

The Economy in Perspective

Caveat forecaster... The most remarkable aspect of current economic conditions is that they are so unremarkable. Real GDP expanded at a 3.7 percent rate during the last four quarters, the unemployment rate stands at 5.2 percent, and core CPI inflation registered 2.2 percent during the last 12 months. In other words, the economy is expanding somewhat faster than its long-term average, unemployment is at its long-term average, and the inflation rate is low and stable. Many forecasters expect real GDP to expand at a slightly slower rate in 2005 than in 2004, but still at a solid pace. Inflation is also thought to be well anchored although inflation measures were slightly elevated during the past year.

Most analysts' relatively sanguine picture of 2005 does not necessarily mean that it will turn out to be a ho-hum year. First, any forecast is just that, a forecast subject to various risk factors. Some, like energy prices, seem obvious. Others, like the pace of productivity growth, are more subtle. If productivity growth slows significantly from its pace of the last decade, might pressure on wages and inflation going forward be stronger than what is built into the average forecast? What about household consumption? If consumers decide to increase their personal saving rates after a long period of decline, might that not come at the expense of some of the consumption spending already built into the projections? Professional forecasters, who know more about these risks than the public does, use projections to evaluate exposure to various possible scenarios—they do not simply plan for the most likely one.

Another reason to be skeptical about forecasts for 2005 is that economists have more talent for describing the future than putting a date on it. The U.S. current account deficit and the dollar provide a good example: Several years ago, a number of economists pointed out that if our current account continued on its (then) present course, one might reasonably expect the U.S. dollar to depreciate against its trading partners' currencies. The logic of this prediction rested on the much-quoted observation that unsustainable events have a way of stopping. If the current account deficit ever stopped growing in proportion to our GDP, economic

theory and historical precedent suggested that dollar depreciation would probably be part of the adjustment process.

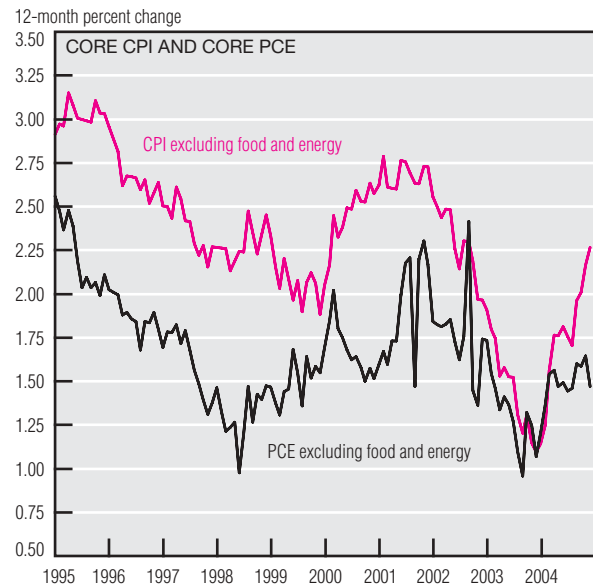
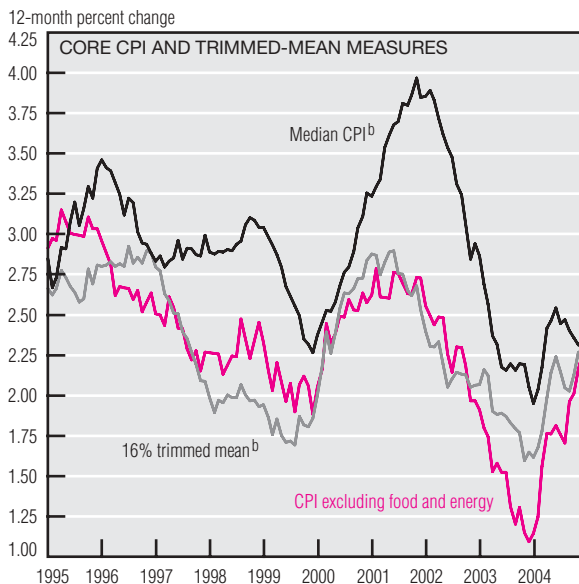
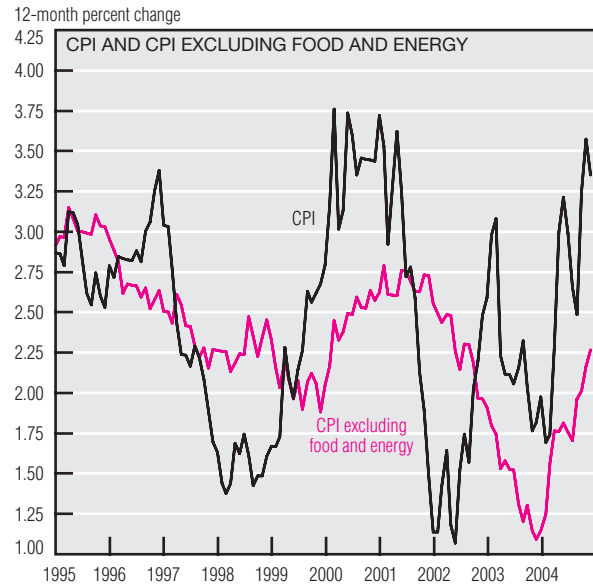
Some forecasters called for a little depreciation, others for a lot. Some expected a sharp adjustment, others a prolonged rebalancing. Whatever their views, they all looked foolish as long as the current account deficit continued to deepen without consequence for the dollar. Eventually, these forecasters' main point proved correct—the dollar did depreciate on a trade-weighted basis against foreign currencies. Whether the amount has been large or small, and the pace fast or slow, lies in the eyes of the beholder. Moreover, the current account deficit itself has not yet begun its predicted reversal, creating yet another opportunity for differences of opinion regarding the timing and magnitude of its doing so.; it is also plausible that it will not occur at all.

Forecasters tackle even longer-term issues than the current account, such as the solvency of the Social Security system. In that debate, the Social Security trustees and the Congressional Budget Office, respectively, estimate that the system will be unable to pay its obligations in about 40 or 50 years. Of course, some scenarios telescope that date forward and others push it back even further, but the indisputable fact is that something's got to give. Some people argue that 40 to 50 years is a long time, and since anything can happen—including a favorable economic future—why bother to press for reforms now. Others contend that since anything can happen—including a less favorable financial future—it is prudent to plan for insolvency now.

One reason to plan ahead for insolvency arises from another set of projections: Medicare and Medicaid deficits will increase rapidly as a share of GDP at the same time that Social Security is headed toward insolvency. Although many potential solutions could put these programs back on sustainable financial paths, predicting when and how a solution will be reached seems as useless today as forecasting when and how much the dollar would depreciate seemed a few years ago. But we are enriched by the exercise.

Inflation and Prices

	Percent change, last:				2004 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
December Price Statistics					
Consumer prices					
All items	-0.6	3.0	3.3	2.5	3.4
Less food and energy	1.8	2.0	2.2	2.1	2.3
Median ^b	2.1	1.8	2.4	2.9	2.4
Producer prices					
Finished goods	-7.6	6.3	4.1	2.2	4.4
Less food and energy	1.6	2.6	2.2	1.0	2.2



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

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

During December, the Consumer Price Index (CPI) declined at a 0.6% annualized rate, reflecting a 19.8% drop in energy prices. The core CPI rose 1.8% for the second straight month, while the median CPI increased 2.1%.

Growth in retail price measures accelerated in 2004; however, core measures, which exclude the more volatile food and energy prices, showed more modest growth (between 1.5% and 2.5%). After rising 1.9% in 2003, the CPI advanced 3.3% in 2004—its

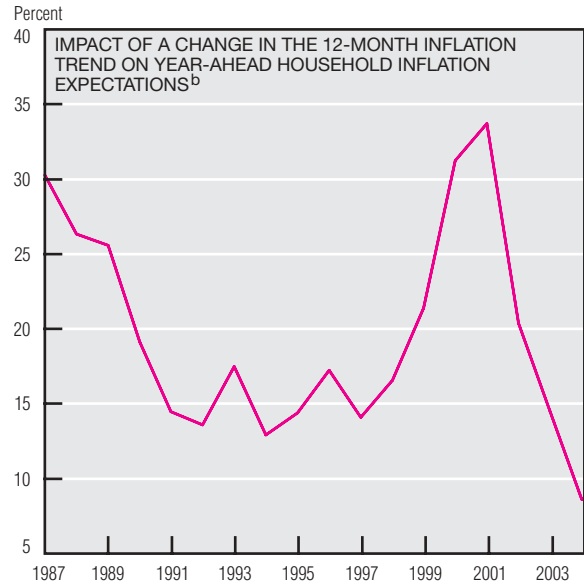
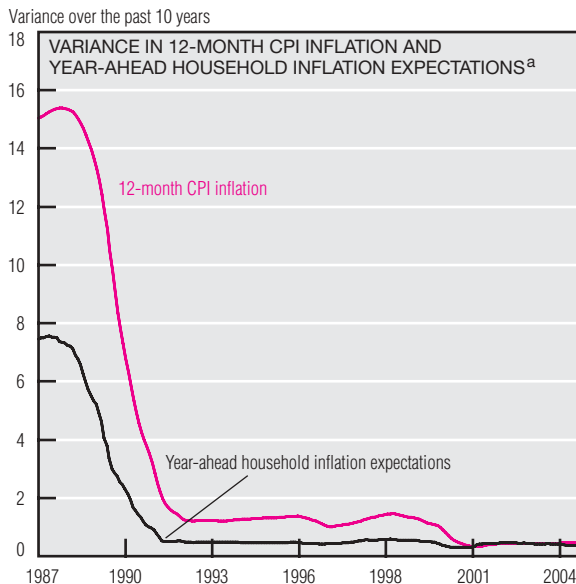
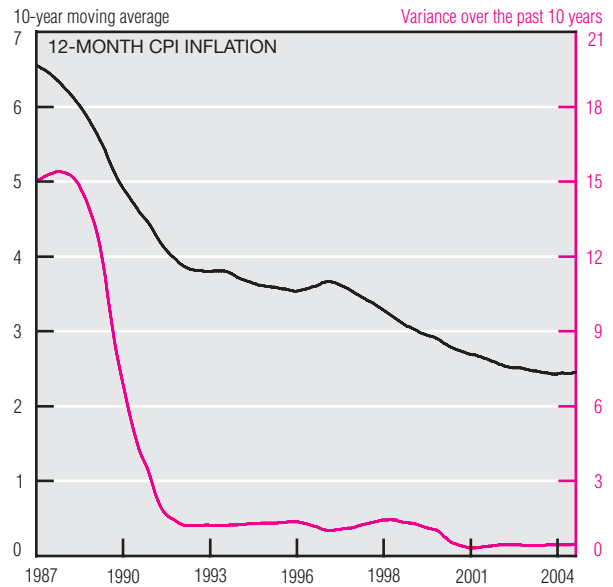
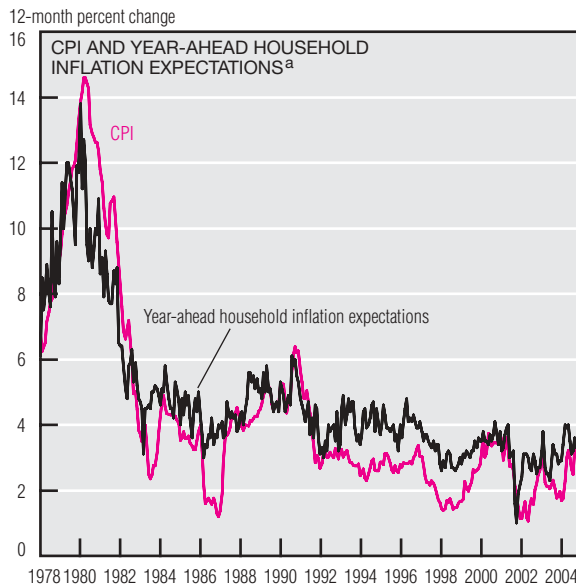
largest annual increase since 2000. The Bureau of Labor Statistics attributed about one-third of the rise to a 16.6% increase in energy prices over the year. Growth in retail prices was more subdued and consistent across the alternative retail price measures. The core CPI rose a more moderate 2.2% in 2004, but still doubled its 2003 growth rate of 1.1%. The Bureau of Labor Statistics attributed three-fourths of the acceleration to rising prices for new and used vehicles and shelter costs. In 2004, the median CPI

rose 2.4%, and the 16% trimmed-mean CPI rose 2.2%. The core Personal Consumption Expenditure (PCE) price index, which measures prices for an alternative consumer-goods market basket, rose a modest 1.5% over the year.

