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The Economy in Perspective

The big picture point by point, or "Sunday Afternoon on the Island of La Grande Jatte" (Georges Seurat, 1886)…Economists who study labor markets and industrial organization have long recognized the general public's incomplete view of the dynamic processes at work in the U.S. economy that create and destroy both jobs and business establishments. When the evening newscaster blithely announces that 57,000 jobs were created in September, few people recognize that between August and September a very large number of people moved into new jobs, even as a similar number left old jobs; the 57,000 figure is the net result of two gross flows moving in opposite directions. The public will hear more about these underlying factors now that the Bureau of Labor Statistics has begun regular publication of its Business Employment Dynamics (BED) data.

Because these newly available statistics are collected from more than 6 million nonfarm business establishments in the United States, they make it possible to examine employment consequences from the perspective of business establishments. For example, the BED data indicate that during the fourth quarter of last year, the net loss of 70,000 jobs from the private sector resulted from 7.746 million job additions and 7.816 million cutbacks. Jobs were added when expanding establishments contributed 6.1 million jobs and opening establishments contributed 1.6 million. During the same quarter, jobs were destroyed when contracting establishments cut 6.2 million jobs and closing establishments eliminated another 1.6 million. The result of these factors, the net loss of 70,000 jobs mentioned earlier, represents less than one-tenth of 1 percent of net employment, but comes from a nearly 15 percent reallocation of labor (7.2 percent new jobs and 7.3 percent lost jobs) in just one three-month span. During that period, roughly one-fourth of the 6.4 million establishments tracked in the BED data set added jobs, one-fourth cut jobs, and one-half displayed no change.

Clearly, when gross flows are as consistently large as those revealed in the BED data, it is time to confront the reality of how the U.S. economy operates to reallocate employment across jobs and business firms. The 1992–2000 economic expansion provides an instructive example. During that period, job gains from expanding establishments gradually rose from 5.5 million to 7 million per quarter, but job losses from contracting establishments drifted up as well, from 5.5 million to nearly 7 million per quarter. Until 2001, the gains always exceeded the losses. Net employment advanced considerably during the long expansion period, but not without considerable movement of people from one job to another as some establishments grew and others shrank. In addition, some people joined new establishments and left closing ones, roughly 2 million of each per quarter.

The most recent recession appears as a period in which job losses from contracting establishments rose sharply while job gains from expanding establishments fell sharply. At the end of 2002, each force accounted for roughly 6 million jobs in each direction, producing no net employment gain. The pattern of establishment openings and closings has not changed materially during the recession–recovery period.

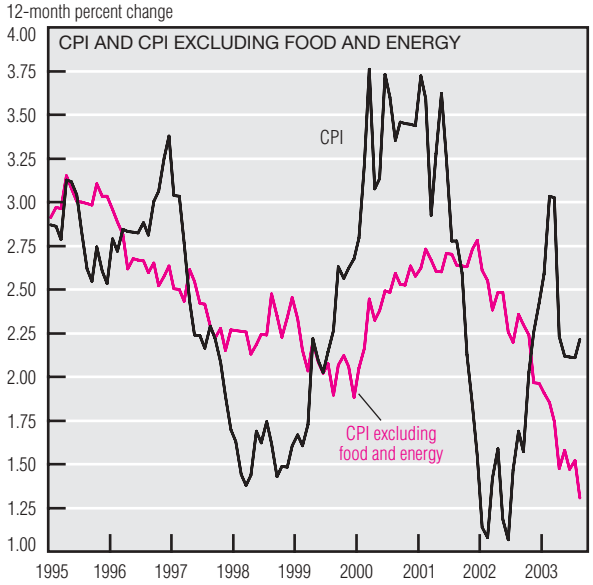
Getting below the surface of the aggregate statistics will prove useful in understanding the employment dynamics of particular industries and regions, and how reallocating both capital and labor across establishments and regions improves the nation's productivity growth over time. For example, previous studies have shown that manufacturing firms tend to make their largest job-destruction decisions during economic downturns, and that manufacturing exporters tend to cluster in certain regions while manufacturing importers cluster in others. U.S. plants' survival, employment, and output seem to be adversely affected by import competition from low-wage firms. As U.S. firms adjust, they seek to increase their plants' capital intensity and hire employees who are more highly skilled. This process leads to productivity growth, but also to worker displacement that creates difficulties for regions with high concentrations of affected establishments. As the world's economies open up to more trade, each country faces challenges in reallocating resources to their most productive uses.

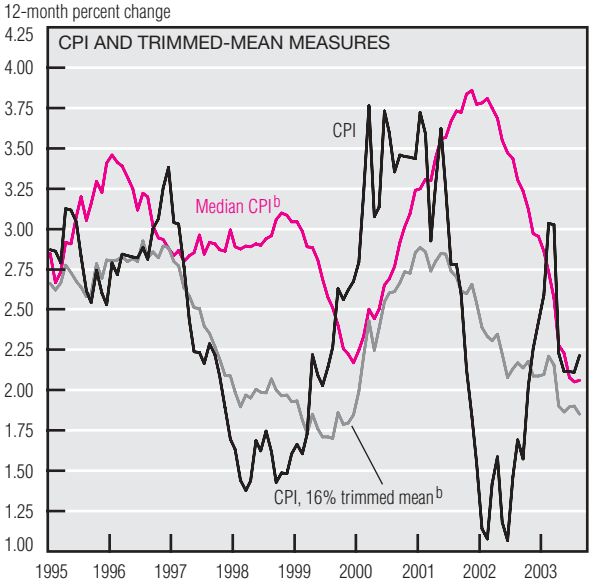
Just as Georges Seurat's greatest paintings used the pointillist technique of creating the whole with tiny points of color, so too the great panorama that is the U.S. economy is often depicted best by analyzing microdata.

Inflation and Prices

August Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2002 avg.
Consumer prices					
All items	4.0	2.6	2.2	2.5	2.4
Less food and energy	1.2	1.2	1.3	2.2	2.0
Median[b]	2.8	2.2	2.1	2.9	3.0
Producer prices					
Finished goods	5.2	4.3	3.5	1.9	1.2
Less food and energy	1.6	0.8	0.5	0.9	–0.5





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) rose 0.3% in August (4.0% at an annual rate), compared with increases of 0.2% (2.0% annualized) in the previous two months. Part of the CPI's acceleration resulted from a sharp increase in its energy index, which rose 2.7% in August after far more modest monthly increases (0.8% in June and 0.4% in July). The primary reason for energy's abrupt jump was an outsize increase in the gasoline index, which rose more than 6% (an annualized rate exceeding 100%), the component's largest monthly increase since February.

Excluding energy prices, as well as the often-volatile food component, yields a less pronounced increase in inflation. According to the CPI excluding food and energy, sometimes called the core CPI, prices rose 0.1% in August (1.2% annualized). The median CPI and the 16% trimmed-mean CPI, other inflation measures intended to be less influenced by volatile items, also showed smaller August increases than the unadjusted CPI. Each of these trimmed-mean measures rose about 0.2%.

For the 12 months ending in August, the CPI rose 2.2%. If food and energy are excluded, inflation according to the core CPI increased 1.3%. Clearly, removing some components from the CPI changes the price trend picture significantly. Breaking down the core CPI further shows a growing price gap between core goods and core services. Underlying inflation in the economy's service sector seems to have settled at around 3%. In the goods-producing portion of the

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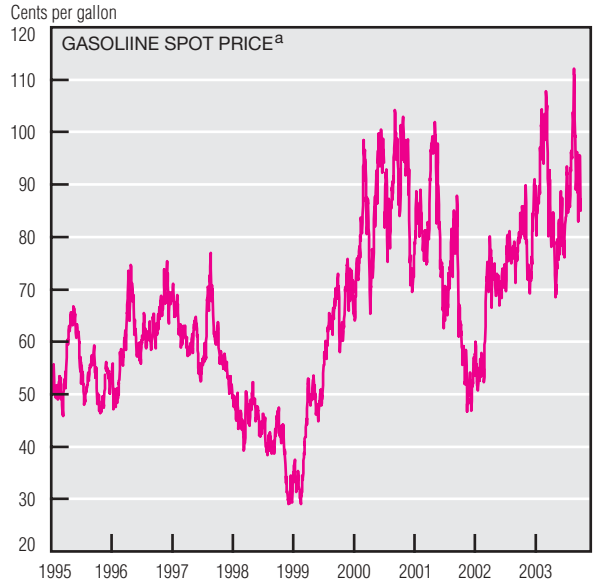
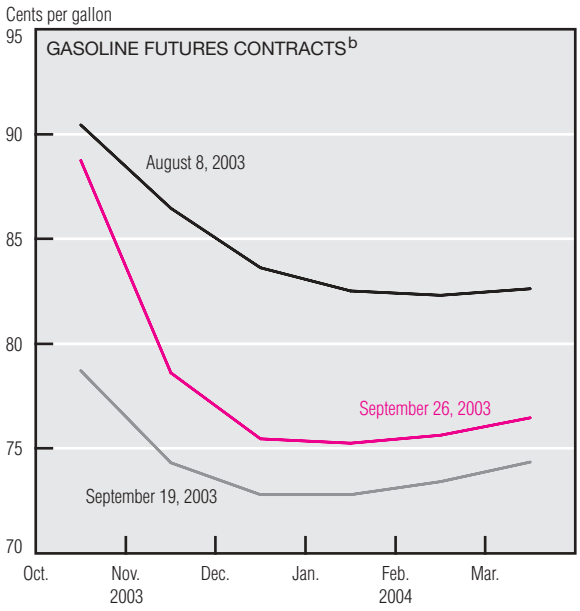
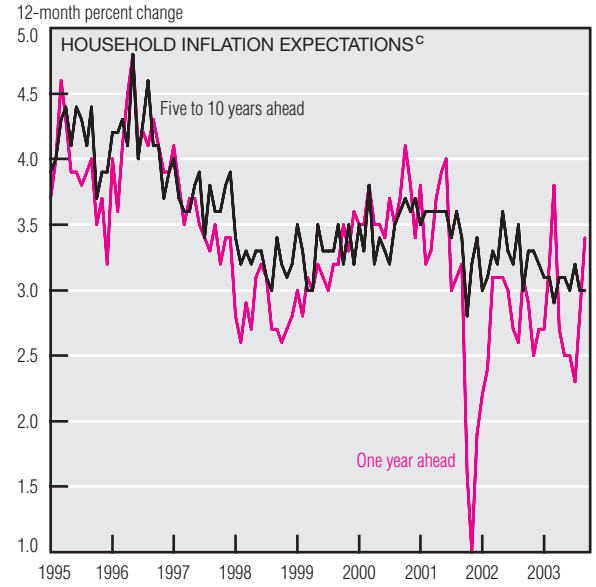
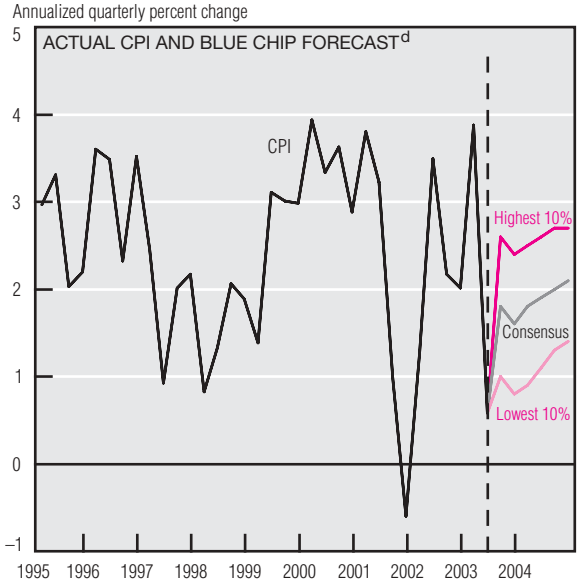
Inflation and Prices *(cont.)*









a. New York Gasoline Conventional Regular Spot Price.
b. New York Phase II Complex Model Reformulated Gasoline.
c. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
d. Blue Chip panel of economists.
SOURCES: U.S. Department of Energy, Energy Information Administration; University of Michigan; Bloomberg Financial Information Services; and *Blue Chip Economic Indicators*, September 10, 2003.

