The Economy in Perspective

by Mark Sniderman

"Money talks" because money is a metaphor, a transfer, and a bridge. Like words and language, money is a storehouse of communally achieved work, skill, and experience.

—Marshall McLuhan,
Understanding Media, ch. 14 (1964)

Inflation—the rate at which the purchasing power of money declines—is a big deal. In his 1931 *Essays in Persuasion*, John Maynard Keynes wrote, "The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens." History is filled with examples of governments, elected or not, that cheapened their currency to the detriment of their own citizens.

The United States last experienced a serious bout of inflation in the 1970s: The buying power of a 1970 dollar was reduced to about 47 cents by 1980. And inflation was not only high but also variable. People found it difficult to plan from one year to the next, and those who saved demanded protection in the form of higher interest rates to compensate them for inflation. Nevertheless, Americans tolerated accelerating inflation for a while. They had been told that inflation in itself was not very harmful to economic growth and that lower inflation would require significantly higher unemployment. But inflation was taking a toll on the economy. Investment suffered and productivity declined. Working people felt that their wages were not keeping up with the prices of the things they bought; retirees feared that they would outlast their savings.

The public eventually demanded an end to the Great Inflation, as it has since been dubbed, and ever since the 1980s has supported Federal Reserve policies designed to bring inflation down and keep it down. People seem to accept the proposition that inflation does not buy more economic growth—on the contrary, they understand that chronic inflation actually harms economic growth and their own welfare.

Returning to the very low inflation rates that prevailed in the 1960s has taken quite a while and has been a gradual process. The purchasing power of a 1980 dollar declined to 63 cents by 1990—a much better performance than the drop to 47 cents in the previous decade, but still a long way from representing a stable currency. Inflation performance improved in the 1990s: The purchasing power of a 1990 dollar was down to 76 cents by the end of the decade. It held its value even better in the new century: From 2000 to 2005, a dollar's worth fell to 88 cents; if inflation finishes this decade at the same pace as in the first half, a 2000 dollar will purchase 79 cents in 2010. This is pretty good performance. By way of comparison, at an average inflation rate of 2 percent per year, a dollar's buying power will decline to 82 cents after 10 years. Given various problems in accurately measuring the full value of goods and services that reflect new and improved products, 2 percent inflation approximates stability in purchasing power.

Thanks to public support and reasonably successful monetary policy, inflation stayed out of the spotlight for a long while, but during the past couple of years a surge in energy prices has propelled inflation concerns back to center stage. It's not that inflation has actually become a serious problem again, but rather that so many people are concerned that it could. From a historical perspective, this manifest public anxiety about inflation represents a heartening development. It means that far from having to convince the people that preserving price stability merits public support, the Federal Reserve can rely on their support when it becomes necessary to take actions toward achieving this goal.

After 17 consecutive increases in its federal funds rate target, the Federal Open Market Committee declined to take further action at its August, September, and October meetings. During this interval, inflation news has been promising: The plunge in oil prices promises some relief. Commodity prices appear to be stabilizing after a period of rapid ascent. House prices have begun to slip in many markets, and a number of experts anticipate further declines. Yet, despite the potential for good news on the inflation front, worries persist.

Weighing all of the evidence, the FOMC continues to cite inflation as one of the key risks our economy faces. But inflation would pose a far more serious risk if the FOMC did not cite it and the public did not support its reduction.

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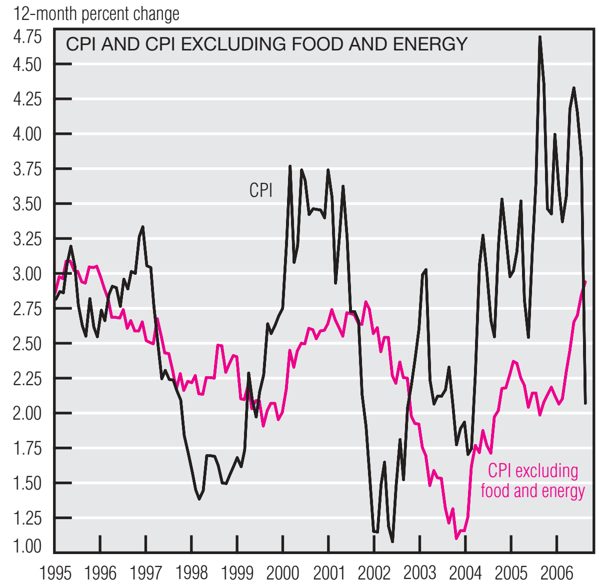
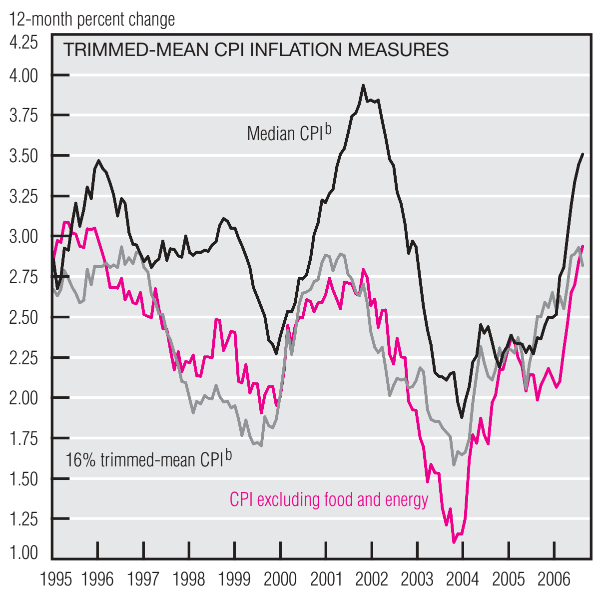
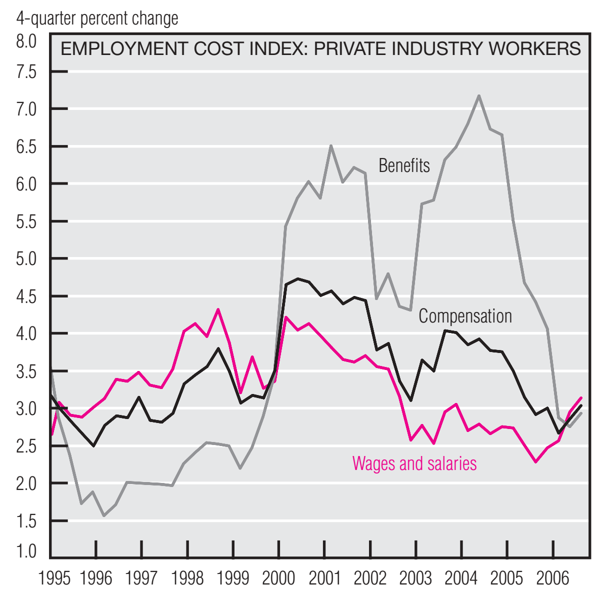
Inflation and Prices

September Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	6 mo.[a]	12 mo.	5 yr.[a]	2005 avg.
Consumer Price Index						
All items	–5.7	0.8	2.9	2.1	2.6	3.6
Less food and energy	2.9	2.7	3.2	2.9	2.1	2.2
Median[b]	3.6	3.8	3.9	3.5	2.7	2.5
16% trimmed mean	2.4	2.9	3.0	2.8	2.3	2.6
Producer Price Index						
All items	–14.5	–4.4	0.9	0.9	2.5	5.7
Less food and energy	7.0	–0.3	1.0	1.2	1.1	1.5







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

The Consumer Price Index (CPI) fell at a 5.7% annualized rate during September, its sharpest one-month decline this year and a dramatic reversal of the 3% rise the index posted the previous month. Not surprisingly, the core inflation measures showed considerably more steadiness in September and suggest that the underlying inflation trend may be stabilizing. The CPI excluding food and energy rose 2.9% for the second straight month, and the median CPI rose 3.6%. The 16% trimmed-mean CPI, which attempts to isolate an inflation trend by eliminating the highest and the lowest 8% of the monthly price changes, rose 2.4%. All of these inflation measures were about the same or down slightly from their trends over the past six and 12 months.

Nevertheless, longer-term growth trends in the "core" retail price measures continue to be elevated: The 12-month growth rates of the CPI excluding food and energy and the 16% trimmed-mean CPI were between 2¾% and 3% in September. The 12-month growth rate in the median CPI reached 3½% during the month, its highest rate in more than four years.

Among the factors that analysts are watching closely to gauge shifts in the inflation trend is the growth in labor costs—which have been inching a bit higher in recent quarters. In 2006:IIIQ, employment costs' four-quarter growth rate ticked up

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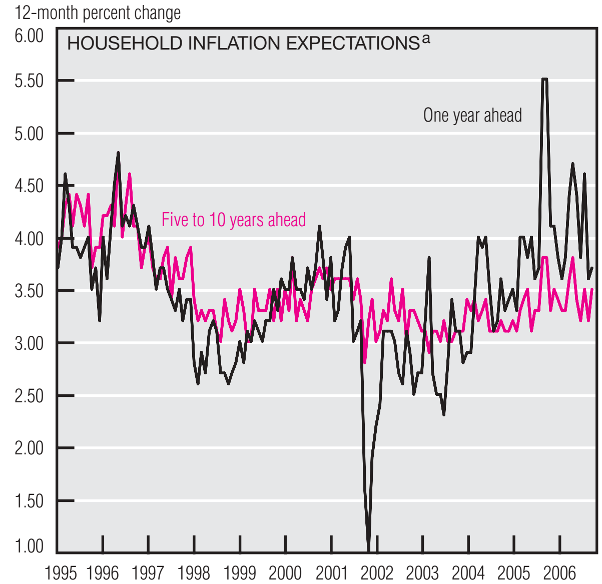
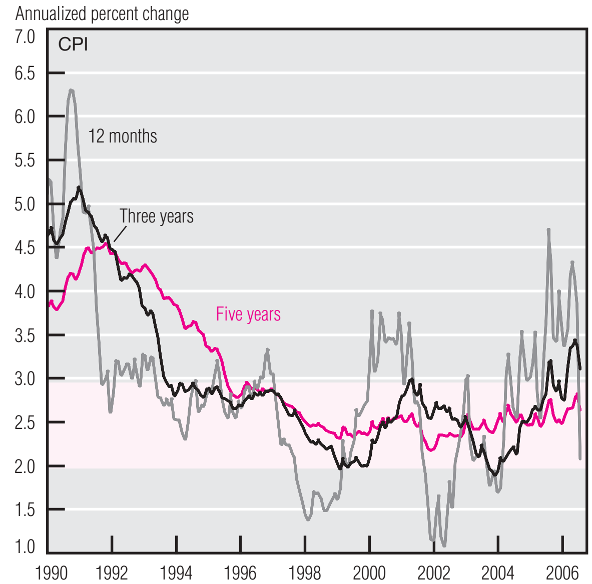
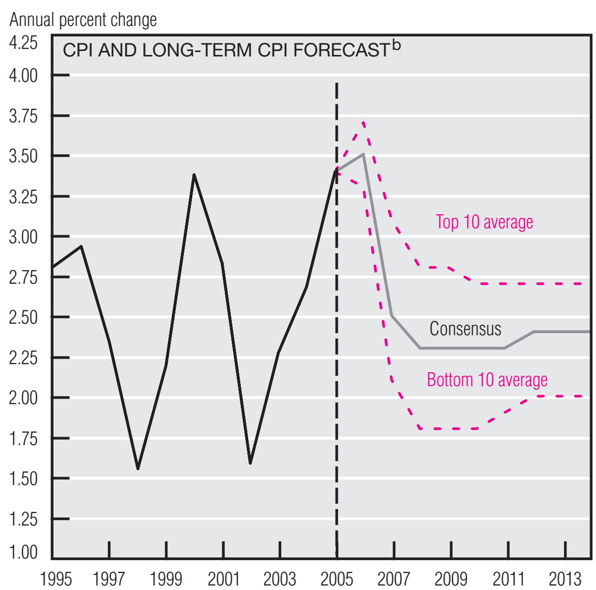
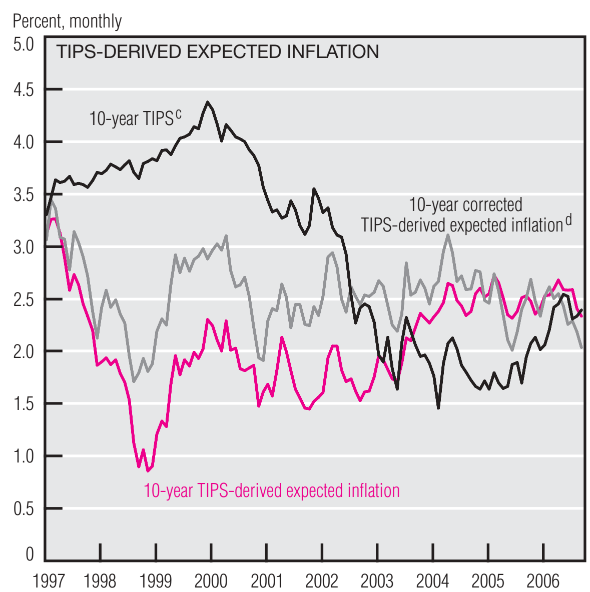
Inflation and Prices (cont.)









