

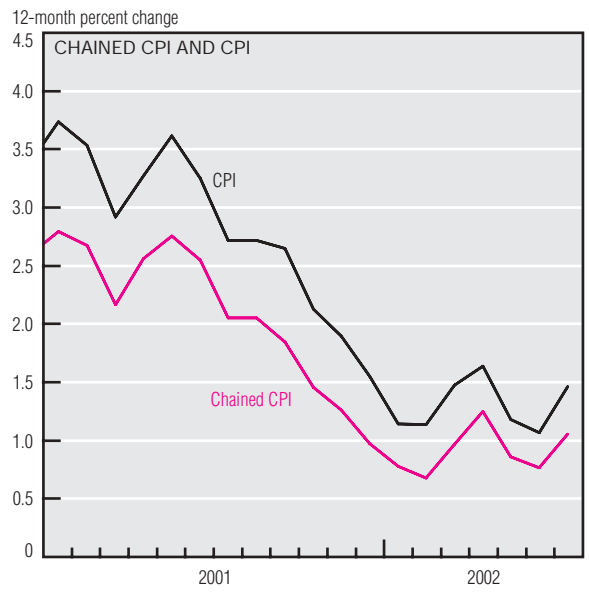
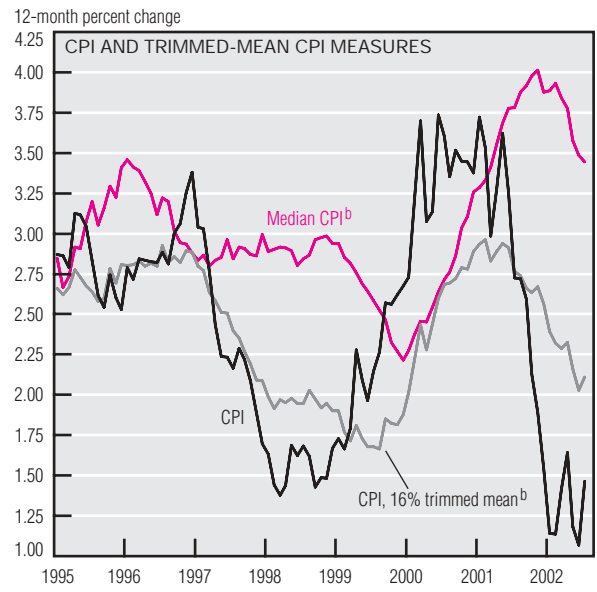
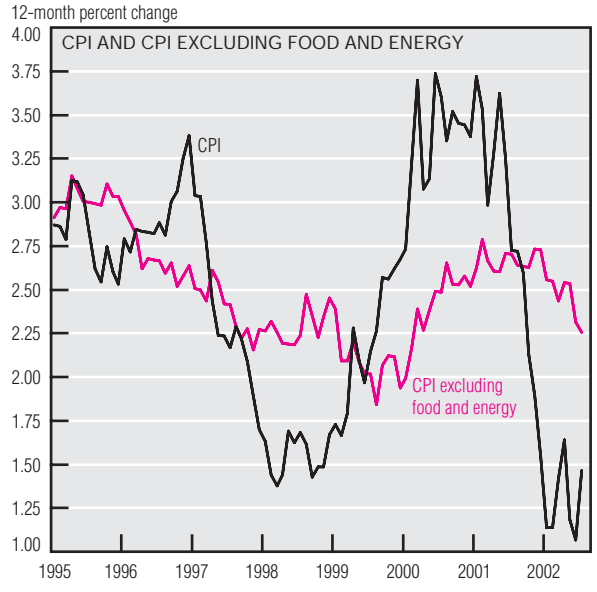
# *The Economy in Perspective*

*(with apologies to William Shakespeare)*

*To cut, or not to cut*—that is the question:  
 Whether 'tis nobler in the end to suffer  
 The slings and arrows of a slow expansion,  
 Or aim policy against a sea of troubles,  
 And by opposing end them? To cut: to reduce  
 A quarter point or more; and thereby strive to end  
 The heartache and the thousand natural shocks  
 Th'economy is heir to. 'Tis a consummation  
 Devoutly to be wish'd. To cut, t'offset—  
 T'offset—perchance to dream: ay, there's the rub;  
 For in th'attempt to counteract, what else may come  
 When we provide still more liquidity  
 Must give us pause. There's the respect  
 That makes calamity of too much money.  
 And who'd deny that commerce now doth wax,  
 Tho' it be slow and without equal measure,  
 Despite pangs of consumer sentiment,  
 The dearth of capital spending, and the ills  
 That linger over trade with foreign lands?  
 Cannot the Fed e'en now provide its aid  
 By means of actions previously taken?  
 Or must it spur the markets further yet,  
 Hoping that rates beneath today's will be  
 The fulcrum whence our commerce may rebound?  
 Are interest rates not now too low to last,  
 Or must we step once back to step twice forward?  
 Will more liquidity buoy up the argonaut  
 Or drown his patience, that most undervalued virtue?  
 Such thoughts do tempt the will,  
 But should we rather bear those ills we have  
 Than fly to others that we know not of?  
 Thus conscience makes hard choices for us all.  
 Messengers bring news of pith and moment  
 And we parse their reports ten-fold, nay, more,  
 Examining each meaning in our councils.—Soft you now!  
 Tho' in their balance stars may point to weakness  
 Our policy's accommodative still.  
 Transcripts of history!—In thy report  
 Will our intentions gain transparency.

# Inflation and Prices

	Percent change, last:				
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	2001 avg.
<b>Consumer prices</b>					
All items	1.3	0.9	1.5	2.3	1.5
Less food and energy	1.9	1.5	2.3	2.3	2.7
Median <sup>b</sup>	3.0	2.8	3.4	3.1	3.9
<b>Producer prices</b>					
Finished goods	-2.6	-2.0	-1.1	-1.1	-1.7
Less food and energy	-3.9	-0.5	-0.2	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 rose 0.1% (1.3% annual rate) in July, the same rate of increase it posted in June. According to the Labor Department, the CPI indexes for food and energy, which were unchanged in June, rose 0.2% for food (2.1% annual rate) and 0.4% for energy (5.0% annual rate) in July. Moreover, the CPI communications index rose sharply during the month, partly because of a hike in postal rates.

Over the most recent 12 months, the CPI has risen at a modest 1.5% rate. Core measures of inflation, by

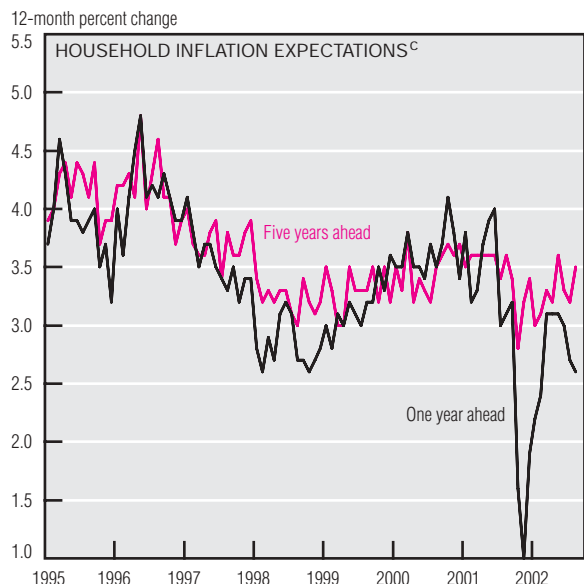
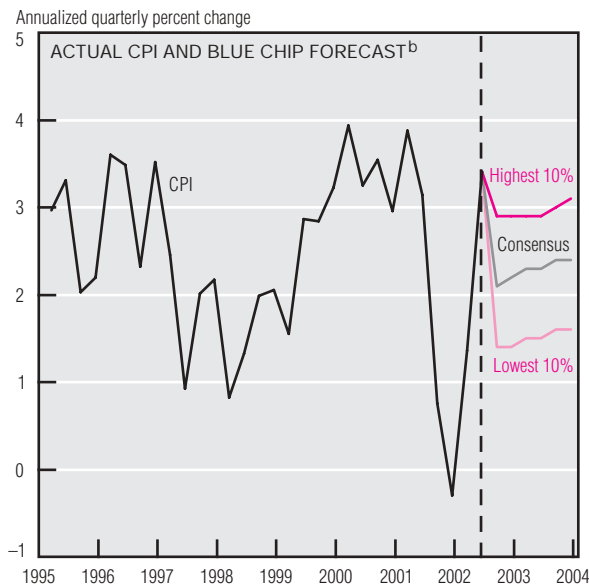
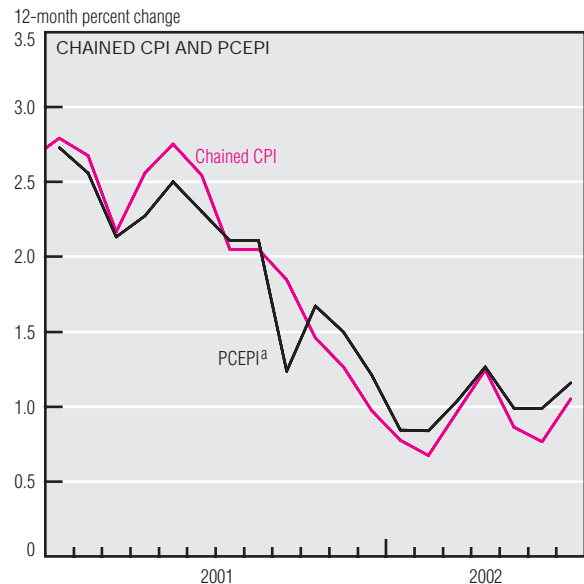
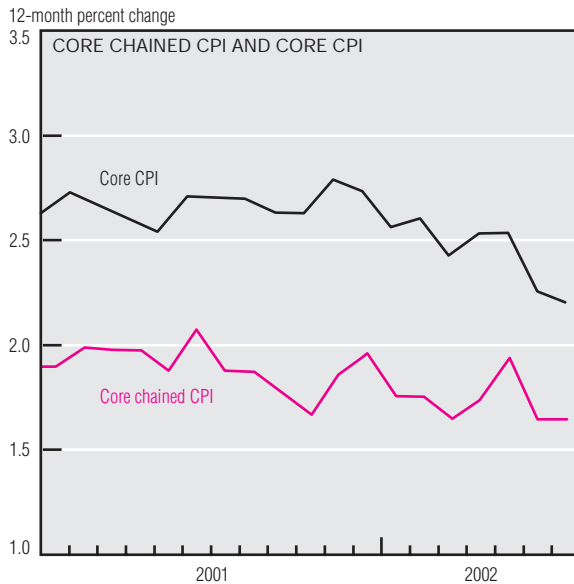
contrast, continue to rise more rapidly. The CPI excluding food and energy, for instance, rose at a 2.3% rate over the past 12 months. During the same period, the trimmed-mean inflation measures—the median CPI and the 16% trimmed-mean CPI—rose 3.4% and 2.1%, respectively. Despite the faster rate of increase, however, all core measures have been trending down throughout the course of this year.

In July, the Labor Department issued a new index, the chained CPI, which is intended to improve on the conventional CPI by addressing the

issue of substitution bias. Substitution bias arises when a price index fails to account for the way a change in (relative) prices might cause consumers to change how they allocate expenditures among the items in their market basket. The conventional CPI, for instance, assumes that the market basket remains fixed: No matter how much the price of one good may rise relative to others, consumers are assumed to continue buying these goods in the same relative quantities. The chained CPI, by contrast, uses a method that accounts for the fact

*(continued on next page)*

## Inflation and Prices (cont.)



a. Personal Consumption Expenditures Price Index.

b. Blue Chip panel of economists.

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

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; University of Michigan; and *Blue Chip Economic Indicators*, August 10, 2002.

that the consumers' market basket changes over time in response to changes in relative prices.

