The Economy in Perspective

Plus ça change, plus c'est la même chose. (The more things change, the more they remain the same.)…Last month, the Boise Corporation announced its intention to acquire OfficeMax, an office supply company based in Cleveland. Quite apart from its local significance, the announcement's national significance lies in Boise's acknowledgement that the acquisition is an important step in the company's transformation from a producer of lumber and paper products to a supplier of paper and office solutions products.

Last month, the Kodak Corporation announced its intention to acquire PracticeWorks, a business that provides dental management software and imaging services. Kodak began its corporate life as a manufacturer of photographic film and cameras. Increasingly, however, the company's business model recognizes the growth of digital photography and imaging, so it seeks opportunities to develop services and products that use digital imagery rather than photographic film.

Last year, IBM announced that it had established a new division to sell engineering and technology-consulting services to clients seeking to benefit from its IT engineering expertise. Even before this announcement, IBM had transformed itself from a company relying principally on manufacturing and selling computers to one whose revenue comes primarily from selling IT-related consulting services and software. The new engineering and technology services division is intended to help client companies exploit the value of intellectual property in designing new products.

These three corporate news stories are just a small sample of the changes that have been taking place in corporate America as business adapts to changes in technology, competition, and customer requirements. Companies that began as agricultural, mining, or manufacturing firms have found, or are finding, that they must change their business models in order to provide value for customers and shareholders alike. Companies that used to sell commodities or make something are finding that intellectual assets mean as much, if not more, than physical assets. Companies that served one customer segment or one geographic region must now think more broadly about how to exploit scale and scope economies before their rivals take away their customers and markets. And speaking of rivals, some companies are discovering that their competitors in one market can be their partners in another, and that their suppliers or customers in one market can be their competitors in another.

Making a profit in business has never been easy, at least making it consistently. Economic theory teaches that in fully contestable markets—that is, markets in which competitors can enter easily and at low cost—one firm cannot consistently earn profits beyond those of any other firm. Otherwise, of course, new contenders would enter and compete away any excess profits. This makes it easy to see why the evolution of business can be thought of as one long progression from invention to innovation to initial advantage to no advantage at all, unless firms are willing and able to adapt. It is also easy to see why firms seek to erect entry barriers, both domestically and internationally, to thwart competitors who are attempting to enter markets they dominate. Generally, those who stand to lose the most from these changes are concentrated in certain industries and places, while those who stand to benefit are the general public.

The entire world has been opening up to capitalism and trade among nations at a very rapid pace during the last several decades. At the same time, a host of new information, physical, and life sciences technologies have fueled the repeated, rapid development of new products and services. The confluence of these developments has been bringing great opportunities and great upheavals to many businesses, communities, and nations.

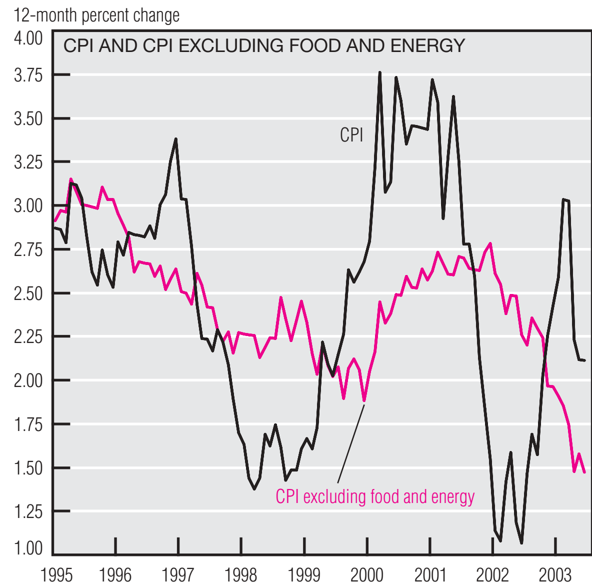
Fortunately or unfortunately, these significant developments are not unprecedented in history. Fortunately, because economic history shows that eras characterized by expanding trade and innovation enjoy substantial increases in the living standards of those who participate. Unfortunately, because political history shows that the tensions created by the social changes associated with economic upheaval can cause civil unrest, protectionism, demagoguery, and even war. A long view of history is needed to appreciate that, despite the destruction wreaked along its path, increased trade among nations and technological advancements truly benefit mankind.

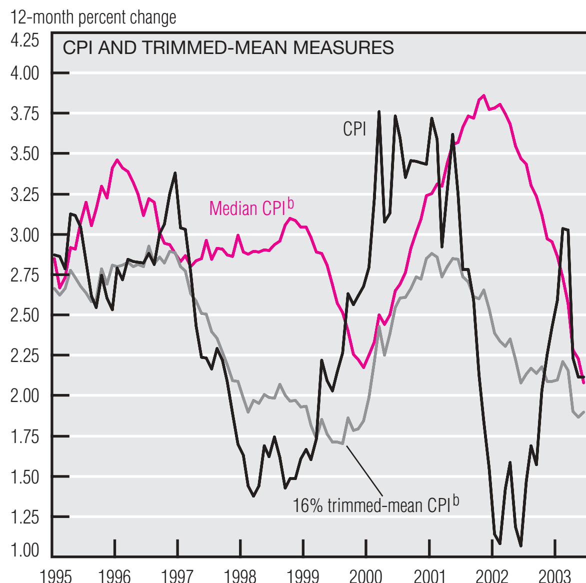
Federal Reserve Board Chairman Alan Greenspan was asked at a U.S. House of Representatives hearing last month to explain which high-tech jobs would remain or be created to replace America's disappearing manufacturing jobs. Mr. Greenspan replied that if our labor market is flexible enough and our capital goods market functions properly, jobs will be created. "[T]hat question has been coming up for generations," he observed. "The answer … is, 'It will happen.'"

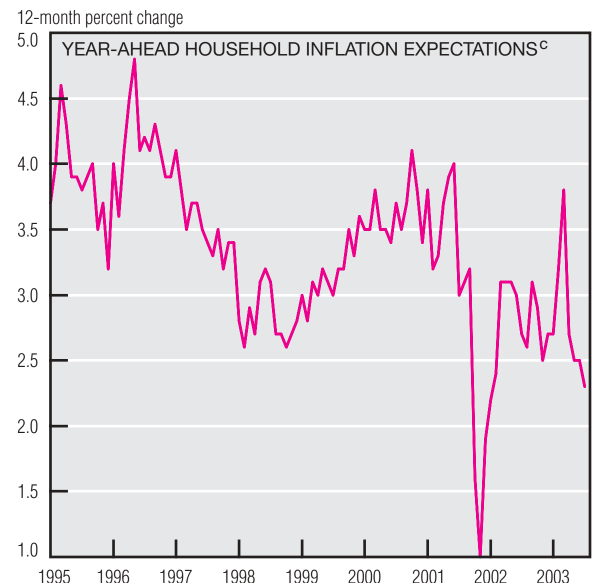
Inflation and Prices

June Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2002 avg.
Consumer prices					
All items	2.0	–0.7	2.1	2.4	2.4
Less food and energy	0.0	1.0	1.5	2.2	2.0
Median[b]	1.1	1.1	2.1	2.9	3.0
Producer prices					
Finished goods	6.1	–6.7	2.9	1.8	1.2
Less food and energy	–1.6	–3.6	–0.3	0.9	–0.5







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 inflation statistics remained subdued in June, seemingly still on the disinflation path begun sometime in 2001. The Consumer Price Index (CPI) rose an annualized 2% in June, mostly on the strength of rising food and energy prices. Even so, the CPI's 2.1% rise over the past 12 months is lower than its 2002 growth rate. Excluding food and energy, the CPI was unchanged in June and has grown only 1 1/2% over the past 12 months, one-half percentage point under its modest 2002 increase. Indeed, this "core" inflation measure has fallen 1 1/4 percentage points since early 2002 and is now posting its lowest 12-month increase since 1966.

Equally dramatic has been the recent downward migration of the Federal Reserve Bank of Cleveland's median and 16% trimmed-mean CPI, two inflation measures that attempt to gauge the persistent component of the inflation trend by eliminating the most extreme observations. Both measures have shown a determined disinflation pattern over the past few years and both now put the inflation trend at about 2%.

The continued downturn in inflation appears to have been accompanied by lowered inflation expectations, at least according to the University of Michigan's *Survey of Consumers*. The survey shows that consumers expect prices to increase slightly more than 2% over the next 12 months, a decline in inflation expectations of about 1 1/2 percentage points since 2000. Indeed, with inflation moderating by virtually every measure, there seems to be little immediate danger that inflation will reignite.

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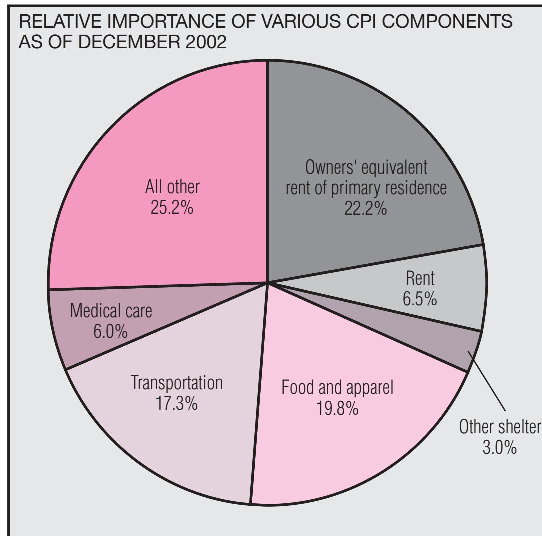
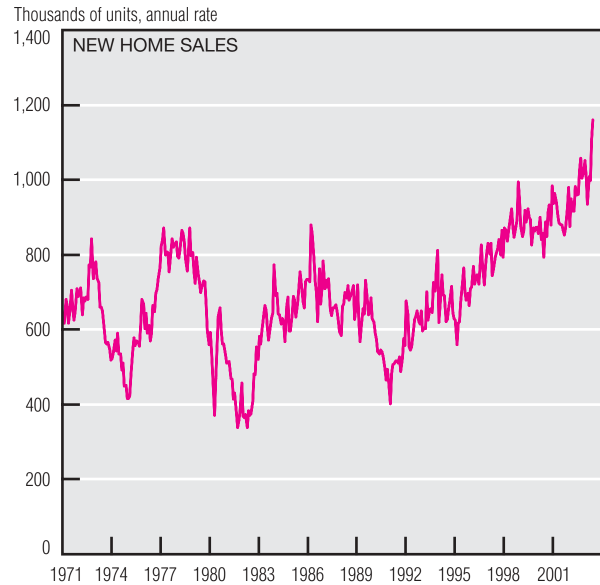
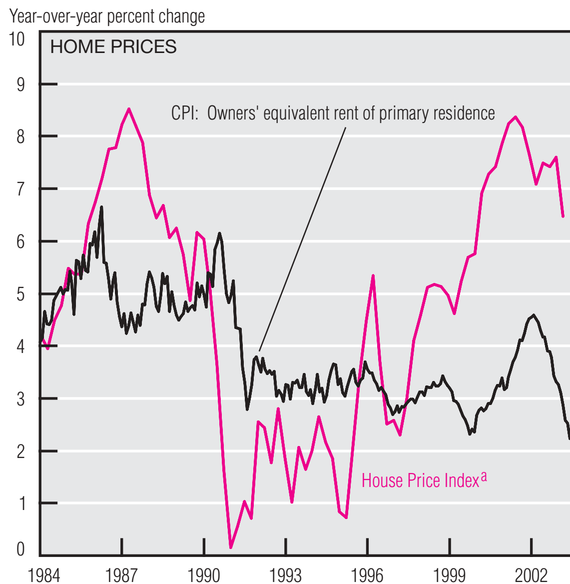
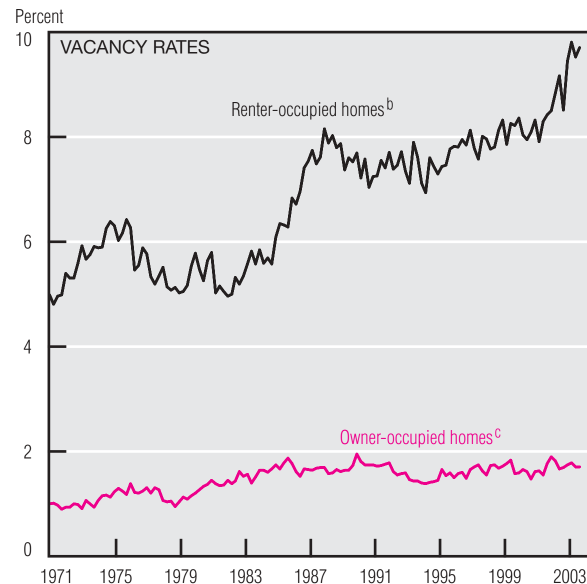
Inflation and Prices (cont.)







