

## *The Economy in Perspective*

*It's about nothing* ... This essay is decidedly *not* about Ben Bernanke, the economist nominated by President Bush to become the next chairman of the Federal Reserve Board. It's not that Mr. Bernanke doesn't deserve the attention: The post is ... well ... rather important, and his credentials are ... well ... rather impressive. It's just that so much has already been written—about his Harvard undergraduate degree and his M.I.T. doctorate, his tenured faculty position at Princeton, his books and scholarly research, his stint as a Federal Reserve Board governor, and his current prominence as chairman of the President's Council of Economic Advisors—that it would be superfluous to make him the subject of a homily delivered by yours truly (though it is worth mentioning that Ben Bernanke is a nice guy). No, this piece will not add to the pile of words already devoted to reexamining the life experiences of Ben Bernanke.

Nor will the essay feature Alan Greenspan, the retiring chairman. He has been in the spotlight more or less continuously since 1987, when he came on the Fed scene and was met almost immediately with a stock market crash. Since then, his mettle has been tested by many troubles and bubbles, and he has always come out on top. Not only has he proven to be an adroit crisis manager, he has also demonstrated an unsurpassed ability to read the tea leaves of our evolving economy. But what would be the point of spilling more ink in his direction, after all the headlines, feature stories and, indeed, even cartoons of the past 18 years? Don't get me wrong: He deserves a paean for prosperity and price stability, but what is there to say that hasn't already been said? Why detract from the ceremonies by descending into *déjà vu* all over again? No, Alan Greenspan—that recipient of the Presidential Medal of Freedom—deserves better than he could get in this brief space.

Nor will this essay dwell on the hurricanes that have desolated the southern coastal areas of the country, and whose floodwaters have coursed through the nation's conscience and energy markets. No, the media have already saturated us with information about the inadequacy of our levees, our disaster plans, and our energy independence. Like the hurricane winds, our feelings swirl:

We have lost so much property and so much trust, and yet—doesn't the receding price of gasoline signal that the world is once again righting itself? That we have dodged another bullet? Far be it from this writer to confront you with talk of nuclear power, renewable energy, increased drilling and refining capacity, and conservation. Let that tempest rage around us a while longer; we can imagine that we live in the eye of the storm, where the air is calm and the levees are fortified.

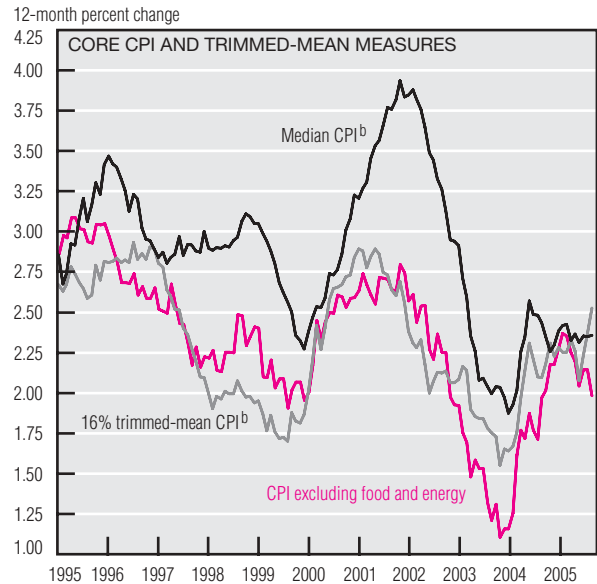
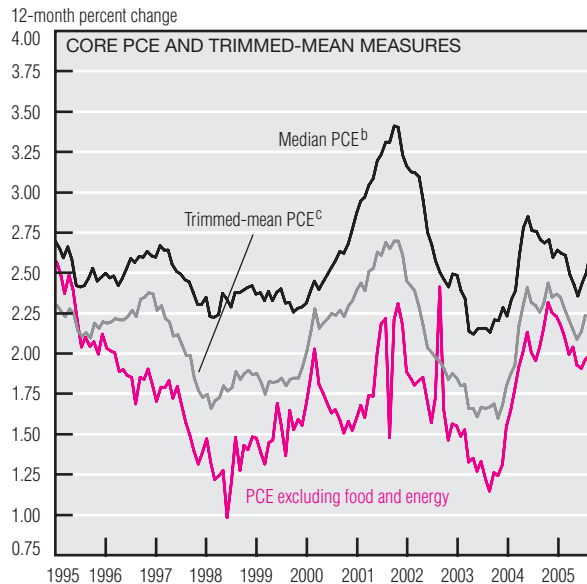
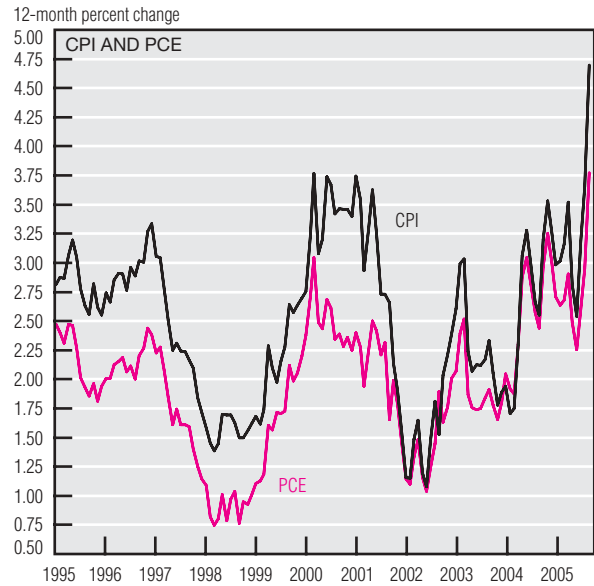
What else is undeserving of further commentary? How about inflation, or the energy price increases that many people either mistake for inflation, or worry will turn into inflation? Hasn't that ground been trodden upon enough? Inflation in the United States has been fairly stable for the last 20 years. Pronounced deviations from trend have come from energy price swings in both directions (remember when oil sold for \$20 a barrel in 2001?) and from movements in the prices of manufactured goods. Overall, however, core inflation and inflation expectations have moved in fairly narrow ranges, especially during the past decade. Federal Reserve officials have been steadfast in their resolve to prevent core inflation from ratcheting up, so lacking evidence to the contrary, why expect anything different? The measured pace seems to be measuring up.

Federal debt is another topic that this column is decidedly not about. Yes, our Treasury bills, notes, and bonds continue to expand prodigiously, but they are all going to good homes where they will be well cared for. And not to worry, we still have enough unfunded liabilities from Medicaid and Social Security to ensure there are more securities to come. But it would be silly to devote further space to this subject, third rail of politics that it is. Better to write about that other deficit, the trade deficit, which would allow us to castigate evildoers from foreign shores. After all, xenophobia is a time-honored tactic—just wait until we get our hands on those rascals!

So many other worthy economic events will not be discussed in this space that they cannot possibly be enumerated. But if asked what this essay is about, just say that, like a vintage *Seinfeld* episode, it's about nothing.

# Inflation and Prices

	Percent change, last:				2004 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	15.7	9.4	4.7	2.7	3.4
Less food and energy	1.2	1.4	2.0	2.0	2.2
Median <sup>b</sup>	1.7	2.1	2.3	2.8	2.3
<b>Producer prices</b>					
Finished goods	24.7	14.8	6.9	2.7	4.4
Less food and energy	3.1	2.6	2.6	1.1	2.2



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Calculated by the Federal Reserve Bank of Dallas.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Bank of Cleveland; and Federal Reserve Bank of Dallas.

The Consumer Price Index surged up 15.7% (annualized rate) in September, the largest monthly rise in overall retail prices in more than 25 years. Energy costs, which accounted for over 90% of the CPI's September rise, soared 289.1% (annualized rate), the highest monthly price increase since the series began in 1957. Meanwhile, growth was considerably more subdued in the core and median CPI, rising 1.2% and 1.7%, respectively.

Longer-term trends in CPI- and PCE-measured inflation were similar:

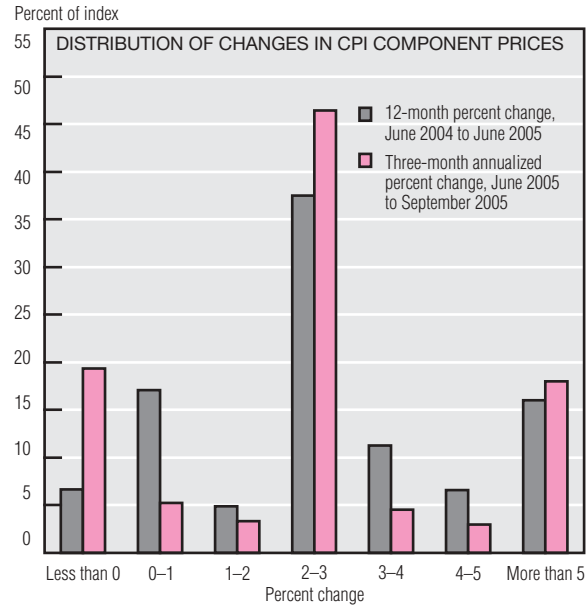
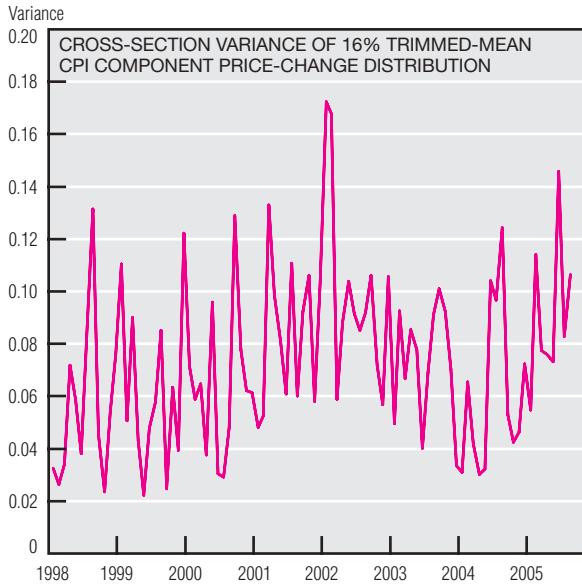
Their 12-month growth rates continued to accelerate. However, longer-term inflation trends among the core retail price measures were relatively stable, despite the recent dramatic increases in energy costs; most measures showed a 2.0% to 2.5% rise since September 2004. Growth in the core, median, and trimmed-mean PCE retail price measures, which consider an alternative basket of consumer goods and services, has remained subdued over the past year, generally fluctuating between 2.0% and 2.75%.

After trending upward throughout 2004, growth in various CPI retail price measures has also remained modest for the past year or so, generally fluctuating between 2.0% and 2.5%.

Interestingly, the variance of the 16% trimmed-mean CPI components' price-change distribution, while volatile, has generally trended upward since early 2004. The greater variance of price changes among components suggests marked differences in the monthly inflation rate of

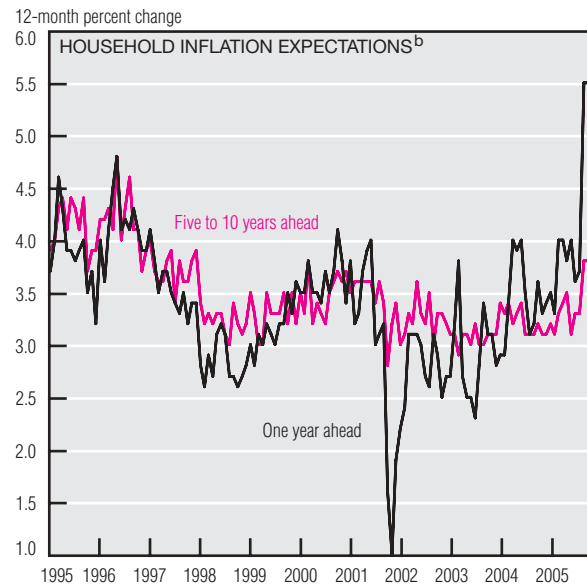
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## Inflation and Prices (cont.)



