

The Economy in Perspective

The Second Law of Thermodynamics...Energy tends to flow spontaneously from being concentrated in one place to becoming diffused or dispersed and spread out, unless it is hindered from doing so.

The Second Law helps explain why hot frying pans cool off after they are removed from the heat source, and why ice cubes melt in a glass of tap water. Left to its own devices, tap water will not store up energy and transform itself into ice cubes.

Foreign exchange markets went to work and discharged some energy after the French public rejected the proposed European Union constitution on May 29, presaging Dutch voters' rejection a few days later. The constitutional referendum expressed the opinion held in some parts of the EU that its economic performance is not meeting expectations. Market participants reacted to this sentiment by lowering the euro's exchange value relative to the U.S. dollar. How member nations' political leaders will respond remains to be seen. Many economists believe that some European labor markets are less flexible than they must be to retain and attract businesses; however, labor market reforms run counter to contemporary European tradition and culture. Common market liberalizations, including the single-currency initiative, along with new EU entrants, have had the effect of pushing European nations in a uniform direction, but the latest developments have impeded that process, at least for the time being.

In another illustration of the Second Law of Thermodynamics, financial markets have been reacting in recent weeks to new assessments of some automotive companies' earnings potential. It has been apparent for quite a while that the cost and productivity structures of several domestic auto assembly companies have put them at a disadvantage compared to some foreign-owned competitors. Those competitors have been expanding production

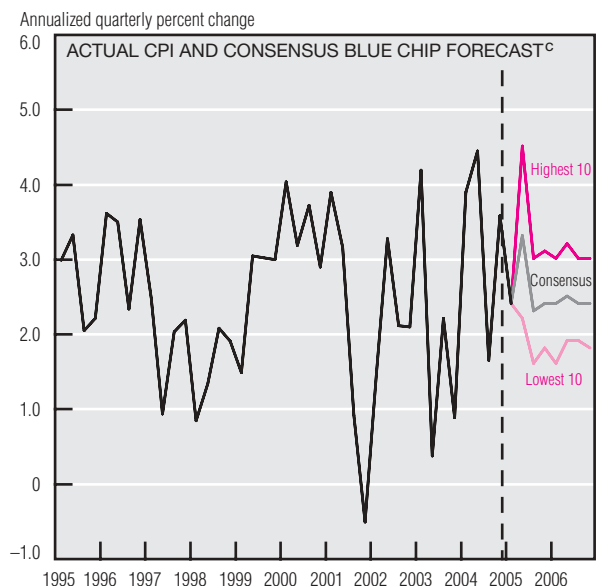
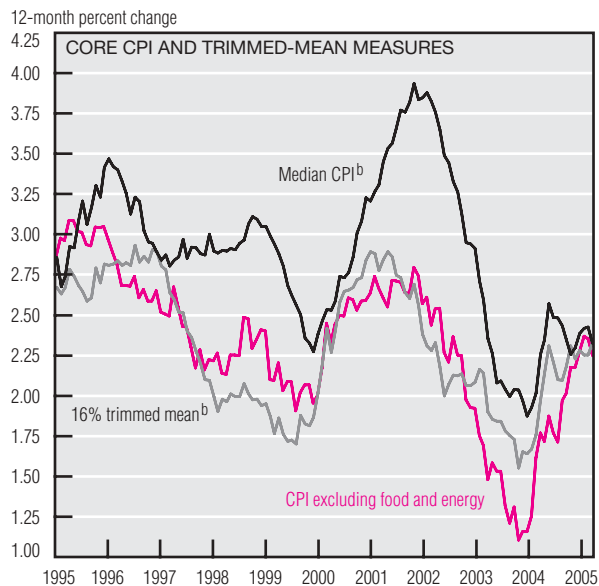
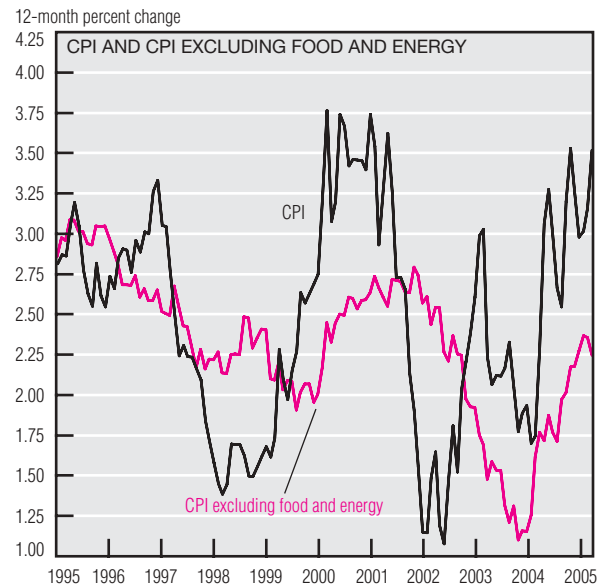
capacity and market share, a strategy that has intensified pressure on domestic firms to take costs out of both overhead and unit production. But, as in the European Union, changes in tradition and culture take time and can be painful to entrenched interests.

The Second Law states that once an obstacle is removed, built-up tensions eventually dissipate. For the U.S. automotive industry, credit rating agencies' downgrades were what set the adjustments in motion, and the repercussions are being felt all along the supply chain as the industry prepares for various consolidations. Some firms are already leaving the industry, and others are working to reduce costs. In at least one significant instance, an investor is betting that a large domestic auto assembler eventually will transform its cost structure successfully enough to become a much healthier competitor.

Thermodynamic forces are also working to convert the potential energy bound up in the Chinese renminbi's peg to the U.S. dollar into kinetic energy. The question, of course, is in what direction and to what degree the currencies will depart from the present fixed exchange rate, when—and if—the Chinese government alters the peg. Some market observers are convinced that the renminbi is seriously undervalued and would appreciate rapidly in a free float, much like an inflated ball that has been held underwater and then released. Others think that focusing on the exchange rate misses the bigger picture: The thermodynamics of the economic relationship between China and the United States involve far more than the dollar/renminbi exchange rate. The United States is a mature economy and, although it constantly reinvents itself, its pace of change is nowhere near that of China today. The hot frying pan that is China will take a long time to cool, and those of us who want to stay in the kitchen must be careful not to get burned.

Inflation and Prices

	Percent change, last:				2004 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	6.4	6.2	3.5	2.6	3.4
Less food and energy	0.6	2.6	2.2	2.1	2.2
Median ^b	2.2	2.6	2.3	2.8	2.3
Producer prices					
Finished goods	7.3	7.0	4.8	2.4	4.4
Less food and energy	3.1	1.6	2.6	1.2	2.2



a. Annualized

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, May 10, 2005.

After jumping 7.8% in March, the Consumer Price Index (CPI) rose a strong 6.4% in April. Energy prices, which account for roughly 8.0% of the overall index, rose a dramatic 69.5% (annualized rate) in April after two months of sharp price increases. However, monthly growth in the core retail price measures was moderate: The core CPI, which excludes the volatile food and energy components, rose a mere 0.6% (annualized rate), and the median CPI rose 2.2% (annualized rate).

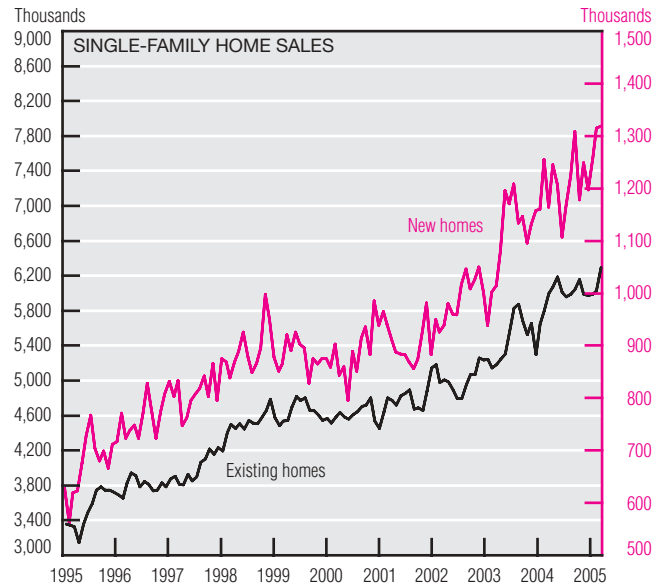
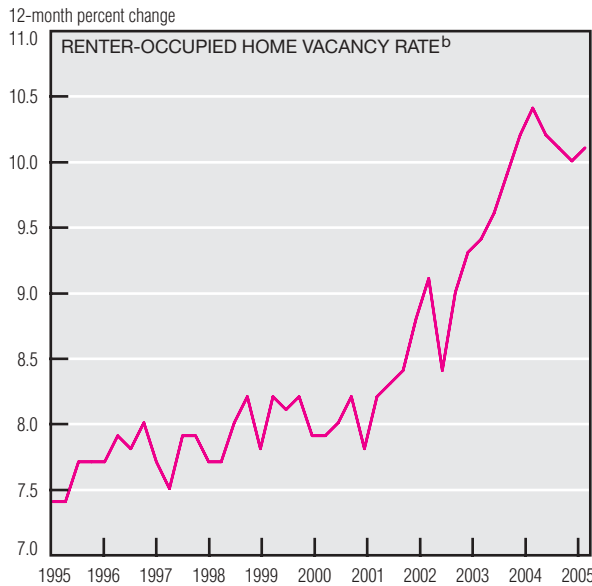
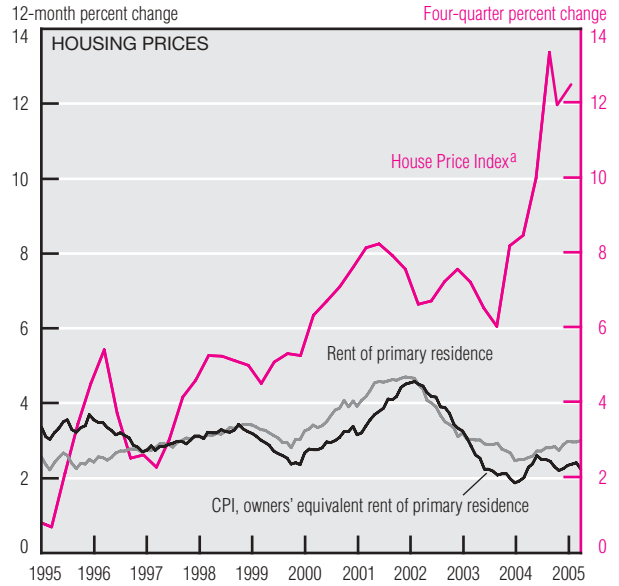
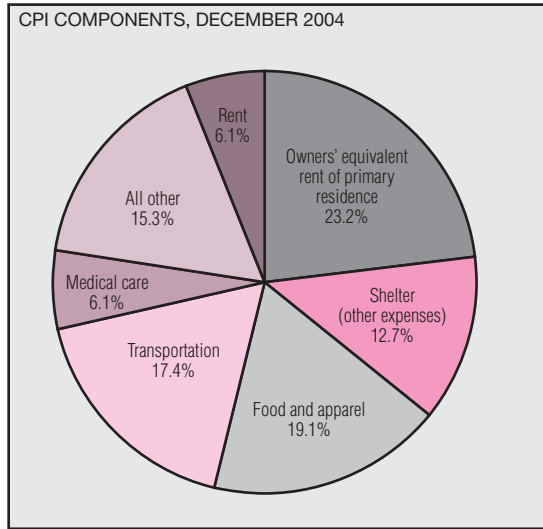
Meanwhile, longer-term inflation trends were mixed during the month. Twelve-month growth rates inched downward 0.1 percentage point (pp) to 2.2% for the core CPI and 2.3% for the median CPI. The 16% trimmed-mean CPI increased 0.1 pp to 2.3%, and the CPI's 12-month growth rate continued to accelerate, reaching 3.5%. The latest CPI consensus forecast by the Blue Chip panel of economists reflects the retail price gains of the overall index. Economists now predict an average inflation rate of

2.6% in 2005, compared with 2.4% last month.

