The Economy in Perspective

by Mark Sniderman

For reasons that have never been clear, economists are invariably asked to give outlook talks at the beginning of each year, as if a) that is the only time they actually think about the next 12 months, or b) that is the only time their audience pays attention. Neither of these explanations seems plausible. Perhaps the human mind has a compelling desire to organize and store information in compartments: Just file the economic outlook for 2006 in the appropriate folder and get on with making dinner.

The Federal Reserve Board's research staff has an excellent forecasting record (as such records go), and at this Bank we pay close attention to that and other forecasts. Like any business, we want to know what other people think about the things we spend so much time thinking about ourselves. That said, we like to believe that we are discriminating forecast consumers. We won't name names, but we do have our favorites. We are drawn to what might be called "the thinking man's forecaster"; not the one who tries to grab our attention with outrageous predictions of a depression or double-digit interest rates, but the one who tries to tell a comprehensive story about how our world is adjusting to the laws of economics and the forces of history.

History suggests that international economic conditions will play a major part in the evolution of the U.S. economy. First, developing economies account for increasing shares of global trade. These countries are likely to become still more important to the United States as trading partners and, in addition, as targets of U.S. direct investment destined to act as a base from which U.S. companies will serve these countries' growing internal markets. There are indirect effects as well. China, for example, has become important not only to the United States but also to Japan, Korea, and many other Asian countries. Strengthening ties within that region could affect ties between Asia and the West.

Second, capital flows from the rest of the world into the United States have become substantial and probably played an important role last year in sustaining sales in the interest-sensitive sectors of the U.S. economy. Many Asian nations now save more than they invest, but the gaps could close over time as their living standards rise and people choose to consume more than they do today. If saving rates in Asian nations decline, the cost of capital to U.S. borrowers could rise.

The increasing globalization of trade and finance creates new markets and opportunities, but insofar as resources respond and adapt, U.S. companies and communities are forced to adjust as well. Our economy excels at reacting to change, but it is not immune to the vicissitudes of history. As a nation, we are being challenged to maintain a labor force that has the skills to sustain an economy with very high productivity levels. Maintaining our high standard of living will increasingly require that we find ways of increasing the skills of the disadvantaged among our population, who suffer from low rates of school completion and require high levels of social services. And, at a time when we must focus on building skills among our youth, we also face enormous fiscal obligations in supporting our elderly population.

So-called "long-term" issues, such as the globalization of commerce and finance, labor force skills, technology, and fiscal imbalances always seem to be just over the horizon, not materially affecting the ebb and flow of today's transactions. But they are present and, like the tides, their persistence has the power to reshape our shores. Most forecasters pay them little heed, since it is hard to detect their influence over year-long periods. By necessity, forecasts are constructed on the pilings of the past. People, however, look to the future and act today on their beliefs and aspirations.

Forecasters are already out on the stump with their estimates of consumption, investment, and government purchases for 2006. The odds of recession are low, as they almost always are in these forecasts, and—as a matter of fact—in reality. There have been only two recessions in the United States since 1982, and neither was severe. Yet who would deny that U.S. economic conditions have changed profoundly during the last 20 years?

There's nothing constant in the world,
All ebb and flow, and every shape that's born
Bears in its womb the seeds of change.

—Ovid (Publius Ovidius Naso),
Metamorphoses, 15:177–78

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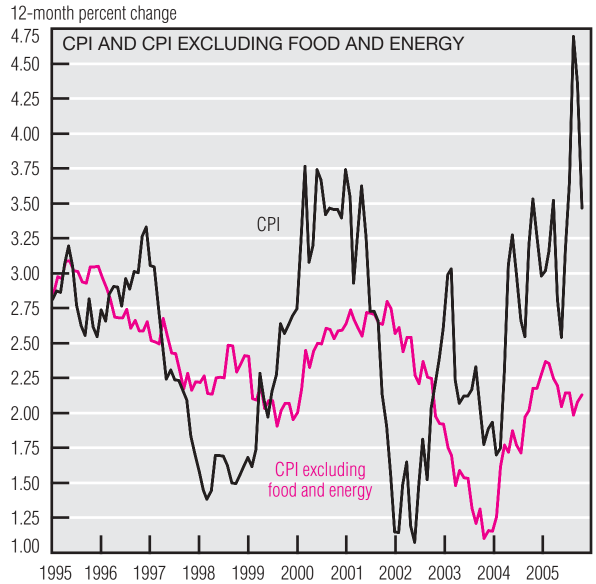
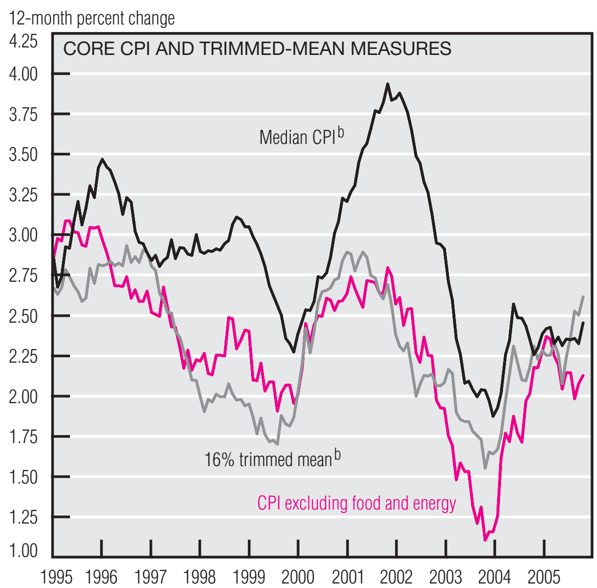
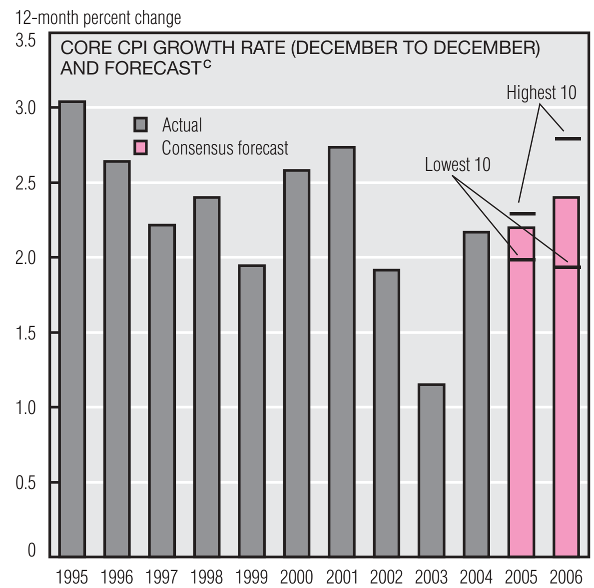
Inflation and Prices

November Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2004 avg.
Consumer prices					
All items	–6.4	3.5	3.5	2.6	3.4
Less food and energy	3.0	2.4	2.1	2.0	2.2
Median[b]	2.6	2.1	2.4	2.7	2.3
Producer prices					
Finished goods	–7.9	7.6	4.4	2.5	4.4
Less food and energy	1.5	0.5	1.8	1.1	2.2







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. The 2005 core CPI forecast is from *Blue Chip Economic Indicators*, November 10, 2005. The 2006 core CPI forecast is from *Blue Chip Economic Indicators*, December 10, 2005.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, November 10, 2005 and December 10, 2005.

The Consumer Price Index (CPI) declined at an annualized rate of 6.4% in November, its largest monthly drop in more than 55 years. However, growth in the core CPI measures was troublesome: The CPI excluding food and energy rose 3.0% (annualized rate) for the second consecutive month, and the median CPI increased 2.6% (annualized rate).

Longer-term inflation trends were mixed. Although the 12-month growth rate in the CPI moderated, falling from 4.3% in October to 3.5% in November, it was still elevated, whereas the core CPI's 12-month growth rate remained steady at 2.1%. Both the median CPI and the 16% trimmed-mean CPI inched upward 0.1 percentage point to 2.4% and 2.6%, respectively. Taken as a whole, the core retail price measures suggest that inflation is still between 2.0% and 2.5%, the range it has held to since the end of 2004 at least. Economists expect this relative price stability to continue: The Blue Chip panel of economists predicts that core retail prices will rise 2.2% in 2005 and 2.4% in 2006.

In addition to delivering relatively low inflation rates, many central banks around the world set inflation targets, which they believe help to anchor inflation expectations and enhance a central bank's ability to respond to short-term changes in output and employment. It is certainly true that the central banks using such targets have enjoyed some success in maintaining a comparatively low level of

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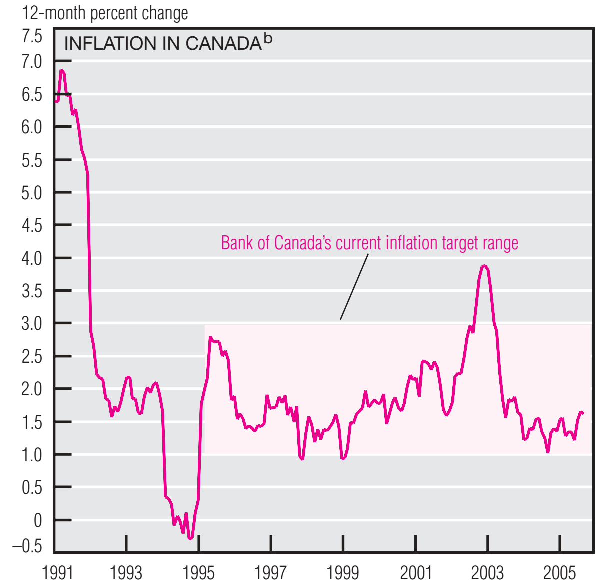
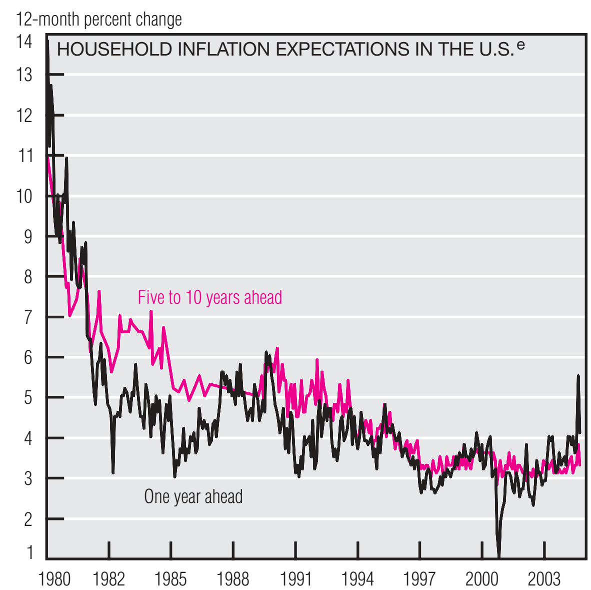
Inflation and Prices *(cont.)*

