The Economy in Perspective

by Mark Sniderman

People often ask me to recommend books about economics but now, with the onset of summer, I am getting requests for “beach books” on the dismal science. I certainly can relate—you can’t just take a pass on macroeconomics for an entire season, yet you want something that won’t give you a headache when you are out all afternoon in the sun. So here are my recommendations for books with an economics theme—for your summer reading pleasure:

Quayle’s Quandary is the eighth novel in Chris Cournot’s thriller series about everyone’s favorite government crusader, Casey Quayle. The story opens with a ceremony at which the Treasury Department bestows on the hero its highest honor for valor, which he earned by thwarting a hedge fund managers’ plot to slip self-serving language into pending tax legislation (read book seven, *Quayle’s Query*). Through a series of circumstances not to be divulged here, the president decides to nominate Quayle as the next Secretary of the Treasury.

The night before his Senate hearing, Quayle sits at his desk, reminiscing about his career and looking back at his numerous studies. He skims through his path-breaking report on foreign exchange markets, the study that propelled him into prominence (read book one, *Qualye’s Quagmire*), and there he finds—egad!—a computational flaw. He double-checks his calculations, but there is no escape—his original conclusion is simply wrong. Like the ethical man that he is, he vows to come clean in tomorrow’s hearing. But there is a problem: He knows that the day after the hearing, the Republic of China plans to announce its decision to freely float the renminbi instead of pegging it to the dollar—and that their decision rests on the persuasiveness of his report. If he disavows the report’s conclusion, the Chinese government will surely change its plan. How will Quayle resolve the tension between his country’s welfare and his own honor? This spellbinding story of intrigue and deception features a complex web of characters engaged in naked trades and dirty floats. As Cournot turns up the heat, make sure you keep applying your sunblock—the time will fly.

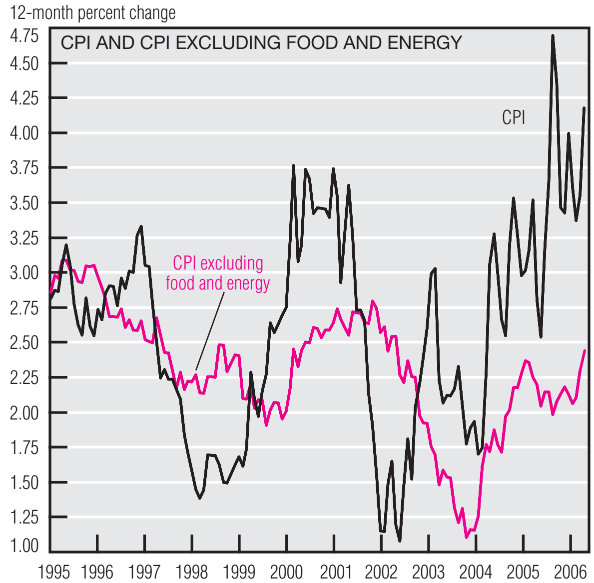
Another novel on my beach-reading list is *Legally Bland*, by Elinor Ely. This first-time author performs a tour de force about a central banker who tries her best to be completely forthright in her public discussions about monetary policy, only to be constantly second-guessed and misunderstood by media groupies. Meet Samantha (“Sam”) Powers, a central banker with all the right credentials. After being appointed to her central-banking post, Sam decides to demystify the secrets of the temple by saying what she means and meaning what she says. But complications arise when commentators try to “decode” her messages, not willing to believe that they were never coded in the first place.

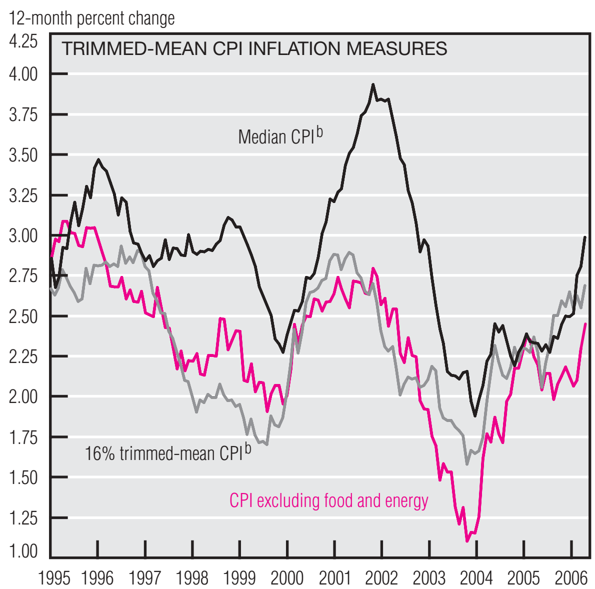
Ely, who was formerly a central-bank official, turns her finely tuned ear to the everyday foibles of central banking. In one episode, Sam agonizes over how to phrase a sentence in her upcoming “Nuts and Bolts” speech, so nicknamed by her staff, who enjoy its double entendre: The speech, which is about the tools of monetary policy, will be given to a convention of hardware industry executives. Sam wants to stake out a middle-of-the-road position on a policy issue, wishing to appear neither hawk nor dove. She edits the draft of the speech, drawing a red line through the sentence, “Under some circumstances, an action might be warranted, but its merits will depend partly on other considerations that may exist at the time,” and penning simply, “I’ll cross that bridge when I come to it.” What could be clearer? But one media outlet prints its coverage of her speech under the headline, “Powers Hints of Interest Rate Moves.” The article’s lead sentence is, “Samantha Powers indicated her desire to hike interest rates another notch, declaring that she would ‘cross that bridge’ at the next policy meeting.” Powers’ repeated encounters with the media spin-meisters take financial markets on a roller coaster ride in this rolicking parable about who’s listening and who’s not. The heroine eventually has her day, and when you stop laughing, you will realize that *Legally Bland* challenges you to know the truth when you see it. This tale about central banking in the sunshine is a perfect choice for summer fun.

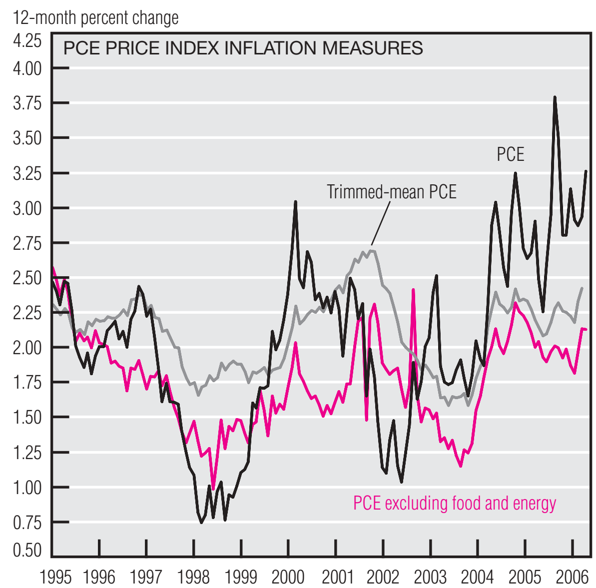
Inflation and Prices

May Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	2005 avg.
Consumer prices					
All items	5.5	5.7	4.2	2.6	3.6
Less food and energy	3.6	3.8	2.4	2.1	2.2
Median[b]	4.3	4.2	3.0	2.7	2.5
Producer prices					
Finished goods	2.3	6.7	4.5	2.5	5.8
Less food and energy	3.1	2.0	1.5	1.2	1.7







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Bank of Dallas; and Federal Reserve Bank of Cleveland.

Inflation pressures intensified further in May. The Consumer Price Index (CPI) continued to accelerate, rising at an annualized rate of 5.5%. Brisk monthly growth in the core retail price measures outpaced longer-term trends: The CPI excluding food and energy rose at a 3.6% annualized rate, while the median CPI surged at a 4.3% annualized rate.

Longer-term growth trends in the core retail price measures reveal increased pressure since at least last fall. The 12-month growth rate in the CPI excluding food and energy ratcheted up to 2.4%, a bit above the 2%–2$^1/_4$% range in which it has fluctuated for about a year. The 12-month growth rates of the 16% trimmed-mean CPI and the median CPI ticked up to 2.7% and 3.0%, respectively. The growth rate of both these measures has risen roughly $^1/_4$ to $^1/_2$ percentage point since last fall. Meanwhile, the Personal Consumption Expenditure (PCE) Price Index excluding food and energy, an alternative measure of underlying retail price pressure, rose 2.6% on a year-to-date basis in May, also up about $^1/_2$ percentage point from its 12-month trend.

Intense retail price increases are widespread. In 2005, about one-third of non-energy CPI components posted average monthly increases of 2%–3%, and prices of another third of these components rose more than 3%. Since the beginning of this year, a majority of the non-energy components have risen at average monthly rates exceeding 3%, while nearly 70%

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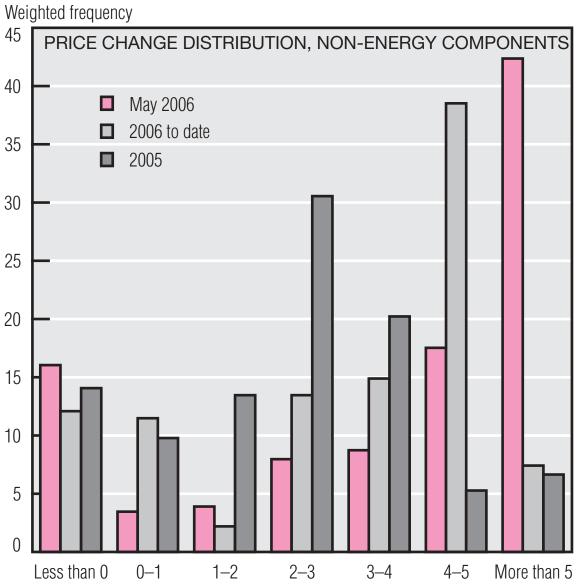
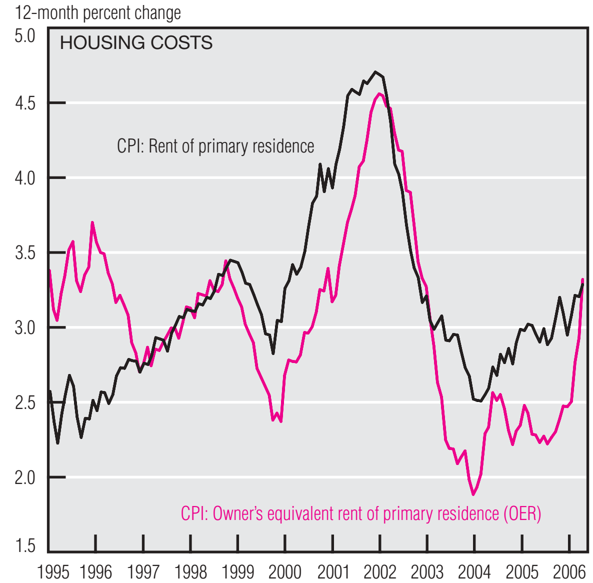
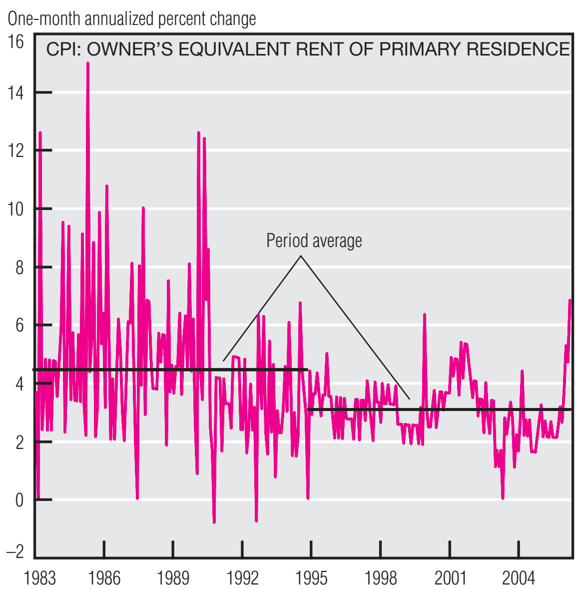
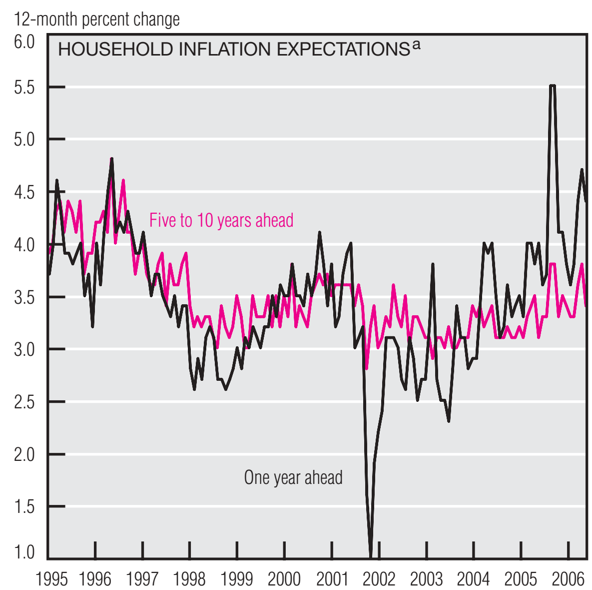
Inflation and Prices (cont.)