### Price Changes for Highest and Lowest 10% of CPI Components<sup>a</sup>

	Relative importance, Sept. 2005	Three-month annualized percent change, June 2005–Sept. 2005	12-month percent change, June 2004–June 2005
Miscellaneous personal goods	0.2	-13.1	-0.6
Infants' and toddlers' apparel	0.2	-12.5	0.2
Lodging away from home	3.0	-11.2	2.9
Men's and boys' apparel	1.0	-4.7	-2.0
Tenants' and household insurance	0.4	-4.7	1.5
New vehicles	4.6	-4.3	0.7
Women's and girls' apparel	1.6	-3.2	-2.7
Tobacco and smoking products	0.8	10.3	4.6
Jewelry and watches	0.3	20.2	-4.4
Car and truck rental	0.1	21.8	1.2
Gas (piped) and electricity	3.9	31.2	6.3
Fuel oil and other fuels	0.3	123.0	29.4
Motor fuel	4.8	234.7	7.1



a. Based on the three-month annualized price-change distribution.

b. Mean expected change as measured by the University of Michigan's *Survey of Consumers*.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; and Federal Reserve Bank of Cleveland.

the core components, and makes it harder to determine a longer-term trend in overall retail prices.

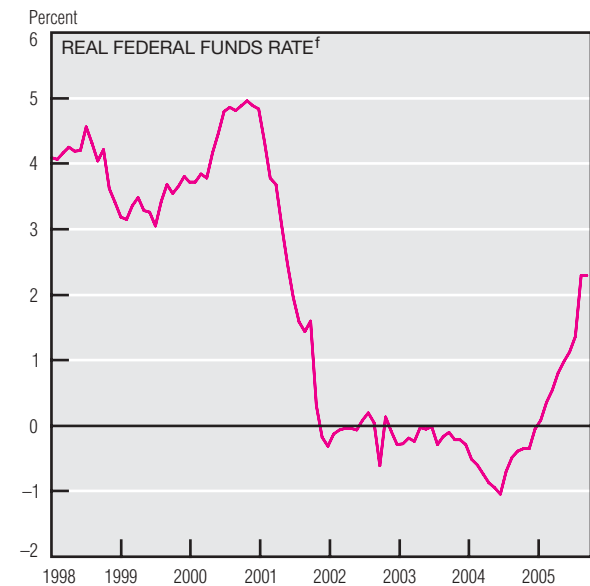
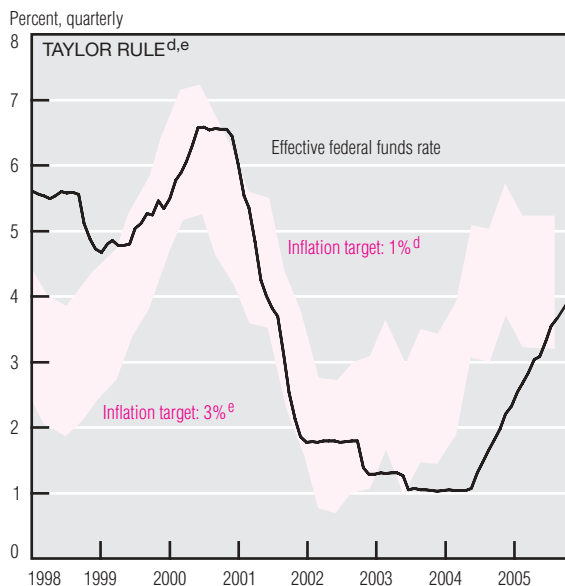
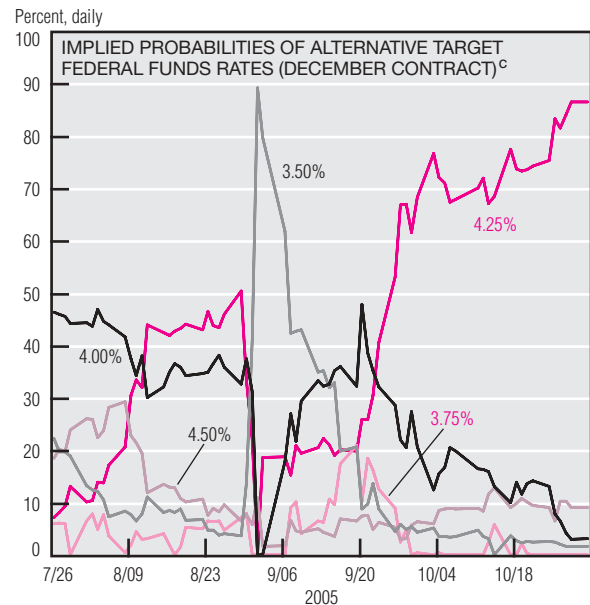
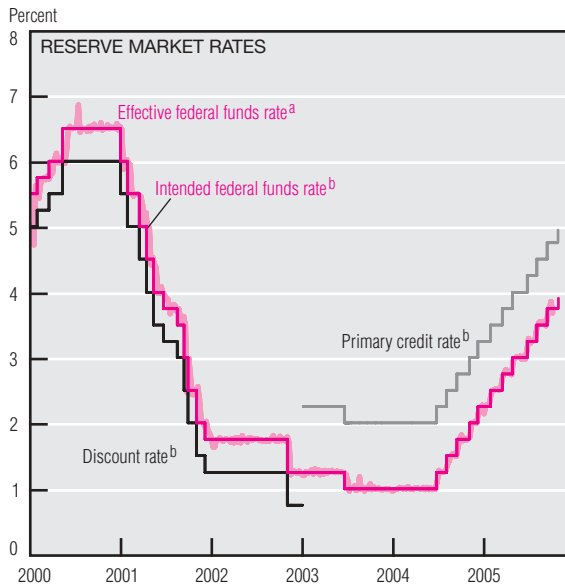
Although the CPI rose dramatically in September, largely because of surging energy prices, more than 45% of the index's components still showed modest price inflation since June (2.0%–3.0% annualized), before the monthly energy shocks began. However, the distribution of changes in CPI component prices over the past three months differs dramatically

from the distribution of inflation rates in the 12 months previous to that, before the energy price shocks. Indeed, nearly four times as many index components registered price deflation over the past three months as over the previous 12. Most of the price deflation over this period was in the index's new-vehicle and lodging-away-from-home components, perhaps reflecting runaway energy prices. Deflation also occurred in apparel prices. The jump in the CPI since June resulted primarily

from price increases among the top 17% of the components in the price-change distribution, of which more than half were energy components with dramatic price increases.

Households seem especially concerned that high energy prices will persist; as a result, inflation expectations remained high though stable in October. Households expect that prices will rise 5.5% over the next year and 3.8% over the next five to 10 years.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Probabilities are calculated using trading-day closing prices from options on December 2005 federal funds futures that trade on the Chicago Board of Trade.

d. This line assumes an interest rate of 2.5% and an inflation target of 1.0%.

e. This line assumes an interest rate of 1.0% and an inflation target of 3.0%.

f. Defined as the effective federal funds rate deflated by the Core Personal Consumption Expenditures Index.

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.

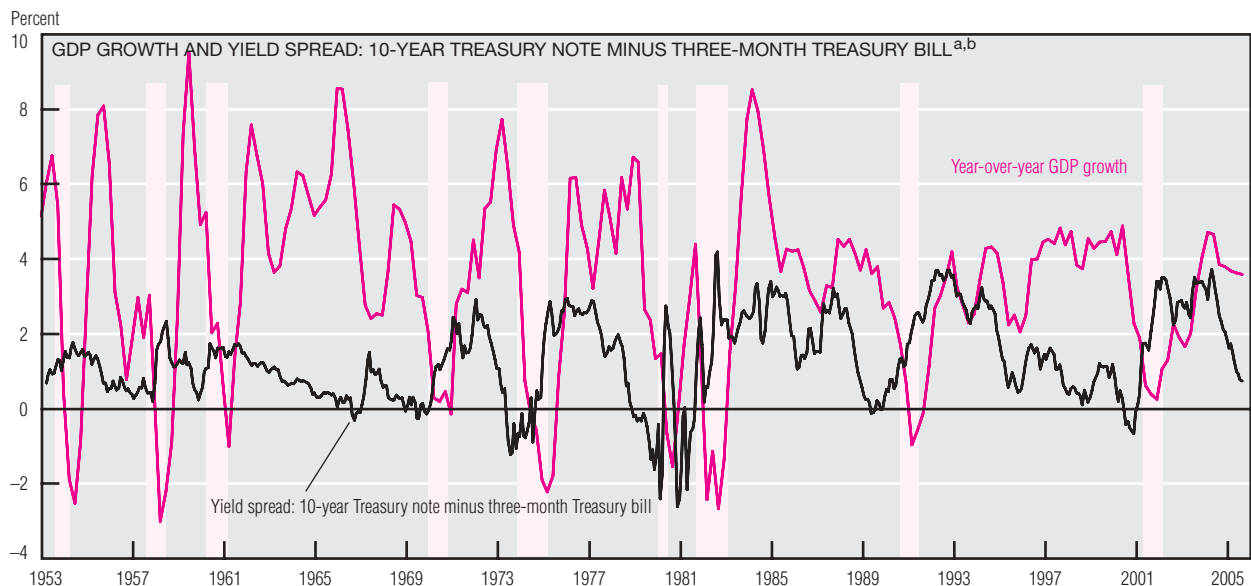
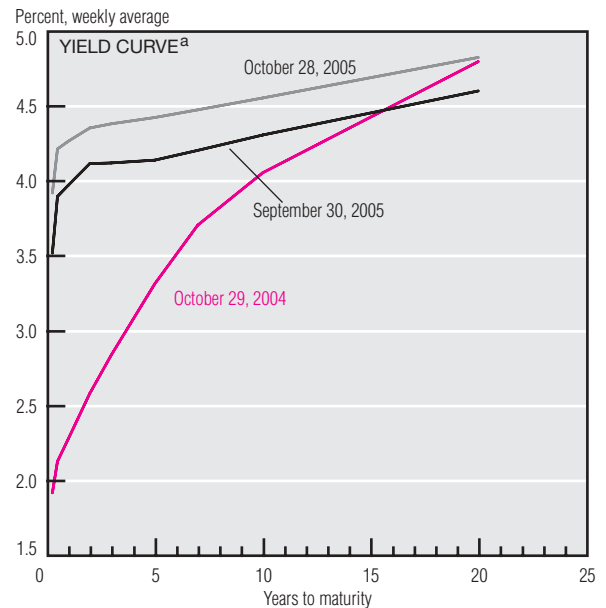
With the November 1 increase, the Federal Open Market Committee has increased the target federal funds rate by 25 basis points for 12 meetings in a row, bringing the rate from 1.00% in June 2004 to 4.00%. The target last reached this level in May 2001. Market participants do not expect a letup anytime soon: Implied probabilities from options on federal funds futures see an 85% chance that the target will be 4.25% in December. Significantly, two-

thirds of the 15% who disagree are expecting the target to jump to 4.50%.

Looking exclusively at rates detaches the problem from the broader contexts of the general economy. One such context is the Taylor rule, which views the fed funds rate as a reaction to a weighted average of inflation, target inflation, and economic growth. Compared with what the Taylor rule would suggest, monetary policy over the past several years has been easy, but recent increases have steadily closed

the gap, bringing the rate back near the middle of the predicted range. Another approach is to compare the target with inflation, producing a real (that is, inflation-adjusted) federal funds rate. This has now moved strongly into positive territory after nearly three years in the negative range, confirming the FOMC's statements that it has been removing policy accommodation that was initially adopted to quell economic weakness and ward off deflation.

# Money and Financial Markets



a. All yields are from constant-maturity series.

b. Shaded bars indicate periods of recession.

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.

The federal funds rate directly affects only the reserve desks of banks and a few brokers and dealers; however, as a transmitter of Federal Reserve policy, it influences other rates of wider concern. Rates such as mortgages and corporate bonds have generally followed long-term Treasuries. The spread between mortgages and Treasuries has been virtually unchanged, barely rising from 161 bp to 164 bp over the past year. Corporate bonds have not risen quite so fast; their

spread to Treasuries has dropped from 210 bp to 175 bp.