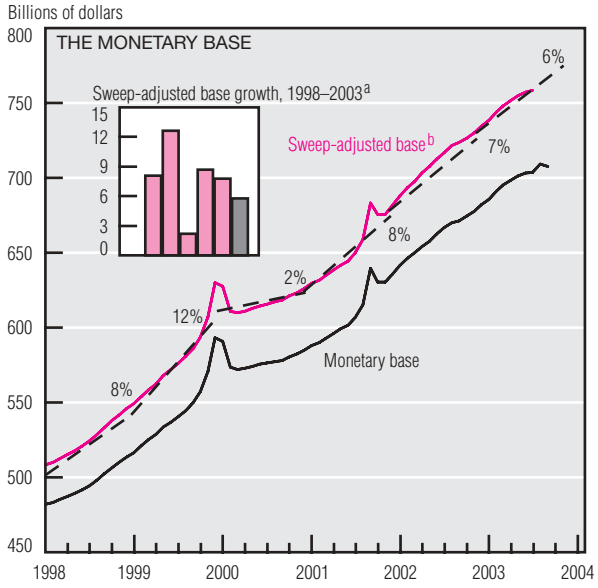
economy, however, an underlying deflation continues.

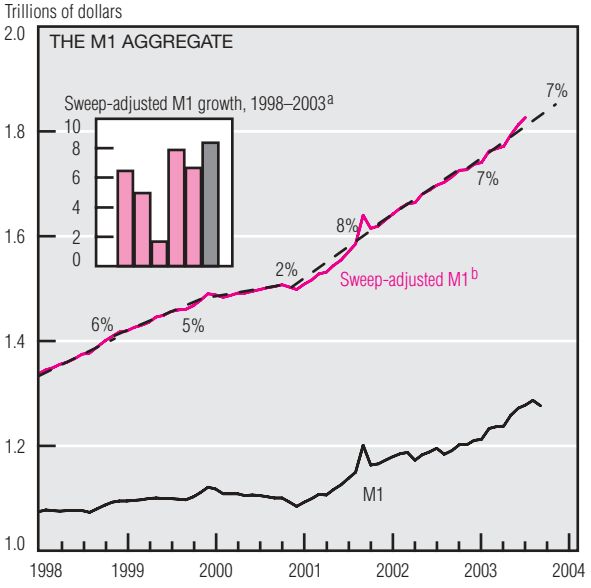
While the advance in gasoline prices accounted for much of August's CPI acceleration, spot gasoline prices have since fallen significantly, more than 10% during September. Prices did spike upward late in the month, after the Organization of Petroleum Exporting Countries (OPEC) announced its intention to curtail crude oil supplies. But this increase was short-lived, and prices have since fallen below pre-announcement levels.

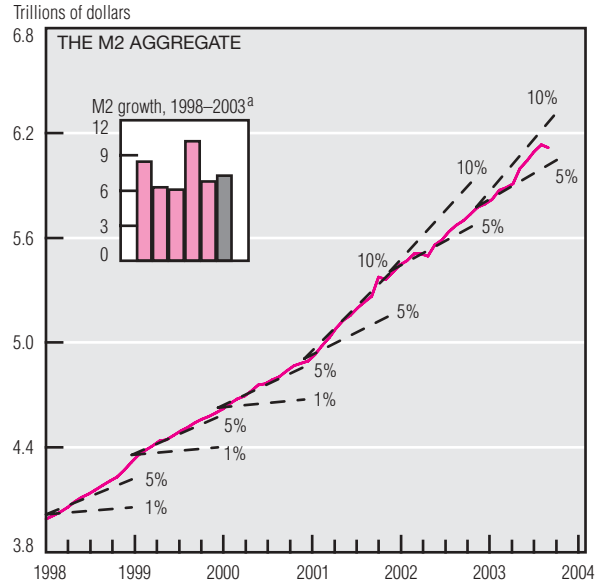
The prices of gasoline futures contracts were also affected by OPEC's announcement. But aside from the October contract, prices for future delivery of gasoline into the first quarter of next year remain well below the levels of early August. And the trend in prices into the future is still decidedly downward.

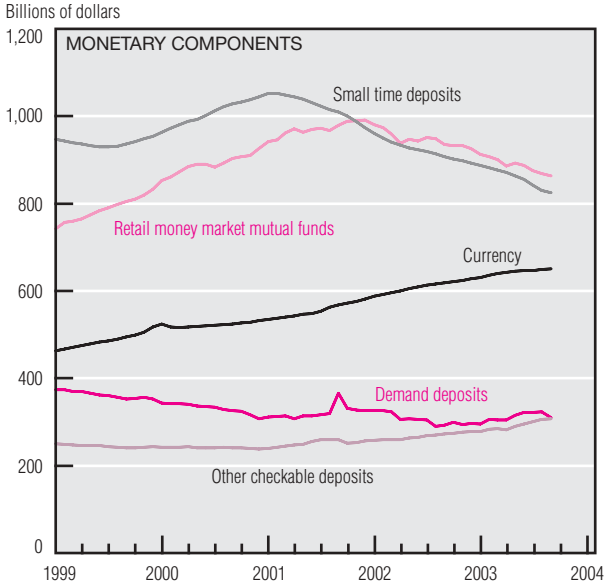
Nevertheless, August's pronounced increase in gasoline prices may have affected households' short-run expectations of inflation. Year-ahead household inflation expectations rose 0.6% in September and are up 1.1% since July. By contrast, households' longer-run inflation expectations have stayed reasonably well anchored at around 3%. Professional forecasters, attempting to predict the CPI's path, expect the index to register an annualized increase of about 2% over the next 18 months. The range of their opinions is rather wide, however, with about 1.5 percentage points separating inflation pessimists from inflation optimists.

Monetary Policy









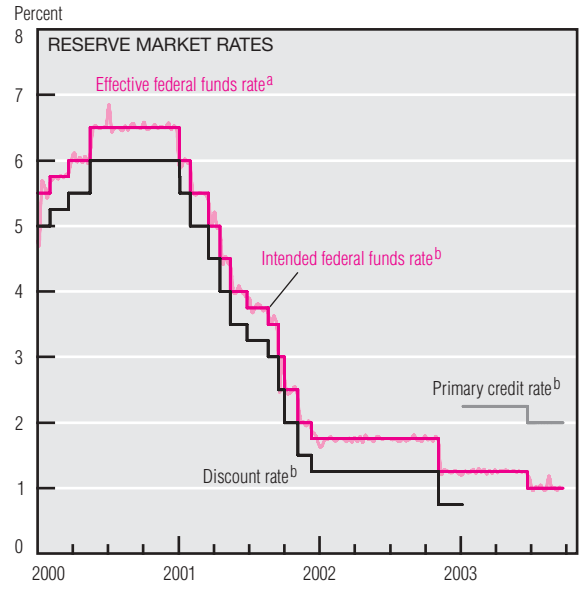
a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2003 growth rates for the sweep-adjusted monetary base and sweep-adjusted M1 are calculated on a July over 2002:IVQ basis. The 2003 growth rate for M2 is calculated on a September over 2002:IVQ basis. Data are seasonally adjusted.
b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
SOURCE: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6.

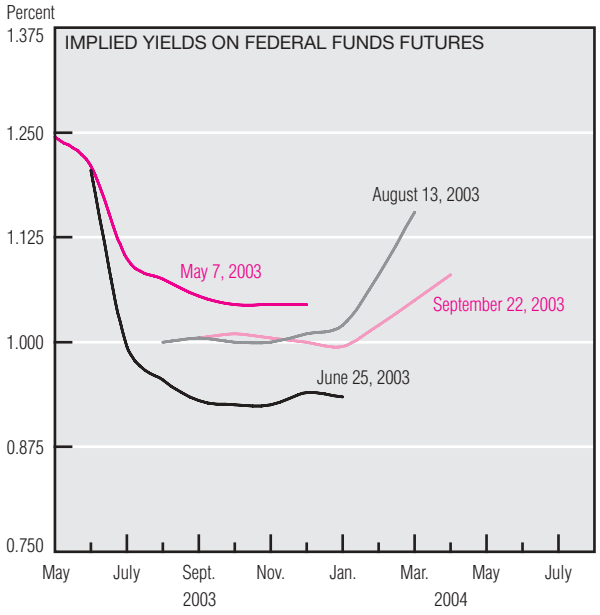
Growth in the monetary base (total currency in circulation plus the sum of total reserves and depository institutions' vault cash that is not applied to reserve requirements) moderated to an annualized 5.7% rate between January and September, far below its five-year average of 7.9%. The decline in base growth resulted mainly from currency growth's 3-percentage-point drop from its five-year average of 8.2%. This more than offset total reserves' 15.9% year-to-date growth.

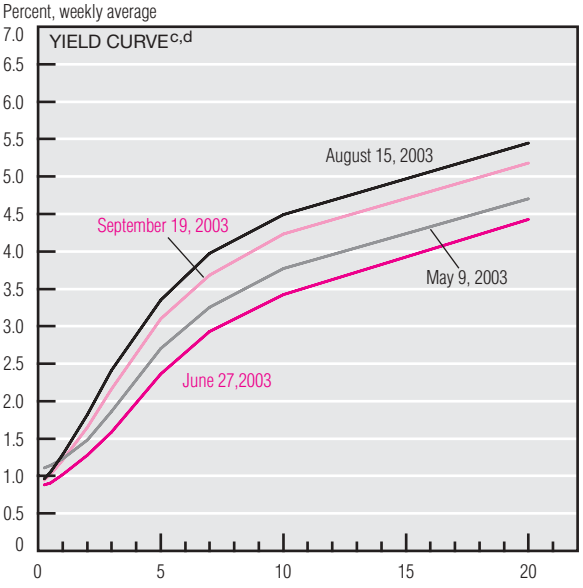
M1, another narrow monetary aggregate, consists of currency in the hands of the public plus demand and other checkable deposits. Its year-to-date annualized growth rate of 8.4% was roughly 2.8 percentage points above its five-year average. The accelerated growth of M1 resulted primarily from a sharp increase in demand deposits and other checkable deposits, whose year-to-date annualized growth rates were 10 percentage points above their five-year averages. The main causes of this growth were the surge in home refinancing activity and the decline in M1 opportunity cost.

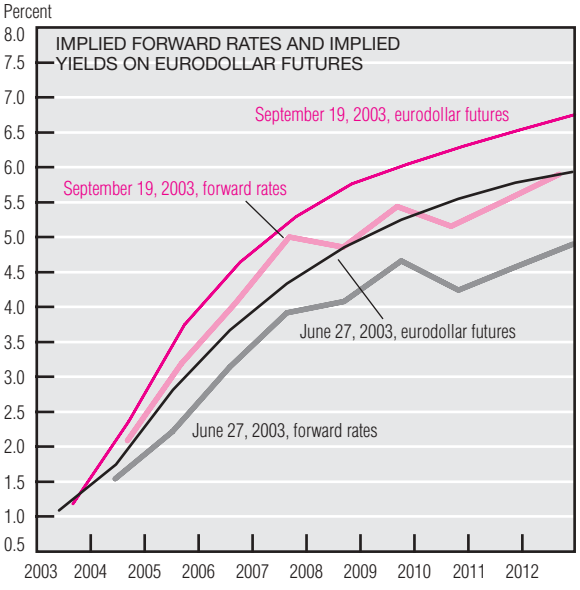
M2 grew more slowly than M1 because the broader aggregates are affected primarily by economic activity, which has been sluggish for the past couple of years. This slower growth resulted from declines in retail money market mutual funds (8.5%) and small time deposits (9.8%), which partly offset the rise in M1 growth and the 18.3% advance in savings deposits. However, M2 growth accelerated from 6.8% in 2002 to 7.3% in 2003 so far, reflecting the recent economic recovery.

