The Economy in Perspective

It's all relative … For 10 years, inflation as measured by the Consumer Price Index has ranged between 1% and $3^{3}/_{4}$%, and inflation as measured by the CPI excluding food and energy (core inflation) has moved in a very similar zone, bounded by 1% and 3%. Many people have come to expect future CPI inflation to fluctuate in ranges similar to these, and to average something close to 2% over time.

Recently, headline inflation has been at the high end of this range, although core inflation remains closer to 2% than 3%. Today's inflation dynamics echo an earlier event: In early 1999, headline CPI inflation accelerated from 2% and stayed near $3^{3}/_{4}$% for most of 2000 and into early 2001; at the same time, core inflation drifted up from 2% to $2^{3}/_{4}$%. Rates dropped considerably after those peaks, but concerns about a resurgence of inflation have once again come to the fore. Headline CPI inflation accelerated from 2% in early 2004 to $3^{3}/_{4}$% currently, while core inflation advanced from about 1% to 2%.

One key difference between the previous experience and the current one is the level of core inflation. Today, core inflation lies about 75 basis points below its 2001 peak and, being near 2%, could be regarded as less worrisome than in 2000–01. Whether to be more or less worried about inflation today depends on your reading of the inflation fundamentals and your view of monetary policy.

Let's start with the inflation fundamentals. Because energy (and food) prices become quite volatile at times, many analysts exclude them from the CPI to see inflation trends more clearly. Whether or not that adjustment makes sense depends on energy prices' return to some "stable trend" level within a reasonable time. In the past 10 years, for example, the monthly CPI energy index has fluctuated at annual rates between –10% and +20%. Between 2000 and early 2004, crude oil prices rose and fell within a range of \$20 to \$35 per barrel.

Aside from energy prices, other specialized factors occasionally exert strong but transient pressures on the total CPI. Exchange rate movements have the potential to temporarily alter import prices—in both directions. For example, take CPI movements since 2000, when the price indexes for core CPI goods and core CPI services began to follow disparate trends. Global competition affects goods prices significantly more than service prices. Changes in core services have stayed primarily in the range of 3%–4% from 2000 until now. Core goods prices disinflated from an initial band of 0%–1% to a low of –3% in 2003, then reinflated to its initial 2004 range, where it has stayed since. The disinflation of core goods prices occurred when a strengthening in the dollar made imported goods less expensive. The subsequent return to trend of small, positive price changes came after a period of considerable dollar depreciation, which raised import prices. During the entire 2000–2005 period, these two movements in import prices roughly cancelled one another out, but CPI inflation measures were first retarded and then boosted, temporarily obscuring the true inflation trend.

When import prices, energy prices, or another special category follows a different pattern than all other retail prices, we ought to think of the situation as a change in *relative* prices—not necessarily a change in the trend inflation rate. Crude oil prices have roughly doubled in the last three years. Supposing that they do not decline, the economy will have experienced a change in the price of oil relative to other prices, and CPI inflation will temporarily rise as a result. But assuming no spillover to the prices of other goods and services, the change in relative prices will have no permanent effect on future CPI inflation.

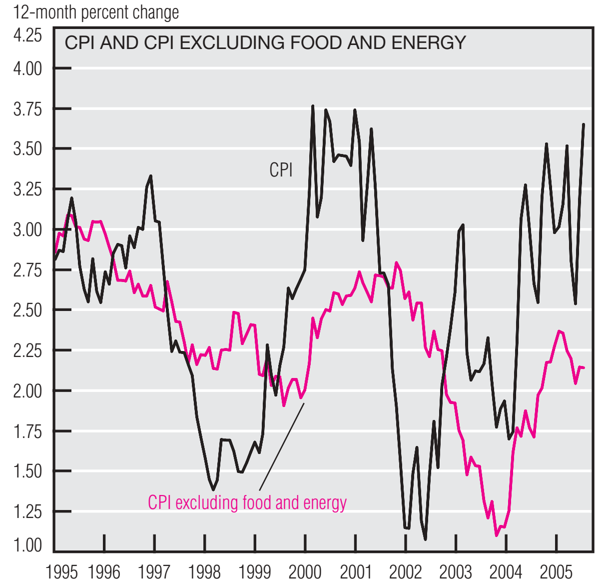
Changes in relative prices are not the same as inflation, which is more commonly thought of as a persistent and broad-based increase in the prices of goods and services. By their nature, relative price changes are self-limiting in their effect on the trend rate of inflation. True, one-time price level jumps (or declines) do reduce (or increase) the purchasing power of money, but once relative prices have adjusted, the jumps or declines will have no impact on inflation in the future. A persistent increase in the prices of a broad range of goods and services requires that monetary policy be set on an accommodative course.

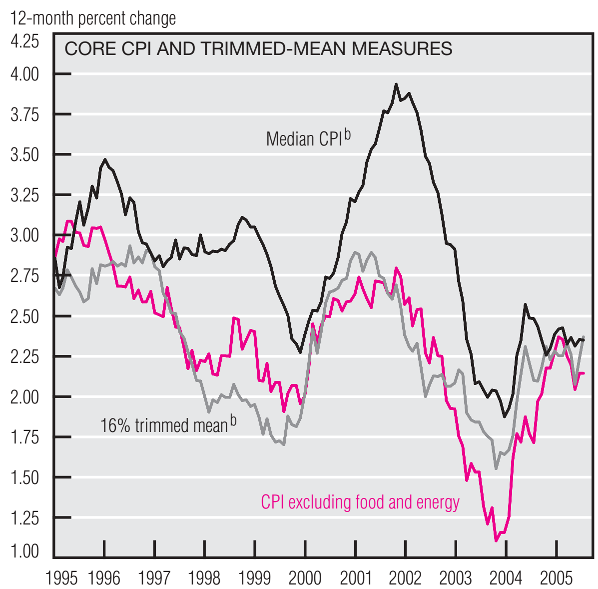
During the last 10 years, the FOMC has found it necessary to move its federal funds rate target as high as 6%, and as low as 1%, to contain the inflation trend within a range of 1%–3%. Although the FOMC's goal has been constant, its strategies and tactics might have changed to meet the challenges of each episode. In the present case, it is worth considering a twist on an old adage: You can pick your inflation targets, but you can't pick your relatives.

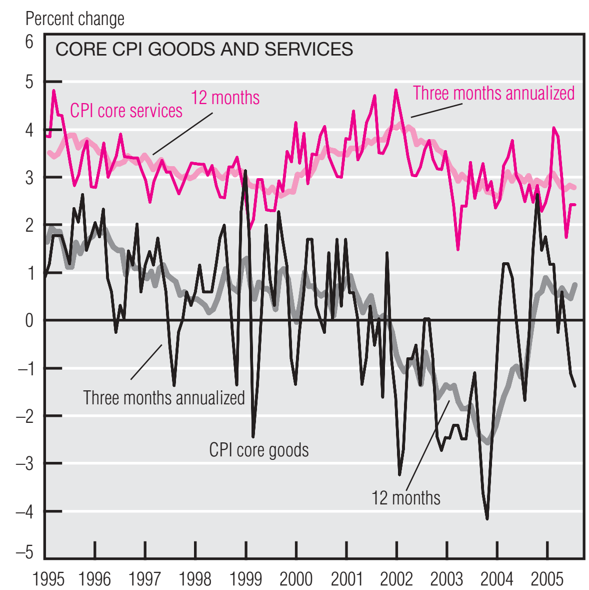
Inflation and Prices

August Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2004 avg.
Consumer prices					
All items	6.3	4.2	3.6	2.6	3.4
Less food and energy	1.2	1.4	2.1	2.0	2.2
Median[b]	2.1	2.3	2.3	2.8	2.3
Producer prices					
Finished goods	7.2	6.7	5.1	2.5	4.4
Less food and energy	0.0	1.3	2.4	1.1	2.2







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The Consumer Price Index rose 6.3% in August, following a 6.4% rise in July. Energy prices surged ahead for the second consecutive month, jumping nearly 80% (annualized rate), but growth in the core retail price measures was much more subdued. The core CPI rose a modest 1.2%, substantially below its 12-month trend of 2.1%, while the median CPI rose 2.1%, also below its 12-month trend of 2.3%.

Meanwhile, the 12-month growth rate of CPI-measured inflation continued to rise, increasing from 3.2% to 3.6% during the month. However, longer-term inflation trends in the core retail price measures were relatively stable. The 12-month growth rates in the core CPI and median CPI held steady at 2.1% and 2.3%, respectively. The 12-month growth rate in the 16% trimmed-mean CPI increased 0.2 percentage point to 2.4%. After trending upward throughout 2004, growth in the core retail price measures has generally remained steady over the past year or so, fluctuating between 2.0% and 2.5%. Inflation stability is also apparent in the major core components: Growth in core services prices has trended between 2.7% and 3.0% for over a year, and growth in core goods prices, after accelerating throughout 2004, has fluctuated in a narrow range, between 0.4% and 0.7%, since the beginning of 2005.

This relatively modest growth in the core retail price measures has continued, despite the dramatic rise in energy prices. Crude oil prices, which have nearly doubled in 2005 so

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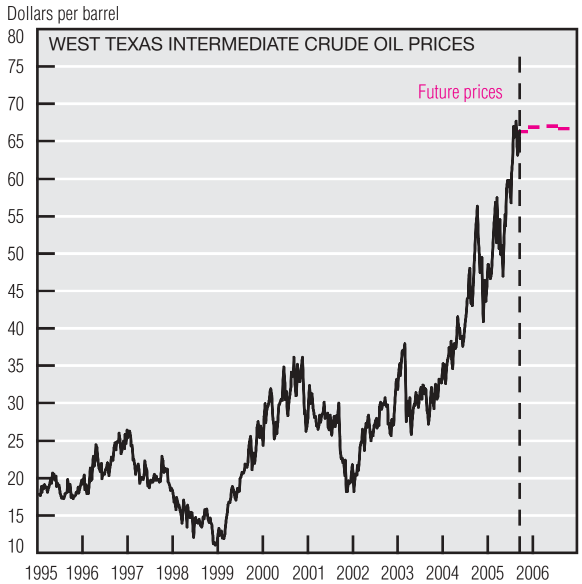
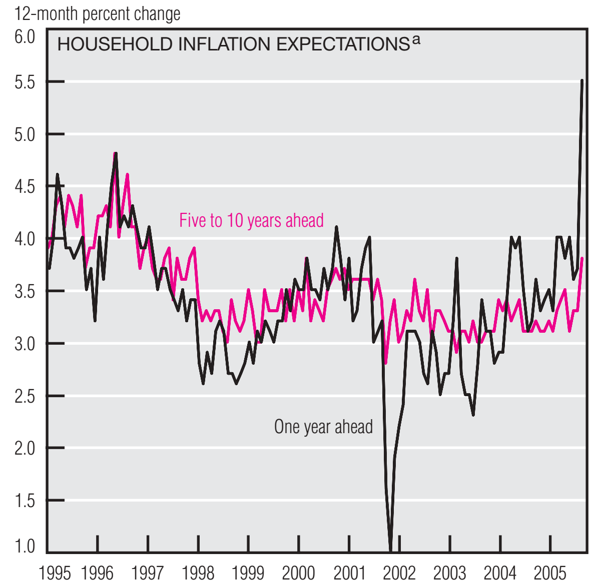
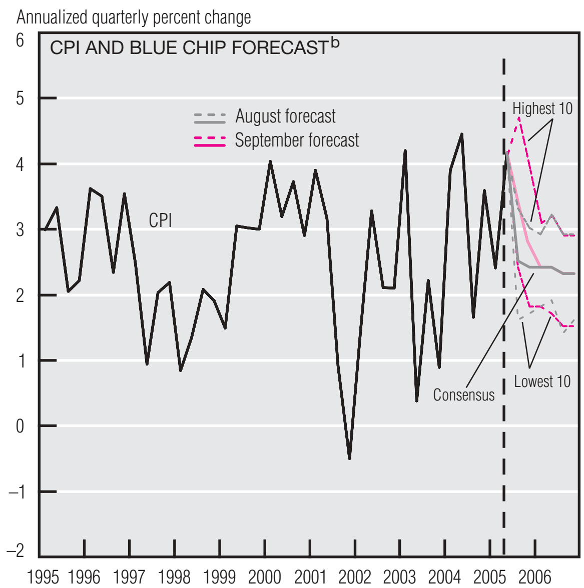
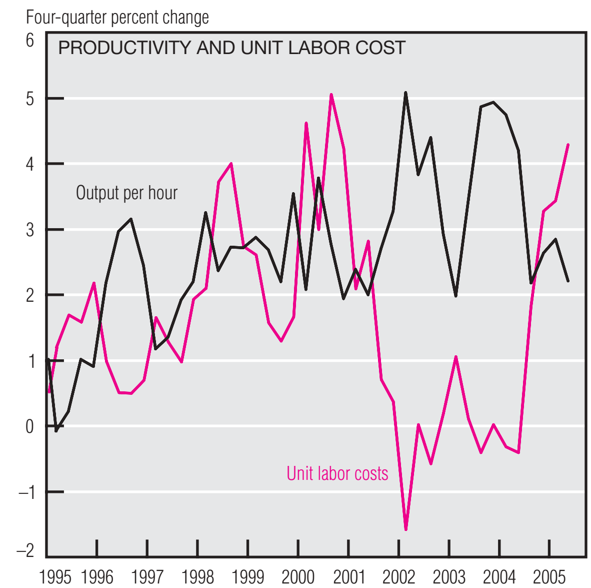
Inflation and Prices (cont.)