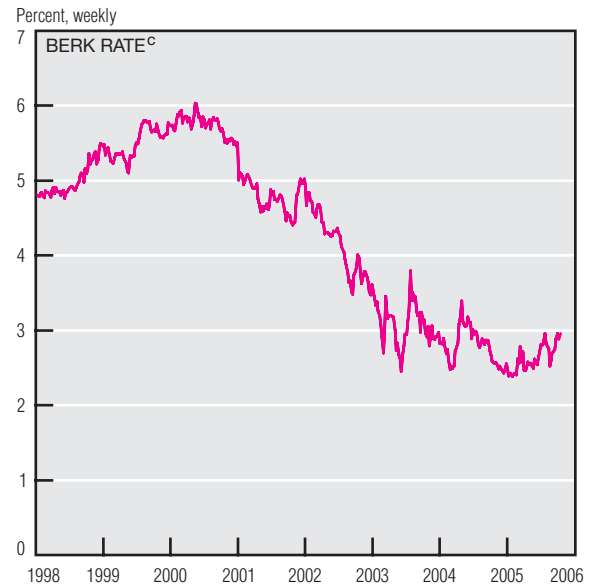
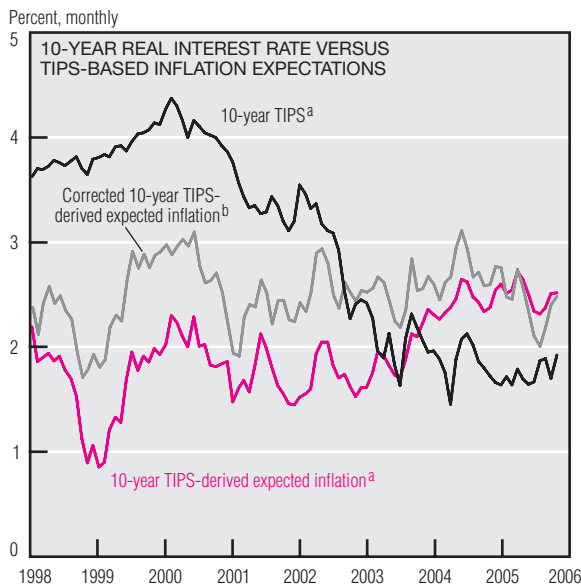
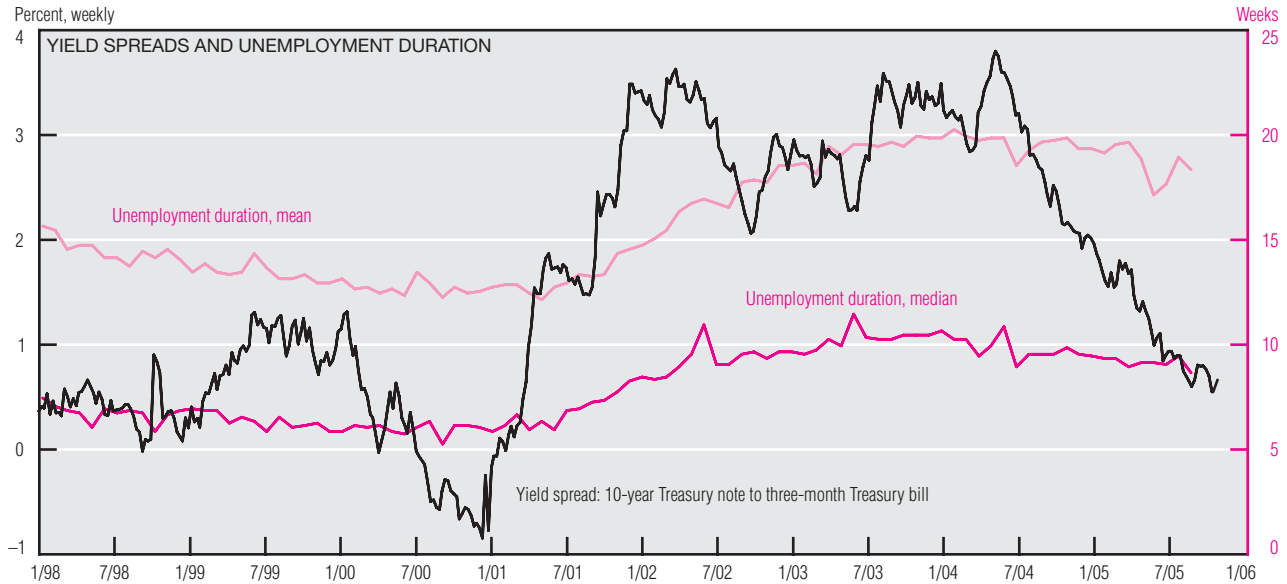
The yield curve, which records changes in the spectrum of long- and short-term rates, has been flattening since last year: Although both short and long rates have risen (except the 20-year rate), the long rates have not kept pace with the short ones. This has reduced the spread between 10-year and three-month Treasuries from historical highs approaching 4.0% to less than 1.0%, which is below the historical average.

The slope of the yield curve is widely regarded as a recession predictor, with an inverted yield curve (short rates above long rates) indicating a recession and, conversely, a steep curve indicating strong growth. One measure of slope, the spread between 10-year bonds and three-month T-bills, bears out this relation. Although the spread remains positive, its low level suggests slower-than-average growth.

Another intriguing—if lesser-known—relation with the real

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## Money and Financial Markets (cont.)



a. Treasury inflation-protected securities.

b. 10-year TIPS-derived expected inflation adjusted for the liquidity premium on the market for 10-year Treasuries.

c. The Berk rate is calculated as the 30-year Government National Mortgage Association yield plus the 10-year TIPS yield minus the 10-year Treasury yield.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

economy involves the slope of the yield curve (again represented by the 10-year three-month spread) and the duration of periods of unemployment. A very flat or inverted yield curve seems to signal that unemployment duration will soon increase. Does the current flattening of the yield curve presage a downturn with longer duration? It is too early to tell although, as in the case of the yield spread and economic growth, the news is somewhat discouraging.

The interest rates in the yield curve represent the interplay between two distinct forces: real interest rates and inflation. Sometimes the underlying dynamics can be gauged by looking at these components separately. One way to separate the two is to compare the rate on Treasury inflation-protected securities (TIPS), which measures the real rate, with ordinary nominal bond rates, which contain a premium for expected inflation. Long-term real rates have held relatively steady in 2005, although the

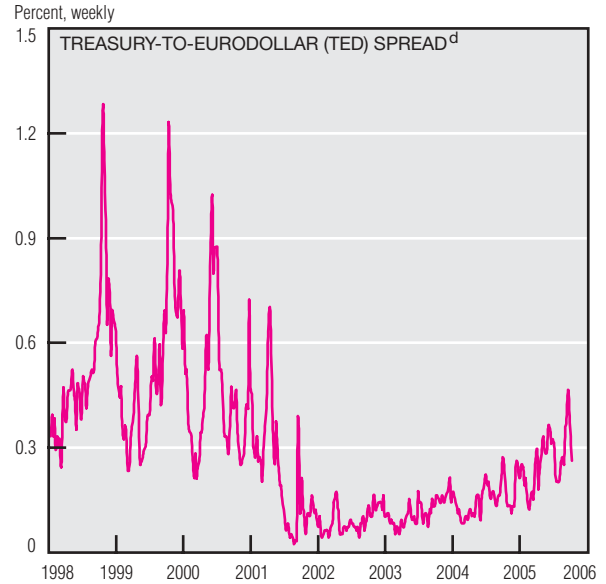
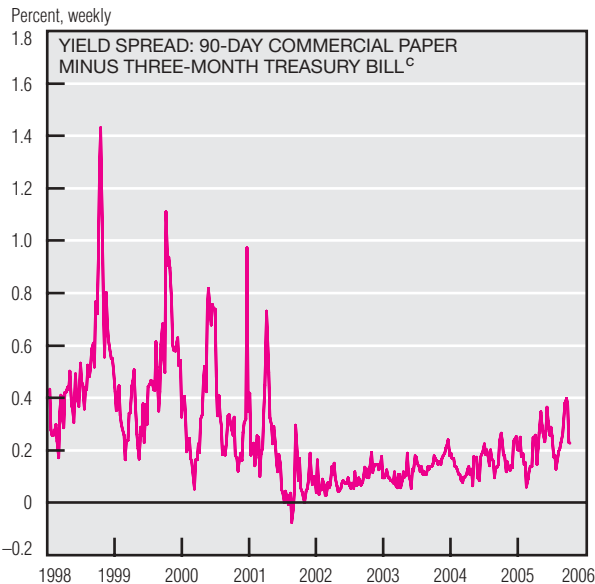
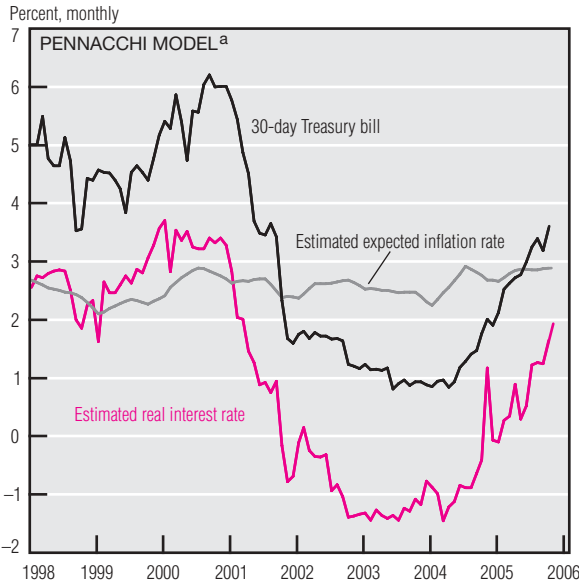
current level of 1.91% is near the yearly high.

The Berk rate, an alternative measure of the real rate, which adjusts for the firm's ability to delay investment, shows a similar pattern. Expected inflation, running at 2.5%, has remained in the same range as in the past two years, though up a bit from early 2005.

Whereas the real and expected inflation rates derived from TIPS are used to estimate long-term rates, expectations regarding shorter-term real inflation rates can be gauged by

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## Money and Financial Markets (cont.)



a. The estimated expected inflation rate and the estimated real interest rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.

b. Merrill Lynch AA and BBB indexes, each minus the yield on the 10-year Treasury note.

c. All yields are from constant-maturity series.

d. Yield spread: three-month Eurodollar deposit minus the three-month, constant-maturity Treasury bill.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Philadelphia; *The Wall Street Journal*; and Bloomberg Financial Information Services.

combining 30-day T-bill rates with survey measures of inflation. The one-month measure, originally developed by George Pennacchi, has risen recently; however, at 2.84%, it is still in the 2.0%–3.0% band it has occupied since 1998.

