The Economy in Perspective

Imagine

(with apologies to John Lennon)

Imagine strong expansion,
It's easy if you try,
There'd be no unemployment,
Just think what you could buy,
Imagine all the people
Living well today...

Imagine budget balance,
It isn't hard to do,
Adjust the rate of spending,
Adjust the revenue,
Imagine all the people
Living without debt...

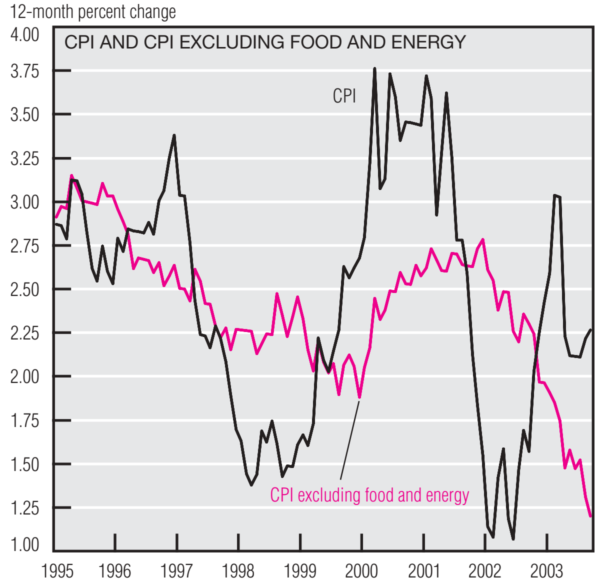
Imagine there's no trade gap,
I wonder if you can,
No need for strain with China,
No need to peg the yuan,
Imagine all the people
Sharing all the world...

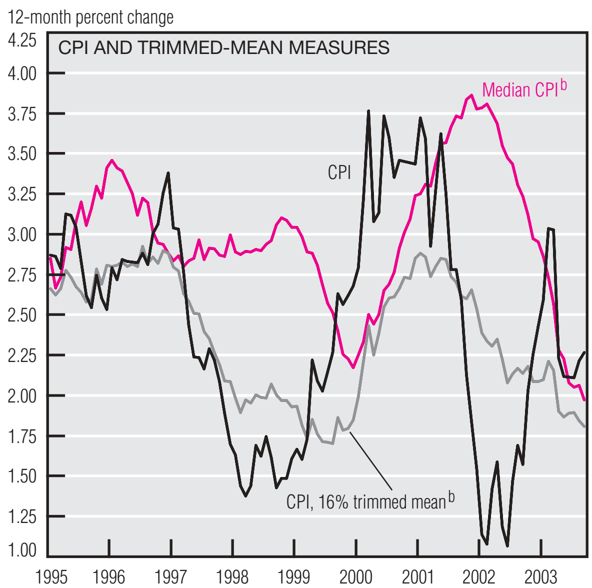
You may say I'm a dreamer,
But I'm not the only one,
Price stability has happened,
No one thought it could be done.

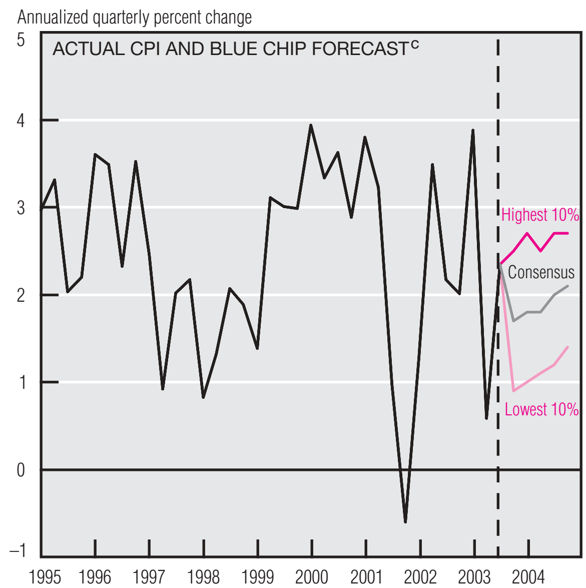
Inflation and Prices

September Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2002 avg.
Consumer prices					
All items	3.3	3.1	2.3	2.5	2.4
Less food and energy	0.6	1.5	1.2	2.1	2.0
Median[b]	1.6	2.4	2.0	2.8	3.0
Producer prices					
Finished goods	3.4	3.4	3.5	2.0	1.2
Less food and energy	0.0	1.3	0.2	0.9	–0.5







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, October 10, 2003.

The Consumer Price Index (CPI) rose at an annualized rate of 3.3% in September, down from August's 4.0% annualized increase. Energy prices continued their steep ascent: After rising 2.7% in August, the CPI's energy index increased 3.0% in September. The Labor Department attributed this primarily to gasoline prices, which spiked up 6.3% in the month.

Eliminating the volatile energy and food components from the CPI, however, suggests that price pressures remain subdued in September. The CPI excluding food and energy, or core CPI, increased at a 0.6% annualized rate. The median CPI and 16% trimmed-mean CPI, measures of inflation that exclude the most extreme price changes, also rose modestly, at annualized rates of 1.6% and 1.7%, respectively. In contrast to the unadjusted CPI, all three of these measures, on a year-over-year basis, have trended downward throughout 2003.

The Blue Chip panel of economists' CPI forecast suggests that prices will continue to rise at an annualized rate of about 2% through the next five quarters. Individual panelists' forecasts fall within a range of about 1.5 percentage points: The most optimistic expect the CPI inflation rate to be approximately 1.4% by the end of 2004, while the most pessimistic expect it to be about 2.7%.

Core CPI inflation has been falling for about two years. Dividing the core

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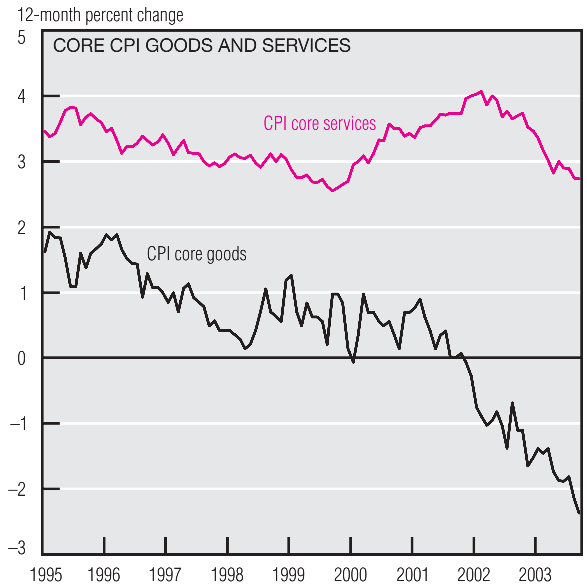
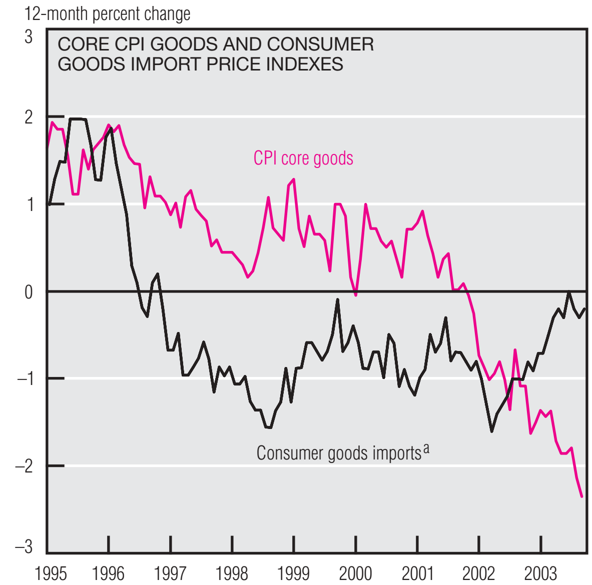
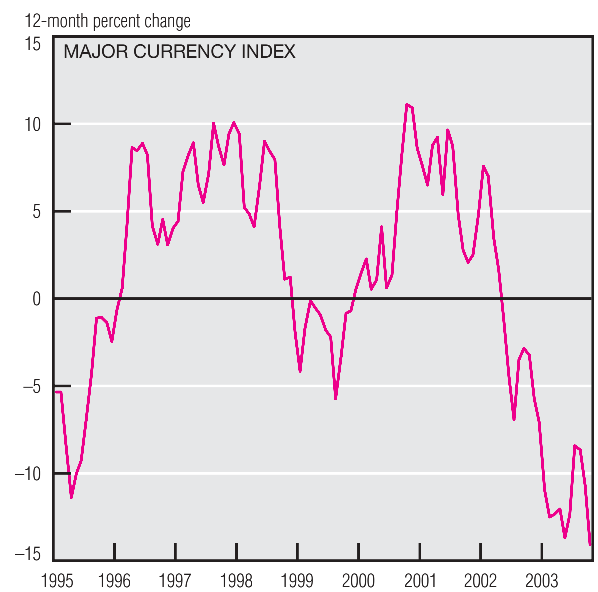
Inflation and Prices *(cont.)*





Prices of Consumer Goods Imports[a]

	Share, percent	Percent change, last 3 mo.[b]	12 mo.	36 mo.[b]
Nondurables	48.5	–0.40	0.20	–0.03
Apparel and footware	31.9	0.0	0.71	–0.23
Other	16.6	–1.18	–0.79	0.27
Durables	46.2	–1.24	–0.,62	–1.18
Household goods	20.3	–0.82	0.0	–0.81
Recreational	10.8	0.41	–0.10	–0.97
Home entertainment	10.6	–2.65	–4.31	–3.65
Other	4.5	–3.74	4.01	2.42
All other	5.5	–0.88	–0.28	–1.41



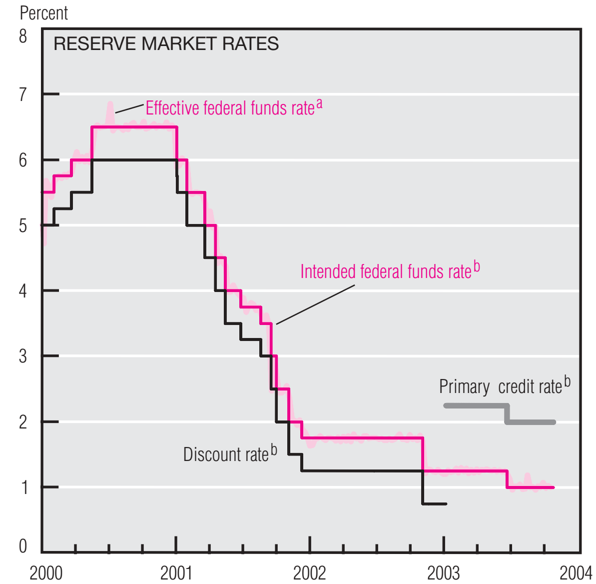
a. Excluding automotives.
b. Annualized.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," H.10, *Federal Reserve Statistical Releases*.

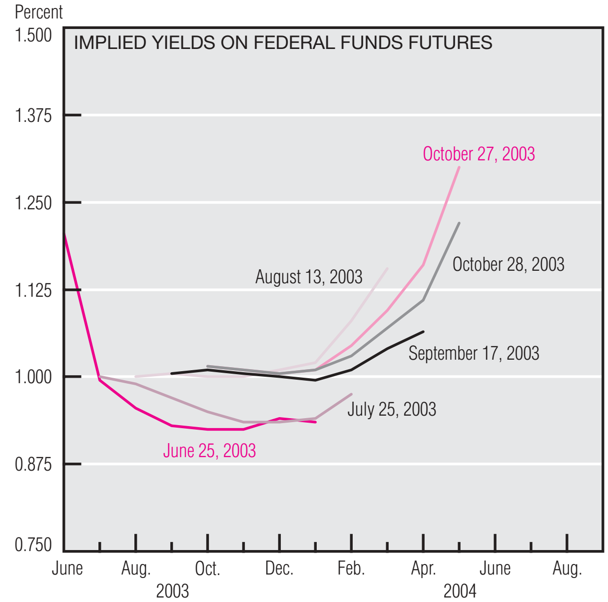
CPI into goods and services shows that both components, like the overall index, have undergone disinflation since early in 2002. However, rates for core goods versus core services prices have diverged during the last two years: Disinflation has been even more pronounced for core goods prices than for core services prices. In fact, whereas core services prices have merely risen more slowly throughout this period, core goods prices have actually fallen.

