The Economy in Perspective

The Rates They Are A-changin'

(with apologies to Bob Dylan)

Come gather 'round people wherever you roam
Recognize that inflation around you has grown
And accept there's a chance it could rise through its zone
Price stability is worth preservin'
So less stimulus from the Fed don't bemoan
For the rates they are a-changin'.

Come writers and critics who prophesize with your pens
Who are so confident in your opinions
But don't speak too soon for the data still spins
And there's no tellin' where it is goin'
The theories out now could later be in
For the rates they are a-changin'.

Come savers, investors, please heed the call
The signs are well-posted and the writin's on the wall
Inflation dynamics no longer are stalled
For markets are equilibratin'.
And many have said that the funds rate's too small
For the rates they are a-changin'.

Thank goodness most people throughout the land
No longer criticize for they quite understand
Reputation requires that you protect your brand
When patience so plainly is wanin'
So stay with the program while the Fed plays its hand
For the rates they are a-changin'.

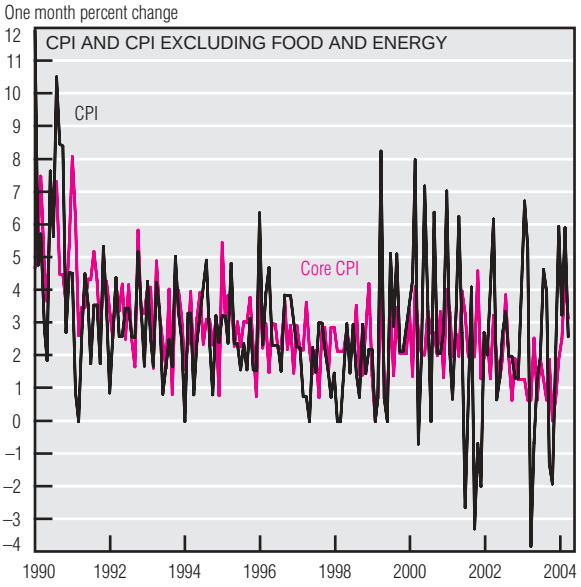
The line it is drawn, the course nearly cast
The risks we face now appeared small in the past
But with measured steps the expansion will last
Futures markets are anticipatin'
A considerable time will be comin' to pass
For the rates they are a-changin'.

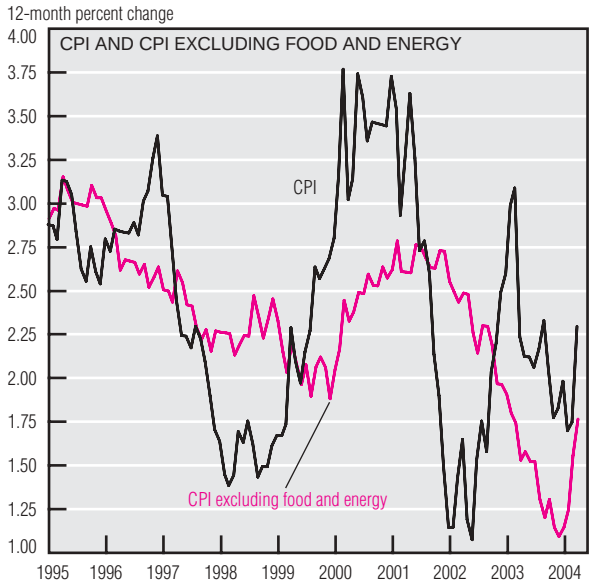
Disclaimer: These lyrics are a Dylanesque take on the current situation; they are not an official statement about the likely course of monetary policy.

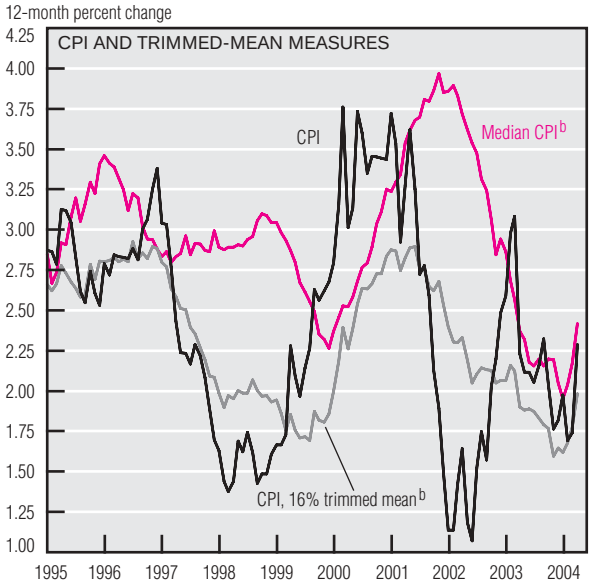
Inflation and Prices

April Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2003 avg.
Consumer prices					
All items	2.6	3.9	2.3	2.5	1.9
Less food and energy	3.1	3.3	1.8	2.1	1.1
Median[b]	4.1	3.4	2.4	2.9	2.1
Producer prices					
Finished goods	8.5	5.3	3.6	2.3	4.4
Less food and energy	2.4	1.9	1.4	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.

The recent broad-based rise in retail prices continues: The volatile Consumer Price Index (CPI) increased at a 2.6% annualized rate in April after surging 6.0% in March. Interestingly, the core CPI, which excludes volatile food and energy prices, increased at a faster rate than the overall index, advancing 3.1% (annualized rate) in April. The median CPI rose at a 4.1% annualized rate, its largest monthly increase since November 2001.

Year-over-year inflation rates continue to rise. The CPI has increased 2.3% since last April, while the core CPI, median CPI, and 16% trimmed-mean CPI posted their highest 12-month growth rates in a year or more, rising by 1.8%, 2.4%, and 2.0%, respectively.

The Blue Chip panel of economists has increased its CPI inflation forecasts. They predict inflation will average 2.1% over the next three quarters, up from their 1.8% estimate last month. The range of inflation forecasts has widened, but both optimists and pessimists have increased their quarterly forecasts for 2004. Optimists anticipate that inflation will register 1.1% by the end of 2004, while pessimists expect a 2.9% inflation rate.

Some economists question the ability of our economic models to predict inflation. Since 1993, economists' year-ahead inflation predictions have had an average error of 0.3 percentage point and 0.7 percentage point in absolute terms. This is no better than a naïve forecast, in which next year's inflation rate is assumed to be the same as this year's.

One particularly contentious issue is how useful measures of economic

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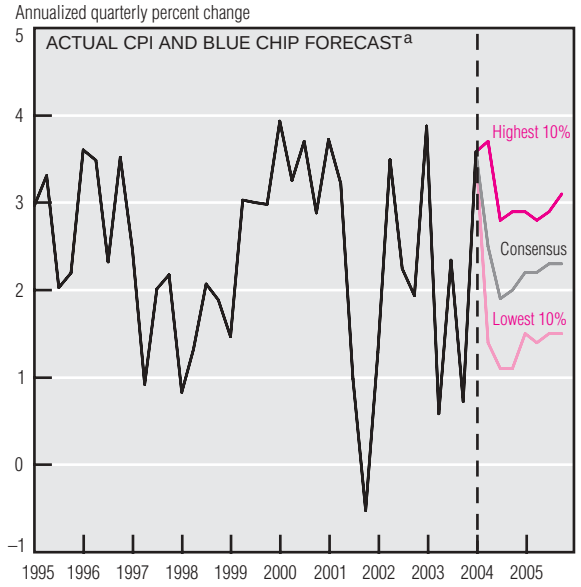
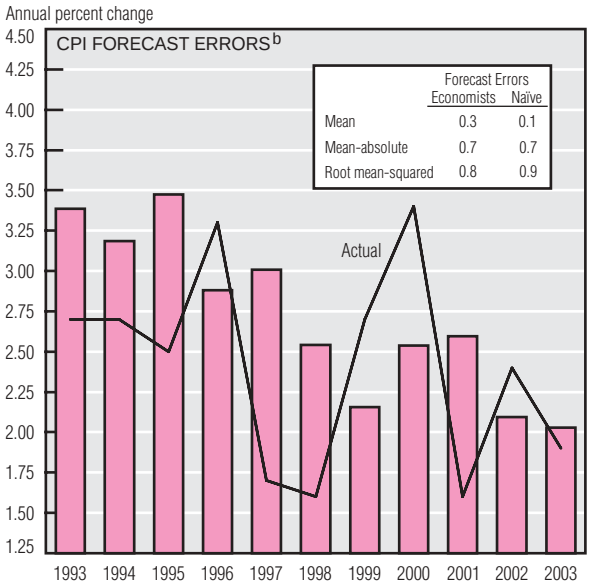
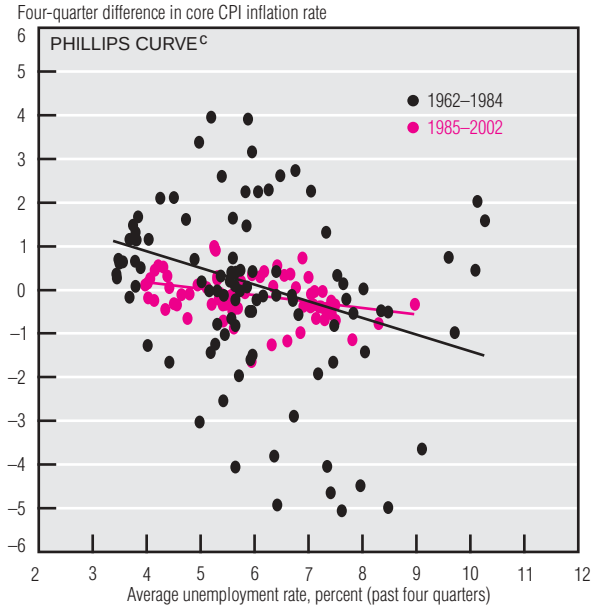
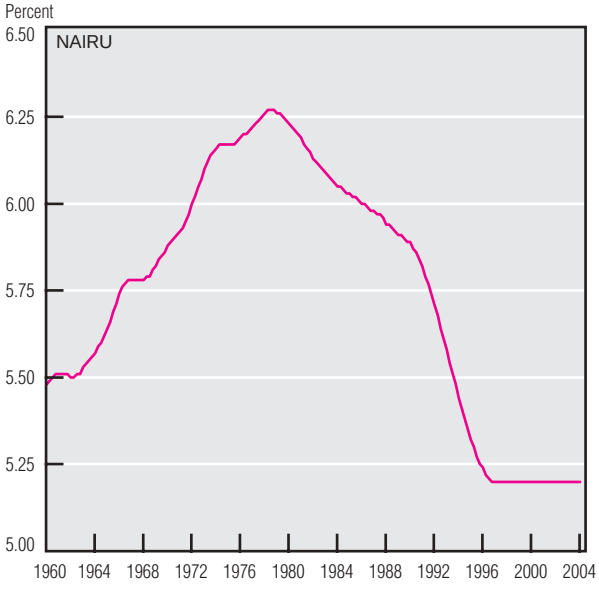
Inflation and Prices *(cont.)*









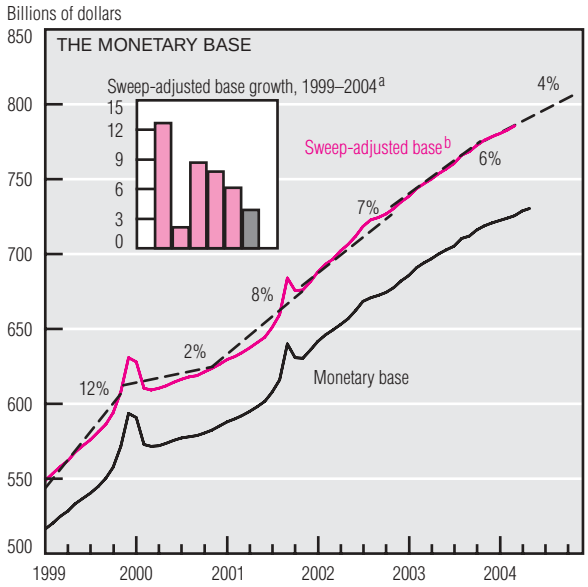
a. Blue Chip panel of economists.
b. CPI forecasts from the *Livingston Survey*.
c. Core CPI inflation rate calculated as the four quarter percent change of the Core CPI Price Index.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office; Federal Reserve Bank of Philadelphia, *Livingston Survey*; and *Blue Chip Economic Indicators*, May 10, 2004.