In addition to spreads between bonds of different maturities, or between real and nominal bonds, useful information can also be gathered from the spread between safe and risky bonds. Such spreads have

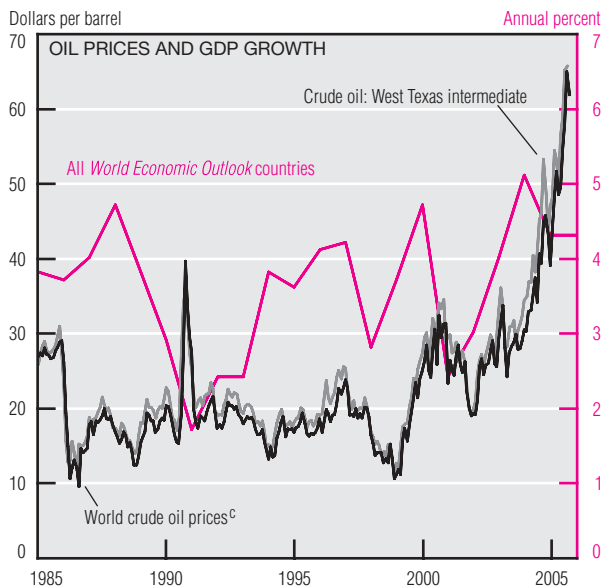
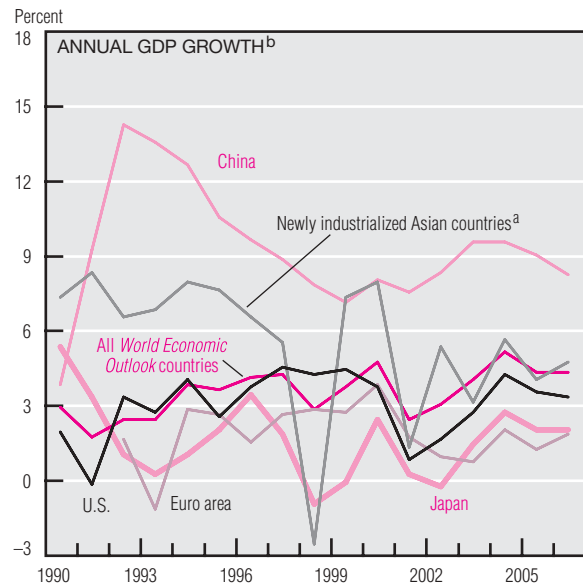
generally been creeping up. Although they remain well below the levels of several years ago, spreads between BBB corporate bonds and 10-year Treasuries rose from 93 bp in January to 129 bp at the beginning of November. The more volatile short spread between 90-day commercial paper and three-month T-bills has returned to its earlier levels, changing from 195 bp to 211 bp over the same period.

Another closely watched risk spread is that between three-month

Eurodollar deposits and the three-month T-bill rate (the TED spread). As the difference between two dollar-denominated interest rates based in different countries, it measures international financial risk while avoiding exchange rate uncertainty. Though starting from a low level, the TED spread trended higher over the year, moving up to 29 bp, which suggests an uptick in market uneasiness about international conditions.

# International Markets

	April 2005 forecast for 2005	Sept. 2005 forecast for 2005	April 2005 forecast for 2006	Sept. 2005 forecast for 2006
All World Economic Outlook countries	4.3	4.3	4.4	4.3
U.S.	3.6	3.5	3.6	3.3
Euro area	1.6	1.2	2.3	1.8
Japan	0.8	2.0	1.9	2.0
China	8.5	9.0	8.0	8.2
Newly industrialized Asian countries <sup>a</sup>	4.0	4.0	4.8	4.7



	April 2005 forecast for 2005	Sept. 2005 forecast for 2005	April 2005 forecast for 2006	Sept. 2005 forecast for 2006
<b>Commodity prices</b>				
Oil <sup>c</sup>	23.2	43.6	-5.9	13.9
Nonfuel	3.8	8.6	-5.1	-2.1
<b>Consumer prices</b>				
Advanced economies	2.0	2.2	1.9	2.0
Other emerging markets and developing countries	5.5	5.9	4.6	5.7

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

b. Data for 2005-06 are IMF forecasts.

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

SOURCES: International Monetary Fund, *World Economic Outlook*; and Bloomberg Financial Information Services.

In September, the International Monetary Fund (IMF) published its second biannual *World Economic Outlook*, which predicted that world GDP would grow 4.3% in 2005 as well as 2006. Although the forecast for 2006 was revised downward 0.1 percent point (pp) from the April issue, the forecast for 2005 was unchanged. The September *Outlook* estimates that 2005 GDP growth in the U.S. will be reduced only 0.1 pp, as the result of hurricane Katrina, but also lowered its 2006 forecast by 0.3 pp because of higher inflation, rising interest rates, and falling consumer confidence. The

euro area continues to disappoint; its already lackluster GDP growth was revised downward in the September *Outlook*. The Chinese economic expansion continues unabated, with robust growth predicted through 2005 and 2006.

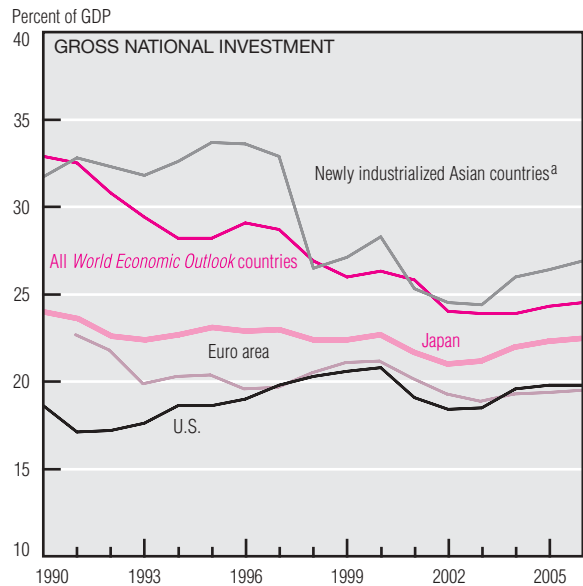
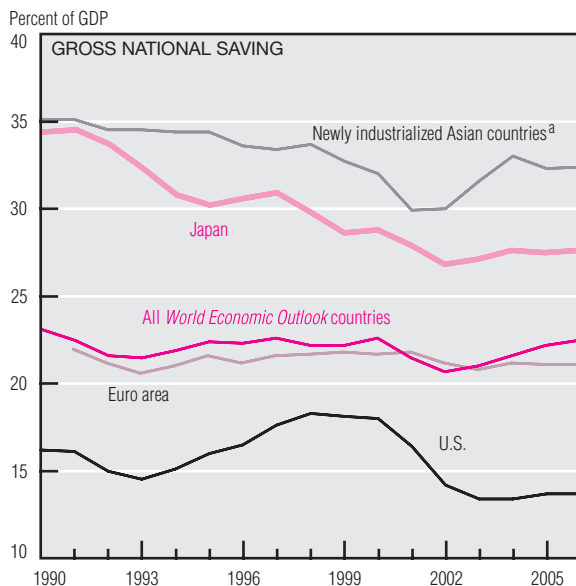
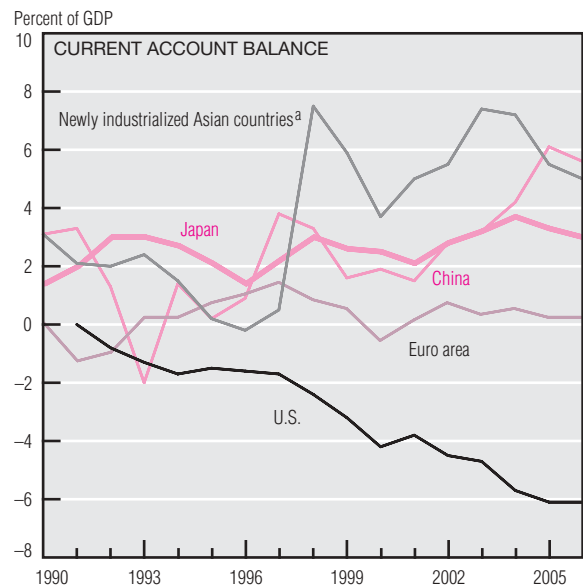
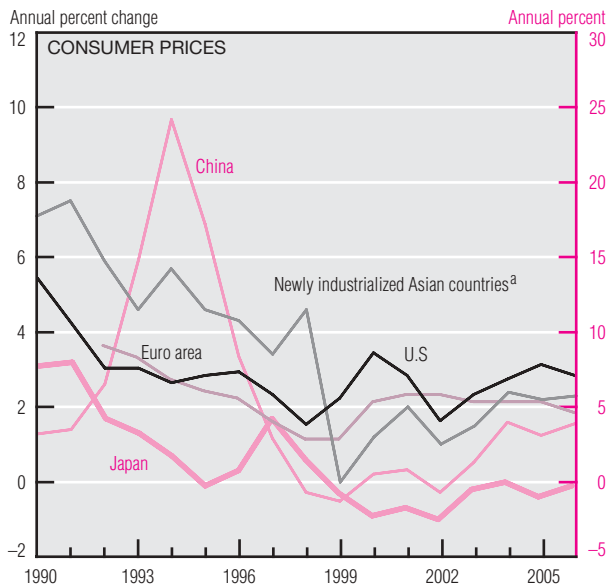
According to many standard economic models, including the IMF's, an oil price increase of \$8 per barrel reduces global GDP growth by about 0.5%. Since April, world oil prices have increased more than \$13, and the price of West Texas intermediate crude oil has risen more than \$12. However, GDP growth forecasts for

2005 and 2006 have held relatively steady. Many effects of rapidly rising energy costs remain to be seen, but slower global GDP growth does not seem certain. April's *Outlook* forecasted a 23.2% rise in oil prices in 2005, and September's nearly doubled this figure to 43.6%. Moreover, although April's *Outlook* predicted that oil prices would finally begin to taper off in 2006, September's was less optimistic, with the price of oil expected to rise an additional 13.9% next year. The September issue revised inflation expectations upward for all categories

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## International Markets (cont.)



NOTE: Data for 2005–06 are IMF forecasts.

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

SOURCE: International Monetary Fund, *World Economic Outlook*.

surveyed and more than doubled nonfuel price expectations for 2005. However, it predicted an easing of consumer price increases for the U.S. and the euro area in 2006. It projected that China's inflation rate would reach 3.8%, although analysts remain concerned that attempts to curb inflation will inhibit China's economic growth.

September's *Outlook* also predicted that the U.S. current account deficit will continue to grow in 2005 and 2006 and, although the current account balances of the industrialized

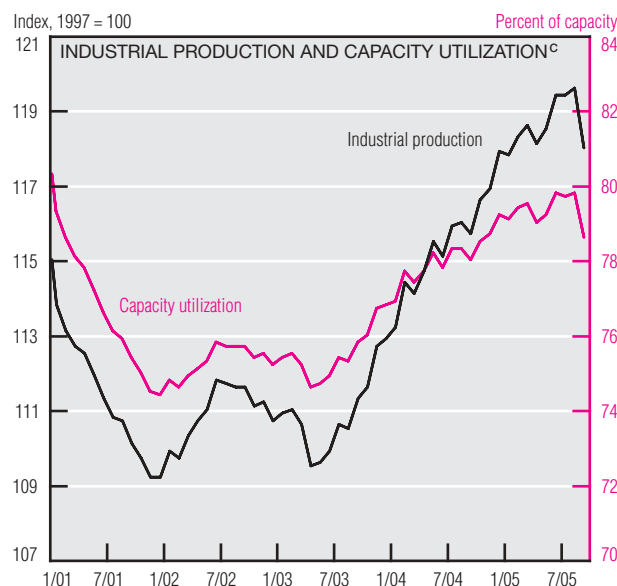
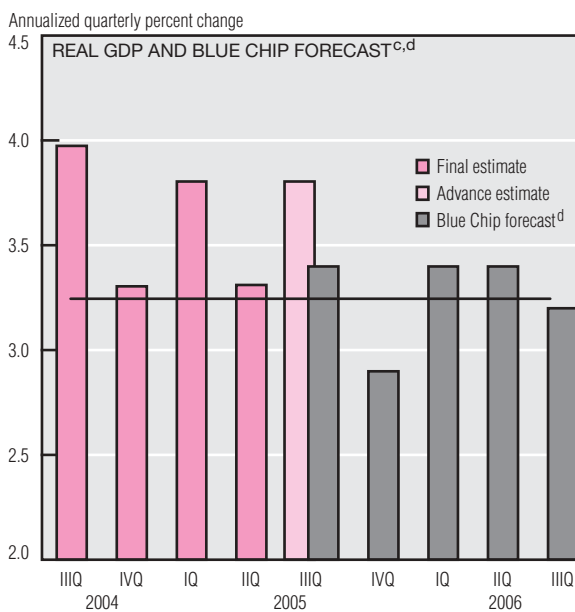
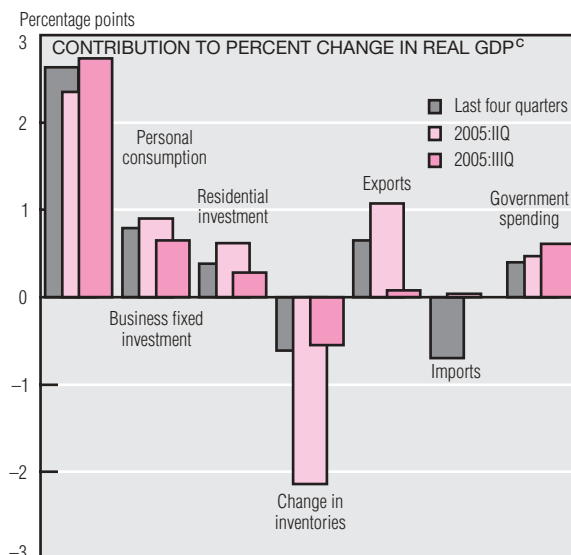
Asian economies will taper off slightly in 2006, they will continue to operate well within the surplus range. Some analysts suggest that the swing in Asia's saving–investment gap has resulted in excessive global saving—which has led directly to the large current account imbalance in the U.S.—whereas others argue that the sharp drop in U.S. national saving is mainly the result of monetary and fiscal policy decisions within the country.

