

The Economy in Perspective

Walking a hard line... In the face of ever-brighter business conditions, passing an economic stimulus package finally proved too hard a row for the U.S. Congress to hoe. Unable to reach a compromise among its members that could also pass muster with the White House, the Senate gave up its effort to move a bill as incoming economic data showed a firming tone across a variety of industries and regions.

Inventory management provides one explanation of the quick improvement in economic circumstances. As retail sales plunged in the aftermath of September 11, merchants immediately curtailed their purchases of hard goods and began to discount their prices—zero-percent financing campaigns in the automobile industry being among the most prominent examples of aggressive merchandising. Inventories of capital goods such as computers and telecommunications gear also shrank dramatically. Now, with inventories depleted and sales running at a faster pace than production, factory orders are finally strengthening. The economy seems to be getting traction.

Confidence always plays a key role during hard times, but there are no hard-and-fast rules for maintaining it. The war against terrorism is undoubtedly having a mixed effect. On one hand, had the World Trade Center not been attacked, it is not even clear that the U.S. economy would be in recession at all. To be sure, a number of industries were hard up well before last September and had already scaled back inventories and work hours. But the attacks initially engendered so much fear and uncertainty among the public that the economy was hard put to stay afloat. Now that our government has launched a hard-hitting response, patriotic confidence seems to have returned. Our hard-nosed pursuit of the enemy will also provide economic lift in the form of sharply higher outlays for national defense and homeland security hardware.

In addition to considering various methods for combating terrorism, Congress has its hands full with the Enron scandal. The hard, sad truth about this affair is likely to be how commonplace it turns out to be in kind, if not degree. Press accounts to date suggest that many of the parties involved acted in their own narrow, short-term self-interest. The entire enterprise seems to have been determined, both in size and sphere of influence, by greed and hubris. Though one hopes there will be

no more supernovas like Enron in our universe, there is already hard evidence of more than a few fallen stars.

Many people say that the widespread practice of egregiously creative financial accounting did not appear until just recently, and perhaps that is so. But the seeds of inspiration most likely were sown in the years of the stock market boom when investors were taken in by the hard-sell campaign of the New Economy messiahs. Out went the time-honored practices of hardheaded accountants, the hard stares of stock analysts, and the hard-line approach of regulators toward corporate disclosure. In that get-rich-quick world, advocates of hard numbers endured hardship.

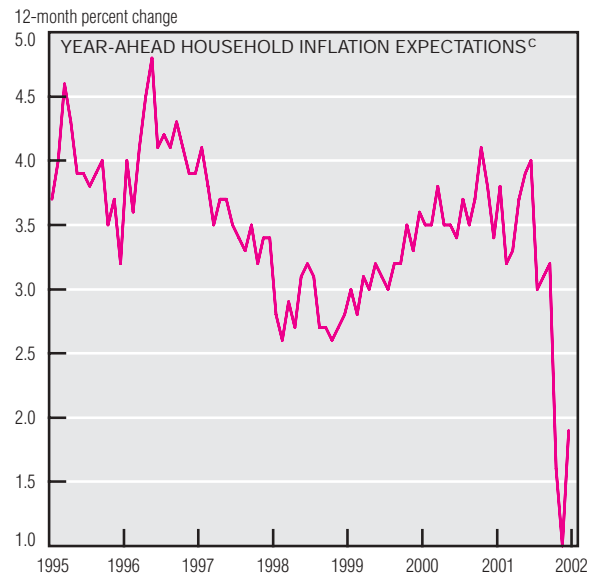
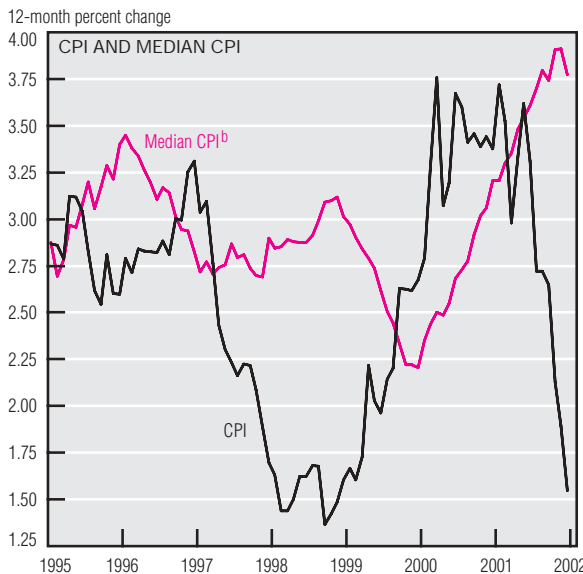
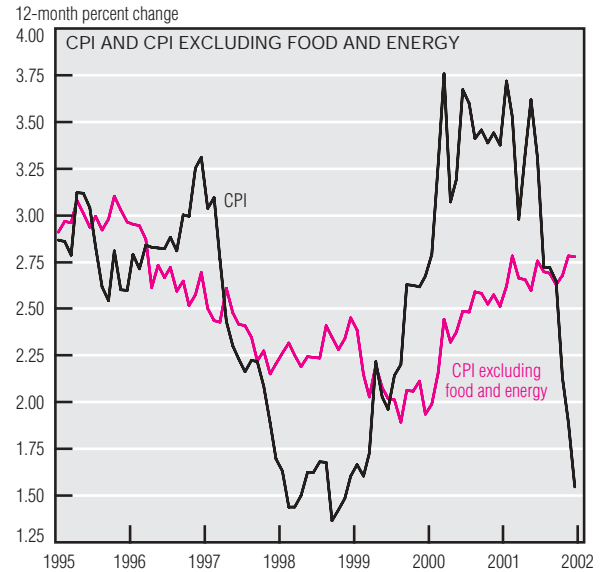
Excuse the hard-boiled attitude, but not so long ago we Americans had a hard time getting serious about price stability. What do the incipient economic recovery, accounting high jinks, and price stability have in common? It's not such a hard line to follow: Hard money, like hard numbers, fosters trust and confidence.

Many analysts still believe that inflation accelerates because labor markets become too tight, in other words, because the unemployment rate dips too low. Since they are certain that current slack in labor markets will suppress inflation, a continuation of today's low rate is a standard feature of the mainstream outlook these days. Accordingly, some observers predict that the Fed will keep its policy rates steady for quite a long time. In fact, given unsettled equity markets, sluggishness in our trading partners' economies, and the dollar's value in foreign exchange markets, some analysts flatly reject any suggestion that the Fed should consider raising the funds rate in the near future.

Inflation accelerates when the central bank persistently creates more money than people want. This condition usually results when central banks hold their policy rates too far below other, market-determined rates. Avoiding such outcomes can make central bankers appear hardhearted, especially if they see a need to move their policy rates before the economy reaches full throttle. But don't be too hard on the hard-liners. Recent low inflation statistics notwithstanding, the core CPI measures still register in the 3% range, just as they have during the past five years. With a hard landing unlikely and expansion hard by, the Fed faces some hard calls.

Inflation and Prices

	Percent change, last:				
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	2000 avg.
Consumer prices					
All items	-2.0	-2.0	1.5	2.2	3.4
Less food and energy	1.3	2.6	2.8	2.4	2.5
Median ^b	2.0	3.5	3.8	3.0	3.2
Producer prices					
Finished goods	-7.5	-10.8	-1.9	0.7	3.6
Less food and energy	-1.6	-1.8	0.7	1.1	1.3



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 c. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

The Consumer Price Index fell in December at a -2.0% annual rate. Energy components again exerted considerable influence on the CPI: Its energy index declined sharply for the third consecutive month. As a result of recent declines in energy prices, the CPI has been falling or unchanged since September. The last time it showed such moderate behavior was 1986—during another period of sharp, persistent declines in energy prices.

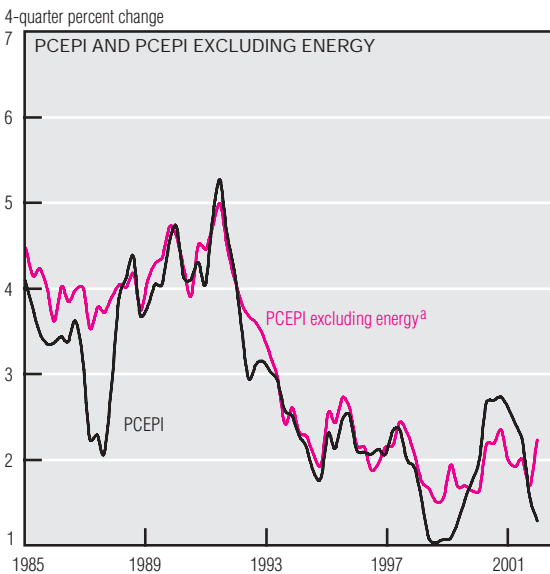
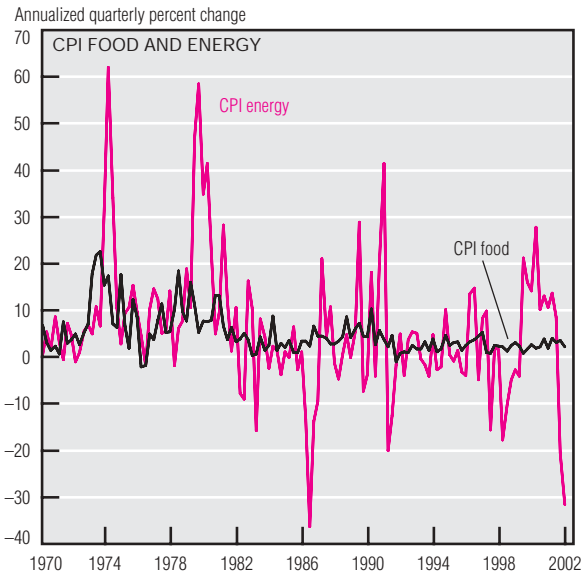
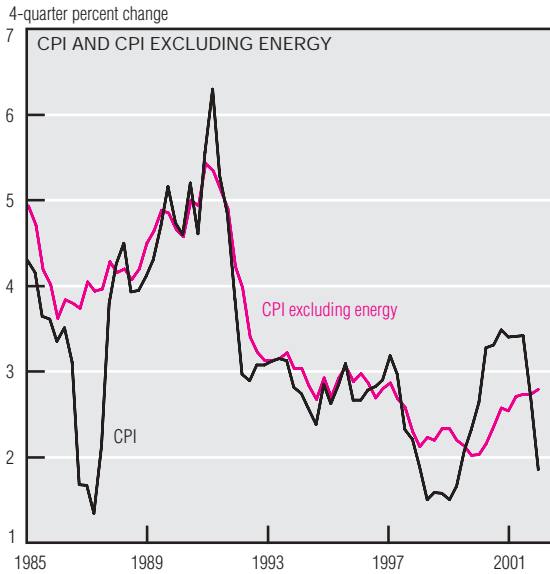
By contrast, the CPI excluding food and energy rose in December (1.3% annual rate), as did the median CPI

(2.0% annual rate). These "core" measures present a dramatically different picture of the economy's inflation performance during 2001 than does the CPI. For the 12 months that ended in December, the CPI rose a modest 1.5%—less than half its increase in the comparable period in 2000 (3.4%). However, both the CPI excluding food and energy and the median CPI showed greater increases in 2001 than in 2000. For the 12 months that ended in December, the CPI excluding food and energy rose 2.8% in 2001 versus 2.5% in 2000; the median CPI rose 3.8% in 2001 versus 3.2% in 2000.

Measures of core inflation are intended to isolate underlying trends. The measures just mentioned represent two distinct approaches. The median CPI belongs to a class of core inflation estimators that are produced by trimming the most extreme observations in the price-change distribution, regardless of their source. In contrast, the CPI excluding food and energy is one of a group of estimators that are produced by eliminating the same subset of components from the computation of the monthly CPI.

(continued on next page)

Inflation and Prices (cont.)



