

The Economy in Perspective

'Tis our true policy to steer clear of permanent alliances with any portion of the foreign world.

—George Washington, in his Farewell Address

Even as U.S. military forces combat terrorism in Afghanistan, Secretary of State Colin Powell prepares to travel to the Middle East. Fears of a widening conflict have been sending oil prices higher in recent weeks, and an escalation of violence in the region could add more uncertainty to energy markets. As developments shift daily, it is clear that that oil and Middle East politics continue to bedevil U.S. economic interests.

Back at home, President Bush recently imposed tariffs on a variety of steel products exported to the United States, levying the highest duties against European countries. As anticipated, the European Union is considering various retaliatory options. Some political analysts conjecture that President Bush imposed the steel tariffs to convince Congress that in his drive to negotiate future trade agreements, he would be mindful of the dislocations these pacts sometimes impose on U.S. industries. If true, this one-step backward, two-steps forward approach to bargaining illustrates that the complexity inherent in trade negotiations lies as much with domestic politics as foreign.

There is no questioning the importance of international trade and finance to the U.S. economy. During the past 10 years, exports from—and imports to—the United States roughly doubled, while the overall economy grew 35%. Over the same period, the United States imported foreign savings at prodigious rates, enabling both households and businesses simultaneously to consume and invest vigorously. The broadening and deepening of international financial markets facilitated the global movement of capital, which correspondingly facilitated the movement of goods and services. These effects are merely two sides of the same coin.

Import competition can displace U.S. companies and employees and, at the same time, U.S. exports can displace foreign producers and employees. In the short term, adjustments can be difficult for nations; in the long term, some industries and

regions expand while others shrink. U.S. manufacturers list China, Japan, and Mexico among their strongest competitors. China has become an economic dynamo and it increasingly occupies the attention of U.S. trade negotiators and business interests.

A decade after Japan's asset bubble burst, its economy remains moribund and its banking system impaired. Clearly, Japan still faces considerable internal adjustments, yet the United States continues to run a significant trade deficit with that country, and the dollar/yen exchange rate remains a strain on trade relations. U.S. trade deficits with both Japan and China heighten the domestic political pressures associated with expanding foreign trade.

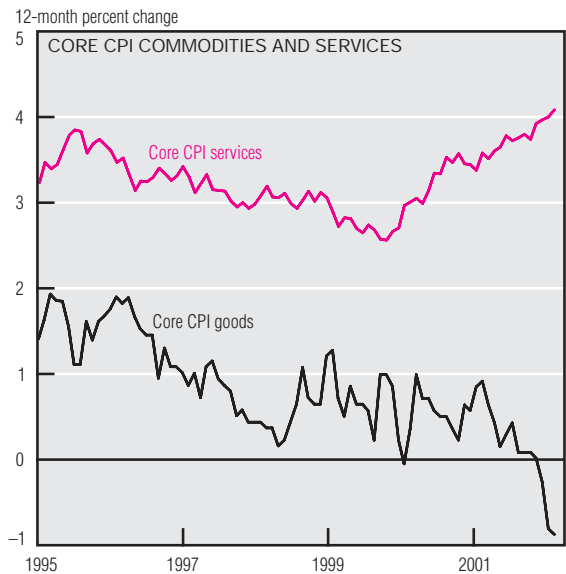
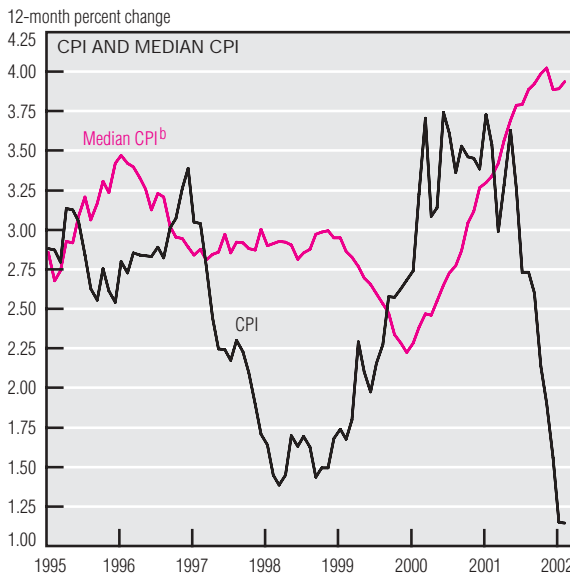
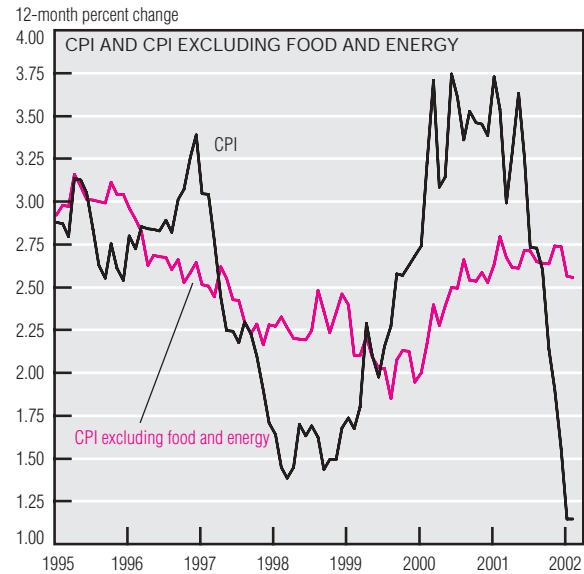
Finally, consider the case of Mexico. In the last five years alone, U.S.–Mexico trade flows have expanded about 50% in each direction, with imports from Mexico somewhat stronger than U.S. exports to her. Consequently, Mexico joins the list of nations sending capital to the United States and amassing claims on future U.S. output, claims that already stand at \$2 trillion globally.

Even as our founding fathers sought financial assistance from France and the Netherlands to finance the Revolutionary War, they warned against becoming enmeshed in foreign intrigues. At the turn of the twentieth century, Americans still harbored a deep suspicion of foreign alliances. It was one thing to fight for democracy, protecting U.S. lives and property through "gunboat diplomacy," but quite another to rule an empire, as Great Britain, Russia, or Germany did.

At the dawn of the twenty-first century, all pretenses of innocence have been abandoned. For better or worse, preserving the American way of life today seems to require the United States to be fully engaged in world affairs economically, politically, and militarily. If George Washington expressed a measure of caution, Thomas Babington, Lord Macaulay, sounded a note of realism when he wrote, "Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular."

Inflation and Prices

	Percent change, last:				
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	2001 avg.
Consumer prices					
All items	2.7	1.1	1.1	2.2	1.5
Less food and energy	3.2	2.1	2.5	2.4	2.7
Median ^b	4.2	3.3	3.9	3.1	3.9
Producer prices					
Finished goods	2.6	-0.9	-2.7	0.8	-1.9
Less food and energy	0.0	-0.3	0.5	1.0	0.7



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

After three consecutive monthly declines, the Consumer Price Index (CPI) rose for the second straight month in February. The 0.2% increase the index registered in February (2.7% at an annual rate) was nearly identical to the increase it posted in January. Energy prices continued to demonstrate their characteristic volatility, falling in February after rising in January.

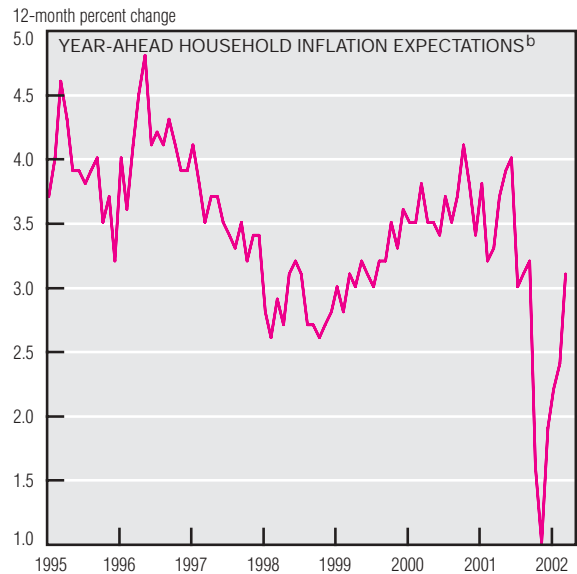
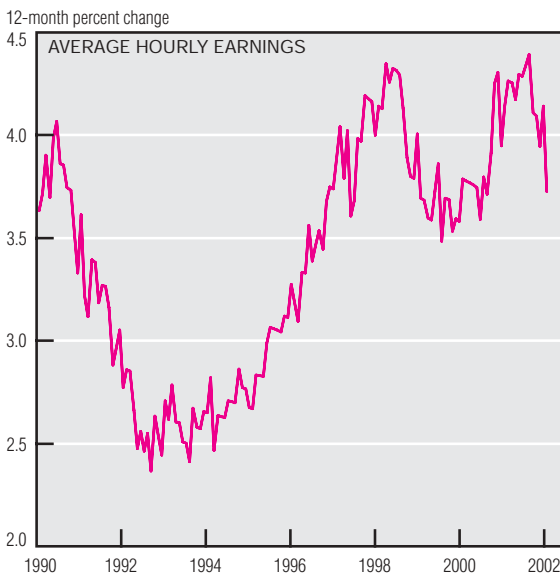
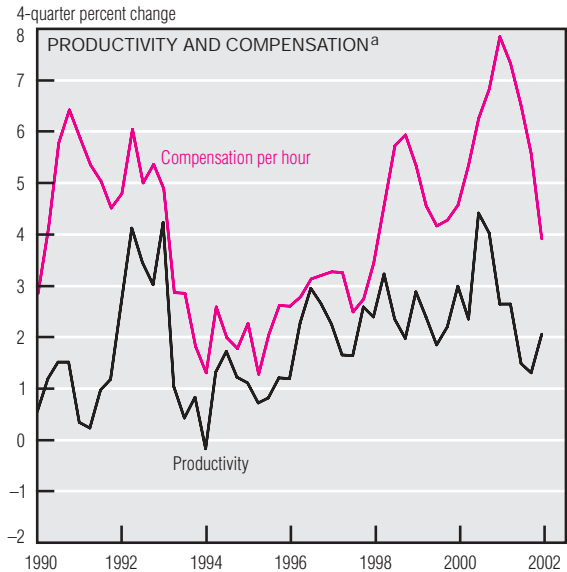
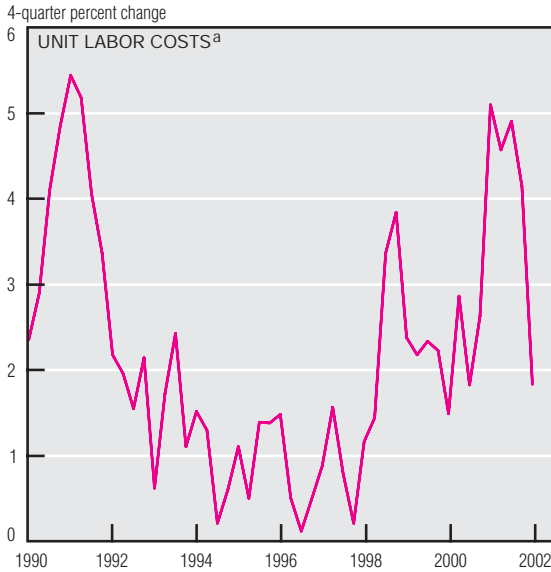
Excluding both food and energy, the CPI rose 0.3% in February (3.2% at an annual rate), higher than its increase of only 0.2% the previous

month. According to the Labor Department, an upturn in apparel prices, along with larger increases for shelter and for tobacco and smoking products, accounted for the greater advance in February. The median CPI, another measure of inflation, rose at a rate of 0.3% in February (4.2% at an annual rate). Over the last 12 months, the median CPI has increased by 3.9% and the CPI excluding food and energy by 2.5%. Over the same period, however, the total CPI rose at the much less rapid rate of 1.1%, its smallest 12-month rate of change in nearly 40 years.