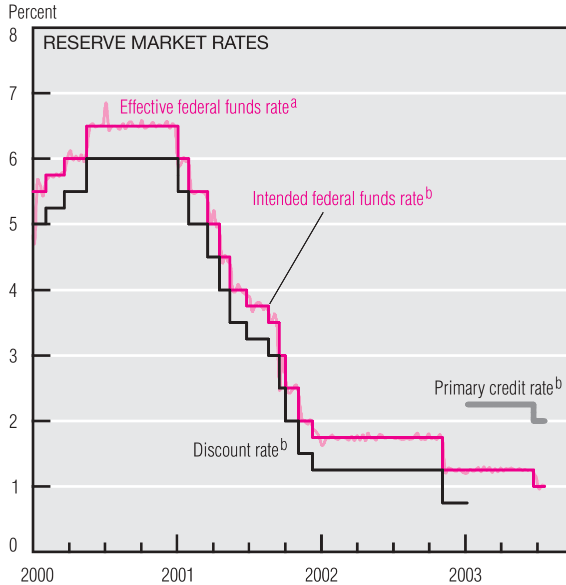


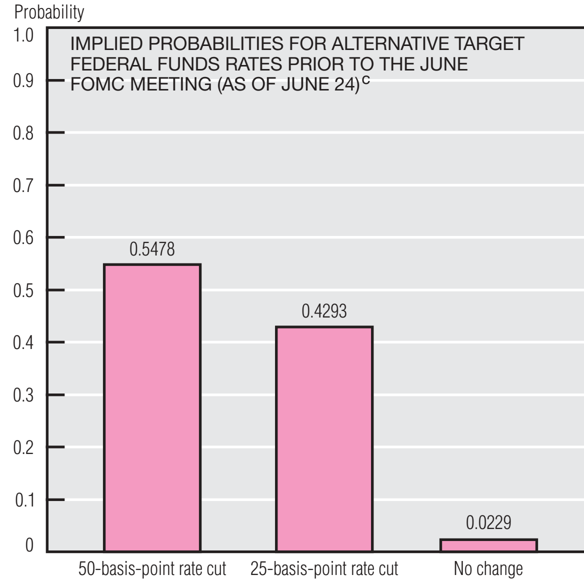
a. Calculated by the Office of Federal Housing Enterprise Oversight.
b. Vacant housing units available for rent year-round divided by the sum of vacant housing units available for rent year-round and renter-occupied housing units.
c. Vacant housing units available for sale year-round divided by the sum of vacant housing units available for sale year-round and owner-occupied housing units.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Office of Federal Housing Enterprise Oversight; and Federal Reserve Bank of Cleveland.

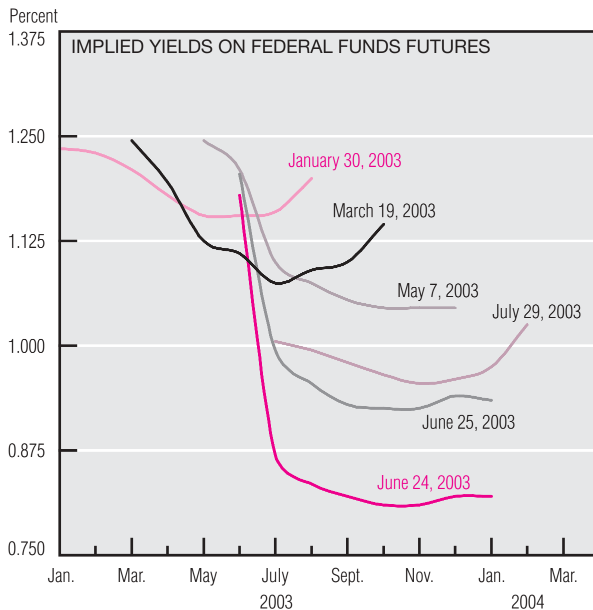
One caution, however, comes from the CPI housing measure. Costs associated with shelter represent more than 30% of the CPI—its single largest component. Prior to the 1980s, the CPI was computed using home purchase prices and mortgage interest rates. This methodology tended to cause wide fluctuations in the inflation measure that were not thought to reflect accurately the true cost of housing to U.S. homeowners. That methodology was changed to an "owners' equivalent rent of primary residence" (OER)—the cost homeowners would have to pay to live in their homes if they attempted to rent the house rather than own it. Roughly 22% of the CPI represents the implied rents of U.S. homeowners.

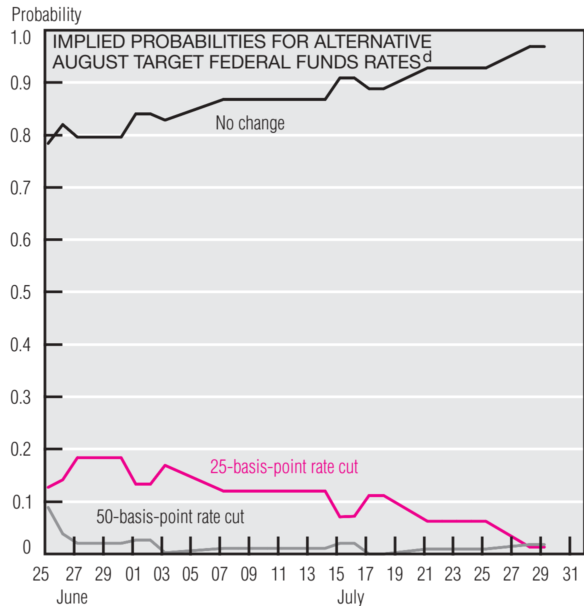
While conceptually appealing, the OER measure is sometimes difficult to implement because the stock of owner-occupied housing is not always easy to replicate in the rental market. For one, it is not a simple matter to assure that the qualities seen in the owner-occupied market are the same as those measured in the rental market. In light of the rather dramatic rise in home sales in recent years, coincident with a rising vacancy rate for rental homes, it is reasonable to be circumspect about the recent moderation coming from the large OER component in the CPI. Consider that home prices have been rising at a rate well in excess of the OER since the late 1990s. If people are abandoning home rentals for home ownership, the disinflation in shelter costs led by OER may be understating actual inflation.

Monetary Policy









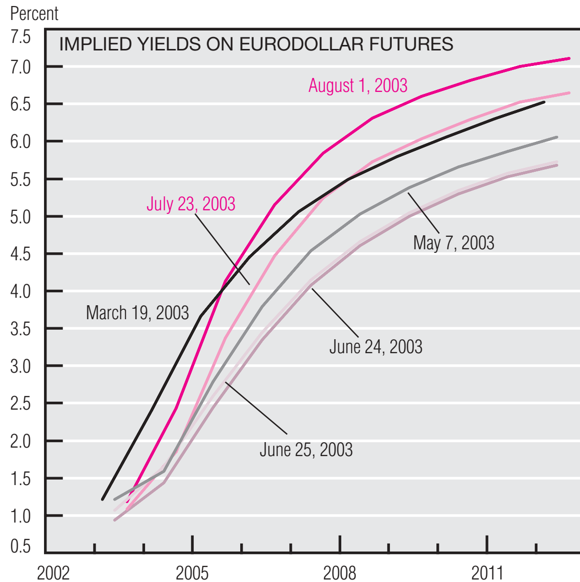
a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated by using prices from options on July 2003 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated by using prices from options on August 2003 federal funds futures that trade on the Chicago Board of Trade.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

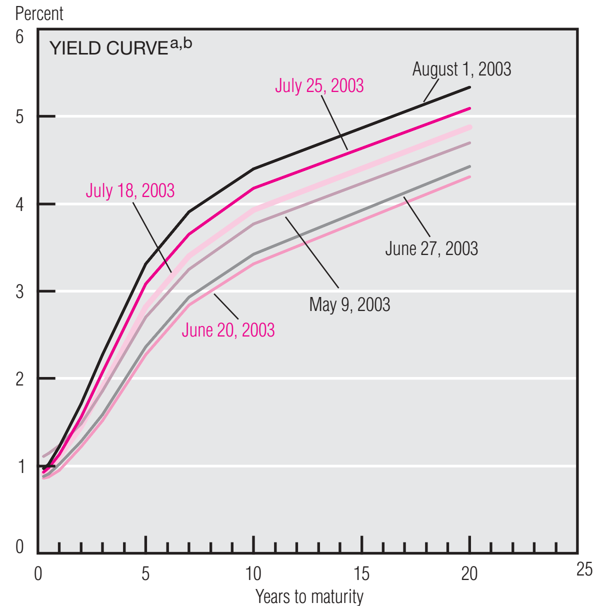
After the surprise of a smaller-than-expected cut in the federal funds rate at the June 24–25 meeting of the Federal Open Market Committee (FOMC), market participants see little chance of a further rate cut. Attention apparently has focused on the language of the FOMC's press release: "The Committee continues to believe that an accommodative stance of monetary policy, coupled with still robust underlying growth in productivity, is providing important ongoing support to economic activity. Recent signs point to a firming in spending, markedly improved financial conditions, and labor and product markets that are stabilizing."

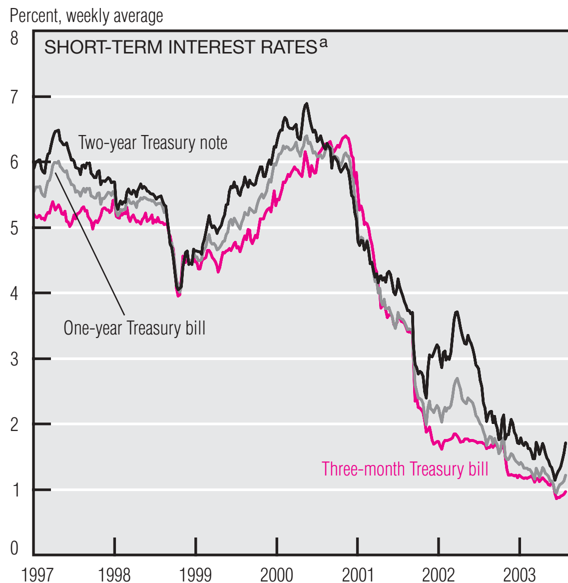
Since early spring, the Chicago Board of Trade has provided a market for options on federal funds futures. Prices on these options enable one to estimate the implied probabilities associated with alternative policy choices. Just before the FOMC's June meeting, the implied probability distribution showed that the odds favored a rate cut of 50 basis points, with a slight chance that no change would be made. This revealed concern that the FOMC would need to act aggressively to avoid a potentially corrosive deflation. The choice of a smaller rate cut seemed to reassure markets that an unwelcome fall in inflation was unlikely.

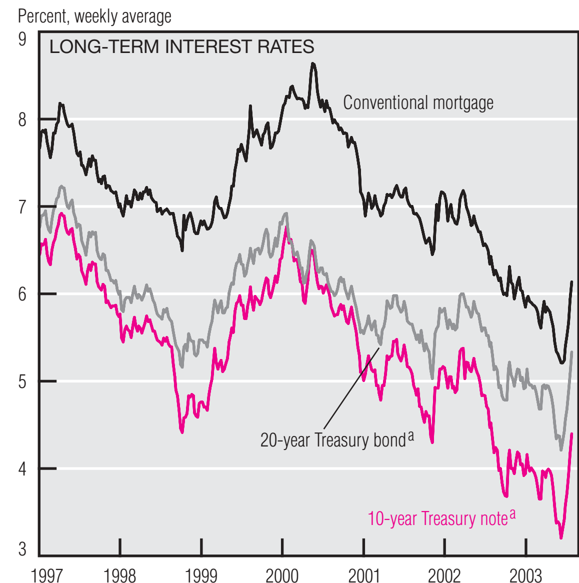
Since then, there has been evidence of increasing confidence in the FOMC's belief that the current policy setting is sufficiently accommodative. As of July 29, options on the August fed funds futures assigned a 97% chance to the no-change scenario, up from less than 80% immediately after the June meeting.

