

The Economy in Perspective

Trading places... Many analysts believe that the U.S. economy overall will perform much the same in 2005 as it did in 2004. They expect that real GDP will grow in a range centered on 3.5 percent and that core CPI inflation will increase at roughly 2 percent. The unemployment rate is expected to fall only slightly because the number of new jobs will expand commensurate with labor force growth. But beneath the surface, individual sectors could recede and others emerge somewhat compared with the recent past.

Most economists expect consumer spending, business investment, housing, and national defense outlays to remain on a solid footing this year. But because interest rates are thought to be trending up, some analysts predict that housing markets and other interest-sensitive sectors could lose some of their vigor over the course of the year. If the overall pace of economic activity is to hold up, where might some additional thrust be found? Many eyes are focused on the external sector.

During the past 15 years, the United States' international trade and investment positions have spiraled into negative territory. Our trade deficit is now more than 5 percent of GDP, and foreigners' holdings of U.S. assets exceed our claims on foreigners by nearly \$2.5 trillion, or 20 percent of GDP. Should these trends continue, it would be increasingly difficult to finance a continuously expanding net foreign debt. The history of the industrialized countries during the last 25 years teaches us to expect that trade deficits of this magnitude will begin to reverse eventually, and that the reversal will probably be preceded by currency depreciation. That depreciation should make imports more expensive and exports cheaper, although the extent and timing of these price movements are uncertain.

In the case of the U.S., the dollar has already depreciated significantly against the currencies of many trading partners in the past two years, so it would not be surprising to see the net export sector strengthen this year relative to 2004. But the general equilibrium effects of a current account reversal are

hard to predict. After all, the financial counterpart of a large trade deficit is a large capital inflow. If the trade deficit shrinks back toward zero, the magnitude of foreign savings flowing into the United States must necessarily shrink toward zero as well. All else equal, U.S. interest rates will tend to rise because funds are scarce and will restrain such interest-sensitive sectors as housing, durable goods consumption, and business investment. If the U.S. export sector expands rapidly enough, it could compensate for a relative weakening in other domestic sectors, but how the overall economy would fare depends partly on adjustments abroad.

The export sectors of foreign economies could slow, even as an enlarged savings pool reduced domestic interest rates and stimulated their interest-sensitive sectors. Foreign countries could also take actions that would stimulate domestic consumption. Whether these forces, on balance, will promote stronger economic growth in the United States, or in foreign countries, is unknown. History provides examples of both outcomes.

The fundamental determinants of a nation's current account include such characteristics as national differences in tax, saving, investment, productivity, and trade policies. Consequently, if current account patterns are to shift in a meaningful way, some aspect of the fundamentals must shift as well. In the United States, for example, greater fiscal restraint over time would increase national saving and, other things equal, lead to less reliance on foreign saving.

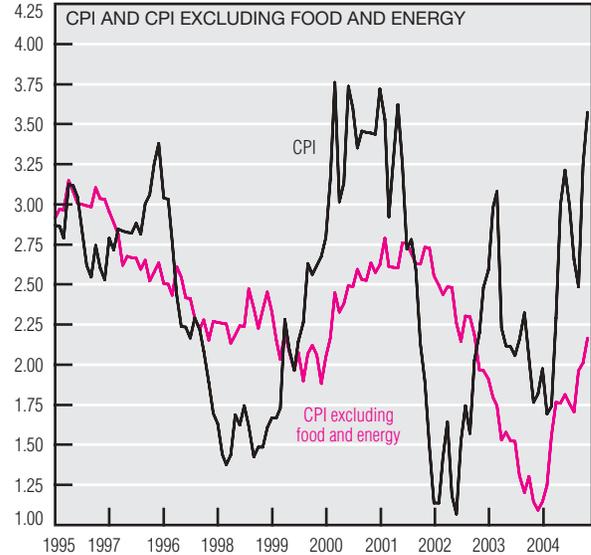
Considering the movement in exchange rates, interest rates, and relative prices that can accompany current account adjustments, it is easy to see why some people might think the cure is worse than the disease. Even though fundamental current account reversals can be accompanied by employment and output expansions in some industries and locations, others might not fare as well. But if the adjustments proceed in an orderly way over an extended period, the reallocations can occur within the context of the other adjustments that take place in dynamic market systems and need not be especially disturbing.

Inflation and Prices

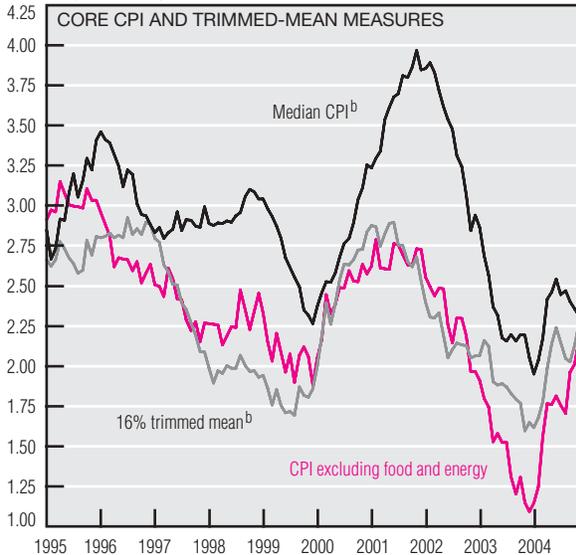
November Price Statistics

	Percent change, last:				2003 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	1.9	3.9	3.6	2.6	1.9
Less food and energy	1.8	2.7	2.2	2.1	1.1
Median ^b	1.1	1.6	2.3	2.9	2.1
Producer prices					
Finished goods	6.5	9.5	5.1	2.4	4.4
Less food and energy	2.4	3.4	1.9	1.0	1.1

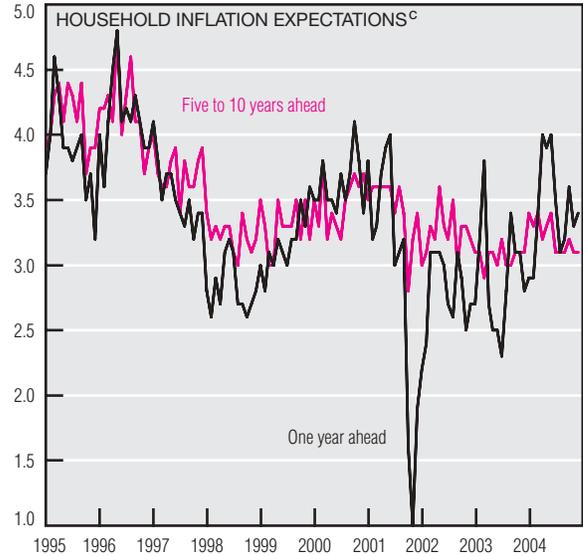
12-month percent change



12-month percent change



12-month percent change



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

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

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

Retail price measures grew modestly in November. The Consumer Price Index (CPI) rose at a 1.9% annualized rate during the month after surging 7.9% in October. Growth in alternative retail price measures was equally restrained: The core CPI, which excludes volatile food and energy prices, rose 1.8%, whereas the median CPI, which examines the center of the monthly price change distribution, rose a mere 1.1%—its smallest monthly growth rate in over a year.

The 12-month growth rates in the core CPI, the 16% trimmed-mean CPI, and the median CPI continued to hold steady between 2.0% and 2.5%. However, although the 12-month growth rate of the median CPI is roughly the same as in November 2003, the rates of the CPI and the core CPI have about doubled since then.

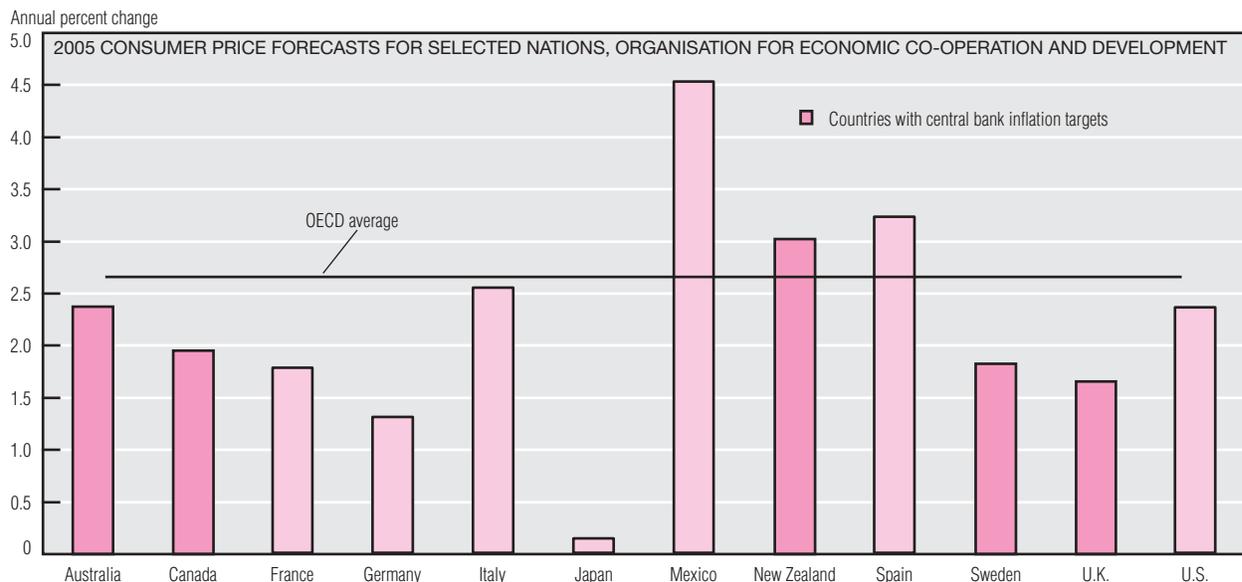
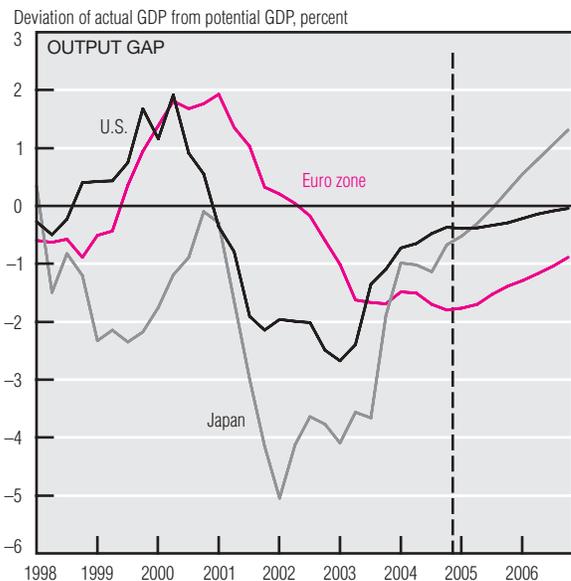
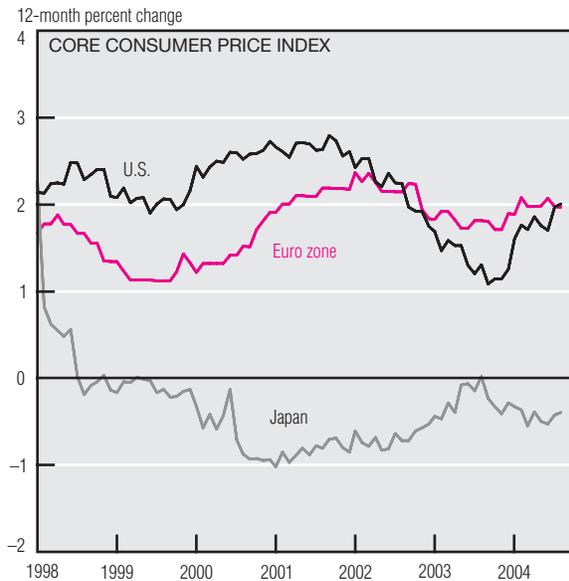
Meanwhile, survey data indicate that inflation expectations are holding steady. The year-ahead inflation expectations of households included

in the University of Michigan's *Survey of Consumers* ranged between 3.1% and 3.6% over the past six months, while five- to 10-year inflation expectations remained constant at around 3.1% over the same period.