Accuracy of Selected Components in Predicting PCEPI Inflation Two Years Ahead^{a,b}

PCEPI components	Root mean square error ^c
Food	0.99
PCE excluding energy	1.10
PCE excluding food and energy	1.23
Nondurable goods	1.70
Motor vehicles and parts	1.71
Transportation services	1.91
Services	2.01
Housing	2.02
Durable goods	2.42
Clothing and shoes	2.76
Medical care services	3.43
Gasoline, fuel oil, and other energy goods	10.52

a. Calculated by the Federal Reserve Bank of Saint Louis.

b. 1983:IIIQ to 2001:IIQ.

c. The root mean square error is computed by taking the difference between an actual value and its forecasted value at any point in time, squaring this difference, averaging the set of these differences at all points in time, and then taking the square root of this average.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; William T. Gavin and Rachel J. Mandal, "Predicting Inflation: Food for Thought," Federal Reserve Bank of Saint Louis, *The Regional Economist* (January 2002), pp. 5-9; and Todd E. Clark, "Comparing Measures of Core Inflation," Federal Reserve Bank of Kansas City, *Economic Review* (2001:IIQ), pp. 5-31.

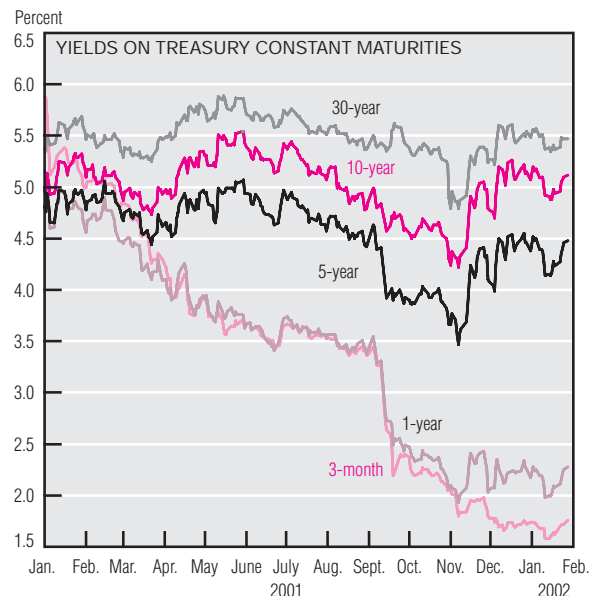
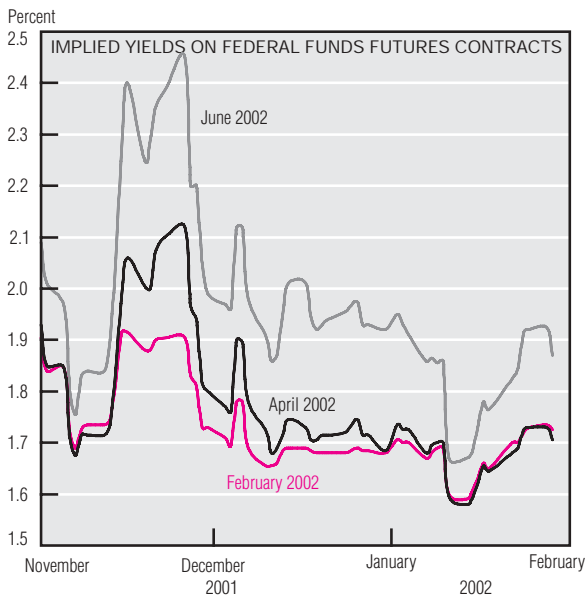
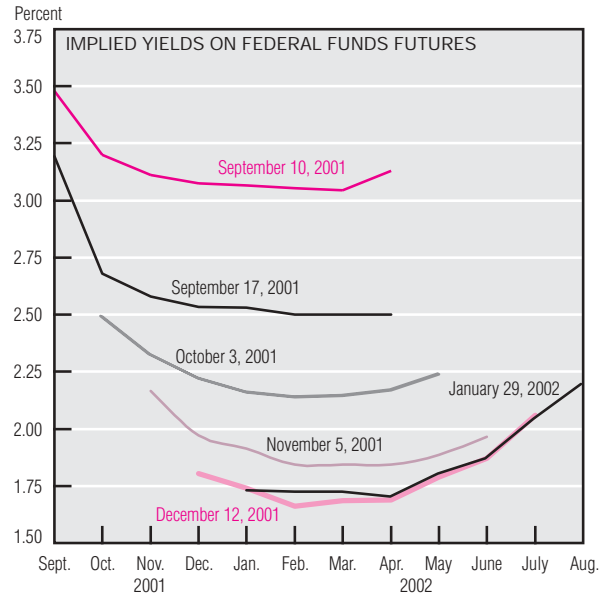
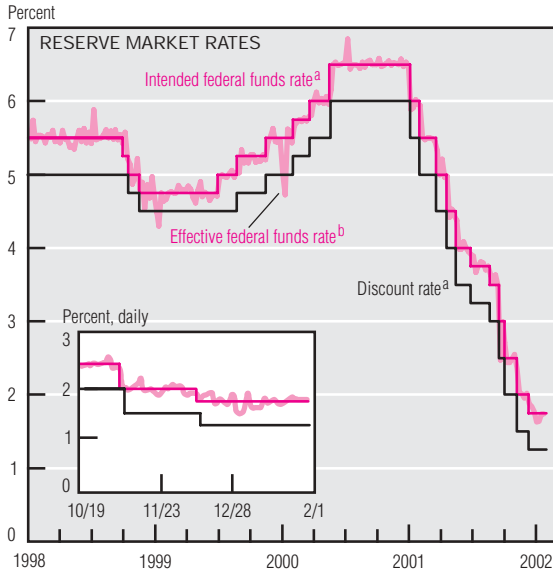
Among the measures that use this second approach, the best known and most widely used variant is probably the CPI excluding food and energy. Recently, though, some analysts have argued that eliminating food from the CPI to arrive at a core inflation measure is no longer justified. At the Federal Reserve Bank of Saint Louis, for example, researchers point to increased stability in food prices over the last several years, attributing it to technological improvements and changes in consumer eating habits. During the last decade, food for use at

home has also come to represent a smaller share of overall consumer expenditures, according to work done at the Federal Reserve Bank of Kansas City. This means that changes in food prices don't influence the overall inflation index as strongly as they once did.

Both these investigations conclude that for measuring the underlying inflation trend, the CPI excluding energy is superior to the CPI excluding food and energy. That finding applies with equal force to the personal consumption expenditures price index (PCEPI), an alternative retail

price statistic. This conclusion is based on examination of the forecasting properties of the CPI and the PCEPI. It assumes that the better core measure should also be the better predictor of future inflation because it should show the longer-term trend more precisely. Examining the root mean square error (a measure of forecast accuracy) of both core inflation indexes suggests that the PCEPI excluding energy has recently been superior to the PCEPI excluding food and energy as a predictor of PCEPI growth two years ahead.

Monetary Policy



a. Daily.
b. Weekly average of daily figures.

SOURCES: Board of Governors of the Federal Reserve System; Chicago Board of Trade; and Bloomberg Financial Information Services.

At its meeting of January 29–30, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%, while the discount rate remained at 1.25%. However, the FOMC continues to believe that “the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.”

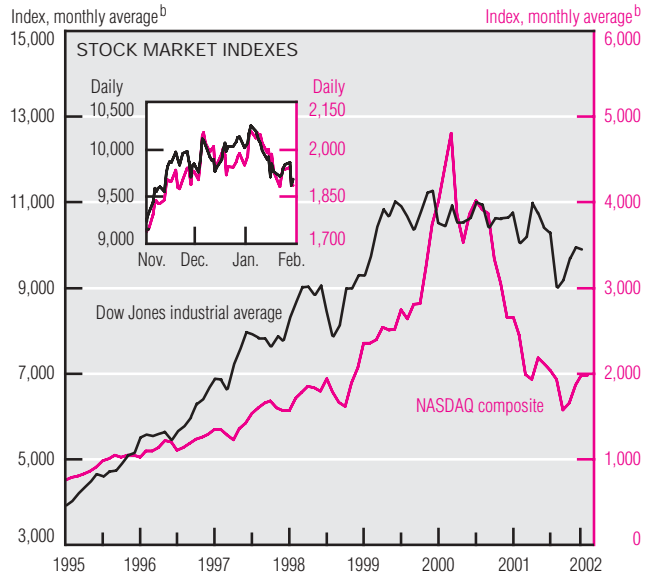
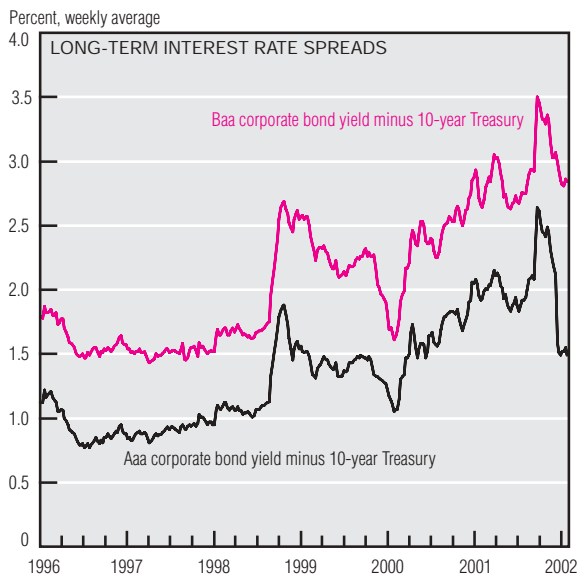
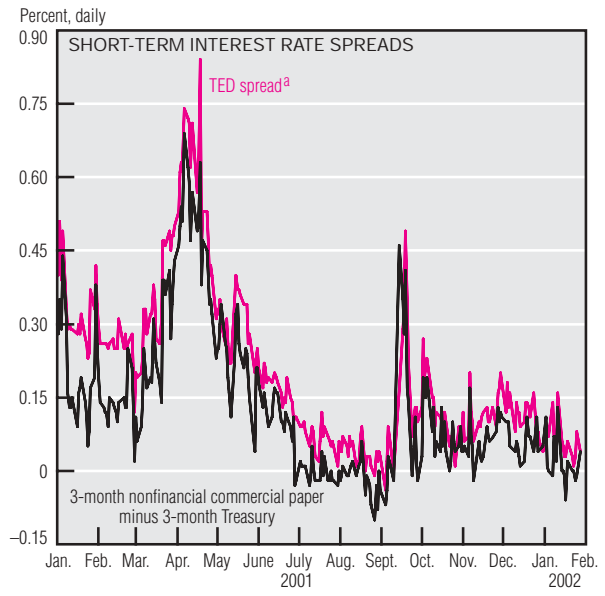
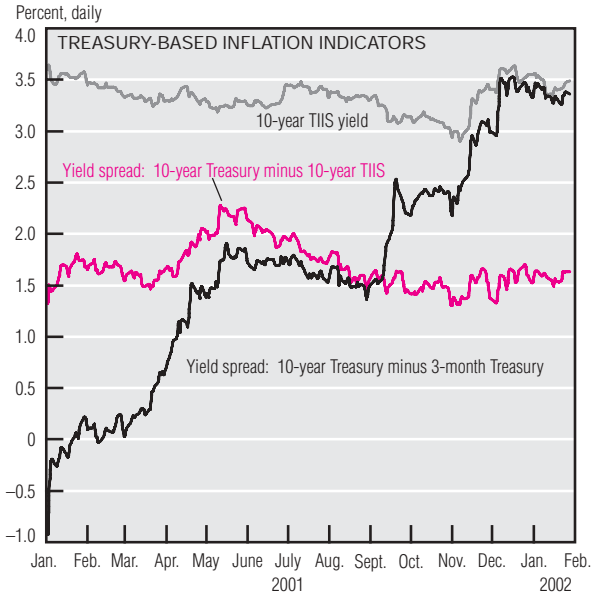
Since no meeting is scheduled for February, the implied yield for the federal funds futures contract for that month should be a good indicator of how market participants expected the FOMC to act at its January 29–30

meeting. Throughout much of January, a fair probability of a further rate cut was priced into the contract. Near the end of the month, yields showed that most participants expected the current easing cycle to end. Recent positive data on consumer sentiment, initial unemployment insurance claims, and the index of leading indicators in particular were likely incorporated in the upward revision of the expected funds rate. During January, short-term Treasury rates moved closely with market expectations of the fed funds rate.

Longer-term rates dropped in the first half of January and rose in the second. Since September, the spread between the 10-year and 3-month Treasuries has increased markedly. This spread is frequently used as an indicator of either higher future inflation or higher future real rates. However, the trends of more inflation indicators, such as the spread between the 10-year Treasury and 10-year inflation-indexed securities (TIIS), suggest that inflation expectations have not changed

(continued on next page)

Monetary Policy (cont.)



NOTE: All Treasuries referred to are constant maturity.

a. 3-month euro minus 3-month constant maturity Treasury bill yield.

b. Through January 29, 2002.

SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

appreciably. The TIPS rate has been flat since September.

Concern over budget deficits is often cited as one factor that can keep long-term interest rates high. Despite the likely need for future deficit spending to fight terrorism, this explanation for the increased spread between the 10-year and 3-month Treasuries does not seem valid either. Rather, the September 11 terrorist attacks had little impact on long-term rates but dramatically reduced short-term rates. Thus, the increase in the spread most likely reflected a sharp

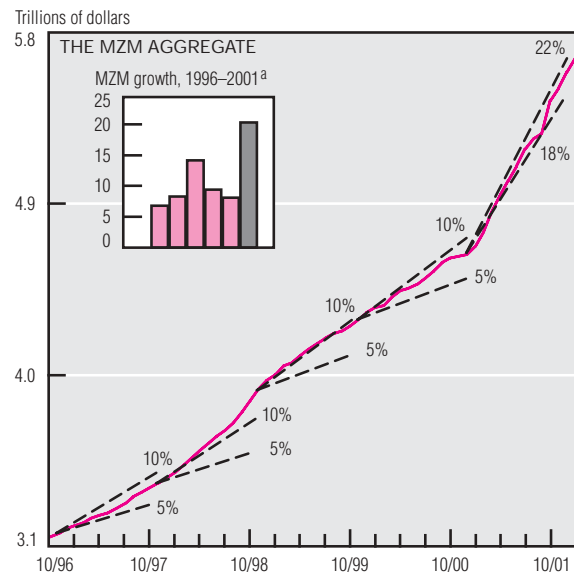
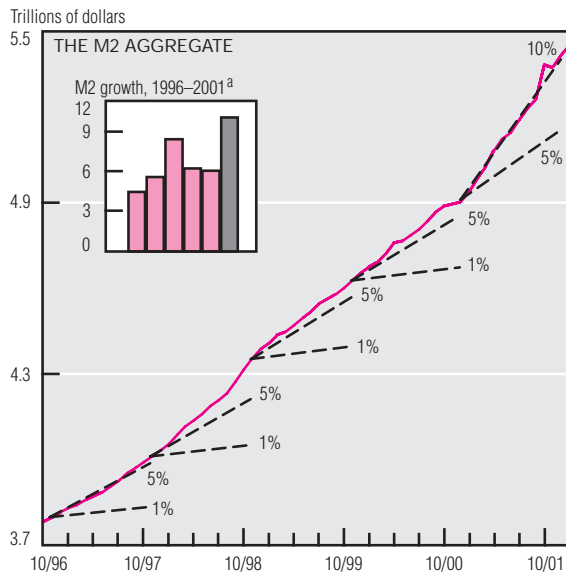
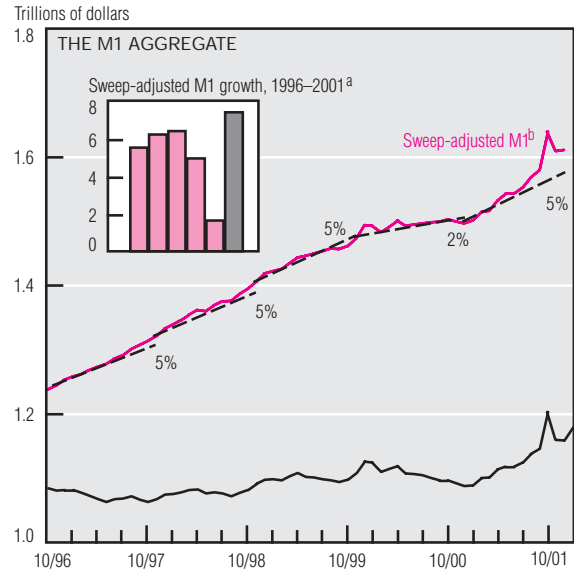
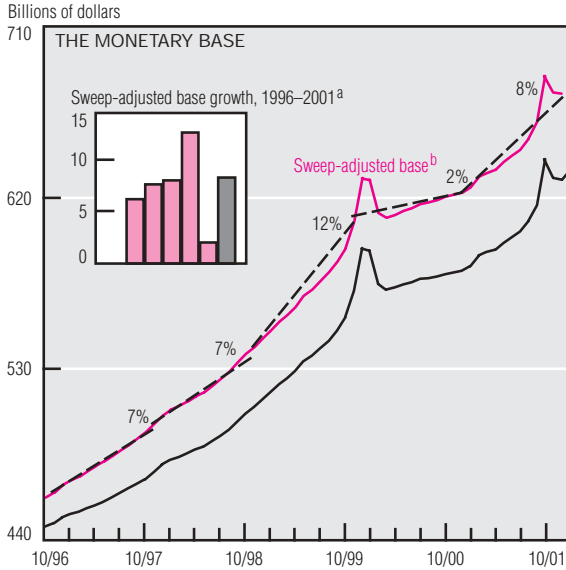
but temporary drop in short-term rates. This decrease was subsequently supported by a cumulative reduction of 1.75 percentage points in the federal funds rate that market participants consider likely to be taken back over the next couple of years.

Recessions are often associated with a sharp rise in the spread between the cost of private borrowing and Treasury borrowing. No such increase has occurred during the current downturn, as indicated by the low spread between commercial paper and the 3-month Treasury.

International financial stability has also contributed to the low Treasury-to-euro (TED) spread.

Other gauges of the spread between private and public borrowing are the spreads between corporate bonds and 10-year Treasuries. Both the Aaa and Baa corporate bond rate spreads dropped appreciably over the last months of 2001 and have been essentially flat since January. The same pattern can be seen in equity prices, which rose for several months but have remained flat or declined slightly since January.

Money and Financial Markets



NOTE: Last plots for the monetary base, M1, M2, and MZM are December 2001. Last plots for the sweep-adjusted base and sweep-adjusted M1 are November 2001. Prior to November 2000, dotted lines for M2 are FOMC-determined provisional ranges. All 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. Data are seasonally adjusted.

b. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6, and "Aggregate Reserves of Depository Institutions," H.3.

In 2001, the monetary aggregates grew rapidly across the entire spectrum of liquidity. A number of factors combined to produce this surge in growth rates. Because 2001 calendar-year data are available for most of the aggregates, one can summarize their behavior and the driving forces behind their growth.

Narrowly defined, more liquid monetary aggregates, such as the sweep-adjusted monetary base and sweep-adjusted M1, grew robustly in

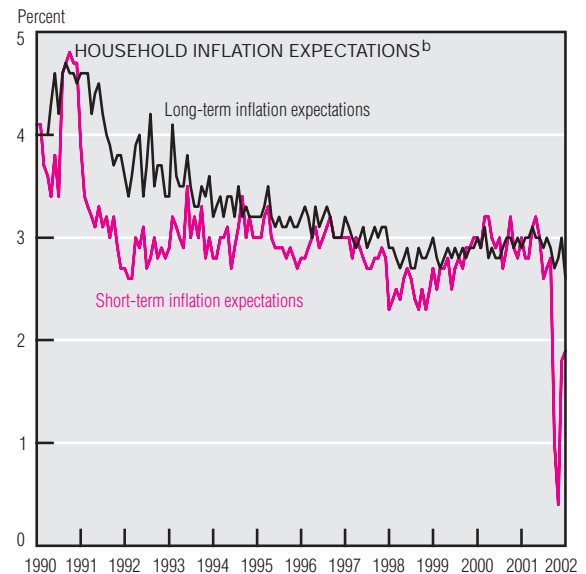
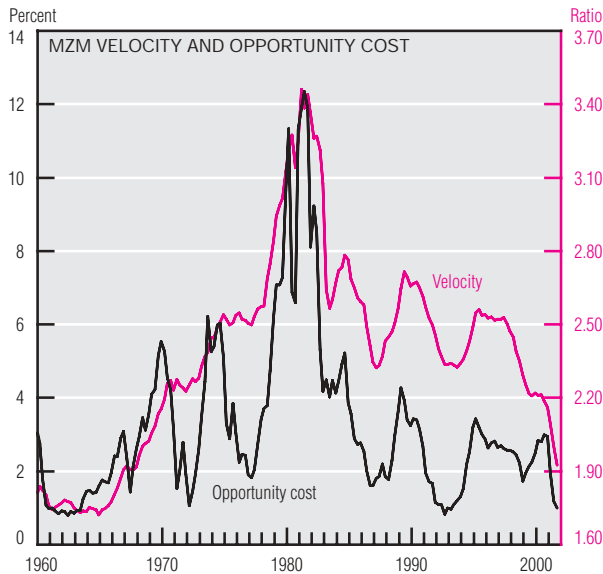
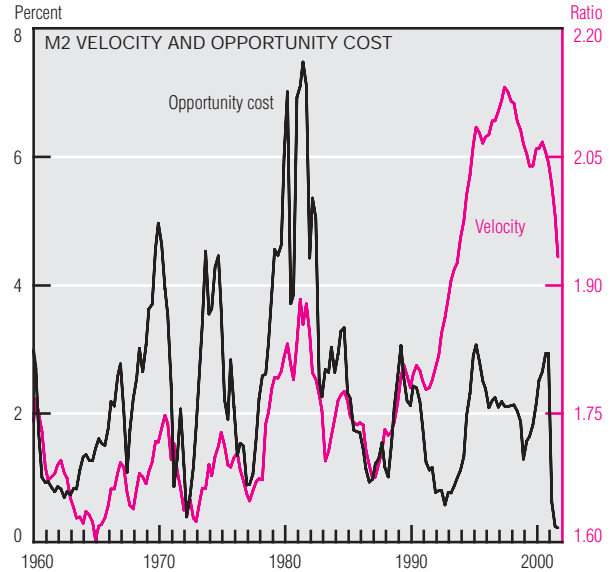
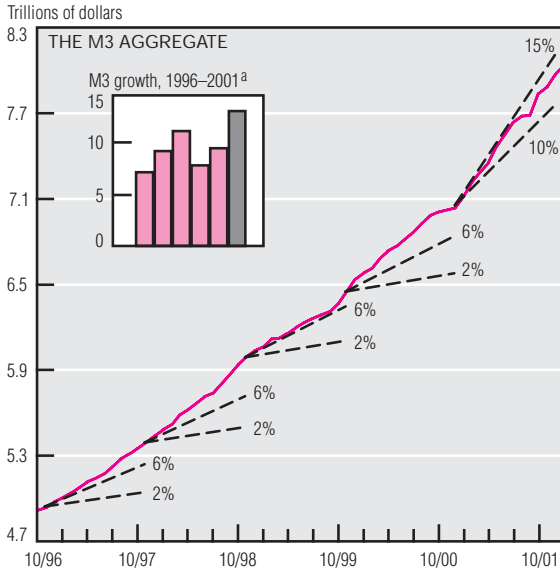
2001, showing increases of 8.4% and 7.3%, respectively. Year-over-year growth, already quite strong for most of 2001, rose sharply during the fourth quarter as the Federal Reserve moved to provide needed liquidity in the wake of the terrorist attacks.

However, annual growth rates are somewhat misleading because of unprecedented volatility in the narrow measures of money during the fourth quarter of recent years. Late in 1999, concerns about the century

date change motivated an expansion of reserves which, when proven unnecessary, were drained out of the system during 2000. The abnormally elevated level of the narrow monetary aggregates during 1999:IVQ relative to 1998:IVQ showed up as a sharp increase in the growth rate one year and a decline the next. A similar scenario followed the events of September 11. But if viewed over a two-year horizon, annualized sweep-adjusted M1 growth rose modestly

(continued on next page)

Money and Financial Markets (cont.)



NOTE: Last plot for M3 is December 2001. Prior to November 2000, dotted lines for M3 are FOMC-determined provisional ranges. All subsequent dotted lines represent growth in levels and are for reference only.

a. Growth rates are percentage rates calculated on a four-quarter over four-quarter basis. Data are seasonally adjusted.

b. Median expected change in consumer prices one and 5-10 years ahead, as measured by the University of Michigan's *Survey of Consumers*.

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 University of Michigan.

between 1999:IVQ and 2001:IVQ, and annualized sweep-adjusted base growth actually fell relative to 2000.

