

## *The Economy in Perspective*

*Appreciating the dollar...* The U.S. dollar has been in the news often lately, and some financial journalists have announced that it is finally getting its comeuppance. After all, they have considered the dollar overvalued for some time and have scratched their heads over its apparent ability to defy gravity. They have declared that the dollar had nowhere to go but down because the United States has been living beyond its means. Undeniably, the United States has run a current account deficit for the better part of 20 years; most recently, that deficit has grown very large. Arriving at this point has required foreigners to invest their excess savings in dollar-denominated assets, whether in the form of land, corporate stock, or U.S. Treasury securities, and to do so at an increasing rate. Although many analysts have concluded that dollar depreciation must be part of adjusting to a new equilibrium, they differ widely over the magnitude, timing, and currency pairs associated with any movement in the dollar. Experience shows that exchange rate changes cannot be forecast with much accuracy.

So, without making specific predictions about the dollar, let's consider a few of the arguments being leveled against that old reprobate. Americans, it is said, consume too much and save too little. Household debt has risen to record levels, both in absolute terms and as a percent of disposable income. And the personal saving rate, for goodness' sake, has dwindled to next to nothing. All true, but are these signs of gluttonous behavior?

Just as corporations have restructured their balance sheets by paying off high-interest debt, households have refinanced their debts at lower rates and improved their cash flow. This has allowed them to purchase durable assets such as automobiles and houses at relatively low interest rates and made their debt burden lighter than it might first appear. As far as the personal saving rate is concerned, research conducted by the Federal Reserve Board staff indicates that the consumption boom and saving rate decline of the 1990s can be attributed almost entirely to the behavior of the wealthiest 20 percent of households. In other words, the economywide decline in the personal saving rate

occurred because the wealthiest families—whose net worth surged during the stock market boom—were spending more than they earned, while the remaining 80 percent of families saved at rates that were the same or higher than before. One could argue that most households' responses to prices and interest rates have been eminently sensible all along.

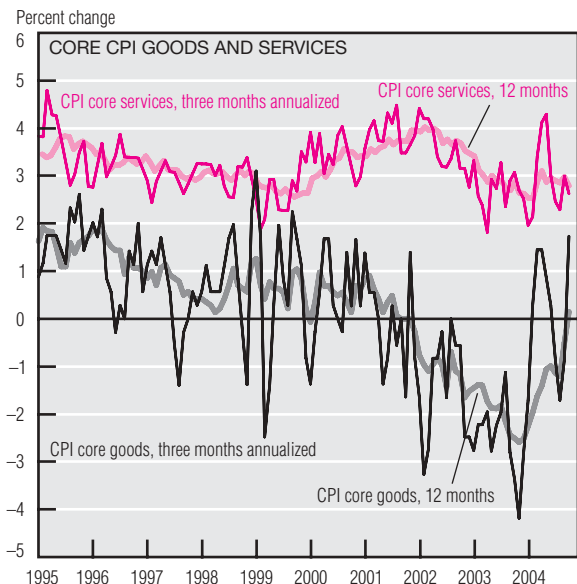
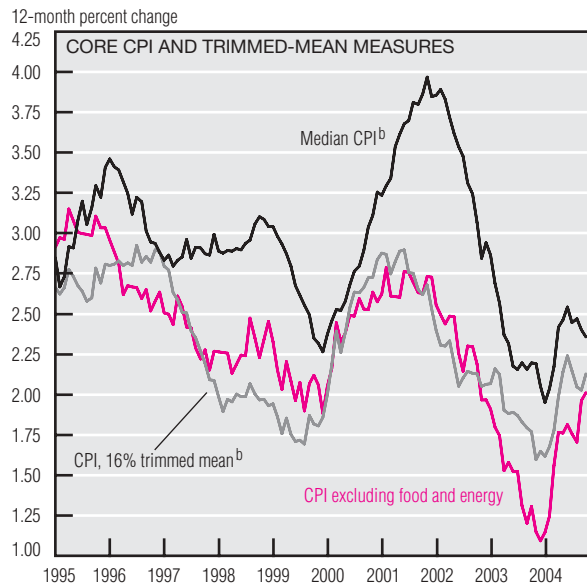
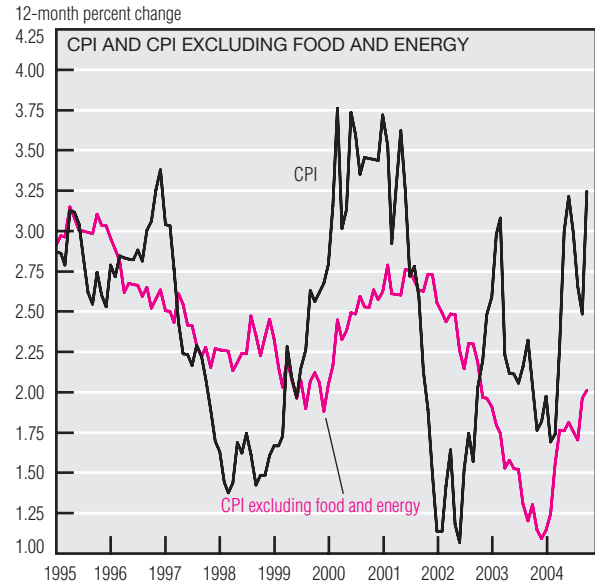
Other rational actors are also involved. The dollar has depreciated by anywhere from one-fourth to one-third of its value against some major currencies since early 2002. But its exchange value has changed little during this period against the currencies of a number of other important trading partners. Some foreign governments have seen merit in trying to control their currencies' value against the dollar, reasoning that it is better to accumulate large holdings of U.S. financial assets than to export less and import more than they otherwise might have done. In these countries, the prevailing exchange rates have also made it rational for households to save more and consume less than they probably would have done had their domestic currencies strengthened, or strengthened further, against the dollar.

Households, businesses, and governments around the world have been doing what they always do: acting in their perceived self-interest, subject to the constraints they face. The U.S. current account deficit has been expanding in an environment where households and firms could borrow funds at relatively low real interest rates and purchase foreign goods at relatively low prices; in our trading partners' economies, private decisions have been made in an environment that has promoted saving and exporting.

The essence of market systems is that people respond to incentives. If their collective choices lead them down an unsustainable path, interest rates, exchange rates, and relative prices will adjust and guide decisions toward a different set of outcomes. If the U.S. current account becomes unsustainably large, it cannot do so solely through Americans' decisions. And if forces are set in motion that eventually shrink our deficit, people everywhere are likely to face a new set of interest rates, exchange rates, and relative prices.

# Inflation and Prices

	Percent change, last:				2003 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>October Price Statistics</b>					
<b>Consumer prices</b>					
All items	7.9	3.4	3.2	2.6	1.9
Less food and energy	2.5	2.3	2.0	2.1	1.1
Median <sup>b</sup>	2.2	2.2	2.4	2.9	2.1
<b>Producer prices</b>					
Finished goods	22.2	6.9	4.4	2.4	4.4
Less food and energy	4.0	2.1	1.7	1.0	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 Consumer Price Index (CPI) surged at an annualized rate of 7.9% in October. The Bureau of Labor Statistics attributed more than half the CPI's advance to energy costs, which rose 63.8% (annualized rate) in October after falling in the three preceding months. However, alternative retail price measures showed more moderate increases, including 2.5% for the core CPI (which excludes more volatile food and energy prices) and 2.2% for the median CPI (which is insulated from the effect of volatile

monthly price changes because it focuses on the center of the monthly price change distribution).

Indeed, year-over-year trends in the alternative retail price measures have been holding steady in the range of 2.0% to 2.5%. In October, 12-month growth rates remained at 2.4% for the median CPI and 2.0% for the core CPI, while the growth rate for the 16% trimmed-mean CPI rose slightly from 2.0% to 2.1%.

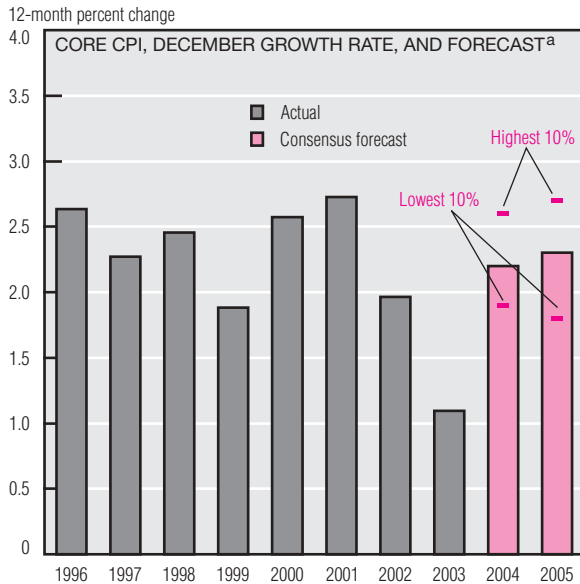
Prices of core goods (commodities excluding food and energy) rose at

an annualized rate of 1.7% over the past three months. On a year-over-year basis, core goods prices rose a slight 0.1% from last October after falling for nearly three years: This turnaround probably reflects upward price pressure on imports resulting from a weaker dollar, as well as a substantial increase in commodity prices over the past year.

The Blue Chip panel of economists has forecasted a 2.2% rise in core CPI prices in 2004 and a 2.3% rise in 2005. The optimists predict

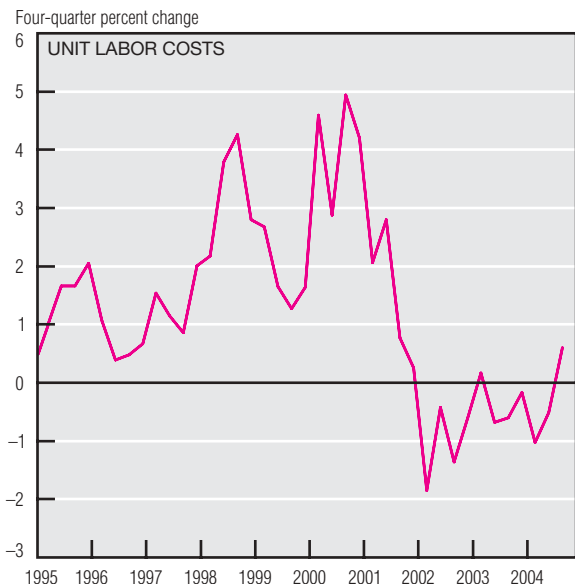
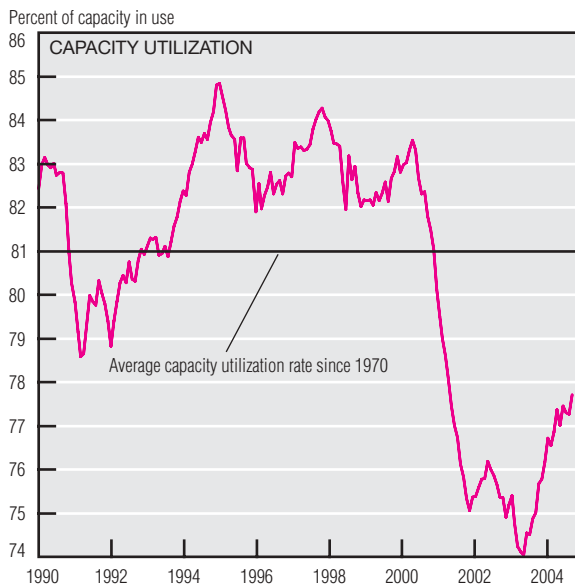
(continued on next page)

## Inflation and Prices (cont.)



### Crude Materials, Producer Price Index

	Percent change last:		
	3 mo. <sup>b</sup>	6 mo. <sup>b</sup>	12 mo.
Materials	-5.6	5.2	15.7
Foodstuffs and feedstuffs	-29.8	-21.6	-6.4
Nonfood materials	11.0	24.8	31.9
Coal	4.5	-2.1	9.1
Petroleum	210.4	99.8	70.3
Logs, timber, etc.	-2.0	4.1	4.7
Iron, steel and scrap	56.3	52.8	90.7
Construction materials	2.0	2.9	3.8
Energy materials	2.7	27.8	33.7
Materials less energy	-7.8	-9.3	4.6



a. Blue Chip panel of economists.

b. Annualized.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; "Industrial Production and Capacity Utilization," *Federal Reserve Statistical Releases*, G.17; and *Blue Chip Economic Indicators*, November 10, 2004.