Despite the widely held view that there is a global savings glut, the world may in fact be investing too

little. Investment has fallen off sharply since the crises in Latin America and the emerging Asian nations that marked the past decade. Responses to the investment slowdown have ranged from accommodative policies (expansionary budgets and low interest rates) within the industrialized countries to a belated tightening of lax policies within the emerging markets. Only recently has investment begun to recover, albeit cautiously, with a slight increase in world investment predicted for 2005 and 2006.

# Economic Activity

	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	104.0	3.8	3.6
Personal consumption	75.2	3.9	3.8
Durables	29.6	10.8	6.6
Nondurables	14.7	2.6	4.2
Services	34.9	3.2	3.0
Business fixed investment	19.4	6.2	7.8
Equipment	22.4	8.9	10.1
Structures	-0.9	-1.4	1.0
Residential investment	7.0	4.8	6.6
Government spending	15.8	3.2	2.1
National defense	12.2	10.3	3.3
Net exports	2.4	—	—
Exports	2.2	0.7	6.5
Imports	-0.2	0.0	4.5
Change in business inventories	-14.9	—	—



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.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, October 10, 2005.

The Commerce Department's advance reading of 3.8% real GDP growth in 2005:IIIQ was 0.5 percentage point (pp) higher than growth in the previous quarter. On a year-over-year basis, real GDP grew 3.6%. However, the total effects of recent hurricanes are still unknown, and the Bureau of Economic Analysis emphasized that the advance report was based on incomplete information. Acceleration in the advance reading resulted primarily from a smaller decrease in inventories as well as acceleration in personal consumption

expenditures and government spending; however, these effects were partly offset by deceleration in exports.

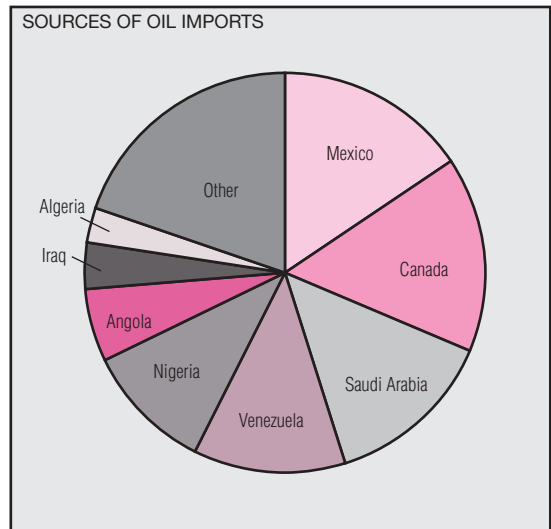
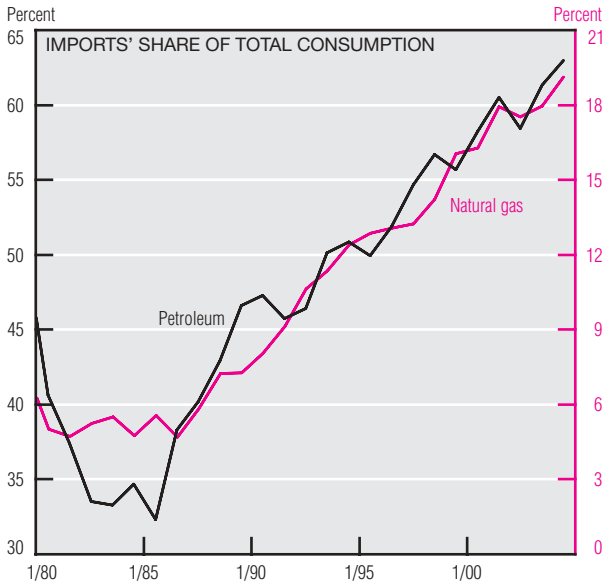
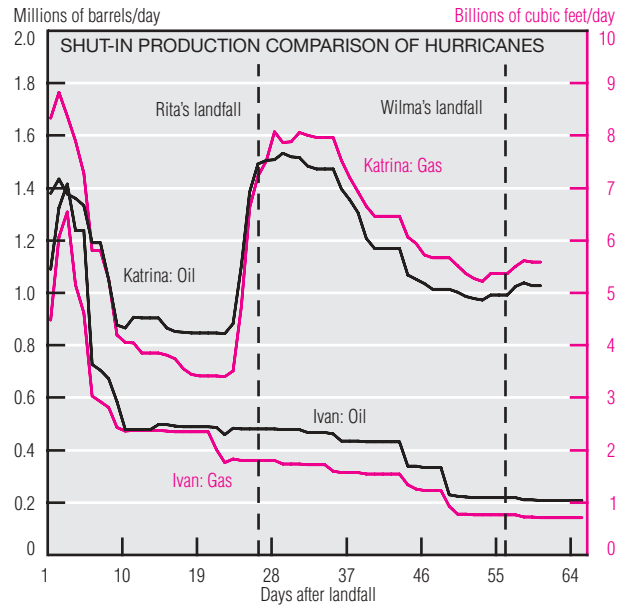
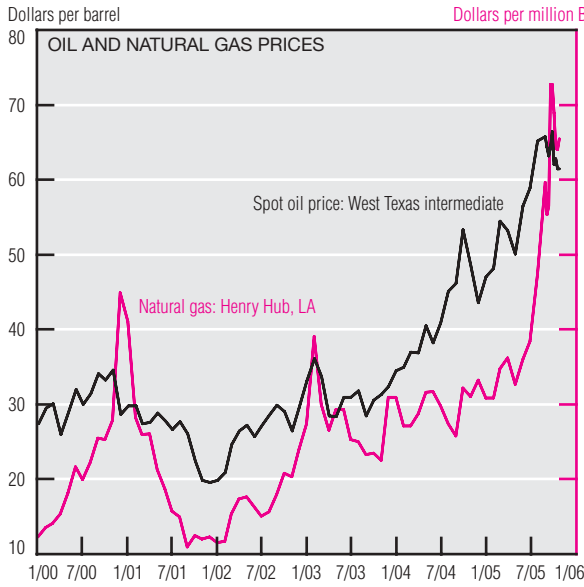
Most components' contributions to the percent change in real GDP were relatively unchanged from the second quarter. However, third-quarter changes in private inventories subtracted only 0.6 pp from the change in real GDP, compared to 2.1 pp in 2005:IIQ. Exports contributed 1.0 pp less than in 2005:IIQ.

Real GDP growth has been 3.8% or higher in only five quarters since 2001. The 2005:IIIQ advance reading was also 0.4 pp higher than the October

Blue Chip economists' predicted growth of 3.4%. In September, they forecasted 3.6% growth for this quarter. They now expect 2005:IVQ growth to slow to 2.9%, then rebound to 3.4% in the first half of 2006.

After rising steadily since April 2004, industrial production fell 1.3% this September; capacity utilization also dropped to 78.6% from its recent high of 79.8%. However, controlling for the Boeing strike (now settled) and for hurricanes Katrina and Rita, industrial production and capacity utilization were fairly stable.

# Oil and Natural Gas



SOURCES: U.S. Department of Energy, Energy Information Administration; and the *Wall Street Journal*.

Energy prices remain high. With the end of summer driving, oil prices eased a bit by October 28, falling to \$61.22 for West Texas intermediate crude. Seasonal demand pressures are working in the opposite direction for natural gas as we begin winter heating. The daily price for natural gas (Henry Hub, LA) remains at about \$13 per million Btu and, while below its \$14.50 September average, shows little sign of further easing.

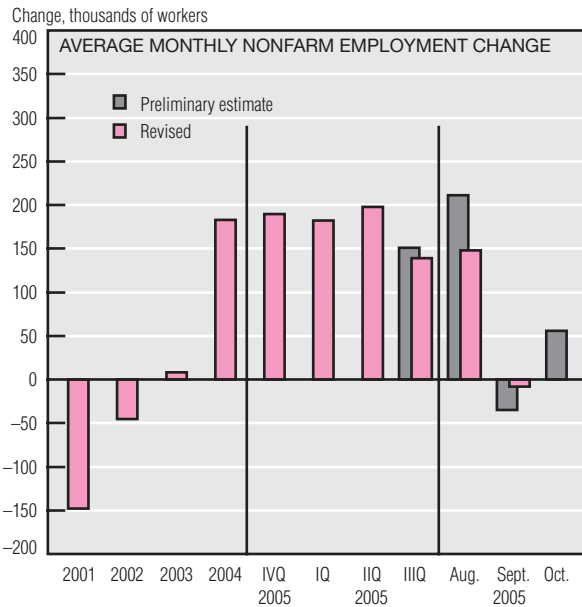
Of course, supply factors also help sustain these high levels. The Gulf of Mexico accounts for about 30% of U.S.

crude oil production and about 20% of our natural gas production. But recovery from hurricanes Katrina, Rita, and, to a much lesser extent, Wilma, is slower than after last year's Ivan. Shut-in (forgone) production remains at 65% for oil (about 1 million barrels/day) and 55% for natural gas (about 5.5 billion cubic feet/day).

In the domestic market, oil is less sensitive to shocks than natural gas: Oil is a more tradable commodity than natural gas, partly because it is easier to ship a liquid and partly because the infrastructure for shipping large amounts of oil already exists. The U.S.

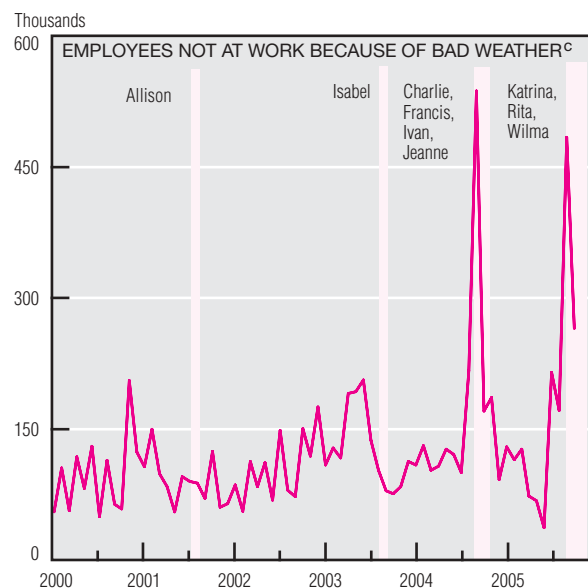
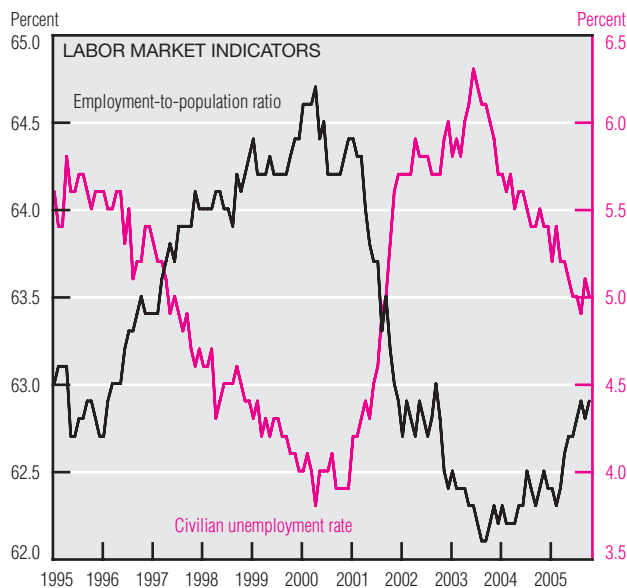
depends on imports for more than 60% of its total petroleum consumption but only 20% of its natural gas. But unlike natural gas, where Canada alone provides 85% of imports, oil comes from a broader array of countries. Canada, Mexico, Saudi Arabia, and Venezuela each supply about 15% of U.S. imports. Nigeria, Angola, Iraq, and Algeria range from 10% to 3%. So although we depend much more on foreign countries for oil than for natural gas, we also have more sources to take up the slack when one supplier suffers a shock.

