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The Economy in Perspective

Attention: Deficit Disorder…The vexed question of the nation's deficits, both actual and projected, has aroused a cacophony of opinions. Despite the tumult, however, there is an element of arithmetic that must be respected.

From *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, published by the Congressional Budget Office, January 2005:

"In the decades beyond CBO's projection period, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation. Over the next 30 years, the number of people age 65 or older will double, while the number of adults under age 65 will increase by less than 15 percent. Moreover, health care costs are likely to continue to grow faster than the economy. (Between 1960 and 2001, the average annual growth rate of national health expenditures exceeded the growth rate of GDP by 2.5 percentage points.)

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If excess cost growth continued to average 2.5 percentage points in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 11.5 percent of GDP in 2030…The Medicare trustees assume that excess cost growth will decline to 1 percentage point, on average; however, even at that rate, federal spending for Medicare and Medicaid would double to 8.4 percent of GDP by 2030.

Outlays for Social Security as a share of GDP are projected to grow by more than 40 percent in the next three decades under current law: from about 4.2 percent of GDP to more than 6 percent. Such costs are likely to creep up gradually thereafter. By contrast, federal revenues credited to Social Security are expected to remain close to their current level—around 5 percent of GDP—over that period.

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the budget that economic growth alone is unlikely to alleviate. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those approaches."

Federal Reserve Board Chairman Alan Greenspan testified at the March 2 Committee Hearing of the U.S. House of Representatives Budget Committee. In response to a congressman's inquiry about the options available for reducing the nation's dependence on foreign capital inflows, he replied that we have very limited choices. We are now borrowing the equivalent of almost 6 percent of our GDP annually, and we use it, essentially, to finance domestic investment. To curtail, at least in part, the amount of investment that is being made in the United States, we would have to either curtail domestic investment—a course he does not favor—or increase domestic savings.

Curtailing domestic investment would require us to slow the pace of housing construction or the amount of plant and equipment that we rely on to enhance our productivity. If we do not want to slow domestic investment, there is only one alternative, and that is to increase domestic savings. How? By bringing the federal budget closer to balance, either through a higher rate of household saving or through increased saving by corporations. That's it. So our choices are limited.

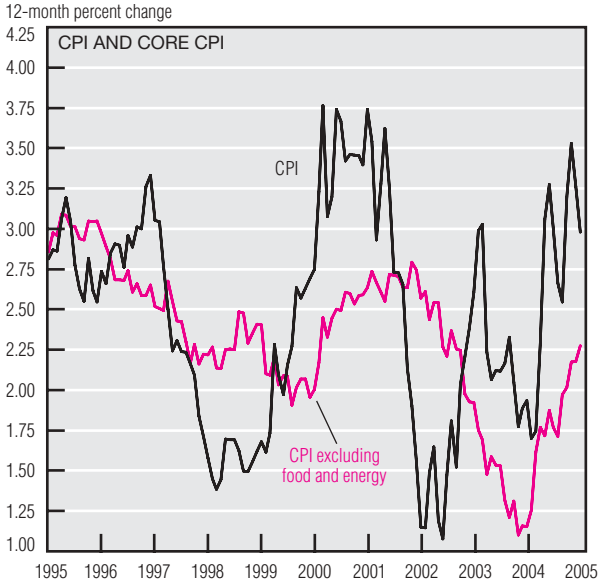
Chairman Greenspan remarked that today's limited possibilities for financing the current account deficit reminded him of the time in 1983 when he was chairman of the Social Security Commission. At their first meeting, he recalled, the commission members contemplated their options for shoring up the dwindling Social Security trust fund. They recognized right away that they could either raise taxes, lower benefits, or advert to general revenues. But, Chairman Greenspan recalled, for several meetings the commission resisted acknowledging the simple, but powerful, arithmetic of the situation until they finally exhausted themselves and concluded that there was no alternative to action.

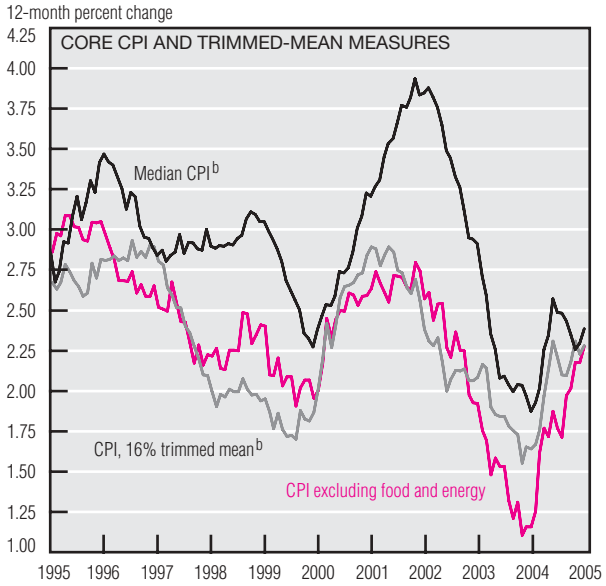
The Chairman's experience foretells what we know to be true: These deficit-inducing issues will be resolved—somehow. Let us work for good solutions.

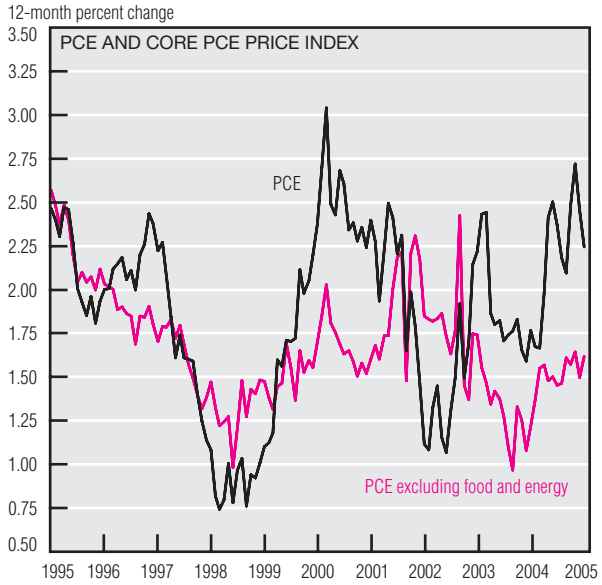
Inflation and Prices

January Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2004 avg.
Consumer prices					
All items	0.6	1.3	3.0	2.5	3.4
Less food and energy	2.4	2.0	2.3	2.1	2.2
Median[b]	3.2	2.2	2.4	2.8	2.3
Producer prices					
Finished goods	3.2	2.7	4.2	2.4	4.4
Less food and energy	9.7	4.8	2.7	1.2	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.

The Consumer Price Index (CPI) rose at an annualized rate of 0.6% in January after remaining unchanged in December; the core CPI, which excludes the volatile food and energy prices, rose at a 2.4% annualized rate. The median CPI, which attempts to control for volatile monthly price changes by considering the center of the monthly price-change distribution, increased at a brisk 3.2% annualized rate, its second-largest advance in the past year.

Longer-term inflation patterns indicate that although the retail price measures inched upward in January, inflation seems to be relatively stable. Although inflation, as measured by the core CPI, has trended upward over the past year, its 12-month growth rate of 2.3% was about 0.6 percentage point below the average rate during the previous economic expansion. The 12-month growth rates of the median and 16% trimmed-mean CPI were 2.4% and 2.3%, respectively. Patterns in the Personal Consumption Expenditure (PCE) Price Index and the core PCE Price Index, which measure an alternative consumer market basket, largely mirror the CPI price measures. The core PCE has fluctuated between 1.4% and 1.6% for the past 12 months.

In its semiannual Monetary Policy Report to the Congress, the Board of Governors of the Federal Reserve System reported recent projections by the Federal Open Market Committee. They showed inflation rising slightly: The central tendency of the group's projection for the core PCE Price Index in 2005 and 2006 is between $1\frac{1}{2}$% and $1\frac{3}{4}$% on a fourth-quarter over fourth-quarter basis. The February projections for 2005 are lower

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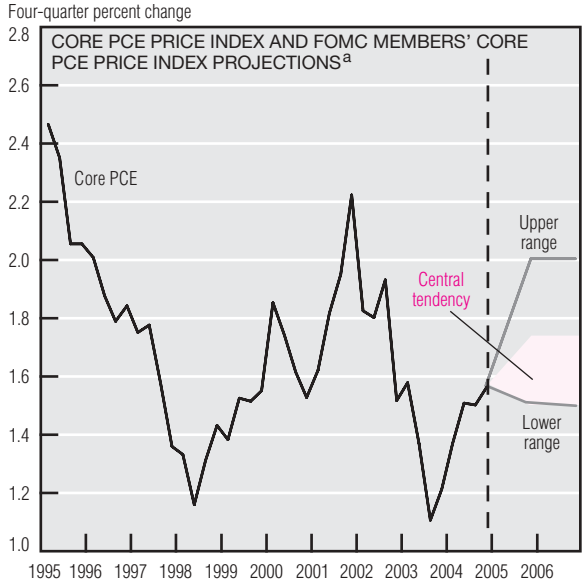
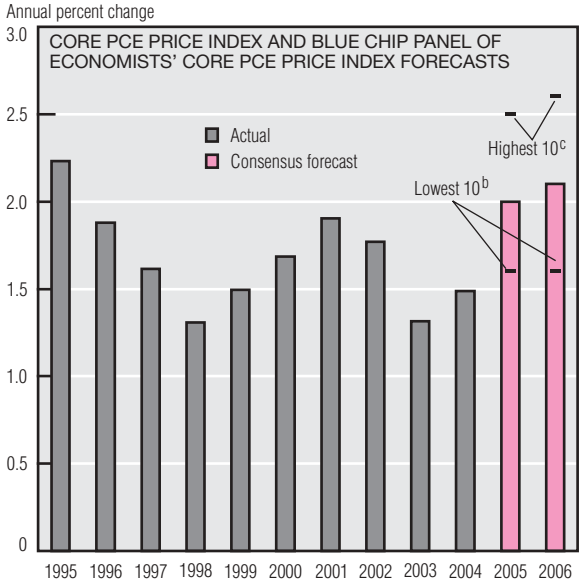
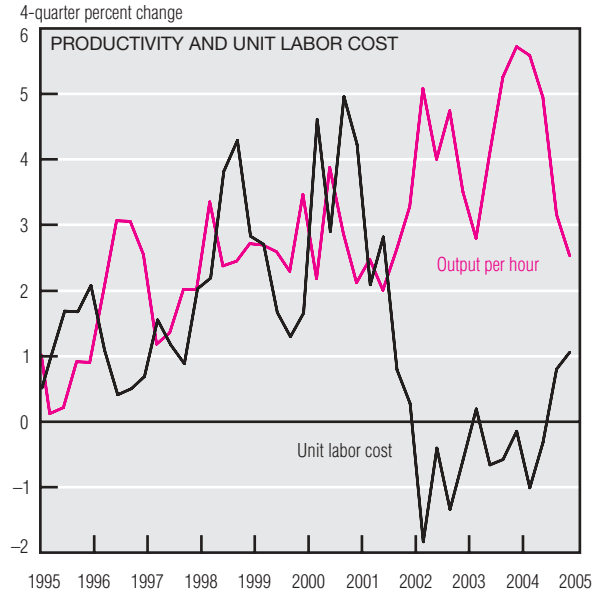
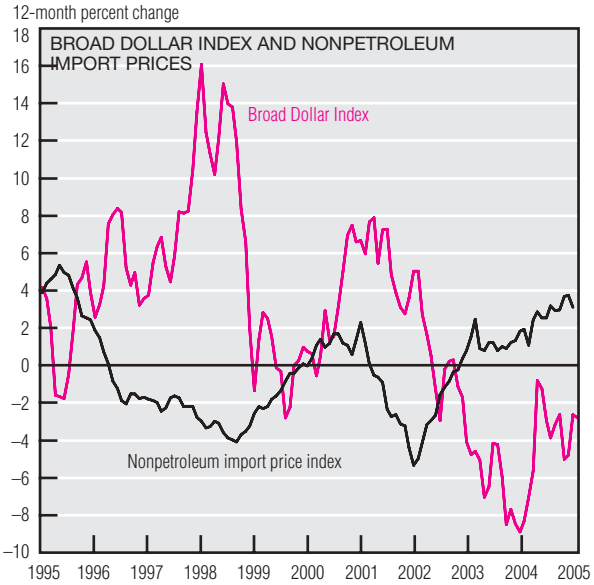
Inflation and Prices (cont.)









