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# *ECONOMIC TRENDS*

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1	•	•	•	•	<i>The Economy in Perspective</i>		
2	•	•	•	•	•	<i>Inflation and Prices</i>	
4	•	•	•	•	•	<i>Monetary Policy</i>	
6	•	•	•	•	<i>Household Saving and Debt</i>		
8	•	•	•	•	•	<i>The World Economy</i>	
10	•	•	•	•	•	<i>Economic Activity</i>	
12	•	•	•	<i>U.S. and Foreign Manufacturing</i>			
13	•	•	•	•	<i>U. S. Employment Changes</i>		
14	•	•	•	•	<i>Fourth District Employment</i>		
17	•	•	•	•	•	•	<i>FDIC Funds</i>
18	•	•	•	•	•	<i>Foreign Central Banks</i>	

## *The Economy in Perspective*

*Off we go (into the wild blue or red yonder)...* We write this page in complete ignorance of the election results; ballots will not even be cast for another few days. Will the outcome matter for the economy? Of course it will. Presidents can influence legislation whether their party controls the Congress or not. Through control over the executive branch's administrative machinery, presidents also have considerable power to influence how laws are implemented on a daily basis. Laws and regulations affect so many aspects of commerce that it would be a mistake to think that presidential politics do not affect the pattern of economic activity.

But it would also be a mistake to attribute too much to presidential decisions. First, we Americans have taken comfort in the center of political and economic thinking for quite some time, and we get nervous when presidents want to lead us away from that zone for any extended time. Consequently, they do not. Second, our large, complex economy is difficult to fine-tune through policy actions alone. Laws and regulations affect certain features of our economy, but they often carry unintended consequences that undermine or distort the original objectives. Sustained macroeconomic performance, manifested in per capita income over time, has less to do with presidential decisions than with our country's support for strong property rights, deep capital markets, labor market flexibility, education, and innovation.

Nevertheless, the cumulative effects of presidential and congressional decisions, spanning political parties and ideology, inevitably affect our economy's evolution and performance. The federal government's involvement with retirement saving (through Social Security) and health care (through Medicare and Medicaid), as well as the tax treatments that apply to these activities, undoubtedly influence the private decisions of millions in regard to their own retirement and health care plans. We know that the demand for richer pensions and better health care is essentially infinite, and without program reforms of some kind, these pressures threaten to push the Treasury beyond its capacity to satisfy the claims of all participants. With the impending retirement of the baby boomers and their attendant medical needs in old age, the nation urgently needs solutions.

The retirement question comes down to how much people should save voluntarily for their own future, versus how much they should rely on a

federal pension. The answer has implications for incentives to work, the private saving rate, and possibly capital formation. How our government participates in health care over time will likely also affect the level of resources we as a nation channel into the health care system, meaning the number, type, and location of hospitals, doctors, medical research, pharmaceuticals, and so on. These decisions, in turn, will have feedback effects on the prices and availability of other goods and services.

Political leaders in both major parties have supported the expansion of trade during the last 50 years. Trade has become a highly visible issue during the last dozen years because the volume of U.S. exports and imports has become fairly significant, especially imports. Although it is popular to claim that the United States has a large trade imbalance with the rest of the world because of cheap foreign labor, the story is far more complicated. After all, foreign companies regularly locate facilities in this country, often paying workers higher wages than U.S. employers pay.

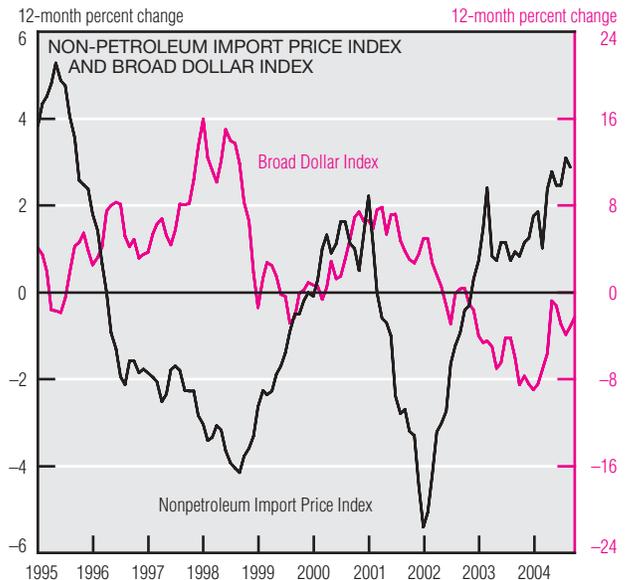
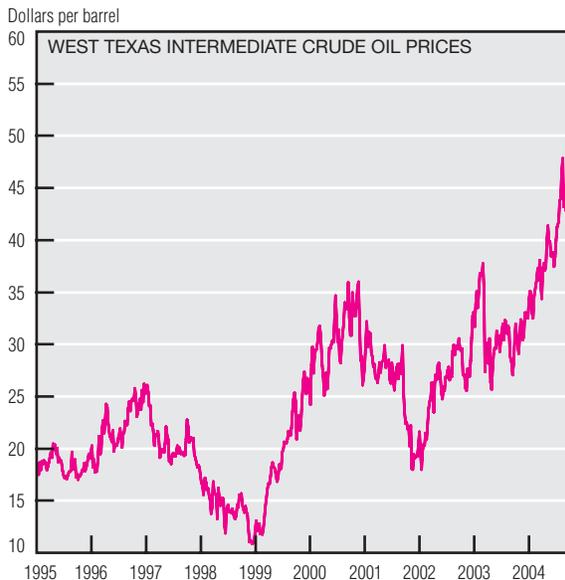
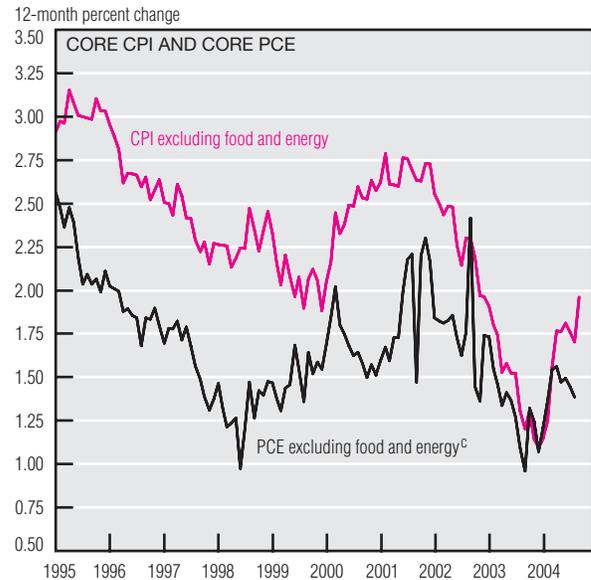
Many people fail to see the connection between imports and our nation's insatiable dependence on foreign capital to help finance our federal outlays (including payments for retirements and health care) and our record levels of home mortgages (housing is one of the most tax-preferred assets available to the public). U.S. households, businesses, and governments do not save enough, collectively, to finance all of the investment that our citizens wish to undertake. In fact, we have become a debtor nation of immense proportions.

The exchange value of the dollar depends on supply and demand: foreign savers, especially those in Asian countries, have been strong demanders of dollars in recent years. If foreigners were to provide us with less of their savings and hold fewer dollar assets, then, all else being equal, the dollar's value would probably fall. Many analysts expect that such a development, should it occur, would be accompanied by rising U.S. interest rates and import prices. U.S. consumers would be less likely to benefit from inexpensive imports, and rising interest rates would curb demand for housing and automobiles.

Many observers think that several aspects of the U.S. economy are on nonsustainable paths. But markets have ways of correcting misalignments, even when political solutions appear elusive. Sustainability has both political and economic dimensions.

# Inflation and Prices

	Percent change, last:				2003 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>September Price Statistics</b>					
<b>Consumer prices</b>					
All items	1.9	0.6	2.5	2.5	1.9
Less food and energy	3.7	1.8	2.0	2.1	1.1
Median <sup>b</sup>	1.4	2.0	2.4	2.9	2.1
<b>Producer prices</b>					
Finished goods	0.8	0.3	3.3	2.0	4.4
Less food and energy	4.0	1.1	1.9	1.0	1.1



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Personal Consumption Expenditures Price Index.

SOURCES: Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," H.10, *Federal Reserve Statistical Releases*; Federal Reserve Bank of Cleveland; and *Wall Street Journal*.

The September inflation statistics showed neither a continuation of the disinflation seen for much of the summer nor the significant reacceleration of inflation that seemed to be occurring last spring.

The Consumer Price Index (CPI) rose 1.9% during the month, a slower pace than its sharp rise of 4.8% in the second quarter but faster than its slight 0.6% uptick in the third. Surging costs of petroleum and other imports have made it difficult to identify a distinct inflation trend. The cost of crude oil has continued to rise at an alarming pace, recently breaking \$55

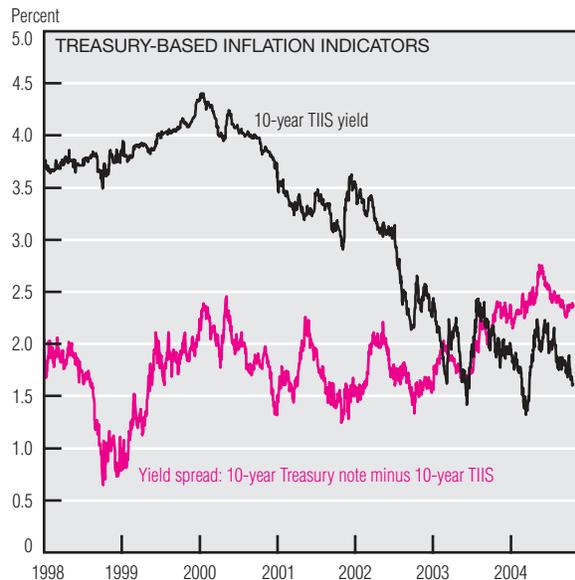
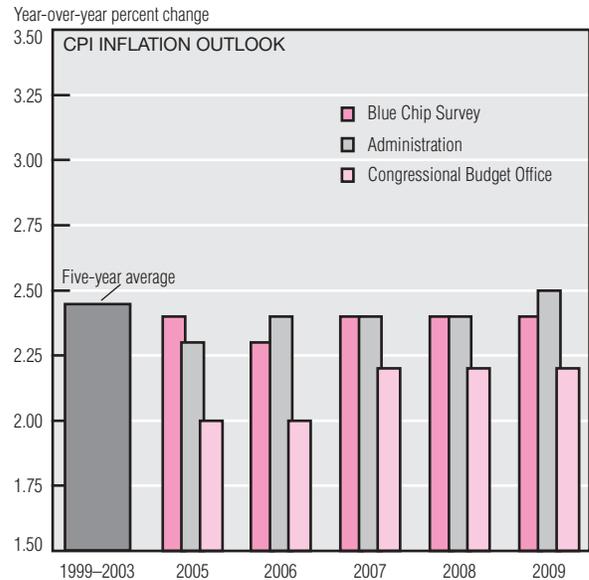
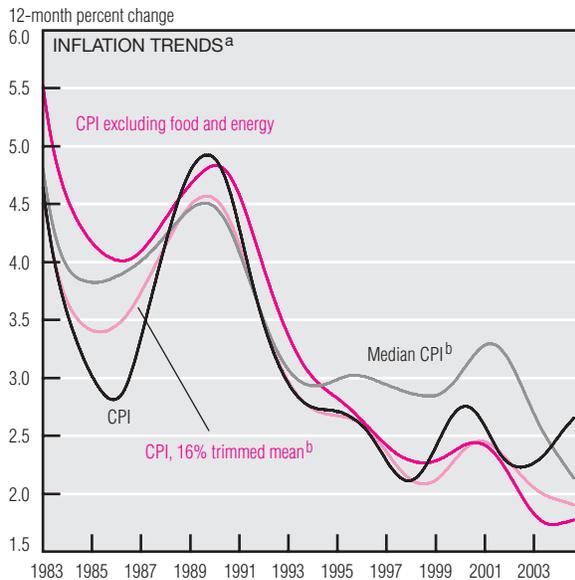
a barrel for West Texas intermediate crude—an increase of 80% since the beginning of the year. Meanwhile, the dollar devaluation that began in late 2002 has been putting upward pressure on nonpetroleum import prices, which, at around 3%, show the highest growth rate in almost a decade.