Money and Financial Markets









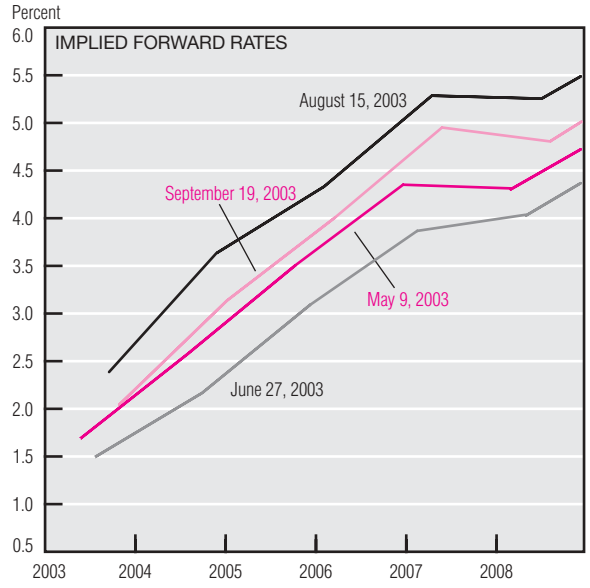
a. Weekly average of daily figures.
b. Daily observations.
c. All yields are from constant-maturity series.
d. Average for the week ending on the date shown.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases* H.15; and Bloomberg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

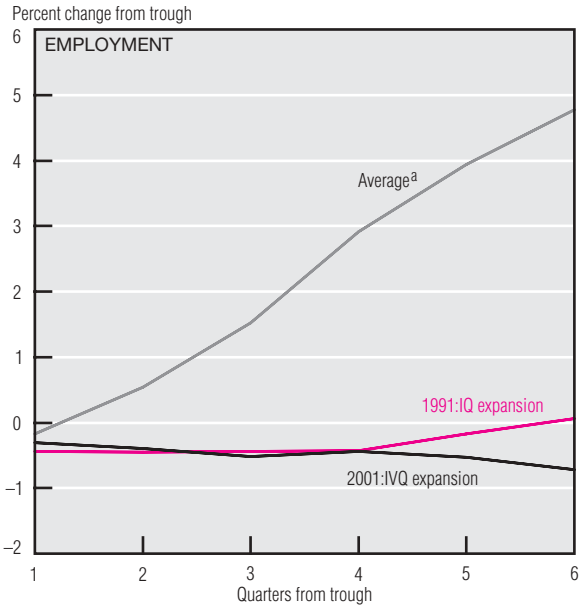
At its September 16 meeting, the Federal Open Market Committee (FOMC) did not change either the federal funds rate target (1%) or the primary credit rate (2%). At its August and September meetings, the FOMC affirmed that "the accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity." Furthermore, it "believes that policy accommodation can be maintained for a considerable period."

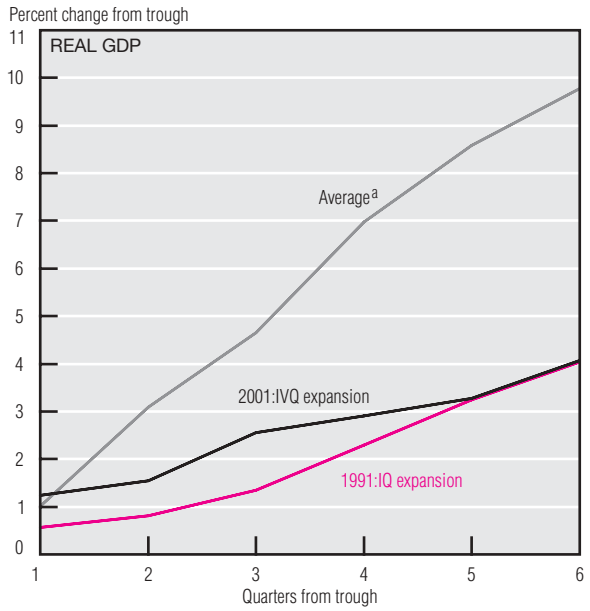
Considering these statements, it is understandable that no future policy actions seem imminent. Virtually none of the participants in federal funds futures markets expect a rate hike this year, although a few are starting to bet that the FOMC might start hiking rates sometime in the first half of next year.

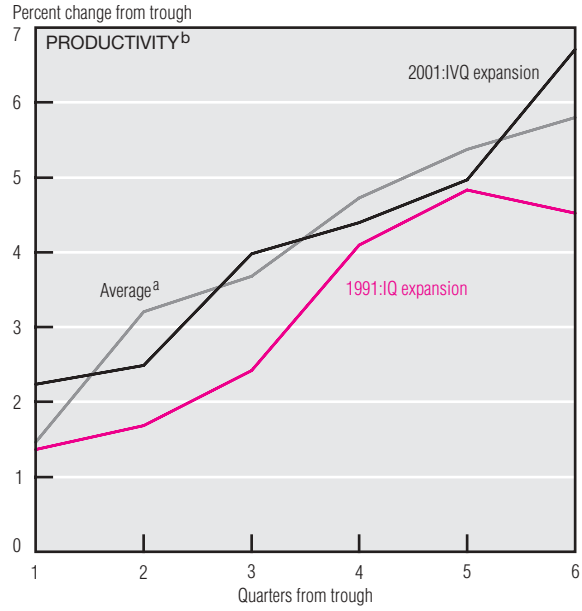
An important determinant of future interest rates is what funds rate the market expects will prevail in the future. This expectation may be measured by forward rates, which are calculated from the yield curve on U.S. government bonds or by the yield on eurodollar futures. These measures are very similar, but rates based on eurodollar futures are higher than forward rates calculated from government bonds. The extra risk present in eurodollar futures suggests that implied forward rates are better at gauging future policy actions. Although this measure is likely to be an overestimate, it suggests that the funds rate may be hiked 100 basis points by the end of 2004 and perhaps 250 basis points by the end of 2005.

Business Cycles and Monetary Policy









a. Average of expansions that started in 1975:IQ, 1980:IIIQ, and 1982:IVQ.
b. Nonfarm business sector.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, *Federal Reserve Statistical Releases*.

The period after the 1991 recession, dubbed the "jobless recovery," was not historically typical; the current episode, sometimes called the "job-loss recovery," is even more anomalous. In the typical recovery, employment has increased nearly 5% six quarters after the National Bureau of Economic Research officially announces that the recession is over. In the six quarters since the NBER's most recent end-date announcement, however, employment has fallen nearly 1%. Not surprisingly, real output also has languished, rising only 4% since 2001:IVQ. This contrasts with the 9% that GDP has usually advanced at this stage in a recovery.

Should monetary policy concern itself with slow job growth? Initially, the answer seems unambiguous. Job losses—and thus a stubbornly high unemployment rate—suggest slack or unused economic resources. Monetary policy could potentially help employ these resources. According to this view, output running below potential has also kept inflation low—indeed, it has decreased inflation somewhat—since the recession ended. This bleak situation is masked by strong growth in productivity, which has increased more since the trough than it typically does. Potential output, led by strong productivity, is advancing, but GDP's inability to keep up with these advances leaves a persistently high output gap.

The view that monetary policy should try to stimulate output is not universal, however. Some fear that the federal funds rate, currently at 1%, cannot be further eased without pushing it to a point where further cuts would be impossible. At that point, monetary policy might be powerless to offset further unwelcome

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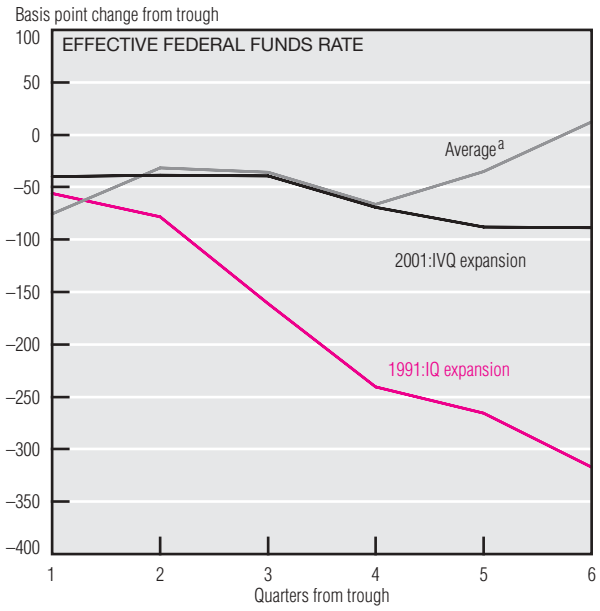
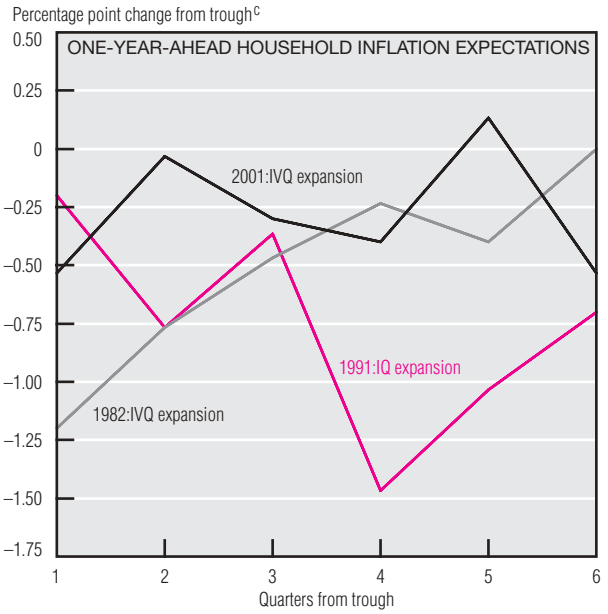
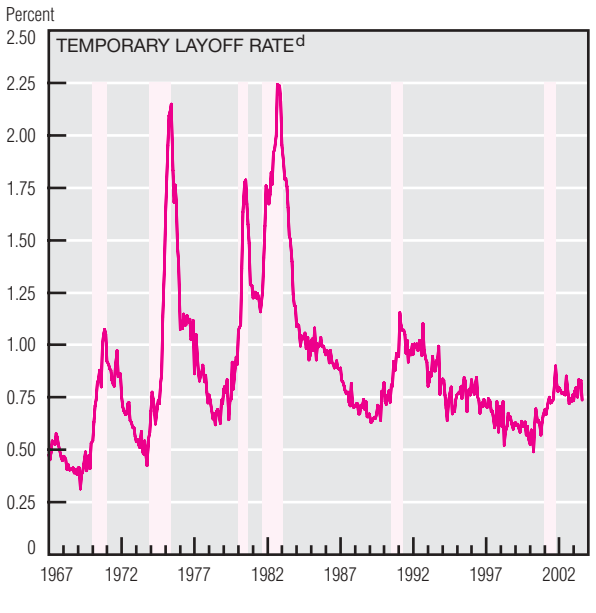
Business Cycles and Monetary Policy (cont.)