Money and Financial Markets









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

The trajectory of expected future policy actions has changed dramatically since the beginning of summer. Although no policy actions appear imminent, federal funds futures suggest that rate hikes might begin early next year. Eurodollar futures, however, indicate that substantial rate hikes are not expected until 2005, keeping market interest rates below estimates of the longer-term equilibrium rate for at least a year. Implied yields on eurodollars remain persistently below the implied yields observed in March, which suggests that the policy stimulus will persist longer than was thought possible last spring.

Concerns about the prospect of deflation have largely abated. In his July 15 testimony before Congress, Federal Reserve Chairman Alan Greenspan reinforced this view by stating that, "…given the now highly stimulative stance of monetary and fiscal policy and well-anchored inflation expectations, the Committee concluded that economic fundamentals are such that situations requiring special policy actions are most unlikely to arise."

The belief that policy has become highly stimulative is consistent with recent changes in interest rates' term structure. The yield curve has steepened substantially since the last meeting of the Federal Open Market Committee. The yield on the one-year Treasury bill increased about 25 basis points (bp) from its recent low, while the yield on the 10-year Treasury bond jumped sharply by more than a percentage point.

Rates in private markets for long-term debt also rose markedly. Mortgage rates increased about 90 bp off

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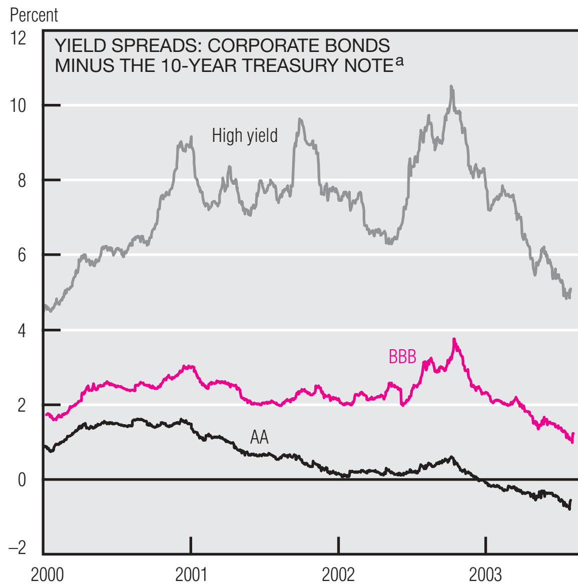
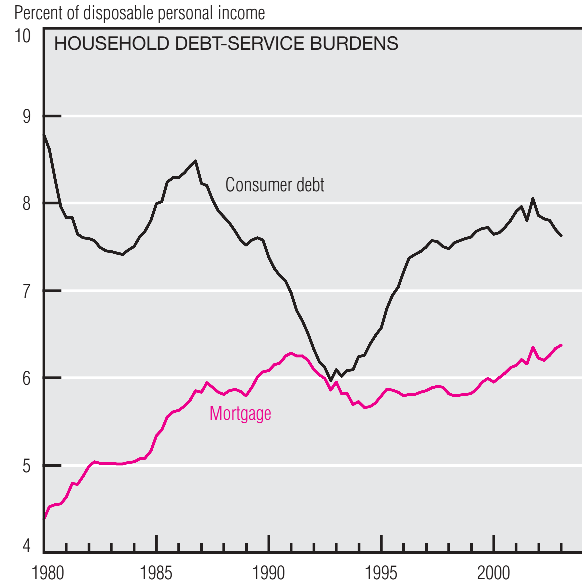
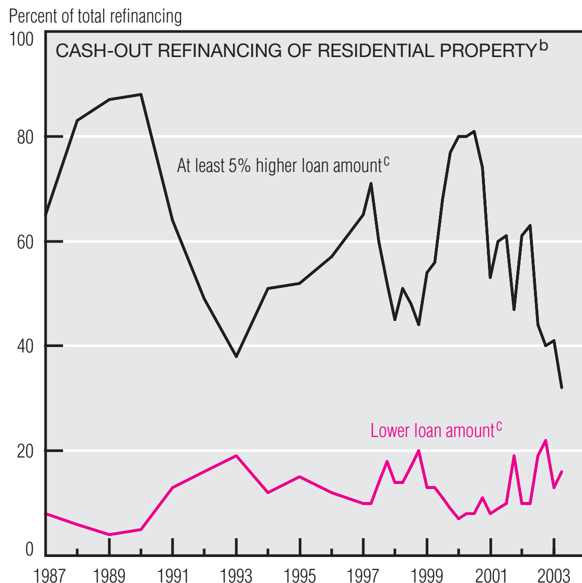
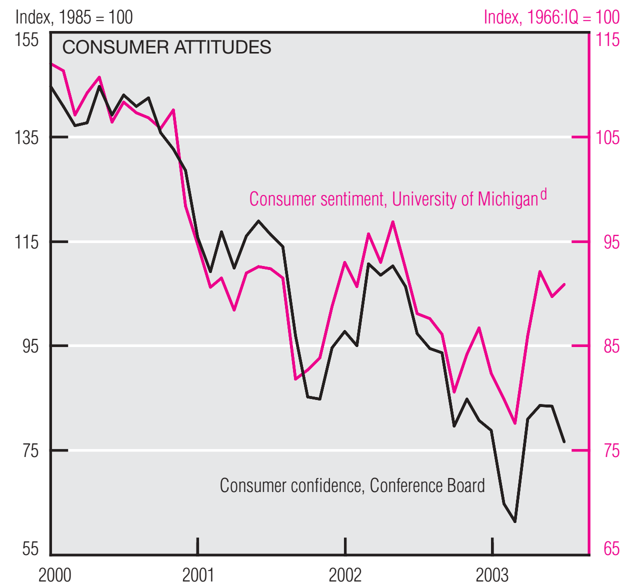
Money and Financial Markets *(cont.)*









a. Merrill Lynch AA, BBB, and High Yield Master II Indexes, each minus the yield on the 10-year Treasury note.
b. Annual data until 1997, quarterly data after.
c. Compared with previous financing.
d. Data are not seasonally adjusted.
SOURCES: Federal Housing Finance Board; Federal Home Loan Mortgage Corporation; Conference Board; University of Michigan; and Bloomberg Financial Information Services.

their lows, while high-grade corporate bonds increased about 70 bp. Because the rate increases imply a more sanguine economic outlook, yield spreads between bonds of different risk classes drifted down slightly, somewhat tempering the general rise in yields, especially for the riskier bonds.

The consumer sector has been the key source of strength since the recovery began. To some extent, this strength derives from changes in technology and from mortgage markets that have dramatically transformed accumulated home equity from a very illiquid asset into an important tool of household finance, especially during sustained periods of mortgage rate declines. The pronounced drop in conventional mortgage rates has raised concern among some analysts.

Mortgage rates' downward trend has become a major factor for consumer spending in recent years. Increasingly, households have been able to extract home equity by drawing on home equity loan lines of credit, to realize capital gains through the sale of existing homes, and to obtain cash by refinancing existing mortgages (cash-outs). Although total household debt has increased relative to income, lower interest rates have helped moderate the rise in debt service and allowed for greater spending.

What some analysts find disconcerting is the prospect of an ultimate cessation of refinancing if longer-term interest rates stop falling, or worse, if they begin to rise. If the consumer sector slows as a consequence, either investment or net exports will need to accelerate to maintain output growth

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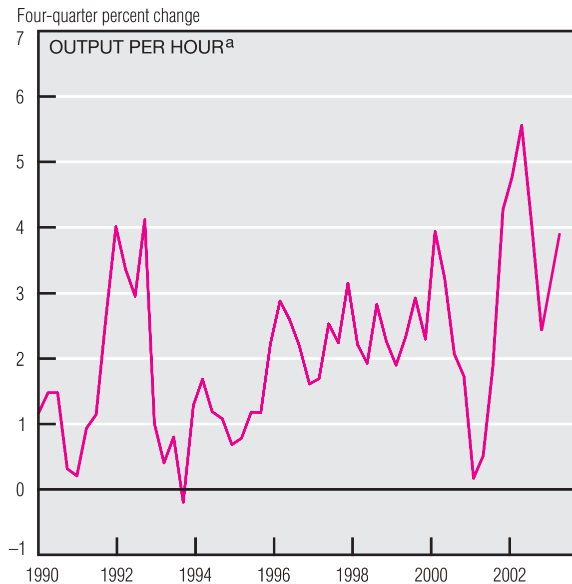
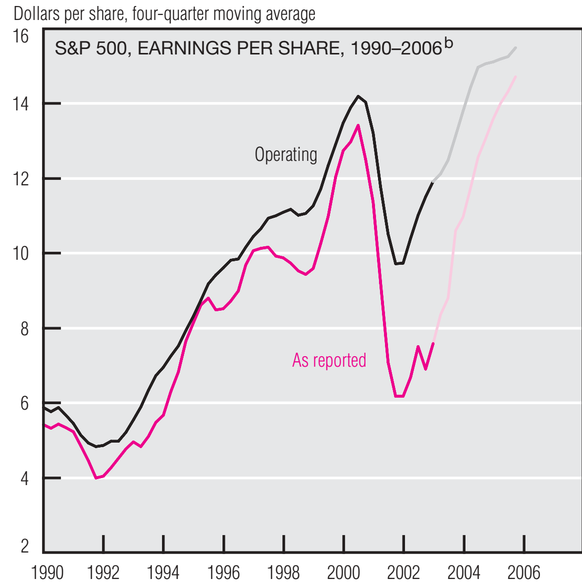
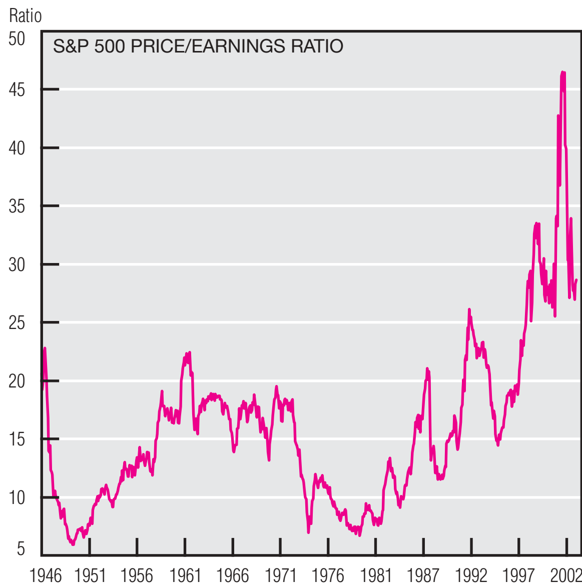
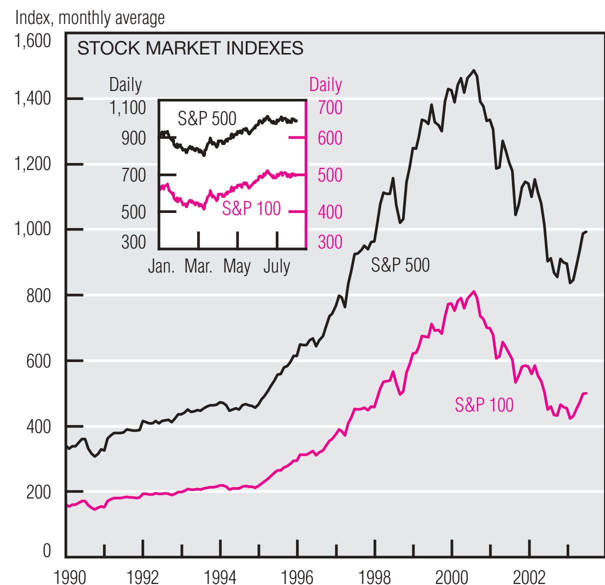
Money and Financial Markets *(cont.)*









a. Nonfarm business sector.
b. After 2003:IQ, earnings are estimates provided by Standard and Poor.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poor Corporation; and Bloomberg Financial Information Services.