The rising cost of oil and other imports can have a major impact on households' cost of living. They can also cause a temporary fluctuation in the price indexes that otherwise would help us gauge inflation, making it difficult to know whether the change is part of a generalized rise in

the overall price level. Unfortunately, the core inflation measures, which help us see through the price data's monthly volatility to gauge its underlying trend, showed mixed behavior in September. The growth rate for CPI excluding food and energy jumped to 3.7%—its largest increase since last March—while the median CPI showed an increase of only 1.4%—its smallest rise since June 2003.

Economists often use statistical "filters," which smooth the data to reveal their trend and cycle components. Applying one popular filter to *(continued on next page)*

## Inflation and Prices (cont.)



### Selected Leading Inflation Indicators

	Percent change last:	
	12 mo.	3 mo. <sup>c</sup>
Gold prices	8.5	26.7
Commodity Futures Price Index	14.5	8.7
Commodity Price Index	13.6	1.6
Institute for Supply Management's Manufacturing Price Index	35.7	-22.5
Nonpetroleum Import Price Index	2.9	1.6
Domestic nonfinancial business debt <sup>d</sup>	2.1	1.4

a. Inflation trends in the price measures determined using the Hodrick–Prescott filter.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Annualized.

d. Quarterly data.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Office of Management and Budget, *Mid-Session Review, Budget of the United States Government, Fiscal Year 2005*, July 2004; Congressional Budget Office, *The Budget and Economic Outlook: An Update*, September 2004; Federal Reserve Bank of Cleveland; *Blue Chip Economic Indicators*, October 10, 2004; Commodity Research Bureau; Institute of Supply Management; and Bloomberg Financial Information Services.

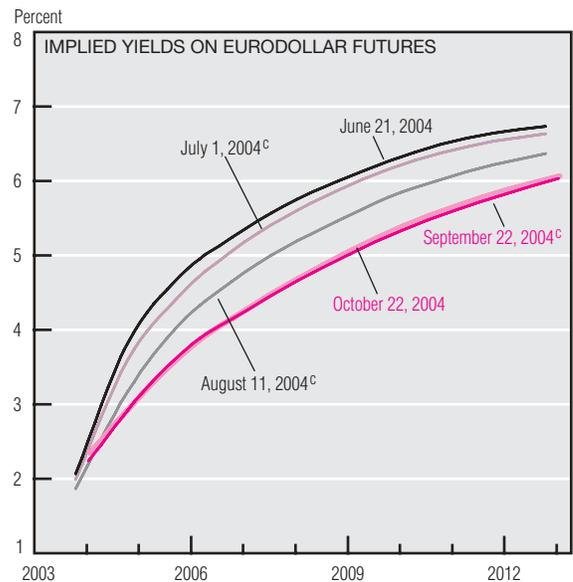
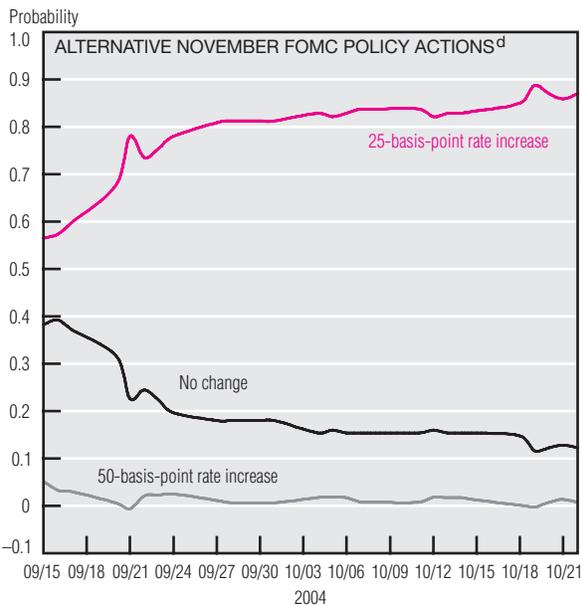
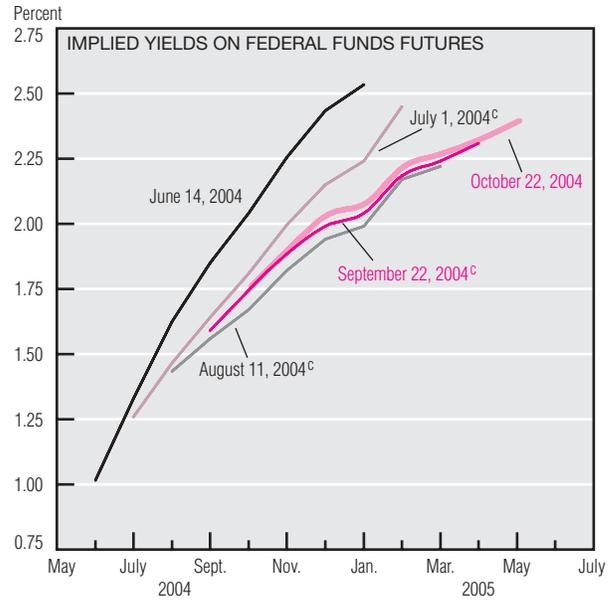
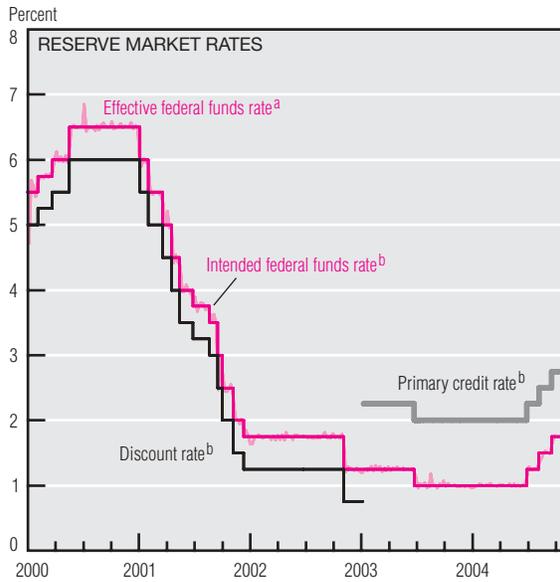
the alternative CPI measures indicates the inflation trend is somewhere between 1.75% and 2.50%. This resembles the CPI growth rate for the past five years and is in the range of long-term forecasts. For example, the consensus view of economists provided by the Blue Chip survey predicts an average rise of 2.4% in the CPI over the next five years. This estimate is about the same as the Administration's forecast and only slightly higher than that of the Congressional Budget Office.

Similarly, only a few indicators that economists use to spot changes in the inflation trend have shown signs that it is changing. In financial markets, the yield spread between ordinary 10-year Treasury securities and TIPS (Treasury inflation-indexed securities) is 2.4%, which is near its level for the past year and consistent with the various economic projections. The constellation of leading inflation indicators, which economists have touted from time to time, has failed to reveal any clear change in the inflation trend. On the

one hand, gold prices are up 8.5% in a year and almost 27% (annualized) in the past three months.

Commodity futures prices likewise have been rising at an above-average rate. However, commodity spot price increases have been subdued over the past three months, and purchasing managers' price reports have been falling. Another closely watched barometer of future inflation—growth in domestic nonfinancial business debt—continues to rise only modestly.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. One day after the FOMC meeting.

d. Probabilities are calculated using prices from options on November 2004 federal funds futures that trade on the Chicago Board of Trade.

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.

At its most recent meeting, held on September 21, the Federal Open Market Committee (FOMC) raised the target federal funds rate 25 basis points (bp) to 1.75%, the third such increase since the record low of 1.00% was reached in June 2003. Many Federal Reserve officials have publicly stated that the federal funds rate remains accommodative. Market participants anticipate that the federal funds rate will rise; however, the timing and magnitude of the increase are uncertain.

Federal funds futures contracts are one tool for gauging short-term policy

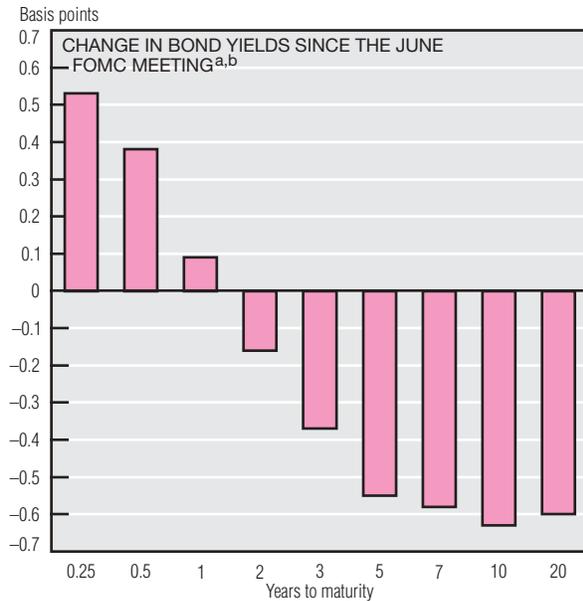
expectations. Expectations of policy changes have remained relatively stable since August, and market participants currently expect a further increase of at least 50 bp over the next six months. However, since the FOMC began to raise rates at the June 29–30 meeting, market participants have postponed their expectations of subsequent increases in the federal funds rate and have revised expectations down about 50 bp since mid-June. Market participants now expect the rate to be roughly 2.0% by the end of 2004. The federal funds options market allows calculation of

the probabilities associated with various federal funds rate changes. It indicates that market participants place a probability of nearly 90% on a 25 bp increase in the federal funds rate at the November 10 meeting. This suggests that participants anticipate a pause in rate hikes in December.

Eurodollar futures, often used to gauge long-term policy expectations, reveal a similar pattern: While longer-term expectations have declined since the beginning of the latest round of federal funds rate increases, they have recently stabilized.

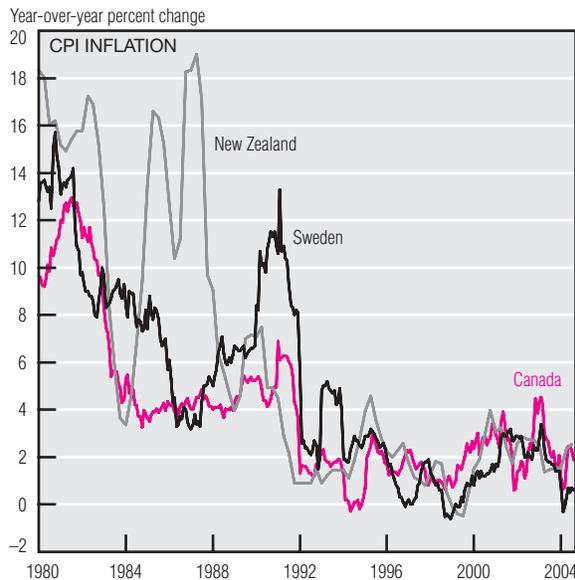
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## Monetary Policy (cont.)



### Inflation Objectives of Selected Countries

Country	Objective <sup>c</sup>
U.K.	2%
Canada	1% to 3%
Sweden	1% to 3%
Australia	2% to 3%
New Zealand	1% to 3%



a. All yields are from constant-maturity series.

b. Difference between the average of the week ending July 2, 2004 and the week ending October 22, 2004.

c. Inflation as measured by the year-over-year percent change in each country's consumer price index.

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

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Statistics Canada; Statistiska Centralbyran (Statistics Sweden); Statistics New Zealand; University of Michigan; and Bloomberg Financial Information Services.