Housing is the largest CPI component, accounting for more than 40% of the index's basket of goods. The owners' equivalent rent (OER) of primary residence—the cost homeowners would assume if they rented their house instead of owning it—is responsible for 23.2% of the overall CPI. The OER is computed using rental prices, which likely have been affected negatively by the relative

(continued on next page)

Inflation and Prices (cont.)



a. Calculated by the Office of Federal Housing Enterprise Oversight.
 b. Vacant housing units available for rent year-round divided by the sum of owner-occupied housing units and vacant housing units available for rent year-round.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Office of Federal Housing Enterprise Oversight; and National Association of Realtors.

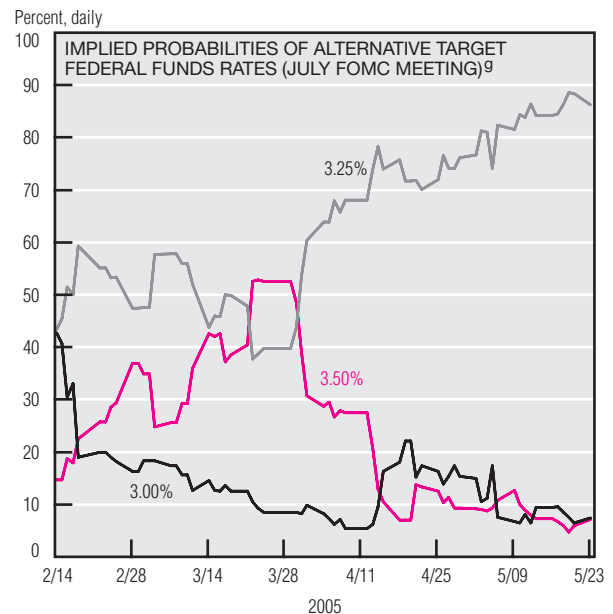
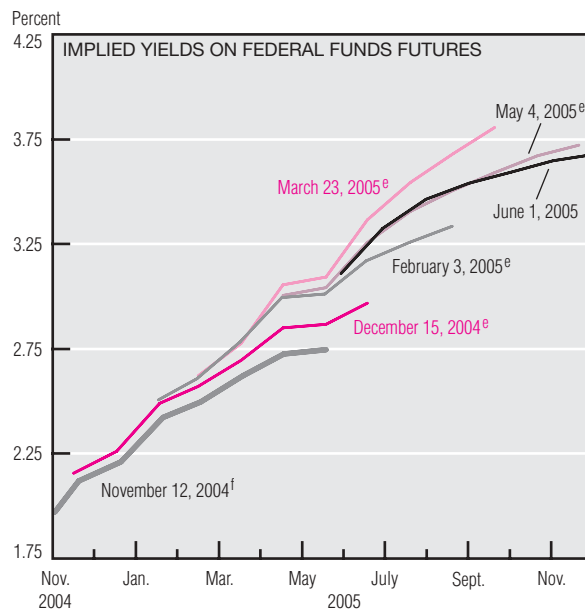
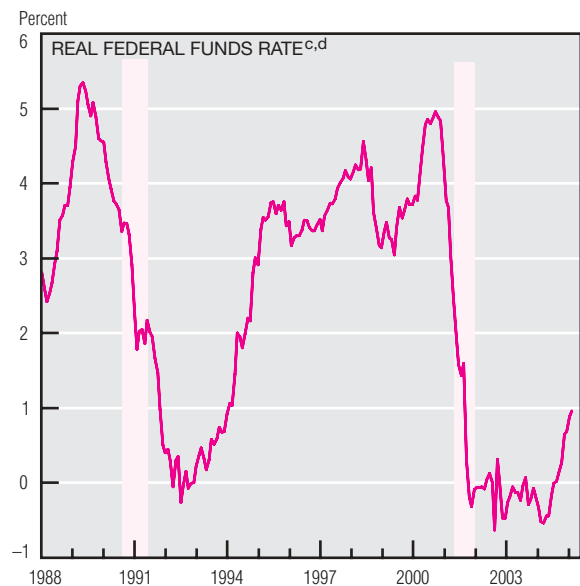
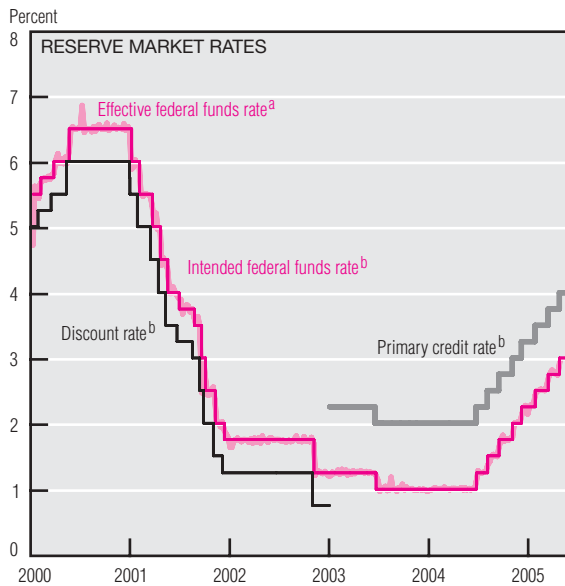
attractiveness of homeownership. Whereas the cost of a home is primarily a household asset, not a cost, OER reflects the share of homeownership that is part of a household's cost of living. In other words, it reflects the cost a household incurs by living in their own home rather than renting it. Indeed, trends in OER growth have largely mirrored trends in rental price growth.

In contrast, the House Price Index, which is compiled by the

Office of Federal Housing Enterprise Oversight using data provided by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, reveals dramatic acceleration in home prices. That index surged 12.5% between 2004:1Q and 2005:1Q, its second-largest four-quarter growth rate since the late 1970s. The discrepancy between the growth rate of house prices and the OER is at a near-record high; it results from a combination of

strong and still-growing demand for homes and a related overstock of rental properties. The increase in rental vacancies (which reached a near-record high of 10.1% in 2005:1Q) may persist, putting downward pressure on rental prices. Meanwhile, sales of existing one-family homes reached a peak of 6.28 million units (seasonally adjusted annualized rate) in April; new one-family home sales reached a peak of 1.32 million units.

Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

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

d. Shaded bars indicate periods of recession.

e. One day after the FOMC meeting.

f. Two days after the FOMC meeting.

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

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

At its May 3 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 2.75% to 3%—about 1 percentage point above the core inflation rate of personal consumption expenditures over the past year. This increase was widely anticipated.

The move was consistent with the FOMC's recent actions and the forward-looking language of its policy statements. For about a year, they have said, "the Committee believes that policy accommodation can be

removed at a measured pace." When the real (inflation-adjusted) fed funds rate was hovering near zero, it was widely understood that sustaining such a policy would ultimately induce inflationary pressures.

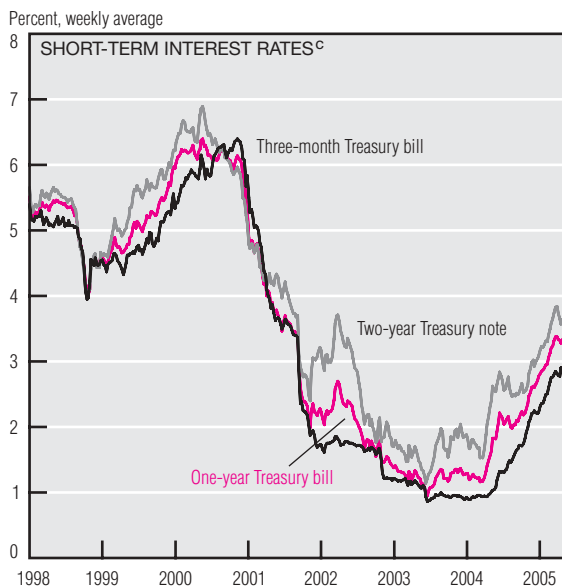
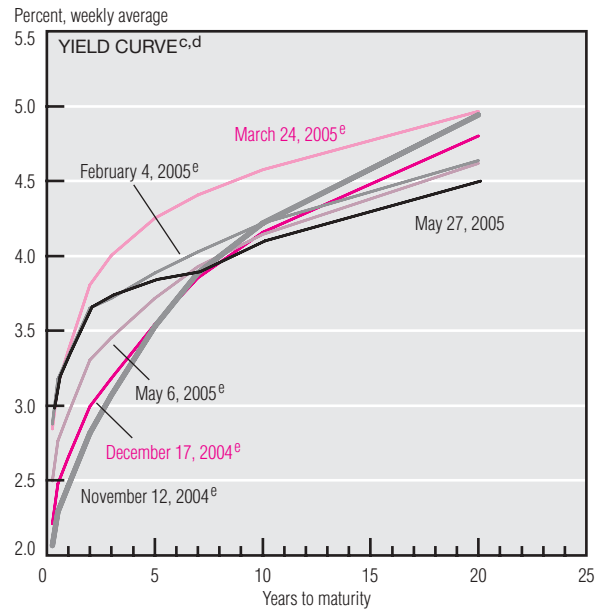
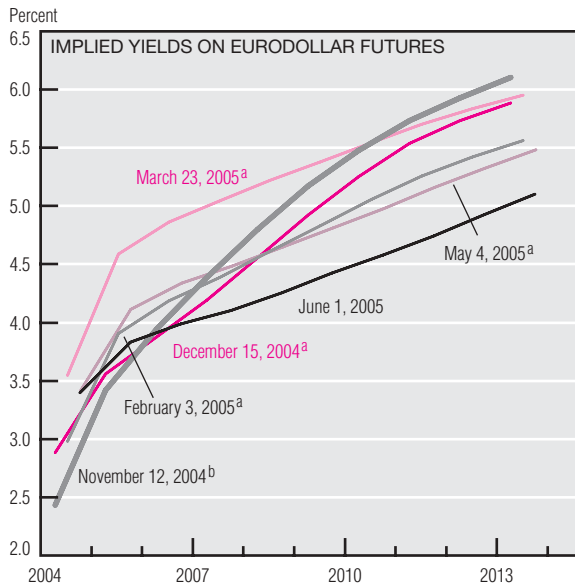
When the economy gained traction in the spring of 2004, the question facing policymakers became not *whether* rates would increase, but how much. Containing inflation expectations has allowed for an attenuated increase in the funds rate compared to past economic recoveries.

But market participants understand that the funds rate eventually will approach a level consistent with a more neutral policy stance. Much attention has thus been given to both the statement language and the meeting minutes, which are now released three weeks after the meeting, for hints as to a change in the pace of rate hikes.

When the May 3 minutes were made public on May 24, they did not cause much surprise; asset prices moved very little. Markets know that

(continued on next page)

Monetary Policy (cont.)



