluding Treasury securities). However, net foreign sales of U.S. Treasury securities

changed little (from \$8.7 billion in 2001:IIQ to \$9.4 billion in 2001:IIIQ).

A basic national income accounting identity relates the current account to the capital account: If the U.S. is running a current account deficit, it must “borrow” to pay the “excess.” An alternate view is that the current account deficit reflects the judgment of world financial markets on the U.S. as an investment. In the current environment, though, it is possible that the change in the deficit is determined by the decline in GDP worldwide rather than a loss of confidence in the U.S. as an investment.

Economic Activity

	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	-31.3	-1.3	0.5
Personal consumption	15.5	1.0	2.4
Durables	2.1	0.9	4.0
Nondurables	2.6	0.6	1.0
Services	10.6	1.2	2.8
Business fixed investment	-28.9	-8.5	-5.8
Equipment	-23.8	-8.8	-7.5
Structures	-5.5	-7.5	-0.5
Residential investment	2.2	2.4	3.9
Government spending	1.1	0.3	3.4
National defense	2.9	3.2	5.8
Net exports	-4.3	—	—
Exports	-56.1	-18.8	-9.2
Imports	-51.8	-13.0	-6.8
Change in business inventories	-23.6	—	—



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; *Blue Chip Economic Indicators*, December 10, 2001; Conference Board; and University of Michigan.

Gross domestic product (GDP) decreased at an annual rate of 1.3% in 2001:IIIQ. The final estimate, released late in December, represents an additional downward revision of 0.2 percentage point from preliminary estimates. Business fixed investment, exports, and inventory investment were the largest contributors to the decrease in GDP. Personal consumption increased 1.0% from 2001:IIQ and contributed a very modest 0.7 percentage point to GDP growth. This is less than half the 1.7 percentage points it contributed

to GDP growth over the last four quarters. As the table shows, the decline in exports was nearly 6% greater than the decline in imports, leading to a second consecutive quarter of deterioration in the trade balance.

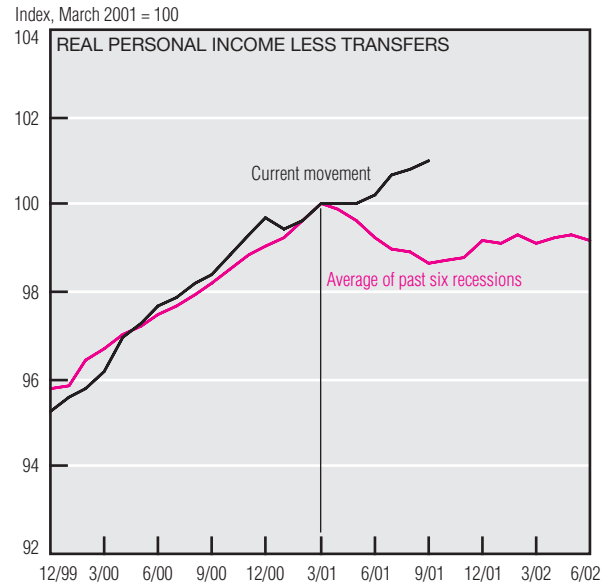
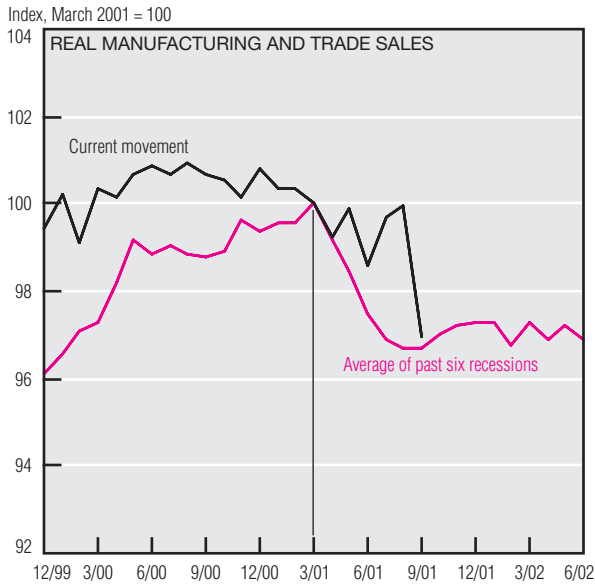
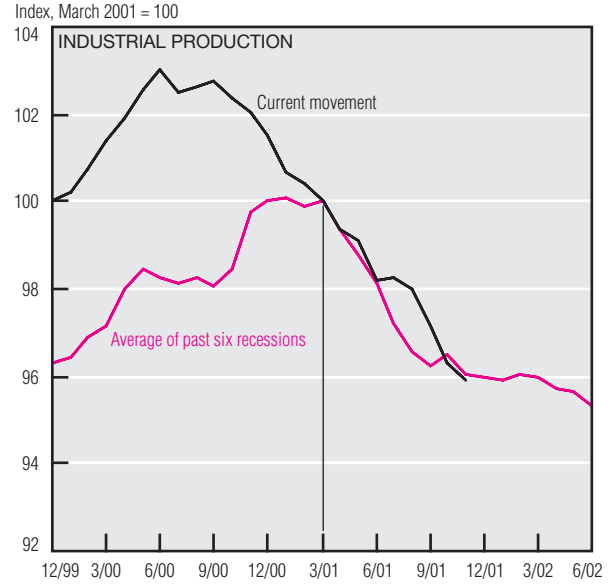
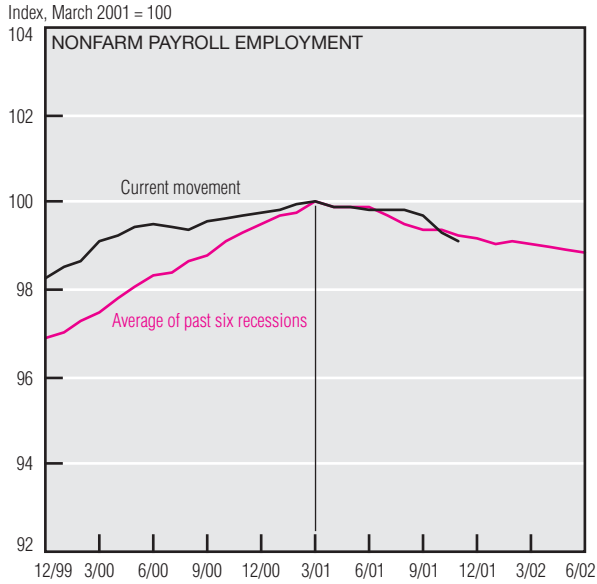
Quarterly real GDP growth for 2001:IIIQ marked the first contraction in output since January 1993 as well as the most significant decrease in real GDP since January 1991. Blue Chip forecasters expect continued weakness in 2001:IVQ before GDP growth becomes positive in 2002:IQ; they do not predict GDP growth to