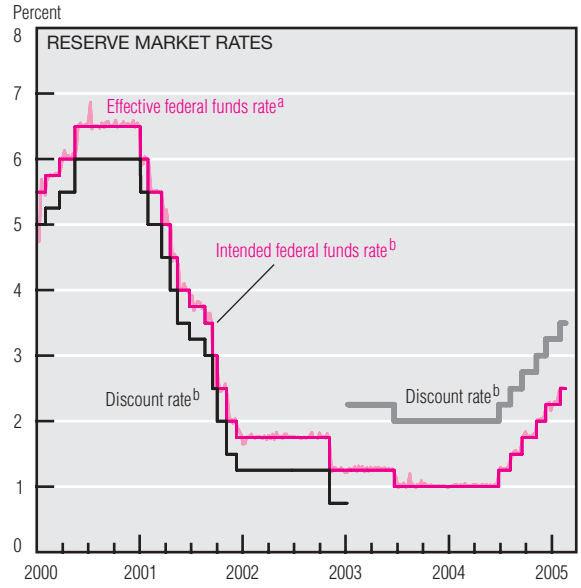
a. Projections by the Board of Governors of the Federal Reserve System and Reserve Bank presidents.
b. Average of lowest 10 forecasts.
c. Average of highest 10 forecasts.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases* H.10 and Monetary Report to the Congress; and *Blue Chip Economic Indicators*, January 10, 2005.

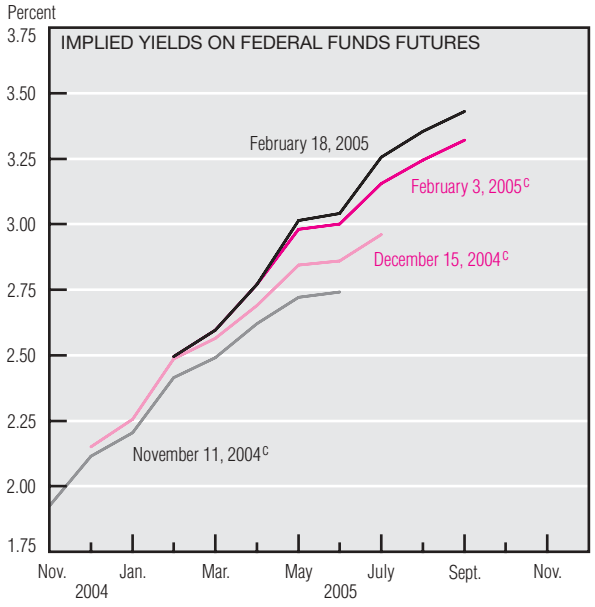
than last July's, in which members anticipated a rise of 1¾% to 2% in core-PCE-measured prices. Private forecasters expect those prices to register in the upper range of the FOMC members' projections: Consensus estimates by the Blue Chip panel of economists show prices rising 2.0% in 2005 and 2.1% in 2006.

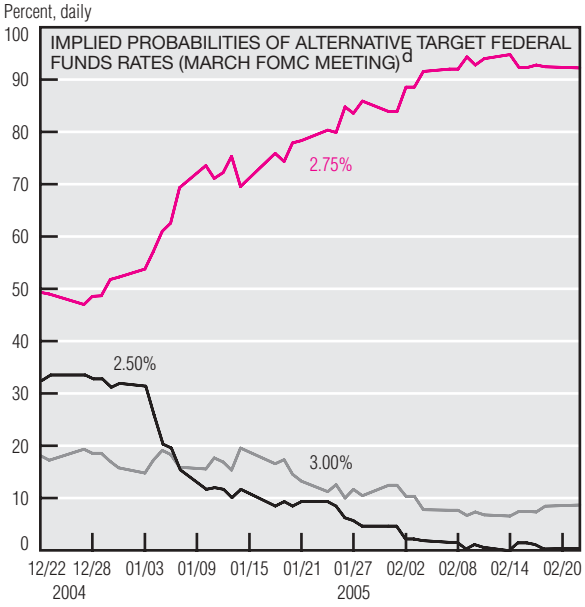
In presenting the Monetary Policy Report to the Congress, Chairman Greenspan noted that the inflation outlook would be shaped by productivity developments, changes in the exchange value of the dollar, and oil prices. He observed that "…the implications for inflation will be influenced by the extent and persistence of any slowdown in productivity. A lower rate of productivity growth in the context of relatively stable increases in average hourly compensation has led to slightly more rapid growth in unit labor costs… To date, with profit margins already high, competitive pressures have tended to limit the extent to which cost pressures have been reflected in higher prices." Whether inflation actually rises, however, "...will depend on the degree of utilization of resources and how monetary policymakers respond."

Inflationary pressure could also arise from further dollar depreciation, which makes imports relatively more expensive in dollar terms. Chairman Greenspan warned that "the recent somewhat quickened pace of U.S. import prices suggests that profit margins of exporters to the United States have contracted to the point where the foreign shippers may exhibit only limited tolerance for additional reductions in margins should the dollar decline further."

Monetary Policy







Economic Projections for 2005 (percent)

	Actual 2004	Federal Reserve governors and Reserve Bank presidents: Range	Federal Reserve governors and Reserve Bank presidents: Central tendency
Nominal GDP[e]	6.2	5.00–6.00	5.50–5.75
Real GDP[e,f]	3.7	3.50–4.00	3.75–4.00
PCE price index excluding food and energy[e]	1.6	1.50–2.00	1.50–1.75
Civilian unemployment rate[g]	5.4	5.00–5.50	5.25

a. Weekly average of daily figures.
b. Daily observations.
c. One day after the FOMC meeting.
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. Change, fourth quarter to fourth quarter.
f. Chain weighted.
g. Average level, fourth quarter.

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

On February 2, the Federal Open Market Committee (FOMC) raised the intended federal funds rate 25 basis points (bp) to 2.5%, the sixth such increase since the current round of tightening began in late June 2004. The FOMC's press release stated that "even after this action, the stance of monetary policy remains accommodative." It noted that "labor market conditions continue to improve gradually" and pointed to a containment of longer-term inflation expectations. The FOMC has said that accommodation can continue to be removed at a "measured pace."

Market participants seem to agree. Implied yields are consistent with 25 bp increases in the funds rate at the March, May, and June meetings. Since the FOMC's February 1–2 meeting, participants in the options market have placed higher probabilities on a 25 bp increase at the March meeting. The implied probability of a 25 bp hike now exceeds 92%.

On February 16, the Fed released its semiannual Monetary Policy Report to the Congress, which presents economic projections by the Board of Governors and Reserve Bank presidents. The central tendency of the projections for real GDP growth for 2005 is 3.75%–4.00%. The core PCE Chain-Type Price Index is expected to grow at an annual rate of 1.50–1.75%, and the fourth quarter unemployment rate is projected at 5.25%.

How reliable might these projections be, in themselves and relative to private forecasters? A scatter plot of perfect projections versus actual

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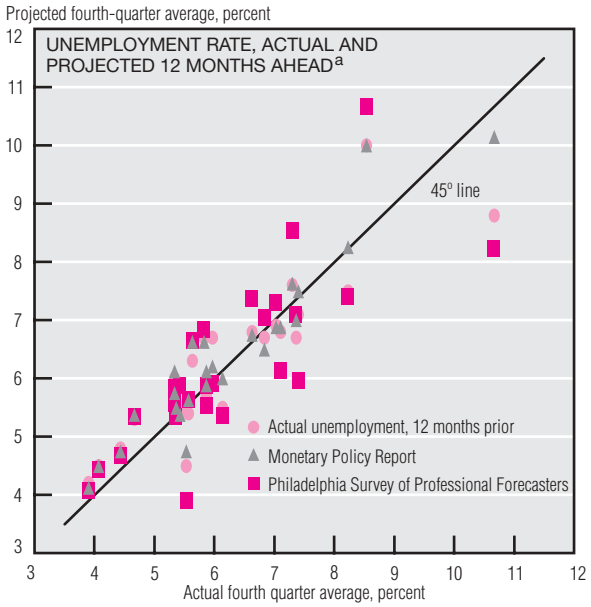
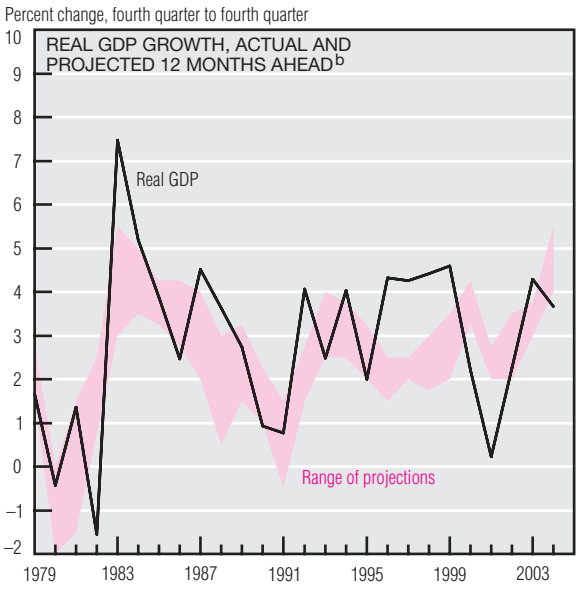
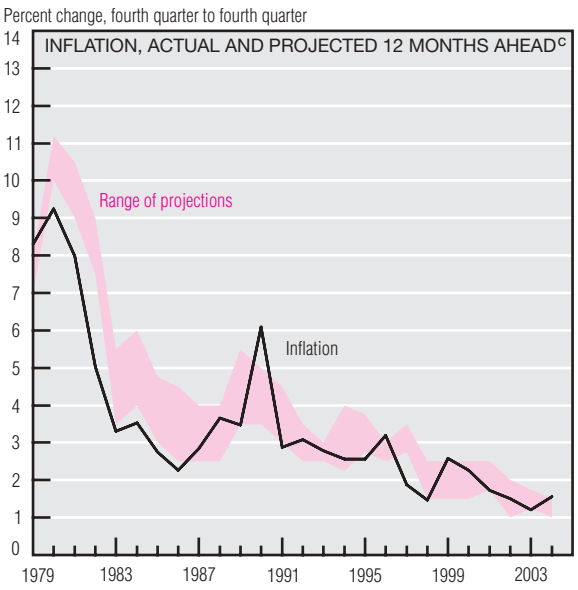
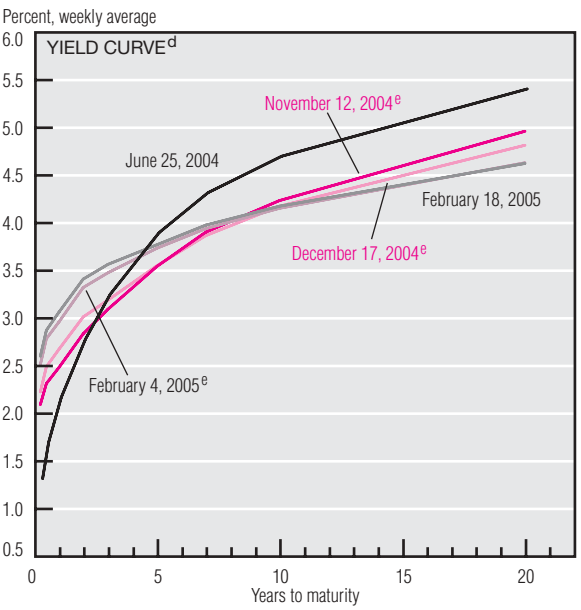
Monetary Policy (cont.)









