# 1

# The Economy in Perspective

*Taking care of business*…In 1925, President Calvin Coolidge told the Society of American Newspaper Editors that the business of America is business. Coolidge, who was president from 1923 to 1928, succeeded to the office after the death of Warren G. Harding, whose administration had been rocked by the Teapot Dome and other scandals involving improper contracts with private businessmen. Coolidge had a sterling reputation for honesty and earned sufficient public trust to be elected to a full term in 1924. Cautious about extending the federal government's authority into matters of banking and commerce, he maintained a laissez-faire philosophy and a pro-business agenda during a period of national prosperity. Later, historians would fault him for not taking stronger action to temper the stock market boom of the Roaring Twenties; whether he had sufficient moral or legal authority to have prevented the 1929 stock market collapse remains a debatable point today.

Americans have had an on-again, off-again attitude about government's relationship to business. One anchoring principle has been respect for private property and individual initiative; but another has been a sense of fair play and a resentment of concentrated power. At various times in our nation's history, the clockworks have been judged out of synch, and governmental power has been expanded or contracted to recalibrate the national balance wheel.

When Calvin Coolidge spoke to the newspaper editors in 1925, he was ruminating on the question of the press' ability to serve the public interest at a time when some newspapers were owned by large and powerful corporations (déjà vu!). His exact words were, "After all, the chief business of the American people is business. They are profoundly concerned with producing, buying, selling, investing and prospering in the world. I am strongly of the opinion that the great majority of people will always find these are moving impulses of our life." Speaking several decades after Theodore Roosevelt took action against big business combinations, Coolidge continued to believe that Americans were, by nature, predisposed to favor private enterprise as an engine of growth and a way of organizing economic life.

During the 1930s, the U.S. economy performed so poorly that the public supported significantly more federal government involvement in economic affairs. For example, the Securities and Exchange Commission was established in 1934 to protect all investors against the unscrupulous behavior of corporations and financial exchanges. The New Deal initiatives redefined the boundaries between the prerogatives of private enterprise and the federal government's responsibility to protect the public. Since that time, those who invest in U.S. firms have come to rely on the accuracy, transparency, and honesty of financial reporting and markets. Increasingly, the investing public has included foreign residents, especially as nations have expanded financial claims on one another through international trade and financial diversification.

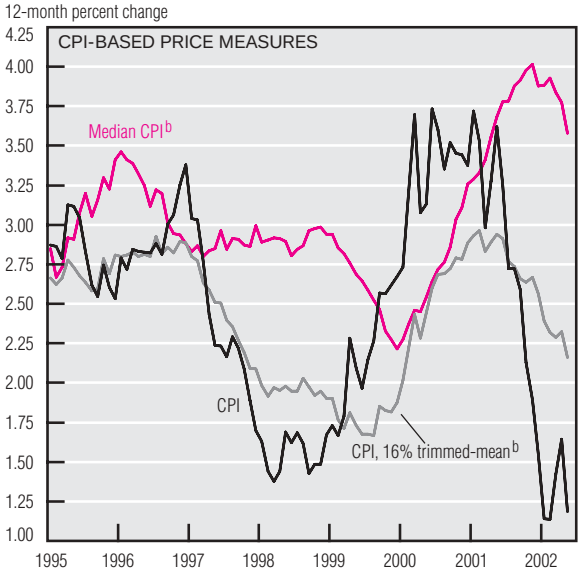
The recent accounting and disclosure scandals surrounding Enron and other prominent U.S. businesses are only the latest example of corporate hubris. When exposed, such egotism destroys trust, the backbone of a market economy. Without trust, many transactions become so expensive to monitor and enforce that they are too costly to undertake in the first place. The modern oversight framework relies on an assumption that relatively few people will spend relatively little time trying to deceive others, so that surveillance requires relatively little in the way of resources. But trust has its limits, and transactions must be verified eventually, even if through statistical sampling rather than itemized reviews. Abraham Lincoln's dictum, that you can't fool all of the people all the time, still holds true.

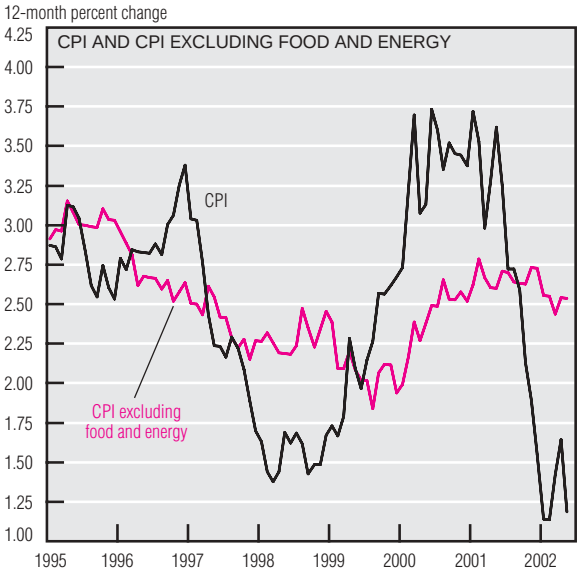
Our history suggests that a mixture of governmental and private steps will be taken in response to the corporate ethical lapses now coming to light. The national balance wheel will be recalibrated, once again, out of a sense of our cultural imperative. If the business of America is indeed business, then restoring investors' confidence in financial reporting, accounting, and auditing is plainly essential. Otherwise America, as we know it, is out of business.

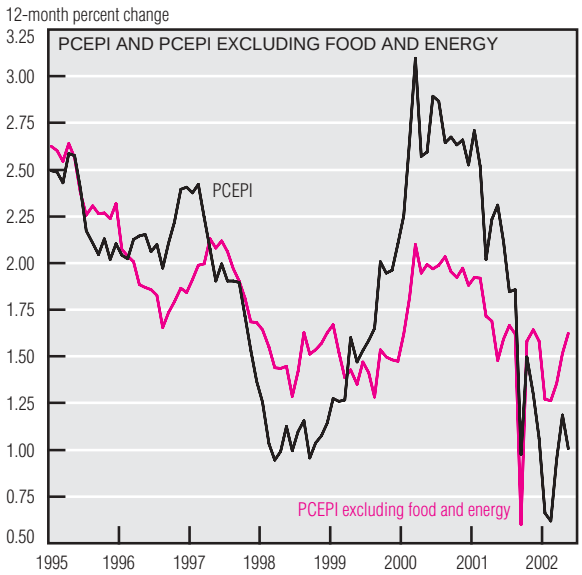
# Inflation and Prices

**May Price Statistics**

| | Percent change, last: 1 mo.[a] | 3 mo.[a] | 12 mo. | 5 yr.[a] | 2001 avg. |
|---|---|---|---|---|---|
| Consumer prices | | | | | |
| All items | 0.0 | 3.4 | 1.2 | 2.3 | 1.5 |
| Less food and energy | 1.9 | 2.1 | 2.5 | 2.4 | 2.7 |
| Median[b] | 2.3 | 3.1 | 3.6 | 3.1 | 3.9 |
| Producer prices | | | | | |
| Finished goods | –5.1 | 1.5 | –2.7 | 1.1 | –1.7 |
| Less food and energy | 0.0 | 0.8 | 0.1 | 1.1 | 0.9 |




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

The consumer price index (CPI) was unchanged in May after rising sharply (0.5%) in April. Wide swings in energy prices continue to exert considerable influence over the direction of this retail price measure. The CPI's energy index fell 0.7% in May, after posting a huge (4.5%) increase in April. Excluding the highly volatile food and energy items from the consumer market basket reveals a comparatively stable pattern of retail price increases. The CPI excluding food and energy was up slightly less than 2% (at an annualized rate) in May; on a 12-month basis, it has fluctuated within a narrow range between $2^{1}/_{2}$% and $2^{3}/_{4}$% since the middle of 2000.

The 12-month rates of change in both the median CPI and the 16% trimmed-mean CPI have been falling steadily for several months, perhaps a sign that underlying inflationary pressures are easing, albeit modestly. Both of these inflation measures are constructed to be less sensitive to the most extreme price movements in any given month, so they may represent broad price trends better than either the official CPI or the CPI excluding food and energy.

The personal consumption expenditure (chain-type) price index provides yet another measure of retail costs. The PCEPI market basket gives less weight to housing costs (which have been rising substantially in recent years relative to other goods), and this, along with other methodological differences, has caused the PCEPI to record less inflation than the CPI. But like the CPI, the PCEPI has shown wide swings in recent years, and for the same basic reason—prices within its market basket have shown widely varying rates of increase.

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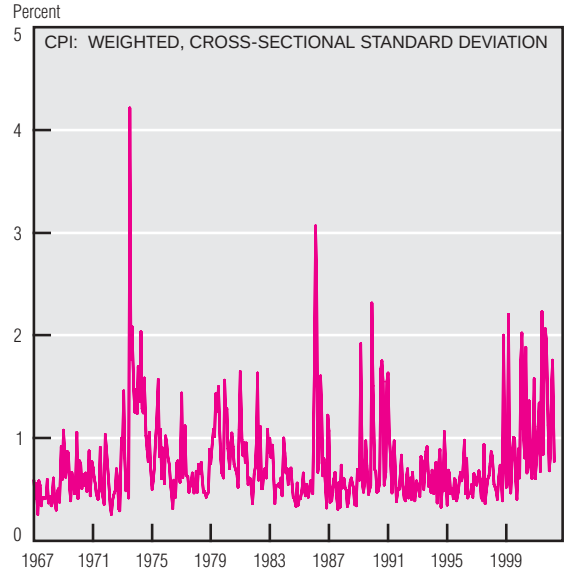
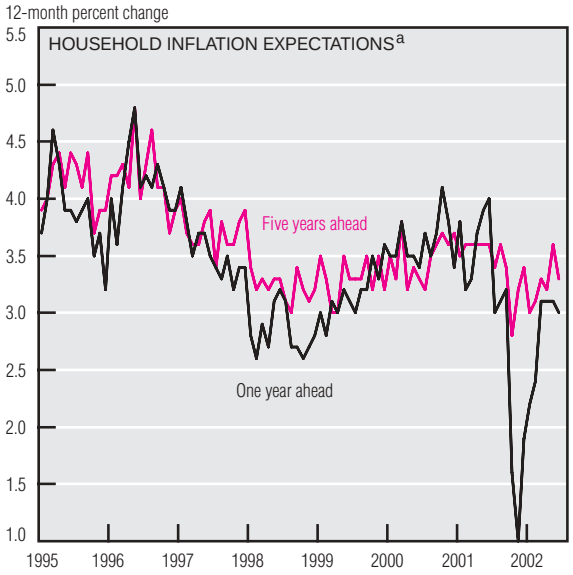
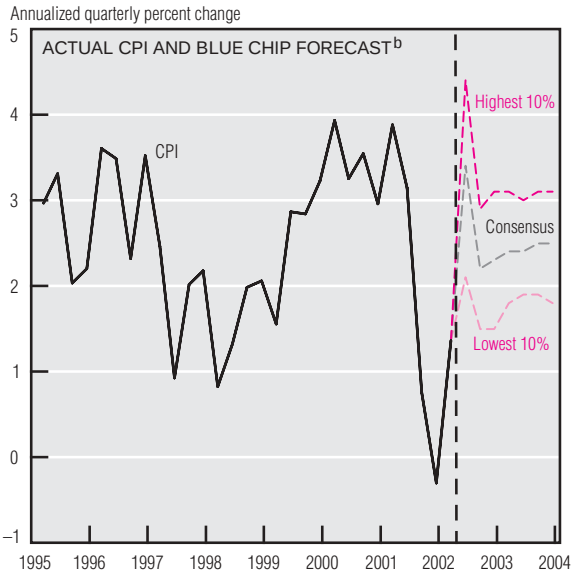
# Inflation and Prices *(cont.)*