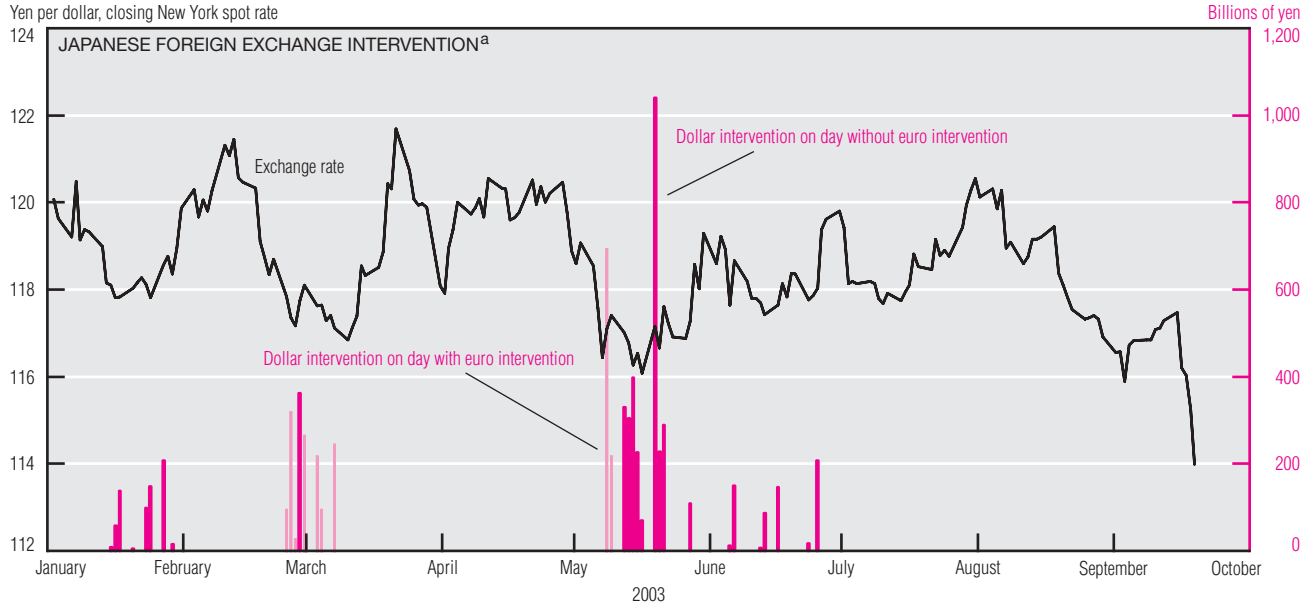
NOTE: Shaded areas indicate recessions.
a. Average of expansions that started in 1975:IQ, 1980:IIIQ, and 1982:IVQ.
b. Inflation is calculated from personal consumption expenditures less food and energy, Chain Price Index.
c. Median expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
d. Shaded areas indicate recessions.
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, "Selected Interest Rates," *Federal Reserve Statistical Releases* H.15; and University of Michigan.

declines in inflation or forestall another recession.

Even without these worries, it is not certain that monetary policy should be accommodative. This prescription generally assumes that there is a positive output gap. Unfortunately, the output gap is not observable, so monetary policymakers must try to gauge it by examining other variables, such as unemployment and inflation. But this is an imperfect method that can be misleading for at least two reasons.

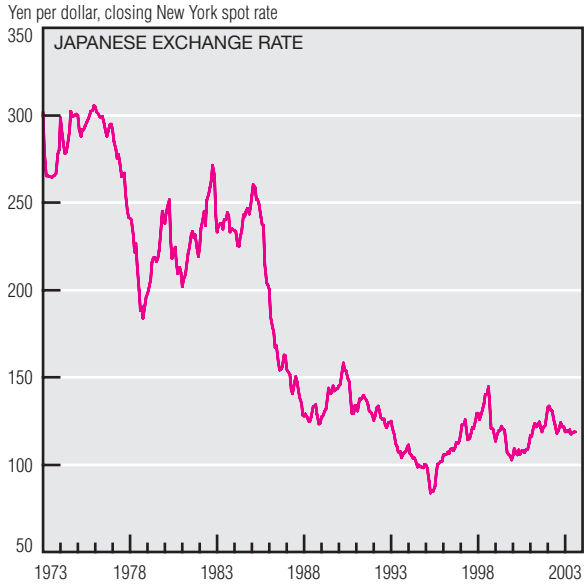
First, falling inflation does not necessarily imply a positive output gap. There is a lot of persistence in the inflation series, so inflation may continue to decline even after the gap has been closed. Adherents of this view observe that, although inflation has declined slightly since the trough, the drop is smaller than is typical during a recovery. Nor do the job losses since the trough, troubling though they are, necessarily indicate a positive output gap. The so-called natural rate of unemployment (the unemployment rate consistent with "full employment") is also unobservable. During periods when the economy is undergoing major structural change, this natural rate will be high. Even though the causes of the current job-loss recovery are still unclear, it seems increasingly likely that much of its unemployment results from structural, rather than cyclical, changes. Temporary layoffs, which indicate cyclical unemployment, barely increased during the most recent recession.

Japanese Intervention



Japanese Purchases of U.S. Dollars

	Actual	Expected (if random)[b]
Did official Japanese purchase of dollars...		
...prompt a dollar appreciation?	15	16
...moderate a dollar depreciation?	5	20
...appear generally successful?	20	21
Total interventions	**35**	
Total days in sample	**172**	



a. The Japanese Ministry of Finance has not yet released daily details on foreign exchange interventions after June 2003. However, from July 1 through July 29, intervention operations totaled approximately $17.1 billion (equivalent). From July 30 through August 29, the ministry did not conduct any foreign exchange intervention.

b. Assumes that successes have a hypergeometric distribution.

SOURCES: Japanese Ministry of Finance; and Bloomberg Financial Information Services.

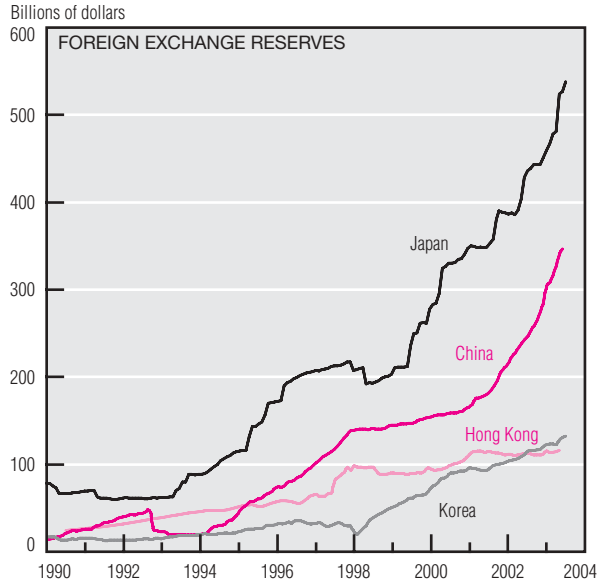
The Japanese Ministry of Finance has recently come under criticism for its frequent, heavy interventions in the foreign exchange market. Although these transactions sometimes give the yen a bit of a nudge, they seem incapable of offering the competitive push that critics fear.

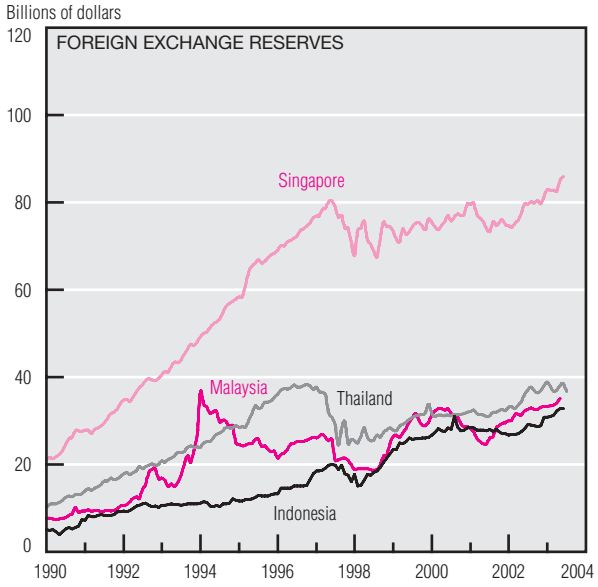
During the first half of this year, the Japanese Ministry of Finance entered the foreign exchange market on 35 days. Many of these interventions were unannounced and conducted so as to disguise their official nature. All of them involved official purchases of dollars, which suggests that the Ministry of Finance sought to prevent—or at least minimize—any depreciation of the dollar against the yen.

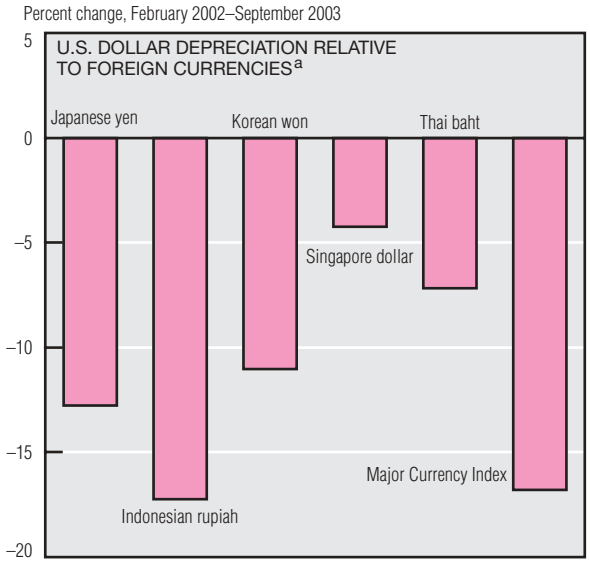
Twenty of these transactions—nearly 60% of the total—appeared successful in terms of either promoting an appreciation or moderating a depreciation of the dollar. But 60% is not a very good success rate. Given the choppy nature of day-to-day exchange rate movements, one would expect 21 such successes to occur purely by chance. The Ministry of Finance would have to score at least 26 successes to claim an influence on the exchange rate.

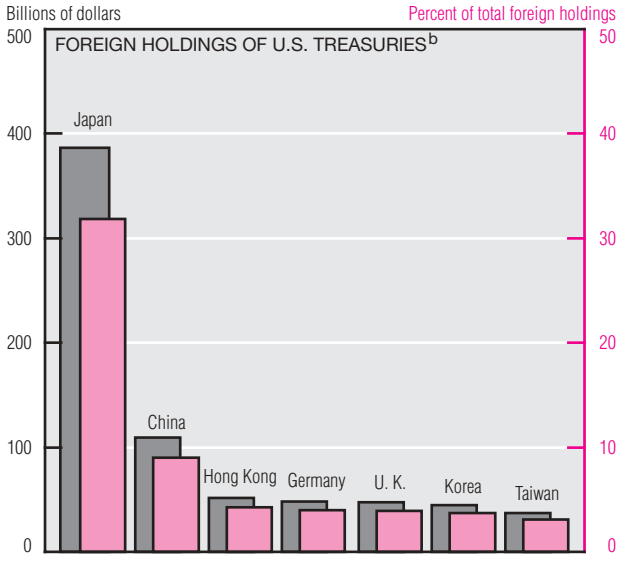
Studies of intervention have shown that the Japanese Ministry of Finance has sometimes affected day-to-day movements in the yen-dollar exchange rate. But these interventions did not affect exchange rate fundamentals and therefore did not give Japan any competitive trade advantage.

International Reserves: Expensive Insurance









a. China and Hong Kong peg their exchange rate to the dollar.
b. Includes both private and official holdings.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, July 2003; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.10; International Monetary Fund, *International Financial Statistics*; and Bloomberg Financial Information Services.

Since the 1997–98 financial crisis, many East Asian countries have greatly increased their holdings of foreign exchange reserves as insurance against exchange rate fluctuations and international crises. Foreign-exchange reserves are highly liquid, interest-bearing instruments denominated in one of the world's key currencies—U.S. dollars, Japanese yen, or euros. The exact currency compositions of countries' reserve portfolios are confidential, but the lion's share seems to be in dollars. Japan, China, Taiwan, Hong Kong, South Korea, and Singapore are now the world's largest holders of foreign exchange reserves.

Some of these countries have acquired foreign exchange to keep their own currencies from appreciating. At its current exchange rate peg, the People's Bank of China must continuously buy dollars to satisfy an excess demand for renminbi. Similarly, in recent years, the Japanese Ministry of Finance has frequently purchased dollars to prevent the yen from appreciating against the dollar.

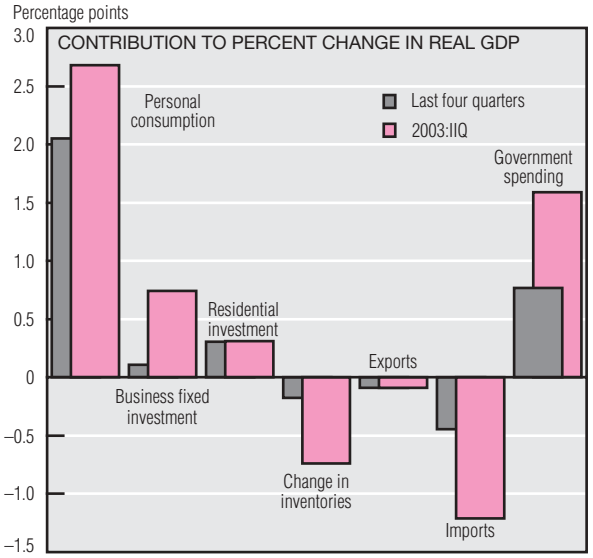
Once a country holds a foreign exchange portfolio, it can sell it to defend its currency's exchange value, an important ability in an international financial crisis. The debt of most emerging market economies is denominated in foreign currencies, not in their own. The depreciation that typically accompanies a financial crisis causes the local currency value of foreign debts to soar, making debt servicing costs even more onerous.

