The Economy in Perspective

Collateral damage… At its early-November meeting, the Federal Open Market Committee reduced its federal funds rate target by 50 basis points, to 1.25%. Although it was the FOMC's first action since December 2001, the November decision was the twelfth consecutive rate reduction, cumulating to 525 basis points, since May 2000. Many observers interpret the November decision as the FOMC's acknowledgment that the economic expansion does not seem to be gaining momentum and that another monetary policy action would provide additional support. As recently as April, most analysts expected that the 2001 recession would have ended officially by now, but its presence—or aftermath—remains at the forefront this holiday season. Consumer sentiment about economic conditions has been wobbly, and business executives continue to complain about corporate profits and the poor environment for capital spending. For some of our important trading partners, economic conditions have been worse than our own; this means weak demand from abroad and downward price pressure. Firms are reluctant to hire new employees, and although overall employment levels have been holding fairly steady, the labor force continues to expand. Consequently, the unemployment rate has yet to show signs of cresting—the recent report that the national unemployment rate rose to 6.0% in November was a sharp disappointment. Disappointment seems to lurk at every turn, and patience is wearing thin.

On December 6, the White House announced the resignations of Treasury Secretary Paul O'Neill and National Economic Council head Lawrence Lindsey. A new team of economic policy leaders is expected to be named shortly as the Bush administration places renewed emphasis on communicating its programs and pushing for their enactment. The charged atmosphere makes it likely that economic stimulus will figure prominently in the administration's initiatives, although it has not officially announced the details of its plans.

Last year, Congress enacted legislation that created a wide range of tax reductions for individuals and corporations, some effective immediately and others to be phased in over a 10-year span. One might reasonably expect the administration to phase in some of the already agreed-upon tax measures more rapidly than last year's legislation specified. One might also expect the administration and Congress to pay additional attention to incentives for bolstering capital spending, which has been so much weaker than household spending on housing and durable goods.

It is necessary to consider how tax policy might be adjusted to stimulate economic growth quickly, but there are risks worth considering as well. The first concerns the need for stimulus. During recessions and expansions alike, economic activity is volatile on a monthly and quarterly frequency, limiting the value of forecasts. If the U.S. economy is currently in a recession, it is a strange recession indeed, for real growth has been in the range of 3% all year. Orders for capital goods may strengthen gradually in the natural course of events next year as excess industrial capacity dissipates.

A second risk concerns the effectiveness of tax policy. To take the most obvious example, if capital goods orders are weak because so much current industrial productive capacity remains unused, would investment tax credits spur much demand?

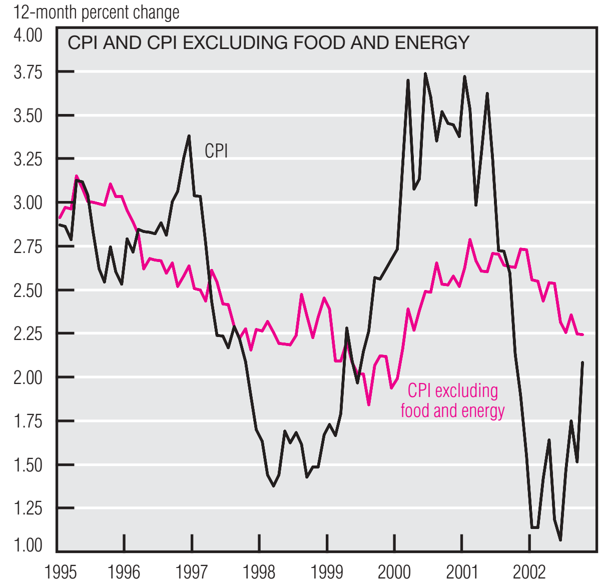
A third risk concerns the interaction between short-term fiscal policy and the U.S. government's long-term fiscal position. In the fiscal year that just ended, the federal government's budget deficit amounted to $159 billion, and total debt outstanding held by the public rose to roughly $3 trillion. Yet the net present value of the government's commitments for the next 75 years to pay Social Security, Medicare, and federal retirement benefits is in the range of $18 trillion to $26 trillion, double the size of our current $11 trillion GDP. As Undersecretary of the Treasury Peter Fisher concluded in a recent speech, the federal government needs to encourage more investment and saving to support faster economic growth, to control the health care costs affecting the budget, and to become more disciplined about the cost of its promised future benefits. Fitting short-term stimulus measures into this longer-term framework presents its own set of challenges.

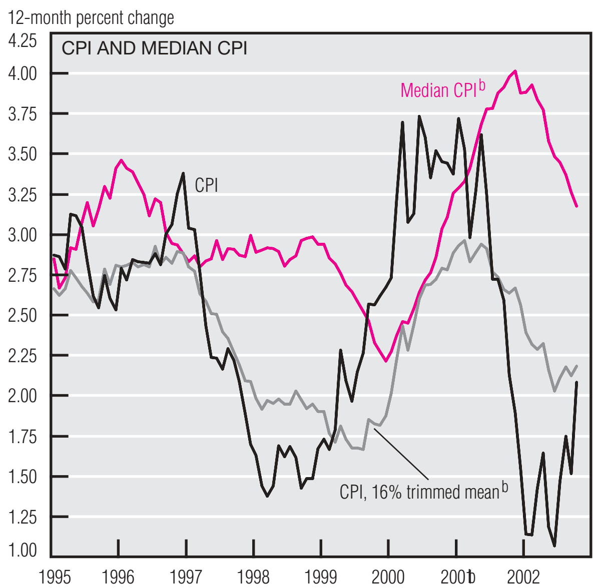
Recessions do not merely inflict damage at their epicenter; they are also capable of casting long and unpredictable shadows. Fortunately, recessions in the United States have been infrequent during the last 20 years, and economic policymakers have become more adept in responding to them. Policymakers' recent actions show that they are paying close attention to this one.

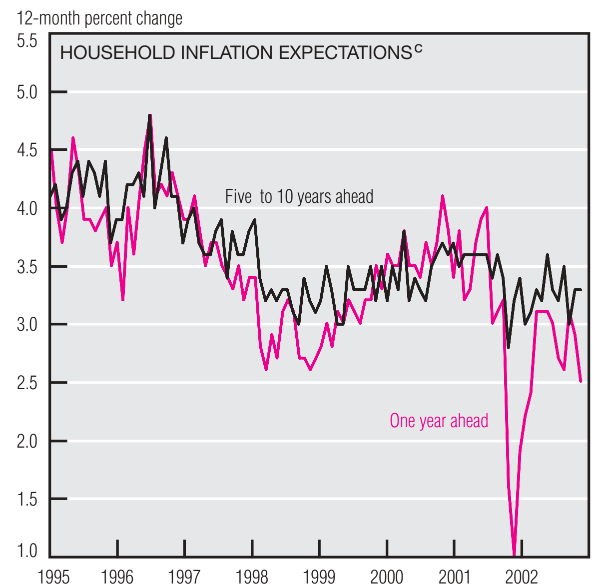
Inflation and Prices

October Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2001 avg.
Consumer prices					
All items	3.4	3.1	2.1	2.3	1.5
Less food and energy	1.9	2.3	2.2	2.3	2.7
Median[b]	3.4	3.2	3.2	3.1	3.9
Producer prices					
Finished goods	13.8	4.7	0.6	1.2	–1.7
Less food and energy	5.7	1.6	0.5	1.1	0.9







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
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; Federal Reserve Bank of Cleveland; and University of Michigan.

The consumer price index (CPI) rose 0.3% (3.4% annual rate) in October; according to the Labor Department, rising energy prices accounted for about half of this increase. Energy prices have been going up at an accelerating rate, advancing at a monthly rate of 0.4% in July, 0.6% in August, and 0.7% in September, then jumping at a rate of nearly 2.0% in October. By contrast, inflation in food prices over the last six months has been almost nil.

Excluding food and energy prices, the CPI rose 0.2% (1.9% annual rate). Among the major CPI categories that showed accelerating inflation in the October report were shelter, transportation, medical care, and recreation. Prices for tobacco and smoking products, though, fell sharply during the month.

On a year-over-year basis, the CPI had advanced 2.1% as of October, the first time in a year that this figure climbed above 2%. The CPI's 16% trimmed mean has also been trending upward, albeit more modestly; in the past four months, it has risen from 2.0% to 2.2%. By contrast, the median CPI continues the downward trend it began at the end of last year. Since then, its year-over-year rate of change has dropped more than 3/4 of a percentage point. However, the median remains nearly a percentage point higher than the trimmed mean.

Households' short- and long-run expectations of inflation have been drifting apart since converging at about 3% in September; the reason was a drop in short-run expectations. Households now expect slightly less inflation in the next year (2.5%) than in the next five to ten years (3.3%). Both long- and short-run inflation expectations by households remain

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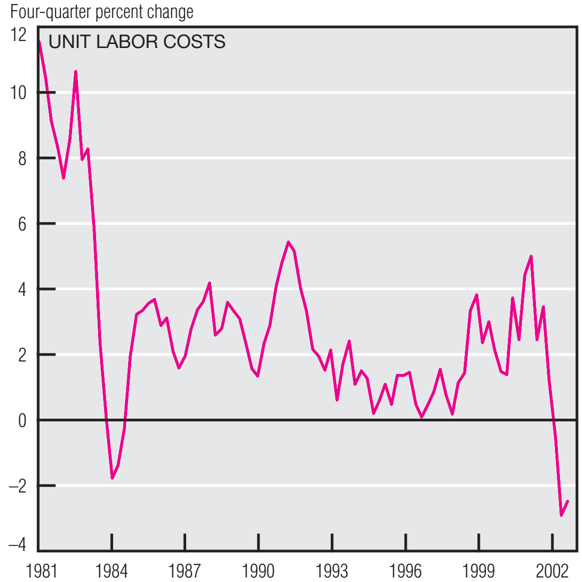
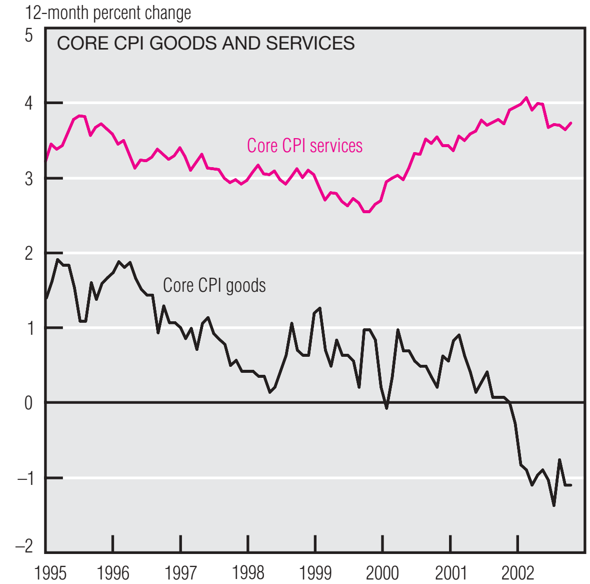
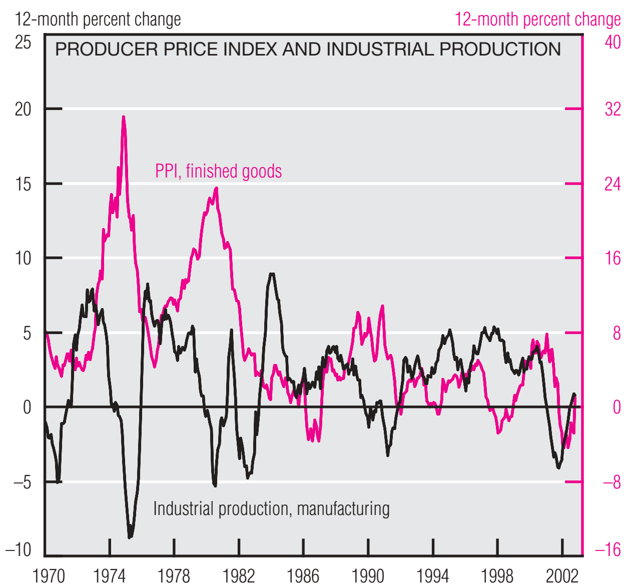
Inflation and Prices *(cont.)*







Changes in PPI and IP, by Industry

	24-month percent change	
	Producer Price Index	Industrial production
Printing and publishing	4.81	–10.86
Foods	2.25	–0.53
Stone, clay and glass products	2.23	–1.85
Furniture and fixtures	2.09	–10.36
Fabricated metal products	1.15	–5.33
Rubber and plastics products	0.80	–3.0
Transportation equipment	0.58	–5.47
Chemicals and products	0.57	0.0
Apparel products	0.0	–12.88
Lumber and products	–0.13	–3.02
Industrial machinery and equipment	–0.77	–10.82
Textile mill products	–1.03	–9.97
Primary metals	–2.16	–8.44
Electrical machinery	–2.69	–7.49
Petroleum products	–3.45	–2.68

