

## *The Economy in Perspective*

*On the policy trail...* The Federal Open Market Committee has maintained its federal funds rate target at 1% for almost a full year, by most reckonings a considerable length of time. With inflation close to 1% and inflation expectations also very low, the real federal funds rate has stayed in the neighborhood of zero during that period. This situation is unusual but not unprecedented—the FOMC set the real funds rate near zero for a period in the aftermath of the 1990–91 recession.

As of May, nonfarm payroll employment is still 1.6 million below its level at the peak of the last business cycle in March 2001. The nation's 5.6% unemployment rate is above the 2000 peak of roughly 4.0%. Similarly, many industries' capacity utilization rates lie well below their pre-recession peaks. So, despite recent reports of accelerating economic activity, it is not surprising that many analysts think the economy is operating below its full-employment potential.

Although the theoretical concept of full employment potential and its cousins—potential output, the nonaccelerating inflation rate of unemployment (NAIRU), and the natural rate of interest—variously describe ideal economic conditions, policymakers face challenges in determining how to implement the concepts empirically and use them in real-time situations. Theoretically, each of these concepts can be thought of as indicating the output level, the rate of unemployment, or the interest rate that would prevail in an economy where supply and demand are balanced in all markets. Generally, no more resources could be employed without reducing overall social welfare.

How can policymakers constructively contribute to the attainment of ideal conditions? A central bank could attempt, in effect, to keep its policy rate on a path consistent with an economy evolving toward full resource utilization with price stability. Unfortunately, even the wisest and best-intentioned central banks are not omniscient. While trying to remain on this so-called neutral policy path, policymakers necessarily must rely on a constellation of judgments about economic structure and forecasts.

Why are policy rates not always characterized as neutral? Why are they sometimes described as “accommodating”? This terminology could mean

that policymakers are simply accommodating an increased demand for liquidity by lowering the price of bank reserves as the economy evolves along its equilibrium path. Alternatively, the term could connote a desire to foster a greater expansion in real economic activity than would occur if the policy rate were set higher, especially if a higher rate were called for by the neutral policy path.

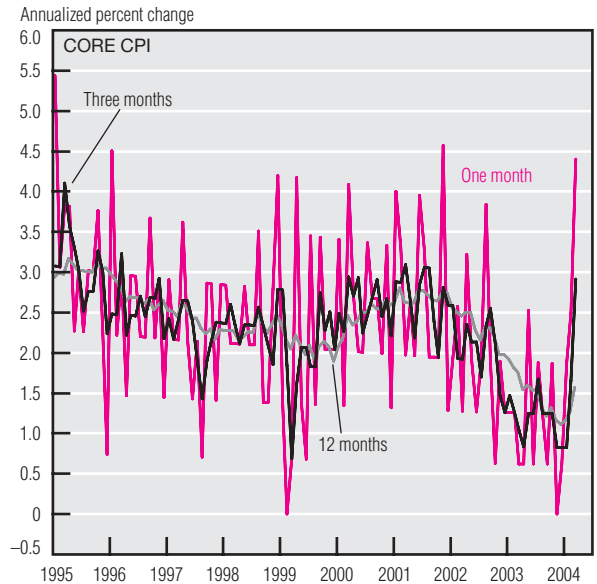
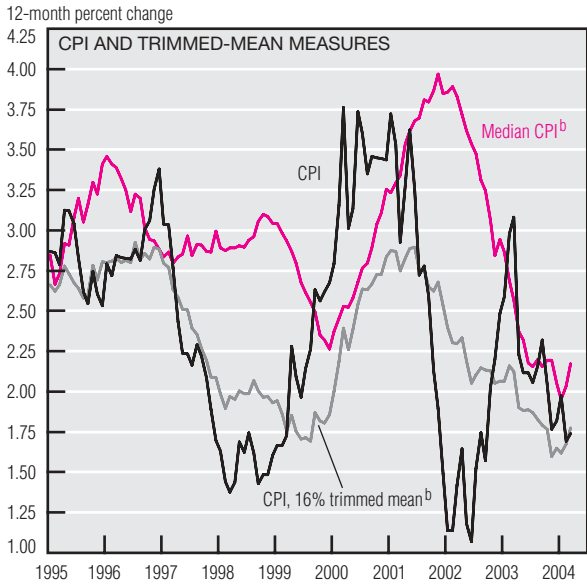
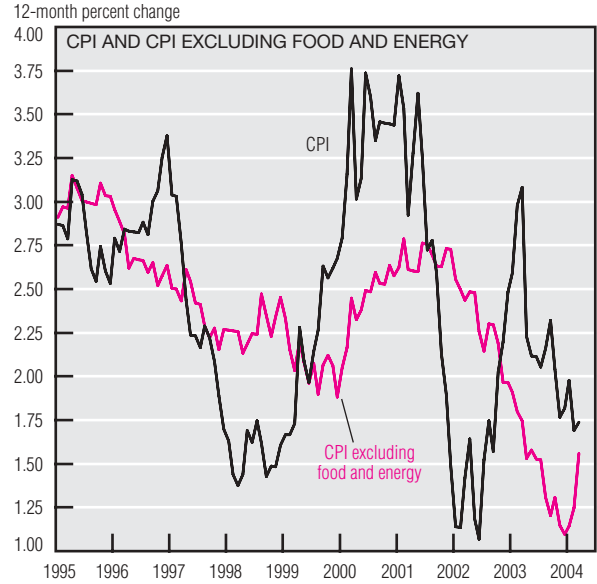
Policymakers might choose to be accommodating if they were uncertain about particular aspects of their forecasts or were risk-averse regarding sluggish economic performance. However, if a central bank underestimated its economy's inflationary potential by putting too much faith in its estimates of economic slack, it could unwittingly “accommodate” an unwelcome acceleration in inflation.

Central bankers have learned that they can promote social welfare not only by achieving their goals, but also by avoiding policy surprises along the way. Consequently, central banks try to give the public information about their goals, economic frameworks, and policy reaction functions (that is, how they tend to respond to incoming data). People move in markets as soon as relevant information becomes available. When people are very well informed about policymakers' intentions and methods, they initiate transactions that make sense if the central bank subsequently acts in ways that are consistent. By the time the central bank actually takes the conforming action, it will have been anticipated and “priced into” the financial markets. A central bank can prevent some market turbulence by providing information about what it does and does not know.

Fortunately, just as people tend not to persist in systematic errors, many central banks also have proved to be quick learners. For if a central bank continues too far down a policy trail that would have undesirable consequences, chances are high that the markets would provide cautionary signposts along the way. Like policymakers, markets are not omniscient—they can make incorrect assumptions and judgements, and anticipate economic conditions that never arise. Consequently, one of the arts of central banking is knowing when to educate markets, and when to let markets educate you.

# Inflation and Prices

	Percent change, last:				2003 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>Consumer prices</b>					
All items	6.0	5.1	1.7	2.6	1.9
Less food and energy	4.4	2.9	1.6	2.2	1.1
Median <sup>b</sup>	3.3	2.6	2.2	2.9	2.1
<b>Producer prices</b>					
Finished goods	6.8	5.1	1.4	2.2	4.4
Less food and energy	2.4	2.1	0.7	0.9	1.1



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.

March data reflect seemingly broad-based increases in retail prices. The Consumer Price Index (CPI) rose an additional 6.0% in March, significantly exceeding its 12-month growth rate of 1.7%. The core CPI (which excludes food and energy) surged an annualized 4.4% in March, its largest monthly increase since November 2001, while the median CPI was up an annualized 3.3%, its largest monthly increase in more than a year.

Because monthly retail price measures are extremely volatile, it is often difficult to extrapolate an accurate inflation trend from just a few months' data. But all of the 12-month CPI growth rates are trending upward: the core rate by 1.6%, the median by 2.2%, and the trimmed mean by 1.8%. The core CPI also reveals substantial price acceleration over the past three months.

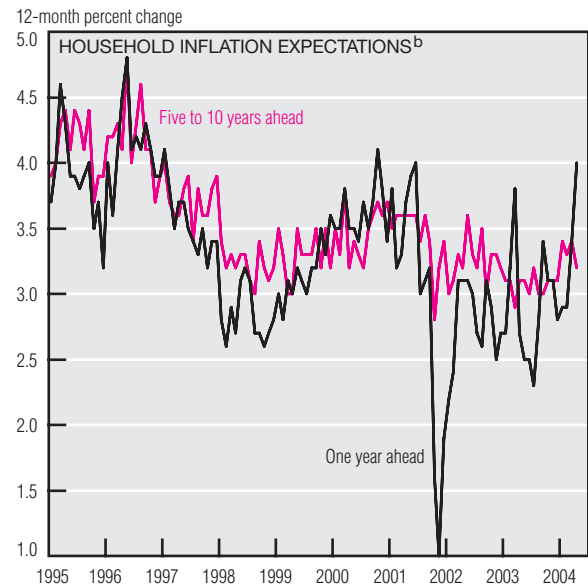
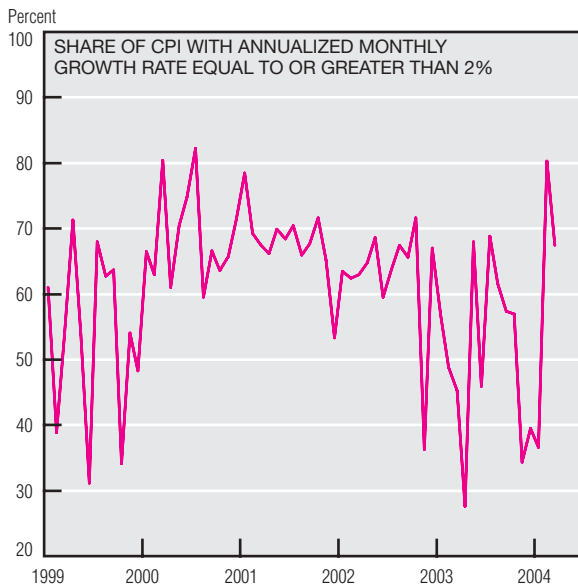
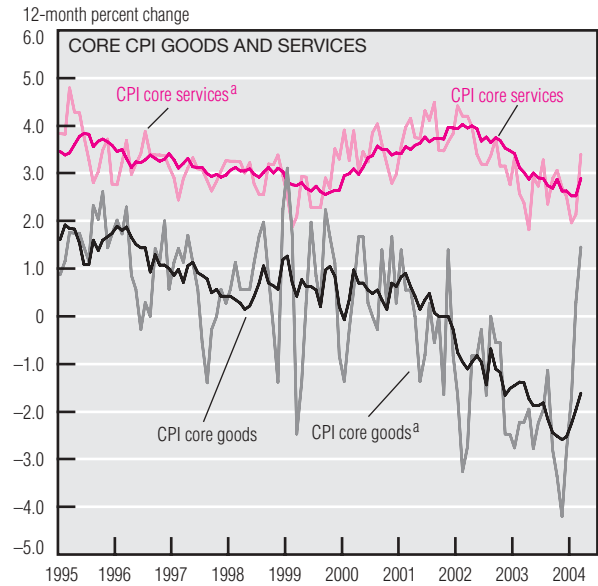
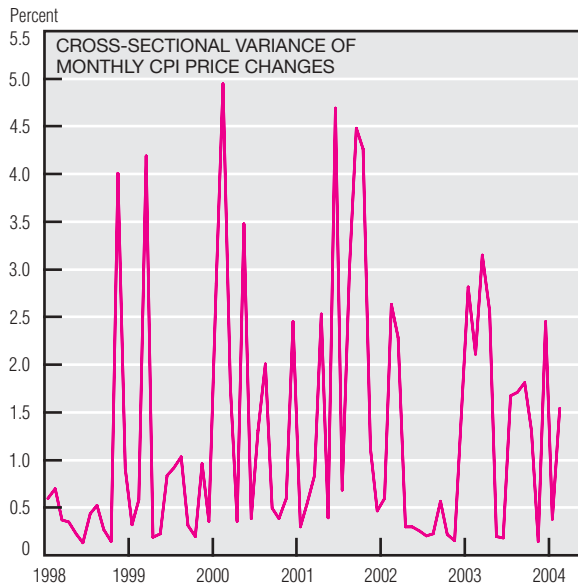
One pertinent question is whether the CPI's recent rise reflects an

increase in the prices of particular, perhaps isolated, components or a broad-based shift in the inflation trend. CPI variance measures the dispersion of consumer price changes: The relatively low variance across the CPI market basket over the past two months is a sign of the broad-based nature of recent retail price changes.

