The Economy in Perspective

by Mark Sniderman

Closing the books…Another year heads into the barn, bows out, comes full circle, folds its tent, fades into the sunset. Any way you say it, 2006 will soon be history. Everyone's view of the year is colored by their values, expectations, and vantage point. On this page, I'd like to reflect on a couple of the issues that dominated my thoughts about the economy this year.

Housing may be the biggest story of 2006, especially when you consider its potential for influencing next year's economy as well. Housing markets slumped in the second half of the year, dragging activity levels from boom to bust in just a few months. Building permits were issued at a seasonally adjusted annual rate of 2.1 million housing units in the first quarter, declined in each successive quarter, and stood at 1.5 million units in October. Builders themselves have suffered to various degrees, but for the most part seem to be financially viable after several strong years of profitability.

The pace of new home building in itself will not be the most pressing issue for the fortunes of the economy. Yes, the downswing in new home construction will be large enough to show up in the statistics for national employment and output; it has already taken its toll this year. But housing market dynamics can depress consumer spending in a variety of ways.

Considering that housing constitutes the largest form of broad-based wealth in the country, consumers have good reason to feel less wealthy now than they did a year ago. As housing prices appreciated, homeowners pulled out some of their equity and spent it on other goods and services. When appreciation petered out, that extra consumption kicker was gone. Finally, short-term interest rates have risen considerably since the time when many homebuyers took out adjustable-rate mortgages that are only now starting to reset. Rising mortgage payments, other things being equal, seem likely to crowd out consumption.

Housing has played a key role in this year's inflation statistics. One of the largest components in the Consumer Price Index market basket is owners' equivalent rent (OER) on primary residences—an estimate of the rent that homeowners would pay if they didn't own their homes. OER accounts for about 25% of the CPI market basket, enough for its volatility to show up in the movements of the total CPI.

Utility prices can obscure the true OER picture, so they are actually subtracted from the initial calculation. This means that when utility bills fall, as they have done lately, the OER rises, as indeed it has. Ironically, this combination of events put upward pressure on the CPI's housing component, just when housing and utility prices were weakening. OER increased at a rate of about $2\frac{1}{2}$% in 2004–05, but is now increasing at a 4% rate. If price movements in the OER component were to decline only by a percentage point, the effect on the CPI's rate of change would be $\frac{1}{4}$%—a welcome reduction.

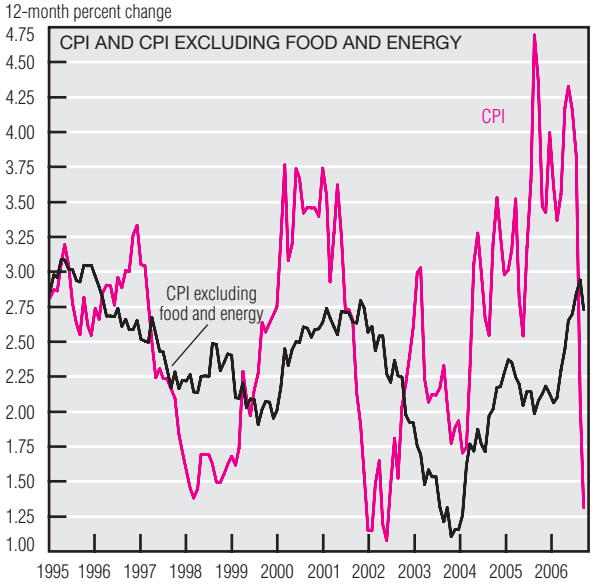
At the moment, the price of energy is playing the hero's role in the inflation drama, although it was the villain during summer stock. The spot price of crude oil today is the same as it was at the beginning of the year, roughly $53 per barrel. Yet by mid-August, the price had escalated to nearly $70, stoking fears of another wave of inflation, just as the economy began to flag under the weight of declines in home building and automobile production. The more recent energy market developments are providing some breathing room for monetary policy makers, who have been on the alert for any signs that inflationary pressures might intensify.

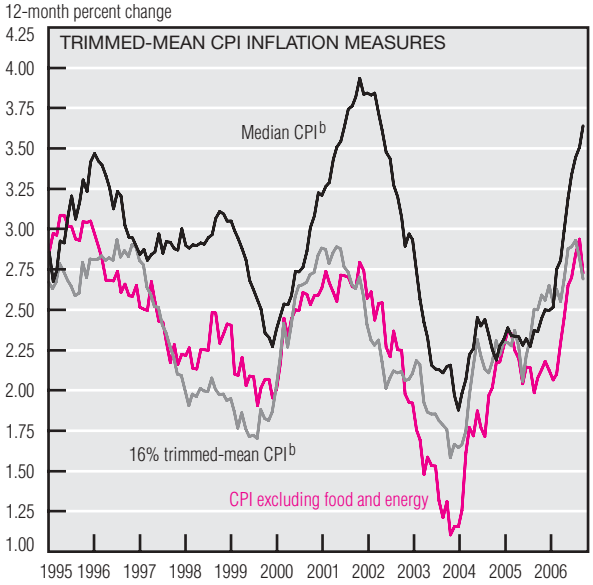
There is one 2006 development that has had almost no effect on this year's economy but looms larger in the picture for 2007, 2008, and beyond. That development is the reversal in positions of the two major political parties in the U.S. Congress. The ascendant party is espousing a different philosophy on trade, energy, and tax policy (to name just a few issues) than the party heading to the backbenches. And yet no party is in a position to dictate to the other. The parties' relative strengths will certainly shape economic performance, but in ways that have yet to become clear.

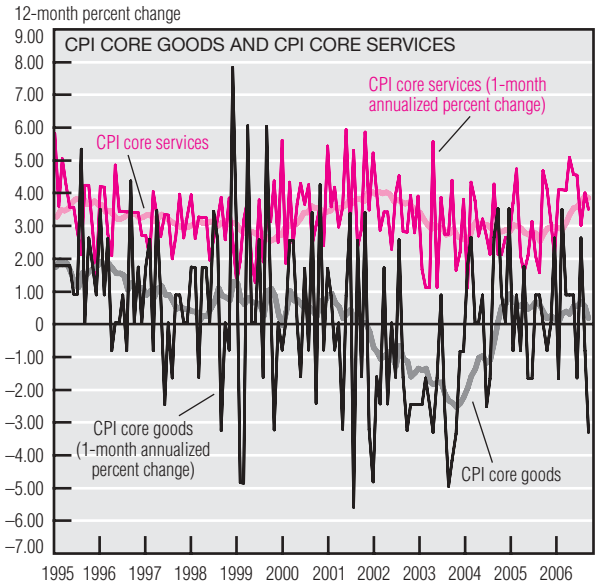
Inflation and Prices

October 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	–5.8	–2.9	0.7	1.3	2.6	3.6
Less food and energy	1.2	2.3	2.8	2.7	2.1	2.2
Median[b]	3.7	3.5	4.0	3.6	2.7	2.5
16% trimmed mean	0.9	2.1	2.7	2.7	2.2	2.6
Producer Price Index						
All items	–17.9	–10.9	–4.2	–1.6	2.5	5.7
Less food and energy	–10.1	–2.7	–0.9	0.6	1.0	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) declined sharply in October for the second straight month, falling at a 5.8% annualized rate. However, the core inflation measures continued to hold steady, with monthly growth rates about the same as—or lower than—their longer-term trends. The CPI excluding food and energy rose a moderate 1.2%, while the median CPI climbed 3.7%.

Longer-term growth trends in the core retail price measures remained elevated. Whereas the CPI's 12-month growth rate dropped sharply (to 1.3%, its four-year low), rates for the CPI excluding food and energy and the 16% trimmed-mean CPI came down only slightly to about 2.7%; both retail price measures remain well above the range generally associated with price stability.

Deceleration in the core inflation measures seems to be heavily influenced by recent softness in prices for core goods (which exclude food and energy). Core services prices, however, remain stubbornly high, contributing to the persistently high readings of the Cleveland Fed's median CPI. This measure, which examines the component in the middle of the monthly price-change distribution, rose a brisk 3.6% over the 12 months that ended in October.

The discrepancy in the behavior of goods versus services prices is clearly reflected in the monthly price-change distribution of the CPI components: Large shares of the consumers' market basket showed either large price increases (above 3%) or price softness (below 1%); only a very small proportion of the CPI components

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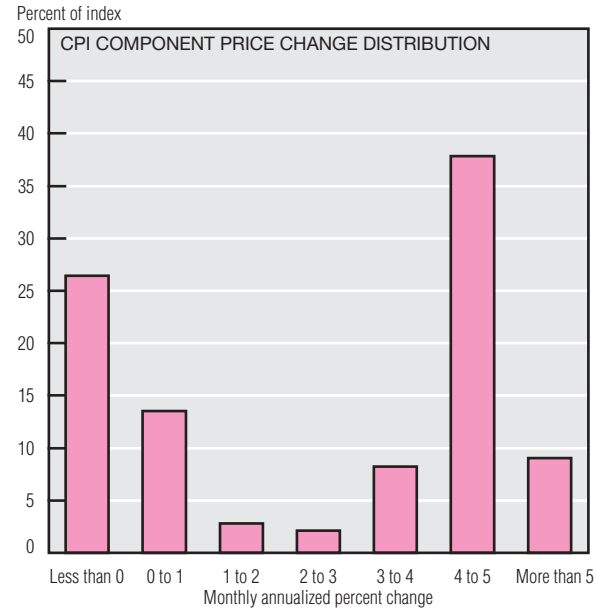
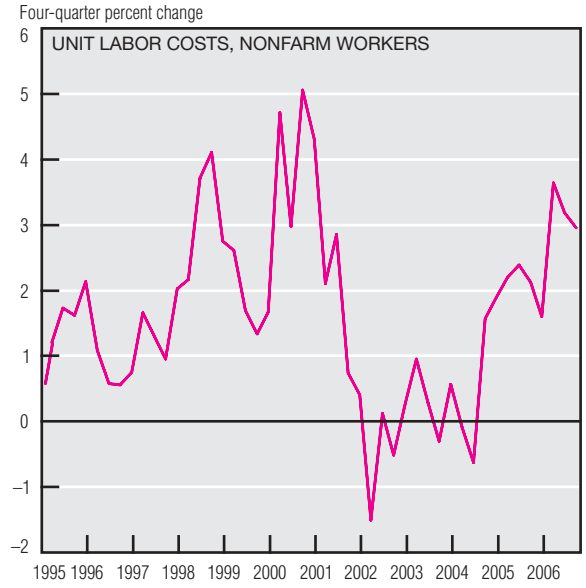
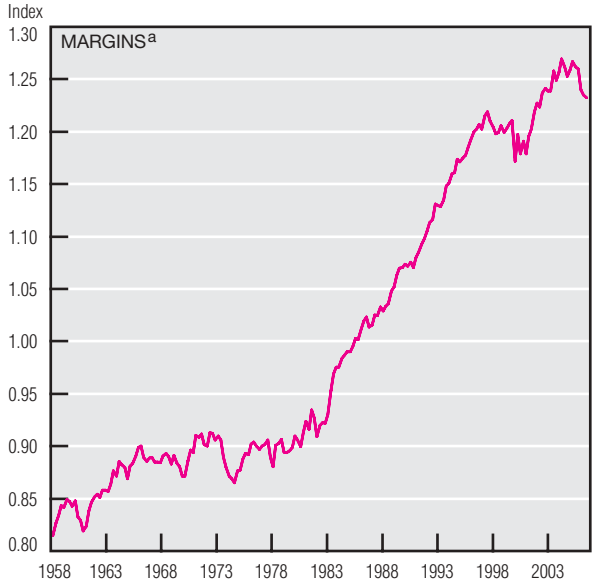
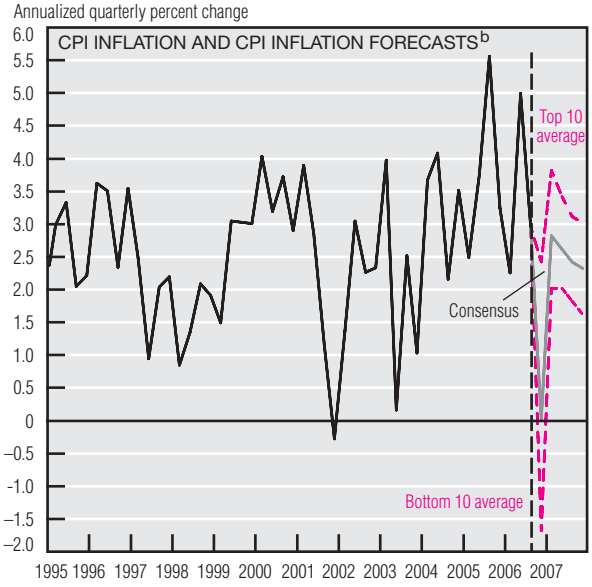
Inflation and Prices (cont.)









a. Ratio of the core CPI to unit labor costs, indexed to the average ratio for the entire period.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Blue Chip Economic Indicators*, November 10, 2006.

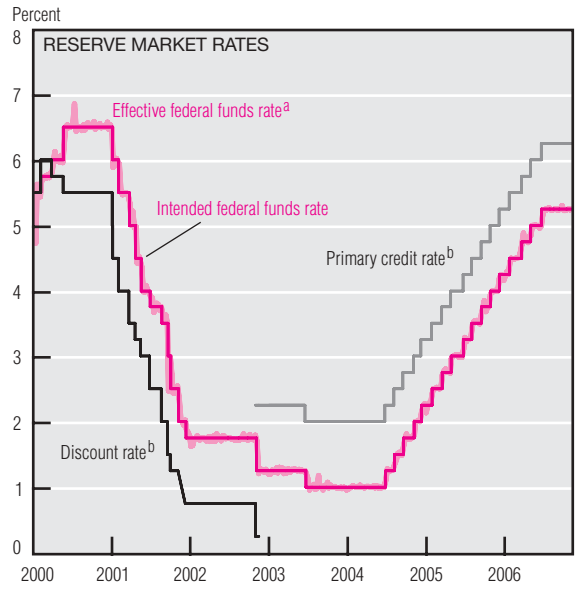
(about 5%) showed price increases in the moderate 1%–3% range.

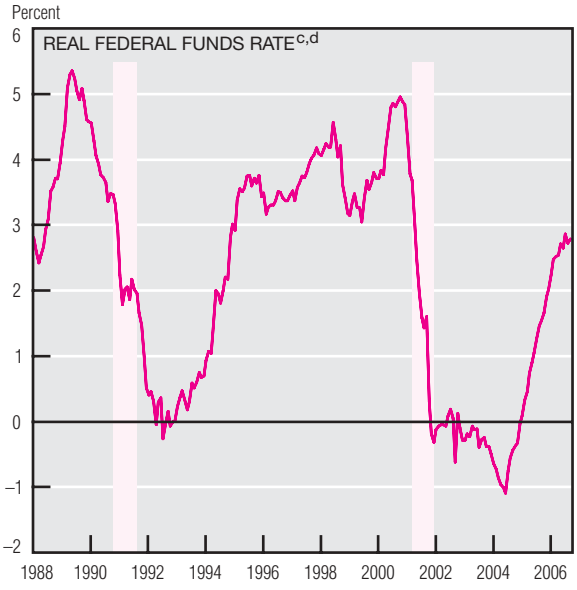
In a recent speech, Federal Reserve Chairman Ben Bernanke stated that "there are substantial uncertainties about the inflation forecast… One factor that we are watching carefully is labor costs…[which] have been rising more quickly of late. Some part of this acceleration no doubt reflects the current tightness in labor markets." Indeed, in 2006:IIIQ, the four-quarter growth rate of unit labor costs was 2.9%, as compensation growth outpaced decelerating productivity growth.

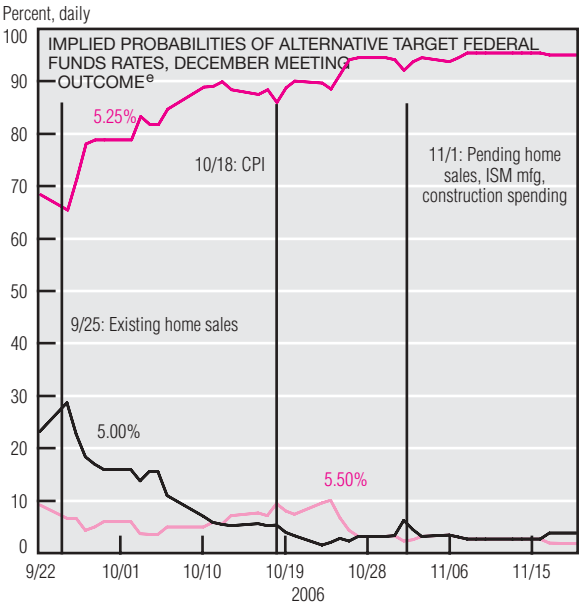
Chairman Bernanke suggested that accelerating growth in unit labor costs would not affect price inflation if firms were to absorb rising labor costs by sacrificing some portion of their profit margins. Margins, as measured by the ratio of prices to unit labor costs, do indeed seem unusually high. But what firms' responses to rising labor costs would be and whether firms' margins are really as high as this measure would indicate are highly speculative matters. Chairman Bernanke also suggested that "the more worrisome possibility is that tight product markets might allow firms to pass all or part of their higher labor costs through to prices, adding to inflation pressures."

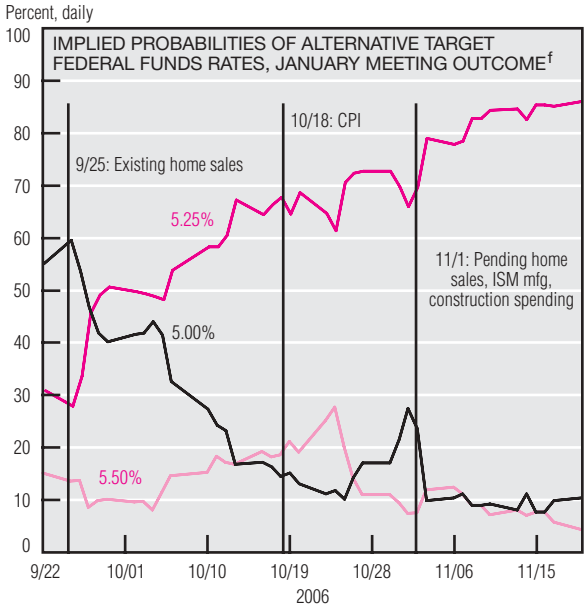
Despite these concerns, economists don't anticipate that the recent acceleration in the growth rate of unit labor costs will have a lasting impact on inflation. The consensus estimate of the Blue Chip panel of economists is that retail prices will hold steady in 2006:IVQ and will rise between $2^{1}/_{4}$% and $2^{1}/_{2}$% by the end of 2007.

Monetary Policy









a. Weekly average of daily figures.
b. Daily observations.
c. Defined as the effective federal funds rate deflated by the core PCE.
d. Shaded bars represent periods of recession.
e. Probabilities are calculated using trading-day closing prices from options on December 2006 federal funds futures that trade on the Chicago Board of Trade.
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; the Chicago Board of Trade; and Institute for Supply Management.

At its October 25 meeting, the Federal Open Market Committee left the target federal funds rate unchanged at 5.25% for the third consecutive time. Likewise, the Board of Governors left the primary credit rate at 6.25%. The press release that followed the Committee's meeting stated, "Going forward, the economy seems likely to expand at a moderate pace," but added, "Nonetheless, the Committee judges that some inflation risks remain." The next meeting is scheduled for December 12.

The real federal funds rate—defined as the effective federal funds rate less core inflation in personal consumption expenditures (PCE)—has shown signs of leveling off and now stands at 2.76%. Holding the effective funds rate constant since the last meeting, the real funds rate has gained 6 basis points because core PCE inflation has slowed slightly.

Participants in the federal funds futures and options market believe that a continued pause is almost assured. As of November 20, the implied probability of the federal funds target rate remaining at 5.25% stood at 95% for December. The probability that this will carry over to the January meeting was down only 10%, to 85%. It is can be very hard to gauge the impact of data releases: The September release on existing home sales came in 1.1% below consensus expectations, with the median price down 2.2% on a year-over-year basis. Market participants may have perceived this as increasing the likelihood of a "hard landing" in the housing market,

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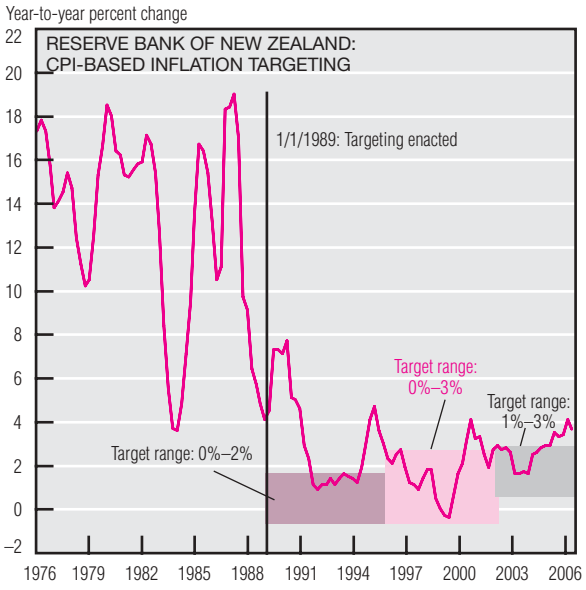
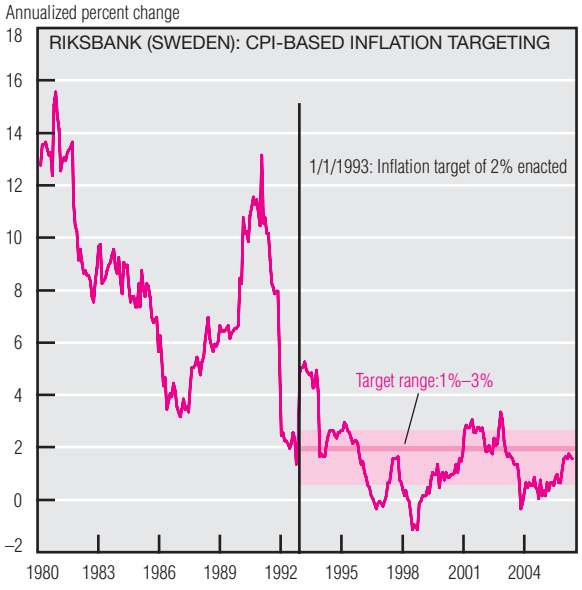
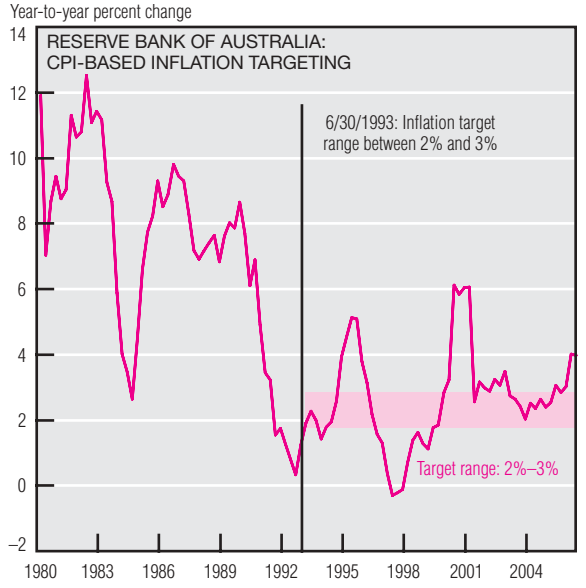
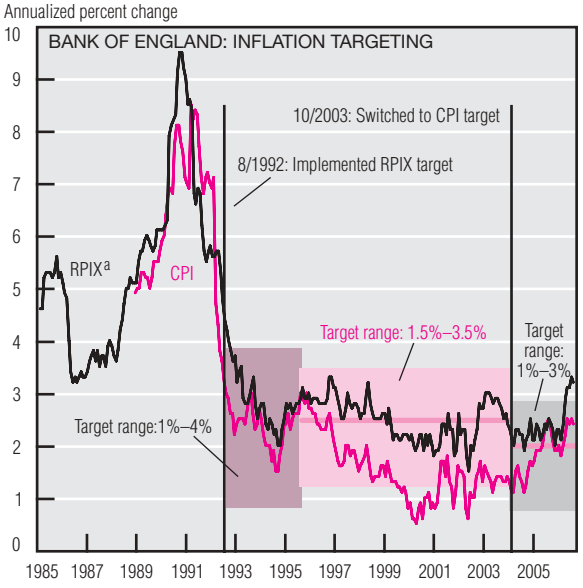
Monetary Policy *(cont.)*









a. RPIX is the Retail Price Index excluding mortgage interest payments.
SOURCES: Reserve Bank of New Zealand; Riksbank, *Statistics Sweden*; Reserve Bank of Australia; and Bank of England, *Statistics England*.