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

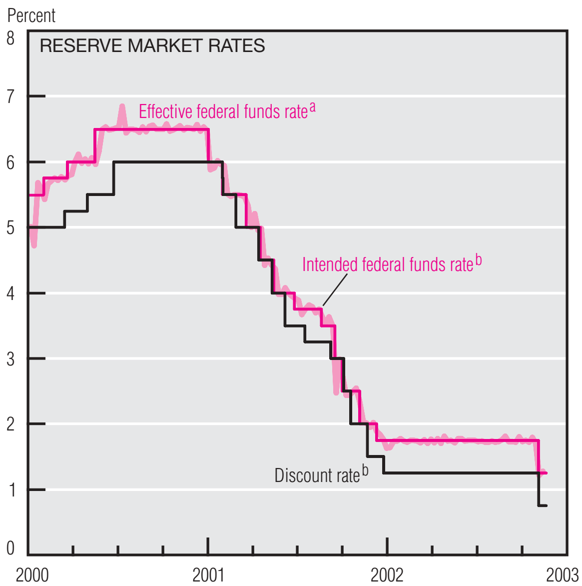
near historically low levels. A look at the labor market seems to support households' optimism about the near-term inflation outlook. On a year-over-year basis, unit labor costs have fallen in four consecutive quarters, reflecting increases in workers' productivity amid decreases in workers' compensation

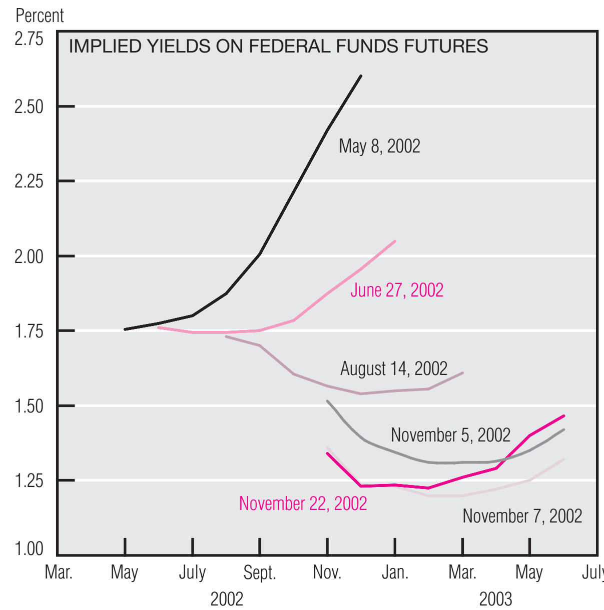
One reason for the sanguine near-term inflation expectations may be declining goods prices. On average, prices of core CPI goods, that is, goods in the CPI market basket excluding energy, have been falling for an unprecedented 11 consecutive months. Core CPI goods prices have not fallen for any prolonged period in more than 40 years and then for only seven straight months.

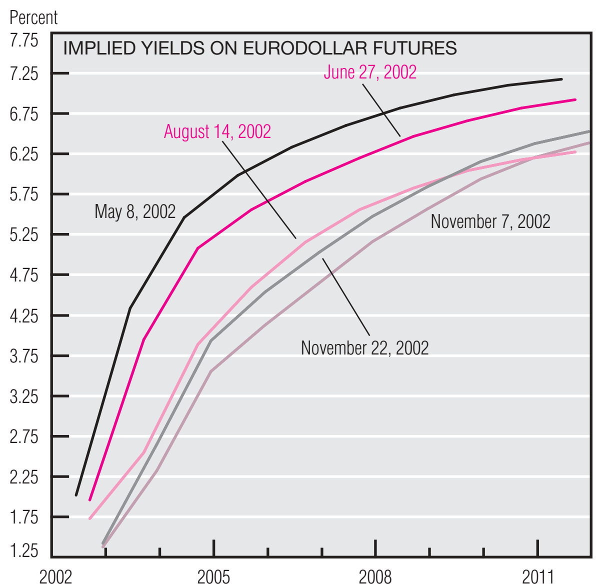
To understand what might be driving down goods prices, it might be instructive to look at producer prices. Consider that in the past, changes in the Producer Price Index (PPI) and industrial production in the manufacturing sector (IP) have tended to move in opposite directions. This suggests that historically, the prices of industrial products have been most affected by supply factors; temporary declines in output have been associated with upward pressure on prices.

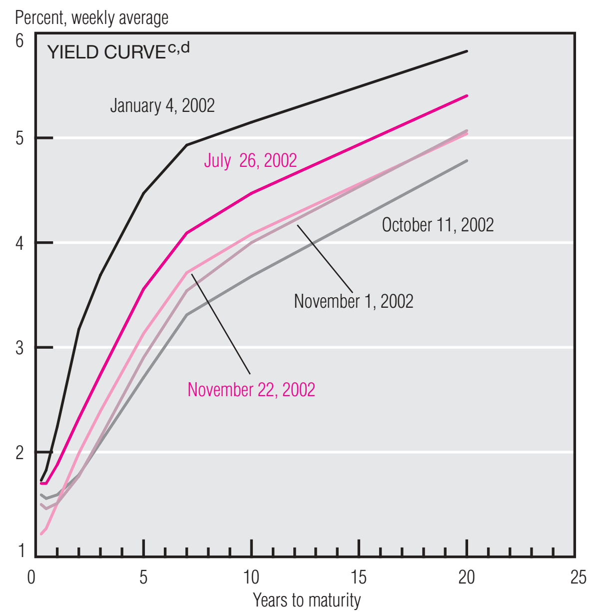
Recently, however, these economic time series have begun to move in the same direction, suggesting that in the aggregate, these changes may be driven by waning demand. However, the industry-level data present a murkier picture. Certainly, some industries have seen significant declines in production, coupled with falling prices. But in other industries, particularly those tied to the automotive sector, prices have continued to rise even as production has declined.

Monetary Policy









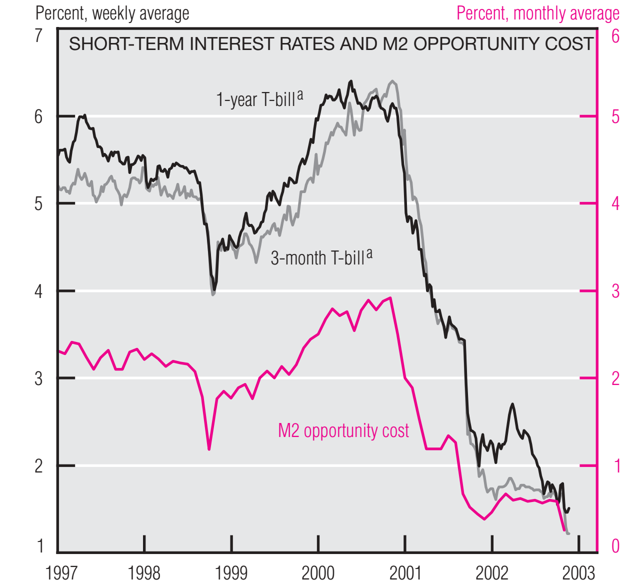
a. Weekly average of daily figures.
b. Daily observations.
c. Average for the week ending on the date shown.
d. All yields are from constant-maturity series.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15; and Bloomberg Financial Information Services.

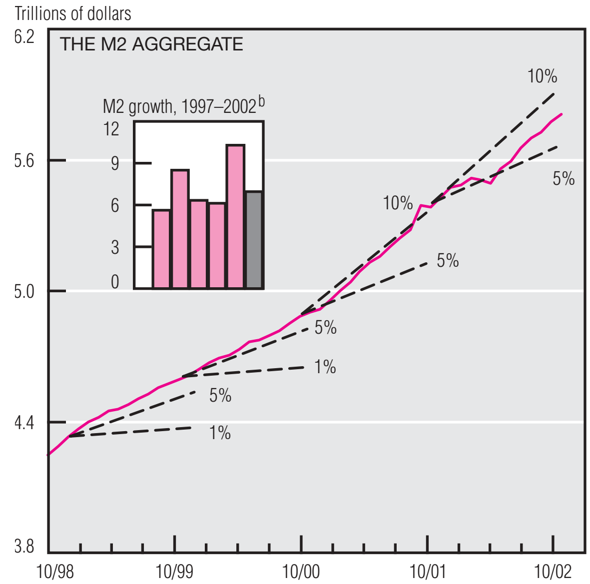
On November 6, the Federal Open Market Committee lowered its target for the federal funds rate by 50 basis points (bp) to 1.25%. In a related action, the Board of Governors lowered the discount rate 50 bp to 0.75%. The magnitudes of the moves surprised markets. Although the fed funds futures market had priced in a rate cut, the implied yield indicated an expectation of a 25 bp change in November, with a possible further cut sometime later.

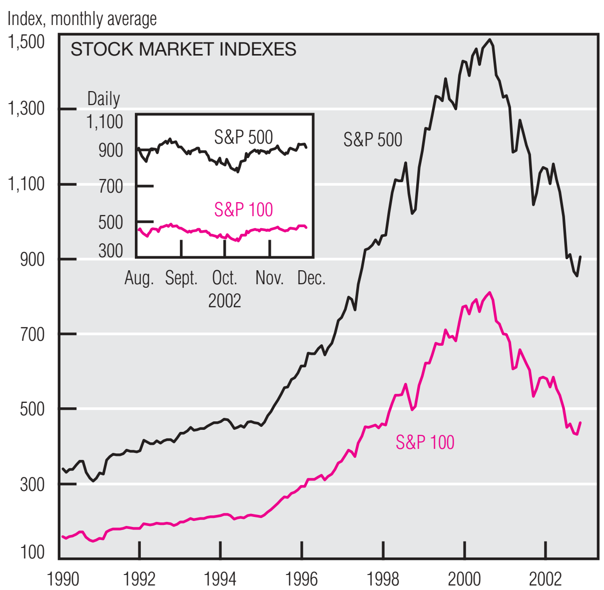
The implied yields on eurodollars—a measure of the expected fed funds rate over long horizons—has shifted up in future years, suggesting that participants in this market expect the current rate reduction to be reversed within a year. Interestingly, expected rate increases will arrive sooner than they would have in the absence of the recent change. Moreover, the yield curve became more steeply sloped after the policy announcement, a reaction consistent with the belief that policy had become more accommodative.

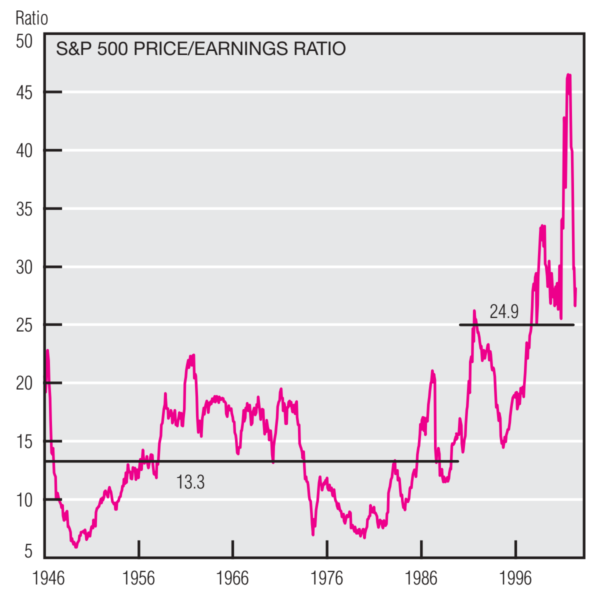
The FOMC's announcement recognized the deterioration in the economic outlook but characterized it as a "soft spot," that is, a transitory weakness. The Committee emphasized its belief that the action taken should prove helpful as the economy works its way through the period of weakness. The FOMC also indicated its belief that with this action, the risks are balanced with regard to the prospects for price stability and sustainable growth in the foreseeable future. On the other hand, it noted that incoming economic data have tended to confirm that greater uncertainty, resulting partly from heightened geopolitical risks, is inhibiting spending, production, and employment.

Money and Financial Markets









a. Constant maturity.

b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2002 growth rate for M2 is calculated on an October over 2001:IVQ basis. Data are seasonally adjusted.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15. and "Money Stock Measures," H.6, *Federal Reserve Statistical Releases*; Standard and Poor's Corporation; and Bloomberg Financial Information Services.

The sharp decline in interest rates over the past two years reduced the opportunity cost of holding monetary instruments nearly to zero. Consequently, the demand for money, as measured by M2, rose sharply in 2001. As short-term interest rates and opportunity cost stabilized in 2002, M2 growth slowed considerably but accelerated in the spring.

