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The Economy in Perspective

The real thing?...At this writing, we have just finished preparations for the May 7 meeting of the Federal Open Market Committee. If you are a Fed watcher, you know that your peers do not expect to see any change in the federal funds rate target at this meeting and perhaps not at the June meeting either. Sentiment about the funds rate waxes and wanes with news about the economy's strength, and lately the news has been interpreted more as mixed than bullish. Professional forecasters generally scoff at the notion that the recovery is in jeopardy, but they now expect a more attenuated expansion path this year than they envisioned a month or two ago.

Seasoned observers of business cycles and economic policymaking realize that several factors make forecasts of the federal funds rate especially volatile in times like these. Data are subject to revision, of course. And since some industries and regions are at different stages in their own cycles, it can take time for aggregated national statistics to reveal an overall pattern of economic activity. Consequently, forecasts of the real economy—and the funds rate—may be unusually sensitive near business cycle peaks and troughs, when the pace and direction of economic growth are shifting.

Just how important to the economy is the federal funds rate's path over the next six to nine months? Financial market traders may care; but for the nation as a whole, economic welfare depends hardly at all on near-term movements in the funds rate. Other factors have so much more effect on economic welfare that it is often difficult to understand why the funds rate attracts such abundant attention. True, the funds rate reflects liquidity conditions in the interbank lending market at a particular moment; over the course of a business cycle, however, we would expect it merely to oscillate around the trend in the real rate of interest.

The real rate of interest reflects the return to capital, which itself reflects the rate of productivity growth that investors expect. An economy characterized by 2 percent productivity growth will double its standard of living every 36 years; a productivity growth rate of 4 percent will cut the doubling time in half. So factors that affect the rate of productivity growth deserve close attention. What might they be?

Innovation to be sure, but more than that: innovation yielding goods and services that can be sold at a profit. Scientific advances might fuel the process, but competitive markets, enforceable property rights, and a legal system for settling disputes are necessary to nurture and sustain innovations that can raise living standards. Current developments in accounting standards, intellectual property rights, antitrust enforcement, and privacy laws all will affect the way scientific discoveries are transformed into goods and services that benefit people.

International trade has the potential to contribute greatly to economic welfare in the long run, but it gets a bad rap in some quarters because imports are thought to eliminate domestic jobs. But the same logic works here as in the case of purely domestic innovation: The whole point of productivity improvements, from the invention of the wheel to today's computers, is to create more effective ways of combining labor and capital. Over time, people who learn how to work with the newest capital goods become more valuable and earn higher incomes. International trade simply expands the arena in which this process of innovation and resource reallocation takes place.

Trade barriers can protect domestic producers in the short run but not the long run. For example, raising the cost of importing foreign steel or sugar simply encourages U.S. companies to import finished steel products and candy, undercutting the value of steel tariffs and sugar quotas. The volume of imports and exports has been growing much faster than total GDP in this country for quite some time, and trade patterns have been an important determinant of what is—and is not—produced here.

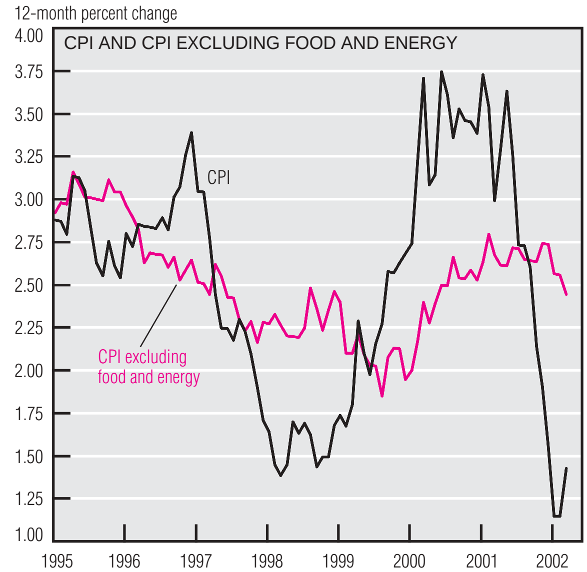
Population aging continues to have far-reaching consequences for the nation's economy, including its impact on health care outlays, which now account for more than 13 percent of GDP, and on Social Security, which is projected to show a cashflow deficit in 2016. It is widely recognized that the federal government faces significant immediate challenges in reforming both the medical care marketplace and the Social Security system. How we meet—or fail to meet—these challenges could have profound consequences for key aspects of U.S. economic performance over the next several decades.

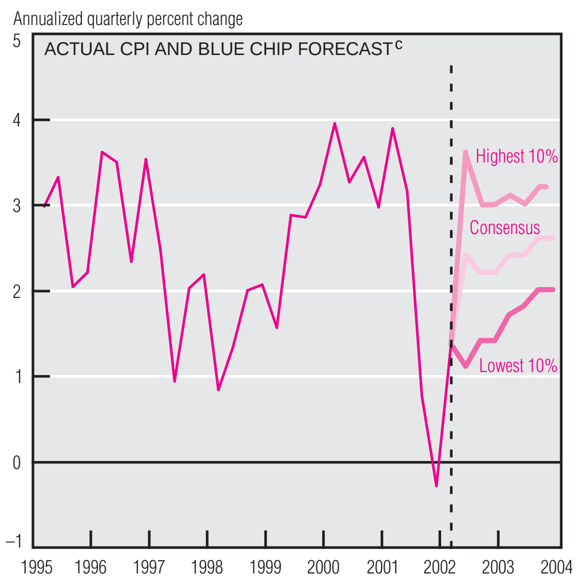
Speculation about the next change in the federal funds rate sometimes seems a bit like a soft drink: It might satisfy a momentary craving but it doesn't contain the protein needed to sustain and improve life.

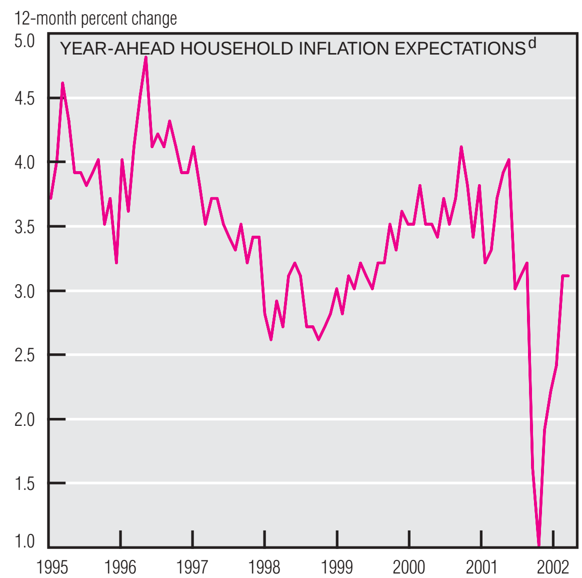
Inflation and Prices

March Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2001 avg.
Consumer prices					
All items	4.1	3.0	1.4	2.2	1.5
Less food and energy	1.3	2.1	2.4	2.4	2.7
Median[b]	3.4	3.8	3.8	3.1	3.9
Producer prices					
Finished goods	12.9	5.6	–1.6	1.0	–1.9
Less food and energy	1.6	0.3	0.5	1.0	0.7







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. Blue Chip panel of economists.
d. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; University of Michigan; and *Blue Chip Economic Indicators*, April 10, 2002.

The roller coaster of retail prices continued in March, when the Consumer Price Index (CPI) jumped an annualized 4.1% following February's 2.7% rise. Over the past three months, retail prices have advanced at a 3% annualized pace, twice the CPI's growth rate in 2001. Do recently accelerated retail price increases signal that inflationary pressures are building? Perhaps. But for most economists, inflation has two defining characteristics that distinguish it from just any price rise: It must be broadly diffused across prices, and its advance must be persistent.

Consider, for example, that once we separate the usually volatile food and energy goods from the consumer's market basket, the recent rise in retail prices looks much more modest (1.3% annualized in March and only 2.1% annualized over the past three months, compared with the 2001 increase of 2.7%). And while both economists and households are predicting that retail prices will rise faster over the next 12 months compared to the past 12, their inflation expectations remain below the growth trends seen in 2000 and the first half of 2001.

To better understand the breadth and likely persistence of recent price increases, we can discount markedly large price movements, say the largest 8% of the increases and 8% of the decreases. With this measure, called the 16% trimmed-mean estimator, we see larger retail price increases currently than with the the more commonly used inflation measures, the CPI and the Personal Consumption Expenditures Price Index (PCEPI). Even more extreme are the trends shown by the median CPI and the median PCEPI, inflation measures that

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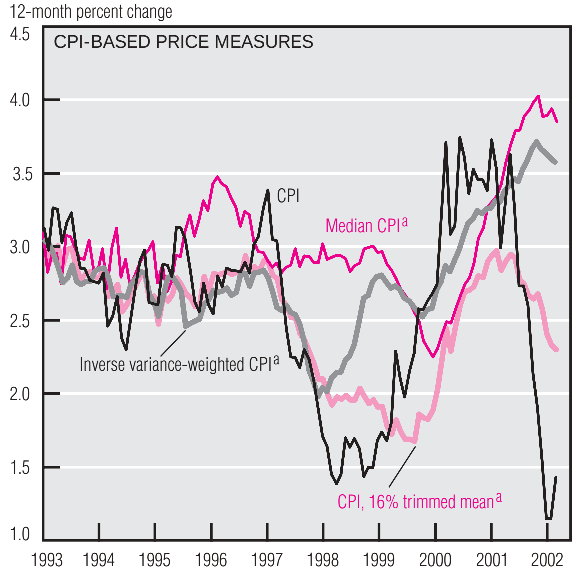
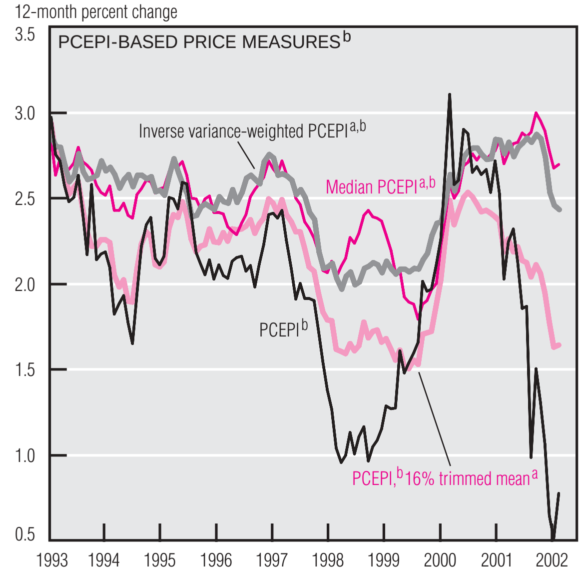
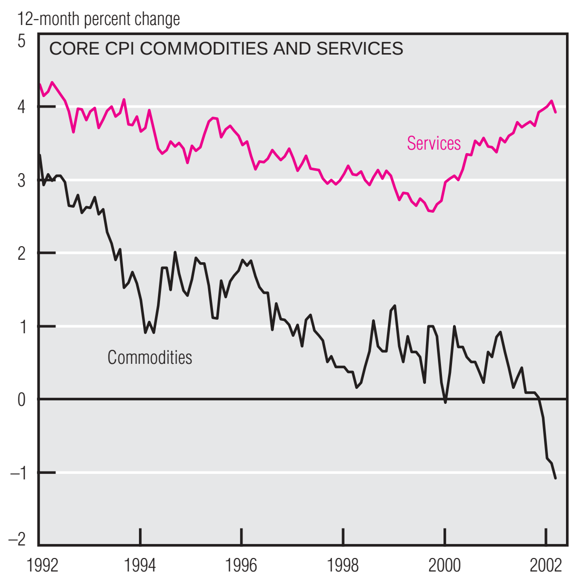
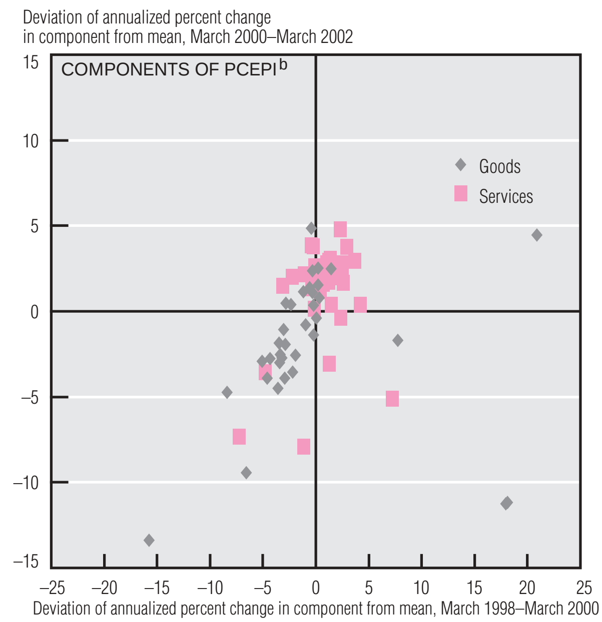
Inflation and Prices (cont.)