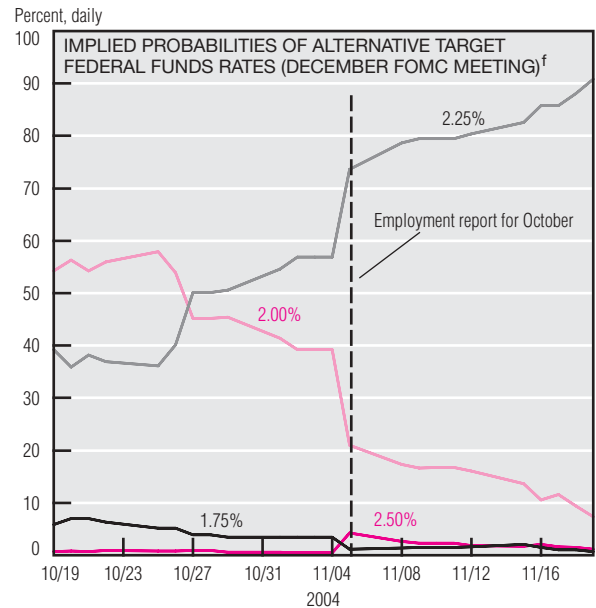
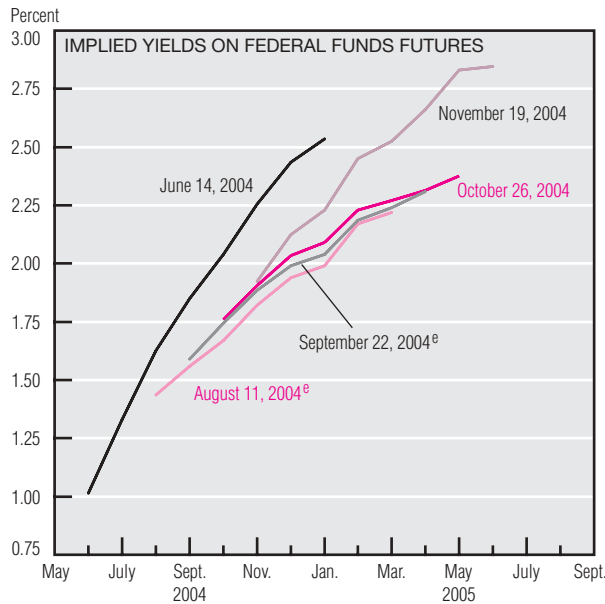
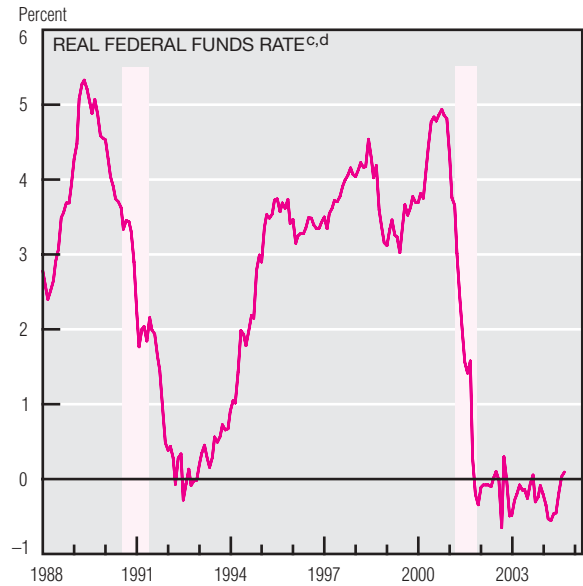
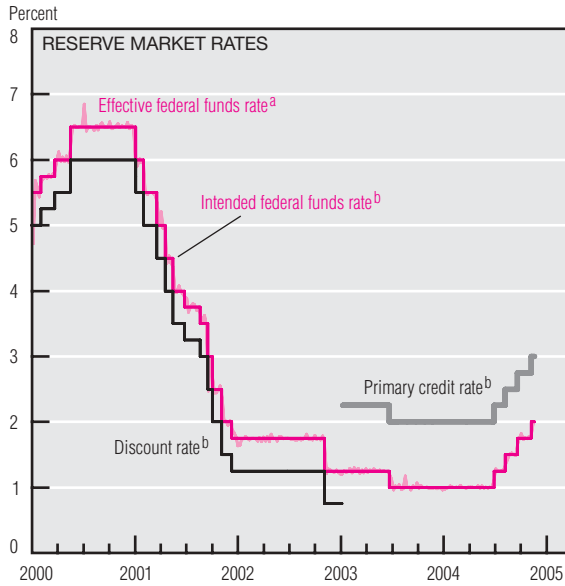
that the inflation trend will approach 1.8% by 2005; the pessimists expect it to approach 2.7%, roughly one percentage point above the current inflation rate and matching its highest level in 10 years. The range of forecast estimates has widened slightly, perhaps because of conflicting trends in traditional inflation indicators such as commodity prices, capacity utilization rates, and unit labor costs.

Crude material prices, which are commonly seen as a bellwether of fu-

ture inflation, have risen dramatically over the past year; yet the relationship between commodity prices and inflation is not particularly strong and is complicated by commodity prices' extreme short-term volatility, making it difficult to spot a change in the long-run trend. Capacity utilization is an indicator of the amount of slack in the U.S. economy and presumably, as this slack disappears, inflationary pressures build. Although capacity utilization has trended upward since mid-2003, at 77.7%, it remains well

below its long-term average of 81.0% and its 84.8% peak during the past economic expansion. Finally, unit labor costs, which have declined over the past two and a half years because of the spectacular rise in U.S. productivity growth, have more recently been trending upward, rising 0.6% in the third quarter. But many believe that the recent moderate rise in labor costs will not necessarily threaten long-term price stability as it may be offset by shrinking corporate profit margins.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

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

d. Shaded bars indicate periods of recession.

e. One day after the FOMC meeting.

f. Probabilities are calculated using trading-day closing prices from options on January 2004 federal funds futures that trade on the Chicago Board of Trade.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; 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.

At its November 10 meeting, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate from 1.75% to 2%—just above the inflation rate for core personal consumption expenditures (PCE) over the past year. A quarter-point hike had been widely anticipated in financial markets.

The action was also consistent with the FOMC's recent pattern of policy announcements and actions. After its May meeting, it adopted statement language noting that

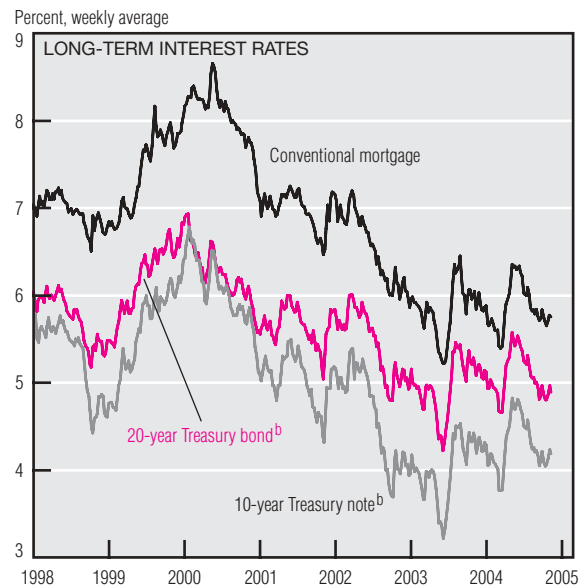
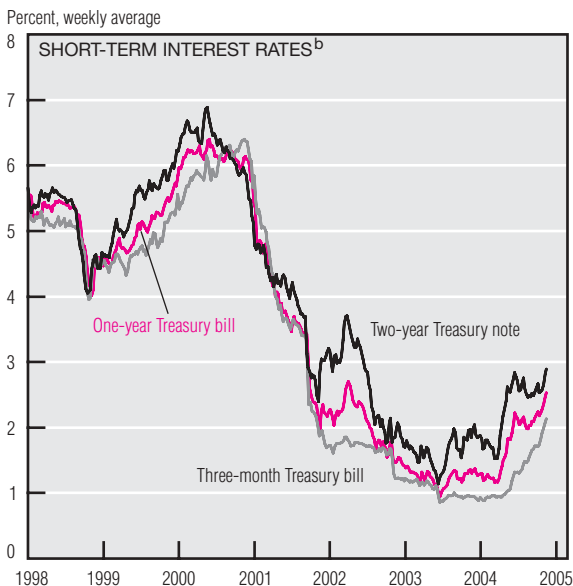
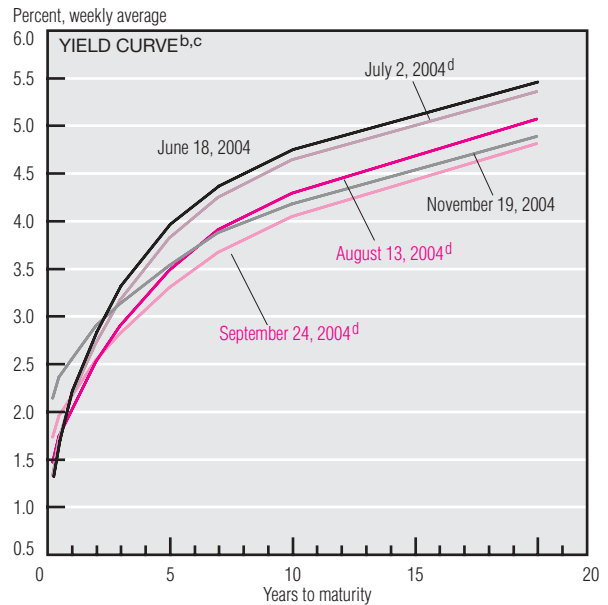
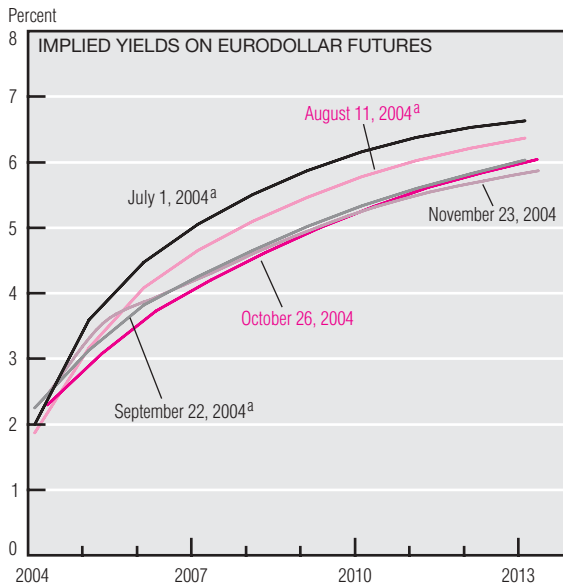
"the Committee believes that policy accommodation can be removed at a measured pace." At all four meetings since May, the FOMC has chosen to raise the fed funds rate target 25 basis points and to repeat the statement language. Futures and options prices during the weeks before each meeting placed high probabilities on the outcomes ultimately chosen. Thus, quarter-point hikes have been viewed as a measured pace of policy tightening.

Two weeks before the FOMC's November meeting, however, prices

for futures and options revealed a possible break in the recent pattern. Specifically, they implied that policymakers would maintain the measured pattern at their November meeting, but then would probably pause, leaving the target rate unchanged in December. During the summer, incoming data indicated that economic activity was weaker than expected, which suggested that policy was no longer as accommodative. Implied yields began to recede from their

(continued on next page)

## Monetary Policy (cont.)



- a. One day after the FOMC meeting.  
 b. All yields are from constant-maturity series.  
 c. Average for the week ending on the date shown.  
 d. 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; and Bloomberg Financial Information Services.

June 14 peaks. In late October, however, data suggested that a pickup might be at hand. A strong employment report on November 5 reinforced the optimistic view, making a December rate hike of 25 basis points unambiguously the most likely outcome. This action would result in a real fed funds rate more clearly in positive territory.

