

The Economy in Perspective

by Mark Sniderman

We may reason on to our heart's content, the fog won't lift.

—Samuel Beckett, 1967

To better understand today's economic and policy environment, go back about 10 years. The stock market was running in high gear, but some market observers began to predict a major market correction, especially in the tech-sector-rich NASDAQ. In 1996, Alan Greenspan, then Federal Reserve Board chairman, made a widely quoted remark about irrational exuberance in the stock market. Eventually the market did collapse, the tech sector most spectacularly, but the years that elapsed between the initial warnings and the correction that began in April 2000 illustrate the difficulties of accurately predicting even seemingly obvious events.

Unlike the equity market crash, which was widely anticipated, the recession that began in March 2001 and lasted until November appeared to take nearly everyone by surprise, despite the now-obvious connection between these two developments. The Federal Reserve's industrial production index peaked in March 2000, coincident with the NASDAQ's zenith, but most forecasters expected the economy's growth rate to moderate to a pace that would be consistent with stable inflation.

For example, in the FOMC's mid-year Monetary Policy Report to the Congress of July 2000, most of the Federal Reserve governors and Reserve Bank presidents reported that they expected real GDP to expand in the range of 4 to 4½ percent in 2000; as it happened, real GDP advanced by 3.7 percent in 2000, short of the projection (but still within the confidence ranges of very good economic forecasters).

Seasoned forecasters continued struggling to keep up with the deterioration in economic conditions. Using the FOMC as an example again, in July 2000, the governors and presidents looked for growth to slow to a pace in the range of 3¼ to 3¾ percent in 2001. Six months later, in February 2001, they revised down their 2001 projection for real GDP to the range of 2 to 2½ percent. In July, the majority of the panel members downgraded their outlook once again, this time to the range of 1¼ to 2 percent. In hindsight, we know that the actual growth rate was 0.8 percent and that a recession was already underway at the time of the July report.

The Federal Reserve had been raising its federal funds rate target from mid-1999 to mid-2000 in the face of a strong economy and concerns about an intensification of inflationary pressures. The FOMC had maintained a 5 percent target from the start of 1999 until its June meeting, when it raised the target to 5¼ percent. The target gradually rose to 6 percent and, in May 2000, the Committee boosted it to 6½ percent. According to the minutes of that meeting, "[t]he members saw little risk in a relatively aggressive policy move, given the strong momentum of the expansion and widespread market expectations of such a move. The greater risk to the economic expansion at this point was for policy to be too sluggish in adjusting, thereby allowing inflationary disturbances and dislocations to build..." The funds rate target remained at 6½ percent until the FOMC conferred by telephone on January 3, 2001, and agreed to cut the rate by 50 basis points. A year later the rate stood at 1¾ percent; it would eventually bottom out at 1 percent and remain there for a considerable time.

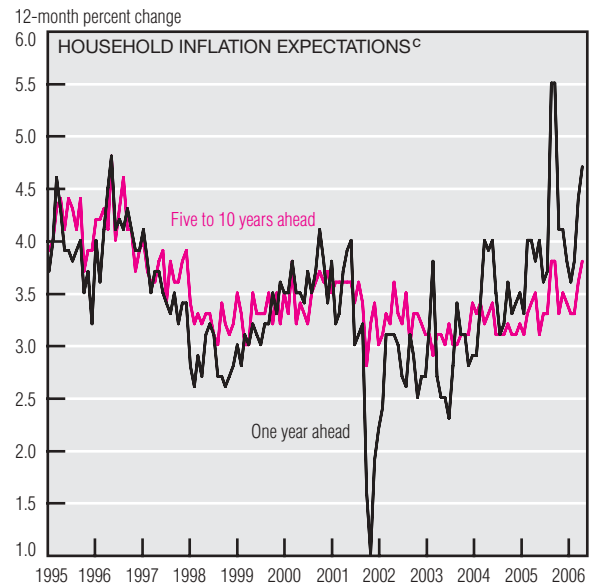
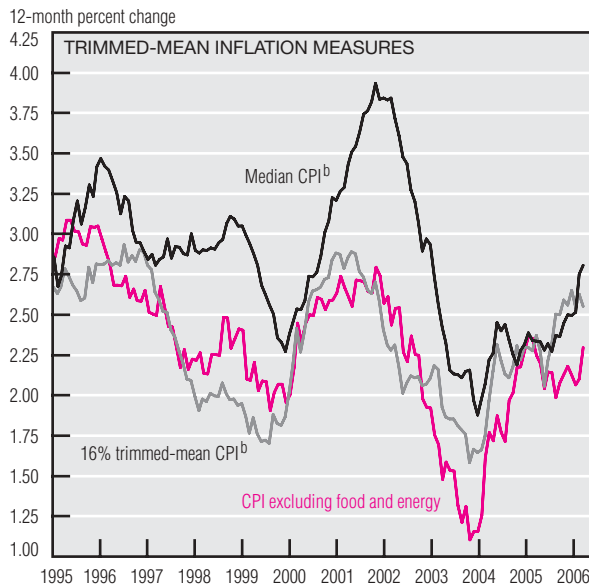
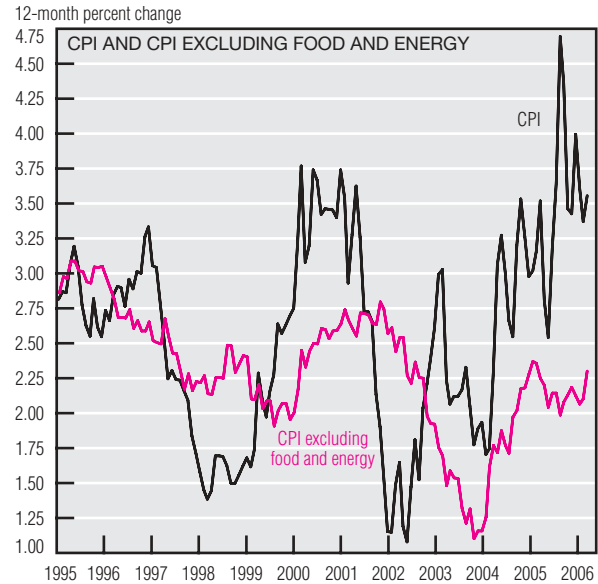
The point is not to cast aspersions on the Federal Reserve's economic projections, for academic studies indicate that the FOMC has access to the best forecasts available. Moreover, the record clearly shows that the FOMC was right to regard inflation as a serious threat to the economy. Despite the FOMC's strenuous actions to contain inflation and inflation expectations, the CPI minus food and energy (the core CPI) increased by 2¾ percent in 2000 and 2001, even higher than the year-over-year readings of the core CPI that have been so disconcerting recently.

It would be easy today to say that the FOMC would not have followed as restrictive a course of action if it had known then what we know now, but it would also be vacuous to say so. The recession, which was relatively brief and shallow, might well have come anyway, and inflation might not have been subdued. There are no certainties when it comes to positing alternative futures. Our recent history reminds us, if we need reminding, that even as policymakers become more transparent, the world they contend with is still shrouded in fog.

Inflation and Prices

April Price Statistics

	Percent change, last:				2005 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	7.5	4.1	3.6	2.6	3.6
Less food and energy	3.6	3.2	2.3	2.1	2.2
Median ^b	3.3	3.9	2.8	2.7	2.5
Producer prices					
Finished goods	11.9	0.3	4.0	2.5	5.8
Less food and energy	1.5	2.0	1.5	1.1	1.7



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

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

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

Inflation pressures remained elevated in April. The Consumer Price Index (CPI) rose 7.5% (annualized rate) in April, accelerating from its three- and 12-month trends. Likewise, the CPI excluding food and energy, which jumped 4.2% in March, rose 3.6% in April, while the median CPI, which surged 5.0% in March, rose 3.3%. Monthly growth in both of these core retail price measures exceeded their longer-term growth trend.

Even longer-term growth in the inflation measures seems to be on the rise. The 12-month growth rate of the

CPI excluding food and energy (2.3%) was a bit above the 2%–2¹/₄% range in which it has fluctuated for about a year. The 12-month growth rate for the 16% trimmed-mean CPI was 2.5%, while the median CPI reached 2.8%. Growth in the core retail price measures is roughly ¹/₄ percentage point above the late-2005 levels.

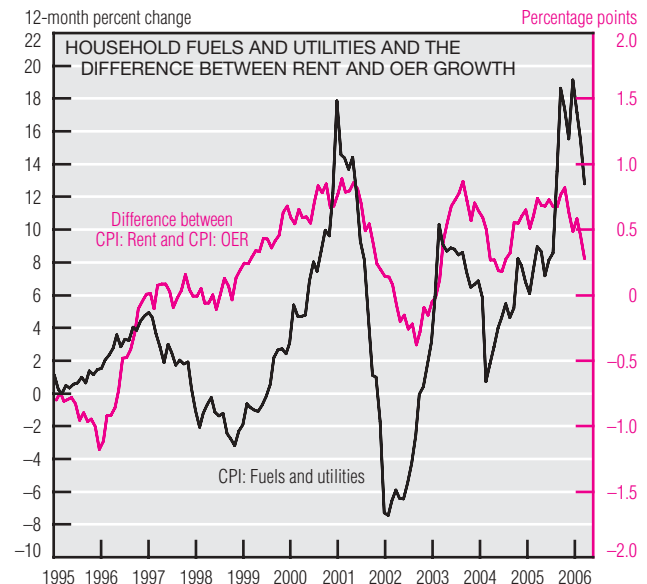
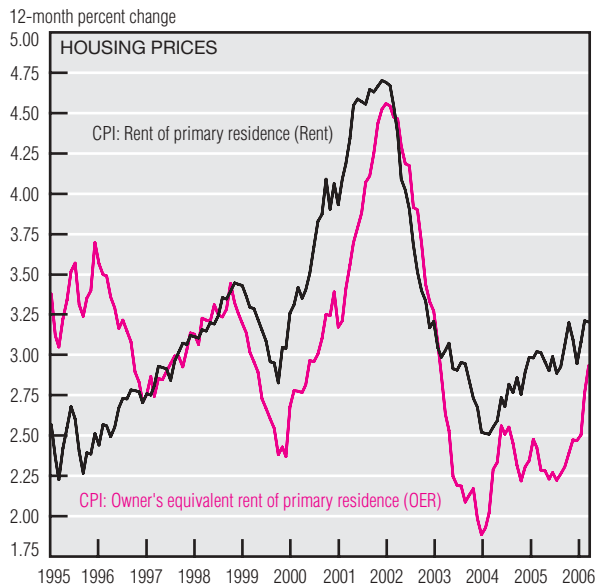
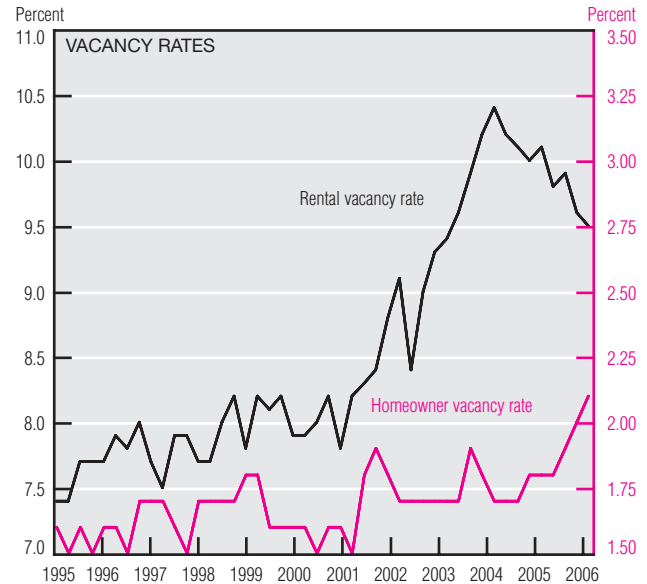
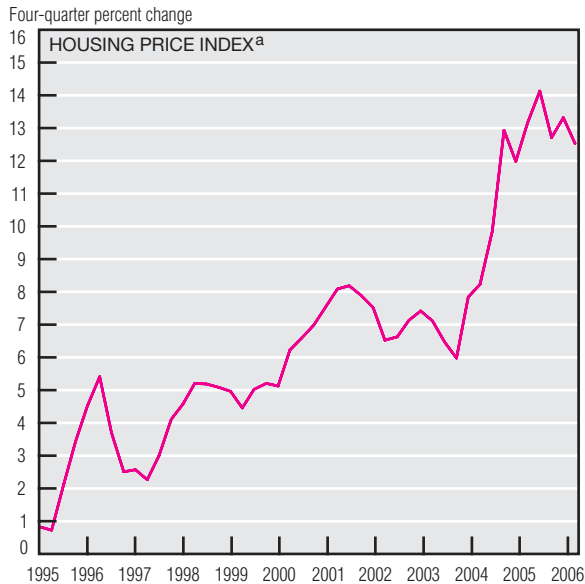
Accompanying the upward tilt in the inflation measures, household inflation expectations for the year ahead jumped to their highest level (4.7%) in a decade (excluding the months following Hurricane Katrina),

while long-term inflation expectations inched upward to 3.8%, a little above the 3%–3¹/₂% range in which longer-term inflation expectations generally have been fluctuating for nearly a decade.