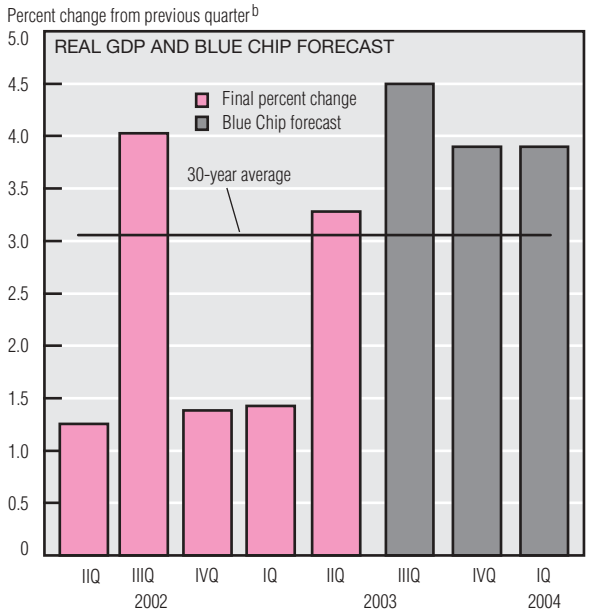
Holding substantial international reserves seems expensive. The return typically earned, though safe, is small compared to the interest costs of the holder nation's debt and relative to the return on investment in domestic development projects.

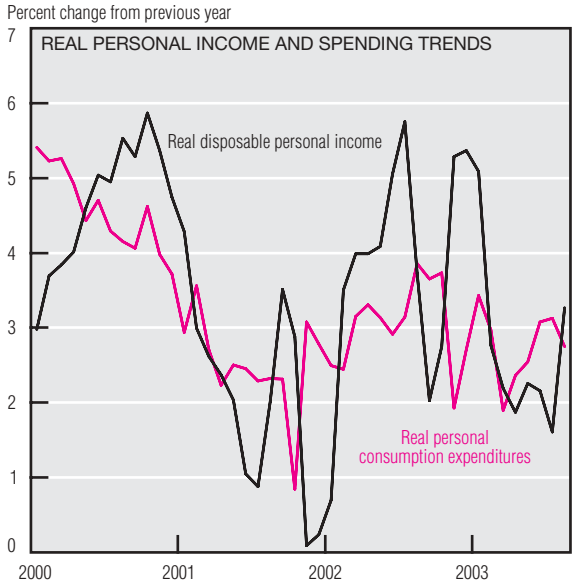
Economic Activity

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

	Change, billions of 1996 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	77.4	3.3	2.5
Personal consumption	63.0	3.8	2.9
Durables	56.1	24.3	8.2
Nondurables	6.7	1.4	3.4
Services	13.1	1.4	1.7
Business fixed investment	20.9	7.3	1.0
Equipment	19.6	8.2	4.0
Structures	2.2	4.2	–8.0
Residential investment	6.5	6.6	6.7
Government spending	35.9	8.5	4.1
National defense	40.5	45.8	13.7
Net exports	–35.8	—	—
Exports	–2.6	–1.0	–0.9
Imports	33.3	8.8	3.1
Change in business inventories	–22.4	—	—







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-weight indexes.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, September 10, 2003.

The final estimate of real gross domestic product (GDP) for 2003:IIQ was 3.3%, revised up 0.2 percentage point from the preliminary release, with modest boosts in some sectors offsetting slight declines in others. Housing, inventories, and government spending contributed more to growth than was previously reported, whereas capital spending and net exports contributed less. Spending on durable goods, the strongest component of personal consumption expenditures, rose 24.3% for the quarter. Leading the way for government spending, defense spending went up $46 billion, an annualized increase of 45.8% over the previous quarter and 13.7% over the past year. Residential investment remained strong, up 6.6%.

The revisions did not affect which categories contributed most to the 2003:IIQ increase in real GDP. These remained personal consumption expenditures (2.7 percentage points), government spending (1.6), and nonresidential fixed investment (0.3). Inventory investment (–0.7) and imports (–1.2) continued to constitute a significant drag on real output growth.

Blue Chip forecasters are optimistic about the outlook for GDP growth in the next few quarters. They forecast growth of 4.5% in 2003:IIIQ and 3.9% in each of the two quarters after that, well above the 3.1% average growth rate of the last 30 years. Supporting this optimistic

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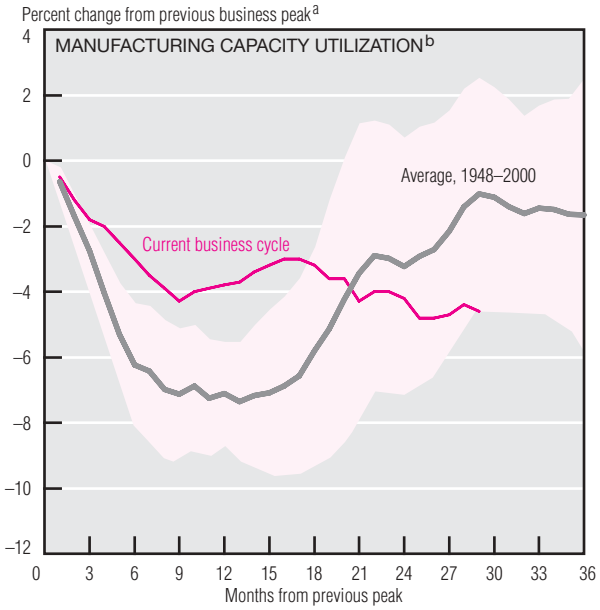
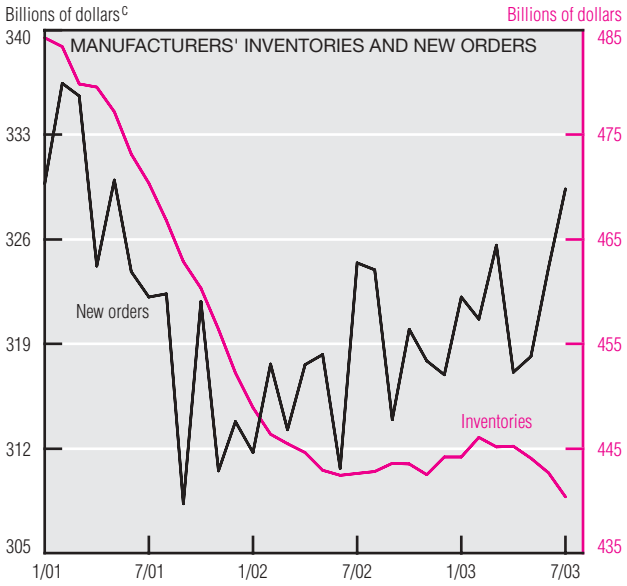
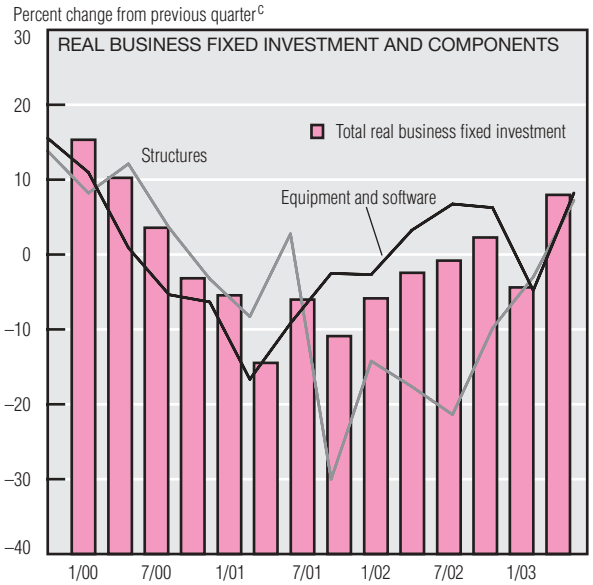
Economic Activity *(cont.)*







a. Seasonally adjusted.
b. The shaded area represents a 95% confidence interval (the 1948–2000 average, plus or minus two times the standard error).
c. Seasonally adjusted at annual rates.
d. Corporate profits with inventory valuation and capital consumption adjustments.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

view, real disposable income rose almost 3.3% over the last year, outpacing the 2.7% posted by real personal consumption expenditures.

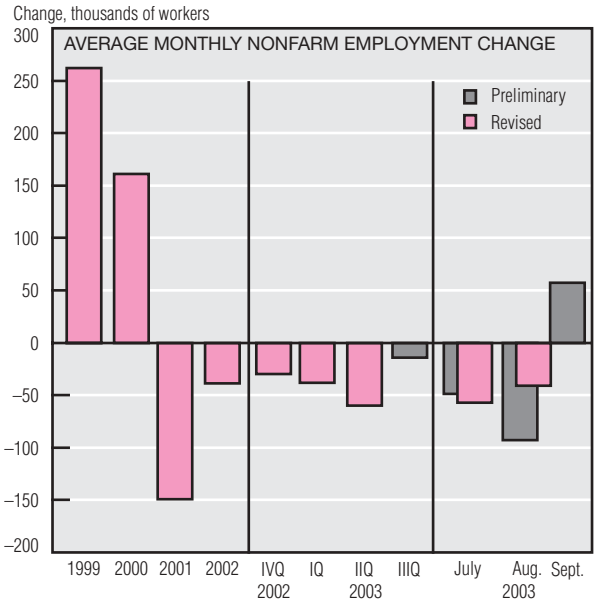
Observers seeking confirmation that the economy continues to improve must look beyond August's 72.7% reading for manufacturing capacity utilization. Although this series performed better than usual in the six quarters since the last business cycle peak, its performance relative to previous business cycles worsened over the last few months and is now in the lower range of the average postwar experience.

Fortunately, there are also several positive signs for future economic activity. Even though manufacturers have continued to economize by trimming their inventories, new orders have trended up for the last two years.

Another positive sign is that overall business fixed investment rebounded nearly 8% in 2003:IIQ. In fact, investment in equipment and software grew 8.2% and has risen in four of the last five quarters. Investment in structures grew 7.2%, its first increase since 2001:IIQ.

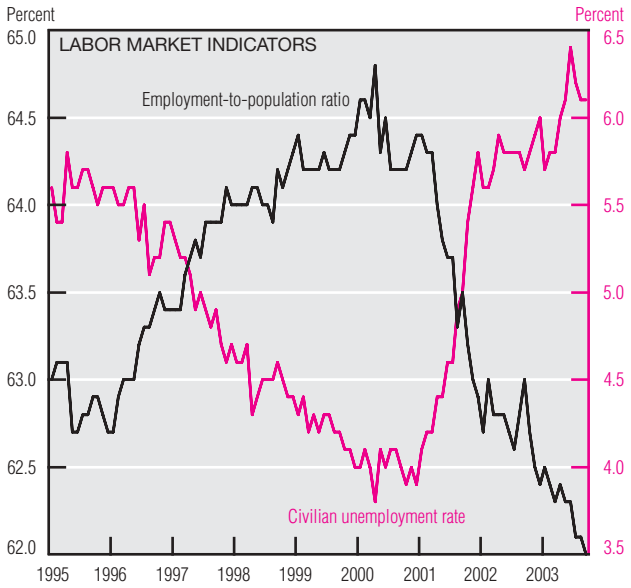
Finally, corporate profits have continued their comeback, rising 10.8% between 2003:IQ and 2003:IIQ. If corporate profits remain strong, firms will be in a good position to take advantage of new opportunities and perhaps raise employment.

