The Economy in Perspective

by Mark Sniderman

A journey of a thousand miles begins with a single step.

—Chinese proverb

On a journey of a hundred miles, ninety is but halfway.

—Chinese proverb

Participants in the federal funds futures market expect the Federal Open Market Committee to raise the funds rate target by 25 basis points at each of the next two policy meetings. If this does happen, the funds rate will have steadfastly traversed a territory of 400 basis points in 16 equal steps over a two-year span. As of today, few believe that the FOMC will implement another rate increase at its June meeting—in fact, the futures market actually expects the funds rate to decline slightly next year from its anticipated June peak of 5 percent.

What is the logic behind this expected funds rate path? What does it imply about the market's view of the real economy, inflation, and the FOMC? First of all, the path's relative stability shows that financial market participants expect the FOMC will have to take very few actions to achieve its policy objectives. Most forecasters call for the economy to continue expanding for the next several years at a pace close to its potential growth rate, and for any existing inflationary pressures to gradually diminish as the expansion lengthens. Second, the level of rates along the path indicates market participants' belief that for the next few years, the FOMC will accept the market-expected inflation rate, that is, just a touch above 2 percent annually on a CPI basis.

A federal funds rate of 5 percent has a certain aesthetic appeal. Many forecasters follow the rule of thumb that potential GDP will grow at a rate near 3 percent, and that 2 percent inflation lies in the middle of the FOMC's comfort zone. With the unemployment rate between $4^{1}/_{2}$ and 5 percent, and the manufacturing capacity utilization rate near its long-term average, there is ample reason for analysts to suspect that the economy—and monetary policy—are tantalizingly close to equilibrium.

Arbitrage conditions across financial markets should guarantee that signals consistent with this vision will appear in a variety of other places, as they do. The Treasury yield curve has become nearly flat from the three-month bill to the 10-year note, but exhibits a small hump (10 to 15 basis points) that peaks at the six-month maturity. Quality spreads in the corporate bond market have remained low and stable for several years, stock market volatility has all but disappeared, and inflation expectations derived from the market for Treasury inflation-protected securities seem well contained.

To dwell forever in policy nirvana requires fulfillment of the expectations that underpin these and many other financial markets. Though this is not impossible, the odds are slim. History is full of unforeseen events. In the economic context, when shocks happen, prices, interest rates, exchange rates, and expectations adjust, sometimes very quickly. Real and financial resources—people, commodities, equipment, and financial capital—are diverted from their original destinations toward places where they command greater economic value.

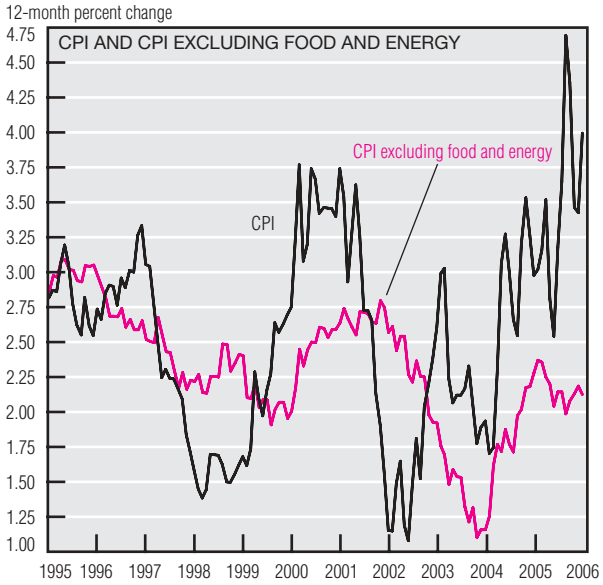
The FOMC cannot predict these unexpected events; even if it could anticipate some of them, it lacks the power to offset their full impact on the U.S. economy. But it is far from helpless: It has the ability to accomplish two very important things. First, it can return the U.S. inflation rate to the long-term path that represents price stability, even if shocks initially turn it from that path. For example, during the 1990s, we saw the FOMC push the inflation rate down until it reached a price stability path; we saw it act again in 2003 to raise an inflation rate that had gotten low enough to be potentially problematic.

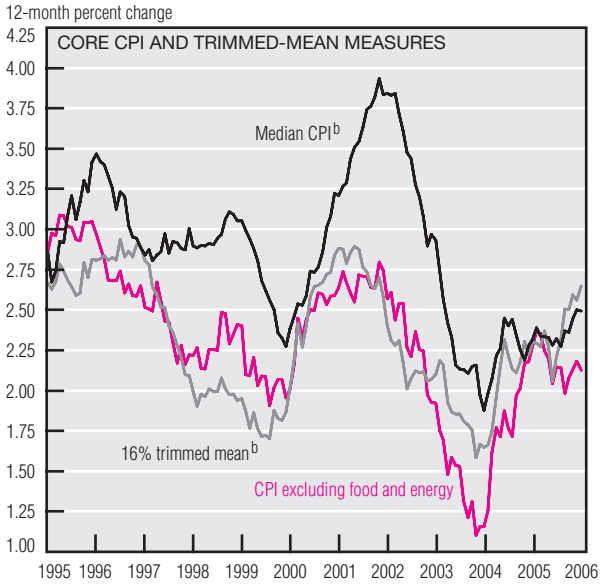
Second, the FOMC can be clear about its objectives and its methods for achieving them. It can establish ongoing communications with the public about its own intentions and expectations, and it can endeavor to be as consistent as is practicable in its analytical framework, data assessment, and policy responses to incoming information. Assuming that it does what it says it will do, a central bank that abides by these principles can create an environment in which the informed decisions of others will reinforce the outcomes that policymakers seek to achieve. Well-informed financial markets will smooth the economy's journey along the best path, one step at a time.

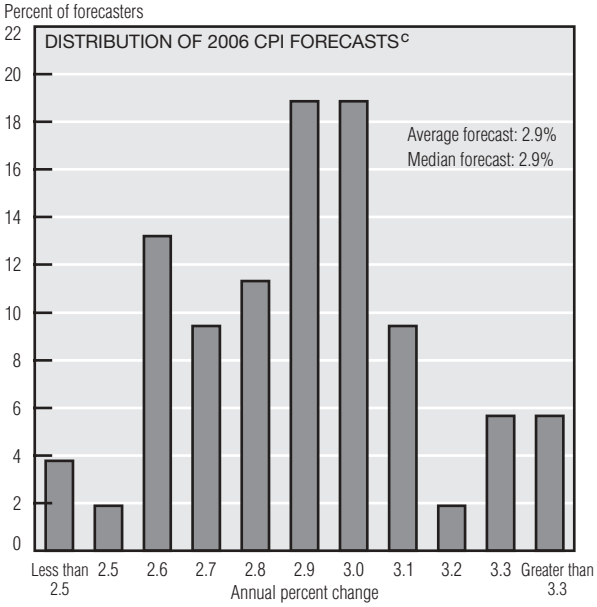
Inflation and Prices

January Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2005 avg.
Consumer prices					
All items	8.2	–0.2	4.0	2.5	3.6
Less food and energy	2.4	2.4	2.1	2.0	2.2
Median[b]	2.6	2.7	2.5	2.7	2.5
Producer prices					
Finished goods	3.0	2.0	5.7	2.5	5.8
Less food and energy	4.7	2.6	1.5	1.1	1.7







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; *Blue Chip Economic Indicators*, February 10, 2006; and Federal Reserve Bank of Cleveland.

The Consumer Price Index (CPI) rose at the brisk annualized rate of 8.2% in January, nearly reversing the declines of the preceding two months. About 70% of the January advance was attributed to a 79.4% (annualized rate) gain in energy costs, which had remained stable or declined since September 2005. Growth in the core retail price measures was more moderate, but slightly above the 12-month trends, with the CPI excluding food and energy up 2.4% (annualized rate) and the median CPI up 2.6% (annualized rate) during the month.

The longer-term trends of underlying inflation are just a bit north of 2%, a level that some might argue is near the upper limit of a range consistent with price stability. Specifically, the 12-month growth rates were 2.1% for the core CPI, 2.5% for the median CPI, and 2.6% for the 16% trimmed-mean CPI. And the consensus and median estimates from the Blue Chip panel of economists predict that the CPI will rise 2.9% in 2006. However, the proportion of them (about 23%) who think the CPI could top 3% this year slightly exceeds the proportion predicting the CPI will fall back to less than a 2.7% rise.

Housing is the largest component of CPI, accounting for more than 40% of its basket of goods. The owners' equivalent rent (OER) of primary residence—the cost homeowners would assume if they rented their houses instead of owning them—is responsible for 23.4% of the overall CPI. The OER is computed using

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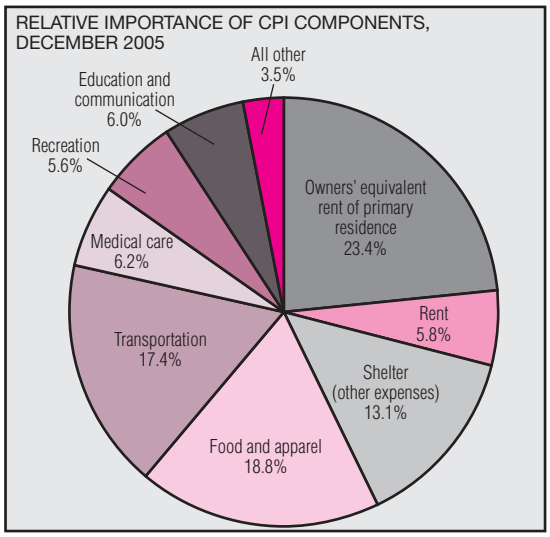
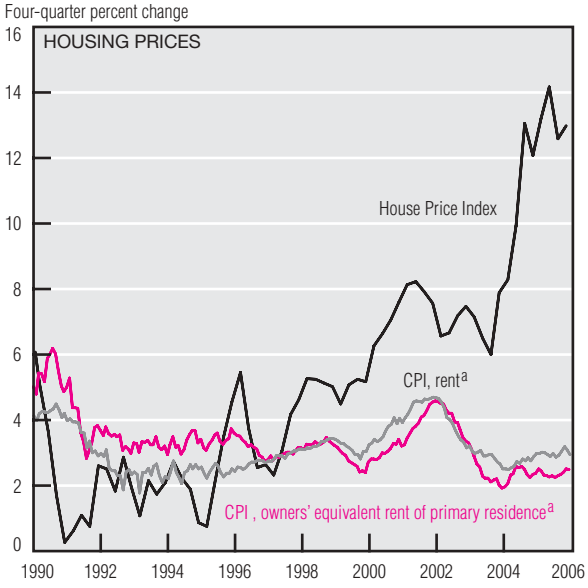
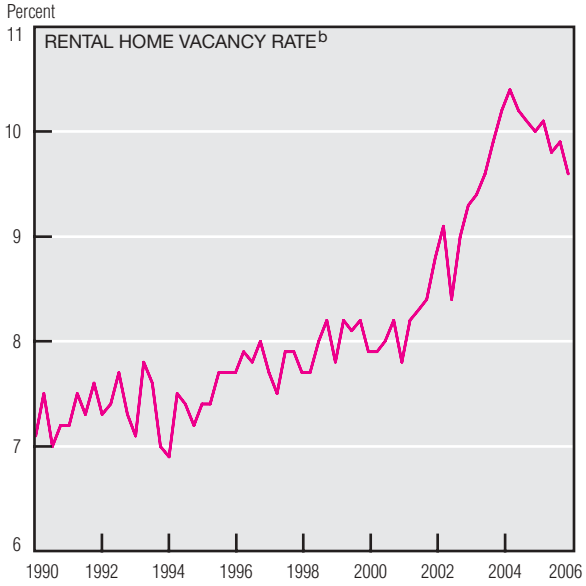
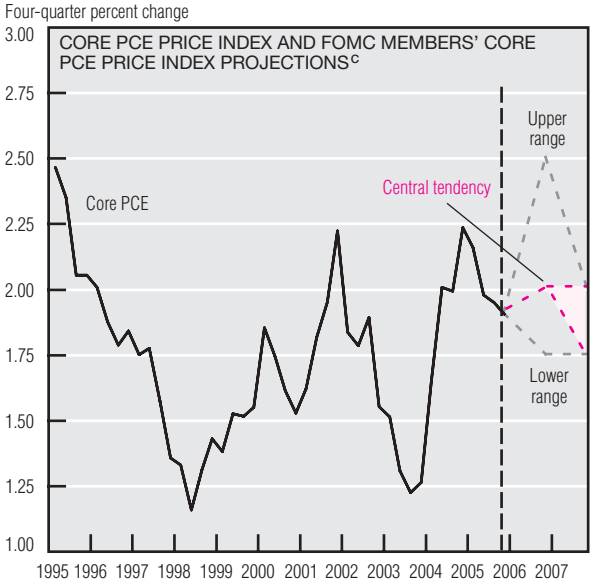
Inflation and Prices (cont.)









