The Economy in Perspective

Matters of interest…The Federal Open Market Committee reduced its federal funds rate target by 25 basis points at its June 25 meeting, and the Board of Governors reduced the discount rate on primary credit by an equal amount the same day. These two policy rates, which stand at 1 percent and 2 percent, respectively, have not been this low since the 1950s, yet some financial market participants anticipate even further reductions. In fact, yields have been falling all along the yield curve for several years. During the last three years, the FOMC has lowered the federal funds rate by 550 basis points in a series of 13 steps, while the market-determined 10-year U.S. Treasury note has fallen by 310 basis points.

Several factors account for interest rates' decline. Most obviously, and almost tautologically, the supply of savings has been expanding faster than the demand for credit. Despite the strength of the automotive and housing sectors, the overall pace of real economic growth remains far below the rates attained during the previous business cycle expansion. Capital spending has been especially weak for several years. Corporate executives evidently think that risk-adjusted returns to new investment projects are poor right now. Until and unless the demand for business credit revives, real interest rates will probably remain low.

Declining inflation and inflation expectations have also played a role in the downward drift of interest rates. In March 2000, the peak of the last business cycle, the core CPI registered a gain of 2½% in the prior year. Inflation expectations, as measured by the University of Michigan's Survey of Consumers, stood at 3¾%. Today's comparable figures are 1½% and 2½%. This decline in actual and expected inflation probably has contributed 100 basis points to the decline in nominal long-term interest rates. And the public seems convinced that inflation will remain at historically low rates for quite some time.

To the extent that inflation reduces economic welfare, lower inflation rates will confer public benefits. Consequently, the Federal Reserve System has been systematically pursuing a goal of price stability for several decades. Many observers might argue that this long-sought goal has finally been realized. Ironically, though, the public seems largely indifferent to the arrival of price stability, linked as it has been to a troubled domestic economy and very low interest rates.

The Federal Reserve's actions have supported the decline of interest rates by making bank reserves available at ever-lower overnight rates and by fostering the expectation that reserves will continue to be available on easy terms. In effect, as households and business firms have signaled a desire for more liquidity and less risk, Federal Reserve actions have been accommodative of market forces pushing interest rates down.

Although business cycles resemble one another, each has its own idiosyncrasies. The current cycle has been so peculiar, especially in regard to poor labor market conditions, that its trough still has no official date. Output is expanding, but employment is not. Moreover, the composition of output growth remains unbalanced, being heavily tilted toward residential construction and automobile purchases. Households and corporations have significantly reduced their appetite for risk, leaving financial intermediaries with plenty of highly liquid liabilities and fewer opportunities to deploy them. To be sure, households and firms have taken advantage of this environment to refinance outstanding debt, but these actions themselves create no new wealth. For every borrower who finds cheaper refinancing, a lender encounters a premature principal repayment and faces reinvestment risk.

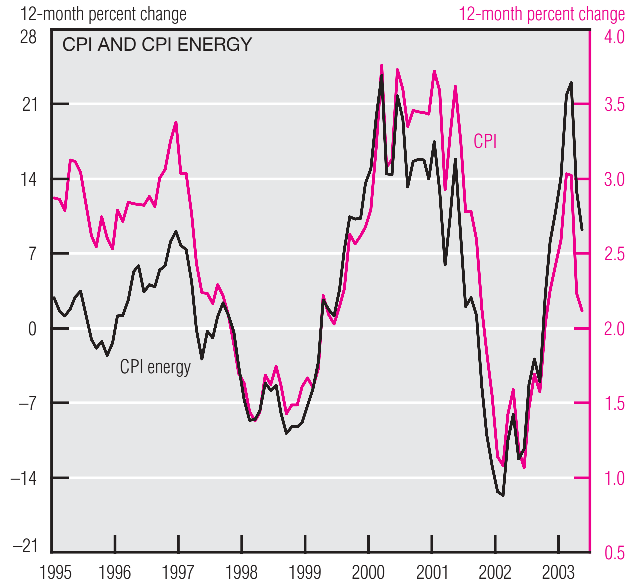
How should one regard the economy's present intransigence? Have policymakers systematically underestimated the need to stimulate demand for goods and services? If so, will recent monetary and fiscal policy actions give economic activity the desired boost? Or do the peculiarities of this business cycle suggest thinking about the U.S. economy from an additional perspective? Are we being affected by powerful external forces—including global competition and geopolitical tensions—that carry consequences for investment, risk taking, and resource utilization? Do these forces act as "headwinds" against the U.S. economy at the moment, preventing vigorous growth? How successful can monetary and fiscal policy actions be in the face of these forces, especially if economic growth continues to be unbalanced?

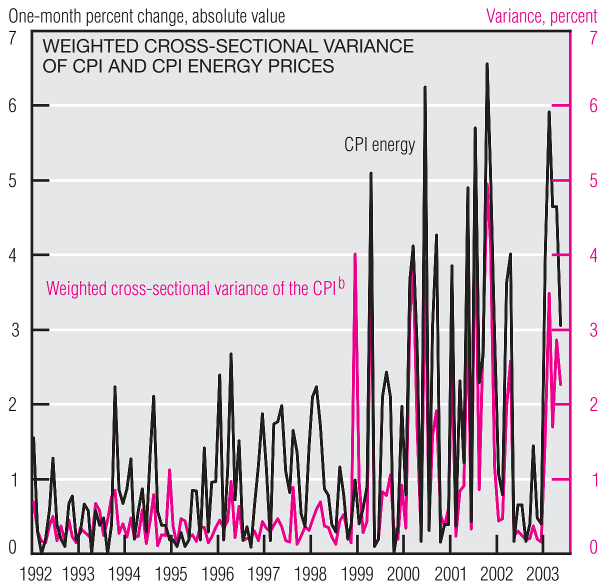
These are indeed matters of considerable interest.

Inflation and Prices

May Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2002 avg.
Consumer prices					
All items	0.0	0.0	2.1	2.4	2.4
Less food and energy	3.2	1.0	1.6	2.2	2.0
Median[b]	2.2	1.1	2.2	2.9	3.0
Producer prices					
Finished goods	–3.3	–3.0	2.5	1.7	1.2
Less food and energy	1.6	–0.3	–0.1	0.9	–0.5





Extreme CPI Price Movements, May 2003

	One-month percent change	Relative importance
Largest Price Increases		
Lodging away from home	4.1	2.6
Processed fruits and vegetables	2.9	0.3
Public transportation	2.0	1.2
Fresh fruits and vegetables	2.0	0.9
Infants' and toddlers' apparel	1.1	0.2
Largest Price Decreases		
Motor fuel	–6.7	3.3
Fuel oil and other fuels	–5.6	0.2
Men's and boys' apparel	–1.8	1.1
Communication	–0.8	2.9
Used cars and trucks	–0.6	2.1

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

The Consumer Price Index (CPI) was unchanged in May, the second straight month in which this retail price measure showed no inflation; in April, it fell 0.3% (–3.8% at an annual rate). Changes in the CPI continued to be highly correlated with changes in energy prices. The CPI's energy component, like the CPI, showed no inflation for the second straight month. In the most recent two-month period, this index declined nearly 8%, after increasing approximately 15% during the first three months of the year.

This volatility in energy prices is not unexpected. Indeed, it is the reason why energy prices are often excluded from the calculation of consumer prices, on the grounds that their variability can obscure the underlying trend in other prices. But in recent years, energy prices have been even more volatile than usual, exhibiting far more pronounced fluctuations than was the case during the energy crises of the 1970s. Energy components constitute only about 7% of the CPI, but the increasing magnitude of their price movements since 1999—measured as the absolute value of the monthly percent change in their prices—has caused a substantial increase in the weighted, cross-component variability in the CPI.

While energy prices showed some of the sharpest decreases in the most recent CPI report, at the opposite end of the spectrum, the CPI's index for lodging away from home showed some of the most significant increases. In fact, the Labor Department reported that most of the increase in the CPI excluding food and energy (the core CPI) resulted from increases in the lodging component and in other

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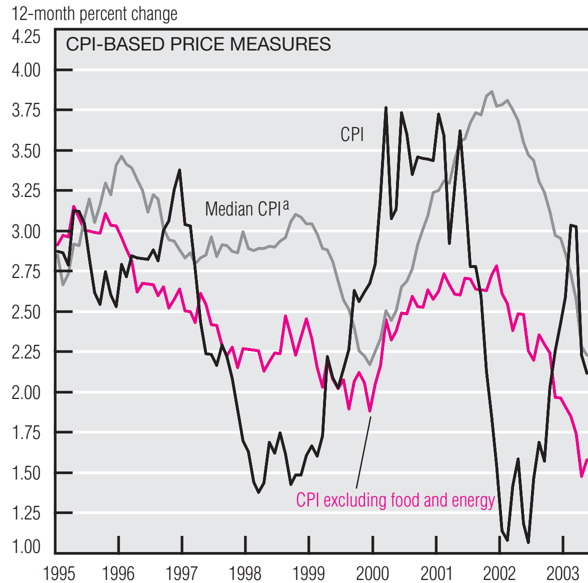
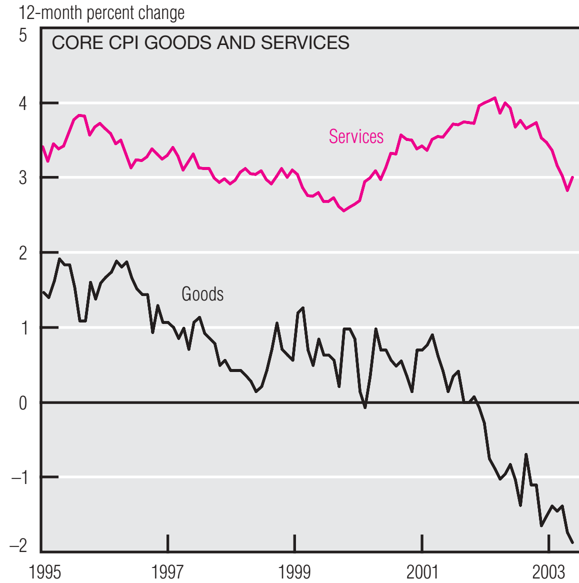
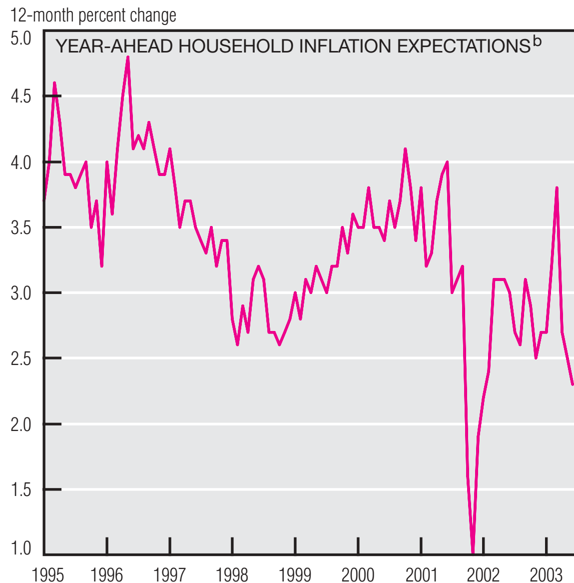
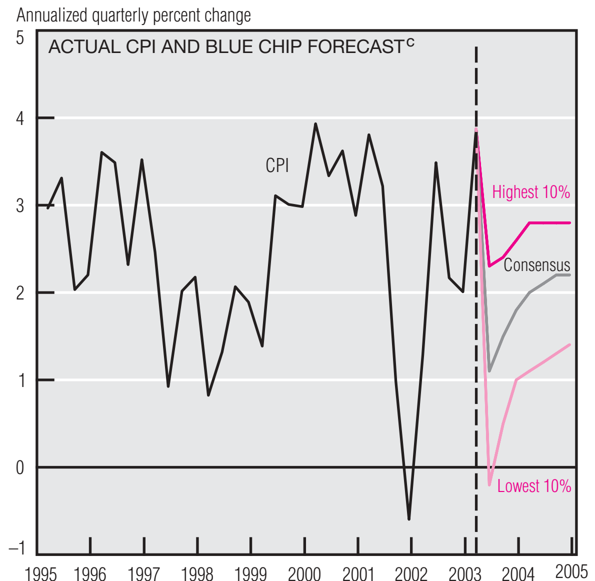
Inflation and Prices *(cont.)*









a. Calculated by the Federal Reserve Bank of Cleveland.
b. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
c. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; University of Michigan; and *Blue Chip Economic Indicators*, June 10, 2003.