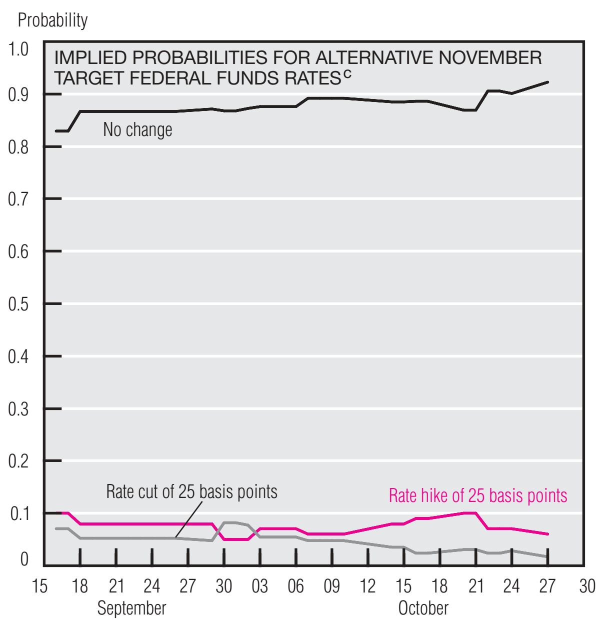
Part of this deflation in core CPI goods prices can be traced to the prices of imported consumer goods, which have been falling for more than six years. In general, the prices of durable goods such as home entertainment items have declined more dramatically during this period than the prices of nondurable goods such as apparel and footwear. However, these declines have been more modest in recent months; indeed, the rate of deflation in imported consumer goods prices has been lessening for almost two years.

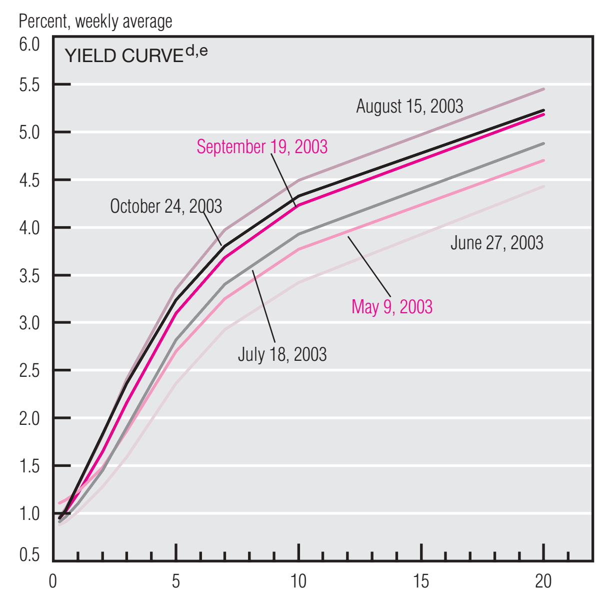
Import prices depend partly on the value of the dollar: When its value falls, the dollar prices of imported goods rise. The Major Currency Index, a trade-weighted average of the dollar's foreign exchange value against a basket of the currencies of our major trading partners, indicates that, on a year-over-year basis, the dollar has depreciated since early 2002.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated by using prices from options on November 2003 federal funds futures that trade on the Chicago Board of Trade.
d. All yields are from constant-maturity series.
e. 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; Chicago Board of Trade; and Bloomberg Financial Information Services.

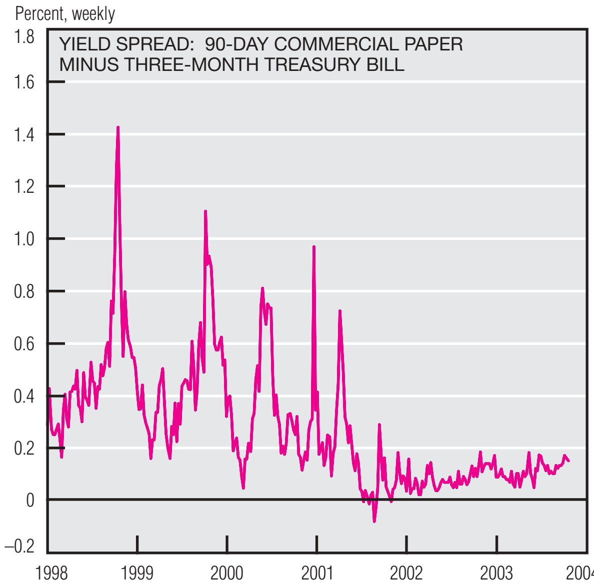
At its October 28 meeting, the Federal Open Market Committee (FOMC) kept the intended federal funds rate at 1%, stating that the "accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity." Nonetheless, the FOMC said that "on balance, the risk of inflation becoming undesirably low remains the predominant concern for the foreseeable future," and reiterated its prior statement that "policy accommodation can be maintained for a considerable period."

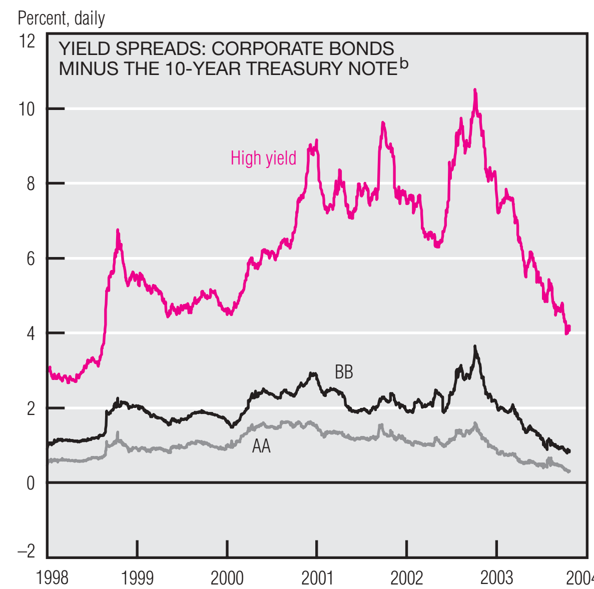
Before the meeting, implied yields on federal funds futures suggested there would be no change in the funds rate on October 28. Since the September meeting, implied yields have increased moderately across the various maturities. Market participants continue to foresee a constant funds rate for the rest of this year and a round of mild tightening in early 2004.

The decision to leave the federal funds rate unchanged did not surprise participants in the options market for fed funds futures at the Chicago Board of Trade; the day before the October meeting, they placed a 92% probability on no change. They had increased their expectations of a 25 basis point increase in previous weeks but reversed themselves in the days just before the meeting.

The yield curve has shifted upward slightly since the September meeting (up 20 basis points for the three-year rate and 10 basis points for the 10-year rate). Ninety-day Treasury bill rates, at 0.95%, remained slightly below the intended federal funds rate, as they have for several months.

Money and Financial Markets





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

Short-term interest rates have been trending downward since late 2000, moving roughly in tandem with changes in the federal funds rate. In fact, the downward trend has moderated since late July, with yields on three- and six-month Treasury bills staying essentially constant during a period when the federal funds rate held at 1%. The one-year Treasury bill rate has varied considerably more during this period.

The spread between the 90-day commercial paper rate and three-month Treasury bill rate has increased moderately since the end of August, possibly because lower-quality issuers began to reenter the market as the expansion proceeded. After falling for two consecutive months, total commercial paper outstanding rose during October.

Significant swings in long-term interest rates have occurred in the last couple of months. From early September to early October, long-term rates fell between 40 basis points (bp) and 60 bp. During the rest of October, the 10- and 20-year Treasury rates retraced most of that decline. The uptick in the conventional mortgage rate was accompanied by a decrease in mortgage applications.

Yield spreads between corporate bonds and Treasury notes have trended downward since October 2002. High-grade, AA-rated bonds show a risk premium of only 30 bp over Treasury notes. The premium on high-yield corporate bonds has fallen nearly 6.5 percentage points since a year ago. The decline in risk spreads should facilitate the expansion of business fixed investment.

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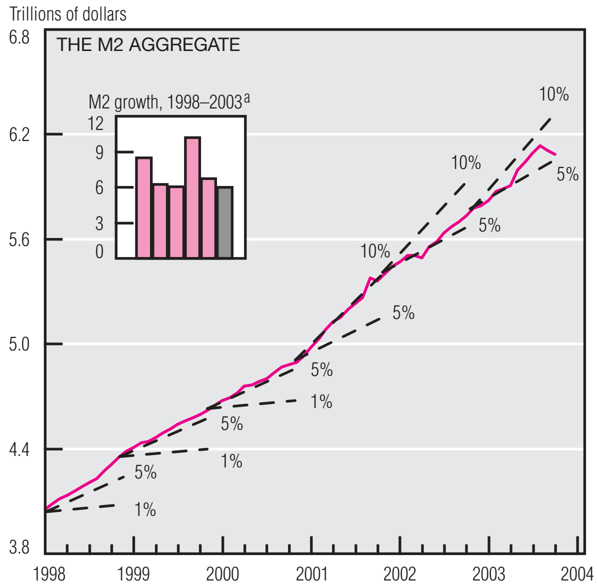
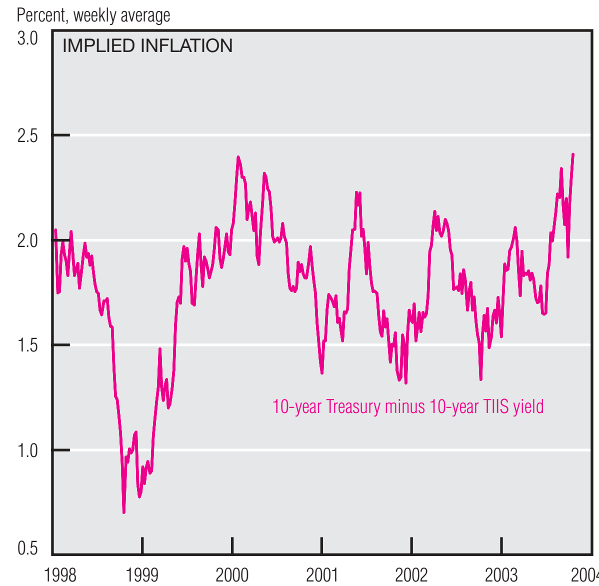
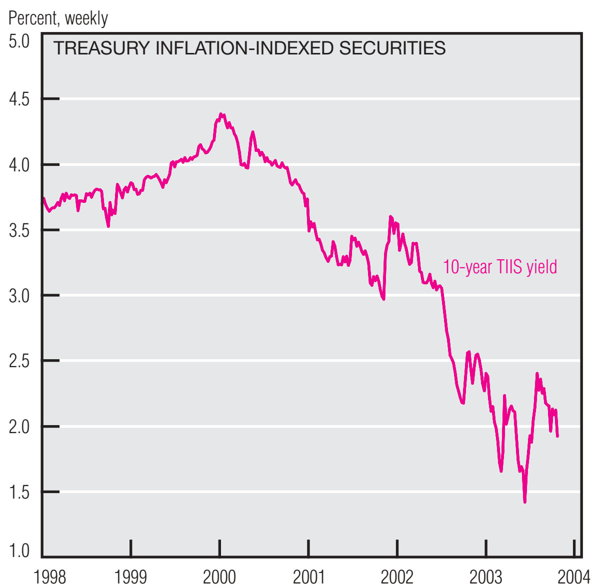
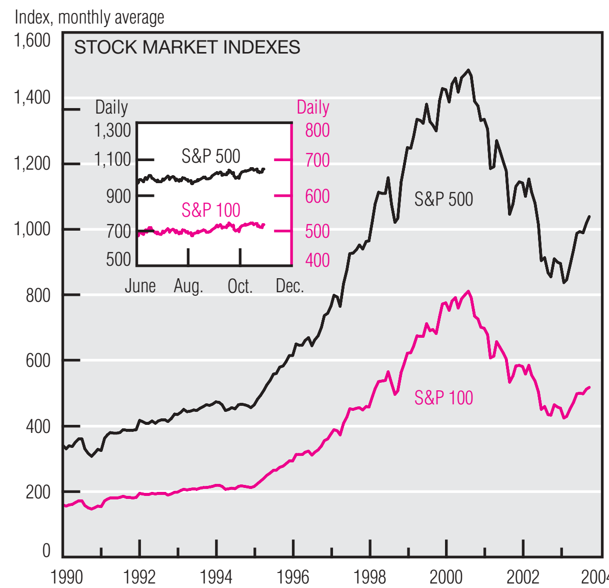
Money and Financial Markets (cont.)









a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2003 growth rate for M2 is calculated on an October over 2002:IVQ basis. Data are seasonally adjusted.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, and "Money Stock Measures," H.6, *Federal Reserve Statistical Releases*; and Bloomberg Financial Information Services.