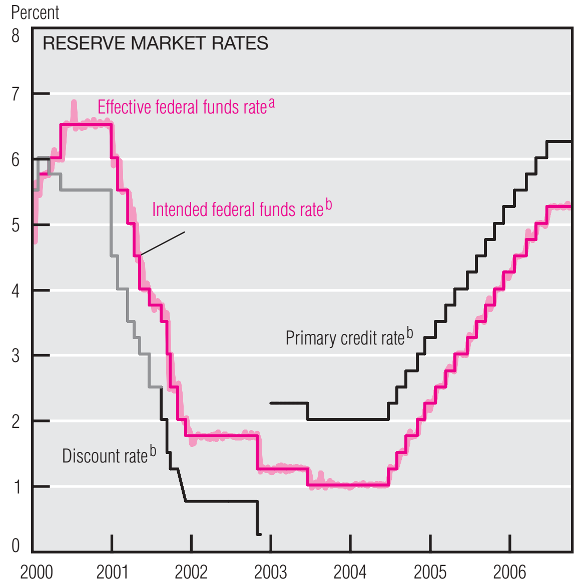
a. Mean expected change as measured by the University of Michigan's *Survey of Consumers*.
b. Blue Chip panel of economists.
c. Treasury inflation-protected securities.
d. Ten-year TIPS-derived expected inflation, adjusted for the liquidity premium on the market for the 10-year Treasury note.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; *Blue Chip Economic Indicators*, October 10, 2006; University of Michigan; and Bloomberg Financial Information Services.

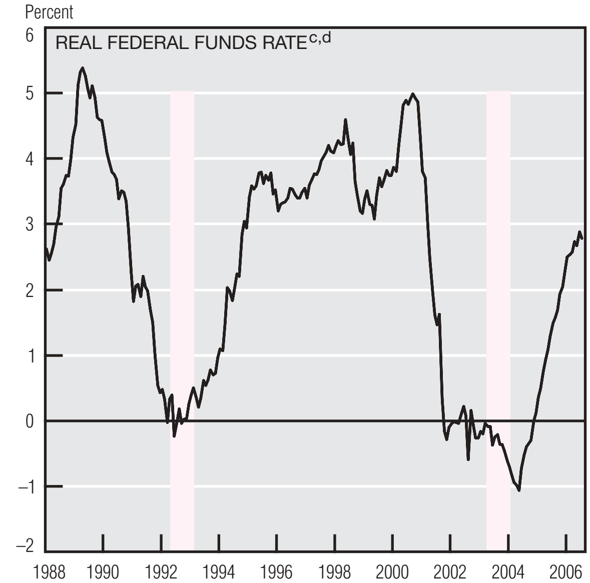
to 3% amid a modest rise in benefit costs. Wage and salary growth has shown steadier acceleration and, at 3.1% over the four quarters ended in 2006:IIIQ, is the strongest wage and salary gain in four years.

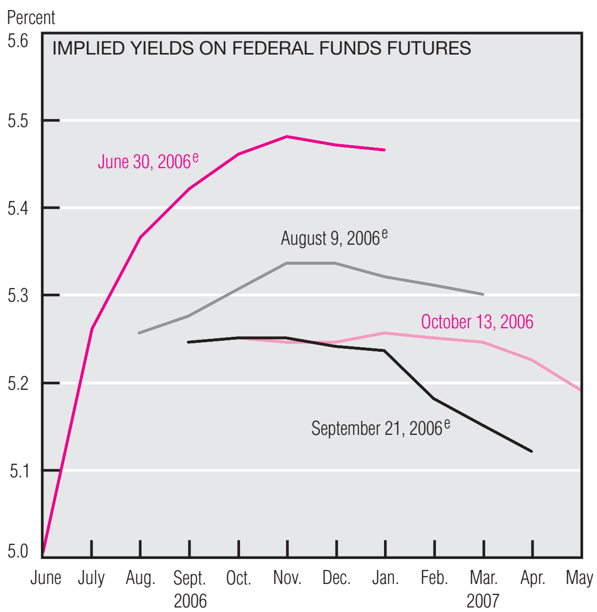
Where is the long-run inflation trend headed? According to the University of Michigan's October survey, households anticipate that prices will rise 3.7% over the next year and average only a slightly more moderate $3\frac{1}{2}$% over the next five to 10 years. This is a bit higher than the long-run inflation predictions that households made between 2001 and 2005.

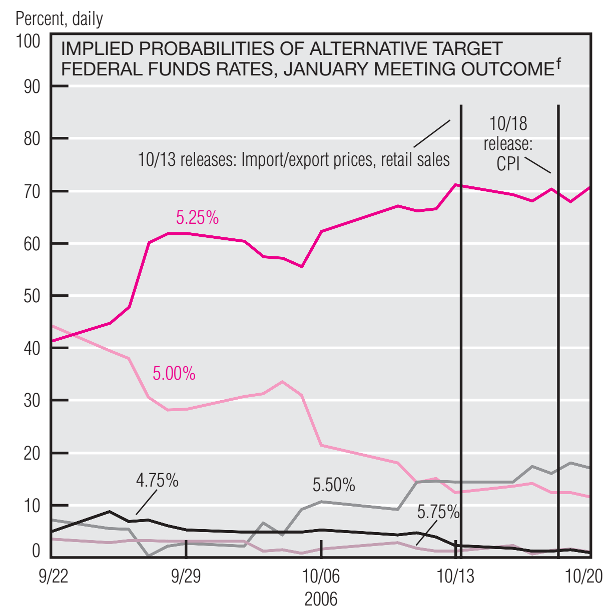
Indeed, although the CPI's five-year growth trend has been maintained within the range between 2% and 3% for more than a decade, it has recently drifted to the upper end of that range. Economists and others generally expect that the long-run CPI trend will eventually begin to drift lower, but the consensus prediction from the Blue Chip panel of economists calls for the CPI to stay between $2\frac{1}{4}$% and $2\frac{1}{2}$% through the forecast horizon ending in 2013. This is similar to the long-run inflation prediction implied in the bond market. The spread between the 10-year Treasury bond and Treasury inflation-protected securities (TIPS) indicates that market participants expect CPI inflation to average between 2% and $2\frac{1}{2}$% over the next 10 years.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE Chain Price Index.
d. Shaded bars indicate periods of recession.
e. One day after the FOMC meeting.
f. Probabilities are calculated using trading-day closing prices from options on January 2007 federal funds futures that trade on the Chicago Board of Trade.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Chicago Board of Trade; *USA Today*; and Bloomberg Financial Information Services.

The Federal Open Market Committee (FOMC) left the target federal funds rate at 5.25% on October 25, the third consecutive meeting with no change. The Board of Governors likewise left the primary credit rate unchanged at 6.25%. The real federal funds rate, defined as the effective federal funds rate less core PCE inflation, has shown signs of leveling off and now stands at 2.73%.

A mid-October survey by *USA Today* reported that about two-thirds of economist respondents said that current target rate was "just right." As for the direction of future policy, more than half expect the Fed to cut interest rates in the first half of 2007. As an alternative to the survey, real-time policy expectations may be derived from implied yields on federal funds futures and implied probabilities from options on these futures. Prices of such instruments reflect the opinions of investors with something at stake.

Implied yields on futures contracts in late winter have risen modestly since the last FOMC meeting, suggesting that rate cuts are not expected before spring. Historically, these estimates appear to have been biased slightly upward for horizons farther out than three months. The small bias is believed to be a term premium for risks associated with hedging.

Evaluating the implied probabilities derived from options on fed funds futures seems to indicate that, at least through February, the fed funds target will remain at 5.25% with a probability

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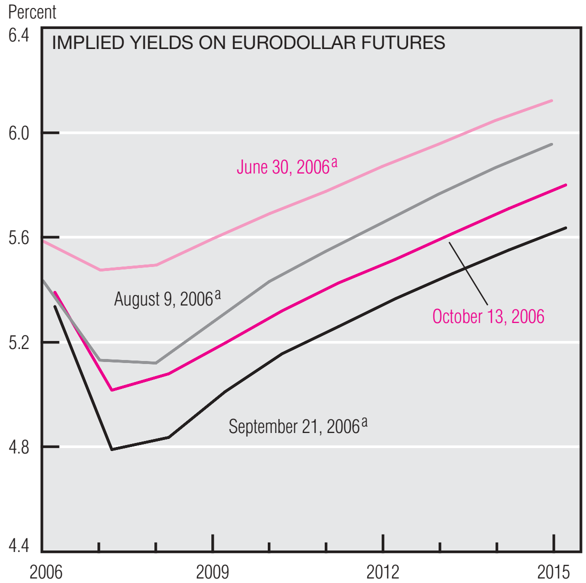
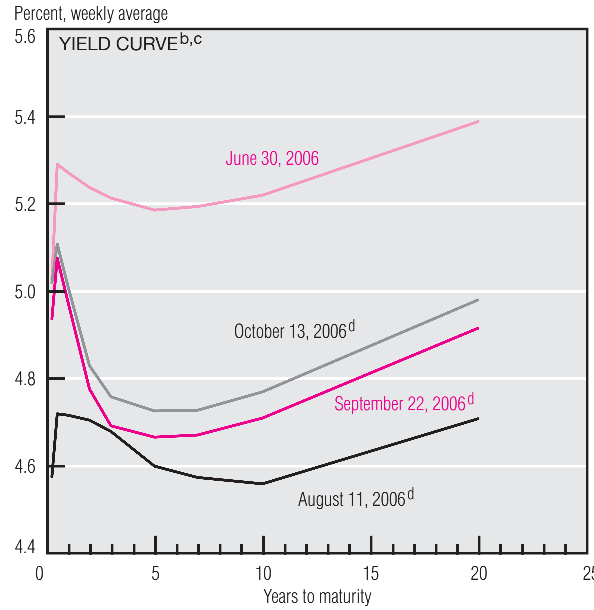
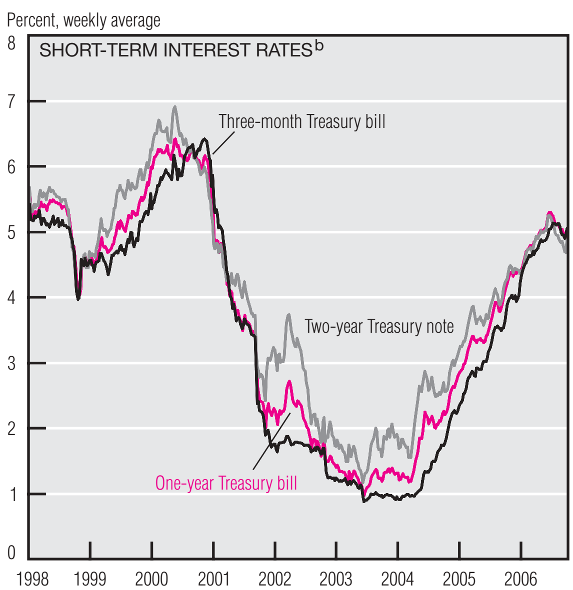
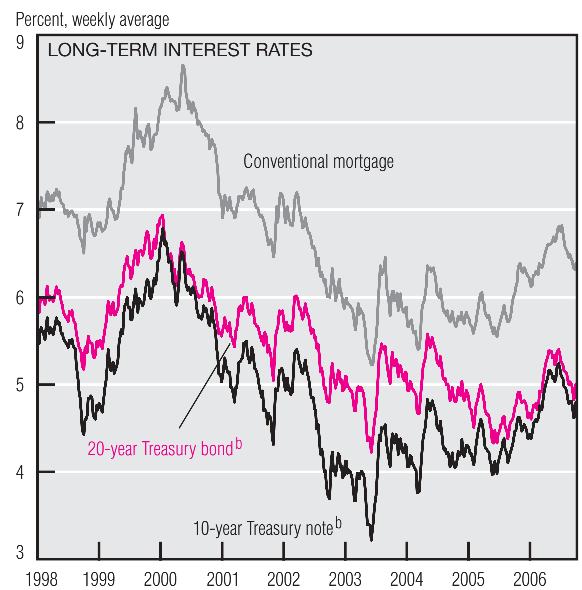








a. One day after the FOMC meeting.
b. All yields are from constant-maturity series.
c. Average for the week ending on the date shown.
d. First weekly average available after the FOMC meeting.
SOURCE: Federal Reserve Board, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

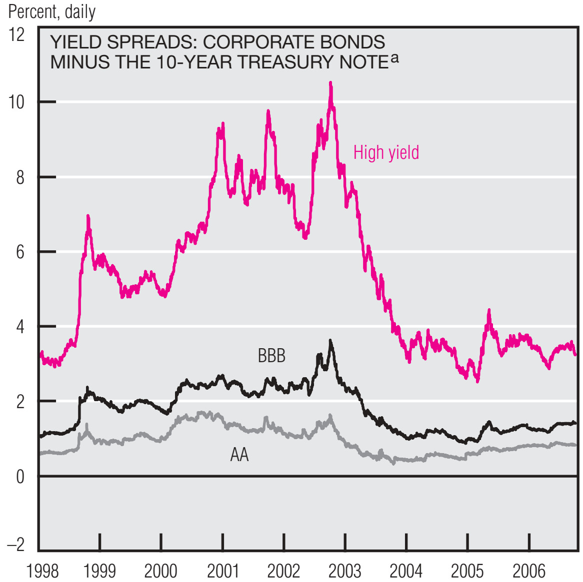
of 70%. Moreover, the implied probabilities estimated most recently reveal that the market considers a rate hike more likely than a rate cut. These differences are not statistically significant.

