Dude, Where’s My Economy?…Objectively speaking, the U.S. economy seems to stand on solid ground. Production and spending accelerated throughout 2003; by year’s end, employment had begun to expand, albeit moderately. Moreover, business and consumer sentiment strengthened throughout the year, and the stock market—the ultimate financial arbiter of expectations—rebounded impressively. Mainstream economic forecasts for 2004 anticipate continued solid growth in economic activity, with joblessness receding and inflation remaining dormant.

Yet the nation still has economic issues to contend with, and public opinion is divided regarding the best course of action. One question that commands attention nationally, but particularly in the Midwest, is the fate of the country’s manufacturing sector. Even manufacturing’s most ardent supporters acknowledge that, for many decades, its contributions to U.S. gross domestic product and employment have been shrinking as a proportion of the economy as a whole.

Such a trend by no means implies that manufacturing businesses or employment have become, or are becoming, unimportant to the country. In fact, improved productivity growth in manufacturing industries is a prominent explanation for manufacturing’s smaller share of the growing national workforce. Over time, strong productivity growth has lowered the prices of many manufactured goods compared to services. And the manufacturing industries can hardly be blamed for another significant factor in the service sector’s expansion—that consumer preferences for services increase disproportionately as household wealth and income increase. Think medical care.

Innovation, productivity, and shifting consumer preferences go a long way toward explaining which industries expand and which contract. Within the context of these longer-term forces, international trade certainly provides additional challenges, as well as opportunities, for domestic manufacturers. Some of today’s business and civic leaders are fixated on the challenges of competing with firms that operate in developing countries, despite two facts. First, longer-term fundamentals historically have influenced the overall size of the manufacturing sector more strongly than foreign competition has. Second, as developing nations mature, they provide expanding markets for U.S.-made goods in which we have a comparative advantage. These desirable items might not be the same ones that originally built up Midwestern manufacturing towns and, in the future, they might not be made in those places either.

As our nation matured, some towns that once prospered because of their location or natural resources were overtaken by innovation, migration, and new methods of doing business. Then, a century ago, the United States entered a stage in which its economic power was expanded tremendously by, but also concentrated in, the hands of monopoly trusts. Abuses of power and corruption doubtless augmented the strength of these trusts, but innovation and productivity were the real forces behind them. It simply made business sense to standardize products, produce in large batches, and streamline the distribution and retailing channels.

We should recall that this era of industrialization brought not only general prosperity but also a reconsideration of the norms of competition and social justice. Innovation and trade can disadvantage some, but they have the potential to create far more winners than losers. Our response to the challenges posed by global trade should not be to resist change but to establish and abide by rules of fairness among the countries that are emerging on the world stage. If we are committed to a world in which nations trade freely with one another, then we must inevitably adjust to the consequences of that commitment.

Fortunately, despite the many trials that lie ahead, the American public seems optimistic about the economy. For example, according to information collected by the Roper Center for Public Opinion Research, the overwhelming majority of respondents to several 2003 surveys expected that the economy would be in better shape after another year and they reported that they were very happy overall in their lives. It is true that most respondents to a December 2003 survey described the nation’s economy as “not so good” or “poor,” but then again, respondents answered this question the same way in 1993.

Hey, people may feel down, but they know they’re not out. Dude, that’s my economy!
The November inflation data show a continuing, generally broad-based pattern of disinflation.

The Consumer Price Index (CPI) declined an annualized 2.6% in November after holding unchanged in October. The decline was partly the result of falling energy prices, which continued their descent by slipping another 3.0% after declining 3.9% in October.

The core CPI, a closely watched measure of inflation that eliminates the CPI’s volatile food and energy components, fell at a 0.6% annualized rate in November, its first decline in more than 20 years. The median CPI and the 16% trimmed-mean CPI, alternative inflation measures designed to exclude the most extreme price changes, rose at a 1.6% annualized rate and declined at a 0.9% annualized rate, respectively. Year-over-year comparisons within the core and alternative CPI inflation measures continued to trend downward.

