

## *The Economy in Perspective*

*Taking stock* ... Although some people worried that the U.S. economy would stumble at the end of this year and limp into the next, it appears to be running in fine form. Income and output actually accelerated last quarter, despite soaring energy prices and storm damage along the Gulf Coast. In November, energy prices receded, and employers impressively stepped up the pace of hiring. Retail store traffic is encouraging, with consumers seemingly throwing off their worries as easily as Katrina uprooted trees. Business confidence has stabilized as well: Stock prices have risen, and market volatility and credit quality spreads remain low. Many private-sector economic forecasters expect the U.S. economy to grow at a moderate pace next year, with headline inflation numbers falling back toward the 2% range.

What can we look forward to? The most interesting characteristic of the 2006 economy may prove to be its maturity. We are now into the fifth year of an economic expansion, far enough along for many of the imbalances that accumulated in the last expansion and recession to have been corrected. Capacity utilization rates have recovered considerably in most industries, and business spending for capital equipment has finally strengthened again. Surveys of business executives indicate that they are optimistic about orders, sales, and equipment spending. Employment growth was strong enough in 2005 to push the unemployment rate down to 5%, which is roughly equal to its long-term average.

As business conditions have matured, so have financial conditions. Many companies and investors took significant financial losses when the 1990s dot-com industry collapsed, but the macro economy has finally worked out the losses and moved on. Corporate profits, cash flow, and balance sheets now look healthy, for the most part, providing a firm foundation for further growth. And, allaying concerns about housing bubbles in some parts of the country, rising interest rates have helped to cool off housing price appreciation. At the macro level, the pricing of corporate bonds and equities is not a red flag as far as investors

are concerned. Banking companies, which often extend credit to those who cannot borrow in the capital markets, report stellar loan quality.

The inflation picture also is brightening. Declining energy prices are relieving the pressure on headline inflation, and thus far core inflation rates have not edged up from past energy price increases being passed through to consumers.\* And if productivity growth continues at a healthy pace, inflation rates are likely to continue their pattern of moderation. Monetary policy has apparently succeeded in anchoring longer-term expectations, an important factor in holding down long-term nominal interest rates.

Although maturity connotes a successful evolution from an uncertain beginning, aging brings its own problems and sows the seeds of potential future disruptions. Yes, the dot-com wreckage has been hauled away, but yellow flags are out for the motor vehicle industry. How serious will their problems prove to be? What combination of sacrifices will ultimately be agreed upon by current and retired employees, investors, and taxpayers through the obligations of the Pension Benefit Guarantee Corporation? How will these adjustments affect communities that rely heavily on the most affected industries? What are the implications of the adjustments for the future of corporate pensions and health care policies?

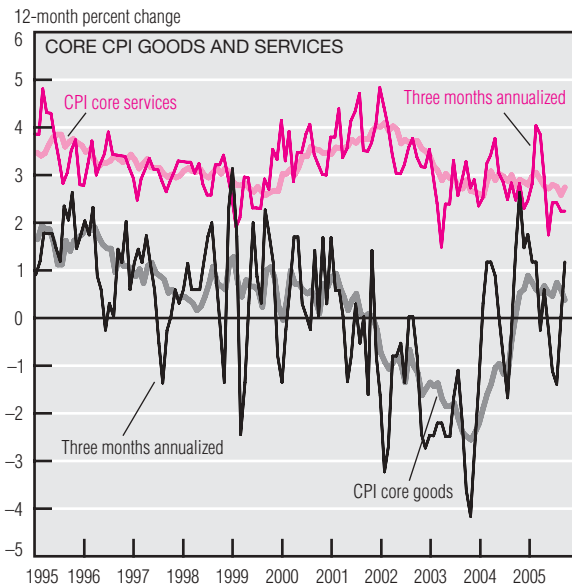
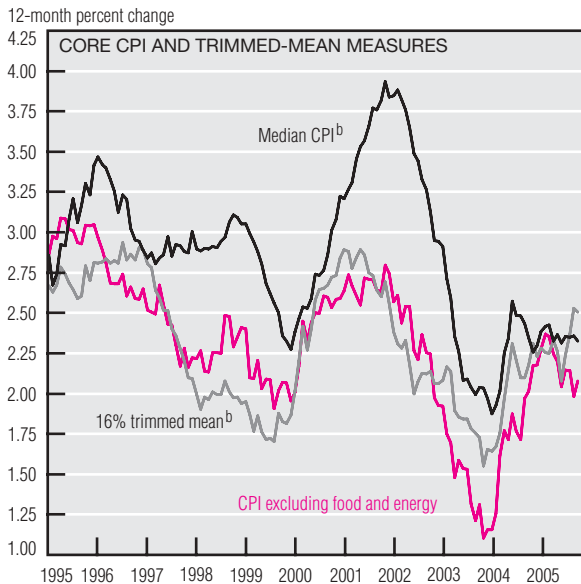
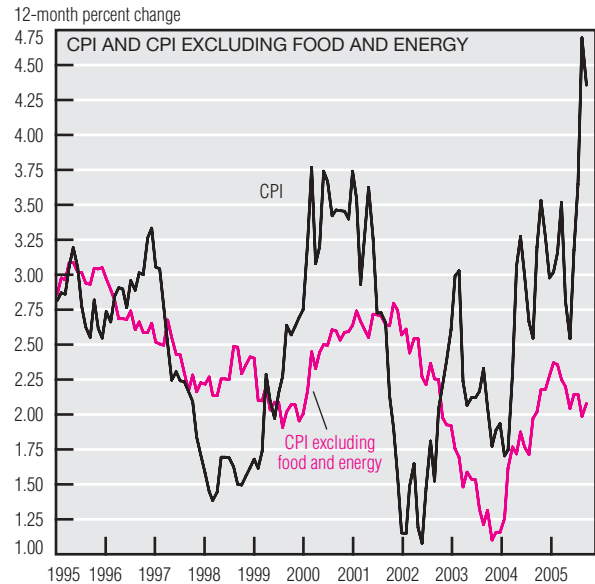
Hurricane Katrina demonstrated more than the fact that low-probability events eventually will come to pass; the devastation of New Orleans was a product of both the storm and inadequate preparedness. Similarly, what some people call institutional legacy costs, others describe as the consequences of a failure to prepare prudently. Private-sector companies are not alone in grappling with the burden of past assurances that are no longer viable. Federal, state, and municipal governments are all confronting problems that were created in the past when decisionmakers shuttled the costs of their actions into the future. Increasingly, that future is now.

Taking stock of the U.S. economy requires us to acknowledge that while maturity has its privileges, it also entails significant responsibilities.

\*This sentence was revised after this issue of *Economic Trends* was printed and before it was posted online.

# 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>Consumer prices</b>					
All items	2.4	8.0	4.3	2.7	3.4
Less food and energy	3.0	1.8	2.1	2.0	2.2
Median <sup>b</sup>	1.9	1.9	2.3	2.7	2.3
<b>Producer prices</b>					
Finished goods	8.6	13.2	5.9	2.8	4.4
Less food and energy	-3.0	0.0	1.9	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.

After surging 15.7% (annualized rate) in September—its largest monthly rise in more than 25 years, the Consumer Price Index (CPI) rose a relatively modest 2.4% (annualized rate) in October. Energy prices, which rose sharply throughout the third quarter, declined 2.9% (annualized) in October. Growth in the core CPI rose to 3.0% (annualized), higher than its three- and 12-month growth trends, whereas the median CPI's monthly growth rate was a subdued 1.9%.

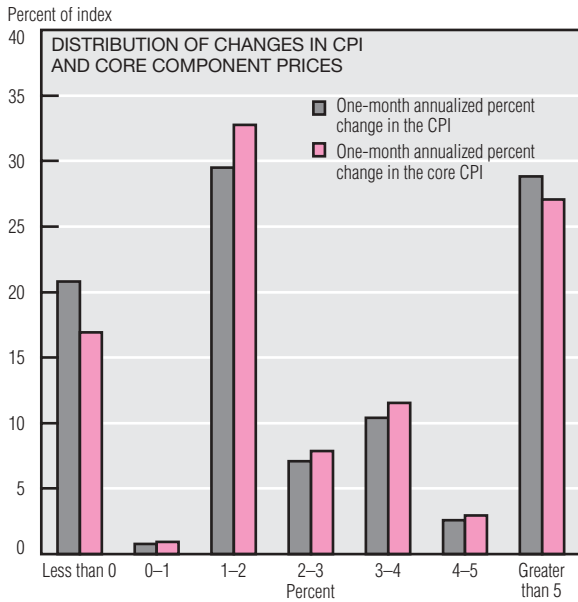
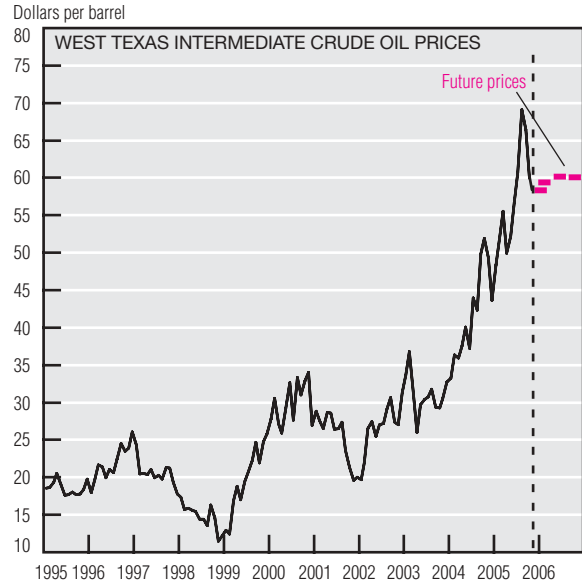
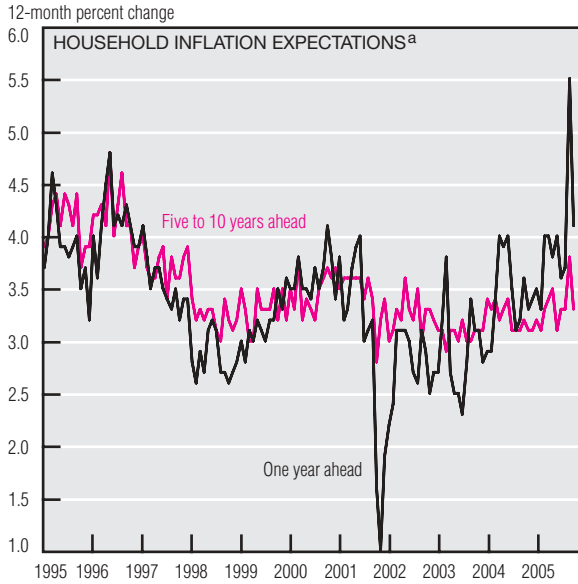
Longer-term inflation trends were mixed. The CPI's 12-month growth

rate ticked down from 4.7% in September to 4.3% in October, the second-highest 12-month growth rate since the early 1990s. The 12-month growth rates of the core CPI and the median CPI remained steady at 2.1% and 2.3%, respectively. However, the 16% trimmed-mean CPI's 12-month growth rate has accelerated just a bit since June, reaching 2.5% in October. Taken as a whole, the data suggest that there has been a retail inflation trend in the range of 2.0% to 2.5% since at least the end of 2004; prices of both core goods and core services have been showing some stability.

Meanwhile, household inflation expectations fell from a 15-year high of 5.5% in September and October to 4.1% in November. The improved household inflation sentiment probably reflects the continued decline in petroleum prices, which fell from their recent peak of nearly \$70 per barrel in August to about \$57 in November. However, even longer-term inflation expectations—which are less likely to be influenced by fluctuations in energy prices—declined 0.5 percentage points to 3.3% in November.

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# Inflation and Prices (cont.)