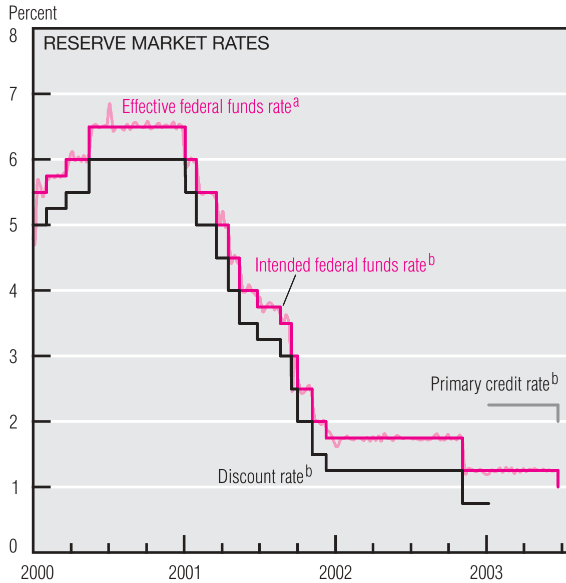
items that make up the CPI's shelter component. This component rose 0.6% in May after rising only 0.1% in the previous month.

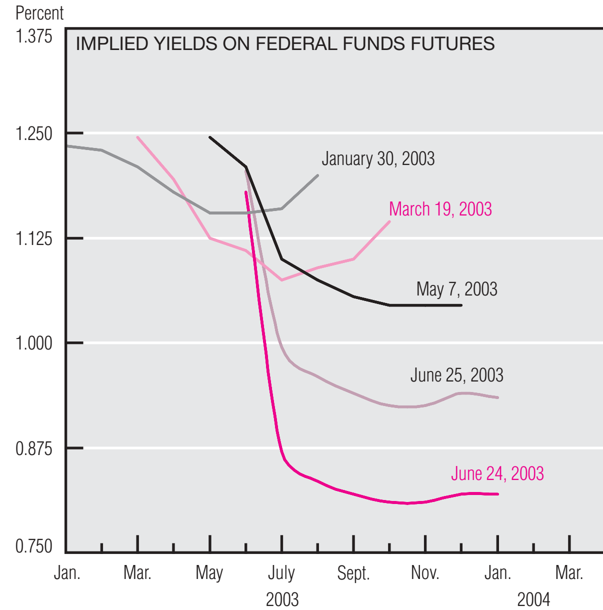
The core CPI itself rose 0.3% (3.2% at an annual rate) in May, and, for the first time in nine months, the 12-month rate of change in this measure rose as well: After falling to 1.5% in April, it ticked up a tenth of a percent to 1.6% in May. Another measure that attempts to isolate the underlying inflation trend is the median CPI. It rose 0.2% (or 2.2% at an annual rate) in May, and rose 2.2% in the 12 months ending in May. For the same 12-month period, the CPI rose 2.1%.

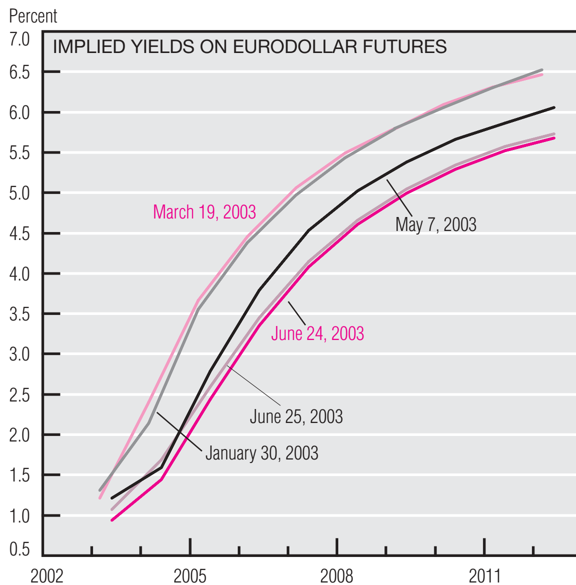
The 12-month rates of change in both the core and the median CPI have been drifting downward since late 2001. Does this suggest that, apart from some volatile sectors, most prices in the economy are moving inexorably toward deflation? Breaking down the core CPI into goods and services reveals that some of the items in consumers' market baskets are indeed undergoing persistent price declines, or deflation. However, more than half of the items in the index—services, to be specific—are seeing price increases on the order of 3% per year.

Households do not foresee deflation in the months ahead. Although their inflation expectations have drifted downward in recent months, they nevertheless expect prices to increase about 2.5% over the next 12 months. Private forecasters anticipate a similar scenario: Their consensus expectation for the coming months has inflation settling between 2% and 2.5% by the end of 2005.

Monetary Policy







Balance of Risks[c]

Statement prior to change	Change in federal funds target rate: –0.5	–0.25	0	0.25	0.5
Inflationary	0	0	5	3	1
Balanced	0	0	7	2	0
Weakness	6	4	3	0	0
No statement	3	0	1	0	0

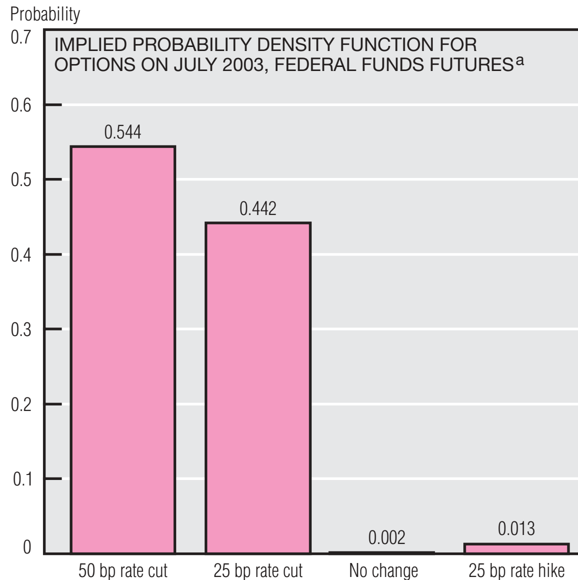
a. Weekly average of daily figures.
b. Daily observations.
c. Data taken from immediate press releases beginning in May 1999.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

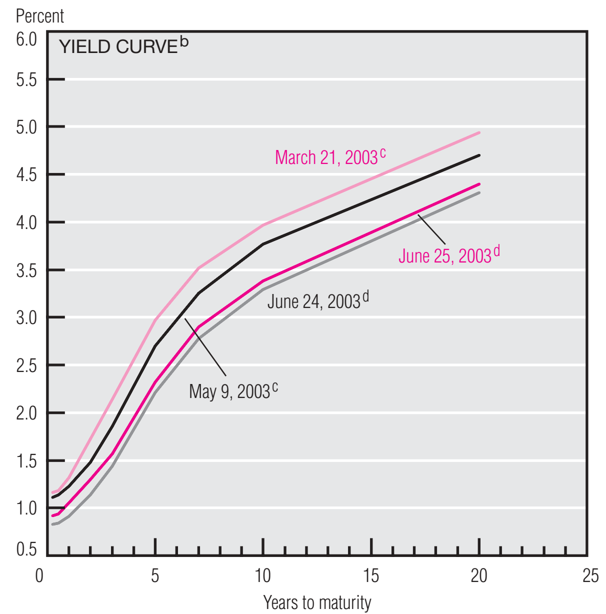
At its June 25 meeting, the Federal Open Market Committee (FOMC) lowered the intended federal funds rate 25 basis points (bp) to 1%, the thirteenth rate cut since the current round of easing began in January 2001. The FOMC's press release stated that although "recent signs point to a firming in spending," the economy "has yet to exhibit sustainable growth." The committee also noted that "the probability, although minor, of an unwelcome fall in inflation exceeds that of a pickup in inflation." In a related action, the Board of Governors approved a 25 bp cut in the discount rate to 2%.

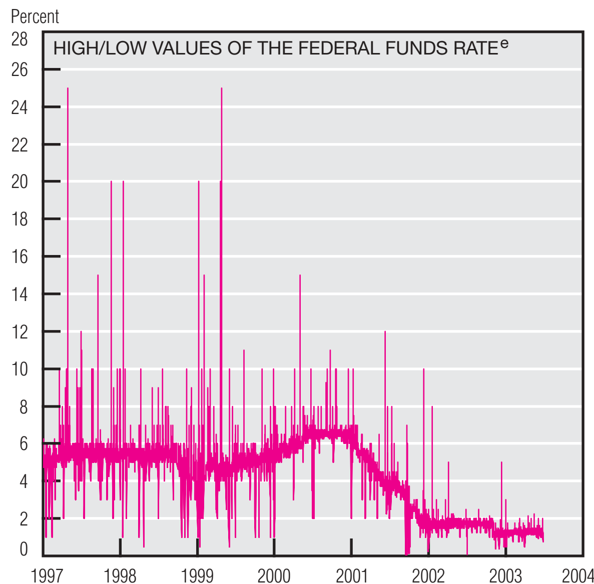
Implied yields on federal funds futures have declined sharply since the FOMC last met on May 6. The actual rate cut did not surprise market participants, although some expected it to be larger. The day before the meeting, implied yields placed a 100% probability on a cut of at least 25 bp with a roughly equal probability of either a 25 bp or a 50 bp cut. After the cut, implied yields bounced up about 12 bp across the maturities. Participants in the fed funds futures market do not foresee any tightening during the current year. Implied yields on eurodollar futures, which give a longer-term view of policy expectations, indicate a round of tightening beginning next year.

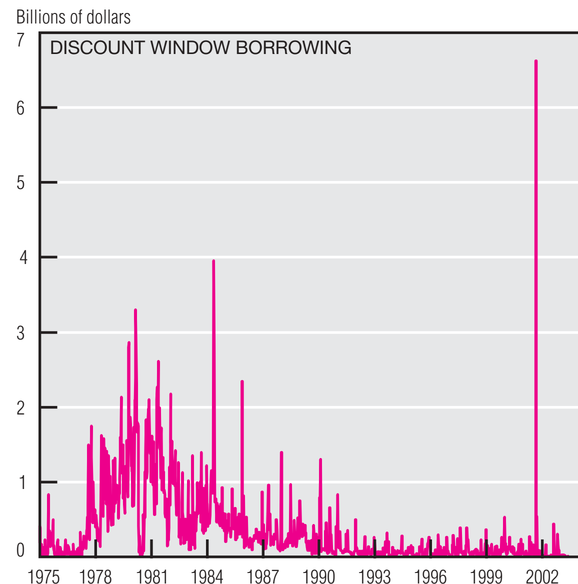
At its May 6 meeting, the FOMC said the risks were weighted mainly "toward weakness over the foreseeable future." Roughly two-thirds of the time, such statements have been followed by policy easing at the next meeting. Nearly half the time, a 50 bp cut has occurred. The June 25 statement said that the risks for sustainable growth "are roughly equal," but that the possibility of further disinflation is the dominant concern.

Money and Financial Markets









a. Probability estimates are derived from option prices as of July 24.
b. All yields are from constant-maturity series.
c. Average for the week ending on the date shown.
d. Daily observations.
e. Highs and lows are reported daily.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15 and "Aggregate Reserves of Depository Institutions and the Monetary Base," H.3, *Federal Reserve Statistical Releases*; Federal Reserve Bank of New York; Chicago Board of Trade; and Bloomberg Financial Information Services.

Options on federal funds futures have traded on the Chicago Board of Trade since March 2003. Unlike the federal funds futures market, the structure of this option market can furnish an estimate of the distribution of expected policy changes. On June 24, participants placed a high probability on a cut at the meeting on the following day, with the probability of a 50 bp cut exceeding that of a 25 bp cut.

Movements in the yield curve since May 6 also foreshadowed an easing at the June 25 meeting. Yields declined roughly 25 bp to 40 bp across the spectrum of maturities. After the rate cut of June 25, the yield curve moved upward 10 bp to 16 bp, with the two-year yield increasing the most.