Formal Inflation Objectives[a]

Country	Target (percent)	Further details
Australia	2–3	Average over the business cycle
Canada	1–3	To the end of 2006; six- to eight-quarter horizon
Mexico	3	Tolerance band of ± 1 percentage point
New Zealand	1–3	Average over the medium term
Sweden	2	One- to two-year horizon; tolerance band of ±1 percentage point
U.K.	2	Tolerance band of ± 1 percentage point
Euro area	<2	Below but close to 2% for the euro area as a whole over the medium term





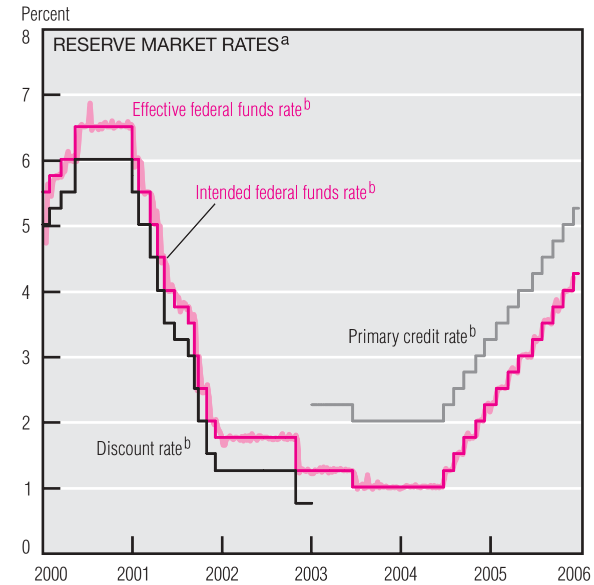
a. Reproduced from a table compiled by the Reserve Bank of Australia <http://www.rba.gov.au/Education/monetary_policy.html#what_are_the_objectives_of_mp>.
b. The Bank of Canada's operational target for monetary policy actions is the core CPI, which excludes the eight most volatile components as well as the effect of changes in indirect taxes on the remaining components.
c. Harmonised Index of Consumer Prices (HICP).
d. CPI excluding food and energy.
e. Mean expected change as measured by the University of Michigan's *Survey of Consumers*.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Organisation for Economic Co-operation and Development; Statistical Office of the European Communities (Eurostat); Reserve Bank of Australia; and University of Michigan.

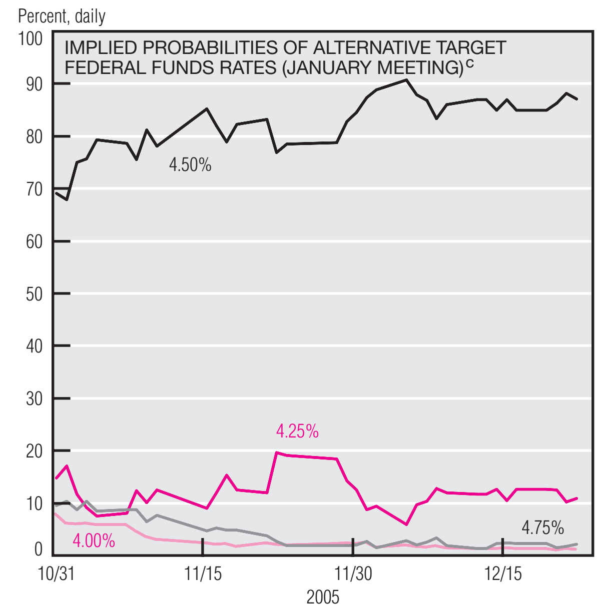
inflation. For example, Canada's 12-month inflation rate has dropped from more than 6.0% in the early 1990s and has remained between 1.0% and 3.0% over the past decade. Inflation has also been brought down substantially in the euro area, although it has been a challenge to contain it below the 2.0% target that the European Central Bank's Governing Council has defined as price stability. Like the U.S., the euro area seems to have been experiencing an inflation trend just above 2.0%.

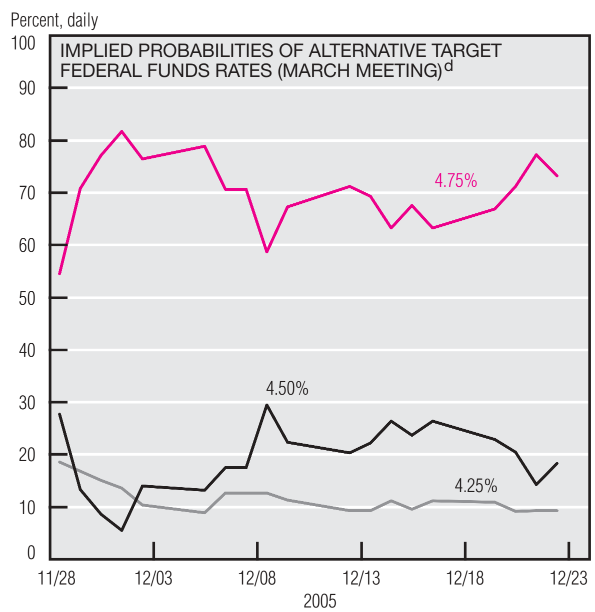
Establishing an inflation target for the Federal Reserve has been advocated by the person nominated to be its next chairman, Ben Bernanke. As a Fed governor, he described his view of inflation targeting as "constrained discretion," in which "the central bank is free to do its best to stabilize output and employment in the face of short-run disturbances … [but] must also maintain a strong commitment to keeping inflation—and, hence, public expectations of inflation—firmly under control … ."

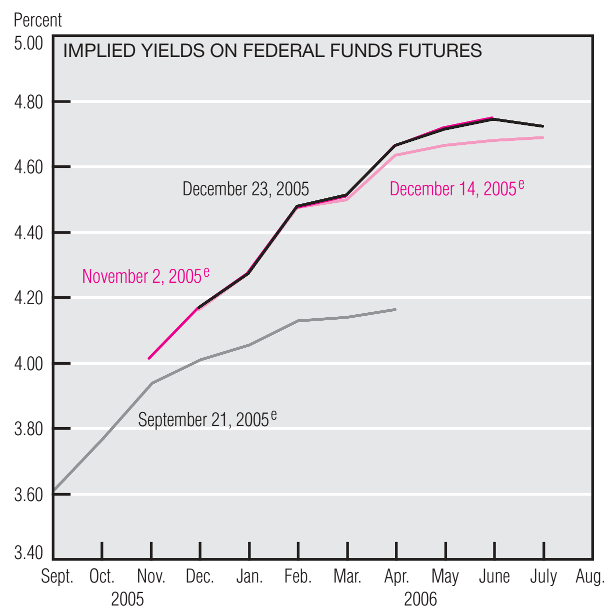
However, some have argued that a central bank needn't define an inflation target explicitly if it can gain a solid reputation for maintaining low and stable inflation. Indeed, in the U.S., where core inflation has fluctuated between 1.0% and 3.0% over the past decade, households have significantly reduced their long-term inflation expectations, which have remained remarkably even despite the shocks that have buffeted the U.S. economy over the past decade.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Probabilities are calculated using trading-day closing prices from options on February 2006 federal funds futures that trade on the Chicago Board of Trade.
d. Probabilities are calculated using trading-day closing prices from options on March 2006 federal funds futures that trade on the Chicago Board of Trade.
e. One day after the FOMC meeting.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; and Bloomberg Financial Information Services.

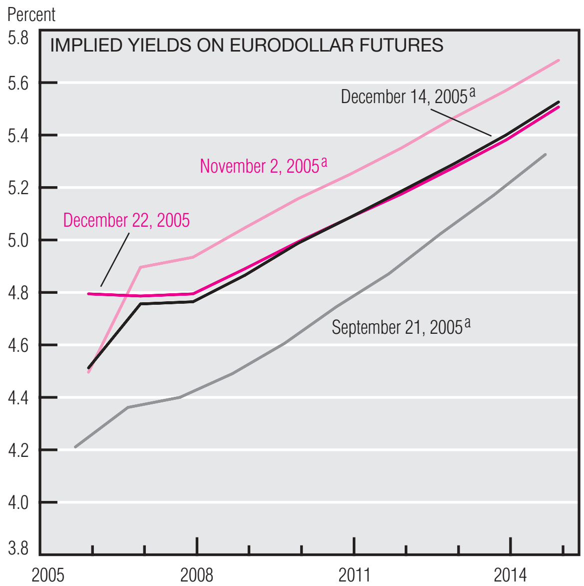
On December 13, the Federal Open Market Committee (FOMC) raised the intended federal funds rate 25 basis points (bp) to 4.25%. Its press release stated that "the expansion in economic activity appears solid." Despite concerns that "increases in resource utilization" and higher energy prices might cause inflationary pressures, it noted that "core inflation has stayed relatively low," and inflationary expectations "remain contained."

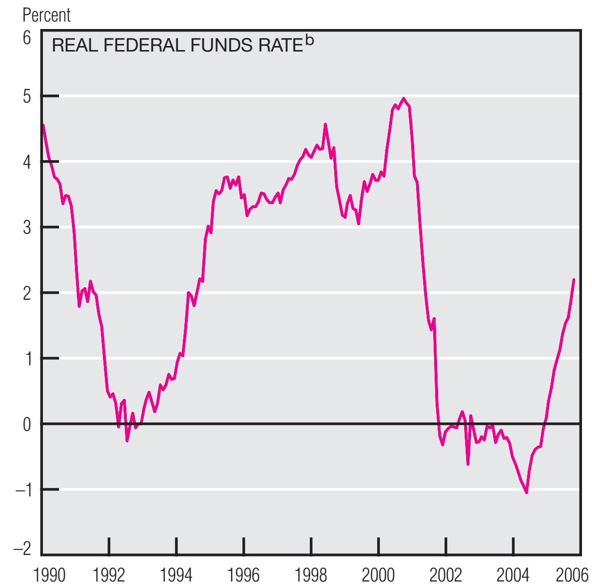
Participants in the federal funds options market had little doubt as to the outcome of the December meeting: They had placed nearly a 94% probability on a 25 bp increase.