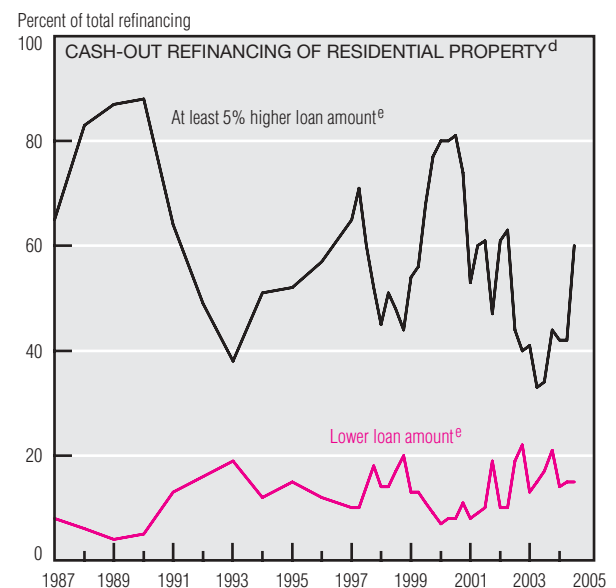
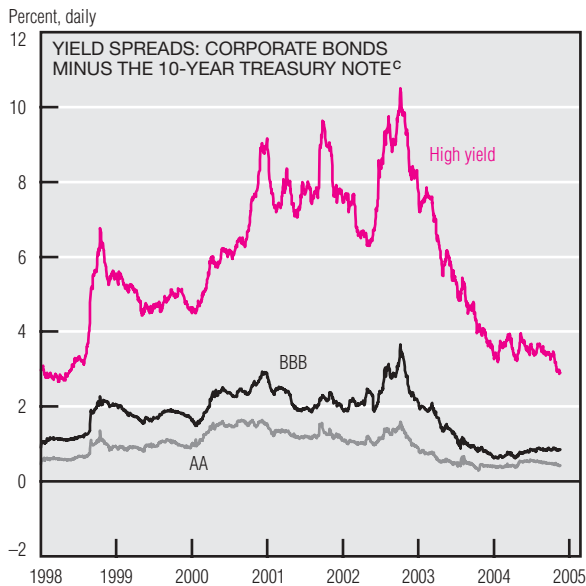
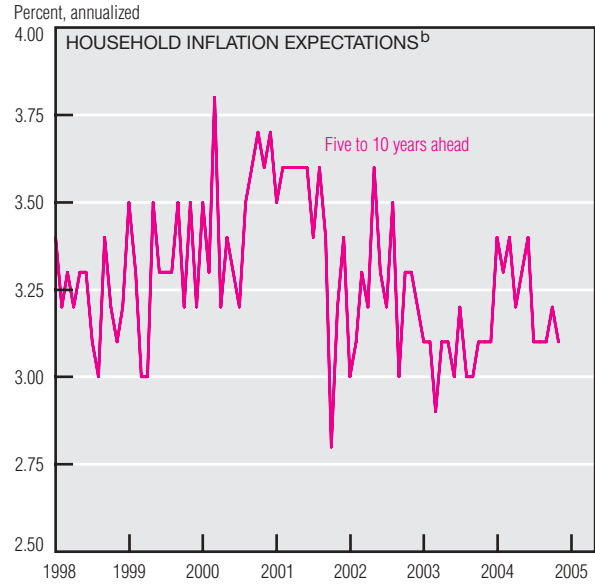
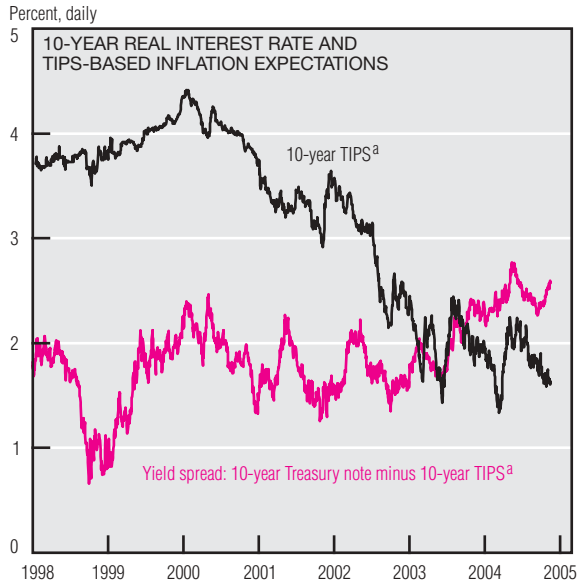
Implied yields derived from euro-dollar futures provide some measure of expected policy actions over longer horizons. Because these yields include premiums related to a variety

of risks exceeding those faced in the federal funds market, they tend to overpredict the fed funds rate, especially in the out years.

Nevertheless, changes over time in the slope of implied yields are largely consistent with changing policy predictions. They reveal a substantial shift in the expected fed funds rate two years and more in the future. Weak incoming data during the summer and early fall suggested not only a policy pause in the near term, but also a less restrictive monetary policy later in the expansion.

The changes in implied yields paralleled changes in the yield curve. Over the second half of 2004, short-term interest rates tended to rise as long-term rates fell. Short-term rates are more closely linked to expected changes in the fed funds rate. The real fed funds rate, which has been near or below zero, could increase and still remain accommodative. Long-term rates, on the other hand, are driven largely by underlying economic fundamentals and inflation expectations.

# Money and Financial Markets



a. Treasury inflation-protected securities.

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

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

d. Annual data until 1997; quarterly data thereafter.

e. Compared with previous financing.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Home Loan Mortgage Corporation; University of Michigan; and Bloomberg Financial Information Services.

In recent months, yields on 10-year Treasury inflation-protected securities (TIPS) have fallen more than yields on nominal 10-year Treasury notes. The spread between the yields on these two securities, which is one measure of inflation expectations, suggests that expected inflation has risen moderately. Presumably, if the declining TIPS yield reflected only weaker economic fundamentals, the nominal rate would decline by an equal amount.

The implied rise in expected inflation is small relative to market fluctuations. The increased spread could thus reflect temporary market factors, especially since the TIPS market volume is relatively small. Moreover, recent survey data on expected inflation do not corroborate the increase.

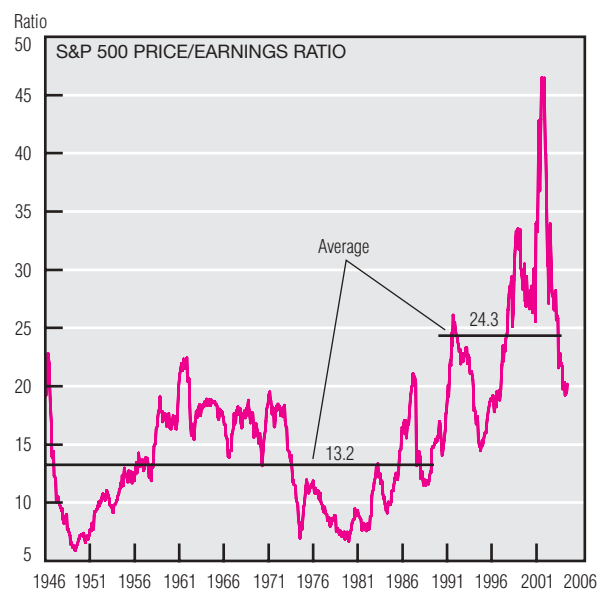
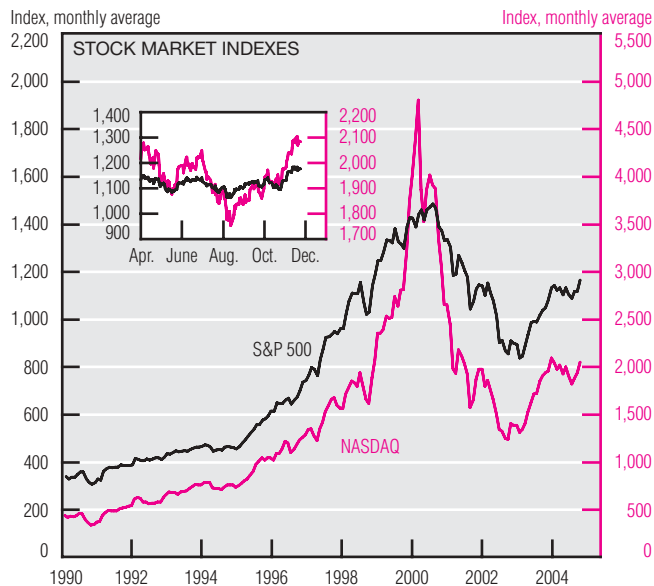
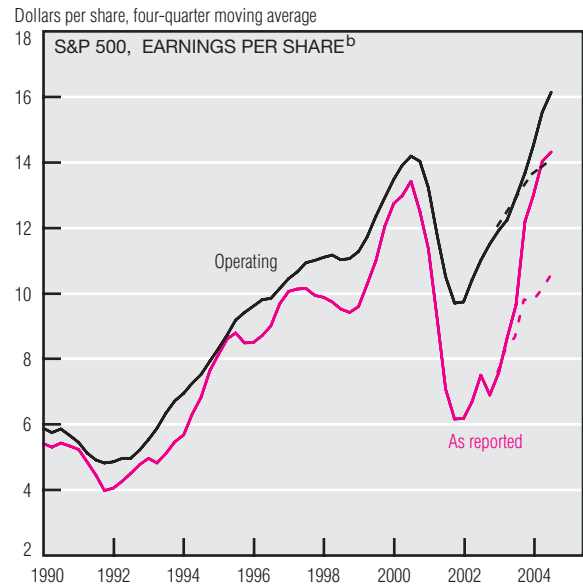
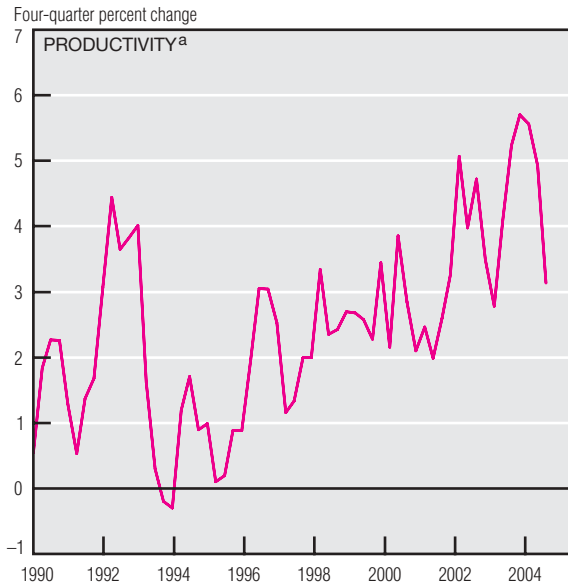
Spreads between corporate bonds and Treasuries have been moderately stable over the past year, reflecting the solid—if not spectacular—state of the economy. Premiums paid on

high-yield bonds have in fact diminished somewhat, suggesting increased confidence about the economy's prospects.

The decline in mortgage rates over the past few months has boosted household liquidity. Refinancing residential property has enabled households to tap their home equity by taking on larger loans. The additional liquidity is a welcome sign for retailers as the holiday spending season begins.

(continued on next page)

## Money and Financial Markets (cont.)



a. Nonfarm business sector.

b. Dashed lines indicate forecasts as of March 19, 2003.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Standard and Poors Corporation; and Bloomberg Financial Information Services.

The key fundamental for real interest rates is the economy's growth potential. In the long run, the equilibrium real interest rate approximately equals the productivity growth rate plus the trend employment growth rate. Considering the strong, persistent productivity growth we have witnessed since the mid-1990s, many analysts believe that the real interest rate is somewhere in the range of  $3\frac{1}{2}\%$ – $4\frac{1}{2}\%$ . They are surprised to see yields on long-term bonds so low. On

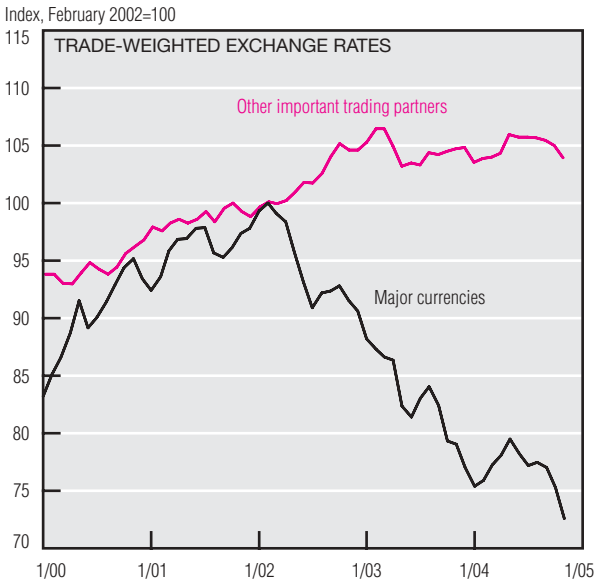
this basis and assuming an expected inflation rate of  $1\frac{1}{2}\%$ – $2\frac{1}{2}\%$ , one might expect nominal long-term Treasuries to eventually rise into the neighborhood of 5%–7%.