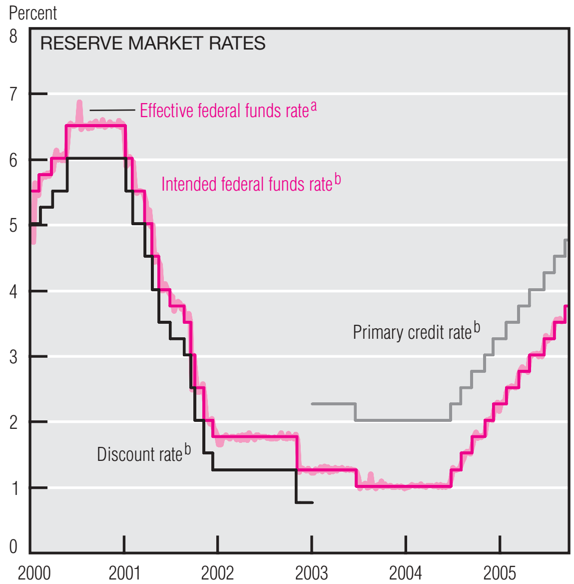


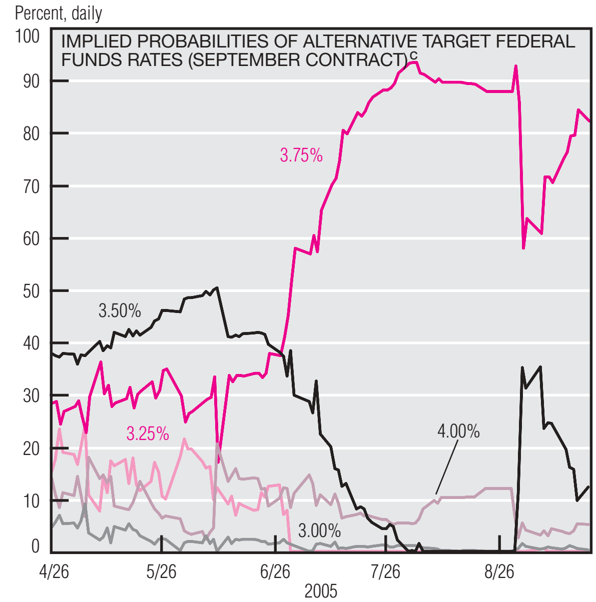
a. Mean expected change as measured by the University of Michigan's *Survey of Consumers*.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; *Blue Chip Economic Indicators*, August 10 and September 10, 2005; the *Wall Street Journal*; and Bloomberg Financial Information Services.

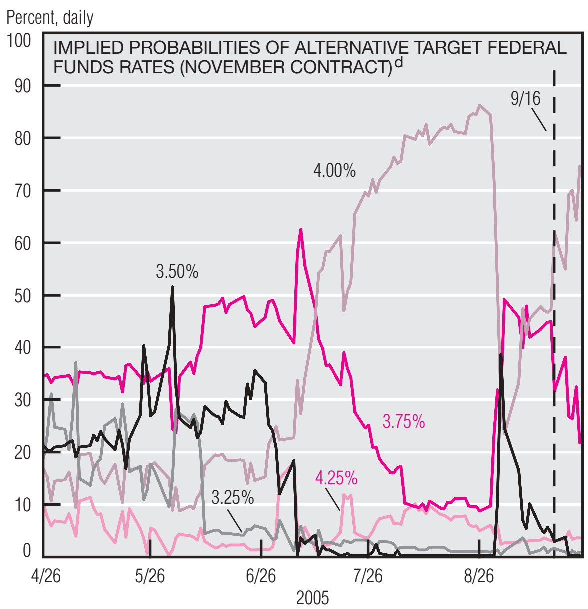
far, are expected to remain high for at least the next year. Household inflation expectations have been shaped by this dramatic and persistent rise in energy prices and by the interruptions in energy supply and distribution caused by the devastating Gulf Coast hurricanes. In September, households expected that inflation over the next year would reach 5.5% (up from 3.7% in August). Long-term inflation expectations jumped as well: Households expected prices to grow 3.8% over the next five to 10 years (up from 3.3% in August).

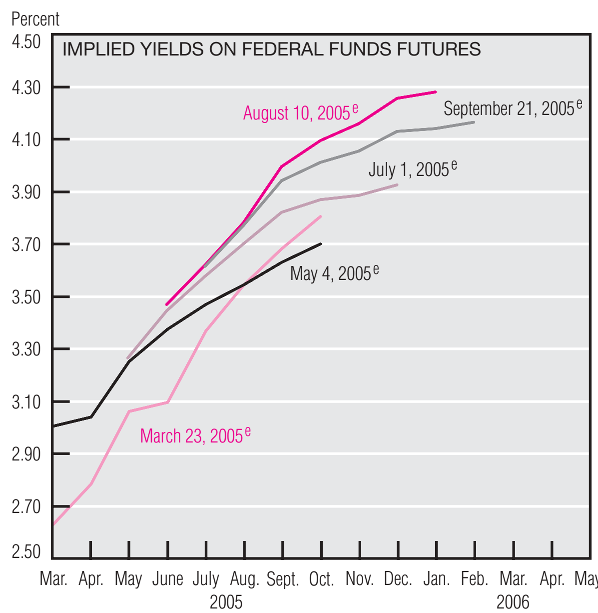
Economists are more sanguine about the inflation outlook, at least over the longer term. In the August survey, the consensus inflation outlook of the Blue Chip panel of economists was an average of 2.5% in the second half of 2005. In the September survey, this number jumped to 3.1%. However, the panel's 2006 forecast remained stable between the August and September surveys: The consensus forecast is for inflation to average about 2.4% in 2006. One of the most important factors that will shape economists' inflation forecasts is the trend in unit labor costs: Year-over-year growth in unit labor costs has accelerated substantially, going from –0.4% to 4.3%. If the recent surge in unit labor costs persists, it may eventually push economists' inflation projections significantly upward.

Monetary Policy









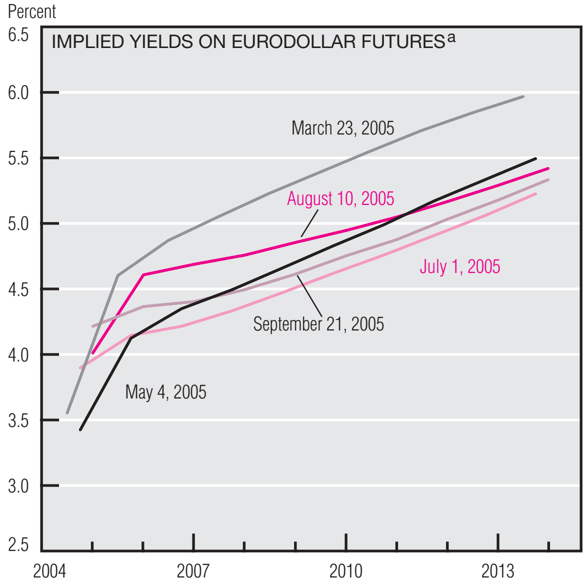
a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on September 2005 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on November 2005 federal funds futures that trade on the Chicago Board of Trade.
e. One day after the FOMC meeting.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

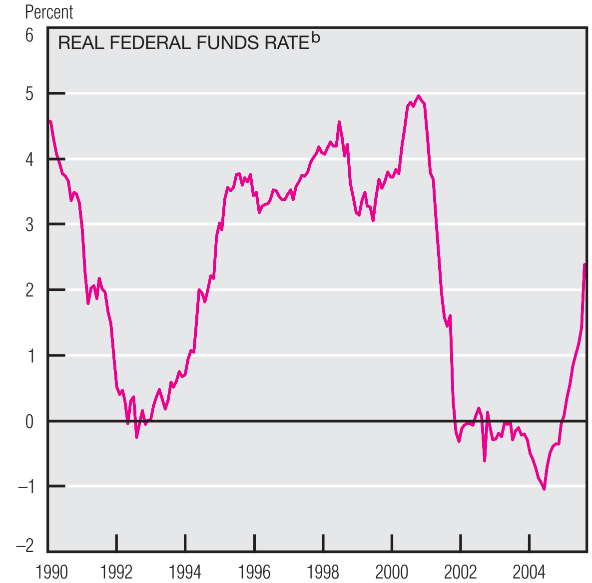
On September 20, the Federal Open Market Committee (FOMC) increased the intended federal funds rate 25 basis points (bp) to 3.75%, the eleventh such increase since the current round of tightening began in late June 2004. The FOMC's press release stated that before Hurricane Katrina, "output appeared poised to continue to grow at a good pace." However, it noted, the storm's economic consequences would "imply that spending, production, and employment will be set back in the near term." Nonetheless, the FOMC maintains the position that accommodation can continue to be "removed at a pace that is likely to be measured."

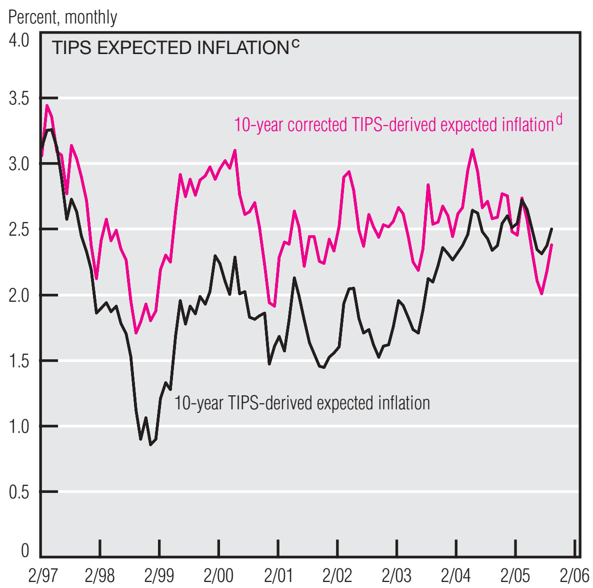
The 25 bp hike in the funds rate did not surprise participants in the federal funds options market. The day before the September meeting, they placed an 82% probability on such a hike. But in the last three weeks, as the extent of Katrina's damage has become clear, their view of policy's future course has changed substantially. On August 29, implied yields placed an 84% probability that the federal funds rate would be raised to 4% at the November meeting; during the first week of September, they thought it most likely that November would bring a pause in policy tightening.

