

## *The Economy in Perspective*

*When to say when...* The Federal Open Market Committee increased its federal funds rate target by 25 basis points, to 3.25%, at its June 30 meeting. That action, which was widely anticipated by financial market observers, was the latest manifestation of the “measured pace” policy that the Committee announced a year ago. As long as the federal funds rate target was moving from 1% to 3%, few analysts expected the measured pace to slow or stop, but now that the target lies above 3%, some analysts think that the FOMC is approaching a resting point in its policy-tightening cycle.

The short end of the Treasury yield curve is pegged near the funds rate target, and futures markets indicate that short-term rates are headed toward 4% by the end of the year, where interest rates now sit at the 10-year segment of the yield curve. For nearly its entire length, the yield curve’s implied one-year-forward rate is 4% (that is, the implied one-year rate between any two adjacent years from two years ahead through 29 years from now is about the same: 4%).

This flatness in the yield curve reflects financial markets’ current belief that the FOMC funds rate target is likely to lie somewhere between 25 and 100 basis points away from a resting place. Right now, options on fed funds futures contracts imply a funds rate in October of 3.75% with a roughly 70% probability. The odds might change as economic data and opinions about how to interpret them evolve. For example, in the spring of 2004, not only was the Treasury yield curve much steeper than it is today (short-term interest rates were much lower then), but the 10-year rate was also expected to climb toward 5%, rather than 4%. Last June, the one-year-forward rate seven years out was approximately 6%, rather than 4%.

What could make market participants alter their views of the economy and monetary policy? Oil prices are one possible factor. Earlier in the expansion, when oil prices initially surged, forecasters worried that the price shock could seriously retard—or even derail—economic recovery. These concerns faded as consumers and businesses maintained their spending through both the initial shock and a subsequent jolt that propelled oil prices above \$50 per barrel. Now that prices have breached the \$60 per barrel mark, it seems that analysts might have become too blasé.

Energy price shocks present complications for monetary policy makers because they can simultaneously slow the pace of growth and raise measured inflation rates. Because it is often difficult to expand the supply of energy and certain other natural resources quickly, their prices rise steeply in the face of strong demand or shortfalls in supply. Unquestionably, continual energy and commodity price hikes have accelerated inflation during the past few years. In theory, price shocks’ effect on inflation should dissipate over time; indeed, this phenomenon could explain why longer-term inflation expectations and interest rates seem so stable, even though core inflation has been creeping up for a few years.

The FOMC has no official inflation target, so it is not possible to refer to a specific benchmark in assessing monetary policy. Nevertheless, several FOMC members have indicated their preference for CPI-based inflation to fluctuate in a range from 1% to 3%. Such a range allows for transitory periods of unusually large price shocks in either direction, among other contingencies. Consequently, one might expect these FOMC members to be comfortable with CPI-based inflation averaging roughly 2% over longer periods of time. During the past 12 months, CPI inflation has increased by 2.8%, and core measures of inflation have been rising at rates nearer 2<sup>1</sup>/<sub>4</sub>% to 2<sup>1</sup>/<sub>2</sub>%, a pace that could become uncomfortable if the inflationary pressures seemed poised to intensify rather than unwind over the next year or so.

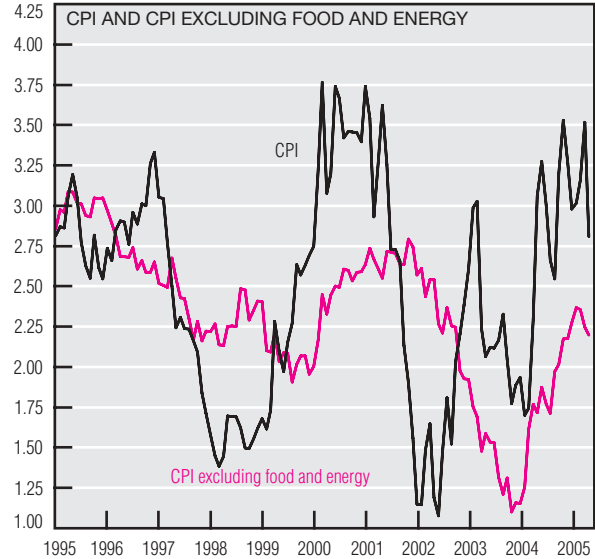
Common gauges of monetary policy are not precise enough to calibrate the stance of policy on their own. One measure, the Taylor rule (using the version reported on regularly by the Federal Reserve Bank of St. Louis), suggests that monetary policy has finally removed enough accommodation to be compatible with an inflation goal of 4%. Another measure, McCallum’s rule (also as reported by the St. Louis Fed), suggests that the monetary base has been growing at a rate that is compatible with a 0% inflation goal. Implementing these rules requires various judgments, and different versions of the rules—including one showing that current policy is compatible with an inflation goal in the middle of the 1%–3% range—will yield different views on when to say when.

# Inflation and Prices

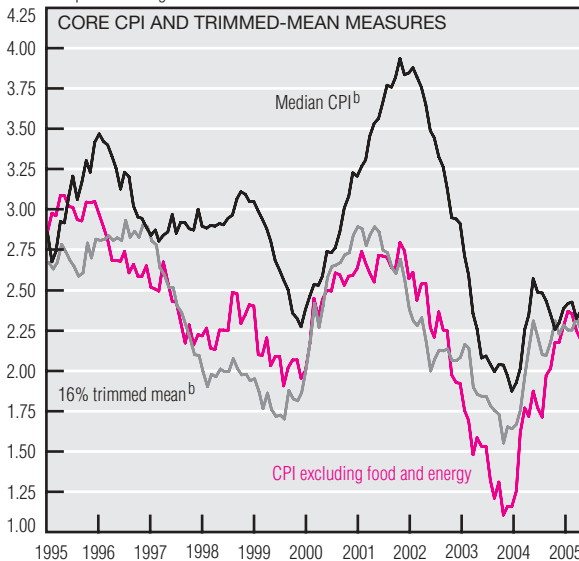
## May Price Statistics

	Percent change, last:				2004 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>Consumer prices</b>					
All items	-0.6	4.4	2.8	2.5	3.4
Less food and energy	1.8	2.2	2.2	2.1	2.2
Median <sup>b</sup>	3.2	2.8	2.4	2.8	2.3
<b>Producer prices</b>					
Finished goods	-7.5	2.6	3.5	2.3	4.4
Less food and energy	0.8	1.6	2.6	1.1	2.2

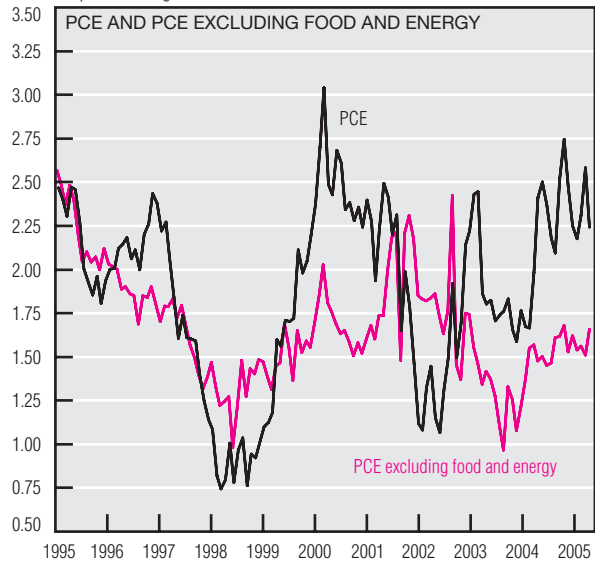
12-month percent change



12-month percent change



12-month percent change



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) declined 0.6% (annualized rate) in May following substantial gains of 6.4% (annualized rate) in April and 7.8% (annualized rate) in March. Energy prices declined at an annualized rate of 21.9% after advancing more than 60.0% the previous two months. Monthly growth in the core CPI, which excludes the volatile food and energy components, rose at a moderate 1.8% annualized rate, and the median CPI rose at 3.2%.

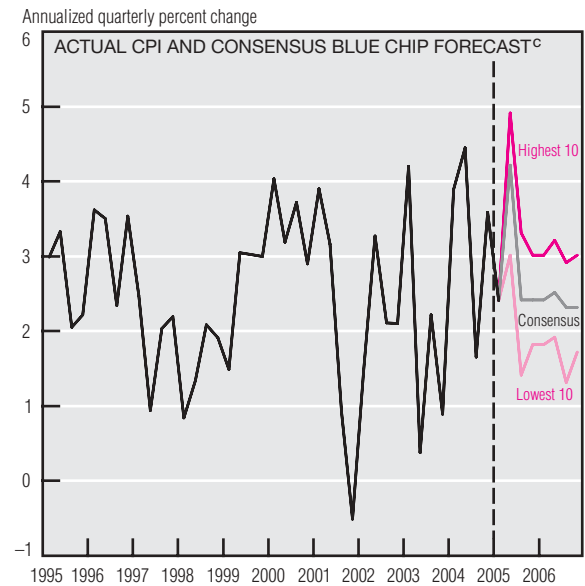
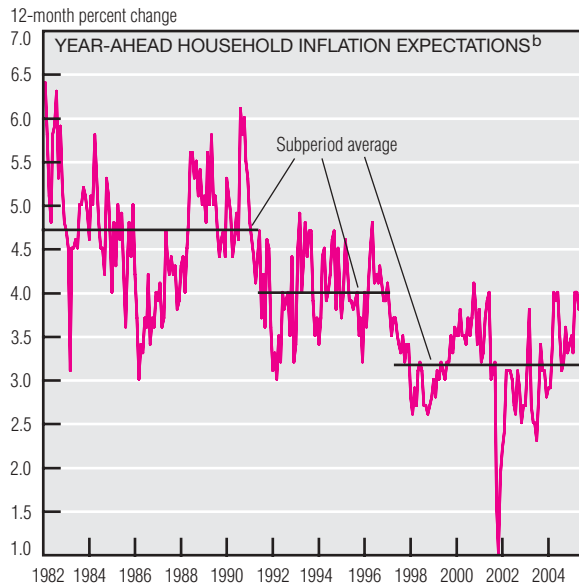
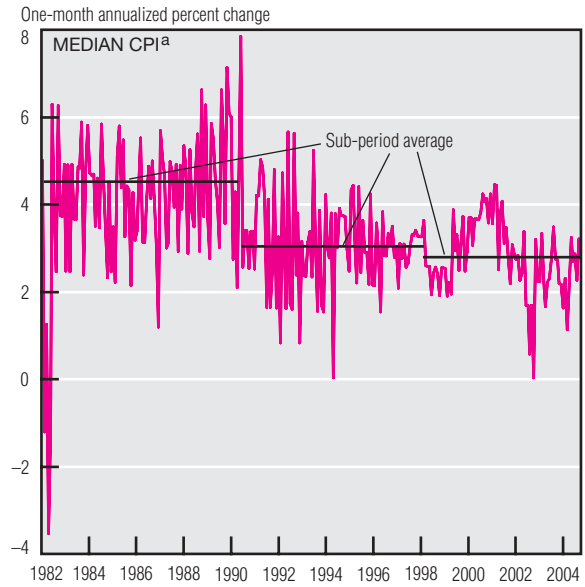
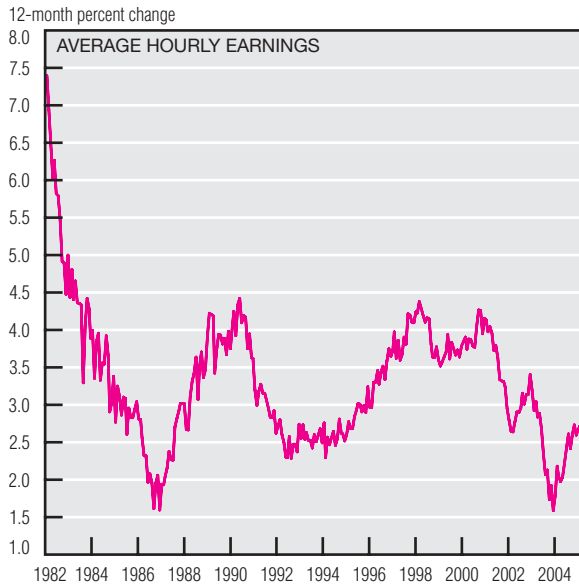
Longer-term inflation trends in the core retail price measures were generally stable during the month. Although the CPI's 12-month growth rate declined from 3.5% in April to 2.8% in May, the 12-month growth rates in the core CPI and the trimmed-mean CPI remained at 2.2% and 2.3%, respectively. The median CPI's 12-month growth rate inched up a mere 0.1 percentage point to 2.4% in May. Longer-term inflation trends in the Personal Consumption Expenditure (PCE) Price Index,

which considers an alternative market basket of consumer goods and services, mirror trends in the CPI. The PCE fell about 0.4 percentage points to 2.2%. The core PCE, which excludes the volatile food and energy components, inched upward 0.1 percentage point to 1.6% in May; this retail price measure has generally fluctuated between 1.5% and 1.6% for more than a year.