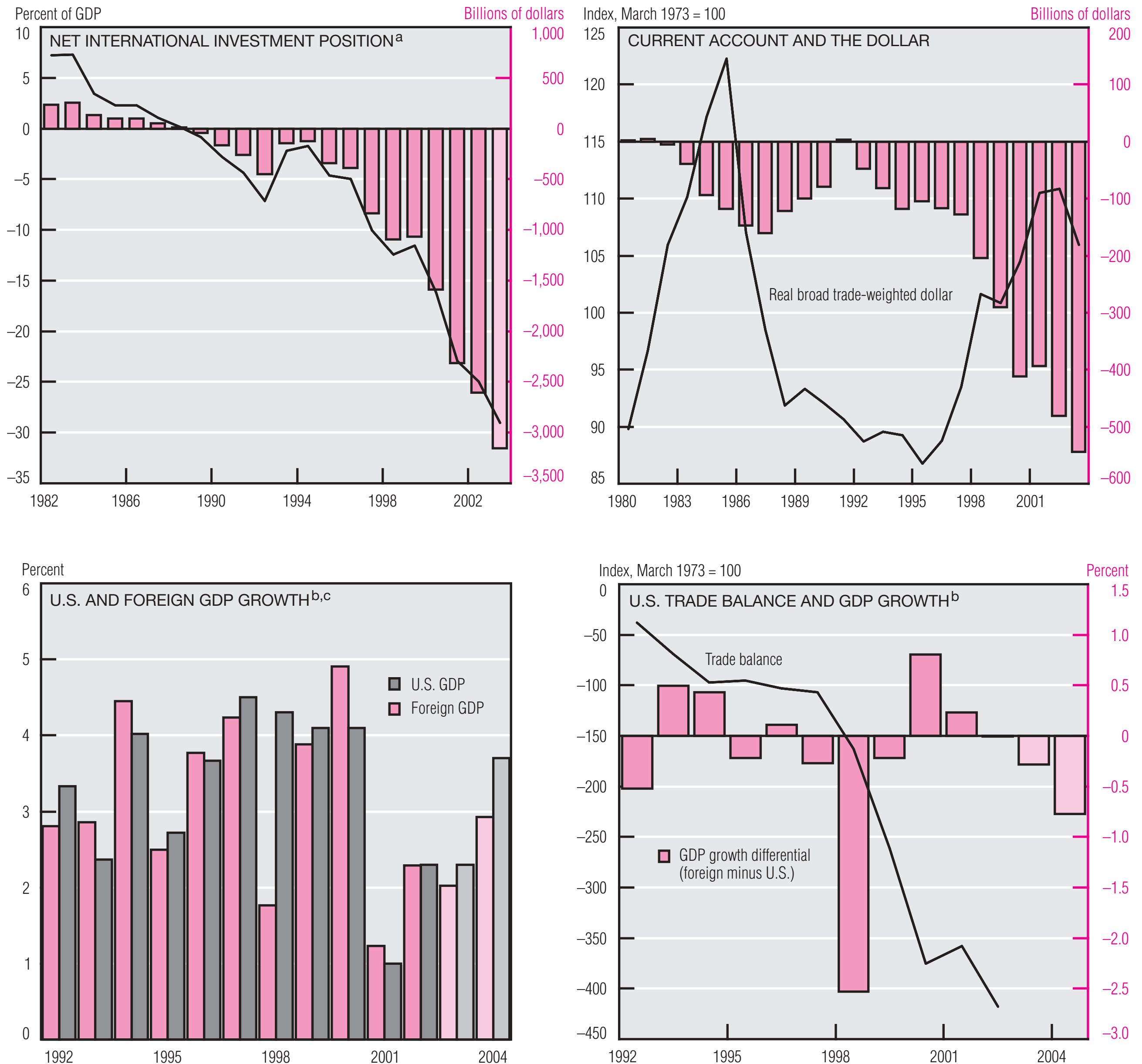
at a level that will lead to employment growth.

On the positive side, consumer confidence has risen from the lows it reached before the war in Iraq. Moreover, diminished yield spreads indicate that financial conditions for corporate businesses are improving. Interest rates on investment-grade bonds are quite low by historical standards.

The key basis for optimism, however, comes from longer-term fundamentals, especially productivity as measured by output per hour. Productivity—the ultimate source of economic growth—accelerated dramatically in the mid-1990s, largely because of the growing use of information technology. And productivity growth has remained persistently high, notwithstanding a cyclical downturn in 2001.

Prospects for continued benefits from adopting information technology— as revealed by analysts' projections for corporate earnings growth —suggest that rising productivity growth rates can be sustained over the intermediate term. Indeed, earnings forecasts have been revised upward substantially over the past few months. Furthermore, should higher earnings growth materialize, the recent decrease in the price/earnings ratio might accommodate sustained improvement in the equity market. On balance, major stock indexes like the S&P 500 have climbed noticeably since May, partly owing to less geopolitical uncertainty and to passage of a tax cut package that included a marked reduction in personal federal tax on corporate dividend income.

What's Driving the Dollar?



a. Data for 2003 are the author's estimates.
b. Data for 2003 and 2004 are forecasts from *Blue Chip Economic Indicators*.
c. Top 15 lending partners.
SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, July 10, 20203.

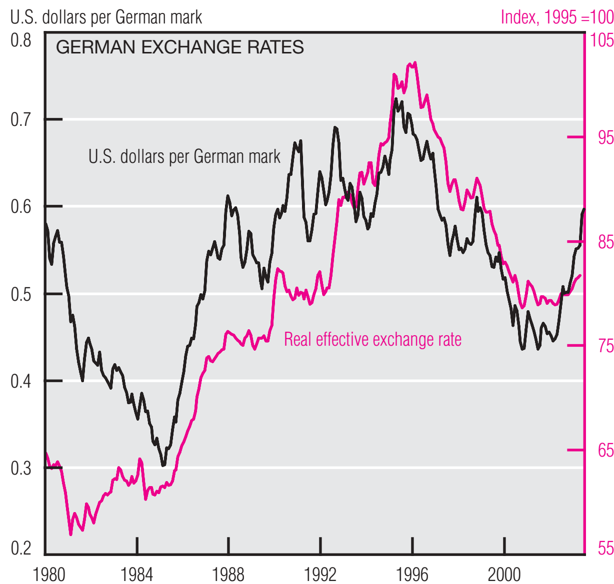
Market reports often suggest that nervous international investors are driving down the dollar's foreign exchange value. A closer look at the data, however, does not seem to support this story.

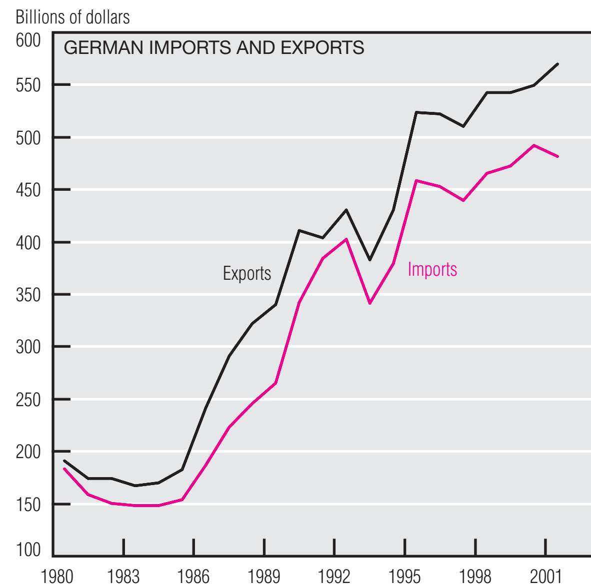
Because of our persistent current account deficits, foreigners now hold net financial claims against the U.S. equal to nearly 30% of our GDP—a percentage that has more than doubled in just five years. Many economists fear that if this pattern continues, foreign investors will become progressively more reluctant to add dollar-denominated claims to their portfolios and will quickly diversify in the face of uncertainty. As this happens, the dollar will depreciate and real interest rates in the U.S. could rise, narrowing the current account deficit.

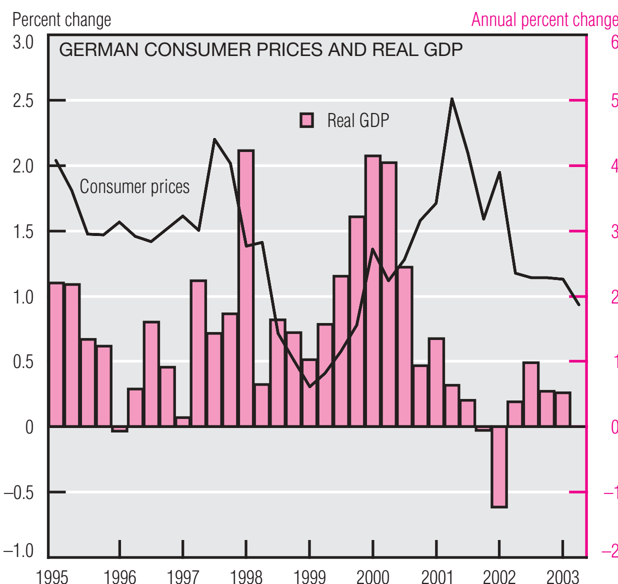
The dollar's overall depreciation since February 2001, however, which has not been associated with a smaller current account deficit, is not consistent with the scenario just described. A more likely story begins with the goods market, not the financial market. Because U.S. economic growth exceeds that of our major trading partners, our demand for imports has exceeded world demand for our exports by a widening margin. Our demand for goods from abroad has provided a supply of dollars to the foreign exchange market that has outpaced foreign demand for dollars, producing a dollar depreciation.

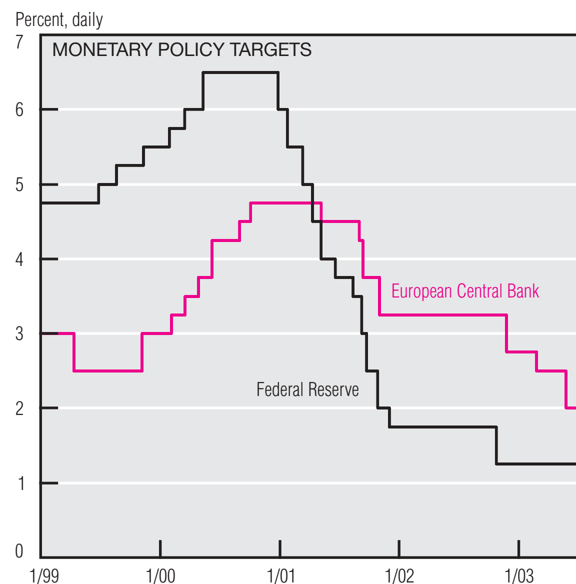
Although premature, concerns about foreign investors' diversification out of dollar assets are not unfounded. Net foreign claims cannot rise indefinitely relative to GDP.

Euro Intervention









a. Federal Reserve: federal funds target rate; European Central Bank: two-week repo rate.
SOURCES: Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; Deutsche Bundesbank; and European Central Bank.

Prompted by the euro's sharp appreciation against the dollar, German chancellor Gerhard Schröder recently suggested that the European Central Bank intervene in the foreign exchange market to "maintain the competitiveness of exports from Europe." The chancellor wants to encourage Germany's expanding trade surplus, a source of growth for the country's otherwise lackluster economic outlook. Unfortunately, he is counting on a rather ineffective policy lever.

