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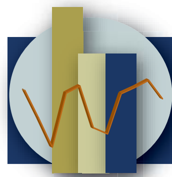

Economic Trends

May 2007
(Covering April 13, 2007, to May 14, 2007)

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The More Things Change, the More They Stay the Same ...

05.14.07
by Mark S. Sniderman

The federal funds rate target has not budged since the Federal Open Market Committee set it at 5¼ percent in June 2006. The Committee's statement announcing this action noted that economic growth was likely moderating from its strong pace earlier that year, partly because housing markets were cooling. The statement also pointed out that measures of core inflation had been elevated for some months and that, although inflation expectations had been well-contained, high levels of resource utilization and of prices for energy and other commodities could sustain inflation pressures.

At the time, judging that some inflation risks remained, the Committee cautioned that some further policy firming might be needed, but that the extent and timing of any actions would depend on incoming evidence about the outlook for inflation and economic growth. In financial markets, there were considerable differences of opinion about whether the next rate movement would be up or down. Now, nearly a year later, the Committee has yet to adjust the funds rate target one way or the other.

The uncertainty about the policy outlook last June grew primarily from uncertainty about the outlook for inflation and economic growth, the factors that the Committee said would shape their decisions. At the time, analysts' prevailing opinion was that the housing sector would suffer a mild downturn through the end of the year. However, their assessment deteriorated as the year progressed, and their growing expectation that policy would ease was reflected in the federal funds futures market. However, by early this year, many analysts thought they saw signs of stabilization, perhaps even of a turnaround, in the housing sector. So, since the rest of the economy seemed to be holding up well, market expectations of a funds rate reduction began to return—though not all the way—to the view that the rate would continue unchanged.

The inflation outlook has been equally difficult to discern. On one hand, the Committee's June 2006 statement explained that the cumulative effect of previous interest rate increases could be expected to slow, even to reverse, inflation's upward momentum. On the other hand, the Committee noted that resource utilization remained high and that energy and commodity prices might still pose inflation risks.

Although financial market participants generally interpreted the Committee's statement as an announcement of a "pause," it seems fair to say that few analysts expected the pause to last quite this long. Interestingly, the reasons for the pause have changed over time, as incoming data caused the perception of risk to shuttle between economic growth and inflation.

The Committee's "wait and see" posture proved very durable in an environment that produced somewhat weaker growth—but also more inflation—than anticipated. For their part, most financial market participants now expect the economic outlook to evolve in such a way that the Committee will gradually lower the federal funds rate target by 50 to 100 basis points beginning later this year. But analysts' reactions to incoming data, the Committee's press statements, and speeches by Federal Reserve officials suggest that although the FOMC may still be "learning to talk," market participants understand fairly well what the Committee intends to accomplish and how it views the complex workings of the global economy.

I remember a time, not so long ago, when monetary policymakers—and many academics too—thought policy worked best when it caught markets by surprise. Today, exactly the opposite opinion prevails: Financial markets

should be able to predict what policymakers will do, even when circumstances change. At the moment, the Committee and the financial markets seem to understand one another well. That understanding is certain to be tested, however , either when the Committee plans to move before the markets expect it to or when the markets tell the Committee to move before it recognizes the need to do so. History provides examples of each.

Inflation and Prices

March Price Statistics

04.30.07
by Michael F. Bryan and Linsey Molloy

Retail price data revealed a relatively more favorable inflation report in March. The Consumer Price Index (CPI) jumped 7.5 percent (annualized) in March, reflecting dramatically rising energy prices, which doubled over the month, but the CPI excluding food and energy rose a mere 0.7 percent (annualized).

The distribution of the price changes of individual CPI components indicated that over half of the index's weighted components rose at a more moderate pace between 1 percent and 4 percent in March, while a bit over one-quarter of the weighted components rose at rates exceeding 4 percent. This compares to the average price-change distribution over the previous 12 months, in which roughly one-quarter of the index's weighted components rose between 1 percent and 4 percent, while nearly half rose at rates exceeding 4 percent.

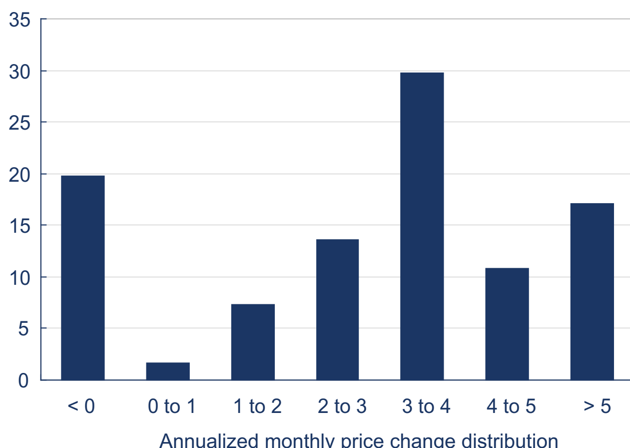
On the other hand, alternative measures of core inflation, including the Median CPI and the 16 percent trimmed-mean CPI, were less sanguine, rising a respective 3.3 and 3.2 percent in March. These monthly increases were not markedly different from the measures' longer-term trends, which are now between 2¾ and 3½ percent. This month's modest rise in the CPI excluding food and energy reflects a deceleration in the prices of the services that are included in this measure of core inflation ("core services"), as well as deflation in the prices of the goods that are included ("core goods"). The overall price of core services, which account for over half of the overall CPI, rose 1.4 percent (annualized) in March, significantly below the longer-run trend, which has fluctuated between 3½ and 4 percent in recent months. This rise was modest despite the rather persistently brisk monthly increases in rents

March Price Statistics

	Percent change, last:					
	1 mo.[a]	3 mo.[a]	6 mo.[a]	12 mo.	5 yr.[a]	2006 avg.
Consumer Price Index						
All items	7.5	4.7	2.4	2.8	2.8	2.6
Less food and energy	0.7	2.3	1.9	2.5	2.0	2.6
Median[b]	3.3	3.1	3.2	3.5	2.7	3.6
16% trimmed mean[b]	3.2	3.3	2.5	2.8	2.3	2.7
Producer Price Index						
Finished goods	12.5	6.9	5.2	3.2	3.4	1.7
Less food and energy	0.0	2.3	2.3	1.7	1.4	2.1

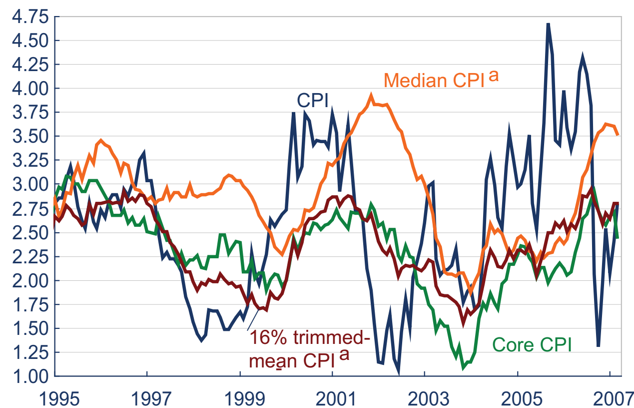
a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

