The Economy in Perspective

Spring is here. Why doesn't my heart go dancing?

—Lorenz Hart, U.S. songwriter

According to the National Bureau of Economic Research, an independent organization that dates U.S. business cycle peaks and troughs, economic activity peaked in March 2001 and declined until November 2001. By that account, more than two years have passed since the recession's trough, and three years since the previous cycle's peak. How has the business cycle progressed?

As measured by real GDP, the March-to-November recession was fairly typical in length, but mild in severity. Real GDP declined less than 1 percent from peak to trough. In the two years following the fourth quarter of 2001, it expanded by roughly 7%, and most analysts expect it to advance another percent in the current quarter. Historically, that is also a mild expansion.

Households have been spending actively during the past two years, spurred on by unusually low interest rates. Consumers have also been able to augment their purchasing power by refinancing their debts and tapping into their housing equity. A rebound in stock prices and, more recently, an apparent halt to the deterioration in labor market conditions, have bolstered consumer confidence. Consumer spending and housing purchases accounted for roughly 5 percentage points out of the total GDP growth of 7 percentage points during the two years ending in 2003:IVQ. Federal government purchases accounted for nearly all of the rest.

Business investment spending has not contributed appreciably to spending, nor has production fully regained its footing. More than two years into the recovery, the Federal Reserve's industrial production index has yet to return to its March 2001 level. Consumer goods production has finally regained—but not yet surpassed—its pre-recession peak, while most capital goods production remains in the doldrums. Capacity utilization rates in the goods-producing sector are fairly low, especially for capital goods, and have not shown much upward movement in the past two years.

These relatively low capacity utilization rates are hardly surprising, considering the delirious capital spending that occurred during the last several years of the prior economic expansion. Capital spending increased at double-digit rates for a considerable period of time in a wide range of industries during the second half of the 1990s, in a boom that not only proved unsustainable but also left a considerable overhang needing to be worked down.

Is it possible that labor markets also became distended during the frenzy leading to the March 2001 business cycle peak? That is, with help-wanted signs posted everywhere, firms paying hiring bonuses, and compensation soaring, is it reasonable to think that many people who otherwise would not have entered the labor force in the latter portion of the last expansion did so because the financial rewards finally became tempting enough?

Economywide labor force participation rates have been rising for many decades, primarily because of the strong, steady advance in adult women's participation, even though the participation rates of adult men have been slowly declining. Teenagers' participation rates generally rose during the 1970s and 1980s before beginning a long decline. Total labor force participation reached a record high at the peak of the last expansion, but since then every group's participation rate has declined—sharply so in the case of teenagers.

Roughly 10 million jobs were filled in the four years leading up to the March 2001 peak, with the employment-to-population ratio hitting an all-time high and the unemployment rate falling to a 30-year low. Now that labor demand pressures have abated, large numbers of people who otherwise might have been in the labor force have decided not to participate. This elasticity of supply helps to explain why, even as the employment-to-population ratio has receded, the unemployment rate still hovers just above $5\frac{1}{2}$ percent today. Not long ago, many economists would have regarded this rate as being consistent with full employment, or nearly so.

Capacity utilization rates have been edging up and the unemployment rate has been edging down, but progress has been languid despite a period of very supportive monetary and fiscal policies. Finally, however, initial unemployment insurance claims have dropped. Capital spending appears to be regaining vigor. And businesses seem far more optimistic about new orders and hiring than they have in quite some time. As the previous business cycle taught us, even from a bleak start a robust expansion can emerge.

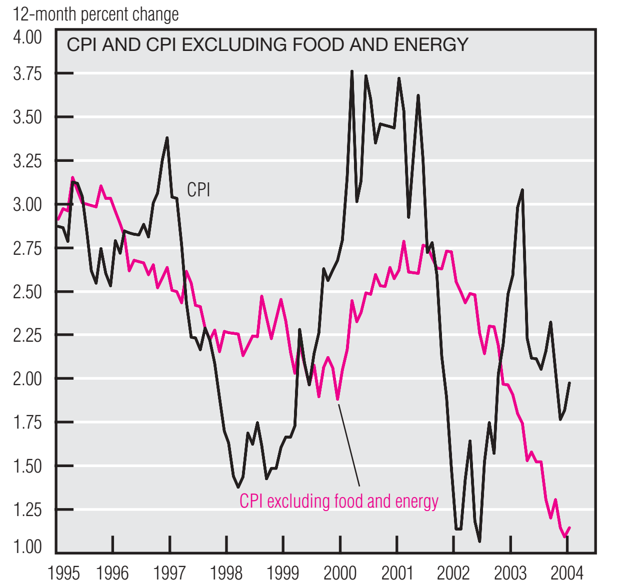
Men must walk, at least, before they dance.

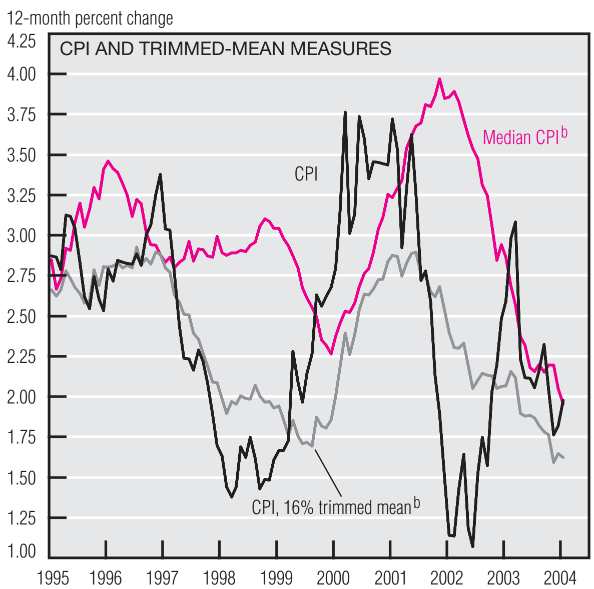
—Alexander Pope

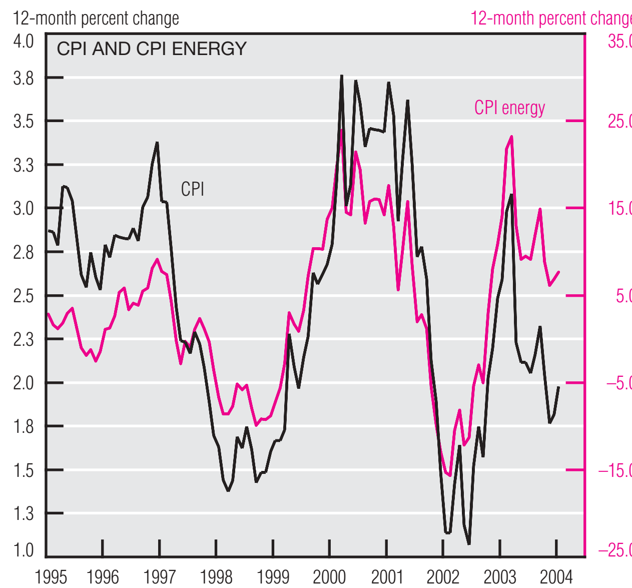
Inflation and Prices

January Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2003 avg.
Consumer prices					
All items	6.0	2.0	2.0	2.4	1.9
Less food and energy	1.9	0.8	1.1	2.1	1.1
Median[b]	1.6	1.6	2.0	2.9	2.1
Core goods	0.0	–1.7	–2.2	–0.7	–2.5
Consumer goods imports	3.7	2.1	0.4	–0.6	0.1
Energy	73.5	7.8	7.7	7.1	16.3







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

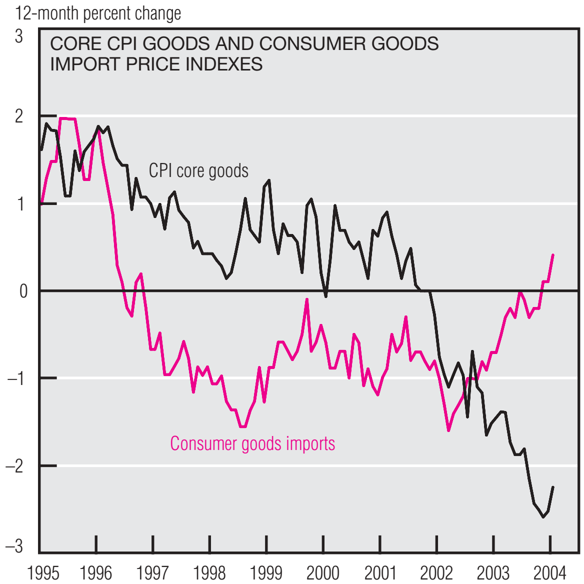
The stronger, if still modest, recent increase in retail prices continued into February. In fact, the Consumer Price Index (CPI) surged an annualized 6.0% in January, the largest monthly increase since February 2003. Although more than three-fourths of the CPI's January increase resulted from a 4.7% rise in energy costs (mostly caused by an 8.0% increase in petroleum-based energy), February's core CPI of 1.9% was also a bit higher than the recent trend. The median CPI and the 16% trimmed-mean CPI, two inflation measures designed to exclude the most extreme price changes, increased at annualized rates of 1.6% and 2.0%, respectively.

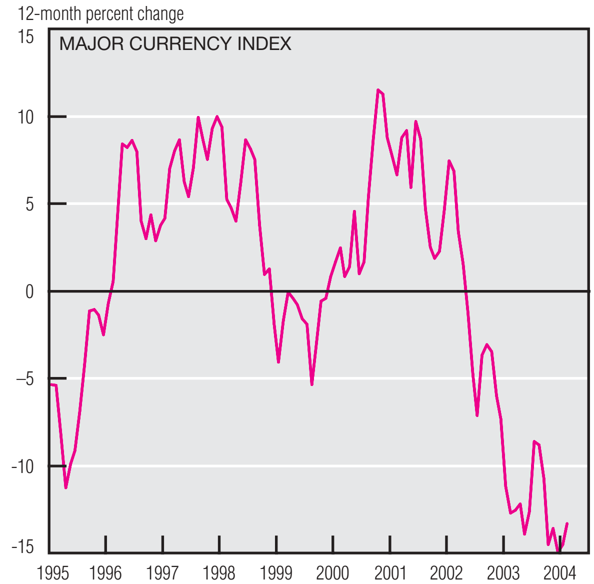
In his semiannual report to Congress, Federal Reserve Chairman Greenspan testified that because of measurement problems, recent inflation performance "puts measured inflation in a range consistent with price stability." Year-over-year inflation measures now indicate that prices are rising 1%–2% annually, with core CPI showing a modest 1% increase since last year.

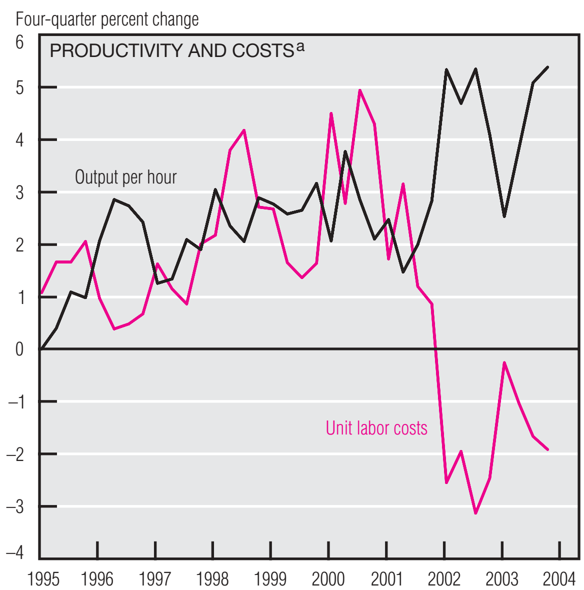
In evaluating the inflation situation, Chairman Greenspan noted that "[t]he recent performance of inflation has been especially notable in view of the substantial depreciation of the dollar in 2003." A falling dollar ordinarily would be expected to put upward pressure on import prices and, in turn, consumer goods prices. Indeed, the falling dollar has been associated with a turnaround in imported consumer goods price increases. Still,

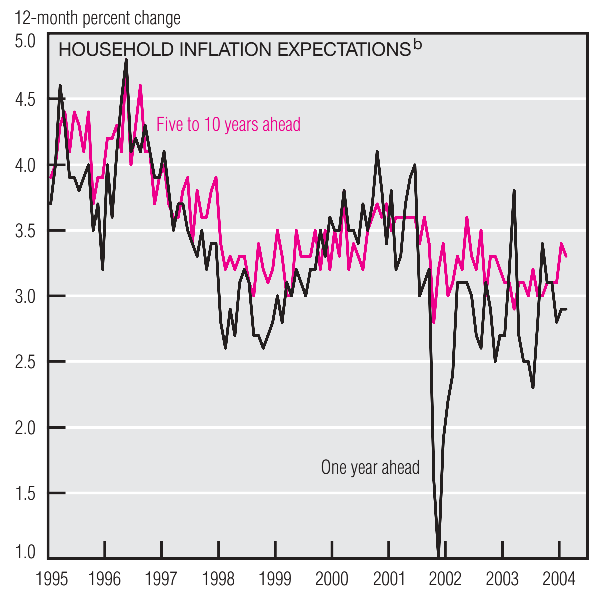
(continued on next page)

Inflation and Prices *(cont.)*









a. Nonfarm business sector.

b. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.