# Labor Markets



## Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2002	2003	2004	YTD 2005	Oct. 2005
<b>Payroll employment</b>	-45	8	183	161	56
<b>Goods producing</b>	-76	-42	29	17	49
Construction	-7	10	23	23	33
Manufacturing	-67	-51	3	-9	12
Durable goods	-48	-32	9	-1	18
Nondurable goods	-19	-19	-6	-8	-6
<b>Service providing</b>	30	50	154	144	7
Retail trade	-10	-5	13	9	-5
Financial activities <sup>a</sup>	6	7	12	16	22
PBS <sup>b</sup>	-17	22	45	38	12
Temporary help svcs.	2	12	15	13	11
Education & health svcs.	40	30	33	32	11
Leisure and hospitality	12	18	22	16	-18
Government	21	-4	12	17	10
	Average for period (percent)				
Civilian unemployment rate	5.8	6.0	5.5	5.1	5.0



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. Seasonally adjusted by the Federal Reserve Bank of Cleveland.

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

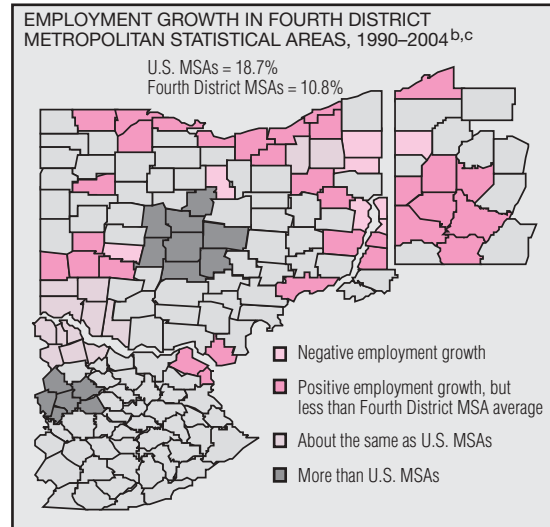
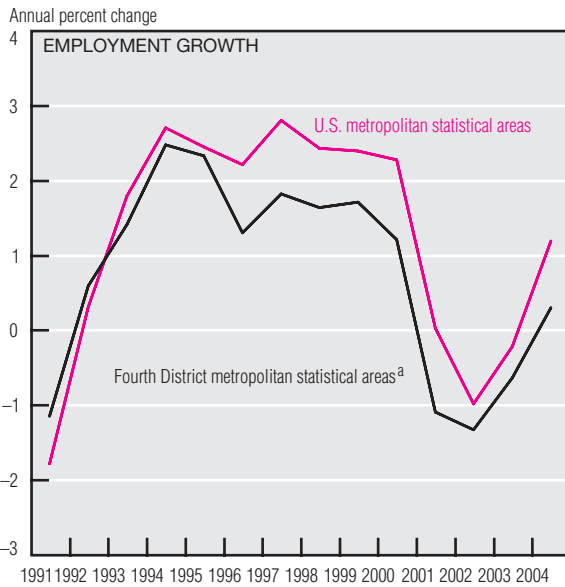
Nonfarm payrolls grew by 56,000 jobs in October, and September's job loss was revised from 35,000 to 8,000. The Bureau of Labor Statistics determined that September's employment in the areas not affected by Hurricane Katrina would probably have been in line with the average monthly increase for the nation as a whole (200,000) during the first eight months of the year; however, October's employment growth would probably have been below that average even without Hurricane Katrina.

Job growth in service-providing industries (7,000) was generally lower than year-to-date averages. The major employment losers were the leisure and hospitality and information sub-industries, which declined by 18,000 and 15,000, respectively. Goods-producing industries, however, added more jobs than in the recent past. Construction industry payrolls increased by 33,000, compared with an average growth of 23,000 jobs per month so far in 2005. Manufacturing employment, which declined by 69,000 jobs from May to September, rose by 12,000 jobs in October.

The unemployment rate inched down 0.1 percentage point in October to 5.0%. Similarly, the employment-to-population ratio (62.9%) was little changed in October.

The number of people who were employed but did not go to work helps to illustrate the impact the storms had on workers. More employees miss work during the winter months; however, after controlling for seasonality, it is clear that the recent hurricanes had an enormous impact on workers' attendance.

# Employment Growth in the Fourth District's Urban Areas



Payroll Employment by Metropolitan Statistical Area <sup>c</sup>				Employment growth (percent change)			Employment growth (percent change)				
	1990-2000	2000-2004	1990-2004		1990-2000	2000-2004	1990-2004		1990-2000	2000-2004	1990-2004
<b>U.S. MSAs</b>	<b>18.8</b>	<b>-0.1</b>	<b>18.7</b>	Pittsburgh, PA	9.8	-1.5	8.2				
<b>4th District MSAs</b>	<b>14.0</b>	<b>-2.8</b>	<b>10.8</b>	Erie, PA	12.4	-4.0	7.9				
Columbus, OH	26.0	0.2	26.2	Sandusky, OH	11.4	-3.7	7.3				
Lexington-Fayette, KY	29.9	-2.8	26.2	Canton-Massillon, OH	12.1	-5.9	5.5				
Cincinnati-Middletown, OH-KY-IN	19.7	-0.3	19.4	Lima, OH	10.0	-5.5	3.9				
Akron, OH	17.2	-0.4	16.6	Cleveland-Elyria-Mentor, OH	9.4	-5.9	2.9				
Parkersburg-Marietta-Vienna, WV-OH	11.3	-1.3	9.9	Dayton, OH	5.9	-5.1	0.5				
Wheeling, WV-OH	8.7	0.3	9.0	Mansfield, OH	4.9	-4.9	-0.3				
Toledo, OH	13.9	-4.3	8.9	Youngstown-Warren-Boardman, OH-PA	8.0	-7.7	-0.3				
Huntington-Ashland, WV-KY-OH	9.6	-0.7	8.8	Springfield, OH	9.1	-10.7	-2.5				
				Weirton-Steubenville, WV-OH <sup>a</sup>	-3.6	-4.8	-8.3				

NOTE: 2004 data are preliminary.

a. Employment for the Weirton, West Virginia-Steubenville, Ohio, MSA is estimated for January 1999.

b. Nine counties that contain MSAs do not appear on the map: Dearborn, Franklin, and Ohio counties in Indiana; Gallatin County, Kentucky; and Cabell, Pleasants, Wayne, Wirt, and Wood counties in West Virginia.

c. Metropolitan statistical areas are defined using the most recent definitions from the Office of Management and Budget (Bulletin no. 05-02).

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, Quarterly Census of Employment Wage Program.

In the early 1990s, employment growth in the Fourth District's urban areas (metropolitan statistical areas or MSAs) mirrored that of MSAs throughout the nation. In 1995, however, employment growth throughout Fourth District MSAs began to differ from the nation's MSAs, which it lagged an average of 0.7% per year in the decade that followed.

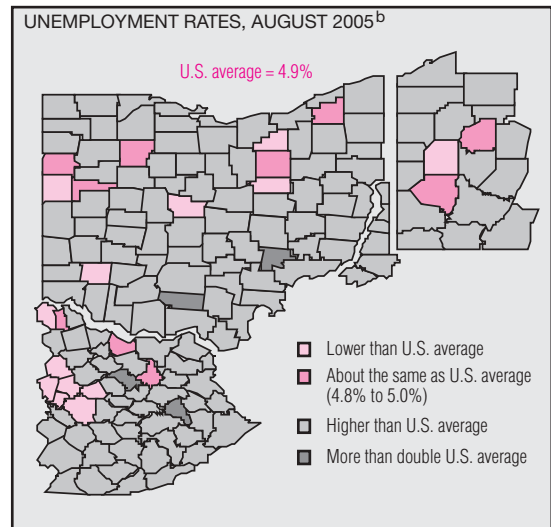
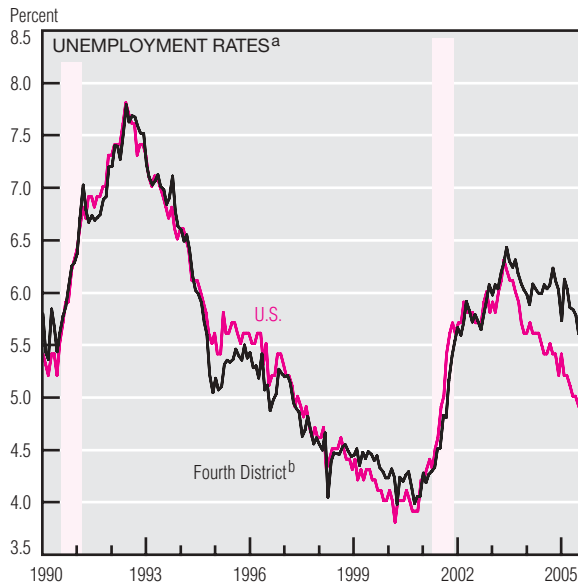
From 1990 to 2004, total payroll employment grew 10.8% in the Fourth District's MSAs, whereas it grew an

average of 18.7% in the nation's MSAs. Within the Fourth District, employment grew most strongly (26.2%) in the MSAs of Columbus, Ohio, and Lexington-Fayette, Kentucky. During the same period, employment in the Cincinnati-Middletown MSA grew 19.4%. Employment actually declined by 8.3% in the Weirton-Steubenville MSA and 2.5% in the Springfield MSA.

Employment growth occurred primarily between 1990 and 2000, after which labor market conditions

deteriorated in most Fourth District MSAs. From 2000 to 2004, employment dropped 2.8% in the District's MSAs, but only 0.1% in the nation's. Employment even declined in areas such as Lexington-Fayette and Cincinnati-Middletown, where it grew dramatically in the 1990-2000 period. Employment losses from 2000 to 2004 in the MSAs of Springfield, Mansfield, and Youngstown-Warren-Boardman more than offset the employment gains made in the previous decade.

# Fourth District Employment



## Payroll Employment by Metropolitan Statistical Area

### 12-month percent change, September 2005

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	-0.2	0.8	0.6	-0.7	0.7	0.1	0.6	1.7
Goods-producing	0.5	0.6	1.6	-2.7	-0.6	-2.9	0.6	0.9
Manufacturing	0.1	-1.0	1.1	-3.3	-2.2	-3.7	-0.6	-0.8
Natural resources, mining, and construction	1.7	3.7	2.7	-0.6	4.1	-1.6	3.9	4.2
Service-providing	-0.4	0.8	0.4	-0.2	1.0	0.6	0.6	1.8
Trade, transportation, and utilities	-0.8	-0.4	-0.7	-2.4	1.1	-0.1	0.9	1.2
Information	-2.0	-0.5	-1.2	-5.3	-2.1	0.9	-2.2	0.9
Financial activities	0.4	0.3	-0.6	-2.7	0.8	0.9	-0.9	2.1
Professional and business services	-0.7	0.7	2.3	0.8	3.4	0.8	-0.7	3.3
Education and health services	1.8	3.0	2.4	1.9	0.4	2.6	0.3	2.7
Leisure and hospitality	-0.2	2.6	-2.3	0.0	0.9	0.9	1.2	1.9
Other services	-1.1	-0.5	1.2	1.7	1.9	1.9	1.0	0.5
Government	-2.0	0.5	0.4	0.2	-0.2	-2.8	1.6	1.0
August unemployment rate (percent) <sup>b</sup>	5.6	5.3	5.4	6.1	6.6	5.2	4.0	4.9

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 rose from 5.6% in July to 5.7% in August. Although employment increased 0.1% during the month, the labor force is estimated to have grown even more (0.2%). From August to September, the U.S. unemployment rate rose from 4.9% to 5.1%.