CPI Component Price-Change Distributions, March 2007



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

CPI, Core CPI, and Trimmed-Mean CPI Measures

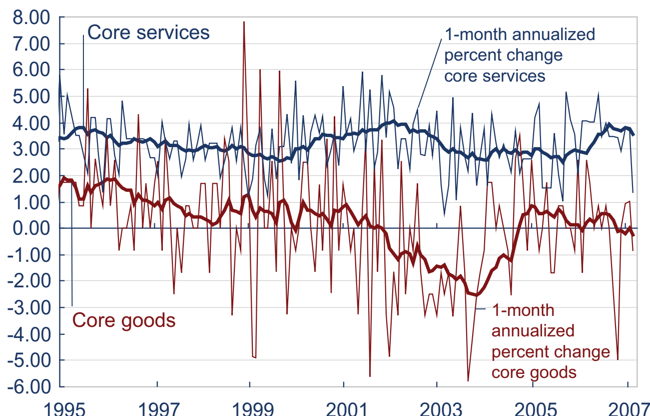


a. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

(including Owner's Equivalent of Rent), which constitute over half of core CPI services.

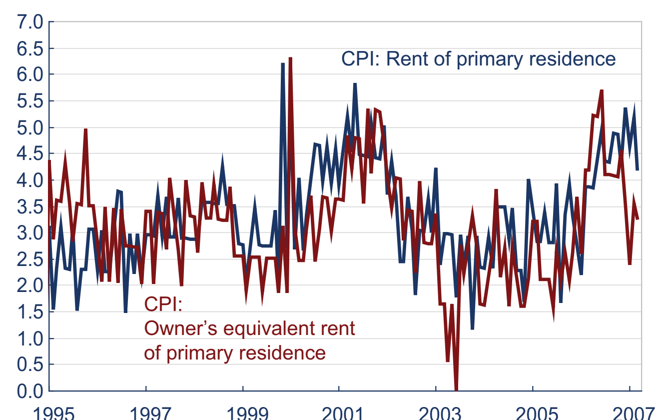
Professional forecasters expect inflation, as measured by the CPI excluding food and energy, to drop from 2.5 percent in 2006 to 2.4 percent in 2007, and to 2.3 percent in 2008. Meanwhile, the year-ahead inflation expectations of households continue to rise; households expect a 4.0 percent rise in retail prices over the next year. Their longer-term inflation expectations, which are correlated with movements in core inflation, ticked up to 3.6 percent in late April, a bit above the 3¼–3½ percent range in which they've fluctuated for nearly one year.

Core CPI Goods and Core CPI Services



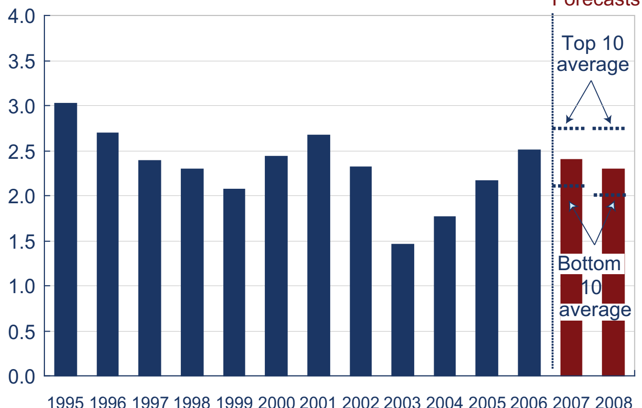
a. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

Housing Prices



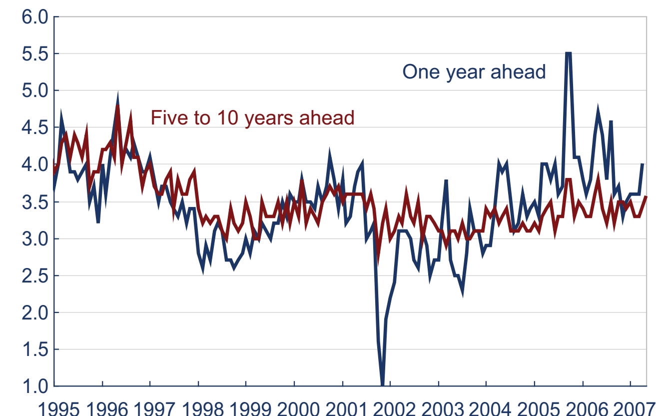
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics.

Core CPI and Forecasts



SOURCES: Blue Chip panel of economists, April 10, 2007.

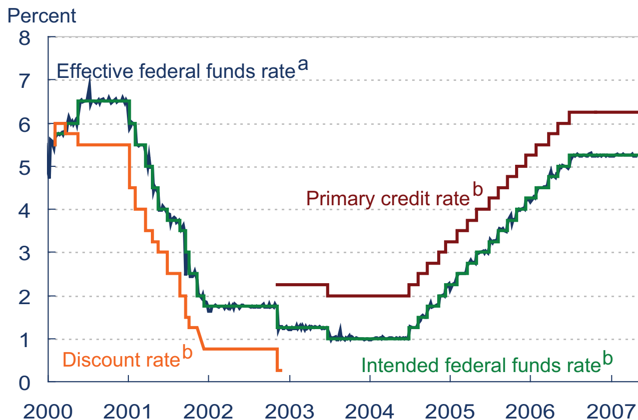
Household Inflation Expectations*



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

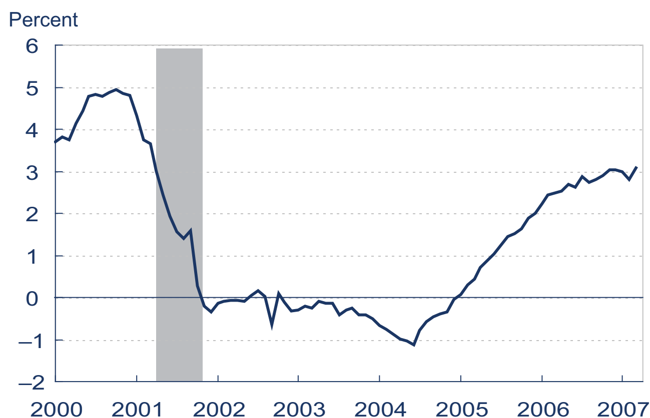
Monetary Policy: No Surprise Here

Reserve Market Rates



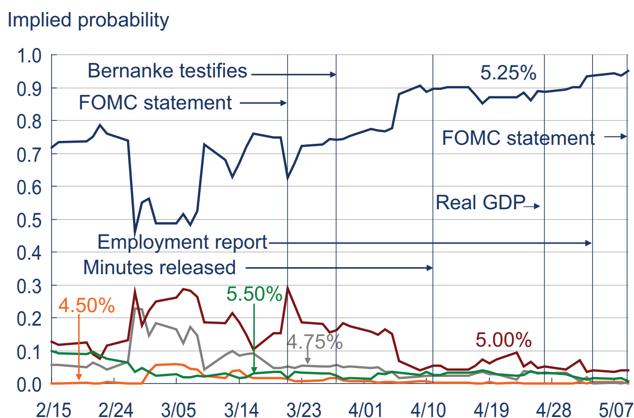
a. Weekly average of daily figures.
b. Daily observations.
SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases, H.15.*

