December 2002
This month's report is sponsored by Coast Central Credit Union

Composite Index

<table>
<thead>
<tr>
<th>Key Statistics</th>
<th>Leading Indicators</th>
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<tbody>
<tr>
<td>Humboldt County</td>
<td>Seasonally Adjusted</td>
</tr>
<tr>
<td>Median Home Price*</td>
<td>$183,000</td>
</tr>
<tr>
<td>30 Yr. Mortgage Rate (12/19)</td>
<td>6.125%</td>
</tr>
</tbody>
</table>
The Index of Economic Activity for Humboldt County

<table>
<thead>
<tr>
<th>Sector</th>
<th>Seasonally Adjusted Sectoral Index Value (1994=100)</th>
<th>Previous Month</th>
<th>Same Month 2001</th>
<th>Same Month 2000</th>
<th>Same Month 1999</th>
<th>Same Month 1998</th>
<th>Same Month 1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Sales</td>
<td>141.8</td>
<td>+0.2</td>
<td>+30.1</td>
<td>+15.5</td>
<td>+16.5</td>
<td>+38.1</td>
<td>+106.2</td>
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<tr>
<td>Retail Sales</td>
<td>129.4</td>
<td>+3.6</td>
<td>+9.3</td>
<td>-3.3</td>
<td>+1.2</td>
<td>+0.7</td>
<td>+18.1</td>
</tr>
<tr>
<td>Hospitality</td>
<td>101.6</td>
<td>+6.3</td>
<td>-0.1</td>
<td>+2.3</td>
<td>-3.9</td>
<td>-4.3</td>
<td>-5.7</td>
</tr>
<tr>
<td>Electricity Consumption</td>
<td>108.2</td>
<td>+4.1</td>
<td>-0.4</td>
<td>-11.9</td>
<td>-15.8</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Total County Employment</td>
<td>104.6</td>
<td>+2.0</td>
<td>+3.3</td>
<td>-3.3</td>
<td>+0.3</td>
<td>+1.0</td>
<td>+3.2</td>
</tr>
<tr>
<td>Lumber Manufacturing</td>
<td>85.1</td>
<td>-9.7</td>
<td>-7.3</td>
<td>-18.8</td>
<td>-26.3</td>
<td>-27.8</td>
<td>-33.1</td>
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</table>

Humboldt County Employment Estimate

<table>
<thead>
<tr>
<th>Model</th>
<th>December 2002</th>
<th>M/M Change*</th>
<th>Accuracy**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model 1</td>
<td>-1,800</td>
<td>83.0%</td>
<td></td>
</tr>
<tr>
<td>Model 2</td>
<td>-1,000</td>
<td>73.4%</td>
<td></td>
</tr>
</tbody>
</table>

* Estimated level of total county employment in the current month relative to the previous month's EDD preliminary estimate.

** Accuracy of model in correctly predicting an increase or decrease in the level of total county employment from the previous month.

Both models are regression-based estimators of employment in the current month. Model 1 uses lagged employment, retail, manufacturing, and help-wanted advertising data, while Model 2 uses lagged employment, help-wanted advertising and unemployment insurance claims data. Click here for a detailed explanation.

Accuracy applies only to the direction of movement, not the magnitude of movement.

Discussion

Composite Index and Overall Performance

The Index of Economic Activity's seasonally adjusted composite value, which now stands at 108.2, rose 4.1 percent from last month's upwardly revised figure.
A look at the graph above shows that local economic activity rose for a third straight month in November. Consequently, the Index's seasonally adjusted composite value is now just one-tenth of a percentage point below the August peak. Home sales increased once again and is now at its second highest level ever. Hospitality is also showing renewed vigor with a healthy increase in seasonally adjusted activity during November. Despite national woes, the local retail sector increased for the first time since August. In one of the more encouraging signs, employment rose 2.0 percent in November. Despite early reports of relatively few temporary retail hirings, Humboldt County retailers added approximately 1,200 jobs. Our employment estimator suggests that many of these positions will evaporate in December, however. We'll have a better idea of near term prospects in the local labor market by our February report. The lumber-based manufacturing sector continues to lose ground in the face of industry-wide structural changes.