- a. One day after the FOMC meeting.
- b. Two days after the FOMC meeting.
- c. All yields are from constant-maturity series.
- d. Average for the week ending on the date shown.
- e. First weekly average available after the FOMC meeting.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

policy makers face increased uncertainty about the direction of inflation and the strength of the economy; nonetheless, they trust that the FOMC will "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

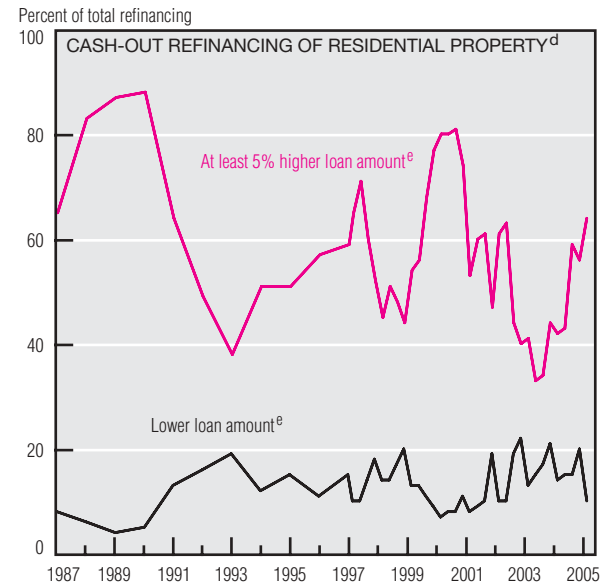
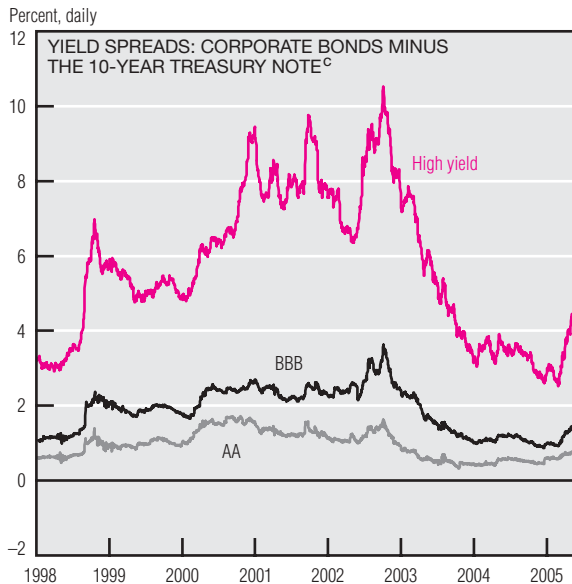
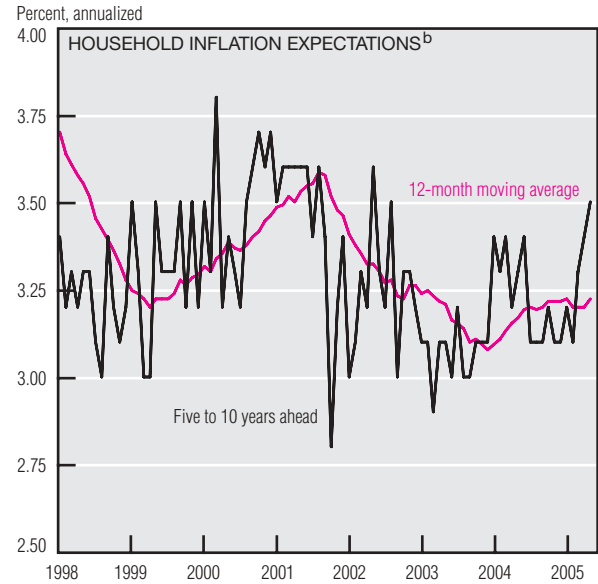
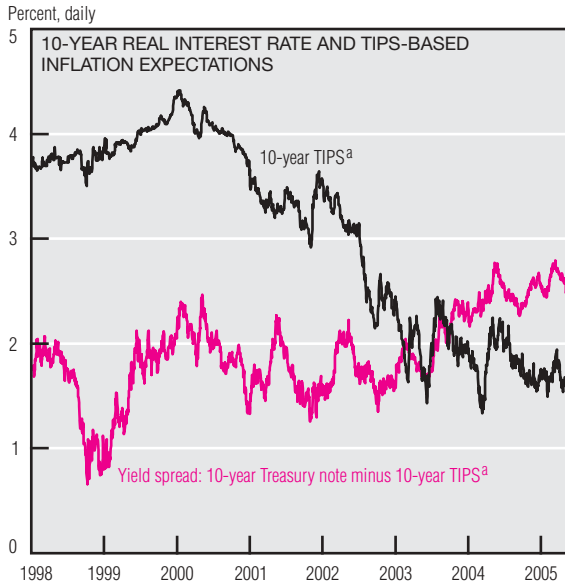
Implied yields derived from federal funds futures have been relatively good predictors of near-term policy actions. Over the winter months, yields suggested that the requisite policy response for maintaining price stability would include at least one

rate hike of 50 basis points (bp) before the end of summer. Since the beginning of spring, however, the expected trajectory of near-term hikes in the fed funds rate has flattened, and the probability of a 50 bp rate hike at the June meeting, recovered from options on fed funds futures, is now less than 10%.

Implied yields that are derived from eurodollar futures provide some measure of expected policy actions over longer horizons. These yields tend to overpredict the fed

funds rate, especially in the out years, and thus need to be adjusted for term premiums. Changes in the trajectory of the implied yields also indicate changing policy predictions. They reveal a substantial retrenchment in the expected fed funds rate two years and more in the future. A similar change has occurred in the term structure of interest rates: Short-term rates have risen, whereas longer-term rates have stabilized at relatively low levels.

Money and Financial Markets



a. Treasury inflation-protected securities.

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

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

d. Annual data until 1997; quarterly data thereafter.

e. Compared with previous financing.

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

The secular decline in long-term rates that began in 1982 resulted primarily from a decline in the inflation expectations associated with a sustained disinflation. However, as inflation approached zero after the 2001 economic downturn, policymakers became concerned about their ability to deal with a potential deflation. Short-term interest rates were taken down and kept near or below inflation, and the FOMC's policy statements emphasized its intent to keep rates low for a considerable period.

Such an emphasis probably kept long-term rates low.

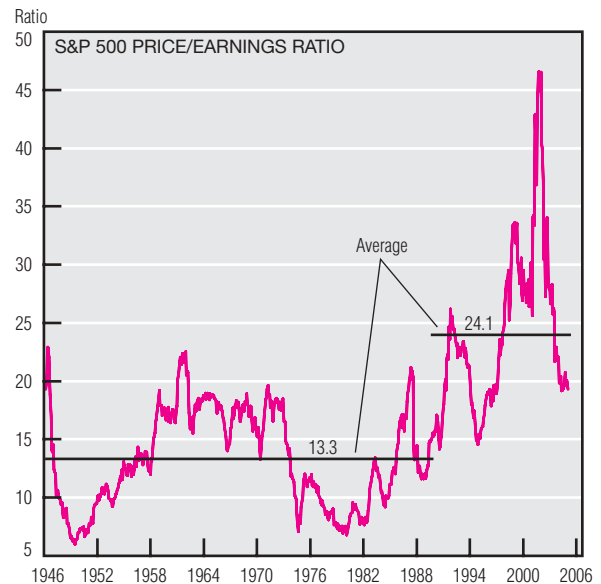
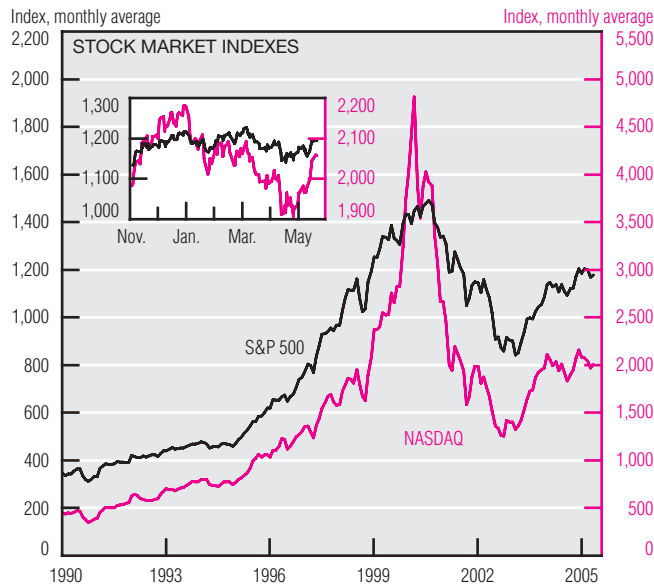
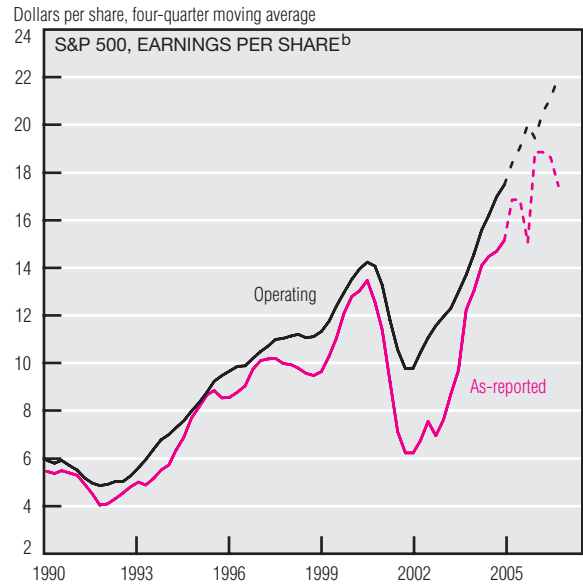
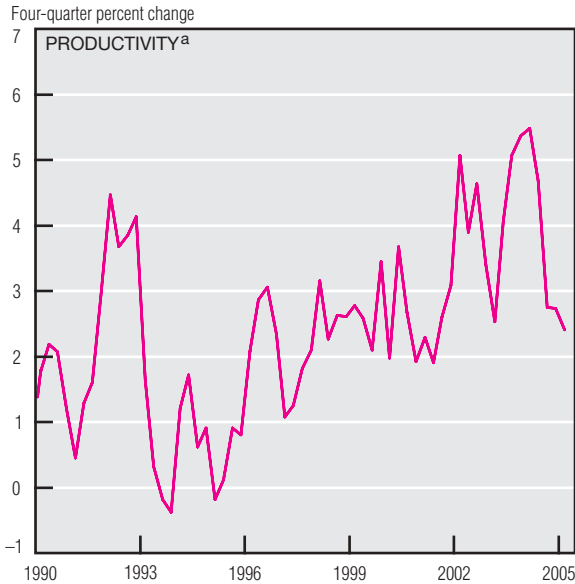
The continued stability of long-term nominal interest rates at relatively low levels over the past year has been described as a conundrum. As the economy recovered and the threat of deflation abated, both nominal and real long-term rates were expected to rise. But real 10-year interest rates, as measured by rates on Treasury inflation-protected securities (TIPS), continued to fall relative to their nominal counterparts. Thus,

expected inflation—measured as the difference between nominal and real interest rates—tended to rise. In part, this may reflect liquidity limitations in the TIPS market. On the other hand, survey data also suggest a slight upcreep in inflation expectations recently in the face of declining nominal Treasury rates.

Some recent downward pressure on Treasury rates may reflect a shift to quality. Holders of privately issued instruments have been demanding a greater premium for risk. Yield

(continued on next page)

Money and Financial Markets (cont.)



a. Nonfarm business sector.

b. Dashed lines indicate the forecast as of 2005:1Q.

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

spreads between corporate bonds and 10-year Treasury notes have widened, especially for riskier assets such as high-yield bonds, commonly known as junk bonds.

Although yield spreads of mortgages over Treasuries also increased, mortgage rates remain quite attractive. Indeed, mortgage refinancing continues to be a good source of household liquidity. Moreover, low-cost financing helps sustain the current housing boom.