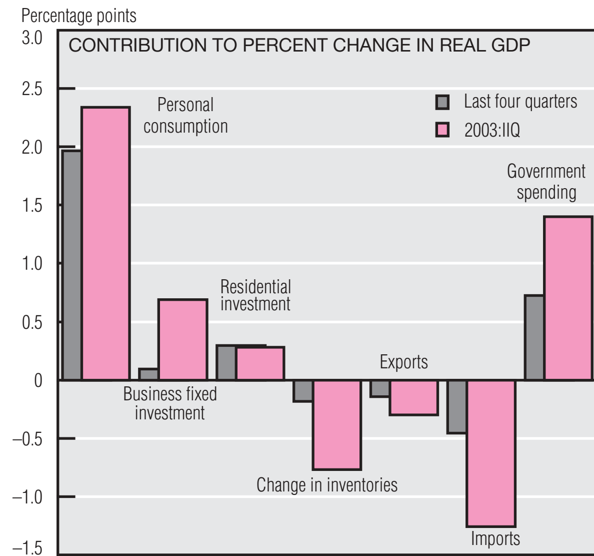
On those rare occasions when exchange markets briefly become unsettled, intervention can sometimes dampen exchange rate movements. Beyond these infrequent and fleeting effects, however, intervention is useless because it does not alter exchange rate fundamentals. The European Central Bank (ECB) will not allow interventions, which are similar to open-market operations, to interfere with the overnight interest-rate target that it uses to guide monetary policy. Buying dollars injects euro reserves into the European banking system, which—other things being equal—would lower overnight interest rates. The ECB, however, will make any necessary adjustments to its normal reserve operations to maintain the targeted interest rate. On balance, then, interventions have no effect on the key mechanism through which they might alter exchange rates—money.

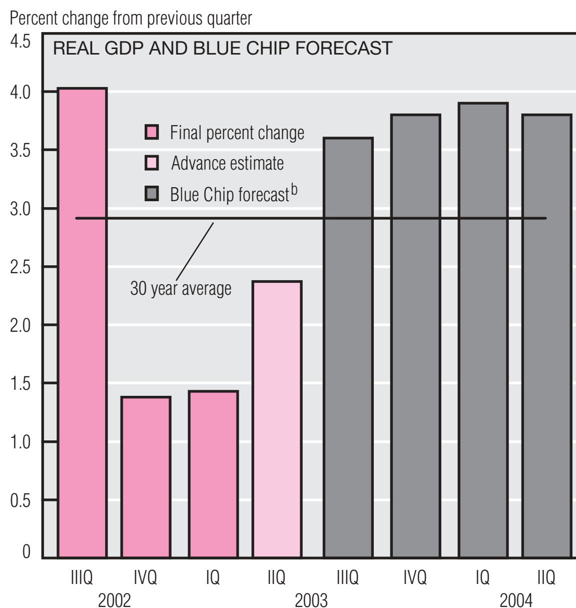
The ECB could foster a euro depreciation through a sufficiently large easing of monetary policy. This might expand German's trade surplus temporarily, but eventually a higher rate of inflation would neutralize any exchange rate gains.

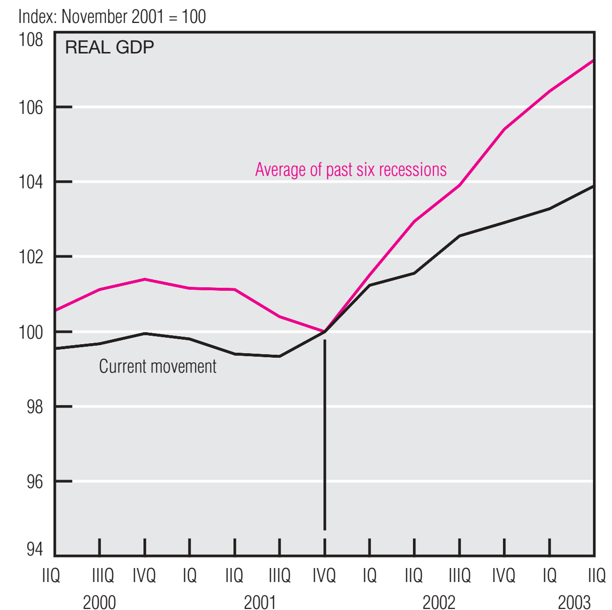
Economic Activity

Real GDP and Components, 2003:IIQ[a]
(Advance estimate)

	Change, billions of 1996 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	56.1	2.4	2.3
Personal consumption	55.1	3.3	2.8
Durables	52.5	22.6	7.9
Nondurables	0.3	0.1	3.0
Services	14.1	1.5	1.7
Business fixed investment	19.6	6.9	0.9
Equipment	17.7	7.5	3.8
Structures	2.5	4.8	–7.8
Residential investment	6.0	6.0	6.6
Government spending	31.7	7.5	3.8
National defense	39.2	44.1	13.4
Net exports	–43.3	—	—
Exports	–8.4	–3.1	–1.5
Imports	34.9	9.2	3.2
Change in business inventories	–22.7	—	—







NOTE: All data are seasonally adjusted and annualized.
a. Chain-weighted data in billions of 1996 dollars. Components of real GDP need not sum to the total because the total and all components are deflated using independent chain-weighted price indexes.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, July 10, 2003.

The advance estimate from the national income and product accounts revealed that real gross domestic product (GDP) rose at an annual rate of 2.4% during 2003:IIQ. Personal consumption expenditures boosted output growth; government spending also contributed substantially because of a 44.1% annualized increase in federal defense spending. In an encouraging sign for business activity, business fixed investment posted its strongest growth since 2000:IIQ. Increases in spending on equipment and software as well as business structures raised total output growth by 0.7 percentage point, a significant increase from its contribution during the last four quarters. However, inventory reductions dampened real GDP growth by nearly 0.8 percentage point. Falling exports and rising imports also subtracted from total output growth.

Real GDP growth in 2003:IIQ was the largest since 2002:IIIQ. Blue Chip forecasters expect the coming quarters to bring even stronger output growth—at a rate higher than the long-term average.

On July 17, the National Bureau of Economic Research announced that the recession that began in March 2001 ended in November 2001. Their most recent memo noted that they put "considerable weight" on real GDP. Thus, real GDP growth played a major role in the official dating of the trough in economic activity. Following three consecutive quarters of negative output growth, real GDP increased at an annual rate of 2.7% during 2001:IVQ. In our current "expansionary" stage, total output growth has followed a slower trend than in the previous six business cycles, but it has grown fairly steadily since the end of this recession. It also has surpassed its prerecession peak of 2000:IVQ.

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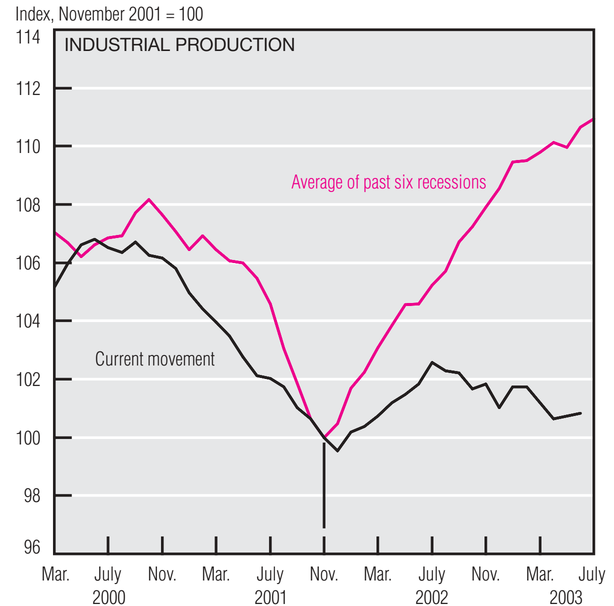
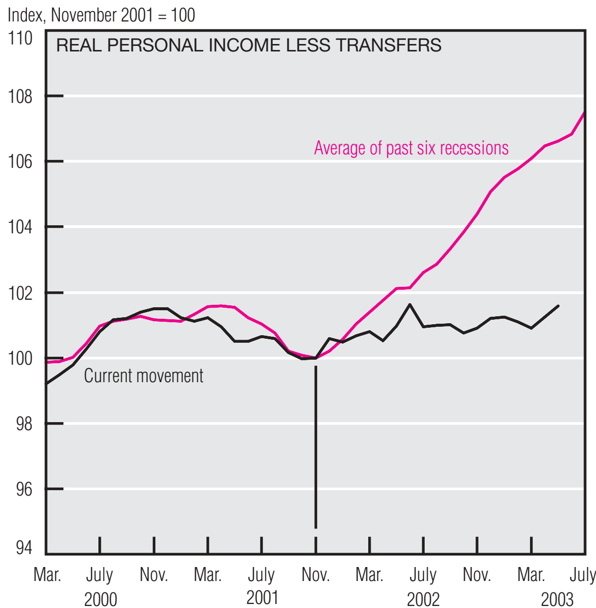
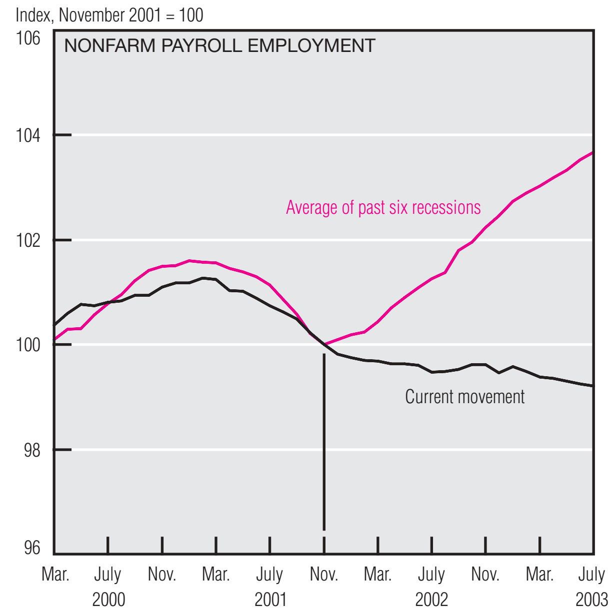
Economic Activity *(cont.)*







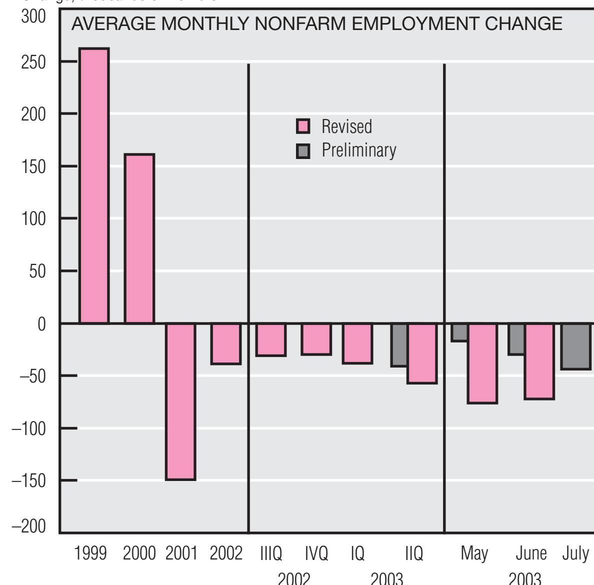
NOTE: Vertical lines indicate the NBER-defined end of the 2001 recession.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and National Bureau of Economic Research.

The task of dating the recession's end was complicated by evidence from other monthly indicators (especially employment) that diverged from output growth. Two of these indicators—real manufacturing and trade sales; and industrial production—receive less emphasis because they focus primarily on manufacturing and goods-producing sectors. Still, the NBER believes that the behavior of these series is consistent with a November 2001 trough. Although total sales bottomed out in September 2001, "extreme events" (in this case, the terrorist attacks) were downplayed in determining the cycle's turning point. Sales recovered immediately after the attacks, only to decline again in November 2001. Since then, sales generally have been growing. Industrial production rose steadily during the first seven months of 2002, although it has once again tapered off.

Because the NBER believes that real personal income less transfers and nonfarm payroll employment reflect economy-wide activity, they emphasize these indicators. Until the trough date, real income closely followed the trend it displayed in past recessions. Since then, although it has surpassed its pre-recession peak, real income is still well below its normal trajectory.