November's leading indicators are mostly positive. Building permits are up by a double-digit percentage for a third straight month. Activity here should be slowing down, however, due to a series of severe storms during December. The two labor market indicators are both positive, though not enough to express unreserved optimism. Help-wanted advertising rose moderately, probably reflecting the need for seasonal retail workers. And, unemployment claims declined for a fourth consecutive month. The decrease may be due to people waiting until after the first of the year to file new claims in order to qualify for higher benefits. Finally, manufacturing orders fell slightly. This indicator has been seesawing up and down for the past few months, but the four-month moving average remains mildly positive.

Home Sales

The Index value of this sector is based on the number of homes sold in Humboldt County each month as recorded by the Humboldt Association of Realtors.

Local real estate market activity in November grew a slight 0.2 percent from October's robust level. This measure now stands at its second highest level in eight years. The record was set in August 2002 when this sector logged a seasonally adjusted Index value of 159.5.

November's median home price rose 1.7 percent from October's $180,000. This sometimes volatile measure is a whopping 18.1 percent higher than it was in November 2001. The current statewide median sale price for existing homes rose 1.6 percent to $328,310 from October's upwardly revised number. This figure is 21.5 percent higher than in November 2001, when it was $270,210 (www.car.org). November's national median price for existing homes is up 1.1 percent from October's level to $161,400, and is 9.7 percent higher than it was in November 2001 (www.realtor.org). The similar figure for new homes dropped 6.5 percent to $167,300. This was the largest month-over-month decline since last July. This measure fell by 7.2 percent, respectively when compared to November 2001 (www.census.gov).

The California Association of Realtors announced that its Housing Affordability Index rose to 30 percent in October. This measure, which represents the percentage of California households that can afford to purchase a median priced home, is 6 percentage points lower than it was in September 2001. The figure for Northern California, not including the Bay Area, Sacramento or the Wine Country, remained at 35 percent when compared to September. It is down 7 percentage points from one year earlier (www.car.org).

The nationwide average for a 30-year fixed rate mortgage (week ending 12/27) dropped to 5.93 percent with an average 6 points according to the country's largest mortgage company, Freddie Mac. This is not only the lowest level since Freddie Mac began keeping track in 1971, it is believed mortgage rates have not been as low since 1965. California's statewide average was even lower at 5.83 percent with an average 9 points (sfgate.com). As of December 19, the local rate available with 2.5 points was 5.625 percent (Humboldt Bank).

A recently released study sponsored by a building industry trade group claims that California's housing sector pumps nearly $260 billion into the state's economy each year. New construction accounts for $40 billion, while the remainder comes from ancillary spending, including shipping costs of building materials to job sites and dollars spent by building employees for their living expenses. The report was prepared to aid the industry's
efforts to loosen restrictions imposed to preserve open space and build tens of thousands more homes annually. According to the state's Department of Finance, approximately 230,000 homes need to be constructed each year to keep up with population growth and job creation. An estimated 160,000 housing units will be built statewide in 2002. Proponents of open space preservation dispute the logic that economic activity and an acute need for more housing justify encroaching on remaining undeveloped areas. They argue that increased housing density would allow for both additional homes and open space (www.sfgate.com).

**Retail Sales**

Seasonally adjusted November sales at participating retailers climbed a strong 3.6 percent following October's steep falloff. This measure is also up when compared to same month activity in four of the five most recent years.

According to the Commerce Department, national November retail sales were 0.4 percent higher than in October. The increase was led by rising activity at furniture and home furnishing stores (up 2.3 percent), building material and garden supply dealers (up 1.2 percent), electronic and appliance stores (up 0.9 percent), and food and beverage stores (up 0.9 percent). Subsectors losing ground since October include miscellaneous store retailers (down 1.5 percent), department stores (down 1.4 percent), clothing and clothing accessory stores (down 1.3 percent), and sporting goods, hobby, book, and music stores (down 0.5 percent). Total retail sales were up 2.1 from November 2001 (www.census.gov).