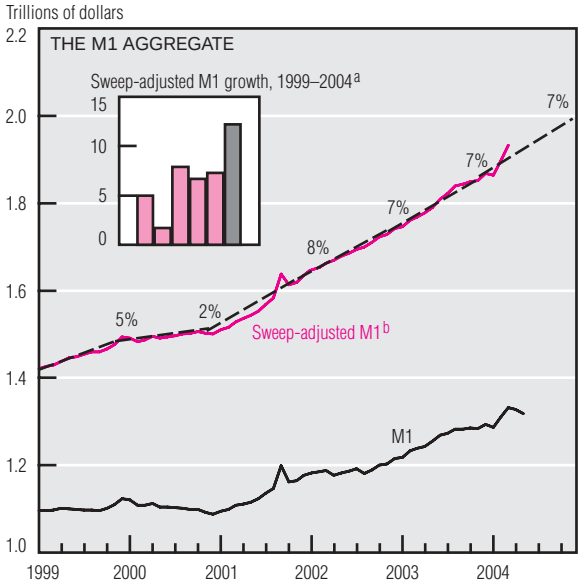
slack are in predicting inflation rate changes. The idea that inflation accelerates as the economy's resources become strained is a key assumption in most forecasts, but gauging the amount of slack in the economy is a daunting task.

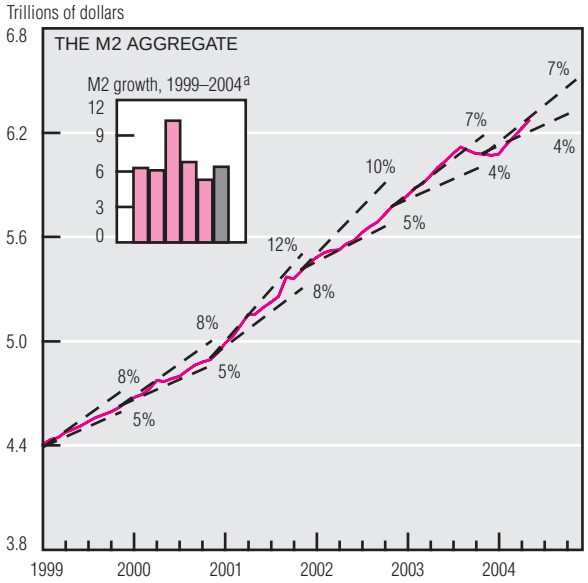
Several alternative measures of economic slack have been suggested such as the gap between potential and actual GDP, and capacity utilization. Another popular approach, sometimes termed the Phillips curve, suggests that inflation will increase when labor markets are tight, that is, when the rate of unemployment falls below the NAIRU (non-accelerating inflation rate of unemployment).

If we assume that NAIRU is constant, the relationship between unemployment and inflation changes has deteriorated since the mid-1980s. One reason for this may be that the economy's potential, as embodied by measures like NAIRU, is not constant; it fluctuates over time. According to the Congressional Budget Office, NAIRU peaked at around $6^{1}/_{4}$% in the late 1970s, falling below $5^{1}/_{4}$% sometime in the last decade. Perhaps inflation has picked up recently because there is less slack in the economy than these measures suggest. That is, NAIRU may now be higher than $5^{1}/_{4}$%. Most economists, however, do not believe NAIRU has increased so much that the economy has begun straining against its capacity or that the recent rise in inflation will persist for long. But, of course, only time and more research will tell.

Monetary Policy







Growth Rates of Monetary Components (percent)

	Annual					YTD	Average, 1999–2003
	1999	2000	2001	2002	2003	2004	
Monetary base[c]	12.7	2.1	8.7	7.8	6.2	3.9	7.5
M1[d]	5.0	1.7	7.9	6.7	7.3	12.2	5.7
M2	6.3	6.1	10.3	6.8	5.3	6.4	6.9
Currency	11.1	4.3	9.1	8.2	5.9	2.9	7.7
Total reserves	–7.2	–6.2	8.8	–6.7	8.3	11.3	–0.6
Check and demand[e]	–4.8	–6.8	4.9	–1.5	7.7	7.0	–0.1
Money market funds	13.7	11.3	8.4	–6.1	–11.6	–14.7	3.2
Small time deposits	–0.7	9.6	–4.9	–9.0	–9.5	–5.1	–2.9
Savings deposits	10.1	6.7	21.7	21.1	15.2	15.4	15.0

a. The far-right bar refers to the most recent data available. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. The 2004 growth rates for the sweep-adjusted monetary base and sweep-adjusted M1 are calculated on a March over 2003:IVQ basis. The 2004 growth rate for M2 is calculated on a May over 2003:IVQ basis. Data are seasonally adjusted.
b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.
c. Refers to the sweep-adjusted base.
d. Refers to sweep-adjusted M1.
e. Refers to demand deposits and other checkable deposits.
SOURCE: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6.

Growth in the sweep-adjusted monetary base (total currency in circulation plus total reserves plus vault cash of depository institutions not applied to reserve requirements) has moderated so far in 2004 to an annualized growth rate of 3.9%, in contrast with its five-year average of 7.5%. The decline in base growth results primarily from currency growth's drop of 4.8 percentage points from its five-year average of 7.7%. Given currency's larger share, its decline more than offset the 11.3% growth of total reserves in 2004.

M1, which consists of currency in the hands of the public plus demand and other checkable deposits, is a slightly broader monetary aggregate. So far in 2004, sweep-adjusted M1 has shown an annualized growth rate of 12.2%, roughly 6.5 percentage points above its five-year average. The acceleration in M1 growth is largely explained by the sharp increase in demand deposits and other checkable deposits, which comprise 49% of M1. Their year-to-date annualized growth rates in 2004 exceed their five-year averages by 7.1 percentage points.

Since 2003:IVQ, the broader monetary aggregate, M2, grew 6.4%, which is 0.5 percentage points less than its 1999–2003 average. Concerns about persistently slow M2 growth since mid-2003 were assuaged when the monetary aggregate began to rebound in January. Since then, M2 has grown at a 9.5% annualized rate, a surge that was associated with positive economic news such as employment reports.

At its May 4 meeting, the Federal Open Market Committee (FOMC) decided to keep the target federal funds

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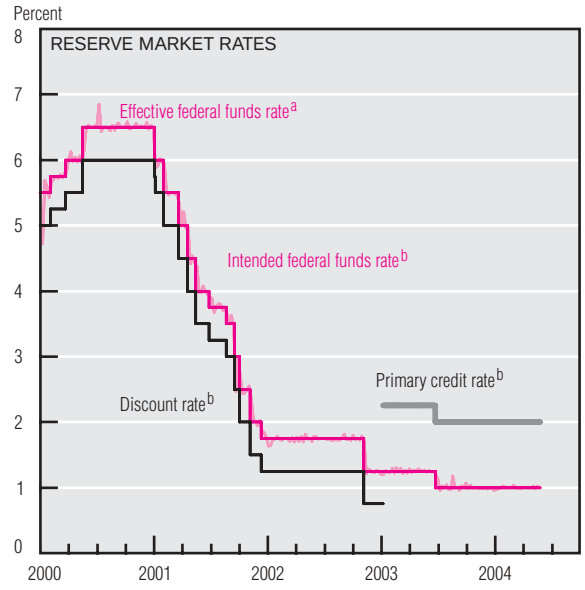
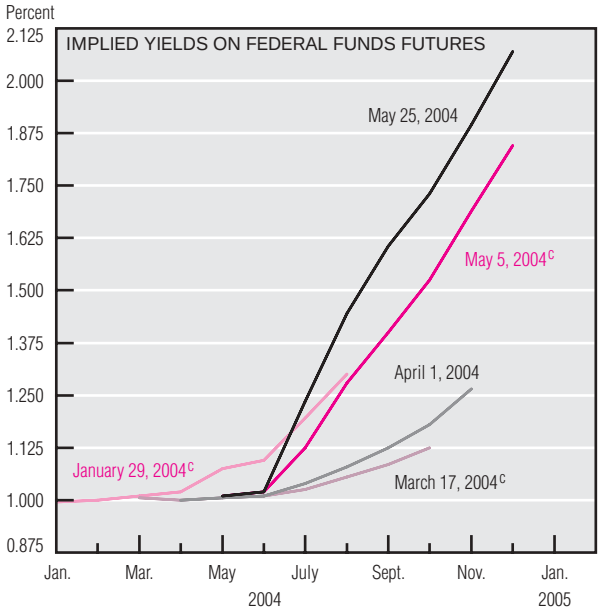
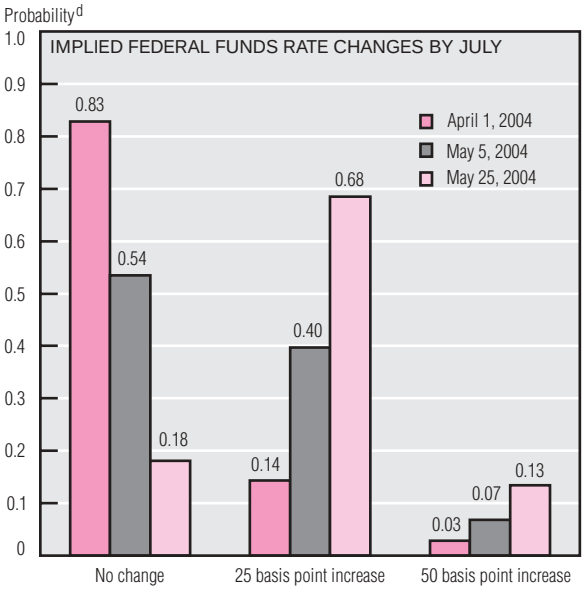
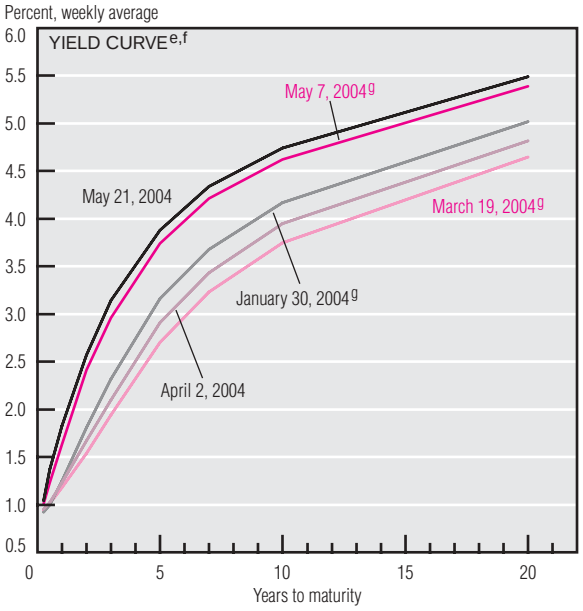
Monetary Policy (cont.)