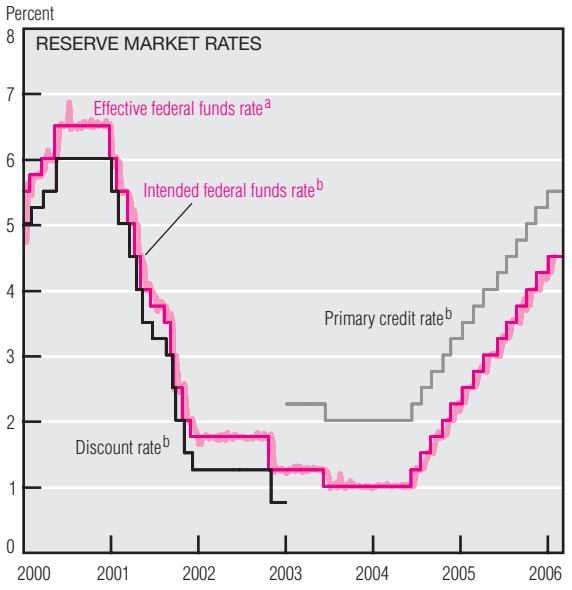
a. Twelve-month percent change.
b. Vacant housing units available for rent year-round divided by the sum of renter-occupied housing units, vacant units rented year-round but awaiting occupancy, and vacant units available for year-round rent.
c. Projections by the Board of Governors of the Federal Reserve System and Reserve Bank presidents.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Office of Federal Housing Enterprise Oversight; and Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*, February 15, 2006.

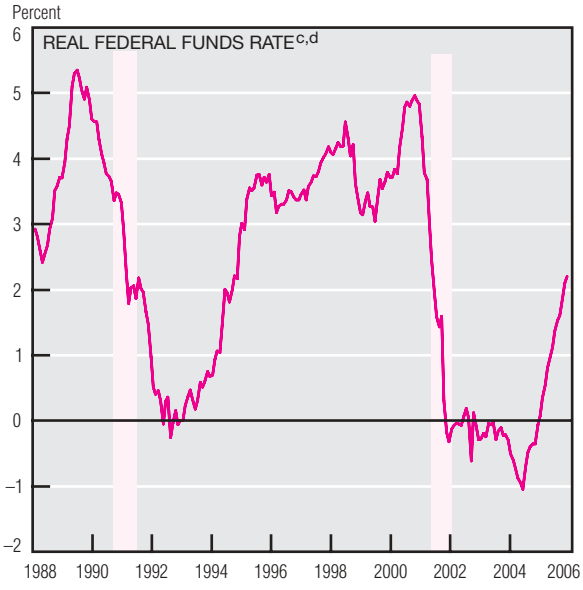
rental prices, which have probably been lowered by the greater attractiveness of owning a home instead of renting. Indeed, as home prices have risen at a double-digit pace in the past couple of years, the OER has moderated to an annual rate of about $2^{1}/_{4}$%—down from rates near 3% for most of the 1990s.

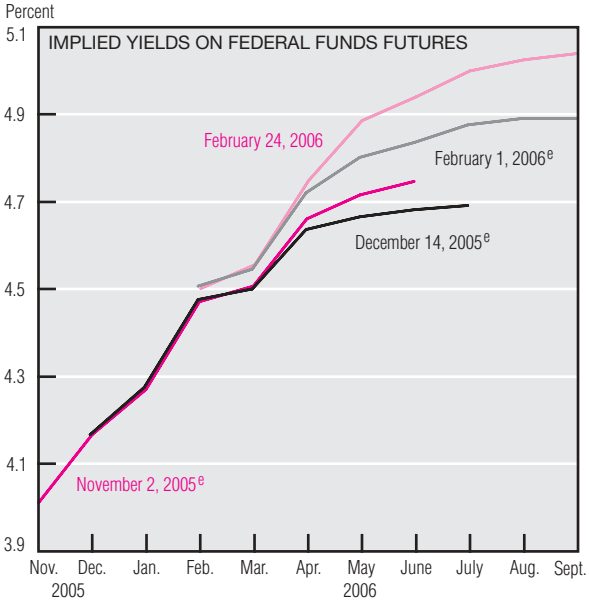
Given the large weight of the implied rental cost of homeownership in the CPI, a firming in the home rental market could have a meaningful impact on the inflation statistic. It might be true that rents are underpriced, partly because of the housing market's strength in the past couple of years, but the potential for a significant rise in rents should be balanced against what continues to be a relatively large stock of vacant rental properties. And although the vacancy rate on rental homes has come down some since peaking in 2004, vacancies are still well above the levels seen throughout the 1990s.

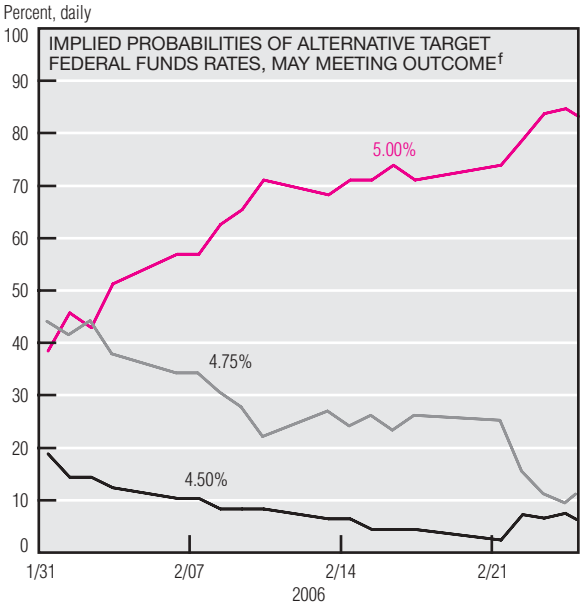
No sustained rise in retail price inflation is currently being predicted inside the Federal Reserve, according to recent projections by voting and nonvoting members of the Federal Open Market Committee, which were reported in the Federal Reserve's semiannual Monetary Policy Report to the Congress. The central tendency of the group's projection for the core PCE Price Index is 2% in 2006 and $1^{3}/_{4}$%–2% in 2007, on a fourth-quarter to fourth-quarter basis.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the 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 May 2006 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.

On January 31, the Federal Open Market Committee (FOMC) voted to raise the target level of the federal funds rate 25 basis points (bp) to 4.50%. Since the FOMC initiated its tightening cycle in June 2004, the target level has increased 3.5 percentage points. The inflation-adjusted fed funds rate now stands more than 300 bp above its low in June 2004. The measured upward pattern of rate hikes is consistent with the FOMC's stated intention of gradually removing monetary accommodation in order to avoid inflationary pressures.

In recent months, however, FOMC meeting minutes reveal that many members believe that the target is at or approaching its neutral level, which suggests that the pattern of rate hikes may be nearing an end. Nevertheless, the FOMC's January 31 policy statement release said that "some further policy firming may be needed." Market participants have heard the message clearly. Federal funds futures indicate that by August the fed funds rate will plateau near 5%.

Options on fed funds futures indicate that the FOMC will almost certainly raise the rate another 25 bp at its next meeting in late March. Moreover, since the January meeting, implied probabilities based on options prices have indicated a better-than-even chance that the fed funds rate will reach 5% by May.

Relatively stable prices in futures and options markets signal that the market expects policy continuity from the FOMC as Chairman Bernanke takes over. His testimony on February 15 and 16, including his remark that "the inverted yield curve is not signaling a

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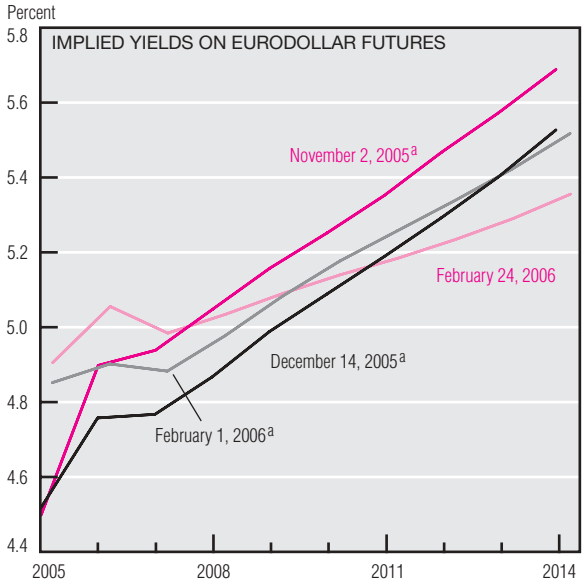
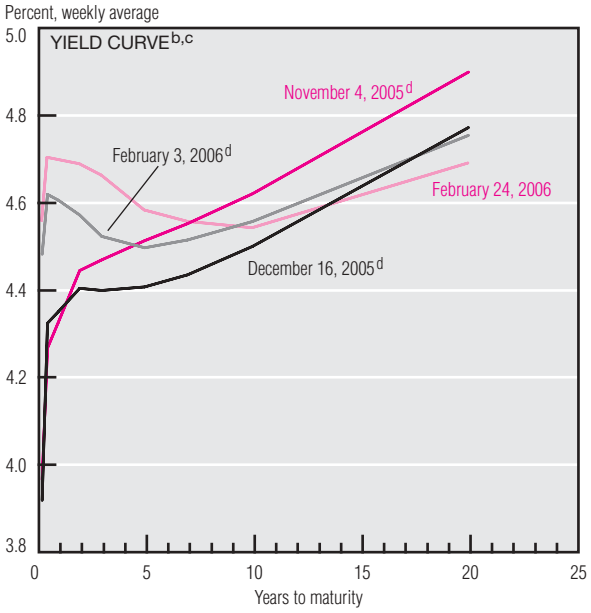
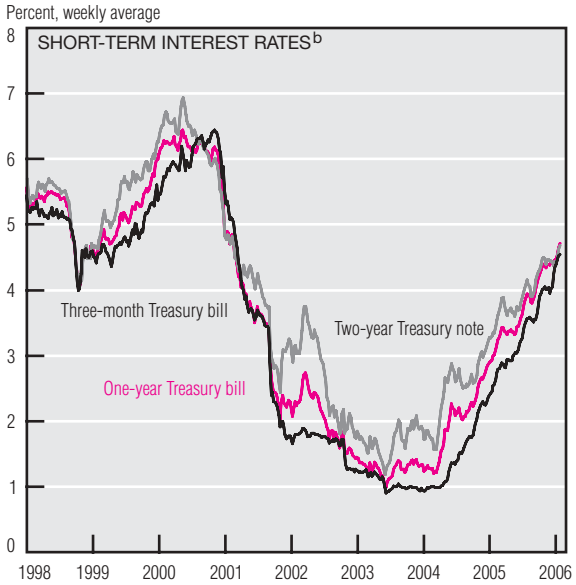
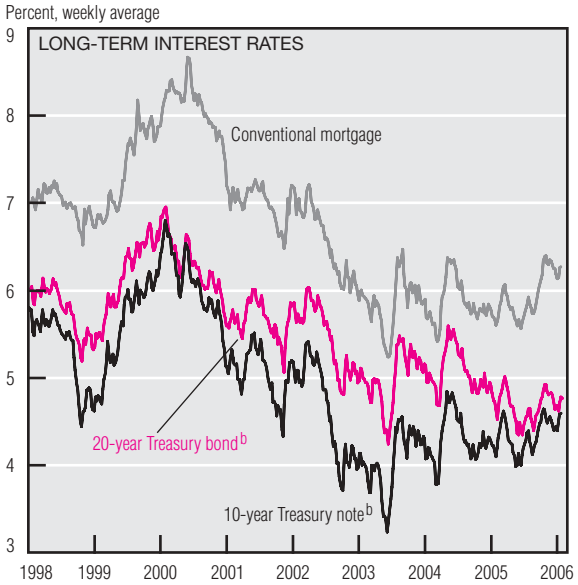
Monetary Policy (cont.)









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.

