

Economic Trends

August 2007

(Covering July 14, 2007, to August 9, 2007)

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Housing Haikus...

08.20.07

by Mark S. Sniderman

Global financiers

Can turn houses into gold

Till their own doors close.



Holding cash seems dense

Until margin calls require

Transparent assets.



Whose fault the defaults?

Diversification's creed:

Spread it all around.



June Price Statistics

June Price Statistics

	Percent change, last					
	1mo. ^a	3mo. ^a	6mo. ^a	12mo.	5yr. ^a	2006 avg.
Consumer prices						
All items	2.3	5.2	5.0	2.7	3.0	2.6
Less food and energy	2.8	2.3	2.3	2.2	2.1	2.6
Median ^b	2.5	1.9	2.5	3.0	2.6	3.6
16% trimmed mean ^b	2.1	2.3	2.8	2.6	2.3	2.7
Producer prices						
Finished goods	2.8	5.7	6.4	3.2	3.7	1.6
Less food and energy	3.8	2.0	2.3	1.8	1.5	2.1

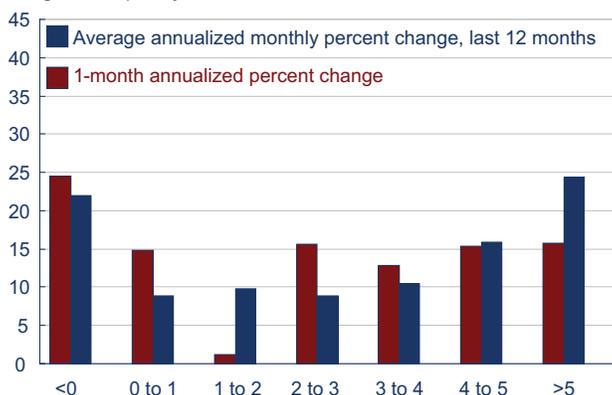
a. Annualized.

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.

CPI Component Price Change Distributions*

Weighted frequency



*Owner's equivalent rent is divided into four regional subcomponents (Northeast, Midwest, South, and West).

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

08.13.07

by Michael F. Bryan and Brent Meyer

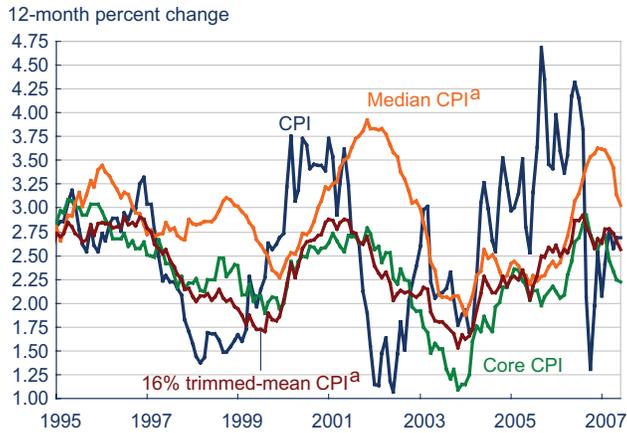
The Consumer Price Index (CPI) increased 2.3 percent (annualized rate) in June, moderating significantly from May's 8.4 percent surge and bringing the headline number under its 12-month percent change. The CPI excluding food and energy (core CPI) increased from 1.8 percent (annualized) in May to 2.8 percent (annualized) in June. This marks the first time that the core CPI has been above the headline number since January 2007. The same is true for the Producer Price Index (PPI), as finished goods less food and energy increased 3.8 percent (annualized), while the headline PPI fell 2.8 percent (annualized).

An investigation into the distribution of retail price changes is also suggestive of a downswing in the underlying trajectory of inflation. Only 44 percent of the components included in the overall CPI rose at a rate exceeding 3 percent in June, compared with 52 percent on average over the last 12 months. On the other side of the distribution, 39 percent of CPI components grew less than 1 percent for the month. During the 12 previous months, roughly 30 percent of the index's components grew less than 1 percent.

The longer-run trend in inflation, as measured by the 12-month percent change in the CPI, core CPI, and the 16% trimmed-mean CPI, remained between 2¼ percent and 2¾ percent. The median CPI, which tracks the price movements of the middle component in the monthly price distribution, continues to decline, but at 3.0 percent (annualized) it is still above its five-year average of 2.6 percent. Inflation in core service prices continued to stay in the 3 percent to 4 percent range, while core goods (commodities less food and energy commodities) have been trending down since the third quarter of 2006 and are now 0.8 percent below last year's level.

July's average household expectations for short-run inflation held steady at 4.2 percent. Longer-term (5

CPI, Core CPI, and Trimmed-Mean CPI Measures

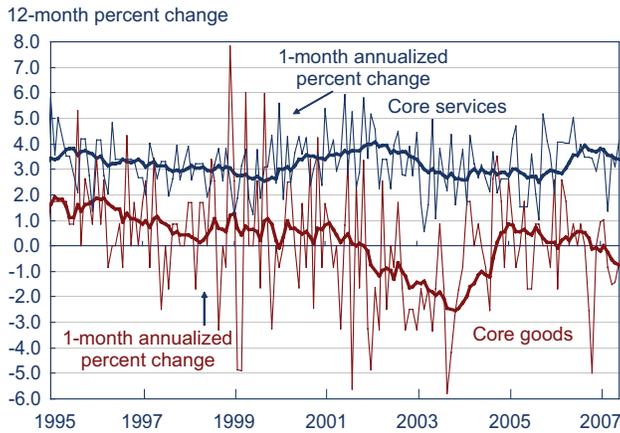


a. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics, and Federal Reserve Bank of Cleveland.

to 10 years out) expectations have been holding just above the 10-year average of 3.4 percent since April and stand a 3.6 currently.

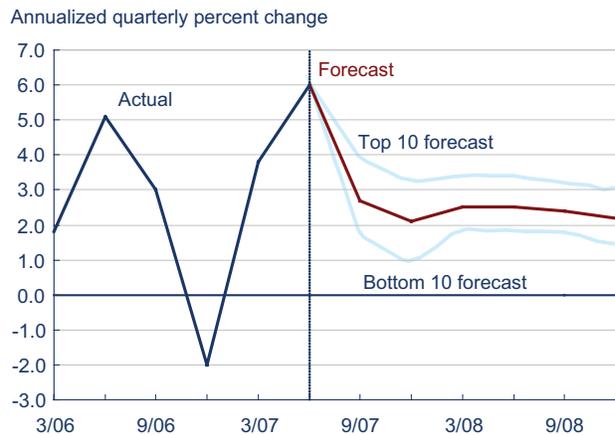
Professional forecasters (Blue Chip Panel of economists) predict that headline inflation will moderate over the short to medium term. Toward the end of 2008, the Blue Chip forecast has CPI inflation just north of 2 percent.

Core CPI Goods and Core CPI Services



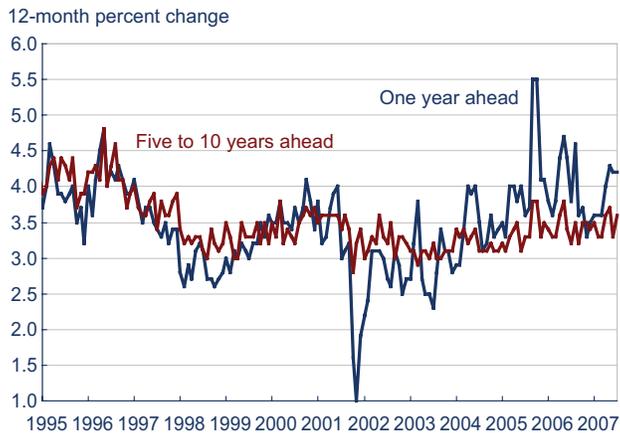
a. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics, and Federal Reserve Bank of Cleveland.

CPI and Forecasts



Source: Blue Chip panel of economists, August 10, 2007.

Household Inflation Expectations*



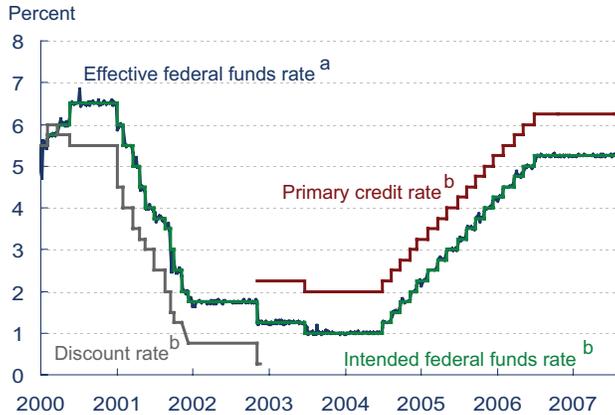
*Mean expected change as measured by the University of Michigan's Survey of Consumers.
Source: University of Michigan.

A Step Toward Neutral

08.08.07

by Charles T. Carlstrom and Bethany Tinlin

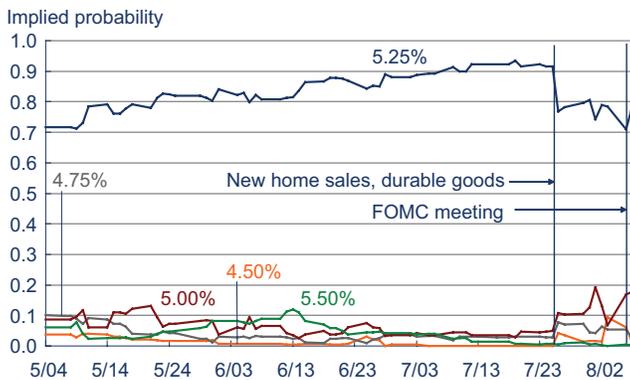
Reserve Market Rates



a. Weekly average of daily figures.
 b. Daily observations.
 Sources: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

The Federal Open Market Committee kept rates unchanged at the August 7 meeting; the federal funds rate has remained at 5.25 percent since July 2006. While the committee did not change rates, it changed the postmeeting statement to acknowledge that "Financial markets have been volatile in recent weeks, credit conditions have become tighter for some households and businesses, and the housing correction is ongoing." Still, the committee maintained that growth is likely to continue at a moderate pace, citing "solid growth in employment and incomes" and "a robust global economy" in support of that view.