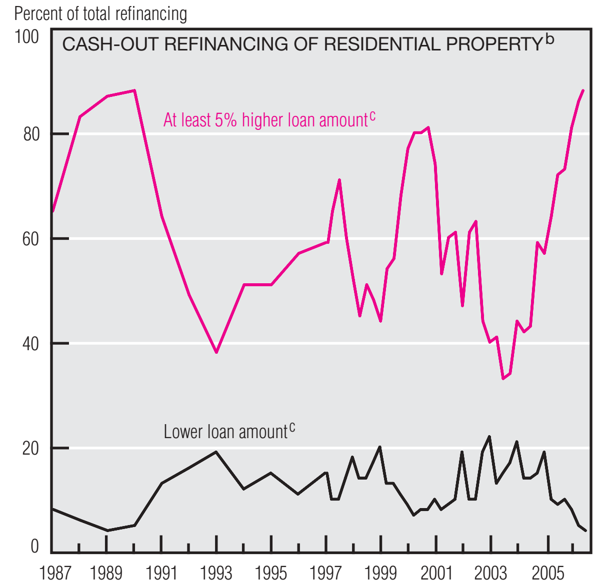
Eurodollar futures provide a measure of expected monetary policy over a longer time horizon—out several years. These yields also include premiums related to various risks beyond those faced in the federal funds market. As a result, they also tend to overpredict the fed funds rate and, as in all forecasts, the bias tends to increase as the horizon recedes. Near-term Eurodollar futures suggest that after the current "pause," fed funds rates will dip through 2007 and start to rebound in 2008. The difference between Eurodollar futures on September 21 and October 13 suggests that the likelihood of any policy "reversal" has lessened.

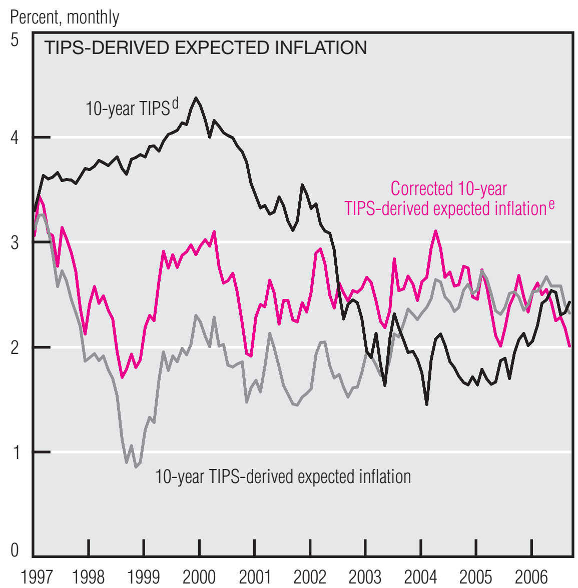
Changes in the yield curve mirrored those in Eurodollar futures. On September 22, the yield on the one-year Treasury bill was 4.97%; by October 13, it had risen to 5.01%. The yield curve currently is inverted.

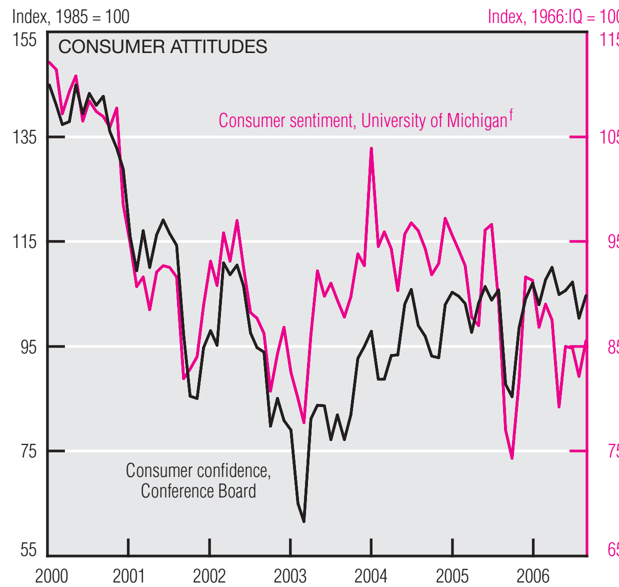
Historically, an inverted yield curve has often foretold a recession. But the relationship between the yield curve and economic activity has changed in recent years, largely because the FOMC has been able to contain inflationary pressures. Transitory inflationary pressures no longer have a substantial effect on long-term inflation expectations (and hence bond rates). Transitory inflationary shocks, however, continue to boost short-term rates as the FOMC acts to contain inflation; consequently, the yield curve inversion is now seen as the result of a stable non-inflationary policy, not the go-stop policies associated with earlier periods.

Money and Financial Markets









a. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
b. Annual data until 1997; quarterly data thereafter.
c. Compared with previous financing.
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: Federal Reserve Board, "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 they have trended up from their 2003 trough, long-term interest rates remain low by historical standards. Moreover, yield spreads between risky assets and safe ones, such as the 10-year Treasury note, have been small, a sign of investors' confidence in financial conditions.

Low mortgage rates, a key stimulus in the housing boom, were reflected by a surge in housing prices over recent years. The modest rise in mortgage rates has been associated with a cooldown in housing expenditures. In many markets, housing prices have declined over the past year.

Together, persistently "low" mortgage rates and rapidly rising housing values have enabled households to refinance their homes at higher loan amounts. The difference between new and old loan amounts—known as cash-out refinancing—has provided a deep well of cash to finance robust consumer spending in recent years. Indeed, about 90% of residential refinancing in 2006:IIQ resulted in a loan amount at least 5% higher than the previous one.

Cash-out refinancing will probably not persist at recent levels if mortgage rates stabilize at higher levels and housing prices continue to fall. If this source of household funds were to shrink, consumers would be less able to finance the high spending levels of recent years. Thus, diminished liquidity could compound the effects of a housing decline on economic activity.

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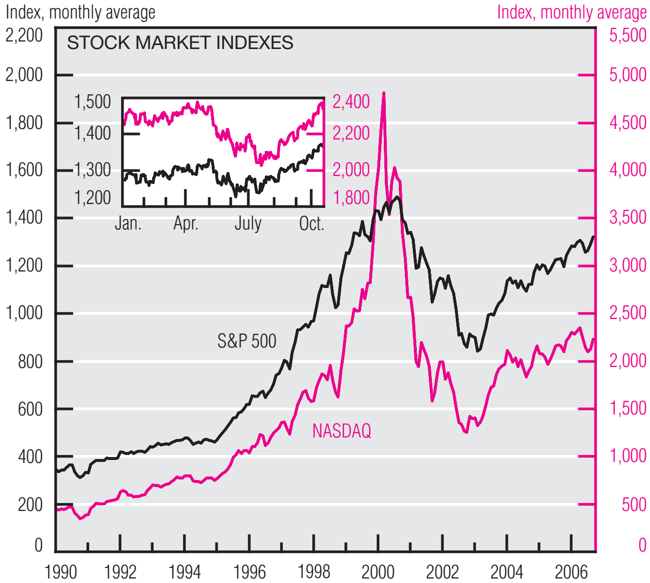
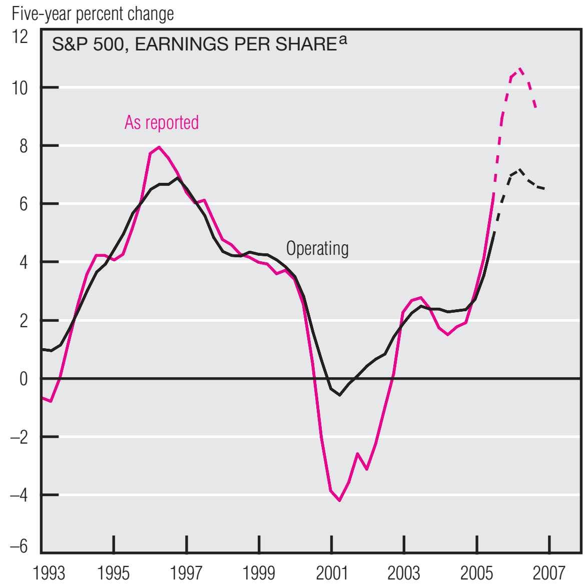
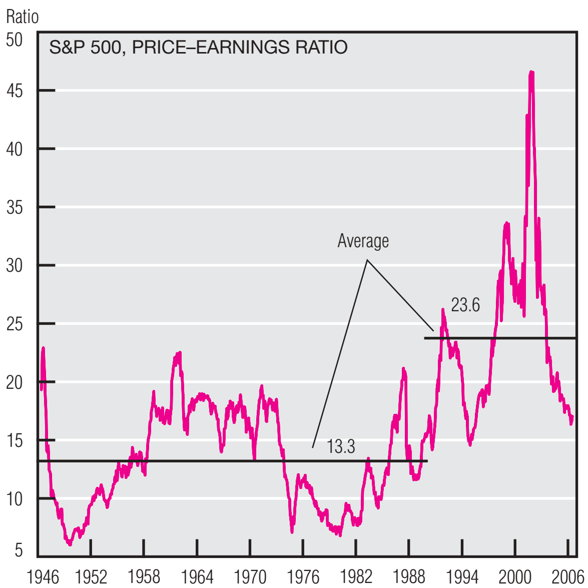
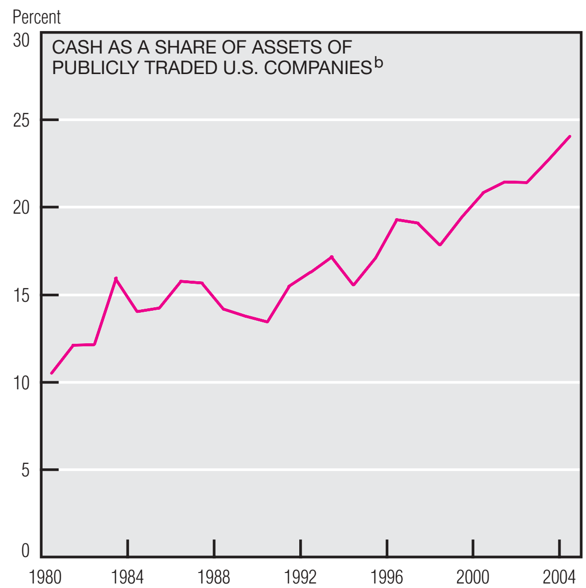
Money and Financial Markets (cont.)









a. Dashed lines indicate the forecast as of October 18, 2006.
b. Percent of total assets of U.S. companies held in cash and marketable securities. Excludes financial firms and utilities.
SOURCES: Standard and Poors Corporation; Chicago Board Options Exchange; Thomas W. Bates, Kathleen M. Kahle, Rene M. Stulz, “Why Do U.S. Firms Hold So Much More Cash Than They Used To?” National Bureau of Economic Research working paper; and Bloomberg Financial Information Services.