Under a policy in effect since January 9, 2003, Federal Reserve Banks extend short-term credit to qualified institutions at the primary credit rate, currently 100 bp above the intended federal funds rate. This credit is extended with "no questions asked," unlike the previous regime, which rationed credit at the discount window. It was hoped that such a change would encourage use of the discount window and contain upward movements in the federal funds rate. However, as has been true since the early 1990s, use of the discount window remains low. In fact, since the introduction of the new regime, outstanding primary credit has averaged only $12 million. From January 1990 to the end of 2002, adjustment credit borrowing averaged $113 million. So far, upward movements in the federal funds rate have been contained. Since the regime change, the federal funds rate reached the primary credit rate on only one day, May 14.

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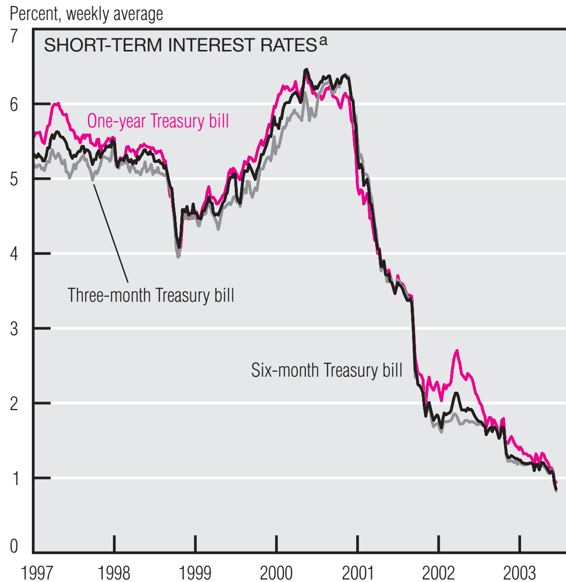
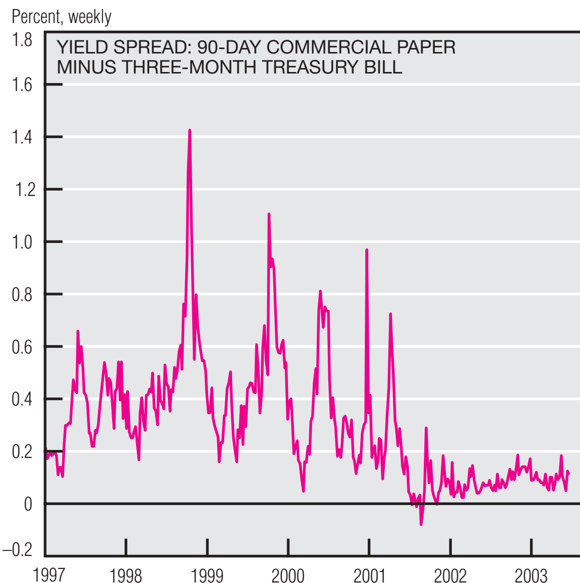
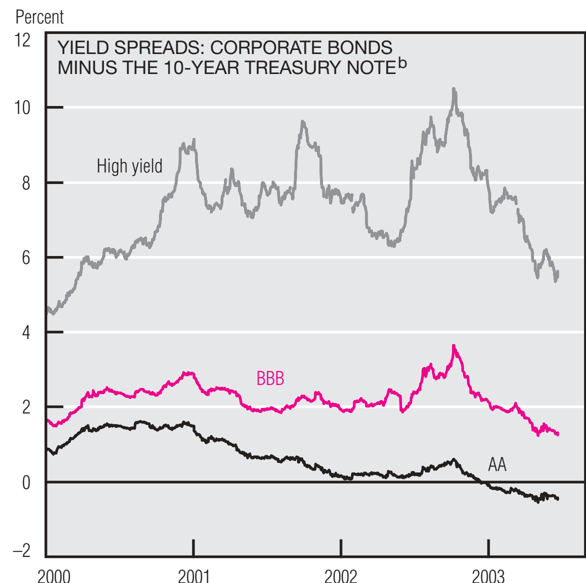
Money and Financial Markets *(cont.)*







a. Yields from constant-maturity series.
b. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Short-term interest rates continue their strong downward trend, moving together with the federal funds rate during this period of easing. The yield curve remains relatively flat at the short end, with three-month, six-month, and one-year Treasury bill rates within 10 bp of one another. Nonetheless, the spread has increased in the last few weeks, which may indicate expectations of a round of policy tightening in the coming year.

Interest rates on conventional mortgages have declined nearly 70 bp since late March. Yields on long-term government securities declined more than 50 bp during the same period. Low mortgage rates contributed to a 6.1% increase in housing starts between April and May.

The spread between the 90-day commercial rate and the three-month Treasury bill rate remains low, probably because only higher-quality issuers remain in the market. Over the last two and a half years, the amount of outstanding nonfinancial commercial paper has fallen nearly 60%. Although they declined in the first part of this year, financial commercial paper issues have rebounded in the last few months.

Yield spreads between corporate bond issues and Treasury notes continue to trend downward. These spreads narrowed noticeably as the outcome of the war in Iraq became more certain. The spread between high-yield corporate bonds and Treasury notes has narrowed the most, having dropped 5 percentage points since the fall of 2002. Notably, the yields on AA-rated corporate bonds have fallen below those of 10-year Treasury notes. The decline in corporate bond rates may give firms the necessary incentive to step up investment in the coming months.

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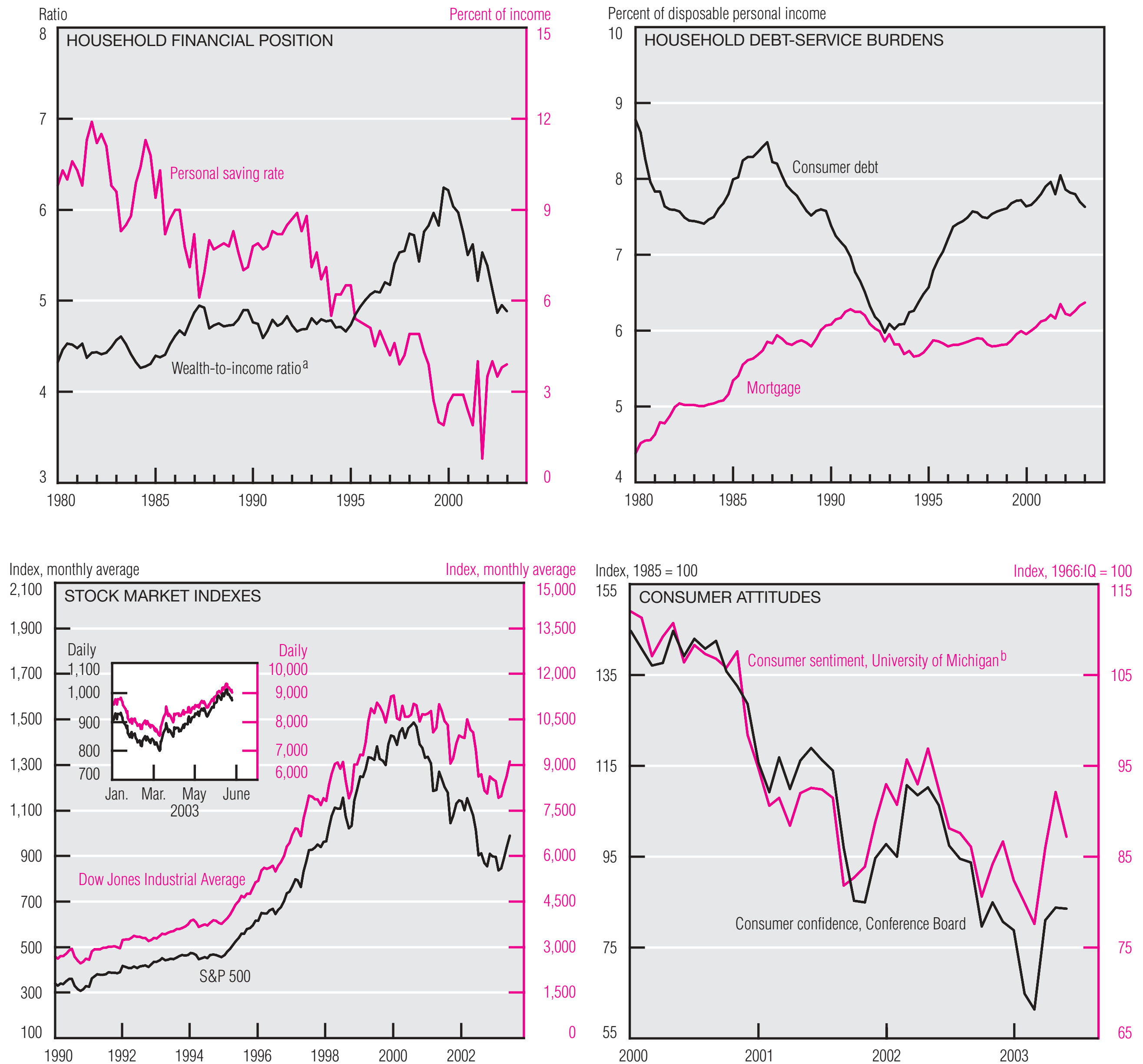
Money and Financial Markets (cont.)



a. Wealth is defined as household net worth. Income is defined as personal disposable income. Data are not seasonally adjusted.
b. Data are not seasonally adjusted.
SOURCES: Board of Governors of the Federal Reserve System, "Household Debt-Service Burden," *Federal Reserve Statistical Releases*; University of Michigan; Conference Board; and Bloomberg Financial Information Services.

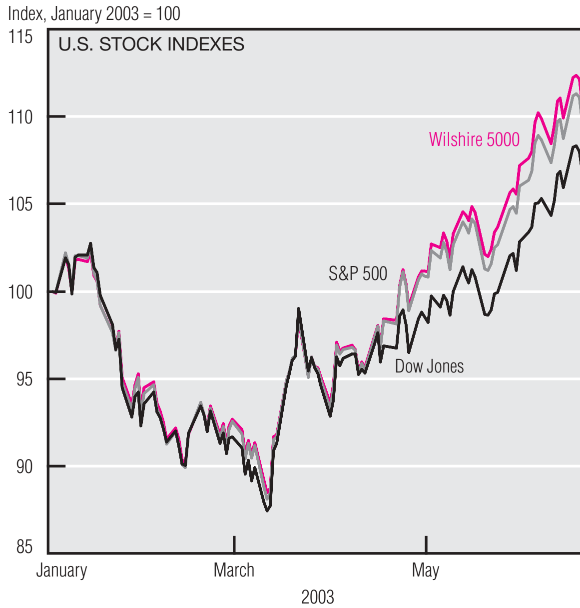
The personal saving rate fluctuated markedly during 2001 as tax cuts were phased in. The rate stabilized in 2002 and has remained relatively steady, between 3.5% and 4%, over the last few months. As consumers begin receiving tax rebate checks in late July from the latest round of tax cuts, the personal saving rate may again fluctuate markedly. After falling more than 1 percentage point since late 1999, the wealth-to-income ratio has remained steady, with moderate increases in personal disposable income this year.

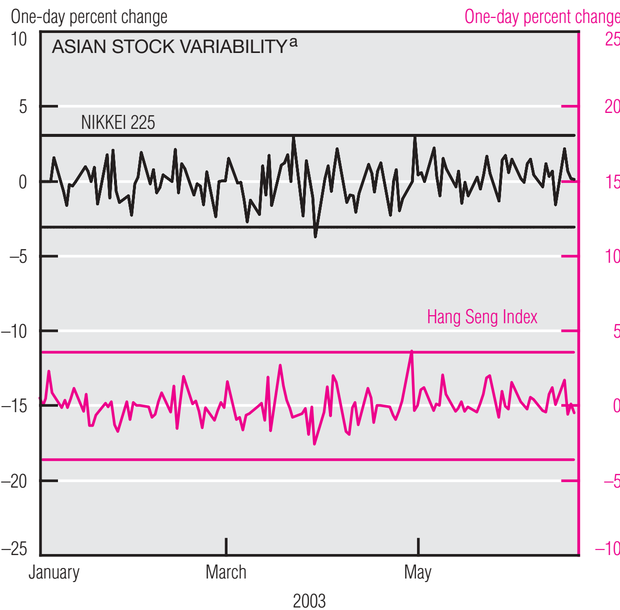
Consumer credit increased 7% in April owing to a marked rise in nonrevolving credit. However, consumers' debt-service burdens have declined in recent months because falling interest rates and rising income have offset overall increases in consumer debt levels. Despite declines in mortgage rates, mortgage debt burdens increased because of the strong housing market.

