

The Economy in Perspective

I am extraordinarily patient provided I get my own way in the end.

—Margaret Thatcher

At the conclusion of its January 28 meeting, the Federal Open Market Committee issued a press release stating that it “could be patient in removing its accommodative policy stance.” Stock and bond markets, which had placed heavy odds against such a message, immediately sold off.

Not surprisingly, certain talking heads initially pronounced some harsh words about the Fed on the evening news, but quickly enough, other voices pointed out that the FOMC had not, in fact, increased interest rates. The real news lay in the change of tone regarding how much time the FOMC expects to elapse before it acts. Instead of repeating its earlier language that it would be “accommodative for a considerable period of time,” the FOMC said that “with inflation quite low and resource use slack, the Committee believes it can be patient in removing its policy accommodation.”

That the FOMC eventually must hike the federal funds rate seems obvious. At 1 percent, the rate is likely to be several hundred basis points below its natural rate—the rate consistent with price stability in an expanding economy whose productive resources are fully employed. By holding the funds rate very low for a long period of time, the FOMC has been accommodating liquidity requirements, stimulative fiscal policies, and natural market forces working to repair imbalances and propel the economy forward. As these forces increasingly take hold, the need for monetary and fiscal policy “scaffolding” should lessen. Indeed, in the case of monetary policy, maintaining an easy stance too long could ultimately accelerate inflation.

Although market participants and policymakers recognize that extremely accommodative monetary policy cannot be maintained indefinitely, judging when and how to throttle back involves elements of the unknowable. Central bank actions affect inflation most importantly several years into the future. In the shorter run, the inflation process is governed by millions of decentralized wage and price decisions that themselves depend heavily on inflation expectations.

With actual and expected inflation very low, businesses facing slack labor markets and idle industrial capacity might find that price increases will not stick—in fact, expectations of such failures might keep businesses from even trying.

Inflation expectations are poised on a balance point today. Some analysts, looking ahead, anticipate that the rapidly expanding economy will quickly lose whatever slack remains. They surmise that inflation could easily accelerate somewhat next year and beyond, unless the Fed prepares to act against it. Other analysts, judging the amount of slack to be considerable and the FOMC’s surveillance to be vigilant, are less animated. Consequently, even though it seems unlikely that inflation in the United States will decline further from this point, it could be quite some time before the expansion’s dynamics translate into significant overall inflationary pressures.

The FOMC’s statement about being patient before removing its policy accommodation seems intended to respond to the concerns of one camp without alarming the other. Market participants expect the FOMC to sift through the incoming economic data, revise its thinking about policy, and remain prepared to respond flexibly to developing circumstances. In the short term, markets can be highly sensitive to incoming information of all kinds, including the FOMC’s assessment of further disinflation and the degree to which it might be regarded as unwelcome.

How the economy will evolve remains, as always, to be seen. It is often tempting and usually a mistake to think either that the economy is charting entirely new territory or that it follows a predictable cyclical course. Two of the earliest students of U.S. business cycles, Wesley Mitchell and Arthur Burns, observed that although business cycles displayed some common patterns, each cycle also had its idiosyncratic components. We tacitly acknowledge this insight when we give a particular episode a name, such as “the jobless recovery.” The irony, of course, is that the original “jobless recovery” (1990–92) has already been replaced by another, more pronounced one. We are still too close to this episode to know by what name it will ultimately be remembered.

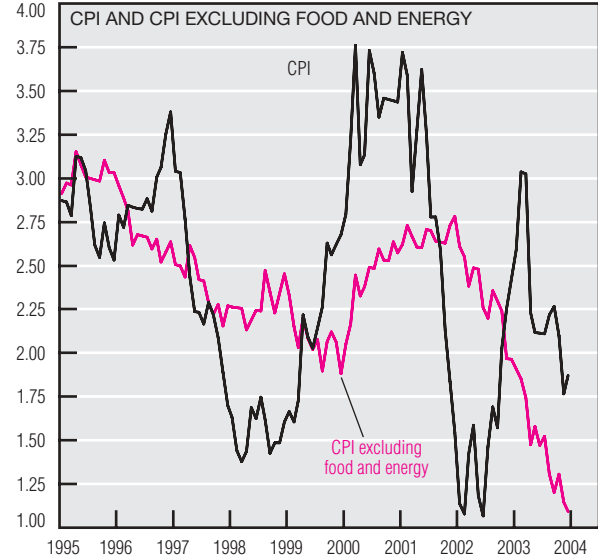
To learn that, we must be patient—at least for a period of time.

Inflation and Prices

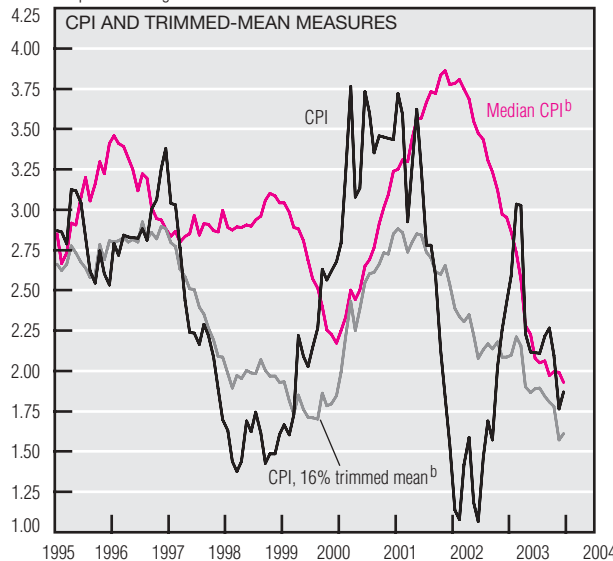
December Price Statistics

	Percent change, last:				2002 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	2.6	0.0	1.9	2.4	1.9
Less food and energy	1.2	1.0	1.1	2.1	1.1
Median ^b	1.6	2.2	1.9	2.8	1.9
Producer prices					
Finished goods	3.4	3.1	4.0	2.0	4.5
Less food and energy	-1.6	1.3	0.9	0.7	1.0

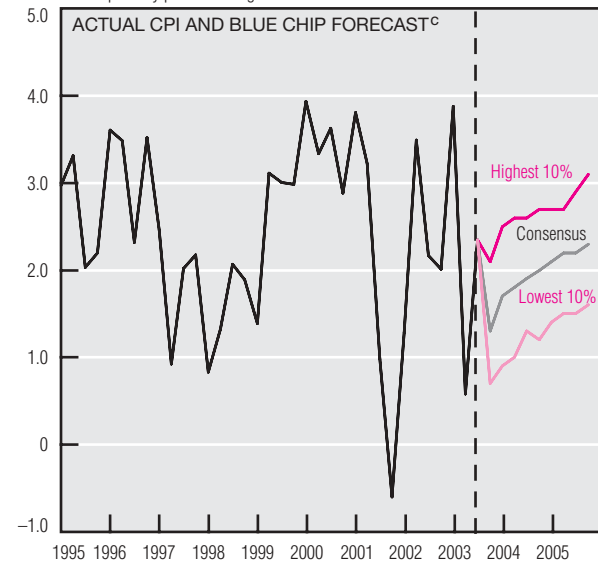
12-month percent change



12-month percent change



Annualized quarterly percent change



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*, January 10, 2004.

The general disinflation trend observed in the year-over-year comparisons continues. The Consumer Price Index (CPI) posted an annualized 2.6% increase in December after a 2.6% annualized *decrease* in November, resulting in an index level consistent with the September and October CPI. Meanwhile, the core CPI, a closely watched measure of inflation that eliminates the CPI's volatile food and energy components, increased at a 1.2% annualized rate—an uptick from last month's uncharacteristic 0.6% decline in the core index. The median

CPI and the 16% trimmed-mean CPI, inflation measures designed to exclude the most extreme price changes, increased at annualized rates of 1.6% and 2.5%, respectively.

The 2003 growth rates for both the core CPI and the median CPI were roughly 1 percentage point less than in 2002—the core CPI rose 1.1% in 2003 compared with a 1.9% rise in 2002, while the median CPI rose 1.9% in 2003 versus a 3.0% rise in 2002.

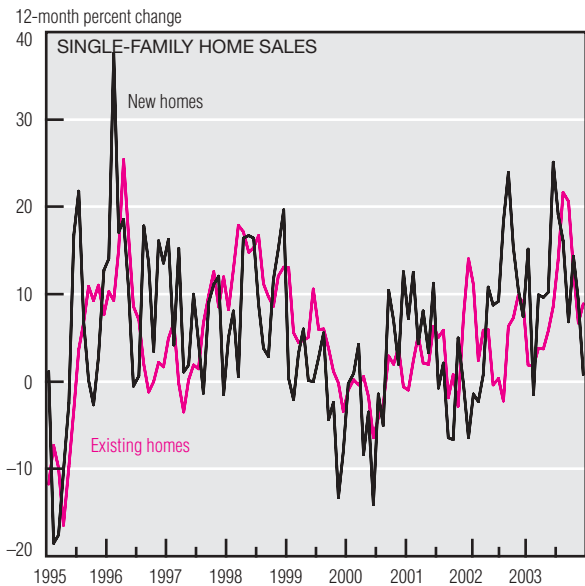
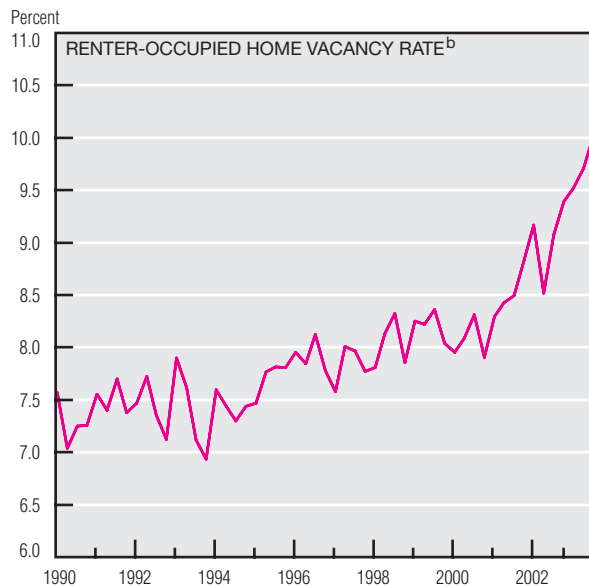
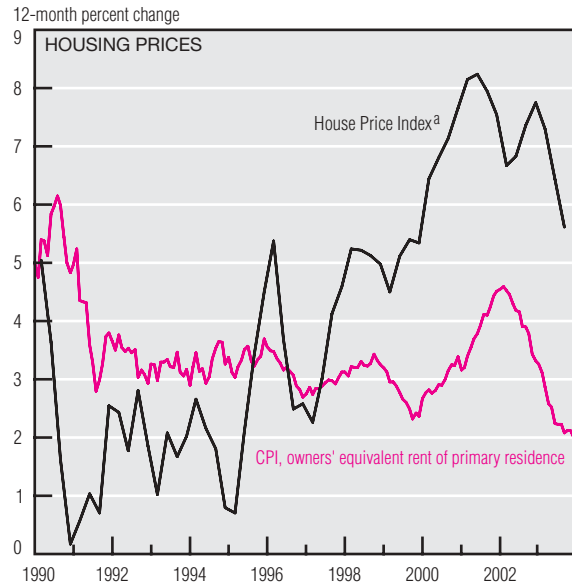
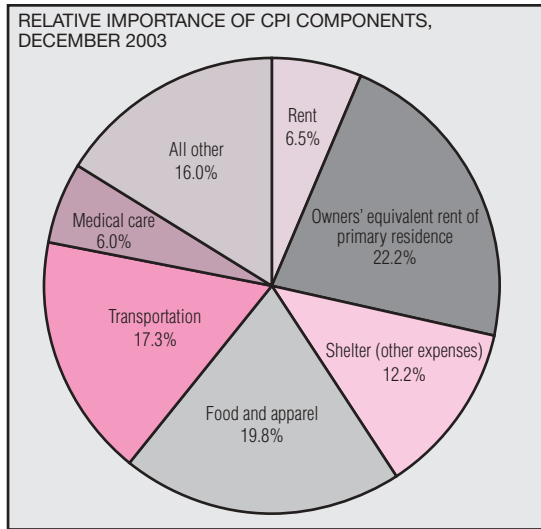
The latest CPI consensus forecast by the Blue Chip panel of economists now predicts an average 1.7% inflation

rate in 2004, compared with 1.9% last month. Although the range of individual panelists' inflation forecasts has widened, both the optimists and the pessimists have generally lowered their quarterly forecasts for 2004, with the optimists predicting a CPI inflation rate of about 1.2% by the end of the year and the pessimists expecting 2.7%. The CPI inflation forecasts for 2005 show consensus expectations of 2.3% by the end of 2005.