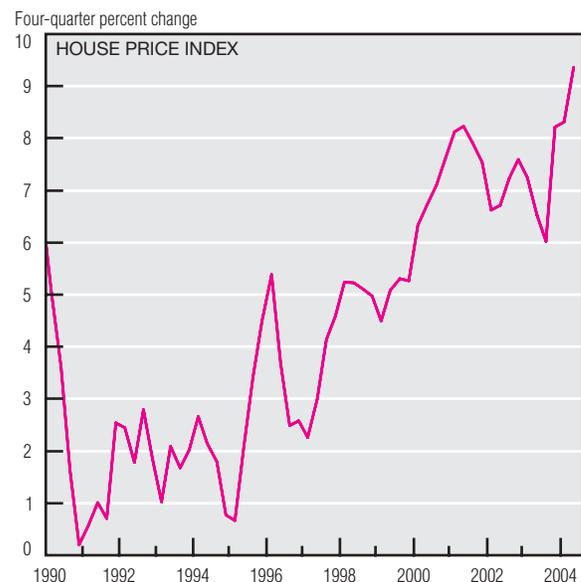
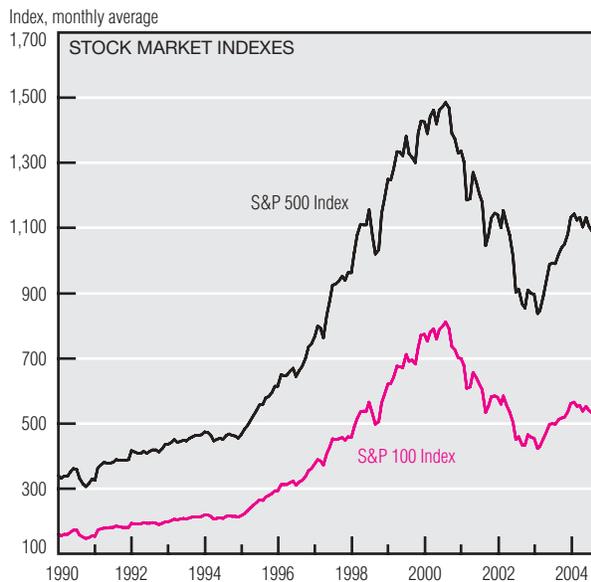
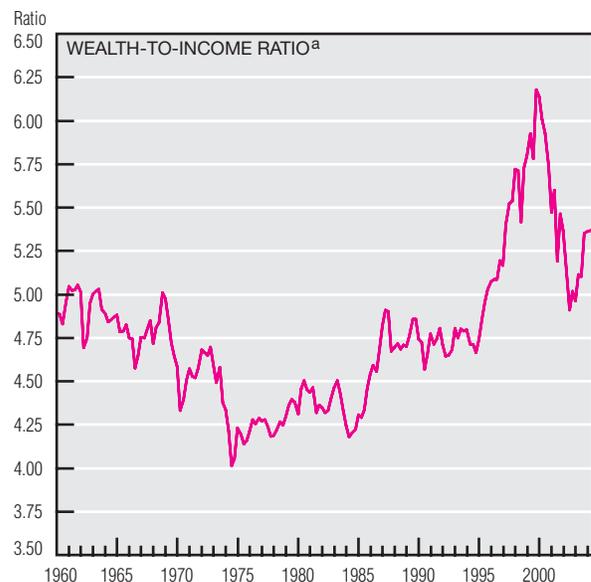
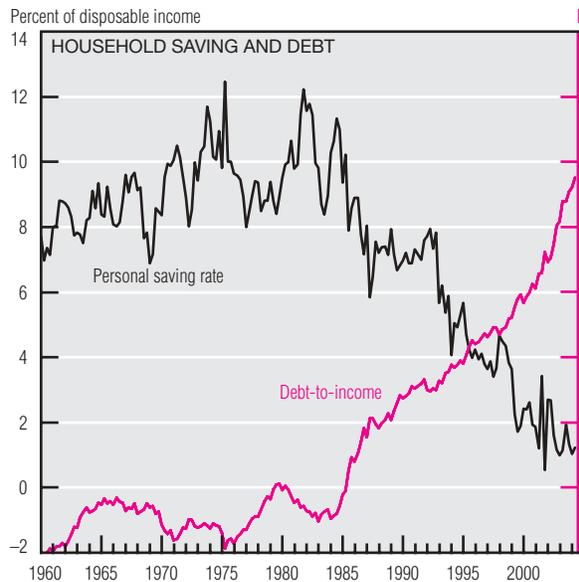
The yield curve has shifted downward across the intermediate- and long-term maturities since the Federal Open Market Committee began the current round of federal funds rate increases. The yields on both the 10- and 20-year maturities fell about 60 bp. Some suggest that the flattening of the yield curve reflects the lower real rate of return on capital resulting from rising energy costs. Others argue that despite rapidly rising energy prices, the flatter yield curve reflects lower long-term inflation expectations. This suggests that the Federal Reserve's price stabilization policy has credibility—

participants believe the Fed will not allow inflation to accelerate in response to the energy price shocks.

Anchoring inflation expectations is a crucial component in stabilizing prices. Some countries have established explicit inflation targets to help achieve and maintain price stability. For example, Canada, Sweden, and New Zealand set inflation target ranges of 1.0% to 3.0% (as measured by each country's consumer price index) in the early 1990s. The range of growth in consumer prices throughout these countries has declined over the past decade.

However, some analysts argue that a central bank needn't explicitly define an inflation target if it can gain credibility for maintaining low and stable inflation, thereby anchoring inflation expectations. Indeed, U.S. households have significantly reduced the range in which their short-term and long-term inflation expectations have varied since the 1970s: Short-term expectations have ranged between roughly 2.5% and 4.0% over the past decade, while long-term expectations have ranged between 3.0% and 4.0%.

# Household Saving and Debt



a. Wealth is defined as net worth; income is defined as personal disposable income. Data are not seasonally adjusted.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Office of Federal Housing Enterprise Oversight; Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1; and *Wall Street Journal*.

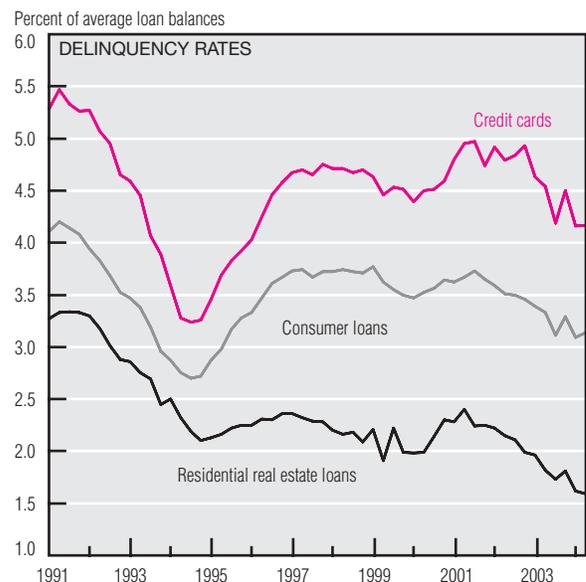
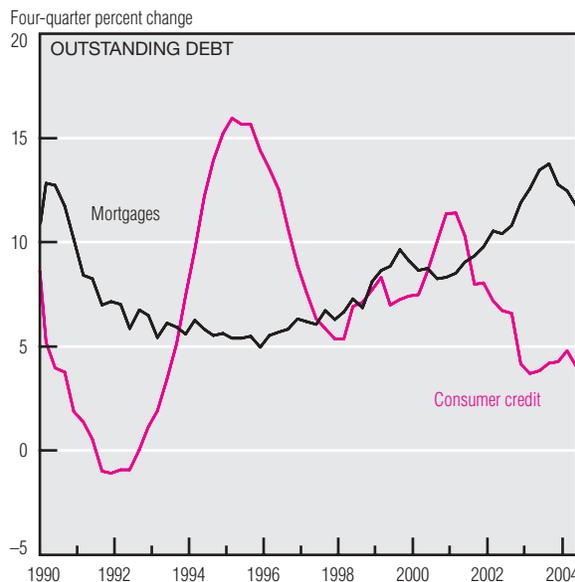
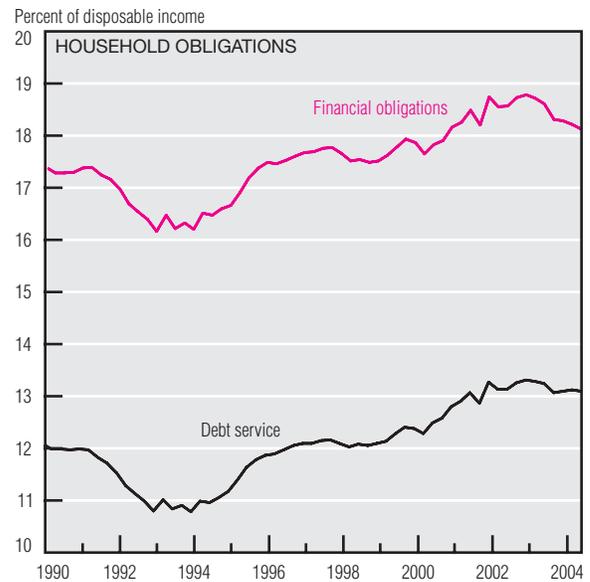
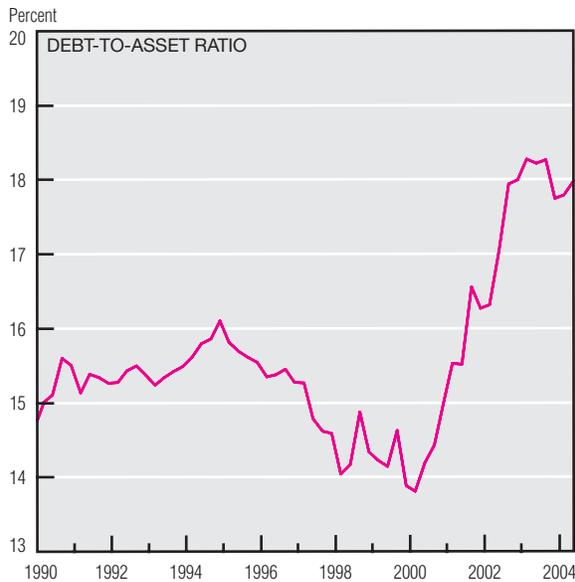
Over the past two decades, the personal saving rate in the U.S. has declined from about 10% to 1.2%. Meanwhile, the debt-to-income ratio has nearly doubled, reaching a record of almost 1.2. Several explanations exist for at least the recent drop in the personal saving rate. Some suggest that because of the significant productivity gains made in recent years, households have increased expectations for their long-run future income and so have increased their current spending. Another explanation suggests that households save less relative to their current income because of their rising

net worth, which is attributed to large capital gains in such assets as equities and residential real estate.

Indeed, households' net worth has increased significantly, largely because of stock market gains and home price appreciation. Since 1990, the S&P 500 Index has appreciated nearly  $3\frac{1}{2}$  times ( $4\frac{1}{2}$  times at its peak in late 2000), while average housing prices have almost doubled and continue to accelerate. In a recent speech, Federal Reserve Chairman Alan Greenspan said, "Despite the recent high debt-to-income ratios... taking into account this higher level of assets, all in all, the

household sector seems to be in reasonably good financial shape with only modest evidence of an increased level of household financial strain." However, he cautioned that "ratios of household debt to income appear to imply somewhat more stress than is likely to be the case... household debt has been rising faster than income as ever-higher levels of discretionary income have increased the proportion of income spent on assets partially financed with debt." While the debt-to-income ratio may be an indicator of household financial stress, Chairman  
*(continued on next page)*

## Household Saving and Debt (cont.)



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, "Charge-Off Delinquency Rates on Loans and Leases at Commercial Banks," and "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1.

Greenspan also pointed out that the ratio reflects a rise in home ownership, improved information technology that enables lenders to reach more households, and increased home equity loans resulting from home price appreciation.