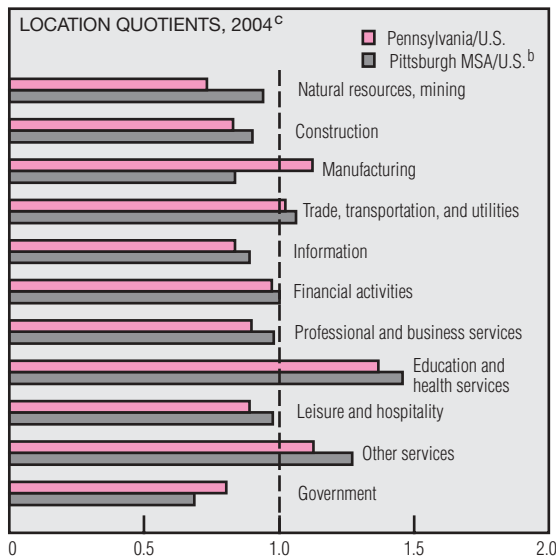
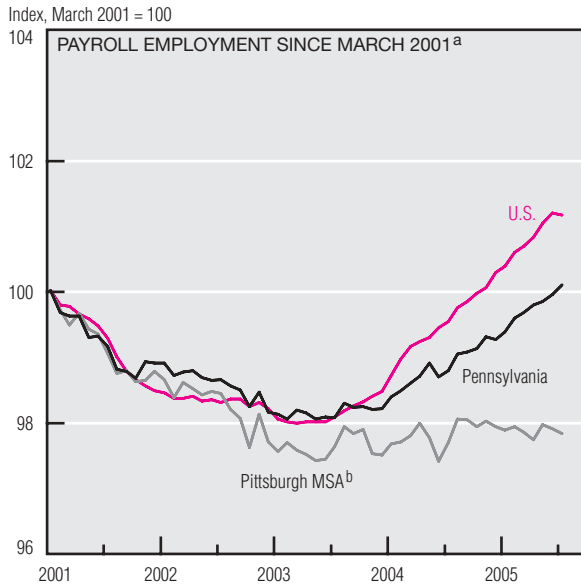
Unemployment rates in the District's counties were generally higher than the U.S. rate in August. In fact, 146 counties had unemployment rates higher than 5.0%, 10 had rates within 0.1 percentage point of the 4.9% U.S. average, and only 13 had rates of 4.8% or less. Similarly, the

District's major metropolitan areas generally had worse unemployment rates than the nation. From July to August, unemployment rates in Cincinnati and Dayton rose half a percentage point. In Lexington, however, the unemployment rate fell by 0.7% over the month, reaching 4.0%.

Employment growth in the District's major metropolitan areas has lagged the U.S. for the past year, with the nation's employment growth since September 2004 at least double that of any major metropolitan area in the District. Whereas some areas, such as Cincinnati, Columbus, and

Lexington, kept up with the U.S. in generating goods-producing jobs, even the strongest-performing major metropolitan area in the District was at least 0.8 percentage point behind in creating service-providing jobs. One service-sector category that stood out in this respect was information. Except for Pittsburgh, employment in the information sector shrank in the District's metropolitan areas, falling by as much as 5.3% in Dayton. By contrast, jobs in this sector have increased by 0.9% nationwide since September 2004.

# Employment in the Pittsburgh Metropolitan Area



**Selected Demographics, 2004**

	Pittsburgh MSA <sup>b</sup>	Pennsylvania	U.S.
Total population	2,260,551	11,957,883	285,691,501
Percent by race			
White	90.0	85.8	77.3
Black	8.9	10.7	12.8
Other	1.1	3.5	9.9
Percent by age			
0 to 19	24.0	25.7	27.9
20 to 34	17.0	18.1	20.3
35 to 64	42.3	41.5	39.8
65 or older	16.8	14.7	12.0
Percent with bachelor's degree or higher			
	26.2	24.7	27.0

a. Seasonally adjusted.  
 b. The Pittsburgh metropolitan statistical area includes Butler, Armstrong, Beaver, Allegheny, Westmoreland, Washington, and Fayette counties.  
 c. A location quotient of one indicates parity between an area and the U.S. regarding an industry's share of total employment.  
 SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

Although the 2001 recession ended almost four years ago, payroll employment in the Pittsburgh metropolitan area has yet to return to its pre-recession levels. In this respect, it is unlike both the U.S., which recovered its pre-recession employment level by January, and Pennsylvania, which recovered its lost jobs by September.

Two sectors in which Pittsburgh area employment has dropped sharply since the recession are information and manufacturing, which are often considered key constituents of

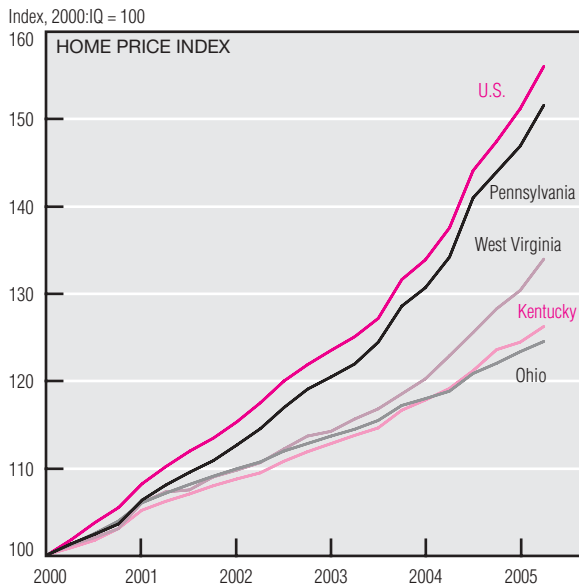
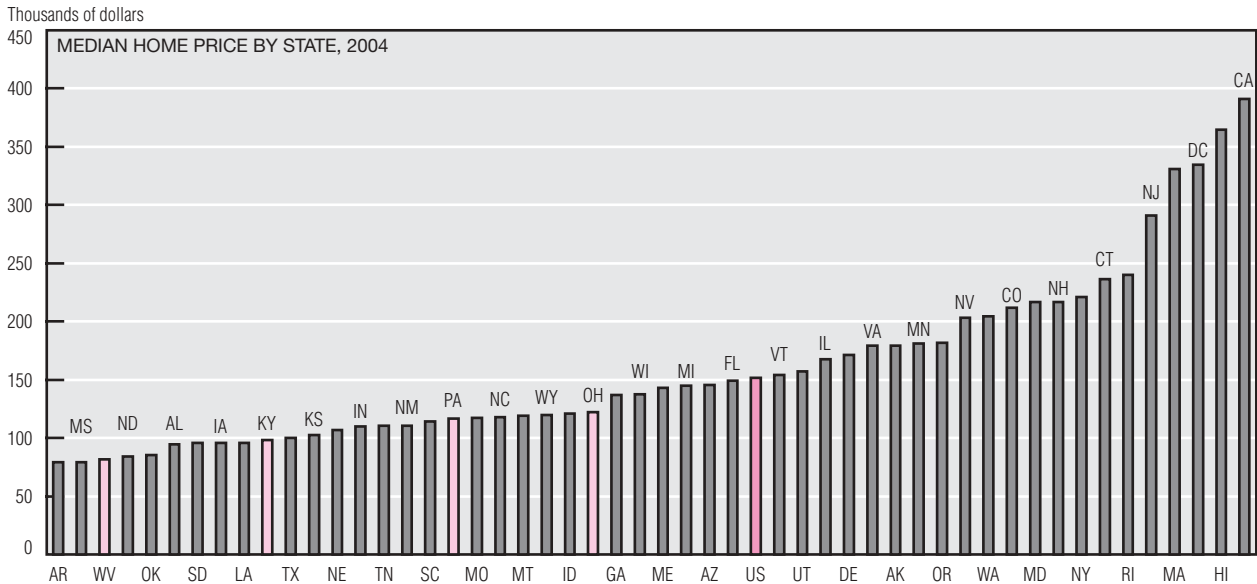
the area's economy. In manufacturing, the primary metals subsector is associated closely with the metro area. Since 2001, however, primary metals employment has declined almost 21%.

Toward the end of the 1990s, some also began to see Pittsburgh as a center for high-tech and information industries, but since the recession, the information sector has lost almost 14% of its jobs. Interestingly, despite Pittsburgh's association with information and manufacturing, Pittsburgh has

relatively less of each than the U.S. has. However, it boasts a much higher concentration of employment in education and health services.

Pittsburgh's demographics differ significantly from Pennsylvania and the U.S. One of the most important differences is in age: In 2004, the metro area had a higher median age (41.4 versus 36.2 in the nation) and a larger share of population older than 64. It also had a slightly smaller share of college graduates than the U.S., but a larger share than the state.

# Fourth District Homes



	Median owner-occupied home value, 2000 (\$ thousands)	Change in Home Price Index, 2000 to 2005:IIQ	Median home value, 2005:IIQ <sup>a</sup> (\$ thousands)
Columbus	120.9	23.9	149.8
Cleveland	117.9	21.9	143.7
Cincinnati	116.5	22.9	143.2
Akron	112.6	20.7	135.9
Lexington	105.0	25.9	132.2
Canton	99.7	20.3	119.9
Toledo	96.8	23.8	119.8
Dayton	99.0	18.9	117.8
Pittsburgh	86.1	29.9	111.9
Youngstown	82.2	22.0	100.3
<b>U.S.</b>	<b>119.6</b>	<b>51.8</b>	<b>181.6</b>

a. Federal Reserve Bank of Cleveland calculations.  
 SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight.

There has been much debate lately about whether the U.S. is experiencing a “bubble” in housing prices. Although it is difficult to tell if homes are selling above their fundamental values, we do know that home prices nationwide have been rising rapidly over the past several years. How does the Fourth District stand?

According to the Census Bureau’s *American Community Survey*, the 2004 median home price for all District states lagged the U.S. average. West Virginia’s median price (\$82,000) was the nation’s third-lowest and

barely more than half the U.S. median price of \$151,000. The District state with the highest median price was Ohio, at \$122,000, followed by \$117,000 in Pennsylvania and \$98,000 in Kentucky.