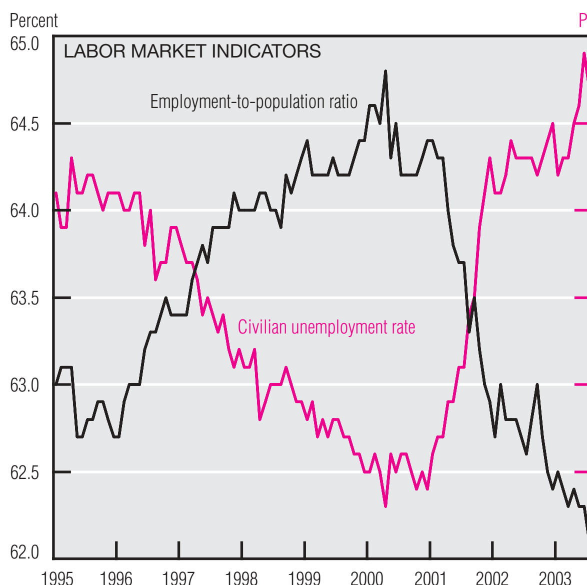
Nonfarm payroll employment has shown even greater weakness. Indeed, it has continued a fairly steady downward slide since November 2001, and its divergence from recent output growth was largely responsible for the delay in assessing an end to the recession. The NBER judged that the recession was over because, even though employment declined, real GDP—the "single best measure of aggregate economic activity"—increased during the period (presumably from productivity gains). However, this does not preclude the possibility that a new, altogether separate, recession may have begun after November 2001.

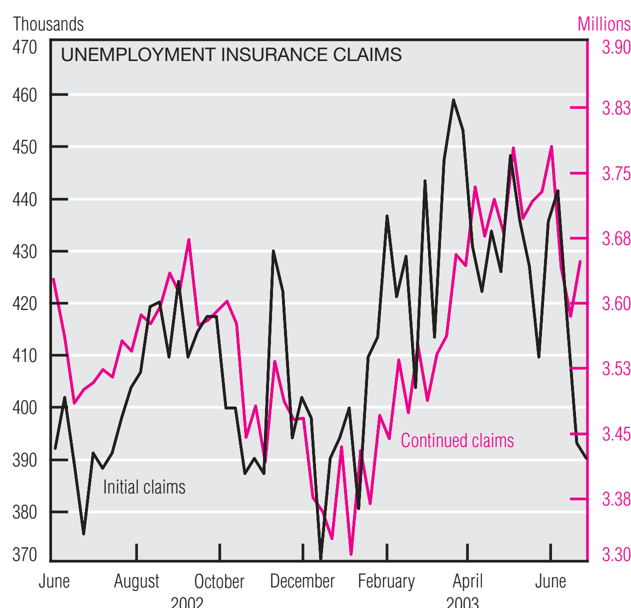
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)[a]				
				Jan.–June	July
	2000	2001	2002	2003	2003
Payroll employment	161	–149	–39	–47	–44
Goods producing	–1	–124	–64	–46	–67
Construction	7	–1	–4	11	6
Manufacturing	–9	–123	–57	–56	–71
Durable goods	2	–88	–41	–40	–54
Nondurable goods	–11	–35	–16	–16	–17
Service providing	162	–25	25	–2	23
Information	15	–15	–14	–11	–8
Financial activities[b]	6	7	5	15	7
PBS[c]	40	–63	–10	6	73
Education and health	32	51	37	22	–1
Leisure and hospitality[d]	22	–2	7	5	13
Government	22	46	16	–12	–10
	Average for period (percent)				
Civilian unemployment rate	4.0	4.8	5.8	6.0	6.2





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

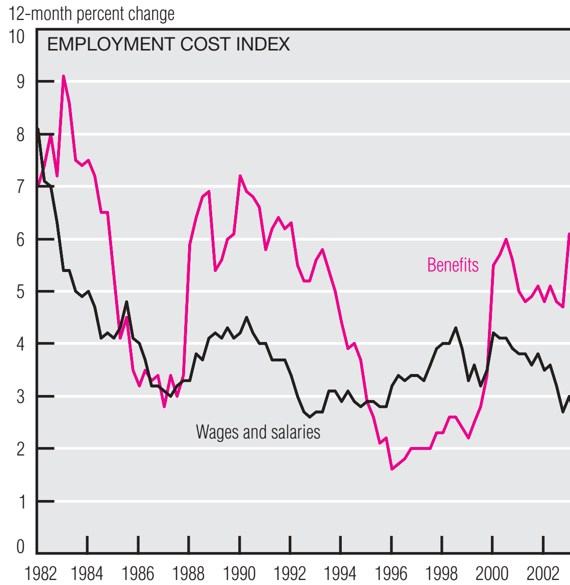
Total nonfarm payroll employment fell by 44,000 jobs in July after dropping a revised 72,000 jobs in June, more than double the June losses reported in the preliminary estimate. Since January 2003, payroll employment has diminished by 486,000 jobs.

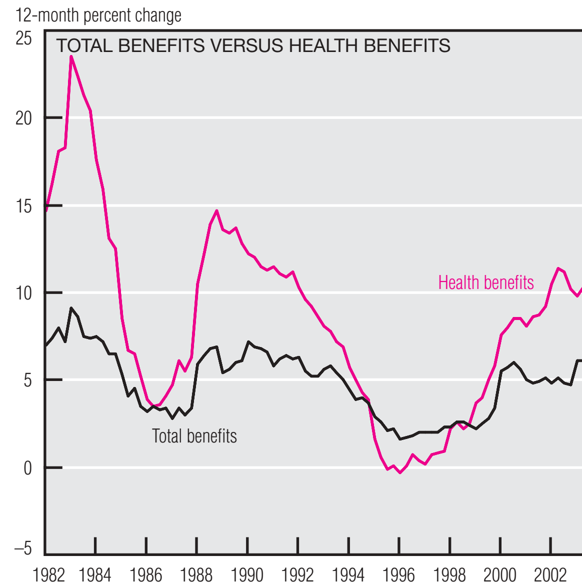
Manufacturing continued to shed jobs, posting a large net loss (71,000 jobs) in July, partly because of shutdowns for retooling in the motor vehicle industry. Employment in manufacturing has decreased more than 1.8 million jobs since July 2000. Construction continued to show strength, adding 6,000 jobs in July. Employment in service-providing industries grew 23,000, with the biggest gain posted by professional and business services (73,000), this industry's largest gain since April 2000. Leisure and hospitality showed a net increase of 13,000 jobs. Financial services continued adding jobs (7,000). Employment losses in information services persisted (down 8,000 jobs), the ninth consecutive monthly decline; losses also continued in state and federal government (down 10,000); and in education and health services (down 1,000).

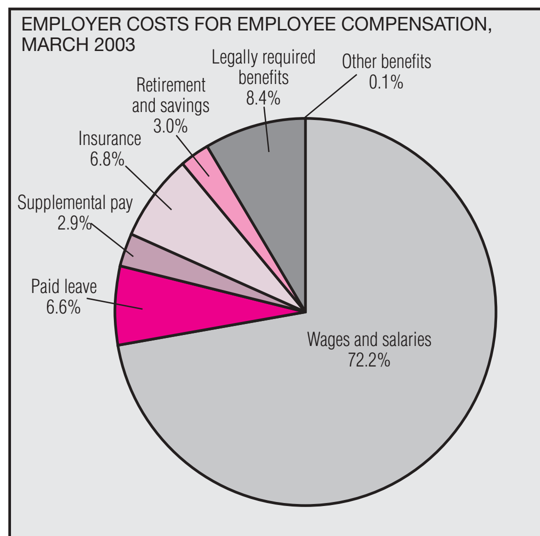
The unemployment rate in July fell 0.2 percentage points to 6.2% as a result of the labor force contraction. Some 556,000 fewer job seekers were reported as the labor force shrank. The employment-to-population ratio inched down 0.2 percentage points to 62.1.

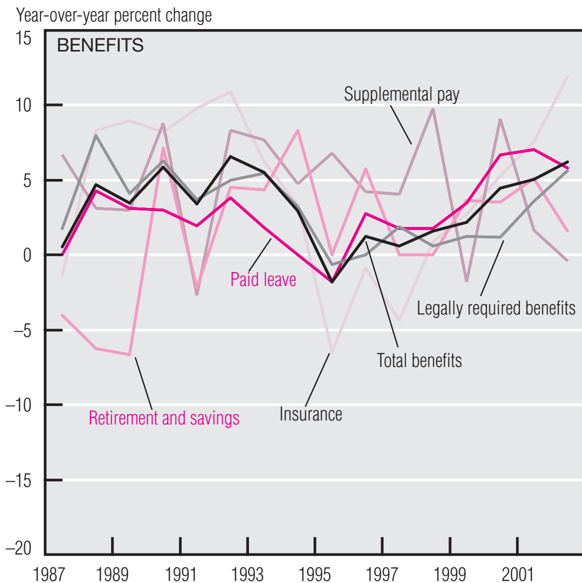
Initial unemployment insurance claims fell to 388,000 in the week ending July 26, the third consecutive weekly decline and the lowest level since February, which suggests an improving labor market. The number of continued claims remained high, however, reaching about 3.65 million in the week ending July 19.

The Employment Cost Index









NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

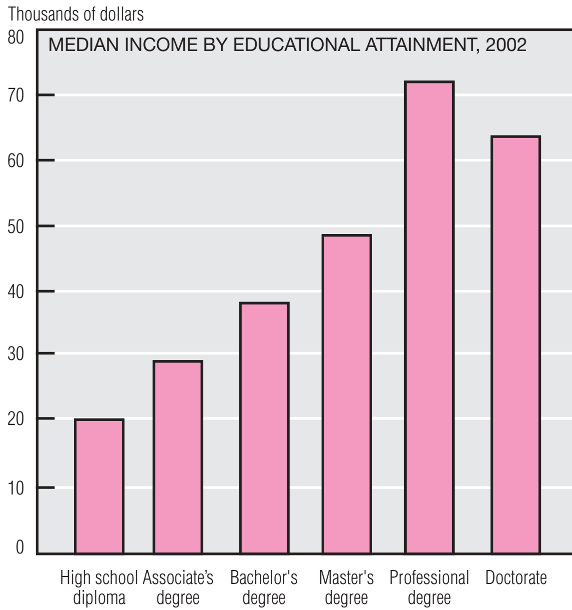
The Employment Cost Index (ECI) is a quarterly measure of the rate of change in employers' costs for both wages and benefits. For most of the 1980s and early 1990s, benefit costs rose faster than wages. In the mid-1990s, the trend reversed course, and wage increases dominated, but in 2000, benefit costs began to outpace wage growth once again.

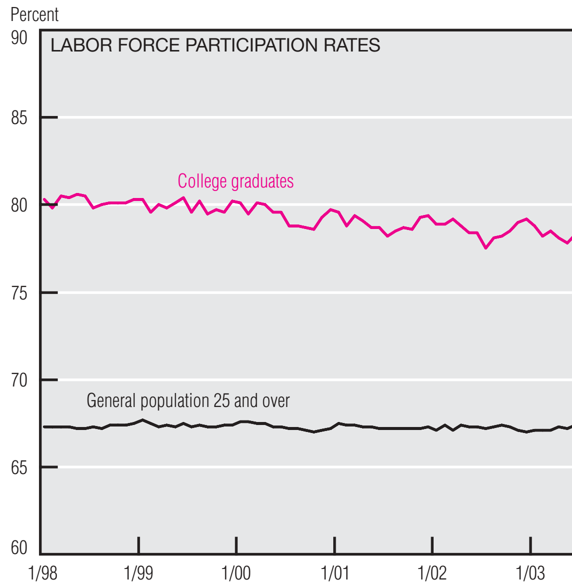
In the late 1980s and early 1990s, employers' health insurance costs increased significantly as a share of total benefits because medical care costs were rising steeply. After a few years of relative stability, health insurance costs began escalating rapidly again in 1999, increasing benefits costs for both employers and employees.