Estimates of the substitution bias inherent in the conventional CPI calculation have generally been lower than +0.5% annually. Indeed, a commission convened by the Senate Finance Committee in the mid-1990s concluded that inflation was being overestimated by 0.2%–0.4% annually. The chained CPI has been available only for the last few years, but simulations by the Bureau of Labor Statistics indicate that these bias estimates were appropriate for most of the 1990s.

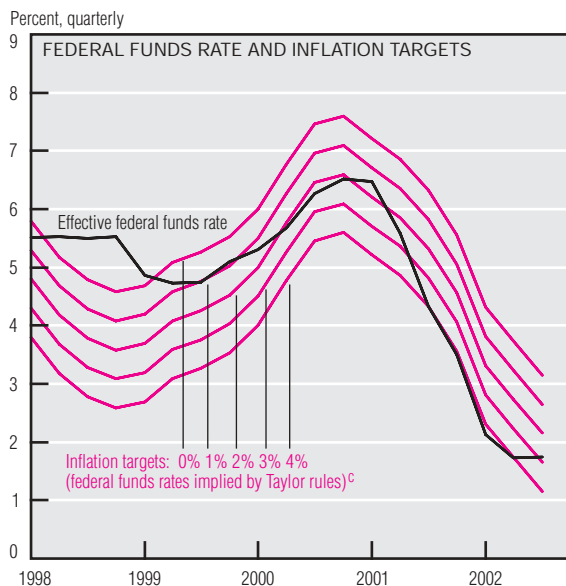
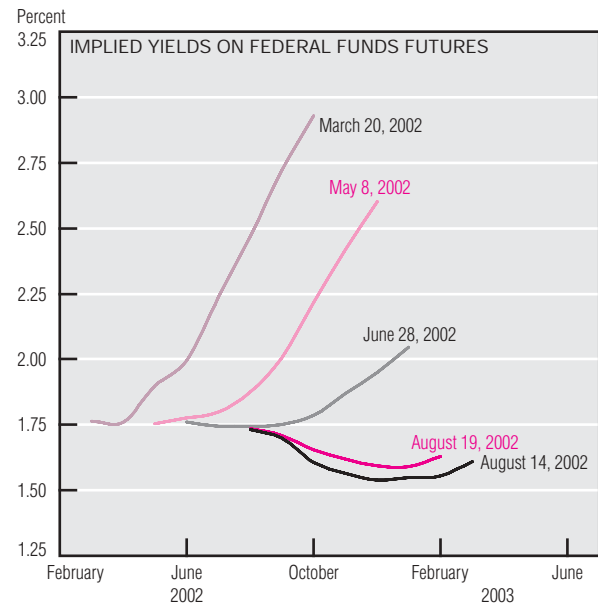
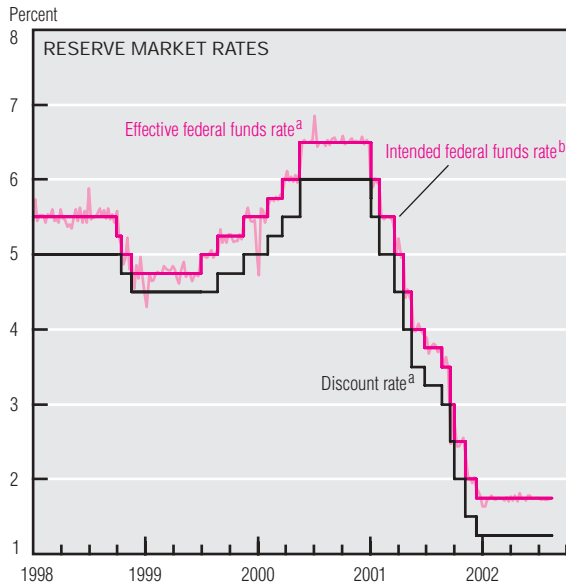
During the current decade, the gap has become much more pronounced, often nearly a full percentage point. In recent months, however, the difference between the year-over-year differential has narrowed to about 0.4%.

Chaining the core measure tells much the same story, with differences in annual growth between the chained and conventional indexes at or near a full percentage point in 2000 and 2001 and narrowing to 0.6% in the most recent several months. Interestingly, the measure that tracks the chained CPI most closely is the

Personal Consumption Expenditures Price Index, which uses a similar chaining method.

Economists' consensus expectation of inflation is about 2.5% over the next 18 months. Households seem optimistic about the inflation outlook over the short run: Their year-ahead expectations of inflation have fallen for the third consecutive month. However, households are less sanguine about the inflation outlook for the next five years or so; these longer-run expectations have been trending up since the beginning of this year.

# Monetary Policy



## Federal Funds Rate Policies, 1982–2002

	Avg.	Max.	Min.
<b>Increase</b>			
Number of months	3.7	12.1	0.7
Percent change	1.09	3.25	.125
<b>Decrease</b>			
Number of months	6.3	39.7	1.4
Percent change	1.61	6.75	.25
<b>Stationary</b>			
Number of months	8.4	18.4	0.9

a. Weekly average of daily figures

b. Daily

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

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

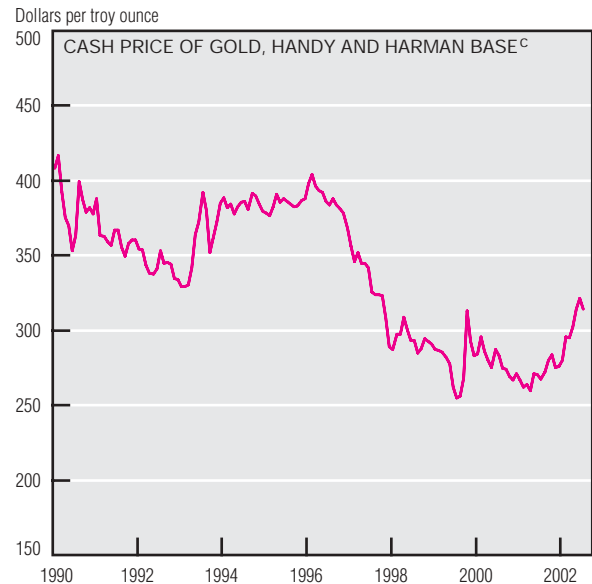
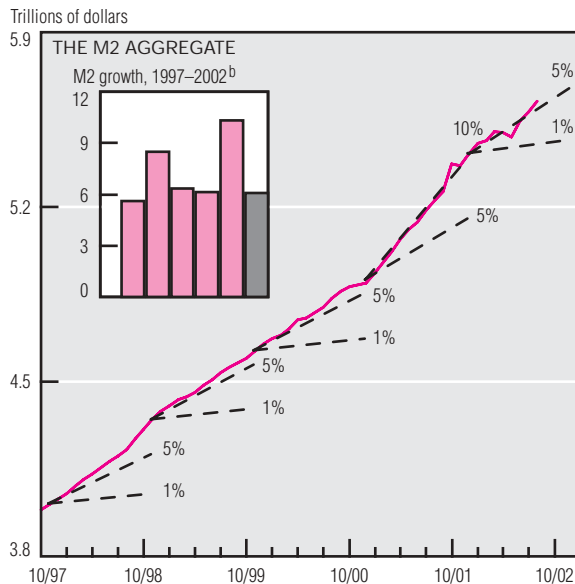
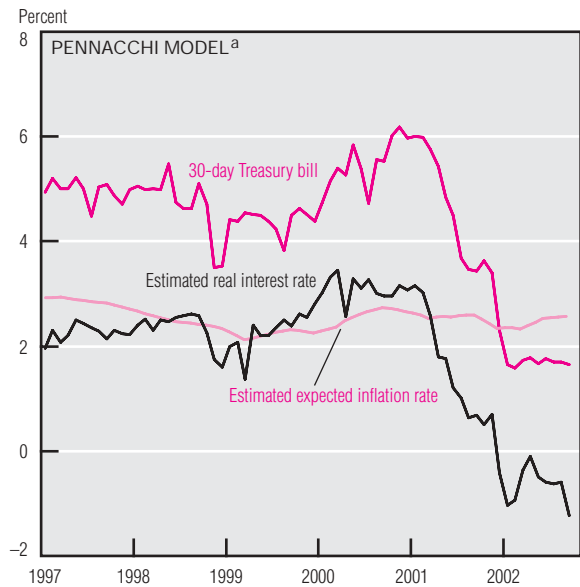
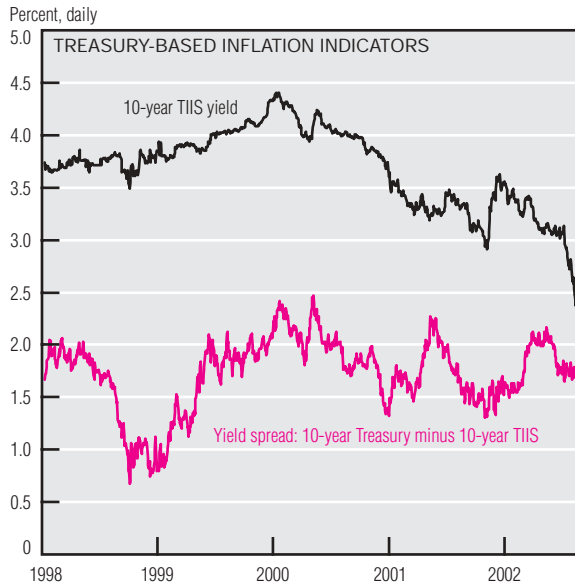
At its August 13 meeting, the Federal Open Market Committee left the target federal funds rate unchanged, although it altered the balance-of-risk statement "towards conditions that may generate economic weakness." The federal funds futures market now has built in a strong possibility of lower rates. With implied yields reaching a minimum of 1.59% in February 2003, the market seems quite confident of a 25 basis point cut by early next year.

The Taylor rule, one gauge of monetary policy, posits that the FOMC chooses the target rate as a balanced response to weakness and inflation. The form of the Taylor rule depends on the weights given to inflation and output, and to the assumed inflation target. Recently, the rule has correctly predicted the direction of changes in the federal funds rate.

Waiting can be the hardest part, but the eight and a half months since the target federal funds rate

last moved is about the average period of no action over the past 20 years. The most recent rate reduction far exceeded the average, both in duration (11 months) and in the size of the decline (4.75%), although it set no records in either. Cumulative rate reductions have been larger and have taken longer to implement than cumulative rate increases. On average, however, periods when the FOMC has held rates steady have been the longest.

# Money and Financial Markets



a. The estimated expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median-forecast GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.

b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.

c. *Wall Street Journal*.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15; Bloomberg Financial Information Services; and *Wall Street Journal*.

The Federal Open Market Committee's August 13 statement indicated that the balance of risks for the economy tilted toward economic weakness, a change from its previous statement that economic weakness and inflation were evenly balanced. How do the financial markets view the current balance of risks? Put another way, do market participants see a 1.75% federal funds rate or an

M2 growth rate of more than 5% as a sign of inflation?