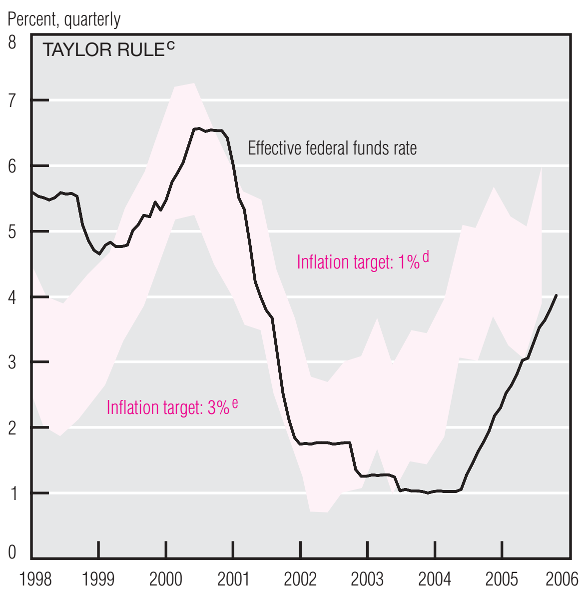
Participants appear to believe the FOMC's statement that "some further measured policy firming is likely." They currently place the highest probabilities on 25 bp funds rate increases at both the January and March meetings. In the first week of December, they became less certain about the future course of the funds rate. The probability associated with a 4.75% funds rate at the March meeting fell more than 20 percentage points, and the probability associated with a 4.50% funds rate rose correspondingly. Assuming that the rate would rise 25 bp in January, participants increasingly came to expect a pause in March. Since early December, much of the change in expectations has been erased.

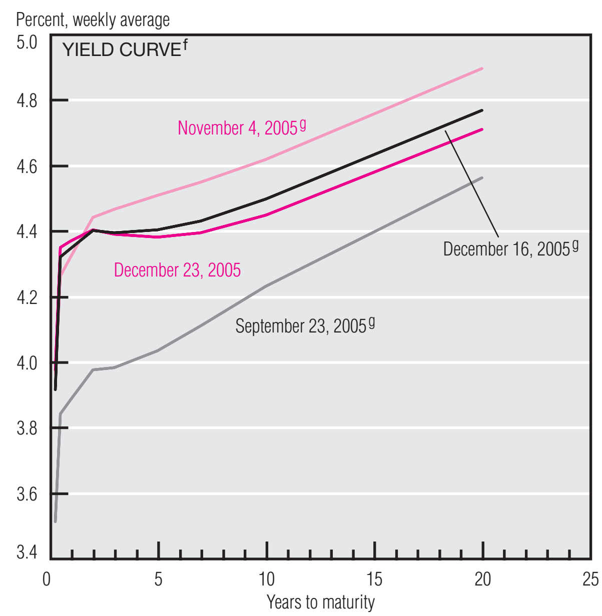
As to future policy firming, some analysts have argued that by dropping the word "accommodation" and adding the word "some," the FOMC's statement foreshadows the end of this round of tightening. But market participants did not react strongly to these wording changes; they do not foresee a pause in the next two meetings.

Money and Financial Markets









a. One day after the FOMC meeting.
b. Defined as the effective federal funds rate deflated by the core PCE.
c. The formula for the implied funds rate is taken from Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy, vol. 39 (1993), pp.195–214.
d. The upper limit of the shaded area assumes an interest rate of 2.5% and an inflation target of 1%.
e. The lower limit of the shaded area assumes an interest rate of 1.5% and an inflation target of 3%.
f. All yields are from the constant-maturity series.
g. The Friday after the FOMC meeting.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Implied yields on Eurodollar futures show that market participants expect a pause in policy tightening in 2006. They may believe that after the rate hikes anticipated for the remainder of 2005 and early 2006, the federal funds rate will be closer to a level consistent with a neutral policy.

Since the current round of tightening began in June 2004, the real (inflation-adjusted) federal funds rate has increased nearly 325 basis points (bp). This is in line with the FOMC's stated desire to remove policy accommodation. The last few increases have brought the nominal federal funds rate closer to the levels suggested by the Taylor rule, which views the rate as a reaction to a weighted average of inflation, target inflation, and economic growth.

The yield curve flattened further in December. On December 27, the 10-year Treasury note yield fell 1 bp below the yield on the two-year Treasury. Situations where long-term rates dip below short-term rates are called "yield curve inversions." The last one occurred on December 29, 2000, a few months before the 2001 recession began; indeed, the last six recessions have been preceded by yield curve inversions. However, inversions do not always signal a recession in the offing; the inversion of 1998, a case in point, was not followed by a downturn. Some analysts maintain that inversions' predictive power has been

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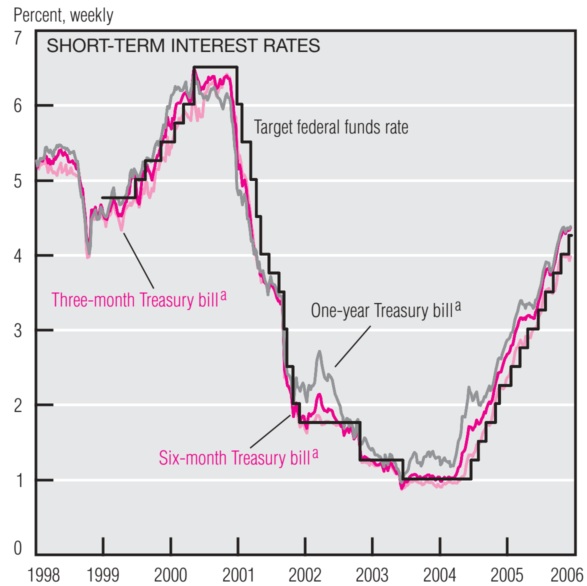
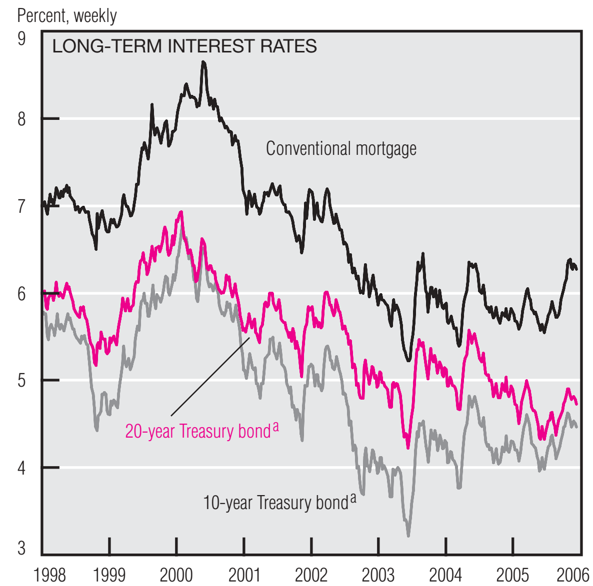
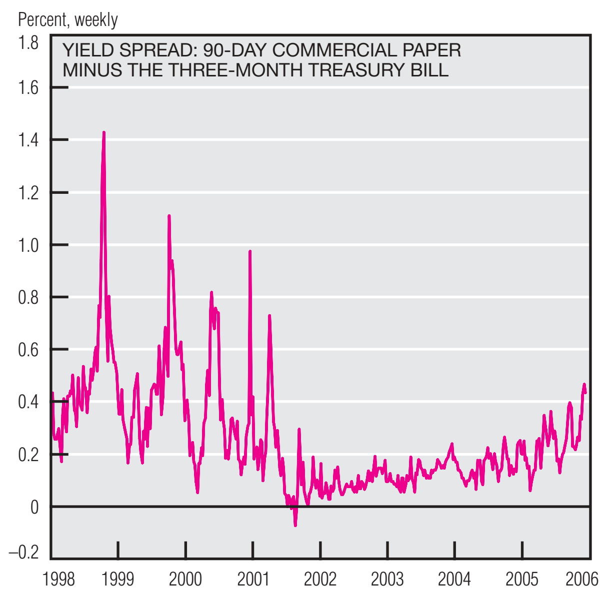
Money and Financial Markets *(cont.)*







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

waning. In a recent letter to the Joint Economic Committee of Congress, Federal Reserve Chairman Alan Greenspan stated that "a flattening of the yield curve is not a foolproof indicator of future economic weakness." Furthermore, light trading in Treasury markets during the holidays means that recent yield data may reflect other factors.

Short-term rates have moved in step with increases in the federal funds rate. Since the current round of policy tightening began, short-term Treasury rates have moved up more than 250 bp at the short end of the maturity spectrum. Long-term rates have moved much less, which has resulted in the observed flattening of the yield curve.

Although long-term rates on conventional mortgages remain at historically low levels, they have increased more than 70 bp since the beginning of July 2005 and are near the levels observed at the beginning of the current round of policy tightening. Despite higher mortgage rates, new home sales and housing starts remained solid in November; however, sales of existing homes softened somewhat in October.

Risk spreads on corporate debt have been rising modestly. One measure—the spread between the yields on 90-day commercial paper and the three-month Treasury bill—is nearly 20 bp higher than at the beginning of September. Risk spreads on longer-term corporate debt have risen more modestly during the same period. Wider risk spreads may indicate that investors are less willing to take on risk and must receive greater compensation to do so. But even with these increases, risk spreads remain well below the levels observed a few years ago.