Real Federal Funds Rate*



*Defined as the effective federal funds rate deflated by the core PCE. Shaded bar represents a period of recession.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases, H.15*; Federal Reserve Bank of Philadelphia; and Bloomberg Financial Information Services.

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



*Probabilities are calculated using trading-day settlement prices of July 2007 federal funds futures and options on that futures contract.
SOURCES: Chicago Board of Trade; and Bloomberg Financial Services.

05.09.07
by John B. Carlson and Bethany Tinlin

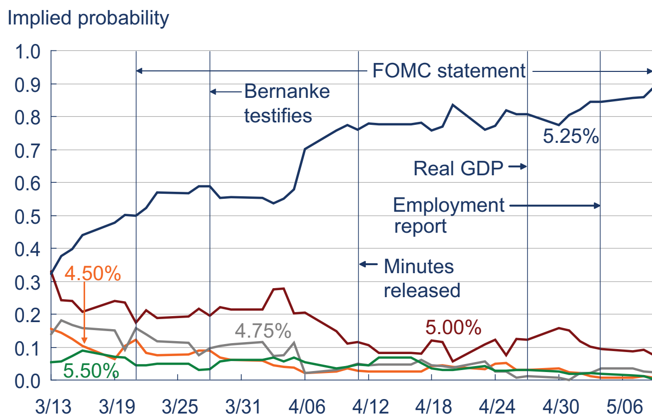
As widely anticipated, the Federal Open Market Committee (FOMC) left the target level of the federal funds rate unchanged at 5.25 percent this afternoon. It was the seventh consecutive meeting with no change. The inflation-adjusted fed funds rate remains near 3 percent, or about 400 b.p. above its low of June 2004.

Changes in the FOMC's post-meeting statement language were minimal, largely reflecting information revealed since the March meeting. For instance, in its rationale the FOMC acknowledged the weak first-quarter GDP report, changing the first sentence of the second paragraph to "Economic growth slowed in the first part of the year …" from the March language, "Recent indicators have been mixed …." The statement maintained its outlook that "the economy seems likely to expand at a moderate pace over the coming quarters." The reference to inflation was made more concise, replacing "Recent readings on core inflation have been somewhat elevated," with the statement "Core inflation remains somewhat elevated."

The FOMC's assessment of risk was unchanged. It kept the statement "the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected." This language, which first surfaced in the March statement, seems to have been slowly digested in markets over the intermeeting period. The initial market reaction after the March meeting focused more on the previous meeting's changes in rationale, which were made to give the Committee greater flexibility when writing its post-meeting statements.

At that time, the characterization of recent economic indicators was weaker than markets had anticipated; hence, it seemed to signal to markets that policy easing might occur sooner than they had anticipated. Indeed, the probability of a rate cut in July increased noticeably after the statement's release. This reaction was quickly reversed, however,

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



*Probabilities are calculated using trading-day settlement prices of July 2007 and August 2007 federal funds futures and options on those futures.
SOURCES: Chicago Board of Trade; and Bloomberg Financial Services.

and market participants seemed to gradually put greater focus on the inflation risk, especially after a strong employment report. Accordingly, the prospect of a rate hike before summer's end diminished.

Market reaction to today's statement was limited, consistent with the minimalist approach to today's changes. Prospects for a rate cut remain very unlikely according to implied probabilities of alternative outcomes for the August meeting.

Money, Financial Markets, and Monetary Policy

Monetary Policy in the United States, the Euro Area, and Japan

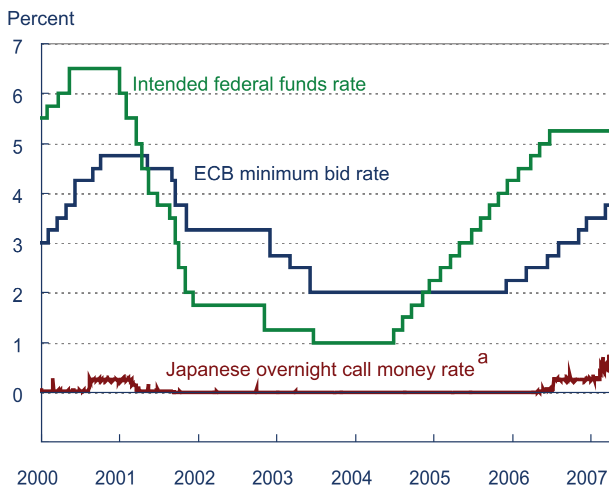
05.01.07
by Guillaume Rocheteau and Bethany Tinlin

The conduct of monetary policy typically depends on specific economic conditions within a country such as its inflation, its level of production, and its level of employment. It also depends on the mandate of its central bank and the bank's objectives in terms of price stability, employment, and growth (among other things). For instance, the European Central Bank pursues price stability as its primary goal, while the Federal Reserve System seeks maximum employment, stable prices, and moderate long-term interest rates. The Bank of Japan aims for price stability and for the stability of the payments and settlement system. Thus, in principle, different countries should be expected to run different monetary policies. But when we focus on the United States, the Euro area, and Japan, we see that while monetary policies differ across those countries, some general patterns in their approaches can be identified.

Policy Instruments: Overnight Rates

To achieve their objectives, central banks set overnight interest rates: the federal funds rate in the U.S., the minimum bid rate in the Euro area, and the uncollateralized overnight call rate in Japan.