The Bureau of Labor Statistics attributes the diminished 2003 core CPI growth rate to a deceleration

(continued on next page)

Inflation and Prices (cont.)



a. Calculated by the Office of Federal Housing Enterprise Oversight.

b. Vacant housing units available for rent year-round divided by the sum of owner-occupied housing units and vacant housing units available for rent year-round.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Office of Federal Housing Enterprise Oversight; and National Association of Realtors.

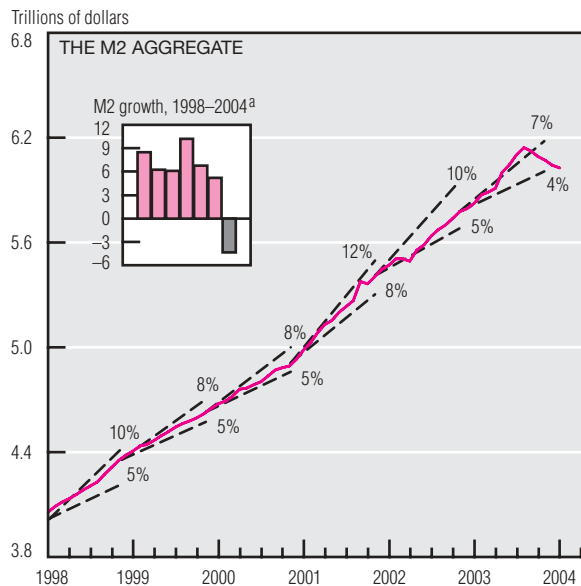
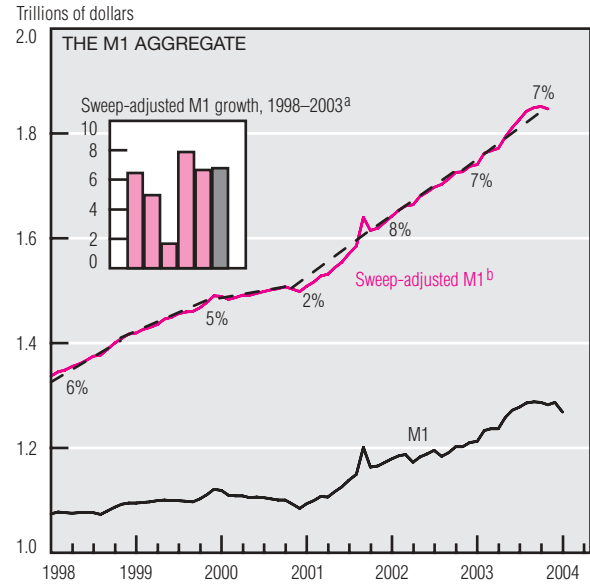
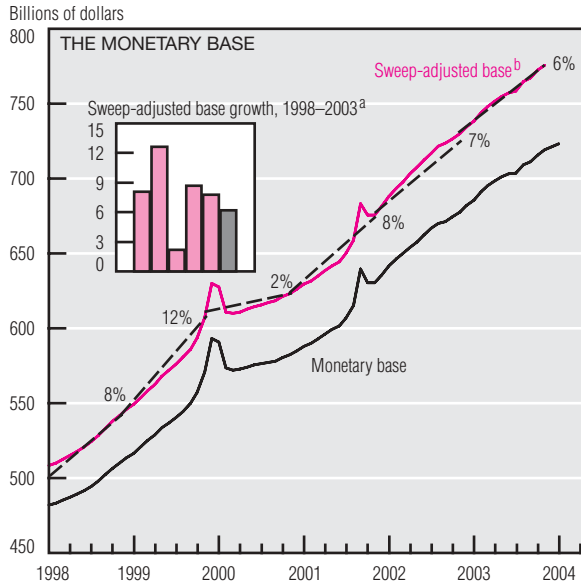
in shelter costs, which increased 2.2% in 2003 compared with the 2002 rise of 3.1%. Shelter costs are the largest CPI component, accounting for over 30% of the index's basket of goods. The owners' equivalent rent of primary residence (OER)—the cost that homeowners would assume if they rented their house instead of owning it—is responsible for 70% of shelter costs and 22.2% of the overall CPI. The OER also decelerated in 2003, rising 2.0% versus 3.3% in 2002. However, the OER may understate

inflationary pressures from the housing market because it is computed using rental prices, which are likely to have been negatively affected by the relative attractiveness of homeownership.

The House Price Index, compiled by the Office of Federal Housing Enterprise Oversight using data provided by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, also reveals disinflating home prices. However, the House Price

Index still maintains a 5.6% growth rate, 3.5 percentage points higher than OER growth. The discrepancy between the growth rate of house prices and the OER results from a combination of strong home sales and a related increase in rental vacancies. In September 2003, rental vacancies reached 10% (the highest since at least 1965, when the rate was first computed), and existing one-family home sales reached near-peak growth rates, increasing 20.6% on a year-over-year basis.

Monetary Policy



Growth Rates of Monetary Components (percent)

	Annual						Average, 1998–2002
	1998	1999	2000	2001	2002	2003	
Monetary base ^c	8.1	12.6	2.2	8.7	7.8	6.2	7.9
M1 ^d	6.5	5.0	1.7	7.9	6.7	6.8	5.8
M2	8.5	6.3	6.1	10.2	6.8	5.2	7.2
Currency	8.4	11.1	4.3	9.1	8.2	6.0	8.2
Total reserves	-3.1	-7.2	-6.2	8.8	-6.7	9.5	-2.9
Checkable deposits ^e	-2.1	-4.8	-6.8	4.9	-1.6	7.5	-2.1
Money market funds	23.0	13.7	11.4	8.2	-6.0	-11.5	10.1
Small time deposits	-1.3	-0.7	9.5	-4.9	-9.0	-9.7	-1.3
Savings deposits	14.0	10.1	6.6	21.7	21.1	15.1	14.7

a. The far-right bars refer to the most recent data available. Growth rates are calculated on a fourth-quarter over fourth-quarter basis except for the far-right bar for M2, which refers to the annualized year-to-date growth rate from 2003:IVQ to January 2004. All 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.

c. Refers to the sweep-adjusted base.

d. Refers to the sweep-adjusted M1.

e. Refers to demand deposits and other checkable deposits.

SOURCES: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6.

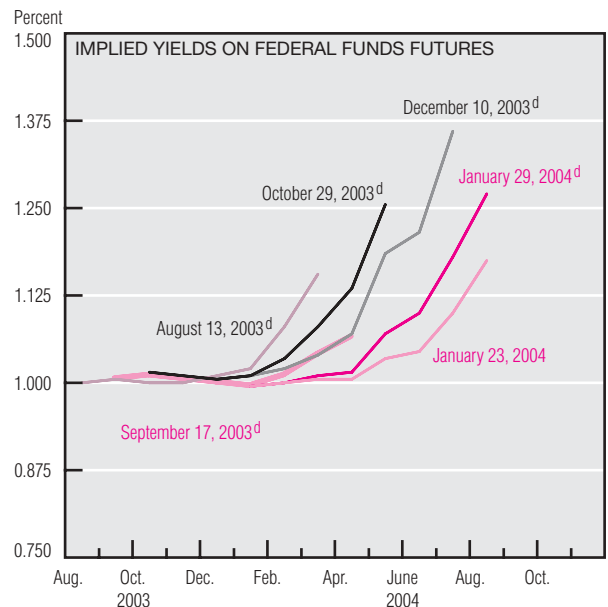
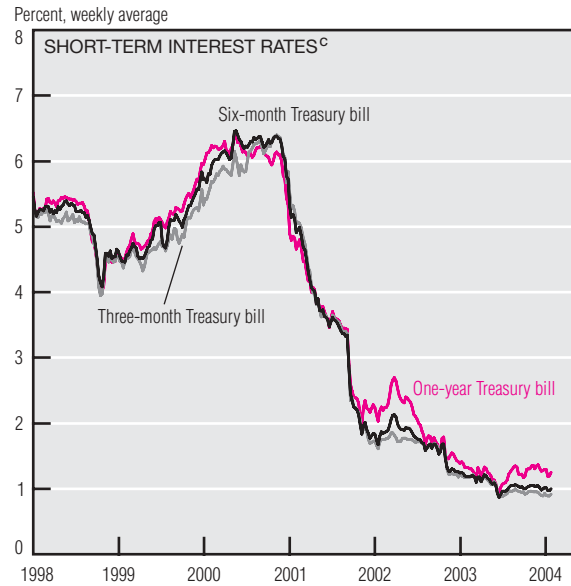
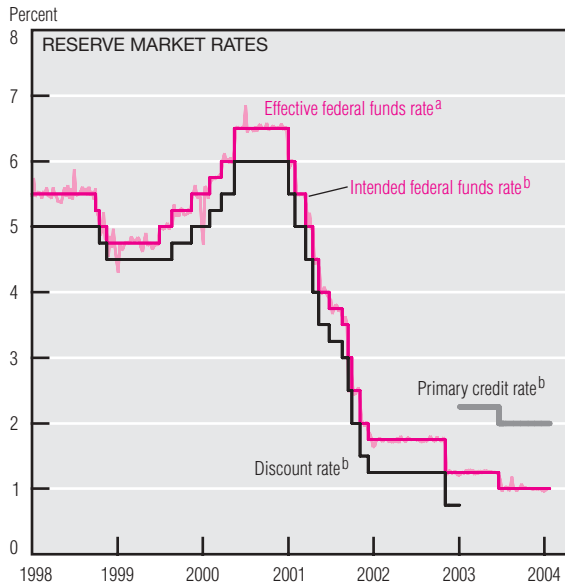
Growth in the sweep-adjusted monetary base (total currency in circulation plus total reserves including depository institutions' vault cash) has been fairly constant over the past couple of years. In 2003, however, it recorded an annual growth rate of 6.2%, slower than the 7.9% average for 1998–2002. The decline in base growth results primarily from a decrease of 2.2 percentage points (pp) in currency growth, which more than offset total reserves' increase of 12.4 pp. Total reserves fell 2.9% from 1998 to 2002 before rising 9.5% in 2003.

M1 (currency in the hands of the public plus demand and other checkable deposits) is a slightly broader monetary aggregate. Like monetary base, sweep-adjusted M1 growth has been fairly stable over the past couple of years, but it is roughly 1.3 pp above its 1998–2002 average. Much of the acceleration resulted from a sharp increase in the sum of demand deposits and other checkable deposits, which comprise nearly half of M1. After falling 2.1% in 1998–2002, its growth rate rose 7.5% in 2003, primarily because the opportunity cost of M1 (market

interest rate minus interest rate on M1 accounts) fell over the same period.

An even broader monetary aggregate, M2, grew 5.2% in 2003, 2.3 pp less than its 1998–2002 average. Although M2 grew overall in 2003, it has fallen almost 1.9% (3.8% annualized) since August. This resulted from sharp declines in retail money market mutual funds (21.6 pp) and small time deposits (8.4 pp) from their averages. These declines were more than offset by higher M1 growth and a slight uptick in savings deposits.