After increasing almost at double-digit annual rates in June through August, M2 fell at an annual 4.75% rate in September and seems headed toward a decline for October as well. These decreases probably result from a sharp drop-off in mortgage refinancing. Certain prepaid mortgage balances are held temporarily in liquid deposits before being disbursed to mortgage-backed securities holders. A decline in mortgage refinancing reduces these liquid deposits.

A measure of expected inflation can be derived by subtracting the interest rate on Treasury inflation-indexed securities (a real rate) from that on non-indexed Treasury securities (a nominal rate). This measure can fluctuate markedly but has had a generally upward trend throughout 2003. Participants in this market do not expect deflation to be a problem over the horizon of these securities.

Treasury inflation-indexed securities, which measure the economy's real interest rate directly, show a drop of 50 bp in the last three months and currently stand at 1.9%. The average real interest rate from 1997 to the present was nearly 3.4%.

The major stock markets fared well in October, with the S&P 500 price index gaining 1.8%. After hitting a low in February, the S&P 500 was up nearly 24% for the year to date. The decline in real interest rates probably has contributed to the year's strong stock market growth, as have the tax cuts on capital gains and dividends implemented in May. The substantial stock market gains, as well as increased holdings of real estate, helped

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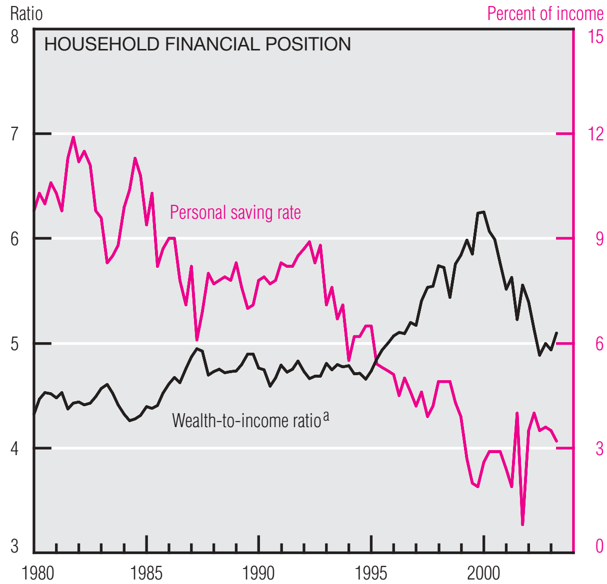
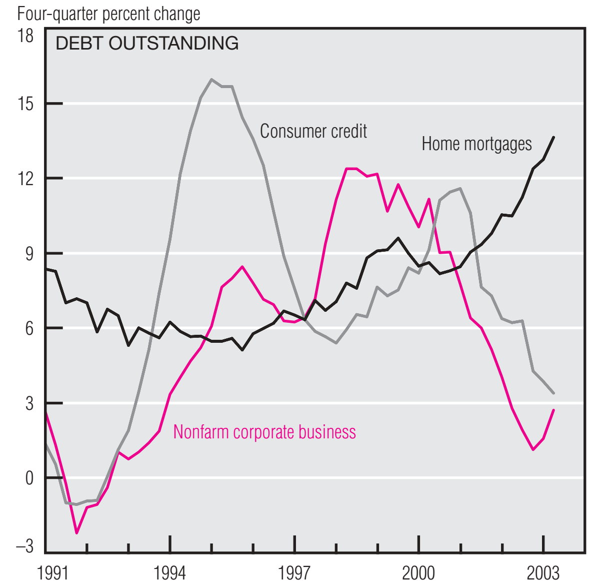
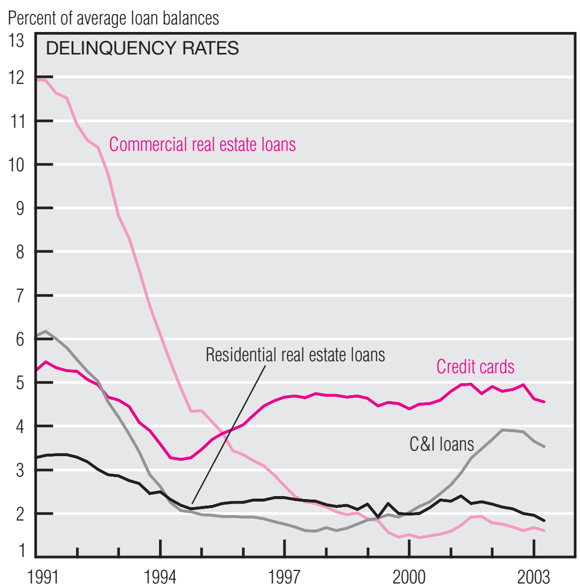
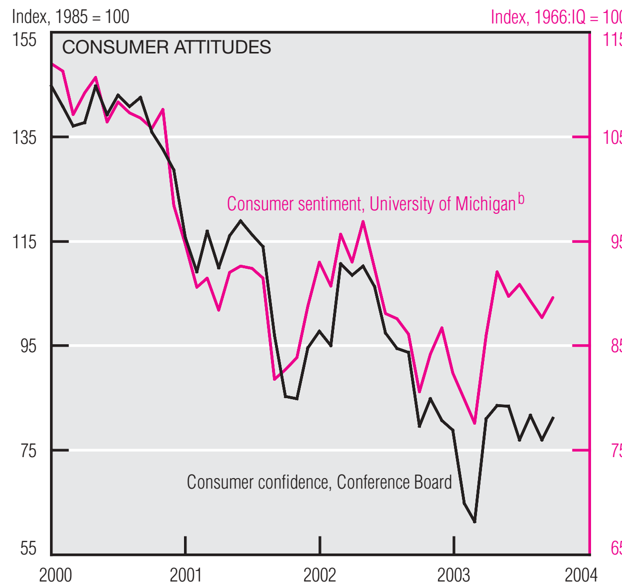
Money and Financial Markets *(cont.)*









a. Wealth is defined as household net worth. Income is defined as personal disposable income. Data are not seasonally adjusted.
b. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," and "Flow of Funds Accounts of the United States," Z.1, *Federal Reserve Statistical Releases*; University of Michigan; and the Conference Board.

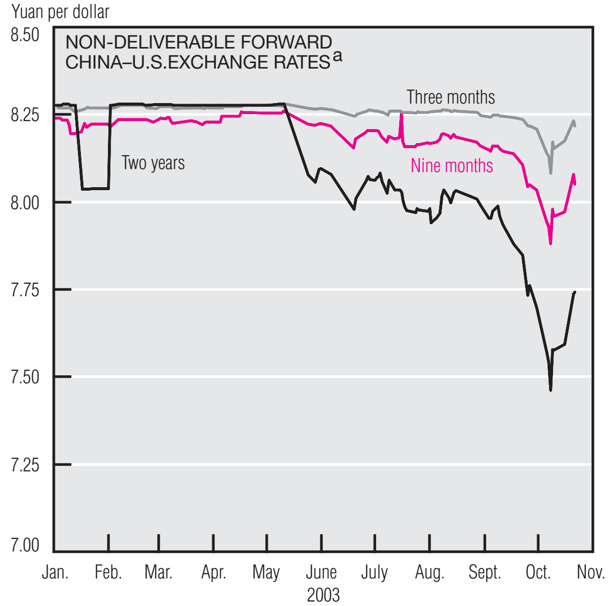
buoy the wealth-to-income ratio over the last few months. The personal saving rate, currently at 3.2%, is less than half its 20-year average.

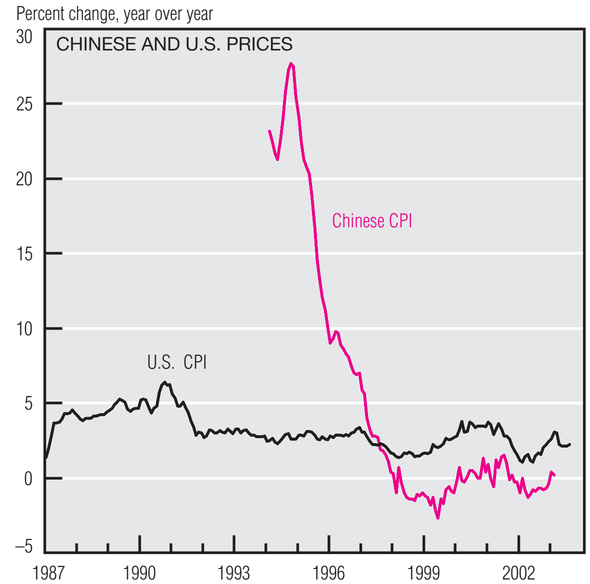
Home mortgage debt grew at brisk double-digit rates in the first half of 2003, but the decline in mortgage applications in the second half may dampen that growth. Cash-out refinancing of mortgages earlier in the year helped homeowners pay down credit card and other high-interest debt, slowing consumer credit growth markedly. Growth in nonfarm corporate business debt remains constrained, partly because rising profits have lessened firms' need for external financing.

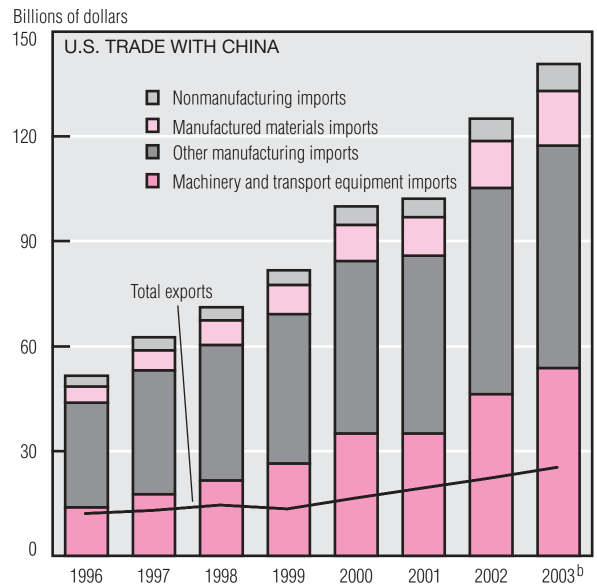
The delinquency rate on commercial and industrial loans moderated during most of 2002 and continued that trend into this year. Falling short- and long-term interest rates, along with slower growth in corporate debt, have facilitated firms' repayment of loans. Consumer credit delinquency rates show similar improvement.