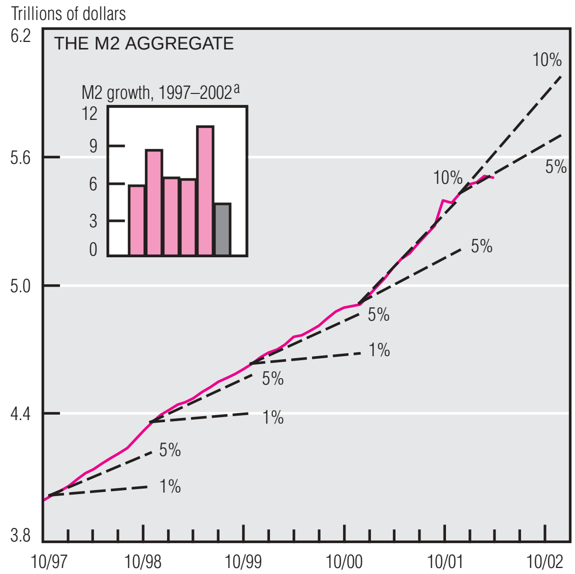
a. Calculated by the Federal Reserve Bank of Cleveland.
b. Personal Consumption Expenditures (chain type) Price Index.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Reserve Bank of Cleveland.

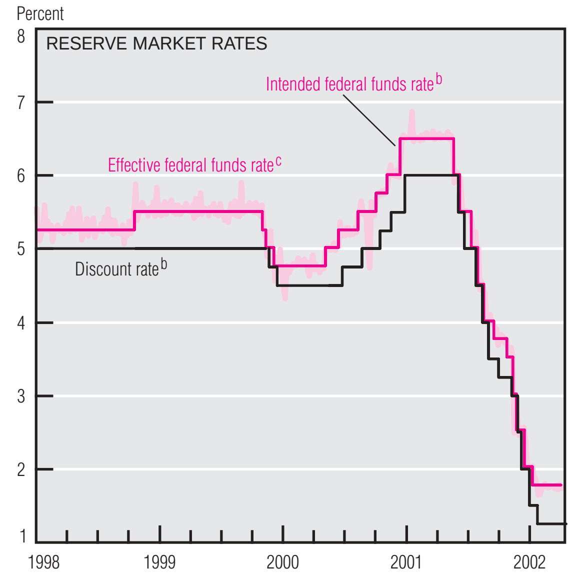
trim away all but the price movements in the center of the price-change continuum. Another way to identify the persistent, broadly diffused pattern in retail prices is to weight price changes in inverse proportion to an item's observed price volatility over time. That is, assign lower weights to prices that fluctuate widely from month to month and give higher weights to prices that show more stable growth patterns. Such "inverse variance-weighted" measures reveal a recent growth trend in retail prices that is quite similar to the median inflation measures.

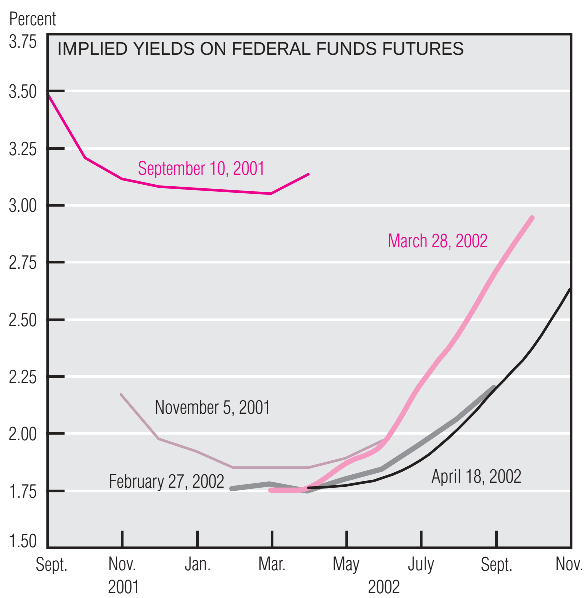
The reason for the divergence between some of these price measures lies in the radically different behavior of commodities price increases compared to services price increases. While the former have been declining for nearly a year and a half—and have accelerated that decline in recent months—the latter have tended to move steadily higher. Because commodity prices tend to be more volatile from month to month than services prices, these alternative inflation measures tend to give them less significance.

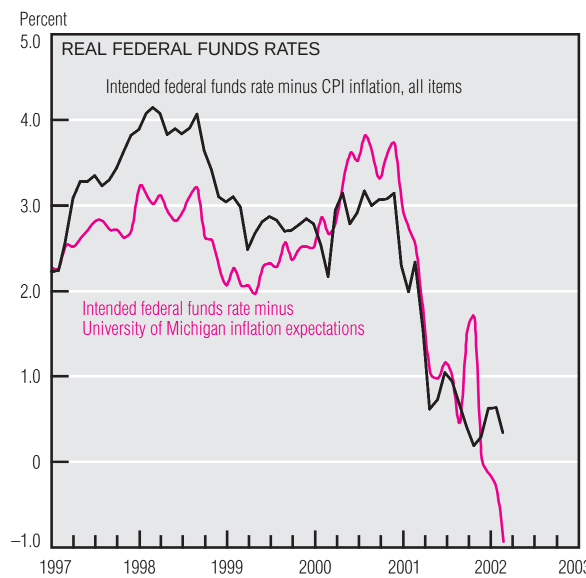
Is inflation heading higher? The answer depends on whether commodity prices follow the pattern we have been seeing in services prices, or vice versa. But this dichotomy in the price behavior of commodities compared to services has been widening for many years now and may not be resolved any time soon. An examination of price increases for 70 components of the PCEPI shows that services prices that exhibited above-average increases over the past two years tended to show above-average increase over the two years previous to those; commodities that tended to show below-average price increases earlier are probably still doing so today.

Monetary Policy









a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
b. Daily.
c. Weekly average of daily figures.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, "Money Stock and Debt Measures," H.6, and "Selected Interest Rates," H.15; and University of Michigan, *Survey of Consumers*.

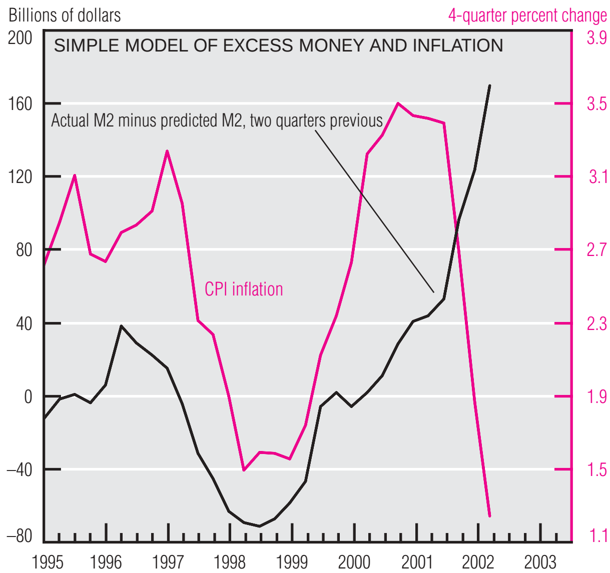
With no FOMC meeting in April and no intermeeting move, the target federal funds rate and the discount rate have remained unchanged since March. The rates have now held steady for more than four months, the longest since the seven-and-a-half months between May 2000 and January 2001, when rates stayed constant at 6.5%, before the 11 moves and 475 basis point (bp) decline of 2001.

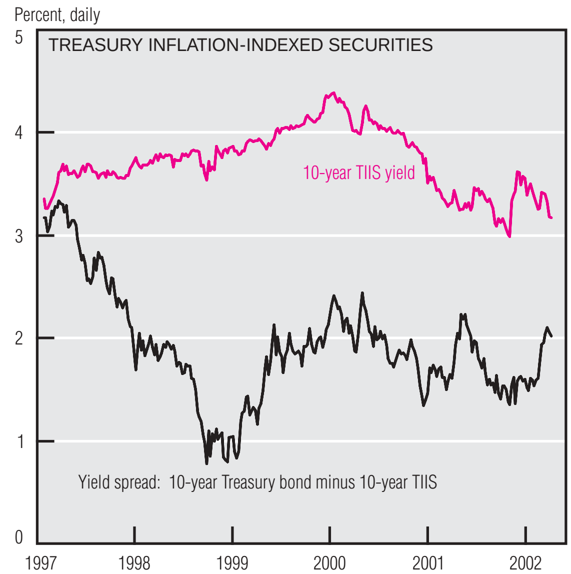
Many market watchers anticipate that the FOMC will increase rates in the near future, reflecting the upward slope in the implied yields for federal funds futures. Since March, however, expectations have lowered, suggesting that market participants see a reduced probability of higher rates late in the year.

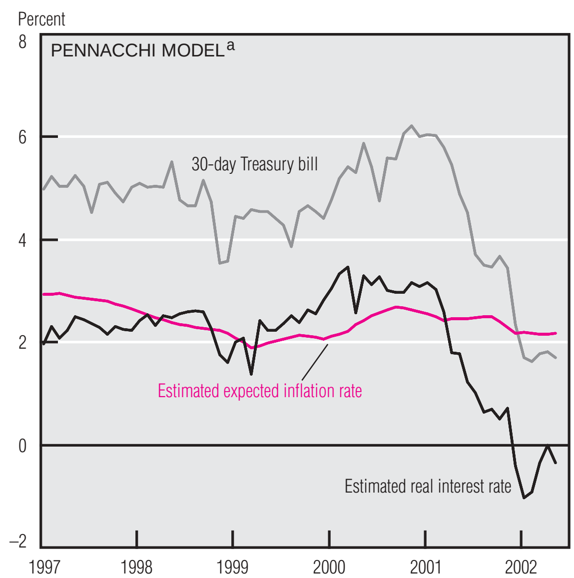
One increasingly popular gauge of policy is the real federal funds rate, that is, the nominal rate less inflation expectations. Different measures of expected inflation give somewhat different results. Subtracting the most recent CPI yields a real rate that has decreased about 300 bp since the beginning of 2001 and still remains positive. Using expectations from the Michigan survey shows a figure much closer to the 475 bp drop in the nominal rate, moving it all the way to –1%.

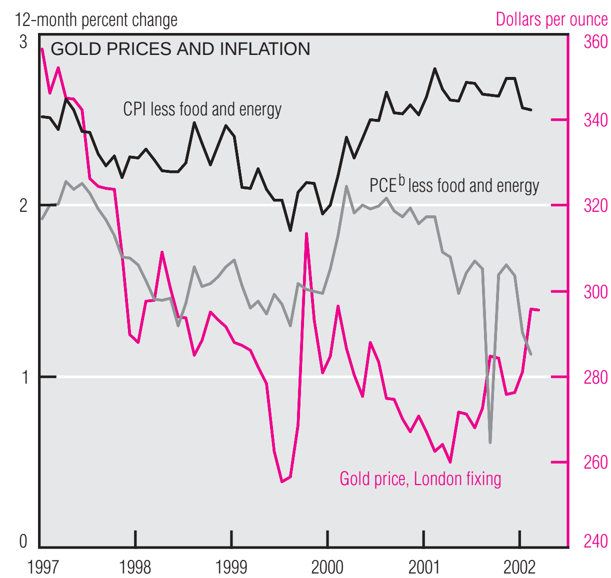
Finally, although most discussions of monetary policy are conducted in the language of interest rates, it pays to remember that target interest rates ultimately work by way of the money market. Growth in the broad monetary aggregate, M2, has been modest by recent experience, falling below 5%.

