The Economy in Perspective

Stormy weather…Recent developments, along with fresh data for 2001, are prompting forecasters to revise their expectations of economic activity downward for the rest of this year. Increasingly, analysts who had expected sunshine are calling for partly cloudy skies, and some are even predicting another thunderstorm. Economic meteorologists are paying particularly close attention to consumers, whose attitudes and spending are thought to signal upcoming weather patterns. Those who fear that a second economic thundershower will follow close behind the one that struck in March 2001, conjecture that consumer spending simply cannot hold up under the atmospheric low-pressure front brought on by sinking stock portfolios.

The newest data show that the U.S. economy was weaker in 2001 than originally reported, and total spending actually contracted in three of the four quarters. Sunshine for the year was virtually nonexistent. The decline in activity after the September terrorist attacks, as it turns out, occurred in the path of an already menacing hurricane. The data revisions show that although total personal income expanded more rapidly than previously estimated for 1999 and 2000, it fell more precipitously in 2001, largely because of weakening labor market conditions.

Consumers are caught up in several financial currents that are likely to affect their spending during the next few years. Households have been gradually building up wealth for the past two decades. Along the way, they have devoted an ever-increasing share of their assets to equities, while shrinking the portions claimed by other financial assets and real estate. Just a few years ago, equity holdings even surged past real estate in importance, inducing analysts to ponder the effects of stock market wealth on consumer spending decisions. Now that the equity-holding waters have receded because of the bear market, households hold roughly equal shares of their wealth in equities and real estate. Consumer sensitivity to the valuation of equity wealth is being tested again, this time in a downdraft.

Households have been overwhelmed by a two-pronged lightning attack. The first bolt came from the recession itself, which weakened employment and income growth. The second bolt was hurled from the stock market accounting cloud. Unlike the decline of the dot-com companies—which may go down in history as the most anticipated stock market collapse ever—recent accounting scandals electrified nearly everyone and burned many people who could not carry the voltage. Caught in the storm, households lost billions of dollars in (illusory) wealth and confidence in the equity markets. It remains to be seen how much the stock market tempest will damage household spending during the next year or so, but it can only add to the strain.

Fortunately, there is a countervailing wind. Sales of new and existing homes were brisk during the last few years of the expansion, and the housing sector continues to be buoyed by interest rates' low-pressure front. In fact, sales have been so strong in some markets that talk of price bubbles is floating in the breeze. Ordinarily, one might wonder how much longer the lift could be sustained with interest rates now at 40-year lows. But if consumers reduce their exposure to stocks, we could see the climate change in favor of housing wealth again. Consumers have learned how to cash out the accumulating equity values in their homes through mortgage refinancing and home equity lines of credit, using the proceeds to supplement their incomes. So even if mortgage rates do not decline from current levels, appreciating house prices could still add gusts to consumer spending in the next several years.

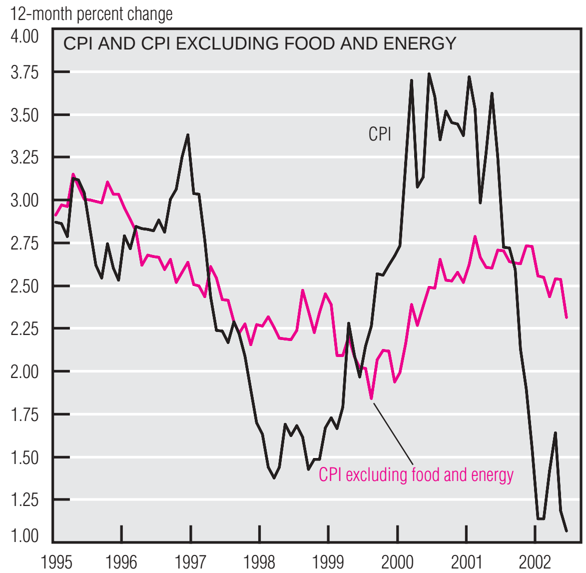
Curiously, then, consumers have been pulled in opposite directions: Vilified for splurging during the go-go 90s, they are now being urged to hang on just a bit longer to prevent the recovery from petering out. Put another way, much was made of the fact that people's saving out of personal income had fallen so low in the latter period of the expansion. The weather report for June was unusual, showing both that the personal saving rate rose to 4 percent and that consumer spending expanded rapidly because of blistering automobile sales. But this pattern can continue only if there are sustained gains in personal income, which in turn require a better investment climate and a firming of labor market conditions.

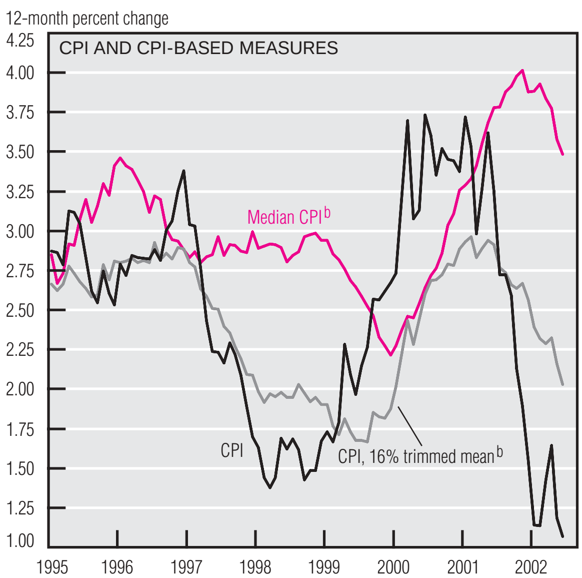
With business fixed investment nearly stagnant, state and local governments awash in tidal waves of red ink, and export sales still falling short of imports, the outlook remains hazy. This uncertainty, however, is a familiar one. When the seasons change, weather patterns become uncertain for a time, until more stable conditions emerge. The U.S. economy is in the midst of shifting from a disruptive El Niño to a more temperate, traditional expansion. Instead of lamenting the stormy weather, let's weather the storm and look forward to a break in the clouds.

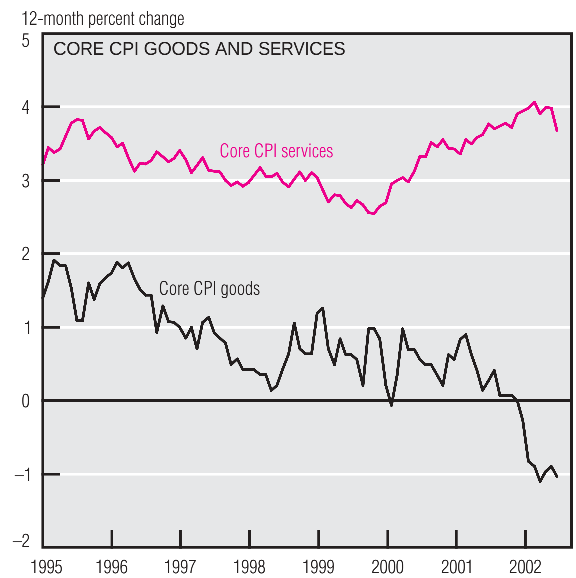
Inflation and Prices

June Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2001 avg.
Consumer prices					
All items	1.3	2.5	1.1	2.3	1.5
Less food and energy	0.6	1.9	2.3	2.3	2.7
Median[b]	3.1	2.9	3.5	3.1	3.9
Producer prices					
Finished goods	1.7	–2.0	–2.0	1.1	–1.7
Less food and energy	2.4	1.1	0.3	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; and Federal Reserve Bank of Cleveland.

The consumer price index (CPI) rose 0.1% in June (1.3% annualized rate) after remaining unchanged in May. According to the Labor Department, a sharp increase in the prices of tobacco and smoking products was offset by declining recreation and communications products prices and disinflation in the indexes for shelter and medical care. The CPI's food and energy indexes registered no change in June; excluding these items, the CPI increased 0.1% (0.6% annualized rate) for the month and 2.3% over the past 12 months. The all-items CPI rose only 1.1% over the same period, its smallest year-over-year percent change since October 1964.

Trimmed-mean measures of the CPI—which eliminate the smallest and largest price changes—also are showing smaller year-over-year rates of change. During 2002, for instance, the median CPI's 12-month rate of increase has slowed nearly half a percentage point, from 3.9% in December 2001 to 3.5% in June 2002. Likewise, the 12-month rate of increase in the 16% trimmed-mean CPI has slowed just over half a percentage point, from 2.6% in December 2001 to 2.0% in June 2002.

The downward pressure on these measures is clearly coming from goods prices. However, the rate of increase in core CPI services prices has begun to trend downward, reversing its course of the past several years. Professional medical care services and rent of primary residence are two of the components responsible for the recent declines.

Despite the recent reversal in core CPI services prices, the gap between

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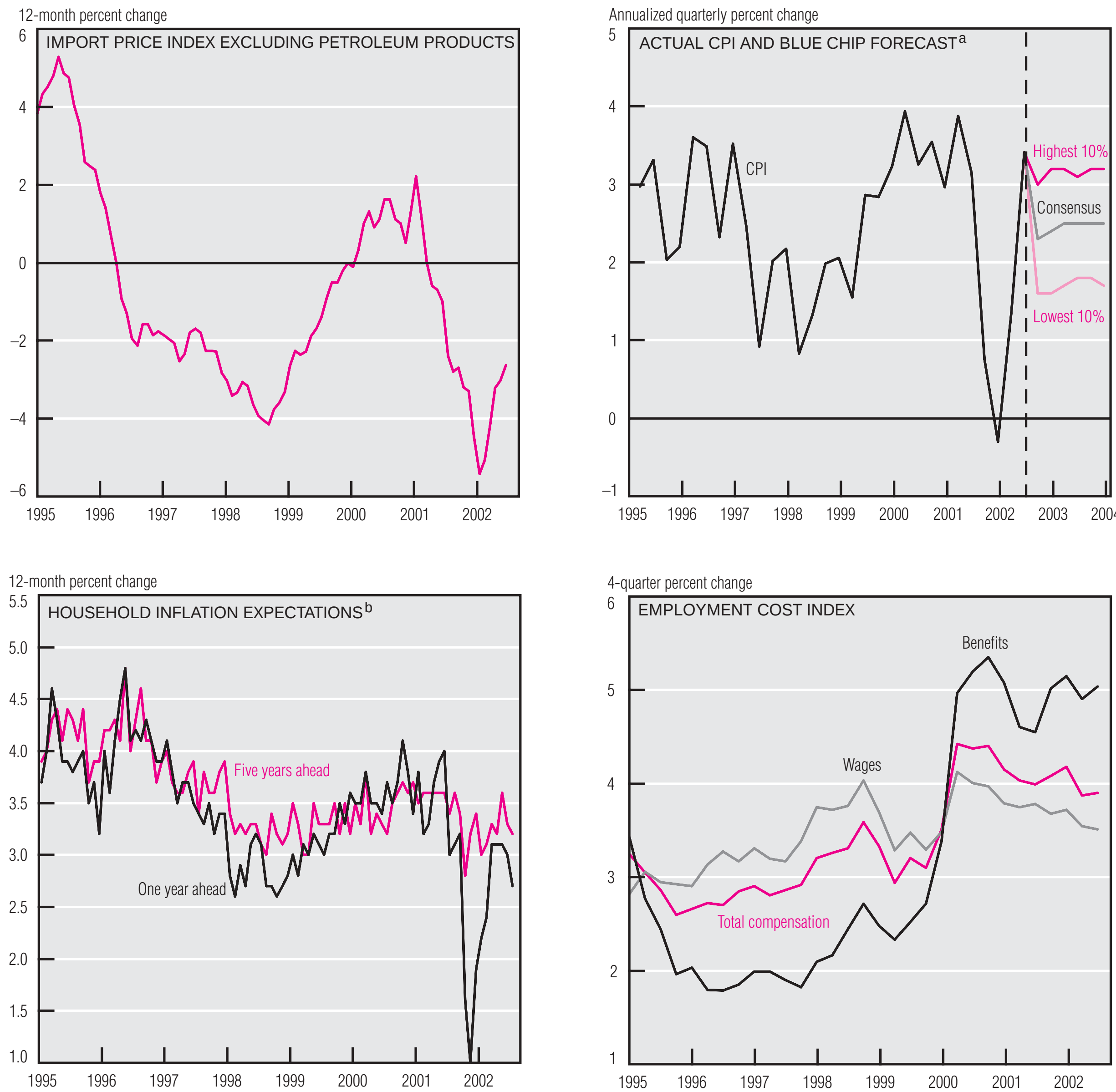
Inflation and Prices (cont.)