Looking ahead, survey data from U.S. households indicate that retail prices over the next 12 months are expected to rise 3½%—about the same inflation expectation that households have held over most of the past three years. In fact, if we exclude the sharp drop that followed

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Inflation and Prices (cont.)



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

b. Estimated over 10-year intervals using an ordinary least-squares equation, which regressed the change in year-ahead household inflation expectations on the change in the 12-month inflation trend during the previous month.

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

September 11, 2001, household inflation expectations have fluctuated within a rather narrow range over much of the past 10 years. In other words, households seem to accept that inflation has been following a rather steady course and they expect moderate inflation to continue in the future.

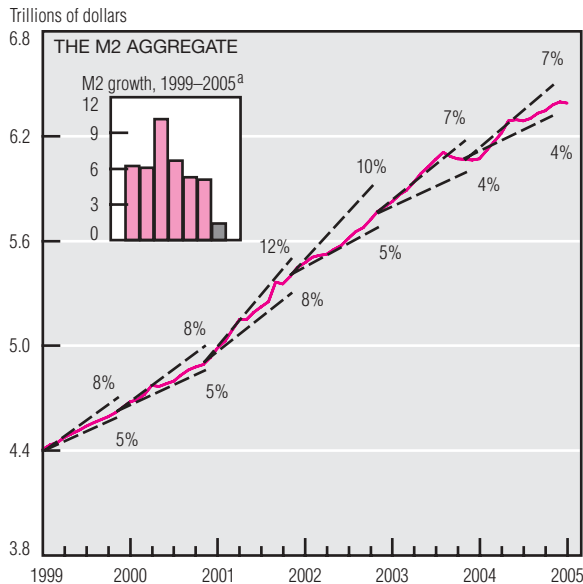
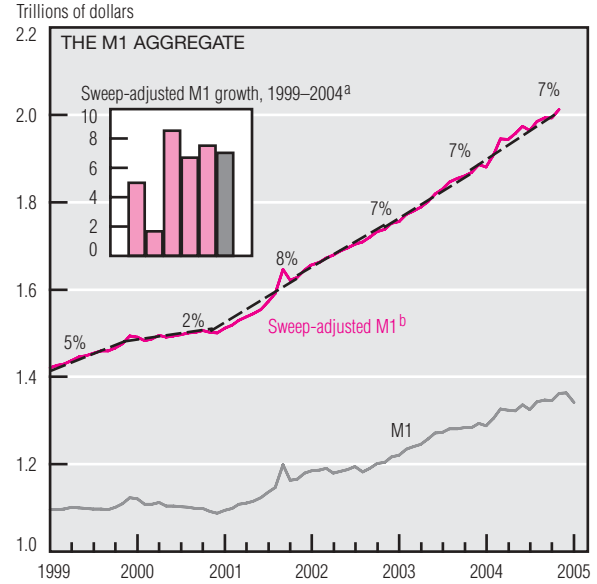
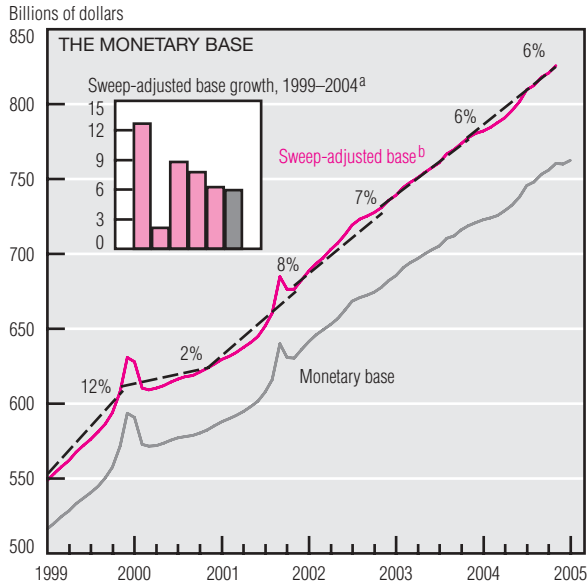
Clearly, as the trend rate of inflation has moderated over time, so too has inflation's year-to-year volatility. Indeed, the trend's volatility, which decreased dramatically with the great

disinflation of the early 1980s, has been reduced further as inflation has moved even lower in the current decade. The more stable inflation environment has been accompanied by reduced volatility in household inflation expectations. That is, households' inflation sentiment appears to be more firmly "anchored" than in the past.

A crude way to gauge that steadiness is to consider what impact a change in the inflation trend has on household predictions for future

inflation—are they likely to perceive a change in the inflation trend as a passing event or a persistent phenomenon? In the late 1970s to early 1980s, about 30% of any change in the inflation trend stayed in household inflation predictions for the next year. Over the past 10 years, changes in the inflation trend seem to have had considerably less influence on the public's outlook; during that period, only about 9% of the change in an observed trend became embedded in year-ahead inflation expectations.

Monetary Policy



Growth Rates of Monetary Components (percent)

	Annual						Average,
	1999	2000	2001	2002	2003	2004	1999–2003
Monetary base ^c	12.7	2.1	8.8	7.8	6.2	5.9	7.5
M1 ^d	5.0	1.7	8.5	6.7	7.5	7.0	5.9
M2	6.2	6.1	10.2	6.7	5.3	5.1	6.9
Currency	11.1	4.3	9.1	8.2	5.9	5.5	7.7
Total reserves	-7.2	-6.2	8.7	-6.6	8.2	7.2	-0.6
Check and demand ^e	-4.8	-6.8	5.2	-1.5	7.3	5.4	-0.1
Money market funds	13.6	11.4	7.8	-6.6	-11.6	-12.0	2.9
Small time deposits	-0.7	9.6	-5.0	-9.1	-9.3	-0.4	-2.9
Savings deposits	10.1	6.7	21.7	21.1	15.2	10.8	15.0

a. The far-right bars refer to the most recent data available. Growth rates are calculated on a fourth-quarter over fourth-quarter basis except for the far-right bar for M2, which refers to the annualized year-to-date growth rate from 2004:IVQ to January 2005. All data are seasonally adjusted.

b. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts.

c. Sweep-adjusted base.

d. Sweep-adjusted M1.

e. Demand deposits and other checkable deposits.

SOURCE: Board of Governors of the Federal Reserve System, "Money Stock Measures," *Federal Reserve Statistical Releases*, H.6.

Growth in the sweep-adjusted monetary base (total currency in circulation plus total reserves plus vault cash of depository institutions not applied to reserve requirements) has been fairly constant for a couple of years. In 2004, however, it showed an annual growth rate of 5.9%, slower than its 7.5% average for 1999–2003. Base growth declined, primarily because currency growth slowed. Currency growth moderated to an annual rate of 5.5%, in contrast with its five-year average of 7.7%. On the other hand, total

reserves rose 7.2% in 2004 after falling 0.6% over the previous five years.

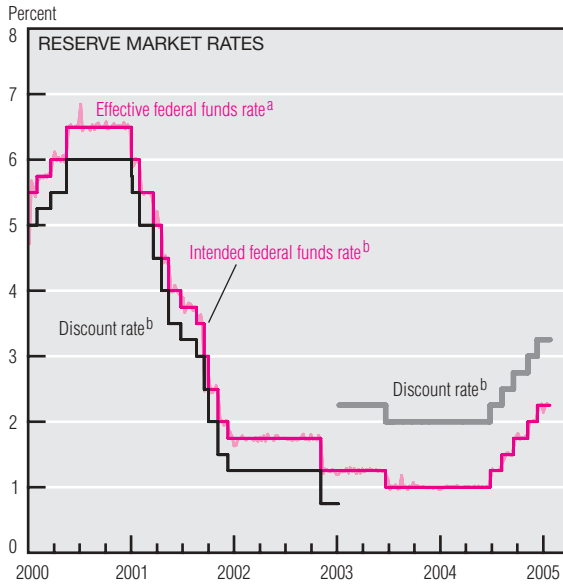
M1, which consists of currency in the hands of the public plus demand and other checkable deposits, is a slightly broader monetary aggregate. Like the monetary base, sweep-adjusted M1 growth has been fairly stable for a couple of years. Unlike base growth, however, M1 growth was slightly higher than its 1999–2003 average. Much of this acceleration resulted from a sharp increase in the sum of demand deposits and other

checkable deposits, which represent roughly 48% of M1. After falling 0.1% in 1999–2003, its growth rate rose 5.4% in 2004.

An even broader monetary aggregate, M2, grew 5.1% in 2004, 1.8 percentage points less than its 1999–2003 average. This slower growth resulted from a 12% decline in retail money market mutual funds and a slight (0.4%) decline in small time deposits in 2004. These declines partly offset the 7% advance in M1 and the 10.8% increase in savings deposits in 2004.

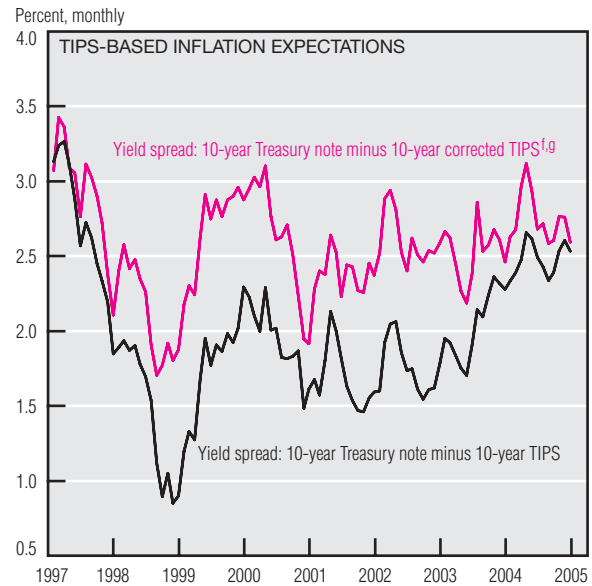
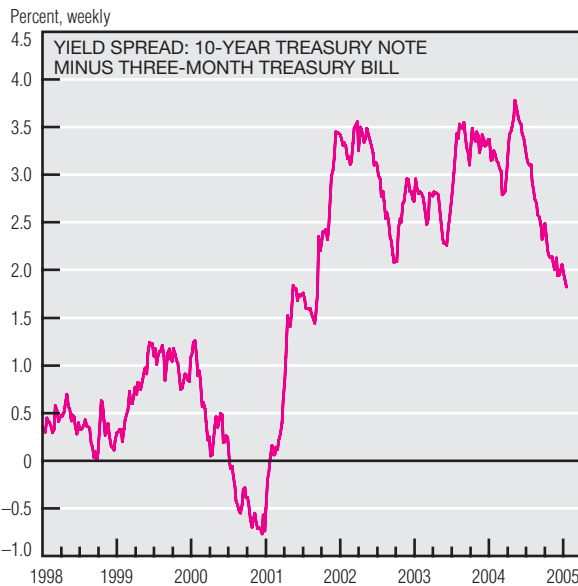
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Monetary Policy (cont.)



Anticipated Target Federal Funds Rates (calculated January 27, 2004)

	February 1-2 meeting			
Target federal funds rate	2.25%	2.50%	2.75%	
Implied probability ^c	0.0%	98.5%	1.5%	
	March 22 meeting			
Target federal funds rate	2.25%	2.50%	2.75%	3.00%
Implied probability ^d	0.4%	4.5%	85.3%	9.8%
	May 3 meeting			
Target federal funds rate	2.50%	2.75%	3.00%	3.25%
Implied probability ^e	3.4%	13.3%	66.2%	17.1%



a. Weekly average of daily figures.

b. Daily observations.