Money and Financial Markets









a. The estimated expected inflation rate and the estimated real 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.

b. Personal consumption expenditures.

SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics and Bureau of Economic Analysis; Federal Reserve Bank of Cleveland; Bloomberg Financial Information Services; and the *Wall Street Journal*.

Because price stability is a long-run goal of the Federal Reserve System, monetary policy's effect on inflation is always a major concern. One way to gauge the effect is to return to the classic definition of inflation: too much money chasing too few goods. This notion is illustrated by a simple model that compares the amount of money in circulation with the usual amount demanded at current interest rates and output. While it generally predicts the direction of inflation throughout the mid- to late 1990s, it misses badly on the recent drop.

Financial markets provide several additional ways to extract expectations. One uses the difference between the yields on a nominal 10-year Treasury bond and the yield on a Treasury inflation-indexed security of similar maturity, although tax and liquidity differences distort the signal. By this measure, inflationary expectations have increased nearly half a percentage point in 2002. Another model that combines shorter maturity securities with survey measures of inflation, however, shows little change in expectations, which continue to come in a little above 2%. This model's estimate of the real rate of interest gives further evidence of how far that rate has dropped over the past year.

The price of gold, a classic measure of inflation, has risen substantially in 2002. Even ignoring the flight-to-quality effect of the Y2K problem,

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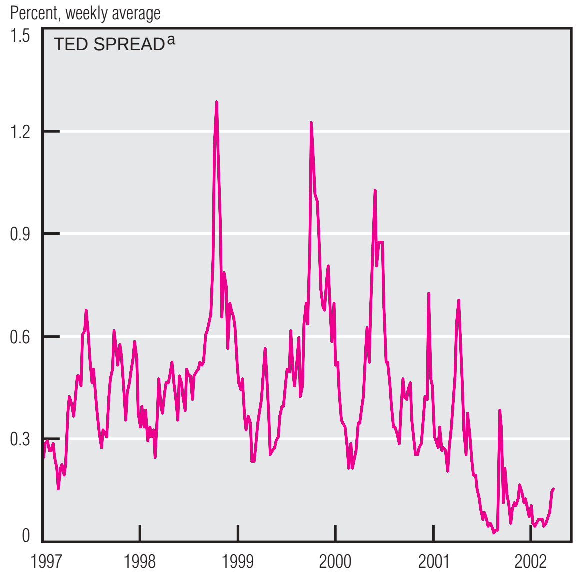
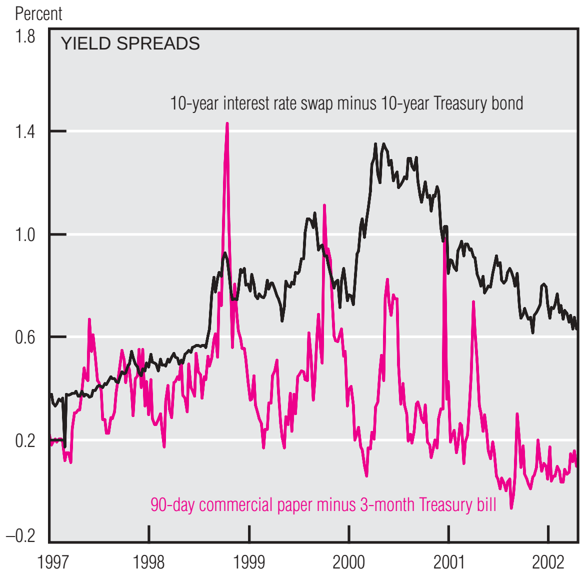
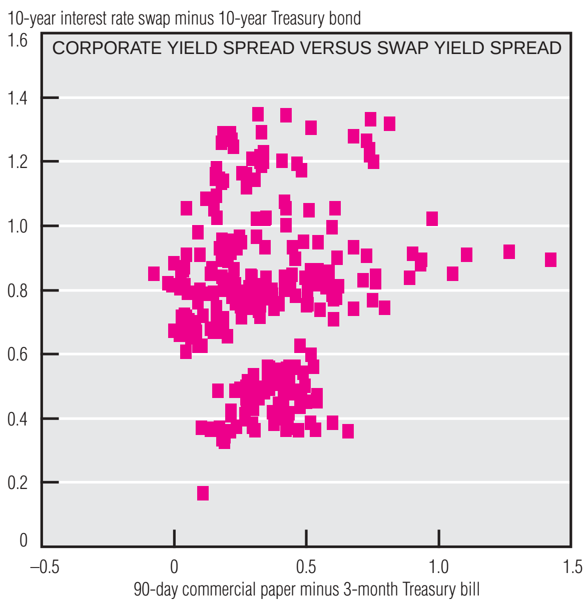
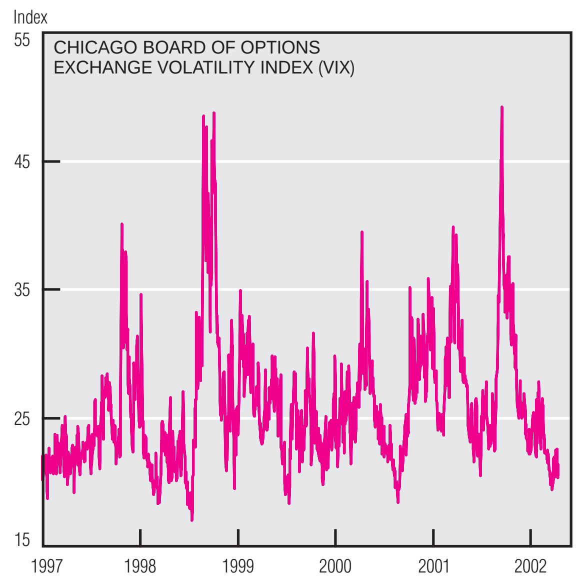
Money and Financial Markets (cont.)









a. Yield spread: 3-month euro minus 3-month constant maturity Treasury bill.

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

gold's recent record in tracking inflation is less than glittering.

Financial markets can also illuminate the real side of the economy. Just as the spread between nominal and real rates tells us about inflation, spreads between safe and risky rates reflect risk and uncertainty in the economy. The spread between 3-month Treasury bills and 3-month euro rates (the TED spread) is the difference between dollar-denominated instruments in the U.S. and abroad. It picks up international concerns without distortion from exchange rate movements. Despite a coup in Venezuela and wars in Afghanistan and the Middle East, the TED spread remains low. So do two purely domestic spreads at different maturities: 10-year interest rate swaps minus 10-year Treasury bonds, and 90-day commercial paper minus 3-month Treasury bills. In fact, the 10-year spread is dropping to levels last seen before the upheavals of 1998 (the Russian default and the Long Term Capital Management debacle). The two spreads—both measuring risk but at different maturities—seem to give disparate signals. The 10-year spread lacks the sharp peaks of the 3-month spread, and a scatter plot shows wide variation.

Another approach is to examine volatility, that is, how much a price is expected to move around. Just looking at past movements, however, may not capture market sentiment about future moves. One way to get forward-looking measures is to examine option contracts, which are

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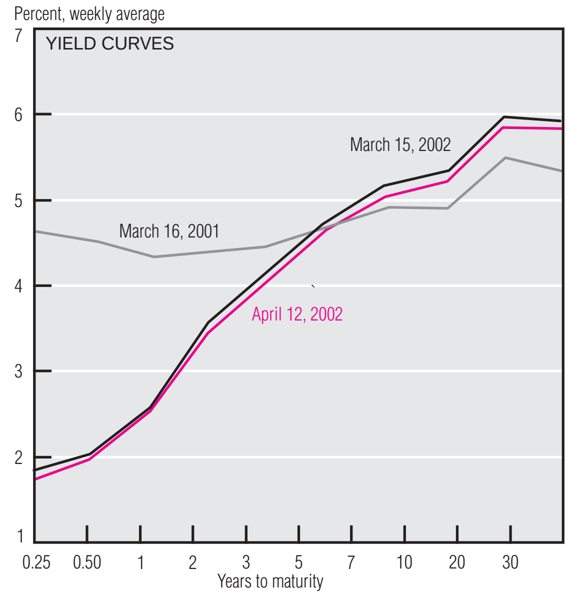
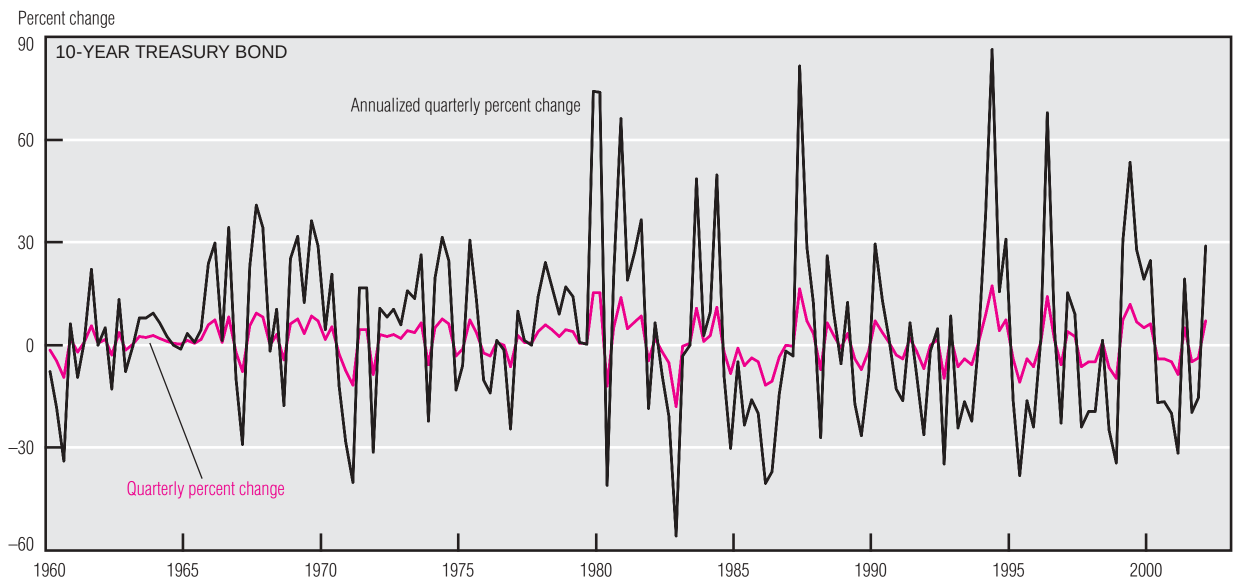
Money and Financial Markets (cont.)





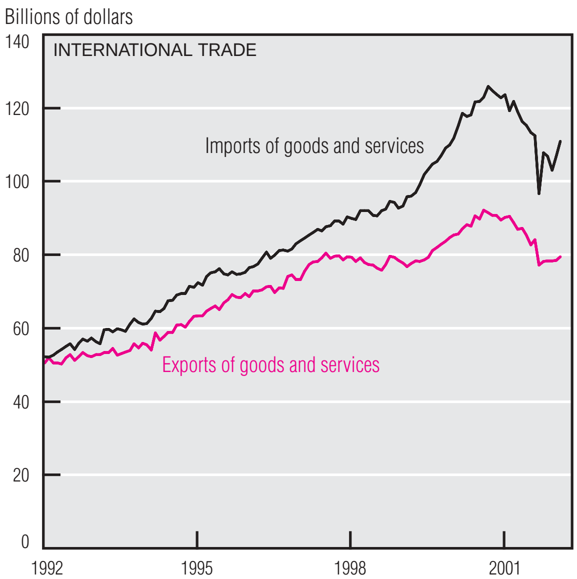
NOTE: All data are constant maturity.
SOURCE: Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Releases*, “Selected Interest Rates,” H.15.

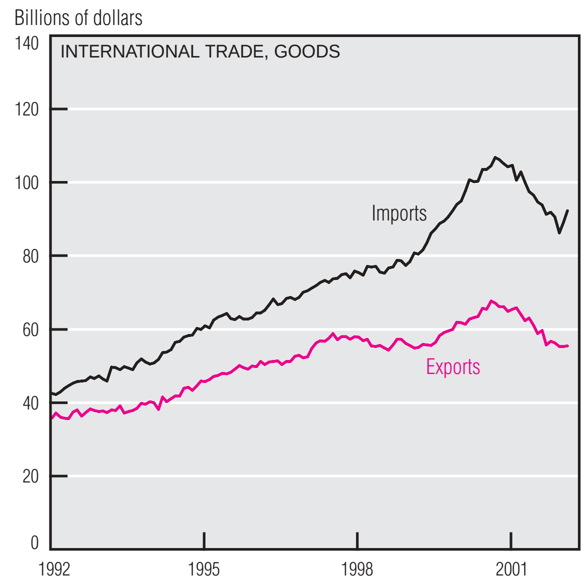
particularly sensitive to volatility. The volatility index (VIX), which measures the implied volatility of the Chicago Board of Options Exchange’s option contract on the S&P 100 index, remains low.