Overnight Rates

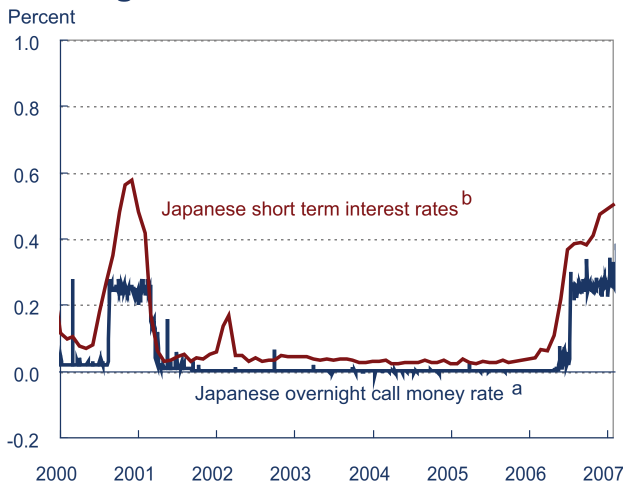


a. Daily data.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," Federal Reserve Statistical Releases, H.15; the European Central Bank; and Bloomberg Financial Information services.

Estimated Response to a One-Percentage Point Change in the Policy Rate, 1996–2006

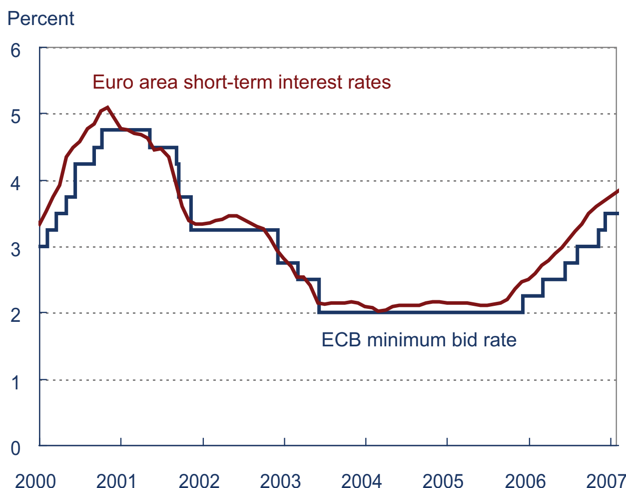
	Euro area	Japan	U.S.
Core inflation	1.14	0.24	1.93
GDP growth	1.32	0.03	2.07

Japanese Short-Term Interest and Overnight Rates



a. Daily data.
b. Monthly data.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Organization for Economic Cooperation and Development; European Central Bank; and Bloomberg Financial Information Services.

Euro Area Short-Term Interest and Overnight Rates



SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," Federal Reserve Statistical Releases, H.15; Organization for Economic Cooperation and Development; European Central Bank; and Bloomberg Financial Information Services.

Since 2000, interest rates have followed a somewhat similar pattern in the US and the Euro area: they declined substantially from 2001 to 2004 and gradually increased after 2004 (U.S.) or 2005 (Euro area). The amplitude of the changes has been higher in the U.S. than in Europe. In contrast, overnight rates in Japan remained close to 0 percent, the minimum that is feasible to achieve, from 2001 to 2006.

Short-term Interest Rates[1]

By changing overnight rates, a central bank affects interest rates at different maturities, thereby influencing the real economy and prices. For instance, three-month interest rates closely follow overnight rates closely.

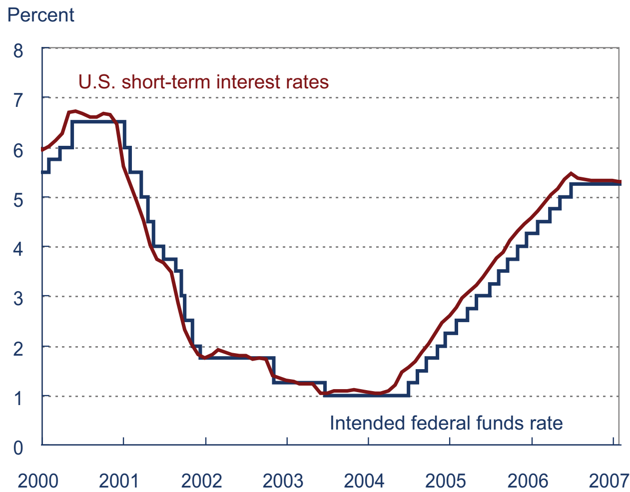
Policy Rules

To understand changes in short-term interest rates, it helps to look at the simple relationship that links the policy rate to core inflation and output growth. This relationship, which can be estimated with a simple regression (known as the Taylor rule), aims to capture in some crude way how policy reacts to economic conditions.[2] While it includes only a few variables, it explains the path of short-term interest rates in the U.S. and the euro area reasonably well.[3]

Note that from 1996 to 2006, the estimated response of the monetary policy rate to a change in GDP growth was larger than that of the euro area's. Such a result is consistent with the Federal Reserve's dual mandate. Note also that a change in core inflation has a much larger effect on policy rates in the euro area and in the U.S. than in Japan. This response—known as the Taylor principle—is considered essential for price stability. The idea is that when inflation increases, the central bank must raise its interest rate high enough to increase the real interest rate and reduce inflationary pressures. If inflation rises one percentage point, for example, the central bank must raise rates by more than one percentage point.

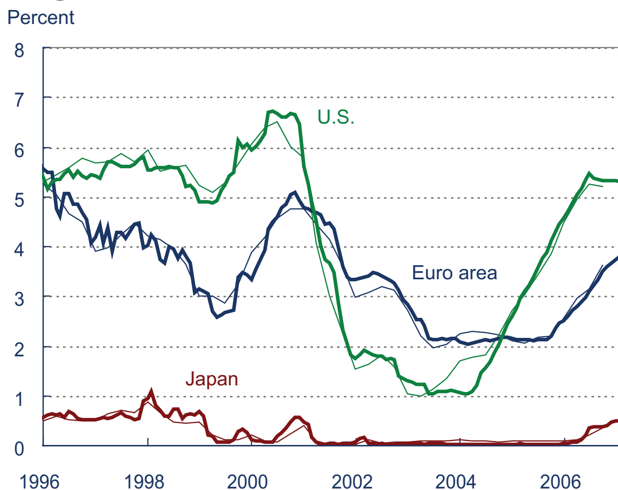
Over the last decade or so, the Bank of Japan has faced a far different situation—deflationary, rather than inflationary pressure—to which the relationship captured by the Taylor rule did not apply. Interest rates varied minimally, hovering near their lower bound of zero.

U.S. Short-Term Interest and Overnight Rates



SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," Federal Reserve Statistical Releases, H.15; Organization for Economic Cooperation and Development; European Central Bank; and Bloomberg Financial Information Services.

Short-Term Interest Rates and Regressed Values*



*Regressed values are represented by a thinner line.
SOURCES: The Organization for Economic Cooperation and Development; the Japanese Cabinet Office; Statistical Office of the European Communities; and the Bureau of Economic Analysis.