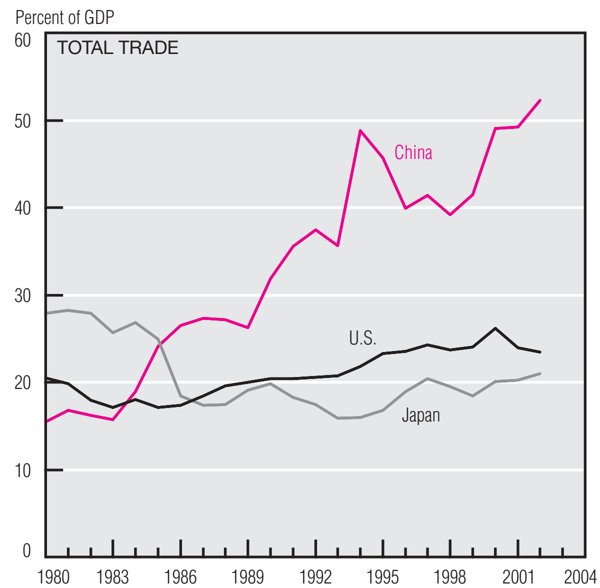
The Conference Board's index of consumer confidence rose slightly in October, but survey respondents expressed concern about their future income levels and the weak labor market. The share of respondents who expect their income to increase in the next six months is at a 10-year low. Nonetheless, the expectations component of the index did increase slightly. The University of Michigan's consumer sentiment index also increased in October, showing small rises in the components for both expectations and present conditions.

China's Trade









a. A rise indicates a depreciation of the renminbi. (China's currency is the renminbi and its currency unit is the yuan. A renminbi consists of one yuan).
b. Annualized by multiplying the total for the first eight months of the year by 1.5.
SOURCES: U.S. Department of Commerce, Bureau of the Census; International Monetary Fund, *International Financial Statistics*; World Bank Group, *World Development Indicators Online*; and William Testa, "Midwest Manufacturing and Trade with China," Federal Reserve Bank of Chicago, *Chicago Fed Letter,* no. 196, November 2003.

There have been many calls for China to stop pegging the yuan–dollar exchange rate in a narrow range around 8.28. Chinese officials have indicated that they will continue to maintain the exchange-rate peg, but will loosen it sometime in the future. Forward yuan–dollar exchange rates are consistent with this: The three-month forward rate recently climbed back close to the pegged rate, and the two-year forward rate is now pricing in a 6.5% decline in the renminbi relative to the dollar.

Why is China being urged to let its currency float? The renminbi is widely considered to be undervalued against the dollar, so that low-priced Chinese exports are hurting domestic manufacturers. Economists typically look at real exchange rates to assess trading advantages. Since the yuan–dollar exchange rate is pegged, real exchange rate changes between the U.S. and China are determined entirely by their differences in inflation. Since U.S. inflation has exceeded Chinese inflation by 2.7% on average since 1998. U.S. imports from China should be getting slightly less expensive relative to domestically produced goods.

Despite these minor changes in recent years, the value of this year's Chinese imports to the U.S. will be nearly twice as big as in 1998, with most of the increase coming from manufacturing. A recent study showed that China's manufacturing import penetration in the U.S.—the ratio of Chinese imports to the domestic manufacturing market—rose from 1.7% in 1997 to 2.7% in 2001. This import surge, apparently without any large change in the terms of trade between China and the U.S., is not surprising in view of some fundamental changes in the Chinese economy. Export-led industrialization, starting roughly with the rise of Deng Xiaoping in December 1978, has helped turn

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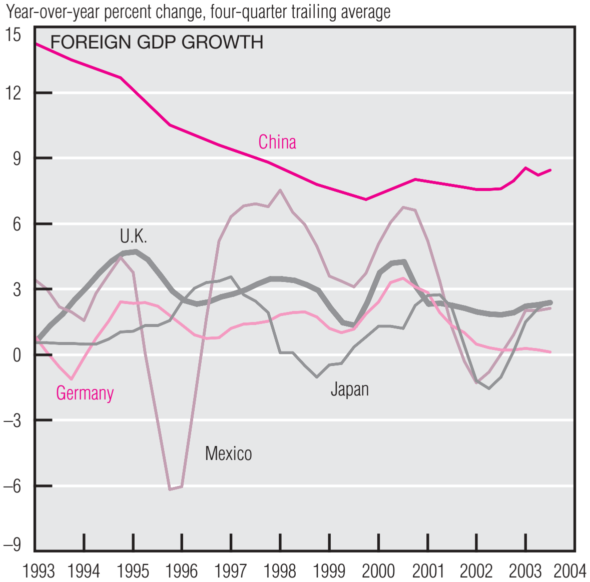
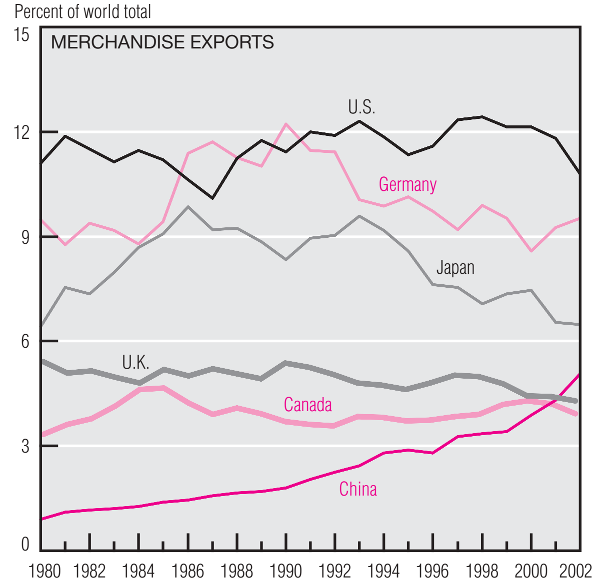
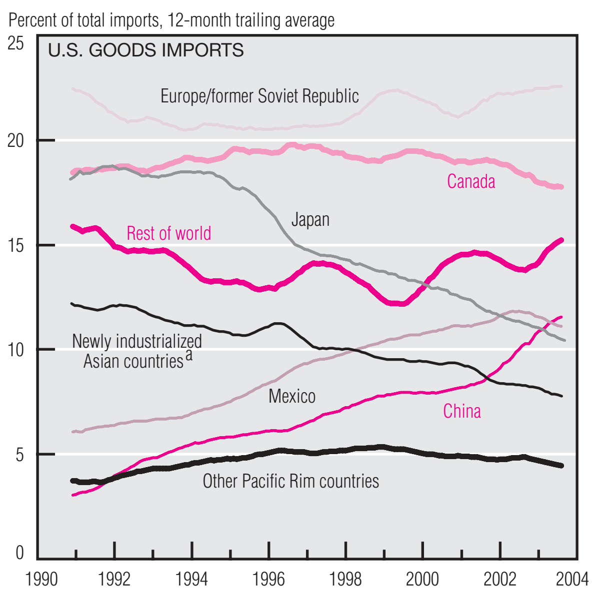
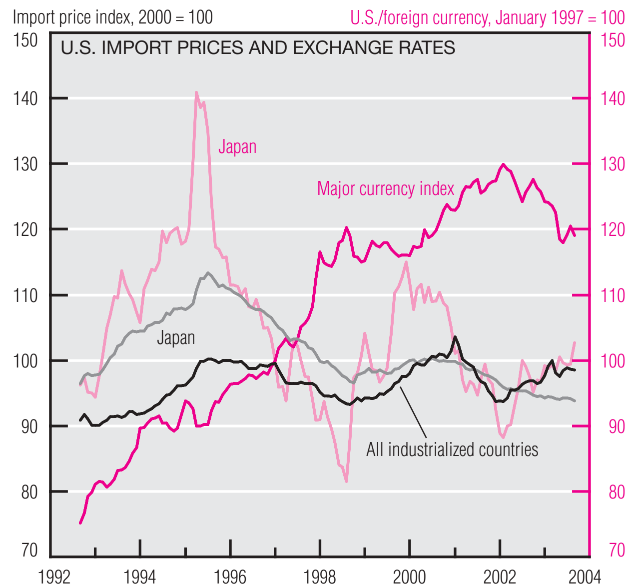
China's Trade (cont.)









a. Hong Kong, Singapore, South Korea, and Taiwan.
SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, G.5; International Monetary Fund, *International Financial Statistics*; and World Trade Organization.

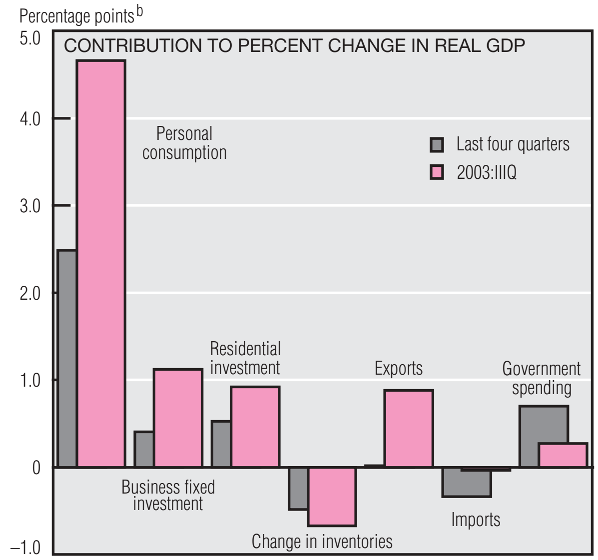
China into a major economic power. Since 1980, its total trade as a share of its GDP has more than tripled—to slightly over 50%. Since 1991, its real GDP growth has exceeded 6% annually. With the combined effects of robust economic growth and a transition toward more foreign trade, China's exports to the rest of the world have boomed. In fact, from 1996 to 2002, China's share of world merchandise exports increased 81%, which is more than the 60% increase in its share of U.S. goods imports. It is uncertain how much this surge in U.S. imports from China has displaced domestic manufacturing. To a large extent, Chinese imports to the U.S. have probably displaced imports from other countries. For example, the import shares of Japan and the newly industrialized Asian countries have been falling since the 1990s; Mexico's share of imports to the U.S. has been falling since about 2002.

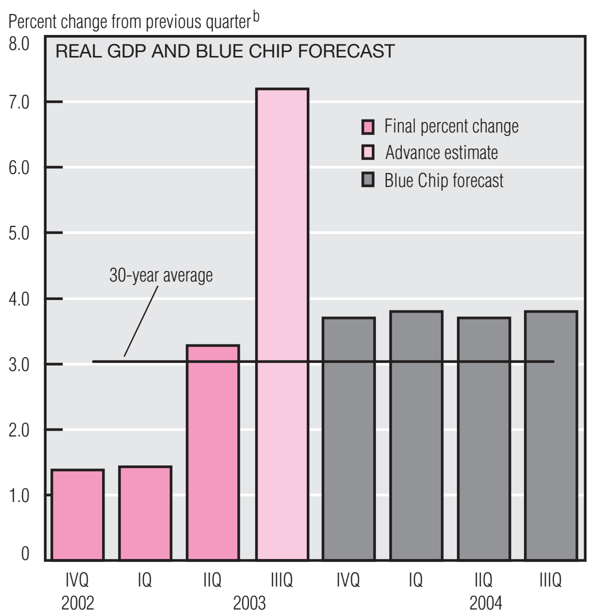
China probably has displaced some domestic manufacturing, but the role of import prices and exchange rates in this displacement is not entirely clear. For example, from 1995 to 1999, prices for Japan's imports to the U.S. fell more dramatically than prices from other industrialized countries, but the U.S. share of Japanese imports continued to drop. Furthermore, even if the renminbi appreciated against the dollar, it is unclear how much it would affect Chinese import prices. Exchange rate changes are not always passed through to changes in import prices, as the case of Japan illustrates. Research has shown that roughly 50% of exchange rate changes were passed through to import price changes in the 1980s but only 25% were passed through in the 1990s. One reason import prices do not respond to exchange rate changes is that some exporters try to maintain volume by accepting lower profits when their currency appreciates relative to the dollar.