The stepped-up pace of retail price increases seems to have been broad-based: More than half of the index's components have shown persistent annualized monthly increases of 3% or more. Still, one particular component of the CPI has received considerable scrutiny in recent months. The owner's equivalent rent of primary

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Inflation and Prices (cont.)



a. Calculated by the Office of Federal Housing Enterprise Oversight.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; and Office of Federal Housing Enterprise Oversight.

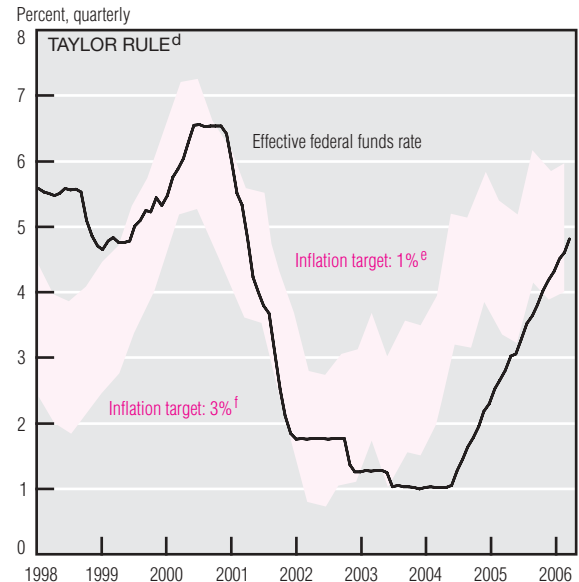
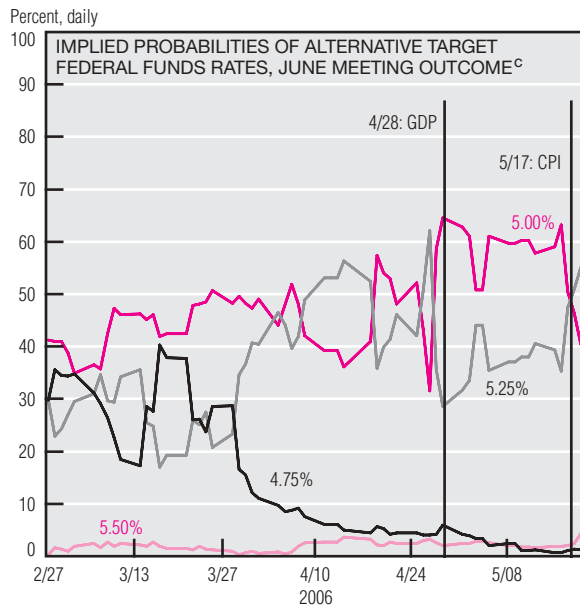
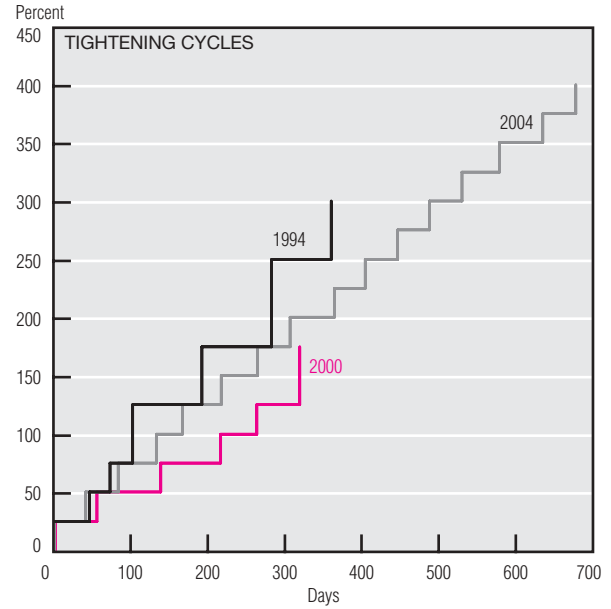
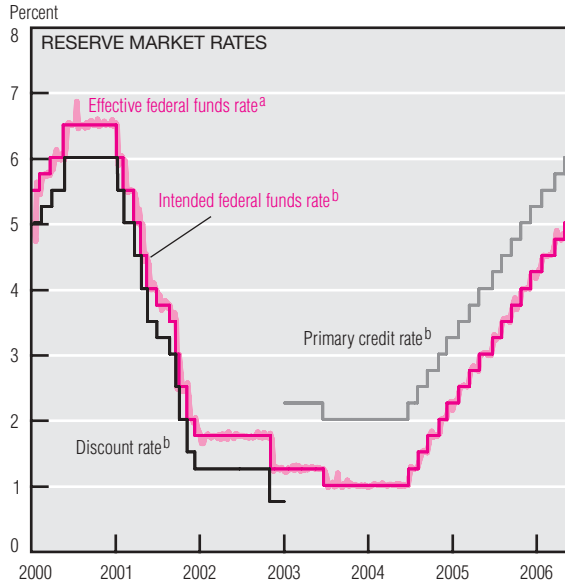
residence (OER)—the opportunity cost a homeowner assumes by occupying their home rather than renting it out—is responsible for nearly one-quarter of the CPI market basket, and monthly growth in OER has been brisk since the beginning of this year. There has been speculation that the OER had been understating inflationary pressures because it is computed using prices from rental markets that may have been temporarily restrained by the boom in homeownership. Indeed, the 12-month growth rate in housing

prices peaked around 14% in 2005:IIQ, and rental vacancy rates, at nearly 10%, are just short of their 50-year peak. A cooling housing market, accompanied by some reduction in rental vacancy rates, may be helping to propel the OER measure higher this year.

Another factor may also be at work: Because residential leases often include utilities provided by the landlord, the Bureau of Labor Statistics subtracts these utility costs from rents when calculating OER. During periods of rising energy prices, the

growth in OER may be understated until these higher energy costs are reflected in higher rents. So some of the recent upward pressure on the OER may be due to landlords incorporating the persistent rise of energy costs into their rental contracts. Those effects may have been exacerbated recently: Utility price growth has slowed a little (from 19% to about 13% on a year-over-year basis since the beginning of 2006), which means the net rental computation in the OER has been smaller this year than in late 2005.

Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. Probabilities are calculated using trading-day closing prices from options on June 2006 federal funds futures that trade on the Chicago Board of Trade.

d. The formula for the implied funds rate is taken from the 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.

e. This line assumes an interest rate of 2.5% and inflation target of 1%.

f. This line assumes an interest rate of 1.5% and an inflation target of 3%.

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

On May 10, the Federal Open Market Committee (FOMC) voted to raise the intended federal funds rate 25 basis points (bp) to 5.00%. That move brought the rate within 150 bp of its most recent high, 6.50%, reached at the last business cycle peak in May 2000. Although the May 2006 press release stated that "some further policy firming may yet be needed," it emphasized that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information."

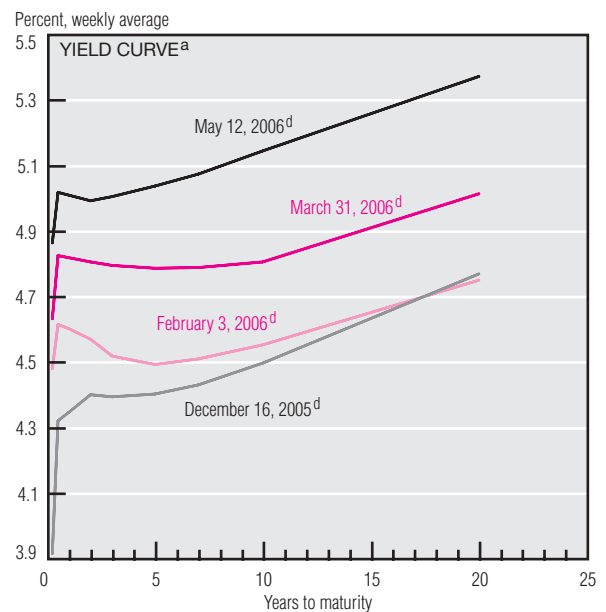
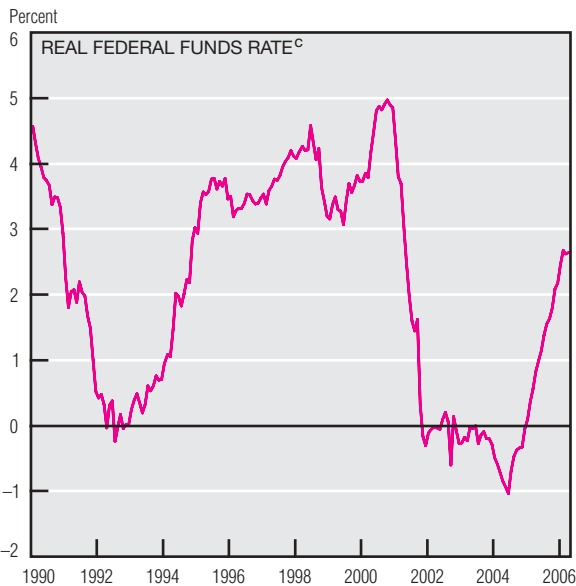
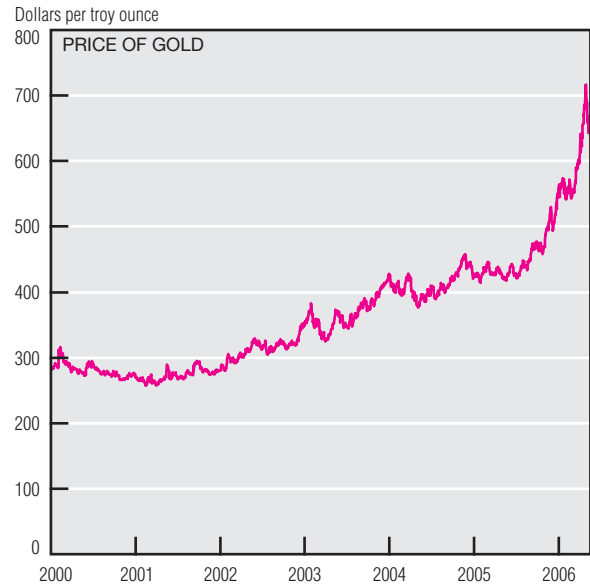
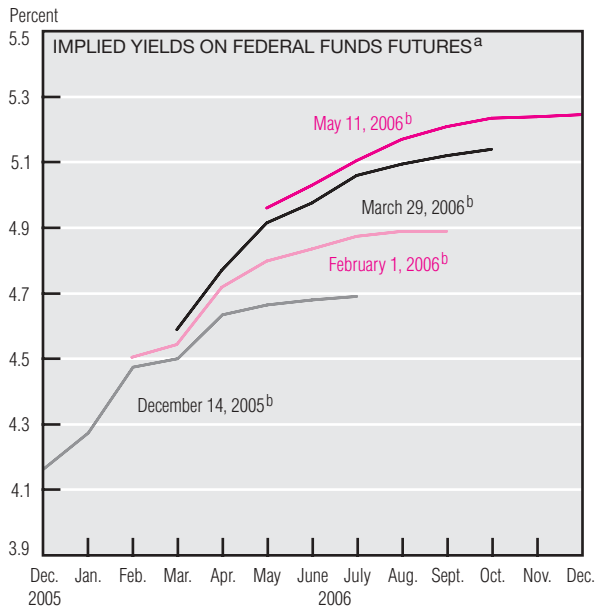
The May meeting marked the sixteenth consecutive increase of 25 bp by the FOMC, raising the fed funds rate a total of 400 bp from its low of 1% in June 2004. Although this tightening cycle has brought a larger total increase than the previous two, it has also lasted much longer (679 days). In comparison, the 2000 tightening cycle brought a rise of 175 bp over 321 days, and the 1994 cycle increased the target 300 bp over 362 days.