Inflation over the Past 25 Years

As the regressions above illustrate, inflation is a key explanatory variable of central banks' behavior. It is remarkable that the three economies under consideration here have experienced a common disinflationary process over the last 25 years. In the U.S. and Europe, inflation has decreased from about 15 percent to about 2 percent–3 percent; in Japan it has decreased from about 8 percent to 0 percent, and even went negative between 2000 and 2004. The phenomenon is the same for core inflation, which excludes food and energy. This convergence from two-digit inflation rates to very low inflation rates reflects the common view that inflation, even at relatively moderate levels, is costly for society.

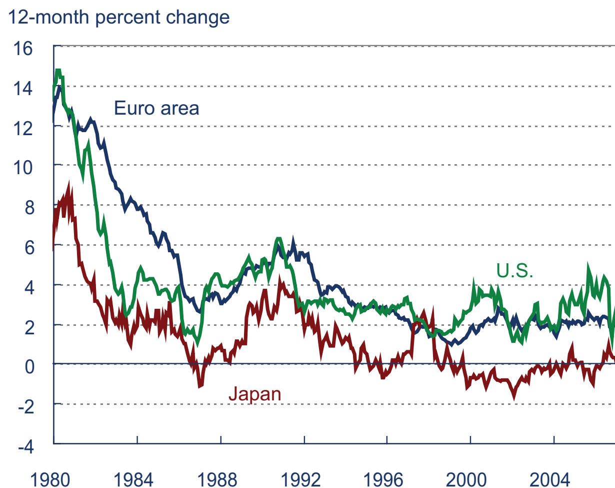
Inflation since 2000

Over the past seven years, inflation has been stable in the U.S. and Europe. Currently, the average inflation rate is slightly higher in the U.S. (about 2.75 percent) than in the euro area (2 percent). The difference between their core inflation rates (2.19 percent and 1.75 percent, respectively) is smaller. Core (12-month) inflation in the U.S. decreased from about 2.7 percent in January 2001 to a low of 1 percent in November 2003, allowing the Fed to cut its rate from 6.5 percent to 1 percent. U.S. core inflation has rebounded since 2004, reaching almost 3 percent in January 2006. The Fed has responded to this inflationary pressure by raising its rate to 5.25 percent.

Compared to the U.S., the euro area's inflation has been less volatile; the maximum 12-month core inflation rate in the euro area was 2.3 percent in March 2002, and the minimum was 1.3 percent in January 2006. This seems consistent with the fact that the primary objective of monetary policy in Europe is price stability, whereas the Fed has multiple objectives.

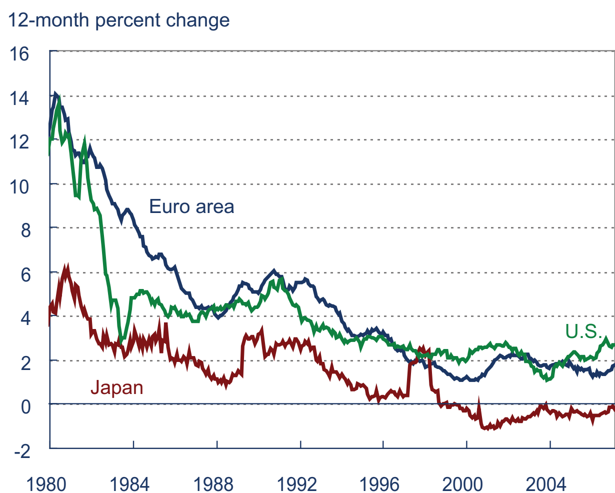
Japan's recent inflation experience is entirely different from that of both the U.S. and Europe. Japan's core inflation rate has been consistently negative over the last seven years. However, since January 2001 it has increased from about -1 percent to nearly 0 percent. One reason for such inflation rates is low output growth, which the country has suffered since the beginning of the 1990s.

Global Disinflation: Consumer Prices, All Items



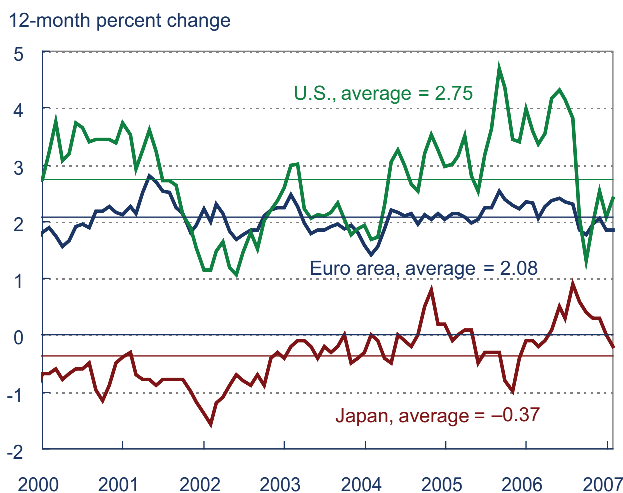
SOURCE: The Organization for Economic Cooperation and Development.

Global Disinflation: Consumer Prices, Less Food and Energy



SOURCE: The Organization for Economic Cooperation and Development

Consumer Prices, All Items



SOURCE: The Organization for Economic Cooperation and Development.

GDP Growth since 2000

As suggested our Taylor rule estimates suggest, monetary authorities also care about output growth. Since 2000, the U.S., the euro area, and Japan have undergone a recession and a recovery. In the U.S., the four-quarter growth rate of GDP declined from 4.8 percent in April 2000 to 0.2 percent in October 2001. In the euro area, the corresponding decline was from 4.6 percent in April 2000 to 0.48 percent in April 2003. Although the recovery was slower in the euro area, both it and the U.S. posted a growth rate of slightly less than 3 percent in July 2006. As we noted earlier, the Fed and the European Central Bank responded to the recession by cutting overnight interest rates and to the recovery by gradually increasing rates. The recession in Japan was much more severe than in the U.S. and Europe, with GDP contracting 4.7 percent from October 2000 to October 2001. Although the country was facing deflationary pressures, the Bank of Japan could not lower interest rates below zero percent. This zero boundary limited the bank's ability to counteract deflationary pressures or to stimulate growth. As a result, Japan's policy rate does not show a strong response to either inflation or growth in the policy rule.

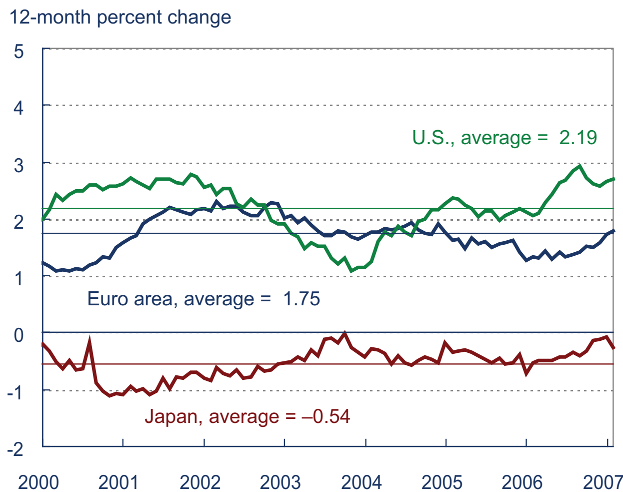
Footnotes

1. According to the OECD's definition, short-term rates are three-month rates for three categories of instruments: interbank loans, Treasury bills, and certificates of deposit or comparable instruments.