Annualized percent change, last	CPI	Core CPI	Median CPI	16% trimmed-mean CPI
One month	2.83	2.75	2.35	2.22
Three months	2.20	2.39	2.12	2.01
Six months	1.99	2.32	2.03	1.97
Nine months	1.98	2.36	2.05	2.01
12 months	2.09	2.44	2.13	2.11

a. Mean expected change as measured by the University of Michigan's Survey of Consumers.  
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; University of Michigan; and the *Wall Street Journal*.

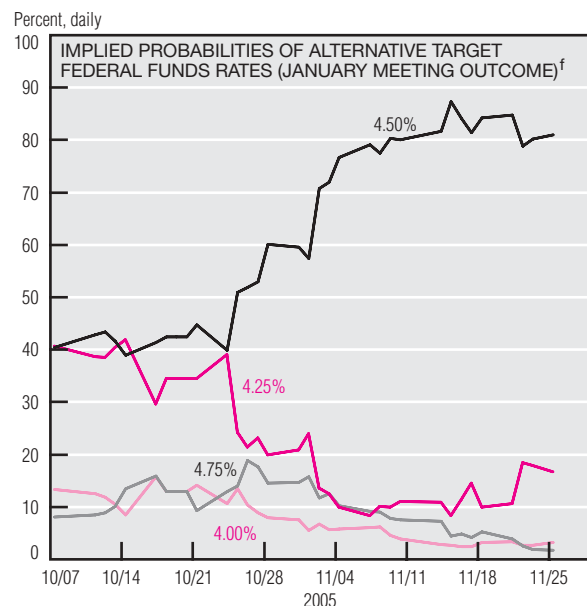
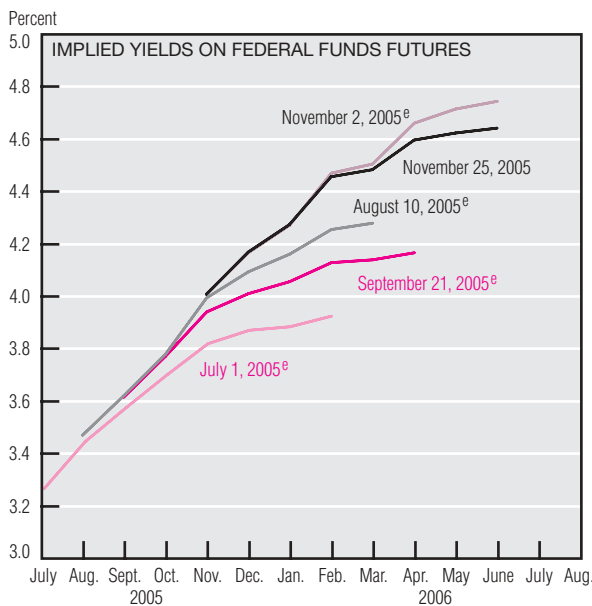
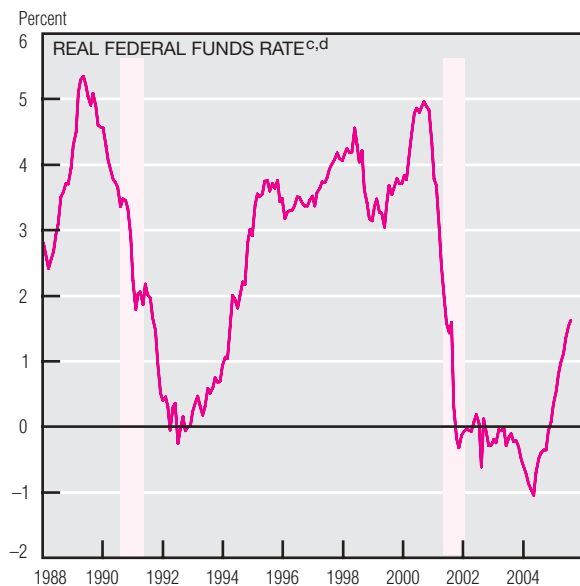
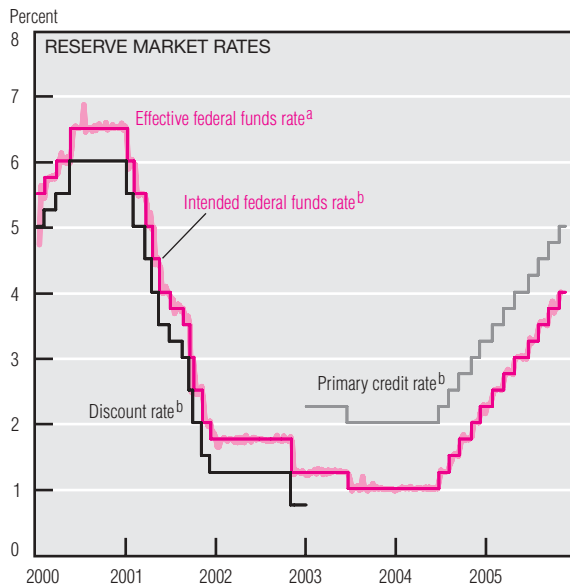
Although underlying inflation patterns seem relatively subdued, some CPI components are still subject to pricing pressure. Indeed, apart from energy, 27% of the CPI's components showed annualized price increases of more than 5% in October. These price increases were largely offset, however, by deflation in roughly 17% of the core CPI's components.

This uneven distribution of component price changes across the consumer's market basket makes it

difficult to gauge any potential shift in the growth trend in overall retail prices. Indeed, even the core inflation measures have been showing somewhat contradictory patterns in the monthly data: The CPI excluding food and energy accelerated, the trimmed-mean CPI decelerated, and the median CPI held comparatively steady. Which of these is likely to be the most accurate? Although no single monthly measure of inflation should be given a great deal of weight, an examination of these alternative

measures' forecasting record suggests that the trimmed-mean and median CPI measures tend to predict future CPI trends more accurately than the more traditional core statistic. That is, when it comes to forecasting CPI-measured inflation over the next 12 months, the one- and three-month annualized percent changes in the median CPI and 16% trimmed-mean CPI are more accurate than either the regular CPI or the CPI excluding food and energy.

# Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Defined as the effective federal funds rate deflated by the recent annual (that is, trailing) core PCE Chain Price Index.

d. Shaded bars indicate periods of recession.

e. One day after the FOMC meeting.

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

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.

At its November 1 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 3.75% to 4%, which is still less than 2 percentage points above the core inflation rate of personal consumption expenditures for the past year. The rate hike was widely anticipated.

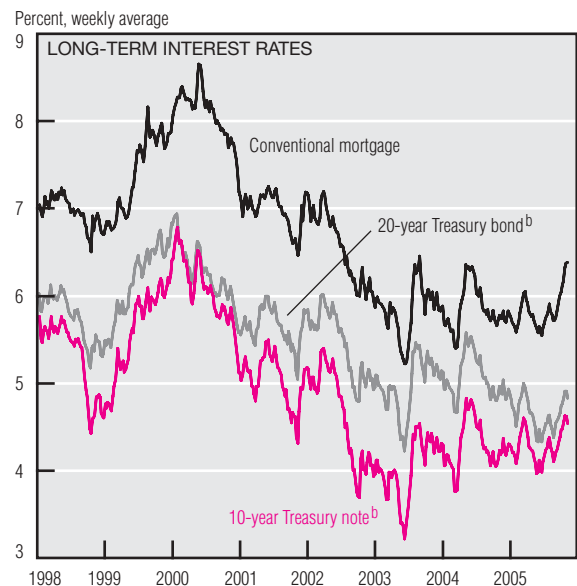
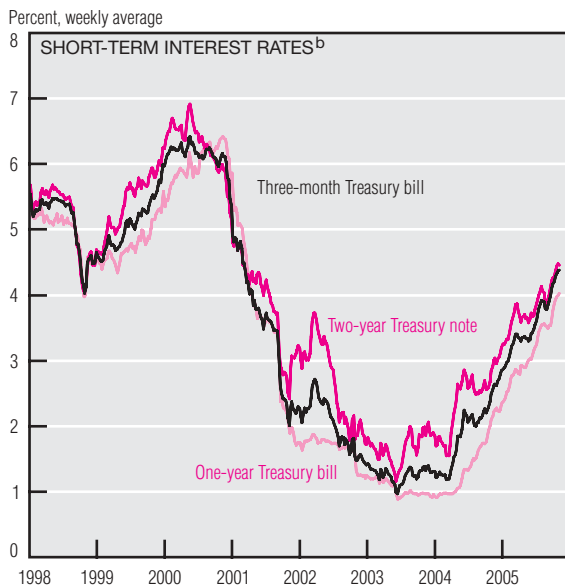
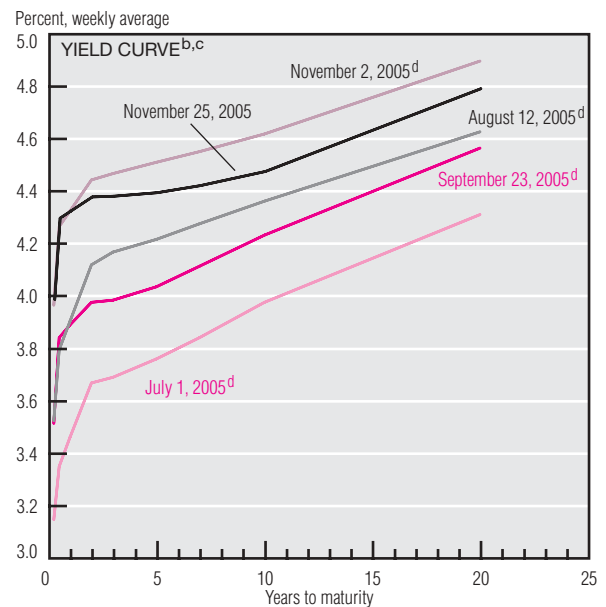
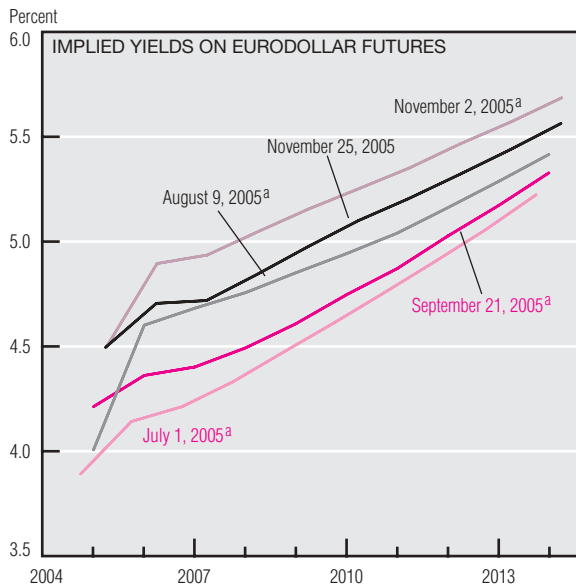
Because the most recent annual core inflation rate is often viewed as a proxy for expected future inflation, the difference between the fed funds

rate and core inflation rate is commonly used to measure the real (inflation-adjusted) fed funds rate. However, in light of hurricane-related inflation concerns, trailing core inflation might be a questionable proxy for inflation expectations. Indeed, the inflation expectations revealed in other, more prospective, measures—such as those from survey data or market yields on inflation-protected securities—are currently higher than recent inflation levels.

Hence, a real fed funds rate based on trailing inflation may be an overestimate. This would suggest that a greater degree of policy accommodation remains.

The November policy move was consistent with the forward-looking language offered in recent statements. For more than a year now, the FOMC policy statement has repeated that "the Committee believes that policy accommodation can be removed at a measured pace." The fed funds rate  
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## Monetary Policy (cont.)



- a. One day after the FOMC meeting.  
 b. All yields are from constant-maturity series.  
 c. Average for the week ending on the date shown.  
 d. First weekly average available after the FOMC meeting.

SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

has risen in increments of 25 basis points at each FOMC meeting without a hint of when a pause might occur.

The minutes of the November meeting, released with a three-week lag, seemed to make preparations for removing the "measured pace" language. Analysts focused on this sentence: "Several aspects of the statement language would have to be changed before long, particularly those related to the characterization and outlook for policy." However, prices of fed funds futures and

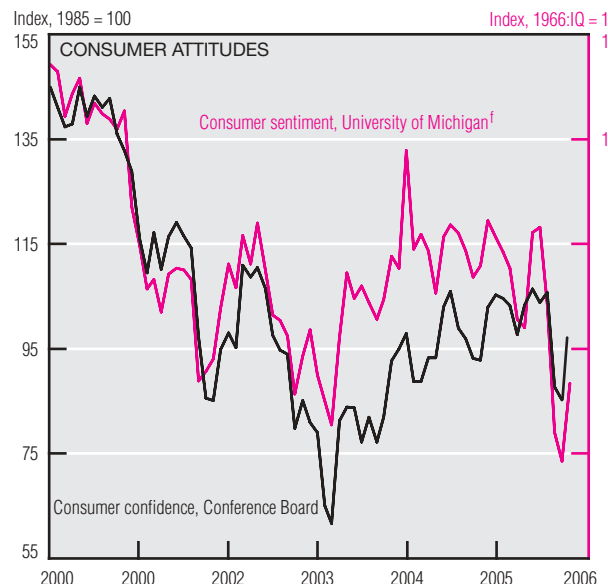
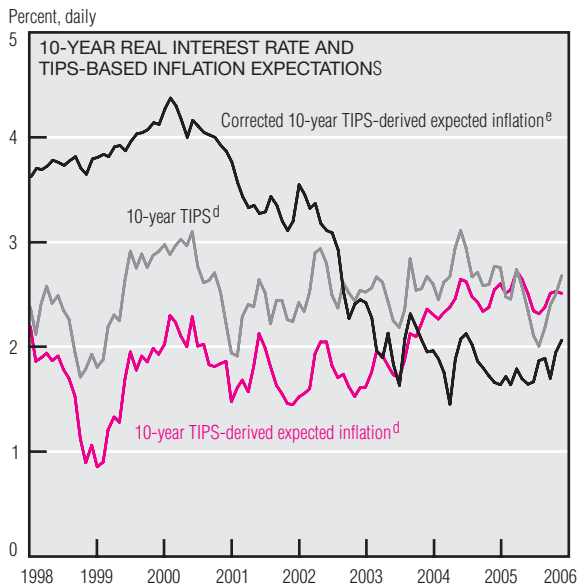
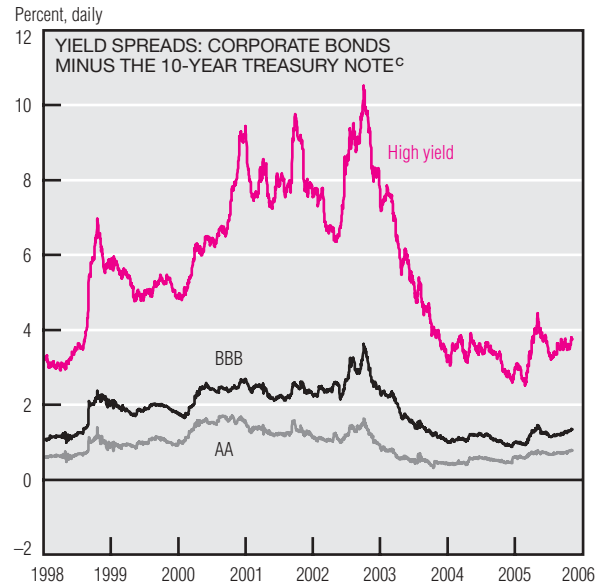
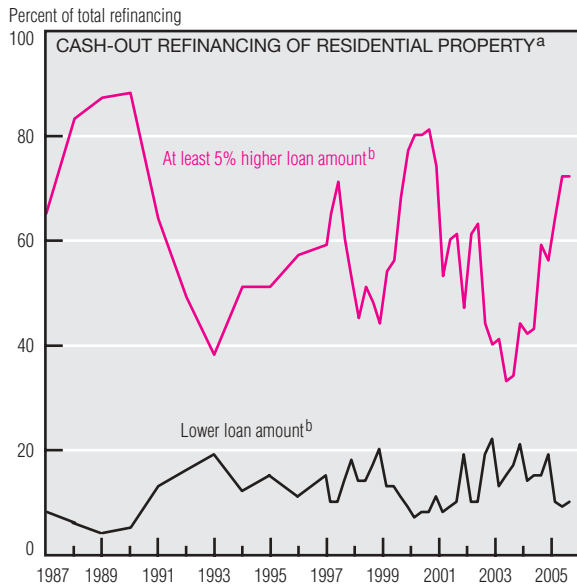
options on those futures suggest that market participants do not expect dramatic changes in the language. Rather, a pause in rate hikes sometime next spring had already been priced into these instruments.

Implied yields based on the prices of fed funds futures indicate that the funds rate is expected to rise to between 4.5% and 4.75% by April. Moreover, options on these futures suggest that rate hikes of 25 basis points each at the December and January meetings remain very likely. Thus the release of the minutes

seemed to have only a marginal effect on when market participants expected a pause. After the minutes were released, investors were giving slightly higher odds that the pause would be announced at the March meeting.

Yields on Treasury bonds tended to fall after the release, but only marginally. On the whole, financial markets seem fairly confident that hurricane-related inflation concerns will come to pass, and that policy may be approaching a more neutral setting.

# Money and Financial Markets



a. Annual data until 1997; quarterly data thereafter.

b. Compared with previous financing.

c. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.

d. Treasury inflation-protected securities.

e. Ten-year TIPS-derived expected inflation, adjusted for the liquidity premium on the market for the 10-year Treasury note.

f. Data are not seasonally adjusted.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Home Loan Mortgage Corporation; University of Michigan; the Conference Board; and Bloomberg Financial Information Services.

Despite 12 straight increases in the federal funds rate, long-term interest rates remain low by historical standards. For more than three years, the economy has been expanding at an average annual rate of 3.5%. Normally, when economies expand at such a healthy pace, investment opportunities abound, boosting the real rate of return on new business investment. In turn, the high returns on new capital tend to pull up the whole yield structure, including long-term real interest rates.

The savings glut in Asia is increasingly viewed as a major damper on the U.S. interest rate structure. The impact of low long-term rates is nowhere more evident than in the housing market. Persistently low mortgage rates have fueled a boom, raising housing prices relative to income levels.

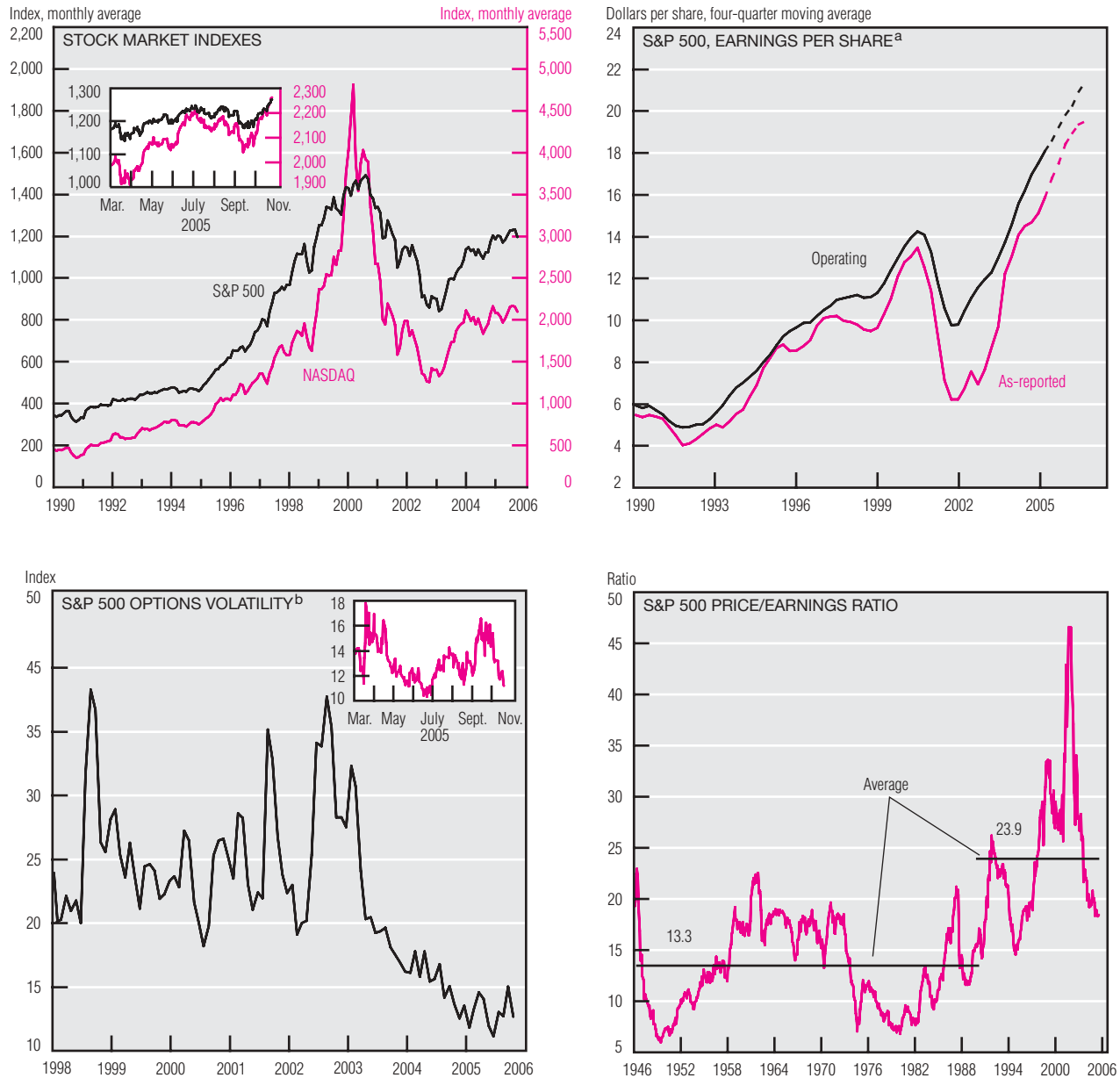
High housing prices and low mortgage rates have combined to give households a substantial source of financing. More specifically, they have enabled households to tap their

increased housing equity by refinancing at higher loan amounts. In recent months, this so-called cash-out refinancing has supplied funds that have allowed households to spend at a pace that has exceeded growth in personal income.

Some analysts are concerned that a sharp uptick in interest rates would stop cash-out refinancing, causing a precipitous drop in consumer spending, especially if housing prices fall significantly. This concern has

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## Money and Financial Markets (cont.)



a. Dashed lines indicate the forecast as of November 22.

b. CBOE Volatility Index (VIX). Monthly data.

SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

been heightened by higher energy prices, which will put additional stress on household budgets and balance sheets.