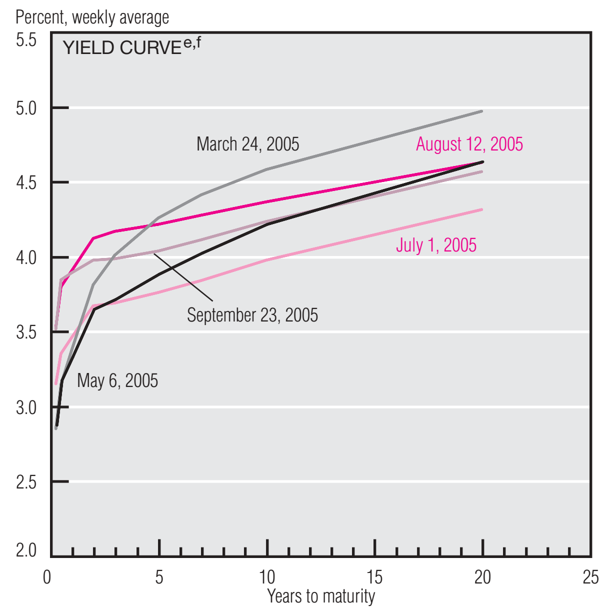
However, the September 16 release of the University of Michigan's consumer sentiment survey reported a major jump in inflation expectations, shifting participants' views away from a pause in November and toward a rate increase. They now place a 75% probability on another 25 bp hike, and fed funds futures also indicate more hikes to come this year.

Money and Financial Markets









a. One day after the FOMC meeting.
b. Defined as the effective federal funds rate deflated by the core PCE.
c. Treasury inflation-protected securities.
d. Yields are from constant-maturity series.
e. Friday after the FOMC meeting.
f. Charles T. Carlstrom, and Timothy S. Fuerst, "Expected Inflation and TIPS," Federal Reserve Bank of Cleveland, *Economic Commentary*, November 2004.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Implied yields from eurodollar futures fell in August and September, suggesting that market participants expect the current round of tightening may end or moderate significantly in 2006. They may believe that after the rate hikes anticipated during the remainder of 2005, the federal funds rate will be more nearly consistent with a neutral policy.

During the current round of tightening, the real (inflation-adjusted) federal funds rate has increased more than 300 basis points (bp), consistent with the Federal Reserve's intention of slowly removing monetary accommodation in order to avoid inflationary pressures.

Policymakers also must take into account the public's outlook on inflation. One way to measure long-term inflation expectations is to look at the difference between the yield on a Treasury bond and the yield on a Treasury inflation-protected security (TIPS), keeping the maturity constant. The last two months have witnessed a small uptick in inflation expectations over a 10-year horizon. Such movements are not unusual and appear consistent with the FOMC's statement that "longer-term inflation expectations remain contained."

The yield curve continued to flatten during August and September, with the spread between 10-year Treasury bonds and one-year Treasury notes being only 34 bp. Such a small and declining spread may be caused by lower long-run inflationary expectations.

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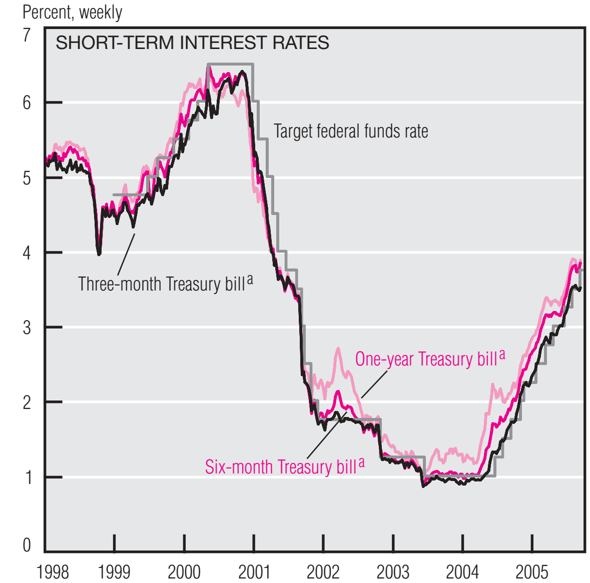
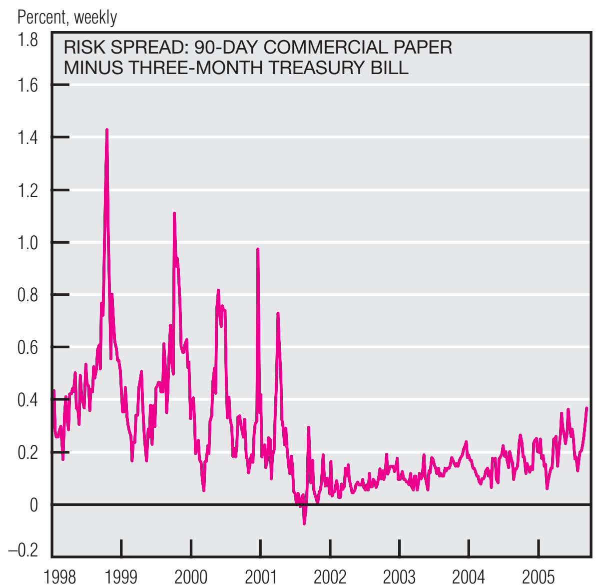
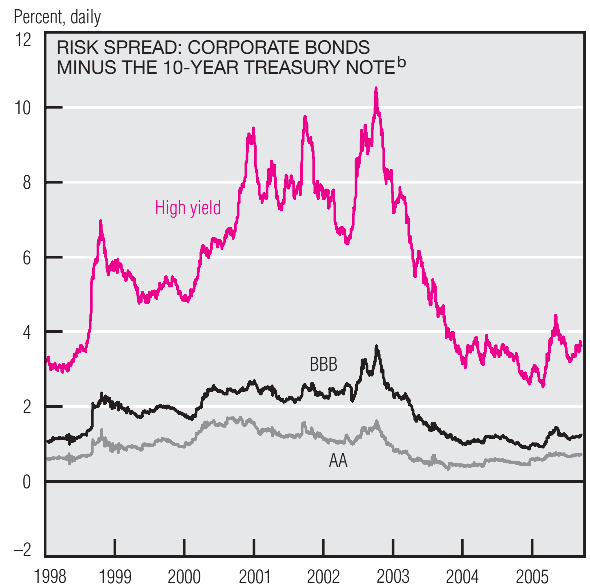
Money and Financial Markets *(cont.)*







a. Yields are from constant-maturity series.
b. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Short-term rates have moved in step with increases in the federal funds rate. Since the current round of policy tightening began, short-term Treasury rates have risen about 200 bp. However, long-term Treasury rates have fallen nearly 50 bp during the same period.

Long-term rates on conventional mortgages remain at historically low levels. Mortgage rates currently stand nearly half a percentage point lower than they were when the Fed began tightening policy in June 2004. In a recent speech, Chairman Alan Greenspan commented that "[t]his decline in mortgage rates and other long-term interest rates in the context of a concurrent rise in the federal funds rate is without precedent in recent U.S. experience."

He attributed the decline in long-term rates to a number of factors, including lower inflation expectations, lower risk premiums arising from reduced inflation volatility, lower term premiums resulting from less variability in real economic activity, and higher worldwide saving. Recent estimates by the Federal Reserve Board suggest that much of the recent decline in long rates has been caused by a fall in term premiums.

Risk spreads on corporate debt remain near historically low levels. Although risk spreads on high-yield bonds rose more than 160 bp from the beginning of the year until mid-May, they have since taken back more than half that increase. Low risk spreads may indicate investors' greater willingness to take on risk.

Since 2002:IIIQ, the household wealth-to-income ratio has trended

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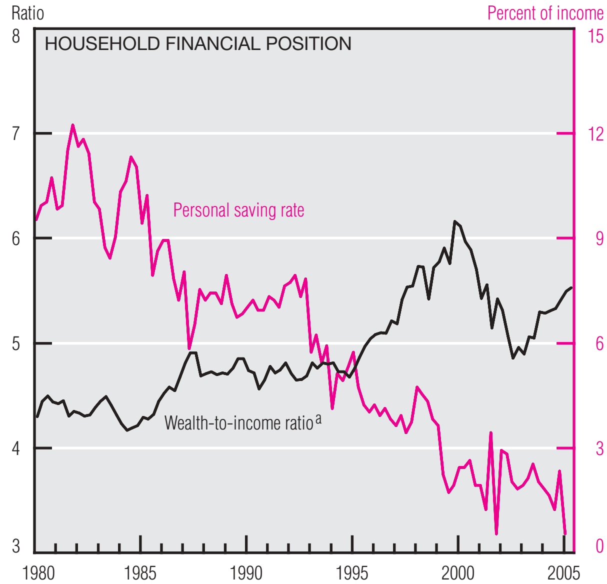
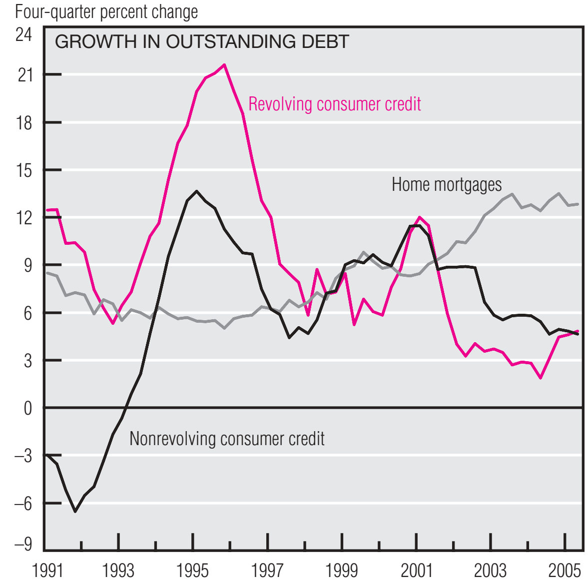
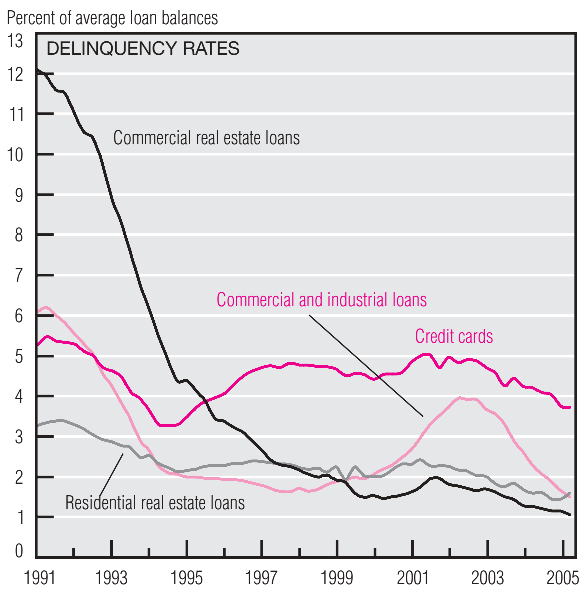
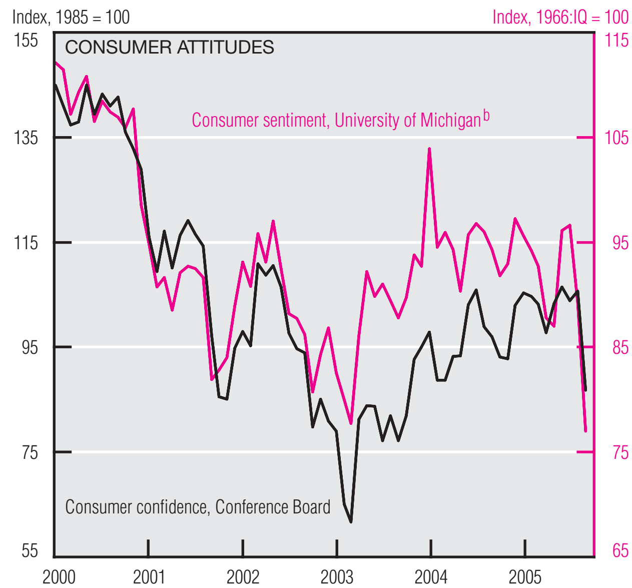
Money and Financial Markets *(cont.)*