Some have noted recent price pressures resulting from rising costs, including a recent upward drift in

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## Inflation and Prices (cont.)



a. Calculated by the Federal Reserve Bank of Cleveland.

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

c. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; and *Blue Chip Economic Indicators*, July 10, 2005.

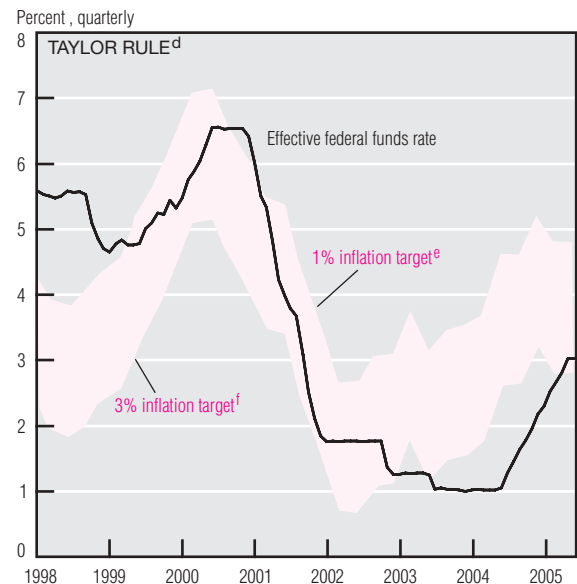
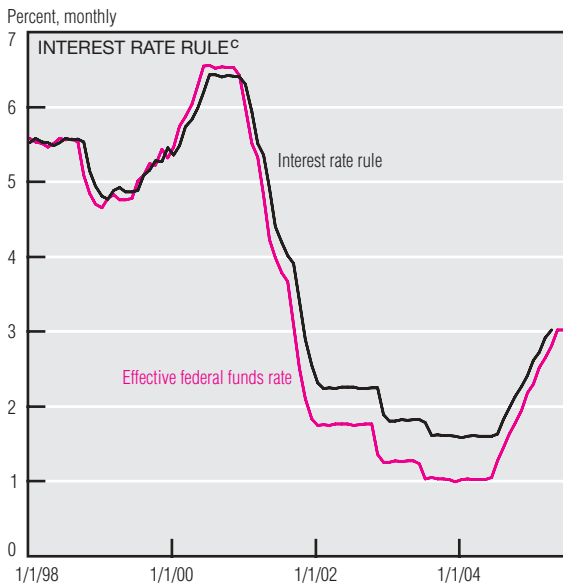
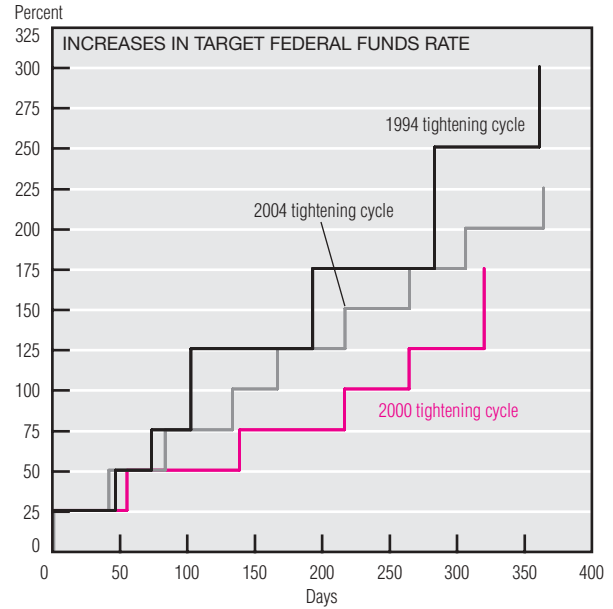
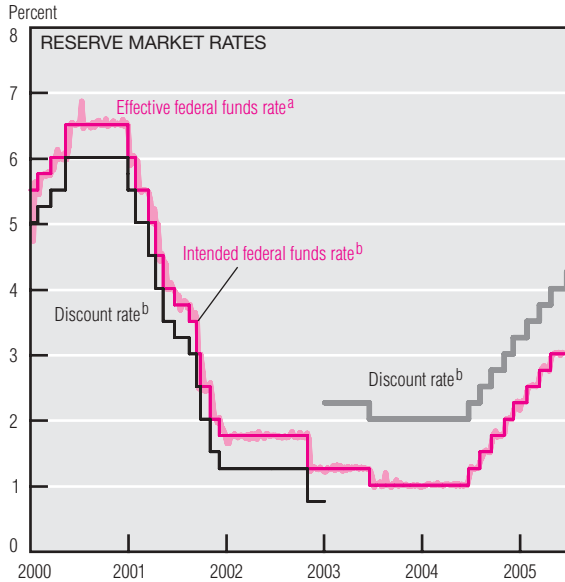
labor compensation, but the long-term inflation trend remains steady. Although price statistics fluctuate over short periods of time, inflation trends tend to be rather inert. As a result, economists often use longer-run averages of the data, and appeal to core inflation statistics to better gauge changes in the inflation trend. Some use statistical measures, such as “break-point” tests, to check for changes in the inflation trend. This approach reveals that inflation, as

measured by the median CPI, has followed three distinct trends in the past 23 years: Inflation averaged 4.5% from 1982 to 1990, 3.1% from 1991 to 1998, and 2.8% since 1998. In other words, the swings in the 12-month inflation trend over the past seven years or so are not clearly distinguishable from variations around one long, stable inflation episode. Applying the same techniques to measures of household inflation expectations yields essentially the same result—

while we have seen variation in the expectations data, year-ahead household inflation expectations appear to have trended just under 3.2% since the late 1990s.

Meanwhile, the Blue Chip panel of economists has increased its year-ahead CPI inflation forecast since June. In the most recent Blue Chip survey, these economists predicted that inflation would average 3.0% in the last three quarters of 2005, up from the 2.8% they estimated in June.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Interest rate rule using effective federal funds rate and two-year Treasury bill.

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

e. Assumes an interest rate of 2.5% and an inflation target of 1%.

f. Assumes an interest rate of 1.5% and an inflation target of 3%.

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.

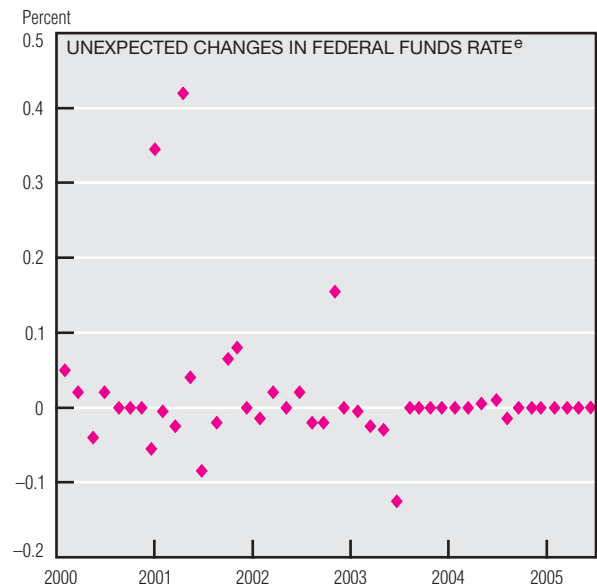
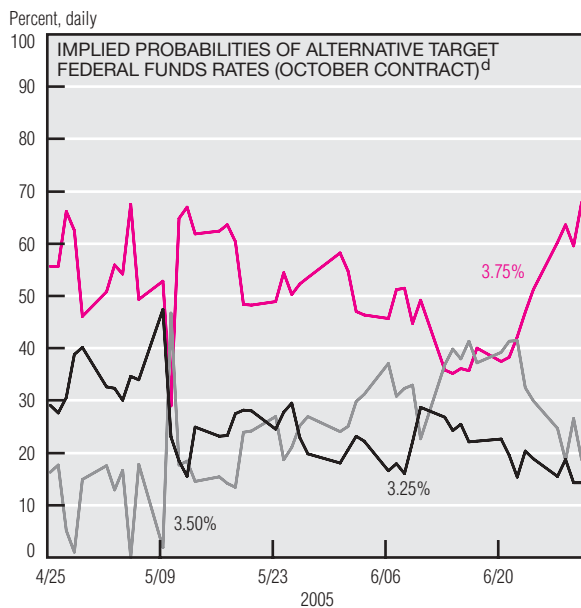
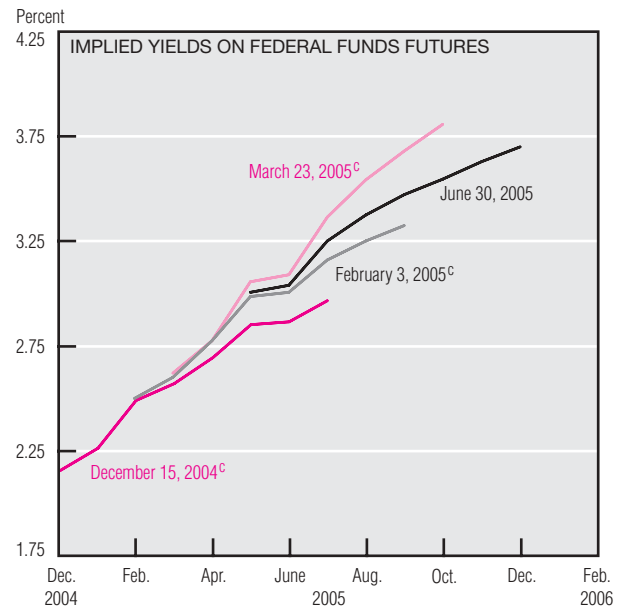
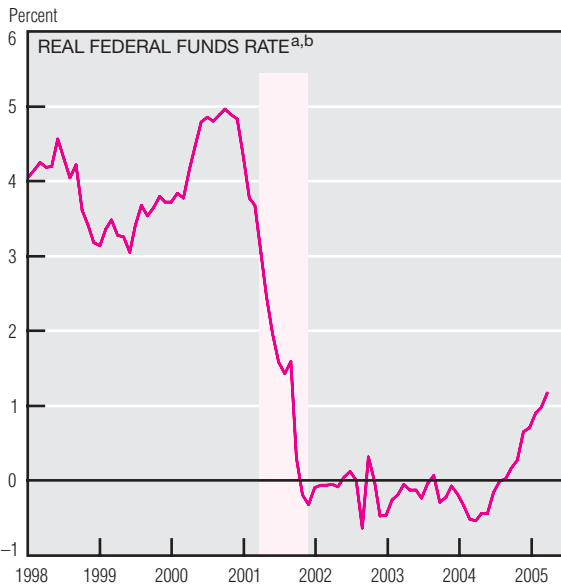
On June 30, the Federal Open Market Committee (FOMC) announced that the target federal funds rate increased by 25 basis points to 3.25, the ninth consecutive increase. The discount rate increased to 4.25%, remaining 100 basis points above the target funds rate. With this "ninth-inning" increase and continuation of the language about a measured pace, the question on everyone's mind is, "How high will the FOMC go?"