Indeed, prices for core services and core goods have both contributed to acceleration in the core

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## Inflation and Prices (cont.)



a. Three-month annualized.

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; University of Michigan; and Federal Reserve Bank of Cleveland.

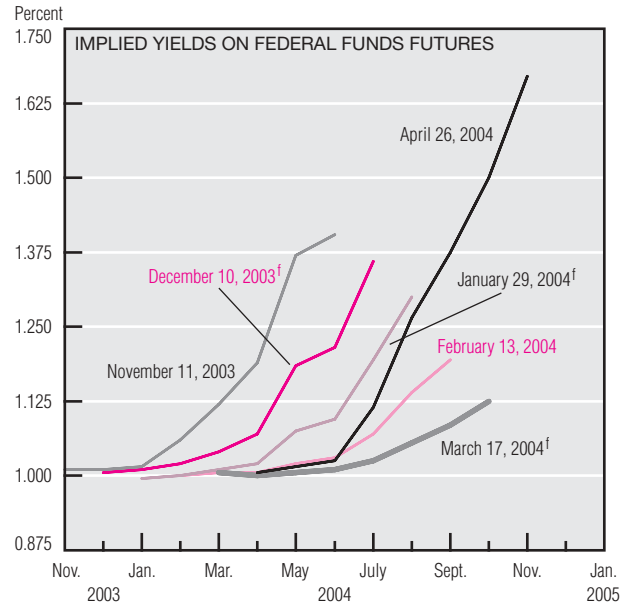
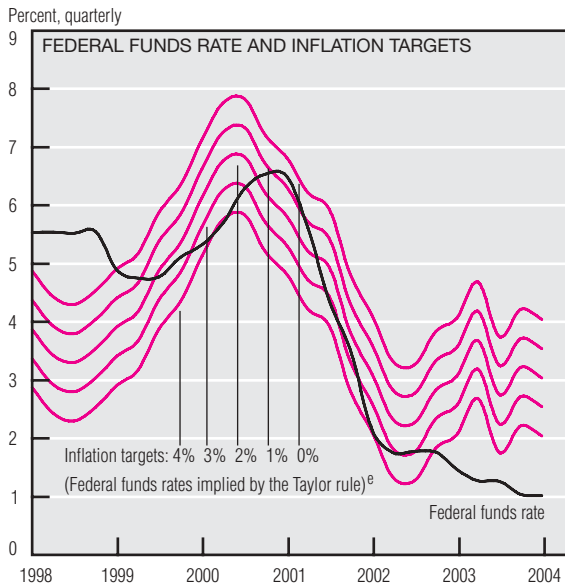
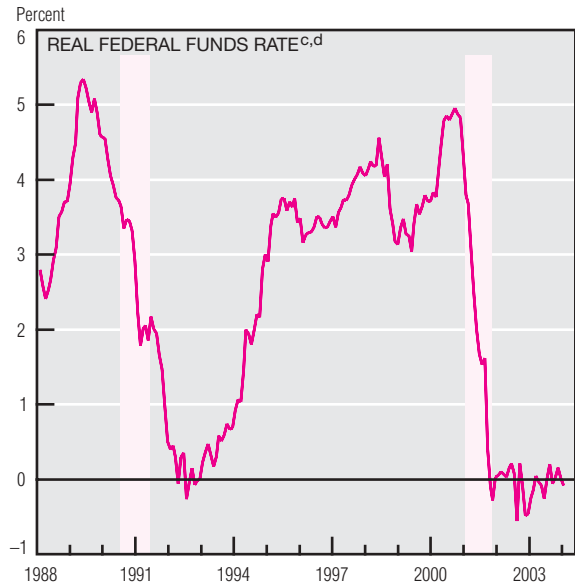
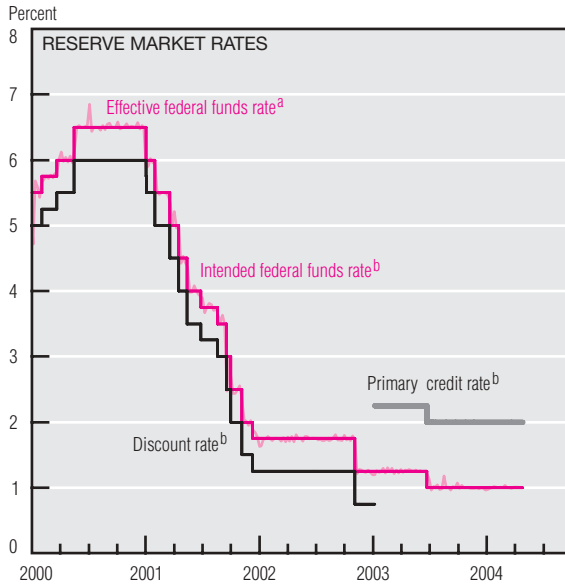
CPI. The year-over-year deflation in core goods prices has slowed since December, perhaps because the weaker dollar created upward pressure on consumer import prices. However, core goods prices have increased over the past three months. There has also been a recent acceleration of core service prices, which account for more than half of all CPI components. In fact, in the past

month, about two-thirds of the total CPI (four-fifths in February) rose 2% or more, another sign of how broad-based recent price increases are. These readings are similar to 2000, when year-over-year CPI inflation averaged about 3.4%, (the highest rate since the early 1990s).

Meanwhile, the University of Michigan's *Survey of Consumers* reveals that inflation expectations for

the next year have substantially increased to 4.0%. This outlook anticipates the highest inflation rate since mid-2001. However, long-term inflation expectations remain steady, with households anticipating a 3<sup>3</sup>/<sub>4</sub>% rise in prices over the next five to 10 years, perhaps an expression of their confidence in the maintenance of long-run price stability.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.

d. Shaded bars indicate periods of recession.

e. The formula for the implied funds rate is taken from Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, vol. 39 (1993), pp. 195-214.

f. One day after the FOMC meeting.

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.

As of this writing, the target federal funds rate remains at 1%, where it has been since June 2003. A low rate in itself does not necessarily signify easy money or an accommodative policy stance, but other measures currently support that interpretation. The real federal funds rate (calculated as the actual funds rate minus the inflation rate) has hovered around zero since late 2001. The fed funds rate has also stayed well below a popular benchmark provided by

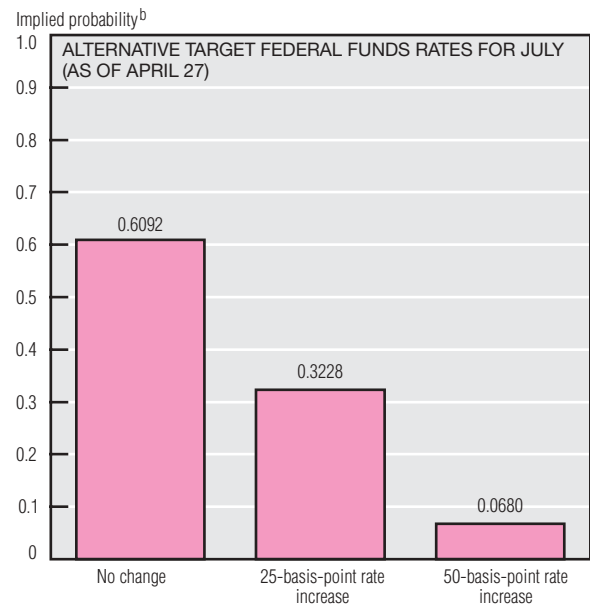
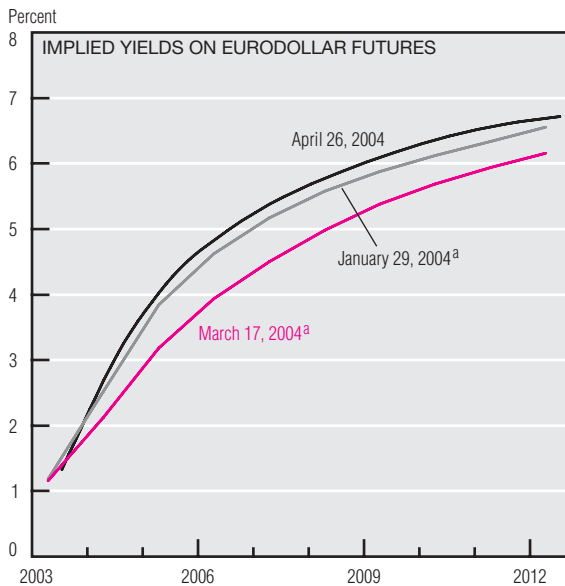
the Taylor rule, which posits that the Federal Open Market Committee chooses the target rate as a balanced response to weakness and inflation. The form of this rule depends on the weights assigned to inflation and output and on the assumed inflation target, but since mid-2002, the rate has fallen well below what the rule would have predicted, even assuming the rather high inflation target of 4%.

Financial markets have certainly been behaving as if low rates will not

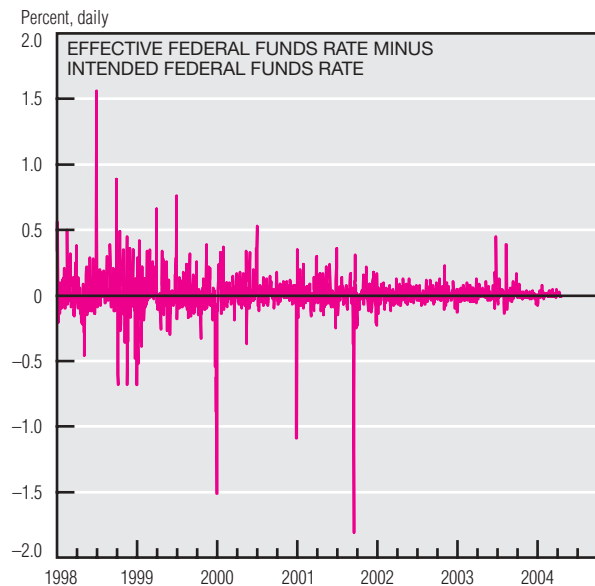
last forever. The implied yield on fed funds futures now reflects the market's belief that an upward move is likely at the June meeting and nearly certain after that. Information about longer-term expectations can be inferred from eurodollar futures; these extend further than fed funds futures contracts, which currently extend only until November. Eurodollar futures suggest that the markets expect further increases in 2005, although comparisons must be made cautiously

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## Monetary Policy (cont.)



	Average	Maximum	Minimum
<b>Increase</b>			
Number of months	3.7	12.1	0.7
Percent change	1.09	3.25	0.125
<b>Decrease</b>			
Number of months	8.4	40.4	1.4
Percent change	1.66	6.75	0.25
<b>Stationary</b>			
Number of months	8.4	18.4	0.9



a. One day after the FOMC meeting.

b. Probabilities are calculated by using prices from options on July 2004 federal funds futures that trade on the Chicago Board of Trade.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

because eurodollars are not federal funds.

Even given the caveats, futures markets can be used to back out an expectation from the market, but this tells us nothing about the uncertainty surrounding that expectation. It's tempting to infer, when looking at a 12.5 basis point (bp) change in fed funds futures, that the market sees a 50% chance of a 25 bp move; however, the market's expectation often includes the views of participants who expect larger and smaller changes.