Despite its promising start, preliminary estimates of the holiday shopping season show a national increase of only 1 to 1.5 percent over last year. This is the third straight year of shrinking year-over-year holiday sales increases and one analyst claims this year's growth may be the lowest since 1970. Worry about a struggling economy, rising unemployment and an impending war with Iraq and a shorter shopping season were cited as the primary reasons for the less than hoped for showing. On the bright side, holiday internet sales increased from 19 to 40 percent, depending on the source of the estimate (nytimes.com).

After much public comment and several design changes, the Eureka City Council recently approved a coastal development permit for a new Target store at the old Montgomery Ward site. The huge retailer plans to demolish the existing building and replace it with 139,000 square foot facility. The Garberville-based Environmental Protection Information Center appealed the approval to the California Coastal Commission claiming the lack of a sufficient buffer between pavement and the Eureka Slough, which abuts the north edge of the site. The city recognizes that storm water runoff from parking lots is a potential source of pollution, and it requires a buffer of at least 100 feet between pavement and environmentally sensitive areas. Target's final design submission was accepted because its proposed buffer, ranging between 40 feet and 250 feet, averages 100 feet. Proponents of the new store say that any improvement is preferable to the current situation where the existing pavement runs right up to the rocks that form the edge of the slough (www.times-standard.com).

The Conference Board's Consumer Confidence Index fell in December for the sixth time in seven, sliding to 80.3 from November's revised 84.9. Analysts had been expecting an increase to 88.0. The Conference Board's head of consumer research said "the major factor dampening consumers' spirits has been the rising unemployment rate and the discouraging job outlook. Until there is an improvement in labor market conditions, there is not likely to be a significant upturn in consumer confidence" (www.conference-board.org).

**Hospitality**

We use average occupancy at a cross section of local hotels, motels and inns as our indicator of economic activity in the hospitality sector. While the performance of this sector is, in turn, a good indicator of performance in the local tourism industry, it's important to note that not all visitors to Humboldt County are tourists, nor do all tourists stay in lodging establishments.

Average occupancy at the participating hotels, motels and inns in November fell from the previous month's level for the third consecutive month. Nevertheless, the Index level for this sector increased by a fairly large amount
The Index of Economic Activity for Humboldt County

once again due to seasonal adjustment. The measure is down in most of the year-over-year comparisons.

Security measures implemented in the wake of the September 11, 2001 attacks are deterring foreign visitors to the United States. According to the Immigration and Naturalization Service, 66 million fewer travelers applied for visas in the twelve months following the attacks. Additionally, visa denials were up over the same period one year previously. Visa hassles, stricter security measures and concerns about racial profiling were cited as reasons for the decline. The extent to which this is negatively affecting the U.S.'s $91 billion per year foreign tourism industry has not yet been quantified, but domestic travel agencies specializing in providing services to clients in the Middle East and southern Asia have been particularly hard hit because potential clients are choosing to go to countries where it is easier to obtain a visa. John Marks, incoming head of the Travel Association of America, claims "the challenges of travel in the new world order" have contributed to declining national tourism activity, and that a possible war with Iraq could exacerbate the situation. In places such as San Francisco, at least some of the drop off in foreign tourism has been mitigated by an increase in local and regional tourism (www.sfgate.com).

Gasoline Prices:

<table>
<thead>
<tr>
<th>Average Price* (as of 11/12)</th>
<th>Change From Prev. Month (cents/gal.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eureka</td>
<td>$1.86</td>
</tr>
<tr>
<td>Northern CA</td>
<td>$1.62</td>
</tr>
<tr>
<td>California</td>
<td>$1.59</td>
</tr>
</tbody>
</table>

* Current average price per gallon of self-serve regular unleaded gasoline as reported by The American Automobile Association's monthly gas survey (www.csaa.com).

Click here for a brief description of the local gasoline market's structure.

One week after the December release of the American Automobile Association monthly report on gasoline prices--showing Eureka's average price unchanged at $1.86 per gallon--local retailers dropped their prices by around 6 cents. This is the first widespread decrease in 5 months (www.times-standard.com).