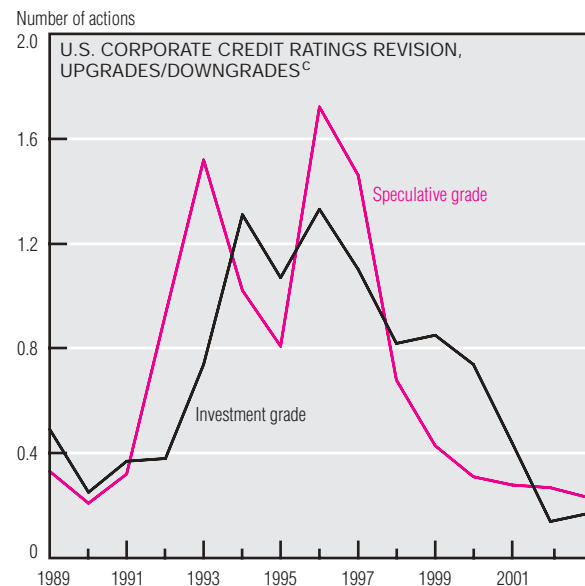
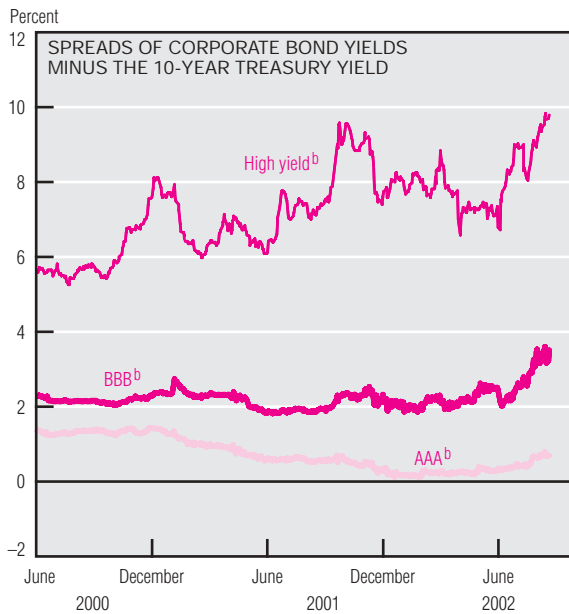
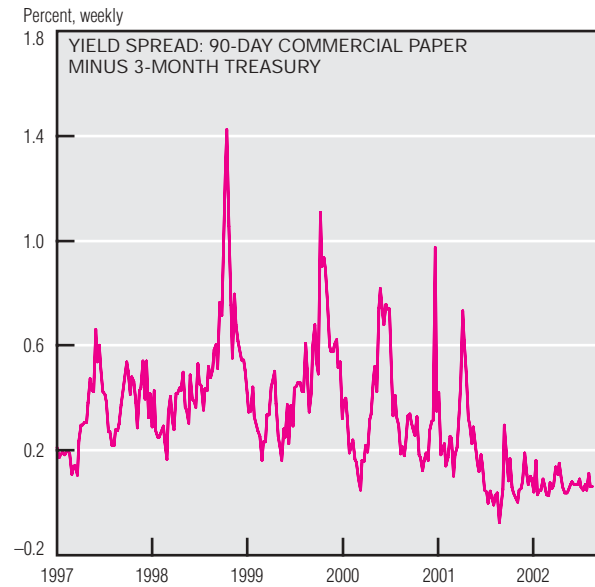
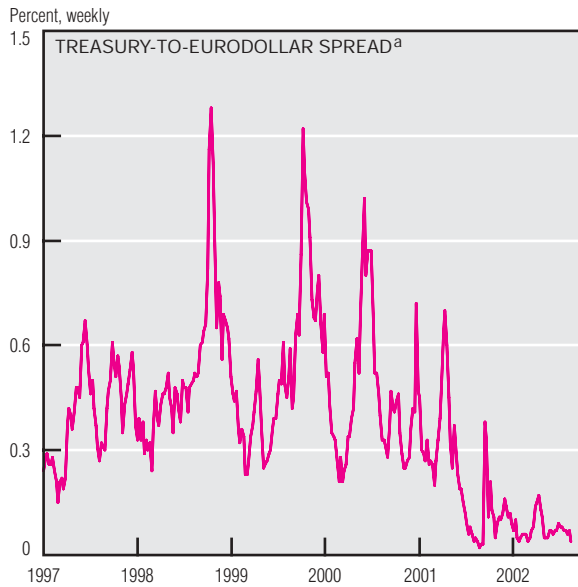
Over the long term, the answer seems to be no. One market measure of expected inflation, the spread between yields on 10-year nominal Treasury bonds and 10-year Treasury inflation-indexed bonds, has fallen. In late May, the spread implied expected inflation exceeding 2%; it now implies values closer to 1.75%. In the short term, the

answer again appears to be no. A measure of expected inflation over the next 30 days, derived from surveys and Treasury bill rates, suggests a rate of only 2.4%

A less favorable indicator of inflation risk comes from the gold market, where prices have increased 21% since April 2001 and 12% since the beginning of this year. However, the price of gold is not an infallible sign of inflation because often it is

(continued on next page)

## Money and Financial Markets (cont.)



a. Three-month eurodollar minus three-month, constant-maturity Treasury bill yield.

b. Merrill Lynch AA, BBB, and 175 indexes, each minus the yield on the 10-year, off-the-run Treasury yield.

c. Moody's Investors Services.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15; and Bloomberg Financial Information Services.

affected by specific market factors such as central bank sales or jewelry demand.

A rise in gold prices often reflects a flight to security when the economic or political outlook becomes uncertain, but other measures of risk in the financial world do not point to uncertainty. The TED spread, the yield difference between eurodollar deposits and Treasury bills, often picks up on such concerns because it measures

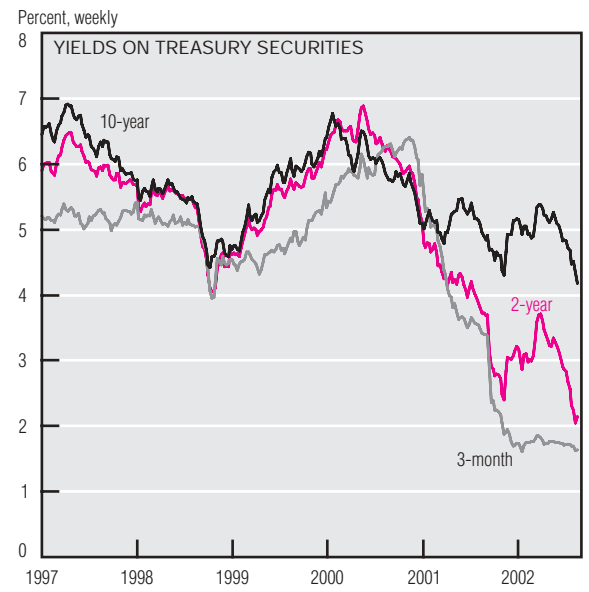
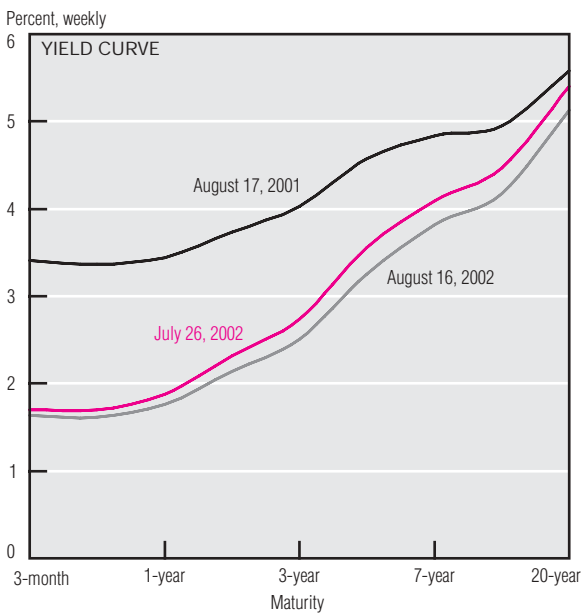
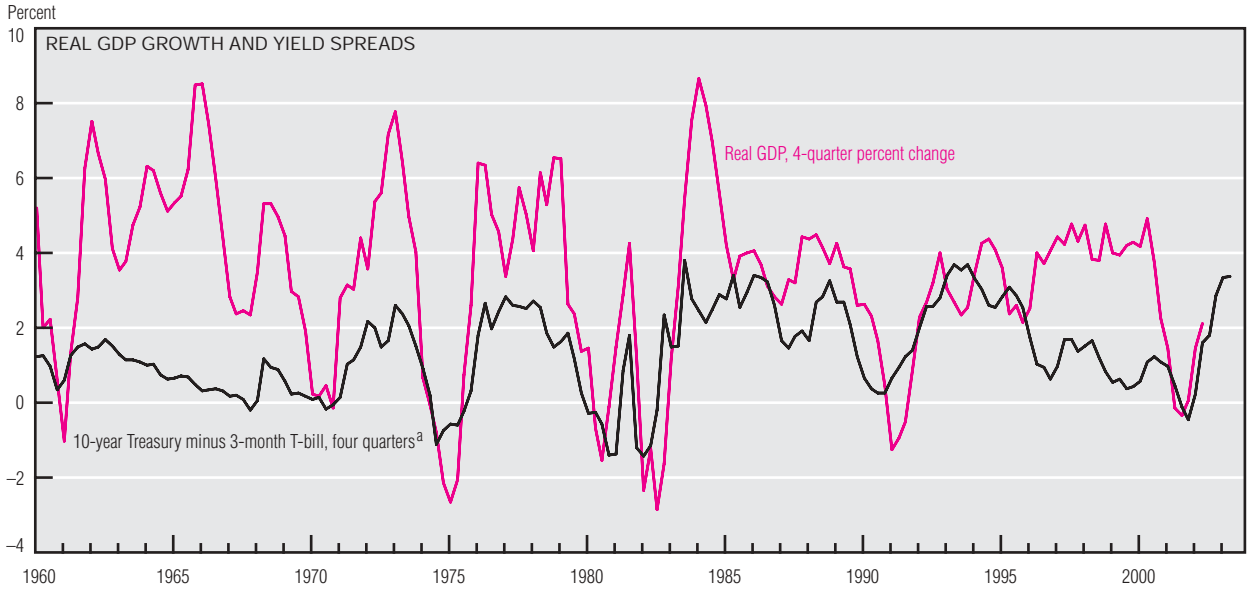
credit risk at international banks without reflecting exchange rate risk; it remains very low. In the domestic market, the yield spread between 90-day commercial paper and three-month Treasury bills also remains quite low.

At the lower end of the credit spectrum, things look less rosy. Spreads over Treasuries of both high-yield and BBB-rated bonds have increased substantially in recent months. Thus,

credit concerns seem to be growing, at least for lower-rated borrowers. Such borrowers become more important if we turn from rates to ratings. In any given year, some firms get stronger and others get weaker, but a good measure of the overall trend is the ratio between ratings upgrades (receiving a higher—that is, better—rating, which suggests the company has become less risky) and downgrades. Not only have

(continued on next page)

# Money and Financial Markets(cont.)



a. Ten-year constant maturity Treasury minus three-month, secondary-market Treasury bill yield.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15.

downgrades outnumbered upgrades for the past several years, but the trend in the ratio has worsened as well.