2. On the basis of quarterly observations, we regress (using ordinary least squares) the three-month interest rate on 12-month core inflation, the four-quarter GDP growth rate, and the lagged policy interest rate.

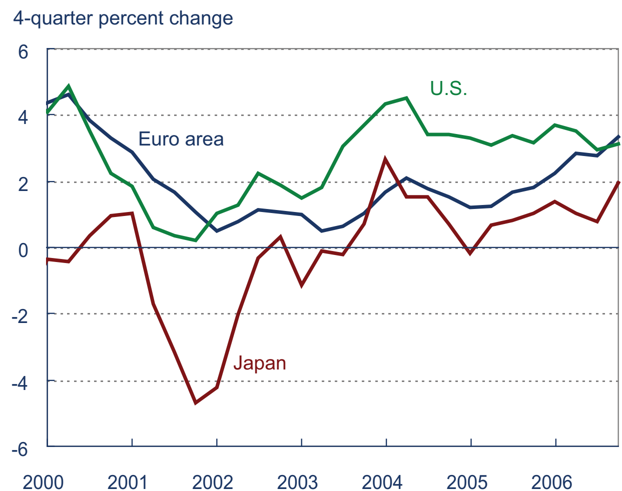
3. There is voluminous literature on estimating monetary policy rules. See Charles T. Carlstrom and Timothy S. Fuerst, "The Taylor Rule: A Guidepost for Monetary Policy,"the Federal Reserve Bank of Cleveland, Economic Commentary (July 2003). The original Taylor rule is evaluated using the output gap, that is, the difference between potential and actual GDP, but we use GDP growth instead.

Consumer Prices, Less Food and Energy



SOURCE: The Organization for Economic Cooperation and Development.

GDP Growth since 2000



SOURCES: The Japanese Cabinet Office; the Statistical Office of the European Communities; and the U.S. Department of Commerce, Bureau of Economic Analysis.

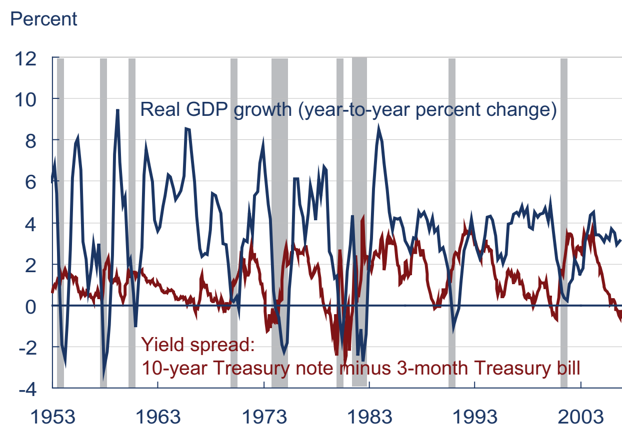
Money, Financial Markets, and Monetary Policy

An Update from the Yield Curve

04.18.07

by Joseph G. Haubrich and Brent Meyer

Yield Spread and Real GDP Growth*

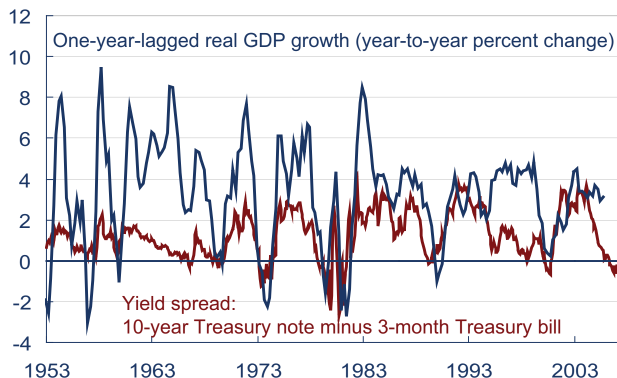


*Shaded bars indicate recessions.
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

As mentioned in recent months, 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.

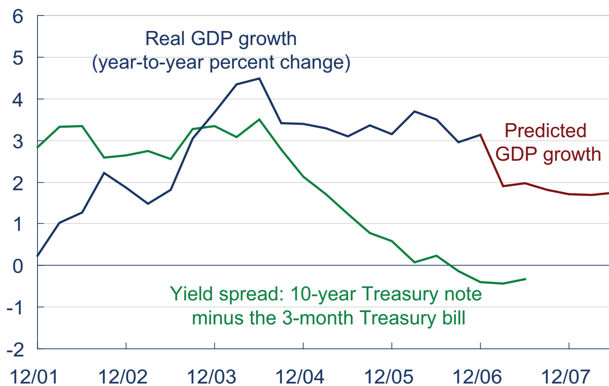
The yield curve has been giving a rather pessimistic view of economic growth for a while now. The spread is currently negative: With 10-year rate at 4.74 percent and the 3-month rate at 5.03 percent (both for the week ending April 13), the spread stands at a negative 29 basis points, the same as it

Yield Spread and Lagged Real GDP Growth



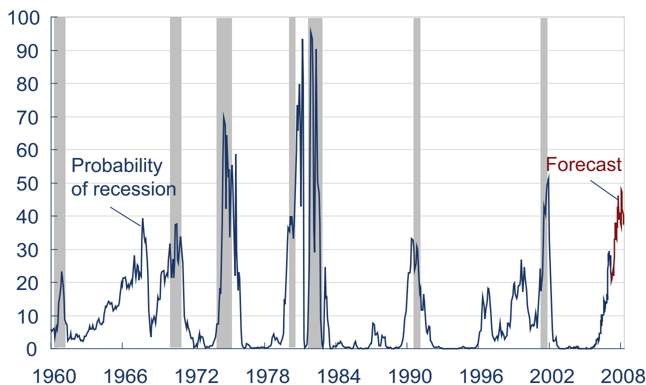
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

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.

was a month ago and, indeed, it has been in the negative range since August. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 1.7 percent rate over the next year. This prediction is well below many other forecasts. On the other hand, the recent woes in the subprime mortgage industry are making pessimism a bit more fashionable these days.