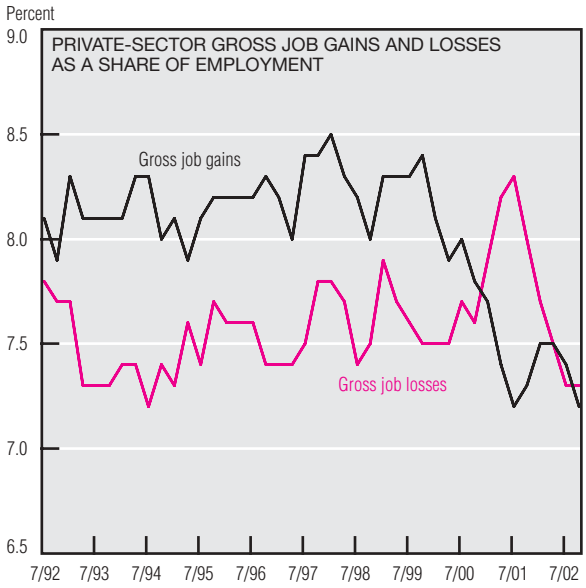
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	2000	2001	2002	Jan.–Aug. 2003	Sept. 2003
Payroll employment	161	–149	–39	–49	57
Goods producing	–1	–124	–64	–44	–17
Construction	7	–1	–4	12	14
Manufacturing	–9	–123	–57	–54	–29
Durable goods	2	–88	–41	–38	–17
Nondurable goods	–11	–35	–16	–17	–12
Service providing	162	–25	25	–5	74
Information	15	–15	–14	–11	–4
Financial activities[a]	6	7	5	11	10
PBS[b]	40	–63	–10	11	66
Education and health	32	51	37	17	9
Leisure and hospitality[c]	22	–2	7	4	–3
Government	22	46	16	–13	–15
	Average for period (percent)				
Civilian unemployment rate	4.0	4.8	5.8	6.0	6.1





NOTE: All data are seasonally adjusted.

a. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.

b. Professional and business services include professional, scientific, and technical services, management of companies and enterprises, administrative and support, and waste management and remediation services.

c. Leisure and hospitality includes arts, entertainment, and recreation, as well as accommodation and food service.

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

After losing a revised 41,000 jobs in August, total nonfarm employment posted a net gain of 57,000 in September, its first increase in eight months. The revisions halved the figure reported earlier.

In September, goods producers lost 17,000 jobs net, compared to the average net monthly loss of 81,000 since the March 2001 peak. Manufacturing employment's decline continued, but at a much slower pace (29,000 in September compared to the 54,000 average monthly loss from January to August). Construction remained strong, growing by 14,000 jobs in September. Service providers added 74,000 jobs, most of them (66,000) in professional and business services. Financial activities increased by 10,000 jobs, consistent with the January–August average monthly change. Education and health services added 9,000. Government continued to shed jobs (15,000) in September. A drop of 4,000 continued the downward trend in information services, which has lost jobs every month this year.

The unemployment rate remained unchanged at 6.1%. The employment-to-population ratio inched down 0.1 percentage point to 62.0.

In September, the Bureau of Labor Statistics began to publish a new data series, Business Employment Dynamics, which tracks private business establishments' quarterly net gains and losses. As a share of employment, gross gains exceeded gross losses every quarter from September 1992 through December 2000, producing a net increase in the number of jobs. The 2001 recession caused a large temporary increase in the rate of gross job losses and a large decline in the rate of gross job gains. The surprisingly weak employment growth of 2002 reflected reluctance to hire workers rather than continued job losses at contracting and closing establishments.

The United Auto Workers' Contract

Contract Highlights

What the UAW achieved:
Wage rate increases of 2% in the third year and 3% in the fourth year.

A pension increase for future retirees.

Better medical coverage.

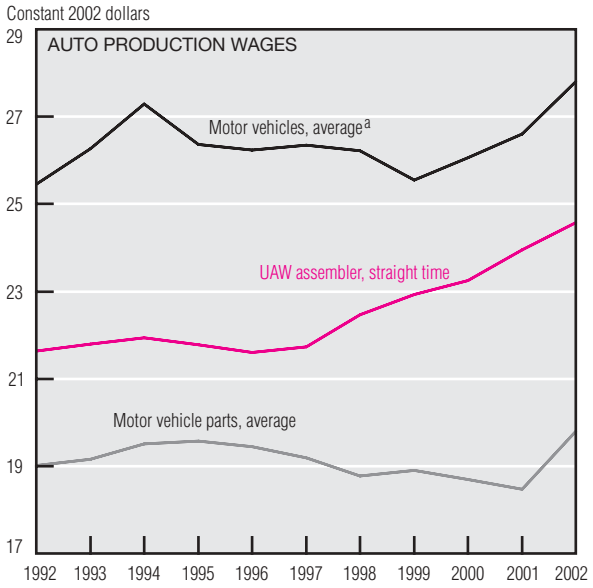
What the auto companies achieved:
For the first two years, bonuses will substitute for wage increases.

Current retirees will not receive monthly pension increases.

Created flexibility to close or sell plants.

Higher employee copays for name-brand prescription drugs.

Tougher restrictions on absenteeism.



UAW Membership at the End of 2003:IQ

	General Motors	Delphi	Ford	Visteon	Daimler Chrysler
Active members	117,780	30,100	72,570	21,880	60,170
Retired members	228,550	6,310	77,460	*	57,490
Surviving spouses	63,480	140	24,220	*	17,580

*Included with Ford employees.

Characteristics of UAW Workers

	GM/ Delphi	Ford/ Visteon	Daimler Chrysler
Median age[b]	48.9	44.1	43.0
Average years of service[b]	23.3	16.6	14.8
Percent of members eligible to retire within five years[c]	60%	39%	33%

NOTE: All data are seasonally adjusted.
a. Motor vehicles comprise automobiles and light trucks. The data series for motor vehicles and motor vehicle parts are reported as production workers' average hourly earnings.
b. End of 2001:IVQ.
c. End of 2003:IQ
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; United Auto Workers; and *Detroit Free Press*.

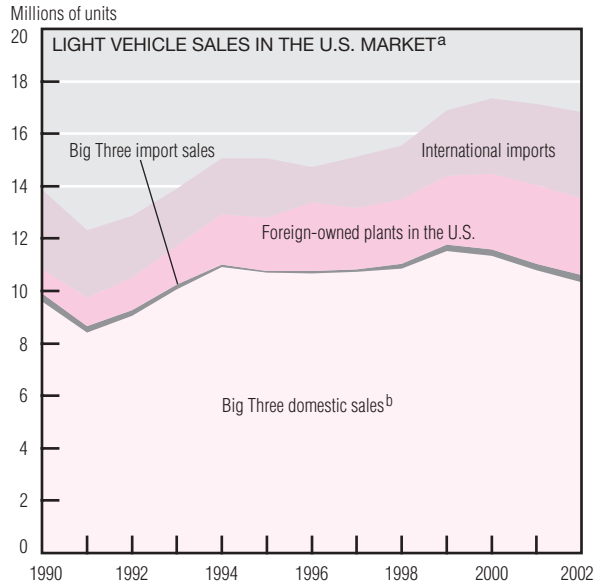
In September, the United Auto Workers (UAW) finished negotiating its contract with the Big Three automakers—General Motors, Ford, and DaimlerChrysler. During this round, the UAW aimed to speed negotiations and create a cooperative environment, hoping to help the Big Three maintain their domestic market share and limit the expansion of transplant factories, the largely nonunion domestic plants of historically offshore automakers. Honda, Toyota, and Nissan are the three largest foreign-owned producers in the U.S.

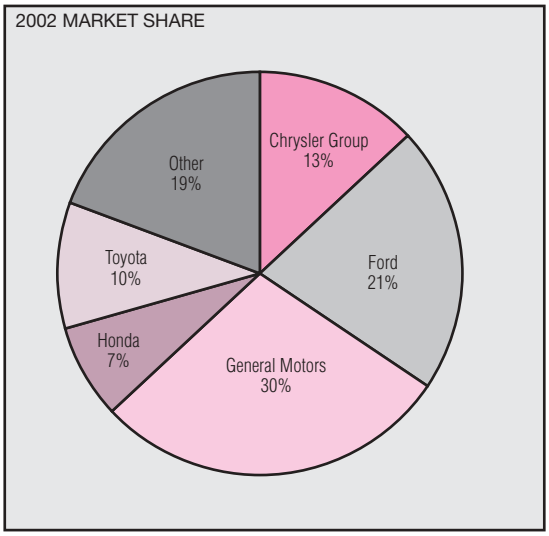
The UAW agreed to accept bonuses instead of wage increases in 2004 and 2005, followed by wage increases of 2% in 2006 and 3% in 2007. Auto production workers' actual average earnings, as measured by the Bureau of Labor Statistics, typically exceed the contract figure reached in negotiations ($27.80 per hour in 2002). This occurs because some workers belong to higher-wage trades and many receive additional pay for working overtime or night shifts.

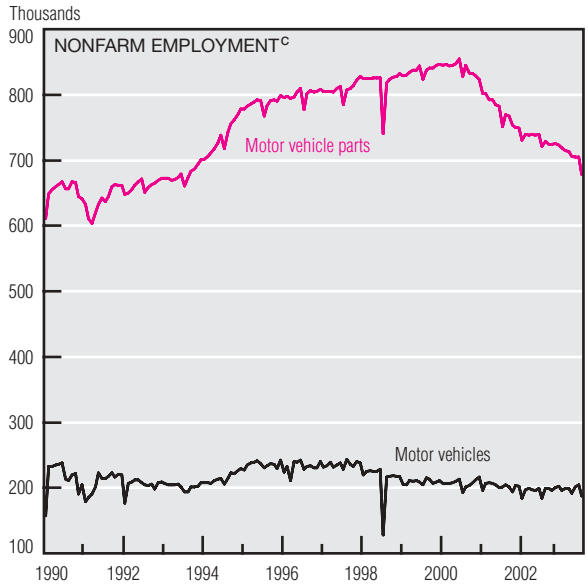
Workers in plants making motor vehicle parts earn substantially less. The new UAW contracts with Delphi, formerly part of General Motors, and Visteon, formerly part of Ford, include wage concessions to help keep them competitive.

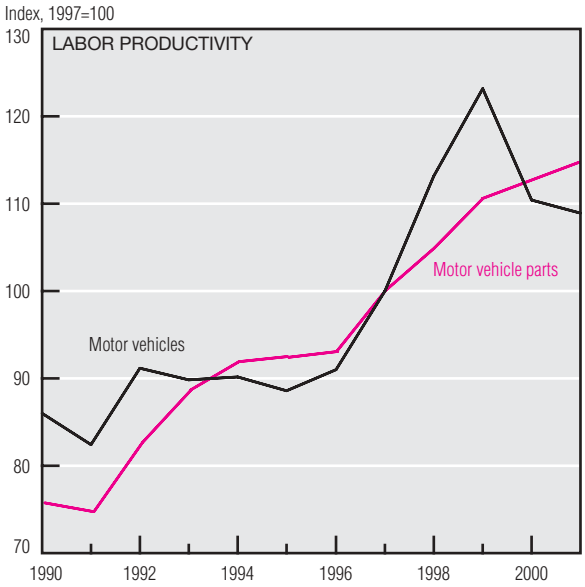
Because the UAW represents far more retirees than active workers, pensions and associated retirement benefits were key issues in the negotiations. The number of retirees covered under the contract is expected to keep rising as companies continue to trim their labor forces and encourage early retirement. The contract increased future retirees' pensions 9% over four years but reigned in the costs associated with current retirees by eliminating monthly increases.

Motor Vehicle Production









NOTE: All data are seasonally adjusted unless otherwise noted.
a. The international firms included are Honda, Mitsubishi, Nissan, Subaru, and Toyota.
b. Domestically produced sales, including Canada.
c. Not seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and United Auto Workers.

The future of domestic motor vehicle production was a critical issue in the recent United Auto Workers' negotiations. In 1999, Ford, General Motors, and DaimlerChrysler (the Big Three) agreed not to close any facilities for the term of the contract. In the most recent round, the UAW agreed to let those automakers reduce some of their excess capacity by closing certain facilities, some potentially in the Fourth District.

Cars produced in foreign-owned plants have continued to gain U.S. market share, despite the steady stream of incentives offered by domestic manufacturers. Total sales of light vehicles (automobiles and light trucks) are still reasonably robust: 16.4 million over the last 12 months. The Big Three's share of total sales fell from about 82% in 2002:IIQ to 79% in 2003:II.