Business balance sheets, on the other hand, are quite healthy, as reflected in the stable spreads of corporate bond rates over Treasuries. Many businesses have ample cash for investing if they choose to spend it. With inflation expectations remaining well-contained and consumer confidence on the rebound, business investment should continue to be a

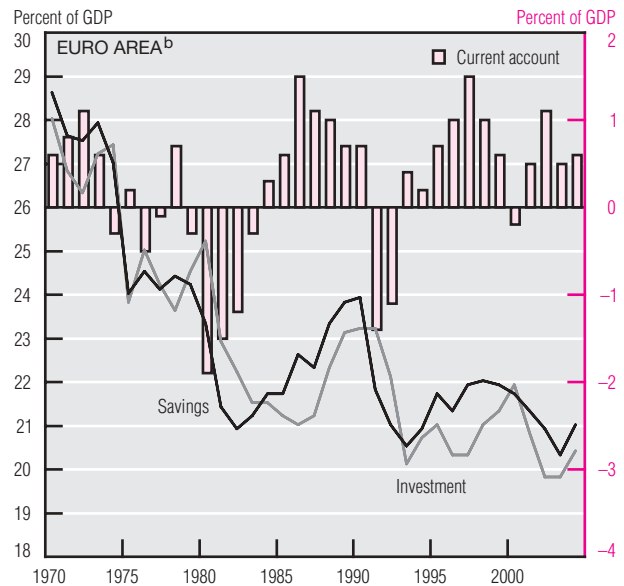
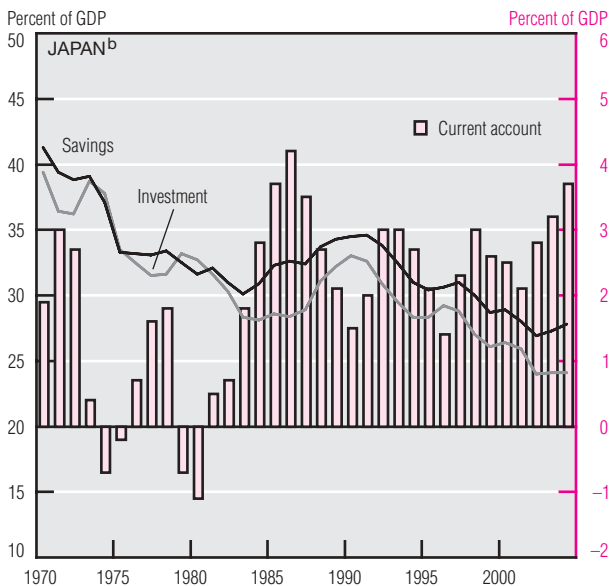
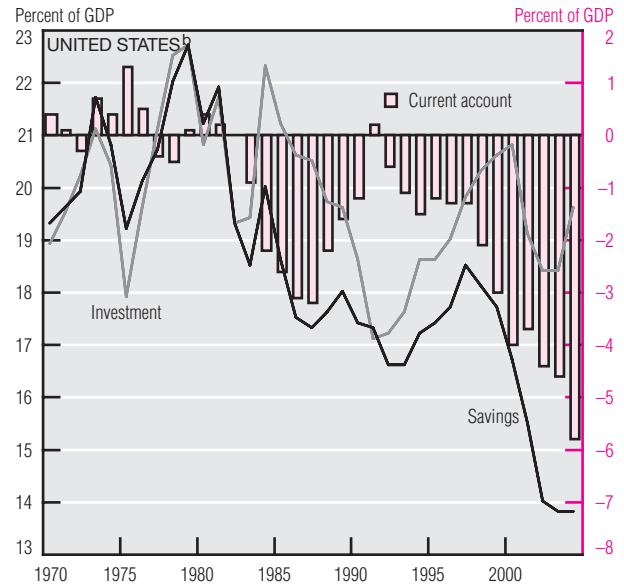
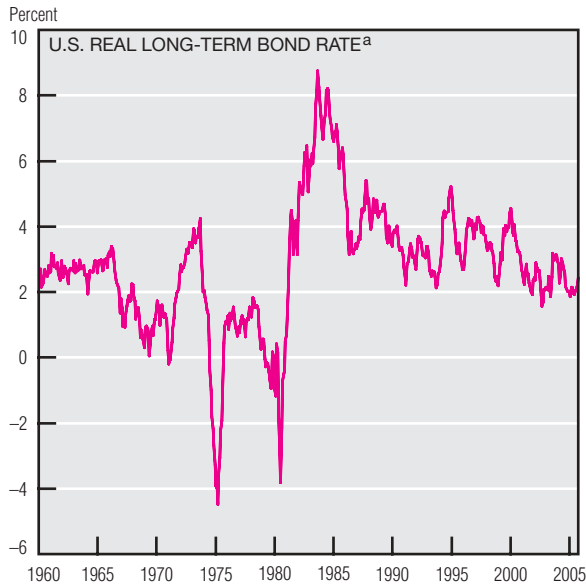
major driver of the expansion. Moreover, although consumer spending might slow, it could continue to be supported by employment gains.

Increased business spending is most evident in the energy sector. More broadly, however, improved investment prospects seem to have been supported by a surge in broad equity indexes in November. Indeed, stock market fundamentals appear quite favorable. Chief among these fundamentals are S&P 500 companies' earnings, which have been increasing

at a rate of 15% over the past year. Earnings are expected to decelerate, but analysts nonetheless project earnings to grow at nearly double-digit rates over the next year. Despite the recent run-up in stock prices, the price-earnings ratio remains well below its average in recent years.

The strength in equities in November was coupled with a decline in equity options volatility. The decline in volatility since October may reflect some taming of inflation fears.

## The Interest Rate Conundrum and the Savings Glut



a. Calculated using 10-year Treasury bond rate and 12-month change in CPI less food and energy.

b. IMF staff calculations. Original sources include the OECD Analytical Database; and the World Bank, *World Development Indicators*.

SOURCES: Federal Reserve Board; Bureau of Labor Statistics; and International Monetary Fund, *World Economic Outlook*, September 2005, pp. 91–124.

Two of the brightest blips on U.S. policymakers' radar screens are the low level of U.S. long-term interest rates and our large, expanding current-account deficit. Global saving and investment patterns go a long way toward explaining both of them.

Real long-term interest rates in the U.S. and elsewhere around the globe seem unusually low for the current state of the business cycle. A recent International Monetary Fund study of 46 countries (including industrialized, emerging-market, and oil-producing

nations) suggests that lackluster global investment helps explain real interest rates.

Expressed as a percentage of world GDP, global investment fell from 23% in 1997 to 21% in 2002. It recovered to approximately 22% in 2004, according to the latest available data. The current pace of worldwide economic recovery and recent declines in the cost of capital seem capable of supporting a higher level of global investment than we have recently seen.

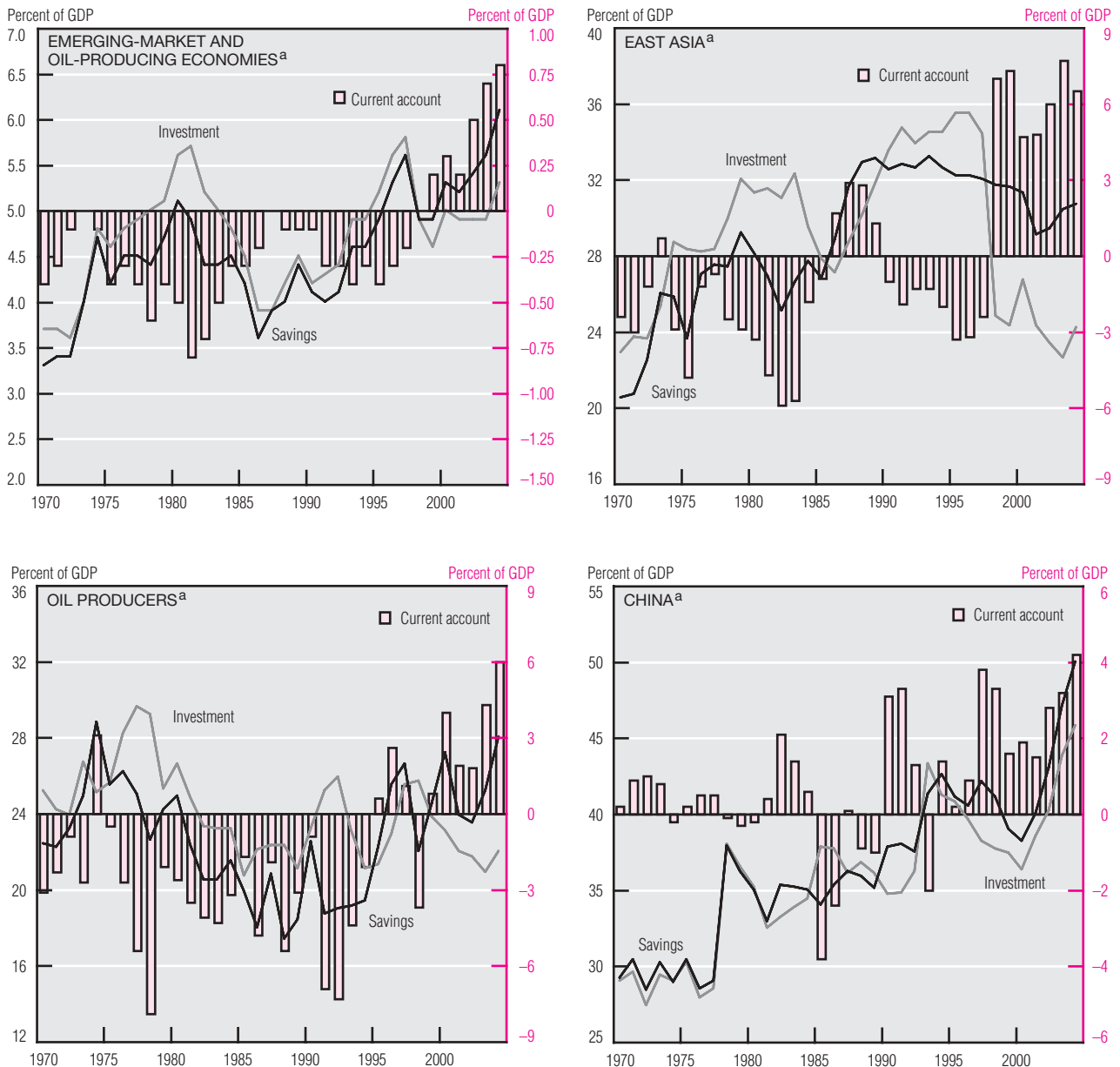
Among industrialized countries, most of the investment decline was concentrated in the euro area and in Japan, where 15 years of subpar economic growth has taken a toll. On balance, investment in most other industrialized countries remained fairly flat between 2001 and 2004. In the U.S., however, fixed investment has recently been rebounding.

Investment in most East Asian countries fell precipitously after the Asian financial crisis in the mid-1990s. A notable exception is China, where

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## The Interest Rate Conundrum and the Savings Glut (cont.)



a. IMF staff calculations. Original sources include the OECD Analytical Database; and the World Bank, *World Development Indicators*.  
SOURCE: International Monetary Fund, *World Economic Outlook*, September 2005, pp. 91–124.

investment has risen sharply. Among oil-producing nations and other emerging-market nations, investment has been unimpressive.

In the aggregate, savings must equal investment; not surprisingly, global savings have declined as a share of world GDP. Within any country or region, however, savings can—and typically do—differ from local investment. Divergences between nations' saving and investment patterns are mirrored in their current-account positions. Countries running current-account surpluses save more

than they invest, whereas countries experiencing current-account deficits invest more than they save.