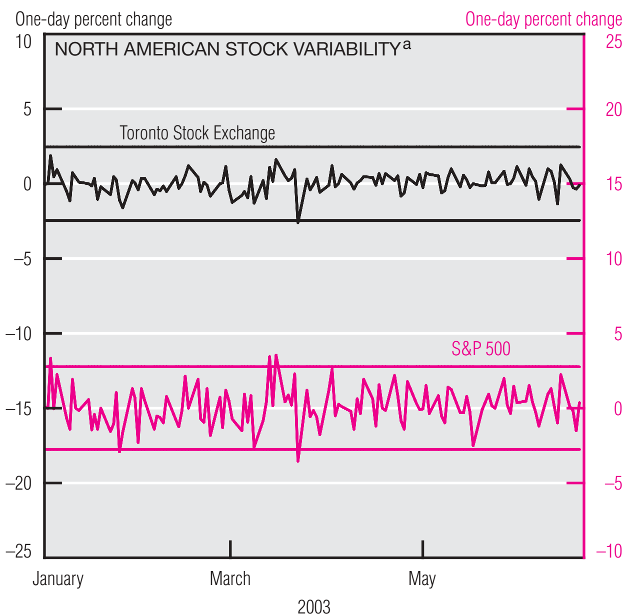
After reaching a six-year low in March, the S&P 500 stock price index has rebounded strongly in recent months, posting an overall increase of nearly 22%. The Dow Jones index showed similar improvements, in which reduced uncertainty regarding geopolitical tensions doubtless played a major role.

The Conference Board's Index of Consumer Confidence was essentially unchanged in June. Consumers' deteriorating views of their current situation were offset by expectations of an improving job market. On the other hand, the University of Michigan's Index of Consumer Sentiment survey fell markedly in June. In this index, consumers' perceptions of their current situation and their outlook for the future both worsened.

International Markets







a. Plus and minus two standard deviations.
SOURCE: Bloomberg Financial Information Services.

Stock prices in the U.S. have increased since the beginning of the year, as measured by three broad indexes: The S&P 500 has risen 9.8%, the Dow Jones 7.5%, and the Wilshire 5000 11.0%. All three fell during the first part of the year, bottomed out in March, and have increased at least 20% since then. Qualitatively speaking, foreign stocks' price movements have mirrored those of the U.S. The Toronto Stock Exchange, the Hang Seng, and the NIKKEI indexes fell during the first part of the year; by late April, they all had reversed their downward trend.

However, the fall and subsequent rise of stock indexes were more pronounced in the U.S. than abroad. Domestic stock prices, as measured by the S&P 500, appear more volatile than foreign stock prices. Except for one observation in each series, the one-day percent change in stock prices—the daily returns—of the foreign indexes remain within a band that represents plus and minus two standard deviations of daily returns. The standard deviations are calculated from daily returns going back to 1998; intuitively, we would expect about 5% of observations for the daily returns to lie outside the bands.

Considering that stock markets are open five days a week, we would expect about five or six observations to lie outside the bands this year. So recent movements in daily returns on foreign stock markets have been rather smooth compared to movements over the past five and a half years. The S&P 500 daily returns have fallen outside the two-standard-deviation bands five times since the

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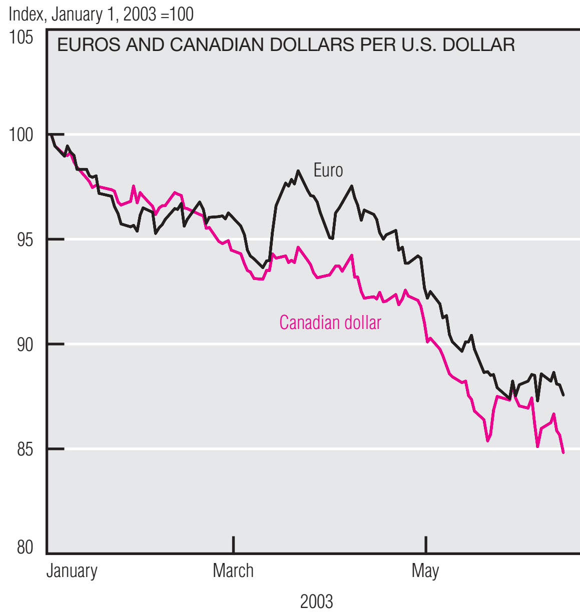
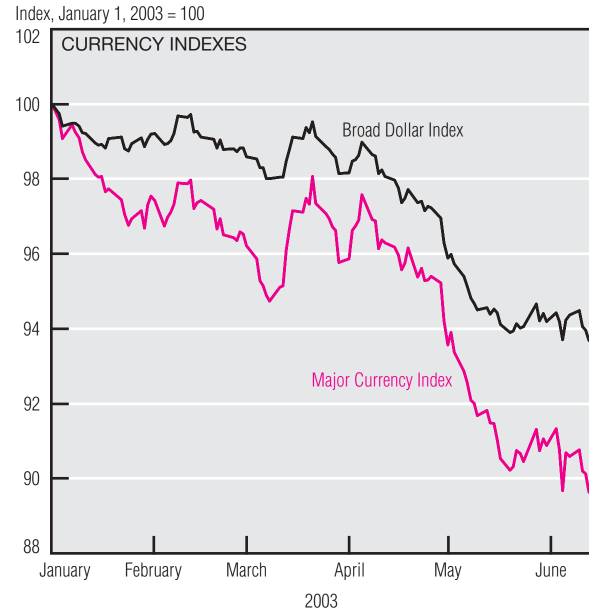
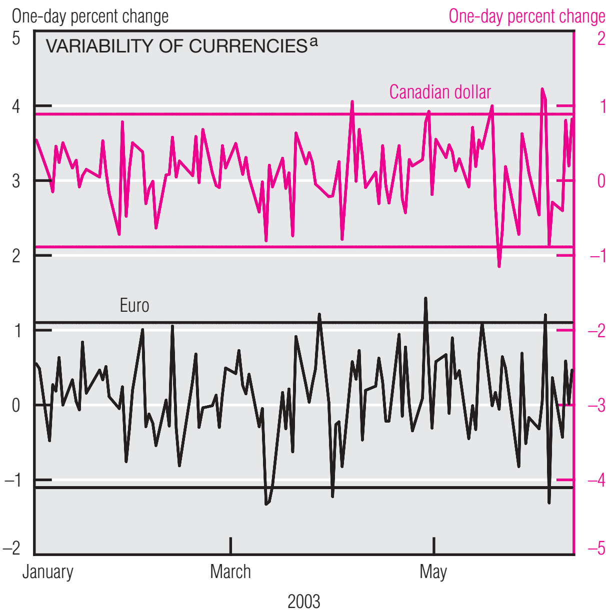
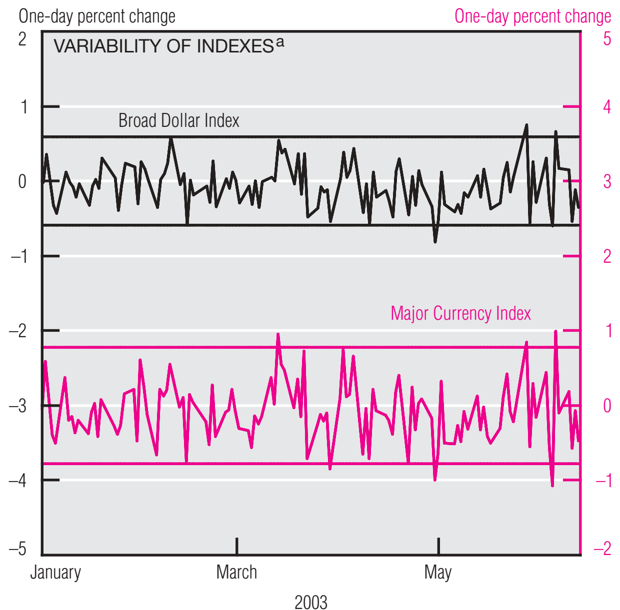
International Markets (cont.)









a. Plus and minus two standard deviations.
SOURCE: Board of Governors of the Federal Reserve System.

beginning of the year, which is within the range of what we would expect.

The value of the U.S. dollar has deteriorated significantly against both the Canadian dollar and the euro since the beginning of the year. The U.S. dollar has depreciated about 15% against the Canadian dollar and about 12% against the euro, both of which are included in the Broad Dollar Index and the Major Currency Index. Since the year began, the Broad Dollar Index has depreciated 6% and the Major Currency Index has depreciated 10%.

One would expect volatility in the value of a single country's currency to exceed the volatility of an index that includes the values of a set of countries' currencies. For example, in an index, an appreciation of one country's currency can be offset by a depreciation of another country's currency.

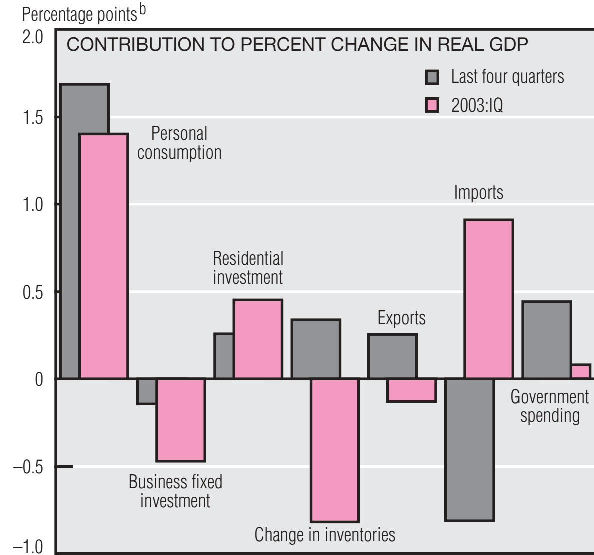
Since the beginning of the year, one-day changes in the Broad Dollar Index (four times) and the Major Currency Index (six times) have fallen outside their historical bands of plus and minus two standard deviations. The standard deviations are calculated using daily changes in the indexes from the beginning of 1998 to the present.

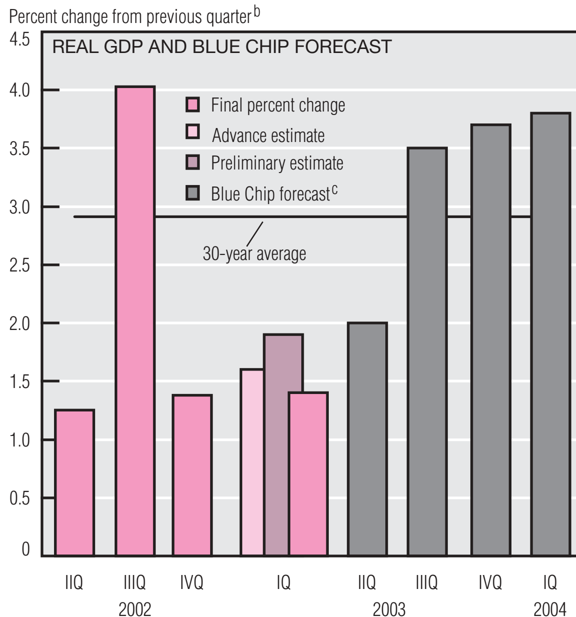
Foreign exchange markets are open five days a week, so we would expect about five or six daily changes to have fallen outside the bands since the beginning of the year. Hence, the volatility of the indexes is in line with recent experience. The one-day changes for both the euro and the Canadian dollar have fallen outside the two-standard-deviation bands more often than would be expected, indicating that the volatility in daily changes has recently increased.