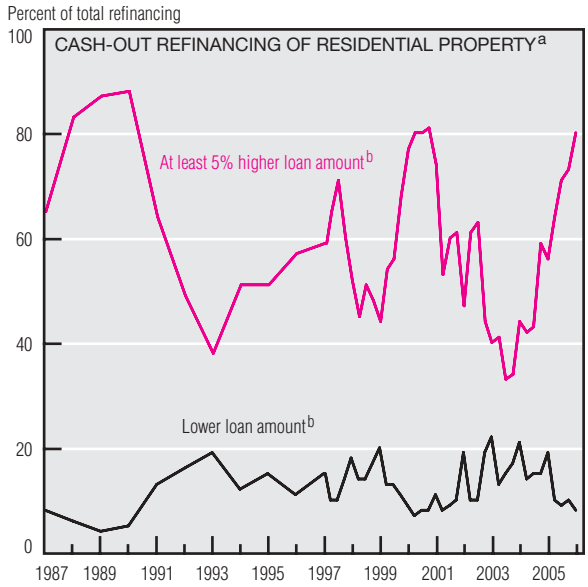
slowdown," had no perceptible effect on market expectations; neither did the minutes released on February 21.

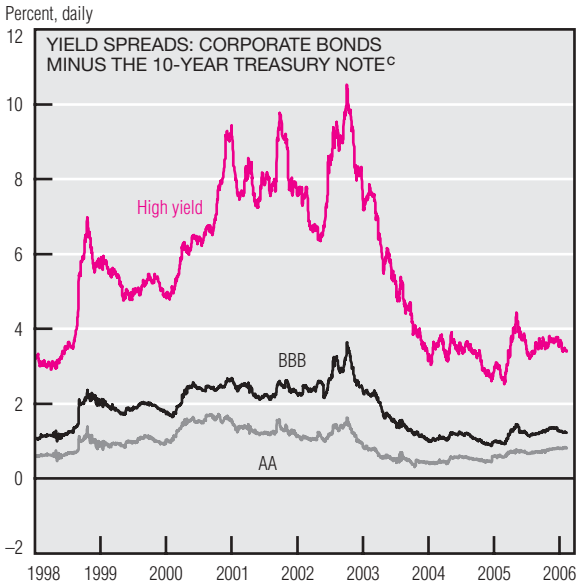
Implied yields derived from Eurodollar futures provide a measure of expected policy actions over a longer period. These yields often overpredict the federal funds rate and, like most forecasts, become less accurate as they predict farther into the future. Near-term Eurodollar futures also suggest that the current round of tightening is not over yet.

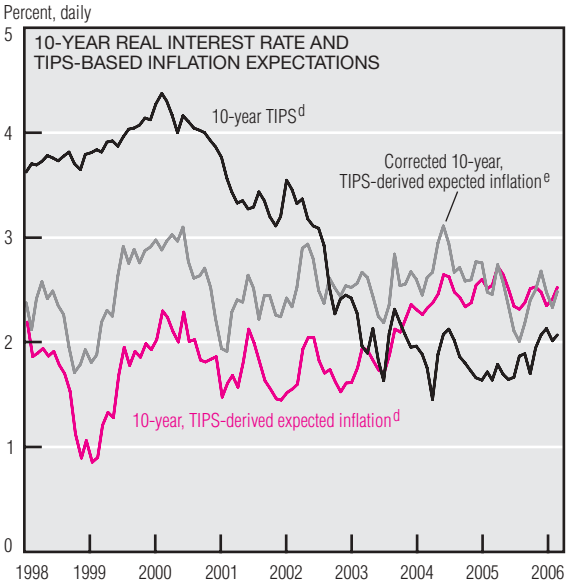
The U.S. Treasury yield curve flattened further in February and is even inverted in some ranges. For example, on the day after the January 31 FOMC meeting, the 10-year Treasury bond was 5 bp lower than the one-year Treasury note. By the end of February, the inversion had increased to 13 bp.

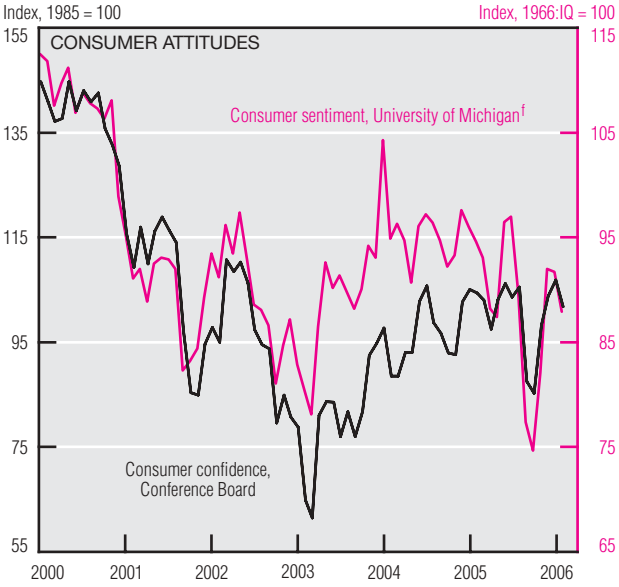
In the past, yield curve inversions often foreshadowed recessions, but this is not necessarily the case today. In recent years, the FOMC has enjoyed enhanced credibility for maintaining price stability. As a consequence, transitory inflation pressures —such as those associated with the recent surge in energy prices—no longer affect long-term inflation expectations as they did in the 1970s and 1980s. During economic expansions, on the other hand, inflationary pressures still tend to boost short-term inflation expectations. Because interest rates reflect inflation expectations over their corresponding terms, inflation shocks temporarily boost short-term rates relative to long-term rates, while the economy continues to grow. Hence, yield curves may be less informative now than they were in recent history.

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.

Long-term interest rates remain low by historical standards, posing something of a conundrum. 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, raising the real rate of return on new business investment. In turn, the high returns on new capital tend to pull up the entire yield structure, including long-term real interest rates.

The impact on the economy of low long-term rates is nowhere more evident than in the housing sector. Persistently low mortgage interest rates have contributed to a housing boom—a situation characterized by a sharp increase in housing prices relative to household income levels.

The housing market is expected to cool considerably this year. A chief concern of many forecasters is that if mortgage rates rise sharply, housing values could plummet. High housing values and low mortgage rates have combined to give households a substantial source of financing. More specifically, households have been able to tap increased housing equity by refinancing at higher loan amounts. This "cash-out refinancing" has provided funds that have allowed households to spend at a pace that has exceeded that of personal income growth in recent months. A sharp uptick in interest rates could halt cash-out

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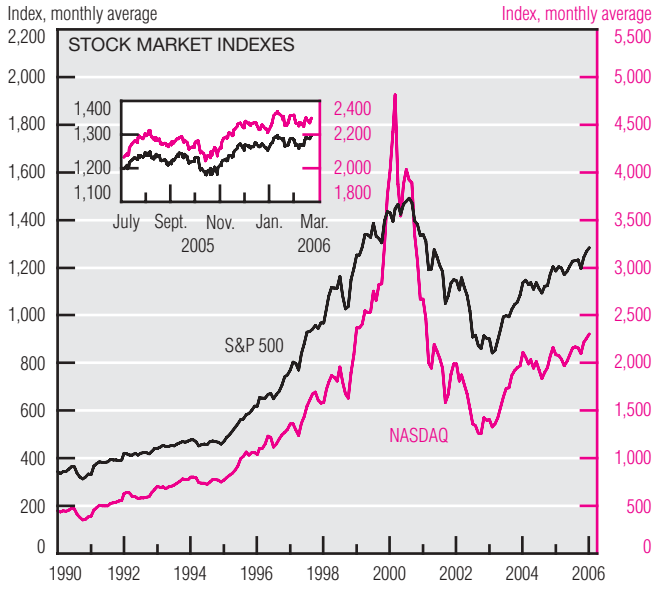
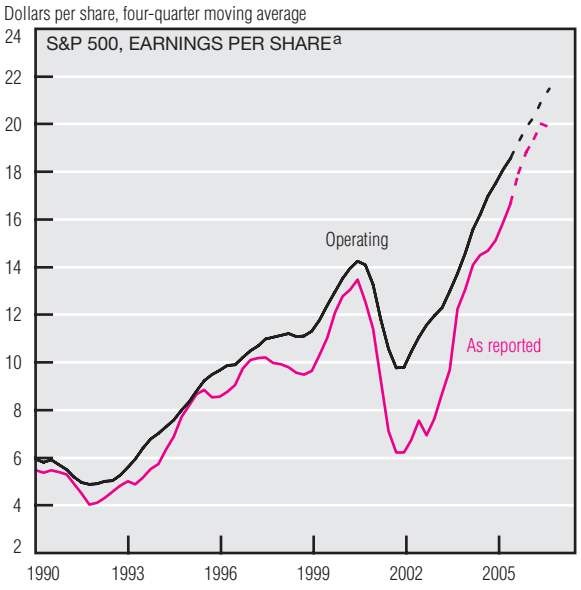
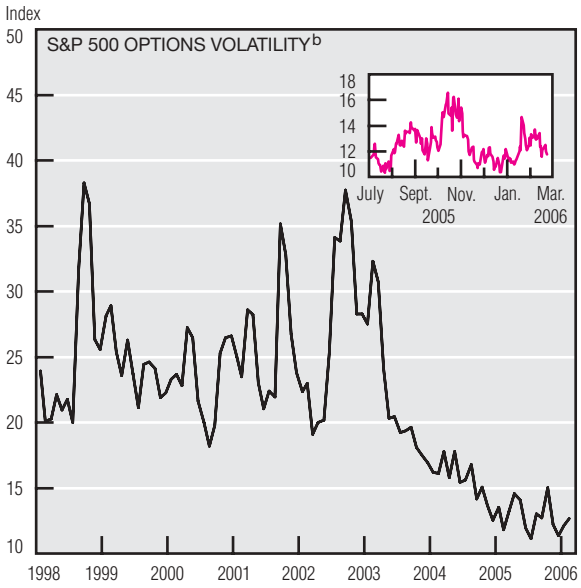
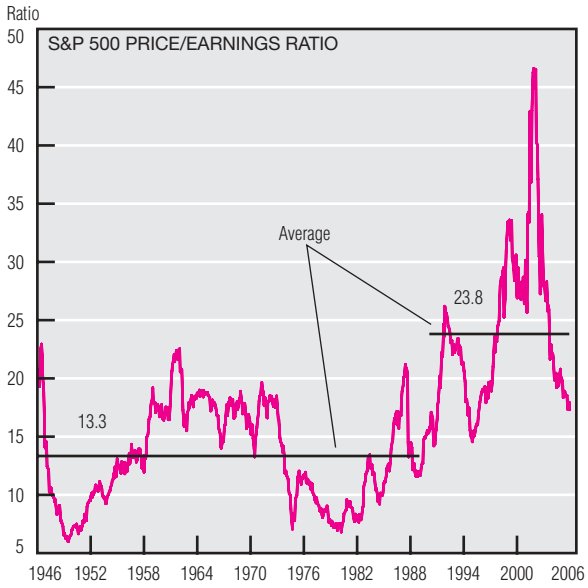








a. Dashed lines represent the forecast as of February 16, 2006.
b. CBOE volatility Index (VIX). Monthly data.
SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

refinancing, causing a sharper-than-expected drop in consumer spending.

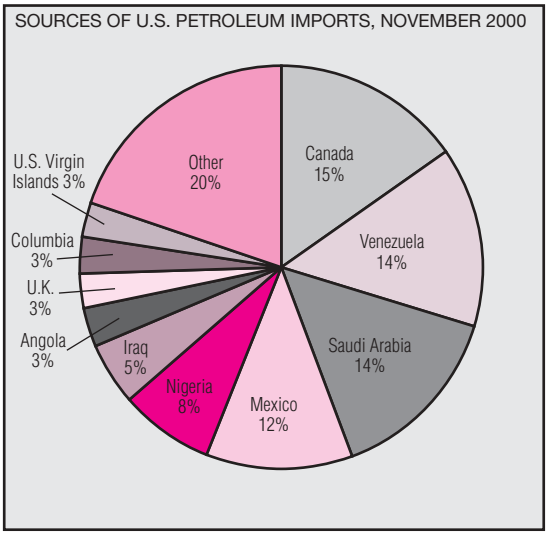
Stable spreads of corporate bond rates over Treasury note rates with comparable terms indicate that corporate balance sheets are quite healthy. Businesses have ample cash to invest if they choose to spend it.