**Extremes of the Price-Change Distribution**

| Component | 24-month annualized percent change | Relative importance, May 2002 |
|---|---|---|
| **Upper tail** | | |
| Tobacco and smoking products | 6.8 | 0.9 |
| Motor vehicle insurance | 6.0 | 2.3 |
| Education | 5.5 | 2.8 |
| Medical care services | 5.0 | 4.5 |
| Miscellaneous personal services | 4.4 | 1.6 |
| Fresh fruits and vegetables | 4.2 | 1.0 |
| Gas (piped) and electricity | 4.1 | 3.4 |
| Rent and owners' equivalent rent | 4.1 | 28.6 |
| **Lower tail** | | |
| Communication | –1.0 | 3.0 |
| Miscellaneous personal goods | –1.0 | 0.2 |
| New and used cars and trucks | –1.2 | 7.1 |
| Jewelry and watches | –1.3 | 0.4 |
| Infants' and toddlers' apparel | –1.6 | 0.2 |
| Women's and girls' apparel | –2.0 | 1.8 |
| Motor fuel and fuel oil and other fuels | –2.7 | 3.1 |
| Men's and boys' apparel | –3.2 | 1.1 |



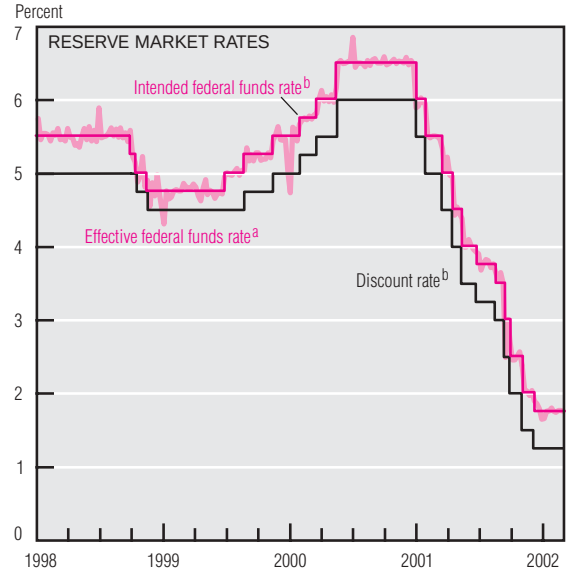



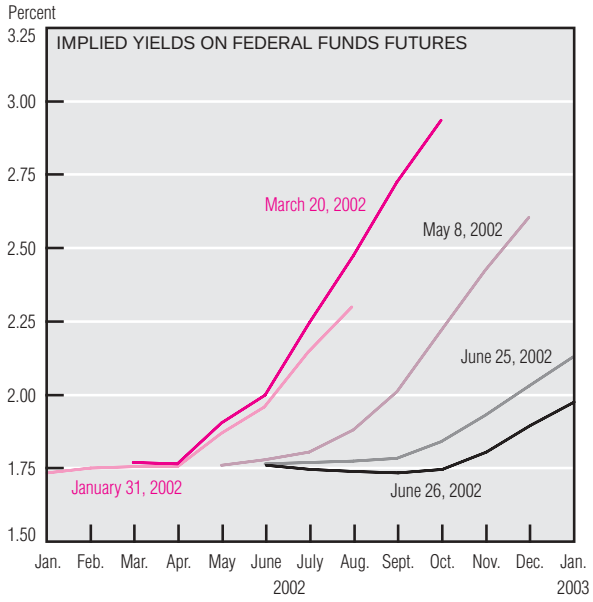

a. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, June 10, 2002.

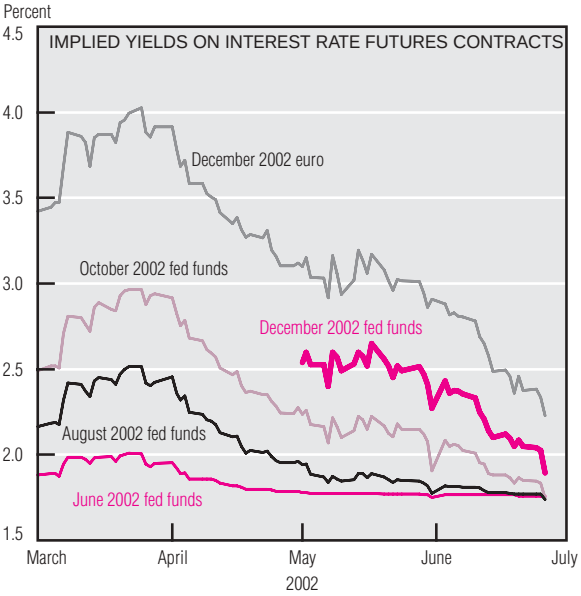
Some of the items in the CPI basket show rather persistent and troubling rates of increase, while others show equal persistence in their outright rates of decline. These divergent patterns make it difficult to gauge the underlying price pressure. In fact, examining the pattern of price changes across goods and services in the CPI's consumer market basket (the weighted standard deviation in the cross-section of price changes in the CPI) shows unusually divergent behavior among the prices of different goods; this unusual behavior has characterized the CPI since about 1999. The varying pattern of price changes within the consumer's market basket contrasts starkly with the 1992–99 period, when price changes were largely uniform across goods and services.

Among the items that have shown large and persistent price increases in recent years are medical care (5%) and housing services (4.1%), whereas price increases for communication, apparel items, and gasoline prices have shown persistent net declines. Whatever causes this diverse behavior in retail prices, greater variability among prices for consumer goods and services does not seem to have affected inflation expectations significantly. Households' long-run expectations (five years ahead or more) have held steady between 3.0% and 3.5% since 1998, while year-ahead expectations, which plummeted after September 11, have settled at about 3%. Similarly, although economists expect CPI inflation to rise a bit from its current low reading, the consensus forecast projects that it will plateau at a rate of 2%–3%, not far from the economy's average trend inflation over the past five years or so.

# Monetary Policy





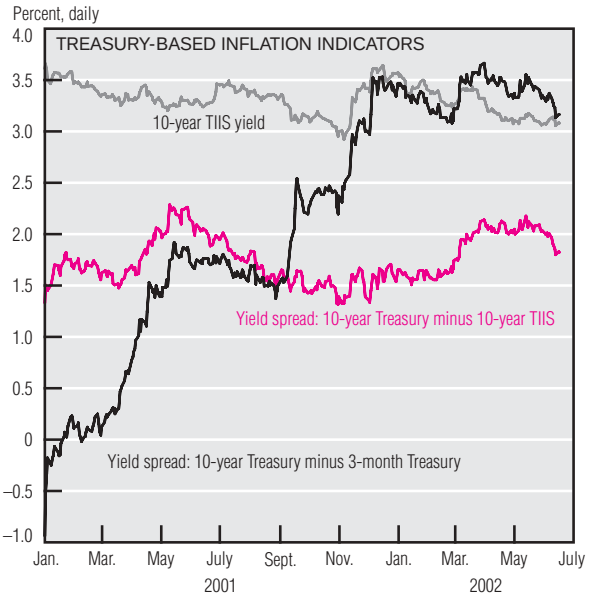
a. Weekly average of daily figures.
b. Daily.
SOURCES: Board of Governors of the Federal Reserve System; Chicago Board of Trade; and Bloomberg Financial Information Services.

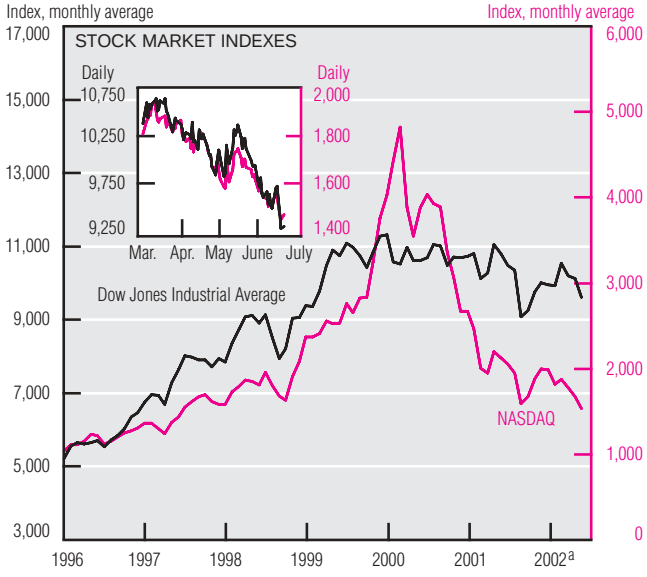
At its June 25–26 meeting, the Federal Open Market Committee left the intended federal funds rate unchanged at 1.75%. The FOMC indicated in its press release that "economic activity is continuing to increase. However, both the upward impetus from the swing in inventory investment and the growth in final demand appear to have moderated." The Committee maintained its stance that risks are balanced with respect to price stability and sustainable economic growth.

Implied yields on federal funds futures contracts declined steadily in April, flattened in mid-May, and fell sharply in late May and June, suggesting that market participants do not expect the funds rate to go up until at least November. Eurodollar futures, which are more active at longer maturities, are also used to gauge monetary policy expectations. Implied yields on the December contract have closely followed those on the fed funds futures contract of similar maturity. Although both eurodollar and fed funds futures have become more accurate in their implied interest rate forecasts in recent years, they are less accurate in forecasting long-term rates. Thus, implied yields as far out as December could change substantially in the coming months.

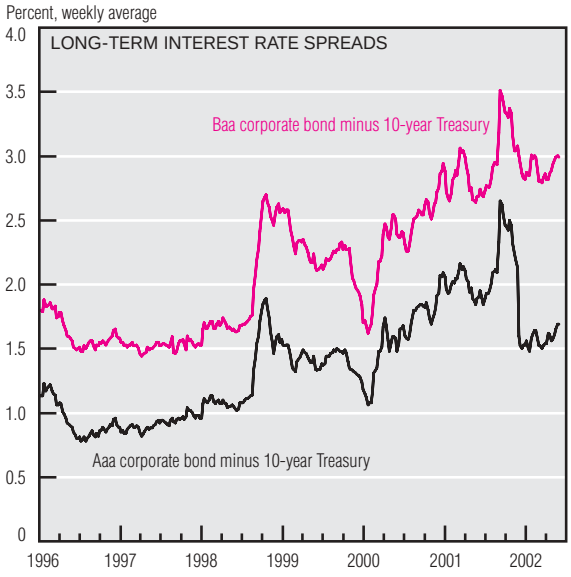
Treasury yields have continued to decline over the past several months for maturities of one year and longer. Intermediate Treasuries fell the most, partly because issuance of State and Local Government Series securities was suspended beginning May 15.

# Money and Financial Markets








NOTE: All non–inflation indexed Treasuries shown are constant maturity.
a. Monthly average for June is through June 24.
b. 3-month rate on eurodollar deposits minus 3-month Treasury bill yield.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

In June, long-term Treasury rates dropped markedly, more than 20 basis points in the case of the 10-year Treasury. This drop could reflect moderating inflation expectations: Both the 10-year to 3-month Treasury spread and the spread between the 10-year Treasury and the 10-year Treasury inflation-indexed security have dropped recently. The stock market's poor performance may be another part of the story. As investors shift from stocks to bonds, bond prices rise and yields fall. The announcement of a delay in the 2-year Treasury note auction (formerly scheduled for June 26) seems to have driven yields down on the short end as well. As a result of greater concern over corporate governance and geopolitical tensions, major stock market indexes are now hovering near the levels reached just after September 11.

Corporate debt market indicators also seem to reflect heightened economic uncertainty. Although the spread between nonfinancial commercial paper and Treasuries has been fairly stable for the past several months, total outstanding commercial paper continues to drop and has been roughly halved since the beginning of 2001. Corporate debt restructuring, reduced business spending, and investor wariness all have contributed to this decline. The low Treasury-to-eurodollar (TED) spread is indicative of stable international financial markets, but recently it has been trending up slightly.