Throughout the past several years, the relatively moderate growth of core retail prices in the U.S. generally has mirrored the euro zone, where the 12-month growth rate of core retail prices has ranged between 1.0% and 2.5%. In the Organisation

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Inflation and Prices (cont.)



SOURCES: Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, No. 76, December 2004.

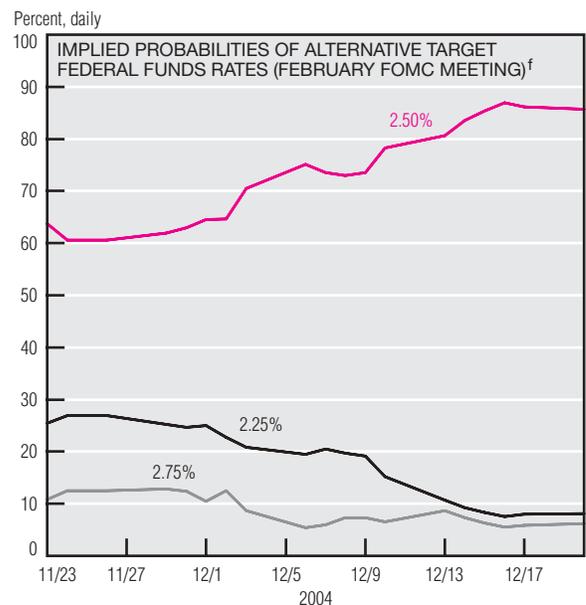
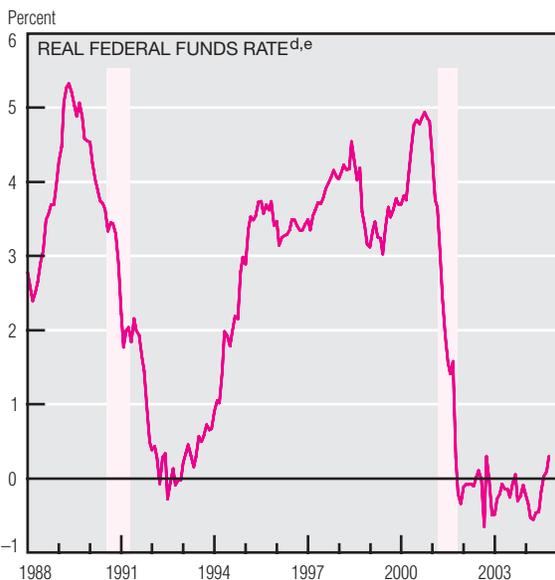
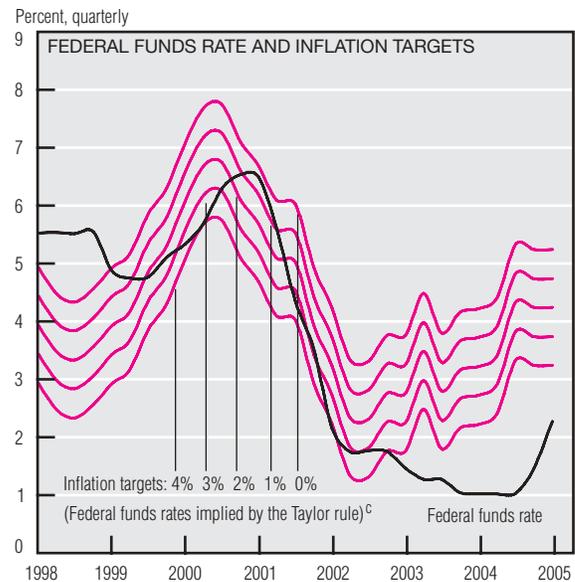
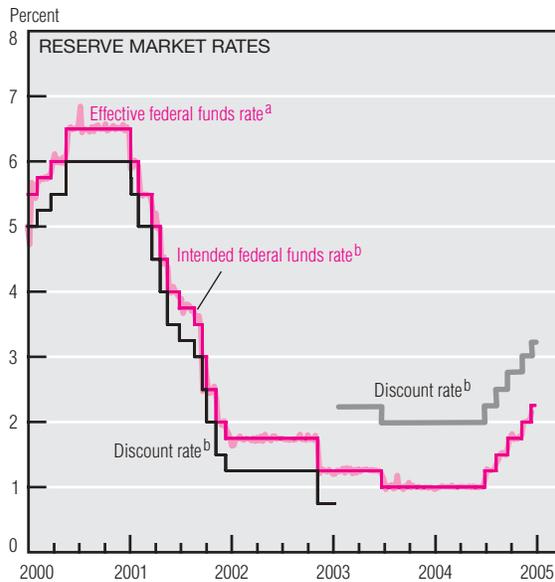
for Economic Co-operation and Development's (OECD) *Economic Outlook*, the moderate rise in overall consumer prices is projected to continue in 2005. The OECD's U.S. inflation forecast predicts that retail prices will rise 2.4% in 2005; prices in most European countries are expected to rise between 1.5% and 2.5%. In contrast, consumer prices in Japan, which has undergone price deflation for more than six years,

are expected to remain essentially unchanged.

One standard economists use to gauge inflationary pressures is the amount of slack (underutilized resources) in the economy, called the output gap. It is intended to measure the difference between the economy's potential output and its actual output; presumably, as the amount of slack is used up, inflation accelerates. Current estimates of the U.S. output gap, as reported by the

OECD, suggest that U.S. potential output has exceeded actual output since 2001 and projects that the gap will close only gradually over the next two years. The OECD's estimate of economic slack in the euro zone suggests somewhat less inflationary pressure there because their economic slack remains even more elevated, whereas for Japan, the OECD forecasts that resources will become fully utilized sometime this year.

Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

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

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

e. Shaded bars indicate periods of recession.

f. Probabilities are calculated using trading-day closing prices from options on February 2005 federal funds futures that trade on the Chicago Board of Trade.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

On December 14, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate by 25 basis points (bp) to 2.25%, its fifth consecutive upward move. (Separately, the Federal Reserve's Board of Governors raised the discount rate to 3.25%.) The FOMC remarked that "even after this action, the stance of monetary policy remains accommodative," and in fact, the fed funds rate remains low by several conventional standards. One, the Taylor rule, posits that the FOMC balances its

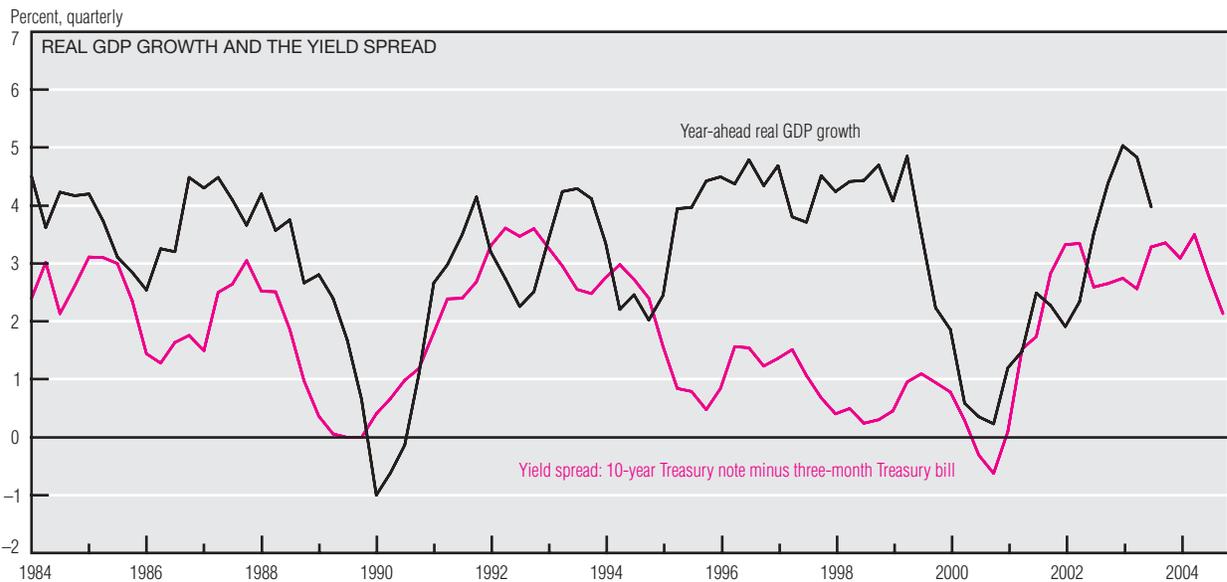
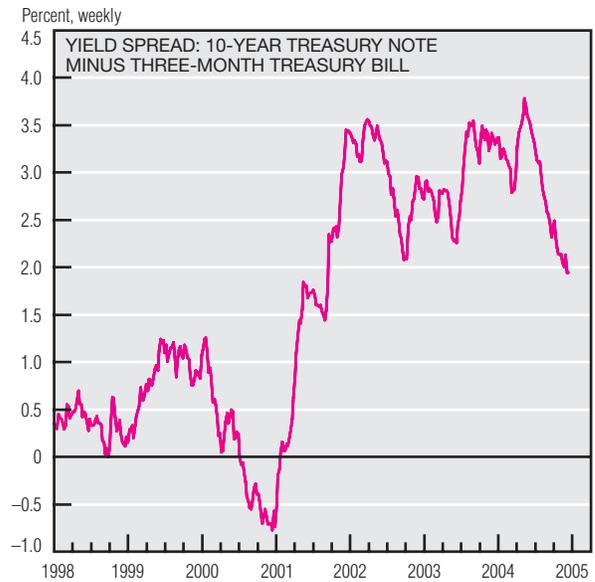
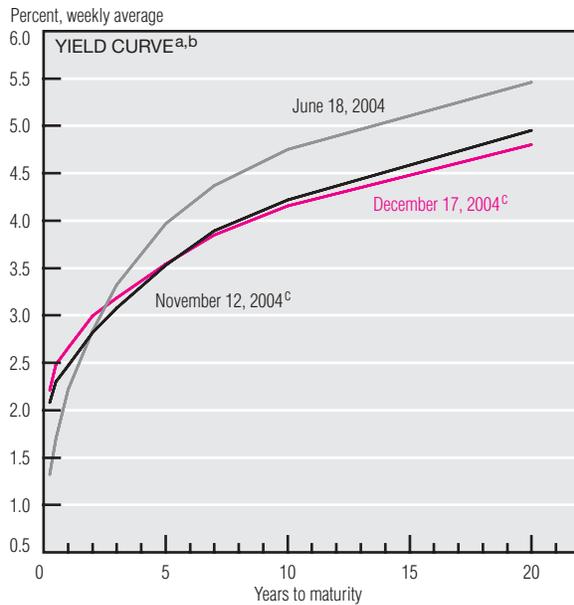
response between economic growth and inflation. The form of the Taylor rule depends on the weights given to inflation and output and the assumed inflation target. Since mid-2002, the rate has stayed below the rule's prediction, even assuming a rather high inflation target of 4%. In the past several months, however, the gap has diminished from 230 bp to 97 bp.

The real federal funds rate (the fed funds rate less current inflation) is another standard. The real rate has been mostly negative since 2001. Although

it increased noticeably in 2004, going positive in August, it remains low by recent historical standards.

Does this accommodative policy presage more rate increases? Market participants seem to think so. Evidence from options on fed funds futures implies that traders see an 86% probability that the rate will be raised to 2.50% at the February 2005 meeting. The odds of no change or increasing the target by 50 bp are both less than 10%.

Money and Financial Markets



a. All yields are from constant-maturity series.

b. Average for the week ending on the date shown.

c. First weekly average available after the FOMC meeting.

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; and Bloomberg Financial Information Services.