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

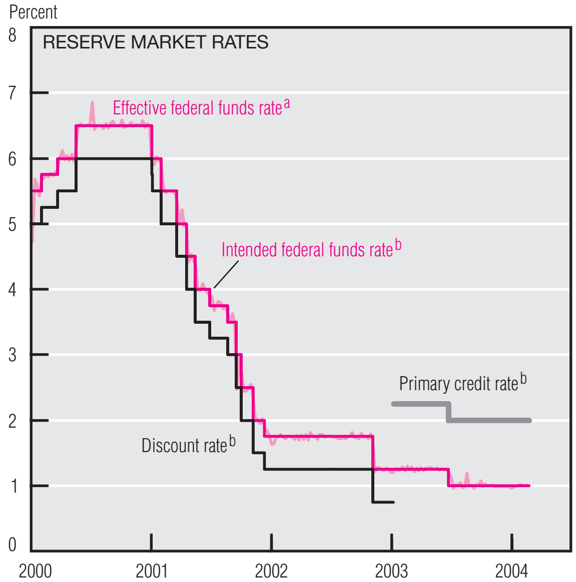
the weaker dollar's pass-through to higher consumer goods prices has been slight. According to the Chairman, "foreign exporters have [apparently] been willing to absorb some of the price decline measured in their own currencies and the consequent squeeze on profit margins it entails."

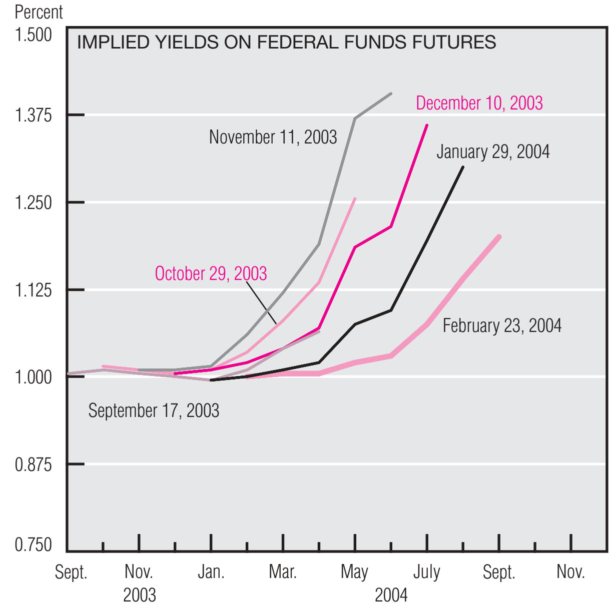
Perhaps an even more important factor in the unusually low inflation numbers over the past several years has been the spectacular rise in U.S. productivity coupled with modest wage growth, which has caused a drop in what economists call unit-labor costs. Output per hour has risen from around 2 1/2% to 4% in the last three years, while increases in hourly compensation fell from around 5 1/2% to about 3%; thus, unit labor costs have fallen dramatically. In fact, the 12-month trend in unit labor cost growth has been *negative* since late 2001.

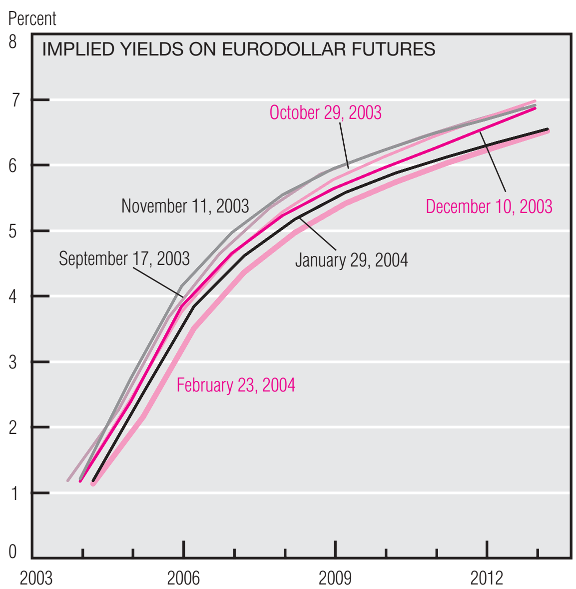
In light of the strong performance of U.S. productivity and generally sluggish labor markets, most hold a favorable prognosis for relative price stability. According to the Chairman, "increases in efficiency and a significant level of underutilized resources should help keep a lid on inflation," and U.S. households seem to share his view. The University of Michigan's Survey of Consumers shows that both short- and long-term inflation expectations are holding steady at recent levels. February survey data show that U.S. households anticipate price increases of about 3% over the next 12 months and 3 1/4% over the next five to 10 years.

4

Monetary Policy







Economic Projections for 2004

		Federal Reserve governors and Reserve Bank presidents	
	Actual 2003	**Range**	**Central tendency**
Nominal GDP[c]	5.90	5.50–6.50	5.50–6.25
Real GDP[d]	4.30	4.00–5.50	4.50–5.00
PCE Chain-type Price Index[c]	1.40	1.00–1.50	1.00–1.25
Civilian unemployment rate[e]	5.90	5.25–5.50	5.25–5.50

a. Weekly average of daily figures.
b. Daily observations.
c. Change, fourth quarter to fourth quarter.
d. Change, fourth quarter to fourth quarter. Chain weighted.
e. Average level, fourth quarter.
SOURCES: Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

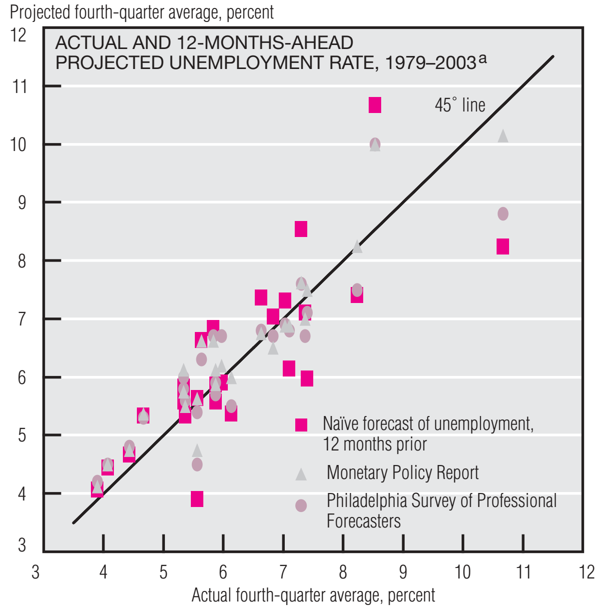
On February 11 and 12, Federal Reserve Chairman Alan Greenspan delivered his semiannual *Monetary Policy Report* to Congress. He began his comments by noting the strong expansion of GDP and productivity in the second half of 2003 but also the limited progress in creating jobs. He stated that "prospects are good for sustained expansion" and that "employment will begin to grow more quickly before long as output continues to expand." He remarked on the low level of inflation, which he said was in a range "consistent with price stability."

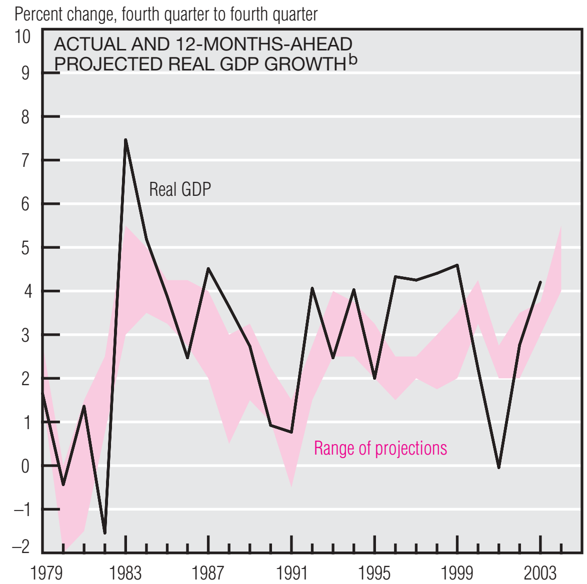
The Chairman also noted that the real federal funds rate "will eventually need to rise toward a more neutral level," but reiterated the Federal Open Market Committee's January 28 statement that the Fed "can be patient" in doing so. Despite his statement that the funds rate will need to rise eventually, participants in the federal funds futures markets continue to push back the date at which they expect the nominal funds rate to increase. Participants currently place an extremely low probability of a rate change occurring at the March meeting. Traders in eurodollar futures have lowered their trajectory for the future funds rate path as well.

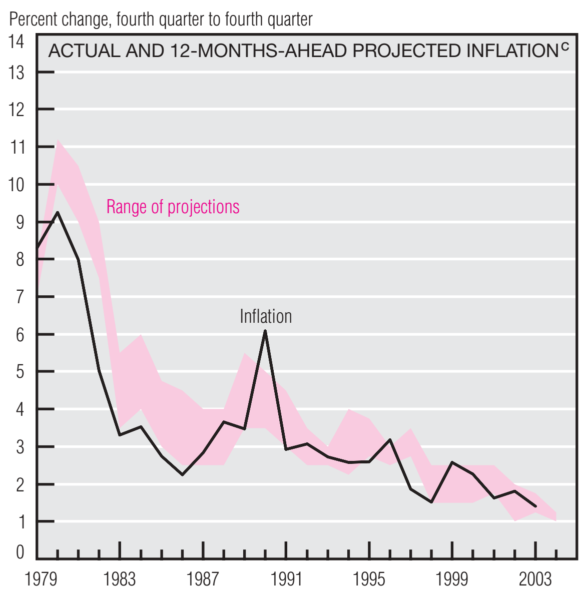
The *Monetary Policy Report* contains a set of economic projections by the Federal Reserve Board of Governors and Reserve Bank presidents. The central tendency of projections for 2004 real GDP growth is 4.50%–5.00%. The PCE Chain-type Price Index is expected to grow at an annual rate of 1.00%–1.25%, and the

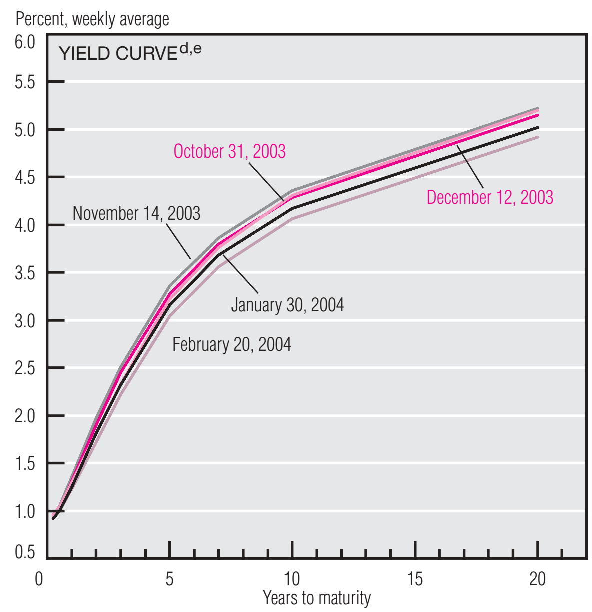
(continued on next page)

Monetary Policy *(cont.)*









a. The *Monetary Policy Report* projection is the midpoint of the range. The *Survey of Professional Forecasters* projection is the median response.
b. Projected and real GDP are both GNP prior to 1992.
c. From 1979 to 1989, inflation and projected inflation are plotted as the implicit GDP deflator; from 1990 to 1999 they are plotted in terms of the CPI; and from 1999 to 2002 as the PCE Chain-type Price Index.
d. All yields are from constant-maturity series.
e. Average for the week ending on the date shown.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*.