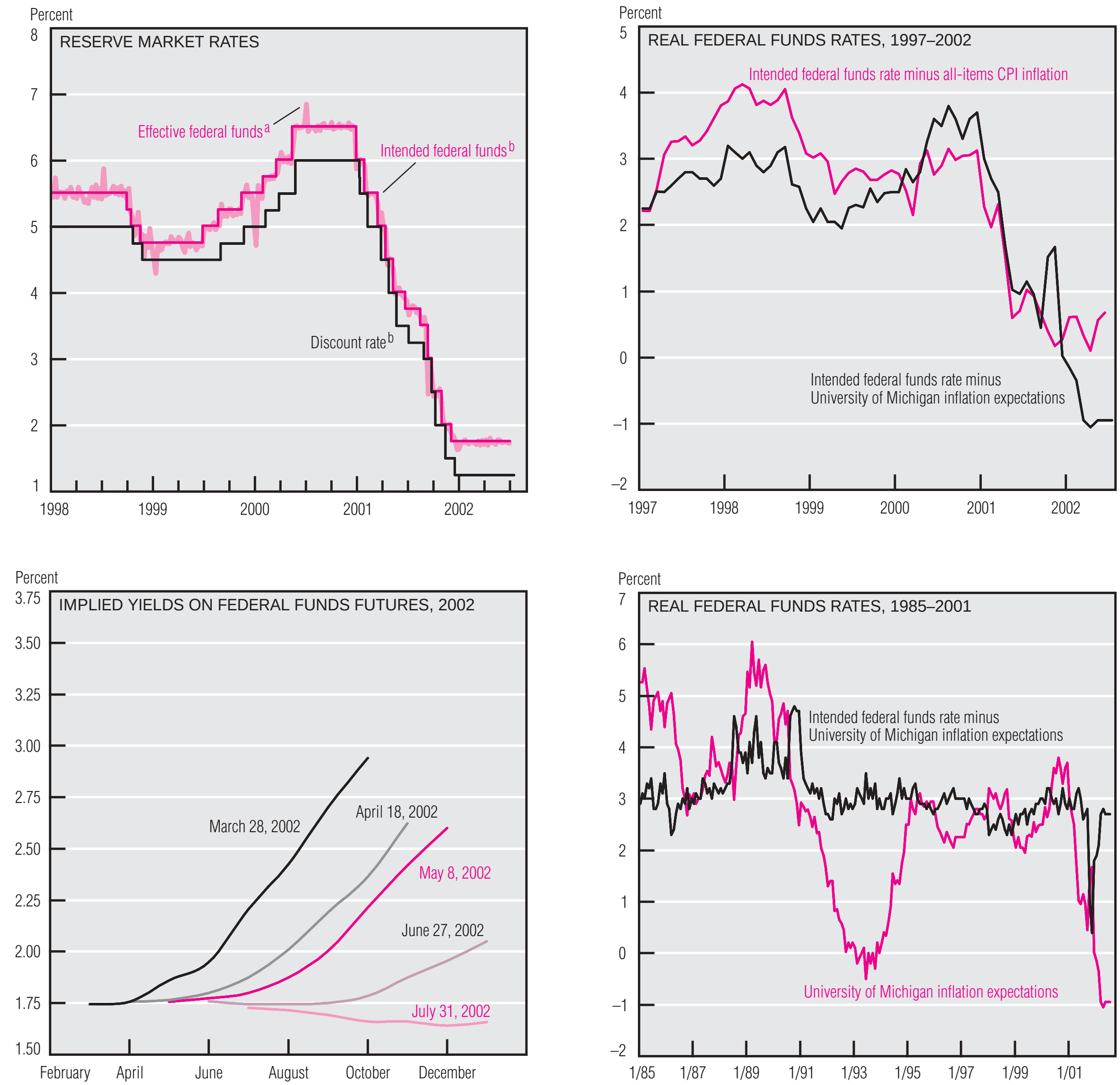
a. Blue Chip panel of economists.
b. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; and *Blue Chip Economic Indicators*, July 10, 2002.

the CPI's goods and services prices has widened since 2000. The reason for this divergence may be that, in general, goods are tradable and services are not. Over the last several years, prices for nonpetroleum products from foreign producers have, on average, been falling, and this is likely reflected in downward pressure on goods prices in the CPI.

The inflation outlook appears hopeful at present. The consensus inflation expectation among economists for the next year and a half is around 2½%. Even the most pessimistic economists surveyed expect inflation to be only slightly above 3% during this period. Households are similarly sanguine about the inflation outlook: Both long- and short-term inflation expectations have fallen in recent months, and they continue to be historically low.

Economists believe there is a link between inflation expectations and wages—namely, that if workers believe inflation is about to increase, they will demand higher wages to preserve their present buying power. The fact that wage rates (as well as total compensation), as measured by the Employment Cost Index (ECI), have moderated may be another indication of households' improving inflation outlook. Many economists also believe that because employment costs represent a significant share of firms' total costs, declining wage growth puts less pressure on output prices, and hence future inflation. In either case, the ECI's decline since the spring of 2000 may bode well for future inflation.

Monetary Policy



a. Weekly average of daily figures.
b. Daily.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15; University of Michigan, *Survey of Consumers*; and Bloomberg Financial Information Services.

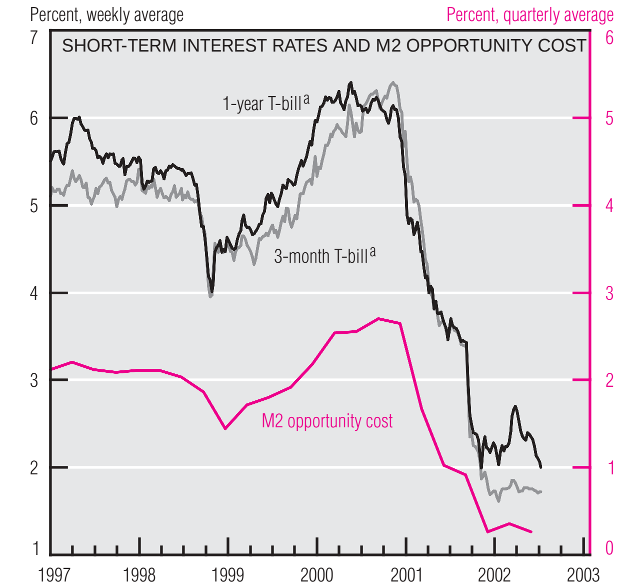
At its June 26 meeting, the Federal Open Market Committee (FOMC) decided to leave the federal funds rate unchanged at $1^{3}/_{4}$%, its intended level since December 2001. Noting that incoming information confirmed a continuing increase in economic activity, the Committee deemed the current policy stance accommodative. In light of current information, the Committee perceives that the risks are balanced with respect to the prospects for its two goals—price stability and sustainable growth.

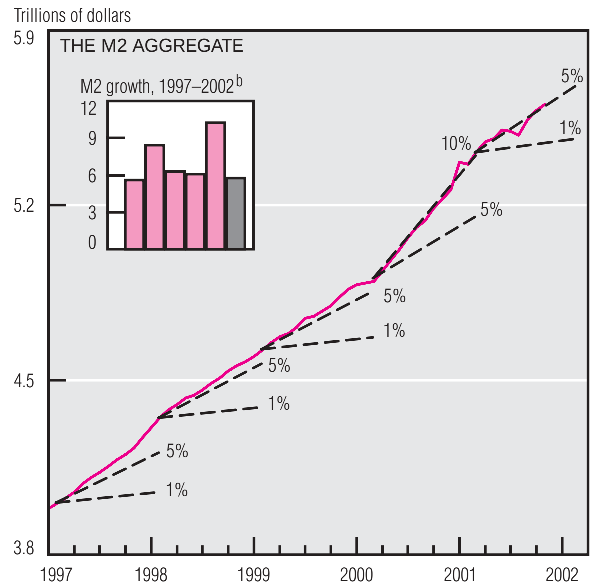
The inflation-adjusted fed funds rate has been near zero in backward-looking terms and negative in forward-looking terms, an unsustainably low rate in either case. Although the unchanged funds rate objective came as no surprise to financial markets, earlier this year the fed funds futures market showed that market participants were expecting rate increases to begin in the spring.

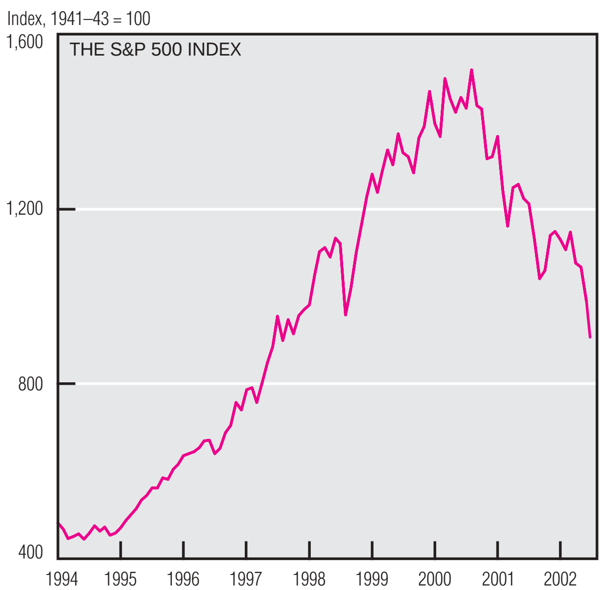
As information confirmed stronger-than-expected economic activity in the first quarter, fed funds futures were priced in anticipation of rates' imminent upward trajectory. Subsequent revelations, however, which raised concerns about the quality of corporate earnings, caused a sharp decline in equity prices and put the sustainability of the economic expansion in doubt. Consequently, the expected arrival of rate increases has been pushed out for several months. In fact, by the end of July, the market had priced in the possibility of another rate cut.