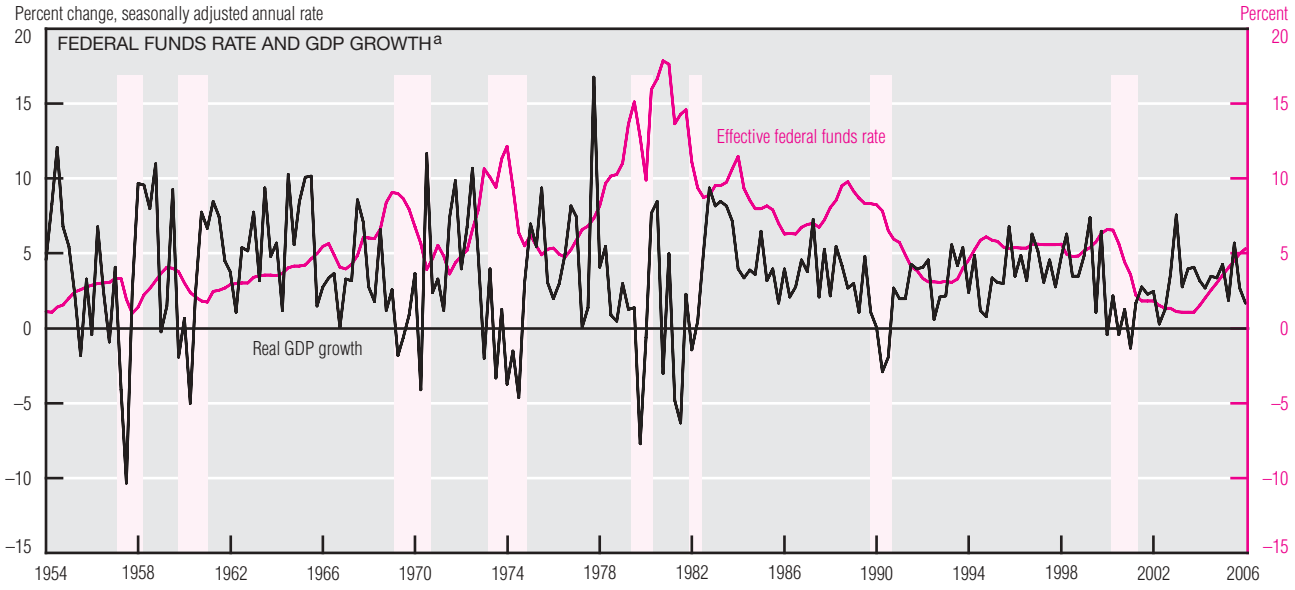
thereby increasing the implied likelihood of a future cut in the fed funds target. However, that perception was short lived, and probabilities started to rebound the very next day.

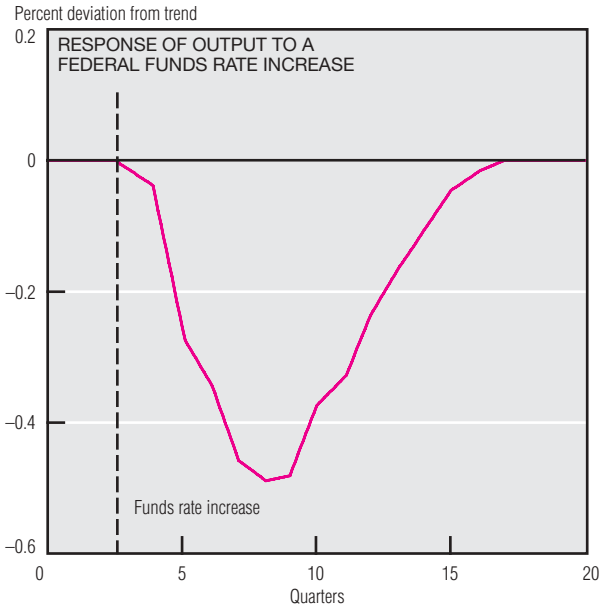
When evaluating current U.S. monetary policy, it is useful to look at how other countries' central banks are working to enhance credibility in an effort to keep inflation low. Many countries use inflation targeting as a means of gaining credibility. In 1989, the Reserve Bank of New Zealand became the first central bank to adopt a formal inflation target and was quickly followed by Canada, England, Sweden, Australia, and others.

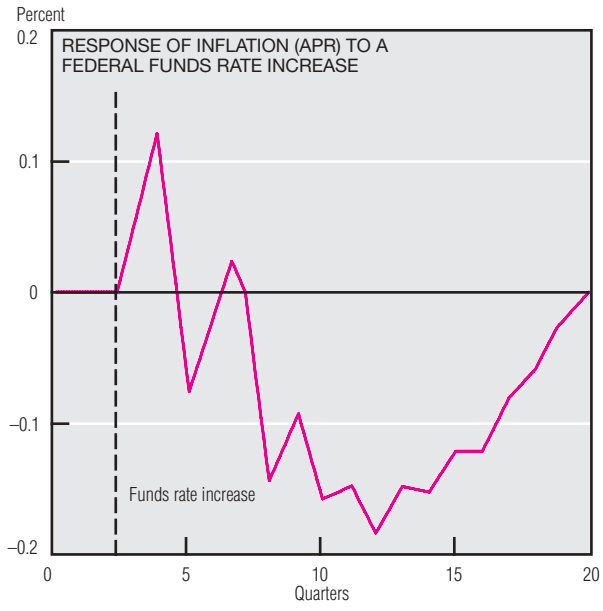
Countries have employed a variety of methods for promoting price stability. Some countries favor an explicit target versus a target range when trying to achieve stable prices. Sweden and England, for example, use an explicit target (currently 2%), whereas New Zealand and Australia prefer to target a range of inflation (currently 1%–3% and 2%–3%, respectively). Even with an explicit target, the Bank of England will act only if it misses the target by more than 1 percentage point on either side; in that case, "the Governor of the Bank of England must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation comes back to the target."

How important are these countries' formal targets for lowering inflation and keeping it low? Each of them had substantial disinflation even before they began inflation targeting; afterward, targeting may have enhanced their ability to keep inflation low. Although a country can theoretically change its inflation target every year, in practice targets change very little. For example, New Zealand has changed its target only three times since 1989, from a low of 0%–2% to the current high of 1%–3%.

Money and Financial Markets







a. Quarterly data.

SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis; and Lawrence J. Christiano, Martin Eichenbaum, and Charles L. Evans, "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy," *Journal of Political Economy* 1 (2005): 6-7.

We know that correlation does not necessarily imply causation. Nonetheless, the association between recessions and hikes in the federal funds rate suggests that increasing the funds rate can indeed cause recessions. But the sheer variety of shocks buffeting the economy implies that the correlation between the funds rate and output growth is quite small. Econometricians are left with the difficult task of isolating the effect of a funds rate increase on variables such as output and inflation.

Vector autoregressions (VARs) try to disentangle these factors and show the impact of an exogenous funds rate increase on output and inflation. The ability to disentangle the various shocks that affect these variables requires the assumption that output and inflation do not respond instantaneously to an interest rate shock.

VAR evidence suggests that an increase in the interest rate temporarily lowers output and reduces inflation. However, the impact on these two variables is not symmetric; increases in interest rates affect output much sooner than they do prices. Inflation does not respond significantly until a year after an interest rate increase, and there may be a lag of 10 quarters before the peak response occurs. Output reaches its trough roughly five quarters after the rate increase.

The lags between interest rate increases and output (and, eventually, rate increases and inflation) make it difficult for the Federal Open Market Committee (FOMC) to determine when tighter monetary policy is tight enough. The wording of the FOMC's recent statements suggests

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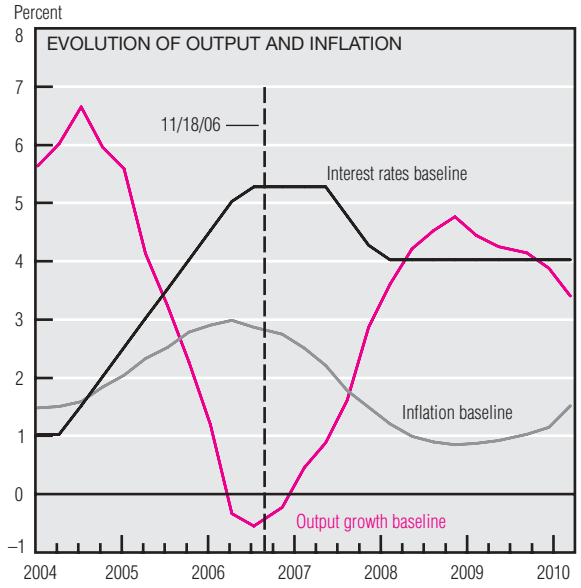
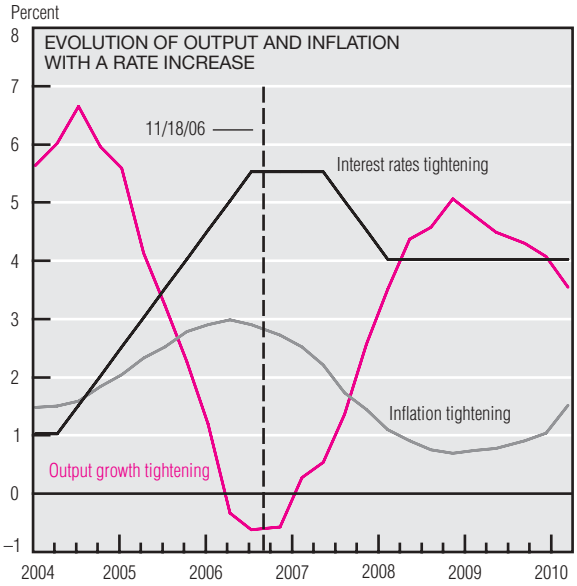
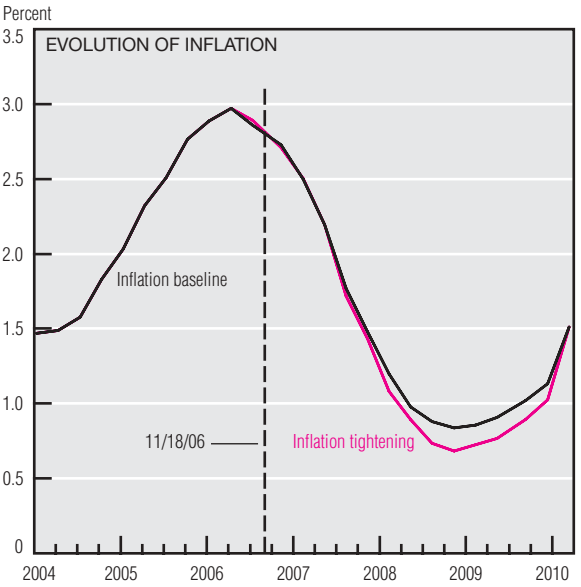
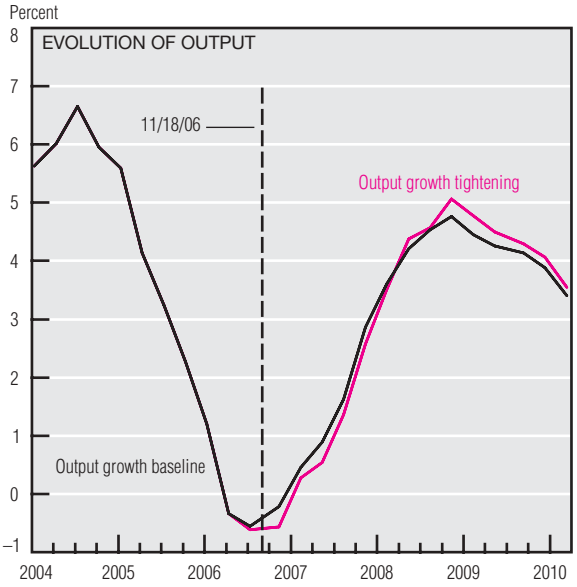
Money and Financial Markets *(cont.)*









NOTE: All charts assume there are only monetary shocks.
SOURCES: Author's calculations; and Lawrence J. Christiano, Martin Eichenbaum, and Charles L. Evans, "Nominal Rigidities and the Dynamic Effects of a Shock to Monetary Policy," *Journal of Political Economy* 1 (2005): 6-7.

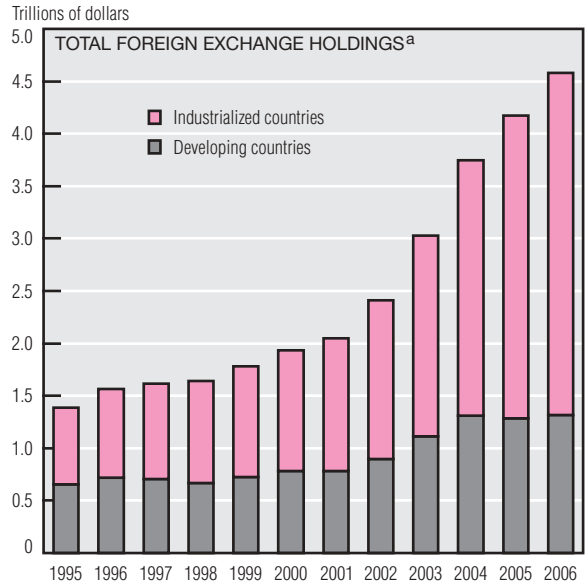
that the recent string of interest rate increases—from a low of 1% to the current 5.25% level—is adversely affecting GDP: "Economic growth has moderated…partly reflecting…the lagged effects of increases in interest rates." Similarly, the FOMC has reaffirmed its belief that, even without any more policy moves, inflation will eventually moderate: "Readings on core inflation have been elevated in recent months…However, inflation pressures seem likely to moderate over time, reflecting…the cumulative effects of monetary policy actions."

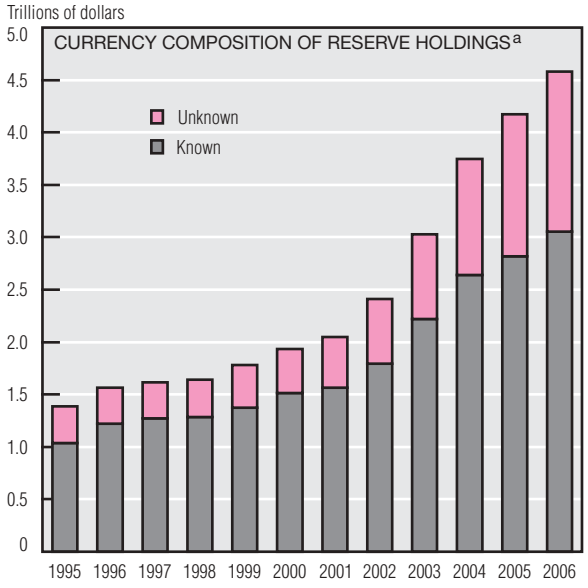
How much have the cumulative effects of past monetary policy tightening curtailed output growth? What about inflation? Should we expect a significant moderation in inflation without further rate hikes? We answer this question, given the VAR evidence above, by assuming that the only shocks to hit the economy over the past 30 months are monetary. We also assume that the funds rate remains at 5.25% for four quarters before slowly declining to its long-run average of 4%.

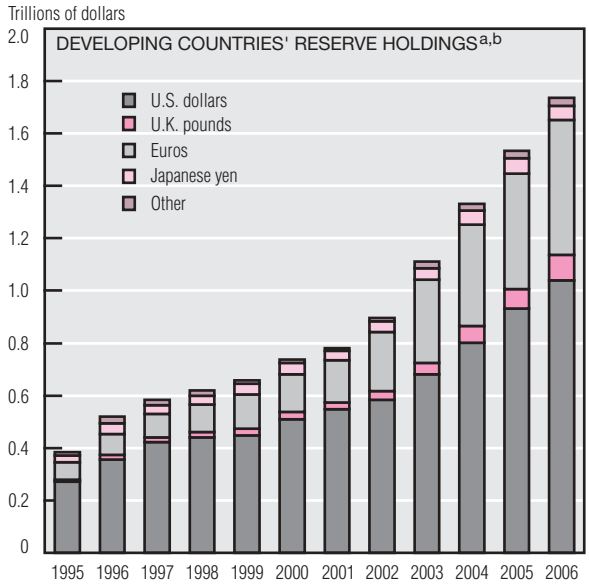
This experiment suggests that even without any additional policy firming, output growth should be near its trough, while inflation should be near its peak. Going forward, output growth should pick up and inflation should moderate, in accord with the FOMC's recent statements.

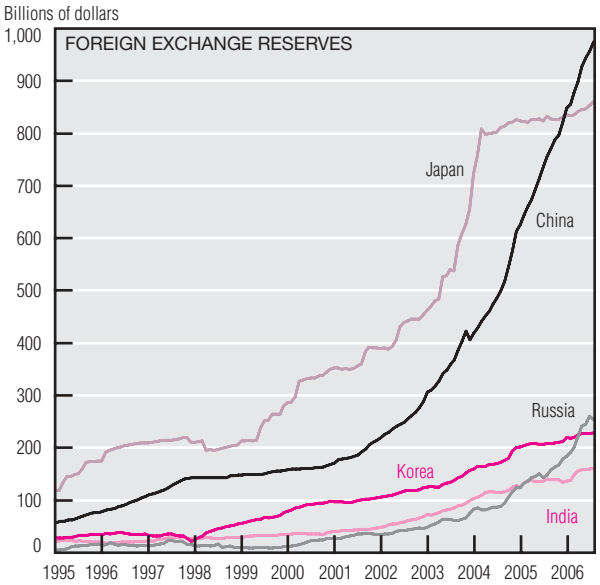
If the funds rate had increased another 25 basis points in August, inflation would have moderated even further. But because of the long lags between rate increases and inflation, the latter will not moderate significantly until it drops below 1.5%, its assumed long-run average.

The Currency Composition of International Reserves









a. Preliminary estimate, 2006:IIQ.
b. Includes only those holdings whose currency composition is known.
SOURCE: International Monetary Fund.

The U.S. dollar is the world's key international reserve currency. Many countries—particularly developing and oil-exporting nations—have amassed huge foreign-exchange portfolios. Some, notably China and Japan, have done so through efforts to prevent their currencies from appreciating against the dollar. Others, adversely affected by global currency crises in 1997–98, have built buffers against banking turmoil and rapid financial outflows. Reflecting the comparative advantage of the U.S. in providing broad, liquid, transparent financial markets, the lion's share of these reserves is in dollar-denominated assets.

However, some commentators fear that the era of the dollar may be coming to a close. Current global imbalances, they contend, suggest that the dollar must depreciate quite substantially, and the prospect of capital losses creates a strong incentive to diversify out of dollars.

No country publicizes the currency compositions of its own reserves, but many allow the International Monetary Fund (IMF) to aggregate the data. The IMF knows or can allocate the currency composition of only two-thirds of total foreign currency reserves, and that proportion has been shrinking.

All of the action is in developing countries, which began trimming their dollar shares in 1997 and accelerated the pace after 2001. In that year, U.S. dollars made up 70% of the reserves whose currency composition is known; by 2002:IIQ, their share was down to 60%. Developing countries seem to be shifting into euros (up 9 percentage points to 30% of the total) and British pounds (up 2 percentage points to 5%).

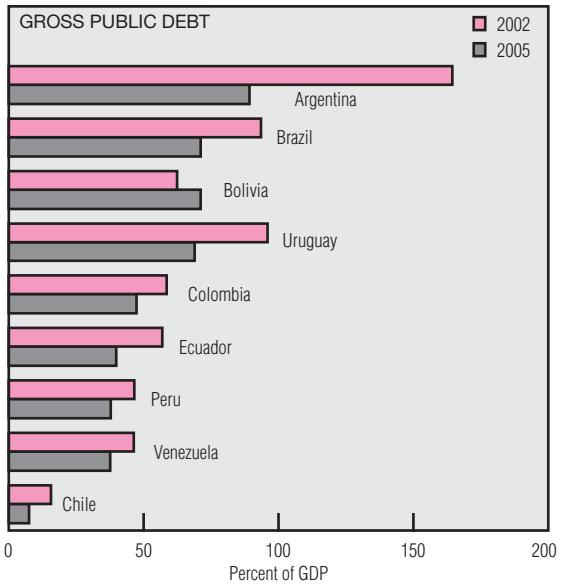
Latin America's Economic Prospects

Real GDP Growth

	Percent			
	Average, 1988–97	Average, 1988–2005	2006[a]	2007[a]
Western Hemisphere	2.9	2.4	4.8	4.2
Argentina	3.2	1.4	8.0	6.0
Bolivia	4.1	2.9	4.1	3.9
Brazil	2.0	2.0	3.6	4.0
Chile	7.9	3.3	5.2	5.5
Colombia	4.0	2.1	4.8	4.0
Ecuador	3.7	3.0	4.4	3.2
Paraguay	3.7	1.2	3.5	4.0
Peru	0.6	3.0	6.0	5.0
Uruguay	3.3	0.8	4.6	4.2
Venezuela	2.6	1.5	7.5	3.7

Inflation

	Percent			
	Average, 1988–97	Average, 1988–2005	2006[a]	2007[a]
Western Hemisphere	162.8	7.9	5.6	5.2
Argentina	159.4	6.4	12.3	11.4
Bolivia	12.5	3.8	4.1	4.0
Brazil	576.3	7.3	4.5	4.1
Chile	13.9	3.2	3.5	3.1
Colombia	24.5	8.9	4.7	4.2
Ecuador	42.7	30.9	3.2	3.0
Paraguay	19.3	8.8	8.9	4.9
Peru	267.1	3.1	2.4	2.5
Uruguay	59.0	9.1	5.9	4.3
Venezuela	51.4	22.4	12.1	15.4



a. International Monetary Fund projections.
SOURCES: International Monetary Fund, *World Economic and Financial Surveys*, Western Hemisphere, November 2006, and *World Economic Outlook*, September 2006.