What accounts for the divergence between the median CPI and these other inflation measures? Much of the difference may result from the growing gap in the inflation rates for goods and services in the CPI. Since 2000, the gap between non-food, non-energy ("core") goods and services prices has widened. Currently, CPI services prices are rising at about 4% per year, while core CPI goods prices are declining. The median CPI, because it excludes extreme price movements, may be filtering out the recent dramatic

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Inflation and Prices (cont.)



a. Nonfarm business sector.

b. 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; U.S. Department of Commerce, Bureau of Economic Analysis; and University of Michigan.

declines in core goods prices; the CPI and the CPI excluding food and energy, because they are weighted means, are likely to be more sensitive to such movements.

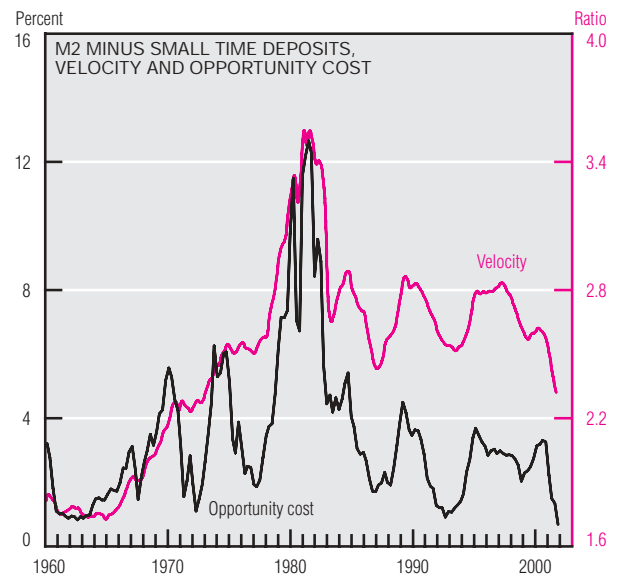
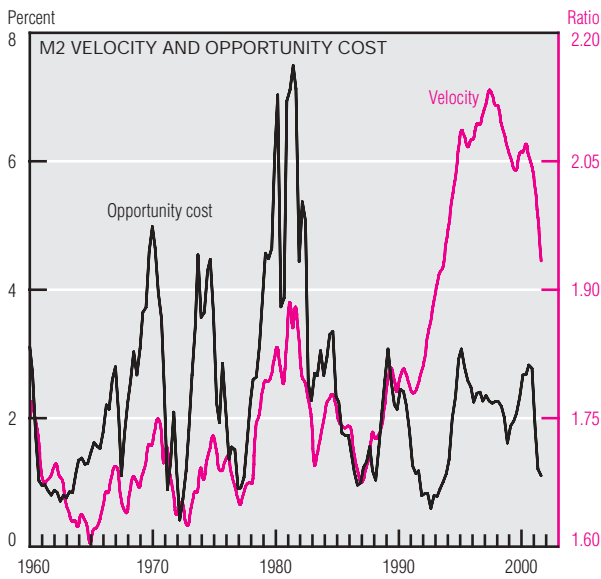
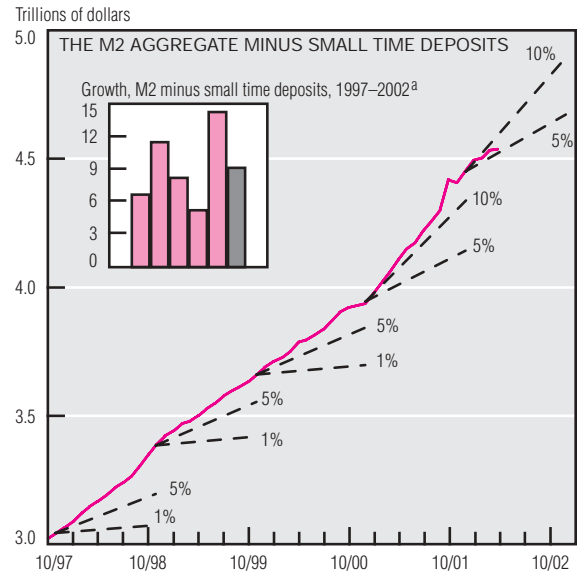
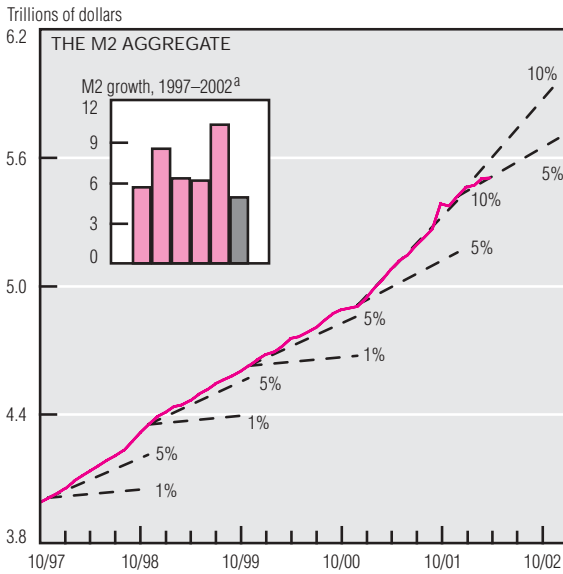
It's difficult to know what precisely is driving apart core goods and services prices, but there may be a clue in labor costs, which represent a disproportionate share of services prices. Unit labor costs—the costs associated with producing a unit of output—spiked upward in 2000, and this may have been reflected in services prices.

The upward spike in unit labor costs in 2000 can be seen as the result of the divergence between compensation growth and productivity growth: Compensation growth continued to accelerate in 2000, but productivity growth began to diminish. As a consequence, firms were paying their workers more money for a unit of output. The year-over-year growth rate of unit labor costs, however, has since reversed course, falling consistently throughout 2001. This suggests that services prices may soon reverse their upward trend—and perhaps

the median CPI along with them. Indeed, assuming that productivity growth remains relatively stable in 2002, and given the recent downward trend in the growth rate of wages as measured by average hourly earnings, it looks as if unit labor costs may continue to fall.

U.S. households, however, don't foresee much of a change in the underlying inflation trend. Their expectation of the likely course of inflation over the next 12 months has returned to the levels that prevailed before September 11.

Monetary Policy



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
SOURCE: Board of Governors of the Federal Reserve System.

In simple textbook models of the aggregate economy, monetary policy is either expansionary, contractionary, or neutral with respect to the real economy and the price level, depending on the pace at which the money supply expands relative to demand. Making use of this framework, however, requires that supply and demand for money have a stable relationship with economic activity and prices. Unfortunately, experience demonstrates that these relationships lack the stability needed to transform

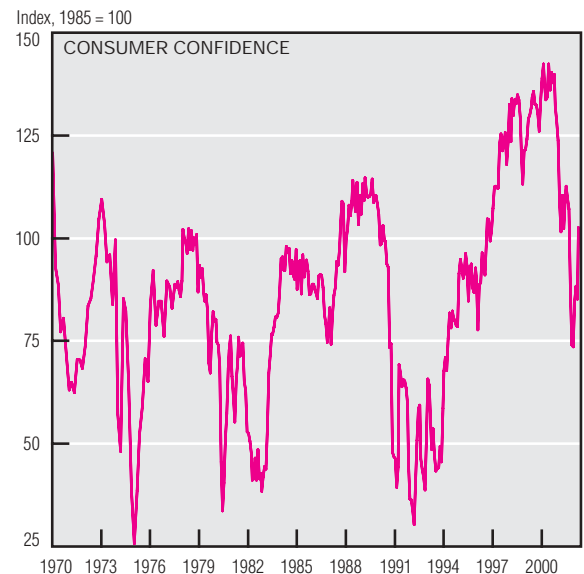
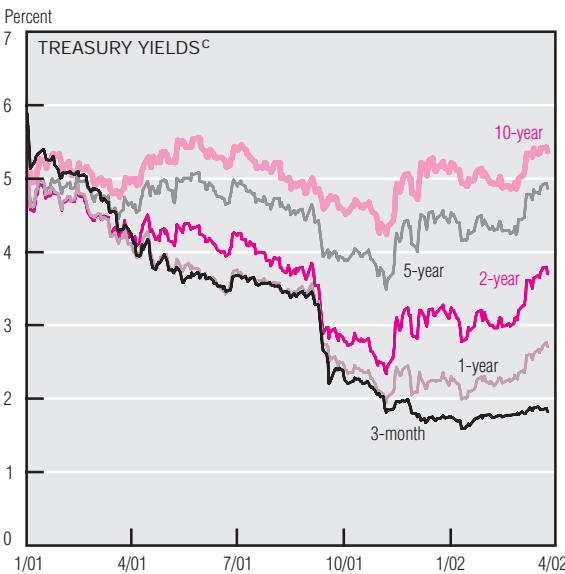
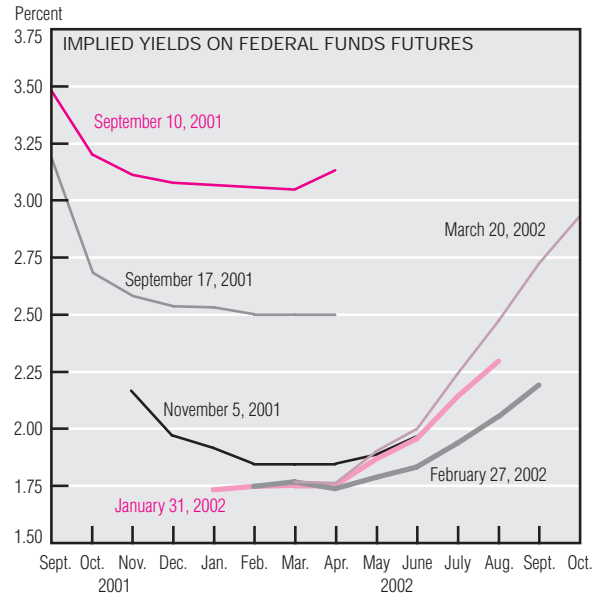
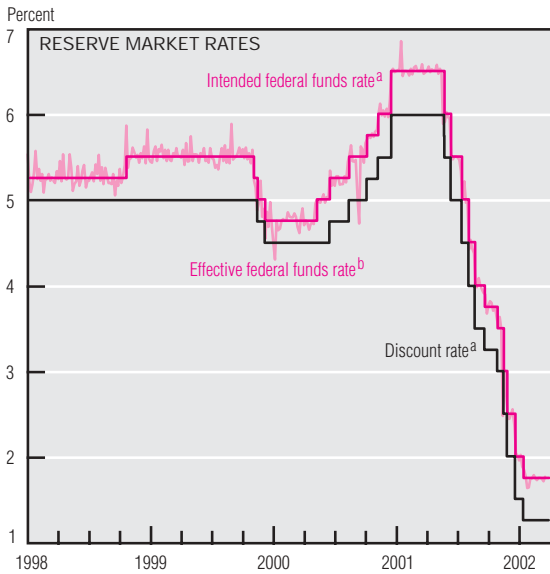
the textbook model into a dependable, real-time policy tool.