surpass its long-term average until 2002:IIIQ.

In recent months, many analysts and news headlines have focused on consumers' attitudes as a measure of the economy's response to the terrorist attacks. Although the Conference Board's Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index experienced fluctuations earlier in the year, both showed a sharp drop after the September 11 attacks. In the following months, consumer sentiment began

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Economic Activity (cont.)



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Conference Board; and National Bureau of Economic Research, Inc.

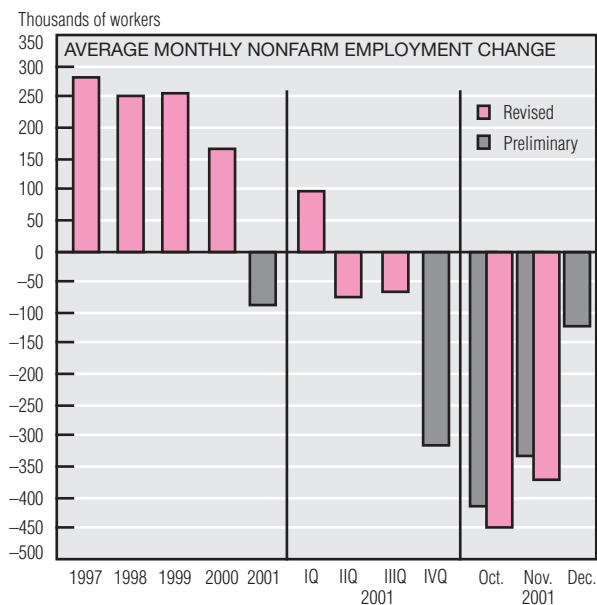
to rebound immediately, while consumer confidence continued to decline until December. This can most likely be attributed to the fact that the Consumer Confidence Index places much greater emphasis on the current employment situation than the Consumer Sentiment Index does.

The financial press considers the economy to be in a recession if real GDP growth is negative for at least two consecutive quarters, but this definition is not universally accepted. The National Bureau of Economic Research (NBER) uses monthly

indicators of economic activity to determine when the economy slips into a recession. Their most important indicator is employment. Three other important indicators are industrial production, real manufacturing and trade sales, and personal income less transfers. The NBER recently determined that the economy slipped into a recession in March 2001. It dates the beginning of a recession by comparing the current movement of each important indicator of economic activity with an average of each of those indicators over the past six recessions. The chart at the upper

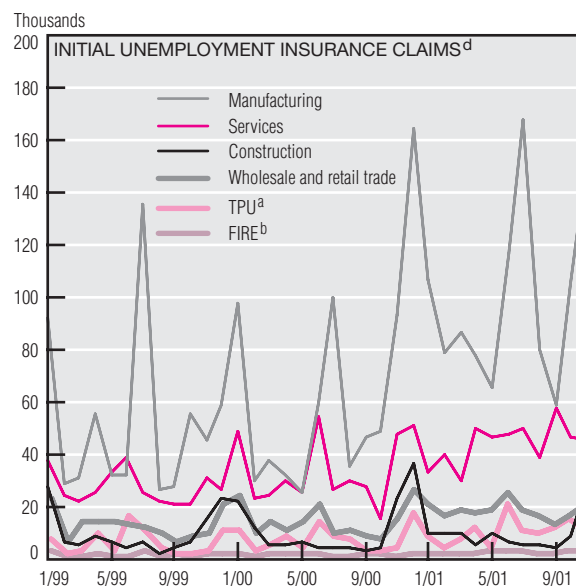
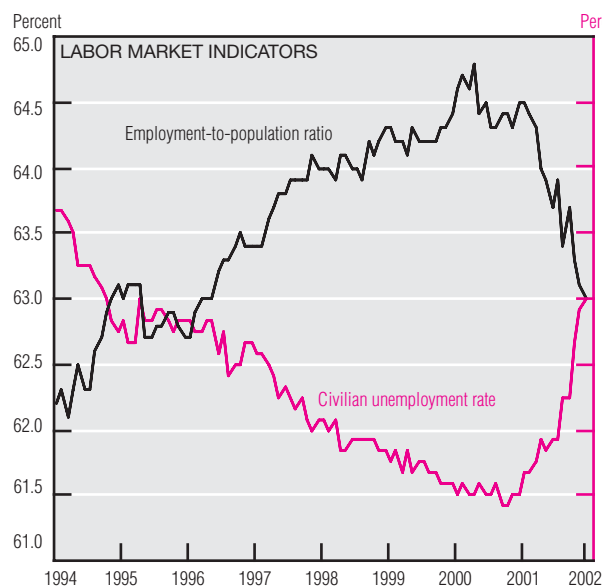
left shows the recent movement in employment (the black line) and the average of movement in employment over the past six recessions (the magenta line). The average movement series is positioned so that a recession begins in March 2001. This chart indicates that recent employment peaked in March 2001. Two of the other three series—industrial production and real manufacturing and trade sales—peaked well before March 2001; one of them—real personal income less transfers—has yet to peak.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1998	1999	2000	2001	Dec. 2001
Payroll employment	251	257	167	-90	-124
Goods-producing	22	7	8	-104	-133
Mining	-3	-3	1	1	-5
Construction	37	26	18	5	5
Manufacturing	-13	-16	-12	-110	-133
Durable goods	-2	-5	1	-80	-95
Nondurable goods	-11	-11	-13	-31	-38
Service-producing	230	250	159	14	9
TPU ^a	20	18	14	-16	-36
Wholesale and retail trade	40	59	34	-17	-87
FIRE ^b	22	7	0	4	-3
Services ^c	120	131	93	5	72
Government	28	35	18	38	63
Average for period (percent)					
Civilian unemployment rate	4.5	4.2	4.0	4.8	5.8



NOTE: All data are seasonally adjusted unless otherwise noted.