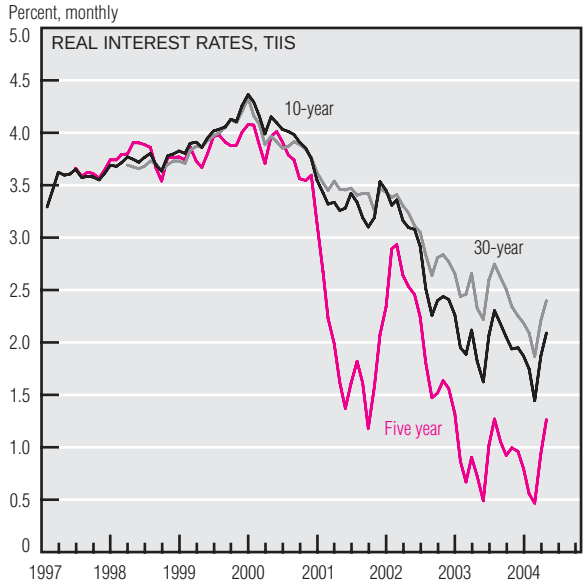
a. Weekly average of daily figures.
b. Daily observations.
c. One day after the FOMC meeting.
d. Probabilities are calculated using prices from options on July 2004 federal funds futures that trade on the Chicago Board of Trade.
e. All yields are from constant-maturity series.
f. Average for the week ending on the date shown.
g. The first weekly average available after the FOMC meeting.
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.

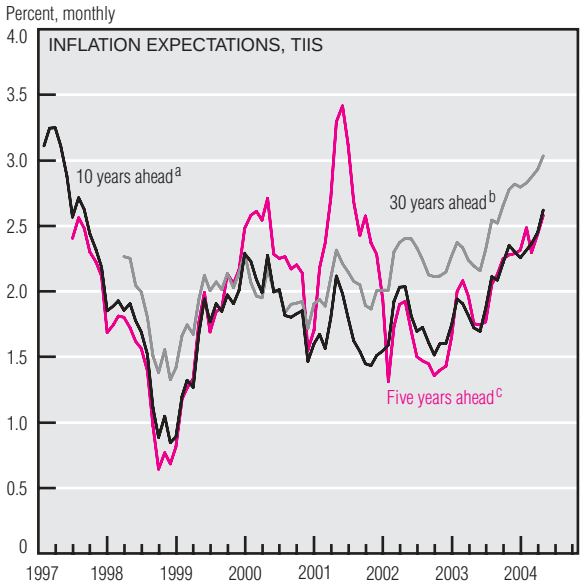
rate at 1% and the primary credit rate at 2%. Despite a growing economy, the target has remained at 1% since June 2003. The FOMC reiterated its prior statement that "output is continuing to expand at a solid rate," but changed its assessment of hiring activity, noting that it now "appears to have picked up." The FOMC also stated that "policy accommodation can be removed at a pace that is likely to be measured" rather than with the "patience" mentioned in the prior statement.

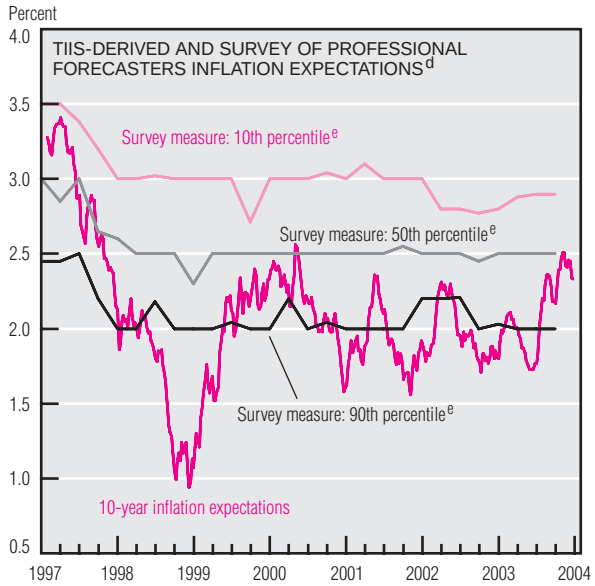
The horizon for the next expected change, as implied by federal funds futures, has been pushed far forward; it is now expected to occur by July. Since early spring, the Chicago Board of Trade has provided a market for options on federal funds futures. Prices on these options enable one to estimate the implied probabilities associated with implied federal funds rate changes. In response to strong employment reports and higher-than-expected inflation numbers, market participants raised their expectations of a June rate increase (there is no July meeting). In early April, they saw only a 17% chance of an increase, versus 81% in late May.

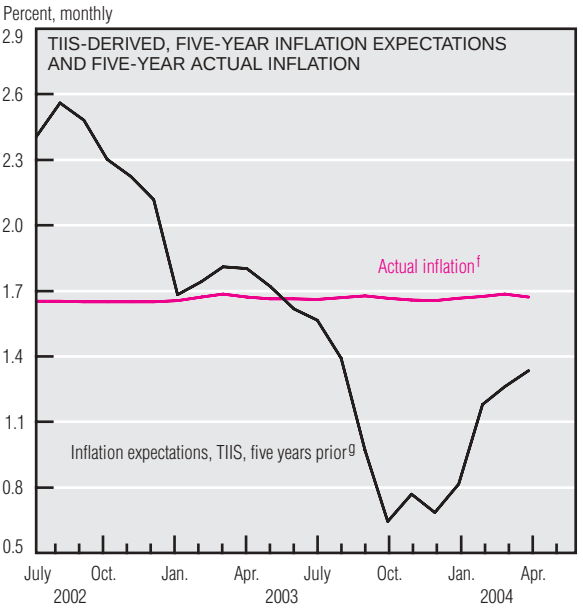
Reflecting strong economic news as well as the likelihood of funds rate hikes in the near future, the yield curve has shifted significantly since the March meeting (up 36 bp for the six-month rate and almost 100 bp for the 10-year rate). For the past three weeks, 90-day Treasury bill rates have remained at 1.04%, slightly above the intended federal funds rate.

Treasury Inflation-Indexed Securities









a. Yield spread: 10-year Treasury minus 10-year TIIS.
b. Yield spread: 30-year Treasury minus 30-year TIIS.
c. Yield spread: five-year Treasury minus five-year TIIS.
d. Brian Sack and Robert Elsasser, "Treasury Inflation-Indexed Debt: A Review of the U.S. Experience," *Federal Reserve Bank of New York Economic Policy Review*, 2004: 47–63.
e. The survey measure is the expected 10-year consumer price index inflation.
f. Annualized five-year CPI inflation.
g. Plotted observations represent inflation expectations from five years prior.
SOURCES: Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; and Bloomberg Financial Information Services.

Today's monetary policy decisions focus on future inflation prospects. Treasury inflation-indexed securities (TIIS) give us market measures of real interest rates with maturities of five, 10, and 30 years. Subtracting these rates from nominal Treasury bills of the same maturity provides market-based measures of expected inflation over that period. These measures suggest that inflation is expected to drift up over time, averaging nearly 2.6 percent over the next five and 10 years. What may be more troubling is that this measure has increased 0.9 percentage point during the past year.

But how accurate are the inflation expectations derived from TIIS data? On average, 10-year inflation expectations derived from TIIS have been more than 50 basis points (bp) lower than those predicted by the *Survey of Professional Forecasters*. However, over the previous five years, actual inflation has averaged only 7 bp higher than forecasts based on TIIS data. Should we expect inflation derived from five- and 10-year TIIS data to be underestimated? Even if it is, is this bias constant? If the bias is constant, then movements in expected inflation will still reflect movements in actual inflation.

One reason that expected inflation derived from TIIS data might be underestimated is that the TIIS market is less liquid than other government bonds; consequently, bid–ask spreads for TIIS tend to be larger than for the others. Real TIIS returns contain a premium resulting from these transaction

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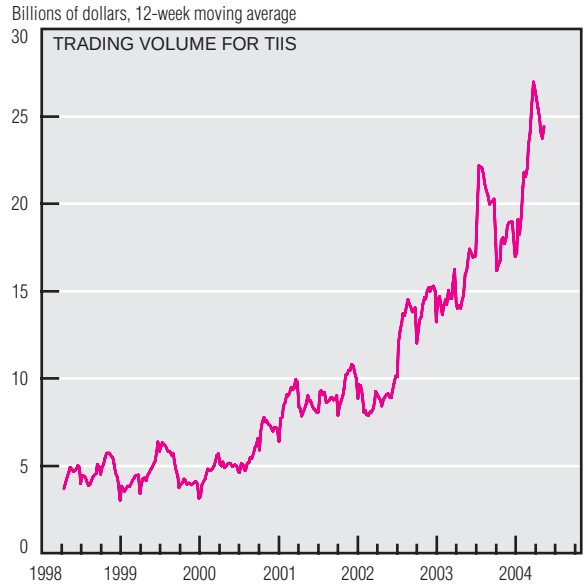
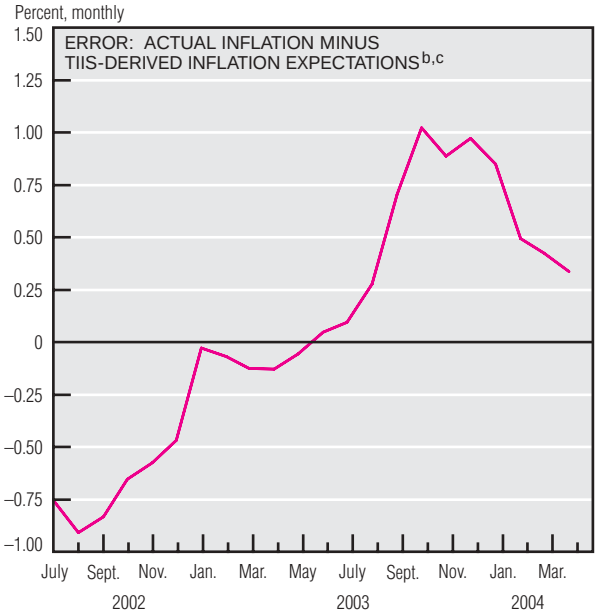
Treasury Inflation-Indexed Securities *(cont.)*



Typical Bid—Ask Spreads for Treasury Securities (1/32nds of price)[a]

Type	Maturities of five years or less	Maturities of five to 10 years	Maturities beyond 10 years
On-the-run nominal	1/4 to 1/2	1/2	—
Off-the-run nominal	1/2 to 1	1/2 to 1	2
Inflation-indexed	1 to 2	2	4 to 16



Predictability of the Sign of Next Month's Error

Current month's error size	Next month's error sign: Positive	Next month's error sign: Negative
Greater than 0.5	5	0
0 to 0.5	5	0
–0.5 to 0	1	5
Less than –0.5	0	5

a. Brian Sack and Robert Elsasser, "Treasury Inflation-Indexed Debt: A Review of the U.S. Experience," *Federal Reserve Bank of New York Economic Policy Review*, 2004: 47–63.
b. Annualized five-year CPI inflation.
c. Plotted observations represent inflation expectations from five years prior.
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.