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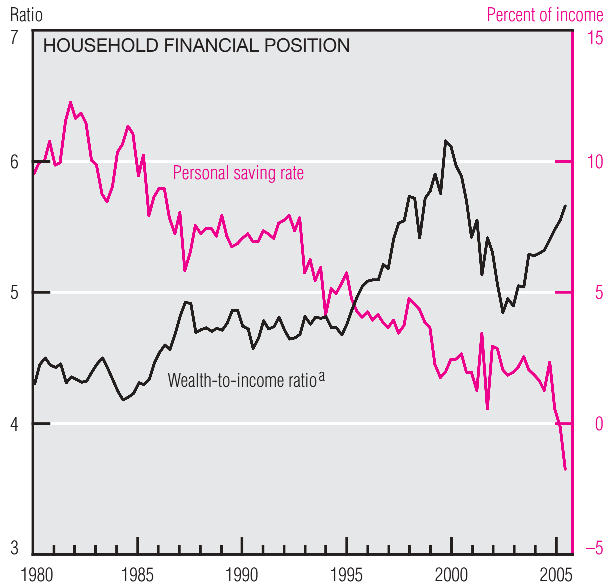
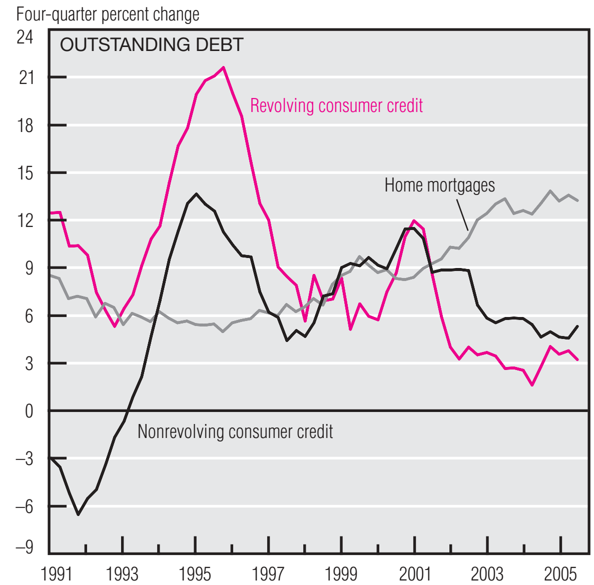
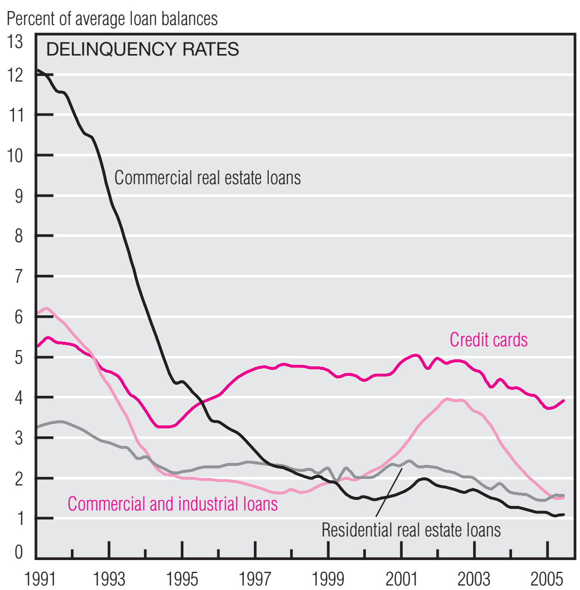
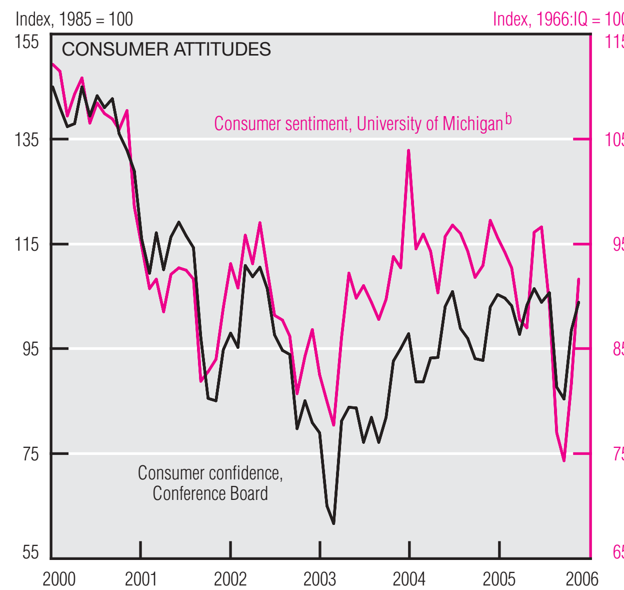
Money and Financial Markets *(cont.)*









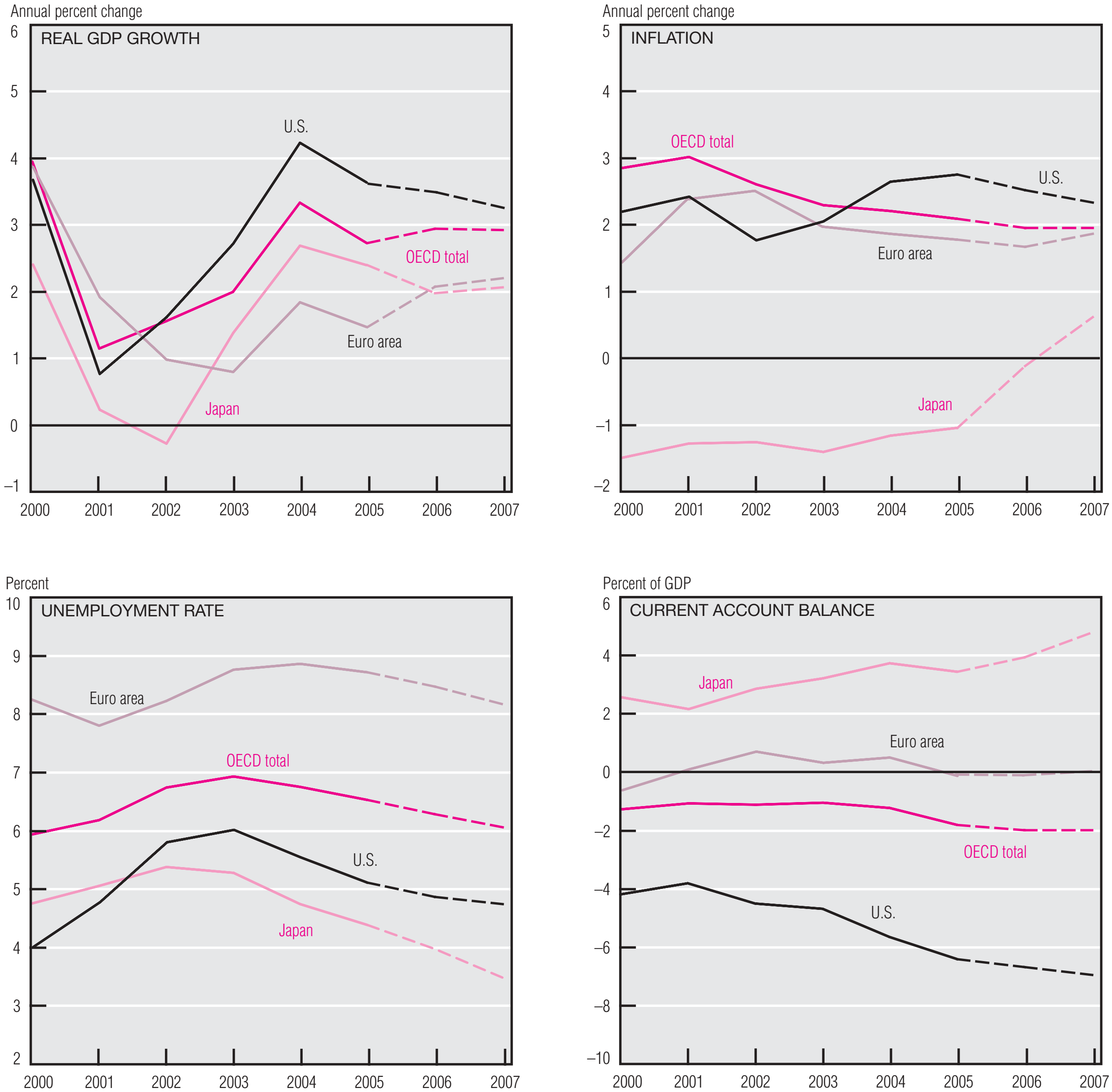
a. Wealth is defined as household net worth; income is defined as personal disposable income.
b. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, “Flow of Funds Accounts of the United States,” *Federal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

Despite modest increases in disposable personal income in 2005:IIIQ, the wealth-to-income ratio rose during the quarter. Higher home prices have been a major contributor to increases in the ratio this year. Stock market gains in late November may bolster the ratio further. Higher wealth-to-income ratios make households more comfortable with saving less. The personal saving rate in the U.S. stood at –1.8% in 2005:IIIQ, its second consecutive quarter in negative territory.

Outstanding consumer debt continued to rise at a robust rate in 2005:IIIQ; home mortgage debt showed the largest gains, with an annual growth rate exceeding 13%. However, recent data indicate that total consumer credit fell at a 4% annual rate in October, the largest percentage decline since 1990. A drop in nonrevolving credit outstanding was attributed to decreased consumer spending on automobiles in October. Nonetheless, levels of consumer debt remain elevated; they have not been associated with appreciable increases in delinquent loan repayment rates, however.

After plummeting in September and October following Hurricane Katrina, the Conference Board’s Index of Consumer Confidence rebounded in November and December. Most of December’s increase resulted from a rise in the present conditions component of the index, although the future expectations component also contributed. The University of Michigan’s Consumer Sentiment Index also rose in the last two months of 2005. Analysts attribute these gains to falling energy prices, rising equity prices, and November’s strong employment report.

The Economies of OECD Nations



SOURCE: Organisation for Economic Co-operation and Development, *Economic Outlook*, no. 78.

In November, the Organisation for Economic Co-operation and Development (OECD) released the preliminary version of its second biannual *Economic Outlook*. The *Outlook* predicts that real GDP growth will remain robust in OECD member countries overall, with North America and Asia continuing to flourish and Europe sustaining its recovery from its weakness in 2002–03. Inflation expectations for most member countries remain relatively stable, with an average rate holding steady just below 2% for both 2006 and 2007. Long-term headline inflation expectations appear well anchored, despite rising energy costs. The unemployment rate is expected to fall in OECD countries, with declines forecast in Europe, the U.S., and Japan during the next two years.

Despite a positive forecast for world growth, the *Outlook* predicts ever-worsening current account balances. The U.S. external deficit is expected to exceed 7% of GDP by 2007, while Japan and other Asian economies continue to operate well within the surplus range. According to the *Outlook*, these imbalances reflect inadequate economic policies, such as tax incentives biased against savings and large fiscal deficits within the U.S., as well as exchange-rate mechanisms focused on maximizing Asian economies' market share. It also stresses that these conditions need not last forever, since a change in U.S. policy regarding savings and deficits or a decrease in foreigners' willingness to hold U.S. assets (or,

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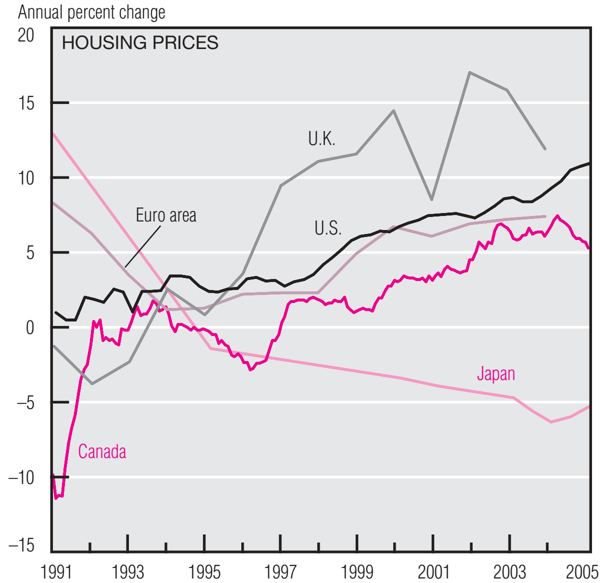
The Economies of OECD Nations *(cont.)*



Household Mortgage Debt
(percent of household disposable income)

	1992	2000	2003
U.S.	58.7	65.0	77.8
Japan	41.6	54.8	58.4
Germany	59.3	84.4	83.0
France	28.5	35.0	39.5
Italy	8.4	15.1	19.8
Canada	61.9	68.0	77.1
U.K.	79.4	83.1	104.6
Spain	22.8	47.8	67.4
Netherlands	77.5	156.9	207.7
Australia	52.8	83.2	119.5

Household Interest Payments[a]
(percent of household disposable income)

	1992	2000	2003
U.S.	4.9	5.2	4.5
Japan	2.5	1.3	1.4
Germany	3.9	4.0	3.0
France	1.7	1.4	1.1
Italy	0.7	0.8	0.7
Canada	5.9	5.7	4.9
U.K.	4.4	3.7	3.0
Spain	1.6	2.2	1.7
Netherlands	5.0	8.4	8.2
Australia	4.8	6.4	7.9

Housing User Costs
(percent of estimated overvaluation, 2004)

U.S.	1.8
Japan	–20.5
Germany	–25.8
France	9.3
Italy	–10.9
Canada	13.0
U.K.	32.8
Spain	13.4
Netherlands	20.4
Australia	51.8

a. Interest payments are approximated using mortgage debt and mortgage interest rates.
SOURCES: Organisation for Economic Co-operation and Development, *Economic Outlook*, no. 78; U.S. Office of Federal Housing Enterprise Oversight; European Central Bank; Japan Real Estate Institute; Statistics Canada; U.K. Office of the Deputy Prime Minister; and the *Economist*.

conversely, an increase in U.S. citizens' willingness to hold foreign assets) could trigger a reversal of the U.S. current account deficit.