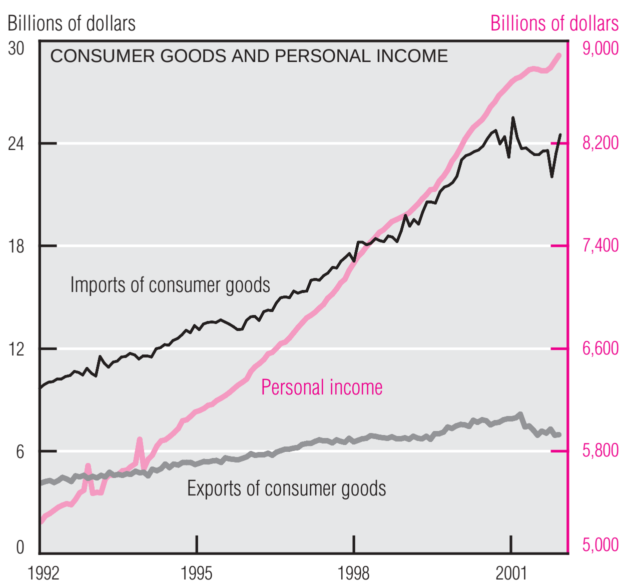
A classic measure of real economic activity is the term spread between 10-year and 3-month Treasury securities. It is at historically high levels, generally a sign of strong growth over the next four quarters. It reflects the yield curve’s general steepening, whose proximate cause is the large drop in short rates. Long rates have crept up, but the small amount suggests that inflation fears have been kept in check.

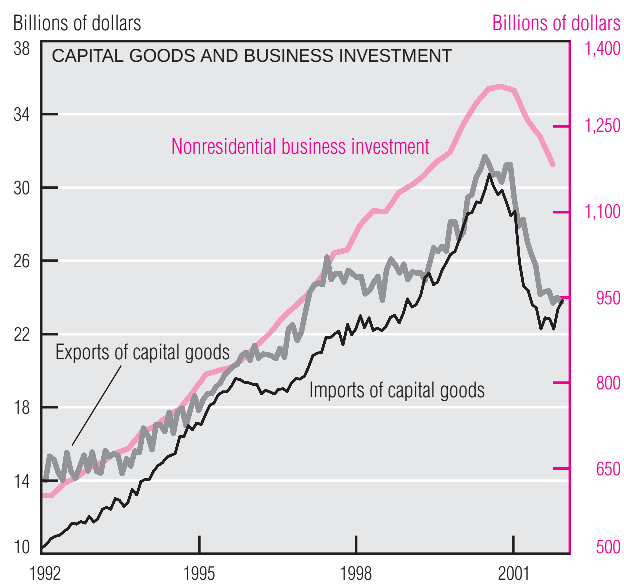
One problem with looking at interest rates is that the level of rates can make changes less comparable. Higher inflation levels, which lead to higher interest rates, compound this problem. Most likely, an interest rate move from 1% to 2% is more significant than a move from 13% to 14%. One way to correct for this is to express interest rate changes as percentages—so the previous examples translate to increases of 50% and 7%. From this perspective, four increases and two decreases particularly stand out. Many of these occurred during the “monetarist experiment” (1979–82) of the Volcker years, when the Federal Open Market Committee concentrated on the money supply. The spike in 1987:IIQ probably reflects inflation fears associated with a weakening dollar, and that in 1996:IIQ reflects unexpectedly strong real growth.

International Trade









SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

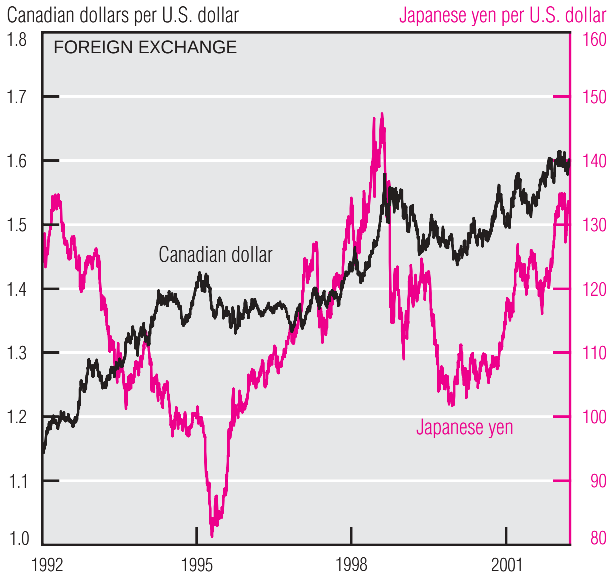
In February, the U.S. deficit on goods and services rose $3.3 billion to reach $31.5 billion, mostly because imports increased $4.2 billion. The goods deficit alone rose $3.2 billion, and the services surplus fell $0.2 billion. Goods imports increased $3.3 billion. Although imports do not represent spending on domestic production, their increase is thought to indicate strengthening domestic demand.

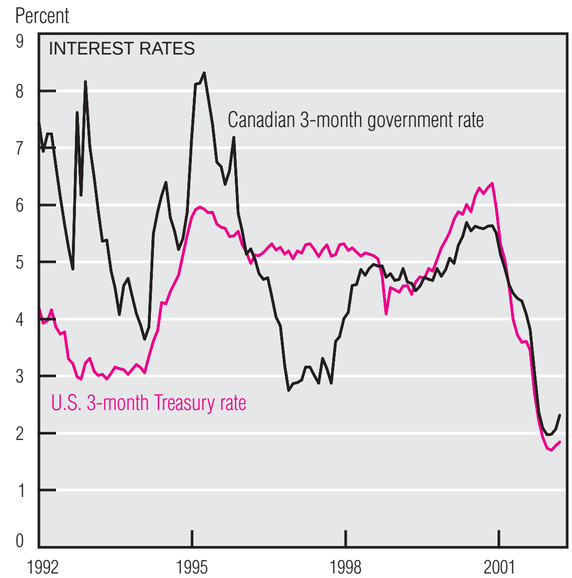
Interpretation of movement in the trade balance depends partly on composition. In consumer goods, one of the most important goods categories, imports increased $1.1 billion, reinforcing the view that the recent strength in personal income demonstrates continued strength in consumer spending.

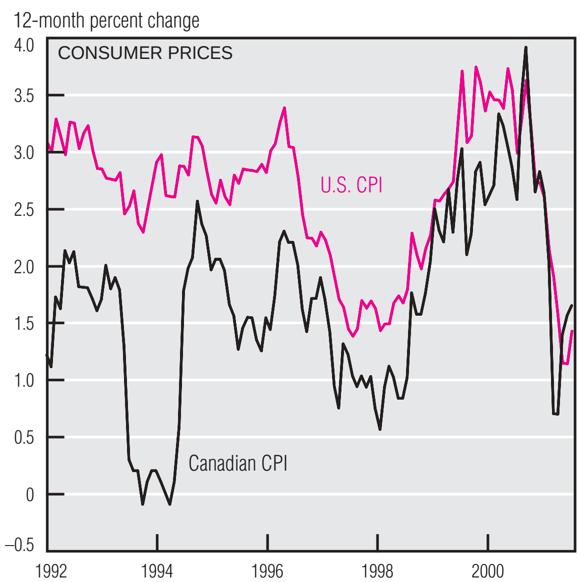
Based on 2001 data, capital goods are the largest end-use category for goods, both exports and imports. Although capital goods exports and imports so far in 2002 are substantially below this year's January and February totals, imports have increased over the last two months, reaching the levels of May 2001. Exports remain well below the levels of that date.

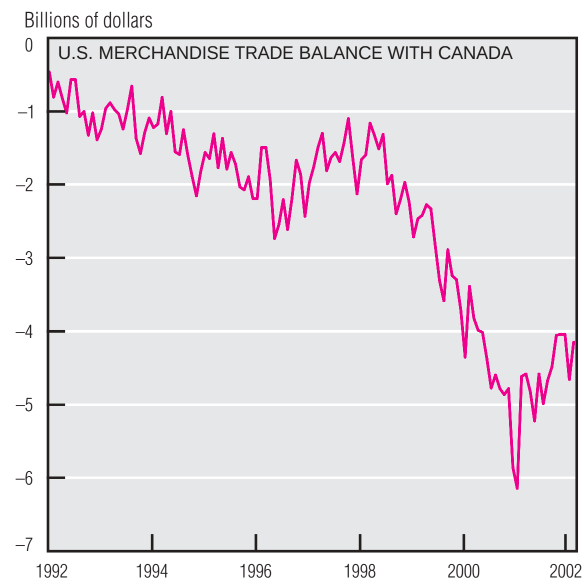
Capital goods imports do not contribute directly to domestic demand but may be seen in the same light as business fixed investment in that they might contribute to productivity growth. However, GDP for 2001:IVQ showed a decline in business fixed investment as well as decreases in both imports and exports of capital goods.

The Canadian Dollar









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

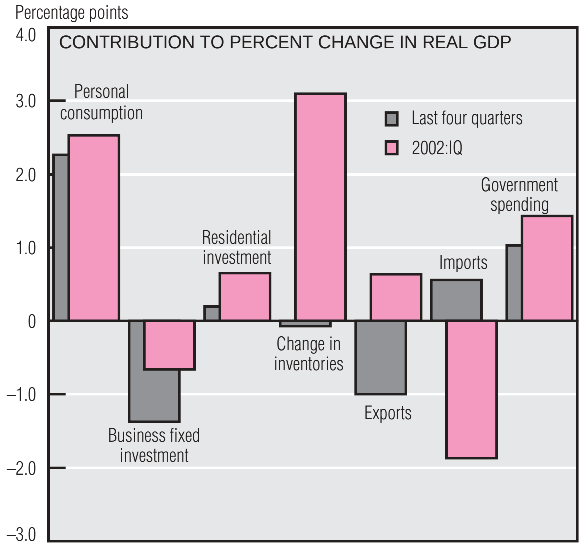
With the Canadian recovery gathering steam, the Canadian dollar has strengthened against the U.S. dollar during the last few weeks. Canadian three-month interest rates have risen above U.S. rates, a result of both the economic recovery and the Bank of Canada's decision to increase overnight rates—presumably a response to strength in Canadian domestic demand. Because the U.S. federal funds rate has remained constant recently, the increase in the Canadian rate has boosted the differential between Canadian and U.S. short-term rates, supporting an immediate upward movement in the value of the Canadian dollar.

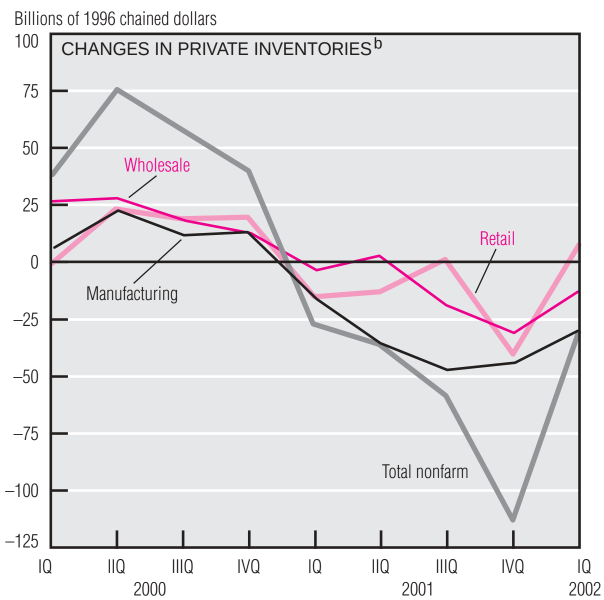
Consumer price inflation remains subdued in both countries, although core inflation in Canada rose a bit in February, which may have encouraged the rate increase. A major difference between the two countries is the quicker pace of economic recovery in Canada. In both countries, improvement in business investment will be a key factor in the coming months.

