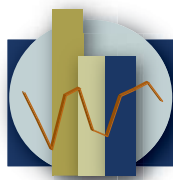


Federal Reserve Bank of Cleveland



Economic Trends

September 2007

(Covering August 10, 2006–September 18, 2007)

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09.20.07

by Mark S. Sniderman

Many people have become anxious about the future course of the U.S. economy and financial system. How could they not, with the unrelenting media coverage of companies in distress, markets seizing up, and credit conditions tightening throughout the land? If a recession were declared tomorrow, would anyone be surprised?

In fact, most economists would. Recessions are very particular economic events, requiring broad-based and persistent declines in production, spending, and employment. As of today, the U.S. economy has not shown any of these characteristics, although payroll employment did decline from July to August. Indeed, according to most of the economic data in hand, the U.S. economy has been expanding at a moderate pace, notwithstanding the residential construction sector's drag on total spending.

So why the front page gloom and doom? Well, credit markets have become tighter for many borrowers over a wide range of financial markets. That mortgage markets have tightened up for many borrowers is not surprising; after all, lax mortgage lending standards created much of our present difficulty. But there are other reasons as well. Domestic and foreign investors, the source of the extra cash that propelled our economy in the past few years, have suddenly become deeply skeptical about some of the investment products being offered to them. They are dubious about the stated quality of those products and their liquidity. As one senior bank examiner put it, investors have gone "on strike."

The investor pullback is posing some unique challenges to the global financial system. Many institutions have made a good living by selling financial instruments designed to meet their customers' need for quality, price, maturity, and risk. In recent years, these instruments have become highly complex because they are claims on pools of various kinds of debt obligations (for example, home mortgages, commercial mortgages, credit card receivables, and auto loans) and the market for these asset-backed securities has become fragile. With investors less willing to acquire assets structured into these kinds of products, millions of people who indirectly relied on them for funds now must wait for financial intermediaries to obtain funds from these investors under terms and conditions unlike those that prevailed until recently.

It is proving to be quite a task. One consequence is that some borrowers cannot obtain funds at all; others can, but only at higher interest rates and on stricter terms than before. Another consequence is that some investors are only willing to commit their funds to financial intermediaries for very short periods—overnight or weekly—rather than the intervals of 30 to 180 days that were commonplace in more tranquil times. Financial intermediaries are understandably reluctant to make long-term loans on the basis of such fragile short-term funding. Some financial institutions that have plenty of secure funding are reluctant to extend credit to their counterparties who, they fear, will not be able to pay them back. Some institutions have obligations to extend credit to customers who cannot find it in the open market; in fulfilling these obligations, they reduce their capacity for lending to other customers. There is sand in the gears, and the financial transmission system needs an overhaul.

The textbook solution to this problem is fairly straightforward: Let markets re-price financial assets and the cost of risk; let them decide which financial institutions are illiquid but solvent, as opposed to illiquid and insolvent. And let central banks provide the cash the market as a whole needs as it gropes to establish a new equilibrium. If a central bank does extend credit to institutions that cannot find funding in the open market, it should require that the credit be secured by good collateral, and it should provide no subsidies.

Central bankers have learned a few things about financial market crises over the years. They have learned that in a crisis, markets may function poorly. Because accurate information can be difficult to come by, people become risk-averse; markets may seize up and credit may not flow efficiently. Consequently, central banks look for opportunities to improve on market outcomes, but they are mindful that certain kinds of interventions could lull private market participants into a false sense of security about risk management, including liquidity risk. Finally, central bankers have learned that no matter what they do, their actions will be grist for someone's mill.

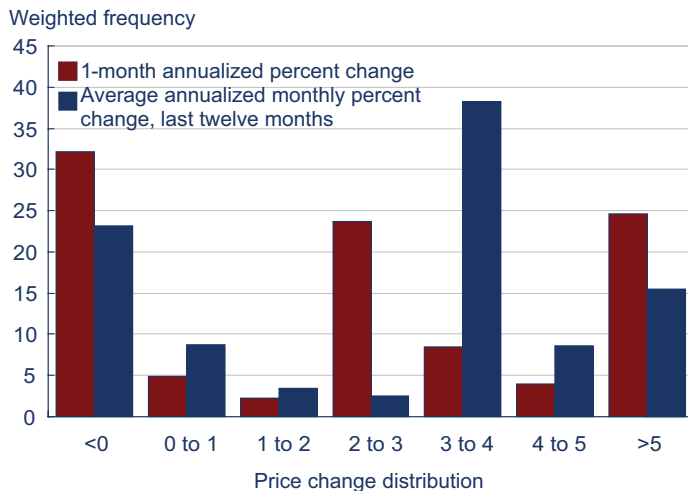
Yesterday the Federal Reserve reduced its federal funds rate target and discount rate on primary credit by 50 basis points each. The FOMC's statement indicated that its action was "intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." Let the millstones turn.

July Price Statistics

09.04.07

by Michael F. Bryan and Brent Meyer

CPI Component Price Change Distributions



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

The Consumer Price Index (CPI) continued to show signs of moderation in July, increasing only 1.4 percent (annualized rate) after rising 4.9 percent over the past six months and 4.0 percent over the past three. The core CPI (excluding food and energy) rose 2.9 percent in July, surpassing its recent trend. Many energy-component prices fell in July, as the aggregated energy index decreased 11.5 percent. Some food prices decreased as well, such as meat, poultry, egg, and fish prices, which fell 4.7 percent in July.

While traditionally the CPI's most volatile components, transitory disturbances to the aggregate price data are not always confined to food and energy items. Men's and boy's apparel, footwear, and medical care prices all posted uncharacteristic increases this month. For example, men's and boy's apparel posted its largest annualized monthly increase since August 1991, jumping 17.6 percent during the month.

An alternative to the traditional measure of core inflation are trimmed-mean inflation statistics, which help us identify the underlying inflation trend regardless of the offending source of the transitory disturbance. (To read more on this subject click [here](#), or for more on the median CPI and to see the disaggregated component price changes click [here](#).) Two such measures, the median CPI and the 16 percent trimmed mean CPI, increased 2.0 percent and 1.8 percent, respectively, in July, both moderating from long-term trends.

A broad deceleration in prices can also be inferred by the component-price-change distribution. Almost two-thirds of the CPI's components increased at rates exceeding 3 percent over the past 12 months, compared to 37 percent in July. Also, nearly one-third of the index decreased in July, as opposed to only 23 percent over the past 12 months.

July Price Statistics

	Percent change, last					
	1mo. ^a	3mo. ^a	6mo. ^a	12mo.	5yr. ^a	2006 avg.
Consumer prices						
All items	1.4	4.0	4.9	2.4	3.0	2.6
Less food and energy	2.9	2.5	2.2	2.2	2.1	2.6
Median ^b	2.0	1.8	2.4	2.9	2.6	3.6
16% trimmed mean ^b	1.8	2.1	2.6	2.5	2.3	2.7
Producer prices						
Finished goods	7.5	5.2	8.9	3.9	3.9	1.6
Less food and energy	1.5	2.5	2.1	2.4	1.5	2.1

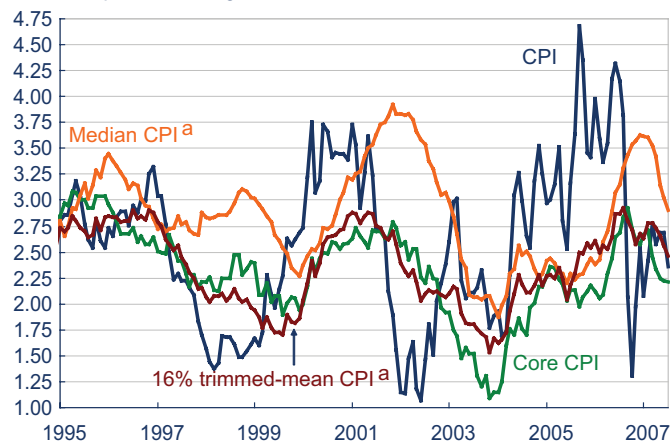
a. Annualized.

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, Core CPI, and Trimmed-Mean CPI Measures

12-month percent change

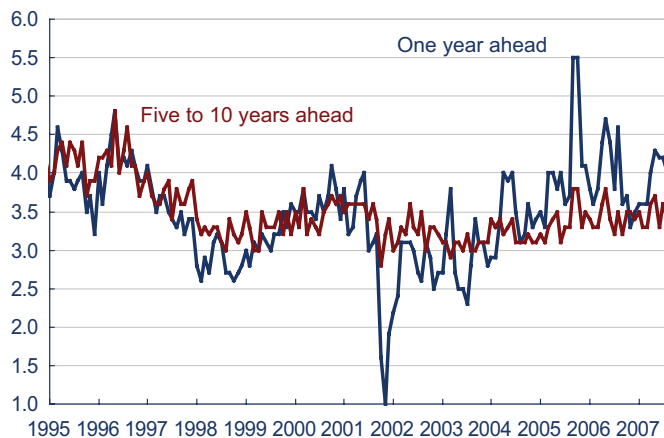


a. Calculated by the Federal Reserve Bank of Cleveland.

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

Household Inflation Expectations*

12-month percent change



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

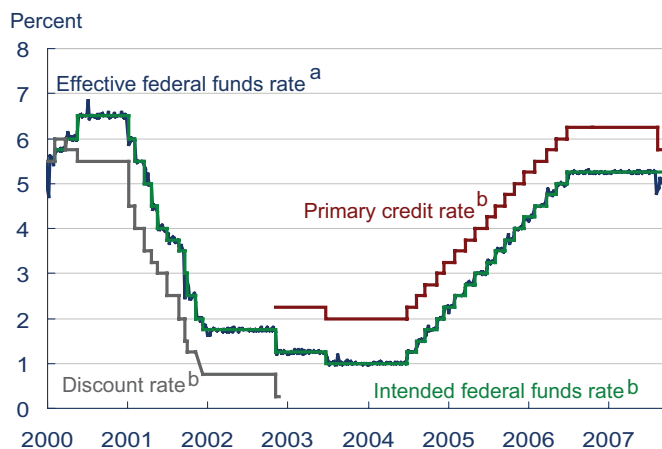
Source: University of Michigan.

