

The Economy in Perspective

Normalization, of a sort... The current expansion, which began in November 2001, followed a mild eight-month contraction (since 1945, the average length of contractions has been 10 months). In one sense, all contractions are alike because the National Bureau of Economic Research (NBER) determines the dates of business cycle peaks and troughs by applying a standard set of measurement criteria. In a nutshell, the NBER defines a contraction as a period of significant decline in economic activity, lasting more than a few months, and in which the decline is spread across the economy and evident in spending, income, sales, production, and employment. An expansion begins when these patterns no longer are evident, although the NBER notes that when an upturn begins, economic activity is "...typically below normal and sometimes remains so well into the expansion."

Many aspects of economic activity have returned to normal, or nearly normal, conditions. Orders and shipments for manufactured goods have been steadily rising during the past year as business firms, flush with cash, have finally begun to step up the pace of their capital spending. Households have continued buying homes and automobiles in large quantities, but the pace of overall retail sales has been somewhat more subdued. Capacity utilization has been climbing, and the overall rate is now on track with the average of past expansions. Most economic forecasters expect the economy to extend its three-year-long expansion into 2005 and beyond. The economy seems to be on a sustainable expansion track, inflation and inflation expectations are low, and the Federal Reserve has been patiently removing its policy accommodation during the past several months.

Labor markets have performed in a conspicuously atypical manner. Typically, employment continues to fall in the early stages of an expansion, but stops falling in about a year; after two years, employment returns to its prerecession peak. In this expansion, payroll employment did not stop falling for nearly two and one-half years; it has yet to return to its previous peak. The weak pattern seems fairly broad based, suggesting that whatever forces are holding back the pace of net job creation are affecting most industries and regions.

A number of explanations have been advanced for the unusually slow rate of job growth, but analysts have yet to reach a consensus. Some focus on

subpar total demand in the economy, while others consider possible mismatches between the labor skills that are in demand by employers and the labor skills being offered in the market. In this view, some employers are constrained from hiring by shortages in the skills they seek, while others can choose workers from an abundant pool. Another analysis holds that job creation, calculated from data collected through the household survey, is stronger than the payroll data indicate. The available evidence does not yet provide a firm explanation for all the facts, and it may well be that no convincing explanation will emerge at all, or at least not without the passage of more time.

In the interim, although some observers question the very sustainability of the expansion in the face of slow employment growth, most others seem to have accepted the notion that the expansion will continue despite the labor market picture. After all, the unemployment rate has gradually declined during the expansion to 5.4%, half a percentage point below its 40-year average. From this perspective, labor markets may be somewhat closer to being in balance than they would be if employment growth were the sole criterion for normalcy.

It is no secret that advances in information processing and telecommunications technologies have profoundly affected how, where, and what businesses produce. These changes have created incentives to replace old capital with new, an activity that proceeded at a feverish pace during the last expansion. At the same time, demand has risen for skills that complement the new technologies and declined for the skills that are most wedded to the old.

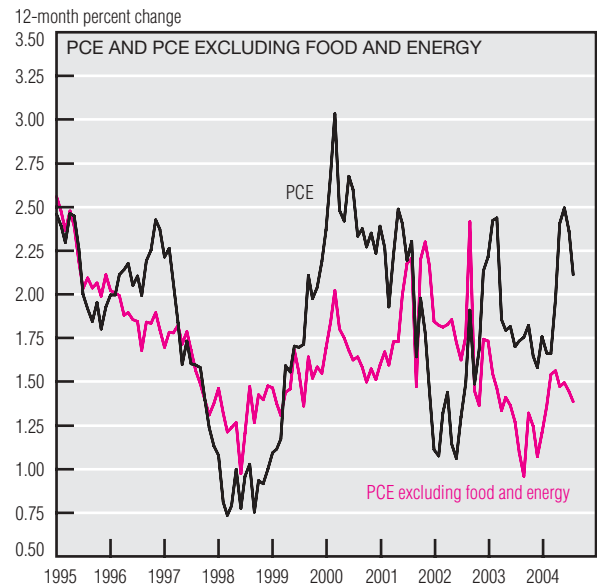
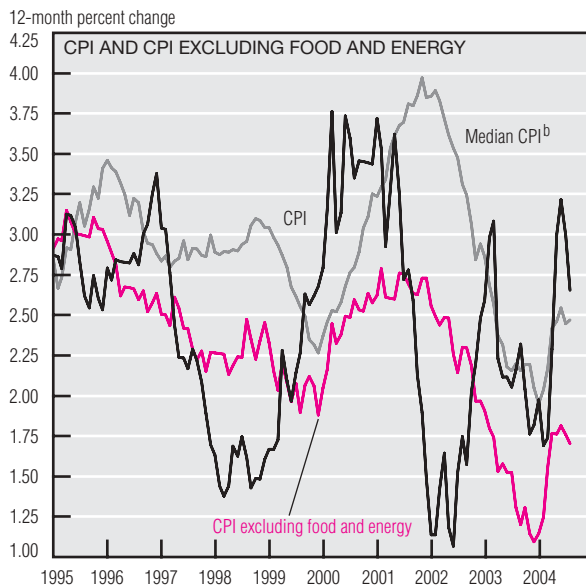
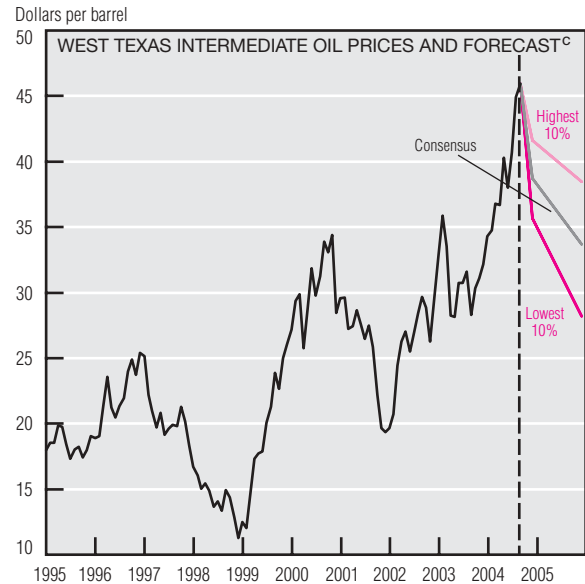
When asked why hiring is atypically slow, some business executives say they are being cautious, but others say they can meet growing demand without adding more workers. To achieve this result businesses may acquire more productive equipment, restructure their processes, or do both. Whatever they do, they are finding ways to increase their productivity and, as we know, productivity in this expansion has been growing abnormally fast.

Perhaps all of this just goes to show that labeling business cycles and their components "normal" or "typical" loses its value rather quickly. As Sigmund Freud once said, "Every normal person, in fact, is only normal on the average." His observation may apply as much to economies as to people.

Inflation and Prices

August Price Statistics

	Percent change, last:				2003 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	0.6	1.3	2.7	2.5	1.9
Less food and energy	0.6	1.0	1.7	2.1	1.1
Median ^b	3.0	2.3	2.5	2.9	2.1
Producer prices					
Finished goods	-0.8	-1.1	3.4	2.2	4.4
Less food and energy	-1.6	0.5	1.5	1.0	1.1



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The August inflation data show continued moderation in retail prices. The Consumer Price Index (CPI) rose a mere 0.6% (annualized rate) during the month, reversing August's 0.6% decline. Energy costs dropped at a 3.1% annual rate (the second consecutive monthly decline), even as oil prices approached their forecasted peak. The core CPI, which excludes the volatile food and energy components, also rose—at a 0.6% annualized rate, its slowest monthly growth

rate this year—while the median CPI increased at a 3.0% annualized rate.

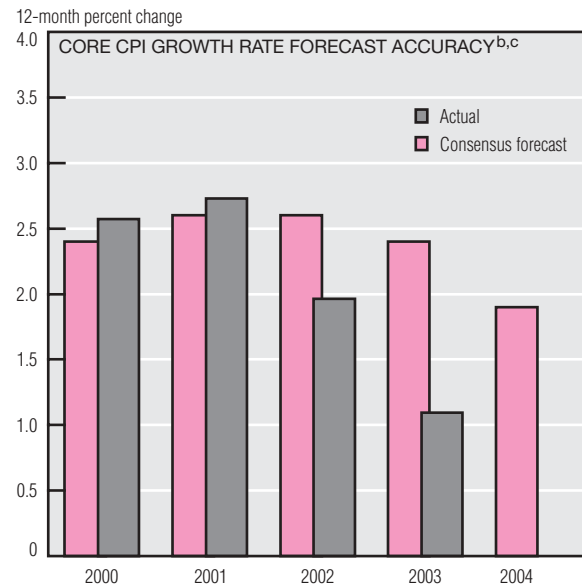
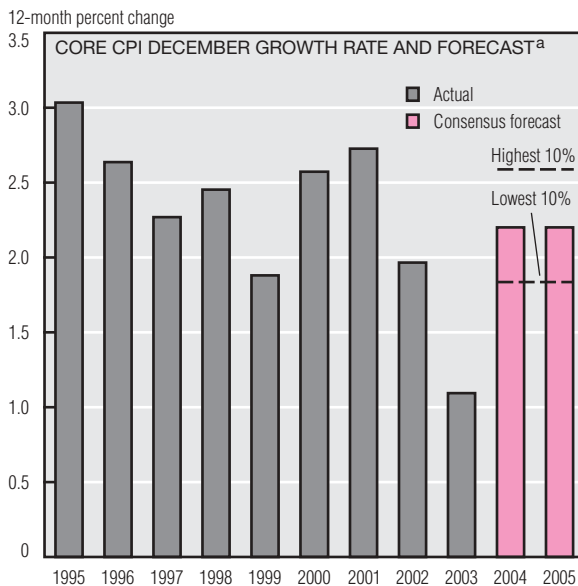
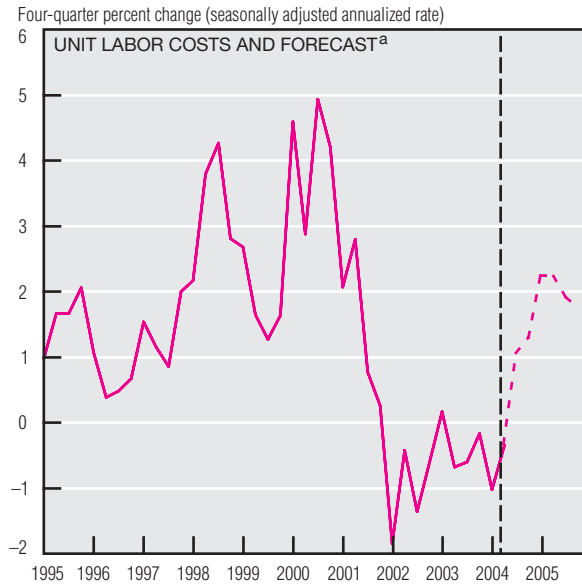
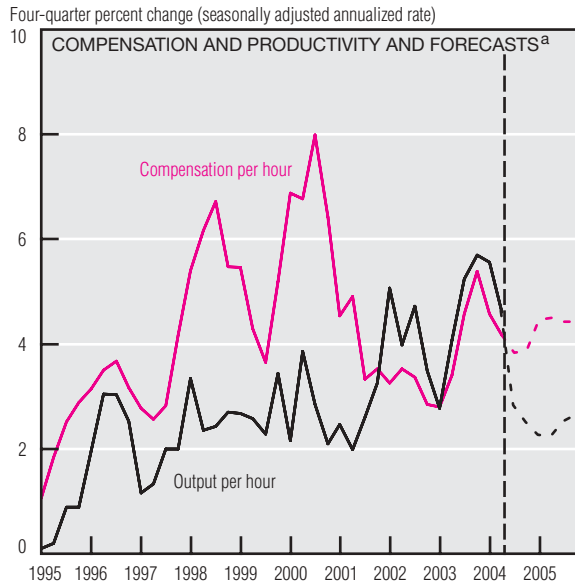
Longer-term trends in the price measures continue to indicate that retail price increases are stabilizing despite escalating energy prices. The CPI increased 2.7% from August 2003, less than July's 12-month growth rate of 3.0%. The 12-month core CPI growth rate fell 0.1 percentage point (pp) to 1.7%, while the median CPI's rose 0.1 pp to 2.5%. The Personal Consumption Expenditures Price Index

(PCE), which measures prices in an alternative consumer goods market basket, reveals similar patterns. The PCE increased 2.1% since August 2003, down from July's 12-month growth rate of 2.4%, while the 12-month growth rate of the core PCE remained stable at 1.4%.

