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The Economy in Perspective

History in the making…Although most economists think the recession that began in March 2001 concluded nearly a year ago, no official endpoint has yet been announced. Criteria for dating business cycles rely on widespread evidence of cumulative changes in income, employment, industrial production, and sales to pin down the timing of cyclical peaks and troughs. As the National Bureau of Economic Research's Business Cycle Dating Committee stated on November 5, "The behavior of the economy in the first eight months of 2002 indicates that the decline in activity that began last year may have come to an end. But recent data indicate that additional time is needed to be confident about the interpretation of the movements of the economy last year and this year."

Earlier this year, when economic momentum seemed to be building, many analysts thought that the recession trough soon would be dated at December 2001 or January 2002. However, in its recent announcement, the Business Cycle Dating Committee said it wants to be sure that it would regard "…a hypothetical subsequent downturn…" as "…a separate recession, not a continuation of the past one." The reason for the NBER's reluctance to date the cyclical trough might be that as the year has unfolded, economic growth has held up reasonably well overall, but performance among sectors has been highly uneven. And employment growth, an important factor in the NBER's dating process, has been unusually shallow.

Along with mixed signals about the economy's progress for the year to date, commercially available forecasts suggest some slippage in the fourth quarter. The same forecasts also indicate that the economy will deliver a more solid performance next year, but this fails to comfort some analysts, who have heard too many similar assurances over the past six months. Among the public, frustration with the pace and composition of the recovery seems to be growing.

But the economy, for its part, is hard at work repairing itself. Economic activity peaked in a range of industries throughout 2000 and early 2001, leaving excessive inventories in the supply chain. Firms curtailed production sharply, sending capacity utilization rates lower and unemployment rates higher. Business investment spending collapsed, especially in the high-tech sector. These abrupt adjustments put strong downward pressure on market interest rates when the supply of funds suddenly exceeded the demand. Lower interest rates promote two kinds of adjustments: On the margin, they discourage saving and encourage both consumption and investment, which helps correct credit's supply-demand imbalance. But when credit demand for business investment remains relatively weak, even at lower interest rates, funds move to the household sector to support housing and automobile purchases, as well as mortgage refinancing. Consumers are taking advantage of lower interest rates to acquire more durable tangible assets at a time when the business sector's appetite for capital spending has diminished.

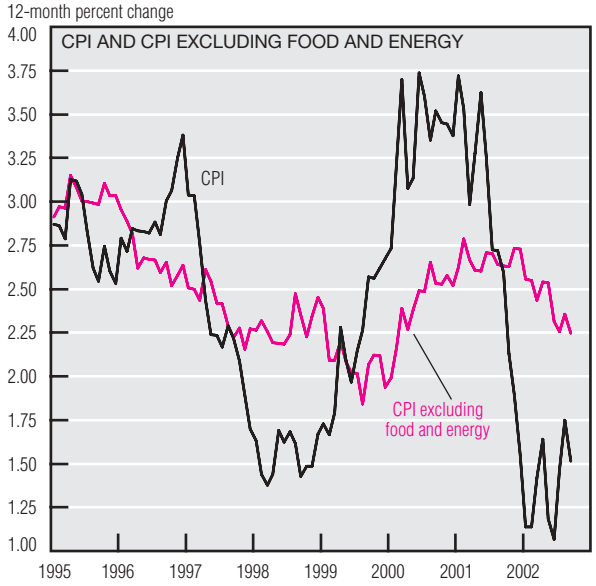
Healthy long-term economic performance eventually requires that spending shift back toward business capital; indeed, speculation about the timing and strength of a pickup in business spending has intensified in recent months. The prognosis is clouded by the forces that contributed to the investment spending collapse, augmented by the subsequent terrorist attacks and corporate accounting scandals. Once investors have changed their fundamental views about the future profitability of certain firms and entire industries, part of the labor and capital those enterprises attracted during the expansion must migrate elsewhere. The transition has been slowed by generalized excess capacity and firms' diminished risk tolerance. Terms and conditions of bank loans and capital market credit reflect these revised judgements about future profitability, and quality spreads have widened in recent months to the detriment of suspect firms. In these cautious times, both firms and households want very liquid financial assets; firms may have additional incentives to pay down debt. Adjustments will continue until balance sheets are aligned with risk preferences.

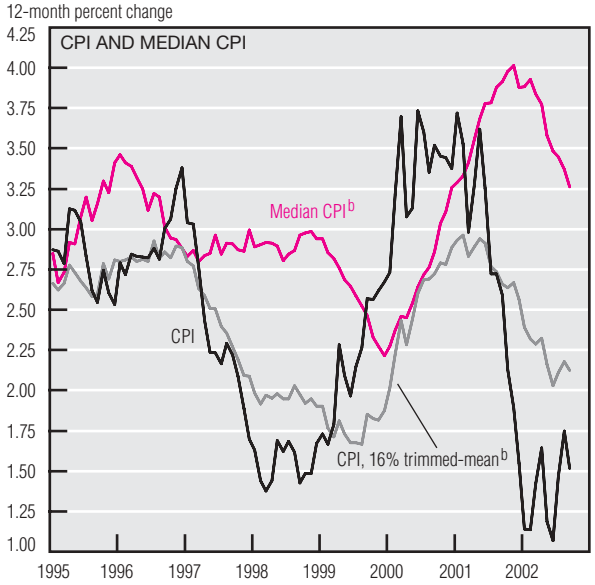
The Federal Reserve cannot dispel anxiety about Iraq, expunge bad credits from lenders' balance sheets, or remove excess-capacity manufacturing plants, but it can contribute to the regeneration process by reducing the federal funds rate when market-determined rates fall. The public's desire to hold more short-term and highly liquid financial assets allows the Fed to add reserves to the banking system with little concern about future inflation. In fact, as economic conditions press market-determined interest rates further down and the public realigns its portfolio, declines in the funds rate might prevent inadvertent liquidity squeezes and unexpected disinflation. Viewed this way, monetary policy doesn't so much stimulate spending as it does foster conditions conducive to spending. The rest is history.

Inflation and Prices

September Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2001 avg.
Consumer prices					
All items	2.0	2.5	1.5	2.3	1.5
Less food and energy	1.3	2.3	2.2	2.4	2.7
Median[b]	2.8	3.1	3.3	3.1	3.9
Producer prices					
Finished goods	0.9	–0.6	–1.8	1.0	–1.7
Less food and energy	0.8	–1.6	–0.4	1.0	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 0.2% (2.0% annual rate) in September. According to the Labor Department, energy prices have risen for three consecutive months: 0.4% in July, 0.6% in August, and 0.7% in September. Despite these recent increases, however, year-over-year comparisons reveal deflation in energy prices. Higher food prices also contributed to the rise in the CPI. The index for food, after declining 0.1% in August, rose 0.2% in September.

Excluding food and energy, the CPI rose only 0.1% (1.3% annual rate) in September, after August's increase of 0.3% (3.9% annual rate). Other core measures showed a similar deceleration. On an annual-rate basis, the median CPI rose 2.8% in September after increasing 3.3% in August, while the 16% trimmed-mean CPI rose 2.0% after increasing 2.9% in August. The 12-month rates of change in all core measures also indicate disinflation and have been trending down throughout the year. By contrast, the CPI's year-over-year change throughout 2002 has been more erratic.

The deceleration in core measures over the last several months results partly from disinflation in the service sector. The 12-month percent change in the prices of core services (which exclude energy services) has been trending down after peaking at about 4% in February, and other core measures of inflation have fallen along with it. This is not surprising, because services constitute about 70% of the items in the CPI less food and energy. Moreover, because goods prices recently have seen much smaller increases than services prices (if not outright declines), measures like the median and the trimmed mean,

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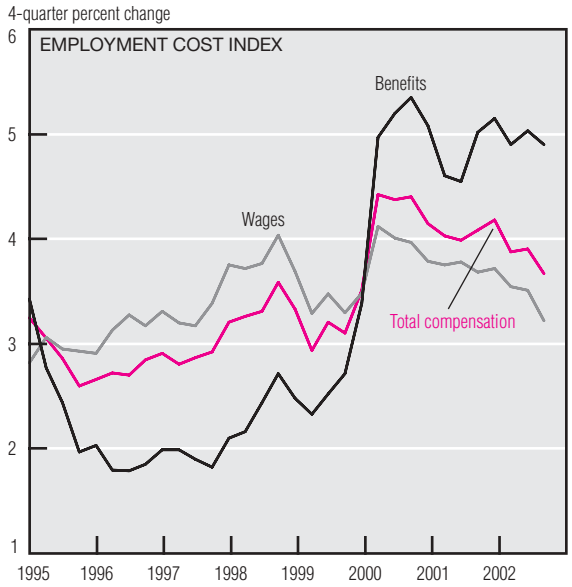
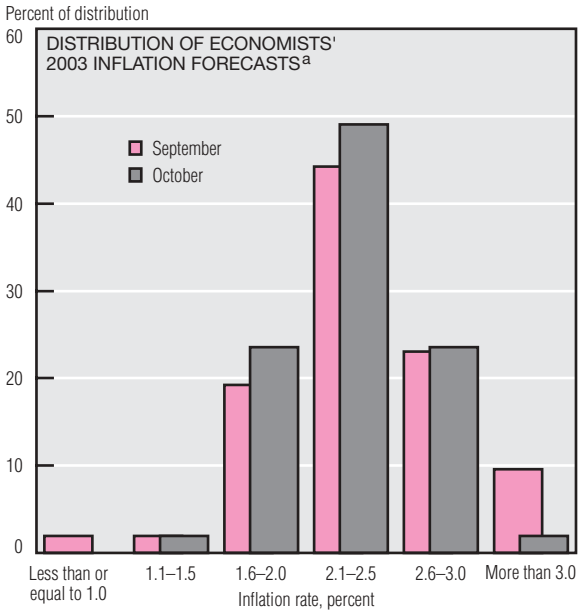
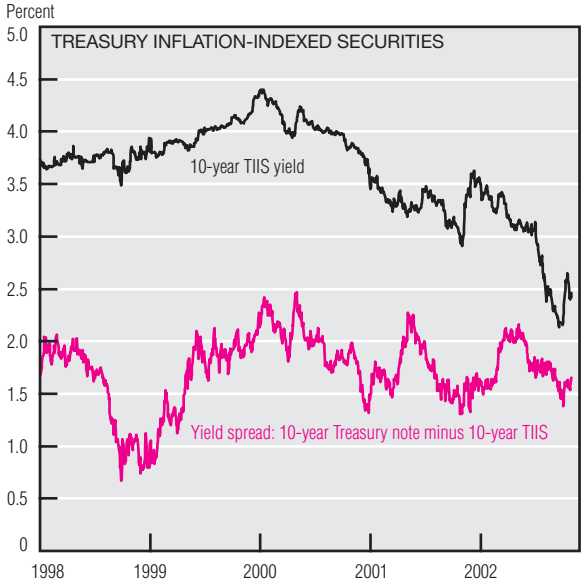
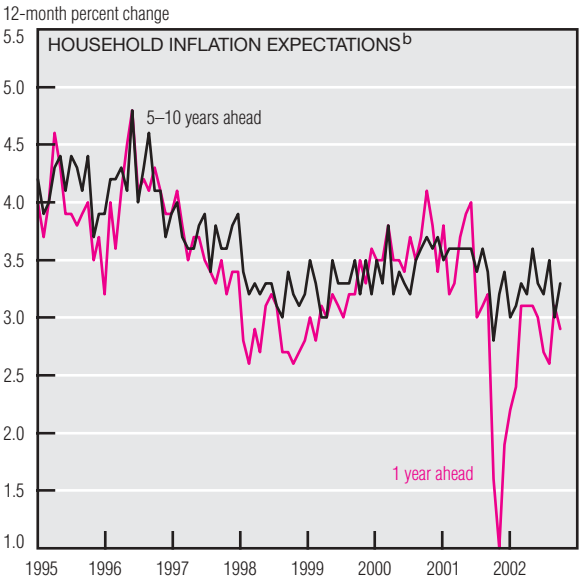
Inflation and Prices (cont.)