Money and Financial Markets



- a. Weekly average of daily figures.
 b. Daily observations.
 c. All yields are from constant-maturity series.
 d. One day after the FOMC meeting.
- 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 January 27–28 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at 1% and the primary credit rate at 2%. Short-term interest rates and the federal funds rate have moved roughly in tandem, dropping significantly since late 2000. At the June 25 FOMC meeting, the funds rate was lowered to its current target level of 1%, and the yields on three-month, six-month, and one-year Treasury bills roughly followed suit. Just before that meeting, however, longer-term interest rates increased markedly. Although

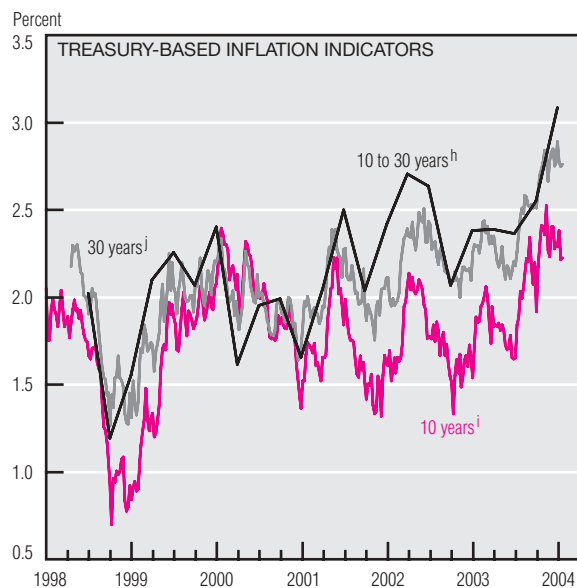
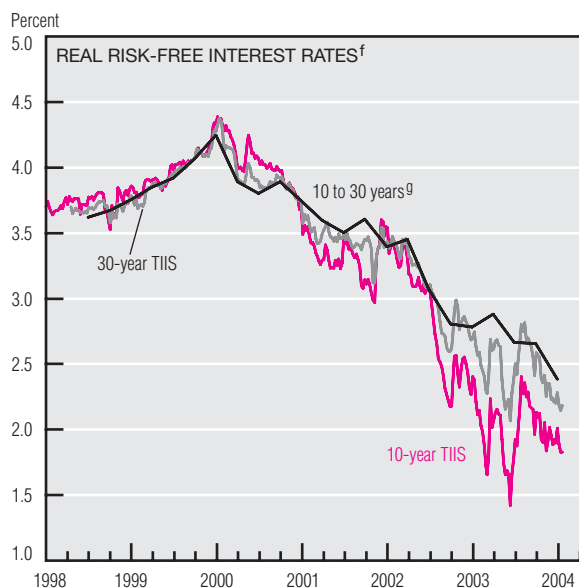
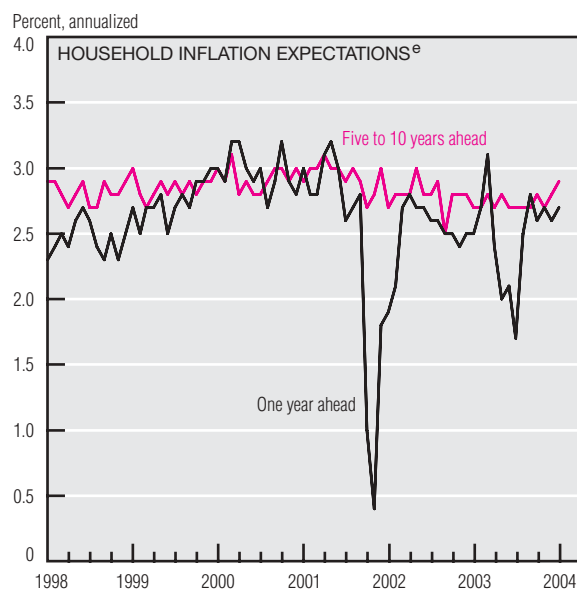
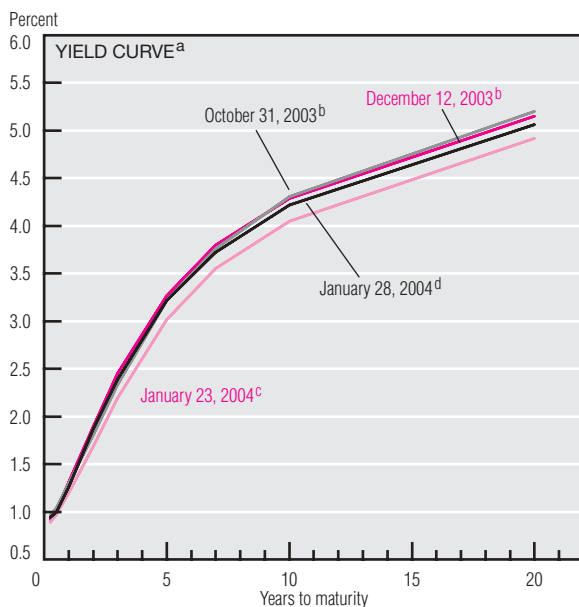
they have decreased slightly since then, they remain significantly above their June 2003 lows.

The best way to tell how interest rates, especially short-term rates, will move in the foreseeable future is to look at the federal funds futures market. Federal funds futures reflect where the market expects the fed funds rate to head. To gauge this, the market often attends to the exact wording of FOMC press releases, and changes in the phrasing can create nearly as much action as a movement in the rate itself.

Since its August 12, 2003 meeting, the FOMC has maintained that "policy accommodation can be maintained for a considerable period." After its January 27–28 meeting, it changed the wording slightly to state that "it can be patient in removing its policy accommodation." Fed funds futures moved up significantly after this statement was released.

One measure of policy accommodation considers the relation between long-term real interest rates and the funds rate. Policy should be more accommodating when inflation is lower
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Money and Financial Markets (cont.)



- a. All yields are from constant-maturity series.
 b. The first weekly average available after the FOMC meeting.
 c. The last weekly average available before the January 27–28 FOMC meeting.
 d. Daily data, January 28 at close of business.
 e. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
 f. Treasury inflation-indexed securities (TIIS).
 g. Implied forward rate derived from 10-year and 30-year TIIS. Quarterly data.
 h. The implied inflation expectation 10–30 years out is the implied forward rate from nominal Treasury bonds minus the implied forward rate from TIIS. Quarterly data.
 i. Yield spread: 10-year Treasury minus 10-year TIIS.
 j. Yield spread: 30-year Treasury minus 30-year TIIS.
 SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; University of Michigan; and Bloomberg Financial Information Services.

than its long-run target. The FOMC, however, has no such inflation target. Policy thus depends on two things that are difficult to measure: inflation expectations and real (that is, inflation-adjusted) rates.

There are few good measures of near-term inflation expectations. Nominal Treasury bills also depend on the real interest rate and expected inflation. If real interest rates stay the same, the yield curve provides one measure

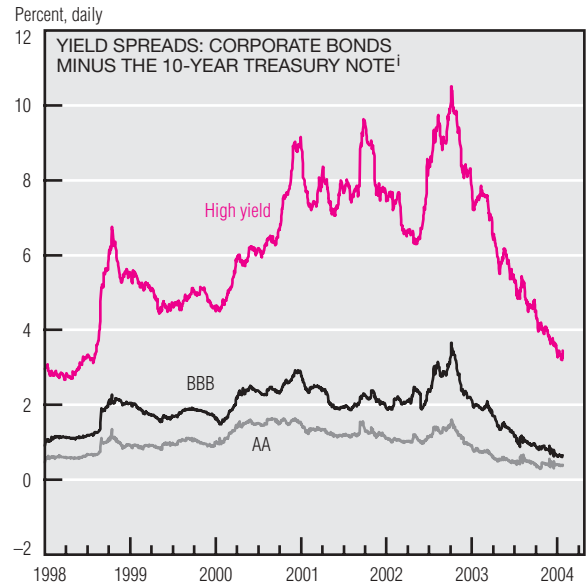
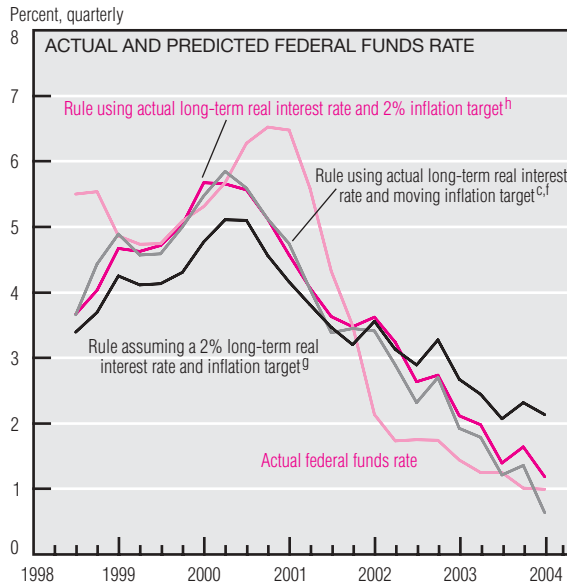
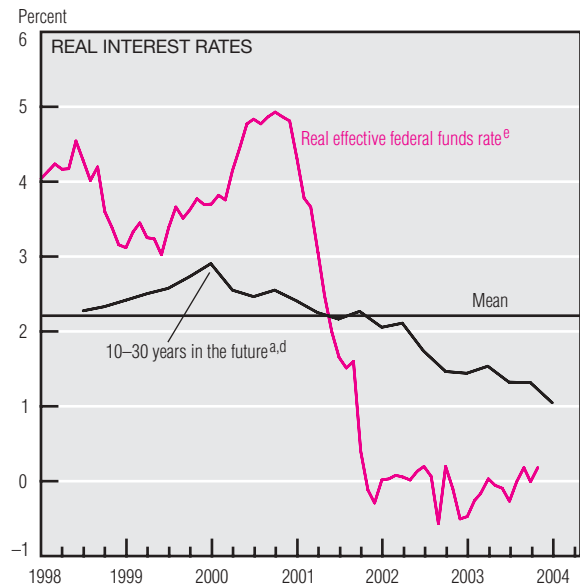
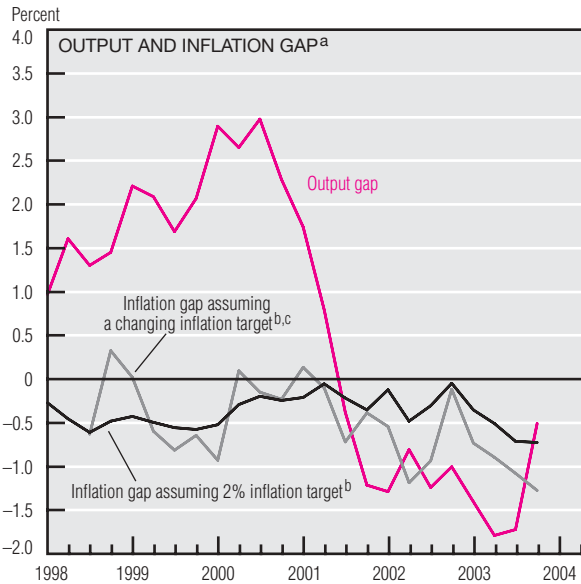
of inflation expectations. Real rate volatility, however, limits this measure's usefulness. The University of Michigan's *Survey of Consumers* suggests that households expect inflation of 2.5%–3% over the next year, but the series is volatile and many question its reliability. Assuming a constant long-run real rate can also be troublesome. Treasury inflation-indexed securities (TIIS), however, provide a market-based measure of future real

rates. Implied forward rates based on TIIS suggest that real rates are not constant, even over long horizons.

Subtracting real interest rates from nominal Treasuries gives market-based measures of expected inflation suggesting that inflation will drift up from its current levels and average 3% in 2014–34. This provides an indirect measure of the FOMC's inflation target, which has increased nearly

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Money and Financial Markets (cont.)



a. Quarterly data.

b. Core PCE chain price index.

c. The inflation target is the implied inflation expectations 10 to 30 years out. Inflation expectations are the implied forward rate from nominal Treasury bonds minus the implied forward rate from Treasury inflation-indexed securities (TIPS).

d. Derived from Treasury inflation-indexed securities. It is adjusted to have the same mean as the real effective federal funds rate.

e. Effective federal funds rate deflated by the core PCE chain price index.

f. The Taylor Rule is modified by using actual long-term real interest rates and moving inflation targets.

g. The formula for the implied funds rate assumes a 2% long-term interest rate and inflation target. The formulation is from John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, vol. 39 (1993), pp. 195–214.

h. The Taylor Rule is modified by using actual long-term real interest rates.

i. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

1/2 percentage point over the past six months.