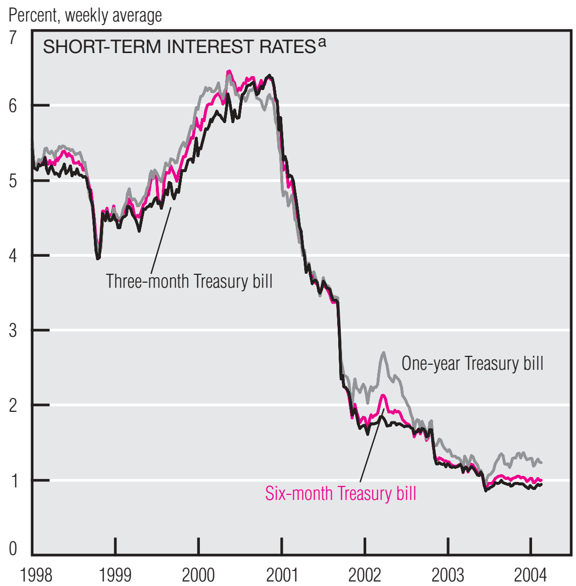
fourth-quarter unemployment rate is projected to be 5.25%–5.50%.

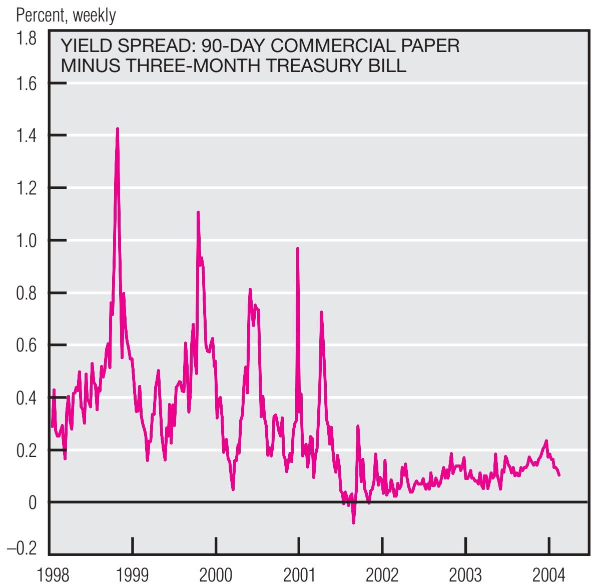
How accurate are these projections and those of private forecasters? If the projections were perfect, a scatter plot of the projections versus the actual values would show all its points lying along a 45-degree line. The scatter plot above compares the Report's accuracy to that of private forecasters and to a naïve forecast predicting that a variable's future value will equal its current value. Certainly, none of these forecasts is perfect. A summary statistic that measures the overall accuracy is the mean absolute error of the forecasts. At a 12-month horizon, the average absolute error of professional forecasters' unemployment projection is 0.54% versus the Fed's 0.40%. Both are superior to the naïve forecast, whose average absolute error is 0.70%.

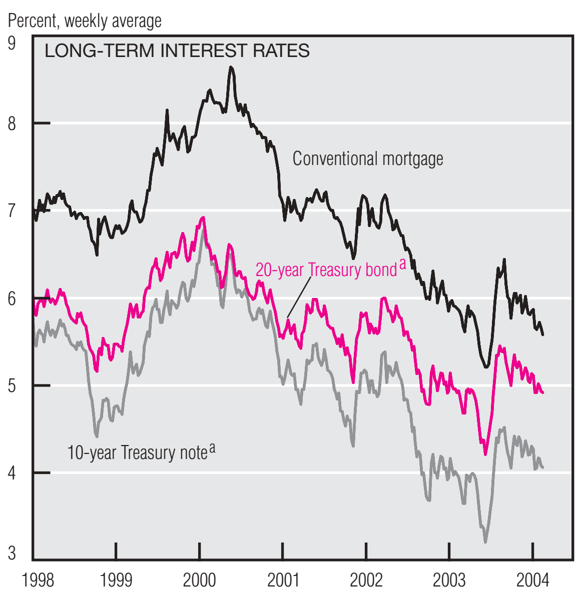
Fed projections of real GDP growth generally follow the pattern of actual values but at times stray far afield. These projections understated real GDP growth during the late 1990s and overstated it during the recent recession. Overall, real GDP projections have an average absolute error of 1.32%. Inflation rate projections track the actual inflation rate fairly closely, with an average absolute error of 0.88%.

Since the FOMC's January meeting, the yield curve has continued to shift downward across the intermediate and long-term maturities. The yield on 10-year maturities fell 11 basis points and the yield on 20-year maturities declined 10 basis points.

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.

After declining strongly from late 2000 to mid-2003, interest rates on three- and six-month Treasury bills have remained nearly constant at values close to the federal funds rate. One-year Treasury bills continue to have a premium of nearly 30 basis points (bp) over 90-day Treasury bills.

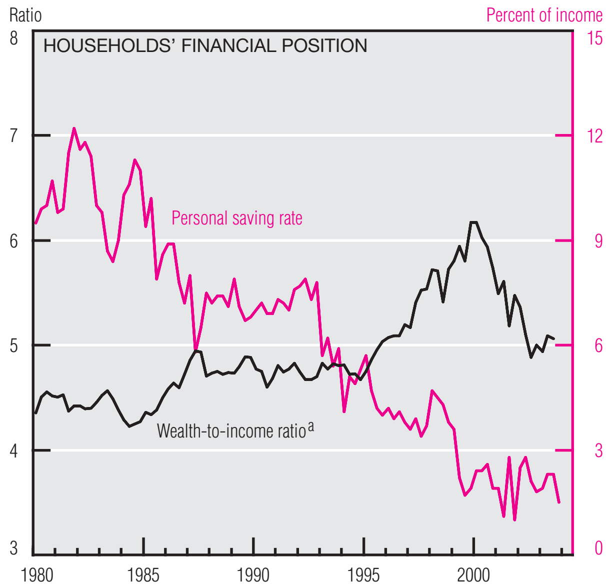
Since late December, the spread between 90-day commercial paper and the three-month Treasury bill rate has fallen about 13 bp. Despite low commercial paper rates, the amount of domestic nonfinancial commercial paper outstanding has contracted by more than two-thirds since it peaked in November 2000.

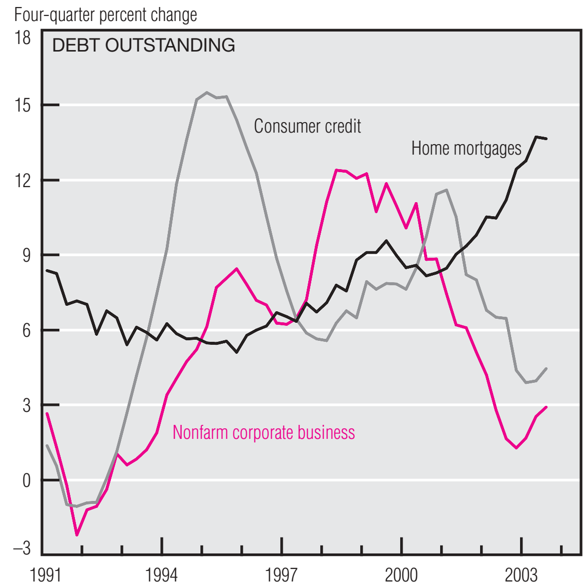
Low interest rates on conventional mortgages in 2003 encouraged a 10% increase in real residential construction expenditures for the year. In June 2003, mortgage rates reached their lowest level in 40 years, then increased markedly during the rest of the summer. However, the downward trend resumed late last year and continued into 2004. Ten- and 20-year Treasury security yields have fallen more than 45 bp since early fall 2003.

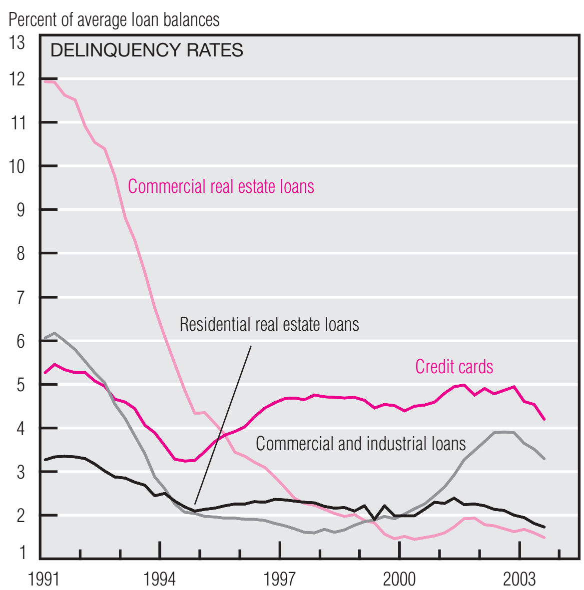
After trending downward since October 2002, yield spreads between AA-rated corporate bonds and Treasury notes have flattened markedly in the last three months. However, the premium on riskier corporate bonds has increased slightly. In his January testimony to Congress, Federal Reserve Chairman Greenspan commented on the strengthening in capital spending that occurred during the final three quarters of 2003, encouraged by lower risk spreads in credit markets and higher corporate profits. Nonfarm corporate

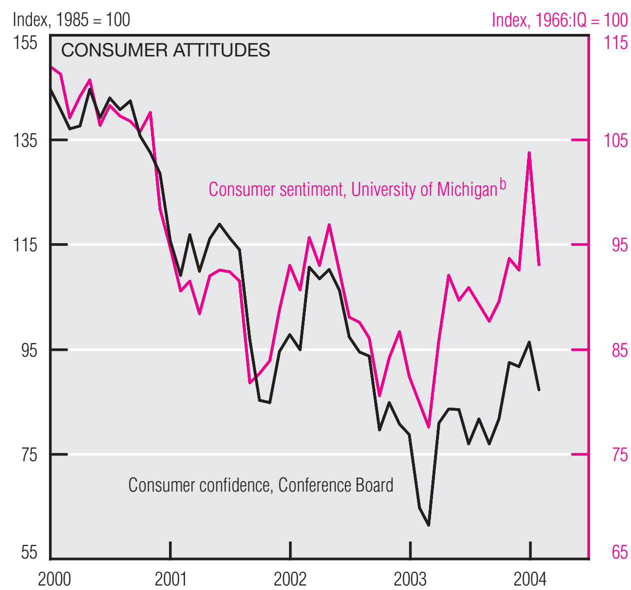
(continued on next page)

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.

business debt grew at a 3% annual rate during 2003:IIIQ.

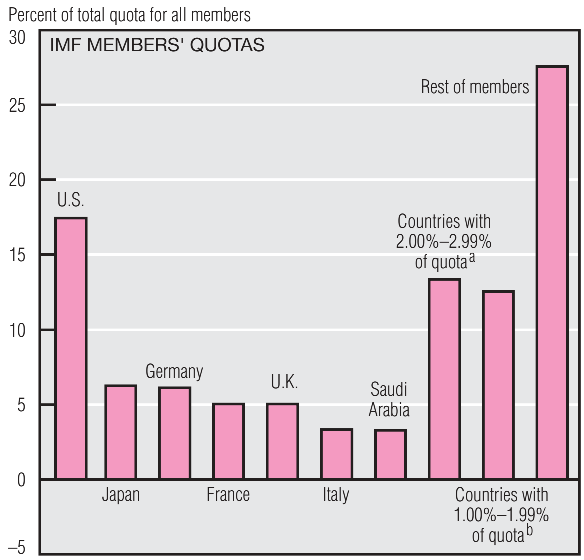
Although consumer debt rose substantially last year, households' net worth increased relative to disposable income because stock prices were up and real estate wealth increased. The personal saving rate has fluctuated markedly around 2% over the past three years.