Ultimately, inflation and inflation expectations are contained because

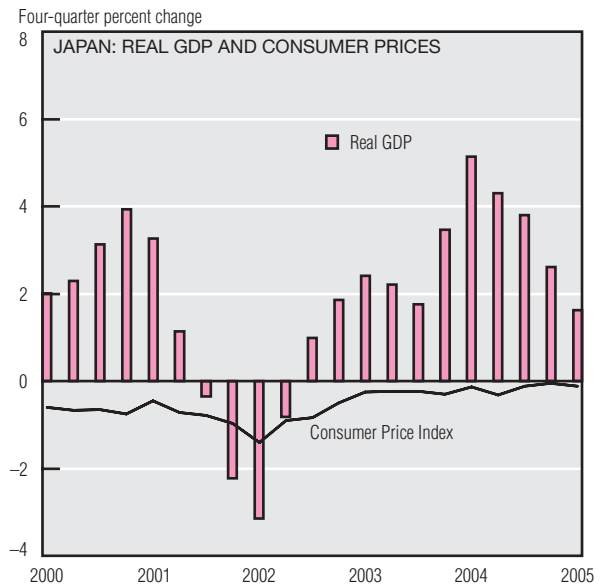
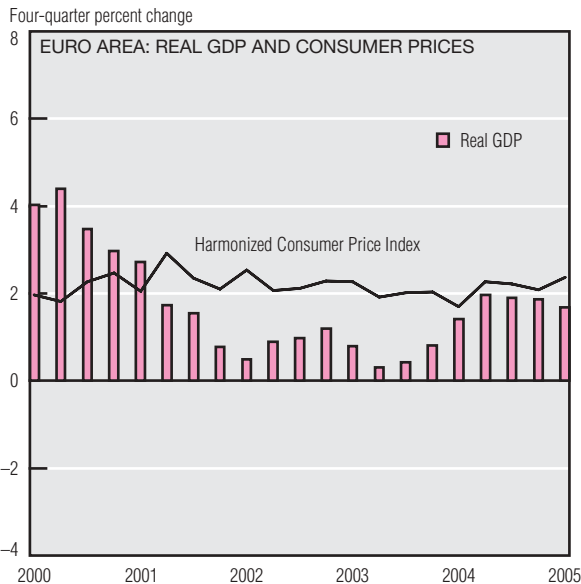
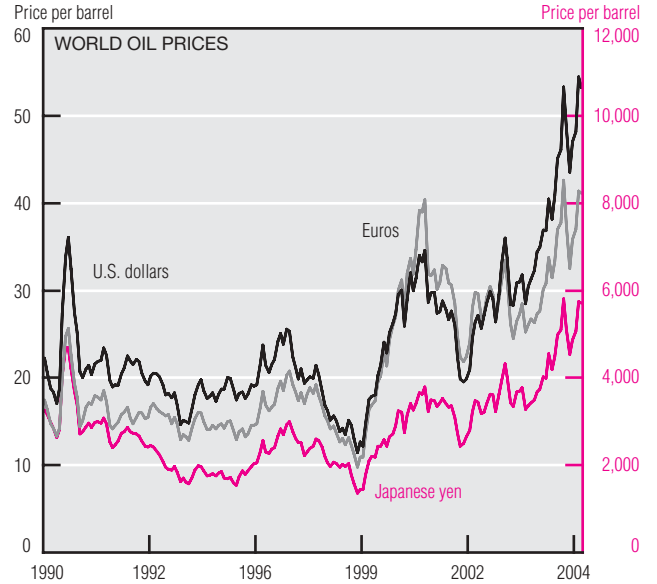
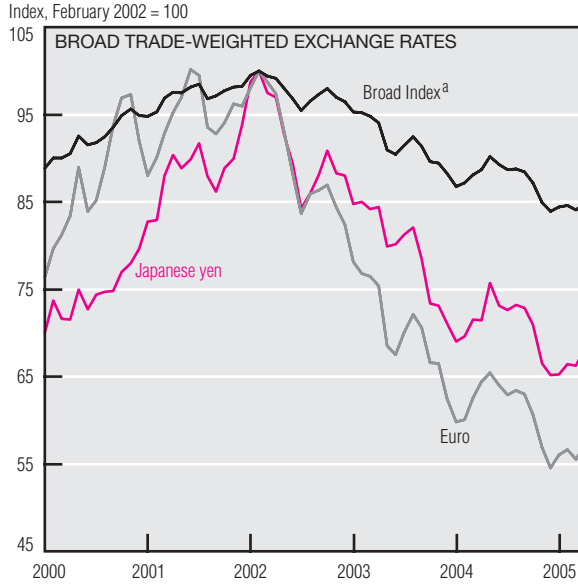
economic growth is supported by strong fundamentals. Robust productivity growth, in particular, helps keep unit labor costs in check. Labor costs account for almost two-thirds of total costs; hence, stable unit labor costs help subdue inflation.

Robust productivity relative to the rest of the world makes the U.S. an investment haven. This country's financial markets are a favorite destination for the rest of the world's savings—a factor that not only maintains downward pressure on bond yields but also exerts pressure on

equity prices. Productivity gains translate into greater expected earnings growth and thus into promising returns on equities.

Indeed, earnings growth at the 500 largest U.S. firms has outstripped equity price increases, causing a substantial decline in the price-earnings ratio to a level below the post-1990 average. Moreover, earnings growth is expected to exceed the growth rate of the economy. Thus, the fundamentals suggest a favorable outlook for the equity markets.

Economic Growth in the Euro Area and Japan



a. The Broad Index measures the trade-weighted average change in dollar exchange rates against our most important trading partners.

SOURCES: Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; Organisation for Economic Co-operation and Development, *Economic Outlook*; and the *Wall Street Journal*.

Economic growth in the euro area and Japan has been sluggish—less than 2% on balance—and is likely to remain so this year and next. The dollar's depreciation and higher oil prices have weighed heavily on these economies. With economic activity in the U.S. expected to advance at a fairly robust rate of 3¹/₄% to 3¹/₂%, global growth differentials will not help narrow the U.S. trade gap.

Since its peak in February 2002, the dollar has depreciated almost 49% on balance against the euro and

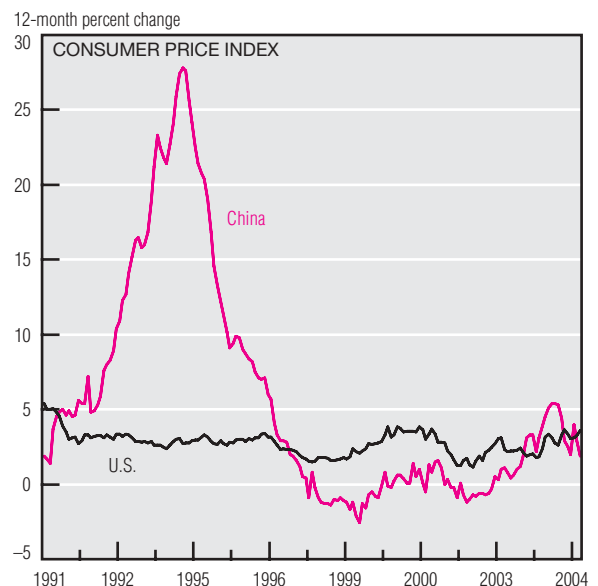
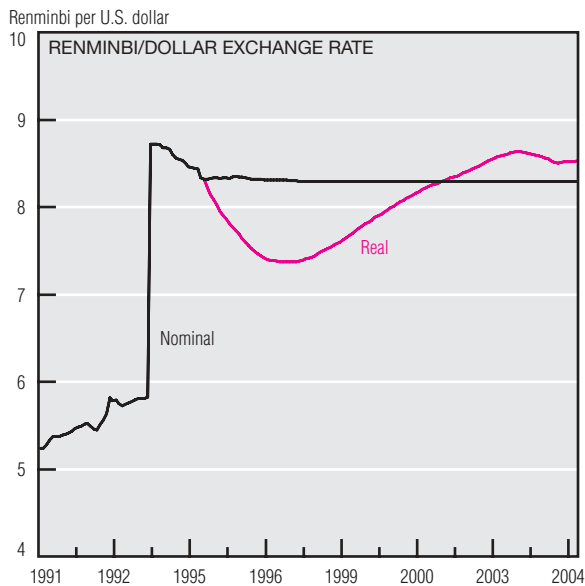
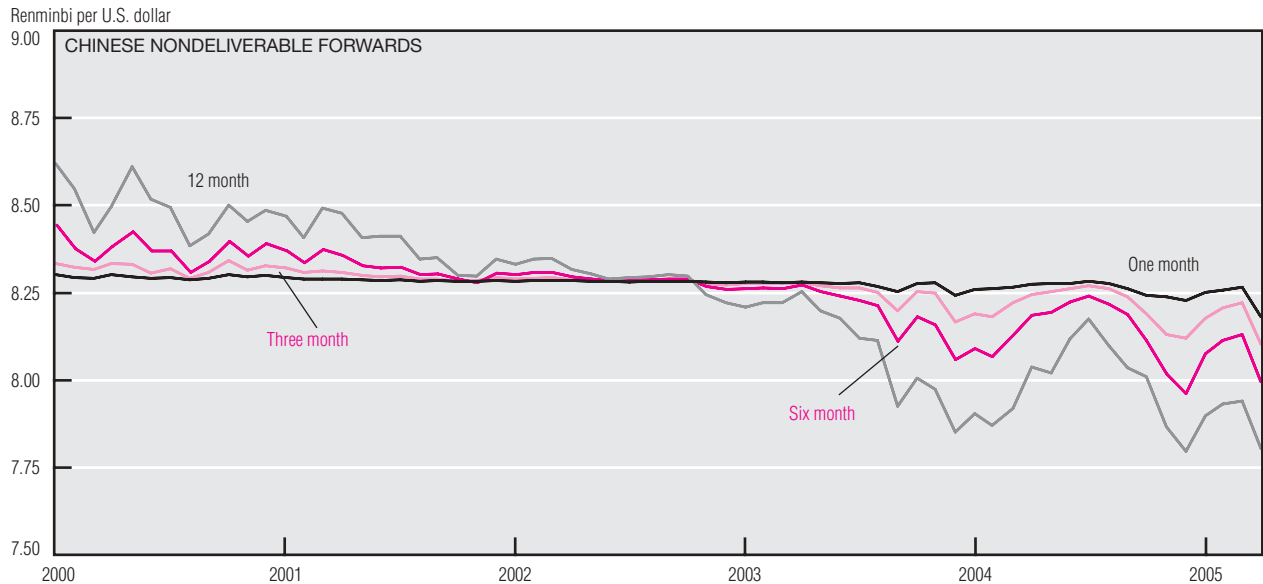
nearly 25% against the Japanese yen. A dollar depreciation shifts worldwide demand toward U.S. goods and services by lowering their foreign-currency price and raising the dollar price of foreign products. In so doing, dollar depreciation tends to reduce foreign economic growth.

Because of this depreciation, the euro and yen prices of oil have not risen as fast as the dollar price. (Oil is priced in dollars around the globe.) Nevertheless, oil prices have risen briskly in both Europe and Japan and, as in the U.S., have had a

negative impact on the pace of economic activity.

Inflation rates in Europe and Japan remain subdued. Although higher oil prices may tend to raise headline price measures, a dollar depreciation has the opposite effect. Ultimately, however, inflation depends on monetary trends. Most analysts expect Europe's year-over-year inflation to remain around the European Central Bank's target of 2%. They also expect that Japan's persistent bout with deflation will soon end.

Betting on a Renminbi Revaluation



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; National Bureau of Statistics of China; and Bloomberg Financial Information Services.

The U.S. has turned up the heat on China to revalue the renminbi: The Treasury has threatened to label China a currency manipulator, and Congress may impose tariffs if China does not comply. Some pundits maintain that such threats will only stiffen China's resistance to revaluation. So, how is the smart money betting?

Forward exchange rates often reveal the market's best guess about a currency's future path, but no forward renminbi market exists because

China restricts such trading. Recently, a market in nondeliverable forwards (NDFs) has arisen to provide cover for companies trading in renminbi. An NDF contract sets an exchange rate for the future purchase or sale of renminbi. But unlike a standard forward contract, delivery on an NDF is made not in renminbi, but in an equivalent amount of a convertible currency, such as U.S. dollars.