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. Monthly data through November 2001, not seasonally adjusted.

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

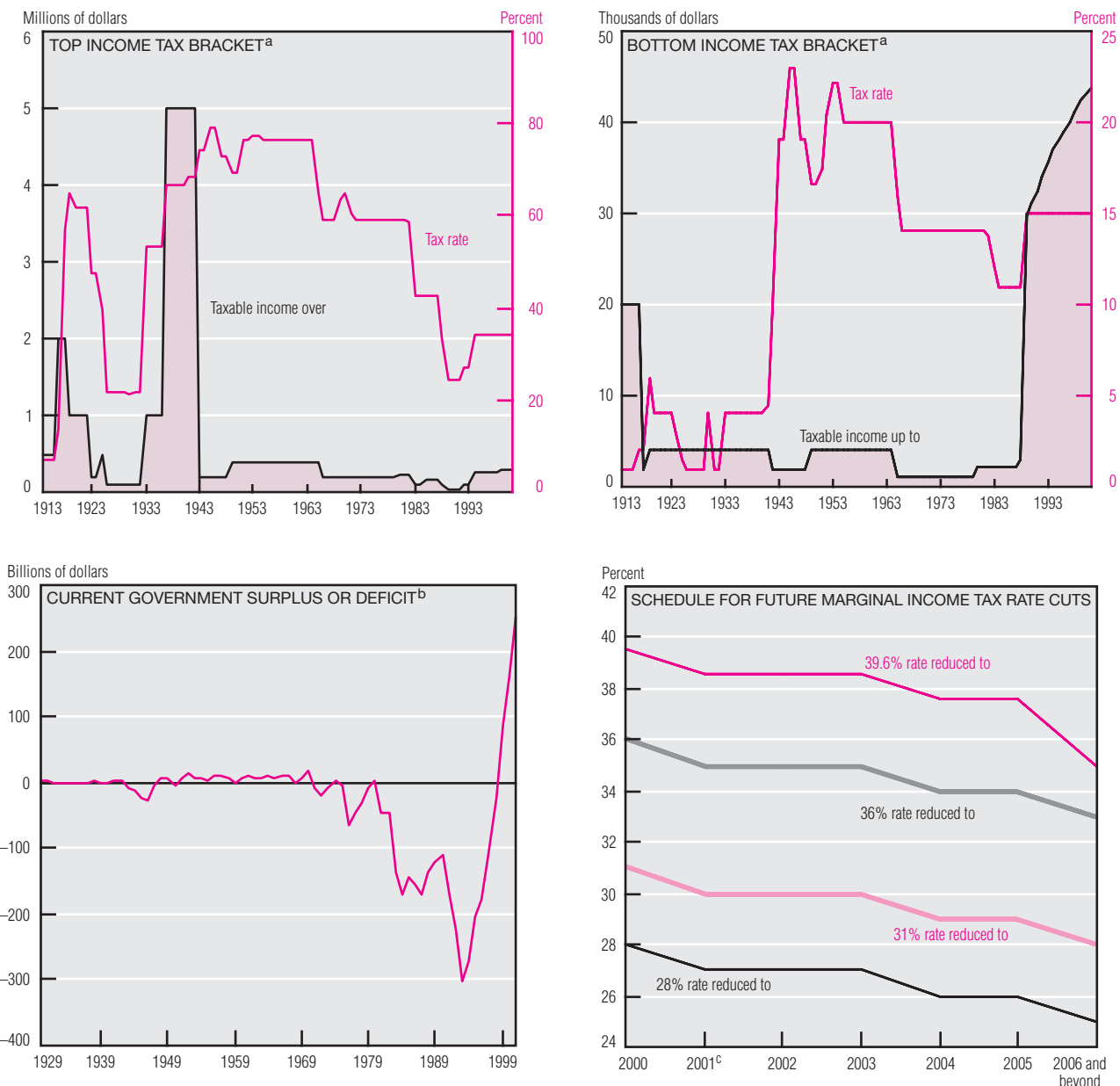
Nonfarm payroll employment fell 124,000 in December, a much smaller decline than those of October and November. In addition, revisions to the October and November data show larger declines than initially reported. Preliminary estimates for 2001 show an average monthly loss of 90,000 jobs, the highest such figure since 1982. In 2001:IVQ, average monthly losses were the steepest posted since 1980:IIQ. Employment in goods-producing industries continued to fall, with net job losses amounting to 133,000. Service-producing industries

added 9,000 jobs, but the gains that occurred in the service and government sectors were offset by substantial losses in wholesale and retail trade (87,000 jobs). Most of these losses were in retail, which did not follow its typical holiday hiring pattern. In 2000, only manufacturing posted average monthly job losses; in 2001, transportation and public utilities as well as retail trade joined manufacturing in posting such losses. The service-producing industries' job gains in 2001 were far below the levels achieved in the three earlier years.

The civilian unemployment rate is now at 5.8%, which is 0.1 percentage point higher than November's level and the highest reached since April 1995. The employment-to-population ratio has dropped to 63%, its lowest point since May 1996.

Since the beginning of 2001, initial unemployment insurance claims have increased across industries. While monthly increases in claims follow seasonal business and production cycles, their peaks and troughs were generally at higher levels during 2001 than in previous years.