In the early 1990s, for example, the M2 measure of money became less reliable as a guidepost for policy. Its relationship to economic activity as summarized by its velocity—the ratio of GDP to M2—changed unexpectedly. M2 velocity increased dramatically relative to its opportunity cost. Thus, the increase in M2 growth during that period was not associated with an increase in inflation, as history would have suggested.

Another measure of money, M2 minus small time deposits, was unaffected by the events of the early 1990s. Although its growth has been strong in recent years, its velocity has fallen dramatically with declines in its opportunity cost. If interest rates rise, as the federal funds futures suggest, we would expect to see sharp declines in the growth of M2 minus small time deposits, along with increases in its velocity and thus prices. Its failure to slow down would be cause for concern.

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Monetary Policy (cont.)



a. Daily.
 b. Weekly average of daily figures.
 c. Constant maturity.

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

At its March 19 meeting, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%. However, the FOMC adopted a neutral stance, namely, that the risks are balanced between heightened inflation pressures and economic weakness. This was the first time since November 15, 2000 that the risk statement was not skewed toward economic weakness.

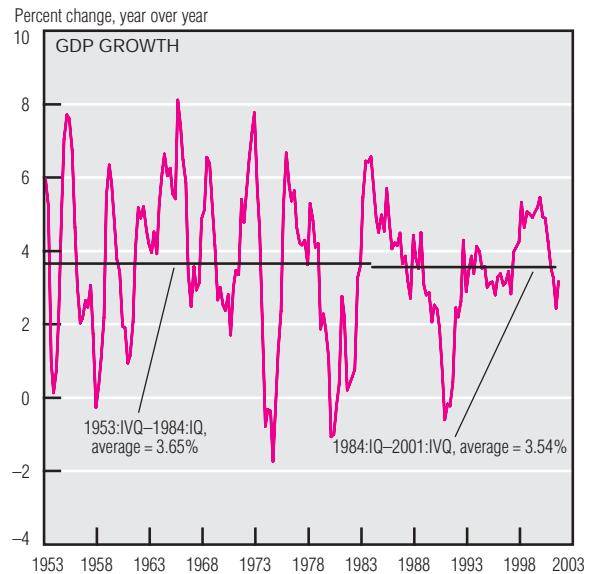
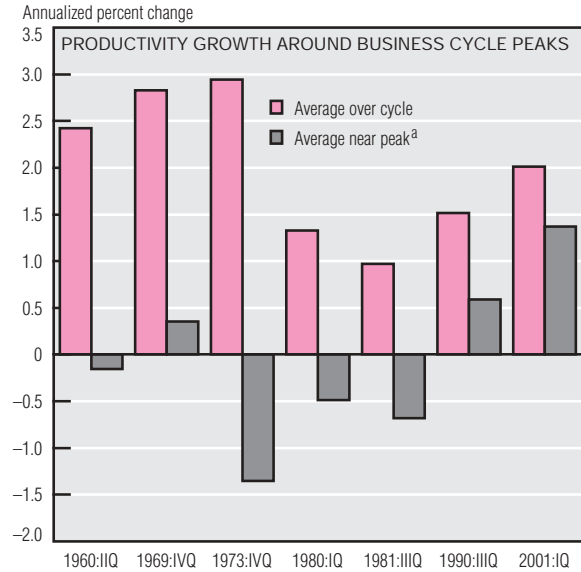
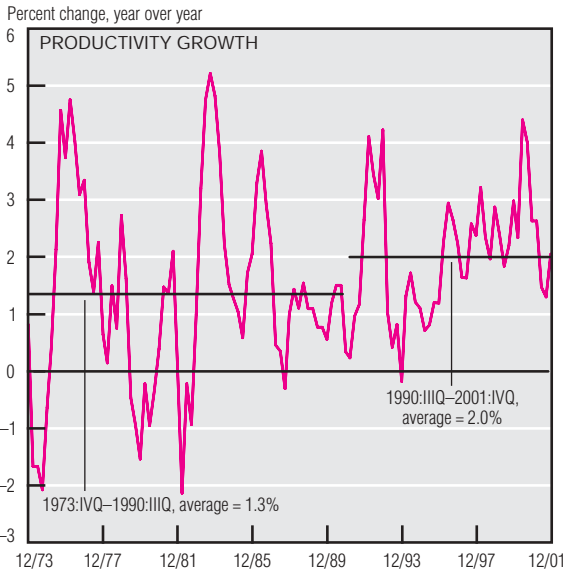
In the weeks leading up to and shortly after the recent FOMC meeting, implied yields on federal funds

rose substantially, particularly for futures delivering in August and later. Market participants are currently pricing in a rise of nearly 125 basis points in the effective federal funds rate by October. This increase in federal funds futures was accompanied by rate increases for Treasury securities longer than one year. The behavior of short-term rates (one year or less) primarily reflects the anticipated increase in the funds rate over the coming year.

Speculating on why long-term rates increase is a tricky business.

Given the recent stronger-than-expected economic data, at least part of the story very likely is that the expected return on investment has gone up. Consumer confidence (as measured by the Conference Board), which often surges near the end of or shortly after recessions, rose a hefty 15 points in March. Furthermore, the present situation and expectations components of the index each went up 15 points, suggesting that appraisals of both current and future economic conditions have improved.

Money and Financial Markets



a. Annualized percent change from two quarters before a business cycle peak to two quarters after it.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

Annualized productivity growth in 2001:IVQ, which recently was revised upward from 3.5% to 5.2%, was surprisingly strong. Although productivity growth often spikes near the end of recessions (as in the current episode), it usually stagnates or even becomes negative around business cycle peaks. This did not occur during the most recent downturn, however. In the five quarters centered on the peak, productivity grew at an annual rate of 1.4%, equaling its average pace during 1974–90.

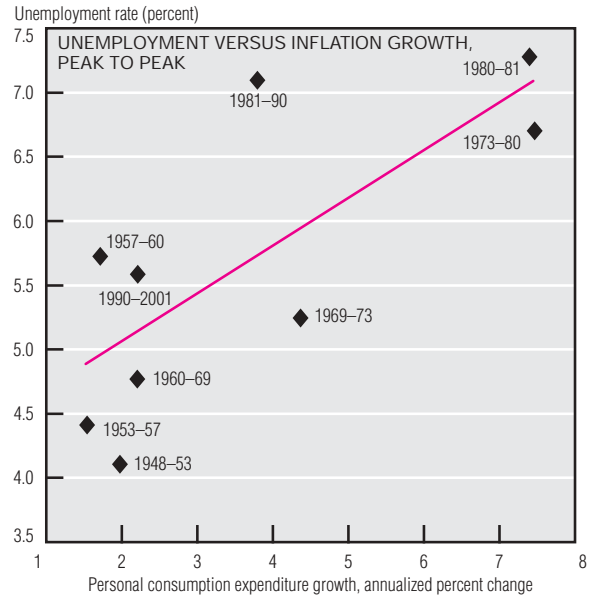
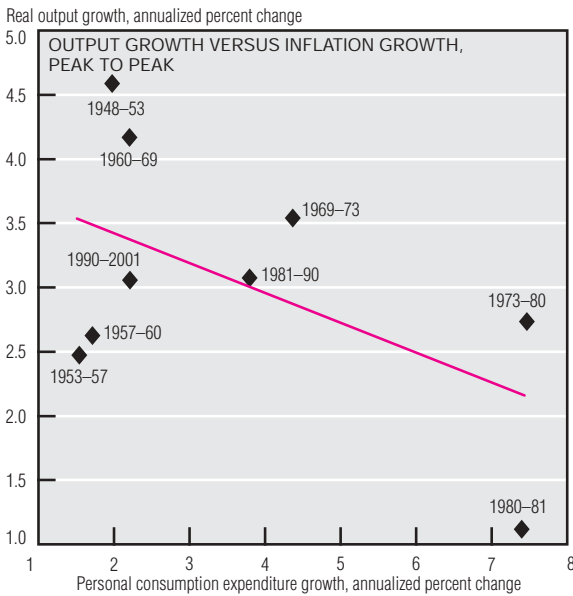
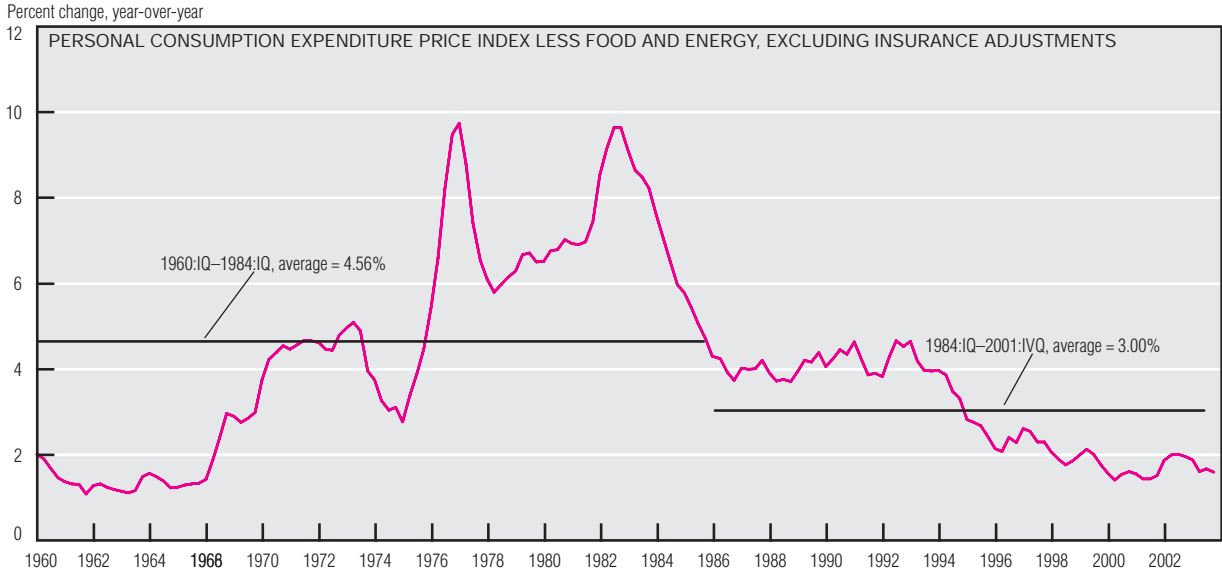
By historical standards, the most recent contraction has been small. The dampening of productivity and output has been consistent with a more generalized reduction in the volatility of economic activity since the mid-1980s. This pattern has been attributed to at least three factors: the improvement of inventory management related to developments in information technology; better monetary policy; and the absence of especially large, negative supply

effects (such as the OPEC-related shocks of 1973–79).

Technological improvements have allowed firms to increase the efficiency of their supply-chain management. This has made production less sensitive to demand shocks, thus curbing business cycle fluctuations. The durable goods sector provides some support for this view: Breaking down the GDP variance into its components shows that roughly two-thirds of the drop in GDP volatility

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Money and Financial Markets (cont.)