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; Bloomberg Financial Information Services; and *Blue Chip Economic Indicators*, September 10, 2002 and October 10, 2002.

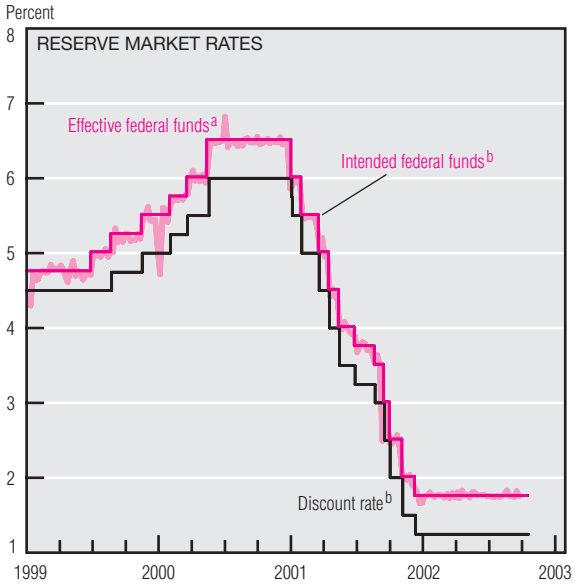
which focus on the middle of the price-change distribution, tend to include disproportionately more services than goods.

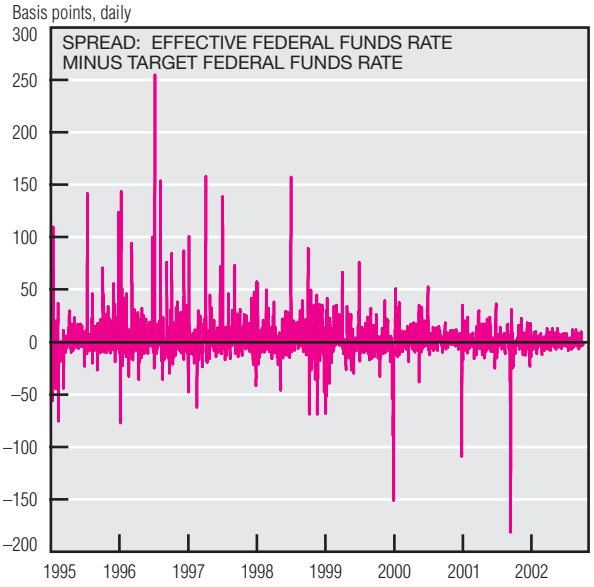
Two factors may explain a hefty share of the disinflation in service-sector prices over the last several months. First, the inflation rate for implied rents has fallen sharply since the beginning of the year, perhaps because the real estate market has slackened. Second, wage growth, as measured by the Employment Cost Index, has decelerated more markedly in 2002 than in 2001. Because wages represent a substantial share of service employers' costs, less rapidly rising wages may mean less inflation in service-sector prices.

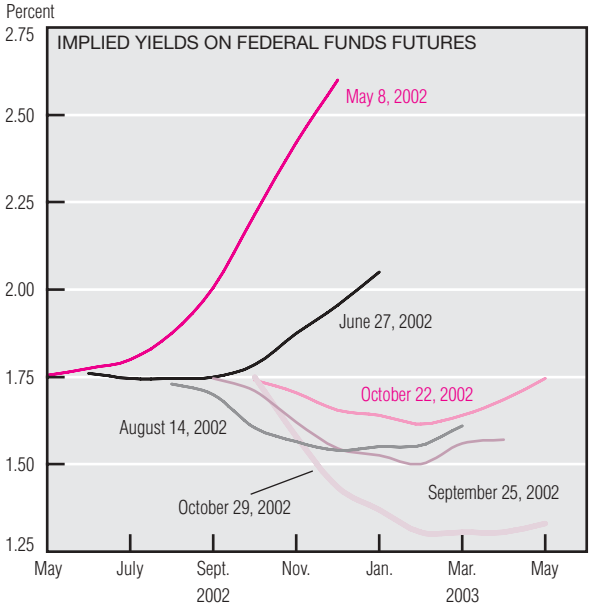
The most recent Blue Chip survey of economists, conducted in October, generated a consensus inflation expectation of 2.3% in 2003, little changed from the 2.4% consensus expectation in the September survey. The distribution of economists' forecasts, however, narrowed in October. Compared with September, more economists—roughly half—saw 2003 inflation settling into the low 2% range. And while nearly 10% of September respondents expected inflation to exceed 3% in 2003, only 2% expected this in October.

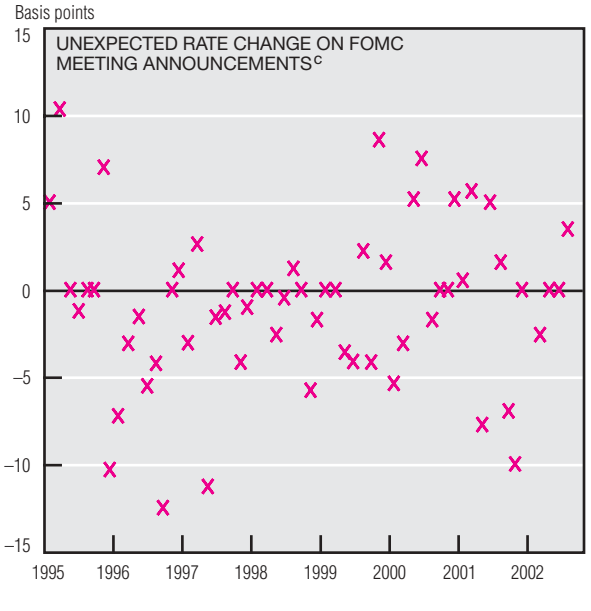
Financial markets provide another way to gauge inflation expectations. The difference between the yields on a 10-year Treasury note and its equivalent-maturity inflation-indexed security—the yield spread—indicates market participants' expectation of average annual inflation over the next 10 years. Currently, this yield spread stands at 1.6%, about half of what households say they expect inflation to average over the next five to 10 years.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. The unexpected rate change is the difference in the federal funds futures market between the day of an FOMC announcement and the day before, weighted as described in Kenneth N. Kuttner, "Monetary Policy Surprises and Interest Rates: Evidence from the Fed Funds Futures Market," *Journal of Monetary Economics,* vol. 47 (2001), pp. 523–44.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of New York; and Bloomberg Financial Information Services.

The daily average effective federal funds rate typically remains close to target. Since the beginning of 2000, the average absolute deviation of the effective rate from the intended rate has been about 7 basis points (bp); the effective rate was within 5 bp of the intended rate for around 60% of the observations. Nonetheless, misses of 50 bp or more are not uncommon.

In the month following the Federal Open Market Committee's September 24 meeting, implied yields on federal funds futures rose roughly 10 bp across the various maturities, then fell dramatically late in October. Market participants currently place a high probability on a 25 bp cut in the federal funds rate at the FOMC's November 6 meeting and a total cut of 50 bp by early 2003.

Apart from a premium for interest rate risk, implied fed funds futures yields should reflect expectations of the effective rate for the delivery month. Fed funds futures predict short-term movements in the intended fed funds rate fairly well, typically within 5 bp of actions at FOMC meetings. Still, market participants often are caught by surprise, especially during periods of rapid adjustment in the intended fed funds rate.

How are changes in the intended fed funds rate related to other market interest rates? Conventional wisdom says that intended fed funds rate increases should lead to equal increases in short-term market interest rates and to less-than-proportional increases in long-term rates, but studies do not support this view. Indeed, if we look at actual changes in the intended rate at FOMC meeting dates

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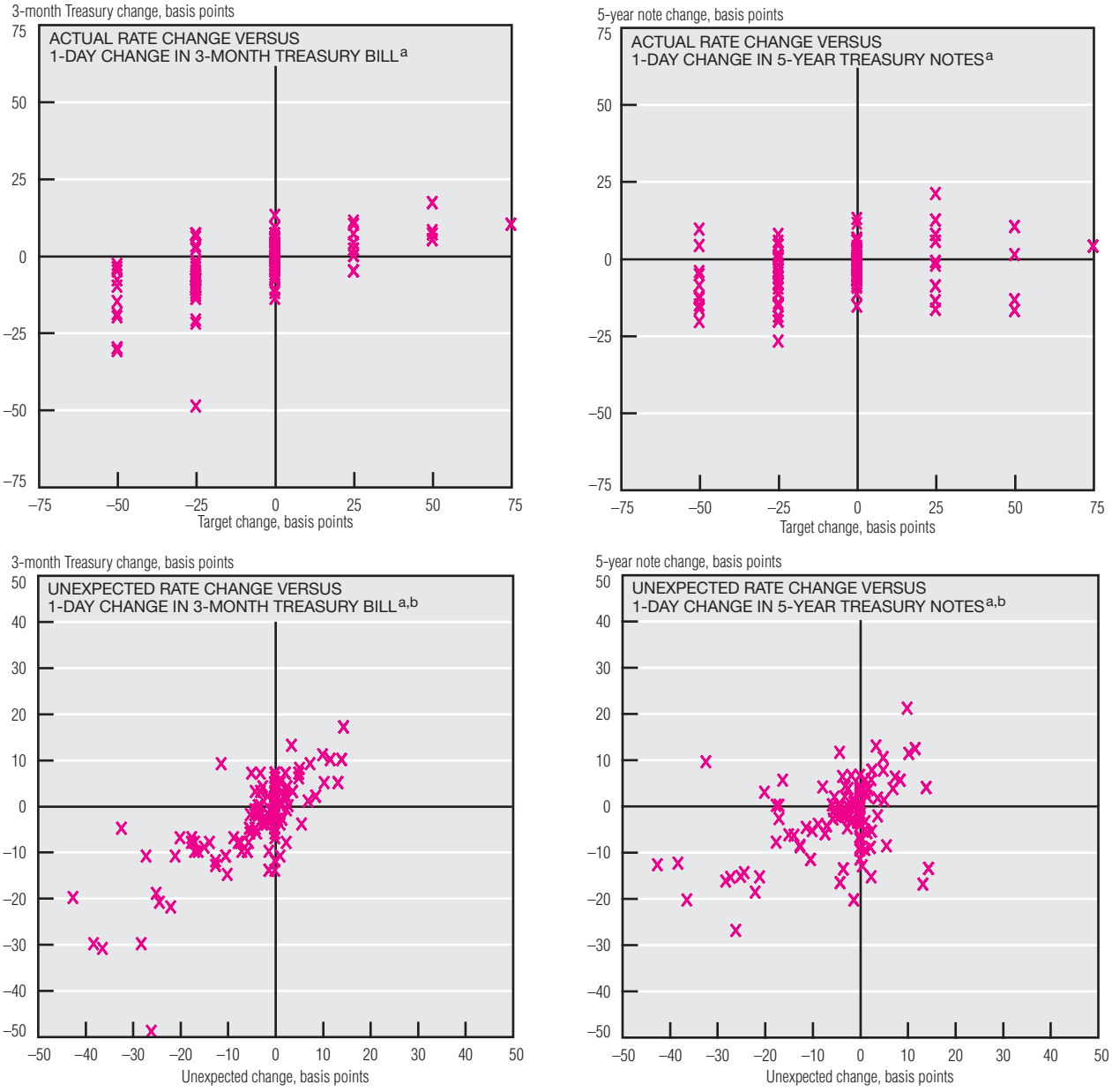
Monetary Policy (cont.)



a. Observations are included if it is an FOMC meeting day announcement or a change in the target rate starting June 1, 1989. The calculated change is the yield on the day of the observation minus the previous days yield.