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

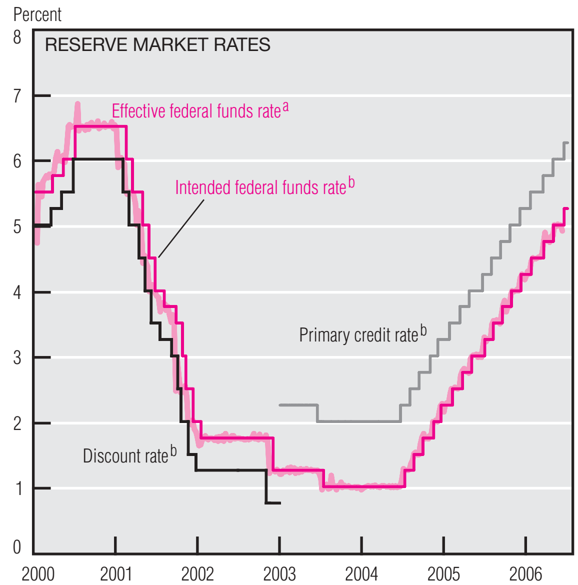
of such components rose 3% or more in May. Indeed, almost 45% of non-energy CPI components rose 5% or more in May, including the single largest component, owner's equivalent rent of primary residence (OER).

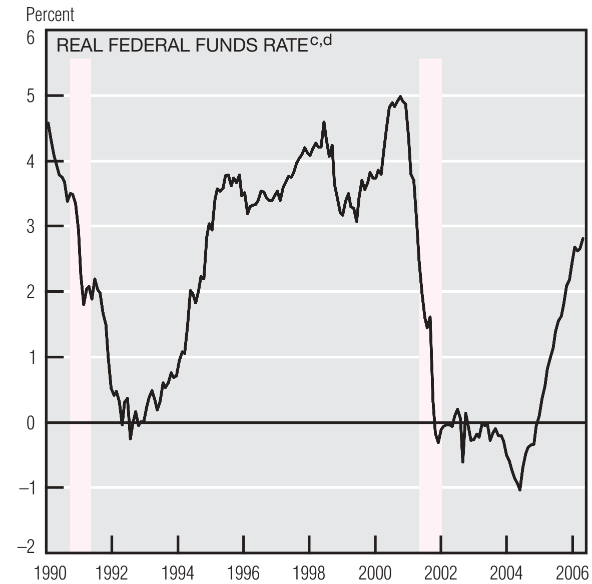
OER—the costs that homeowners would assume if they rented their homes instead of owning them—accounts for nearly one-quarter of the CPI market basket. Monthly growth in OER has accelerated since the beginning of the year. OER jumped 6.8% in May, well above its 3.1 average monthly percent change. Some of the recent rise can be tied to decelerating utilities costs, which are subtracted from this housing cost measure, but some part of the rise seems to come from a rental market that is growing stronger after several years of relative softness.

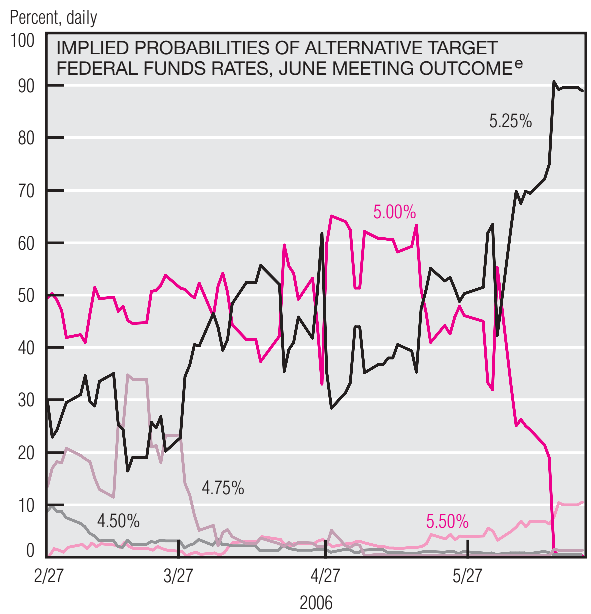
The recent pressure on the OER component of the CPI may be with us for the summer. Since 1995, the monthly OER index has been computed from six-month rent changes, a procedure that reduces its monthly volatility but also causes the measure to exhibit some persistence. In other words, monthly changes in OER tend to influence the CPI's behavior over a period of several months.

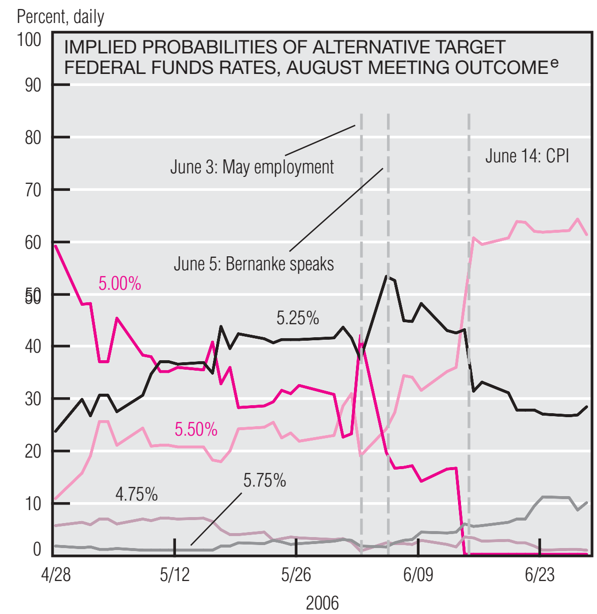
One encouraging development is that household inflation expectations moderated a bit in June. Short-term inflation expectations fell from 4.7% to 4.4%, while longer-term expectations dropped from 3.8% to 3.4%.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE Chained Price Index.
d. Shaded bars indicate periods of recession.
e. 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 June 29, the Federal Open Market Committee (FOMC) raised its target for the federal funds rate 25 basis points (bp), taking it to 5.25%. The inflation-adjusted (or real) fed funds rate now stands near 3%. The most recent policy action was widely anticipated, but uncertainty remains about the future course of policy.

Between the May and June FOMC meetings, analysts’ expectations about policy shifted markedly, largely based on the understanding that future policy decisions were likely to be data dependent. Financial market participants sift through incoming economic reports and speeches by Federal Reserve officials to formulate expectations about policy actions at upcoming meetings. More precisely, analysts assess how such information could change the FOMC’s outlook and thus affect the likelihood of alternative policy outcomes.

Sometimes the effects are transitory, as they appeared to be after the May employment report was released on June 3. At other times, the effects on the distribution of market opinion are more permanent. This is often the case after a surprising inflation report because price stability is a key goal for the Federal Reserve. The CPI release on June 14 illustrates the point: The new inflation numbers seemed to be unexpectedly strong and broad based, causing analysts to revise their expectations of how the FOMC would react. After the report,

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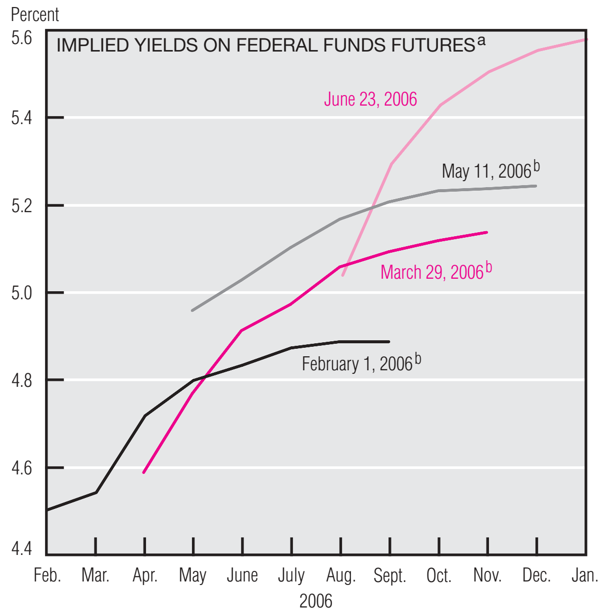
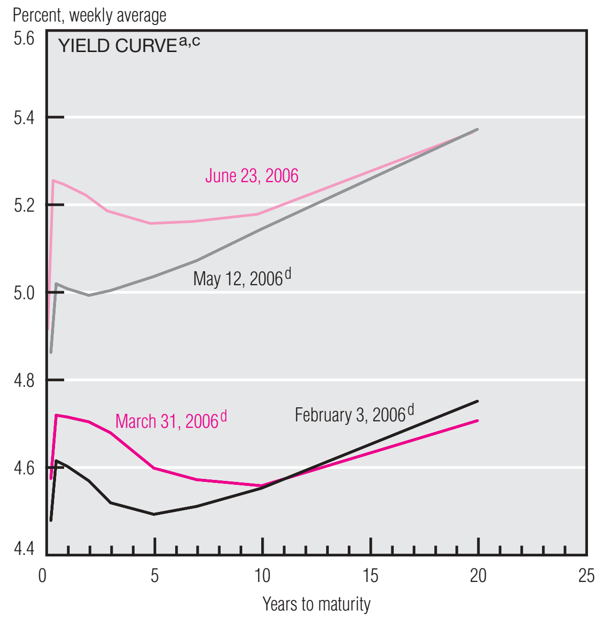
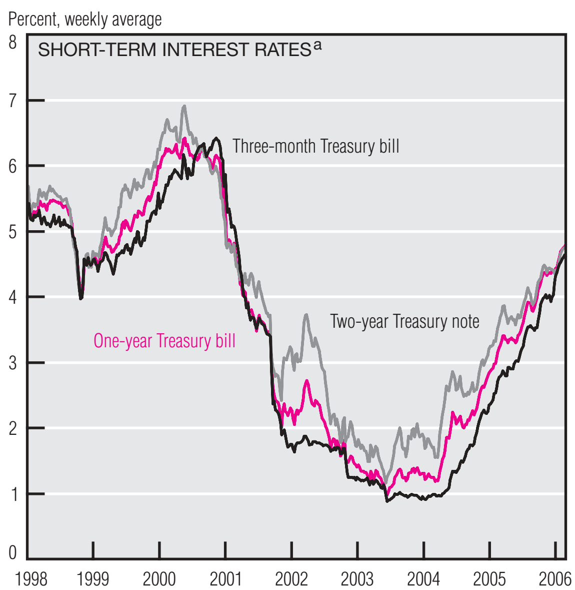
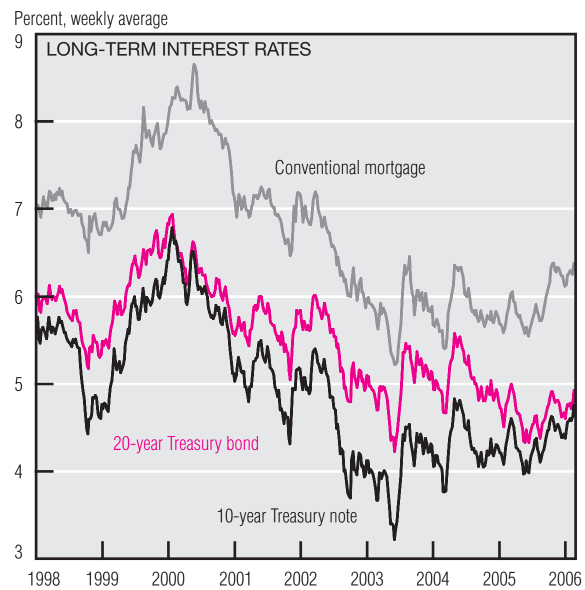
Monetary Policy *(cont.)*









a. Yields are from constant-maturity series.
b. One day after the FOMC meeting.
c. Average for the week ending on the date shown.
d. First weekly average available after the FOMC meeting.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

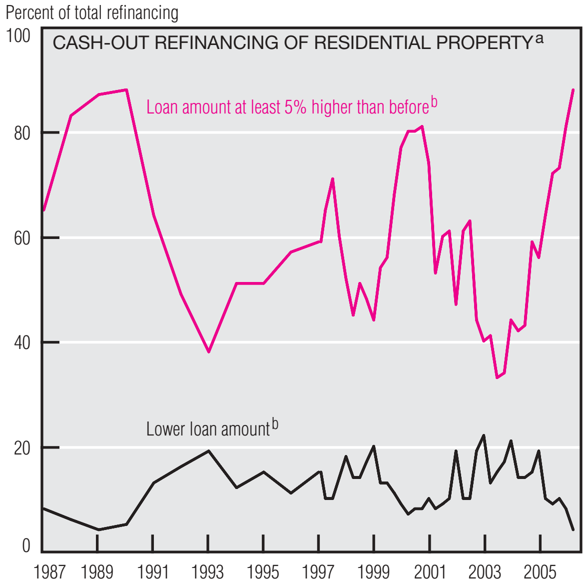
analysts became certain there would be a rate hike at the June meeting. Moreover, the odds of another rate hike at the August 8 meeting went from even to likely.