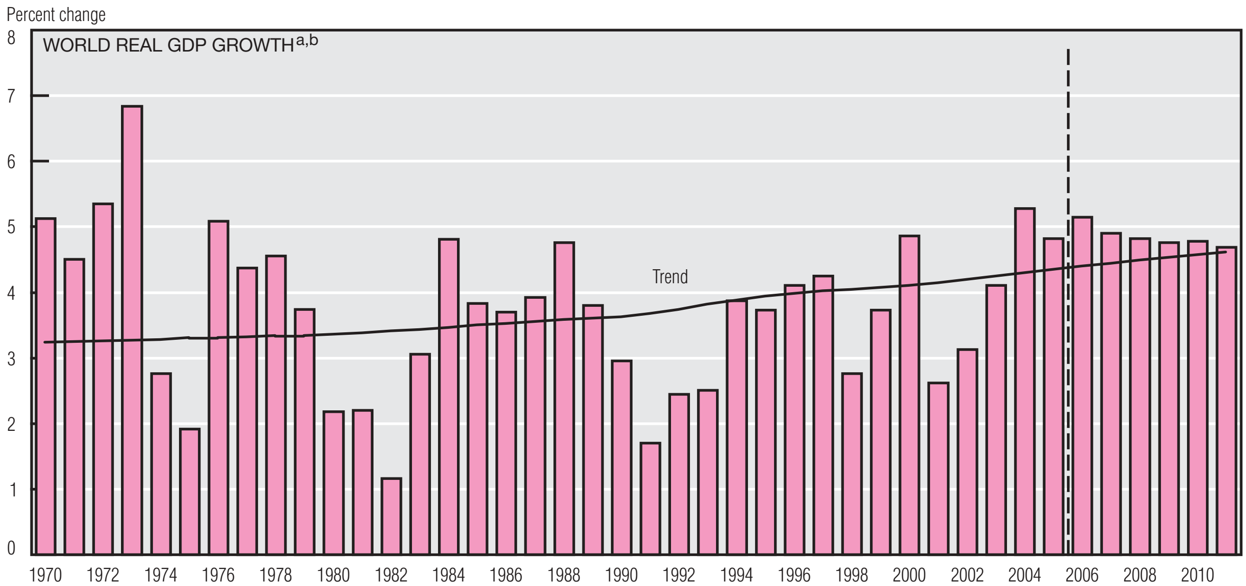
Concerns about a weakening economy figured in the Federal Open Market Committee’s August decision to pause from the steady, “measured pace” policy of quarter-point rate hikes that it had been following for three years. Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues have edged lower in recent weeks, suggesting that the pause in policy rate hikes is consistent with the FOMC’s primary goal of achieving price stability.

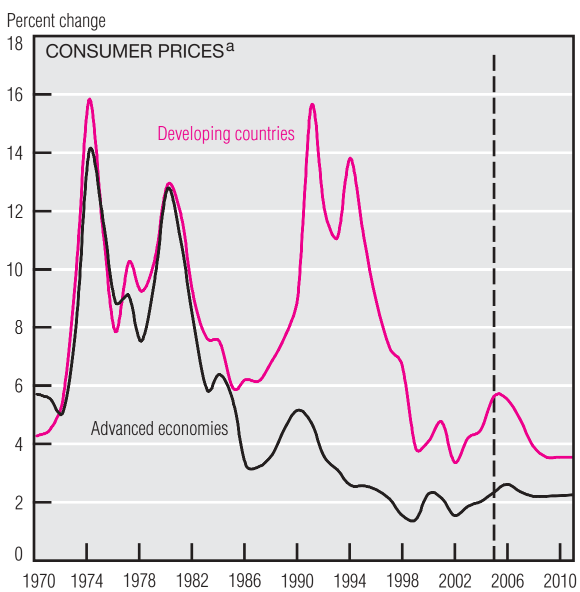
Low and stable bond rates have been good for stock prices, which fundamentally are based on the present value of expected future dividends. Lower and more certain interest rates mean that equity holders discount future dividends by less, hence equities are valued more. Equity prices have risen sharply since early summer.

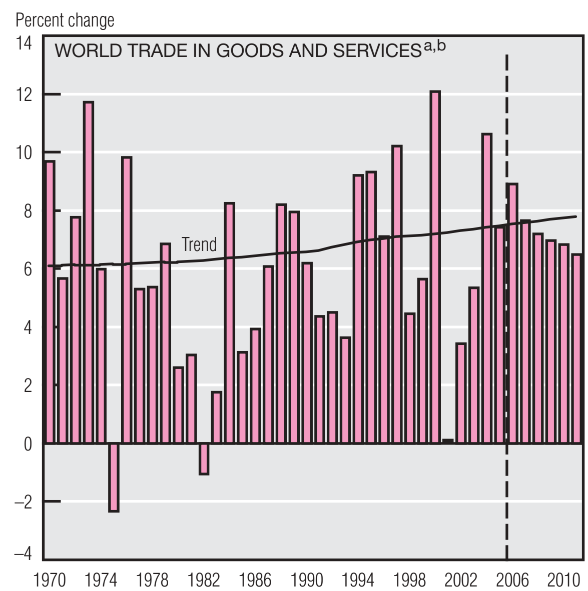
Another key stock-price fundamental—earnings growth—has been persistently strong, approaching rates not seen for a decade. In recent years, earnings growth has exceeded the run-up in equities prices, as evidenced by the declining price–earnings ratio.

Strong earnings growth has helped firms build cash relative to other assets. Whereas some analysts see high cash holdings as a positive for future equities prices, others argue that additional cash is needed because cash flows have become more variable. Firms may be reluctant to use this additional cash for dividends until they are confident that the cash-flow increase is permanent. Thus, the rise in cash holdings may not portend stronger dividend growth or higher stock prices.

International Growth and Inflation







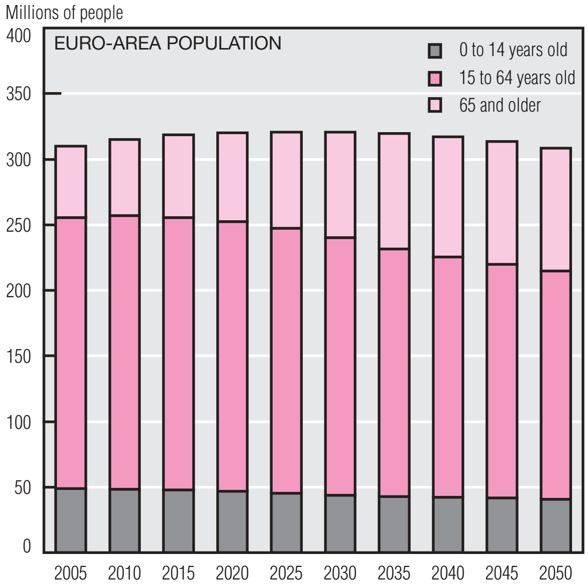
a. The area beyond the dotted line represents IMF estimates.
b. Average growth rates for individual countries are aggregated using PPP weights; over time, the aggregates shift in favor of faster-growing countries, which gives the trend line an upward slope. IMF calculations.
SOURCE: International Monetary Fund, "Global Prospects and Policy Issues," *World Economic Outlook* (September 2006), chapter 1.

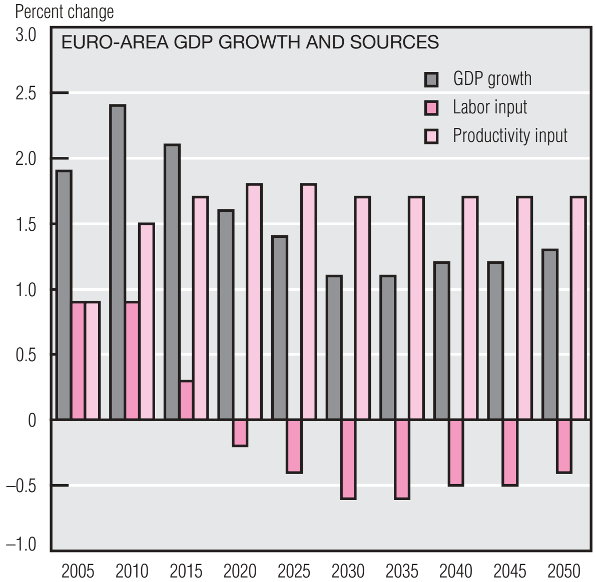
This is the fourth consecutive year of strong output growth in the current global expansion. Output increased rapidly in the first half of 2006, leading the International Monetary Fund's most recent *World Economic Outlook* to project a 5.1% increase in real GDP. The IMF's analysis shows that thus far the expansion has been broad based; the U.S. economy posted strong first-quarter growth, the euro area expansion has begun to accelerate, and Japan has continued to experience positive economic growth. On the emerging-market side, China has maintained its strong growth, while developing Europe and the rest of Asia have continued to expand. Even Latin America and Africa have posted strong growth numbers.

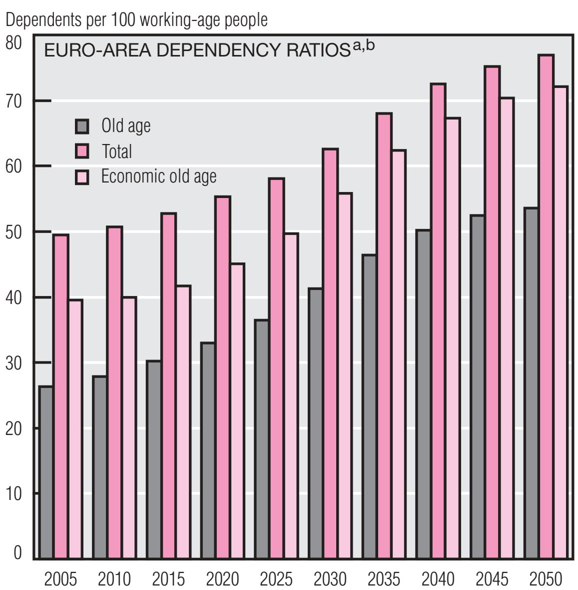
All this output growth has increased inflationary pressures as output gaps narrowed around the globe. Many advanced economies already are experiencing uncomfortably high levels of inflation that ultimately could inhibit future growth. At the same time, inflationary pressures are mounting in developing countries, partly because of a period of rapid growth and partly because of large exchange rate depreciations.

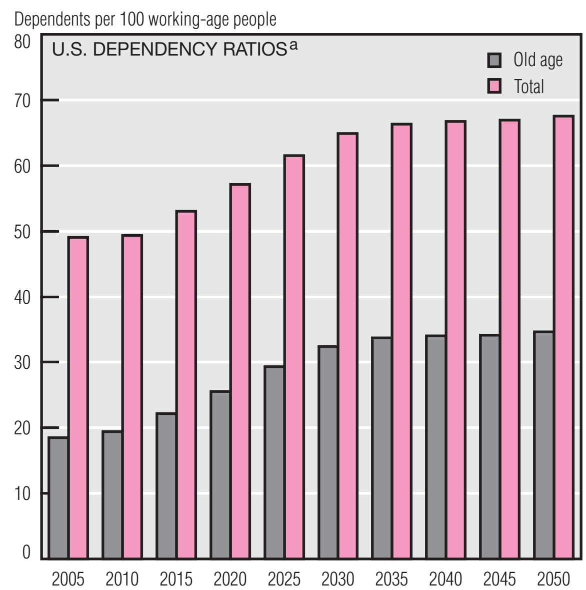
Despite ever-growing trade imbalances, global trade has continued to expand at a pace well above trend. Nonetheless, protectionist pressures are beginning to increase, and the IMF is predicting that growth in trade will fall below trend in the coming years.

Labor Force Changes in the Euro Area









a. The old-age dependency ratio is the ratio of the population aged 65 and older to the population aged 15 to 64. The total dependency ratio is the ratio of the population aged 65 and older plus the population aged 14 and younger to the population aged 15 to 64.

b. The economic old-age dependency ratio, as calculated by the EU Commission, is the ratio of the inactive population aged 65 and older to the employed populations aged 15 to 71.

SOURCES: U.S. Department of Commerce, Bureau of the Census; European Central Bank, "Demographic Change in the Euro Area: Projections and Consequences," *Monthly Bulletin* (October 2006), pp. 49–64; and European Commission, "The Economic Impact of Ageing Populations in the EU25 Member States," *European Economy* (December 2005).