Long-run inflation trends have also inched lower recently. The 12-month trend in the core CPI and the 16 percent trimmed-mean CPI have been decreasing since February and now range between 2.2 percent and 2.4 percent. The 12-month trend in the median CPI has fallen under 3 percent for the first time since May 2006 and now stands at 2.9 percent.

Inflation expectations, as measured by the University of Michigan's Survey of Consumers, have come down some over the past three months. In August, households' inflation expectation for the coming year was 4.0 percent—still somewhat elevated, but down from their expectation of the previous few months. Longer-term household inflation expectations have also moved just a bit lower recently, falling from 3.6 percent in July to 3.4 percent in August.

The Long-Anticipated Rate Cut

Reserve Market Rates

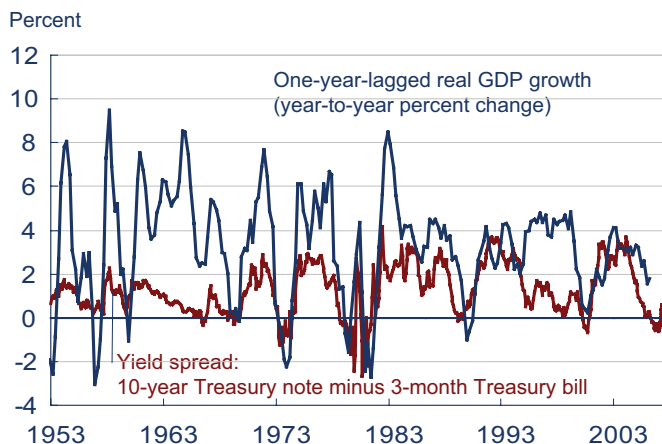


a. Weekly average of daily figures.

b. Daily observations.

Sources: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

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.

09.18.07

by John B. Carlson and Michael Shenk

fig 1,2, 5, 6, 3, 4, The Federal Open Market Committee voted unanimously today to lower the fed funds target 50 basis points to 4.75 percent. This was the first rate cut since June 2003. In a related action, the Board of Governors approved a 50 basis point reduction in the Primary Credit rate to 5.25 percent. This action followed a 50 basis point reduction on August 17.

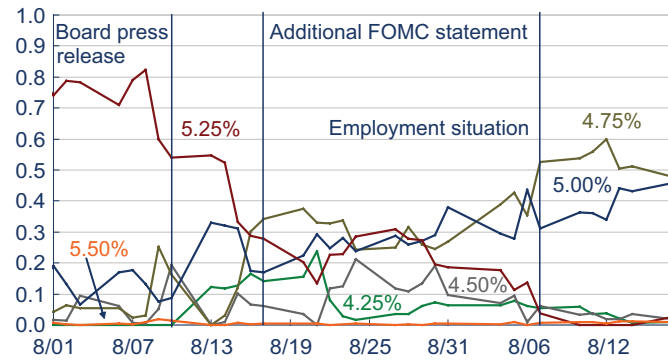
The Committee's statement emphasized that "today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." Recognizing that readings on core inflation had improved modestly this year, the FOMC noted, however, "that some inflation risks remain, and it will continue to monitor inflation developments carefully."

Although the prices of futures and options on fed funds suggested that market participants expected a rate cut, opinion was somewhat divided between a 25 basis point cut and a 50 basis point cut. In any case, equity markets welcomed the Committee's choice. Broad market indexes jumped almost three percentage points after the policy announcement.

The period since the August 7 FOMC meeting has been eventful to say the least. Within days of that meeting, it had become evident that the default rate on subprime mortgages was much higher than had been anticipated. Furthermore, it was rapidly becoming clear that the effects of the jump in foreclosures were spilling over into other markets, generating a substantial and rather sudden increase in financial market volatility. The market turmoil caused many lenders to back away from markets, putting a strain on banks, which had established backup credit arrangements with the stranded borrowers. The strain on the banking system to provide the full amount of credit came into question.

September Meeting Outcomes*

Implied probability



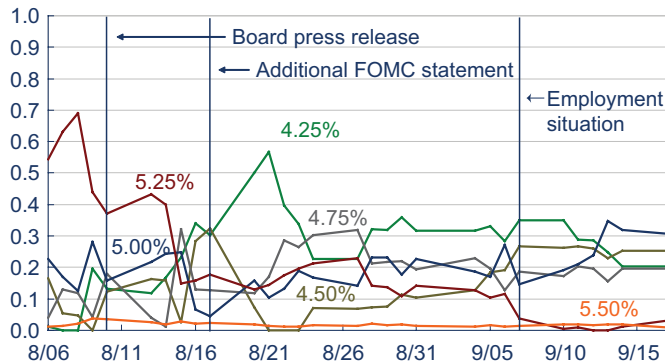
*Probabilities are calculated using trading-day closing prices from options on January 2007 federal funds futures that trade on the Chicago Board of Trade. Source: Chicago Board of Trade and Bloomberg Financial Services.

It was but three days from that meeting that the Board of Governors responded to assuage market concerns in a press release. The August 10 statement said:

“The Federal Reserve will provide reserves as necessary through open market operations to promote trading in the federal funds market at rates close to the Federal Open Market Committee’s target rate of 5¼ percent. In current circumstances, depository institutions may experience unusual funding needs because of dislocations in money and credit markets. As always, the discount window is available as a source of funding.”

October Meeting Outcomes

Implied probability



Probabilities are calculated using trading-day closing prices from options on January 2007 federal funds futures that trade on the Chicago Board of Trade. Source: Chicago Board of Trade and Bloomberg Financial Services.

The announcement fueled expectations that the FOMC would follow with a sequence of reductions in the fed funds target. Indeed, implied yields on prices of fed funds futures suggested that some market participants believed that an intermeeting rate cut was possible in August.

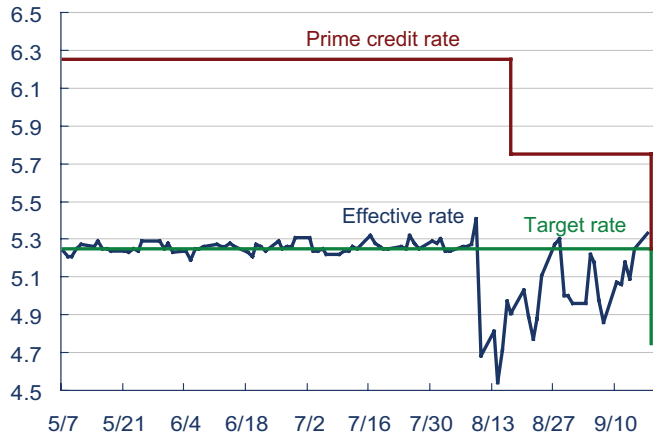
The FOMC did not change rates before today’s meeting, but it met on August 17 and issued a statement, which was released in conjunction with one from the Board of Governors announcing that it had voted to decrease the primary credit rate at the Reserve Banks from 6¼ percent to 5¾ percent, effective immediately. The FOMC’s statement read:

Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.

Such an intermeeting statement is very unusual, but it reflected the unusual nature of the circumstances. The FOMC had found little evidence that financial turmoil had yet substantively affected economic activity. Thus, the statement sought to reassure markets that it would act promptly to cut the funds rate if it were to see adverse effects on the economy.

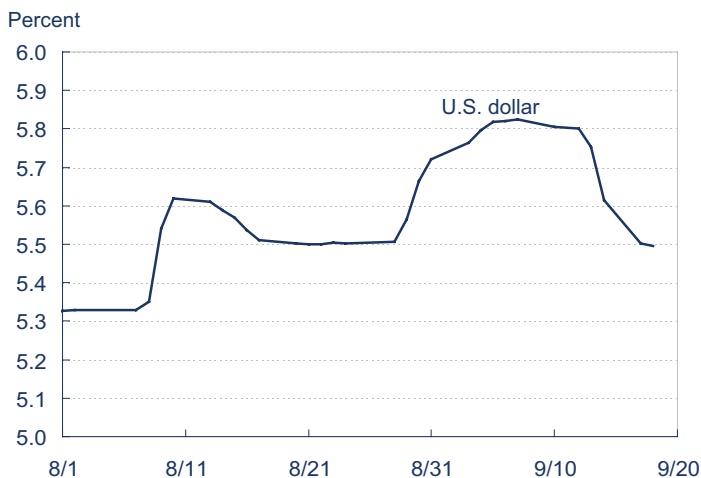
Effective Federal Funds Rate

Percent



Source: Federal Reserve Board, “Selected Interest Rates,” *Federal Reserve Statistical Releases*, H.15.

One-Month LIBOR Rates



Source: Bloomberg Financial Services.

The announcement generally reinforced a shift in market participants' beliefs about the future path of policy. A rate cut by September at this point seemed likely. The question was whether it would be a 25 basis point cut or a 50 basis point cut. The odds of the more dramatic action increased sharply when a weak employment report offered some evidence that the economy was being adversely affected.

Although the FOMC did not officially vote to reduce fed funds rate during the intermeeting period, the effort to supply sufficient reserves resulted in an average daily fed funds rate well below the target rate. The rate traded closer to the target in the past few weeks, however, as markets seemed to calm. Indeed, term lending rates for loans among banks in Europe tended to stabilize if not recede. For example, the one-month London Interbank rate (Libor) has declined over the past week.

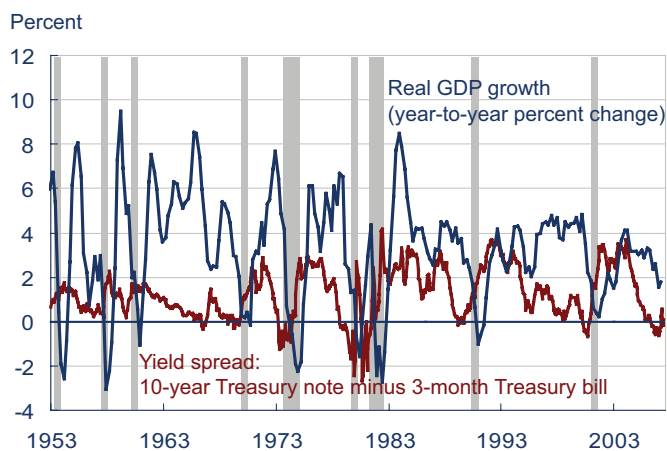
Money, Financial Markets, and Monetary Policy

What Is the Yield Curve Telling Us?