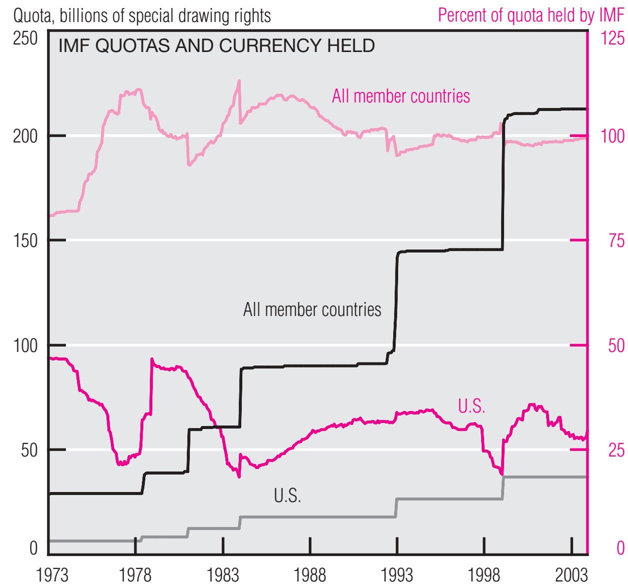
Last year's low mortgage rates encouraged substantial refinancing of homes, and homeowners used some of the proceeds to pay down higher-interest consumer debt. Even so, consumer debt grew during the year, mainly because credit card debt increased. However, in December 2003, nonrevolving debt growth exceeded credit card debt growth for consumers. Analysts expect nonrevolving debt growth to slow down in the coming months as auto sales wane. After a strong performance through much of last year, home mortgage growth slowed in December and January.

Despite higher levels of household debt, delinquency rates on credit cards and residential real estate loans continued to trend downward. Commercial loans showed similar improvement.

The University of Michigan's Consumer Sentiment Index rose dramatically in January, reaching its highest level since November 2000. Both the present conditions component and expectations component of the index rose vigorously. Although analysts expected a modest gain in February, the index retraced nearly all of January's increase in the preliminary release of the February survey. Both components of the index declined in February, as did the Conference Board's Index of Consumer Confidence.

The International Monetary Fund





IMF Financial Assistance Facilities

Financial assistance	Purpose	Charges	Obligation schedule, years	Expectations schedule, years
Standby arrangements	Provide shorter-term assistance for balance-of-payments problems	Basic GRA rate plus surcharges[c]	$3^1/_4$–5	$2^1/_4$–4
Extended Fund Facility	Addresses longer-term structural problems	Basic GRA rate plus surcharges[c]	$4^1/_2$–10	$4^1/_2$–7
Special lending facilities	Varies	Basic GRA rate plus 0–500 basis points[c]	2–5	1–4
Poverty Reduction and Growth Facility[d]	Resolves deep-seated balance-of-payments problems; aims at sustained poverty-reducing growth	0.5% per year	$5^1/_2$–10	—

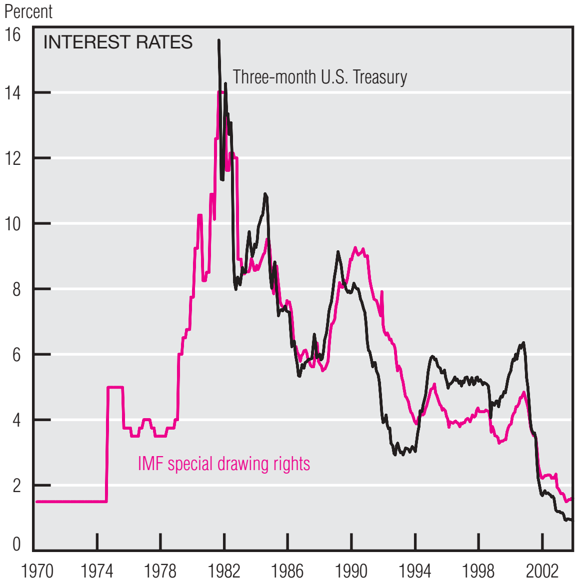
a. China, Canada, Russian Federation, Netherlands, and Belgium.
b. India, Switzerland, Australia, Brazil, Spain, Venezuela, Mexico, Sweden, and Argentina.
c. Basic rate on general resources account funds, set as a fixed proportion of the rate on special drawing rights.
d. Replaced the Enhanced Structural Adjustment Facility in 1999.
SOURCES: International Monetary Fund, *International Financial Statistics* and 2003 *Annual Report*; and Board of Governors of the Federal Reserve System.

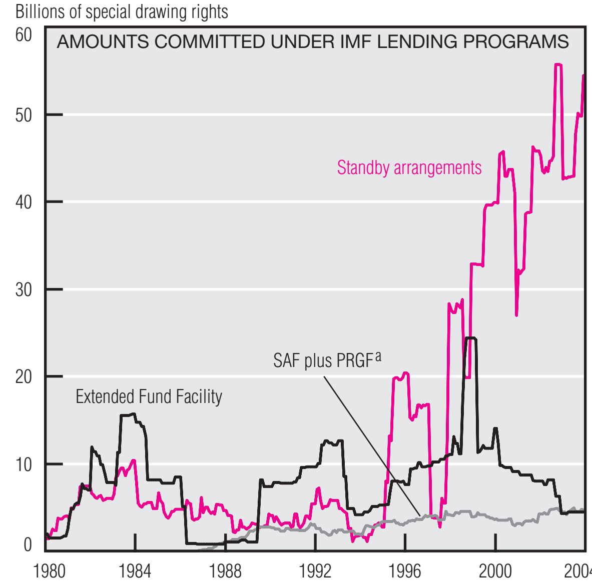
Since its creation in 1945, the International Monetary Fund (IMF) has grown from 45 member countries to 184. The IMF has often been compared to a credit union because it loans funds to member countries from the pooled resources of all the members. The general resources account contains the bulk of these funds. Quotas, usually reviewed every five years, set the maximum amount countries are called to contribute to the general resources account and determine member countries' voting power. Votes such as the quota reviews usually made every five years can require a majority of up to 85%. Special drawing rights, the IMF's unit of account, are valued as a weighted average of currencies from the U.K., the euro area, the U.S., and Japan. The interest rate on special drawing rights, a weighted average of three-month bond rates in the same regions, determines the general resources account's basic interest applied to IMF loans.

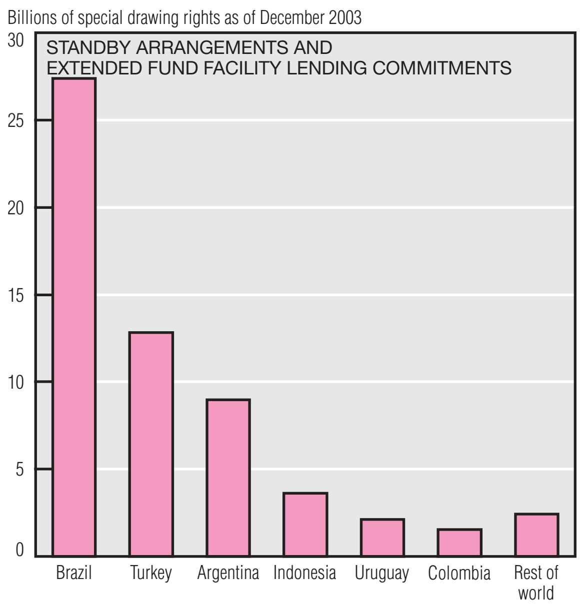
Most IMF loan commitments are made either as standby arrangements, which are designed to help shorter-term, cyclical balance-of-payments problems, or through the Extended Fund Facility, which addresses longer-term structural problems. Both programs add progressive surcharges to the basic general resources account rate on loans that are two or three times larger than the receiving country's quota. Special lending facilities are intended to prevent short-term crises of market confidence or

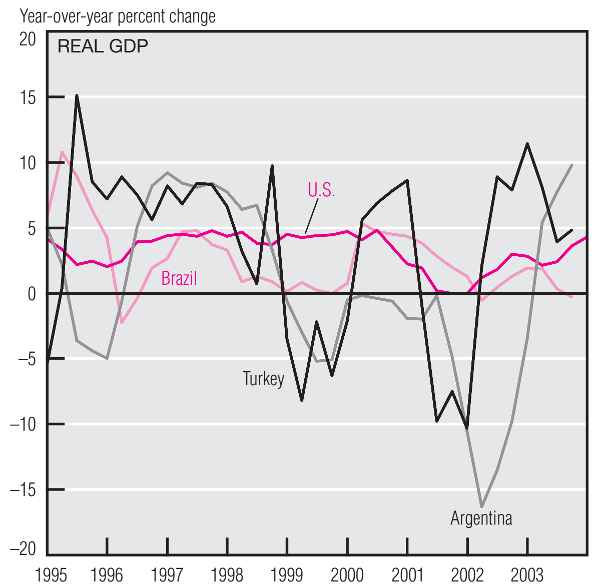
(continued on next page)

The International Monetary Fund *(cont.)*









a. The Poverty Reduction and Growth Facility (PRGF) replaced the Enhanced Structural Adjustment Facility (ESAF) in 1999.
SOURCES: International Monetary Fund, *International Financial Statistics*; and Bloomberg Financial Information Services.

temporary import or export problems, provide emergency assistance, or prevent financial contagion. If a borrower's financial position is not strong enough to repay loans by the expectations deadline, the country may ask the IMF's executive board to extend the loan period forward to the obligations deadline. The Poverty Reduction and Growth Facility, instituted in 1999, provides poor countries with low-interest loans aimed at enhancing long-term sustainable growth.

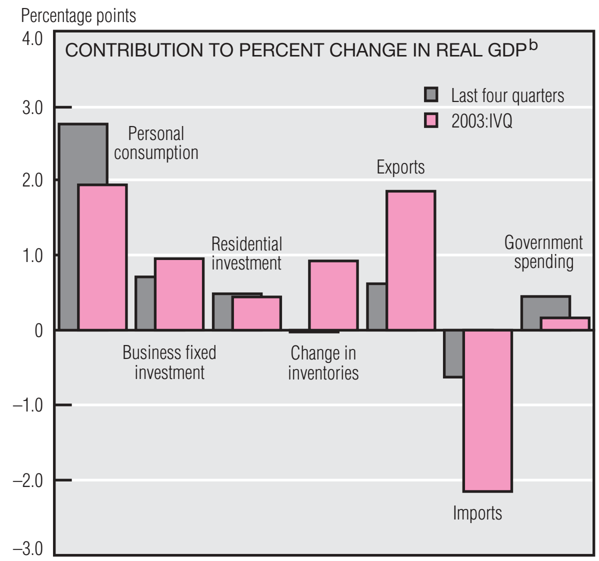
Countries receiving loans must make a number of commitments on financial and economic policies designed to ensure macroeconomic stability and timely repayment. This process, known as conditionality, has been controversial and was revised in September 2002. New guidelines were designed to take account of country-specific circumstances.

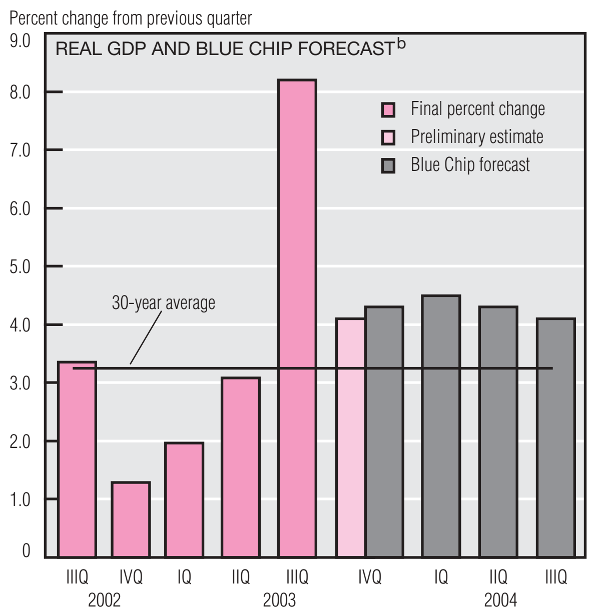
Brazil, Argentina, and Turkey currently account for over 80% of the combined loans committed through standby arrangements or by the Extended Fund Facility. These three countries have encountered a number of economic and social problems such as fiscal imbalances, civil unrest, and legal uncertainties, as well as bouts of inflation and currency depreciation. Through a combination of loan packages and conditional reforms and policies, the IMF seeks to return these countries to financial and economic stability.