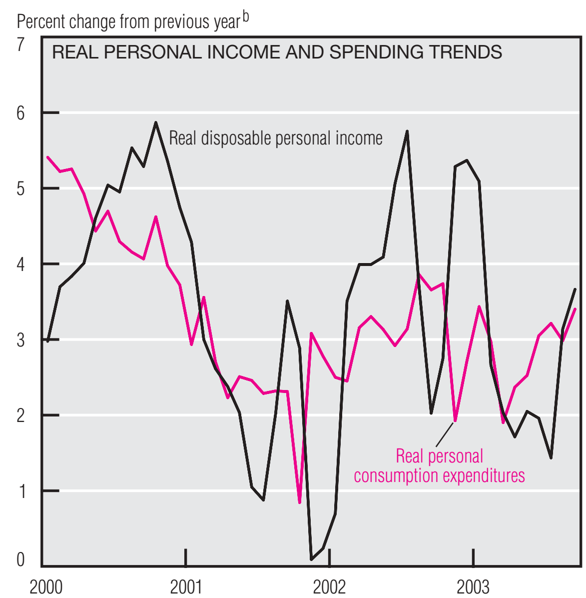
Economic Activity

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

	Change, billions of 1996 $	Annualized percent change, last: Quarter	Annualized percent change, last: Four quarters
Real GDP	167.8	7.2	3.3
Personal consumption	108.2	6.6	3.5
Durables	65.1	26.9	9.1
Nondurables	38.1	7.9	5.1
Services	20.5	2.2	1.7
Business fixed investment	53.8	14.0	6.2
Equipment	36.5	15.4	6.0
Structures	–1.3	–2.4	–2.9
Residential investment	19.6	20.4	11.5
Government spending	5.7	1.3	3.7
National defense	0.0	0.0	11.9
Net exports	23.5	—	—
Exports	23.8	9.3	0.1
Imports	0.3	0.1	2.3
Change in business inventories	–18.2	—	—







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

Real gross domestic product (GDP) skyrocketed to an advance estimate of 7.2%, the highest growth rate since 1984:IQ and a full percentage point higher than most forecasters had expected. (One caution: This number will be subject to more than the usual amount of revision because the series will be re-benchmarked in December.) Consumer spending (6.6%), business fixed investment (14.0%), and residential investment (20.4%) led the way. Foreign trade statistics were also encouraging: Exports surged 9.3%, whereas imports grew a scanty 0.1%. Government spending was up only 1.3%, partly because defense spending was flat. Inventories (down $18.2 billion, the largest decline since 2001:IVQ) and investment in structures (down 2.4%) were the only negative components.

Personal consumption expenditures alone contributed 4.7 percentage points to real GDP growth. Business fixed investment, residential investment, and exports each added about one percentage point. Inventories were the most significant drag, reducing real GDP growth by almost 0.7 percentage points.

While Blue Chip forecasters are optimistic about the outlook for GDP growth in the next few quarters, most expect the rate to fall back toward earth. On average, they anticipate that real GDP growth will be in the range of 3.7%–3.8% over the next four quarters, still well above the 3.1% average observed over the last 30 years. Income and spending numbers appear to support this strong outlook. Over the last year, real disposable personal income rose 3.7%, outpacing real personal consumption expenditures' 3.4% growth rate.

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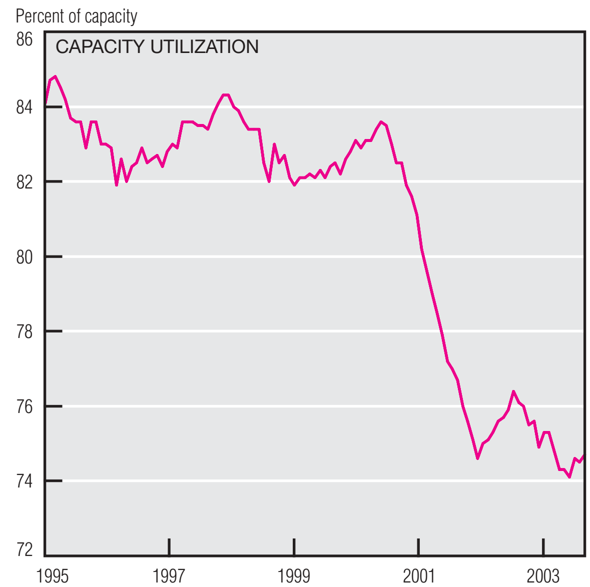
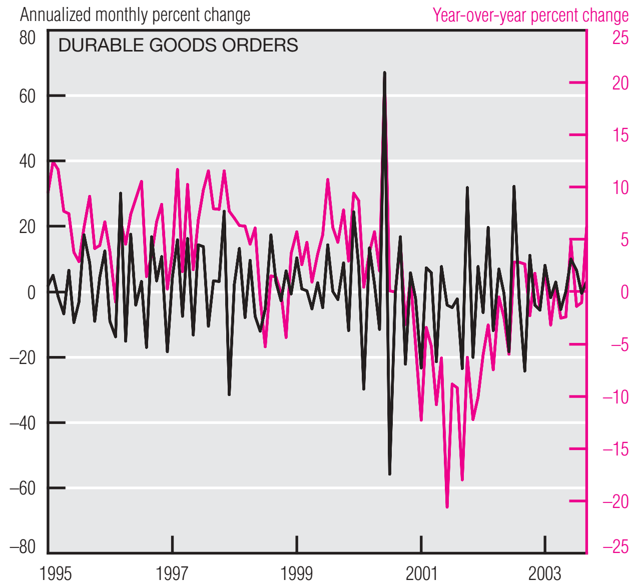
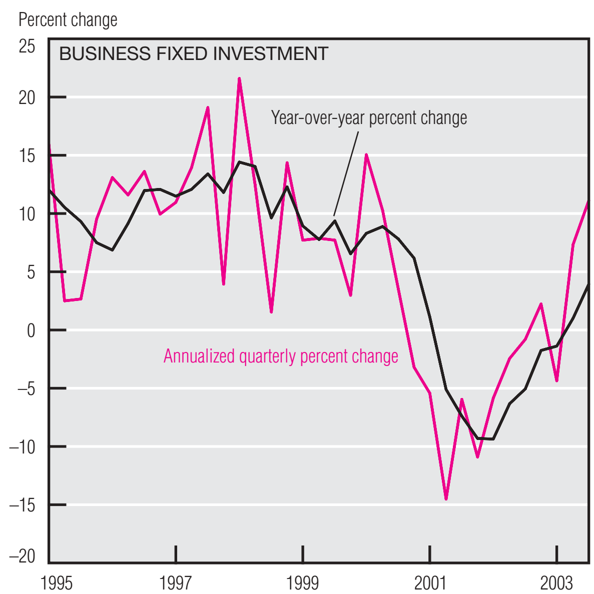
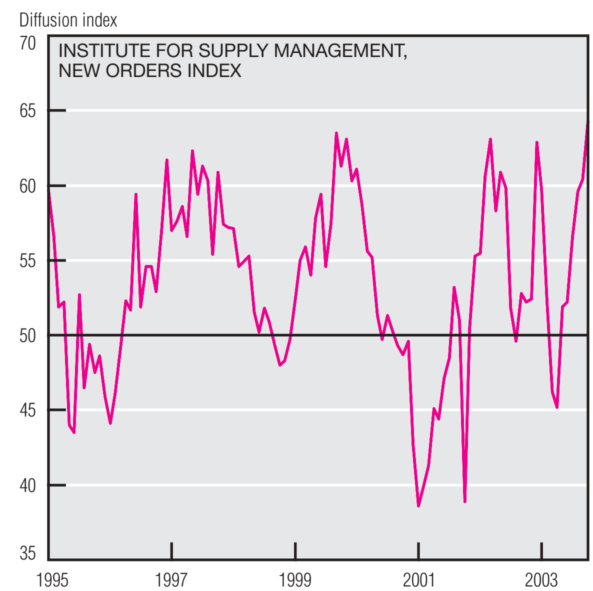
Economic Activity *(cont.)*









SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Institute for Supply Management.

Now that the blockbuster GDP growth of 2003:IIIQ is history, the question is how much of it can be sustained. Many economists believe that the key is whether businesses finally gain enough confidence in the recovery to boost capital spending and hiring. Capacity utilization crawled up to 74.7% after bottoming out at 74.1% last June, but still remains very low.

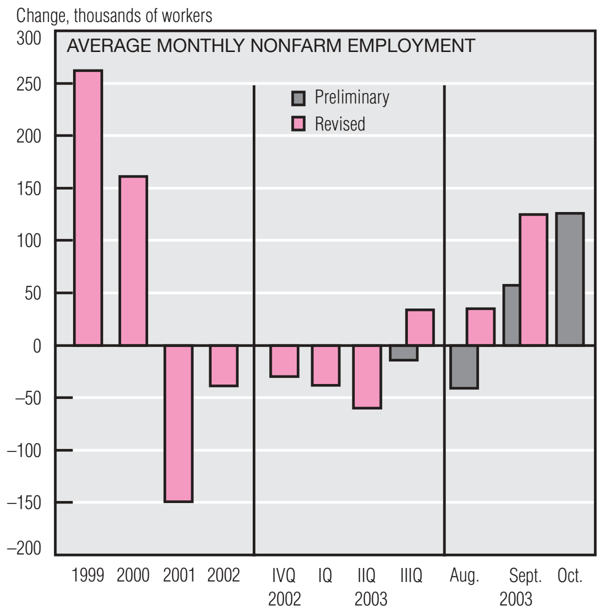
Durable goods orders yield more promising numbers. This is a very volatile series, but an upward trend is apparent in the year-over-year growth rates. This series has rebounded fairly steadily and now stands at 6.2% after bottoming out at –20.6% in June 2001.

Further positive news can be found in business fixed investment. Fixed private nonresidential investment was up 11.1% last quarter, led by spending on equipment and software. On a year-over-year basis, this series grew 3.9%, its first positive change since April 2001.

Moreover, the Institute for Supply Management's New Orders Index soared to 64.3 from an already robust 60.4 and has been above 50 since last May. By construction, this diffusion index is bounded by zero and one, with a number greater than 50 indicating growth. The index is calculated from a monthly survey that asks purchasing managers about the general direction of orders. The survey includes roughly 400 manufacturing firms representing 20 industries and all 50 states.

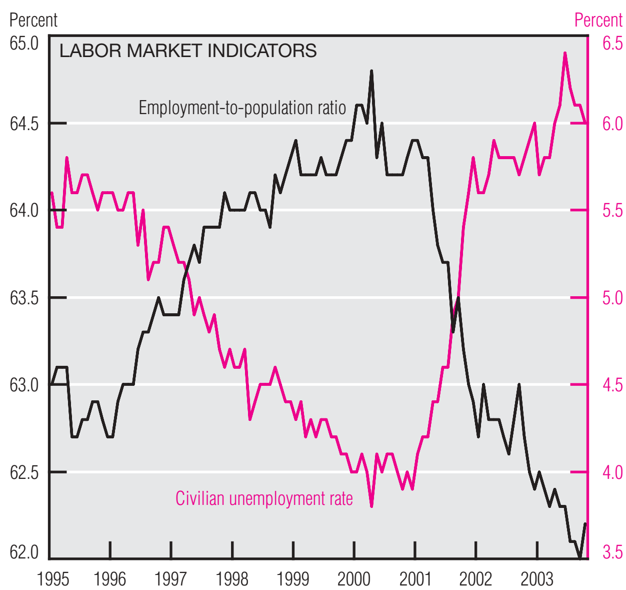
Altogether, it seems likely that the expansion will continue, albeit with real GDP growth in the next few quarters closer to 4% than to last quarter's 7.2%.