08.28.07

by Joseph G. Haubrich and Katie Cocoran

Yield Spread and Real GDP Growth*

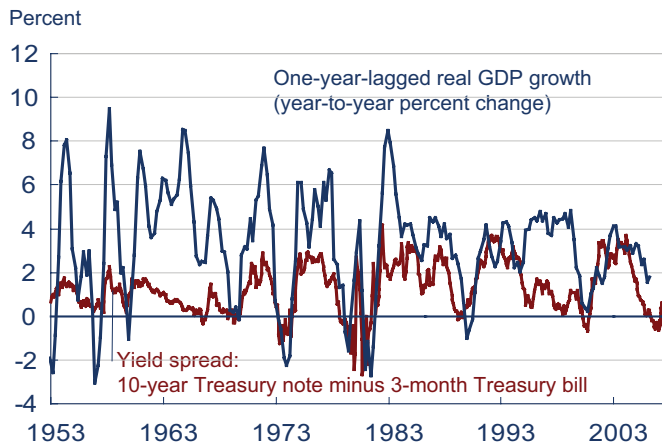


*Shaded bars indicate recessions.

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

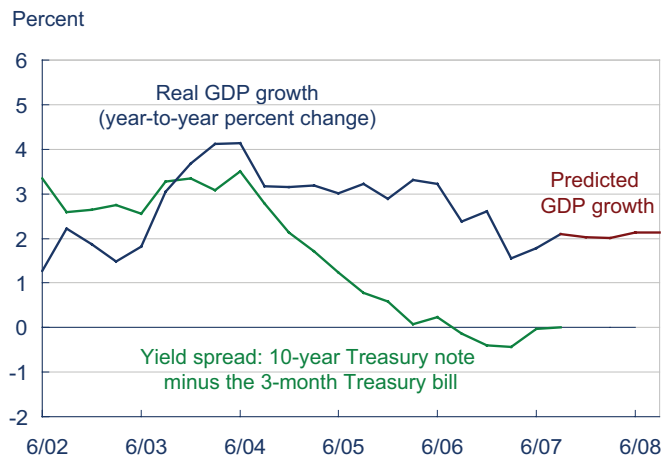
Since last month, the yield curve has twisted downward, with long rates falling more than short rates. This has once again returned the curve to inversion. One reason for noting this is that the slope of the yield curve has achieved some notoriety as a simple forecaster of economic growth. The rule of 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.

Yield Spread and Lagged Real GDP Growth



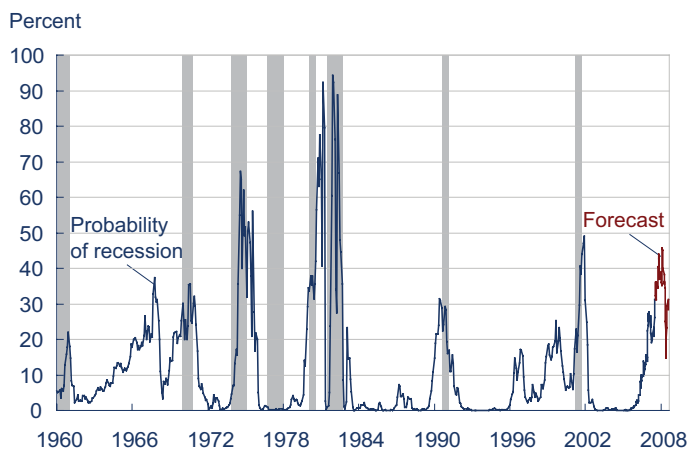
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

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.

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.

The yield curve had been giving a rather pessimistic view of economic growth for a while now, but with a nearly flat curve, this is less pronounced. The spread has turned negative with the 10-year rate at 4.79 percent and the 3-month rate at 4.83 percent (both for the week ending August 10). Standing at -4 basis points, the spread is down from July's 14 basis points and June's 54 basis points, though it remains not nearly as inverted as May's -23 basis points. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 2.1 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. Looking at that relationship, the expected chance of a recession in the next year is 28 percent, up from July's 24 percent, but still down from May's value of 35 percent and April's 38 percent.

The current 28 percent is close to the 26.2 percent calculated by James Hamilton over at Econbrowser (though to be fair, we are calculating different events: Our number gives a probability that the economy will be in recession over the next year; Econbrowser looks at the probability that the first quarter of 2007 was in a recession).

Of course, it might not be advisable to take these numbers quite so literally, for two reasons. First, probabilities are themselves 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 *Economic Commentary* “Does the Yield Curve Signal Recession?”

International Markets

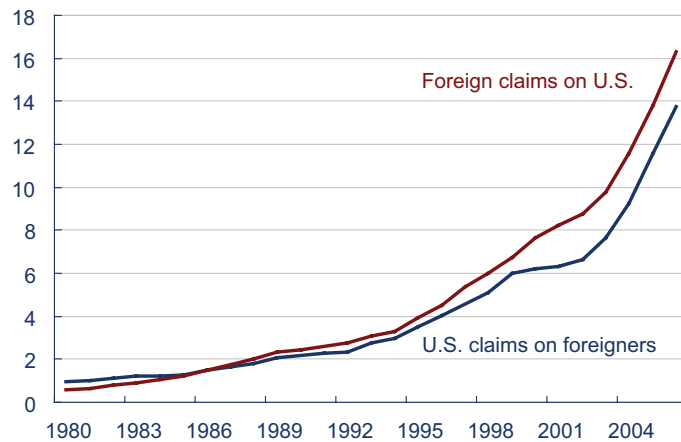
U.S. International Investment Position

09.06.07

by Owen F. Humpage and Michael Shenk

U.S. and Foreign Claims

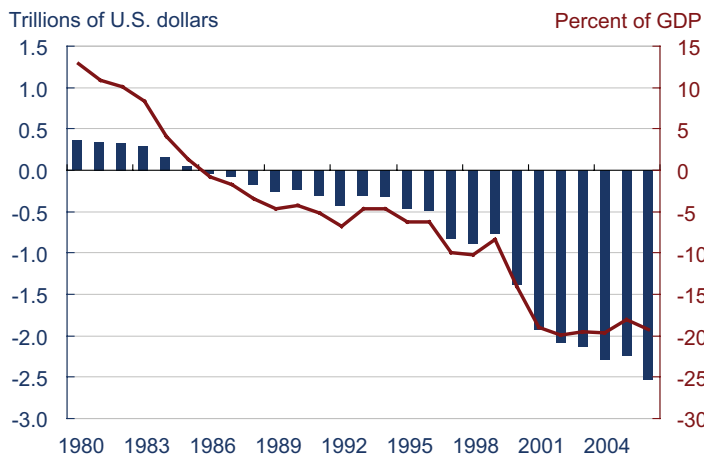
Trillions of U.S. dollars



Sources: Bureau of Economic Analysis; Haver Analytics.

Net International Investment Position

Trillions of U.S. dollars



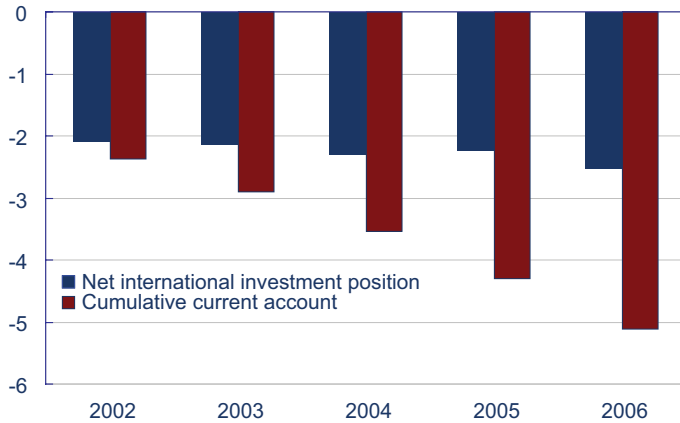
Sources: Bureau of Economic Analysis; Haver Analytics.

The United States has financed its persistent current-account deficits by issuing financial claims—stocks, bonds, bank accounts—to rest of the world. These financial claims essentially entitle the rest of the world to future U.S. output. Since 1982, foreigners have consistently held more claims on the United States than U.S. residents have held on them. Last year, foreigners possessed a net \$2.5 trillion in claims against the United States, an amount equal to 19.2 percent of our GDP.

The Commerce Department’s Bureau of Economic Analysis (BEA) estimates the claims that Americans hold on the rest of the world and that foreigners hold on the United States and publishes the data each July as the International Investment Position of the United States. Year-to-year changes in the international investment position reflect both the financing of our current-account deficits and changes in valuation of previously issued, outstanding financial instruments. Valuation changes stem in part from exchange-rate movements. The BEA estimates the value for most of these financial instruments from current market transactions, but direct investments—those involving a management positions in foreign companies—are difficult to update because their worth may reflect firm-specific and intangible characteristics. The BEA values direct investments for the international investment position of the United States using two alternative methods. The current-costs approach measures affiliates’ investments in plant and equipment using the current cost of capital, the purchase of land using price indexes, and changes in inventories using estimates of replacement costs. The market-value approach relies on stock prices of owners’ equity shares.

The Importance of Valuation Effects

Trillions of U.S. dollars

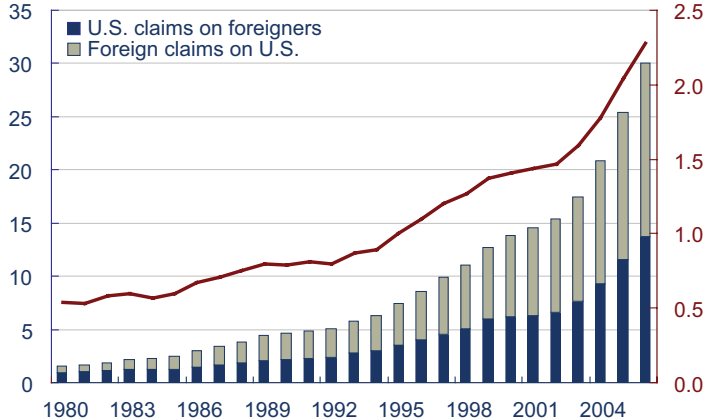


Sources: Bureau of Economic Analysis; Haver Analytics.