The economic outlook for developing countries in the Western Hemisphere is one of the brightest in decades. According to the International Monetary Fund, the region is likely to post real economic growth of around 4.8% this year and 4.2% in 2007, with a regional inflation rate moderating to about 5% in 2007. That said, public debt remains relatively high, and fiscal spending has recently accelerated despite the stepped-up pace of economic activity.

Latin American countries owe much of their improved growth to a strong demand for fuel and nonfuel commodities. Colombia, Ecuador, and Venezuela, for example, benefited from the sharp rise in oil prices, while Chile and Peru benefited from a jump in metals prices. In consequence, private domestic consumption and investment are poised to propel Latin America's economic activity next year.

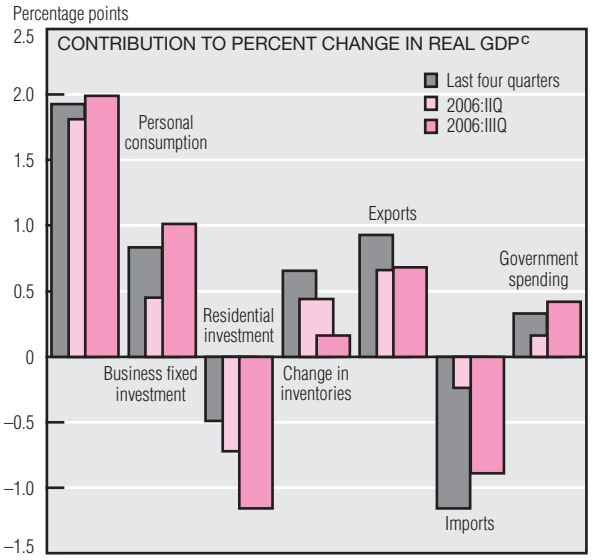
Even with higher commodity prices, most countries in the region have made big strides in lowering their inflation rates. Many of them, notably Brazil, Chile, Colombia, and Peru, have implemented formal inflation targeting regimes and have allowed their exchange rates greater flexibility. Notable outliers in the inflation fight are Argentina and Venezuela, where inflation continues to breach double-digit levels.

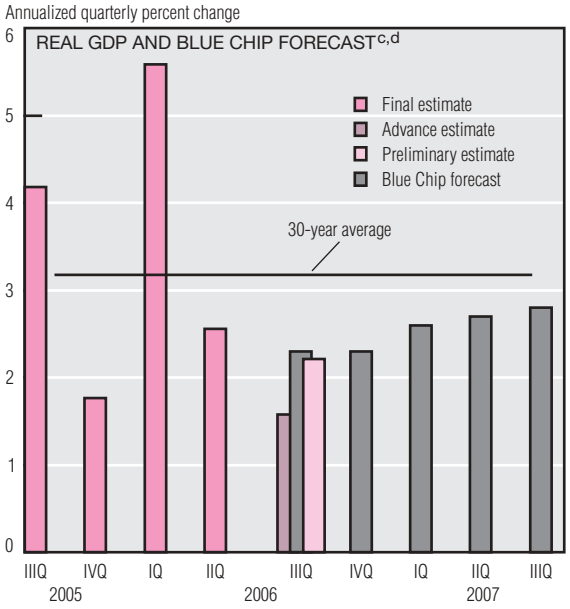
Primary fiscal surpluses are shrinking. Although revenues—particularly commodity-based revenues—keep growing, government outlays, a high proportion of which are mandated, are rising rapidly. Stronger fiscal positions, faster economic growth, exchange rate appreciation, lower interest rates, and debt restructuring have all contributed to a healthy drop in many countries' public debt ratios.

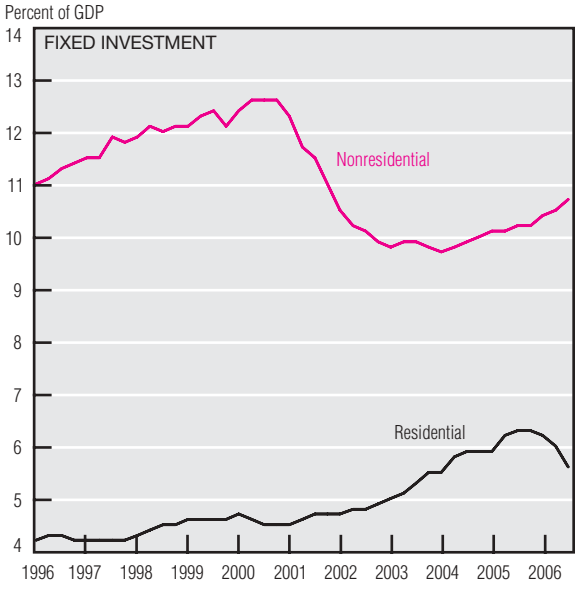
Economic Activity

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

	Change, billions of 2000 $	Annualized percent change	
		Current quarter	Four quarters
Real GDP	62.4	2.2	3.0
Personal consumption	57.0	2.9	2.7
Durables	17.3	5.9	2.7
Nondurables	6.6	1.1	3.1
Services	35.3	3.1	2.6
Business fixed investment	31.3	10.0	8.3
Equipment	18.4	7.3	5.9
Structures	10.7	16.7	14.4
Residential investment	–29.1	–18.0	–7.9
Government spending	10.9	2.2	1.7
National defense	–1.3	–1.1	–1.2
Net exports	–5.2	—	—
Exports	19.8	6.3	9.0
Imports	25.0	5.3	7.2
Change in business inventories	4.3	—	—







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*, November 10, 2006.

Real GDP increased at an annual rate of 2.2% in 2006:IIIQ, according to the Commerce Department's preliminary estimate. This upward revision of 0.6% was largely unanticipated, the consensus growth estimate having been 1.8%. The largest revision was to inventories: They were estimated to have increased $4.3 billion from 2006:IIQ, compared with the advance estimate, which showed a $3.0 billion decrease. There was also a substantial revision to net exports (up $10 billion); this was largely the result of the change in imports, where the increase was revised from 7.8% to 5.6%.

Despite the upward revision, real GDP growth continues its slowdown from the beginning of the year and is nearly a full percentage point below the 30-year average of 3.17%. Contributions to the percent change in real GDP reveal that personal consumption, business fixed investment, imports (less negative), and government spending have outpaced their four-quarter averages; on the other hand, residential investment, change in inventories, and exports are all less than their four-quarter averages.

In their October 10 report, the Blue Chip panel of economists forecasted that annualized real GDP growth for 2006:IIIQ would be 2.3%. Although they were off by 0.7% according to the advance estimate, the preliminary estimate finds them off by only 0.1%. The panel forecasts an upward trend in each of the next three quarters (2.3%, 2.6%, and 2.7%).

(continued on next page)

Economic Activity *(cont.)*

a. Seasonally adjusted
b. Data series is from the nonfarm business sector.
SOURCE: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and the Federal Reserve Board.

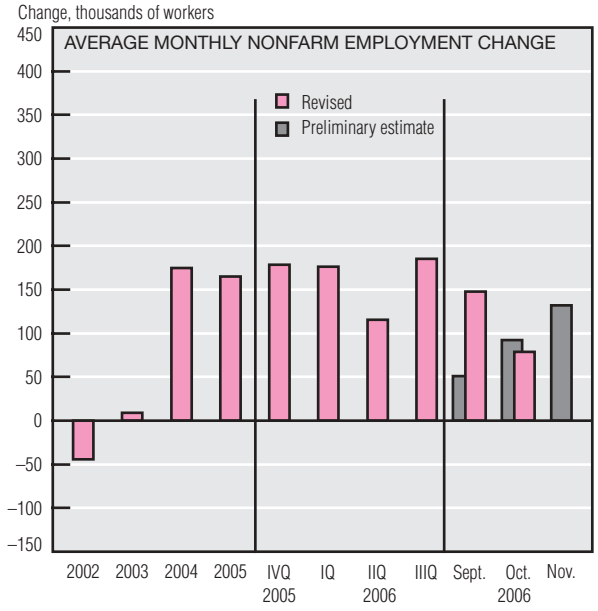
Business fixed investment, though nowhere near its late-2000 high, has steadily increased since 2004:IIIQ and is now 10.6% of GDP. In contrast, investment in residential structures has been trending down since 2005 and stands at 5.6% of GDP. Although the recent housing market downturn has received considerable attention, residential investment still accounts for a relatively high share of GDP.

Another gauge of the general business climate is the inventory-to-sales ratio. Nondurable goods inventories have been slowly creeping up since 2005. However, the inventory ratios for both durable goods and retail trade have been relatively flat.

Reflecting the economy's overall slowdown, industrial production fell slightly from a high of 114.0 in August to 113.7 in October. Because its volatility is largely determined by the weather, the utilities industry's performance must be viewed over a longer period; it appears to have leveled off in the last couple of years. Mining has recovered completely from the severe drop in oil and gas extraction caused by Hurricanes Rita and Katrina. Capacity utilization rates have eased slightly overall and for manufacturing; mining's utilization rate, in contrast, is the highest since May 2001.

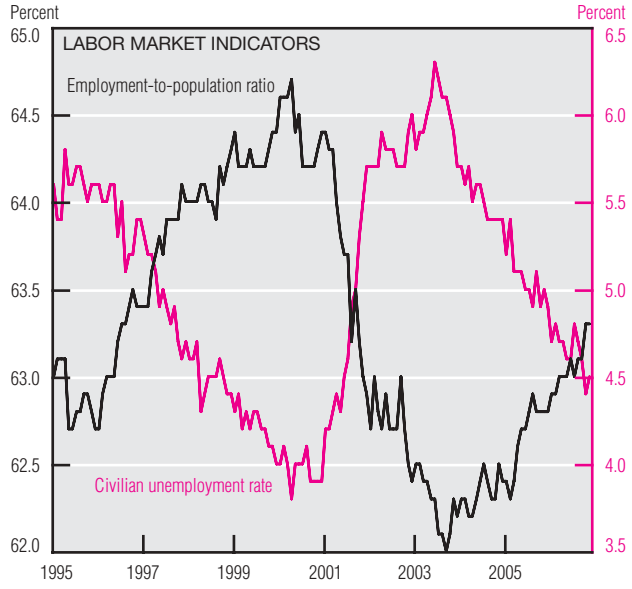
Worker productivity and compensation affect the economic climate as well. Real compensation was up more than 3% at an annual rate in the second and third quarters, far outstripping productivity gains. Were this situation to continue, it could lead to higher inflation if firms tried to raise prices in an attempt to recoup their costs. At this point, considering that real compensation has trailed productivity gains for most of the last five years, the more likely interpretation is that compensation is merely catching up with past productivity gains.

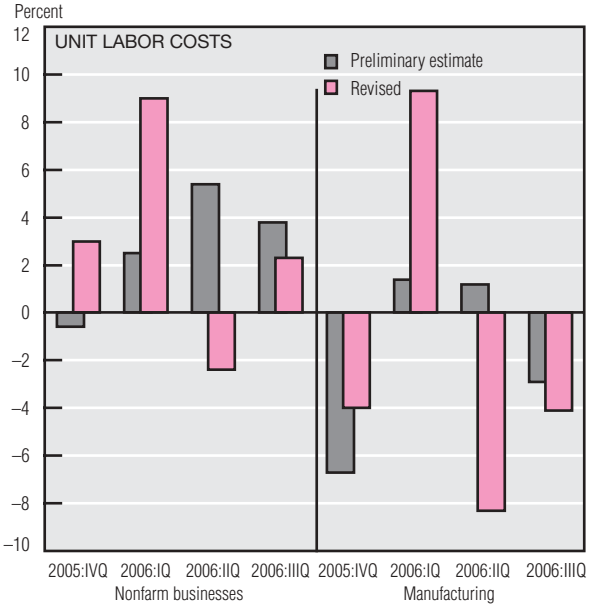
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2003	2004	2005	Jan.–Oct. 2006	Nov. 2006
Payroll employment	9	175	165	151	132
Goods producing	–42	28	22	8	–40
Construction	10	26	25	7	–29
Manufacturing	–51	0	–6	–4	–15
Durable goods	–32	9	1	2	–13
Nondurable goods	–19	–9	–7	–6	–2
Service providing	51	147	143	144	172
Retail trade	–4	17	13	–9	20
Financial activities[a]	7	8	12	14	11
PBS[b]	23	40	41	32	43
Temporary help svcs.	12	13	14	–4	5
Education & health svcs.	30	33	31	38	41
Leisure & hospitality	19	26	21	28	31
Government	–4	13	14	23	28
	Average for period (percent)				
Civilian unemployment rate	6.0	5.5	5.1	4.7	4.5





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.

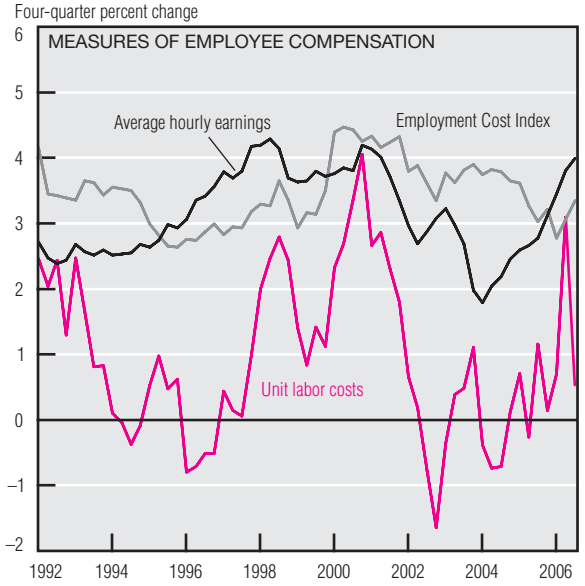
Nonfarm payrolls grew by 132,000 in November. This moderate increase was accompanied by the Labor Department's net upward revision of 84,000 jobs for the previous two months. November's increase was above expectations but slightly below the three-month average of 138,000.

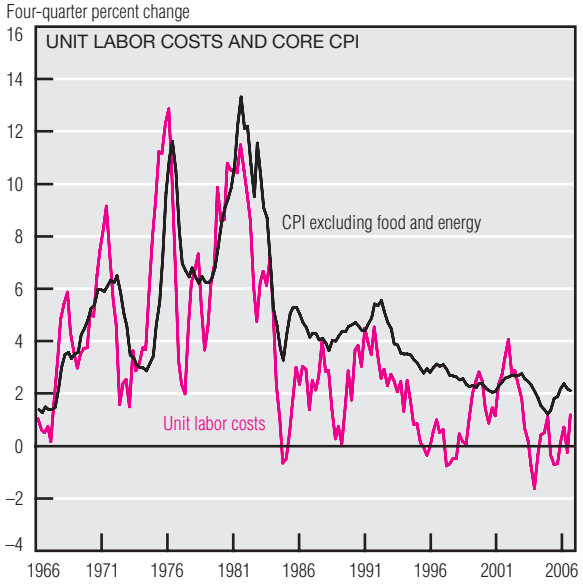
Service-providing industries added the most jobs (172,000), led by professional and business services (43,000). Educational and health services (41,000) and leisure and hospitality (31,000) were also buoyant. Goods-producing industry payrolls continued to sink, losing 40,000 jobs in November. Weakness in the home-building and remodeling sectors drained jobs from the construction industry (–29,000). Manufacturing was also weak; its 15,000 payroll reduction occurred mainly in the durables sector (–13,000).

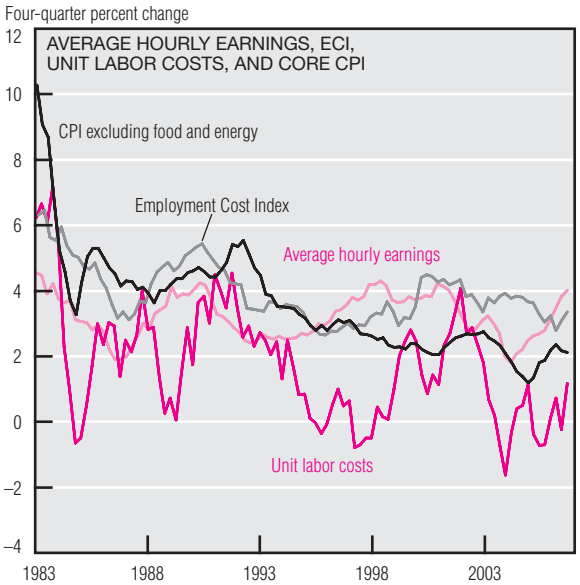
The civilian unemployment rate edged up from 4.4% in October to 4.5% in November, which is still below the first nine months of the year, when the rate ranged from 4.6% to 4.8%. The labor force participation rate was largely unchanged at 66.3% and the employment-to-population ratio held at 63.3%.

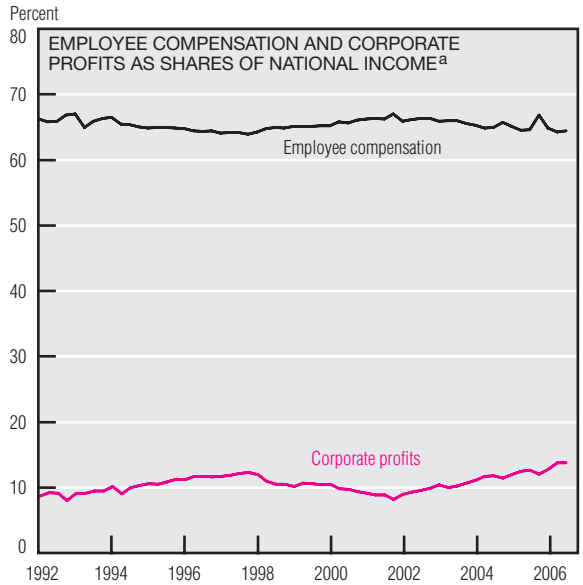
Unit labor costs hinted at inflationary pressure in the labor market early in the year, but the recent dramatic revisions do not. Nonfarm business costs fell a net 9.3% in the last two quarters, with the most severe adjustment (from 5.4% to –2.4%) in 2006:IIQ. Manufacturing costs fell a net 10.7% in the last two quarters, most dramatically (from 1.2% to –8.3%) in 2006:IIQ. The revised data suggest that the labor market will exert less pressure on inflation than previously was thought.

Labor Costs









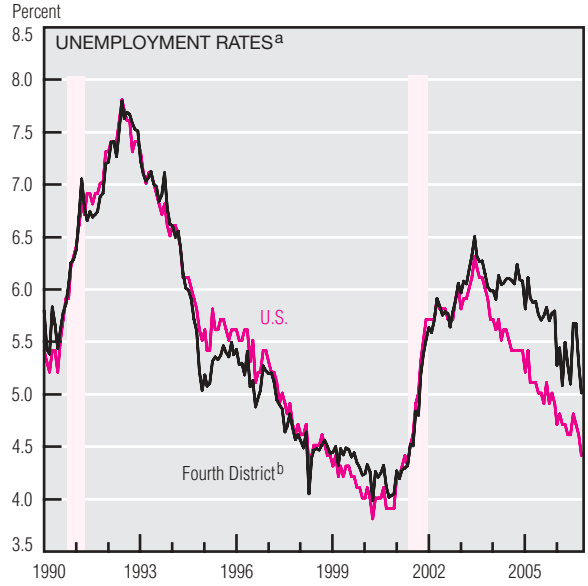
NOTE: Data are seasonally adjusted.
a. Corporate profits, adjusted for inventory valuation (IVA) and capital consumption (CCA).
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of Economic Analysis.

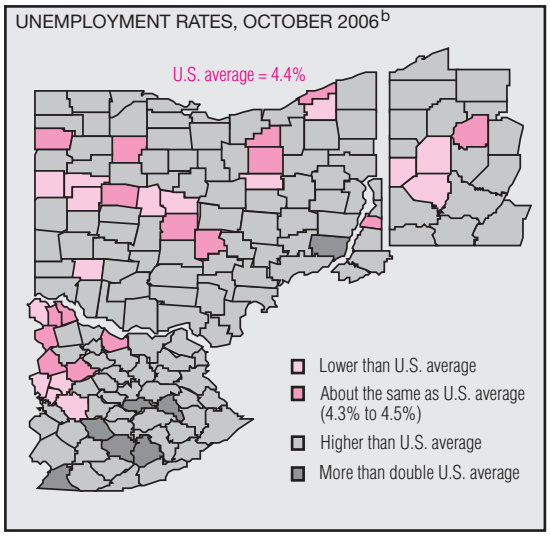
Unit labor costs, relatively stagnant since 2002, are showing signs of an upward trend. Since the beginning of this year alone, unit labor costs, a productivity-adjusted measure of compensation, have risen nearly 2%, the highest growth rate since 2001. Other measures of compensation include average hourly earnings and the Employment Cost Index. The percent change in average hourly earnings decreased from 4.1% to 1.8% between 2000 and 2004; it has since rebounded and now hovers around 4%. Meanwhile, the ECI, which takes into account not only wages and salaries but also benefits costs, fell less than either unit labor costs or average hourly earnings; however, it has not rebounded like the other two series. Its annualized growth rate is 3.3%, down from to 4.4% in 2000.

Some economists argue that rising labor costs can increase inflation over the long run. This theory seemed to be substantiated in the 1970s, when the core Consumer Price Index was highly correlated with unit labor costs. This correlation, however, has broken down over the last two decades, and unit labor costs are no longer a good predictor of inflation. In fact, neither average hourly earnings nor the Employment Cost Index is strongly correlated with the core Consumer Price Index.

Employee compensation as a share of national income has remained relatively flat, but corporate profits have been trending upward since 2002. How will firms react if wages continue to rise? Should higher wages cause inflation concerns? Although current data do not answer these questions, they do show that labor costs are poor inflation predictors.