In the financial sector, stock market volatility remains a big story. Although economic fundamentals softened somewhat in the fall, earnings reports surprised investors, coming in slightly better than forecast for the third quarter. After hitting bottom in October, the S&P 500 turned around but remains well below its level at the beginning of the year. Earlier declines were consistent with the realization that the recovery was much weaker than had been expected when 2002 began, particularly for investment. Falling stock prices, combined with rising earnings, resulted in a precipitous decline in the price-to-earnings ratio.

Another factor contributing to the stock market decline is concern over the quality of financial reports. The issue has shifted from worry about potential corporate fraud to questions about legal but improper accounting practices. One practice now receiving closer scrutiny is public companies' developing their own measures of earnings and reporting them in press releases. Such measures—called pro forma, street, or operating earnings—differ from the measures defined by generally accepted accounting

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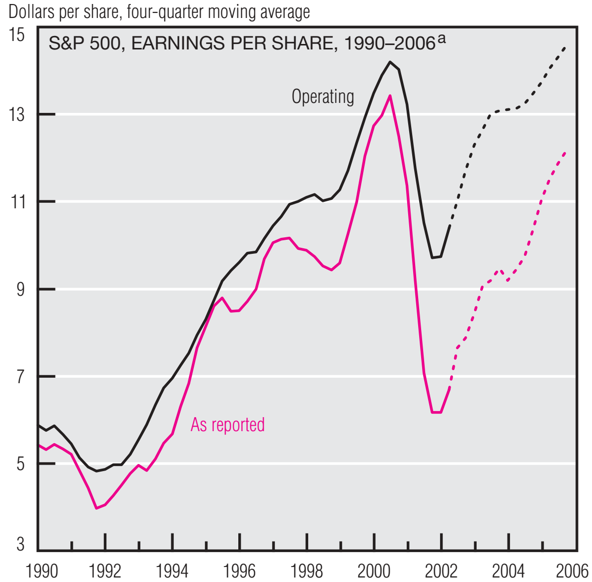
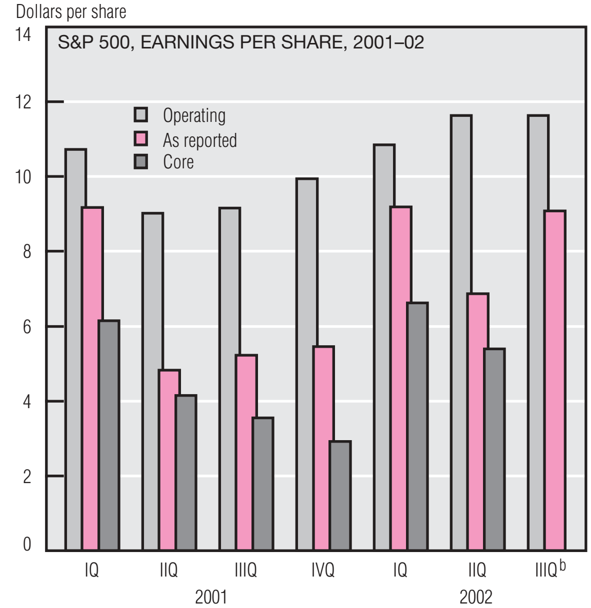
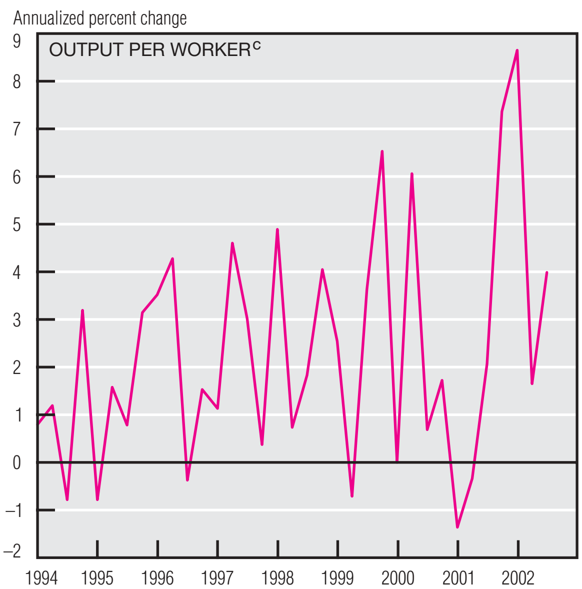
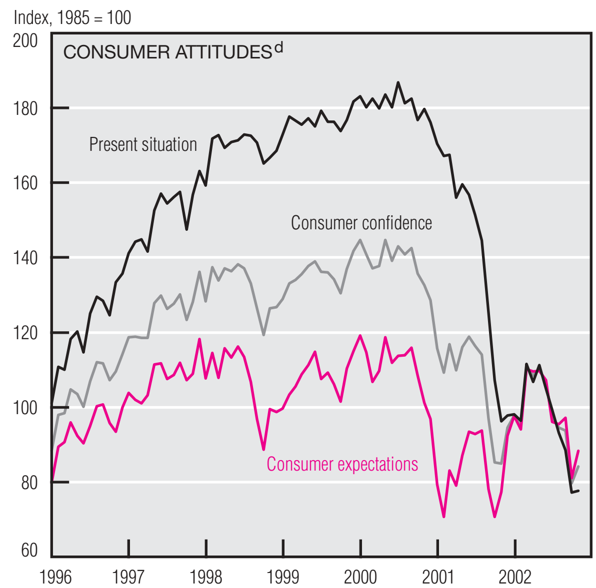
Money and Financial Markets (cont.)









a. Dashed line shows earnings estimates provided by Standard and Poor's.
b. Preliminary.
c. Nonfarm business sector.
d. Data are seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poor's Corporation; and Conference Board.

principles—GAAP—earnings in that they omit various nonrecurring, noncash, and miscellaneous items. Full reports typically provide GAAP earnings somewhere but they feature company-defined measures far more prominently.

The discrepancy between company-defined ("operating") earnings and GAAP ("as reported") earnings has been increasing over time. Does the operating earnings measure exaggerate a firm's performance? Excluding items such as nonrecurring costs may be appropriate if such charges are truly unrelated to a firm's future earning power. The great question is whether the items excluded from alternative measures are truly nonrecurring. If they are, one would expect the discrepancy to diminish, with GAAP earnings growing faster than the alternatives. Only time can resolve this question.

Two other issues are the treatment of employee stock options (ESOs) and pension fund gains and expenses. Under current GAAP rules, firms are not required to expense the value of the stock options they grant. Because ESOs are a form of compensation, critics argue that omitting them from expenses exaggerates earnings. During the past year, more than 100 firms in the S&P 500 announced their intention to expense earnings voluntarily.

Weakness in the stock market has reduced the value of pension fund portfolios, increasing the need for cash contributions. Critics note that current GAAP rules do not fully reflect increased pension expenses. Standard and Poor's calculates a core

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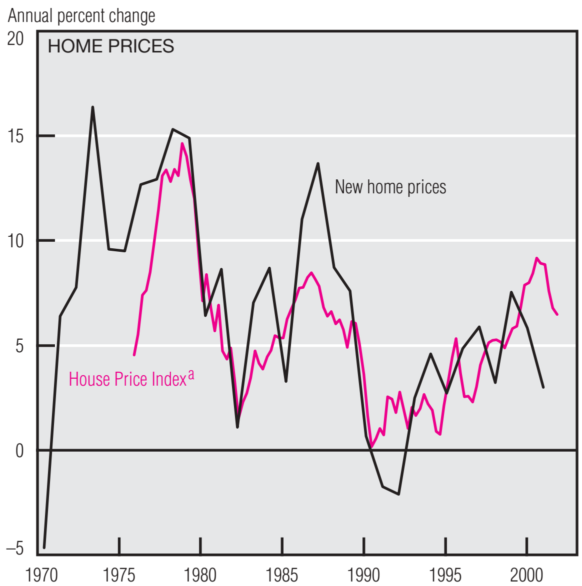
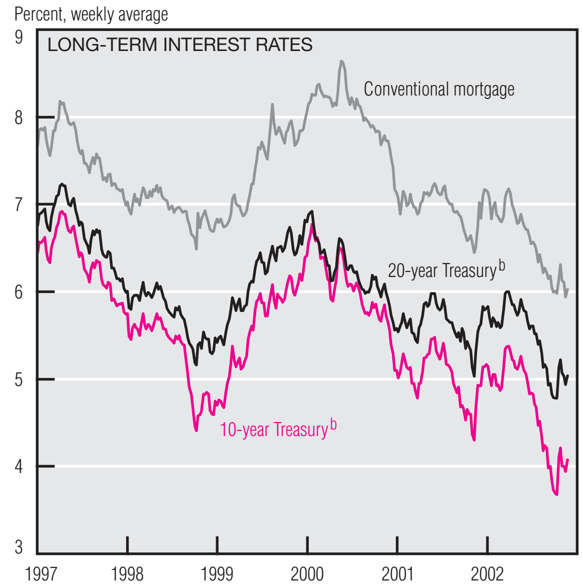
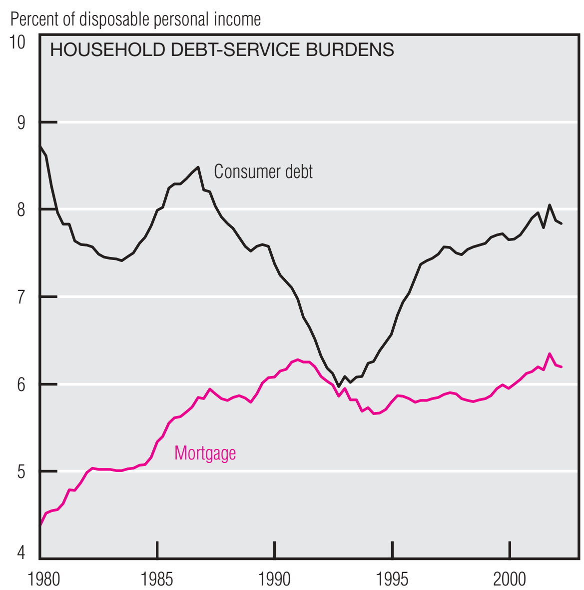
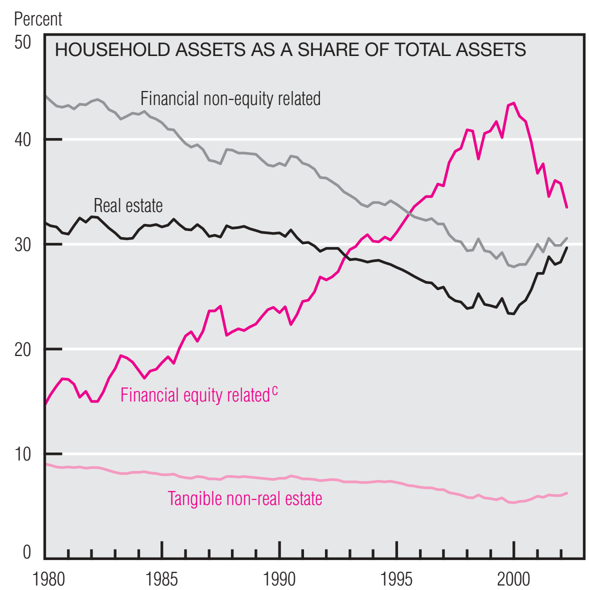
Money and Financial Markets *(cont.)*









a. Includes new and existing homes.
b. Constant maturity.
c. Equity-related assets are defined as corporate equities, mutual fund shares, and pension fund reserves.
SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight; and Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

earnings measure for the S&P 500 that adjusts GAAP earnings for the value of ESOs and pension funds.

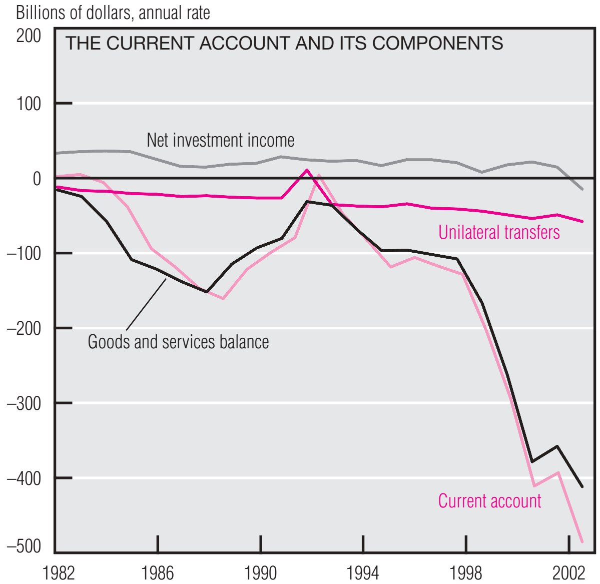
Despite the earnings quality issue, the stock market has firmed since its October low. The underlying fundamentals of continued strong productivity growth and steady consumer spending provide some support for optimism. Nevertheless, measures of consumer confidence remain tempered, even with the most recent increase in consumer expectations.