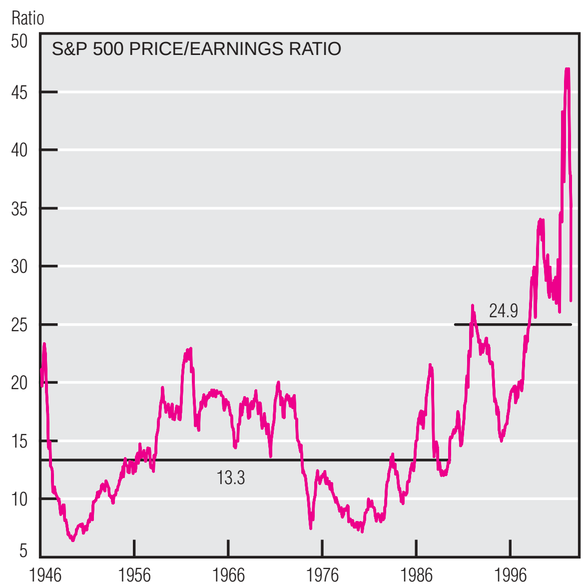
But how long can a funds rate be maintained near zero before inflation accelerates? Experience during the early 1990s suggests that such a state can be sustained for an extended period, provided rates are raised rapidly enough when inflationary pressures emerge.

Money and Financial Markets









a. Constant maturity.
b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis.
SOURCES: Board of Governors of the Federal Reserve System; Standard and Poors Corporation; and *Wall Street Journal*.

The drop in short-term interest rates over the past 18 months sharply reduced the opportunity cost of holding monetary assets. Consequently, the demand for money, as measured by M2, rose sharply in 2001. As short-term rates have stabilized at lower levels, M2 growth has slowed considerably.

In the financial sector, the stock market remains the big story. Despite reasonably strong economic fundamentals and quickly rising second-quarter earnings, stock prices plunged to five-year lows in July. Although price-to-earnings (P/E) ratios receded, they still exceed recent historical averages. If earnings projections for 2002 and 2003 come to pass, P/E ratios will continue to fall.

A series of revelations about corporate violations of accepted accounting standards has damaged investor confidence. With no way to assess how widespread such accounting abuses are, investors have become skittish, questioning the accuracy of all earnings reports and, more importantly, analysts' projections of future earnings.

By August 14, markets will have some benchmark for assessing the magnitude of the accounting problem. On that date, the largest corporations' chief executive officers and chief financial officers will be required to personally attest to the accuracy of their financial reports. Moreover, Congress has acted swiftly to provide clear guidelines for reducing the conflicts of interest that permitted the kinds of accounting shenanigans that have become visible in recent months.

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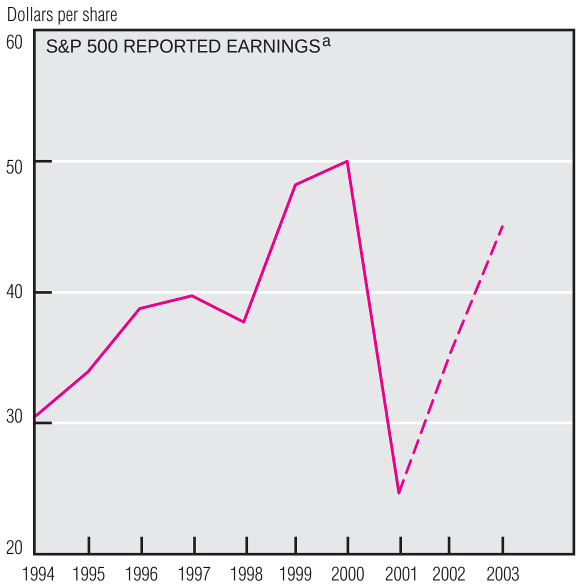

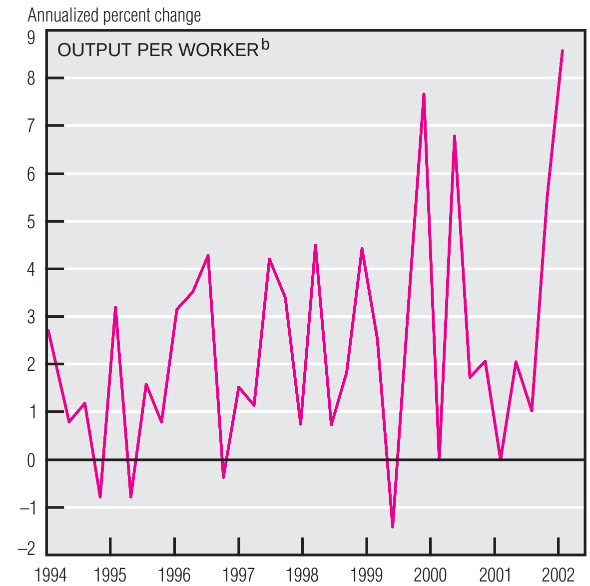

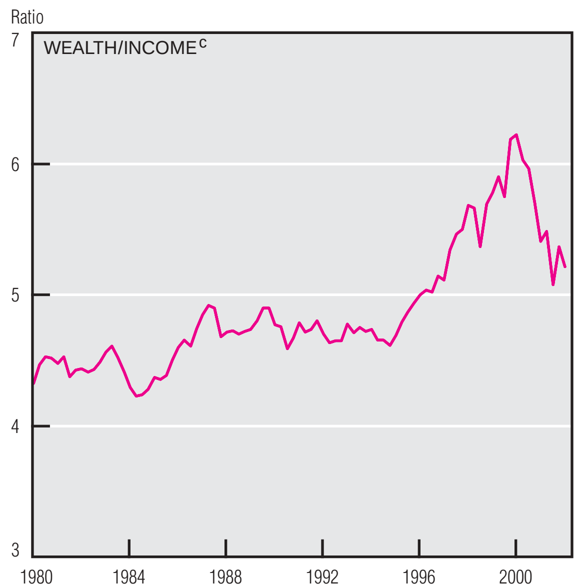

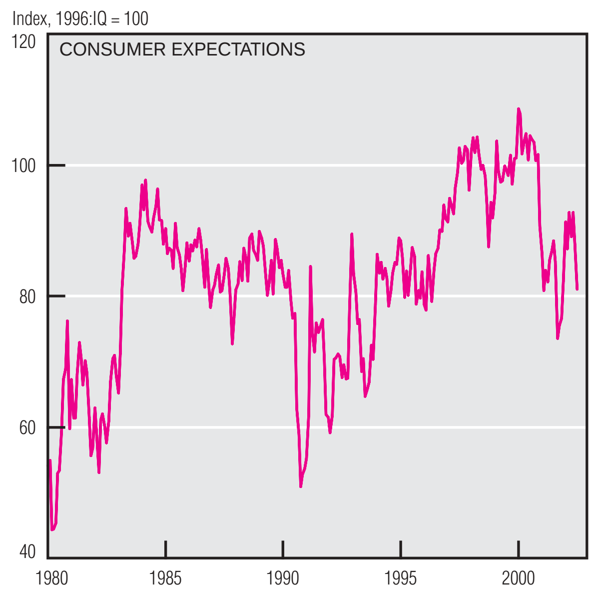

a. Dashed line shows earnings estimates provided by Standard and Poors.
b. Nonfarm business sector.
c. Wealth equals assets minus liabilities.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Standard and Poors Corporation; and University of Michigan, *Survey of Consumers*.

One key fundamental for earnings is productivity's pronounced acceleration in recent quarters. Productivity jumped 5.5% in 2001:IVQ and 8.5% in 2002:IQ, reaching a level more than 4% higher than in 2001:IQ. The late 1990s' increase in trend productivity shows no sign of slackening. With higher trend productivity and relatively stable employment costs, profit margins are expected to keep increasing.

The unrelenting bear market of early summer aroused concerns that falling stock market wealth would be associated with another dip in economic activity. It is unusual for equity prices to drop in the six months after a cyclical trough. The question is whether the price plunge reflects an underlying deterioration in economic fundamentals or simply a transitory crisis of confidence. Although the wealth-to-income ratio has fallen, it still exceeds its average for the 1980s and early 1990s.

Investment has been slow to turn around in the face of excess capacity, but consumers have not been shaken by stock market volatility. Consumer expectations have held up well, slipping only modestly from recent levels. One important element in consumer resilience appears to be the continued, albeit slower, appreciation in housing prices.

A substantial share of household spending in the past 20 years was made possible by falling interest rates. Lower rates allowed consumers to assume a higher level of debt for a given level of debt burden

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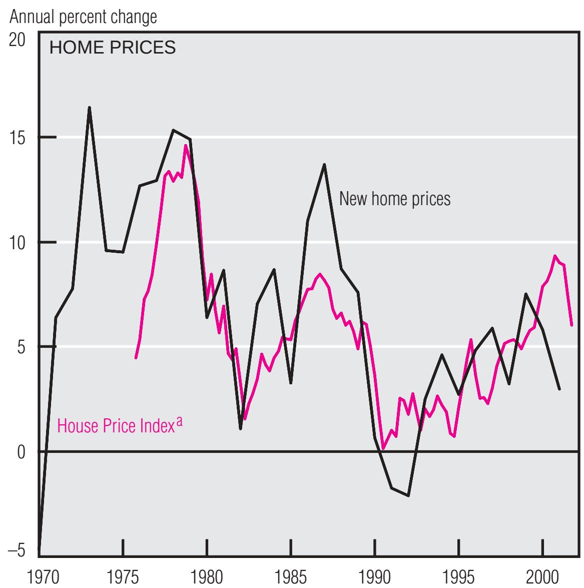
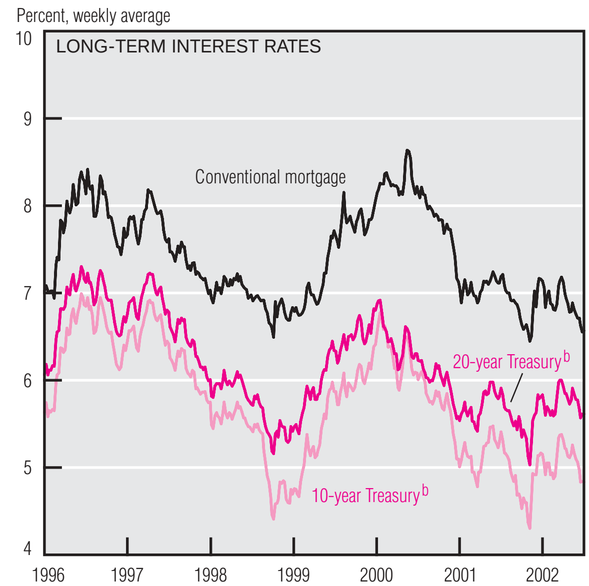
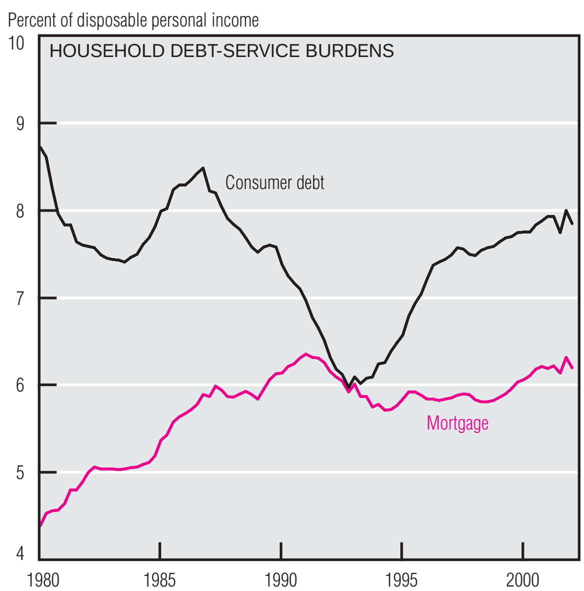
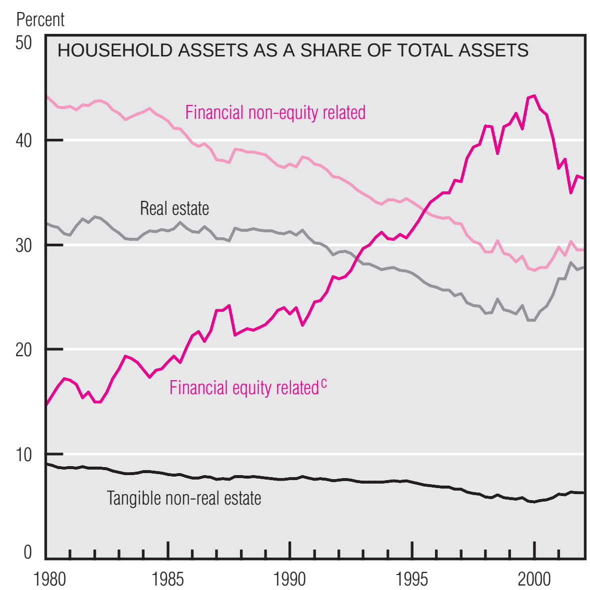