Spreads between corporate bonds and Treasuries have been inching up in recent weeks as well. Some of this increase may be attributed to recent disappointing earnings announcements combined with concerns over future earnings.

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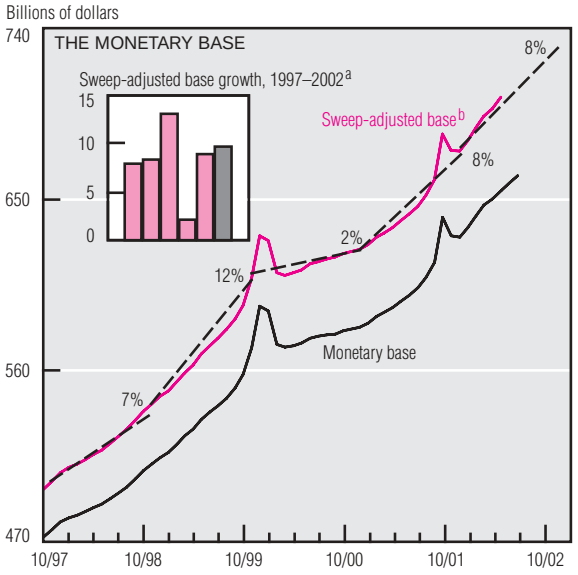
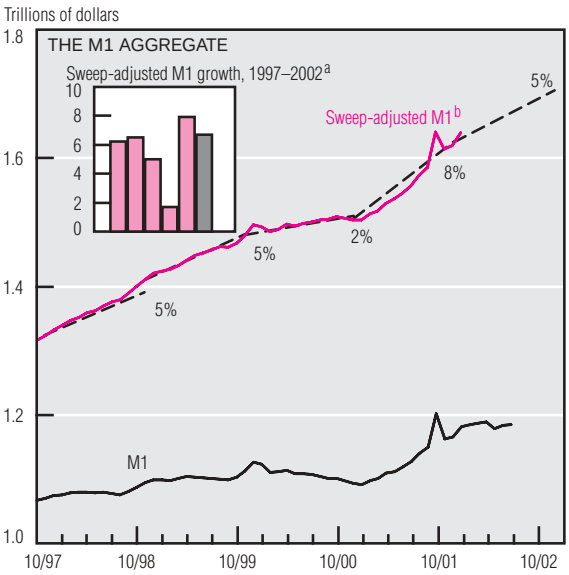
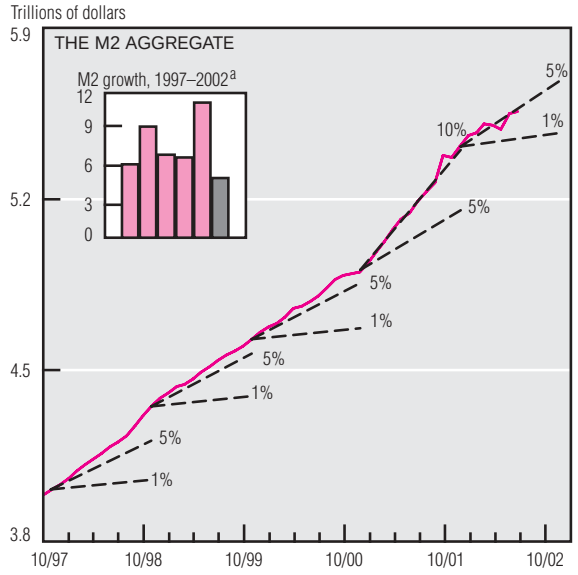
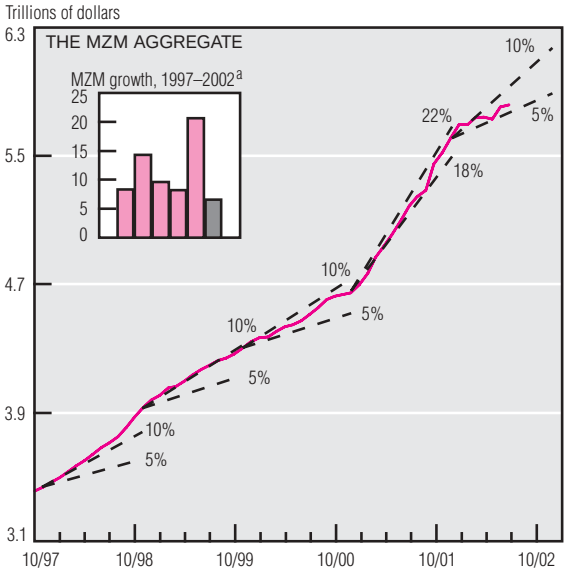
# Money and Financial Markets *(cont.)*




NOTE: All data are seasonally adjusted.
a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis.
b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
SOURCE: Board of Governors of the Federal Reserve System.

The monetary base (total currency in circulation plus total reserves plus vault cash of depository institutions not applied to reserve requirements) grew fairly steadily in the first half of 2002. During that period, M1 growth slowed to a 2.2% annualized rate, primarily because a $28.2 billion decline in demand deposits through June nearly offset a $29.4 billion increase in currency. M2 growth through June was also lower than in some recent months. Although savings deposits—nearly half of M2—have grown briskly so far in 2002 (at an annual rate of about 17%), small time deposits and retail money market mutual funds declined about 9% annually, offsetting roughly half of savings deposits' growth. MZM growth, which surged in 2001 as large investors moved funds from stocks to institutional money funds (IMMFs), has been fairly stable so far this year. Likewise, M3, which also includes IMMFs, has reverted to lower growth in 2002.

Since the 1980s, financial deregulation, innovations in the mutual funds industry, and the introduction of sweep accounts have destabilized the velocity of M1 and M2. These changes weakened those aggregates' link with nominal GDP, and in 1993 the Federal Open Market Committee stopped using the aggregates as intermediate targets for monetary policy. Since 1993, researchers have looked for other monetary aggregates that could be used as an intermediate target, MZM among them. MZM (defined to capture as closely as possible monetary instruments with zero maturity) includes both IMMFs and savings deposits, whereas M2

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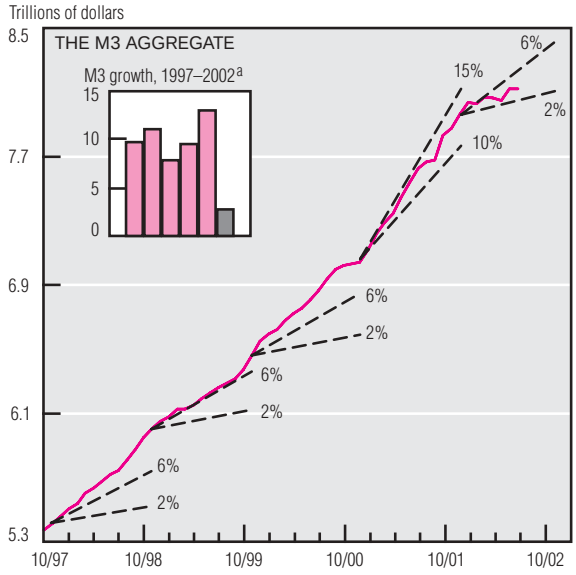
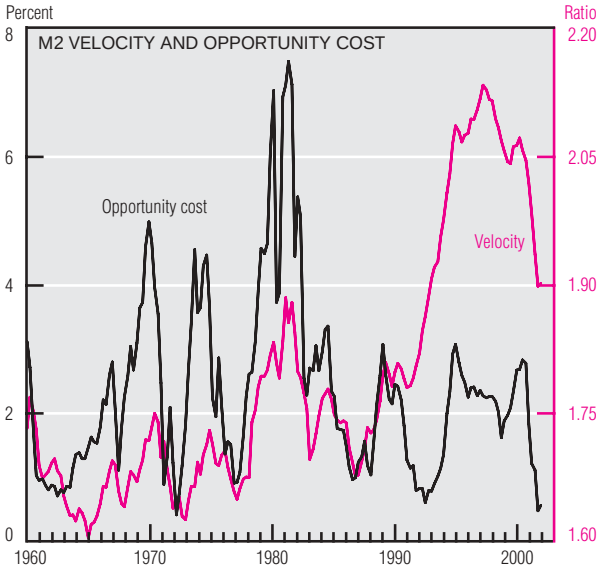
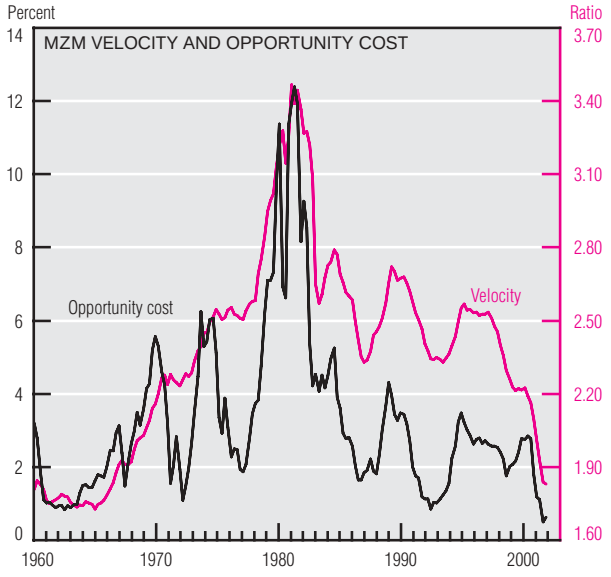
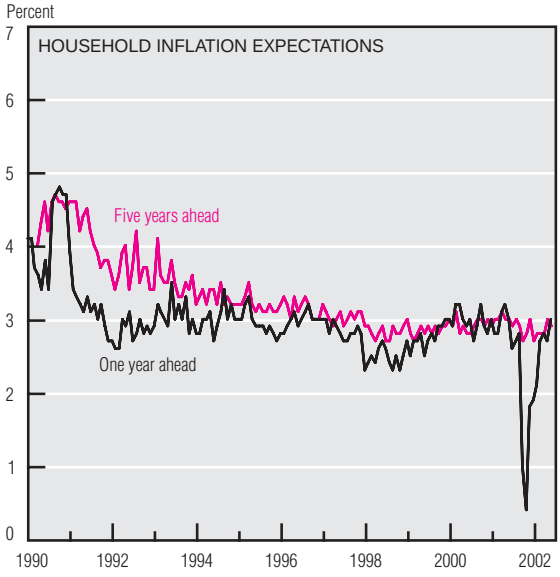
# Money and Financial Markets *(cont.)*



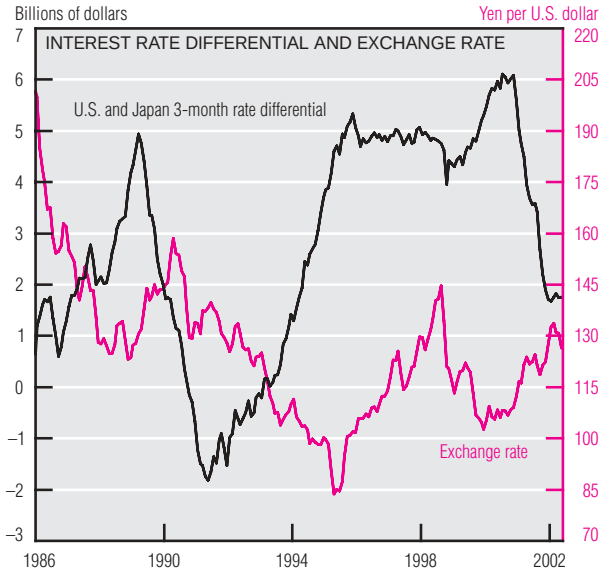



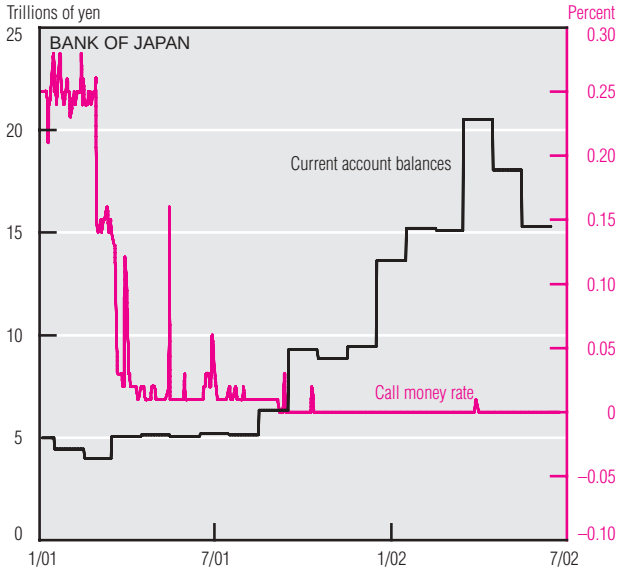

a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
b. Median expected change in consumer prices.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and University of Michigan.