Fourth District Employment





Payroll Employment by Metropolitan Statistical Area

	12-month percent change, October 2006							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	–0.1	0.5	0.9	–0.3	0.5	0.5	1.0	1.4
Goods-producing	–0.3	0.2	–0.2	–0.1	1.3	–1.2	–0.2	0.7
Manufacturing	0.3	–0.1	–0.8	–1.6	1.6	–2.9	–1.7	–0.2
Natural resources, mining, and construction	–2.2	0.9	1.1	5.1	0.6	1.6	3.8	2.1
Service-providing	0.0	0.5	1.1	–0.3	0.3	0.8	1.3	1.6
Trade, transportation, and utilities	–0.9	–0.1	0.0	–3.6	–0.2	–0.7	1.5	0.4
Information	0.5	0.5	–0.6	–0.9	0.0	–4.5	–2.2	0.0
Financial activities	–0.4	–1.2	0.5	–1.1	3.7	0.3	–0.9	1.9
Professional and business services	0.1	0.9	2.6	1.9	–2.3	1.0	1.3	2.7
Education and health services	2.0	2.8	2.5	0.0	1.8	1.8	0.0	2.4
Leisure and hospitality	0.2	0.6	2.2	0.8	2.7	2.5	2.7	2.6
Other services	–0.5	1.6	1.4	1.8	–2.0	–0.3	–1.0	1.0
Government	–1.5	–0.1	–0.5	0.2	–0.4	1.5	2.8	1.1
October unemployment rate (percent)	4.9	4.5	4.7	5.6	5.7	4.3	4.0	4.4

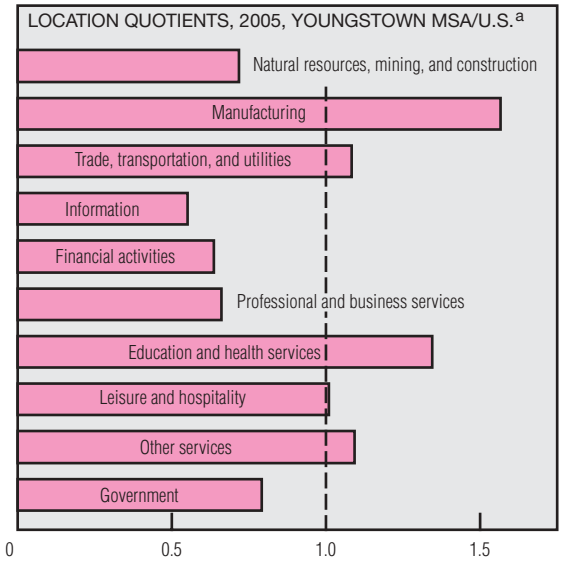
a. Shaded bars represent recessions.
b. Seasonally adjusted using the Census Bureau's X-11 procedure.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Kentucky Office of Employment and Training, Workforce Kentucky; Ohio Department of Job and Family Services, Bureau of Labor Market Information; Pennsylvania Department of Labor and Industry, Center for Workforce Information and Analysis; and West Virginia Bureau of Employment Programs, Workforce West Virginia.

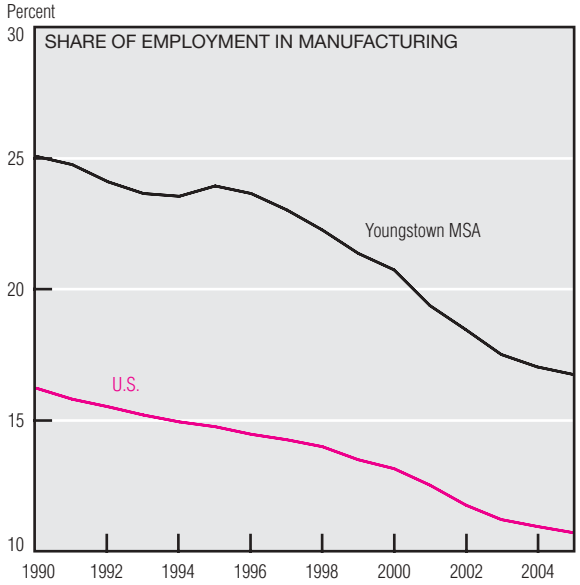
The Fourth District's unemployment rate was 5.0% in October, down 0.3 percentage point (pp) from the previous month and 0.7 pp from the previous year. From September to October, employment increased 0.3%, unemployment decreased 3.6%, and the labor force increased 1.8%. By comparison, the U.S. unemployment rate was 4.4% in October, down 0.2 pp from the previous month.

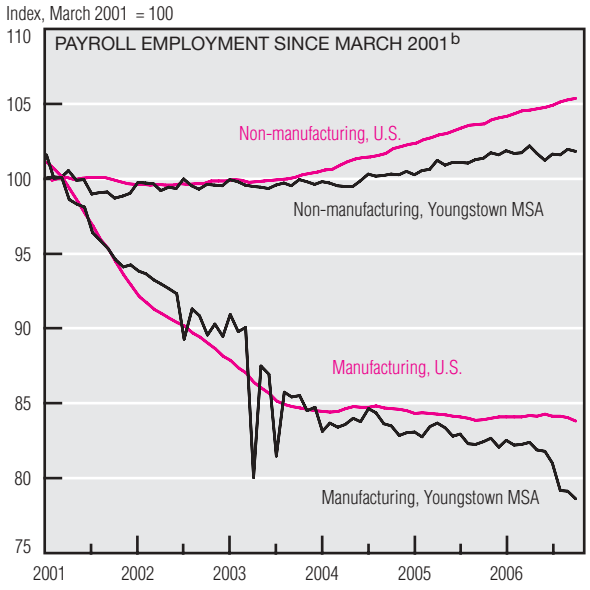
Among the District's counties, 137 out of 169 had unemployment rates higher than the national average in October; seven of them were more than double the U.S. rate. However, there has been recent improvement: Rates in 122 counties dropped over the month, and rates in almost all counties (163) fell during the previous two months. Similarly, unemployment rates declined over the month in most of the District's major metropolitan areas. Pittsburgh's rate fell below the national average, joining Lexington. Several other metro areas came close to the U.S. average.

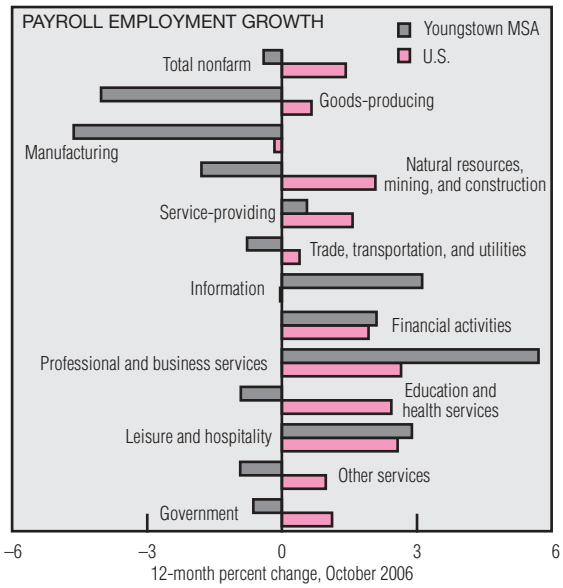
Over the past year, the nation has increased employment by 1.4%; however, none of the District's metro areas have kept up, partly because they have trailed U.S. growth in both goods-producing and service-providing industries. In fact, although the nation increased goods-producing employment 0.7% over the year, Cleveland, Cincinnati, Dayton, Pittsburgh, and Lexington all lost jobs in that sector. The leisure and hospitality industry, however, experienced positive growth in all of the District's metro areas, and, in several of them, outpaced U.S. growth.

The Youngstown Metropolitan Statistical Area









NOTE: The Youngstown-Warren-Boardman, OH-PA Metropolitan Statistical Area consists of Trumbull and Mahoning counties in Ohio and Mercer County in Pennsylvania.
a. The location quotient is the simple ratio between two locations of a given industry's employment share.
b. Seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Youngstown metropolitan statistical area, home to more than half a million people, comprises three counties in Northern Ohio and Pennsylvania. Youngstown is traditionally thought of as an area heavily invested in manufacturing. Indeed, more than 40,000 people—or 16.7% of total employment—work in that sector, compared to 10.7% for the U.S. Conversely, several industries, such as information and financial activities, have much smaller employment shares than the nation.

Although manufacturing's share of total employment is higher in the metro area than in the U.S., the area's reliance on the sector has decreased significantly. In 1990, 25.0% of the metro area's total employment was concentrated in manufacturing, but by 2005, that percentage had fallen to 16.7%. This drop changed manufacturing from Youngstown's largest industry in 1990 to its third largest in 2005, behind the trade, transportation, and utilities industry (21.0% of total employment) and the education and health services industry (17.5%).

Since the last business cycle peak in March 2001, Youngstown's manufacturing sector has shed 21.5% of its jobs, compared with the U.S. decline of 16.3%. Growth in non-manufacturing employment also trailed the nation's.

The area's manufacturing employment remained fairly stable in 2005

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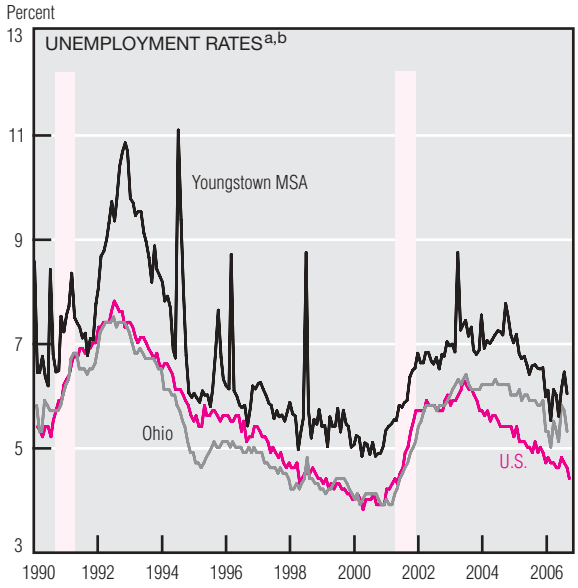
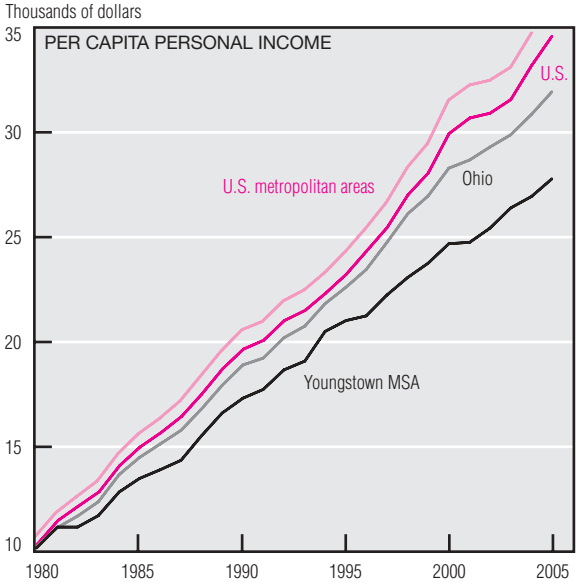
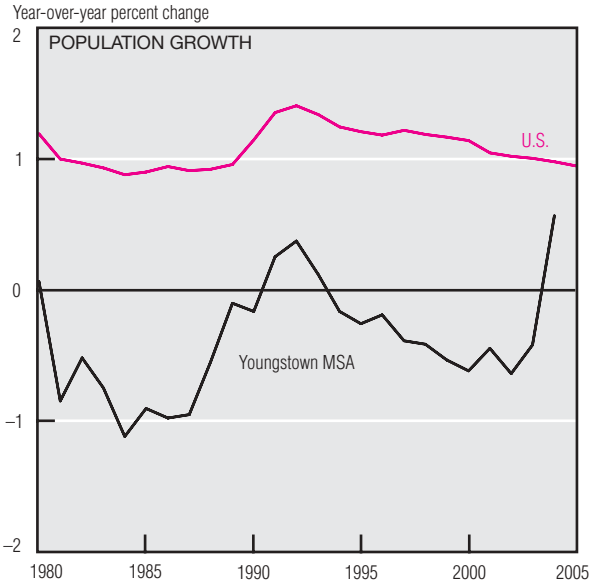
The Youngstown Metropolitan Statistical Area *(cont.)*



Selected Demographics, 2005

	Youngstown MSA	Ohio	U.S.
Total population (millions)	0.6	11.2	288.4
Percent by race			
White	88.3	85.7	76.3
Black	11.2	12.3	12.8
Other	0.6	2.0	10.9
Percent by age			
0 to 19	25.3	27.0	27.8
20 to 34	17.0	19.3	20.1
35 to 64	41.4	40.8	40.0
65 or older	16.4	12.8	12.1
Percent with bachelor's degree or higher	17.3	23.3	27.2
Median age	41.4	37.6	36.4





NOTE: The Youngstown-Warren-Boardman, OH-PA Metropolitan Statistical Area consists of Trumbull and Mahoning counties in Ohio and Mercer County in Pennsylvania.
a. Shaded bars indicate recession.
b. Seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

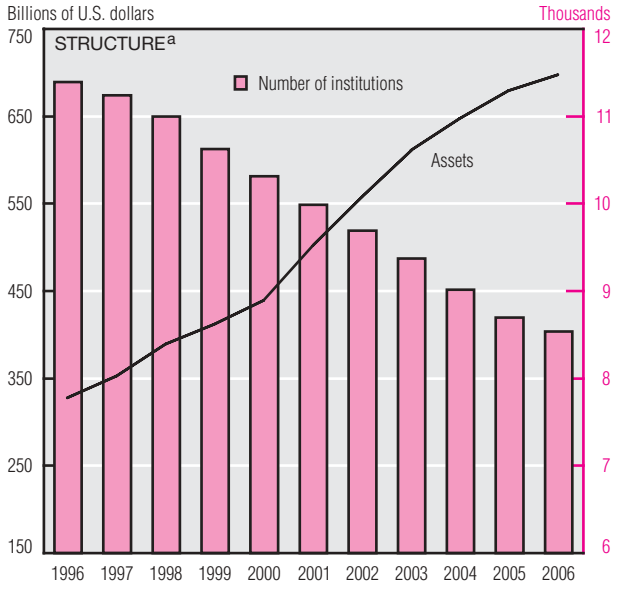
but has fallen more recently. Over the last year, Youngstown has shed 4.6% of its jobs in that sector. Information and the professional and business services industries, however, create a bright spot: Employment in information increased 3.1% over the year, compared to almost no change for the nation, and employment in professional and business services increased 5.7%, compared to a 2.7% gain for the nation.

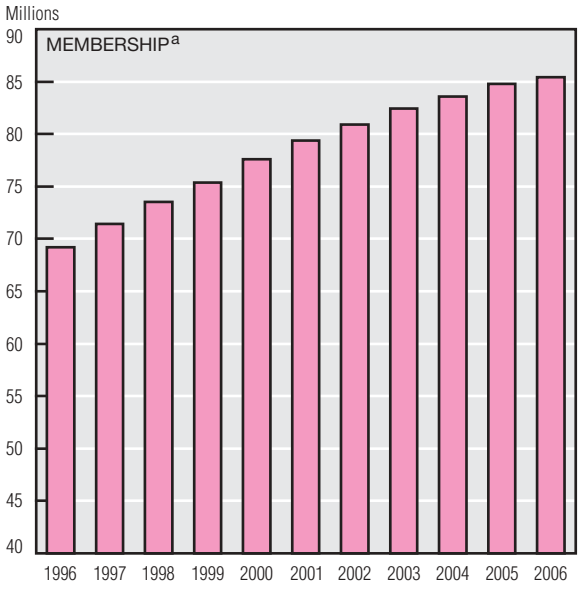
Another labor market measure—the unemployment rate—shows that Youngstown's employment performance has been weaker than both the state's and the nation's. However, the area's unemployment rate has recently closed in on Ohio's, trailing it by 0.8 pp in October.

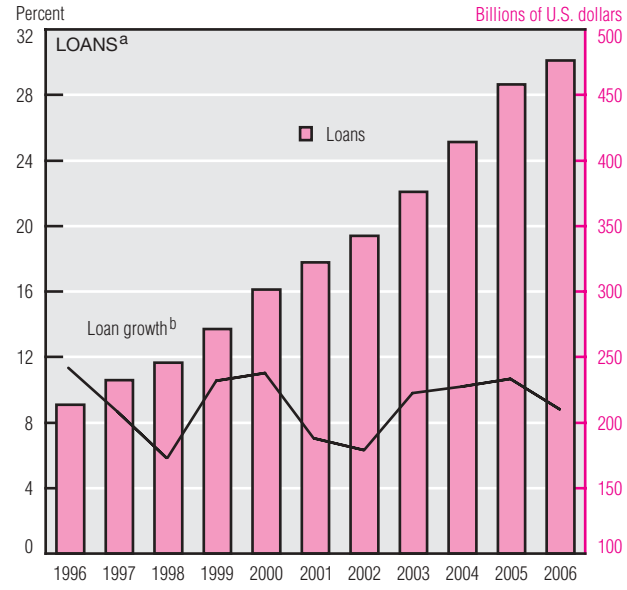
Besides a heavy dependence on manufacturing, relatively low education levels may also be responsible for Youngstown's slower economic performance. In 2005, 17.3% of the area's residents aged 25 and older held a bachelor's degree, compared to 23.3% for the state and 27.2% for the nation. Youngstown's lower education levels are probably a factor in its below-average per capita income.

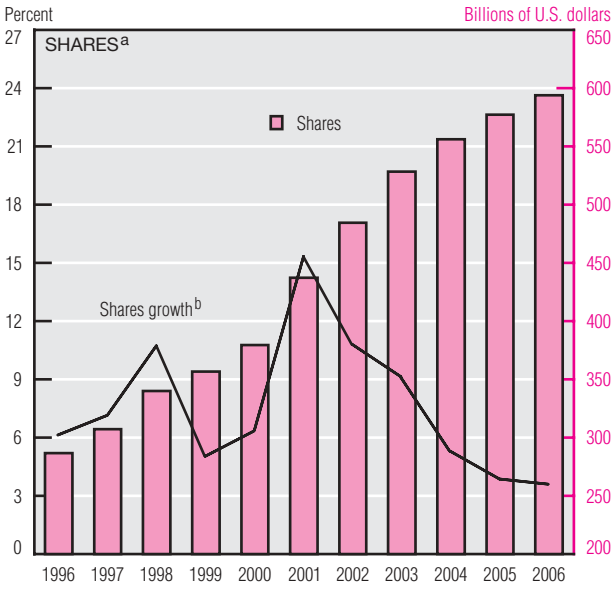
Youngstown's population growth has trailed the nation's by an average of 1.5% since 1980; and 2004 was the first year the metro area increased its population since 1993.

Credit Unions









NOTE: Data are for federally insured credit unions.
a. All values for 2006 are through the second quarter.
b. Growth rate is for 12 months.
SOURCE: National Credit Union Administration, *Quarterly Data*, June 2006.

Credit unions are mutually organized depository institutions that provide financial services to their members. Like banks and savings associations, the credit union industry continues to consolidate. The number of credit unions fell steadily from 11,392 in 1996 to 8,540 by 2006:IIQ. Over the same period, however, their total assets more than doubled from $326.9 billion to $697 billion. The number of credit union members also increased steadily from 69.2 million to 85.4 million.

Growth in credit unions' assets has been fueled by positive loan growth, although growth in both assets and loans has tapered off in recent years. From the end of 1996 to the middle of 2006, loans increased from $213.8 billion to $476.4 billion; loans as a share of assets grew modestly from 65.4% to 68.4%. Year-over-year loan growth has varied between 5.8% and 11.3% over the past 10 years, with an average annual growth rate of 7.5%.

Federally insured credit union shares have also risen steadily since 1996, totaling $594 billion in 2006. Shares, which are analogous to deposits in banks and savings associations, are the primary source of credit unions' funds, accounting for roughly 85% of the total. The annual shares growth in 2006 (3.6%) was the lowest in 10 years, slowing dramatically from a 15.3% pace in 2001. Shares grew at a 6.8% annual rate during this period but, like loans, are following a tapering trend.

Credit unions continued to accumulate capital, which more than

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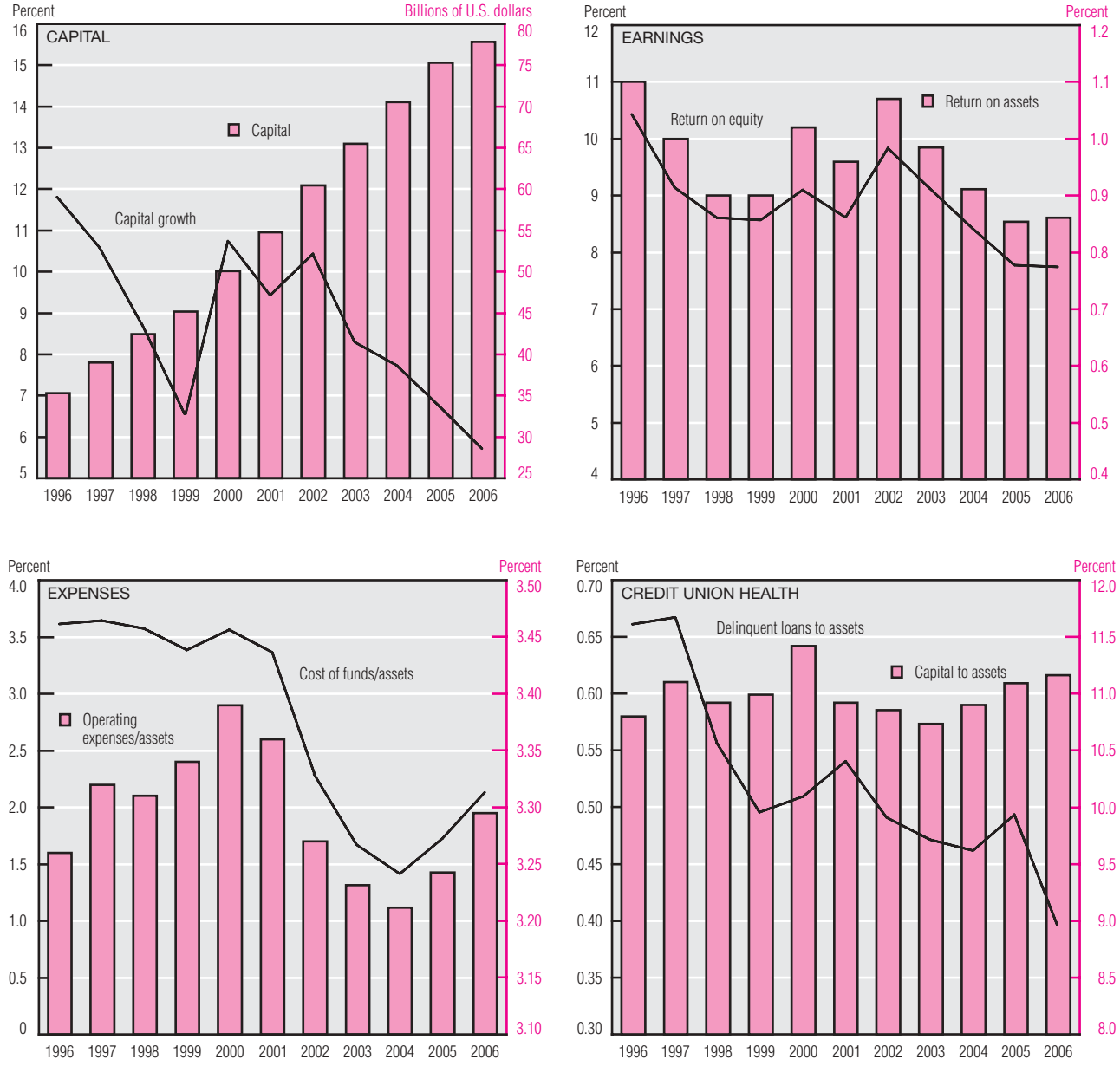
Credit Unions (cont.)