Is current monetary policy overly accommodative by historical standards? At first glance, policy seems particularly easy. The current funds rate is significantly (1.14 percentage points) lower than the Taylor rule, a benchmark widely used to describe past FOMC actions. This rule posits that past policy accommodation was balanced between weakness (the output

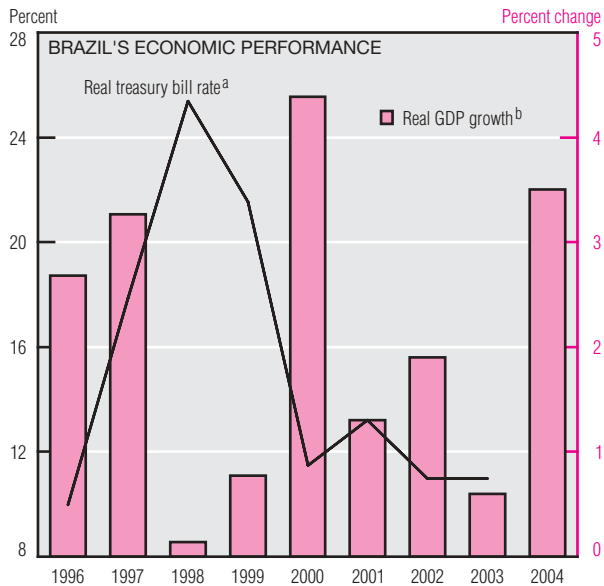
gap) and inflation's deviation from its target.

The Taylor rule usually assumes that long-term real interest rates are constant at 2%. If we replace this with the real rate that markets expect in the distant future, current policy is only 19 basis points below this historical benchmark. The 2% inflation target assumed by the Taylor rule, however, is also questionable. Replacing it with what markets expect inflation to

average in 2014–34 shows that policy is slightly tighter than this modified Taylor rule predicts.

The output gap also enters into this popular policy benchmark. The gap is especially difficult to measure, but sharp declines in yield spreads—hence the cost of business borrowing—suggest that the output gap may close, causing upward pressure on the funds rate.

Brazil's Public-Sector Debt



Brazil's Public-Sector Debt, September 2003

	Billions of Brazilian real	Percent of GDP	Billions of U.S. dollars
Gross public-sector debt	1,230.4	79.7	420.2
Assets	363.6	23.6	124.2
Net public-sector debt	891.1	57.7	304.3
General government	866.9	56.2	296.1
Central bank	2.0	0.1	0.7
Gov't-owned enterprises	22.2	1.4	7.6

Percentage-Point Change in Brazil's Debt-to-GDP Ratio, 2003–13, under Alternative Economic Assumptions^c

Interest rate (percent)	GDP growth (percent)				
	2.0	3.0	3.5	4.0	4.5
8.0	-11.2	-18.1	-21.2	-24.2	-27.0
9.0	-4.0	-11.6	-15.1	-18.4	-21.5
10.0	-4.0	-4.5	-8.4	-12.0	-15.4
11.0	12.7	3.3	-1.0	-5.0	-8.8
12.0	22.2	11.9	7.2	2.7	-1.5
13.0	32.6	21.2	16.0	11.1	6.5

Percentage-Point Change in Brazil's Primary Surplus Needed to Stabilize the Debt-to-GDP Ratio^c

Interest rate (percent)	GDP growth (percent)				
	2.0	3.0	3.5	4.0	4.5
8.0	-0.9	-1.4	-1.7	-2.0	-2.3
9.0	-0.3	-0.9	-1.2	-1.5	-1.8
10.0	0.3	-0.3	-0.6	-0.9	-1.2
11.0	0.8	0.2	-0.1	-0.4	-0.7
12.0	1.4	0.8	0.5	0.2	-0.1
13.0	2.0	1.4	1.0	0.7	0.4

a. Nominal treasury bill rate minus inflation. Real interest rates are averaged over the first eight months of 2003.

b. GDP figures for 2003 and 2004 are International Monetary Fund projections.

c. The ratio of initial debt to GDP is 57.7%, and the initial primary budget surplus is 4.25%.

SOURCES: Board of Governors of the Federal Reserve System; International Monetary Fund; and Banco Central do Brasil.

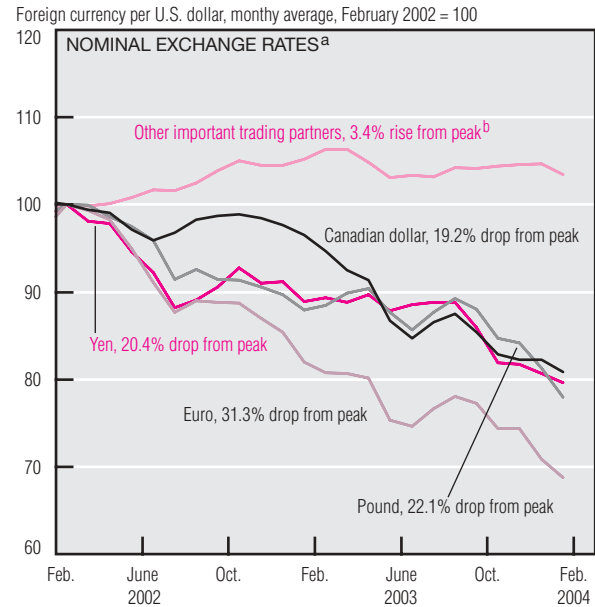
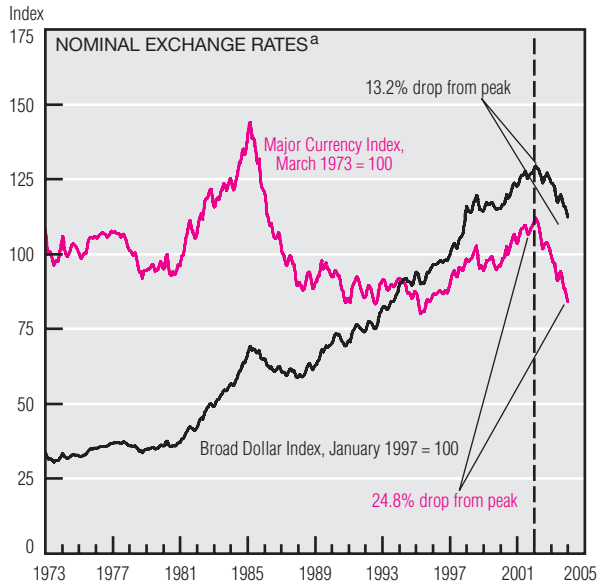
The Achilles heel of sustained economic prosperity in Brazil—Latin America's biggest economy and the twelfth largest in the world—is the nation's public-debt burden. High and still-growing levels of debt increase Brazil's chances of defaulting on its obligations, either by repudiating its contractual commitments or through inflation and currency depreciation. These prospects cause investors to demand a risk premium,

which raises real interest rates in Brazil and reduces its investment, employment, and growth.

With relatively small improvements in economic conditions and continued fiscal improvements, however, Brazil could stabilize its ratio of public debt to GDP. For a given level of Brazil's primary budget surplus (receipts minus non-interest expenditures), this will happen only if the country's rate of economic growth exceeds its real interest rates.

Given Brazil's experience, the combinations of growth and real interest rates that could achieve a decline in the nation's consolidated debt ratio over the next decade seem feasible, but they lie on the more optimistic end of the assumptions. If, however, Brazil maintains a primary budget surplus of roughly 5%, which it recently attained, the country could lower its debt burden, even if its economic growth and real interest rates were no better than their past averages.

The Current Account and the Dollar



Balance of Payments (billions of dollars)

	Current account balance	Total net financial flows	Official financial flows	Private financial flows	Other items	Statistical discrepancy
2002:IQ	-426.9	446.3	26.5	419.8	-1.1	-18.3
2002:IIQ	-491.3	370.7	183.0	187.7	-1.1	121.8
2002:IIIQ	-490.9	684.8	30.2	654.6	-1.5	-192.4
2002:IVQ	-514.3	610.2	124.9	485.3	-1.4	-94.4
2003:IQ	-554.8	562.7	164.0	398.7	-1.6	-6.3
2003:IIQ	-557.6	600.0	229.0	371.0	-6.2	-36.2
2003:IIIQ	-540.2	493.2	175.3	318.0	-3.2	50.1
Change						
2002:IQ– 2003:IIQ	-130.7	153.7	202.5	-48.9	-5.1	-17.9
2003:IIQ– 2003:IIIQ	17.4	-106.8	-53.8	-53.0	3.0	86.3

a. Data through January 27.

b. Weighted average of a subset of Broad Dollar Index currencies that do not circulate widely outside the country of use.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10.

The current account deficit narrowed in 2003:IIIQ, the first significant drop since the dollar began its recent decline. This pattern—smaller deficit, depreciating dollar—suggests that investors' diversification out of dollar-denominated assets has become a key underlying market development. When investors diversify out of dollar assets, the supply of dollars in foreign exchange markets outpaces the demand, and the dollar depreciates. This depreciation makes U.S. goods more competitive in world markets

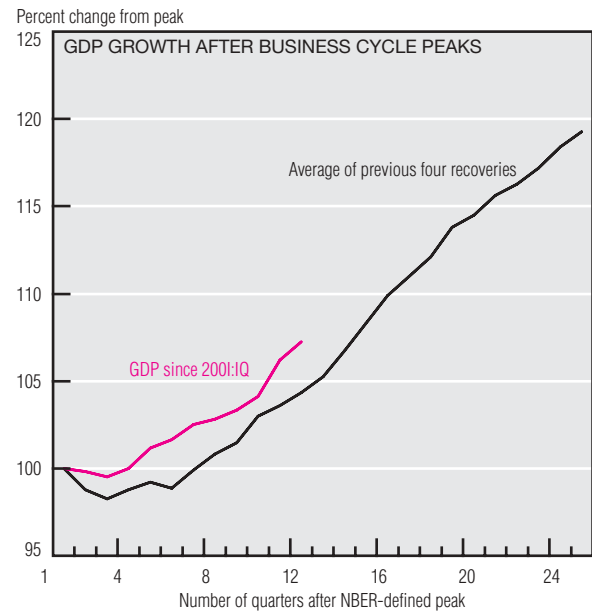
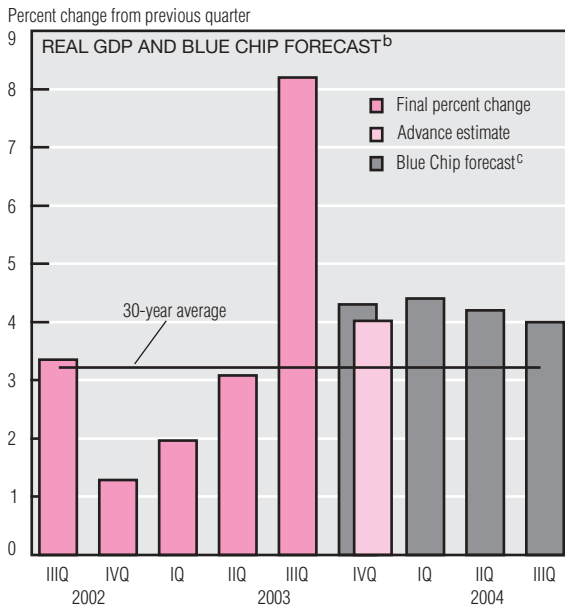
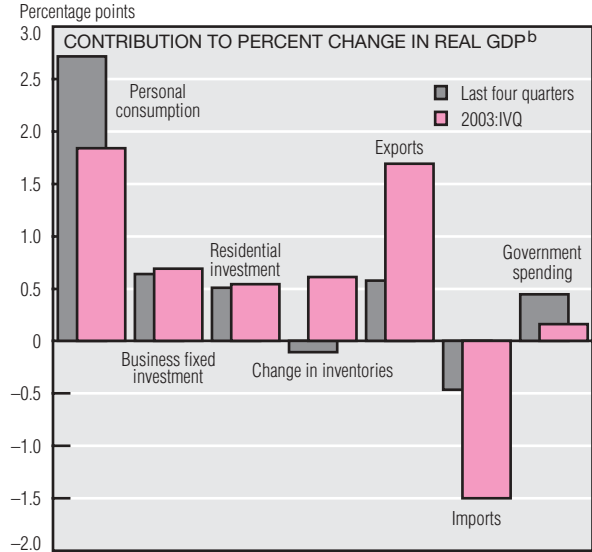
and narrows the current account deficit. All else equal, diversification could put upward pressure on real interest rates and make investment in the U.S. harder to finance. Although it will tend to raise the prices of traded goods, a dollar depreciation fueled by investor diversification need not signal an accelerating inflation rate.