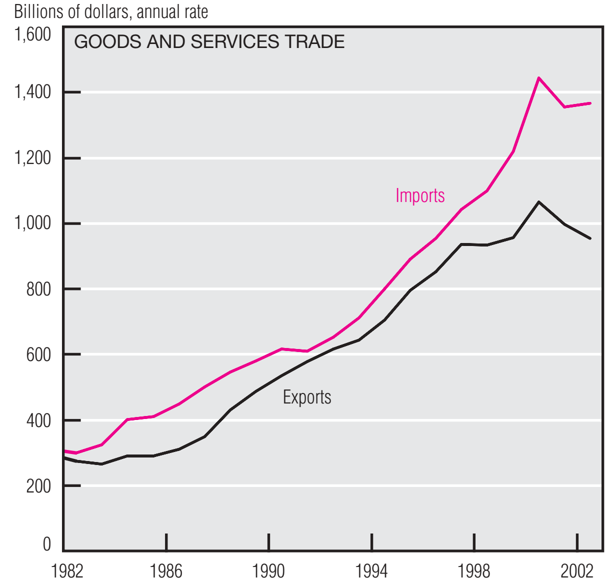
Household spending during 2002 was supported by funds made available from mortgage refinancing. Because the holiday season is so critical, markets are likely to be sensitive to the strength of retail spending in December.

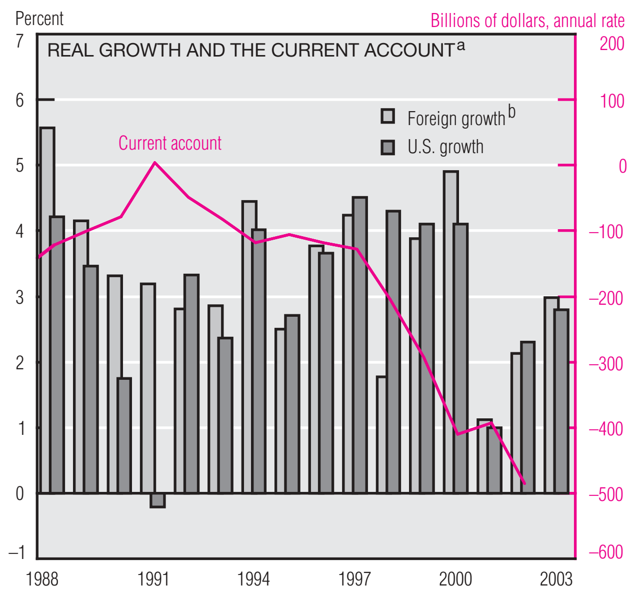
Housing prices have held up reasonably well despite limited employment growth. The housing price index, though decelerating, has continued to increase. A key factor in housing strength is that falling mortgage rates have made home ownership more affordable. Debt service burdens for mortgages are essentially unchanged from 1990. Worries about a housing price bubble do not seem justified by these facts.

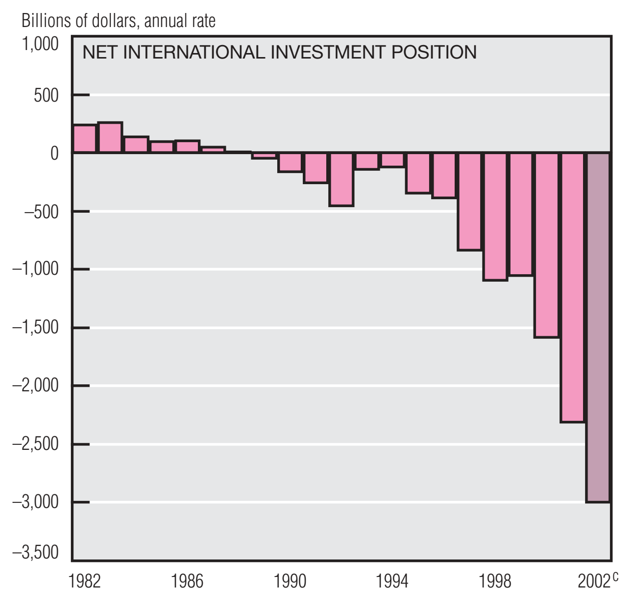
The decline in mortgage rates is ultimately bounded. Thus, to the extent that consumer spending has been fueled by mortgage refinancing and housing by affordability, private spending by households could slow. Hopefully, investment spending by firms will continue to accelerate and pick up the slack.

The Current Account Deficit









a. Data for 2002 and 2003 are averages of data from several sources.
b. Foreign GDP growth is the trade-weighted average growth rate for the top 15 U.S. trading partners in 1992–97: Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, Netherlands, and Brazil.
c. Author's estimate.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Organization for Economic Cooperation and Development, *Economic Outlook*; International Monetary Fund, *International Financial Statistics*; DRI/McGraw-Hill; *Blue Chip Economic Indicators*, November 10, 2002; and *The Economist*.

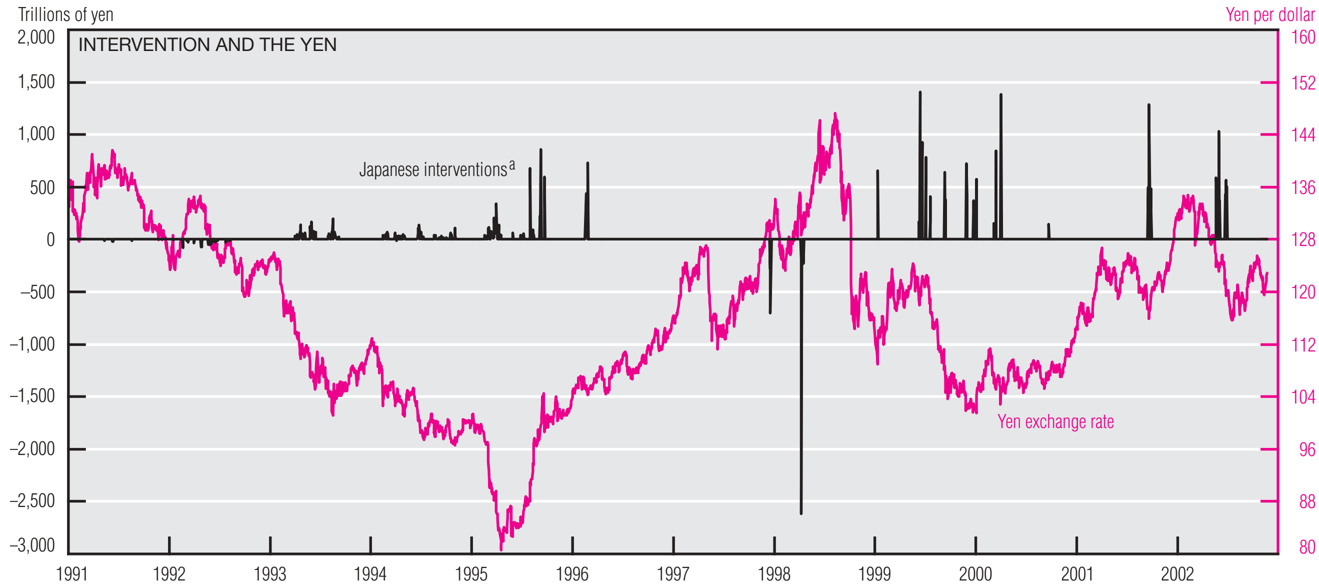
The U.S. seems to be emerging from the most recent economic frost a little faster than the rest of the world. As a consequence, our perennial current account deficit, which seemed dormant in 2001, is blooming again.

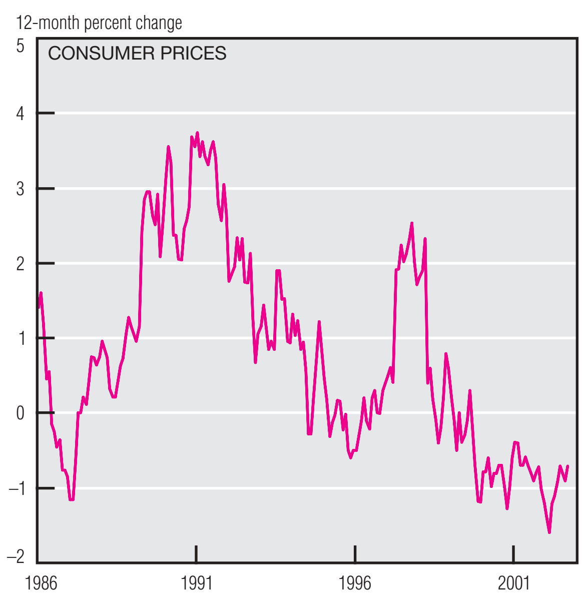
The nation's current account deficit in the first half of 2002 equaled $485 billion (annual rate), approximately 4.7% of GDP. Most observers recently trimmed their foreign growth estimates and expect the U.S. current account deficit will easily exceed 5% of GDP by year's end. Typically, foreign economic growth must exceed U.S. economic growth by approximately 1% before our trade pattern improves. Although trade shortfalls account for nearly all of our current account deficits, net income receipts, traditionally a surplus item for the U.S., became a deficit entry this year.

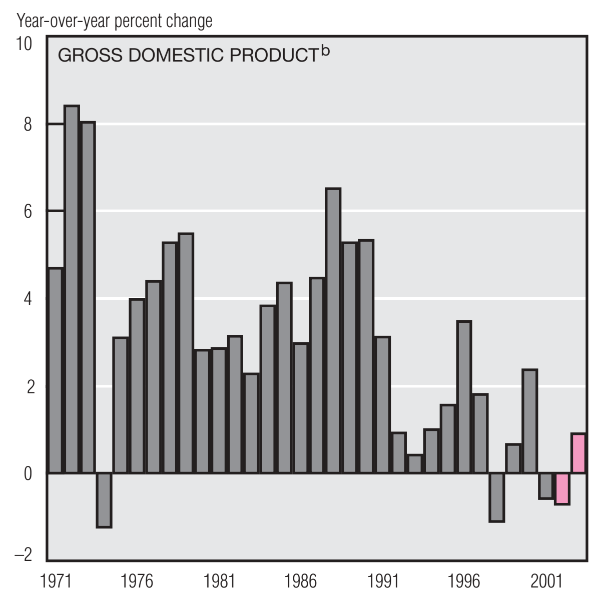
Our persistent current account deficit indicates that the U.S. has not exported enough goods and services to pay for its imports, unilateral transfers, and net income payments to foreigners. To settle the balance, the U.S. either must give foreigners financial claims against its future output or reduce its existing claims to their future output. This process creates financial inflows that, abstracting from measurement error, exactly equal the current account deficit.

These inflows consist of various financial instruments that give foreigners claims on our future output. Since the late 1980s, the resulting stock of foreign claims against this nation has exceeded the stock of U.S. claims on other countries. This year, the market value of our negative net international investment position will approach $3 trillion or 29% of GDP.

Japanese Interventions







a. Positive values are official purchases of dollars; negative values are official sales of dollars.
b. Data for 2002 and 2003 are from the Blue Chip forecast.
SOURCES: Board of Governors of the Federal Reserve System; Japanese Ministry of Finance; and Organization for Economic Cooperation and Development.

On November 19, Japanese Finance Minister Masajuro Shiokawa formally asked the Bank of Japan not to neutralize the monetary effects of any foreign exchange interventions that the Ministry of Finance (MF) might undertake. The move surprised many analysts because it potentially gives the MF leverage over Japanese monetary policy and could compromise the Bank of Japan's independence.

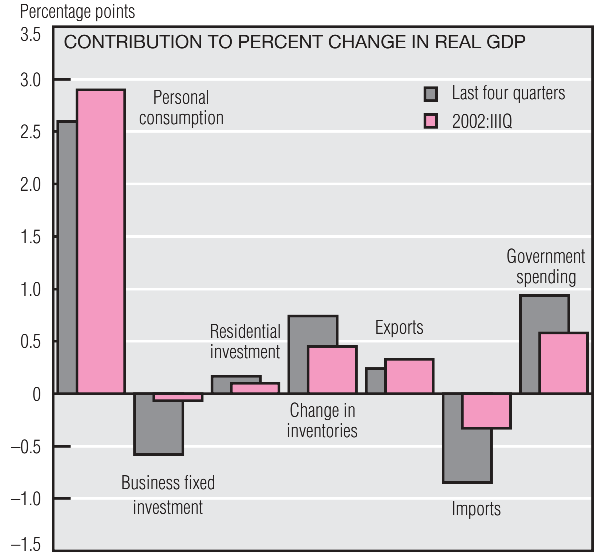
The Bank of Japan executes all official Japanese foreign exchange transactions at the direction of the MF. Since 1993, MF interventions have been fairly frequent and large. These operations can alter the amount of yen reserves in the Japanese banking system. An intervention purchase of dollars, for example, adds to yen reserves. The Bank of Japan, however, undertakes traditional open-market operations to offset any such reserve changes that conflict with its independently determined monetary objectives.