Beyond the near-term price disturbances, caused by oil among other important factors, are the longer-term issues that could accelerate inflation—a persistent rise in the

(continued on next page)

Inflation and Prices (cont.)



a. *Blue Chip Economic Indicators*, September 10, 2004.

b. Blue Chip panel of economists.

c. Forecasts reported in June, July, or August for the 12-month growth rate in December of the following year.

SOURCES: Department of Labor, Bureau of Labor Statistics; and *Blue Chip Economic Indicators*, July 10, 1999, August 10, 2000, June 10, 2001, August 10, 2002, June 10, 2003, and September 10, 2004.

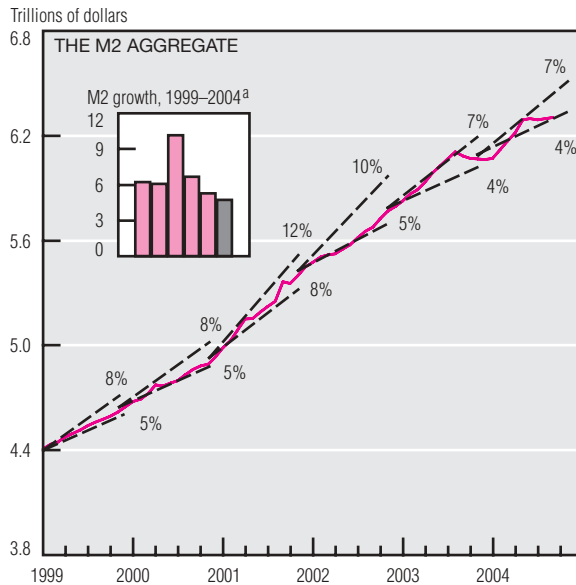
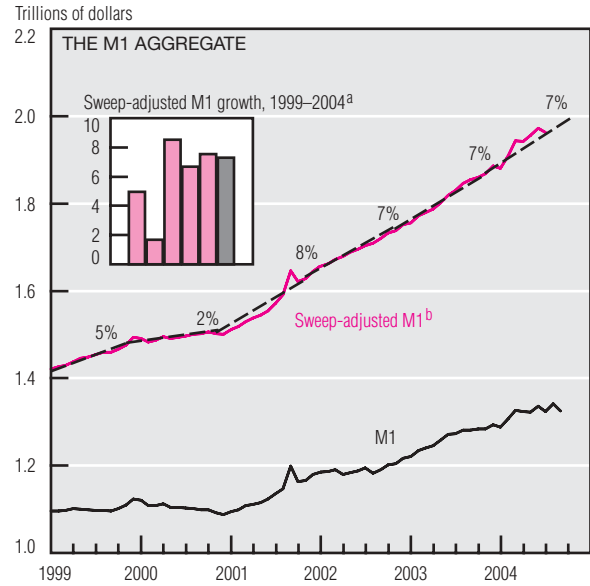
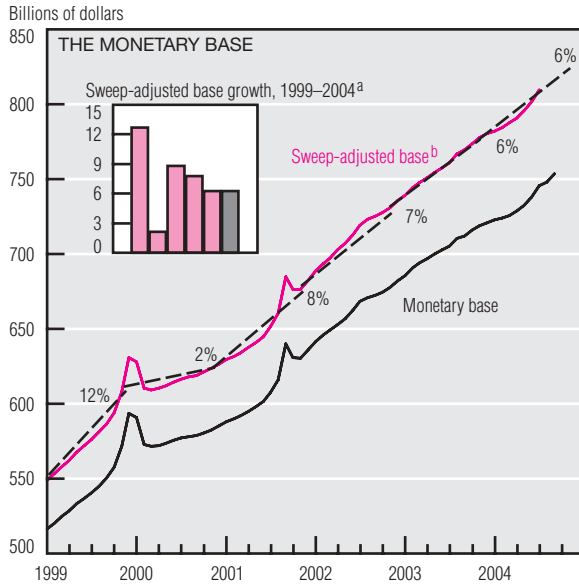
overall level of prices. Among the longer-term factors, economists often look to patterns in unit labor costs—the difference between the growth rate of worker compensation and the growth rate of their productivity.

Indeed, many economists credit much of the current expansion's relatively modest inflation performance to strong U.S. labor productivity growth, which has exceeded the growth of worker compensation over much of the past four years. In other words, the

trend in U.S. unit labor costs has been negative since 2001, which may have put substantial downward pressure on U.S. prices over this period. The consensus view among economists, however, is that this pattern of strong growth in productivity relative to compensation will not persist much longer and, indeed, may have turned around already. According to *Blue Chip Economic Indicators*, unit labor costs are now thought to be trending higher and should top 2% by year's end.

The stronger pace of unit labor costs is consistent with economists' expectation that the growth rate of the core CPI will also top 2% this year and will hold there in 2005, higher than the annual core CPI growth rates in 2002 and 2003. However, in each of the previous two years, economists have overpredicted the core CPI's growth rate by a substantial margin.

Monetary Policy



Growth Rates of Monetary Components (percent)

	Annual					Average,	
	1999	2000	2001	2002	2003	YTD 2004	1999–2003
Monetary base ^c	12.7	2.1	8.8	7.8	6.2	6.3	7.5
M1 ^c	5.0	1.7	8.5	6.7	7.5	7.3	5.9
M2	6.2	6.1	10.2	6.7	5.3	4.7	6.9
Currency Total	11.1	4.3	9.1	8.2	5.9	5.4	7.7
reserves	-7.2	-6.2	8.7	-6.6	8.2	7.7	-0.6
Cumulative sweeps	15.6	11.9	12.6	15.3	9.8	13.8	13.0
Check and demand ^d	-4.8	-6.8	5.2	-1.5	7.3	1.7	-0.1
Money market funds	13.6	11.4	7.8	-6.5	-11.6	-11.9	2.9
Small time deposits	-0.7	9.6	-5.0	-9.1	-9.3	-2.8	-2.9
Savings deposits	10.1	6.7	21.7	21.1	15.2	11.4	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 July over 2003:IVQ basis. The 2004 growth rate for M2 is calculated on a September 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. The monetary base and M1 are sweep-adjusted.

d. 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 including depository institutions' vault cash) has increased its annualized year-to-date growth rate to 6.3% in 2004, up sharply from its year-to-date rate of 3.9% in May. This rise brings it closer to its five-year average of 7.5%. Current year-to-date annualized growth is less than 0.1% above 2003. Surprisingly, sweep-adjusted base growth increased slightly despite declines in total reserves growth (8.2% in 2003 and 7.7% currently) and currency

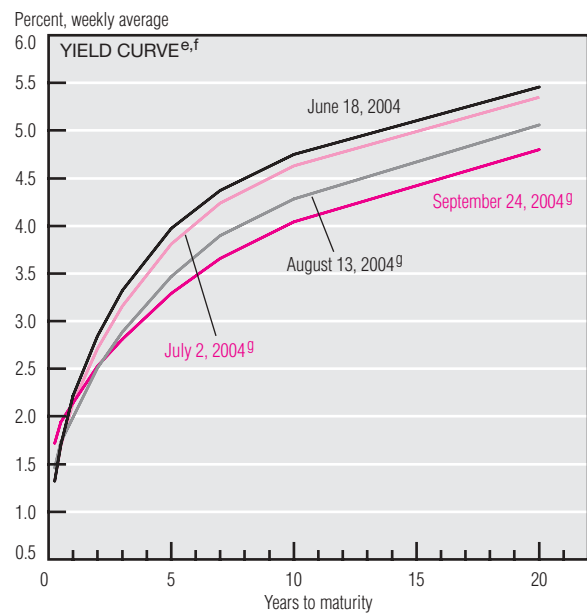
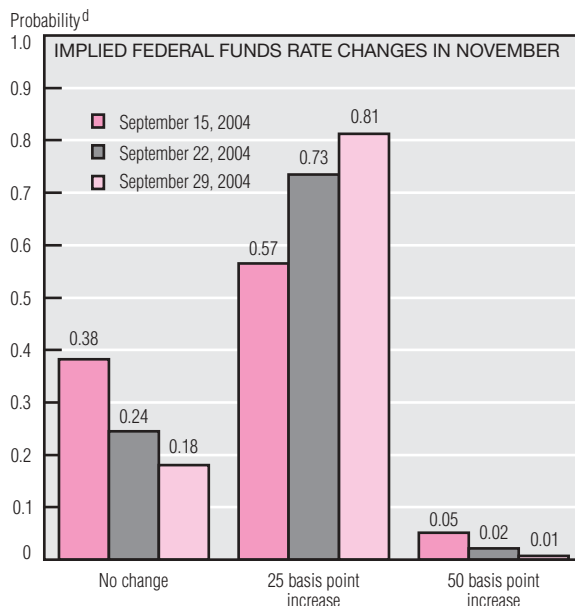
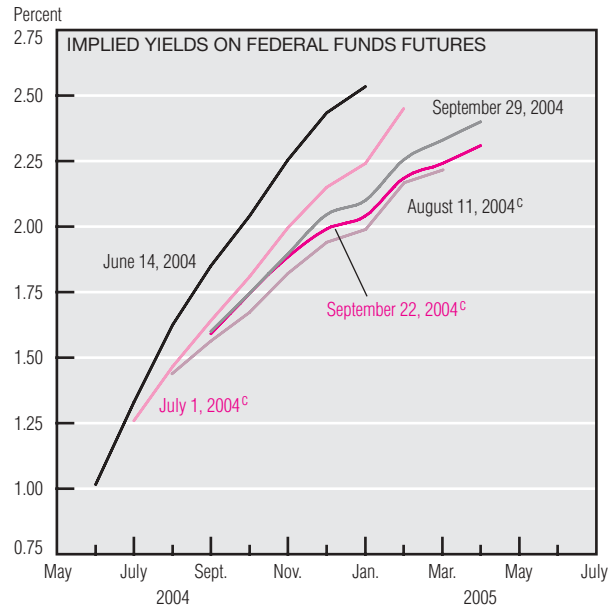
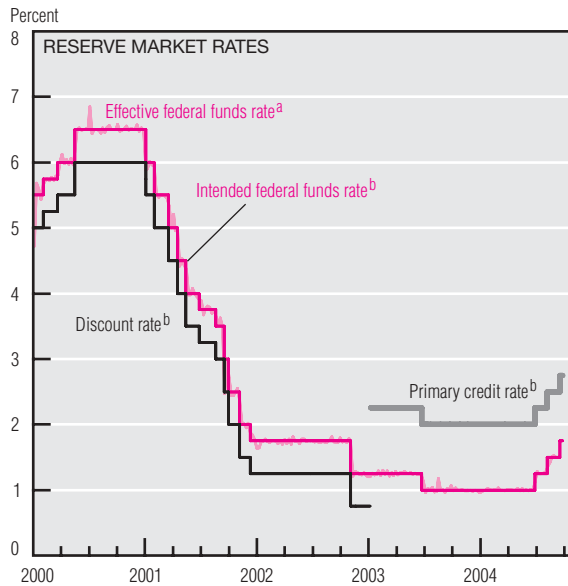
growth (5.9% in 2003 and 5.4% currently). The cause is strong growth in cumulative sweeps—13.8% currently and 9.8% in 2003.

M1 (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 had an annualized year-to-date growth rate of 7.3%, down slightly from the 7.5% growth it registered in 2003, and higher than its five-year average of 5.9%. The slowdown in M1 growth over the past year results primarily from slower growth in

demand deposits and other checkable deposits, which make up nearly half of M1. Their year-to-date annualized growth rate is 1.7%, compared to 7.3% in 2003.