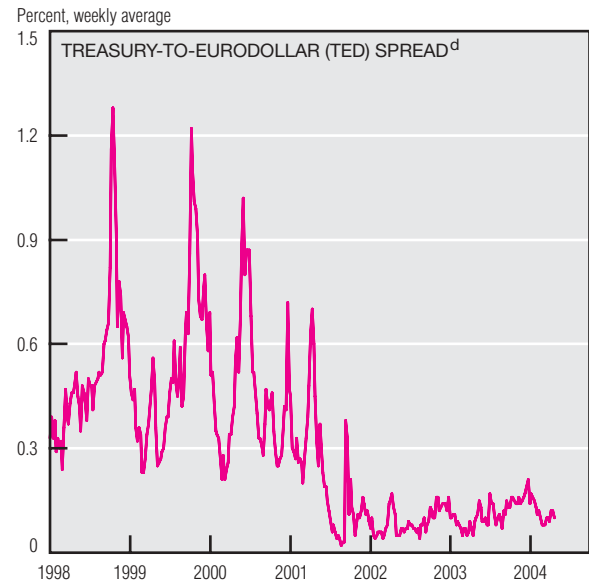
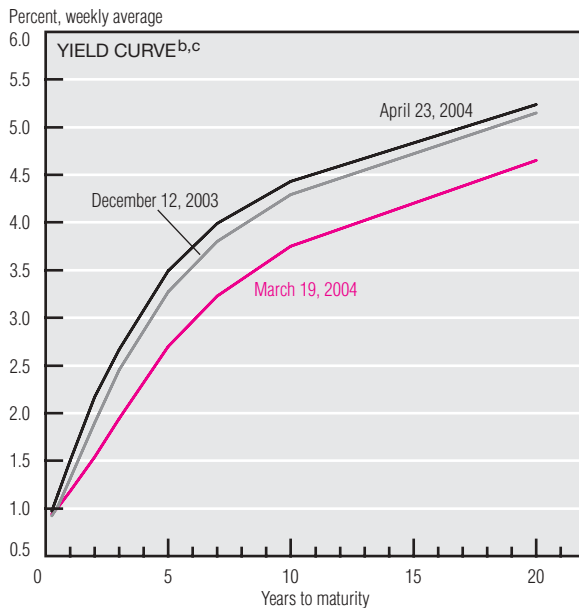
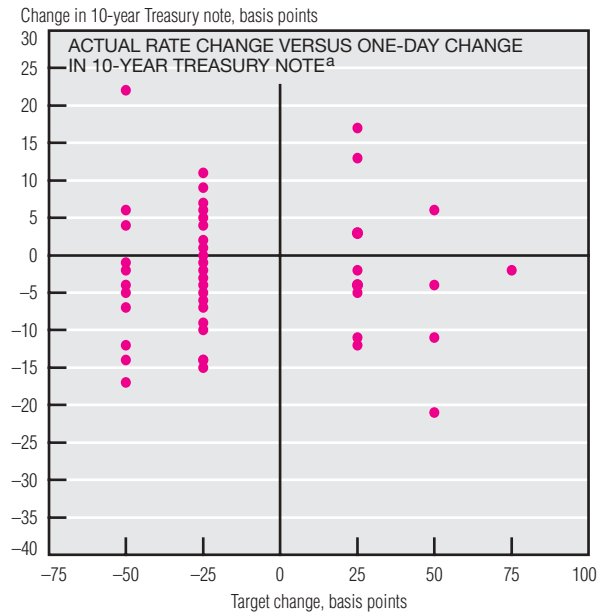
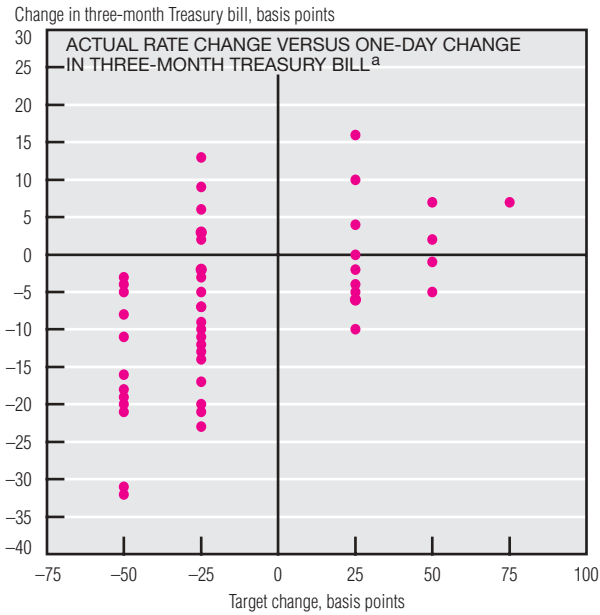
Information about those views can be derived from another financial instrument, options on fed funds futures. These suggest that market participants see a slight chance of a 50 bp increase by July.

Has the FOMC kept rates low for longer than usual, irrespective of the justification? And is there any historical evidence to suggest how extensive the increases will be when they come? Since 1983, the FOMC has kept rates constant for a mean length of 8.4 months; the current

hold pattern has lasted 10 months. Increases averaged a bit less than four months, but the average decrease lasted more than eight months and some lasted far longer.

The emphasis on the target fed funds rate makes sense only if the actual, effective fed funds rate stays close; that is, if the target is hit. Here the Fed's marksmanship looks good: On a daily basis, the average difference between target and actual is less than 1 bp, although on rare occasions it is appreciably higher.

# Money and Financial Markets



- a. Observations are included if there was a change in the target rate starting June 6, 1989. The calculated change is the yield on the day of the target rate change minus the previous day's yield.
- b. All yields are from constant-maturity series.
- c. Average for the week ending on the date shown.
- d. Yield spread: three-month Eurodollar deposit minus three-month, constant-maturity Treasury bill.
- SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

One reason the federal funds rate gets such intense scrutiny, even though few people directly borrow and lend at that rate, is that Federal Reserve policy affects other rates as well. But the connection is not as tight as is often supposed. Since 1989, lowering the fed funds target has usually been accompanied by lower interest rates in other markets, but not always. Even the three-month Treasury bill, thought to be quite sensitive to monetary policy, increased 20% of the time when the target rate fell 25 basis points (bp).

The 10-year rate shows an even higher proportion of such opposite moves. Digging deeper into the data may reveal more consistent patterns, depending on whether the change was anticipated or unanticipated, which part of business cycle the economy is in, or the slope of the yield curve.

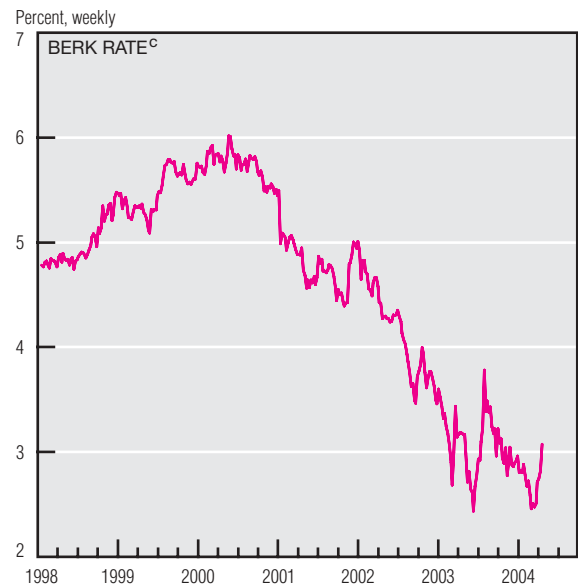
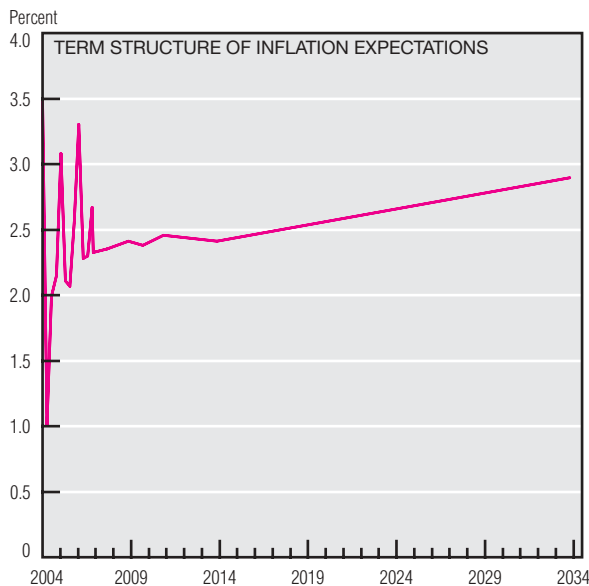
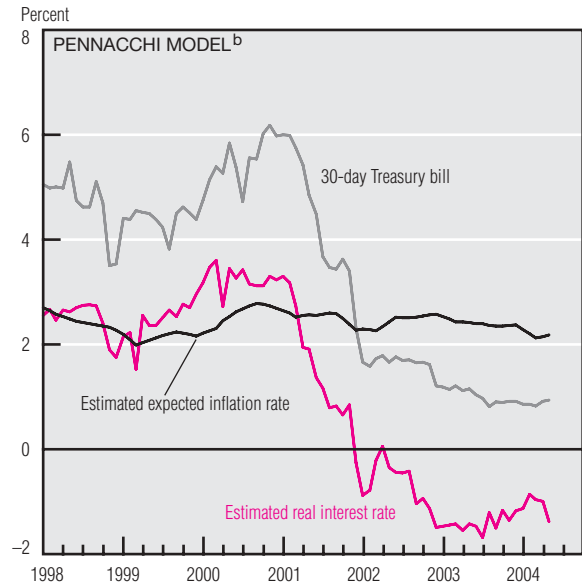
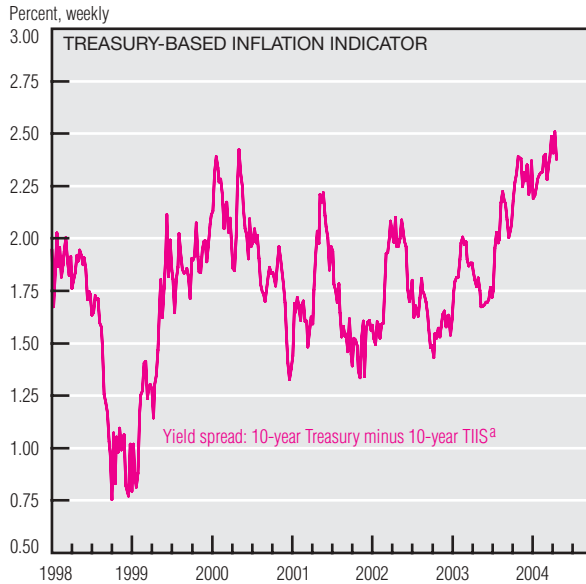
Since March, an already steep yield curve has gotten even steeper. The bellwether 10-year, three-month spread has increased from 281 bp to 346 bp, well above the historical average of 120 bp. This rise has been

driven almost exclusively by increases in long rates because short rates have been restrained by the steady fed funds rate. Historically, such a steep yield curve has foretold robust economic growth for the following year. Supporting that, the spread between Treasury bonds and eurodollar deposits (the TED spread), which is often thought to reflect concern over international tensions, remains low by recent historical standards.

Some observers believe inflation fears caused the increase in long

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## Money and Financial Markets (cont.)



a. Treasury inflation-indexed securities.

b. The estimated expected inflation rate and the estimated real interest rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.

c. The Berk rate is calculated as the 30-year GNMA yield plus the 10-year Treasury inflation-indexed securities yield minus the 10-year Treasury yield.

SOURCES: Chicago Mercantile Exchange; Bloomberg Financial Information Services; and *Wall Street Journal*.

rates, but more direct measures of inflationary expectations give a different view. The “break-even” inflation rate, defined as the difference between a 10-year nominal Treasury bond and a 10-year TIPS bond (which is protected against inflation), stands at 2.38%, almost exactly where it stood in January. But because of tax, liquidity, and different risk characteristics (particularly regarding inflation) this may overstate expectations by anywhere from 35 bp to 120 bp. Still, the lack of an upward trend this year is encouraging.