The federal funds rate gets attention, not because everyone borrows or lends at that rate (only banks do), but because its movement affects other rates at which people do borrow and lend. A good overview of how these other rates have changed is provided by the yield curve, which plots interest rates on Treasury securities against their maturity. The latter half of 2004 has seen a gradual flattening of the yield curve. Since last month, three-month rates have increased

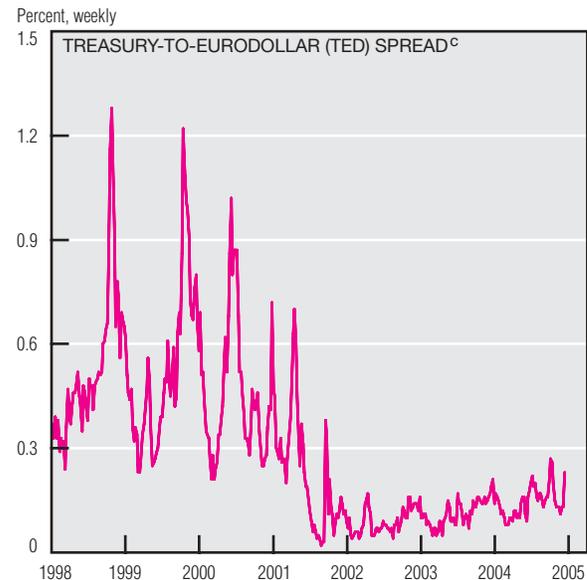
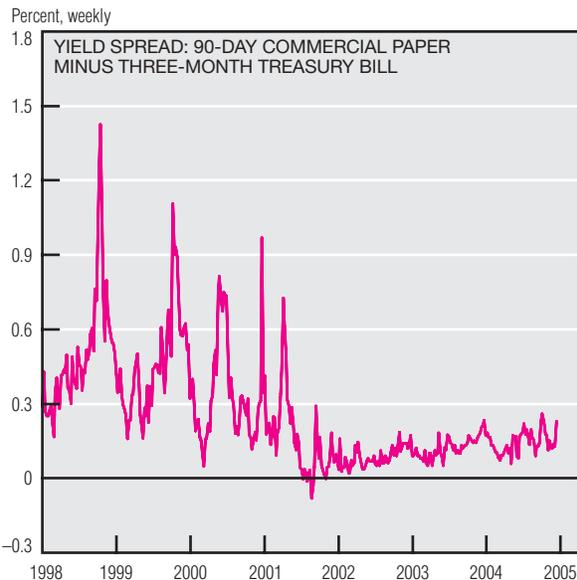
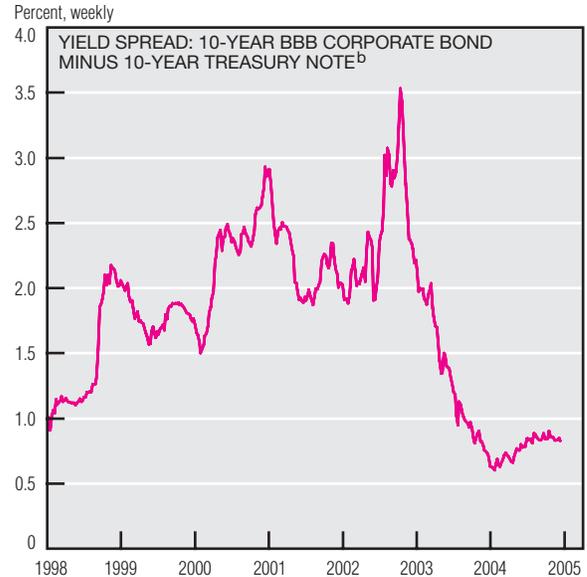
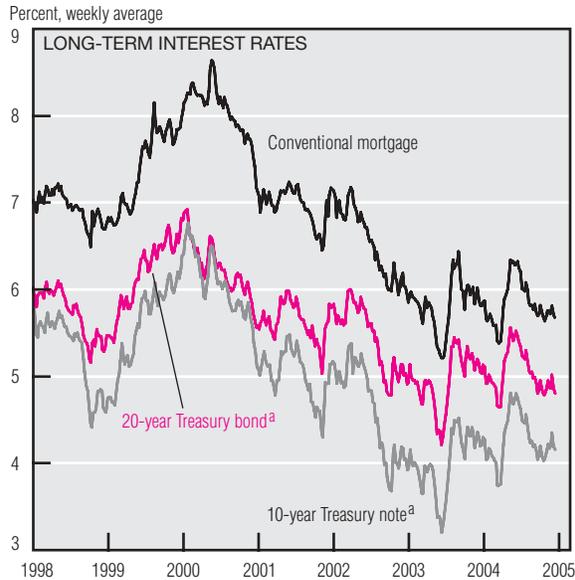
from 2.08% to 2.21% as 10-year rates fell from 4.22% to 4.15%. This merely continued an earlier trend: In June, the three-month rate stood at 1.32% and the long rate at 4.75%.

Despite this flattening, the yield curve remains steep by historical standards. Although it dropped from 378 basis points (bp) in May to its current level of 195 bp, the benchmark 10-year, three-month spread remains well above its historical average of 120 bp.

The slope of the yield curve is often watched as an indicator of future economic growth. A steep yield curve heralds strong growth, and an inverted yield curve (short rates above long rates, a negative spread) signals a recession. Though not always right, the spread has an enviable record, as a plot of the 10-year, three-month spread against year-ahead future GDP growth shows. This relation indicates robust growth for 2005.

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Money and Financial Markets (cont.)



a. All yields are from constant-maturity series.

b. Merrill Lynch BBB index minus the yield on the 10-year Treasury note.

c. Yield spread: three-month eurodollar deposit minus the three-month, constant-maturity Treasury bill.

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

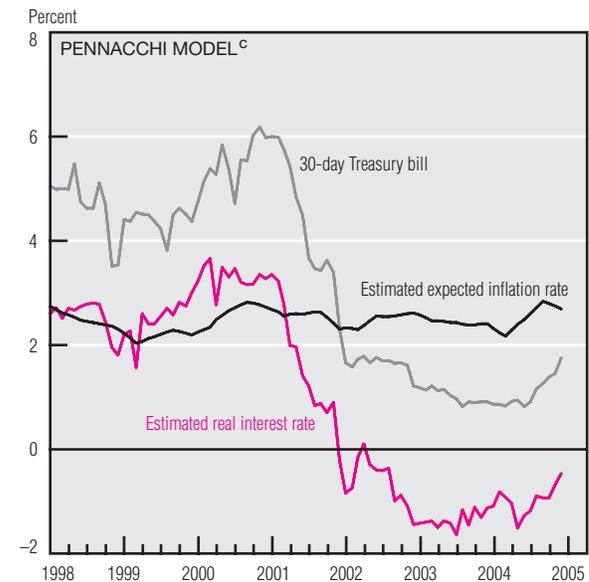
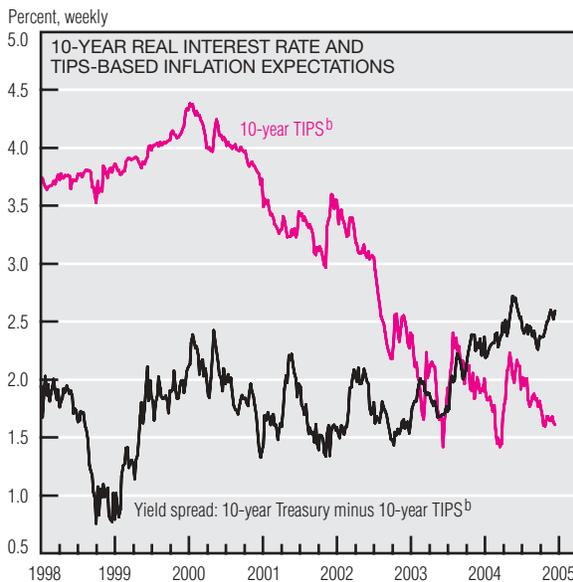
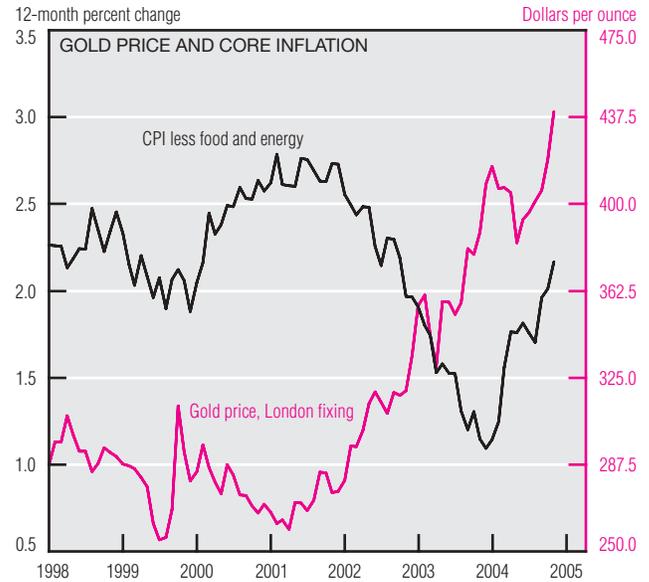
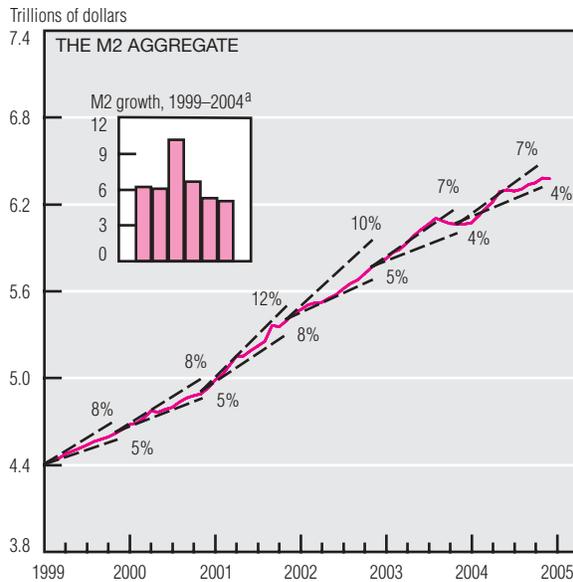
Important as Treasuries are, other interest rates are more directly relevant to most people. Homeowners look to mortgage rates; businesses look to their bond rates. These have generally come down along with Treasury rates, but the differences are revealing. Since May, mortgage rates have in fact fallen faster than (10-year) Treasuries, dropping 66 bp to the Treasuries' 46 bp. Other risk spreads (so called because they track the difference between safe Treasury and

risky private rates) have increased lately. At the longer end, the spread between 10-year, BBB-rated corporate debt and 10-year Treasuries has increased 9 bp since May (and 20 bp since January). At the shorter end, the spread between commercial paper and three-month T-bills has moved up 17 bp. Neither change, however, seems particularly worrisome because both the absolute level and the change remain low by historical standards.

Another closely watched risk spread is that between three-month eurodollar deposits and the three-month T-bill rate—the TED spread. Because it shows the difference between two interest rates denominated in dollars but based in different countries, it measures international financial risk while avoiding exchange rate uncertainty. Although it has shown slight increases lately, it remains low, despite wars and rumors of war.

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Money and Financial Markets (cont.)



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.

b. Treasury inflation-protected securities.

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

SOURCES: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6; Bloomberg Financial Information Services; and *Wall Street Journal*.