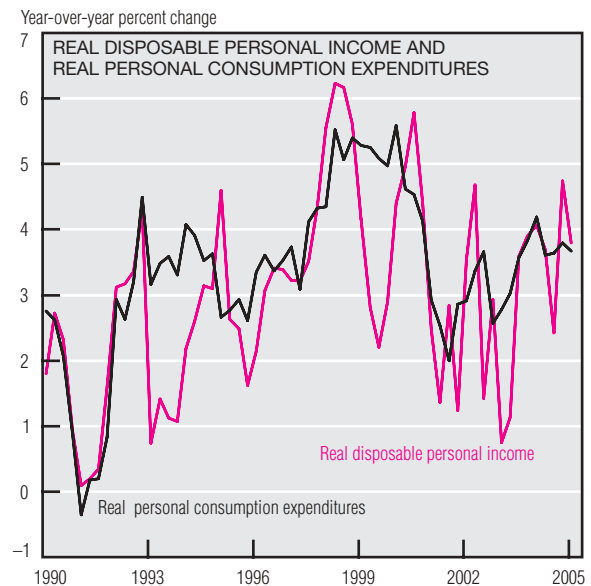
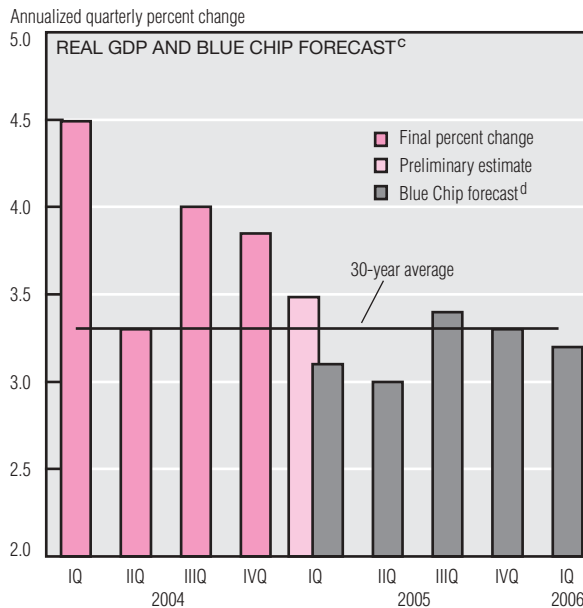
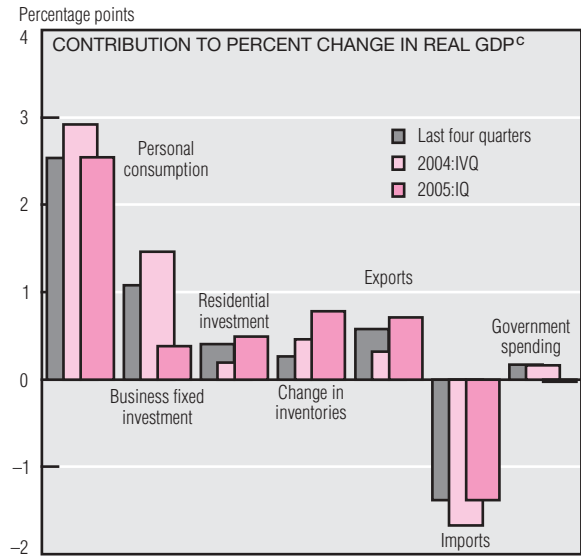
Forward rates on renminbi NDFs have been below Rmb 8.28 per dollar since mid-2002, suggesting that the

market expects a renminbi appreciation. Recently, NDFs generally have fallen to new lows.

A renminbi revaluation seems an eventual certainty, but betting on how it might affect trade is still risky. Trade depends on the real, or inflation-adjusted, exchange rate. A change in the peg will certainly affect the real rate for a while, but few economists expect it to have a lasting effect on the real exchange rate.

Economic Activity

	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	94.5	3.5	3.7
Personal consumption	69.5	3.6	3.6
Durables	4.8	1.7	5.4
Nondurables	29.9	5.4	4.0
Services	34.2	3.2	3.1
Business fixed investment	11.2	3.5	10.8
Equipment	14.5	5.6	13.8
Structures	-2.0	-3.3	1.1
Residential investment	12.1	8.8	7.4
Government spending	-0.8	-0.2	0.9
National defense	0.4	0.3	2.8
Net exports	-18.9	—	—
Exports	19.9	7.2	5.9
Imports	38.7	9.1	9.4
Change in business inventories	21.2	—	—



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

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

c. Data are seasonally adjusted and annualized.

d. Blue Chip panel of economists.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, May 10, 2005.

According to the U.S. Commerce Department's preliminary estimate, GDP growth in 2005:IQ was 3.5%, up from the advance estimate of 3.1%. The revision was attributed primarily to upward revisions for personal consumption expenditures, residential investment, and exports. Imports, which subtract from GDP, decreased.

Most components' contributions to the change in real GDP have remained relatively stable over the last four quarters. The only significant changes occurred in business fixed investment

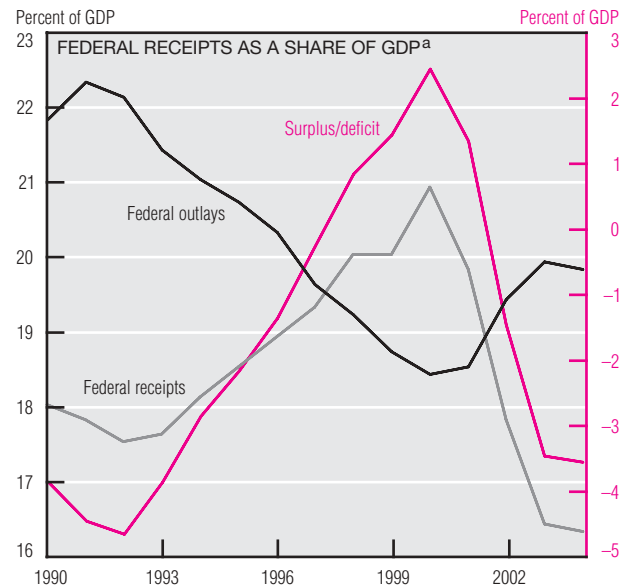
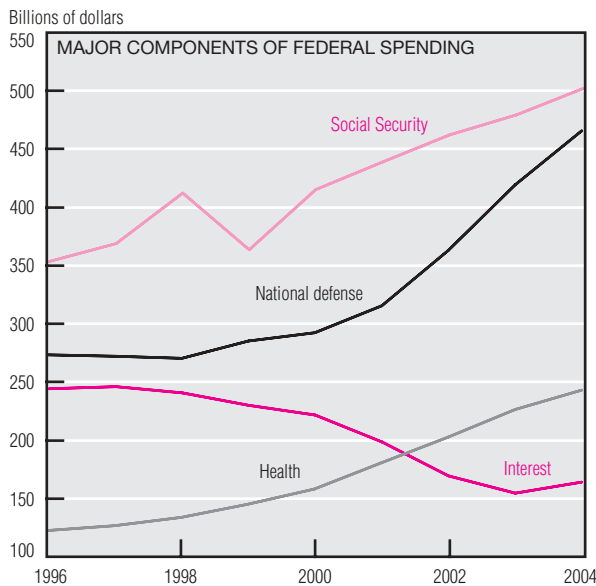
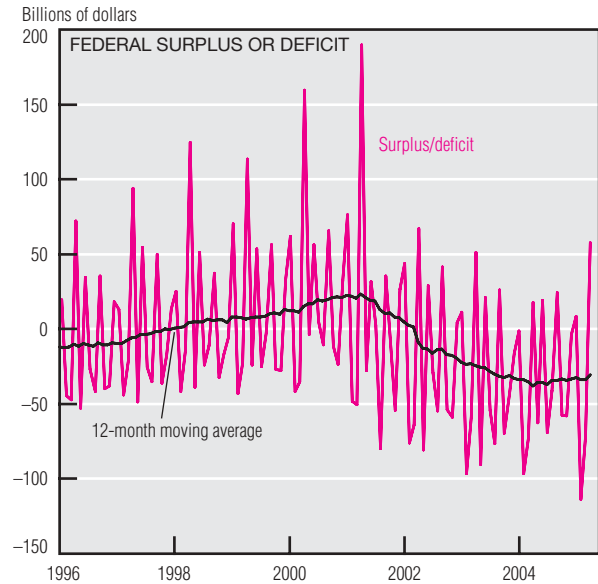
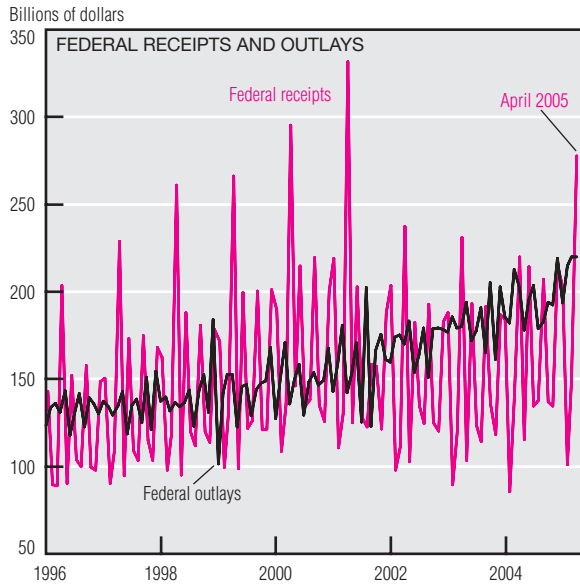
and changes in inventories. However, compared to 2004:IVQ, personal consumption, business fixed investment, and government spending combined to subtract 1.7 percentage points (pp) from GDP, which was partly offset by increases in other components.

Although the preliminary GDP reading for 2005:IQ was lower than both 2004:IIIQ and 2004:IVQ, it was still 0.2 pp higher than the 30-year average. In May, the Blue Chip forecasters downgraded their estimate of GDP growth for 2005:IIQ to 3.0% from the 3.6% predicted in April.

They also lowered their estimates of 2005:IIIQ and 2006:IQ growth by 0.1 pp each.

Although real disposable personal income growth tends to vary more than real personal consumption expenditures, both series follow the same basic trends. Since 2001:IIIQ, the long-term trend has been an increase in year-over-year growth. Despite the 2005:IQ slowdown in income growth, both series have averaged annual growth of 3.6%, only 0.1 pp lower than the overall economy.

Federal Spending



a. Fiscal year.

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

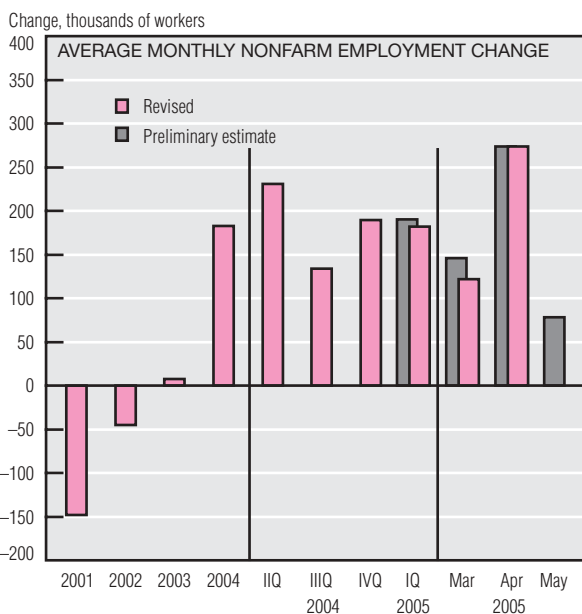
Federal tax receipts surged 26% in April 2005 compared to April 2004, putting the budget almost \$58 billion in surplus. Although the surprisingly strong tax receipts were good news, given the volatility of this series, particularly in April, the best that can be said is that receipts could signal that the federal budget deficit will not again set a record this fiscal year. The strong receipts provide further evidence that the budget deficit may have bottomed out for the cycle; the 12-month moving average has been improving since April 2004.

Before getting too optimistic about the budget prospects, we should note that a great deal of spending pressure remains. Defense and health outlays have been in the forefront, and few observers expect spending in these areas to slow, let alone decline. In a recent development, interest outlays rose slightly last year after falling since 1997. Budget surpluses drove this figure down in the late 1990s; falling interest rates continued to cut the cost despite the budget deficits that returned in April 2002. With continued deficits and the rise in short-term

rates, interest outlays now appear to be on an upward path.