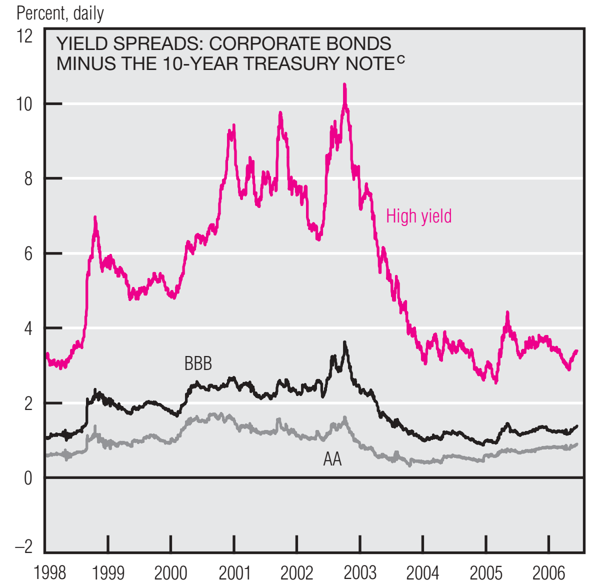
Market commentary suggests that changes in the distribution of expected policy outcomes were somewhat shaped by concerns expressed in recent speeches by Federal Reserve officials, who have used words like "unwelcome," "bothersome," and "uncomfortable" to describe the inflation report. Thus, market participants' response seems to confirm a belief that the FOMC will take whatever policy actions are required to assure price stability.

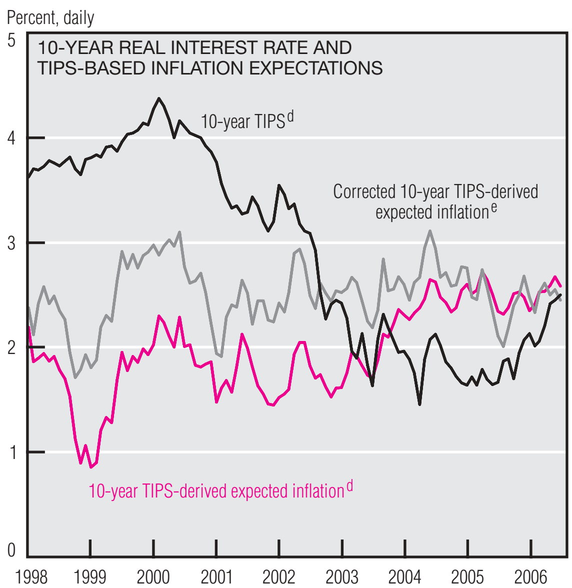
At this time, the prices of fed funds futures imply that another rate hike in August would take the funds rate very near a level where it will plateau. However, as we have seen in the past, markets are often surprised—and in both directions. An August increase is not set in stone. Potential lagged effects of cumulative policy tightening might turn out to be sufficient to contain inflation.

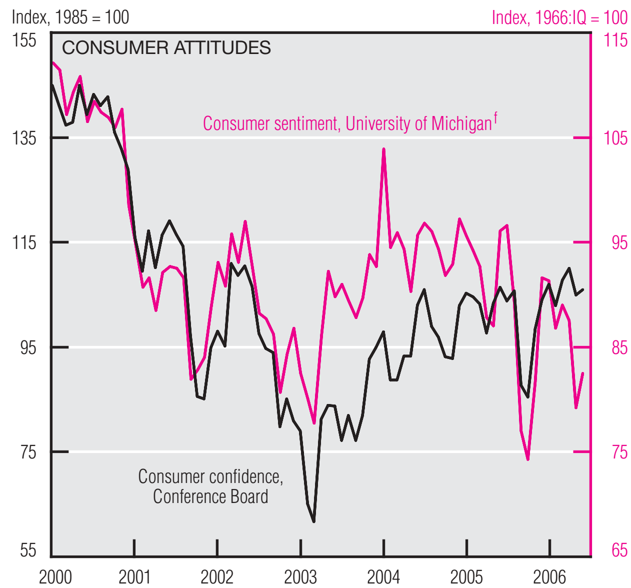
Since the initial hike in 2004, the fed funds rate has risen more than four percentage points. Short-term interest rates—such as those on home-equity credit lines—have increased in lockstep with policy rates. Longer-term rates—such as those on home mortgages—have also risen, but to a far lesser extent. Ultimately, however, higher borrowing costs are expected to be associated with both a moderation in economic growth and lower inflation.

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; Conference Board; and Bloomberg Financial Information Services.

Although long-term interest rates have trended upward from their 2003 trough, they remain low by historical standards. Some view this as the consequence of a savings glut in developing countries, especially in Asia.

Low mortgage rates have been a key stimulant in the housing boom, which has been reflected in a surge in housing prices over recent years. The modest rise in mortgage rates is ultimately expected to be associated with a cooling in spending on housing and hence housing prices. If foreign savings are abruptly curtailed, however, interest rates could start to rise more quickly.

Moreover, some analysts worry that housing prices may have become unsustainable, especially in coastal cities, where those prices have risen the most sharply. In such areas, the housing market could fall off more swiftly than anticipated. Together, persistently low mortgage rates and rapidly rising housing values have enabled households to refinance their homes at higher loan values.

The difference between old and new loan amounts—known as cash-out refinancing—has provided a deep well of cash to finance robust consumer spending in recent years. Indeed, more than 80% of residential refinancing in the first quarter of 2006 resulted in a loan amount that was at least 5% higher than before. Such a source of funds cannot persist if mortgage rates continue to rise and housing prices cool. Thus, consumer spending, which like housing

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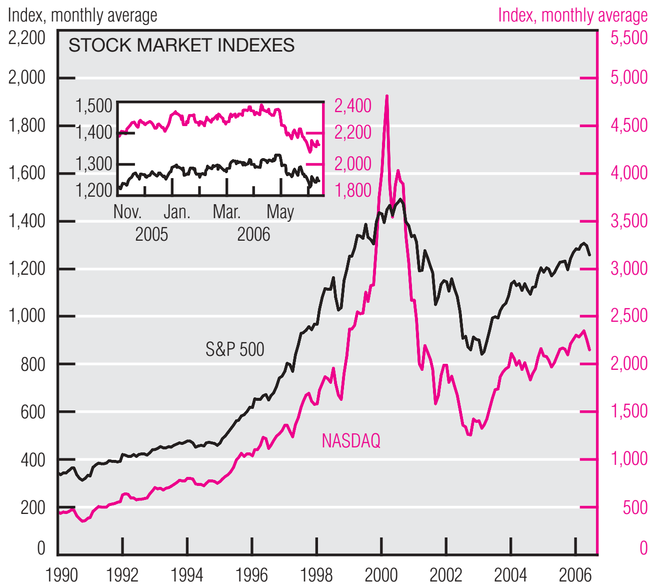
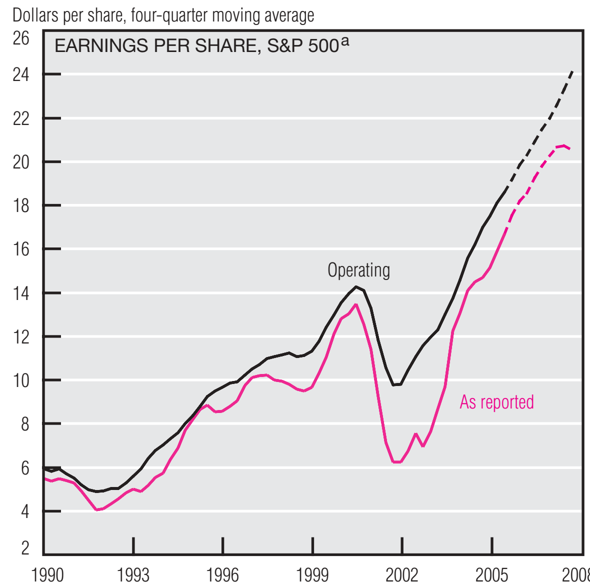
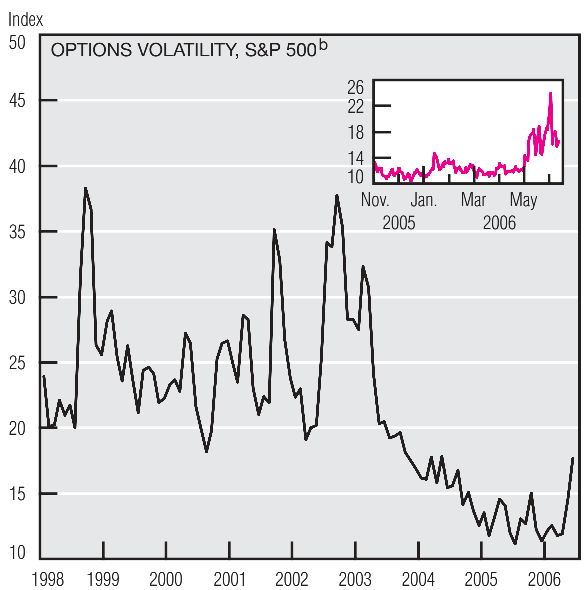
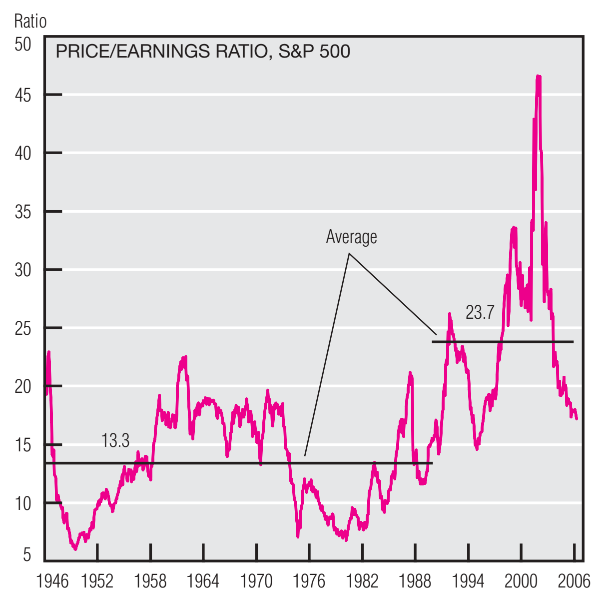
Money and Financial Markets *(cont.)*









a. Dashed lines indicate the forecast as of June 22, 2006.
b. Chicago Board Options Exchange Volatility Index (VIX). Monthly data.
SOURCES: Standard and Poor's Corporation; Chicago Board Options Exchange; and Bloomberg Financial Information Services.