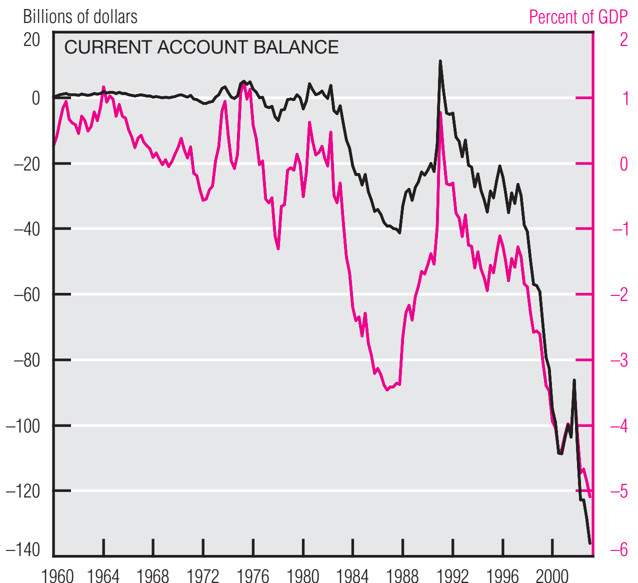
Economic Activity

Real GDP and Components, 2003:IQ[a,b]
(Final estimate)

	Change, billions of 1996 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	33.8	1.4	2.0
Personal consumption	33.0	2.0	2.4
Durables	–5.2	–2.0	3.0
Nondurables	28.9	6.1	3.0
Services	7.9	0.9	2.0
Business fixed investment	–13.2	–4.4	–1.4
Equipment	–12.2	–4.8	2.7
Structures	–1.6	–2.9	–13.2
Residential investment	9.6	10.1	5.7
Government spending	1.7	0.4	2.3
National defense	–3.5	–3.3	5.5
Net exports	21.9	—	—
Exports	–3.5	–1.3	2.7
Imports	–25.4	–6.2	6.2
Change in business inventories	–21.0	—	—







NOTE: All data are seasonally adjusted.
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. Annualized.
c. Blue Chip panel of economists.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, June 10, 2003.

According to the Commerce Department's final estimate, real GDP increased at an annual rate of 1.4% in the first quarter of 2003, matching growth in the last quarter of 2002. Consumer spending increased 2.0% (annual rate) and made the largest positive contribution, but growth in that category was lower than in the past year. Residential investment, however, was robust in comparison to the previous four quarters. Vigorous housing activity led to a 10.1% increase (annual rate) in this category and boosted real Gross Domestic Product (GDP) growth nearly 0.5 percentage points. In contrast, business spending slipped, mostly in the category of equipment and software spending. During the quarter, business also cut inventories, which fell $21.0 billion (1996 chained dollars), and represented the greatest drag on the U.S. economy.

The final estimate for real GDP growth in the first quarter represented a 0.5% reduction from May's preliminary estimate. But Blue Chip forecasters expect acceleration in growth next quarter, followed by even stronger numbers for the subsequent three quarters.

The current account deficit—the combined balance on trade in goods and services, income, and net unilateral current transfers—increased from $128.6 billion to $136.1 billion during the first quarter of 2003. The deficit on goods accounted for half of the increase. The current account balance has not been positive since the second quarter of 1991, and the most recent deficit is the largest to date. As a share of GDP, the current account deficit rose from 4.9% to 5.1%, also the highest reading on record.

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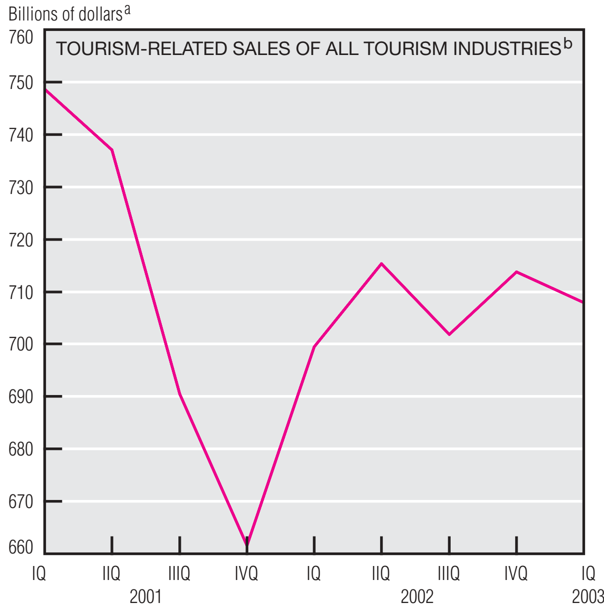
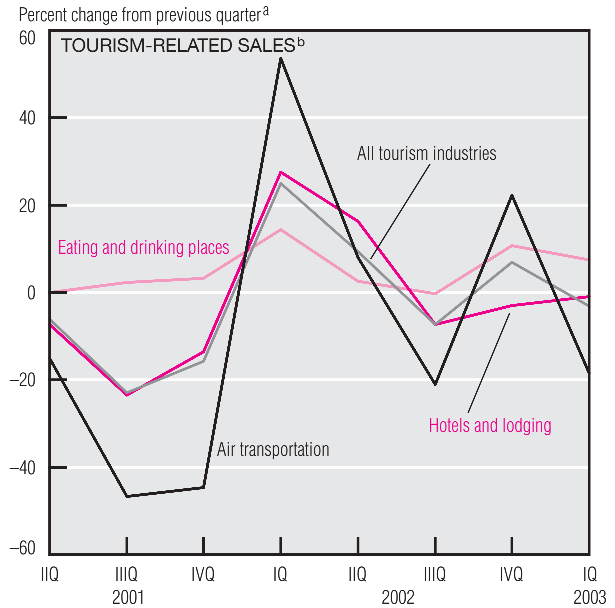
Economic Activity (cont.)





Tourism-related Sales of Tourism Industries[a]
(Billions of dollars, 2003:IQ)

Tourism industry	Direct tourism-related sales	Direct total sales	Tourism-related sales, percent
Hotels and lodging places	110.0	137.5	80.0
Eating and drinking places	64.9	381.7	17.0
Railroads and related services	1.3	44.7	3.0
Local and bus passenger transit	2.4	10.5	23.0
Taxicabs	5.0	10.9	46.0
Air transportation	89.3	117.5	76.0
Water transportation	9.6	56.5	17.0
Automotive rental and leasing	23.1	39.8	58.0
Travel agency services	3.5	16.8	21.0
Amusement and recreation services	17.4	86.8	20.0
Membership sports and recreation clubs	6.3	19.8	32.0
Motion pictures and other entertainment	8.0	44.2	18.0
Professional sports clubs and promoters	2.0	22.6	9.0
Gasoline service stations	3.8	53.8	7.0
Retail excluding restaurants and gas	32.8	1,092.5	3.0
All tourism industries	**379.4**	**2,135.6**	**17.8**

Indirect Sales per Dollar of Direct Tourism-related Sales, 2003:IQ

Tourism industry	Indirect sales
Hotels and lodging places	$0.79
Eating and drinking places	$1.06
Railroads and related services	$0.76
Local and bus passenger transit	$0.76
Taxicabs	$0.76
Air transportation	$0.89
Water transportation	$1.14
Automotive rental and leasing	$0.98
Travel agency services	$0.76
Amusement and recreation services	$0.75
Membership sports and recreation clubs	$0.75
Motion pictures and other entertainment	$0.75
Professional sports clubs and promoters	$0.75
Gasoline service stations	$1.82
Retail excluding restaurants and gas	$0.56
All tourism industries	**$0.87**

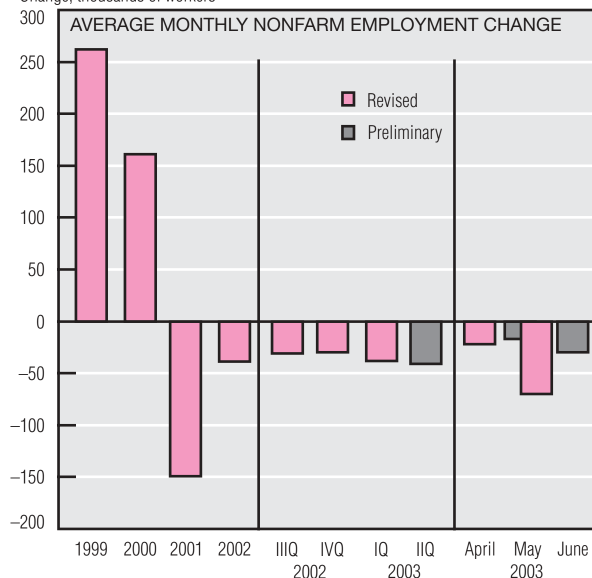
a. Data are seasonally adjusted and annualized.
b. Total sales include direct (from tourism industry to visitor) and indirect (from supplier to tourism industry) sales.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The Travel and Tourism Satellite Accounts, developed by the Bureau of Economic Analysis, are especially useful in observing not only the impact of the terrorist attacks of September 11, 2001 but also the more recent behavior of various tourism industries. In 2003:IQ, total tourism sales decreased $5.7 billion, reaching a level of $708.0 billion (annualized). Total sales remain almost midway between pre-September 11 levels and the trough of 2001:IVQ. Hotels and lodging places, eating and drinking places, and air transportation represent more than 70% of total sales. As one might expect, both hotel and airline sales fell sharply in the last half of 2001.

In fact, air transportation sales plummeted more than 45% (annual rate) during these quarters. This industry has shown a great deal of volatility and probably will continue to do so. Because it owes 76% of its sales to tourism, air transportation is particularly susceptible to sudden, unusual events. For example, it seems likely that the outbreak of the SARS virus affected air travel throughout much of the first half of 2003, to a greater extent than some other industries.

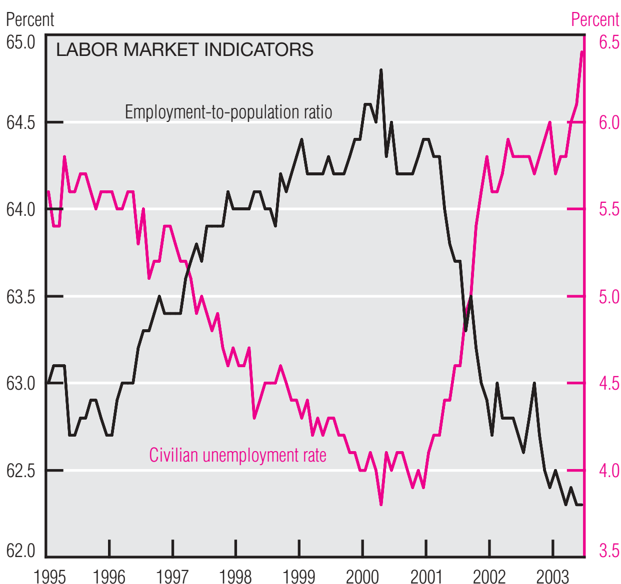
Total tourism sales represent both direct and indirect sales. Direct sales are defined as sales by tourism industries to out-of-town visitors (for example, a meal provided by a restaurant to a business traveler). Indirect sales are defined as sales to tourism industries by a supplier (for example, the sale of fuel to airlines). Therefore, total tourism sales take into account the full impact of tourism as it filters through the economy. Thus, every dollar of sales for all tourism industries results in $0.87 worth of purchases from other industries.