The broader monetary aggregate, M2 has grown 4.7% in 2004 to date, 2.2 percentage points below its 1999–2003 average but only 0.6% less than its growth in 2003. Slower M2 growth resulted from continued decline in retail money market mutual funds. Although the decline in small time deposits also persisted, it has slowed since 2003.

Money and Financial Markets



a. Weekly average of daily figures.

b. Daily observations.

c. One day after FOMC meeting.

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

e. All yields are from constant-maturity series.

f. Average of the week ending on the date shown.

g. First weekly average available after the Federal Open Market Committee 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.

On September 21, the Federal Open Market Committee (FOMC) raised the target federal funds rate to 1.75%, 25 basis points (bp) higher than the target established on August 10. Following the decision, the Federal Reserve's Board of Governors raised the primary credit rate 25 bp to 2.75%. The next probable move will occur in November 2004, as implied by yields on federal funds futures. The probability of a 25 bp increase at the November meeting (there is no meeting in October) was estimated at

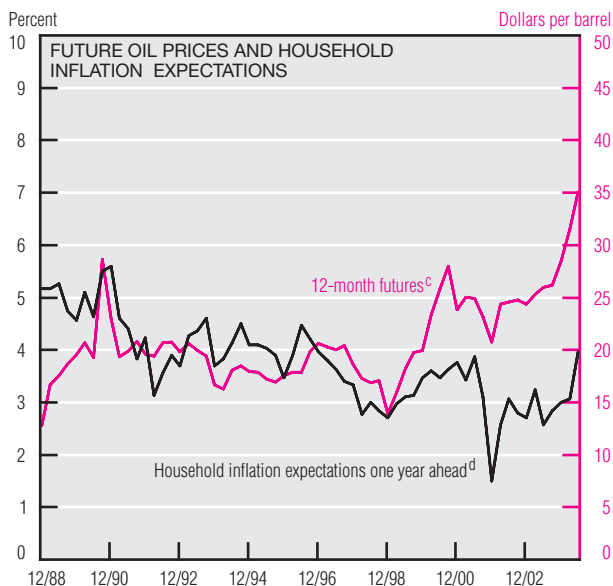
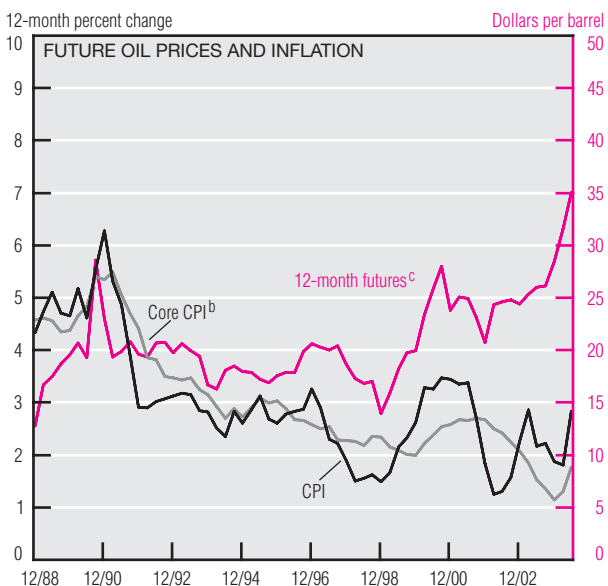
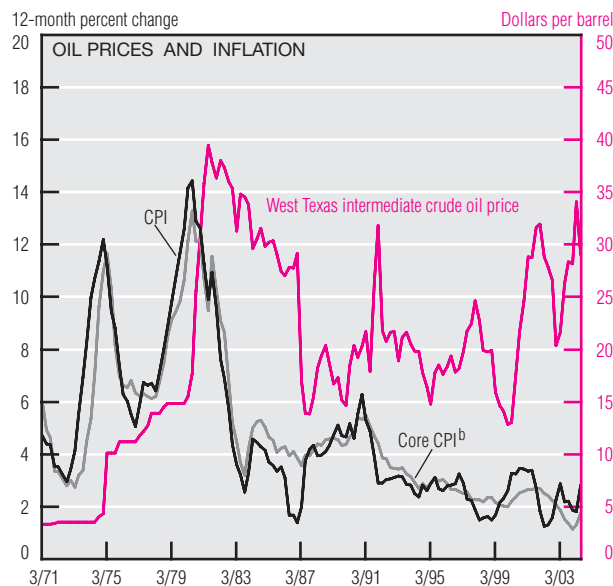
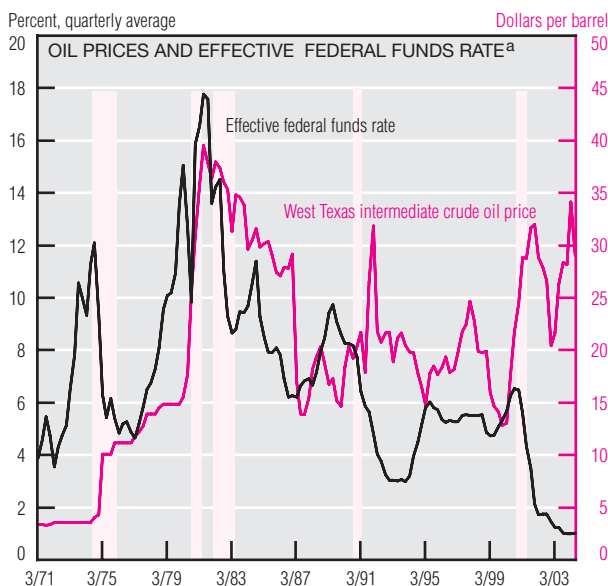
81% on September 29, compared to 57% on September 15, a week before the previous meeting.

The FOMC stated that "even after this action, the stance of monetary policy remains accommodative" and, together with steady underlying productivity growth, supports economic activity. The FOMC also believes that "output growth appears to have regained some traction" and that "labor market conditions have improved modestly" despite the hike in energy prices.

Higher energy prices did not seem to increase long-term inflation expectations. The yield curve has flattened continuously over the last few months and over the past year. The rate reduction was most significant at the long end. The 10-year rate moved down 24 bp from August's meeting and 59 bp from June's.

The increases in the federal funds rate appear to reinforce public confidence that the Fed will not let inflation accelerate.

Oil Prices, Monetary Policy, and Recessions



a. Shaded bars indicate periods of recession.

b. Excluding food and energy.

c. Light sweet crude oil price futures. West Texas intermediate crude oil qualifies for delivery.

d. Mean expected change as measured by the University of Michigan's Survey of Consumers.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; University of Michigan; and Bloomberg Financial Information Services.

Oil price increases seem to have accompanied every recession since 1971. Yet concluding that oil price shocks *cause* recessions is problematic because increases in the funds rate also have tended to precede recessions during this period. Are recessions caused by spikes in oil prices or by sharp increases in monetary policy?

Some analysts blame oil, but only indirectly. They conclude that recessions are caused not by oil price shocks but by the Federal Reserve's tendency to tighten monetary policy in response to

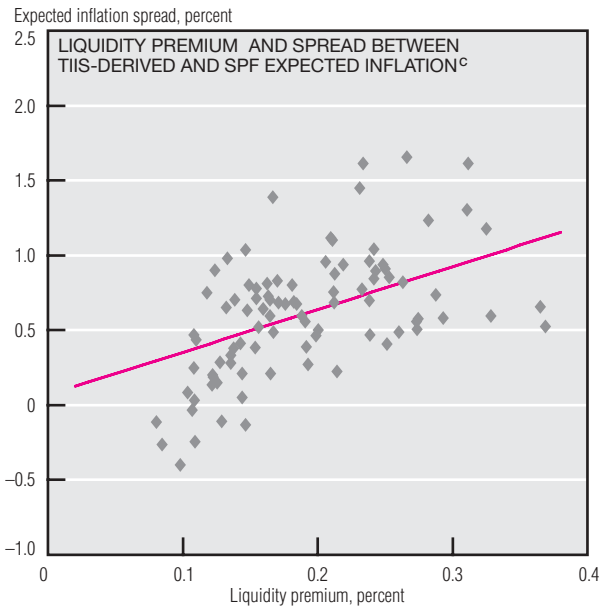
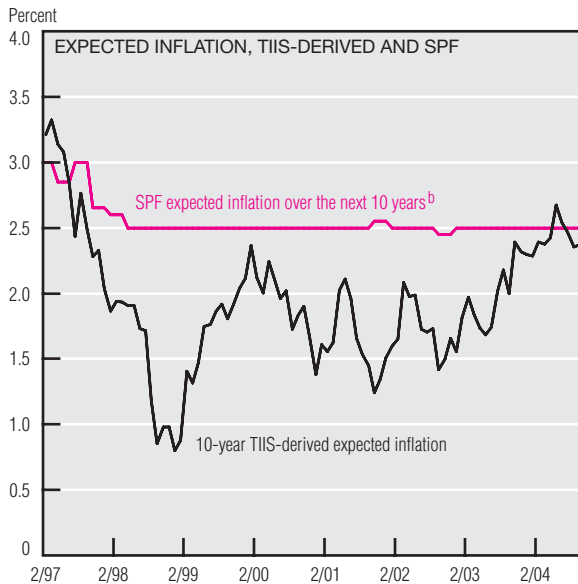
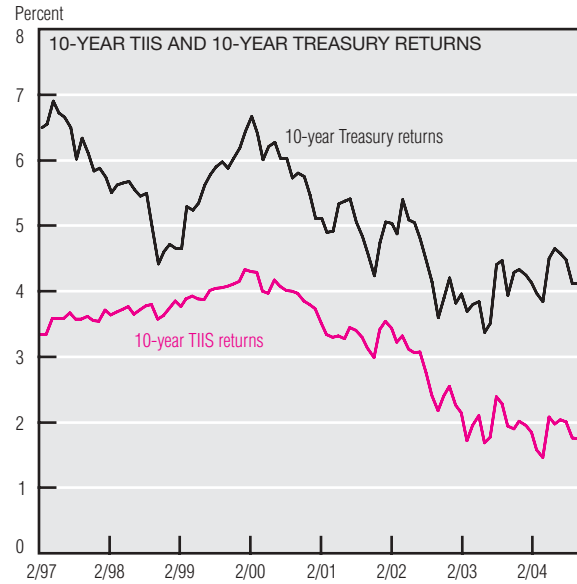
those shocks. The large funds rate increases preceding the 1975 and 1979 recessions are good examples. The funds rate increased dramatically as inflation took off during these periods, but since then there has been virtually no correlation between oil prices and inflation.

Possibly, rising oil prices cause inflation only if they are expected to be permanent. Although oil price futures are imperfect predictors of spot prices, we look to see if there is any correlation between inflation and the oil price increases that are expected to occur 12 months out.

There does seem to be a slight correlation between expected inflation and future oil prices.

Although the data suggest that there is a small correlation between inflation and oil price increases, it is doubtful that oil was the primary cause of the huge inflation spikes of the 1974 and 1979 recessions. The question of whether recessions result from funds rate increases or from oil price increases is even more difficult. Perhaps recessions are caused by a confluence of both factors—the so-called perfect storm.

Expected Inflation and the TIPS Market



- a. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
 b. Median expected change in CPI as measured by the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters* (SPF).
 c. Liquidity premium is calculated as the difference between yields of on-the-run versus off-the-run conventional Treasuries, using data from the Board of Governors.
 SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of Philadelphia; University of Michigan; and Bloomberg Financial Information Services.

Ascertaining long-term inflation expectations is notoriously difficult. Survey measures are available but not necessarily reliable. When surveyed, households report that they expect inflation to register 3.1% over the next five to 10 years. But the Survey of Professional Forecasters indicates that they expect inflation to register only 2.5% over the next 10 years. Households' inflation expectations, in fact, are consistently about 50 basis points (bp) higher than professional forecasters'.