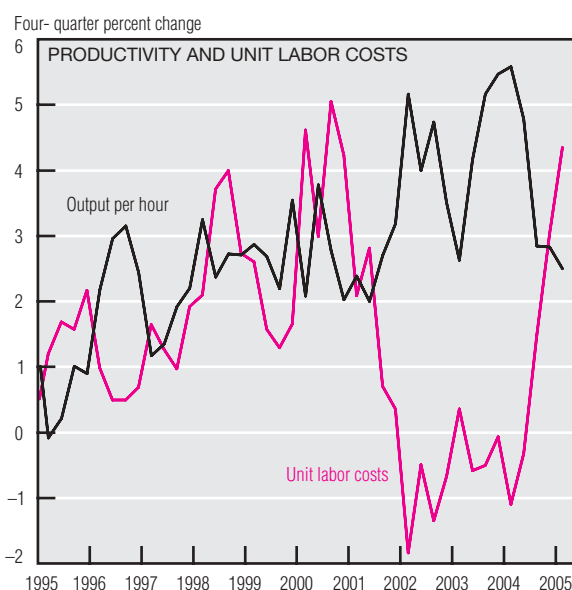
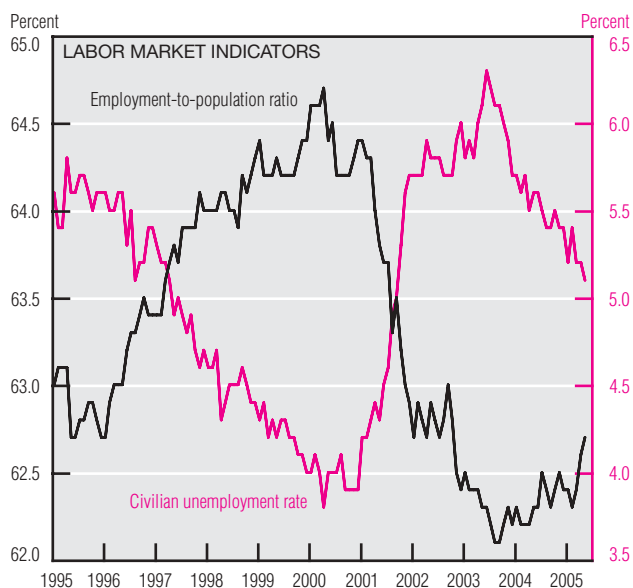
Last year, despite these spending pressures, federal outlays as a share of GDP eased down 0.1 percentage point to 19.8%. Federal receipts' share of GDP, which has been falling sharply since 2000, continued to fall (albeit only slightly) and now stands at 16.3%. The net result is that the 2.4% of GDP budget surplus in 2000 has become a -3.6% of GDP deficit. At some point, policymakers must reconcile the nearly 20% of GDP they want to spend and the only 16.5% of GDP they seem willing to tax.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	May 2005
Payroll employment	-148	-45	8	183	78
Goods producing	-124	-76	-42	29	14
Construction	-1	-7	10	23	20
Manufacturing	-123	-67	-51	3	-7
Durable goods	-88	-48	-32	9	3
Nondurable goods	-35	-19	-19	-6	-10
Service providing	-25	30	50	154	64
Retail trade	-24	-10	-5	13	11
Financial activities ^a	8	6	7	12	4
PBS ^b	-63	-17	22	45	-1
Temporary help svcs.	-37	2	12	15	-4
Education & health svcs.	50	40	30	33	40
Leisure and hospitality	-1	12	18	22	-6
Government	46	21	-4	12	5
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.5	5.1



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.

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

Nonfarm payrolls increased by 78,000 jobs in May, the smallest monthly gain since August 2003. However, job growth averaged 176,000 throughout April and May, generally in line with the average monthly gain of 184,000 in the previous 12 months.

Service-providing industries showed the most significant moderation, adding 64,000 jobs in May, less than half the average monthly gain this year. Education and health services added 40,000 jobs. Employment growth slowed in several sectors, including retail, leisure and hospitality, and information. Notably, employment in

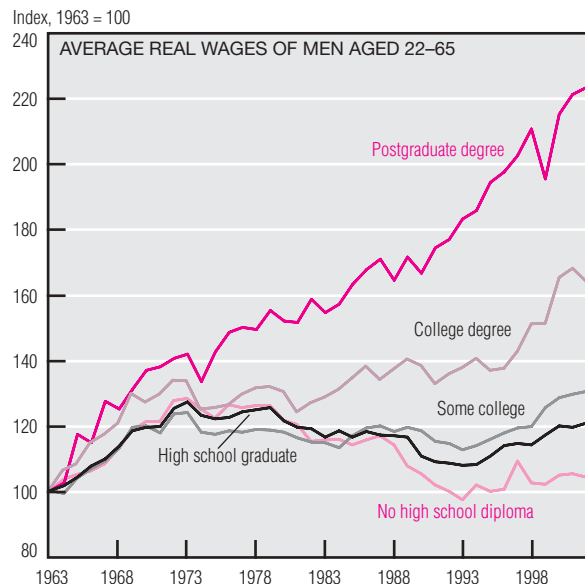
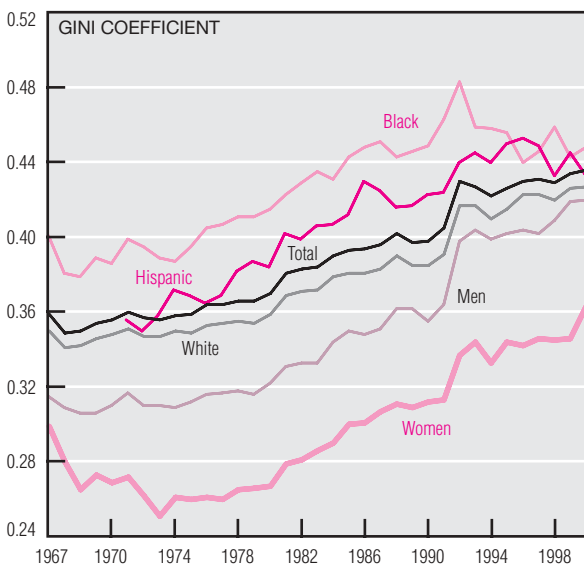
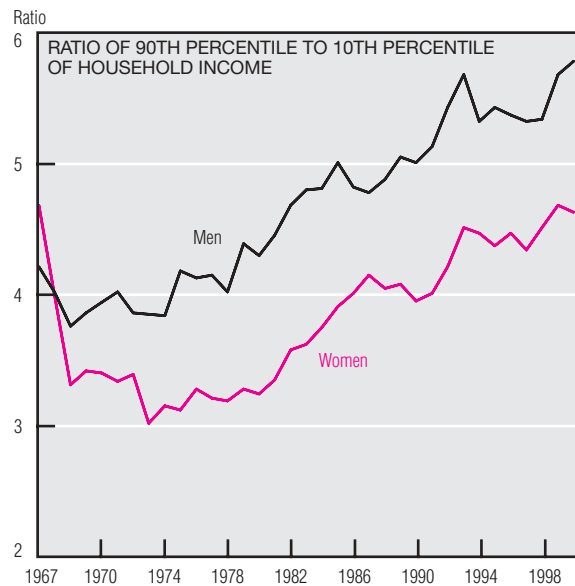
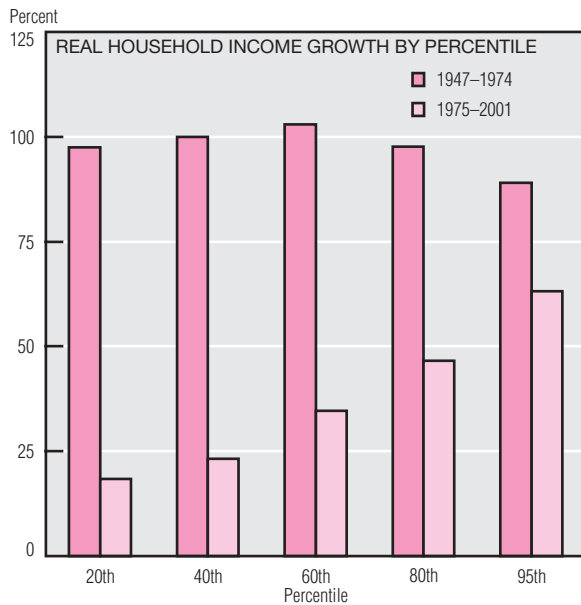
professional and business services fell by 1,000 jobs after adding 33,000 in April. Employment in goods-producing industries, which is still 2.6 million jobs below the previous peak of 24.7 million in July 2000, grew by 14,000 jobs in May. The construction industry grew by 20,000 jobs, down from the 30,000 monthly average for the year to date. Manufacturing employment, which contracted in nine of the 12 previous months, fell by 7,000 jobs.

The unemployment rate dropped 0.1 percentage point to 5.1%—the lowest since September 2001—largely because of stronger employment

growth in the household report. The employment-to-population ratio reached 62.7%, the highest in more than two years.

Meanwhile, although workers' year-over-year productivity growth rate has continued to slow, falling from 2.8% in 2004:IQ to 2.5% in 2005:IQ, it still exceeds the post-1980 average rate of 2.1%. Slower productivity growth and rising compensation growth have pushed up unit labor costs, which reached the highest 12-month growth rate in more than four years.

Income Inequality



SOURCES: U.S. Department of Commerce, Bureau of the Census; and Zvi Eckstein and Eva Nagypál, "The Evolution of U.S. Earnings Inequality: 1961-2002." Federal Reserve Bank of Minneapolis, *Quarterly Review*, December 2004, pp. 10-29.

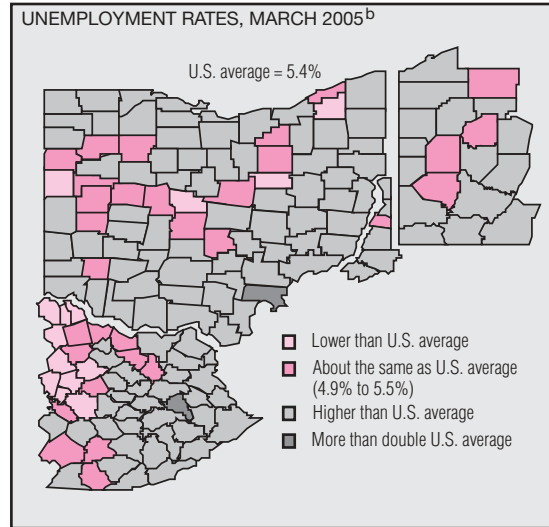
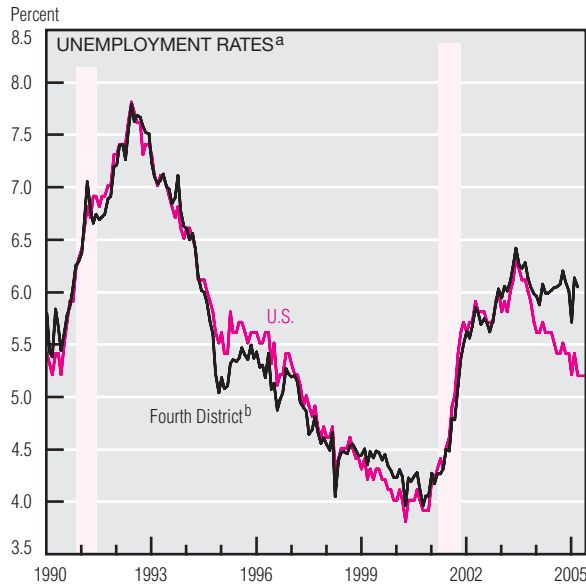
Between 1947 and 1974, income growth was distributed fairly evenly among households in various income groups. However, income inequality has increased over the past 30 or so years. Since the mid-1970s, real income growth for households at the 95th percentile of the distribution has grown at a pace nearly 3½ times that of households at the 20th percentile. A similar pattern holds between men and women.

The Gini coefficient (lower-left chart), a more complete measure of income inequality, considers the entire income distribution. It indicates that income inequality is rising overall.

One explanation holds that the increasing disparity of income in the U.S. over the past 30 years results from skill-biased technological change that has benefited higher-skilled workers. The skill-biased hypothesis asserts that technology improvements boost the productivity (and hence the income)

of skilled labor by more than it does the unskilled. Since the 1980s, demand for skilled labor has kept pace with the relatively greater supply of skilled workers (as estimated by the rising proportion of college-educated workers), exerting upward pressure on wages for higher-skilled workers. Since the early 1980s, the average real wage has risen roughly 30% for male college graduates and nearly 50% for males with a postgraduate degree.