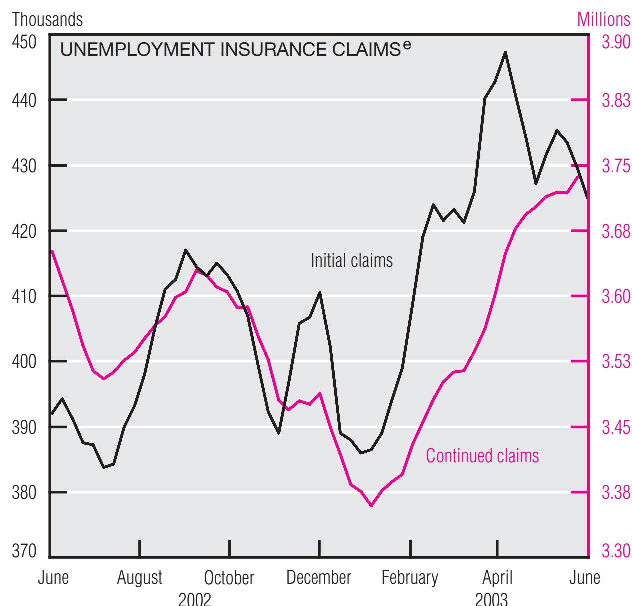
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)[a]				
	2000	2001	2002	Jan.-May 2003	June 2003
Payroll employment	161	–149	–39	–41	–30
Goods producing	–1	–124	–64	–44	–40
Construction	7	–1	–4	11	16
Manufacturing	–9	–123	–57	–54	–56
Durable goods	2	–88	–41	–40	–36
Nondurable goods	–11	–35	–16	–14	–20
Service producing	162	–25	25	3	10
Information	15	–15	–14	–12	–10
Financial activities[b]	6	7	5	17	9
Professional and business services[c]	40	–63	–10	3	–3
Education and health services	32	51	37	27	23
Leisure and hospitality[d]	22	–2	7	1	22
Government	22	46	16	–14	1
	Average for period (percent)				
Civilian unemployment rate	4.0	4.8	5.8	5.9	6.4





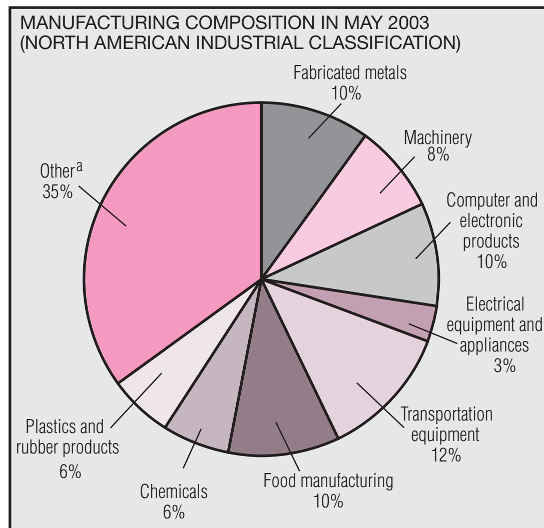
NOTE: All data are seasonally adjusted.
a. Data are according to the North American Industrial Classification System.
b. Financial activities include finance, insurance, and real estate; and rental and leasing.
c. Professional and business services include professional, scientific, and technical services; management of companies and enterprises; administrative and support; and waste management and remediation.
d. Leisure and hospitality includes arts, entertainment, and recreation; and accommodation and food services.
e. Four-week moving average.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

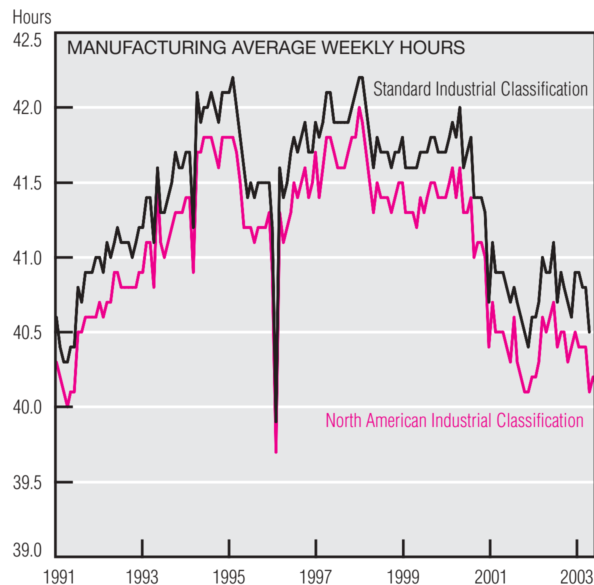
Total nonfarm payroll employment fell by 30,000 jobs in June, after losing a revised 22,000 in April and 70,000 in May. (All employment figures show net changes, that is, job gains minus job losses.) The revision for May showed a loss of 70,000 jobs, four times the loss reported in the preliminary estimate.

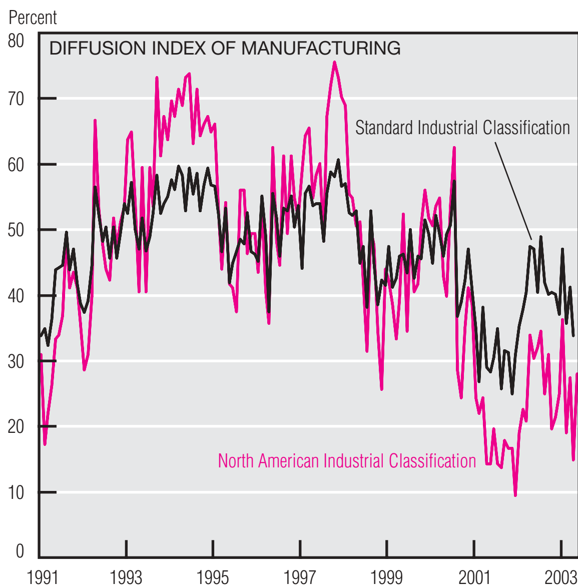
In June, service-providing industries continued to gain jobs, while goods producers continued to lose them. Goods-producing industries posted an overall loss of 40,000 jobs. Manufacturing accounted for the highest number of losses (56,000), which is consistent with the average monthly losses over the previous 12 months. Construction added 16,000 jobs, its fourth consecutive gain since February of this year. After posting four straight months of job losses, leisure and hospitality added 22,000 jobs in June. Education and health services, which added 23,000 jobs, was the only sector where employment has increased every month since August 1998. The information sector lost 10,000 jobs, and financial activities posted a gain of 9,000. Government employment held steady in June, adding 1,000 jobs.

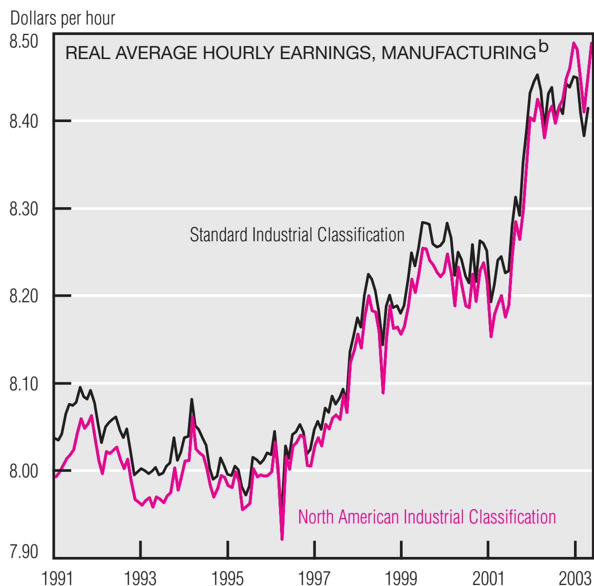
June's unemployment rate rose to 6.4%, the highest level since April 1994. The entry of new job seekers into the labor force led this surge. The employment-to-population ratio remained at 62.3. The four-week moving average of initial unemployment insurance claims continued to fall in the week ending June 28, its third consecutive weekly decline from a recent peak of 435,250 claims in early June. But the number of continued claims remained high, reaching about 3.74 million in the week ending June 21.

A New Industrial Classification System









NOTE: All data are seasonally adjusted.

a. "Other" includes wood products, nonmetallic mineral products, primary metals, furniture and related products, miscellaneous, beverage and tobacco products, textile mills, textile product mills, apparel, leather and allied products, paper and paper products, printing and related support activities, and petroleum and coal products.

b. Real average hourly earnings in constant 1982 dollars calculated using the CPI for urban wage earners and clerical workers (CPI-W).

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

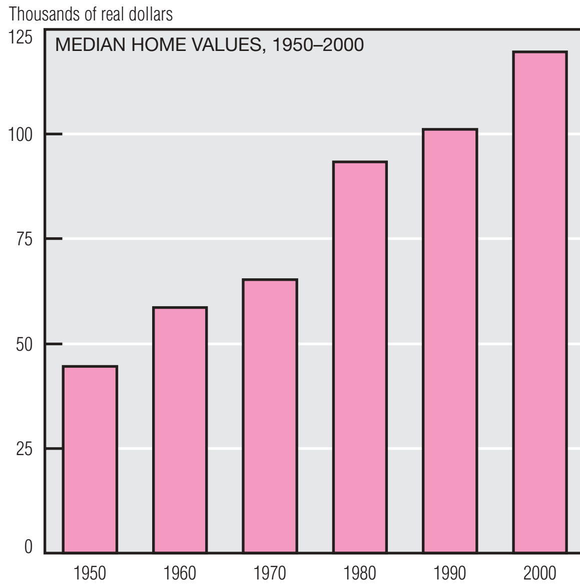
The conversion from the Standard Industrial Classification (SIC) to the North American Industrial Classification (NAICS) took effect in June, creating major definitional changes for the industries previously reported under the SIC. The conversion includes reorganizing the manufacturing and service sectors, creating an information sector, and redefining wholesale and retail. These changes have led to some large quantitative differences. To allow comparison of the two series, the Bureau of Labor Statistics has constructed the NAICS series going back to 1939.

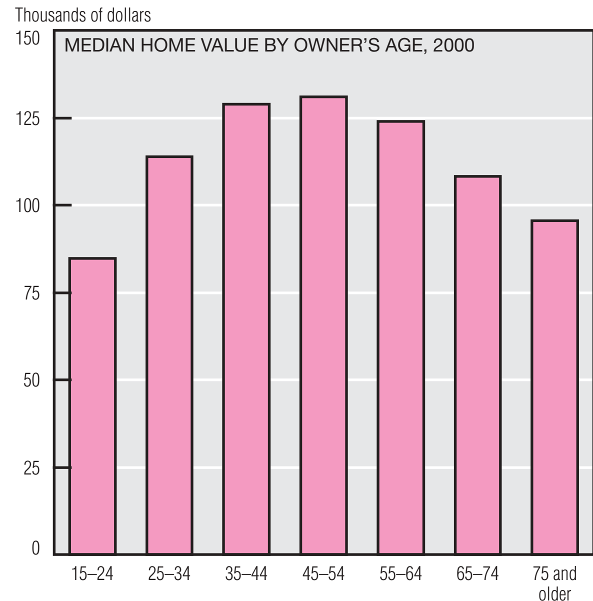
The NAICS is a six-digit hierarchical classification system that identifies 1,170 industries (compared to 1,004 in the SIC) and divides these industries into 20 sectors (compared to 10 in the SIC). The manufacturing sector is now divided into 21 subsectors. This May, transportation equipment had the largest share in the composition of manufacturing employment (12%), followed by food (10%) and computer and electronic products (10%). Under the SIC, computer and electronic products was not recognized as an individual industry; it was lumped together with other industries in the industrial and machinery category.

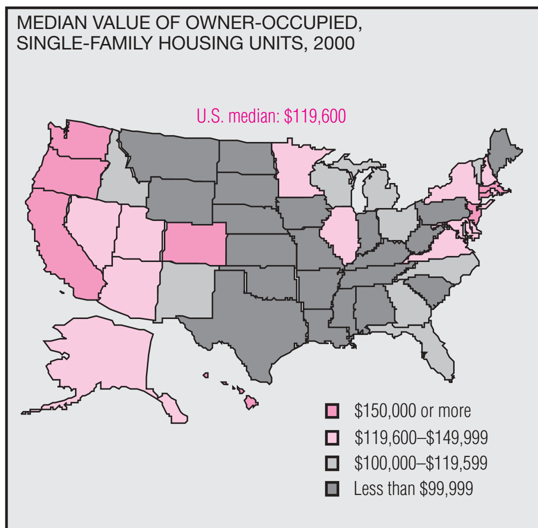
Transferring some SIC industries from the NAICS manufacturing sector has caused a decline in the average number of hours reported. In addition, the new manufacturing sector appears more volatile, at least in terms of the Employment Diffusion Index. Using the NAICS rather than the SIC, this sector looked stronger in the mid-1990s but much weaker during the current recession.