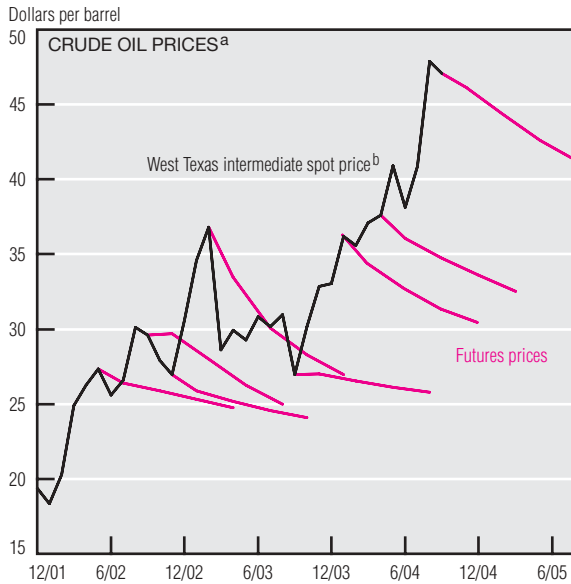
Treasury Inflation-Indexed Securities (TIPS), introduced in 1997, promised

investors a real return without the inflation premium present in ordinary Treasury notes. In principle, subtracting TIPS from nominal T-notes of the same maturity should give economists a market-based measure of expected inflation, but these securities have not achieved that goal. Expected inflation from the TIPS market has tended to be around 50 bp lower than professional forecasters' expectations and a full percentage point lower than households'.

One reason expected inflation from TIPS data might underestimate actual expected inflation is that the

market for TIPS is less liquid than other government bonds; thus, their real returns are overstated. It is difficult to estimate the magnitude of the liquidity premium, which probably varies over time. Fortunately, there is a measure of the liquidity premium for T-notes; it is their on-the-run/off-the-run spread, which may be correlated with the liquidity premium in the TIPS market. Indeed, this appears to be so. This premium is highly correlated with the difference between Blue Chip forecasts of expected inflation and those derived from the TIPS market.

Predicting Oil Prices

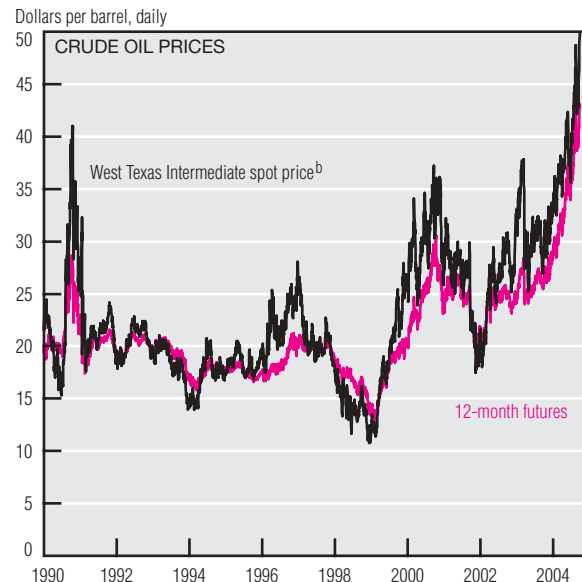


Futures Forecast Errors^{a,c}

Futures Prices	Three months	Six months	12 months
Mean	0.76	1.61	2.83
Median	0.54	1.47	1.36
Maximum	14.38	14.87	22.09
Minimum	-9.25	-8.65	-7.22
Standard deviation	3.01	4.46	6.05
Number of observations	217	214	185

Correlation among Spot, Futures, and Future Spot Prices^{a,b}

Futures prices	Current and future spot prices			
	Spot	Two mo. spot	Five mo. spot	11 mo. spot
One month	0.998			
Three months	0.989	0.890		
Six months	0.972	0.886	0.736	
12 months	0.938	0.862	0.722	0.466
Spot	1.000	0.882	0.715	0.462



a. Data are taken from the last trading day for one-month-ahead futures, typically the third business day before the 25th of the month.

b. For days before the 25th of the month, the spot price measures oil that is deliverable from the 25th of the current month to the 25th of the next month.

c. Prices are in dollars per barrel.

SOURCES: New York Mercantile Exchange; and Bloomberg Financial Information Services.

Bad as the economic consequences of higher oil prices may be, the fog surrounding their future path compounds the problem. To gain some clarity, many observers have looked to oil futures prices as a quick and easy means of forecasting where spot oil prices are headed. Unfortunately, futures prices are not very accurate predictors.

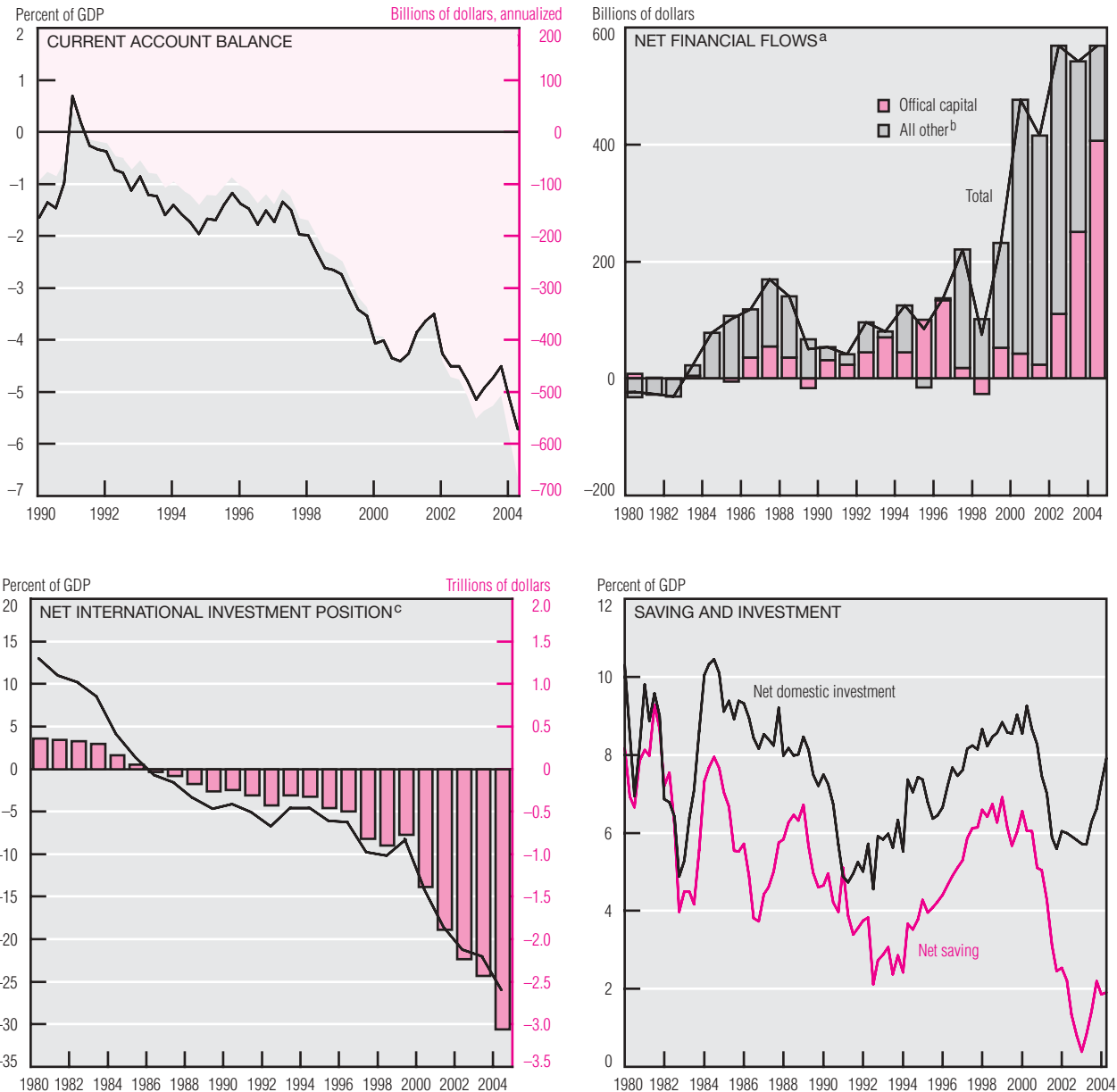
Futures markets in crude petroleum exist to provide producers, traders, and major users of oil with a low-cost way to hedge against

unanticipated changes in oil prices. In providing the hedge, futures markets immediately fold all available information that is relevant to the pricing of crude into current futures prices. Their informational efficiency, however, does not necessarily make futures prices good predictors.

Futures prices are statistically correlated with the spot prices that they presumably predict, but none of these correlations is substantially higher than the correlation between current and future spot prices. This indicates that spot prices and futures

prices both incorporate the same information about prospective changes in oil prices. Moreover, the prediction errors associated with oil futures are statistically large, and the further out one looks, the larger the forecast errors grow. This is not surprising, but the forecast errors also indicate that oil futures prices typically underpredict future spot prices. Large, skewed prediction errors suggest the need for caution when using futures markets to divine what path oil prices will take.

The U.S. Current Account Deficit



a. Includes capital account transactions.

b. Includes direct investment, portfolio investment, other miscellaneous financial flows, and capital account transactions.

c. The net international investment position for 2004 is estimated by adding the annualized current account deficit for the first half of 2004 to the investment position for 2003. GDP for 2004 is estimated by averaging GDP for the first two quarters with Blue Chip forecasts for the last two quarters.

SOURCE: U.S. Department of Commerce, Bureau Economic Analysis.

The U.S. current account deficit reached a record high in 2004:IIQ, renewing concerns that its continued growth could cause a flight from the dollar, adversely affecting economic growth, and complicating monetary policy.

The U.S. has financed a long string of current account deficits by issuing net financial claims to foreigners, including official claims to foreign governments. As a consequence, foreigners now hold substantially more claims on the U.S. than we hold on

the rest of the world. This is shown by our negative net international investment position, which could equal \$3 trillion or roughly 25% of our GDP by year's end.

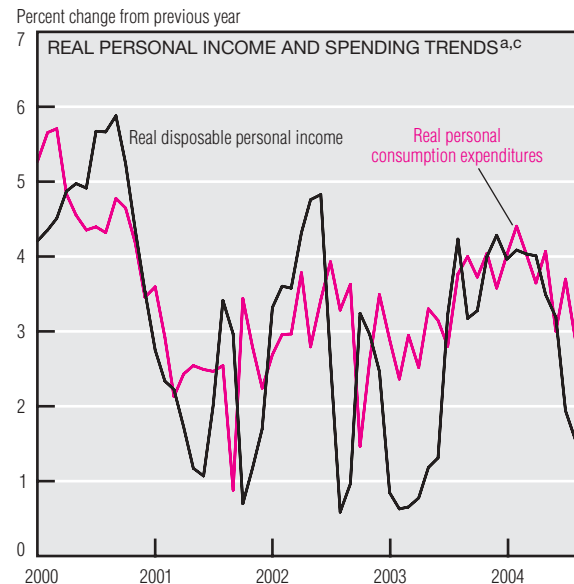
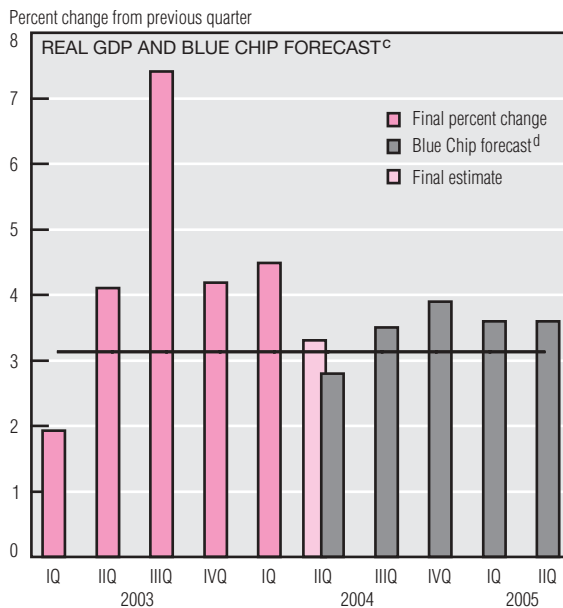
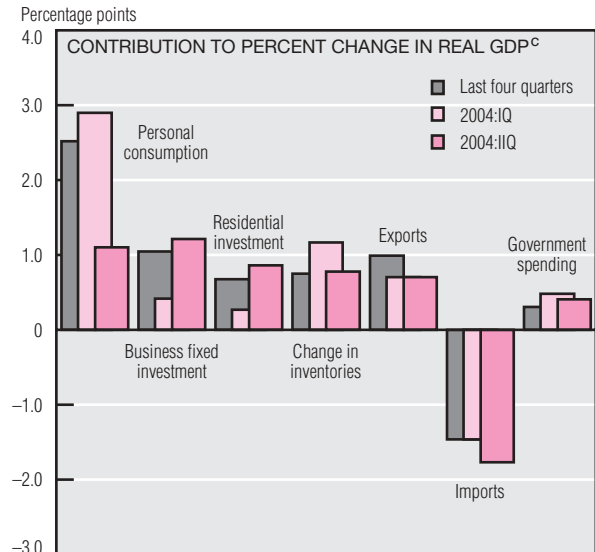
The net international investment position cannot fall indefinitely as a share of GDP. Eventually, foreign investors will become hesitant to add any more dollar-denominated assets to their portfolios, triggering a dollar depreciation and a rise in U.S. real interest rates. These adjustments will probably shrink the current account

deficit, but they also can affect investment and prices in the U.S. We do not know if, when, or how fast this adjustment will take place.