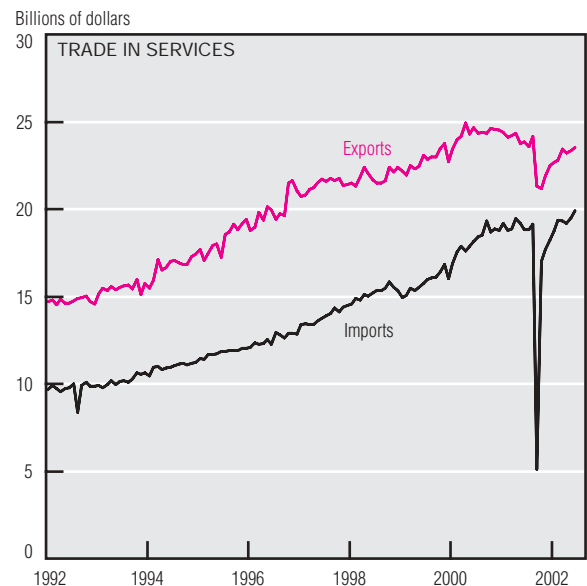
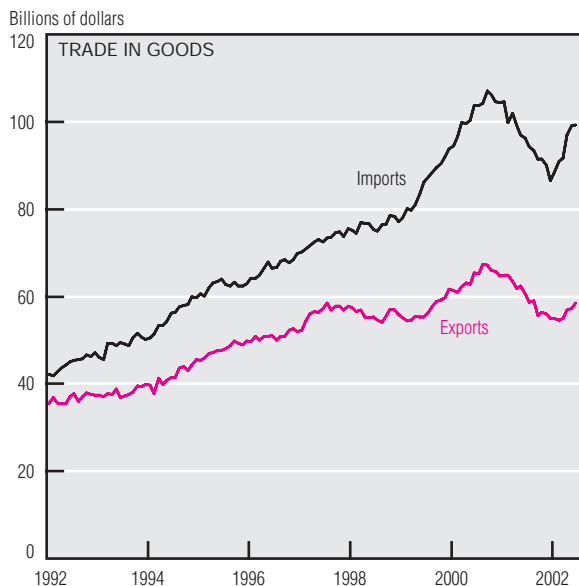
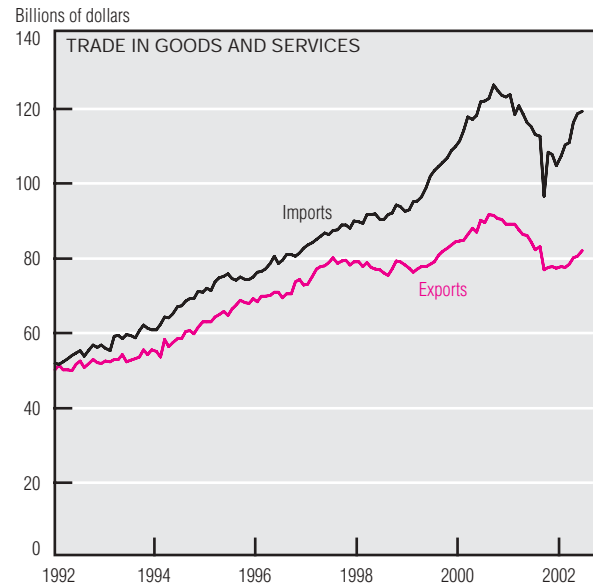
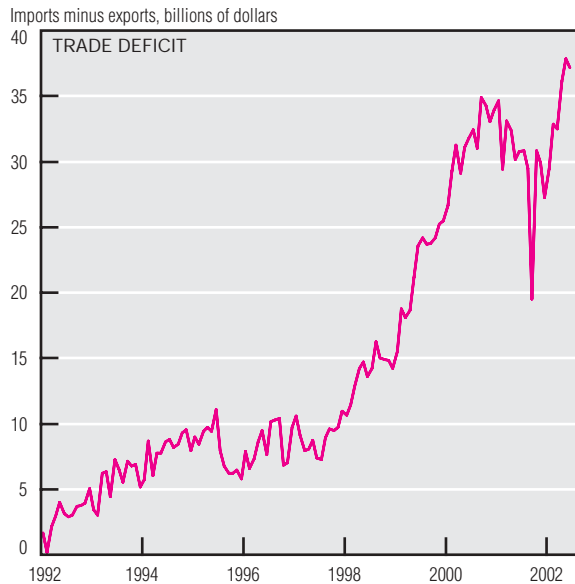
A classic measure of risk in the economy is the term structure of interest rates coming out of the Treasury yield curve. The yield curve has moved little since last month, although it has steepened noticeably since this time last year, mainly

because short rates have fallen. For most of 2002, however, short rates have held steady, with longer-term rates dropping 120 basis points since late spring.

In the past, a steep yield curve indicated robust economic growth. Plotting the 10-year, 3-month spread against GDP growth for the year ahead shows that the yield curve has been a fairly reliable signal since

1960, although periods of high growth occasionally are accompanied by a low spread. A negative spread (inverted yield curve) reliably indicates recessions, although, like many other signs, it was confused by the 1967 mini-recession. Thus, while the present steep yield curve may not guarantee a strong recovery, it suggests a low likelihood of a "double-dip" recession.

# International Trade



SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

In June, the U.S. trade deficit—the difference between exports and imports of goods and services—fell \$0.7 billion to \$37.2 billion. A deficit occurs when imports exceed exports. Both exports and imports increased in June, but the deficit narrowed because exports increased more than imports. The U.S. trade deficit emerged in 1992 and grew steadily until 1998, but it has tripled since then, reaching an all-time high of \$37.8 billion in May.

In June, the goods deficit fell by \$0.9 billion from May's record level to

\$40.8 billion. Goods exports rose from \$57.3 billion to \$58.5 billion, and goods imports increased from \$99.0 billion to \$99.3 billion. The May-to-June change in the goods balance reflects increased trade in capital goods, consumer goods, and foods, feed, and beverages; and decreased trade in industrial supply and materials, and automotive vehicles, parts, and engines.

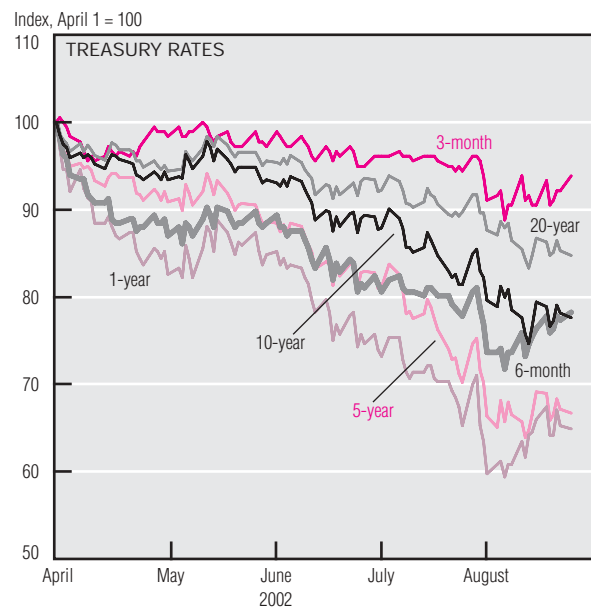
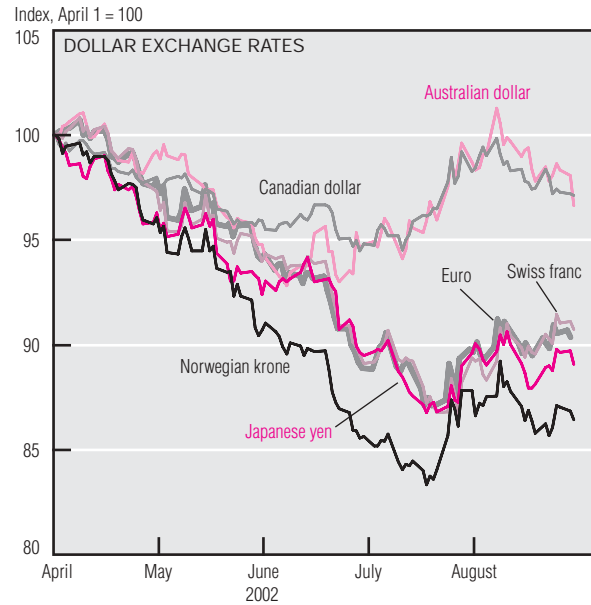
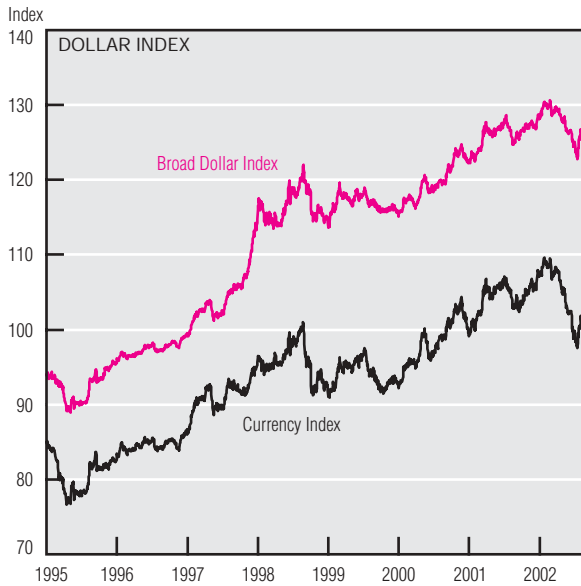
While most people are aware of the trade deficit, not everyone realizes that the U.S. runs a surplus in services trade, perhaps because the surplus is

relatively small. In June, the services surplus decreased \$0.2 billion to \$3.6 billion as services exports increased from \$23.4 billion to \$23.5 billion and services imports increased from \$19.5 billion to \$19.9 billion. The May-to-June change in the services balance reflected increased exports in royalties and license fees services.

Rising imports suggest that U.S. domestic demand for goods and services remains strong. Rising exports also indicate strength in foreign demand for U.S. goods and services.



# International Markets



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

The Broad Dollar Index measures the average change in the dollar's exchange rate against the currencies of our 36 most important trading partners. The Major Currency Index measures the average change against major international currencies such as the euro, the Australian and Canadian dollars, and the U.K. pound. Both of these indexes have increased in value between the last half of the 1990s and the beginning of this year. Both fell sharply in the first half of this year and have more or less stabilized since then.

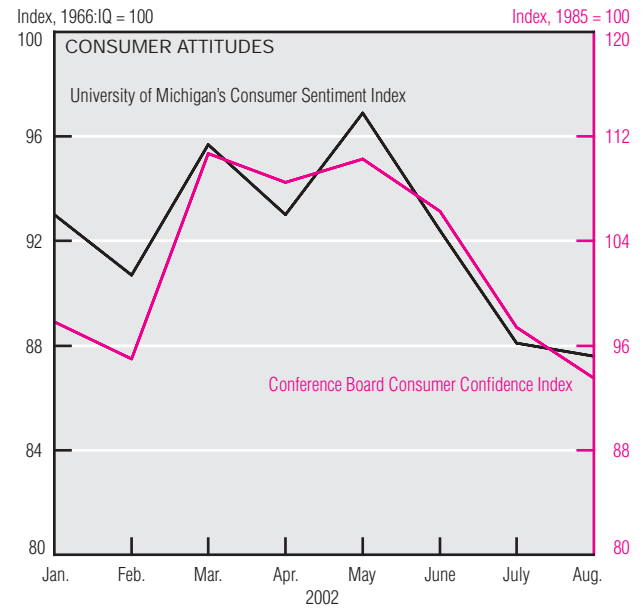
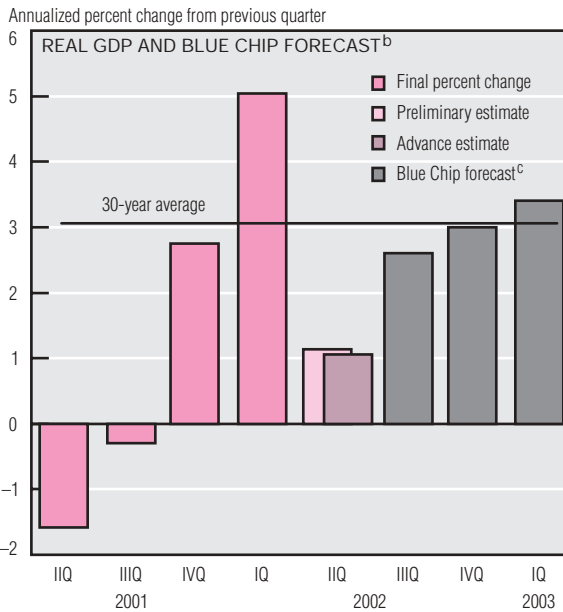
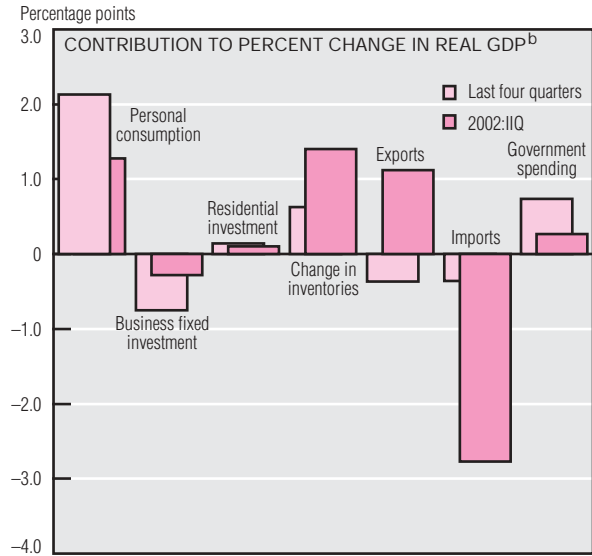
The values of other nations' currencies against the U.S. dollar do not necessarily rise and fall together. In April and May, for example, the U.S. dollar depreciated against several currencies, including the Canadian dollar and the Japanese yen. Since June, the dollar has appreciated against the Canadian and Australian dollars and depreciated against the Japanese yen, the euro, the Swiss franc, and the Norwegian krone.