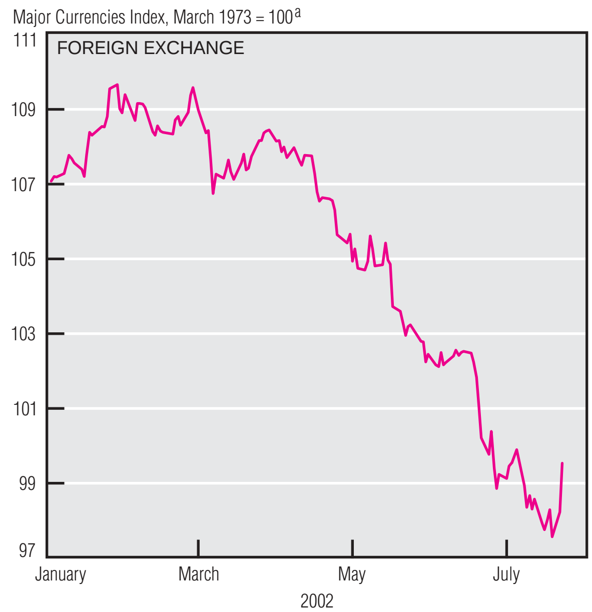


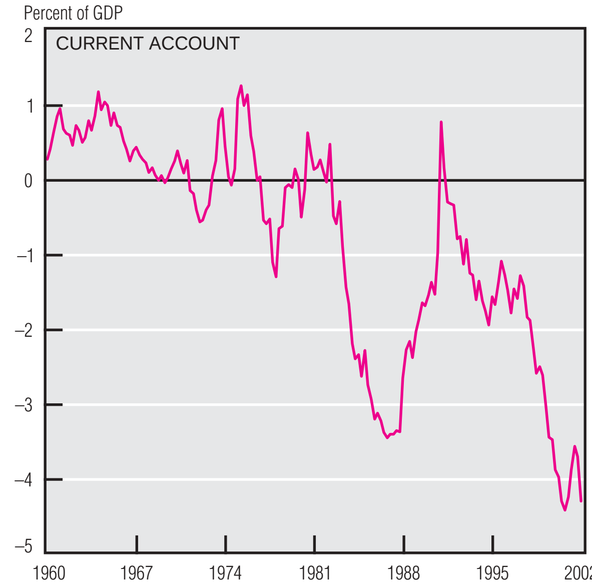
a. Includes new and existing homes.
b. Constant maturity.
c. Equity-related assets are defined as corporate equities, mutual fund shares, and pension fund reserves.
SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight; and Board of Governors of the Federal Reserve System.

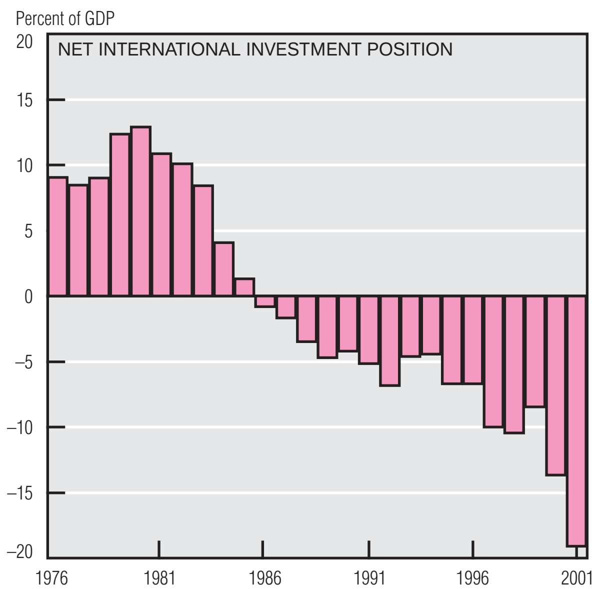
(as measured by their monthly payments). So lower interest rates not only made home ownership accessible to greater numbers of households, but also allowed those who already owned homes to tap equity values through mortgage refinancing. It is important to remember that falling interest rates were largely the result of lower inflation expectations, the ultimate product of disinflation. With inflation currently near historical lows, it is doubtful that interest rates will continue to trend downward, which suggests that this source of consumer finance will diminish in the years ahead.

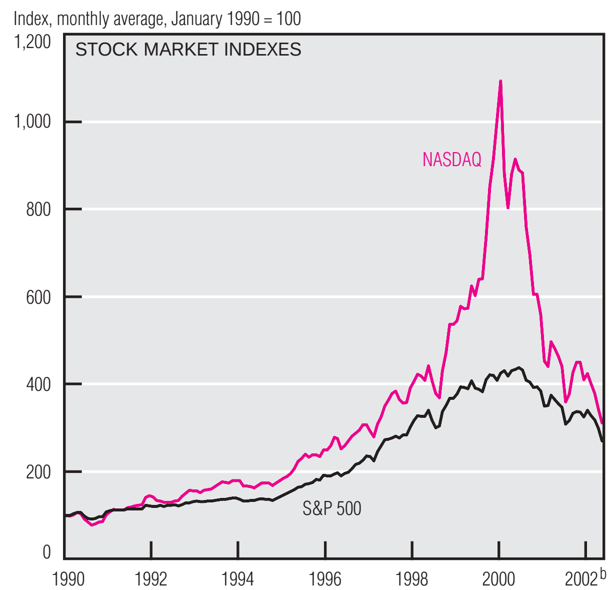
Some market analysts fear a housing price bubble. To a large extent, the rise in housing prices has encouraged greater consumer spending because liquidity-constrained households have been able to use increased housing values as a source of finance. If higher housing prices were not based on fundamentals, a persistent adjustment in consumer spending could result, precipitating another dip in aggregate economic activity. But the fundamentals for continued strong housing demand in the years ahead appear to be sound. Demographics reveal that “echo boomers”—the children of baby boomers—are just beginning to reach home-buying age. Moreover, a greater number of households are buying second homes. Although real estate as a share of wealth has risen sharply in recent years, this is largely a reflection of the sharp decline in stock prices. Real estate is still below its share in the 1980s.

Is the Dollar Sustainable?









a. Includes the currencies of Canada, the euro area, Japan, U.K., Switzerland, Australia, and Sweden.
b. Data through July 23.
SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and *Wall Street Journal*.

Shaken by disclosures in U.S. equity markets, the dollar has slid about 7% against the currencies of our major trading partners since April. Some economists worry that a more fundamental adjustment may be in the offing.

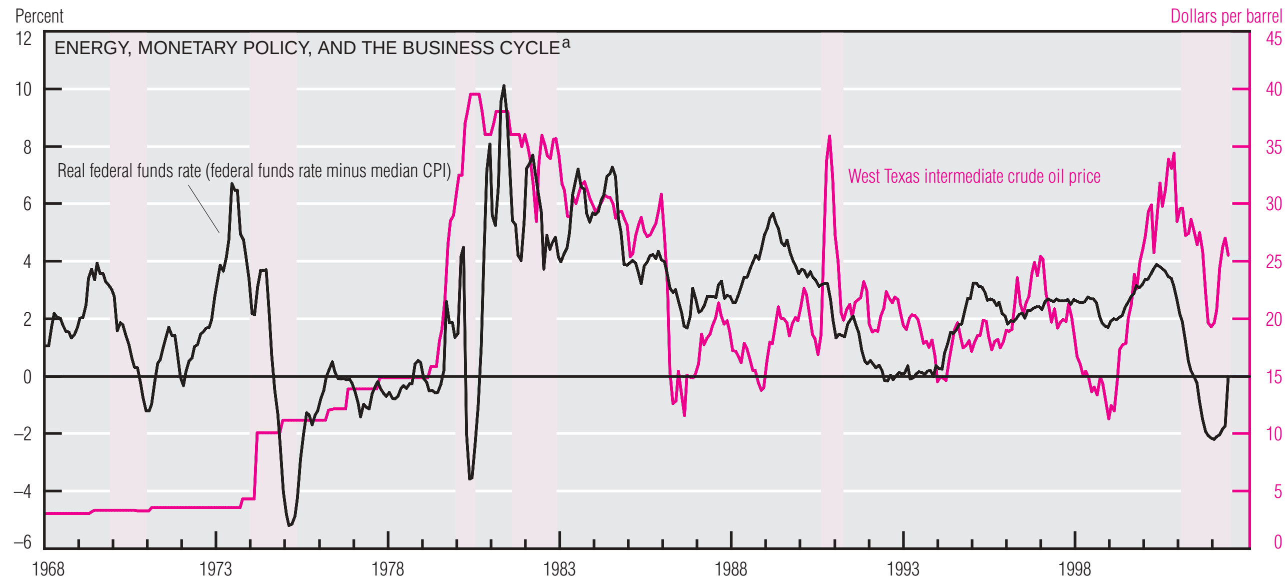
The U.S. has run a current account deficit almost continuously since 1982, primarily because we import more than we export. This year, the current account deficit will approach $500 billion, or 5% of GDP, and most analysts expect that it will continue to expand over the next year.

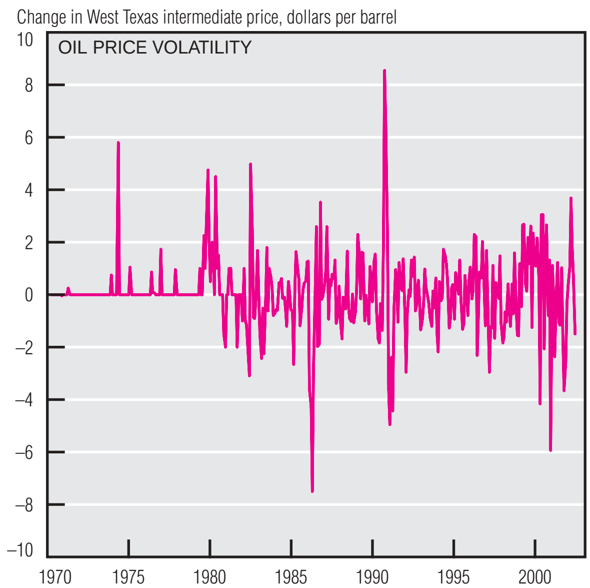
We finance this deficit by issuing financial instruments—stocks, bonds, bank accounts—to foreigners, giving them a claim to our future output. Currently, international investors' net financial claims against the U.S. are equal to approximately 19% of our GDP. (The Commerce Department records this as a negative net international investment position.) Although 19% is high, it is not unprecedented, and we have no metric by which to judge it excessive or unsustainable.