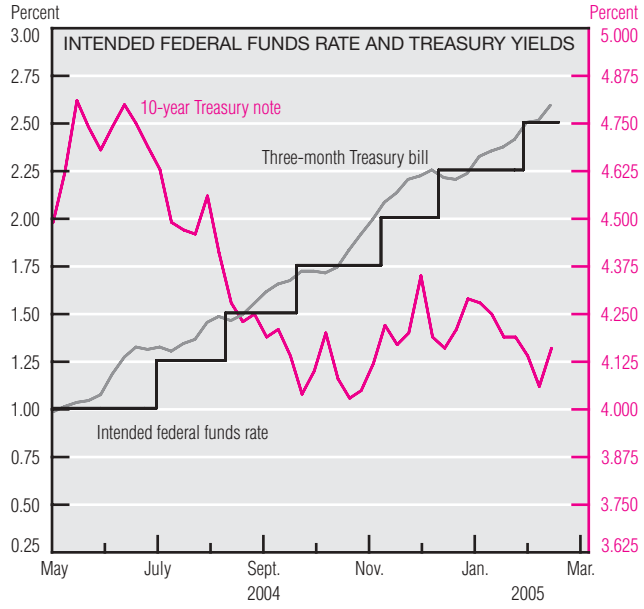
a. The *Monetary Policy Report* projection is the midpoint of the range. The *Survey of Professional Forecasters* projection is the median response.
b. Projected and real GDP are both GNP prior to 1992.
c. From 1979 to 1989, inflation and projected inflation are plotted as the implicit GDP deflator; from 1990 to 1999, they are plotted in terms of the CPI; from 2000 to 2001, they are plotted in terms of the PCE Chain-type Price Index; and from 2002 to 2004 as the core PCE Chain-type Price Index.
d. All yields are from constant-maturity series. Average for the week ending on the date shown.
e. The first weekly average available after the FOMC meeting.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*.

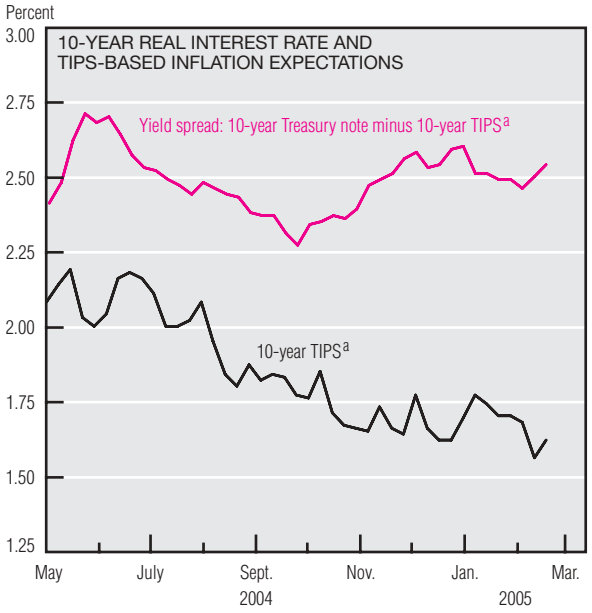
values would lie along a 45-degree line. Here, we compare the Monetary Policy Report's accuracy in projecting unemployment with that of private forecasters and with a naïve forecast that simply predicts a future value equal to the current one. At times, these values miss the actual unemployment rate by one or more percentage points. We can gauge their overall performance by calculating mean absolute errors. Over a 12-month horizon, the mean absolute error of professional forecasts of the unemployment rate is 0.52% versus the Federal Reserve's 0.38%. Both are more accurate than the naïve forecast's mean absolute error of 0.69%.

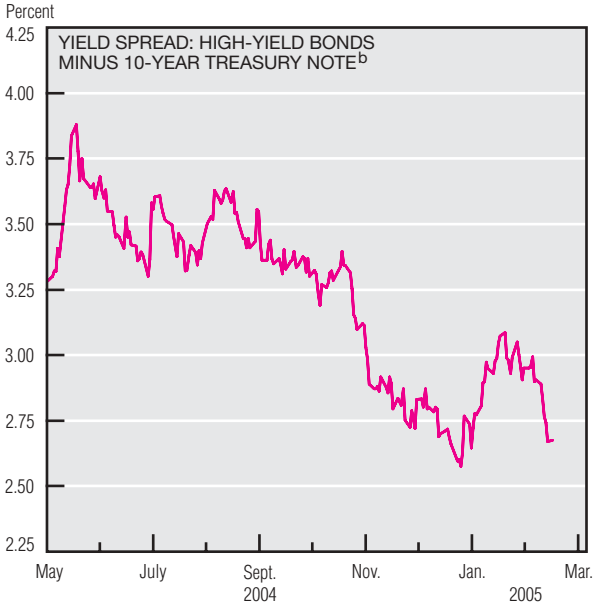
In recent years, Fed projections of real GDP growth (fourth quarter to fourth quarter) have tracked actual real GDP growth quite well, but the timing of its upturns and downturns has always been difficult to project. And for prolonged periods, the projections over- or understate real GDP growth considerably. The inflation projections, (0.85% mean absolute error) fared better than projections of real GDP growth.

Since the FOMC began tightening in June 2004, the yield curve has flattened significantly. In returning policy to a more neutral stance since then, the FOMC has increased the target federal funds rate by a cumulative 150 bp. Yields on three-month Treasury bills have essentially followed suit. At the curve's long end, however, the yield on 10-year Treasury bonds has fallen nearly 50 bp.

Money and Financial Markets







a. Treasury inflation-protected securities.
b. Merrill Lynch High-Yield Master II Index minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15 and Bloomberg Financial Information Services.

In his February 16 testimony before Congress, Federal Reserve Chairman Greenspan discussed these yield curve movements. Changes at the long end of the nominal yield curve can be attributed to one or both of two causes: changes in real rates and changes in inflation expectations. Treasury inflation-protected securities (TIPS), which provide one measure of a real interest rate, indicate that long-term real interest rates have fallen about 50 bp since June. Since the real rate's decline matches that of the nominal rate, TIPS imply that long-term inflation expectations are generally flat.

Some analysts argue that this decline reflects market participants' view of slower economic growth in the future, possibly a consequence of rising energy prices. But, as Chairman Greenspan observed, this "does not mesh seamlessly with the rise in stock prices and the narrowing of credit spreads observed over the same interval." Others suggest that the yield curve's flattening reflects lower long-term inflation expectations. This appears contrary to the information from TIPS yields.

Technical factors, such as heavy purchases of Treasury securities by foreign central banks, may have contributed to the puzzling drop in long-term yields. However, the Chairman remarked that accounting for the decline in long-term rates by technical factors affecting only U.S. markets may be missing the point "because yields and risk spreads have narrowed globally." Certainly, the cause of the decline in long-term rates remains unclear.

With strong consumer spending in 2004, the personal saving rate fell to $^{1}/_{2}$% in 2004:IIIQ. More recently, the personal rate has increased and now stands at 1.3%. Strong growth in

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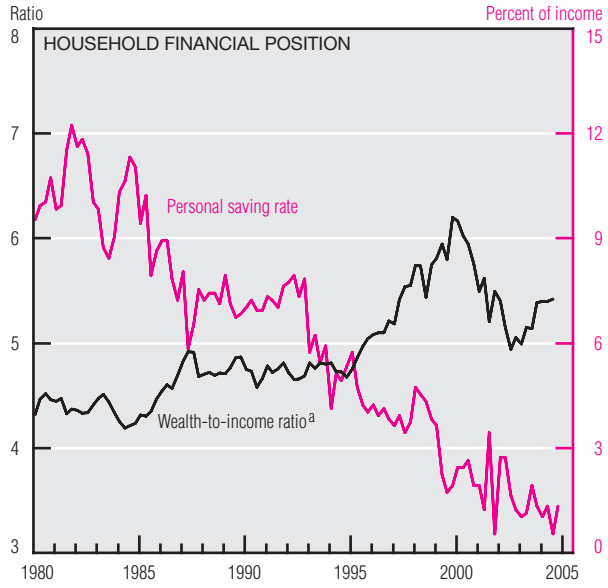
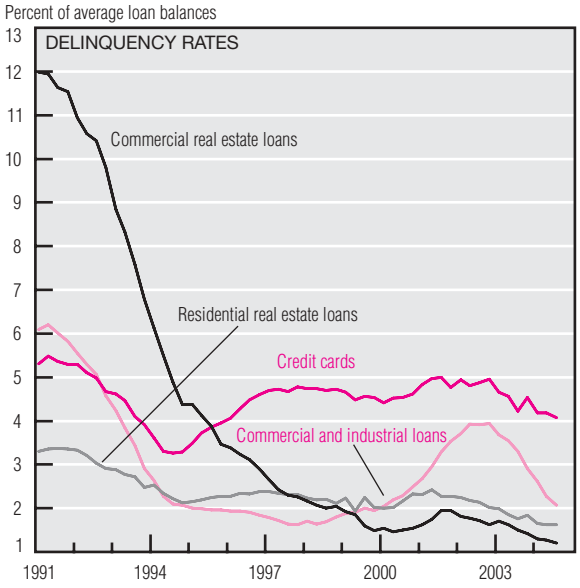
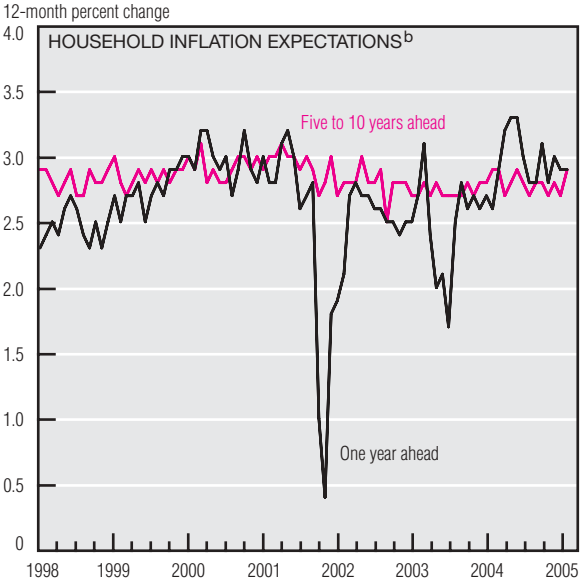
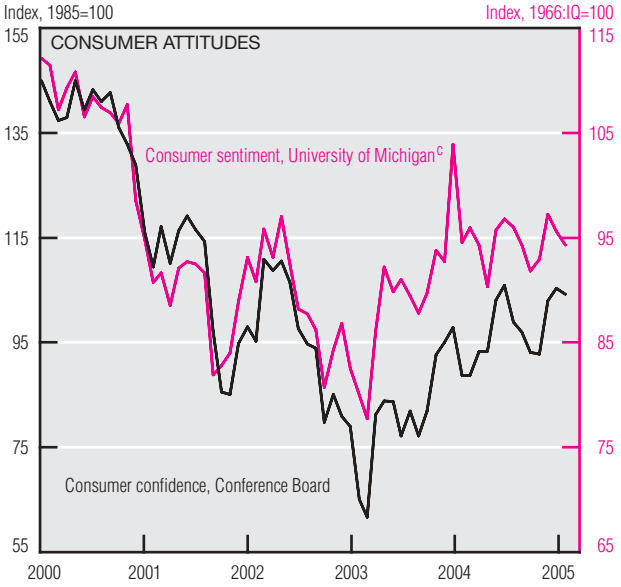
Money and Financial Markets (cont.)









a. Wealth is defined as household net worth; income is defined as personal disposable income. Data are not seasonally adjusted.
b. Median expected inflation as measured by the University of Michigan's Survey of Consumers.
c. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks" and "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1; University of Michigan; and the Conference Board.

equity prices and home prices led to a sharp increase in the wealth-to-income ratio during 2003, which supported consumer spending. Although equity prices moderated in 2004, continued increases in home prices led to further rises in the wealth-to-income ratio last year.