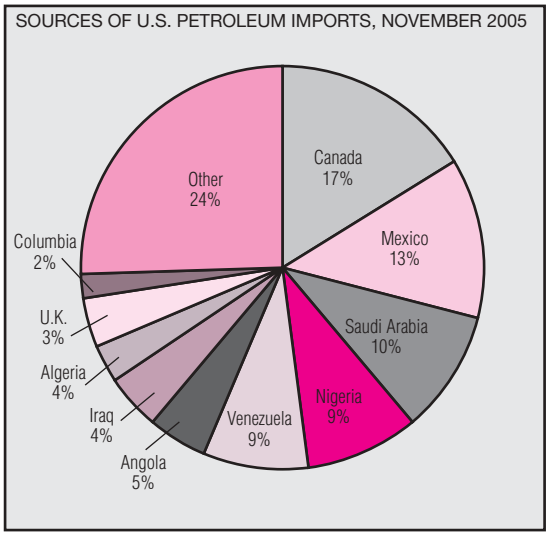
With inflation expectations remaining well contained and consumer confidence on the rebound, business investment is expected to supplant consumer spending as the chief driver of the expansion, especially in employment growth. Moreover, although consumer spending might slow, it could continue to be supported by employment gains.

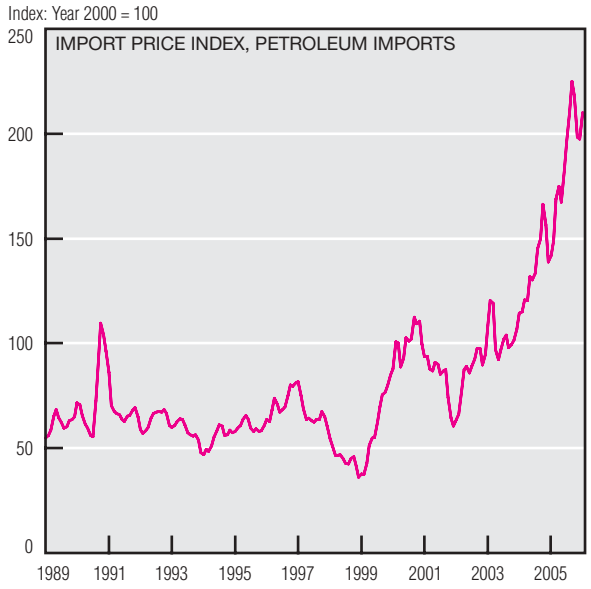
The positive outlook for investment seems to be supported by a surge in broad equity indexes early this year. Stock market fundamentals remain quite favorable, chiefly earnings at S&P 500 companies, which increased at double-digit rates during 2005. Although they are expected to decelerate, their earnings are projected to grow just under 10% during 2006.

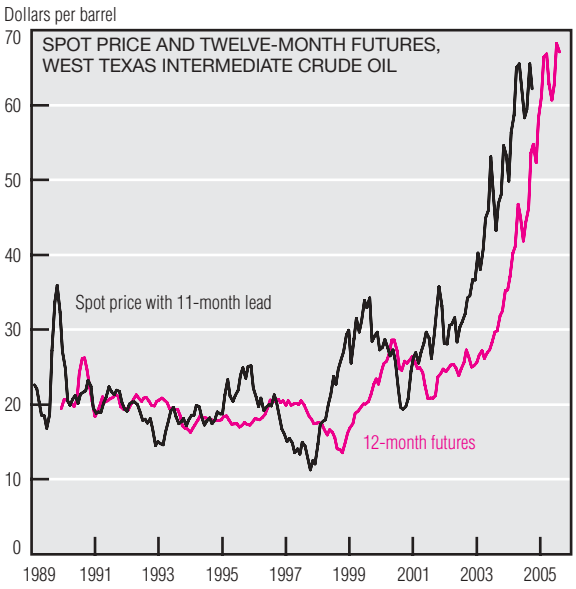
Equities' strength since October was coupled with diminished volatility in equity options. The decline in volatility since October may reflect some soothing of inflation fears. Continued progress in reducing inflation over the short term is important to maintaining healthy financial conditions. Despite the recent run-up in stock prices, the price–earnings ratio remains well below its average of recent years.

Oil Prices









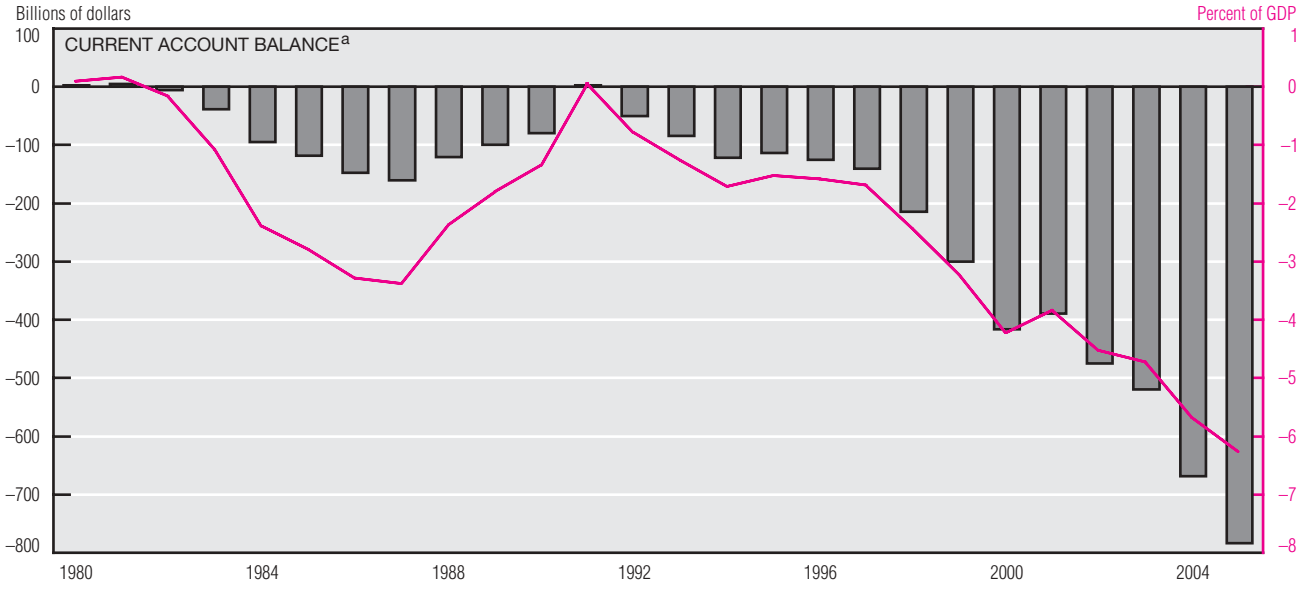
SOURCES: U.S. Department of Energy, Energy Information Administration; and Bloomberg Financial Information Services.

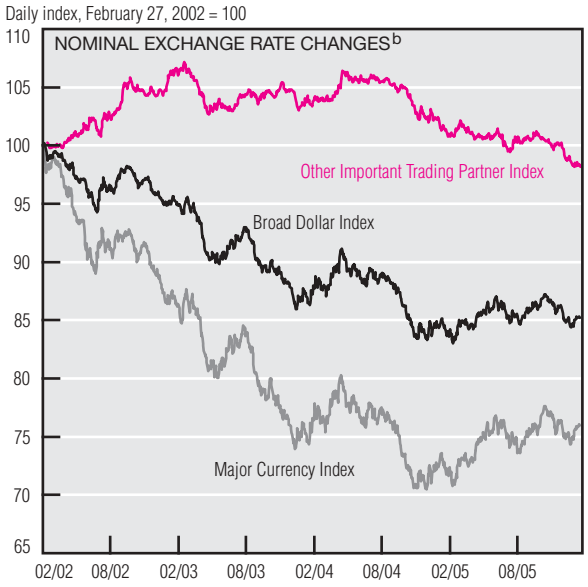
In November 2005, the two largest exporters of oil to the U.S. were its neighbors. Canada and Mexico combined accounted for about 30% of total U.S. oil imports, up from about 27% five years earlier. During the same period, oil imports from Saudi Arabia and Venezuela decreased from 14% to 10% and from 14% to 9%, respectively. The share of U.S. oil imports from the other top 10 countries has remained relatively constant.

Import prices for petroleum products have more than doubled in the last two years. In September 2005, the Petroleum Import Price Index reached its highest point, nearly 225, before settling down to 209 in January 2006. During this time, the spot price of a barrel of oil soared from just under $29 to slightly over $62.

In the mid-1990s, the 12-month oil futures contract seemed a fairly good indicator of future oil prices. More recently, however, oil futures contracts have been poor predictors of oil prices one year out, substantially underpredicting the spot price of oil. This probably results from the increased volatility in spot oil prices over the last five years. In more volatile circumstances, like the current oil market, the value associated with futures markets comes from the hedging opportunities that futures contracts provide rather than their ability to predict spot prices.

The Current Account and Dollar Depreciation





Selected Global Current Account Balances

	Billions of dollars		
	1996	2004	Change
U.S.	–124.9	–668.1	–543.2
Other advanced economies	150.9	354.1	203.2
Developing countries	–84.9	227.7	312.6
Asia	–37.8	93.0	130.8
Africa	–5.0	0.6	5.6
Central and Eastern Europe	–17.8	–50.1	–32.3
Middle East	12.7	102.8	90.1
Commonwealth of Independent States	2.5	63.1	60.6
Western Hemisphere	–39.6	18.3	57.9

a. The 2005 observation is estimated using data from the first three quarters.
b. The Broad Dollar Index measures dollar movements against the currencies of our 26 most important trading partners. The Other Important Trading Partner Index measures dollar movements against 19 emerging-market currencies. The Major Currency Index measures dollar movements against developed countries' currencies. All indexes are constructed on a trade-weighted basis.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and International Monetary Fund, *World Economic Outlook Database*, September 2005.

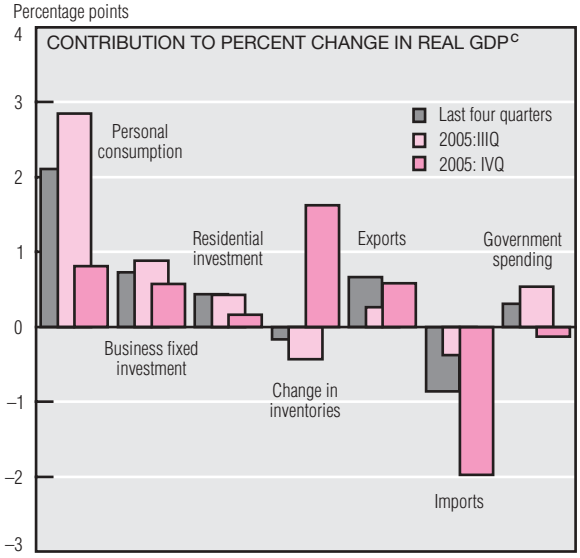
In 2005, the U.S. current account deficit will reach an estimated $783 billion or about 6.3% of GDP. Globally, current account balances must sum to zero. Less obviously, at the national level, the current account must equal the financial flows account because a country that runs a current account deficit must finance it by a financial inflow. There are two possible causes for the large U.S. deficit: Either the U.S. has a high demand for current consumption, which it must finance by borrowing from the rest of the world, or the rest of the world desires to invest in U.S. assets, which implies that we must run a current account deficit.

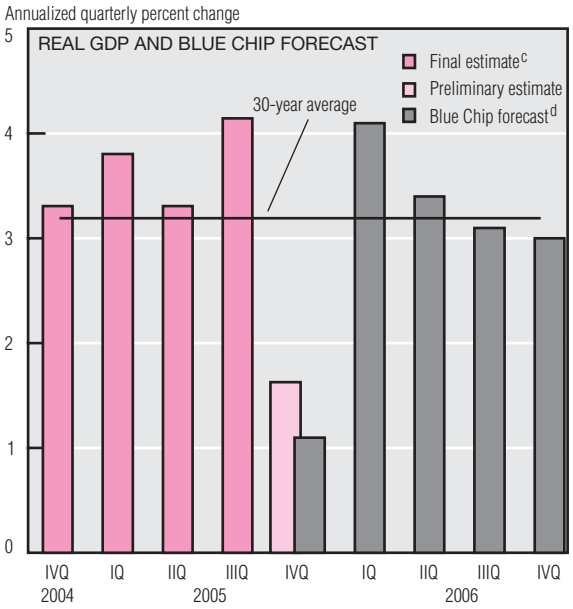
Which scenario is more likely? If the U.S. is demanding higher levels of consumption, then the dollar's value might decrease when our residents must purchase foreign currency with dollars in order to buy foreign goods. On the other hand, foreigners' desire to invest in U.S. assets could have the contrary effect—causing the dollar to appreciate—because the demand for dollars would be stronger. A quick look at the data cannot distinguish one story from the other. During the three-year period beginning in February 2002, the dollar depreciated substantially, which suggests that the dominant force behind the growing current account deficit was high U.S. consumption. Since February 2005, however, the dollar has stabilized and appreciated somewhat, which implies that strong foreign demand for U.S. investments is the dominant force behind the increase in the U.S. current account.