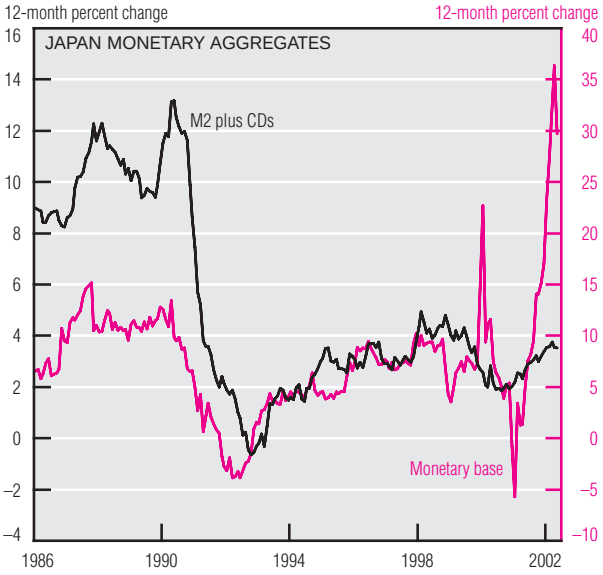
includes time deposits but not IMMFs. In the early 1990s, the widespread substitution of bond market mutual funds reduced demand for M2 but not for MZM. However, demand for MZM is particularly sensitive to changes in the aggregate's opportunity cost (the effective rate on the 3-month Treasury bill minus the share-weighted average of the MZM components' rates of return). As short-term Treasury yields fell in 2001, so did the velocity of MZM and M2 when they became less costly to hold. Because changes in short-term interest rates are difficult to predict, MZM growth rates are especially unpredictable. This is evident in MZM's dramatic rise when short-term interest rates plunged in 2001. Because its growth is so difficult to forecast, MZM may not be suitable as an intermediate target.

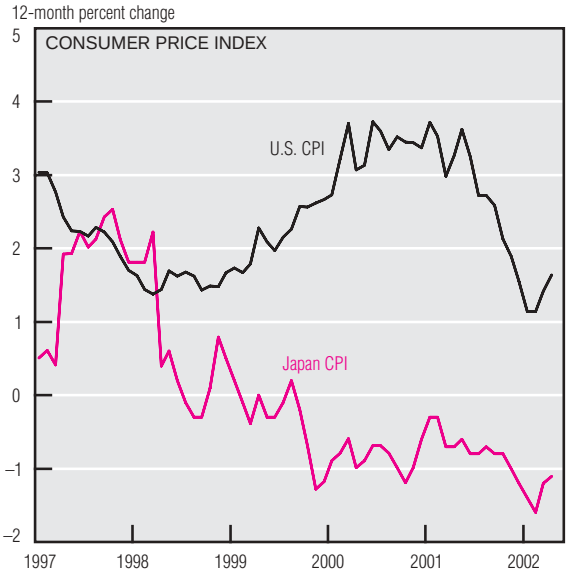
If market rates begin rising late this year or early next and monetary policy continues its current accommodative stance, money growth will probably accelerate and, if excessive, could increase inflationary pressures. Although the moderate pace of recent M2 and MZM growth despite low nominal interest rates suggests minimal inflationary pressures, the previously noted structural changes of the past few years have rendered monetary aggregates less useful in gauging such pressures. However, indirect measures also suggest that inflation pressures will remain subdued over the short and medium term. The University of Michigan's Survey of Consumers, for example, currently reports median one- and five-year inflation expectations of about 3%.

# The Japanese Economy




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

The dollar value of the yen has risen recently despite quantitative easing by the Bank of Japan. In addition, Japanese authorities intervened against the yen in late May and early June. Market observers, however, do not view these actions as particularly strong and speculate that stronger actions may be forthcoming if the yen continues to appreciate and damage Japanese exports.

One factor in the yen's strength against the dollar is the decline in U.S. short-term interest rates and other rates of return on investments in the U.S. The overall dollar sentiment appears bearish to many analysts. Another factor is Japan's relatively positive first-quarter GDP numbers; however, it is unclear whether the Japanese economy will continue to rebound.

Quantitative easing by the Bank of Japan appears to be best measured by current account balances held at the Bank, which comprise bank reserves and deposits of nonbanks. These balances have risen sharply since last fall, and the bellwether short-term interest rate, the call money rate, has bottomed out. However, M2 plus CDs—the monetary aggregate most closely related to economic activity—has risen little despite the rise in the monetary base. This implies that quantitative easing has not influenced spending.

Quantitative easing could depreciate the yen if it leads to higher Japanese inflation through purchasing-power parity, whereby Japanese products could remain competitive internationally only if the yen's international value fell. However, continued deflation and the weakness in M2 plus CDs reduce the likelihood of this occurring in the near term.

# U.S. International Transactions


a. Positive entries correspond to inflows, negative entries to outflows.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

Data for 2002:IQ show a sizeable increase in the U.S. current account deficit, from $95.1 billion in 2001:IVQ to $112.5 billion. This movement can be attributed mainly to a deterioration in the goods deficit—from $100.7 billion to $106.4 billion—resulting from both declines in exports and increases in imports.

Net financial inflows into the U.S—that is, the difference between the net acquisition of assets in the U.S. by foreigners and the net acquisition of assets abroad by U.S. residents—declined from $150.7 billion to $99.4 billion. Growth in U.S.-owned assets abroad slowed significantly, from a $100.1 billion increase in 2001:IVQ to an increase of only $13.9 billion in 2002:IQ. This was largely the result of declining U.S. claims on foreigners reported by U.S. banks. Foreign-owned assets in the U.S. rose $113.3 billion in 2002:IQ after increasing $250.8 billion during 2001:IVQ, due partly to a swing from positive net foreign purchases of Treasury securities to net foreign sales.

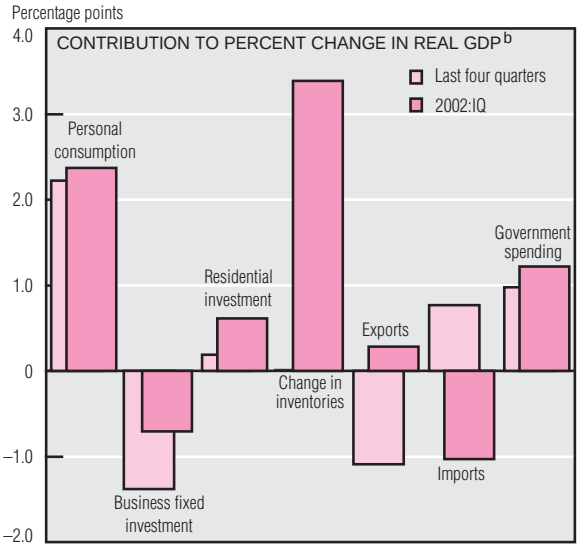
In textbook discussions of the construction of data on international transactions, a current account deficit must be offset by a surplus on the capital and financial accounts. However, preliminary data for 2002:IQ show that, although the current account deficit increased, net financial inflows into the U.S. fell. This is "explained" by a $78 billion swing in the statistical discrepancy that reconciles the tabulation of international transactions.

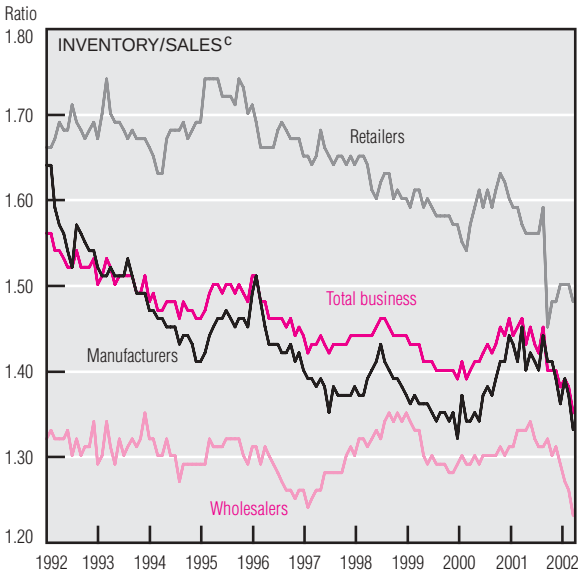
Revisions to the 1995–2001 data have altered our view of the trajectory of the U.S. current account and the capital and financial accounts. The revisions lowered both the current account deficit and net inflows into the U.S., indicating that foreign holdings of long-term U.S. debt instruments had been overstated.

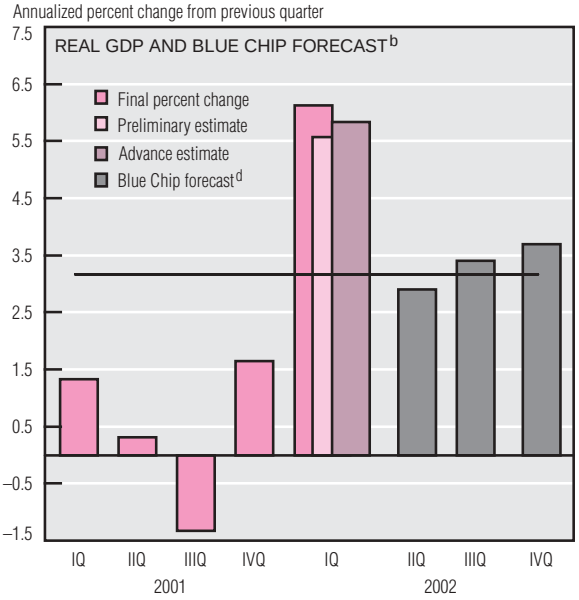
# Economic Activity

**Real GDP and Components, 2002:IQ[a,b]**
**(Final estimate)**

| | Change, billions of 1996 $ | Percent change, last: Quarter | Percent change, last: Four quarters |
|---|---|---|---|
| Real GDP | 140.0 | 6.1 | 1.7 |
| Personal consumption | 53.2 | 3.3 | 3.2 |
| Durables | –24.9 | –9.4 | 8.1 |
| Nondurables | 37.5 | 8.2 | 2.8 |
| Services | 34.4 | 3.8 | 2.4 |
| Business fixed investment | –19.7 | –6.2 | –10.8 |
| Equipment | 0.3 | 0.1 | –7.5 |
| Structures | –15.7 | –22.8 | –19.7 |
| Residential investment | 13.0 | 14.6 | 4.3 |
| Government spending | 27.0 | 6.6 | 5.5 |
| National defense | 16.0 | 18.3 | 8.0 |
| Net exports | –21.8 | — | — |
| Exports | 7.1 | 2.8 | –10.0 |
| Imports | 28.9 | 8.3 | –5.5 |
| Change in business inventories | 91.6 | — | — |