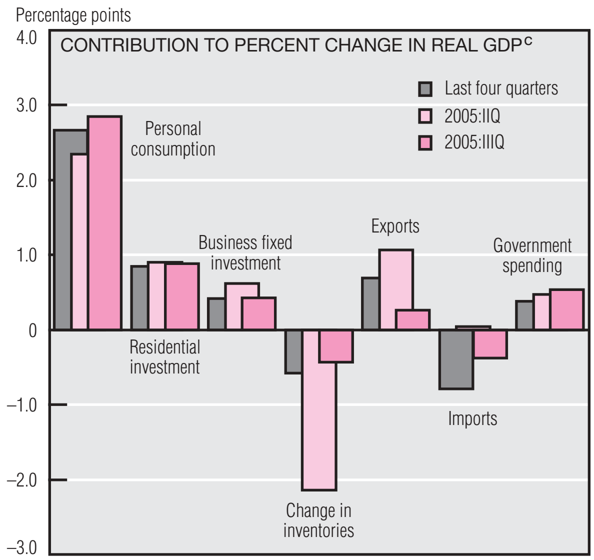
In the majority of OECD countries, housing prices in real terms have been rising since the mid-1990s. In the past two years alone, they have surged at an annual rate of more than 5% in the U.S., the euro area, the U.K., and Canada. Within the euro area, France and Spain have seen housing prices leap more than 15% over the past year, exceeding even the U.S. rate. In most cases, analysts believe prices have been driven up by two factors: low interest rates and households' shifting their investments from equities to real estate. A striking exception to the global housing boom is Japan, where housing prices have been falling since the mid-1990s.

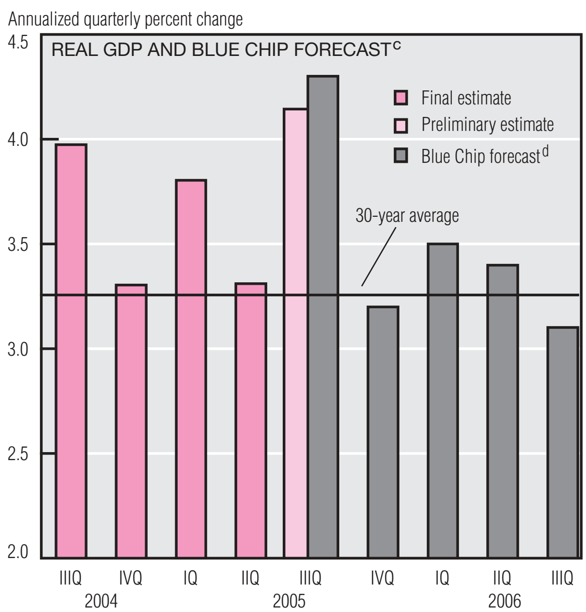
Mortgage debt has jumped in many OECD countries, more than doubling in some cases, but the proportion of household income devoted to interest payments did not follow suit. Households' overall ability to service their debt has improved or held steady since the early 1990s in countries such as the U.K., France, Germany, Italy, and Spain. However, notable exceptions include Australia and the Netherlands, where the share of household income needed to pay mortgage interest has increased. According to the OECD, one consequence of the housing boom has been overvaluation, which, in this case, it defines as a high price-to-rent ratio (the nominal housing price index divided by the rent component of the CPI). It estimates that housing prices are considerably "overvalued" in Australia, the Netherlands, and the U.K.

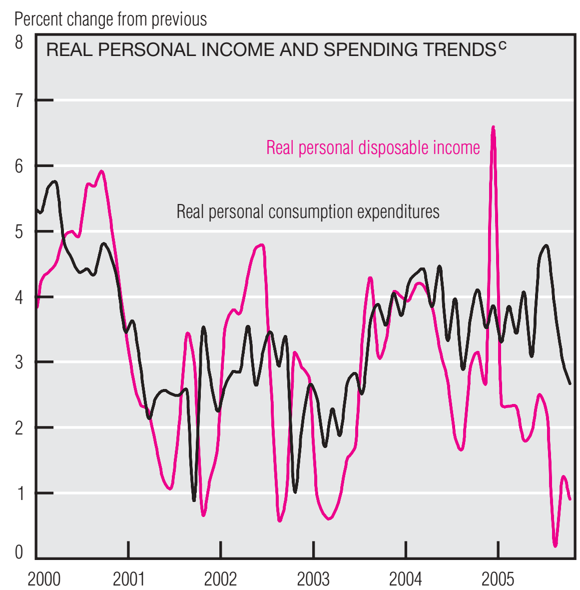
Economic Activity

Real GDP and Components, 2005:IIIQ[a,b]
(Final estimate)

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	113.1	4.1	3.6
Personal consumption	78.4	4.1	3.8
Durables	25.8	9.3	6.3
Nondurables	19.9	3.5	4.5
Services	35.9	3.3	3.0
Business fixed investment	26.2	8.4	8.3
Equipment	26.6	10.6	10.6
Structures	1.4	2.2	1.9
Residential investment	10.7	7.3	7.2
Government spending	14.0	2.9	2.0
National defense	11.9	10.0	3.3
Net exports	–3.3	—	—
Exports	7.3	2.5	6.9
Imports	10.6	2.4	5.1
Change in business inventories	–11.6	—	—







a. Chain-weighted data in billions of 2000 dollars.
b. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.
c. Data are seasonally adjusted and annualized.
d. Blue Chip panel of economists.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, December 10, 2005.

The Commerce Department's final reading of 4.1% real GDP growth for 2005:IIIQ was 0.8 percentage point (pp) higher than the 3.3% estimate for the second quarter. In the preliminary reading, GDP growth was 4.3%; the downward revision to the final estimate was primarily the result of a downward revision to durable goods, as well as several smaller revisions that were partly offset by an upward revision to exports.

Compared to 2005:IIQ, only two components significantly increased their contribution to the change in real GDP: Changes in inventories contributed an additional 1.7 pp, and personal consumption expenditures (PCE) contributed 0.5 pp more. Exports, however, subtracted 0.8 pp from the change in real GDP.

Real GDP growth was at its highest level since 2004:IQ, when it reached 4.3%; it was also significantly higher than the 30-year average of 3.3%. Although the Blue Chip economists' December forecast said that growth would slow to 3.2%, this is nonetheless an upward revision from the 3.0% growth they predicted in November.

PCE accounts for roughly 70% of total GDP, making it an important indicator of the economy's overall health. On a year-over-year basis, PCE grew at a fairly steady rate of 3%–4% in 2004. Since July 2005, however, the pace has slowed to less than 3%. The annual growth rate of real personal disposable income has been declining even more sharply and is currently less than 1%. So far, consumers have been able to increase their consumption faster

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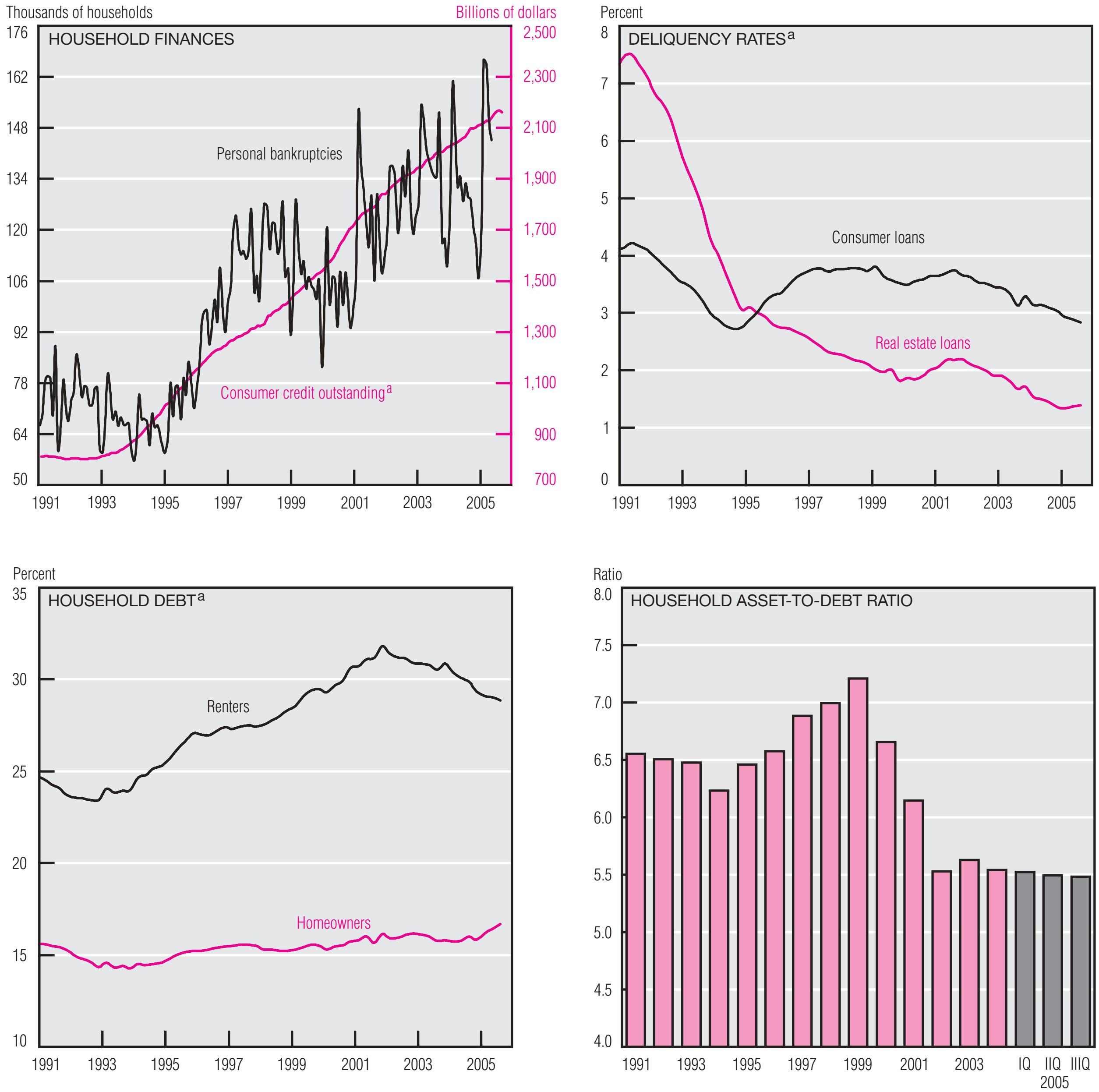
Economic Activity *(cont.)*



a. Data are seasonally adjusted.
SOURCES: Administrative Office of the U.S. Courts; and Board of Governors of the Federal Reserve System.