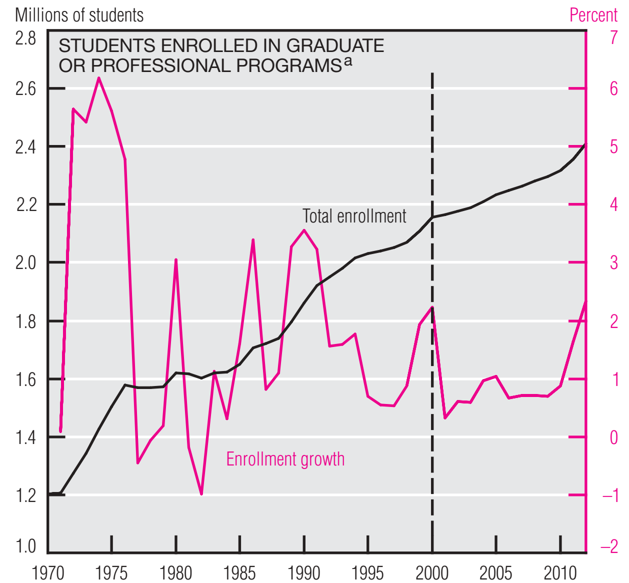
In March 2003, wages and salaries accounted for 72.2% of employers' costs for employee compensation (for civilian workers in private industry); benefits were responsible for the remaining 27.8%. Legally required benefits, employers' largest non-wage costs, represented 8.4% of total compensation. Over the last two years, rapid increases in state unemployment insurance costs and workers compensation have substantially increased the share of legally required benefits. Employers' costs for paid leave accounted for 6.6% of total compensation, insurance benefits for 6.8%, and retirement and savings for 3.0%.

Since 1995, the year-over-year percent change in total benefits has been accelerating, mainly because of a marked increase in the year-over-year percent change in insurance benefits (including health benefits) and legally required benefits. Because benefit costs represent a large share of overall employer costs, their rise has increased the costs of labor.

Graduate and Professional School Enrollment







a. Data after 2000 are projected.
SOURCES: U.S. Department of Education, National Center for Education Statistics; and *Current Population Survey*, March 2002.

It has been clear for some time that people with a college degree earn substantially more than high school graduates do. In 2002, the median income for those with a bachelor's degree was $37,203, nearly double the $19,900 earned by high school grads.

College graduates not only enjoy higher incomes than people with high school diplomas; their unemployment rate is considerably lower than the U.S. average. By occupation, managerial and professional workers, most of whom hold college degrees, have similarly low unemployment.

College grads also have a higher rate of labor force participation than the U.S. population as a whole, whose rate has remained steady at roughly 67% over the last five years. For college graduates, the participation rate, which was about 80% in the late 1990s, has fallen to around 77% in recent years, suggesting that more of them than usual are voluntarily leaving the workforce to pursue other options.

Beyond college, people who earn a graduate degree also benefit substantially. In 2002, their median income was roughly $12,000 higher than people with a bachelor's degree. The median income for a professional degree (for example, law, divinity, or a doctorate in a medical field) exceeded $71,000—more than 90% higher than the median income for college grads.

Historically, enrollment in graduate and professional programs has grown most quickly before a recession, when firms try to adjust for weaker demand by reducing costs, partly through layoffs and hiring freezes. As the labor market becomes saturated with unemployed college

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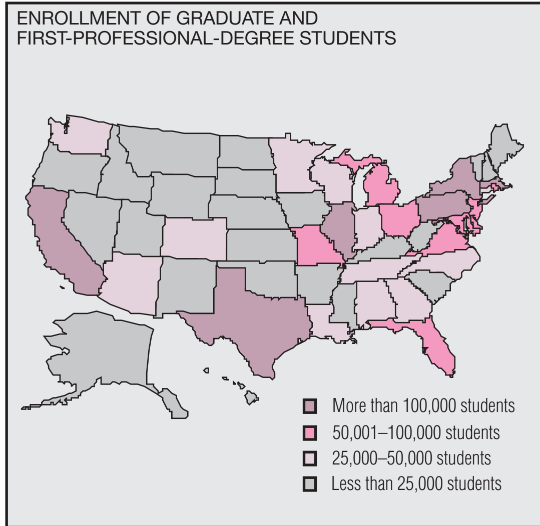
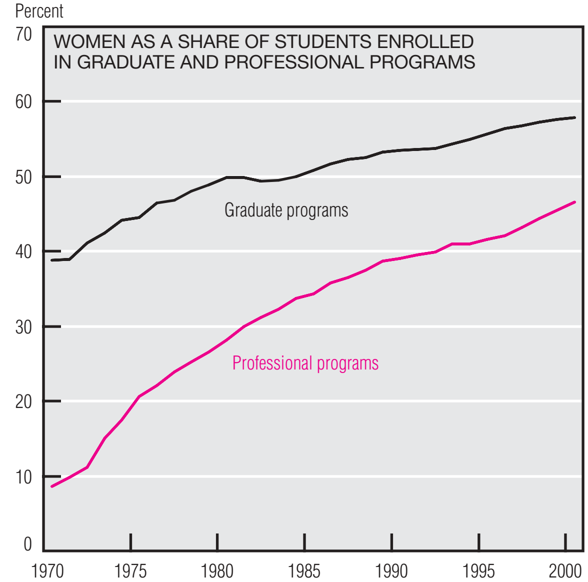
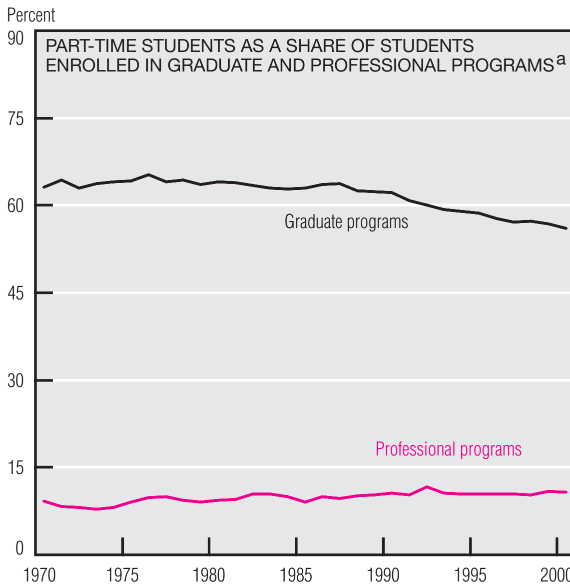
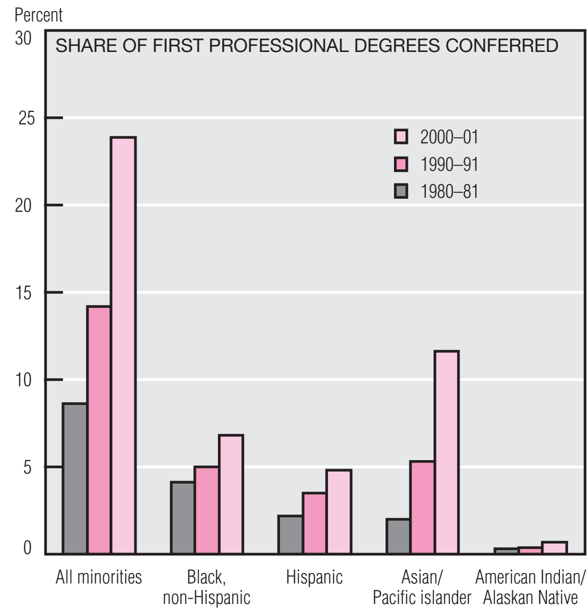
Graduate and Professional School Enrollment *(cont.)*









a. Data for 2000 are the most recent available.
SOURCES: U.S. Department of Education, National Center for Education Statistics; and *Current Population Survey*, March 2002.

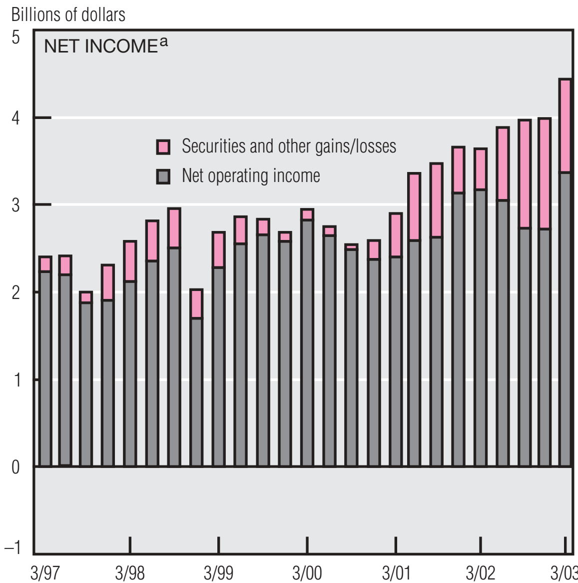
graduates, some of them leave to pursue advanced education in order to obtain better jobs in the future. Indeed, post-baccalaureate enrollment rose sharply in 1973, 1980, and 1990 (years in which recessions began), as well as in 2000 (the year before the most recent recession), when enrollment in graduate and professional programs was the highest recorded.

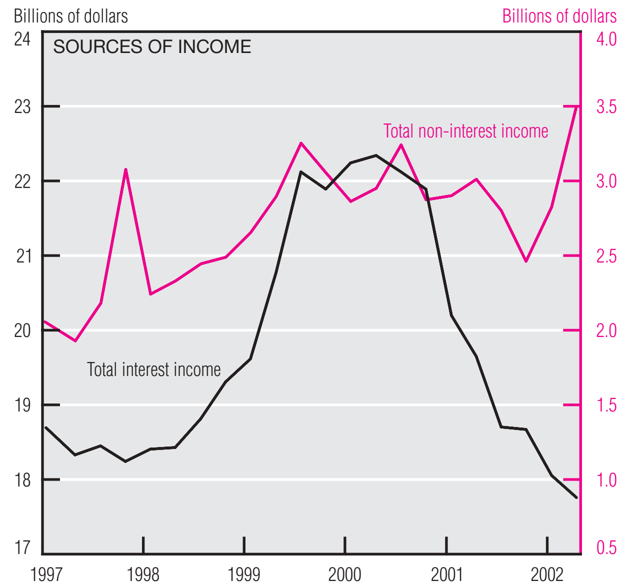
Nationwide, enrollment exceeded 100,000 in six states, including the Fourth District state of Pennsylvania. Ohio reported nearly 80,000 post-baccalaureate students, while Kentucky and West Virginia each reported fewer than 25,000.

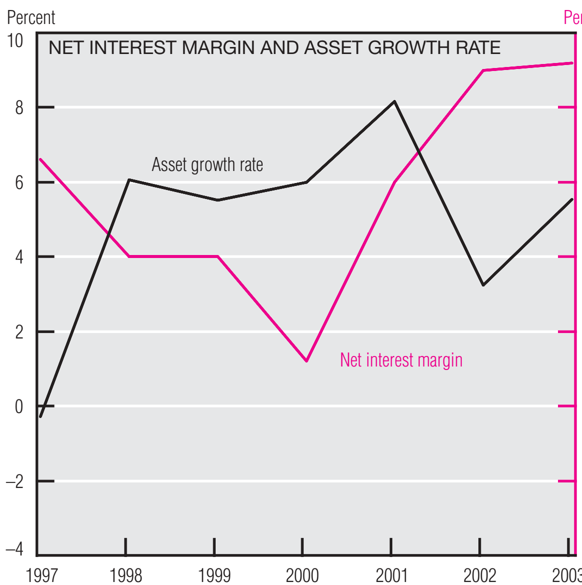
As enrollment in graduate and professional programs has grown over the years, student demographics have changed. The share of students who pursue a professional degree on a part-time time basis has generally remained constant (largely because most professional degree programs do not accept part-time students). Throughout the 1990s, the percentage of graduate students opting for part-time studies fell at a fairly steady rate, indicating that more students chose to pursue advanced degrees on a full-time basis.