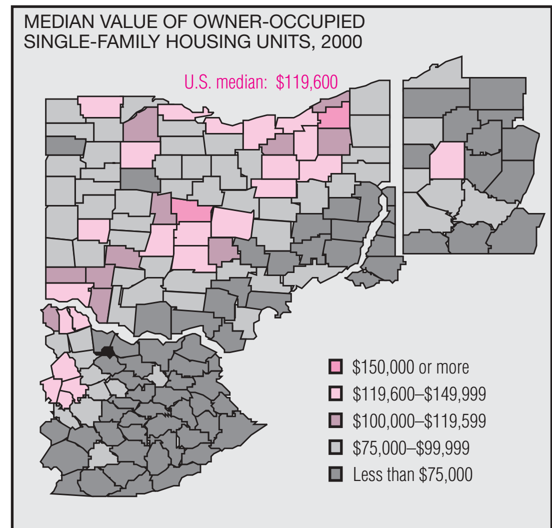
Real average hourly earnings are quite similar under the two classifications; however, earnings measured under the NAICS are now higher than under the SIC.

Home Values









SOURCE: U.S. Department of Commerce, Bureau of the Census.

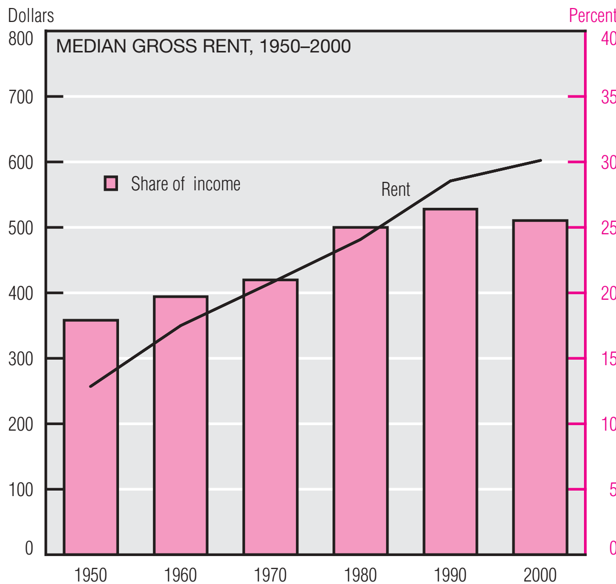
The 2000 Census reported that the median value of a home in the U.S. was $119,600, more than 18% higher than the value reported in the 1990 Census, after adjusting for inflation. Since 1960, the median home value in the U.S. has more than doubled.

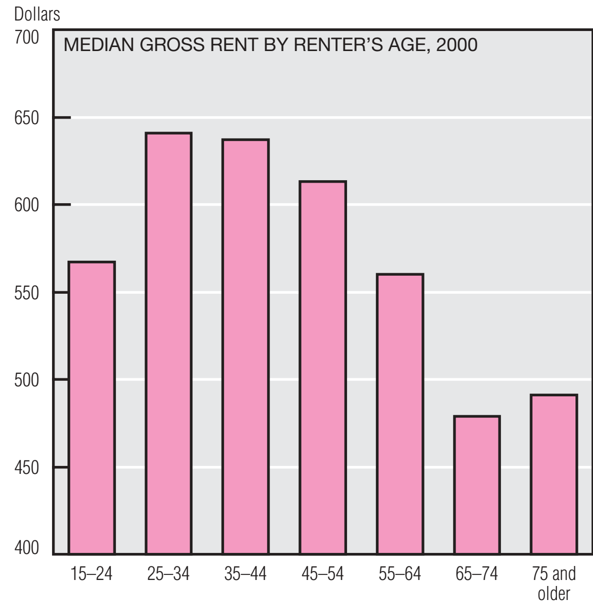
Median home values vary by the owner's age. Owners aged 45 to 54 reported the highest median home value, followed closely by the next-youngest and next-oldest age groups.

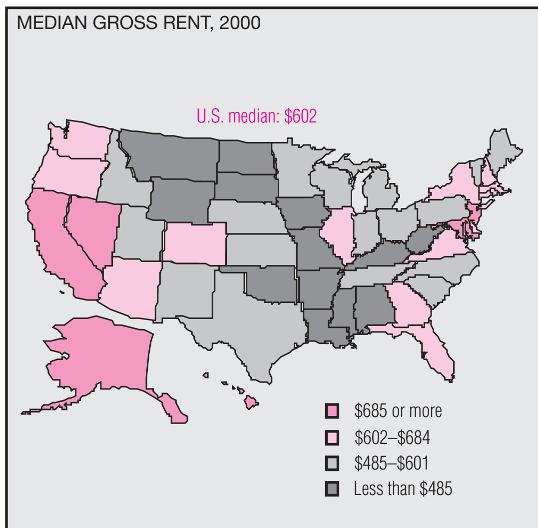
Geographically, the states reporting the highest median home values are found on the West Coast and in Colorado, New Jersey, Connecticut, and Massachusetts. States in the Midwest and South reported the lowest median home values.

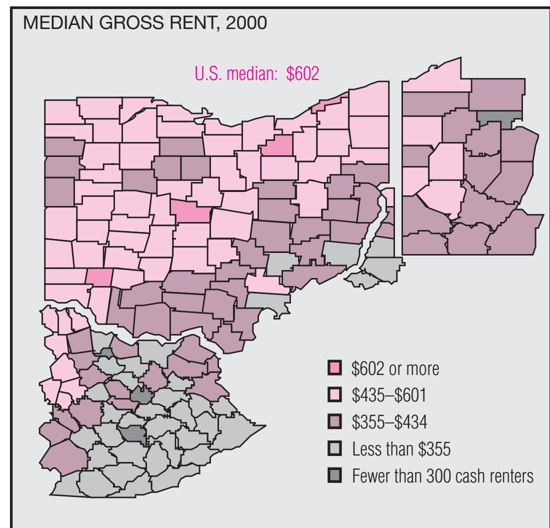
Within the Fourth Federal Reserve District, every county where median home values exceeded the national median was adjacent to a large city. The highest median home values were found in Geauga County (adjacent to Cuyahoga County, which contains Cleveland) and Delaware County (adjacent to Franklin County, which contains Columbus). The counties in the Fourth District where median home values are significantly lower than the national median are concentrated in the Appalachian region and in the heavily agricultural and mining regions of eastern Kentucky and western Pennsylvania.

Rental Costs









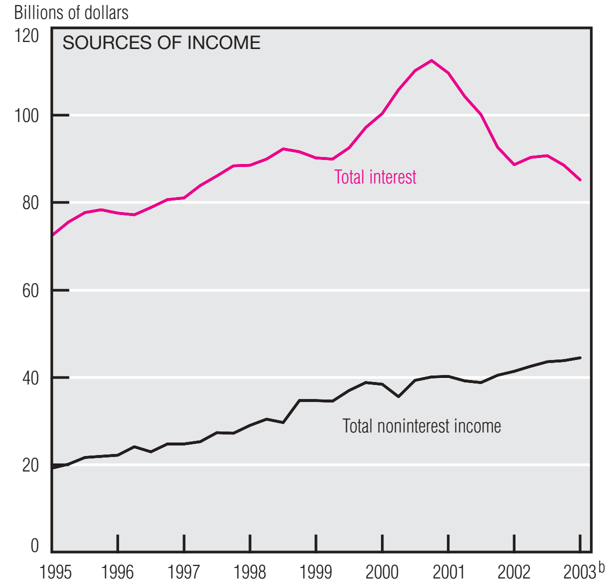
NOTE: All rents are monthly rates.
SOURCE: U.S. Department of Commerce, Bureau of the Census.

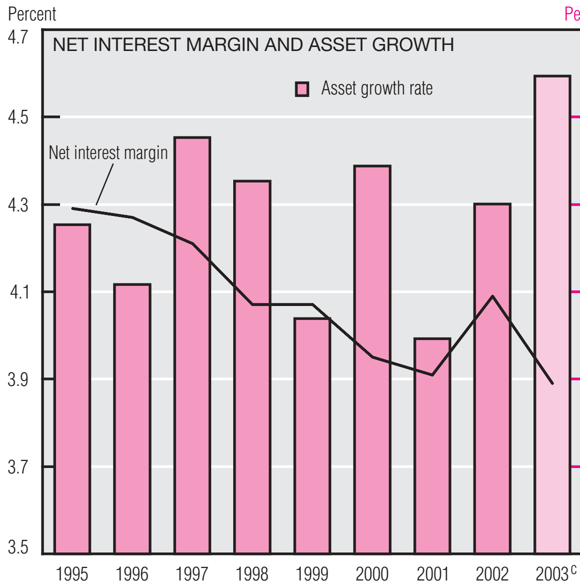
More than a third of the U.S. population resides in rental property. In 2000, the share of renters (33.8%) was the lowest recorded in census history. The same year, the cost of renting was the highest in census history, with a median monthly rental cost in the U.S. of $602. Monthly rents have risen steadily since 1950, even after adjusting for inflation. Although monthly rental costs in the 2000 Census were higher than in the 1990 Census, rent as a share of income fell slightly over the last decade.

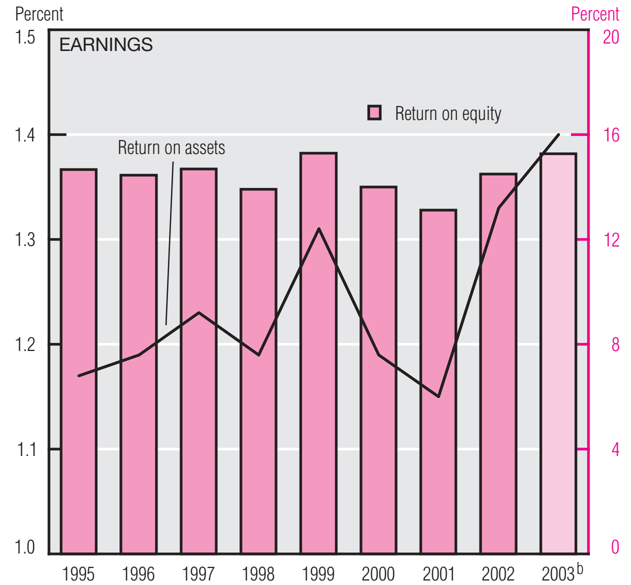
Renters aged 25 to 34 tend to pay the highest median rents, and roughly half the people in this age group in the U.S. rent their primary residence. Only heads of households aged 15 to 24 rent more frequently (over 82%). They tend to pay lower median rents than the group aged 25 to 34, however, because many in this group are students or just beginning to work full time.

Nationwide, the states with the highest median rental rates are Alaska, Hawaii, California, Nevada, Maryland, and New Jersey, while the states with the lowest median rates are found in the Midwest and the South. Within the Fourth Federal Reserve District, the highest median rates are found in counties adjacent to the cities of Cleveland, Cincinnati, and Columbus. Lower rents are found in the Appalachian area of the District and in the tobacco-farming and mining regions of eastern Kentucky. Among cities with more than 10,000 people, three Fourth District cities rank among the 10 least expensive in the nation in median rental rates: Erie's rents are the nation's second lowest, while Cincinnati's are the fifth lowest and Dayton's are the seventh lowest.

Depository Institutions







a. Net income equals net operating income plus securities and other gains and losses.
b. Annualized data.
c. For 12 months ending March 31.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured depository institutions' net operating income recovered energetically from the dip it took in 2002:IVQ. By the end of 2003:IQ, it was up to $23.5 billion; this was an increase of 16.9% from the previous quarter and 10.1% from the same quarter a year earlier. Net income, the sum of net operating income plus securities gains and losses, was also up 14.9% from the same quarter of 2002. Declining credit losses and substantial gains on securities sales promoted overall earnings growth.

Depository institutions' total interest income declined slightly from 2002:IVQ to 2003:IQ, when it had dropped to $85 billion. Falling interest rates brought the number significantly lower than the $113 billion posted in 2000:IVQ. Total noninterest income continued to grow in 2003:IQ and was 7.4% higher than the same quarter a year earlier, another sign that the earnings pressures that affected banks during the 2001 recession are finally abating.

Despite improved overall earnings, the net interest margin reversed its recent upward trend, resuming a decade-long descent. Net interest margin is interest plus dividends earned on interest-bearing assets minus interest paid to depositors and creditors, expressed as a percentage of average earning assets. It declined from 4.09% in 2002:IQ to 3.89% in 2003:IQ.