Since the beginning of April, the expected outcome of the June meeting has alternated between 5.00%

and 5.25%. After the GDP report on April 28, participants in the federal funds options market seemed to settle on a 60% probability of a pause at the next meeting. However, the CPI report released on May 17 sparked fears of inflation and another 25 bp increase in the fed funds rate. Currently, the odds of a further rate increase are 55%.

The Taylor rule views the federal funds rate as reacting to a weighted average of inflation, target inflation, and economic growth. According to
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Monetary Policy (cont.)



- a. All yields are from the constant-maturity series.
 b. One day after the FOMC meeting.
 c. Defined as the effective federal funds rate deflated by the core PCE.
 d. The Friday after the FOMC meeting.

SOURCES: 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.

this equation, the current federal funds rate is well within its recommended range.

Consistent with the options data, participants in the federal funds futures market expect that the FOMC will pause soon and that rates will reach a plateau near 5.25%, remaining there through the end of the year. However, after the December 2005 meeting, participants were expecting rates to be between 4.50% and 4.75%. Given that the federal funds futures market has recently been underpredicting rates, the 5.00% estimate for the rest of 2006 may be a bit

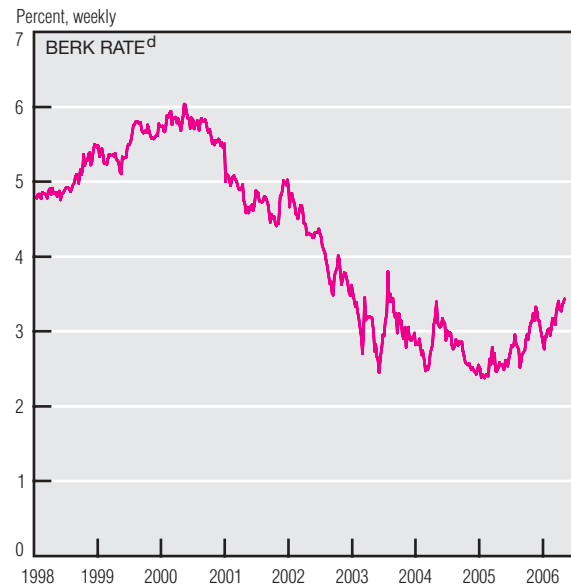
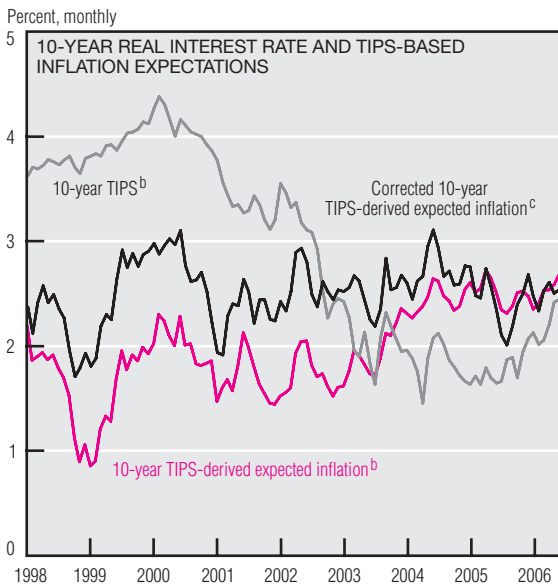
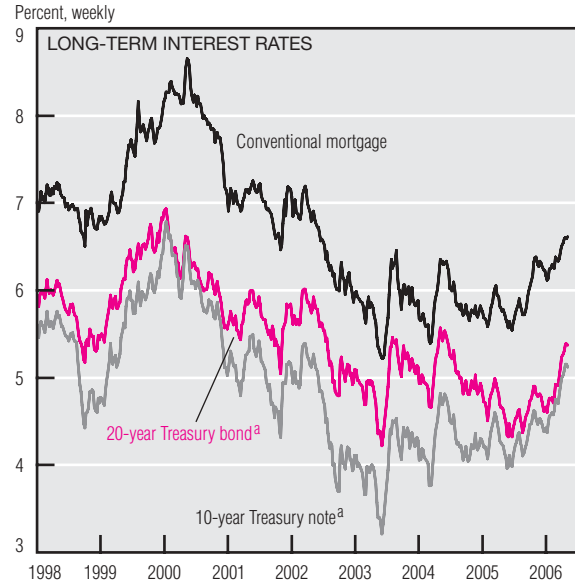
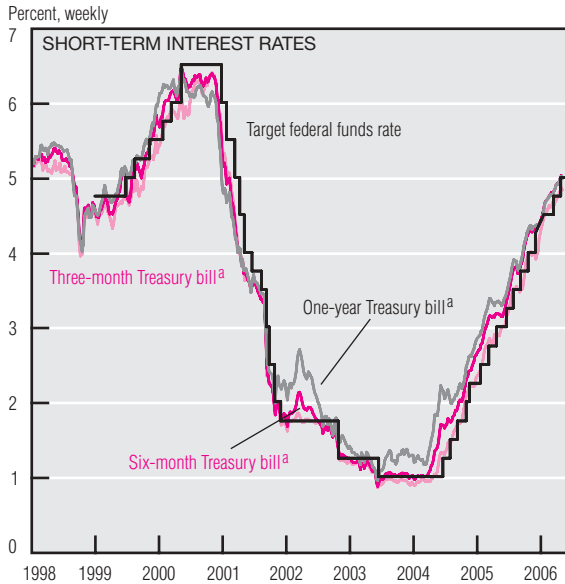
low, especially considering the most recent inflation report.

After increasing slowly but steadily for more than four years, the price per ounce of gold has jumped an astonishing 150% since August 2005. Historically, the price of gold has tended to increase with inflationary expectations, so its recent leap has caused some to wonder how much higher the FOMC may have to raise rates. Although the nominal federal funds rate has increased in an effort to curb any inflationary pressures, the inflation-adjusted federal funds rate has also continued to rise and

now stands 365 bp above its recent low of -1.07% in June 2004.

After a period earlier this year, when parts of the Treasury yield curve were inverted, the curve has returned to normal, with long-term rates once again higher than shorter-term rates. On the Friday after the FOMC's May 10 meeting, the spread between the 10-year Treasury bond and the two-year Treasury note was 15 bp, compared to -1.6 bp after the February meeting. Although positive again, the spread remains below its historical average of 74 bp.

Money and Financial Markets



a. Yields from constant-maturity series.

b. Treasury inflation-protected securities.

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

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

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

The inversion of the yield curve observed earlier this year has nearly disappeared. The curve remains mildly inverted only for maturities in the range of six months through two years. The two-year Treasury rate currently is just 2.6 bp below the six-month rate. Short-term rates have moved in step with federal funds rate increases. Since the current round of policy tightening began in June 2004, Treasury rates have moved up more than 330 bp at the short end of the maturity spectrum. Long-term Treasury yields increased more than 30 bp from the beginning of April,

resulting in a noticeable steepening at the long end of the yield curve. The 20-year Treasury rate rose to 5.37% (the highest level in almost two years), while the 10-year rate reached 5.14% (the highest in almost four years.)

Inflation expectations continue to be contained, as indicated by the difference between the yield on 10-year Treasury bonds and the yield on Treasury inflation-protected securities (TIPS) of the same maturity. This difference, adjusted for the liquidity premium on the TIPS market versus the ordinary Treasuries market, was close to 2.5% in May, about in line

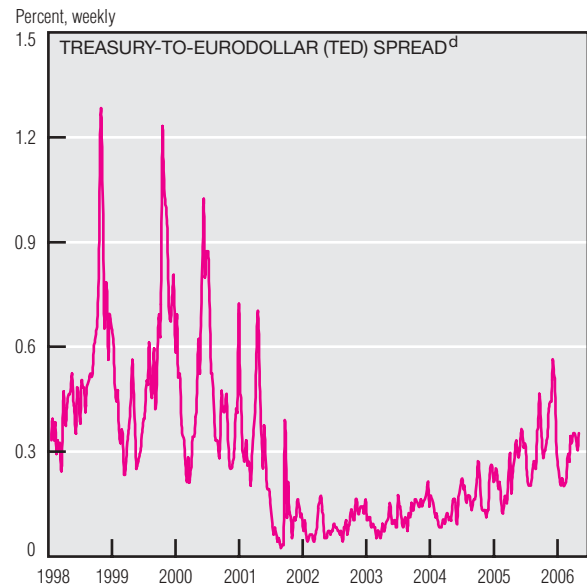
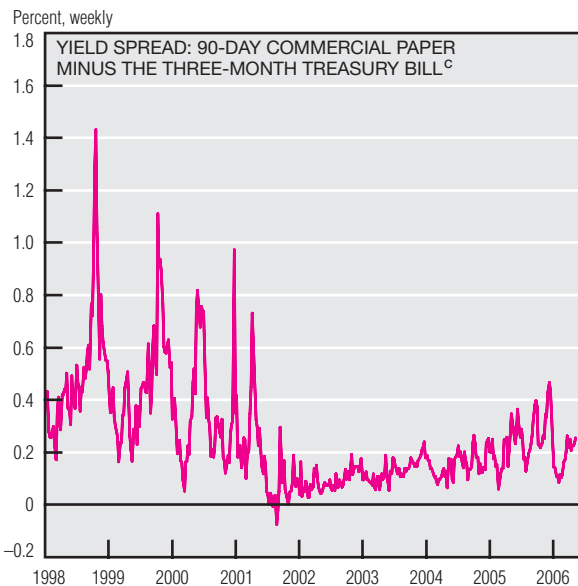
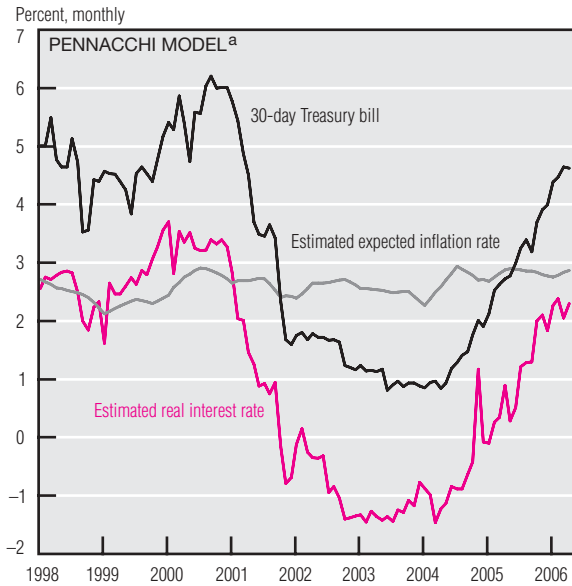
with its level for the past 18 months and thus consistent with the FOMC's statement that "inflation expectations remain contained."

The real rate, as measured by TIPS, was about 32 bp higher than at the end of 2005. An alternative measure of the real rate, the Berk rate, which adjusts for the firm's ability to delay investment, showed a similar pattern; it was about 40 bp higher than it was at the end of 2005.

Whereas the real and expected inflation rates derived from TIPS are used to estimate long-term rates,

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Money and Financial Markets (cont.)



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

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

c. All yields are from constant-maturity series.

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

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

expectations regarding shorter-term real inflation rates can be gauged by combining 30-day T-bill rates with survey measures of inflation. The one-month measure, originally developed by George Pennacchi, has risen recently; however, at 2.84% in April 2006, it was still in the 2.0%–3.0% band it has occupied since 1998.