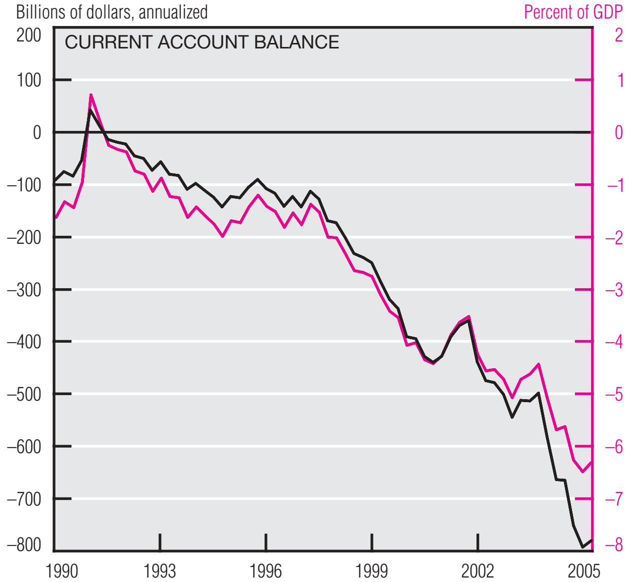
a. Wealth is defined as household net worth; income is defined as personal disposable income.
b. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1; University of Michigan; and the Conference Board.

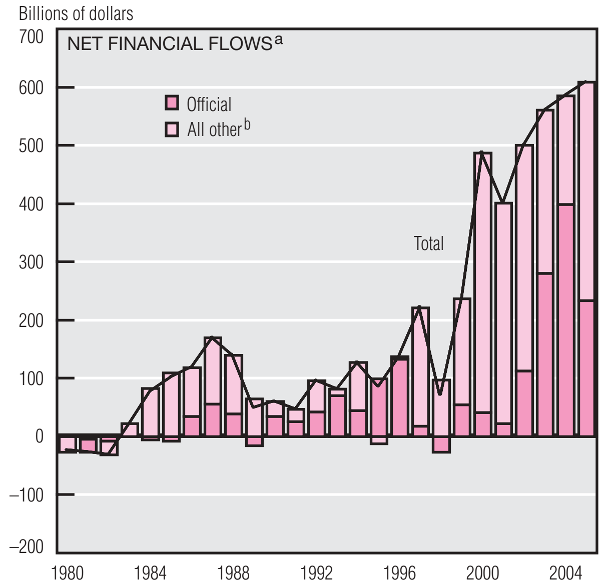
upward. Rising stock market prices contributed to this trend in its early stages. Even though stock prices have changed little so far this year, the upward trend in the wealth-to-income ratio continues, primarily because of rising home prices. Increases in the wealth-to-income have helped support consumer spending. After averaging 4.9% over the last 20 years, the personal saving rate currently is 0.3% of disposable income. Higher levels of wealth enable households to feel more comfortable with a lower saving rate.

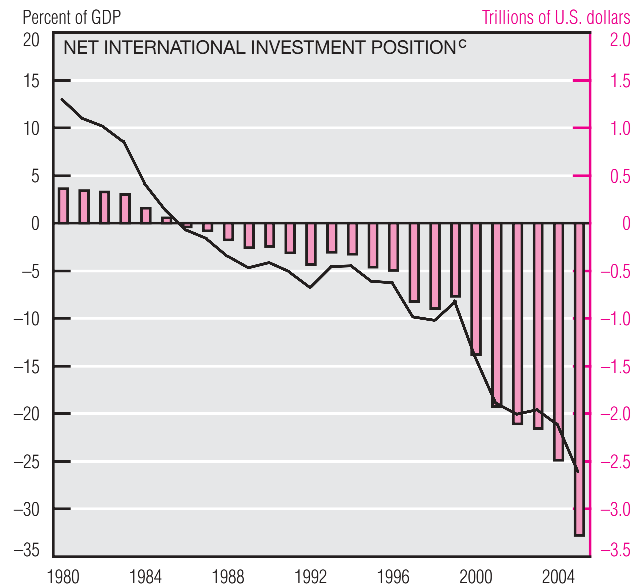
Household debt rose at an annual rate of over 9.5% during the first half of the year, fueled strongly by an increase in mortgage debt. Nonetheless, mortgage debt growth during the first half of the year was attenuated compared to its brisk growth during 2004. Growth in consumer credit remained less robust because households turned to home equity to finance expenditures. Despite the increases in household debt, delinquency rates on consumer loans remain low.

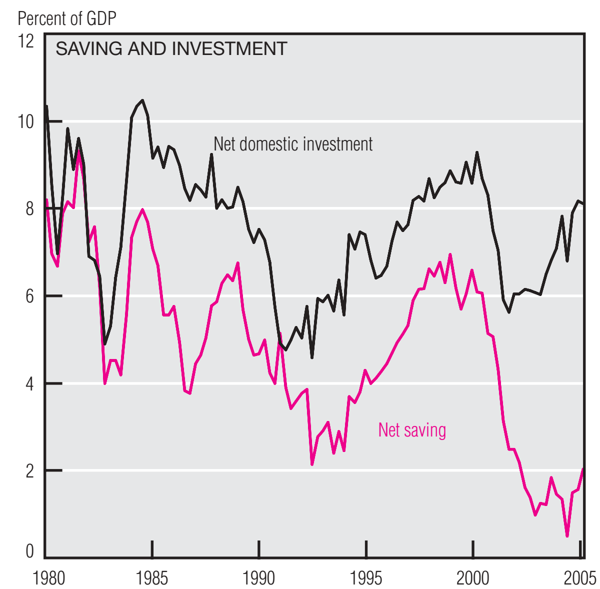
The University of Michigan's Consumer Sentiment Index plummeted in September. The decline, greater than anticipated, was the largest drop since December 1980. Analysts attributed the steep decline in confidence to soaring energy prices and the impact of Hurricane Katrina. The Conference Board's Index of Consumer Confidence took a similar hit in September and likewise posted its largest drop in 25 years. Consumer confidence weakened in all components of the index. Analysts expect consumer confidence to rebound as recent declines in wholesale energy prices feed through to consumers.

The Current Account









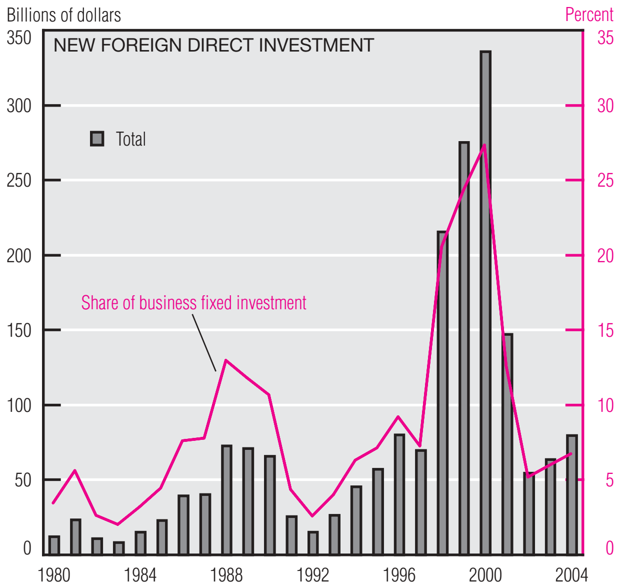
a. Includes capital account transactions.
b. Includes direct investment, portfolio investment, other miscellaneous financial flows, and capital account transactions.
c. The net international investment position for 2005 is estimated by adding the annualized current account deficit for the first half of 2005 to the investment position for 2004. GDP for 2005 is estimated by averaging GDP for the first two quarters with Blue Chip forecasts for the last two quarters.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics*; and *Blue Chip Economic Indicators*, September 2005.

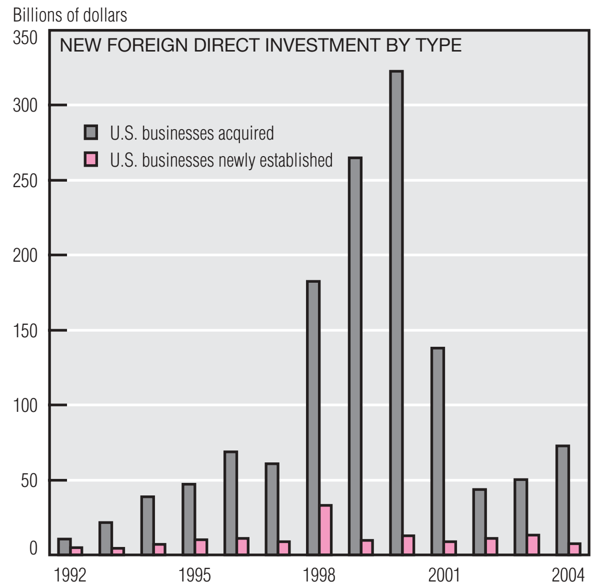
During the first half of 2005, the U.S. registered a current account deficit of $789 billion, an amount equal to 6.4% of GDP, as we continued importing more goods and services from the rest of the world than we exported to them. A country that runs a current account deficit finances its surfeit of imports by issuing net financial claims to foreigners, including official claims to foreign governments. Net official claims accounted for approximately 38% of the total in the first half of this year, down from 68% in 2004.

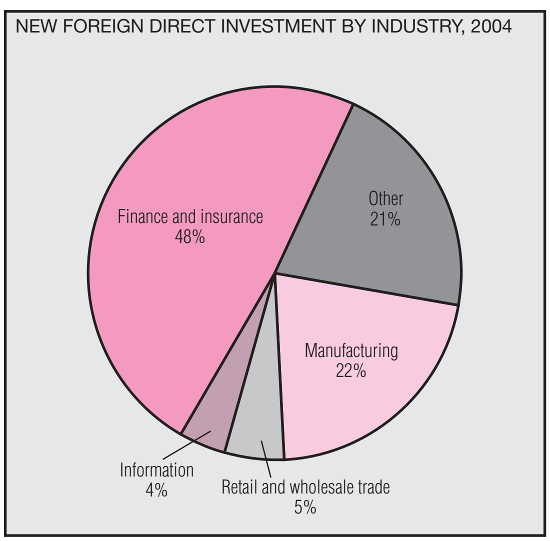
Because they have financed our current account deficits for the past 22 years, foreigners now hold substantially more claims on the U.S. than we hold on the rest of the world. This is shown by our negative net international investment position, which could top $3.3 trillion—or 26% of GDP—in 2005.