The European Central Bank's October bulletin focuses on the euro area's changing demographics. As an area becomes more developed, its birthrate begins to decline and life expectancy increases. The combination of these two factors causes a demographic shift in which a greater proportion of the population is "old."

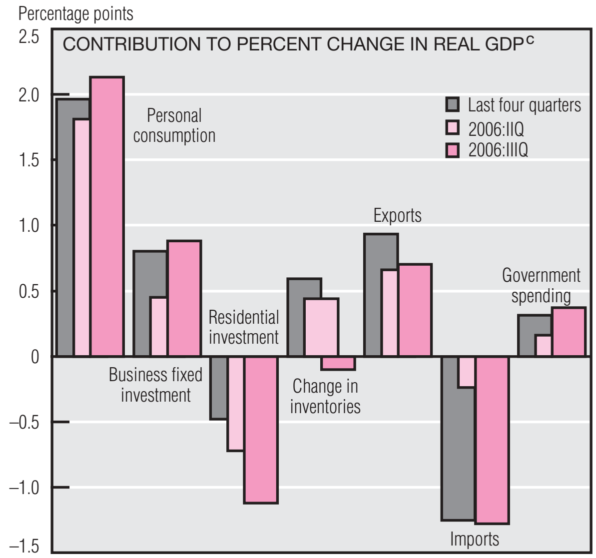
The euro area is currently in the midst of one such demographic shift, which may have major economic implications. Its labor force, defined as men and women aged 15 to 64, is projected to expand through 2015 but at a declining rate; in fact, by 2020 the labor force is expected to be declining. This makes any increase in output growth, which can be thought of as a combination of labor growth and productivity growth, entirely dependent on increased productivity.

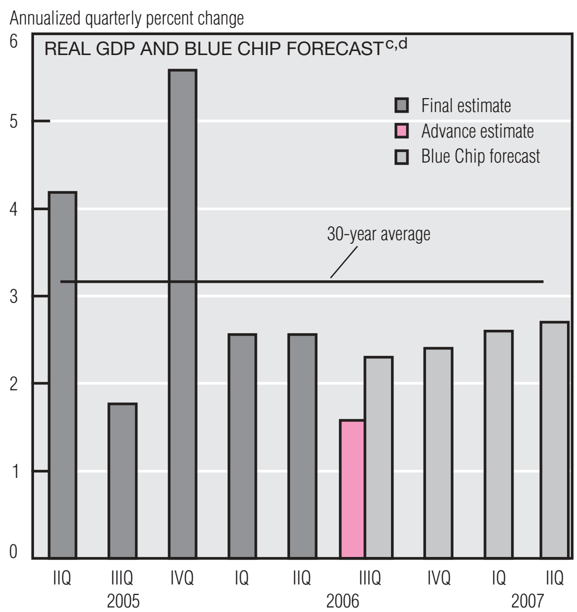
Moreover, the euro area's workers will be responsible for supporting an increasing number of dependents. A country's dependency ratio measures how many people outside the labor force must be supported by 100 people within the labor force. By 2050, the euro area's old-age dependency ratio is expected to reach 53.6. This means that about every two working-age people will be responsible for supporting one "old" person. In contrast, the U.S., which likewise is experiencing a demographic shift, will have a dependency ratio of only 34.6 or approximately three workers for every "old" person.

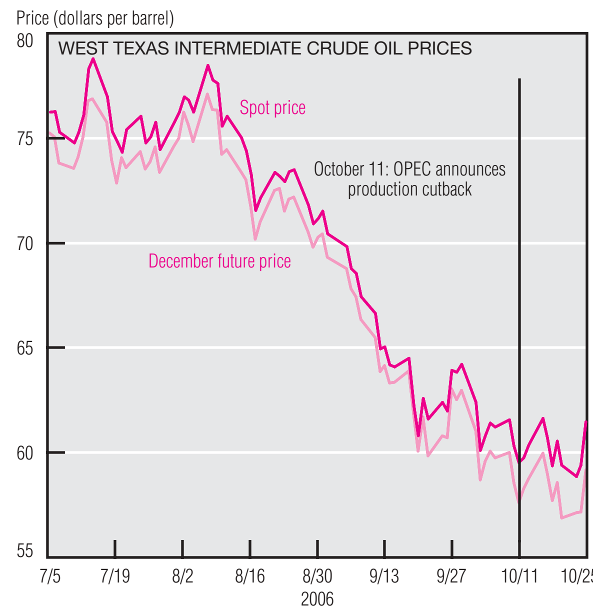
Economic Activity

Real GDP and Components, 2006:IIIQ[a,b]
(Advance estimate)

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Four quarters
Real GDP	44.8	1.6	2.9
Personal consumption	61.2	3.1	2.8
Durables	24.2	8.4	3.3
Nondurables	9.4	1.6	3.2
Services	31.5	2.8	2.5
Business fixed investment	27.2	8.6	7.9
Equipment	16.4	6.5	5.7
Structures	9.1	14.1	13.7
Residential investment	–28.0	–17.4	–7.7
Government spending	9.6	1.9	1.6
National defense	–0.8	–0.7	–1.1
Net exports	–15.7	—	—
Exports	20.5	6.5	9.0
Imports	36.2	7.8	7.8
Change in business inventories	–3.0	—	—







a. Chain-weighted data in billions of 2000 dollars.
b. Components of real GDP need not sum 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; U.S. Department of Energy, Energy Information Administration; and *Blue Chip Economic Indicators*, October 10, 2006.

Real GDP increased at an annualized rate of 1.6% in 2006:IIIQ, according to the Commerce Department's advance estimate. This was roughly one full percentage point lower than last quarter's final estimate of 2.56% and 1.6% below the 30-year average of 3.17%. The third-quarter slowdown resulted primarily from cooling in the housing market and the cumulative effects of past monetary policy rate increases.

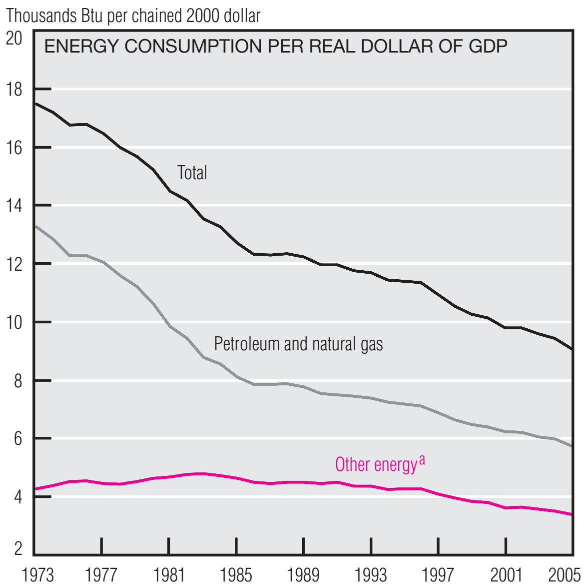
Large negative changes in residential investment, inventories, and imports were the heaviest drags on GDP growth. Residential investment was down 10% from 2005:IIIQ.

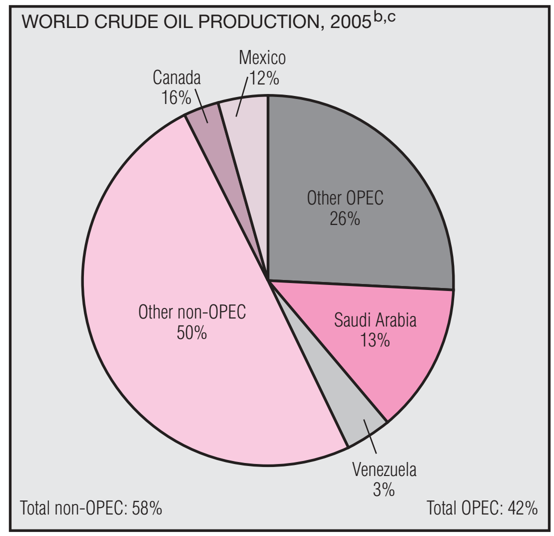
In its October 10 report, the Blue Chip panel of economists forecasted annualized real GDP growth at 2.3% for 2006:IIIQ. It was off by 0.7%. The panel forecasts an upward trend over the next three quarters of 2.4%, 2.6%, and 2.7%, respectively. Intriguingly, the advance estimate of GDP growth was right in line with a derivatives auction held by the Chicago Mercantile Exchange just prior to the release.

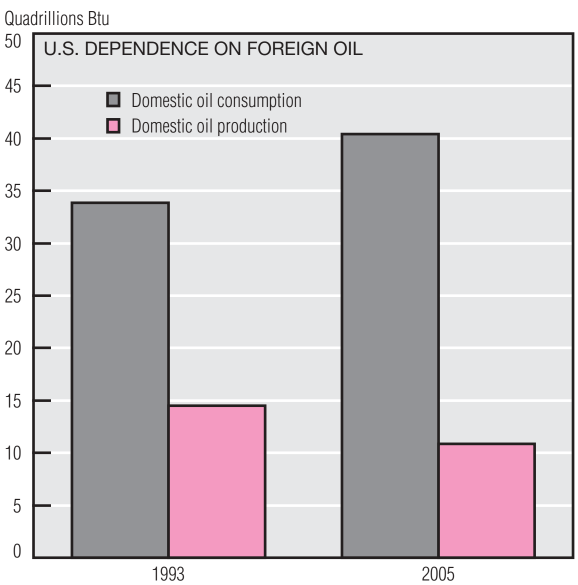
Energy issues have received increased attention in the last four years. Oil, which cost less than $20 per barrel as recently as February 2002, soared to its most recent high of more than $77 on August 7, 2006. Since then, with the ending of the summer driving season and the slowing of the economy, prices have fallen to around $60. There is some good news: The economy's energy efficiency has improved, so the U.S. is less affected by energy price fluctuations than it formerly was. Since 1973,

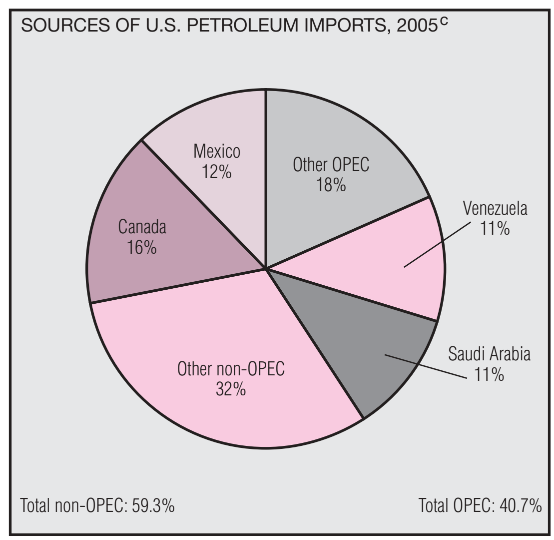
(continued on next page)

Economic Activity (cont.)









a. "Other energy" consists of coal, nuclear electric power, renewable energy, and net imports of coal coke and electricity.
b. This measure of crude oil production includes lease condensate.
c. Selected countries.
SOURCES: U.S. Department of Energy, Energy Information Administration; and Bloomberg Financial Information Services.

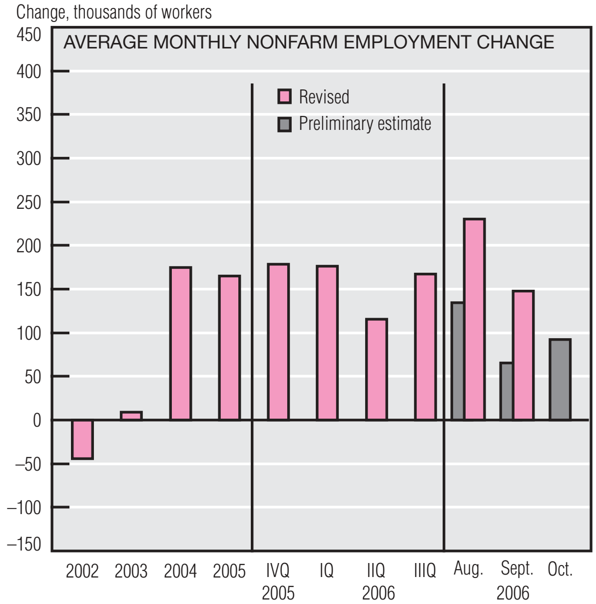
the energy required to produce a dollar of real GDP fell by almost half, mostly because of economizing on the use of petroleum and natural gas.