NOTE: The personal consumption expenditure price index is chain-weighted.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

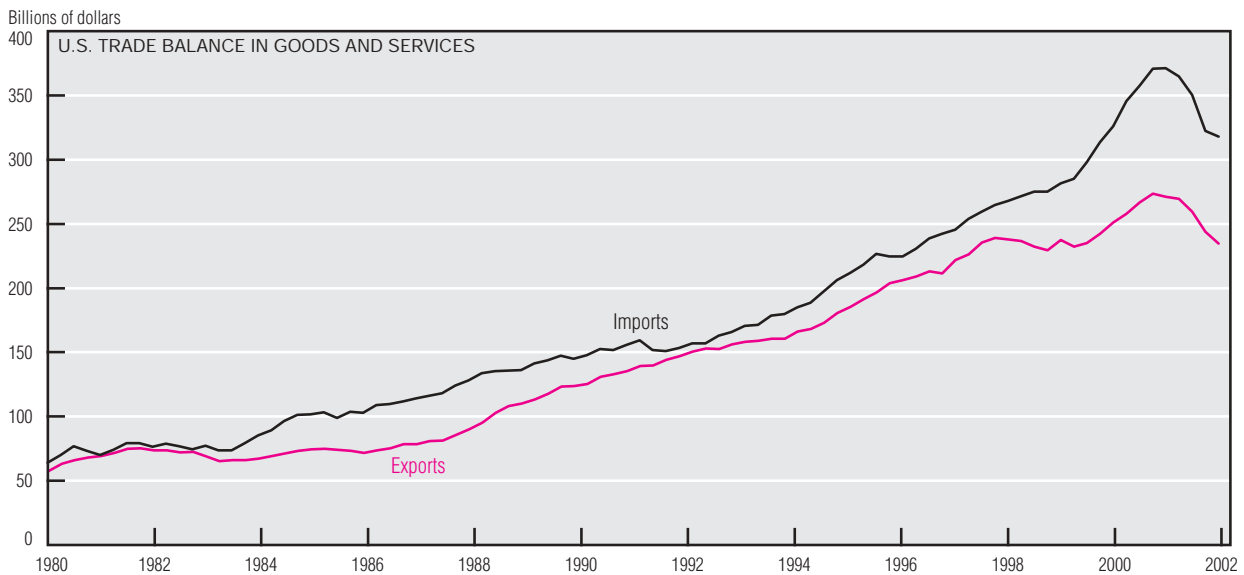
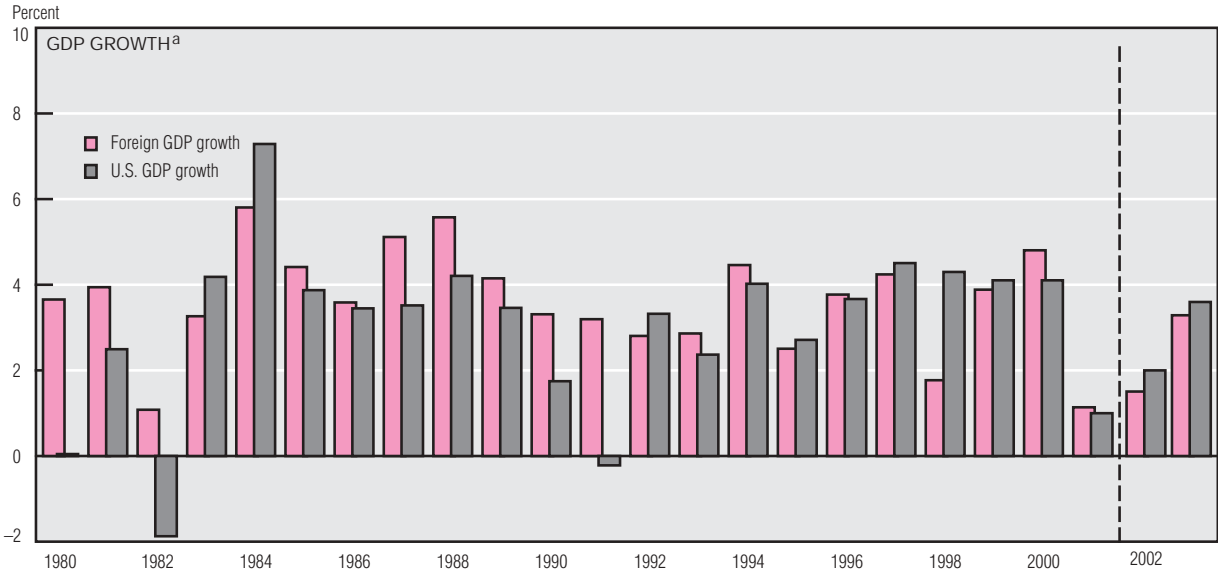
since 1984 can be explained by a reduction in the volatility of durable goods production. Durable goods industries have been investing most heavily in information technology capital than nondurable goods industries have been and have also had larger reductions in inventory-to-sales ratios.

However, some analysts attribute the lower variability of GDP to monetary policy that pays more single-minded attention to price stability,

which has reduced inflation's volatility as well as its level over the past 20 years. Advocates of this view associate the 1970s' huge swings in output and inflation with "stop-and-go" monetary policies that focused excessively on output stabilization, which only increased inflation. They argue that a subtle policy change that occurred in 1979 put less emphasis on stabilizing output around its uncertain potential, concentrating on the inflation outlook instead.

Comparison of unemployment and inflation across business cycles provides scant evidence of a trade-off, contrary to the conventional view. Rather low inflation is associated with low unemployment. A similar comparison between output growth and inflation shows that low inflation is associated on average with higher output growth, making it the sine qua non of a healthy, growing economy.

Foreign Trade and the Business Cycle



a. Foreign GDP growth is the trade-weighted average growth rate for the top 15 U.S. trading partners in 1992–97: Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, Netherlands, and Brazil. Data for 2001 are estimates; data for 2002 and 2003 are forecasts. SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Organisation for Economic Co-operation and Development, *Economic Outlook*; International Monetary Fund, *International Financial Statistics*; DRI/McGraw-Hill; *Blue Chip Economic Indicators*; and *The Economist*.

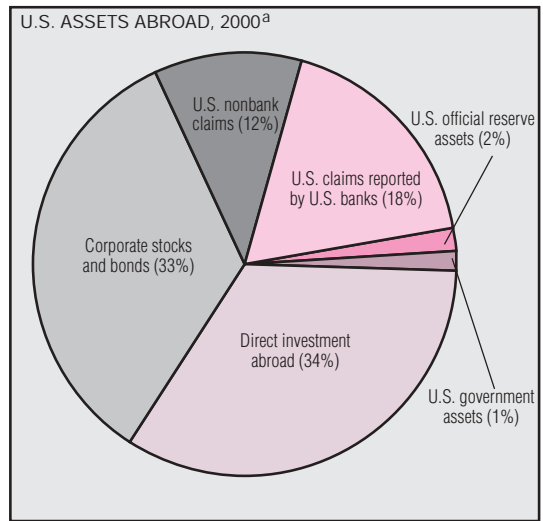
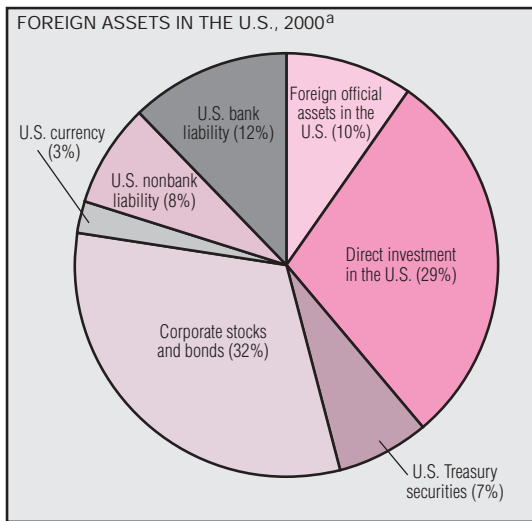
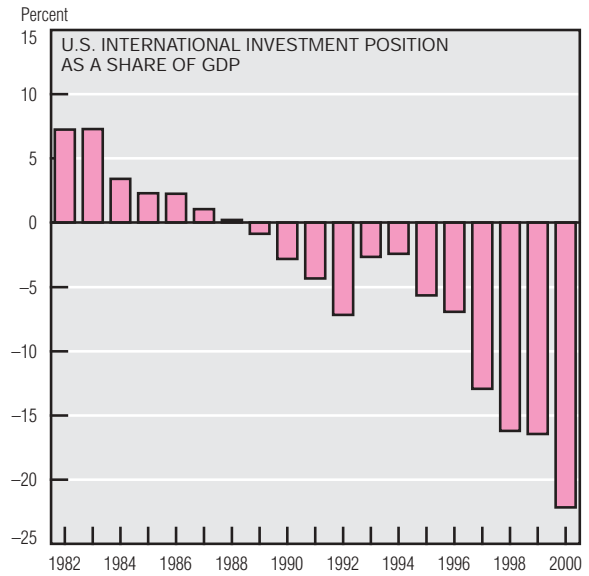
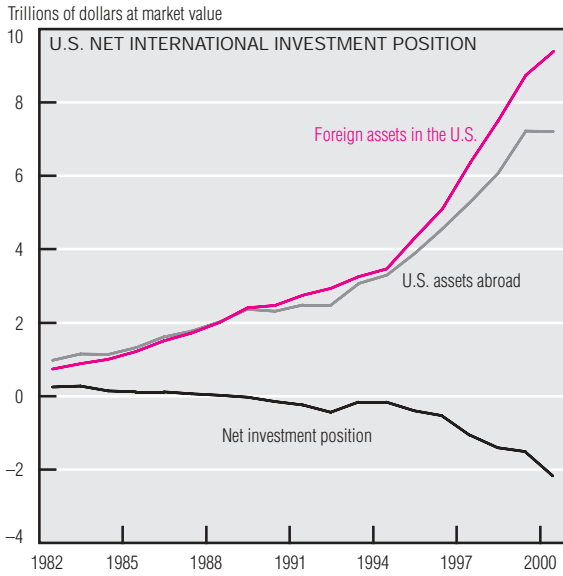
Economic conditions in the U.S. have always been linked to those of our major foreign commercial partners. Some fear, however, that closer global integration will cause business cycles here and abroad to become more synchronous and, consequently, more severe. While reasonable, this prognosis seems a bit premature.

Over the past 20 years, U.S. economic activity has risen and fallen in fairly close association with foreign economic activity. Often, however,

when the U.S. slid into recession, foreign economic growth remained firm, at least initially, and world demand for our goods and services buffered the downturn. This was the case in 1980 and in 1991, and even though foreign economic growth slowed in 1982, it still exceeded U.S. growth and cushioned our contraction. Similarly, rapid U.S. economic growth moderated the global recessionary impact of foreign financial crises in 1997 and 1998.

Last year, the pattern seemed markedly different. Foreign and U.S. economic growth slowed in tandem, pulling U.S. exports (and imports) down dramatically. This pattern, however, seems more fluke than forecast. Although the rates of U.S. and foreign growth have converged somewhat, their correlation has not changed appreciably over the past two decades. One must look beyond business cycle patterns to explain U.S. trade developments in 2001.

The U.S. International Investment Position



a. Market value. Shares may not add to 100 because of rounding.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

The U.S. has financed its persistent trade deficits by issuing financial claims against its future output to the rest of the world. As a consequence, foreigners now hold more than \$2.1 billion in net claims against the U.S., an amount exceeding 23% of our gross domestic product. Does mortgaging tomorrow's output for today's imports imply a lower standard of living sometime in the future?