Valuation changes can have a profound effect on our net international investment position. Between 2002 and 2006, for example, our cumulative current-account deficit totaled nearly \$3.2 trillion, but our net international investment position fell by a substantially smaller, \$0.6 trillion—from -\$1.9 trillion in 2001 to -\$2.5 in 2006. The offset stemmed from valuation changes that boosted U.S. claims on foreigners relative to foreign claims on the United States. In part, these favorable valuation changes reflect the dollar's steep depreciation over this period. Because far more of U.S. claims on foreigners are denominated in foreign currencies than are foreign claims on us, a dollar depreciation raises the dollar value of our assets by more than our liabilities and improves our net international investment position.

Globalization of Financial Markets

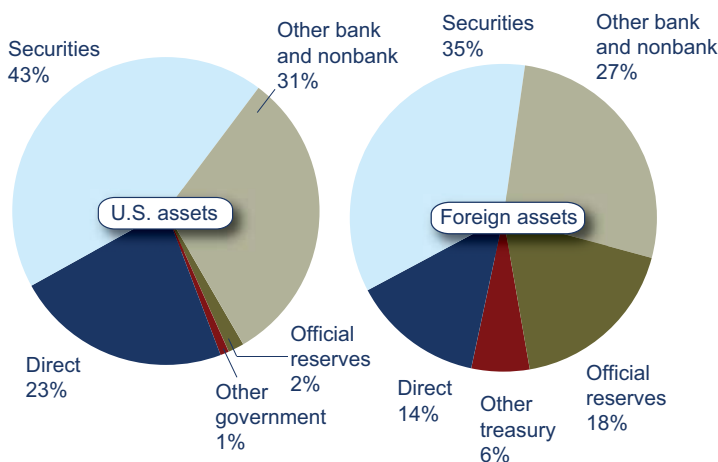
Trillions of U.S. dollars



Sources: Bureau of Economic Analysis; Haver Analytics.

Indicative of the growing globalization of financial markets, both U.S. and foreign assets have increased sharply as a share of GDP since the mid-1990s. Since 1995, foreigners have especially increased their holding of official dollar-denominated reserve assets and their investments in private U.S. securities. In 2006, official reserve assets accounted for 18 percent of all foreign claims against the United States, while private securities amounted to 35 percent of the total. Over this same period, U.S. residents have also added substantial amounts of private foreign securities to their portfolios. Private securities now account for 43 percent of all U.S. claims on foreigners and direct investments make up 23 percent.

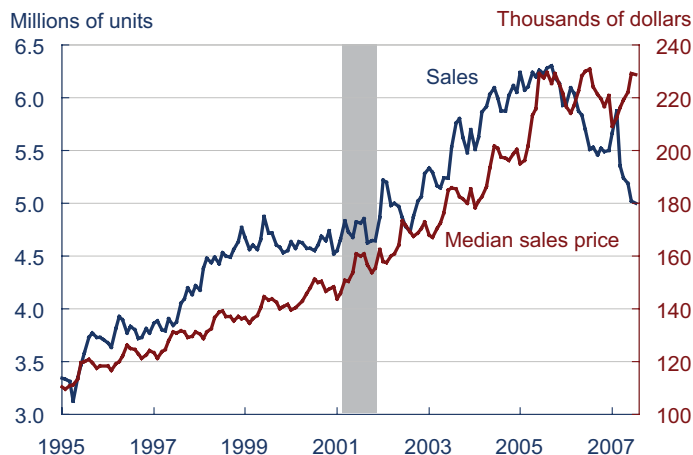
U.S. and Foreign Asset Shares



Sources: Bureau of Economic Analysis; Haver Analytics.

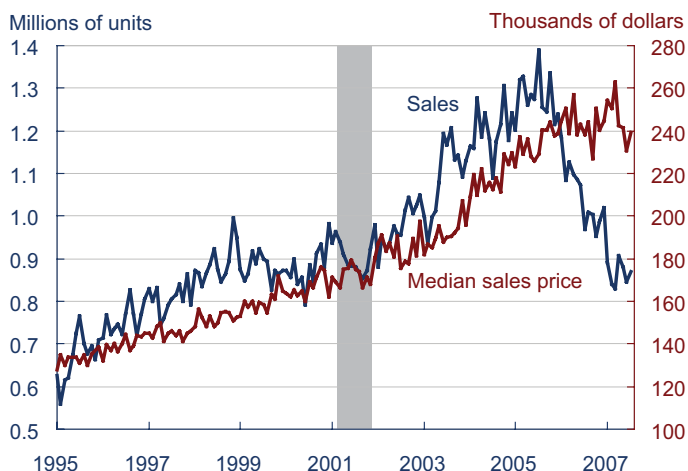
Housing Markets

Existing Single-Family Home Sales



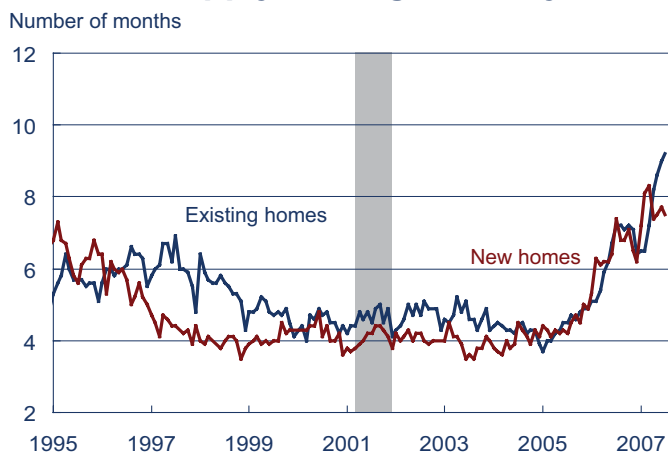
Source: National Association of Realtors.

New Single-Family Home Sales



Source: Census Bureau.

Months' Supply of Single-Family Homes



Sources: Census Bureau; and National Association of Realtors.

09.06.07

by Michael Shenk

Toward the end of each month a great deal of data on the housing market is released. By combing through the data releases we are able to get a fairly good look at what is going on in the housing market. This month's review tells us the market is still in the doldrums.

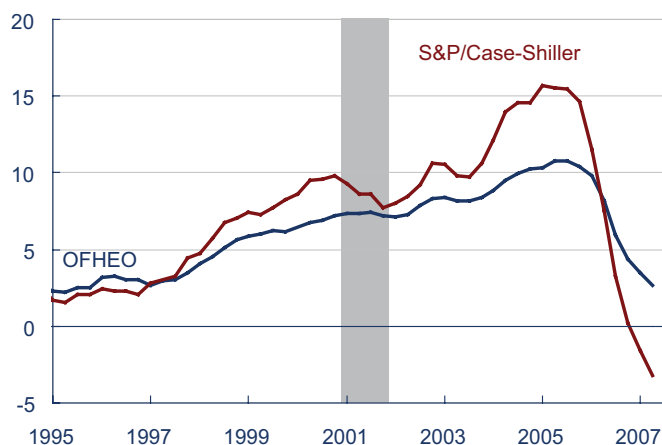
In July, sales of existing single-family homes fell a relatively modest 0.4 percent, after having declined 3.3 percent in June. Since September 2005, when the sales of existing single-family homes peaked, sales have fallen at an annualized rate of 11.8 percent, which translates into the slowest sales pace since September 2002. Since the 2005 peak, the median sales price of existing homes has fluctuated somewhat but on average has remained fairly constant at around \$220,000.

In the market for new single-family homes, sales increased 2.8 percent in July to regain some of June's 4.0 percent decline. Sales of new single-family homes peaked two years ago and have fallen steadily since that time. The pace of the decline over this two-year period has been faster than that of the market for existing homes, coming in at an annualized -20.9 percent. However, of late that pace has slowed somewhat; over the most recent 12-month period, sales have fallen only 10.2 percent. While this is still a rapid rate of decline, it is only about one-third of the pace at which sales were falling during the previous 12-month period. Much like in the market for existing homes, the median price of new single-family homes has fluctuated as sales have fallen, but on average it has remained fairly steady at just above \$240,000.

Both the new and existing home sales releases also include data about inventory levels. Inventories, which are typically measured in months of supply at the current sales pace, are important to the housing market going forward. An oversupply of homes on the market will generally put downward pressure on prices and prolong a return to normal

Housing Price Indexes

Percent change, year over year



Sources: OFHEO; S&P, Fiserv, and MacroMarkets, LLC.

rates of price appreciation. According to the most recent releases, inventories of both new and existing single-family homes remain elevated.

To get a better idea about movements in housing prices, it is useful to look at two other recent releases: the S&P/Case-Shiller home price index and the Office of Federal Housing Enterprise Oversight (OFHEO) housing price index. While each index is constructed differently, both show a rapid decline in the 12-month growth rate of home prices. The S&P/Case-Shiller index, which uses a repeat sales method in order to control for quality, shows an outright decline in prices over the past year for both of the first two quarters of 2007. The OFHEO purchase-only index, which also looks at repeat sales but excludes nonconforming loans*, shows slow annual price appreciation over the same period but no outright decline. Because the OFHEO index excludes pricier homes, it tends to show slower rates of both price increases and price declines when compared to the broader S&P/Case-Shiller index.

*Nonconforming loans are mortgages that either do not meet the underwriting guidelines of Fannie Mae or Freddie Mac or mortgages that exceed the conforming loan limit, a figure linked to an index published by the Federal Housing Financial Board.