A Brief History of Marginal Income Tax Rates



a. Rates apply to joint filers (1948–present). Taxable income excludes zero-bracket amount (1977–86). Tax rates shown do not include the effects of the alternative minimum tax (1979–present) or those of phase-outs for exemptions, deductions, and other tax benefits.

b. Calendar years. Negative values indicate deficits.

c. Effective July 1.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Account Tables; and Joint Committee on Taxation, "Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals," March 6, 2001, JCX-6-01.

The U.S. income tax was first enacted in 1861, abolished in 1872, reintroduced in 1894, and declared unconstitutional by the Supreme Court in 1895. The Sixteenth Amendment (1913) empowered Congress to levy taxes on "income from whatever source derived," without apportioning the revenue among the states. Soon after, the Revenue Act reinstated the income tax but made it applicable to only a very few, relatively affluent households.

Generally, marginal rates were increased and brackets lowered before both world wars. Between the wars,

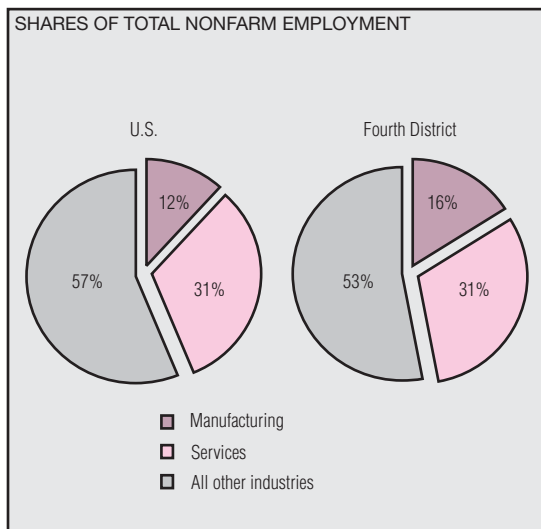
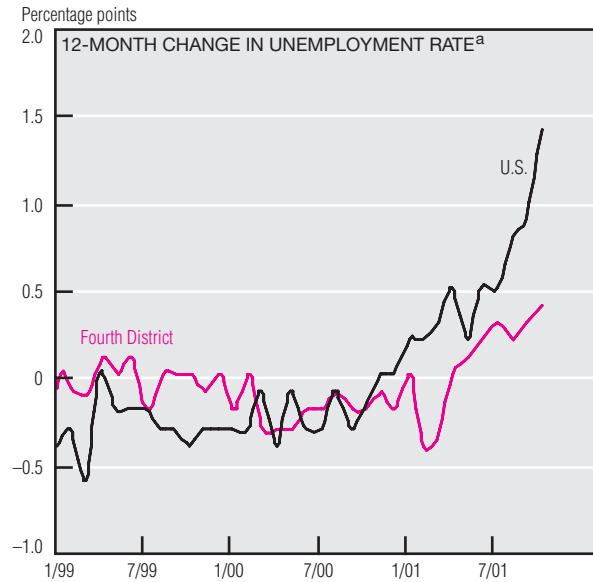
the top marginal rate for the highest bracket was raised sharply twice, but each increase was accompanied by a sharp rise in the top bracket, making it applicable only to the very rich. Tax rates were hiked again before the Korean War. In contrast, rates were lowered substantially during the early 1960s, just before the Vietnam War. These rate cuts, which followed Keynesian fiscal prescriptions, were intended to stimulate the economy by boosting consumer demand.

Since the early 1960s, the trend in marginal tax rates has generally been negative. The rate reductions

of the early 1980s were part of a comprehensive fiscal and regulatory effort to create credible, long-lasting work and investment incentives.

Marginal rates were hiked before the Gulf War and again in 1993 to combat runaway federal deficits. More recently, projections of surging federal surpluses partly reversed the early 1990s' rate hikes. The rate reduction schedule enacted in 2001, however, incorporates implementation lags that could induce workers and businesses to postpone productive activity and investment.

Regional Conditions



Nonfarm Employment, Goods-Producing Sector

	Average monthly change (thousands) ^b	
	January-June	June-November
All industries	-84	-124
Mining	3	0
Construction	12	-8
Manufacturing	-99	-96
Primary metals	-5	-5
Industrial machinery and equipment	-15	-19
Electronic and other electrical equipment	-19	-22
Electronic components and accessories	-10	-12
Transportation equipment	-11	-7

a. Data are not seasonally adjusted.
b. Compares the first six months of 2001 with the last six months for which data are available.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Fourth District's unemployment rate has diverged notably from the national trend in recent months. A year-over-year comparison, without seasonal adjustments, shows that the District's rate is rising (which is not surprising for a recession), but less quickly than the U.S. rate. Why should this be?

Some have suggested that the District's heavy reliance on auto manufacturing, coupled with strong auto sales in recent months, have insulated its labor market, but this does not appear to be so. While it is true that

the District relies more heavily on manufacturing industries than the U.S. does, selling more cars has not translated into higher production. In fact, District auto makers reported very little overtime in the fall, and some plants closed for a few weeks in response to slumping demand for particular models.