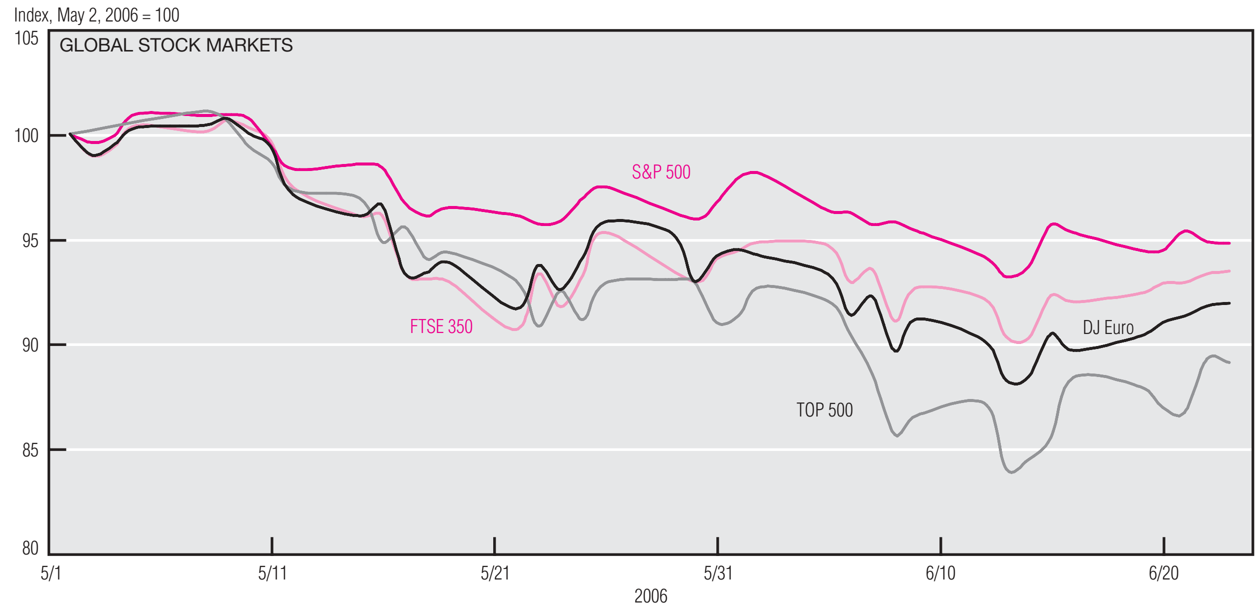
is expected to slow, is also vulnerable to rapidly deteriorating financial conditions.

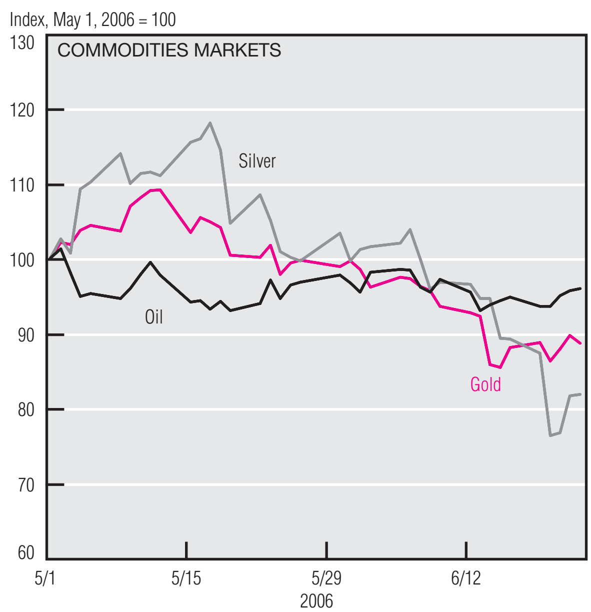
Market commentary cited the minutes of the FOMC's May meeting, which noted that "participants discussed in some detail inflation expectations—a potentially important factor influencing future inflation trends … Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues had edged higher. It was possible, though, that investors' uncertainty regarding inflation prospects, not just inflation expectations themselves, had risen. On balance, participants judged that inflation expectations had risen somewhat—a development that would have to be taken into account in policymaking and warranted close monitoring—but remained contained."

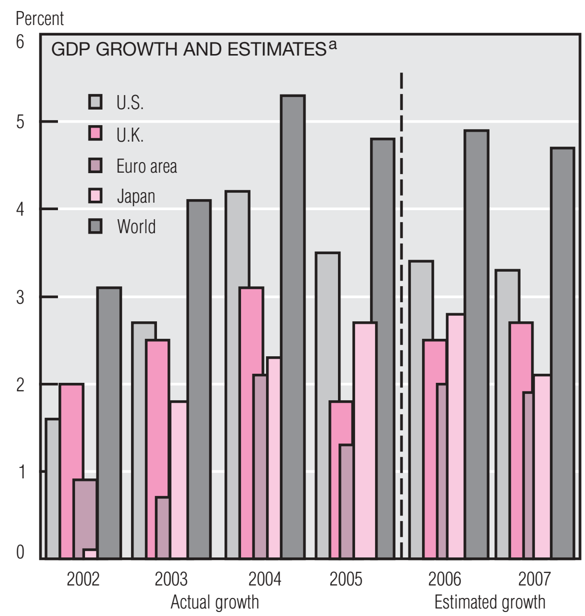
Market reaction in the period between FOMC meetings seemed to validate these views. Market-based estimates of expectations about the future path of policy reacted consistently with the revelation of factors affecting the inflation outlook. Market-based estimates of inflation expectations actually fell in response to unfavorable inflation news, suggesting a belief that the FOMC would do whatever was necessary to contain inflation expectations.

The market's view that additional policy firming would be needed roiled an already unsettled equities market. Low and stable bond rates have been good for equities prices, which are fundamentally based on the discounted present value of future earnings. Higher, more uncertain interest rates imply a lower discount factor and hence lower equities prices. Equities prices fell sharply during the intermeeting period.

Global Market Developments







a. 2006 and 2007 data are International Monetary Fund estimates.
SOURCES: International Monetary Fund, *World Economic Outlook Database*, April 2006; and Bloomberg Financial Information Services.

In recent weeks, equities markets have taken a tumble. Although falling stock prices are nothing new, the scope of the recent downturn makes it noteworthy. Since the beginning of May, the S&P 500 has slipped about 5%, the English and European markets have fallen about 7% and 8%, respectively, and the Japanese market has dropped more than 10%. It is also surprising that during the same period, commodities markets, which typically move in the direction opposite to equities, have also fallen. Silver has slumped almost 20%, while gold has decreased more than 10%; even oil is off about 5%. Do these declines in equities and commodities prices mean the world is headed for a period of slow economic growth? Not according to recent forecasts: World output is expected to expand at a rate close to 5% this year; the euro area, the U.K., and Japan are all expected to grow at a faster pace this year than last.

However, inflation, which can have a negative impact on growth, has trended up slightly in the past few months. Even Japan, which has experienced deflation in the recent past, has shown signs of inflation in 2006. In response, central banks have been raising their discount rates. The European Central Bank raised rates on June 15, and the FOMC announced the seventeenth consecutive rate hike at its June 29 meeting; although the Bank of

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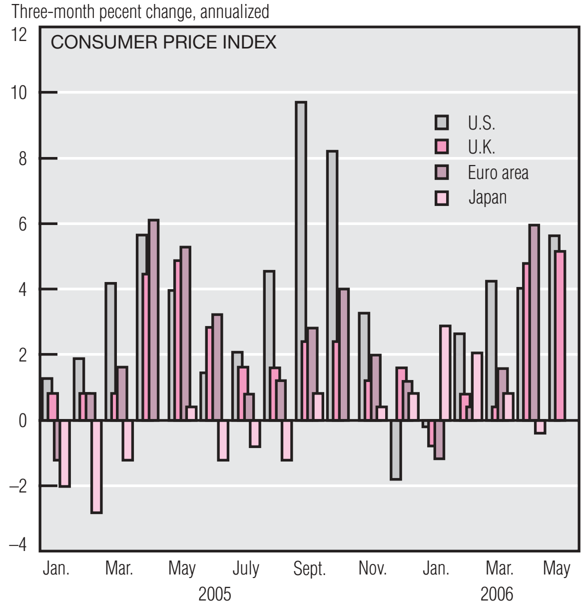
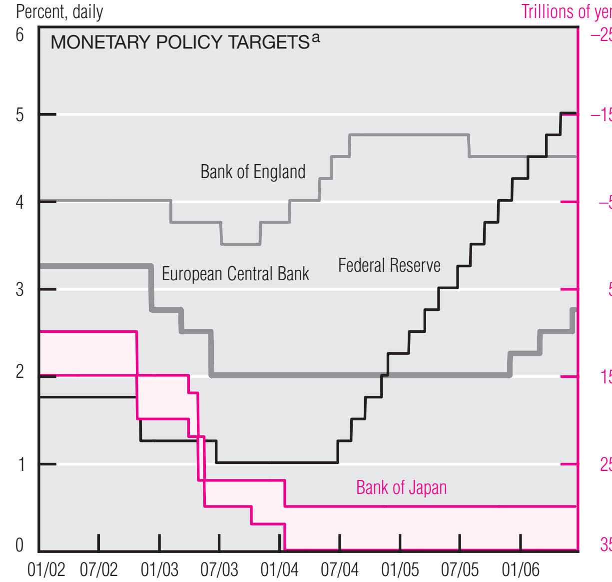
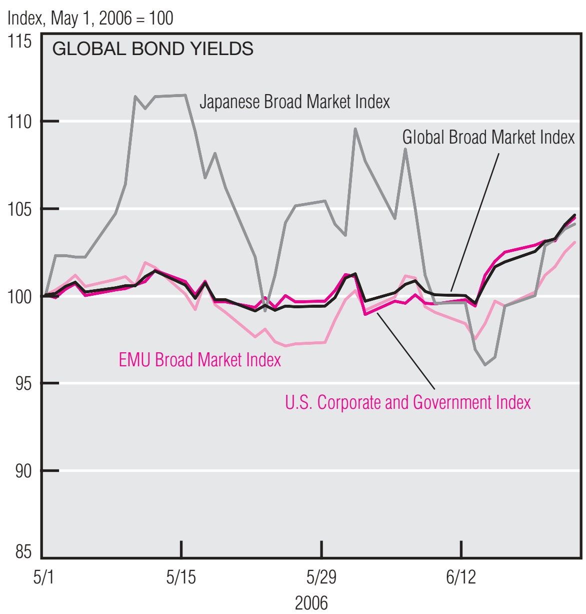
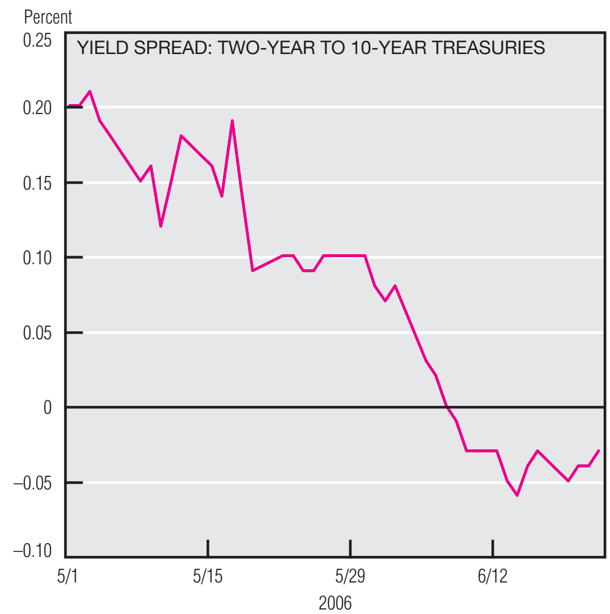
Global Market Developments (cont.)









a. Japan targets a range of quantity of current account balances.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Bank of England; Bank of Japan; European Central Bank; International Monetary Fund, *World Economic Outlook Database*, April 2006; Organisation for Economic Co-operation and Development, *OECD Main Economic Indicators*, 2006; and Bloomberg Financial Information Services.

Japan's discount rate remains effectively zero, it is expected to begin tightening soon.