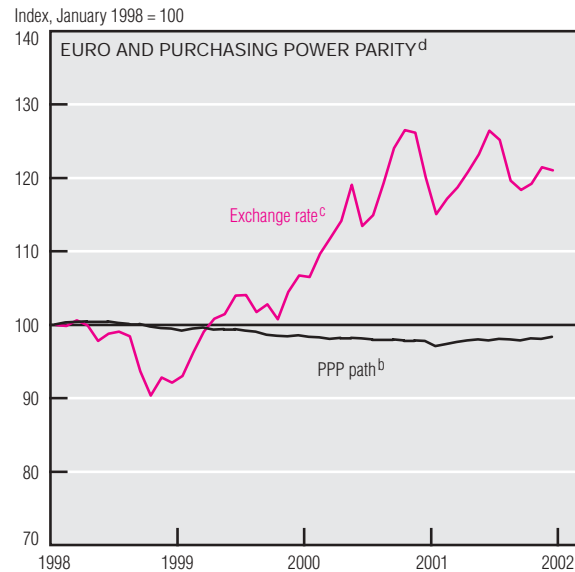
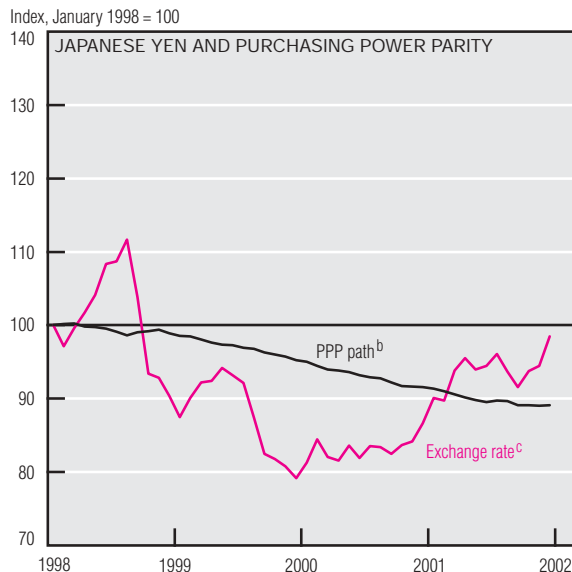
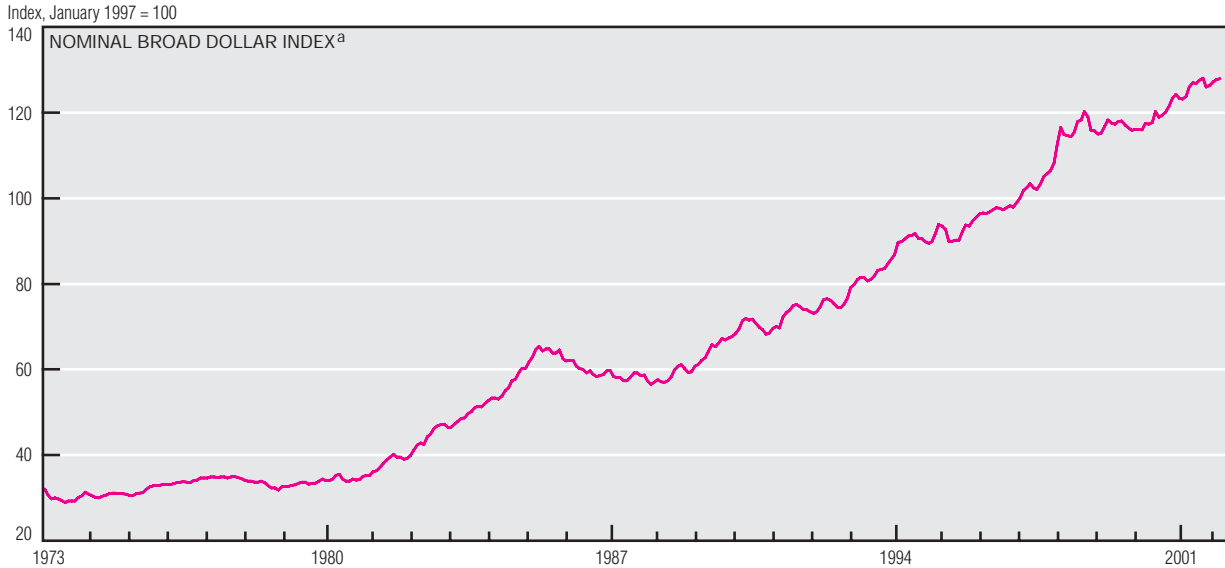
The broader (less liquid) monetary aggregates such as M2, M3, and M3M are, by their very nature, more insulated from the types of shocks that cause the narrow monetary aggregates to expand or contract. Often, these forces simply wash out in the broad monetary aggregates. Nonetheless, 2001 growth in the broad monetary aggregates was, if

anything, even stronger than in the narrower ones. In 2001:IVQ, growth from four quarters previous in M2, M3, and M3M reached 10.3%, 12.9%, and 20.4%, respectively.

Despite this growth in the broad monetary aggregates, inflation and inflation expectations have remained subdued. This is because velocity, which measures the rate at which dollar balances turn over during a given period, has been declining for both M2 and M3M. Opportunity cost measures earnings lost by holding

the components of an aggregate instead of an alternative asset such as a U.S. Treasury security. Thus, swings in the opportunity cost of money often coincide with changes in its velocity. Essentially, dollars turn over more slowly when opportunity costs fall because they are less costly to hold. This enables money to grow faster without igniting inflation. Thus far, the good news is that despite elevated money growth, inflation expectations have not risen.

Is the Dollar Overvalued?



a. The nominal broad dollar index measures the average change in the dollar's nominal exchange value against the currencies of our 36 most important trading partners.

b. Ratio of foreign CPI to U.S. CPI.

c. Nominal exchange rate in foreign currency units per U.S. dollar.

d. For dates prior to January 1999, a "synthetic" euro is constructed from the currencies of the euro-zone countries.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Statistical Office of the European Communities; and Japan Ministry of Public Management, Home Affairs, Post, and Telecommunications.

Despite continuing weakness in U.S. economic activity and sharp reductions in the Federal Reserve's key target interest rates, the dollar remains strong in foreign exchange markets. Its persistence has surprised many observers. Some now complain that the dollar is overvalued, implying that its exchange value is fundamentally incorrect, detrimental to U.S. economic growth, and ultimately unsustainable.

"Overvalued" (or "undervalued") typically refers to the difference

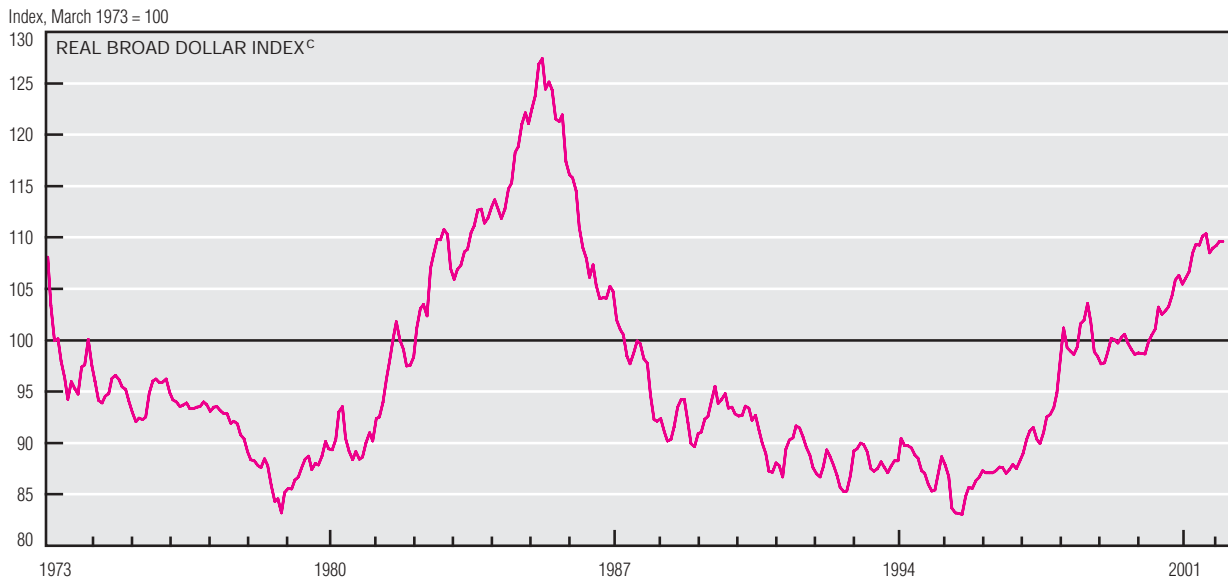
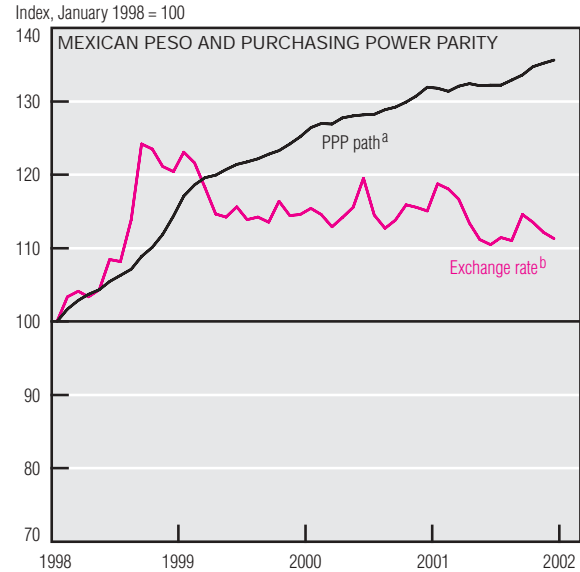
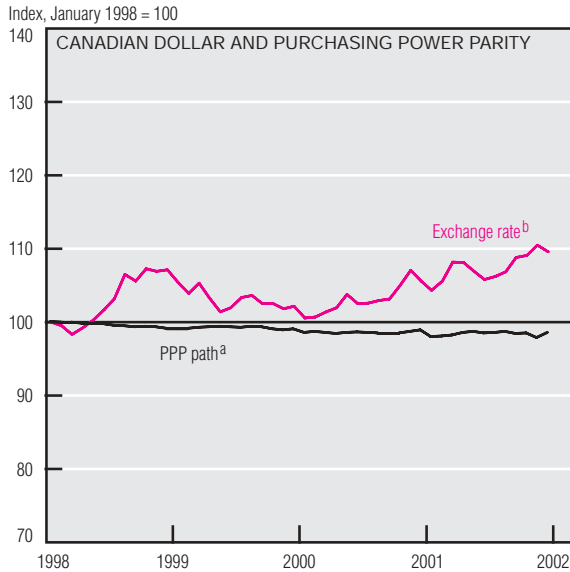
between a current exchange rate and its purchasing power parity (PPP) value. The PPP theory maintains that exchange rates will adjust to inflation differentials between countries. It relies on international trade and the arbitrage of goods prices. If, for example, prices are rising faster in the U.S. than in Japan, consumers will shift away from U.S. goods toward Japan's. To buy Japanese products, however, consumers must first acquire Japanese yen, and, in the process, they will bid down the value

of the dollar relative to the yen. PPP contends that the dollar's depreciation will exactly offset the price advantage that Japanese goods enjoy. If the U.S. has a 2% annual rate of inflation and Japan's rate is zero, PPP predicts that the dollar will depreciate by 2% per year against the yen.