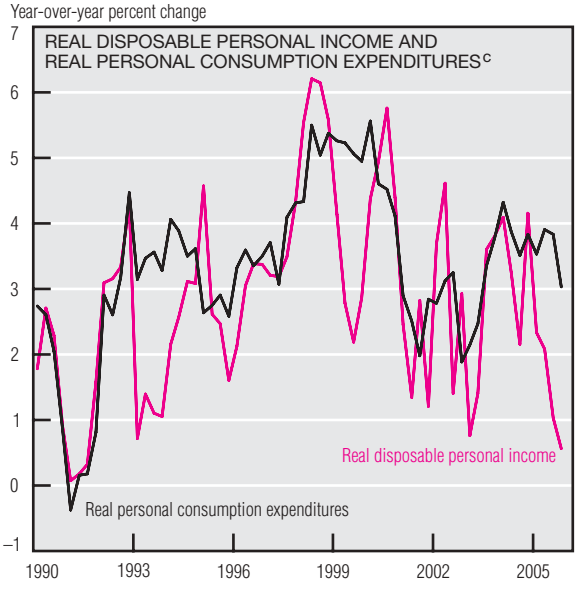
Economic Activity

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

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	45.3	1.6	3.2
Personal consumption	22.7	1.2	3.0
Durables	–51.9	–16.6	0.2
Nondurables	29.0	5.1	4.4
Services	33.5	3.0	2.9
Business fixed investment	17.3	5.4	7.1
Equipment	16.0	6.1	9.0
Structures	2.1	3.3	1.5
Residential investment	3.9	2.6	7.5
Government spending	–3.4	–0.7	1.6
National defense	–11.8	–9.0	1.7
Net exports	–38.7	—	—
Exports	16.7	5.7	6.5
Imports	55.5	12.8	5.5
Change in business inventories	43.7	—	—







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*, February 10, 2006.

The Commerce Department's preliminary reading of real GDP growth for 2005:IVQ was 1.6%, up 0.5 percentage point (pp) from January's advance reading. The final 2005:IIIQ growth was 4.1%. The preliminary report's upward revision resulted primarily from upward revisions to exports, government spending, equipment and software, and change in inventories, partly offset by an upward revision to imports.

Most components' contributions to the change in real GDP decreased in 2005:IVQ. The two exceptions were change in inventories, which added 2.1 pp, and exports, which added 0.3 pp, compared to 2005:IIIQ. Imports subtracted 2.0 pp after deducting only 0.4 pp last quarter. Personal consumption expenditures, which traditionally makes the largest positive contribution to GDP, added only 0.8 pp, versus 2.9 pp the previous quarter.

The GDP growth rate has averaged 3.2% over the past 30 years, twice as high as the 2005:IVQ preliminary reading of 1.6%. In fact, the preliminary estimate was the lowest since 2002:IVQ. However, as of February 10, the Blue Chip panel of economists predicted that 2006:IQ growth will be 4.1%, up 0.5 pp from their January estimate. For the rest of 2006, they expect growth between 3.0% and 3.4%.

Since personal consumption is typically the largest component of GDP, its trends are important for the overall economy. Although real personal consumption expenditures are growing, the year-over-year annual growth rate has slowed to 3.0%. In fact, it is a bit surprising that consumers have not reined in spending more, considering that year-over-year growth in the more variable real

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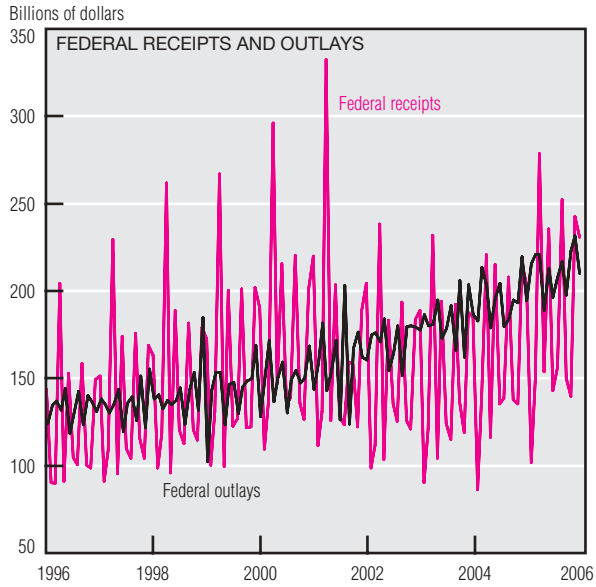
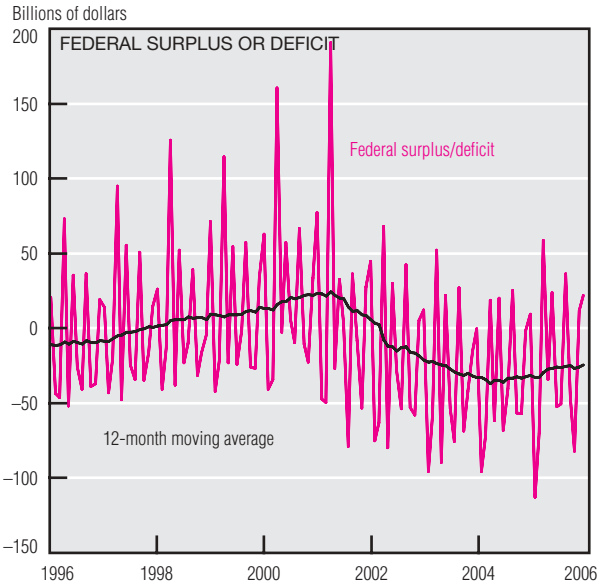
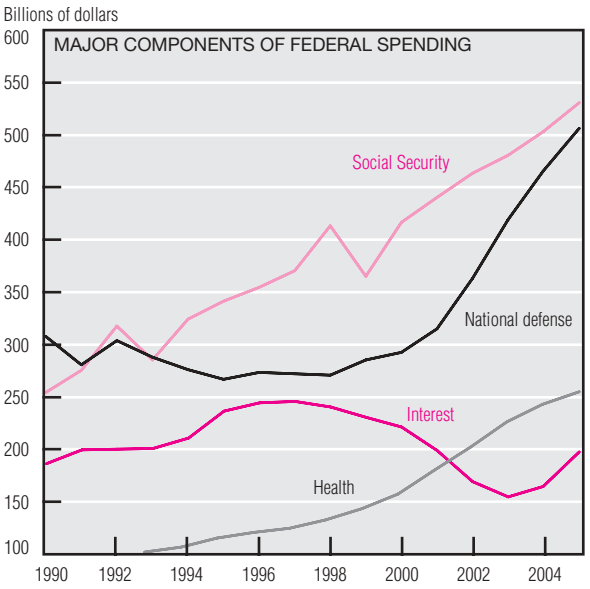
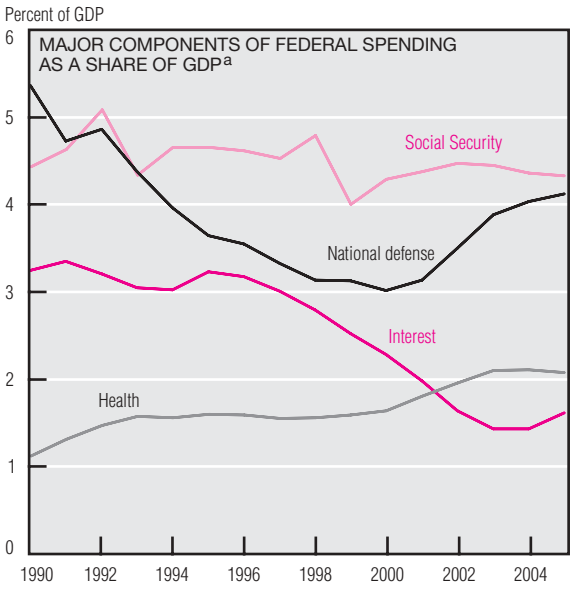
Economic Activity (cont.)









a. Fiscal year GDP.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of the Treasury; and Office of Management and Budget.

disposable personal income slowed from 4.1% in 2004:IVQ to only 0.5% in 2005:IVQ.

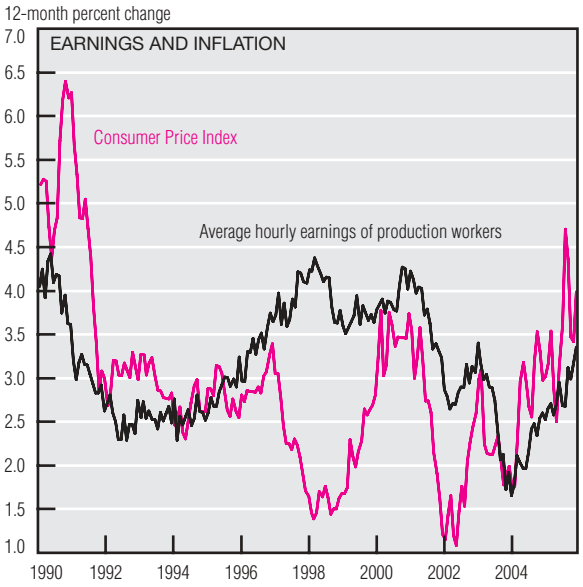
Growth in federal receipts for January 2006 has increased 13.7% on a year-over-year basis. Outlays over the same period were only up 7.9%, easing the budget deficit by about 21%. Nonetheless, the deficit's 12-month moving average is still $25.6 billion per month.

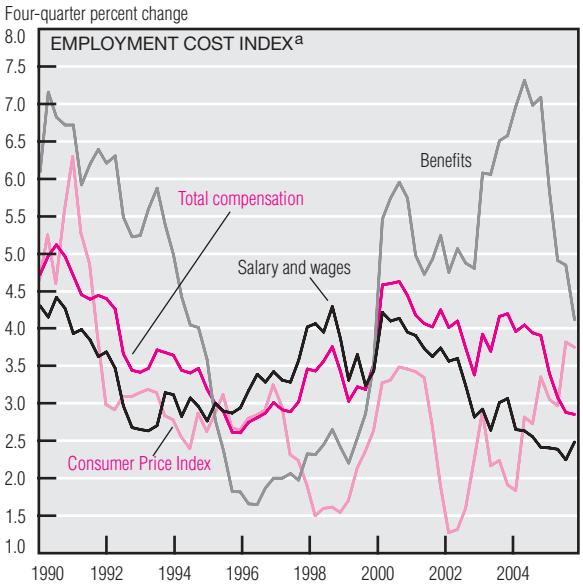
In 2005, all the major spending categories increased faster than GDP's 3.5%. The fastest-growing category was federal outlays on interest, up 20.3% from 2004 to 2005, the result of the one-two punch of rising deficits and interest rates. National defense, at 8.7%, was the next fastest. Social Security and health grew at slower rates, 5.6% and 4.7%, respectively.

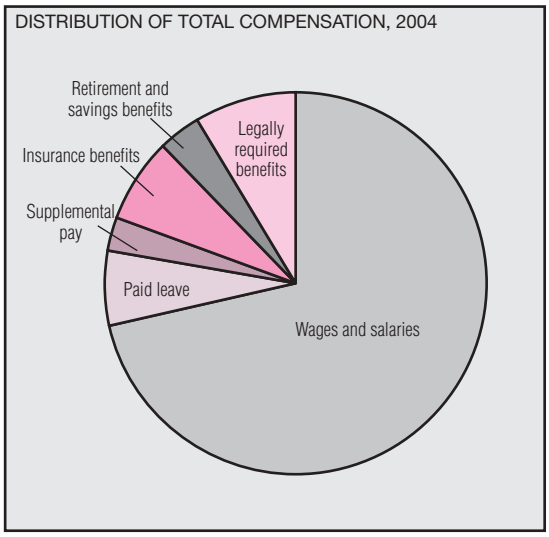
While these growth rates can seem alarming, as a percent of GDP the trends look a bit less so. Social Security has been roughly 4.4% of GDP since 1990. National defense, which increased to 4.1% in 2005, remains below its level at the end of the Cold War. Even the fast-growing interest outlay category, currently 1.6% of GDP, is far below the 3.2% it averaged in the first half of the 1990s. An exception to this more benign view is outlays on health, 2.1%, which has nearly doubled since 1990, but the bottom line is that last year's deficit declined a full percentage point, from 3.6% to 2.6%.