Foreign investors' attitudes may depend on U.S. saving and investment. During much of the 1990s, rapid growth in domestic saving and investment—implying a rising potential for future growth—accompanied an expanding U.S. current account deficit. Since 2000, saving and investment have fallen relative to GDP, but the trend may be reversing.

Economic Activity

	Change, billions of 2000 \$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	87.2	3.3	4.8
Personal consumption	29.4	1.6	3.6
Durables	-0.8	-0.3	5.4
Nondurables	0.7	0.1	4.7
Services	28.3	2.7	2.7
Business fixed investment	34.9	12.4	10.8
Equipment	31.8	14.2	13.9
Structures	4.0	6.9	1.3
Residential investment	21.1	16.5	13.2
Government spending	10.7	2.2	1.6
National defense	2/3	1.9	3.8
Net exports	-30.2	—	—
Exports	19.4	7.3	10.8
Imports	49.6	12.6	10.7
Change in business inventories	21.1	—	—



a. Chain-weighted data in billions of 2000 dollars.

b. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.

c. Data are seasonally adjusted and annualized.

d. 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*, September 10, 2004.

According to the U.S. Commerce Department's final estimate, the annualized growth rate of real GDP in 2004:IIQ was 3.3%, up from the preliminary estimate of 2.8%. This increase resulted partly from upward revisions to business inventories, residential investment, and business fixed investment. In addition, exports were higher and imports were lower than originally reported, with the revision increasing the change in net exports by \$8.4 billion.

Given its larger share, personal consumption is usually the component

with the largest positive contribution to GDP. In 2004:IIQ, however, business fixed investment's contribution was the largest (1.2 percentage points), while personal consumption's was 1.1 percentage points (pp). Exports were unchanged from 2004:IQ, although imports' negative impact increased 0.31 pp.

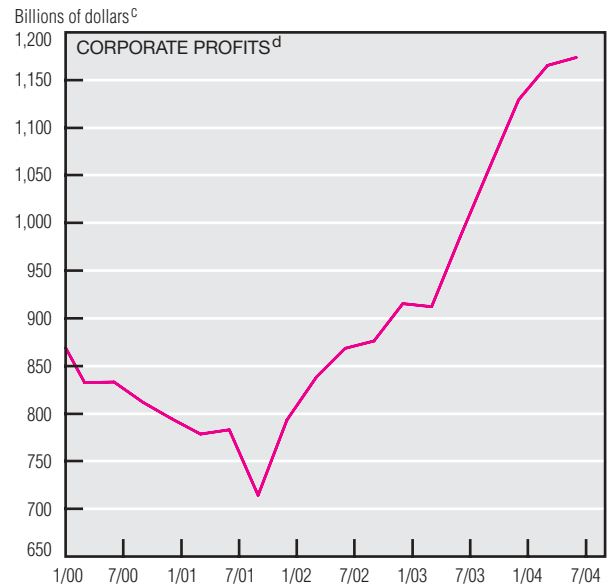
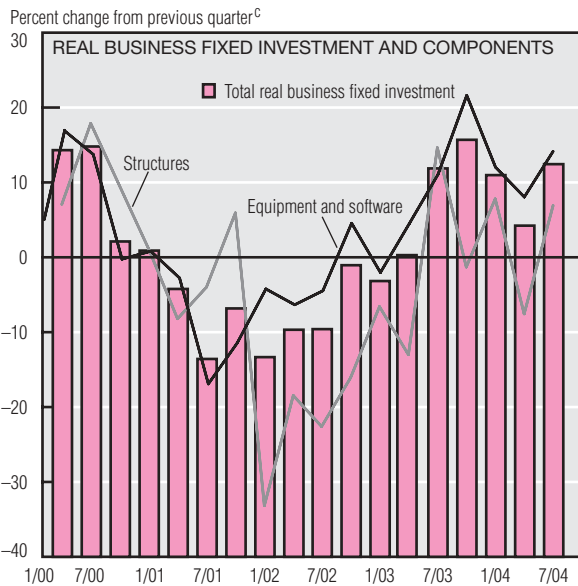
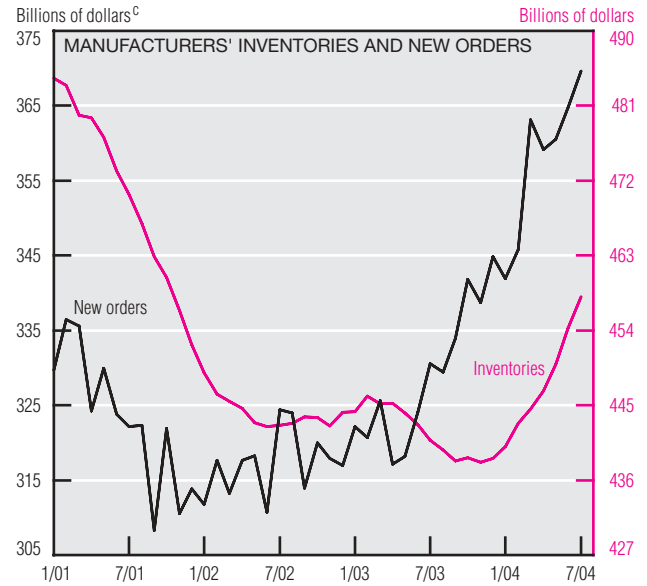
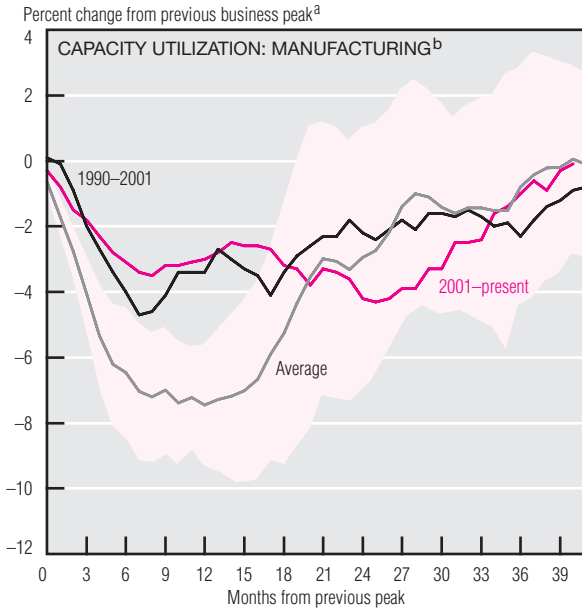
The final growth estimate for 2004:IIQ was slightly higher than Blue Chip forecasters' prediction. They expect growth to be slightly higher over the next four quarters, with estimates

coming in at or above 3.5% for each quarter. If these predictions are correct, the economy should perform well above the 30-year average in the upcoming quarters.

Since the beginning of 2004, year-over-year-growth in both real disposable personal income and real personal consumption expenditures has slowed. Real disposable personal income growth slowed by 2.7 pp from August 2003 to August 2004, while growth in real personal consumption expenditures slowed by

(continued on next page)

Economic Activity (cont.)



a. Seasonally adjusted.
 b. The shading represents a 95% confidence interval (the 1948-2000 average, plus or minus two times the standard error).
 c. Seasonally adjusted annual rates.
 d. Corporate profits with inventory valuation and capital consumption adjustments.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Board.

a more modest 0.9 pp in the same period.

Conditions in manufacturing have improved markedly over the last year. At 76.8%, manufacturing capacity utilization has now rebounded to the level last recorded at the beginning of the most recent economic downturn in March 2001. Because manufacturing capacity utilization peaked in April 2000, earlier than the economy as a whole, capacity utilization has not yet reached the 82.2% level observed then. During the current business cycle, this indicator

performed better than average in the period right after the last peak, but over the past two years its performance has been fairly typical.

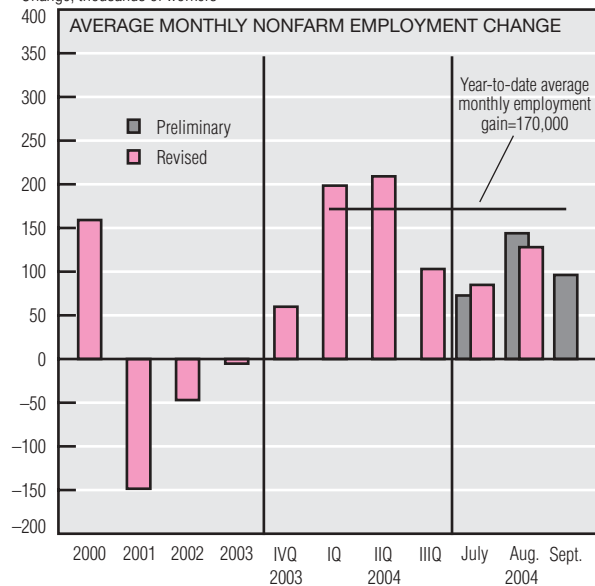
Another sign of health in manufacturing is that new orders increased 11.8%, or \$39 billion, from July 2003 to July 2004, with inventories rising a more modest 3.9% over that period to support the higher level of sales. Bolstered by the inflow of orders, business fixed investment has also continued to rebound, up 12.4% at a seasonally adjusted annual rate (SAAR) in 2004:IIQ and 10.8% from

2003:IIQ to 2004:IIQ. Investment in equipment and software has grown even more strongly, up 14.2% SAAR and 13.9% over the last year. Investment in structures has been less steady, rising 6.9% SAAR in 2004:IIQ but only 1.3% since 2003:IIQ.

In a further reflection of improved performance, corporate profits have surged 19% (\$188 billion) from 2003:IIQ to 2004:IIQ. Something to watch, however, is that the pace did slacken from the first to the second quarter, rising only 2.9% SAAR.