Fourth District Employment



Payroll Employment by MSA

12-month percent change, April 2005

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	0.3	0.4	0.4	-0.5	-0.3	0.3	0.6	1.7
Goods-producing	2.1	0.0	2.7	-4.4	-2.5	-2.0	1.5	1.5
Manufacturing	1.8	-1.3	2.7	-5.5	-4.2	-1.9	1.2	-0.1
Natural resources, mining, and construction	3.3	2.7	2.7	n/a	3.2	-2.3	2.4	4.6
Service-providing	-0.1	0.4	-0.1	0.4	0.2	0.7	0.4	1.7
Trade, transportation, and utilities	-1.2	0.7	-1.7	-1.4	0.3	-0.2	-0.7	1.2
Information	-0.5	1.0	1.9	0.9	-2.1	-3.3	-2.2	0.2
Financial activities	0.7	0.1	-1.5	-4.3	0.8	-0.3	-1.8	2.1
Professional and business services	1.1	-0.7	1.7	-0.7	1.4	2.4	6.0	3.3
Education and health services	2.1	0.6	0.3	0.6	-0.4	2.0	0.0	2.2
Leisure and hospitality	1.0	1.9	0.1	5.9	-0.3	2.6	1.2	2.5
Other services	-1.8	0.3	-0.9	3.6	3.2	1.4	2.0	0.9
Government	-2.7	0.2	0.6	0.2	-0.6	-2.2	-2.1	0.7

a. Shaded bars indicate recessions.

b. Seasonally adjusted using the Census Bureau's X-11 procedure.

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

In March, the Fourth District's unemployment rate fell 0.1 percentage point to 6.0%, compared to the 5.2% U.S. average (which was unchanged in April). The number of unemployed people in the District fell by about 7,000 (down 1.3%) from February to March; during the same period, the labor force increased by about 8,000 (up 0.1%).

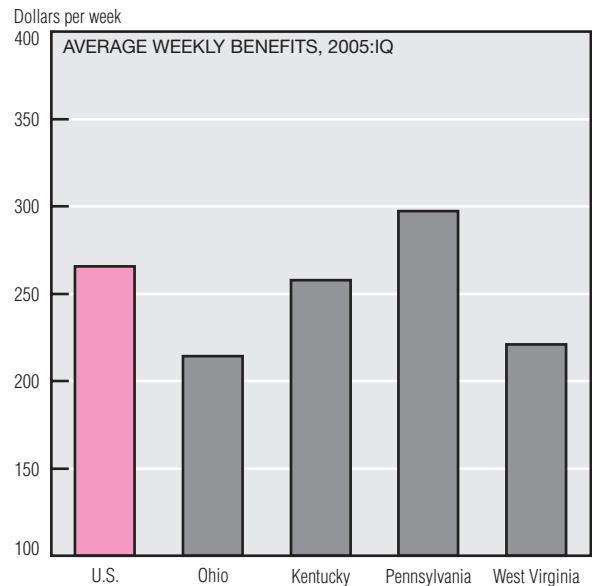
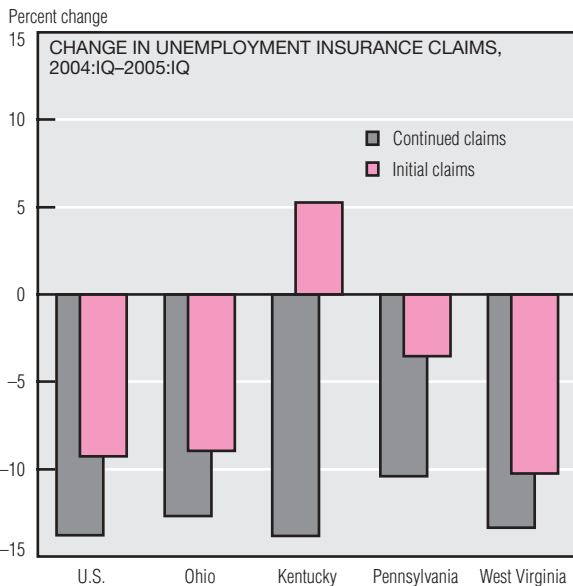
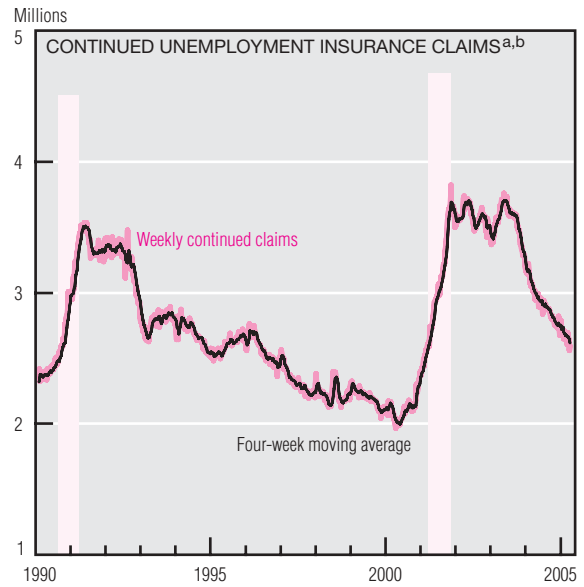
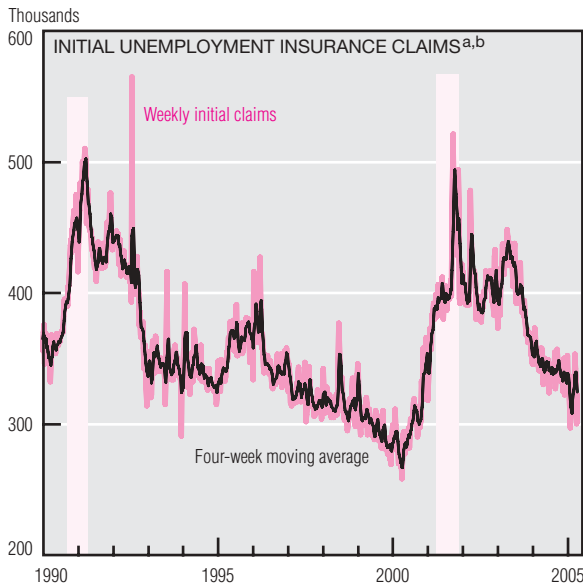
In almost 75% of District counties, unemployment rates exceed the U.S. average. In fact, every county in the Fourth District portion of western Pennsylvania and West Virginia has an

average or above-average unemployment rate. But Fourth District Kentucky, especially the area around Lexington and Covington, looks strong compared to the U.S.

In some of the District's major metropolitan areas, year-over-year employment growth in goods-producing industries is stronger than the U.S.; Lexington, Cleveland, and Cincinnati have experienced solid growth. However, all of the District's metropolitan areas lag the nation in service-providing jobs. In every one of these areas, annual employment growth in service-providing industries

is less than half the U.S. average. Pittsburgh, with a 0.7% annual rate of employment growth in service-providing industries, leads the other metropolitan areas but remains a full percentage point below the U.S. growth rate for these industries. The lower rate of service employment growth may be caused partly by slower population growth: Except for Lexington, which has kept pace with the U.S. since 2000, population growth in each of the District's major metropolitan areas during that period was far below the nation's.

Unemployment Insurance



a. Seasonally adjusted.
 b. Shaded bars indicate recessions.
 SOURCE: U.S. Department of Labor, Employment and Training Administration.

The U.S. Unemployment Insurance (UI) program, launched by the Social Security Act of 1935, gives monetary assistance to the unemployed. The program is also a countercyclical tool that helps sustain income levels in difficult economic times.

As a byproduct, the UI program furnishes statistics on the number of insured unemployed people. The number differs from the total unemployed for several reasons: The program excludes certain groups such as the self-employed; it also excludes

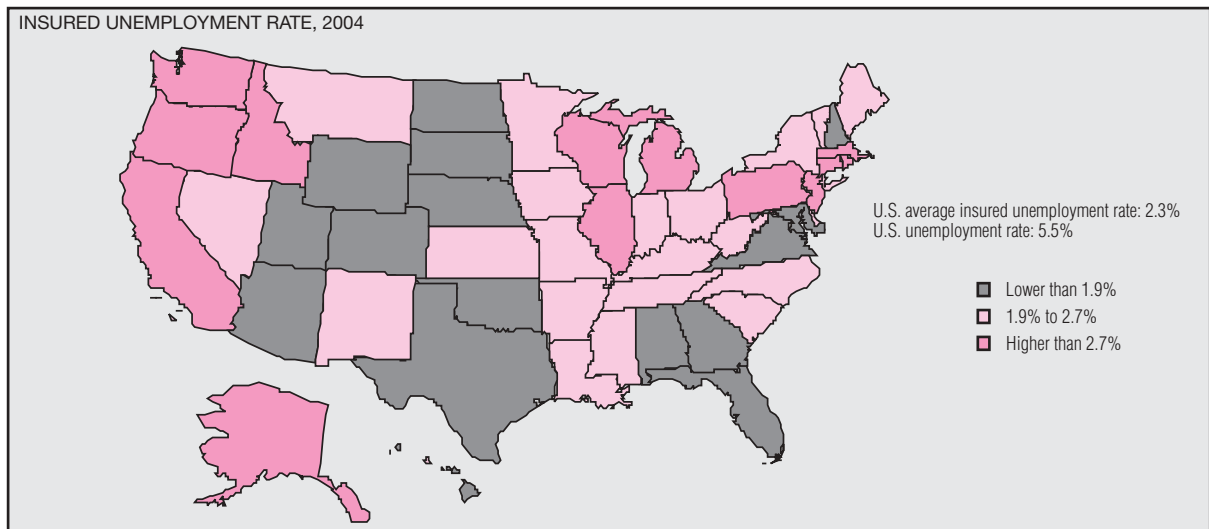
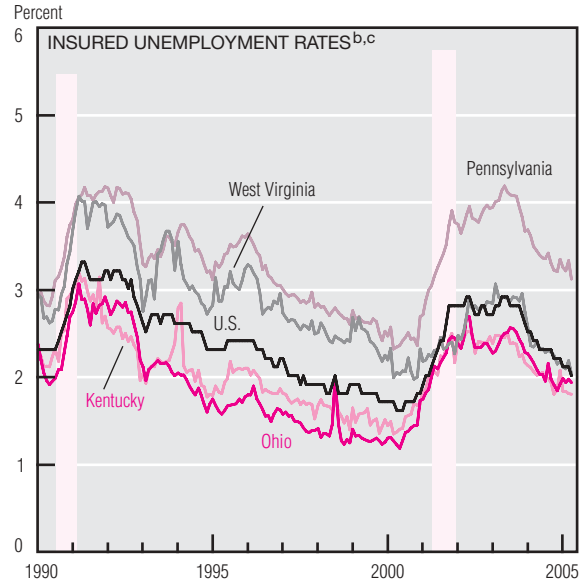
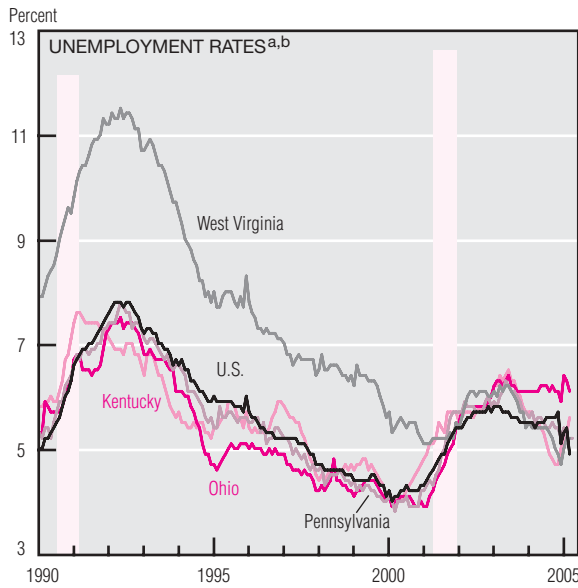
workers who do not qualify for the program for various reasons, including misconduct and exhaustion of benefits.

The number of initial claims is a timely (weekly) statistic that provides national or statewide information on the number of people laid off during the week. Although initial claims do not exactly equal jobs lost, the number of initial claims provides insight into future labor market fundamentals such as the unemployment rate.