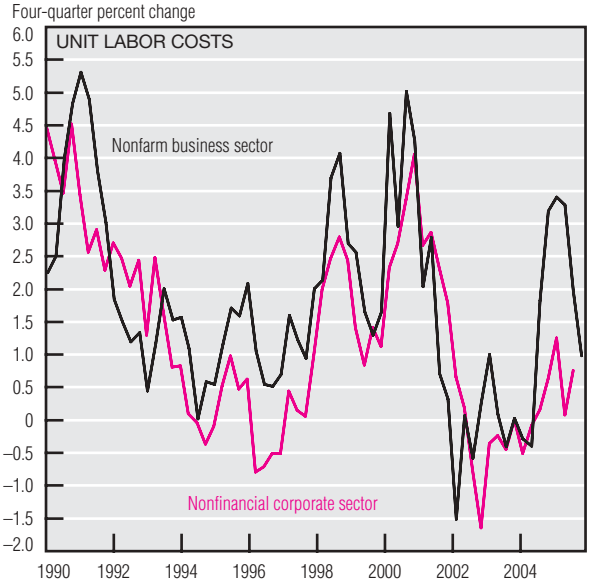
Before one becomes too complacent, it is important to note that, although federal receipts have increased from 16.5% to 17.5% of GDP over the last year, federal outlays remain firmly rooted at 20%. In addition, policymakers need to keep a wary eye on a buildup of budgetary pressures caused by the aging of the baby boomers and the continuing costs of conflicts abroad.

Labor Costs









a. Private industry workers.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Labor costs account for roughly 70% of firms' production costs. For this reason, logic suggests that rising labor costs might signal potential inflation pressure should firms try to recoup labor cost increases by raising their product prices. However, measuring labor cost inflation is a challenge, and there are several ways to do it.

Average hourly earnings of production and nonsupervisory workers provide the timeliest measure. Although inflation growth has generally exceeded average hourly earnings growth for about two years, earnings growth has more than doubled since 2004, rising 3.3% on a year-over-year basis in January 2006. However, this measure is limited because it reflects only changes in hourly wage rates and pay for overtime. Moreover, it captures only the wages of production and nonsupervisory workers, who historically have accounted for roughly 70% of all private employees. Finally, average hourly earnings cannot control for movement across industries and occupations; thus, increased earnings may reflect a shift toward higher-paying industries rather than wage inflation.

The Employment Cost Index (ECI) is a more comprehensive measure. It comprises many important elements of labor compensation, including benefits such as paid leave, bonuses, insurance, payroll taxes paid by employers, and retirement and savings benefits: When combined, these benefits account for nearly 30% of total compensation. Furthermore, the ECI computes total compensation based on a fixed mixture of industries and

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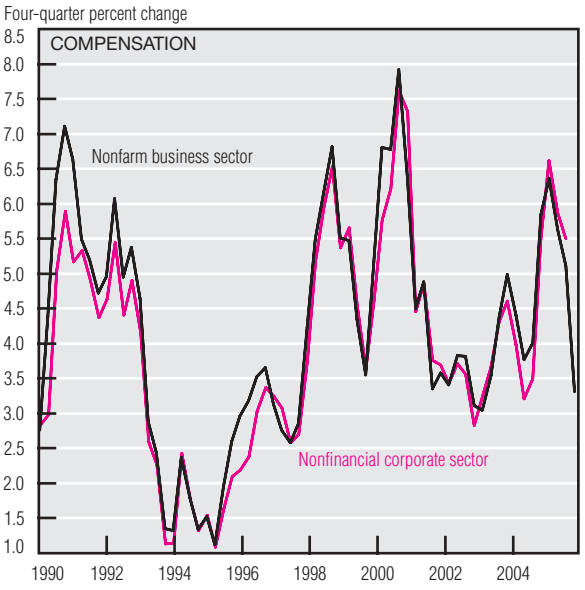
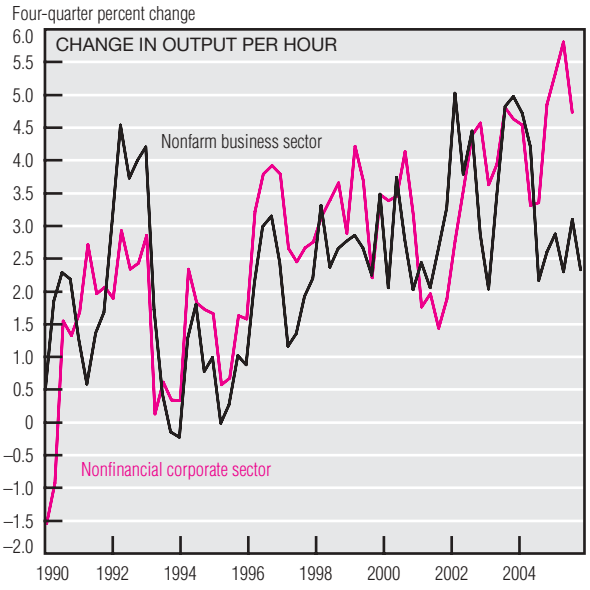
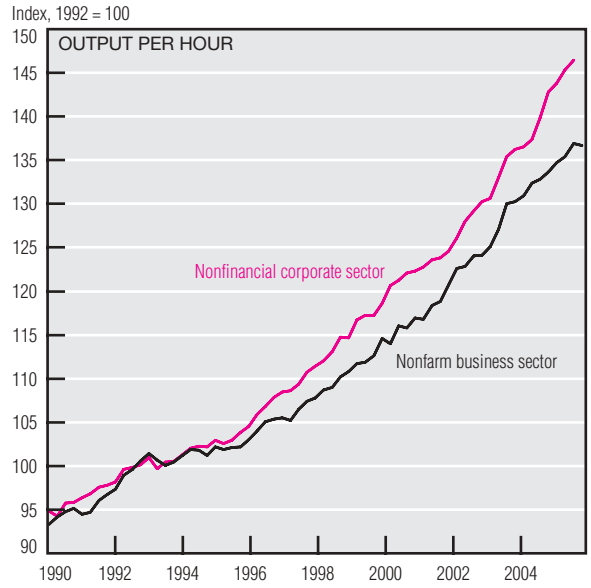
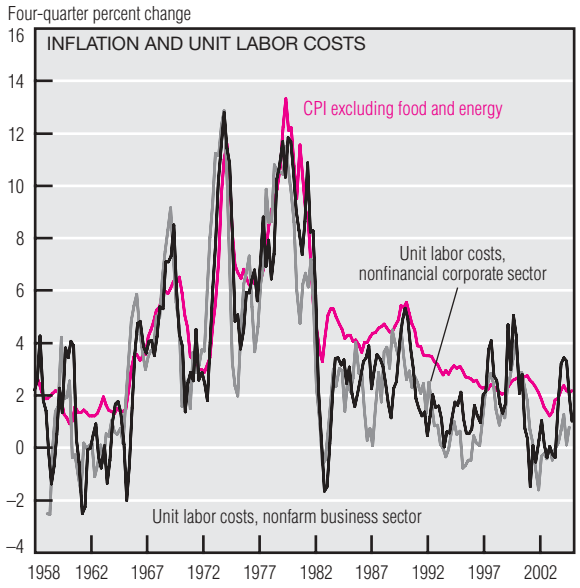
Labor Costs *(cont.)*









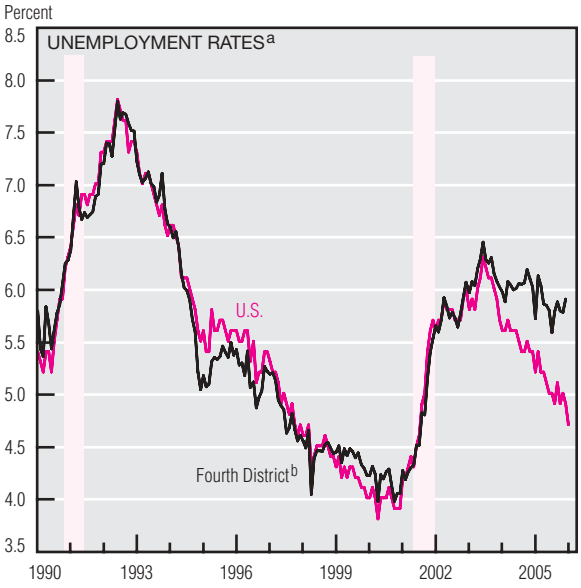
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

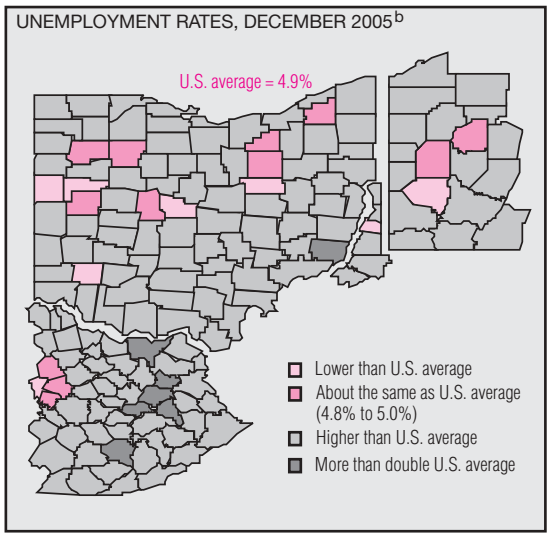
occupations, in order to distinguish labor cost growth from growth caused by shifts in industrial and occupational structure over time. The ECI suggests that labor cost growth has decelerated since 2000, registering 2.8% year-over-year in 2005:IVQ. The ECI is a straightforward measure of labor costs, but it does not account for productivity.

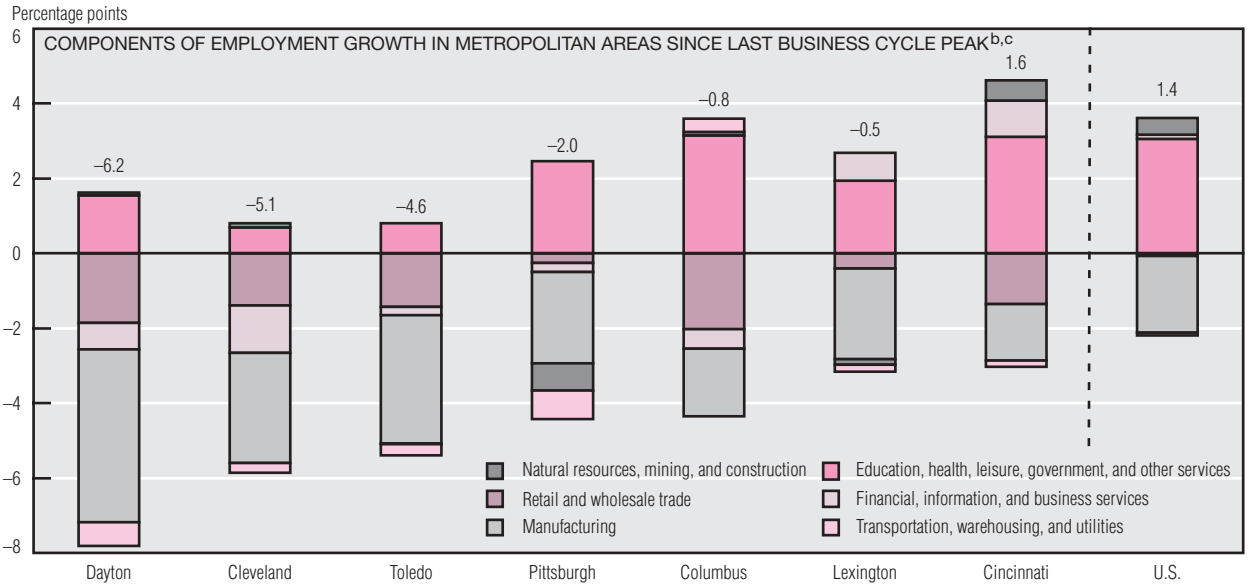
Finally, unit labor costs for nonfarm business, a compensation measure that is adjusted for labor productivity, is decelerating after a period of unusually elevated growth. From 2004:IVQ to 2005:IVQ, unit labor costs for nonfarm business rose a mere 1.0%. Inflation in unit labor costs for the nonfinancial corporate sector has been relatively modest over the past two years, generally ranging between –0.5% and 1.0%. Since these sectors have similar compensation, the difference in their unit labor costs reflects a relatively higher level and faster growth in labor productivity in the nonfinancial corporate business sector. Some contend that this sector provides a better measure of labor cost inflation because it excludes noncorporate entities, whose productivity is difficult to measure.