Using PPP as a guide, the dollar currently seems overvalued by nearly 11% against the Japanese yen, 23% against the euro, and 11% against the Canadian dollar. The U.S. dollar is undervalued by almost 28% relative to

(continued on next page)

Is the Dollar Overvalued? (cont.)



a. Ratio of foreign CPI to U.S. CPI.

b. Nominal exchange rate in foreign currency units per U.S. dollar.

c. The real broad dollar index measures the average change in the dollar's real exchange value against the currencies of our 36 most important trading partners.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Banco de México; and Statistics Canada.

the Mexican peso. A more comprehensive assessment, however, is afforded by the Board of Governors' real broad dollar index. This statistic, which incorporates both exchange rate movements and inflation differentials, describes the dollar's value relative to PPP against the average of our 36 most important trading partners. By construction, the real broad dollar index equals 100 whenever the dollar is at its PPP value. If PPP always held, the index would

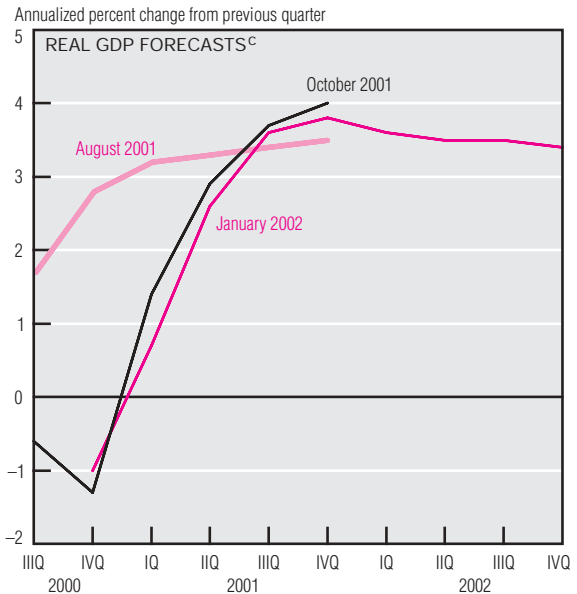
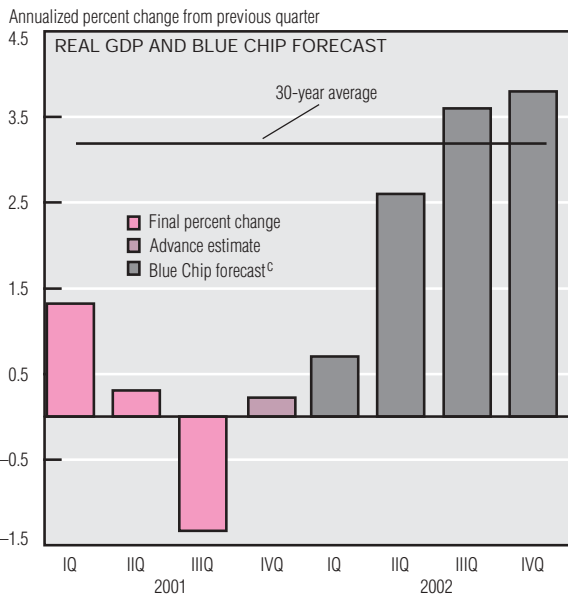
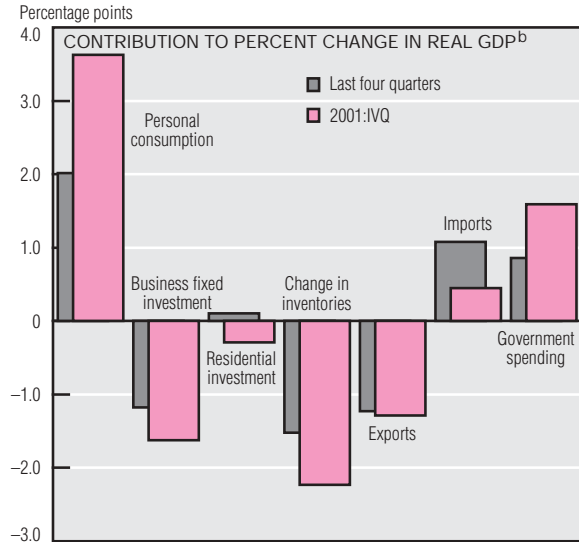
constantly equal 100. This measure suggests that the dollar is currently overvalued by approximately 10%.

The real broad dollar index shows, however, that PPP is a poor guide to the dollar's foreign exchange value. Variations from PPP are the norm, not the exception, and the magnitude of the dollar's current departure from PPP is not unusual. Moreover, deviations from PPP can last many years. Exchange rates may eventually drift back toward their PPP values, but they need not stay there.

Deviations from PPP can stem from a host of fundamental economic factors. The dollar's recent strength, for example, may reflect expectations that past strong productivity advances will continue as the economy rebounds. While the word "overvalued" can have meaning when governments interfere with the determination of exchange rates, it is largely devoid of economic content when private market forces hold sway. Then, "overvalued" becomes a political statement.

Economic Activity

Real GDP and Components, 2001:IVQ ^{a,b} (Advance estimate)	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	5.2	0.2	0.1
Personal consumption	84.5	5.4	3.0
Durables	79.6	38.4	13.4
Nondurables	4.3	0.9	1.0
Services	14.8	1.6	1.9
Business fixed investment	-43.6	-12.8	-9.2
Equipment	-13.5	-5.2	-8.5
Structures	-24.5	-31.0	-11.0
Residential investment	-6.3	-6.4	2.4
Government spending	36.1	9.2	4.9
National defense	8.2	9.3	5.6
Net exports	-21.6	—	—
Exports	-34.2	-12.4	-11.3
Imports	-12.6	-3.4	-7.5
Change in business inventories	-58.7	—	—



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*, August 10 and October 10, 2001 and January 10, 2002.

The advance estimates for the national income and product accounts, released January 30, have led many to ask whether the current recession may be over. According to the advance estimate, real GDP growth was 0.2% (annualized rate) in 2001:IVQ. Spending on personal consumption grew at a whopping 5.4% (annualized rate) from the previous quarter, its highest growth rate since 2000:IQ. Much of this spending was spurred by durable goods, especially October's surge in auto sales. Government spending also posted an extraordinary

gain of 9.2% (annualized), based in large part on strong spending for the war in Afghanistan.

Change in inventories was the greatest drag on GDP growth for 2001:IVQ. Without this drag, real GDP growth would have been 2.2 percentage points higher in 2001:IVQ and 1.5 percentage points higher over the last four quarters.

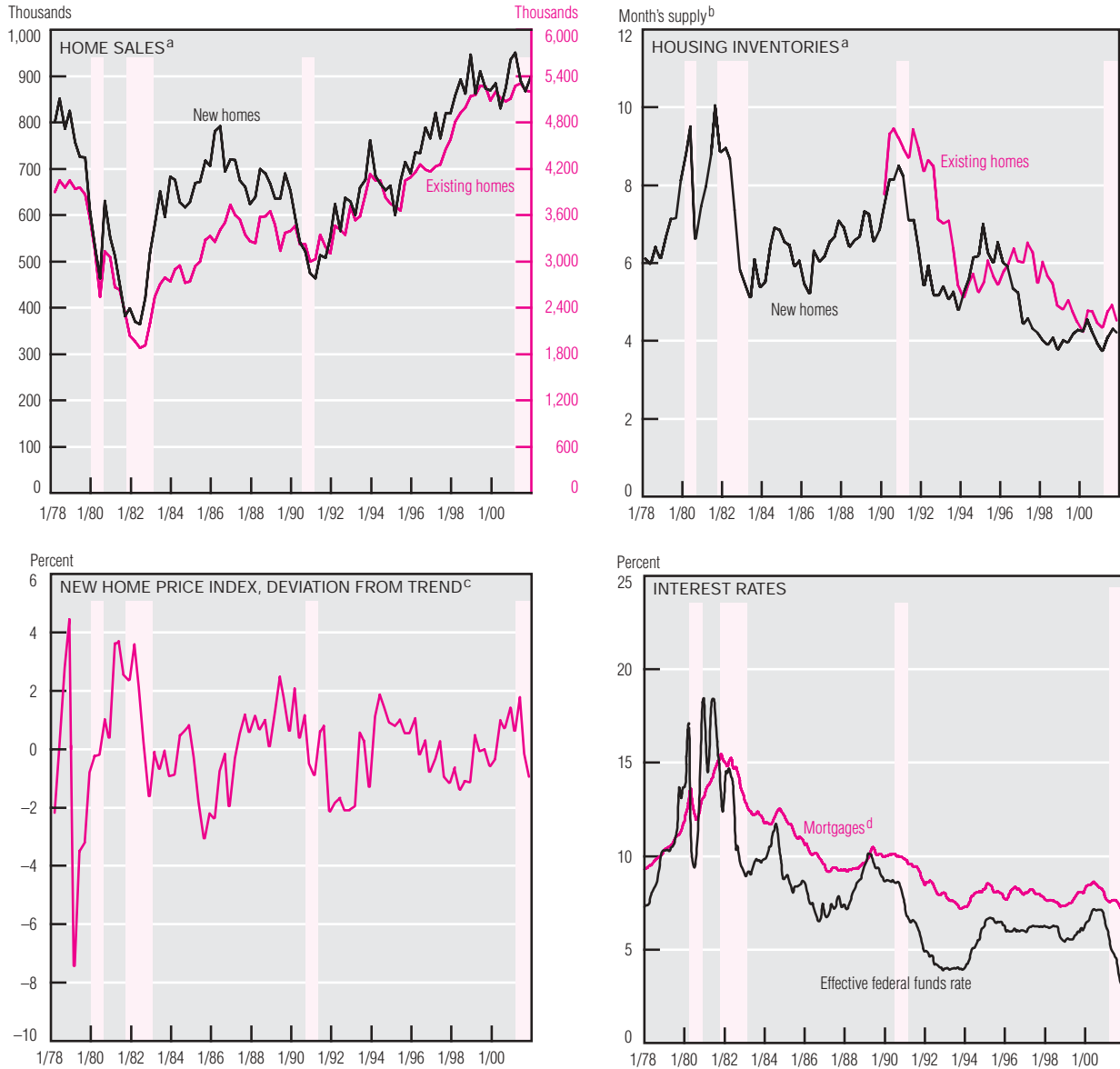
Blue Chip forecasters predict continued growth in real GDP over the next four quarters. By 2002:IIIQ, the current period of slow growth is expected to be over, with the Blue

Chip forecast exceeding the 30-year average of GDP growth.

The recent strength in real GDP is still somewhat surprising, considering the Blue Chip forecasts. Before the terrorist attacks, Blue Chip forecasters had predicted 2.8% (annualized) growth in real GDP for 2001:IVQ; by October, they had modified their prediction to -1.3% (annualized). As late as January, forecasters were still expecting real GDP growth of -1.0% (annualized) for 2001:IVQ.

(continued on next page)

Economic Activity (cont.)



NOTE: Shaded areas mark NBER-defined recessions.
 a. Data are seasonally adjusted and annualized.
 b. Months' supply is a ratio of houses for sale to houses sold. It indicates how long the inventory currently for sale would last at the current sales rate if no additional houses were built.
 c. The trend is calculated using the Hodrick–Prescott filter. This technique minimizes the sum of the squared differences between the series and the trend line, subject to a constraint on the size of the second differences. A weight of 1,600 is assigned to the constraint, which is appropriate for quarterly data. See Edward C. Prescott, "Theory Ahead of Business Cycle Measurement," Federal Reserve Bank of Minneapolis, *Quarterly Review*, Fall 1986, pp. 9–22.
 d. Represents contract interest rate for purchases of single-family existing homes.
 SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System; Federal Housing Finance Board; National Association of Realtors; and Bloomberg Financial Information Services.

Both existing and new homes posted record sales in 2001, a remarkable feat considering that the U.S. has officially been in a recession since March 2001. Typically, home sales fall sharply before a recession or at its beginning, then rise near its end. Similarly, housing inventories typically peak during recessions. During the current downturn, however, inventories have barely budged, and they remain at near-record lows.

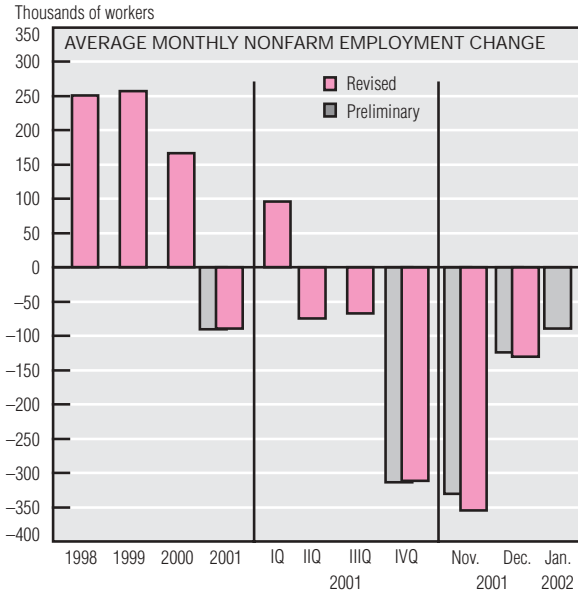
New home prices also surged relative to trend during the first half of

the year. All these indicators point to unusually robust demand for housing. The source of this strength is, of course, near-record-low home mortgage rates, the likes of which have not been seen since the 1960s.