Prior to last year's third quarter—between 2002:IQ and 2003:IIQ—the dollar depreciated, and the U.S. current account deficit widened as business activity in this country outpaced economic growth abroad.

All else equal, when the U.S. grows faster than the rest of the world, our imports increase relative to our exports, and the current account deficit expands. As we buy more abroad than we sell there, the supply of dollars in the foreign exchange market outpaces the demand for them, and the dollar depreciates. Should it reappear and persist, this pattern of events would have few negative implications for real interest rates and investment but could be a harbinger of future inflation pressures.

Economic Activity

	Change, billions of 2000 \$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	104.0	4.0	4.3
Personal consumption	47.6	2.6	3.8
Durables	2.3	0.9	11.2
Nondurables	23.3	4.4	4.6
Services	21.8	2.1	2.0
Business fixed investment	32.9	6.9	6.4
Equipment	21.9	10.0	8.9
Structures	-1.8	-3.0	-1.3
Residential investment	13.1	10.6	8.9
Government spending	3.9	0.8	2.4
National defense	2.2	1.8	7.7
Net exports	4.5	—	—
Exports	46.2	19.1	6.1
Imports	41.7	11.3	3.4
Change in business inventories	15.2	—	—



a. Chain-weighted data in billions of 2000 dollars. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
 b. Data are seasonally adjusted and annualized.
 c. Blue Chip panel of economists.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, January 10, 2004.

The advance estimate from the national income and product accounts revealed that real gross domestic product (GDP) rose at a 4.0% annual rate during the fourth quarter of 2003, a little less than most forecasters had expected. Major contributors to the increase in real GDP included personal consumption expenditures, exports, equipment and software, inventory investment, and residential fixed investment. Personal consumption expenditures rose 2.6%, less

than the third quarter's 6.9% increase and less than 2003 as a whole. Exports posted substantial growth of 19.1% (annualized) and contributed 1.69 percentage points to total output growth. In an encouraging sign for business activity, equipment and software rose 17.6% in the third quarter and 10% in the fourth.

Government spending added 0.16 percentage point to output growth in 2003:IVQ, down from the previous quarter and below the 2003 average.

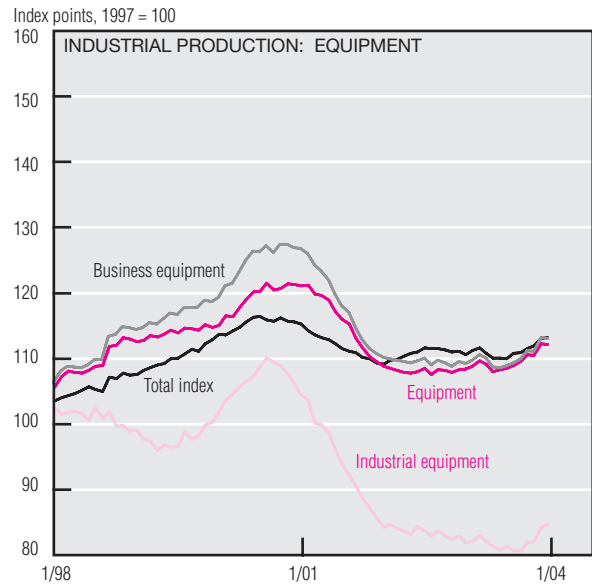
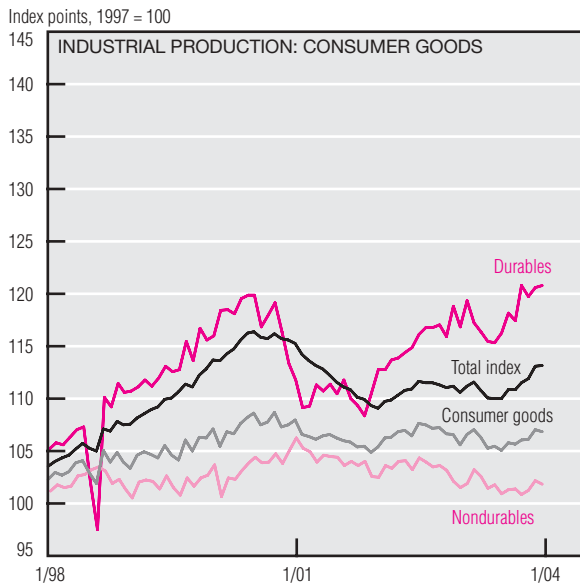
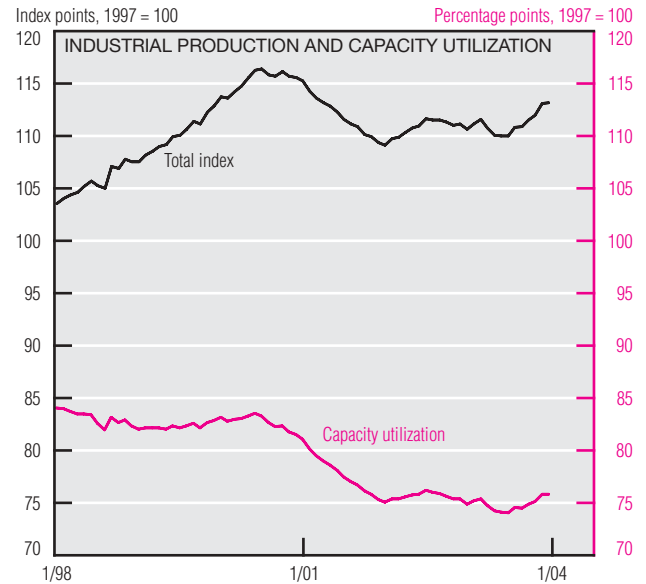
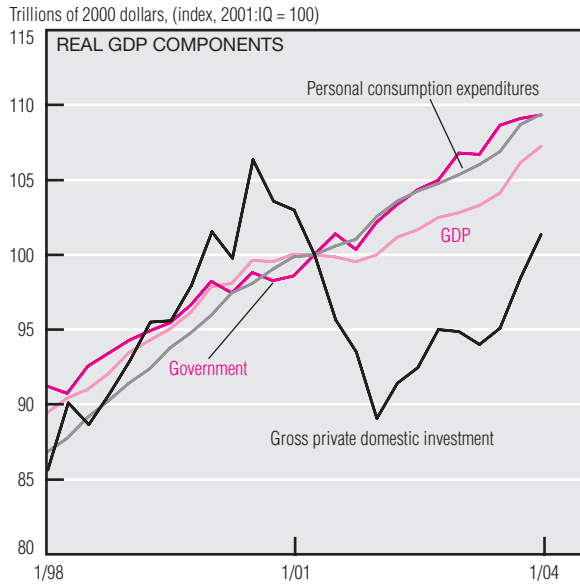
About half of the government contribution came from growth in national defense, which ticked up 1.8%, contributing 0.08% to output growth.

Residential fixed investment rose 10.6% and business fixed investment posted a 6.9% gain in 2003:IVQ, pushing fixed investment to an 8.1% increase.

Blue Chip forecasters expect that output growth in the next four quarters will be slightly higher than in 2003:IVQ.

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Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

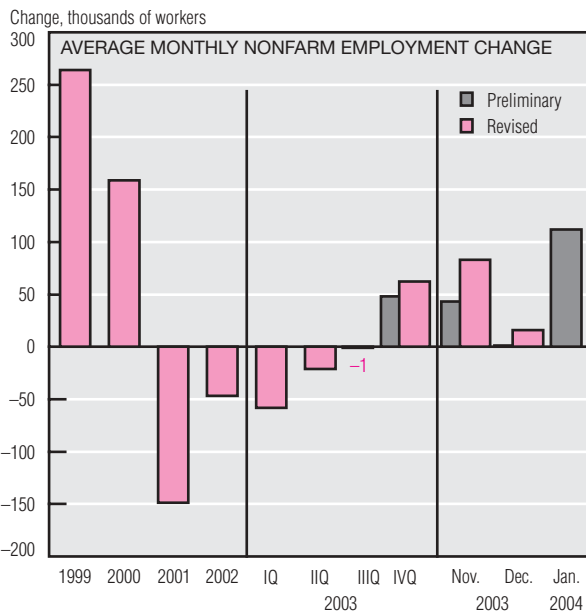
Gross investment increased markedly in 2003, but the investment-intensive aggregates of the industrial production index do not reflect this improvement. During the 2001 downturn, GDP consumption and government spending remained steady, whereas gross investment suffered large losses. As total GDP output improved in 2003, so did investment. Over the course of 2003, business fixed investment posted gains of 2.8%, reversing the negative changes of the previous two years.

Although GDP has surpassed the peak levels set in March 2001, total industrial production has not broken the highs established in June of 2000. Last December, the industrial production index rose only 0.1%. Moreover, the rate of capacity utilization was unchanged at 75.8% in December and is running well below the 30-year average of 81.3%.

The industrial production series related to the consumer portions of GDP have grown steadily, but equipment and other investment-

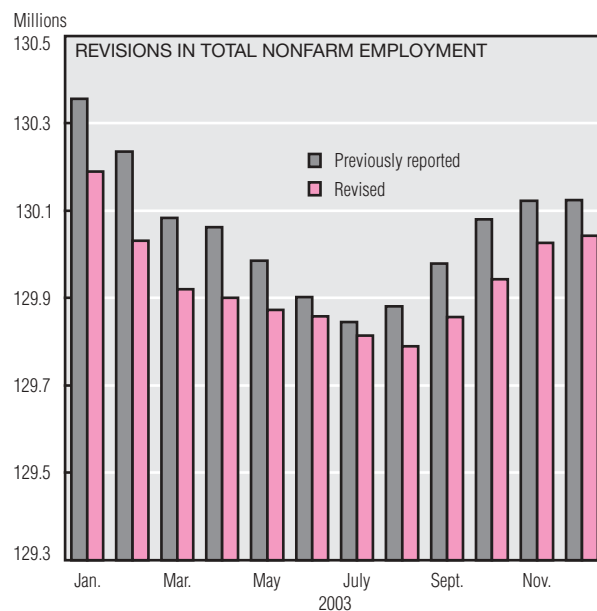
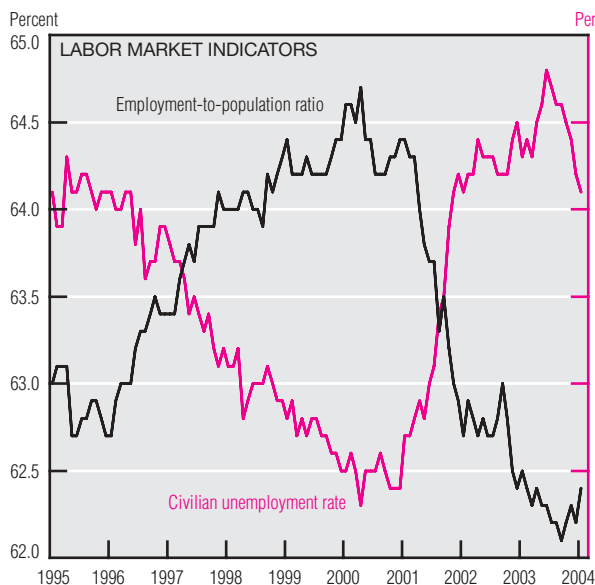
related aggregates have not performed as well. Consumer durable goods, which account for about 8% of the industrial production index, have grown at a higher rate than the index as a whole: Consumer durables are up 6.8% from March 2001, but the total index rose only 1.7%. Industrial equipment, which represents about 5% of the index, fell about 15% over the same period.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	2000	2001	2002	2003	Jan. 2004
Payroll employment	159	-149	-47	-4	112
Goods producing	-1	-124	-76	-42	7
Construction	7	-1	-8	7	24
Manufacturing	-9	-123	-67	-49	-11
Durable goods	2	-88	-48	-31	3
Nondurable goods	-11	-35	-19	-18	-14
Service providing	159	-25	29	37	105
Information	15	-15	-19	-10	-10
Financial activities ^a	6	8	6	6	2
PBS ^b	40	-63	-17	23	-22
Education and health	32	50	40	28	22
Leisure and hospitality ^c	22	-1	11	8	21
Government	22	46	21	-5	-13
	Average for period (percent)				
Civilian unemployment rate	4.0	4.8	5.8	6.0	5.6



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 include arts, entertainment, and recreation, as well as accommodations and food service.