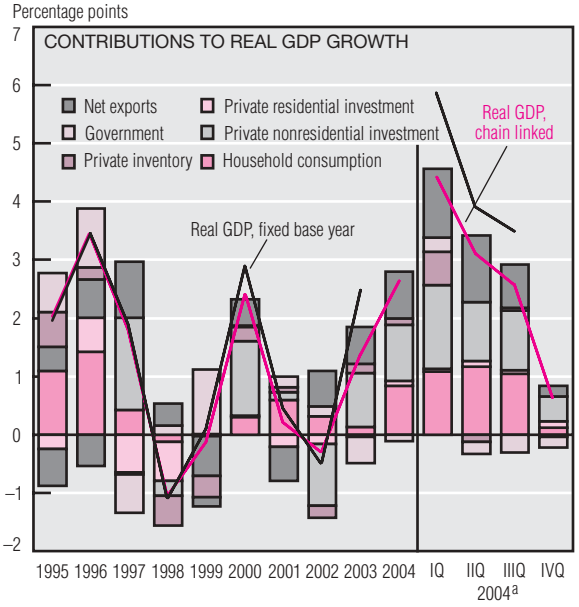
Despite an estimated increase in total household debt of 9.75% in 2004, fueled mainly by increases in home mortgage debt, delinquency rates on residential real estate loans and credit cards continue to drift down. Low interest rates and gains in disposable income contributed to households' ability to repay debt. Even with rapid growth in commercial real estate loans in 2004, delinquency rates on commercial loans fell because of firms' strong earnings and strengthened cash positions.

Household survey data are consistent with the FOMC's view that longer-term inflation expectations remain well contained. Although short-term expectations varied markedly in response to headlines about energy prices in 2004, longer-term inflation expectations remained relatively steady at around 2.8%. In February the Conference Board's Index of Consumer Confidence fell slightly, erasing part of January's gain, and the University of Michigan's Consumer Sentiment Index registered a similar decline. Respondents' views of their current economic situation remained stable, but their expectations about their future personal finances deteriorated.

Japan's Economy

Japan's Real GDP Growth and Selected Components

	Annualized quarterly percent change					
	2003		2004			
	IIIQ	IVQ	IQ	IIQ	IIIQ	IVQ
GDP	2.0	5.7	5.8	–0.8	–1.1	–0.5
Consumption	0.5	4.7	3.1	0.3	–0.8	–1.3
Residential investment	9.2	–4.1	1.6	4.6	3.3	3.5
Nonresidential investment	1.7	21.1	–8.4	16.1	1.7	2.8
Government consumption and investment	–0.4	–2.6	11.9	–13.3	–0.6	1.1
Exports	14.4	22.6	20.2	14.8	2.6	5.1
Imports	9.6	8.1	14.3	8.1	10.1	13.0



Japanese Trade

	1999	2000	2001	2002	2003	2004
Share of Japanese exports (percent)[b]						
U.S.	31.0	30.0	30.4	28.8	24.9	22.7
China	5.6	6.3	7.7	9.6	12.2	13.0
Association of Southeast Asian Nations plus newly industrialized Asian countries	30.7	33.9	31.5	32.4	33.3	34.1
European Union (15 countries)	17.8	16.4	16.0	14.7	15.3	15.0
Other	15.2	17.1	14.9	13.4	14.4	14.4
Share of Japanese imports (percent)[b]						
U.S.	21.7	19.1	18.3	17.4	15.6	14.3
China	13.8	14.5	16.6	18.3	19.7	20.4
Association of Southeast Asian Nations plus newly industrialized Asian countries	13.8	12.3	12.8	13.0	12.8	12.6
European Union (15 countries)	9.9	13.0	12.7	21.1	13.4	13.4
Other	25.9	28.0	27.7	27.4	28.2	29.6
Growth rate						
Exports	–7.1	8.0	–4.9	6.2	5.5	12.5
Imports	–5.2	10.8	3.0	0.0	3.0	11.5

a. Four-quarter percent change.
b. 2004 data through the first three quarters.
SOURCES: International Monetary Fund, *Direction of Trade Statistics Yearbook*, 2004; Organisation for Economic Co-operation and Development, *Monthly Statistics of International Trade*, January 2005, and *Productivity Database*; and Government of Japan's Economic and Social Research Institute, Cabinet Office, Statistics Bureau, and Ministry of Internal Affairs and Communication.

In the fourth quarter of 2004, Japan's real GDP fell at an annualized rate of 0.5%. Following the downward revisions to second- and third-quarter growth rates, 2004:IVQ was the third straight quarter in which real GDP contracted. Nevertheless, the real GDP growth rate of 2.6% for 2004 was the highest since 1996, mainly because of large quarterly growth rates in 2003:IVQ and 2004:IQ.

Net exports have been among the major contributors to Japan's real growth in recent years, and the overall trade increase has contributed to the economy's expansion. China's share of Japan's total trade is now nearly equal to that of the U.S. In recent years, the former has been growing and the latter shrinking. Japan's increased exposure to China has made some analysts fear that a slowdown in China's growth could adversely affect Japan's economy.

Unlike the U.S., Japan's consumer spending has not been a key source of economic growth in the past decade, mainly because real compensation per worker has been decreasing. That is, nominal compensation has been falling faster than prices. Employers have been able to reduce their real labor costs by shifting from regular to nonregular workers (part-time employees, workers on short-term contracts, and workers employed by temp agencies). Although the total number of workers has not changed much since 1997, total hours worked have been trending downward.

Japan has experienced persistent deflation over the past decade. As a countermeasure, the Bank of Japan switched in March 2001 from targeting

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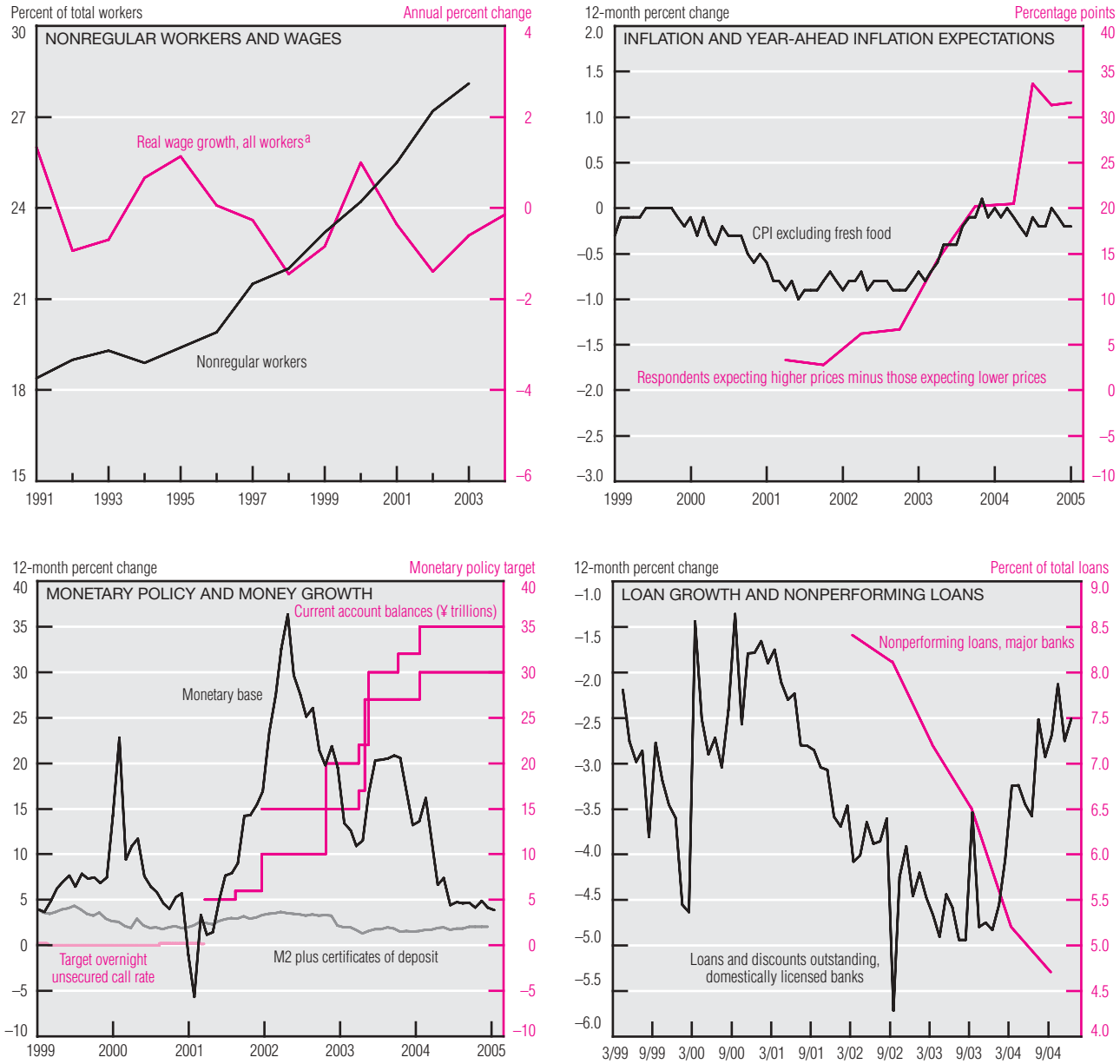
Japan's Economy (cont.)



a. Growth in compensation per employee in the business sector minus annual percent change in consumer prices. Data for 2004 are from an OECD forecast.
SOURCES: Organisation for Economic Co-operation and Development, *OECD Economic Outlook* no. 76, annex tables and *OECD Economic Surveys–Japan*, January 2005; Bank of Japan, *Results of the Opinion Survey on the General Public's Mindset and Behavior*; Japan's Financial Services Agency; and Bloomberg Financial Information Services.

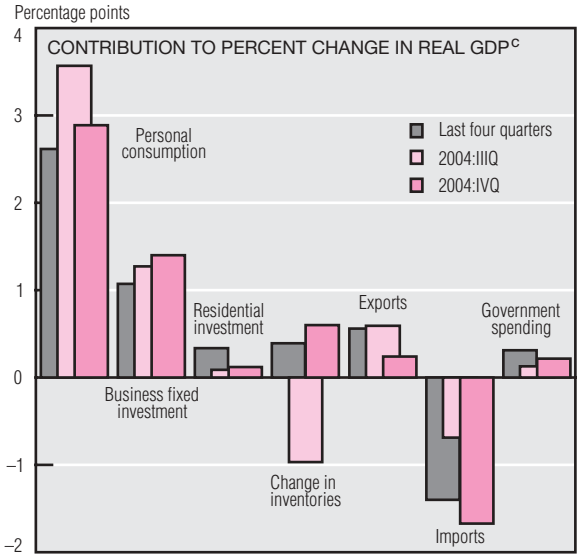
an overnight unsecured call rate to a program of "quantitative easing," in which current account balances held at the central bank are targeted. The Bank of Japan supplies these balances, currently targeted at 30¥–35¥ trillion, primarily by purchasing government bonds. In 2003, the Bank announced that it would continue its program of quantitative easing at least until core inflation (measured by the 12-month change in consumer prices excluding fresh food) rises to 0% or higher and its Policy Board forecasts a positive inflation rate for the year ahead. The rate of price inflation has now reached nearly 0%, and survey measures of consumer inflation expectations have been increasing as well.