The historically high productivity growth of the past year and a half was largely unanticipated, as is evident in the growth of corporate earnings measures relative to their expectations in March 2003. Although analysts expected earnings to rebound somewhat from their 2001 lows, earnings growth has been surprisingly robust.

Strong productivity largely offset rising compensation costs, allowing much of recent years' revenue growth to show up on the bottom line of corporate income statements.

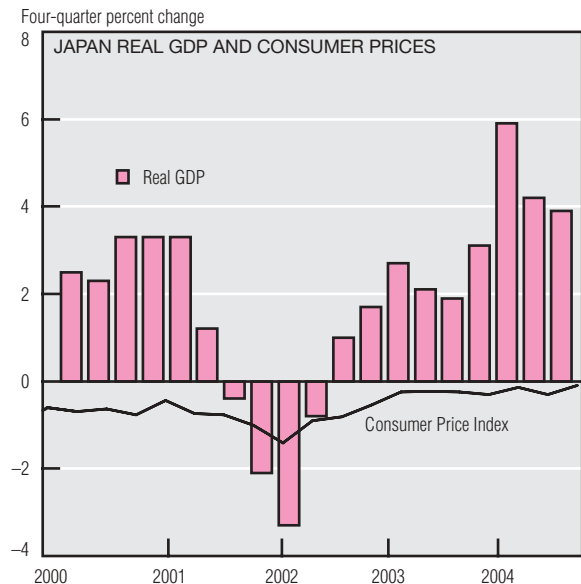
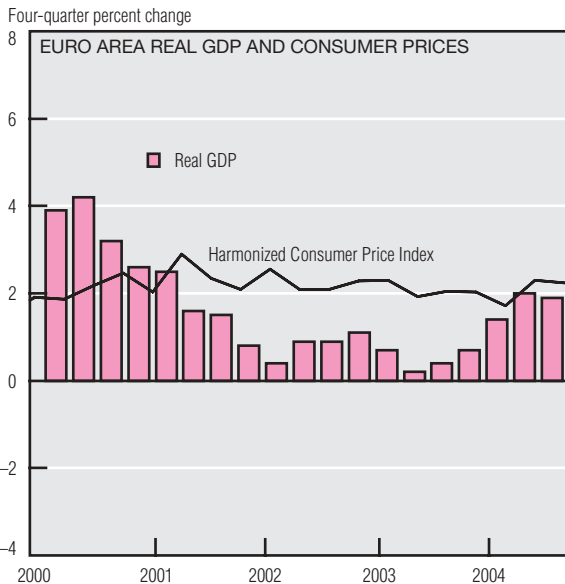
The rebound in stock prices over the past two years was thus based on strong fundamentals. Because the rise in stock price indexes was much smaller than the rise in corporate profits, however, the price/earnings ratio has fallen to levels more consistent with historical norms.

# Monetary Policy and the Dollar's Decline



Dollar Exchange Rate Movements<sup>a</sup>

	Percent change, February 27, 2002— November 19, 2004
Canada dollar	-25.8
Euro area euro	-33.8
Japan yen	-23.6
Mexico peso	25.0
U.K. pound	-23.8



a. Percent change from peak in trade-weighted dollar. Negative sign indicates a dollar depreciation. Positive sign indicates a dollar appreciation.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; and Bloomberg Financial Information Services.

Third-quarter GDP growth in the euro area and Japan came in lower than analysts had anticipated, prompting many foreign policymakers to complain that the dollar's renewed depreciation poses a major downside risk to their countries' future economic growth. Dollar depreciation shifts worldwide demand toward U.S. goods and services by raising the dollar price of foreign items and lowering the foreign-currency price of U.S. products. What can policymakers do?

The European Central Bank and the Bank of Japan recently focused on

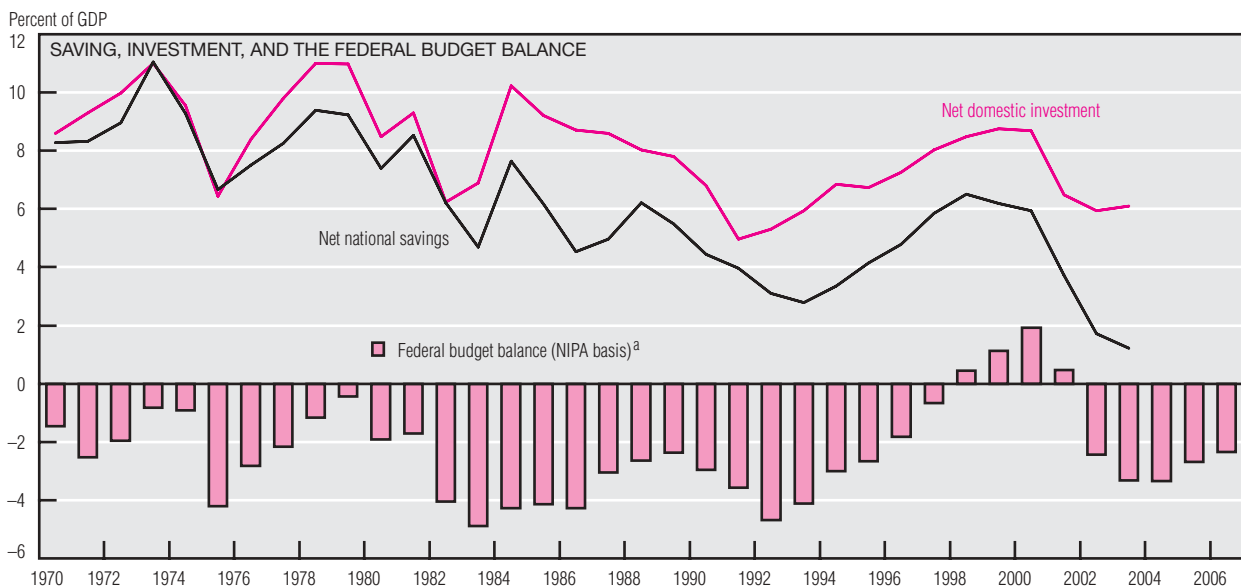
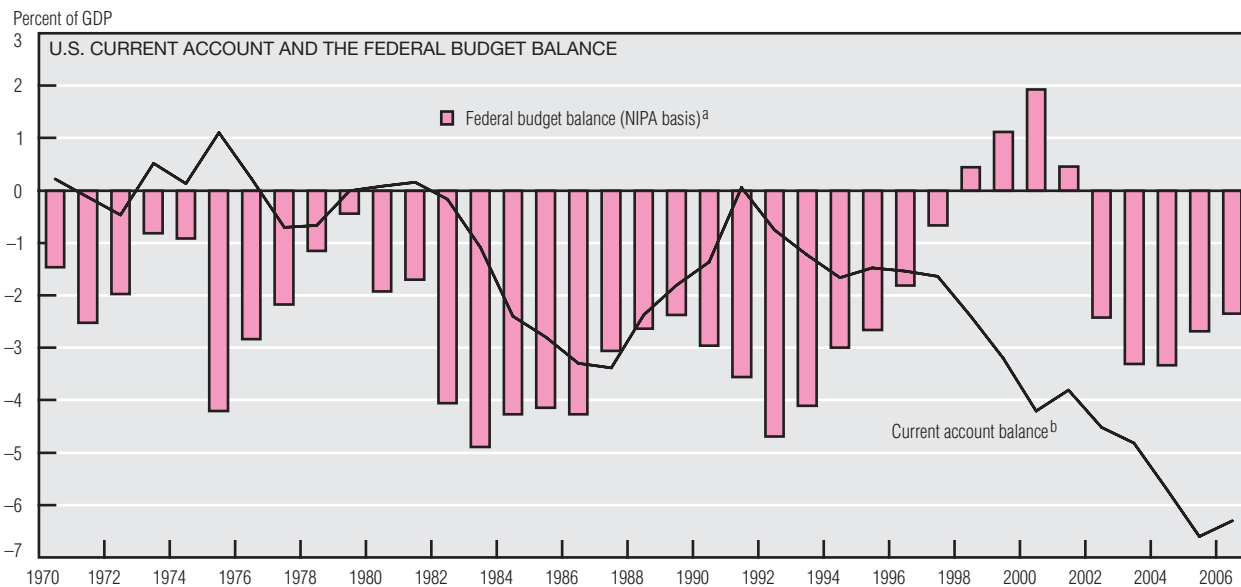
providing sufficient liquidity to accommodate economic growth. The Federal Reserve System, on the other hand, has moved since midyear to reduce the accommodative stance of monetary policy. A further move by each of the three parties in its present direction would seem consistent with slowing the dollar's recent descent and promoting its individual business cycle objective.

Ardently pursuing a weaker dollar, on the other hand, could eventually put each country's inflation objective at risk. The problem is not so great

in Japan, where prices continue to drop, or in the U.S., where inflation, though low, has recently been on an uptick. In Europe, however, inflation is already at the European Central Bank's target limit. Further easing to offset the dollar's appreciation might eventually interfere with the Bank's inflation objective. In that case, any competitive trade advantage gained by offsetting the dollar's depreciation might be lost through higher prices.



# The Twin Deficit Problem



a. Congressional Budget Office forecasts for 2004–06. NIPA refers to U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*.

b. Author's forecasts for 2004–06.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Congressional Budget Office.

The U.S. finances its current account deficits by issuing financial claims—stocks, bonds, Treasury issues, bank accounts, etc.—to the rest of the world. When foreigners hold net financial claims on the U.S., Americans tap these funds to finance investments and consumption. Any country that runs a current account deficit like ours and experiences an inflow of foreign savings will find that its domestic investment exceeds its domestic savings by exactly that amount, assuming no measurement error.

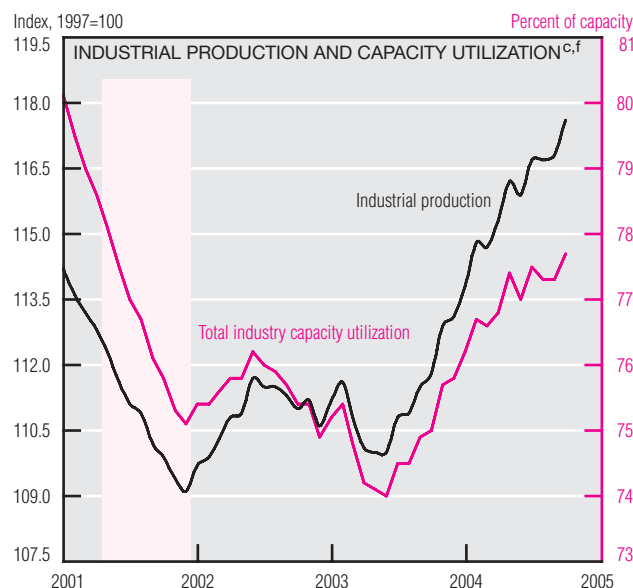
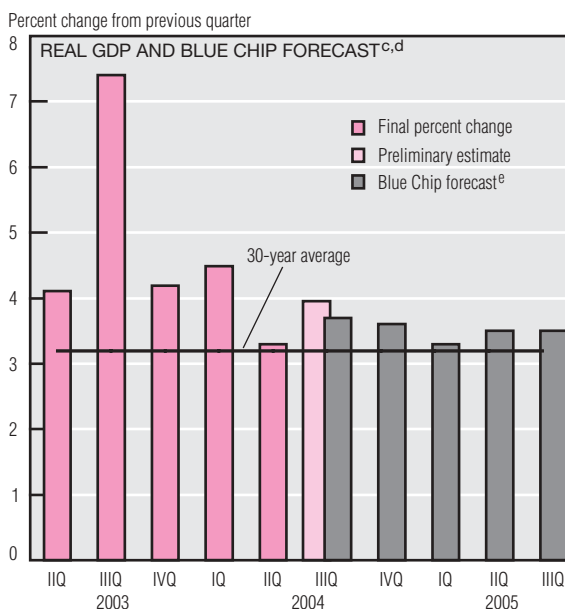
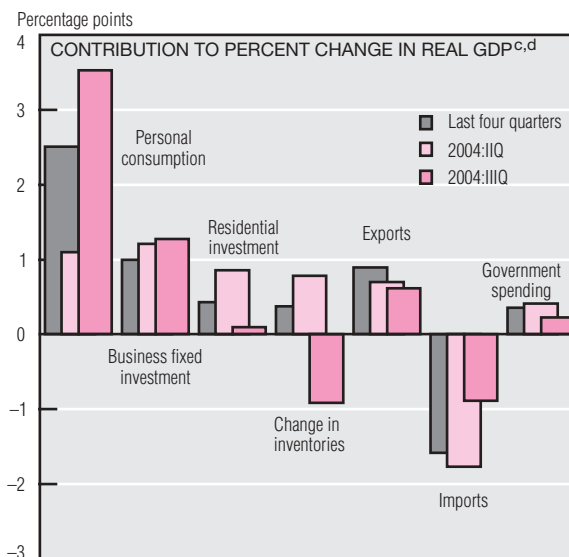
Because the federal government finances its budget shortfalls by issuing

debt instruments to savers, budget deficits (all else constant) reduce the amount of private savings available for financing private investment here—and raise interest rates in the bargain. Attracted by the prospect of higher yields, foreigners channel their savings into the U.S. and fill the growing wedge between domestic investment and savings. In the process, aggregate demand also expands, widening the current account deficit. Many economists refer to this connection as the “twin deficit problem”: A wider government budget deficit leads to a wider current account deficit (all else constant).