One approach is to look at the FOMC's past behavior. "Tightening cycle" is a bit of a misnomer (because tightening should be judged relative to market rates, not in an absolute fashion), but comparing recent increases to the past provides a useful perspective. Increases since 2004 have proceeded slightly faster and gone further than in the 2000 cycle, but still lag behind the 1994 increases on both counts.

Concentrating on rates alone strips the problem of its economic context, which may be at least partially restored by viewing the federal funds rate as a "rule" or reaction to the broader economy. One such rule regards movements in the funds rate as responses to changes in market interest rates, specifically the two-year Treasury yield. This puts current rates right in line with what is predicted. The most famous rule, named for

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## Monetary Policy (cont.)



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

b. Shaded bars indicate periods of recession.

c. One day after the FOMC meeting.

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

e. Difference in the federal funds futures the day before and the day of FOMC meetings since 1998.

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

John Taylor, posits that the funds rate is a reaction to a weighted average of inflation and deviations in output from its potential. Compared with what the Taylor rule suggests, monetary policy has been easy; recent increases have steadily closed the gap, however, so that the funds rate is back in the predicted range, albeit at the lower end.

Another useful rule looks at the real federal funds rate, that is, the funds rate less inflation. After fluctuating around zero for two and a half

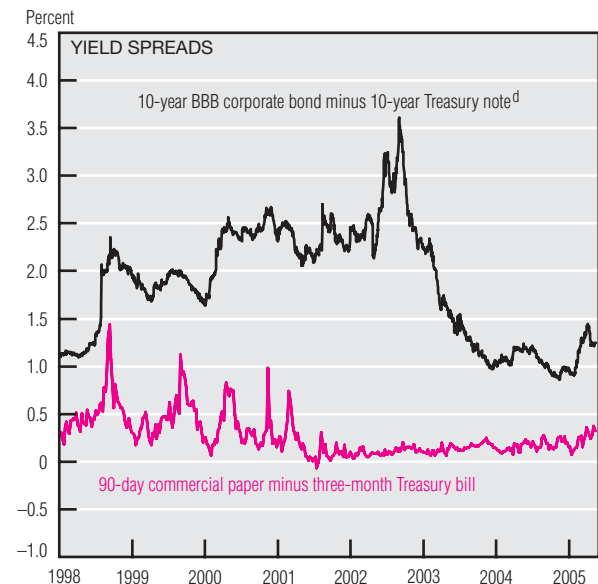
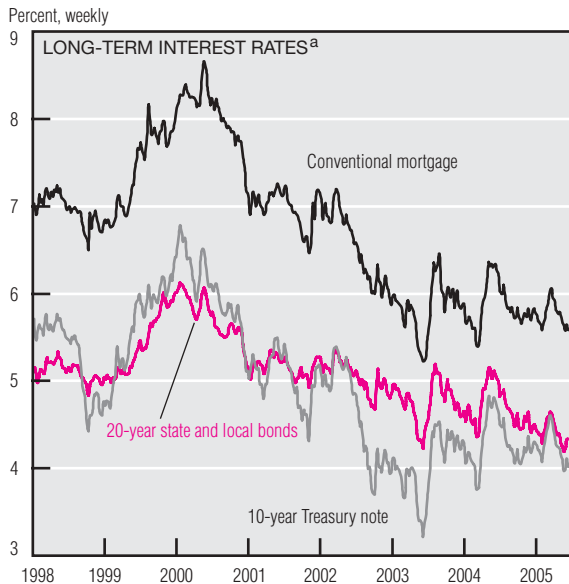
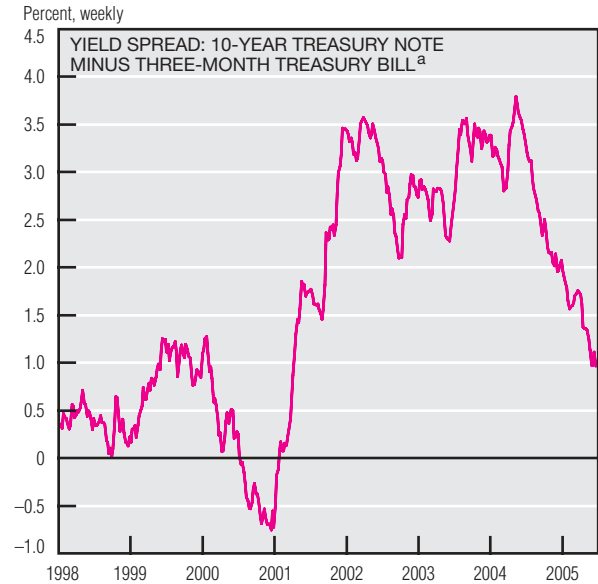
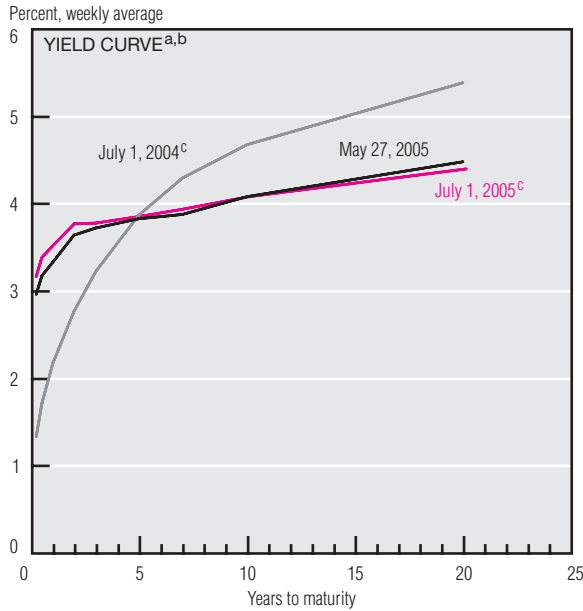
years, it has now moved sharply upward, though it remains well below its late 1990s level.

These rules provide a strategic view of monetary policy, but many people are more interested in the tactical question of what is happening next. One good gauge of the market consensus is the futures market for the federal funds rate, which indicates that sentiment is clustered around 3.5% for August's meeting and 3.75% for September's. Data from the options market on fed funds futures

show a broader range of opinion, though, with almost a third expecting a pause before the rise to 3.75%.

Tactically, of course, the FOMC has signaled its intentions quite clearly over the past two years. In fact, since mid-2003, the funds futures market has rarely been surprised by announcements from the FOMC. It has sometimes been a different story in the past, particularly at the two intermeeting moves of January 3 and April 18, 2001, when the target rate was reduced by 50 basis points.

# Money and Financial Markets



a. All yields are from constant-maturity series.  
 b. Average for the week ending on the date shown.  
 c. One day after the FOMC meeting.  
 d. Merrill Lynch BBB 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.

Although the Federal Reserve sets the federal funds rate and the discount rate, the ultimate impact on the economy depends on what happens to other interest rates, which policy may influence but not control. The yield curve shows what has happened across the spectrum of long- and short-term rates. The most notable change has been the flattening of the yield curve since last year: Short rates have risen, but long rates have fallen. This has brought the spread between the 10-year and three-month Treasuries down from historical highs approaching 4% to

the vicinity of 1%, slightly below the historical average. This spread has achieved some notoriety as a recession predictor, and, despite its steep fall, its current level suggests positive growth in the upcoming year.

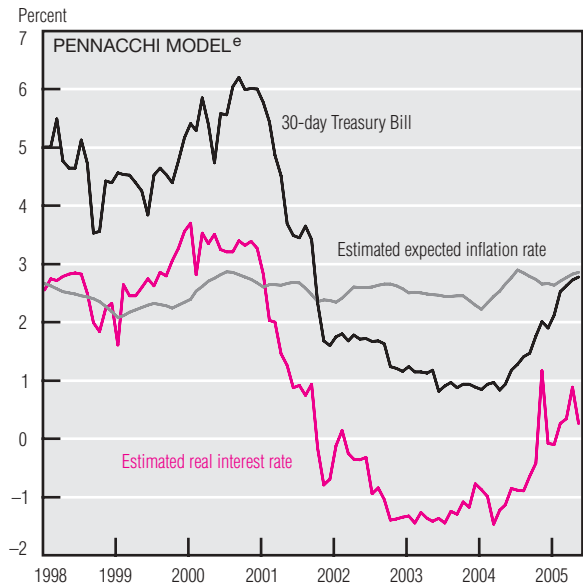
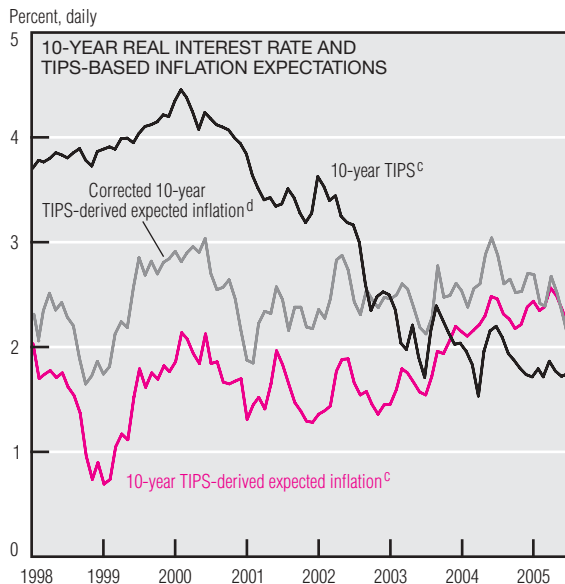
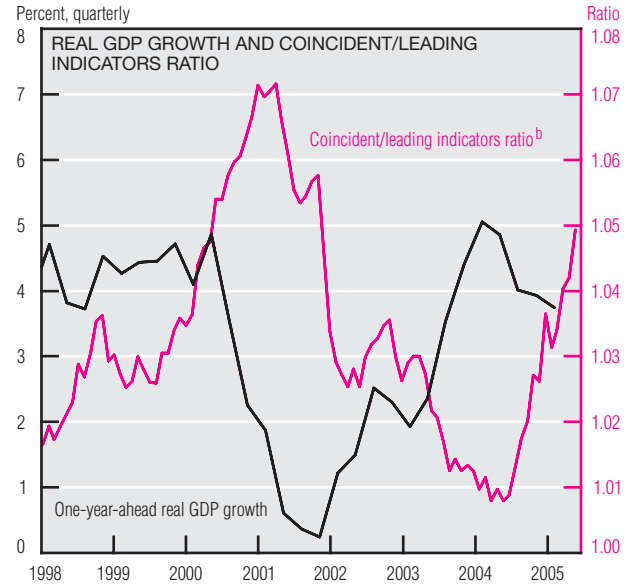
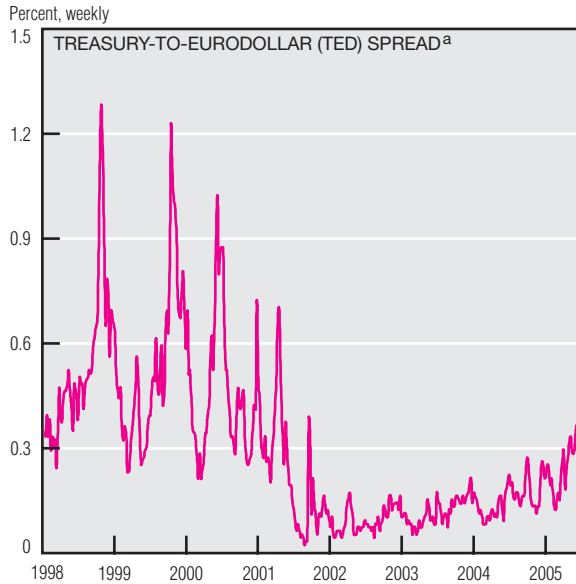
As long-term Treasury rates have fallen, so have other long rates, with mortgages and state and local bonds following almost in lockstep. The spread between mortgages and 10-year Treasuries has been virtually unchanged, moving from 156 basis points (bp) to 153 bp over the past year. Not all rates have moved so tightly, however. The spread between

90-day commercial paper and 30-day Treasury bills has more than doubled since late 2004; a longer-term spread, between corporate bonds and 10-year Treasuries, moved up in the spring, although it has since retreated to 123 bp. Both spreads remain low by historical standards, suggesting low levels of risk.