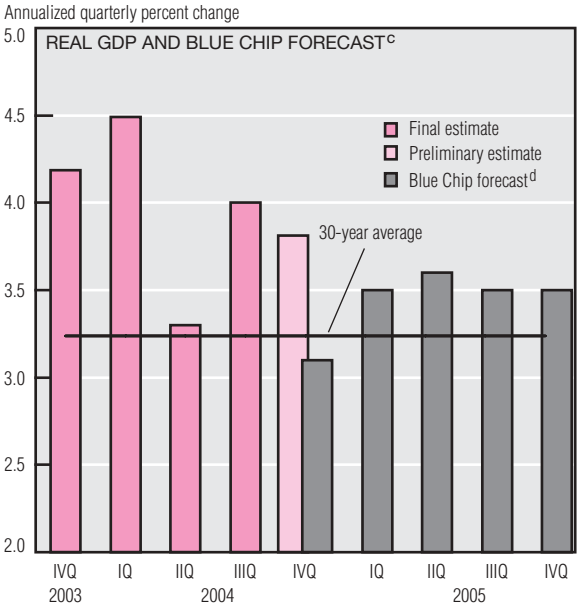
The monetary base grew significantly as the Bank ratcheted up current account balances. However, no similar increase occurred in one of the major monetary aggregates (M2 plus certificates of deposit). Moreover, loan growth has remained negative since the program's inception, although it recently has been moving closer to 0%. The problems within Japan's banking sector have been well documented. A positive development for banking is that the goal of halving the nonperforming loan ratio at major banks from 8.4% in March 2002 to 4.2% in March 2005 seems achievable. Japan hopes to improve the efficiency of its economy further by a phased-in privatization (2007–17) of Japanese Post, the largest financial institution in the world with assets totaling 80% of Japan's GDP.

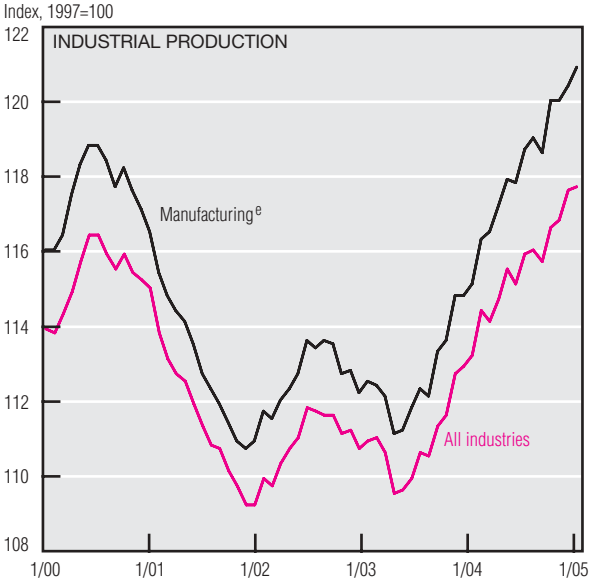
Economic Activity

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

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	102.3	3.8	3.9
Personal consumption	78.4	4.2	3.7
Durables	8.7	3.1	5.4
Nondurables	32.8	6.1	4.4
Services	36.9	3.4	3.1
Business fixed investment	41.4	14.0	10.8
Equipment	42.9	18.0	14.4
Structures	0.8	1.3	–0.2
Residential investment	3.0	2.1	1.7
Government spending	5.7	1.2	1.7
National defense	–0.4	–0.3	5.5
Net exports	–40.2	—	—
Exports	6.7	2.4	5.7
Imports	46.9	11.4	9.8
Change in business inventories	16.5	—	—







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.
e. Uses the NAICS definition of manufacturing.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; National Bureau of Economic Research; and *Blue Chip Economic Indicators*, February 10, 2004.

The U.S. Commerce Department's preliminary estimate of real GDP growth in 2004:IVQ is 3.8%, substantially higher than the advance estimate of 3.1%. This brought 2004:IVQ growth within 0.2 percentage point (pp) of 2004:IIIQ growth of 4.0% and only 0.1 pp below the 2004 average. Just three subcomponents were revised downward in the preliminary estimate: durables consumption, services consumption, and national defense spending. The largest upward revision was to exports ($17.8 billion).

From 2004:IIIQ to 2004:IVQ, the contribution to real GDP from change in private inventories increased 1.6 pp. However, this increase was partly offset by decreases from personal consumption (0.7 pp) and net exports (1.4 pp).

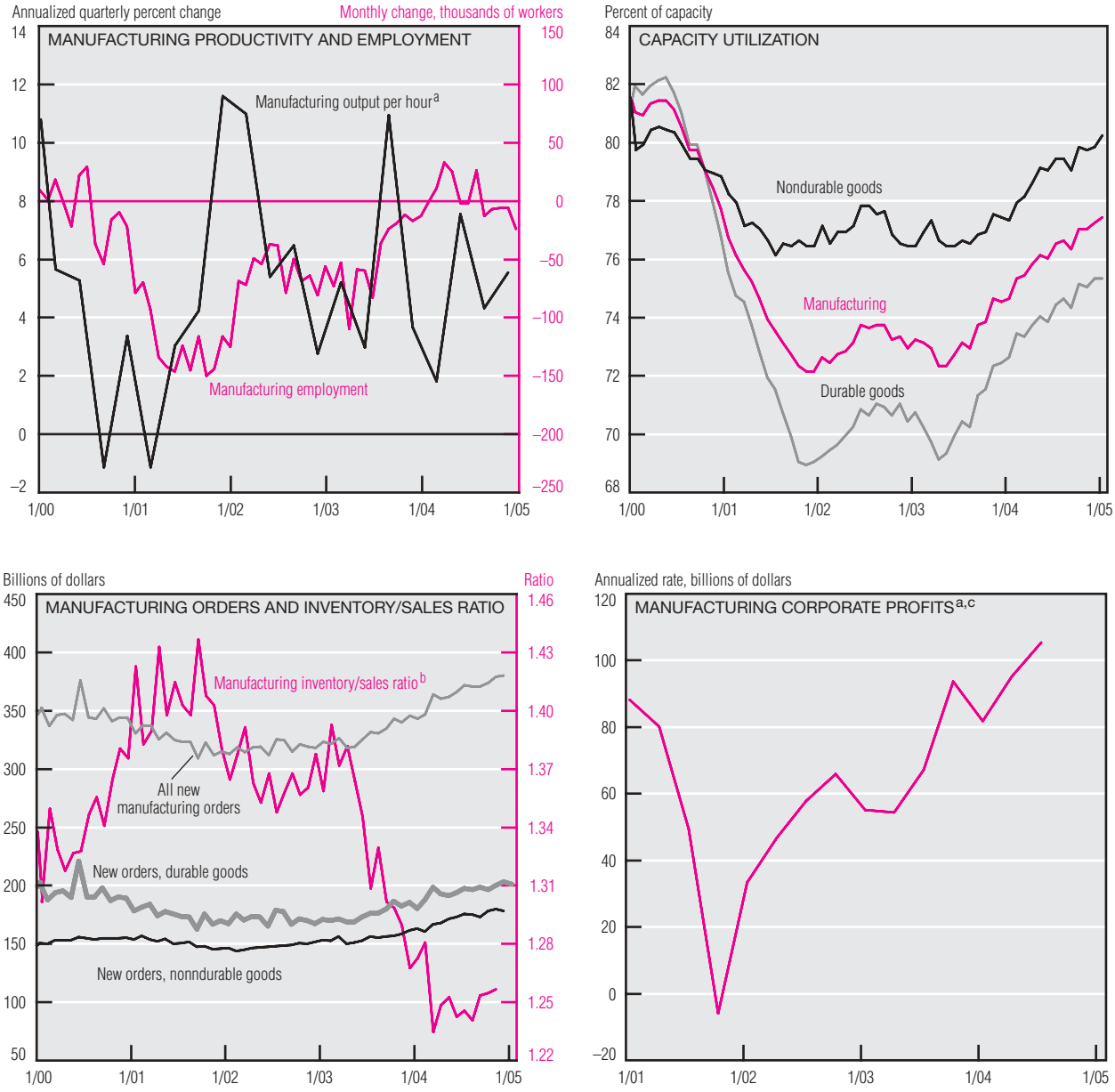
With the preliminary estimate's upward revision to GDP, 2004:IVQ growth remained above its 30-year average of 3.2%. It also surpassed the Blue Chip forecasters' February estimate for both the current quarter and all of 2005.

In October 2004, the Industrial Production Index topped its June 2000 peak and has continued to rise since then. Currently, it is 1.3 pp above its June 2000 peak. Manufacturing production, defined by the NAICS code, has been even stronger and now is 2.1 pp above its previous peak.

As manufacturing production has rebounded, its labor productivity growth has been quite strong. After slowing to a near-zero average around the end of 2000 and the beginning of 2001, labor productivity growth has

(continued on next page)

Economic Activity (cont.)



NOTE: All data are seasonally adjusted and use the NAICS definition of manufacturing.
a. Annualized rate.
b. Chained 2000 dollars.
c. Corporate profits before tax with inventory valuation adjustment.
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.

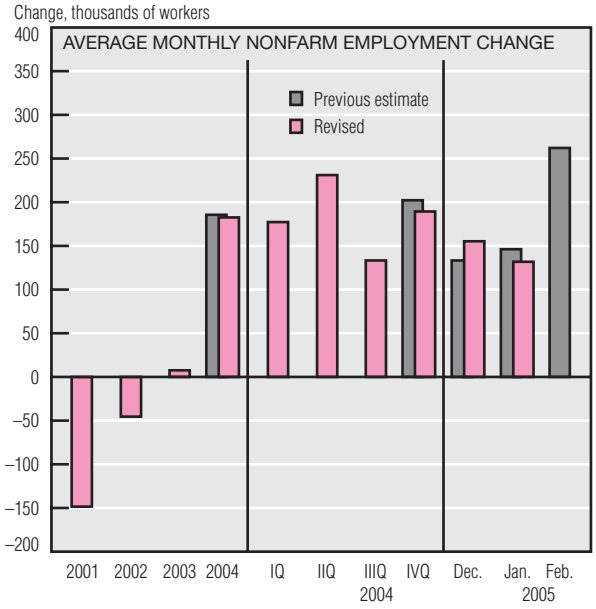
averaged about 6%. Given the rapid labor productivity growth relative to output growth, employers shed a lot of manufacturing jobs over the last five years. Manufacturing employment for January 2004 stands 3 million below that of January 2000. Only in the last year did employment levels firm somewhat.

Manufacturing capacity utilization, a measure of how intensively capital is used, followed a pattern like that of employment through early 2003; however, it has continued to increase over the past year while employment has leveled off. At 77.4, overall capacity utilization in manufacturing remains significantly below its previous peak of 81.4 in May 2000. This is because durable goods utilization remains far below its previous peak, whereas nondurable goods utilization has rebounded almost to its previous peak in May 2001.

A positive indicator for future manufacturing activity is that growth in new orders has been robust for both durable and nondurable goods. Inventory-to-sales ratios declined quickly from the 2001 recession's highs before stabilizing in 2002. The ratio plummeted in 2003, hitting a record low of 1.23 in March 2004 and stabilizing near this level.