Core consumer goods prices, which account for 23% of the total CPI, have shown persistent declines over the past two years, and that deflation appears to be accelerating. Moreover, the gap between core services prices and core goods prices continues to widen: Whereas the price level of core services is still increasing at a year-over-year rate of roughly 3.0%, the price level of core goods is deflating at a year-over-year rate of approximately 2.5%. Prices of

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new vehicles, used cars and trucks, household furnishings, and apparel all show persistent declines.

Interestingly, accelerated deflation in core goods prices persists as the year-over-year rate of change in commodity prices continues to rise. Some argue that commodity price movements are a leading indicator of inflation because they are a significant input cost for producers; however, evidence of this leading relationship is mixed. After falling for more than five years, the recent significant increase in commodity prices since mid-2002 has not yet produced a rise in core goods prices.

Meanwhile, the University of Michigan’s Survey of Consumers reveals that household inflation expectations for the next year are falling as well. December survey data suggest that on average, households expect a 2.8% increase in prices in the next year and a 3.1% increase in the next five. The Blue Chip panel of economists still expects CPI-measured inflation to grow at an annualized rate of about 2% over the next five quarters, a forecast similar to the current CPI growth trend. The inflation pessimists predict a rate of 2.8% by 2004, and the inflation optimists now expect a CPI increase of about 1.2% by then, a reduction from last month’s 1.4% estimate.
At its December 9 meeting, the Federal Open Market Committee (FOMC) decided to keep its target federal funds rate at 1%. The press release noted, however, that the FOMC now finds a reduced probability of “an unwelcome fall in inflation.” In line with the October 28 statement, policy accommodation is expected to continue for “a considerable period.”

Market expectations may have reacted more strongly to the minutes of the October meeting, which some market observers took to indicate that the target rate would remain at its current level longer than they had previously expected. They were perhaps reacting to the minutes’ statement that FOMC members felt current trends “were likely to hold inflation to very low levels over the next year or two.”

So it is not surprising that the implied yields of federal funds futures show only small increases through 2004, although a glance at the market’s predictions since 2000 shows it is far from infallible. The December decision also keeps rates well below a popular benchmark provided by the Taylor rule, which posits that the FOMC chooses the target rate as a balanced response to weakness and inflation. The form of the Taylor rule depends on the weights given to inflation and output and to the assumed inflation target. However, the low rates have not led to a surge in the money supply, which has grown less than 5% in 2003.
Much of the current discussion about monetary policy focuses on the prospects for inflation—what do financial market indicators say? Expectations derived from the yield spread between the Treasury’s nominal and inflation-indexed securities show a pronounced upward trend in the latter half of 2003. These expectations have neared their six-year high, although inflation during this period has been low by historical standards.

Some close observers of the gold and commodities markets have become concerned about the risk of higher inflation. Gold prices have posted a dramatic increase of $60 (18%) since March 2003. The commodities futures price also has increased recently, although it remains near the level at which it started the year. Prices for both gold and commodities have increased substantially since 2001. Unfortunately for fans of these two indexes, however, neither shows a strong correlation with inflation. What gold prices show, if anything, is a negative correlation with core CPI inflation. Commodity prices sometimes seem to anticipate future inflation but they have not done so for the past three years.

A classic definition of inflation is “too much money chasing too few goods.” By this definition, comparing the money supply with money demand on the basis of income and interest rates may indicate incipient inflation. While the measure of excess money has trended high in 2003, its record over the past five years suggests that this indicator should be used with caution.

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Another gauge of policy is the relation between the intended federal funds rate and other market rates. A comparison with the two-year Treasury note is particularly apt because that yield is long enough to avoid being a mere reflection of guesses about the Fed’s move, yet short enough to avoid speculation about long-run trends. Except for a few brief episodes, the target fed funds rate has been below the two-year yield since late 2001. Since June 2003, the spread has increased from 11 basis points (bp) to 84 bp, confirming the continued ease of policy.