than their income by taking on more debt. By the end of 2005:IIIQ, consumer credit outstanding was up an annualized 3.3%.

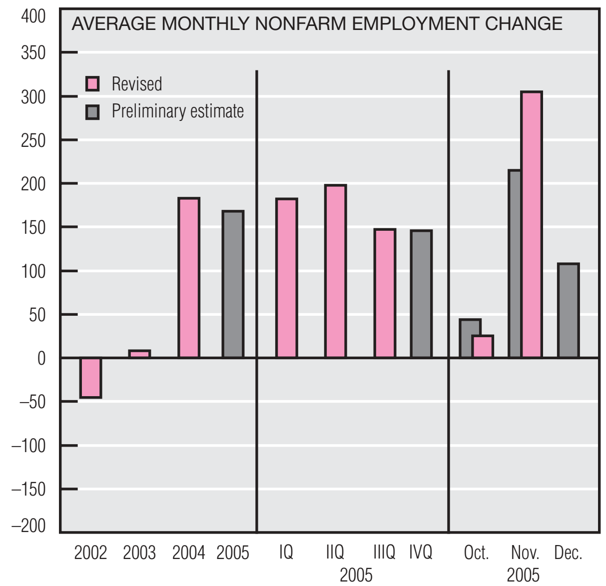
How concerned should policy-makers be about this increased debt load? One measure of households' financial health is the number of personal bankruptcy filings. That statistic is likely to be distorted this year because of the new bankruptcy act, which passed in April and took effect October 17. Currently, data are available only through June 2005; they are likely to be very volatile for the rest of the year because some households pushed their filings forward in order to file under the old law.

Other measures suggest that households' financial health remains relatively stable. Delinquency rates for consumer loans have been trending down since September 2001. The delinquency rate for loans secured by real estate has tended to fall over the same period, although it has ticked up slightly since 2005:IQ.

Financial obligation ratios are arguably a better measure of overall financial health because they include information from all households, not just those filing for bankruptcy or falling behind in their payments. For renters, this ratio has been trending down since 2001:IVQ, whereas it has increased slightly for homeowners.

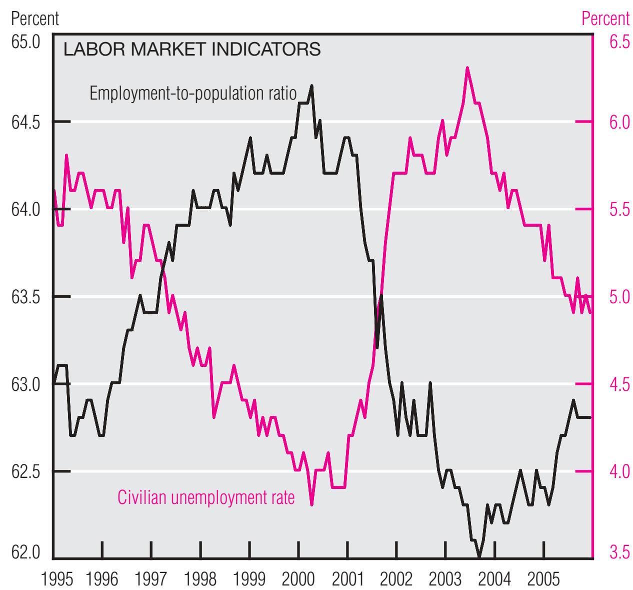
To fully assess households' financial health, one must consider not only their incomes and liabilities but also their assets. On average, households' asset-to-debt ratio has been fairly flat since 2002, another sign that overall household financial health is stable.

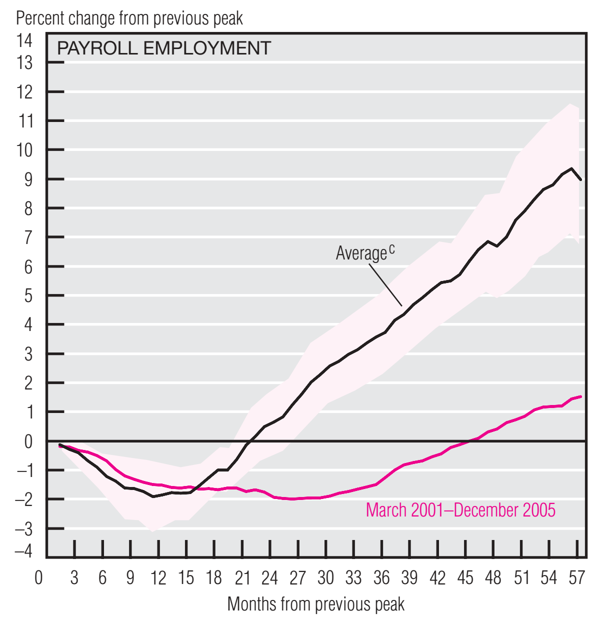
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2002	**2003**	**2004**	**2005**	**Dec. 2005**
Payroll employment	–45	8	183	168	108
Goods producing	–76	–42	29	20	12
Construction	–7	10	23	21	–9
Manufacturing	–67	–51	3	–4	18
Durable goods	–48	–32	9	1	15
Nondurable goods	–19	–19	–6	–6	3
Service providing	30	50	154	148	96
Retail trade	–10	–5	13	8	–16
Financial activities[a]	6	7	12	16	12
PBS[b]	–17	22	45	41	33
Temporary help svcs.	2	12	15	13	9
Education & health svcs.	40	30	33	30	25
Leisure and hospitality	12	18	22	20	23
Government	21	–4	12	16	14
	Average for period (percent)				
Civilian unemployment rate	5.8	6.0	5.5	5.1	4.9





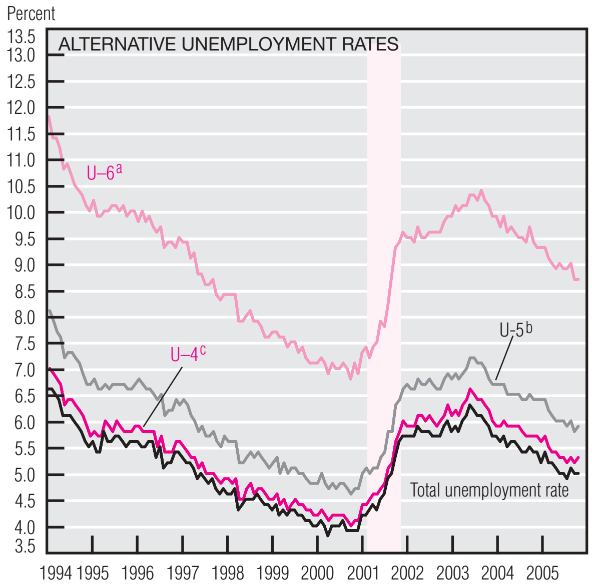
NOTE: All data are seasonally adjusted.
a. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.
b. Professional and business services include professional, scientific, and technical services, management of companies and enterprises, administrative and support, and waste management and remediation services.
c. The shaded area represents the average plus or minus one standard error.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

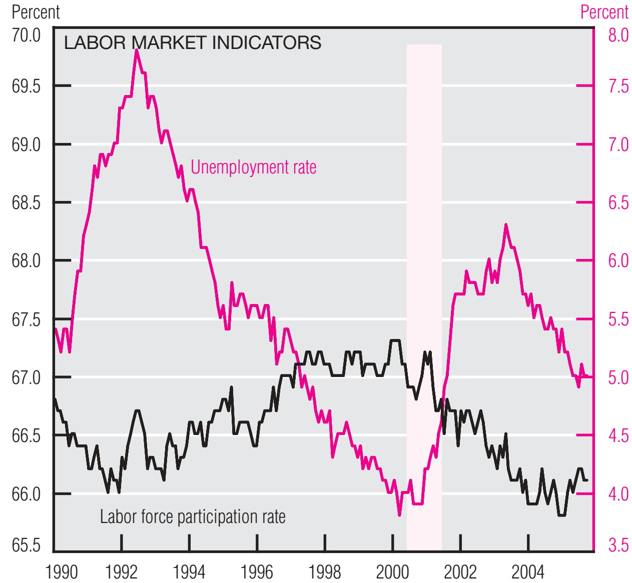
Job growth was robust in 2005: Payroll employment, having increased by 2.0 million jobs during the year, finally exceeded the level it reached at the peak of the most recent economic expansion, in March 2001. (In previous economic recoveries, employment typically took no more than two years to regain the level it posted at the previous peak.) After its upwardly revised net gain of 305,000 in November 2005, nonfarm payroll employment rose by 108,000 in December. That was less than the average monthly job gain of 165,000 for October and November, as well as the average monthly gain of 168,000 for the year.