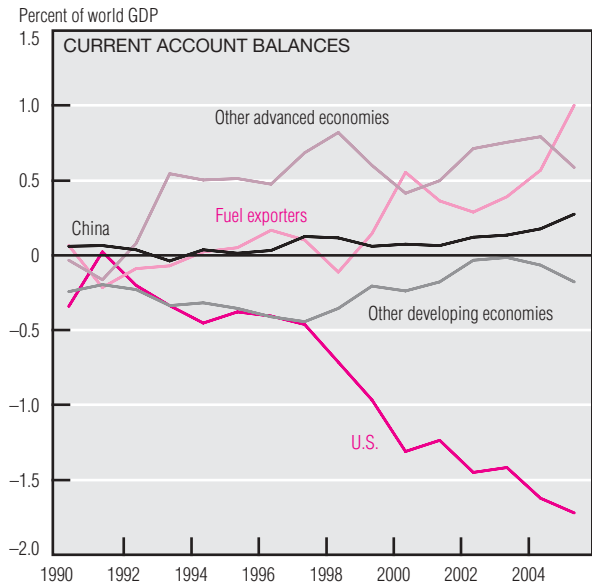
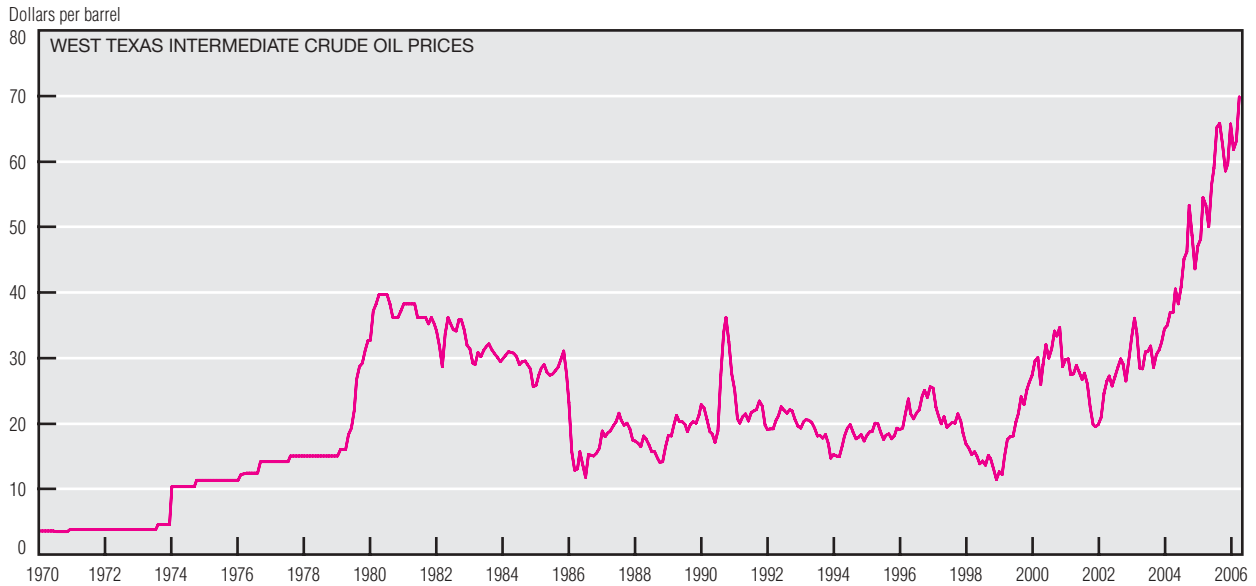
In addition to spreads between bonds of different maturities, or between real and nominal bonds, we can gather useful information from the spread between safe and risky

bonds. Such spreads have generally been creeping up for 18 months but have remained stable if not slightly down since the beginning of 2006. Spreads between BBB corporate bonds and 10-year Treasuries dropped from 125 bp in January to 119 bp in mid-May, while spreads between AA corporate bonds and 10-year Treasuries were nearly unchanged (79 bp).

The more volatile short spread between 90-day commercial paper and three-month T-bills was 25 bp in the middle of May, close to the 23 bp

level of early January. Another closely watched risk spread is that between three-month Eurodollar deposits and the three-month T-bill rate (the TED spread). As the difference between two dollar-denominated interest rates based in different countries, it measures international financial risk while avoiding exchange rate uncertainty. Although the TED spread trended up in 2005, reaching 56 bp at year's end, it is now at the 35 bp level, suggesting that the peak of market uneasiness about international conditions is past.

Petrodollars



SOURCES: International Monetary Fund, "Globalization and Inflation," *World Economic Outlook*, April 2006, pp. 71–96; the *Wall Street Journal*, the *Economist*, April 22, 2006, p. 74; and Haver Analytics.

The price of oil has risen fairly steadily, from \$20 per barrel in 2002 to \$60–\$70 this year. Although oil prices are setting new records, the real price of a barrel of oil—the price after stripping out the effects of inflation—remains well below the record reached in late 1979. This inflation adjustment, together with greater energy efficiency, helps to explain why the recent round of energy-price hikes has not hit oil importers as severely as in the late 1970s and early 1980s.

Nevertheless, higher oil prices and a rising, price-insensitive demand for crude have recently increased the real export revenues of oil-producing countries more sharply than at any time in the past, according to International Monetary Fund (IMF) estimates. Real export revenues reached \$763 billion last year, more than double the revenues just three years earlier. How the oil-exporting countries recycle their petrodollars—oil is priced and traded in U.S. dollars—can

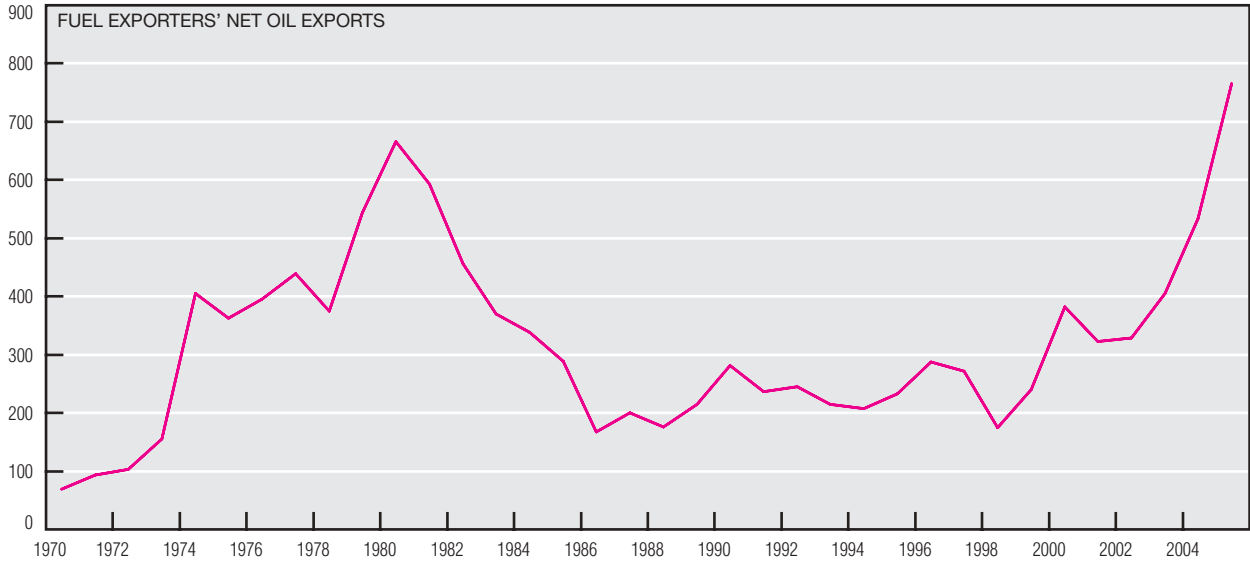
have important implications for how the world adjusts to oil-price shocks.

Oil-exporting countries are spending a smaller share of their export revenues on imports than before, even though a much larger portion of the current oil-price run-up may prove to be permanent. For example, the IMF estimates that OPEC is currently spending 24% of each additional oil dollar, compared with 42% between 1978 and 1981, and 52% between 1973 and 1975. Moreover,

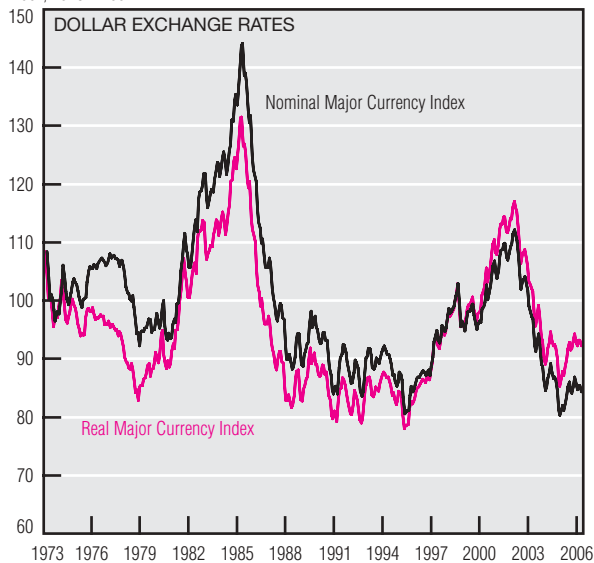
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Petrodollars (cont.)

Billions of 2005 U.S. dollars



Index, 1973 = 100



Percent



SOURCES: Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; International Monetary Fund, "Globalization and Inflation," *World Economic Outlook*, April 2006, pp. 71–96; the *Economist*, April 22, 2006, p. 74; and Haver Analytics.

oil producers are currently buying a smaller share of their overall foreign imports from the U.S. than in 1981. In 2004, oil exporters obtained approximately 8.4% of their merchandise imports from the U.S., which is not such a bad thing from the oil exporters' perspective. Usefully spending this large amount in a short time is difficult, but it also implies that oil-importing countries—particularly the U.S.—will experience larger current account deficits than in the past. The IMF estimates that over the past two years, higher oil prices have

accounted for approximately half of the deterioration in the U.S. current account position.

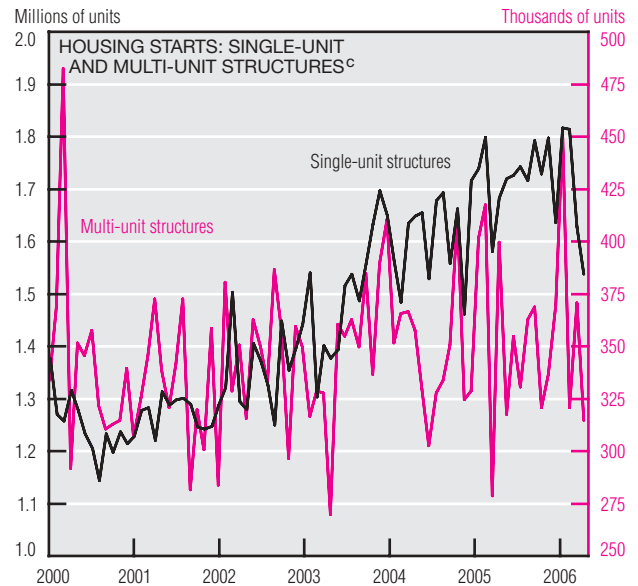
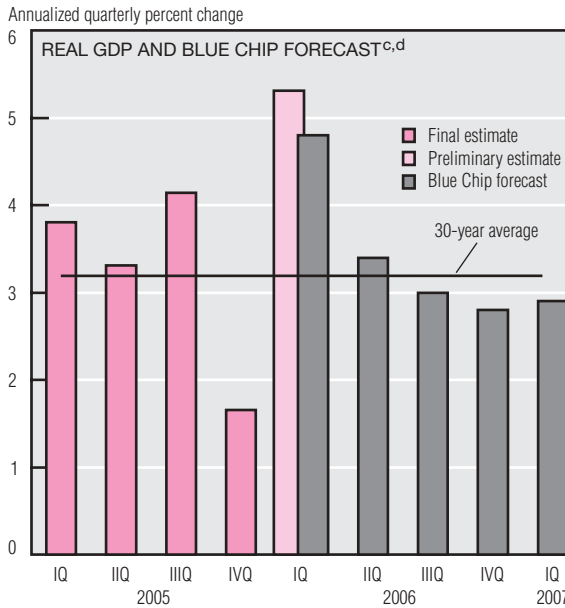
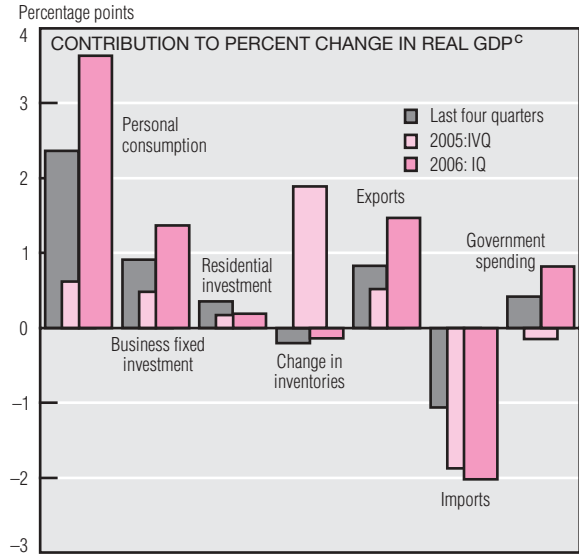
Instead of spending their revenues, oil producers are saving them. Petrodollars have moved directly and indirectly into the U.S. securities markets. (During the 1970s and early 1980s, oil exporters re-channeled a larger proportion of their unspent revenues in the form of bank loans.) The inflow of oil revenues has helped to finance our growing current account deficit without significantly higher interest rates in the United

States or a sharp depreciation of the dollar. The IMF estimates that the flow of petrodollars into the U.S. bond market could recently have shaved—at most—one-third of a percentage point off of 10-year Treasury bond yields.