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

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

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

f. The corrected TIPS yield is adjusted for the liquidity premium.

g. The liquidity premium is calculated as the difference between yields of on-the-run versus off-the-run conventional Treasuries, using data from the Board of Governors of the Federal Reserve System.

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

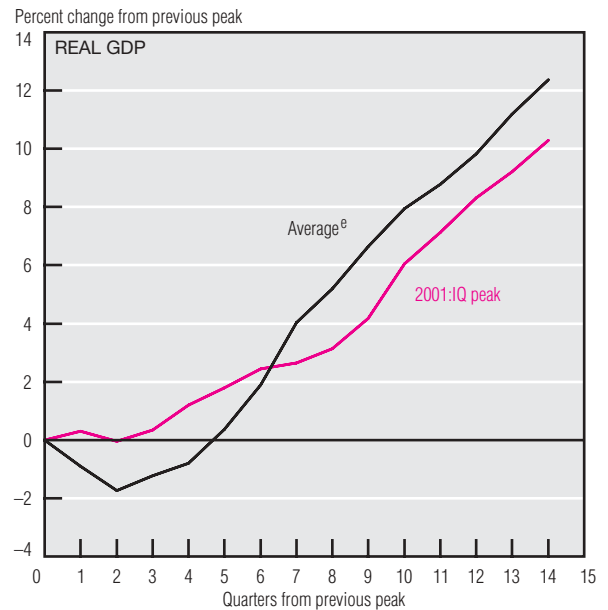
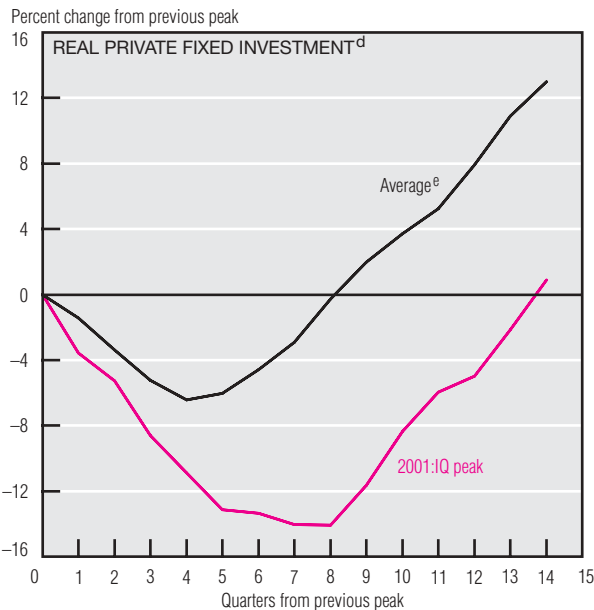
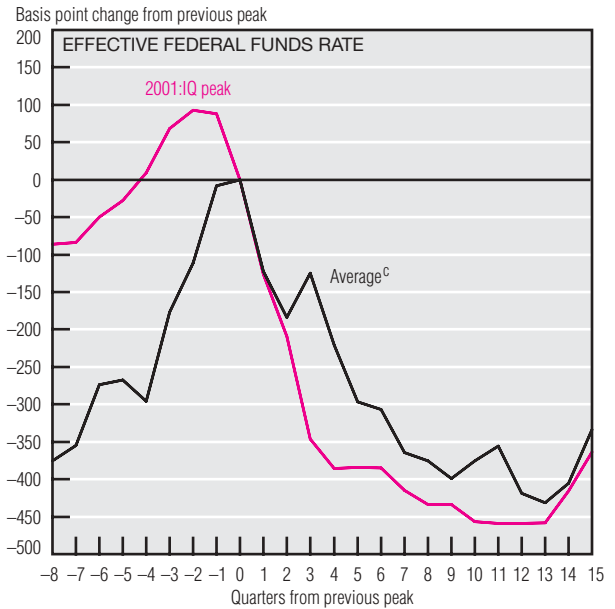
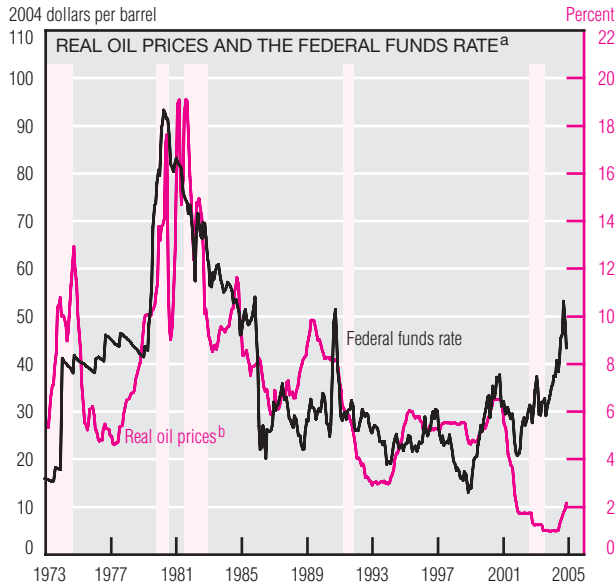
At its meeting on December 14, 2004, the Federal Open Market Committee raised the target federal funds rate 25 basis points (bp) to 2.25%, the fifth such increase since the rate stood at 1% in June 2003. Evidence from options on federal funds futures implies that market participants expect a 25 bp rate increase at each of the next three meetings, which would raise the target federal funds rate to 3% after the May meeting.

The yield curve has flattened continuously over the past few months.

The yield spread between the 10-year Treasury note and the three-month Treasury bill dropped from 343 bp in June to 182 bp in late January. Although an inversion of the yield curve frequently portends a recession, as it did in 2001, a flattening of the yield curve is not necessarily bad news for the economy. Flattening can result from changes in economic fundamentals, inflation expectations, or both. The yield curve can be expected to flatten with increases in short-term interest rates if long-term inflation

expectations remain well anchored. If we use Treasury inflation-protected securities (TIPS) to gauge inflation expectations over the next 10 years, we see that both the raw TIPS numbers and those adjusted for liquidity risk are hovering around 2.6%. The five recent hikes of 25 bp each in the target rate, coupled with the market's expectation of gradual, continued tightening, seem to have reinforced the public's confidence that the Federal Reserve will not let inflation accelerate.

Business Cycles



a. Shaded bars indicate periods of recession.

b. Prices of West Texas intermediate crude oil, deflated by the Consumer Price Index.

c. Includes peaks in 1957:IIIQ, 1960:IIQ, 1969:IVQ, 1973:IVQ, 1980:IQ, 1981:IIIQ, and 1990:IIIQ.

d. Nonresidential.

e. Includes peaks in 1948:IVQ, 1953:IIQ, 1957:IIIQ, 1960:IIQ, 1969:IVQ, 1973:IVQ, 1980:IQ, 1981:IIIQ, and 1990:IIIQ.

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 *Wall Street Journal*.

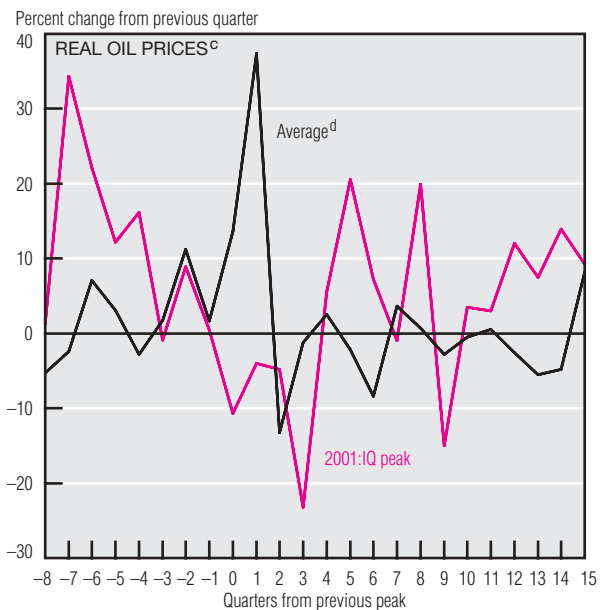
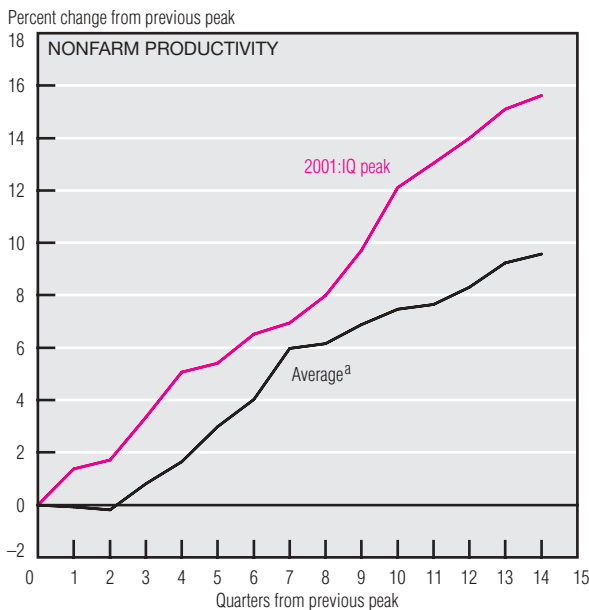
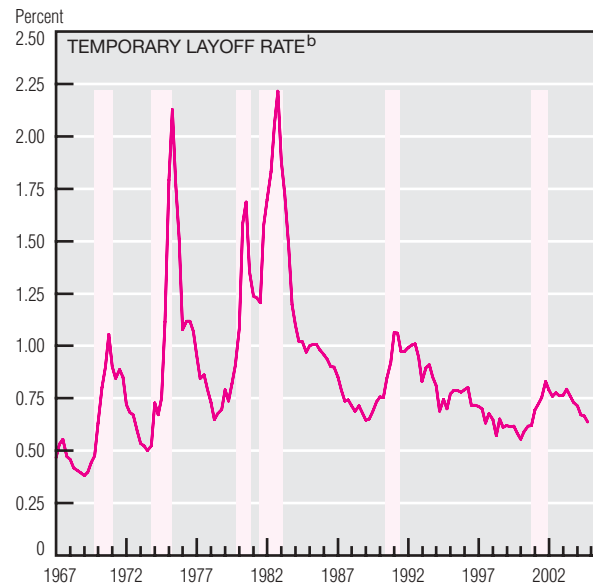
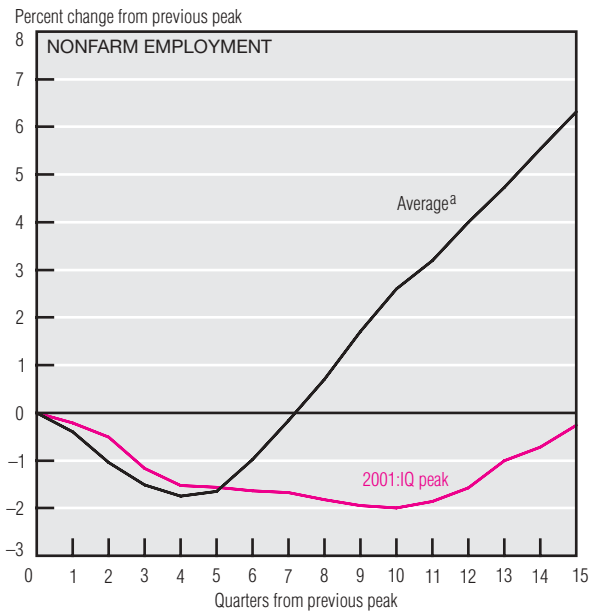
Oil prices and the federal funds rate typically spike before recessions. Both are likely to be causal factors, although the spikes' timing and impact on the economy vary. Oil prices spiked before the 2001 downturn, but earlier than they typically do. And although the fed funds rate also jumped, the increase was less pronounced than usual, which suggests that policy changes were not as influential as they sometimes have been.