Economic Activity and Labor

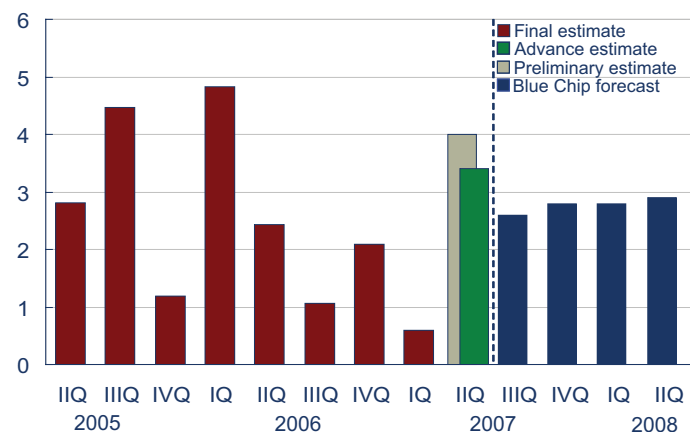
Real GDP: Preliminary Estimate

09.04.07

by Paul W. Bauer and Brent Meyer

Real GDP Growth

Annualized quarterly percent change



Sources: Blue Chip Economic Indicators, August 10 2007; and Bureau of Economic Analysis.

Real GDP grew at a 4.0 percent annualized rate in the second quarter of 2007, well above last quarter's 0.6 percent growth and above the 1.9 percent growth seen over the last four quarters. Personal consumption increased 1.4 percent, down from 3.7 percent in the first quarter. Business fixed investment grew 11.1 percent on a strong increase in structures. Residential investment, however, continued to deteriorate, falling 11.6 percent.

Real GDP growth was revised up from 3.4 percent (annualized rate) in the advanced report, to 4.0 percent in the preliminary estimate. Unfortunately, that may be unsustainable, as the Blue Chip Panel of Economists expects growth to fall back under 3

Real GDP and Components, 2007:II (Preliminary estimate)

2007:IIQ preliminary estimate	Quarterly change, billions of 2000\$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	111.2	4.0	1.9
Personal consumption	29.5	1.4	2.9
Durables	5.2	1.7	5.0
Nondurables	-2.1	-0.4	2.5
Services	26.0	2.3	2.8
Business fixed investment	35.2	11.1	4.1
Equipment	10.9	4.2	0.6
Structures	17.8	27.7	12.8
Residential investment	-15.3	-11.6	-16.4
Government spending	20.2	4.1	1.9
National defense	10.2	8.6	2.8
Net exports	41.0	—	—
Exports	24.9	7.6	7.1
Imports	-16.1	-3.2	1.9
Change in business inventories	5.3	—	—

Source: Bureau of Economic Analysis.

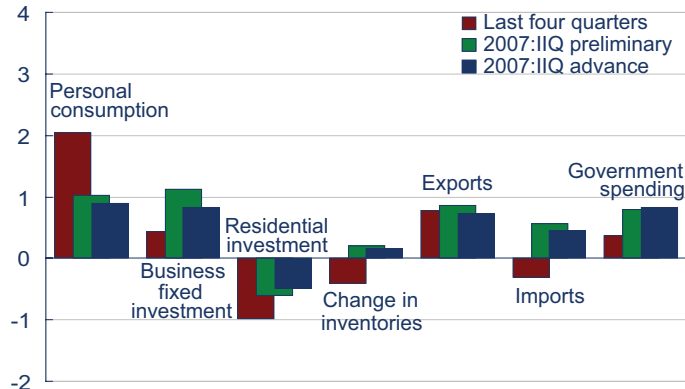
percent well into next year.

Investigating the contribution of various GDP components to the percent change in real GDP tells us that the upward revision was primarily due to upward adjustments in business fixed investment and exports, as well as a downward revision in imports, which was partially taken back by a downward revision to residential investment. Import growth subtracts from GDP growth. Therefore, a downward revision to imports (-3.2 percent from -2.6 percent) translates into a bump in real GDP growth of 0.1 percentage point.

The final release for the second quarter of 2007 is due on September 27, 2007. Looking back over the last four quarters, final revision usually puts GDP growth in between the advanced and preliminary estimates (with the exception of last quarter). While completely arbitrary, since the revisions are based on more complete information and not an average of the first two estimates, if the observation holds true with the next revision, this should still prove to be the strongest quarter (for GDP growth) since the first quarter of 2006.

Contribution to Percent Change in Real GDP

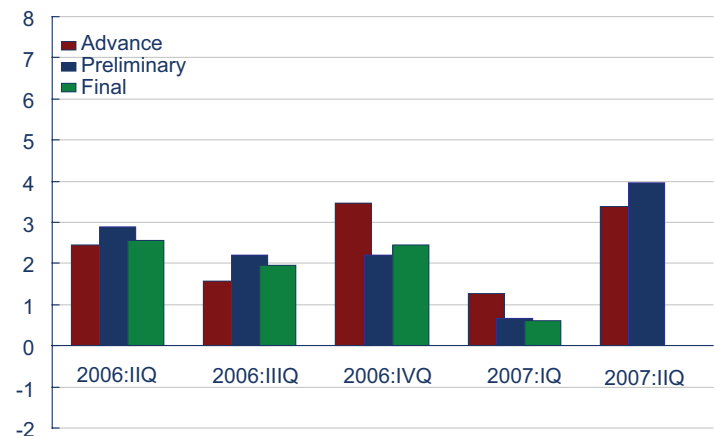
Percentage points



Source: Bureau of Economic Analysis.

Revisions to GDP

Annualized percent change

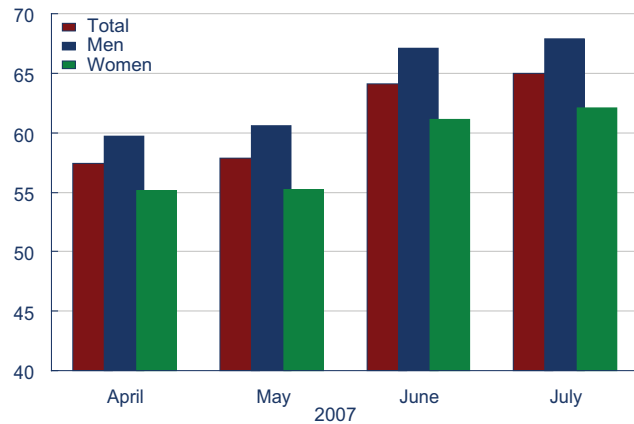


Source: Bureau of Economic Analysis.

Younger Workers and Summertime Employment

Labor Force Participation Rate: Ages 16–24

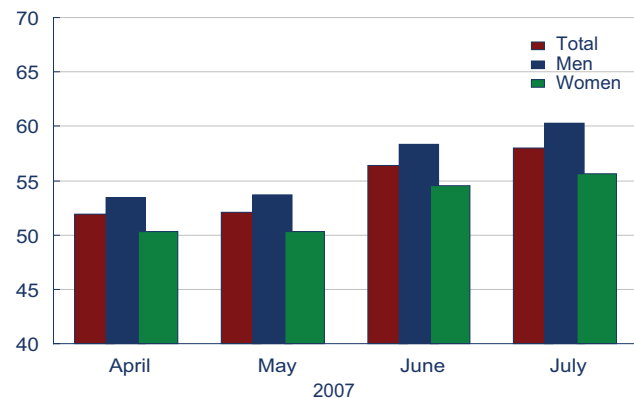
Percent (not seasonally adjusted)



Source: Bureau of Labor Statistics.

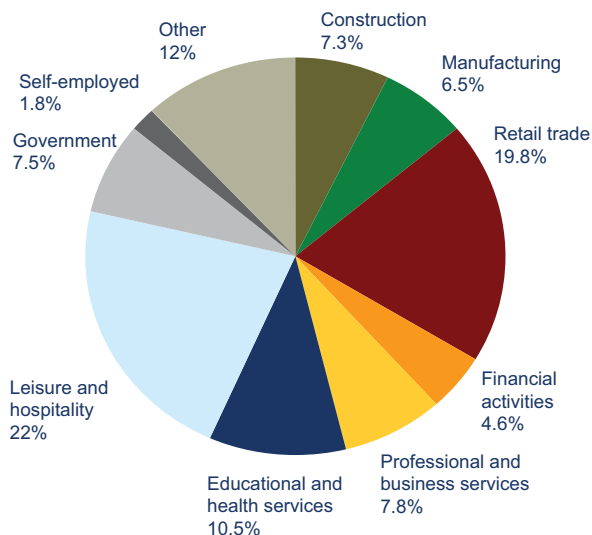
Employment-to-Population Ratio: Ages 16–24

Ratio (not seasonally adjusted)



Source: Bureau of Labor Statistics.

Employment by Industry: Ages 18–24



Source: Bureau of Labor Statistics.

09.04.07

by Murat Tasci and Bethany Tinlin

Each year before summer begins, a substantial number of high school and college students enters the labor market, as they look for temporary or permanent employment. Many of them do in fact find a job. This year, the number of employed workers between the ages of 16 and 24 increased 2.3 million from April to July, according to a recent report by the Bureau of Labor Statistics.

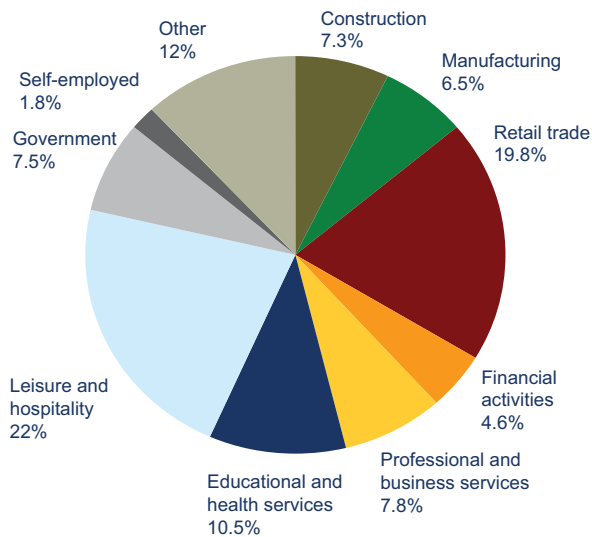
In addition to the workers in this age group who found jobs, there were others who were looking but didn't find one—the sum of these two being the total youth labor force. The size of this labor force increased over the period as well, from 21.4 million to 24.3 million. As a result, the labor force participation rate for this age group rose from April to July as well, from 57.4 percent to 65 percent.