While inflows of petrodollars may ease the financing of our current account deficits, they cannot maintain a fundamentally unsustainable situation indefinitely. Petrodollars merely delay and prolong the adjustment process.

Economic Activity

Real GDP and Components, 2006:IQ ^{a,b} (Preliminary estimate)	Change, billions of 2000 \$	Annualized percent change	
		Current quarter	Four quarters
Real GDP	146.4	5.3	3.6
Personal consumption	101.3	5.2	3.4
Durables	53.4	20.5	4.3
Nondurables	32.8	5.7	4.5
Services	25.0	2.2	2.6
Business fixed investment	41.3	13.1	8.7
Equipment	35.4	13.8	10.0
Structures	7.0	11.4	4.8
Residential investment	4.6	3.0	5.9
Government spending	21.1	4.3	2.2
National defense	11.3	9.5	3.3
Net exports	-14.7	—	—
Exports	42.6	14.7	8.1
Imports	57.2	12.8	6.6
Change in business inventories	-5.6	—	—



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*, May 10, 2005.

Real GDP increased at an annual rate of 5.3% in 2006:IQ, according to the preliminary estimate released by the Commerce Department. This was 0.5 percentage point (pp) higher than the advance estimate of 4.8%. The upward revision resulted primarily from stronger exports and an increase in private inventory investment, which was partly offset by a downward revision to personal consumption expenditures. In 2005:IVQ, real GDP increased 1.7%.

Compared to the previous quarter, most components made significantly higher contributions to the change in

real GDP in 2006:IQ. Personal consumption expenditures contributed 3.6 pp in 2006:IQ, compared to only 0.6 pp in 2005:IVQ. Exports added 1.0 pp more, bringing that component's total contribution to 1.5 pp. The exception was changes in private inventories, which subtracted 0.1 pp in 2006:IQ after adding 1.9 pp the previous quarter.

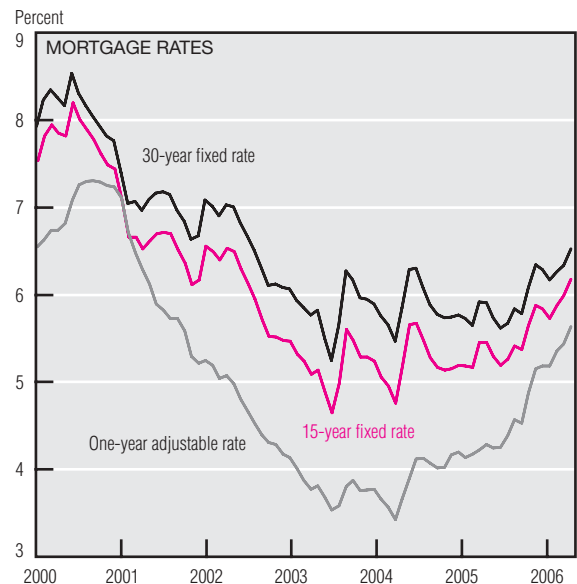
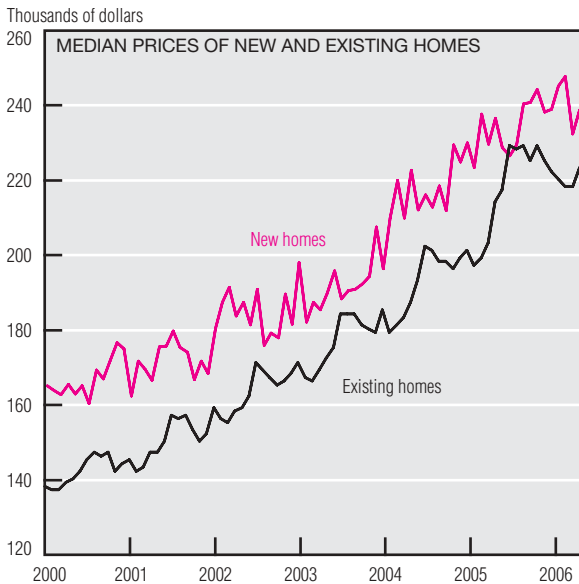
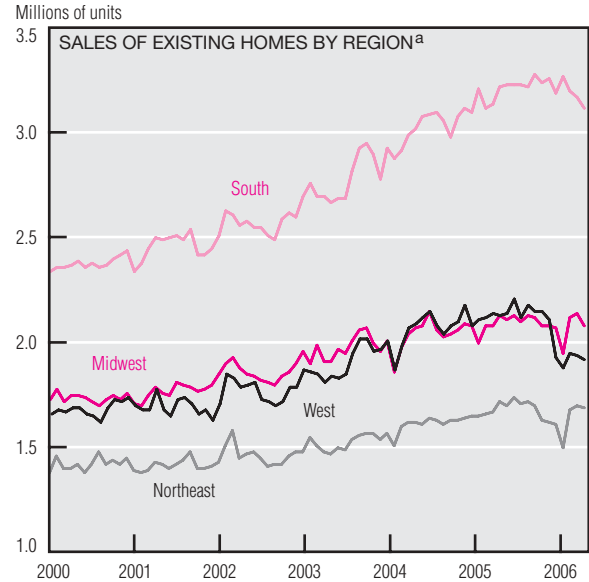
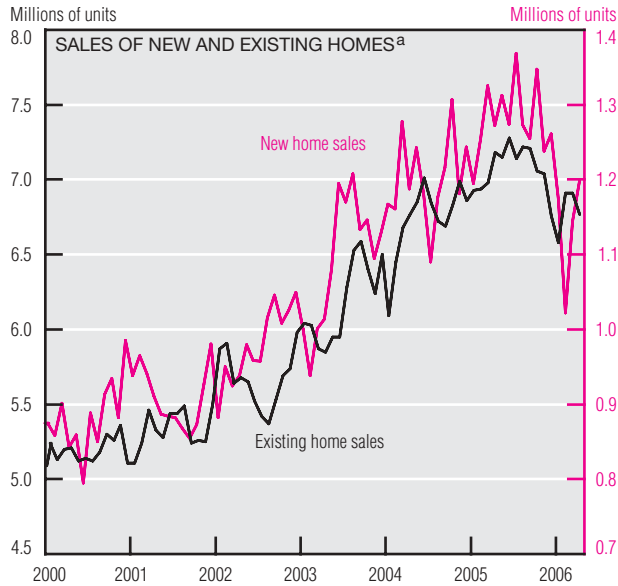
GDP growth has topped 5.0% only twice since the beginning of 2000. During that time, GDP averaged 2.7%. Growth in 2006:IQ was 2.6 pp above that average and 2.1 pp above the 30-year average of 3.2%. However,

in their April and May publications, Blue Chip forecasters predicted that growth will slow in the remaining three quarters of 2006 to 3.4%, 3.0%, and 2.8%.

The housing market is often seen as an early warning signal for the economy. In this context, the sharp fall in housing starts since the start of the year is disconcerting. Following 6% declines in both February and March, housing starts fell a further 7.4% in April to the lowest level since November 2004. Single-unit starts, which accounted for 83% of total

(continued on next page)

Economic Activity (cont.)



a. Data are seasonally adjusted and annualized.

SOURCES: U.S. Department of Commerce, Bureau of the Census; Federal Home Loan Mortgage Corporation; and National Association of Realtors.

starts, also reached a 17-month low. The volatile multi-unit starts dropped 15% in April, but they remained within 32,000 of the five-year average of 346,000 units.

April starts were down 18.4% from January, with single-family dwellings down 15.4% and multiple-unit structures down 30.4%. Although mild weather has been credited with the large number of starts in January, it is difficult to imagine that all of the subsequent fall is catch-up after the strong January figures.

New home sales for April recovered to their January level, having

dropped considerably in February. Existing home sales in April were down 7% relative to August 2005 and were at roughly the same level as in December 2005. The South has been the big contributor to the run-up in sales of existing homes since 2000. The more recent fall-off in existing home sales came in the South and West, with the Midwest and Northeast holding fairly steady.

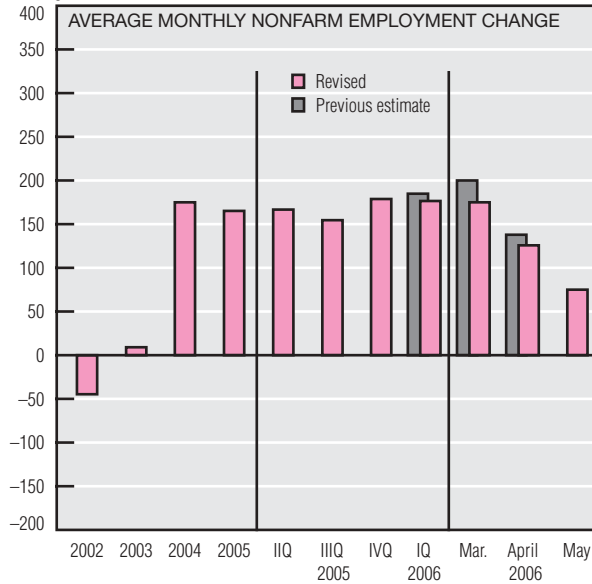
Since 2000, home prices have trended up. Some of the surprising numbers for new home sales in April came from the rise in prices relative to March, along with increasing

sales. Prices of existing homes also rose in April, despite a drop in the number of units sold.

Over the past couple of years, mortgage rates have gradually crept up. In April, a typical 30-year fixed rate mortgage was 6.51%, up from 5.89% a year earlier. The 15-year fixed rate also rose, to 6.16% from 5.44% a year earlier. The one-year adjustable rate rose more rapidly; it stood at 5.62% in April, up from 4.27% a year earlier. These higher mortgage rates may be behind the flattening in home sales as well as the deceleration in home-price appreciation.