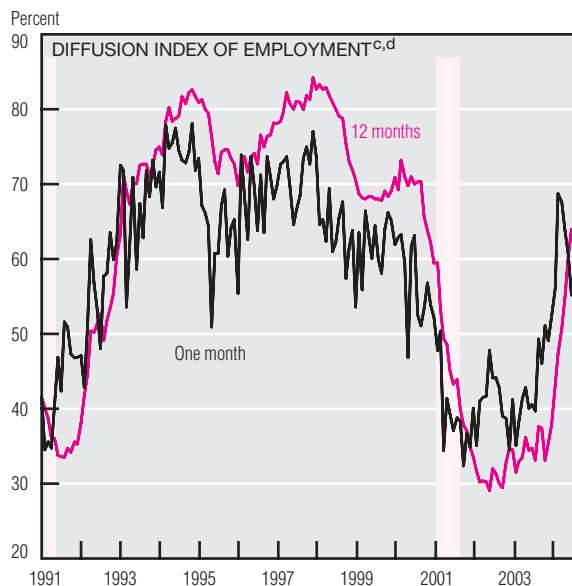
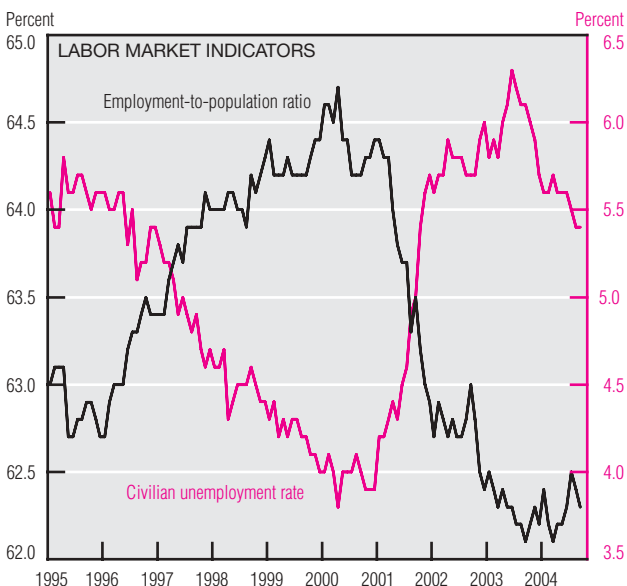
Labor Markets

Change, thousands of workers



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	YTD	Sept. 2004
Payroll employment	-149	-47	-5	170	96
Goods producing	-124	-76	-42	27	-13
Construction	-1	-8	7	17	4
Manufacturing	-123	-67	-48	7	-18
Durable goods	-88	-48	-30	12	-10
Nondurable goods	-35	-19	-18	-5	-8
Service providing	-25	29	37	144	109
Retail trade	-24	-11	-5	16	-15
Financial activities ^a	8	6	6	12	26
PBS ^b	-63	-17	23	42	34
Temporary help svcs.	-37	2	15	17	33
Education & health svcs.	50	40	28	24	8
Government	46	21	-4	11	37
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.6	5.4



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. Percent of total nonfarm industries with increased employment over one month (or 12 months) plus half of those with unchanged employment.

d. Shaded areas indicate recessions as dated by the National Bureau of Economic Research.

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

In September, total nonfarm payrolls increased by 96,000. The Commissioner's Statement from the Bureau of Labor Statistics indicated that the hurricanes had no apparent impact on employment in September. The average monthly employment gain in the third quarter was 103,000, roughly half of the average gain for the first half of the year.

Manufacturing employment fell by 18,000 in September, the largest decline since December 2003. Service-providing industries added 109,000

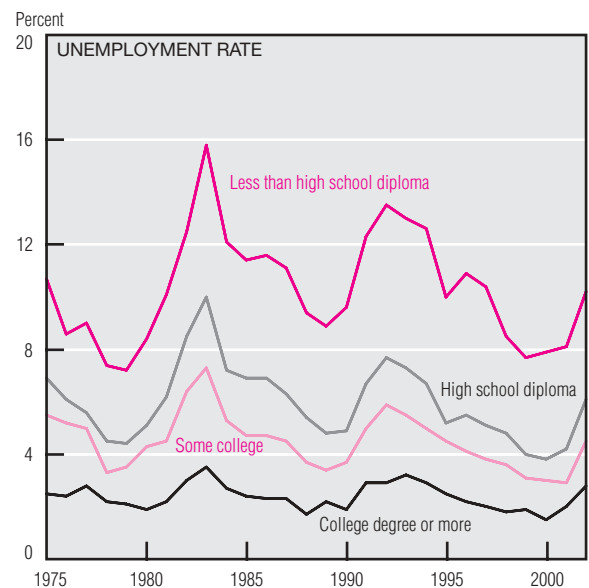
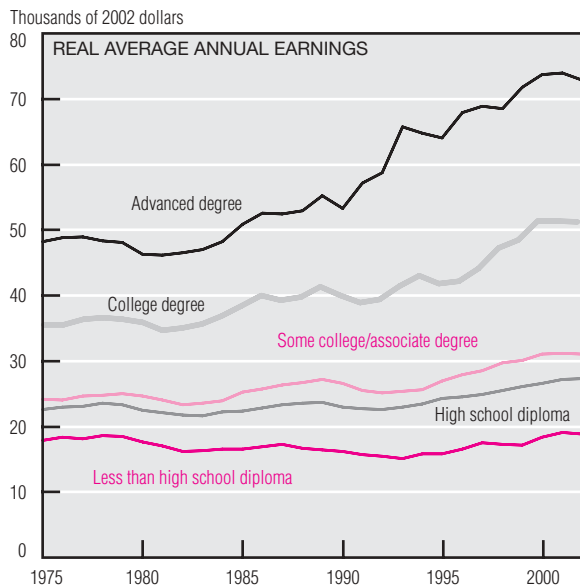
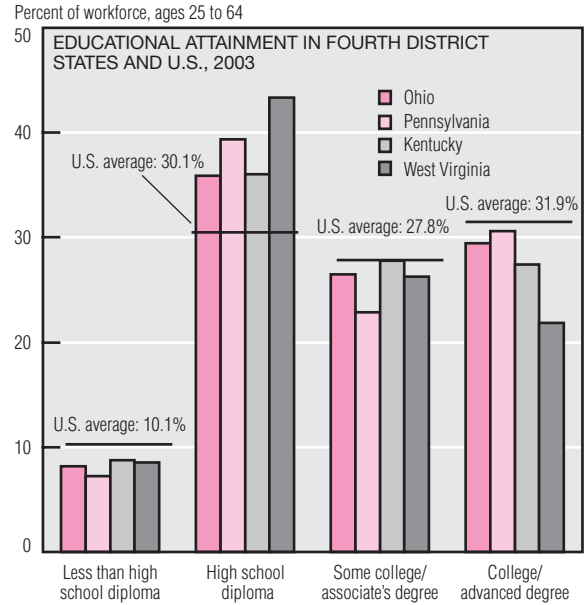
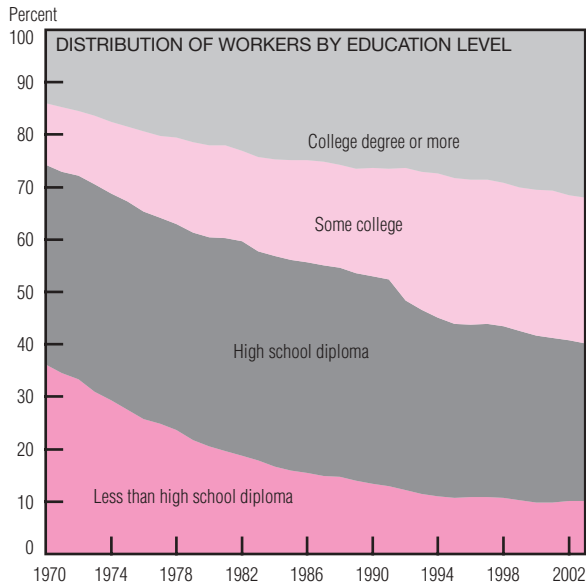
net jobs, more than half of them in financial activities and temporary help services. Jobs in retail trade declined by 15,000 in September, the third consecutive monthly drop after average gains of 30,000 in the first half of the year. Government payrolls rose by 37,000 in September and 103,000 in the third quarter.

September's unemployment rate remained at 5.4%. It has fallen 0.3 percentage point (pp) this year after dropping 0.6 pp in the second half of 2003. The employment-to-population

ratio fell 0.1 pp in September to 62.3%; in contrast to unemployment, it has not changed significantly in the last 15 months.

The Diffusion Index of Employment measures the share of industries where employment rose in a given period. The one-month diffusion index was near 70 in March and April, when job gains peaked, but has fallen to just over 55 in the last three months. The 12-month index has risen 30 points this year, reaching its highest level since October 2000.

Education and the Workforce



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census.

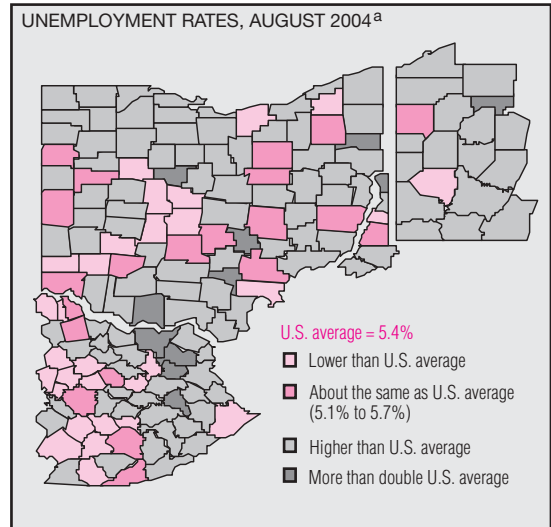
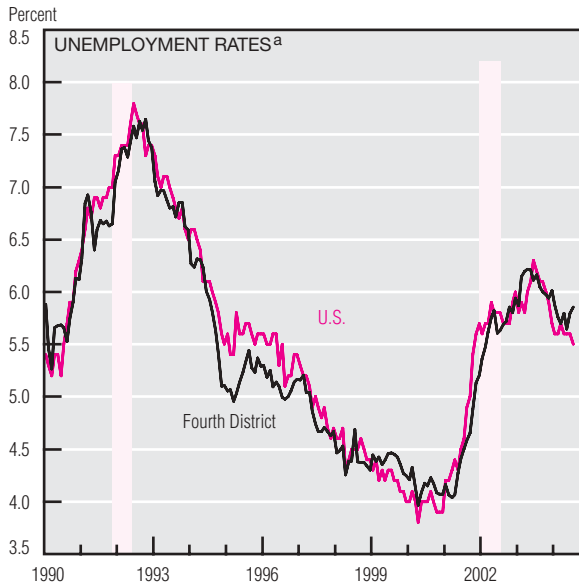
The American workforce is becoming increasingly educated as younger generations replace older ones. Over the past 30 years, the fraction of American workers who did not graduate from high school plummeted from about 36% in 1970 to 10% in 2003. Meanwhile, the share of workers with at least a college degree more than doubled, rising from about 14% to 32%. In 2003, the proportion of workers in Fourth District states who had at least a college degree was below the U.S. average, while the proportion of workers with a high school diploma was above average.

Real (inflation-adjusted) average annual earnings vary substantially by education level, suggesting that more schooling and degrees translate into higher income. The real average annual earnings of high school dropouts and high school graduates have remained relatively stagnant since 1975; in contrast, earnings have increased about 44% for college graduates and 51% for advanced degree recipients. Moreover, the earnings disparity between individuals without a high school diploma and college graduates—including those with advanced degrees—has widened. In

1975, the average earnings of those who continued beyond college were about 2½ times more than those of high school dropouts—by 2003, this had increased to roughly four times more.

Variation in earnings by education may also result partly from differences in unemployment rates. The more educated individuals have a better chance of being employed. Workers without a high school diploma are about four times more likely to be unemployed than those who continued their studies beyond college.