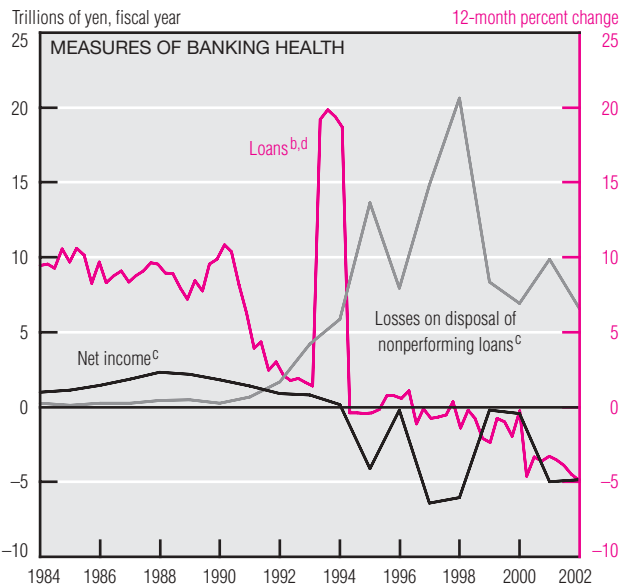
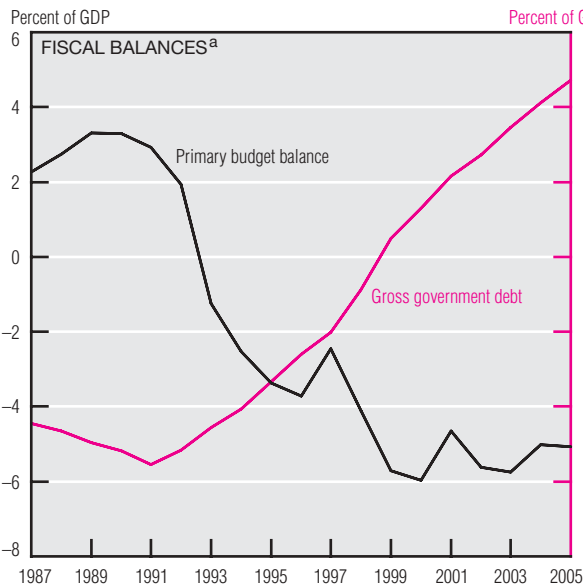
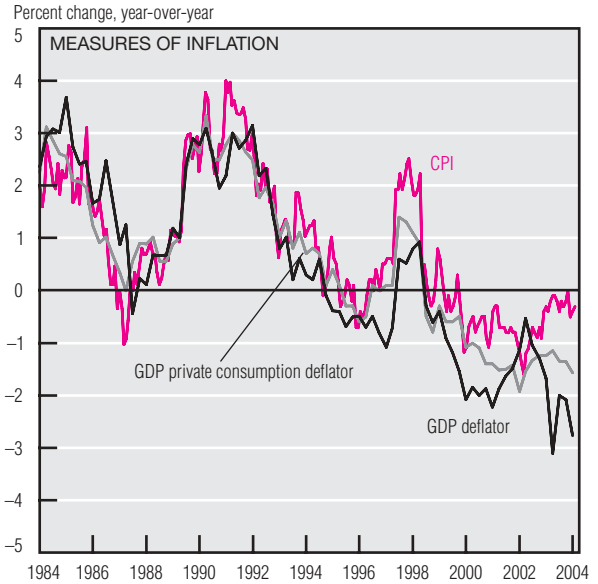
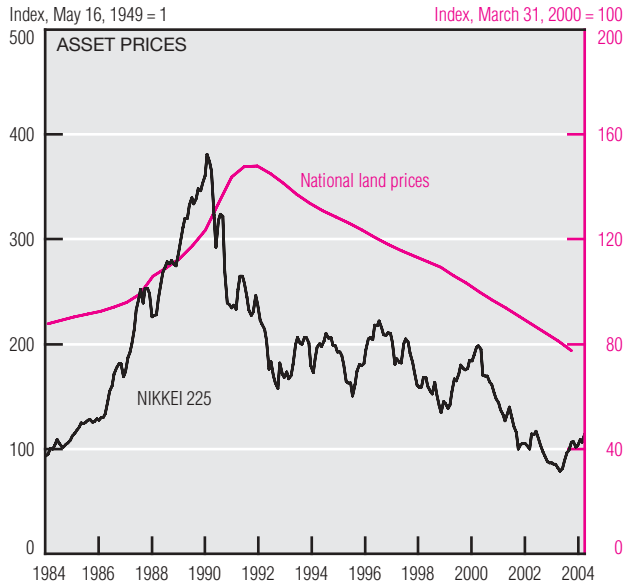
The Pennacchi model, which combines Treasury-bill rates and survey measures of inflation, has also stayed relatively flat in 2004.

Inflation expectations can be inferred from the recently introduced CPI futures contracts. With a shorter maturity than TIPS, these contracts help fill out an overview of the “term structure” of inflation expectations because people may have different views of inflation in the short versus the long term. Because the market is new, (trading in CPI futures at the

Chicago Mercantile Exchange only began in February), the inflation numbers look quite volatile.

Perhaps inflationary expectations have held steady because monetary policy has found the right balance between ease and tightness. In fact, some real rates have been increasing lately. The Berk rate, which measures the real rate with an adjustment for a firm’s ability to delay investment, has risen almost 70 bp since mid-March.

# Japan's Economy



a. Data for 2003–05 are OECD forecasts.

b. Includes overdrafts beginning 1993:IIQ. The exception is Shinkin Bank overdrafts, which are included beginning in 1994:IIQ.

c. All banks holding current accounts.

d. Domestically licensed banks.

SOURCES: Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.1; Bank of Japan; Japanese Ministry of Finance; Japanese Economic and Social Research Institute; Organisation for Economic Co-operation and Development; and Bloomberg Financial Information Services.

When its stock and land price bubbles burst in the early 1990s, Japan entered a period of weak economic growth and disinflation (now deflation) from which it has not yet recovered. Falling asset prices have reduced investment's share of GDP from 19% in the early 1990s to roughly 16% now and have discouraged lending by reducing the value of both banks' capital and the collateral required to promote favorable lending terms.

Government spending stabilized in the second half of the 1990s, but the continued revenue declines caused by

economic weakness and deflation have created a primary budget deficit of about 5% of GDP. Because of structural reforms designed to enhance growth prospects, government authorities have deferred moving the budget to surplus status until the early 2010s. Low inflation has helped keep long-term interest rates and debt financing costs low. If interest rates increase, it may become difficult to maintain fiscal stability over the medium term.

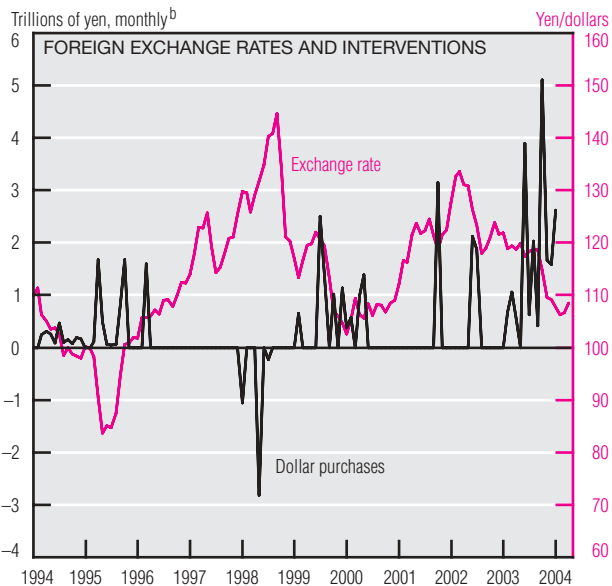
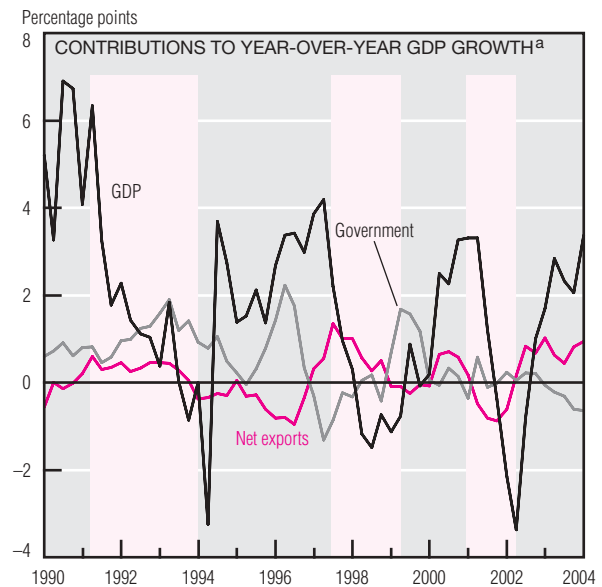
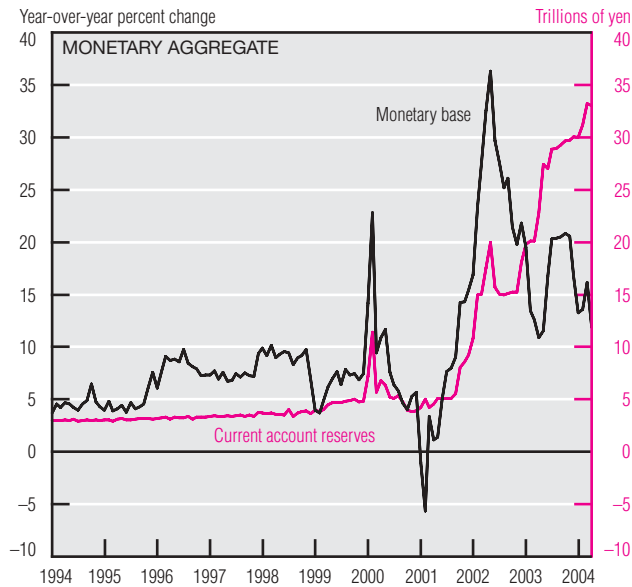
Inefficiencies in the banking sector, such as the evergreening of loans,

have produced a large number of nonperforming loans. Low (and now negative) inflation levels have exacerbated the problem by discouraging spending and increasing the real value of debt payments. Nonperforming loans have significantly reduced bank profitability and discouraged the new lending needed to spur economic growth. In October 2002, the government announced its goal of halving the stock of such loans by March 2005, and it has made some progress toward this goal.

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## Japan's Economy (cont.)



a. Recession bars are dated by the Economic and Social Research Institute.

b. Data through 2003.

SOURCES: Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.1; Bank of Japan; Japanese Ministry of Finance; Japanese Economic and Social Research Institute; Organisation for Economic Co-operation and Development; and Bloomberg Financial Information Services.

To reduce deflationary expectations, the Bank of Japan committed itself to a program of quantitative easing in March 2001 by targeting current account balances that banks hold at the central bank. This has led to dramatic growth in the monetary base and has slowed disinflation, perhaps even reversing it. However, the program has not yet solved either the deflation problem or the problem of declining loans.