The answer depends on how we use the associated inflow of net foreign savings. If it continues to

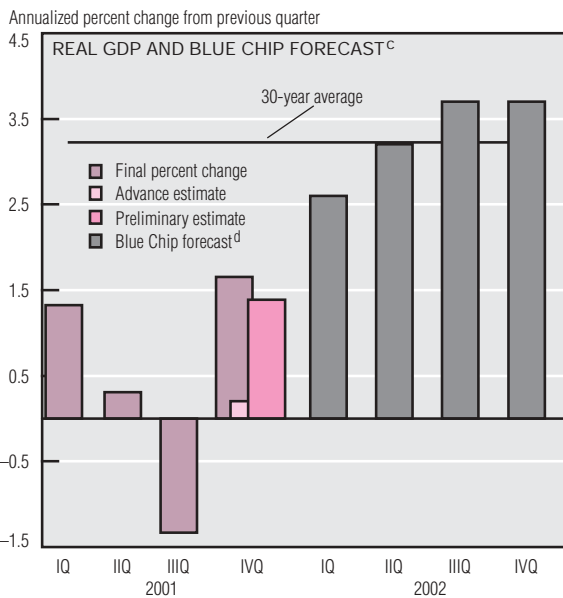
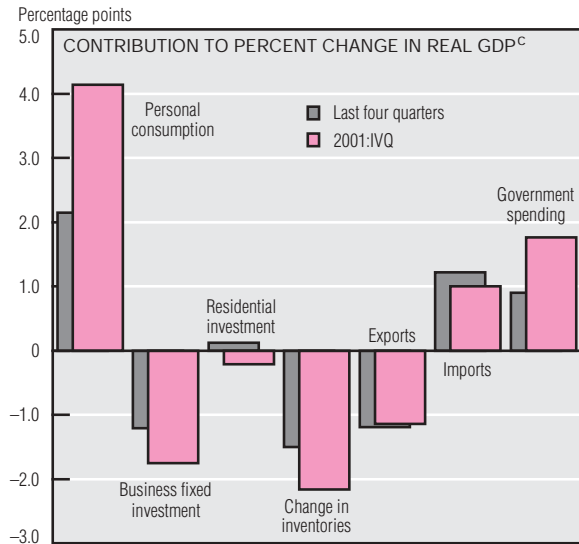
promote productive investment and rapid economic growth, as seems to have been the case since the mid-1990s, servicing and retiring the large stock of foreign claims need not lower the trajectory for our standard of living. If, however, the inflow of foreign savings finances private consumption and government spending, as often seemed the case in the 1980s, financing them eventually would reduce our consumption.

The foreign portfolio consists mainly of direct investments (29%)—

implying a degree of management control—and U.S. corporate stocks and bonds (32%). These shares have expanded over the past two years, largely at the expense of U.S. Treasury securities, which now account for 7% of the portfolio. Official assets (dollar reserves) equal 10% of the foreign portfolio and a small portion (3%) consists of currency. Similarly, U.S.-owned foreign assets consist mainly of direct investments (34%) and corporate stocks and bonds (33%).

Economic Activity

	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	38.2	1.7	0.5
Personal consumption	96.4	6.1	3.1
Durables	81.5	39.4	13.6
Nondurables	11.6	2.5	1.4
Services	17.8	2.0	1.9
Business fixed investment	-47.0	-13.8	-9.4
Equipment	-13.8	-5.3	-8.5
Structures	-26.9	-33.6	-11.8
Residential investment	-4.5	-4.6	2.9
Government spending	39.8	10.2	5.1
National defense	7.9	9.0	5.5
Net exports	-1.7	—	—
Exports	-30.0	-10.9	-10.9
Imports	-28.3	-7.5	-8.5
Change in business inventories	-57.4	—	—



	Percent change, peak to trough:		
	Current recession	1990 recession	Average of last six recessions
Manufacturing			
Output	-4.5	-4.1	-6.9
Hours	-5.9	-3.7	-8.2
Productivity	1.4	-0.4	1.3
Nonmanufacturing			
Output	1.0	-0.7	-0.2
Hours	-0.4	-0.8	-0.1
Productivity	1.4	0.1	-0.1
Total economy			
Output	0.2	-1.3	-1.7
Hours	-1.2	-1.3	-2.1
Productivity	1.4	0.0	0.4

NOTE: All data are seasonally adjusted.
 a. Chain-weighted data in billions of 1996 dollars.
 b. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
 c. All data are annualized.
 d. Blue Chip panel of economists.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics (published and unpublished data); and *Blue Chip Economic Indicators*, March 10, 2002.

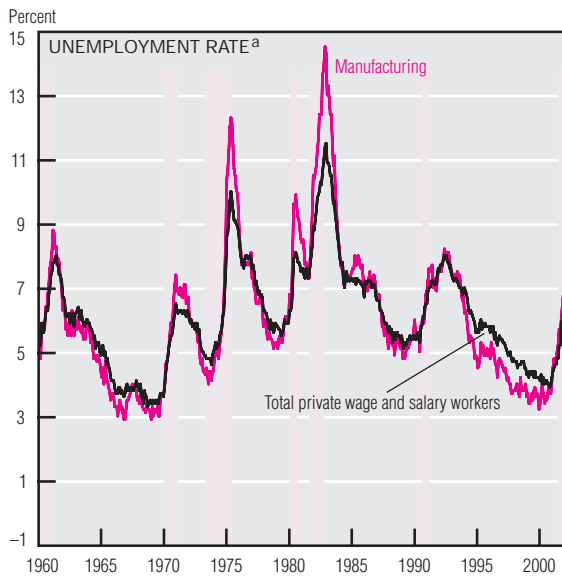
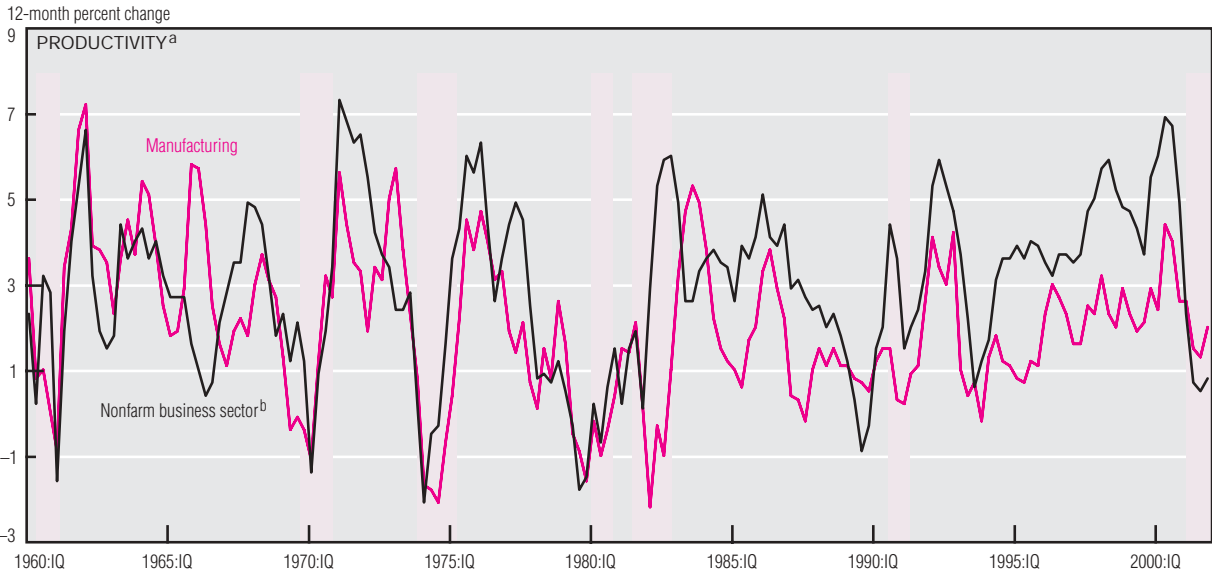
The final estimate from the national income and product accounts shows that during 2001:IVQ, real gross domestic product grew at an annual rate of 1.7%. This rate of real GDP growth reflects the resilience of the U.S. economy: It more than triples the real GDP growth rate over the past four quarters. Consumers expressed unreserved confidence during 2001:IVQ, with personal consumption increasing at an annualized rate of 6.1% from the previous

quarter and contributing 4.1 percentage points to real GDP growth. Strong government spending also contributed substantially. The greatest drags on output growth in 2001:IVQ came from business fixed investment and the fast pace of inventory liquidation, which accounted for a combined -3.9 percentage points. Blue Chip forecasters predict robust growth in real GDP for 2002. In fact, they expect it to reach its long-term average as early as 2002:IIQ.

Although the National Bureau of Economic Research, the official arbiter of recessions, has not declared the current recession to be over, accumulating evidence makes it increasingly likely that it ended around December 2001. Assuming that this is the case, it is constructive to examine this recession's similarities to—and differences from—earlier ones. One of the most remarkable features of this recession is that output fell during only one quarter, 2001:IIIQ. Over the

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Economic Activity (cont.)



Real GDP and Components during Recessions

	Percent change, peak to trough:		
	Current recession	1990 recession	Average of last six recessions
Real GDP	0.2	-1.3	-1.7
Personal consumption	2.4	-1.3	0.0
Durables	10.8	-6.4	-6.3
Nondurables	0.8	-1.2	-0.1
Services	1.5	-0.2	1.9
Business fixed investment	-9.4	-4.5	-6.2
Residential investment	0.8	-13.1	-11.0
Business inventories	-3.7	-0.6	0.1
Government spending	3.8	1.4	1.6
Exports	-10.7	2.0	1.2
Imports	-7.3	-5.9	-6.2

NOTE: All data are seasonally adjusted.

a. Shaded areas mark NBER-defined recessions.

b. The nonfarm business sector accounted for about 76% of GDP in 1996.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

course of the recession, it rose 0.2%. This contrasts sharply with the 1.7% average decline in output during the previous six recessions.

Another remarkable feature of this recession is the surprising strength in productivity. This strength comes almost exclusively from nonmanufacturing productivity, which rose 1.4% during the recession. During a typical recession it falls 0.1%. Manufacturing productivity, which grows 1.3% in a typical recession, advanced 1.4% during this one.

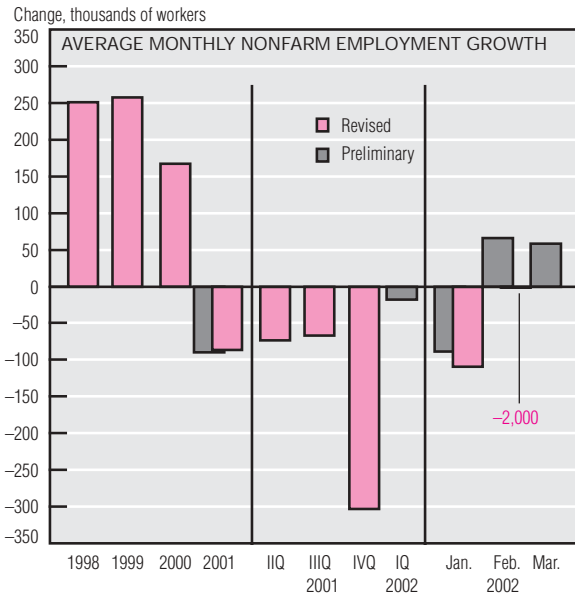
Unemployment also increased less than it usually does, but this is entirely due to the mildness of this recession. If GDP had fallen as much as it usually does, unemployment would have increased by more than is usual.