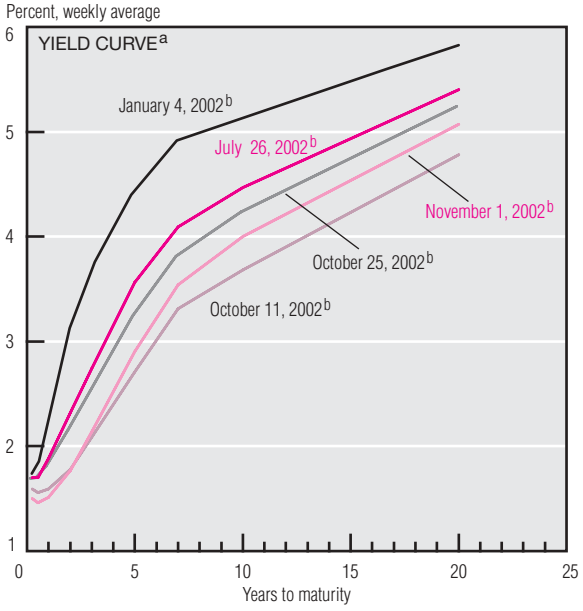
b. The unexpected rate change is the difference in the federal funds futures market between the day of an FOMC announcement or target rate change and the day before, weighted as described in Kenneth N. Kuttner, "Monetary Policy Surprises and Interest Rates: Evidence from the Fed Funds Futures Market," *Journal of Monetary Economics*, vol. 47 (2001), pp. 523–44.

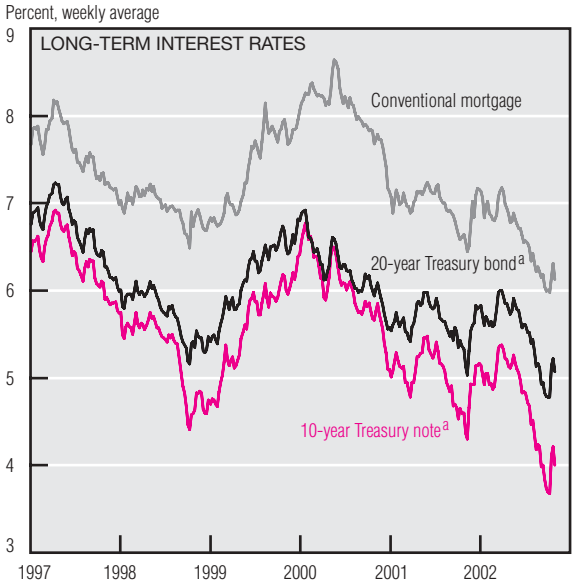
SOURCES: Board of Governors of the Federal Reserve System, "Selected Rates," *Federal Reserve Statistical Releases*, H. 15; Federal Reserve Bank of New York; and Bloomberg Financial Information Services.

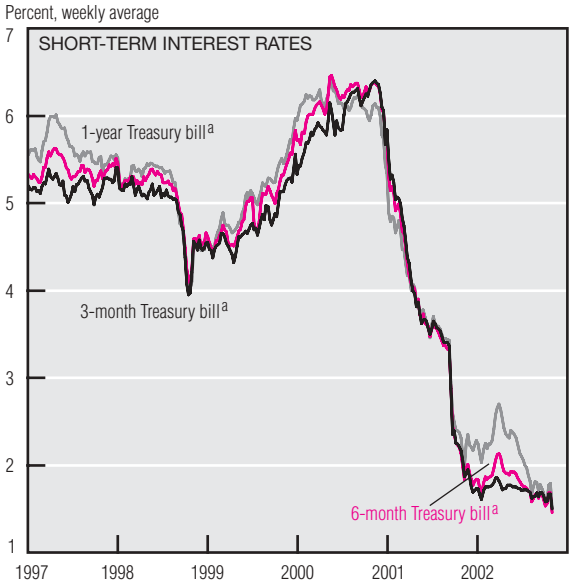
versus the change in yields on U.S. Treasury securities from the day of each meeting to the next day, we do not see a strong correlation, especially for longer-term rates. For example, the top left chart plots the actual change in the intended fed funds rate versus the change in the three-month T-bill rate from the day of the intended rate change to the day after. The points in this chart are positively correlated, but certainly less than proportional, contrary to the simple theory. This illustrates that increases in the intended rate are only mildly associated with increases in the three-month T-bill rate. Changes in the intended rate have little impact on the five-year Treasury note rate. The conventional wisdom is wrong because the FOMC often is responding to movements in market rates rather than vice versa.

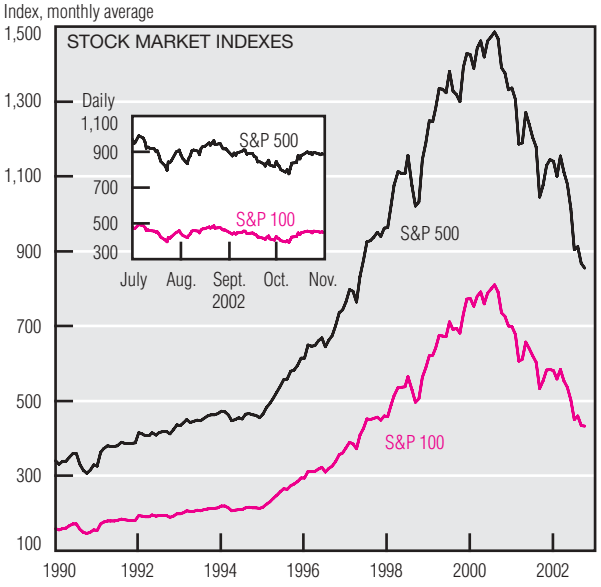
How do these patterns alter if we look only at unanticipated Fed actions? By using fed funds futures, we can analyze the relation between unanticipated changes in the intended rate and other market interest rates. Here, the link seems tighter. Unanticipated changes in the intended rate show a strong positive correlation with ensuing one-day changes in the three-month Treasury bill rate. Furthermore, they are of similar magnitude—an unanticipated 10 bp increase in the intended rate is matched with an increase of about 10 bp in the three-month T-bill rate. Although the correlation between unanticipated changes in the intended rate and changes in longer-term Treasury securities is positive, it is weaker than for shorter-term securities.

Money and Financial Markets









a. All yields are from constant-maturity series.
b. Average for the week ending on this date.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15; and Bloomberg Financial Information Services.

Toward the end of October, the yield curve became slightly inverted, with the six-month Treasury bill yield falling below the three-month yield. This inversion probably was driven by expected cuts in the federal funds rate. The yield curve also steepened significantly during October when, on net, long-term rates rose and short-term rates fell. Nonetheless, the curve remains fairly flat at the short end, as it has for much of the year.

From the end of March 2002 through the first part of October, long-term rates followed a strong downward trend, reflecting expectations of lower future inflation or lower real interest rates. After declining 170 basis points (bp) between late March and mid-October, the 10-year Treasury note has rebounded more than 30 bp. The 20-year Treasury bond and conventional mortgage rates also showed net increases in the last half of October, although to a lesser degree.

Short-term rates displayed much less variability over the same period. Only the one-year Treasury bill showed a pattern similar to that of longer-term rates, falling 115 bp between the end of March and the first part of October. The rates on three- and six-month Treasury bills have shown little trend throughout most of the year. All short-term rates fell precipitously in the last week of October amid strengthened expectations that the federal funds rate would drop over the next few months.

After peaking in March 2000, the S&P 100 and 500 stock market indexes have fallen dramatically. Having retraced their strong growth of the late 1990s, these indexes are now roughly at spring 1997 levels.

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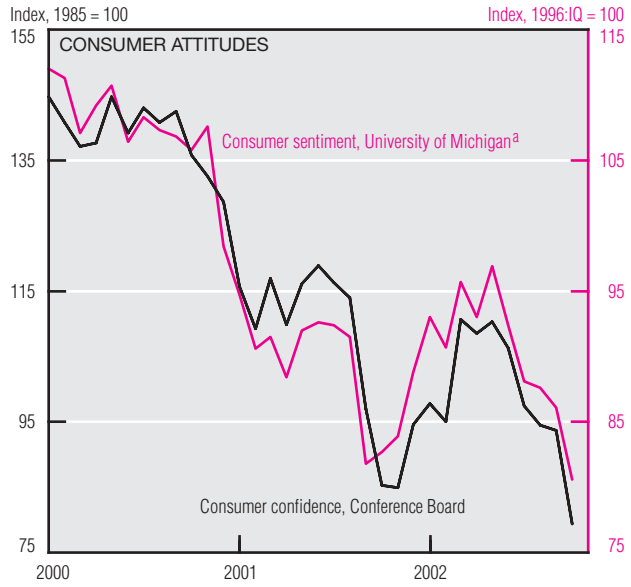
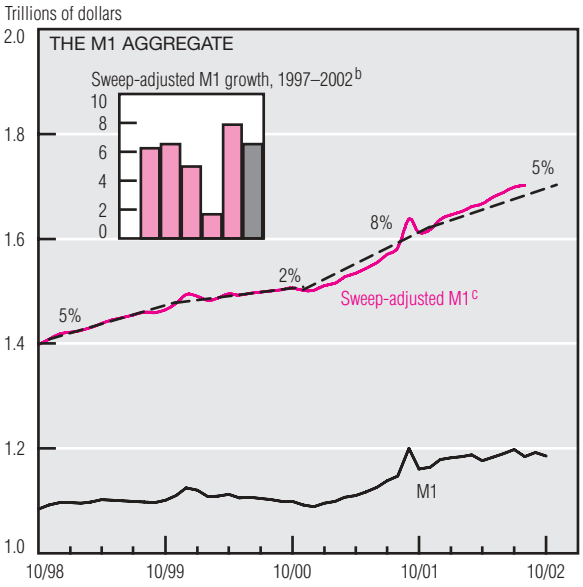
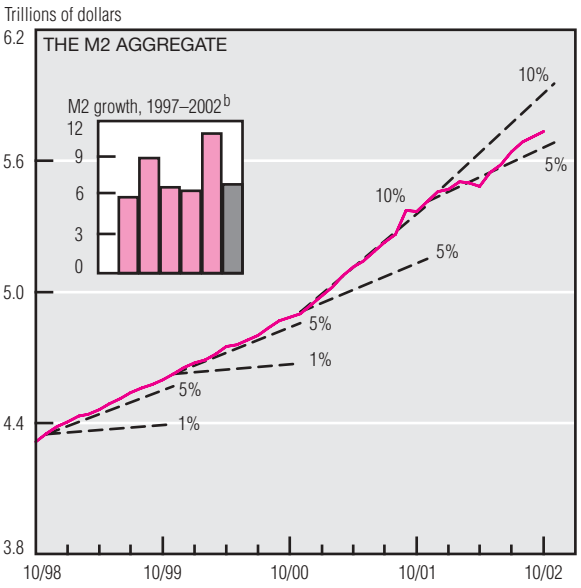
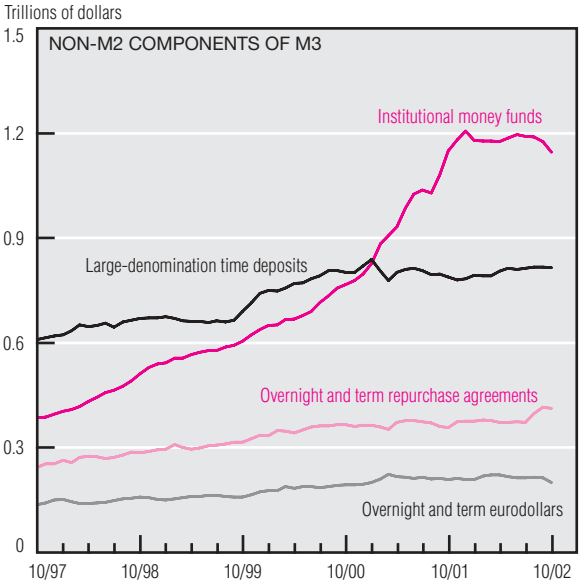
Money and Financial Markets (cont.)









a. Data are not seasonally adjusted.
b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2002 growth rate for M2 is calculated on a September over 2001:IVQ basis. The 2002 growth rate for the sweep-adjusted M1 is calculated on an August over 2001:IVQ basis. Data are seasonally adjusted.
c. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
SOURCES: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6; University of Michigan; Conference Board; and Bloomberg Financial Information Services.