All else, however, rarely stays constant. Although this connection is logically straightforward, economists have not mustered much empirical support for it because widening U.S. budget deficits set off all sorts of economic reactions. For example, if budget deficits result in higher interest rates, private investment might fall and private savings might rise with constant or even smaller current account deficits. It seems that the federal and current account deficits are more like distant cousins than twins.

# Economic Activity

	Real GDP and Components, 2004:IIIQ <sup>a,b</sup> (Preliminary estimate)		
	Change, billions of 2000 \$	Annualized percent change, last:	
		Current quarter	Four quarters
Real GDP	105.0	3.9	4.0
Personal consumption	94.4	5.1	3.6
Durables	43.5	17.2	5.5
Nondurables	25.7	4.8	4.2
Services	31.0	2.9	2.9
Business fixed investment	37.4	13.0	10.1
Equipment	39.5	17.2	12.8
Structures	-0.2	-0.3	1.5
Residential investment	2.5	1.8	8.1
Government spending	5.9	1.2	1.9
National defense	11.3	9.8	8.4
Net exports	7.7	—	—
Exports	17.3	6.4	9.5
Imports	25.0	6.0	11.5
Change in business inventories	-25.2	—	—



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.

d. Data are annualized.

e. Blue Chip panel of economists.

f. Shaded areas indicate recessions.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; National Bureau of Economic Research; and *Blue Chip Economic Indicators*, November 10, 2004.

According to the preliminary estimate for 2004:IIIQ, real GDP rose at an annual rate of 3.9%, up from the advance estimate of 3.7%. The upward revision was primarily a reflection of downward revision to imports of 1.7 percentage points (pp) and upward revisions of 0.8 pp to personal consumption expenditures for nondurable goods and 2.3 pp to equipment and software. These were partly offset by a downward revision to private nonfarm inventory investment (1.3 pp).

Unlike the previous quarter, personal consumption in 2004:IIIQ returned to its usual position as the largest contributor to the percent change in real GDP. Imports' negative contribution to real GDP lessened in 2004:IIIQ, while changes in business inventories, which made positive contributions to GDP over the last four quarters, became a drag this quarter.

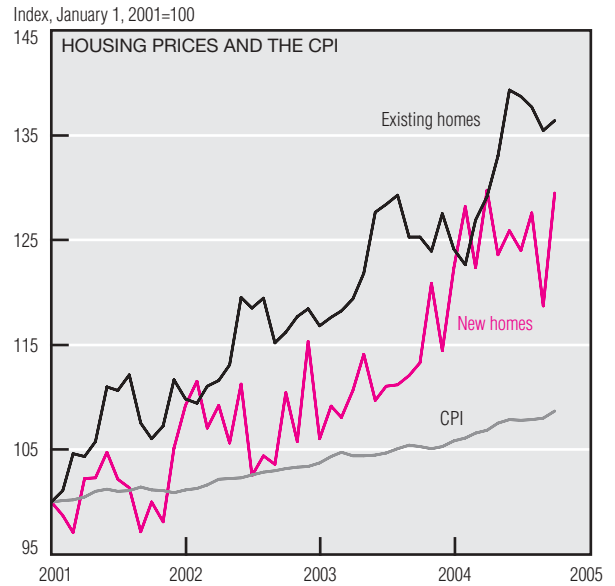
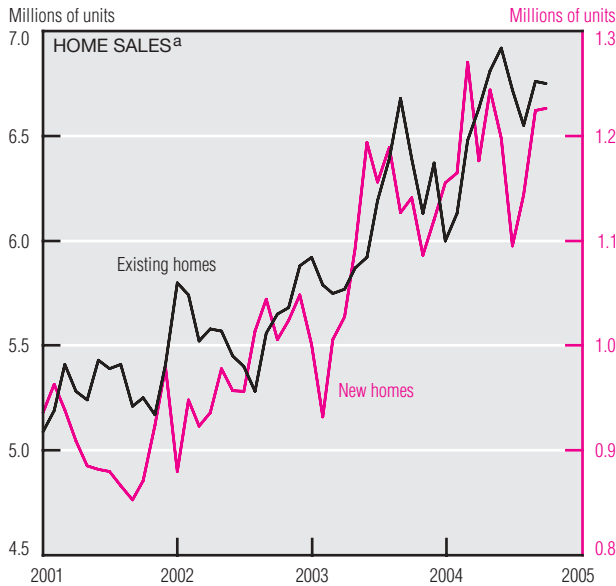
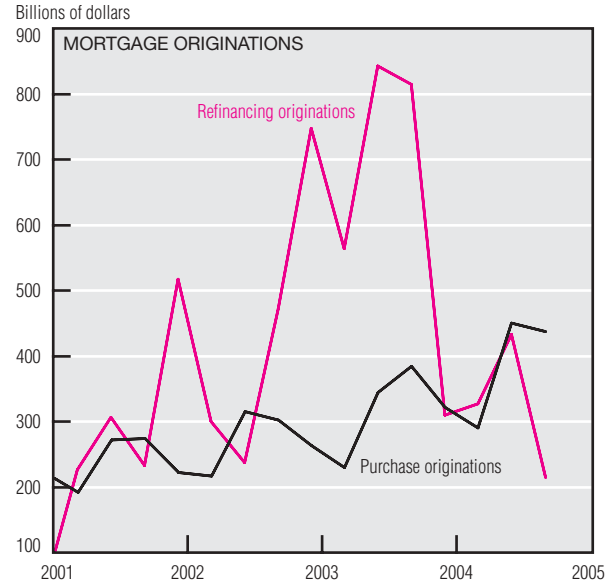
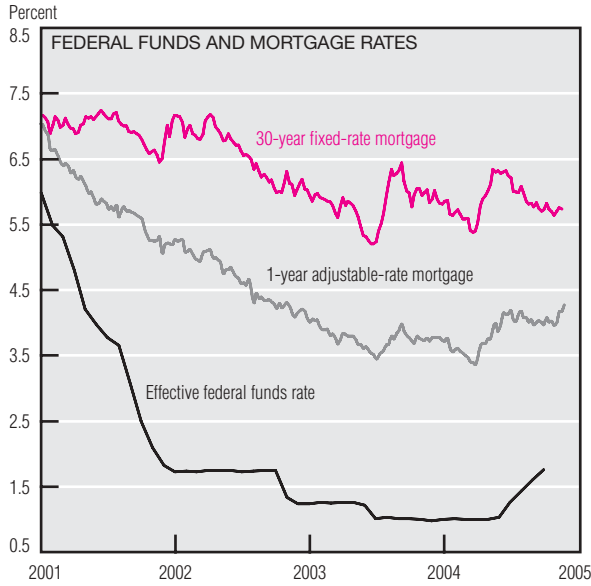
Blue Chip forecasters remain confident that growth will stay on track, predicting 3.6% real GDP growth in 2004:IVQ, only slightly slower than the previous quarter. With the exception

of 2005:IQ, revised downward 0.2 pp from October's forecast, they expect that growth in the next year will remain close to 3.5%.

The industrial sector continues to show signs of strength. At 117.6, industrial production has increased 7.8% since its low at the end of the 2001 recession; it is now slightly above its previous peak of 116.4 in June 2000. Total industrial capacity utilization has also rebounded during this period but, at 77.7%, it remains well below its June 2000 level of 83.3%.

(continued on next page)

## Economic Activity (cont.)



a. Seasonally adjusted annual rates.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System; Mortgage Bankers Association; National Association of Realtors; and Freddie Mac.

The federal funds rate is now 100 basis points (bp) higher than it was at the end of June, but mortgage rates have not increased as much. The 30-year fixed-rate mortgage has increased about 34 bp from its low of 5.4% in 2004, while the average one-year adjustable-rate mortgage, which is much more sensitive to federal funds rate movements, is up about 90 bp from its low for the year.

While not dampening purchase originations, which are driven by home sales, these modestly higher mortgage rates have helped to reduce

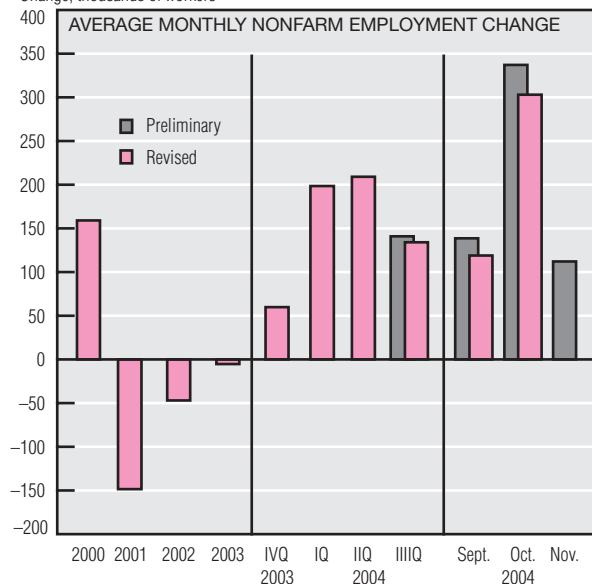
sharply the number of homeowners with a financial incentive to refinance their existing mortgages. The large number of mortgage holders who have already refinanced at this rate also plays a role. Refinancing originations in 2004:IIIQ fell to \$215 billion, the lowest level since 2001:IQ. Purchase originations have remained high because sales of both new and existing homes have remained near their historic peaks. In October, sales of existing homes decreased 0.1% to 6.75 million, still 5.6% higher than October 2003, while new home sales

increased 0.2% to 1.2 million, up 7.4% from the previous year.

Driven by high demand, housing prices continue to rise at a much faster pace than inflation, although prices are slightly off the record highs set earlier in the year. Existing homes, with a median price of \$187,000, experienced the greatest price growth, soaring 36.4% since the beginning of 2001. The median new home now costs \$221,800, up 29.5%. In contrast, consumer prices including food and energy have risen only 8.7% over this period.

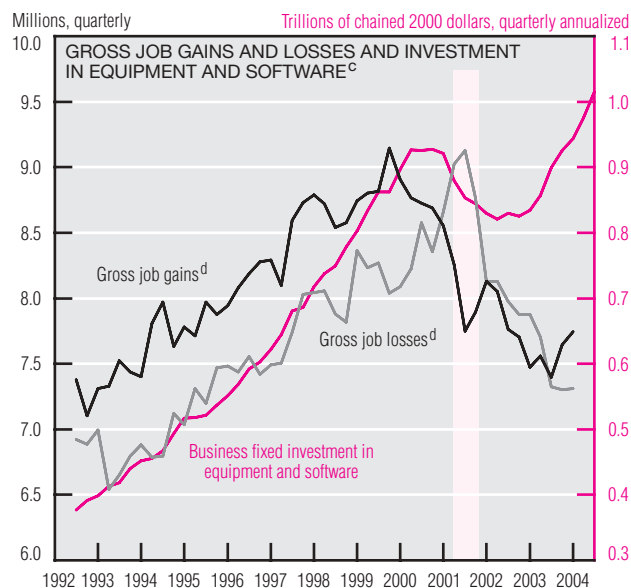
# Labor Markets

Change, thousands of workers



## Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	YTD	Nov. 2004
<b>Payroll employment</b>	-149	-47	-5	185	112
<b>Goods producing</b>	-124	-76	-42	33	8
Construction	-1	-8	7	24	11
Manufacturing	-123	-67	-48	7	-5
Durable goods	-88	-48	-30	10	-6
Nondurable goods	-35	-19	-18	-3	1
<b>Service providing</b>	-25	29	37	153	104
Retail trade	-24	-11	-5	14	-16
Financial activities <sup>a</sup>	8	6	6	11	12
PBS <sup>b</sup>	-63	-17	23	47	28
Temporary help svcs.	-37	2	15	19	9
Education & health svcs.	50	40	28	31	31
Leisure and hospitality	-1	11	8	19	34
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.5	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. Shaded areas indicate recessions as dated by the National Bureau of Economic Research.

d. Gains and losses in private establishments only. Gross job gains measures net job gains at expanding and opening establishments. Expanding establishments are those with net employment gains during the current quarter. Gross job losses measures net job losses at contracting and closing establishments. Contracting establishments are those with net employment losses during the current quarter.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis.