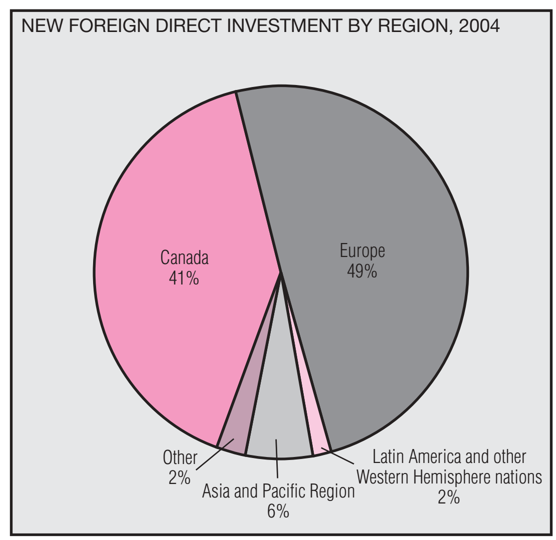
When foreigners acquire financial claims on the U.S., they channel their savings into this country. Since late 2001, this inflow of foreign savings has financed an increase in net domestic investment and, as revealed by our flat savings rate, an increase in overall consumption. The increase in net domestic investment bodes well for the sustainability of our current account deficit. By fostering growth, investment eases the difficulty of servicing these claims, but a higher rate of net domestic saving would also help.

New Foreign Direct Investment in the U.S.









SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Thomas W. Anderson, "Foreign Direct Investment in the United States, New Investment in 2004," *Survey of Current Business*, June 2005, pp. 30–37.

Foreigners account for a substantial part of all new direct investment in the U.S., chiefly through acquisition of existing U.S. businesses. (Direct investment implies that the foreign investor has acquired a controlling interest—10% or more—in a U.S. firm.) In 2004, according to the most recent data, foreigners spent $79.8 billion to acquire new or existing U.S. firms, an amount equal to approximately 7% of total U.S. business fixed investment. New foreign direct investment grew in both 2003 and 2004, when U.S. economic growth far outpaced that of other large industrial countries.

Despite recent increases, new foreign investment in this country remains far below the levels experienced from 1998 through 2003. During that period, new foreign investment averaged a whopping $243 billion per year, more than one-fifth of all business fixed investment.

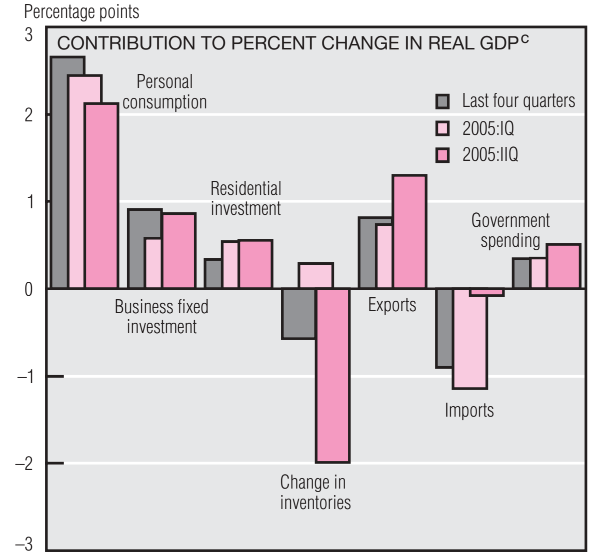
The profitable, open U.S. financial and insurance industries attracted nearly half of all new foreign direct investment in 2004, with banks and other depository institutions contributing almost all of the gains. The manufacturing sector attracted slightly less than one-quarter of all new foreign direct investment in 2004.

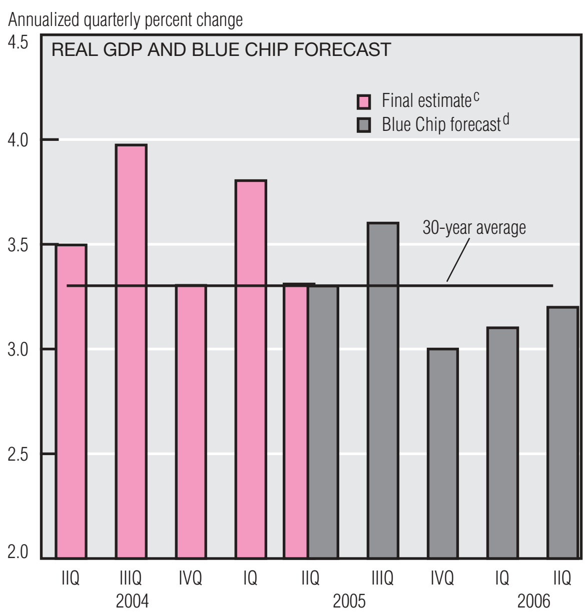
Europe and Canada contributed 90% of all new investment in the U.S. that year. The U.K. accounted for the largest share (61%) of European investments in the U.S., followed—at some distance—by Germany (12%), France (12%), and Switzerland (9%). Asia and the Pacific Region accounted for 6% of the total, but this mostly represents Australian investments.

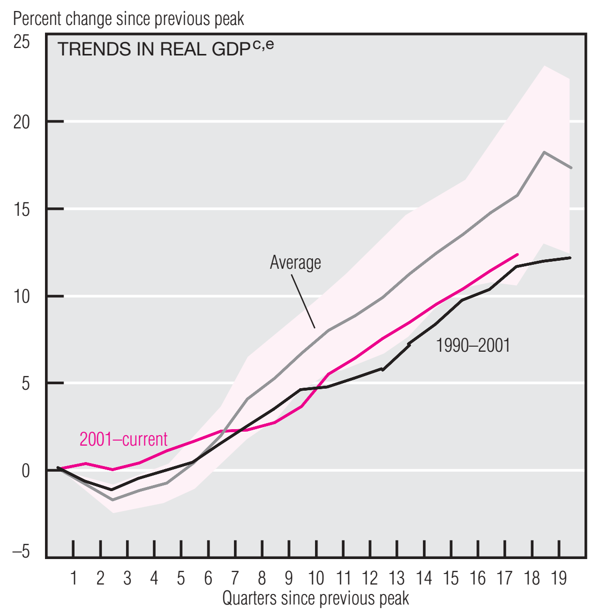
Economic Activity

Real GDP and Components, 2005:IIQ[a,b]
(Preliminary estimate)

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	89.9	3.3	3.6
Personal consumption	58.3	3.0	3.8
Durables	21.0	7.7	6.6
Nondurables	19.5	3.5	4.5
Services	20.7	1.9	2.9
Business fixed investment	25.6	8.4	9.1
Equipment	25.4	10.4	11.6
Structures	1.7	2.7	1.7
Residential investment	13.8	9.8	5.8
Government spending	13.1	9.8	1.8
National defense	2.9	2.4	2.7
Net exports	34.2	—	—
Exports	36.6	13.2	8.3
Imports	2.4	0.5	5.9
Change in business inventories	–55.6	—	—







a. Chain-weighted data in billions of 2000 dollars.
b. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
c. Data are seasonally adjusted and annualized.
d. Blue Chip panel of economists.
e. The shaded band represents the average for the nine previous business cycles, plus or minus two standard errors.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, September 10, 2005.

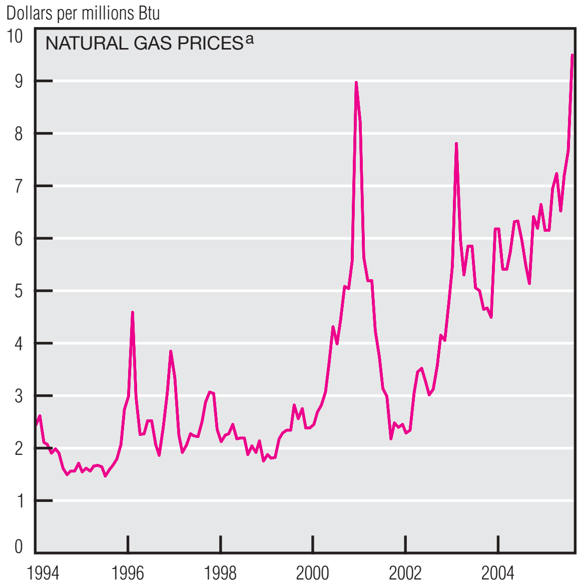
The Commerce Department's final reading of real GDP for 2005:IIQ was 3.3%, unchanged from the preliminary estimate. This was 0.5 percentage point (pp) lower than the final 2005:IQ growth of 3.8%. The deceleration was attributed primarily to a downturn in inventories, partly offset by deceleration in imports and acceleration in exports. Imports, which subtract from GDP, grew at an annual rate of only 0.5%, compared to 5.9% over the last four quarters. Exports, which contribute positively to GDP, grew at an annual rate of 13.2%, compared to 8.3%.

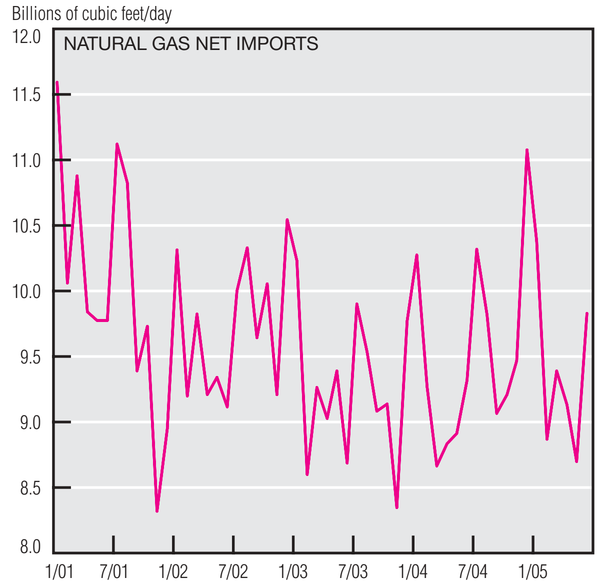
Personal consumption was the largest positive contributor to the change in real GDP, adding 2.1 pp. Exports contributed 1.3 pp, compared with only 0.7 pp in 2005:IQ. However, inventories subtracted 2.0 pp from real GDP, its heaviest drag since 2001:IVQ.

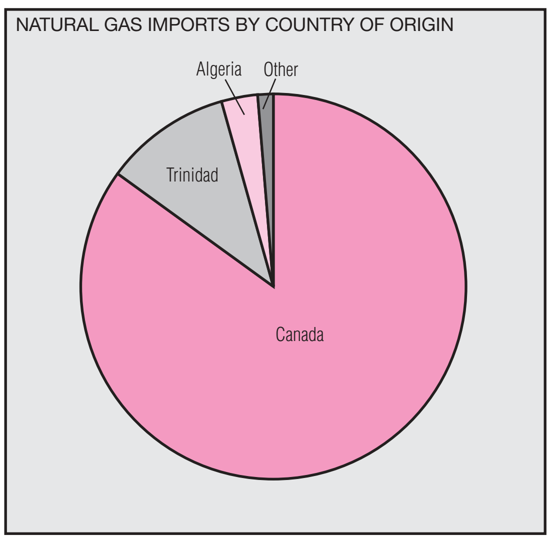
Real GDP growth as low as 3.3% was last observed in 2004:IVQ. Before that, 2003:IQ was the last time real GDP growth was less than in 2005:IIQ. The economy is currently growing at exactly its 30-year average rate. But except for 2005:IVQ, Blue Chip forecasters do not expect this to continue. Their September 10, 2005, publication predicted that growth in 2005:IIIQ would be 3.6%, 0.3 pp lower than the August prediction of 3.9%. They also lowered their 2005:IVQ prediction by 0.3 pp to 3.0%.