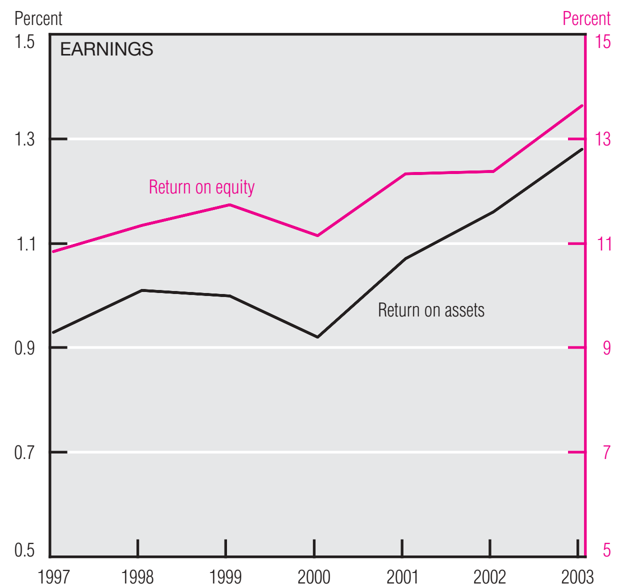
A more striking demographic shift concerns the shares of women and minority students. Thirty years ago, women comprised less than 10% of students in professional programs; they now account for nearly half of such programs' enrollment. Minority students accounted for roughly 25% of all graduates from professional programs in 2000–01, up from less than 9% in 1980–81.

Savings Institutions









NOTE: Observations for 2003 are first-quarter annualized data.
a. Net income equals net operating income plus securities and other gains/losses.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured savings institutions reported net income for 2003:IQ of $4.43 billion, which was $796 million (21.9%) higher than the same quarter a year earlier and $448 million higher than 2002:IVQ. As in previous quarters, net income was buttressed by one-time gains in securities sales—to the tune of $1.60 billion.

S&Ls' non-interest (fee) income for 2003:IQ increased 16.2% from the same quarter a year earlier and $3.5 billion from 2002:IVQ. Total interest income continued its fall to a level 9.6% lower than a year earlier. However, the process of re-pricing S&Ls' loan portfolios seemed to be heading toward completion in the first quarter of 2003. The result has been a modest (1.0%) decline in net interest income in 2002:IQ– 2003:IQ because reductions in interest income from lending were nearly matched by declines in borrowing costs.

Savings institutions' strong earnings performance was once again apparent in the net interest margin (calculated as interest plus dividends earned on interest-bearing assets minus interest paid to depositors and creditors; it is expressed as a percentage of average earning assets). S&Ls' net interest margin continued to increase from a low of 2.96% in 2000 and now stands at 3.36%, its highest level since 1993. Although S&Ls'

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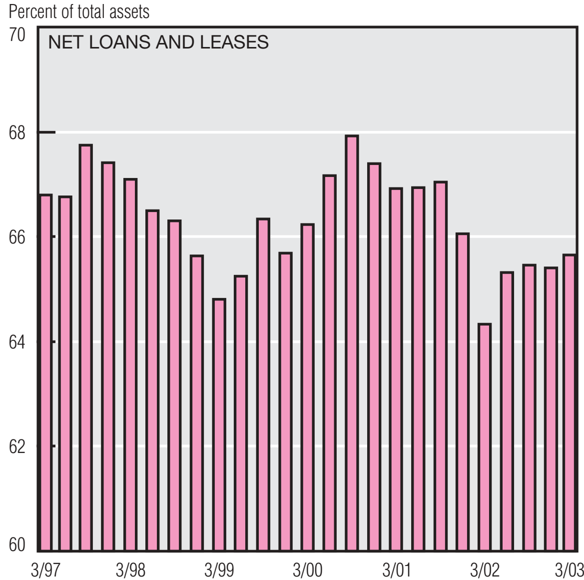
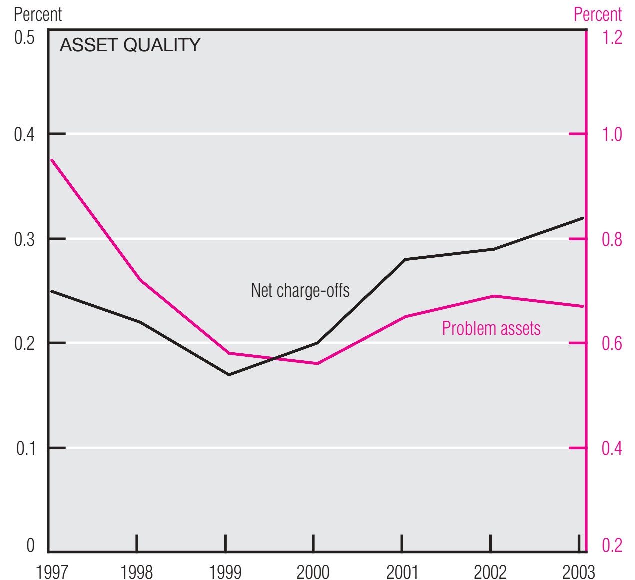
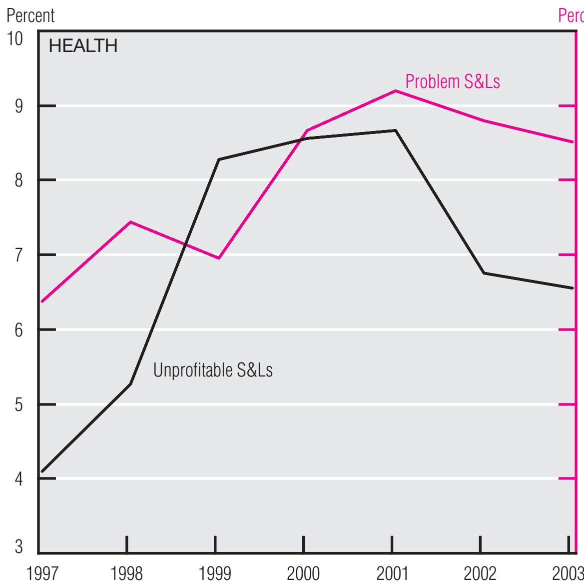
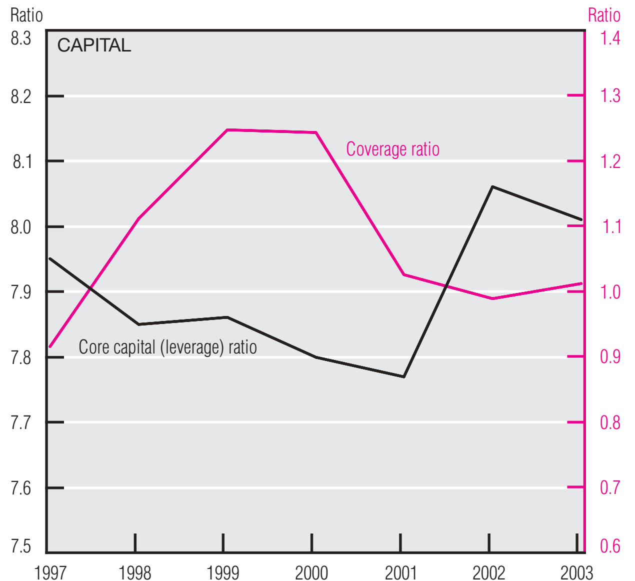
Savings Institutions *(cont.)*









NOTE : Observations for 2003 are first-quarter annualized data.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

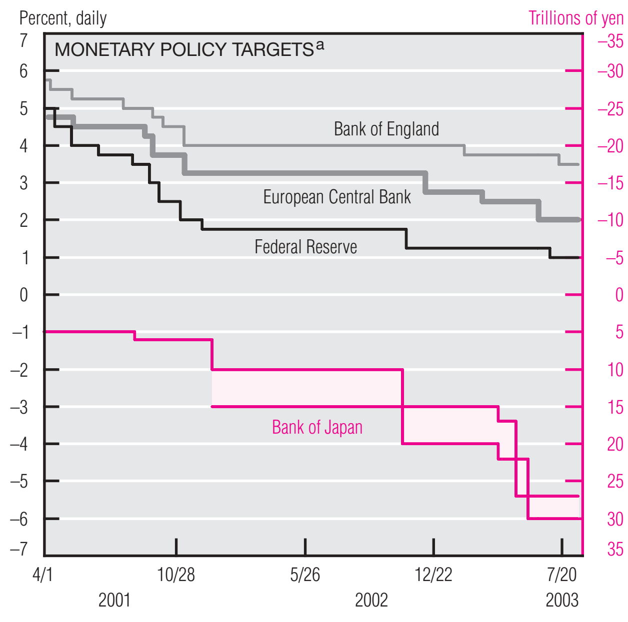
asset growth increased to 5.53%, their return on assets went up to 1.28% and their return on equity rose to 13.64%.

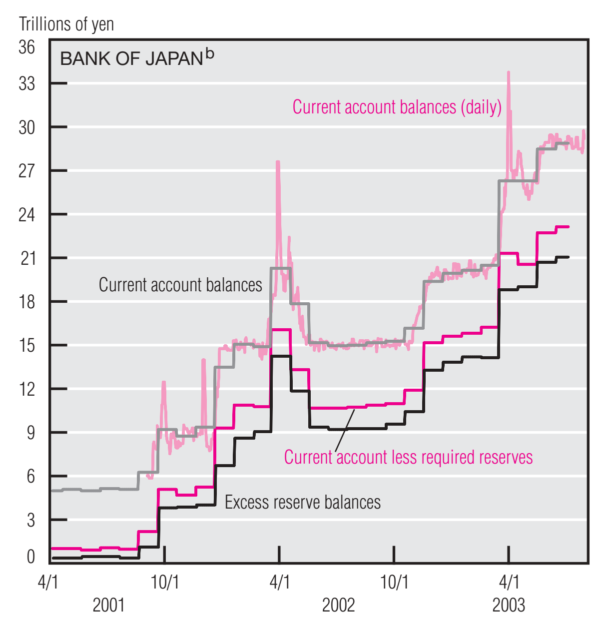
In 2003:IQ, net loans and leases as a share of total assets (65.7%) was up slightly from the previous quarter but was still below its recent high of 67.9% in 2000:IIIQ, indicating a continued decline in savings institutions' direct holdings of loans.

Asset quality showed mixed signs in 2003:IQ. Net charge-offs (gross charge-offs minus recoveries) rose to 0.32. Problem assets (noncurrent assets plus other real estate) made up 0.67% of total assets, representing only a slight decrease in the problem asset ratio from 0.69% in 2002.

Asset quality does not seem to be a significant problem for FDIC-insured savings institutions as a whole, however. Problem S&Ls (those with substandard exam ratings) declined from 1.16% in 2002 to 1.10% in 2003:IQ. The percent of unprofitable institutions fell to 6.55%. The coverage ratio stood at $1.01 in loan loss reserves for every dollar of noncurrent loans. The increase in the coverage ratio since the previous quarter was caused primarily by a $162 million increase in loan loss reserves during a period when noncurrent loans declined by $34 million. For 2003:IQ, core capital, which protects savings institutions against unexpected losses, decreased to 8.01% from 8.06% in 2002.

Foreign Central Banks





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

b. Current account balances at the Bank of Japan are required and excess reserve balances of 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 stating the sixteenth of one month and ending 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 Bank of England reduced its policy rate 25 basis points (bp) to 3.5% on July 10. None of the other three major central banks has adjusted its policy setting since the Federal Open Market Committee (FOMC) reduced its federal funds rate target to 1% on June 26. The dollar has appreciated slightly against all three other currencies during that period. Market commentary suggests that the outlook for more rapid growth in the U.S. economy has brightened, at least relative to that of large nations in the Euro area. In turn, the Governor of the Bank of Japan remarked that, with improvement in other economies, "a cyclical upswing in Japan's economy will begin to materialize in tandem with the gradual improvement in exports and production."

In addition to the Bank of England, no fewer than 17 rate-setting central banks loosened policy on or after June 26, as little as 5 bp (to 7.25%) in Colombia and as much as 300 bp (to 35.00%) in Turkey. Some central banks do not calibrate policy with an interest rate, and several of these have relaxed their policy stance also. For example, the Singapore Monetary Authority re-centered its exchange rate policy band at a slightly depreciated level without changing the width of its zero-percent appreciation path. Peru's central bank reduced its cutoff auction reference rates 25 bp on July 3, about a week before its president's sudden resignation, which was said to be unrelated to monetary policy.