The 2001 recession was driven primarily by investment, which fell nearly twice as far from its peak as it typically does. One reason for this, distinct from both oil prices and interest rates, may have been excess investment or "capital overhang" leading into the recession. But the real anomaly was not how the economy behaved going into the recession but how it behaved coming out. Now, nearly four years after the National Bureau of Economic Research

declared the recession officially over, employment is just approaching its prerecession level; in a typical recovery, it would be 6% higher than it was before the downturn. Some researchers believe that the persistently weak employment numbers reflect a fundamental restructuring in the economy. They point out that almost all the layoffs in this recession were permanent; temporary layoffs, which generally increase during a recession, were unusually flat.

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Business Cycles (cont.)



- a. Includes peaks in 1948:IVQ, 1953:IIQ, 1957:IIIQ, 1960:IIQ, 1969:IVQ, 1973:IVQ, 1980:IQ, 1981:IIIQ, and 1990:IIIQ.
 b. Shaded bars indicate periods of recession.
 c. Prices of West Texas intermediate crude oil, deflated by the Consumer Price Index, 2004 dollars per barrel.
 d. Includes peaks that started in 1973:IVQ, 1980:IQ, 1981:IIIQ, and 1990:IIIQ.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Wall Street Journal*.

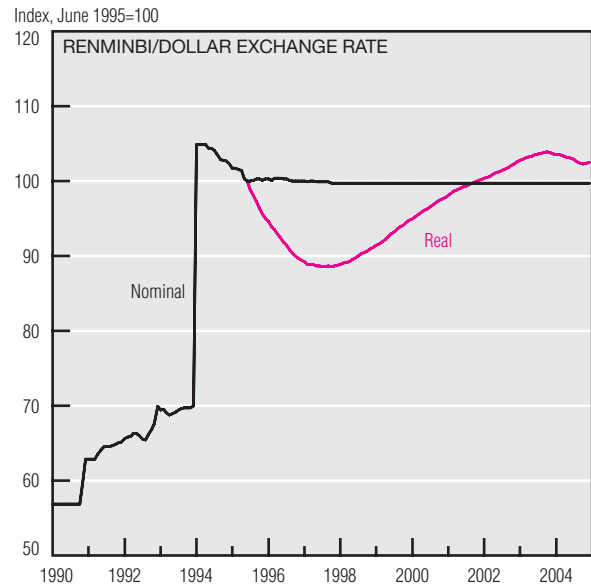
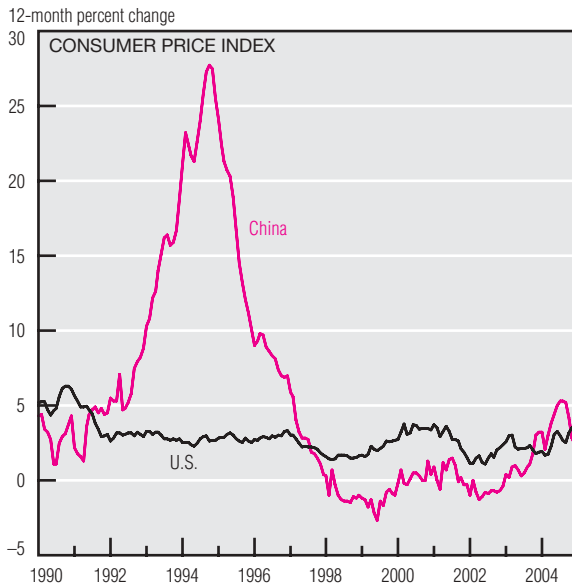
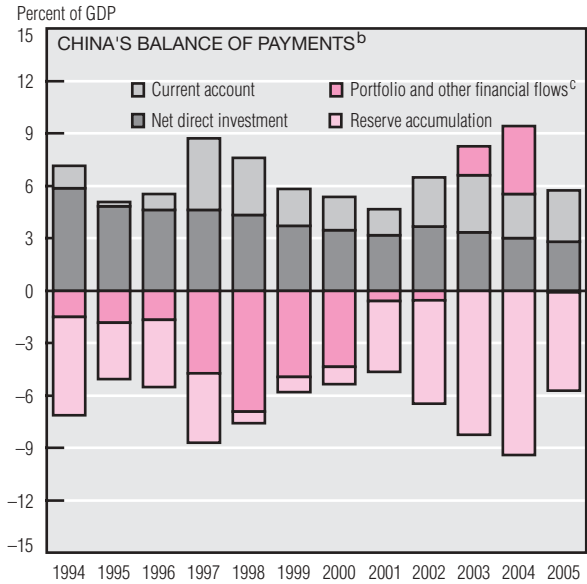
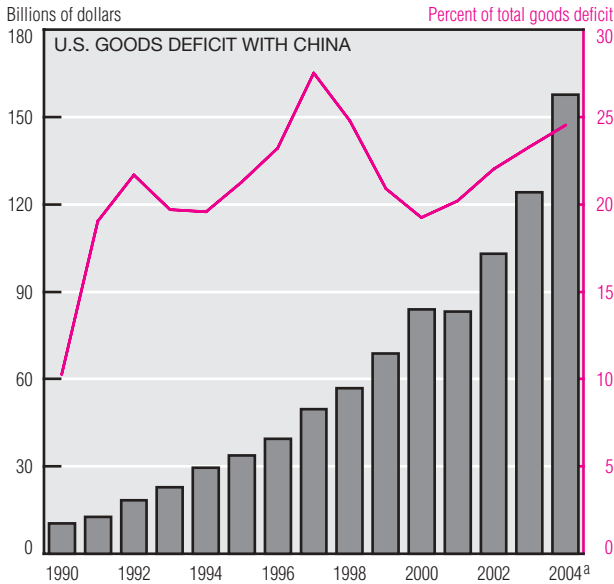
Yet using the recession to explain what has been going on in the recovery may be misleading. The recession, which ended almost four years ago, is in many ways a distant memory. While the recovery has been atypical, the terminology unfortunately causes us to focus on the recession for what was, and to some extent still is, happening. But the cause of the “job-loss recovery” may be independent of what originally caused the 2001 downturn. If that is

so, what explains the labor market’s sluggishness?

Productivity growth doesn’t seem to be the answer. It has been robust, so that one would expect firms to have hired more workers. Perhaps the causes of labor’s feeble recovery are the usual ones: interest rates, oil prices, or a combination of the two. Interest rates, however, were cut as aggressively and consistently as after a typical recession. Oil, however, is a likely culprit. At the end of 2001, crude oil sold for \$20 per barrel;

a year later a barrel was going for \$30. After a short pause, oil prices continued their near-relentless climb, peaking at nearly \$50 per barrel at the close of 2004. This strongly suggests that oil has been a major cause of employment’s inability to recover from the recession. Yet high oil prices have not translated into another recession; the economy seems to be healthy otherwise. Productivity’s steady advance has allowed output to continue growing.

The Chinese Renminbi



a. Covers December 2003 through November 2004.

b. Data for 2004 and 2005 are International Monetary Fund forecasts.

c. Includes other errors and omissions through 2003.

SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; International Monetary Fund, *International Financial Statistics*, IMF Country Report No. 04/351 November 2004; and National Bureau of Statistics of China.

During the 12 months ending in November 2004, the U.S. registered a \$157.6 billion deficit in goods trade with China, a shortfall that accounts for nearly 25% of the total U.S. trade deficit. In recent years, China generally has run a current account surplus equal to approximately 3% of its GDP and has experienced direct investment inflows of a similar magnitude. Contrary to the claims of many analysts, China's exchange rate policies do not seem to explain much of its trade performance.

In 1995, China pegged its currency, the renminbi, to the U.S. dollar at

approximately Rmb 8.3 per dollar. This peg, however, tells us nothing about China's competitiveness relative to the U.S. because it ignores price patterns. The real renminbi-dollar exchange rate adjusts the exchange rate peg for changes in relative inflation rates, thereby providing a clearer picture of China's competitiveness.

On a real basis, the dollar has appreciated only 2.5% against the renminbi since the beginning of the peg; that movement cannot confer much of a trade advantage on China. The real exchange rate has, however, undergone some large swings. Between

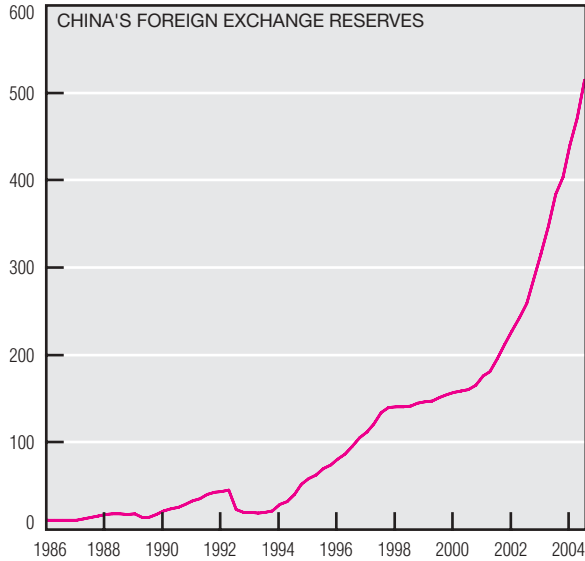
June 1995 and October 1997, the dollar depreciated 11.4% against the renminbi because China's inflation rate exceeded that of the U.S. Between October 1997 and October 2003, however, the dollar appreciated 17.3% against the renminbi on a real basis because China's inflation rate was lower than that of the U.S. Since October 2003, China's inflation rate has generally exceeded ours, and the dollar has again depreciated 1.4% against the renminbi on a real basis.

To keep the renminbi pegged at Rmb 8.3 per dollar in the face of an overall balance-of-payments surplus,

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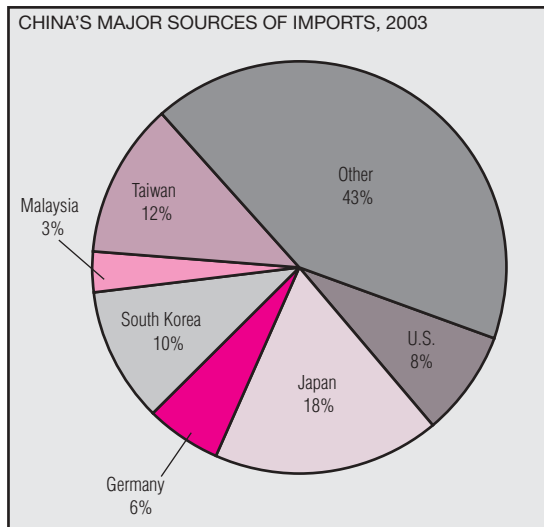
The Chinese Renminbi (cont.)

Billions of dollars, end of quarter



Factors Determining the Monetary Base

	Billions of renminbi			
	Monetary base	Foreign assets	Domestic assets	Misc. liabilities
Change, 1995:IIQ–2004:IIIQ	3,979.69	3,413.09	1,037.33	470.73
Change, 2000:IVQ–2004:IIIQ	1,918.01	2,387.07	-92.18	376.87



SOURCE: International Monetary Fund, *International Financial Statistics, Direction of Trade Statistics Yearbook 2004*.

the People's Bank of China, the country's central bank, buys dollars on the foreign exchange market. The process expands China's monetary base and risks generating inflation. In fact, this mechanism will prevent China from realizing a long-term trade advantage from its peg, because a rising inflation rate will dull China's competitive edge.

The People's Bank of China can frustrate the impact of its dollar acquisitions on its monetary base and inflation by selling domestic assets from its portfolio or by increasing nonmonetary liabilities on

its balance sheet, but since the inception of the peg in 1995, the bank has generally not done so. Between 1995:IIQ and 2004:IIIQ, China's central bank acquired the equivalent of Rmb 3.4 trillion in foreign exchange, and its monetary base grew nearly Rmb 4 trillion.