Economic activity has picked up recently, with real GDP growing 2.7% in 2003, and the International Monetary

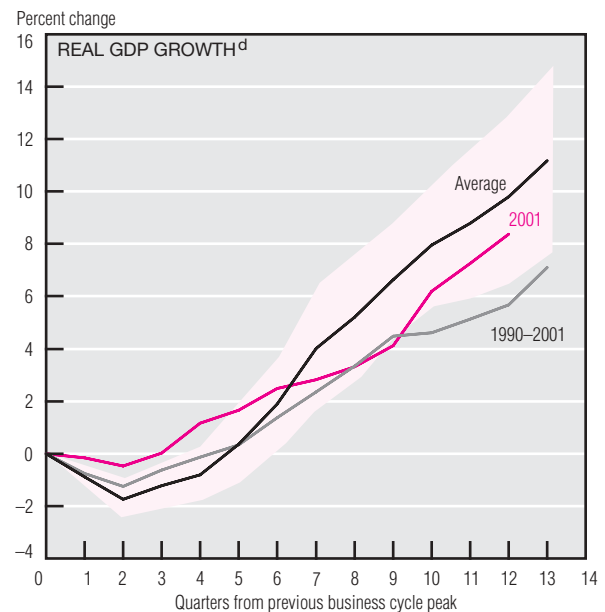
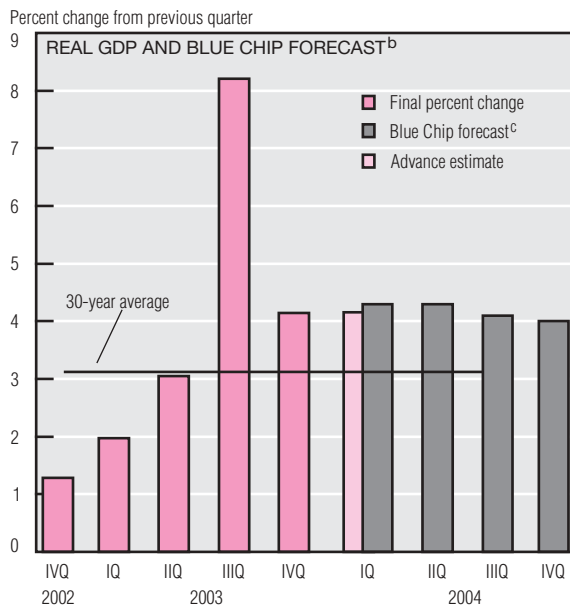
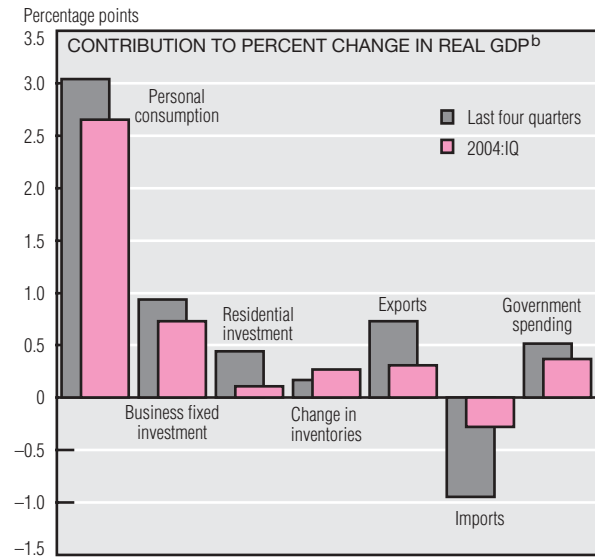
Fund has increased its forecast of 2004 real GDP growth from 0.8% last September to 3.4% this March. Unlike Japan's two previous recoveries, this one has benefited significantly from net exports' contribution to real GDP growth. To promote export growth, the Ministry of Finance has been selling yen through foreign exchange interventions. Although the yen has appreciated against the dollar over the past two years, it has done so less than the euro.

Japan's recent growth is heartening. However, productivity growth has fallen from the levels reached in the

late 1980s and early 1990s, and hours worked have generally been declining over the past 14 years. The Organisation for Economic Co-operation and Development now forecasts that hours worked in 2003–08, adjusted for cyclical factors, will fall 0.3% annually, and that during this period, Japan will have the lowest potential GDP growth of any country in the OECD. This underscores the importance of success with structural reforms and antideflation strategies to the nation's growth prospects.

# Changes in the GDP

Real GDP and Components, 2004:IQ <sup>a</sup> (Advance estimate)	Change, billions of 2000 \$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	108.5	4.2	4.9
Personal consumption	69.4	3.8	4.3
Durables	-12.7	-4.7	9.6
Nondurables	34.1	6.5	5.1
Services	44.7	4.3	2.9
Business fixed investment	20.4	7.2	9.4
Equipment	25.8	11.4	12.9
Structures	-4.0	-6.6	-1.5
Residential investment	2.7	2.1	8.8
Government spending	9.6	2.0	2.7
National defense	17.0	15.1	13.5
Net exports	0.6	—	—
Exports	8.5	3.2	7.8
Imports	7.9	2.0	6.9
Change in business inventories	6.3	—	—



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.

d. The shaded band represents the average for the nine previous business cycles, plus or minus two standard errors.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; National Bureau of Economic Research; and *Blue Chip Economic Indicators*, April 10, 2004

The advance estimate for real GDP growth in 2004:IQ was 4.2%, slightly above the previous quarter's 4.1% final estimate but below the Blue Chip economists' forecast of 4.3%. Nonetheless, most observers remain upbeat because the growth was fairly broad based. Personal consumption expenditures, the largest contributor to real GDP growth in 2003:IVQ, rose 3.8%, led by nondurables (up 6.5%) and services (up 4.3%). Spending on durables dipped 4.7%, but was still up 9.6% from the previous four quarters.

Business fixed investment, the second largest contributor to growth, was up 7.2%. Investment in equipment rose 11.4%, but investment in structures fell 6.6%. Residential investment also slowed, up only 2.1%, far less than the 8.8% of the previous four quarters.

Net exports improved for the third straight quarter; although exports grew only 3.2%, imports slowed even more, increasing just 2.0%. Government spending growth slowed to 2.0% overall, but growth in national defense spending continued at a strong clip,

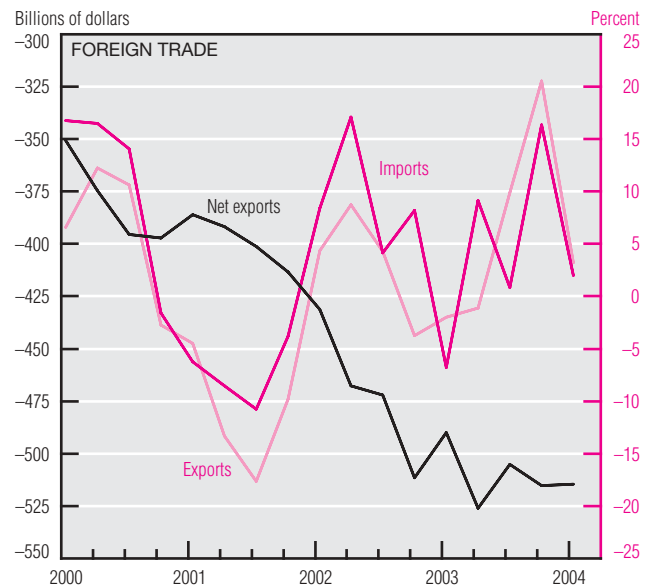
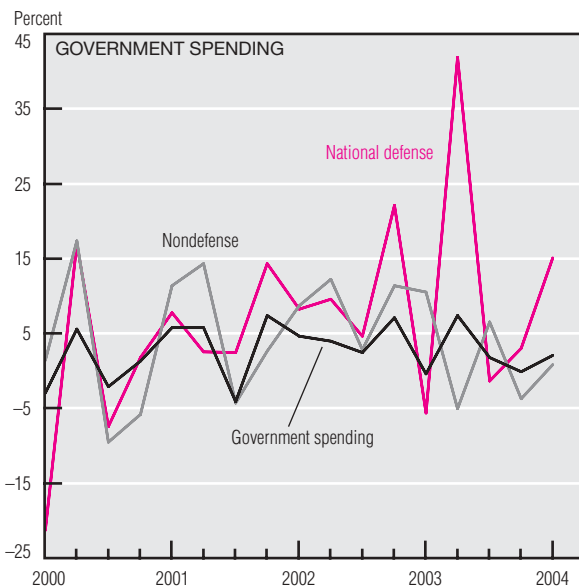
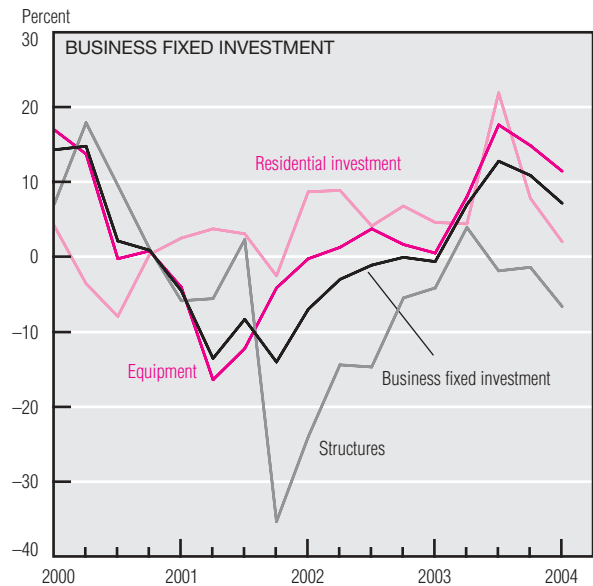
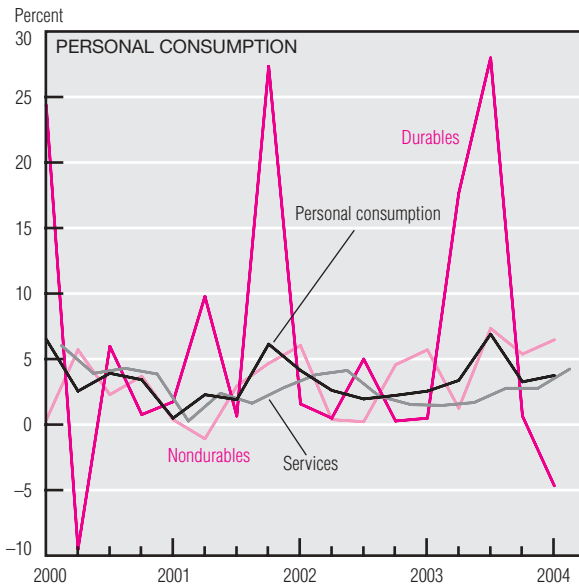
up 15.1%. The 2.5% increase in the implicit GDP deflator and the 2.0% rise in core CPI caused concern for some.

Looking forward, Blue Chip forecasters expect that real GDP growth will stay close its the current rate, well above the 30-year average of 3.1%, through the end of the year. If that occurs, the current expansion will continue to be fairly typical of expansions of similar duration.

The beginning of the economy's third year of expansion is a good time

(continued on next page)

## Changes in the GDP (cont.)



NOTE: All data are seasonally adjusted and annualized.  
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis

to ask how the GDP's components have been performing. Since 2001:IIIQ, when real GDP began growing again, higher personal consumption expenditures, currently comprising about 71% of GDP, have accounted for much of its 3.5% average annual growth. About 57% of personal consumption came from services, its most stable component, which has grown at an annual average rate of 2.7%. Nondurable spending, about 29% of consumption and its next most stable component, grew at a brisker 4.2%

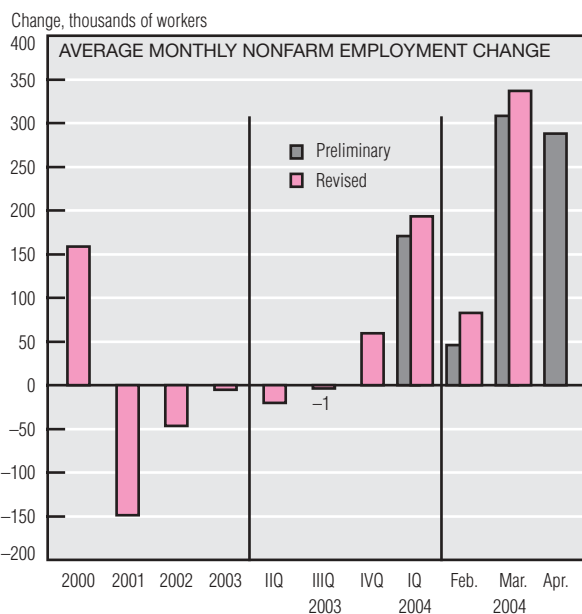
rate over the same period. The smallest component (14%) of consumption was durable goods, which grew at the highest rate (7.1%), but was by far the most volatile.

Investment, 16% of GDP, grew at an annual rate of 4.2% over this period. Growth in equipment and software (5.3%) and residential investment (6.5%) were both fairly strong. Investment in structures suffered most in the last downturn; even in the current recovery period, when overall real GDP was growing, this component still fell at an annualized rate of 11.1%.

Federal, state, and local government expenditures account for about 18% of GDP. Overall government spending has grown 3.6% since 2001:IIIQ; national defense spending, currently 26% of government spending, grew 10.5%. In contrast, nondefense government spending grew a mere 1.5%.