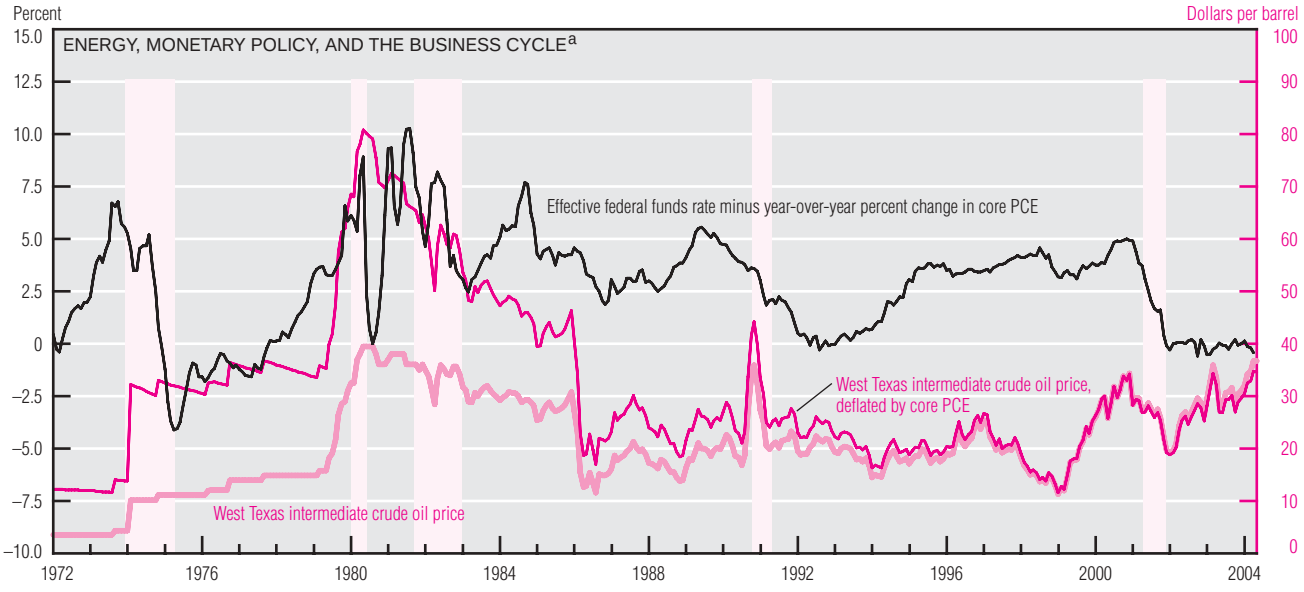
costs, so expected inflation calculated from TIIS will be underestimated. Transaction costs, however, can only account for around 6 bp of the 50 bp bias found in the 10-year TIIS data.

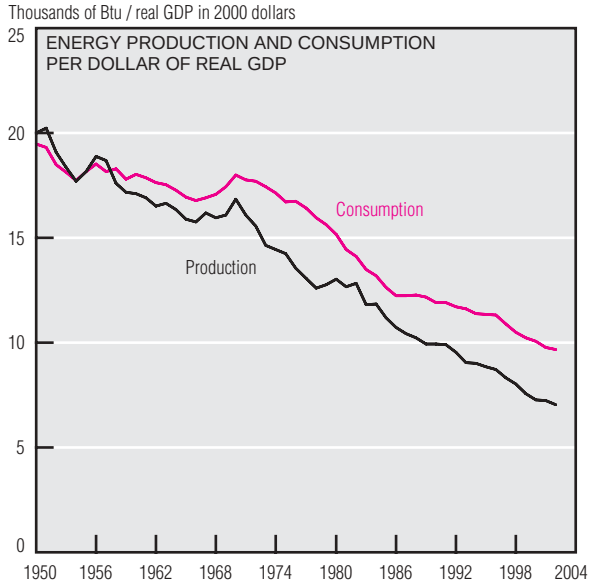
Another reason for a bias is that inflation variability makes the real return from holding non-indexed government bonds uncertain. By construction, the real return from holding a TIIS contract is known with certainty. If people dislike the uncertainty associated with holding non-indexed government debt, then these bonds will have a larger real return. This, however, would predict that expected inflation from TIIS data would overstate true expected inflation. The bias in inflation expectation derived from 10-year TIIS measures suggests that investors actually prefer this uncertainty.

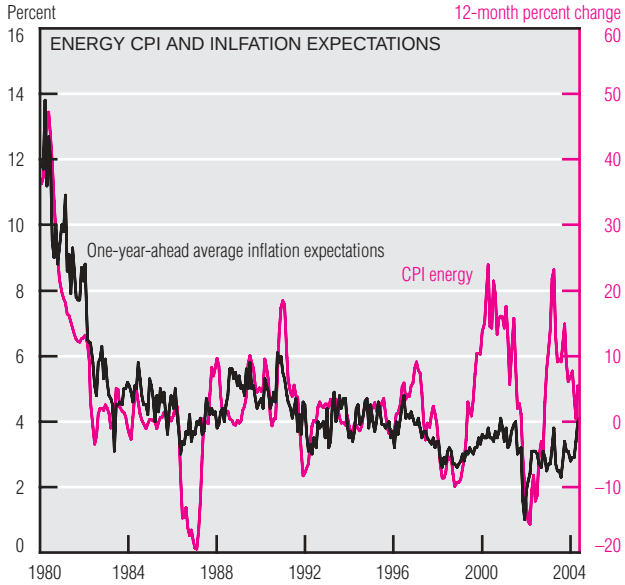
Why might investors prefer the uncertainty associated with holding non-indexed government debt? Uncertainty concerns investors to the extent it affects the variability of their consumption. If realized real returns are negatively associated with consumption, then these risky securities may actually reduce consumption variability. In fact, the Phillips curve suggests that inflation and consumption may be positively correlated; thus real returns and consumption may be negatively correlated.

If these biases are constant over time, then movements in expected inflation derived from TIIS will still reflect movements in actual inflation expectations. But the data suggest that, at least for the five-year TIIS, these premiums might not be constant. Today's error contains information predicting tomorrow's bias; but 20 out of 21 times, the sign of today's error predicted the sign of tomorrow's.

Oil Prices and the Business Cycle







a. Shaded areas indicate recessions as dated by the National Bureau of Economic Research.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Energy, *Annual Energy Review 2002;* Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; University of Michigan, *Survey of Consumers;* National Bureau of Economic Research; and *Wall Street Journal*.

With oil trading around a record high of $40 per barrel, is another recession far behind? Since World War II, oil prices have spiked before nearly every U.S. recession, including the most recent one.

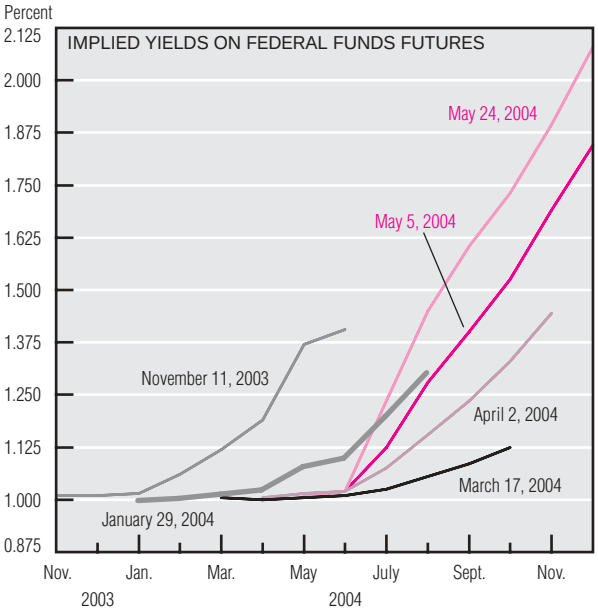
Many economists suggest that oil costs alone are too small relative to output to explain such a severe business cycle response to energy price spikes. They contend that imperfections in the adjustment process or some other mechanism must interact with oil prices to leverage such shocks into full-blown economic downturns.

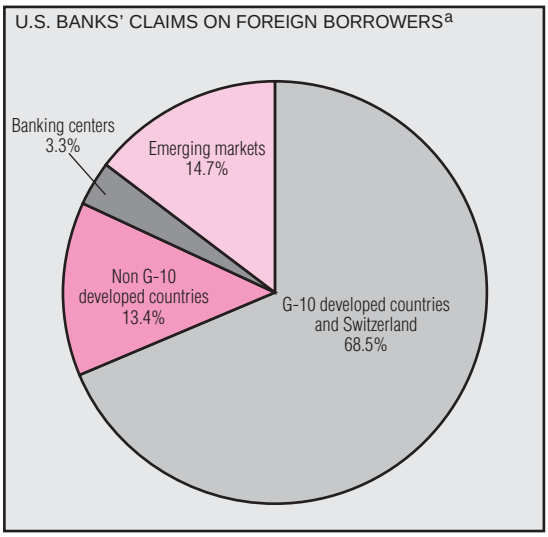
A prime suspect is monetary policy. Indeed, an increase in the real federal funds rate—the observed funds rate minus the inflation rate—also has preceded nearly every recession.

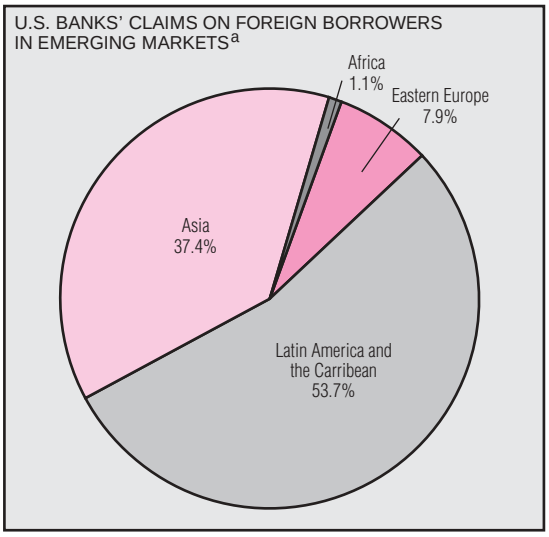
If the relationship between business activity and oil prices does, in fact, turn on the stance of monetary policy, more's the concern. Market observers expect the FOMC to raise the federal funds target rate before year's end.

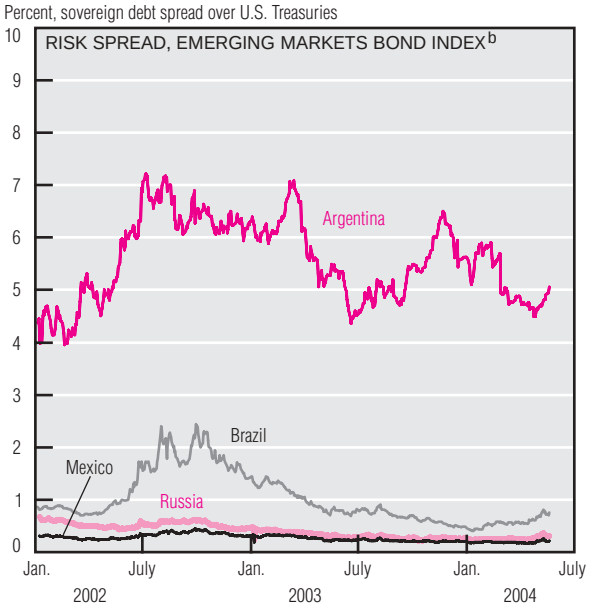
Fortunately, some studies suggest that the economic impact of oil price shocks has waned since the early 1980s. The U.S. economy has become much less dependent on oil. We now use about half as much energy to produce a unit of GDP as we did in the 1970s. Other analysts, however, attribute the post-1980 break between oil prices and economic activity to monetary policy changes. Over the past two decades, the Federal Reserve has built a strong reputation for price stability, and inflation expectations no longer parallel energy price patterns closely. Calm inflation expectations provide the Fed with more policy leeway.

Emerging Market Debt









a. Federal Financial Institutions Examination Council, *Country Exposure Lending Survey* (March 31, 2004), Table 1. Based on a survey of 72 U.S. banking organizations.

b. Data from J.P. Morgan. Includes external-currency-denominated Brady bonds, loans, and eurobonds as well as U.S. dollar-denominated local market instruments.

SOURCES: Chicago Board of Trade; J.P. Morgan; and Bloomberg Financial Information Services.