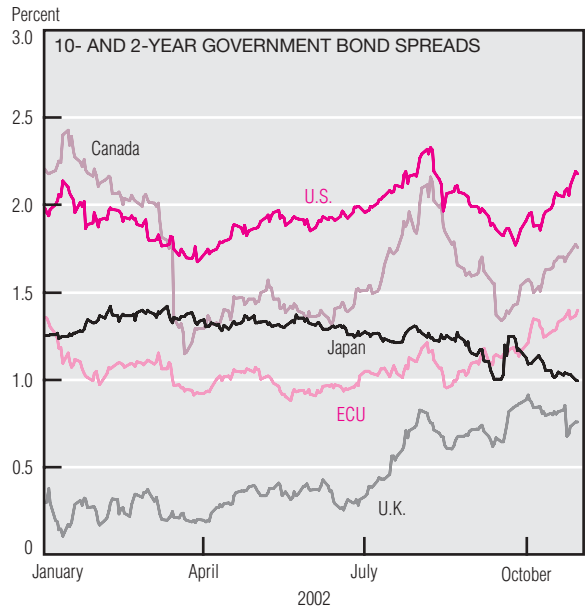
Both indexes, however, improved somewhat in the last three weeks of October, with the S&P 500 increasing 4.5% for the month.

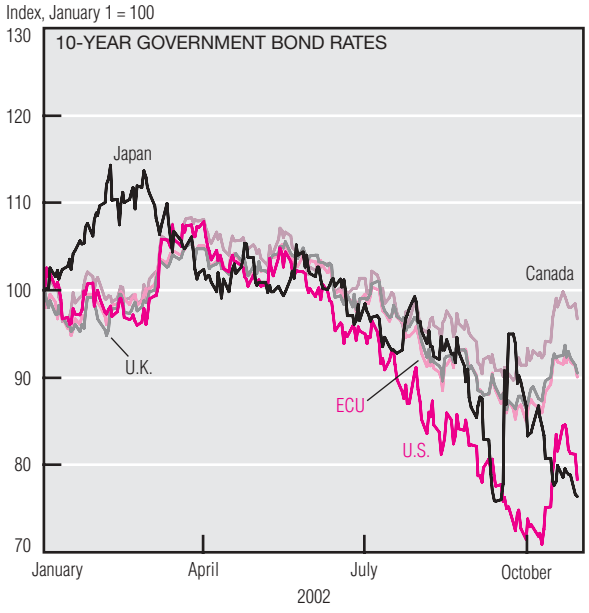
Consumer confidence, as measured by the Conference Board index, fell to 79.4 in October, considerably lower than expected. This marked the index' fifth consecutive decline and its largest monthly percentage decline since July 1992. The Conference Board index reflects consumers' perceptions of the present situation and their expectations of future conditions. Most components of the index declined, but the expectations component was the hardest hit. Consumers expressed concern about the stock market outlook; however, the survey was conducted before recent market gains. The University of Michigan index of consumer sentiment also fell in October. Both indexes are now at their lowest levels since 1993.

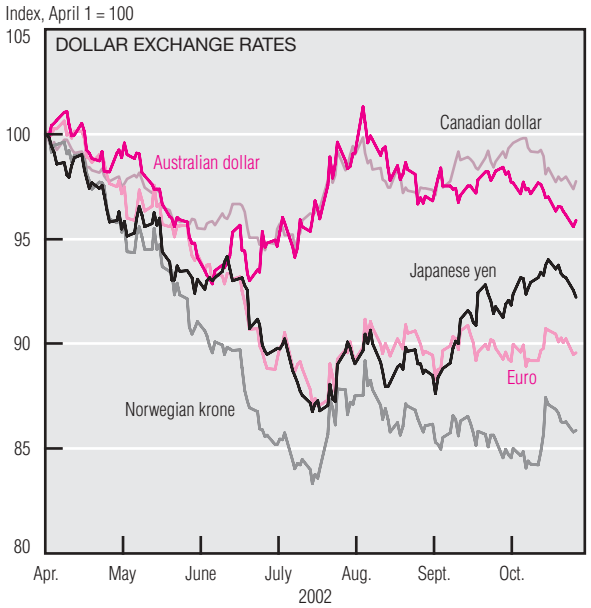
After increasing 7.9% during 2001, the growth rate of sweep-adjusted M1 has moderated this year to an annualized 6.5%. Growth in M2 also moderated in 2002 relative to last year's strong growth of 10.3%. So far this year, M2 has grown at a 6.6% annualized rate. Year-to-date growth rates for both M1 and M2 remain in line with growth in nominal income, suggesting hat inflationary pressures could remain low.

The composition of M3 has also shifted recently. Institutional money funds have fallen in each of the last four months, but these decreases were partially offset by increases in overnight and term repurchase agreements. Although money funds often swell during periods of stock market uncertainty, this has not occurred in recent months.

International Markets







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

The difference between the 10-year and two-year government bond yields is a measure of the steepness of the yield curve. For the U.S., Canada, the U.K., and the ECU, yield curves were all quite flat in late March and early April. Since then, they have steepened, except for a brief period of flatness between August and late September. Japan's yield curve remained unchanged until the end of August, when it began to flatten out.

Ten-year government yields declined steadily between late March and late September in all of the selected countries. Since September, 10-year rates in the U.S., Canada, the U.K., and the ECU have risen somewhat. Japan's 10-year rate increased significantly in late September but has fallen since then, taking back the entire increase.

The U.S. dollar lost ground to many currencies between April and July of this year. Subsequently, however, it has appreciated against the currencies of Japan, Canada, the U.K., and the ECU and has maintained its value against the Swiss franc and the Norwegian krone.

Stock markets around the world have been losing value since April. The NASDAQ lost almost 40% of its value between April and early October. Between April and *late* October, the Dow 30 was the best-performing index, but it still lost almost 20% of its value. Among the broad market indexes, the worst performer was the Euro 500, whose value slipped slightly more than 30%.

In August, the U.S. trade deficit, the difference between exports and imports of goods and services, increased $3.4 billion to $38.5 billion.

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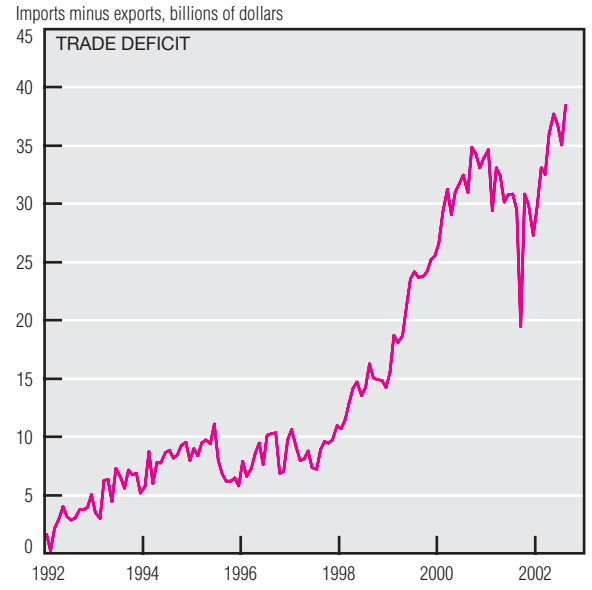
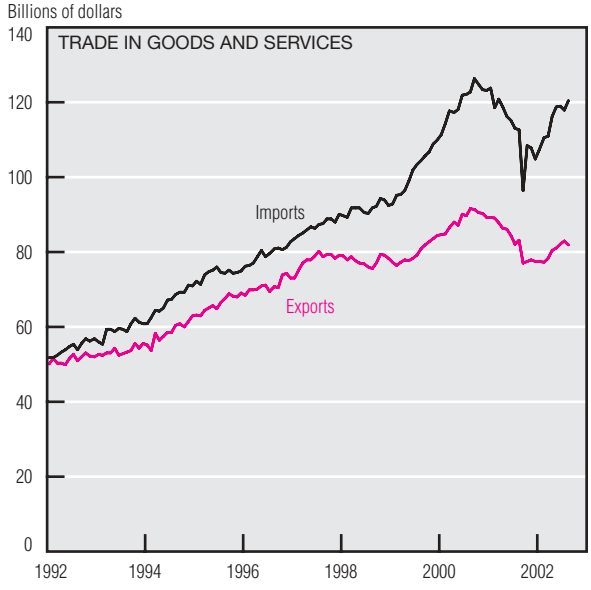
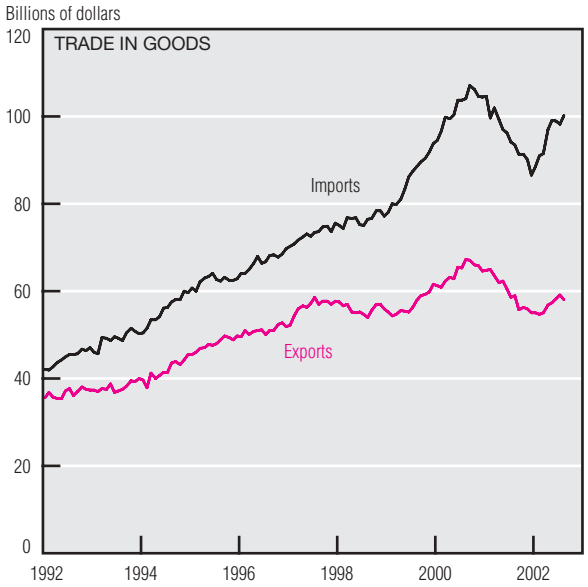
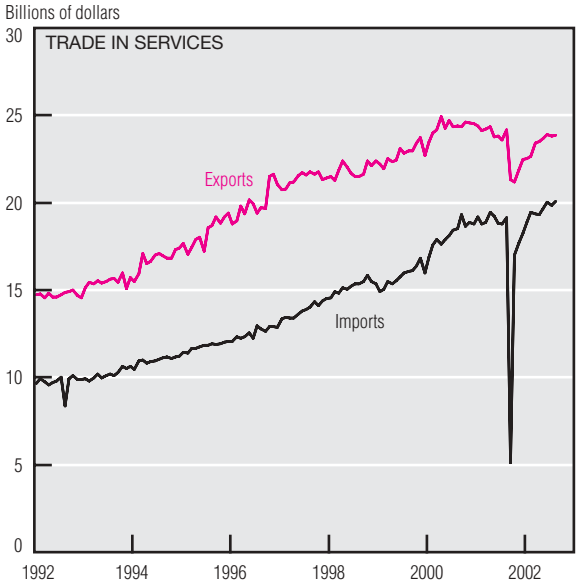
International Markets *(cont.)*









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

A deficit occurs when imports exceed exports, so when exports of goods and services fell slightly and imports rose that month, the deficit widened. The deficit, which started in 1992, grew slowly but steadily until 1998; since then, it has tripled, reaching an all-time high of $38.5 billion in August.

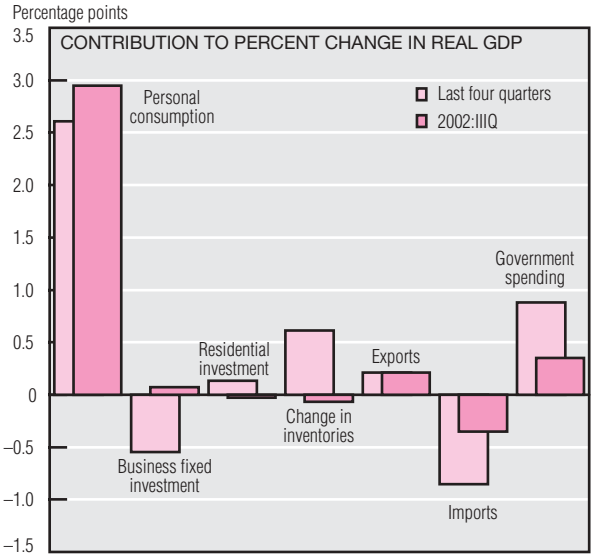
The entire U.S. trade deficit results from the deficit in the trading of goods, which it resembles closely. In August, the goods deficit increased about $3.2 billion to $42.3 billion, when goods exports decreased from $59.1 billion to $58.0 billion and goods imports increased from $98.1 billion to $100.3 billion. The July-to-August change in the goods balance reflects increases in the trade of consumer goods and industrial supply and materials. There were decreases in the trade of capital goods, and food and beverages, as well as automotive vehicles, parts, and engines.