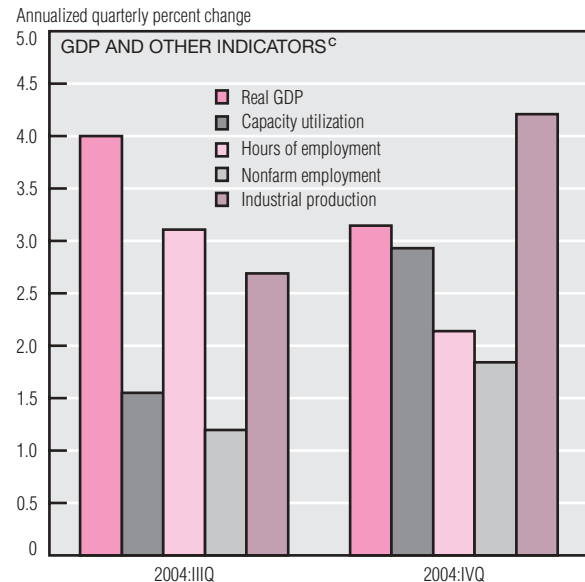
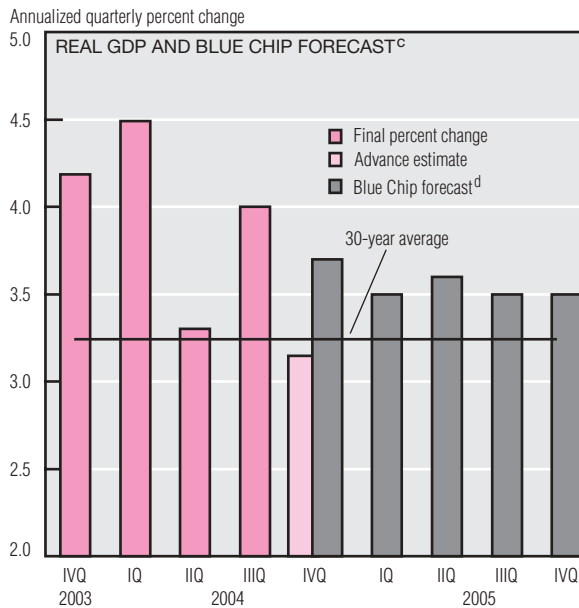
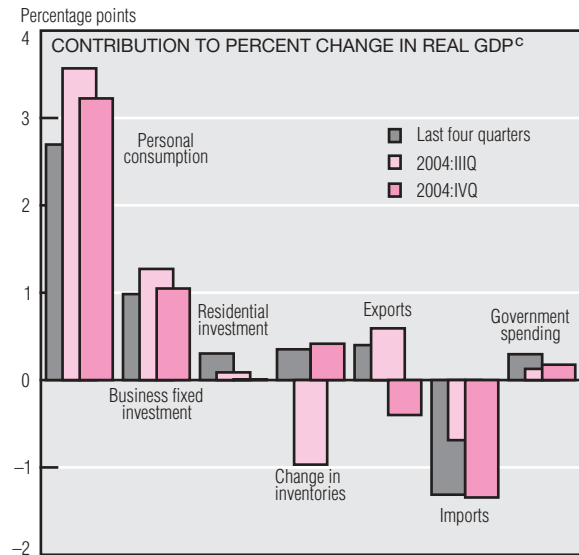
Since the end of 2000, however, the picture has changed. The People's Bank has acquired nearly Rmb 2.4 trillion in foreign assets, but the monetary base has grown only Rmb 1.9 trillion. The bank has offset the effect of reserve growth on its monetary base by reducing its holdings of domestic

assets slightly and by increasing other, nonmonetary liabilities on its balance sheet. Overall, since 2000, the bank has neutralized 20% of the increase in its foreign reserves. It has also raised reserve requirements, another anti-inflation measure, and the government has tried to slow investment spending.

To be sure, China has many artificial barriers to trade and financial flows that help it sustain an overall balance-of-payments surplus, but the contribution of its exchange rate policies seems to have been overstated.

Economic Activity

Real GDP and Components, 2004:IVQ ^{a,b} (Advance estimate)	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	84.7	3.1	3.7
Personal consumption	87.6	4.6	3.9
Durables	18.3	6.7	6.3
Nondurables	31.5	5.8	4.3
Services	39.4	3.7	3.2
Business fixed investment	31.0	10.3	9.9
Equipment	35.9	14.9	13.6
Structures	-2.5	-4.1	-1.6
Residential investment	0.4	0.3	5.7
Government spending	4.6	0.9	1.6
National defense	0.0	0.0	5.5
Net exports	-48.7	—	—
Exports	-11.1	-3.9	4.1
Imports	37.6	9.1	9.2
Change in business inventories	11.3	—	—



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

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

c. Data are seasonally adjusted and annualized.

d. Blue Chip panel of economists.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; National Bureau of Economic Research, National Income and Product Accounts; and *Blue Chip Economic Indicators*, January 10, 2004.

Real GDP grew at an annual rate of 3.1% in 2004:IVQ, according to the U.S. Commerce Department's advance estimate. This was 0.9 percentage point (pp) lower than the 2004:IIIQ growth rate of 4.0%. The growth rate slowed for most subcomponents, most notably exports, which decreased at an annualized rate of 3.9% in the fourth quarter after increasing 6.0% in the third. Durable goods increased 6.7% in 2004:IVQ, compared with an increase of 17.2% the previous quarter, and

national defense spending was unchanged after growing at an annualized rate of 10.0%.

Unlike 2004:IIIQ, when changes in private inventories subtracted 1.0 pp (pp), they contributed 0.4 pp to real GDP growth in 2004:IVQ. However, this was offset by net exports, which subtracted 1.7 pp.

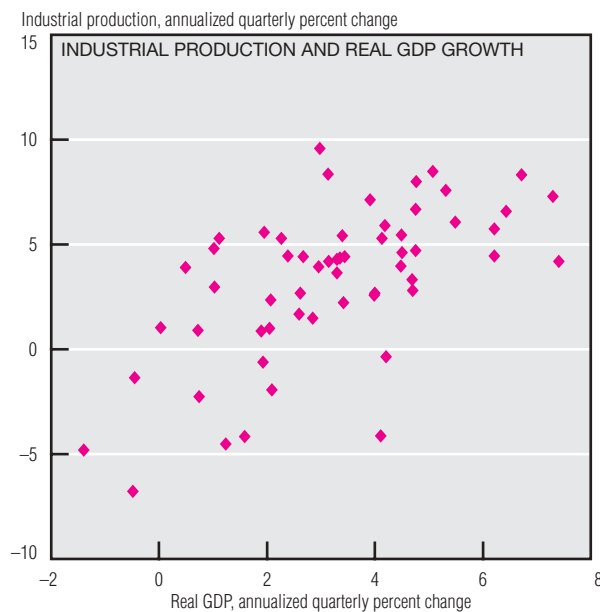
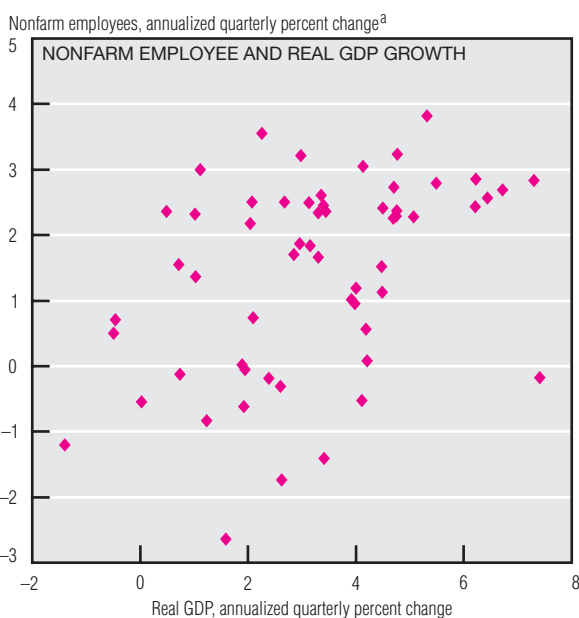
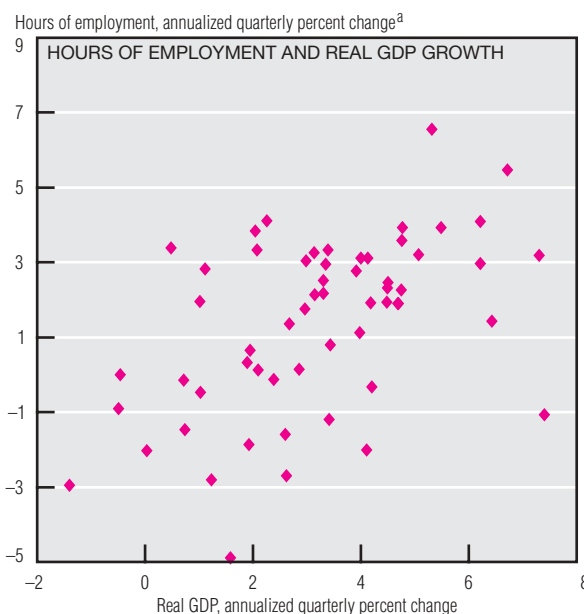
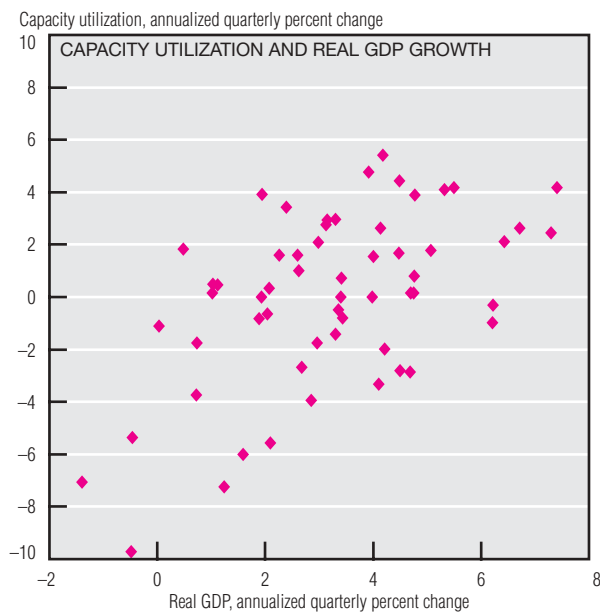
Blue Chip forecasters had predicted growth of 3.7% for 2004:IVQ, 0.6 pp higher than the advance estimate of 3.1%. It was also 0.1 pp lower than the 30-year average and the

lowest annual growth rate since 2003:IQ, when the economy grew at 1.9%. However, Blue Chip forecasters estimate that growth will average 3.5% in 2005.

There are often substantial revisions to the National Income and Product Accounts between the advance and final estimates. Supply-side components give some hint of the likely direction of these revisions. Growth in capacity utilization was up 1.4 pp. Hours were down 1.0 pp, while employment was up more than 0.6 pp.

(continued on next page)

Economic Activity (cont.)



NOTE: All data are seasonally adjusted and annualized.

a. Establishment survey.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

Given capital and labor shares for the U.S. economy, this evidence suggests a more modest fall in GDP than the advance estimate. The increase in industrial production lends further support to this conclusion.

A relationship between GDP and inputs (which generally are measured more frequently) allows inferences about what the final GDP might be. There is a positive correlation of 0.63 between growth in capacity utilization and real GDP growth. Capacity utilization refers to how intensively capital is

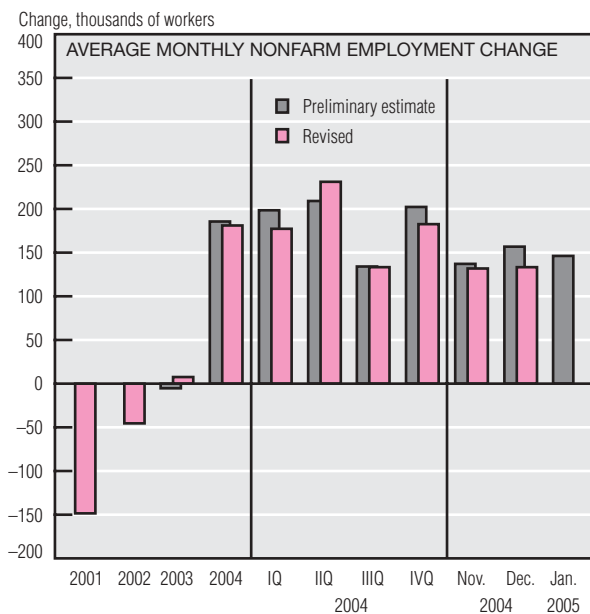
being used. Capital's share of income is roughly 30%, so an increase of 1 pp in capacity utilization should raise GDP 0.3 pp.