Honda, Toyota, and Nissan, whose cars are selling very well, are producing more of them in U.S. plants. Honda now makes an annual 815,000 units in the U.S., roughly 68% of the number they sold here in the last 12 months. During that period, Toyota and Nissan produced a combined 1.1 million units, about 49% of their U.S. sales.

Although total U.S. sales and production figures have been remarkably steady for a recession, employment in motor vehicle assembly and parts has been trending down since

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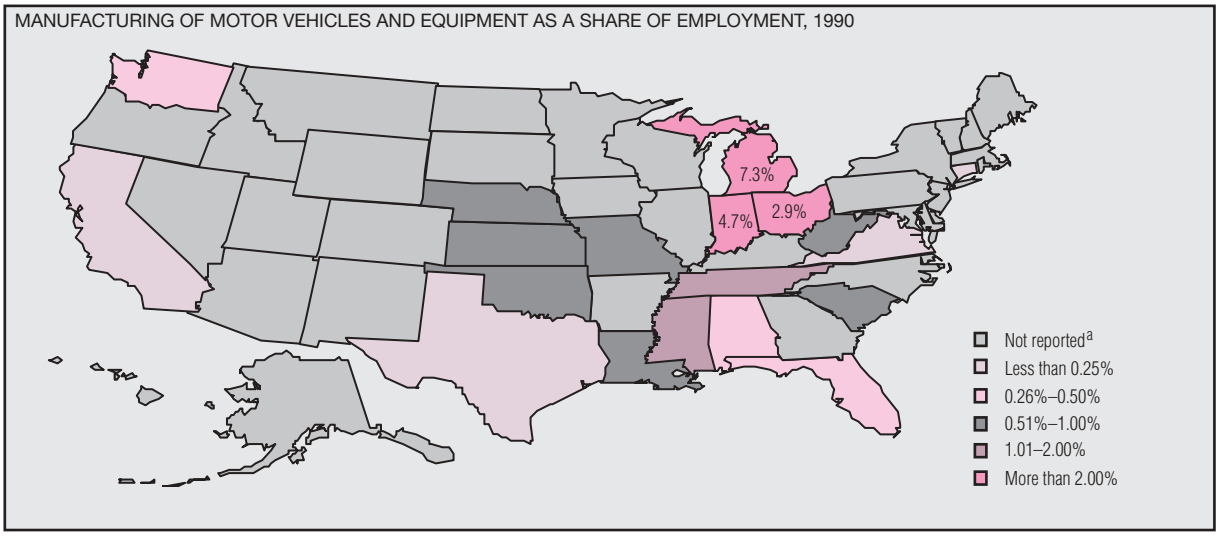
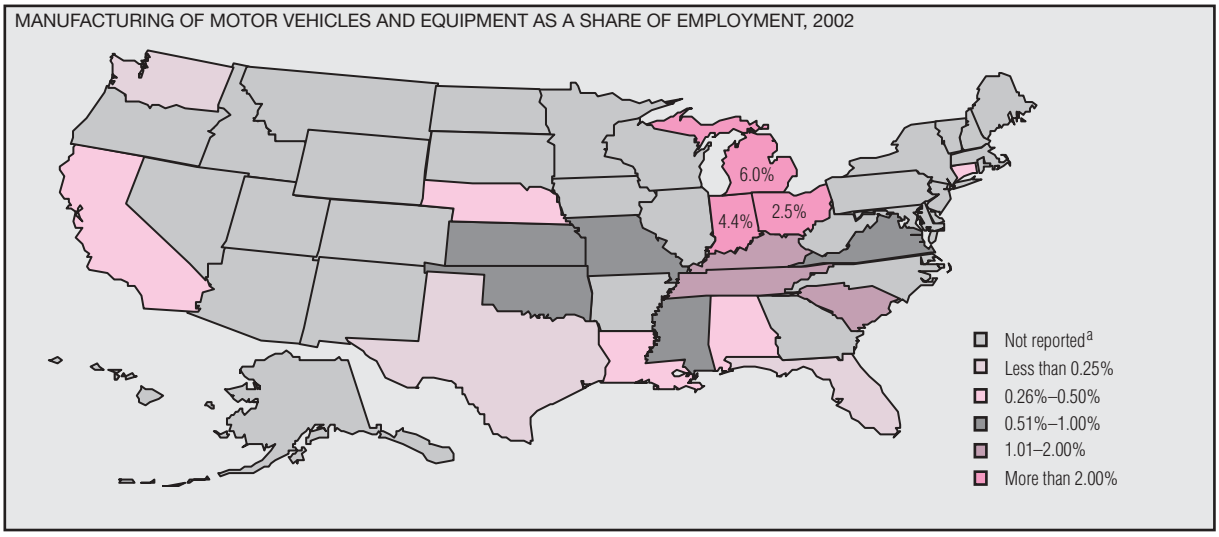
Motor Vehicle Production (cont.)





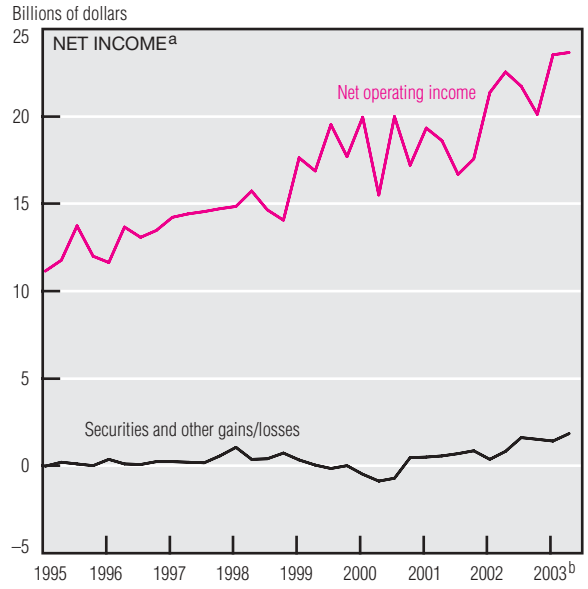
NOTE: All data are seasonally adjusted unless otherwise noted.
a. These states do not meet the Bureau of Labor Statistics' reporting standards, primarily because their auto industry employment is low.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and United Auto Workers.

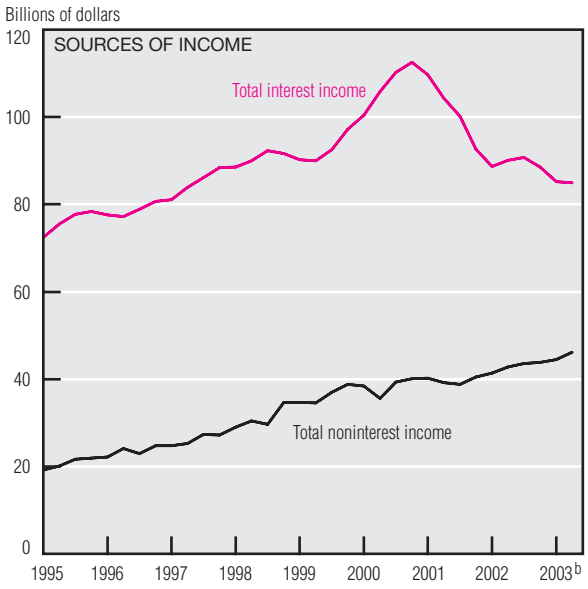
June 2000. Productivity growth in these industries has been substantial. Since 1999, the parts industry, which is characterized by intense competition, has shown the strongest gains.

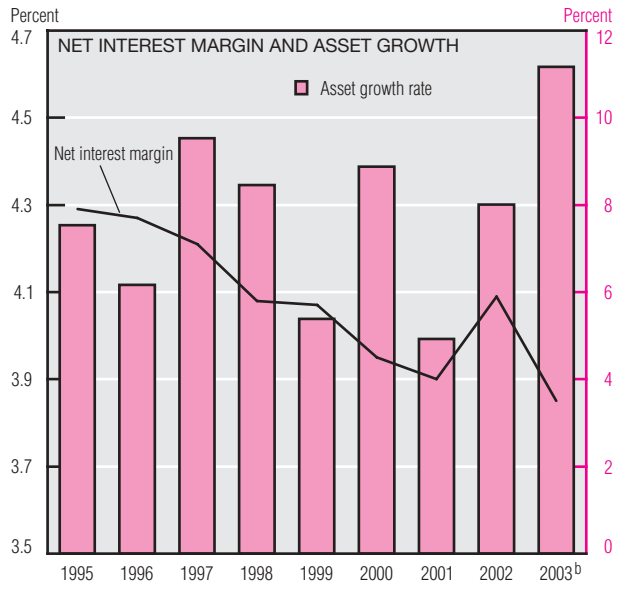
The Fourth District has a relatively large stake in auto production. In 2002, auto and parts production accounted for 2.5% of Ohio's workforce and 1.1% of Kentucky's, compared with the national average of 0.9%. The Fourth District's overall share has been fairly stable since 1990, with auto production consolidating around the I-75 corridor and expanding south. Much of the District's gain in auto employment occurred because foreign automakers located substantial facilities here. Honda's Ohio plants employ 1% of the state's assembly workers and have drawn many suppliers to the area. Similarly, the Toyota plant that opened in 1998 in Georgetown, Kentucky, accounts for almost all of that state's assembly jobs and increased employment in parts production as well.

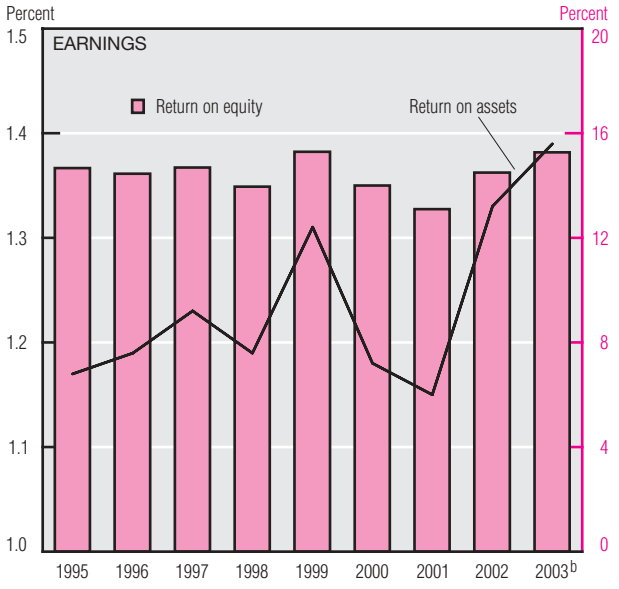
The District's auto manufacturing jobs will probably drop, more likely because of workforce attrition than through the recently negotiated closings of plants under the new UAW contract. The Ford assembly plant in Lorain, which employs 1,700 workers, is the largest of the plants in the District that are suggested for closure.

FDIC-Insured Commercial Banks









a. Net income equals net operating income plus securities and other gains and losses.
b. Through 2003:IIQ. Data are annualized.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

In 2003:IIQ, FDIC-insured commercial banks' net operating income improved slightly from the previous quarter and recovered strongly from its dip in 2002:IVQ. Compared to the second quarter of last year, it was up 5.0%. Net income (net operating income plus securities gains and losses) also improved, increasing 9.2% from a year ago. Lower credit losses and substantial gains on securities sales fuelled overall earnings growth.

Commercial banks' total interest income, $85 billion, was unchanged from the previous quarter. Falling interest rates made this figure significantly lower than the $113 billion reported in 2000:IVQ. Total noninterest income continued to grow, rising 7.9% from a year ago, another sign that the earnings pressures affecting banks during the 2001 recession are finally abating.

Overall earnings (interest plus dividends earned on interest-bearing assets minus interest paid to depositors and creditors, expressed as a percentage of average earning assets) improved, even though the net interest margin declined from 4.09% in 2002 to 3.85% in 2003:IIQ.