After peaking in November 2001, the month the most recent recession ended, the number of initial claims has continued to trend downward. The number of initial claims improved over the past year, although the four-week moving average—for which a value greater than 400,000 is considered a sign of recession—increased by 16,000 over the past two months to 323,000. Compared to last year, the percent change in initial claims for Fourth District states has been similar

(continued on next page)

Unemployment Insurance (cont.)



a. Seasonally adjusted.
 b. Shaded bars indicate recessions.
 c. State data are seasonally adjusted by the Federal Reserve Bank of Cleveland.
 SOURCE: U.S. Department of Labor, Employment and Training Administration.

to the nation's—with the exception of Kentucky, which has 5.3% more initial claims than a year ago.

Trends for continued claims usually follow those of initial claims but are slower to fall during a recovery. The four-week moving average for the number of continued claims reached its most recent postrecession peak in June 2003 and has trended downward since then. The change in continued claims for Fourth District states has followed the U.S., where every state's

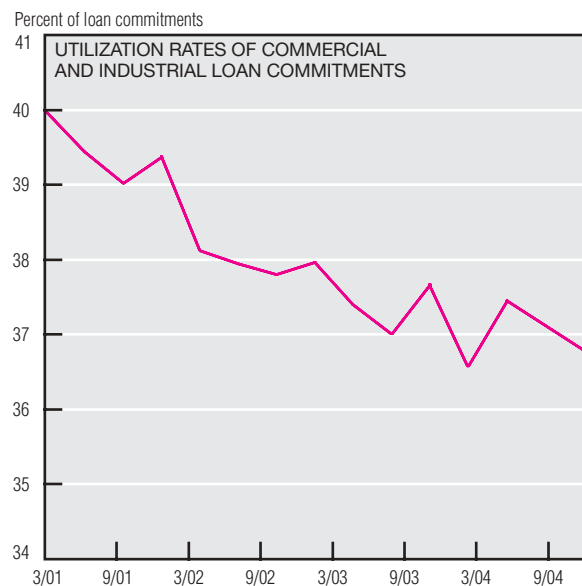
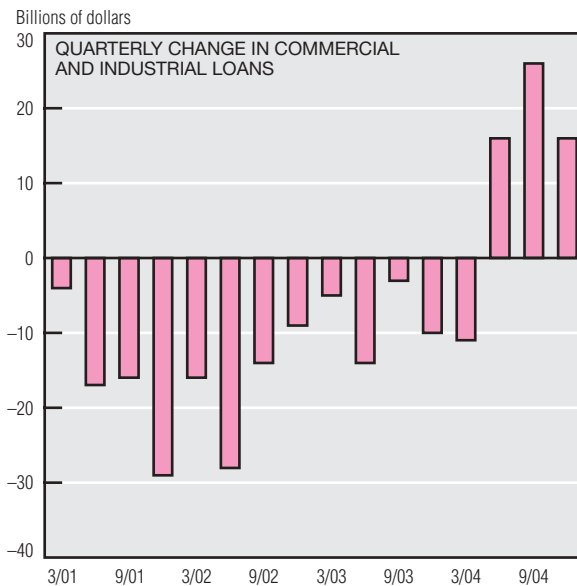
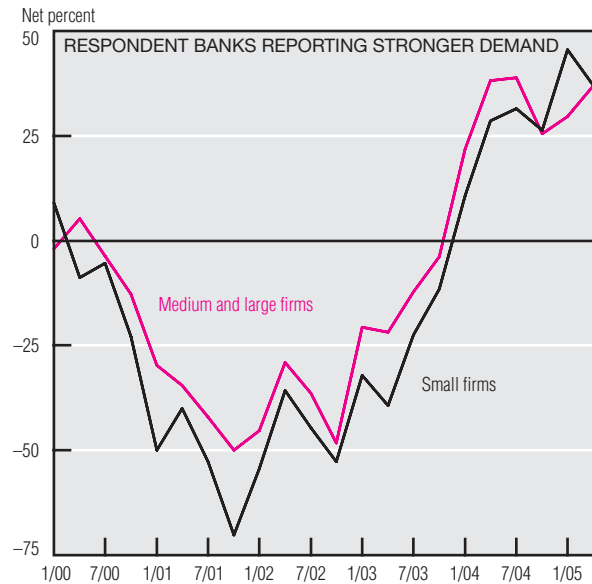
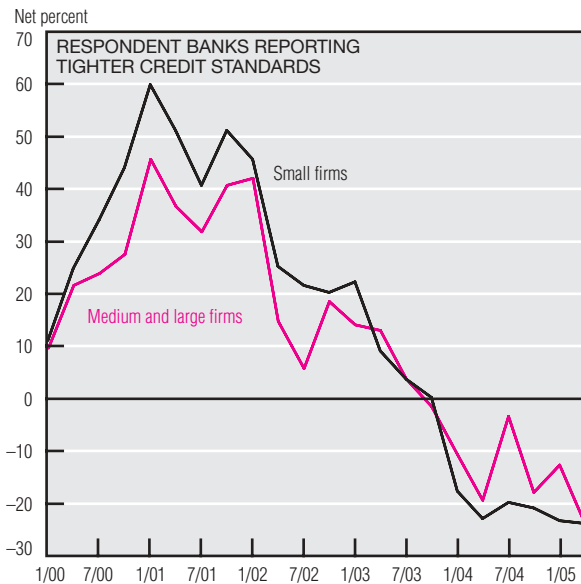
continued claims were less than 90% of the number a year ago.

UI statistics are also used to calculate the insured unemployment rate, which counts the number of people claiming regular unemployment benefits divided by the number who are covered by the unemployment system. One difference between the insured unemployment rate and the regular unemployment rate (the number of unemployed divided by the labor force) is that UI data are the raw data of total claims rather than a

survey sample. Because eligible unemployed people do not always file a UI claim and because claims in most states end after 26 weeks, the insured unemployment rate is lower than the regular unemployment rate.

The insured unemployment rate varies by state because of economic conditions and differences in state policies such as benefits levels and qualification rules. In 2004, the rates for Ohio, Kentucky, and West Virginia were close to the U.S. average of 2.3%; Pennsylvania, at 3.4%, exceeded it.

Business Loan Markets



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

Credit availability for businesses continued to improve throughout 2004, according to the Federal Reserve's *Senior Loan Officer Survey*. In the January 2005 survey (covering the months of November, December and January) 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.

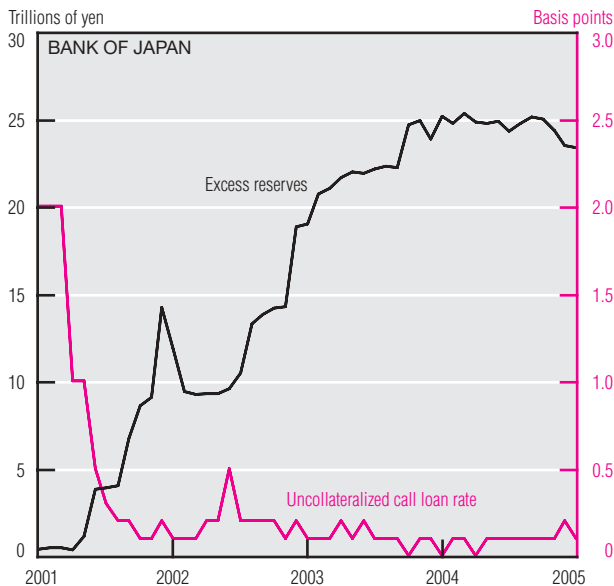
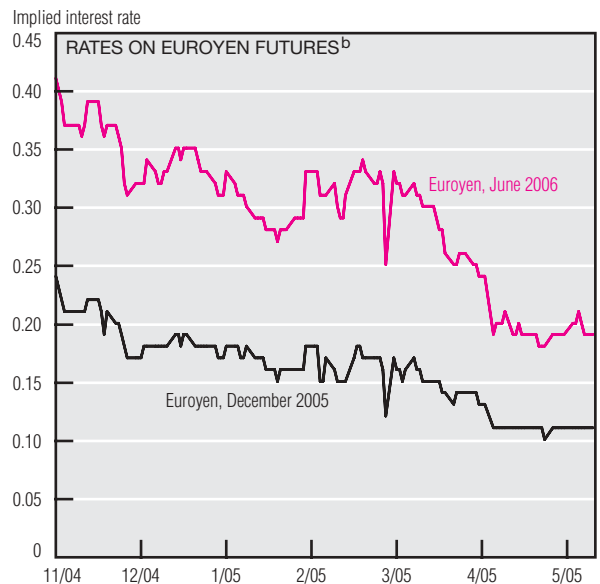
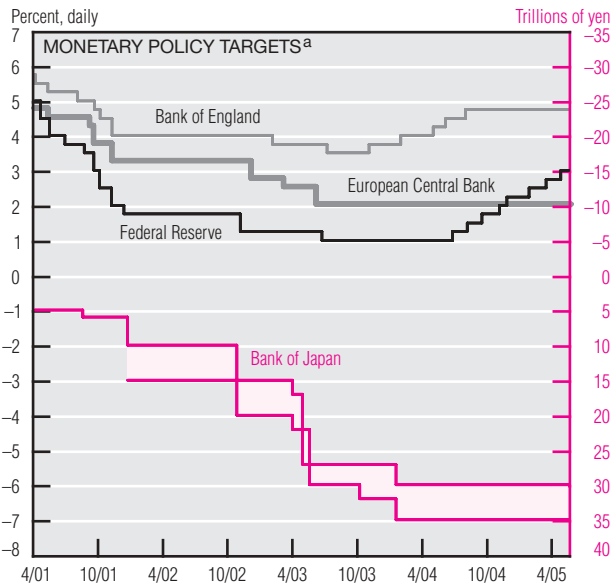
This relaxation in lending standards was partly a response to increased competition from other banks and

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. Even with greater demand, prices dropped, indicating 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:IVQ, marking the third consecutive quarter of expanding business loan portfolios. Overall, holdings of commercial and industrial loans at the end of 2004 were up \$47 billion over the end of 2003. This is the first time since 2000 that FDIC-insured institutions' business loan portfolios have grown during a year. Interestingly, this 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). This suggests an increase in the supply of business credit.

Foreign Central Banks



Frequency of Undersubscription in the Bank of Japan's Funds-Supplying Operations

	Offers	Undersubscriptions
2001	542	16
2002	459	171
2003	310	17
2004	310	23
January–April 2005	102	47

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. Futures contracts on three-month Japanese yen interbank deposits held outside Japan.
 SOURCES: Board of Governors of the Federal Reserve System; Bank of England; Bank of Japan; European Central Bank; Eiji Maeda, Bunya Fujiwara, Aiko Mineshima, and Ken Taniguchi, "Japan's Open Market Operations under the Quantitative Easing Policy," Bank of Japan Working Paper Series No. 05-E-3, April 2005; and Bloomberg Financial Information Services.

None of the four major central banks has changed its policy setting since the Federal Reserve raised its funds rate target to 3% on May 3. Other aspects of policy decisions have worried market participants amid recent uncertainty about the strength and durability of global economic expansion.

Among the nine members of the Bank of England's Policy Committee, the number of dissenters in favor of raising the interest rate target shrank from two at the April meeting to one at the early May meeting.

For Japan, doubts about the strength of the economic outlook

contributed to low implied yields on Euroyen futures, but technical matters generated interest in lowering the quantity of current account balances without tightening monetary policy. Among the nine members of the Bank of Japan's Policy Board, dissenters rose from none at the mid-March meeting to two at the May 20 meeting in favor of lower account balances.

The Bank of Japan did make a significant change in its policy announcement language. Heretofore, the Bank has merely stated a target range for balances with the technical caveat that, in the event of "a surge in liquidity

demand, the Bank will provide more liquidity irrespective of the above target." To this has been added a further technical caveat that when "liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target." This addition reflects the market's shrinking appetite for excess reserves and the increased incidence of undersubscription in the Bank's funds-applying operations.