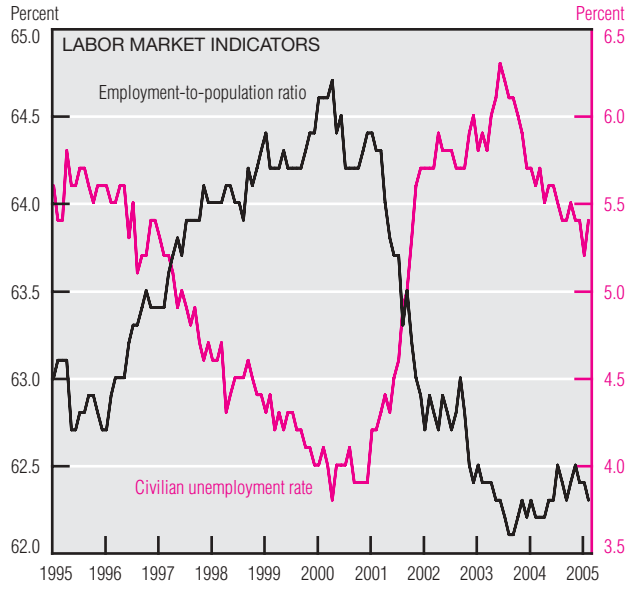
Finally, after plunging in the first three quarters of 2001, manufacturing's corporate profits have rebounded fairly steadily since 2001:IVQ. Although growing profits and increasing orders, capacity utilization, and productivity bode well for manufacturing firms and their shareholders over the next few quarters, significant employment growth in this sector appears unlikely.

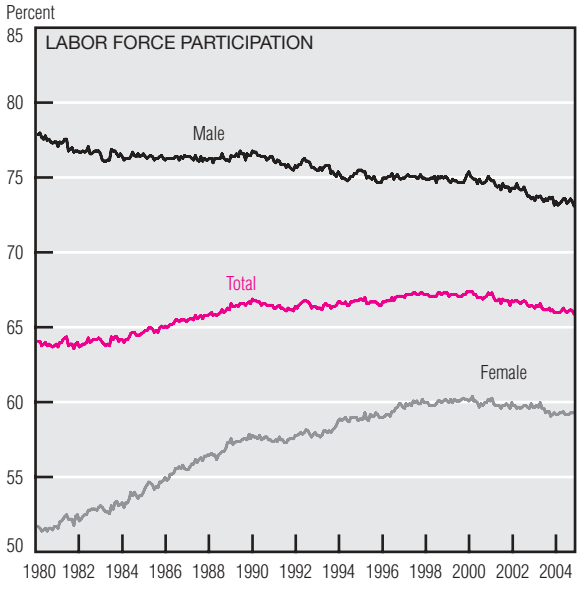
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	Feb. 2005
Payroll employment	–148	–45	8	183	262
Goods producing	–124	–76	–42	29	55
Construction	–1	–7	10	23	30
Manufacturing	–123	–67	–51	3	20
Durable goods	–88	–48	–32	9	23
Nondurable goods	–35	–19	–19	–6	–3
Service providing	–25	30	50	154	207
Retail trade	–24	–10	–5	13	30
Financial activities[a]	8	6	7	12	12
PBS[b]	–63	–17	22	45	81
Temporary help svcs.	–37	2	12	16	30
Education & health svcs.	50	40	30	33	18
Government	46	21	–4	22	33
	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.

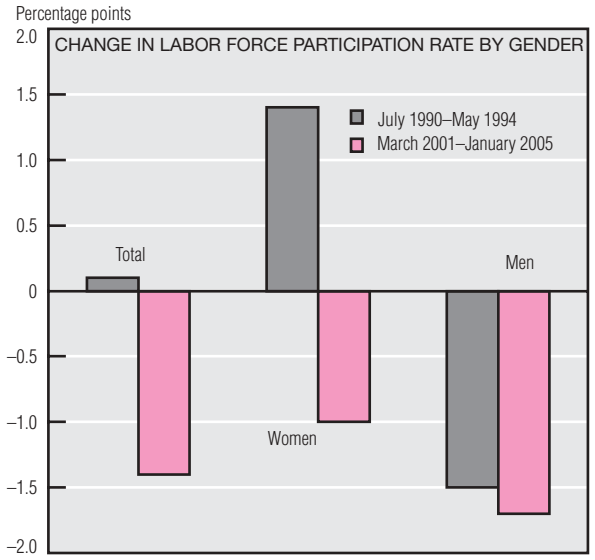
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

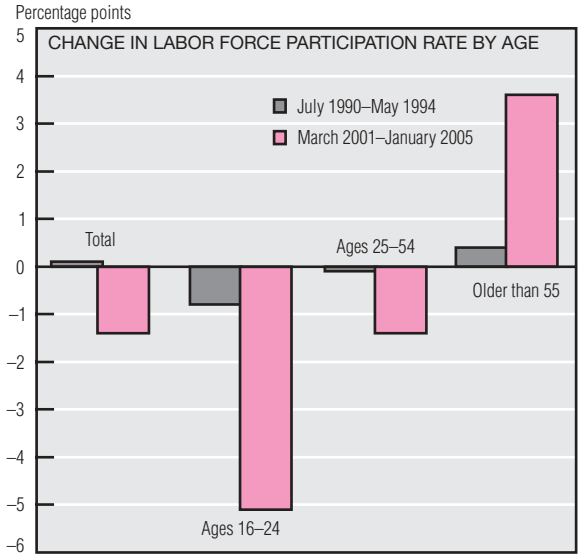
Nonfarm payroll employment grew by 262,000 jobs in February 2005, exceeding the 183,000 average monthly gain in 2004. At 132.8 million, nonfarm payroll employment surpassed the February 2001 peak by about 300,000 jobs.

Nearly 80% of the month's job growth was in service-providing industries, where it was generally broad-based. Professional and business services posted the largest gain (81,000), of which over one-third came from temporary help services. Job growth also occurred in health care (23,000), retail (30,000), and food services (27,000). Goods-producing industries grew by 55,000 jobs in February; however, the sector continues to be 2.7 million jobs below the July 2000 peak of 24.7 million. Construction employment, which added an average of 23,000 per month in 2004, grew by 30,000 in February, after showing no January growth because of severe weather. After declining for five months, manufacturing jobs increased by 20,000 in February, which the Bureau of Labor Statistics attributed partly to the return of 10,800 auto workers from temporary layoffs.

The unemployment rate, which dropped to 5.2% in January after fluctuating between 5.4% and 5.5% since July 2004, returned to 5.4%. The employment-to-population ratio, which has fluctuated between 62.2% and 62.4% for a year, inched down 0.1 percentage point to 62.3% in February. The overall labor force participation rate held steady at 65.8% but has been trending slightly downward for the past couple of years. Men's labor force participation was up 0.1 percentage point from its historic low of 73% in January. Women's participation, which has risen substantially over the long term, has declined slightly over the past four years.

Labor Force Participation





Reasons Why People Did Not Work or Look for Work (percent distribution)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Women aged 25–54													
Ill or disabled	12.6	14.0	16.5	17.7	19.2	19.5	21.3	20.9	20.2	21.1	21.9	21.3	21.9
Retired	1.3	1.3	2.1	2.5	2.2	3.2	3.2	3.3	3.0	4.4	4.5	5.1	4.5
Home responsibilities	77.2	75.8	71.6	69.7	69.9	68.8	67.6	67.6	68.6	67.7	66.3	65.3	65.3
Going to school	4.6	4.6	7.2	7.0	6.0	5.2	5.5	5.6	5.9	4.9	4.9	5.4	5.9
Could not find work	1.9	2.3	0.9	0.9	0.6	1.0	0.7	0.6	0.4	0.6	0.6	0.6	1.0
Other	2.4	2.0	1.7	2.2	2.1	2.3	1.6	2.0	1.9	1.4	1.8	1.8	1.4
Total aged 16–24													
Ill or disabled	2.9	3.2	4.2	4.8	4.2	3.9	4.4	4.1	3.8	3.9	3.8	3.6	4.0
Retired	0.1	0.1	0.4	0.5	0.4	0.4	0.3	0.5	0.7	0.3	0.6	0.8	0.7
Home responsibilities	15.7	16.2	16.5	16.8	15.5	13.9	12.6	11.4	12.3	12.8	13.2	11.3	11.6
Going to school	74.5	74.0	73.4	72.4	73.7	75.5	76.9	78.3	77.4	77.7	77.5	79.2	78.8
Could not find work	2.5	2.9	1.9	1.7	2.2	1.9	1.9	1.3	1.8	1.6	1.5	2.0	1.8
Other	4.2	3.6	3.6	3.9	4.0	4.4	3.9	4.4	4.0	3.7	3.5	3.1	3.2

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

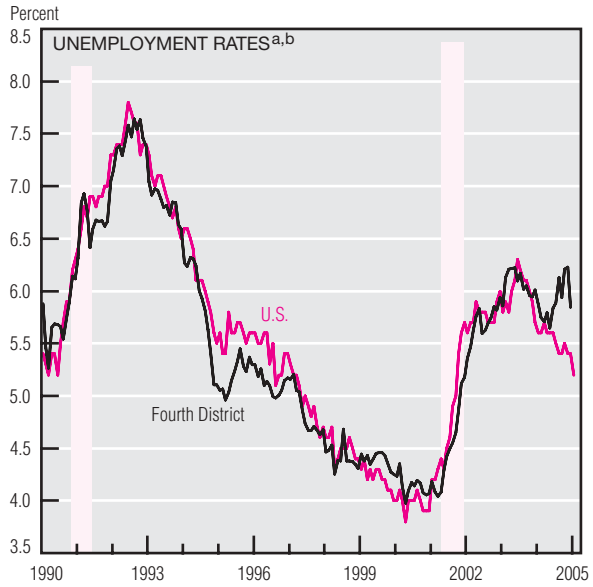
In the 46 months between the March 2001 business cycle peak and January 2005, the labor force participation rate fell from 67.2% to 65.8%. After the 1990 recession, however, the rate slightly exceeded prerecession levels (66.6%) within 46 months of the peak. Comparing these recessions shows that the decline in participation since 2001 can be attributed primarily to people aged 16 to 24 and to women.

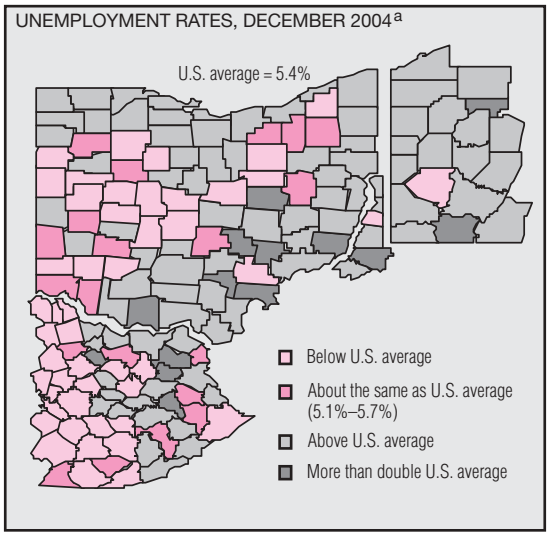
From March 2001 to January 2005, women's participation fell 1 percentage point; after the 1990 recession, it rose 1.4 percentage points within the same length of time. The share of women not participating in the labor force because of illness or disability increased dramatically from 12.6% in 1991 to 21.9% in 2003. Although this occurred well before the 2001 recession, it may partly explain the sustained decline in women's participation. Indeed, experiences in several European countries suggest that people who leave the labor force because of illness or disability may be less likely than others to return. Greater difficulty finding jobs also limited women's participation.

Participation among people aged 16 to 24 is down 5.1 percentage points from March 2001; after the 1990 recession, it fell less than 1 percentage point. The difference probably reflects the delayed entry into the labor force associated with more time pursuing an education.

Unlike their younger counterparts, people older than 55 increased their participation more than 3 percentage points after March 2001, possibly because of lower stock prices and changes in Social Security regulations.