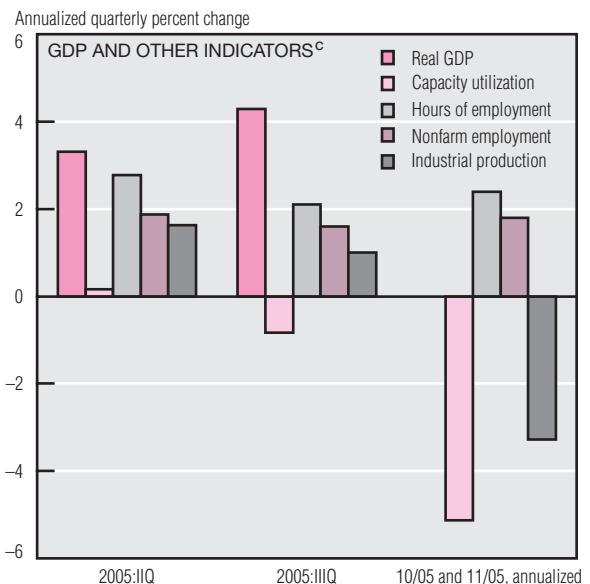
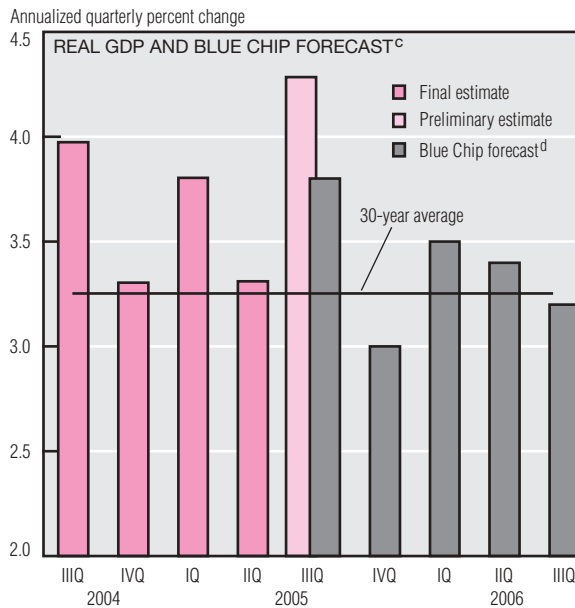
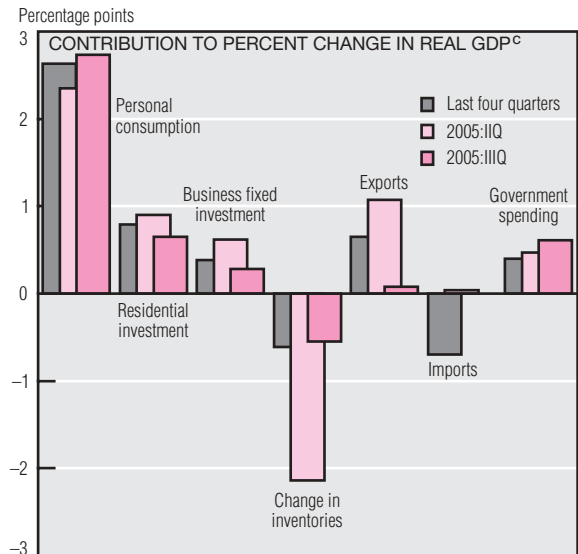
In most countries and regions covered in the IMF study, savings closely paralleled—but slightly exceeded—local investment. Consequently, most countries and regions maintain small current-account surpluses.

There are, however, striking exceptions. As a consequence of federal budget deficits and low private savings, overall savings in the U.S. have fallen sharply since 1997 and remain well below our level of investment. In contrast, most East Asian countries

and oil-producing countries maintain savings substantially in excess of local investment. Inflows of savings from these emerging-market economies account for roughly two-thirds of the divergence between U.S. investment and savings. The pattern of their savings, currently at record levels, generally reflects many East Asian governments' wish to acquire foreign-exchange reserves as a buffer against future financial crises and as a consequence of relatively low returns in investment projects in these emerging economies.

# Economic Activity

	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	116.9	4.3	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*, November 10, 2005.

The Commerce Department's preliminary reading of 2005:IIIQ real GDP growth was 4.3%, up from the advance reading of 3.8%. The upward revision to the preliminary estimate resulted from upward revisions to residential fixed investment, nondurable consumption, and business spending on equipment and software.

Most components' contributions to the percent change in real GDP were similar to their average for the previous four quarters. However, the components with the largest contributions did shift from 2005:IIQ to 2005:IIIQ. Personal consumption

contributed 2.7 percentage points (pp) to the change in real GDP, compared to only 2.4 pp in 2005:IIQ; private inventories subtracted only 0.6 pp from the change in real GDP, compared to 2.1 pp in 2005:IIQ. Conversely, exports contributed a modest 0.1 pp in the third quarter, after adding 1.1 pp to the change in real GDP in 2005:IIQ.

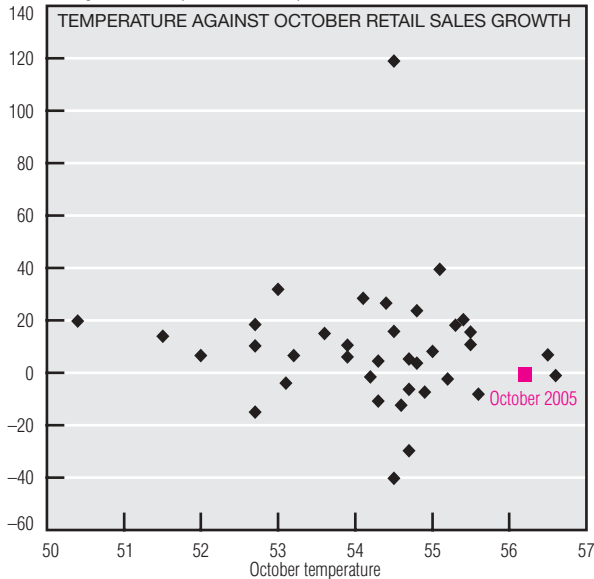
Real GDP growth of 4.3% or higher has not been achieved since 2004:IQ. This is significantly higher than the 30-year average of 3.3%. However, according to the November report, the Blue Chip panel of economists

predicts that growth will slow to 3.0% in 2005:IVQ and then remain between 3.1% and 3.5% in 2006.

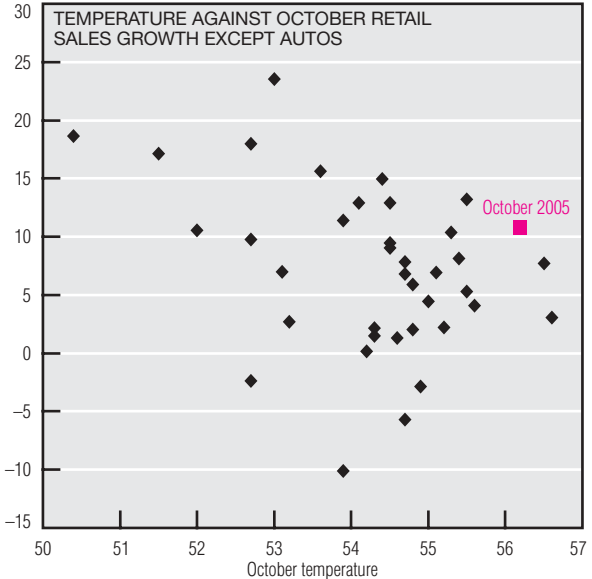
Although real GDP growth increased in the third quarter, other important indicators of the economy's health faltered. Industrial production and capacity utilization decreased between 2005:IIQ and 2005:IIIQ, and data from the first two months of the fourth quarter suggest that they will continue to drop. However, monthly data from both hours of employment and nonfarm employment currently indicate that these numbers will increase in 2005:IVQ.

# Temperature and Retail Sales

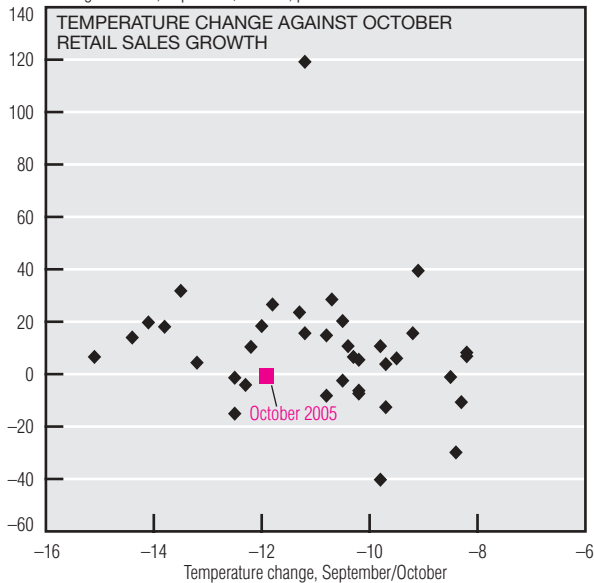
Annualized growth rate, September/October, percent



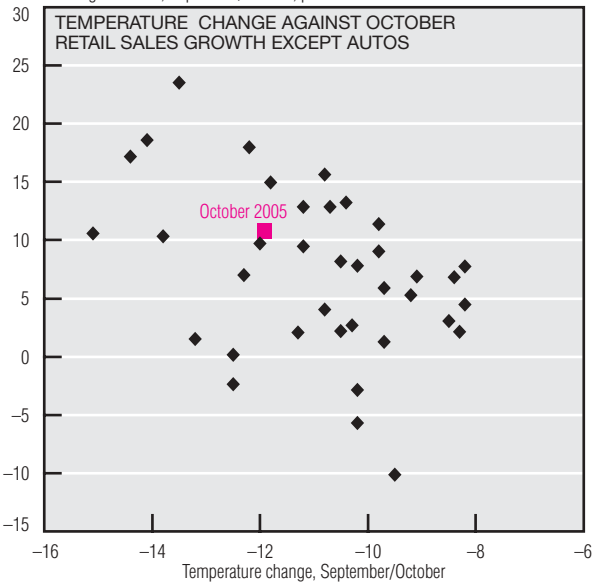
Annualized growth rate except autos, September/October, percent



Annualized growth rate, September/October, percent



Annualized growth rate, September/October, percent



NOTE: All retail data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and National Climatic Data Center.

Many retailers credited colder October weather with improving the month's sales. It is easy to think of individual goods—down-filled jackets and swimsuits, say—whose sales depend on temperature. It is less obvious that such a relationship should exist in aggregate economic data, partly because of “averaging out” over the many goods sold in the U.S., but principally because such data are seasonally adjusted, which removes the obvious effects of temperature. Nonetheless, can we see a relationship between temperatures and retail sales in aggregate U.S. data?

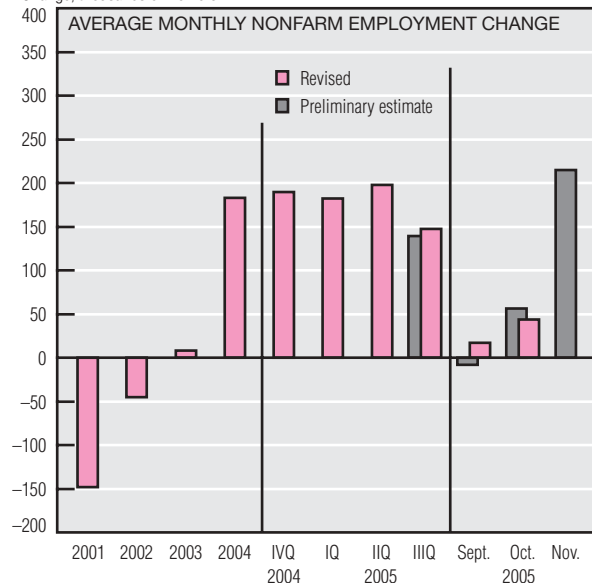
Retail sales growth from September to October seems unrelated to average U.S. temperatures in October. (The 120% growth rate recorded in 2001 was presumably an aftershock of the September 11 attacks.) A loose relationship between these variables emerges if we exclude automobiles from retail sales, which may be warranted in light of automotive companies' recent rebates and special pricing.

But these figures may not get at the essence of what retailers mean when they say that colder temperatures

improved retail sales in October. Perhaps sales took off when the temperature fell sharply between September and October. For total retail sales, it is difficult to discern a pattern. However, if we again exclude automobiles, the size of the drop in temperature seems to be positively correlated with the rate of growth in retail sales. At the very least, October's retail sales growth seems to have been more closely linked to the amount of temperature change than to the average temperature level.