Fourth District Employment and Business Cycles



Payroll Employment in Fourth District Metropolitan Statistical Areas

	12-month percent change, August 2004							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Wheeling	Pittsburgh	Lexington
Total nonfarm	-0.1	0.1	0.8	-1.4	-2.1	2.0	-0.1	0.7
Goods-producing	-1.4	-0.5	-2.1	-3.1	-1.5	0.0	1.2	1.1
Manufacturing	-2.0	-0.7	-2.1	-2.7	-2.0	0.0	-1.2	-0.2
Natural resources, mining, and construction	0.4	-0.2	-1.8	-4.7	0.0	0.0	5.5	4.9
Service-providing	0.2	0.2	1.4	-1.0	-2.3	2.3	-0.4	0.5
Trade, transportation, and utilities	-1.2	-1.3	1.8	-3.8	-3.1	5.0	-0.9	-0.4
Information	0.5	0.0	3.2	0.9	4.3	0.0	-2.0	5.3
Financial activities	0.5	1.2	-0.4	-1.5	3.3	3.4	1.1	-3.6
Professional and business services	0.7	2.5	0.9	-4.1	-5.2	4.2	-0.9	-2.9
Education and health services	2.8	1.2	3.0	2.4	-1.4	-0.8	1.3	0.9
Leisure and hospitality	0.7	-1.5	3.7	-0.7	-4.9	0.0	-0.6	7.6
Other services	-3.9	-2.2	-0.3	1.0	0.0	3.6	-0.5	3.8
Government	-0.4	0.9	-1.4	0.6	-0.9	2.9	-1.9	-0.9

NOTE: Data are not seasonally adjusted unless otherwise noted.

a. Seasonally adjusted.

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

The Fourth District's unemployment rate rose sharply in August to 6.2%, an increase of 0.3 percentage point (pp) from July. This was the sharpest jump in 18 months and the third consecutive increase. Ohio, Pennsylvania, and West Virginia also saw statewide unemployment increases of 0.3 pp in August. By contrast, Kentucky's unemployment rate fell 0.2 pp to 5.1%, the lowest rate of any state in the District.

Nationally, the unemployment rate in August was 5.4%. Most counties in the District—almost three of every

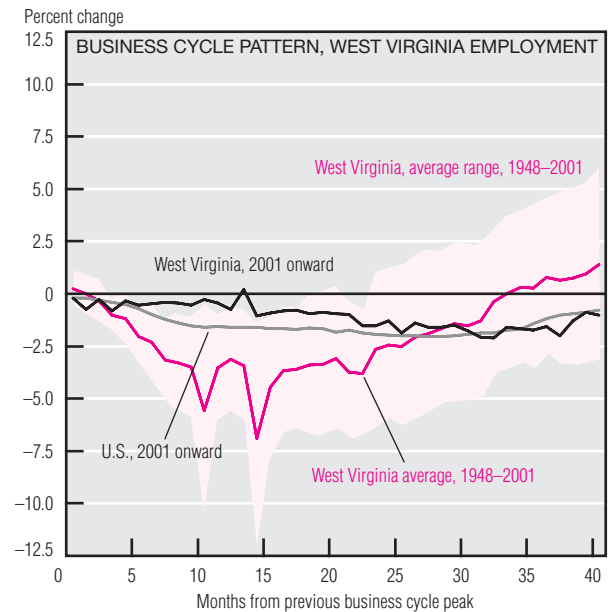
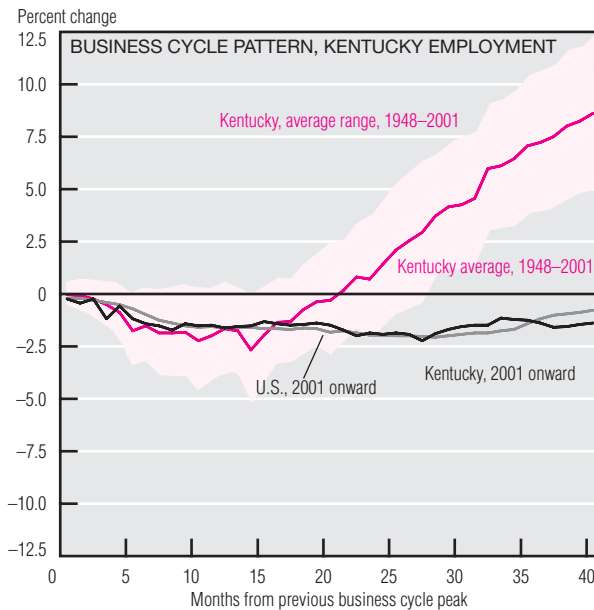
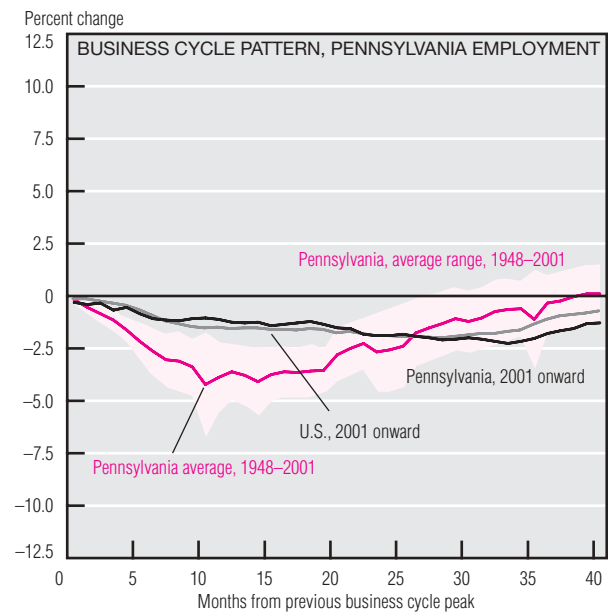
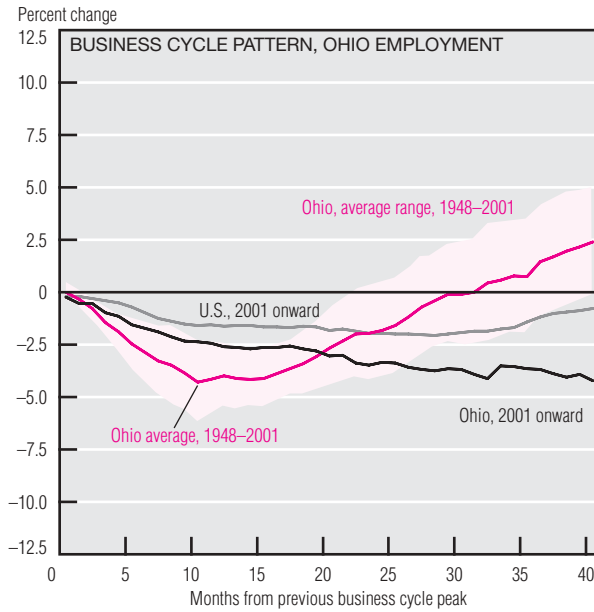
four—reported rates exceeding that. The month before, unemployment topped the national average in two of every three District counties. However, the number of counties where unemployment was more than double the U.S. average stayed about the same between July (12 counties) and August (11).

Among the District's major metropolitan areas, Wheeling posted the strongest year-over-year employment gains. By contrast, Dayton and Toledo experienced the sharpest declines; employment in service-providing

industries was hardest hit, especially in enterprises related to trade, transportation, and utilities, as well as professional and business services. Employment in manufacturing industries continued to fall across most of the District's major metropolitan areas, with the most marked declines in Dayton, Cincinnati, Cleveland, and Toledo.

Much of the concern about the current expansion has focused on weaker-than-expected employment growth. On average, national employment during past expansions returned *(continued on next page)*

Fourth District Employment and Business Cycles (cont.)



NOTES: All data are for nonfarm business and are seasonally adjusted. Shaded bands indicate a 95% confidence interval for the states' 1948-2001 average.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

to pre-recession levels within about two years of the preceding recession's start. But now, after more than three years, U.S. employment has not yet regained its pre-recession peak, nor has employment in Fourth District states.

In percentage terms, employment since the start of the recent recession has fallen somewhat less in the U.S. than in Fourth District states; of those states, Ohio has fared the worst by far. While Kentucky, Pennsylvania, and West Virginia have each lost about 1% of employment since

the start of the last recession—only slightly more than the nation—Ohio has lost about 4% of its jobs.

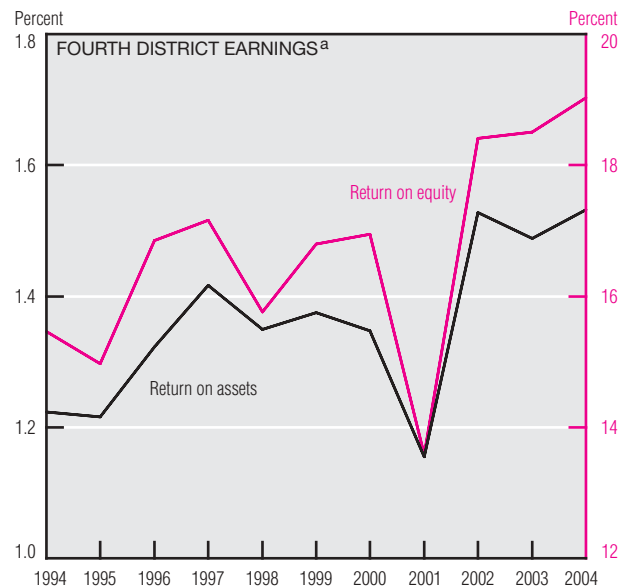
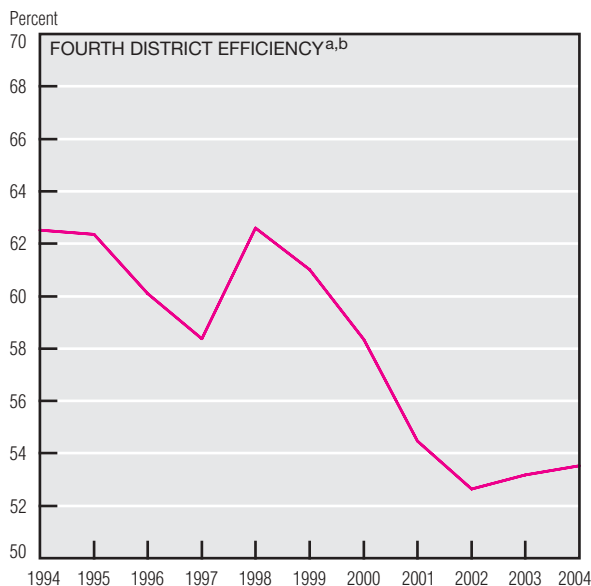
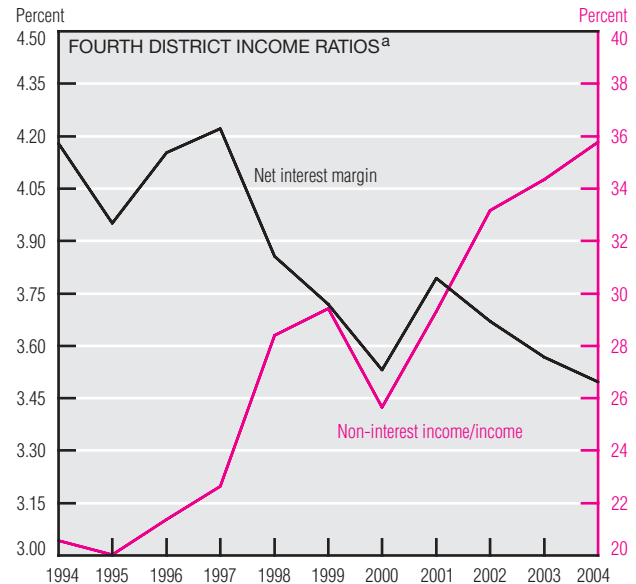
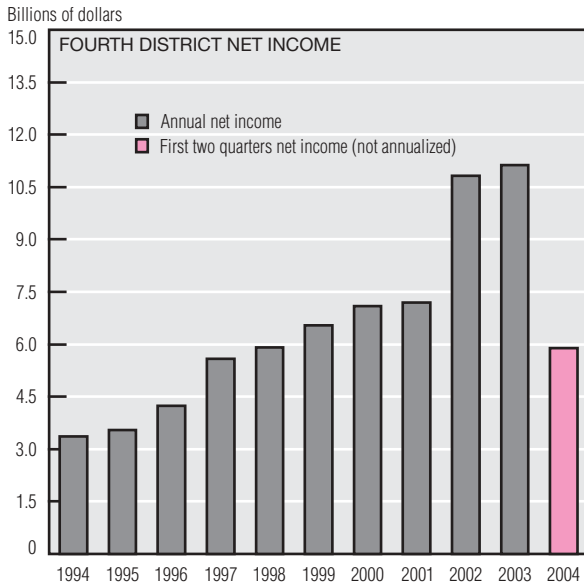
The ranges of past recessions make it clear that every recession is different. And during each recession there is variation among Fourth District states as well. Ohio usually recovers somewhat more slowly than the nation, but during this expansion the state's employment growth has lagged both its own typical historical experience and the nation's current performance.