The summertime employment of younger workers typically peaks around July, and this year was no different. The bulk of the increase occurred in June—almost 70 percent of the additional 2.3 million young workers entered the employment pool in June alone.

The industry employing the greatest percentage of these young workers in July 2007 was leisure and hospitality (22 percent). Retail trade was second in terms of industries employing workers in this age group (close to 20 percent). Youths employed in other industries—education and health services, professional and business services, government, construction, and manufacturing—totaled nearly 40 percent.

Some differences emerged in the summer labor market outcomes of males and females in this age group. The rise in the labor force participation rate of younger workers was somewhat stronger among men than women—it rose 13.7 percent for men, 12.7 percent for women. The rise in employment between April and July was likewise significantly higher for men, generating a 13 percent rise in the employment-to-population ratio, whereas

Employment by Industry: Ages 18–24



Source: Bureau of Labor Statistics.

for women the ratio rose only 10.6 percent. The relatively higher rate of men's employment during this period also translates into a smaller increase in the number of those that remained unemployed throughout the same period. Even though the male labor force expanded substantially, a significant proportion of male workers were able to find jobs during this period, resulting in only a 4.7 percent rise in their unemployment rate from April to July. Young women were not as successful in finding employment and experienced a 20.4 percent rise in their unemployment rate during the same period.

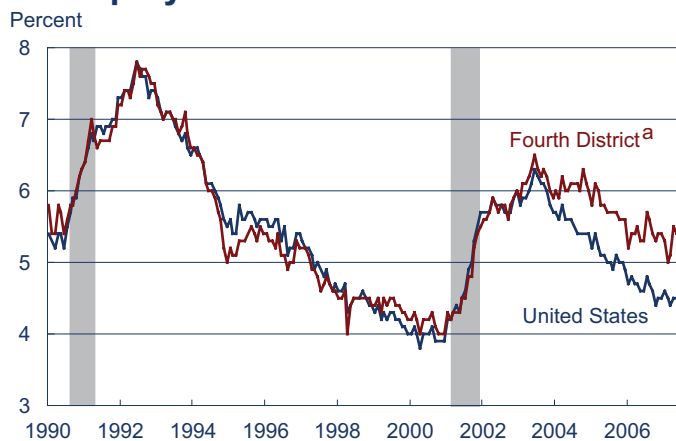
Regional Activity

Fourth District Employment Conditions

08.21.07

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>.

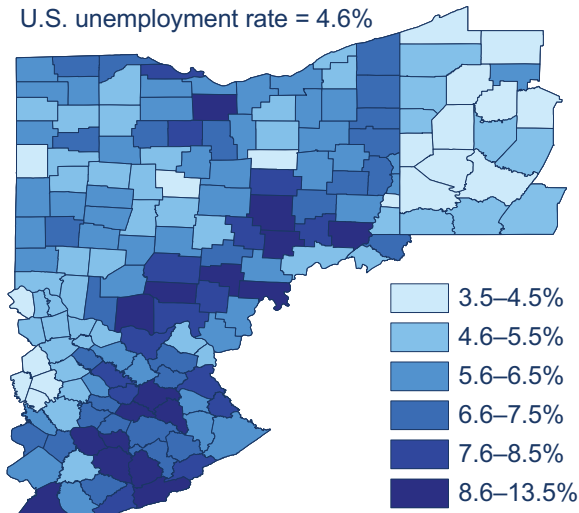
Source: U.S. Department of Labor, Bureau of Labor Statistics.

The district's unemployment rate rose to 5.6 percent in June (a 0.2 percent increase over May's rate). The increase mirrors the small increase in the national unemployment rate (0.1 percent). Analysis of the Fourth District's underlying employment statistics offers insight into the rate increase. The number of workers employed in the district actually increased (0.1 percent), but because the number of people in the labor force increased as well (0.4 percent), the number of unemployed workers rose 3.9 percent. On a year-over-year basis, the Fourth District's unemployment rate increased 0.3 percent while the national unemployment rate remained unchanged.

Of the 169 counties in the Fourth District, 20 had an unemployment rate below the national average in June, 1 had a rate equal to it, and 148 had a higher rate. Rural Appalachian counties continue to experience high levels of unemployment—seven rural Appalachian counties have unemployment rates above 10 percent. Fourth District Pennsylvania's unemployment rate (at 4.5 percent) remains slightly below the nation's, while Fourth District Kentucky and Ohio have unemployment rates (5.8

Unemployment Rates, June 2007*

U.S. unemployment rate = 4.6%



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

percent and 6.1 percent) well above the nation's. Unemployment rates for the District's major metropolitan areas ranged from a low of 4.1 percent in Pittsburgh to a high of 6.4 percent in Toledo.

Cleveland and Toledo have experienced declines in nonfarm employment over the last 12 months of -0.5 percent and -1.2 percent, respectively. Lexington is the only metropolitan area where nonfarm employment grew faster (2.1 percent) than the national average (1.5 percent). Employment in goods-producing industries fell nationally and in almost all District cities except for Akron, which added 0.3 percent more goods-producing jobs over the past year. Cleveland, Columbus, Cincinnati, and Dayton all lost goods-producing jobs at more than double the national rate. Service-providing employment increased in six of the eight major metropolitan areas of the Fourth District, with Lexington posting strong growth (2.8 percent). Employment in professional and business services grew in all Fourth District metro areas except for Cleveland (-0.7 percent) and Toledo (-0.8 percent). All major District metro areas posted job gains in the education and health services industry.

Payroll Employment by Metropolitan Statistical Area

	12-month percent change, June 2007								
	Cleveland	Columbus	Cincinnati	Pittsburgh	Dayton	Toledo	Akron	Lexington	U.S.
Total nonfarm	-0.5	0.2	0.2	0.4	-1.2	0.0	1.1	2.1	1.5
Goods-producing	-1.9	-1.7	-1.9	-0.4	-2.7	-1.3	0.3	-0.8	-0.8
Manufacturing	-2.9	-1.4	-1.5	-1.1	-3.1	-1.9	0.2	-1.7	-1.3
Natural resources, mining, construction	1.6	-2.4	-2.8	0.2	-1.2	0.6	0.6	1.5	0.1
Service-providing	-0.2	0.5	0.7	0.5	-0.8	0.3	1.3	2.8	1.9
Trade, transportation, utilities	-0.5	0.1	-0.1	-0.1	-2.7	-0.9	0.1	-1.5	1.0
Information	0.5	-2.6	-3.1	-1.3	0.0	4.9	0.0	6.4	1.6
Financial activities	-0.8	-1.4	-0.8	-1.6	1.5	-0.8	-1.4	2.7	1.2
Professional and business services	-0.7	1.5	0.5	1.4	-1.1	0.9	3.5	1.3	2.0
Education and health services	0.4	1.4	3.7	2.3	0.0	1.0	1.8	1.9	3.2
Leisure and hospitality	0.0	2.6	1.0	-0.3	-0.3	-0.3	1.5	7.7	3.6
Other services	1.3	-2.3	1.2	-1.1	0.0	0.0	-0.7	-1.0	1.0
Government	-0.4	0.2	-0.3	0.5	-0.8	1.5	1.3	6.4	1.5
June unemployment rate (percent, seasonally adj.)									
	5.9	5.1	5.3	4.1	6.3	6.4	5.9	4.2	4.6

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

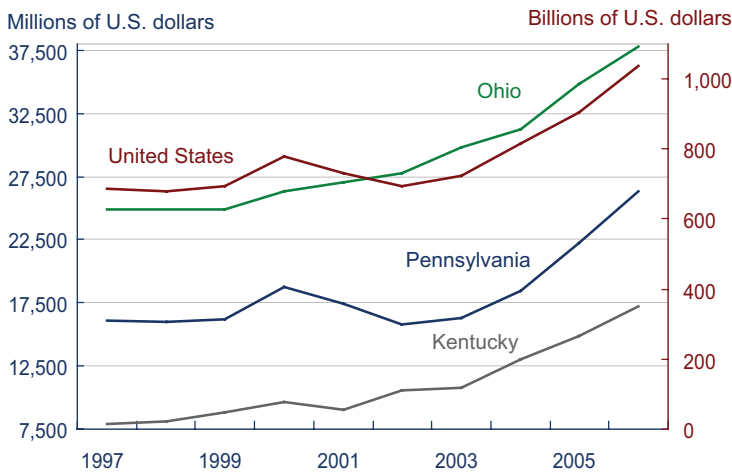
Regional Activity

Ohio Exports

8.20.07

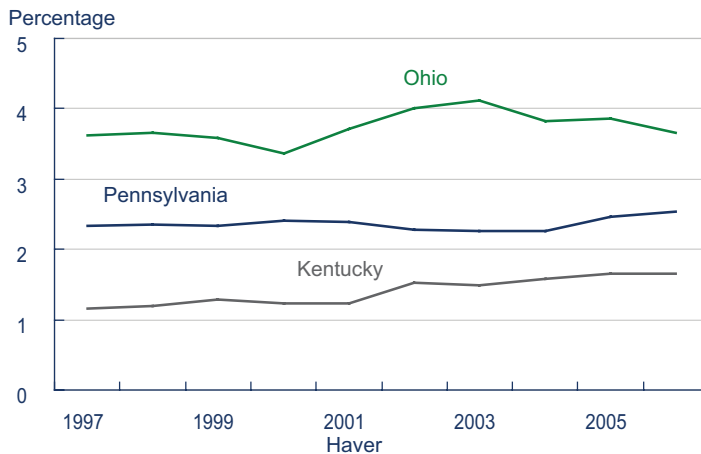
by Tim Dunne and Kyle Fee

State and U.S. Exports



Sources: MISER/WISER, Census Bureau; and Haver Analytics.