Employment in the Fourth District





Payroll Employment

	12-month percent change, December 2004							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Wheeling	Pittsburgh	Lexington
Total nonfarm	–0.3	0.0	0.7	–0.5	–1.5	0.3	0.9	1.5
Goods-producing	–0.2	–0.3	–2.3	–2.0	–1.6	–1.1	1.4	2.6
Manufacturing	–0.2	0.3	–1.6	–1.6	–3.6	–2.0	–0.7	1.5
Natural resources, mining, and construction	–0.2	–1.2	–4.2	–3.9	5.9	0.0	5.1	5.7
Service-providing	–0.3	0.1	1.3	–0.1	–1.5	0.5	0.8	1.2
Trade, transportation, and utilities	–1.4	–2.2	1.8	–3.5	–3.5	0.0	1.0	0.4
Information	–1.9	–3.4	2.6	3.5	4.3	0.0	–3.7	0.0
Financial activities	0.4	1.6	0.7	0.0	1.6	0.0	0.9	0.0
Professional and business services	0.2	2.0	1.4	–0.4	–2.2	2.2	2.0	–0.7
Education and health services	2.1	1.6	1.3	3.0	1.1	–3.0	1.8	2.0
Leisure and hospitality	–0.8	0.1	5.7	2.2	–2.8	1.4	0.9	8.4
Other services	–2.3	–1.1	0.0	–4.2	0.0	3.6	0.9	2.8
Government	–1.1	0.3	–2.4	0.1	–2.0	2.9	–1.9	–0.9

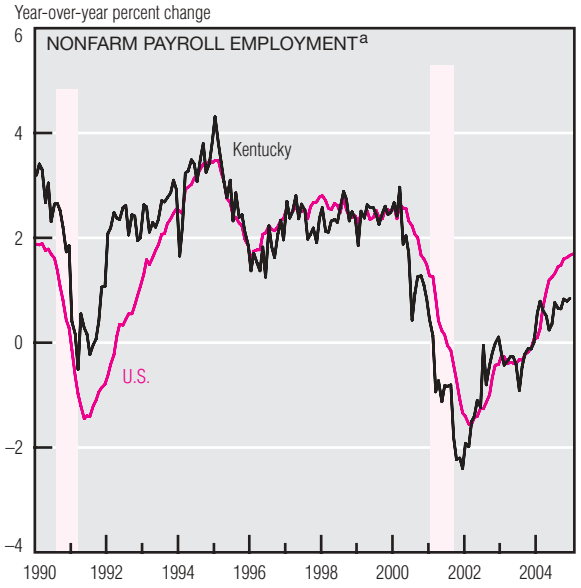
a. Seasonally adjusted.
b. Shaded areas represent periods of recession.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

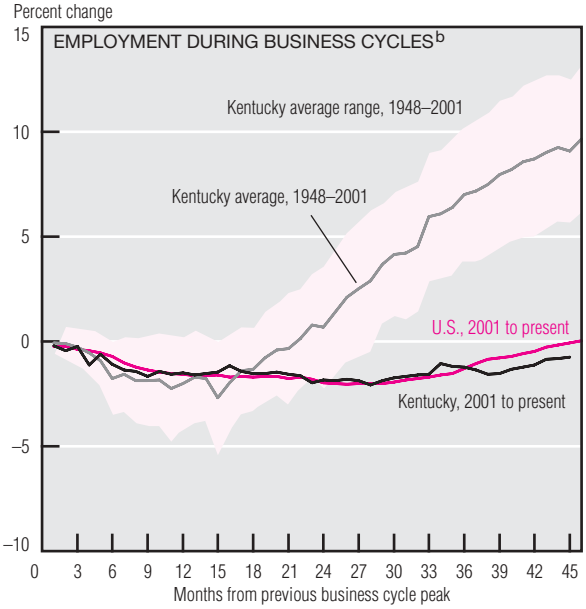
The Fourth District's unemployment rate fell a sizeable 0.4 percentage point to 5.8% in December. This decline seems to have been driven largely by a reduction in the estimated size of the labor force; estimated employment actually fell slightly during the month. Similarly, while the U.S. unemployment rate held steady at 5.4% in December, its 0.2 percentage point decline to 5.2% in January resulted more from a decrease in the labor force than an increase in employment.

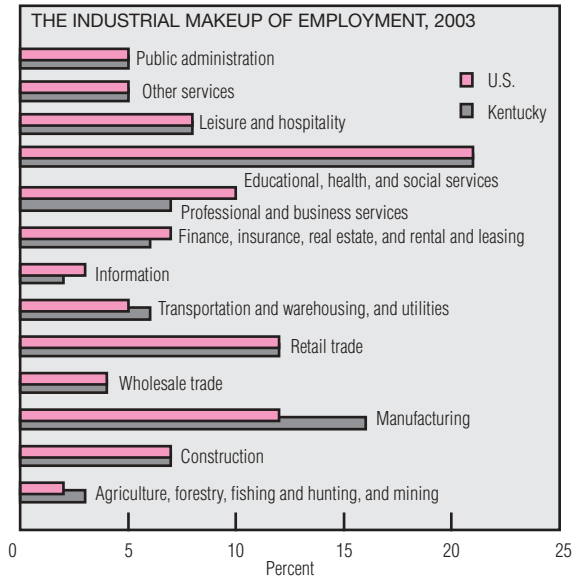
The unemployment rates for counties in the western half of Fourth District Kentucky generally are lower than the U.S. average. In fact, the Lexington metropolitan area's rate in December was 2.8%. Ohio's midsection also showed strength, particularly the area near and west of Columbus (its MSA's unemployment rate was 4.4%). Conversely, counties in the Fourth District portion of Pennsylvania had unemployment rates above the national average (except Allegheny, where the rate was 4.3%).

Employment changes in the 12 months ending in December, as measured by nonfarm payrolls, were mixed across the District's major metropolitan areas. The Toledo area saw the most substantial drop, with percentage declines about even in goods- and service-providing employment. By contrast, Lexington posted the strongest overall gain, and its increases were broad-based. Lexington and Columbus were among the few major metropolitan areas in the District to add manufacturing employment in 2004.

Kentucky Employment







NOTE: Employment data are seasonally adjusted.
a. Shaded areas represent periods of recession.
b. Shaded band indicates a 95% confidence interval around Kentucky's 1948–2001 average.
SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

Kentucky's labor market conditions stand out among the Fourth District states. Indeed, its December unemployment rate of 4.5% was the lowest in the District and almost a full percentage point below the U.S. average; by that measure, Kentucky outperformed the nation throughout 2004. However, it failed to keep up with U.S. employment growth over the same period. Last year, employment in Kentucky grew by 0.8%, compared to the nation's 1.7% increase. And from the last business cycle peak in March 2001, Kentucky lost 0.8% of its employment, while the nation saw a slight gain.

U.S. employment finally surpassed the March 2001 business cycle peak this January, ending the longest recovery period for employment since the Great Depression. If Kentucky had followed its average employment gains in past business cycle expansions, it would have added 10% more jobs at this point. Typically, it has reached prerecession employment levels 22 months after the previous business cycle peak; by December, 45 months had passed since the peak. Indeed, much like the U.S. as a whole, Kentucky's economy has grown, but with less-than-typical employment gains.

One factor affecting employment is the economy's industrial makeup. Kentucky looks much like the nation for many sectors. However, it has notably larger manufacturing, transportation and warehousing, and utilities and agricultural sectors—all three being slow growth sectors.

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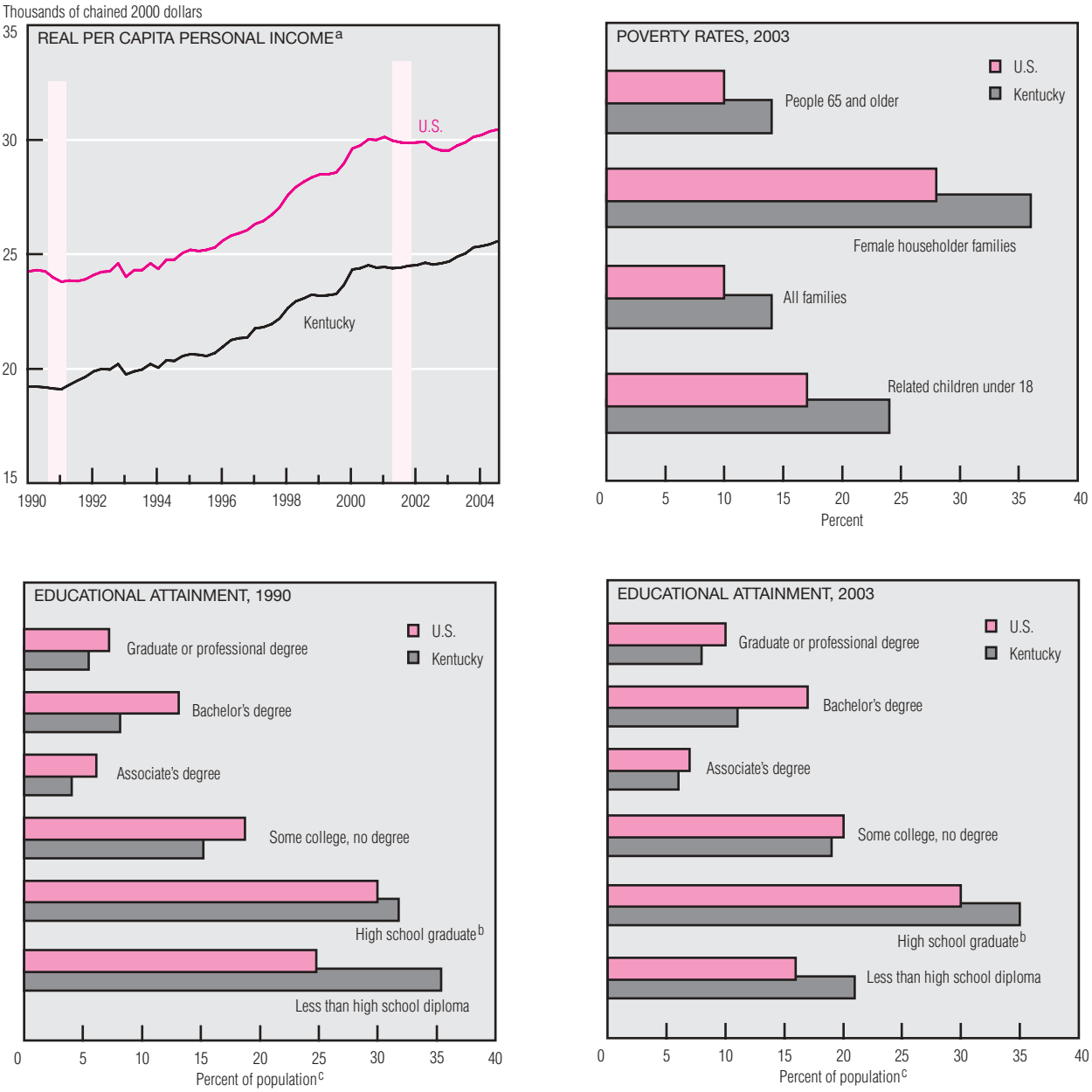
Kentucky Employment *(cont.)*



NOTES: Educational attainment data for 2003 are from the American Community Survey; data for 1990 are from Census 2000.
a. Shaded areas represent periods of recession.
b. The "high school graduate" category includes people with a G.E.D. and similar equivalents.
c. Aged 25 and older.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

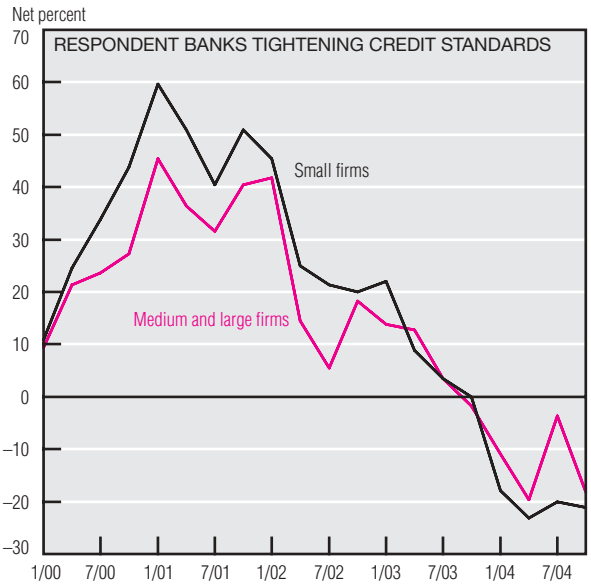
Although the December unemployment rate was lower in Kentucky than in Ohio, Pennsylvania, or the U.S., Kentucky's per capita income was only $27,610 in 2004:IIIQ, much lower than in Ohio ($31,379), Pennsylvania ($33,149), or the U.S. ($32,879). In fact, this has been the case since 1948, when the data series on states' personal income became available. Nevertheless, since 2001:IIQ, personal income has been growing faster in Kentucky than the U.S.