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

Nonfarm payroll employment posted a net gain of 112,000 jobs in January 2004, its fifth consecutive monthly gain. The employment increase for December 2003 was revised to 16,000. Total payroll has increased by 366,000 jobs since last September.

Construction remained strong, making a net gain of 24,000 jobs in January, which brought the sector's increase to 147,000 jobs since March 2003. Employment in health and education services continued to grow, rising by 22,000 jobs in January and bringing its gain to an impressive 1.5 million jobs over the last three years.

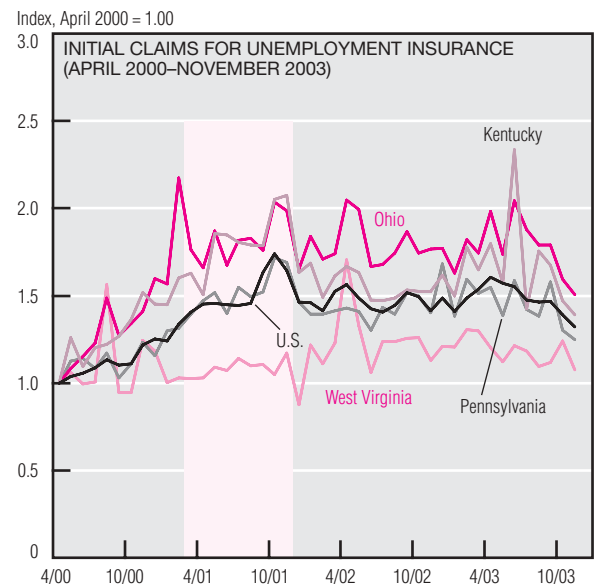
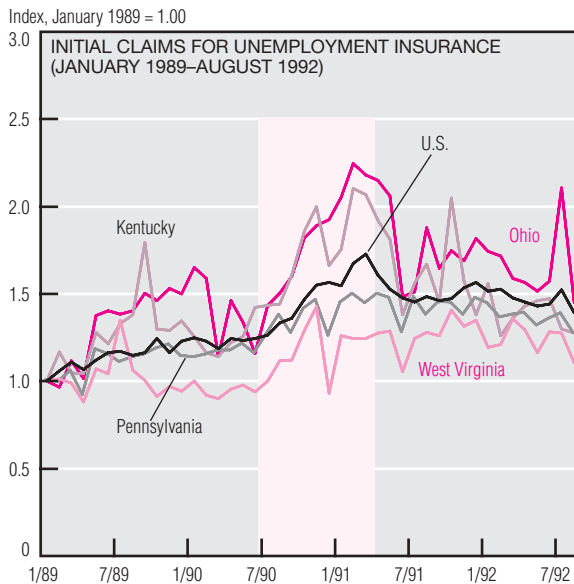
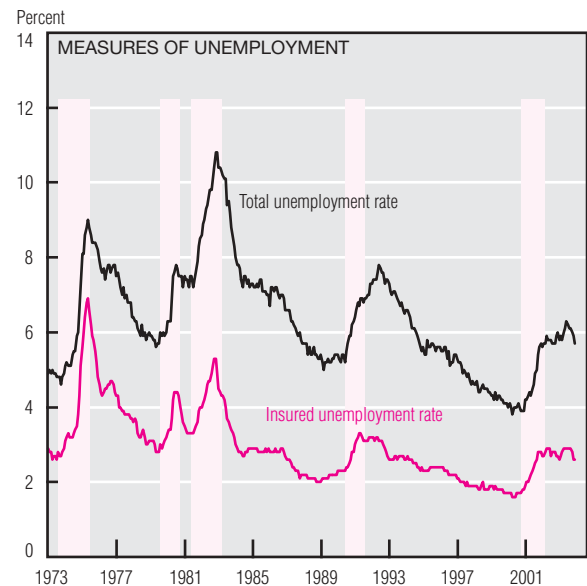
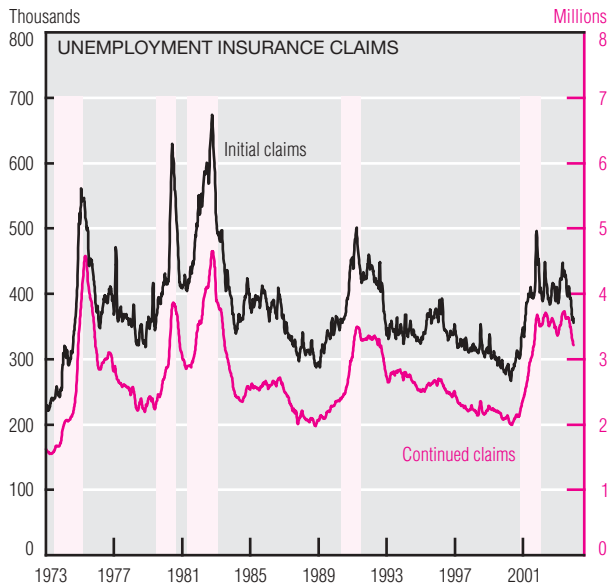
Manufacturing employment continued to fall, but much more slowly than before; it was down 11,000 jobs in January, compared to its average monthly loss of 49,000 in 2003. Information services posted a net loss of 10,000 jobs in January 2004; the sector's employment decreased by 117,000 in 2003. Professional and business services declined by 22,000 jobs in January 2004, after an increase of 45,000 jobs the month before.

The household unemployment rate in January 2004 decreased 0.1 percentage point to 5.6%—a significant drop from its peak of 6.3% in June 2003.

The employment-to-population ratio rose to 62.4%, continuing the upward trend that began in October 2003.

Effective February 2004, the Bureau of Labor Statistics implemented revisions in the establishment-based employment series to reflect the annual benchmark adjustments; it also updated the seasonal adjustment factors. The revisions lowered the employment numbers for the reference month, March 2003, by about 122,000. Incorporating the new seasonal adjustment factors has smoothed the 2003 employment growth pattern.

Unemployment Insurance Claims



NOTES: All data are seasonally adjusted. Shaded areas indicate recessions.

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, and Employment and Training Administration.

Unemployment insurance claims, a closely followed economic indicator, have trended sharply downward over the last two months. In the week ending January 22, the four-week moving average reached 344,500 claims, the lowest level since the most recent recession ended. Typically, initial claims increase sharply when a recession begins and fall immediately after it ends. This was not the case for the last two recessions, 1990–91 and 2001. During the recovery periods that followed them, sometimes called “jobless recoveries,” the number of initial claims stayed high for several months before starting to fall. Of the two, the

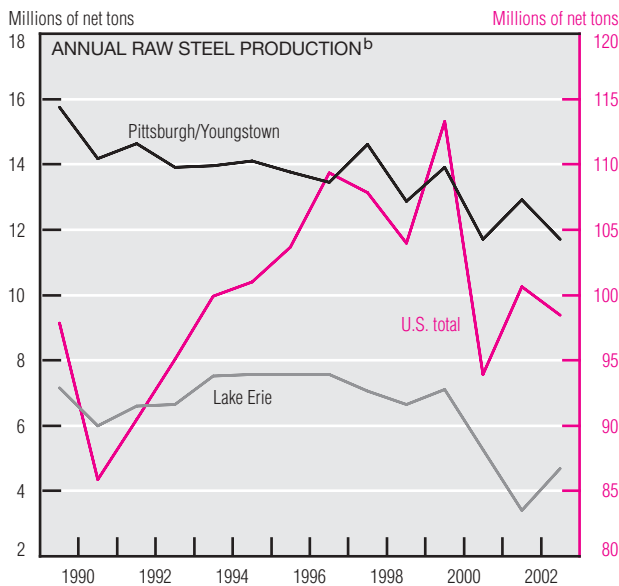
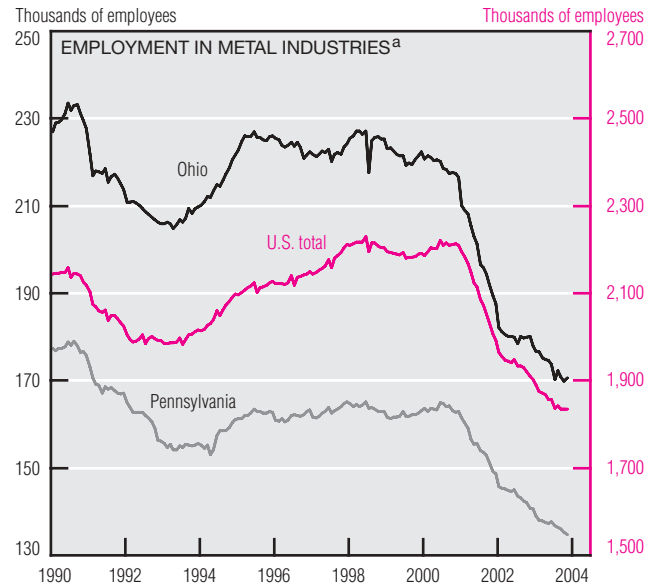
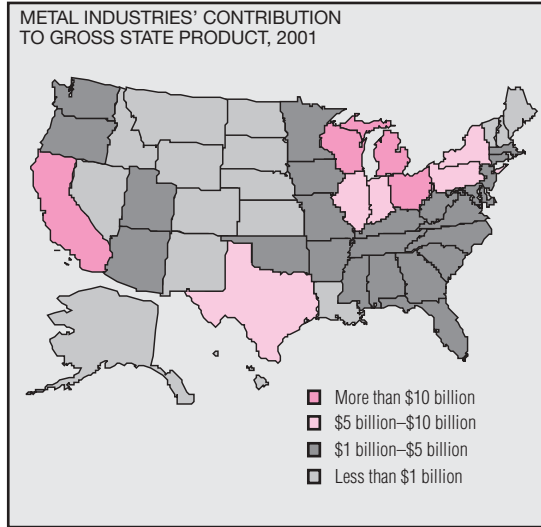
post-2001 recovery went on longer before initial claims dropped below 400,000, the level typically associated with employment growth.

During the last two months, the number of continuing claims (those made by individuals receiving regular 26-week state benefits) also fell to a postrecession low. Continued claims are slower to fall because several weeks may pass before workers are employed again. Combined decreases in initial and continuing claims have lowered the insured unemployment rate to 2.6%.

The bottom two charts show the trends across states in the Fourth

Federal Reserve District as well as the U.S. average for January 1989–August 1992 and April 2000–November 2003 (each period starting from the pre-recession low of the initial claim level and ending 43 months after it). For most of January 1989–August 1992 (indexed to 1.0 for January 1989), increases of initial claims in Ohio and Kentucky outpaced the U.S. average. The pattern was similar for April 2000–November 2003 (indexed to 1.0 for April 2000), but the rates of increase in initial claims for these two states were higher than in the previous period.