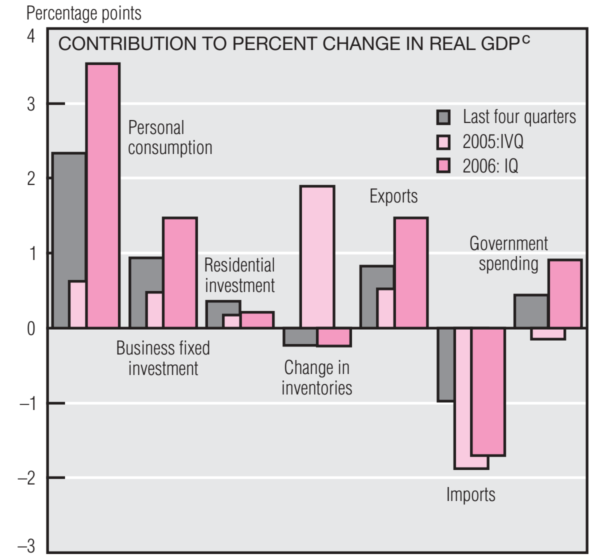
The behavior of equities prices over the past couple of months is a bit of a puzzle. These prices are determined by the present value of expected future dividend payments, so they will drop if expected dividends fall and/or the interest rate that discounts dividends increases. In May and the first part of June, however, interest rates did not change appreciably, nor did private forecasters' views of future growth. A weaker growth forecast could lower expectations of future dividend payments.

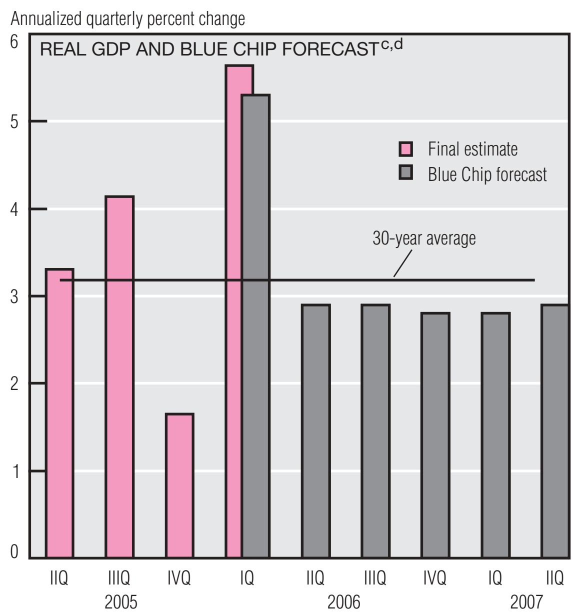
The U.S. economy represents another concern for global markets. A slowdown could affect U.S. consumer spending, which has been a major force for global economic growth over the past few years. Concerns that higher interest rates could push the U.S. into a period of slower growth are beginning to take hold. The yield spread between two-year and 10-year U.S. securities has recently become inverted, an indicator that often—but not always—precedes a period of slower growth. However, many expect global growth to be healthy, even if the U.S. faces a slowdown. Robust growth in Europe and Asia over the last few years should allow consumers there to pick up some of the slack should U.S. consumer spending taper off. All in all, this would produce a period of more balanced economic growth and a global economy that is less dependent on U.S. consumers.

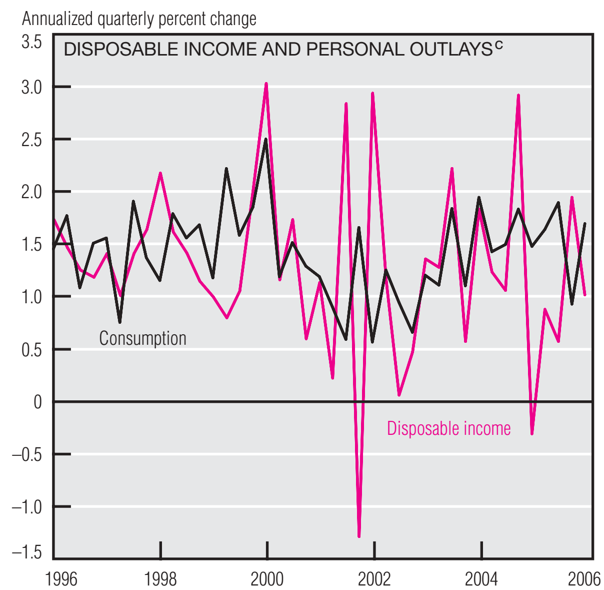
Economic Activity

Real GDP and Components, 2006:IQ[a,b]
(Final estimate)

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	155.3	5.6	3.7
Personal consumption	98.2	5.0	3.3
Durables	52.9	20.3	4.3
Nondurables	33.6	5.9	4.5
Services	21.6	1.9	2.6
Business fixed investment	44.5	14.2	8.9
Equipment	37.9	14.8	10.3
Structures	7.7	12.6	5.1
Residential investment	5.0	3.3	6.0
Government spending	23.4	4.8	2.3
National defense	11.3	9.5	3.3
Net exports	–5.7	—	—
Exports	42.6	14.7	8.1
Imports	48.2	10.7	6.1
Change in business inventories	–8.4	—	—







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*, June 10, 2005.

Real GDP increased at an annual rate of 5.6% in 2006:IQ, according to the Commerce Department's final estimate, which was 0.3 percentage point (pp) above the preliminary estimate of 5.3%. The upward revision resulted primarily from a downward revision to imports. This was the strongest quarter of economic growth since 2003:IIIQ.

Most components made significantly higher contributions to real GDP change in 2006:IQ than in the previous quarter. PCE contributed 3.53 pp, compared to only 0.62 pp in 2005:IVQ. Exports added 1.0 pp more, bringing its total contribution to 1.5 pp. The exception was changes in private inventories, which subtracted 0.2 pp in 2006:IQ after adding 1.9 pp the previous quarter. Profits from current production were $1.656 trillion in the quarter at a seasonally adjusted annualized rate. This new record represented an upward revision of $60 billion from the preliminary estimates.

The first quarter of 2006 was only the third time that GDP growth has topped 5.0% since the beginning of 2000; it was also 2.4 pp above the 30-year average of 3.2%. However, recent data releases suggest that the economy is losing momentum. Blue Chip forecasters revised their growth estimates downward for the rest of this year. Most notably, they lowered their estimate for 2006:IIQ by 0.5 percentage points from 3.4% to 2.9%.

Once again, disposable income, up only 1% in 2006:IQ, lagged personal outlays. The change in personal outlays increased 1.7% for 2006:IQ, up from 0.9% in 2005:IVQ.

With many analysts anticipating that the FOMC is nearing the end of

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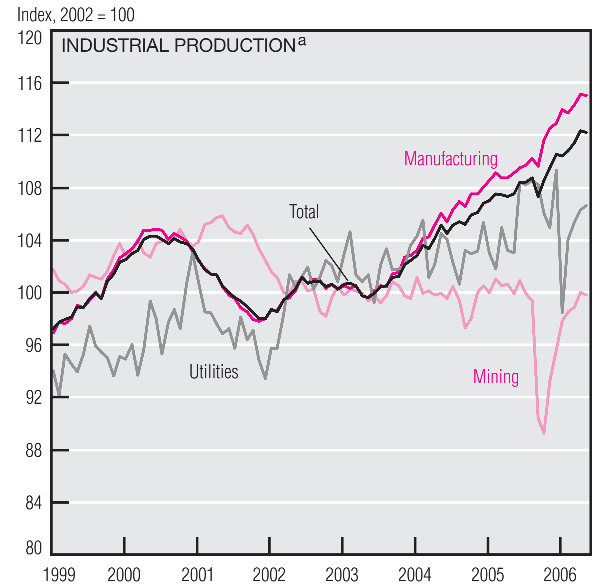
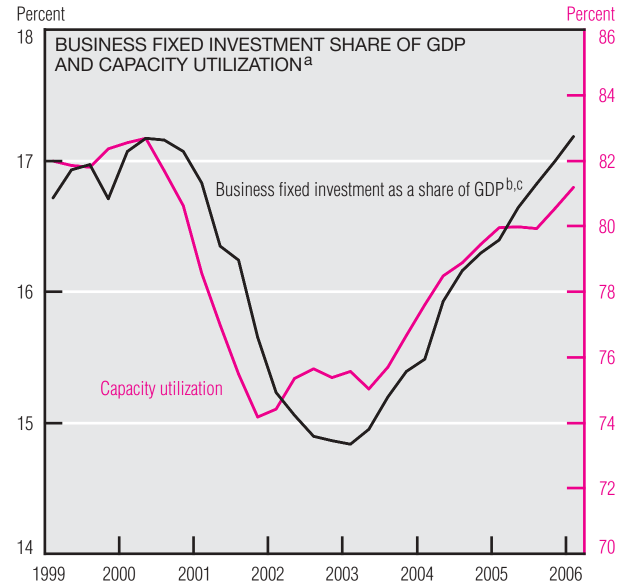
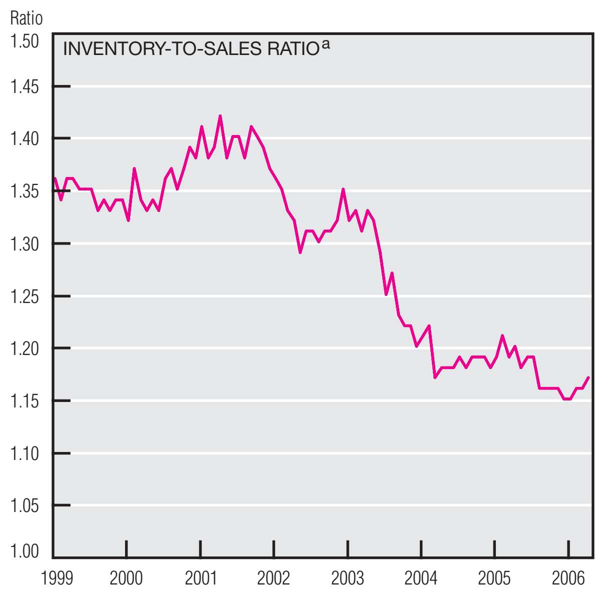
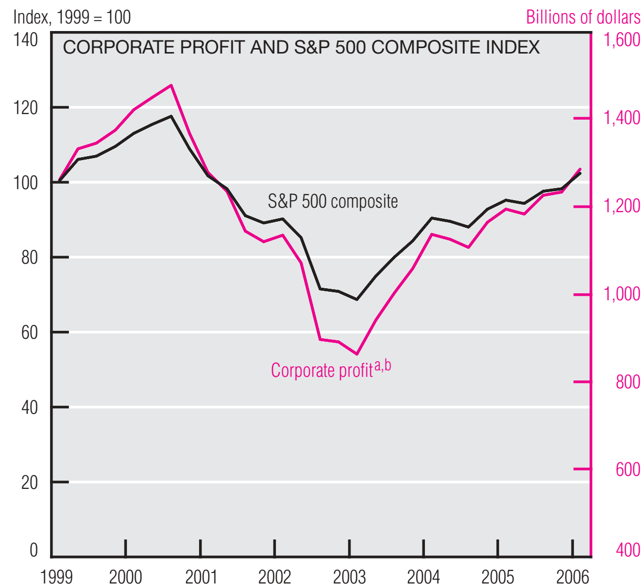
Economic Activity *(cont.)*









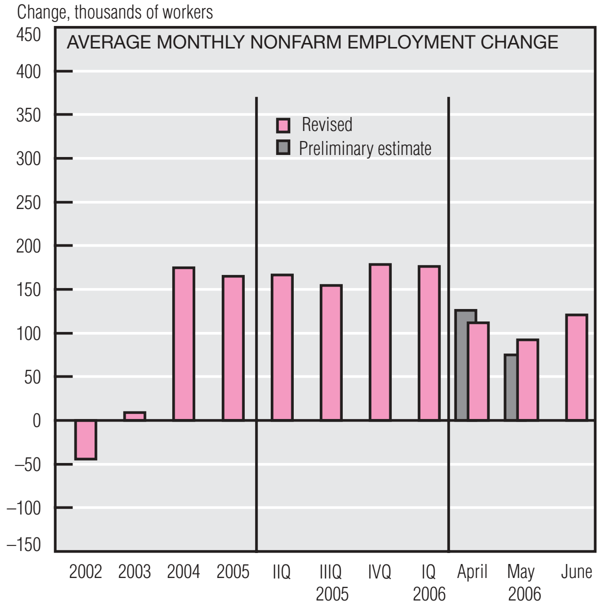
a. Seasonally adjusted.
b. Annualized.
c. Fiscal year GDP.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and the *Wall Street Journal*.

its current sequence of rate increases, economic observers are scouring incoming economic data for signs that the economy is either heating up too much or cooling down too fast. Driven by manufacturing output, which increased 5.4% over the last year, total industrial production rose 4.3% but was essentially flat from April to May 2006. Utilities were up only 3.4% from May 2005 to May 2006, but this series is highly volatile because unseasonable weather can cause sharp swings in demand. Except for the hurricanes' disruptions of Gulf Coast oil and natural gas production last fall, mining output has been essentially flat since April 2003.