In late March, expectations about the future course of U.S. monetary policy began to change. As suggested by implied yields of federal funds futures, markets have come to anticipate a substantial hike in the federal funds target rate by the end of the year. Fed watchers now wonder whether rate hikes will come in a series of incremental moves or through a few large jumps. The pattern may matter.

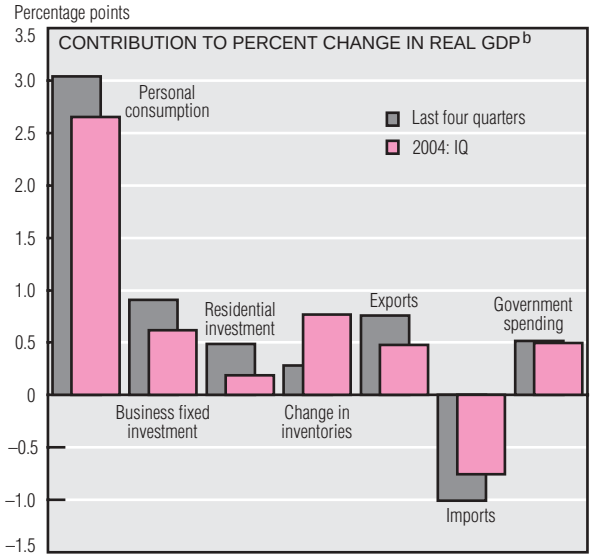
For one thing, a sharp hike in U.S. interest rates could present particular problems for heavily indebted emerging markets and their international creditors. According to a recent survey, U.S. banking organizations hold approximately $101 billion in total claims on emerging market economies. Latin American countries account for roughly 54% (or $54.3 billion) of all U.S. bank loans to emerging markets. Our two most important Latin American debtor countries have received the great bulk of all U.S. bank loans in the region: Mexico accounts for nearly 40% and Brazil for 29%. Chile, Argentina, Venezuela, and Columbia combined hold another 19% of our total Latin American bank exposure.

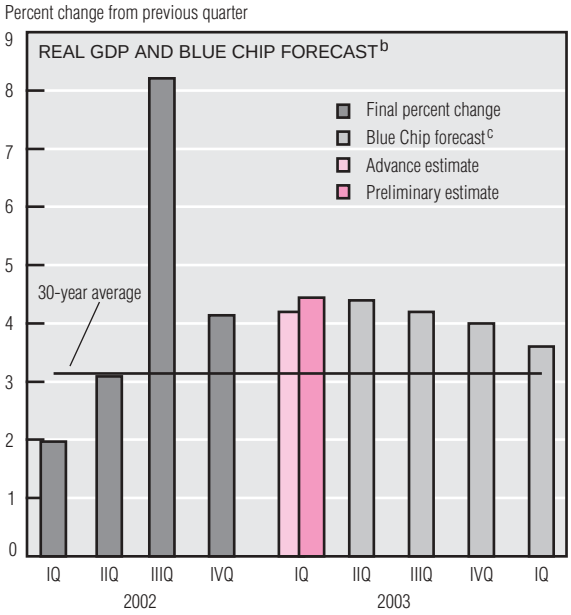
As a rule of thumb, debtor countries must grow at a rate greater than the interest cost on their obligations if they hope to avoid painful fiscal adjustments and remain solvent. In March, some emerging market risk spreads, a barometer of lenders' sentiments, had already begun to widen slightly.

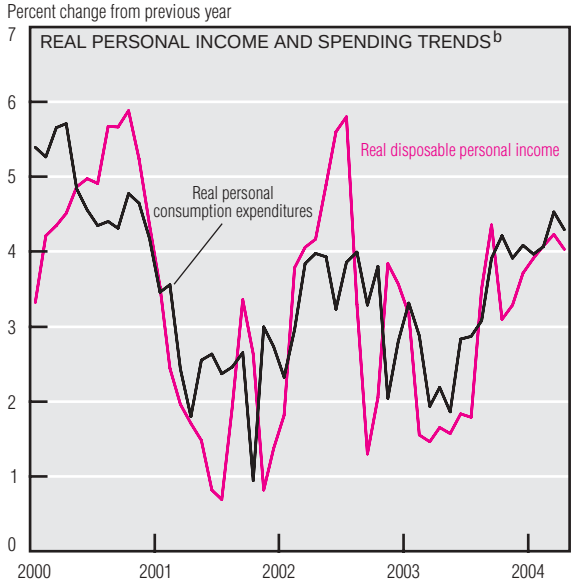
GDP Growth and Household Finances

Real GDP and Components, 2004:IQ[a]
(Preliminary estimate)

	Change, billions of 2000 $	Annualized percent change, last: Quarter	Four quarters
Real GDP	115.9	4.4	5.0
Personal consumption	71.1	3.9	4.3
Durables	–11.4	–4.2	9.8
Nondurables	35.0	6.6	5.1
Services	44.5	4.2	2.9
Business fixed investment	16.6	5.8	9.1
Equipment	22.2	9.8	12.5
Structures	–4.3	–7.1	–1.6
Residential investment	4.9	3.8	9.3
Government spending	13.7	2.9	3.0
National defense	15.0	13.3	13.0
Net exports	–10.0	—	—
Exports	13.0	4.9	8.3
Imports	23.0	5.9	7.9
Change in business inventories	19.2	—	—







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

According to the preliminary estimate from the U.S. Commerce Department's Bureau of Economic Analysis, real gross domestic product (GDP) rose at an annual rate of 4.4% for 2004:IQ, up from the advance estimate of 4.2%. Most of the revisions were minor; the most significant were modest increases in inventories and imported goods.

Because of its larger share, the major contributor to real GDP growth was personal consumption. Contributions from business fixed investment, change in inventories, and government spending were similar to one another.

Blue Chip forecasters expect solid economic growth to continue at an annual rate of about 4%, well above the 3.1% averaged over the last 30 years.

Because personal consumption accounts for roughly 70% of GDP and about 60% of the change in real GDP over the last year, the household sector's health is an important concern for policymakers. One positive sign is that real personal disposable income has grown at an annual rate of at about 4% since last September; however, it has been more than matched by growth in real personal consumption expenditures. These expenditures have been fueled partly by rising levels of consumer credit outstanding, which topped $2 trillion for the first time at the beginning of the year.

Is this high debt load cause for concern? Bankruptcy filings have been down in the last two months but they remain at a fairly high level despite a significant decline late last year.

Some analysts consider the level of personal bankruptcies to be a

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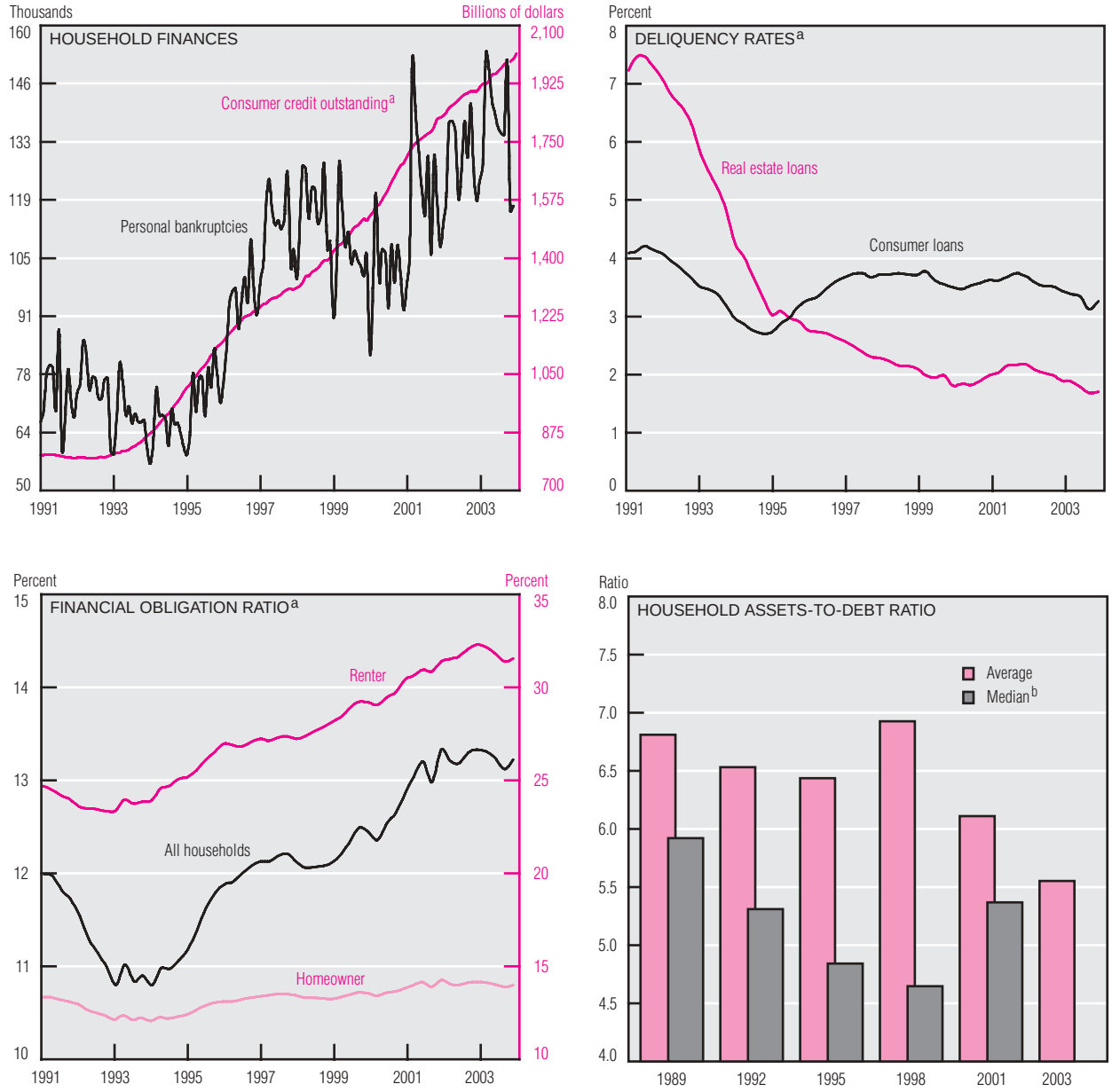
GDP Growth and Household Finances *(cont.)*

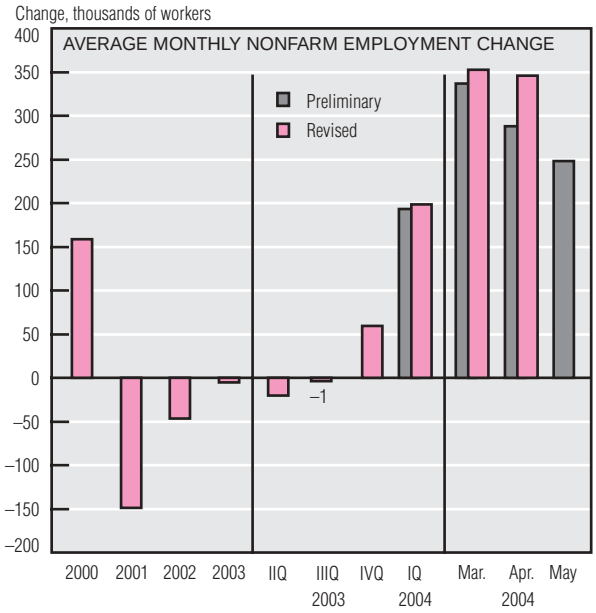


a. Data are seasonally adjusted.
b. Median data are from the *Survey of Consumer Finances*, which is published every three years.
SOURCES: Administrative Office of the U.S. Courts; and Board of Governors of the Federal Reserve System.

flawed measure of household financial health because it is affected by changes in lender practices and the law. Delinquency rates, another measure of consumers' ability to keep up with debt obligations, have been on a downward trend for real estate loans and fairly flat for consumer loans. Many observers prefer to look at debt service ratios because they include information from all households, not just those filing for bankruptcy or falling behind in their payments. This ratio has risen only modestly for homeowners since the early 1990s but much more sharply for renters. Since the beginning of 2003, the ratio for both groups has been flat or declining.