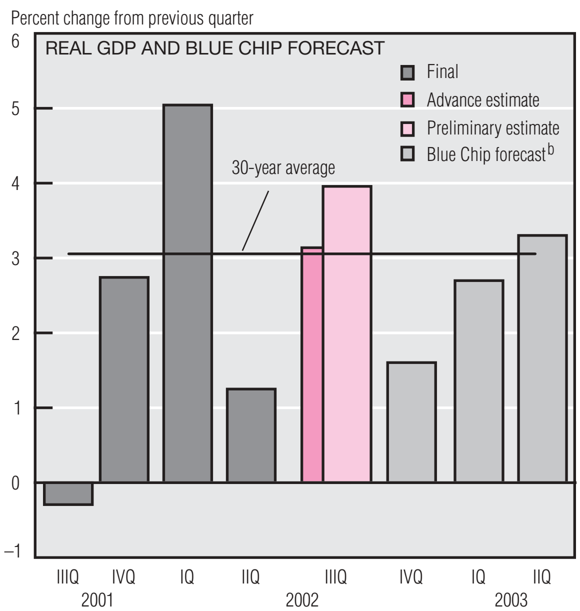
The MF may feel that undertaking a monetary operation in exchange markets could have a bigger economic kick than standard open-market procedures, or it may just want to increase the overall size of monetary operations. Japan's economic malaise has persisted with little respite for more than a decade. The Bank of Japan eased monetary policy to halt the decline in both output and prices; but with short-term interest rates near zero, the traditional channels of monetary influence seem ineffective. Recently, the Bank lowered its economic growth outlook, largely because of deteriorating prospects for Japan's critically important export sector.

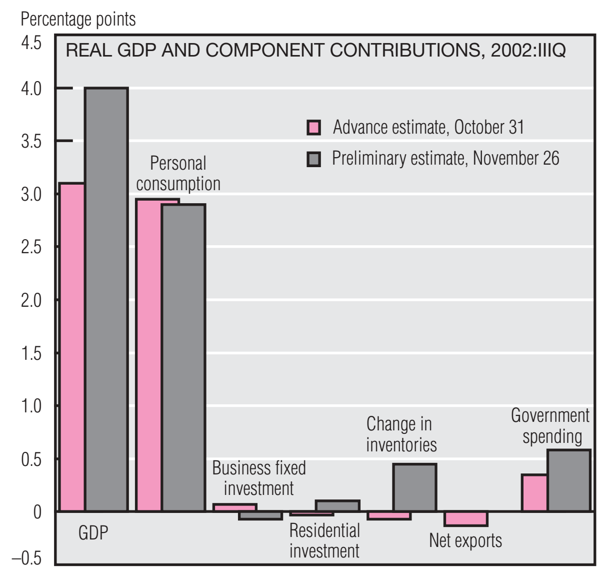
Economic Activity

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

	Change, billions of 1996 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	91.6	4.0	3.2
Personal consumption	66.8	4.1	3.7
Durables	52.3	23.1	12.0
Nondurables	4.4	0.9	3.1
Services	20.2	2.2	2.5
Business fixed investment	–2.1	–0.7	–5.1
Equipment	15.4	6.6	1.1
Structures	–13.0	–20.6	–20.9
Residential investment	2.0	2.1	3.7
Government spending	12.9	3.1	5.1
National defense	6.9	7.1	10.2
Net exports	–0.1	—	—
Exports	8.8	3.3	2.5
Imports	8.9	2.3	6.5
Change in business inventories	10.6	—	—







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*, November 10, 2002.

The preliminary estimate showed that real gross domestic product (GDP) advanced at an annual rate of 4.0% during 2002:IIIQ. Personal consumption expenditures rose 4.1% (annual rate) and made the largest contribution to real GDP growth. Consumer spending was boosted by a rise of 23.1% (annual rate) in durable goods expenditures. Business spending fell slightly, with expenditures on structures falling $13.0 billion (chained 1996 dollars). Residential investment and government spending both added to real GDP growth, but at a slower rate than in the last four quarters. In international trade, exports increased 3.3% and imports rose only 2.3% (annual rates).

The preliminary estimate put real GDP growth nearly 1% above its long-term average. Blue Chip forecasters, however, predict that real GDP growth will not surpass this average again until 2003:IIQ. The preliminary figure of 4.0% real GDP growth issued in November represented a substantial upward revision from the advance estimate of 3.1% (annual rates). Inventories were among the most important factors in the revision: Whereas the advance release had estimated that inventories reduced real GDP growth by 0.1%, the preliminary figure showed them adding nearly 0.5%. Last month, business spending was expected to increase real GDP growth slightly. But instead of making its first positive contribution since 2000:IIIQ, business spending declined for the eighth consecutive quarter.

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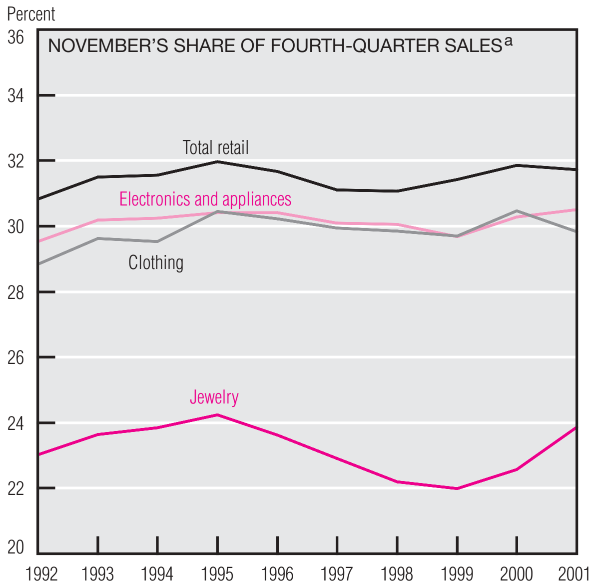
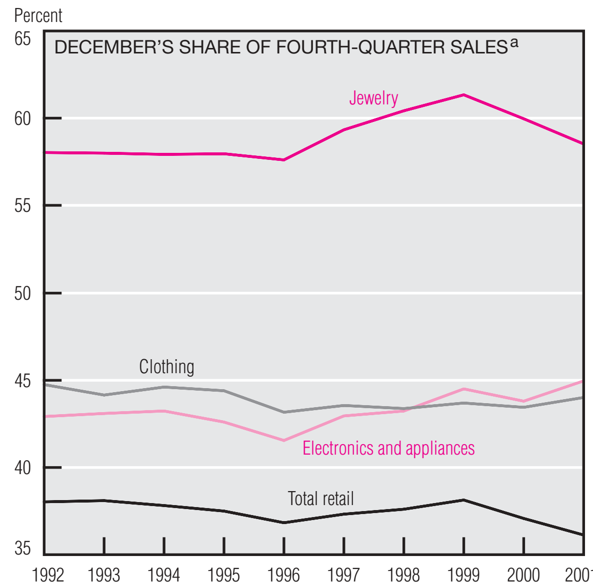
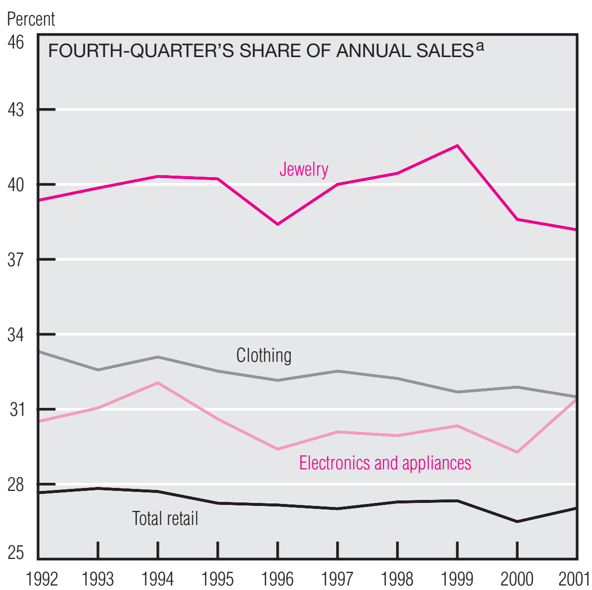
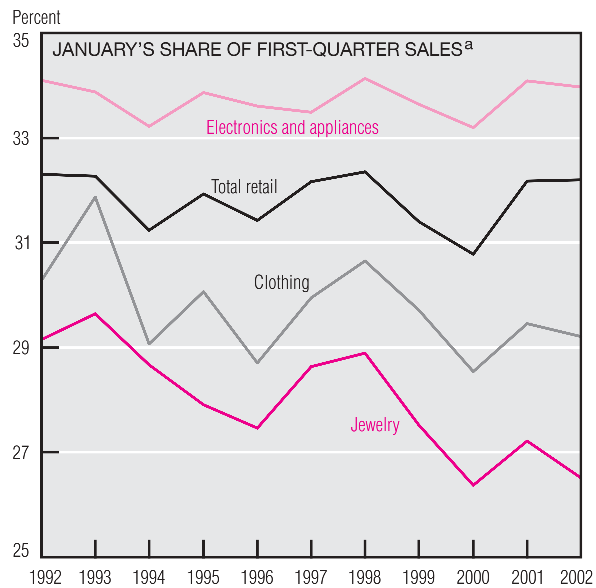
Economic Activity *(cont.)*









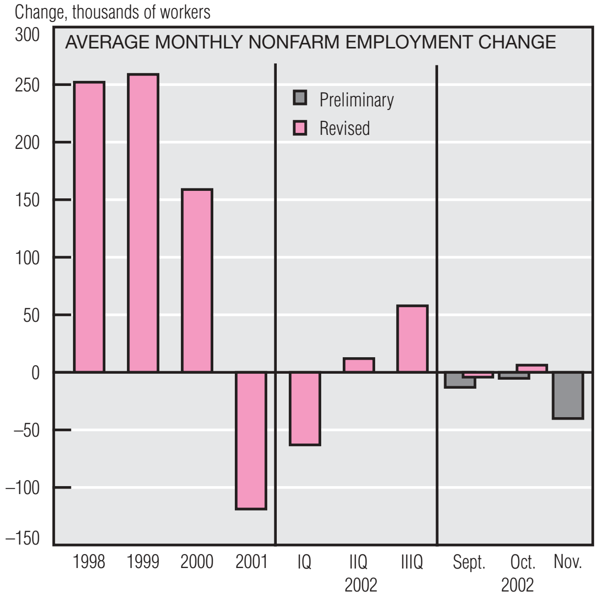
a. Current dollars, not seasonally adjusted.
SOURCE: U.S. Department of Commerce, Bureau of the Census.

The holiday season is in full swing, and December is the biggest month for shopping. For example, both clothing and electronics and appliances typically post about 30% of their fourth-quarter sales in November but nearly 45% in December. This pattern is especially dramatic for jewelry, where roughly 24% of fourth-quarter sales occur in November compared to 60% in December.

The importance of the holiday season—and thus the fourth quarter—is evident for many items. Without the seasonal component, roughly 25% of a given item's purchases would occur in the fourth quarter. Jewelry sales have the largest seasonal component by far, with nearly 38% of 2001 sales made in the fourth quarter. Clothing and electronics and appliances follow, with about 31% of annual sales in the fourth quarter. The season is becoming somewhat less important, however, for jewelry and clothing. Its impact on total retail sales is also lessening slightly, perhaps because other outlets, such as the Internet, account for a greater share of holiday purchases. It is also notable that although the holiday season is certainly important for retailers' yearly success, its importance is probably less than the rhetoric suggests. Retailers make about 27% of their annual sales in the fourth quarter.

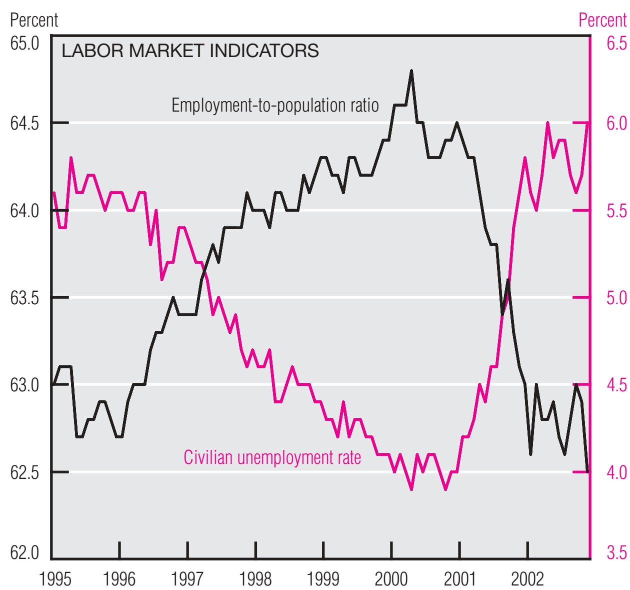
There is no evidence for the many reports that people are delaying some of their holiday shopping until January to take advantage of post-holiday sales. January's importance in first-quarter sales for all the usual holiday items is either stable or decreasing.