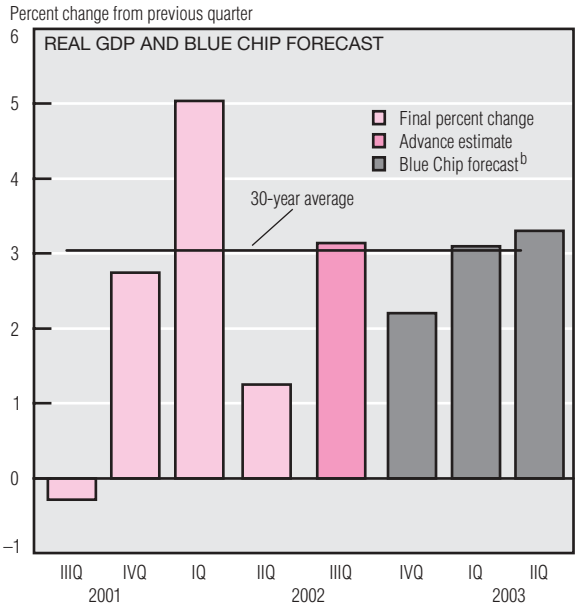
While most people are aware of the goods deficit, not everyone realizes that the U.S. is also running a trade surplus in services, exporting more than it imports. However, the services trade surplus is significantly smaller than the goods trade deficit. In August, the services surplus decreased $0.2 billion to $3.8 billion because while services exports increased from $23.8 billion to $23.9 billion, services imports also increased from $19.8 billion to $20.1 billion. The July-to-August change in the services balance reflected increased exports in the travel category as well as in direct defense expenditures and other private services.

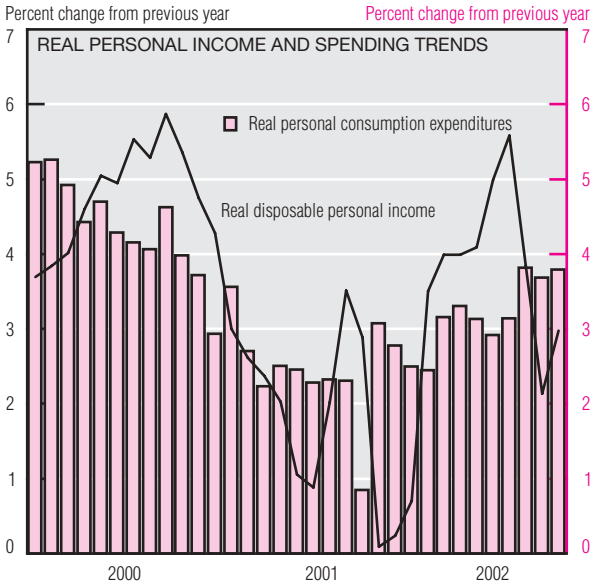
Economic Activity

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

	Change, billions of 1996 $	Percent change, last: Quarter	Four quarters
Real GDP	72.8	3.1	3.0
Personal consumption	68.4	4.2	3.8
Durables	51.3	22.7	11.9
Nondurables	6.3	1.3	3.2
Services	20.7	2.3	2.5
Business fixed investment	1.7	0.6	–4.7
Equipment	15.3	6.5	1.1
Structures	–9.9	–16.0	–19.7
Residential investment	–0.7	–0.8	2.9
Government spending	7.8	1.8	4.8
National defense	5.0	5.1	9.6
Net exports	–3.8	—	—
Exports	5.7	2.1	2.2
Imports	9.5	2.5	6.5
Change in business inventories	–3.0	—	—







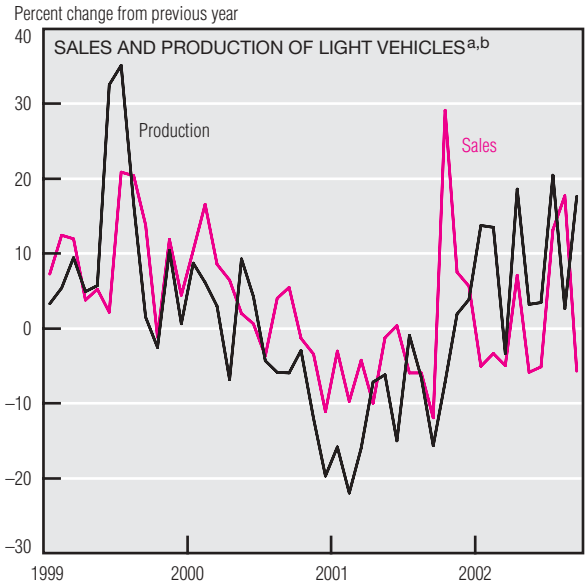
NOTE: All data are seasonally adjusted and annualized.
a. Chain-weighted data in billions of 1996 dollars. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
b. Blue Chip panel of economists.
SOURCES: U.S.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

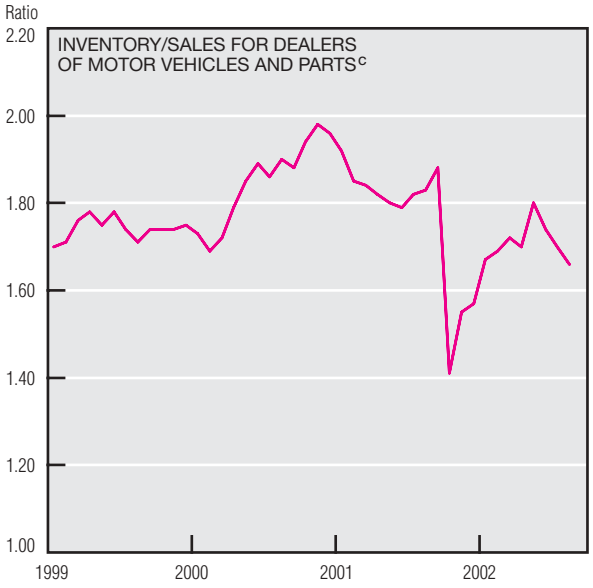
The advance estimate of real gross domestic product (GDP), released October 31, revealed that output increased 3.1% during 2002:IIIQ (annual rate). Personal consumption expenditures grew a robust 4.2% and were a major contributor to the increase in real GDP, comprising nearly three percentage points of total output growth. The $51 billion (chained 1996 dollars) increase in durable goods spending was largely driven by automobile sales during the quarter. In a positive sign for business spending, business fixed investment rose 0.6%, marking the category's first gain since 2000:IIIQ. However, spending on residential investment and business inventories showed signs of slowing. Along with imports, these categories exerted a drag on real GDP growth. Although government spending increased 1.8%, its growth was more modest than the 4.8% jump of the past four quarters.

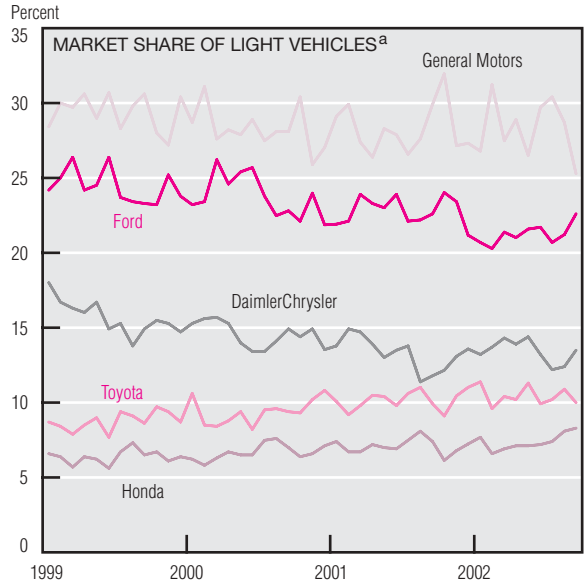
The advance estimate of real GDP growth in 2002:IIIQ just barely exceeded the long-term average. Blue Chip forecasters expect that the rate will slow to 2.2% (annualized) in 2002:IVQ, but they predict that real GDP growth will exceed its long-term average during the first half of 2003.

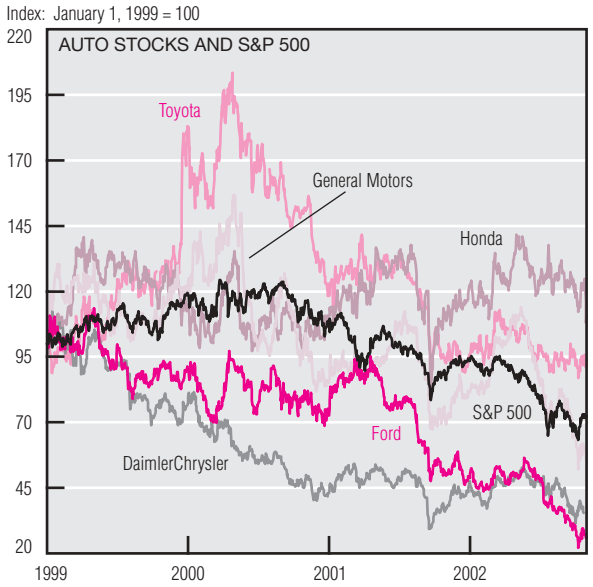
Although income growth has displayed volatility, spending growth seems to be stabilizing. Following the plunge of September 2001, real personal consumption expenditures have bounced back. Recent growth in consumer spending has not reached early-2000 levels, but it has exceeded the rates seen during most of 2001. This September, real personal consumption expenditures rose 3.8% (year-over-year), exceeding the 3.0% gain in real disposable personal income.

The Automobile Industry









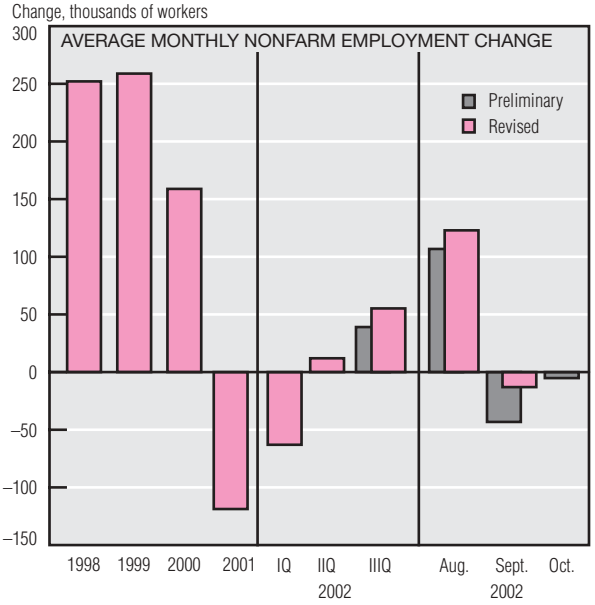
a. Light vehicles comprise cars and light trucks (less than 14,001 pounds).
b. Sales combine domestically made and imported units. Production refers to U.S.-produced vehicles.
c. Seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census; Bloomberg Financial Information Services; and *Ward's Automotive Reports*.

The U.S. automobile industry has been experiencing considerable turmoil. A year ago, sales soared in response to widespread dealer incentives, primarily zero-percent financing, but since then consumers have come to expect such incentives and are less responsive to them. Although sales were sluggish this September, production has held up better in 2002 to date than in 2001. At this point, production and sales appear to be well balanced at the industry level; dealers' inventory-to-sales ratio has rebounded from last fall's abnormal low to a level closer to the one they held over the 1999–2000 period.