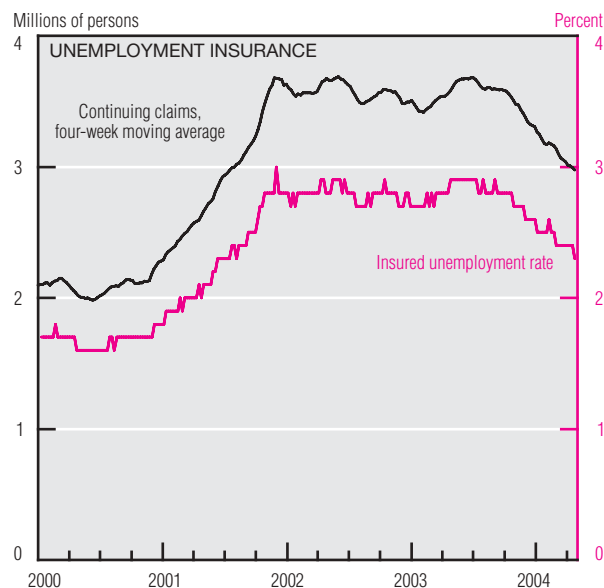
Over the same period, net exports seem to have stabilized at around -\$515 billion. Growth rates for exports and imports have tracked each other quite closely, but the trade deficit persists because the level of imports is so much higher than that of exports.

# Labor Markets



## Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	YTD	Apr. 2004
<b>Payroll employment</b>	-149	-47	-5	217	288
<b>Goods producing</b>	-124	-76	-42	35	42
Construction	-1	-8	7	25	18
Manufacturing	-123	-67	-48	7	21
Durable goods	-88	-48	-30	10	20
Nondurable goods	-35	-19	-18	-4	1
<b>Service providing</b>	-25	29	37	182	246
Retail trade	-24	-11	-5	39	23
Financial activities <sup>a</sup>	8	6	6	5	8
PBS <sup>b</sup>	-63	-17	23	54	123
Temporary help svcs.	-37	2	15	16	35
Education & health svcs.	50	40	28	26	31
Leisure and hospitality	-1	-11	8	27	36
	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.

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

Nonfarm payroll employment registered a net increase of 288,000 jobs in April. At the same time, net gains for the previous two months were revised up a total of 66,000 jobs to 420,000. After a net increase of almost 250,000 jobs over the last four months of 2003, nonfarm payroll employment has added more than 850,000 net jobs thus far in 2004.

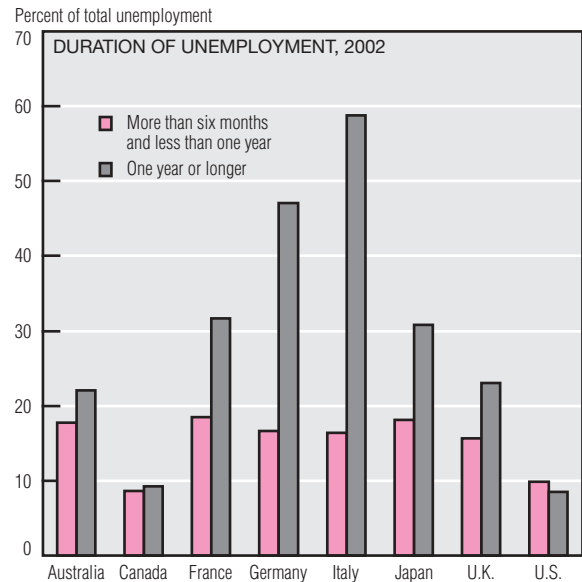
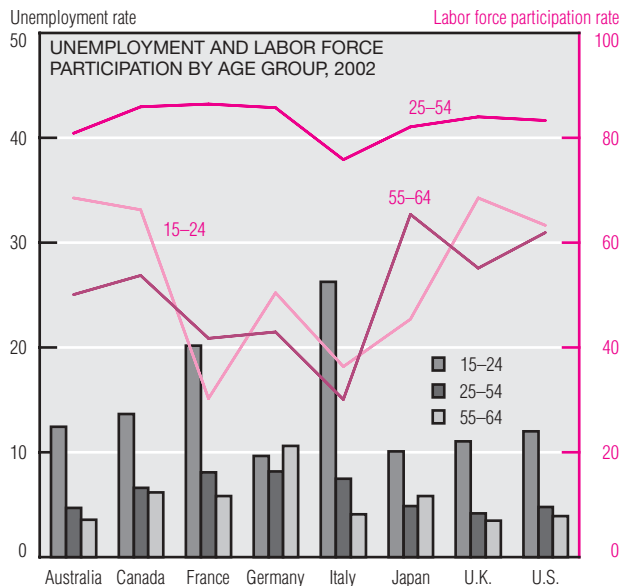
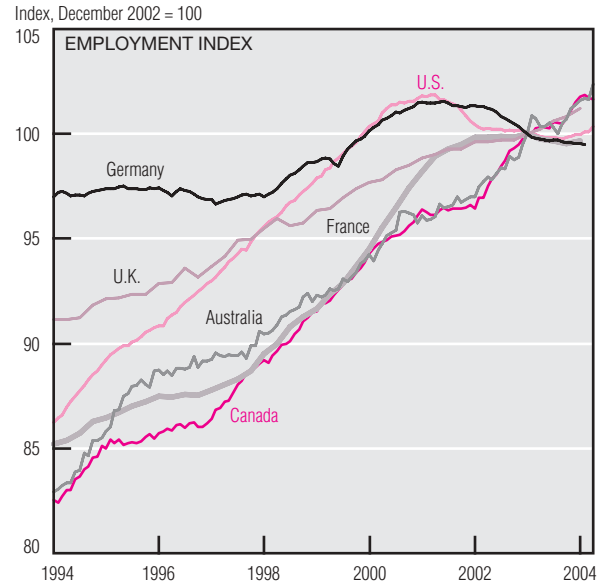
Services accounted for much of the employment growth in March and April, gaining about 250,000 net jobs each month. Professional and business services accounted for half of April's employment increase in

service-providing industries. Temporary help services, often a leading indicator of total employment, posted a net gain of 35,300 jobs for the month. The sector has added 260,500 net jobs over the past 12 months, the largest such gain in four years. Manufacturing gained 21,000 net jobs in April, its third straight monthly increase following 42 consecutive months of decline. Recent net job gains in the sector continued to be concentrated in durable manufacturing.

The civilian unemployment rate fell 0.1 percentage point and has largely been flat so far in 2004 after dropping

0.6 percentage point in the second half of 2003. However, the number unemployed for 15 weeks or more declined by 350,000, dropping below 3 million for the first time since September 2002. The four-week moving average of continuing unemployment claims has fallen steadily since the beginning of October, declining more than 600,000 to under 3 million for the first time since July 2001. The insured unemployment rate also began trending downward in October, three months after the civilian unemployment rate began to fall.

# Employment Conditions in the OECD



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Australian Bureau of Statistics; Statistics Canada; Deutsche Bundesbank; Eurostat; French National Institute for Statistics and Economic Studies; Japanese Ministry of Public Management, Home Affairs, Post, and Telecommunications; U.K. Office for National Statistics; Organisation for Economic Co-operation and Development, *Labor Force Statistics*; and Bloomberg Financial Information Services.

Unemployment rates fell and employment rose in most nations of the Organisation for Economic Co-operation and Development (OECD) from 1997 to 2001. For countries like Australia and the U.K., the drop in unemployment was spectacular and persistent, thanks to sustained growth and the structural reforms of the 1980s. Then, from 2001 to 2003, unemployment rates steadily rose from 8.0% to 9.1% in the euro zone and from 4.8% to 6.0% in the U.S. In Japan, unemployment trended up from 2.3% in 1993 to more than 5.0% in 2002–03; however,

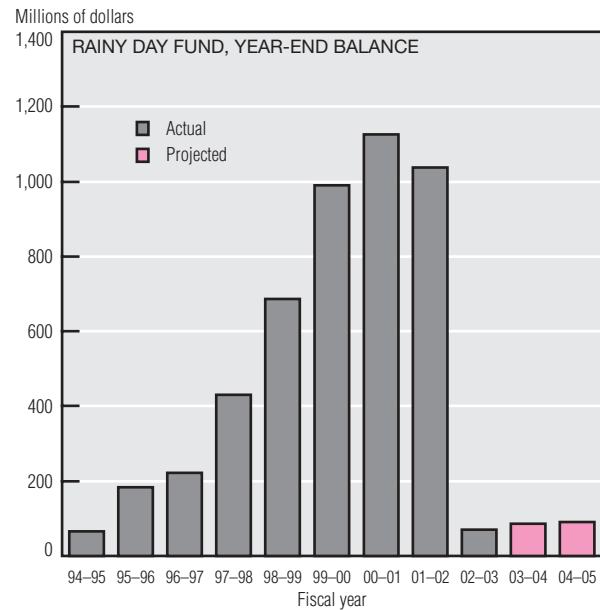
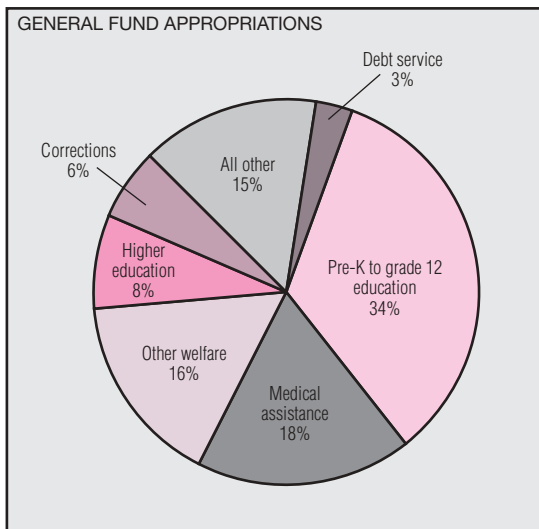
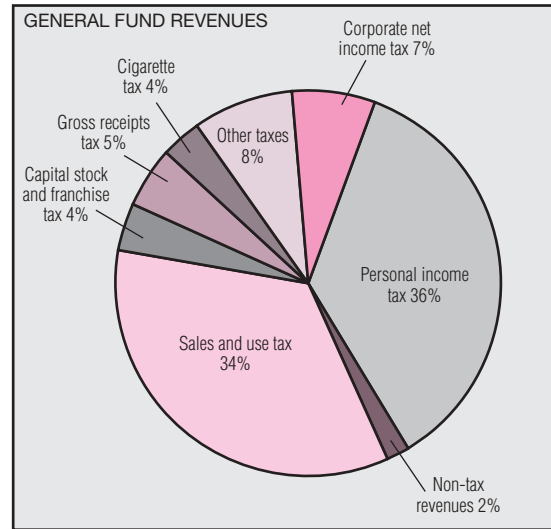
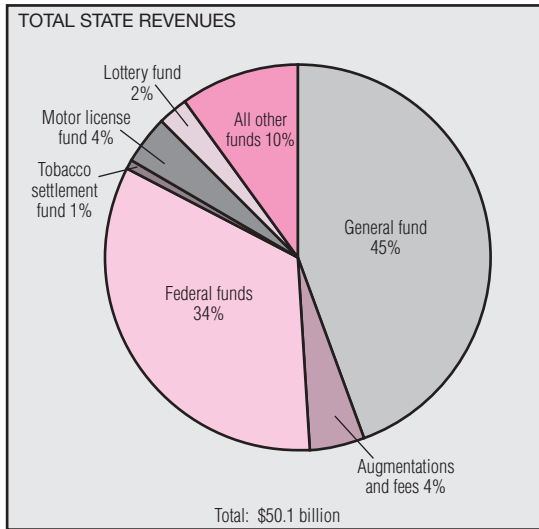
in the second half of 2003, it dropped back from 5.4% to 5.0% as the country's growth gathered momentum.