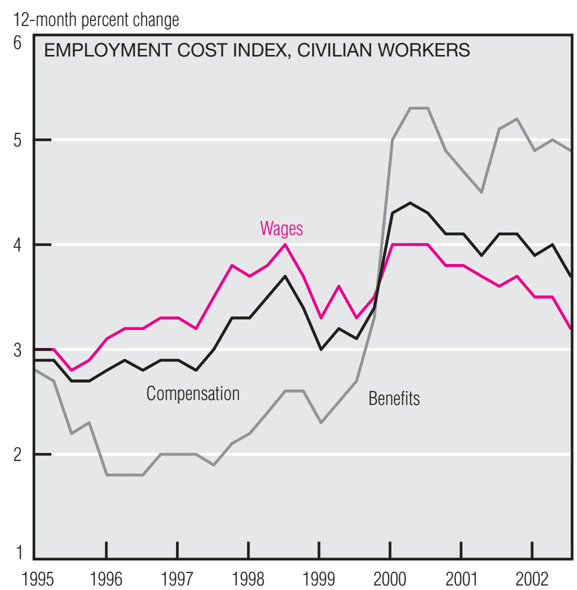
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1999	2000	2001	Jan.–Oct. 2002	Nov. 2002
Payroll employment	259	159	–119	3	–40
Goods-producing	8	–1	–111	–57	–51
Mining	–3	1	1	–1	–2
Construction	26	8	–3	–9	–4
Manufacturing	–16	–11	–109	–47	–45
Durable goods	–5	1	–79	–37	–36
Nondurable goods	–11	–12	–30	–10	–9
Service-producing	252	161	–8	59	11
TPU[a]	19	17	–23	–13	–10
Wholesale and retail trade	60	25	–31	–7	–44
FIRE[b]	7	5	10	7	7
Services[c]	132	92	–2	50	50
Health services	9	15	27	22	27
Help supply	32	0	–54	8	–23
Government	35	22	39	22	8
	Average for period (percent)				
Civilian unemployment rate	4.2	4.0	4.8	5.7	6.0





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

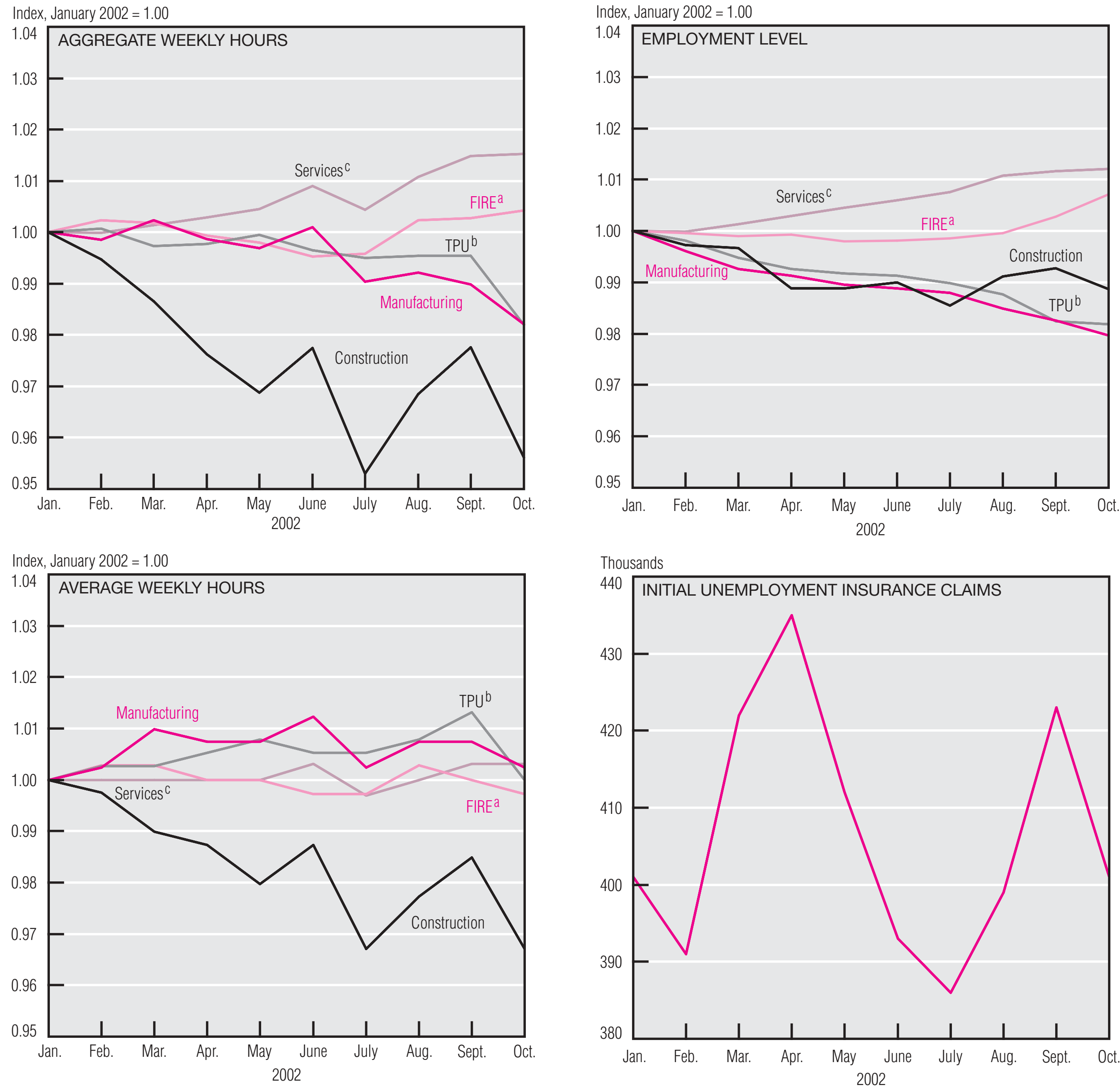
Nonfarm payroll employment posted a net loss of 40,000 jobs in November. Employment numbers for October and September, however, have been revised upward by 11,000 and 9,000, respectively. Instead of a loss, it now appears that 6,000 jobs were added in October.

The goods-producing industries continued their decline with a net loss of 51,000 jobs in November, while service-producing industries continued their rise with a net gain of 11,000 jobs. Manufacturing employment fell 45,000, consistent with the industry's average monthly decline since the beginning of 2002. Over the past two years, manufacturing as a whole has shown a net loss of 388,000 jobs. Construction declined only slightly in November, in comparison to its net loss of 22,000 jobs the previous month. Jobs in help supply services declined for the second consecutive month, this time by 23,000. Health services added 27,000 jobs, accounting for about half of all services gains. Employment in wholesale and retail trade fell sharply for a net loss of 44,000. After posting large gains in October, government added only 8,000 jobs in November. Finance, insurance, and real estate continued to gain jobs, although the gains were smaller than in recent months.

The unemployment rate rose to 6.0%, 0.3 percentage points higher than last month. This matches the level reached in April of this year. The employment-to-population ratio fell 0.4 percentage points to 62.5, the lowest so far this year.

Total compensation, as measured by the Employment Cost Index, rose at a rate of 3.7% between 2001:IIIQ and 2002:IIIQ. This was its slowest rate in three years. The wage component grew at a 3.2% rate, its slowest since early 1996. Benefits increased at a 4.9% rate, far outpacing wage cost growth.

The Economy's Health



NOTE: All data are seasonally adjusted.
a. Finance, insurance, and real estate.
b. Transportation and public utilities.
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.

Some have argued that the economy entered the recovery or expansion phase of the business cycle in January 2002; others say it is still too early to tell. These mixed signals are certainly evident in the labor market.

The economy's industries have behaved in various ways over the first 10 months of the year. To compare industries more clearly, the charts show each industry's employment, hours, and aggregate hours indexed to 1.0 for January 2002.

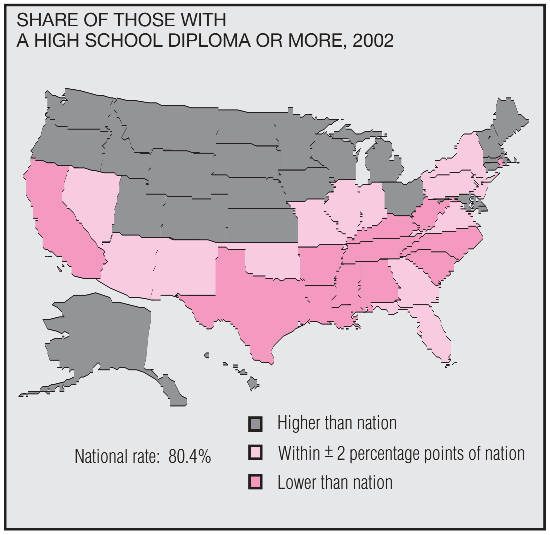
Aggregate weekly hours show how differently these industries have performed so far this year. For the services industry, aggregate weekly hours have risen approximately 1.5%; for construction, they have fallen about 4%; for manufacturing as well as transportation and public utilities, they have fallen roughly 1%.

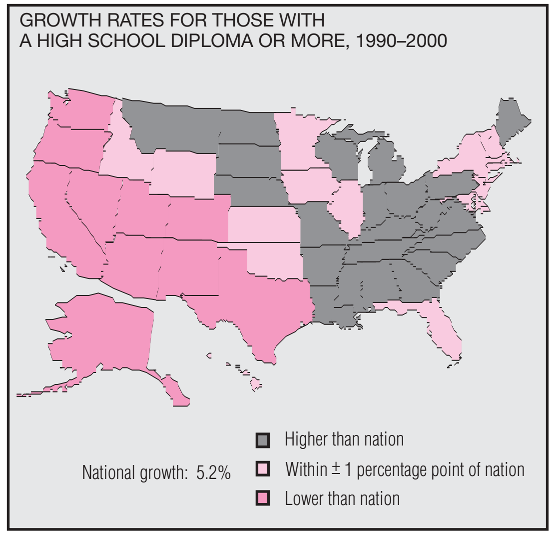
Aggregate hours are the product of the employment level and average hours per week. Employment has fallen in manufacturing; construction; and transportation and public utilities. In finance, insurance, and real estate, employment has been mostly flat but has begun rising in the past few months. The services industry is the only one to show sustained employment growth. Some of these changes may result from longer-run secular rises or declines, especially in manufacturing.

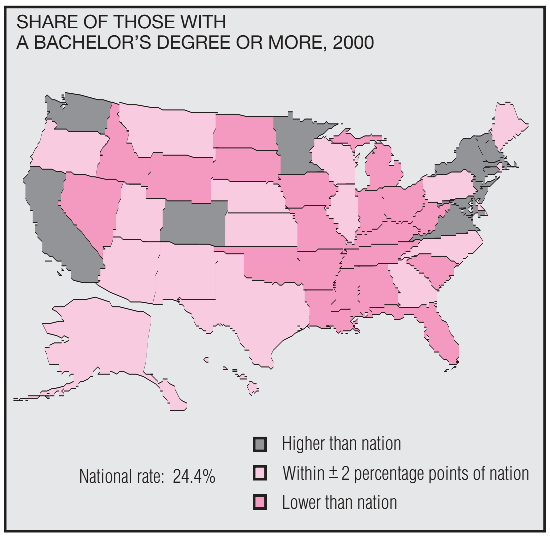
In terms of hours per week, the construction industry has declined substantially. In manufacturing and in transportation and public utilities, hours have risen moderately for much of the year. In every industry except construction, however, the level is about what it was at the beginning of the year.

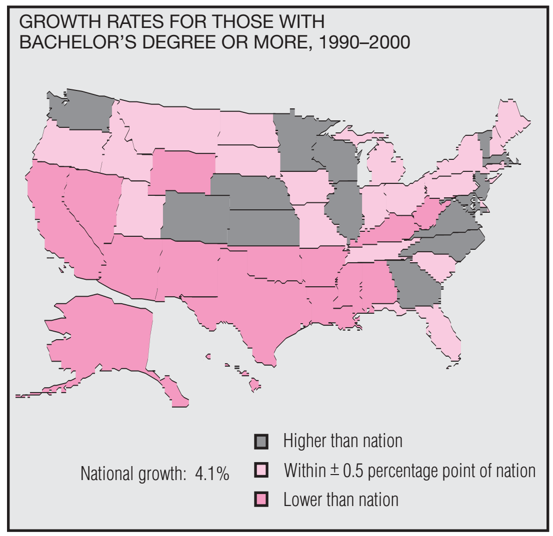
Unemployment insurance claims, after bouncing around for the first 10 months of the year, are close to the level posted when 2002 began.