Another closely watched risk spread is that between the three-month Treasury bill rate and the rate on three-month eurodollar deposits (the TED spread). As the difference between two dollar-denominated interest

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## Money and Financial Markets (cont.)



a. Yield spread: three-month Eurodollar deposit minus the three-month, constant-maturity Treasury bill.

b. Conference Board's coincident and leading indicators ratio. Monthly data.

c. Treasury inflation-protected securities.

d. 10-year TIPS-derived expected inflation adjusted for the liquidity premium on the market for 10-year Treasuries.

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

SOURCES: 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; *Wall Street Journal*; and Bloomberg Financial Information Services.

rates based in different countries, it measures international financial risk while avoiding exchange rate uncertainty. Although it started at a low level, the TED spread has tripled since March, moving up to 36 bp, a level not seen since April 2001. This suggests that the market is becoming more uneasy about international conditions.

One sign that the financial markets watch is the Conference Board's Index of Leading Economic Indicators. Another, the Index of Coincident Indicators, gets less press, even though the

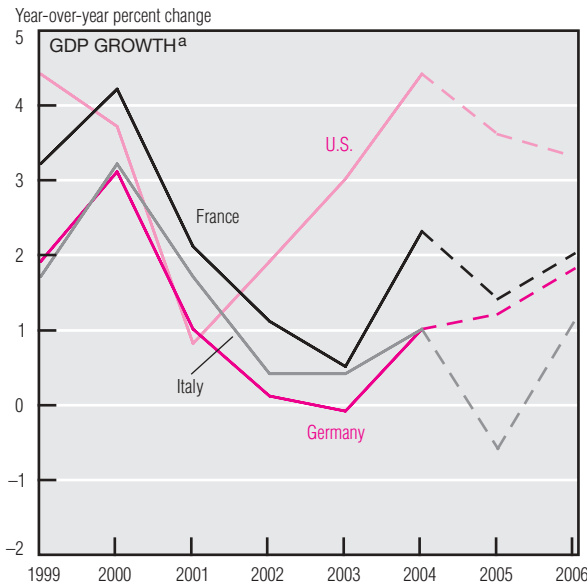
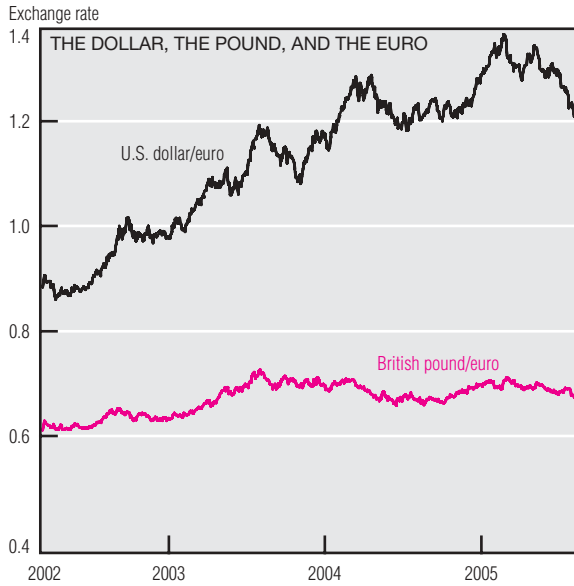
ratio of the two indexes has an intriguing, though inverse, correlation with economic growth. But this ratio, which is signaling slower growth ahead, should be taken with a grain of salt.

Spreads can also help uncover inflation expectations. The difference between the yield on Treasury inflation-protected securities (TIPS), a real rate, and the corresponding nominal rate on bonds not so protected, provides a measure of expected inflation. By this measure, 10-year inflation ex-

pectations have dropped fully 0.5% since March, from 2<sup>3</sup>/<sub>4</sub>% to 2<sup>1</sup>/<sub>4</sub>%. Of course, tax and liquidity differences between the bonds make this spread a less pure inflation measure than it seems. An estimate of shorter-term inflationary expectations can be found by combining 30-day Treasury bill rates with a survey measure of inflation. This one-month measure, originally developed by George Pennacchi, has risen recently, although it has stayed in a band between 2% and 3% since 1998.



# The European Union



a. Forecast data (dashed lines) are provided by the Organisation for Economic Co-operation and Development.

SOURCES: Organisation for Economic Co-operation and Development; European Central Bank; Eurostat; and Bloomberg Financial Information Services.

The recent French and Dutch votes to reject the European Union's constitution have raised doubts about the sustainability of Europe's single currency, the euro. Although it lost some ground to the U.S. dollar in the first two quarters of 2005, the euro remains far above the initial exchange rate in January 2002. Moreover, the euro/British pound exchange rate remained fairly stable over the same period.

All this might seem to imply that the decline in the euro's value against the dollar is related to the strengthening of the U.S. economy. Some member

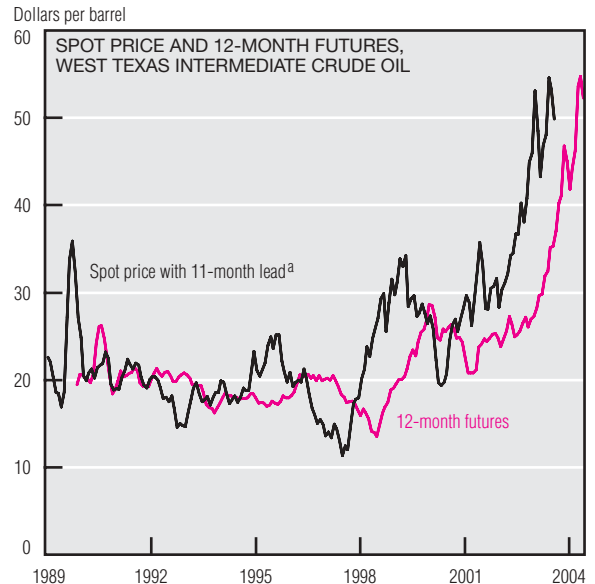
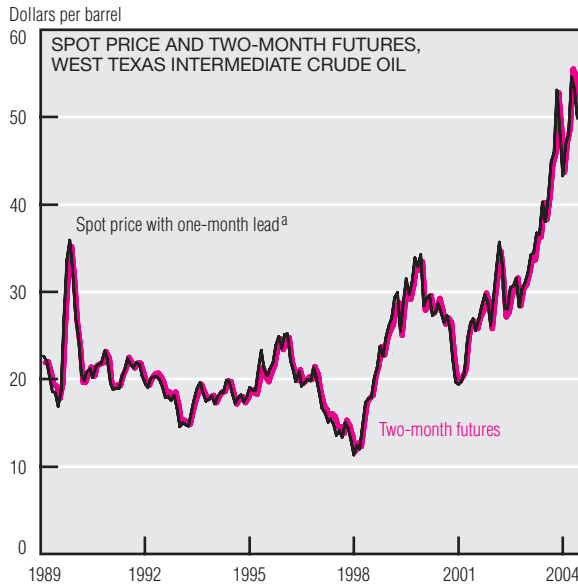
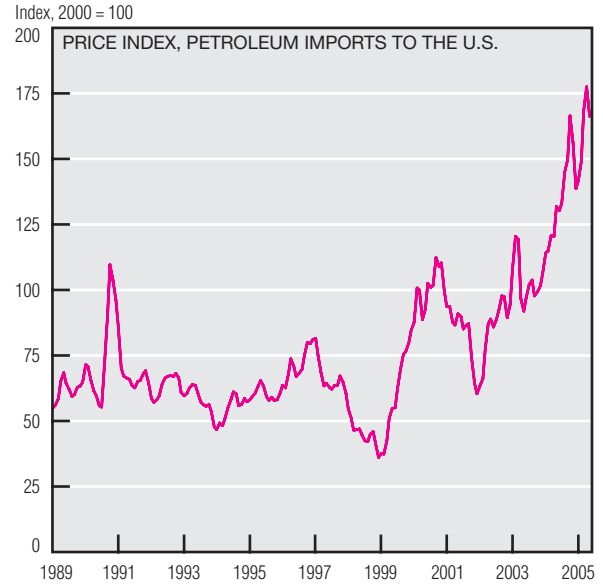
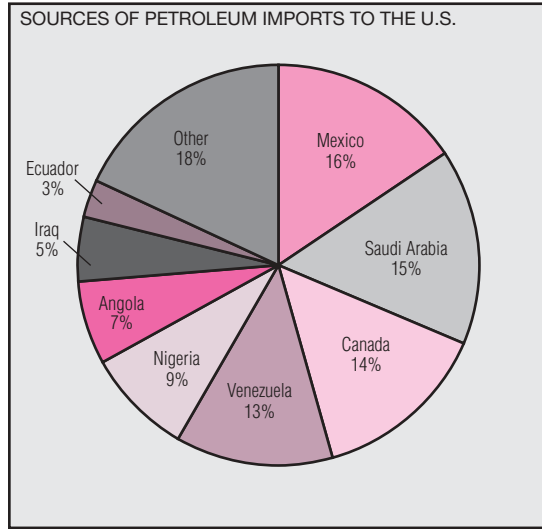
countries of the European Monetary Union showed signs of economic weakness before the euro was introduced. Unemployment rates in France and Germany have been rising steadily and now hover near 10%; Italy's unemployment is around 8%. GDP growth for France, Germany, and Italy has been less than 2.5% recently, compared to 4% for the U.S. These low growth rates are expected to continue into the near future; indeed, Italy's growth is expected to fall into negative territory.

The European Central Bank established a "two-pillar" monetary strategy

at the time of its creation. One pillar is inflation control; the other is monetary growth. During the past five years, the Bank's inflation target of "close to, but below, 2%" has rarely been met, although the European Union's inflation rate recently dipped just below 2%. Unlike the Federal Reserve System, the European Central Bank has no policy goal related to the output side of the economy. Whereas the Fed may take a policy action in response to real economic conditions, the ECB would probably not, if doing so threatened its inflation objective.



# Oil Prices



a. The one-month NYMEX futures price is also referred to as the spot price of oil.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Energy, Energy Information Administration; and Bloomberg Financial Information Services.

In March 2005, the U.S. imported 65% of all the oil it consumed. About 30% of those imports came from its immediate neighbors: 16% from Mexico and 14% from Canada. Slightly more than two-thirds of U.S. oil imports came from five countries.

Import prices for petroleum products have nearly doubled over the past three years. During the same period, the spot price of a barrel of oil has increased from around \$25 to more than \$60. Oil prices have been more volatile in the past five years than in the mid-1990s.