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

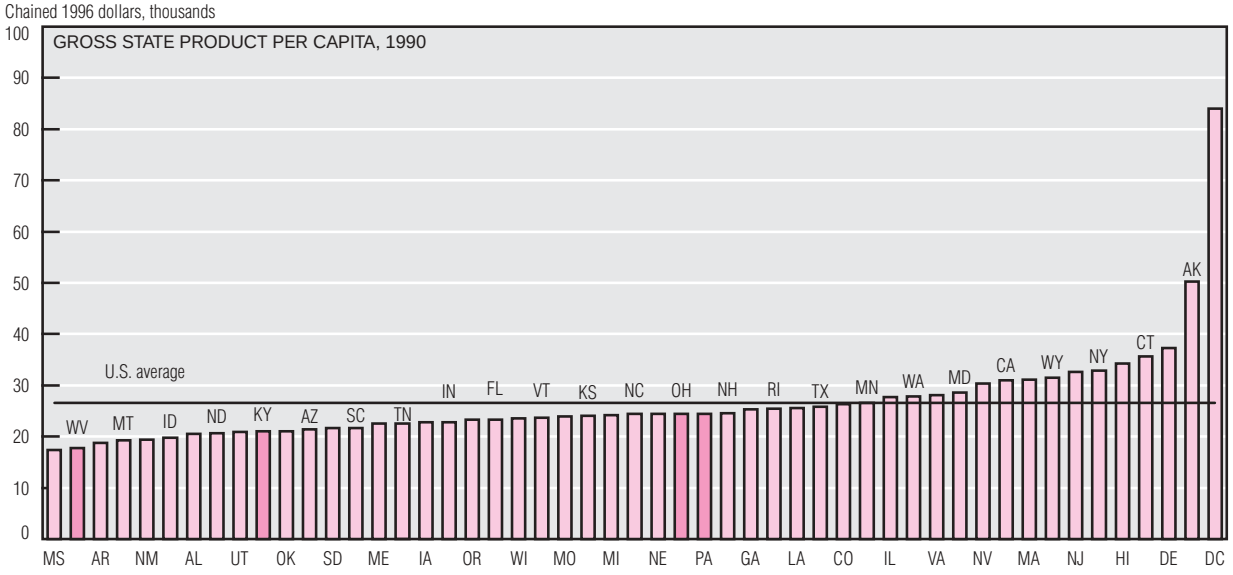
Real gross domestic product (GDP) grew at an annual rate of 6.1% in 2002:IQ, the fastest pace since 1999:IVQ. Consumer spending combined with an extraordinary housing market to boost output growth: Consumption increased 3.3% from 2001:IVQ, while residential investment rose nearly 15%. Strong government spending also contributed. Although business fixed investment declined for the fifth consecutive quarter, its 6.2% decrease in 2002:IQ was an improvement over the previous four quarters. Both export and import spending increased for the first time since 1999:IIIQ; however, the increase in import spending presented the greatest drag on the economy.

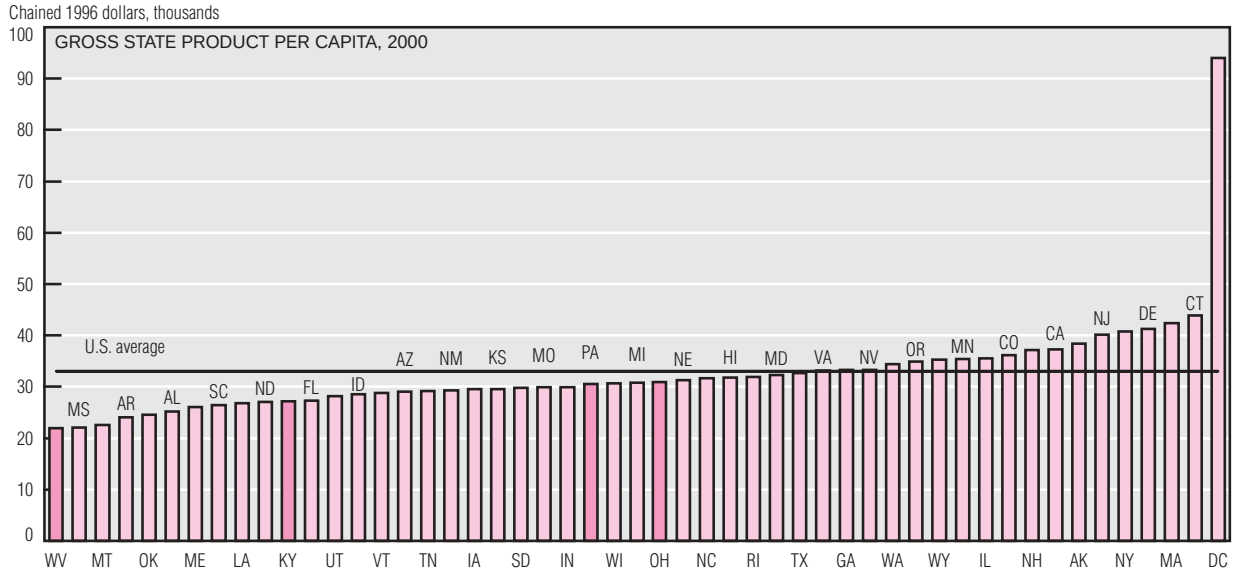
The strongest contributor to real GDP in 2002:IQ was the slowdown in inventory liquidation. Changes in inventories represented 3.4 percentage points of the quarter's real GDP growth. Including the most recent correction, inventories have declined for 15 consecutive months, and the ratio of inventory to sales for all businesses reached a record low of 1.35 in April. Since the beginning of 2002, wholesalers have experienced a greater decline in their inventory-to-sales ratios than either retailers or manufacturers.

The final estimate of real GDP growth for 2002:IQ came in higher than the advance and preliminary estimates. However, Blue Chip forecasters expect real GDP growth to weaken by more than 3% in 2002:IIQ and to surpass its long-term average in 2002:IIIQ.

*(continued on next page)*

# Economic Activity (cont.)



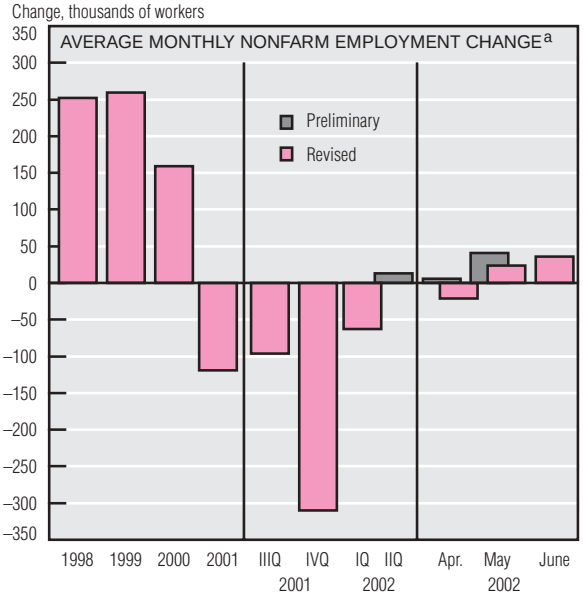

NOTE: Darker bars indicate Fourth District states.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

Gross state product (GSP) represents the value of goods and services produced within a state's borders. Per capita GSP represents the value of goods and services produced per state resident. Generally speaking, per capita GSP can be used to measure the income or well-being of a state's residents. For some states, however, this measure may be significantly distorted. For example, a state that has a large city near its border may attract sizable numbers of workers from neighboring states. This distortion is particularly pronounced for the District of Columbia, whose per capita GSP was $94,026 in 2000, more than double Connecticut's. The District draws many of its workers from Maryland and Virginia, so its per capita GSP is overstated and that of its neighbors is understated.

Comparing per capita GSP for various states over different periods reveals some interesting facts. In 2000, when U.S. GDP per capita was $33,015 (up 24.3% from a decade earlier), every state in the Fourth District fell below the U.S. average. Ohio led the District with $30,965, and West Virginia lagged with $21,977, the lowest per capita GSP in the nation. Compared to 1990, the national ranking in per capita GSP fell in three Fourth District states: Ohio's ranking slipped from 24 to 25; Pennsylvania's from 23 to 28; and West Virginia's from penultimate to last. Only Kentucky moved up, from 42 to 41.

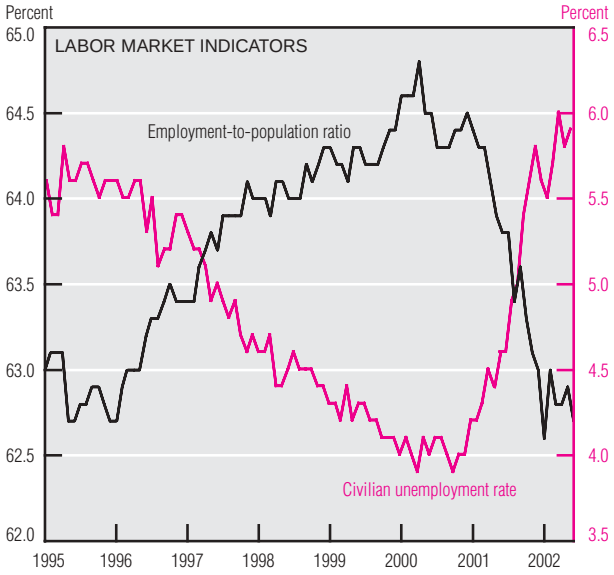
Between 1990 and 2000, growth rates of per capita GSP for Fourth District states exceeded the U.S. average of 24.3% except for West Virginia (24.1%). Kentucky's growth rate was 29.4%, while Ohio came in at 26.5% and Pennsylvania at 25.0%.

# Labor Markets




**Labor Market Conditions[a]**

| | Average monthly change (thousands of employees) | | | | |
|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | Jan.–May 2002 | June 2002 |
| Payroll employment | 259 | 159 | –119 | –37 | 36 |
| Goods-producing | 8 | –1 | –111 | –78 | –10 |
| Mining | –3 | 1 | 1 | –1 | –1 |
| Construction | 26 | 8 | –3 | –19 | 14 |
| Manufacturing | –16 | –11 | –109 | –58 | –23 |
| Durable goods | –5 | 1 | –79 | –40 | –18 |
| Nondurable goods | –11 | –12 | –30 | –18 | –5 |
| Service-producing | 252 | 161 | –8 | 41 | 46 |
| TPU[b] | 19 | 17 | –23 | –12 | 6 |
| Wholesale and retail trade | 60 | 25 | –31 | –3 | –19 |
| FIRE[c] | 7 | 5 | 10 | –2 | 3 |
| Services[d] | 132 | 92 | –2 | 42 | 33 |
| Government | 35 | 22 | 39 | 16 | 14 |
| | Average for period (percent) | | | | |
| Civilian unemployment rate | 4.2 | 4.0 | 4.8 | 5.7 | 5.9 |