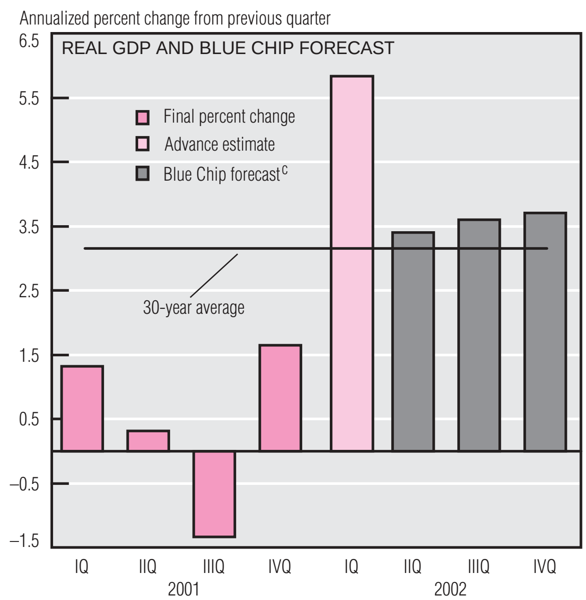
Although Canada's economy is heavily influenced by the U.S., the value of its currency is determined in global financial markets. There is only a weak correspondence between the bilateral, U.S.–Canada trade balance and the exchange rate between the two countries. Since 1992, the Canadian dollar has generally been weakening against the U.S. currency, although the U.S. has been running a trade deficit with Canada. Canada has a trade surplus with the rest of the world, providing a net stimulus to its economy.

Economic Activity

Real GDP and Components, 2002:IQ[a] (Advance estimate)	Change, billions of 1996 $	Percent change, last: Quarter	Four quarters
Real GDP	133.5	5.8	1.6
Personal consumption	57.2	3.5	3.3
Durables	–21.2	–8.0	8.5
Nondurables	38.8	8.4	2.9
Services	34.2	3.8	2.4
Business fixed investment	–18.2	–5.7	–10.7
Equipment	–1.2	–0.5	–7.7
Structures	–13.5	–19.9	–18.9
Residential investment	14.0	15.7	4.6
Government spending	31.9	7.9	5.8
National defense	17.0	19.6	8.3
Net exports	–35.8	—	—
Exports	16.9	6.8	–9.2
Imports	52.7	15.5	–3.9
Change in business inventories	83.1	—	—







NOTE: All data are seasonally adjusted and annualized.

a. Chain-weighted data in billions of 1996 dollars. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.

b. Changes in wholesale, manufacturing, and retail inventories do not sum to the change in total nonfarm private inventories because other industries' inventories and the residual are not included.

c. Blue Chip panel of economists.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators,* April 10, 2002.

Real gross domestic product (GDP) grew at an annual rate of 5.8% in 2002:IQ, according to the advance estimate from the national income and product accounts released April 26. This is the fastest rate of real GDP growth since 1999:IVQ. Although spending on durable goods declined, overall consumer spending remained robust, increasing 3.5% from 2001:IVQ. In addition, consumers gave a boost to the housing sector, where residential investment grew nearly 16%. Government expenditures, concentrated primarily in national defense, also bolstered output growth. Business fixed investment and imports, in contrast, were drags on real GDP growth. However, increased imports signal stronger consumption demand.

A major reason for real GDP growth's strong showing was a substantial decline in the rate of inventory liquidation. Changes in private inventories contributed a whopping 3.1 percentage points to real GDP growth, and inventories rose $83.1 billion (1996 chained dollars) from 2001:IVQ. Although the change in total private nonfarm inventories remained negative in 2002:IQ, the pace of inventory liquidation declined substantially from the record set in 2001:IVQ. In 2002:IQ, inventory reductions moderated for both manufacturers and wholesalers; retailers actually began to accumulate inventories.

Blue Chip forecasters predict that the real GDP growth rate will slacken in the coming quarters but still remain above its long-term average for the rest of the year.

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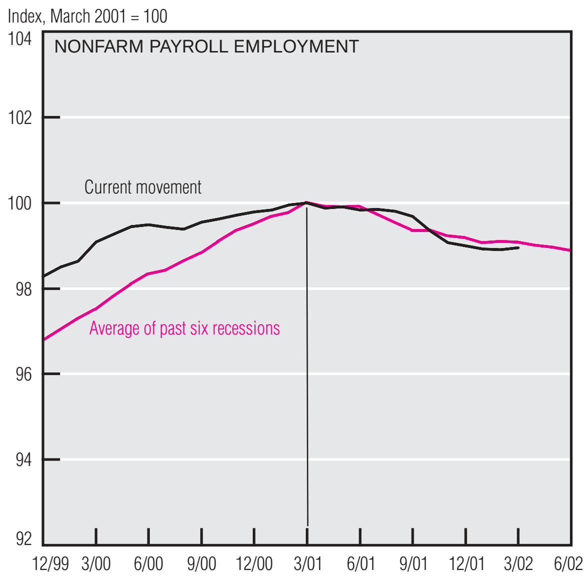
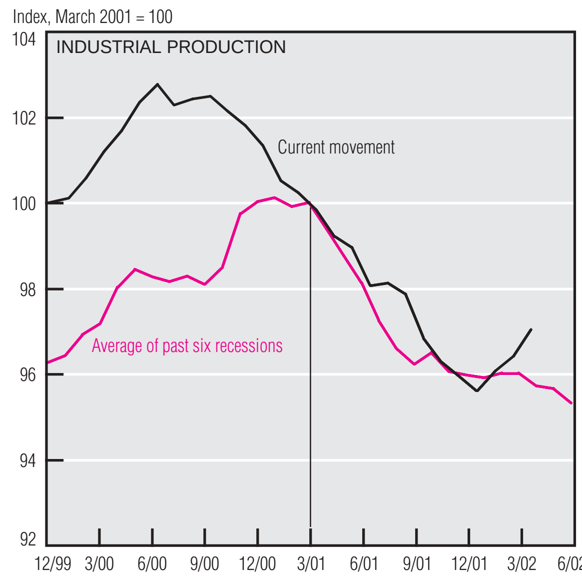
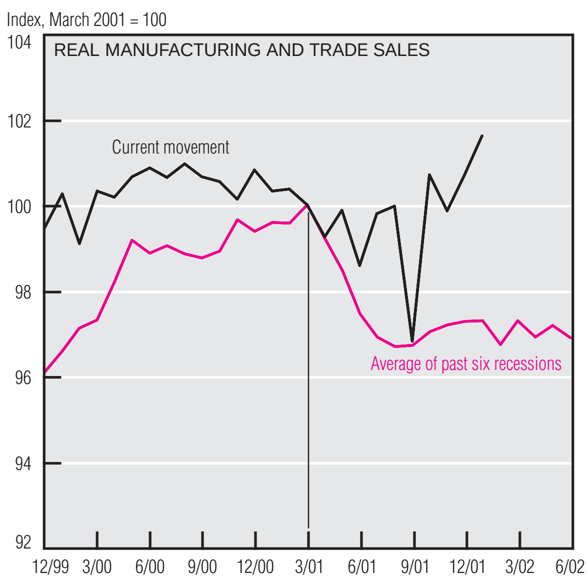
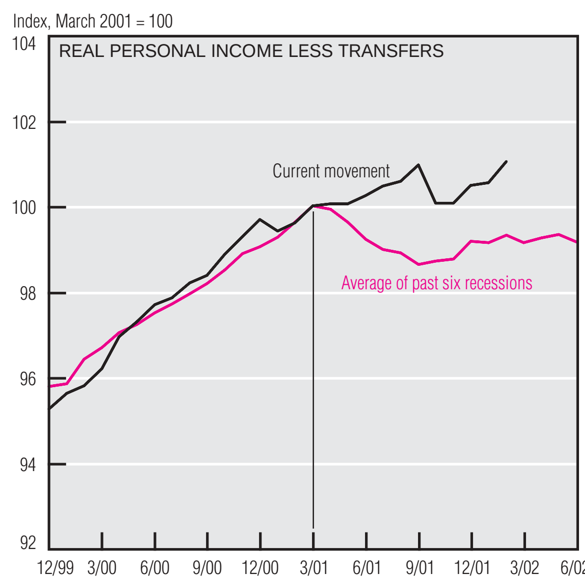
Economic Activity (cont.)









NOTE: Vertical lines indicate the NBER-defined beginning of the current recession.

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

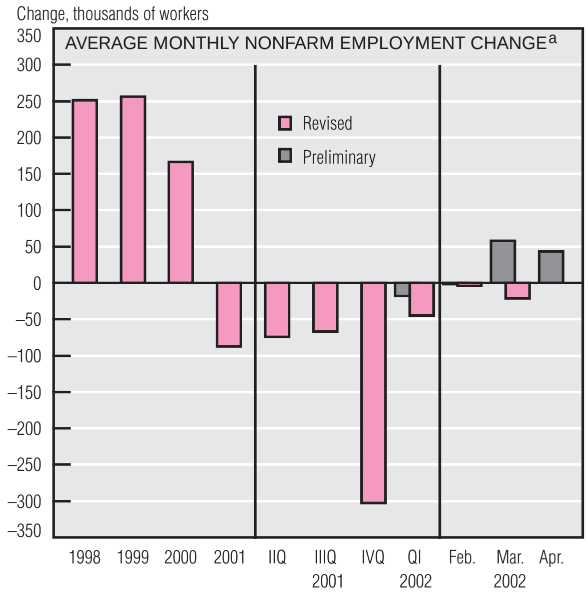
The National Bureau of Economic Research's (NBER) Business Cycle Dating Committee has not yet marked the end of the latest recession. In light of recent data, though, many analysts believe the recession may have ended as early as last December.

According to the NBER, the four most important monthly indicators of economic activity are employment, industrial production, real manufacturing and trade sales, and real personal income less transfers. The charts show recent movement in economic activity (green lines) compared to the average movement in activity over the past six recessions (red lines). The average-movement series are superimposed, so that the beginning of a recession corresponds to March 2001 (the start of the current recession).

The NBER considers employment to be the broadest and most reliable indicator. Nonfarm payroll employment peaked in March 2001 but appears to have bottomed out recently. It posted an increase in March 2002, the first in eight months. Industrial production rose for a third consecutive month in March, marking its largest gain since May 2000.

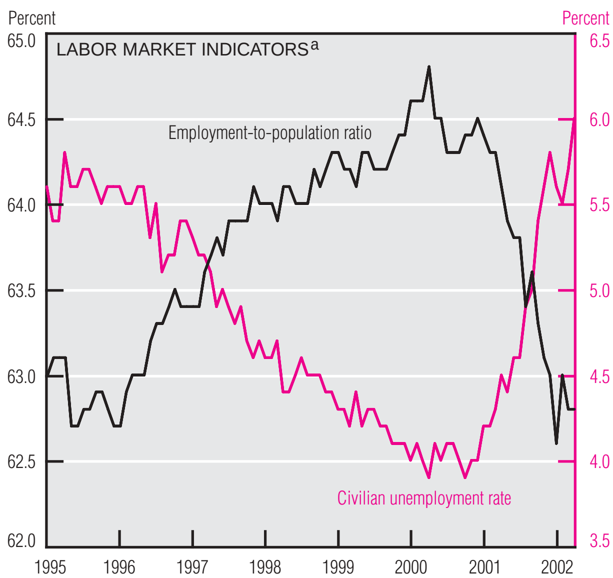
Real manufacturing and trade sales have been volatile, but increased in December 2001 and January 2002. Recent activity in real personal income less transfers did not peak until September 2001. However, the series increased from November 2001 through February 2002. All four series have already begun rebounding from declines. The latter two series have surpassed previous peaks, satisfying one of the NBER's dating criteria: Usually activity must surpass its previous peak before a trough date can be determined.