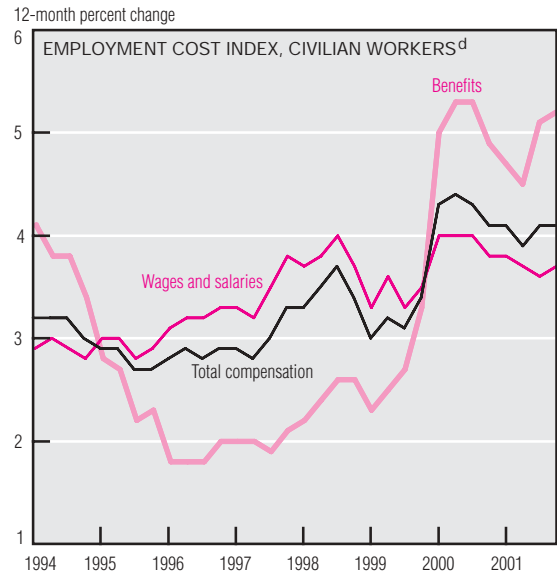
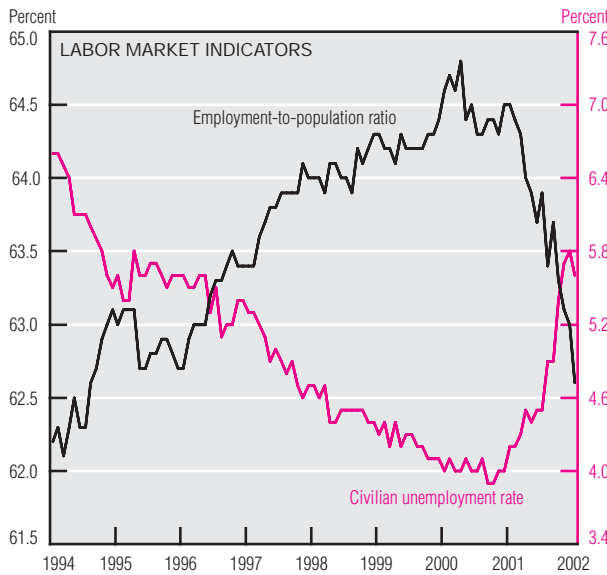
To a large extent, housing's strength reflects two facets of monetary policy, which has been especially proactive during this downturn: The federal funds rate was first lowered in January, although the recession did not officially begin until March, and real GDP did not decline until

2001:IIIQ. Yet the central bank is expected to take back these decreases when necessary, so long-term inflation remains subdued. Mortgage rates, however, may be bottoming out and the housing market may finally be slowing. New home sales declined from their 2001:IQ level, and their prices fell in the second half of the year. Their prices relative to trend likewise dropped precipitously after 2001:IIQ.

Labor Markets



	Average monthly change (thousands of employees)				
	1998	1999	2000	2001	Jan. 2001
Payroll employment	251	257	167	-89	-89
Goods-producing	22	7	8	-103	-145
Mining	-3	-3	1	1	-2
Construction	37	26	18	5	-54
Manufacturing	-13	-16	-12	-109	-89
Durable goods	-2	-5	1	-79	-82
Nondurable goods	-11	-11	-13	-30	-7
Service-producing	230	250	159	14	56
TPU ^a	20	18	14	-16	0
Wholesale and retail trade	40	59	34	-15	54
FIRE ^b	22	7	0	4	9
Services ^c	120	131	93	3	-2
Government	28	35	18	37	-5
	Average for period (percent)				
Civilian unemployment rate	4.5	4.2	4.0	4.8	5.6



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. Not seasonally adjusted.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Although January's employment report shows another decline, it is much less severe than those for the final months of 2001. Nonfarm payroll employment posted a net loss of 89,000 jobs in January, but that is substantially less than the average monthly loss of more than 300,000 for 2001:IVQ. December's estimates were also revised slightly downward. Every industry in the goods-producing sector lost jobs in January. While manufacturing's loss of 89,000 jobs was the highest of any industry, this was

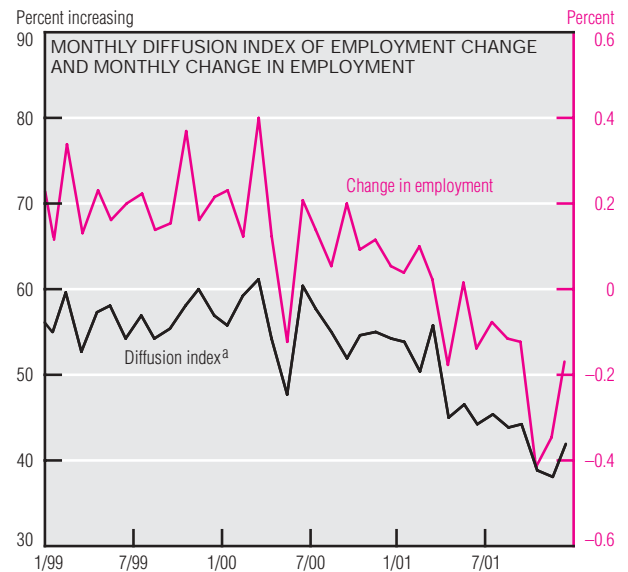
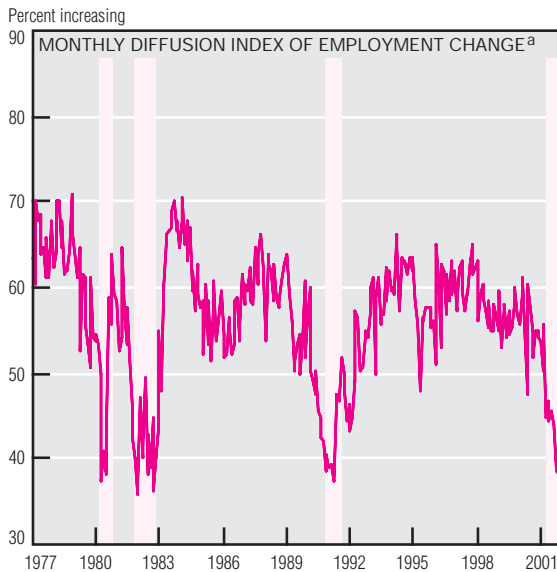
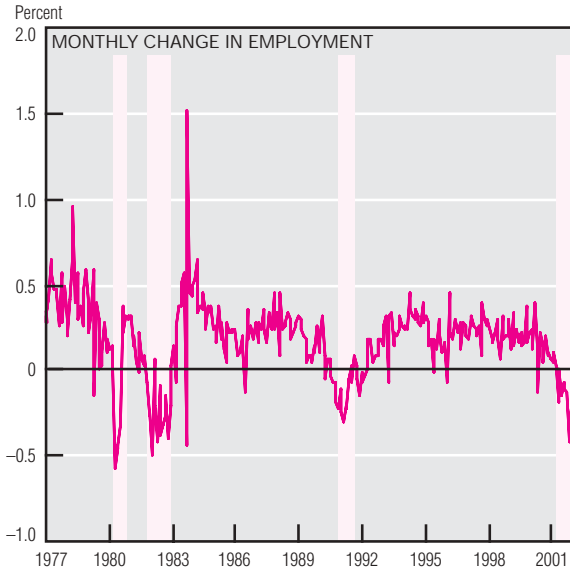
still an improvement on its average monthly losses of more than 130,000 for 2001:IVQ and 109,000 for the year. Service-producing industries performed better, adding 56,000 jobs in January, mostly in wholesale and retail trade. Every service-producing industry except government did better in January than throughout 2001:IVQ.

The unemployment rate fell 0.2 percentage point to 5.6% after reaching 5.8% in December; except for that month, it is still at its highest point since mid-1996. The employment-to-

population ratio fell again to 62.6, its lowest point since August 1994.

In late January, the employment cost index for 2001:IVQ was released. Its 12-month percent change showed that although total compensation remained the same as in 2001:IIIQ, both wages and benefits inched up 0.1 percentage point. While total compensation dropped slightly from 2000, benefits rose sharply from the late 1990s because of an increase in benefits such as paid time off and medical benefits.

Recessions and Employment Change



NOTE: Shaded areas mark NBER-defined recessions.
 a. Index includes private nonagricultural payrolls.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and National Bureau of Economic Research.

The National Bureau of Economic Research, a U.S. organization that dates business cycles, recently announced that the current recession (shown as a shaded area on the charts above) began in March 2001. Because the NBER waits until the data show that an economic downturn is large enough to qualify as a recession, its announcement may come some time after a downturn has begun.

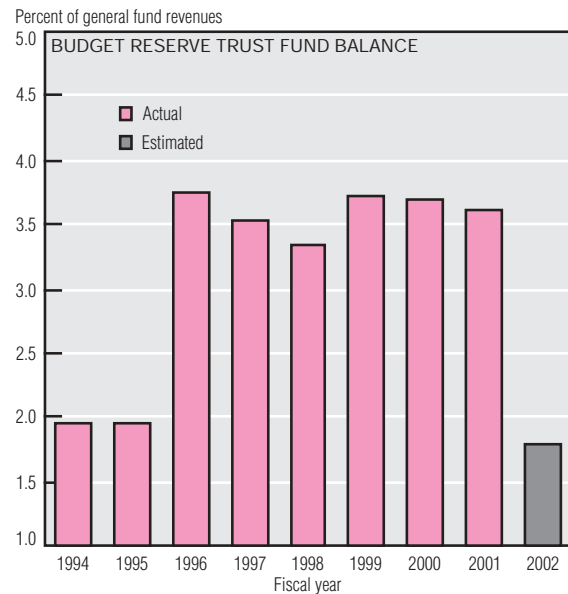
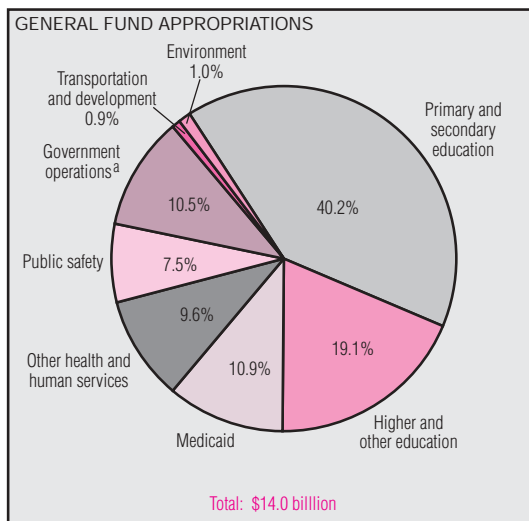
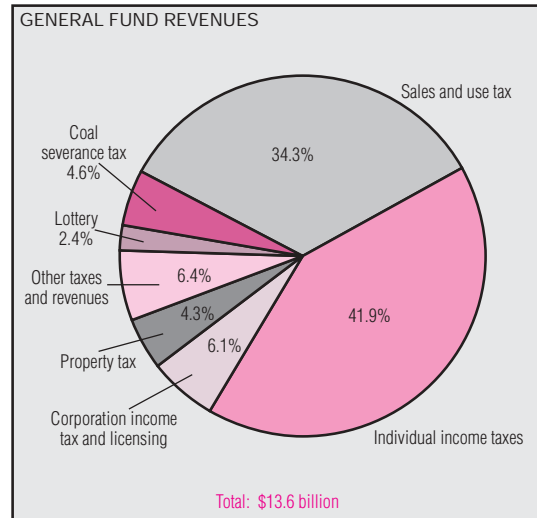
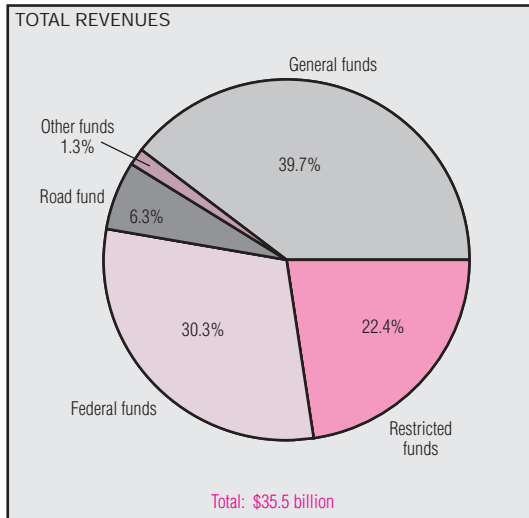
Dating recessions is not an exact science, as the charts above show. For example, the fall and rise that occurred between 1983 and 1985 was not designated as a recession. The depth or

severity of a decline can be measured in several ways. In a downturn, employment growth begins to drop and may become negative. All the periods labeled as recessions have negative employment growth near -0.5% . The unemployment rate is less useful for capturing the trough of a recession because it typically continues to rise after the dated recession is over.