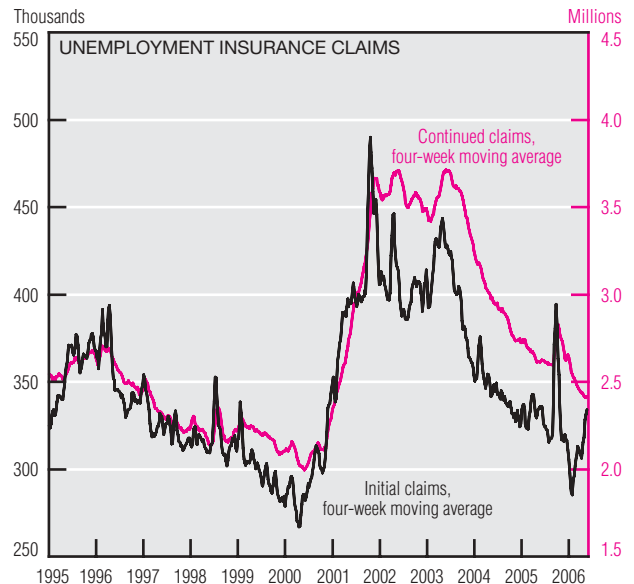
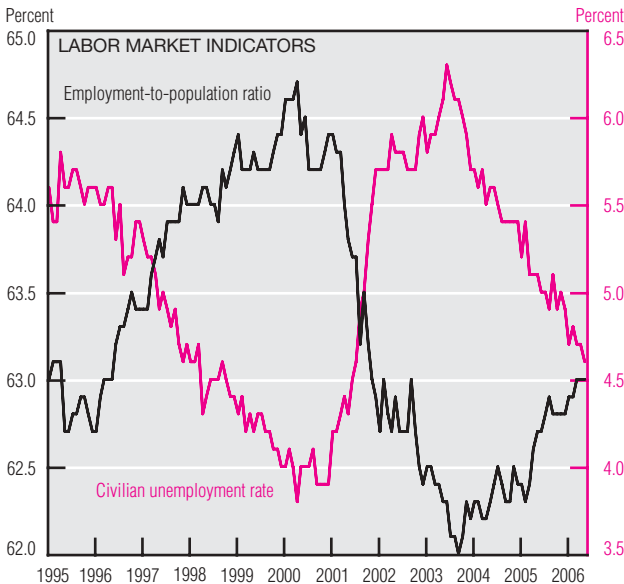
Labor Markets

Change, thousands of workers



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2003	2004	2005	Jan.- Apr. 2006	May 2006
Payroll employment	9	175	165	164	75
Goods producing	-42	28	22	36	-10
Construction	10	26	25	24	1
Manufacturing	-51	0	-6	6	-14
Durable goods	-32	9	1	12	-9
Nondurable goods	-19	-9	-7	-6	-5
Service providing	51	147	143	128	85
Retail trade	-4	17	13	-9	-27
Financial activities ^a	7	8	12	22	12
PBS ^b	23	40	41	24	27
Temporary help svcs.	12	13	14	-7	-3
Education & health svcs.	30	33	31	38	41
Information	-11	-6	-1	1	-13
Government	-4	13	14	8	8
	Average for period (percent)				
Civilian unemployment rate	6.0	5.5	5.1	4.7	4.6



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.

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

Nonfarm payroll growth was 75,000 in May, the third straight month it slowed. Net job gains in March and April were revised down a combined 37,000, to 175,000 and 126,000, respectively.

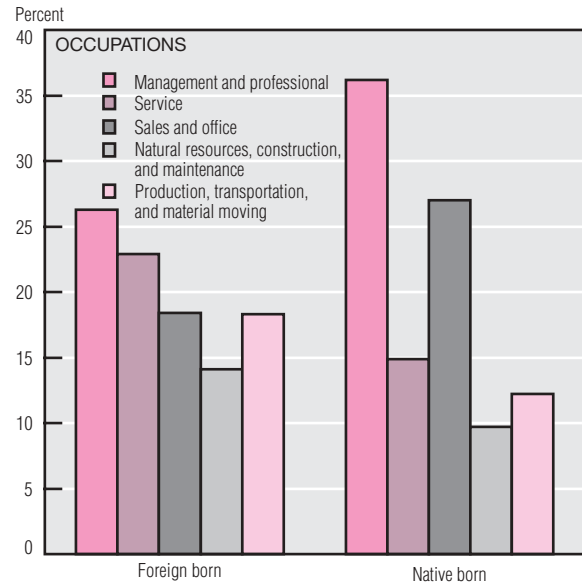
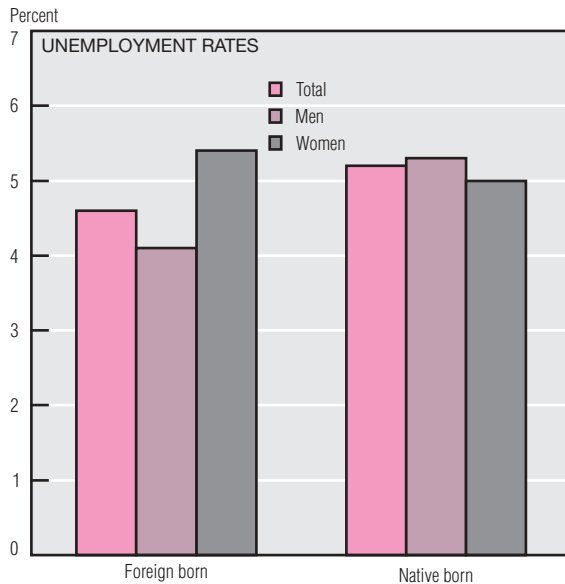
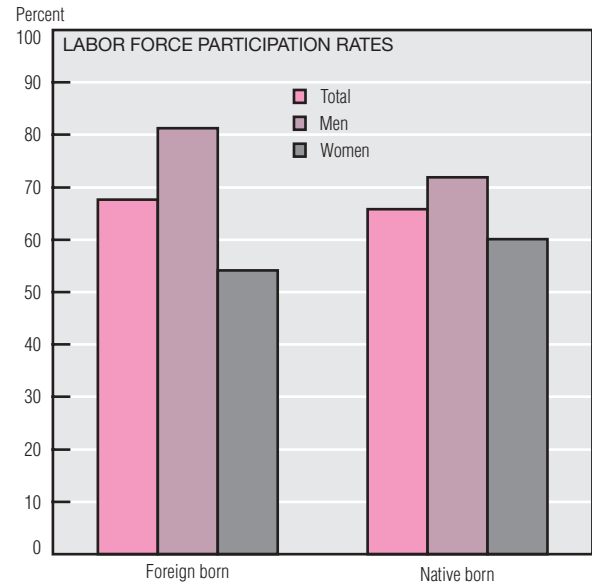
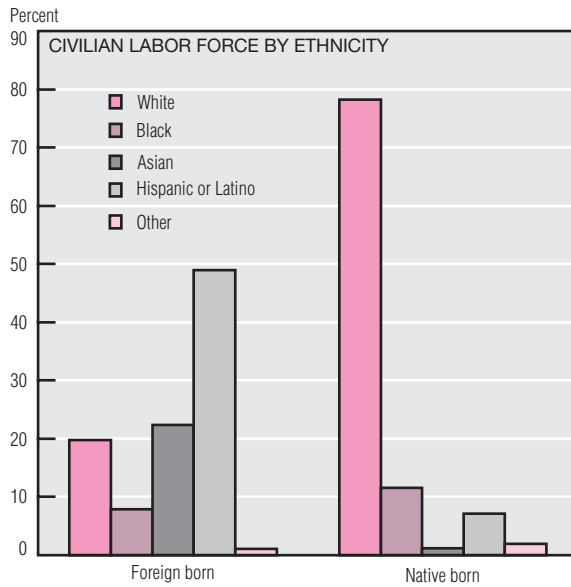
Manufacturing employment declined 14,000 in May after rising 19,000 in April. Much of the decline was concentrated in the transportation equipment and the computer and electronic products industries. Construction employment increased only 1,000 for the second time in the last three months. For the second

straight month, the service-providing sector added fewer than 90,000 net jobs, just under half of them in education and health services. Professional and business services employment increased 27,000, despite the fourth decrease in temporary help services in the last five months. Retail employment fell 27,100 in May following a 43,500 decline in April.

May's employment-to-population ratio was 63.0% for the third straight month. The unemployment rate declined 0.1 percentage point to 4.6% because jobs growth from the household survey used to determine the

rate was stronger than the more commonly cited measure of employment growth from the payroll survey. Notwithstanding recent declines in the unemployment rate, the four-week moving average of initial unemployment insurance claims rose from just under 300,000 in late January and early February to 333,500 in the week ending May 27. Weekly initial claims remained well below 400,000, an often-cited bellwether of recession. Furthermore, the downward trend in continued claims has been sustained so far this year.

Native- and Foreign-Born Workers



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

In 2005, foreign-born workers (legally admitted and undocumented immigrants, refugees, and temporary residents) represented about 15% of the labor force, up from about 11% in 1996. They differ from native-born workers in ethnic background, labor force participation, unemployment rates, and occupations.

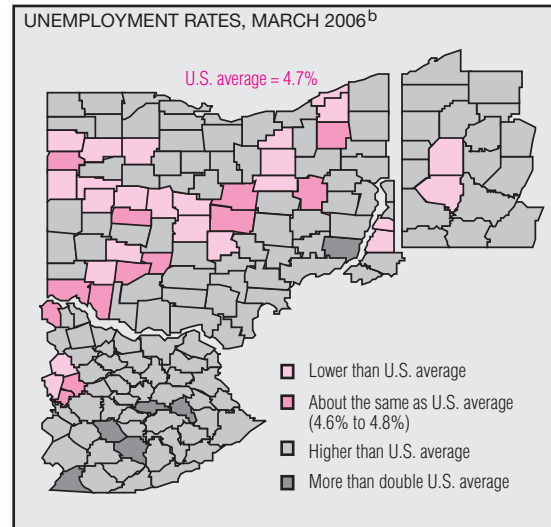
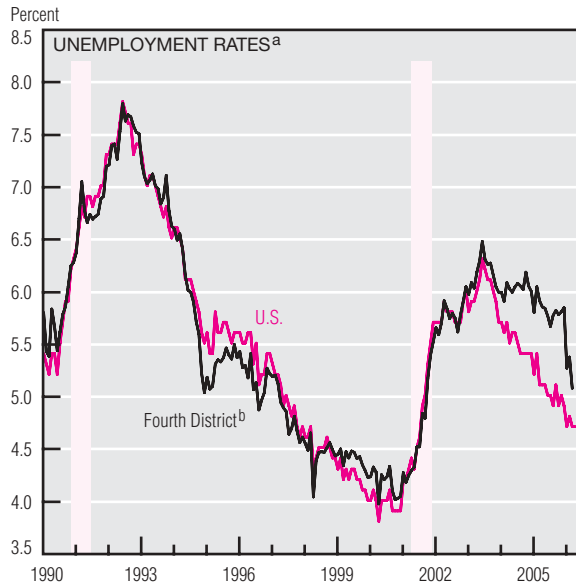
The ethnic composition of foreign-born and native-born workers differs dramatically, primarily because of immigration from Asia and from Central and South America. Whereas about 80% of native-born workers are

non-Hispanic or non-Latino whites, nearly half of foreign-born workers are Hispanic or Latino. Over one-fifth of immigrant workers are Asian, compared to a mere 1% of the native born.

Total labor force participation is similar among foreign-born and native-born workers; however, the labor force participation rate of foreign-born men (81%) is nearly 10 percentage points above that of native-born men. Native-born workers' 5.2% unemployment rate exceeds the 4.6% rate among foreign-born workers, reflecting relatively higher unemployment rates among native-born men.

In 2005, foreign-born workers tended to have less education than the native born: About 93% of native-born workers (older than 25) were at least high school graduates, compared to about 72% of the foreign born. Foreign-born workers were more likely to work in construction and maintenance; production, transportation, and material moving; and service industries. In contrast, native-born workers were more likely to be in sales and office; and management and professional occupations.