Differences in unemployment rates among OECD countries are particularly pronounced when they are broken down by age categories. Young people (those aged 15 to 24) have the highest unemployment; in the U.S., for example, the rate is 12%. But this age group fares worst in countries with high overall unemployment: Young people's jobless rates run to 20% in France and 26% in Italy. Moreover, the rate of labor

market participation for this age group is low—30% in France and 36% in Italy, compared to 69% in the U.K. and 63% in the U.S.

Long-term unemployment, measured as the share of unemployed people who have been jobless for at least a year, differs dramatically between Europe and North America. In European countries, this proportion is high (32% in France, 47% in Germany, and 59% in Italy); in North America, long-term unemployment shares are relatively low (8.5% in the U.S. and 9% in Canada).

# The Pennsylvania State Budget



NOTE: Budget figures are for Pennsylvania's fiscal year 2004-05, which begins July 1, 2004.  
 SOURCE: Commonwealth of Pennsylvania, Office of the Budget.

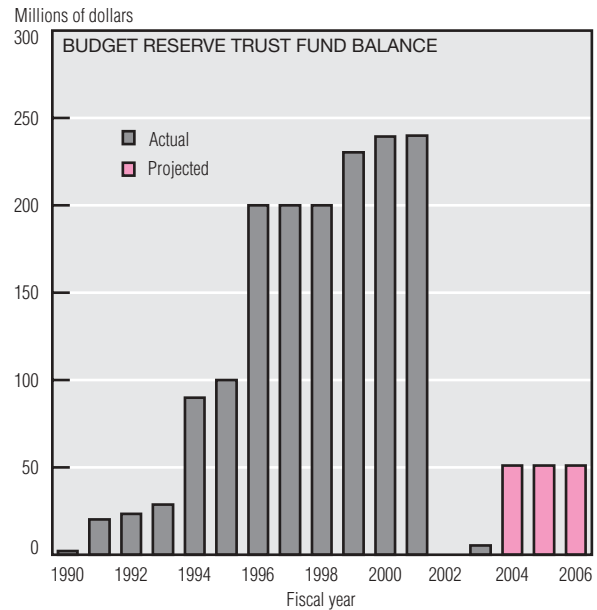
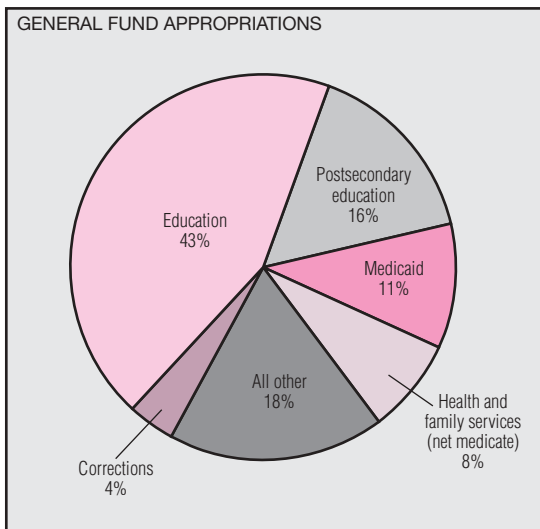
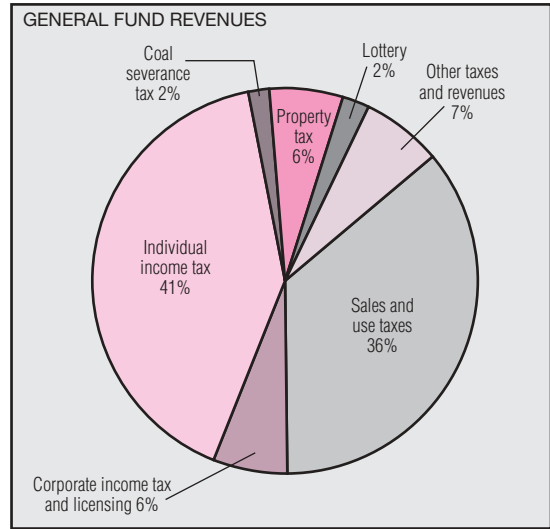
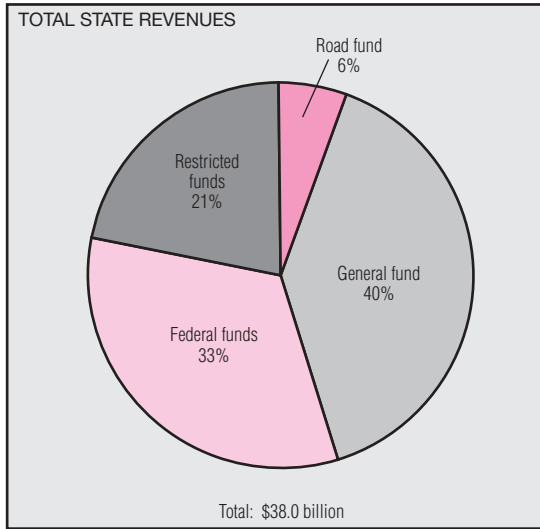
In February, Pennsylvania governor Edward G. Rendell presented his annual budget proposal for fiscal year 2004-05. Only about half of the state's revenues are available for discretionary appropriations; the rest are subject to spending restrictions. For example, dollars from the motor license fund and other special funds have specific, predetermined uses. Most federal funds are also restricted, but some of those earmarked for social welfare improvement are not associated with specific programs

and can be allocated by the state legislature.

The 2004-05 budget focuses primarily on expenditures from general fund revenues, which comprise about 45% of the state's total revenues. Governor Rendell has devoted about three-quarters of his proposed general fund appropriations to education, health, and human services. General fund dollars are derived primarily from personal income taxes and sales taxes, which account for about 70% of general fund revenues.

Pennsylvania's constitution mandates a balanced budget, so the general fund's revenues must meet or exceed appropriations. They are projected to exceed appropriations by approximately \$2 million in fiscal year 2004-05. According to current law, 25% of the general fund's projected year-end balance must be transferred to a rainy day fund so that the state will be able to maintain its service level despite any revenue shortfalls. Additional revenues for the upcoming fiscal year are projected to put the rainy day fund at just under \$100 million.

# The Kentucky State Budget



NOTE: Biennial budget figures are for Kentucky's fiscal years 2005 and 2006, which begin July 1, 2004.  
 SOURCE: State of Kentucky, Office of the Budget.

In January, Kentucky governor Ernie Fletcher presented his proposed budget for the state's fiscal years 2005 and 2006, (The biennial budget process generally occurs in every even-numbered year.) The governor's budget focuses primarily on expenditures from the general fund. That fund accounts for nearly 40% of the state's total revenues, most of which are collected from sales taxes and individual income taxes. The remaining 60% of revenues are restricted in various ways. For instance, fuel tax receipts are earmarked primarily for constructing and main-

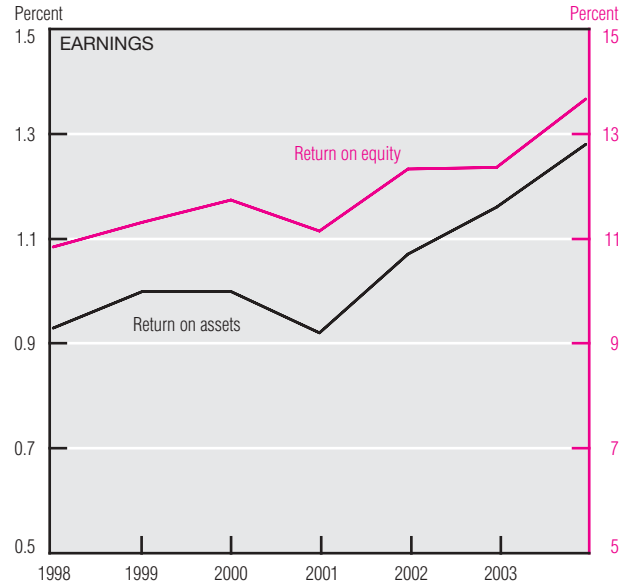
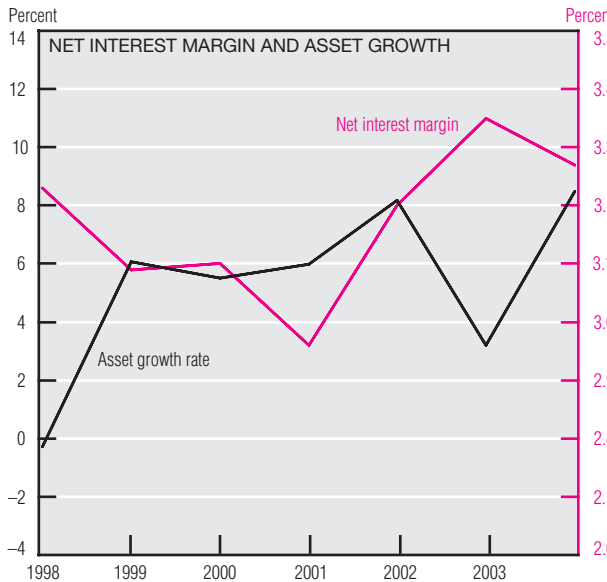
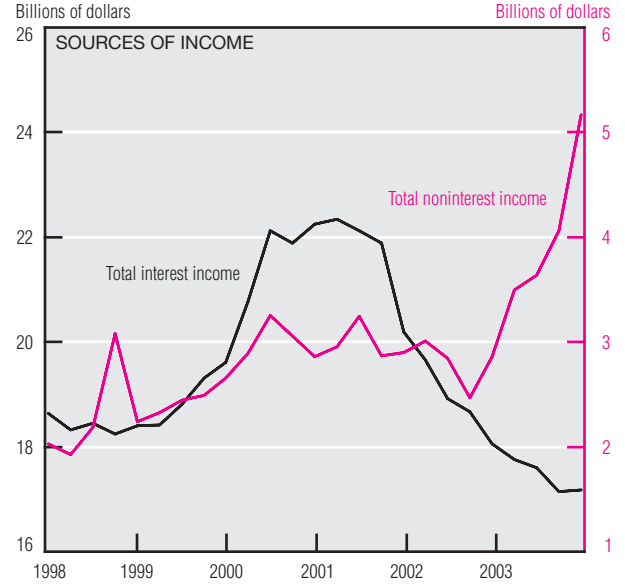
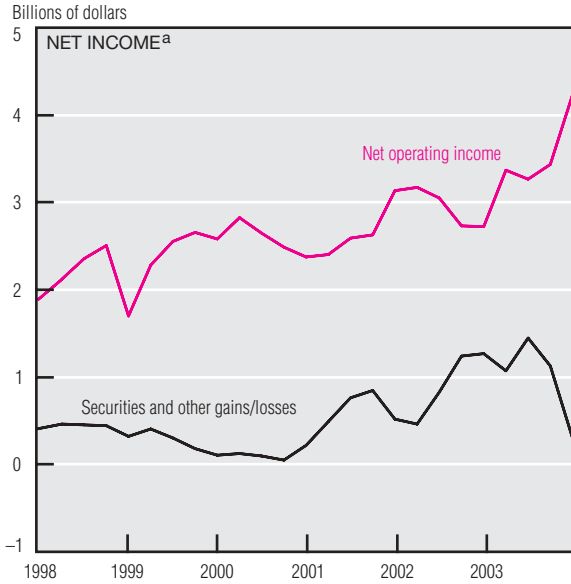
taining state highways and interstates; most federal government dollars are used for social welfare programs.

Governor Fletcher has said that the proposed budget is aimed at improving the state's competitiveness by "resolving budgetary shortfalls without burdening the people and businesses of Kentucky with higher taxes." His proposed appropriations allocate about 80% of the general fund revenues to education, health, and human services.

For the 2004 fiscal year, which ends June 30, Kentucky had expected to

have a budgetary shortfall, something prohibited by the state's constitution. But because of a series of spending restraints (some enacted as early as the end of 2002) and, to a lesser degree, federal fiscal relief, the state expects to end the fiscal year in the black. Moreover, it expects to achieve this without drawing down its budget reserve trust fund, which fell nearly to zero in 2002 and 2003. Instead, Kentucky is working to build this fund back up and projects a reserve of almost 1% of general fund revenues in each of the next two fiscal years.