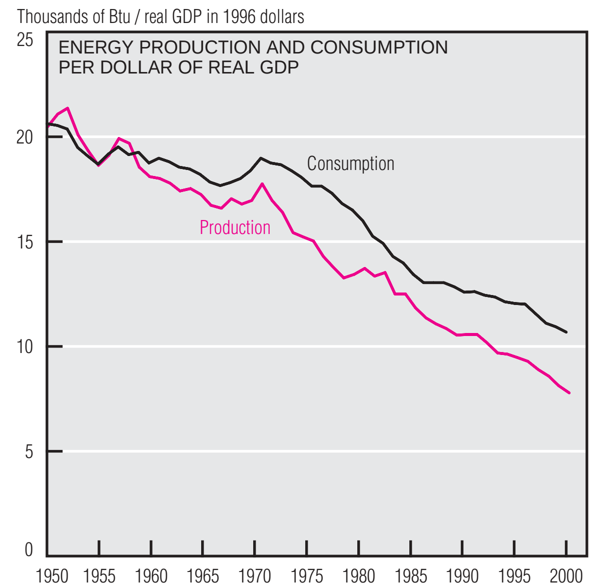
Nevertheless, some analysts fear that international investors will become increasingly reluctant to hold additional dollar-denominated assets in their portfolios. In that case, U.S. interest rates would rise, and the dollar would depreciate in foreign exchange markets to trim the trade deficit and to coax additional financial inflows.

Whether the U.S. is on the cusp of such a development is anyone's guess, but the accounting scandals rocking U.S. equity markets cannot but make international investors more skittish about holding U.S. securities.

Energy, Monetary Policy, and the Business Cycle







a. Shaded areas indicate recessions.
SOURCES: U.S. Department of Energy; Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland; and *Wall Street Journal.*

With the economy moving toward recovery, price pressures will eventually build, and the Federal Open Market Committee will need to focus more keenly on price stability. Threading policy between recovery and price stability will be especially difficult if oil prices remain high and volatile.

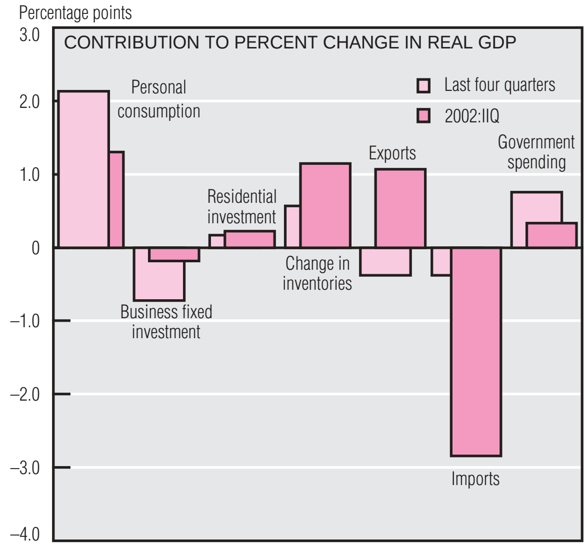
Oil prices have spiked before nearly every U.S. recession since World War II, including the recent slowdown. Many economists have suggested, however, that oil costs alone are too small relative to output to explain such severe business-cycle responses. They contend that imperfections in the adjustment process or some other mechanisms—primarily monetary policy—leverage oil price shocks into economic downturns. Indeed, an increase in the real federal funds rate—the observed funds rate minus the median CPI inflation rate—also has preceded nearly every recession.

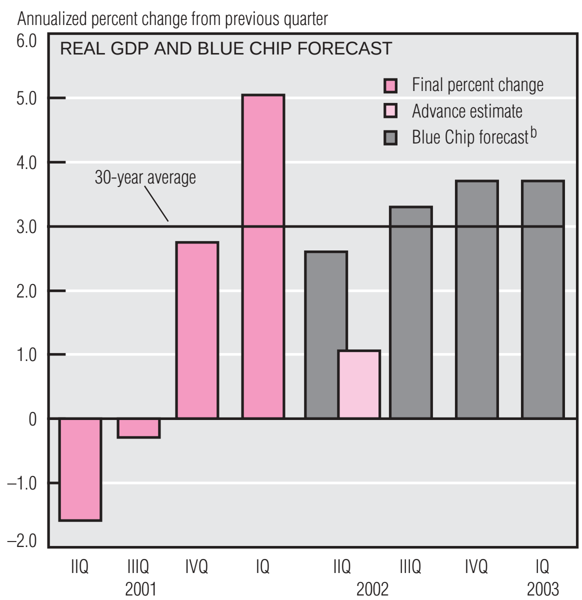
Economic studies, however, indicate that the economic impact of oil price shocks has waned since the early 1980s. Although oil price increases preceded the downturns of 1990–91 and 2001–02, these recessions were especially mild. Many economists point out that the U.S. economy has become much less dependent on oil. We now use about half as much energy to produce a unit of GDP as we did in 1970. Many others, however, attribute the post-1980 break between oil prices and economic activity to a change in the nature of monetary policy. The Federal Reserve has rebuilt its reputation for price stability, with the result that inflation expectations no longer parallel energy price patterns closely. Price credibility has real value.

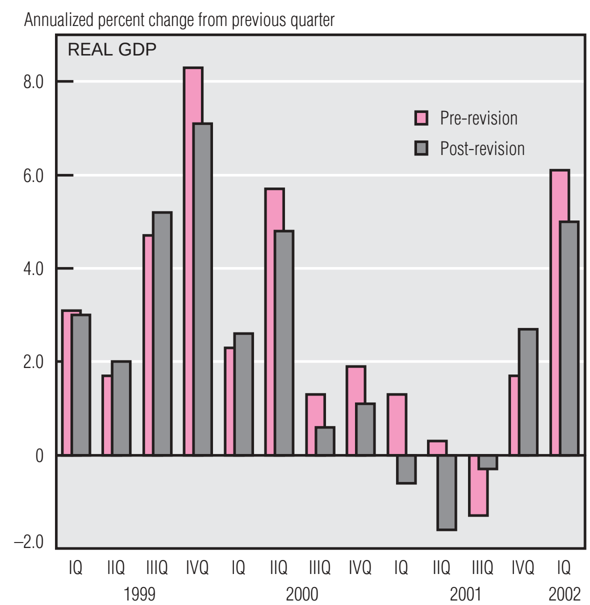
Economic Activity

Real GDP and Components, 2002:IIQ[a]
(Advance estimate)

	Change, billions of 1996 $	Percent change, last: Quarter	Four quarters
Real GDP	24.7	1.1	2.1
Personal consumption	30.4	1.9	3.1
Durables	5.8	2.4	7.6
Nondurables	–2.8	–0.6	3.0
Services	27.0	3.0	2.2
Business fixed investment	–4.8	–1.6	–6.1
Equipment	6.9	2.9	–3.0
Structures	–9.0	–14.0	–14.6
Residential investment	4.6	5.0	3.8
Government spending	7.5	1.8	4.1
National defense	7.5	8.0	9.6
Net exports	–50.9	—	—
Exports	28.9	11.7	–3.6
Imports	80.0	23.5	2.9
Change in business inventories	29.9	—	—







NOTE: All data are seasonally adjusted and annualized.

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. Blue Chip panel of economists.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, July 10, 2002.

The advance estimate from the national income and product accounts shows that real gross domestic product (GDP) grew at a 1.1% annualized rate during 2002:IIQ. Consumer spending for the quarter rose 1.9%, which was considerably less than the 3.1% growth rate of the last four quarters. Even so, it remained the strongest contributor to real GDP growth. On a somewhat more positive note, business fixed investment fell only 1.6%, a marked improvement on the 6.1% decline of the last year. The change in inventories contributed 1.2 percentage points of real GDP growth as the economy began to accumulate inventory for the first time since 2000:IVQ. Exports' increase of nearly 12% was dwarfed by a 23.5% surge in imports, which created the greatest economic drag by lowering real output growth 2.8 percentage points.

Blue Chip forecasters had predicted that real GDP would grow 2.6% in 2002:IIQ—more than double the advance estimate of 1.1%. As of July 10, they also expected real GDP growth to surpass its long-term average by 2002:IIIQ; however, the discrepancy between the 2002:IIQ forecast and the advance estimate may modify their expectations.

Every July, national income and product account estimates are revised, beginning with data three years prior (the most recent revision, reported July 31, covers 1999:IQ onward). One of the most significant findings of July's revision was that real GDP growth seems to have declined during the first three quarters of 2001, not 2001:IIIQ alone.

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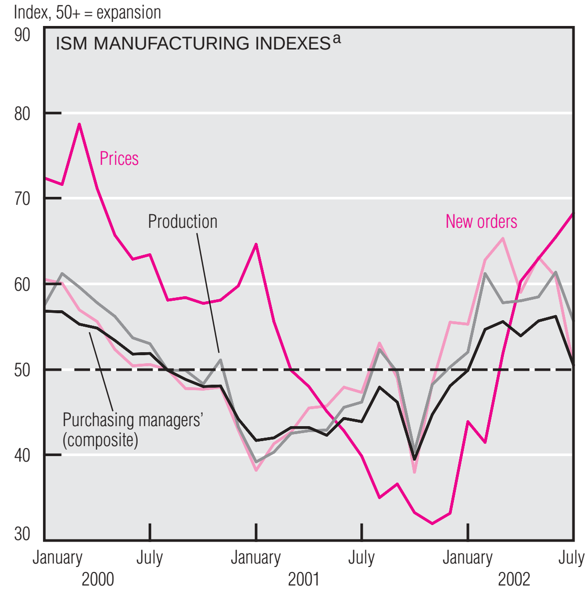
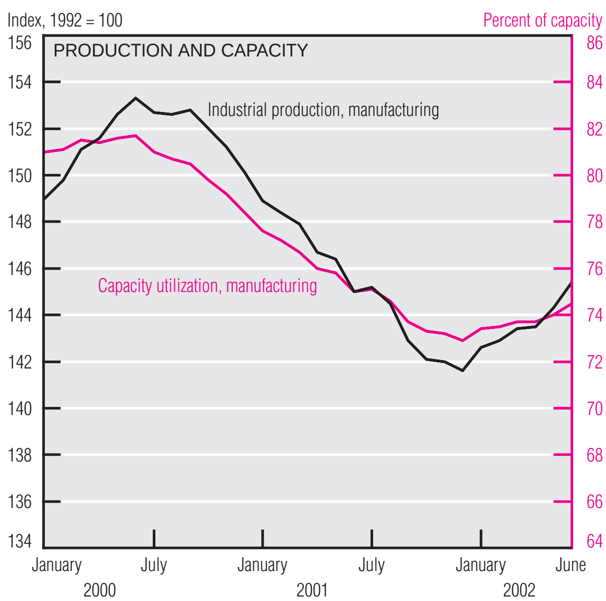
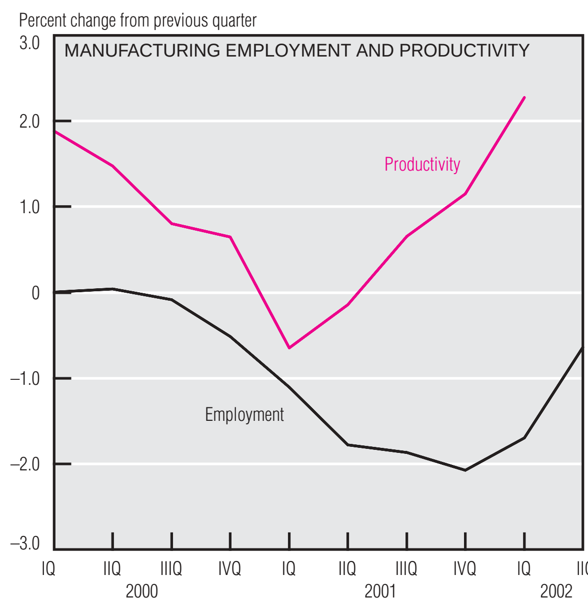
Economic Activity (cont.)







a. Refers to the Institute for Supply Management (formerly the National Association of Purchasing Management).

SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and Institute for Supply Management.

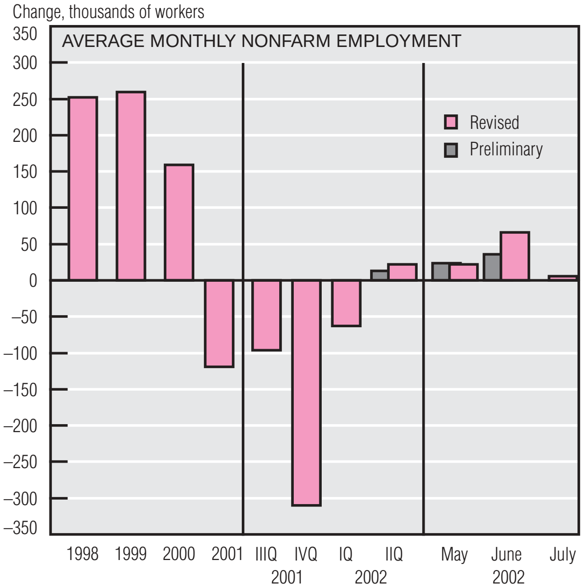
Manufacturing's road to recovery has been far from smooth. The Institute for Supply Management's composite index fell to 50.5 in July from June's 56.2. Although technically indicating an expansion, the figure was weaker than expected. New orders led the decline, falling to 50.4 in July from 60.8 in June. The production component also fell, but was still a relatively high 55.7. The price component rose sharply to 68.3, partly because the dollar weakened.

Further evidence of turbulence is the disappointing 4.1% fall in June orders for durable goods. Even without transportation, including the extremely volatile aircraft component, orders were still down more than 3%. Of course, considering the large fluctuations this series is subject to, one should not overemphasize one month's figure.

Manufacturing has some bright spots. Capacity utilization and industrial production have been rising steadily since December 2001. Both of these series show far less month-to-month fluctuation than durable goods orders, and so may be more reliable indicators of manufacturing's health. Manufacturing output has now recovered more than a third of the decline experienced since July 2000.

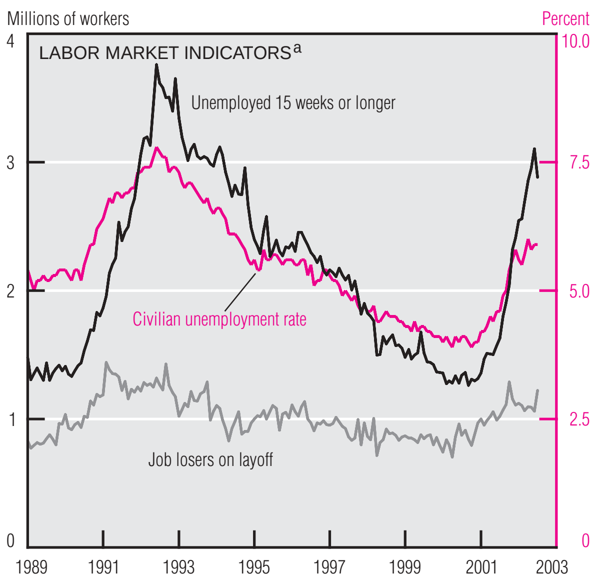
Another positive indicator is that manufacturing employment declines have been slowing since 2001:IVQ. Even in the best of times, manufacturing employment has grown slowly because productivity has increased so fast that employers have not needed to hire many new workers to meet demand. This state of affairs is likely to continue because annual productivity growth averaged about 4% for the four quarters ending 2002:IQ.

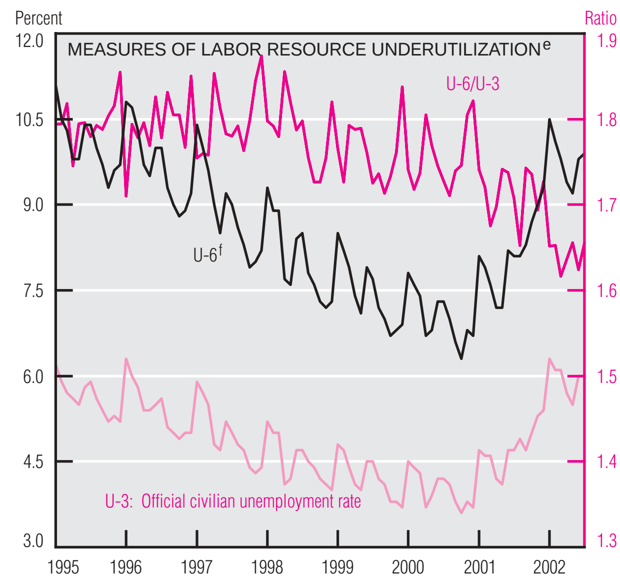
Labor Markets



Labor Market Conditions[a]

	1999	2000	2001	Jan.–June 2002	July 2002
	Average monthly change (thousands of employees)				
Payroll employment	259	159	–119	–20	6
Goods-producing	8	–1	–111	–66	–40
Mining	–3	1	1	–2	–3
Construction	26	8	–3	–13	–30
Manufacturing	–16	–11	–109	–51	–7
Durable goods	–5	1	–79	–37	–18
Nondurable goods	–11	–12	–30	–13	11
Service-producing	252	161	–8	45	46
TPU[b]	19	17	–23	–11	–3
Wholesale and retail trade	60	25	–31	–2	–13
FIRE[c]	7	5	10	–2	2
Services[d]	132	92	–2	45	50
Health services	9	15	27	22	29
Help supply	32	0	–54	20	–35
Government	35	22	39	18	–16
	Average for period (percent)				
Civilian unemployment rate	4.2	4.0	4.8	5.8	5.9





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. Data are not seasonally adjusted.
f. Unemployed persons plus marginally attached workers plus persons employed part time for economic reasons divided by the labor force plus marginally attached workers. (Marginally attached workers are those not in the labor force who want to work and have actively searched for a job within the last 12 months, but not within the last four weeks.)
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

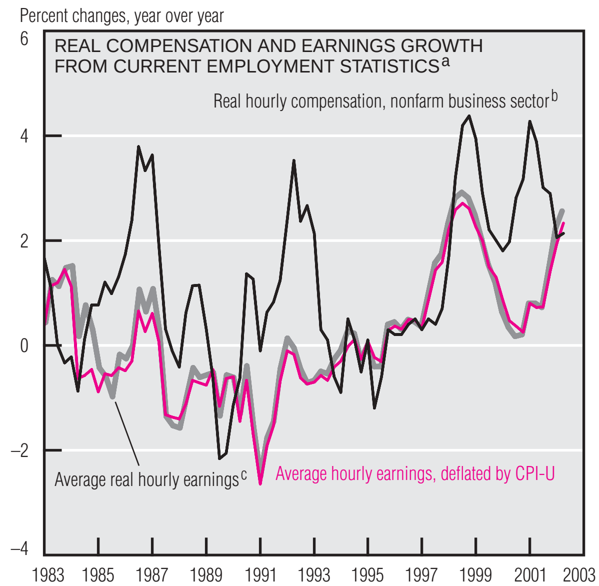
Nonfarm payroll employment was virtually unchanged in July (up 6,000) after a revised increase of 66,000 jobs in June. The second-quarter net employment increase (67,000) seems to compare favorably with the first-quarter job loss (189,000), but most of that loss (165,000) came in February.

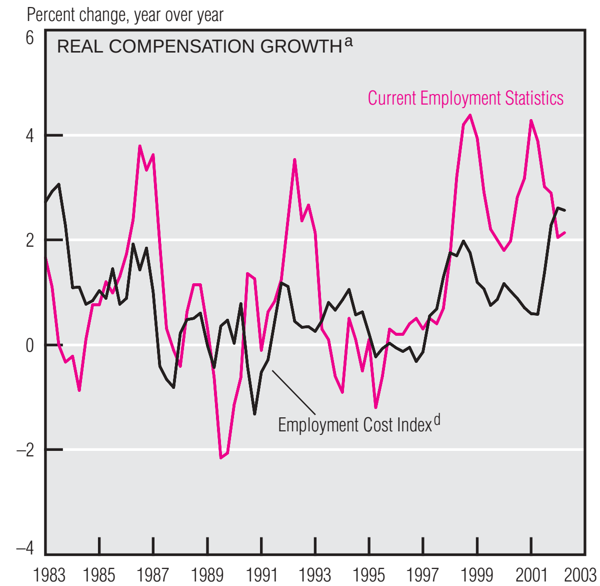
Services employment increased 50,000 jobs in July, 29,000 of them coming from health services. However, help supply services declined 35,000 jobs. Goods-producing industries showed a net loss of 40,000 jobs, with much of the loss in construction (30,000). This decline offset much of the job gain in services.

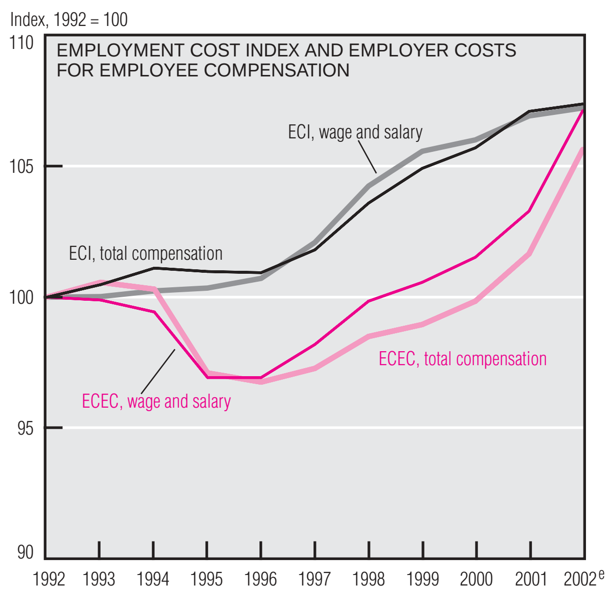
Although the unemployment rate was unchanged at 5.9%, the number of unemployed on temporary layoff rose 162,000, while the number of job losers not on layoff fell by about the same amount (163,000). Consistent with this, the number unemployed for 15 weeks or longer fell 220,000 to 2.9 million. That number had been increasing every month since May 2001, when it was at 1.5 million.