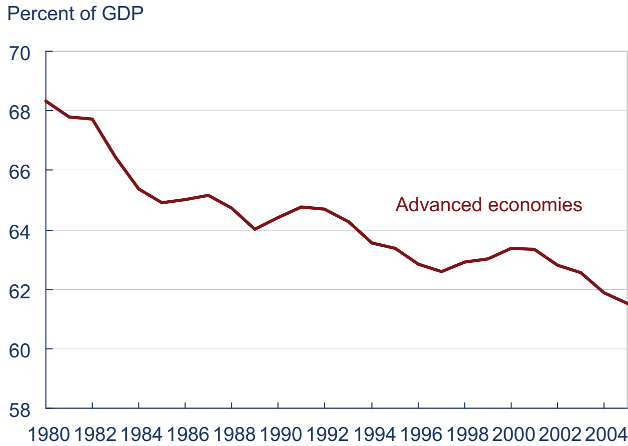
While such an approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in the case of recessions. Thus, it is sometimes preferable to focus on using the yield curve to predict a discrete event: whether or not the economy is in recession. Looking at that relationship, the expected chance of a recession in the next year is 38 percent, down a bit from last month's value of 46 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?"

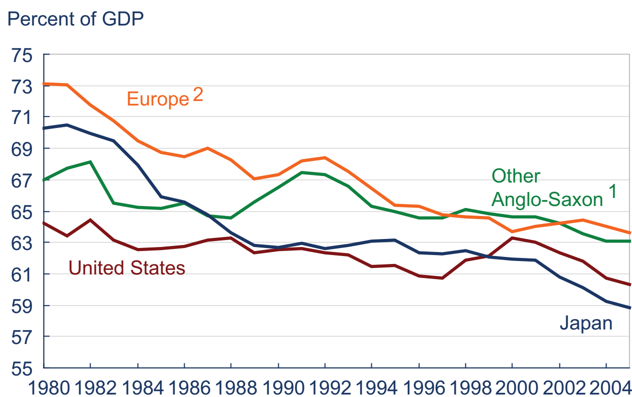
Do Workers Benefit from Globalization?

Income Share of Labor



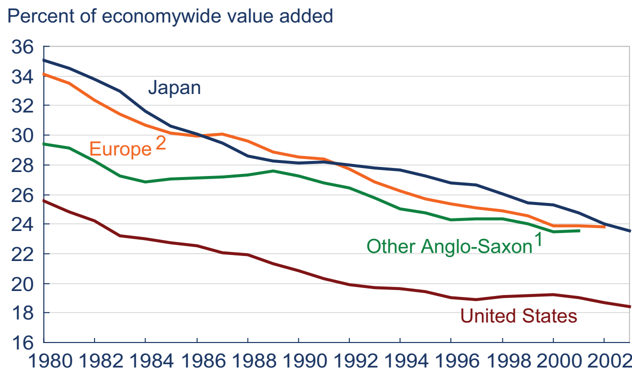
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

Income Share of Labor



1. Includes Australia, Canada, and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, and Sweden.
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

Income Share of Labor Unskilled Sector



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Norway, Portugal, and Sweden.
Source: International Monetary Fund, *World Economic Outlook*,April 2007.

05.03.07
by Owen F. Humpage and Michael Shenk

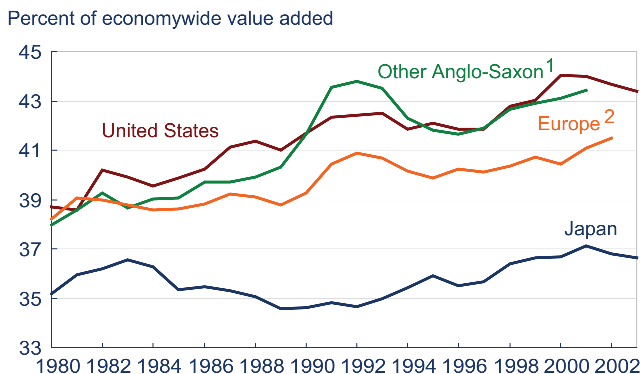
Over the past 50 years or so, advances in transportation and communications, together with a loosening of government barriers to trade and financial flows, have greatly expanded the possibilities for international commerce. While countries that embrace globalization can improve their overall standards of living, not all of their citizens may share in the bounty. Rudimentary economic models suggest that when highly developed countries open up their economies to developing countries, whether through trade, the location of production, or immigration, unskilled workers in the advanced economies can find themselves worse off, if not in terms of their absolute purchasing power, then relative to their more highly skilled colleagues. Even highly skilled workers, however, can find themselves with a shrinking share of national income, leaving business owners with the lion's share.

The International Monetary Fund (IMF) recently looked at the evidence bearing on this controversial subject and concluded that globalization has generally given workers in advanced developed countries a bigger piece, but a small share, of a growing economic pie. Unskilled workers bear the brunt of the globalization burden, as theory suggests. Over the past 25 years, the share of income going to skilled workers in most advanced economies has increased, but the share of income going to unskilled workers has declined.

The real earnings of unskilled workers in most advanced economies have continued to grow; they are receiving a bigger piece of the economic pie. Their earnings are not growing as fast as those of their skilled counterparts, however. In the United States, the gap between the real earnings of skilled and unskilled workers has widened by approximately 25 percent, according to IMF estimates. Two factors determine the real earnings of workers: employment and real compensation per worker. The employment of unskilled workers in the United States has expanded, but more slowly than the

Income Share of Labor Skilled Sector

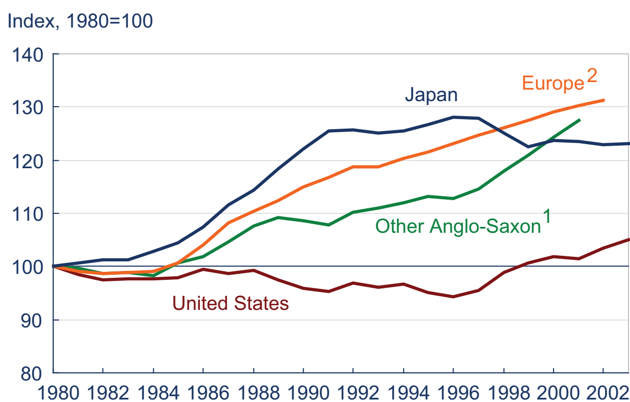
Percent of economywide value added



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Norway, Portugal, and Sweden.
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

Index of Unskilled Real Labor Compensation per Worker

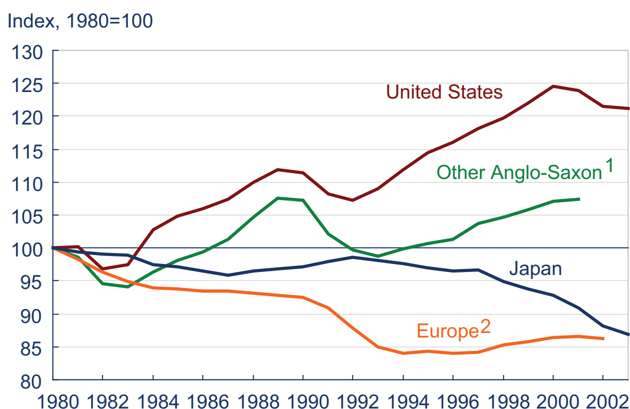
Index, 1980=100



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden.
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

Index of Unskilled Employment

Index, 1980=100



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden.
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

employment of skilled workers. Real compensation per unskilled worker in the United States, however, fell until fairly recently and has since made only meager gains. The situation is somewhat different in most other advanced economies, where real compensation per unskilled worker has risen almost as much as that of their skilled counterparts, but their employment prospects have been rather dismal.