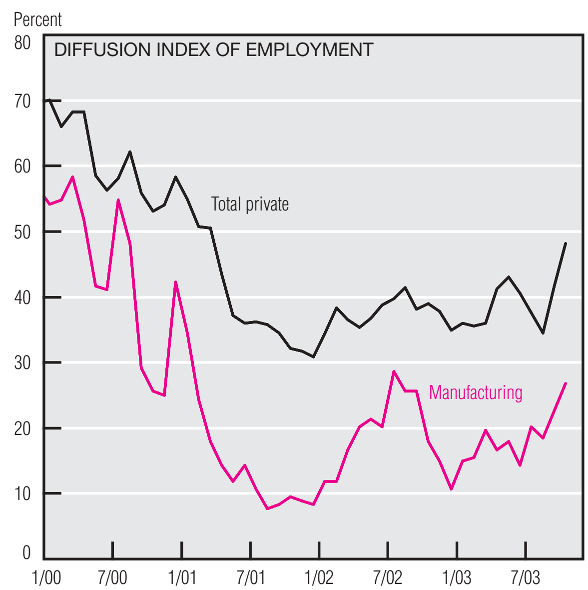
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	2000	2001	2002	Jan.–Sept. 2003	Oct. 2003
Payroll employment	161	–149	–39	–21	126
Goods producing	–1	–124	–64	–39	–17
Construction	7	–1	–4	12	6
Manufacturing	–9	–123	–57	–51	–24
Durable goods	2	–88	–41	–35	–10
Nondurable goods	–11	–35	–16	–16	–14
Service providing	162	–25	25	18	143
Information	15	–15	–14	–10	–8
Financial activities[a]	6	7	5	11	–9
PBS[b]	40	–63	–10	17	43
Education and health	32	51	37	22	56
Leisure and hospitality[c]	22	–2	7	4	23
Government	22	46	16	–9	10
	Average for period (percent)				
Civilian unemployment rate	4.0	4.8	5.8	6.0	6.0





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.

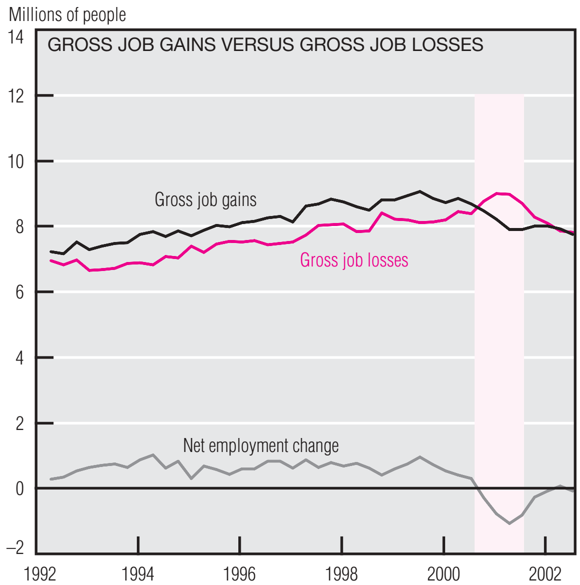
Total nonfarm payroll employment increased by 126,000 jobs in October. Employment numbers for September and August have been revised upward considerably: Instead of a net loss in August, there was a net gain of 35,000 jobs; for September, the net gain was revised upward by 68,000, reaching a total of 125,000 jobs.

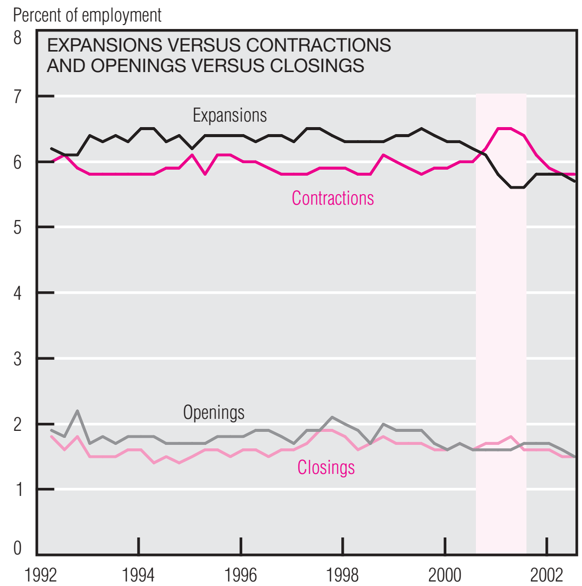
Service providers showed a net gain of 143,000 jobs in October, with 56,000 jobs from education and health services alone. Professional and business services and leisure and hospitality services both remained strong, increasing by 43,000 and 23,000 jobs, respectively. Government employment increased by 10,000 jobs in October, and gains for both August and September were revised upward substantially. Employment in manufacturing continued its downward trend but at a much slower pace, losing 24,000 jobs in October, well below the monthly average net loss of 53,000 in the previous 12 months. Information services, another industry that has been weak throughout 2003 so far, continued to shed jobs, posting a net loss of 8,000 in October.

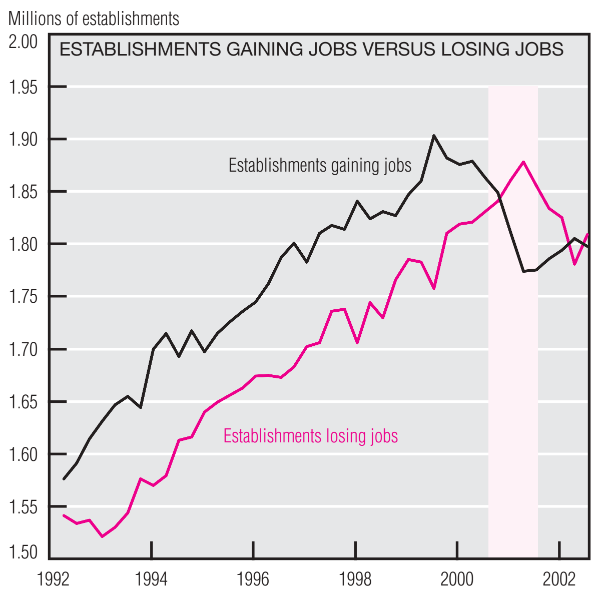
The unemployment rate in October fell 0.1 percentage point to 6.0%, and the employment-to-population ratio rose 0.2 percentage point to 62.2%.

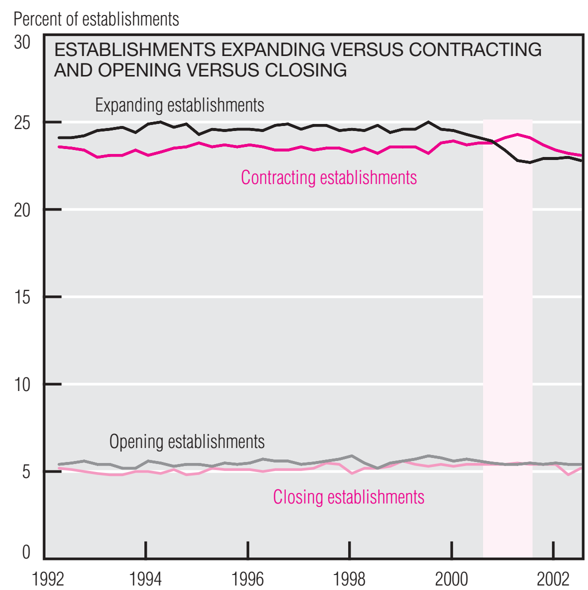
Another positive feature of this report is the greater breadth of employment gains. The three-month diffusion index reports the share of detailed industries in which employment is increasing. For total private employment, the index measured 48.2% in October, the highest since the March 2001 peak. The manufacturing index rose to 26.8%, its strongest reading since July 2002.

Measuring Employment Changes









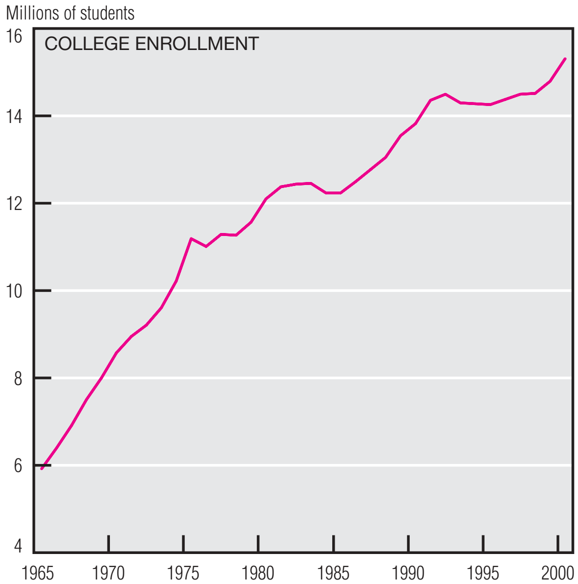
NOTE: All data are seasonally adjusted. Shaded areas mark periods of recession.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

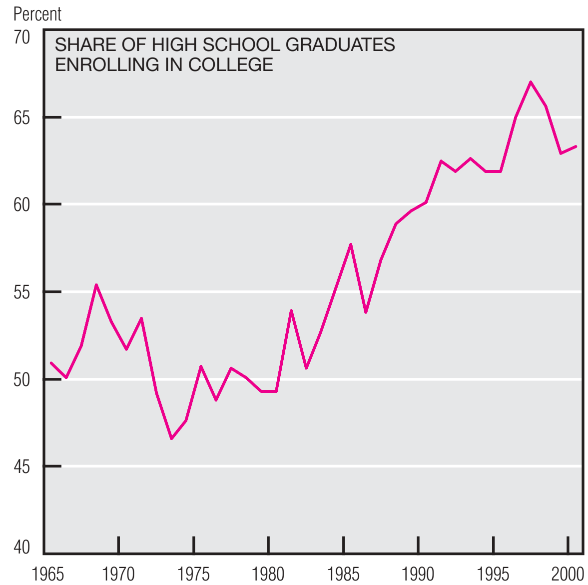
The Bureau of Labor Statistics' new data series, Business Employment Dynamics, measures the gross gains and losses that underlie net changes in employment. Employment expansion at existing establishments and from the opening of new establishments is termed *gross job gains*. Contraction at existing establishments and from establishment closings is termed *gross job losses*. The difference between gross gains and gross losses is *net employment change*.

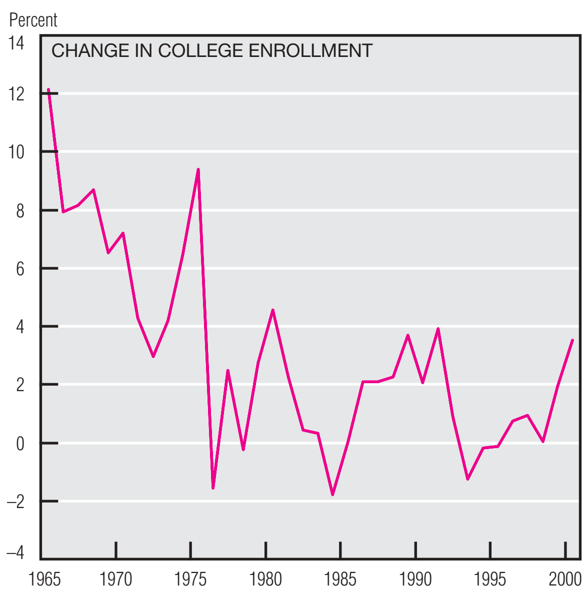
Throughout the expansion phase of the 1992:IIIQ–2000:IVQ business cycle, gross job gains remained slightly larger than gross losses, consistently producing net gains. It is clear that the 1990s trend increase in these series was simply the result of workforce expansion because gross gains and losses, expressed in percentage terms, were strikingly steady. Layoffs and downsizing are often attributed to recessions, yet job losses resulting from contractions and closings were quite steady throughout the 1990s, indicating the layoffs and downsizing occur even when the labor market is operating smoothly.

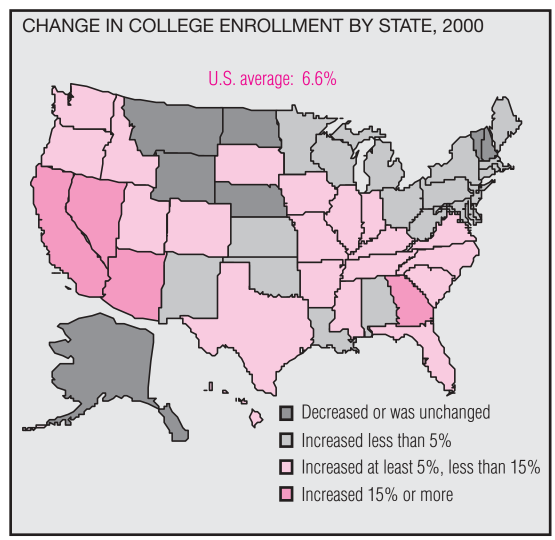
The recession phase of the current business cycle reversed this pattern: Gross job losses rose rapidly while gross job gains declined even more sharply, producing a precipitous employment drop. Surprisingly, after the recession phase, gross job losses declined but gross job gains remained well below pre-recession levels, showing that reluctance to hire workers, not continued layoffs, was the real source of weak employment growth in 2002.