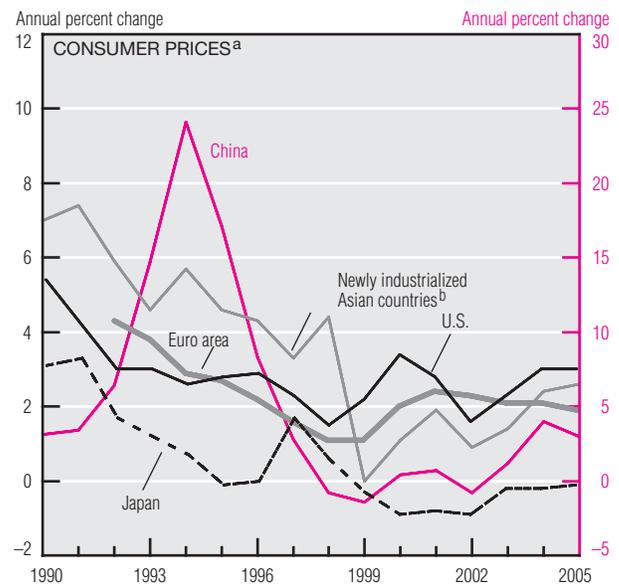
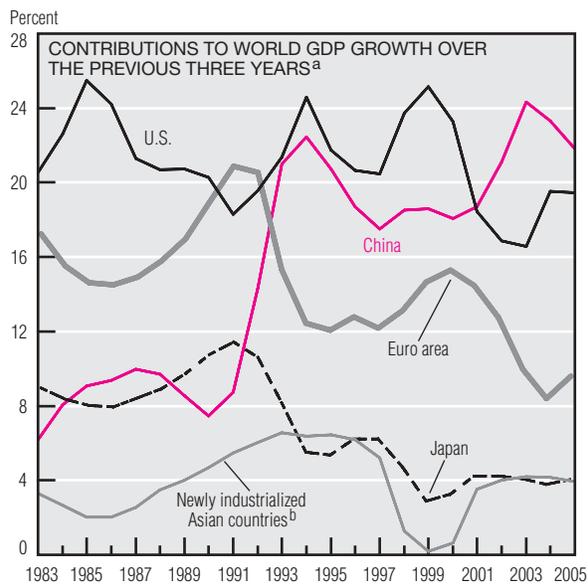
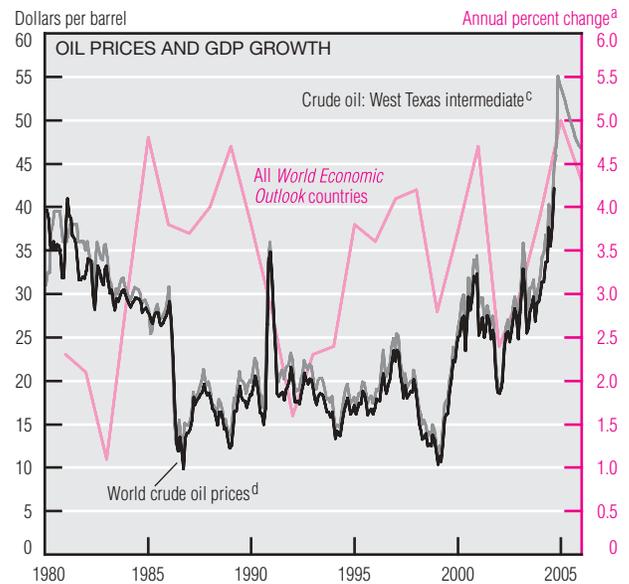
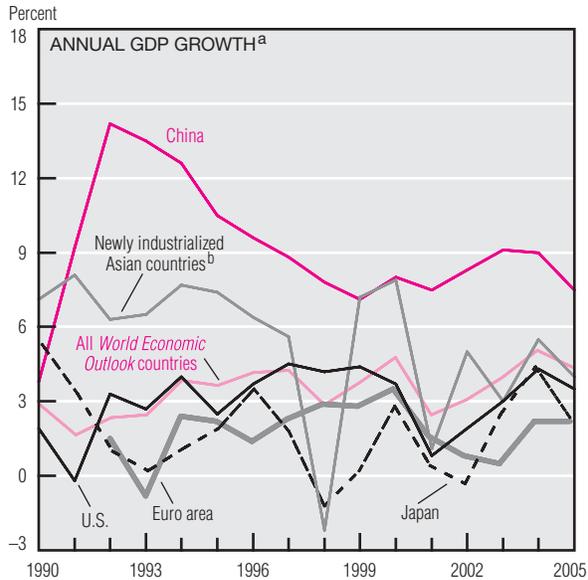
The debt-to-asset ratio suggests that household debt is, most recently, growing at a faster pace than household assets. However, the household debt-service ratio (the ratio of required payments on outstanding mortgage and consumer debt to disposable income) has moderated over the past couple of years but remains high

compared to levels over the past 24 years. Similarly, household financial obligations, a broader measure that includes debt service as well as contractual payments for such things as automobile leases, rents, homeowners' insurance, and property taxes, is relatively high at nearly 18% of disposable income. Chairman Greenspan attributed these measures' recent stability to historically low mortgage rates. The resulting wave of mortgage refinancing reduced monthly payments directly and indirectly by extracting equity to repay more expensive consumer debt. Moreover,

recent tax cuts may also have contributed to the moderation in measures of household debt service and financial obligations.

Growth of both consumer credit and home mortgage debt has slowed in recent quarters although growth in home mortgage debt remains historically high. Delinquency rates continue to decline despite rising interest rates. Although delinquency rates on credit card loans and consumer loans have stopped falling, rates on residential real estate loans recently fell to 1.6%, the lowest level in more than 10 years.

# The World Economy



a. Data for 2004-05 are IMF forecasts.

b. Includes Hong Kong, Singapore, South Korea, and Taiwan.

c. Data for October 2004 and after are NYMEX sweet, crude, light-oil futures as of October 15, 2004.

d. Average of West Texas intermediate, U.K. Brent, and Dubai Fateh crude oil prices.

SOURCES: International Monetary Fund, *World Economic Outlook* and *International Financial Statistics*; New York Mercantile Exchange; and *Wall Street Journal*.

In September, the International Monetary Fund (IMF) published its second biannual *World Economic Outlook*. The *Outlook* predicts that aggregate real GDP for the 175 countries covered will grow 5.0% in 2004, the highest world growth rate in nearly three decades. It also expects that growth will moderate to 4.3% in 2005, partly because of rapidly rising oil costs. According to many standard economic models, including the IMF's, an oil price increase of \$8 per barrel reduces global GDP growth by about 0.5%. After the *Outlook* was published, spot

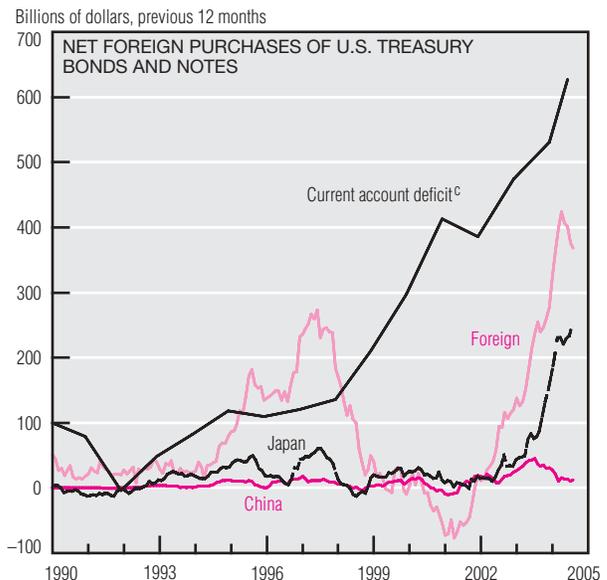
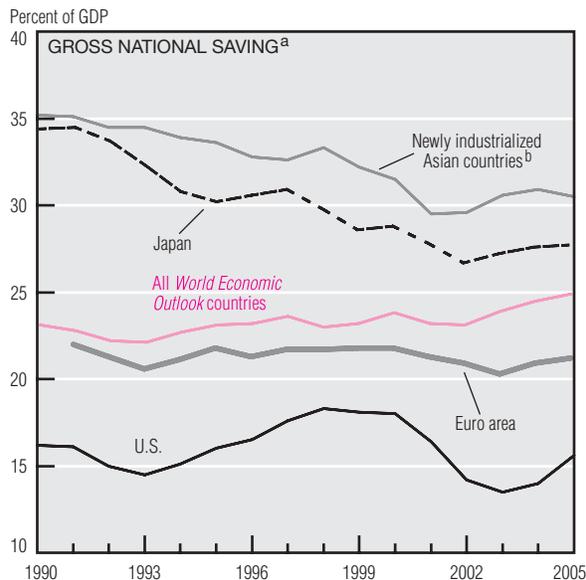
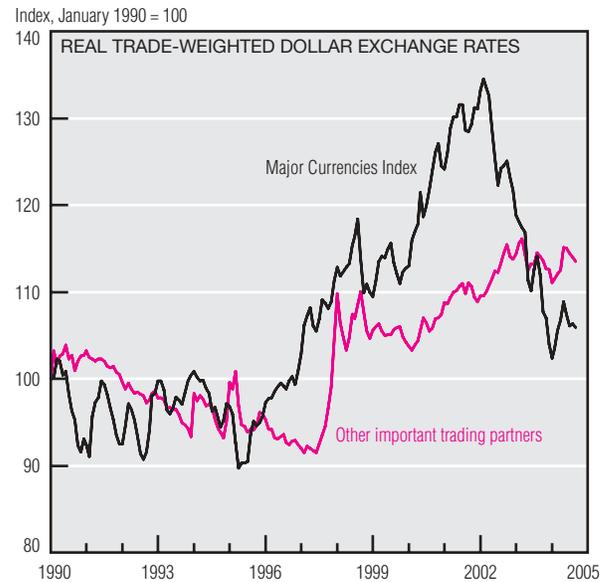
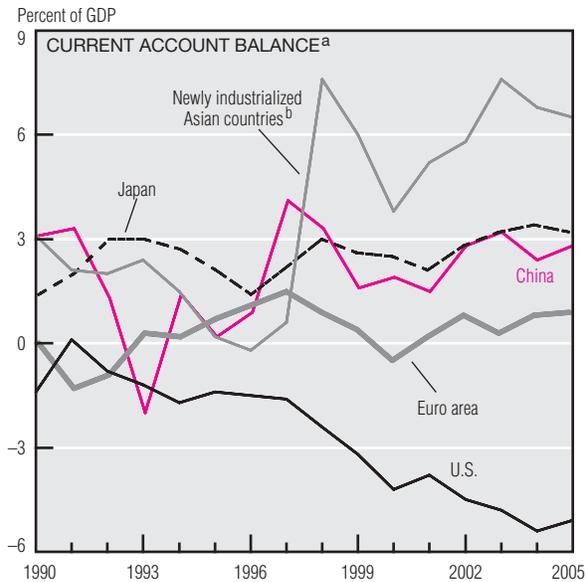
and futures oil prices rose above their September levels.

The IMF calculates world growth as a weighted average of individual countries' growth rates. A country's weight is proportional to its GDP, valued at purchasing power parity (PPP), which values "like goods" produced in different countries at a common price. According to PPP, China has been the largest contributor to world growth in recent years. When valued at PPP, China's GDP is second only to the U.S. There is some controversy about PPP-based numbers because they may differ widely from more familiar

measures valued by exchange-rate conversions. When GDP is converted to a common currency using exchange rates, Japan's economy is the world's second largest.

September's *Outlook* predicts that China's inflation rate will average 4.0% in 2004, higher than the inflation rates of other large economies. China grew 9.1% in 2003 and is expected to grow 9.0% this year, exceeding the 7% target that Premier Wen Jiabao announced in March. In its first-quarter monetary policy report, the People's Bank of China characterized its stance  
*(continued on next page)*

## The World Economy (cont.)



a. Data for 2004–05 are IMF forecasts.

b. Includes Hong Kong, Singapore, South Korea, and Taiwan.

c. Annual data through 2003. Data for 2004 are annualized from the first two quarters.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of the Treasury; Board of Governors of the Federal Reserve System; and International Monetary Fund, *World Economic Outlook*.

for upcoming periods as “appropriately tight, aiming at avoiding a hard brake on the economy.” Some analysts are concerned that China’s attempts to curb inflation and overinvestment in some sectors of its economy will curtail its economic growth.