Implied Probabilities of Alternative Target Federal Funds Rates, September Meeting Outcome*



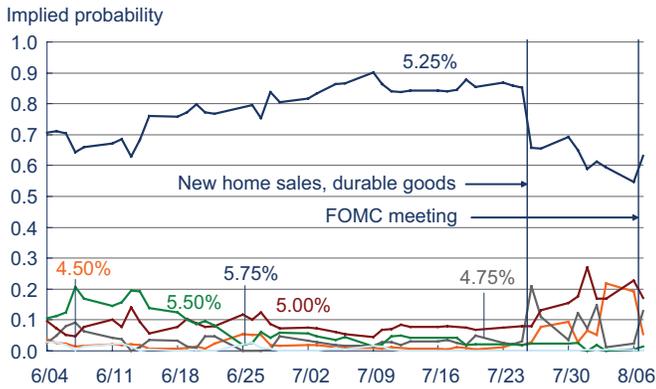
*Probabilities are calculated using trading-day closing prices from options on federal funds futures that trade on the Chicago Board of Trade.
 Sources: Chicago Board of Trade; and Bloomberg Financial Services.

The committee acknowledged an increase in the downside risks to growth while maintaining that its "predominant policy concern remains the risk that inflation will fail to moderate as expected." While the increased discussion of the downside risks to growth was seen by many as a step toward neutral, the implied probability of a rate cut in either September or October actually fell slightly following the meeting. These declines occurred as the probability of no change in both September and October increased.

Judging from the behavior of implied probabilities of federal funds futures, the market had already factored in a possible change in the statement language, since in the weeks leading up to the FOMC meeting, the probability of a rate cut increased. On July 26 the probability that the fed would cut rates in September increased 15 percent, sparked by a particularly disappointing release on new home sales. June new home sales were down 22 percent from June 2006 and 6.6 percent from the previous month. Markets now place nearly a 40 percent probability on the possibility that the Fed will cut rates by the October meeting.

The volatility of financial markets was mentioned in the statement, after the S&P 500 fell almost 6 percent in the slightly over two-week period lead-

Implied Probabilities of Alternative Target Federal Funds Rates, October Meeting Outcome*



Probabilities are calculated using trading-day closing prices from options on federal funds futures that trade on the Chicago Board of Trade.
Sources: Chicago Board of Trade; and Bloomberg Financial Services.

ing up to the meeting. This decline was primarily influenced by concerns about subprime failures and credit-risk repricing. While the market has undeniably been volatile on a daily basis over the past two weeks, this volatility rapidly disappears when the market is averaged over even a weekly basis. On a weekly basis, the current volatility in the S&P 500 is not particularly different from the movement of the market over the last several years.

Nevertheless, the market bears watching in light of the drop over the last couple of weeks. Large drops in the stock market are correlated with oncoming recessions. As it now stands, the declines have only reversed the gains the market had achieved over the previous two months. However, if these declines were to continue, concerns about a future recession may increase.

S&P 500



Source: Bloomberg Information Services.

S&P 500*



*Monthly average of daily data.
Sources: *Wall Street Journal*; and National Bureau of Economic Research.

S&P 500



Source: Bloomberg Information Services.

When Did Inflation Persistence Change?

07.27.07

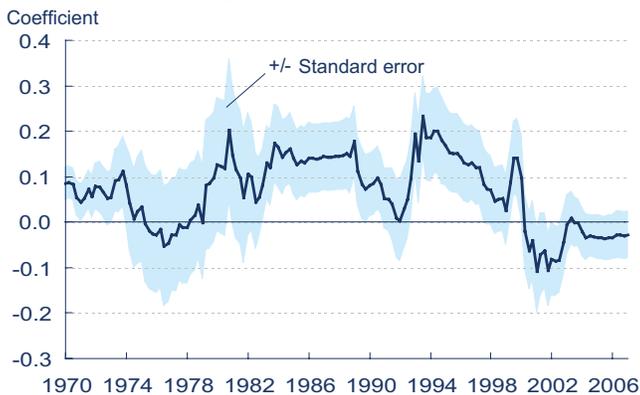
by Charles T. Carlstrom and Bethany Tinlin

Inflation Persistence Assuming Constant Long-Term Inflation*



*Inflation is based on core PCE using unfiltered data. The coefficients are calculated using 10-year rolling regressions of inflation on the output gap and 4-quarter lags of inflation. Inflation persistence is defined as the sum of the 4-quarter lag coefficients. Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

Output Gap Coefficient Assuming Constant Long-Term Inflation*



*The output gap is defined as the natural log of real gross domestic product less the natural log of potential gross domestic product, taken from the Congressional Budget Office. The output gap coefficients are calculated using 10-year rolling regressions of unfiltered inflation on the output gap and 4-quarter lags of inflation. Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

Policymakers and academics have noticed that the inflation process in the United States and other countries has changed markedly. Two formerly characteristic features of the process have been deviating from their historical norms. First, inflation persistence—the degree to which current inflation depends on past inflation—appears to have declined. Second, the relationship between current inflation and the output gap has also fallen. (The output gap is the percent by which actual output deviates from its potential.)

The timing of this decline suggests that something else may be going on. Before 2000, every percentage point in the previous year's inflation was associated with almost a 1 percentage point increase in current inflation. Six quarters later, that number had fallen to 0.4. This roughly coincides with the period of time in which the decline in inflation that had been occurring more or less steadily since the early 1990s had abated and leveled off.

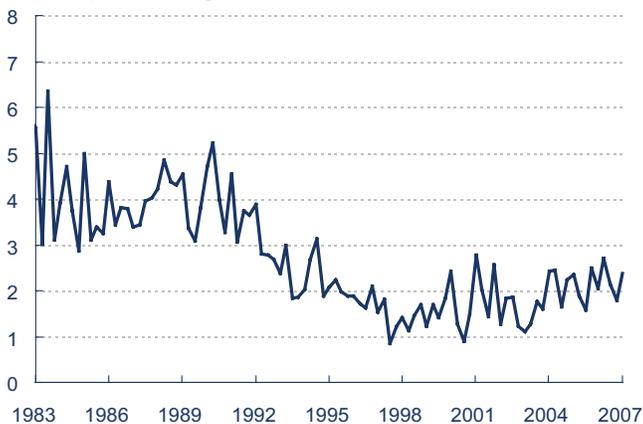
To the extent that the steady decline in inflation until 2000 reflected a lowering of the Fed's implicit long-run inflation target, the timing of the change in inflation persistence may be mismeasured. A sustained decrease in long-term inflation would artificially increase measured inflation persistence since it would be picking up the declining trend in long-term inflation. Thus, the actual decline in inflation persistence may have occurred much earlier. Survey data also suggest that over this period of time, professional forecasters were expecting inflation over the next 10 years to fall.

To correct for this effect we need some measure of long-run inflation. Unfortunately, the Fed's implicit long-term inflation target is not directly observable. We address this problem by smoothing the data. By smoothing the data, we are left with a measure of the underlying trend in inflation. This gives us a reasonable measure of long-term inflation.

By filtering out the high frequency (e.g., quarterly

Core PCE

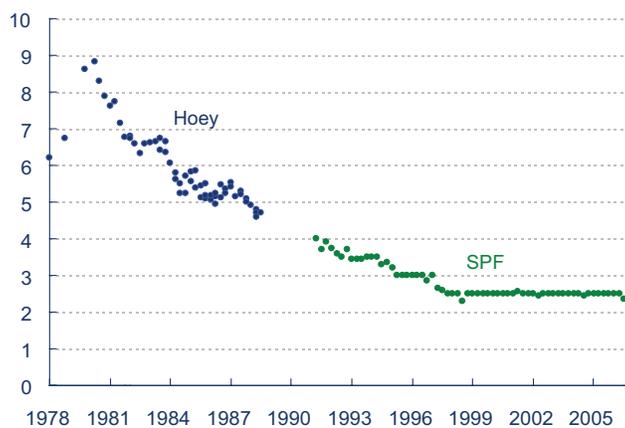
1-quarter percent change annualized



Source: Bureau of Economic Analysis.

Hoey and SPF Inflation Expectations

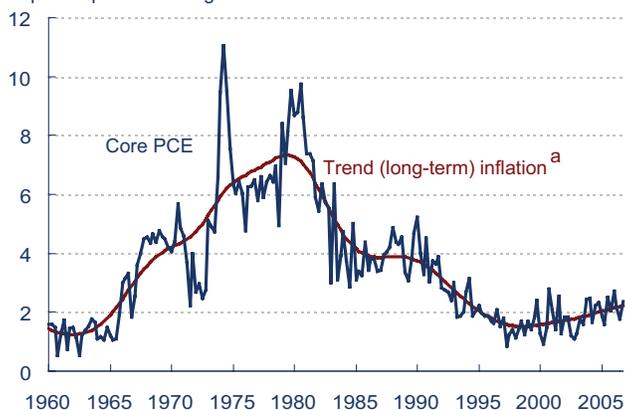
Percent



Sources: Survey of Professional Forecasters and the Hoey Survey.

Core PCE and Trend Inflation

1-quarter percent change annualized



a. Data is detrended using an HP filter, lambda = 1600.

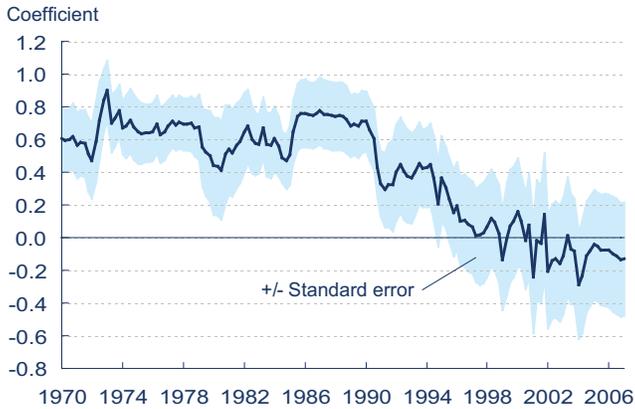
Sources: Bureau of Economic Analysis and the Congressional Budget Office.

and annual movements) we have a relationship that best captures whether inflation persistence would be declining in a period where long-term inflation is constant, as appears to be true during the current period. We also have a better measure of how the output gap affects inflation in such an environment. While the current decline in inflation persistence is historically unusual, the decline in the gap-inflation trade-off does not seem unusual. This coefficient has declined but the decline is modest and its current value is not low by historical standards. The impact of the output gap on inflation is currently (and is typically) very small.

Comparing our estimates of inflation persistence and the inflation-gap relationship for both the raw inflation data (“constant long-run inflation”) and where the monetary authority’s implicit long-term inflation target changes over time (“variable long-term inflation”), we see some interesting differences. The decline in inflation persistence is more pronounced and has been pushed back to around 1990.