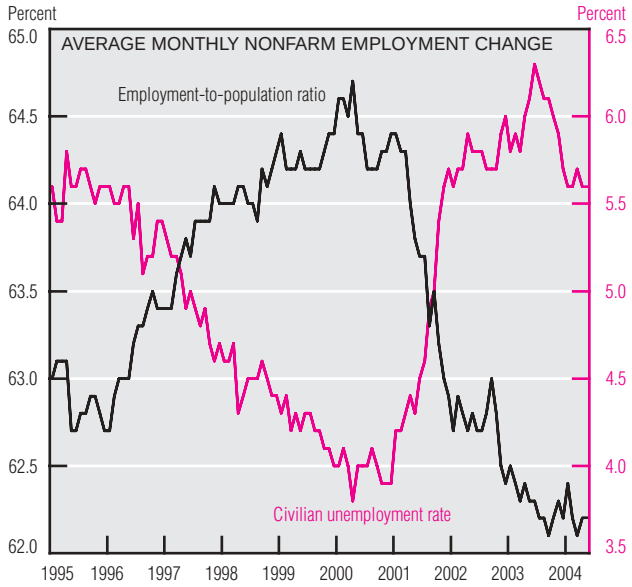
Of course, to assess the financial health of households fully, one must look not only at their incomes and liabilities but also at their assets. Before the stock market drop that followed the dot-com collapse, the average ratio of household assets to debts was fairly flat going back to 1989. Because a relatively few households hold a majority of shares, the median is better than the average as a gauge of the typical household. The median fell from 1989 until 1998 but rose in 2001. Unfortunately, it is only available every three years, but it is likely to be up further. More of the median household's wealth is tied up in a home than in stocks, so the price of its home matters more than the value of its shares. Although share prices have not performed very well since 2001, real estate is up sharply.

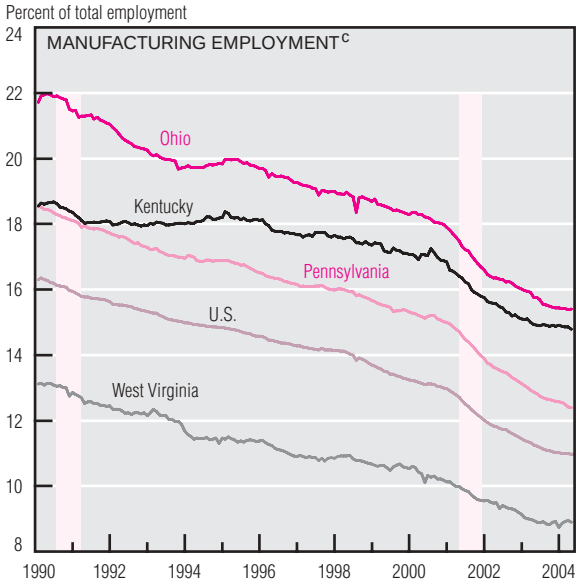
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	YTD	May 2004
Payroll employment	–149	–47	–5	238	248
Goods producing	–124	–76	–42	47	72
Construction	–1	–8	7	27	37
Manufacturing	–123	–67	–48	16	32
Durable goods	–88	–48	–30	17	26
Nondurable goods	–35	–19	–18	–1	6
Service providing	–25	29	37	191	176
Retail trade	–24	–11	–5	37	19
Financial activities[a]	8	6	6	10	15
PBS[b]	–63	–17	23	54	64
Temporary help svcs.	–37	2	15	21	31
Education & health svcs.	50	40	28	33	44
Leisure and hospitality	–1	–11	8	32	40
	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. Shaded areas indicate recessions as dated by the National Bureau of Economic Research.

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

Nonfarm payroll employment rose 248,000 in May. The net job gain for April was revised up 58,000 to 346,000, bringing the total increase in nonfarm employment over the past three months to nearly 950,000. Since declining by 2.7 million jobs from March 2001 to August 2003, nonfarm payroll employment has increased by more than 1.4 million over the past nine months.

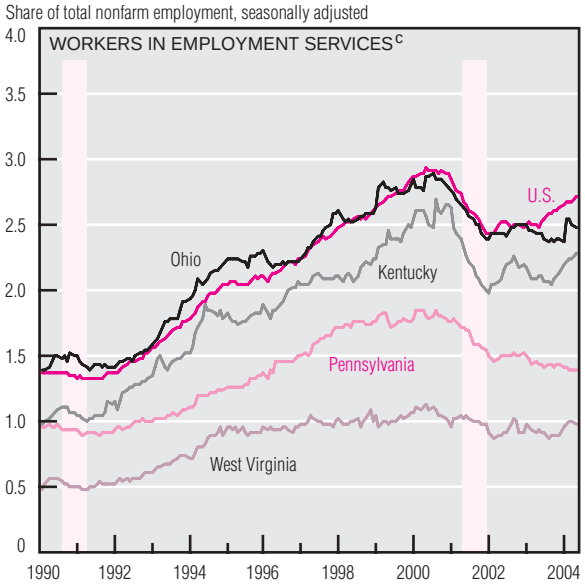
Goods-producing industries added 72,000 net jobs in May, 32,000 of them in manufacturing. Since bottoming out in January, manufacturing employment has increased by 91,000, with most of the gain coming from durable goods industries. Service-providing industries added 176,000 net jobs in May after gaining mor1e than 250,000 in each of the previous two months. Within the sector, professional and business services, education and health services, and leisure and hospitality each had substantial job gains for the third consecutive month. Both the unemployment rate of 5.6% and the employment-to-population ratio of 62.2% remained at their previous levels in April. After falling 0.6% in the second half of 2003, the unemployment rate has been fairly stable in 2004 so far. The labor force participation rate remained at 65.9%, its lowest level since 1988.

Since 1990, manufacturing's share of employment has declined 5.3 percentage points in the U.S. and 5.8 percentage points in Fourth District states, with more abrupt drops occurring around recessions. In the years between the last two recessions, Kentucky's share of employment in manufacturing fell 1.5 percentage points. During the same period, the share for the other Fourth District states and the U.S. as a whole fell between 2.5 and 3.75 percentage points.

The Employment Services Industry

Largest Occupations in Employment Services, May 2003

	Thousands of workers in employment services	Share of occupation in employment services industry (percent)
Laborers and hand movers[a]	476	21.1
Office clerks, general	179	6.1
Packers and packagers—hand	146	16.2
Helpers—production workers	85	18.8
Packaging and filing machine operators	79	19.6
Secretaries[b]	73	4.0
Registered nurses	70	3.1
All occupations	3,299	2.6



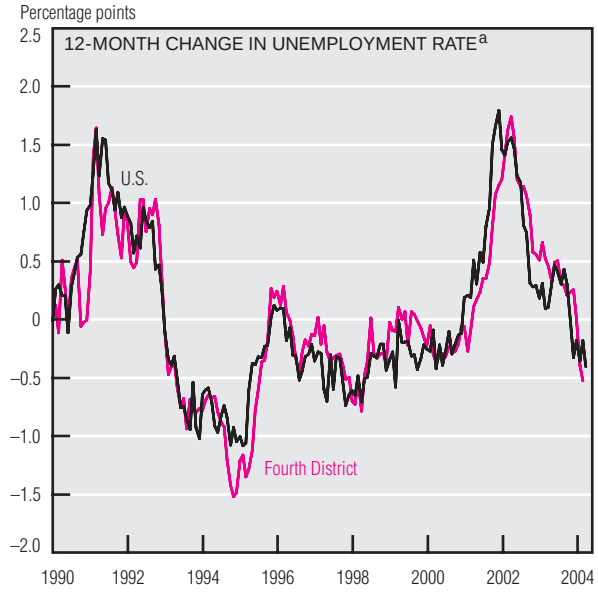
NOTE: Shaded bars indicate recessions as dated by the National Bureau of Economic Research.
a. Hand movers include freight, stock, and material movers.
b. Excludes legal, medical, and executive secretaries.
c. State data are seasonally adjusted by the author using the X-11 procedure.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics; and National Bureau of Economic Research.

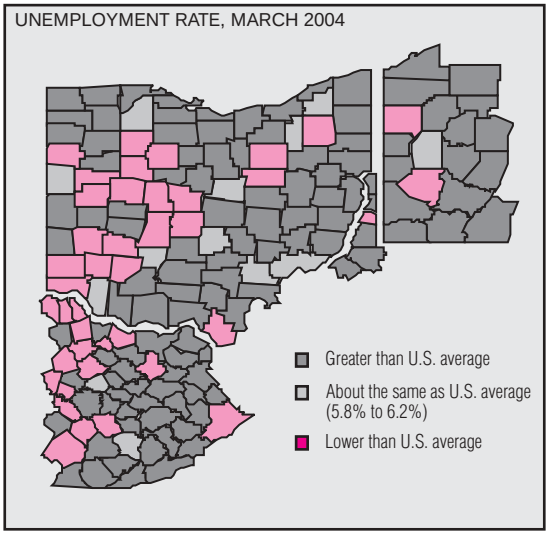
Employment services was one of the fastest-growing industries throughout the 1990s. By March 2001, the end of the expansion, it accounted for 3.6 million workers (2.7% of U.S. employment). About two-thirds of these workers are at temporary help agencies; the remaining third work for professional employer organizations and employee placement agencies. This makes employment in the industry more volatile than aggregate employment and potentially a leading indicator. The potential for signaling future employment gains comes from firms' tendency to make permanent hires from their temporary workers. The data reveal that hiring in employment services and temporary-help agencies leads aggregate employment by about six months and is about five times as volatile. The scale of these changes can make this industry appear to be the only or primary expanding sector. However, its workers are spread throughout the economy.

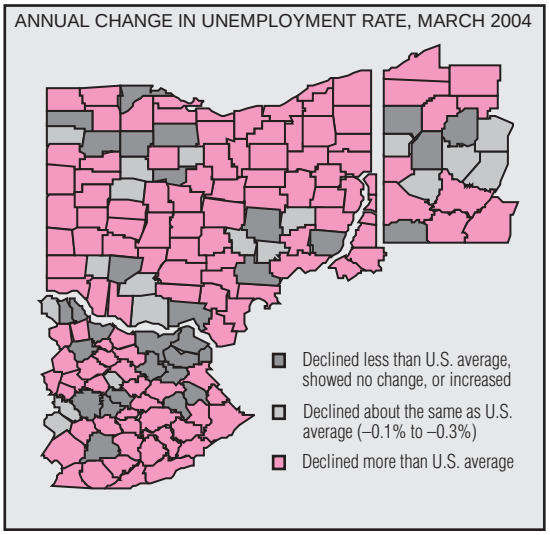
One way to determine where people are actually working is to observe their occupations. For the seven largest occupations, employees in employment services are likely to be found working in manufacturers and wholesalers, offices, and hospitals. Indeed, about one-fifth of all laborers (typically employed throughout the industries that produce and deliver goods) and packaging machine operators (primarily involved in manufacturing) come from the employment services industry.

Among Fourth District states, the number of employment services workers has increased significantly in Ohio, Kentucky, and West Virginia since 2003:IVQ. Pennsylvania, whose recent employment growth has lagged the other three states, still reports net job losses in employment services.

Fourth District Unemployment Rates







NOTE: Data are not seasonally adjusted unless otherwise noted.
a. Seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics and Employment Training Administration.