State Share of Total U.S. Exports



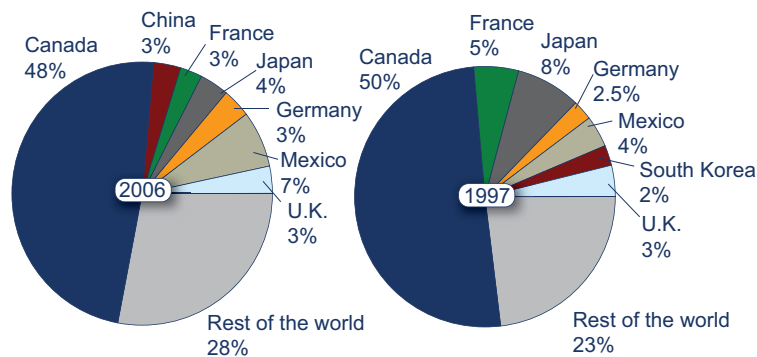
Sources: MISER/WISER, Census Bureau; and Haver Analytics.

Exports from Ohio grew at a nominal rate of 8.7 percent from 2005 to 2006, according to a recent U.S. Census Bureau report. In comparison, the nation's exports grew at a nominal growth rate of 14.7 percent, while exports out of Pennsylvania and Kentucky (other Fourth District states) grew at rates of 18.2 percent and 15.7 percent. Ohio exported \$37.3 billion of goods and services in 2006, more than most states. Only six states exported more, California and Texas ranking first and second among them.

Since 1997, Ohio's share of total U.S. exports has remained relatively steady, hovering between 3.6–4.1 percent. Kentucky's share, while significantly less than Ohio's, has grown steadily over time, rising about 0.5 percent from 1997 to 2006. Pennsylvania's share of exports grew slightly over the same period.

With respect to Ohio's trading partners, Canada receives the largest share of the state's exports (48.3 percent in 2006), which reflects a strong flow of automotive-related goods. Mexico is Ohio's the next-largest trading partner, taking in 7.1 percent of Ohio's exports. The share of the state's exports going to Mexico increased 80 percent from 1997 to 2006, while the share going to China increased roughly 260 percent over the same period, though the volume of exports to China remains relatively small (\$1.3 billion of goods in 2006). In contrast, the share of exports going to Japan has been cut in half. Compared to other states, a much larger fraction of Ohio's exports go to Canada, which is not too surprising given Ohio's proximity to Canada and the distribution of that country's industries.

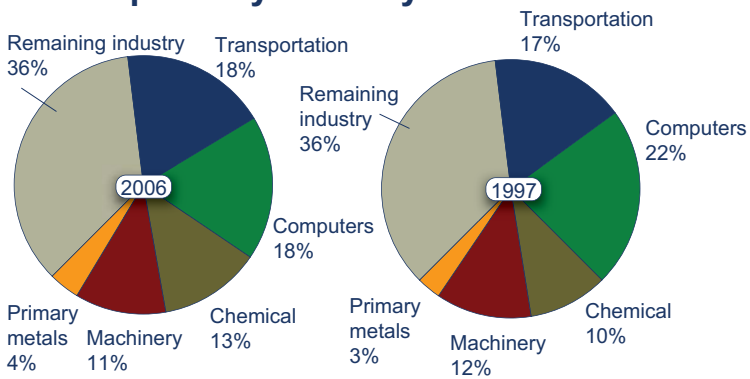
Ohio Exports by Country



Sources: WISER; and Haver Analytics.

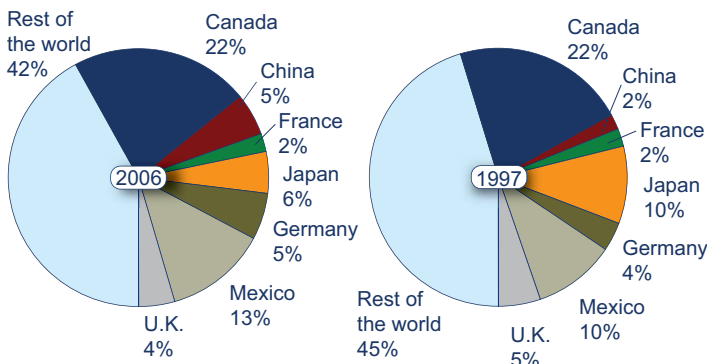
In terms of the industrial composition of exports, the industries with the largest export shares in 2006 are transportation (34 percent), machinery (14 percent), and chemicals (12 percent). These same three industries were the leading Ohio exporters in 1997. Compared with the nation as a whole, Ohio has

U.S. Exports by Industry



Source: WISER; and Haver Analytics.

U.S. Exports by Country



Source: WISER; and Haver Analytics.

higher export share of transportation equipment but a lower share of computer equipment. This is particularly true for agricultural commodities and for some manufactured goods that are sold through out-of-state distribution centers.

Some products are intermediate goods that are used to produce exported goods but are not counted as exports in the trade statistics. The Census Bureau, in its publication *Exports from Manufacturing Establishments*, estimates the value of manufactured exports and their related employment by state, including estimates of both directly exported products as well as the intermediate goods and services used to produce exports. For 2005, the Census Bureau estimates that Ohio produced \$56.8 billion of exported goods—final plus intermediate goods. Under this definition of exports, Ohio ranks third in the country in terms of exported manufactured goods, behind only California and Texas. The employment related to export production in Ohio totals 162.3 thousand jobs. Overall, these estimates suggest that 20 percent of the manufacturing shipments in Ohio are either direct exports or intermediate goods used to produce exported goods.

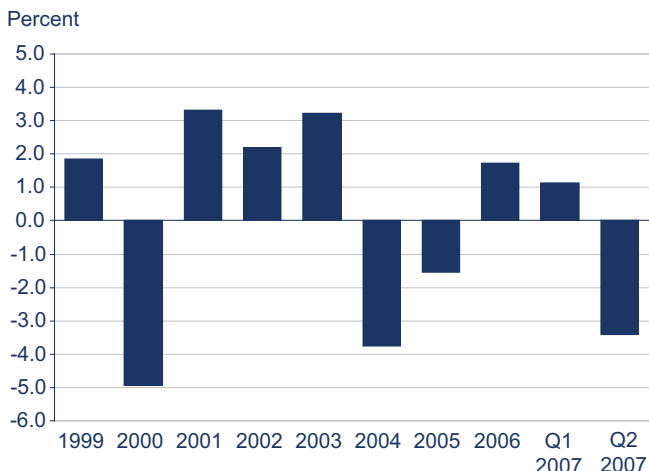
Banking and Financial Institutions

Fourth District Community Banks

08.22.07

by O. Emre Ergungor and Patrick Higgins

Annual Asset Growth



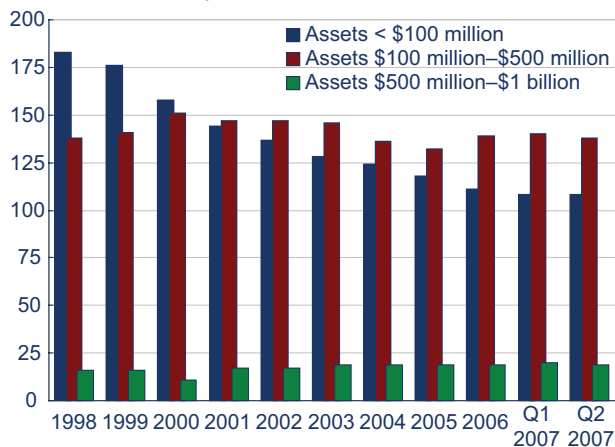
a. Growth rates for 2007:Q1 and 2007:Q2 are annualized year-to-date asset growth. For other years, Q4/Q4 growth rates are used.
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income.

Of the 290 banks headquartered in the Fourth Federal Reserve District as of June 30, 2007, 265 are community banks—commercial banks that have less than \$1 billion in total assets.

The assets of community banks in the Fourth District have risen in five of the past eight years and declined in three. A decline in the community banking assets within the district does not necessarily mean that any banks closed shop or left the district. A community bank might disappear from our radar because it is acquired by bank holding company that is headquartered in another district (which would change the district the bank and branch offices belong to) or because it is acquired by another Fourth District holding company and

Fourth District Community Banks by Asset Size

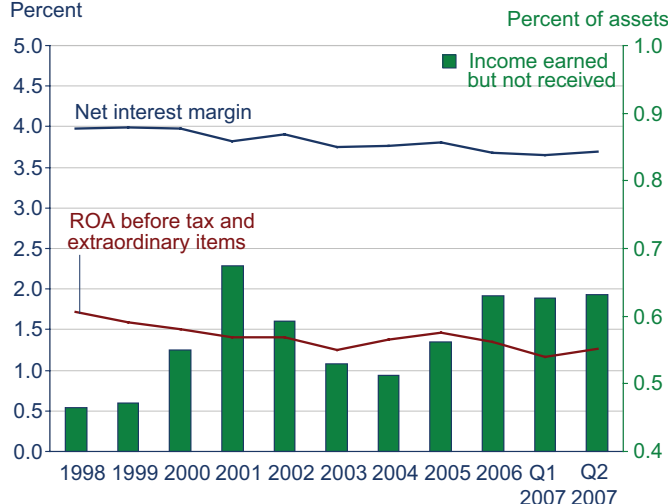
Number of community banks



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

Income Stream

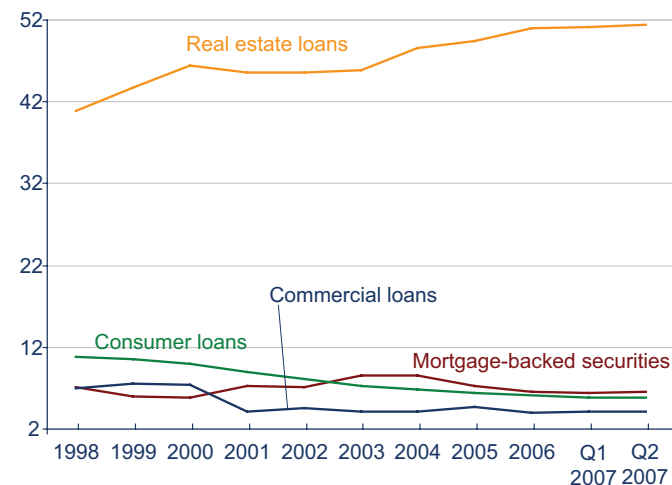
Percent



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

Balance Sheet Composition

Percent of assets



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

the combined assets of the banks after the acquisition exceed the \$1 billion cutoff. The latter phenomenon occurred twice in May 2007. The Lorain National Bank, a Fourth District bank with assets of \$853 million in the first quarter of 2007, acquired Morgan Bank, National Association—an other Fourth District bank whose assets were \$125 million in the first quarter of 2007. By the second quarter of 2007, the assets of the acquirer totaled \$1.003 billion, just over the threshold that defines a community bank. This acquisition explains most of the second-quarter 2007 decline in year-to-date community bank asset growth. Including the Lorain National Bank's second-quarter 2007 assets with the Fourth District's second-quarter 2007 community bank assets pushes up asset growth in that quarter from -3.4 percent to 0.7 percent.