Lower prices might be short lived, though. The price of crude oil has risen 27 percent since early November. On the east coast, the price for February delivery of crude oil recently rose to nearly $33 per barrel, the highest price in two years. Analysts expect the increase to show up in rising gasoline prices of at least 5 to 10 cents per gallon in the near future. The imminent war with Iraq and an ongoing general strike in Venezuela will likely lead to further increases. As reported here last month, prices in California could go substantially higher due to the above reasons combined with a mandated conversion from MTBE to ethanol (www.nytimes.com).
The allegedly large (as high as five times the statewide average and twice the national industry norm) profit margins being realized by local gasoline distributors would presumably give them room to soften the impact of potential price increases here in Humboldt County. A little encouragement from the public certainly couldn't hurt the situation. Contact information for local government representatives can be found in the "blue" pages of the phone book.

Electricity Consumption

We use kilowatts-hours of electricity consumed as our indicator of the energy sector of the Humboldt county economy. Electricity consumption is a somewhat mixed or ambiguous indicator that usually correlates with economic activity. However, beneficial increases in energy efficiency and conservation reduce the sector's Index value. Because we collect our data for this sector quarterly, values are estimated, and are revised when the quarterly data are received.

Estimated November consumption of electricity rose a seasonally adjusted 4.1 percent from the previous month.

According to analysis of annual performance reports, power outages occur more frequently and last longer in PG&E's service area than in most parts of the country. In 1999, the most recent year for which nationally comparable data are available, the average PG&E customers was affected by 1.48 blackouts. The national average for outage frequency was 1.21 per customer. The average duration of a PG&E outage was 156.8 minutes, 280 percent longer than the typical outage in northern Indiana and 241 percent longer than in upstate New York. In 2001, average frequency and duration of PG&E blackouts increased to 1.53 per customer and 215.6 minutes, respectively. These data exclude outages caused by major storms. Critics claim the utility has been deferring maintenance (trimming trees and replacing older poles, lines and transformers) over the years in the pursuit of profits, and, more recently, due to the need to cut costs since filing for bankruptcy last year. PG&E asserts it is continuing to invest more than $1 billion per year in its infrastructure and that the problem is due to "mountainous terrain and difficult coastal conditions" (www.sfgate.com).

A former executive of the nation's largest natural gas pipeline company was recently indicted for falsely reporting gas trades in November 2001. Federal prosecutors claim that Todd Geiger, then a vice president of El Paso Corporation, reported 48 fictitious gas transactions to a trade publication that indexes the price of natural gas based on factors such as the volume of trading activity. The indictment alleges that as a result, El Paso was able to realize an illegally inflated profit. If convicted of all charges, Geiger faces up to ten years in prison and $750,000 in fines (www.nytimes.com).

Similar attempts at manipulation of the natural gas market by several other energy firms continue to be investigated by the Commodity Futures Trading Commission, the federal oversight body many believe to have made possible such shady dealings when it exempted energy trading from regulation several years ago. One of these companies, Dynegy Inc., recently agreed to pay federal regulators $5 million to settle allegations that it conspired with one of its partners, NRG Energy Inc., to inflate natural gas prices from January 2000 to June 2002. In doing so, Dynegy did not admit to any wrongdoing, though it fired seven employees and disciplined six others involved in the alleged activities. The high price of natural gas was one of the primary causes of California's energy crisis last year (www.sfgate.com and www.nytimes.com).

Despite the ongoing emergence of information detailing the naked rapacity of many energy providers over the past few years, the California Public Utilities Commission will likely allow unregulated traders to buy and sell the rights to move natural gas through southern California's system of pipelines. The proposal was approved in concept late last year, but never implemented. Opponents of the new rule, which is expected to pass on a 3-2 vote, claim it does not provide adequate consumer protection. They fear that if a firm corners a sufficiently large amount of pipeline capacity, soaring prices similar to those that set off the energy crisis could result (www.sfgate.com).