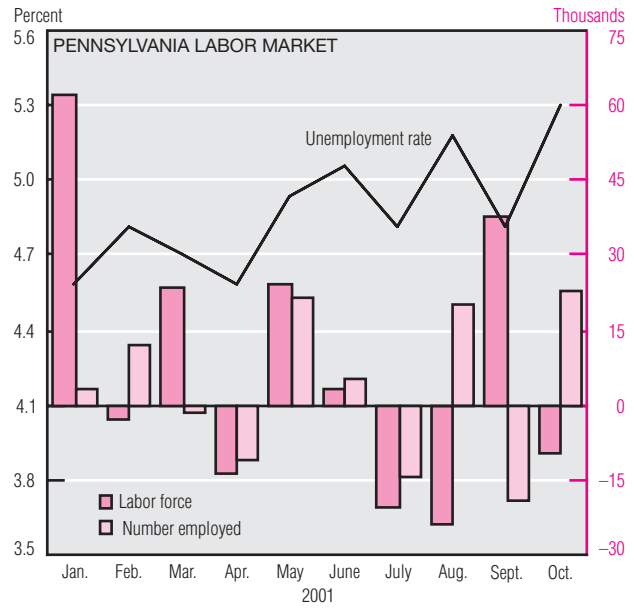
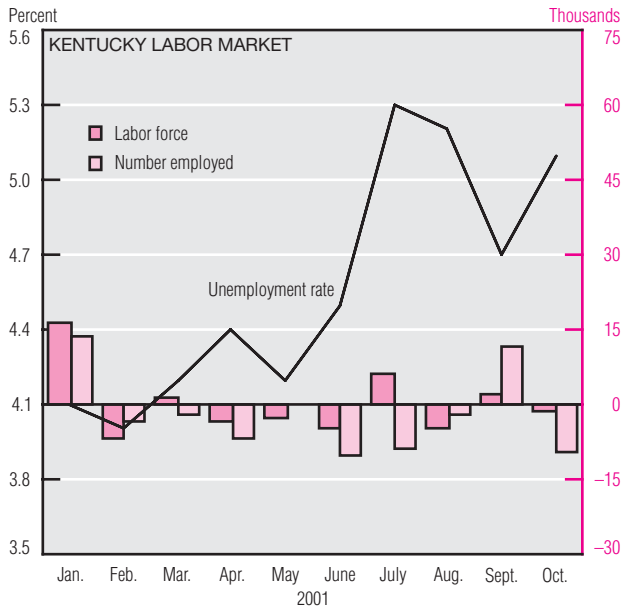
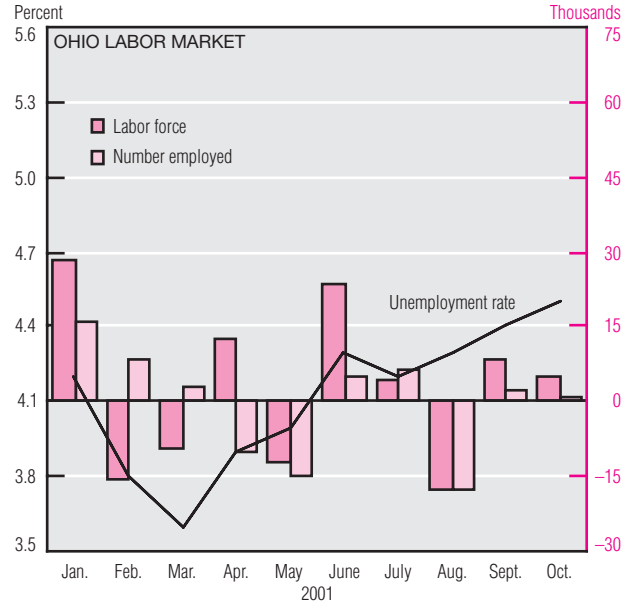
The two factors that do seem to make the District's labor market diverge from the national pattern are the industrial mix of its employment and the size of the labor force from which unemployment figures are calculated.

In both goods- and service-producing sectors, average monthly employment losses have increased in the last six months. To the District's benefit, its employment losses have moderated in the industries (such as manufacturing, especially transportation equipment) on which it depends more heavily than the nation does. At the same time, the District's employment losses have accelerated in industries where its share of nonfarm employment is smaller than the U.S. average (construction, wholesale trade, finance, and business services).

(continued on next page)

Regional Conditions (cont.)

	Average monthly change (thousands) ^a	
	January–June	June–November
All industries	26	-59
Wholesale trade	-8	-12
Retail trade	26	-18
Finance, insurance, and real estate	8	-2
Finance	5	-2
Services	31	-14
Business services	-38	-39
Health services	24	22
Educational services	12	6



NOTE: All data are seasonally adjusted.
 a. Compares the first six months of 2001 with the last six months for which data are available.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