Although labor costs are an important part of production costs, the historical link between employment cost pressures—as measured by unit labor costs—and core inflation, which was strong during the higher-inflation 1970s, has become less reliable. In recent years, unit labor costs in both nonfarm business and the nonfinancial corporate sector have been poor indicators of changing inflation rates.

Fourth District Employment







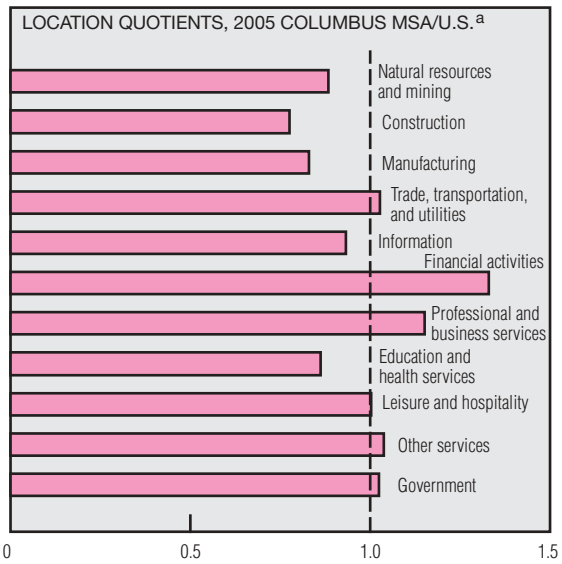
a. Shaded bars represent recessions.
b. Seasonally adjusted using the Census Bureau's X-11 procedure.
c. The numbers above the bars represent total employment growth (percent) since March 2001.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

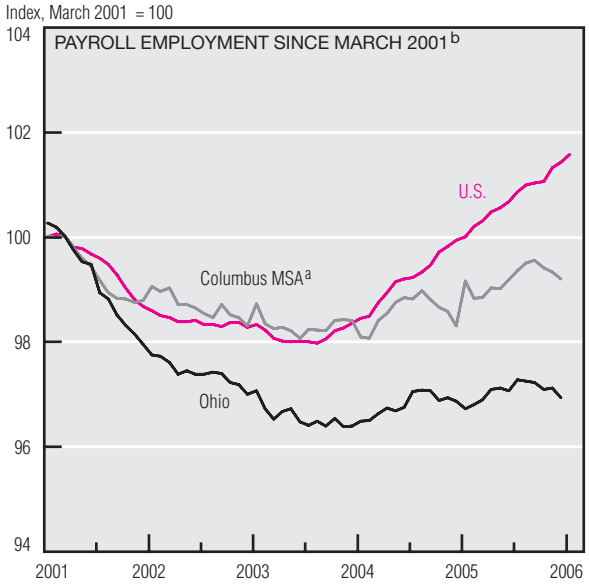
The Fourth District's unemployment rate rose 0.1% in December to 5.9%. In contrast, the U.S. unemployment rate fell from 5.0% to 4.9%. This trend continued in January, when the U.S. unemployment rate fell further, reaching 4.7%. The gap between the District and U.S. unemployment rates has progressively widened since 2003, when the rates were roughly equal.

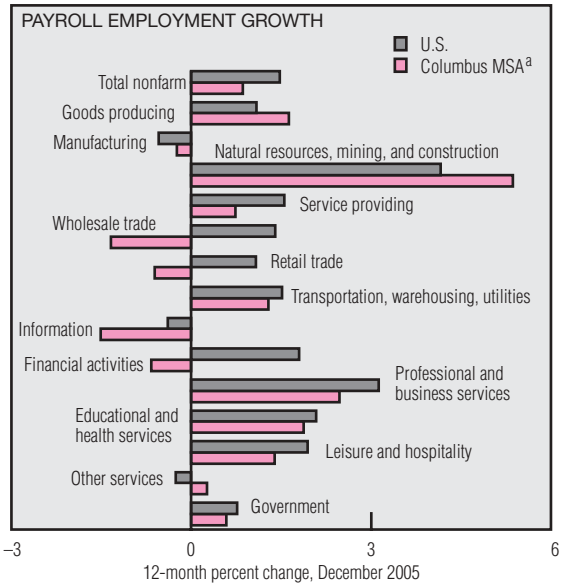
Not surprisingly, the unemployment rate in most District counties also exceeded the national average in December. These include Ohio counties with major population centers such as Cleveland, Cincinnati, and Columbus, as well as counties with smaller cities like Akron, Dayton, Toledo, and Youngstown. Circumstances improved somewhat outside of Ohio: The unemployment rate in Fayette County, Kentucky, of which Lexington is the seat, was roughly equal to that of the U.S. And rates in Ohio County, West Virginia, and Allegheny County, Pennsylvania, of which Wheeling and Pittsburgh, respectively, are the seats, were lower than the national average.

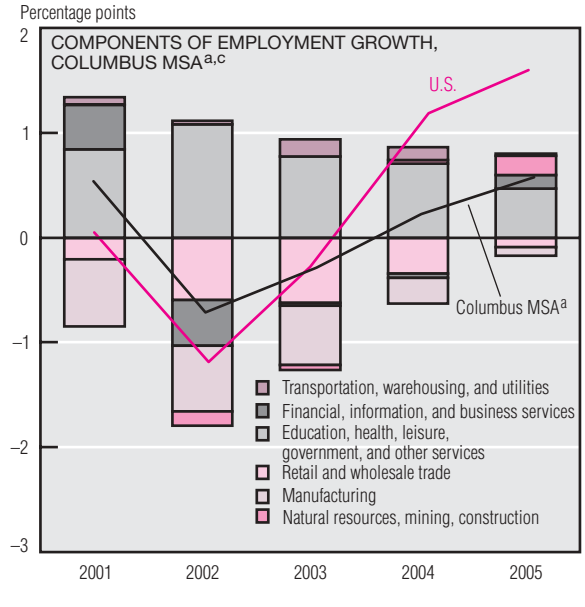
During the period from the last business cycle peak in March 2001 through December 2005, few of the District's metro areas had higher employment growth than the nation, Cincinnati being an exception. Manufacturing contributed negatively to all metro areas and even the U.S., but the metro areas where employment growth was slower tended to have larger negative contributions from manufacturing. These areas also showed declines in financial, information, and business services, and posted relatively weaker gains in education, health care, leisure, and government services.

The Columbus Metropolitan Area









a. The Columbus, OH Metropolitan Statistical Area consists of Delaware, Fairfield, Franklin, Licking, Madison, Morrow, Pickaway, and Union counties.
b. Seasonally adjusted.
c. Lines represent total employment growth.
SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

Columbus is Ohio's third-largest metropolitan area, with over 1.5 million residents. In terms of employment composition, it resembles the U.S. in many ways, but there are a few differences. First, Columbus is less focused on goods production than the nation as a whole; it also has a higher concentration of white-collar, service-sector jobs. Interestingly, although it is home to the state government, the proportion of its workforce in government appears to be about equal to the nation's.

How has the metro area's employment fared in recent years? Throughout the recession and early in the recovery, its employment performance tracked the nation's and was better than the state's. Columbus' labor-market performance continues to be stronger than the state's, but since late 2003, it has lagged the nation's. Consequently, although the U.S. has surpassed the job total it began the recession with, Columbus has yet to do the same.

Over the 12 months ending in December 2005, Columbus performed somewhat better than the nation in goods-producing industries, but fared worse in the much larger service-providing category, posting notable losses in retail and wholesale trade, information, and financial services. The last of these is significant in view of the metro area's above-average concentration of finance jobs. Nevertheless, the combined employment growth in financial, information, and business services in 2005 contributed positively to the metro area's overall employment growth for the first time in several years. The sectors that contributed

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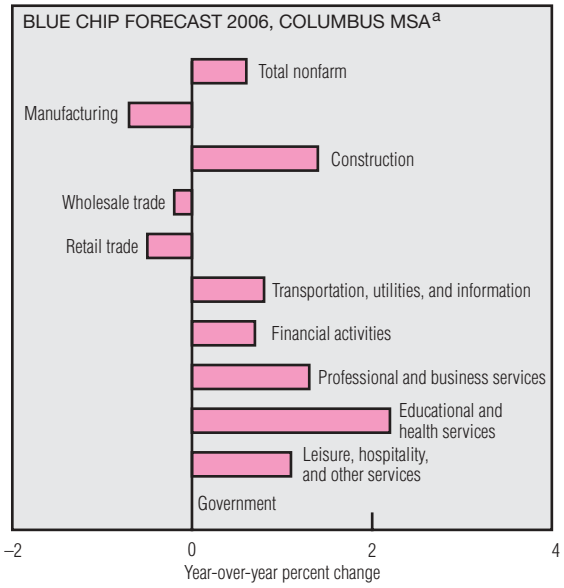
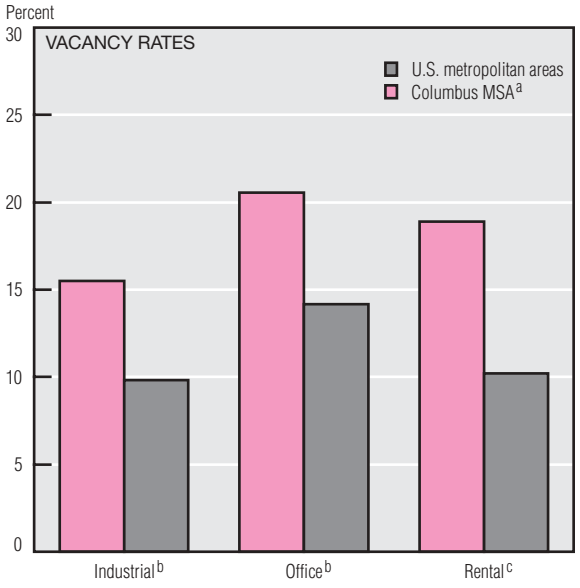
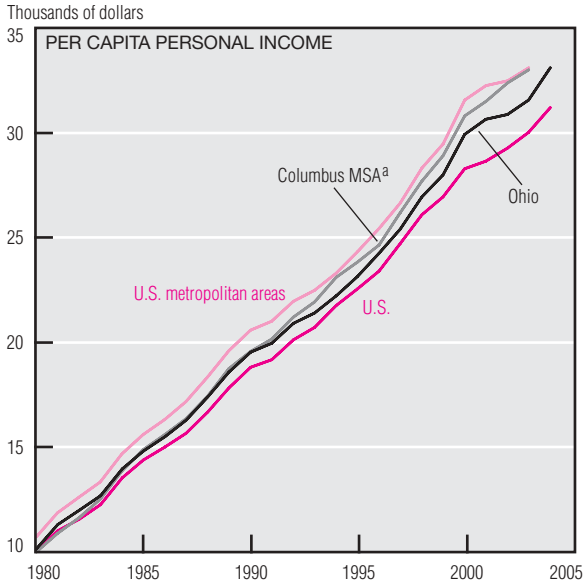
The Columbus Metropolitan Area *(cont.)*





Selected Demographics, 2000

	Columbus MSA[a]	Ohio	U.S.
Total population (millions)	1.5	11.4	281.4
Percent by race			
White	81.3	85.0	75.1
African American	13.4	11.5	12.3
Other	5.3	3.6	12.5
Percent by age			
0 to 19	28.4	28.2	28.5
20 to 34	23.7	19.8	20.8
35 to 64	37.8	38.7	38.3
65 or older	10.0	13.3	12.4
Percent with bachelor's degree or higher	29.1	21.1	24.4
Total population change (percent), 1990–2000	19.8	5.0	13.0
Median age	33.6	36.2	35.3



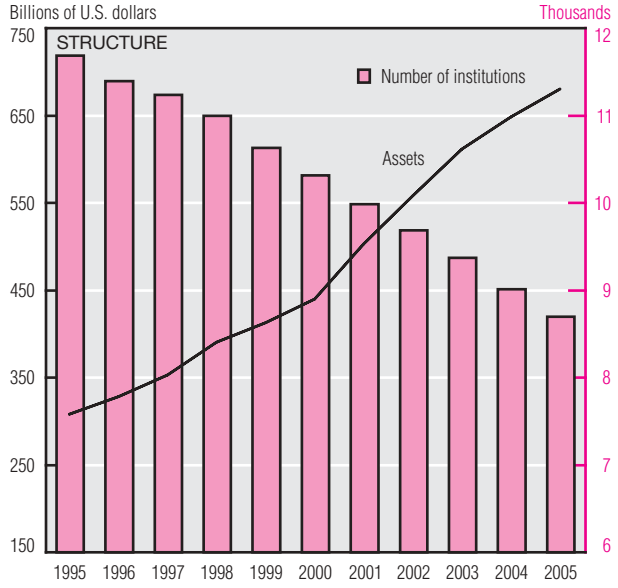
a. The Columbus, OH Metropolitan Statistical Area consists of Delaware, Fairfield, Franklin, Licking, Madison, Morrow, Pickaway, and Union counties.
b. Industrial and office vacancy rates for 2005:IVQ.
c. Rental vacancy rates for 2004.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Columbus Chamber of Commerce; and CB Richard Ellis.