Higher Education Enrollment









SOURCE: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 2002.

In our increasingly high-tech economy, education is becoming ever more important. U.S. college enrollment held steady in the mid-1990s but rose later in the decade, primarily because the number of women attending college increased substantially. In 2000 (the latest data available), more than 15 million students nationwide were enrolled in institutions of higher learning.

Although college enrollment rose in the late 1990s, the percentage of high school graduates enrolling in college declined. After a fairly steady rise that began in the early 1980s, 67% of high school graduates went on to college in 1997, the highest share recorded in the 40 years the Department of Education has tracked matriculation rates. By 2000, however, that share had fallen to slightly more than 63%.

College enrollment growth in recent years has been meager compared with increases in the 1960s and early 1970s. During that period, the nation was shifting away from a manufacturing-based economy, where a high school diploma was enough to land a job that paid well and could last a person's entire working life. The U.S. was developing a service-based economy, where employers wanted people with higher degrees. Typically, in the years following recessions, U.S. college enrollment has shown very meager growth (less than 0.5%) or outright declines. Enrollment was flat or fell in 1976, after the 1973–75 recession; in 1983 and 1984, after the 1981–82 recession; and in 1993–95, after the recession of 1990–91.

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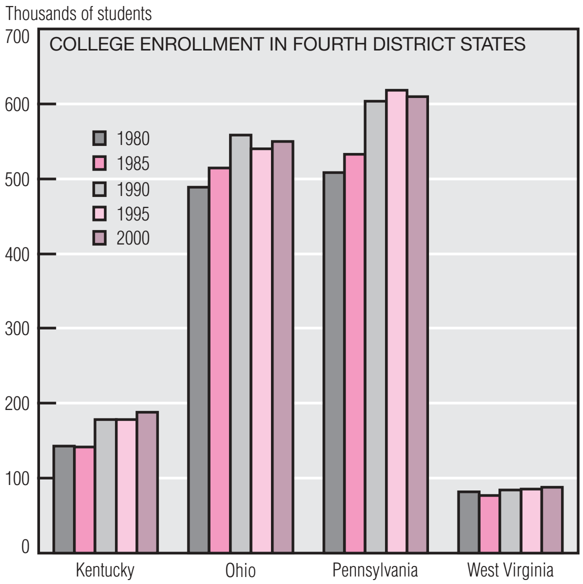
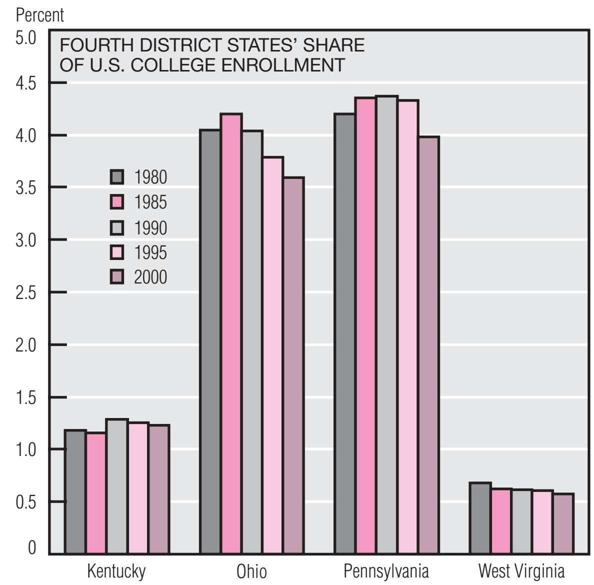
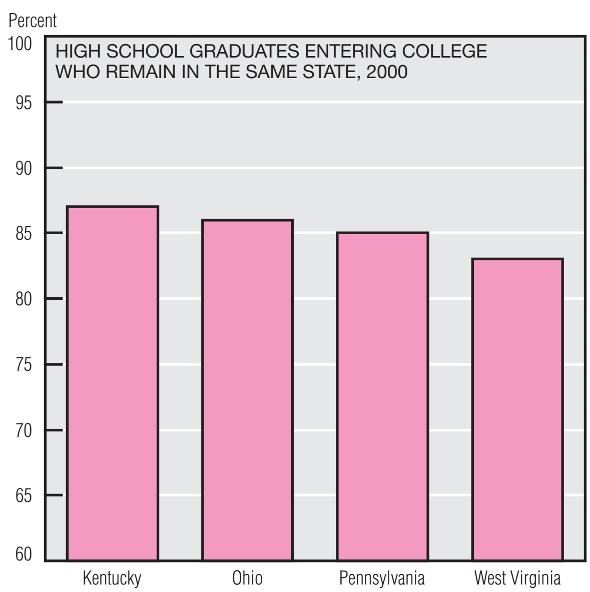
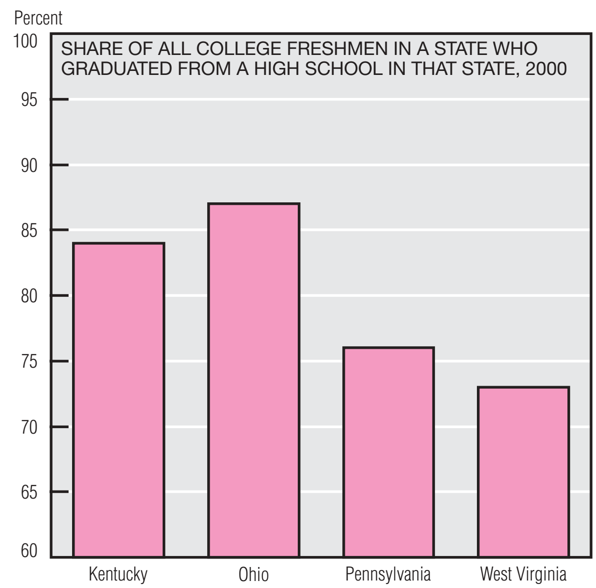
Higher Education Enrollment *(cont.)*









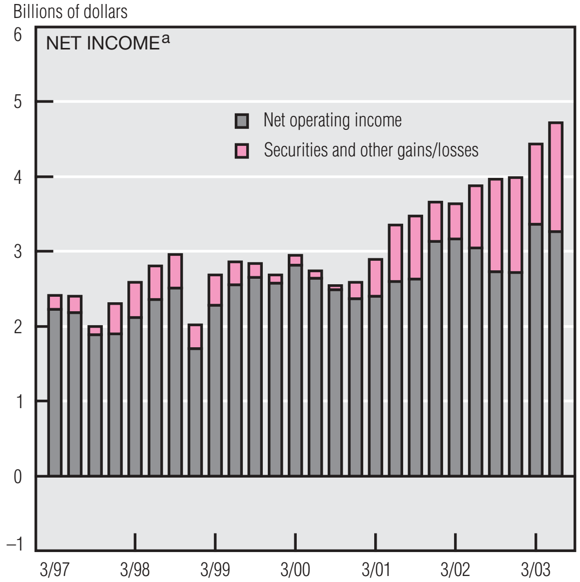
SOURCE: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 2002.

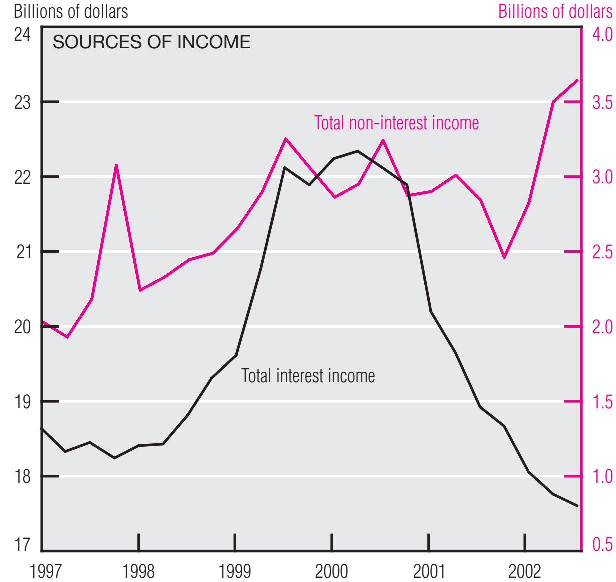
From 1996 to 2000, college enrollment rose 6.6% nationwide. The strongest enrollment growth occurred in California, Nevada, Arizona, and Georgia, where rates exceeded 15%. The Fourth District states of Ohio, Pennsylvania, and West Virginia also experienced some growth over this period, but the rates were well below the national average (1.0%, 3.8%, and 0.9%, respectively). Kentucky fared slightly better, with enrollment growing 5.3% between 1996 and 2000. In all four of the Fourth District states, enrollment has remained relatively steady over the last 10 years: In 2000, enrollment in each Fourth District state was near 1990 levels.

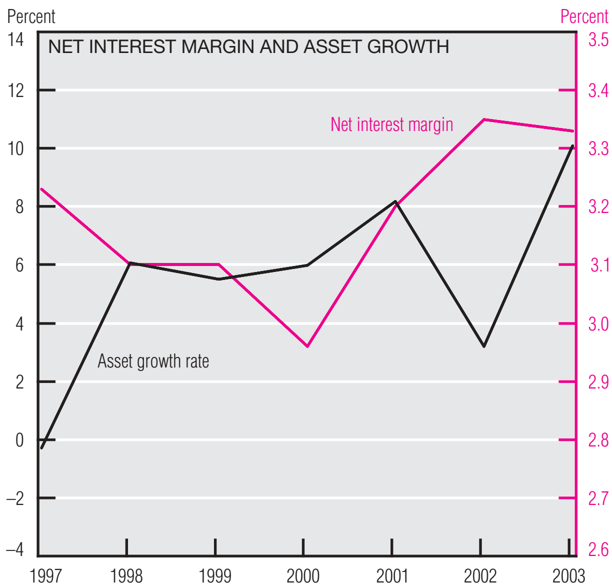
Although enrollment numbers have held their ground, the share of the nation's college students educated in Fourth District states has fallen. Ohio and Pennsylvania have seen the largest drops, losing a combined 1% share of national enrollment between 1985 and 2000.

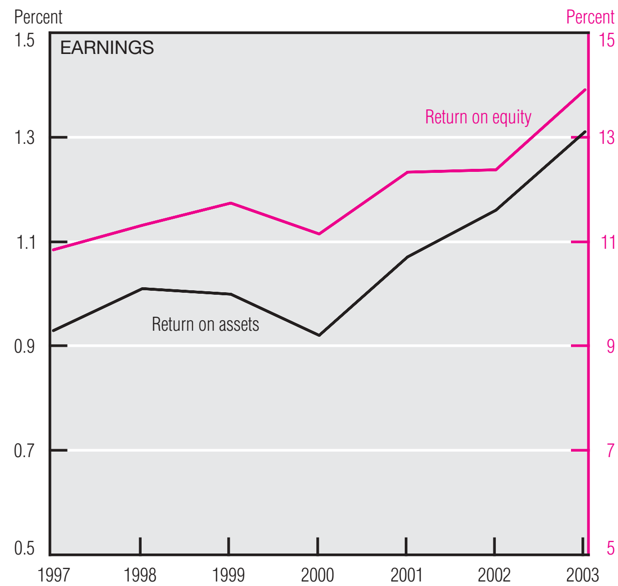
In 2000, more than four out of every five high school students who went on to college in Kentucky, Ohio, Pennsylvania, and West Virginia stayed in their home state (the rates were 87%, 86%, 85%, and 83%). The share of high school graduates remaining in their state as a percentage of all college students in the state varied more widely within the Fourth District: 87% of Ohio college students were graduates of Ohio high schools, whereas only 73% of West Virginia college students had graduated from high schools in West Virginia.