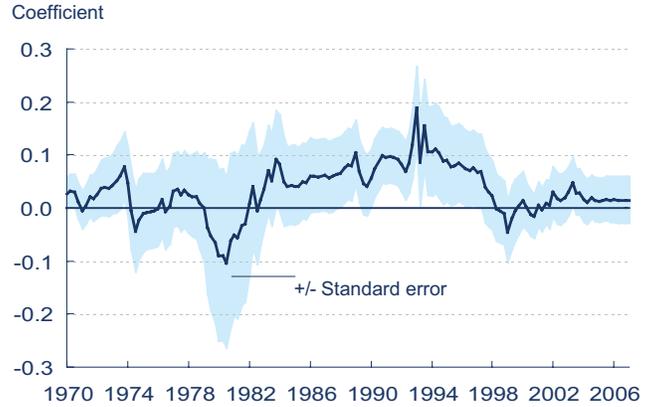
Note that since these are 10-year rolling windows, any possible change that may have led to the decline in inflation persistence could conceivably have occurred anywhere between 1980 and 1990. Two obvious suspects, both of which occurred in the early 1980s, come to mind: the sharp decline in output variability (the so-called “Great Moderation”) and the change in the central bank’s operating procedure. Since 1983 the operating procedure has de-emphasized monetary targets and reacted much more aggressively to control inflation than it did in earlier periods.

Inflation Persistence Assuming Variable Long-Term Inflation*



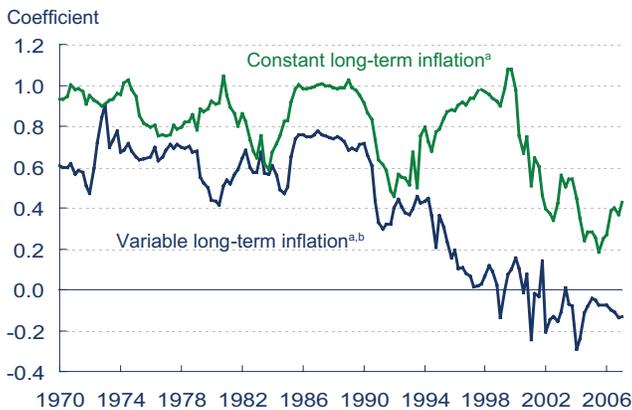
*Variable long-term inflation is based on core PCE using HP-filtered data (lambda = 1600). The coefficients are calculated using 10-year rolling regressions of inflation on the output gap and 4-quarter lags of inflation. Inflation persistence is defined as the sum of the 4-quarter lag coefficients.
Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

Output Gap Assuming Variable Long-Term Inflation*



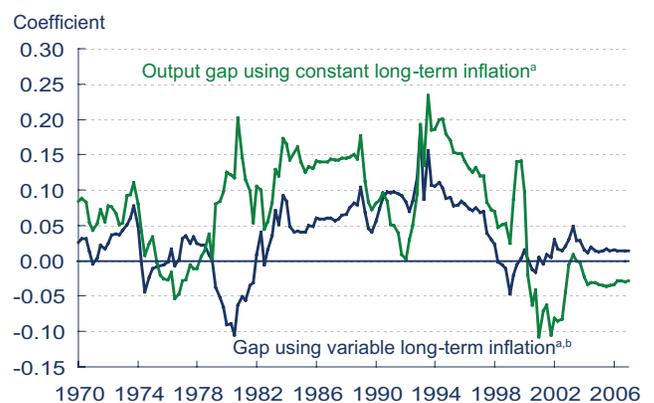
*The output gap is defined as the natural log of real gross domestic product less the natural log of potential gross domestic product, taken from the Congressional Budget Office. The output gap coefficients are calculated using 10-year rolling regressions of HP-filtered inflation (lambda = 1600) on the output gap and 4-quarter lags of inflation.
Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

Inflation Persistence



a. Inflation is based on detrended core PCE.
b. Inflation is detrended using the HP filter (lambda = 1600).
Note: The coefficients are calculated using 10-year rolling regressions of inflation on the output gap and 4-quarter lags of inflation. Inflation persistence is defined as the sum of the 4-quarter lag coefficients.
Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

Output Gap



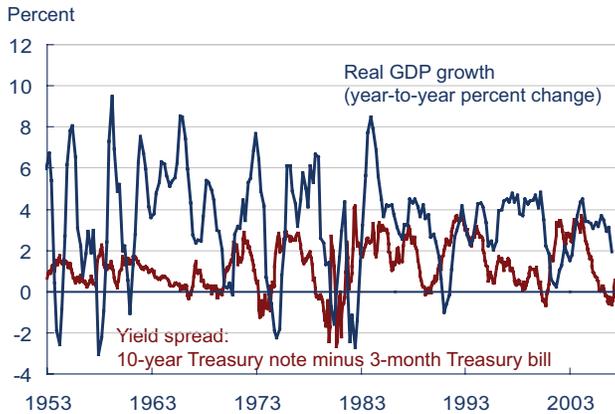
a. Inflation is based on the core PCE.
b. Inflation is detrended using the HP filter (lambda = 1600).
Note: The output gap is defined as the natural log of real gross domestic product less the natural log of potential gross domestic product, taken from the Congressional Budget Office. The output gap coefficients are calculated using 10-year rolling regressions of inflation on the output gap and 4-quarter lags of inflation.
Sources: Bureau of Economic Analysis, the Congressional Budget Office, and authors' calculations.

What Is the Yield Curve Telling Us?

07.18.07

by Joseph G. Haubrich and Brent Meyer

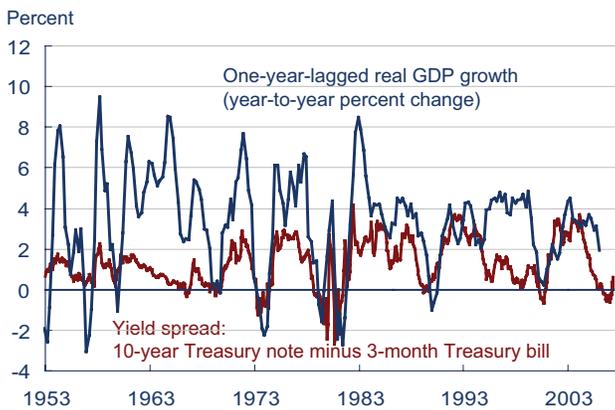
Yield Spread and Real GDP Growth*



*Shaded bars indicate recessions.

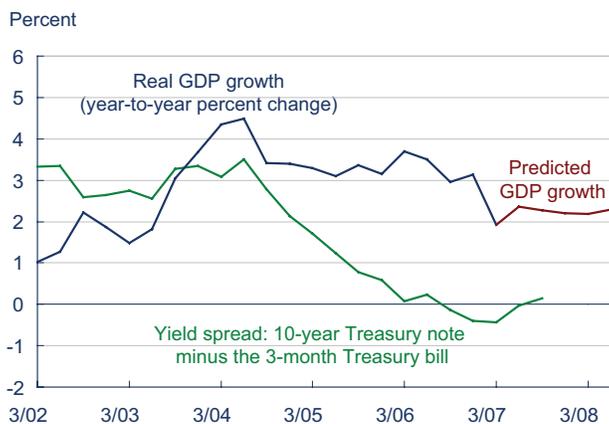
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Yield Spread and Lagged Real GDP Growth



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Predicted GDP Growth and the Yield Spread



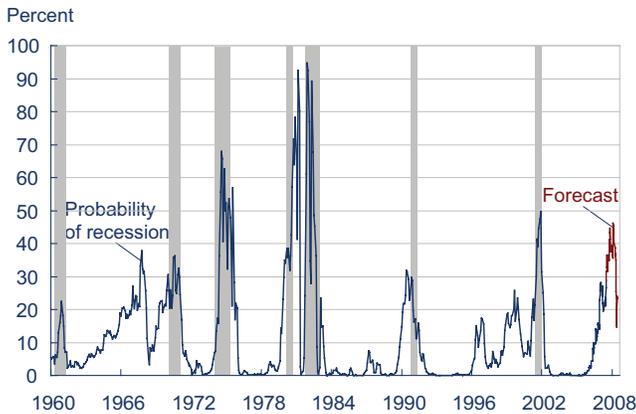
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; the Board of Governors of the Federal Reserve System; and authors' calculations.

Since last month, the yield curve has flattened, with short rates rising and long rates falling. Even so, long rates remain higher than short rates, and the movement was not enough to return the curve to inversion. One reason for noting this is that the slope of the yield curve has achieved some notoriety as a simple forecaster of economic growth. The rule of thumb is that an inverted yield curve (short rates above long rates) indicates a recession in about a year, and yield curve inversions have preceded each of the last six recessions (as defined by the NBER). Very flat yield curves preceded the previous two, and there have been two notable false positives: an inversion in late 1966 and a very flat curve in late 1998. More generally, though, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year bonds and 3-month T-bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

The yield curve had been giving a rather pessimistic view of economic growth for a while, but with the inversion gone, this view is less pronounced. The spread has turned positive, with the 10-year rate at 5.10 percent and the 3-month rate at 4.96 percent (both for the week ending July 13). The spread stands at 14 basis points, down considerably from June's 54 basis points, but still well above May's negative 23 basis points. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 2.3 percent rate over the next year. This prediction is on the low side of other forecasts, in part because the quarterly average spread used here remains negative.

While such an approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in the case of recessions. Thus, it is sometimes preferable to focus on using the yield curve to predict a discrete event: whether or not the economy is in recession.

Probability of Recession Based on the Yield Spread*



*Estimated using probit model. Shaded bars indicate recessions.
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and authors' calculations.

Looking at that relationship, the expected chance of a recession in the next year is 24 percent, up from June's 15 percent, but still down from May's value of 35 percent and April's 38 percent.

Of course, it might not be advisable to take this number quite so literally, for two reasons. First, this probability is itself subject to error, as is the case with all statistical estimates. Second, other researchers have postulated that the underlying determinants of the yield spread today are materially different from the determinants that generated yield spreads during prior decades. Differences could arise from changes in international capital flows and inflation expectations, for example. The bottom line is that yield curves contain important information for business cycle analysis, but, like other indicators, should be interpreted with caution.

For more detail on these and other issues related to using the yield curve to predict recessions, see the Commentary "Does the Yield Curve Signal Recession?"