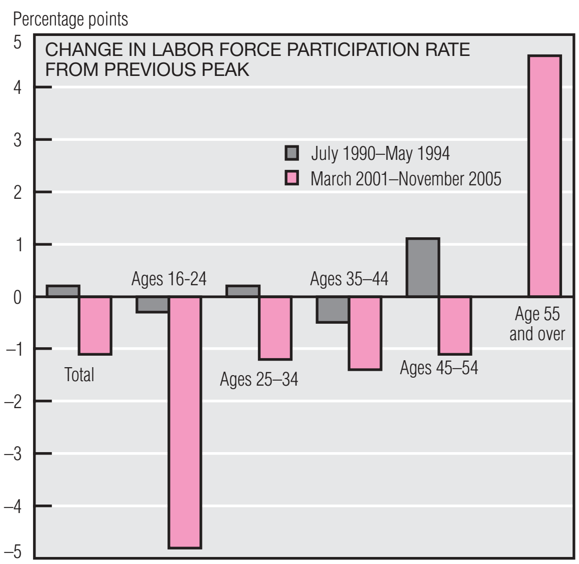
December employment growth was sustained in the service-providing industries (except retail trade, which lost 16,000 jobs). The month's largest job gains came from professional and business services (33,000), education and health services (25,000), and leisure and hospitality (23,000). Manufacturing employment, which showed a net average loss of 4,000 jobs per month in 2005, gained 18,000 jobs in December. The year's gains were concentrated in service-providing industries (which accounted for nearly 90% of job growth), especially professional and business services (486,000) and education and health services (363,000). Manufacturing employment, which in 2004 posted its first calendar-year increase since 1997, declined by 51,000 in 2005.

The unemployment rate, which has fluctuated between 5.1% and 4.9% over the past nine months, ticked down 0.1 percentage point to 4.9% in December after data revisions. The employment-to-population ratio remained at 62.8 for the fourth consecutive month.

Unemployment in the Economic Expansion







People Ages 16 to 24 Who Did Not Work or Look for Work (percent distribution)

	1991	1994	2000	2004
Sick or disabled	2.9	4.8	3.9	5.2
Retired	0.1	0.5	0.3	0.6
Home responsibilities	15.7	16.8	12.8	12.3
Attending school	74.5	72.4	77.7	77.0
Could not find work	2.5	1.7	1.6	1.7
Other	4.2	3.9	3.7	3.1

a. Total unemployed plus all marginally attached workers and those employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers.
b. Total unemployed plus discouraged workers and all other marginally attached workers, as a percent of the civilian labor force plus all marginally attached workers.
c. Total unemployed plus discouraged workers, as a percent of the civilian labor force plus discouraged workers.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

During the current economic expansion, the unemployment rate has fallen from a peak of 6.3% in June 2003 to 5.0% in November 2005, consistent with rates in the mid-1990s. Trends in alternative measures, which broaden the definition of unemployment by including discouraged workers, marginally attached workers (who have sought work in the recent past), and workers who have settled for less work for economic reasons, also suggest an improving labor market.

Throughout the 1990s, employment growth was supported by rising labor force participation and a falling unemployment rate. During the current expansion, reductions in labor force participation have helped to lower the unemployment rate despite moderate employment growth. Trends in labor force participation for older and younger people since the March 2001 business-cycle peak differ from trends after the 1990 recession: Those older than 55 have increased their participation rates nearly 5 percentage points (pp) since March 2001; after the 1990 recession, participation returned to pre-recession levels within the same length of time. After the 1990 recession, participation among people ages 16 to 24 fell less than 0.5 pp; since March 2001, however, it has dropped nearly 5 pp. The decline in young people's participation is partly the reflection of an increase in the number of individuals not working because of illness, disability, retirement, or difficulty in finding employment.

U.S. and Fourth District Poverty Rates

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

The poverty rate is the percentage of people whose family income falls below an officially determined threshold, which varies by family size and composition. After dropping nearly 4% from 1993 to 2000, the U.S. poverty rate has been trending steadily up. Poverty rates in the Fourth District and its metropolitan areas have also increased, but specifics on many areas remain unknown. New data from the U.S. Census Bureau enable us to pinpoint the performance of individual counties within the District.

With the exception of the Cincinnati and Lexington areas, poverty rates in eastern Kentucky were strikingly high in 1995, averaging about 28%. Though somewhat better, southeast Ohio counties' poverty rates still exceeded the national average. In contrast, northwest Ohio, along with areas near Cleveland, Columbus, and Cincinnati, posted poverty rates that were roughly half the U.S. average.

By 2003, poverty in some District areas had lessened. The District's part of Kentucky, for example, showed substantial improvement in the counties that were formerly its poorest. Rates also fell significantly in southeast Ohio counties, where rates that previously exceeded the nation's dropped to—or below—it.

Nevertheless, the pictures from 1995 and 2003 look remarkably similar, hiding much of the underlying movement during this period. Between 1995 and 2000, the U.S. poverty rate fell 2.5%, and many Fourth District counties enjoyed sim-

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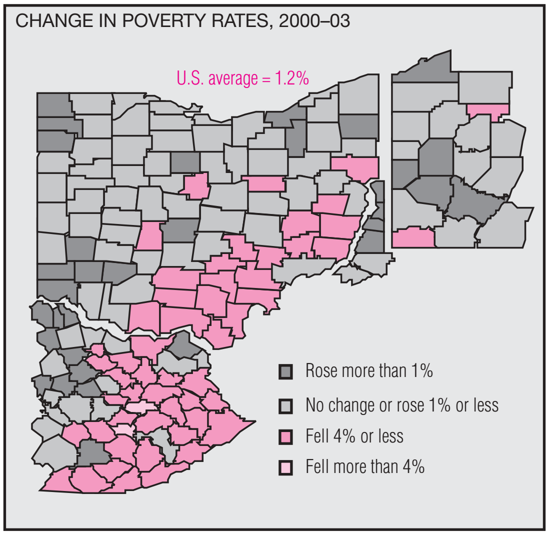
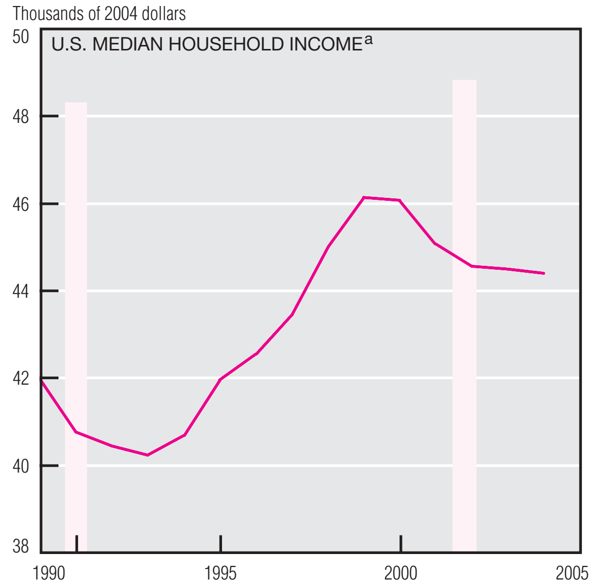
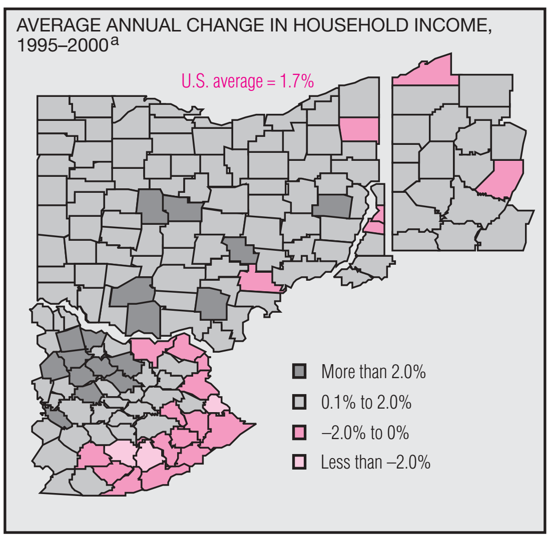
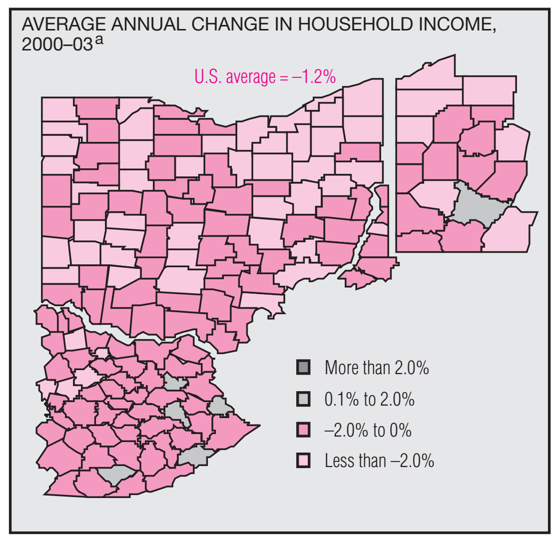
U.S. and Fourth District Poverty Rates (cont.)









a. Real median household income.
SOURCE: U.S. Department of Commerce, Bureau of the Census.

ilar improvements; rates fell in all but eight counties, and did not increase more than 1% in any. Although many areas of Kentucky started with high poverty rates, almost every county improved substantially, with rates dropping more than 4%.

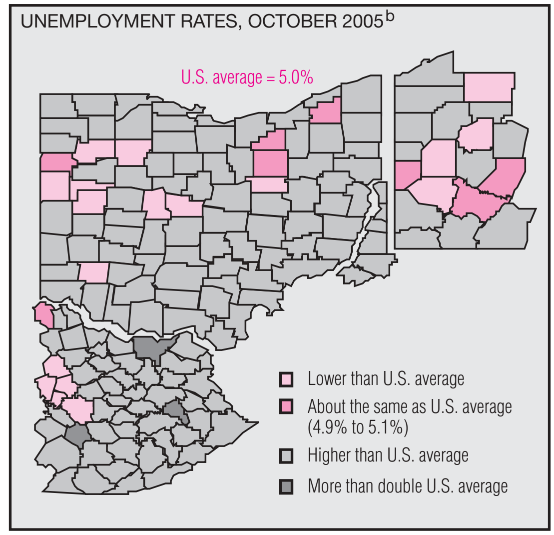
The 2000–03 period was another story: The poverty rate rose 1.2% in the U.S., and most areas of the District reflected this. However, poverty rates in the counties of eastern Kentucky and southern Ohio continued to drop, some as much as 5%.

Improvements like the ones in these counties, running counter to trend, can reflect either a general increase in family income or some compression in income inequality. Thus, examining changes in median household income can help us understand poverty rate changes.

From 1995 to 2000, the real median family income rose $4,115 in the U.S., for an average annual increase of 1.9%. The majority of Fourth District counties had similar gains. However, contrary to what one might expect from observing the trend in poverty rates, southeastern Kentucky's inflation-adjusted median household income actually fell.

Furthermore, from 2000 to 2003, real median household income declined in almost all Fourth District counties, in line with the U.S. as a whole. Although slower than many areas in Ohio and Pennsylvania, counties in eastern Kentucky continued to record declines in median household income. Such declines, which would not be expected in a region with falling poverty rates, suggest that income inequality decreased in these areas.