# Savings Institutions



a. Net income equals net operating income plus securities and other gains and losses.  
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

FDIC-insured savings institutions (S&Ls) reported net income of \$4.53 billion for 2003:IVQ. This was \$544 million higher than a year earlier but \$33 million lower than the third quarter. One-time gains on securities sales were only \$0.30 billion in 2003:IVQ, compared to \$1.13 billion in 2003:IIIQ.

S&Ls' noninterest (fee) income stood at \$5.17 billion, up 80.7% from a year earlier. Their total interest income of \$17.2 billion is far below the recent high of \$22.3 billion reached

in 2001:IQ and 4.8% lower than a year earlier. However, they seem to have completed the process of repricing their loan portfolios around the end of 2003:IQ. In the face of this portfolio adjustment, net interest income has increased only 4.8% over the past year because reductions in interest income from lending were nearly matched by declines in borrowing between 2002:IVQ and 2003:IVQ.

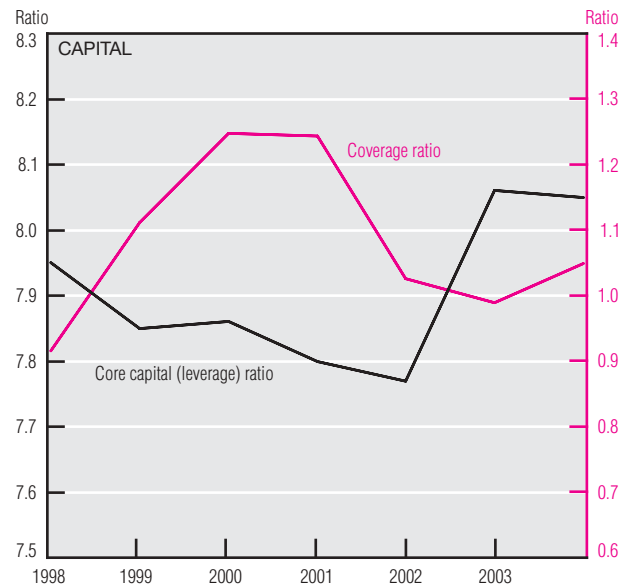
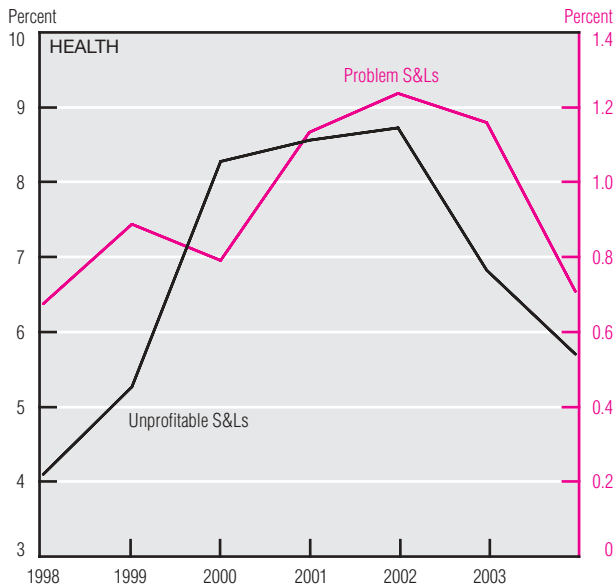
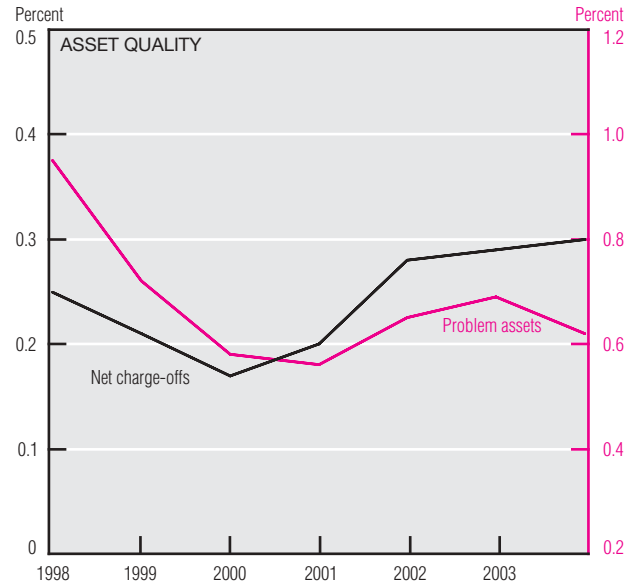
Although the net interest margin declined slightly to 3.27% from the

recent peak of 3.35% reached at the end of 2002, overall earnings 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 13.6% rate on a year-over-year basis, outstripping the relatively robust asset growth of 8.49% for the same period. As a result, S&Ls' return

(continued on next page)



## Savings Institutions (cont.)



SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

on assets continued its recent upward trend, rising to 1.28% in 2003:IVQ. A similar picture emerges for return on equity, which reached 13.66% for the quarter.

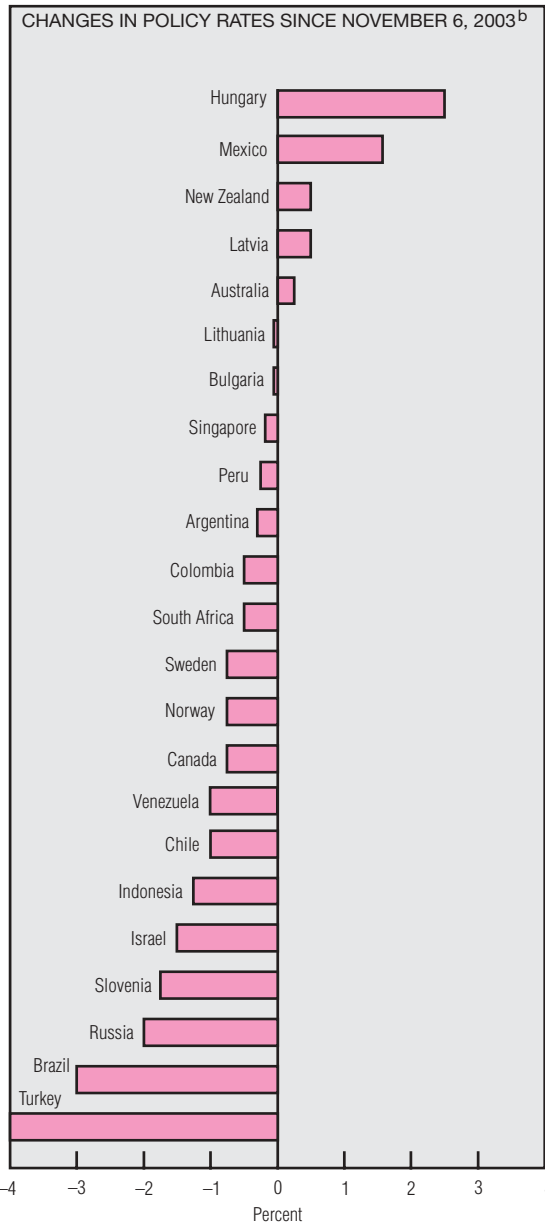
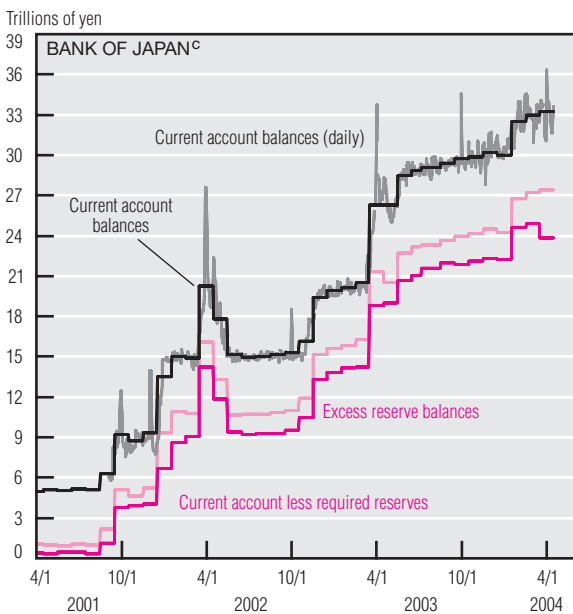
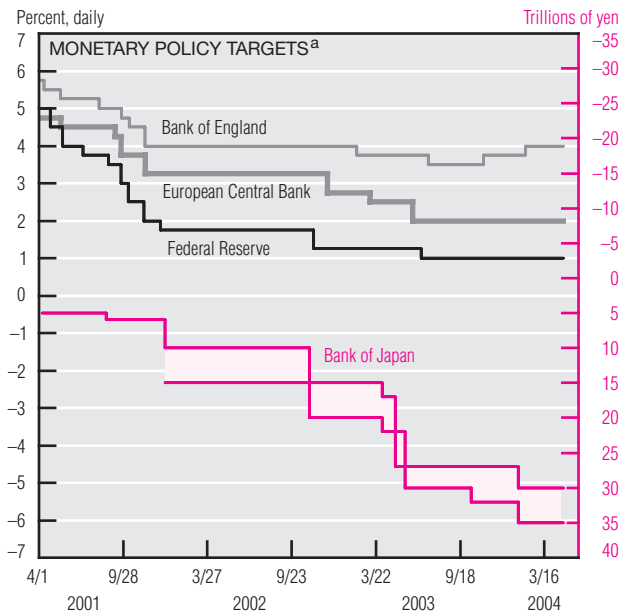
In 2003:IVQ, net loans and leases as a share of total assets reached 67.6%, up slightly from the previous quarter. This share was very close to its recent high of 67.9% in 2000:IIIQ, however, suggesting an end to the decline in savings institutions' direct holdings of loans.

Asset quality showed mixed signs in 2003:IVQ. Net charge-offs (gross charge-offs minus recoveries) rose to 0.30%. Problem assets (noncurrents assets plus other real estate) made up 0.62% of total assets for the quarter, which represented only a slight decrease in the problem asset ratio from its 2002 level of 0.69%.

However, asset quality is not currently a significant problem. Problem S&Ls (those with substandard exam ratings) declined significantly from 1.16% in 2002 to 0.71% in 2003:IVQ.

The share of unprofitable institutions continued to fall, reaching 5.7%. The coverage ratio stands at \$1.05 in loan loss reserves for every dollar of non-current loans. The slight increase in the coverage ratio between 2002 and 2003:IVQ resulted from a \$185 million increase in loan loss reserves and a \$307 million decrease in noncurrent loans during that period. In 2003:IVQ, core capital, which protects savings institutions against unexpected losses, decreased very slightly to 8.05% 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: repo rate.  
 b. Date of the first of the Bank of England's recent rate increases.  
 c. Current account balances at the Bank of Japan are required and excess reserve balances at depository institutions subject to reserve requirements plus the balances of certain other financial institutions not subject to reserve requirements. Reserve requirements are satisfied on the basis of the average of a bank's daily balances at the Bank of Japan starting the sixteenth of one month and ending the fifteenth of the next.  
 SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; and Bloomberg Financial Information Services.

Public discussion of expected monetary tightening has begun to spread around the globe, although the four major central banks left their policy settings unchanged in April. In Europe, the Governing Council of the European Central Bank concluded that an unchanged policy rate was "in line with the maintenance of price stability over the medium term," while officials outside the bank continued to press for a cut in its main refinancing rate.

The Bank of England's Monetary Policy Committee, noting that "global economic recovery still seemed to be developing broadly as expected," left its policy rate unchanged in April after raising it 50 basis points since October. Federal Reserve Chairman Alan Greenspan's remark that deflation "was no longer an issue" in the U.S. triggered spirited public speculation about the timing of potential future increases in the policy rate. Economic recovery and lower excess reserves led to talk of an end to

the Bank of Japan's policy of quantitative easing. Governor Fukui, however, reiterated that for this to happen, the bank would need to see both past and prospective core CPI measures at or above zero and might continue the policy "even if these two conditions are fulfilled." The Bank of China continued to battle rapid growth and potential inflationary pressures in April by raising reserve requirements for the second consecutive month.