In the last four weeks, stock market values around the world have risen. Since April, however, they have

fallen significantly in many countries. One of the hardest hit markets is the NASDAQ, which has lost about 28.5% since April 1. Japan's NIKKEI 225 has outperformed several important stock indexes but has still managed to lose about 12.8% of its value over the same period. The value of U.S. Treasuries at virtually all maturities has increased since April, as reflected by a decrease in their interest rates. In early August, the yield on a two-year note dropped as far as 1.9%, its lowest level in almost 40 years.

# Economic Activity

	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	26.4	1.1	2.1
Personal consumption	30.0	1.9	3.1
Durables	5.3	2.2	7.5
Nondurables	0.5	0.1	3.2
Services	23.9	2.7	2.1
Business fixed investment	-7.7	-2.6	-6.4
Equipment	7.3	3.1	-2.9
Structures	-11.6	-17.7	-15.6
Residential investment	2.1	2.3	3.1
Government spending	6.1	1.4	4.0
National defense	7.2	7.6	9.5
Net exports	-47.5	—	—
Exports	30.3	12.3	-3.4
Imports	77.9	22.8	2.7
Change in business inventories	36.2	—	—



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. All data are seasonally adjusted and annualized.  
 c. Blue Chip panel of economists.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; *Blue Chip Economic Indicators*, August 10, 2002; Conference Board; and University of Michigan.

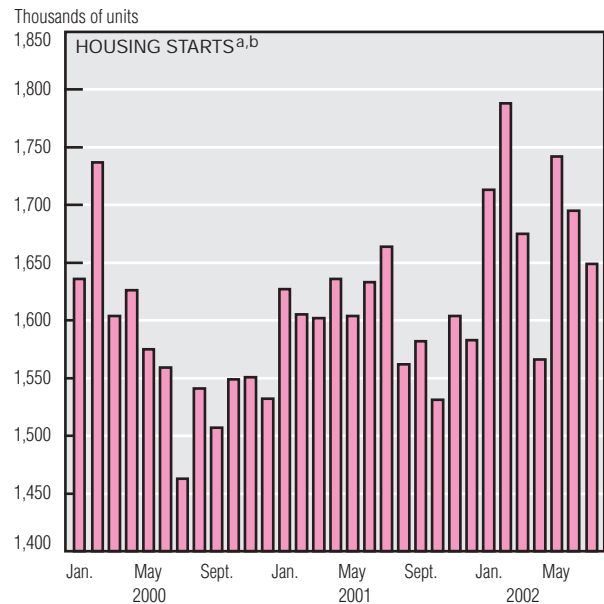
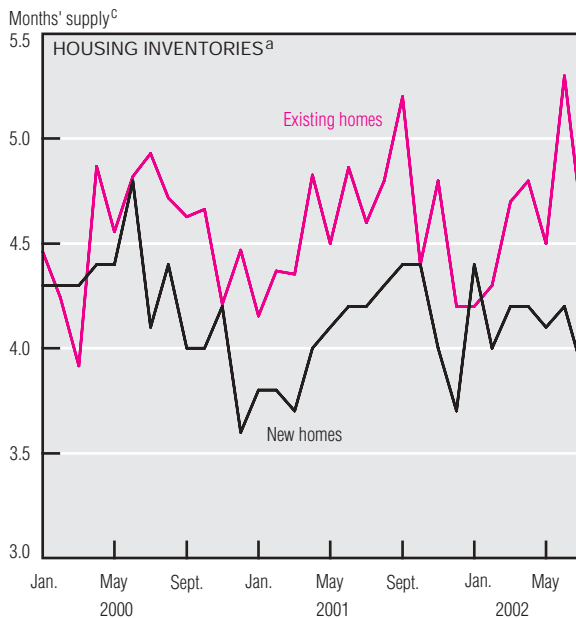
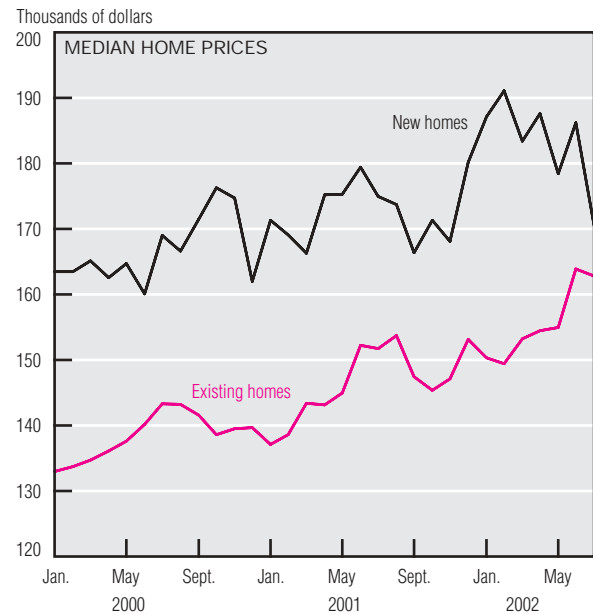
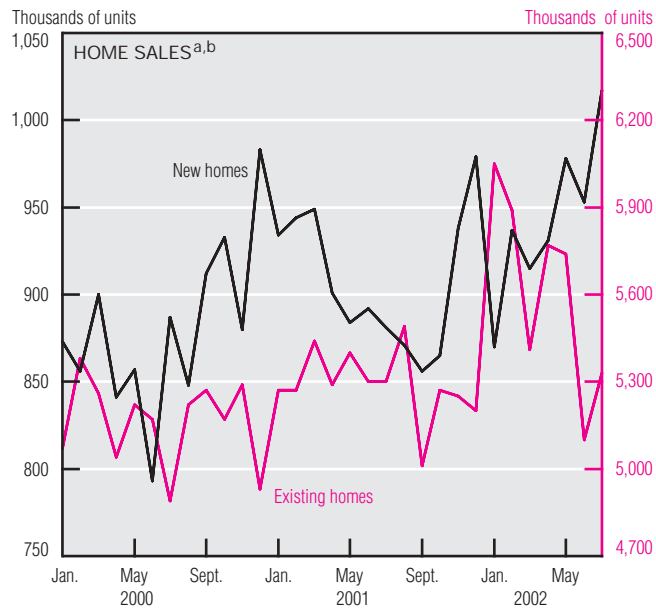
Preliminary estimates of the national income and product accounts showed that real gross domestic product increased at an annual rate of 1.1% in 2002:IIQ. August's preliminary estimate of real GDP growth was essentially unchanged from July's advance estimate. Personal consumption, residential investment, and government spending all increased. However, the growth rate for each of these categories was lower than in the previous four quarters. On a somewhat positive note, business fixed investment decreased only 2.6%—less than half

its rate of decrease over the past year. The increase of \$77.9 billion (chained 1996 dollars) in imports was more than double the increase in exports. Imports, the greatest drag on the economy, reduced real GDP growth by 2.8%. Changes in inventories gave GDP growth its biggest boost (1.4%). Forecasters and consumers have reassessed their outlook in recent months. After July's modest advance estimate of real GDP growth in 2002:IIQ, Blue Chip forecasters changed their projections. Now they do not expect quarterly real GDP

growth to surpass its long-term average until 2003:IQ (previously they had forecasted 2002:IIIQ). Consumer confidence measures likewise have remained depressed. In July, the Conference Board noted that falling stock prices, coupled with reports of corporate scandals, were damaging the Consumer Confidence Index. That index, as well as the University of Michigan's Consumer Sentiment Index, declined further in August. They have moved in tandem throughout 2002.

(continued on next page)

## Economic Activity (cont.)



a. Seasonally adjusted.

b. Annualized.

c. Months' supply is the ratio of houses for sale to houses sold. It indicates how long the inventory currently for sale would last at the current sales rate if no additional houses were built.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and National Association of Realtors.

After 2001, when sales of new and existing homes reached record highs, many observers expected the housing sector to cool off considerably, but events have not justified their fears. In July, new home sales rose nearly 7% to a record high of 1.02 million units (annual rate). Although existing home sales have retreated from the record high of 6.05 million units (annual rate) in January 2002, forecasters remain optimistic. Noting that existing home sales rose 4.5% in July, the National Association of Realtors projected that 2002 sales

of existing homes would top the record set in 2001.

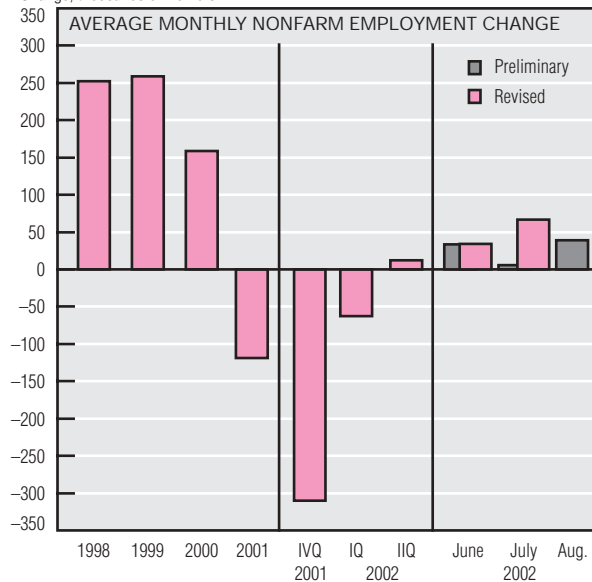
Overall, home prices have gained momentum in recent months. The median price of existing homes rose between February and June. Even after July's modest decline, their price was \$11,100 higher than a year earlier. The median price of new homes rose to a record \$191,900 in February 2002; however, after a series of staggered declines, by July the price level was \$170,500—lower than in July 2001. But remember that there are only about one-fifth as many new home sales as existing home sales. High

prices have prompted talk of a "housing bubble," but whether recent prices warrant that label remains to be seen.

As vigorous demand drove overall home sales up in July, housing inventories declined. Since January 2002, inventories of existing homes have risen and those of new homes have fallen. The level of housing starts appears more volatile in 2002 than in the previous year. Even after the most recent decline, July's annualized rate of housing starts surpassed all but two months in 2000–2001.