This recession has shown extraordinary strength in personal consumption, which rose throughout the period. Durable goods consumption grew a whopping 10.8% from the peak of the business cycle to its trough, largely because of its fourth-quarter increase. But even without the

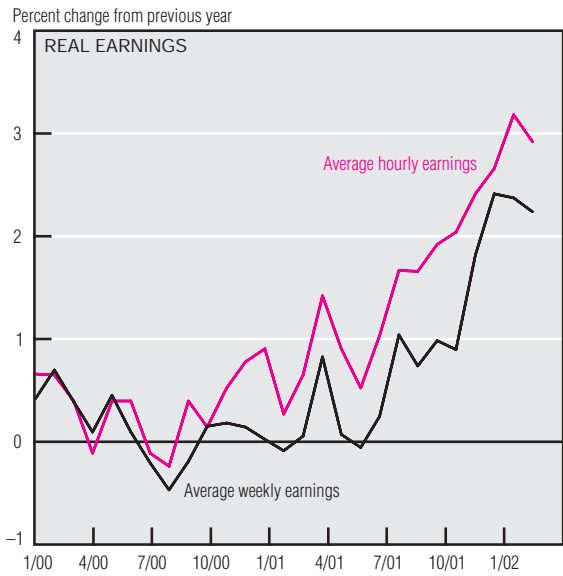
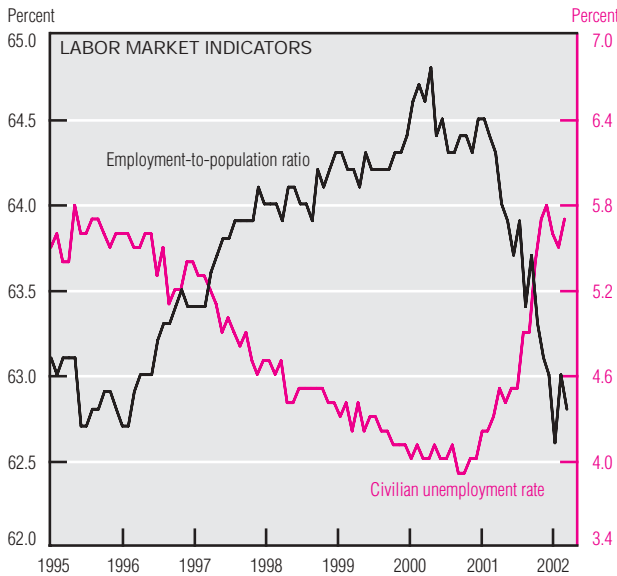
fourth quarter, durable goods consumption would have grown nearly 2% during this recession. Housing mirrored the strength in consumption. Residential investment, which typically falls 11% during a recession, rose 0.8% this time around.

On the flip side, business fixed investment fell 9.4%, although it usually declines only 6.2%. The weakness in investment is especially surprising in view of the strength in productivity, which normally would portend strong investment growth.

Labor Markets



	Average monthly change (thousands of employees)				
	1998	1999	2000	2001	March 2002
Payroll employment	251	257	167	-87	58
Goods-producing	22	7	8	-103	-77
Mining	-3	-3	1	1	-2
Construction	37	26	18	5	-37
Manufacturing	-13	-16	-12	-109	-38
Durable goods	-2	-5	1	-79	-31
Nondurable goods	-11	-11	-13	-31	-7
Service-producing	230	250	159	16	135
TPU ^a	20	18	14	-16	-6
Wholesale and retail trade	40	59	34	-14	-8
FIRE ^b	22	7	0.0	4	-6
Services ^c	120	131	93	5	118
Government	28	35	18	37	37
Average for period (percent)					
Civilian unemployment rate	4.5	4.2	4.0	4.8	5.7



NOTE: All data are seasonally adjusted.
 a. Transportation and public utilities.
 b. Finance, insurance, and real estate.
 c. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Although nonfarm payroll employment added 58,000 jobs in March, the indicators still appear weak. In the most recent Labor Department estimate, February employment change was revised downward from a net gain of 66,000 to a net loss of 2,000. Preliminary data suggest that throughout 2002:IQ, there was an average monthly loss of 18,000 jobs, but this was much less than the average monthly loss of 303,000 jobs posted in 2001:IVQ.

In March, as in previous months, service-producing industries added

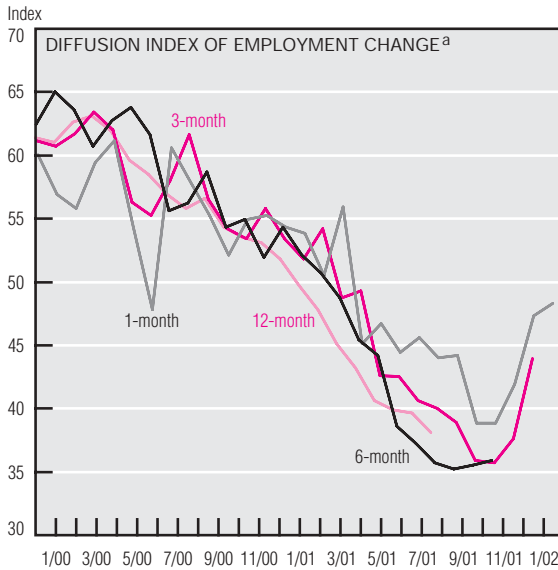
employment, while goods producers continued to cut it. Goods-producing industries posted a net loss of 77,000 jobs, with construction declining almost as much as manufacturing. However, this is the smallest monthly loss for manufacturing since December 2000. The gains in service-producing employment result from the combined increase of more than 150,000 jobs in services and government, while the other components declined slightly.

Reversing February's improvement, the unemployment rate rose

again to 5.7% (up 0.2 percentage points) and the employment-to-population ratio fell to 62.8%. Since October 2001, the unemployment rate has remained within 0.2 percentage point of 5.6%.

Year-over-year real earnings increased steadily throughout 2001. Real average hourly earnings in January 2002 were more than 3% higher than in the same month in 2001, although the percent increase from February 2001 to February 2002 was smaller. Real average weekly earnings followed a similar trend.

Employment Change



Employment Change by Region

	Percent change					Thousands
	Peak to trough ^b		Last month			
	3/01-12/01	10/01-11/01	11/01-12/01	12/01-1/02	1/02-2/02	
New England	-1.1	0.0	-0.1	0.2	0.0	6,996
Middle Atlantic	-0.9	-0.1	0.0	-0.1	-0.1	18,226
South Atlantic	-1.0	-0.3	-0.2	0.0	-0.1	24,518
East South Central	-0.6	0.0	-0.1	0.3	0.0	7,577
East North Central ^c	-0.5	-0.2	-0.6	—	—	22,016
West North Central	-1.1	-0.1	-0.2	0.2	-0.1	9,797
West South Central	-0.8	-0.1	-0.1	0.1	0.0	14,055
Mountain	-1.0	-0.2	-0.1	0.3	0.0	8,559
Pacific	-0.8	-0.3	0.0	0.1	0.0	19,745

Employment Change by Industry

	Percent change					Thousands
	Peak to trough ^b		Last month			
	3/01-12/01	10/01-11/01	11/01-12/01	12/01-1/02	1/02-2/02	
Goods-producing						
Mining	1.3	-0.4	-0.5	-0.4	-1.1	556
Construction	-1.1	0.0	0.0	-0.9	0.4	6,812
Manufacturing	-5.9	-1.0	-0.7	-0.6	-0.3	16,879
Service-producing						
TPU ^d	-3.0	-0.9	-0.5	-0.3	0.1	6,901
Wholesale trade	-1.8	-0.4	0.0	-0.1	-0.2	6,919
Retail trade	-0.4	0.0	-0.3	0.2	0.2	23,464
FIRE ^e	0.2	0.1	-0.1	0.1	-0.1	7,626
Services ^f	-0.3	-0.3	0.2	0.1	0.1	41,021
Government	1.7	0.0	0.3	0.0	0.1	21,083

Unemployment Rate (percent)

	Peak 3/01	Trough ^b 12/01	Most recent 1/02
U.S.	4.3	5.8	5.6
New England	3.2	4.3	4.1
Middle Atlantic	4.2	5.5	5.5
South Atlantic	4.1	5.4	5.1
East South Central	4.8	5.8	5.5
East North Central	4.5	5.4	5.3
West North Central	3.8	4.2	4.0
West South Central	4.5	5.7	5.5
Mountain	4.0	5.6	5.6
Pacific	5.0	6.4	6.5

NOTE: All data are seasonally adjusted. The recession start date is from the NBER. U.S. regions follow the standard census division of states.
a. The diffusion index of employment change is based on seasonally adjusted data for 1-, 3-, and 6-month spans and unadjusted data for a 12-month span. Data are centered within the span. Figures show the percent of industries with employment increasing plus half of the industries with unchanged employment.
b. Estimated; the NBER has not set an end date.
c. The most recent data available for the region are for December 2001 rather than February 2002.
d. Transportation and public utilities.
e. Finance, insurance, and real estate.
f. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and National Bureau of Economic Research.

The National Bureau of Economic Research dated the start of the latest recession at March 2001. Many analysts have proposed December 2001, or perhaps January 2002, as an ending date, and recent labor market data tend to support their view.

The diffusion index of employment is based on firms' responses as to whether they have increased employment, decreased it, or kept it the same. The index turned around in December. As reported in February, it approached 50 for the 1-month time

span, indicating that the same fraction of firms increased employment as decreased it in February.

Between the beginning of the recession and its presumed end in December, employment declined in all regions and almost all industries. However, while the declines were about the same size in all regions, they were much more concentrated in some industries than in others.

Most regions posted month-to-month employment declines until December. In that month, most regions showed net gains. The positive

changes in January were smaller, and some changes were negative.

Employment was hardest hit in manufacturing and in transportation and public utilities. Since October, percentage losses have been smaller, but the manufacturing sector is still posting employment declines, and wholesale trade shows no sure signs of recovery.

Unemployment rates have also begun to drop. In December, the Pacific region was the only one in which they rose.