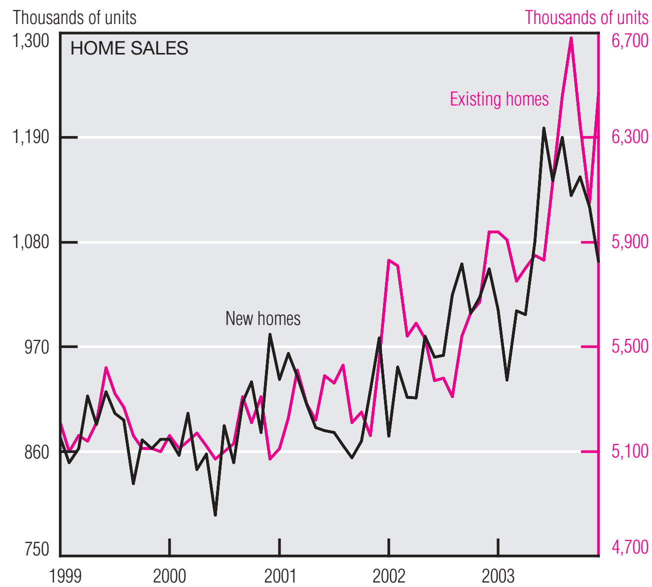
Economic Activity

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

	Change, billions of 2000 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	106.1	4.1	4.3
Personal consumption	50.3	2.7	3.9
Durables	–0.4	–0.1	10.9
Nondurables	27.2	5.2	4.8
Services	22.8	2.2	2.0
Business fixed investment	26.4	9.6	7.1
Equipment	32.4	15.1	10.1
Structures	–4.3	–7.0	–2.3
Residential investment	10.8	8.6	9.7
Government spending	4.0	0.8	2.4
National defense	4.9	4.2	8.3
Net exports	–9.2	—	—
Exports	50.4	21.0	6.5
Imports	59.7	16.4	4.6
Change in business inventories	24.0	—	—







NOTE: All data are seasonally adjusted and annualized.
a. Chain-weighted data in billions of 1996 dollars. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, February 10, 2004.

According to the Commerce Department's revised estimate, the annualized growth rate of real GDP in 2003:IVQ was 4.1%, a modest increase from the 4.0% reported in the initial estimate. The Blue Chip panel of economists' forecast of output growth in 2004:IQ was also revised slightly upward in February, from 4.4% to 4.5%. Their estimate for 2003:IVQ was 4.3%, a little higher than the actual number, but the most recent Commerce Department revision shrinks the difference.

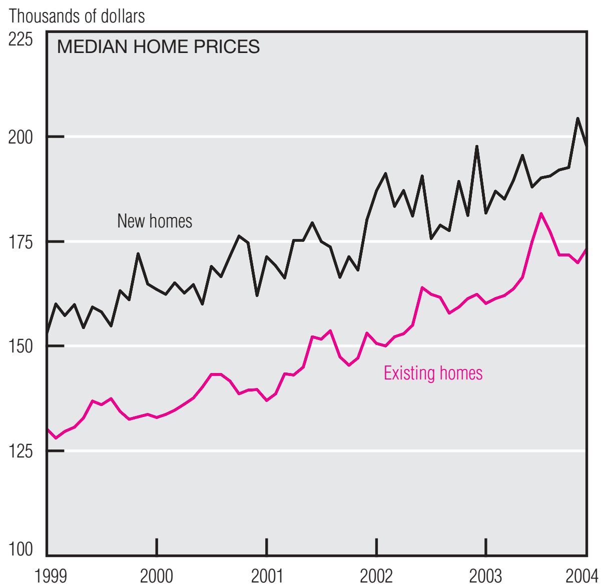
Imports had the largest negative impact, taking 2.15 percentage points (pp) from output growth in the fourth quarter. Exports, meanwhile, made a positive contribution of 1.85 pp to output growth.

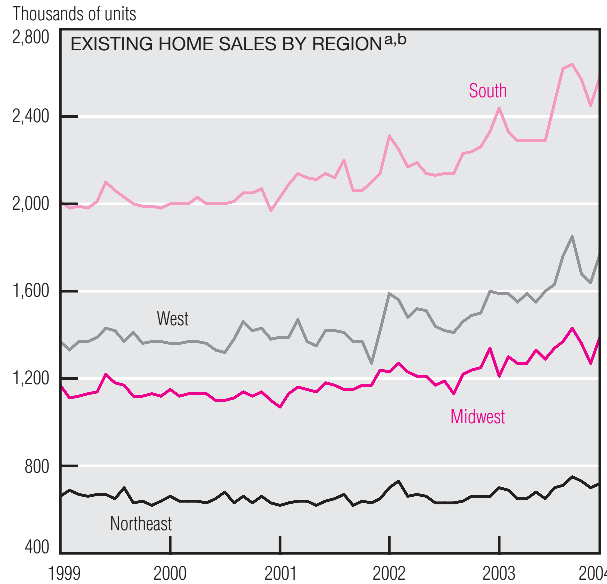
Personal consumption after the revision remained the largest source of output growth, adding 1.93 pp in 2003:IQ and an average of about 2.74 pp for the year. Government spending added 0.16 pp to output growth, down from the previous quarter and lower than the 2003 average. About half of the government contribution came from growth in national defense, which ticked up 4.2%, adding 0.19 pp to output growth and offsetting the negative impact of government's nondefense and consumption spending.

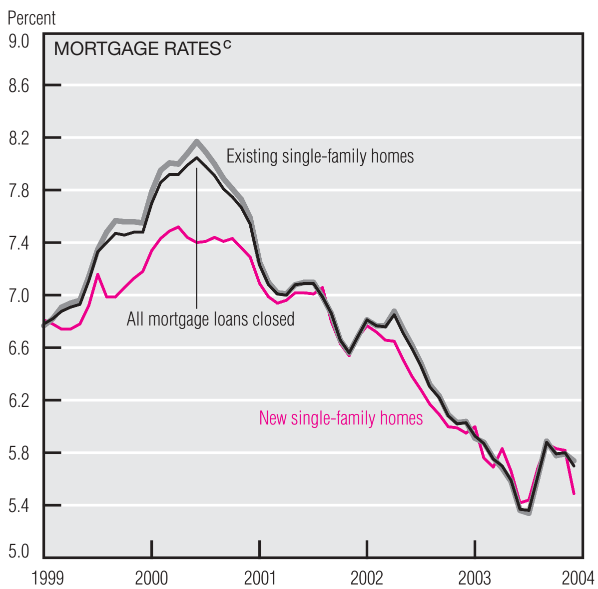
Residential fixed investment rose 10% and business fixed investment

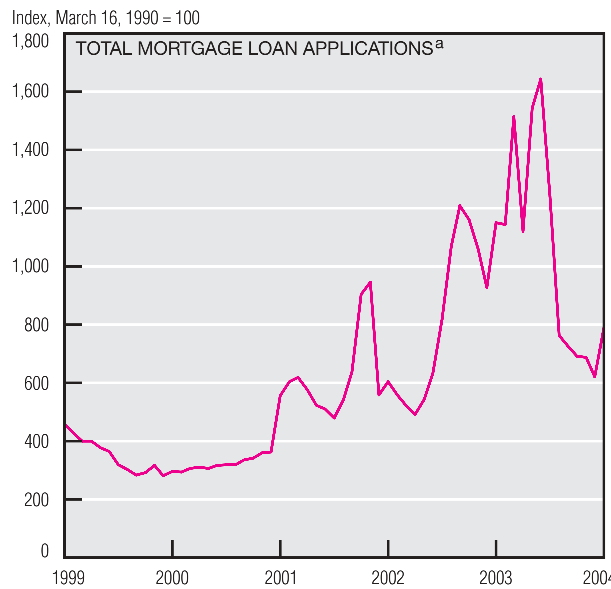
(continued on next page)

Economic Activity *(cont.)*









a. Seasonally adjusted.
b. Annual rates.
c. Contract interest rate.
SOURCES: U.S. Department of Commerce, Bureau of the Census; Federal Housing Finance Board; Mortgage Bankers Association of America; and National Association of Realtors.

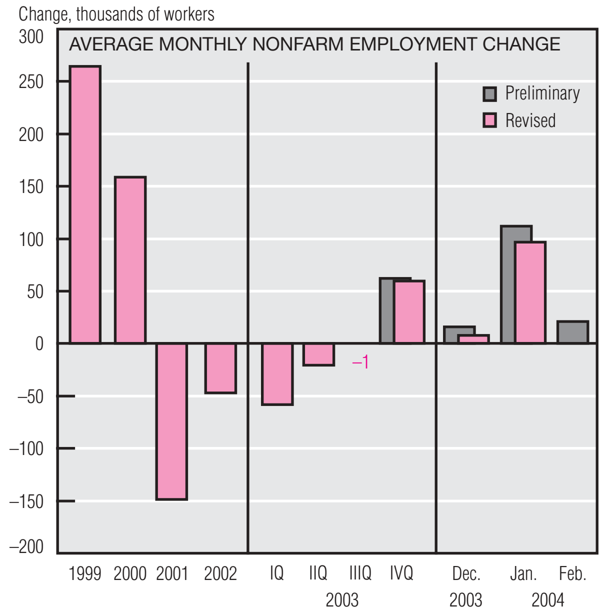
gained 6.9% in 2003:IVQ, pushing fixed investment's increase to 8.1%.

Data on housing sales have always been notoriously volatile, but trends from recent data suggest that the housing market may be cooling off. In December 2003, new homes sold at a median price of $198,000, reversing some of November's gains, but remaining well above pre-November levels. Meanwhile, prices of existing homes ticked up in December to $173,000 after dropping from July's peak of $182,000, a level 6.7% above the median existing home sale price in December 2002.

Market volume falls short of the highs established in 2003, but still surpasses previous years. Existing home sales in each of four geographical regions peaked in September, which is typically a high-volume month. Although sales ran below the September peak, on a year-over-year comparison, sales exceeded 2002 levels. In particular, December sales were about 6.7% higher in 2003 than in 2002.

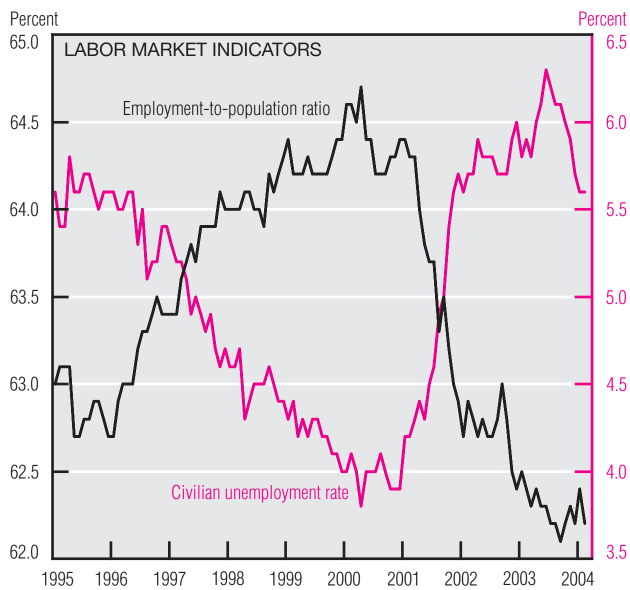
Interest rates for mortgage loans, after increasing for the last several months, have risen from the all-time lows set in the summer of 2003. However, the recent 5.7% contract interest rate for all new and existing homes is still lower than in any year before 2003. Mortgage loan applications have slowed significantly since peaking last year, and are now running at about the same level as in the summer of 2002.