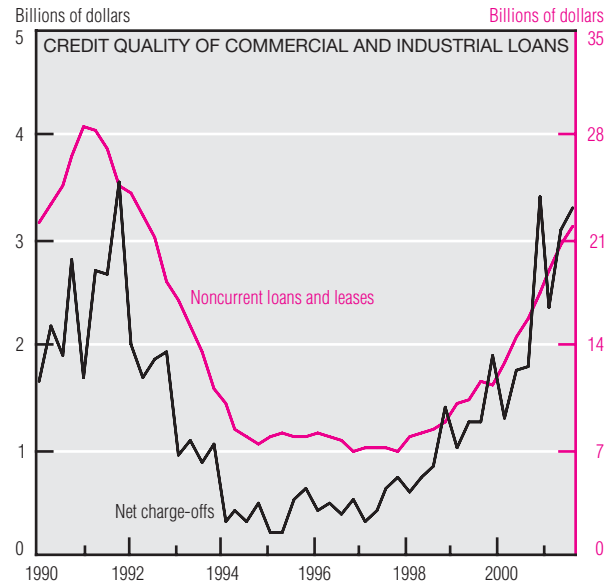
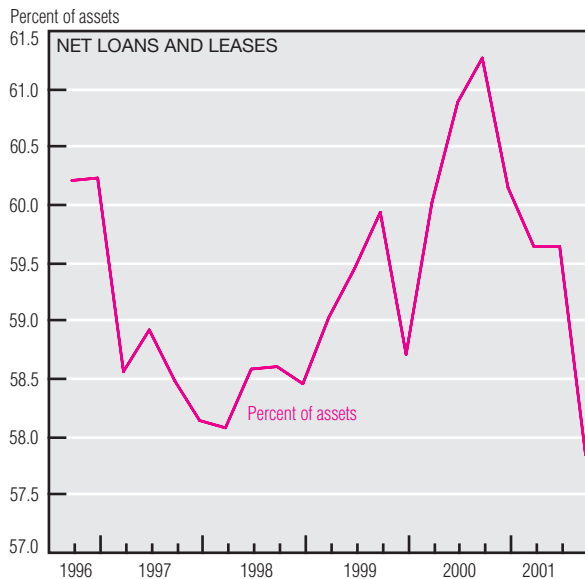
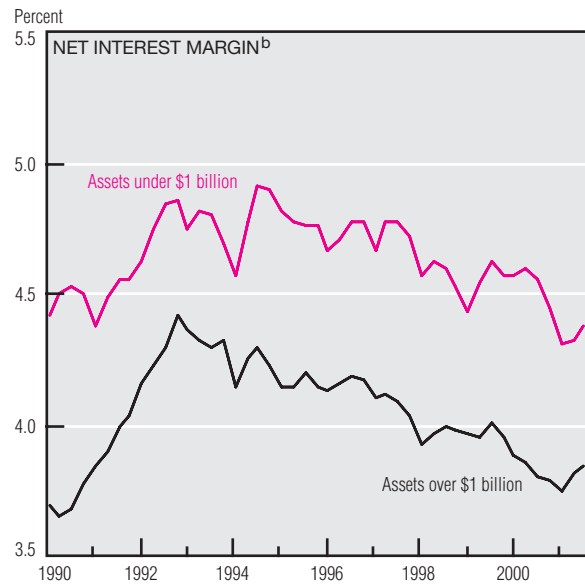
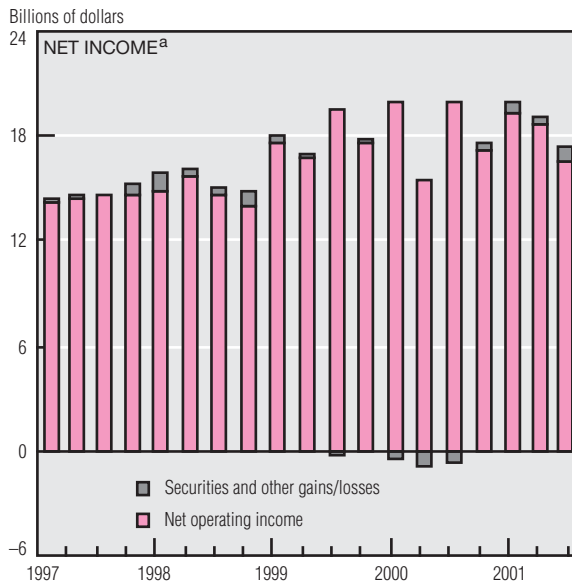
Undoubtedly, the District's labor market also benefits from its heavier-than-average dependence on health services employment. While its total employment gains have slowed slightly from the average monthly increase of 24,000 new jobs in the first six months of 2001, the health services industry continues to add more jobs than any other subindustry.

The District's divergence from the U.S. unemployment trend is also shaped by the composition and size of its labor force. Seasonally adjusted

data for states with more than 10 counties in the District (Kentucky, Ohio, and Pennsylvania) show that the labor force fluctuates significantly from month to month. Although Ohio's employment has grown in the last two months for which data are available, its labor force has grown at a faster rate than its jobs. Thus, despite a period of job growth, the number of unemployed has increased and the unemployment rate has risen. In Kentucky, movement in the unemployment rate does reflect changes in the number of jobs. Its

labor force changes in September and October were negligible compared to its employment changes. Pennsylvania's labor force figures have compounded the effects of employment expansion or contraction in the last three months. For each expansion in jobs, the state's labor force has contracted, further shrinking the number of unemployed. For each contraction in jobs, an expansion in the state's labor force has augmented the number of unemployed.

Commercial Banks



a. Net income equals net operating income plus securities and other gains and losses.

b. Interest and dividends earned on interest-bearing assets minus interest paid to creditors, expressed as a percent of average earning assets

SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2001:IIIQ.

Commercial banks have been adversely affected by the current recession. Between 2000:IIIQ and 2001:IIIQ, their net income declined \$1.9 billion to \$17.4 billion. In 2001:IIIQ, as in 2000:IIQ, a decline in credit quality contributed significantly to lower net income. To cover their expected third-quarter loan losses, banks set aside \$11.6 billion, the largest quarterly addition to reserves since 1990:IVQ. Net operating income, excluding discretionary transactions such as gains (or losses) on the sale of investment securities and extraordinary items, was 16.6%

lower than a year earlier. Most of the industry's decline in profits occurred at large banks that had sizable expenses for asset-quality problems. The industry's return on assets fell to 1.08% in the 2001:IIIQ, compared to 1.28% a year earlier.