Census 2000: Educational Attainment









NOTE: All data refer to persons who are 25 and older.
SOURCE: U.S. Department of Commerce, Bureau of the Census, 2000 Census, Summary File 3.

The Census Bureau recently released information on educational attainment from the 2000 Census (Summary File 3). It provides data on those 25 and older for two attainment levels: a high school diploma or more and a bachelor's degree or more.

In 2000, 80.4% of people in the U.S. had at least a high school diploma or equivalent. The states with higher percentages of high school graduates are in the Northwest, Great Plains, Upper Midwest, and New England regions; the states with lower percentages are in the South plus California and Rhode Island.

Between the censuses of 1990 and 2000, the South and parts of the Midwest and Great Plains improved their educational attainment rates more quickly than the nation as a whole; the western states had slower growth rates than the U.S. For the nation, the share of people 25 and older with at least a high school diploma increased 5.2% over the decade. In six states, the shares of high school grads rose less than 3%; in California, the increase was less than 1%.

Almost 25% of people in the U.S. have at least a bachelor's degree, with higher rates in Washington, California, Colorado, and Minnesota as well as the Washington, D.C., area and some New England states. In Connecticut, Maryland, Colorado, and Massachusetts, more than 30% of the population has at least a bachelor's degree.

Between 1990 and 2000, states that had the highest growth rates for the share of the population with at least a bachelor's degree were scattered all over the nation. Burgeoning numbers of high-tech jobs in Washington, North Carolina, Virginia, and Maryland could account for some of the increase in those states.

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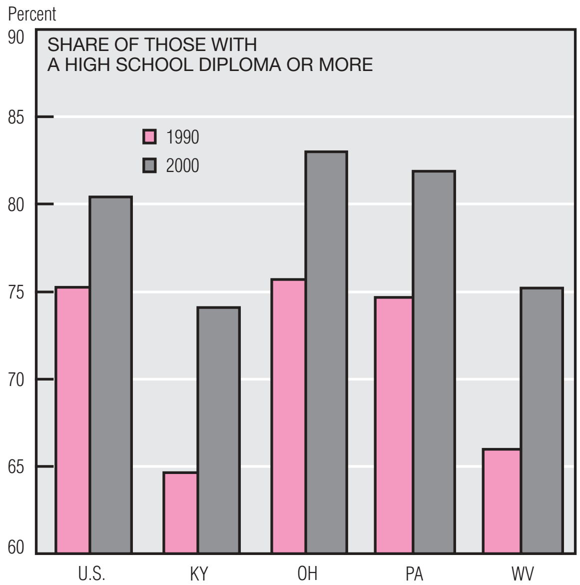
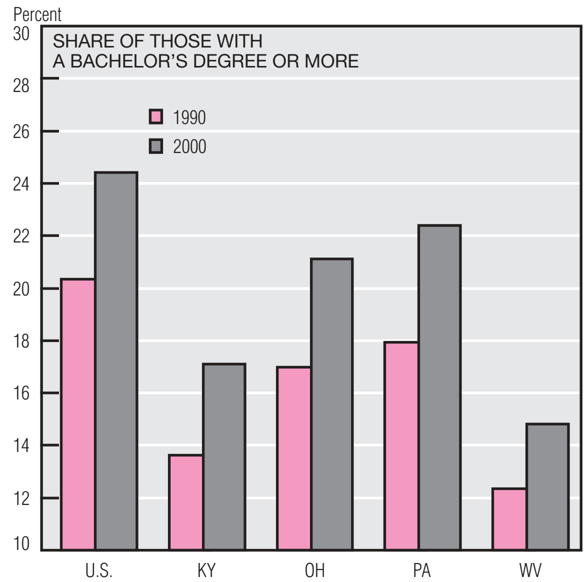
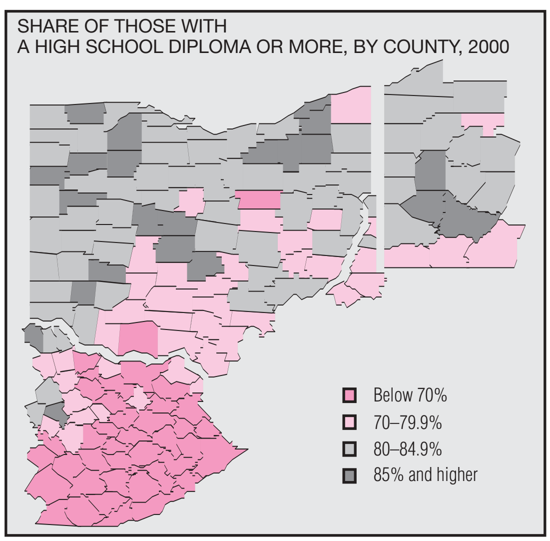
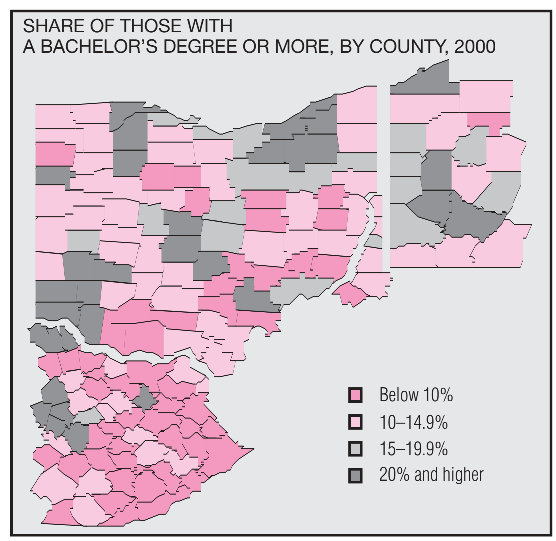
Census 2000: Educational Attainment *(cont.)*









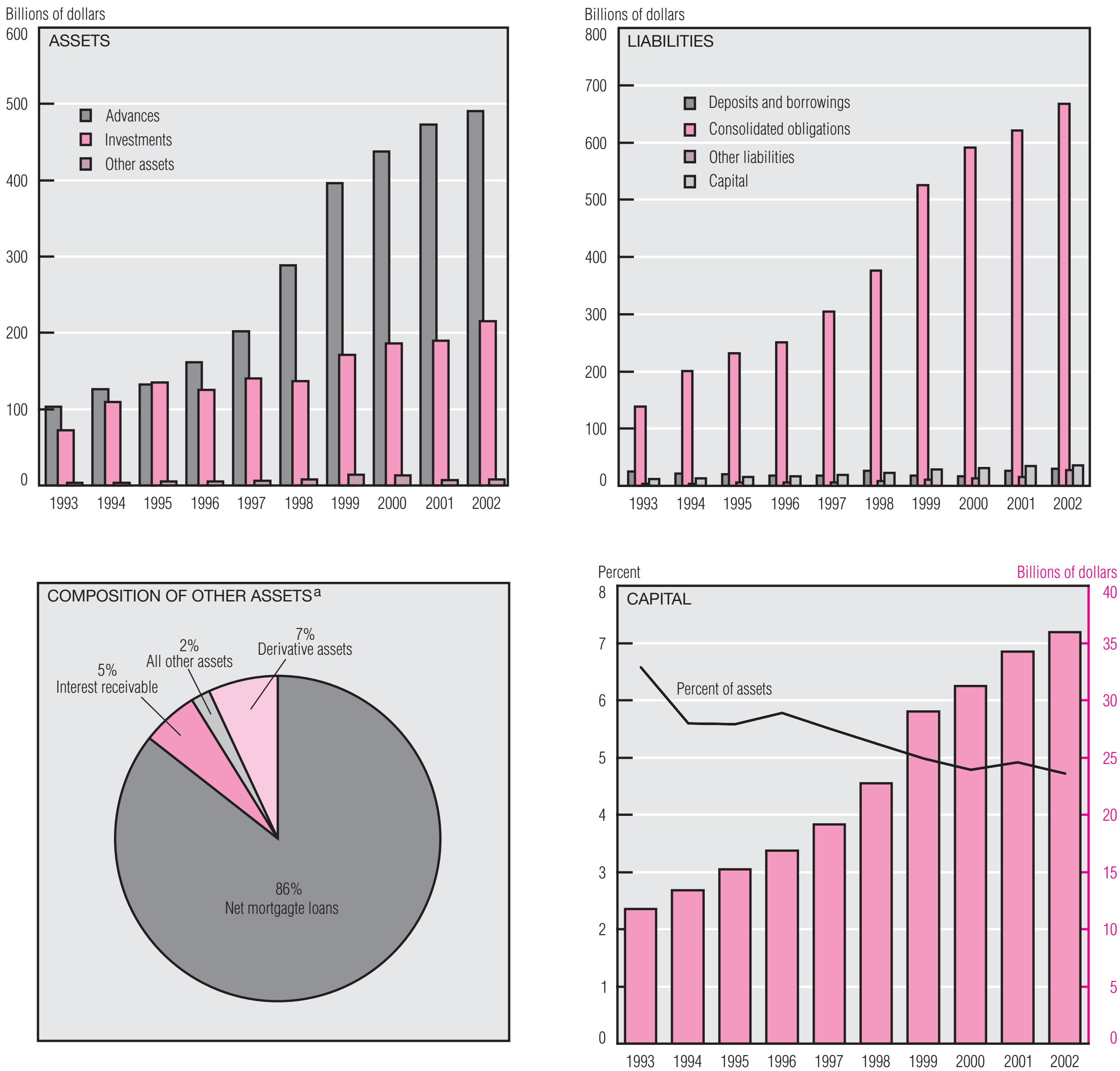
NOTE: All data refer to persons who are 25 and older.
SOURCE: U.S. Department of Commerce, Bureau of the Census, 2000 Census, Summary File 3.

Every Fourth District state increased the percentage of those at both attainment levels—high school and college. In 1990, Ohio was the only state in the District to exceed the nationwide percentage of those with at least a high school diploma (75.7% versus 75.2%). By 2000, rates in both Ohio and Pennsylvania were higher than the nation. Kentucky and West Virginia were still among the least educated states in the nation (second and fourth from the bottom); however, the shares of those with at least a high school diploma improved considerably. Districtwide, the percent of those with at least a bachelor's degree lagged the nation again in 2000; however, Pennsylvania's rate of increase was higher than the nation's.

Counties near major cities generally have a higher share of people with at least a high school diploma; however, this is not always true of counties in which those cities are located. The counties with the lowest percentages are concentrated in eastern Kentucky, which relies heavily on agriculture, and Holmes County, Ohio, which has a large Amish population.

The counties with the highest percentages of the population with a bachelor's degree or beyond are focused in and around counties with major cities. The counties with the lowest percentages are in Eastern Kentucky and in pockets of southern, eastern, and central Ohio. For both levels of attainment, rural counties with a college or university often have higher rates than the surrounding counties (for example, Rowan County, Kentucky has Morehead State University, and Athens County, Ohio has Ohio University). Counties that have smaller colleges or at least one major employer (particularly hospitals and private companies) often surpass neighboring countries' shares of people with a bachelor's degree or more.

Federal Home Loan Banks



a. Data through 2002:IIIQ.
SOURCES: Federal Home Loan Bank System, *Quarterly Financial Report*, September 30, 2002; and annual reports.

The 12 Federal Home Loan Banks (FHLBs) are stock-chartered, government-sponsored enterprises whose mission initially was to provide short-term advances to member institutions, funded with deposits from those institutions. Membership was open to specialized housing-finance lenders, mostly savings and loan associations and mutual savings banks. With continued shrinkage of their traditional clientele and the financial system's ongoing consolidation, FHLBs have been reinventing their role in financial markets. Advances—borrowings by FDIC-insured institutions from the FHLB—are an important source of funding for member institutions' mortgage portfolios. By the end of 2002:IIIQ, advances had risen to $490.74 billion, far outstripping all other FHLB investments and assets.

The lion's share of funding for FHLB assets came from $667.56 billion of consolidated obligations of the Federal Home Loan Bank System—bonds issued on behalf of the 12 FHLBs collectively. The market sees these bonds as implicitly backed by the U.S. government; hence, they allow FHLBs to raise funds at lower rates of return than AAA-rated corporations. Member institutions' deposits, short-term borrowings, and other liabilities provided only a miniscule amount of funds. FHLBs have added to their capital as they have grown. Since 1996, however, the pace of asset growth has outstripped capital growth; by the end of the 2002:IIIQ, the capital-to-asset ratio had fallen to 4.72%.