An administrative law judge at the Federal Energy Regulatory Commission recently found that energy companies overcharged California by $1.8 billion during the state's energy crisis, an amount much less than the
$8.9 billion state officials had been seeking. Furthermore, the judge ruled that California still owes the power
generators around $3 billion for unpaid bills. The judge said that most of the overcharges came from the largest
power companies including Enron, Duke Energy, Dynegy, Mirant, and Reliant Energy. These firms were also
owed the most. A spokesperson for the Electric Power Supply Association, a trade organization representing
energy firms, said the ruling was unclear regarding how much individual companies owed and were owed.
Governor Davis criticized the ruling as being "rigged." FERC rules prohibited the judge from considering $3.4
billion in refunds being sought by the California Department of Water Resources. Californians paid
approximately $27 billion for electricity in 2000, nearly four times what was paid in 1999 (www.sfgate.com).

Total County Employment

In their preliminary report for November, the Employment Development Department (EDD) reported that
58,900 people were employed in Humboldt County. This is a 1.9 percent increase over October's revised figure,
and it indicates that a net 1,100 jobs were created during the month. As a result, the seasonally adjusted Index
value for the sector rose 2.0 percent. This measure is also up in most of the year-over-year comparisons.

Preliminary EDD data indicate the following changes in Humboldt county employment:

- Total county employment in the various service industries increased 3.0 percent from a revised 44,000 in
  the month of October to a preliminary 45,300 for the month of November. This sector is up 5.8 percent
  over last year's figure. Most of the month-over-month occurred in the Other Retail Trade and Federal
  Government classifications. Business Services, Other Services and Other State Government (non-education)
  each lost around 100 positions. The preliminary figure for the retail subsector shows 13,000 jobs, which is
  10.2 percent higher than October's figure. This number is 18.2 percent higher than it was in November

- Total county manufacturing employment came in at a preliminary 4,800. This is 2.0 percent lower than
  October's revised 4,900. The 100 jobs lost were in the Food and Kindred Product classification. Total
  manufacturing employment is down 2.0 percent from November 2001.

The unemployment rate for Humboldt County rose steeply from October's upwardly revised 5.2 percent to the
current 6.0 percent according to the preliminary EDD report. Meanwhile, the national rate rose three-tenths of
a percentage point to 6.0 percent and the state rate remained unchanged at 6.3 percent.

The latest release of UCLA's Anderson Forecast predicts a limited economic recovery for California in 2003.
Employment is projected to rise by 0.7 percent in 2003 and 2.2 percent in 2004. This level of growth is not
expected to lower the unemployment rate, though. The report estimates that unemployment will increase to 6.7
percent. While California has experienced a relatively mild rate of job loss during the most recent downturn, 0.5
percent compared to 1.1 percent nationally, the state saw its personal income figure fall 0.5 percent. This
measure rose 3.9 percent nationally (www.sfgate.com).

Three weeks after the 107th Congress adjourned, President Bush urged legislators to extend unemployment payments for the more than 800,000 workers whose benefits expired on December 28. He recommended that the extension be retroactive and said he would direct the Labor Department to work with state officials to minimize any delays in disbursing payments. Opponents criticized the president for foot-dragging. They also claim he has done little for the estimated 1 million people who have already exhausted their benefits (www.sfgate.com).

A number of other gloomy indications point to ongoing labor market weakness. The number of Americans who have been out of work for six months or longer continues to grow. This figure has swelled from approximately 1.33 million in March to 1.73 million Americans in November. An additional 390,000 unemployed people left the labor force in November, increasing the estimated total of discouraged workers to over 1.7 million. As noted last month, if these people were counted as unemployed, the unemployment rate would be half a percentage point or more higher (www.sfgate.com).

A recent poll conducted by a Philadelphia employment consulting firm shows one-fifth of Americans believe they could be laid off during 2003. Over three-quarters of those surveyed expect unemployment to rise, and over four-fifths say that finding comparable work will be difficult for workers who become unemployed (www.sfgate.com).

A distressing trend among older workers is emerging in the wake of the stock market collapse. As the value of many people's 401(k)'s and stock-based pension plans have evaporated, fewer are able to afford retirement. Even as total employment is falling, the number of workers 55 and older is rising (www.nytimes.com).

**Lumber Manufacturing**

We use a combination of payroll employment and board feet of lumber production at major county lumber companies as our indicator of the manufacturing sector for the Humboldt county economy. Lumber-based manufacturing generates about two-thirds of total county manufacturing employment.