# Labor Markets

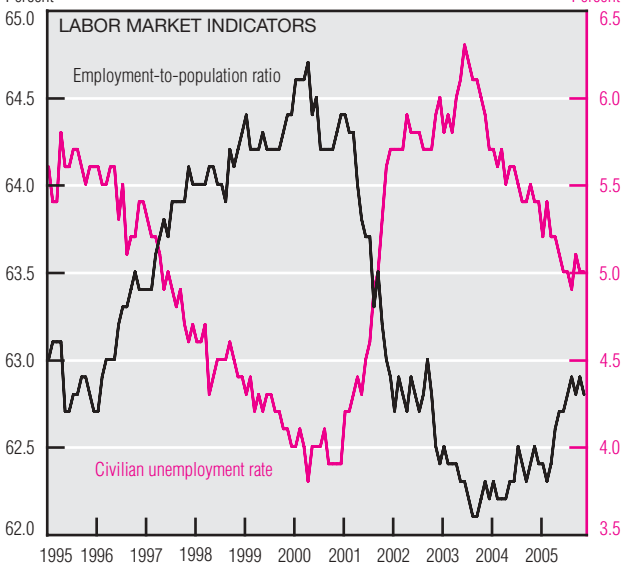
Change, thousands of workers



## Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2002	2003	2004	YTD 2005	Nov. 2005
<b>Payroll employment</b>	-45	8	183	167	215
<b>Goods producing</b>	-76	-42	29	22	50
Construction	-7	10	23	25	37
Manufacturing	-67	-51	3	-6	11
Durable goods	-48	-32	9	1	9
Nondurable goods	-19	-19	-6	-7	2
<b>Service providing</b>	30	50	154	145	165
Retail trade	-10	-5	13	11	9
Financial activities <sup>a</sup>	6	7	12	16	13
PBS <sup>b</sup>	-17	22	45	36	29
Temporary help svcs.	2	12	15	11	5
Education & health svcs.	40	30	33	31	36
Leisure and hospitality	12	18	22	17	29
Government	21	-4	12	16	21
	<b>Average for period (percent)</b>				
Civilian unemployment rate	5.8	6.0	5.5	5.1	5.0

Percent



## November Employment Status of Adults Who Evacuated Their Homes in August because of Hurricane Katrina<sup>c</sup>

Employment status, November 2005	Total	November residence same as in August	November residence different than in August
Civilian noninstitutional population (thousands)	886	442	443
Civilian labor force (thousands)	489	233	256
Participation rate (percent)	55.2	52.7	57.7
Employed (thousands)	389	204	185
Employment-population ratio	43.9	46.1	41.6
Unemployed (thousands)	100	29	71
Unemployment rate (percent)	20.5	12.5	27.8
Not in labor force (thousands)	397	209	188

NOTE: All data are seasonally adjusted unless otherwise noted.

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. Not seasonally adjusted. Not fully representative of the total evacuee population. For further information see [www.bls.gov/cps](http://www.bls.gov/cps).

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

Nonfarm payrolls grew by 215,000 in November, beating consensus expectations by 5,000 jobs. This followed meager growth in September (17,000) and October (44,000), which was attributable to Hurricane Katrina's direct and indirect effects.

November's employment gains included every major industry. Large gains occurred in construction (37,000) and food services (39,000). Manufacturing payrolls increased by

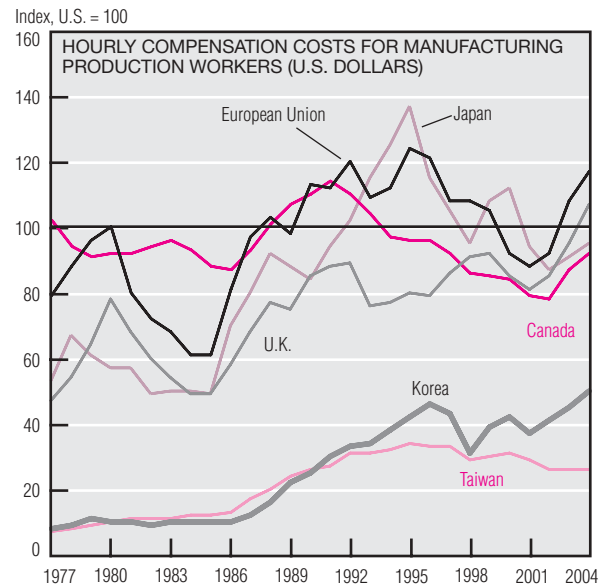
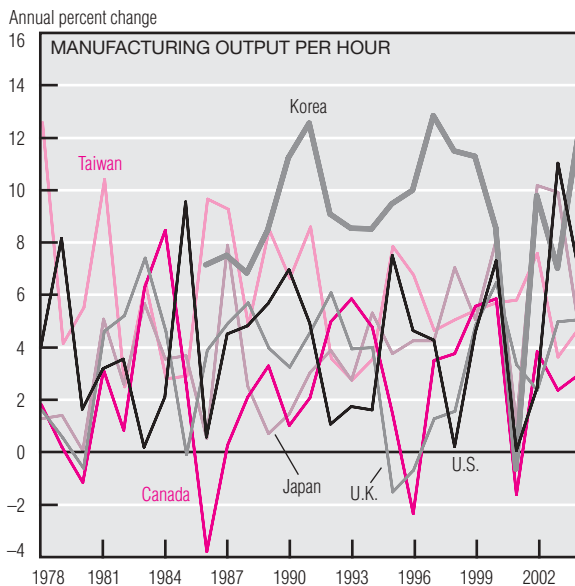
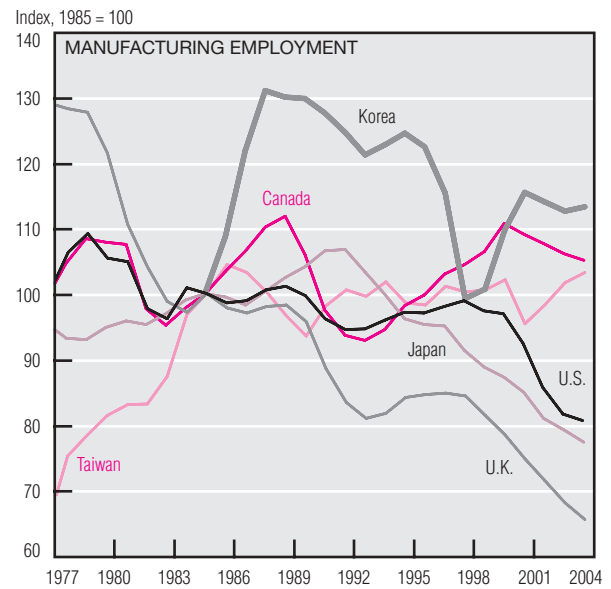
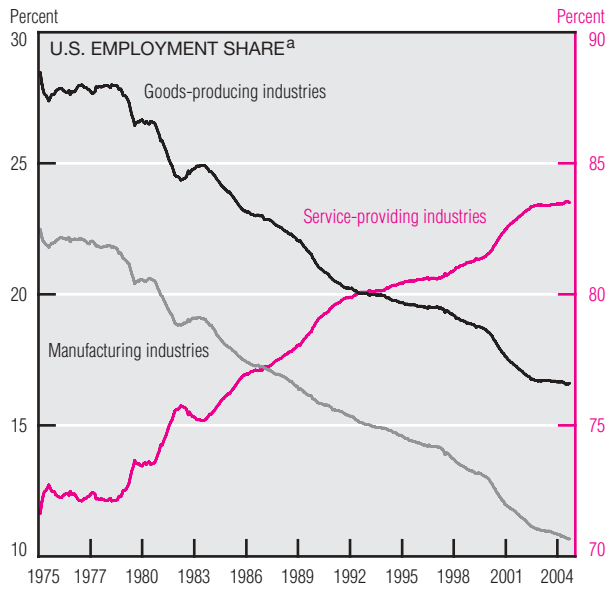
11,000, the industry's first back-to-back monthly increase in over a year. Retail and temporary help services made modest gains over the month.

The national unemployment rate held at 5.0% in November, after ranging from 4.9% to 5.1% for the previous six months. The employment-to-population ratio, which has varied only slightly in the last four months, was essentially unchanged at 62.8%.

Beginning in October, the household survey included questions

designed to identify Hurricane Katrina evacuees. The survey indicated that 900,000 persons 16 and older had been forced out of their homes by the storm in August; by November, half of them had returned home. Of the 55.2% of evacuees who were classified as being in the labor force, 20.5% were unemployed. However, the unemployment rate among those who had returned home was 12.5%.

# Manufacturing Employment



a. Total nonfarm payroll employment.  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Manufacturing's share of total U.S. employment has been dropping for at least 60 years. Since 1975 alone, the share plummeted from about 22% to roughly 11% of all nonfarm jobs. Since 1977, manufacturing employment has dropped roughly 18% in Japan and a whopping 49% in the U.K. In contrast, manufacturing employment has risen slightly (about 3%) in Canada, and most dramatically in Taiwan, where it has jumped nearly 40% in the last 25 years or so. In 2004, manufacturing employment fell in the

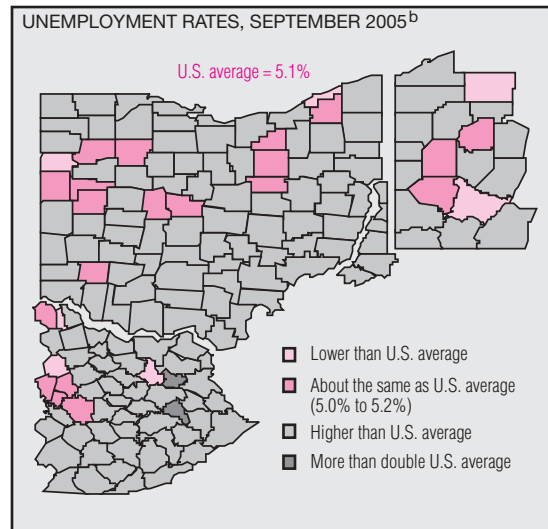
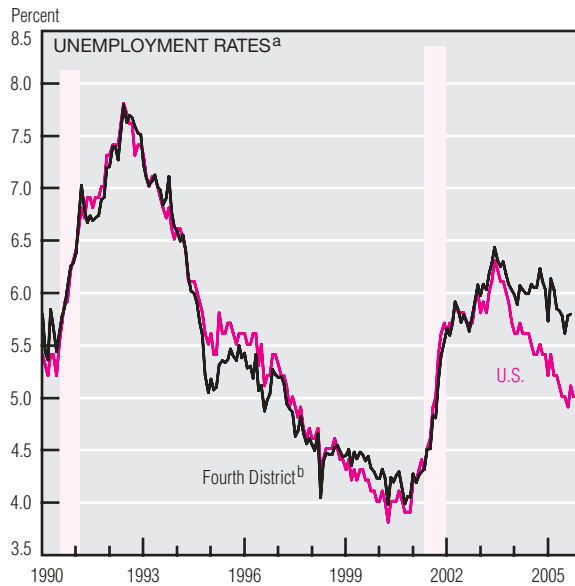
U.S., U.K., Canada, and Japan, but rose in Korea and Taiwan.

Increased productivity generally slows employment growth. In 2004, manufacturing employment posted its largest declines in the U.S., U.K., and Japan, three countries where productivity growth exceeded historical average annual growth rates. However, higher productivity does not necessarily correspond to lower manufacturing employment. For example, although Taiwan has experienced substantial productivity growth since the

mid-1970s, manufacturing employment rose for a decade after the late 1970s and has remained relatively unchanged since the early 1990s.

Manufacturing employment rose in the countries that have relatively low hourly compensation costs. Over the past 20 years or so, manufacturing employment has risen in Korea and Taiwan, where hourly compensation costs have ranged between 10% and 50% of those for U.S. manufacturing workers.