Unemployment patterns in the Fourth District generally follow national trends very closely. In the last two recessions, the rise in national unemployment was mirrored by the Fourth District rate. In the most recent recession, however, the rise in the District's unemployment rate lagged the nation by two months. In the recovery from the 1990–91 recession (the "jobless recovery") unemployment rates in both the U.S. and the District continued to climb for a year, then fell steadily through the expansion. After the most recent recession, however, changes in the District's unemployment rate did not follow the same pattern: Unemployment in the District and the nation did not climb drastically after the recession ended in November 2001, nor did it begin falling a year after the recession ended. According to March 2004 data (the most recent available), unemployment in the District and across the nation continued to hover around 5.7%, well above the rates of about 4.2% that both areas enjoyed throughout 2000.

During the most recent recession, national and District unemployment levels remained well below those experienced during and immediately after the 1990–91 recession (when Fourth District unemployment peaked at 7.7%). But the year-over-year increase in unemployment rates was actually greater in the most recent recession than in 1990–91.

Examined by county, unemployment rates in the District tend to be lower around major metropolitan areas and along the transportation corridors that connect them (including I-75, which stretches from Toledo to Lexington, and I-71, which crosses

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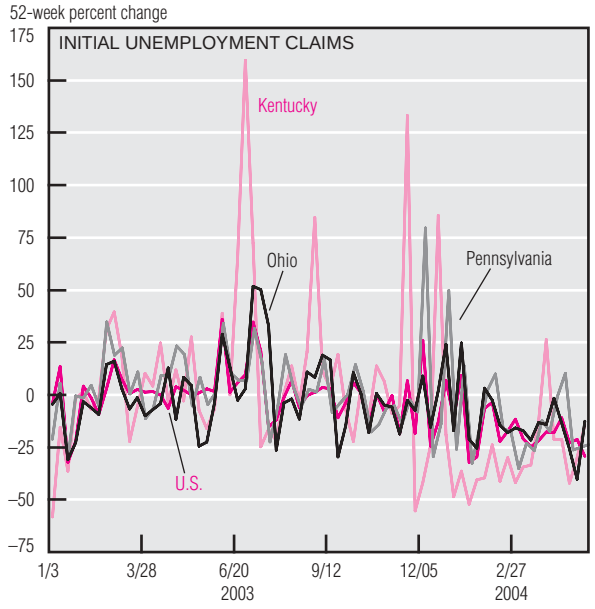
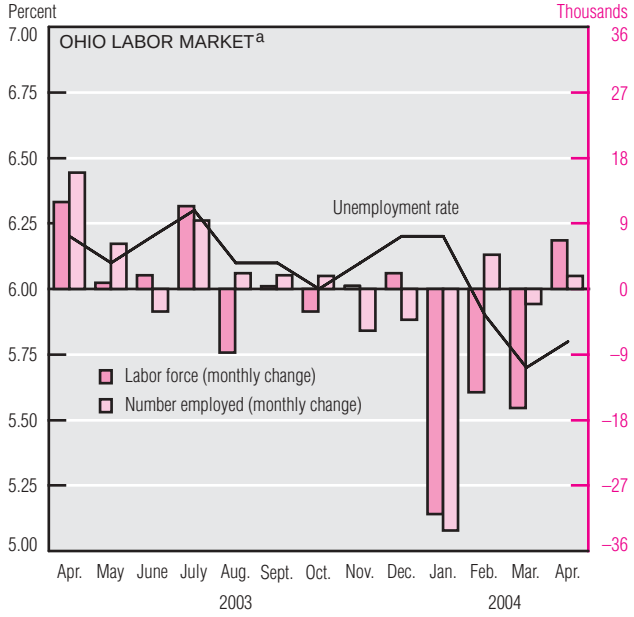
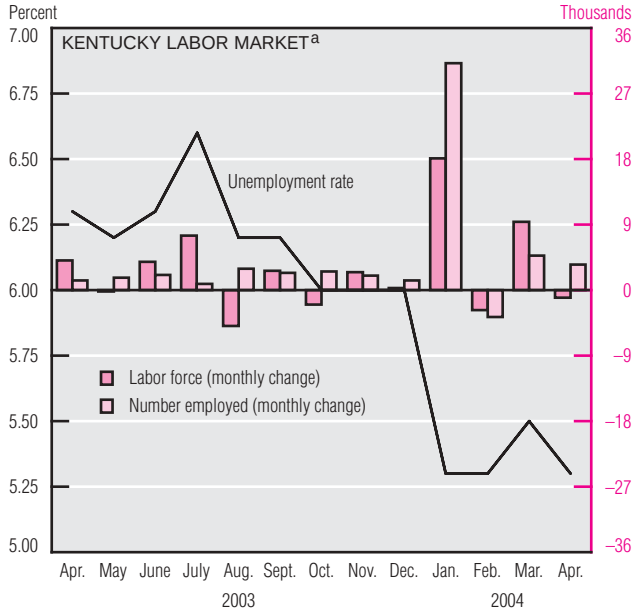
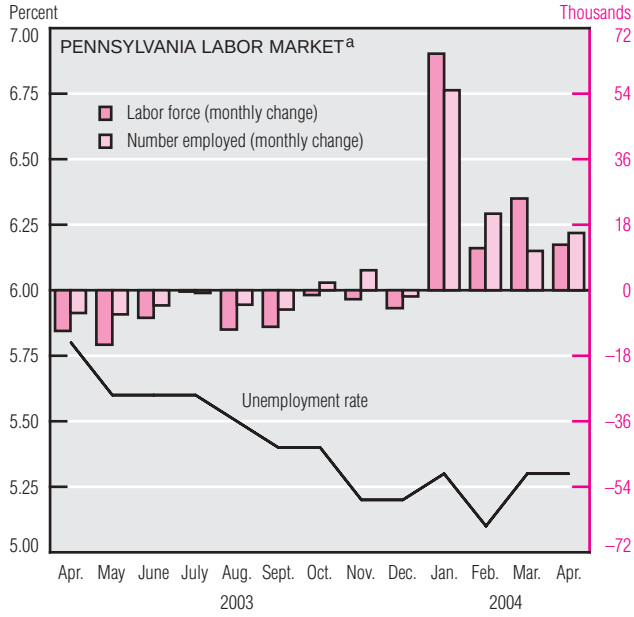
Fourth District Unemployment Rates *(cont.)*









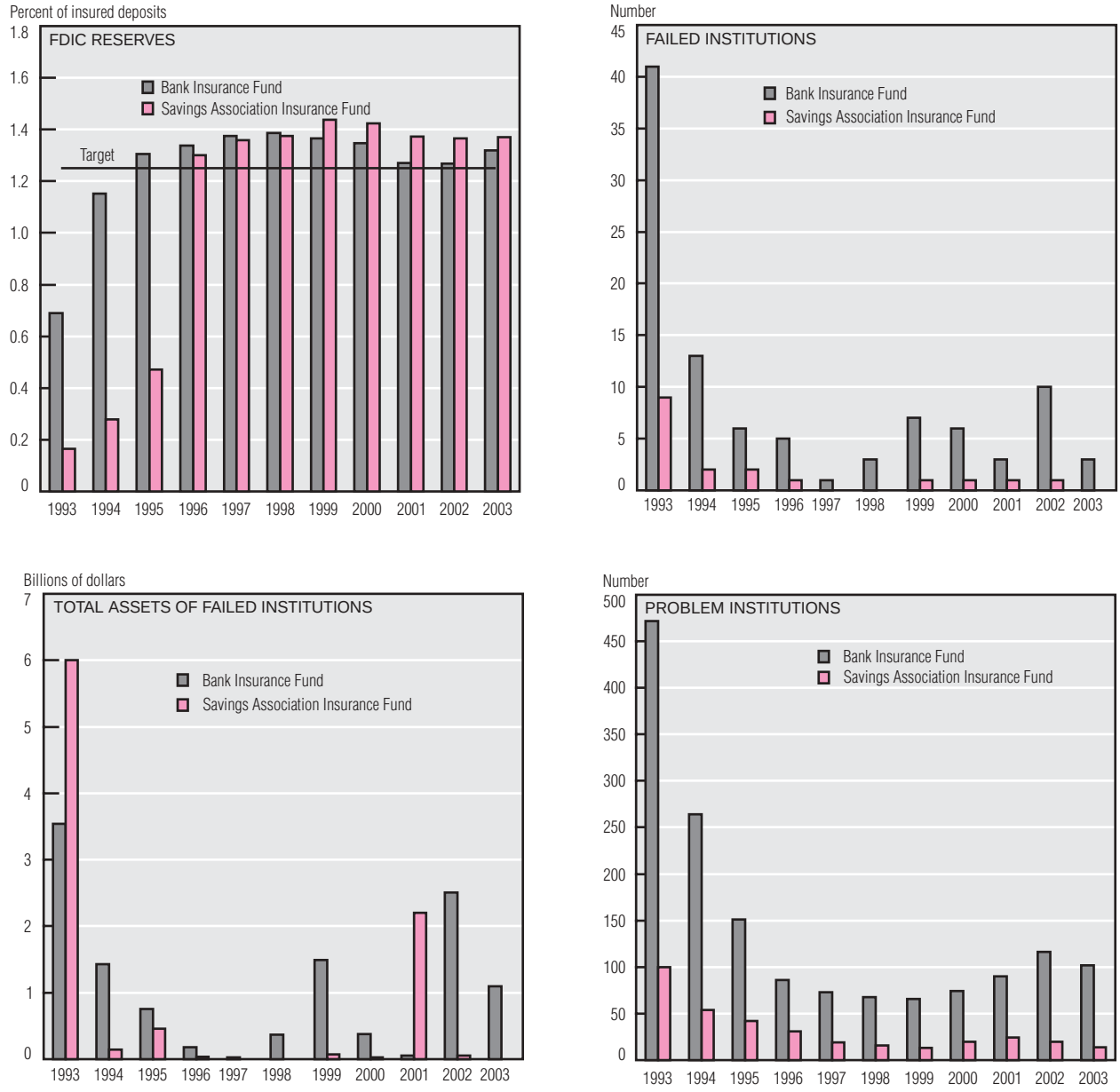
a. Data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

the state from Cincinnati to Cleveland). The District's Appalachian area tends to show significantly higher unemployment rates than the nation, as does Eastern Kentucky, whose economy is dominated by agriculture. Annual changes in unemployment do not display such clear patterns.

The two-month lag in reporting local unemployment rates does not allow for timely analysis of current market conditions, so economists sometimes use unemployment insurance claims to gain perspective on current conditions. Since January, the number of initial claims has generally declined from year-ago levels. Seasonally adjusted data for states with more than 10 counties in the District (Kentucky, Ohio, and Pennsylvania) show significant monthly fluctuations in employment levels. But the January numbers are probably misleading because annual revisions made that month adjust sample-based employment estimates to actual job counts from employer tax reports.

Earlier this year, Ohio's unemployment rate fell because its labor force shrank faster than jobs did; the rate rose slightly in April because labor force growth outpaced job growth. Kentucky's rate declined recently because labor force changes were negligible compared to employment changes in January, February, and April. Recent labor market conditions have been stronger in Kentucky and Pennsylvania than in Ohio. In fact, Pennsylvania's unemployment rate has not exceeded 5.75% for the past year; although the state's job growth has continued over the past four months, its unemployment rate has remained close to 5.25% because its labor force has also been growing.

FDIC Funds



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

Insured deposits have grown over the past five years at an average annual rate of nearly 4% for members of the Bank Insurance Fund (BIF) and more than 5% for members of the Savings Association Insurance Fund (SAIF), both funds of the Federal Deposit Insurance Corporation. This robust deposit growth, coupled with the increased costs associated with bank and thrift failures from 2000 to 2003, has had a small but detrimental impact on the two funds.