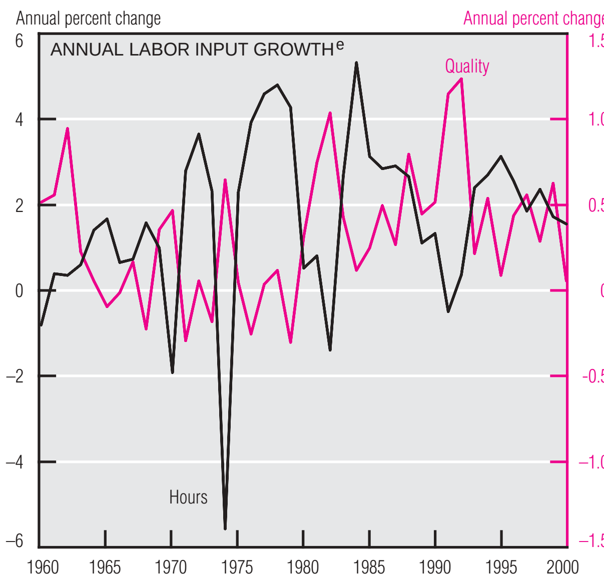
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
	1999	**2000**	**2001**	**Jan.–Mar. 2002**	**April 2002**
Payroll employment	257	167	–87	–45	43
Goods-producing	7	8	–103	–98	–91
Mining	–3	1	1	–3	7
Construction	26	18	5	–25	–79
Manufacturing	–16	–12	–109	–69	–19
Durable goods	–5	1	–79	–57	–1
Nondurable goods	–11	–13	–31	–13	–18
Service-producing	250	159	16	53	134
TPU[b]	18	14	–16	–11	5
Wholesale and retail trade	59	34	–14	20	22
FIRE[c]	7	0	4	–5	18
Services[d]	131	93	5	31	87
Government	35	18	37	19	2
	Average for period (percent)				
Civilian unemployment rate	4.2	4.0	4.8	5.6	6.0





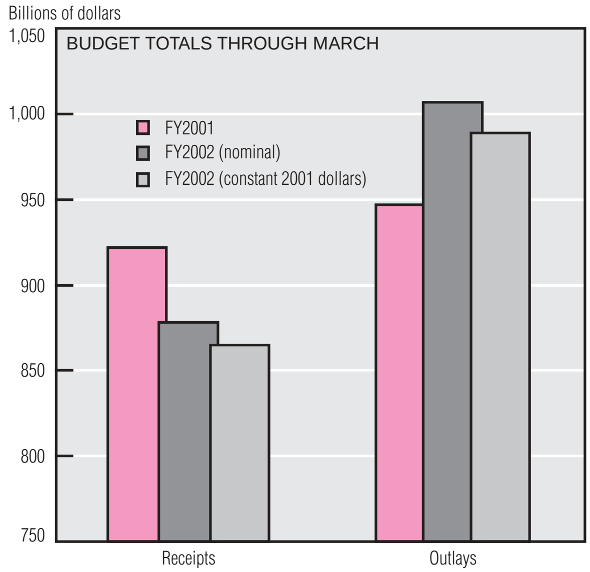
a. All data are seasonally adjusted.
b. Transportation and public utilities.
c. Finance, insurance, and real estate.
d. The services industry includes travel; business support; recreation and entertainment; private and/or parochial education; personal services; and health services.
e. Labor input growth is the weighted sum of growth in hours across 504 labor market categories, including experience, gender, and education; the weights are category-specific shares of total labor compensation. Quality growth is the difference between labor input growth and hours growth.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

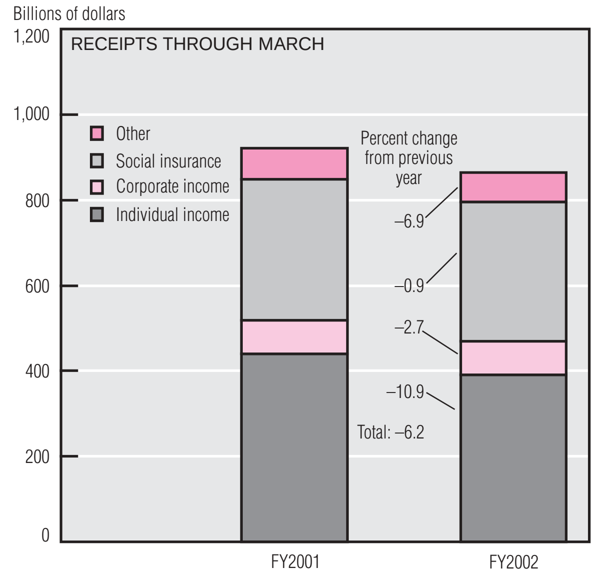
Nonfarm payroll employment added 43,000 jobs in April, the first net gain since August 2001. The monthly change for March was revised down from 58,000 to –21,000. Service-producing industries added 134,000 jobs in April, 87,000 of them in services. Help supply services, a component of business services, showed a net gain of 126,000 jobs over the last two months, after a net loss of 311,000 from April 2001 to February 2002. Goods-producing industries posted a net loss of 91,000 jobs in April, mostly in construction (–79,000).

Employment in durable goods manufacturing was stable—a dramatic improvement from 2002:IQ, when the average net job loss was 57,000. According to the Bureau of Labor Statistics' (BLS) household survey, the preliminary civilian unemployment rate for April was 6.0%, the highest recorded since August 1994. Employment increased 82,000, but the labor force grew 565,000, leading to the surge of 0.3 percentage points in the unemployment rate.

When measuring multifactor productivity, the BLS estimates growth in both the quality and quantity of labor hours, which tend to be negatively related. In boom periods, tight labor markets cause firms to hire less-skilled workers, reducing growth in labor quality. In 2000, when the unemployment rate was the lowest since 1969, labor quality grew only 0.05%, its lowest rate since 1979. During recessions, firms lay off workers with less skills and experience, improving the average quality of the labor force. Some of the growth in hourly earnings witnessed in 2001 probably reflects layoffs of low-skilled workers, which raised average earnings.

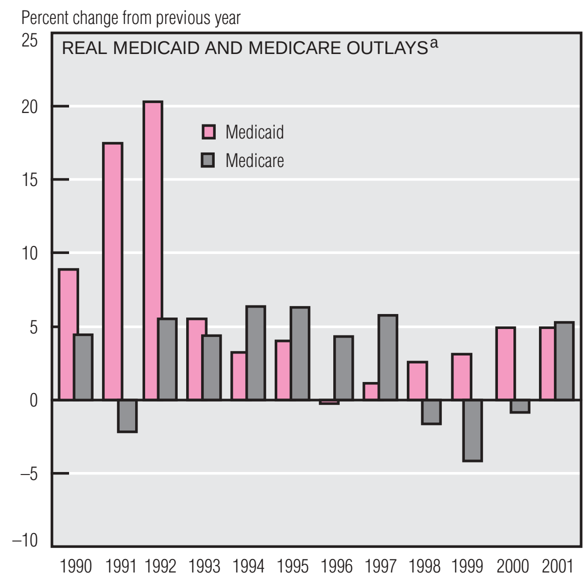
New Federal Budget Estimates





Outlays through March

	Billions of dollars FY2001	FY2002 (real)	Real percent change
Defense/military	144	156	8.1
Social Security benefits	210	219	4.1
Medicare	117	118[a]	0.5
Medicaid	63	69[a]	9.2
Unemployment insurance	15	24	57.6
Other programs and activities	286	314	9.8
Net interest on the public debt	113	89	–21.6
Total	947	987	4.2



NOTE: The federal government's fiscal year begins in October. Unless otherwise noted, numbers are given as constant 2001 dollars, calculated using the seasonally adjusted urban Consumer Price Index (CPI-U) for the period.
a. Calculated using the seasonally adjusted CPI-U for health care.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Congressional Budget Office.

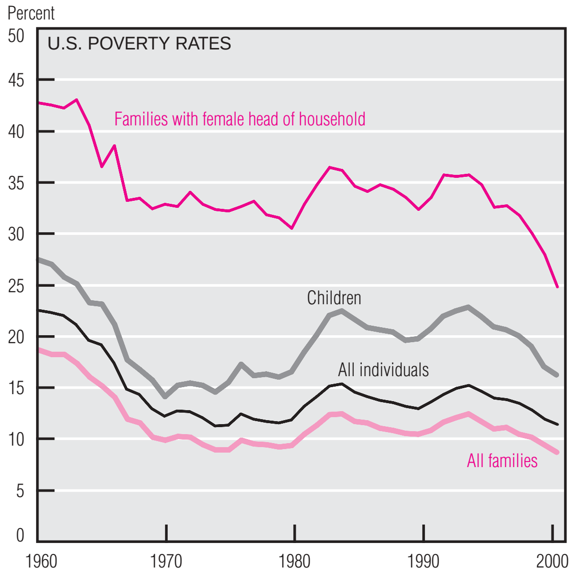
Federal receipts fell $44 billion between the first half of fiscal year (FY) 2001 and the first half of FY2002. In real terms, total receipts declined 6.2% over these two periods. Individual income taxes dropped $42 billion (10.9% in real terms), about half of which resulted from the 2001 tax cut. Receipts through March mostly reflect economic activity in 2001:IVQ, and do not yet confirm other macroeconomic indications of a strong rebound.

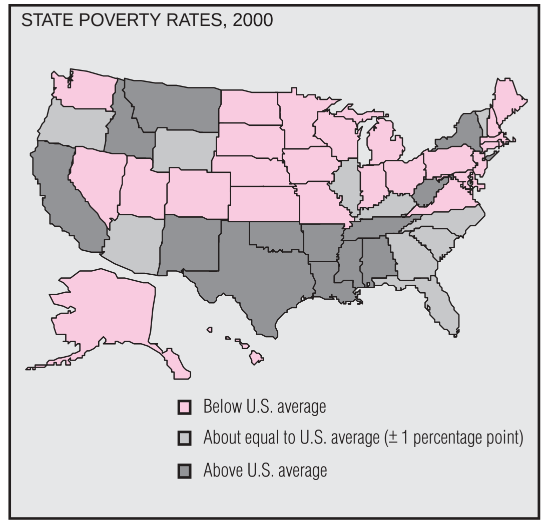
Federal outlays were $60 billion higher in the first half of the current fiscal year than in the same period last year. Adjusting for inflation and excluding the effects of payment shifts across fiscal years, total federal outlays rose 4.2%—somewhat faster than average GDP growth over the same period.

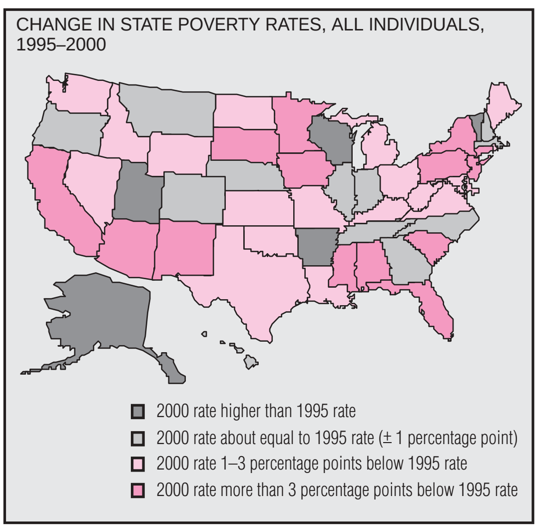
Real Medicare outlays have been stable so far this year, but Medicaid spending growth has been especially rapid, with outlays for the first half of FY2002 (October 2001–March 2002) up 9.2% from the same period in FY2001. Rising enrollment, more intensive use of services, and rising prices have ramped up health care costs; Medicare and Medicaid are growing considerably faster than in the mid-1990s.

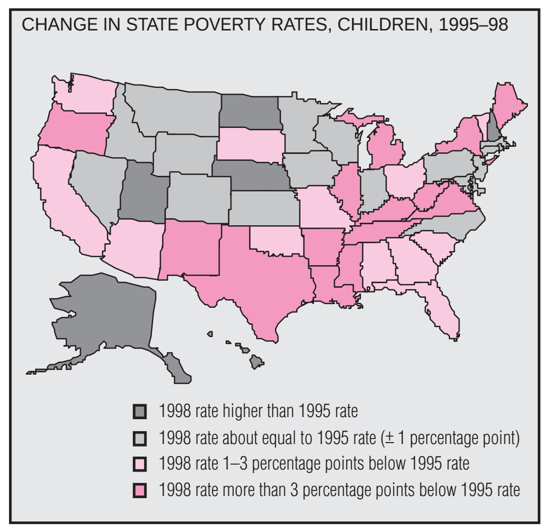
The economic slowdown has caused real outlays on unemployment benefits to surge 57.6%. Without a quicker, sharper economic rebound, these outlays are likely to remain high because of the recent extension of unemployment benefits. Overall, federal spending is expected to strengthen in the second half of FY2002, especially in the areas of defense and transportation. Moreover, the FY2003 budget proposes to increase discretionary authority 9% in nominal terms.