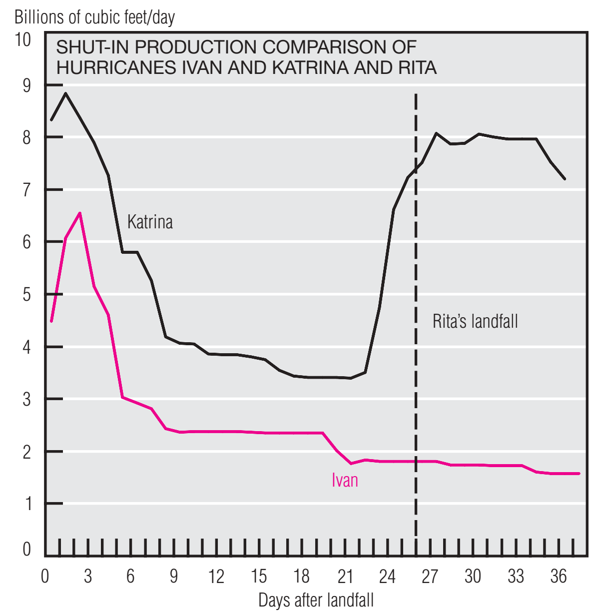
Compared to previous recessions, real GDP growth since the 2001 event still lags the post-1949 average. However, it is slightptly higher than the 1990 recession and within the average range for all recessions in the last 56 years.

Natural Gas







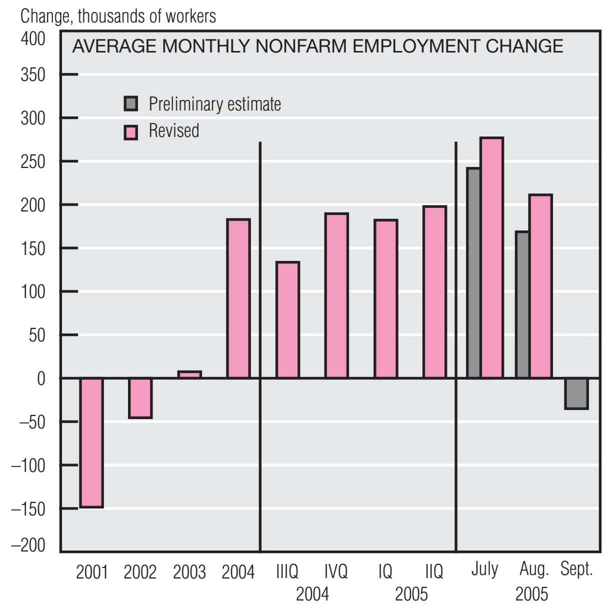


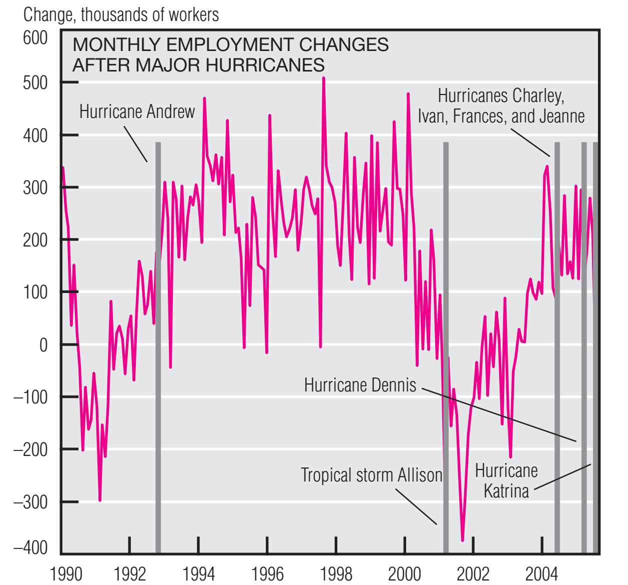
a. Prices at Henry Hub, Louisiana.
SOURCES: U.S. Department of Energy, Energy Information Administration; Board of Governors of the Federal Reserve System; and the *Wall Street Journal*.

As the winter heating season draws nearer, many consumers are worried about natural gas supplies and prices. By August, prices had already surpassed the most recent price spikes of December 2000 and February 2003. Although increased imports seem to have some ability to help meet demand, this potential is likely to be limited, at least in the upcoming heating season, because of short-run capacity constraints. In 2004, net imports met only about 15% of U.S. demand for natural gas. About 85% of imports come from Canada; most of the rest is from Trinidad (11%) and Algeria (3%).

A key question is how quickly Gulf of Mexico production, which normally accounts for about 20% of U.S. total production, can be brought back on line. Hurricane Katrina, which made landfall on August 29, caused a huge spike in lost or "shut-in" production. More than half of the loss had returned within two to three weeks. However, only 26 days after Katrina, Hurricane Rita roared through the Gulf, making landfall on September 24 and returning shut-in production to the level reached just after Katrina. As of October 4 (36 days after Katrina made landfall), about 7.2 billion cubic feet per day—roughly 69% of normal Federal Gulf of Mexico production—remained shut in. After Hurricane Ivan hit last year, shut-in production peaked at 6.5 billion cubic feet per day. It fell more than halfway within the first week, but seven weeks later it still stood at about 1 billion cubic feet per day. Thus, if history is any guide, much of the lost production will return in the next several weeks, but as much as 10% of normal Gulf production (or about 2% of normal U.S. production) could be shut in for months, depending on the severity of damage to Gulf production facilities.

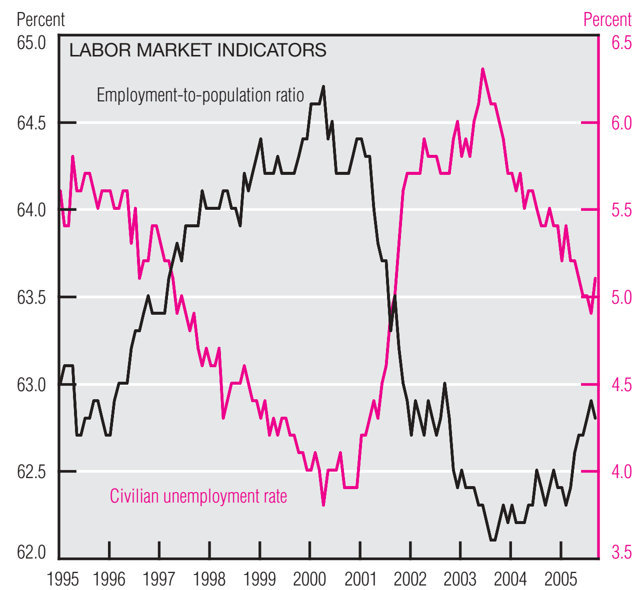
Labor Markets





Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2001	2002	2003	2004	Sept. 2005
Payroll employment	–148	–45	8	183	–35
Goods producing	–124	–76	–42	29	1
Construction	–1	–7	10	23	23
Manufacturing	–123	–67	–51	3	–27
Durable goods	–88	–48	–32	9	–21
Nondurable goods	–35	–19	–19	–6	–6
Service providing	–25	30	50	154	–36
Retail trade	–24	–10	–5	13	–88
Financial activities[a]	8	6	7	12	11
PBS[b]	–63	–17	22	45	52
Temporary help svcs.	–37	2	12	15	32
Education & health svcs.	50	40	30	33	49
Leisure and hospitality	–1	12	18	22	–80
Government	46	21	–4	12	31
	Average for period (percent)				
Civilian unemployment rate	4.8	5.8	6.0	5.5	5.1



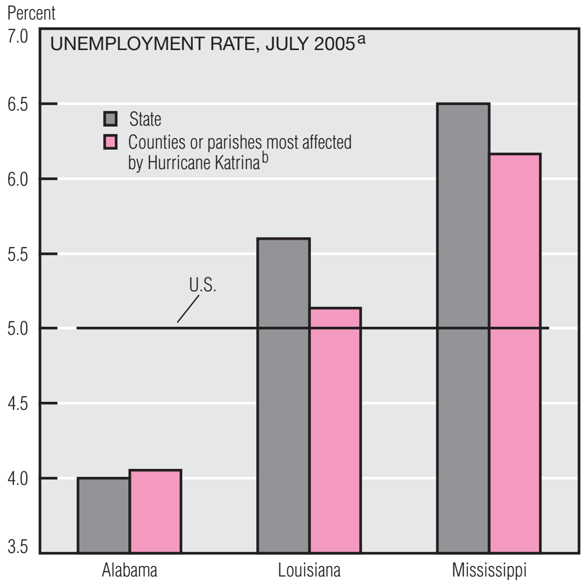
NOTE: All data are seasonally adjusted.
a. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.
b. Professional and business services include professional, scientific, and technical services, management of companies and enterprises, administrative and support, and waste management and remediation services.
c. Percent of total nonfarm industries with increased employment over three months (or six months) plus half of those with unchanged employment.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Employment changed little in September. After a total upward revision of 77,000 jobs for July and August, nonfarm payroll employment declined by 35,000 jobs in September, significantly fewer than had been anticipated in the wake of Hurricane Katrina. The BLS noted that September employment may be underestimated because of technical adjustments to account for responses in disaster areas. This is the first time the BLS has had to modify estimation procedures in response to a disaster. Previous natural disasters have had limited impact on monthly employment. Since the beginning of this year, payroll employment gains have averaged a healthy 203,000 jobs a month.

Service-providing industries declined by 36,000 jobs, largely in the retail and leisure and hospitality industries. Employment in retail trade fell by 88,000 jobs, while employment in leisure and hospitality fell by 80,000. Jobs in education anpd health services rose by 49,000. Professional and business service industries added 52,000 jobs, of which 32,000 jobs were in temporary help services, which were boosted by hiring associated with hurricane recovery efforts. Meanwhile, the construction industry increased by 23,000 jobs, which is consistent with average monthly gains this year. Manufacturing employment continued to falter, dropping by 27,000 jobs; however, this number includes a temporary strike by 18,000 workers in the aerospace industry.

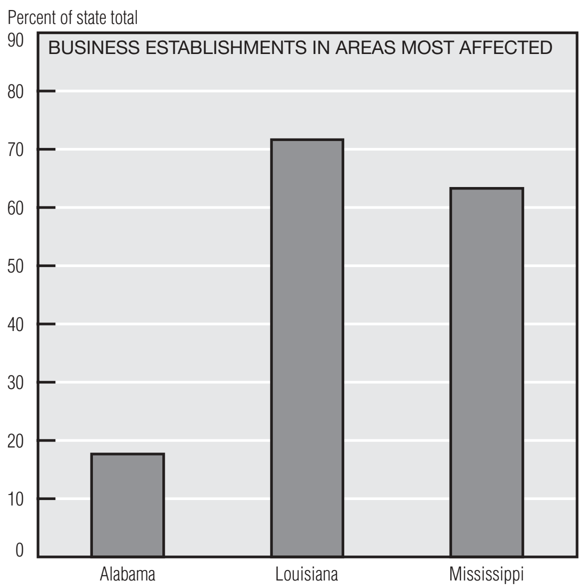
After reaching a four-year low of 4.9% in August, the unemployment rate inched upward to 5.1% in September, and the employment-to-population ratio inched downward to 62.8%.