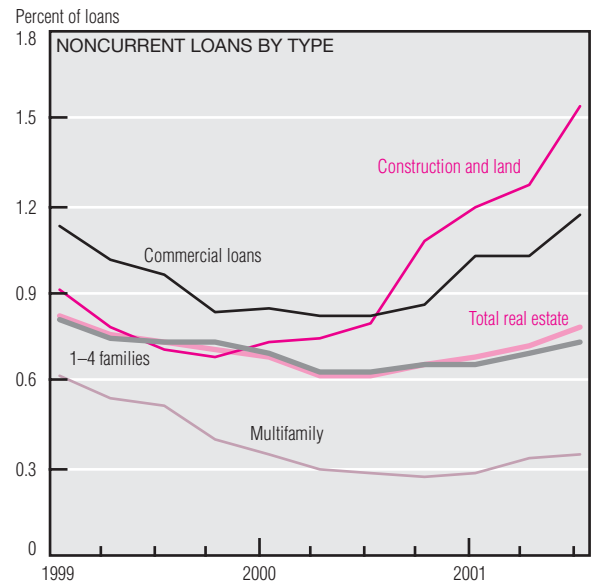
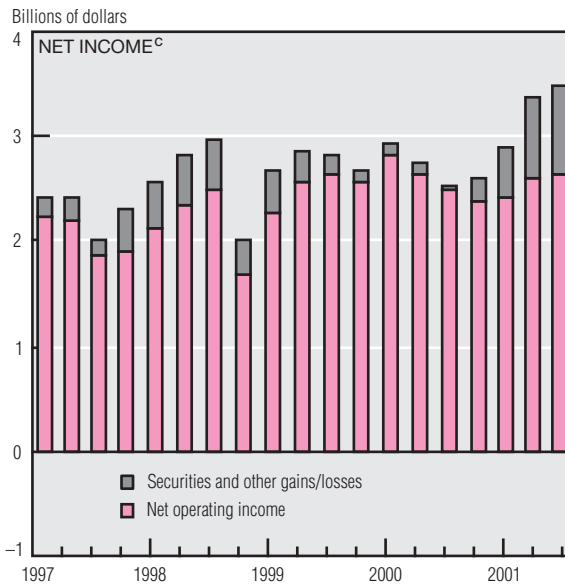
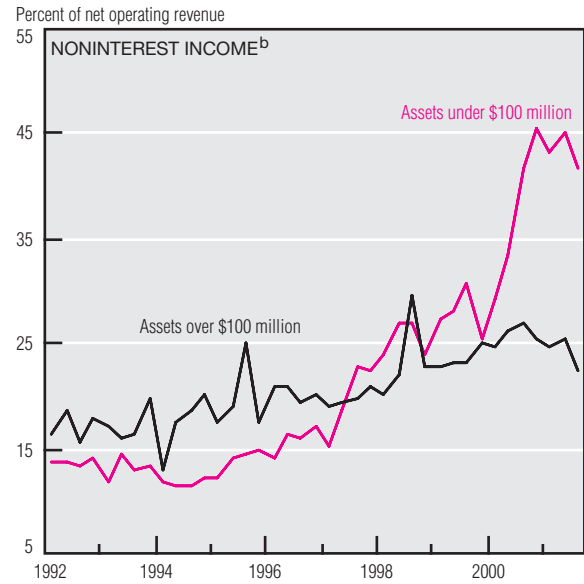
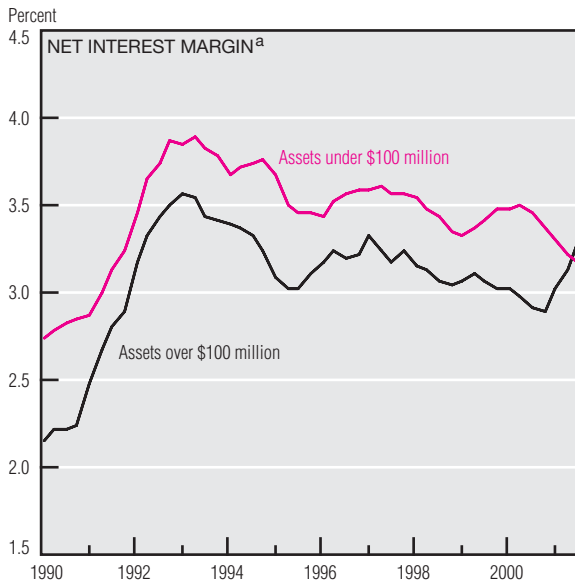
Banks' net interest margin rose slightly between the second and third quarters of 2001. Because of lower interest rates, the cost of funding declined faster than income, thus increasing the net interest margin, but it is too early to tell whether this represents a significant reversal of trends.

In 2001:IIIQ, for the first time since 1997:IQ, the industry posted a decline

in net loans. This reflects the smaller number of loan applications since the onset of the recession and, possibly, higher charge-offs and banks' reluctance to issue loans. The ratio of net loans and leases to assets is at a six-year low of 57.9%.

Net charge-offs have continued to increase since 2001:IQ. Noncurrent loans and leases—the sum of loans and leases 90 days or more past due in nonaccrual status—have been growing steadily since 1998:IQ. This shows the underlying decrease in credit quality that commercial banks have been facing since 1998.

Savings and Loan Associations



a. Interest and dividends earned on interest-bearing assets minus interest paid to creditors, expressed as a percent of average earning assets.

b. Net operating revenue equals net interest income plus noninterest income.

c. Net income equals net operating income plus securities and other gains and losses.

SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2001:IIIQ.

In 2001:IIIQ, the net interest margin (NIM) of large savings institutions rose 14 basis points (bp) to 3.28% over the previous quarter. Low interest rates reduced the cost of borrowing faster than interest income, resulting in higher net interest income. Small institutions' NIM fell 5 bp to 3.17%, reflecting the large share of fixed rate deposits in their liability structure. In a declining interest rate environment, they had less flexibility to adjust their cost of funds. This was the first quarter since 1990 in which large savings institutions had a higher NIM than small ones.