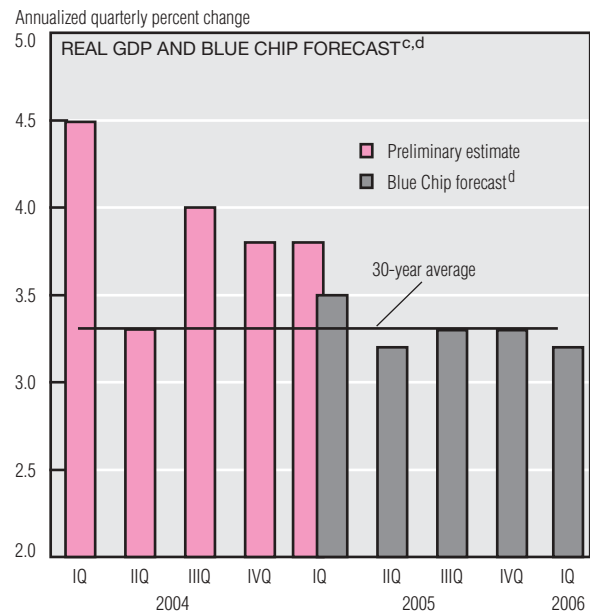
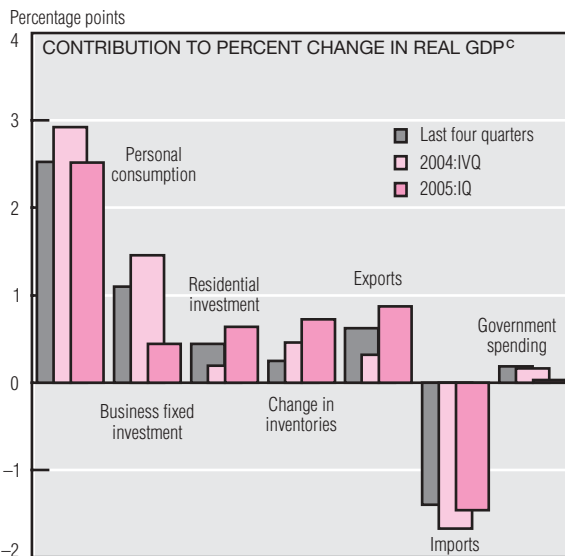
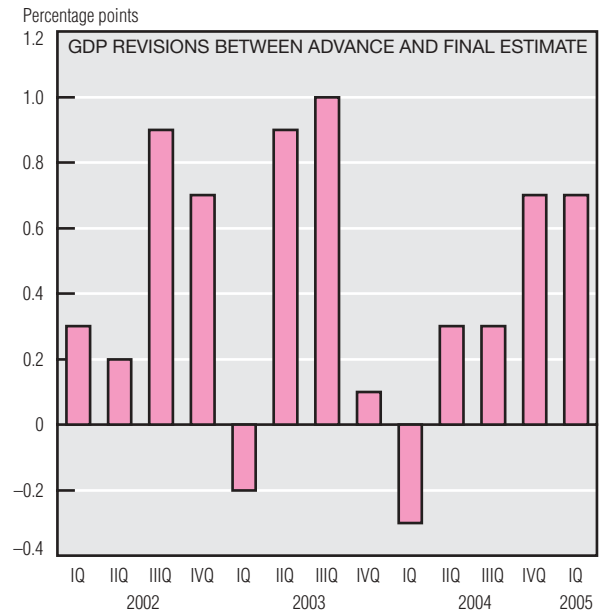
Oil and oil products are important inputs for many production processes, so it is no surprise that a futures market for oil has developed, allowing buyers to hedge risks associated with oil price movements. The purchaser of a futures contract receives a payout if the spot price of oil turns out to be higher than the contracted futures price; he must give a payout if the spot price turns out to be lower.

The spot price of oil is a misnomer: Because the oil is deliverable in one month, its price is essentially equivalent to the one-month futures

price. The futures market might serve as a barometer for the spot price of oil in the future. This seems to be the case for the two-month futures contract because the futures price tracks the one-month-ahead spot price of oil closely. The 12-month futures contract, however, does not do a particularly good job of predicting the price of oil one year out. On average, the futures price seems to underpredict the spot price.

# GDP Growth

	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	101.9	3.6	3.7
Personal consumption	68.8	3.6	3.6
Durables	5.0	1.8	5.4
Nondurables	30.0	5.5	4.0
Services	33.2	3.1	3.0
Business fixed investment	13.0	4.1	10.9
Equipment	15.8	6.1	13.9
Structures	-1.5	-2.5	1.3
Residential investment	15.7	11.5	8.1
Government spending	0.8	0.2	1.0
National defense	0.6	0.5	2.9
Net exports	-16.4	—	—
Exports	24.6	8.9	6.3
Imports	40.9	9.6	9.5
Change in business inventories	19.6	—	—



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*, June 10, 2005.

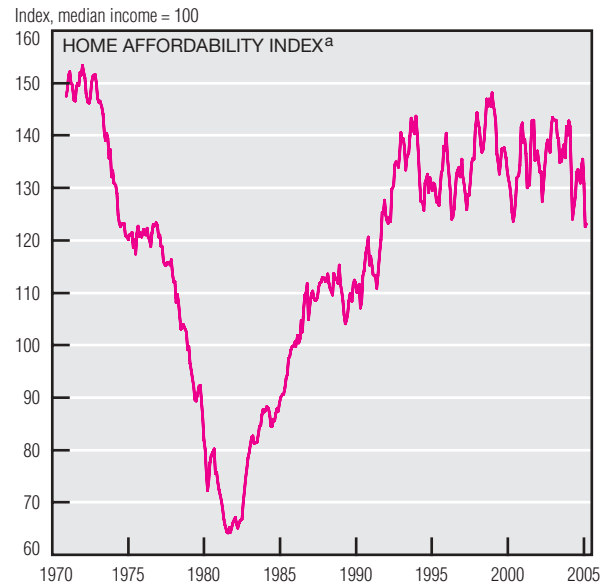
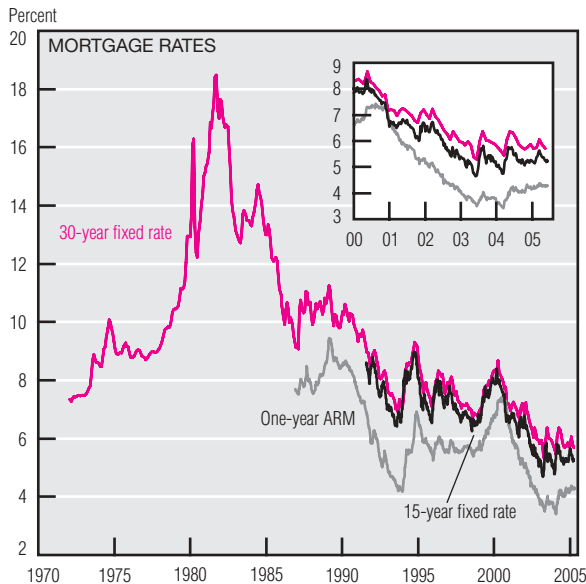
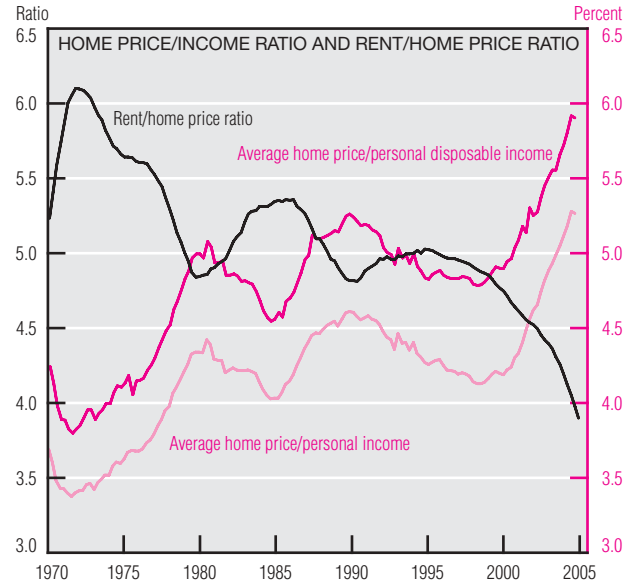
The Commerce Department's final reading of real GDP for 2005:IQ was 3.8%. This figure has been revised up from its advance reading of 3.1% in April and its preliminary reading of 3.5% in May. Such upward revisions are not unusual: There often are substantial changes between the advance and final estimates of real GDP growth. The final estimate has been a downward revision only twice since the beginning of 2002, and the average revision over that period has been 0.4 percentage points (pp).

The upward revision to real GDP from the preliminary estimate was largely the result of accelerations in exports, residential investment, and business fixed investment. In 2005:IQ, export's contribution to the change in real GDP increased 0.6 pp, and residential investment's contribution increased 0.5 pp, but these increases were partly offset by personal consumption expenditures and business fixed investment.

For the past three quarters, real GDP growth has remained significantly

higher than the 30-year average of 3.3%. However, in their June newsletter, the Blue Chip forecasters predicted that GDP growth will slow to between 3.2% and 3.3% over the next four quarters. In May's newsletter, they had predicted that 2005:IIQ growth would be 0.2 pp lower at 3.0% and that 2005:IIIQ growth would be 0.1 pp higher at 3.4%. The rest of their predictions remained unchanged.

# Home Prices



a. Not seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Morris Davis, Andreas Lehnert, and Robert F. Martin, "The Rent-Price Ratio for the Aggregate Stock of Owner-Occupied Housing," Board of Governors of the Federal Reserve System, June 2005; and National Association of Realtors.

Since 1970, residential investment—new home construction—has averaged 4.5% of GDP. Since 1991, its share of GDP has increased 2.5 percentage points. Recent increases in home prices seem to be reflected in this sector's greater share of output in the past 10 to 15 years. If higher home prices reflect a bubble or changes in demand, then a sharp fall in home prices may cause a sharp fall in investment in this sector and possibly in overall GDP as well.

Is there a bubble in home prices? One sign is the ratio of home prices to income. A rise in this ratio indicates

that homes are less affordable, suggesting that a bubble does exist. Since the late 1990s, home prices have indeed risen relative to per capita personal (disposable) income.

Another sign is the ratio of implicit rents to home prices. A low ratio suggests that housing is being held because expected home price appreciation is above average. The fall in the rent/home price ratio since 1995 is consistent with a bubble.

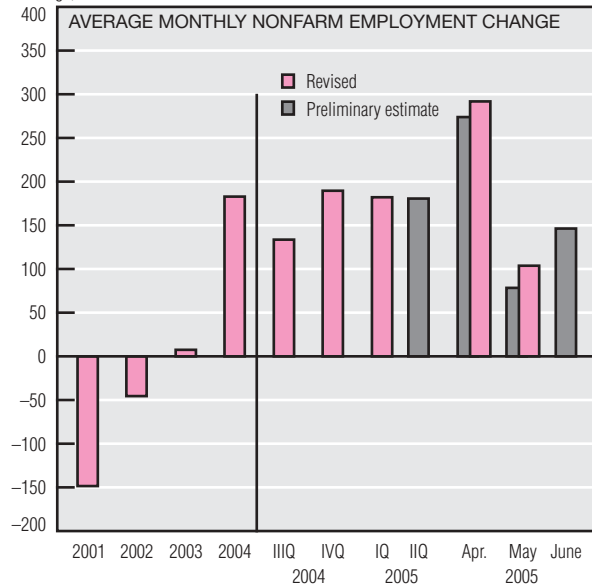
Neither measure accounts for interest rate movements. In the first half of 2000, the 30-year fixed mortgage rate was 8.3%; in the first half of 2005, it fell to 5.7%. Such a drop

makes a larger mortgage more affordable at a given income level. The affordability index captures the effect of interest rates, home prices, and income on affordability. The index shows that homes are far more affordable than in the 1980s, although it held fairly constant during the recent run-up in housing prices.

This has caused some to suggest that higher home prices should be expected given the rise in income and the sharp decline in mortgage rates. But the jury is still out on whether home prices are experiencing a bubble.