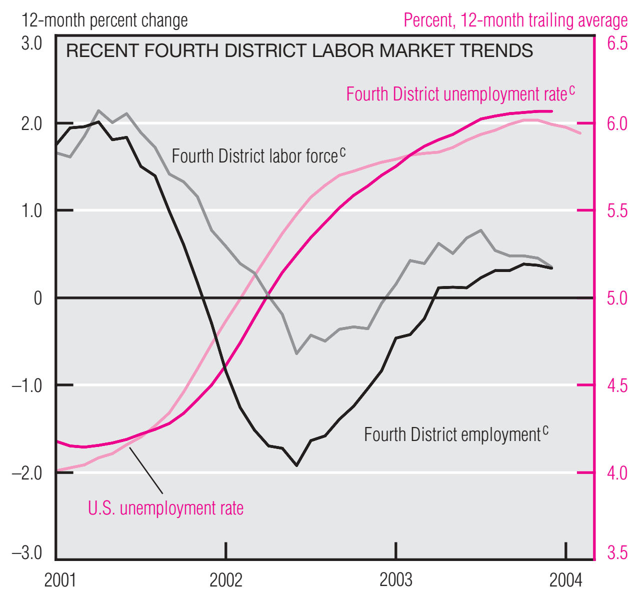
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	2001	**2002**	**2003**	**YTD**	**Feb. 2004**
Payroll employment	–149	–47	–5	59	21
Goods producing	–124	–76	–42	–3	–25
Construction	–1	–8	7	5	–24
Manufacturing	–123	–67	–48	–8	–3
Durable goods	–88	–48	–30	4	8
Nondurable goods	–35	–19	–18	–12	–11
Service providing	–25	29	37	62	46
Information	–15	–19	–10	–6	2
Financial activities[a]	8	6	6	3	9
PBS[b]	–63	–17	23	0	10
Temporary help svcs.	–37	2	15	9	32
Education & health svcs.	50	40	28	13	13
Government	46	21	–4	8	21
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.6	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. Calculated by the Federal Reserve Bank of Cleveland using Bureau of Labor Statistics data. Excludes Fayette County, Kentucky.

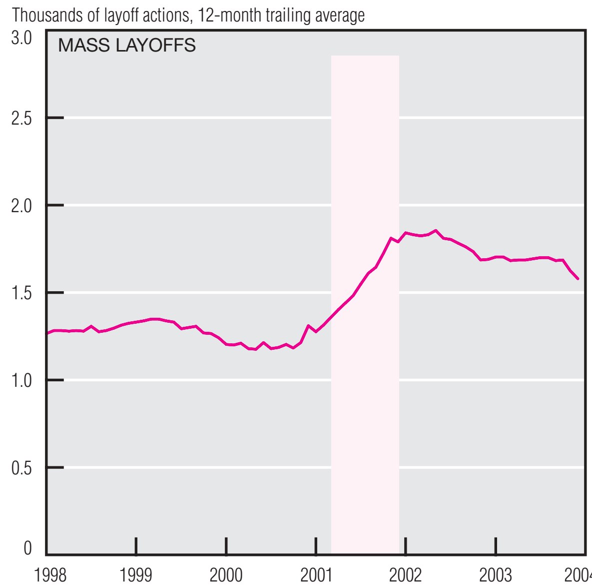
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

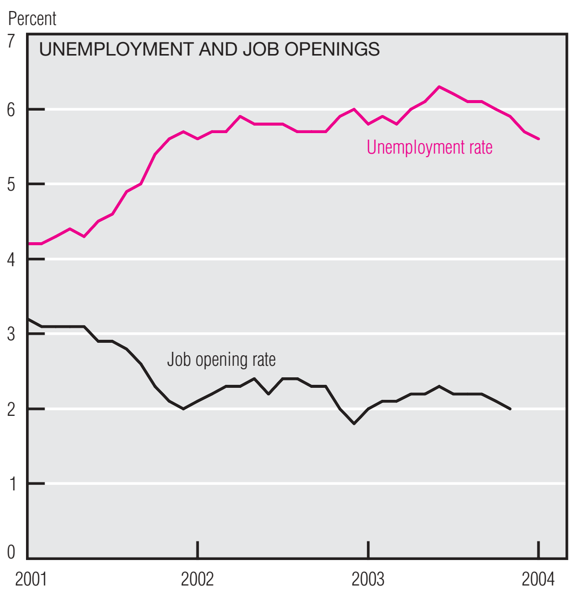
Nonfarm payroll employment recorded a net gain of only 21,000 jobs in February, compared with forecasters' projection of a 128,000 net gain. The previous two months' net gains were revised down by a total of 23,000. Still, nonfarm payroll employment has increased for six straight months, averaging a net gain of 61,000 jobs per month.

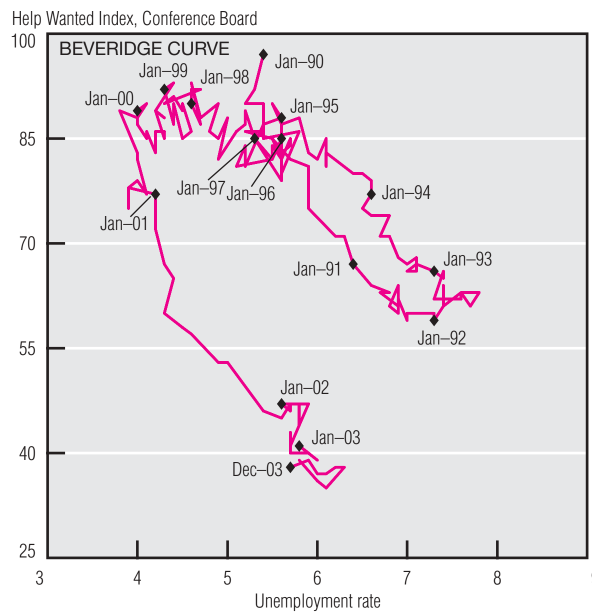
Construction employment posted a net loss of 24,000 jobs in February, following January's net gain of 34,000 jobs. Manufacturing lost an average of 11,000 net jobs over the past four months, after reporting a monthly average net loss of 83,000 jobs from January 2001 to October 2003. This recent slowdown in the rate of job losses has been concentrated primarily in durable goods industries, which have added 21,000 net jobs since November 2003. Over the past six months, the average number of hours per week has risen 1.0 hour for workers in durable goods manufacturing industries and 0.6 hour for those in nondurable goods. Service-providing industries added 46,000 net jobs in February, slightly more than the average monthly net gain of 40,000 jobs since January 2003. Employment in temporary help services rose by 32,000 jobs.

In February, the national unemployment rate remained at 5.6%, while the labor force participation rate fell 0.2 point to 62.2%. The average participation rate in 2003 was 62.3%. Because of differences in data sources and estimation methods, it is difficult to make point-in-time comparisons of labor market data for the U.S. versus the Fourth Federal Reserve District. However, labor market trends since 2001 in the Fourth District and in the rest of the country appear to be at least qualitatively similar.

Employment Changes







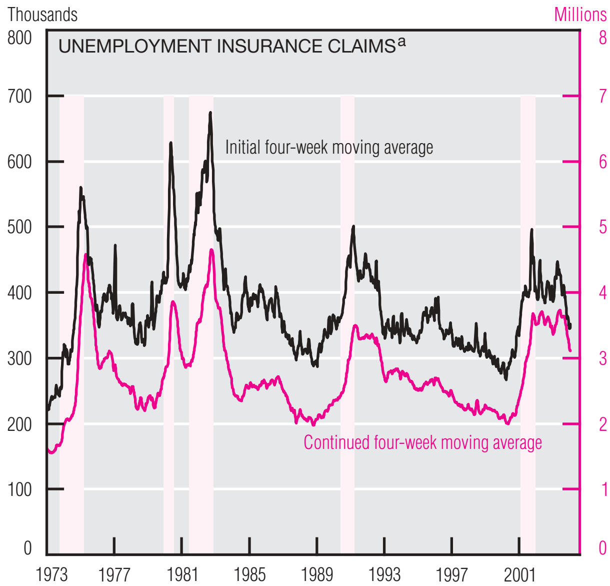
SOURCES: U.S. Department of Labor, Bureau of Labor Services; and the Conference Board.

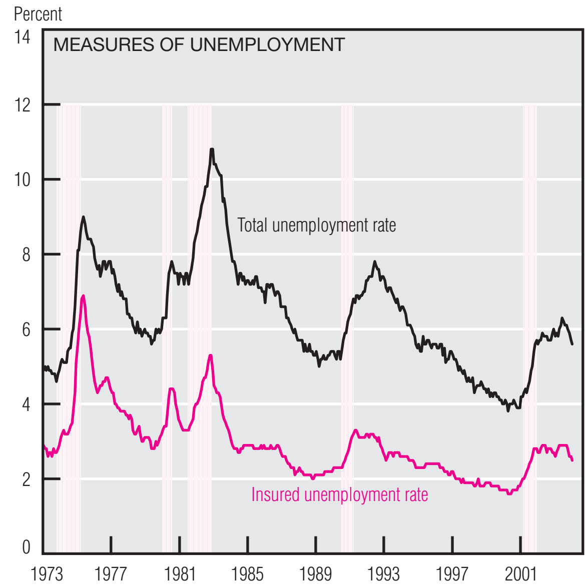
The change in aggregate employment is the difference between gross job creations and gross job destructions. Job gains occur in new establishments and those that are expanding, whereas job losses take place in establishments that are closing or contracting. About 7% of all private sector jobs are created or destroyed each quarter. In 2003:IIQ, there were sizeable flows of both job gains (7.5 million) and job losses (7.7 million). Job losses are highly counter-cyclical, as illustrated by their peak during the 2001 recession period (the shaded area in the upper two charts). Although job destructions have fallen almost continuously since peaking in 2001 (2003:IQ excepted), they have still outpaced job gains, leading to continued reductions in aggregate employment. Nevertheless, there is encouraging evidence—a 69,000 increase in job gains from 2003:IQ to 2003:IIQ, the first such increase since 2002:IQ.

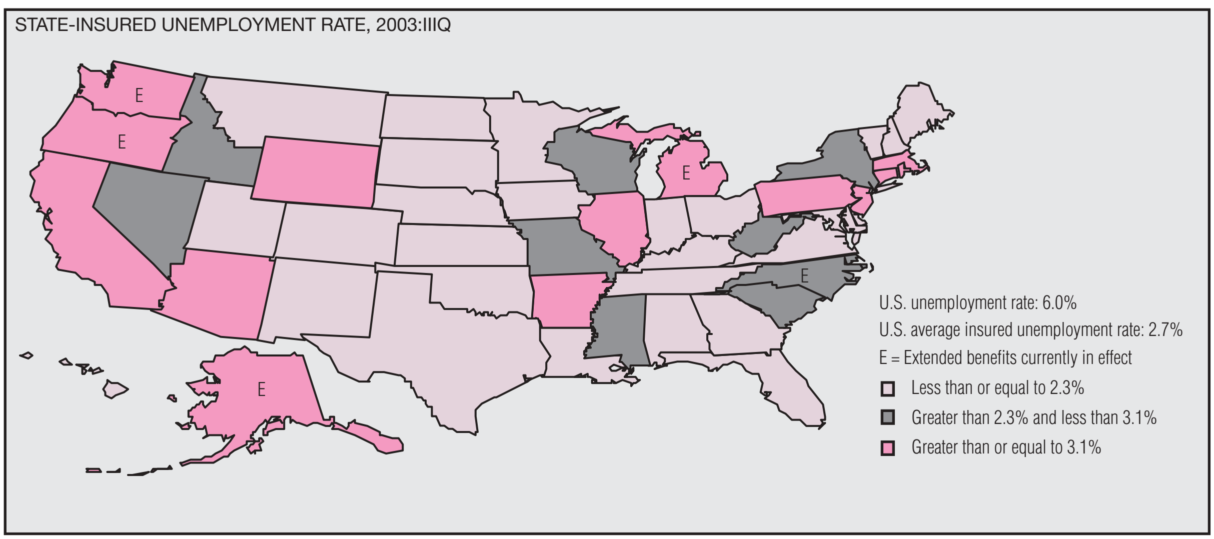
The reduction in job losses is also reflected by a drop in mass layoffs (those involving at least 50 workers from a single establishment). Approximately 19,000 mass layoffs occurred in 2003, roughly 1,300 fewer than in 2002 and 2,500 fewer than in 2001.