One more possible comparison is between interest rates and inflation. Inflation means borrowers pay back dollars that are worth less than the dollars they borrowed, so yields should be adjusted for inflation. This makes the real fed funds rate (adjusted for inflation by subtracting the current growth in CPI from the yield) even lower than its minimum nominal value of 1%; in fact, it has been negative for most of the year. One may also estimate real rates using inflation expectations, and the Pennacchi approach estimates 30-day real rates. These have remained steadfastly and substantially negative throughout 2003.

Longer-term real rates, though low, have stayed positive and become more variable. An important real rate, which is thought to have a particular influence on investment spending,
Money and Financial Markets (cont.)

takes a common callable bond, the 30-year GNMA, and subtracts, as an inflation estimate, the yield difference between a 10-year Treasury bond and a 10-year Treasury inflation-indexed security. This option-adjusted rate (dubbed the “Berk rate” after the economist who developed the idea) has decreased lately, falling about 23 bp since mid-October.

Longer-term interest rates, which have moved little recently, remain well above the lows reached in summer 2003. Conventional mortgages have followed the 20-year bond closely, although the spread between them has narrowed from 100 bp to 77 bp since August. Likewise, the yield curve has remained quiescent; indeed, it has ended up near the level it reached at the end of 2002. This means, among other things, that the 10-year, three-month spread remains quite high by historical levels—nearly triple its historical average of 120 bp. Although it is sometimes taken as an indicator of future inflation, it is more reliable as a predictor of strong economic growth in the upcoming year.

International news has been especially prominent in 2003. By one measure, at least, the effect on the financial markets has not been proportionate. The Treasury-to-Eurodollar (TED) spread looks at the difference between the rate on Eurodollar deposits and Treasury notes. It is thought to pick up traders’ worries about international problems because it is a way to arbitrage rates between the U.S. and the rest of the world without bearing any currency risk. The TED spread remains quite low by historical standards.
The U.S. dollar continues to decline, particularly against other major currencies. In December, the dollar reached a new low against the euro. Despite this decline, the current account deficit grew for the second straight year in 2003, primarily because of a trade deficit in goods. Many analysts would agree that the current account deficit, as a proportion of GDP, cannot grow indefinitely. Some research has shown that historically, reversal occurs when the current account deficit reaches about 5% of GDP, slightly below where it stands now. In 1986, the deficit reached 3.5% before falling. These may not be good guidelines for the future, however. As Federal Reserve Chairman Greenspan said in a recent speech, “our debt-raising capacity appears to be related to the reduced cost and increasing reach of international financial intermediation.”

Saying that the current account deficit cannot rise indefinitely is equivalent to saying that the capital account surplus cannot rise indefinitely, since they are tautologically equal. The surplus in the first two quarters of 2003 was financed by accumulating foreign-owned assets in the U.S. that exceeded the outflow of U.S.-owned assets abroad. In the third quarter, foreign claims on domestic assets fell, particularly in foreign direct investment and non-Treasury securities. The capital account surplus was virtually unchanged because outflows of U.S. assets owned abroad fell by almost the same amount. In short, foreigners seemed less willing to invest in non-Treasury domestic assets. If this trend continues, either the rate of return on domestic assets must increase, or the capital account surplus must fall.

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International Markets (cont.)

The strong economic growth of the U.S. compared to the rest of the world may be one reason the current account deficit has been able to increase as much as it has. According to U.S. Treasury Secretary John Snow, “when our economy is growing faster than Europe or Japan it means we are capable of buying more goods from them than they are buying from us.” Since the middle of 2001, GDP and stock market growth from the euro area and Japan have, in fact, lagged behind ours. However, while the U.S. trade deficit with the euro area has been rising predictably over this period, the trade deficit with Japan has been falling. Furthermore, net purchases of long-term domestic securities from Japan have been rising, whereas those from the euro area have been falling. This illustrates the fact that although the total current account deficit must equal the capital account surplus, the equivalence need not hold on a country-by-country basis.