Labor input is probably best measured by hours of work. The correlation between growth in hours and growth in real GDP is 0.57, showing that these series are also positively associated. Labor's share of income is around 70%, so a 1 pp increase in the growth of hours should translate into a 0.7 pp increase in the growth of real GDP.

Employment is an alternative measure of the labor input. Employment growth is also positively correlated with real GDP (0.50), although less closely than hours.

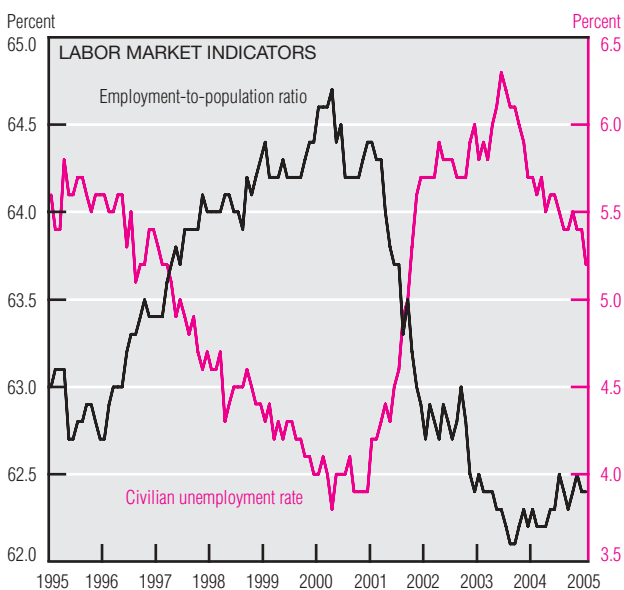
Industrial production is an output measure that is less inclusive than GDP. An advantage of looking at this series is that it is available monthly, whereas GDP is available only on a quarterly basis. The correlation between the growth in these two series is relatively strong at 0.69.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	Jan. 2005
Payroll employment	-148	-45	8	181	146
Goods producing	-124	-76	-42	27	-31
Construction	-1	-7	10	22	-9
Manufacturing	-123	-67	-51	3	-25
Durable goods	-88	-48	-32	8	-12
Nondurable goods	-35	-19	-19	-5	-13
Service providing	-25	30	50	154	177
Retail trade	-24	-10	-5	13	19
Financial activities ^a	8	6	7	12	21
PBS ^b	-63	-17	22	43	25
Temporary help svcs.	-37	2	12	16	18
Education & health svcs.	50	40	30	34	35
Leisure and hospitality	46	21	-4	22	20
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.5	5.2



NOTE: All data are seasonally adjusted unless otherwise noted.

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. Data not seasonally adjusted.

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

Nonfarm payroll employment increased 146,000 in January. December's growth was revised down 24,000, although the employment level was raised 161,000 after the benchmark revision and updating of seasonal factors. Payroll employment declined by 2.7 million from February 2001 to May 2003, but has increased by the same number since then.

Service-providing industries increased by 177,000 jobs in January; education and health services contributed 35,000, approximating the monthly gain in 2004. Manufacturing

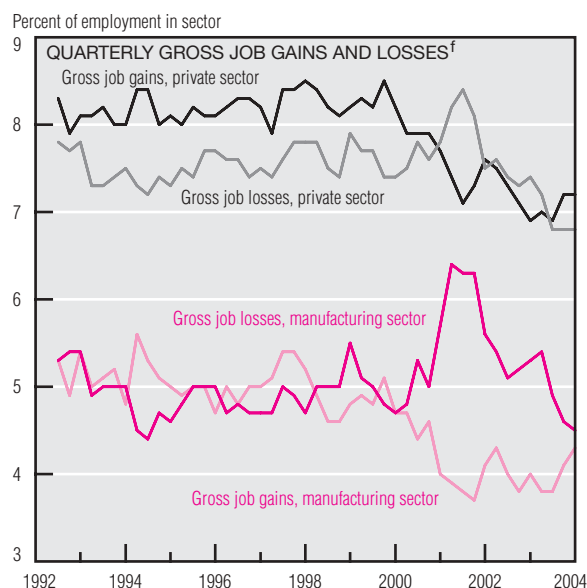
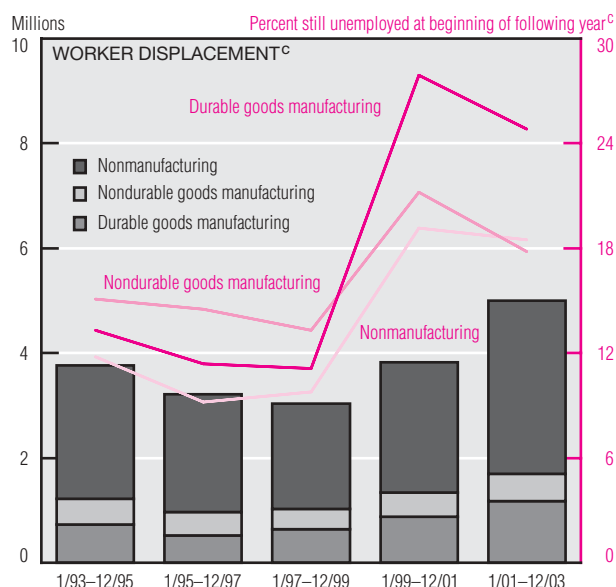
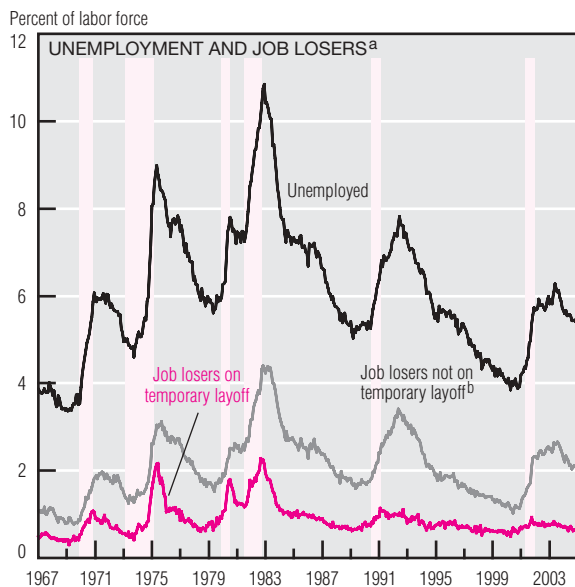
jobs fell by 25,000 in January, nearly half in the transportation equipment industry. After increasing 85,000 from January through August of last year, manufacturing payrolls have fallen by 61,000. Construction jobs fell 9,000, the first decline since February 2004, possibly because of adverse weather.

In January, the unemployment rate fell 0.2 percentage point (pp) to 5.2%, mostly the result of lower labor force participation. The unemployment rate has fallen more than 1 pp from its 6.3% peak in June 2003. The employment-to-population ratio, which changed

little during the same period, remained at 62.4% in January.

The Employment Cost Index, which measures changes in compensation costs not influenced by employment shifts across industries or occupations, rose 0.7% from 2004:IIIQ to 2004:IV; its components, wages/salaries and benefits costs, increased 0.4% and 1.4%, respectively; benefits accounted for more than 60% of the total compensation increase, continuing recent years' trends of accelerating benefits costs and declining wage and salary growth.

Job Reallocation in the Recovery



a. Recession periods dated by the National Bureau of Economic Research.

b. Job losers not on temporary layoff include permanent job losers or persons who completed temporary jobs.

c. Displaced workers are those who had three or more years-tenure on a job they lost or left because of plant or company closings or moves, insufficient work, or elimination of their positions or shifts. Includes only private nonfarm wage and salary workers 20 years and older.

d. For example, for workers displaced in the January 2001–December 2003 period, measures the percent unemployed in January 2004.

e. The bubble area is proportional to industry employment (two-digit SIC) at business cycle peak. Omits metals mining and includes only commercial banks, not all depository institutions. See Erica L. Groshen and Simon Potter, Federal Reserve Bank of New York, *Current Issues in Economic and Finance*, August 2003.

f. Gross job gains are net gains at expanding or opening firms. Gross job losses are net losses at contracting or closing firms.

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

The labor market recovery after the November 2001 business cycle trough has been unusually weak. Has increased sectoral reallocation (a permanent shift in the way employment is distributed among economic sectors) been a factor in this slow transition?

The recessions of the 1970s and 1980s had a feature that the 1990–91 and 2001 episodes lacked: a spike in the percentage of labor force participants on temporary layoff. The decrease in temporary layoffs compared to other layoffs during the last

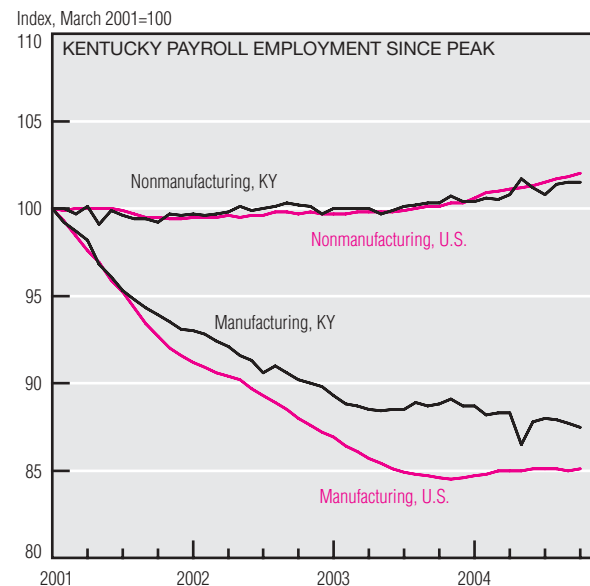
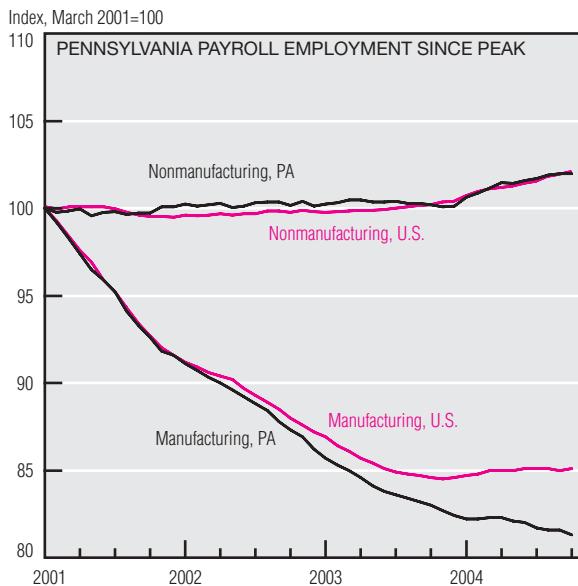
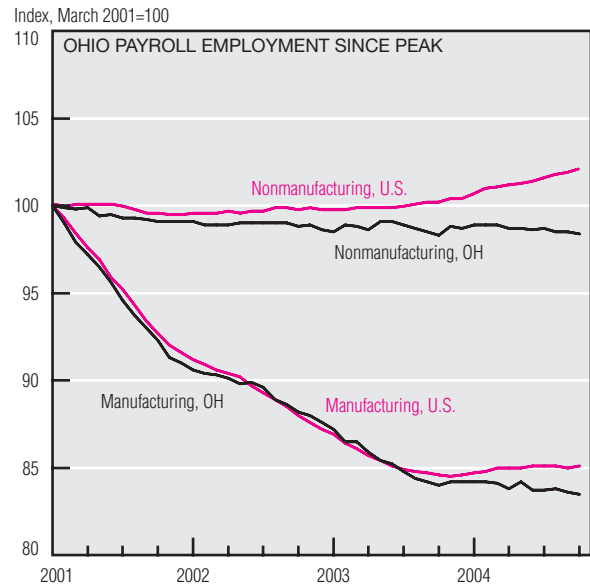
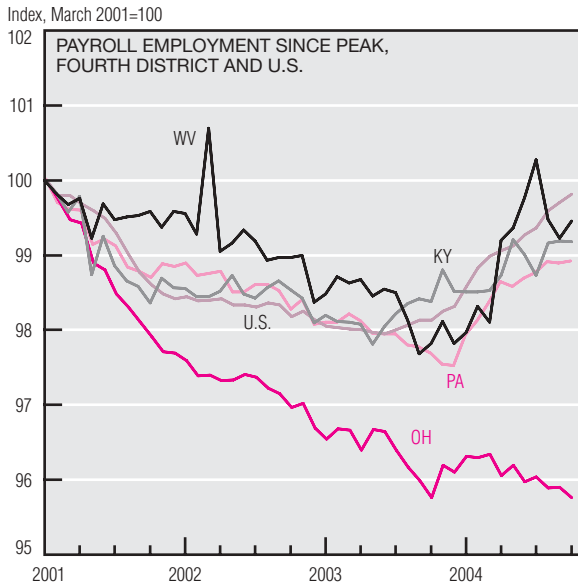
recession is consistent with the idea of increased sectoral reallocation.