The preliminary November *Index* value for this sector fell 9.7 percent from October's upwardly revised 94.3.

A source in the local lumber producing industry reported that redwood sales through early December remained strong despite the seasonal slowdown. The market for fir continues to face downward price pressure due to Canadian competition. According to this source, less efficient mills producing fir lumber will struggle to survive.

A group of Seattle-area investors joined with a group called Englewood Forest Products to make an offer to purchase Eel River Sawmills. Englewood made an unrelated, unsuccessful offer last year. The proposed sale includes Eel River's mills, rolling stock, Fairhaven power plant, and half of the firm's timberlands. The amount of the offer has not been disclosed. If the deal is accepted, the new owners plan to reopen the mills that have been idle for a year or longer (www.times-standard.com). It remains unclear whether the sale will go through, however. KIEM television broadcasted a report on New Years Day claiming the buyers were only interested in the power plant.

Production at the nation's factories, mines and utilities rose 0.1 percent in November. The meager increase was largely the result of a sharp rebound in automobile production following the temporary shutdown of several plants in October due to a lockout at west coast ports (www.federalreserve.gov).

The near term outlook does not look good, however. New orders for durable goods fell an unexpected large 1.4 percent in November. Economists had predicted a 0.8 percent improvement over October's 1.7 percent increase (www.sfgate.com).

National manufacturing output in November, as measured by the Institute of Supply Management, contracted for a third straight month. The current ISM Index level of 49.2 implies that output fell at a slower rate than in
October when the figure was 48.5. A number higher than 50 indicates growth (www.ism.ws).

Weakness in the industrial sector is further reflected in rising rate of manufacturing job loss. Employment in this sector, which has fallen for a staggering 28 consecutive months, was reduced by a further 45,000 positions during November (www.sfgate.com). The average number of monthly jobs lost rose from around 20,000 in the second quarter to 47,000 during the third quarter (www.nytimes.com). Based on monthly losses in October and November, the fourth quarter average will probably be even higher. For much of 2001, more than 100,000 workers in this sector were thrown out of work each month.

Leading Indicators

We track four leading indicators to get a sense of the direction of change in the county economy in the near future. The four leading indicators are (i) number of help-wanted advertisements in the Times Standard, (ii) number of claims for unemployment insurance, (iii) volume of manufacturing orders, and (iv) number of building permits issued. Our graphs in this section use a four-month moving average in order to "smooth" ordinary month-to-month volatility. In this way, any underlying trends present in the series become more apparent.

Employment-Based Economic Indicators:

A count of help-wanted ads indicates the number of new job openings.

Claims for unemployment insurance indicate the number of newly unemployed people in Humboldt County. Thus the number of new unemployment claims is a negative indicator of economic activity.

Manufacturing Economic Indicator:
Manufacturing orders, are a leading indicator of activity and employment in the County.

Home Sales Economic Indicator:

Building permits are an indicator of both construction activity and the availability of new housing stock.

The Bigger Picture

The Federal Reserve Bank's Federal Open Market Committee voted leave interest rates unchanged at it December 10 meeting. The federal funds target rate remains at 1.25 percent. Minutes from the committee's previous meeting, which were released three days after the December decision was reached, reveal that "the members agreed that monetary policy could do little to improve the performance of the economy in the near term, but . . . that a 50-basis points [one-half of a percentage point] easing likely would feed through to some degree to market rates, with favorable implications for spending next year" (www.sfgate.com and www.nytimes.com).

With the Fed's acknowledgment of the limited palliative potential of monetary policy in the near term, fiscal policy takes on a comparatively larger role in the effort to improve economic conditions. Thus far, the Bush Administration's plans for fiscal stimulus appear to be limited to making the temporary tax cuts passed last year permanent. Many economists question the potential effectiveness of further tax cuts given the possibility of huge deficits in the near future. The national economy is already hundreds of billions of dollars in the red. A war with Iraq alone will cost anywhere from $100 billion to over $1 trillion depending on how quickly it is won and how much subsequent peacekeeping/nation building efforts cost. According to economic theory, when people expect the federal deficit to rise, interest rates tend to also rise and private investment is "crowded out," thus negating the intended purpose of the stimulus (www.nytimes.com).