Although our trade deficit with Japan has fallen—partly because of our increased trade with China—Japan continues to be the largest purchaser of long-term domestic securities, and its purchases of Treasury securities continue to grow relative to the rest of the world. China’s economy and exports have grown more than those of surrounding countries, but the stock indexes of the newly industrialized Asian countries have significantly outperformed China’s stock market this year—and ours as well, for that matter. China itself runs a large trade deficit with these countries and probably will have a small current account surplus in 2003.
Even with a benchmark revision, the final real gross domestic product (GDP) for 2003:IIIQ contained no surprises. Real GDP surged ahead 8.2%, the same as in the last estimate. The only changes worth mentioning are that final sales were revised up slightly and inventory investment was revised down.

Real personal consumption accounted for 4.9 percentage points of the total increase in real GDP, far above the average increase of 2.6 percentage points over the last four quarters. Business fixed investment was the next-largest contributor, adding another 1.25 percentage points. The only negatives were inventories and imports, each subtracting about 0.1 percentage point, but this was far less than the 0.4 percentage point drag that each exerted over the last four quarters.

Although Blue Chip forecasters do not expect the third quarter’s outsized real GDP growth to continue, they do predict that real growth will average nearly 4% over the next four quarters. This is well above the 3.2% average growth of the last 30 years.

Investors will be very pleased with corporate profits’ strong rebound. As a percent of GDP, corporate profits are at the highest level since 1997:IIIQ. Pretax earnings adjusted for inventory earnings and depreciation rose 9.9% in the third quarter of 2003, after pushing forward 10.3% in the second quarter.

Strong GDP growth in the second half of 2003 has boosted industrial

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Production and manufacturing production to their highest levels since March 2001, yet they remain about 3% below their respective June 2000 peaks. Mirroring this improvement in production, their rates of capacity utilization have also rebounded from the most recent lows. After falling as far as 74.0% for industrial production and 72.6% for manufacturing late last spring, in November they recovered to 75.7% and 74.3%, respectively. Nonetheless, they remain far below the roughly 80% they tended toward in the late 1990s.

Performance for some high-tech industries has been a bit brighter. Semiconductor production is up more than 150% from January 2000. Although its capacity utilization is down from the remarkable 100% achieved in May 2000, the current 82.4% is much more sustainable, close to the 83.3% it averaged in the 1990s. Production of computers and peripheral equipment is up a still-impressive 57%, although its capacity utilization of 74.4% is significantly below its 1990s average of 79.4%

Communication equipment manufacturers have recovered somewhat from the aftereffects of their boom around the turn of the millennium, but have not yet recovered fully. Production in this sector is still down about 5% from its January 2000 level, and capacity utilization remains at only 52.1%, which is higher than its 46.9% nadir but far lower than its 1990s average of 81.4%.
The labor market’s 2003 performance was mixed, with disappointing numbers for the first half of the year and significant improvement in the final four months. From the beginning to the middle of the year, total nonfarm employment posted net losses; after August, payroll employment increased by 328,000 jobs. Employment trends across industries such as professional and business services, education and health services, and construction have strengthened in 2003. In recent months, job gains have been increasingly broad based. By November 2003 (the latest available data), the share of industries that reported a net increase in employment was at its high for the year. Since 2001, the long-suffering manufacturing industry has posted a net loss of 2.5 million jobs; in recent months, that number has begun to decline.

The diffusion index of employment shows whether establishments’ payroll has increased, decreased, or stayed the same. An index score of 50 means that the number of establishments where employment increased equaled the number where it decreased. The diffusion index’ one-month span for total private employment approached 50 in September for the first time in 2003, then continued to rise, reaching 54.7 in November. The manufacturing sector’s index varied between 19 and 42 in 2003 until hitting 42.3 in November. Over the course of the year, the numbers of
layoff events and initial unemployment insurance claims declined. Although they trended upward again in recent months, they remained below the levels recorded at the beginning of 2003.