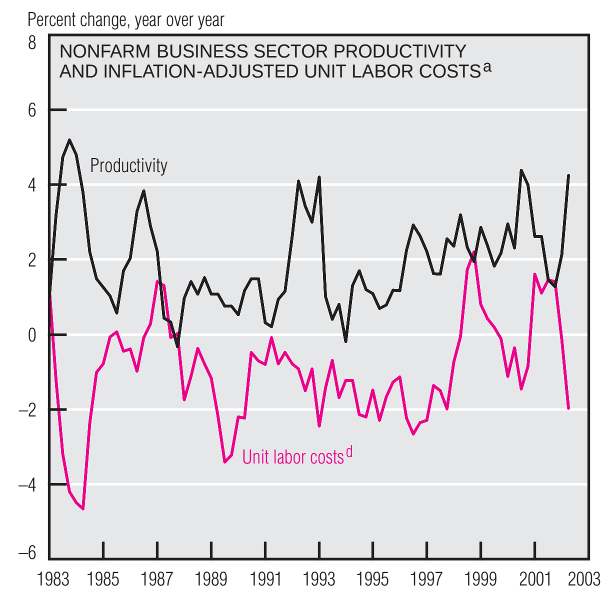
The number of persons working part time for economic reasons rose from 3.9 million in June to 4.2 million in July. These workers are not counted as unemployed by the official unemployment rate. The Bureau of Labor Statistics releases a range of unemployment indicators (U-1 to U-6) to measure this and other types of underemployment. Alternative measures usually—but not always—mirror trends in the official unemployment rate (U-3). The broadest, most popular alternative measure, U-6, includes those who work part time for economic reasons. From July 2001 to July 2002, U-6 grew 22%, (from 8.1% to 9.9%) while U-3 grew 28% (from 4.7% to 6.0%), lowering the U-6/U-3 ratio.

Labor Earnings Growth









a. Seasonally adjusted.
b. Uses CPI for all urban consumers (CPI-U) as a deflator.
c. Uses CPI for urban wage earners and clerical workers (CPI-W) as a deflator.
d. Inflation adjustment is made by dividing the series by the CPI-U.
e. First quarter.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

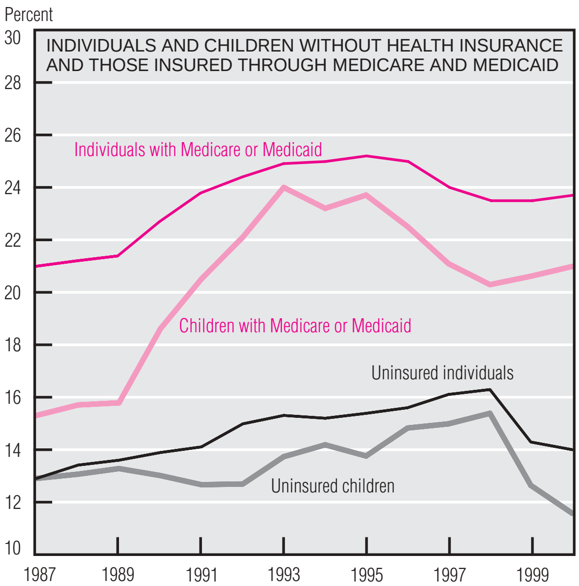
Measures of labor earnings growth are quite sensitive to differences in definition and method. In the past several years, average real hourly earnings growth from the Labor Department's Current Employment Statistics (CES) data series has increased, while real hourly compensation growth, which includes benefits, has decreased. Even when both series are deflated by the CPI-U, trend differences remain.

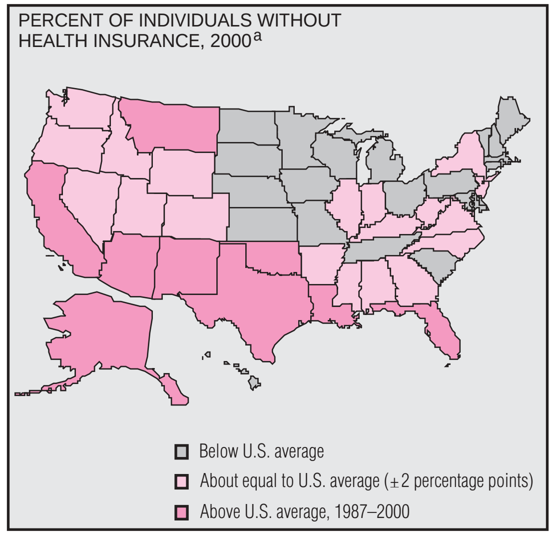
Both real compensation and real earnings are affected by employment shifts. The Employment Cost Index (ECI), which uses fixed weights across industries and occupations, measures compensation growth without the influence of employment changes. Real total compensation from the ECI is generally more volatile than the CES measure, and the two series have behaved quite differently in the past several years.

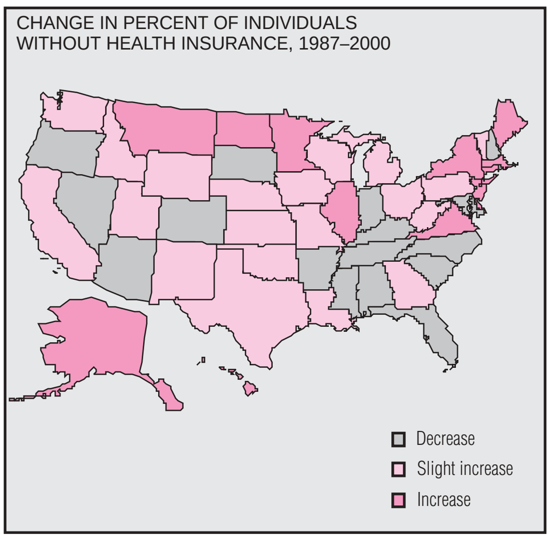
Employer Costs for Employee Compensation (ECEC), a series calculated with data from the ECI survey, uses current rather than fixed employment weights. From 2001 to 2002, ECEC measures of real compensation and of wages and salaries grew more than the ECI. Some of the recent ECEC increase came from a reduction in hours for lower-wage and salary workers during the most recent recession. Conversely, the ECI's growth exceeded the ECEC's in the 1990s because of the shift toward lower-paying jobs during that decade.

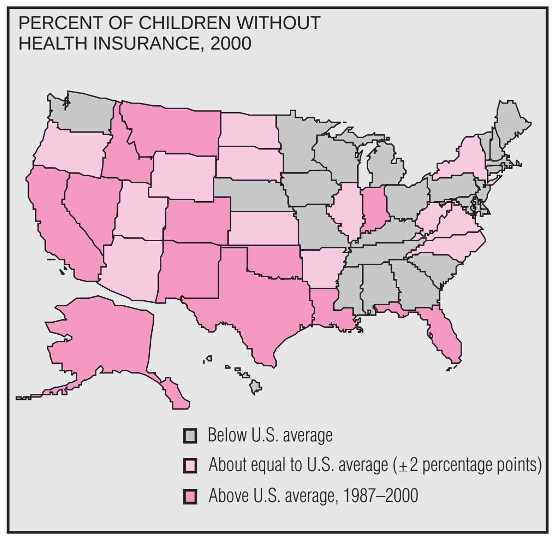
ECEC data are used to assess employers' labor costs, but they do not measure labor costs relative to production. These are measured by unit labor costs (compensation per unit of real output). Unit labor costs, which are negatively related to productivity, have fallen dramatically in recent quarters, as often happens near the end of a recession.

Health Insurance









a. Includes only those who were uninsured at all times during the year.
SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Population Survey*.

Access to affordable health care is a significant problem facing the U.S. With health care costs rising, access to insurance that defrays the costs to consumers is now more important than ever.

In 1987, both children (those 18 and younger) and the total population were uninsured at the same rate (13%), but they have not followed the same trend since then. Remarkably, the share of the total population that is uninsured dropped to 14.3% in 1999 from a high of 16.3% in 1998. The share of children who are uninsured fell to 11.6% in 2000, the lowest figure since the *Current Population Survey* began tracking the statistic in 1987. The number of people receiving Medicare or Medicaid has increased, but the decrease in the number of uninsured probably results from more than increased public insurance coverage.

In 2000, 14% of the total population lacked health insurance, with lower rates in the midwestern and northeastern states. The higher rates of uninsured people were concentrated in the south-central and southwestern states plus Florida, Montana, and Alaska. The southern states' higher rate of uninsured people results at least partly from immigration into the region and the type of labor done there.

Over the 13-year period, a slightly different picture emerges. Whereas the U.S. average rate of uninsured individuals increased (which means that rates would inevitably rise in some states), the states with significant increases in uninsured rates were mostly in New England and the north-central region.

For children, the highest uninsured rates are mostly in the West; all states

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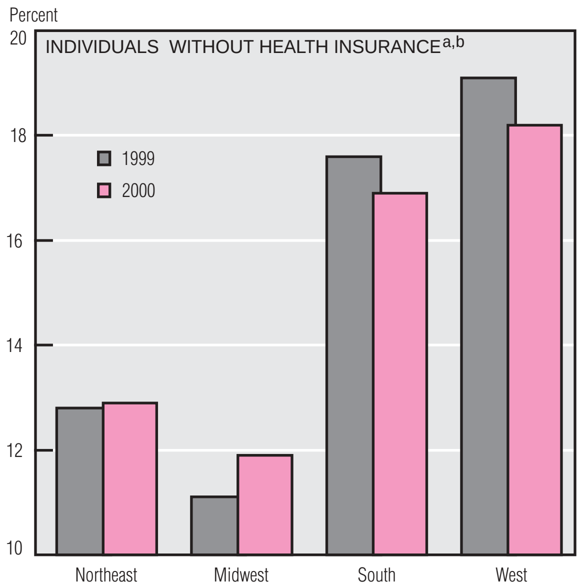
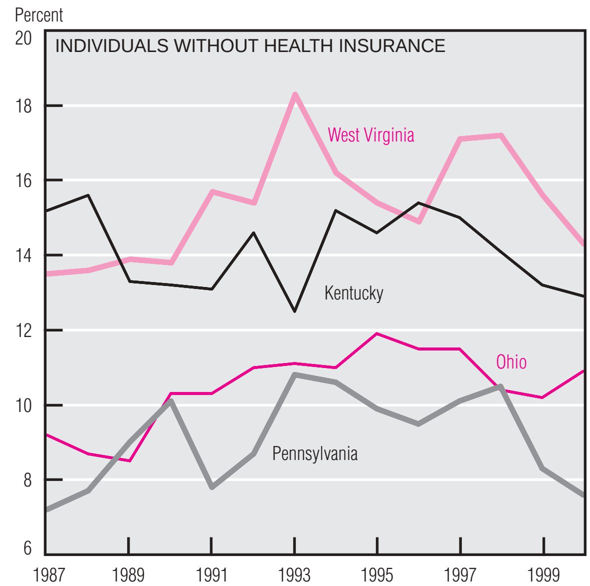
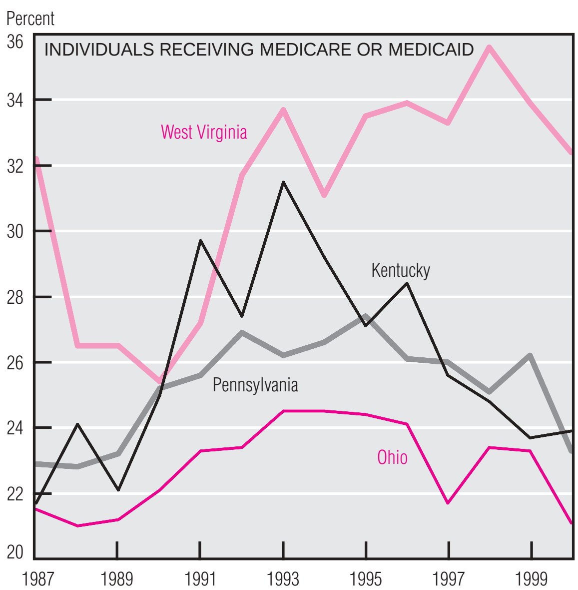
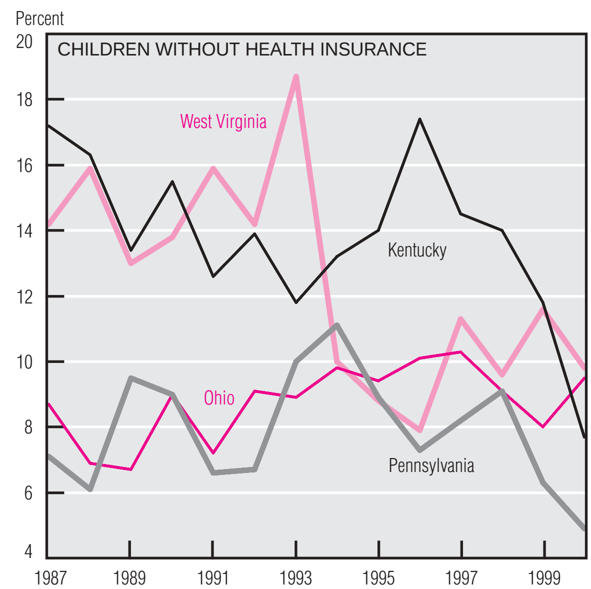
Health Insurance *(cont.)*