Poverty









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

Overall U.S. poverty rates for both individuals and families fell again in 2001. At 11.3%, the rate for individuals is the lowest since 1974. The family poverty rate of 8.6% is the lowest since the Census Bureau began calculating it in 1959.

Some groups continue to experience disproportionately high poverty rates. The rate for children (16.8%) is about 50% higher than the rate for individuals. Households headed by females are nearly three times more likely to live in poverty than families in general.

Poverty rates tend to be near or above the national average in the south, and below average in the north. The latest available data show that the states with the highest poverty rates are Arkansas (17.8%), Louisiana (17.3%), and New Mexico (16.8%). Poverty rates are lowest in New Hampshire (5.2%), Minnesota (6.0%), and Connecticut (6.6%).

The Personal Responsibility and Work Opportunity Reauthorization Act of 1996 made sweeping welfare reforms: the introduction of time limits for welfare benefits, the removal of barriers to work for poor adults—especially single mothers with children—and the devolution of control over welfare spending to the states. Since 1995, states have made notable progress in reducing poverty. With the exception of Arkansas, the only states where poverty rates have increased since 1995 are those with the lowest 1995 rates; nevertheless, their rates remained significantly below the national average in 2000.

The 1996 welfare reforms focused principally on improving impoverished children's quality of life. Not surprisingly, states made substantial

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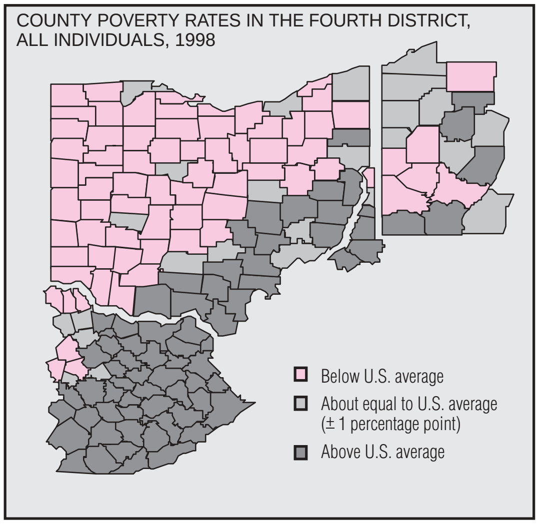
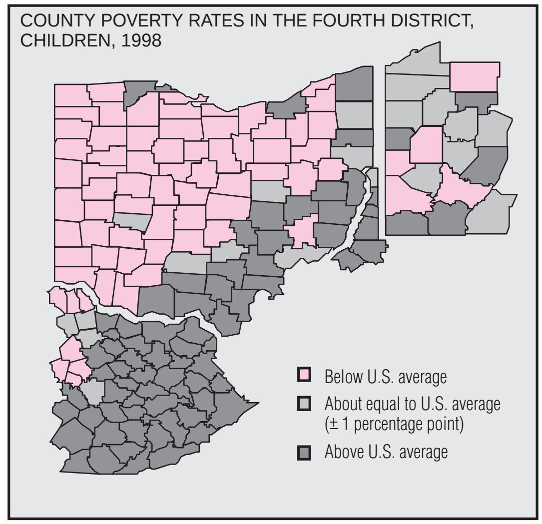
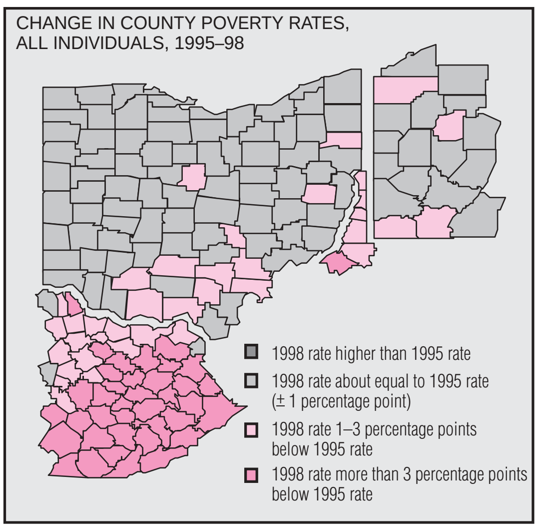
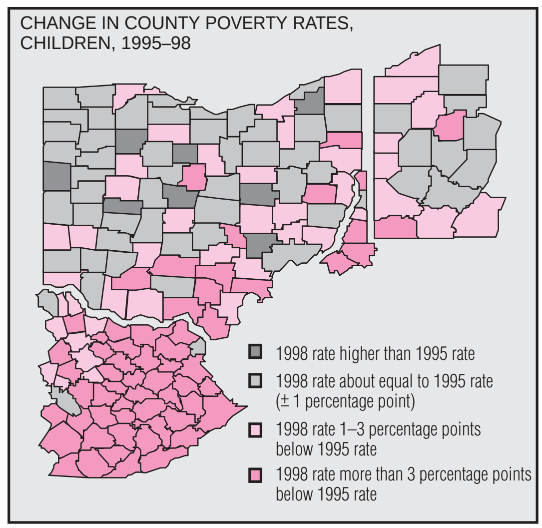
Poverty (cont.)









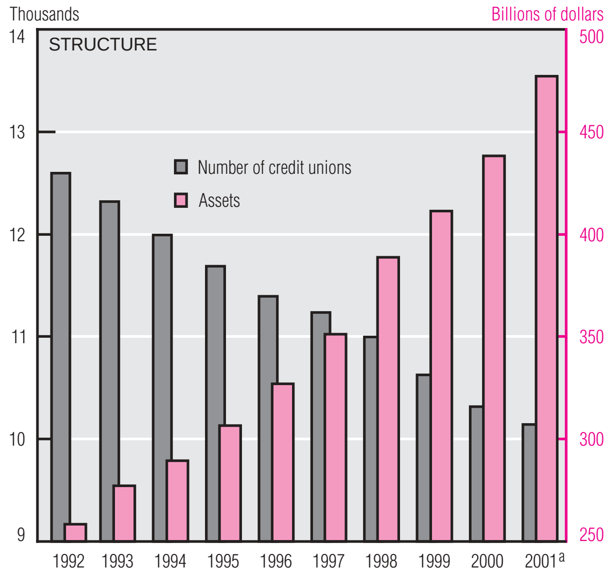
SOURCE: U.S. Department of Commerce, Bureau of the Census.

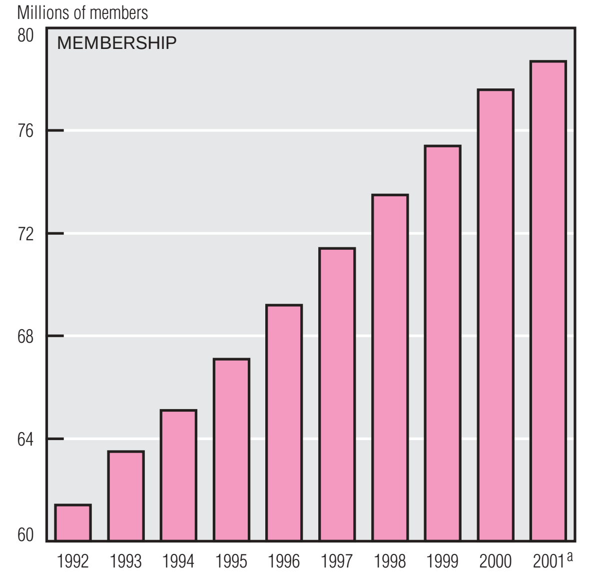
progress in lowering children's poverty rates from 1995 to 1998 (the latest year for which poverty data for children are available). As with general poverty rates, the states where children's rates were lowest in 1995—Alaska, New Hampshire, and Utah—posted increases but still remained substantially below U.S. poverty rates for children in 1998.

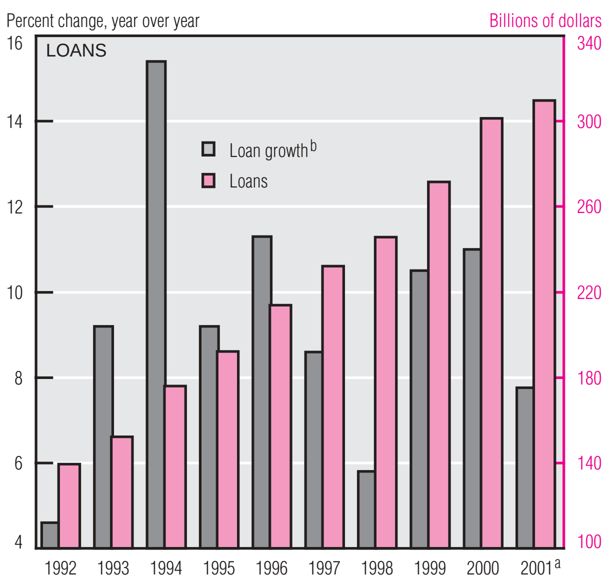
Within the Fourth District, poverty is concentrated around the Appalachian region—the southeast corner of Ohio, the eastern part of Kentucky, and most of the West Virginia panhandle. These areas' poverty rates exceeded the U.S. average in 1998 (the last year for which data are available at the county level). Within the District, the poverty rate was highest in Owsley County, KY (35.2%), and lowest in Delaware County, OH (4.6%). Child poverty rates in Fourth District counties follow geographic patterns very similar to those of overall poverty. In Cuyahoga County and Lucas County, the centers of the Cleveland–Lorain–Elyria and Toledo metropolitan statistical areas, however, children's rates are substantially higher than the national average despite general-population poverty rates about equal to U.S. averages.

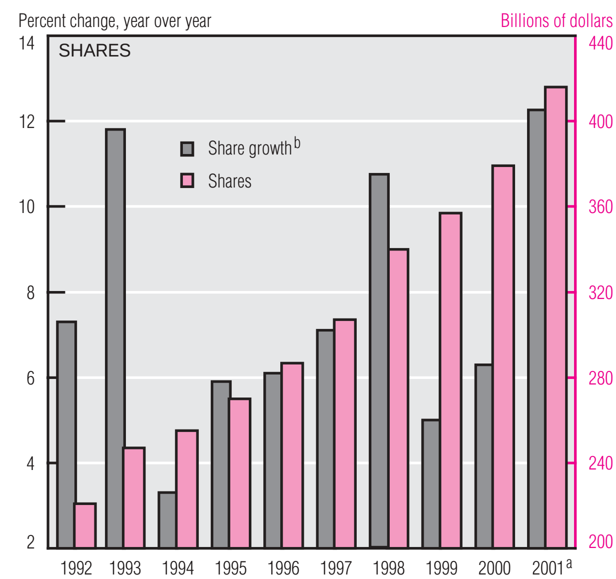
The Fourth District's states have had varying success in lowering poverty. Although Kentucky has made significant improvement, rates in Ohio and Pennsylvania remained relatively stable from 1995 to 1998. The concerted efforts of Fourth District states to improve children's living standards (a goal perennially set forth in state budgets) have been more successful than their attempts to lower poverty rates in general, but several Ohio counties saw child poverty rates rise between 1995 and 1998.

Credit Unions









a. Through June 2001.
b. Growth for 2001 is the percent change from June 2000 to June 2001.
SOURCES: National Credit Union Administration, *Year-End Statistics for Federally Insured Credit Unions* and *Mid-Year Statistics for Federally Insured Credit Unions*, various issues.

Credit unions are mutually organized depository institutions that provide financial services to their members. Like banks and savings associations, credit unions are consolidating. Their numbers fell from 12,596 in 1992 to 10,145 at mid-2001. However, their total assets rose nearly 85% over the same period, from $258.4 billion to $477.2 billion. The number of credit union members also increased steadily from 61.4 million in 1992 to 78.7 million at the end of 2001:IIQ.

Credit unions' asset growth was fueled by positive loan growth throughout the period. Loans rose from $139.5 billion at the end of 1992 to $309.7 billion through June 2001; loans as a share of assets grew from 54% to 65% over the same period. Loan growth was remarkably strong in the early 1990s but tapered off in the middle of the decade. The return to high growth rates in 1999 and 2000 was short-lived, and the rate fell back to 7.8% for the 12 months ending in June 2001. This rate is still higher than the 4.2% loan growth rate of commercial banks over the same period.