While BIF reserves increased between 2002 and 2003, they stood at 1.32% of insured deposits at the end of this period, compared to their peak of 1.39% in 1998. SAIF reserves stood at 1.37% of insured deposits, making 2003 the third straight year that the fund balance grew at the same rate as SAIF-insured deposits; however, it was still below the peak of 144 basis points of reserves per dollar of insured deposits that it reached in 1999. Both funds are considered stable because their year-end reserves continue to exceed the 1.25% target set by Congress in the Financial Institution Reform, Recovery, and Enforcement Act of 1989.

The solid position of the two FDIC funds is evidenced by the stability of the banking and thrift industries. Bank failures since 1995 have been miniscule in terms of the numbers and total assets of the failed institutions. The three BIF members that failed in 2003 were small institutions with total assets of only $1,097 million. For the third time in the last seven years, no SAIF member failed; it has been more than eight years since more than one SAIF member failed in a single year. The minimal number of thrift institution failures over the past decade contrasts

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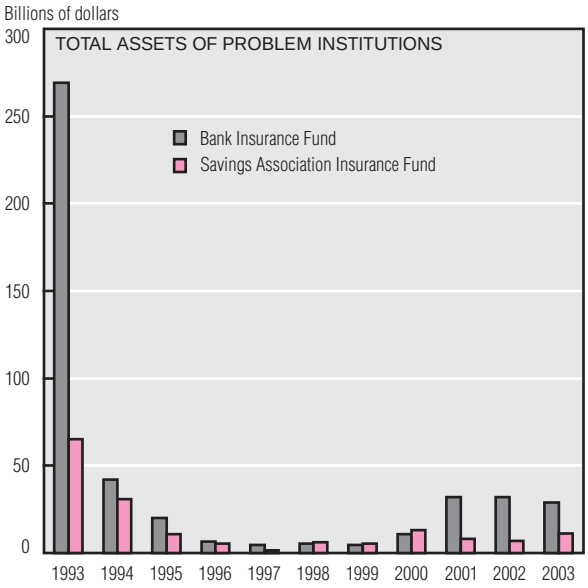
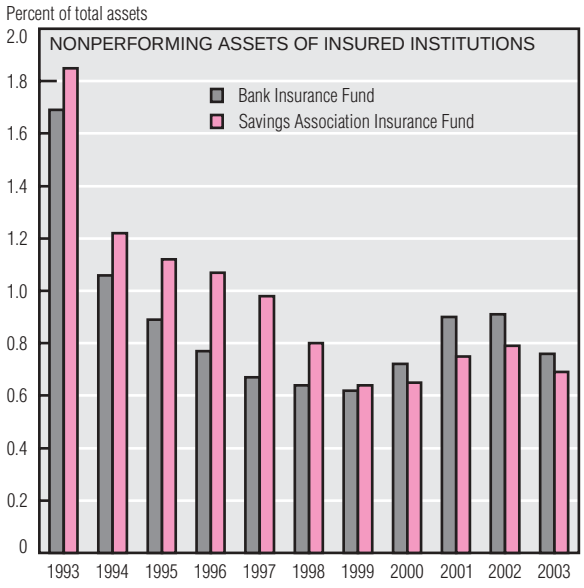
FDIC Funds *(cont.)*





BIF Assessment Base Distribution[a]
(Number of members and total assessable deposits in billions of dollars)

	Supervisory Risk Group					
	A		B		C	
Capital group	**Members**	**Deposits**	**Members**	**Deposits**	**Members**	**Deposits**
1. Well capitalized	7,357	3,988	468	119	81	20
2. Adequately capitalized	64	10	9	1	9	1
3. Undercapitalized	2	0	0	0	6	0

SAIF Assessment Base Distribution[b]
(Number of members and total assessable deposits in billions of dollars)

	Supervisory Risk Group					
	A		B		C	
Capital group	**Members**	**Deposits**	**Members**	**Deposits**	**Members**	**Deposits**
1. Well capitalized	1,099	1,008	67	32	13	1
2. Adequately capitalized	3	1	2	0	1	0
3. Undercapitalized	0	0	0	0	0	0

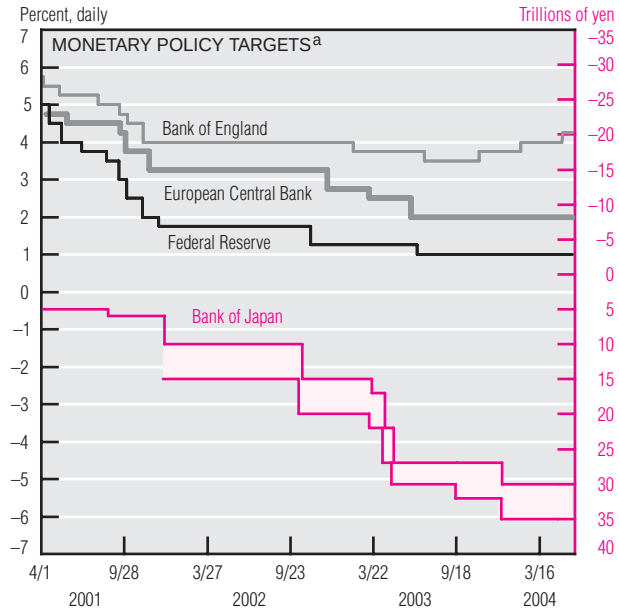
a. BIF-assessable deposits held by both BIF and SAIF members.
b. SAIF-assessable deposits held by both BIF and SAIF members.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

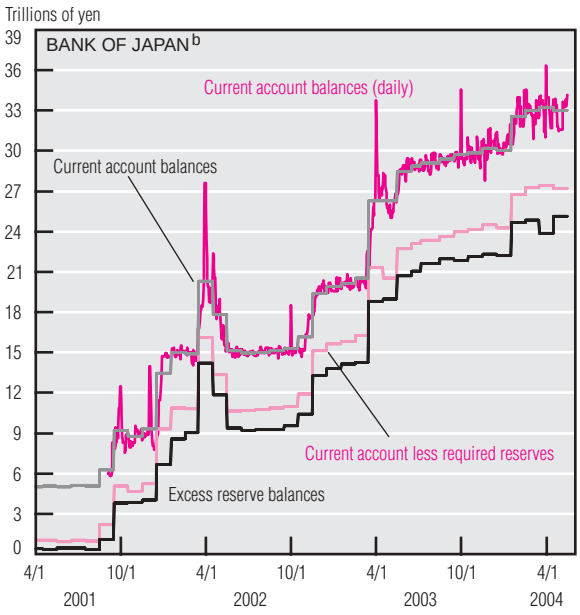
dramatically with the widespread solvency problems that plagued the industry throughout the 1980s. Not only did the number of bank and thrift failures in 2003 decrease from the previous year; total failures represented a tiny share of FDIC-insured institutions in terms of number of firms and total assets.

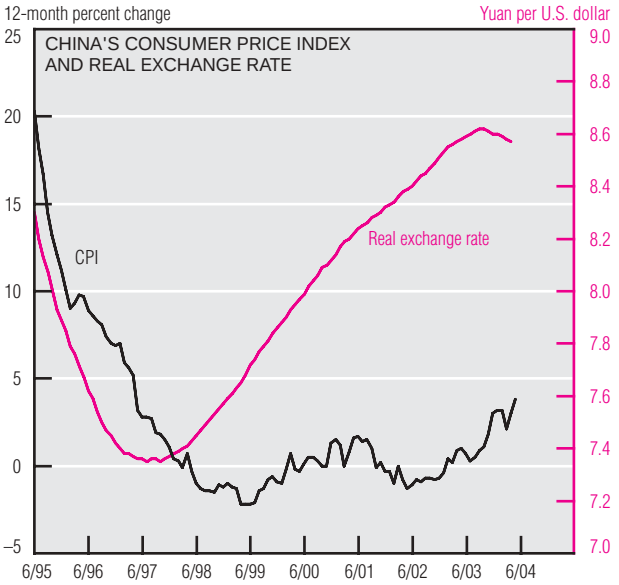
Since the end of 2002, problem institutions (those with substandard examination ratings) have declined from 116 to 102 for the BIF and from 20 to 14 for the SAIF. Moreover, the decrease in the BIF's number of problem institutions was matched by a decline in assets in problem banks and thrifts. For both funds, however, the continued low number of problem institutions and the small sum of assets they held suggest that losses to the insurance fund will remain low in the near future. This conjecture is supported by the low levels of nonperforming assets as a share of total assets on the books of BIF and SAIF members.

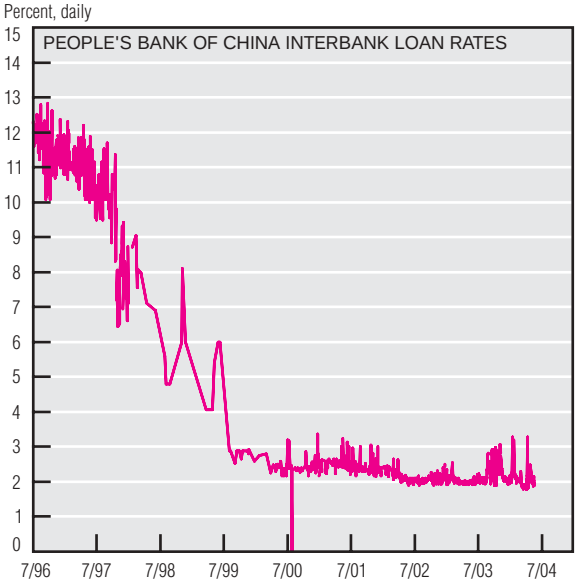
The Federal Deposit Insurance Corporation Improvement Act of 1991 mandated that FDIC insurance premiums be risk-adjusted. To do this, the FDIC assigns an insured institution to one of three risk groups (A–C) based upon their most recent examination rating and one of three risk groups (1–3) based on their level of capitalization, creating a total of nine risk groups. With both funds above their target reserve ratio, well-capitalized institutions in supervisory risk group A by statute pay no premiums. Currently, 92% of all BIF members (7,357 out of 7,996) and nearly 93% of all SAIF members (1,099 out of 1,185) are in this group. Furthermore, these banks and thrifts account for more than 96% of the BIF's assessable deposits (3,928 out of 4,079) and nearly 97% of the SAIF's assessment base (1,008 out of 1,042).

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; People's Bank of China; and Bloomberg Financial Information Services.

The Monetary Policy Committee raised the Bank of England's policy rate 25 basis points to 4.25% on May 6, "to keep CPI inflation on track to meet the 2% target in the medium term." The committee deemed this change necessary because of "a small and diminishing margin of spare capacity."

The Federal Reserve left its policy rate unchanged at the May 4 Federal Open Market Committee meeting. However, markets interpreted its statement that "policy accommodation can be removed at a pace that is likely to be measured" as indicating a greater likelihood of a small move than was suggested by its previous statement that it "can be patient in removing its policy accommodation."

Amid further indications of a broad-based economic recovery, the Bank of Japan continues to maintain the current "extremely easy monetary policy" of quantitative easing. However, Governor Fukui has alluded to the bank's eventual need for an "exit policy" to extricate itself from the current procedure, but "avoid sharp fluctuations in financial markets and …prevent any sudden discontinuities in market conditions."

In China, inflation has been rising relative to the 2004 target of 3% set by the People's Bank. Although the bank has maintained a fixed nominal exchange rate relative to the U.S. dollar, the real (inflation-adjusted) exchange rate has been appreciating. The effects of monetary tightening frequently have been apparent in spikes in interbank loan rates, which have not been controlled since 1996.