In January 2003, the share of men holding more than one job increased, then decreased, until the year-end figure was close to January’s. From February to April, the corresponding figure for women declined precipitously but it regained its share over the course of the year. The employment-to-population ratio for men fell in the first few months of 2003 and then rose to 69.1 by November. For women, it fell over the course of the year. The overall unemployment rate varied between 5.7% and 6.4%, reaching 5.9% in November. The jobless rate for all groups rose in the first half of 2003. Although it trended downward in the second half of the year (except for teenagers), it was nonetheless higher in November than in January 2003. The share of those unemployed for a short duration (less than five weeks) and those with a medium duration (five to 14 weeks) fell over the past year, but the share of those unemployed for a longer duration (15 weeks or more) rose significantly. At the beginning of 2003, 37% were unemployed for 15 weeks or more; by year’s end that number had risen to 41%; for those unemployed less than five weeks, the share fell from 32.6% to 30.1% over the same period.
Migration of College Graduates

The U.S. Department of Education conducts a Baccalaureate and Beyond survey that tracks the location, employment, and family patterns of college graduates. So far, this longitudinal study has looked at students who obtained their degrees in 1993 and those who obtained their degrees in 2000. The first study surveyed students in April 1993, when they graduated, and again in April 1994 and April 1997. The 2000 class was surveyed in April 2000 and April 2001 and will be surveyed again in April 2004. The survey provides a unique opportunity to track college graduates as they move from state to state.

Among 1993 graduates, 72.4% were still in the state where their degree-granting college was located one year after graduation (1994), and 66.7% were still in the same state as their degree-granting institution four years after graduation (1997). Retention rates in the Fourth District states of Ohio and Kentucky exceeded the national average in both 1994 and 1997: More than ¾ of Ohio graduates still lived in the state in 1994, and just over 73% still lived there in 1997. Kentucky’s retention rate rose during the survey period: In 1994, 80.9% of Kentucky graduates lived in the state; by 1997, that figure had risen to 83.3%, the highest retention rate of any state for which data were available in the 1997 survey.

Respondents in the survey of 2000 graduates seemed more willing to move, within a year of graduation, from the state in which they attended college: In 2001, 69.2% of 2000 grads nationwide were still in the state where their school was located. Although Ohio’s retention rate of 65.1% was below the national mean, it

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Migration of College Graduates (cont.)

2000 GRADUATES FROM OHIO COLLEGES: LOCATION IN 2001
65.9% of 2000 graduates from Ohio schools remained in Ohio in 2001.

2000 GRADUATES FROM PENNSYLVANIA COLLEGES: LOCATION IN 2001
63.8% of 2000 graduates from Pennsylvania schools remained in Pennsylvania in 2001.

2000 COLLEGE GRADUATES LIVING IN OHIO IN 2001: LOCATION OF DEGREE-GRANTING COLLEGE
80.0% of Ohio residents who graduated from college in 2000 attended Ohio colleges.

2000 COLLEGE GRADUATES LIVING IN PENNSYLVANIA IN 2001: LOCATION OF DEGREE-GRANTING COLLEGE
78.8% of Pennsylvania residents who graduated from college in 2000 attended Pennsylvania colleges.

NOTE: Data not available for Alaska and Hawaii.

was well within the average range: The middle 25 states had retention rates between 60% and 71%. The Fourth District states of Kentucky, Pennsylvania, and West Virginia were also among the middle 25, with retention rates of 69.0%, 63.4%, and 61.6%, respectively. Five states were able to keep more than four out of every five (80%) graduates they produced in 2000, five others could not keep even half.