NOTE: Data are for federally insured credit unions.
a. All values for 2006 are through the second quarter.
b. Growth rate is for 12 months.
c. Return on assets is on average assets; return on equity is on average equity.
d. All ratios are for average total assets.
SOURCE: National Credit Union Administration, *Quarterly Data*, June 2006.

doubled from $35.3 billion at the end of 1996 to $77.8 billion by 2006:IIQ. Because retained earnings are credit unions' only source of capital, the pace of capital accumulation mirrors the general downward trend in return on assets (ROA) and return on equity (ROE) since 1996. ROA fell from a high of 1.1% in 1996 to a low of 0.85% in 2005, then reached a plateau at 0.86% in 2006. ROE followed a similar pattern over the 10-year period, evening out at 7.7%.

The decline in credit unions' profitability over the second half of the 1990s resulted partly from the steady increase in operating expenses per dollar of assets and the relatively high cost of funds. After constant improvement in operating efficiency between 2000 and 2004, operating expenses as a percent of assets increased to 3.3%. In the low-interest-rate environment of 2000–2004, the cost of funds declined; since then, it has risen in response to higher interest rates.

Overall, the health of the credit union industry appears sound. Capital as a share of assets stood at 11.2% by 2006:IIQ. Delinquent loans as a share of assets fell to a 10-year low, from 0.66% in 1996 to 0.40% in 2006. Moreover, credit unions held nearly $28.21 of capital for every $1 of delinquent loans by the end of that period. In short, credit unions remain a viable alternative to commercial banks and savings associations for such basic depository institution services as checking accounts, consumer loans, and savings accounts.

The Akron Metropolitan Statistical Area

12.21.06

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The Akron metropolitan area - home to 702,000 residents - stretches across Summit and Portage Counties. The region is typical of many metro areas in the Fourth District in that it has seen limited population growth over the past three decades. In fact, since 1970 Akron's population grew by only 3.5 percent compared to 46 percent for the United States.

Population

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

Although Akron enjoys a relatively diverse economy, the manufacturing sector still claims the highest employment concentration relative to the United States, followed by professional and business services.

Location Quotients, 2005, Akron MSA / U.S.

Note: The location quotient is the simple ratio between two locations of a given industry's employment share

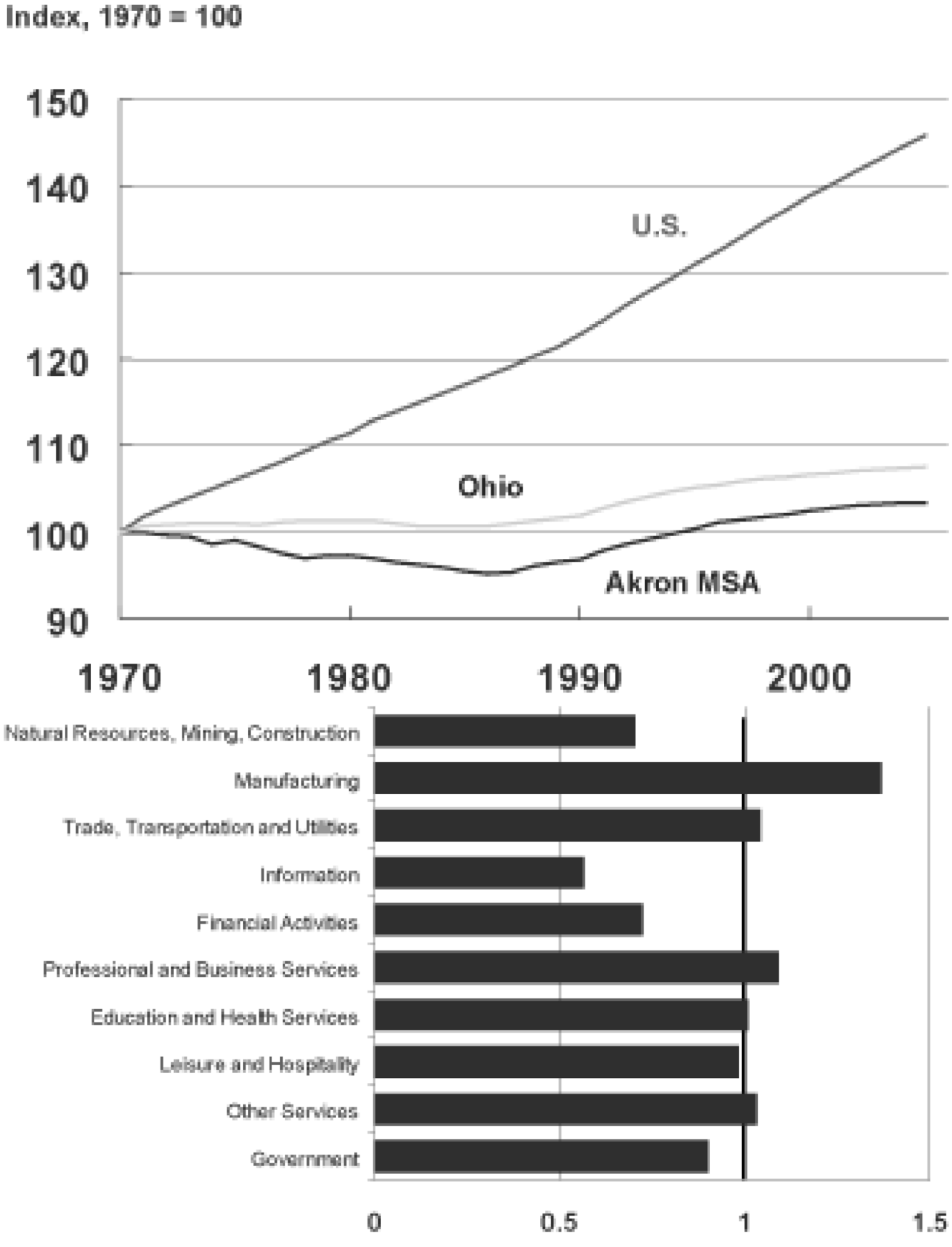
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Nevertheless, manufacturing employment in the Akron region has experienced a dramatic decline since the last business cycle peak in March 2001 - 17.4 percent compared to a 16.3 percent decrease for the United States. In contrast, Akron outpaced the country as a whole in non-manufacturing job growth during the same time period - 8.4 percent locally versus 5.3 percent nationally.

Payroll Employment Since March 2001

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

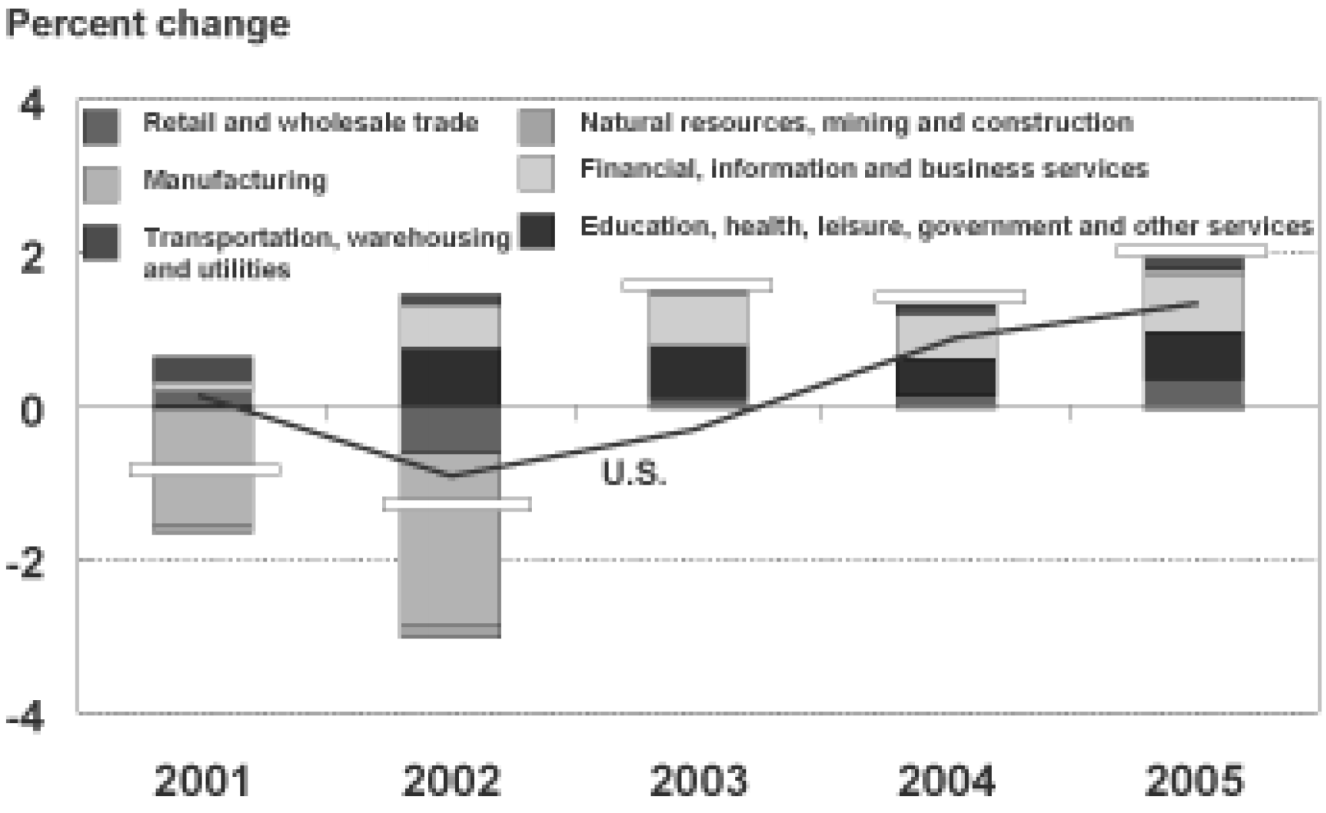
Looking more closely at total annual employment growth, we see that the United States did slightly better than the Akron metro area in 2001 and 2002. This was due primarily to a larger decline in local manufacturing jobs. However, beginning in 2003 and continuing through 2005 the trend was reversed. During this latter period Akron showed annual employment gains of 1.5 to 2.0 percent. Further,



Components of Employment Growth Akron MSA

Note: The white bars represent total annual growth for the Akron MSA. The blue line is U.S. growth.

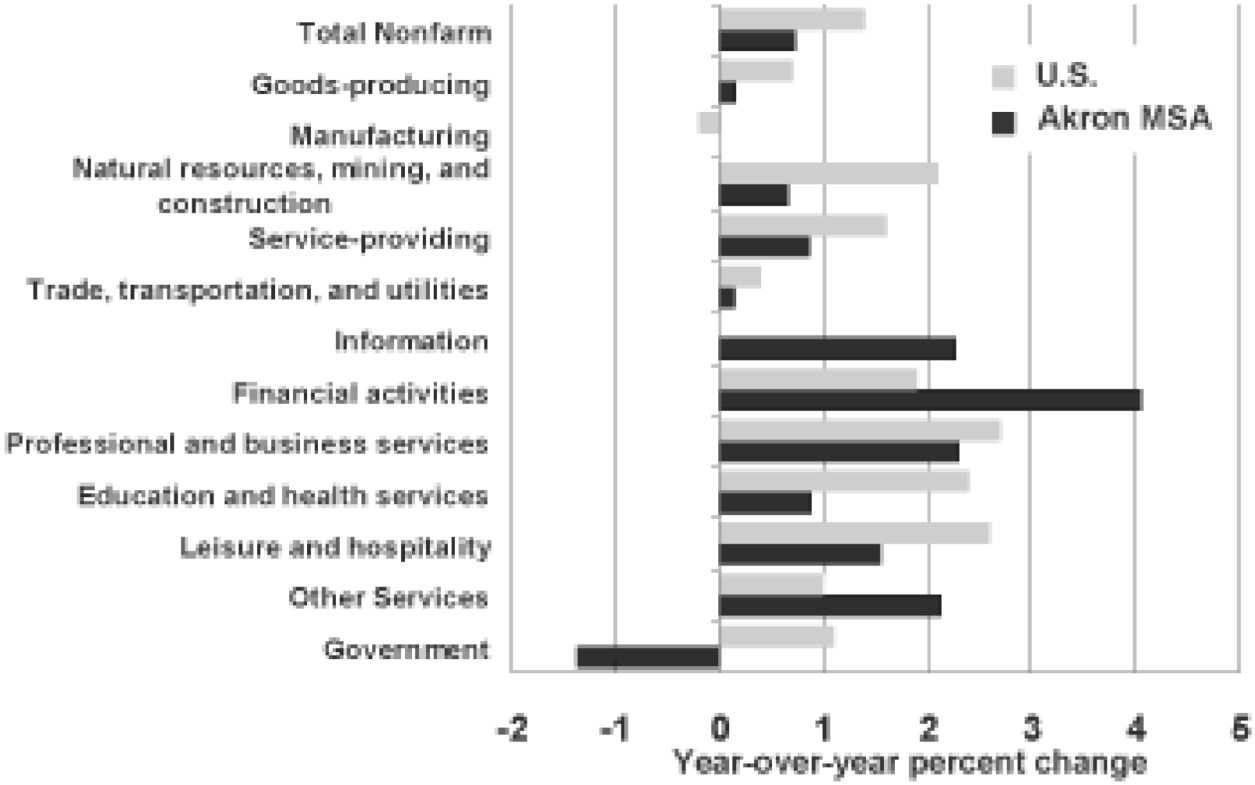
manufacturing job losses became negligible and increases were seen in two broad sectors - finance, information and business services and education, health, leisure, government and other services.



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

Local employment trends seen during 2003 through 2005 continued into 2006. For the 12-month period ending in October, financial activities, information, and professional and business services led all other industry sectors in employment growth with increases ranging from 2.3 to 4 percent. Manufacturing continued to show a negligible employment change on a year-over-year basis.

Payroll Employment Growth, October 2006



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

During the 1990s, the Akron metro area enjoyed a consistently lower unemployment rate than the United States. In fact, during the mid 1990s, local unemployment was about one percentage point less than was reported nationally. Only during the past three years has this trend been reversed. For the 12-month period ending in October 2006, Akron's average unemployment rate was 0.5 percentage point higher than in the United States.

Unemployment Rate

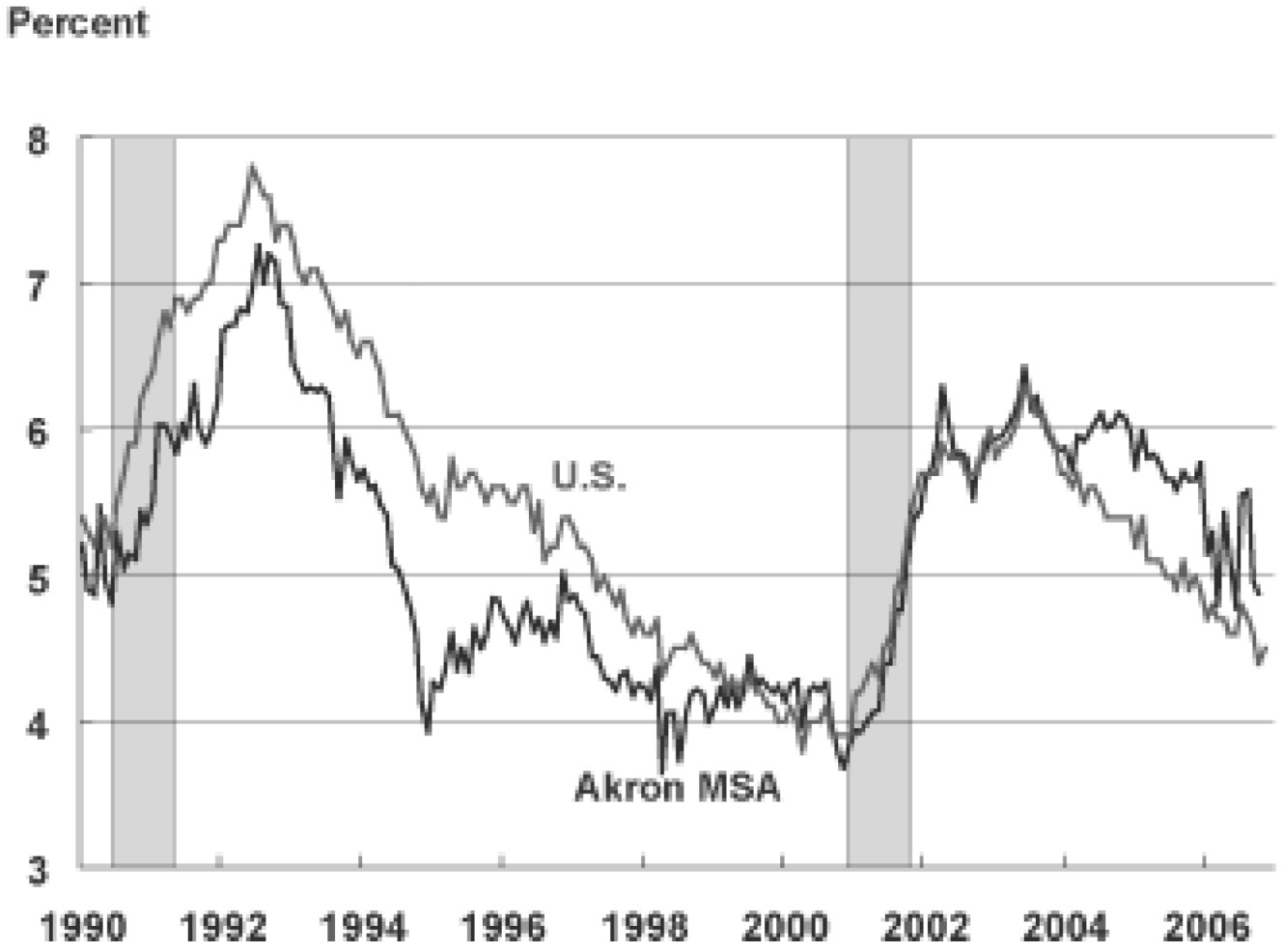
Source: U.S. Department of Labor, Bureau of Labor Statistics.

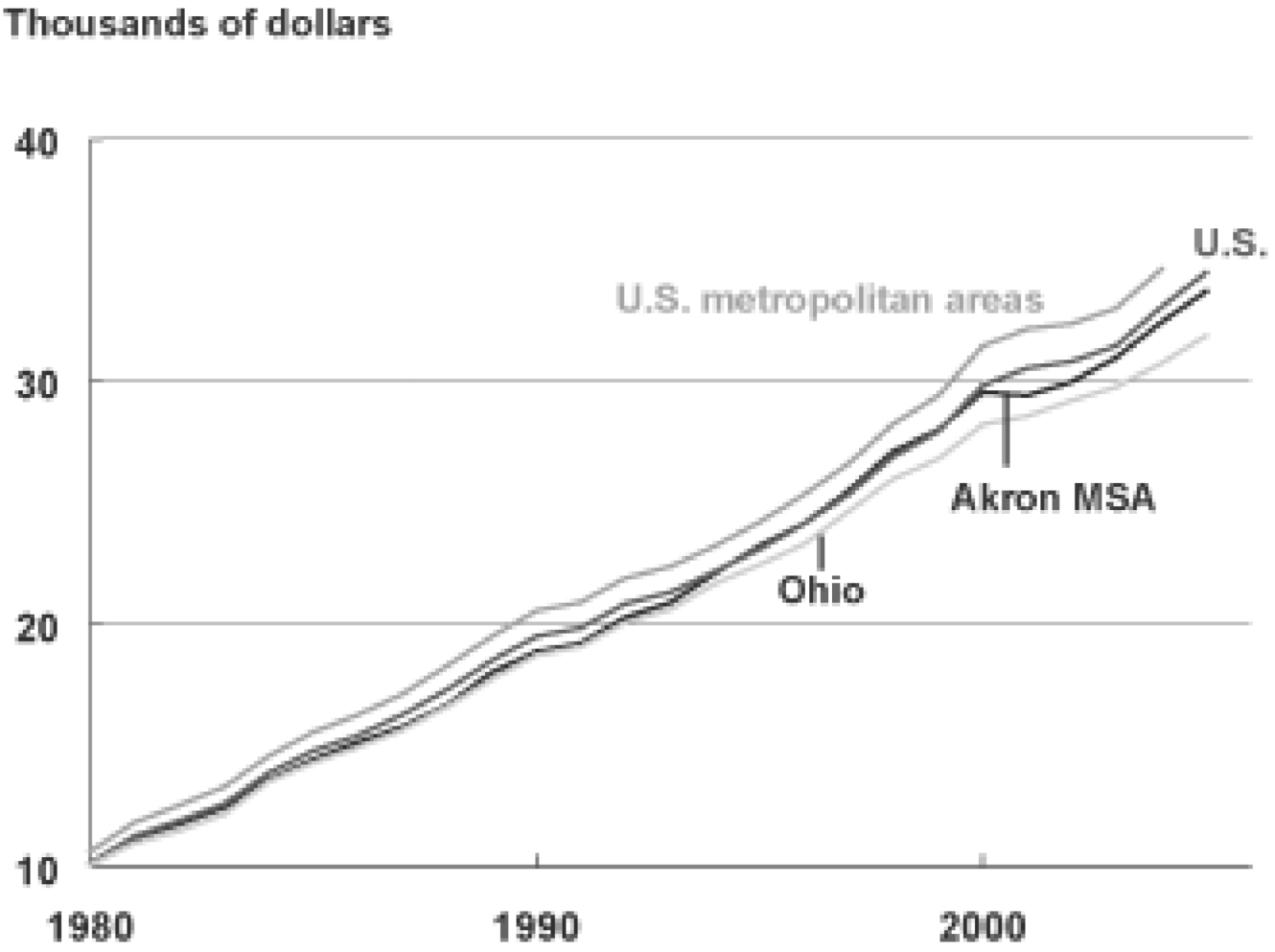
Over time, average per capita personal income across all U.S. metro areas has been somewhat higher than in Akron with a gap of about 6.4 percent. However, when comparing per capita income growth, we find that the growth rates in Akron and the United States are almost the same. Between 1980 and 2004, local income increased by 219 percent compared to 226 percent nationally.

Per Capita Personal Income

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The similarity in growth may be partially due to the educational attainment of Akron residents. In 2005, over 28 percent of these residents held a bachelor's degree or higher. This compares to 23.3 percent in Ohio and 27.2 percent nationally.