A second concern for some analysts is the continued increase in the U.S. current account deficit. Although the dollar fell in 2002 and 2003 before stabilizing this year, the current account deficit has not reversed its course. Analysts commonly cite the low U.S. saving rate as a major cause of

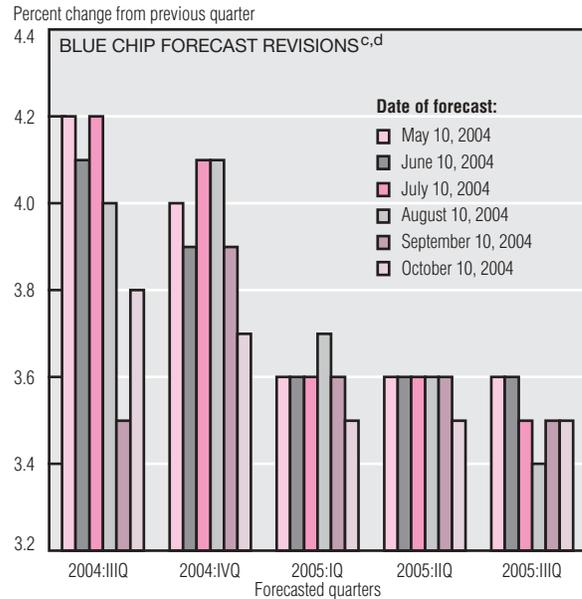
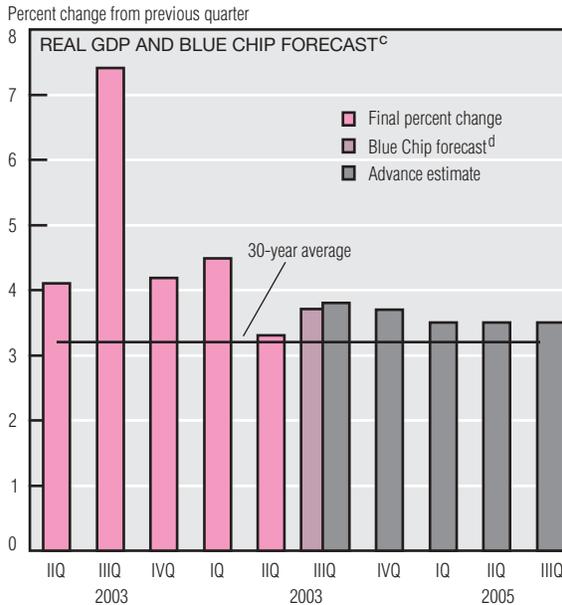
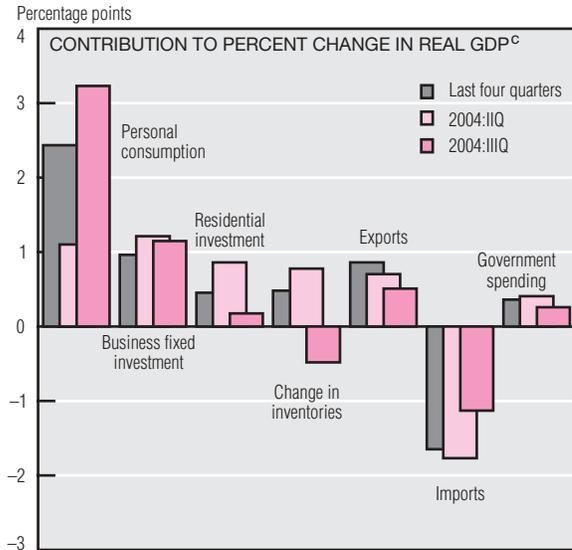
our deficit status. However, the flip side of the coin is that other countries have been willing to finance our current consumption of foreign goods by purchasing future claims to U.S. output. In recent years, these claims have largely taken the form of net foreign official purchases of U.S. Treasury securities. Japan has accounted for more than two-thirds of all foreign official and nonofficial net purchases of U.S. Treasury securities over the past 12 months.

Fiscal stimulus in the U.S. and other areas of the world is one reason cited for the recent relatively shallow and

short-lived recession. However, this stimulus also may have worsened government fiscal balances in the U.S., Europe, and Japan, among others. Continued increases in government deficits could prove problematic. For example, should Japan become less willing to purchase U.S. government securities, it could exert upward pressure on medium- and longer-term U.S. real interest rates if the fiscal deficit does not fall. And a rise in longer-term interest rates from this source would probably have a negative impact on economic growth prospects for the U.S. and the world.

# Economic Activity

	Change, billions of 2000 \$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	98.7	3.7	3.9
Personal consumption	86.5	4.6	3.5
Durables	42.6	16.8	5.4
Nondurables	21.3	4.0	4.0
Services	28.4	2.7	2.9
Business fixed investment	33.8	11.7	9.8
Equipment	34.4	14.9	12.2
Structures	0.8	1.3	1.9
Residential investment	4.3	3.1	8.4
Government spending	6.6	1.4	1.9
National defense	10.7	9.2	8.3
Net exports	-17.7	—	—
Exports	14.0	5.1	9.2
Imports	31.7	7.7	11.9
Change in business inventories	-13.0	—	—



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. Quarters seasonally adjusted at annual rates.  
 d. Blue Chip panel of economists.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; National Bureau of Economic Research; and *Blue Chip Economic Indicators*, October 10, 2004.

According to the U.S. Commerce Department's advance estimate, the annualized growth rate of real GDP in 2004:IIIQ was 3.7%. This was 0.4 percentage point (pp) higher than the second-quarter growth rate of 3.3%, and only 0.1 pp lower than the Blue Chip forecast of 3.8% for the third quarter. Growth was supported by a rebound in consumption spending and continued strength in business spending on equipment and software.

Personal consumption expenditures' contribution to the change in

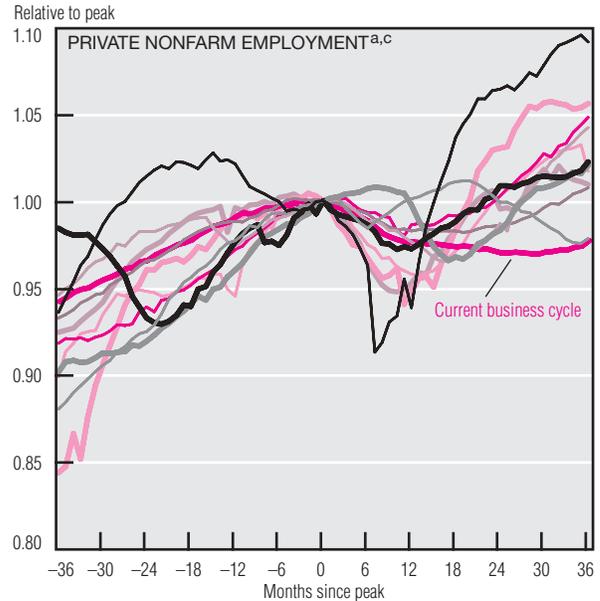
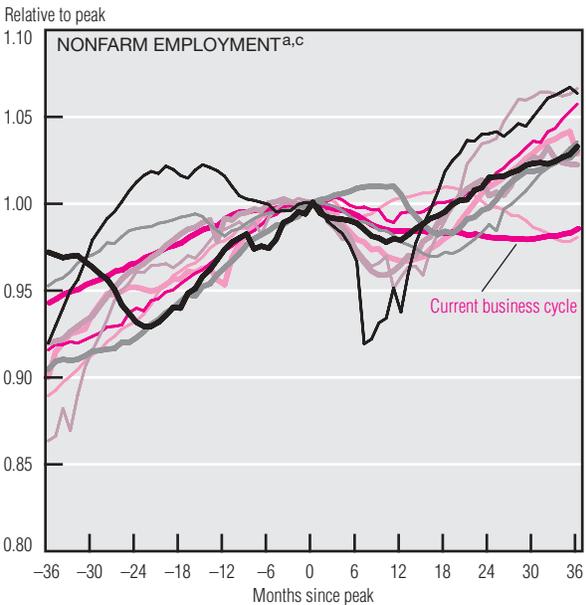
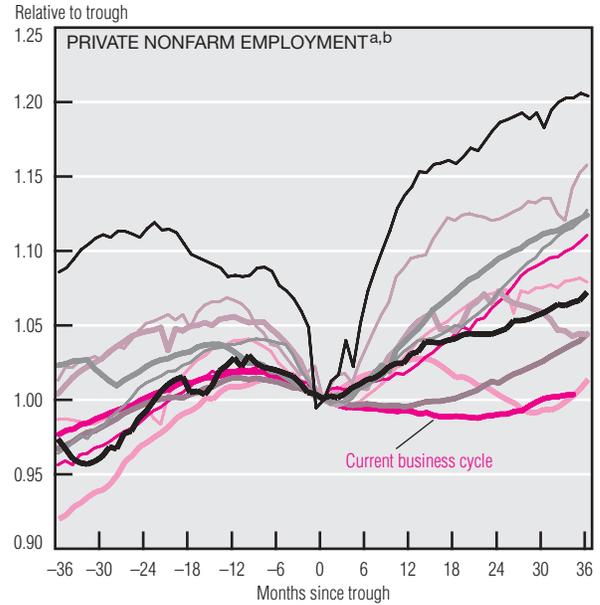
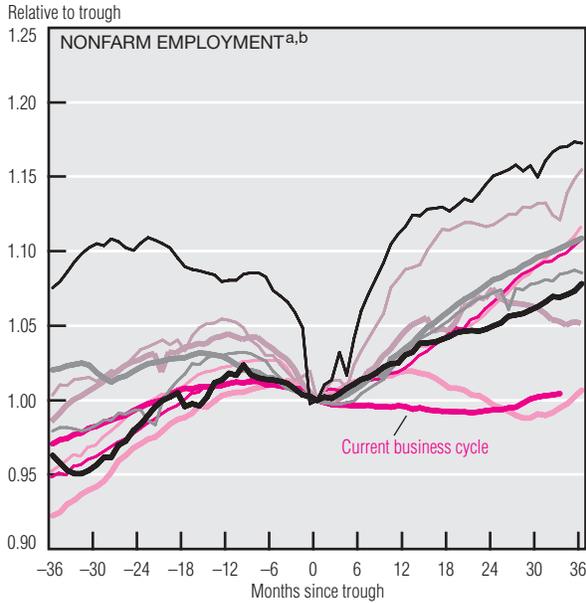
real GDP reached its highest level of the last four quarters, increasing by 2.1 pp in 2004:IIIQ. By contrast, contributions from both residential investment and change in inventories dropped to their lowest levels of the year. Exports accounted for 0.5 pp, while imports subtracted 1.1 pp, with the net effect of decreasing real GDP by \$17.7 billion.

The advance estimate of 2004:IIIQ growth was only slightly lower than the Blue Chip economists' forecasts for the quarter, and equal to their forecasts for 2004:IVQ. For 2005,

they expect the economy to grow at a steady rate of 3.5%. However, forecasts are apt to change over time as new information comes in. For example, the Blue Chip growth forecast for 2004:IIIQ–2005:IIIQ has been revised downward each month since May; July's forecast of 4.2% growth in 2004:IVQ was revised down to 3.5% by September. Forecasts are likely to change even in a one-month period, as they did between September and October for four of the five quarters shown.

(continued on next page)

## Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

a. Each line represents a business cycle in the post-World War II period.

b. Negative numbers indicate the months before the trough. For each cycle, the 36 months before and after the trough are plotted.

c. Negative numbers indicate the months before the peak. For each cycle, the 36 months before and after the peak are plotted.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and National Bureau of Economic Research.

Much has been made of the economy's weak employment growth since the end of the last recession. The charts above summarize the behavior of employment over the 11 business cycles since World War II; each line represents a different business cycle.