What is more likely to be seen in sectoral reallocations is increased worker displacement. The years covered by the two most recent Displaced Worker Surveys (DWS) showed spikes in displacements. And researchers have found that worker displacement rates fell less in the 1990s than one might have expected, given the strong labor market conditions.

A less roundabout way to identify sectoral reallocation, suggested by several researchers, is seeing how many

industries have employment increases both during and after a recession or employment decreases in both phases. According to these researchers, increased sectoral reallocation is suggested by the larger proportion of industries in one of these two categories for the 2001 recession than for previous episodes. Others take issue with this methodology. They note that both job creation and job destruction have fallen since the last business cycle peak and contend that this is less consistent with the hypothesis of increased sectoral reallocation.

Fourth District Employment



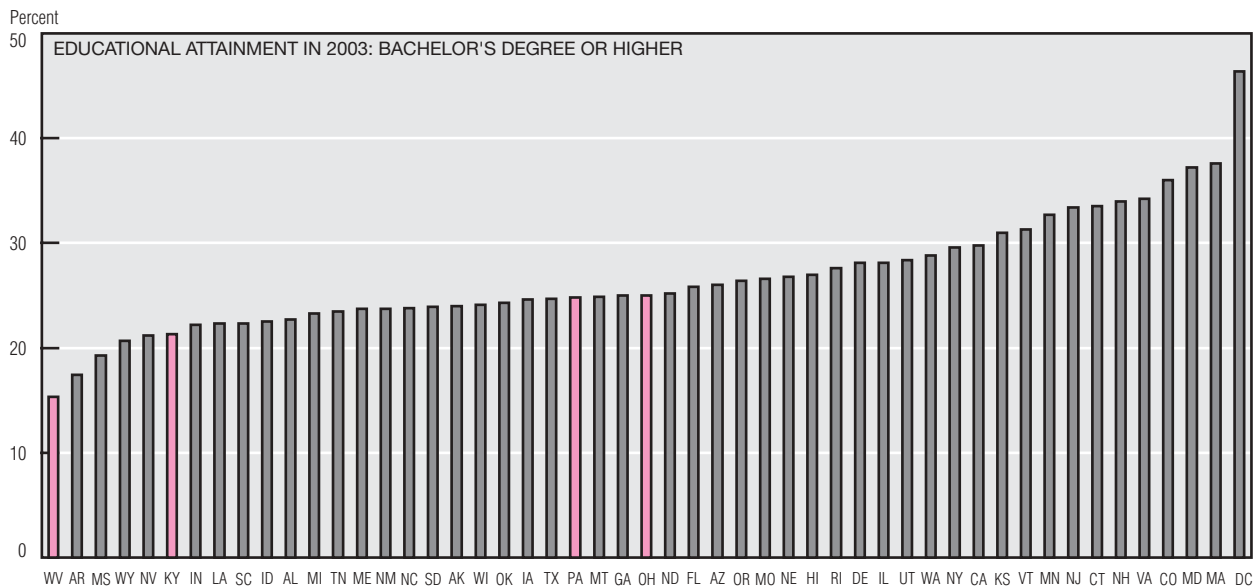
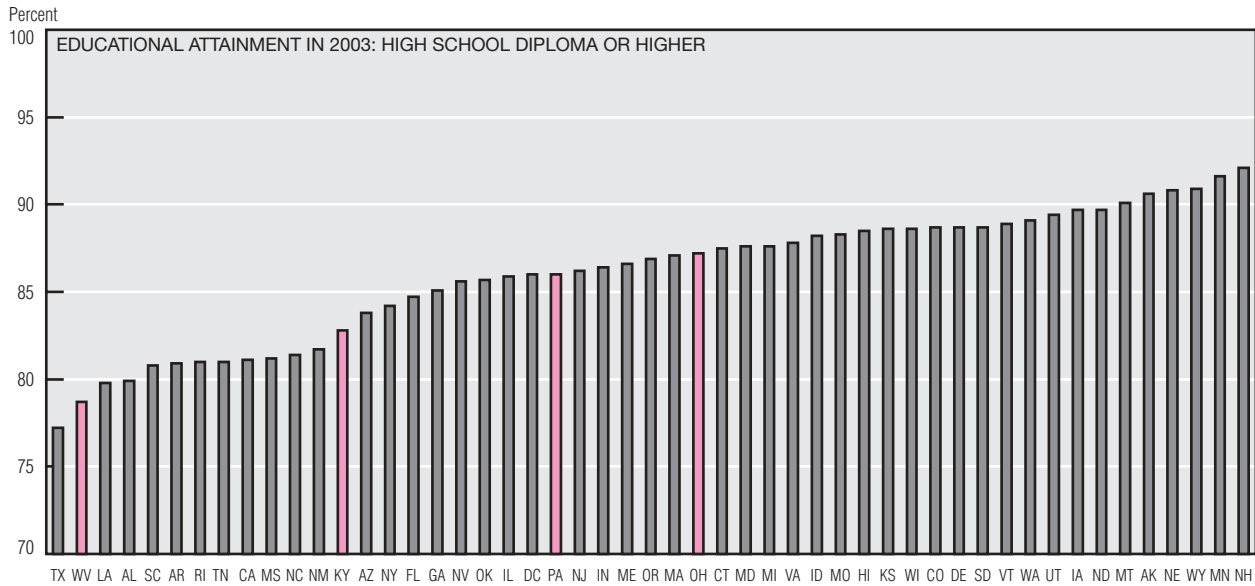
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

By some measures, Ohio's economic performance during the current recovery has been disappointing. Ohio trails the other Fourth District states in employment growth. Kentucky, Pennsylvania, and West Virginia have tracked the nation, more or less, since the last business cycle peak. Ohio employment, on the other hand, lags the national average by more than four percentage points.

Why is Ohio's employment growth so slow? Many have cited weakness in manufacturing jobs, which account for 15.3% of the state's employment. Since the last business cycle peak, Ohio has lost 1.6% more manufacturing jobs than the nation. But Pennsylvania, whose industrial makeup is 12.2% manufacturing, has lost an even greater percentage of its manufacturing jobs than Ohio—about 2% more.

Weakness in nonmanufacturing industries is what makes Ohio employment remarkable. Since the last peak, nonmanufacturing jobs increased by 2% nationwide; in Ohio, they *decreased* by 1.6%. Nonmanufacturing employment has fared much better in Pennsylvania and Kentucky, where it never fell more than 1% from its 2001 levels. These two states have tracked U.S. nonmanufacturing employment almost exactly.

Education in the U.S. and Fourth District States



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

Very few people would deny that there is a positive relationship between economic development and education. How does the Fourth Federal Reserve District stack up against the nation? It depends on the state.

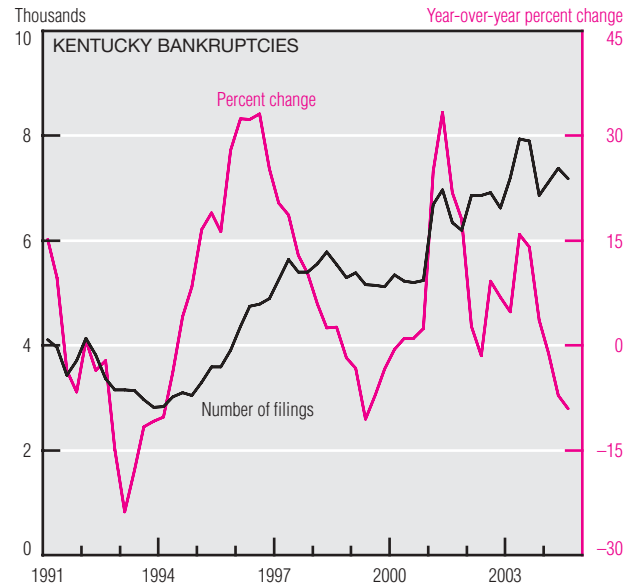
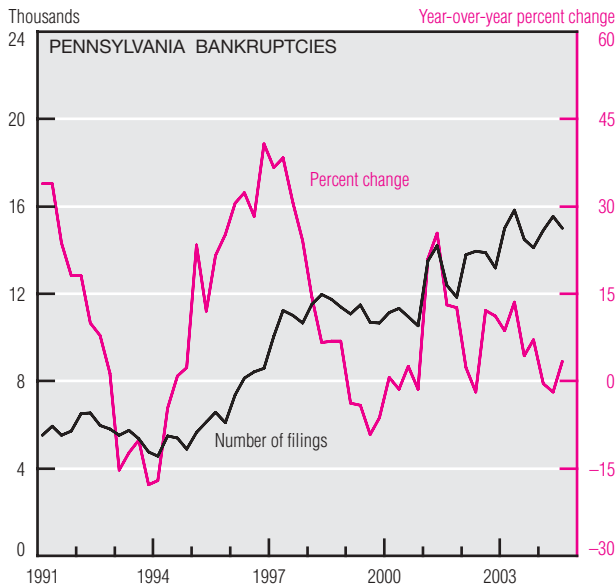
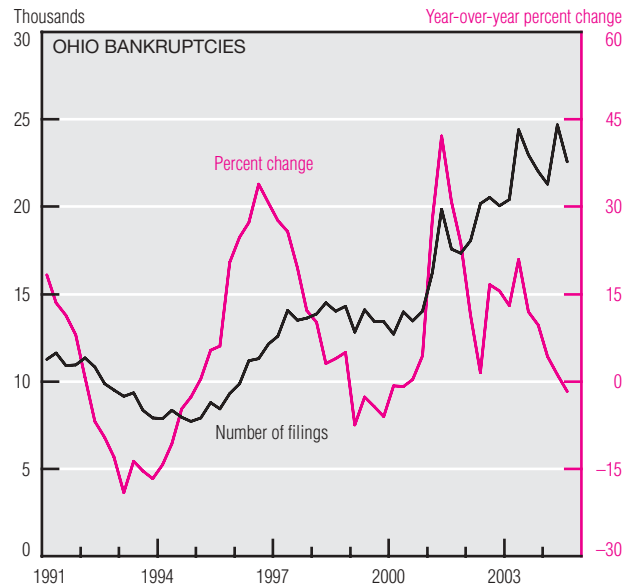
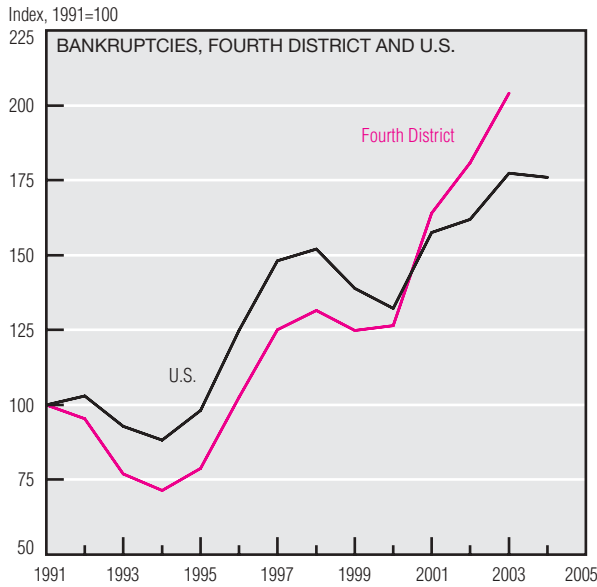
Of the four states in the District, West Virginia had the nation's second-lowest share (78.7%) of residents 25 or older with at least a high school diploma in 2003, less than every state

except Texas. West Virginia was about 10 percentage points lower than Ohio, the Fourth District leader. Kentucky was in between, with 82.8% of adults obtaining a high school diploma. The national average was 84.6%.