Percent
8
7
6
5
4
3
U.S.
Akron MSA
1990
1992
1994
1996
1998
2000
2002
2004
2006



Selected Demographics

	Akron MSA	Ohio	U.S.
Total population (millions)	0.7	11.2	288.4
Percent by race			
White	86.1	85.7	76.3
Black	12.2	12.3	12.8
Other	1.7	2.0	10.9
Percent by age			
0 to 19	26.0	27.0	27.8
20 to 34	19.3	19.3	20.1
35 to 64	41.6	40.8	40.0
65 or older	13.0	12.8	12.1

	Akron MSA	Ohio	U.S.
Percent with a bachelor's degree or higher	28.1	23.3	27.2
Median age	38.3	37.6	36.4

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

Fourth District Banking Conditions

12.21.06

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FDIC-insured commercial banks headquartered in the Fourth Federal Reserve District posted net income of $8.7 billion for the first three quarters of 2006 or $11.6 billion on an annual basis. (JP Morgan Chase, chartered in Columbus, is not included in this discussion because its assets are mostly outside the District and its size - roughly $1 trillion - dwarfs other District institutions.) The U.S. banking industry as a whole posted earnings of $112.75 billion for the same period or $150.32 billion on an annual basis.

Annual Net Income *

* Through 2006:IIIQ only. Data for 2006 are annualized.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

Fourth District banks' net interest margin (core profitability computed as interest income minus interest expense divided by average earning assets) fell slightly to 3.06% of total income at the end of 2006:IIIQ, but still exceeds the 2.95% U.S. average. Fourth District banks' non-interest income edged up to 30.48%, while the national average slipped down to 30.52% of total income.

Income Ratios *

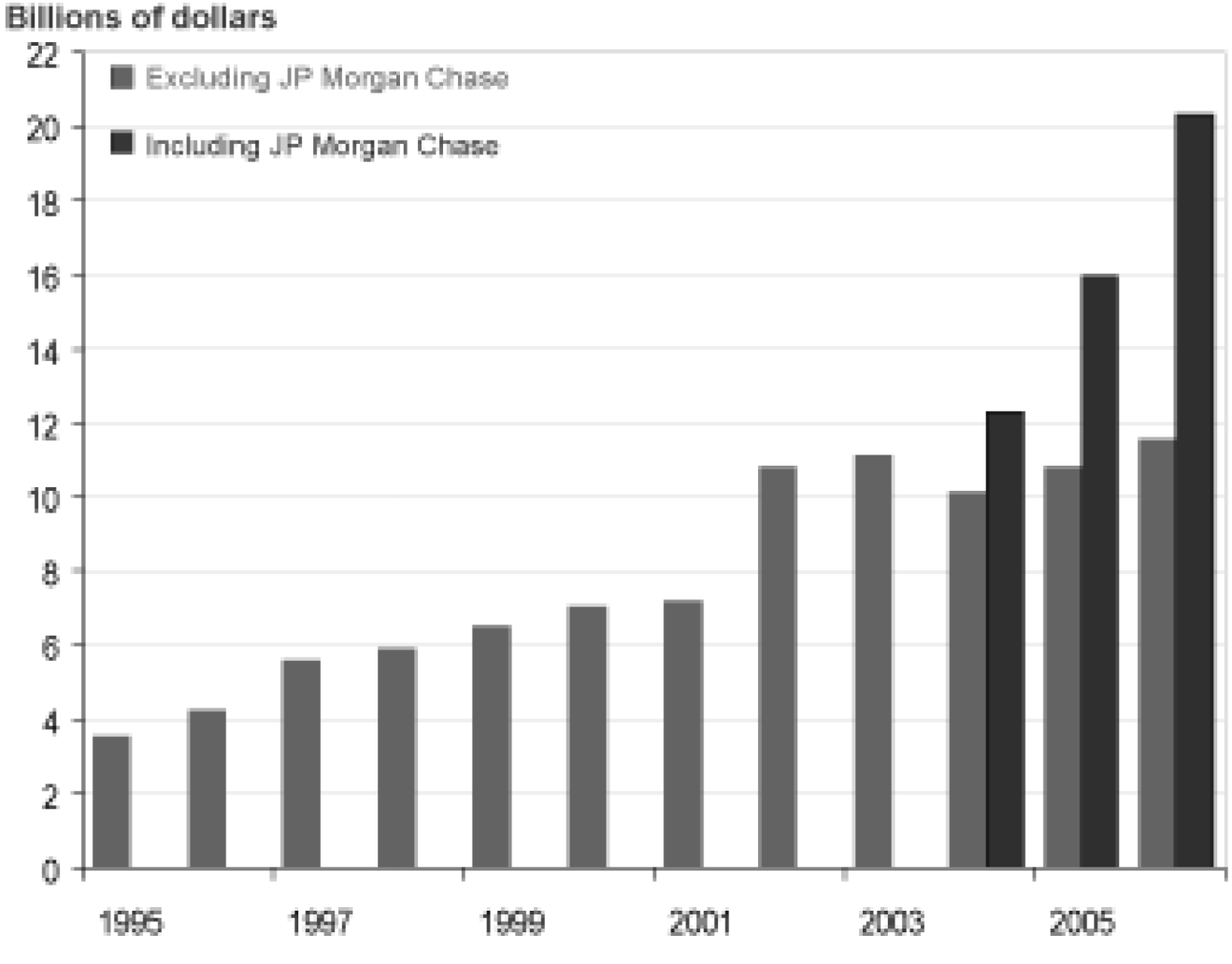
* Through 2006:IIIQ only. Data for 2006 are annualized.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

Fourth District banks' efficiency (operating expenses as a percent of total income) continued to worsen in 2006:IIIQ, deteriorating to 56.21% from the 52.64% record set in 2002. (Lower numbers correspond to greater efficiency.) Banks outside the Fourth District fared better, with the national average continuing to improve to 54.46% (from 56.40% at the end of 2005).

Efficiency * **

* Through 2006:IIIQ only. Data for 2006 are annualized.
** Efficiency is operating expenses as a percent of net interest income plus non-interest income.



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

At the end of 2006:IIIQ, District banks posted a 1.39% return on assets (down from 1.43% at the end of 2005) and a 14.45% return on equity (down from 15.32% at the end of 2005). The District's decline contrasted with an upward trend nationwide: At the end of 2006:IIIQ, the U.S. banking industry reported that return on assets rose to 1.19% (from 1.08% at the end of 2005); and return on equity rose to 12.63% (from 11.55% at the end of 2005).

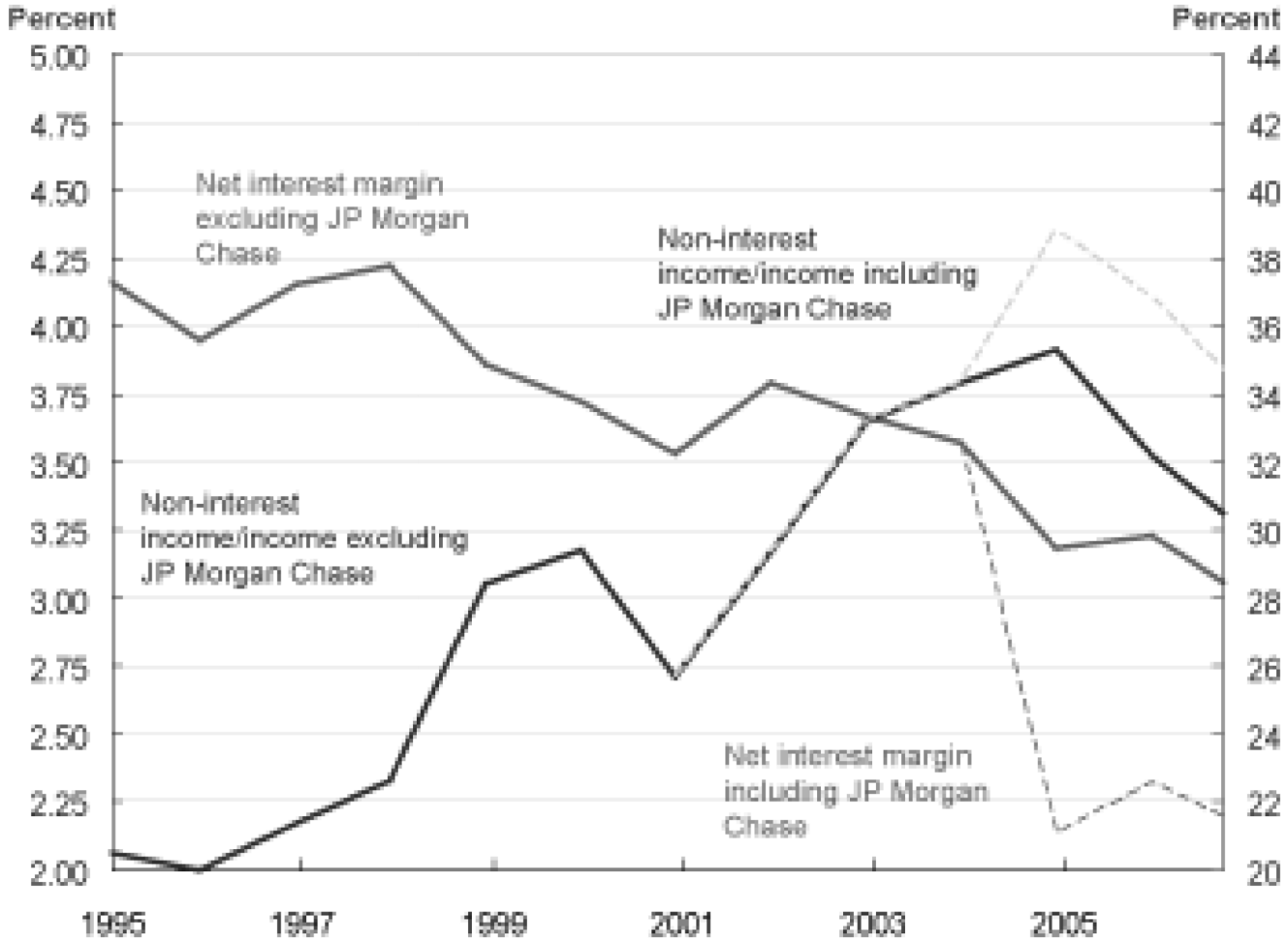
Earnings *

* Through 2006:IIIQ only. Data for 2006 are annualized.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

Overall, Fourth District banks' financial indicators point to stable balance sheets. Asset quality, as measured by net charge-offs (losses realized on loans and leases currently in default minus recoveries on previously charged-off loans and leases) continued to improve in 2006:IIIQ. Net charge-offs dropped from 0.38 percent at the end of 2005 to 0.3 percent of total loans, the lowest level in over a decade. Problem assets (nonperforming loans and repossessed real estate) as a share of total assets, however, rose to 0.68 percent, from 0.59 percent at the end of 2005. The increase in problem assets may translate into higher charge-offs in the future if borrowers cannot catch up with their late payments. At the national level, both asset quality ratios are still improving. Net charge-offs and nonperforming loans fell to a historically low 0.32 percent of loans (down from 0.46 percent at the end of 2005) and 0.42 percent of assets (down from 0.45 percent at the end of 2005), respectively.

Asset Quality *



* Through 2006:IIIQ only. Data for 2006 are annualized. a. Problem assets are shown as a percent of total assets, net charge-offs as a percent of total loans.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

Fourth District banks held $17.62 in equity capital and loan loss reserves for every dollar of problem loans, 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.

Coverage Ratio *

* Through 2006:IIIQ only. Data for 2006 are annualized.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

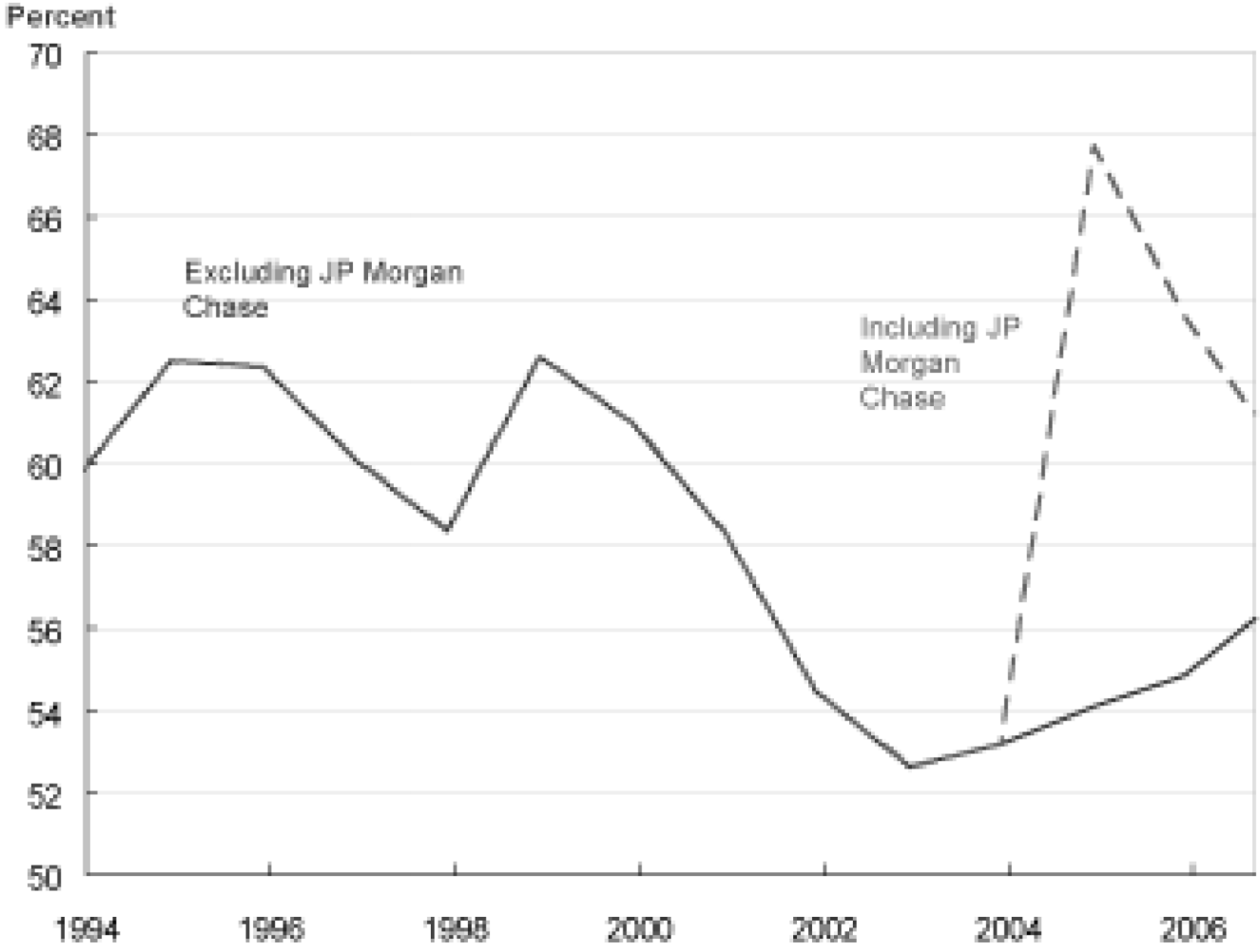
Equity capital as a percent of Fourth District banks' assets (the leverage ratio) rose to 9.65 percent (from 9.36 percent at the end of 2005).

Core Capital (Leverage) Ratio *

* Through 2006:IIIQ only. Data for 2006 are annualized.

Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.

The percent of unprofitable institutions in the Fourth District fell to 5.17 percent for the third quarter of 2006 (from 5.43 percent at the end of 2005). Unprofitable banks' asset size also dropped because the share of District banks' assets accounted for by unprofitable banks fell from 0.56 percent to 0.14 percent. Industrywide, the share of unprofitable institutions rose from 6.28 percent to 6.82 percent at the end of

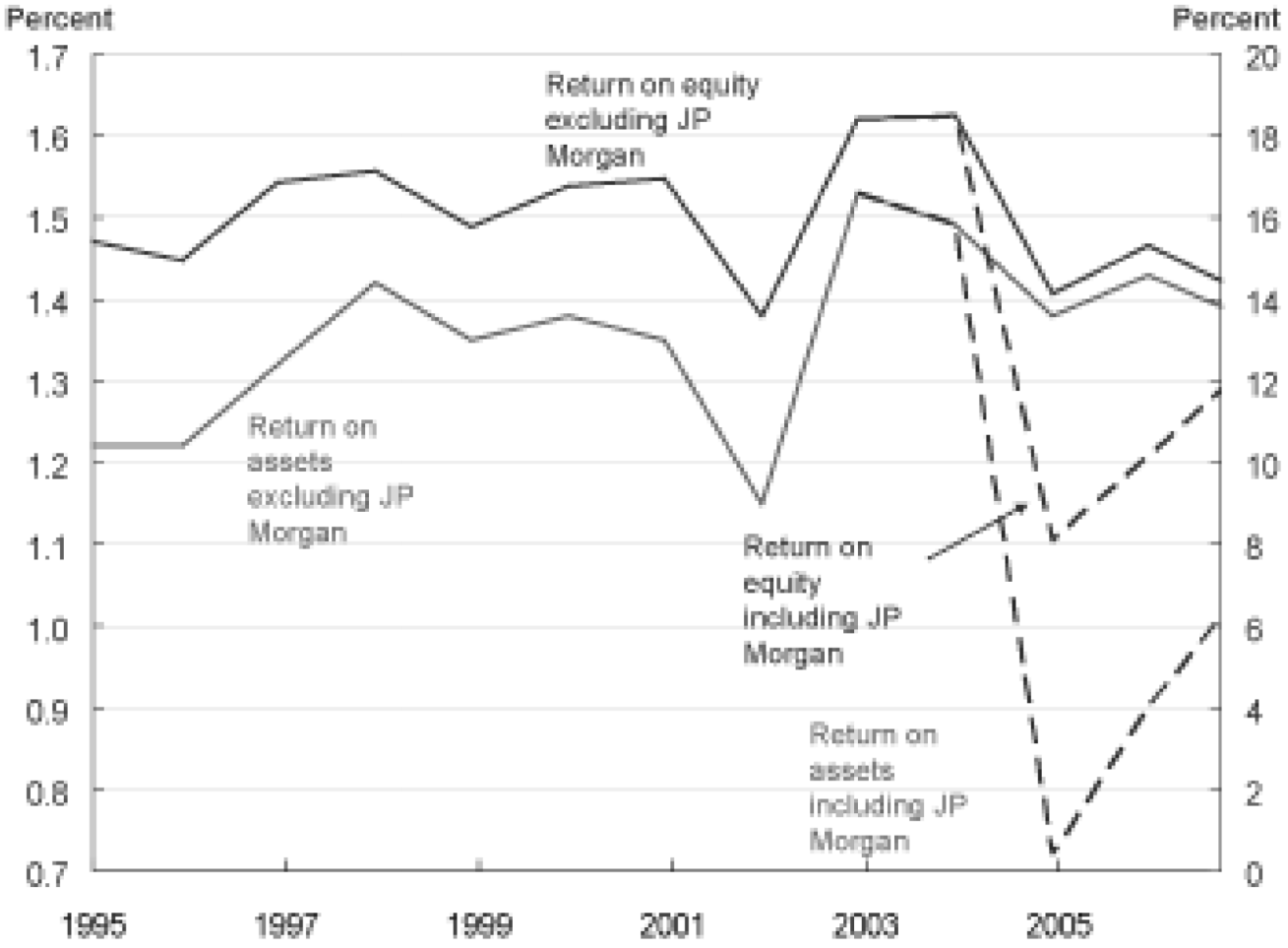


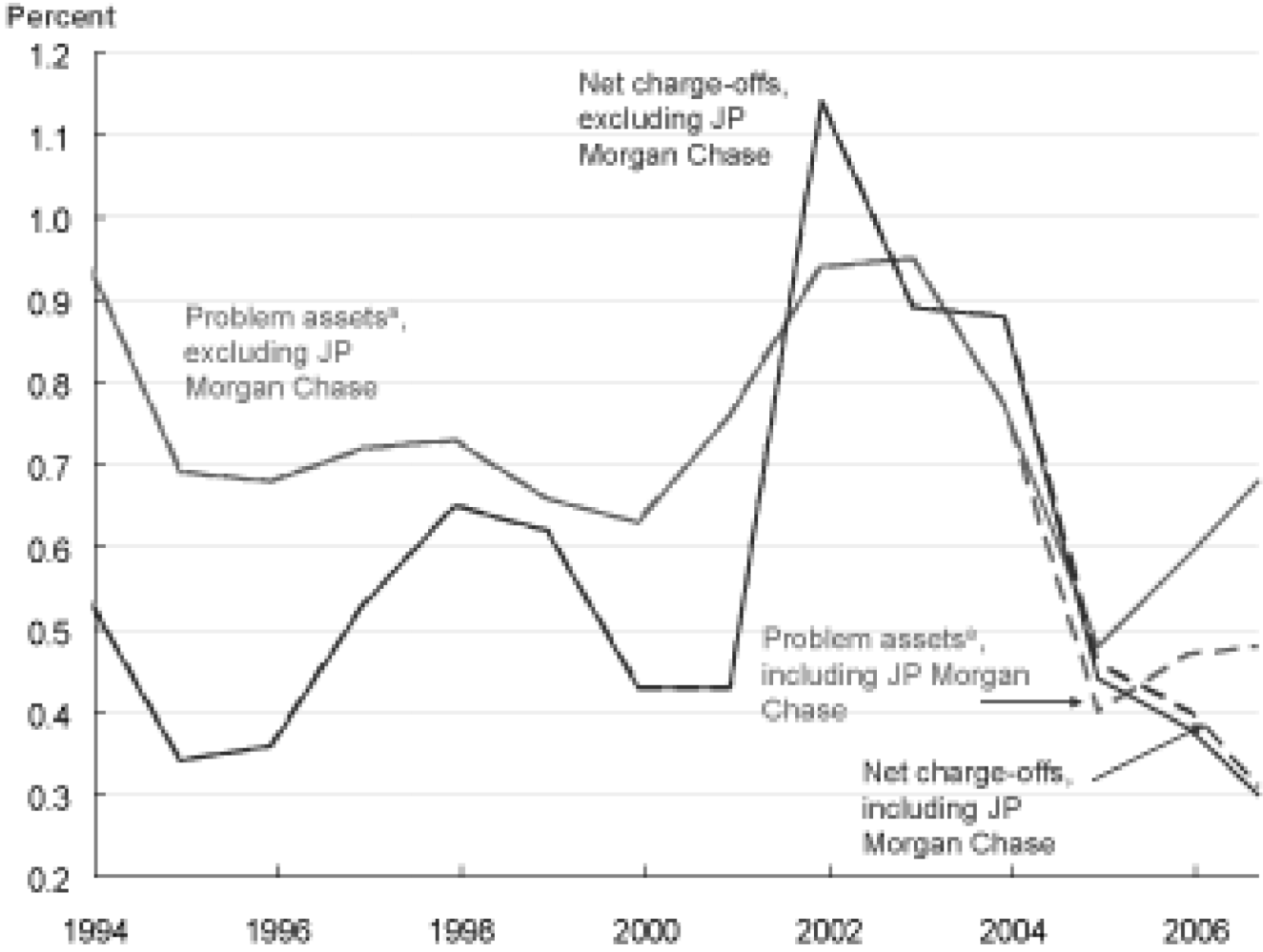
2006:IIIQ. However, unprofitable banks' asset size dropped from 1.13 percent at the end of 2005 to 0.43 percent at the end of 2006:IIIQ. Thus, the industrywide increase in the number of unprofitable banks comes from the smaller financial institutions.