Nonfarm payroll employment grew 112,000 in November after increasing 303,000 in October. Employment gains for September and October were revised down a total of 54,000. Following a drop of 2.7 million from April 2001 to August 2003, employment has grown 2.3 million.

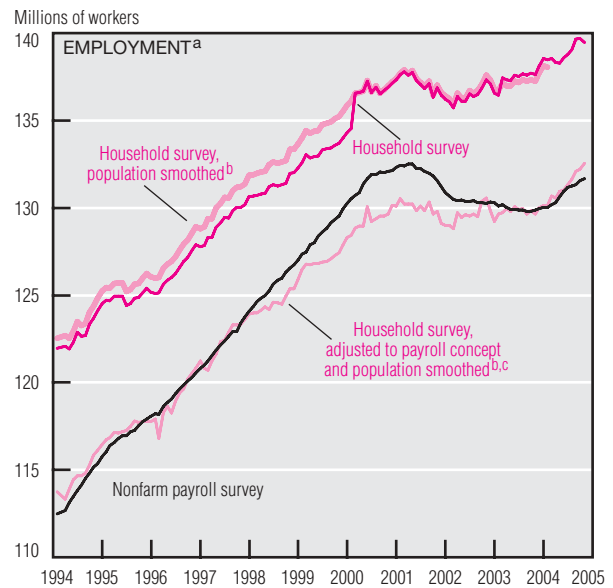
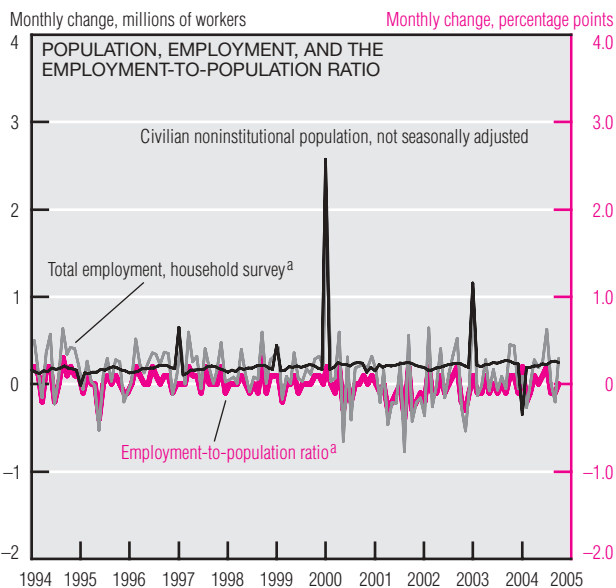
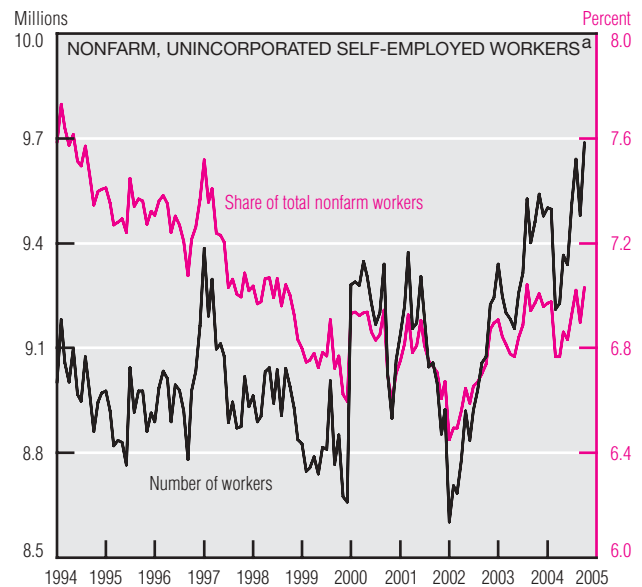
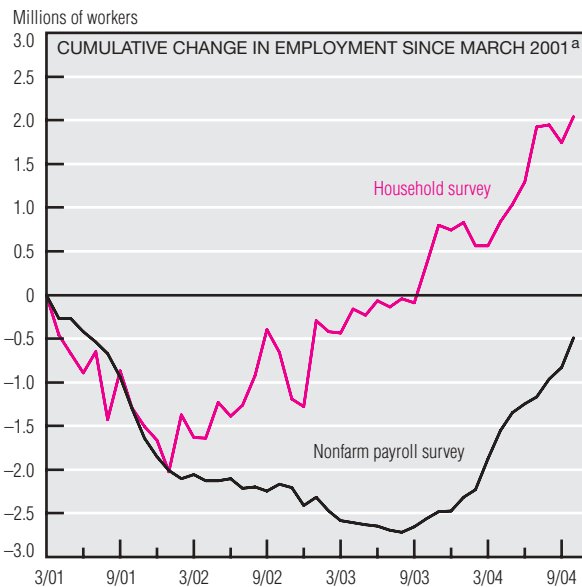
Manufacturing employment fell 5,000 in November and has changed little since its increase of 75,000 from March through May. Construction added 11,000 net jobs following October's hurricane-related increase

of 65,000. Employment in service-providing industries grew 104,000 in November after October's 241,000 increase. About half of this drop-off was in professional and business services, which added 28,000 net jobs in November, compared to the 100,000 net jobs gained the month before. Retail trade employment fell 16,000 in November; since its increase of 179,000 in the first half of the year, it has fallen 23,000. The leisure and hospitality industry added 34,000 net jobs in November, the second-largest gain since January 2003.

In November, the civilian unemployment rate fell 0.1 percentage point and the employment-to-population ratio rose 0.2 percentage point. Over the year, both indicators have improved 0.3 percentage point.

Increased employment growth in the 2003:IVQ and the 2004:IQ resulted largely from rising gross job gains (gains at opening and expanding firms). Gross job gains and equipment and software investment have followed similar patterns since 1992, consistent with the hypothesis that investment and hiring decisions are related.

# Measuring Employment



a. Seasonally adjusted.

b. Population smoothing removes breaks in series for population adjustments in January 2000, January 2003, and January 2004. For details, see <http://www.bls.gov/cps/cpscomp.pdf>.

c. For an explanation of conceptual adjustments, see [http://www.bls.gov/cps/ces\\_cps\\_trends.pdf](http://www.bls.gov/cps/ces_cps_trends.pdf). Adjustments for 2004 account only for conceptual differences, not population smoothing.

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

The most recent Bureau of Labor Statistics (BLS) payroll survey reports that nonfarm employment is 0.5 million lower than it was in March 2001. The BLS's household survey, used to measure the unemployment rate, estimates that employment has *grown* by 2.0 million over the same period.

The two surveys have different concepts of employment. For example, the household survey accounts for the unincorporated self-employed, whose numbers have increased in recent years. However, adjusting the household survey estimate of employment to make it conceptually

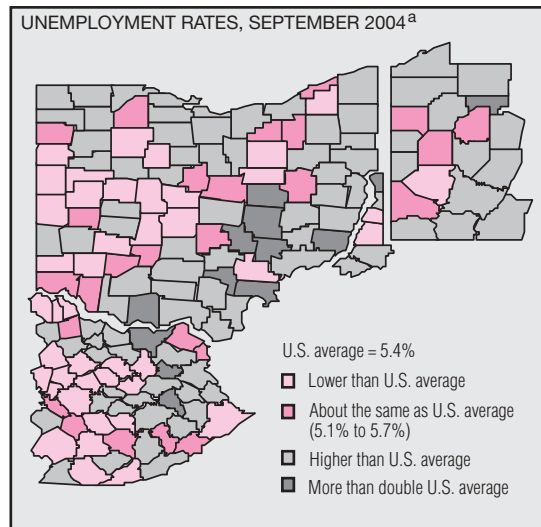
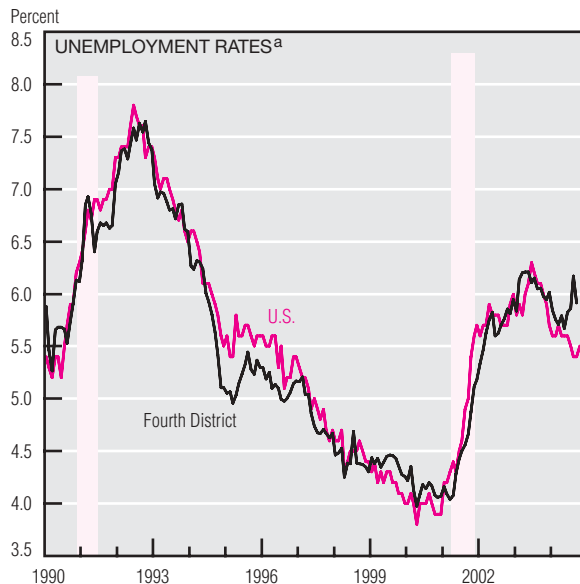
equivalent to the payroll survey estimate does not eliminate the growth discrepancy between the two employment measures since March 2001. The two surveys also differ in their methods for estimating employment. Instead of measuring employment directly, the household survey uses the employment-to-population ratio and infers employment from the Census Bureau's monthly population estimate.

The effect of the household survey's methodology is strikingly evident in January 2002: Because the new census count raised population

estimates for people ages 16 and up by about 2.6 million, household employment for that month was revised up by about 1.6 million. The BLS provides a population-adjusted employment series that smoothes out breaks caused by population events like this one, but only with a considerable time lag.

Errors in population estimates after January 2000 could explain some of the difference between the two employment growth measures, but estimates would have to be wildly off to account for all of it.

# Fourth District Conditions



**Payroll Employment in Fourth District Metropolitan Statistical Areas**

**12-month percent change, September 2004**

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Wheeling	Pittsburgh	Lexington
Total nonfarm	0.1	0.2	0.8	-1.2	-2.0	1.0	0.1	0.8
Goods-producing	-0.6	-0.3	-2.1	-3.4	-2.1	0.0	1.0	1.5
Manufacturing	-1.2	-0.1	-1.9	-3.3	-3.4	0.0	-1.2	0.5
Natural resources, mining, and construction	1.2	-0.7	-2.6	-3.6	2.0	0.0	4.9	4.2
Service-providing	0.3	0.3	1.4	-0.7	-1.9	1.2	0.0	0.6
Trade, transportation, and utilities	-1.3	-1.4	1.4	-3.5	-3.1	3.3	-0.5	0.0
Information	0.5	-1.5	1.9	1.7	4.4	0.0	-2.5	7.1
Financial activities	0.6	1.4	0.4	0.0	2.5	0.0	1.2	-1.8
Professional and business services	0.6	2.1	1.1	-3.8	-4.7	0.0	-0.4	-3.2
Education and health services	2.5	1.6	2.7	2.0	-0.7	-3.0	1.6	0.6
Leisure and hospitality	0.5	-1.5	4.1	1.2	-4.6	2.8	0.2	7.6
Other services	-3.3	-1.4	1.1	-1.6	-1.4	3.6	0.0	3.8
Government	0.3	1.0	-1.3	1.0	0.0	3.0	-1.9	-1.1

a. Seasonally adjusted.  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Fourth District's unemployment rate—compiled from county unemployment rates that are released a month after the states'—fell sharply in September, declining 0.3 percentage point to 5.9%. Beginning in early summer, the District's unemployment rate had risen steadily, diverging sharply from the nation's; by August, it had returned to its expansion high of 6.2%. But the September reading showed the difference between the District and U.S. unemployment rates had

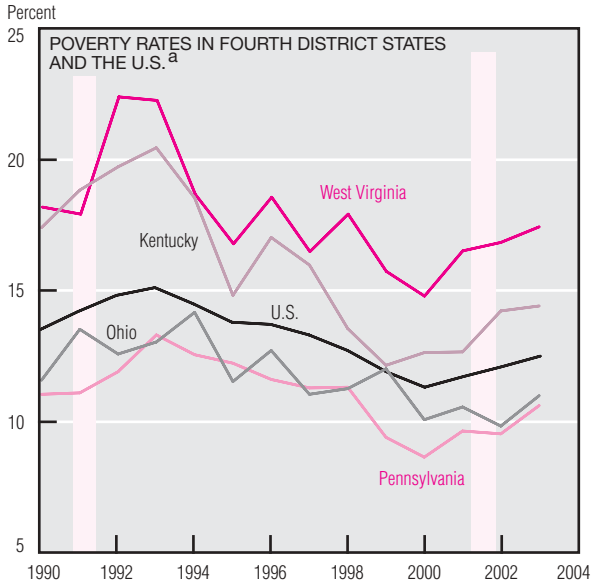
narrowed to a half percentage point. Is this likely to continue?