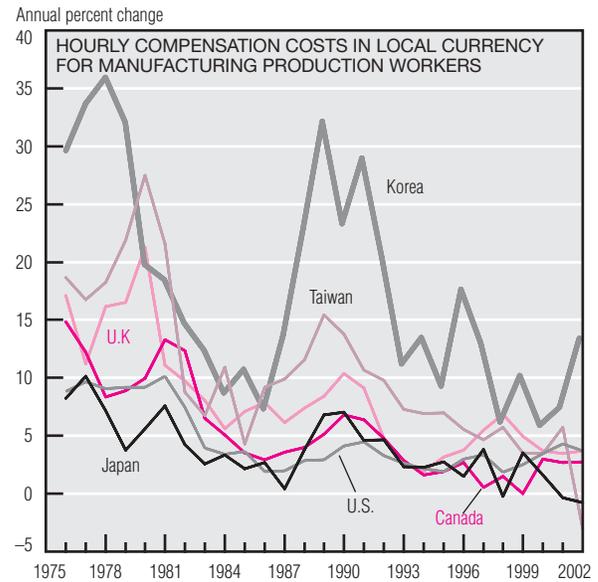
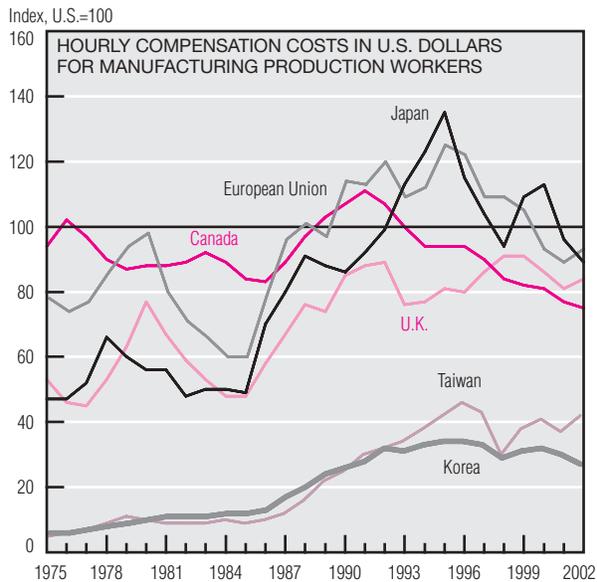
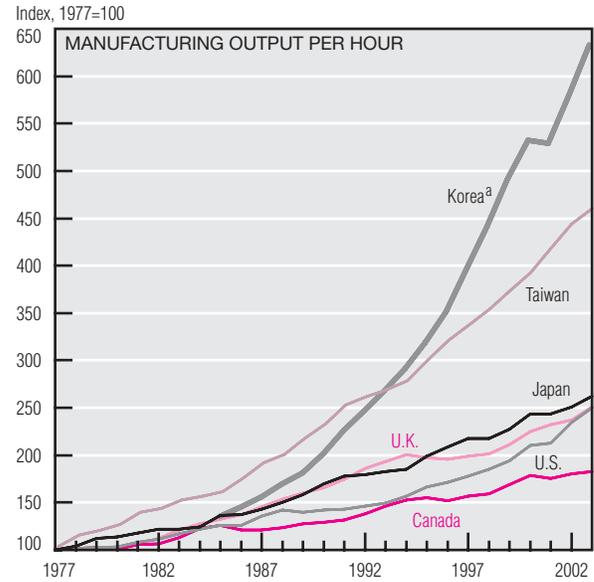
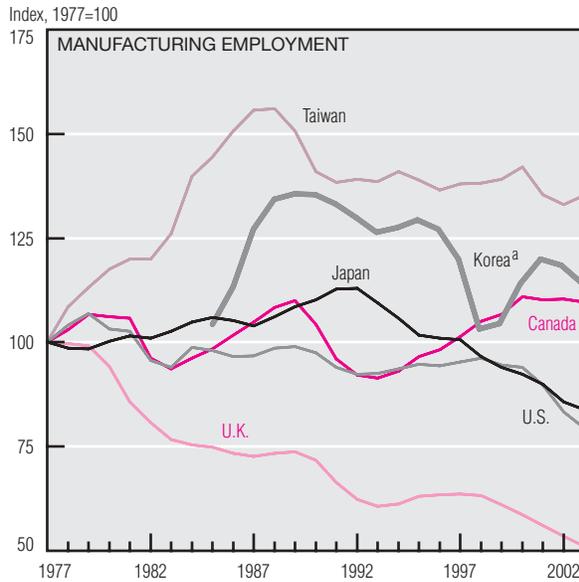
Typically, employment falls until the trough is reached, then rises. Employment growth since the last trough (November 2001) has been modest. Of the 11 business cycles in the charts, only one showed weaker employment performance: The 1980 recession,

which was followed quickly by the 1981–82 recession. Even the “jobless recovery” after the 1990–92 recession saw job growth 24 to 36 months after the recovery began.

Employment performance since the end of the last recession has been unusual, as it was prior to the trough. Only three recessions had smaller job losses leading up to the trough: 1969–71, 1980, and 1990–91. One explanation for why firms have not created many jobs since the end of the recession is that they did not cut jobs in the first place.

Leading up to a peak, employment typically is rising; it falls immediately after the peak, then rises again. On this score, the 2001 recession was also atypical. Leading up to the peak, employment was relatively high, exceeded only by the 1945, 1958–59 and 1981–82 recessions. However, given the relatively small number of recessions (11), and the range of variability across recessions, it is difficult to say how atypical the 2001 recession was.

# U.S. and Foreign Manufacturing



a. Data collection for Korea did not start until 1985. Korea's value for 1985 is indexed to equal the average of the other plotted values for that year.  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Over the last 25 years, several industrialized economies have had the same experience—a decline in manufacturing employment. Since 1977, manufacturing jobs in the U.S. have fallen 20% and in the U.K. almost 50%. Japan's manufacturing employment rose steadily until 1992 but has fallen sharply since then. Canada, Taiwan, and Korea are exceptions. In 2003, manufacturing employment dropped in every country charted above except Taiwan.

Productivity growth is often blamed for manufacturing employment's

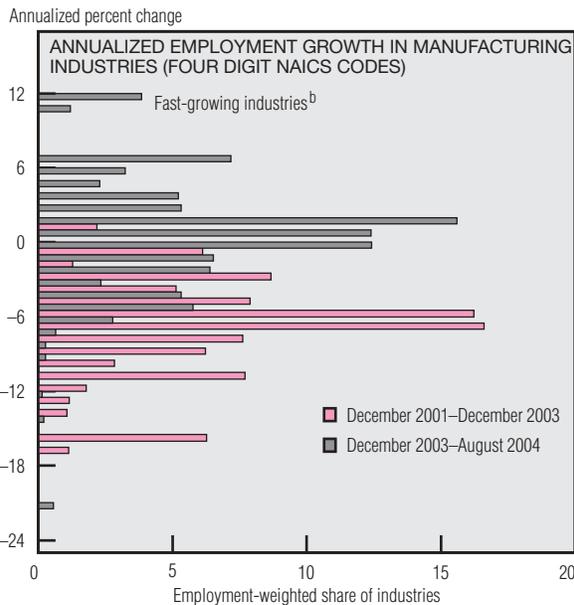
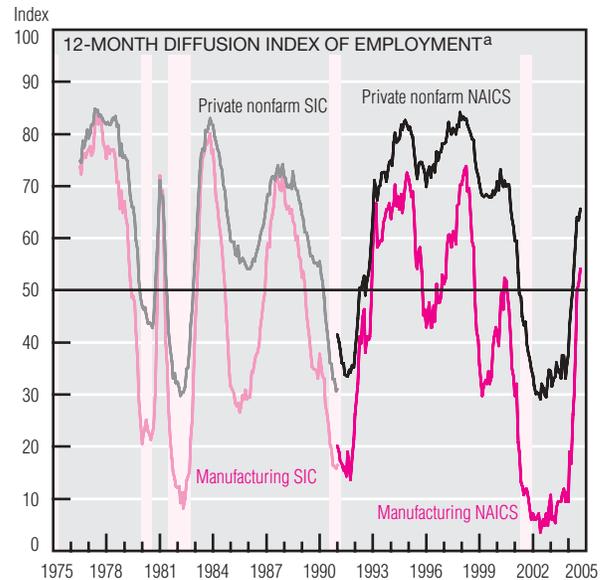
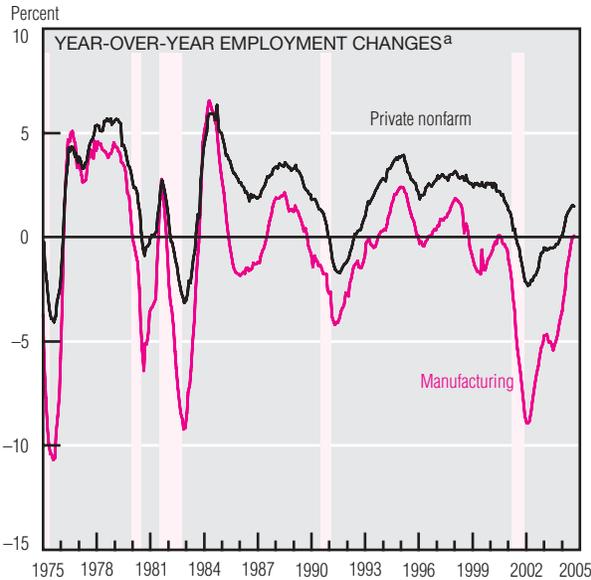
decline. For instance, manufacturing employment in 2003 decreased most severely in the U.S. (4.7%), the U.K. (4.4%), and Korea (3.6%), three countries where productivity growth was high. In 2003, Korea registered the largest increase in manufacturing productivity (9%). The U.S. posted the second-highest increase (6.8%), well above its average rate of annual productivity growth since 1977 (3.6%). The U.K. also sustained its manufacturing productivity growth (5.5%).

However, rising productivity does not necessarily translate into lower

employment, as illustrated by the experiences of Korea and Taiwan since 1977. Korea's manufacturing growth was interrupted by its 1997 currency crisis; Taiwan's flattened out in the 1990s.

Compensation costs can also help explain countries' varying experiences. Since 1977, manufacturing employment has increased in countries with low relative costs (Taiwan and Korea). International differences have narrowed since 1977 because compensation costs grew at higher rates in newly industrialized economies.

# U.S. Employment Changes



## Annualized Employment Growth (Percent)

	2001–2003	2004
<b>Total manufacturing</b>	-5.87	0.56
<b>Durable goods</b>	-6.52	1.57
Wood products	-3.30	1.74
Nonmetallic mineral products	-4.15	3.99
Primary metals	-8.76	-0.20
Fabricated metal products	-5.83	3.29
Machinery	-7.75	2.31
Computer and electronic products	-10.58	1.90
Electronic equipment	-8.43	-0.56
Transportation equipment	-4.46	0.37
Furniture and related products	-5.57	0.82
<b>Nondurable goods</b>	-4.78	-1.07
Food manufacturing	-1.03	-1.70
Beverages and tobacco products	-1.74	1.55
Textile mills	-13.07	-3.80
Textile products mills	-6.70	3.53
Apparel	-14.28	-6.62
Leather and allied products	-11.72	2.11
Paper and paper products	-5.22	-0.29
Printing and related activities	-5.77	-2.08
Petroleum and coal products	-2.72	2.26
Chemicals	-2.79	-0.52
Plastics and rubber products	-5.02	0.45

a. Shaded bars indicate recessions as dated by the National Bureau of Economic Research.

b. All industries with annualized growth of at least 12%.