Since 1999, after Chrysler merged with Daimler, General Motors, Ford, and DaimlerChrysler have lost market share to Toyota, Honda, and other producers. Despite this erosion, General Motors retains the lion's share of the U.S. market, followed by Ford and then DaimlerChrysler.

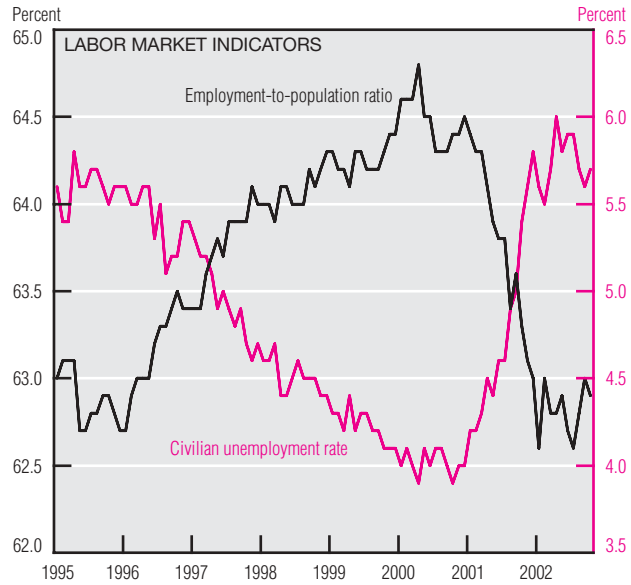
Over the last four years, automakers' financial performances have diverged much more than their market share. Beginning soon after its merger, DaimlerChrysler has underperformed the S&P 500. Ford's stock price has fallen slightly more over this period. General Motors has managed to nearly match the S&P 500, but both Toyota and Honda have beaten this index. In response to profitability concerns, GM and Ford have had their credit ratings lowered in recent weeks. Factories have large fixed costs and union contracts that entitle workers to most of their pay even when laid off. These conditions seemingly leave the Big Three no alternative, in the short run, but to try to keep plants running by offering more dealer incentives.

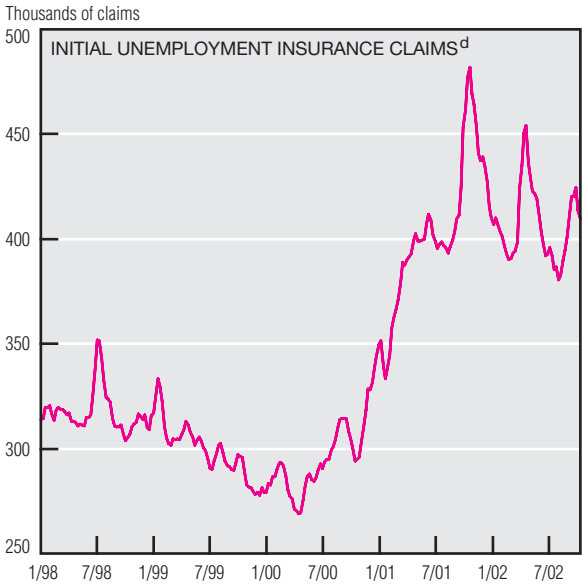
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1999	2000	2001	Jan.–Sept. 2002	Oct. 2002
Payroll employment	259	159	–119	1	–5
Goods-producing	8	–1	–111	–55	–75
Mining	–3	1	1	–1	1
Construction	26	8	–3	–7	–27
Manufacturing	–16	–11	–109	–46	–49
Durable goods	–5	1	–79	–36	–40
Nondurable goods	–11	–12	–30	–10	–9
Service-producing	252	161	–8	56	70
TPU[a]	19	17	–23	–14	–4
Wholesale and retail trade	60	25	–31	–8	–2
FIRE[b]	7	5	10	2	34
Services[c]	132	92	–2	56	18
Health services	9	15	27	22	20
Help supply	32	0	–54	16	–56
Government	35	22	39	19	24
	Average for period (percent)				
Civilian unemployment rate	4.2	4.0	4.8	5.7	5.7





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

Nonfarm payroll employment held steady in October with a net loss of just 5,000 jobs. Revisions, however, show that the September loss was less than half the number reported earlier.

Continued losses in goods-producing industries more than offset gains in service-producing industries. Manufacturing employment's decline (down 49,000 jobs) was consistent with the sector's average monthly net decline since the beginning of this year. Construction fell sharply (27,000 jobs), far more than the average monthly net decline for 2001 and 2002 to date. Help supply services, an industry that has added jobs every month this year, declined dramatically (56,000) in October. Many help supply service workers are placed with manufacturers; the sector's recent weakness probably explains the loss of related service jobs. Finance, insurance, and real estate added 34,000 jobs in October, bringing the net increase since June to 70,000 jobs. Services, including health services and government, continued to add jobs.

In the household employment survey, the unemployment rate inched up to 5.7%, 0.1 percentage point higher than last month and equal to the average for January through September. The employment-to-population ratio fell 0.1 percentage point to 62.9.

The four-week moving average of initial unemployment insurance claims, considered a leading economic indicator, continued to fall in the week ending October 26 from a recent peak of 424,000 claims in late September. Since April 2000, when they reached a 25-year low, initial claims have risen by about 130,000. Since March 2001, the four-week moving average has varied between 382,000 and 482,000 claims.

Unemployment Claims

NOTE: Shaded areas mark periods of recession. December 2001 is the estimated end date of the most recent recession.
a. Seasonally adjusted.
b. Data prior to 1990 are Federal Reserve Bank of Cleveland calculations.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; National Bureau of Economic Research; and Federal Reserve Bank of Cleveland.

The number of initial claims for unemployment insurance is an important economic indicator because it provides frequent, timely information about the U.S. workforce. This number received a great deal of attention last month, because the four-week moving average exceeded 400,000, which many consider an indicator of recession. Other indicators, however, do not suggest a renewed recession. Even so, the unemployment insurance system provides a wealth of current labor market information.

Trends for continued claims resemble those for initial claims, but are slower to fall during a recovery because several weeks may pass before workers are employed again. After the recessions of 1990–91 and 2001 (which is widely believed to have ended last December), the number of continued claims stayed high for several months before starting to decline. During these so-called "jobless" recoveries, the average duration of unemployment continued to increase long after the recession ended, partly because some states opt to extend the maximum permissible period for claiming benefits, which is typically around 26 weeks. The current average duration, 16.6 weeks, is the longest since just after the 1981–82 recession.

Absolute measures of unemployment tend to increase as the labor force increases. A better measure of unemployment is the insured unemployment rate (the share of the labor force that claims unemployment benefits), which adjusts for the growth of the labor force. It is lower than the total unemployment rate because some unemployed persons do not qualify or do not choose to receive benefits. Even under extended-benefit regimes, some workers cannot qualify

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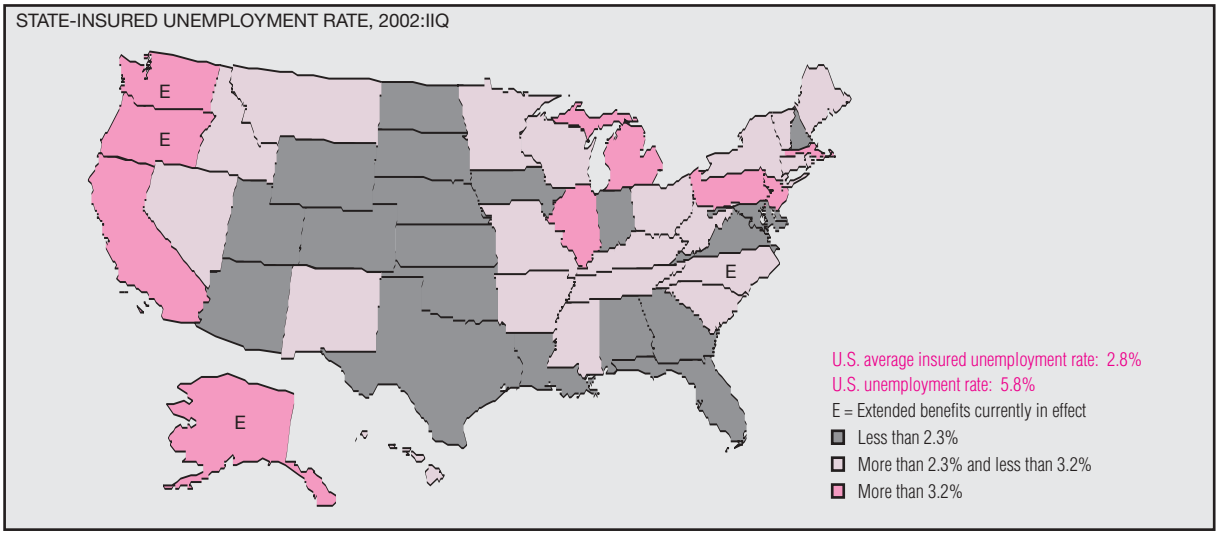
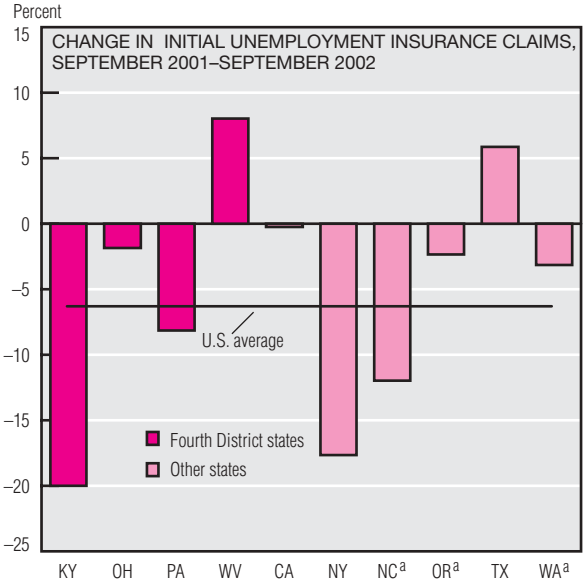
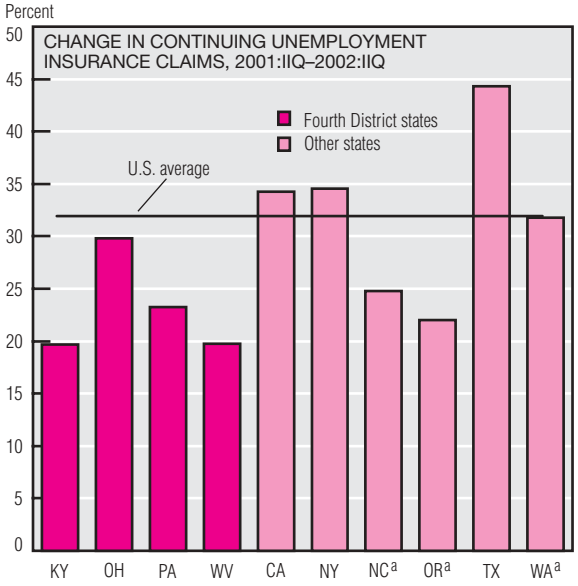
Unemployment Claims *(cont.)*







a. States with extended benefits.
SOURCE: U.S. Department of Labor.

because they have been unemployed too long.

Unemployment claims data are compiled from each state into national figures, so they allow one to observe regional differences that may be obscured in sample-based measures like those derived from the Bureau of Labor Statistics' household survey. Some differences between states result from differences in their programs (for example, whether the state extends its benefits), but there are also striking regional differences in conditions. During 2002:IIQ, states that were heavily invested in high-tech industries, including the West Coast states, Massachusetts, and New Jersey, posted insured unemployment rates that far exceeded the U.S. average. In the industrial Great Lakes region during the same period, some states did better than the national average and others did worse. In the Fourth District, insured unemployment rates for Ohio, Kentucky, and West Virginia were close to the U.S. average, but Pennsylvania, which has a lot of employment in aerospace manufacturing, posted an above-average rate.