The Steel Industry

Steelmaker	Location	Date of bankruptcy	Total employees
Wheeling-Pitt Steel	Wheeling, WV	November 2000	4,800
Erie Forge and Steel	Erie, PA	December 2000	300
LTV Steel	Cleveland, OH	December 2000	18,000
CSC Ltd.	Warren, OH	January 2001	1,225
Republic Technologies	Akron, OH	April 2001	4,600
Edgewater Steel	Oakmont, PA	August 2001	140
Riverview Steel	Glassport, PA	August 2001	60

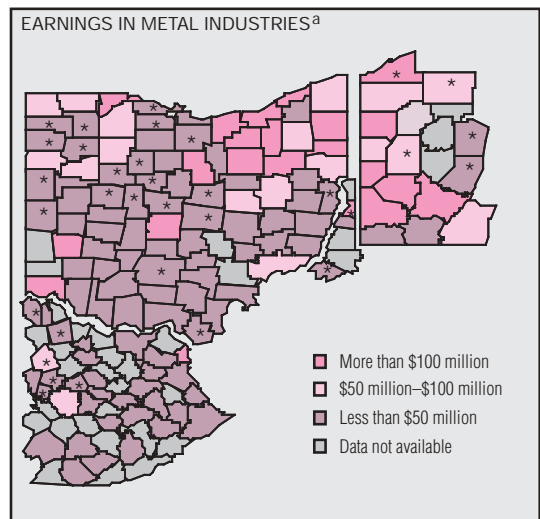
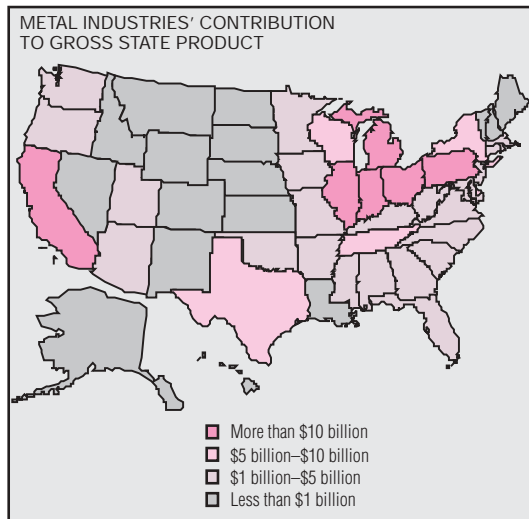
Bush Administration Tariffs

Items with 30% tariffs:
Plates; hot-rolled, cold-rolled, and coated sheets; tin mill products; hot-rolled and cold-finished bars; all slabs over quota of 5.4 million short tons

Items with 15% tariffs:
Rebars, specified welded tubular products, stainless steel bars, and rods

Items with 13% tariffs:
Carbon and alloy fittings and flanges

Items with 8% tariffs:
Stainless steel wire



NOTE: Metal industries are those included under the following standard industrial classification codes: 3300 (primary metal industries); and 3400 (fabricated metal products excluding machinery and transportation equipment).
a. Data for counties marked by asterisks reflect only one SIC division because disclosure rules bind the release of data for the other SIC division.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; White House, Office of the Press Secretary; and United Steelworkers of America.

Although President Bush's steel products proclamation of March 5, 2002 highlighted the industry's troubles, they have long been evident in the Fourth District, where seven steelmakers have declared bankruptcy in the last 18 months.

The Bush administration's tariffs, ranging from 8% to 30%, will remain in effect for three years, but imports from NAFTA partners Canada and Mexico are excluded, as are imports from developing countries that are World Trade Organization members. The president may reconsider within

the next three months and, if he deems appropriate, exclude any item listed in the proclamation. He will reevaluate the tariffs in 2003.

Within the U.S., six states derived more than \$10 billion of gross state product from the primary metal and fabricated metal industries in 1999. Within the Fourth District, the areas with significant earnings from these industries are centered in Cleveland-Akron, Youngstown-Warren, Pittsburgh, and Wheeling.

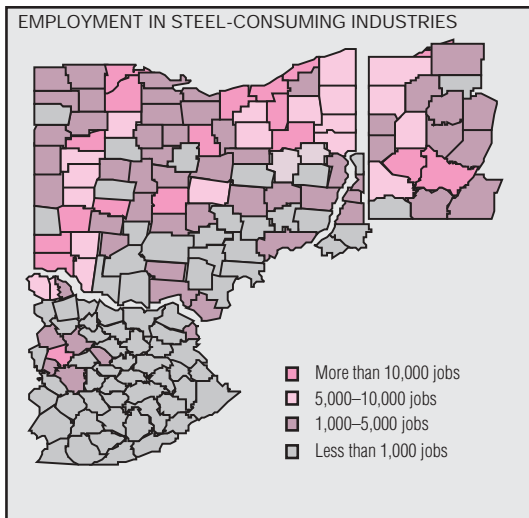
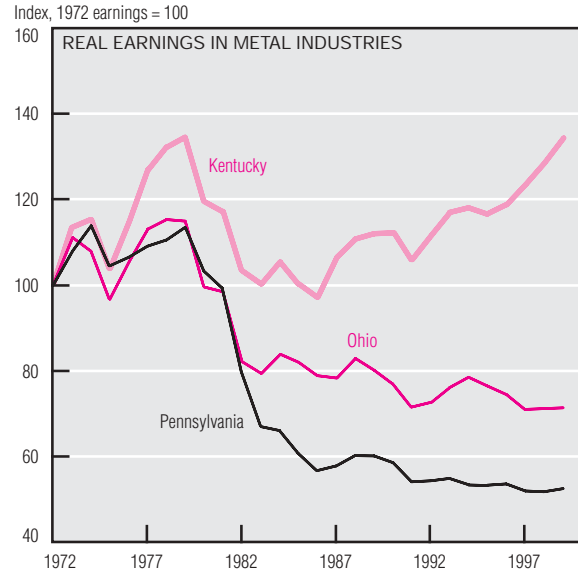
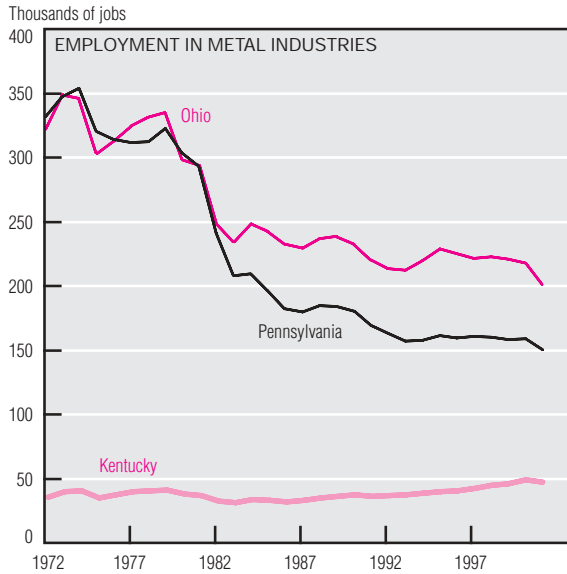
In Ohio and Pennsylvania, employment in metal industries fell from

1972 through the recession of the early 1980s. Job losses moderated after 1984, and while employment continued to shrink, it did so at a much slower rate. Real earnings in metal industries followed an almost identical pattern from 1972 to 1999.

Because heavy manufacturing took hold significantly later in Kentucky than in Ohio and Pennsylvania, Kentucky's story is much different. Its metals industry includes far more mini-mills, smaller-scale manufacturing facilities that deal primarily with

(continued on next page)

The Steel Industry (cont.)



European Union Tariffs

Items with 26% tariffs:
 Non-alloy hot-rolled sheets, plates, and narrow strips, alloy hot-rolled flat products; quarto plates; alloy merchant bars and light sections; non-stainless steel flanges

Items with 24.8% tariffs:
 Wide plates

Items with 14.9% to 19.4% tariffs:
 Non-alloy hot-rolled coils; cold-rolled and electrical sheets; tin mill products; non-alloy merchant bars and light sections, rebars, stainless steel wire, and fittings (609.6 mm)

NOTE: Metal industries are those included under the following standard industrial classification codes: 3300 (primary metal industries); and 3400 (fabricated metal products excluding machinery and transportation equipment).
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Consuming Industries Trade Action Coalition; and "Details of New EU Tariffs on U.S. Steel Imports," *Financial Times*, March 25, 2002.

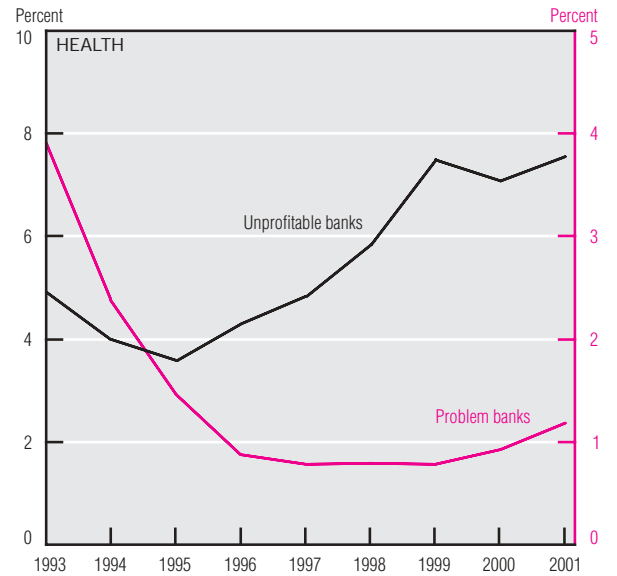
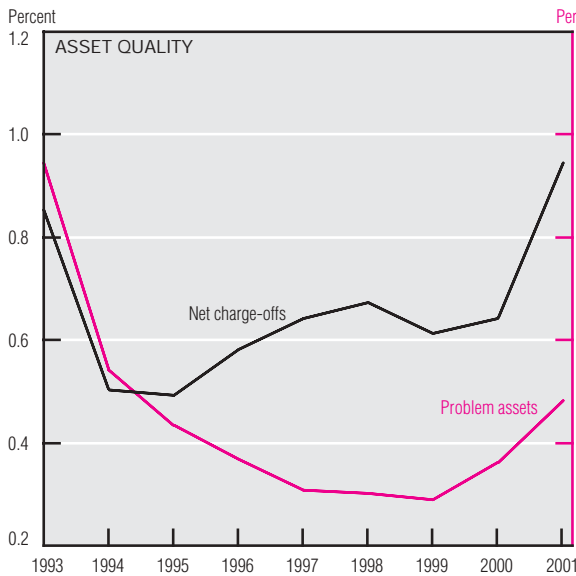
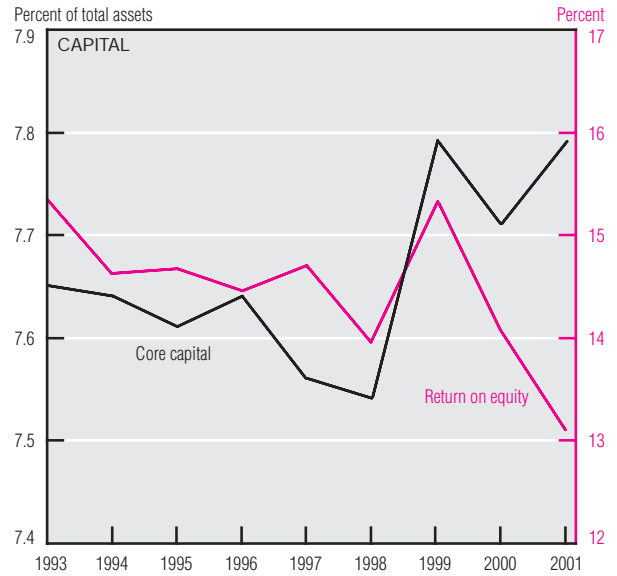
scrap or ready-made steel. In contrast, the integrated mills scattered across Ohio and Pennsylvania produce steel from raw materials before making it into parts used by their customers. Kentucky's employment in primary and fabricated metals was actually higher in 2001 than in 1972, and earnings have grown vigorously since the late 1980s. Compared to integrated mills' stories of bankruptcy and forced closures over the last two years, mini-mills have been relatively insulated from the industry's downturn. Most

of the bankrupt steelmakers in the Fourth District specialize in production or processing.