Moreover, recent analysis done by the Center on Budget and Policy Priorities, a non-partisan budget policy
organization, shows that virtually every state will face worsening budget problems in 2003 and 2004. California's deficit for this period is projected to be over $30 billion. The situation will be exacerbated if a growing federal deficit reduces the amount of federal money going to the states. In any event, state governments, many of which are legally bound to operate within a balanced budget, will be forced to raise taxes and cut services. Recent experience suggests these moves will disproportionately affect moderate and low-income workers (www.cbpp.org and www.nytimes.com).

Up to now, the Bush Administration, with some justification, has been able to place the blame for the ailing economy on the collapse of the stock market bubble, the policies of his predecessor, the September 11 attacks and Senate opposition. However, with both houses of Congress now firmly under Republican control and ready to enact his policies, the president will be held accountable for ensuing economic performance.

If an increase of media awareness is any indication, one major economic problem facing the president could be the threat of deflation. The number of stories discussing the possibility of deflation occurring in the U.S. has grown exponentially over the past two years. Princeton economics professor Paul Krugman explains the process of deflation clearly: "First, for whatever reason, the economy becomes depressed. The central bank responds by cutting interest rates-but it turns out that even cutting rates all the way to zero isn't enough to restore more or less full employment. At that point the economy crosses...the point of no return, beyond which deflation feeds on itself. Prices fall in the face of excess capacity; businesses and individuals become reluctant to borrow, because falling prices raise the real burden of repayment; with spending sluggish, the economy becomes increasingly depressed, and prices fall all the faster." The Japanese have been struggling with this problem since 1998. This recent example from the world's second largest economy has allowed the Fed to become better prepared to handle the potential threat (www.nytimes.com).

Aware that his economic performance to date has been less than stellar, the president asked for and received the resignations of two key advisors. Secretary of the Treasury Paul O'Neill and director of the White House National Economic Council Lawrence Lindsey were replaced by John Snow and Stephen Friedman, respectively. Snow was the CEO of CSX, the largest railroad in the eastern U.S., and Friedman is a former chairman of Goldman, Sachs & Co., a large investment banking firm.

In a separate move, the president nominated William Donaldson to replace Harvey Pitt as chairman of the Securities and Exchange Commission. Donaldson was a co-founder of one of Wall Street's leading investment banks, and has served as chairman of the New York Stock Exchange and CEO of the insurance firm Aetna. Mr. Bush characterized the nominee as "a strong leader with a clear mission to vigorously enforce our nation's laws against corporate corruption." Critics of the nomination fear that Donaldson, as a consummate insider, may be reluctant to ruffle feathers on Wall Street. To Senate is expected to confirm the nomination (www.sfgate.com).

If confirmed, perhaps the new head of the SEC can begin by looking into some of the more egregious examples of corporate greed. According to an article in the New York Times, "at the 100 worst-performing companies in the Standard & Poor 500-stock index, 47 executives and directors took home at least $5 million each by selling stock through early December, while the average share price of their companies has fallen by more than 60 percent." At the very least, something needs to be done to link compensation more directly to performance.

**Explanatory Note:** For those of you who are new or less familiar with the Index, we have been tracking economic activity since January 1994. The composite indices plotted as blue and green lines in the diagram at the top of this page are weighted averages of each of the six sectors described in the table above. Each sectoral index, and the composite index, started at a value of 100 in 1994. Thus if the retail sectoral index value is currently 150, that means that (inflation-adjusted) retail sales among the firms that report data to us are 50 percent higher than in January 1994. We also seasonally adjust each sector, and the composite index, to correct for "normal" seasonal variation in the data, such as wet season vs. dry season, and so trends in the seasonally-adjusted composite index (the blue line in the diagram above) provide a better indication of underlying growth and fundamental change in the economy. This month's report reflects data gathered from the previous month, and so the "November 2002" report reflects data from October 2002. As is common, our initial report is preliminary, and as we receive final data we revise our reports accordingly.