## Fourth District Employment



	12-month percent change, October 2005							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	-0.1	0.6	0.9	-1.3	0.5	-0.1	0.7	1.4
Goods-producing	0.4	1.1	2.0	-3.1	-1.6	-3.3	1.3	0.9
Manufacturing	0.7	-0.6	0.5	-3.4	-2.8	-3.6	0.0	-0.7
Natural resources, mining, and construction	-0.4	4.5	5.5	-1.8	1.7	-2.9	4.7	4.0
Service-providing	-0.2	0.5	0.6	-1.0	1.1	0.4	0.6	1.5
Trade, transportation, and utilities	-1.0	-0.6	-0.5	-2.4	1.8	-0.5	0.9	1.0
Information	-1.0	0.0	0.0	-3.6	-4.2	0.4	-2.2	0.2
Financial activities	0.4	0.1	-0.5	-2.2	0.0	1.2	-0.9	2.4
Professional and business services	-0.3	1.2	2.6	0.0	3.7	0.5	-1.0	2.7
Education and health services	1.2	3.8	2.3	0.5	1.1	2.3	0.7	2.2
Leisure and hospitality	0.6	2.1	-1.9	-2.0	1.5	1.4	1.6	1.7
Other services	0.0	-0.5	1.4	4.0	3.9	1.3	0.0	0.2
Government	-1.5	-1.4	0.9	-1.5	-1.9	-2.8	1.6	0.9
September unemployment rate (percent)	5.7	5.3	5.4	6.0	6.7	5.1	4.6	5.1

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 unemployment rate rose 0.1 percentage point to 5.8% in September. Although employment increased 0.3% over the month, both the labor force and the number of unemployed were estimated to have grown even more (0.4% and 0.6%, respectively). The U.S. unemployment rate fell from 5.1% in September to 5.0% in October.

Unemployment rates in the great majority of the District's counties exceeded the 5.1% U.S. average in September. In 142 counties, unemployment rates exceeded 5.2%; 20

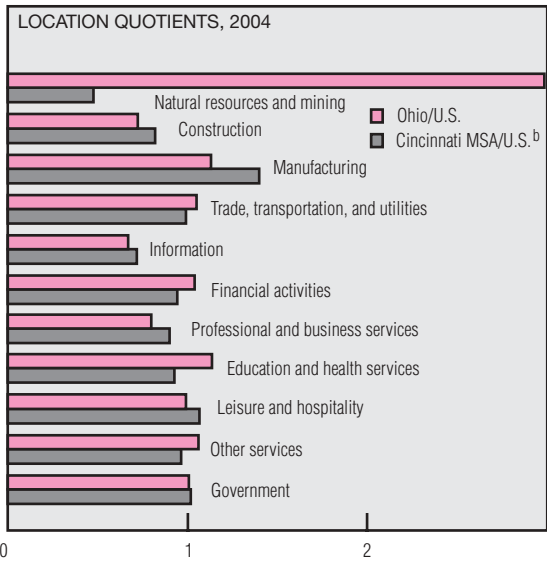
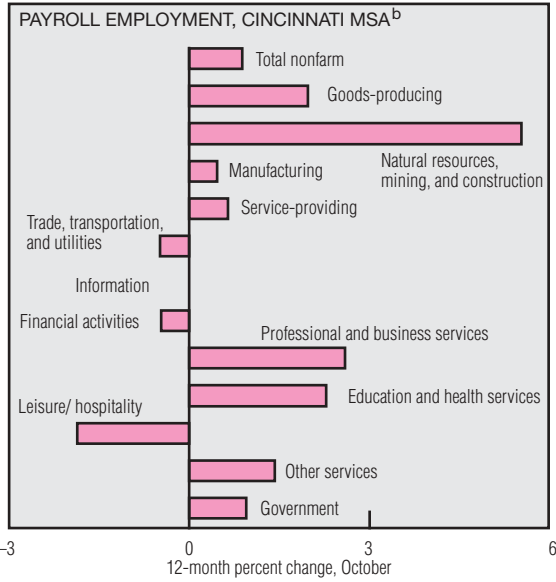
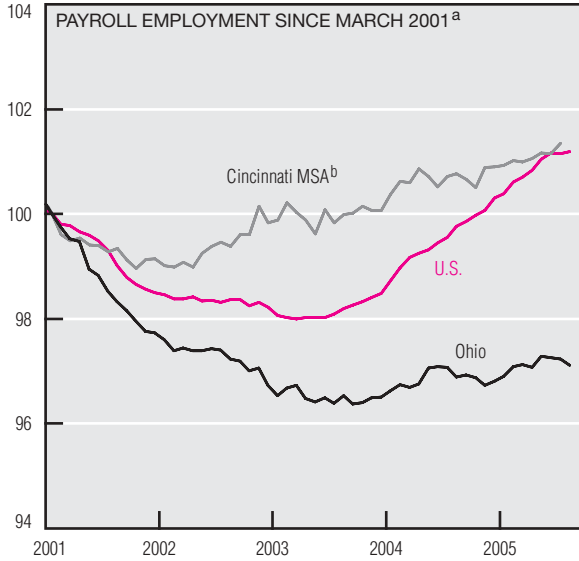
counties had rates that were within 0.1 percentage point of the U.S. average; and only seven counties had unemployment rates of 4.9% or lower. From August to September, rates in the District's major metropolitan areas were little changed, generally remaining above the national rate. Lexington's unemployment rate rose 0.7% on the month; however, its September unemployment rate of 4.6% was still well below the nation's.

In the 12 months ending in October, the Cleveland, Dayton, and Pittsburgh metropolitan areas all lost net

employment. Dayton's nonfarm employment drop was caused by declines in both goods-producing and service-providing industries; Cleveland's nonfarm employment decline resulted from a contraction in service-providing industries alone; and Pittsburgh's decline was traceable to goods-producing industries. A bright spot for the District was the education and health services industry, whose employment increased as much as 3.8% over the year in Columbus.

# The Cincinnati Metropolitan Area

Index, March 2001 = 100



	Cincinnati MSA <sup>b,c</sup>	Ohio	U.S.
Total population (millions)	2.1	11.2	285.7
Percent by race			
White	85.3	85.7	77.3
Black or African-American	11.7	12.3	12.8
Other American	3.0	1.9	9.9
Percent by age			
0-19	29.4	26.7	27.9
20-34	20.7	19.1	20.3
35-64	38.3	39.9	39.8
65 or older	11.7	12.5	12.0
Percent with bachelor's degree or higher	24.8	23.3	27.0
Median age	35.2	37.5	36.2

a. Seasonally adjusted.

b. The Cincinnati-Hamilton metropolitan statistical area consists of Dearborn, Franklin, and Ohio counties in Indiana; Boone, Bracken, Campbell, Gallatin, Grant, Kenton, and Pendleton counties in Kentucky; and Brown, Butler, Clermont, Hamilton, and Warren counties in Ohio.

c. Calculated by the Federal Reserve Bank of Cleveland.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

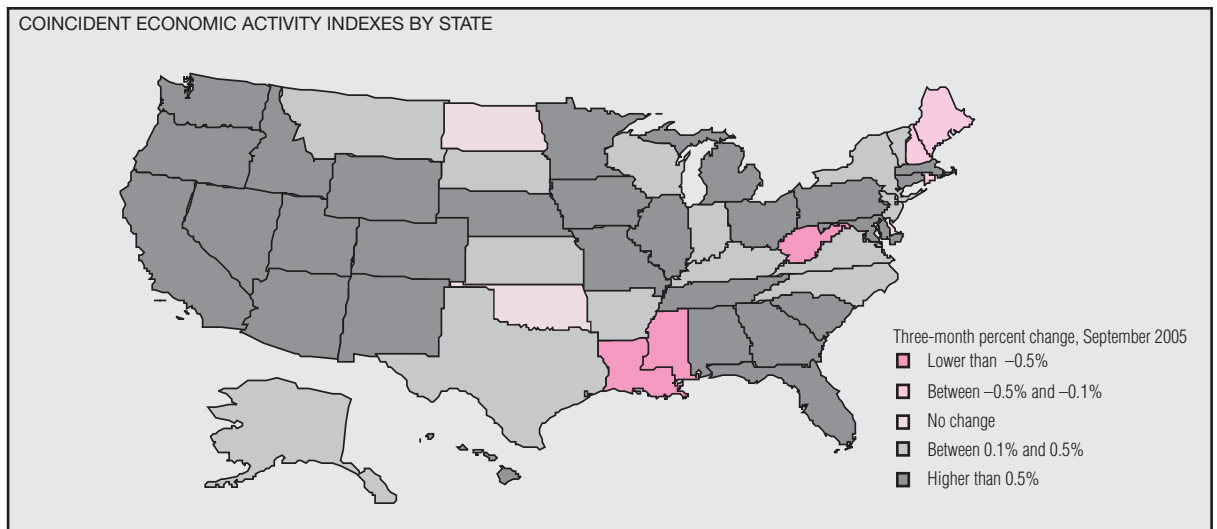
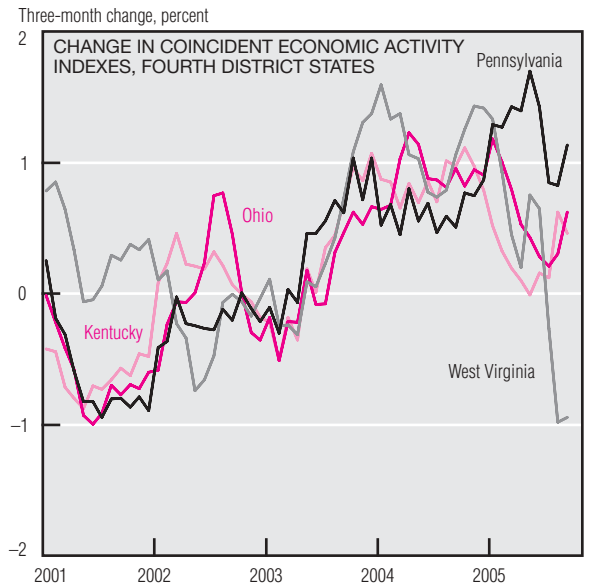
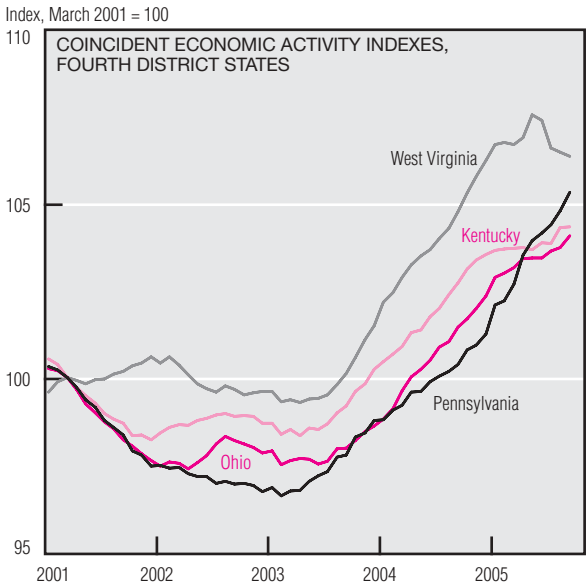
Cincinnati was undoubtedly hurt by the last recession, but it was affected less than the U.S. or Ohio, at least where employment is concerned. Throughout the recovery, Cincinnati's employment fell more slowly than the rest of the U.S. and for fewer weeks. Moreover, since the last business cycle peak in March 2001, the city has added about 1% to its non-farm employment (roughly the same rate as the U.S. average). Ohio, in contrast, suffered a 3% loss.

Much of Cincinnati's recent employment growth has occurred in goods-producing rather than service-providing industries. Goods-producing employment grew 2.0% during the year, compared to a 0.7% gain in service-providing employment. Among the big gainers were natural resources, mining, and construction; professional and business services; and education and health services. The leisure and hospitality industry, however, declined over the year.