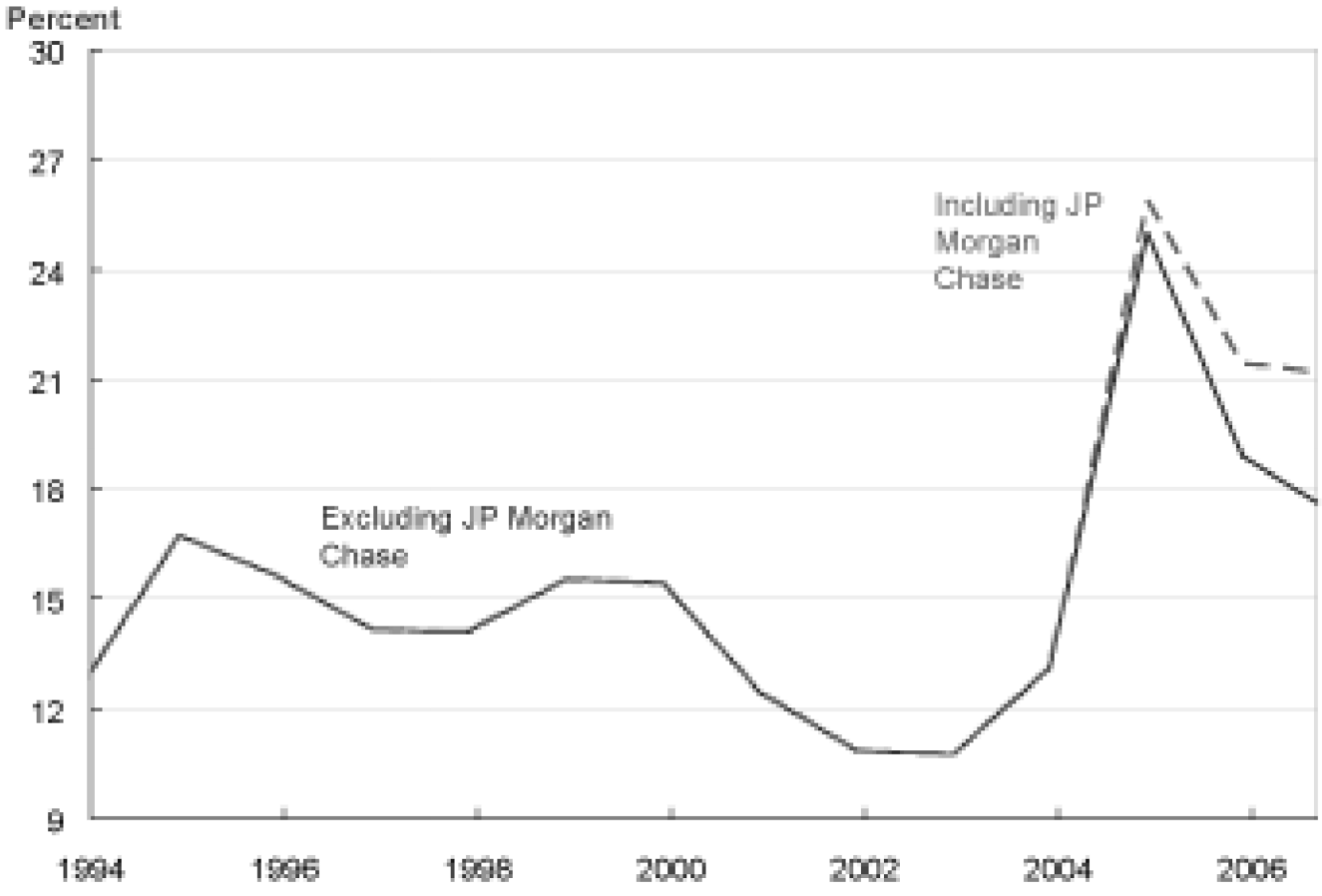
Unprofitable Institutions *

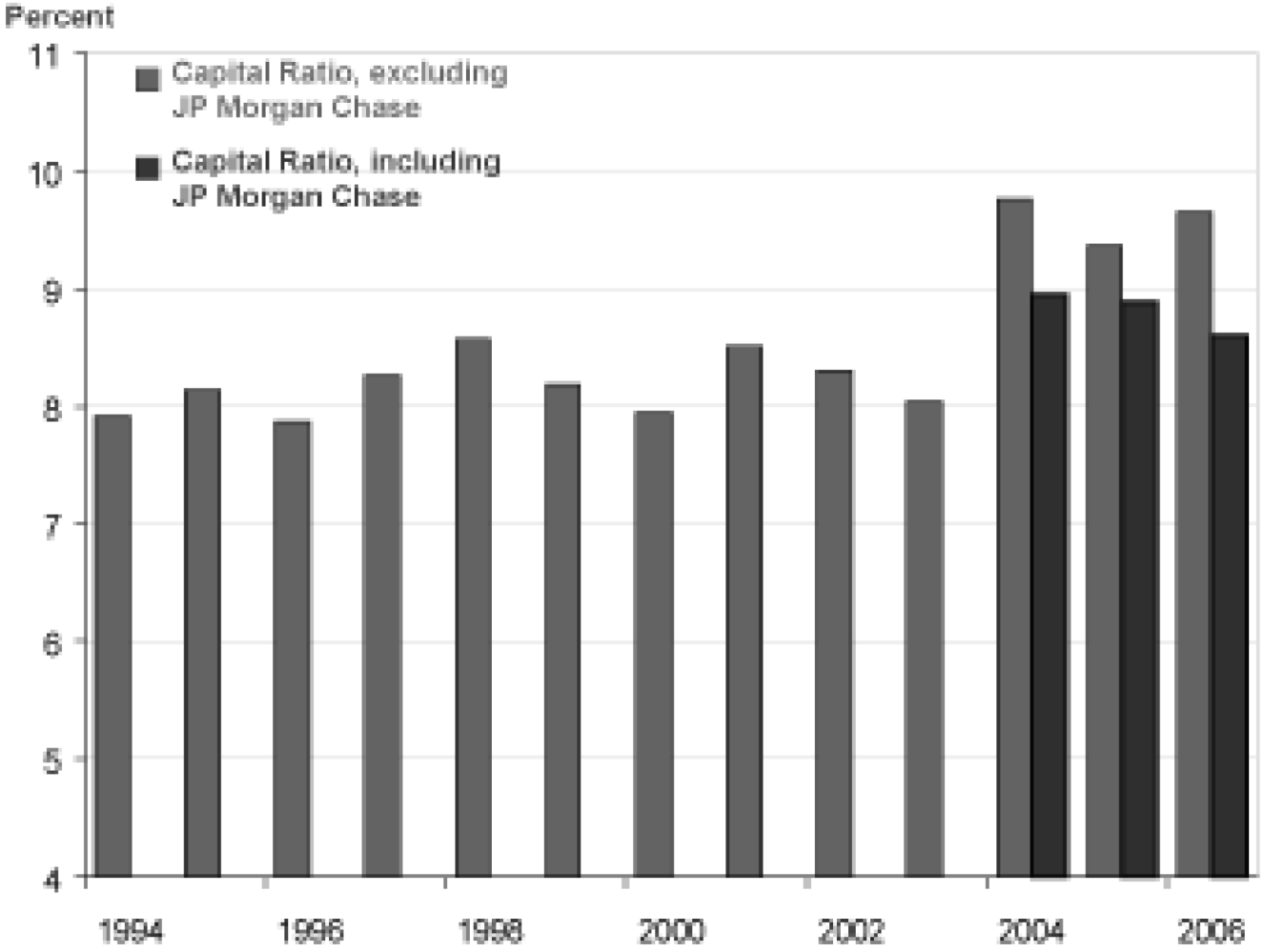
* Through 2006:IIIQ only. Data for 2006 are annualized.

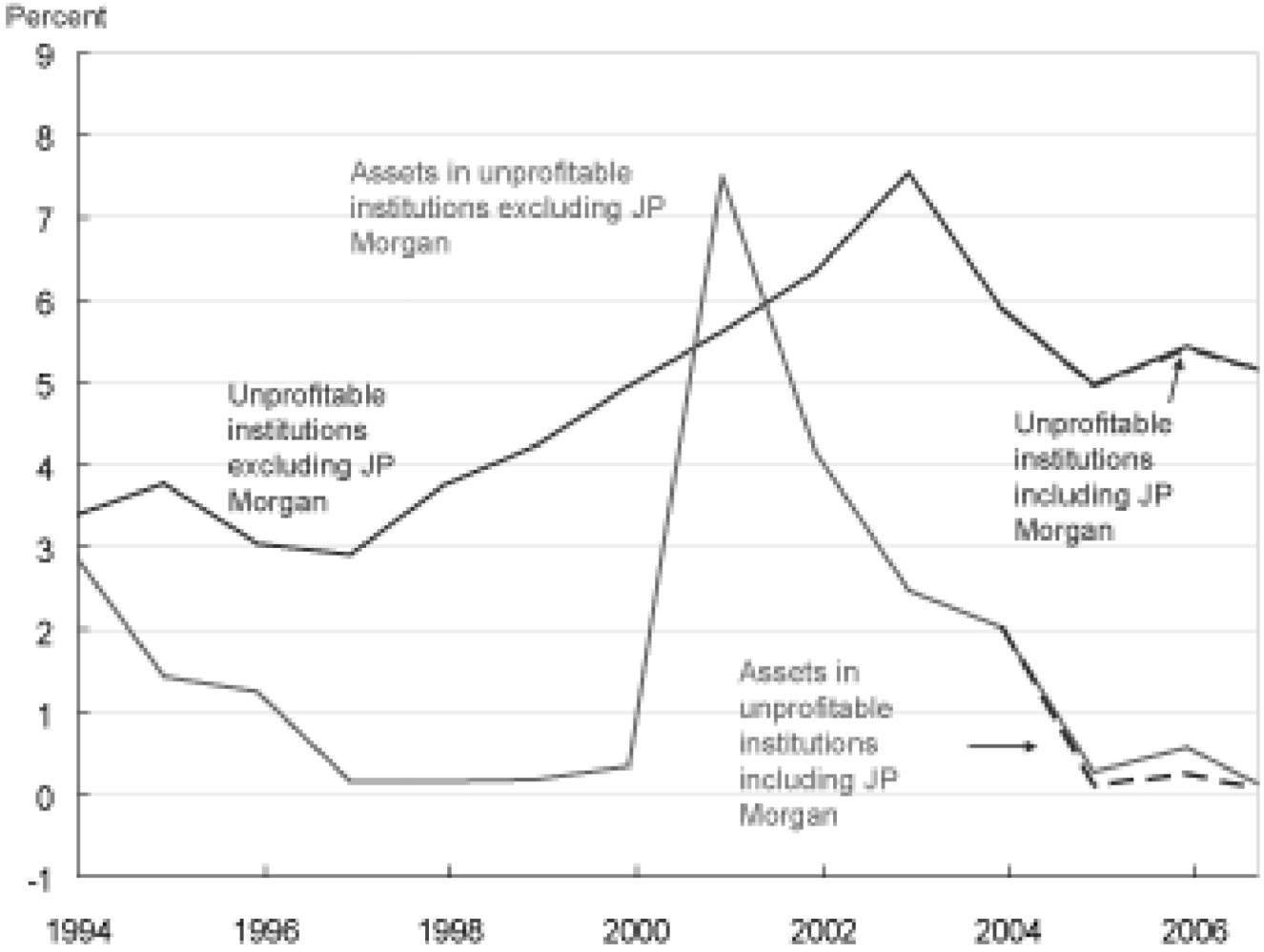
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Third Quarter 2006.


Percent
Percent
1.7
1.6
1.5
1.4
1.3
1.2
1.1
1.0
0.9
0.8
0.7
20
18
16
14
12
10
8
6
4
2
0
1995
1997
1999
2001
2003
2005
Return on equity excluding JP Morgan
Return on assets excluding JP Morgan
Return on equity including JP Morgan
Return on assets including JP Morgan


Percent
1.2
1.1
1.0
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
Net charge-offs, excluding JP Morgan Chase
Problem assets[a], excluding JP Morgan Chase
Problem assets[a], including JP Morgan Chase
Net charge-offs, including JP Morgan Chase
1994
1996
1998
2000
2002
2004
2006


Percent
30
27
24
21
18
15
12
9
Including JP Morgan Chase
Excluding JP Morgan Chase
1994
1996
1998
2000
2002
2004
2006


Percent
11
10
9
8
7
6
5
4
Capital Ratio, excluding JP Morgan Chase
Capital Ratio, including JP Morgan Chase
1994
1996
1998
2000
2002
2004
2006


Percent
9
8
7
6
5
4
3
2
1
0
-1
1994
1996
1998
2000
2002
2004
2006
Assets in unprofitable institutions excluding JP Morgan
Unprofitable institutions excluding JP Morgan
Unprofitable institutions including JP Morgan
Assets in unprofitable institutions including JP Morgan

Revisions to Real GDP

12.22.06

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There will be another revision in July 2007 - as there is every year - but until then the final word from the Bureau of Economic Analysis is that real Gross Domestic Product grew at an annualized rate of just under 2 percent in the third quarter. This is slightly below the preliminary estimate issued in November, but still above the growth rate estimate in October's advance report.

Revisions to Real GDP: 2006:IIIQ

Sources: U.S. Department of Commerce, Bureau of Economic Analysis.

There is both unpleasant and (maybe) not-so-unpleasant news buried in the details of the latest revision. The single largest reason for the decline in the growth estimate from the preliminary report was a downgrading of private investment spending.

Contributions to Revisions in Contributions to Real GDP : 2006:IIIQ

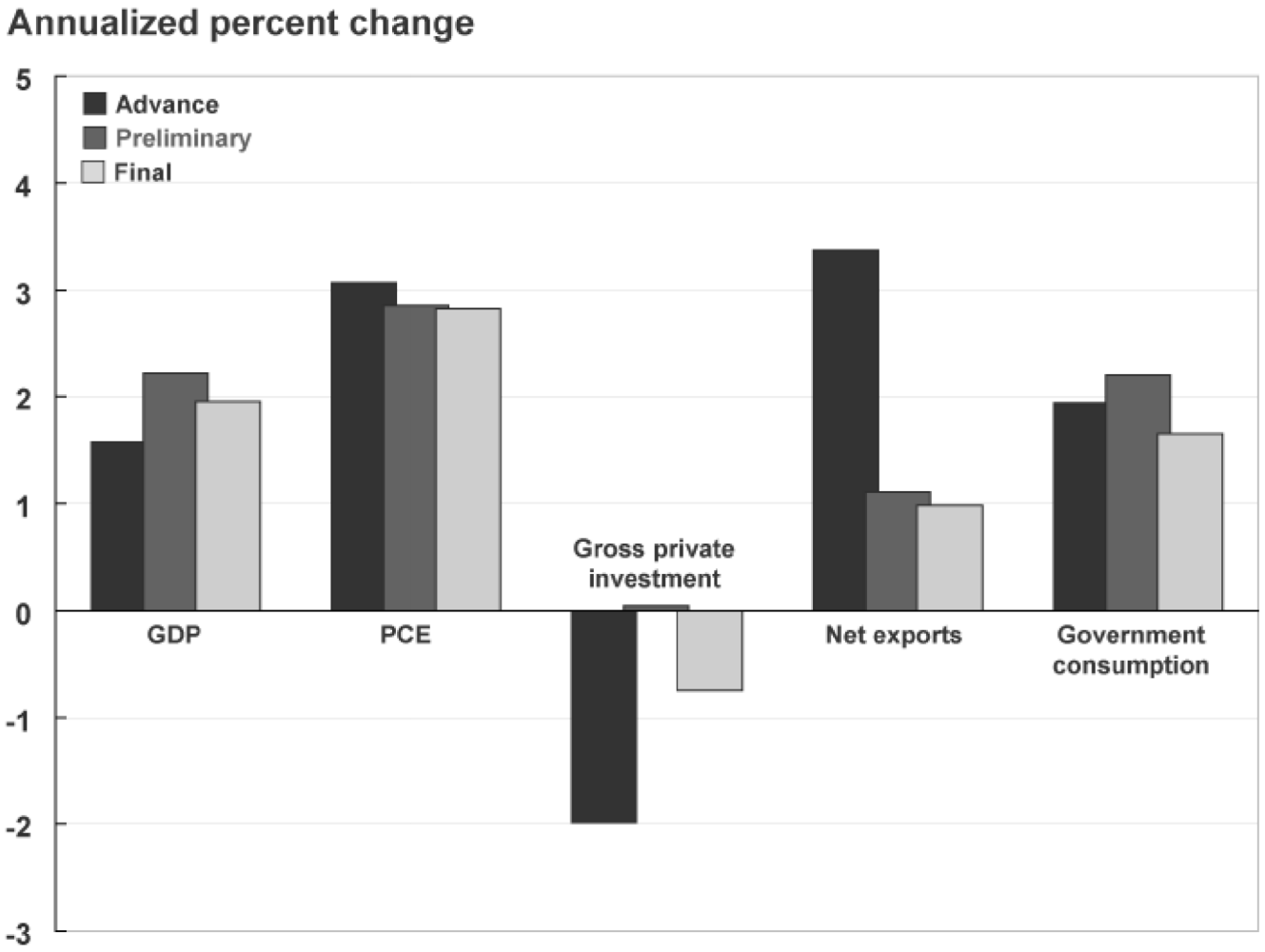
Sources: U.S. Department of Commerce, Bureau of Economic Analysis.

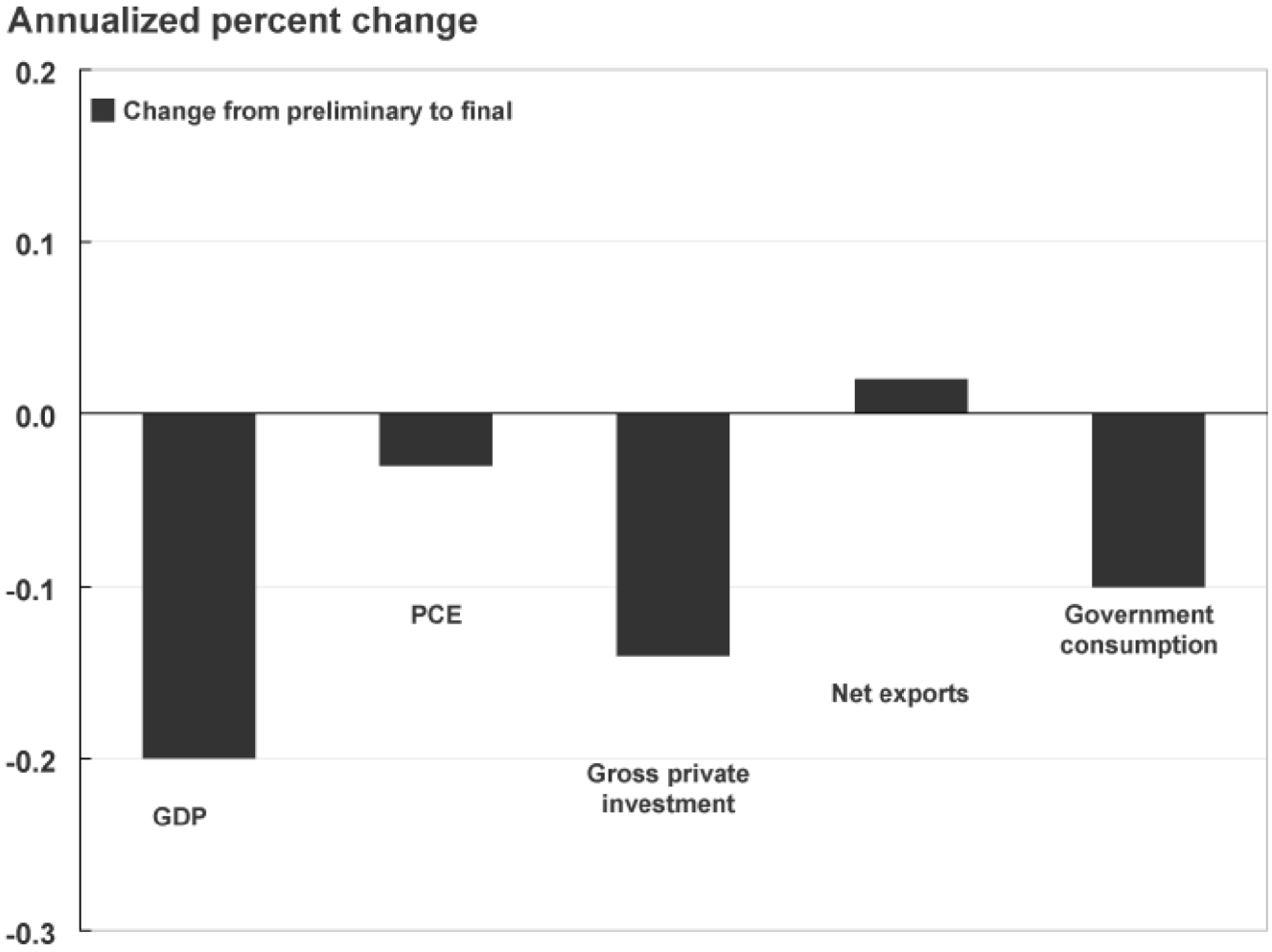
The unpleasantness came by way of the fact that part of the decline in the investment estimate was a reflection of the ongoing weakness in residential investment. But the largest factor was a revision in the estimated pace at which businesses accumulated inventories over the quarter.