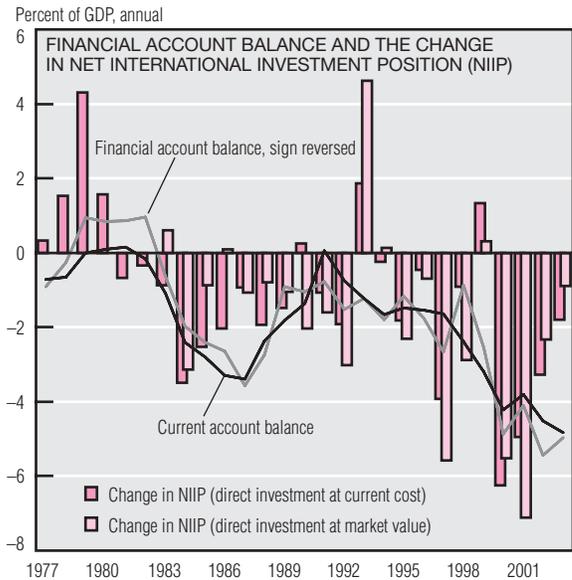
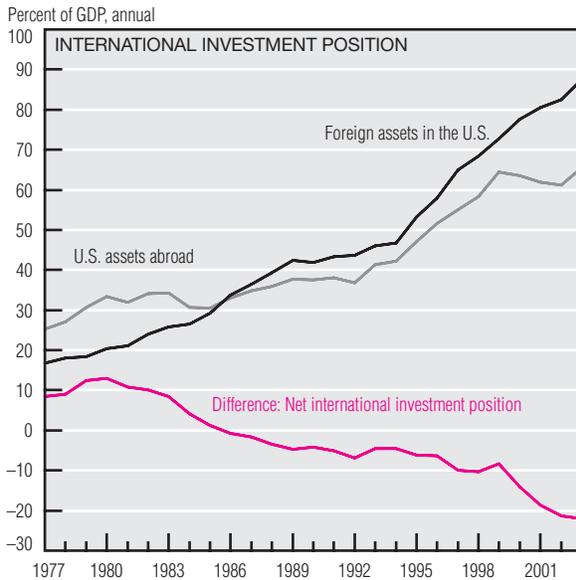
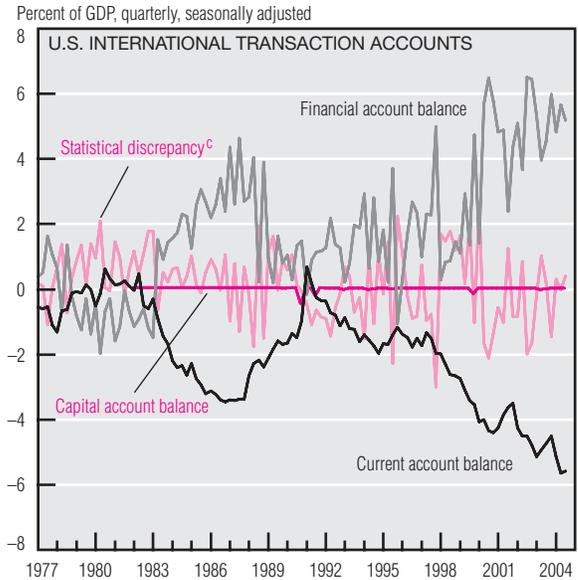
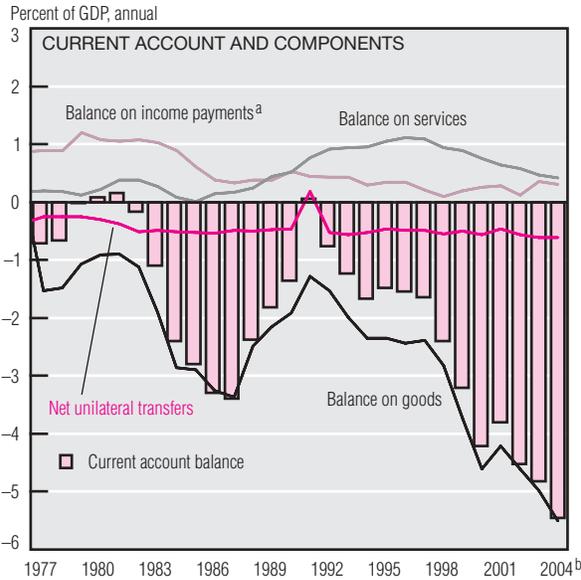
Money in circulation grew at a 5% pace in 2004. In itself, this tells little about inflation because the economy is growing too, but financial markets also embody expectations of inflation. The recent rise in gold has kindled some fears of inflation, but the link between gold and consumer prices is often tenuous because of both shifting industrial demand and central banks' sales of the metal.

Another measure comes from the yield on Treasury inflation-protected

securities (TIPS). The difference between that real rate and a corresponding nominal rate provides a measure of expected inflation. Although real rates have fallen since May, expected inflation has increased 33 bp since September. Of potentially greater concern, however, is the increase of nearly 120 bp since October 2002. Some of this increase probably derives from changes in the liquidity of TIPS, however, and does not reflect price-level expectations.

Combining financial data with survey measures gives a complementary view of real rates and expected inflation. The Pennacchi model, which combines survey forecasts with T-bill rates, shows a real rate that is negative though increasing, with inflation creeping up half a percentage point since March. It thus appears to confirm other measures that show rising concerns about inflation.

International Transactions



- a. Payments on domestically owned assets abroad minus payments on foreign-owned assets in the U.S.
 b. 2004 data are based on averages through the first three quarters only.
 c. Sum of current, financial, and capital account balances with signs reversed.
 SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The current account balance measures the combined balance on international trade, net foreign investment income, and net unilateral transfers to foreigners. Largely because of persistent trade deficits, the current account balance has fallen considerably over the last seven years, reaching 5.6% of GDP in the third quarter of this year. A current account deficit must be exactly offset by the combined surplus in the capital account and the financial account. (The financial account is the difference between the net inflow of foreign-owned assets in the U.S. and

the net outflow of U.S.-owned assets abroad.) Since the capital account is small, relatively speaking, a current account deficit will very nearly equal a financial account surplus, except for measurement error.

The financial account feeds directly into the net international investment position (NIIP), the difference between U.S.-owned assets abroad and foreign-owned assets in the U.S. As foreign- and U.S.-owned assets have grown over time, changes in the valuation of these asset positions have come to play a larger role in year-to-

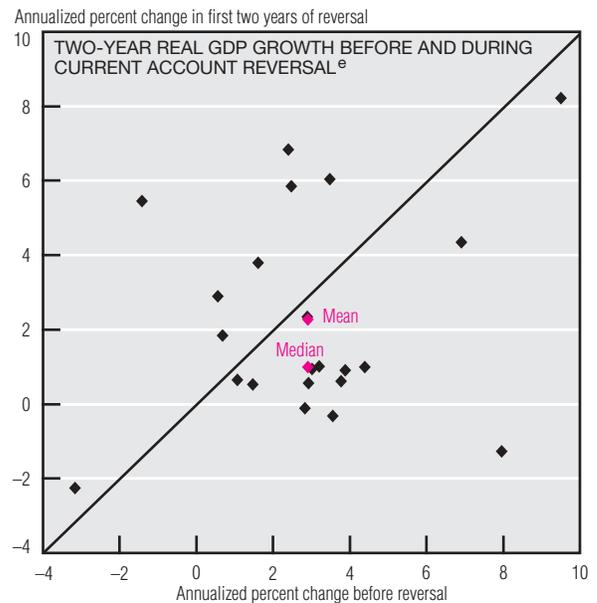
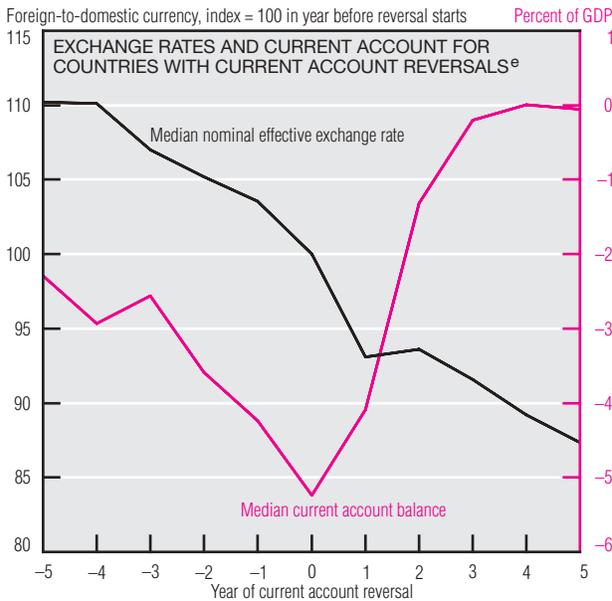
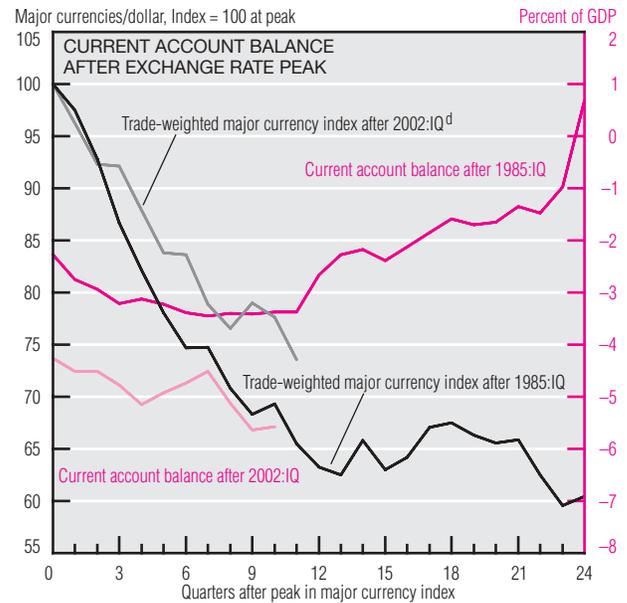
year changes in the NIIP. For example, in 2003 the financial account showed a \$546 billion surplus, but the NIIP declined only \$198 billion. Since roughly half of U.S. assets abroad are held in foreign currencies, and most foreign-owned assets are dollar denominated, the direct effect of the 2003 dollar depreciation was an increase in the NIIP that offset nearly half of the negative contribution from the financial account.

The NIIP has nevertheless continued to fall relative to GDP. In recent

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International Transactions (cont.)

Net International Investment Position (NIIP) (Trillions of dollars)					
	2002 position	Financial flows	Exchange rate changes	Price & other changes	2003 position
NIIP^a	-2.23	-0.55	0.26	0.09	-2.43
U.S.-owned assets abroad^a	6.41	0.28	0.33	0.18	7.20
U.S. gov't assets	0.24	0.00	0.01	0.02	0.27
Direct investment ^a	1.84	0.17	0.06	0.00	2.07
Non-U.S. gov't stocks and bonds	1.85	0.07	0.23	0.33	2.47
Other ^b	2.48	0.04	0.03	-0.16	2.39
Foreign-owned assets in U.S.^a	8.65	0.83	0.07	0.09	9.63
Foreign official assets	1.21	0.25	0.00	0.01	1.47
Foreign direct investment ^a	1.51	0.04	0.00	0.01	1.55
Nonofficial stocks and bonds	3.24	0.36	0.31	0.28	3.93
Other ^c	2.68	0.18	0.02	-0.21	2.67



a. Direct investment valued on current-cost basis.

b. Includes U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns and U.S. claims reported by U.S. banks, not included elsewhere.

c. Includes U.S. currency, U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns, and U.S. liabilities reported by U.S. banks, not included elsewhere.

d. Observation for 2004:1VQ is based on data through December 17.

e. Data since 1980 from countries with 1997 per capita GDP of at least \$10,000. Definition of current account reversals is from Caroline L. Freund, "Current Account Adjustment in Industrialized Countries," Board of Governors of the Federal Reserve System, International Finance Discussion Paper no. 692, 2000.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

years, the rate of return on domestically owned assets abroad has exceeded the rate of return on foreign-owned assets in the U.S. to such an extent that income receipts on the former have exceeded income payments on the latter. As the NIIP continues to fall, some analysts expect that the balance on income receipts and payments will soon become negative. The growth in this financing cost of accumulating net foreign