International Markets

The Dollar's Depreciation and Inflation

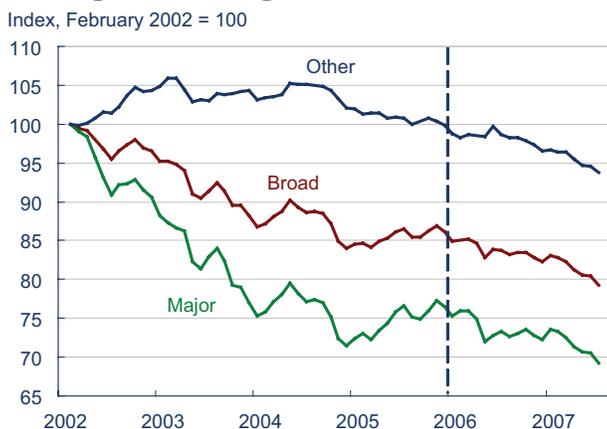
08.07.07

By Owen F. Humpage and Michael Shenk

Factors underlying the dollar's depreciation may be changing in a manner that could put upward pressure on U.S. prices, should they continue. Nevertheless, dollar depreciations do not cause inflation. Inflation is a purely home-grown, monetary phenomenon.

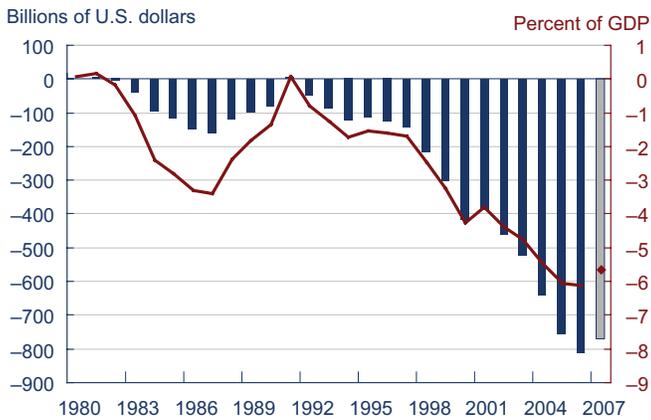
Since early February 2002, the U.S. dollar has depreciated nearly 31 percent on a trade-weighted basis against the currencies of the major industrialized countries and has also depreciated more than 6 percent on a similar basis against the currencies of key developing countries. On a real basis—that is, after controlling for the effects of domestic and foreign inflation—the dollar has depreciated nearly 26 percent against the major industrialized countries' currencies and almost 7 percent against the key developing countries' currencies.

Foreign Exchange Indexes



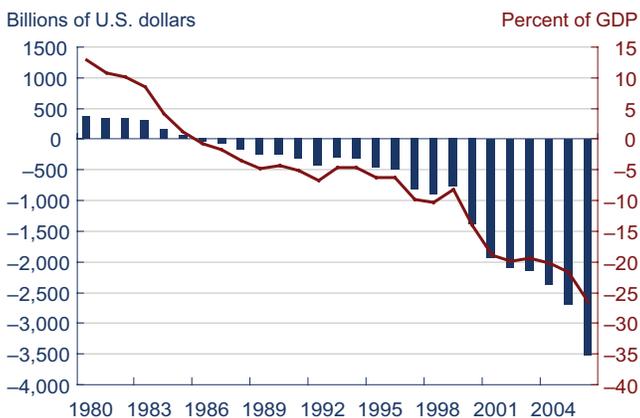
Source: Board of Governors of the Federal Reserve System.

Current Account Deficit*



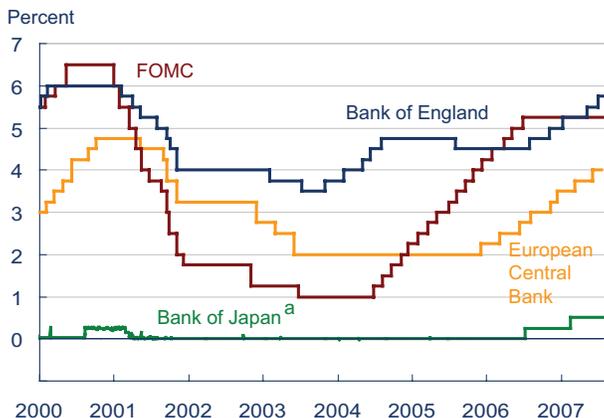
*2007 data points are annualized first-quarter data.
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; Haver Analytics.

Net International Investment Position



Sources: Bureau of Economic Analysis; Haver Analytics.

Key Policy Rates



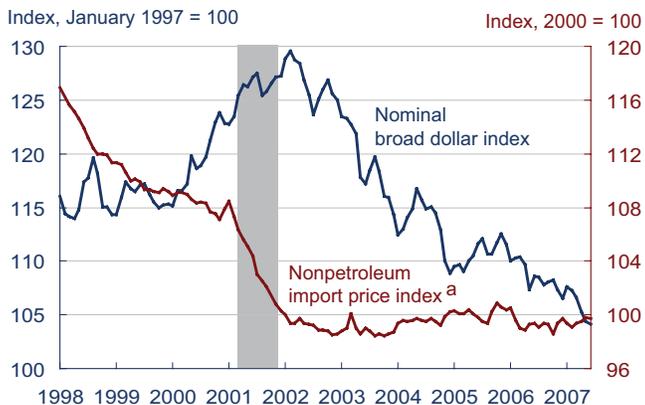
a: Daily data until 3/9/2006.
Sources: Board of Governors of the Federal Reserve System, "Selected Interest Rates," Federal Reserve Statistical Releases, H.15; The Bank of England; The Bank of Japan; The European Central Bank; and Bloomberg Financial Information services.

Economists have always found explaining movements in exchange rates difficult, even in hindsight, but comparing movements in the dollar with broad changes in the current-account deficit can provide some insight. Between early 2002 and late 2005, the dollar depreciated as the current-account deficit widened, suggesting that an expansion of U.S. aggregate demand motivated both events. U.S. economic growth at the time was not obviously faster than economic growth elsewhere across the globe, but between mid-2003 and late 2005, U.S. output converged on, and eventually surpassed, potential output quicker than was generally the case abroad. Americans consumed and invested more than they produced domestically. A small part of the dollar's depreciation against the currencies of the major industrialized countries reflected a slightly higher rate of inflation in the United States than in many other large industrialized countries. At best, this seems to explain only about 5 percentage points of the overall depreciation against our large trading partners; it describes none of the dollar's depreciation against the key developing countries.

Last year, however, the situation seemed to change. The dollar continued to depreciate, but the current-account deficit narrowed from a record 6.8 percent of GDP in the fourth quarter of 2005 to 5.7 percent of GDP in the first quarter of 2007. This pattern of exchange-rate and current-account movements, along with myriad anecdotal reports, tentatively suggests that foreign investors are becoming somewhat reluctant to acquire U.S. financial claims, although they are not outright dumping dollars.

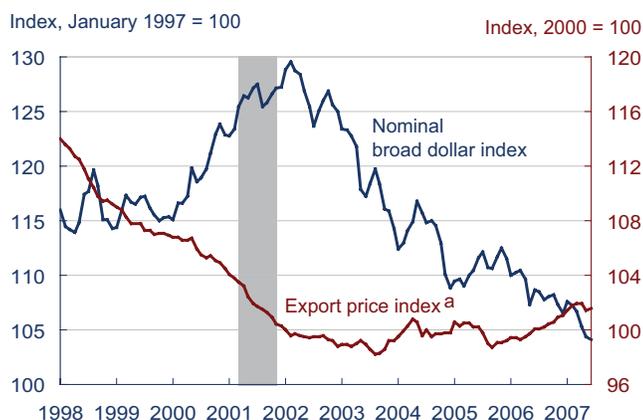
Many analysts have been anticipating such a development. The United States has financed its persistent string of current account deficits by issuing financial claims to the rest of the world. As a consequence of this process, the world now holds financial claims amounting to \$3.5 trillion against the United States, or 26 percent of our GDP. (Our negative net international investment position measures this.) Economists have long argued that the stock of outstanding financial claims could not grow continuously relative GDP (a comparison which indicates our ability to service and repay the claims). At some point, they argued, foreigners

Exchange Rate and Relative Import Prices



a. Nonpetroleum import price index divided by CPI less food and energy.
Sources: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System.

Exchange Rates and Relative Export Prices



a. Export price index divided by CPI.
Sources: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System.

would become reluctant to add dollar-denominated assets to their portfolios. When this point was reached—and economists did not know when that might be—the dollar would depreciate and real interest rates in the United States might also rise to coax foreigners into holding additional dollar-denominated assets. The broad-based dollar depreciation since late 2005 is certainly consistent with this story.

The relative thrust of U.S. and foreign monetary policies may be encouraging international investors to diversify. Since June 2006, the FOMC has kept the federal funds target rate at 5.25 percent, while other key central banks have tightened. Markets do not expect the Federal Reserve to change policy anytime soon, but the chances are better than not that other central banks will move their key policy rates upward.

A dollar depreciation exerts upward pressure on U.S. prices through a couple of different channels, but how a depreciation affects the overall inflation rate depends on the stance of U.S. monetary policy. Inflation is, after all, purely a monetary phenomenon. A dollar depreciation lowers the foreign-currency prices of U.S. made goods and services, making our exports more attractive to foreigners. The resulting increase in foreign demand for U.S.-made traded goods raises their dollar prices. Similarly, a dollar depreciation increases the dollar prices of foreign-made goods and services. Many of these are consumer goods, and as their prices rise, U.S. consumers look for domestic substitutes, thereby also putting upward pressure on the prices of domestically produced alternatives. In addition, to the extent that imported goods enter into the production of domestically made goods and services, the dollar depreciation will raise the costs of domestic production. The bottom line is that a dollar depreciation will raise the relative price of all traded goods and any nontrade substitutes in this country, as well as domestic goods with a high import component in their manufacture. But this is not inflationary.

As long as U.S. monetary authorities have not caused the dollar depreciation because of an excessively easy monetary policy, and as long as U.S. monetary policymakers do not subsequently ac-

commodate a dollar depreciation with an easier monetary policy, the price effects of a dollar depreciation will not lead to a general inflation in the United States. The dollar depreciation from 2002 through 2005 appears to have been a response to U.S. developments, including the stance of U.S. monetary policy. Import prices advanced apace with prices overall, and relative export prices rose only a bit faster than the consumer price index. The depreciation over the last year, however, seems foreign in origin. It has not had a price impact as of yet, but should it continue, this foreign-sourced dollar depreciation could complicate the conduct of monetary policy as it shifts worldwide demand towards the United States, but it will not cause inflation. That depends of the FOMC.