The Organization of Petroleum Exporting Countries (OPEC), in an attempt to stem further price declines, announced on October 11, 2006 its decision to cut back production by 1.2 million barrels of oil per day, roughly 4% of its output. Because OPEC members currently produce 42% of the world's oil, their actions have an impact on oil markets; however, the problem with all producer cartels is agreeing to and carrying through on quota reductions. Differences in their financial health and production capabilities cause OPEC members' interests to diverge. In any case, the still relatively high price of oil gives non-OPEC producers plenty of incentive to boost their output as much as possible.

Even though the U.S. economy needs less energy to produce a dollar of GDP than it used to, its dependence on foreign oil has increased. Since 1993, U.S. consumption of oil has risen nearly 20%, whereas its oil production fell more than 25%. Currently, OPEC supplies 41% of U.S. petroleum imports, down from 51% in 1993. However, because the world market sets the price of oil, this does not give the U.S. any shelter from market forces.

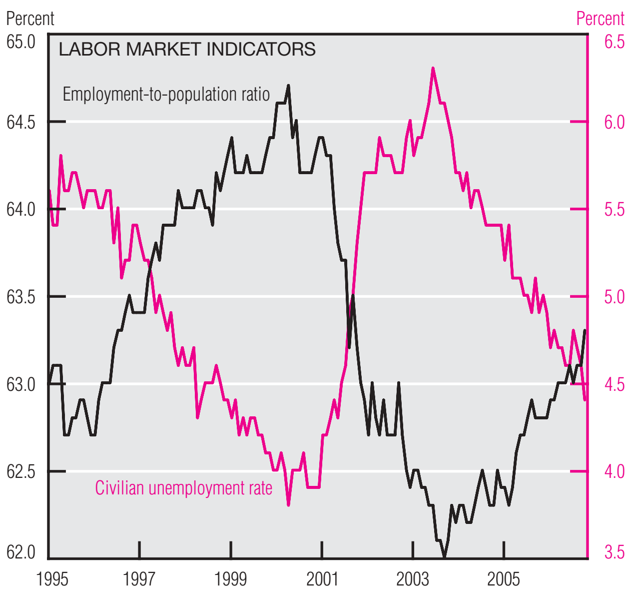
Saudi Arabia formerly was the biggest exporter of oil to the U.S. but Canada now holds that title, supplying 16% of U.S. oil imports. Mexico, another non-OPEC country, supplies 12%, and Venezuela, a country with which the U.S. has an increasingly shaky relationship, is tied for third place with Saudi Arabia at 11%.

Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2003	2004	2005	Jan.–Sept. 2006	Oct. 2006
Payroll employment	9	175	165	153	92
Goods producing	–42	28	22	15	–60
Construction	10	26	25	11	–26
Manufacturing	–51	0	–6	0	–39
Durable goods	–32	9	1	5	–19
Nondurable goods	–19	–9	–7	–5	–20
Service providing	51	147	143	137	152
Retail trade	–4	17	13	–11	–4
Financial activities[a]	7	8	12	15	1
PBS[b]	23	40	41	33	43
Temporary help svcs.	12	13	14	–4	15
Education & health svcs.	30	33	31	37	28
Leisure & hospitality	19	26	21	25	35
Government	–4	13	14	19	34
	Average for period (percent)				
Civilian unemployment rate	6.0	5.5	5.1	4.7	4.4



October Revisions

	August	September	Total change
Payroll employment	97	42	139
Goods producing	5	–11	–6
Construction	–3	–15	–18
Manufacturing	7	3	10
Durable goods	5	1	6
Nondurable goods	2	2	4
Service providing	92	53	145
Retail trade	–0.1	3.7	3.6
Financial activities[a]	11	2	13
PBS[b]	2	1	3
Temporary help svcs.	–0.6	–3	–3.6
Education & health svcs.	22	3	25
Leisure & hospitality	18	17	35
Government	36	24	60

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.

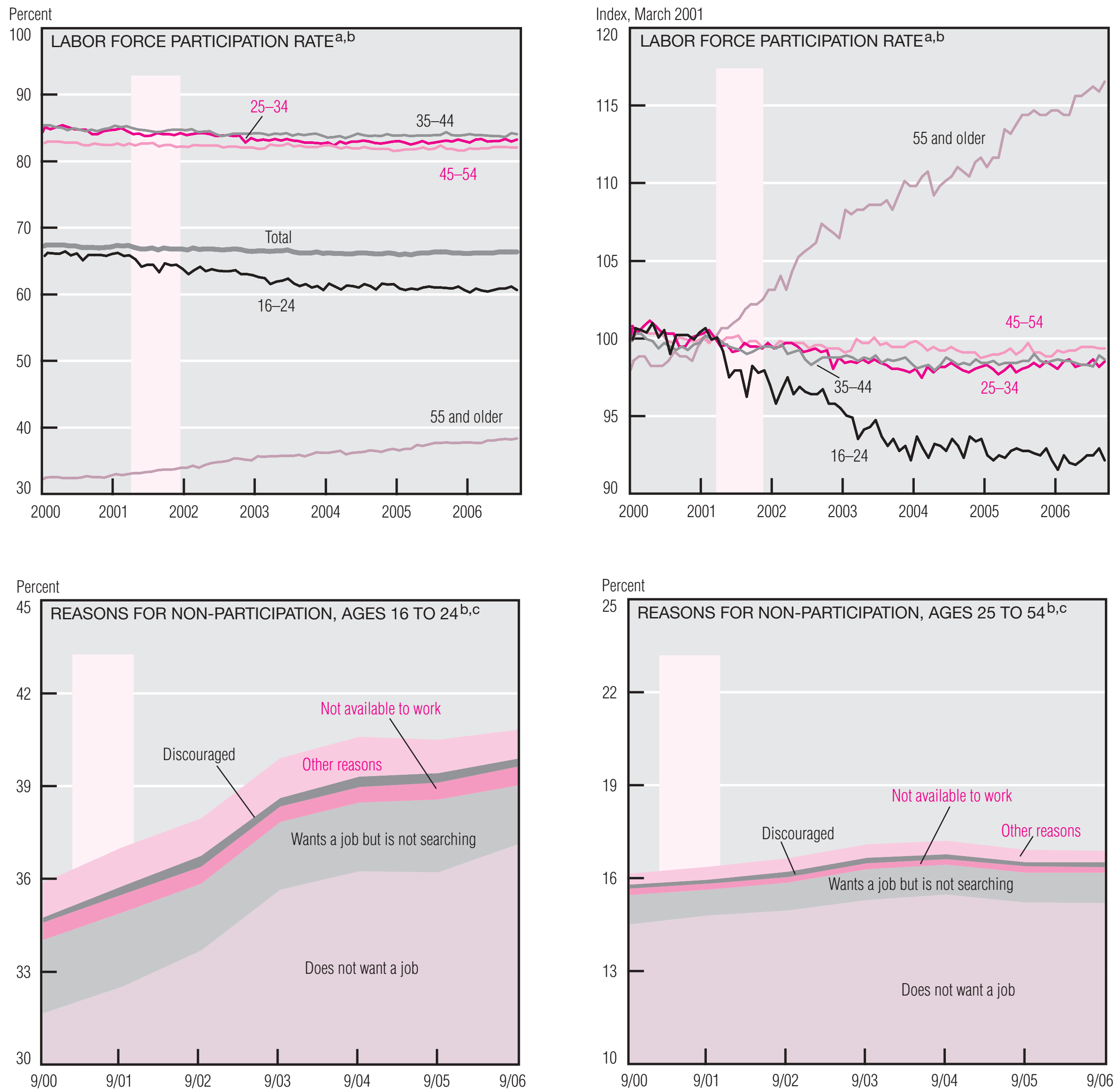
Nonfarm payrolls increased a moderate 92,000 in October, boosted by a net upward revision of 139,000 jobs for August and September. Although October's increase was below expectations, the three-month average of 157,000 was in line with the recent trend.

Service-providing industries added the most jobs (152,000), led by professional and business services (43,000). Leisure and hospitality (35,000) and government (34,000) were also positive influences. Goods-producing industries continued to trim payrolls, shedding 60,000 jobs in October. Durable and nondurable manufacturing were equally weak and posted a combined net loss of –39,000 jobs. Wood products, motor vehicles, and parts manufacturing were the most seriously affected. The –26,000 job loss in construction (particularly for residential specialty-trade contractors) reflects continuing softness in the home-building and remodeling sectors.

The civilian unemployment rate dropped from 4.6% to 4.4%, the lowest since April 2001. The labor force participation rate held at 66.2% and the employment-to-population ratio edged up to 63.3%.

The Bureau of Labor Statistics noted that revisions to the most recent data are unusually large. For both August and September, firms' late reports on employment levels showed more growth than earlier reports. The growth came predominantly from a few service providers (government; leisure and hospitality; and education and health services); revisions for most other industries were small or even negative.

Labor Force Participation

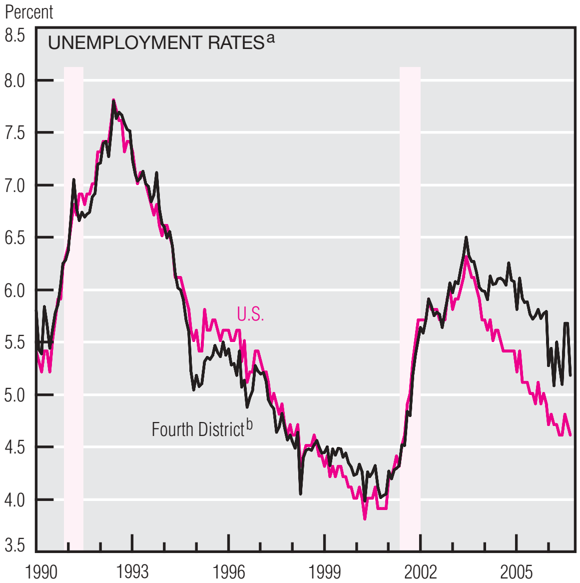


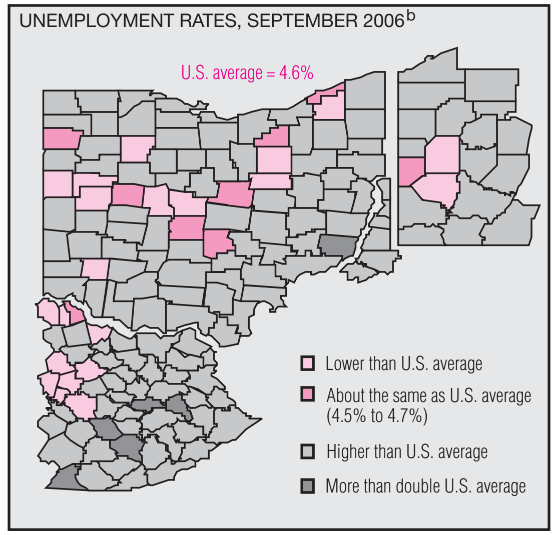
a. Data are seasonally adjusted.
b. Shaded areas indicate recessions.
c. Non-participation reasons for those 16 to 24 years old as a percent of the civilian non-institutional population of the same age, not seasonally adjusted.
d. Non-participation reasons for those 25 to 54 years old as a percent of the civilian non-institutional population of the same age, not seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Unemployment rates have fallen during the economy's recovery from the 2001 recession, partly because increasing numbers of people do not participate in the labor force. One major drag on national labor force participation since the recession has been the group of people 16 to 24 years old, whose rates have dropped 5.2%. Rates have fallen less for those aged 25 to 54 than for the younger cohort. Some age groups have even been edging back up to their pre-recession levels: People over 55 have increased their participation rate by 5.4% since March 2001.

As in most age groups, the majority of young non-participants do not want a job. They could have any of several reasons that the Bureau of Labor Statistics classifies as non-economic. Those who do want a job are grouped according to their current availability to work and whether they have searched for a job in the past year. People who have searched and are available are classified as discouraged if they report a lack of jobs as the reason they have stopped searching. Discouragement among people aged 16 to 24 has been growing, but this change is dwarfed by the increasing numbers who do not want a job. Discouraged workers make up an even smaller share of the group between 25 and 54 years old. Their recent pattern of participation, like that of the 16–24 age group, has been strongly affected by changes in the number of people who do not want a job.