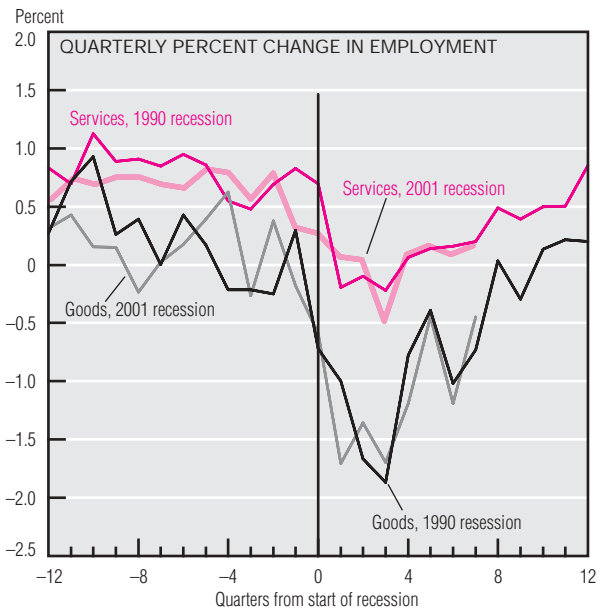
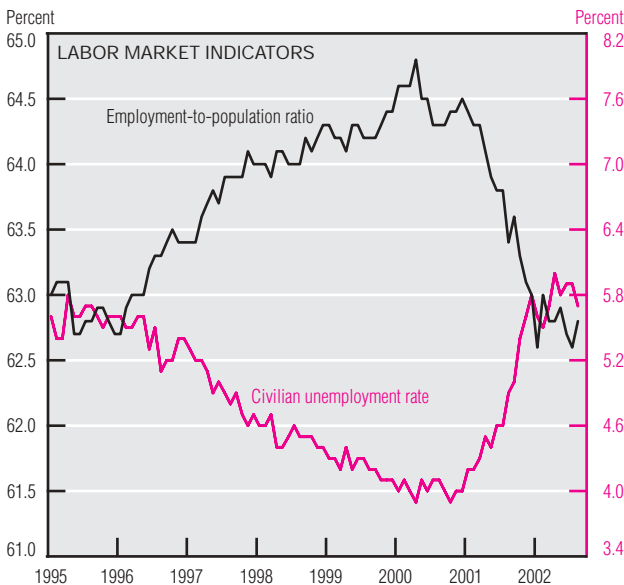
# Labor Markets

Change, thousands of workers



## Labor Market Conditions

	Average monthly change (thousands of employees)				
	1999	2000	2001	Jan.-July 2002	Aug. 2002
Payroll employment	259	159	-119	-12	39
Goods-producing	8	-1	-111	-63	-33
Mining	-3	1	1	-2	1
Construction	26	8	-3	-16	34
Manufacturing	-16	-11	-109	-45	-68
Durable goods	-5	1	-79	-34	-46
Nondurable goods	-11	-12	-30	-10	-22
Service-producing	252	161	-8	51	72
TPU <sup>a</sup>	19	17	-23	-10	-13
Wholesale and retail trade	60	25	-31	0	-63
FIRE <sup>b</sup>	7	5	10	-2	7
Services <sup>c</sup>	132	92	-2	47	100
Health services	9	15	27	22	26
Help supply	32	0	-54	13	51
Government	35	22	39	16	41
<b>Average for period (percent)</b>					
Civilian unemployment rate	4.2	4.0	4.8	5.8	5.7



NOTE: All data are seasonally adjusted.

a. Transportation and public utilities.

b. Finance, insurance, and real estate.

c. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.

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

Nonfarm payroll employment grew by 39,000 jobs in August. Estimates for July employment growth were revised upward to 67,000, far higher than the previously estimated growth of 6,000 jobs. The revised July increase is well above the average monthly gain of 12,000 jobs in 2002:IIQ and the average monthly loss of 63,000 jobs in 2002:IQ, suggesting further improvement in the labor situation.

The service-producing sector showed an increase in jobs, and the goods-producing sector posted a decrease. Although construction and mining reported a combined gain of 35,000 jobs, both durable and non-

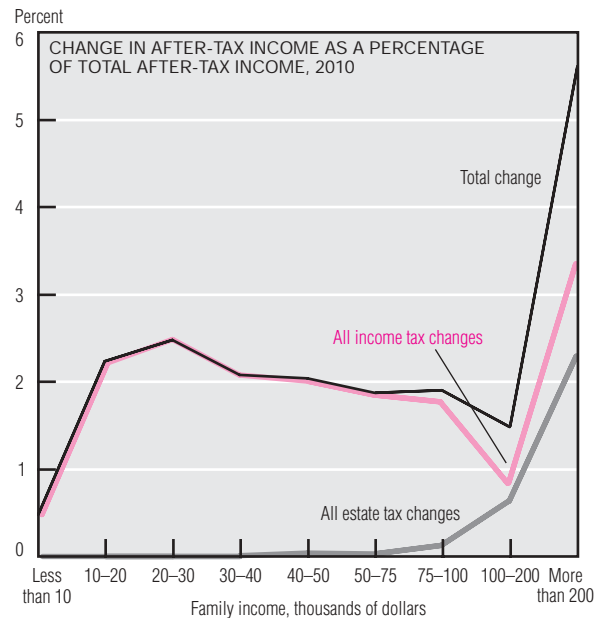
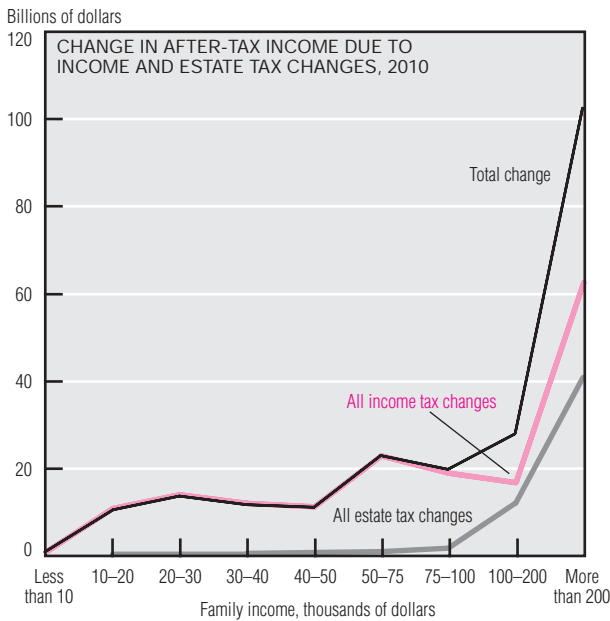
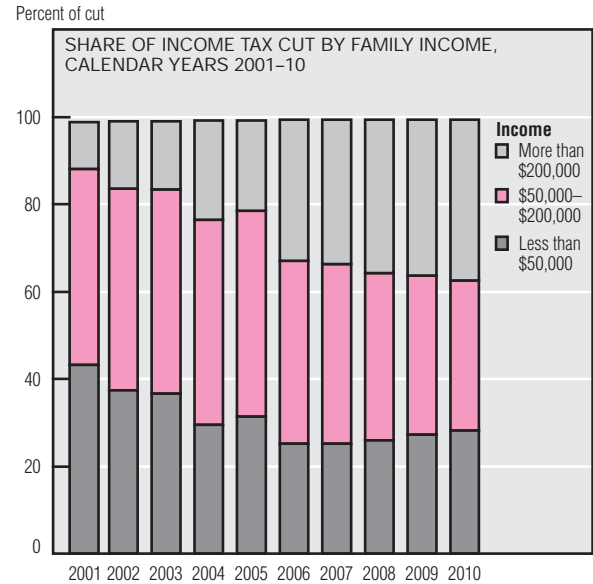
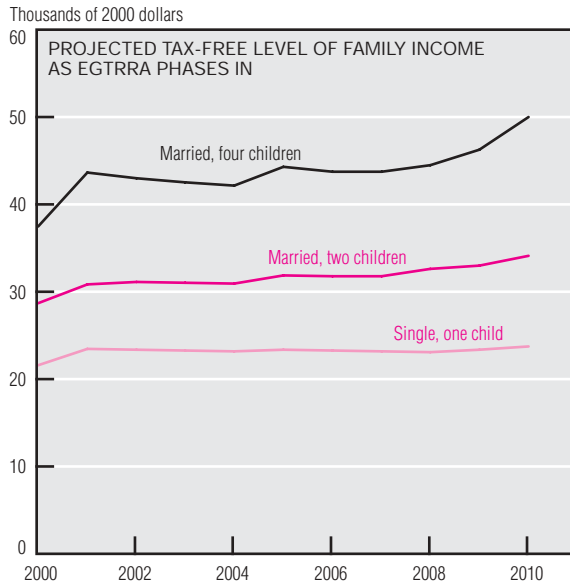
durable manufacturing declined. The goods-producing sector showed an average monthly loss of 63,000 jobs from January through July 2002. Services, government, and finance, insurance, and real estate gained jobs in August. Between January and July, monthly employment growth in wholesale and retail averaged zero, but this sector lost 63,000 jobs in August. Help supply services showed a net gain of 51,000 jobs in August, reinforcing the steady employment recovery.

Between July and August, the unemployment rate dropped 0.2 percentage point to 5.7%, the lowest level since March of this year. The

ratio of employment to population increased 0.2 percentage point to 62.8%, continuing the month-to-month volatility that has been evident since January 2002.

During the recession that began in 2001:IQ, employment changes in goods and service-producing industries have followed patterns similar to those of the 1990 recession. For service-producing sectors, the dip into negative employment change lasted less than four quarters during both recessions. The most recent data suggest continued progress toward resuming employment growth in the goods-producing sector.

# The Impact of 2001 Tax Cut Legislation



NOTE: Data are from the Urban-Brookings Tax Policy Center's microsimulation model.

SOURCE: Len Burman, Elaine Maag, and Jeff Rohaly, "EGTRRA: Which Provisions Spell the Most Relief?" Urban-Brookings Tax Policy Center Report no. 3, June 2002.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 phases in tax cuts through 2010. Its provisions are "sunset" at the end of calendar year 2010, but few expect the cuts to be eliminated entirely. The version of the tax cut bill that Congress passed after strenuous debate contains benefits for households at all income levels.

Modifications to the child tax credit, the child and dependent care tax credit, and the earned income tax credit benefit low-income groups the

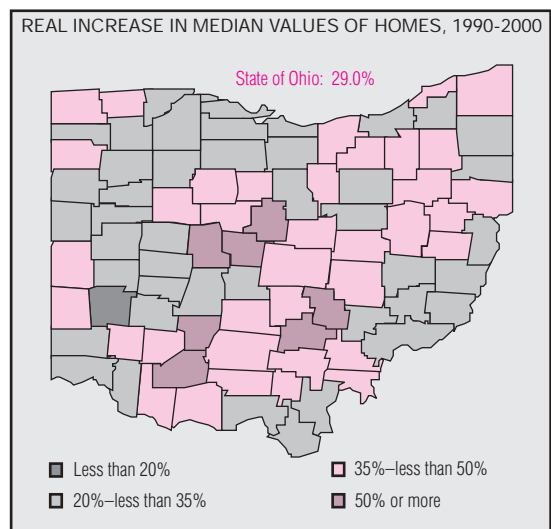
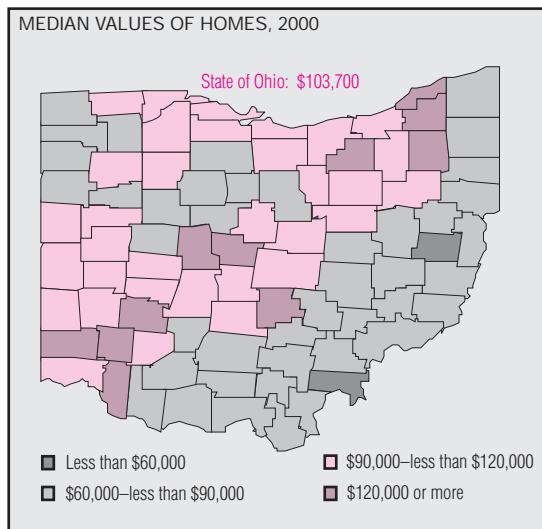
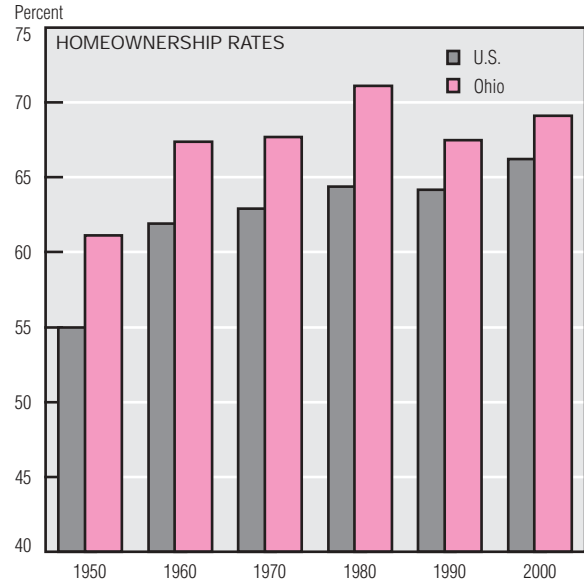
most. Overall, these changes will benefit households with children far more than households that have none. For example, tax-free income, one measure of the new provisions' benefit, will increase most for households with four or more children.