a. Standard regions as defined by the Census Bureau.
b. Includes only those who were uninsured at all times during the year.
SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Population Survey*.

east of the Mississippi, save two, had rates below or consistent with the national rate.

Although the share of uninsured individuals in the Midwest has risen, the region's population is still insured at much higher rates than in the South and West. The presence and strength of labor unions, as well as the type of employment they represent, probably account for their high rates of insured people.

Within the Fourth District, the populations of Ohio and Pennsylvania have historically had lower percentages lacking insurance, although uninsured rates in both states rose between 1987 and 2000. In fact, Pennsylvania has one of the lowest rates of any state in the nation. Rates of uninsured in Kentucky and West Virginia have been volatile over the years, with West Virginia peaking in 1993, when 18.3% of the state's population had no health insurance (by 2000 the figure was around 14%).

Ohio has the lowest rate of federal health care assistance use of any state in the Fourth District. Unlike the nation as a whole, Ohio's rate of uninsured children has increased slightly since 1987. West Virginia and Kentucky, on the other hand, have mirrored the national trend and have made substantial progress in improving children's uninsured rates. In 2000, West Virginia had the same rate as Ohio. Kentucky posted large declines in the rate of uninsured children since 1996, showing a drop of almost 10 percentage points in four years. Pennsylvania still boasted the lowest rate (5%) in 2000.

Savings Associations

a. Observation for 2002 represents annualized first-quarter data.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured savings associations reported net income of $3.6 billion for 2002:IQ. This was an increase of $739 million (24.5%) from a year earlier. Compared to the previous quarter, however, it amounted to a decrease of $76 million.

Despite declining interest income, S&Ls' noninterest (fee) income remained quite strong, rising slightly to $3 billion. Total interest income in 2002:IIQ was 13% lower than a year earlier. But because of lower interest rates, the cost of borrowing fell faster than interest income, producing a 22.7% increase in net interest income.

Savings institutions' strong earnings performance is once again apparent in the net interest margin (the difference between interest and dividends earned on interest-bearing assets and interest paid to depositors and creditors; it is expressed as a percentage of average earning assets). During 2002:IQ, S&Ls' net interest margin rose to 3.52%. This factor, coupled with asset growth's drop to 5.01%, pushed S&Ls' return on assets to 1.11%. First-quarter return on equity went up to 12.83%. The 2002:IQ levels for all three of these indicators were the highest since 1993.

Net loans and leases as a share of total assets fell from 66.5% in

(continued on next page)

Savings Associations (cont.)

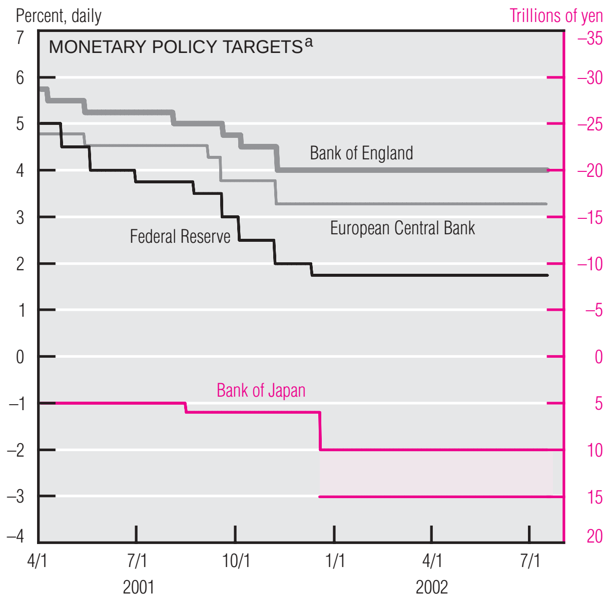
a. Observation for 2002 represents annualized first-quarter data.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

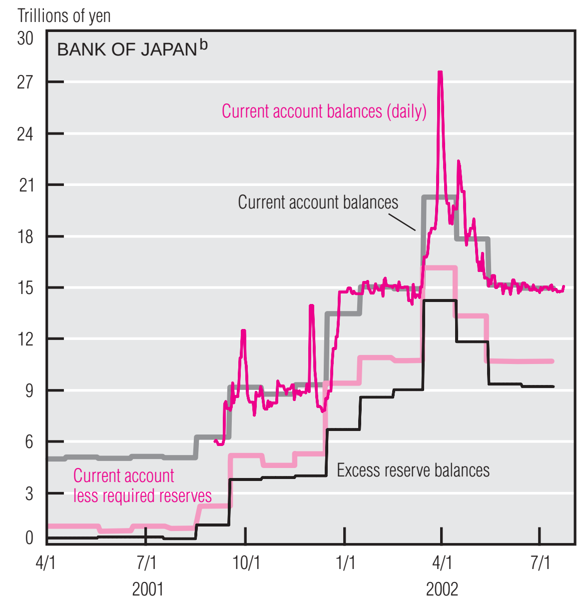
2001:IVQ to 64.7% in 2002:IQ, well below its recent high of 67.9% in 2000:IIIQ. This ratio indicates continued decline in lending-market activity.

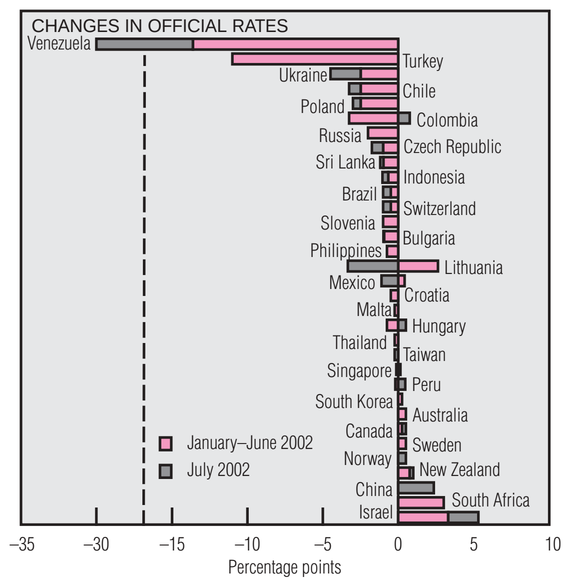
Asset quality showed a slight improvement in 2002:IQ. Net charge-offs (gross charge-offs minus recoveries) declined slightly from the previous quarter, reaching $570 million (about 0.26% of S&Ls' loans and leases). Net charge-offs rose for residential mortgages and real estate construction loans but declined for loans to individuals. Problem assets (nonperforming loans and repossessed real estate) were on the rise, reaching 0.68% of total assets.

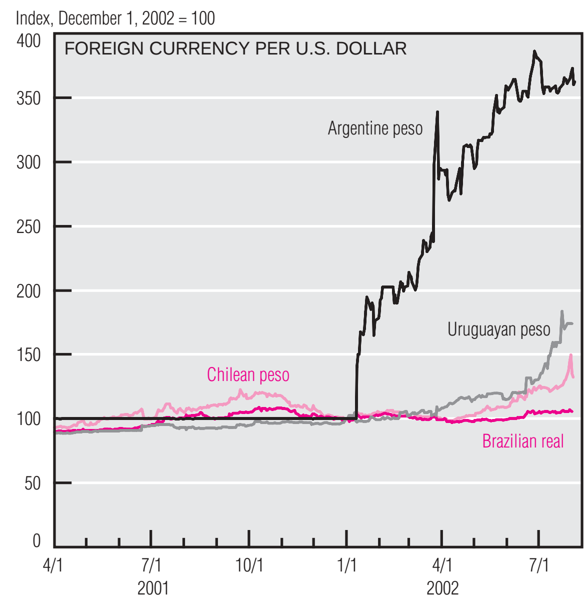
Problem S&Ls (those with substandard examination ratings) rose to 1.45%, the highest level since 1997. However, asset quality is not a significant problem for FDIC-insured savings associations, where the percent of unprofitable institutions is falling. Since the end of 2001, the coverage ratio has dropped from $1.02 in loan loss reserves for every dollar of noncurrent loans to 99 cents per dollar. The $205 million increase in loan loss reserves was less than the $430 million increase in noncurrent loans; the result was a decline in the coverage ratio. In 2002:IQ, core capital, which protects savings associations against unexpected losses, rose to 7.89% from 7.80% in 2001.

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.

Policy settings at the four major central banks have remained unchanged throughout this year. Recently, market speculation in the U.S. has shifted somewhat with the emergence of uncertainty as to whether the next policy move will be an increase or a decrease.

The Bank of Japan has continued to supply about ¥15 trillion in current account balances, at the upper end of its policy target of ¥10 trillion–¥15 trillion. Likewise, excess reserves' swollen value continues about unchanged. Banks have retained as excess reserves almost 90% of the nearly threefold increase in current account balances over the past year. Another 9% has been added to the balances of financial institutions not subject to reserve requirements. Only 2% of the growth in current account balances has been used to meet increased need for required reserves. Although they account for only this small portion of current account balances' massive increase, required reserves nonetheless grew 4.8% over the past year (June 2001–June 2002), while nominal GDP probably fell over the same period.

Rate increases have been seen this year in the "dollar" countries of New Zealand, Australia, and Canada and in the non-euro central banks of Sweden and Norway. Rate cuts have been prevalent among central banks in Eastern Europe and Latin America, with very wide rate swings in some members of both groups. Rate cuts are also evident in some far eastern nations but not in Singapore, South Korea, or China.

In Argentina, a month's rapid peso depreciation was reversed around the beginning of July, while Uruguay's peso came under continued pressure.