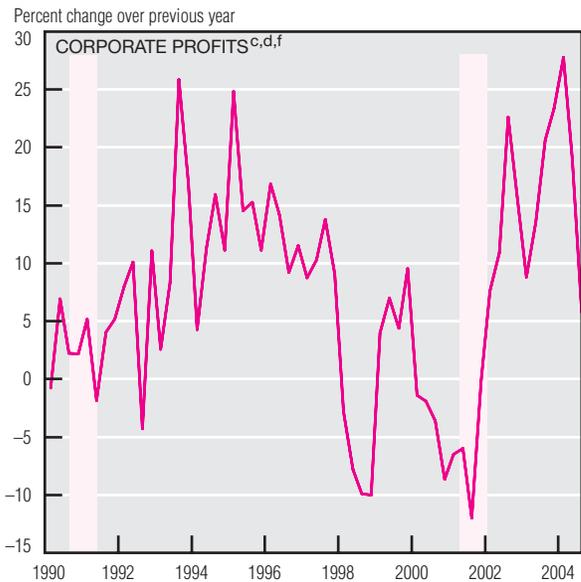
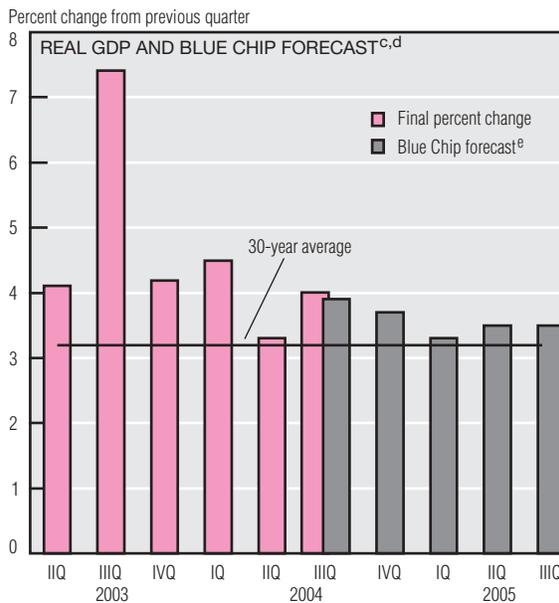
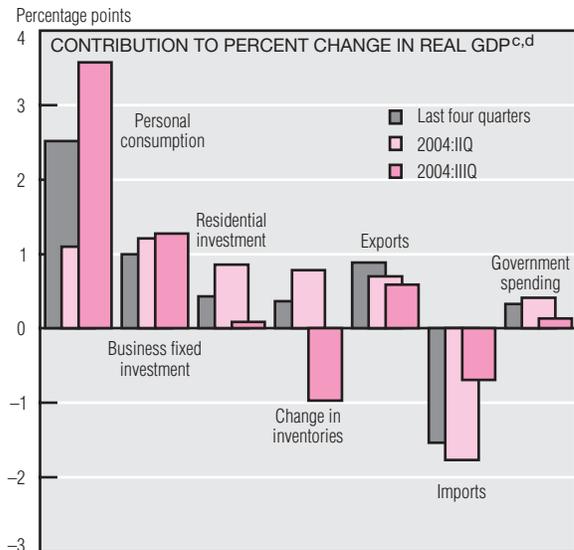
debt, as measured by the NIIP, precludes an indefinite deterioration of the current account balance.

Current account reversals have often been preceded by currency depreciation. Dollar depreciation should put upward pressure on import prices and downward pressure on export prices (although changes often are not one for one and can occur with a lag). In 1985, the dollar began declining against major currencies; after peaking at more than 3% of GDP in

1988, the current account deficit fell and it was eliminated altogether by 1991. Since 1980, other industrialized countries have typically experienced currency depreciation before and during current account reversals. These reversals have tended to occur when the deficit reached about 5% of GDP and have often been accompanied by slower growth. Such a slowdown in the U.S. could have negative consequences for the world economy.

Economic Activity

Real GDP and Components, 2004:IIIQ ^{a,b} (Final estimate)	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Since 2003:IIIQ
		Real GDP	106.3
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 bars indicate recessions.

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

According to the U.S. Commerce Department's final estimate, the annualized growth rate of real GDP in 2004:IIIQ was 4.0%, up from the preliminary estimate of 3.9% and the final 2004:IIQ estimate of 3.3%. Most of the revisions were minor; the dollar change in real GDP is now estimated to be \$106.3 billion, whereas the preliminary estimate put the change at \$105.0 billion.

Personal consumption was up sharply, contributing 3.6 percentage points (pp), or 2.5 pp more than in

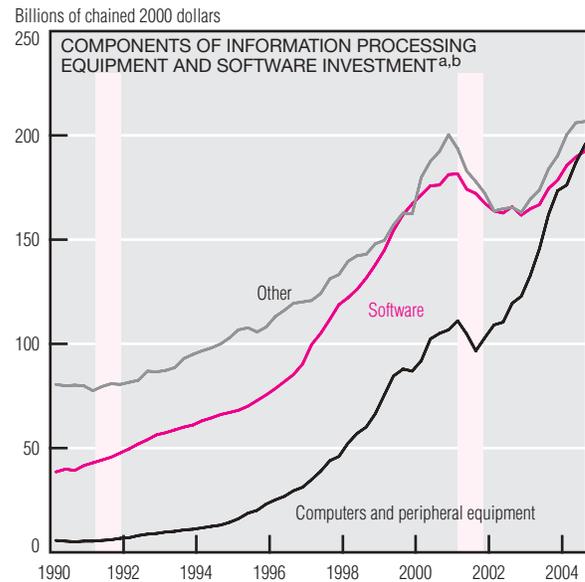
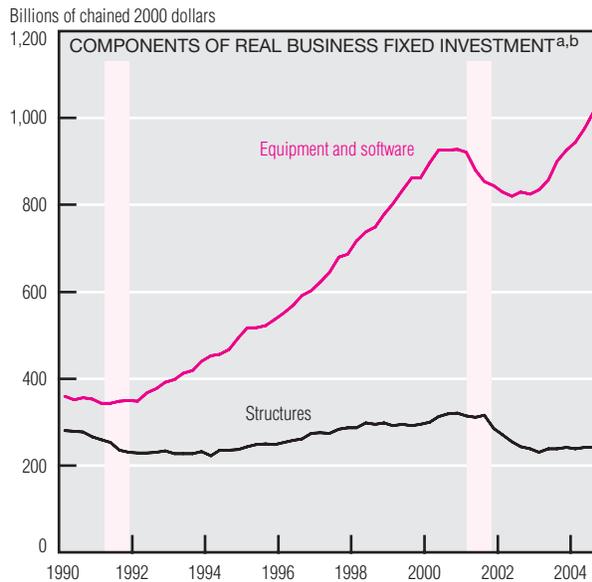
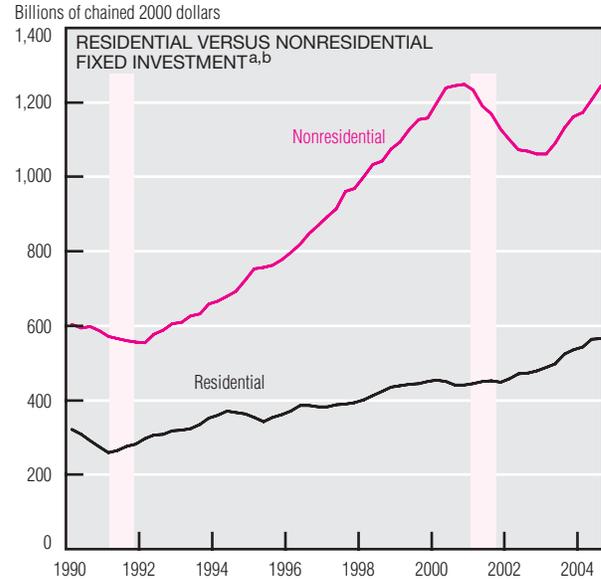
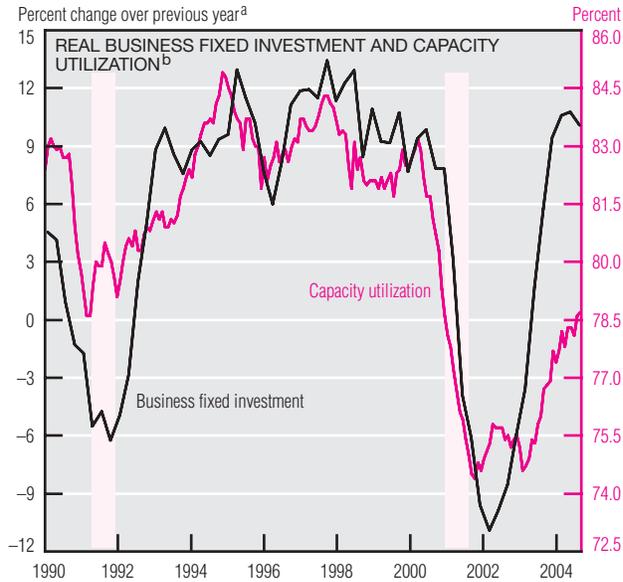
2004:IIQ, whereas residential investment's contribution fell 0.8 pp to 0.1 pp in 2004:IIIQ. A decline in private inventory investment made it a drag on GDP; its contribution to growth dropped from 1.8 pp in the second quarter to -1.0 pp in the third. This is the first time since 2003:IIQ that private inventories have subtracted more from GDP than imports have.

With the final estimate of GDP growth at 4.0%, 0.8 pp above the 30-year average of 3.2%, Blue Chip forecasters expect it to decelerate

somewhat but to stay above that average throughout 2005. They estimate that GDP growth will fall in 2004:IVQ to 3.7%, and again in 2005:IQ to 3.3%. After that, however, they expect GDP growth to level off at 3.5%.

Corporate profits with inventory valuation and capital consumption adjustments decreased \$55.9 billion in 2004:IIIQ after increasing \$8.3 billion the previous quarter. The severity of the hurricane season was a major factor: Benefits paid by insurance
(continued on next page)

Economic Activity (cont.)



NOTE: Shaded bars indicate recessions.

a. Annual rate.

b. Seasonally adjusted.

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

companies reduced profits by \$79.7 billion, and uninsured losses lowered it another \$10.4 billion.

Although corporate profits had an off quarter, their 5.8% year-over-year increase was enough to keep business fixed investment at the relatively high level of 10.1% between 2003:IIIQ and 2004:IIIQ. This solid investment rate is all the more remarkable given the relatively low rate of capacity utilization, which averaged 82.9% from 1995 to 2000. Even after the recently released annual revision, November's total capacity utilization stood at only

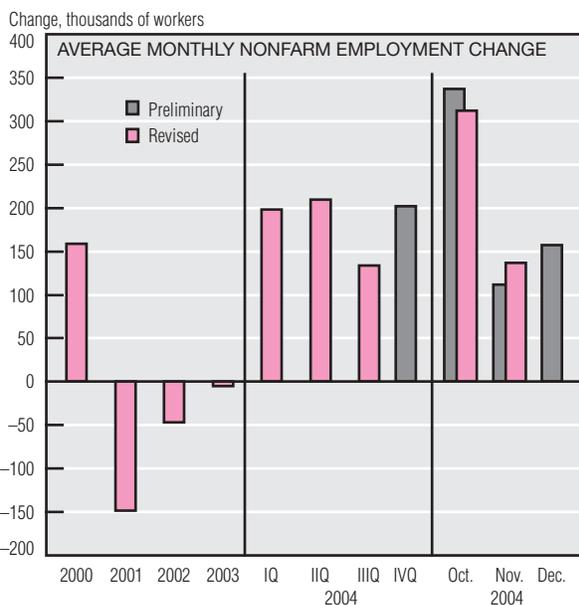
78.7%, about 1 pp higher than the figure first released.

Although residential investment slowed only modestly after the last business cycle peak, nonresidential investment declined sharply from late 2000 to early 2003 and has only just surpassed its previous peak. In sharp contrast to residential investment, nonresidential investment in structures remains fairly weak, leaving equipment and software accountable for most of the gains.