Fourth District Employment





Payroll Employment by Metropolitan Statistical Area

	12-month percent change, September 2006							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	−0.1	0.4	1.1	−0.9	0.4	0.9	1.3	1.3
Goods-producing	−0.3	0.4	0.3	−2.1	−0.3	−0.9	−0.8	1.2
Manufacturing	0.2	−0.3	−0.2	−3.9	0.0	−3.4	−1.7	0.1
Natural resources, mining, and construction	−1.7	1.6	1.5	4.3	−1.2	3.4	1.5	3.0
Service-providing	0.0	0.4	1.2	−0.6	0.6	1.2	1.8	1.3
Trade, transportation, and utilities	−0.9	−0.1	0.1	−4.0	−0.2	0.0	2.8	0.4
Information	0.0	−1.5	−0.6	−0.9	−2.5	−3.1	2.2	−0.5
Financial activities	−0.5	−1.5	0.6	−2.1	4.4	0.1	0.0	2.1
Professional and business services	0.4	0.7	2.3	2.1	−1.7	1.3	2.0	2.4
Education and health services	2.1	3.1	2.7	0.2	2.0	2.3	2.3	2.1
Leisure and hospitality	0.0	0.1	2.0	1.3	2.9	3.4	4.3	1.9
Other services	0.0	0.8	1.9	0.6	−1.4	0.3	−1.0	0.5
Government	−1.5	0.2	−0.1	−0.6	0.2	1.4	0.0	0.6
September unemployment rate (percent)	5.1	4.4	4.9	5.7	5.9	4.7	4.1	4.6

a. Shaded bars represent recessions.

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

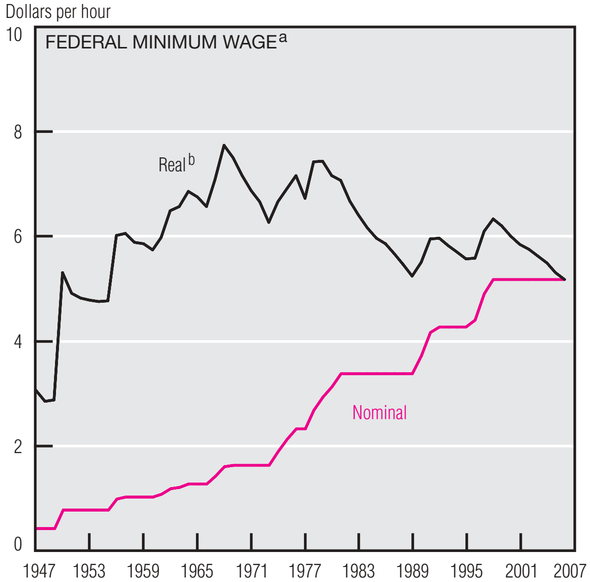
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Kentucky Office of Employment and Training, Workforce Kentucky; Ohio Department of Job and Family Services, Bureau of Labor Market Information; Pennsylvania Department of Labor and Industry, Center for Workforce Information and Analysis; and West Virginia Bureau of Employment Programs, Workforce West Virginia.

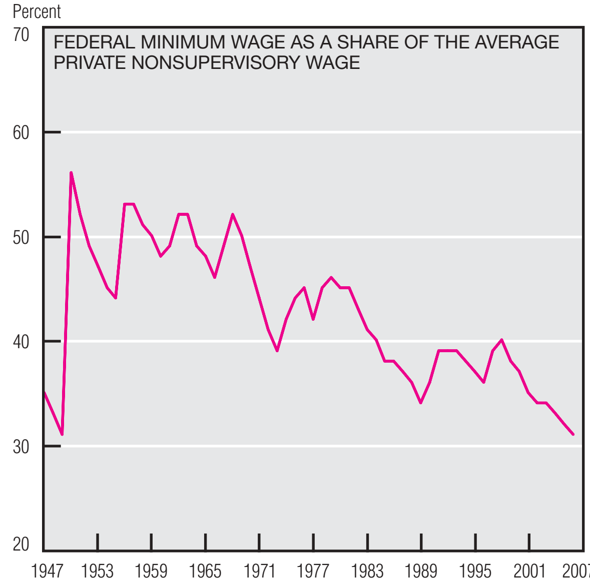
The Fourth District's unemployment rate fell 0.5 percentage point (pp) to 5.2% in September. Over the month, employment rose 0.7%, unemployment fell 8.7%, and the labor force increased 0.2%. The change in the unemployment rate reflects state trends: Rates fell in all four of the District's states—Ohio's by 0.4 pp, Pennsylvania's by 0.3 pp, Kentucky's by 0.5 pp, and West Virginia's by 0.5 pp. By comparison, the U.S. unemployment rate was 4.6% in September, down 0.1 pp from the previous month.

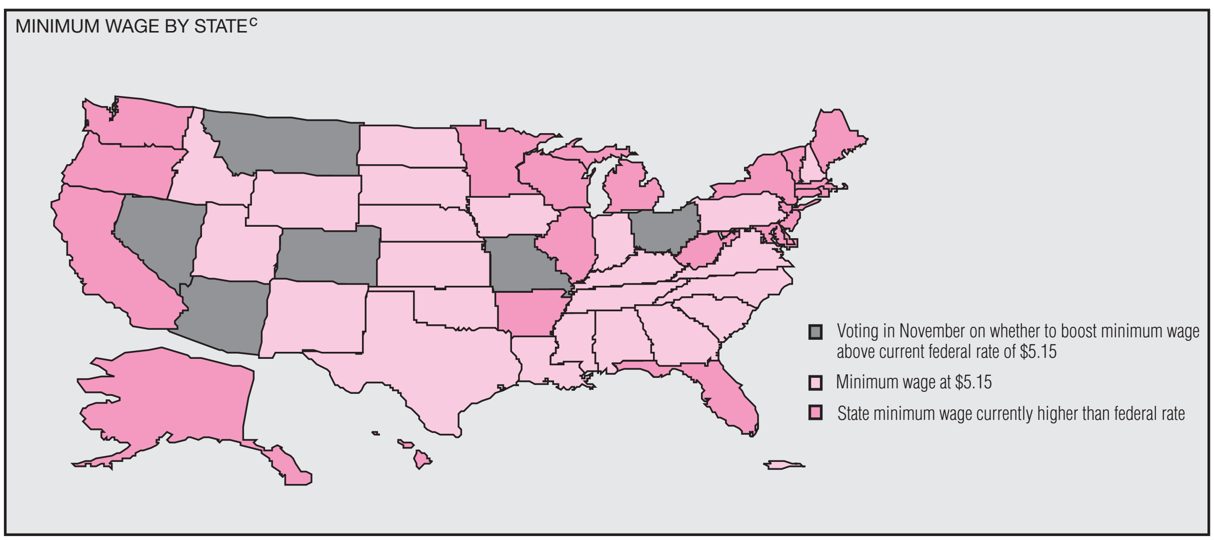
Unemployment rates were above the U.S. average in the great majority of Fourth District counties (139 out of 169) in September. However, almost every county (159) showed improvement between August and September. Fourth District metropolitan areas experienced similar improvement: Unemployment rates in each of the seven major metro areas in the table above decreased over the month by at least 0.4 pp.

These metro areas differed in the employment changes they have experienced since September 2005. Whereas growth in Lexington and Cincinnati kept up with the nation, Cleveland and Dayton lost employment over the year. In fact, Dayton shed jobs in both goods-producing (–2.1%) and service-providing industries (–0.6%).

The Minimum Wage







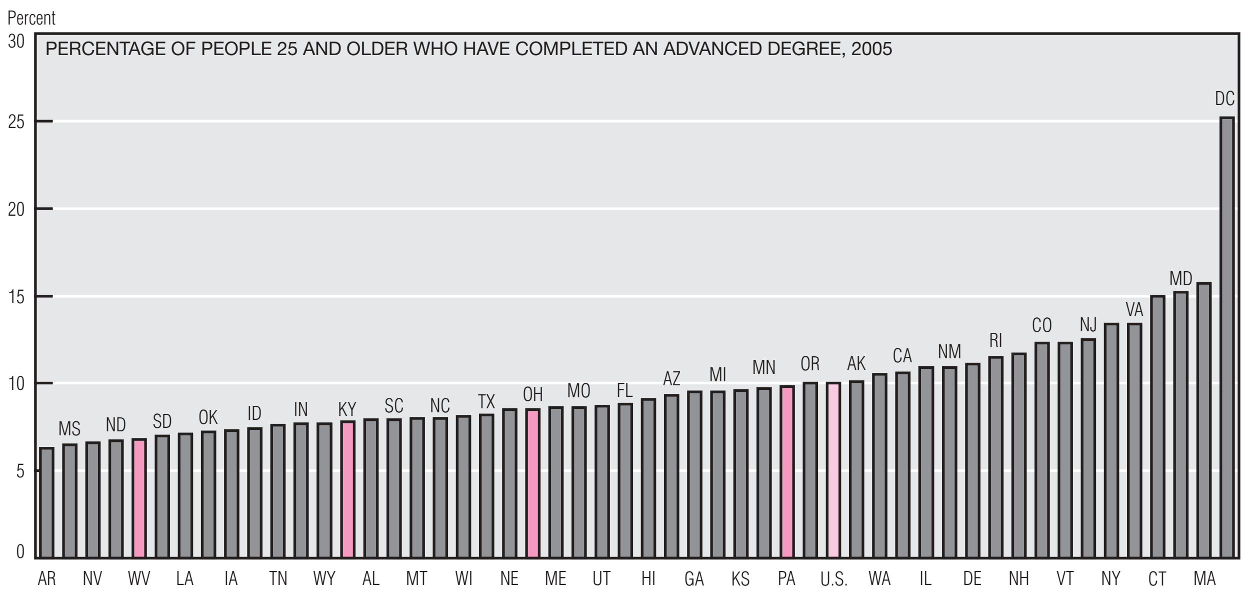
a. Where the minimum wage changed during the year, the annual rate is a weighted average.
b. In 2006 dollars.
c. Where federal and state law have different minimum wage rates, the higher standard applies.
SOURCES: U.S. Department of Labor, Employment Standards Administration; Employment Policies Institute; Economic Policy Institute; and Stateline.org.

The federal minimum wage has remained at $5.15 per hour since 1997. At that rate, a full-time worker would make $10,712 per year, about $9,000 below the poverty line for a family of four with no other family income. Adjusted for inflation, the federal minimum wage is at its lowest real value since 1955. And compared with the average wage of private nonsupervisory workers, the minimum wage is at its lowest relative level in more than 50 years.

As a way around this, several states have recently raised their state minimum wage, and employers must pay the state or the federal rate, whichever is higher. This year alone, lawmakers in 11 states have raised their state's minimum wage; voters in six more states, including Ohio, will decide in the November election whether to increase their rate. There are now 21 states whose minimum wage exceeds the federal rate; in addition, North Carolina and Pennsylvania have passed legislation to go above the federal level starting in 2007.

In Ohio's case, the current proposal would raise the minimum wage to $6.85 per hour and then index it to inflation. According to estimates from the Employment Policies Institute, more than 300,000 Ohio workers currently make between the current and the proposed minimum wage. Proponents of the hike contend that anyone who works a full-time job should earn a "living wage," while its opponents argue that an increase in the minimum wage may cause job losses.

Higher Education in the Fourth District

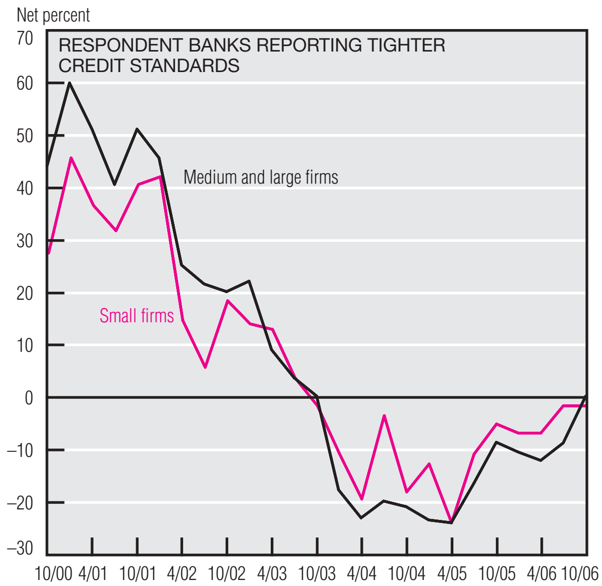


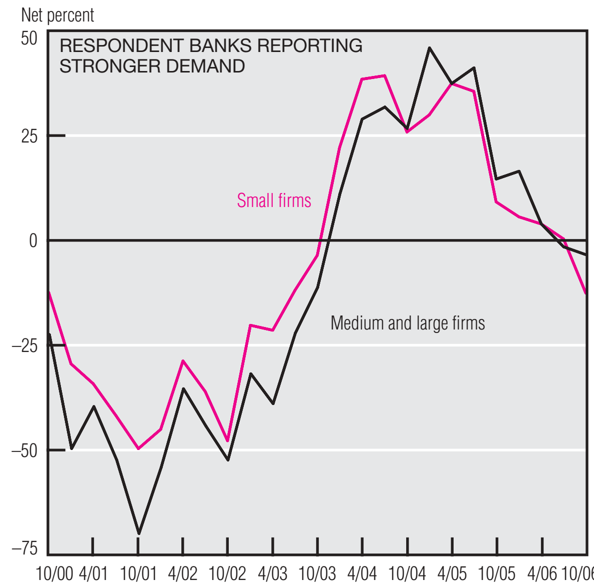
SOURCE: U.S. Department of Commerce, Bureau of the Census.