In September, unemployment rates declined in every District state, but the most important contribution was the drop of 0.3 percentage point in Ohio, where almost 70% of the District's labor force is concentrated. The District's high employment rate during the summer can be traced to Ohio's poor performance in those months.

Ohio's unemployment rate declined markedly in September, with lower

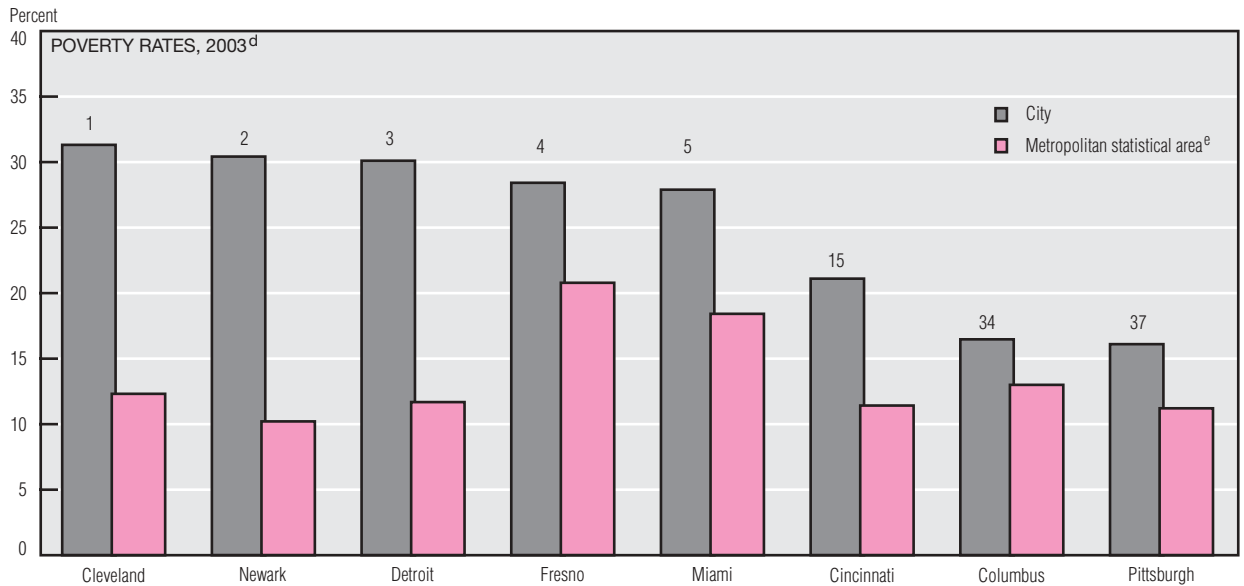
rates in 74 of the state's 88 counties compared with about 20 over the preceding three months. Improved District employment seemed confirmed by 12-month growth of September's nonfarm payrolls in most of the District's largest urban areas. However, Ohio's unemployment rate rebounded to 6.3% in October, suggesting that September may only have been a respite.

# Urban Poverty in the Fourth District



**City Poverty Rates<sup>b</sup>**

	Percent of residents below poverty level			
	2003	2002	2001	2000
Cleveland	31.3	26.3	25.9	24.3
Cincinnati	21.1	23.2	19.8	20.7
Toledo	20.3	19.4	18.7	17.7
Columbus	16.5	16.9	14.4	15.7
Pittsburgh	16.1	17.5	15.6	18.6
Lexington <sup>c</sup>	18.1	18.8	—	—
U.S.	12.7	12.4	12.1	12.2



a. Poverty rates from the Current Population Survey.  
 b. Poverty rates from the American Community Survey. Refers to cities, not MSAs.  
 c. Includes all of Fayette County.  
 d. Numbers above bars are national rankings.  
 e. Due to insufficient data, the Cincinnati MSA is represented by Hamilton County, which has 48% of the MSA's population; the Columbus MSA is represented by Franklin County, which has 67% of the MSA's population.  
 SOURCE: U.S. Department of Commerce, Bureau of the Census.

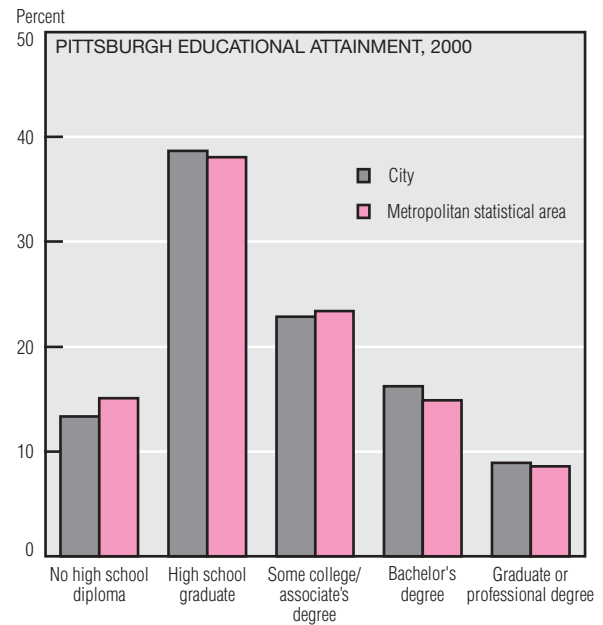
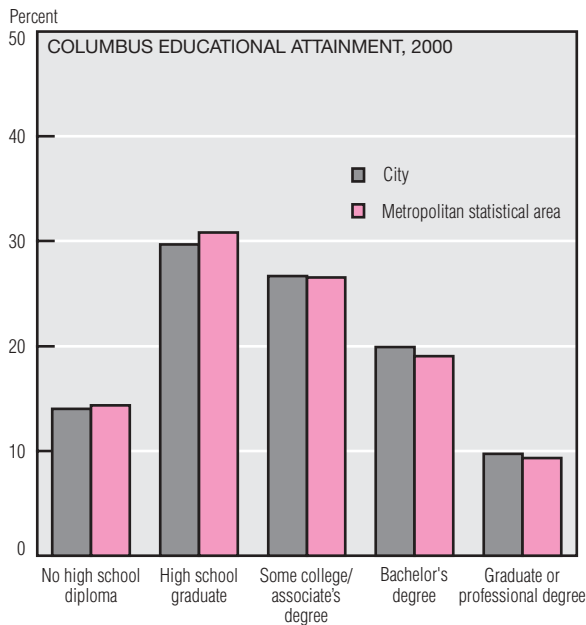
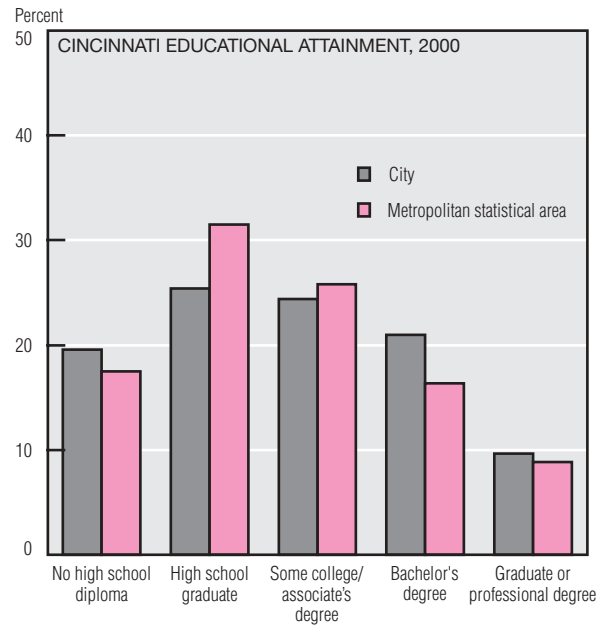
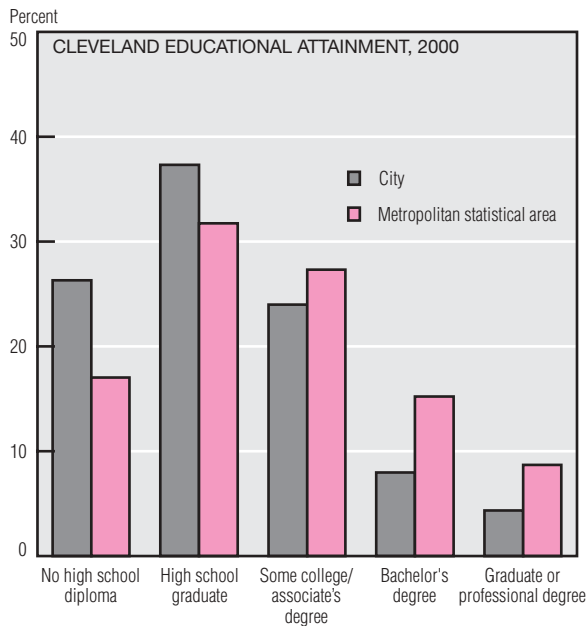
Cleveland recently attracted national attention when the Census Bureau ranked its poverty rate the highest of any U.S. city with a population over 250,000. In part, Cleveland's worsening poverty rate reflects the harsh impact of the recent recession. However, the recession worsened poverty rates across the country to some degree. After trending downward for a decade, poverty rates in the U.S. and in all four Fourth District states began

ticking up in 2000—in advance of the recession. Compared to other District cities of similar size, Cleveland also fares poorly: In 2003, its 31.3% poverty rate was more than 10 percentage points higher than that of Cincinnati, the city with the second-highest poverty rate in the District. Cleveland's poverty rate was nearly double Columbus's 16.5% and Pittsburgh's 16.1%. The comparison to Pittsburgh is especially

striking because the two cities have similarly high concentrations of manufacturing. Finally, Cleveland's poverty rate increase in 2000–03 was 14 times greater than the U.S. and seven times greater than Ohio. Cleveland's difficult passage through the recession is part—but not all—of the story. Because city boundaries are historically determined, they do not usually encompass all relevant economic activity in a labor market. A more

(continued on next page)

## Urban Poverty in the Fourth District (cont.)



SOURCE: U.S. Department of Commerce, Bureau of the Census.

appropriate context for an area's economic information is the metropolitan statistical area (MSA), which is designed to capture most of an area's related economic activity and may span several counties. In this context, the Cleveland MSA looks fairly unremarkable and far more like its counterparts in the District.