Reducing the marriage tax penalty will benefit both low- and middle-income groups, and the scheduled lowering of marginal income tax rates will benefit all income groups. However, the act's failure to simultaneously increase the alternative

minimum tax threshold means that benefits to middle-income households will shrink over time. Because elimination of the estate tax and most of the high-bracket marginal rate reductions will be phased in, the proportion of total benefits reaped by the highest-income taxpayers will gradually increase.

The recent reemergence of federal budget deficits and the scheduled sunset of EGTRRA after 2010, however, render these projections highly uncertain.

# Housing in Ohio



a. Regions indicated are census regions.  
 b. Includes Ohio.  
 SOURCE: U.S. Department of Commerce, Bureau of the Census.

Owning a home has long been regarded as a sound method of gaining financial stability because housing values tend to be less volatile than stock prices and resilient during economic downturns. Data from the 2000 census reveal that a higher share of individuals owned their homes in the Midwest (which includes Ohio) than in any other area of the U.S. Historically, Ohio's homeownership rates have exceeded the national average. While the 2000 census reported the highest homeownership rate on record for the nation as a whole,

Ohio's historical high point was the 1980 census. For Ohio, the 2000 census showed a higher homeownership rate than the 1990 census, but the latest rate is still 2 percentage points lower than in 1980.

The median value of homes in Ohio was \$103,700 in 2000, with the highest concentration of more expensive homes in the counties bordering Cuyahoga, Franklin, and Hamilton counties (which contain Cleveland, Columbus, and Cincinnati, respectively). Residents continued to move further from the city in which they

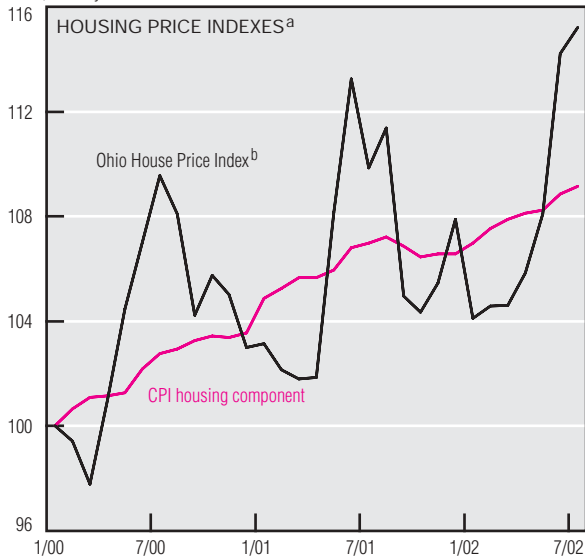
worked during the years between the 1990 census and the 2000 census. Over these 10 years, home values rose more than 50% (real dollars) in the counties directly north of Columbus and those along the I-71 corridor between Cincinnati and Columbus.

Home values have continued to appreciate since the 2000 census. Nationally, the housing component of the CPI has risen steadily despite the recession that began in March 2001. Although the price of housing in Ohio shows very seasonal movements, it

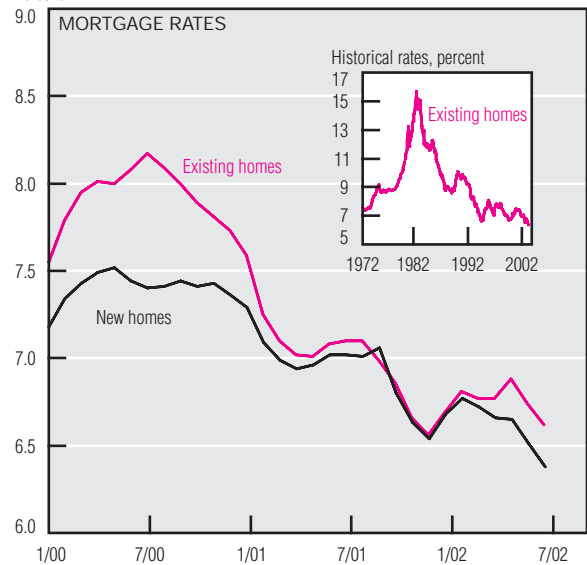
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## Housing in Ohio (cont.)

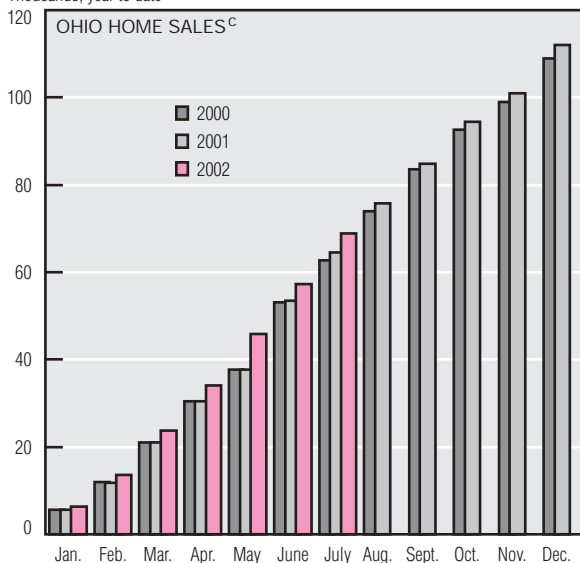
Index, January 2000 = 100



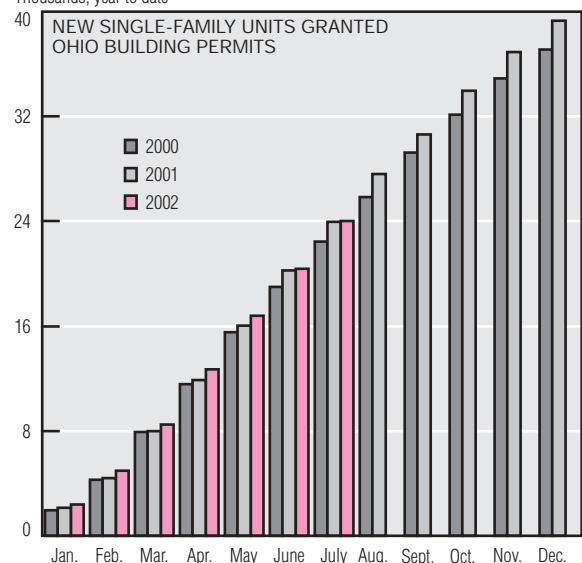
Percent



Thousands, year to date



Thousands, year to date



a. Not seasonally adjusted.

b. Calculated by the Federal Reserve Bank of Cleveland based on figures from the Ohio Association of Realtors.

c. New and existing homes.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and Ohio Association of Realtors.

has trended up since 2000. Home prices tend to peak in the summer months, when demand is highest (favorable weather and the school-year cycle induce most families to move during the summer).

Housing prices are on the rise, and mortgage rates for both new and existing homes are at 30-year lows. Since the start of 2000, rates have fallen more than a percentage point. Although mortgage rates for existing homes were near those for new homes during the second half of 2001, the spread has been increased

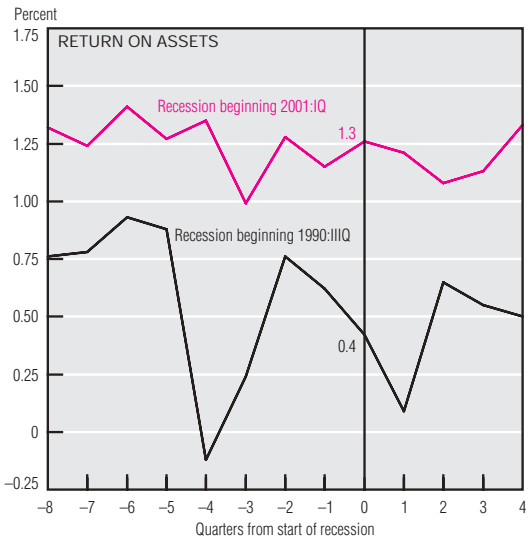
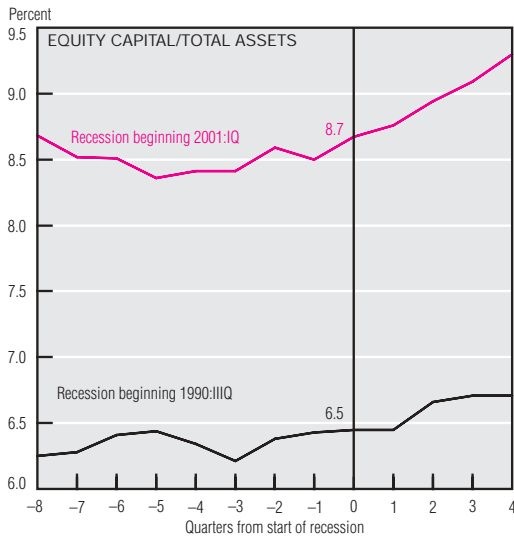
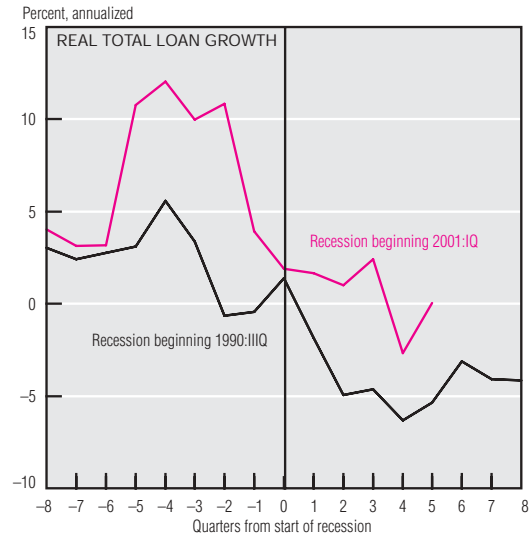
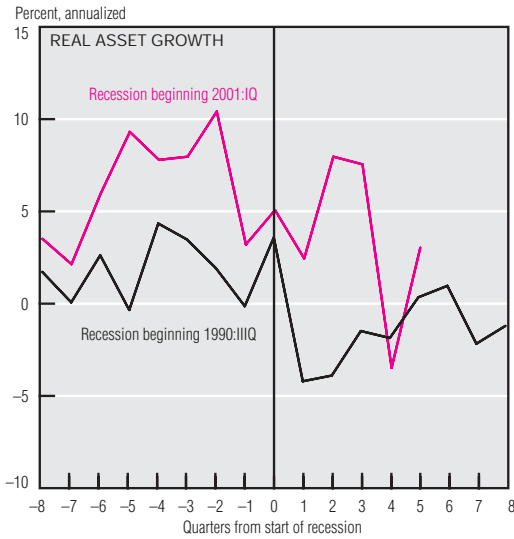
in favor of new homebuyers since the beginning of 2002.

Historically low mortgage rates have doubtless helped to boost Ohio home sales. Sales for the year to date are higher than both 2000 and 2001 levels. (Sales in 2001 reached a record high). The Fourth District's Beige Book report noted that residential construction continued to be unaffected by the recession throughout 2001. After the terrorist attacks in September 2001, home investment accelerated; this trend has been sustained through 2002. In July 2002, Ohio home sales for the year to date (68,832 units) were

4.4% higher than July 2001 levels, and strong home sales are expected to continue.

The number of housing units for which the state issues building permits is a leading indicator of housing construction activity. In early 2002, Ohio's year-to-date permits for single-family units were notably greater than in 2002, suggesting that strength in residential housing construction will continue in the near future. Permit activity slowed to near 2001 levels in June and July, but whether this slowing proves to be temporary remains to be seen.

# Banking Conditions in the Recessions of 1990 and 2001



SOURCES: Board of Governors of the Federal Reserve System; and Federal Deposit Insurance Corporation, *Quarterly Banking Report*, various issues.

Going into the 2001 recession, FDIC-insured commercial banks' real asset and loan growth was much stronger than in the late 1980s and early 1990. Both statistics dipped into negative territory when the 1990 recession began. Asset growth stayed there for five quarters, and loan growth was still negative after two years. In the 2001 recession, however, these statistics fell below zero only in 2002:IQ, largely because of a seasonal drop in balances due from depository institutions and a decline in commercial loans, residential mortgage loans, and consumer loans other than

credit cards. Both growth numbers recovered in 2002:IIQ.