The Domestic Steel Industry



NOTE: Metal industries are those classified under primary metal and fabricated metal product manufacturing.

a. Not seasonally adjusted.

b. The American Iron and Steel Institute's raw steel production regions are Northeast Coast, Pittsburgh/Youngstown, Lake Erie, Detroit, Indiana/Chicago, Midwest, Western, and Southern.

c. Seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; and American Iron and Steel Institute.

President Bush's December decision to eliminate the Section 201 steel tariffs on various carbon and alloy steel products refocused national interest on the domestic steel industry. Over the past three years, more than 30 U.S. steel companies have filed for bankruptcy and many more have consolidated significantly. Steel production directly affects the economy of our region, which is home to the nation's three largest integrated domestic steel producers: ISG (the former LTV Steel Corporation), U.S. Steel, and AK Steel.

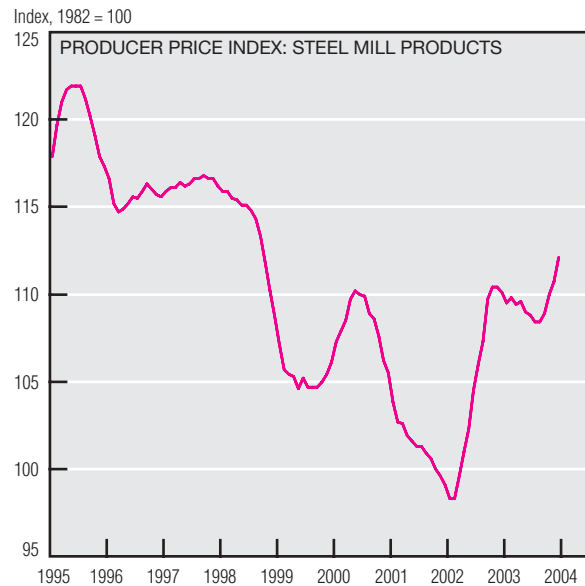
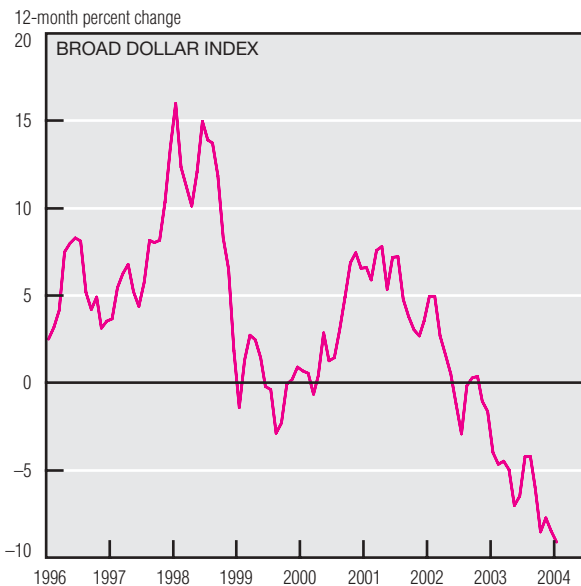
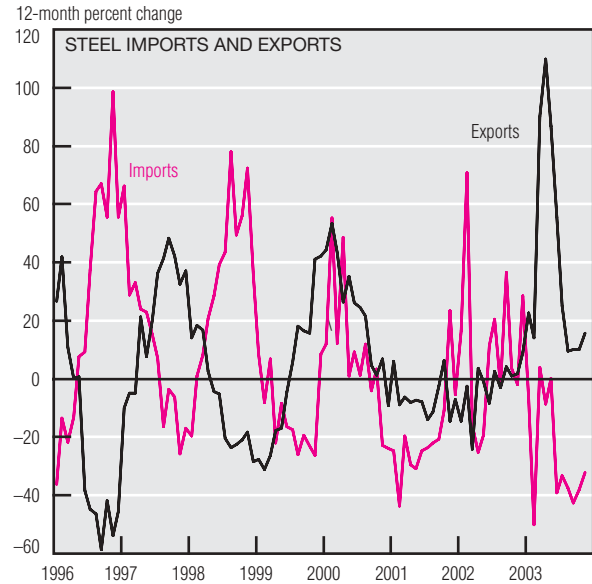
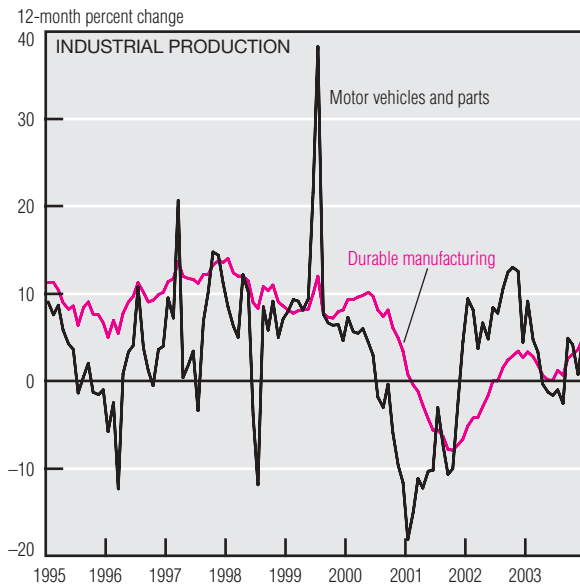
Within the U.S., nine states derived more than \$5 billion of gross state product from the primary metal and fabricated metal industries in 2001. Two of the nine, Ohio and Pennsylvania, fall within the Fourth Federal Reserve District, with significant earnings from these industries concentrated in northeast Ohio and western Pennsylvania.

Both of these states have experienced declines in employment throughout the primary metal and fabricated metal manufacturing industries, like the U.S. as a whole. The

accelerated employment decline in the region's metal industries over the past three years results partly from surging steel company bankruptcies since 2000 and ongoing consolidation of steel production and distribution channels.

Nationally, total raw steel production, about one-fifth of which originates in the Fourth District, remains significantly below 2000 production levels. Although raw steel production in the Lake Erie region increased slightly in 2003, the Fourth District as a whole is still below its production levels. (continued on next page)

The Domestic Steel Industry (cont.)



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Industrial Production and Capacity Utilization," *Federal Reserve Statistical Releases*, G.17 and "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; and American Iron and Steel Institute.

levels of the 1990s and early 2000. However, activity in the domestic steel industry has recently increased somewhat. New orders placed with iron and steel mills are at the highest level since early 2000, probably because of increased manufacturing activity and decreased imports into the domestic market.

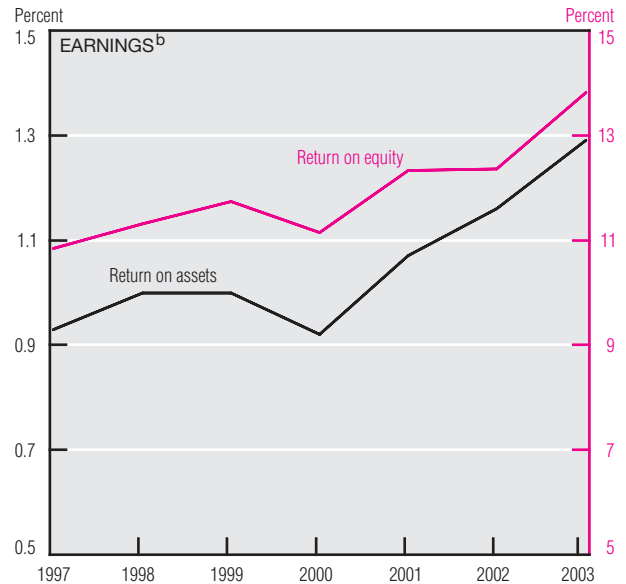
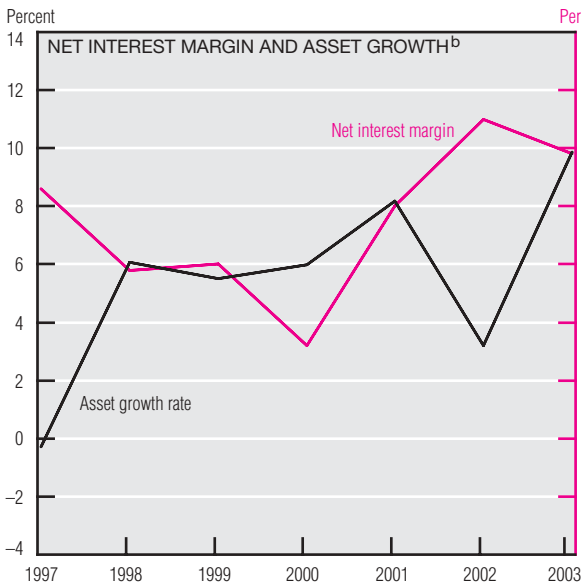
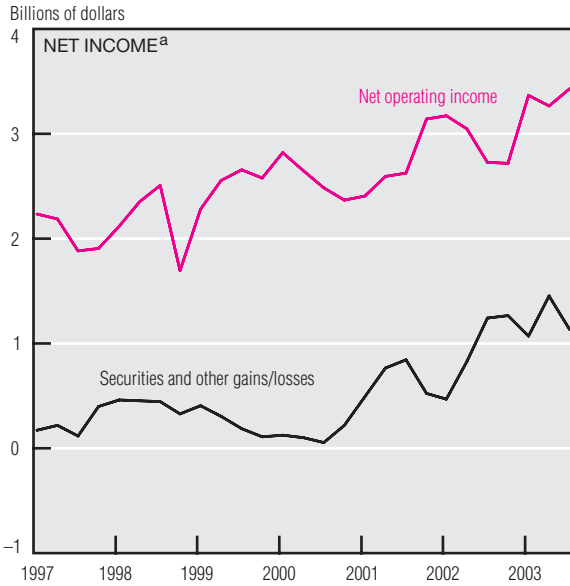
The Institute for Supply Management's Production Index has signaled an expanding manufacturing economy for the past eight months, and durable goods manufacturing was up 4.9% in December on a year-over-year basis. Demand from the automotive

industry, which accounts for 16% of domestic steel shipments, is strong and expected to remain so.

Many industry observers note that lifting Section 201 tariffs on steel imports will not affect the domestic steel industry immediately. Although the tariffs were still effective in November—when steel imports to the U.S. were 30% less than the year before—many analysts assert that the current low levels of steel imports to the U.S. have resulted largely from increased demand in steel markets overseas and the depreciation of the U.S. dollar. The price of imported steel rises as

the dollar depreciates, making imported steel relatively less attractive to domestic consumers. The Broad Dollar Index, a trade-weighted average of the dollar's foreign exchange value against the currencies of our major trading partners, has fallen since 2002. Reduced import competition and increased domestic demand are also partly responsible for the recent upward trend in steel prices. Flat-rolled steel products, largely used in industrial, automotive, and appliance applications, have posted significant price spot market increases, rising approximately 20% since June 2003.

Savings Institutions



a. Net income equals net operating income plus securities and other gains and losses.
 b. Data for 2003 are annualized based on the first three quarters.
 SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured savings institutions (S&Ls) reported net income of \$4.56 billion for 2003:IIIQ. This was \$590 million (14.9%) higher than a year earlier but \$152 million lower than the second quarter. As in previous quarters, net income was buttressed by one-time gains on the sale of securities—to the tune of \$1.13 billion.