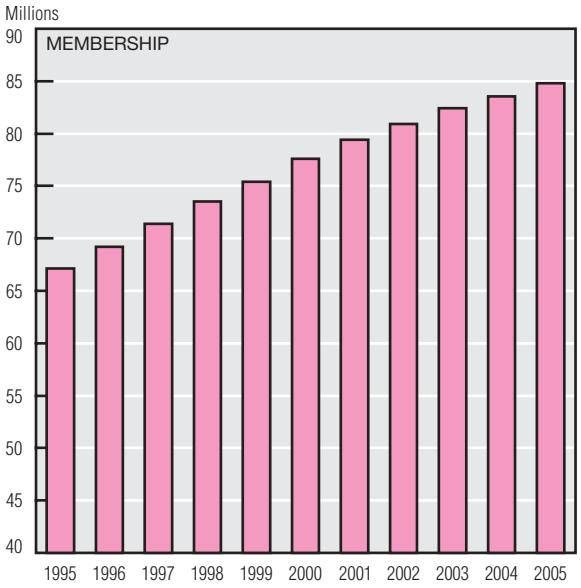
negatively to job growth in 2005 were manufacturing and retail and wholesale trade, which have been responsible for most of the area's job losses since 2001.

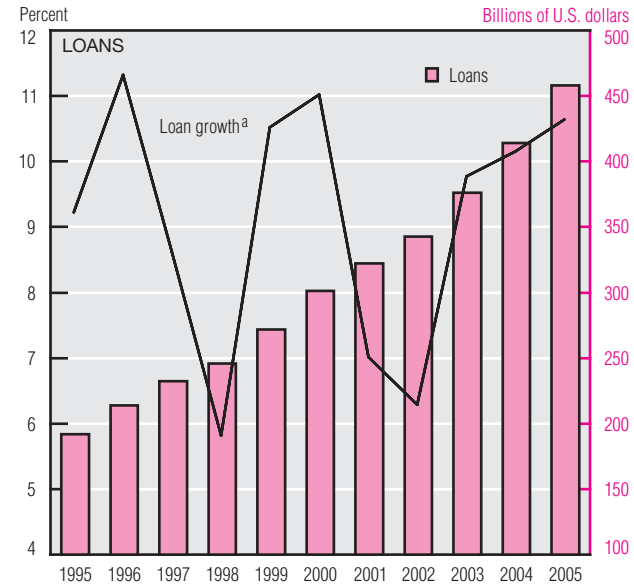
According to a group of Columbus-area economists, the metro area can expect the pace of local job gains to be lower than the national average again in 2006, to about the same extent as in 2005. As in recent years, manufacturing and retail and wholesale trade are expected to have a negative effect on the area's overall job growth. Although the forecast for construction in the metro area is positive, above-average vacancy rates are likely to limit job gains in the sector. Columbus' vacancy rates are about 1.5 times as high as the national average for office and industrial properties, and nearly twice as high for residential rental units.

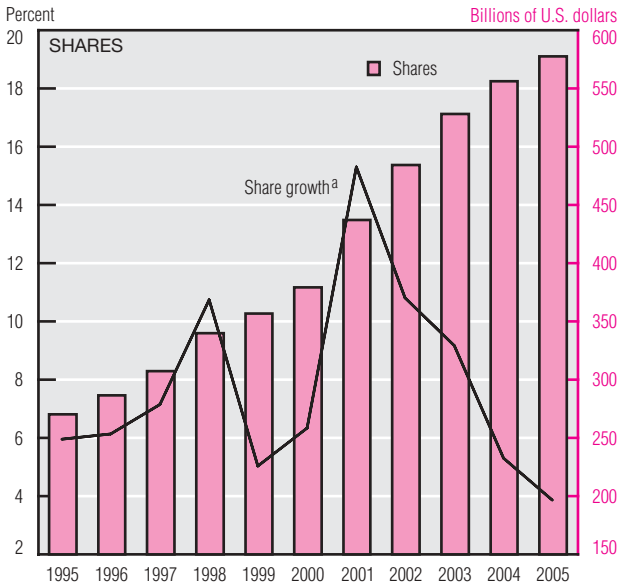
Between 1990 and 2000, the Columbus metro area enjoyed strong population gains, which put it among the fastest-growing cities in the nation. More recent estimates, however, suggest some slowing in its population growth. Like Ohio, Columbus has a higher proportion of white residents than the nation as a whole, as well as a significantly smaller share of non–African American minorities. The area's age profile tends to skew slightly younger, with a lower median age than in Ohio or the U.S. as a whole. Given Columbus' higher concentration of white-collar, service-sector jobs, it's not surprising that the population tends to be more highly educated. This translates into a per capita income that is greater than the state's or the nation's, but about average compared to other U.S. population centers.

Credit Unions









NOTE: Data are for federally insured credit unions.
a. Twelve-month growth rate.
SOURCE: National Credit Union Administration.

Credit unions are mutually organized depository institutions that provide financial services to their members. Like banks and savings associations, credit unions appear to be consolidating. Their numbers fell steadily from 11,687 in 1995 to 8,695 at the end of 2005. However, their total assets more than doubled over the same period from $306.6 billion to $678.7 billion. The number of credit union members also increased steadily from 67.1 million in 1995 to 84.8 million at the end of 2005.

Growth in credit unions' assets has been fueled by positive loan growth. From the end of 1995 to the end of 2005, loans increased from $192.1 billion to $458.3 billion; loans as a share of assets grew modestly over that period, rising from 62.7% to 67.5%. Year-over-year loan growth has varied between 5.8% and 11.3% over the past 10 years, with an average annual growth rate of 7.9%.

Shares in federally insured credit unions have also risen steadily since 1995. Shares, which are analogous to deposits in banks and savings associations, are the primary source of funds for credit unions, accounting for roughly 85% of total funds. Like loan growth, annual share growth has fluctuated between 3.8% and 15.3% for the past 10 years. Overall, shares grew at a robust 7.3% annual rate during this period.

Credit unions continued to accumulate capital, which increased from $31.6 billion at the end of 1995 to $75.3 billion at the end of 2005, a gain of more than 138%.

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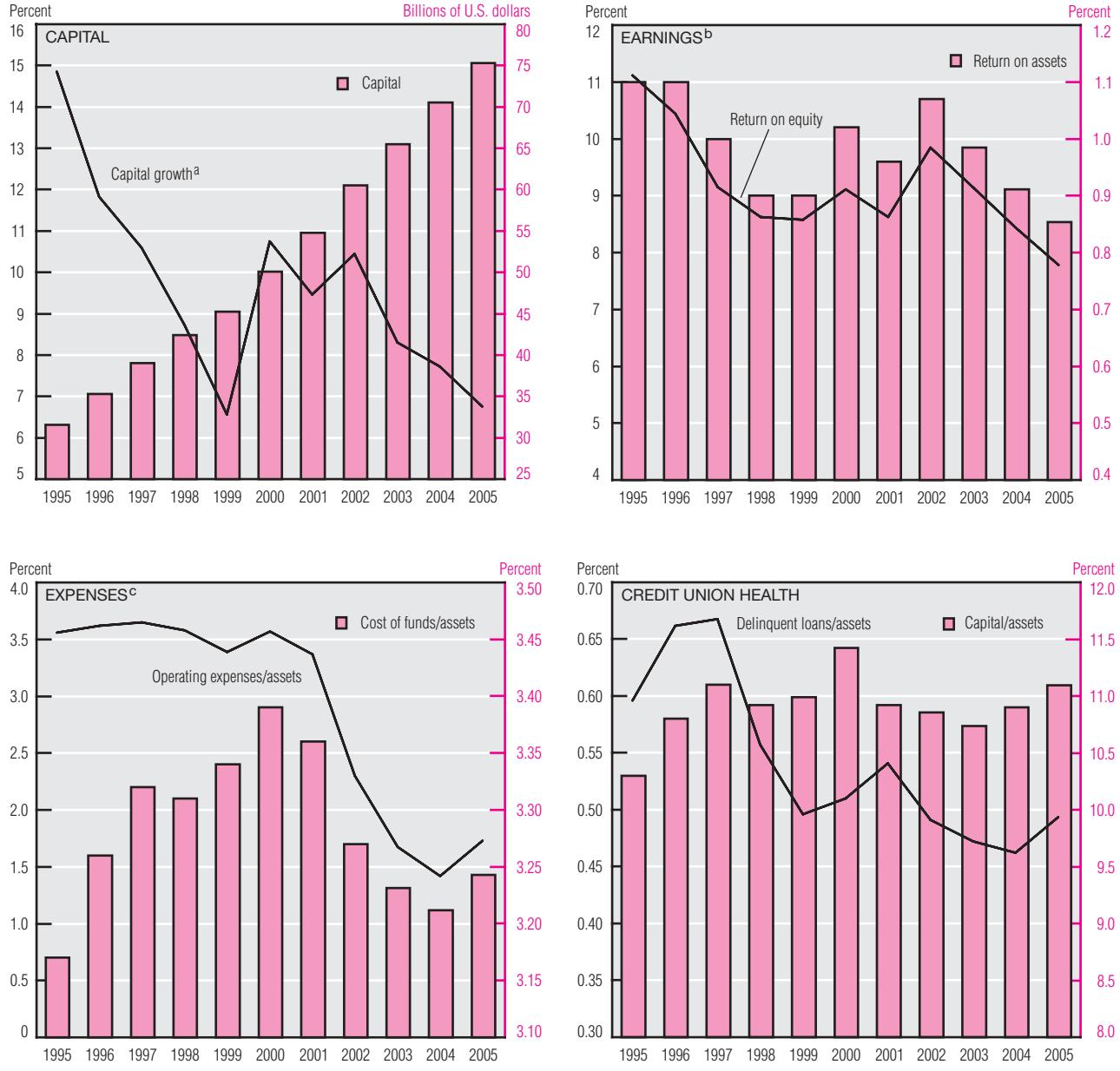
Credit Unions (cont.)



NOTE: Data are for federally insured credit unions.
a. Twelve-month growth rate.
b. Return on average assets; return on average equity.
c. All ratios are on average total assets.
SOURCE: National Credit Union Administration.

The increase in capital and the declining interest margins are responsible for the general downward trend in return on assets and return on equity since 1995. Return on assets fell from a high of 1.1% in 1995 to 0.9% in 1999, rebounded to 1.1% in 2002, then, at the end of 2005, fell back close to its 1999 level. Return on equity followed a similar pattern during the same period. Credit unions' decline in profitability over the second half of the 1990s resulted partly from a steady increase in operating expenses per dollar of assets and the relatively high cost of funds. The improvement in operating expenses since 2000 points to credit unions' increased efficiency, which is important for the industry's future viability. Declines in the cost of funds over the past five years have largely resulted from a low-interest-rate environment. That trend reversed in 2005.

Overall, the health of the credit union industry appears to be sound. Capital as a share of assets stood at 11.1% at the end of 2005. Delinquent loans as a share of assets fell from 0.67% in 1997 to 0.49% at the end of 2005. Moreover, at the end of 2005, credit unions held about $22.5 of capital for every $1 of delinquent loans. In short, credit unions remain a viable alternative to commercial banks and savings associations for basic depository institution services such as checking accounts, consumer loans, and savings accounts.