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

The nation's economic recovery began in December 2001, but the labor market has taken much longer to recover. Since September 2003, nonfarm private employment has grown continuously, reflecting overall improvement in the labor market. Manufacturing employment suffered the most severe impact of the recession, with year-over-year growth reaching a 20-year low of -8.9% in February 2002. Since then, manufacturing employment's rate of decline has been decreasing; the sector's

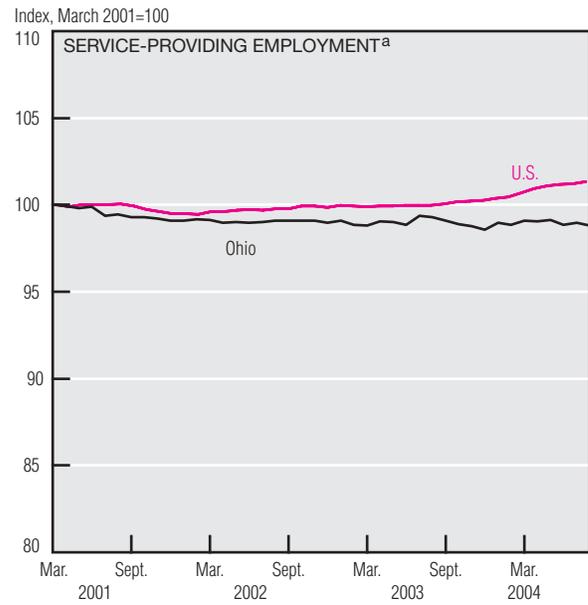
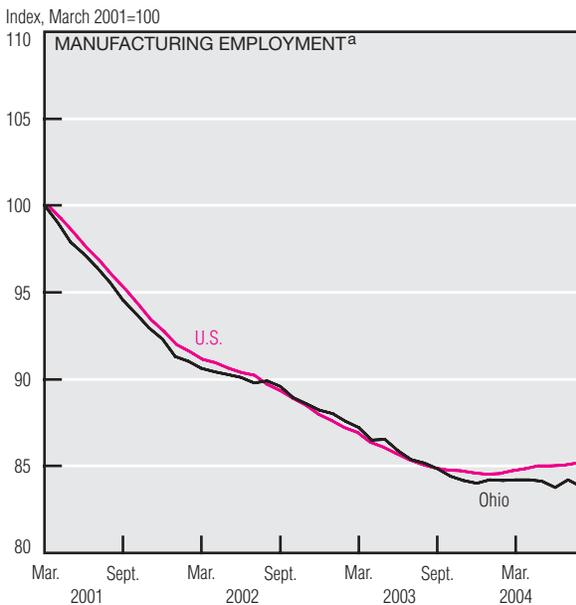
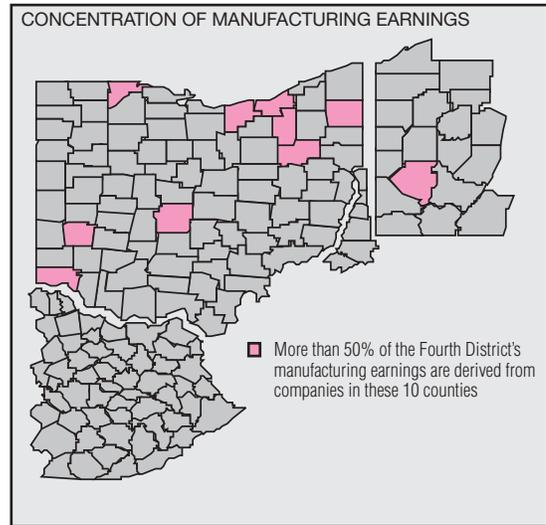
employment even began to grow in September 2004.

The recent improvement in manufacturing can be observed in the Diffusion Index of Employment, which measures the share of industries in which employment is rising at any point in time. For manufacturing employment, this index rose from an exceptionally low 3.6% in June 2002 to 54.2% in September 2004.

The disaggregation of manufacturing employment according to the North American Industry Classification System (NAICS) confirms that

the number of industries with a positive employment growth rate has increased in 2004. From 2001 to 2003, employment in durable goods industries contracted sharply because of financial difficulties and weak demand. In 2004, employment has grown in durable goods industries (mineral and metal products, machinery, electronic products) because of strong demand from the housing market and other manufacturing industries. In contrast, employment in non-durable goods industries declined.

# Fourth District Employment



a. Seasonally adjusted.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis.

The Midwest traditionally has been a manufacturing-intensive region. Indeed, although the manufacturing sector's proportion of the region's economic activity has declined in recent decades, the Midwest is still more manufacturing intensive than other parts of the country. In the Fourth Federal Reserve District, for example, manufacturing employment accounts for about 16% of the workforce; the comparable figure for the country is about 11%.

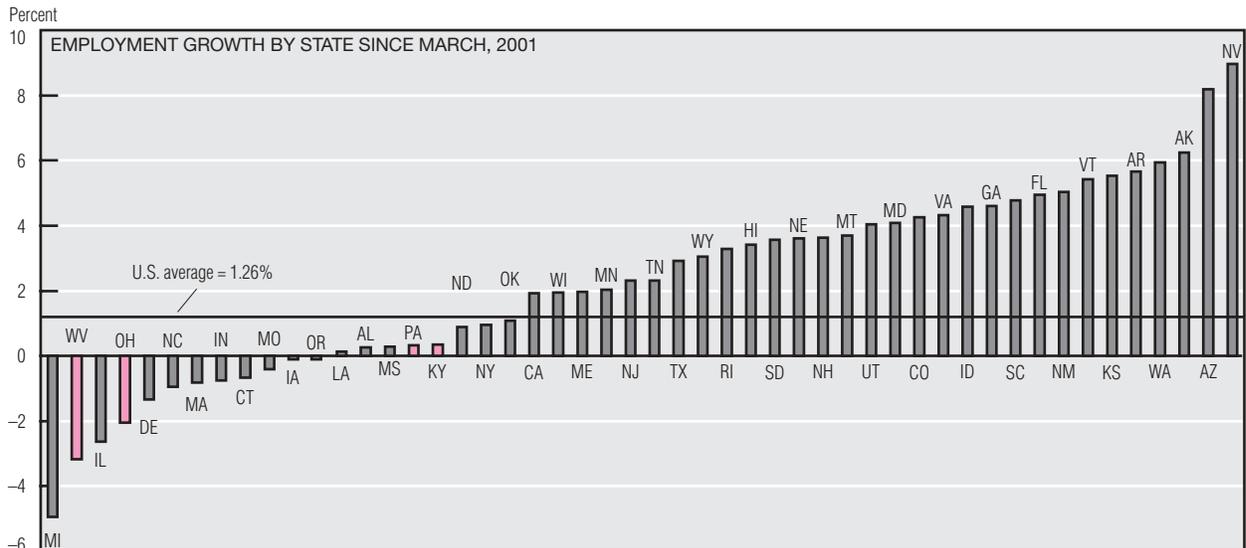
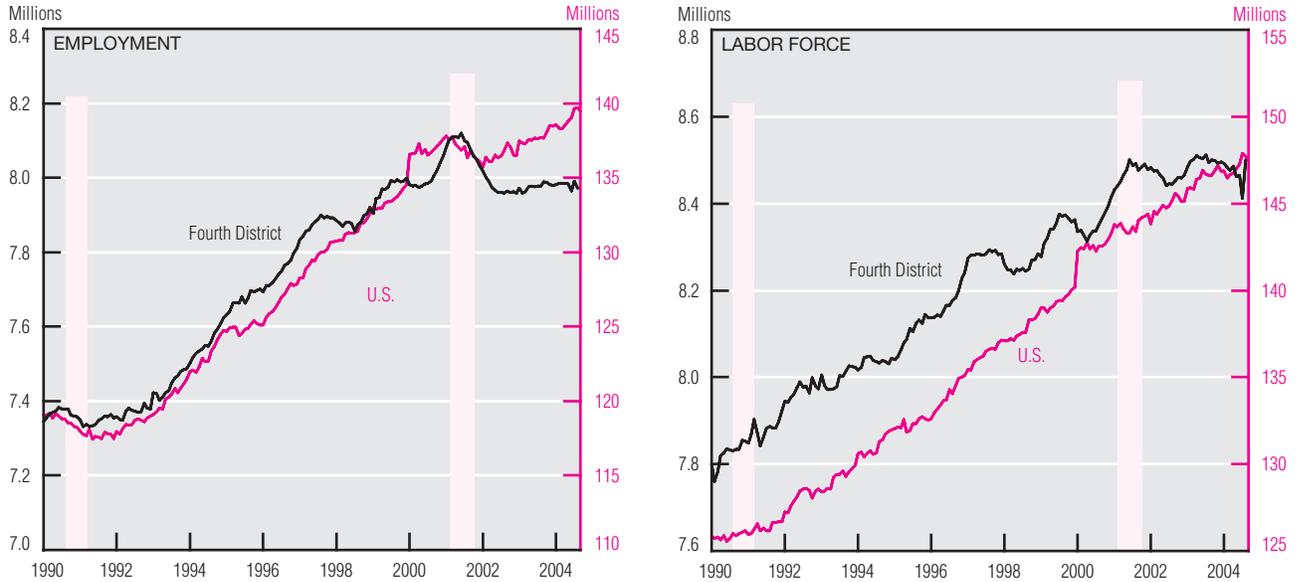
Workers' earnings also show how much more the Fourth District depends on the manufacturing sector. Roughly three-quarters of the District's counties derive a higher proportion of corporate earnings from manufacturing than the nation as a whole. Within the District, these earnings are especially concentrated in the area that stretches northwest from Pittsburgh to Cleveland—that is, from the headwaters of the Ohio River to Lake Erie. In fact, the cities

in this area have a high concentration of manufacturing firms partly because they are near the waterways that were critical to the development of manufacturing in the early stages of the nation's growth.

The period of three and a half years that ended in January marked the nation's longest string of month-to-month net job losses in U.S. manufacturing since World War II and the most pronounced percentage reduction in manufacturing employment

(continued on next page)

## Fourth District Employment (cont.)



NOTE: All data are seasonally adjusted.  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

for any postwar period of that length. Ohio has lost a substantial number of manufacturing jobs—the sector’s rate of employment loss since the business cycle peak has been about the same for the state and the U.S.: Each has lost roughly 15% of its manufacturing workforce.

Not surprisingly, the sharp nationwide decline in manufacturing employment over the last several years had an outsized impact on the industrial Midwest. The Fourth Federal Reserve District, the part of the

region that relies most heavily on manufacturing, bore the brunt of these losses.

Perhaps surprisingly, the District’s employment performance in the service sector has been weaker than the nation’s. Since the business cycle peak, Ohio has lost roughly 1% of its service sector jobs, while the U.S. has added about 1%.

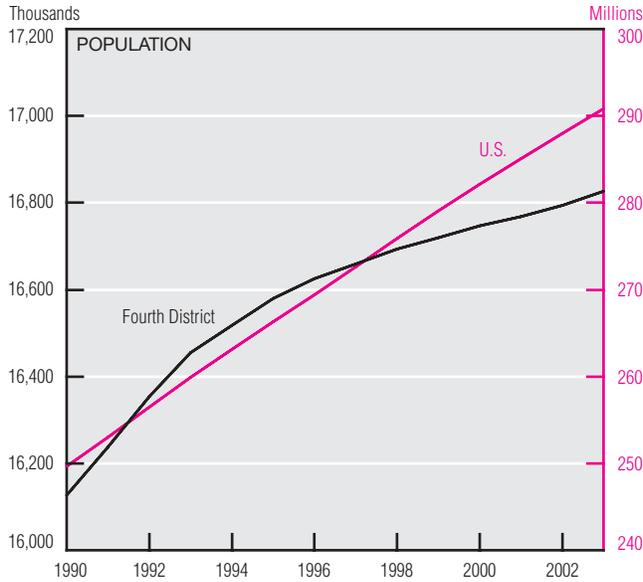
These developments have combined to limit employment growth in the District during the recovery. The trajectory of employment gains for

the District and nation, once roughly similar, are now markedly different. The same applies to labor force growth: Whereas they formerly rose at roughly equal rates, since the recession, labor force growth in the District has diverged from the nation’s.

The District’s less robust labor market is also evident in state-by-state comparisons. Since the business cycle peak, two District states, Ohio and West Virginia, have posted no employment growth. Although

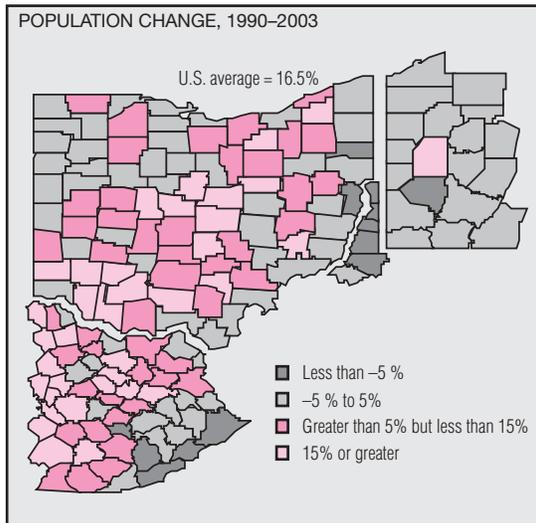
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# Fourth District Employment (cont.)