Cincinnati's industrial mix of employment differs markedly from the nation's in several ways: The share of its employment occupied in natural resources and mining is nearly triple that of the U.S. It also has a significantly smaller share of employment in the construction and information industries.

As for demographics, Cincinnati and Ohio have similar shares of minority residents. However, Cincinnati has a smaller percentage of residents 65 and older, and a larger percentage with a bachelor's degree.

# Coincident Economic Indexes



SOURCE: Federal Reserve Bank of Philadelphia.

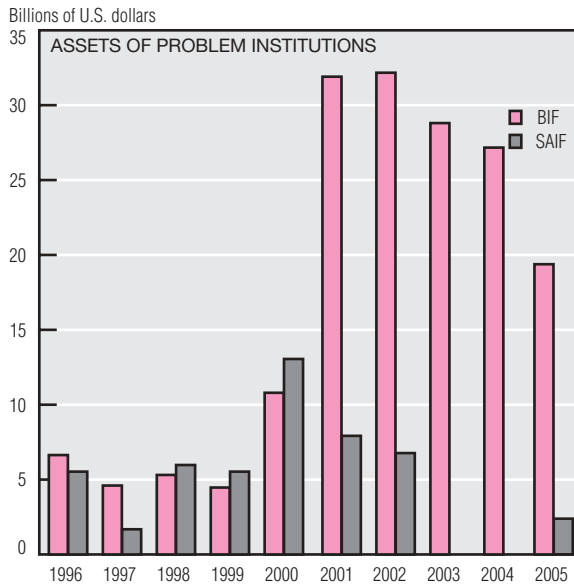
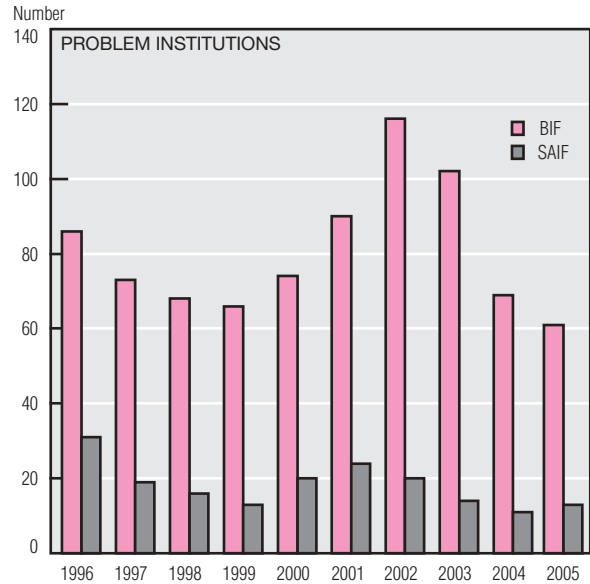
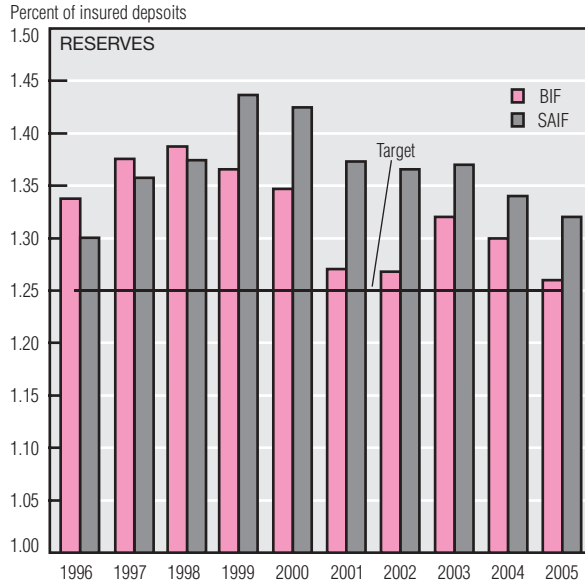
Although measures such as the unemployment rate and gross domestic product are significant, they can leave out important information that is captured in other economic series. To round out the picture, the Federal Reserve Bank of Philadelphia regularly calculates and publishes coincident economic indexes for each state, incorporating data from several sources (nonfarm employment, the unemployment rate, average

hours worked in manufacturing, and wages and salaries). Although Ohio's coincident economic index has risen steadily since mid-2003, it still lags behind the other Fourth District states. West Virginia continues to have the highest coincident index of any District state, the rank it has held since May 2001. Changes in the indexes over three-month periods help distinguish trends from temporary aberrations. In the three months ending September

2005, West Virginia's index dropped sharply, making it one of only three states to undergo such a decline; the other two were hurricane-ravaged Mississippi and Louisiana. The recent decline in West Virginia's coincident index can be attributed primarily to the state's rising unemployment rate, which has resulted from major layoffs in the steel and manufacturing industries, and to its payroll employment performance.



# FDIC Funds



SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile* (various issues).

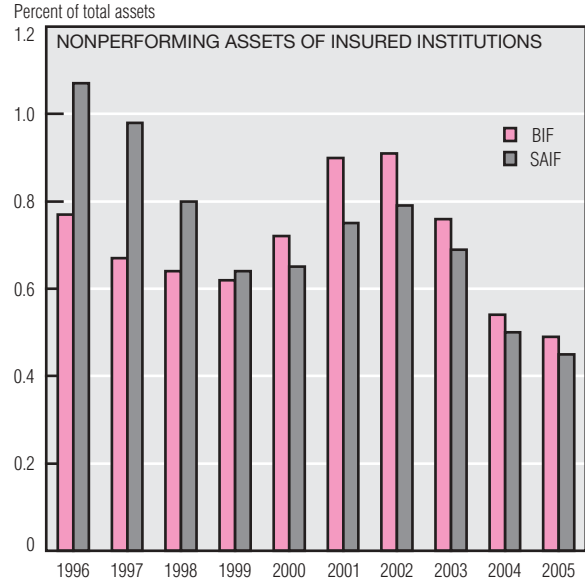
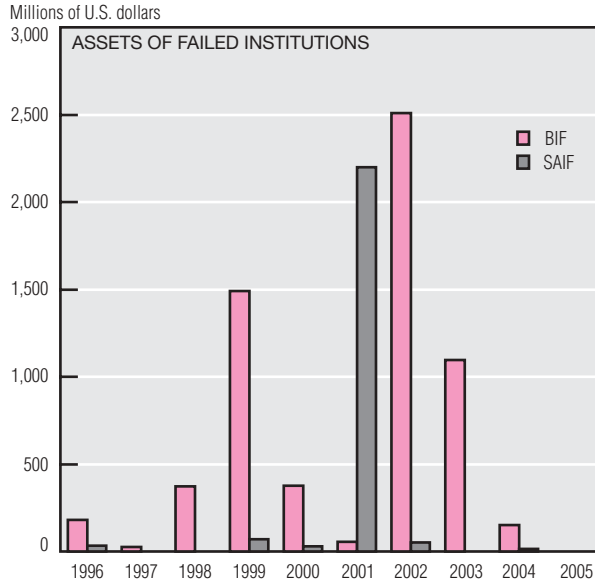
Insured deposits grew over the past five years at an average annual rate of 4.99% for members of the FDIC's Bank Insurance Fund (BIF) and 4.54% for members of its Saving Association Insurance Fund (SAIF). This robust deposit growth has had a material impact on both funds.

At the end of 2005:IIQ, BIF reserves stood at 1.26% of insured deposits, marginally above the reserve target ratio of 1.25% and well below its peak level of 139 basis points of reserves for each dollar of insured deposits at the end of 1998. SAIF reserves dropped

from 1.34% of insured deposits at the end of 2004 to 1.32% at the end of 2005:IIQ, continuing the steady decline that started at year-end 2003. Although the SAIF reserve ratio remains comfortably above the target ratio of 1.25% of insured deposits, it is considerably below its 1999 peak of 144 basis points. Despite recent declines in reserve ratios, the financial position of both FDIC funds remains solid. Their strength results partly from the stability of the banking and thrift industries, as evidenced by member institutions' low failure rates and generally robust

balance sheets. Bank failures since 1996 have been miniscule in the number of institutions as well as their total assets. The three BIF members that failed in 2004 were small institutions with total assets of only \$151 million. No BIF or SAIF members failed during the first half of 2005. If no SAIF members fail in the second half of 2005, it will mark the fourth year out of the last nine with no failures and over 10 years since more than one SAIF member failed. The rarity of thrift institutions' failures over the past decade contrasts starkly to the *(continued on next page)*

# FDIC Funds (cont.)



**BIF Assessment-Base Distribution<sup>a</sup>**  
**Assessable Deposits in Billions as of June 30, 2005**  
**Supervisory and Capital Ratings for Second Semiannual Assessment Period, 2005**

Capital group	Supervisory risk subgroup					
	A		B		C	
<b>Well-capitalized</b>						
Number of institutions	7,301	94.0%	352	4.5%	47	0.6%
Assessable deposit base	\$4,570	98.0%	\$72	1.5%	\$13	0.3%
<b>Adequately capitalized</b>						
Number of institutions	50	0.6%	5	0.1%	7	0.1%
Assessable deposit base	8	0.2%	\$1	0.0%	\$0	0.0%
<b>Undercapitalized</b>						
Number of institutions	0	0.0%	0	0.0%	3	0.0%
Assessable deposit base	0	0.0%	\$0	0.0%	\$0	0.0%

**SAIF Assessment-Base Distribution<sup>b</sup>**  
**Assessable Deposits in Billions as of June 30, 2005**  
**Supervisory and Capital Ratings for Second Semiannual Assessment Period, 2005**

Capital group	Supervisory risk subgroup					
	A		B		C	
<b>Well-capitalized</b>						
Number of institutions	1,039	93.1%	60	5.4%	11	1.0%
Assessable deposit base	\$1,190	98.1%	\$21	1.7%	\$2	0.2%
<b>Adequately capitalized</b>						
Number of institutions	4	0.4%	1	0.1%	0	0.0%
Assessable deposit base	\$0	0.0%	\$0	0.0%	\$0	0.0%
<b>Undercapitalized</b>						
Number of institutions	0	0.0%	0	0.0%	1	0.1%
Assessable deposit base	\$0	0.0%	\$0	0.0%	\$0	0.0%

a. Number reflects the number of BIF members; base reflects the BIF-assessable deposits held by both SAIF and BIF members. Institutions are categorized according to their capitalization and supervisory subgroup rating, which is generally determined by on-site examinations.  
 b. Number reflects the number of SAIF members; base reflects the SAIF-assessable deposits held by both BIF and SAIF members. Institutions are categorized according to their capitalization and supervisory subgroup rating, which is generally determined by on-site examinations.  
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile* (various issues).

widespread solvency problems that plagued the industry throughout the 1980s. Not only have the numbers of bank and thrift failures been low over the last decade; they also represent a tiny percent of FDIC-insured institutions in terms of both number of firms and total assets.

Since the end of 2004, problem institutions (those with substandard examination ratings) have declined from 69 to 61 for the BIF, while increasing slightly from 11 to 13 for the SAIF. Moreover, for both FDIC funds, the change in the number of problem

institutions was matched by a change in the assets of problem banks and thrifts. However, the continued low number of problem institutions and the small amount of assets they held suggests that members' losses will remain low in the near future. This conjecture is supported by the low levels of nonperforming assets as a percent of total assets on the books of BIF and SAIF members.

The Federal Deposit Insurance Corporation Improvement Act of 1991 mandated that FDIC insurance premiums be adjusted for risk. So for

both funds, the FDIC assigns each member to one of nine risk groups on the basis of its most recent examination rating and its level of capitalization. With both funds exceeding their target reserve ratios, well-capitalized institutions in supervisory risk group A pay no premiums by statute. Currently, 94% of BIF members and 93% of SAIF members are in this group. Furthermore, these A-group banks and thrifts account for at least 98% of both BIF's and SAIF's assessable deposits.