Low interest rates are one cause of shrinking margins, but strong asset growth is just as important. FDIC-insured commercial banks' assets grew an annualized 11.7% in 2003:IIQ, the best showing in almost a decade. But even with near-record asset growth, depository institutions' 1.4% return on assets was the highest since 1989. At 15.3%, return on equity was also at its highest level since 1999.

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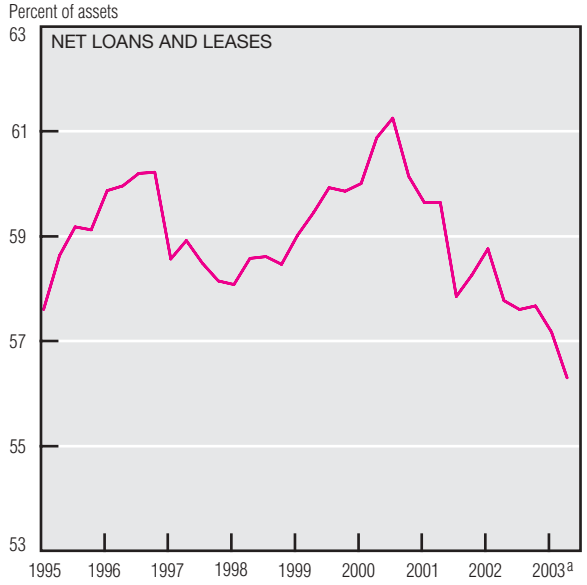
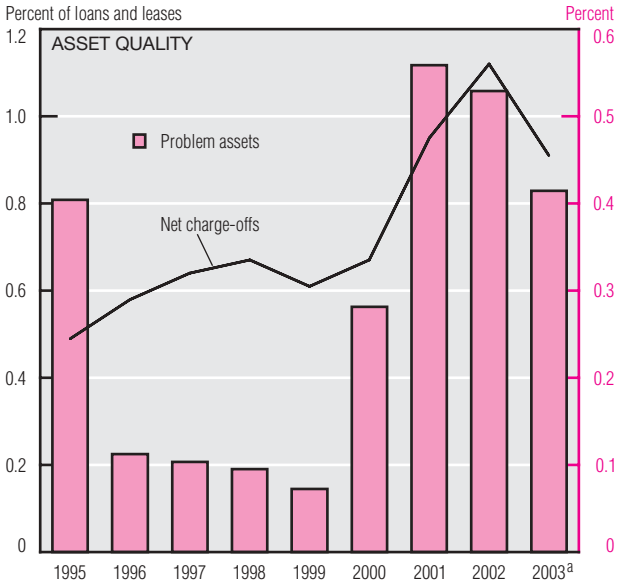
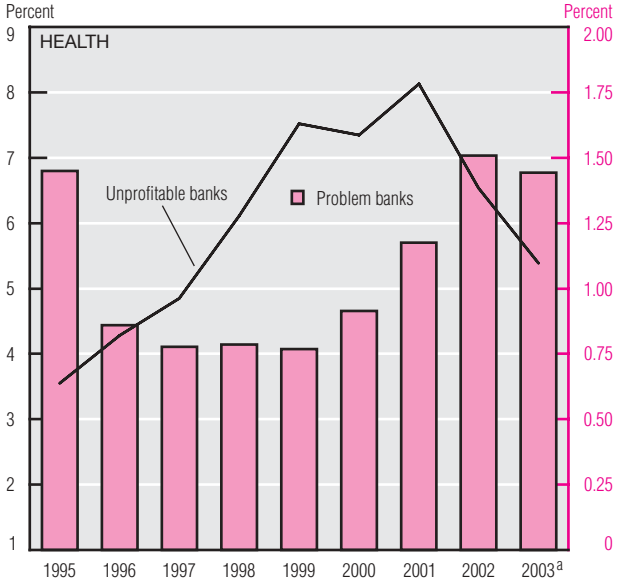
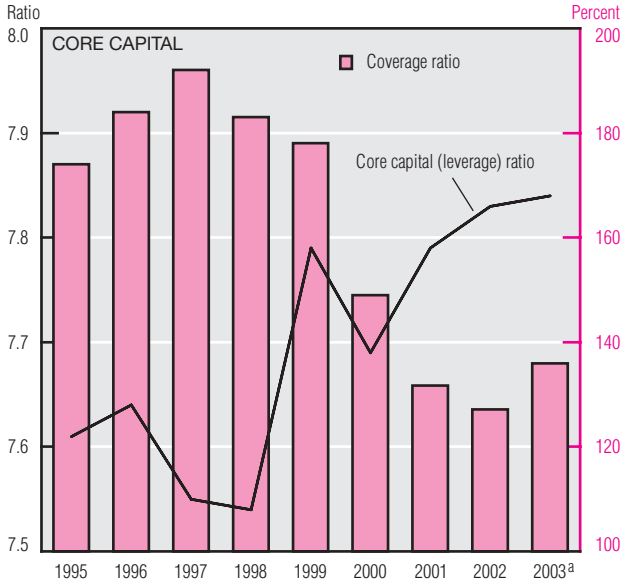
FDIC-Insured Commercial Banks *(cont.)*









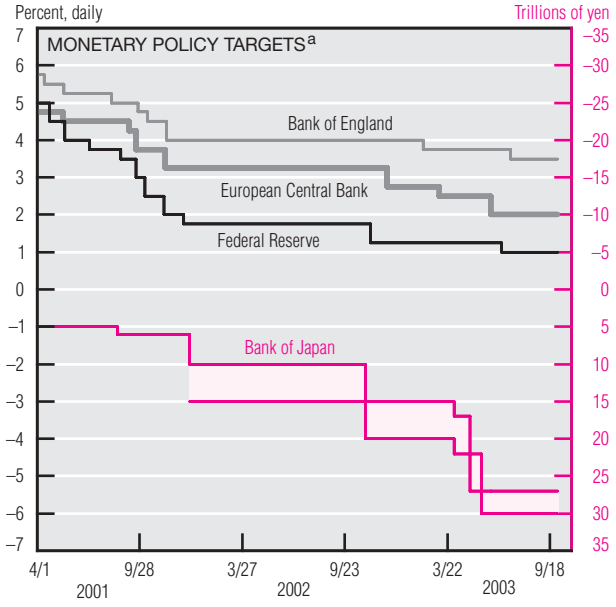
a. Through 2003:IIQ. Data are annualized.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

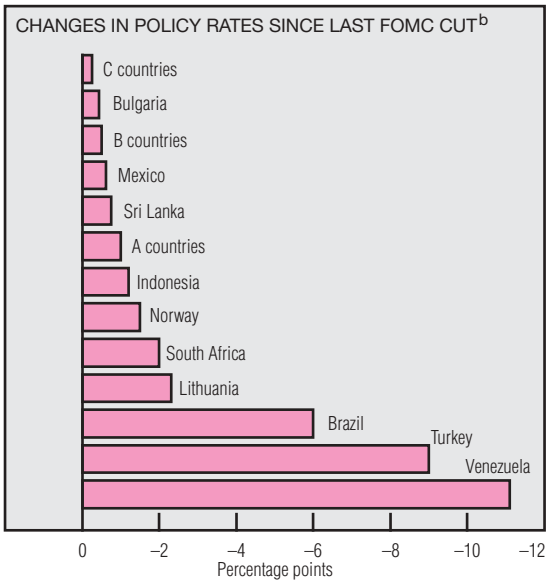
In 2003:IIQ, FDIC-insured commercial banks' net loans and leases fell slightly to 56.3% of total assets from 57.8% a year ago. Net loans and leases rose 8.4%, but total assets grew 11.2%, producing a slightly lower year-over-year ratio. Although the ratio was well below the 2000:IIIQ high of 61.3%, lending was brisk in 2003:IQ, partly because low interest rates boosted refinancing activity.

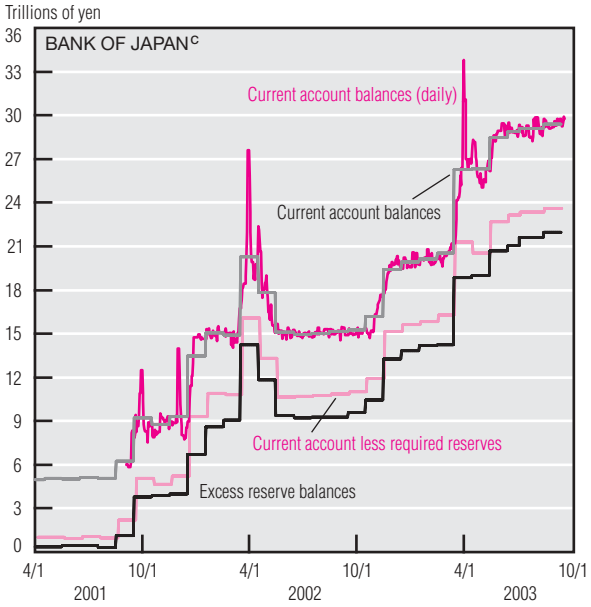
Asset quality showed signs of improvement in 2003:IIQ. Net charge-offs (uncollectible loans and leases removed from the balance sheet, minus recoveries) fell to 0.9% of total loans, the first decrease since 1999. Problem assets (nonperforming loans and repossessed real estate) fell to 0.41% of loans and leases from 0.53% at the end of 2002. Improved asset quality reflects the lower debt-servicing costs that result from refinancing at lower interest rates and aggressive tightening of lending standards.

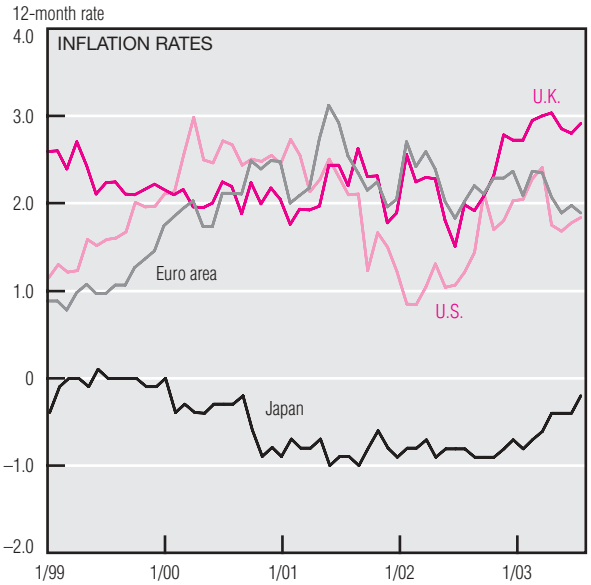
FDIC-insured commercial banks' improved asset quality is also apparent in the decline of unprofitable institutions to a 5.4% share in 2003:IIQ. Problem banks (those with substandard exam ratings) fell to a 1.4% share of all banks. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) rose from 127% at the end of 2002 to 136% in 2003:IIQ, the first increase since 1997. Core capital, which protects commercial banks against unexpected losses, remained flat at 7.84%. All of these performance indicators point to strengthening in the banking sector.

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. A countries are Israel and Peru; B countries are Canada and Thailand; C countries are Czech Republic, Malta, New Zealand, Philippines, South Korea, Sweden, and Taiwan.

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 the sixteenth of one month and ending the fifteenth of the next.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; 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 major central banks' operating targets have not changed over the past three months, but interest rate cuts in other countries have been common. The Bank of Japan's supply of current account balances crept up within the unchanged target range of ¥27 trillion–¥30 trillion. However, that gain was small compared to the almost sixfold gain in daily average balances since August 2001. The Bank of Japan also has announced a one-year extension of its program for purchasing stock from commercial banks' portfolios; like the U.S. Federal Open Market Committee, it has discussed improving communication of its policy intentions to the public.

In a September 14 referendum, 56% of Swedish voters favored retaining the krona as their national currency instead of adopting the euro. Thus, with the U.K. and Denmark, Sweden remains a member of the European Union but not of the European System of Central Banks.

Inflation rates for the euro and the dollar have converged over the past year to a point just below the ECB's target ceiling, while Japan's deflation rate has moved up toward zero. The U.K.'s inflation rate, however, has stuck stubbornly above the government's 2.5% target and is more than one percentage point higher than an alternative inflation index comparable to that used by the ECB. The government has announced that it will target that alternative index starting next year.