**Regional Labor Market Conditions[e]**

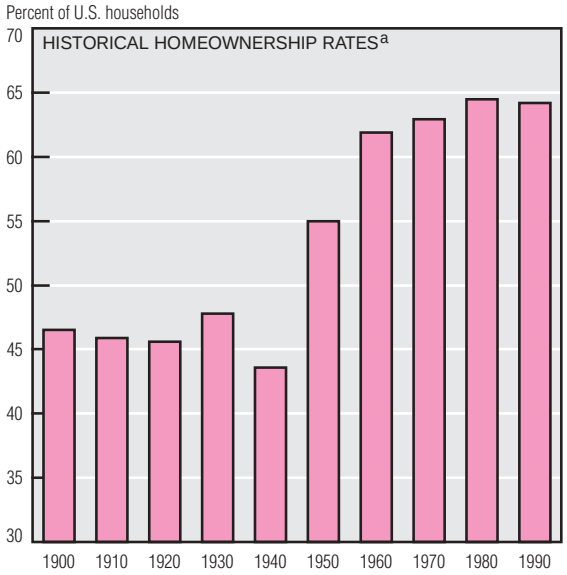
| | Unemployment rate | | | Percent change: March 2001–May 2002 | | |
|---|---|---|---|---|---|---|
| | March 2001 | May 2002 | Increase, March 2001–May 2002 | Unemployed | Labor force | Employed |
| New England | 3.2 | 4.2 | 1.0 | 32.5 | 1.7 | 0.7 |
| Middle Atlantic | 4.2 | 5.8 | 1.6 | 40.0 | 1.7 | 0.0 |
| East North Central | 4.5 | 5.8 | 1.3 | 29.0 | 0.4 | –0.9 |
| West North Central | 3.8 | 4.2 | 0.4 | 12.3 | 1.5 | 1.1 |
| South Atlantic | 4.1 | 5.2 | 1.1 | 29.3 | 1.6 | 0.5 |
| East South Central | 4.8 | 5.5 | 0.7 | 16.7 | 1.4 | 0.6 |
| West South Central | 4.5 | 5.9 | 1.4 | 36.1 | 2.5 | 0.9 |
| Mountain | 4.0 | 5.4 | 1.4 | 38.2 | 3.1 | 1.7 |
| Pacific | 5.0 | 6.4 | 1.4 | 29.0 | 1.2 | –0.3 |
| United States | 4.2 | 5.8 | 1.6 | 41.8 | 0.8 | –1.0 |

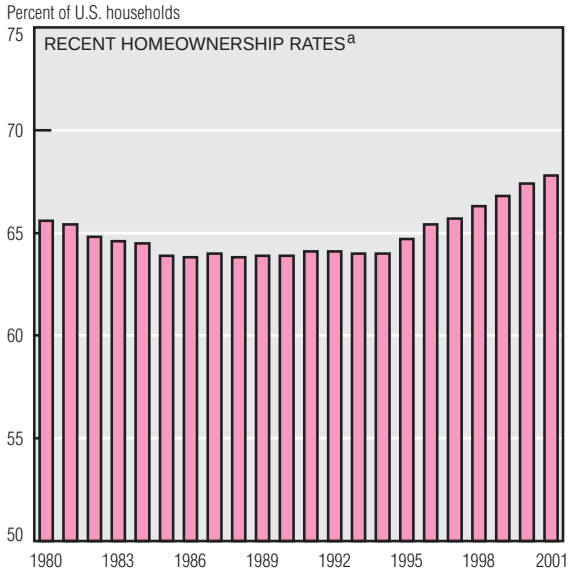
a. All data are seasonally adjusted.
b. Transportation and public utilities.
c. Finance, insurance, and real estate.
d. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.
e. National estimates are based on the Current Population Survey. Regional estimates are based on several sources, including the Current Population Survey, the Current Establishment Survey, and state unemployment insurance data.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

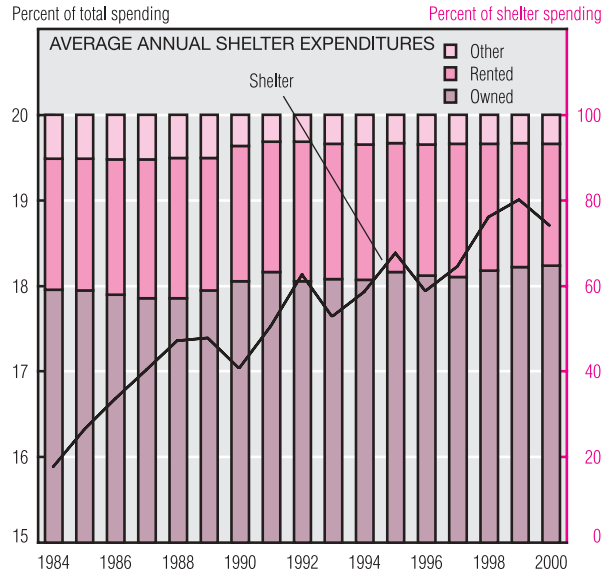
Nonfarm payroll employment rose 36,000 jobs in June, making 2002:IIQ monthly average employment growth equal to 13,000 jobs. Preliminary numbers show 2002:IIQ with the smallest quarterly decline in employment since it began falling in 2001:IIQ. Goods-producing industries saw only a slight decline in employment. Manufacturing employment fell by 23,000 jobs—far fewer than the 106,500 average monthly net decline between March 2001 and March 2002. Construction's net increase in employment in June (14,000) was the largest since May 2001. Services added 33,000 jobs (net), and health services gained 34,000. Help supply services added slightly fewer (9,000) jobs than in the previous three months on average (44,000). At 5.9%, the unemployment rate was virtually unchanged over the previous two months, although the average duration of unemployment continued the increase that began in July 2001.

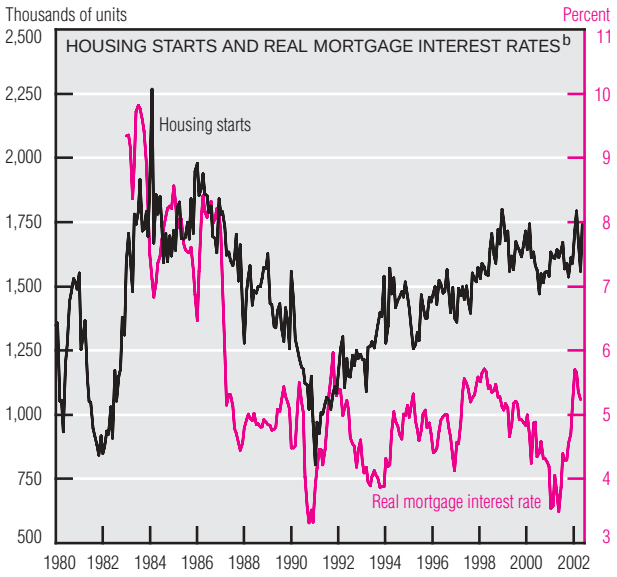
The most recent recession's effect on labor markets has varied across regions. Since March 2001, the West North Central and East South Central regions saw the smallest increases in the unemployment rate and the Middle Atlantic the largest. The Mountain, Pacific, and West South Central regions experienced similar increases in the unemployment rate (1.4%). The Mountain region's much faster increase in the number of unemployed was neutralized by its faster labor force growth. Regional and national employment statistics are compiled independently and are not necessarily consistent with each other. For example, employment in the U.S. has declined 1.0% overall, but it declined less or even increased in individual regions.

# The Housing Market



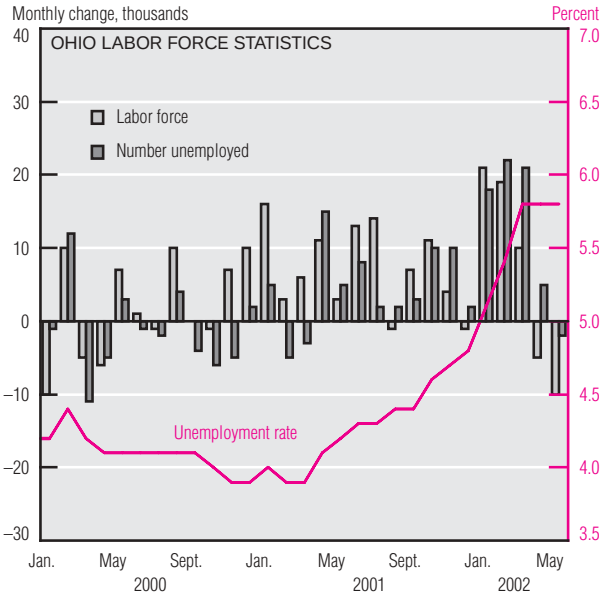

a. The first chart uses data from the decennial census; the second uses an annual survey on housing. As a result, the 1990 numbers in these two charts are not equal.
b. The real mortgage rate is calculated by subtracting CPI inflation from the contract interest rate of all loans closed.
SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; and Federal Housing Finance Board.

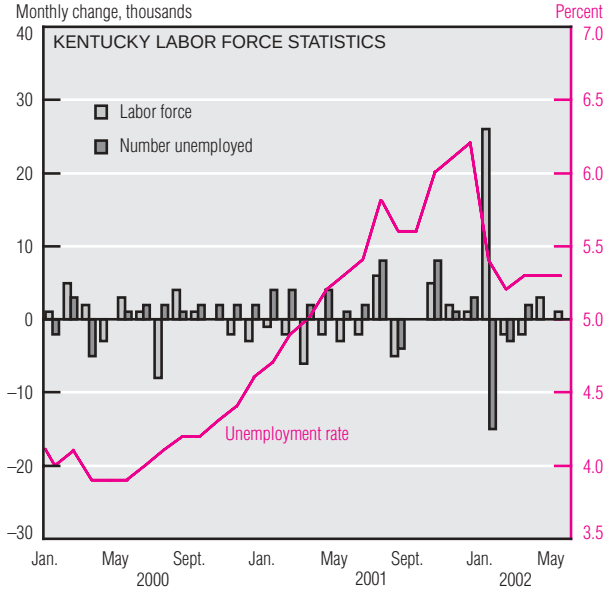
The rate of home ownership has risen considerably since the early 1900s, when just 47% of U.S. households owned their homes. It picked up in the 1920s, when strong income growth stimulated the housing sector. During the Great Depression of the 1930s, it fell back to 43% but surged again during the 1940s and 1950s, probably because the home mortgage interest deduction became more useful for minimizing taxes. Although legislated as early as 1913, the deduction did not begin to encourage home ownership until personal income tax rates and brackets were raised significantly and became effective for a much wider segment of the population. Between 1940 and 1990, the homeownership rate rose from 43% to 64.4%. It dipped significantly in the high-interest-rate environment of the early 1980s and fell slightly again after the 1991 recession, then resumed its upward course in the mid-1990s, reaching 67.8% by 2000.

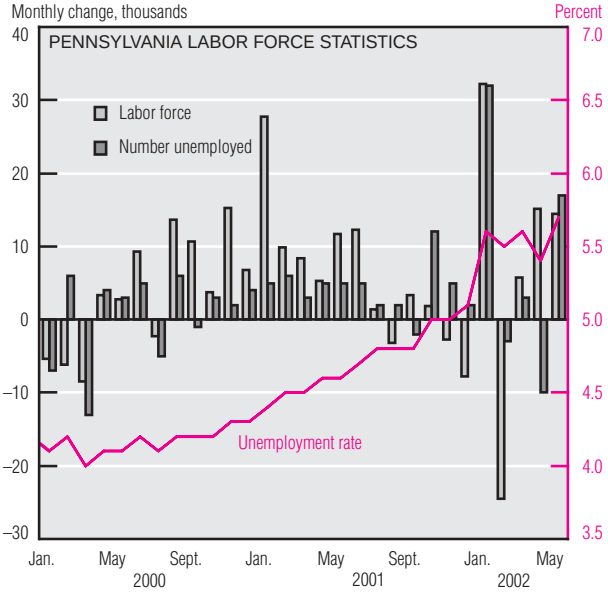
The fraction of total household spending devoted to shelter-related outlays rose from about 16% in the early 1980s to almost 19% in 2000. Outlays on owned shelter as a share of total shelter expenditures have also increased.