On average, in previous expansions, Kentuckians could expect

employment to rebound much more quickly than their counterparts in other District states—almost a year sooner. In the current expansion, however, both Ohioans and Kentuckians have experienced employment growth that is well below the range of their historical experience.

Pennsylvania and West Virginia normally regain jobs more slowly than the U.S. In the most recent recovery, however, these states' performance has been in line with the nation's as well as their own historical experience.

Fourth District Commercial Banks



a. Through 2004:IIQ only. Data for 2004 are annualized.

b. Efficiency is operating expenses as a percent of net interest income plus non-interest income.

SOURCES: Author's calculation from Federal Financial Institutions Examination Council, *Quarterly Bank Reports of Condition and Income*.

FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District continued the past two years' strong earnings performance into the first half of 2004. Their net income was \$5.88 billion for these six months (\$11.76 billion on an annual basis); this set a pace that, if maintained, will break the record of \$11.1 billion in 2003. Overall, Fourth District bank performance was representative of the U.S. banking industry, which posted unprecedented earnings in the first half of 2004.

Bank earnings remained strong—despite continued shrinkage in the

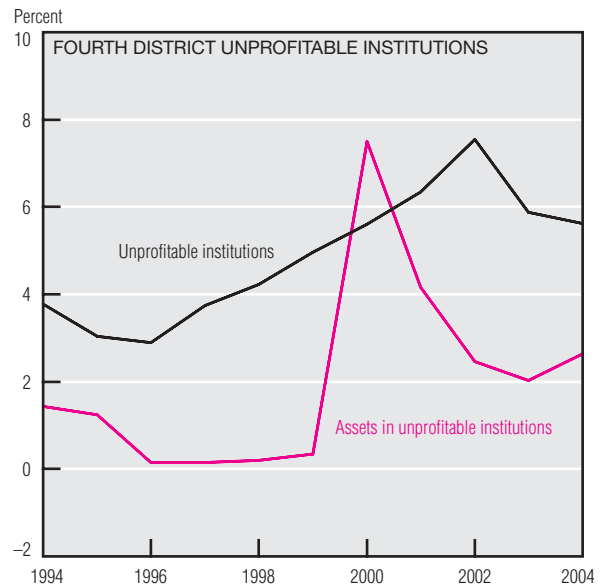
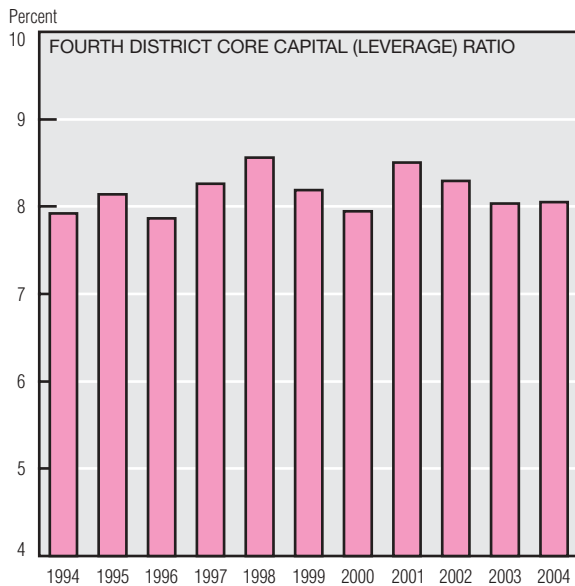
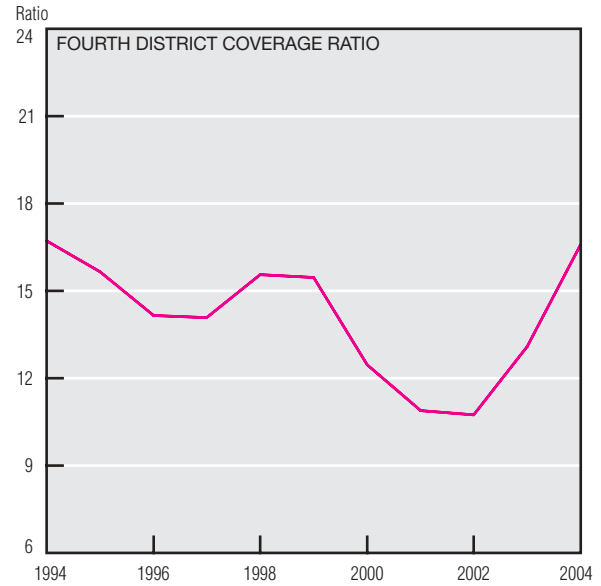
net interest margin caused by low interest rates—because the yield on earning assets fell more quickly than the cost of funds. By the end of 2004:IIQ, Fourth District banks offset smaller margins with sharp growth in non-interest income, which made up a record 35.76% of total income. This performance was similar to that of their counterparts nationwide, whose comparable figure was 36.47%.

Improved efficiency was another factor in banks' stellar earnings performance in the past few years. Efficiency is measured by operating expenses as a percent of net interest income plus

non-interest income, so lower numbers correspond to greater efficiency. Although Fourth District banks' 53.6% efficiency ratio at the end of 2004:IIQ did not quite equal their 52.6% at the end of 2002, this ratio (which is inversely related to efficiency) remained well below its recent high of 62.6% in 1998.

District banks posted a return on assets of 1.53% for the first half of 2004, up slightly from 1.49% at the end of 2003; return on equity also rose, reaching 19.0%. This compared favorably with their own first-half *(continued on next page)*

Fourth District Commercial Banks (cont.)



NOTE: All 2004 data are for the first two quarters.

a. Problem assets are shown as a percent of total assets, net charge-offs as a percent of total loans.

b. For net charge-offs, the 2004 observation is annualized on the basis of the first two quarters.

SOURCES: Author's calculations from Federal Financial Institutions Examination Council, *Quarterly Bank Reports on Condition and Income*.

profit performance in recent years and with the nation's 1.19% return on assets and 13.72% return on equity.

Overall, financial indicators for banks in the Fourth Federal Reserve District point to strengthening balance sheets. Asset quality showed continued signs of improvement during the first half of 2004. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) for the first six months of the year represented an annualized 0.56% of total loans. Problem assets (nonperforming loans and

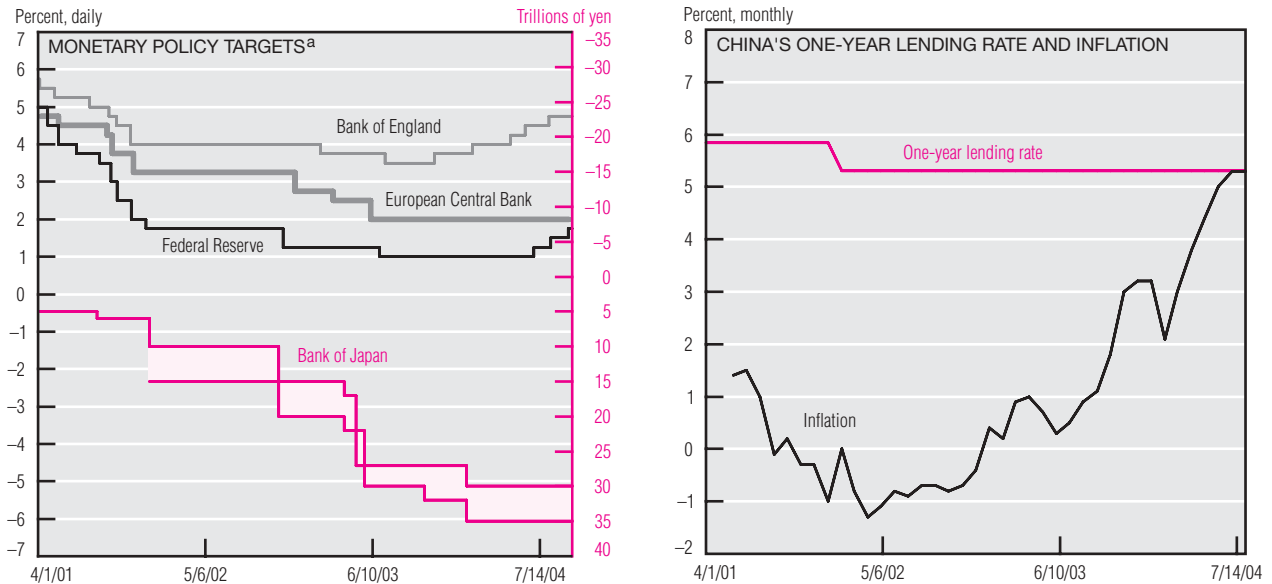
repossessed real estate) as a share of loans and leases fell to 0.61% from 0.77% at the end of 2003. Fourth District Banks' improvement in asset quality mirrored that of the overall banking industry, in which net charge-offs were 0.58% of loans and nonperforming loans were 0.59% of assets.

Reflecting an industrywide trend toward stronger balance sheets, Fourth District banks held \$16.61 in equity capital and loan loss reserves for every dollar of problem loans, well above the recent low in the coverage ratio of 10.75 at the end of 2002. This improvement resulted largely from a

marked reduction in problem loans and a slight strengthening of bank capital. Equity capital as a percent of Fourth District banks' assets rose somewhat, moving from 8.04% at the end of 2003 to nearly 8.05% by the end of 2004:IIQ.

Improved asset quality was also reflected in the percent of unprofitable institutions, which fell to 5.61% from nearly 5.88% at the end of 2003. However, the average size of unprofitable banks increased in 2004 as assets in unprofitable institutions increased slightly from 2.02% to 2.63% of Fourth District banks' assets.

Foreign Central Banks



Central Banks' Monetary Policy Stances

Accommodative

United States: "accommodation can be removed at a pace that is likely to be measured"

European Central Bank: rate "very low by historical standards...lending support to economic activity"

Japan: "...CPI is still on a declining trend" so "pursue an easy monetary policy even as the economy continues to recover"

Sweden: "rate is low in an historical perspective" and "will need to be raised in the long run"

Switzerland: raised rate to reverse 2003 cut made under "extraordinary circumstances"

Not Accommodative

Brazil: raised rate "to rein in inflation without disrupting...economic recovery"

Canada: raised rate: "to avoid a buildup of inflationary pressures" while "close to production capacity"

New Zealand: raised rate: "looking ahead, we do not have much inflation headroom"

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.

SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

The Federal Reserve, alone among the major central banks, changed its policy rate during the past month, raising it another 25 basis points to 1.75%. The Federal Open Market Committee characterized the policy situation as one in which "the stance of monetary policy remains accommodative" but also said that "policy accommodation can be removed at a pace that is likely to be measured."

"Accommodation" has no precise definition, but at least seems to imply that the nominal policy rate would have to be higher in the longer run if an economy is expected to achieve

tolerably low inflation and sustainable real growth. Many observers think that the Peoples Bank of China is being accommodative by holding the one-year loan rate at 5.31%, where it has been for the past two and a half years, while maintaining that "price performance in China remains stable on the whole." Other central banks suggest that they are or have been accommodative, referring to their policy rates as being at historic lows or at lows that reflect extraordinary conditions.

Not all central banks can afford to be accommodative lest they risk

letting inflation rise. Some—notably Brazil, Canada, and New Zealand—recently raised their rates, arguing that the absence of excess capacity already makes inflation their dominant concern. Still other banks perceive themselves to be in less demanding situations. The Bank of England is not convinced that "little or no remaining spare capacity" prevents inflation from being "well anchored." The Bank of Norway left its rate unchanged, enjoying the enviable combination of lower inflation and stronger real growth.