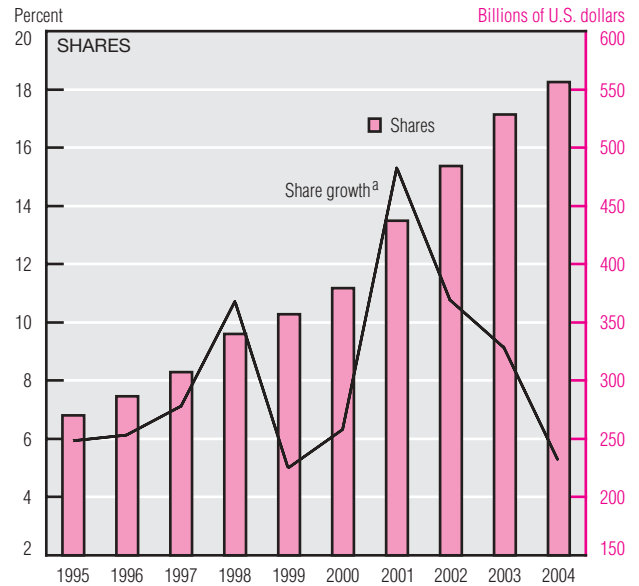
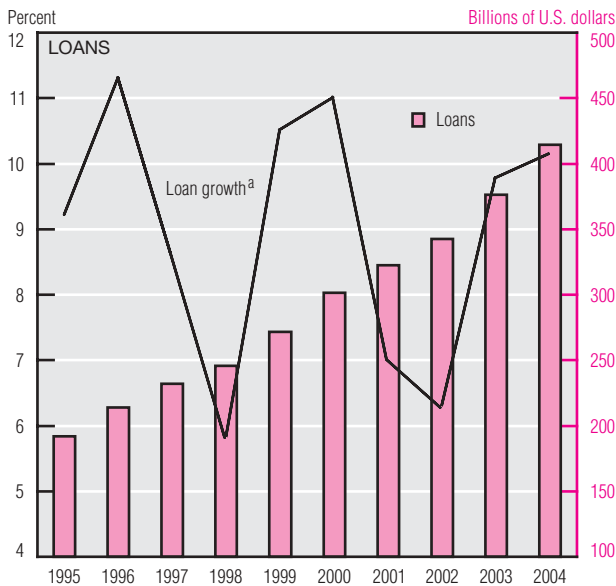
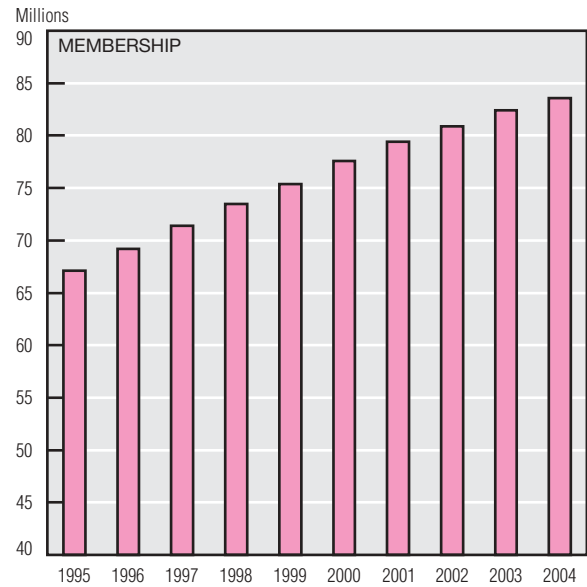
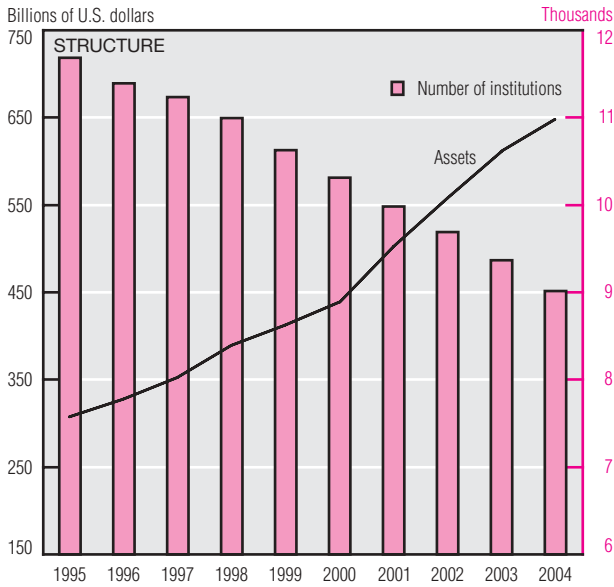
Furthermore, the rate of home price appreciation in most District states has been lagging the nation’s since 2000, according to HUD’s Office of Federal Housing Enterprise Oversight. From 2000:IQ to 2005:IIQ, the Home Price Index—which some have criticized for not holding housing quality constant—rose 55.8% for

the U.S., on a par with Pennsylvania, but significantly outpacing West Virginia, Kentucky, and Ohio. During that period, Pennsylvania’s home prices rose 51%, followed by West Virginia’s 34%, Kentucky’s 26%, and Ohio’s 24%.

Since 2000, home values in most of the District’s major metropolitan areas also have appreciated far less than the U.S. average. Of the District’s 10 most populous metropolitan areas, Columbus had the highest median value and Youngstown had the lowest.



# Credit Unions



NOTE: Data are for federally insured credit unions.

a. Growth rates are 12 month/annual.

SOURCE: National Credit Union Administration, Yearend/Midyear Statistics for Federally Insured Credit Unions (<http://www.ncua.gov/ReportsAndPlans/statistics/statistics.html>).

Credit unions are mutually organized depository institutions that provide financial services to their members. Like banks and savings associations, credit unions appear to be consolidating. Their numbers fell steadily from 11,687 institutions in 1995 to 9,014 at the end of 2004. However, their total assets more than doubled over the same period from \$306.6 billion to \$647.0 billion. The number of credit union members also increased steadily from 67.1 million in 1995 to 83.6 million at the end of 2004.

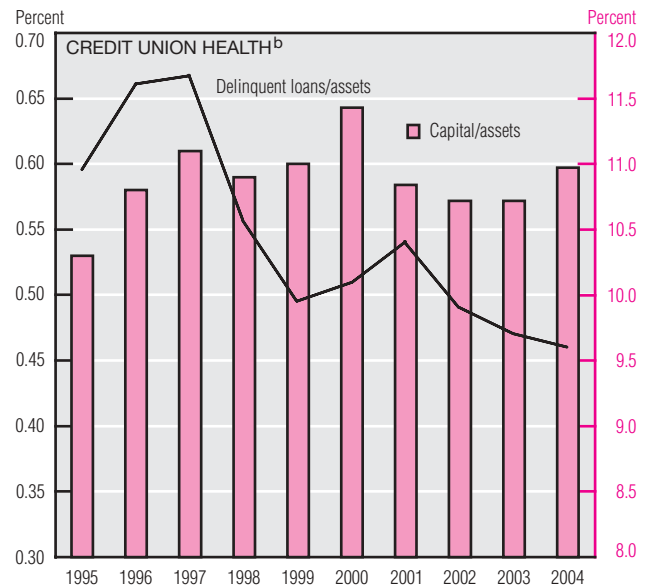
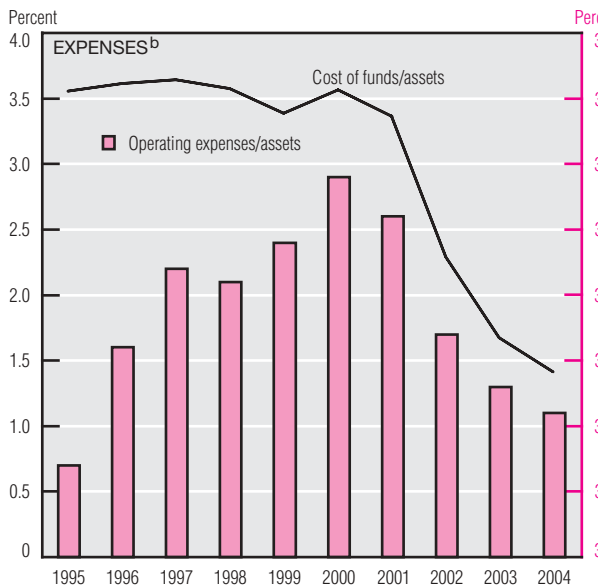
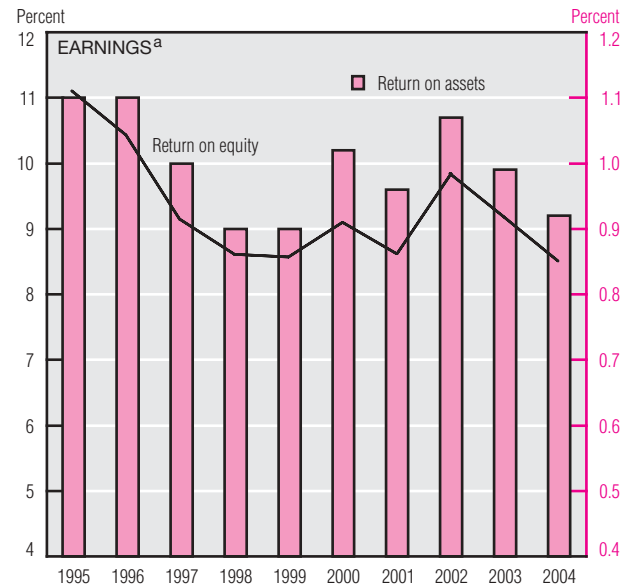
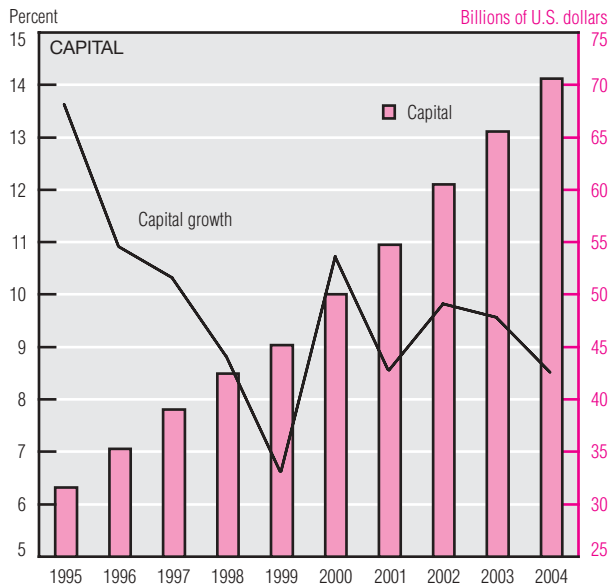
Growth in credit union assets has been fueled by positive loan growth. From the end of 1995 to the end of 2004, loans increased from \$192.1 billion to \$414.3 billion; loans as a share of assets grew modestly over that period, rising from 62.7% to 64.0%. Year-over-year loan growth has varied from 5.8% to 11.3% over the past 10 years, with an average annual growth rate of 7.8%.

Federally insured credit union shares have also risen steadily since 1995. Shares, which are analogous

to deposits in banks and savings associations, are the primary source of funds for credit unions, accounting for roughly 86% of total sources of funds. Like growth in loans, annual share growth has fluctuated between 5.0% and 15.3% over the past 10 years. Overall, shares grew at a robust 10.6% annual rate during this period. Credit unions continued to accumulate capital, which rose from \$31.6 billion at the end of 1995 to \$70.6 billion at the end of 2004, an increase of more than 123%.

(continued on next page)

## Credit Unions (cont.)



NOTE: Data are for federally insured credit unions.

a. Returns and expenses are on average assets; return on equity is on average equity.

b. All ratios are on average total assets.

SOURCE: National Credit Union Administration, Yearend/Midyear Statistics for Federally Insured Credit Unions (<http://www.ncua.gov/ReportsAndPlans/statistics/statistics.html>).

Not surprisingly, considering that retained earnings are the only source of capital for credit unions, the pace of capital accumulation mirrors the general downward trend in return on assets and return on equity since 1995. Return on assets fell from a high of 1.1% in 1995 to 0.9% in 1999. Return on assets rebounded to 1.1% in 2002 but declined in both 2003 and 2004. Return on equity followed a similar pattern over the same period. Credit unions' decline in profitability over the second half of

the 1990s resulted partly from a steady increase in operating expenses per dollar of assets and the relatively high cost of funds. The improvement in operating expenses since 2000 points to credit unions' increased efficiency, which is important for the industry's future viability. Declines in the cost of funds over the past five years are largely the result of a low-interest-rate environment.

Overall, the health of the credit union industry appears to be sound. Capital as a share of assets stood at

11% at the end of 2004. On the other hand, delinquent loans as a share of assets fell from 0.67% in 1997 to 0.46% at the end of 2004. Moreover, at the end 2004, credit unions held nearly \$24 of capital for every \$1 of delinquent loans. In short, credit unions remain a viable alternative to commercial banks and savings associations for basic depository institution services such as checking accounts, consumer loans, and savings accounts.