Fourth District Employment



	12-month percent change, April 2006							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	0.3	1.0	1.1	-0.4	1.0	0.7	0.8	1.4
Goods-producing	-0.5	0.7	0.6	-0.8	0.8	-0.5	-0.6	1.3
Manufacturing	-0.3	0.4	0.1	-1.0	0.4	-2.0	-2.0	0.0
Natural resources, mining, and construction	-1.2	1.3	1.7	0.0	2.0	2.1	3.2	3.7
Service-providing	0.5	1.1	1.2	-0.3	1.0	0.8	1.2	1.4
Trade, transportation, and utilities	-0.9	0.3	-0.3	-1.8	0.0	0.5	3.3	0.7
Information	-4.1	0.5	-1.9	-1.8	-2.5	-3.5	0.0	-0.1
Financial activities	-0.6	0.3	0.9	-3.2	4.4	0.3	0.9	2.6
Professional and business services	2.1	2.0	3.4	1.9	1.5	0.0	2.0	2.5
Education and health services	2.6	2.0	1.8	0.6	2.2	2.0	-0.3	2.3
Leisure and hospitality	2.2	1.4	2.2	0.8	1.2	4.7	1.2	1.7
Other services	-1.1	1.1	0.5	0.0	-0.7	-0.5	0.0	0.1
Government	-1.2	0.7	0.2	-1.1	0.6	-1.0	0.0	0.7
March unemployment rate (percent)	4.9	4.4	5.0	5.0	5.7	4.8	4.7	4.7

a. Shaded bars represent recessions.

b. Seasonally adjusted using the Census Bureau's X-11 procedure.

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

The Fourth District's unemployment rate fell to 5.1% in March from 5.4% a month earlier. Employment in the District was up compared to both February (0.4%) and March 2005 (1.4%). The labor force was unchanged over the month and has increased 0.4% since March 2005. Nationally, the unemployment rate was 4.7% in March and remained there in April.

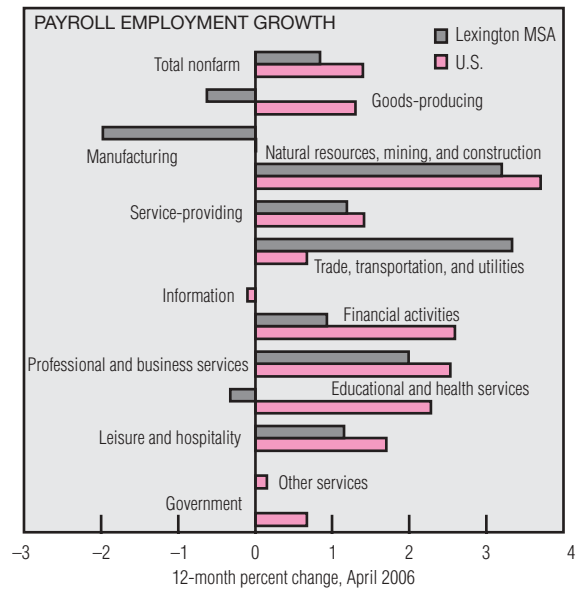
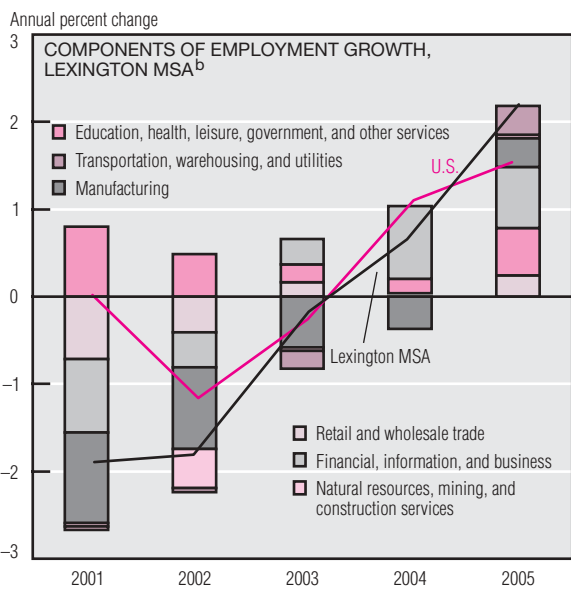
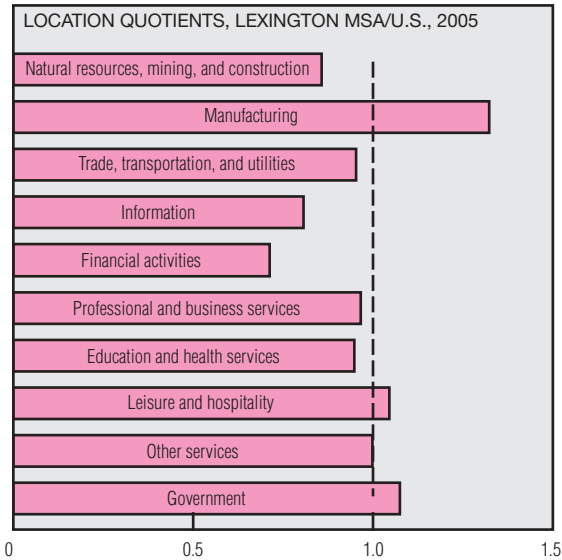
County unemployment rates in the District tended to exceed the U.S. rate in March. Unemployment rates were above the U.S. average in 68%

of Ohio counties. In Kentucky, where unemployment was 6% in March, 51 of the 56 counties in the state's Fourth District area posted rates that were above the national average. Most Pennsylvania and West Virginia counties within the District had above-average unemployment rates as well, except the counties near Wheeling and Pittsburgh.

According to another measure of employment change, based on the Current Employment Statistics survey, total employment growth over the last year trailed the national rate

(1.4%) in every major metropolitan area of the District; however, growth rates in Cincinnati (1.1%), Columbus (1.0%), and Toledo (1.0%) came close to average. Both goods-producing and service-providing industries underperformed. Although employment growth in the professional and business services, education and health services, and leisure and hospitality industries generally lagged the U.S., almost all of the District's metropolitan areas posted increases in these industries over the year.

The Lexington Metropolitan Area



NOTE: The Lexington-Fayette, KY metropolitan statistical area consists of Bourbon, Clark, Fayette, Jessamine, Scott, and Woodford counties.
 a. Seasonally adjusted.
 b. Lines represent total employment growth for the U.S. and the Lexington MSA.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Lexington area is an economically important component of the Fourth District. In terms of employment, it is the ninth-largest metro area in the District and the second-largest in Kentucky. The industrial composition of the area's employment is generally similar to the nation's, but its manufacturing sector's presence is somewhat stronger. In addition, Lexington's proportion of jobs in information and finance lags the U.S. average.

When the national recession began in March 2001, employment fell more sharply in the Lexington area than in the U.S. or Kentucky. (In terms of employment, the state and nation have performed similarly throughout the recession and recovery.) Recently, however, employment has grown more rapidly in the area than in either the U.S. or Kentucky.

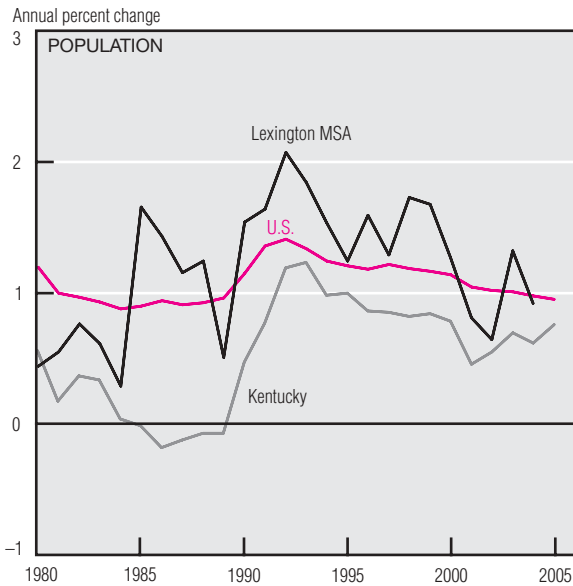
Lexington's above-average share of manufacturing employment may partly explain its more marked job losses when the recession began.

The manufacturing sector subtracted from Lexington's employment growth from 2001 to 2004 but added to it in 2005. Within the service sector, education, health care, leisure, and government have added to the area's total employment growth in each of the last five years.

As of April, Lexington's year-over-year employment growth was weaker than the nation's (0.8% versus 1.4%). The area's manufacturing employment contracted sharply; its health-

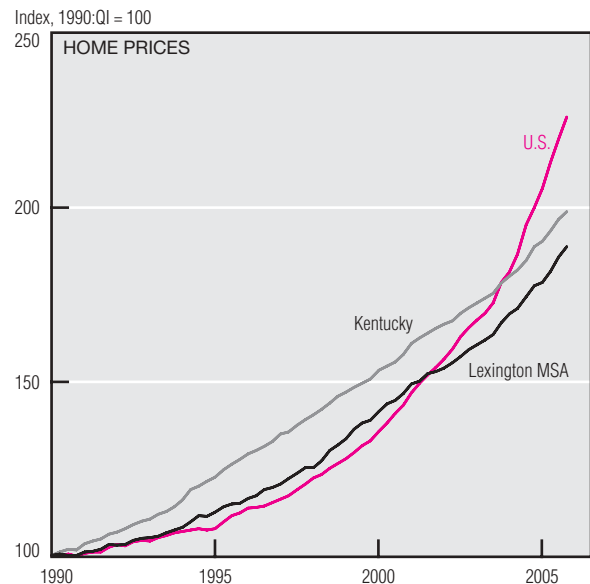
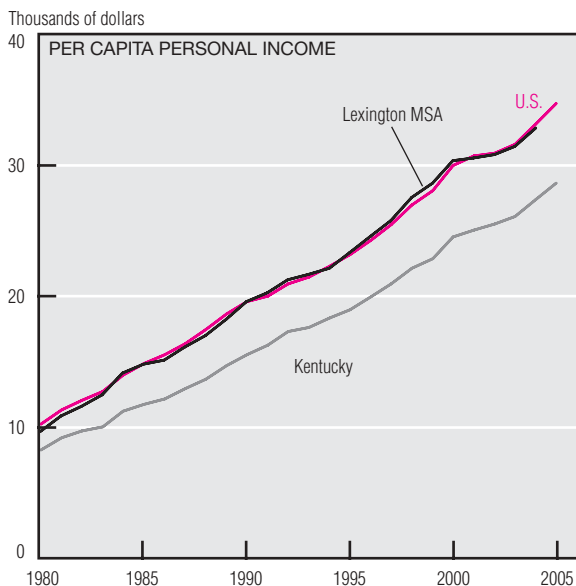
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The Lexington Metropolitan Area (cont.)



Selected Demographics, 2004

	Lexington MSA ^a	Kentucky	U.S.
Total population (millions)	0.5	4.0	285.7
Percent by race			
White	88.0	91.2	77.3
Black	10.0	7.3	12.8
Other	2.0	1.4	9.9
Percent by age			
0-19	25.7	26.6	27.9
20-34	24.1	20.3	20.3
35-64	40.0	40.9	39.8
65 and older	10.2	12.1	12.0
Percent with bachelor's degree or higher			
	29.7	19.0	27.0
Median age	35.1	37.3	36.2



NOTE: The Lexington-Fayette, KY metropolitan statistical area consists of Bourbon, Clark, Fayette, Jessamine, Scott, and Woodford counties.

a. Includes Madison County.

SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and U.S. Department of Housing and Urban Development, Office of Federal Housing Enterprise Oversight.

care and education employment also suffered. Until April, its year-over-year employment growth exceeded the nation's back to the beginning of 2005.