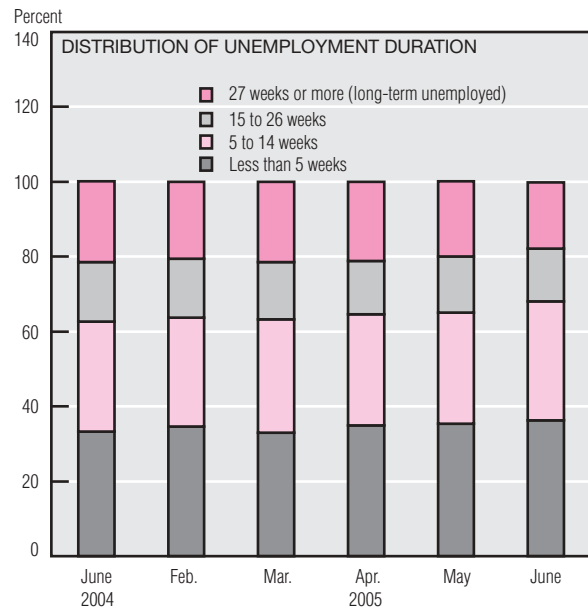
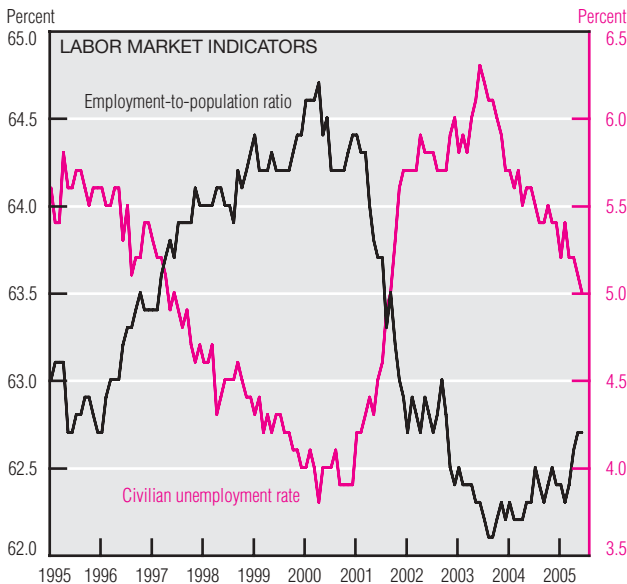
# Labor Markets

Change, thousands of workers



## Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	June 2005
<b>Payroll employment</b>	-148	-45	8	183	146
<b>Goods producing</b>	-124	-76	-42	29	-4
Construction	-1	-7	10	23	18
Manufacturing	-123	-67	-51	3	-24
Durable goods	-88	-48	-32	9	-12
Nondurable goods	-35	-19	-19	-6	-12
<b>Service providing</b>	-25	30	50	154	150
Retail trade	-24	-10	-5	13	2
Financial activities <sup>a</sup>	8	6	7	12	16
PBS <sup>b</sup>	-63	-17	22	45	56
Temporary help svcs.	-37	2	12	15	9
Education & health svcs.	50	40	30	33	38
Leisure and hospitality	-1	12	18	22	19
Government	46	21	-4	12	2
	<b>Average for period (percent)</b>				
Civilian unemployment rate	4.8	5.8	6.0	5.5	5.0



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 employment increased by 146,000 jobs in June, exactly half the gains posted in April (292,000) but about 50% more than in May (104,000). June's gains were below consensus, but the April and May numbers were revised upward by a combined 44,000 jobs. The second quarter averaged a monthly increase of 181,000 jobs.

Job gains materialized in professional and business services, education and health services, financial activities, and construction. Manufacturing lost 24,000 net jobs, its worst drop in

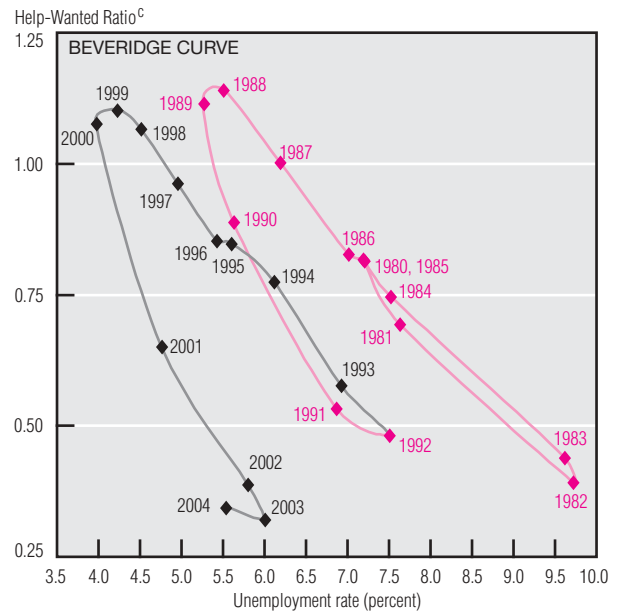
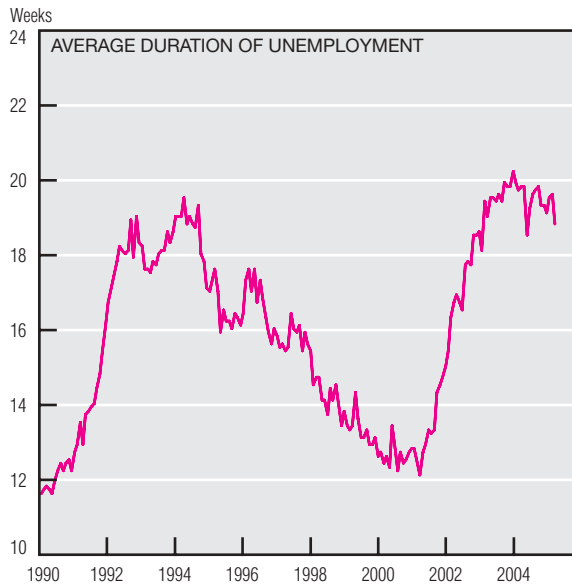
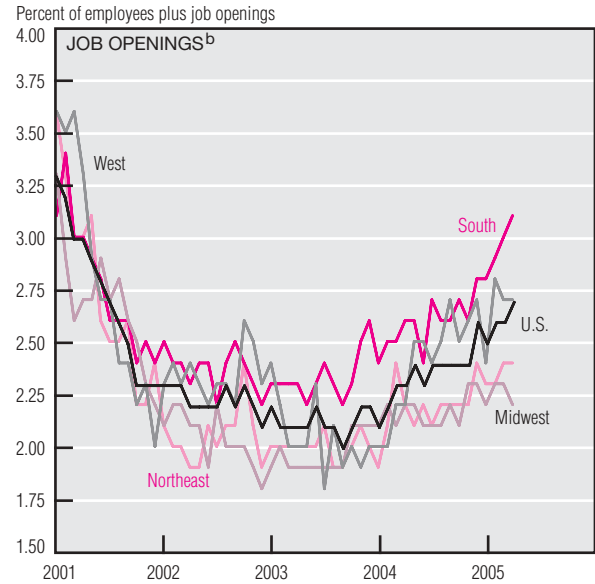
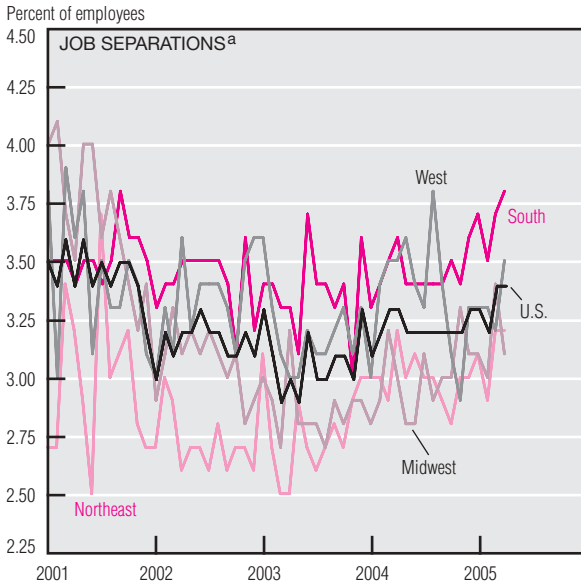
five months. Losses were especially severe in motor vehicles (-17,900) and transportation equipment (-14,300). By contrast, computer and electronic products employment rose by 7,400 jobs.

The unemployment rate fell 0.1 percentage point to 5.0%, its lowest level since the end of the 2001 recession. The rate for men older than 20 dropped to 4.3%, and the rate for women the same age remained at 4.6%. The unemployment rate for those aged 16 to 19 was 16.4%, down from 17.9% in May.

The employment-to-population ratio (62.7%) and the participation rate (66%) were virtually unchanged. In the course of a year, the employment-to-population ratio increased 0.4 percentage point.

The fraction of long-term unemployed (those jobless for 27 weeks or longer) was also reduced, from 20.1% in May to 17.8% in June. The average duration of unemployment was 17.1 weeks, 1.7 weeks less than in May and 2.7 weeks less than a year earlier.

# Unemployment Changes



a. The number of job separations during the month divided by the number of employees.

b. The number of job openings on the last business day of the month divided by the sum of the number of employees and the number of job openings.

c. Jobs advertised divided by number of unemployed.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and the Conference Board.

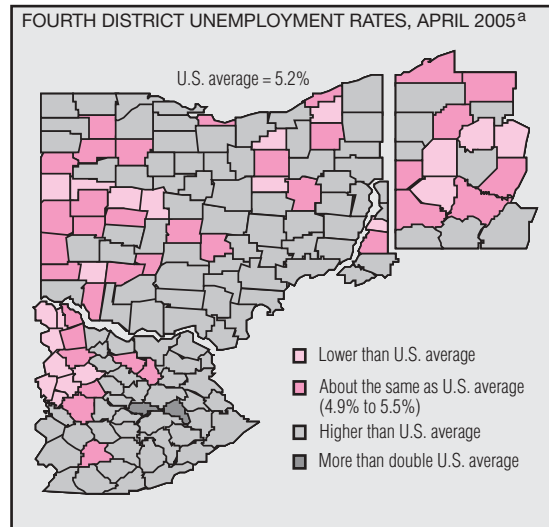
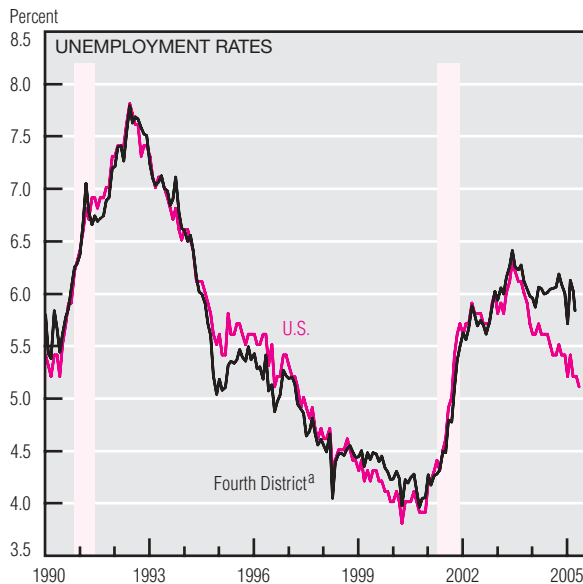
Nonfarm job openings and separations influence the dynamics of the labor market. The U.S. rate of job separations has recently trended up and is now close to its average 2001 recession level of 3.5%. The rate of job openings fell from 3.2% before the 2001 recession to 2.0% in September 2003; in April 2005, it reached 2.7%, still short of its prerecession level. The rate of openings varies by region: Since the 2001 recession ended, it has generally remained sluggish in the Midwest and has trended upward in the South and West.

For a given rate of unemployment, the openings rate is a determinant of how long it takes an unemployed worker to find a job: Greater job availability may shorten unemployment duration. The average duration of unemployment declined from its February 2004 peak of more than 20 weeks to 18.8 weeks in May 2005. This exceeded the 25-year average of 15.6 weeks, a sign that job creation remains unusually weak.

The Beveridge curve shows how firms' hiring decisions (job vacancies as captured by the Conference Board's

Help-Wanted Advertising Index) translate into unemployment changes. During booms, the number of vacancies generally increases and unemployment declines; the reverse occurs during recessions. Since the beginning of the 1990s, the Beveridge curve has shifted downward (see color shift at lower right), suggesting a more effective matching process between vacancies and unemployed workers—an indicator of lower structural unemployment.

## Fourth District Employment



### Payroll Employment by Metropolitan Statistical Area

#### 12-month percent change, May 2005

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	0.0	0.3	0.5	-0.4	0.1	0.2	0.6	1.5
Goods-producing	1.9	0.3	2.9	-4.0	-1.8	-2.4	2.4	1.3
Manufacturing	1.3	-1.6	2.7	-5.0	-4.2	-1.8	2.1	-0.3
Natural resources, mining, and construction	3.8	4.1	3.2	n/a	6.4	-3.3	3.1	4.3
Service-providing	-0.4	0.3	0.0	0.4	0.6	0.6	0.2	1.6
Trade, transportation, and utilities	-1.5	-0.3	-1.6	-2.2	0.2	-0.2	-0.9	1.3
Information	0.0	1.5	3.7	-1.8	-2.1	-2.1	-2.2	-0.1
Financial activities	0.0	0.3	-1.1	-4.2	0.8	-0.1	-0.9	1.8
Professional and business services	-0.2	0.2	2.6	-1.5	2.0	1.8	3.5	2.7
Education and health services	2.2	0.2	1.0	4.9	0.0	1.6	0.3	2.2
Leisure and hospitality	0.2	1.5	-1.7	3.1	0.6	1.7	2.0	2.0
Other services	-0.7	-0.5	-0.7	2.4	1.9	1.2	2.0	0.7
Government	-2.6	0.5	0.7	0.2	0.6	-1.2	-1.8	0.7

a. Seasonally adjusted using the Census Bureau's X-11 procedure.  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Fourth District's unemployment rate for April fell to 5.9%, its second consecutive monthly decline of 0.1 percentage point. The nation's unemployment rate was 5.2% in April and fell to 5.1% in May, the lowest since September 2001.