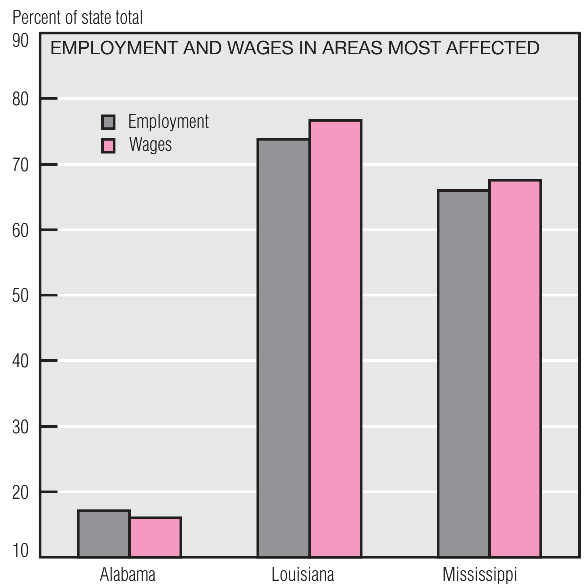
The Gulf Region before Hurricane Katrina



Business Establishments in the Areas Most Affected, 2004 Annual Average[c]

	Establishments: Number	Establishments: Share of U.S. total
Total	**145,341**	**1.7**
Private, total	138,968	1.7
Natural resources and mining	3,292	2.7
Construction	12,897	1.6
Manufacturing	5,664	1.5
Trade, transportation, and utilities	37,699	2.0
Information	2,100	1.5
Financial activities	15,787	2.0
Professional and business services	21,801	1.6
Education and health services	13,470	1.8
Leisure and hospitality	12,198	1.8
Other services	13,446	1.2
Unclassified	705	0.4
Federal government	1,346	2.6
State government	1,700	2.6
Local government	3,337	2.2



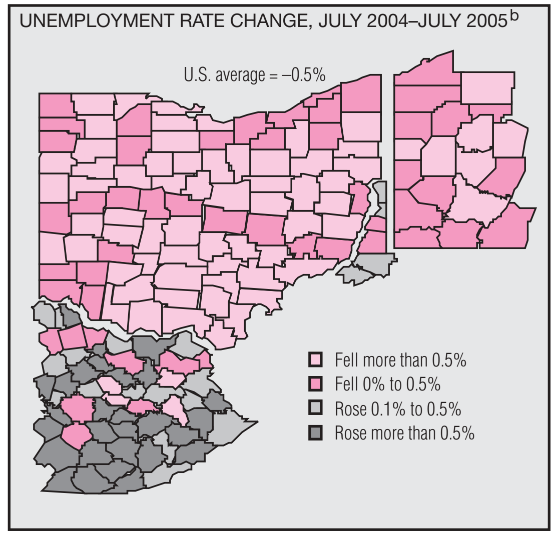


a. Data are seasonally adjusted.
b. The most affected areas, as defined by the Bureau of Labor Statistics, are comprised of the eight counties in Alabama, 31 parishes in Louisiana, and 47 counties in Mississippi that the Federal Emergency Management Agency designated to receive both individual and public disaster assistance as of September 8, 2005.
c. Reproduced from a table created by the BLS, http://www.bls.gov/katrina/data.htm.
SOURCES: Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

Hurricane Katrina caused terrible loss of lives and immeasurable human suffering. It also disrupted local economies throughout the south-central U.S. Areas affected by the storm are eligible to receive assistance from the Federal Emergency Management Agency for state and local governments and certain private nonprofit organizations. A smaller number of areas are also eligible for assistance to individuals and households. These “most affected” counties or parishes in Louisiana and Mississippi had weak labor market conditions even before the storm. Although these areas’ unemployment rates were lower than their states’, they exceeded the 5.0% U.S. rate.

The roughly 145,000 business establishments in the most affected areas of Alabama, Louisiana, and Mississippi accounted for about 1.7% of all U.S. businesses before the storm. These areas had a larger share of establishments in the natural resources and mining industry (2.7%) and federal and state government (2.6%). In 2004, the areas’ businesses accounted for more than 2.4 million jobs, or 1.9% of total U.S. employment, but they accounted for about 74% of workers in Louisiana and 66% in Mississippi. These businesses paid nearly $77 billion in wages, about 1.5% of total U.S. wages but close to 77% of wages paid in Louisiana and 68% in Mississippi. Although the storm devastated local economies, these areas represent only a small fraction of U.S. businesses, employment, and wages.

Fourth District Employment



Payroll Employment by Metropolitan Statistical Area

	12-month percent change, August 2005							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	–0.3	0.4	0.7	–1.2	1.4	0.5	0.4	1.7
Goods-producing	0.4	1.0	2.0	–3.0	–0.4	–2.3	1.3	0.9
Manufacturing	–0.1	–1.2	1.7	–3.6	–2.2	–2.7	0.3	–0.8
Natural resources, mining, and construction	2.1	5.4	2.9	–1.2	4.7	–1.6	3.8	4.0
Service-providing	–0.5	0.3	0.4	–0.7	1.9	1.0	0.2	1.9
Trade, transportation, and utilities	–1.4	–1.0	–0.7	–2.9	1.4	0.7	0.7	1.6
Information	–2.5	0.5	–2.3	–5.3	–2.1	–0.4	–2.2	0.5
Financial activities	0.4	–0.1	–0.3	–4.3	1.5	0.4	–0.9	2.3
Professional and business services	–0.7	–0.5	2.4	–0.4	4.3	1.3	2.1	3.1
Education and health services	1.5	2.7	2.1	2.5	0.4	2.2	0.0	2.4
Leisure and hospitality	–0.3	2.1	–1.8	–1.0	0.6	0.9	1.2	2.6
Other services	–0.9	–1.5	1.4	3.4	3.2	1.7	1.0	0.7
Government	–1.5	0.4	0.5	–0.8	3.3	–0.2	–1.7	0.9
July unemployment rate (percent)[b]	5.7	5.0	5.2	5.8	5.9	5.4	4.7	5.0

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

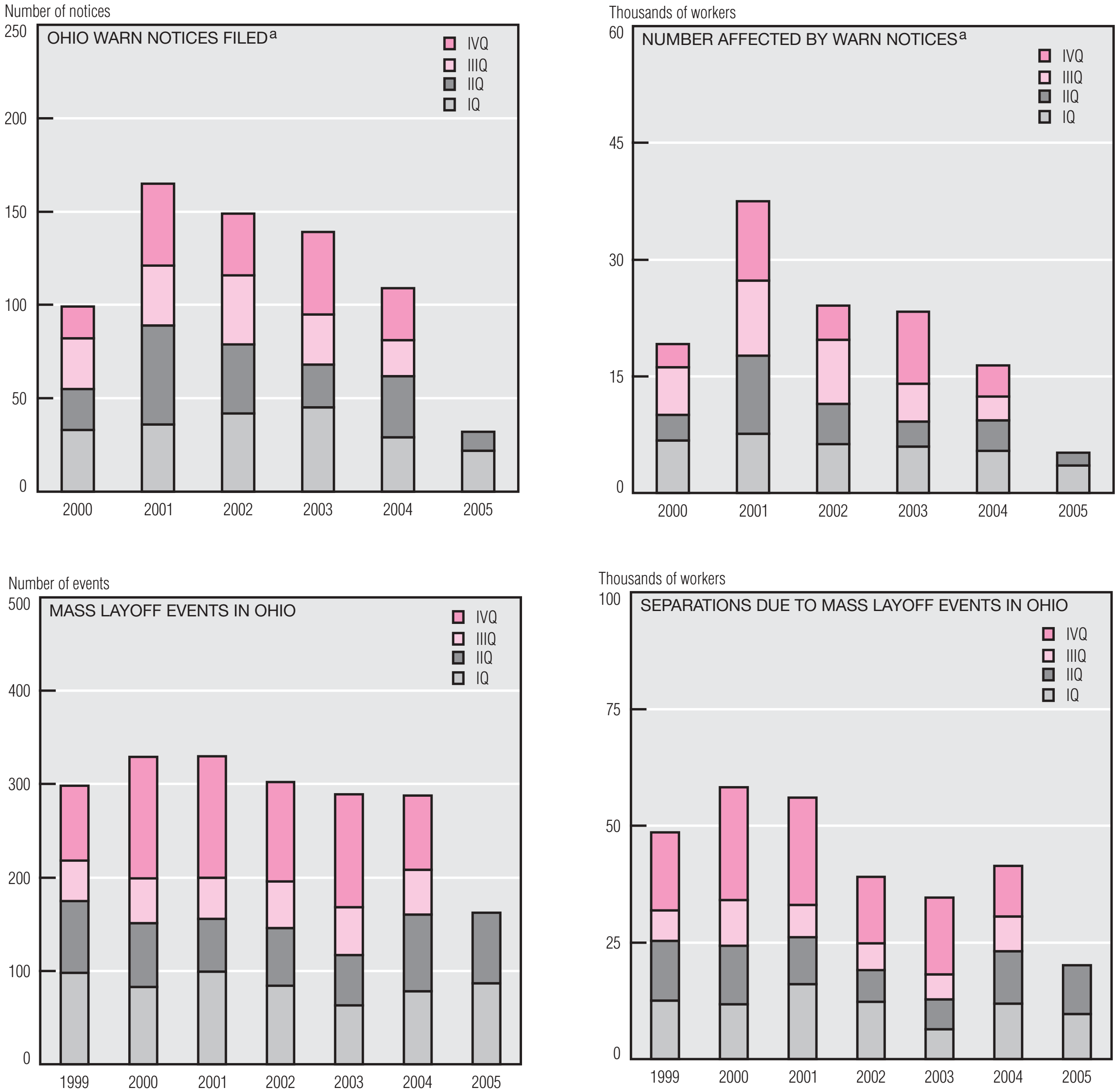
The Fourth District's unemployment rate fell to 5.6% in July, down 0.2 percentage point from June and its lowest level in nearly three years. The U.S. rate fell from 5.0% in July to 4.9% in August.

The July unemployment rate was higher in most Fourth District counties than in the nation. In the District, 136 counties had unemployment rates higher than the U.S. rate of 5.0%, 28 had lower rates, and five had the same rate as the nation.

However, comparing the District to the nation makes it difficult to see local improvement over time, because the District's unemployment rates have been following a downward path similar to the nation's over the past several months. To show the District's progress more distinctly, individual counties' current performance can be compared to their standing in July 2004: 122 counties' unemployment rates were the same or better than a year earlier, whereas rates worsened in only 47 counties. Most of the counties where the unemployment rate rose are in Kentucky, whose unemployment rate increased 0.3 percentage point over the same period.

Of the District's major metropolitan areas, only Cleveland and Dayton have lost employment since August 2004. Although Cleveland had positive goods-producing employment growth, its service-providing employment growth lagged the nation's significantly. During the same period, the Dayton metropolitan area lost both goods-producing and service-providing jobs

Mass Layoffs in Ohio



a. WARN covers certain employers in advance of plant closing and mass layoffs. A covered plant closing occurs when a plant is shut down for more than six months or when at least 50 employees lose their jobs in any 30-day period at a single site of employment. A covered mass layoff occurs when a layoff of six months or longer affects at least 500 workers, or 33% or more of the employer's workforce when a layoff affects 50–499 workers.

SOURCE: Ohio Department of Job and Family Services, Bureaus of Workforce Services and Labor Market Information.

The Worker Adjustment Retraining Notification (WARN) Act protects workers, their families, and their communities by requiring employers to give notice 60 days before plant closings and mass layoffs. This advance notice gives workers time to search for new jobs or obtain job retraining. Relatively few WARN notices were issued in 2005:IQ, and even fewer in 2005:IIQ. The number of workers affected likewise fell.

The Mass Layoff Statistics (MLS) program is designed to identify, describe, and track major job cutbacks. A mass layoff event occurs when at least 50 initial unemployment compensation claims are filed against an establishment within a five-week period and the layoff lasts more than 30 days. The MLS data include events that do not meet the WARN standard. And companies can sometimes configure layoffs to avoid issuing WARN notices. Thus there are more layoff events than notices filed. Since 2001, the annual number of mass layoff events in Ohio has trended downward. Through the first six months of 2005, this number was nearly equal to that reported for the same period in 2004. However, in 2005:IIQ, the number of events was 8.5% lower than in 2004:IIQ.