## Metropolitan Area Populations

	Thousands of people		
	1990	2003	Percent change
Pittsburgh	2,470	2,410	-2.4
Cleveland-Elyria-Mentor	2,104	2,140	1.7
Cincinnati-Middletown	1,850	2,047	10.7
Columbus	1,411	1,675	18.7
Dayton	845	846	0.2
Akron	659	702	6.5
Toledo	655	661	0.9
Youngstown-Warren-Boardman	614	593	-3.4
Lexington-Fayette	350	422	20.6
Canton-Massillon	395	407	3.2
Huntington-Ashland	288	287	-0.6
Erie	276	280	1.5
Parkersburg-Marietta	162	163	0.7
Wheeling	159	150	-5.4
Springfield	148	143	-2.9
Weirton-Steubenville	142	129	-9.6
Mansfield	126	128	1.7
Lima	110	108	-1.5
Sandusky	77	79	2.3
<b>U.S.</b>	<b>249,623</b>	<b>290,810</b>	<b>16.5</b>



## City Populations

	Thousands of people		
	2000	2003	Percent change
Columbus	713	728	2.1
Cleveland	476	461	-3.2
Pittsburgh	334	325	-2.5
Cincinnati	330	317	-4.0
Toledo	313	309	-1.4
Lexington-Fayette	261	267	2.2
Akron	217	212	-2.1
Dayton	166	162	-2.5
Erie	103	101	-2.1

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

Kentucky and Pennsylvania have shown some increase in employment during this period, it was less than the national average.

The District's population has followed a path similar to that of its employment and labor force. Since 1990, its population has been growing steadily, but at a rate much slower than the U.S. as a whole (4.3% versus 16.5%).

Population growth within the District has varied widely. For example,

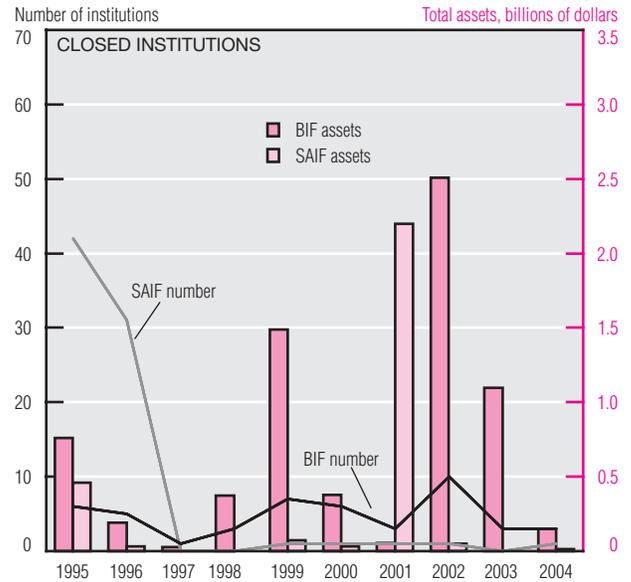
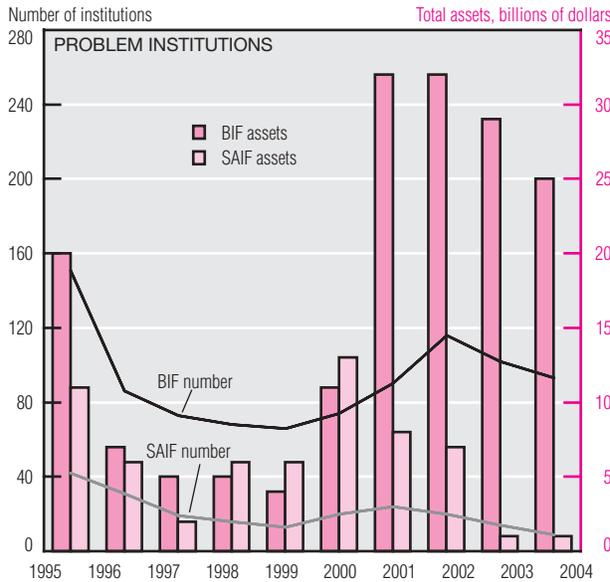
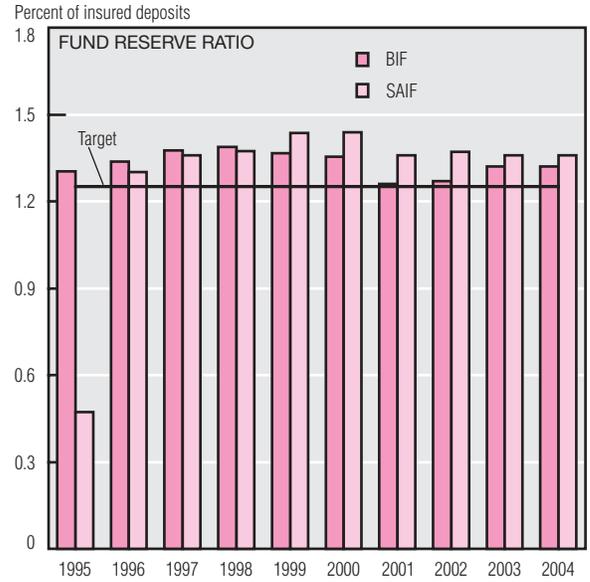
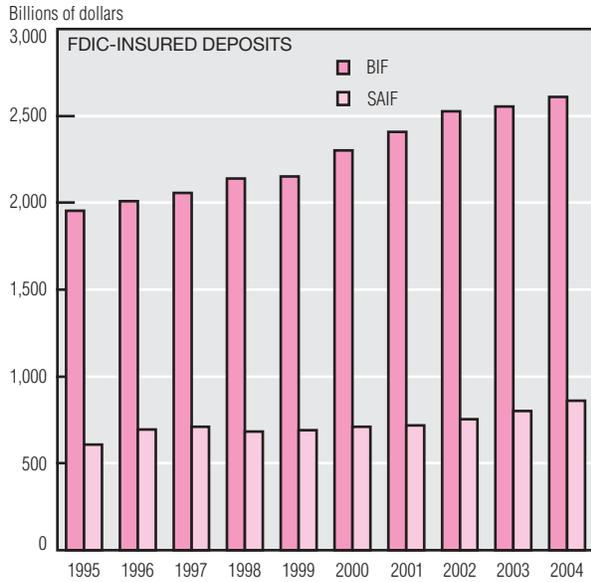
the Columbus and the Lexington metropolitan areas have posted double-digit population gains since 1990, while seven of the District's 19 metropolitan have lost residents.

A breakdown by county presents a more detailed picture. Rural areas, such as the eastern border of Kentucky and the northern tip of West Virginia, suffered large population declines. In some instances, counties that contain a major urban area, such as Lucas (Toledo), Cuyahoga (Cleveland), Hamilton (Cincinnati), and

Allegheny (Pittsburgh), experienced population declines while the surrounding suburbs flourished. This did not occur in Franklin (Columbus), Fayette (Lexington), or Summit (Akron) counties.

An examination of population by city further pinpoints continued declines on urban areas. In fact, with the exception of Cincinnati, Columbus, and Lexington, population decreased in every District city where the population exceeded 100,000 in 2000.

# FDIC Funds



NOTE: All 2004 data are as of the end of the second quarter.  
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

During the first half of 2004, FDIC-insured deposits grew: Deposits insured by the Bank Insurance Fund (BIF) grew at an annualized rate of 4.14% and those insured by the Savings Association Insurance Fund (SAIF) at 6.63%. As of June 30, the FDIC insured over \$2,607 billion of BIF members' deposits and over \$926 billion of SAIF members'. Despite moderately robust growth in insured deposits, BIF reserves at midyear held steady at 1.32% of insured deposits, and SAIF reserves matched their year-end 2003 level of 1.36%. Although both funds remain below the peak

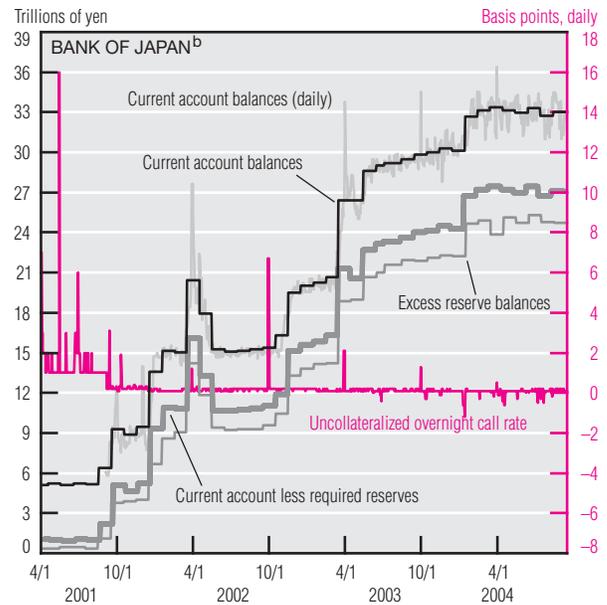
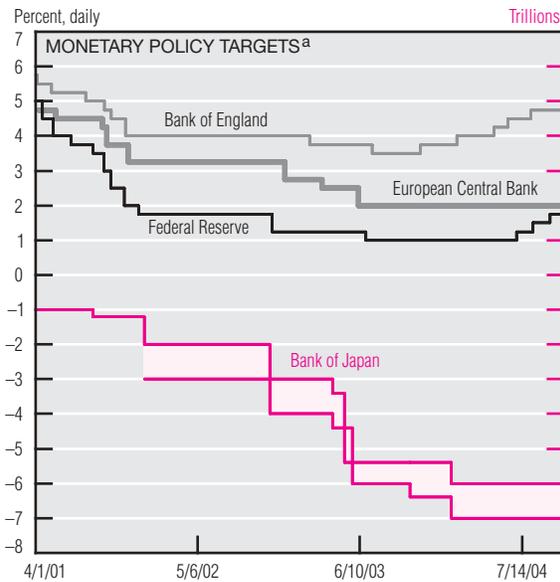
reserve-to-deposit ratios posted at the end of the 1990s, they continue to exceed the 1.25% target set by Congress in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

The stability of the banking and thrift industries shows the solid position of the two FDIC funds. Compared to the previous decade, bank failures since 1995 have been miniscule in terms of the number of and assets in the failed institutions. The three BIF members that failed during the first half of 2004 were small institutions with total assets of \$151 million; the

sole SAIF member that failed had assets of only \$15 million.

Problem institutions (those with substandard examination ratings) fell from 102 to 93 for the BIF and from 14 to nine for the SAIF from the end of 2003 to midyear 2004. For both FDIC funds, the decrease in the number of problem institutions matched a decrease in the assets of problem banks and thrifts. Moreover, both funds' continued low number of problem institutions and the small amount of assets these institutions held suggest that losses to the insurance fund will remain low in the near future.

# Foreign Central Banks



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

b. Current account balances at the Bank of Japan are required and excess reserve balances 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. Yields on European Union bonds are as of the end of month.

d. Indexes are normalized to 100 on January 2, 1998.

SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; Bank of England; European Central Bank; Wholesale Markets Brokers' Association; and Bloomberg Financial Information Services.

None of the four major central banks has changed its policy setting since the Federal Reserve's Federal Open Market Committee adopted a 1.75% target for the federal funds rate on September 21. After 10 months, the Bank of Japan's ¥30–¥35 trillion target for current account balances remains consistent with excess reserves near ¥25 trillion and an overnight interest rate hovering around zero. According to recent remarks of Governor Fukui, "...zero percent [inflation] is merely a passing point," not an ultimate goal in

deciding when Bank of Japan policy might let the overnight rate move above zero.

Rising dollar-denominated energy prices have tended to dampen the real growth outlook around the globe. This has been reinforced in many countries by the potential trade-related impacts of recent currency appreciation relative to the dollar. Both events might raise prices directly or lower prices through weaker economic activity. At the same time and no doubt reflecting these factors,

nominal long-term interest rates denominated in the dollar, euro, yen, and U.K. pound have been falling relative to central banks' policy-related rates. Likewise, equity price indexes in all four currencies have been falling. The difficulty for central banks concerned with preventing inflation always comes in judging the extent to which movements in these nominal variables reflect reduced inflation expectations rather than reduced expectations of real returns to capital.

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