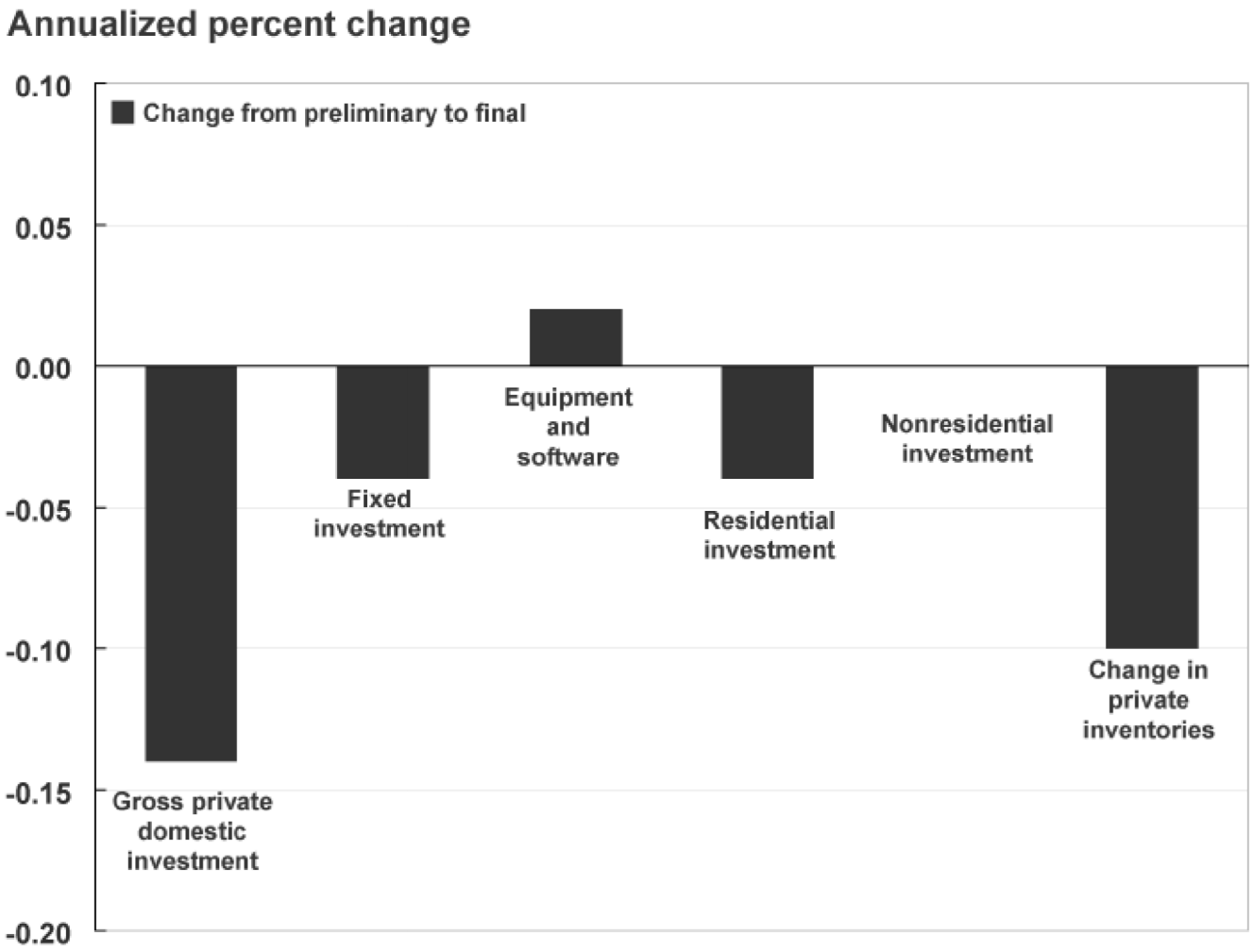
That's the maybe not-so-unpleasant news. To the extent that an accumulation of inventories is either unwanted or intended to build desired ratios relative to sales, a slower pace of inventory build-up would be consistent with one less potential drag on production going forward, small though it may be.

Contributions to Revisions in Contributions to Real GDP : 2006:IIIQ

Sources: U.S. Department of Commerce, Bureau of Economic Analysis.


Annualized percent change
5
4
3
2
1
0
-1
-2
-3
Advance
Preliminary
Final
GDP
PCE
Gross private investment
Net exports
Government consumption


Annualized percent change
Change from preliminary to final
0.2
0.1
0.0
-0.1
-0.2
-0.3
GDP
PCE
Gross private investment
Net exports
Government consumption


Annualized percent change
0.10
0.05
0.00
-0.05
-0.10
-0.15
-0.20
Change from preliminary to final
Gross private domestic investment
Fixed investment
Equipment and software
Residential investment
Nonresidential investment
Change in private inventories

Durable Goods Orders and Personal Income and Consumption Reports

12.26.06

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Durable goods orders rose 1.9 percent in November, reversing October's decline of 8.2 percent. However, if transportation is excluded, total durable goods orders fell 1.1 percent. Analysts often exclude transportation to discern the underlying trend in orders. Aircraft, which are part of transportation, are very expensive. If large numbers are ordered, as sometimes happens, the industry can dominate the series. For example, the October number was big and negative, primarily because of hefty aircraft orders in September. The figure below illustrates aircraft's effect on total durables.

Durable Goods Orders

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

It shows durable goods excluding transportation orders (the dark blue line) as a smoothed version of total durable goods orders. The red line represents transportation orders alone.

Personal Income and Consumption

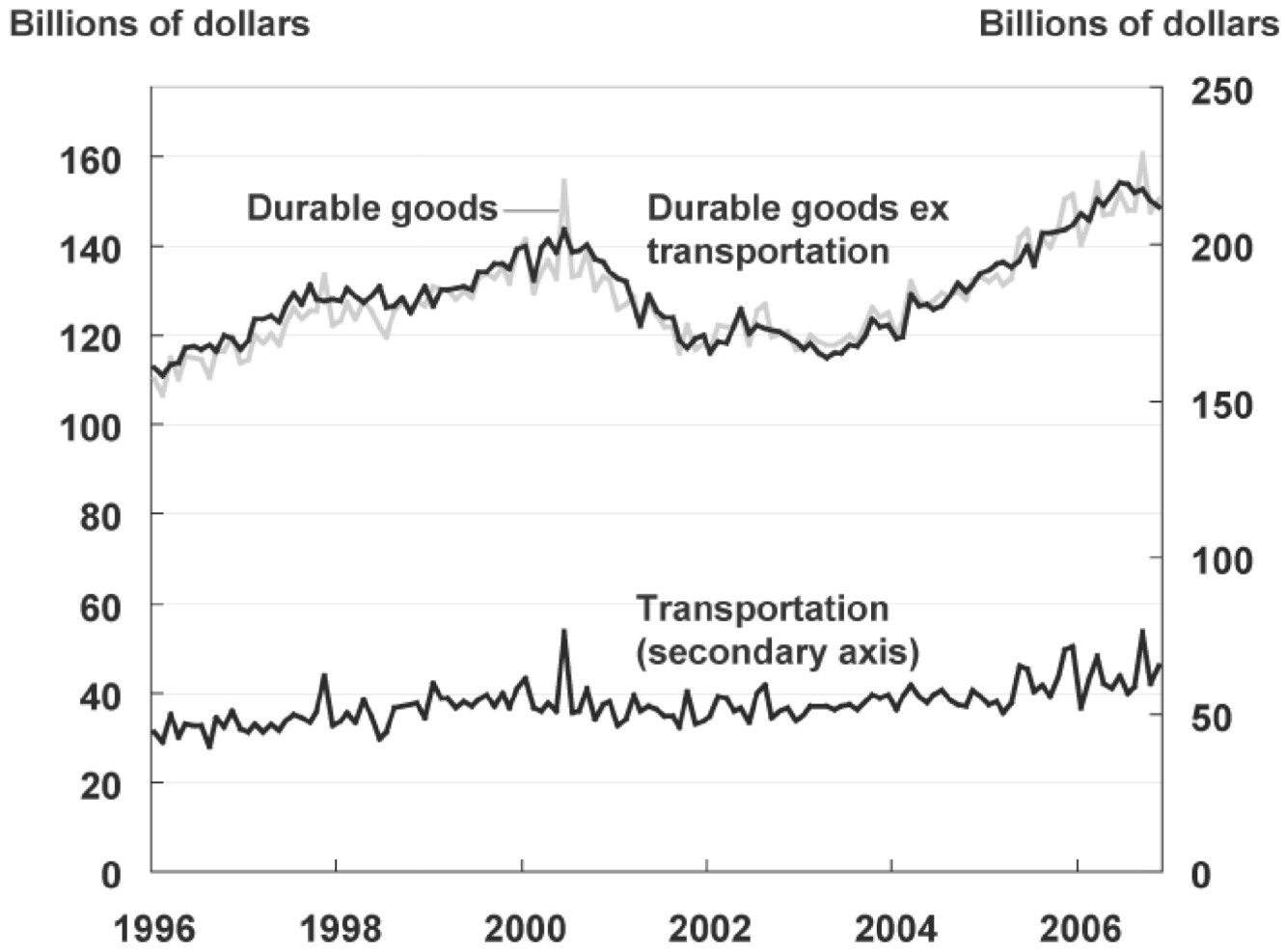
Personal income, which rose 0.3 percent in November, and consumption, which increased 0.5 percent, are used as inputs in constructing the GDP series.

Over the past five years, personal income as a fraction of GDP has fallen fairly steadily from a high of nearly 87 percent to slightly over 82 percent.

Personal Income as a Share of GDP

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

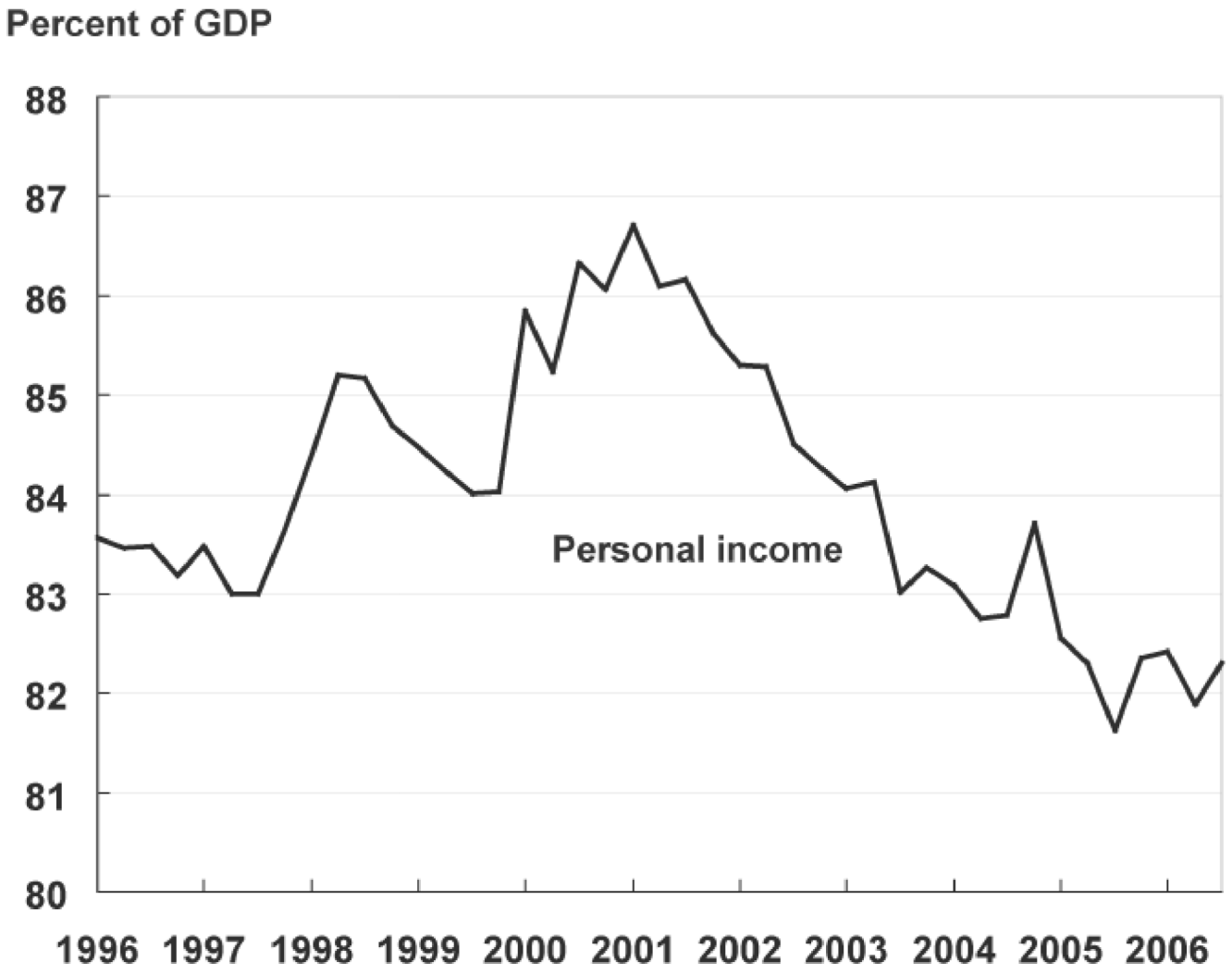
This decline is consistent with observed increases in corporate profits as a share of GDP. Although personal income accounts for a huge fraction of GDP, the quarterly growth rates for personal income and the GDP series behave quite differently.

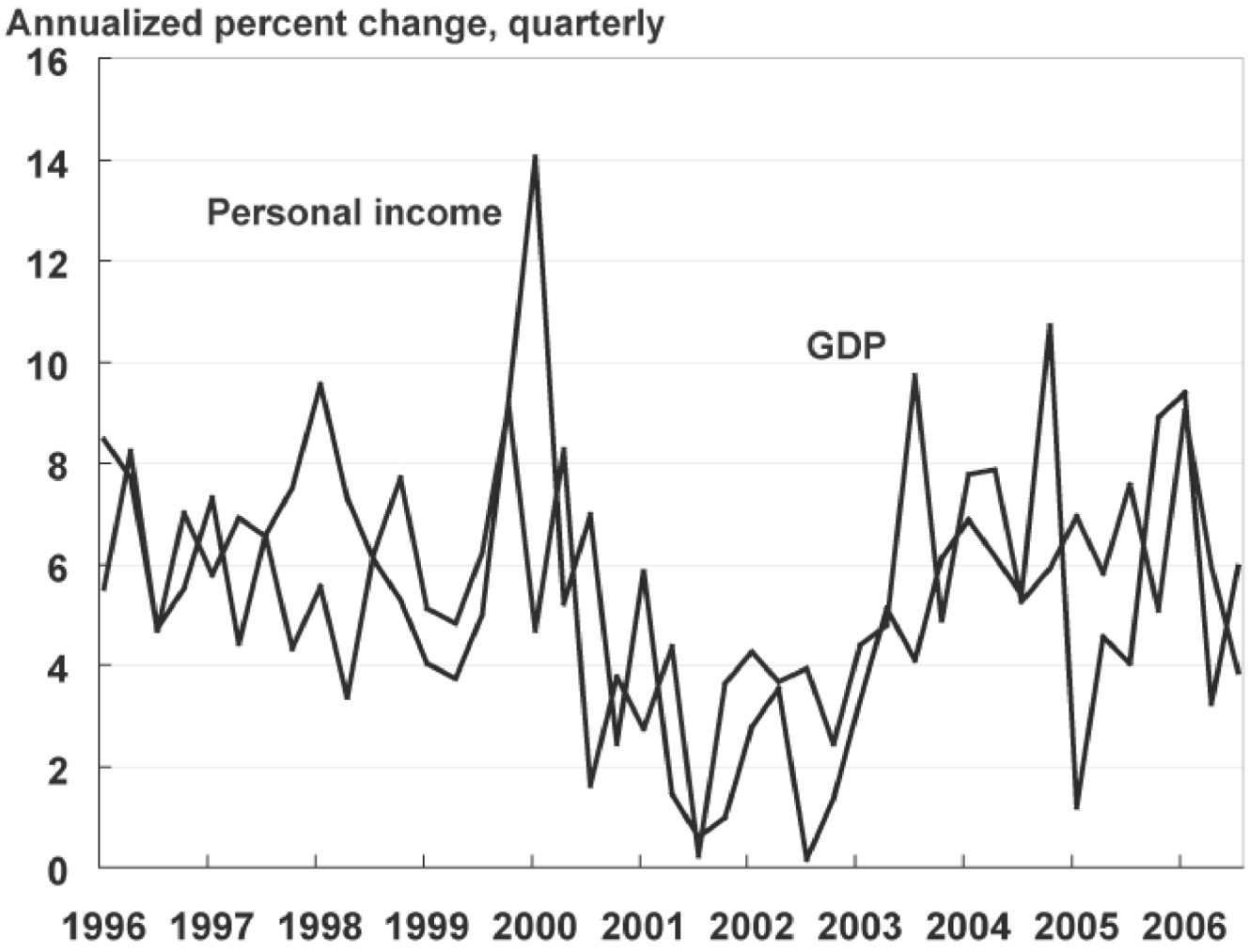


Growth in GDP and Personal Income

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The personal income series seems more volatile than the GDP series. The chart above suggests the need for caution when using monthly personal income data to estimate quarterly GDP growth.


Percent of GDP
88
87
86
85
84
83
82
81
80
Personal income
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006


Annualized percent change, quarterly
16
14
12
10
8
6
4
2
0
Personal income
GDP
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006

Labor Turnover

12.29.06

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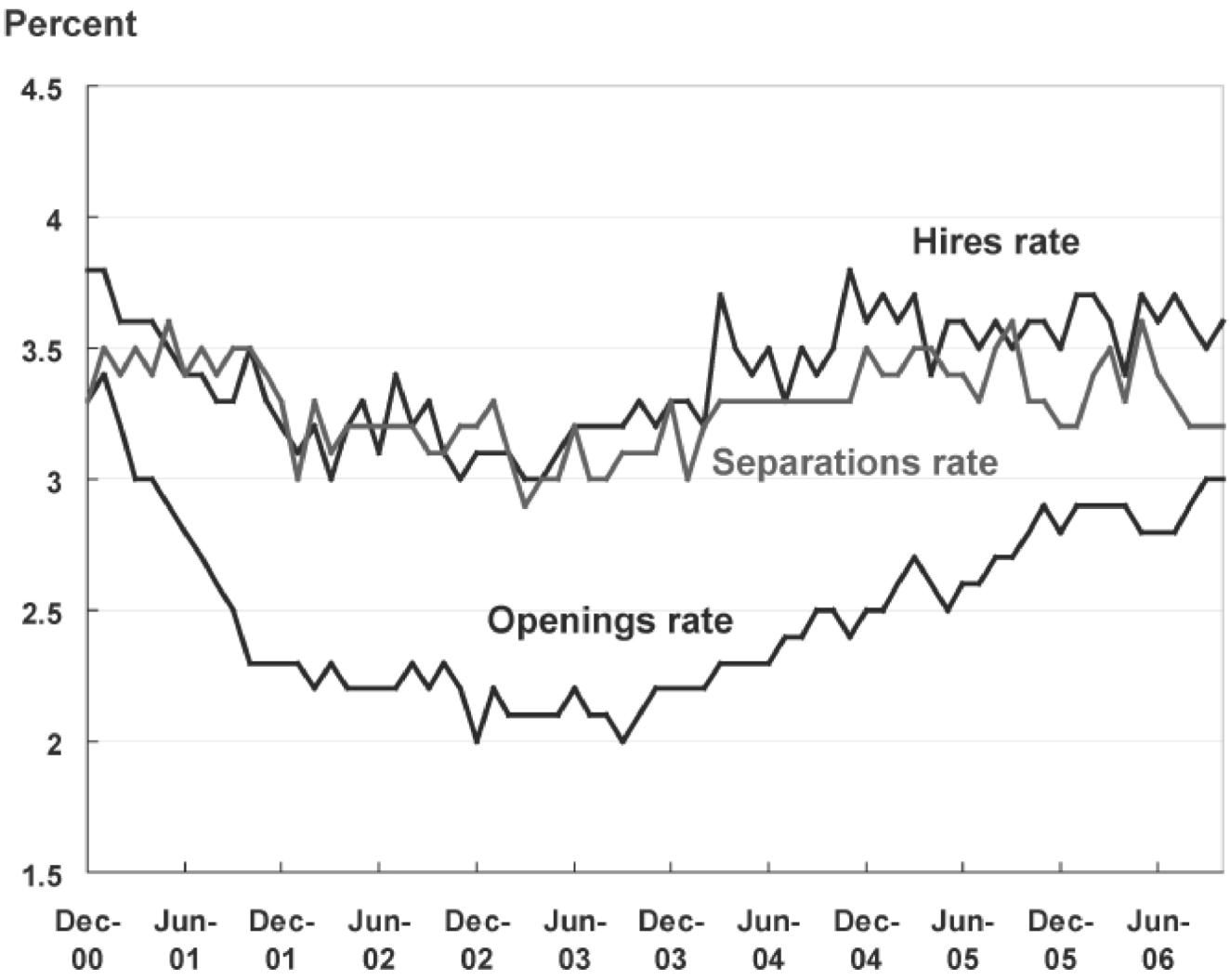
One of the more useful recent additions to the menu of government statistics available to economic analysts is the Bureau of Labor Statistics' Job Openings and Turnover Survey, commonly referred to as JOLTS. The survey, begun in 2001, provides data on employment, job openings, hires, quits, layoffs, discharges, and other separations from employment.

The net hires rate - the difference between the hires rate and the rate of job separations of all sorts - has been positive since September 2005, consistent with the employment growth evident from the usual payroll and household surveys released on the first Friday of every month. The detail available from JOLTS makes it clear that a big part of the story behind the employment picture this year has been the recent decline in separations rate. At 3.2 percent, this is the lowest separations rate since January 2004. Furthermore, the job openings rate - a measure of job availability - has been increasing steadily, implying a growing demand for labor.

Labor Turnover

Source: U.S. Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey, November 2006.

Most of the employment growth in the past two years was driven by professional and business services, with an average net hire rate of 0.57 percent. Although the rate of net hires in the information sector has been negative since 2004, there is clear evidence of unmet demand for labor in this area, as indicated by the sector's higher-than-average rate of job openings.



Average Net Hires Rate by Industry, 2004 - October 2006

	Percent			
	Hires	**Separations**	**Net hires**	**Job openings**
Total private	4.0	3.8	0.24	2.8
Mining	3.4	2.9	0.46	1.8
Construction	5.5	5.3	0.19	1.8
Manufacturing	2.5	2.6	-0.07	1.9
TPU[a]	4.0	3.8	0.13	2.3
Information	2.4	2.5	-0.08	3.1
FIRE[b]	2.4	2.3	0.11	2.8
PBS[c]	5.2	4.6	0.57	3.7

	Percent			
	Hires	**Separations**	**Net hires**	**Job openings**
Education and health services	2.7	2.4	0.31	3.4

a. Transportation and public utilities.
b. Finance, insurance, and real estate.
c. Professional and business services.
Source: U.S. Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey, November 2006.

Since 2004, most of the monthly growth in net hires occurred in the South, accounting for 48 percent of U.S. employment growth. The other three regions of the country shared the remaining 52 percent of growth almost equally. As for job openings, the South accounted for 39 percent of the total since 2004, followed by the West at 23 percent, the Midwest at 20 percent, and the Northeast at 18 percent.

Regional Shares in Job Openings and Labor Turnover, 2004 - October 2006

	Percent			
	Hires	**Separations**	**Job openings**	**Net hires**
Northeast	0.17	0.17	0.18	0.18
South	0.38	0.38	0.39	0.48
Midwest 0	.22	0.22	0.20	0.16
West	0.23	0.23	0.23	0.18

Source: U.S. Department of Labor, Bureau of Labor Statistics, Job Openings and Labor Turnover Survey, November 2006.