In 1997, the Federal Home Loan Bank of Chicago initiated the Mortgage Partnership Finance Program, in which nine of the 12 FHLBs participate. The 12 FHLBs currently have a combined $47.07 billion in mortgages,

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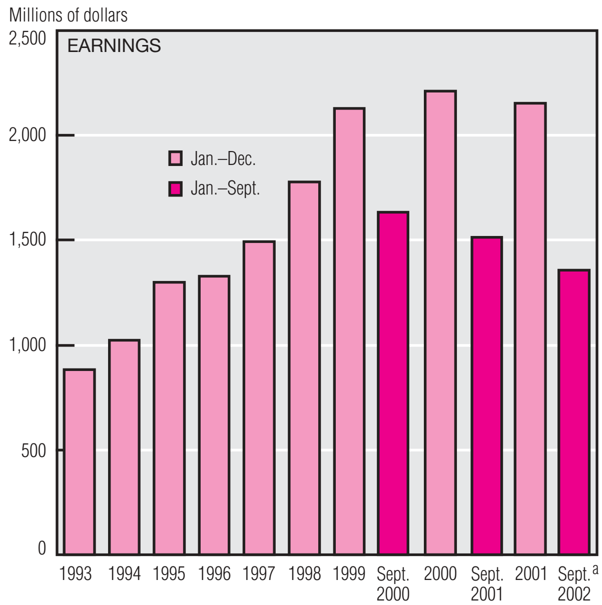
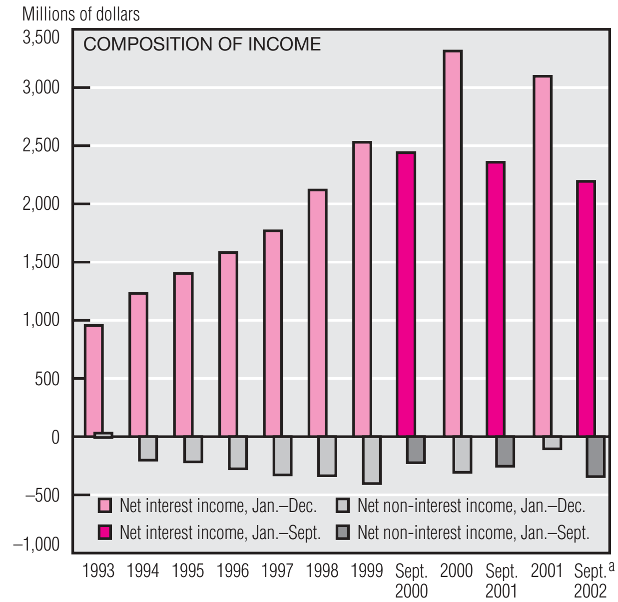
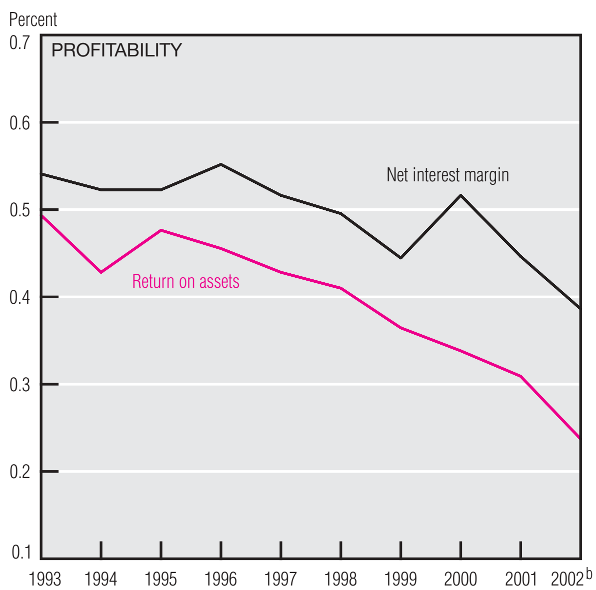
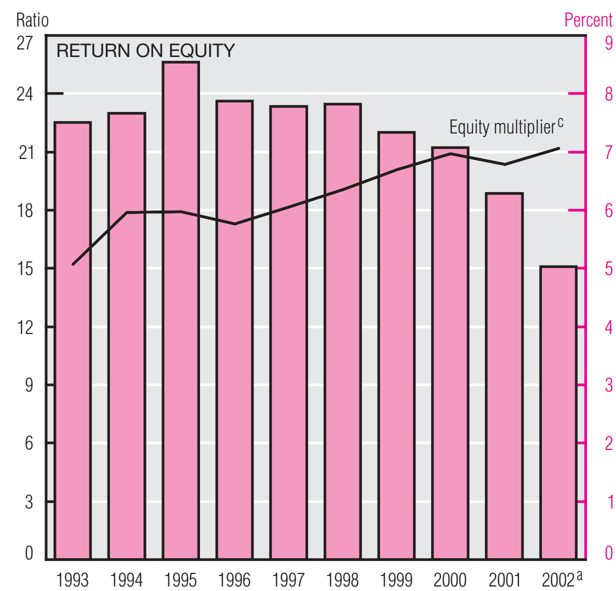
Federal Home Loan Banks *(cont.)*









a. Data through 2002:IIIQ.
b. Data for 2002:IIIQ are annualized.
c. The equity multiplier is the ratio of total assets to equity.
SOURCES: Federal Home Loan Bank System, *Quarterly Financial Report*, September 30, 2002 and annual reports.

more than twice their holdings a year ago. Mortgage portfolios are expected to be a major source of future asset growth.

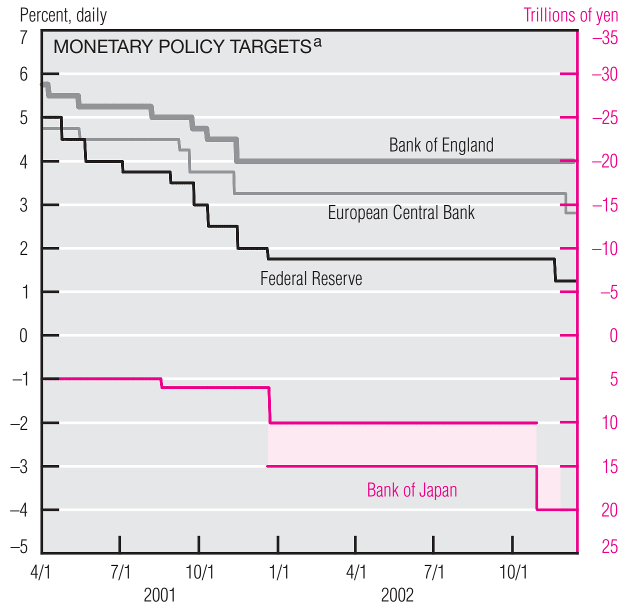
FHLBs' earnings (income) rose steadily from 1994 through 2000, then fell in 2001. Their $1,356 million in net income in the first nine months of 2002 was down from $1,515 million for the same period in 2001.

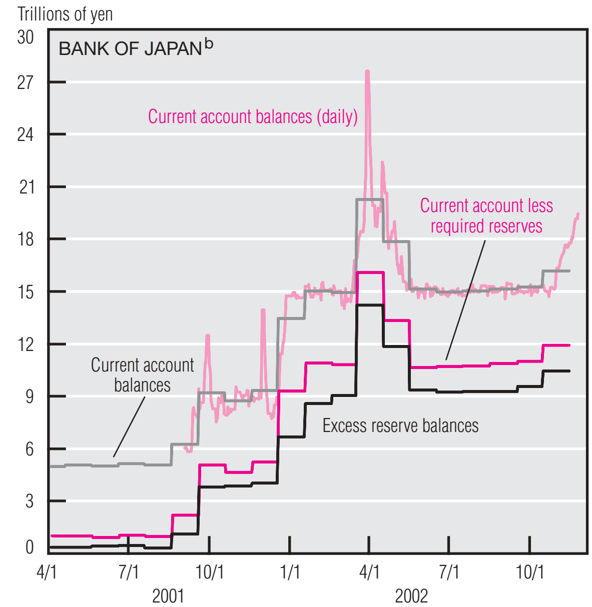
Breaking down income into interest and non-interest sources shows that FHLBs' primary source of earnings is net interest income (interest income less interest expense). Net interest income grew from $954 million in 1993 to $3,096 million in 2001. The net interest income of $2,194 million for the first nine months of 2002 was down from $2,358 million for the same period in 2001.

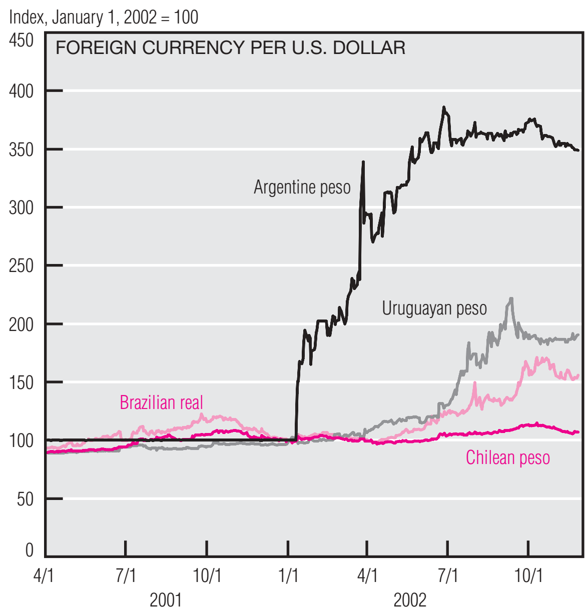
Unfortunately, FHLBs' improvements in earnings and net interest income have resulted from strong asset growth, not improvements in underlying profitability. Return on assets declined from 49 basis points (bp) in 1993 to 31 bp at the end of 2001. The annualized return on assets through 2002:IIIQ is 24 bp. Profitability in 2002 has been hurt by a decline in the net interest margin (net income before loan loss provisions as a percentage of average earning assets), from 54 bp at the end of 1993 to an annualized 39 bp at the end of 2002. Moreover, FHLBs' net interest margins pale by comparison to the 300–400 bp typical of depository institutions.

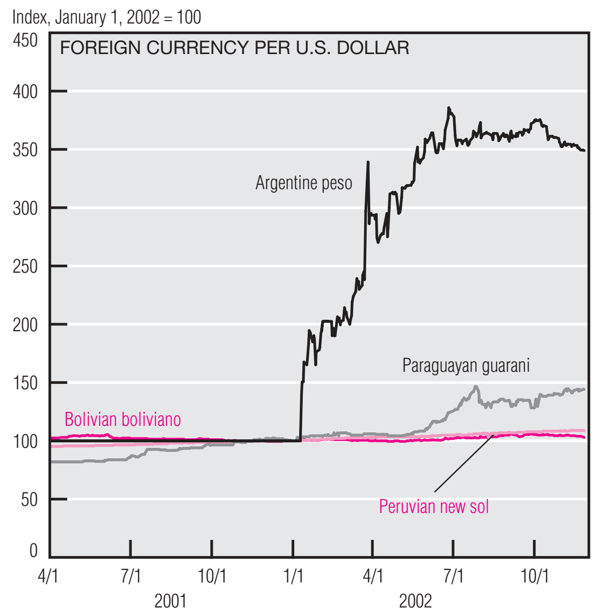
Finally, although leverage has increased continually since 1996, return on equity fell slightly to 5.03% for the first nine months of 2002 from 6.29% at the end of 2001. These persistently weak returns on assets and equity put further pressure on FHLBs to undertake nontraditional lines of business in search of higher returns.

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.

On November 6, the Federal Reserve reduced its federal funds rate target 50 basis points (bp) to 1.25%. Since then, the Bank of England's Monetary Policy Committee has twice left its policy rate unchanged. Although the European Central Bank did not change its policy rate on November 7, it did cut the rate 50 bp to 2.75% on December 6. Also in November, the Bank of Japan noted reduced prospects for economic growth but left its target for the range of current account balances unchanged. Nonetheless, the actual supply of balances, currently more than ¥19 trillion, has been moving steadily toward ¥20 trillion, the upper end of the target range.

Banco Central do Brasil raised its rate target 100 bp in mid-November. The Brazilian real seems unaffected by recent election results and by reports that President-elect Lula will appoint a new central bank president. Argentina defaulted on more than 90% of an $805 million payment to the World Bank in October. In Argentina, inflation has moderated somewhat, the exchange rate has strengthened a bit, and depositors now have access to previously frozen accounts (other than CDs).

The effects of the Argentine and Brazilian situations continue to plague neighboring economies. The Paraguayan central bank president resigned in frustration over congressional resistance to tax reforms needed to secure emergency aid from the International Monetary Fund. In Uruguay, five coalition cabinet ministers threatened to quit over the government's handling of the economy.