S&Ls' noninterest (fee) income stood at \$4.06 billion, up 64.7% from a year earlier. Their total interest income of \$17.1 billion is far below the

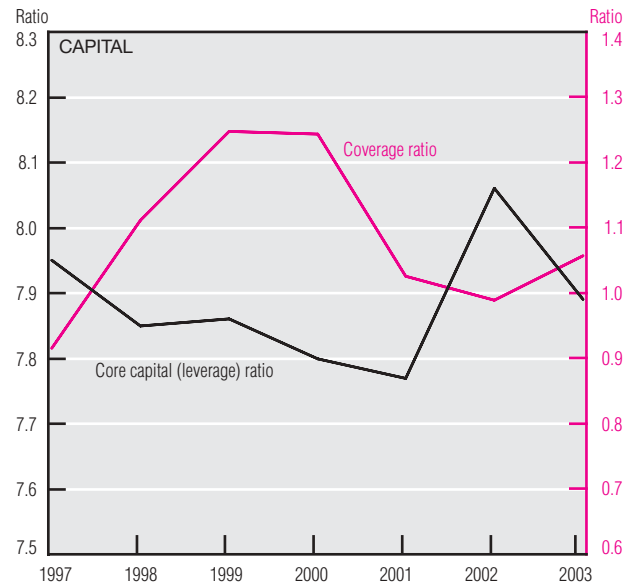
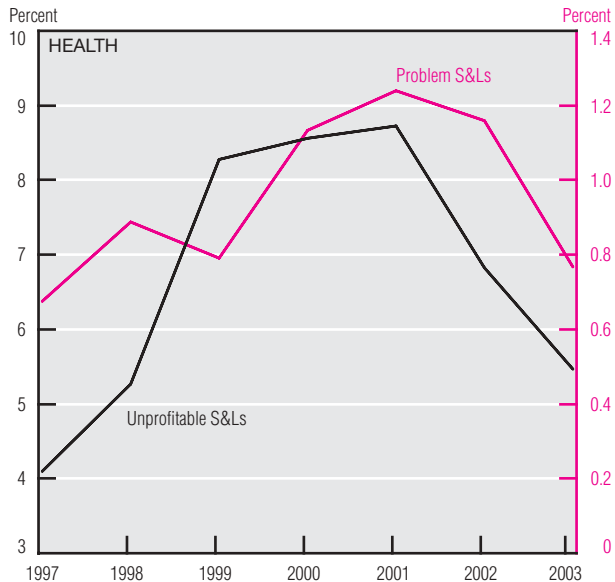
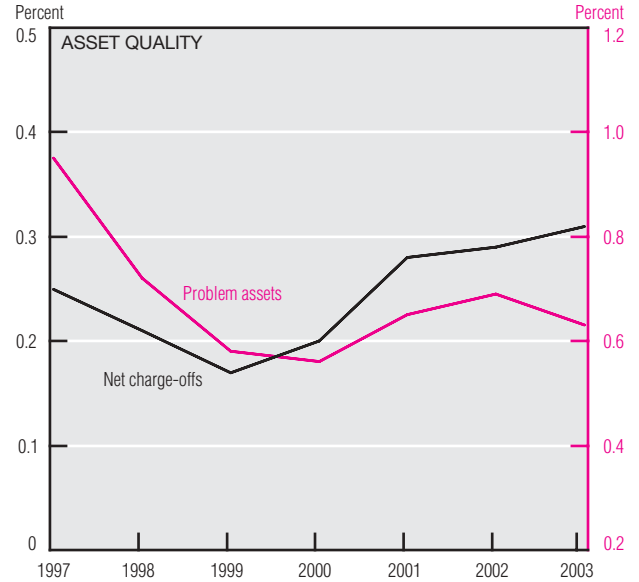
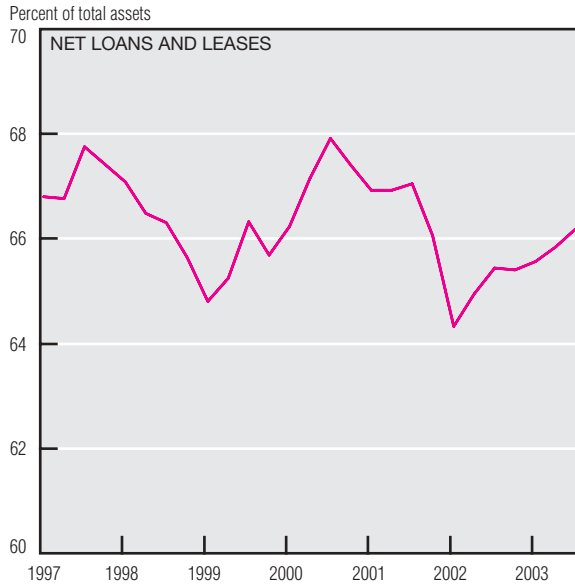
recent high of \$22.3 billion in the first quarter of 2001 and 8.1% lower than a year ago. However, the process of repricing S&Ls' loan portfolios seems to have been completed around the end of 2003:IQ. In the face of this portfolio adjustment, net interest income has increased only 2.1% over the past year, because reductions in interest income from lending have been nearly matched by declines in borrowing between 2002:IIIQ and 2003:IIIQ.

Although the net interest margin declined slightly to 3.29% from its

recent peak of 3.35% at the end of 2002, overall earning performance continued to be strong. (The net interest margin is calculated as interest and dividends earned on interest-bearing assets minus interest paid to depositors and creditors; it is expressed as a percentage of average earning assets.) S&Ls' net income grew at a 14.9% rate on a year-over-year basis, outstripping the relatively robust asset growth of 9.86% for the same period. As a result, S&Ls'

(continued on next page)

Savings Institutions (cont.)



NOTE: Observations are through 2003:IIIQ. Data are annualized.
 SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

return on assets continued its recent upward trend, rising to 1.29% in 2003:IIIQ. A similar picture emerges for return on equity, which reached 13.81% for the quarter.

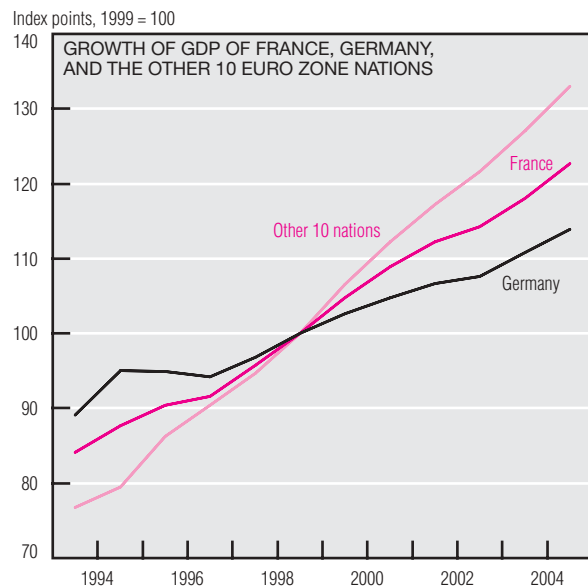
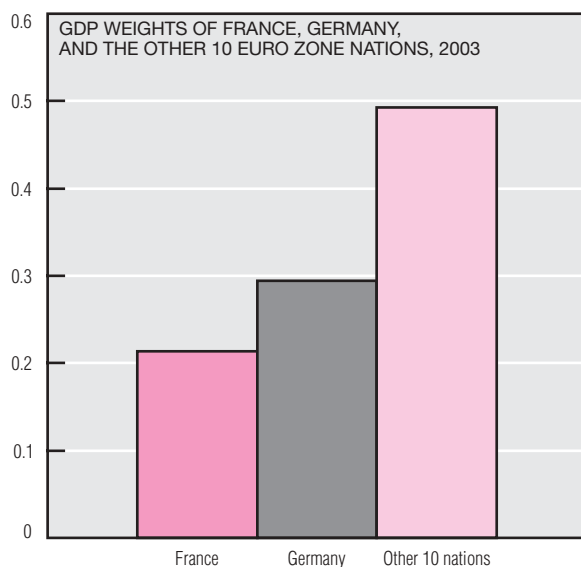
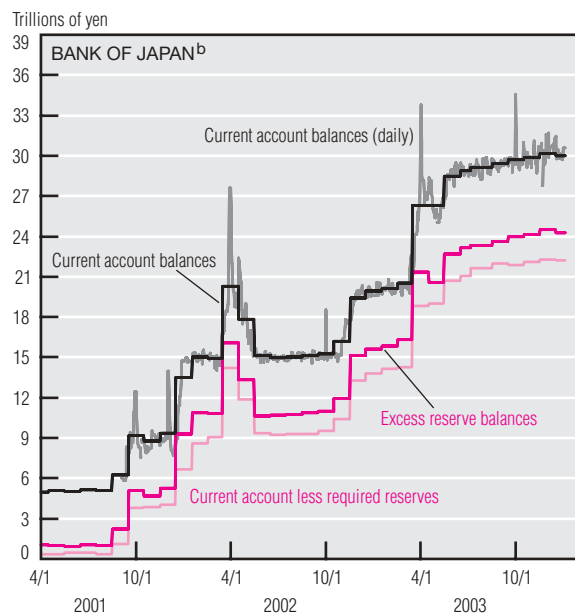
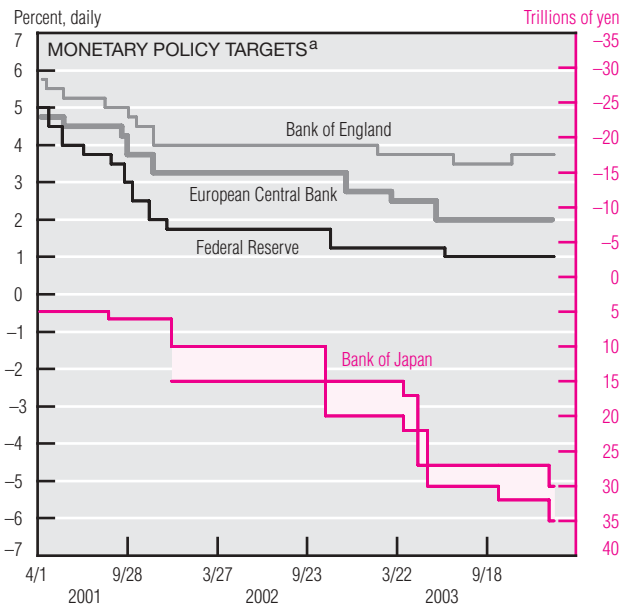
In 2003:IIIQ, net loans and leases as a share of total assets rose slightly to 66.2% compared to the previous quarter. This share was less than its recent high of 67.9% in 2000:IIIQ, however, indicating a continued decline in savings institutions' direct holdings of loans.

Asset quality showed mixed signs in 2003:QIII. Net charge-offs (gross charge-offs minus recoveries) rose to 0.31%. Problem assets (noncurrent assets plus other real estate owned) made up 0.63% of total assets for the quarter, a slightly smaller share than the 0.69% posted in 2002.

However, asset quality is not currently a significant problem for FDIC-insured savings institutions. Problem S&Ls (those with substandard exam ratings) declined significantly to 0.77% in 2003:QIII compared to 1.16% in

2002. The percent of unprofitable institutions continued to fall, reaching 5.47%. The coverage ratio stood at \$1.06 in loan loss reserves for every dollar of noncurrent loans. The slight increase in the coverage ratio compared to 2002 resulted from a \$351 million increase in loan loss reserves and a \$208 million decrease in non-current loans for the same period. In 2003:IIIQ, core capital, which protects savings institutions against unexpected losses, decreased to 7.89% 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; and Bank of England.

The Bank of Japan, alone among the four major central banks, adjusted its monetary policy setting recently. The actual monthly average supply of current account balances has been increasing gradually for most of the past year, reaching a level of about ¥30 trillion. On January 20, the Bank raised its current account balance target from “around 27 to 32 trillion yen” to “around 30 to 35 trillion yen,” in order to “reaffirm its policy stance to overcome deflation and ensure a continued recovery.”

In the euro area, implementation of the Stability and Growth Pact continues to be an issue. The European Commission has filed a legal action with the European Court of Justice, formally challenging the finance ministers' decision to hold in abeyance the Commission's November 2003 recommendation that excessive deficit procedures be imposed on France and Germany. Moreover, in a regularly scheduled review of several European Union nations, the Commission warned that France's debt-to-GDP ratio was projected to run

above 60% throughout 2005 and that risks surround the nation's plan to reduce its budget deficit below 3% of GDP by the end of 2005. By comparison, the ratio of publicly held Treasury debt to GDP in the U.S. was about 36% in 2004:IIIQ. Germany is one of the nations scheduled for review in February.

Trend growth through 2005 for France and Germany, which together account for about half of the euro area's GDP, is noticeably slower than that of the other 10 euro area nations.