Economic Activity and Labor

The Employment Situation

08.07.07

By Yoonsoo Lee and Cara Stepanczuk

Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2004	2005	2006	Jan-Jun 2007	July 2007
Payroll employment	172	212	189	144	92
Goods-producing	28	32	9	-14	-12
Construction	26	35	11	-4	-12
Manufacturing	0	-7	-7	-13	-2
Durable goods	8	2	0	-12	3
Nondurable goods	-9	-9	-6	-1	-5
Service-providing	144	180	179	157	104
Retail trade	16	19	-3	10	-1
Financial activities ^a	8	14	16	4	27
PBS ^b	38	57	42	18	26
Temporary help svcs.	11	18	-1	-8	-7
Education and health svcs.	33	36	41	49	39
Leisure and hospitality	25	23	38	33	22
Government	14	14	20	24	-28
	Average for period (percent)				
Civilian unemployment rate	5.5	5.1	4.6	4.5	4.6

Nonfarm payrolls grew by 92,000 jobs in July—slower than expected and below the average monthly increase reported during the first six months of 2007 (144,000). A nominal loss in the goods-producing sector trimmed 12,000 jobs from the total, while the service-providing sector added 104,000 to it. Changes were more muted in both sectors this past month than the monthly average in 2007; on average the goods-producing sector has dropped 13,300 jobs each month this year, and the service-providing sector has added an average 149,700. Although employment growth has been moderating, the labor market remains firm: The monthly unemployment rate (4.6 percent) is similar to its average during the first half of 2007, and except for government, which experienced large employment declines, most sectors' employment grew in July at about the same rates as in recent months.

A drop of 28,000 in government payrolls accounted for some of the weakness in the report; it was the first loss for the sector since January 2006 (-34,000). More than half of the drop was due to a decline in local government education. Employment in temporary help services is often used as an indicator of business confidence and overall de-

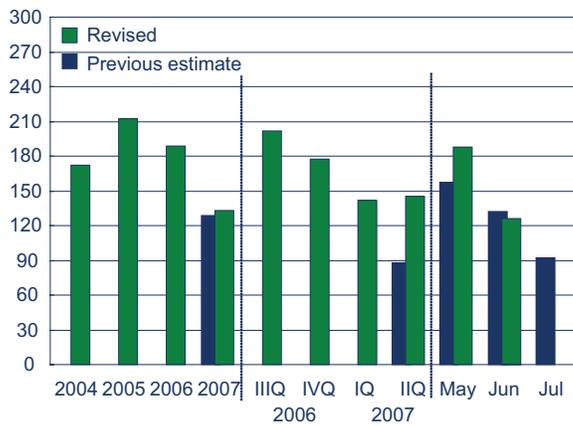
a. Financial activities include the finance, insurance, and real estate sector and the rental and leasing sector.

b. PBS is professional business services (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.

Average Monthly Nonfarm Employment Change

Change, thousands of workers



Source: Department of Labor, Bureau of Labor Statistics.

mand conditions for labor, as businesses can adjust to new conditions by changing their orders for temporary workers. While the decline in temporary help services may be an indication of softening employment, the magnitude of the change is about the same as in recent months. In contrast, other parts of the service-providing sector remained solid and mostly on par with recent months: Education and health services added 39,000 jobs, financial activities added 27,000, and professional and business services added 26,000. Financial activity, boosted by credit intermediation and related activities (+11,000), experienced its strongest payroll increase since September 2006.

The loss of goods-producing jobs was held to 12,000 in July. Construction, which lost 12,000 jobs, contributed most of the losses to this sector. July's construction payroll reduction also exceeds the industry's average monthly payroll change since the start of 2007 (-4,000). However, the employment losses in this sector remain relatively small compared to the sharp contraction recently observed in homebuilding activity. Since last August, employment in construction has declined less than 1 percent. During the same period, total housing starts declined 30.4 percent. If these differing trends reflect the lagged adjustment of employment to slowing activity in this sector, overall employment growth in the coming months may decline further. The loss of manufacturing jobs, which numbered only 2,000, was well above the manufacturing industry's average monthly loss of 13,000 jobs so far in 2007.

Economic Activity and Labor

08.06.07

by Tim Dunne and Brent Meyer

Real GDP and Components 2007:IIQ

	Change, billions of 2000\$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	95.3	3.4	1.8
Personal consumption	25.7	1.3	2.9
Durables	5.0	1.6	5.0
Nondurables	-4.8	-0.8	2.4
Services	25.2	2.2	2.7
Business fixed investment	25.9	8.1	3.4
Equipment	5.9	2.3	0.1
Structures	14.5	22.2	11.5
Residential investment	-12.1	-9.2	-15.9
Government spending	20.9	4.3	2.0
National defense	11.2	9.4	3.0
Net exports	34.2		
Exports	21.2	6.4	6.8
Imports	-13.1	-2.6	2.0
Change in business inventories	3.5		

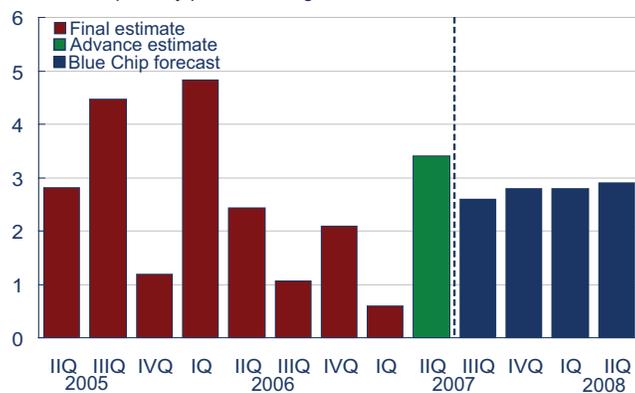
Source: Bureau of Economic Analysis.

Real Gross Domestic Product (GDP) grew at a 3.4 percent annual rate in the second quarter of 2007, according to the advance estimate released by the Bureau of Economic Analysis (BEA). The acceleration from first quarter's four-year low (0.6 percent) reflected strong increases in private nonresidential investment and exports, a decline in imports, and some slowing in the recent losses in residential fixed investment. A decrease in personal consumption expenditures in the second quarter—from 3.7 percent to 1.3 percent—partly offset the gains seen in the other components. The decrease in personal consumption expenditures was primarily due to a drop in demand for durable and nondurable goods, which fell from 8.8 percent to 1.3 percent and 3.0 percent to -0.8 percent, respectively.

Looking at the contribution of individual components to the percent change in real GDP, we see that business fixed investment added 0.8 percent to real GDP growth, doubling its average contribution of 0.4 percent over the last four quarters. Also, the free fall in residential fixed investment abated somewhat, and this component took away only 0.5 percentage point of growth, compared to 0.9 over the last four quarters. Exports grew in the second quarter almost as strongly as they had over the past year, adding 0.7 percentage point; and imports actually fell for the first time since 2003, boosting real GDP growth by one-half of a percentage point.

Real GDP Growth

Annualized quarterly percent change

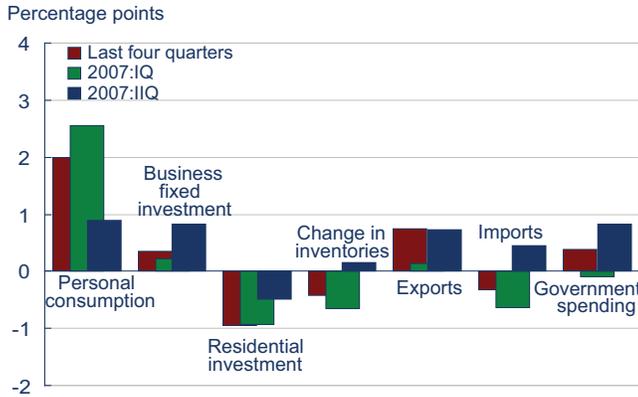


Sources: Blue Chip Economic Indicators, July 2007; Bureau of Economic Analysis.

Real GDP growth for the second quarter came in slightly above expectations and its 30-year average of 3.2 percent. The July 10 Blue Chip forecast had predicted second-quarter growth of 3.0 percent. Looking ahead to the next four quarters, expectations are for growth to average 2.8 percent.

It is important to note that the most recent data are from the advance estimate and are subject to further revisions that may significantly change our current perceptions. Not only does the BEA revise current data, once a year (usually in July) it also “benchmarks” historical data to “incorporate newly

Contribution to Percent Change in Real GDP

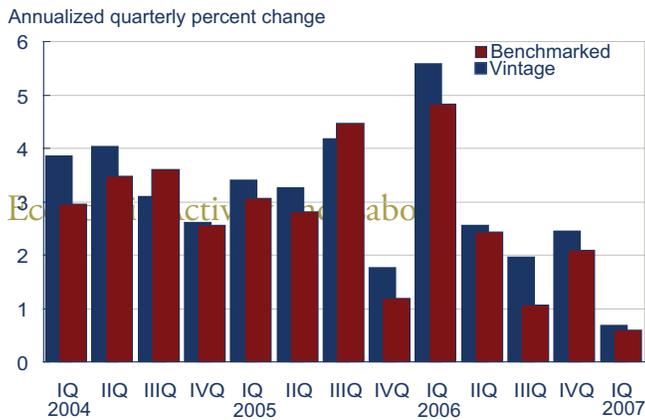


Source: Bureau of Economic Analysis.

available and more comprehensive source data, as well as improve estimating methodologies.” The most recent benchmark revised the data back to 2004, considerably changing what we thought we knew about the economy over the past few years.

The estimates were almost exclusively revised down. In fact, the estimate for the average annualized percent change of real GDP in 2004 was revised down to 2.7 percent from 3.0 percent. The revisions were just as striking for personal consumption expenditures and private fixed investment. Annualized average growth of personal consumption expenditures dropped to 3.3 percent from 3.6 percent, and private fixed investment dropped from 3.6 to 3.2 on average. An implication of these downward revisions in real GDP growth is that productivity growth may not have been as robust as previously thought. However, the revisions to the productivity growth series will also depend upon upcoming revisions that the BLS makes to the payroll series. If payrolls are also revised downward, then the net effect on the productivity numbers remains uncertain.

Revisions to Real GDP Growth



Source: Bureau of Economic Analysis.