Within this latter category, computers and peripheral equipment

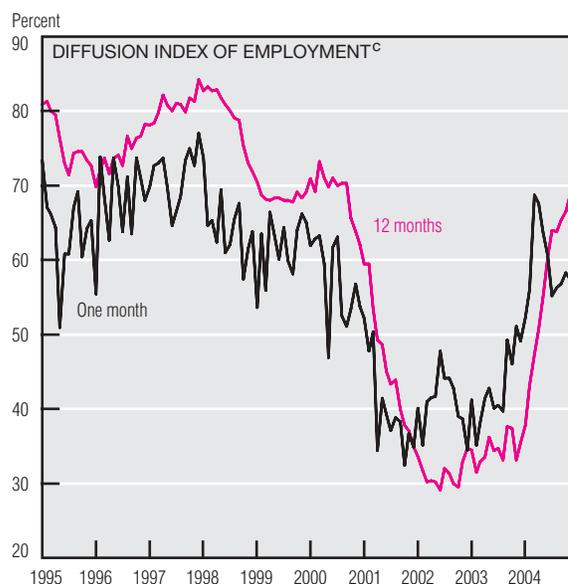
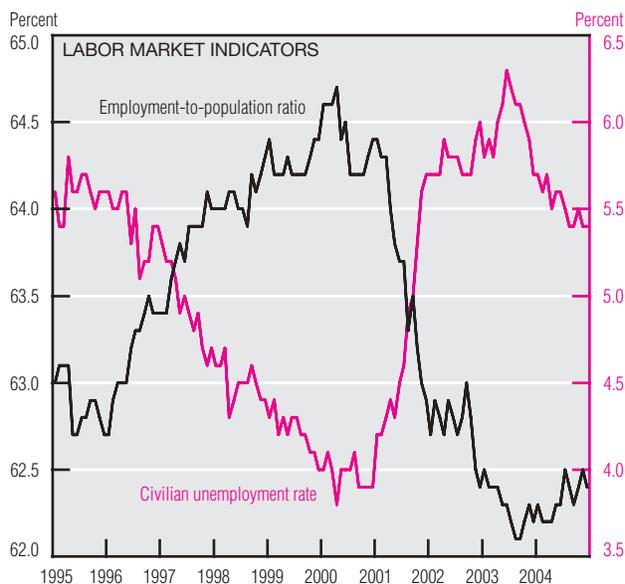
showed the strongest gains since 2001:IIIQ. Its dollar value became slightly larger than software investment and not much smaller than other information processing equipment. Given the strong rate of GDP growth expected over the next year, investment is likely to remain fairly robust because, even with the low rate of capacity utilization, a large proportion of investment is being made in high-tech, computer-related equipment where new products are more productive and frequently cheaper than the equipment they replace.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	Dec. 2004
Payroll employment	-149	-47	-5	186	157
Goods producing	-124	-76	-42	30	13
Construction	-1	-8	7	22	7
Manufacturing	-123	-67	-48	6	3
Durable goods	-88	-48	-30	9	0
Nondurable goods	-35	-19	-18	-3	3
Service providing	-25	29	37	156	144
Retail trade	-24	-11	-5	14	-20
Financial activities ^a	8	6	6	12	14
PBS ^b	-63	-17	23	46	41
Temporary help svcs.	-37	2	15	17	9
Education & health svcs.	50	40	28	34	47
Leisure and hospitality	-1	11	8	17	12
	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. Percent of total nonfarm industries with increased employment over one month (or 12 months) plus half of those with unchanged employment.

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

Although employment growth continued in 2004, it was disappointing compared to earlier expansions. Nonfarm payroll employment increased by 157,000 in December, better than November's upwardly revised 137,000 net gain but still below the average monthly increase of 186,000 in 2004. Payroll employment has increased by 2.5 million jobs since August 2003 (2.2 million of them in 2004), less than the 2.7 million lost between March 2001 and August 2003.

Service-providing industries sustained their growth in December except retail trade, which lost nearly

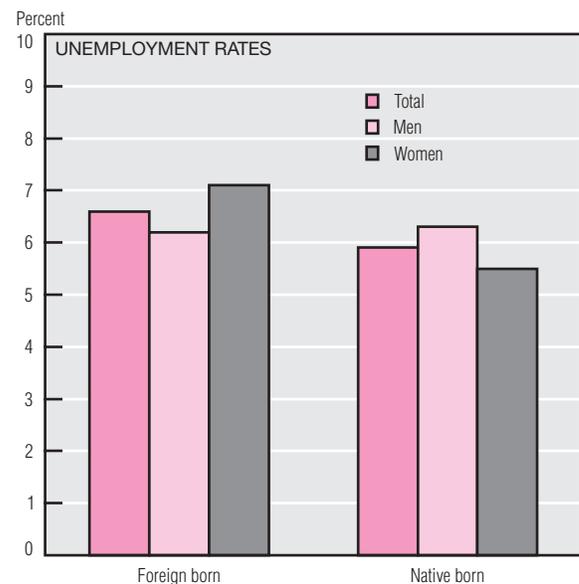
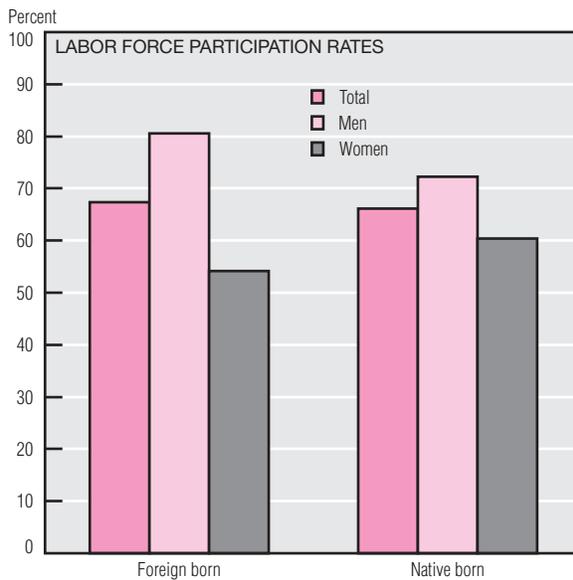
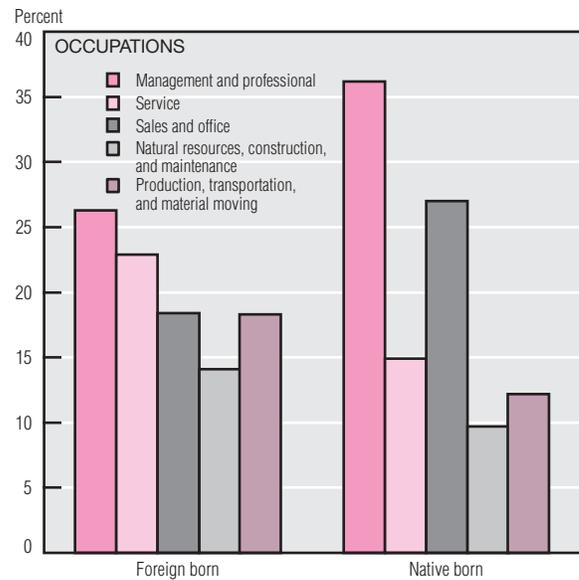
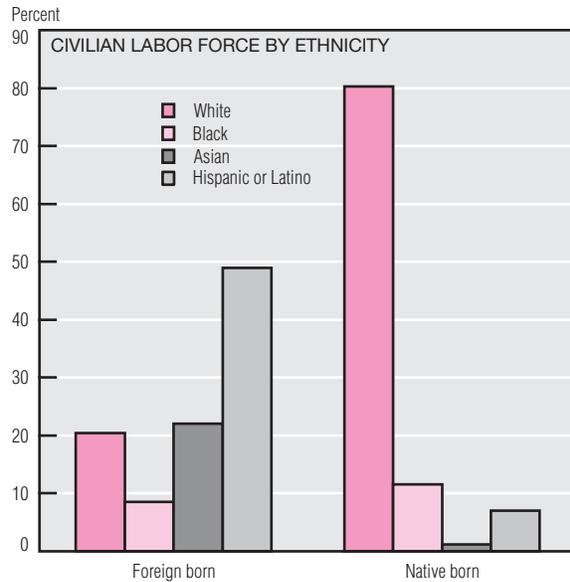
20,000 jobs. The largest gains were in education and health services (47,000 jobs, of which roughly two-thirds were in health care and social assistance industries). Gains were also high in professional and business services (41,000) and financial activities (14,000). After declining for three consecutive months, manufacturing employment grew slightly (3,000) in December. Job gains in 2004 were concentrated in service-oriented industries, especially professional and business services (546,000) and education and health services (402,000). Manufacturing employment rose by

76,000 in 2004, the first calendar-year increase since 1997.

The unemployment rate held at 5.4% in December. Both the ratio of employment to population (62.4) and the labor force participation rate (66%) were nearly unchanged in 2004.

The diffusion index of employment measures the share of industries where employment growth is positive. The one-month index rose slightly in December to 57.6%, reflecting the breadth of job creation. Employment rose in two-thirds of industries in 2004, compared to about one-third in 2003.

The Foreign-Born Labor Force



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

A significant fraction of U.S. workers were born overseas to parents who were not U.S. citizens. In 2003, these foreign-born workers represented about 14% of the labor force. They differ from native-born workers in their participation and unemployment rates, ethnic backgrounds, and occupations. Identifying these differences is essential to understanding how immigration influences the U.S. labor market.

In ethnic composition, the two groups differ dramatically, notably because of immigration from Asia and Latin and South America. Almost half

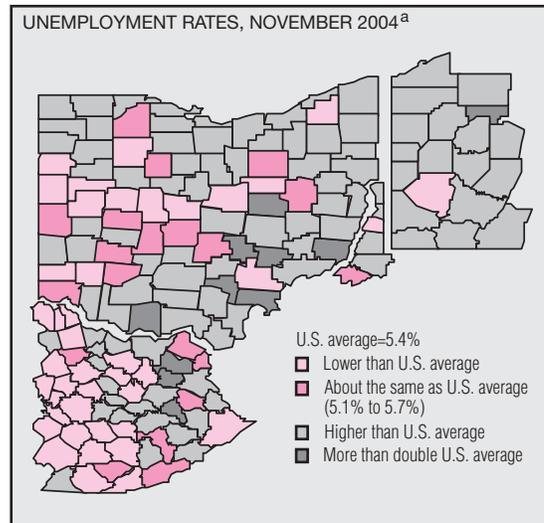
of foreign-born workers have Hispanic or Latino origins, but the vast majority (80%) of native-born workers are non-Hispanic or -Latino whites. Also, nearly 25% of foreign-born workers are from Asia, compared to only 1% of U.S. natives.

In 2003, foreign-born workers tended to have less education than the native born and were more likely to work in construction, maintenance, transportation, material moving, and service industries (food preparation, building, cleaning). In contrast, native-born workers were more likely to be in sales, office, management, and professional occupations.

The 67.4% labor force participation rate of the foreign born exceeded the 66.1% of the native born. The difference was even more pronounced among men; 80.6% of foreign-born men participated in the labor force, compared to 72.3% of the native born. In contrast, only 54.2% of foreign-born women participated, compared to 60.4% of native-born women.

Foreign-born workers' 6.6% unemployment rate exceeded native-born workers' 5.9%. Almost all the difference was explained by women, whose unemployment rates were 7.1% for the foreign born and only 5.5% for the native born.

Fourth District Employment



Payroll Employment by Metropolitan Statistical Area

12-month percent change, November 2004

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Wheeling	Pittsburgh	Lexington
Total nonfarm	0.0	0.2	0.4	-1.0	-1.2	1.2	0.9	1.4
Goods-producing	0.5	-0.6	-2.1	-2.7	-0.9	5.4	2.0	1.8
Manufacturing	0.1	-1.0	-1.4	-2.5	-2.4	2.0	-0.9	1.2
Natural resources, mining, and construction	1.9	0.0	-3.8	-3.8	4.2	9.1	7.1	3.4
Service-providing	-0.1	0.3	0.9	-0.6	-1.3	0.5	0.7	1.3
Trade, transportation, and utilities	-1.5	-2.0	1.0	-4.5	-4.5	0.0	0.9	1.6
Information	-1.9	-3.4	3.3	4.4	4.3	-8.3	-2.5	1.7
Financial activities	0.6	1.0	-0.7	-1.0	4.1	0.0	1.0	-0.9
Professional and business services	0.2	2.1	1.3	-2.2	-1.9	4.3	1.8	-2.5
Education and health services	2.3	2.0	1.6	2.8	1.4	-3.7	1.7	0.6
Leisure and hospitality	-0.5	0.4	4.1	2.0	-4.1	1.4	1.0	9.5
Other services	-2.2	-1.4	0.6	-4.2	0.0	3.6	1.1	2.8
Government	-0.5	1.1	-2.3	0.7	0.2	3.9	-2.5	-0.5

a. Seasonally adjusted.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Ohio Department of Job and Family Services, Bureau of Labor Market Information; Center for Workforce Information and Analysis, Pennsylvania Department of Labor and Industry; Workforce Kentucky, Department for Employment Services; and West Virginia Bureau of Employment Programs.

In November, the Fourth Federal Reserve District's unemployment rate rose 0.1 percentage point to 6.2%, while the national unemployment rate fell by the same amount to 5.4%. The discrepancy of 0.84 percentage point between the U.S. and the District is the largest since the Bureau of Labor Statistics started publishing labor market data for all counties in 1990.