Another measure that can be used is the diffusion index of employment. The index is based on the responses of firms in the Bureau of Labor Statistics' Establishment Survey, which asks whether their employment is

increasing, decreasing, or unchanged. A diffusion index of 50 means that the fraction of firms that are decreasing employment is the same as the fraction increasing it. A diffusion index of 40, which roughly corresponds to the troughs of recessions, says that 20% more of the firms surveyed are decreasing employment than increasing. Although it may be too early to declare that the worst of this recession is past, the diffusion index for December, which climbed above 40, brought some good news.

The Kentucky Budget



NOTE: Budget calculations are based on recommended figures for fiscal years 2002–2003. Kentucky’s fiscal year 2002 will begin July 1, 2002.
 a. Includes dollars allocated to local government as well as the operation of state executive, judicial, and legislative offices.
 SOURCE: Commonwealth of Kentucky, Office of the State Budget Director.

Kentucky’s governor presents a biennial proposal for state finances in every even-numbered year. In January, Governor Patton presented his budget proposal for the 2002–2004 biennium, which includes fiscal years 2002 and 2003.

The state’s revenues are derived from various sources, and most of the dollars it collects come with spending restrictions. Dollars derived from the road fund and restricted funds have uses specifically mandated by Kentucky’s state legislature, while dollars derived from the federal government

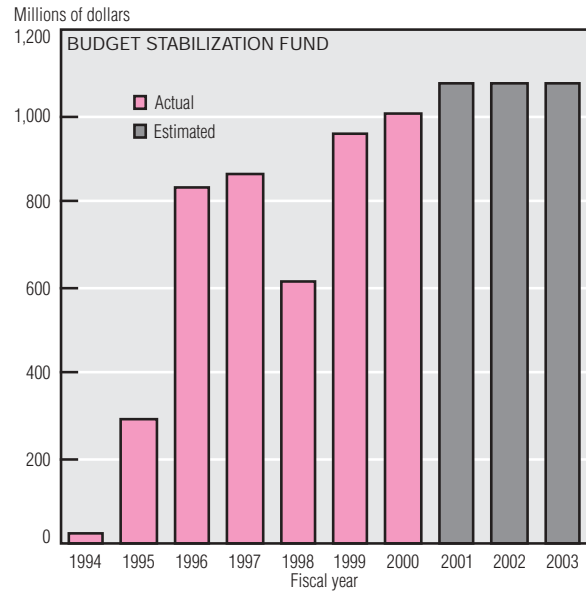
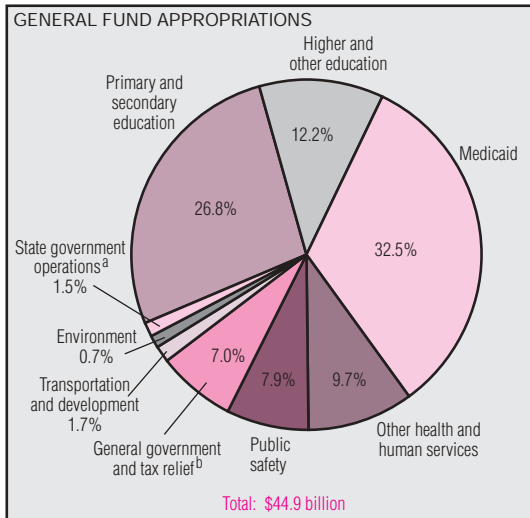
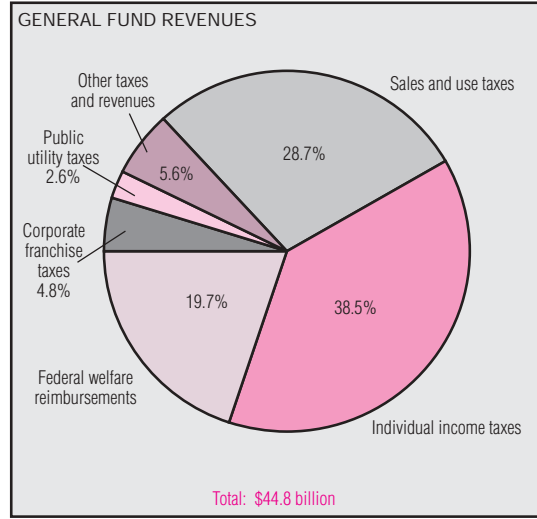
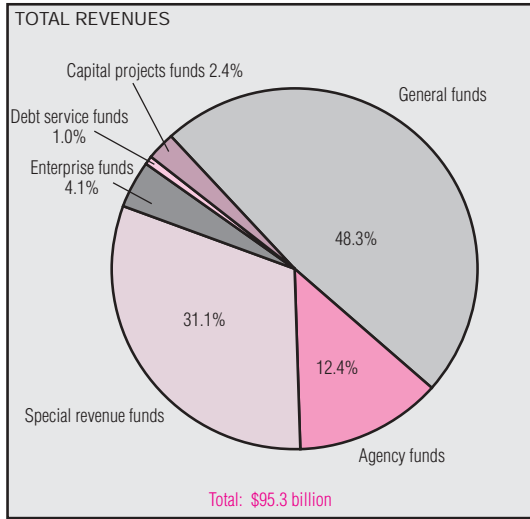
are largely associated with social welfare programs. The governor’s budget focuses primarily on expenditures from the general fund, which comprises nearly 40% of the state’s total budget. Collected for general purposes, dollars from this fund reflect the state’s discretionary spending. Most general fund dollars are derived from income and property taxes on individuals and businesses.

The governor’s proposed appropriations are a good indicator of his priorities. For example, Governor Patton, stressing the importance of education as a key strategy for

strengthening Kentucky’s financial future, has suggested that nearly 60% of the general fund balance be appropriated for education purposes.

The recession is evident in state spending plans: This biennium, Kentucky will spend more dollars than it expects to collect in revenues. The governor has proposed using some of the state’s budget reserve trust fund (commonly known as the “rainy day” fund) to smooth state spending. The 2002–2004 biennium will be the first time in more than 10 years that this fund’s balance has declined.

The Ohio Budget



NOTE: Budget calculations are based on recommended figures for the biennium encompassing fiscal years 2002–2003. Ohio's fiscal year 2002 began July 1, 2001.
 a. Dollars allocated to state executive, judicial, and legislative offices.
 b. State funds allocated to local governments and used for consumer tax relief.
 SOURCE: State of Ohio, Office of Budget and Management.

Ohio's budget process follows a biennial cycle: The governor proposes a state budget in every year ending in an odd number. In January 2001, Governor Taft presented his biennial budget for fiscal years 2002 and 2003.

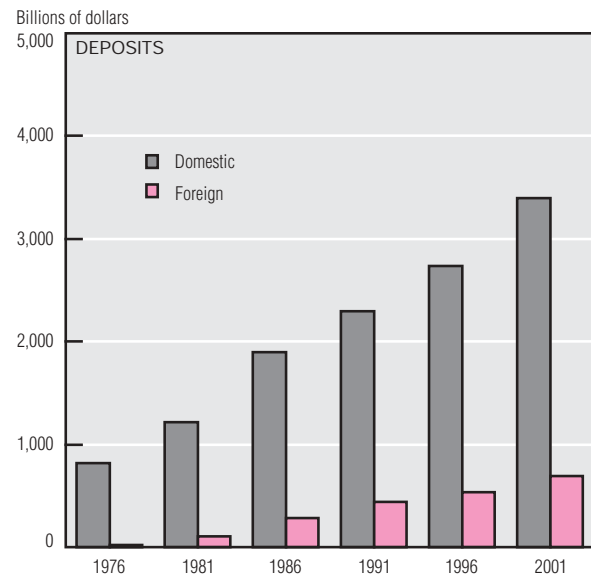
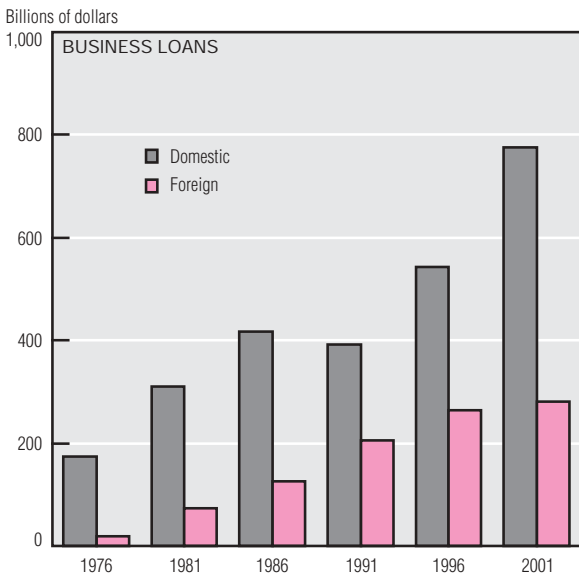
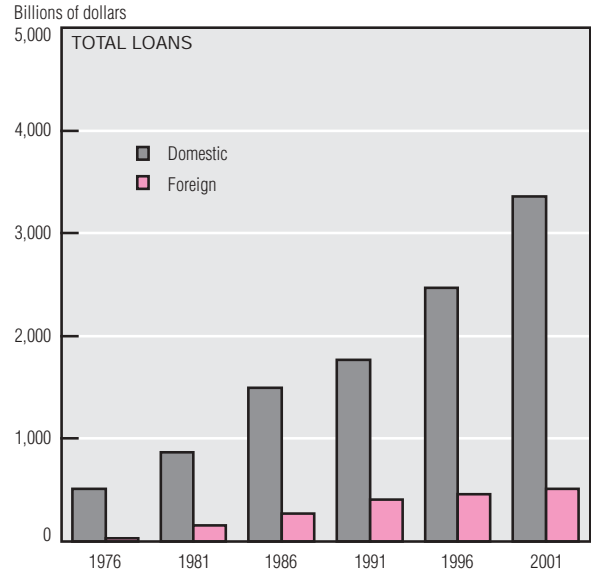
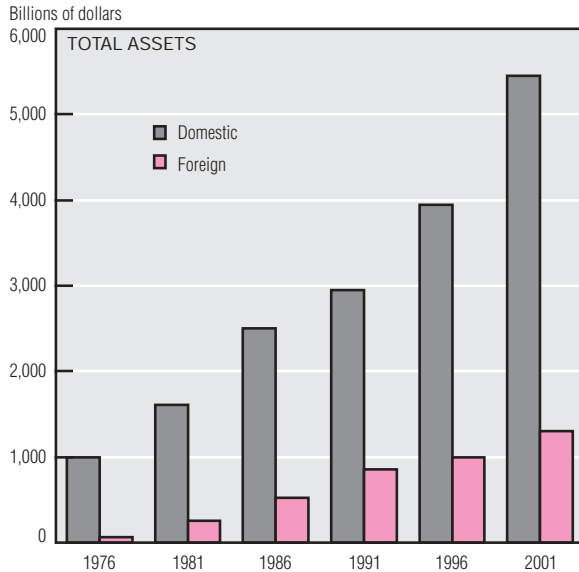
Roughly half of Ohio's collected revenues have restrictions on the way they are spent. In most cases, these restricted funds are authorized by the state legislature for special projects. In Ohio, transfers from the federal government for social welfare projects are part of the general fund because the state has some discretion in the

way it distributes welfare dollars. The rest of the general fund is collected from income, sales, and property taxes levied on individuals and businesses.

General fund appropriations offer a glimpse into the executive branch's political priorities. Improving the quality of life for Ohio's children is one of these priorities; as a result, more than 40% of state dollars are directed to Medicaid as well as other health and human services. Governor Taft's proposed budget also highlighted the importance of education programs, which will receive almost 40% of the state's general fund.

Since his tenure began, Governor Taft has worked to build a budget stabilization fund (commonly known as the "rainy day" fund) that is roughly equal to 5% the state's general fund in any fiscal year. The purpose of the rainy day fund is to allow Ohio to avoid cuts in the level of services offered to its citizens, if a revenue shortfall should result from poor economic circumstances. Although the governor's 2002–2003 budget does not make substantial contributions to this fund, it calls for maintaining the balance near 5% through the end of 2003.