In studying the 2001 data, it is important to remember that economic factors unique to the recession may have affected retention rates. Both Ohio and Pennsylvania were net exporters of education in 2001, with Ohio exporting a net of roughly 9,000 graduates, and Pennsylvania exporting about 12,000. A major cause of this phenomenon was undoubtedly the region’s struggling labor markets. A number of critical industries in both states underwent significant job reductions both before and during the recession.

Of students leaving Ohio and Pennsylvania on graduation, a significant number move to California, Florida, and New York. Apart from migrants to those populous states, most graduates tend to move within the region: Ohio grads tend to stay in the Great Lakes region, while Pennsylvania grads who move out of state tend to favor the East Coast. Just as some of the students educated in Ohio and Pennsylvania elect to move out of those states when they graduate, some students graduating from schools in other states choose to move into Ohio and Pennsylvania. In Ohio, the largest share of immigrating college grads come from Indiana schools, while the largest share of those migrating to Pennsylvania are from Ohio schools.
In 2003:IIIQ, FDIC-insured commercial banks’ net operating income improved on the previous quarter and recovered strongly from its dip in 2002:IVQ. Compared to a year earlier, it was up 17.4%. Net income, the sum of net operating income and securities gains and losses, was also up, gaining 10.6% relative to a year earlier. The increase in earnings was kept in check by reduced gains on the sales of securities and other assets.

Commercial banks’ total interest income, at $83 billion, declined slightly from the previous quarter. Because of falling interest rates, it was significantly less than the $113 billion achieved in 2000:IVQ. Total noninterest income continued to rise, reaching a level 9.3% higher than a year earlier, another sign that the earnings pressures affecting banks during the recession of 2001 are abating.

The improvement in overall earnings occurred despite the narrowing net interest margin (interest plus dividends earned on interest-bearing assets minus interest paid to depositors and creditors, expressed as a percentage of average earning assets). It declined from 4.09% in 2002 to 3.81% in 2003:IIIQ.

Although low interest rates are one cause of shrinking margins, another reason, just as important, is strong asset growth. Assets of FDIC-insured commercial banks grew 7.8% (annualized) in 2003:IIIQ. Yet, even with near-record asset growth, depository institutions’ return on assets reached almost 1.4%, the highest since 1989. Return on equity, at 15.2%, was at its post-1999 peak.

Although net loans and leases as a share of total assets increased slightly to 57.2% in 2003:IIIQ compared to the previous quarter, it was still down (continued on next page)
FDIC-insured commercial banks' improvement in asset quality was also reflected in the decline of unprofitable institutions' share to 5.4%. Problem banks (those with substandard exam ratings) as a proportion of total banks also fell to 1.34%. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) rose to 141% in 2003:IIIQ from 127% at the end of 2002, the first increase since 1997. Core capital, which protects commercial banks against unexpected losses, increased slightly to 7.86%. All of these performance indicators show that the banking sector is strengthening.
The four major central banks left their policy targets unchanged as the British pound, the euro, and the yen continued to appreciate relative to the U.S. dollar. While the Bank of England held its repo rate at 3.75%, one member of its Monetary Policy Committee voted against the decision, preferring a 4% rate. Also, consistent with last June’s announcement and with practice elsewhere in the European Union, the Chancellor of the Exchequer has reset the Bank’s inflation target to 2%, reflecting a change to a harmonized index of consumer prices as the basis for targeting.

According to the Bank of Japan, economic recovery is expected to continue, “albeit at a moderate pace,” and consumer prices are “basically projected to continue falling slightly.” Likewise, the European Central Bank “noted that the economic recovery in the euro area has started and that confidence has strengthened further”; that annual inflation rates are likely to fluctuate around 2% over the coming months; and “that a gradual and limited decline should take place later on.”

In a somewhat controversial decision, the European Council held in abeyance the Excessive Deficit Procedures that the European Commission recommended imposing on France and Germany. The Commission’s autumn forecasts projected that the two nations’ government deficits and debt would remain above the Growth and Stability Pact ceilings of 3% and 60% of GDP, respectively, through 2005.