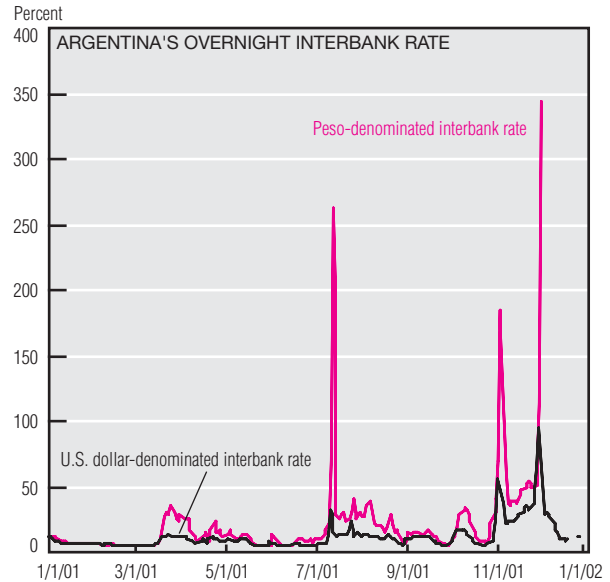
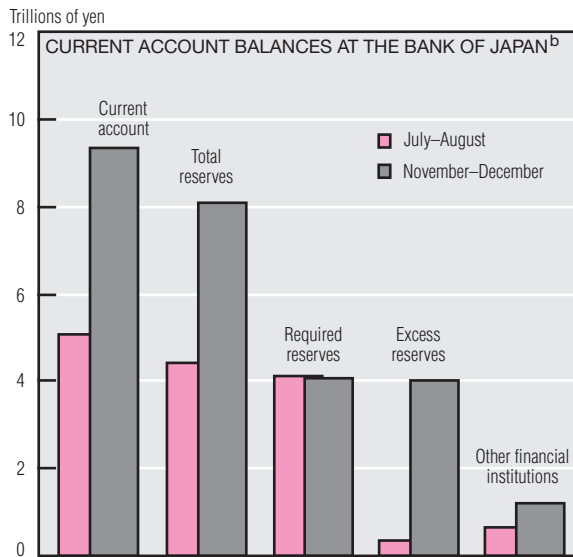
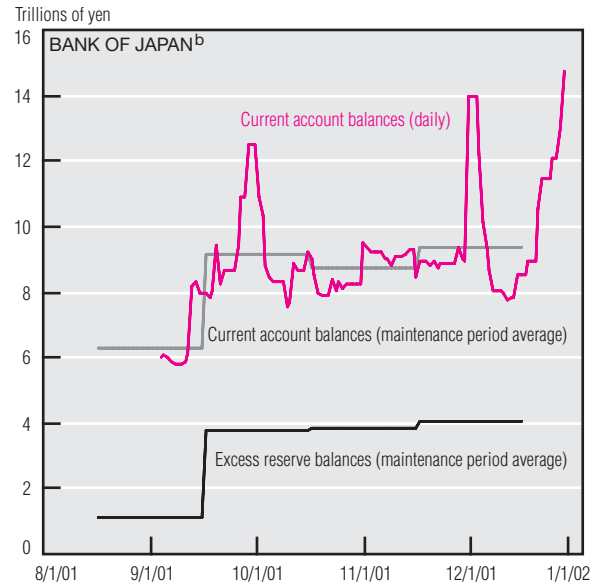
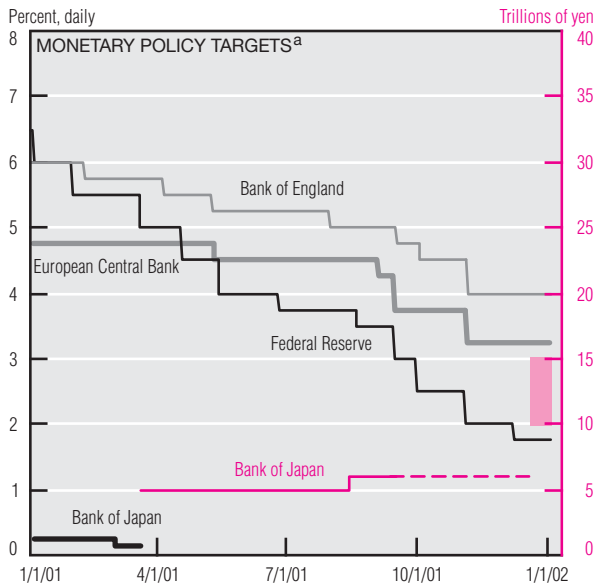
With most mortgage refinancing activity already behind us, current and prospective income from servicing fees is lower. This explains why savings institutions' total noninterest income declined \$372 million (11%) from the second quarter.

Despite this drawback, total net income for 2001:IIIQ was \$3.5 billion, \$936 million higher than it was a year earlier. This improvement is mainly the result of larger gains from selling securities at appreciated prices in a low interest rate environment. Note that mortgage-backed securities constitute the majority (about three-

quarters) of the securities portfolio. The average return on assets of 1.09% for the 2001:IIIQ was the second-best quarterly ROA since the record of 1.14% set in 1998:IIIQ.

The noncurrent-loans rate on real estate loans increased 6 bp to 0.82%. Home mortgages account for the majority (69%) of real estate loans made by savings institutions. Weakness in this category is the main culprit in the deterioration of the industry's noncurrent loans rate. Home mortgages' noncurrent rate increased 5 bp to 0.76% during the third quarter.

Foreign Central Banks



a. Bank of England and European Central Bank: two-week repo rate. Federal Reserve: overnight interbank rate. Bank of Japan: before March 19, 2001, overnight interbank rate; after March 19, a level of current account balances “around” the indicated quantity; after July 18, “above” the indicated quantity; after December 19, “around” the indicated range.

b. 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 other financial institutions not subject to reserve requirements. Reserve requirements are satisfied on the basis of the average of a bank’s daily balances maintained at the Bank of Japan starting the sixteenth of a 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 Central Bank of Argentina.

Only two major central banks took easing actions over the past month. In the U.S., the Federal Open Market Committee reduced the intended level of the overnight federal funds rate from 2% to 1.75% at its December 11 meeting. The Bank of Japan increased its target for the supply of current account balances from “above 6 trillion yen,” established in mid-September, to “around 10 to 15 trillion yen,” adopted on December 19. The Bank also increased the monthly volume of its intended purchases of Japan

Government bonds from 600 to 800 billion yen, and adopted several “measures to strengthen money market operations.” So far this year, the Bank’s more abundant supply of current account balances has been reflected almost entirely in banks’ holdings of excess reserves and not at all in required reserves.

Recurrent bouts of anxiety about Argentina’s economy and the durability of its peso-dollar peg have been reflected in volatile—and sometimes very substantial—spreads of peso-

denominated interest rates above dollar-denominated rates. By the beginning of December, peso-denominated interbank rates no longer were being quoted. Depositors, seeking to protect themselves against a possible devaluation of the peso, began a run on the banking system that triggered a bank holiday ending December 27. The then-government of Mr. Rodriguez Saa said it would maintain the dollar value of the peso but would issue a new, third fiat currency, the *argentino*.