As output has expanded, so has capacity utilization, a widely followed measure of how close the economy is to its potential; however, at 81.1% it has just reached the level it averaged in the late 1990s. Consequently, there is little upward pressure on prices from this source. Investment, which expands capacity, was up 3.9% from March 2005 to March 2006 and could keep capacity utilization at a moderate level. The inventory-to-sales ratio is another measure that is often considered an indicator of the health of the economy. This series also seems to be sending a favorable signal: It has been relatively unchanged over the last 12 months.

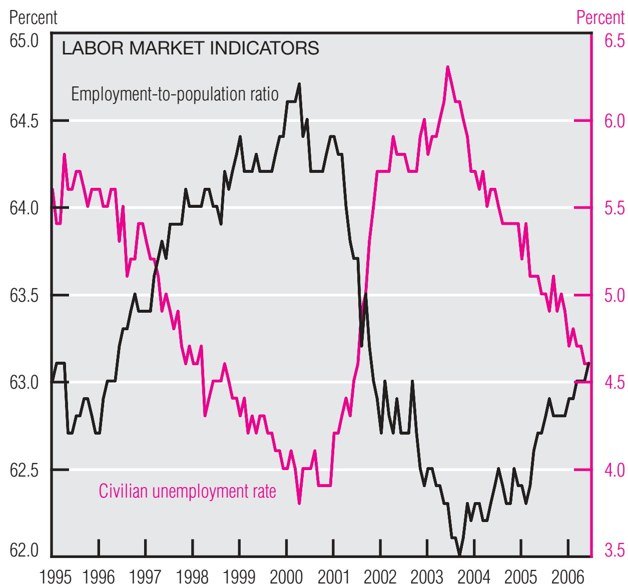
Despite the stock market's recent downturn of about 2% since the end of the first quarter, investors have been pleased with corporate profits, which increased 28.5% from 2005:IQ to 2006:IQ. Over the same period, the S&P 500 Composite Index rose 7.6%.

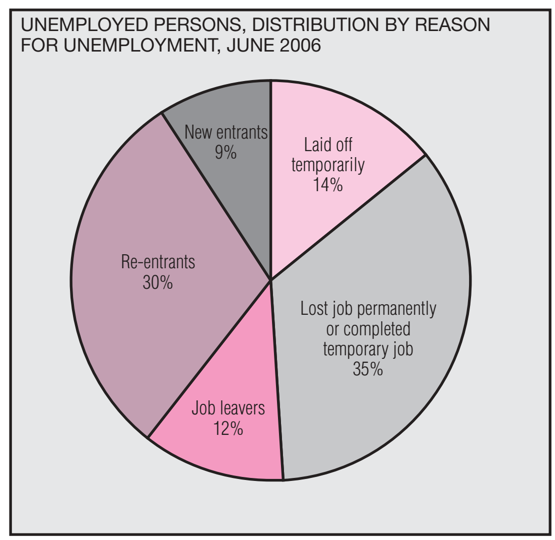
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2003	2004	2005	Jan.–May 2006	June 2006
Payroll employment	9	175	165	147	121
Goods producing	–42	28	22	27	15
Construction	10	26	25	19	–4
Manufacturing	–51	0	–6	3	15
Durable goods	–32	9	1	9	15
Nondurable goods	–19	–9	–7	–7	0
Service providing	51	147	143	120	106
Retail trade	–4	17	13	–15	–7
Financial activities[a]	7	8	12	19	3
PBS[b]	23	40	41	27	25
Temporary help svcs.	12	13	14	–6	–8
Education & health svcs.	30	33	31	35	26
Leisure & hospitality	19	26	21	19	16
Government	–4	13	14	12	31
	Average for period (percent)				
Civilian unemployment rate	6.0	5.5	5.1	4.7	4.6





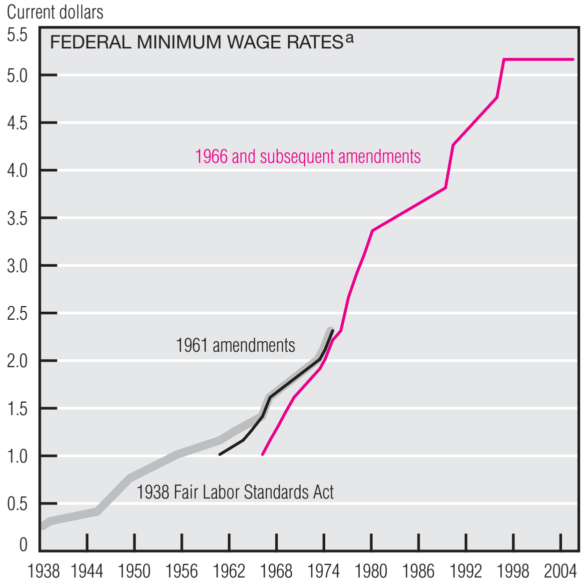
NOTE: All data are seasonally adjusted.
a. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.
b. Professional and business services include professional, scientific, and technical services, management of companies and enterprises, administrative and support, and waste management and remediation services.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

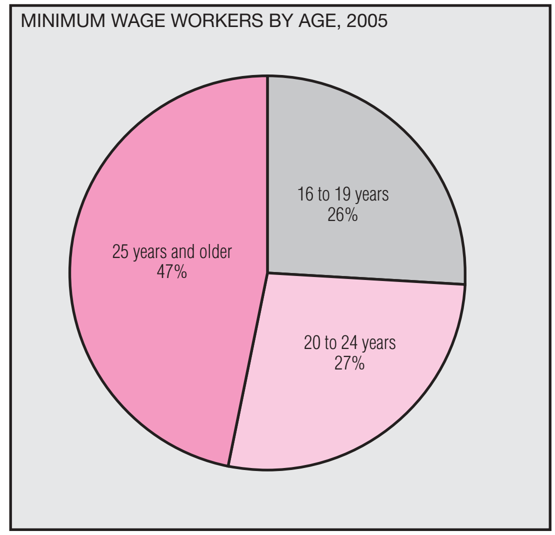
Nonfarm payroll growth was muted in June, showing a net increase of only 121,000 jobs. In 2006:IIQ, payroll growth averaged 108,000 per month, less than the average monthly increase of 169,000 jobs during the previous four quarters.

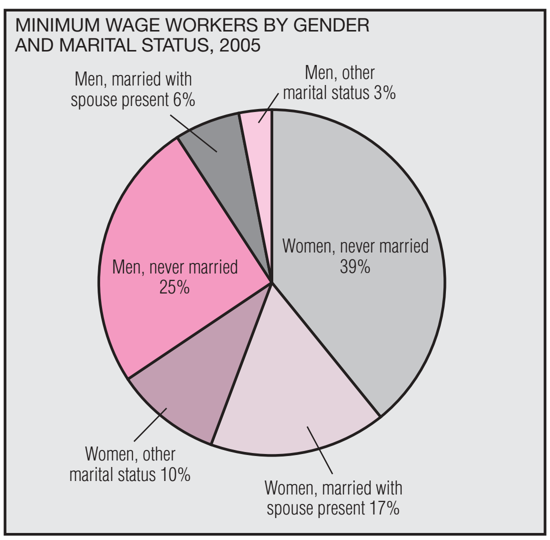
Employment growth in service-providing industries was sluggish: It was up 106,000 jobs during the month, well below the average monthly growth since the beginning of this year and throughout the previous two years. Job growth among private service-providing industries was concentrated in education and health services (up 26,000) and professional and business services, which increased by 25,000 jobs in June, only slightly less than the 27,000 average monthly gain since January and below the 41,000 average monthly gain in 2005. Job growth in temporary help services, an industry that is generally considered a bellwether of underlying job growth, fell in June and has been sluggish so far this year. Meanwhile, manufacturing employment rose by 15,000 jobs during the month, well above its average monthly growth rate since January.

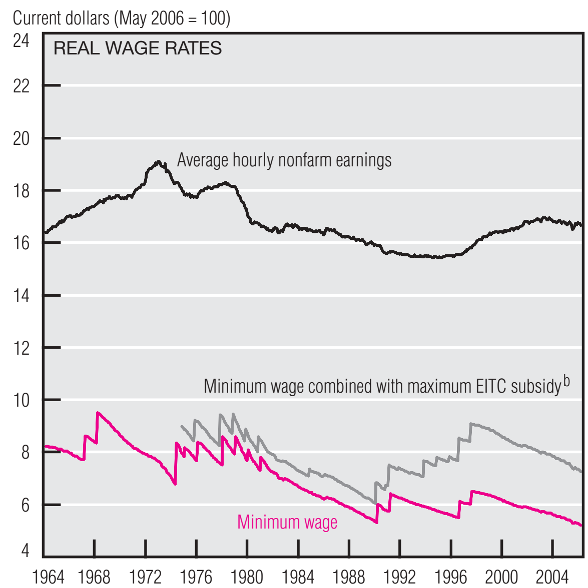
The employment-to-population ratio inched up to 63.1%, while the unemployment remained at 4.6% (the lowest rate in five years) for the second consecutive month. People who have lost their jobs permanently or have completed temporary jobs account for the largest share of the unemployed (35%), while re-entrants into the labor force account for 30%.

Low-Wage Workers









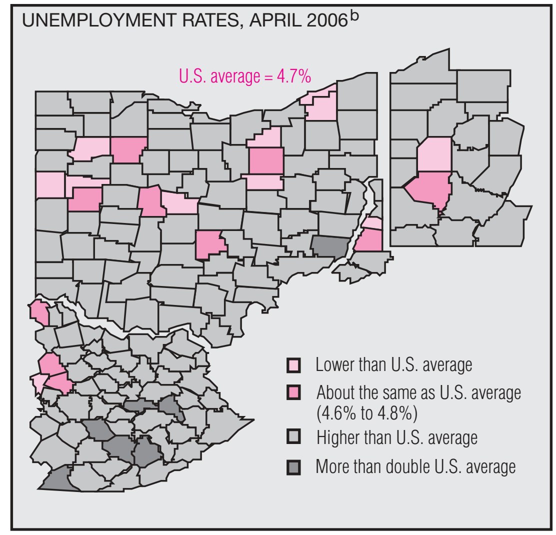
a. Overlaps represent extended coverage established by amendments.
b. The maximum EITC subsidy is for a family with two or more eligible children.
SOURCES: Department of Labor, Bureau of Labor Statistics and Employment Standards Administration.

Last year, nearly two million workers, or about 1½% of all wage and salary workers, earned the prevailing federal minimum wage of $5.15 per hour—or less. Roughly half of them were under 25, and about one-fourth were teenagers; most worked part time, and most were in service occupations such as food preparation. Of the hourly workers who earned the prevailing minimum wage or less, 66% were women and about 40% were never-married women.

Studies suggest that raising the minimum wage by 10% will reduce employment among low-skilled workers by about 1% to 2%. However, studies also indicate that a higher minimum wage not only induces firms to substitute capital for unskilled labor, thereby laying off part-time and lower-wage workers, but also leads to reduced hours for those who remain. Thus, minimum wage increases, which are designed to aid low-wage workers, can actually lower their earnings because the pay increase is offset by a decrease in hours.

A more effective antipoverty policy is the Earned Income Tax Credit (EITC), a refundable tax credit that reduces or eliminates the taxes paid by low-wage workers. Studies suggest that the EITC does help families rise above poverty-level earnings and serves as a positive work incentive, which leads to higher earnings. The maximum EITC subsidy can boost effective wages for eligible workers by up to 40%.