Low interest rates are one reason for the shrinking margins; another reason, just as important, is the staggering growth of assets to 10.9% (annualized) in 2003:IQ, the highest in almost a decade. Even with strong asset growth, depository institutions showed overall improvement in earnings. Their return on assets rose to

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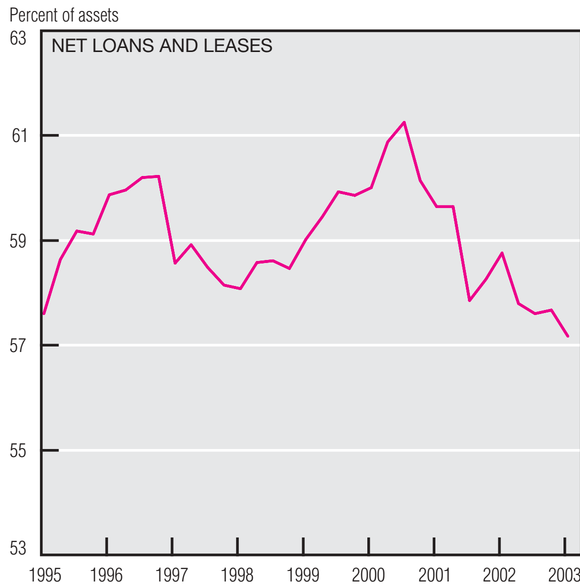
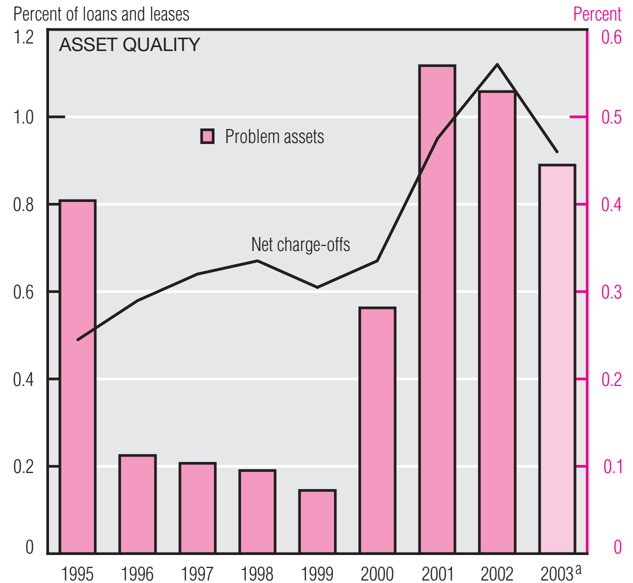
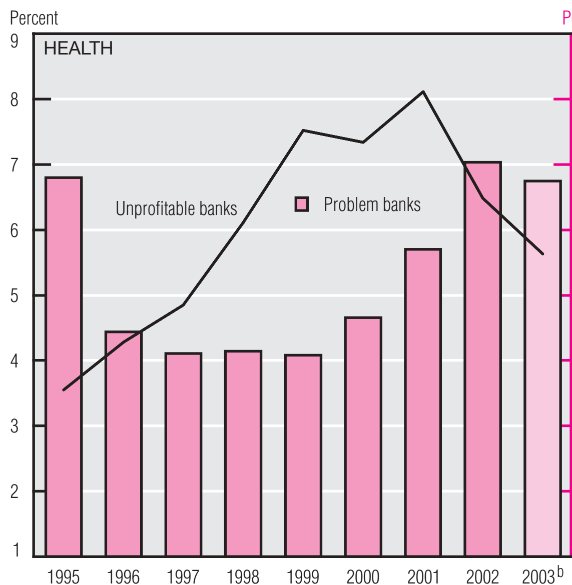
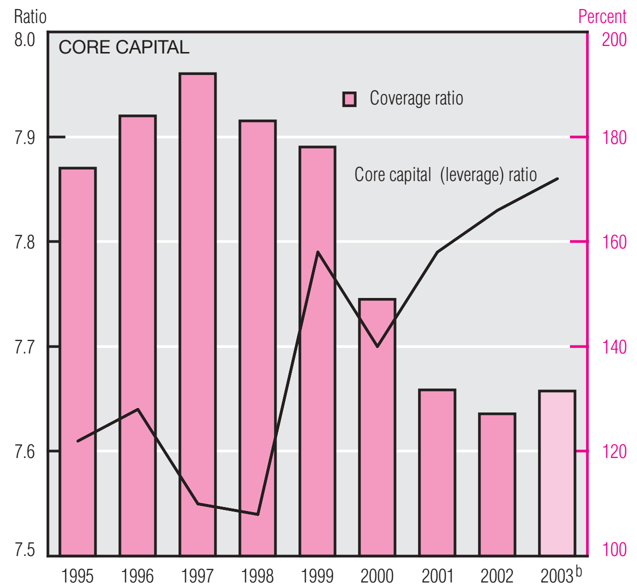
Depository Institutions *(cont.)*









a. Net charge-offs are annualized.
b. First-quarter data.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

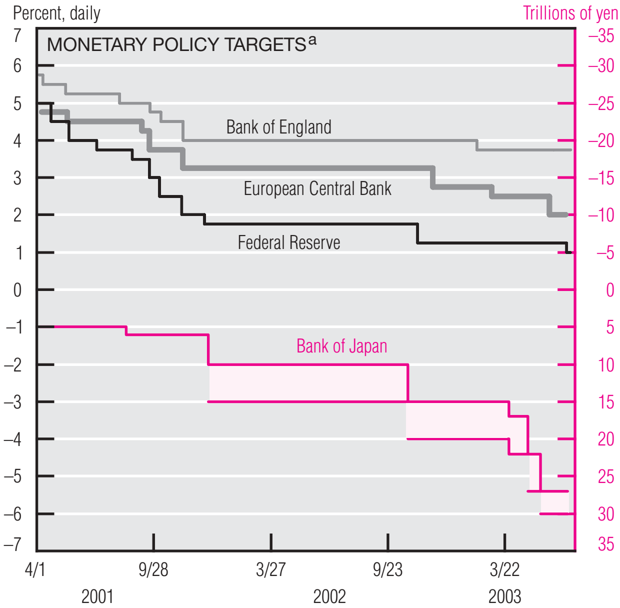
1.4%, the highest level since 1989, and their return on equity to 15.3%, the highest level since 1999.

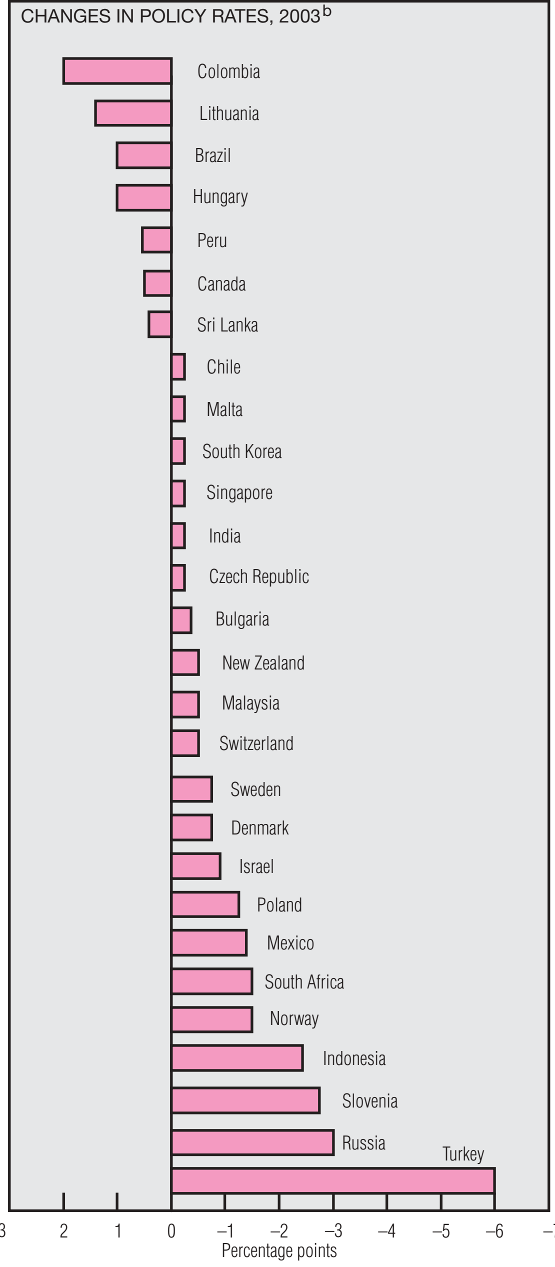
Net loans and leases as a share of total assets decreased slightly from 58.8% in 2002:IQ to 57.2% in 2003:IQ. Net loans and leases grew 8.0%, but total assets grew 10.9%, so the year-over-year ratio decreased slightly. Although the first quarter's 57.2% ratio was well below the recent high of 61.3% in 2000:IIIQ, lending was brisk, partly because low interest rates stimulated refinancing activity.

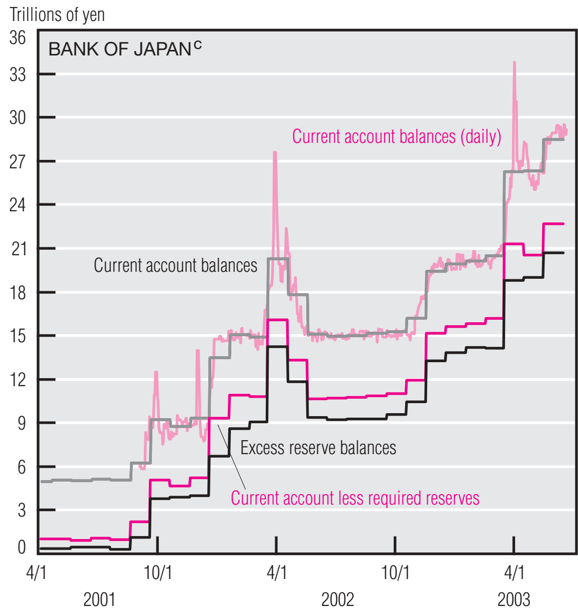
Asset quality showed signs of improvement. Net charge-offs (loans and leases removed from balance sheets because of uncollectibility, minus recoveries) fell to 0.9% of total loans, the first drop since 1999. Problem assets (nonperforming loans and repossessed real estate) as a share of loans and leases fell to 0.44% from 0.53% in 2002. The improvement in asset quality was caused by the lower debt-servicing costs that resulted from refinancing at lower interest rates, as well as aggressive tightening of lending standards.

Better asset quality is also reflected in the decline of unprofitable institutions to 5.6% in the first quarter. Problem banks (those with substandard exam ratings) as a share of total banks fell to 1.4%. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) rose to 131% in the first quarter from 127% at the end of 2002, the first increase since 1997. Core capital, which protects depository institutions against unexpected losses, remained flat at 7.86%. All of these performance indicators point to a strengthening banking sector.

Foreign Central Banks







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

b. Ten countries showed no change: Argentina, Australia, China, Costa Rica, Hong Kong, Latvia, Philippines, Taiwan, Thailand, and Ukraine.

c. Current account balances at the Bank of Japan are required and excess reserve balances at depository institutions subject to reserve requirements plus the balances of certain other financial institutions not subject to reserve requirements. Reserve requirements are satisfied on the basis of the average of a bank's daily balances at the Bank of Japan, starting on the sixteenth of one month and ending on the fifteenth of the next.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; Wholesale Markets Brokers Association; and Bloomberg Financial Information Services.

The European Central Bank reduced its policy rate to 2% early in June. The cut of 50 basis points (bp) was motivated by weaker prospects for economic growth and an improved outlook for medium-term inflation (below 2%). Commenting on published assessments of the potential for deflation in some of the European Central Bank's member countries, ECB President Duisenberg said, "At the regional level, a period of relatively low price increases or even price level declines will improve a region's competitiveness within the currency area. Within a monetary union, deflation is not a meaningful concept when applied to individual regions."

In the U.S., the Federal Open Market Committee reduced its target for the federal funds rate by 25 bp, its first change since a reduction of 50 bp in November of last year.

Widespread talk of global economic weakness and prospects for deflation may obscure differences in monetary policy developments around the world this year. It is true that policy easing has been widespread, as suggested by the actions of 21 of the 37 central banks (other than the "Big Four") for which Bloomberg Information Services provides data. However, tightening was the rule in another six of these cases, including Canada. Another 10 central banks (not shown) made no policy move. A similar variability can be seen within major regional groupings of nations.