Equity capital cushions banks against unexpected losses. When the 1990 recession began, the ratio of equity capital to total assets stood at 6.5%, much lower than its 2001 level of 8.7%. Most significantly, after the current recession started, the equity ratio increased 50 basis points (bp) while total assets continued to grow. In contrast, the increase of 30 bp in 1990 resulted mainly from a decline in total assets.

The statistics for return on assets explain this healthy equity growth.

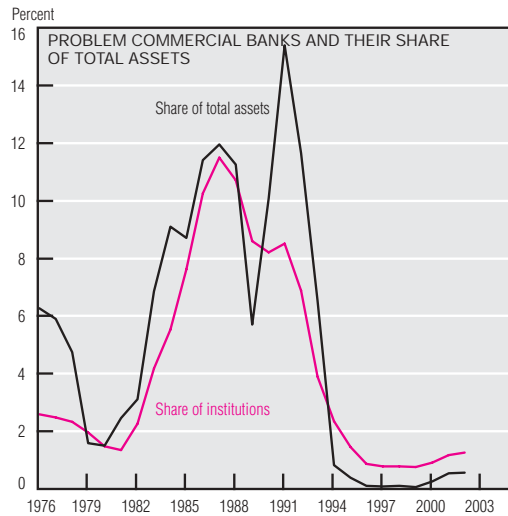
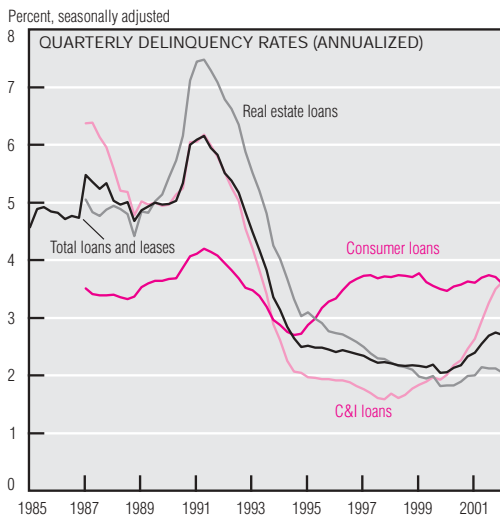
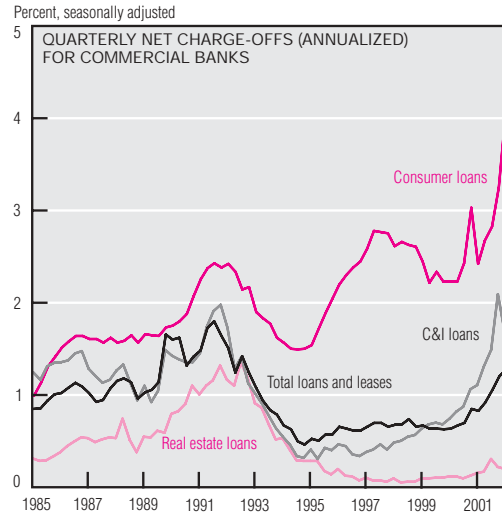
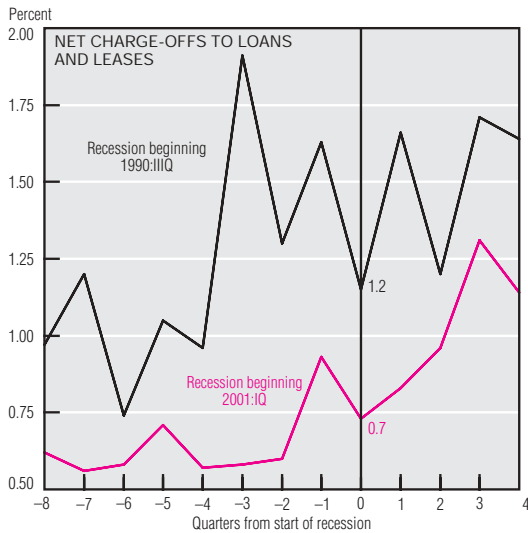
Going into the 2001 recession, commercial banks' income was much higher and considerably less volatile than in the late 1980s. In fact, commercial banks' net income rose to a record high of \$21.7 billion in 2002:IQ; for 64% of banks, net income was higher than in 2001:IQ, when the recession began (data not shown). The key factors were wider interest margins at large banks and slow growth in noninterest expense.

Asset quality in FDIC-insured commercial banks has improved substantially since 1990. In 2001:IQ, banks'

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# Banking Conditions in the Recessions of 1990 and 2001 (cont.)



SOURCES: Board of Governors of the Federal Reserve System; and Federal Deposit Insurance Corporation, *Quarterly Banking Report*, various issues.

net charge-offs to total loans and leases stood at 0.7%, compared to 1.2% in 1990:IIIQ. However, the rate has recently increased to 1.1%, mainly because charge-offs rose sharply for credit cards and moderately for commercial loans. The decline in the quality of credit card loans results partly from the economic slowdown, but another important factor is the personal bankruptcy legislation pending in Congress. The legislation, which will make it more difficult to erase unsecured credit card debt, may have prompted some

consumers to declare bankruptcy while they can.

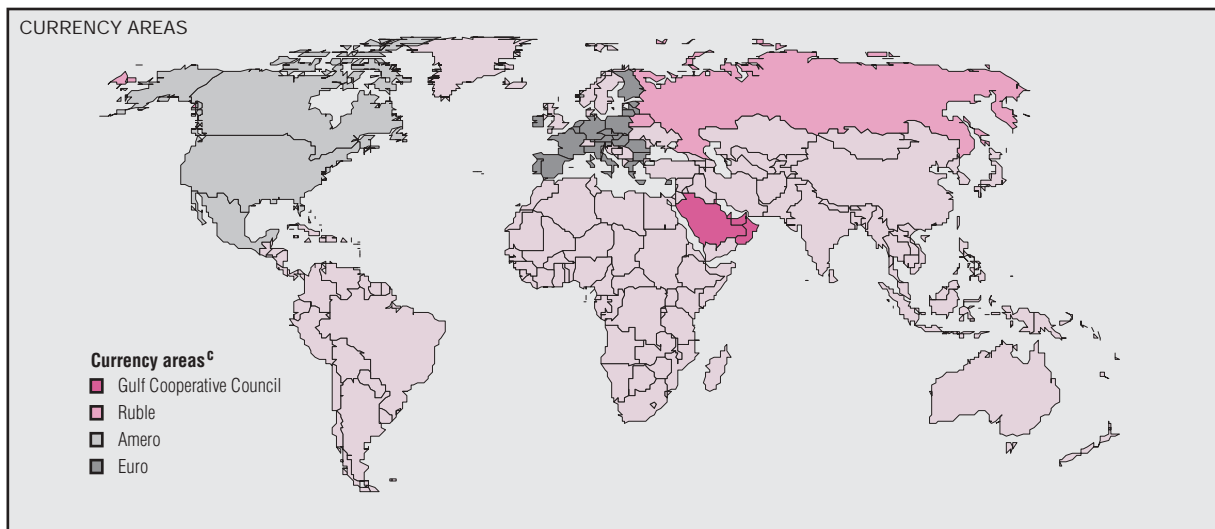
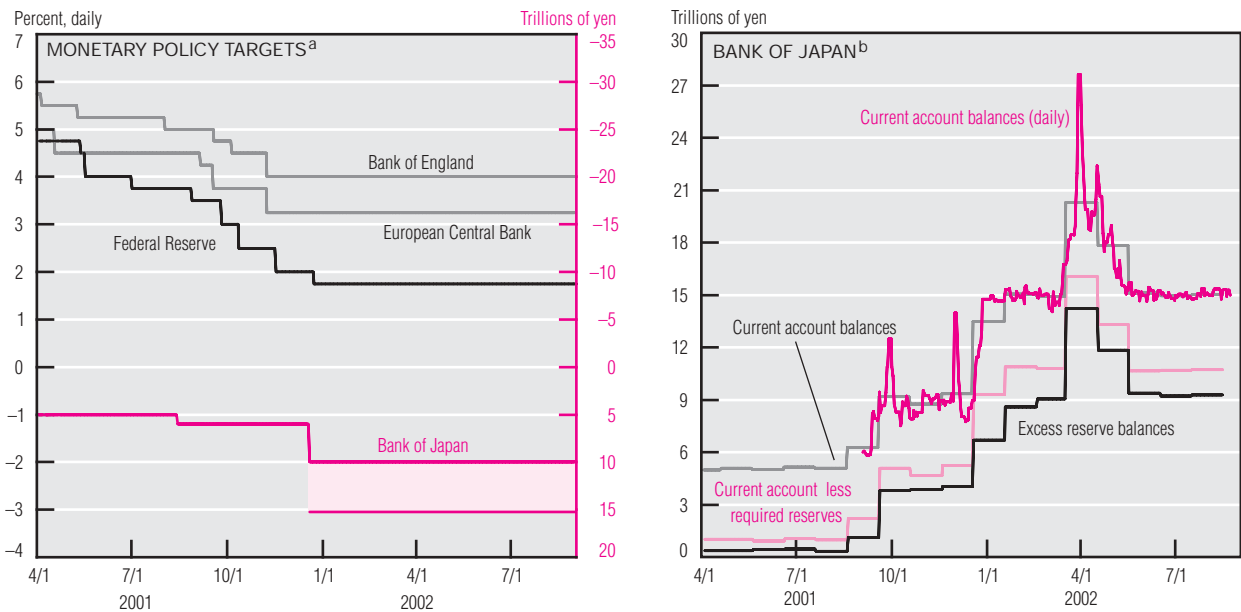
Although the current total charge-off rate seems to have approached its early-1990s high, loan delinquencies are still very low. The commercial loan delinquency rate, 3.6% in 2002:IQ, is well below its high of 6.2% in 1991. Real estate loan portfolios are much healthier now than 10 years ago. The current delinquency rate of 2% is far lower than the 7.5% rate for 1991. Moreover, banks today are much better equipped to absorb potential losses that these problem loans could cause. For every dollar in

problem loans, banks now hold \$1.30 in loan loss reserves; in 1991, that number was only about 67 cents (data not shown).

The number of problem banks—those that receive a poor rating from bank examiners—has been declining since the early 1990s and now constitutes 1.3% of all banks and only 0.6% of total banking assets. In 1991, 10% of banking assets were held by problem institutions.

Overall, the data indicate that commercial banks are well prepared to weather the current recession.

# Foreign Central Banks



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

b. Current account balances include balances at depository institutions subject to reserve requirements and balances at certain other financial institutions.

c. The Gulf Cooperative Council includes the United Arab Emirates, Bahrain, Qatar, Kuwait, and Saudi Arabia; the euro area includes 12 current members plus Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, and Slovenia; the amero area includes the U.S., Canada, and Mexico; and the ruble area includes Russia and Belarus.

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

None of the four major central banks changed its policy setting over the past month. At their most recent meetings, however, the Federal Reserve, Bank of England, and European Central Bank each shaded their outlooks for economic activity relative to those of previous meetings.

The Bank of Japan has settled into a steady routine, having maintained about ¥15 trillion in current operating balances for the past several months, both as a monthly average

for each maintenance period and on a daily basis.

Several stories about currency unions have surfaced recently. President Putin has proposed introducing the Russian ruble as the common currency of Russia and Belarus at the beginning of 2004 rather than in 2005 as originally planned, but Belarus' reaction has been cool. Twelve nations now are known to be waiting to join the European Union and European Monetary System; what EU requirements will be and how successfully each nation will meet them remains to

be seen. Gulf Cooperative Council officials hope that their nations will form a monetary union in 2010, as planned. All six already have agreed to peg their currencies to the U.S. dollar, in which petroleum has been priced so far. Finally, Herbert Grubel, professor (emeritus) of economics at Simon Fraser University, has proposed creating a new currency, the amero, for use in Mexico, the U.S., and Canada. Though far from an official plan, this proposal has been receiving considerable press attention.