The Beveridge curve shows the inverse relationship between job vacancies (as approximated by the Help Wanted Index) and unemployment. The index was low in December 2003 but should rise as the expansion translates into more job creation. One can also see a recent downward shift of the Beveridge curve, suggesting that the economy achieves a lower unemployment rate for a given level of vacancies.

Measuring Unemployment







a. Seasonally adjusted.
SOURCES: U.S. Department of Labor, Employment and Training Administration and Bureau of Labor Statistics.

In contrast with the weak employment growth figures, national unemployment indicators suggest a gradually improving labor market. The number of initial claims for unemployment insurance, a frequent and timely measure of current labor market conditions, has continued to decline. Since the end of September, the four-week moving average has registered fewer than 400,000 claims, the number that many consider an indicator of recession. The trends for continued claims are similar.

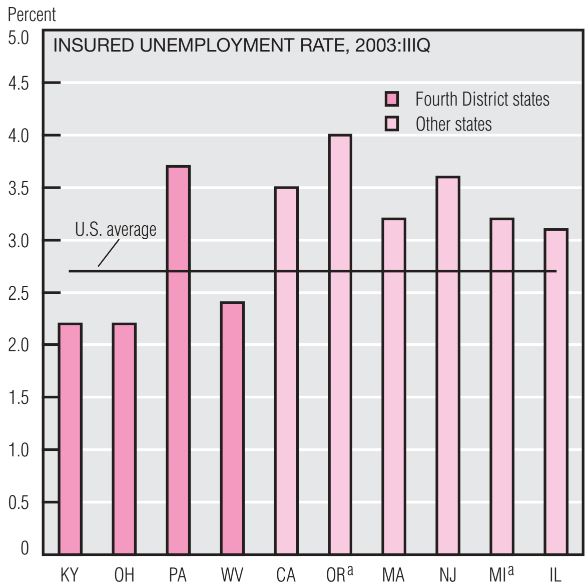
The total unemployment rate has been falling since last July, and the insured unemployment rate has been dropping since last October. The insured unemployment rate (the share of the labor force that claims unemployment benefits) always is lower than the total unemployment rate because some unemployed persons do not qualify for benefits or do not choose to receive them.

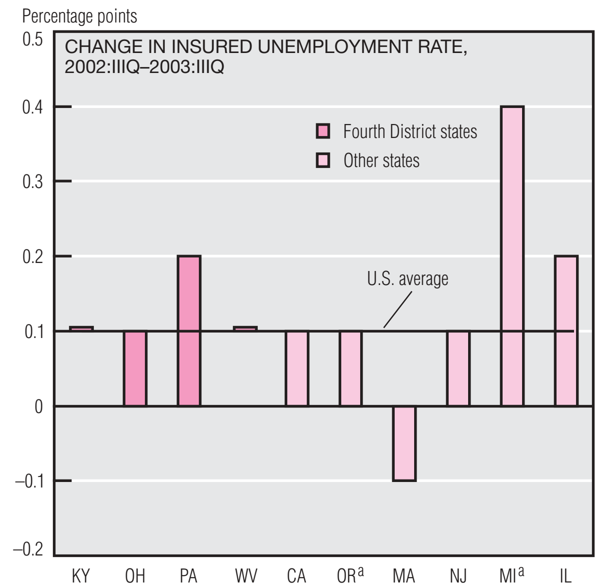
Data on state unemployment insurance claims show regional unemployment differences that may be obscured in sample-based measures, such as those derived in the Household Survey designed by the Bureau of Labor Statistics. Although the differences in state unemployment insurance programs (for example, the existence of an extended benefits program) affect state-insured unemployment rates, most of the differences between states result from local economic conditions.

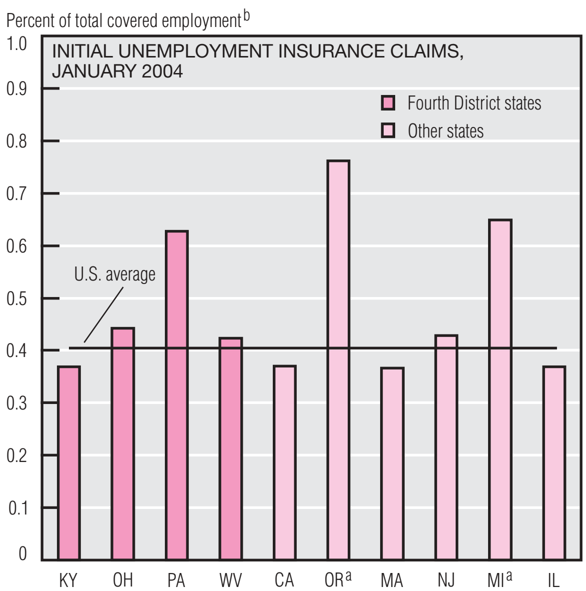
Throughout the Fourth District, state-insured unemployment rates

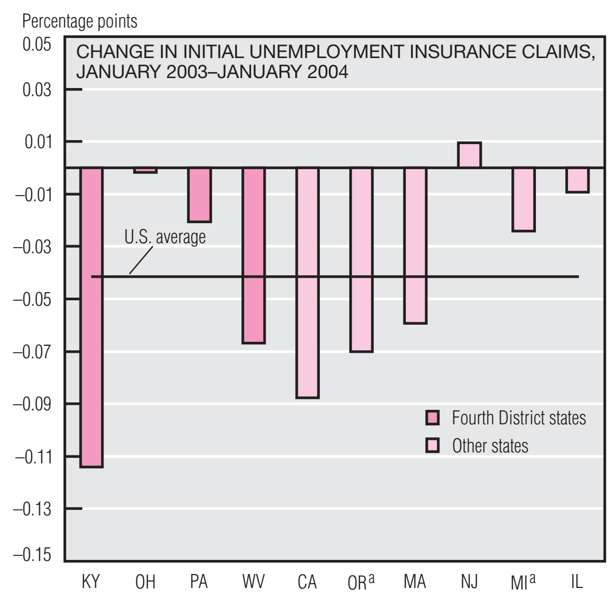
(continued on next page)

Measuring Unemployment (cont.)







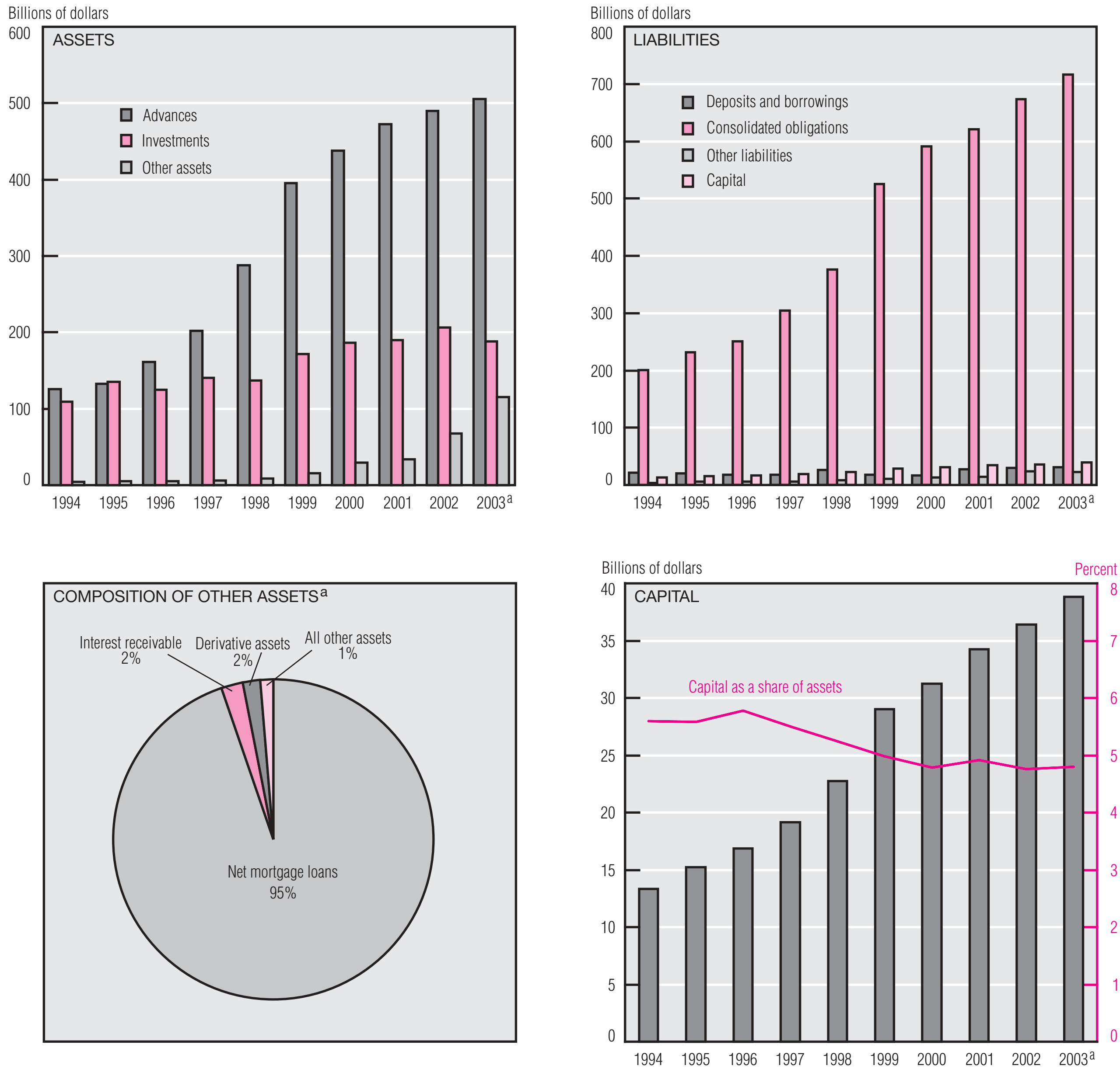


a. States with extended benefits.
b. Calculated using 2003:IIIQ total covered employment data.
SOURCE: U.S. Department of Labor, Employment and Training Administration.

varied substantially: Rates in Ohio and Kentucky were below the national average of 2.7%, but Pennsylvania, with its heavy concentration of workers in metal industries, posted an above-average rate. However, insured unemployment in both Ohio and Pennsylvania increased from year-ago levels at a rate equaling or exceeding the U.S. average, whereas rates in Kentucky and West Virginia remained stable. States that are heavily invested in high-tech industries, such as the West Coast states, Massachusetts, and New Jersey, experienced insured unemployment rates well above the U.S. average. Above-average rates also were recorded in Illinois and in Michigan, which has a high concentration of businesses in the automotive industry.

Numbers of initial unemployment insurance claims were higher in Ohio, Pennsylvania, and West Virginia than we would expect based on the states' covered employment levels. All the Fourth District states have seen declines in initial claims since January 2003, but the declines have been much slower in Ohio and Pennsylvania. Overall, recent unemployment insurance data suggest that labor markets in Pennsylvania and Ohio have improved less than in the nation as a whole over the last year. Similar weakness is also evident in New Jersey, Michigan, and Illinois.

Federal Home Loan Banks



a. Data through 2003:IIIQ.
SOURCES: Federal Home Loan Bank System, *Quarterly Financial Report,* September 30, 2003, and annual reports.