1. ATUS data are collected for all segments of the population 15 and older for weekdays as well as weekends and holidays. Hence, an average day measures the average time allocation across all persons and days.

Revisions to Real Private Fixed Investment



Source: Bureau of Economic Analysis.

Revisions to Real Personal Consumption Expenditures



Source: Bureau of Economic Analysis.

How Do Americans Spend Their Time?

07.31.07

by Murat Tasci and Laura Kleinhenz

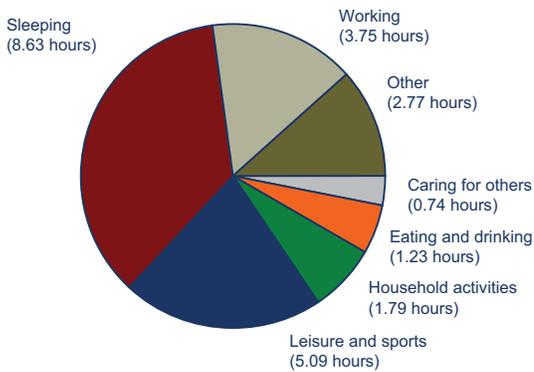
The American Time Use Survey (ATUS), which has been sponsored by the Bureau of Labor Statistics and conducted by the U.S. Census Bureau since 2003, provides information about how people in the United States spend their time on an average day.¹ By including valuable information about what activities people do during the day and how much time they spend doing each, the survey creates a larger picture of employment. For instance, on an average day in 2006, people spent 3.40 hours working. However, only about 45 percent of the entire population (51 percent of men and 39 percent of women) worked on an average day. Among the civilian population, the average daily number of work hours was 7.59 (8.04 hours for men and 7.04 for women).

Not surprisingly, sleeping was the most time-consuming daily activity for the civilian population as a whole. Leisure and sports came next, with 5.09 hours; much of their leisure time was spent watching television (about 2.58 hours a day).

It is important to recognize that time allocation can differ significantly among subgroups within the civilian population. Consider, for instance, that the average workday for employed adults aged 25 to 54 with children was eight hours in 2005. This subgroup used significantly less time for sleeping (7.6 hours) and leisure (2.6 hours) than the civilian population as a whole, seemingly to compensate for the extra hours spent working.

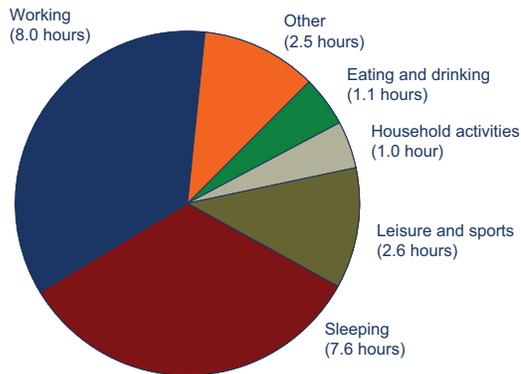
ATUS data also provide information about the timing and location of certain activities. For instance, we can see how many people work on weekends or at home. It turns out that in 2003–05, about 32 percent of employed people worked on an average weekend day. Among those holding more than one job, 57 percent worked weekends. More interestingly, 18 percent of single-job holders aged 15 and older worked at home on the average work day. For multiple-job holders, this proportion is 32 percent. The proportions working at home are higher for

Time Spent in Primary Activities, 2006*



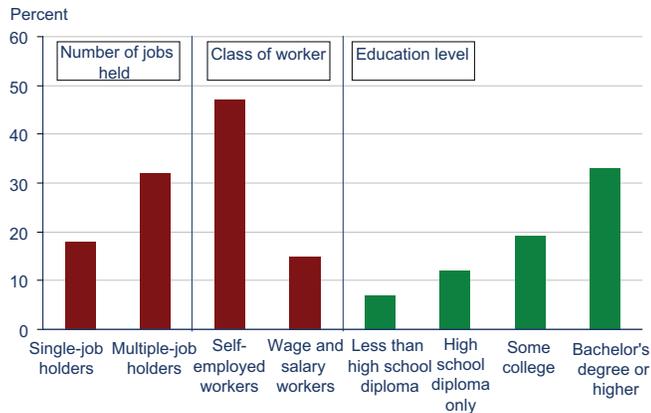
*Time is a daily average, and a primary activity is an individual's main activity. Other activities done simultaneously are not included. Note: Data refer to civilians 16 years and over. All major activity categories include related travel time. Source: Bureau of Labor Statistics.

Time Use on Average Work Day for Employed People Aged 25 to 54 with Children



Note: Data include employed persons ages 25 to 54 who lived in households with children under 18. Data include nonholiday weekdays and are annual averages for 2005. Source: Bureau of Labor Statistics.

Percent of Employed Persons Who Worked at Home on an Average Workday, 2003–05



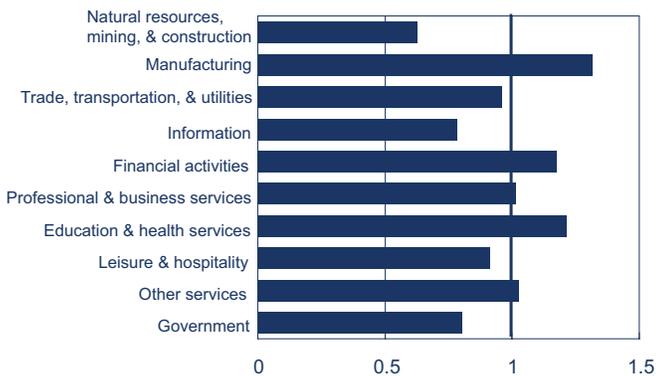
Note: Data include all employed persons age 25 and over on days they worked. Data include all days of the week and are an average for 2003–05. Source: Bureau of Labor Statistics.

self-employed workers (47 percent) and those with a bachelor's degree or higher (33 percent).

Regional Activity

The Cleveland Metropolitan Statistical Area

Location Quotients, 2006 Cleveland MSA / U.S.



Note: A location quotient (LQ) is used to measure the degree to which an industry is concentrated in a region relative to a reference economy. An LQ greater than 1.0 says that the region (in this case, the Cleveland MSA) has a higher concentration of an industry's employment than the reference economy (in this case, the United States). Source: U.S. Department of Labor, Bureau of Labor Statistics.

08.06.07

By Kyle Fee and Bob Sadowski

The Cleveland metropolitan statistical area (MSA) is located along the southern shores of Lake Erie. Counties within the MSA include Cuyahoga, Geauga, Lake, Lorain, and Medina. Ever since the turn of the twentieth century, Cleveland has been recognized as a manufacturing center, and despite the sector's downturn, the region retains a high concentration of manufacturing jobs. In 2006, Cleveland's concentration of manufacturing employment was 31 percent higher than the nation as a whole.

In recent years, the region has built an international reputation as a major player in the health care sector. Employment within the sector has grown rapidly, to the point where health care edged past manufacturing as Cleveland's largest sector employer. The region's employment concentration in health services and education is about 22 percent greater than is found nationally. However, the rise in the number of health care jobs is not characteristic of the overall employment picture.

Since the employment turnaround began after the last recession, total nonfarm employment in the

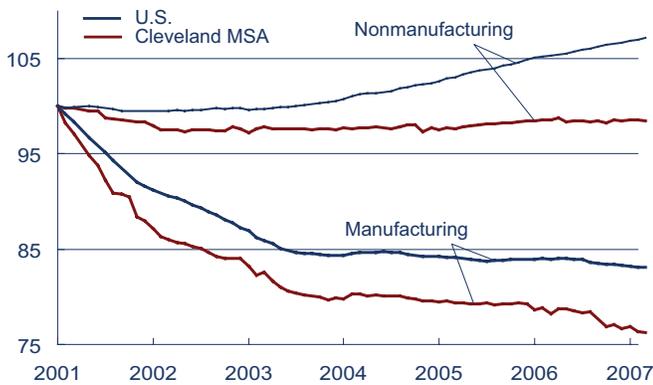
Payroll Employment since March 2001



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

Payroll Employment since March 2001

Index, March 2001 = 100

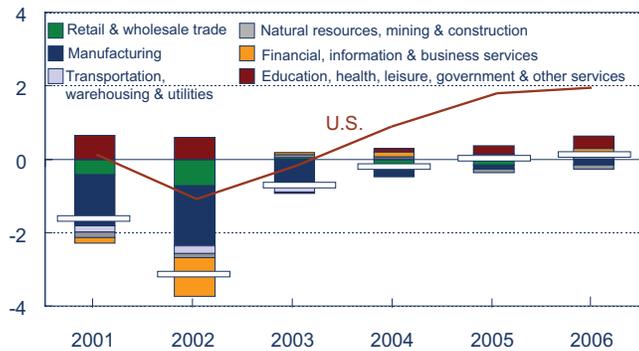


Source: U.S. Department of Labor, Bureau of Labor Statistics.

U.S. has grown over 6 percent. In Cleveland, by contrast, employment growth has been flat. Decomposing the employment data into manufacturing and nonmanufacturing sectors, we see that the U.S. outperformed the local area in both categories. Since the last business cycle peak through 2006, the U.S. shed 16.6 percent of its manufacturing jobs, while Cleveland lost 23.4 percent. Likewise, in all nonmanufacturing sectors, employment in the U.S. rose 6.6 percent, while in Cleveland it declined 1.4 percent.

Components of Employment Growth, Cleveland MSA

Percent change

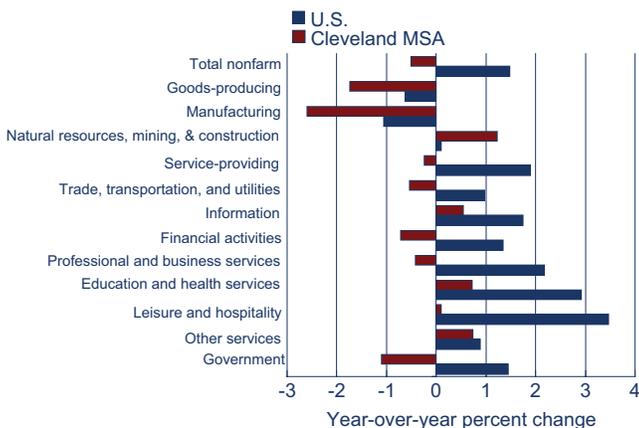


Note: The white bars represent total annual growth for the Cleveland MSA. The red line is U.S. growth.