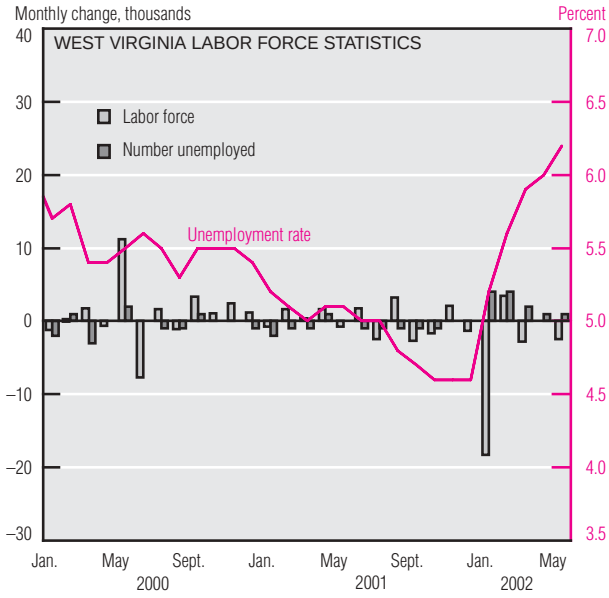
Housing starts hit a low point during the 1991 recession, the culmination of a five-year decline. Since then, they have increased steadily, perhaps in response to more favorable interest rates, and have stayed high despite last year's economic slowdown. Some attribute this continued strength to households' reshuffling of portfolios, which shifted assets out of a languid stock market and into housing. Whether and how long this sector will continue to prosper despite the recent spike in real mortgage interest rates remains to be seen.

# Employment in the Fourth District




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

Kentucky reported the Fourth District's lowest seasonally adjusted unemployment rate for May (5.3%), while rates in Ohio (5.8%) and Pennsylvania (5.7%) were the same as—or slightly lower than—the U.S. average of 5.8%. West Virginia registered an unemployment rate of 6.2% in May.

Kentucky is the only state in the District that did not report a year-over-year increase (its current unemployment rate is the same as a year ago). Ohio posted the largest increase (1.6 percentage points), followed by Pennsylvania (1.3 percentage points). West Virginia reported an increase of 1.1 percentage points for the year ending May 2002.

Kentucky's strong labor force performance compared with the other District states in the last six months contrasts with its abysmal performance from June 2000 to July 2001. During that period, its unemployment rate rose from 4.0% to 5.8%, and for eight consecutive months beginning with November 2000, the labor force shrank while the number of unemployed in the state grew.

During the first four months of 2002, Ohio reported a considerably larger average monthly increase in the number of unemployed than did other District states. In May, the number of unemployed persons in the state (345,100) fell from the previous month for the first time since March 2001, but this probably results from a technicality—the elimination of "discouraged workers" from the labor force. These workers are not counted as part of the labor force if they have not interviewed for a job within four weeks of the survey date.

Year-over-year, Kentucky is the only state in the District to report jobs growth; it posted an increase of

*(continued on next page)*

# Employment in the Fourth District *(cont.)*

## Kentucky Employment

| | Thousands of employees | | |
|---|---|---|---|
| | May 2002 | Change from May 2001 | Change from April 2002 |
| Payroll employment | 1,827.4 | 14.5 | 3.8 |
| Goods-producing | 409.3 | –7.7 | 1.0 |
| Mining | 20.3 | 0.4 | 0.1 |
| Construction | 88 | 0.8 | 0.4 |
| Manufacturing | 301 | –8.9 | 0.5 |
| Service-producing | 1,418.1 | 22.2 | 2.8 |
| TPU[a] | 106.3 | –1.8 | 0.3 |
| Wholesale and retail trade | 427.1 | 5.4 | –1.5 |
| FIRE[b] | 76.1 | 1.1 | 0.1 |
| Services | 495.7 | 13.9 | 3.9 |
| Government | 312.9 | 3.6 | 0.0 |

## Ohio Employment

| | Thousands of employees | | |
|---|---|---|---|
| | May 2002 | Change from May 2001 | Change from April 2002 |
| Payroll employment | 5,516.1 | –51.6 | 4.8 |
| Goods-producing | 1,246.2 | –33.8 | 2.4 |
| Mining | 12.2 | –0.6 | –0.1 |
| Construction | 228.8 | –7.4 | –0.2 |
| Manufacturing | 10,05.2 | –25.8 | 2.7 |
| Service-producing | 4,269.9 | –17.8 | –7.2 |
| TPU[a] | 247.3 | –4.1 | 0.1 |
| Wholesale and retail trade | 1,315.5 | –16.8 | –4.0 |
| FIRE[b] | 311.9 | –0.4 | 0.2 |
| Services | 1,598.3 | –3.8 | 0.8 |
| Government | 796.9 | 7.3 | –4.3 |

## Pennsylvania Employment

| | Thousands of employees | | |
|---|---|---|---|
| | May 2002 | Change from May 2001 | Change from April 2002 |
| Payroll employment | 5,647.4 | –66.7 | 2.3 |
| Goods-producing | 1,120.6 | –48.2 | –1.5 |
| Mining | 19.0 | 0.2 | –0.3 |
| Construction | 253 | 5.3 | 4.0 |
| Manufacturing | 848.6 | –53.7 | –5.2 |
| Service-producing | 4,526.8 | –18.5 | 3.8 |
| TPU[a] | 292.9 | –13.7 | 0.3 |
| Wholesale and retail trade | 1,259.7 | –15.6 | –2.9 |
| FIRE[b] | 327.1 | –1.7 | –0.3 |
| Services | 1,991.7 | 3.9 | 5.4 |
| Government | 735.4 | 8.6 | 1.3 |

## West Virginia Employment

| | Thousands of employees | | |
|---|---|---|---|
| | May 2002 | Change from May 2001 | Change from April 2002 |
| Payroll employment | 730.9 | –5.7 | –3.3 |
| Goods-producing | 129.5 | –4.3 | –1.7 |
| Mining | 22.2 | 0.2 | –0.6 |
| Construction | 33.8 | 0.2 | –0.7 |
| Manufacturing | 73.5 | –8.9 | 0.5 |
| Service-producing | 601.4 | –1.4 | –1.6 |
| TPU[a] | 36.6 | –0.5 | –0.4 |
| Wholesale and retail trade | 160 | –2.1 | –1.1 |
| FIRE[b] | 29.2 | –0.3 | –0.4 |
| Services | 234.7 | 2.1 | –0.1 |
| Government | 140.9 | –0.6 | 0.4 |

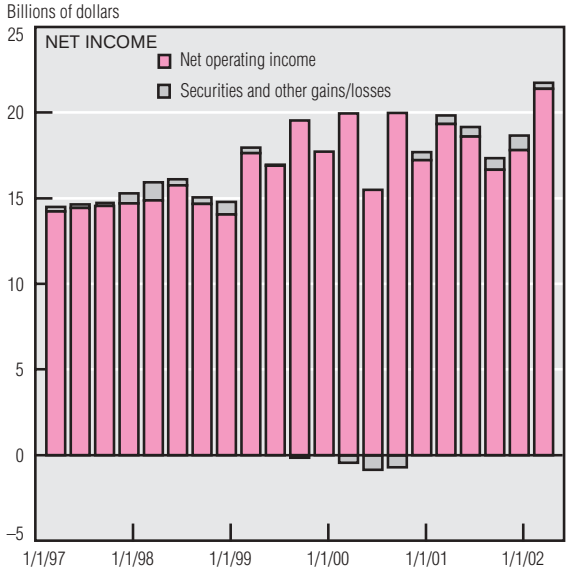
a. Transportation and public utilities.
b. Finance, insurance, and real estate.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

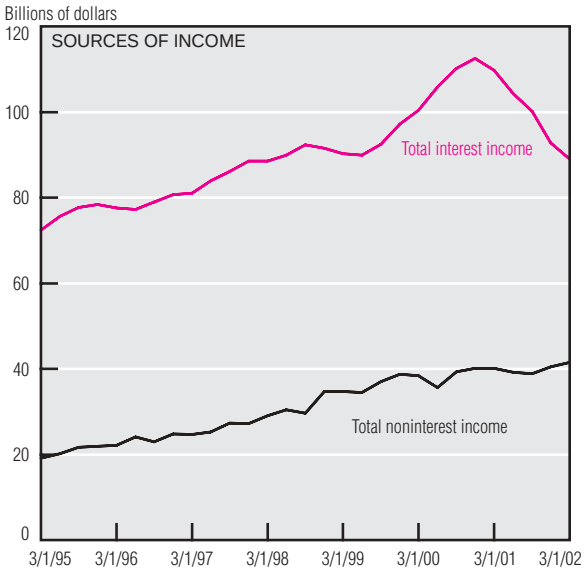
14,500 jobs—0.7% of its total nonfarm employment. Ohio lost 51,600 jobs (0.9%), and Pennsylvania lost 66,700 (1.2%). West Virginia posted a loss of 5,700 jobs, roughly 0.7% of its total workforce.

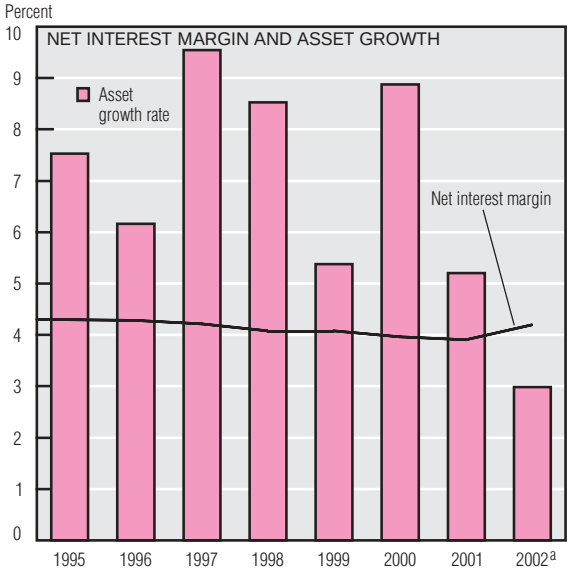
In every state in the District, the goods-producing sector (comprising the mining, construction, and manufacturing industries) registered year-over-year losses. Not surprisingly, manufacturing suffered the heaviest losses (the same was true in all 50 states). In Pennsylvania, the goods-producing sector's entire job loss resulted from heavy annual losses in manufacturing (53,700 jobs). The exact causes of manufacturing employment losses in District states are not yet identified, but state experts have suggested that attrition, foreign competition, and technological replacement all figured significantly in the downsizing of the manufacturing workforce within each state.

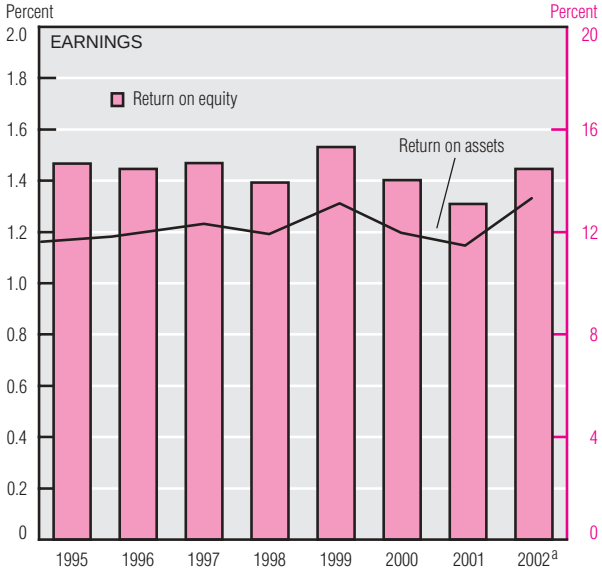
Although it fared far better than the goods-producing sector in the most recent recession, the service-producing sector (comprising transportation and public utilities; trade; finance, insurance, and real estate; services; and government industries) posted losses in every District state except Kentucky. Compared with other service-producing industries in Ohio and Pennsylvania, government's performance was strong: For Ohio, the increase of 7,300 jobs in government was the only net industry employment gain from May 2001 to May 2002.