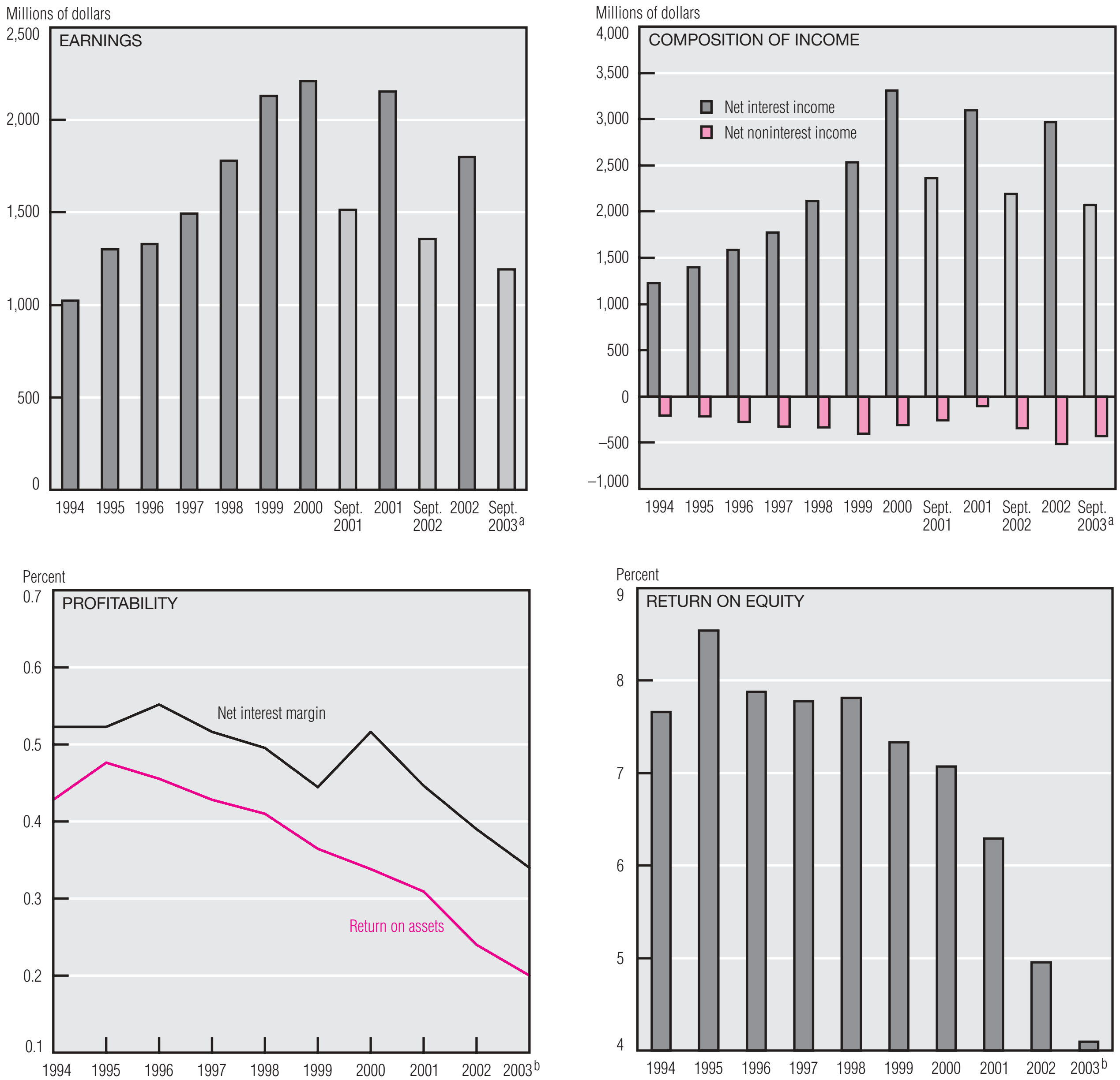
The 12 Federal Home Loan Banks are stock-chartered, government-sponsored enterprises whose original mission was to provide short-term advances to member institutions, using funds that those institutions deposited. Membership was open to specialized housing-finance lenders, mostly savings and loan associations and mutual savings banks. With continued shrinkage of their traditional clientele and ongoing consolidation of the financial system, the FHLBs have been reinventing their role in financial markets. Their advances, which now represent an important source of funding for member institutions' mortgage portfolios, rose to $506 billion at the end 2003:IIIQ, easily outstripping all their other investments and assets.

By far the largest share of funding for FHLBs' assets came from $717 billion of consolidated obligations of the Federal Home Loan Bank System—bonds issued on behalf of the 12 FHLBs collectively. The market considers these bonds to be implicitly backed by the U.S. government; consequently, FHLBs can raise funds at lower rates of return than AAA-rated corporations. Member institutions' deposits and short-term borrowings, along with other liabilities, provided only a miniscule share of funds. FHLBs have added to their capital as they have grown, but asset growth has outstripped capital growth, and the capital-to-assets ratio fell from 5.8% in 1996 to 4.8% at the end of 2003:IIIQ.

In 1997, the Federal Home Loan Bank of Chicago initiated the Mortgage Partnership Finance Program, through which it began to invest directly in mortgages besides supporting members' own mortgage portfolios through advances. FHLBs now

(continued on next page)

Federal Home Loan Banks *(cont.)*



a. Data through 2003:IIIQ.
b. The data for 2003:IIIQ are annualized.
SOURCES: Federal Home Loan Bank System, *Quarterly Financial Report,* September 30, 2003, and annual reports.

hold $108 billion in mortgages, more than double what they held a year ago, and mortgage portfolios are projected to be a major source of asset growth in the future.

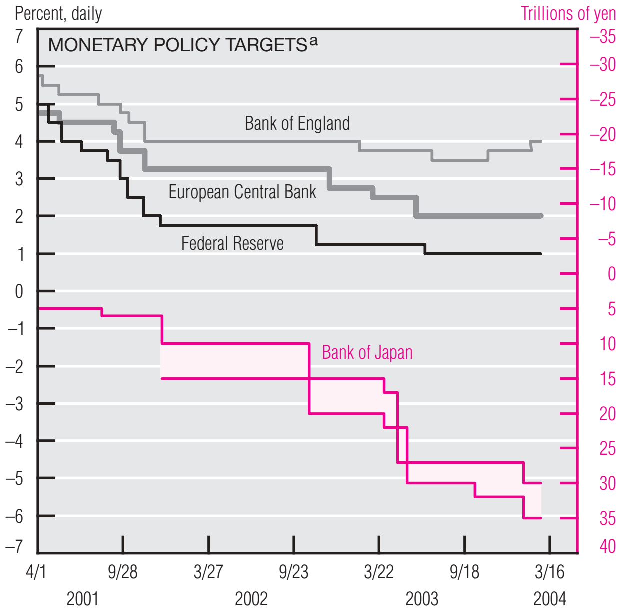
FHLBs' earnings grew steadily from 1994 through 2000 before declining in 2001 and 2002. Their net income of $1,192 million for the first nine months of 2003 was lower than the $1,356 million earned during the same period in 2002.

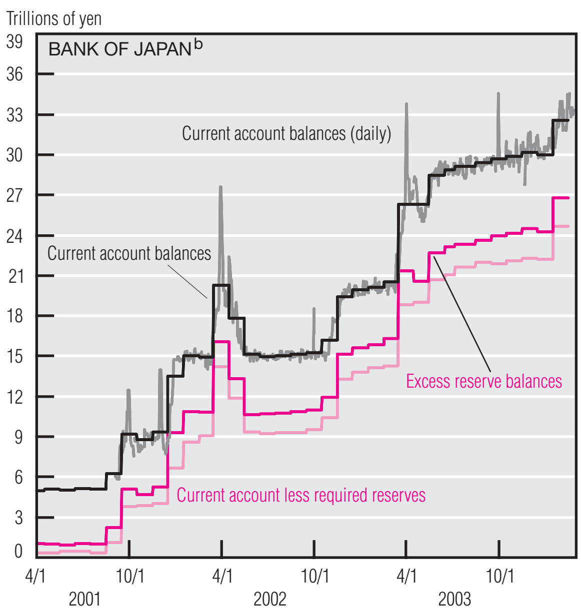
FHLBs' net interest income rose from $1,230 million in 1994 to $3,311 million at the end of 2000. The trend since then has been downward. For the first nine months of 2003, their net interest income of $2,075 million was down from $2,194 million for the same period in 2002. The most important reason for the increasingly negative spread between non-interest income and non-interest expense since 1994 is the steady increase in FHLBs' operating expenses, especially in the area of employee compensation.

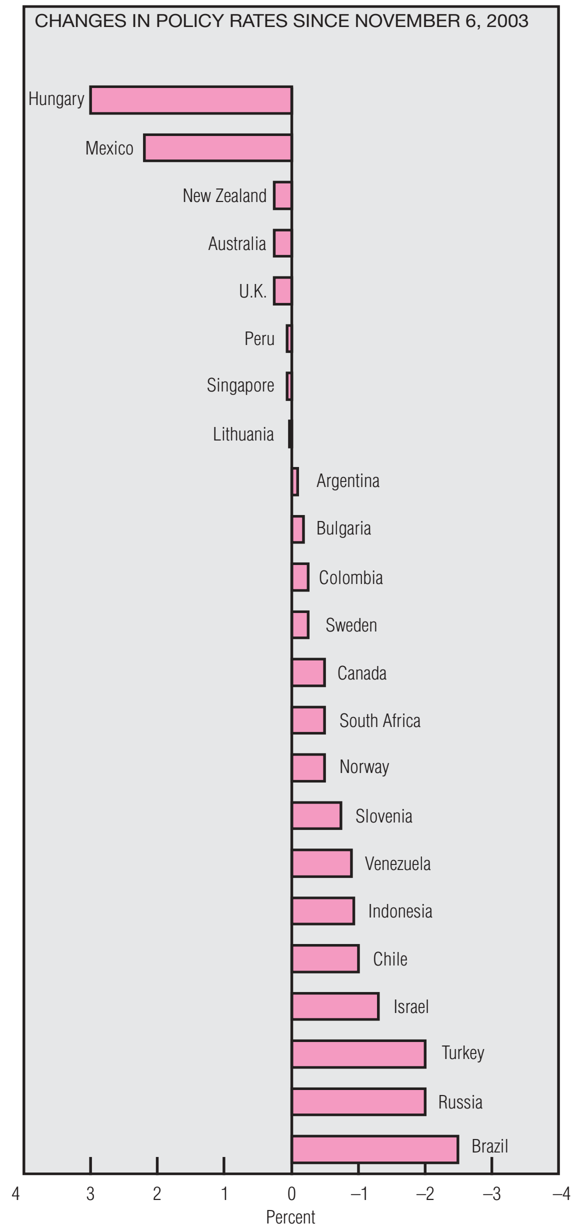
Improvements in earnings and net interest income have resulted from strong asset growth rather than greater underlying profitability. Return on assets fell from 43 basis points (bp) in 1994 to 24 bp at the end of 2002. The annualized return on average assets through 2003:IIIQ was 20 bp. Profitability was hurt by the net interest margin's decline from 39 bp at the end of 2002 to an annualized 34 bp for the first nine months of 2003.

Finally, despite continued increases in leverage since 1996, return on average equity fell from 4.9% at the end of 2002 to 4.1% in the first nine months of 2003. These persistently weak returns on assets and equity further pressured FHLBs to undertake nontraditional lines of business in search of higher returns.

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: 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; and Bloomberg Financial Information Services.

The Bank of England's Monetary Policy Committee raised its repo rate to 4% in early February, the second increase of 25 basis points in three months. The committee said that this tightening action was required because, "although sterling has appreciated, continued [output] growth above trend means that inflationary pressures are likely to pick up gradually over the next couple of years."

The Bank of Japan, on the other hand, has increased the supply of current account balances recently, consistent with its Policy Board's easing of the target range to ¥30 trillion–¥35 trillion in January. In the bank's view, the economy will continue recovering at a moderate pace, but consumer prices are expected to keep falling slightly "because the imbalance between supply and demand in the economy still remains considerable."

Disparate policy moves are evident among other nations, largely reflecting the emergence of differences in the direction of expected economic growth and inflation. Since the Bank of England increased its repo rate last November 6, other central banks also have tightened their policy settings either slightly or, as in Hungary's case, by more substantial amounts. During the same period, however, some central banks have extended the series of easing moves that many began during the 2000–2001 recession. On January 20, the Bank of Canada lowered its overnight target rate by one-quarter of one percentage point to 2.5%.