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

Looking at the components of annual employment growth helps us to pinpoint why Cleveland is lagging the nation. Manufacturing job loss is the main culprit, especially for the 2001–2003 period. Further, in 2002, several other sectors played significant roles in the region’s employment decline: the financial, information, and business services sector and retail and wholesale trade. In contrast, the education, healthcare, leisure, government, and other services category made a positive contribution to employment change in each year except 2003. In fact, this component was the major contributor to the region’s positive growth—albeit slight—in 2005 and 2006.

Payroll Employment Growth, May 2007



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

Employment trends similar to those observed in the Cleveland MSA and the United States between 2001 through 2006 continued into 2007. For the 12-month period ending in May, the U.S. reported higher employment growth than Cleveland in all industry sectors except natural resources, mining, and construction. On a year-over-year basis, total nonfarm employment in the U.S. grew by about 1.5 percent, compared to a 0.5 percent decline in the region.

Prior to middle of 2003, the MSA’s unemployment rate closely tracked the nation’s. However, since the beginning of 2004, the unemployment rate in the U.S. has averaged 0.6 percentage point less than is found regionally.

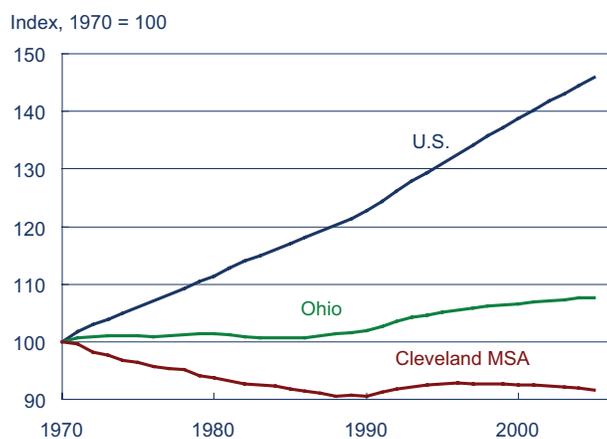
In addition to Cleveland’s overall decline in employment, the region has also lost population. Since 1970, the region’s population has declined almost 9 percent, to 2.1 million. This compares to 7.7 percent growth in Ohio and 47 percent across the U.S. It should be noted that Cleveland is not

Unemployment Rate



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

Population



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

Selected Demographics, 2005

	Cleveland, OH		
	MSA	Ohio	U.S.
Total population (millions)	2.1	11.2	288.4
Percent by race			
White	76.9	85.7	74.7
Black	18.8	12.3	12.1
Other	4.3	2.0	13.2
Percent by age			
0 to 19	26.9	27.0	27.8
20 to 34	17.5	19.3	20.1
35 to 64	41.8	40.8	40.0
65 or older	13.8	12.8	12.1
Percent with bachelor's degree or higher	26.6	23.3	27.2
Median age	39.0	37.6	36.4

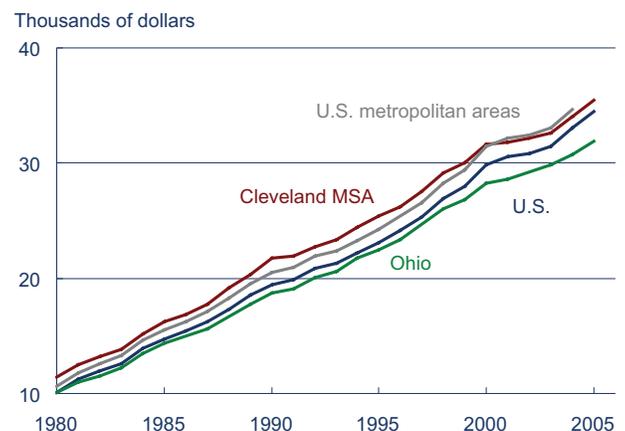
Source: U.S. Department of Commerce, Bureau of the Census, American Community Survey.

unique among MSAs in the Fourth District in this respect. Many regions in the district have seen their populations remain flat or decline over the past few decades.

Between 1980 and 2000, per capita personal income in the Cleveland metro area exceeded that of aggregate U.S. metro areas by an average of just over 4 percent. Part of this disparity can be attributed—at least until the recent past—to the large number of high-paying manufacturing jobs and Fortune 500 company headquarters in the region. Beginning in 2001, average per capita income in U.S. metro areas rose slightly above Cleveland's and has continued to do so since. In 2004, per capita income in Cleveland was \$34,078, compared to an average of \$34,688 across all U.S. metro areas.

Looking at some selected demographic statistics, we see that the Cleveland metro area is almost on par with the United States in terms of the percentage of people who hold a bachelor's degree or a higher degree—26.6 percent and 27.2 percent, respectively, and it exceeds the state's share by 3.3 percentage points. The share of Cleveland's minority population is equal to that of the United States. However, the share of black residents in Cleveland exceeds that of the nation by over 6 percentage points. Other minority groups are not as well represented in Cleveland as they are across the nation. Finally, the median age in Cleveland is slightly higher than in Ohio or the United States.

Per Capita Personal Income



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

Fourth District Employment Conditions

07.18.07

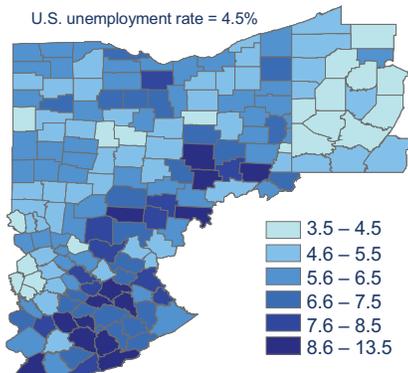
by Tim Dunne and Kyle Fee

Unemployment Rates*



a. Seasonally adjusted using the Census Bureau's X-11 procedure.
 *Shaded bars represent recessions. Some data reflect revised inputs, reestimation, and new statewide controls. For more information, see <http://www.bls.gov/lau/launews1.htm>.
 Source: U.S. Department of Labor, Bureau of Labor Statistics.

Unemployment Rates, May 2007*



*Data are seasonally adjusted using the Census Bureau's X-11 procedure.
 Source: U.S. Department of Labor, Bureau of Labor Statistics.

May's employment report showed relatively stable conditions in the Fourth District's labor markets. The district's unemployment rate remained unchanged at 5.4 percent for the month, which was a bit higher than the national unemployment rate of 4.5 percent (also unchanged from April). While the unemployment rate stayed constant, there were changes in the number of workers employed, the number unemployed, and size of the labor force. Compared to the previous month, the District's employment and labor force both increased 0.1 percent; however, this was offset by a 1.3 percent increase in the number of unemployed people. On a year-over-year basis, the District's labor force and the number of people employed increased 0.8 percent and 0.7 percent, respectively, and the unemployment rate rose slightly (0.1 percent).

Of the 169 counties in the Fourth District, 18 had an unemployment rate below the national average and 151 had a higher rate in May. Rural Appalachian counties experienced the highest unemployment rates, with six counties having unemployment rates above 10 percent. Pennsylvania's labor market continued to show the most strength, with the Pennsylvania counties that are within the Fourth District registering an unemployment rate of 4.4 percent. The unemployment rates of both Fourth District Kentucky (5.4 percent) and Ohio (5.7 percent) exceeded the national rate. Unemployment rates for the District's major metropolitan areas ranged from a low of 4.0 in Lexington to a high of 6.2 in Toledo.

Lexington's employment grew at a rate of 1.9 percent on a year-over-year basis and was the only major metropolitan area in the District to increase employment faster than the national average of 1.4 percent. Nonfarm employment dropped in Cleveland (-0.6 percent), Toledo (-0.3 percent), and Dayton (-1.1 percent) since last May. Employment in goods-producing industries fell in almost all District cities as well as nationally (-0.7 percent).

Cleveland, Columbus, Cincinnati, and Dayton all lost goods-producing jobs at more than double the national rate. Service-providing employment fared better and increased in four of the seven major metro areas; Lexington remained at the top of the Fourth District with a 2.8 percent increase in service-providing jobs. All major District metro areas posted job gains in the education and health services industry. The professional and business services sector posted job gains in all major District metro areas except for Cleveland, which contracted 0.5 percent.

Payroll Employment by Metropolitan Statistical Area

12-month percent change, May 2007

	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total Nonfarm	-0.6	0.3	0.3	-1.1	0.3	0.4	1.9	1.4
Goods-producing	-1.8	-1.9	-1.5	-2.8	-0.8	-0.8	0.6	-0.7
Manufacturing	-2.6	-1.4	-1.1	-3.3	-1.6	-1.2	0.0	-1.2
Natural resources, mining, construction	1.2	-2.8	-2.5	-0.7	2.0	0.5	2.4	0.0
Service-providing	-0.3	0.6	0.7	-0.7	0.2	0.6	2.3	1.8
Trade, transportation, and utilities	-0.6	0.4	-0.1	-3.3	0.2	-0.3	-1.3	0.9
Information	0.5	-2.6	-2.5	1.0	5.0	-0.9	6.5	1.7
Financial activities	-0.8	-0.8	-1.1	1.0	-0.8	-1.7	2.8	1.0
Professional and business services	-0.5	2.0	0.7	0.2	1.5	1.5	1.3	2.2
Education and health services	0.6	1.6	3.6	0.2	0.4	2.2	1.9	3.0
Leisure and hospitality	0.0	2.4	1.4	0.3	-0.9	0.2	5.6	3.4
Other services	0.7	-1.1	1.2	-0.6	-1.3	-0.7	-1.0	0.9
Government	-1.1	-0.4	-0.6	-1.1	-1.9	0.8	4.9	1.3
May unemployment rate (seasonally adjusted, percent)	5.7	4.8	5.0	6.1	6.2	4.2	4.0	4.5

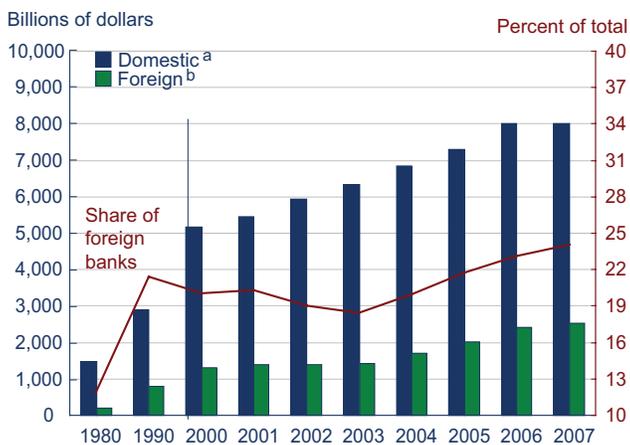
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Foreign Banks in the United States