Through September 2002, initial claims for the nation as a whole have fallen slightly. All the Fourth District states except West Virginia have seen initial claims fall from the levels observed a year before. Kentucky's decline has been dramatic, largely because its labor market was struggling long before the recession began in March 2001 and started to recover much earlier than the rest of the country.

This September initial claims in New York declined sharply year-over-year from the exceptionally high levels

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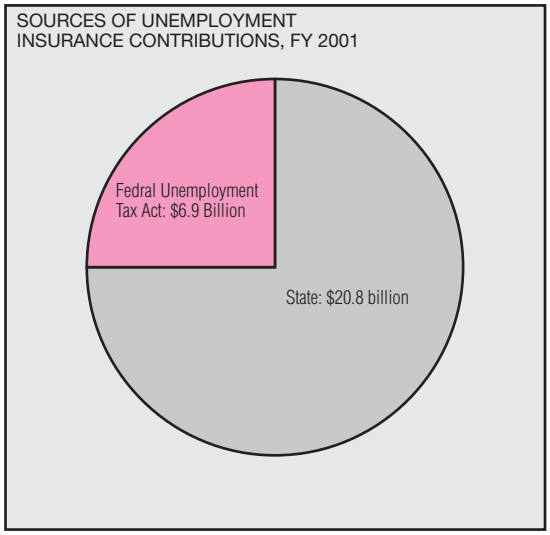
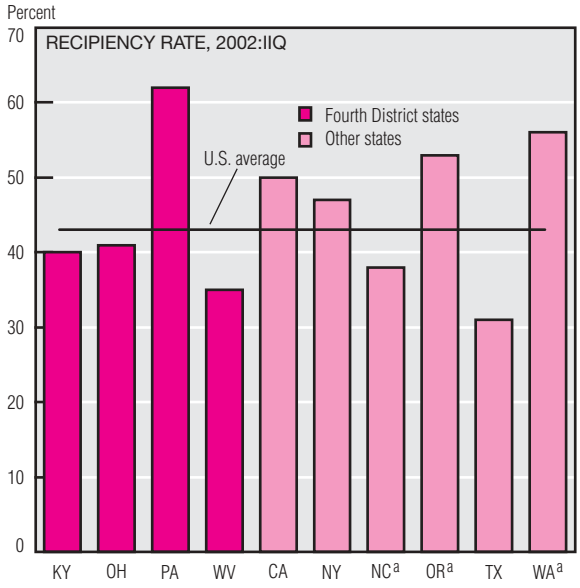
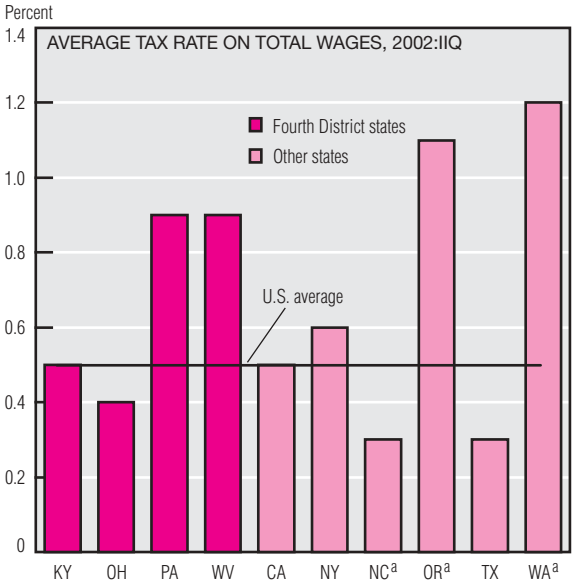
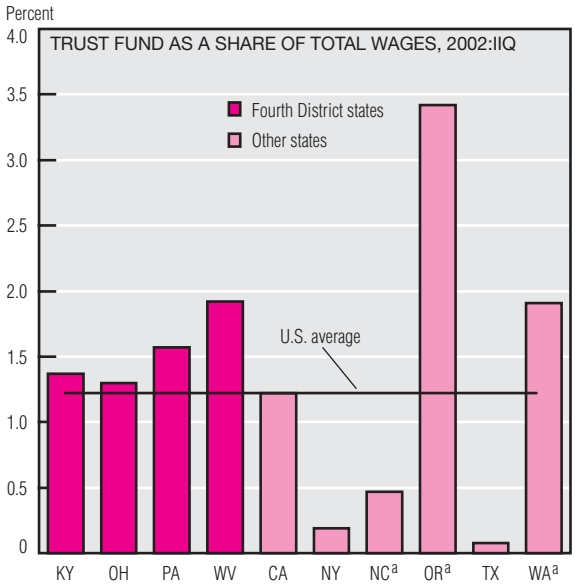
Unemployment Claims *(cont.)*









a. States with extended benefits.
SOURCE: U.S. Department of Labor.

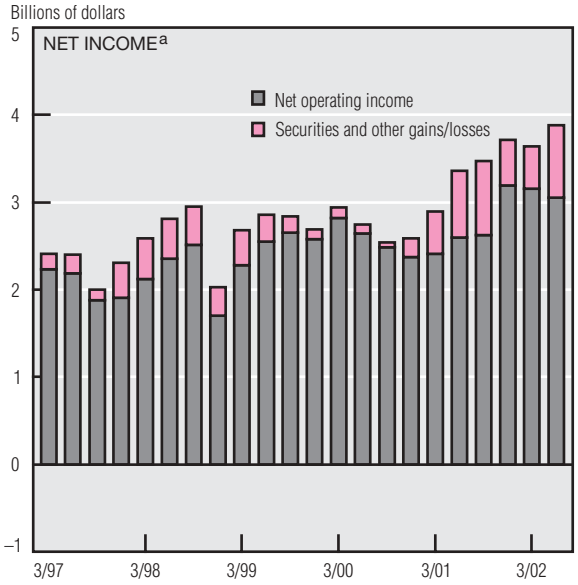
caused by last year's terrorist attacks. Despite the onset of the recovery, Texas, another state with a large high-tech industrial presence, still shows year-over-year increases in initial claims. Nationally, although the monthly number of initial claimants is lower than a year earlier, the number drawing unemployment benefits remains far above 2001 levels.

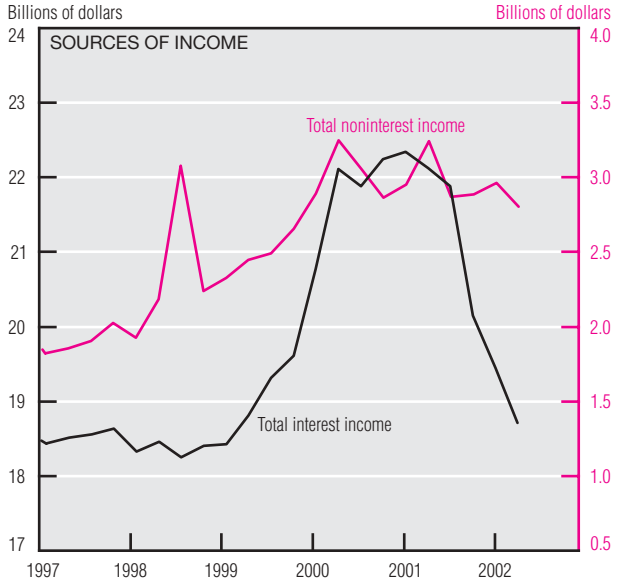
States contribute 75% of all dollars that unemployment insurance programs distribute to claimants, so they have considerable control over how they administer their programs. Within federal guidelines, they can determine their qualifying rates and how long an individual is permitted to claim benefits. As a result, state recipiency rates (insured unemployed as a share of total unemployed) varies widely. States where labor market shocks have been particularly large tend to have higher recipiency rates because their unemployed have more work experience, the primary factor in determining eligibility for benefits. States where extended benefits are in effect have some of the highest recipiency rates in the country.

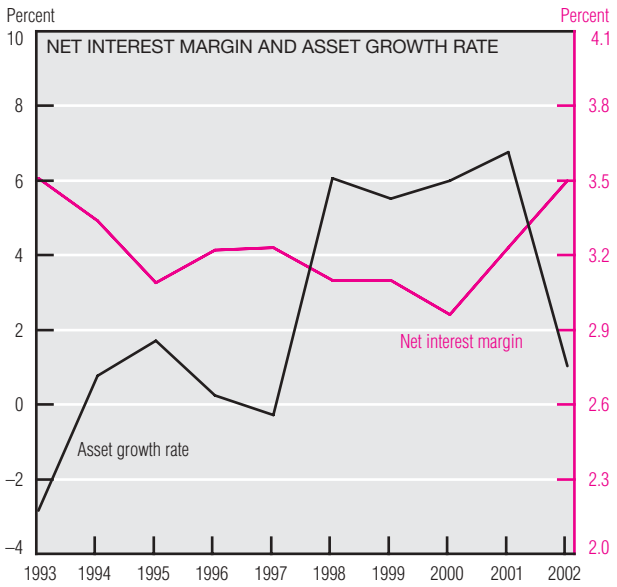
Of course, states fund their unemployment insurance programs out of tax revenues. Nationally, the average tax rate for state trust funds dedicated to these programs is 0.5% of total wages. In the Fourth District, tax rates for Pennsylvania and West Virginia are nearly double the national average.

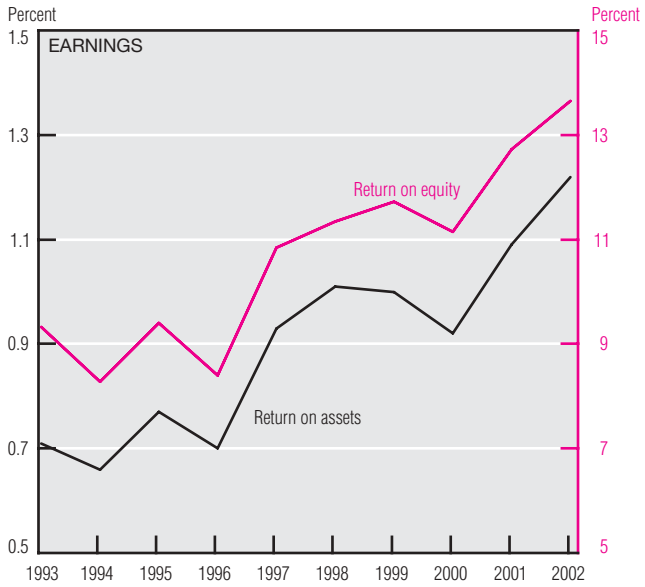
During the recession, all states had to draw down their trust fund balances considerably in order to distribute benefits, but some states continue to see their trust fund balances shrinking. In each Fourth District state, the unemployment insurance trust fund as a share of total wages exceeds the national average.

Savings Institutions









NOTE: Observation for 2002 is second-quarter annualized data.
a. Net income equals net operating income plus securities and other gains and losses.
SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2002:IIQ.

FDIC-insured savings institutions reported net income of $3.9 billion for 2002:IIQ; this was $519 million (15.5%) higher than a year earlier and $243 million higher than the previous quarter.

Savings and loans' noninterest (fee) income decreased to $2.8 billion, which was only slightly lower than the previous quarter but 13.6% lower than a year ago. Low mortgage rates continued to increase refinancing and reduced mortgage-servicing rights, leading to a 5.7% decline in noninterest income as compared to the previous quarter. The total interest income in 2002:IIQ was 15.4% lower than a year ago.

Savings institutions' strong earnings performance is once again apparent in the net interest margin, which is 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:IIQ, S&Ls' net interest margin reached 3.5%, its highest level since 1993. This factor, coupled with a steep decline in asset growth to 1.04%, pushed the S&Ls' return on assets to 1.22%, again the highest since 1993. Second-quarter annualized return on equity was 13.65%, also the highest since that year.