Foreign Banking Organizations



NOTE: Observations are year-end except the last one, which is 2001:IIIQ in all charts.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

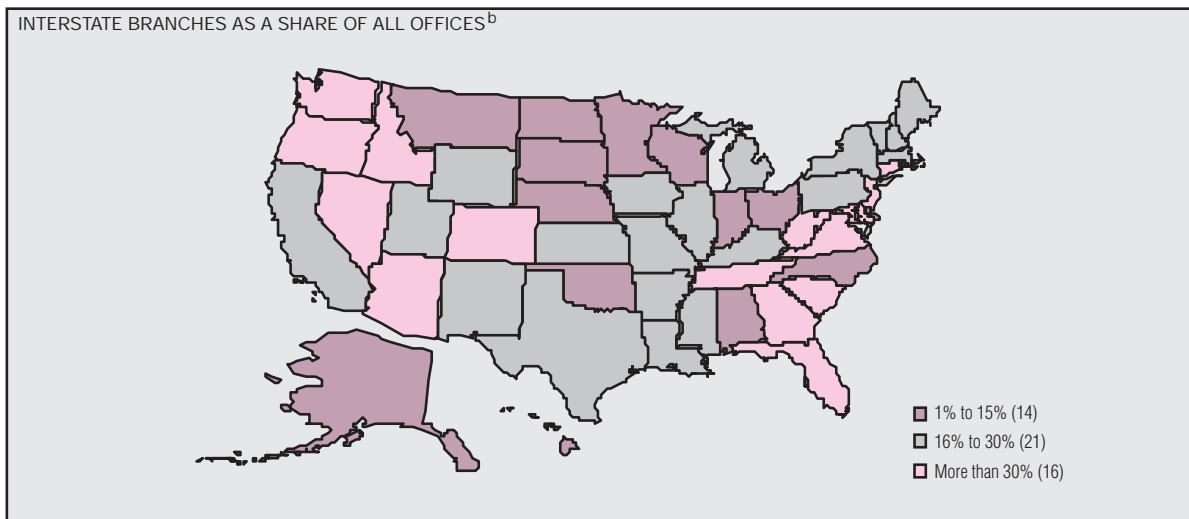
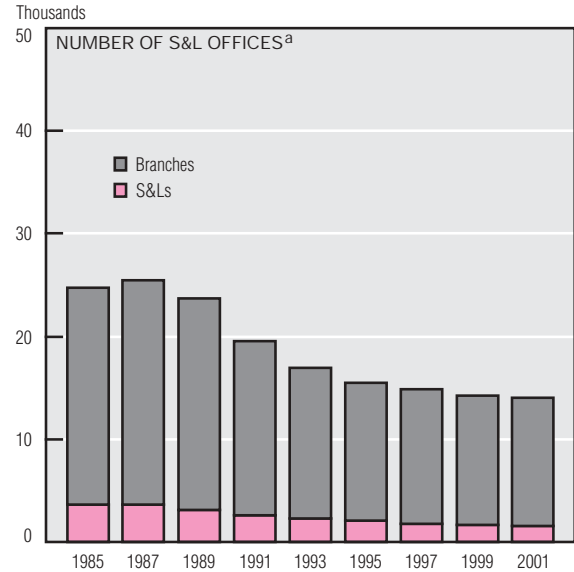
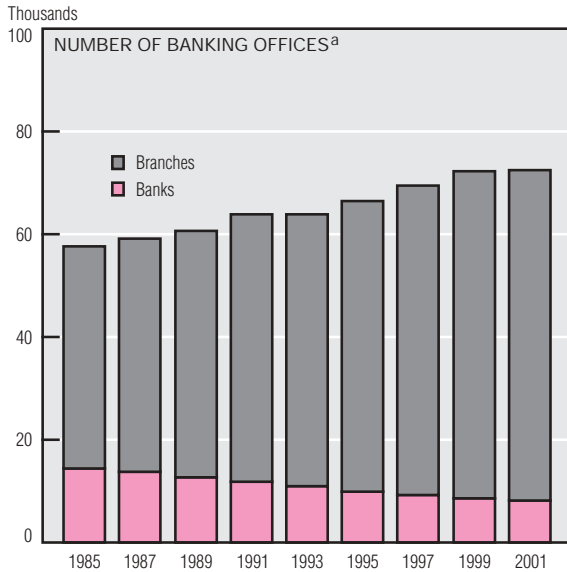
The impact of financial markets' increasing globalization is evident in the U.S. banking industry. The numbers clearly indicate that foreign banks are becoming an increasingly important part of the U.S. banking system. Total U.S. banking assets held by foreign banks rose steadily from \$61 billion in 1976 to nearly \$1,305 billion in 2001. This means that the share of assets held by foreign banking organizations more than tripled—from 5.8% to 19.3%—over that period.

Similar patterns are apparent in foreign banking organizations' market share of total loans, which increased from \$35 billion in 1976 to \$513 billion in 2001; this increase more than doubled their share from 6.4% to 13.3%. Their holdings of business loans also increased over the same period from \$20 billion to \$281 billion, which represented an increase in share from 10.2% to 26.6%. The greater share of business loans held by foreign banking organizations relative to their share of

total loans and total assets indicates their focus on commercial lending.

Comparable increases can be seen in deposits held by foreign banking organizations, which now stand at \$696 billion or a 17.0% deposit share. These data confirm that foreign banking organizations are important competitors in the U.S. banking system.

Structure of Depository Institutions



a. Observations are year-end except the last one, which is 2001:IIIQ.
 b. Percent of branches owned by out-of-state commercial banks and savings institutions.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

Passage of the 1994 Reigle–Neal interstate banking legislation spurred consolidation of depository institutions. The total number of FDIC-insured commercial banks declined from 14,417 at the end of 1985 to 8,149 in 2001. However, the total number of banking offices (the sum of the number of banks and their branches) increased more than 23% over the same period from 59,080 to 72,440.

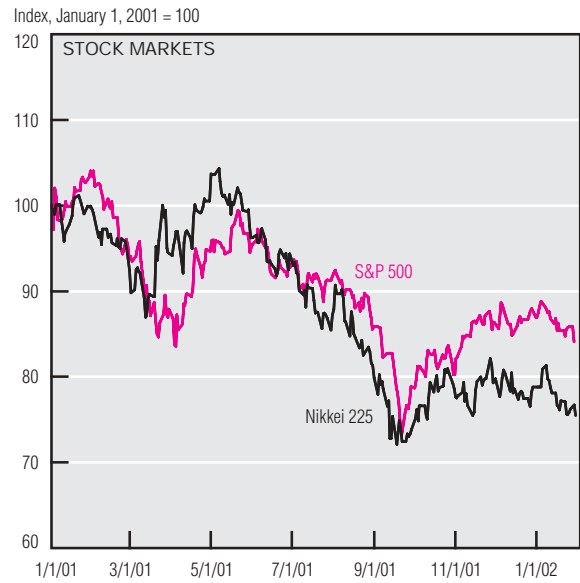
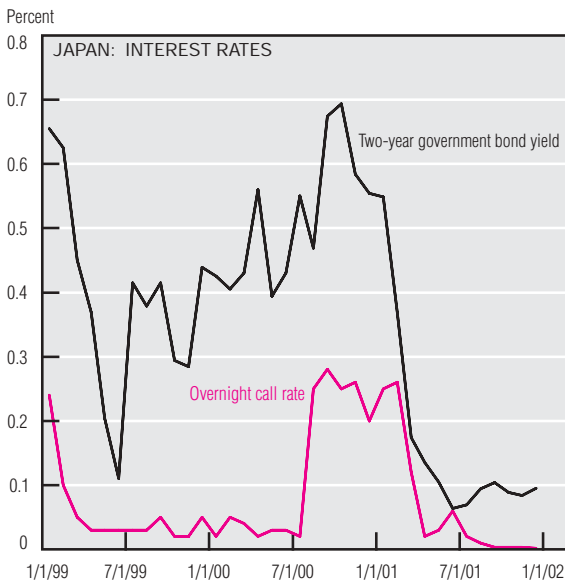
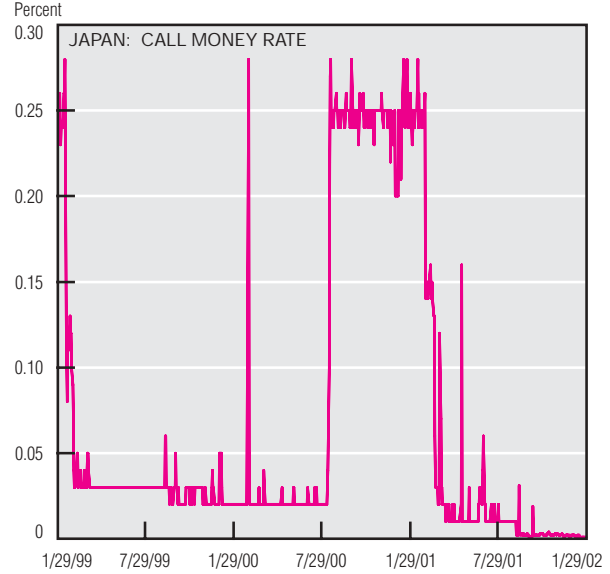
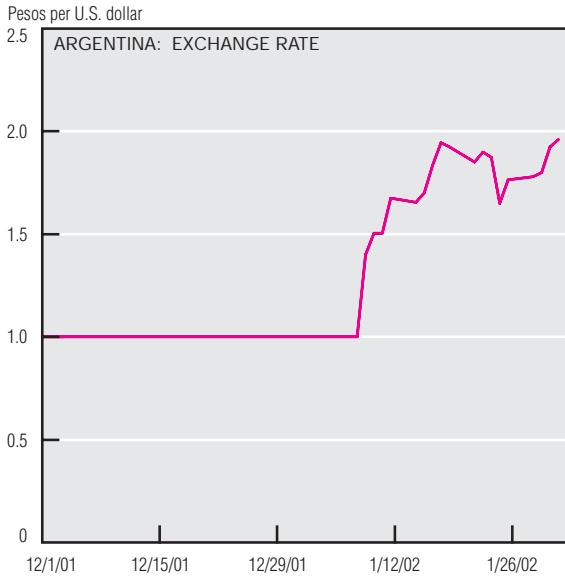
The number of insured savings institutions in the U.S. declined by more than half from a peak of 3,626 in

1985 to 1,552 in 2001. The number of savings institution offices also fell by 45% from their peak of 25,515 in 1987 to 14,076 in 2001. But these effects imply an increase in the number of offices per insured savings institution. From the end of 1985 to 2001, the number of federally insured depository institutions' offices (the sum of banking offices and savings institution offices) increased slightly from 82,417 to 86,516. These counts do not include other channels for delivering banking services. Hence, the reduction in the number of insured

depository institutions does not mean a decrease in the availability of bank services for the average consumer.

Interstate branching continues to be uneven across regions. By and large, the Southeast and the West still have the highest share of interstate branches as a percent of all offices. The effect of the industry's interstate consolidation is evident: Over two-thirds of states now report that more than 15% of all depository institution branches are branches of an out-of-state bank or savings association.

Foreign Central Banks



SOURCES: Bank of Japan; Underwriters Association of Japan; Association of Call and Discount Companies (Nihon Keizai Shinbun); Haver Analytics; and Bloomberg Financial Information Services.

In January, the Argentine government abandoned the currency board arrangement that had maintained one-to-one parity between the peso and the U.S. dollar for about a decade. In its place is a dual exchange rate system with a fixed rate of 1.4 pesos per dollar for international transactions and a floating rate for all other transactions. Trading typically has been within the range of 1.5 to 2.0.

The Governor of the Bank of Japan recently called attention to the visible results of last year's progressively easier monetary policy. Early on, the Bank reduced its target for the overnight

call rate from 25 basis points (bp) to 15 bp and then effectively to zero as it abandoned interest rate targeting in March. Since then, it has targeted a quantity of its current account balance liabilities to banks and money market institutions. As this quantitative target was increased, the overnight rate declined to less than 1 bp as banks built up very substantial holdings of excess reserves. Indeed, starting in September, the Bank of Japan began releasing overnight call rate data in ticks of 0.001%, revised from the previous 0.01%, in accordance with a change in market convention.

Also in March, the Bank committed itself to maintaining its policy of quantitative easing until inflation continuously registered zero or above. Apparently, the resulting expectations of continued low overnight rates brought the two-year interest rate down to less than 10 bp and compressed its spread above the overnight rate to an unusually low level. Initially, the March changes in policy were associated with stock prices that outperformed the U.S. More recently, however, U.S. equity markets have regained the lead.