Fourth District Employment



Payroll Employment by Metropolitan Statistical Area

	12-month percent change, May 2006							
	Cleveland	**Columbus**	**Cincinnati**	**Dayton**	**Toledo**	**Pittsburgh**	**Lexington**	**U.S.**
Total nonfarm	0.0	1.0	1.1	–0.3	0.4	0.6	1.0	1.4
Goods-producing	–1.2	1.2	–0.1	–0.9	–0.7	–0.7	0.0	1.3
Manufacturing	–0.7	0.9	–0.6	–1.2	–1.0	–2.5	–0.8	–0.1
Natural resources, mining, and construction	–2.9	1.7	1.3	0.0	0.0	2.2	2.3	3.9
Service-providing	0.2	0.9	1.3	–0.2	0.6	0.8	1.3	1.4
Trade, transportation, and utilities	–1.0	0.5	–0.5	–1.5	–0.2	0.2	2.6	0.5
Information	–2.5	–0.5	–2.5	–2.7	–7.3	–3.9	–2.2	–0.4
Financial activities	–0.4	–0.3	0.9	–3.1	4.4	0.1	2.8	2.7
Professional and business services	1.8	2.1	3.5	2.3	1.8	0.5	0.0	2.7
Education and health services	1.6	2.3	2.1	0.6	2.4	2.2	1.3	2.4
Leisure and hospitality	2.0	1.1	2.5	1.8	0.9	3.7	3.9	1.7
Other services	–0.7	1.6	1.2	–1.8	0.0	–0.8	–1.0	0.6
Government	–1.5	0.0	0.7	–1.1	–1.2	–0.8	–0.2	0.6
April unemployment rate (percent)[b]	4.9	4.9	5.5	5.9	6.1	4.9	4.7	4.7

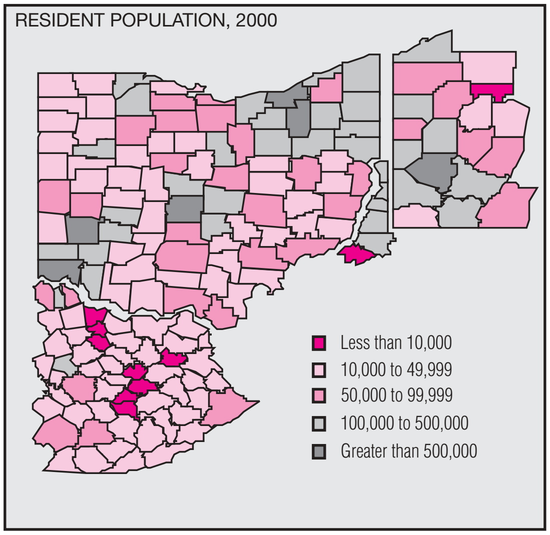
a. Shaded bars represent recessions.
b. Seasonally adjusted using the Census Bureau's X-11 procedure.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

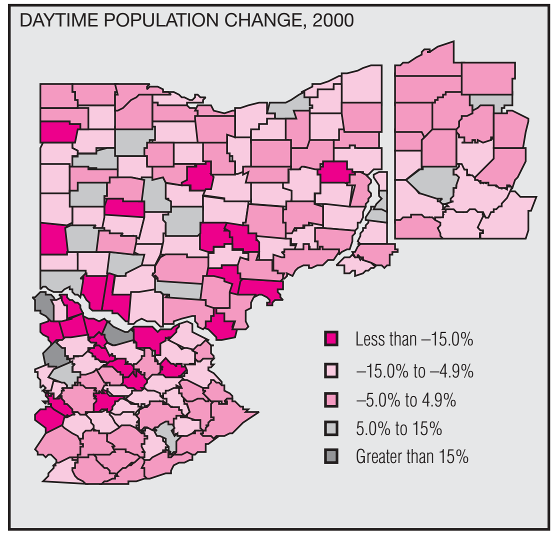
The Fourth District's unemployment rate rose from 5.1% in March to 5.5% in April, largely because the estimated number of unemployed rose 8.3%. (However, compared to April 2005, the number who had no job but were looking for one fell 6.1%.) In comparison, the U.S. unemployment rate dropped from 4.7% in April to 4.6% in May.

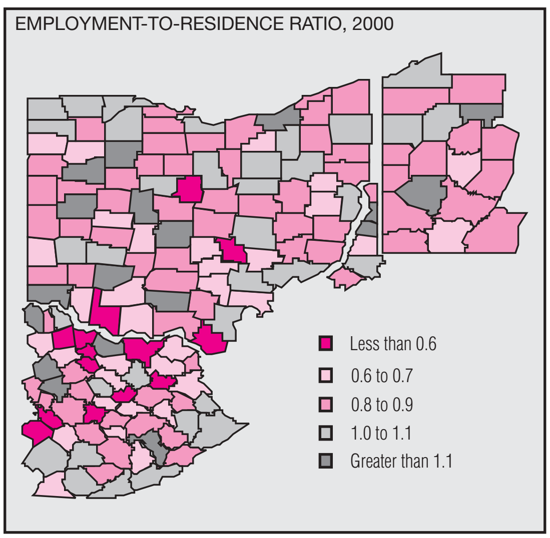
In April, 11 of the District's counties had unemployment rates that were lower than the national average, and 10 had rates near that mark; jobless rates in the other 148 counties were higher than average. From March to April, rates in all of the District's major metropolitan areas stayed the same or increased. Unemployment rates exceeded the U.S. average in each of these areas except Lexington, which matched the average.

May's nonfarm employment was up from May 2005 levels in each of the District's major metropolitan areas but Dayton, which lost 0.3% of its jobs. Part of the reason for Dayton's poor showing was a decrease in service-providing employment over the year; it was the only major metro area in the District where this occurred. Nevertheless, industries such as professional and business services, education and health services, and leisure and hospitality continue to do well: Employment in these three industries increased over the year in every major metropolitan area in the District.

The Fourth District's Daytime Population







City Populations, 2000

	Total resident population, thousands	Estimated daytime population, thousands	Percent change	Employment-to-residence ratio
Columbus	711	794	11.6	1.22
Pittsburgh	335	473	41.3	1.97
Cincinnati	331	434	31.0	1.70
Cleveland	478	593	24.0	1.65
Lexington	261	291	11.6	1.22
Toledo	314	329	5.1	1.12

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

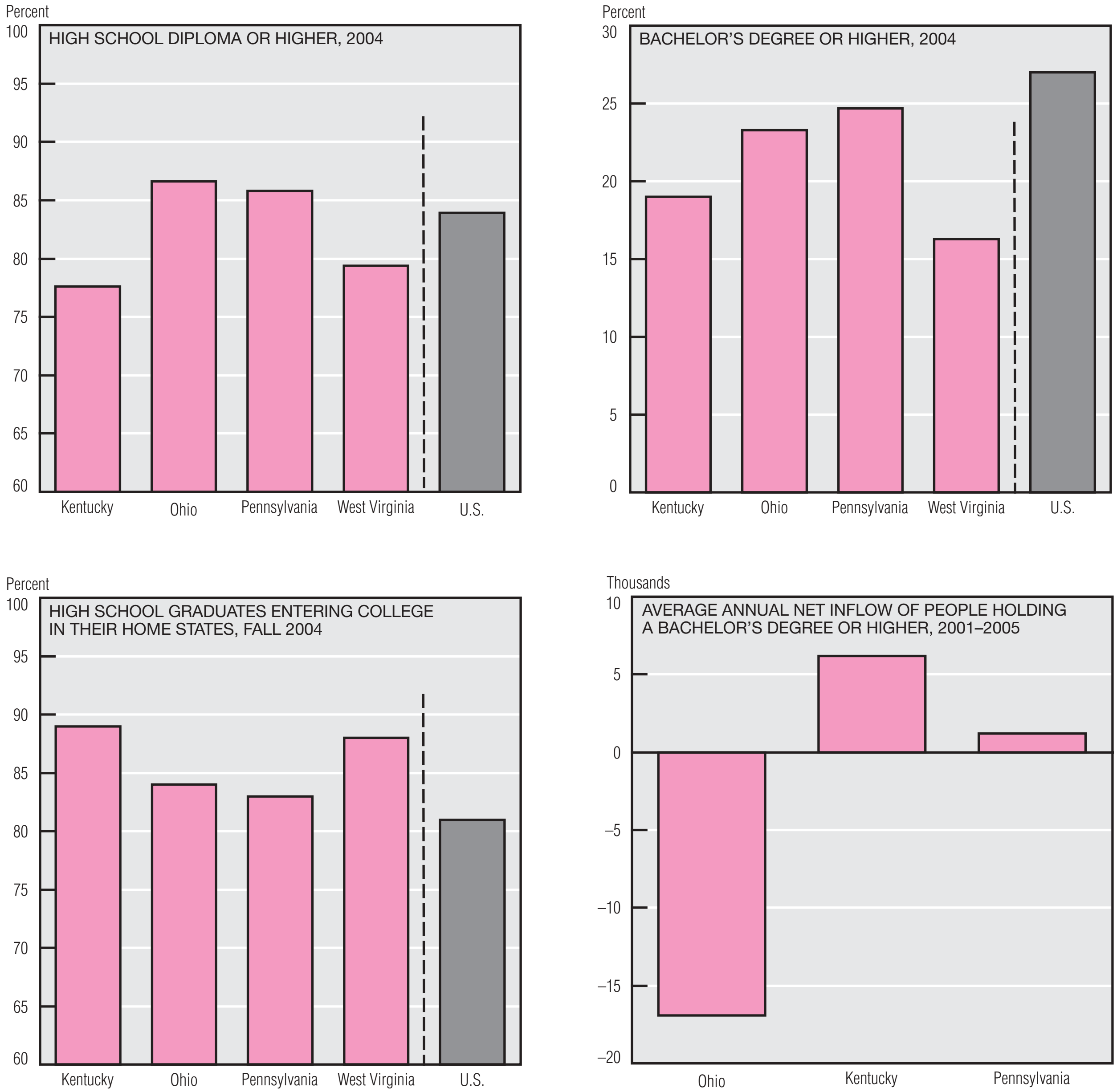
People usually think of population in terms of residents, that is, the number of people living in an area. That number can change significantly during the day, however, because some people commute to work in an area different from that in which they live. The measure of daytime population captures this by adjusting resident population by the number of in-commuters and out-commuters.

The populations of counties such as Franklin (which contains Columbus), Hamilton (Cincinnati), Cuyahoga (Cleveland), Allegheny (Pittsburgh), and Fayette (Lexington) all expanded at least 5% during the day in 2000 because more workers commuted into than out of them. Not surprisingly, the daytime population of surrounding counties tended to fall. For example, the number in Campbell County, which borders Cincinnati's Hamilton County, fell an estimated 18% during the day.

Very similar to the daytime population measure is the employment-to-residence ratio, which represents the number of people working in an area relative to the number of workers living there. A ratio higher than one would indicate that more workers are working in an area than living there, making the area a net importer of labor. This is the case in most counties that contain major cities.

Among the largest cities in the District, Pittsburgh's population changes most by day, expanding more than 40%. Indeed, the number of workers who have jobs in the city is almost double the number who live there.

Educational Attainment in the Fourth District



SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Education, National Center for Education Statistics.

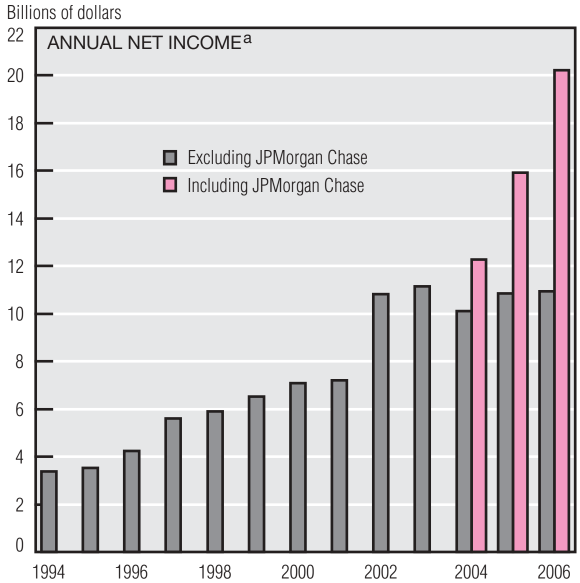
In the Fourth District states, 84.6% of the residents who were 25 or older in 2004 had attained a high school diploma, slightly beating the national average of 83.9%. The percentage of residents with high school diplomas was higher in Ohio and Pennsylvania than in the nation; however, Kentucky and West Virginia trailed the national average by 6.3% and 4.5%, respectively.