In population growth, the area has generally performed as well as or better than the national average since 1985; it has also been outperforming the state since 1980. By 2004, Lexington's population had grown to almost half a million. It tends to be less diverse and younger

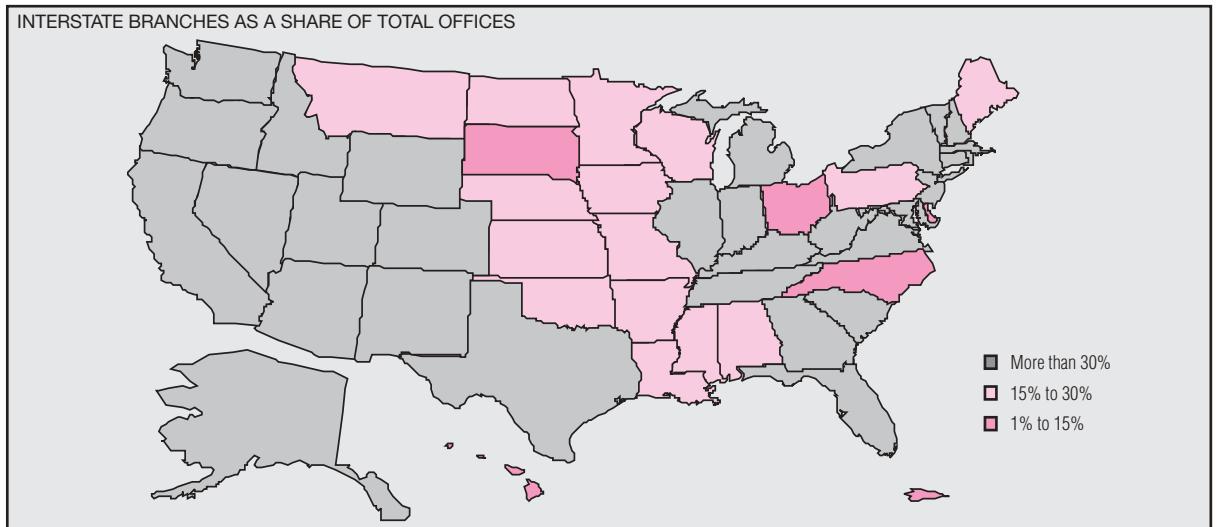
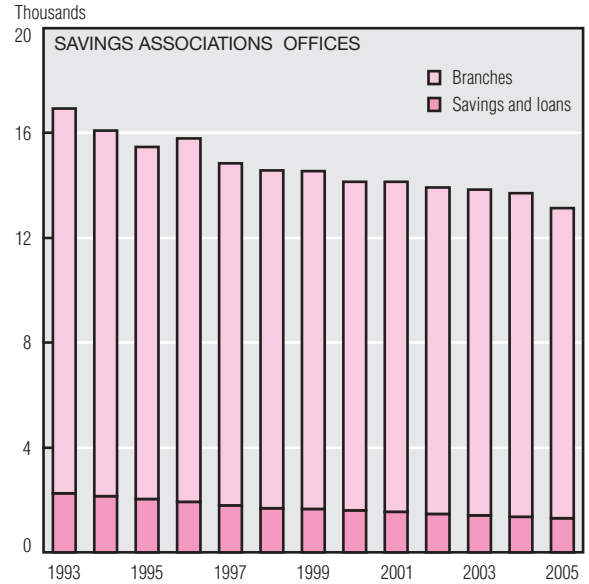
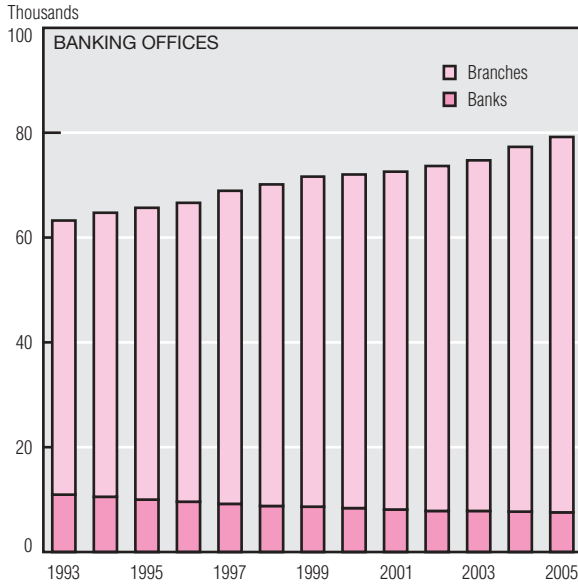
than the nation's. The area has a higher percentage of residents in the 20-to-34 age bracket than either the state or the U.S. It is also better educated: The share of college graduates in Lexington's population is somewhat larger than in the U.S. but markedly larger than in Kentucky as a whole.

The disparity in educational attainment between the Lexington area and Kentucky may help account for differences in per capita personal income.

Although Lexington and the U.S. are similar in per capita income and educational attainment, there is a much greater gap on both measures between Lexington and Kentucky.

Home-price appreciation is one respect in which the area and the state are similar: Neither has shared much in the recent nationwide acceleration in home prices. Since 1990, U.S. home prices have risen roughly 25% to 35% more than those in either Lexington or Kentucky.

Banking Structure



SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile* and *QBP Graph Book*, December 31, 2005.

Passage of the 1994 Reigle–Neal Act, which regulates interstate banking, has spurred the consolidation of depository institutions. The number of FDIC-insured commercial banks fell from 9,972 at the end of 1995 to 7,527 at the end of 2005, a decline of more than 24%. Over the same period, the number of FDIC-insured savings associations decreased more than 35%, from 2,030 in 1995 to 1,305 at the end of 2005.

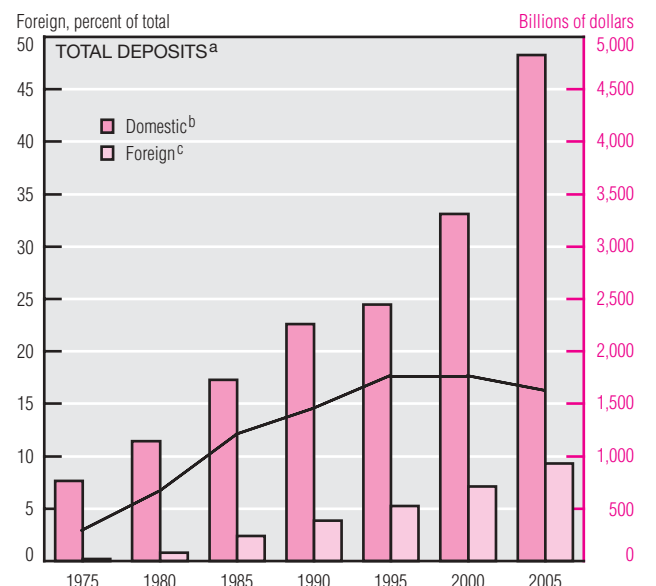
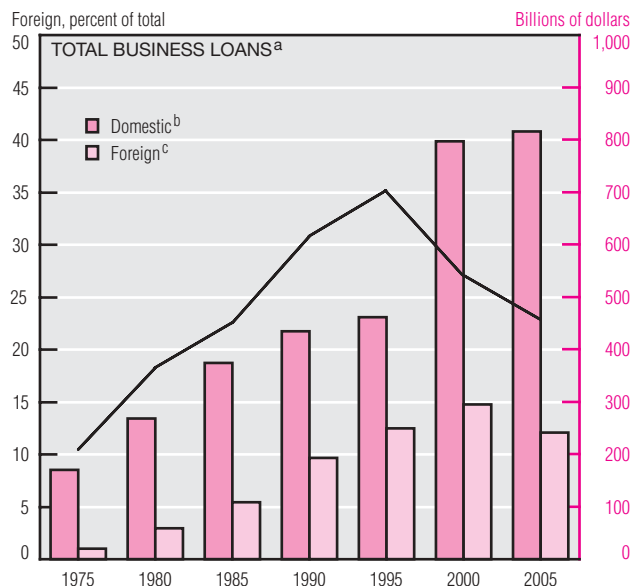
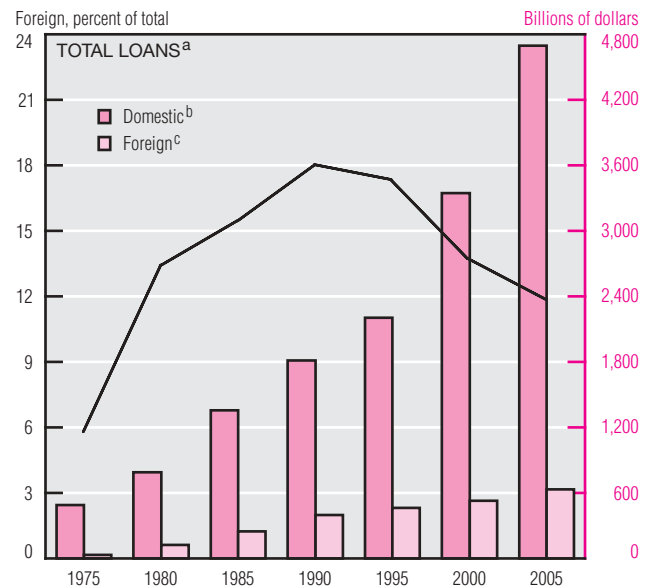
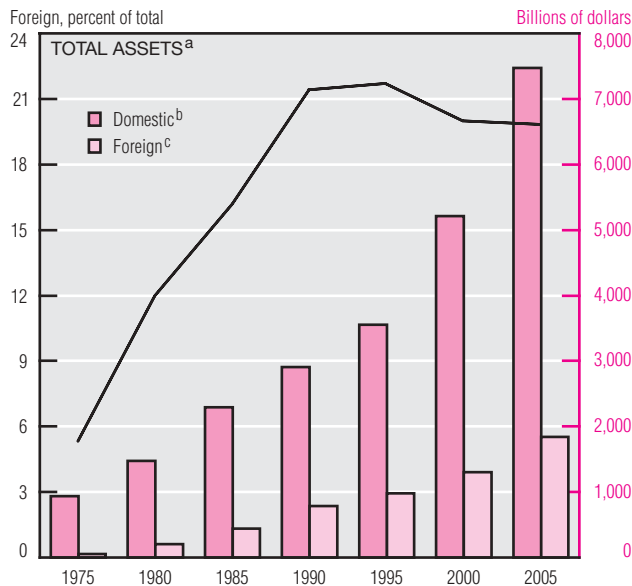
The number of savings associations’ offices also dropped, but less

sharply than the number of institutions (only around 15%, from 15,461 in 1995 to 13,136 at the end of 2005). The total number of banking offices, however, grew more than 20% over that period, from 65,711 to 79,243. From the end of 1995 to the end of 2005, the total number of FDIC-insured depository institutions’ offices increased almost 14%, from 81,172 to 92,379. This count does not include other channels for delivering banking services, such as automated teller machines, telephone banking, and online

banking. Hence, the reduction in the number of insured depository institutions has not decreased the availability of bank services for most consumers.

The effects of the banking industry’s interstate consolidation are evident: All but six states now report that more than 15% of depository institutions’ branches are part of an out-of-state bank or savings association. And in over half the states, 30% or more of all branches are offices of out-of-state depository institutions.

Foreign Banking Organizations



NOTE: Foreign banks are those owned by institutions located outside the U.S. and its affiliated insular areas.

a. Total claims, including domestically owned commercial banks as well as foreign banks' branches and agencies in the 50 states and the District of Columbia; New York investment companies (through September 1996); U.S. commercial banks, of which more than 25% are owned by foreign banks; and international banking facilities. The data exclude Edge Act and agreement corporations; U.S. offices of banks in Puerto Rico, the U.S. Virgin Islands, and other U.S.-affiliated insular areas; and foreign bank offices in U.S.-affiliated insular areas.

b. Excludes commercial banks, more than 25% of which are owned by foreign banks, but includes international banking facilities as well as banks owned by nonbank foreigners.

c. Adjusted to exclude net claims on own foreign offices.

SOURCE: Board of Governors of the Federal Reserve System, *Structure and Share Data for U.S. Offices of Foreign Banks*.

The U.S. banking industry shows the impact of financial markets' increasing globalization. Despite some loss of market share since 1991, foreign banks remain important competitors in the U.S. Their total assets have risen steadily since 1975, more than trebling their share of U.S. banking assets from 5.3% to 19.8%, but still down from the peak of 22.6% at the end of 1991.

Similar patterns are apparent in foreign banking organizations' market shares of loans and deposits. Their total loan holdings rose from

\$29.9 billion in 1975 to \$631.0 billion at the end of 2005, more than doubling their share. Foreign banks' 11.8% share of U.S. loans at the end of 2005 marked a 37% decline in their market share from its 1991 peak of 18.9%. Much like their total loans, foreign banks' 1992 peak business loan market share has been eroded by more than a third. On the other hand, they increased their holdings of business loans from \$19.9 billion in 1975 to \$241.4 billion by December 31, 2005, more than doubling their share of U.S.

business loans. Given the nature of the lending process and the importance of established relationships with customers, it is not surprising that foreign banking organizations' loan share has grown much more slowly than their share of total assets.

Finally, foreign banking organizations' 16.2% share of deposits confirms that they are important competitors in the U.S., but recent trends suggest that the domestic industry is equal to the challenge posed by foreign competition.