The number of separations (job losses) in mass layoff events fell in 2002 and 2003, only to rise again in 2004. The average number of separations per event followed a similar pattern. For the first six months of 2005, there were 162 mass layoff

(continued on next page)

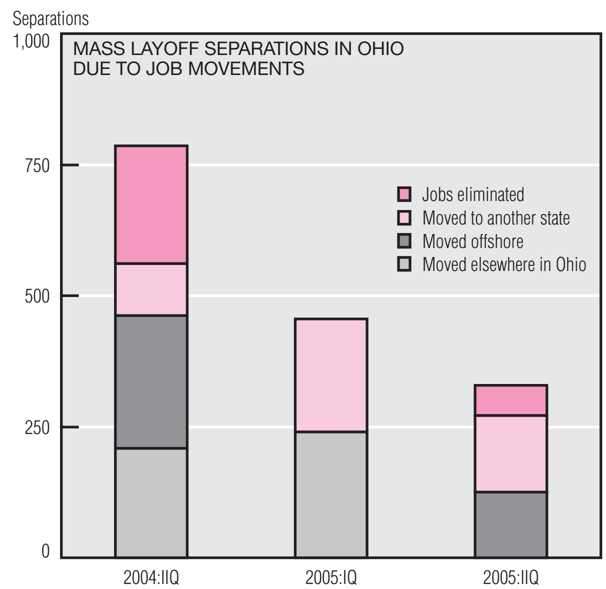
Mass Layoffs in Ohio *(cont.)*

Mass Layoffs in Ohio by Industry[a,b]

	Establishments with mass layoffs					Workers separated	
	2005:IIQ		2004:IIQ			2005:IIQ	
	Number	Percent of total	Number	Percent of total	Year-over-year percent change	Number	Percent of total
Goods producing							
Construction	12	16	13	16	–8	1,402	14
Manufacturing	17	23	14	17	21	2,104	20
Durable goods	16	21	11	13	45	2,049	20
Nondurable goods	—	—	3	4	—	—	—
Service providing							
Wholesale trade	—	—	3	4	—	—	—
Retail trade	—	—	8	10	—	—	—
Transportation, warehousing, and utilities	10	13	6	7	67	1,591	15
Professional and business services	6	8	5	6	20	1,217	12
Education and health	18	24	16	20	13	1,897	18
Leisure and hospitality	4	5	7	9	–43	712	7
Other services	5	7	6	7	–17	795	8
Total	75	100	82	100	–9	10,378	100

Mass Layoff Events in Ohio by Primary Reason[c]

	Percent of total		
	2005:IIQ	2004:IIQ	Average 2000:IQ–2005:IIQ[d]
Contract completed	21.3	13.4	20.5
Reorganization	6.7	9.8	15.0
Seasonal	53.3	53.7	34.3
Slack work	14.7	9.8	16.2
Total	100.0	100.0	100.0



a. Natural resources and mining, information, finance activities, and public administration each had less than three layoffs.
b. Dashes indicate data suppressed to protect confidentiality; totals include suppressed industries.
c. The reasons that accounted for fewer than three layoffs each in 2005:IIQ were bankruptcy, ownership change, contract cancellation, domestic relocation, financial difficulty, plant/machine repair, discontinued product lines, import competition, other, and information not available.
d. The average since 2000 counts suppressed data as zero.
SOURCE: Ohio Department of Job and Family Services, Bureau of Labor Market Information.

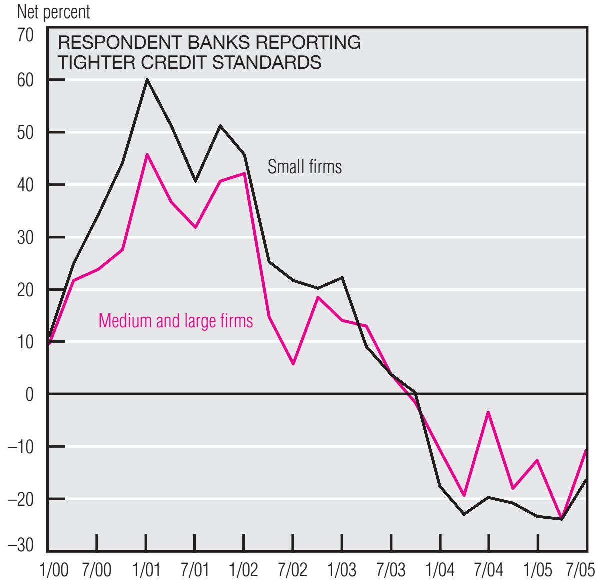
events, for an average of 124 separations per event.

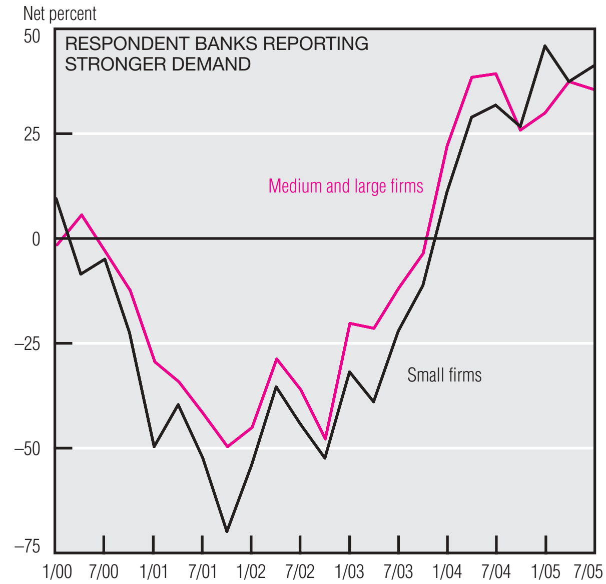
In 2005:IIQ, about a fourth of establishments with mass layoffs were in the education and health industries and another fourth in manufacturing. Compared to 2004:IIQ, transportation and warehousing and durable goods industries saw significant increases in the number of layoff events. However, the number declined in the construction, leisure and hospitality, and other services industries.

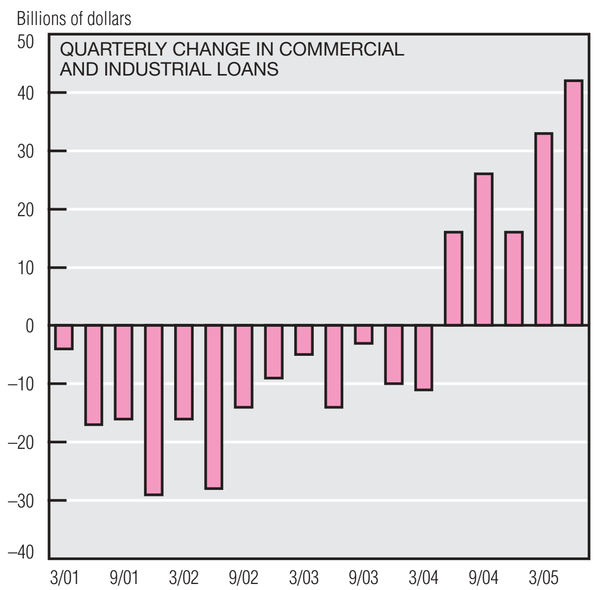
Employers identified as having mass layoffs are asked the main reason. In 2005:IIQ, they reported that 53% of mass layoffs resulted from seasonal factors, 21% from a contract completion, 15% from slack work, and the rest from company reorganization. In that quarter, the number of events caused by reorganization was less than the average quarterly number since 2000, but more events than average resulted from seasonal factors.

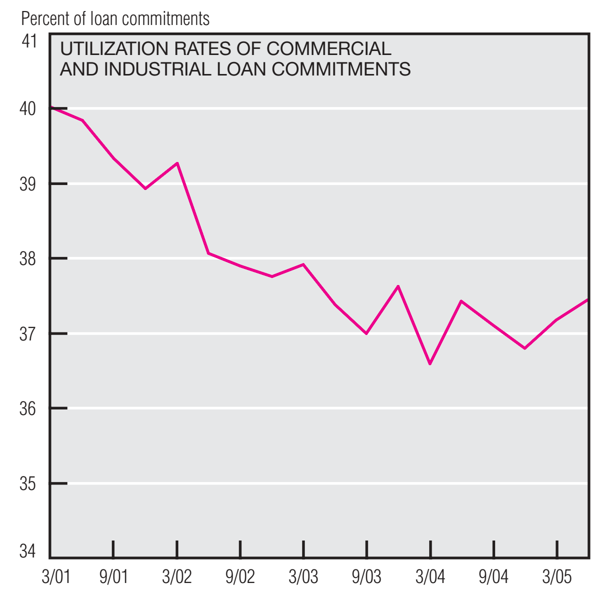
The MLS program began providing information on worker relocation in 2004. In the mass layoff events associated with the movement of work in the second quarter of this year, 146 jobs were moved outside Ohio, 125 went offshore, and 58 were eliminated. All of these separations resulted from three business closures in the manufacturing sector.

Business Loan Markets









SOURCES: Board of Governors of the Federal Reserve System, *Senior Loan Officer Survey*, July 2005; and Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

Credit availability for businesses continued to improve in 2004, according to the Federal Reserve's *Senior Loan Officer Survey*. A positive net percentage indicates that, compared to the previous quarter, more banks reported higher standards than reported no change or easing standards. A negative net percentage means the opposite. In the July 2005 survey (covering May, June, and July), respondent banks reported further easing of lending standards for commercial and industrial loans, although a slightly smaller fraction reported easing credit standards than in recent surveys. Respondents had narrowed their lending spreads, reduced collateral requirements, and increased the size of credit lines.

This relaxation of standards was partly a response to stronger competition from other banks and other sources of business credit. More important, perhaps, is that many respondents eased credit terms because of increased risk tolerance or a less uncertain economic outlook. While lending standards were relaxed, demand for commercial and industrial loans continued to be strong. Even with greater demand, prices dropped, indicating a plentiful supply of business credit.

Relaxed lending standards continued to translate into more commercial and industrial loans. Bank and thrift holdings of such loans increased \$42 billion in 2005:IIQ, the fifth consecutive quarter of expanding business loan portfolios. This increase coincided with little change in the utilization rate of business loan commitments (credit lines extended by banks to commercial and industrial borrowers), further evidence of an increased supply of business credit.

Fourth District Banks

a. Problem assets are shown as a percent of total assets, net charge-offs as a percent of total loans.

SOURCE: Author's calculations from Federal Financial Institutions Examination Counsel, *Quarterly Bank Reports on Condition and Income*.

Overall, Fourth District banks' financial indicators point to strong balance sheets. (JPMorgan Chase, chartered in Columbus, is not included in this discussion because its assets are mostly outside the District and its size—roughly $1 trillion—dwarfs other District institutions.) Asset quality continued to improve in 2005:IIQ. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) represented 0.33% of total loans, much better than the national average of 0.45% (down from 0.53% at the end of 2004). Problem assets (nonperforming loans and repossessed real estate) as a share of total assets increased slightly to 0.53% from 0.48% at the end of 2004, slightly worse than the national average of 0.47% of assets (down from 0.52% at the end of 2004).

Fourth District banks held $21.45 in equity capital and loan loss reserves for every dollar of problem loans, well above the coverage ratio's recent low of $10.75 at the end of 2002 but below the record high of $25.46 at the end of 2004. Equity capital as a share of Fourth District banks' assets (the leverage ratio) fell to 9.45% from the record high of 9.76% at the end of 2004.

The share of unprofitable banks in the Fourth District rose slightly, from 4.97% at the end of 2004 to 5.16% in the first half of 2005. Their asset size also increased, from 0.27% of District banks' assets to 0.60%. Industrywide, the share of unprofitable banks fell to 5.53% from 6.07% at the end of 2004. Their asset size fell from 0.62% at the end of 2004 to 0.51% at the end of 2005:IIQ.