# Depository Institutions




a. Observation for 2002 is first-quarter annualized data.
SOURCE: Federal Deposit Insurance Corporation.

Profits made a comeback to FDIC-insured commercial banks during the first three months of 2002. First-quarter net income reached a record-setting $21.7 billion, which represents a 16.4% improvement over the previous quarter and a 9.6% increase over 2001:IQ.

Despite declining interest income, commercial banks' noninterest (fee) income was still strong, reaching a high of $41.5 billion in 2002:IQ, the second consecutive quarter it has increased. This is another sign that the earnings pressures that tormented banks in the second and third quarters of 2001 are finally abating.

Commercial banks' strong earnings performance is once again apparent in the net interest margin, which reached 4.2%, up from 3.9% in 2001. This factor, coupled with asset growth declining to 3%—the slowest rate since 1992—pushed banks' return on assets to 1.33%, the highest level since 1989. This is the second consecutive quarter that return on assets has increased; it was 1.26% in 2001:IVQ. First-quarter return on equity, at 14.5%, also showed an improvement over 2001. However, it is still below its 2001:IQ level of 14.7% and well below its recent high of 15.3% in 1999.

In 2002:IQ, net loans and leases as a share of assets increased to 58.7%, up from 58.2% in 2001:IVQ. Although the increase is small and the level is well below its recent high of 61.3% in 2000:IIIQ, the ratio still indicates increasing activity in the lending market.

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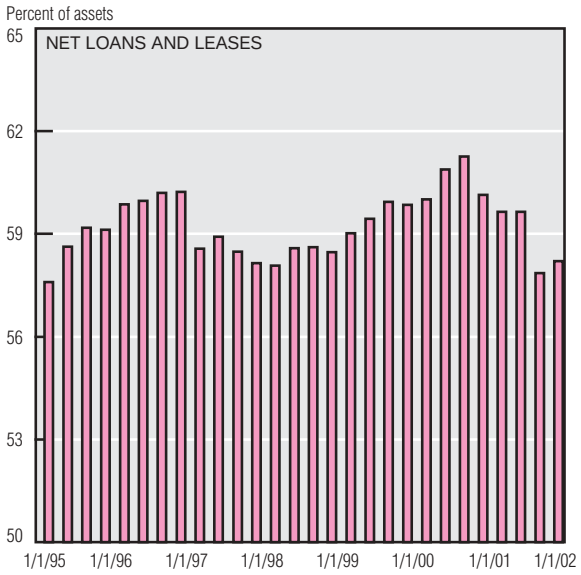
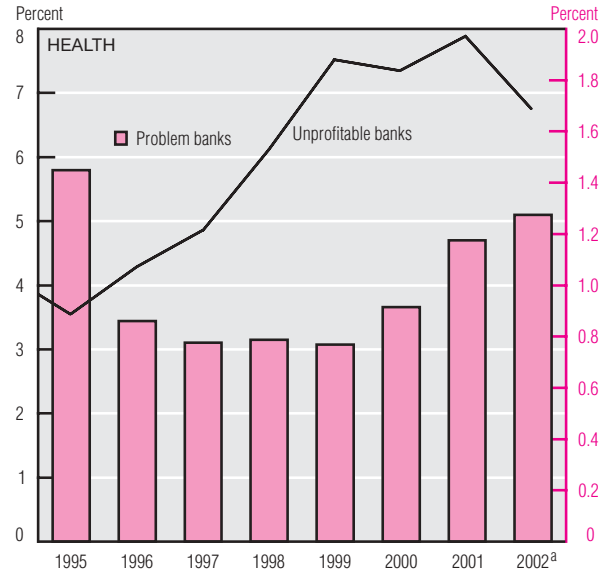
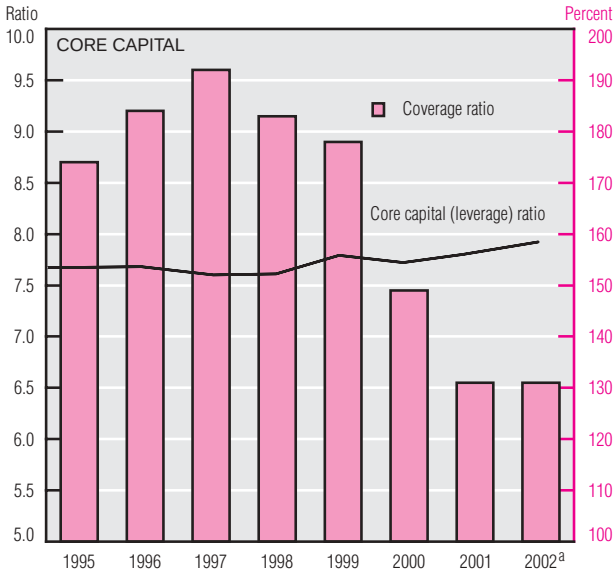
# Depository Institutions *(cont.)*







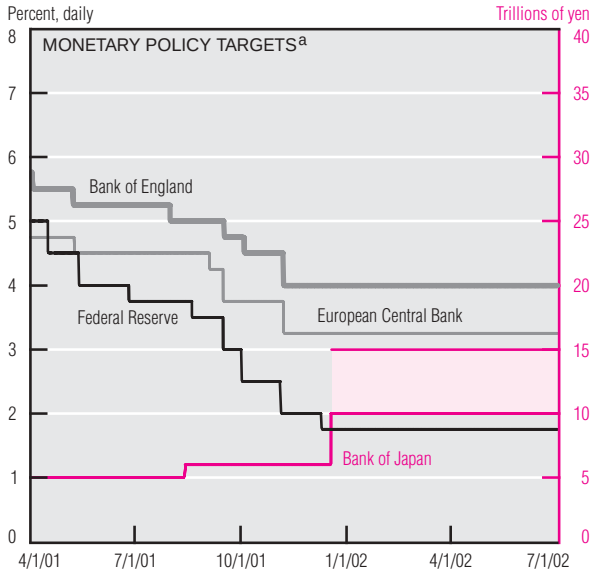



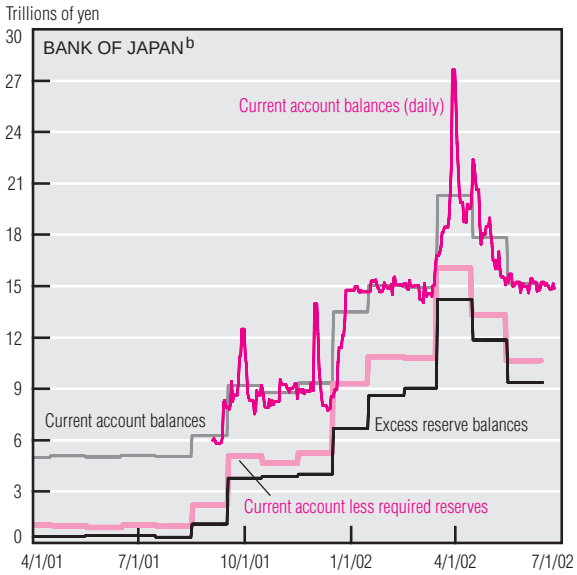

a. Observation for 2002 is first-quarter annualized data.
SOURCE: Federal Deposit Insurance Corporation.

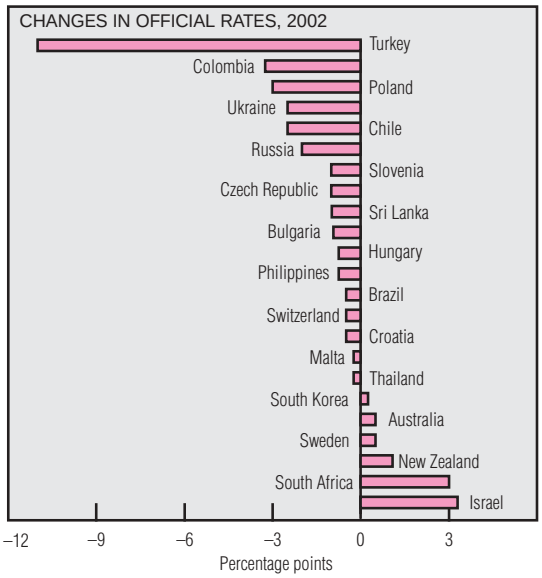
Unfortunately, asset quality continued to slip in the first quarter. Net charge-offs (gross charge-offs minus recoveries) have been rising since 1999, and they exceeded $11 billion, 1.1% of commercial banks' loans and leases. In 2001:IQ, net charge-offs were less than $7 billion. The greatest deterioration occurred in the loan portfolios of banks with total assets over $10 billion. Problem assets (nonperforming loans and repossessed real estate) are also on the rise: They reached 0.57% of total assets, their highest level since 1994.

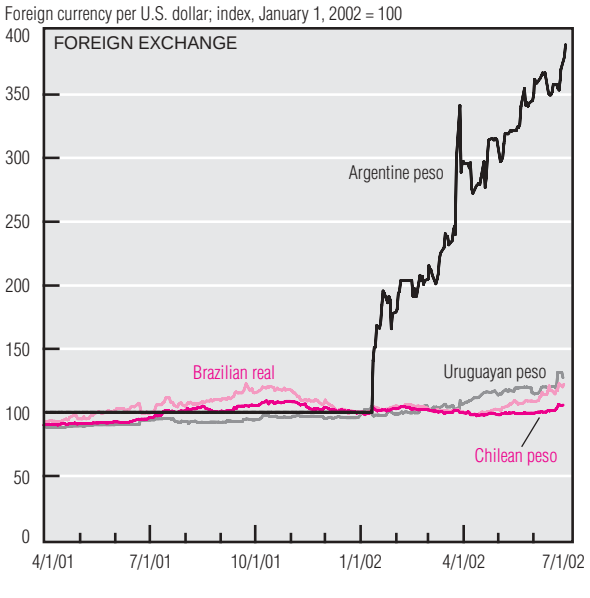
Parallel to declining asset quality, the percent of problem banks (that is, banks with substandard exam ratings) reached 1.27%, the highest level since 1995. However, declining asset quality is not a significant problem for FDIC-insured commercial banks, where the percent of unprofitable institutions is falling. Loss reserves, which protect banks against expected losses, remain at healthy levels, although they have declined since 1998. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) currently stands at 131%. Core capital, which protects banks against unexpected losses, is at its highest level—7.95%—up from 6.17% in 1990. All of these performance indicators are consistent with a strong banking sector.

# Foreign Central Banks




a. Federal Reserve: overnight interbank rate. Bank of England and European Central Bank: two-week repo rate. Bank of Japan: quantity of current account balances; since December 19, 2001, it has targeted a range for the quantity.
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.
SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; Bank of Canada; and Bloomberg Financial Information Services.

The policy settings of the four major central banks remain unchanged.

The Bank of Japan has brought its supply of current account balances within the target range after overshooting it to accommodate special liquidity needs. Throughout the bank's balance-targeting period, variations in supply have been reflected almost entirely in variations in excess reserves. The adage, "you can lead a horse to water, but you can't make it drink" seems to apply—although, in this case, the horse might become thirsty eventually. Cautious optimism has crept into official views of Japan's economic outlook, though the weakening dollar may be tempering that view.

Repeated announcements of no change in the major banks' explicit policy settings have dominated this year's news coverage. However, many other central banks, including many in Eastern Europe, have changed their policy settings over the past six months.

Since Argentina ended official parity with the dollar early this year, its peso has depreciated to almost four to the dollar, a rate of depreciation many times that of the Brazilian real and the Chilean and Uruguayan pesos. These nations are feeling the impact of the Argentine crisis as their exports become less competitive in Argentine markets and as Argentine imports become more competitive in their own markets. Uruguay abandoned the managed float of its peso in June, and the International Monetary Fund doubled the size of its standby credit to that nation.