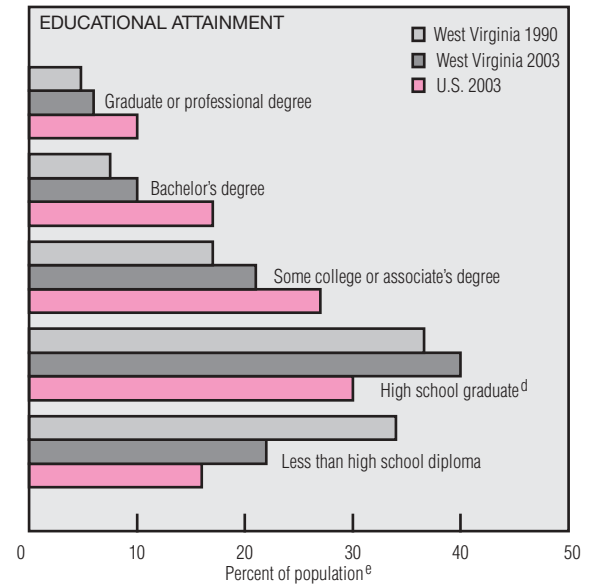
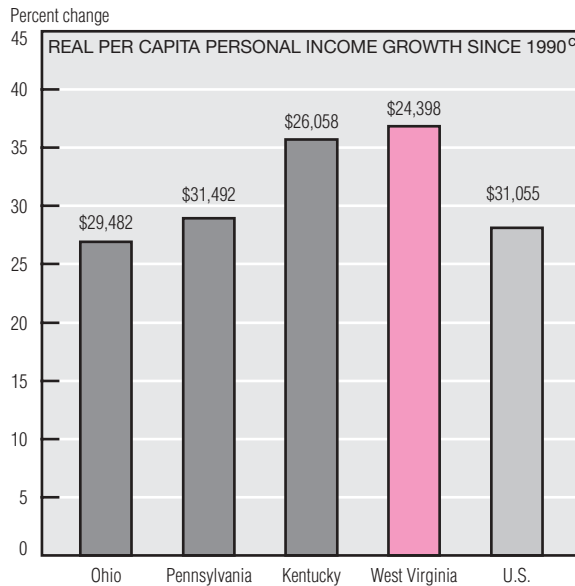
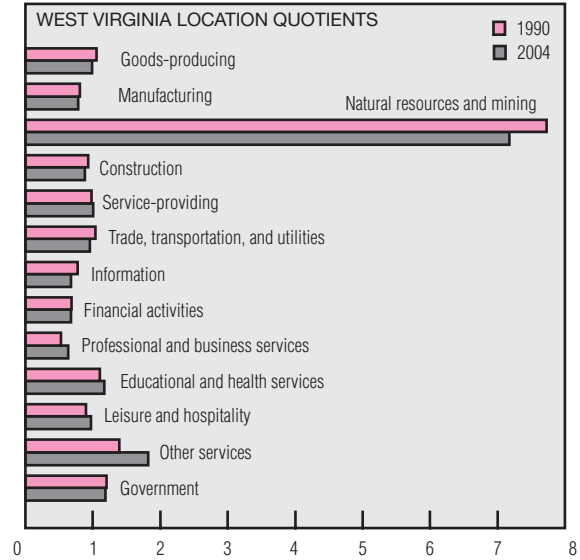
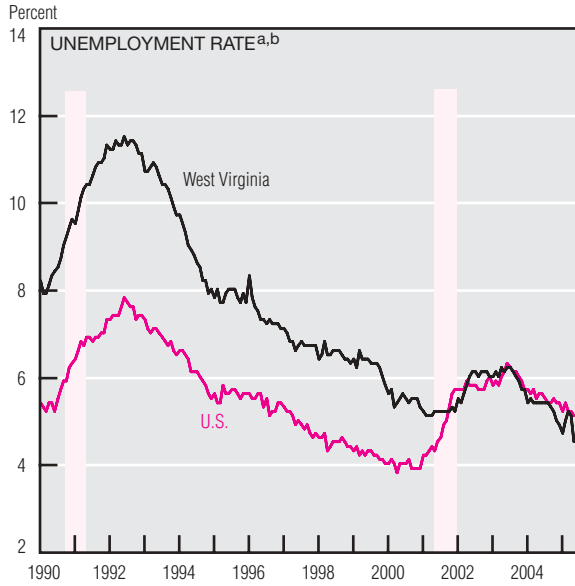
For the great majority of District counties, unemployment rates declined from March to April. In all but three counties in Fourth District Pennsylvania, unemployment rates fell.

Even so, more than half of all District counties posted unemployment rates that exceeded the U.S. average.

Over the past year, nonfarm employment has increased in all of the District's major metropolitan areas except Dayton, but these gains did not keep pace with the nation's. Employment in education and health services increased or stayed the same in all major metropolitan areas. Natural resources, mining, and construction was another strong sector, with

many metropolitan areas recording employment increases of more than 3% over the past year. While Cleveland, Cincinnati, and Lexington added manufacturing employment, other metropolitan areas' rates of decline in that sector were higher than the nation's. Toledo was the only metropolitan area to gain employment in trade, transportation, and utilities over the past year.

# West Virginia Employment and Income



a. Shaded bars indicate recessions.  
 b. Seasonally adjusted.  
 c. The number above each bar is the real per capita income for 2004:IVQ, expressed in chained 2000 dollars.  
 d. High school graduates include people with a G.E.D. or similar equivalent.  
 e. Aged 25 and older.  
 SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

Throughout the 1990s, West Virginia's unemployment rate was significantly higher than the nation's. Since the last recession ended, however, it has tracked the U.S. average closely. In fact, for the past two years, the state's unemployment rate has been lower than or equal to the national average; in May, 4.5% of West Virginia's labor force was out of work, compared to 5.1% for the U.S.

Although the state's unemployment rate has converged with the nation's over the past 15 years, its

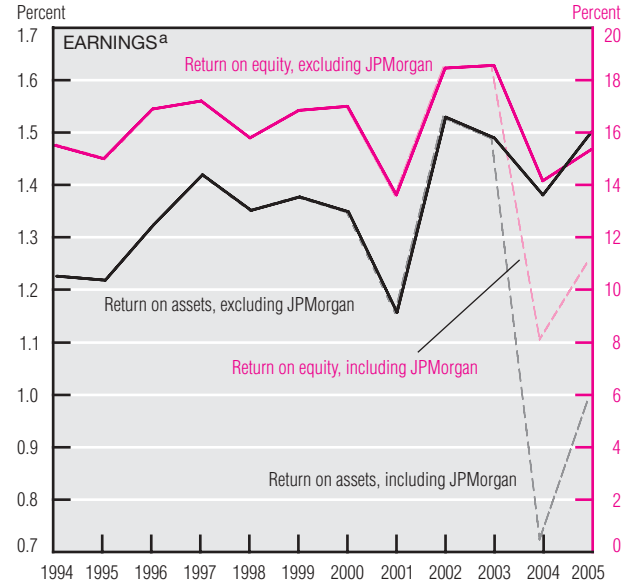
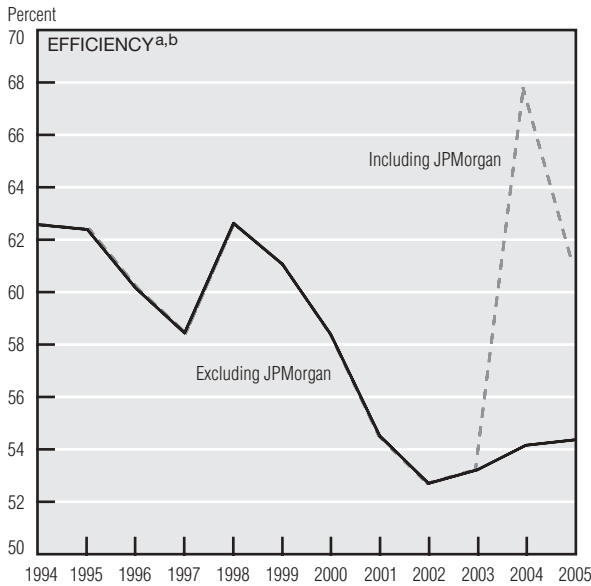
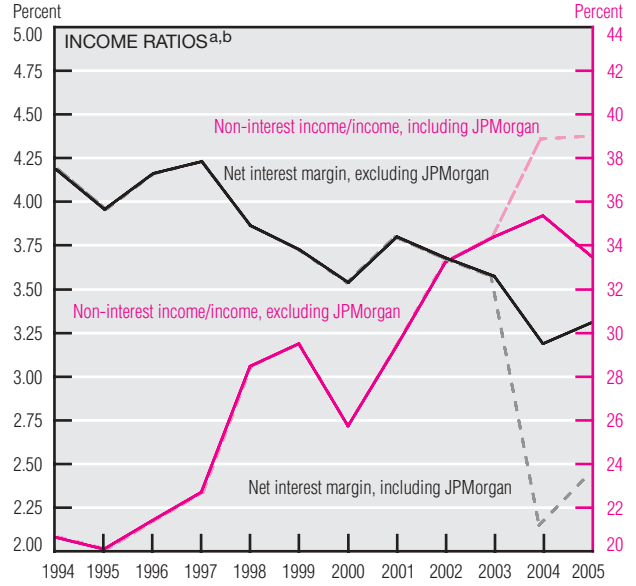
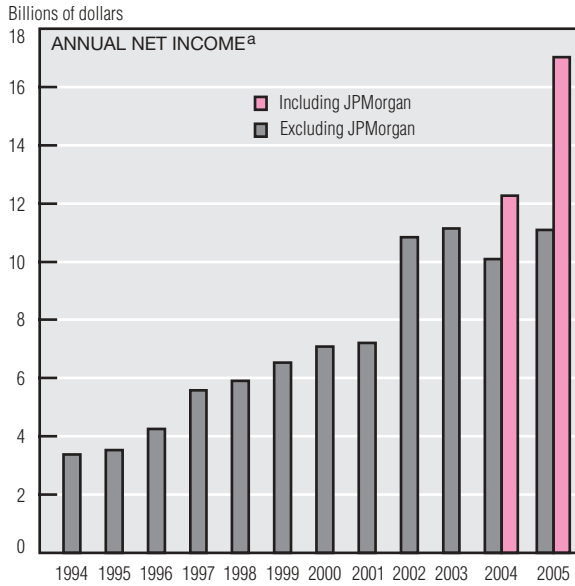
industrial composition has not necessarily done so. The upper right chart uses the location quotient, the simple ratio of a given industry's employment share in the state to that industry's employment share in the nation. A location quotient of one indicates that the state and the nation had the same share of employment in the specified industry. For West Virginia, most industries' location quotient did not change significantly.

Over the last 15 years, West Virginia's per capita personal income growth

has risen more (in percentage terms) than any other Fourth District state but its per capita personal income level remains below its District counterparts and the U.S. The state's rapid growth in per capita personal income may be partly explained by its rising education level: Since 1990, the number of high school dropouts has been reduced by 12%. But the percentage of its population without a high school diploma remains above the nation's.



# Fourth District Banks



a. Through 2005:IQ only. Data for 2005 are annualized.  
 b. Efficiency is operating expenses as a percent of net interest income plus non-interest income.  
 SOURCES: Author's calculation from Federal Financial Institutions Examination Council, *Quarterly Bank Reports of Condition and Income*.

FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District posted net income of \$2.77 billion for the first quarter of 2005 or \$11.08 billion on an annual basis. (JPMorgan Chase, chartered in Columbus, is not included in this discussion because its assets are mostly outside the District and its size—roughly \$1 trillion—dwarfs other District institutions.) The U.S. banking industry as a whole posted earnings of \$33.60 billion for the same period or \$134.40 billion on an annual basis.

Fourth District banks' net interest margin (interest income minus interest

expense divided by average earning assets) at the end of 2005:IQ rose slightly to 3.30%, exceeding the 3.18% U.S. average. Non-interest income, however, fell to 33.44% of total income, the first such decline in five years. This resembled the performance of U.S. banks, whose net interest margin was up from the end of 2004 and whose non-interest income fell to 34.13% of total income.

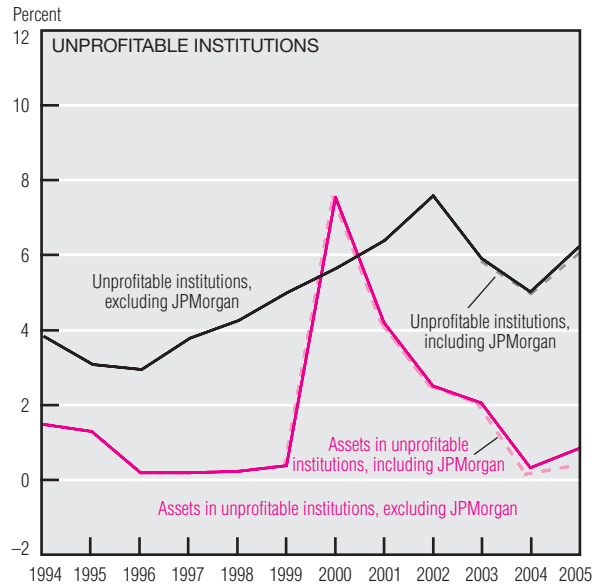
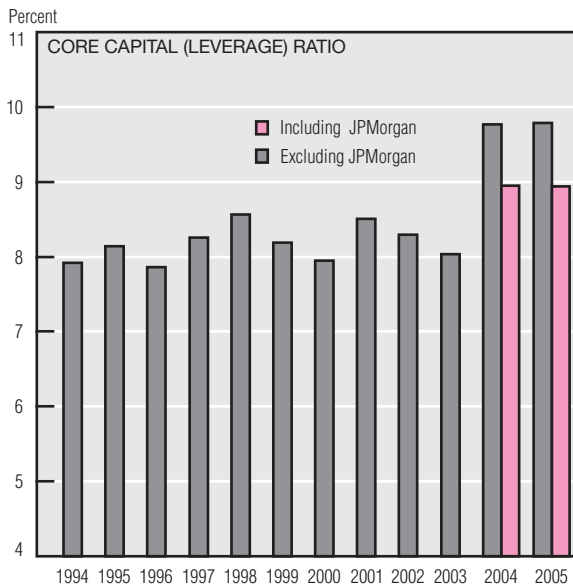
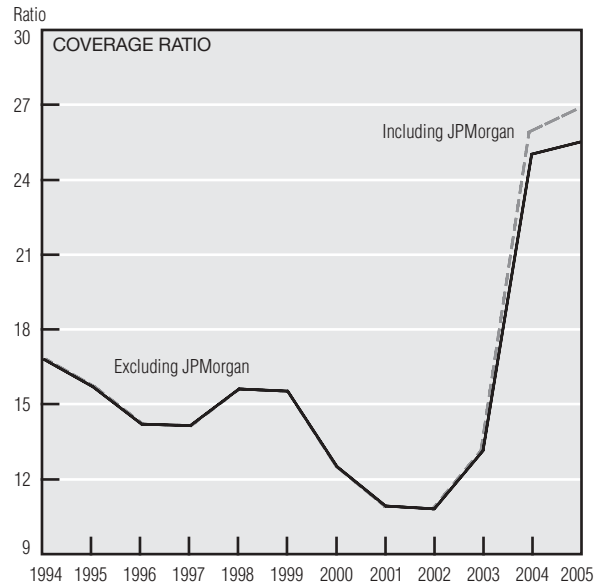
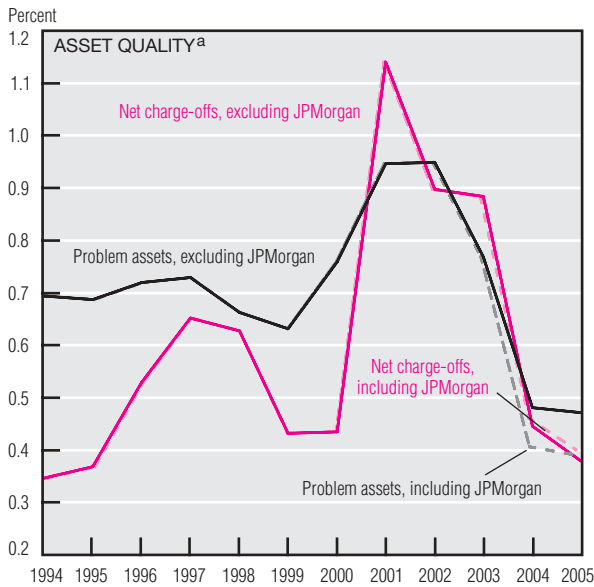
Fourth District banks' efficiency (operating expenses as a percent of net interest income plus non-interest income) had deteriorated to 54.32% by the end of 2005:IQ from the

52.64% record set in 2002. (Lower numbers correspond to greater efficiency.) Nationwide, efficiency improved slightly from the end of 2004:IVQ, dropping to 55.38%.

At the end of 2005:IQ, District banks posted a 1.50% return on assets (up from 1.38% at the end of 2004) and a 15.31% return on equity (up from 14.12% at the end of 2004). The District's performance was in line with the nationwide trend: At the end of 2005:IQ, the U.S. banking industry reported that return on assets rose to 1.24% (from 1.12% at the end of 2004);

(continued on next page)

# Fourth District Banks (cont.)



a. Problem assets are shown as a percent of total assets, net charge-offs as a percent of total loans.  
 SOURCES: Author's calculations from Federal Financial Institutions Examination Council, *Quarterly Bank Reports on Condition and Income*.

return on equity rose to 12.98% (from 11.56% at the end of 2004).

Overall, Fourth District banks' financial indicators point to stable balance sheets. Asset quality continued to improve in 2005:1Q. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) represented 0.38% of total loans. Problem assets (nonperforming loans and repossessed real estate) as a share of total assets fell slightly to 0.47% from 0.48% at the end of 2004. District banks' improved asset quality mirrored that of the U.S.

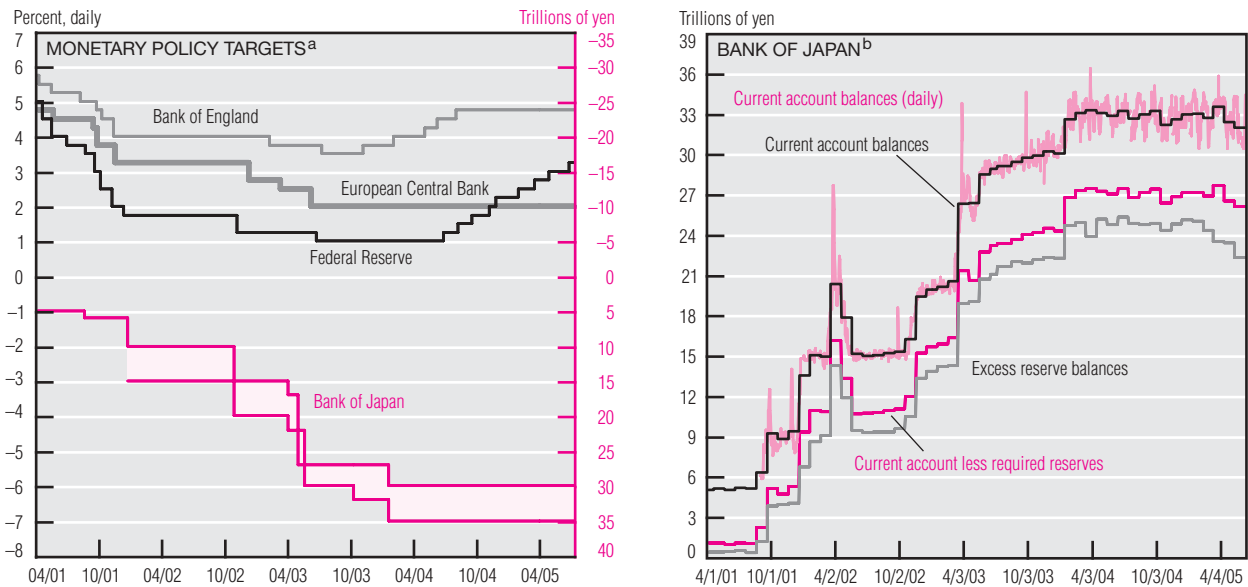
banking industry, where net charge-offs and nonperforming loans were 0.46% of loans (down from 0.53% at the end of 2004) and nonperforming loans were 0.48% of assets (down from 0.52% at the end of 2004).

Reflecting the industrywide trend toward stronger balance sheets, Fourth District banks held \$25.46 in equity capital and loan loss reserves for every dollar of problem loans, well above the recent coverage ratio low of 10.75 at the end of 2002. This improvement resulted from a marked reduction in problem loans as well as a significant strengthening of bank capital. Equity capital as a percent of

District banks' assets (the leverage ratio) rose from 9.76% at the end of 2004 to 9.79% at the end of 2005:1Q.

The first quarter showed an uptick in the percent of unprofitable institutions to 6.18% from 4.97% at the end of 2004. Unprofitable banks' asset size also increased from 0.27% of District banks' assets to 0.80%. Industrywide, the percent of unprofitable institutions fell to 5.43% from 6.07% at the end of 2004. Unprofitable banks' asset size for the U.S., however, increased slightly to 0.65% from 0.62% at the end of 2004.

## Foreign Central Banks



### African Currency Unions

	Central bank	Member countries
West African Economic and Monetary Union	Bank of the West African States	Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo
Economic and Monetary Community of Central Africa	Bank of the Central African States	Cameroon, Central African Republic, Chad, Republic of the Congo, Equatorial Guinea, Gabon
Common Monetary Area	South African Reserve Bank	Lesotho, Namibia, South Africa, Swaziland
West African Monetary Zone <sup>c</sup>		The Gambia, Guinea, Ghana, Liberia, Sierra Leone, Nigeria

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

b. Current account balances at the Bank of Japan are required and excess reserve balances at depository institutions subject to reserve requirements plus the balances of certain other financial institutions not subject to reserve requirements. Reserve requirements are satisfied on the basis of the average of a bank's daily balances at the Bank of Japan starting the sixteenth of one month and ending the fifteenth of the next.

c. Postponed from July 1, 2005 to December 1, 2009.

SOURCES: Board of Governors of the Federal Reserve System; Bank of England; Bank of Japan; European Central Bank; and [www.banknotes.com](http://www.banknotes.com).

As expected, the Federal Open Market Committee raised its overnight federal funds rate target from 3% to 3.25% at the end of June. The Bank of England's repo rate, maintained at 4.75% in early June, has been unchanged since August of last year. In mid-June, the Bank of Japan retained its target for current account balances at ¥30–¥35 trillion, where it has stood since January 2004. The European Central Bank left its deposit, repo, and loan rates unchanged at 1%, 2%, and 3% respectively, levels first established in June 2003.

Rejection of the proposed European constitution, inability to agree on a multiyear budget for the European Union, and actual or potential breaches of the Union's debt and deficit guidelines triggered only incidental concerns about the euro's durability as the common currency of European nations.

Commitment to a common currency is not unique to Europe. Three actual and one intended common currency areas operate in Africa. Each parallel central bank of the West African and Central African states administers its own CFA franc that is

pegged to the euro and guaranteed by the Bank of France but accepted only in its own region. The South African Reserve Bank administers the rand for the Common Monetary Area, although each of the other three members still issues its own currency pegged to the rand. The Anglophone nations of the West African Monetary Zone recently postponed for four years the introduction of the common eco currency, which will operate on a par with the CFA franc and be administered by a West African Central Bank.