While the actual impact of the tariffs remains to be seen, some foresee adverse effects, including a strain on steel-consuming industries (such as construction and manufacturers of appliances and automobiles) as their production costs rise along with steel prices. Such consuming industries are located throughout the District, but they coincide mostly with concentrations of heavy manufacturing.

Another adverse affect may be strained trade relations. In the last week of March, the European Union announced tariffs ranging from 14.9% to 26% on selected steel imports. An important caveat, however, is that the tariffs apply only to imports exceeding a declared quota (under the Bush administration's tariffs, only one item allows duty-free imports to a quota level). For 2002, the import quotas on all products are set at 2001 levels, which are the highest on record for the European nations.

Commercial Banks



a. Income less interest expenses, both divided by average earning assets.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured commercial banks reported record earnings of \$74.3 billion in 2001, \$3.2 billion over the record set in 1999. These record profits translated into a return on assets of 1.16%, down slightly from 1.19% in 2000. The downside of the bank earnings picture is that capital gains accounted for more than 6% of first-half profits. Downward pressures on core earnings continued as the net interest margin fell to 3.90% for 2001, a drop of 5 basis points (bp) from the end of 2000.

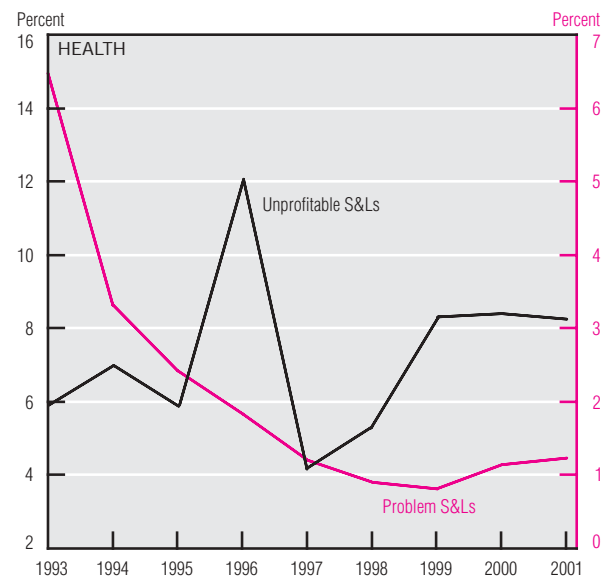
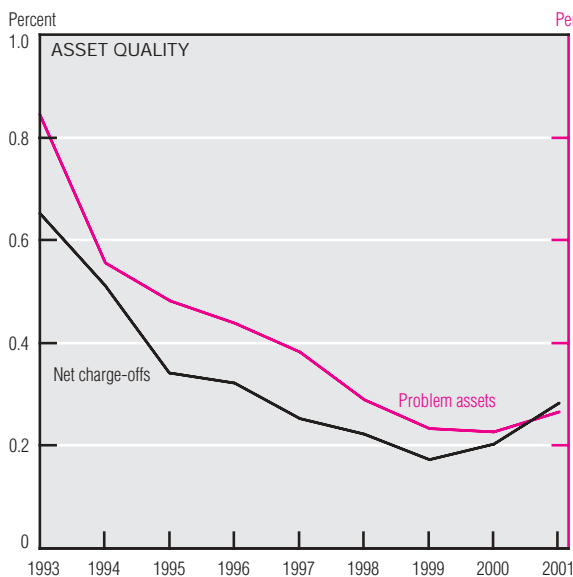
Return on equity for 2001 was 13.1%, down from 14.07% for 2000. This deterioration results from a drop of 3 bp in return on assets, magnified by a slight decrease in leverage as core capital rose from 7.71% at the end of 2000 to 7.79% at the end of 2001. The recession that began in March has had only minor effects on overall bank asset quality. Both problem assets and net charge-offs increased in 2001; however, despite an increase of 30 bp, problem assets remained less than 1% of total assets.

Although earnings improved during 2002:1Q compared to year-end

2001, the share of banks with substandard examination ratings—problem banks—rose to 1.18% in 2001. In addition, the share of unprofitable banks increased from 7.06% at year-end 2000 to 7.54% at year-end 2001.

While most of these changes are consistent with a strong banking sector, the latest data are mixed. There appears to be continued deterioration, albeit minimal, in asset quality. Moreover, it remains to be seen whether noninterest sources of income can continue to offset declining net interest margins.

Savings Associations



a. Interest income less interest expenses, both divided by average earning assets.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

Savings associations' performance mirrored that of commercial banks during 2001. Savings associations earned a record \$13.3 billion in 2001, translating into a return on assets of 1.08%—the highest since 1946. Like banks, savings associations took advantage of lower interest rates to boost earnings to \$4.2 billion through capital gains. However, savings associations' earnings benefited from a 27 basis point increase in their net interest margin to 3.23%.

Return on equity for 2001 was 12.73%, compared to 11.14% at the

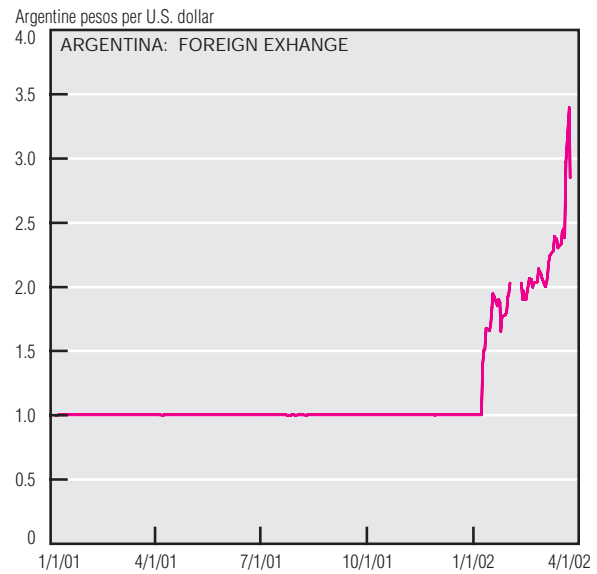
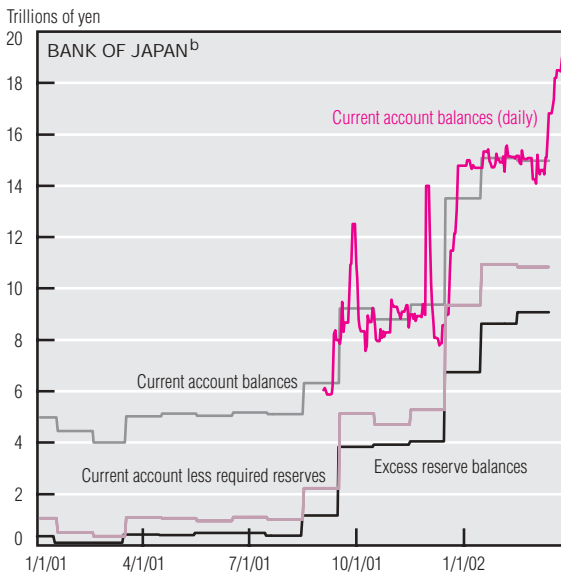
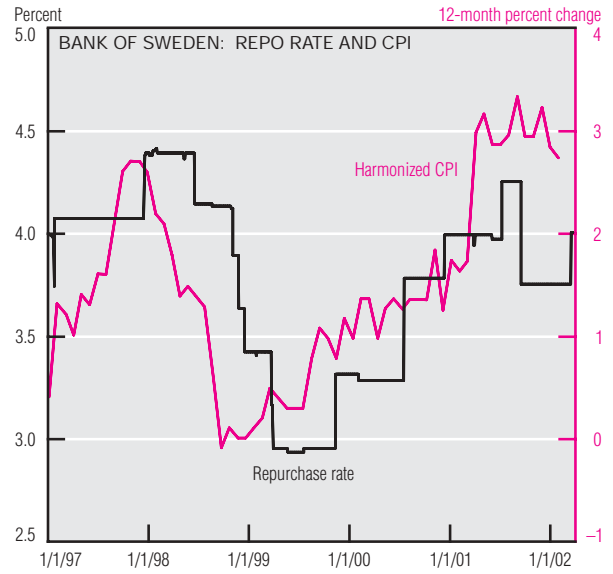
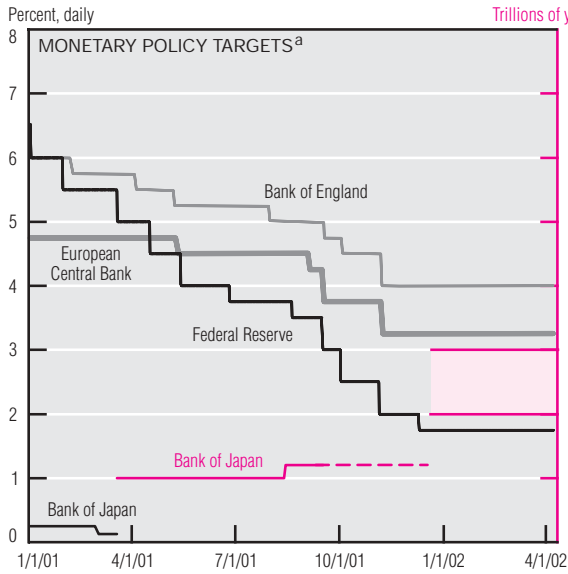
end of 2000. The rise appears to have been driven by improvements in return on assets and a slight increase in leverage: Core capital decreased from 7.81% of total assets at the end of 2000 to 7.80% at the end of 2001. Asset-quality indicators for savings associations show some weakening. By year-end 2001, nonperforming (problem) assets had risen to 0.66% of total assets, and net charge-offs had increased to 0.28% of loans.

Other indicators of industry health are mixed. Unlike commercial banks, savings associations' steady or increasing profits have been

accompanied by a decrease in the number of unprofitable institutions from 8.36% in 2000 to 8.22% in 2001. On the other hand, the share of problem savings associations (those with substandard examination ratings) was 1.22% at year-end, up from 1.13% at the end of 2000.

While most of these changes are consistent with weakening in the housing finance sector, the latest data suggest no significant deterioration in savings associations' health. Like commercial banks, savings associations have yet to show more than minor effects of the slowing economy.

Foreign Central Banks



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

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 at the Bank of Japan starting the sixteenth of one month and ending the fifteenth of the next. All observations are maintenance period averages, unless otherwise noted.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; and Bloomberg Financial Information Services.

The four major central banks left their policy settings unchanged over the past month. The Bank of Sweden became the first central bank of a developed country to raise its policy rate since the first intimations of economic recovery became widely noted. At its March meeting, the Bank of Japan retained its target of ¥10 billion–¥15 billion for current account balances. Toward the end of March, actual balances exceeded that target, apparently reflecting a decision to ensure “financial market stability

towards the end of a fiscal year” by providing more liquidity. Likewise, for the reserve maintenance period ending April 15, the Bank of Japan temporarily suspended the limit of five days per maintenance period on use of its Lombard-type lending. With reported shortages of collateral contributing to underbidding in open market operations, the bank widened the range of eligible collateral to include loans to the Deposit Insurance Corporation as well as to the government’s special account for the allotment of local allocation tax

and local transfer tax. These are in addition to government bonds, foreign government bonds, international financial institution bonds, debts of special purpose companies (including commercial paper), and loans on deeds to companies. The Argentine exchange rate has continued to depreciate despite continued government sales of dollars. The index of market rates lately has moved close to 3.5 pesos per dollar, with some reported trades exceeding four pesos per dollar.