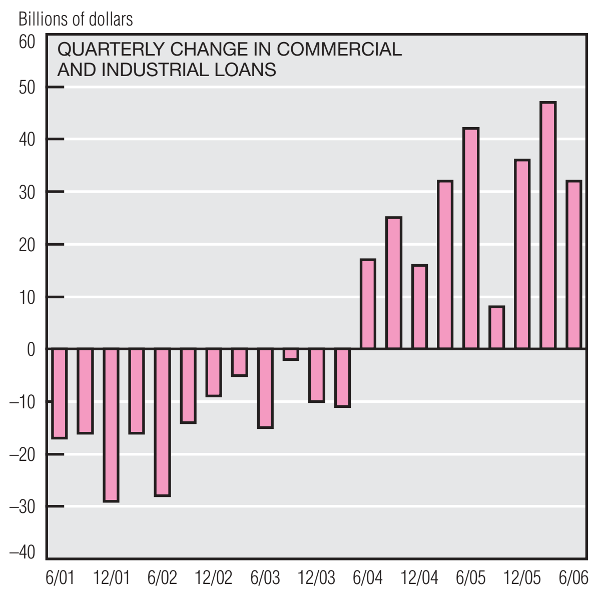
According to the 2005 American Community Survey, 16.9% of West Virginia residents aged 25 and older hold a bachelor's degree. This is the lowest share of any state, 10 percentage points below the national average, and nearly 2 percentage points below Mississippi, the second-lowest state. Kentucky has a similarly low proportion of bachelor's degree holders, the fourth-lowest share of any state. Nonetheless, both of these states have been gaining ground: Since 2000, West Virginia's number of bachelor's degree holders has increased by 20.2% and Kentucky's by 18.5%, outpacing the U.S. average growth of 15.8%. In Ohio, 23.3% of residents hold a bachelor's degree; in Pennsylvania, the share is 25.7%. The national mark is 27.2%.

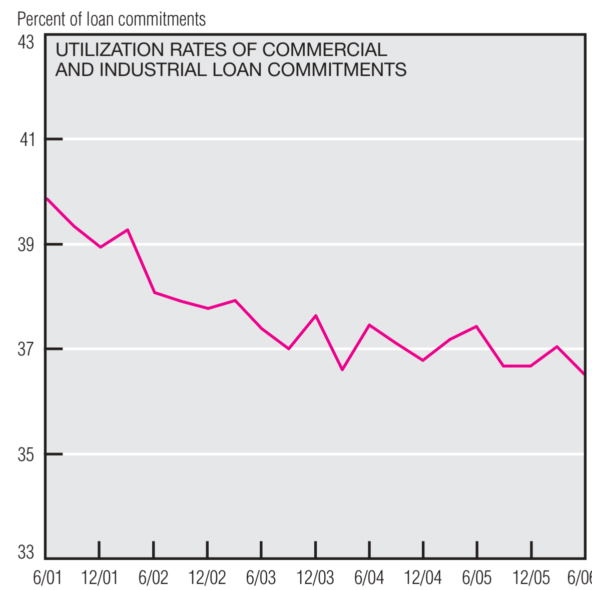
As for advanced degrees, 6.8% of West Virginians hold a degree past the bachelor's. West Virginia's percentage makes it the fourth-lowest state, which is not statistically different from the bottom spot. Kentucky had 1% more advanced degree holders than did West Virginia; at 9.8%, Pennsylvania was the Fourth District state that came closest to the national share of 10.0%. Whereas the U.S. as a whole has raised its number of advanced degree holders by 18.4% since 2000, every District state increased its number by a greater percentage. The most successful were Ohio, which increased its number of advanced degree holders by 28.1%, and West Virginia, which posted a gain of 26.8%.

Business Loan Markets









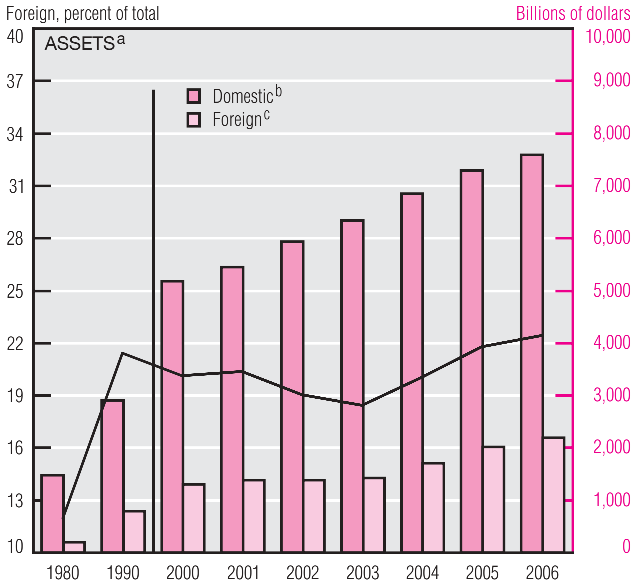
SOURCES: Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices* (October 2006); and *Quarterly Banking Profile* (June 2006).

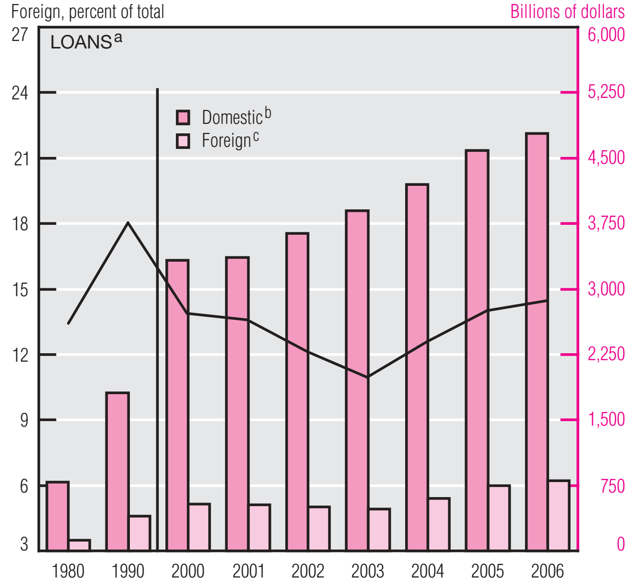
Credit availability for businesses improved at a slower rate in 2006:IIIQ, according to the Federal Reserve's *Senior Loan Officer Opinion Survey*. In the October 2006 survey, domestic and foreign banks reported mixed changes in lending standards and terms for commercial and industrial (C&I) loans. However, domestic banks tightened standards and terms for commercial real estate loans.

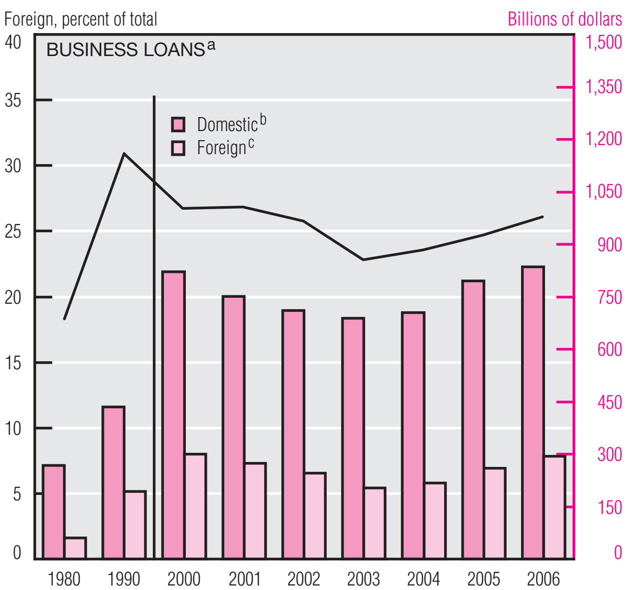
Demand for C&I loans for businesses of all sizes has softened considerably since the beginning of the year. The share of respondent banks reporting stronger demand for business loans from medium and large firms fell from 16.1% in January 2006 to –3.7% in July, which indicates that more banks report weakening demand than strengthening or unchanged demand. Demand for small business loans also moderated, with the share of respondents who reported stronger demand falling to –13% (from 5.3% in January 2006). An increased need to finance mergers and acquisitions and to invest in plant or equipment heightened demand for C&I loan demand at some banks. Those that reported lower demand ascribed it to a decreased need to invest in plant or equipment, improvement in customers' internally generated funds, and less need for inventory financing.

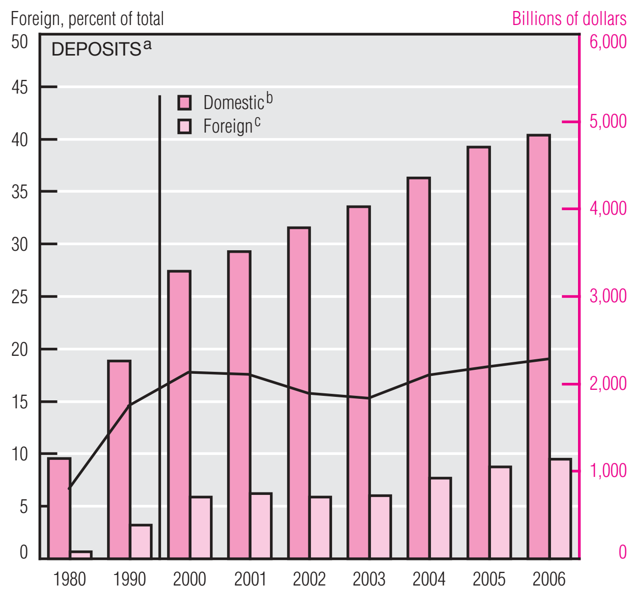
Relaxed lending standards continued to translate into more C&I loans. Bank and thrift holdings of such loans increased by $32 billion in 2006:IIQ, the ninth consecutive quarter of expanding business loan portfolios. Although the utilization rate of business loan commitments (credit lines extended by banks to commercial and industrial borrowers) edged down, it still shows an ample supply of business credit.

Foreign Banks in the U.S.









NOTE: Foreign banks are those owned by institutions outside the U.S. and 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. banks' offices in Puerto Rico, the U.S. Virgin Islands, and other affiliated insular areas; and foreign banks' offices in U.S.-affiliated insular areas.

b. Excludes commercial banks but includes international banking facilities as well as banks owned by foreign nonbank entities.

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

SOURCES: Federal Reserve Board, *Structure and Share Data for U.S. Offices of Foreign Banks*; and Federal Deposit Insurance Corporation, *Outlook 2005: The Globalization of the U.S. Banking Industry*.

Foreign banks are becoming more competitive with the U.S. domestic banking industry. While the number of foreign banks' branches and agencies in the U.S. declined from 593 at the end of 1991 to 270 at the end of 2004, their assets swelled from $800 billion to $2.2 trillion. Their share of U.S. banking assets rose to 22.4% in the first half of 2006, still below the 1991 peak of 22.6% but well above the 2003 trough of 18.4%.

Foreign banks' market shares of loans and deposits follow a similar pattern: Their total loan holdings rose to $807 billion, or 14.4%, of all loans at the end of 2006:IIQ, following a 2003 trough of 10.9%. Although assets held in U.S. branches of foreign banks are predominantly commercial and industrial loans, recent trends suggest that foreign banks may be sharpening their focus on the U.S. consumer banking market, as exemplified by HSBC's acquisition of Household International, Inc. in 2003. In contrast with the $329 billion growth in total loans over the last three years, business loan portfolios grew only $92 billion in 2006:IIQ.

Although foreign banks' 19.0% share of deposits confirms that they are important competitors in the U.S., recent trends suggest that the domestic banking industry is equal to the challenge.