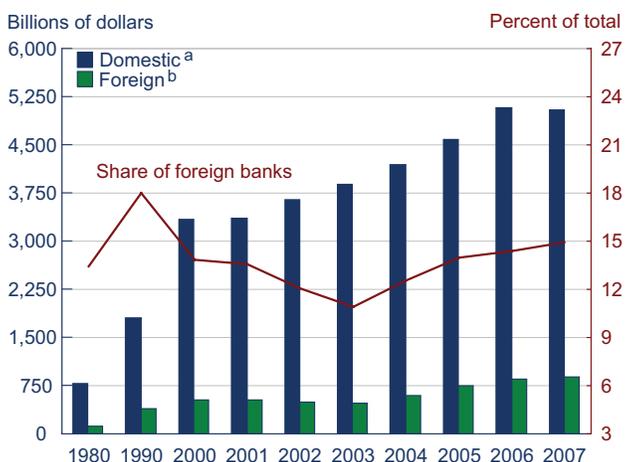
08.06.07

by James Thomson and Cara Stepanczuk

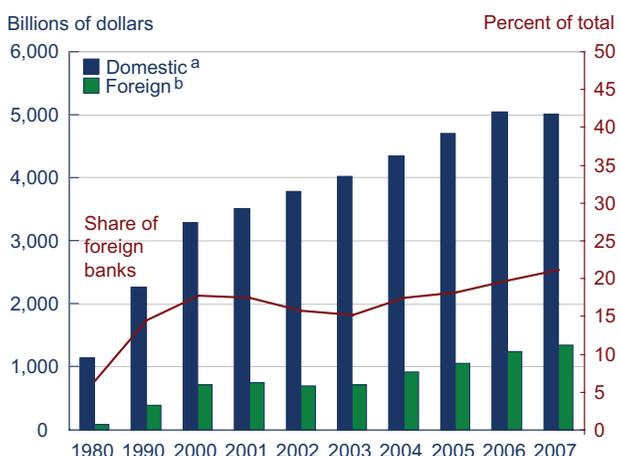
Assets of Domestic and Foreign Banks in the U.S.*



Loans of Domestic and Foreign Banks in the U.S.*



Business Loans of Domestic and Foreign Banks in the U.S.*

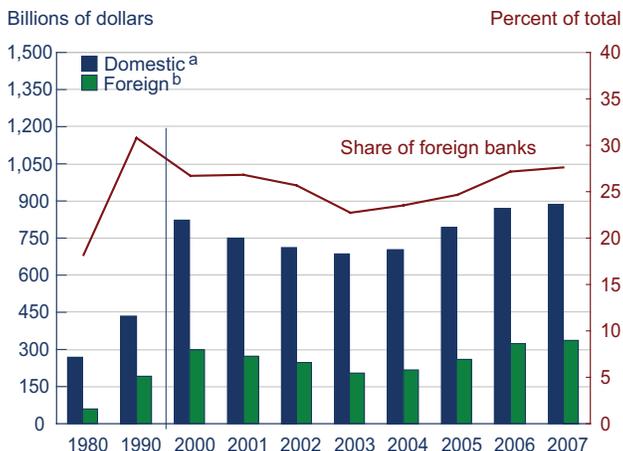


Foreign banks are growing competitors of the U.S. domestic banking industry. The numbers clearly indicate that foreign banks are becoming an increasingly important part of the U.S. banking system. Assets held by branches and agencies of foreign banks in the United States have grown substantially over time, from \$800 billion at the end of 1991 to \$2.5 trillion in the first quarter of 2007. Their share of U.S. banking assets has risen since 2003 to a historical high of 24.1 percent in the first quarter of 2007, well above the previous peak of 22.6 percent in 1991.

A similar pattern is apparent in foreign banking organizations' market shares of loans and deposits. Their total loan holdings rose to \$885 billion, or 14.9 percent, of all loans at the beginning of 2007, after having gone through a trough of 10.9 percent in 2003. The predominant type of asset held in the U.S. branches of foreign banks is commercial and industrial loans. Recent trends suggest that foreign banks remain active in business lending, as the annual growth rate of business loans (nearly 29 percent) mirrors that of growth in total loans over the same period (from the end of 2003 through the first quarter of 2007).

Finally, foreign banking organizations' 27.6 percent share of deposits confirms that they are important competitors in the United States. Moreover, the growth in deposit share for these organizations suggests that foreign banking companies will remain important competitors in U.S. financial markets.

Deposits of Domestic and Foreign Banks in the U.S.*



Footnotes and Sources

*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 2006); U.S. commercial banks, of which more than 25 percent 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.

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

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

Source: Federal Reserve Board, Structure and Share Data for U.S. Offices of Foreign Banks.

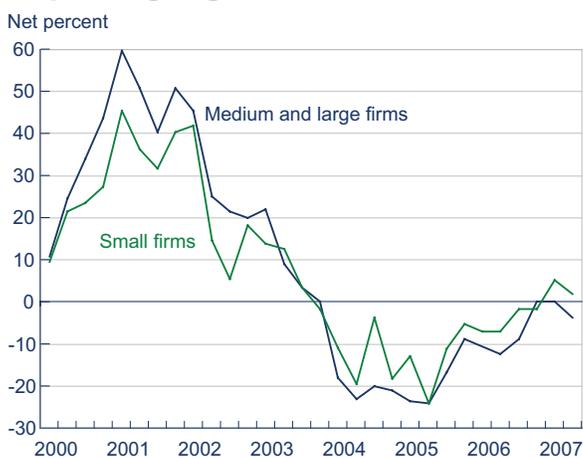
Banking and Financial Institutions

Business Loan Markets

08.06.07

by James Thomson and Cara Stepanczuk

Domestic Banks Reporting Tighter Credit Standards



Source: Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, March 2007.

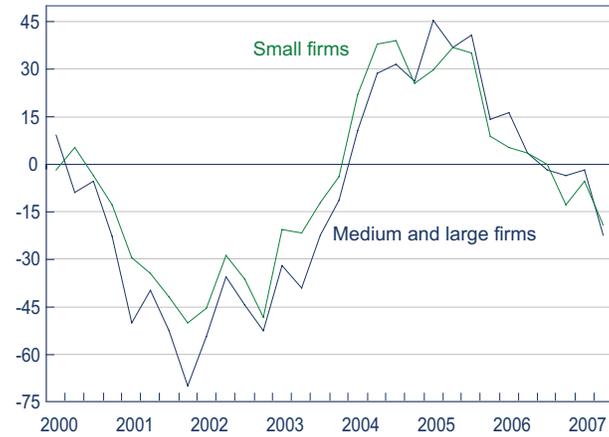
The April 2007 Senior Loan Officer survey (covering the months of February, March, and April) revealed a slight increase in credit availability for businesses. After a slight tightening of standards reported on the previous survey, domestic and foreign banks reported that their lending standards were little changed for commercial and industrial loans for borrowers of all sizes in the last three months. More domestic banks narrowed their lending spreads (loan rates over the cost of funds), attributing their decision to more aggressive competition from other banks and nonbank lenders, and increased liquidity of business loans in the secondary market. Many foreign banks, as well as some domestic banks, also reduced the cost of credit lines and eased loan covenants.

Demand for commercial and industrial loans continued to weaken over the past three months, and at a faster rate, than reported in the January survey. Those institutions that reported weaker demand for commercial and industrial loans cited as motivation a decreased financing need for accounts receivable and competition from other credit sources.

Bank balance sheets have yet to reflect the decline in businesses' appetite for bank loans in the face of stable credit standards. The \$35 billion increase in

Domestic Banks Reporting Stronger Demand

Net percent



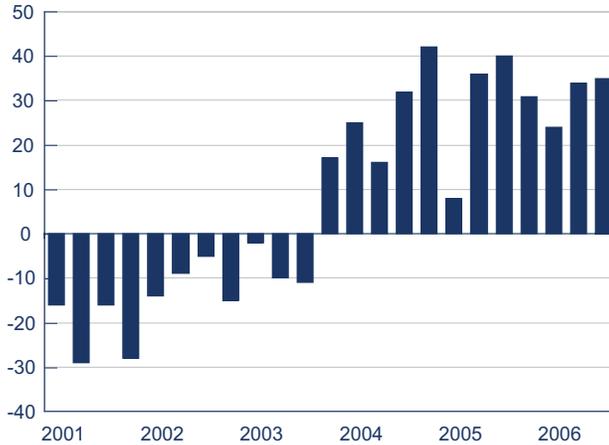
Source: Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, March 2007.

bank and thrift holdings of business loans in the first quarter of 2006 marks the twelfth consecutive quarter of increase in the bank and thrift holdings of commercial and industrial loans. The sharp reversal in the trend of quarterly declines in commercial and industrial loan balances on the books of FDIC-insured institutions prior to the second quarter of 2004 is still going strong.

The utilization rate of business loan commitments (drawdowns on prearranged credit lines extended by banks to commercial and industrial borrowers) held at 36.3 percent of total commitments, potentially indicating the declining importance of bank credit to commercial borrowers as a result of easier access to capital markets. However, this trend could reverse if current problems in housing markets and subprime mortgages spill over into the corporate debt market.

Quarterly Change in Commercial and Industrial Loans

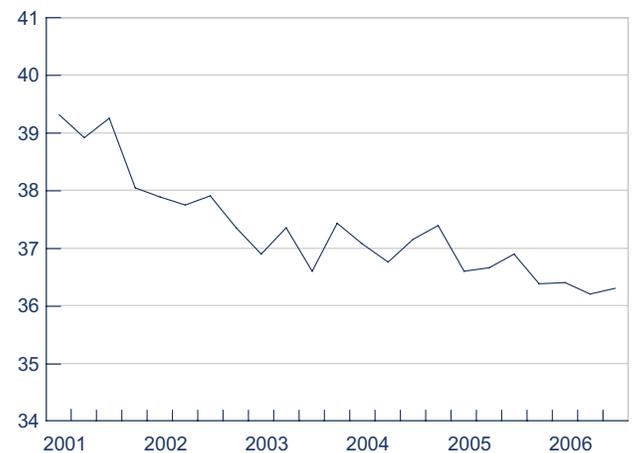
Billions of dollars



Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile, First Quarter 2007.

Utilization Rate of Commercial and Industrial Loan Commitments

Percent of loan commitments



Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile, First Quarter 2007.