Credit union shares (the equivalent of deposits in banks and savings associations) have also risen steadily since 1992. Shares are credit unions' primary source of funds, accounting for roughly 87% of total funds. Share growth increased every year from 1994 to 1998, when it peaked at 10.7%. It fell in 1999, perhaps as the result of high stock market returns in 1998 and 1999. With the weakening of the market, however, shares grew at the 10-year-high rate of 12.3% from June 2000 to June 2001. The largest increase in share dollars occurred in share draft, regular share, and money market accounts, which mature in less than one year.

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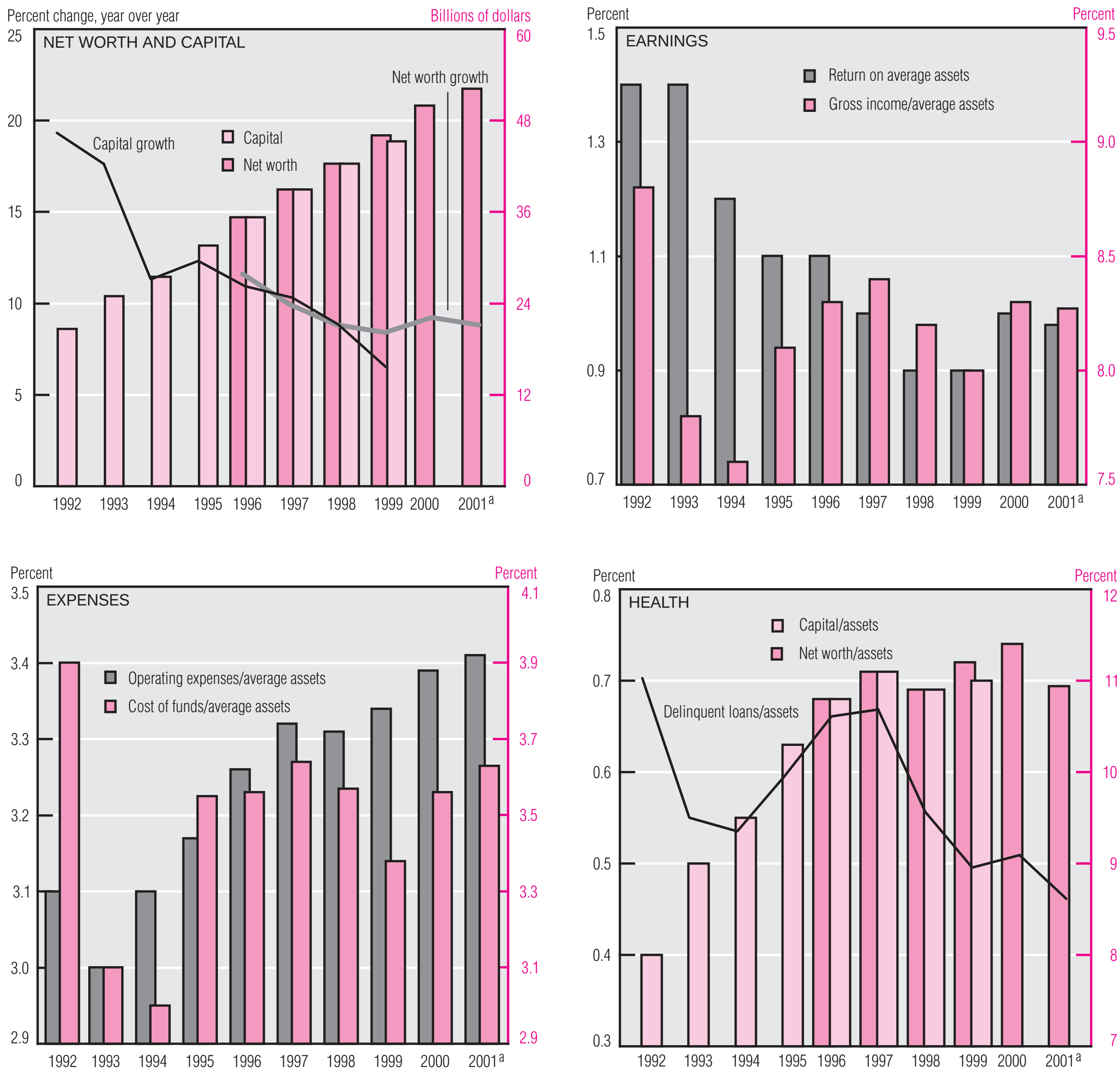
Credit Unions *(cont.)*



a. Through June 2001.
b. Growth for 2001 is the percent change from June 2000 to June 2001.
SOURCES: National Credit Union Administration, *Year-End Statistics for Federally Insured Credit Unions* and *Mid-Year Statistics for Federally Insured Credit Unions,* various issues.

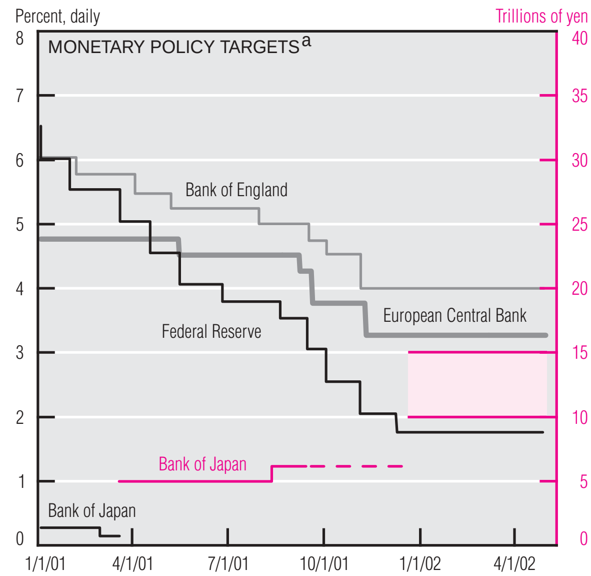
Credit unions continued to accumulate capital from the end of 1992 through mid-2001, more than doubling it over the period. However, the rate of capital growth fell from 19.3% in 1992, using the standard capital growth measure, to 8.8% at the end of 2001:IIQ, using the new "net worth growth" measure. These measures differ in the treatment of allowances for loan, lease, and investment losses. Given the capital growth rate's past ups and downs, it is difficult to tell whether it has stabilized.

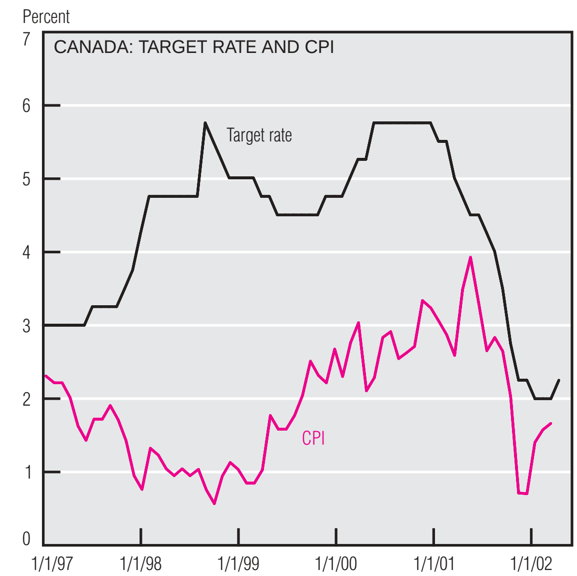
Because retained earnings are credit unions' only source of capital, the pace of capital accumulation since 1995 has matched the decline in return on assets. Return on assets fell from a high of 1.4% in 1992 to 0.9% at the end of 1999, then rose to 1% in mid-2001. The decline in credit unions' profitability during most of the 1990s resulted partly from a persistent increase in operating expenses per dollar of assets after 1993 and a sharp rise in the cost of funds in 1995 due to rising market interest rates.

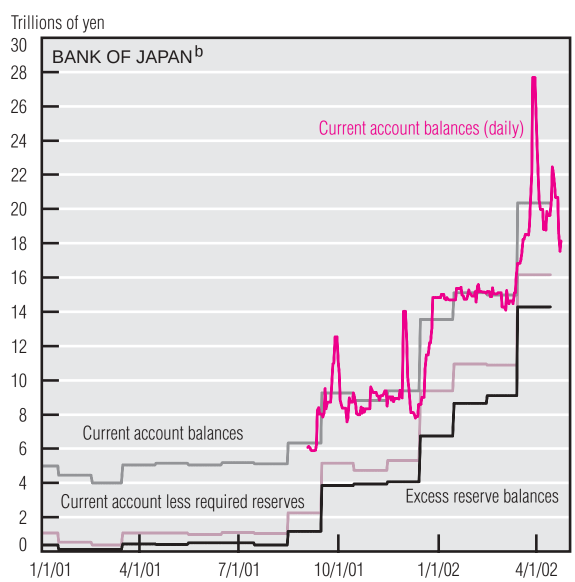
Overall, the credit union industry is healthy. Net worth as a percent of assets has averaged around 11% since 1996; it stood at 10.9% at mid-2001. Moreover, delinquent loans as a percent of assets fell from 0.7% in 1992 to less than 0.5% at mid-2001. In other words, at the end of 2001:IIQ, credit unions held approximately $24 of net worth for every $1 of delinquent loans.

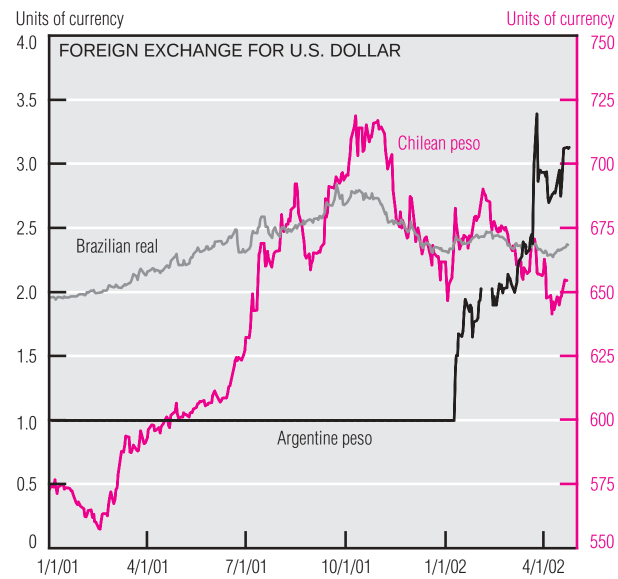
Credit unions have remained viable despite intense competition from commercial banks and savings associations, which provide some of the same services as credit unions (consumer loans, checking accounts, and savings accounts).

Foreign Central Banks









a. Federal Reserve and Bank of Japan: overnight interbank rates (since March 19, 2001, the Bank of Japan has targeted a quantity of current account balances; since December 19, 2001, it has targeted the range of a quantity of current account balances). Bank of England and European Central Bank: two-week repo rate.

b. Current account balances at the Bank of Japan equal 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. All observations are maintenance-period averages, unless otherwise noted.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; Bank of Canada; and Bloomberg Financial Information Services.

The four major central banks continue to keep their policy settings unchanged. The Bank of Canada, on the other hand, raised its policy rate 25 basis points to 2.25% in mid-April. The bank said this move was aimed at "keeping inflation at its 2 per cent target over the medium term" in the face of "stronger-than-expected economic growth in Canada and the United States."

The Bank of Japan, with an unchanged target of ¥10 trillion to ¥15 trillion for current account balances, has tended to supply more than that amount on a daily basis. This is consistent with its announced intention "to provide more liquidity irrespective of the guideline" in case of "a risk of financial market instability, such as a surge in liquidity demand." A surge was expected in connection with the end of Japan's fiscal year (March 31). It remains the case that excess reserves have consumed almost the entire increase in the supply of balances over the past year.

The Argentine peso depreciated sharply toward the end of March, then improved a bit before depreciating again during that nation's most recent difficulties. Some have expressed concern about possible contagion from that nation to the financial position of other Latin American nations. Comovement between the Argentine, Chilean, and Brazilian exchange rates is apparent in the very short run (several days or a week), including the most recent episode in April. However, both of the latter two currencies have seen almost no net change over the entire period since the Argentine peso began its depreciation of more than 60% this year.