Not surprisingly, educational attainment at the college level shows a similar pattern. Of the 50 states, West Virginia had the lowest rate of adults (people 25 or older) with at least a

bachelor's degree (15.3%). This rate was one-third as high as Washington D.C., the area where the highest share of residents held at least a bachelor's degree. Massachusetts, at 37.6%, led every other state. In Kentucky, 21.3% of the adult population had a bachelor's degree or higher. Ohio and Pennsylvania, the other Fourth District states, were near the national average of 27.2%.

Bankruptcies in the Fourth District



SOURCE: Administrative Office of the U.S. Courts.

Bankruptcies cost businesses and consumers billions of dollars every year, but they also offer essential protection for debtors. The two main types of bankruptcies are Chapter 7 and Chapter 13. In a Chapter 7 bankruptcy, individuals' or businesses' debts are abolished, but their nonexempt assets are liquidated. Nonexempt assets (property that creditors can take as compensation) differ from state to state. In a Chapter 13 bankruptcy (Chapter 11 for businesses), the debtor, creditors, and

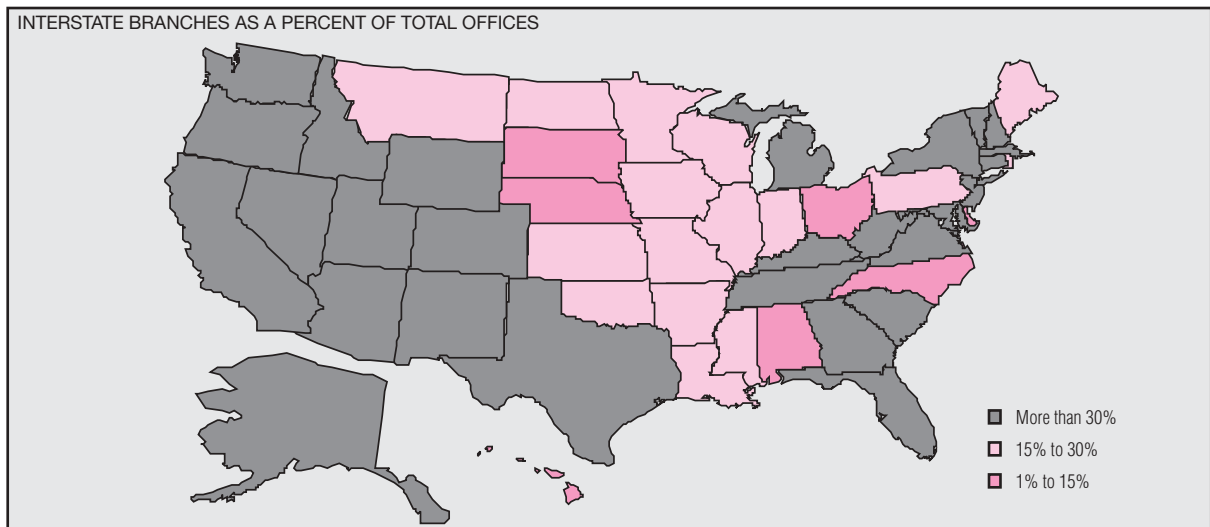
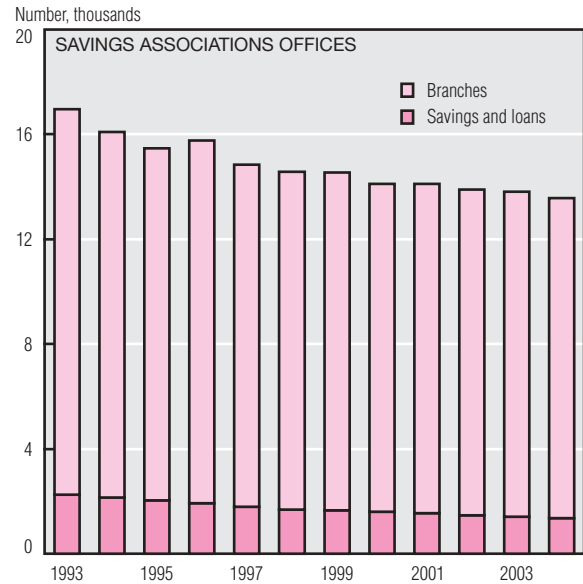
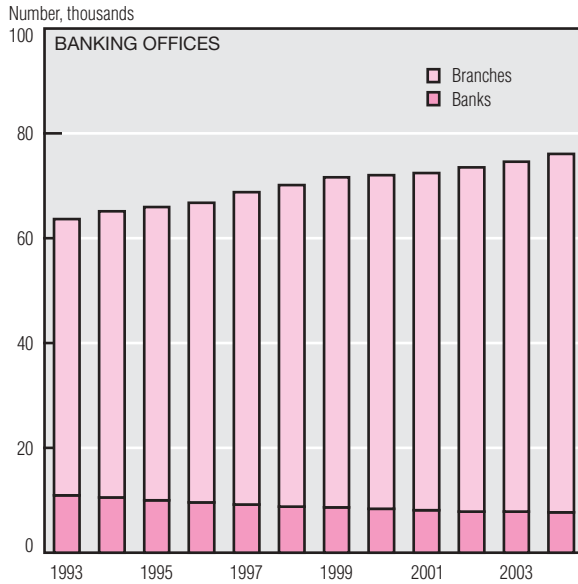
court agree on a plan for repayment, usually within three to five years.

Bankruptcies in the Fourth District have tracked the national average closely over the past decade. Although it is true that the number of bankruptcies filed is influenced primarily by economic conditions, such as consumer debt and labor market changes, it is also a function of legislation. For example, large year-over-year increases in bankruptcy filings in 2001 were caused by both economic conditions and proposed bankruptcy

reform legislation that would have made it more difficult to file after 2001. Although the reform never passed into law, talk of it caused an increase in filings, designed to beat the proposed legislation. As economic conditions improved and talk of reform quieted, the acceleration in bankruptcy filings fell off a bit.

Bankruptcy filings in the Fourth District states generally rose throughout the last decade. For all four of these states, bankruptcy levels are at about the same level as a year ago.

Banking Structure



NOTE: All 2004 data are as of the end of the third quarter.

SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile* and *QBP Graph Book*, September 30, 2004.

Passage of the 1994 Reigle–Neal Act, which regulates interstate banking, spurred consolidation of depository institutions. The number of FDIC-insured commercial banks fell from 10,998 at the end of 1993 to 7,672 at the end of 2004:IIIQ, a decline of more than 30%. Over the same period, the number of FDIC-insured savings associations fell nearly 40%, from 2,262 in 1993 to 1,365 at the end of 2004:IIIQ.

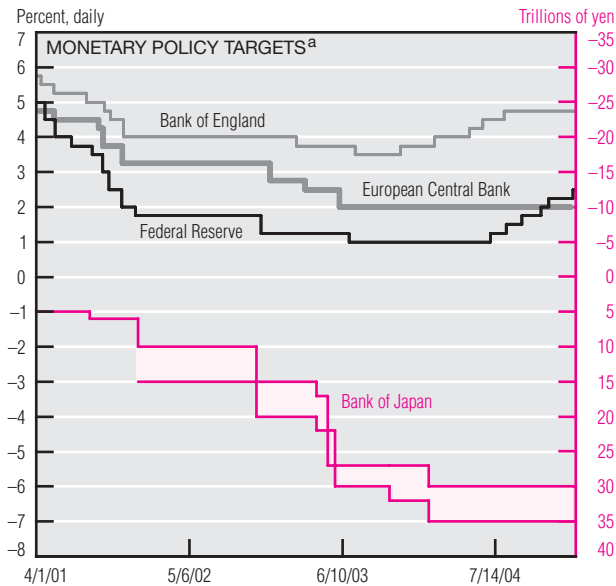
The number of savings associations offices also declined, but less sharply

than the number of institutions (only around 20%, from 16,953 in 1993 to 13,571 at the end of 2004:IIIQ). Total banking offices, however, increased nearly 20% over that period, from 63,622 to 76,102. From the end of 1993 to September 30, 2004, the total number of FDIC-insured depository institutions' offices increased 11%, from 80,575 to 89,673. This count does not include other channels for delivering banking services, such as automated teller machines, telephone banking, and online banking. Hence,

the reduction in the number of insured depository institutions has not decreased the availability of bank services for the average consumer.

Finally, the effects of interstate consolidation of the banking industry are evident: All but seven states now report that more than 15% of depository institutions' branches are part of an out-of-state bank or savings association. And in over half the states, 30% or more of all branches are offices of out-of-state depository institutions.

Foreign Central Banks



Minutes of Monetary Policy Meetings

United States: Minutes of scheduled meetings released three weeks after the policy decision.

European Union: No minutes.

United Kingdom: Minutes of meetings released on the second Wednesday after the policy decision.

Japan: Minutes approved at the first or second meeting, held about one month after the meeting concerned and released after approval.

Frequency of Monetary Policy Meetings

United States: Eight regularly scheduled Federal Open Market Committee meetings during a year, at intervals of six to eight weeks.

European Union: Twelve regularly scheduled Governing Council meetings during a year, normally on the first Thursday of each month.

United Kingdom: Twelve regularly scheduled meetings during a year, normally the Wednesday and Thursday following the first Monday of each month.

Japan: "In principle," 24 monetary policy meetings during a year. Typically, meetings are held monthly on a schedule announced at the end of each quarter for the following six months.

Other Releases

United States: Press release announcing the policy decision immediately after the meeting. No press conference. Meeting transcripts published with a five-year lag.

European Union: Press conference immediately after the meeting. Press conference transcripts published on the EU website a few hours later. No press release. Meeting transcripts not yet published.

United Kingdom: Press release announcing the policy decision immediately after the meeting. No press conference or meeting transcripts.

Japan: Same-day press release of policy decision. Press conference for a policy change. Meeting transcripts published with a 10-year lag.

a. Federal Reserve: overnight interbank rate. Bank of Japan: a quantity of current account balances (since December 19, 2001, a range of quantity of current account balances). Bank of England and European Central Bank: repo rate.

SOURCES: Board of Governors of the Federal Reserve System; Bank of England; Bank of Japan; and European Central Bank.

On February 2, the Federal Reserve's Federal Open Market Committee again raised its target for the overnight interbank (federal funds) rate by 25 basis points, bringing the target to 2.50%. The Bank of England and the European Central Bank have not changed their target repurchase agreement rates recently, and the Bank of Japan continues to maintain its ¥30–¥35 trillion target for the supply of its current account balance liabilities.

The current theory of monetary policy entails transparency of operations. Markets can operate more efficiently if the public understands the policy objective, knows how the central bank calibrates its policy instrument to achieve that objective, and believes that the central bank is credible—that is, that it will do what it says it will. Policy actions usually can be detected quickly by expert money market analysts, but immediate announcement of an action ensures that even those who are not active market

participants have up-to-date information. Public understanding of the policy process is enhanced by timely release of detailed information about policy deliberations. The Federal Open Market Committee recently accelerated the release of its minutes from just after the next meeting to before the next meeting. While the European Central Bank does not publish minutes, its governor holds a press conference immediately after each meeting to characterize the deliberations and respond to questions.