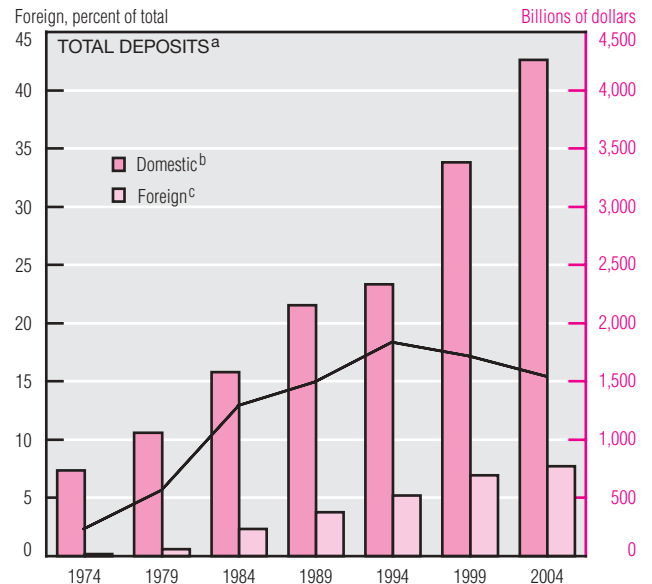
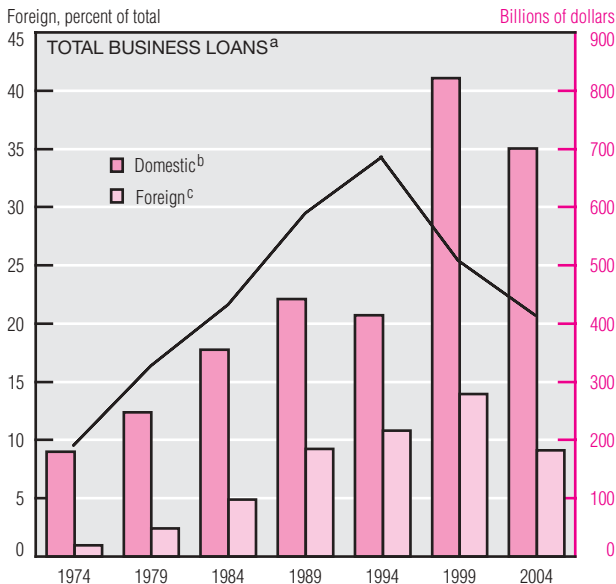
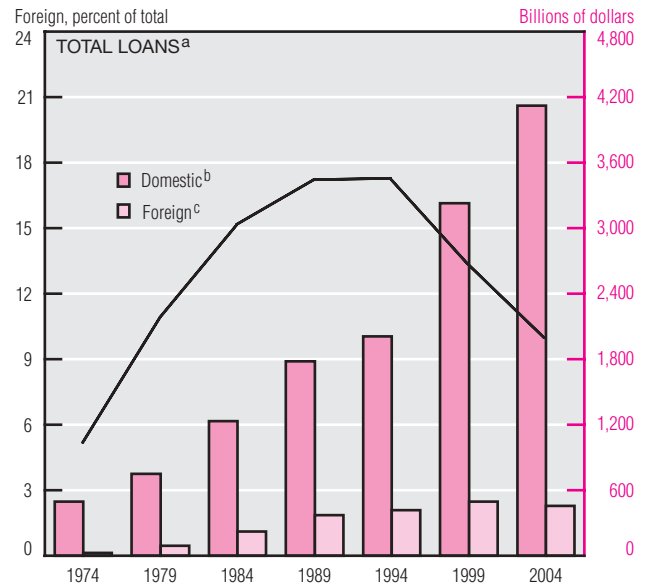
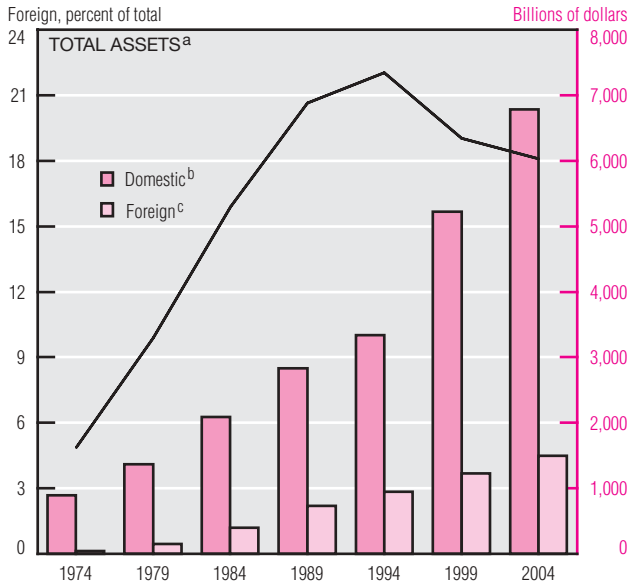
Income differences between the city and the metropolitan area can be partly explained by educational attainment: On average, higher

education levels are associated with higher earnings. In 2000, suburban Cleveland had double the central city's share of people with at least a bachelor's degree. And whereas people with no more than a high school education made up half of the MSA's working-age population, they accounted for about two-thirds of the central city's. These city/MSA disparities in education are more pronounced for Cleveland than for Cincinnati, Columbus, or Pittsburgh.

In educational attainment, Cleveland's central city also compares poorly with Cincinnati, Columbus, and Pittsburgh. In 2000, the share of the central city population with no more than a high school education was over 60% in Cleveland but around 40%–50% in Cincinnati, Columbus, and Pittsburgh. People with at least a bachelor's degree made up only 12% of the central city population in Cleveland, compared to better than 25% in Cincinnati, Columbus, and Pittsburgh.



# Foreign Banking Organizations



NOTE: All 2004 data are as of the second quarter.

a. Total claims, including domestically owned commercial banks as well as foreign banks' branches and agencies in the 50 states and the District of Columbia; New York investment companies (through September 1996); U.S. commercial banks, of which more than 25% are owned by foreign banks; and international banking facilities. The data exclude Edge Act and agreement corporations; U.S. offices of banks in Puerto Rico, the U.S. Virgin Islands, and other U.S.-affiliated insular areas; and foreign bank offices in U.S.-affiliated insular areas. Foreign banks are those owned by institutions located outside the U.S. and its affiliated insular areas.

b. Excludes commercial banks, with more than 25% ownership by foreign banks, but includes international banking facilities as well as banks owned by nonbank foreigners.

c. Adjusted to exclude net claims on own foreign offices.

SOURCE: Board of Governors of the Federal Reserve System, *Structure and Share Data for U.S. Offices of Foreign Banks*.

The U.S. banking industry shows the impact of financial markets' increasing globalization. Clearly, foreign banks are becoming more important to our country's banking system. Total assets held by foreign banks have risen steadily from \$46 billion in 1974 to over \$1,497 billion in mid-2004, more than trebling the share of assets they held from 4.9% to 18.1%.

Similar patterns are apparent in foreign banking organizations' market share of both loans and deposits. Their

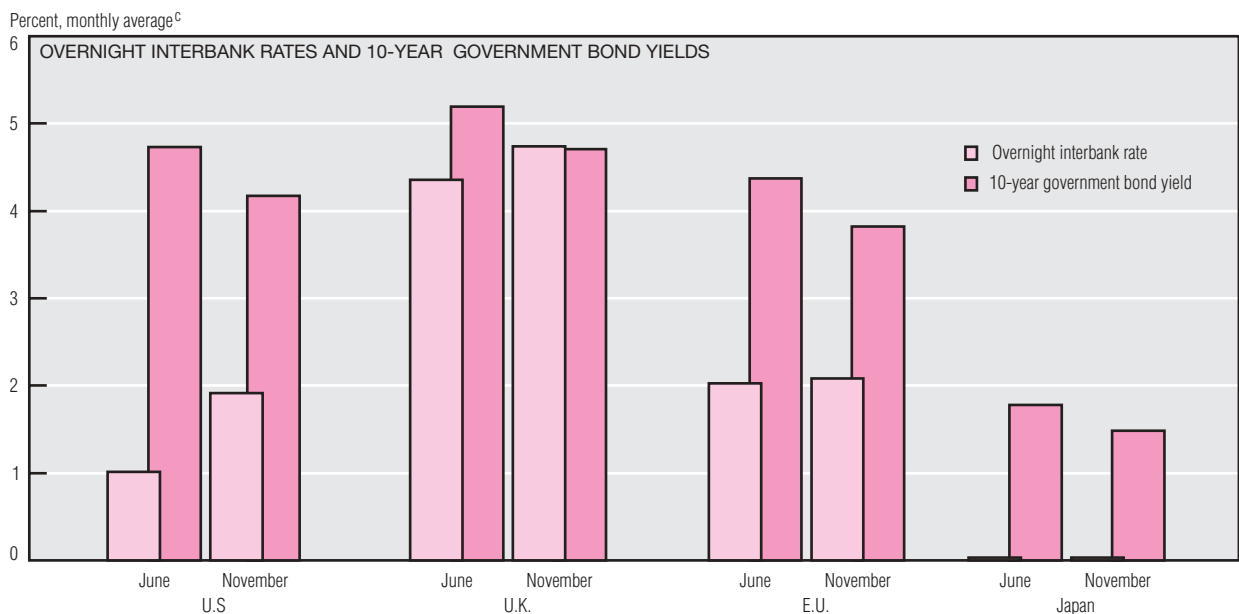
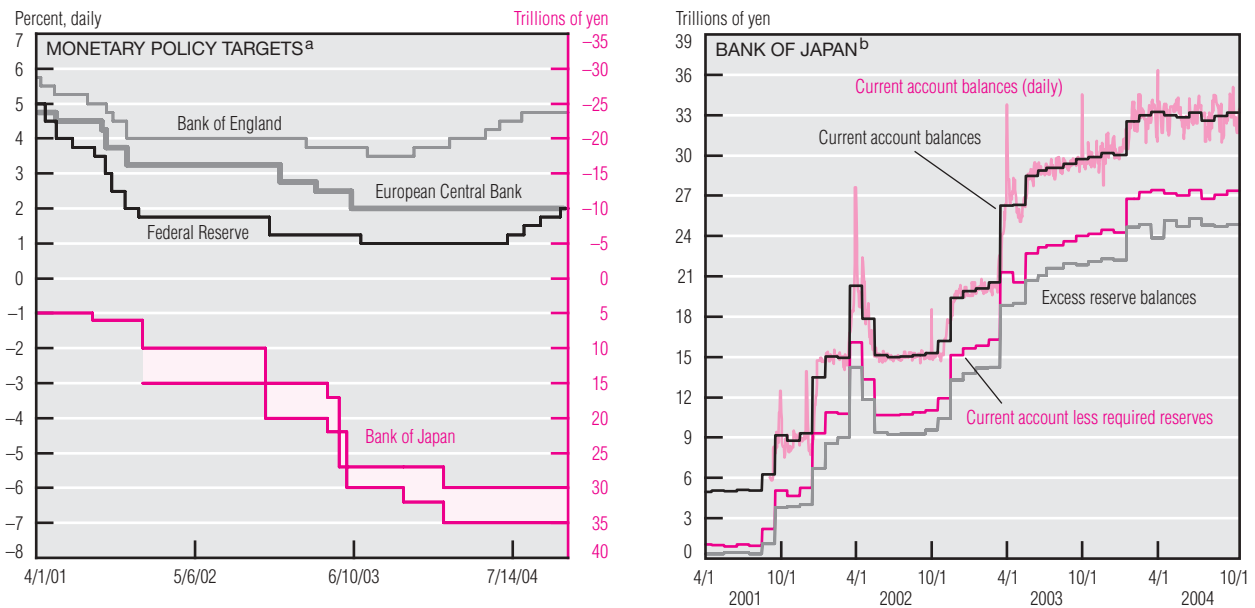
holdings of total loans increased from \$27.0 billion in 1974 to \$455.6 billion at the end of 2004:IIQ, nearly doubling their share of total loans from 5.15% to 9.95%. Given the nature of the lending process and the importance of established bank-customer relationships, it is not surprising that foreign banking organizations' loan share has grown much more slowly than their share of total assets.

On the other hand, foreign banking organizations increased their holdings

of business loans from \$18.8 billion in 1974 to \$182.3 billion as of June 30, 2004, increasing their share from 9.46% to 20.64%. Their greater share of business loans, compared to their share of total loans and total assets, indicates a focus on commercial lending.

Finally, the \$722.8 billion in deposits held by foreign banking organizations, a 15.36% share, confirms that they are important competitors in the U.S. banking system.

# 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.

c. Monthly averages for June and November are based on the first 29 days of the month.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; Bank of England; European Central Bank; Wholesale Markets Brokers' Association; and Bloomberg Financial Information Services.

At its November 10 meeting, the Federal Open Market Committee (FOMC) continued its series of policy rate increases with another 25 basis point (bp) rise in the target for the overnight uncollateralized interbank loan (federal funds) rate. The Bank of England and the European Central Bank target slightly longer-term money market rates, but neither has changed its target repurchase agreement rate recently; the Bank of Japan continues into the eleventh month of a ¥30–¥35 trillion target for its supply of current account balance liabilities.

The FOMC's series of rate increases began at its June 30 meeting. Since then, the federal funds rate has increased 100 bp, in line with the FOMC's view that "policy accommodation can be removed at a pace that is likely to be measured." The U.K.'s overnight interbank rate rose about 50 bp over the same period, reflecting comparable increases in the Bank of England's money market rate target; overnight rates in the euro countries and Japan were essentially unchanged. Long-term bond yields

have declined about 50 bp in the U.S. since June, with comparable or slightly smaller reductions in long-term yields in the other three currencies' bond markets, reflecting some softening since June in the global outlook for real growth and/or inflation. The 150 bp compression in the spread between overnight and long-term dollar yields is one sign of the lessening degree of policy accommodation sought by the FOMC. Although smaller, such a compression is apparent in each of the other three major currencies as well.