Depository Institutions









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

FDIC-insured savings institutions reported net income of $4.72 billion for 2003:IIQ, $838 million (21.6%) higher than the same quarter a year earlier. Compared to 2003:IQ, this was an increase of $281 million. As in previous quarters, net income was buttressed by one-time gains on the sale of securities, to the tune of $1.45 billion.

S&Ls' non-interest (fee) income stood at $3.64 billion, 28.0% higher than a year earlier. Total interest income continued to fall, reaching a level 6.9% lower than a year earlier. However, the process of re-pricing S&Ls' loan portfolios seems to have been completed toward the end of 2003:IQ. This adjustment resulted in a modest (2.3%) increase in net interest income between 2002:IIQ and 2003:IIQ because reductions in interest income from lending were nearly matched by declines in borrowing costs.

Overall earnings performance continued to be strong despite a small drop in the net interest margin (calculated as interest and dividends earned on interest-bearing assets minus interest paid to depositors and creditors, expressed as a percentage of average earning assets). S&Ls' net interest margin declined slightly from 3.35% in 2002 to 3.33% in 2003. Although S&Ls' assets grew at a rate of 10.08% on a year-over-year basis, their net income grew at a 21.6% rate

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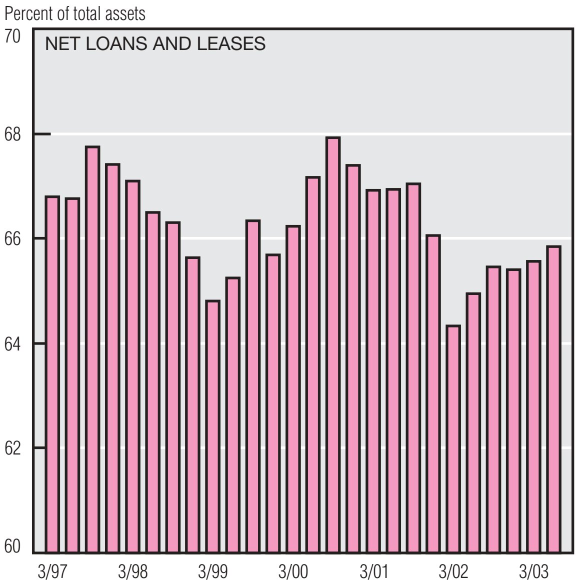
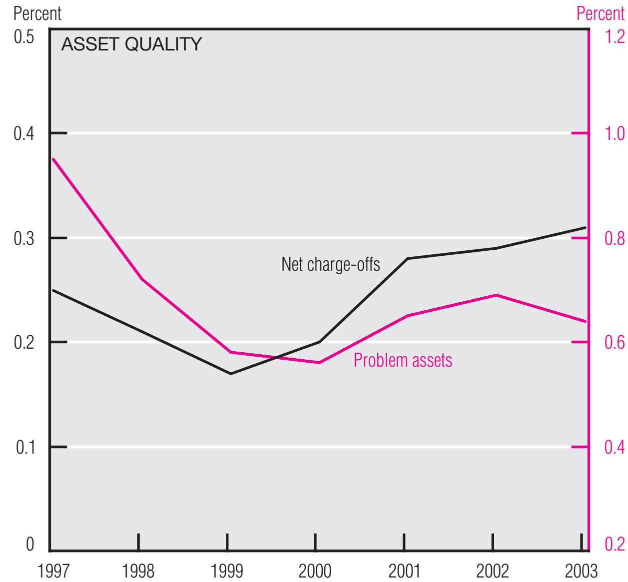
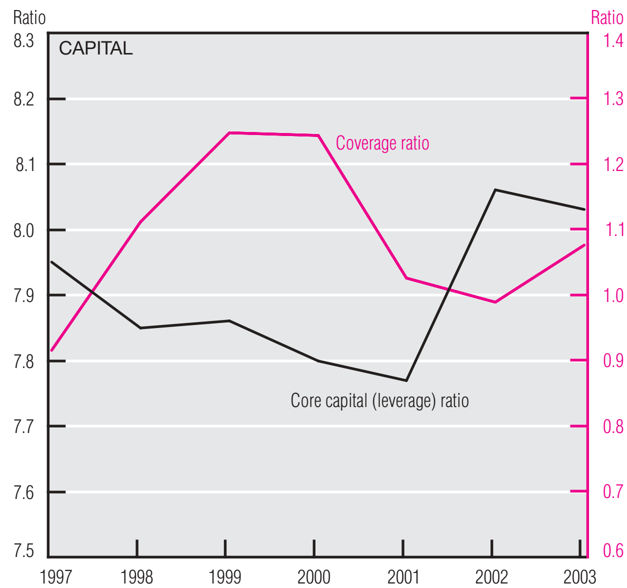
Depository Institutions *(cont.)*







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

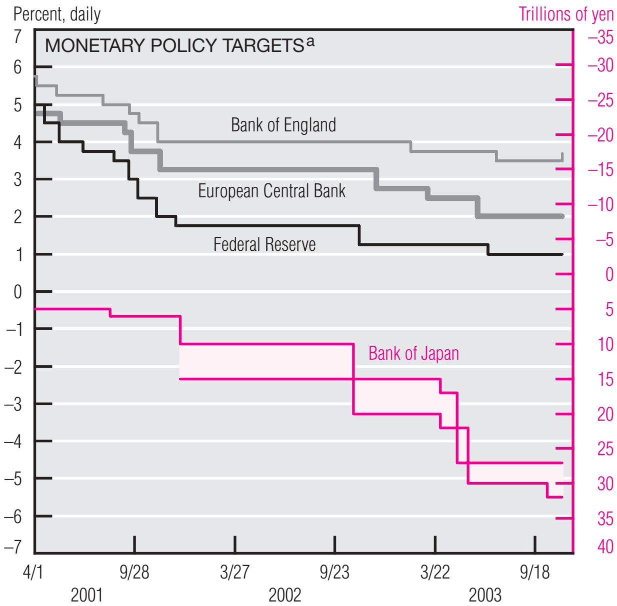
over the same period, raising the return on assets to 1.31% and the return on equity to 13.91%.

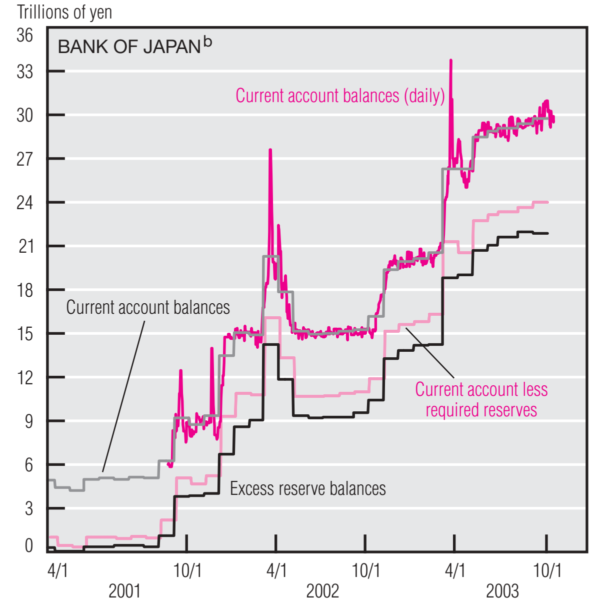
In 2003:IIQ, net loans and leases as a share of total assets (65.8%) were up slightly from the previous quarter. This is lower than its recent high of 67.9% in 2000:IIIQ, indicating a continued decline in S&Ls' direct loan holdings.

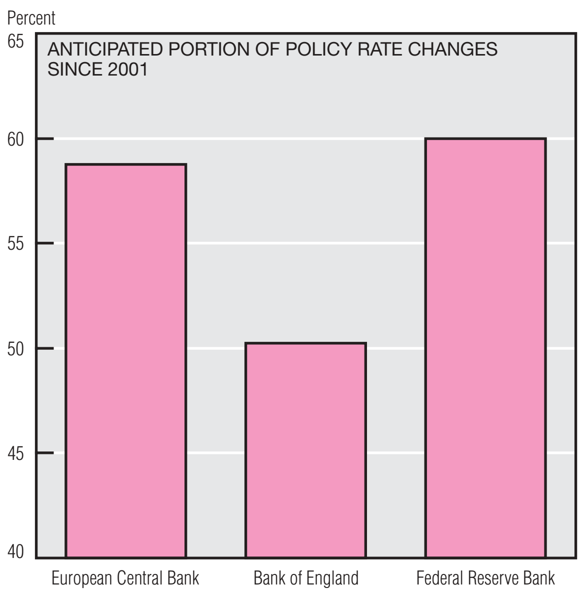
Asset quality showed mixed signs in 2003:IIQ. Net charge-offs (gross charge-offs minus recoveries) rose to 0.31%. Problem assets (non-current assets plus other real estate) made up 0.64% of total assets, which represented only a slight decrease in the problem asset ratio from its 2002 level of 0.69%.

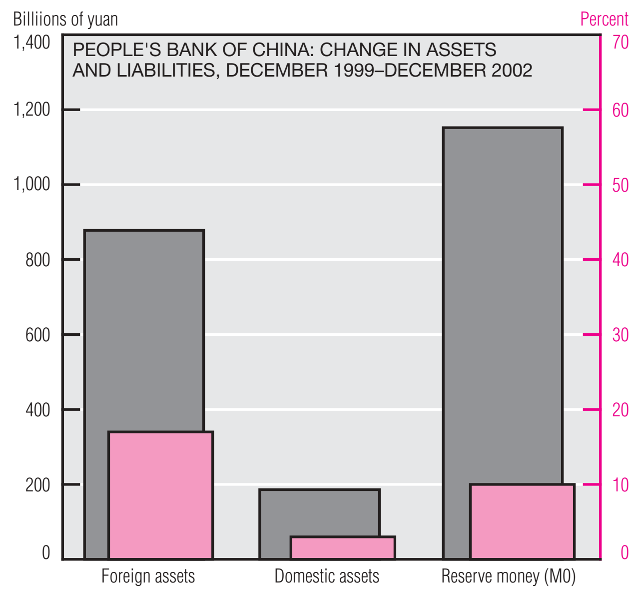
However, asset quality is not a significant problem for FDIC-insured saving institutions. Problem S&Ls (those with substandard exam ratings) declined significantly to 0.84% in 2003:IIQ from 1.16% in 2002. The percent of unprofitable institutions has been falling and now is 4.95%. The coverage ratio stands at $1.08 in loan loss reserves for every dollar of non-current loans. The increase in the coverage ratio since the previous quarter resulted from a $231 million increase in loan loss reserves, coupled with a $288 million decline in non-current loans during the same period. Core capital, which protects savings institutions against unexpected losses, decreased to 8.03% in 2003:IIQ 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 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: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; People's Bank of China; Wholesale Markets Brokers Association; and Bloomberg Financial Information Services.

Major central banks have not moved in concert lately. The Bank of Japan made another easing adjustment, raising the top of its target range for current account balances. The Federal Reserve and European Central Bank maintained policy unchanged. The Bank of England tightened by raising its repo rate 25 basis points to 3.75%—a change that was widely expected after a narrow vote against tightening in October. Indeed, markets generally anticipate changes in policy. Both the Federal Reserve and the Bank of Japan recently have considered improving transparency in communicating policy intentions. The appointment of a new European Central Bank president has spurred conjecture about changes in that bank's format for communicating policy decisions.

Transparency implies that actual changes in a policy setting will be anticipated, with no reaction of market interest rates. Comparing the average change in the one-month riskless rate from the day before a change in the policy target to the day after suggests that policy actions are largely anticipated. Over the past two years, on average, 60% of the amount of each change in the policy rate was anticipated in both the U.S. and the euro area; in the U.K., the average was about 50%.

The fixed exchange rate of the People's Bank of China has attracted much attention. Preventing appreciation has required sizeable purchases of foreign exchange. Over the three most recent years for which data are available, rapid accumulation of foreign exchange by the People's Bank was accompanied by rapid growth of reserve money, with virtually no purchases of domestic assets.