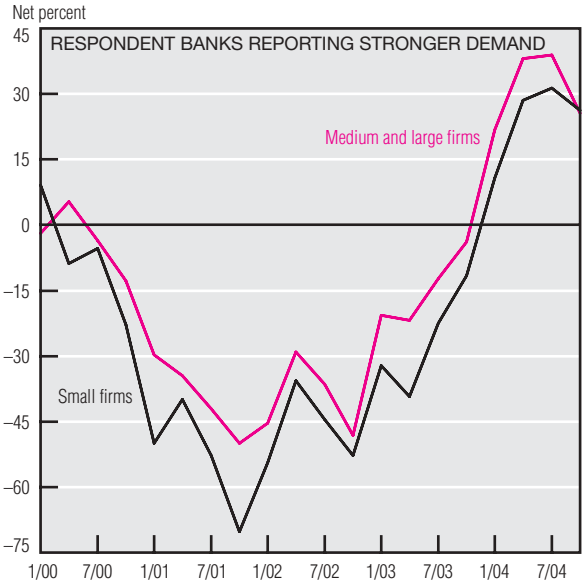
Lower per capita personal income generally is associated with higher poverty rates, and Kentucky is no exception. Its poverty rates are 1.3 to 1.4 times higher than those of the U.S. for many major categories.

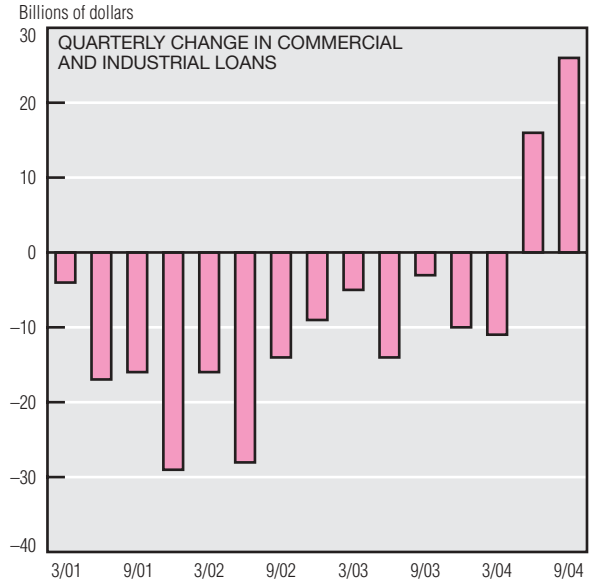
Differences in poverty rates can be partly explained in terms of educational attainment, with higher education levels typically associated with better incomes. In both 1990 and in 2003, the U.S. had a more educated population than Kentucky; in 2003, it had 2% more citizens with a graduate or professional degree and 6% more with a bachelor's degree.

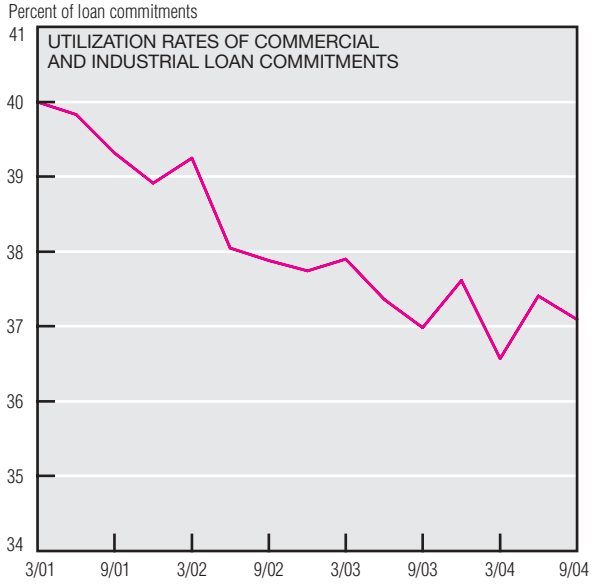
However, although a gap remains, Kentucky has made significant gains during the last decade. Between 1990 and 2003, the share of Kentucky's population without a high school diploma declined from 35% to 21%. Moreover, the share of Kentuckians with at least some post-secondary education increased roughly 11 percentage points during this period, from about 33% to 44%.

Business Loan Markets







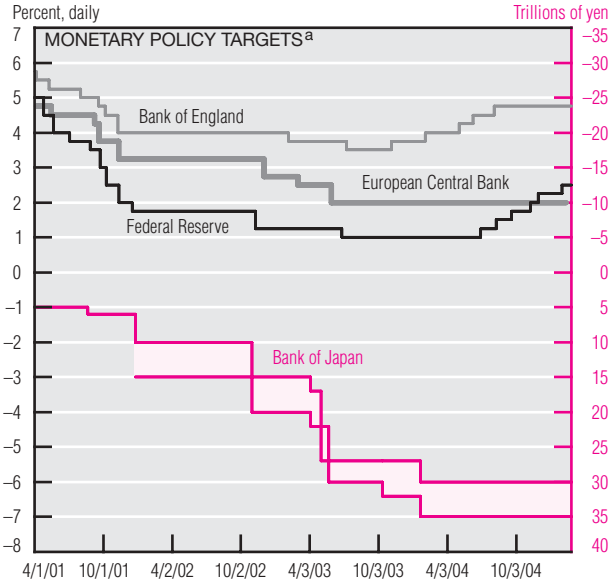


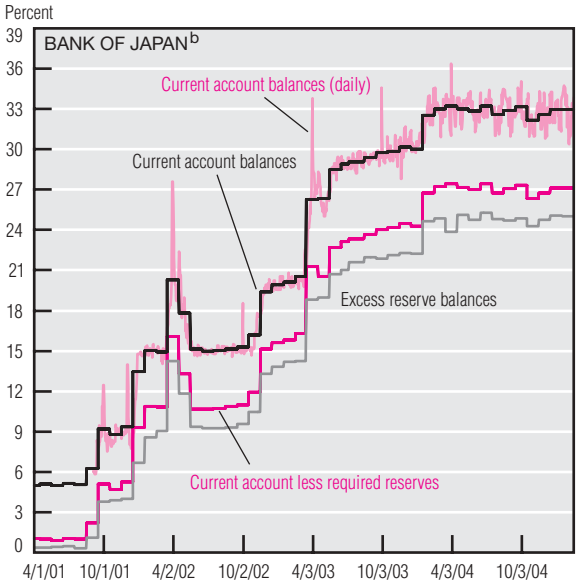
SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Senior Lending Officer Survey, January 2005*; and Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

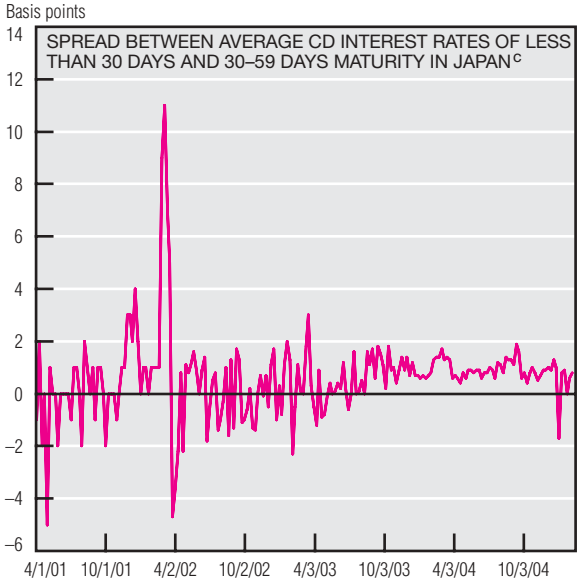
Credit availability for businesses continued to improve for most of 2004, according to the Senior Loan Officer Survey. In the October survey (covering August, September, and October) respondent banks reported that they had further eased lending standards for commercial and industrial loans to borrowers of all sizes. They also indicated that they had narrowed their lending spreads, reduced collateral requirements, and increased the size of credit lines. This relaxation in lending standards was partly a response to increased competition from other banks and other sources of business credit. What may be more important is that many respondents said they eased credit terms because the economic outlook was more favorable or less uncertain. Lending standards were relaxed despite a reportedly increased demand for commercial and industrial loans by businesses of all sizes. And even with greater demand, prices dropped, indicating that there was a plentiful supply of business credit.

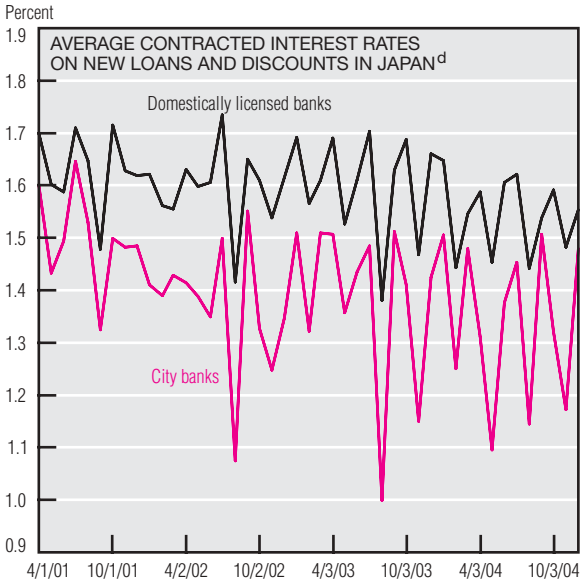
The relaxation of bank lending standards in 2004 appeared to translate into increased bookings of commercial and industrial loans by depository institutions. Holdings of commercial and industrial loans increased $16 billion in 2004:IIQ and $26 billion in 2004:IIIQ. This reversed 13 consecutive quarters of declines in commercial and industrial loan balances on the books of FDIC-insured institutions. The increase in booked credits coincided with a decrease in the utilization rate of business loan commitments (credit lines extended by banks to commercial and industrial borrowers), another sign of an increase in the supply of business credit.

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 of 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. Calculated as the difference between average interest rates on new issues of certificates of deposit of city banks; weekly data.

d. New loans and discounts exclude overdraft accounts and include renewed continuing loans; end of month data.

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

None of the four major central banks has changed its policy setting since the last Federal Reserve action.

Japan's overnight interbank rate has been essentially zero for about three years, reflecting the Bank of Japan's anti-deflation policy of quantitative easing. For the past year, that policy has maintained a level of current account balances and excess reserves of the banking system that is more than ¥25 trillion higher than at the beginning of 2001. Recently, the Bank has had occasional difficulty attracting sellers of all the securities it wished to buy in order to maintain that level of balances. This has triggered questions about whether the effective demand for its liquidity might be declining relative to the past year's target.

As long as the Bank is able to meet its current account balance target, the zero floor on nominal overnight interest rates suggests that excess effective liquidity might show up in lower nominal interest rates at nearby maturities and risk classes. There are hints of such an effect. Since the end of September, the average interest rate on new CDs at the maturity of 30–59 days has declined very slightly relative to rates on 0–29 day CDs. Average contracted interest rates on loans and discounts of all domestically licensed banks have continued to decline; this has occurred three times as much at city banks, where loan quality is thought to be better.