Fourth District Employment



Payroll Employment by Metropolitan Statistical Area

	12-month percent change, November 2005							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	–0.2	0.6	1.0	–1.0	0.1	–0.1	0.8	1.5
Goods-producing	0.1	1.8	2.0	–3.8	–2.0	–3.3	1.1	1.2
Manufacturing	0.1	0.1	0.6	–4.5	–2.8	–3.5	0.0	–0.4
Natural resources, mining, and construction	0.4	5.0	5.2	–1.3	0.6	–3.0	3.9	4.3
Service-providing	–0.3	0.4	0.7	–0.4	0.6	0.4	0.7	1.5
Trade, transportation, and utilities	–1.0	–0.4	–0.9	–1.5	1.1	–0.2	0.9	1.1
Information	–1.5	–0.5	1.2	–3.6	–4.2	1.3	–2.2	0.4
Financial activities	0.7	–0.3	0.2	–2.2	2.3	0.1	0.0	2.5
Professional and business services	–0.1	1.9	2.4	0.2	2.0	0.8	–1.0	2.7
Education and health services	1.1	1.2	2.7	1.3	0.6	1.9	1.3	2.2
Leisure and hospitality	0.8	1.0	0.1	–1.3	0.0	2.1	2.0	1.6
Other services	–0.2	–0.3	1.0	5.8	3.9	1.5	1.0	0.3
Government	–2.0	–0.4	0.1	–1.2	–1.3	–3.2	0.9	0.7
October unemployment rate (percent)	6.0	5.3	5.5	6.1	6.6	4.8	4.7	5.0

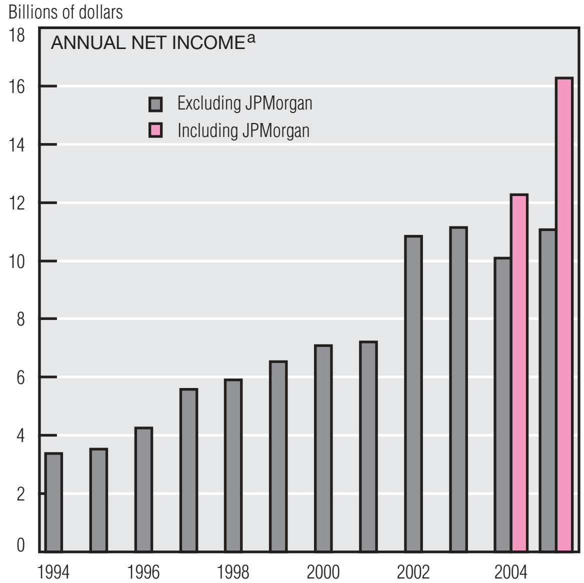
a. Shaded bars represent recessions.
b. Seasonally adjusted using the Census Bureau's X-11 procedure.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

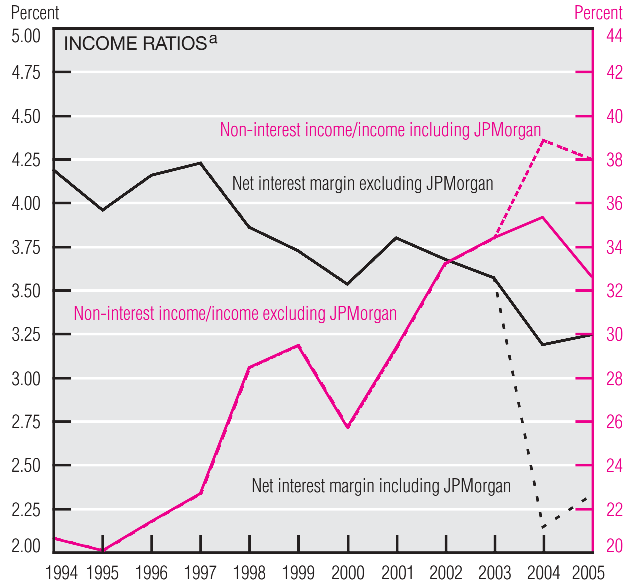
The Fourth District's unemployment rate fell 0.1 percentage point in October to 5.8%. Although household employment actually fell 0.2%, the labor force fell even more (0.4%). From October 2004, employment grew 0.9% and the labor force expanded 0.5%. The U.S. unemployment rate was 5.0% in both October and November.

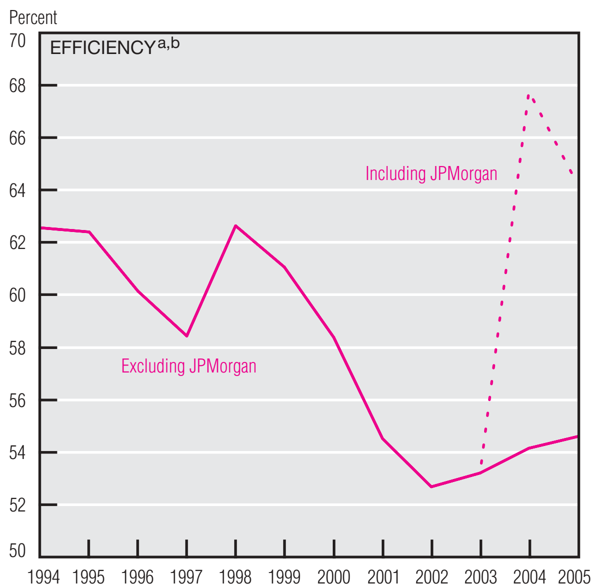
Unemployment rates continued to exceed the U.S. average in almost every District county. Specifically, rates in almost 85% of them were above the national average in October, whereas only 27 of the 169 counties had rates that were average or lower. Unemployment rates in the District's major metropolitan areas changed little from September to October. Pittsburgh and Lexington outperformed the nation, but rates in Cleveland, Dayton, and Toledo were at least 1 percentage point higher than the U.S. average.

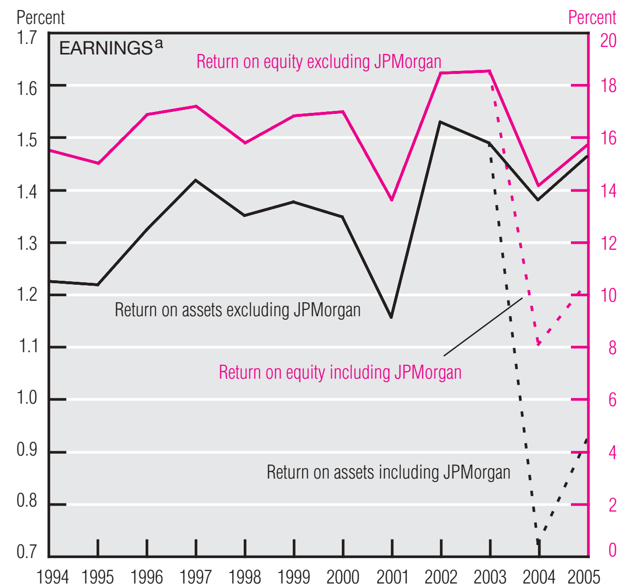
Employment growth in each of the District's major metro areas was lower than the 1.5% average U.S. growth rate for the 12 months ending in November. Even so, Cincinnati's employment increased in every major industry except trade, transportation, and utilities. Lexington's jobs growth was also broad based, with goods-producing employment up 1.1% on a year-over-year basis and service-providing employment up 0.7%. Education and health services added jobs in every major metro area of the District, by as much as 2.7% in Cincinnati. Employment growth in the leisure and hospitality industry was similarly strong with the exception of Dayton, where it was –1.3%

Fourth District Banks









a. Through 2005:IIIQ only. Data for 2005 are annualized.
b. Efficiency is operating expenses as a percent of net interest income plus non-interest income.
SOURCE: Author's calculation from Federal Financial Institutions Examination Council, *Quarterly Bank Reports of Condition and Income*.

FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District posted net income of $8.29 billion for the first three quarters of 2005 or $11.06 billion on an annual basis. (JPMorgan Chase, chartered in Columbus in 2004, is not included in this discussion because its assets are mostly outside the District and its size—roughly $1 trillion—dwarfs other District institutions.) For the same period, the U.S. banking industry as a whole posted earnings of $97.23 billion or $129.64 billion on an annual basis.

At the end of 2005:IIIQ, Fourth District banks' net interest margin (interest income minus interest expense divided by average earning assets) had risen slightly to 3.24%, exceeding the 3.06% U.S. average. Non-interest income, however, fell to 32.59% of total income, the first such decline in five years. Nationwide, the net interest margin was nearly unchanged from the end of 2004, and non-interest income fell to 33.04% of total income.

By the end of the third quarter, Fourth District banks' efficiency (operating expenses as a percent of net interest income plus non-interest income) had deteriorated to 54.54% from the 52.64% record set in 2002. (Lower numbers correspond to greater efficiency.) Nationwide, efficiency improved slightly, dropping to 55.94% from 56.62% at the end of 2004.

District banks also posted a 1.46% return on assets at the end of the third quarter, (up from 1.38% at the end of 2004) and a 15.68% return on equity (up from 14.12%). The District outperformed the nation: By the end of

(continued on next page)

Fourth District Banks *(cont.)*

a. Problem assets are shown as a percent of total assets, net charge-offs as a percent of total loans.
SOURCE: Author's calculations from Federal Financial Institutions Examination Council, *Quarterly Bank Reports on Condition and Income*.

2005:IIIQ, the U.S. banking industry's return on assets had edged up to 1.13% (from 1.12% at the end of 2004); return on equity had climbed to 12.08% (from 11.56%).

Fourth District banks' financial indicators point to strong balance sheets overall, with asset quality continuing to improve in 2005:IIIQ. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) represented 0.32% of total loans (down from 0.44% at the end of 2004), much better than the national average of 0.45% (down from 0.53%). Problem assets (nonperforming loans and repossessed real estate) as a share of total assets increased slightly to 0.55% from 0.48% at the end of 2004, slightly worse than the national average of 0.44% of assets (down from 0.52%).

Fourth District banks held $20.14 in equity capital and loan loss reserves for every dollar of problem loans, which was well above the recent coverage-ratio low of 10.75 at the end of 2002 but below the record high of 24.97 at the end of 2004. Equity capital as a share of Fourth District banks' assets (the leverage ratio) fell to 9.32% from the record high of 9.76% at the end of 2004.

The share of unprofitable banks in the District rose from 4.97% at the end of 2004 to 5.65% at the end of 2005:IIIQ. Unprofitable banks' asset size also increased from 0.27% of District banks' assets to 0.59%. Industrywide, the share of unprofitable banks fell to 6.01% from 6.07% at the end of 2004. Their asset size dropped from 0.62% at the end of 2004 to 0.50% at the end of 2005:IIIQ.