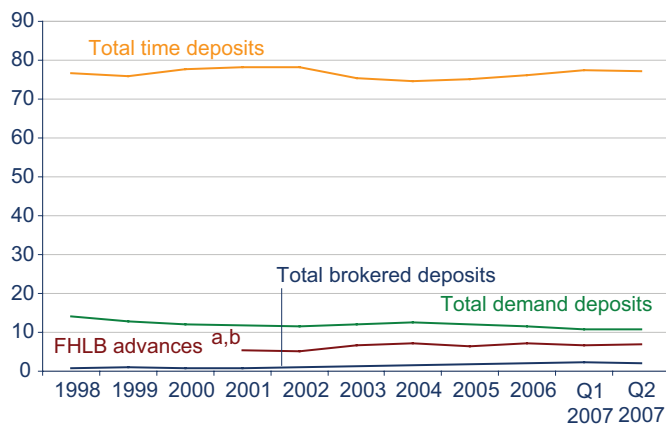
Another acquisition of a Fourth District community bank occurred in May 2007 when the Bank of Kentucky, whose assets have exceeded \$1 billion since 2006, acquired the First Bank of Northern Kentucky. These two acquisitions account for the decline in the number of community banks headquartered in the Fourth District, from 268 in the first quarter of 2007 to 265 in the second quarter. Since the end of 1998, the number of Fourth District community banks has declined by 72 (from 337) as a result of other bank mergers and acquisitions.

The structure of the market with respect to asset size has also changed since 1998. Back then, most Fourth District community banks had less than \$100 million in total assets. Now banks in the \$100 million to \$500 million category constitute the majority.

The income stream of Fourth District community banks has shown some slight deterioration since 1998. The return on assets (ROA) deteriorated from 1.7 percent in 1998 to 1.3 percent in the second quarter of 2007. (ROA is measured by income before tax and extraordinary items, because one bank's extraordinary items can distort the averages in some years.) The decline is due in part to weakening net interest margins (interest income minus interest expense divided by earning assets). The net interest margin has trended down, from 3.97

Liabilities

Percent of liabilities

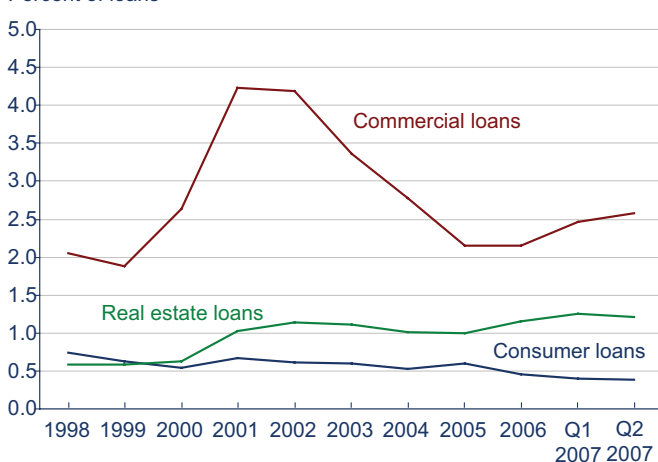


a. Federal Home Loan Bank advances. b. Data starts in 2001.

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

Problem Loans

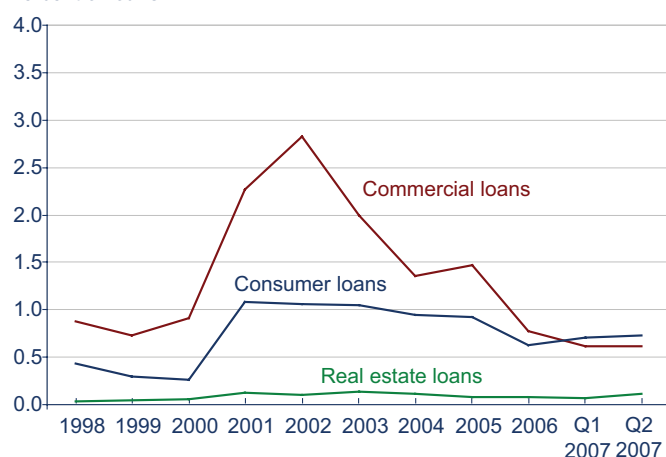
Percent of loans



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

Net Charge-Offs

Percent of loans



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

percent in 1998 to 3.69 percent in the second quarter of 2007.

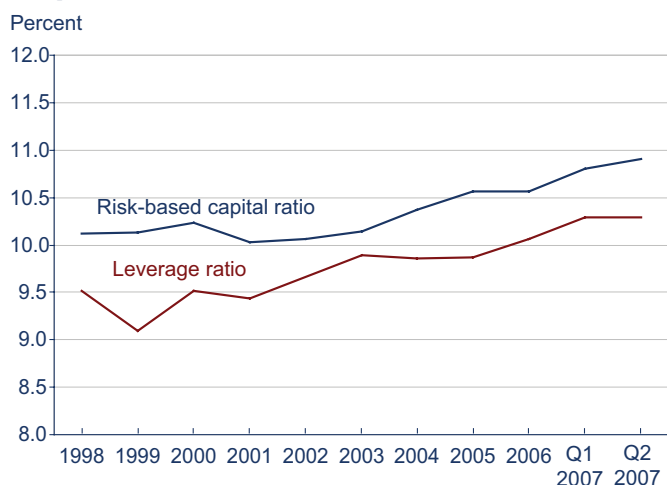
One issue which may become a cause for concern in the future is the elevated level of income earned but not received; at 0.63 percent in the second quarter of 2007, this figure remains at its highest level since 2001. If a loan agreement allows a borrower to pay an amount that does not cover the interest accrued on the loan, the uncollected interest is booked as income even though there is no cash inflow. The assumption is that the unpaid interest will eventually be paid before the loan matures. However, if an economic slowdown forces an unusually large number of borrowers to default on their loans, the bank's capital may be impaired unexpectedly.

Fourth District community banks are heavily engaged in real-estate-related lending. In the second quarter of 2007, 51.4 percent of their assets were in loans secured by real estate. Including mortgage-backed-securities, the share of real-estate-related assets on their balance sheets was 58 percent.

Fourth District community banks finance their assets primarily through time deposits (77 percent of total liabilities). Brokered deposits—a riskier type of deposit for banks because it chases higher yields and is not a dependable source of funding—are seldom used. Federal Home Loan Bank (FHLB) advances are loans from the FHLBs, which are collateralized by banks' small business loans and home mortgages. Although they have gained some popularity in recent years, FHLB advances are still a small fraction of community banks' liabilities (6.9 percent of total liabilities).

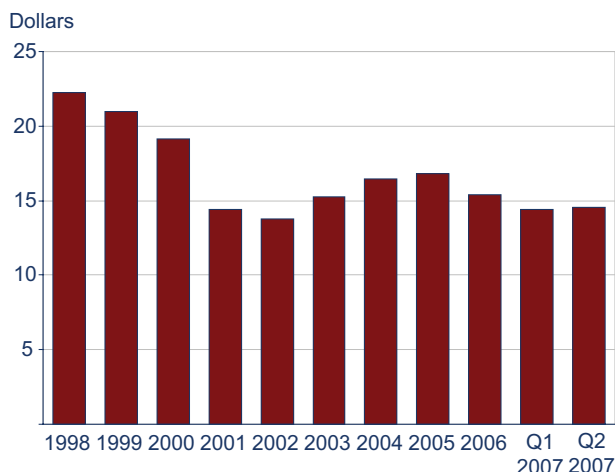
Problem loans include loans that are past due for more than 90 days but are still receiving interest payments as well as loans that are no longer accruing interest. Problem commercial loans rose sharply in 2001, returned to 1998–2000 levels by the end of 2006 thanks to the strong economy, and have since crept up some to their current level of 2.58 percent. Problem real estate loans were only 1.25 percent of all outstanding real-estate-related loans in the first quarter of 2007 and 1.21 percent of all such loans in the second quarter. These are still the highest figures since 1998. Problem consumer loans

Capitalization



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

Coverage Ratio*



*Ratio of capital and loan loss reserves to problem assets.

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

have continued their decline in 2007. Currently, 0.38 percent of all outstanding consumer loans (credit cards, installment loans, etc.) are problem loans.

Net charge-offs are loans that are removed from the balance sheet because they are deemed unrecoverable minus the loans that were deemed unrecoverable in the past but are recovered in the current year. As with the problem loans, there was a sharp increase in the net charge-offs of commercial loans in 2001 and 2002. Consumer loans followed a similar path but have remained slightly elevated since the recession. Fortunately, the charge-off level for commercial loans has returned to its pre-recession level. Net charge-offs in the second quarter of 2007 were limited to 0.61 percent of outstanding commercial loans, 0.73 percent of outstanding consumer loans, and 0.11 percent of outstanding real estate loans.

Capital is a bank's cushion against unexpected losses. Recent trends in capital ratios indicate that Fourth District community banks are protected by a large cushion. In the second quarter of 2007 the leverage ratio (balance sheet capital over total assets) was above 10 percent, and the risk-based capital ratio (a ratio determined by assigning a larger capital charge on riskier assets) was nearly 11 percent. The growing ratios are signs of strength for community banks.

An alternative measure of balance sheet strength is the coverage ratio. The coverage ratio measures the size of the bank's capital and loan loss reserves relative to its problem assets. As of the second quarter of 2007, Fourth District community banks had almost \$15 in capital and reserves for each \$1 of problem assets. While the coverage ratio declined considerably following the high charge-off periods of the early 2000s, balance sheets are still strong.

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ISSN 0748-2922