County rates for the month reveal that most of the Pennsylvania area included in the District saw higher unemployment rates than the U.S.

Only Allegheny County had an unemployment rate at least as low as the nation's. In contrast, Kentucky's labor market generally outperformed the U.S.; nearly 60% of its counties posted unemployment rates at or below the national average. Considerably less than half of Ohio's 88 counties enjoyed below-average rates.

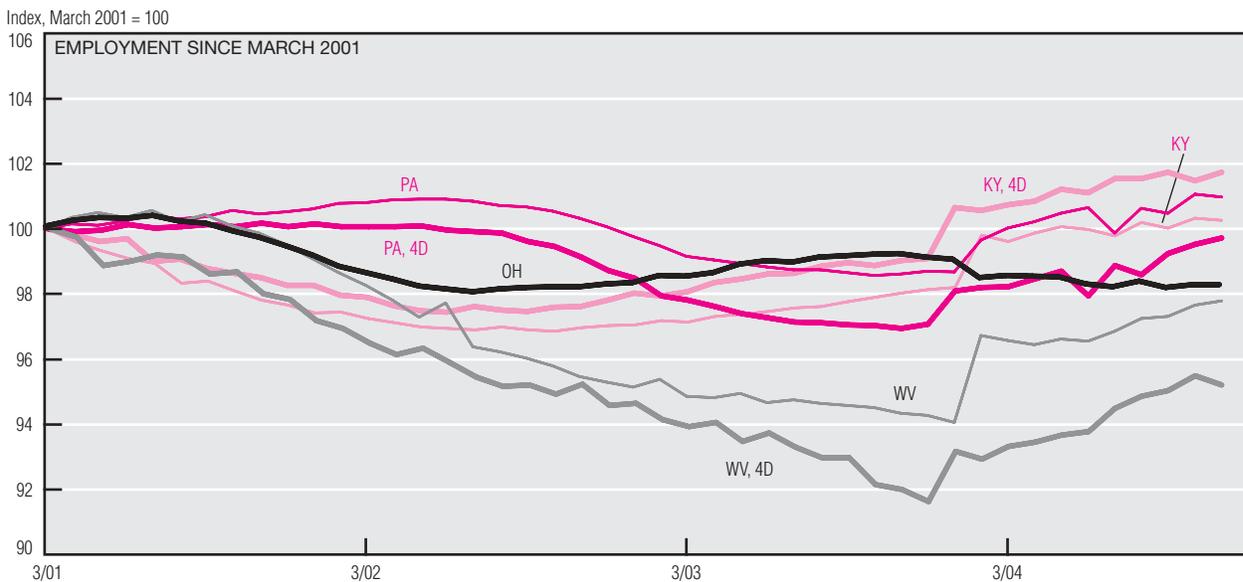
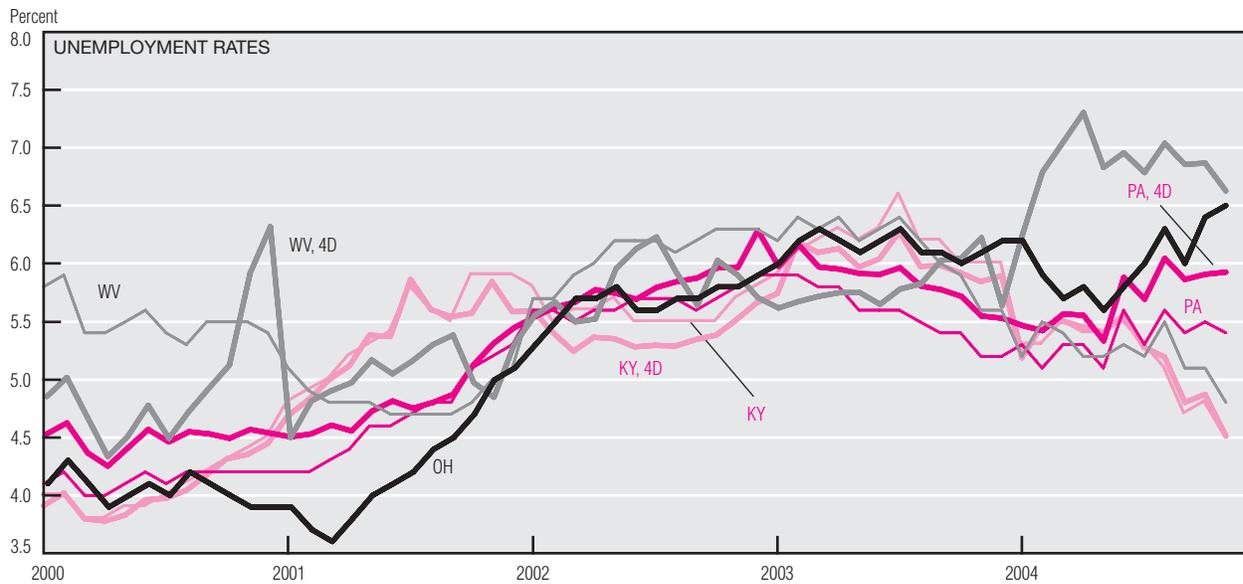
Not surprisingly, payroll employment data were consistent with unemployment rates for each area. Lexington led the District's major metropolitan areas in year-over-year nonfarm employment growth, whereas

employment growth in Dayton and Toledo was negative in both goods-producing and service-providing industries over the year.

An interesting picture emerges when unemployment rates for the District's areas of each state are compared with the state as a whole. The difference between the rate in the District's portion of western Pennsylvania and the entire state is 0.5 percentage point. The recent improvement in steel has certainly helped the Pittsburgh area: Allegheny County, where steel is most heavily concentrated,

(continued on next page)

Fourth District Employment (cont.)



NOTE: All data are seasonally adjusted. Lines labeled "4D" refer to the part of the state included in the Fourth District.

SOURCES: Ohio Department of Job and Family Services, Bureau of Labor Market Information; Center for Workforce Information and Analysis, Pennsylvania Department of Labor and Industry; Workforce Kentucky, Department for Employment Services; and West Virginia Bureau of Employment Programs.

was the only Pennsylvania county in the District to enjoy an unemployment rate lower than the national average. Despite improvements in the Pittsburgh area, other areas are still contending with severe unemployment problems. Forest County reported Pennsylvania's highest unemployment rate, 13.7%, more than double the national average.

Although improvements in steel have reached some areas of the District, the steel industry continues to struggle in others. In the panhandle of West Virginia, the industry's struggles,

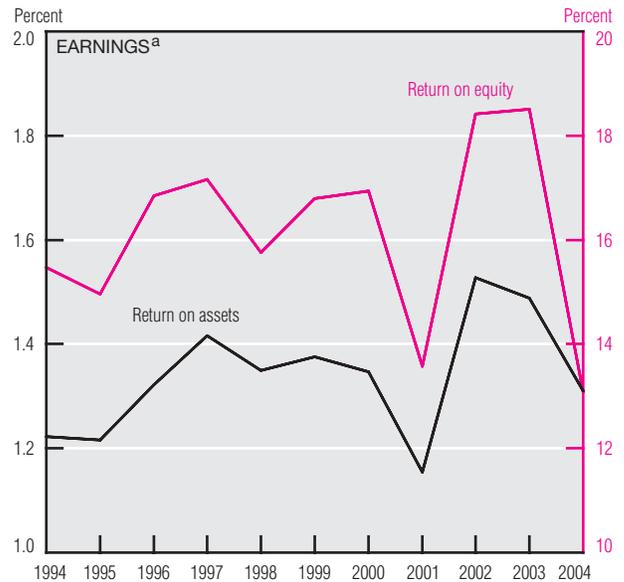
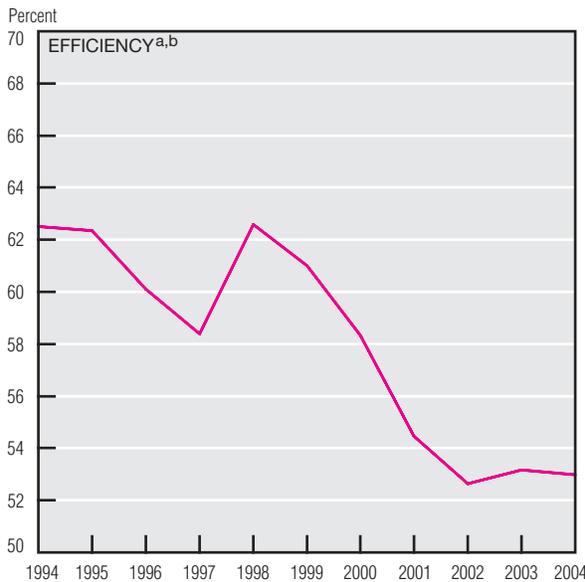
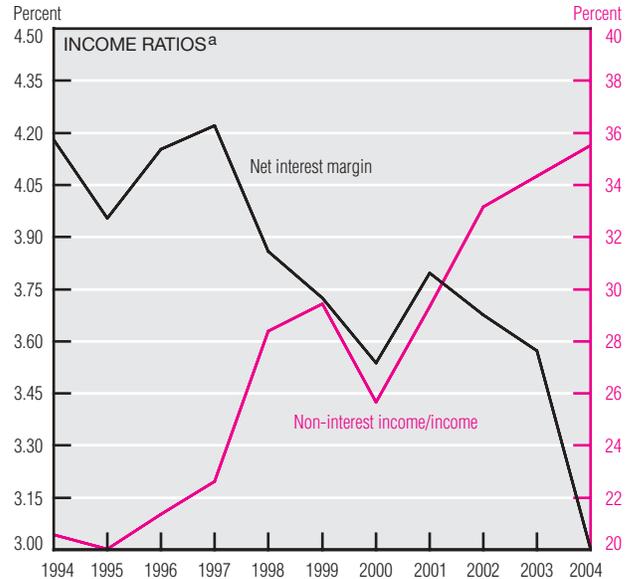
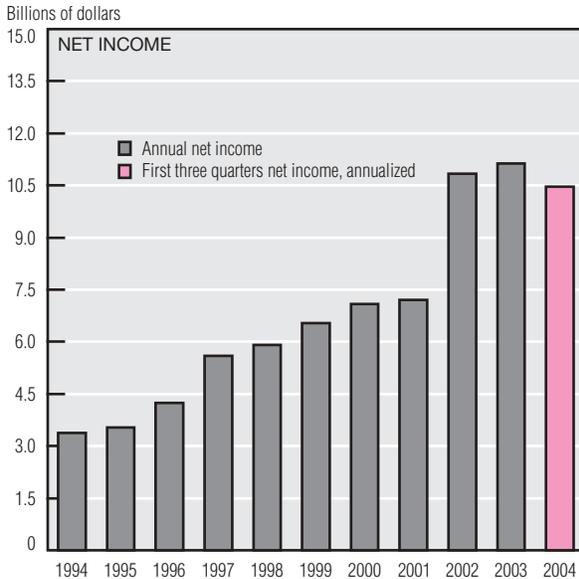
along with the departure of some mid-sized non-steel employers, raised unemployment rates in Fourth District counties well above the state average for most of 2004. This contrasted sharply with the area's historical performance relative to the state: For most of the past decade, the panhandle has enjoyed rates far below state averages.

The Fourth District's portion of Kentucky tracked the state's overall unemployment extremely closely throughout 2004. The District's relatively high unemployment is not

improved at all by Ohio's rate—the entire state is within the District.

As might be expected, a state's employment patterns echo its unemployment rate. Since the last business cycle peak in March 2001, the recovery in employment has been softer in the District's portion of both West Virginia and Pennsylvania than in either of those states overall. Employment performance was stronger in Kentucky's eastern half than in the state as a whole. And Ohio has yet to reach prerecession employment levels.

Fourth District Banking



a. Through 2004:IIIQ only. Data for 2004 are annualized.
 b. Efficiency is defined as operating expenses as a percent of net interest income plus noninterest income.
 SOURCES: Author's calculations from Federal Financial Institutions Examination Council, *Quarterly Bank Reports of Condition and Income*.

FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District posted net income of \$7.85 billion for the first three quarters of 2004 (\$10.46 billion on an annual basis). This suggests that the District is likely to maintain the fast pace of earnings growth set in the first two quarters and that 2004 earnings are apt to match the strong performance of the previous two years. The U.S. banking industry as a whole posted earnings of \$88.67 billion for the same period (\$118.22 on an annual basis), which will probably take the actual 2004 earnings above the \$111.76 billion in 2003.

Fourth District banks' net interest margin at the end of the third quarter

reached a record low of 2.99%, not much less than the 3.09% U.S. average. By the end of 2004:IIIQ, Fourth District banks had offset smaller margins with strong growth in non-interest income, which made up 35.52% of total income, only 24 basis points down from the record high of 35.76% at the end of 2004:IIQ. This resembled the performance of banks nationwide, whose comparable figure was 35.38%, slightly below the 36.47% posted in the previous quarter.

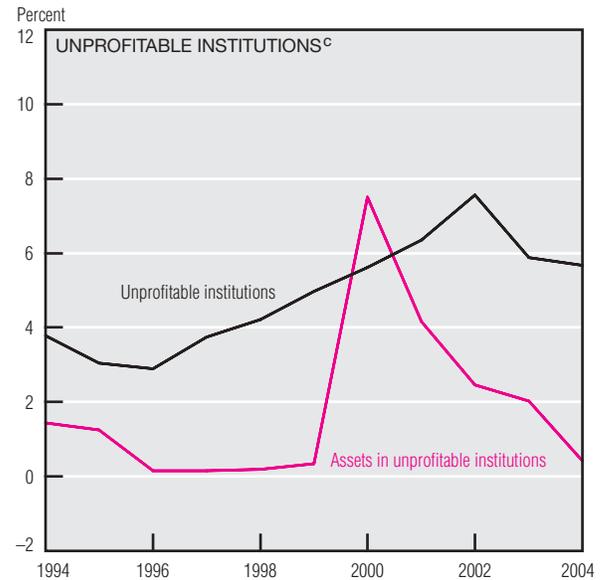
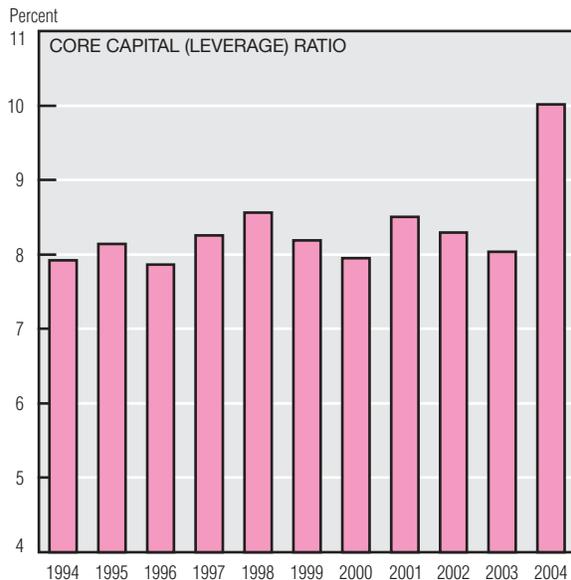
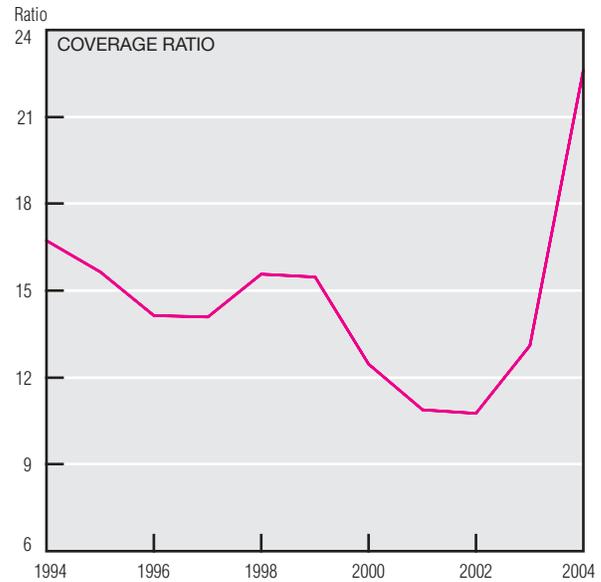
Efficiency (operating expenses as a percent of net interest income plus noninterest income) remained flat for Fourth District banks in 2004:IIIQ, reaching 52.97%, only slightly more

than the record low of 52.64% in 2002. (Lower numbers correspond to greater efficiency.) Nationwide, efficiency improved somewhat, reaching 56.28%, which was better than 2002 and 2003.

District banks posted a return on assets of 1.31% for the first three quarters of 2004, down from 1.49% at the end of 2003. Return on equity fell sharply, reaching 13.08% for the first three quarters of 2004 (versus 18.51% at the end of 2003) because the capital position of a few large banks increased significantly. Three-quarter profit performance for District

(continued on next page)

Fourth District Banking (cont.)



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

c. An institution is considered to be unprofitable if its return on assets is negative.

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

banks compares favorably to recent years and exceeds the corresponding performance of the U.S. banking industry, which posted a 1.14% return on assets and a 12.26% return on equity.

Overall, Fourth District banks' financial indicators point to strengthening balance sheets. Asset quality continued to improve in the first three quarters of 2004. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) for those months represented an annualized 0.43% of total loans.

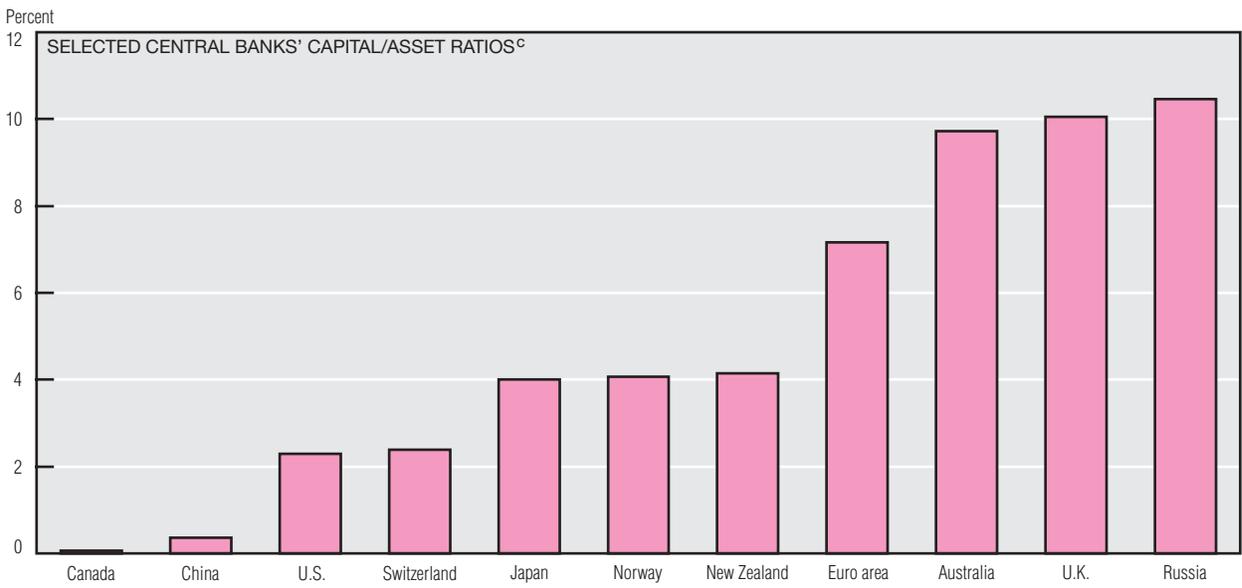
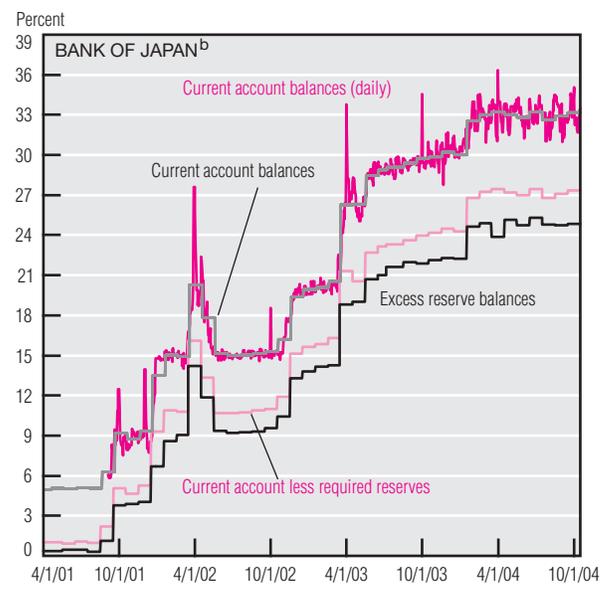
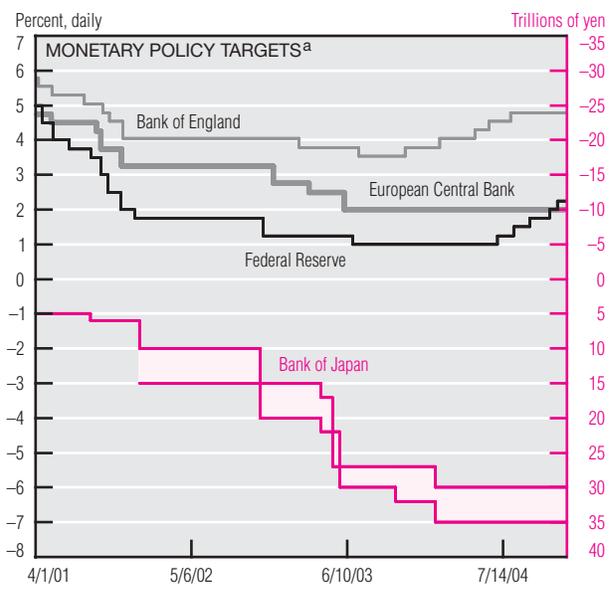
Problem assets (nonperforming loans and repossessed real estate) as a share of loans and leases fell to 0.54% from 0.77% at the end of 2003. District banks' improvement in asset quality mirrored that of the overall banking industry, in which net charge-offs and nonperforming loans were 0.52% of loans and nonperforming loans were 0.57% of assets.

Reflecting the industrywide trend toward stronger balance sheets, Fourth District banks held \$22.61 in equity capital and loan-loss reserves for every dollar of problem loans, well above the recent coverage ratio

low of 10.75 at the end of 2002. This improvement resulted largely from a marked reduction in problem loans and a significant strengthening of bank capital. Equity capital as a percent of Fourth District banks' assets (the leverage ratio) rose from 8.04% at the end of 2003 to 10.01% by the end of 2004:IIIQ.

Improved asset quality was also reflected in the percent of unprofitable banks, which fell to 5.68% from nearly 5.88% at the end of 2003. Unprofitable banks' average size also declined, with assets dropping from 2.02% of District banks' assets in 2003 to 0.42%.

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. The Bank of England's ratio is based on data as of February 29, 2004; other ratios are based on December 31, 2003 data.
 SOURCES: Board of Governors of the Federal Reserve System; and selected nations' central banks.

The Federal Reserve's Federal Open Market Committee continued its series of policy rate increases at its December 14 meeting, bringing the target for the overnight federal funds rate up 25 basis points to 2.25%. The Bank of England and European Central Bank have not changed their target repurchase agreement rates recently, and the Bank of Japan is poised to begin a second year of maintaining the ¥30 trillion to ¥35 trillion target for the supply of its current account balance liabilities.

Capitalization varies widely among central banks, at least as recorded on their balance sheets. A cushion of capital to cover losses might seem irrelevant for modern central banks, which are created by governments with virtually unlimited ability to create base money if needed to meet obligations. Current thinking, however, suggests that a central bank's capitalization can be an important defense of its policy independence. Interest rate risk might lead to the realization of substantial losses on

even the safest central bank assets. Any consequent impairment of capital and appearance of insolvency might damage the central bank's credibility in preventing inflation. Depending on national legislation, the bank might have to seek recapitalization and/or budgetary assistance and approval from the legislative or executive branch of government, creating opportunities for bringing effective political pressures to bear on policy decisions.