In 2002:IIQ, net loans and leases as a share of total assets rose to 65.3%, well below the recent high of

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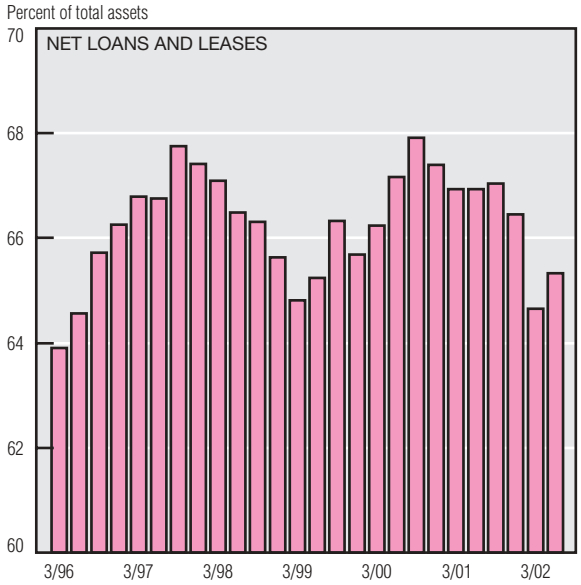
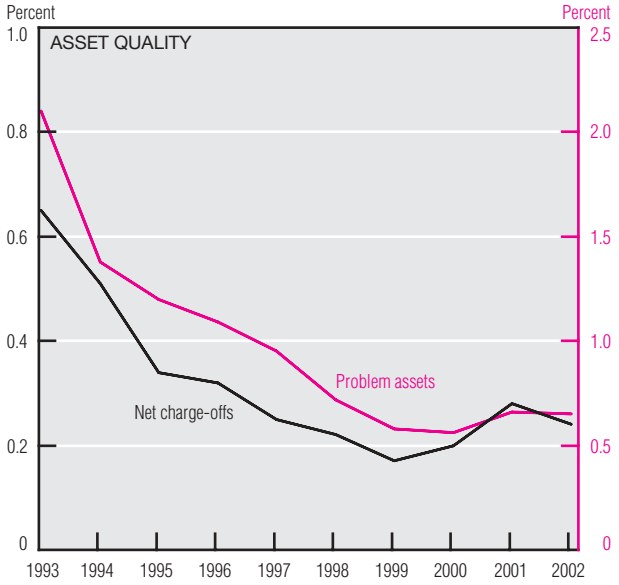
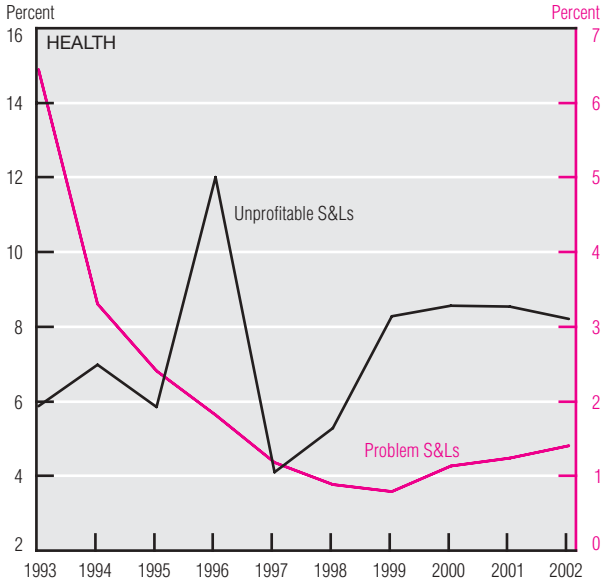
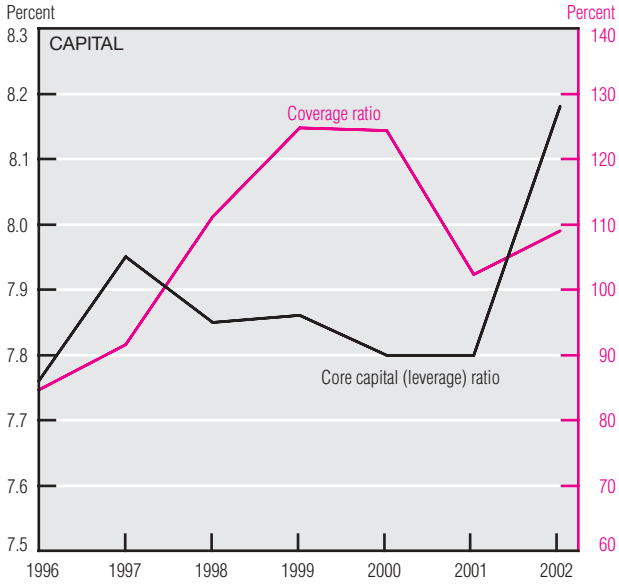
Savings Institutions *(cont.)*









NOTE: Observations for 2002 are second-quarter annualized data.
SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2002:IIQ.

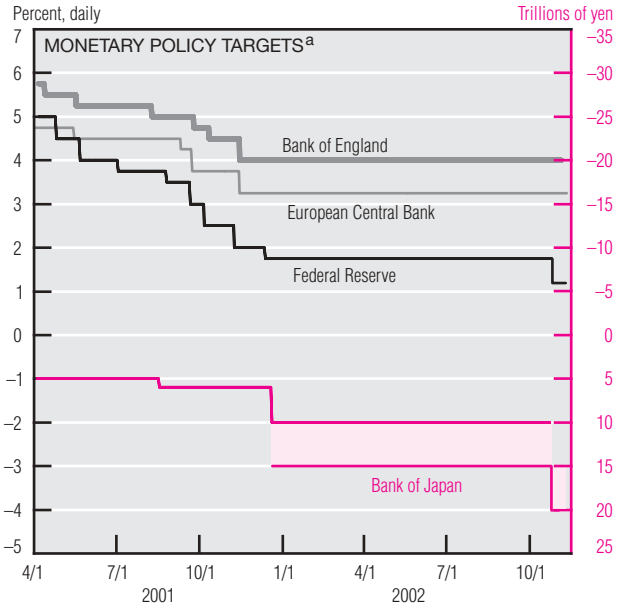
67.9% in 2000:IIIQ. Overall, the ratio still indicates declining activity in lending markets, despite the small monthly increase.

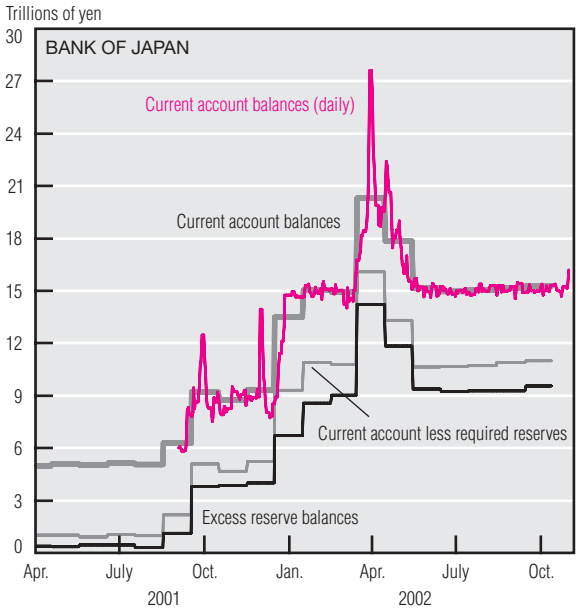
Asset quality showed a slight improvement in the second quarter. Net charge-offs (gross charge-offs minus recoveries) improved slightly compared to the previous quarter. Net charge-offs to loans stood at 0.24%, and problem assets (noncurrent assets plus other real estate) improved slightly to 0.65% of total assets. This was the first improvement after six consecutive quarterly increases in the level of problem assets.

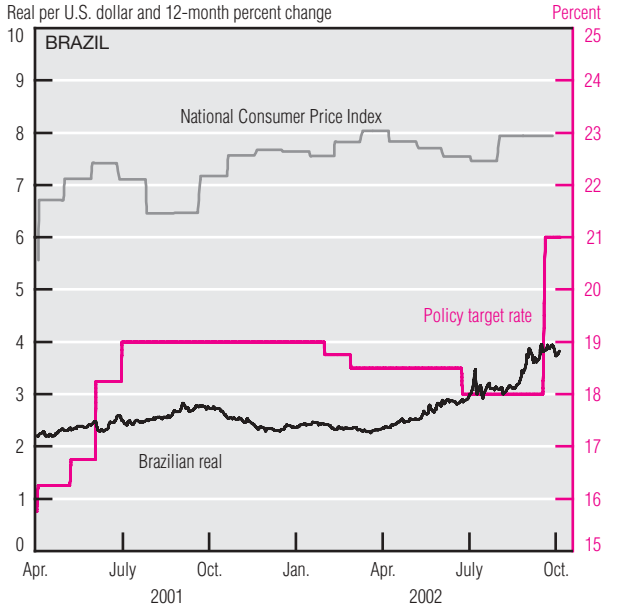
The share of problem S&Ls (those with substandard exam ratings) reached 1.40%, the highest level since 1997. However, declining asset quality is not a significant problem for FDIC-insured saving institutions, where the percent of unprofitable institutions is falling. Since the end of 2001, the coverage ratio went from $1.02 up to $1.09 (109%) in loan-loss reserves for every $1.00 of noncurrent loans. The increase in the ratio was led by an increase of $184 million in loan-loss reserves and a $513 million decrease in noncurrent loans.

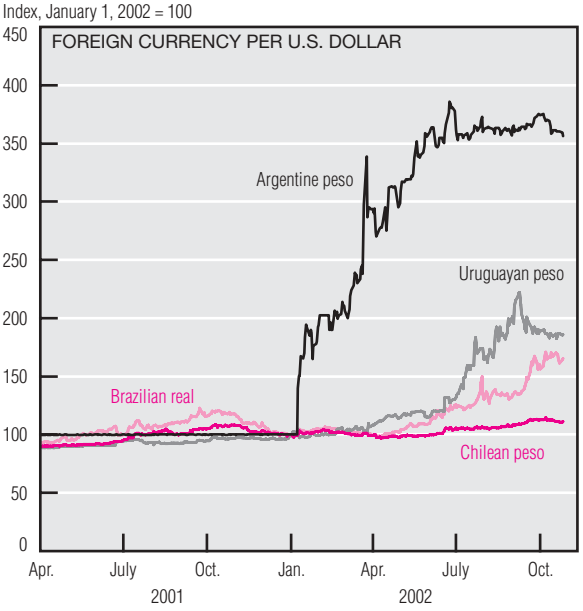
Core capital, which protects savings institutions against unexpected losses, increased from 7.80% in 2001 to 8.18% in 2002:IIQ; this was the highest since 1990, when the ratio was first calculated.

Foreign Central Banks









a. Federal Reserve: overnight interbank rate. Bank of Japan: a quantity of current account balances (since December 19, 2001, the range of a quantity of current account balances). Bank of England and European Central Bank: two-week repo rate.
SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; Banco Central do Brasil; and Bloomberg Financial Information Services.

Views of the global economic outlook seemed to consolidate recently around a longer period of weakness.

On November 6, the Federal Reserve reduced its target for the federal funds rate by 50 basis points to 1.25% and now sees risks as balanced with respect to its long-run goals of price stability and sustainable economic growth. On October 30, the Bank of Japan adopted a more accommodative policy position, noting increasing economic uncertainties resulting from "global economic developments, … likely acceleration in the pace of dealing with the non-performing loan problem," and volatile stock prices. It adopted measures that included raising the target for money market operations to between ¥15 trillion and ¥20 trillion in current account balances, increasing outright purchases of long-term government bonds to ¥1.2 trillion per month, and extending the maturity of bills purchased to one year.

Brazil's central bank raised its target for the SELIC money market rate by 300 basis points before the country's recent presidential election. Previously, it had raised capital requirements against banks' long dollar positions as well as reserve requirements. The higher target came after an increase in the inflation rate in August and a sharp movement in the exchange rate. Other exchange rates in the Americas have been relatively stable. The Argentine peso's recent stability was said to reflect expected agreement with the International Monetary Fund for rescheduling the nation's payments to multilateral agencies.