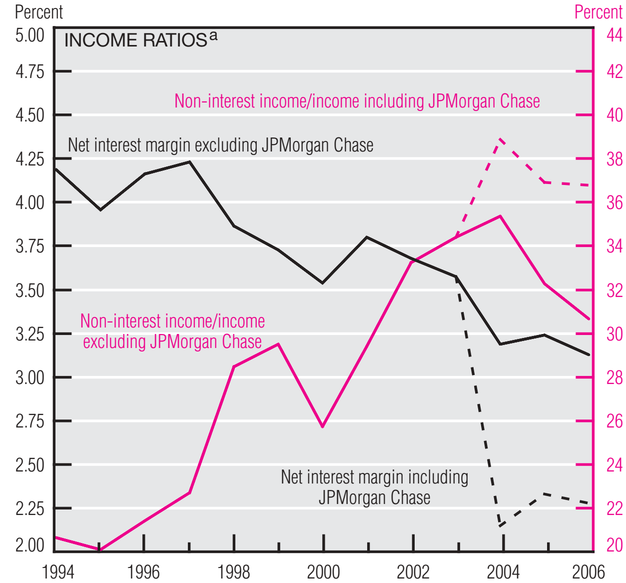
A similar pattern is apparent at the post-secondary level. The percentage of residents holding a bachelor's degree lagged the U.S. average in Kentucky (by 8.0%) and West Virginia (by 10.7%). Although much closer to the national average, Ohio and Pennsylvania still trailed it by 3.7% and 2.3%, respectively.

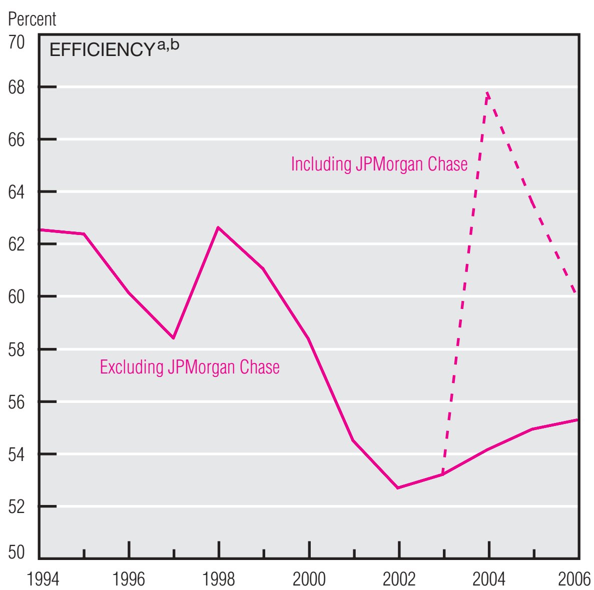
When the Fourth District states' 2004 high school graduates went on to college in the fall, the vast majority remained in their home states. In Kentucky, 89% of college-bound graduates stayed in the state. The percentages were similar in Ohio, Pennsylvania, and West Virginia, all of which are above the national average.

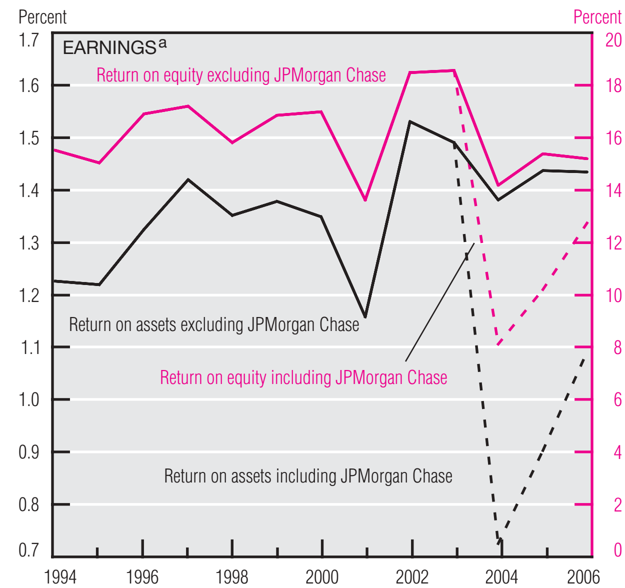
Besides educating its own residents, a state can raise educational attainment levels by importing people who earned college degrees elsewhere. Ohio has done poorly in this respect: In the last five years, the state suffered net annual losses of almost 17,000 people with a bachelor's degree or higher. Kentucky, in contrast, imported more than 6,000 college grads annually during the same period.

Fourth District Banking Conditions









a. Through 2006:IQ only. Data for 2006 are annualized.
b. Efficiency is operating expenses as a percent of net interest income plus non-interest income.
SOURCE: Author's calculations from Federal Financial Institutions Examination Council, *Quarterly Bank Reports of Condition and Income*.

FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District posted net income of $2.74 billion for 2006:IQ ($10.94 billion on an annual basis), up about 1% from 2005. (JPMorgan Chase, chartered in Columbus in 2004, is not included in this discussion because its assets are mostly outside the District and its size—roughly $1 trillion—dwarfs that of other District institutions.) For the same period, the U.S. banking industry as a whole posted earnings of $37.69 billion ($150.76 billion on an annual basis), an increase of about 20% from the end of 2005.

At the end of 2006:IQ, Fourth District banks' net interest margin (a measure of core profitability computed as interest income minus interest expense divided by average earning assets) had fallen slightly to 3.12% but still exceeded the 3.04% U.S. average. Non-interest income, however, fell to 30.60% of total income, about a 13% decline from the peak of 35.30% at the end of 2004. Nationwide, net interest margin was nearly unchanged from the end of 2005. Non-interest income fell to 31.63% of total income. This trend suggests that in an environment of rising interest rates, interest income is returning to its traditional role as banks' primary source of income.

At the end of 2006:IQ, District banks' efficiency (operating expenses as a percent of net interest income plus non-interest income) had deteriorated to 55.23% from the 52.64% record set in 2002 (lower numbers correspond to greater efficiency). Nationwide, efficiency improved significantly, declining to 54.92% from 56.40% at the end of 2005.

At the end of 2006:IQ, District banks posted a 1.43% return on assets (unchanged from the end of 2005) and a 15.15% return on equity (slightly

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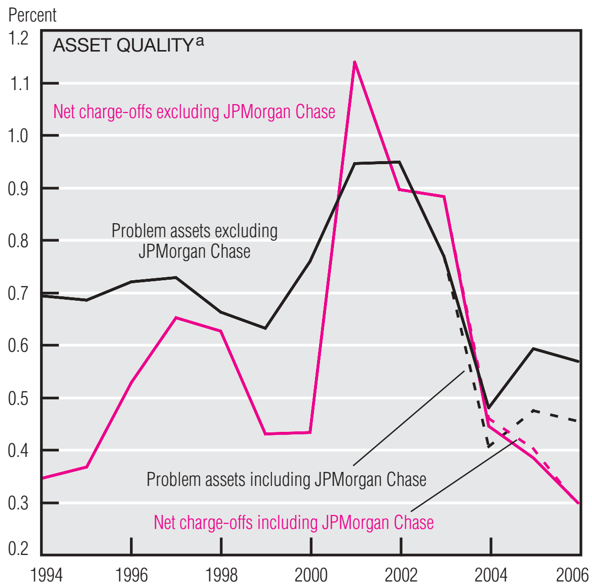
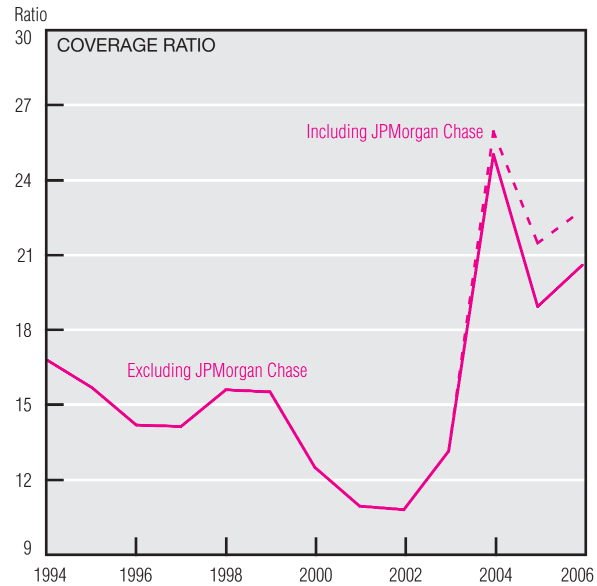
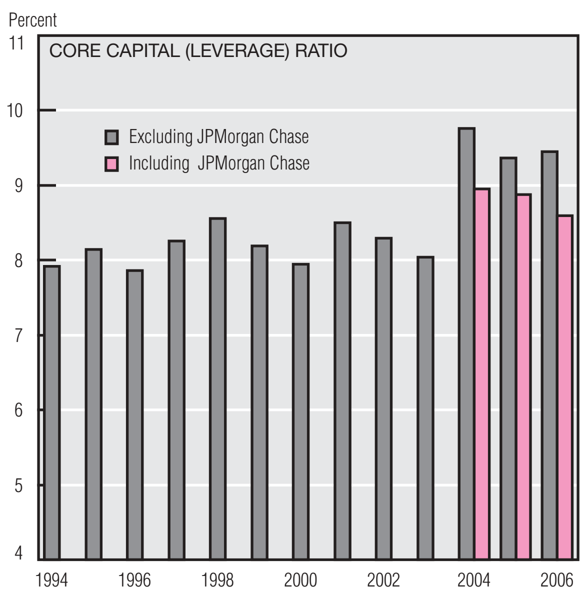
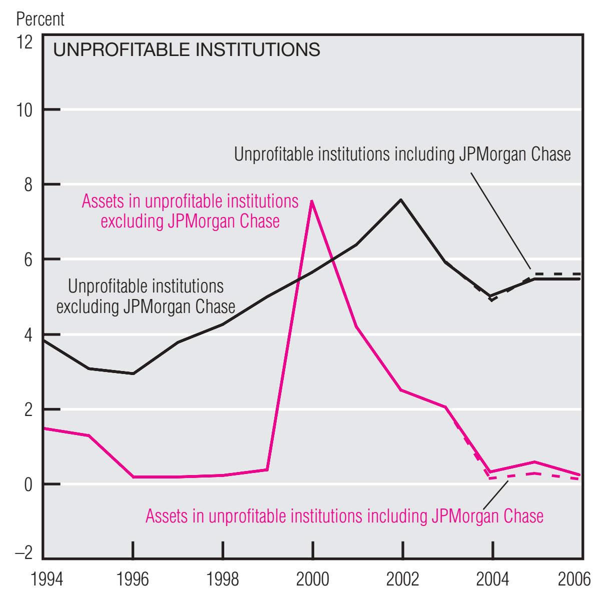
Fourth District Banking Conditions (cont.)









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

down from 15.32% at the end of 2005). Despite a hiccup in income numbers relative to the nation, the District performed better than the industry nationwide. At the end of 2006:IQ, the U.S. banking industry's return on assets was 1.25% (up from 1.08% at the end of 2005), while return on equity was 13.32% (up from 11.55% at the end of 2005).

Fourth District banks' overall financial indicators pointed to fairly strong balance sheets at the end of 2006:IQ. Net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) represented 0.30% of total loans (down from 0.38% at the end of 2005), the same as the U.S. average (down from 0.46%). Problem assets (nonperforming loans and repossessed real estate) as a share of total assets fell slightly to 0.57% from 0.59% at the end of 2005, worse than the national average of 0.42% of assets (down from 0.45%).

Fourth District banks held $20.54 in equity capital and loan loss reserves for every dollar of problem loans, which was well above the recent coverage-ratio low of 10.75 at the end of 2002, but below the record high of 24.97 at the end of 2004. Equity capital as a share of Fourth District banks' assets (the leverage ratio) rose from 9.36% at the end of 2005 to 9.45% at the end of 2006:IQ.

The share of unprofitable banks in the Fourth District fell from 5.43% at the end of 2005 to 5.17% at the end of 2006:IQ. The average size of such banks also fell, from 0.56% of District banks' assets to 0.20%. Industrywide, the share of unprofitable banks grew from 6.28% at the end of 2005 to 6.54% at the end of 2006:IQ; their asset size, however, fell from 1.13% to 0.76% during the same period.