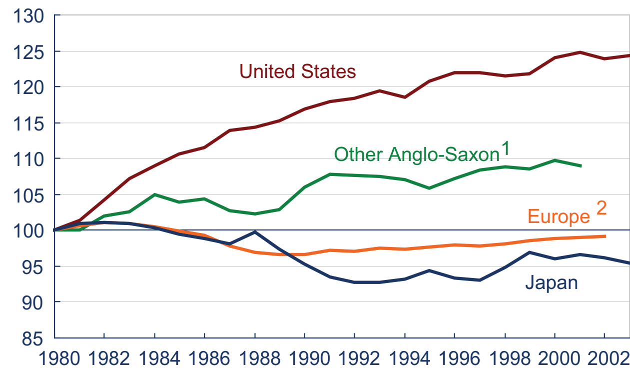
Globalization is not the only force behind these labor patterns. Technological change and governmental policies can also have a big impact on labor's overall share of income and on the portions of income going to the skilled and unskilled sectors. Of course, all of these factors are inter-related. Isolating the individual impact of any particular one is a tricky task, so one should always interpret such attempts cautiously.

The IMF staff estimates that while globalization and technological change both adversely affected the share of income going to unskilled workers, technological change had the bigger impact. This is not all that surprising because business investments associated with advances in information and communication technology often substitute for unskilled labor, while enhancing the productivity of their skilled counterparts. Even though the share of income going to skilled workers rose over the past 25 years, globalization held it back. This probably reflects the influence of offshoring. Firms in advanced economies often outsource the production of intermediate inputs and services that then fit into a more highly skilled production process. The manufacture of these offshored intermediate goods and services frequently involves a higher skill set than the fabrication of imported final goods. Consequently, offshoring tends to affect the income share of workers higher up on the skill spectrum than do final goods imports. In any event, offshoring remains a small part of the overall production in advanced economies.

The IMF study presents a quandary to the anti-globalization crowd. Should society care about the absolute well-being of workers, which globalization enhances, or should it worry about their relative well-being? If it is the latter, do you want to stop technological changes as well?

Index of Skilled to Unskilled Real Labor Compensation per Worker

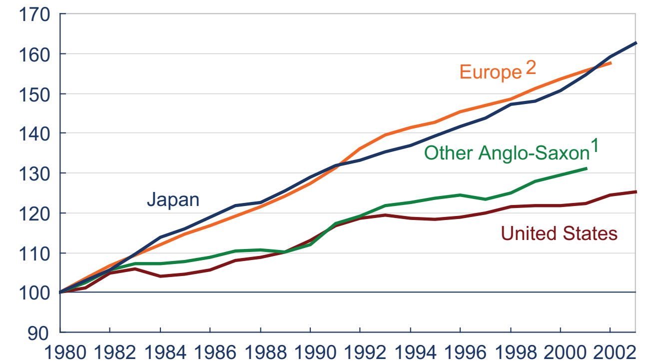
Index, 1980=100



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden
Source: International Monetary Fund, *World Economic Outlook*, April 2007.

Index of Skilled to Unskilled Employment

Index, 1980=100



1. Includes Canada and the United Kingdom.
2. Includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden.
Source: International Monetary Fund, World Economic Outlook, April 2007.

Economic Activity and Labor

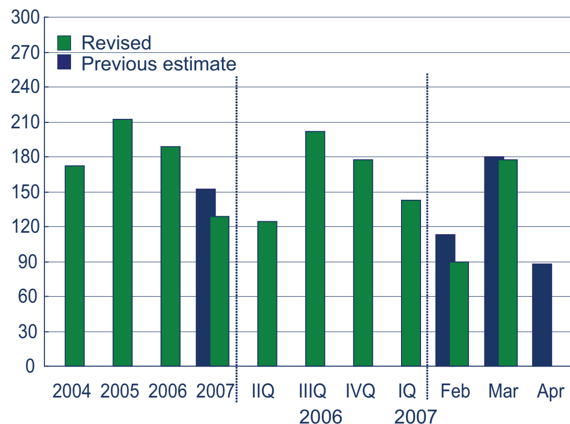
The Employment Situation

05.07.07

By Peter Rupert and Cara Stepanczuk

Average Monthly Nonfarm Employment Change

Change, thousands of workers



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

Nonfarm payroll employment increased by 88,000 in April, much lower than the first-quarter average monthly gain of 143,000 jobs and the 2006 average monthly gain of 189,000 jobs. In addition, February and March payrolls were revised down –26,000. The report was weaker than the expected 110,000 increase and had the lowest increase since November 2004.

Goods-producing industries continued to soften after last month's spike, as April's loss of 28,000 jobs nearly reversed the 36,000 gain in March. The manufacturing sector accounted for most of the decline (–19,000). The construction sector also hurt the headline number by failing to maintain its strength from March: The construction sector lost 11,000 jobs in April after having provided 28.2 percent of March's job growth (+50,000). Construction payroll growth has been flat since the beginning of the year.

Service-providing industry job growth (+116,000) was subpar, as well, compared to the first-quarter average montly gain (+149,000) and the 2006 average montly gain (+179,000). The payroll

Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2004	2005	2006	Jan-Mar 2007	Apr 2007
Payroll employment	**172**	**212**	**189**	**143**	**88**
Goods-producing	28	32	9	–17	–28
Construction	26	35	11	2	–11
Manufacturing	0	–7	–7	–12	–19
Durable goods	8	2	0	–14	–13
Nondurable goods	–9	–9	–6	2	–6
Service-providing	**144**	**180**	**179**	**149**	**116**
Retail Trade	16	19	–3	25	–26
Financial activities[a]	8	14	16	3	–11
PBS[b]	38	57	42	18	24
Temporary help services	11	18	–1	–4	-6
Education and health services	33	36	41	41	53
Leisure and Hospitality	25	23	38	24	22
Government	14	14	20	27	25
	Average for period (percent)				
Civilian unemployment rate	**5.5**	**5.1**	**4.6**	**4.5**	**4.5**

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.

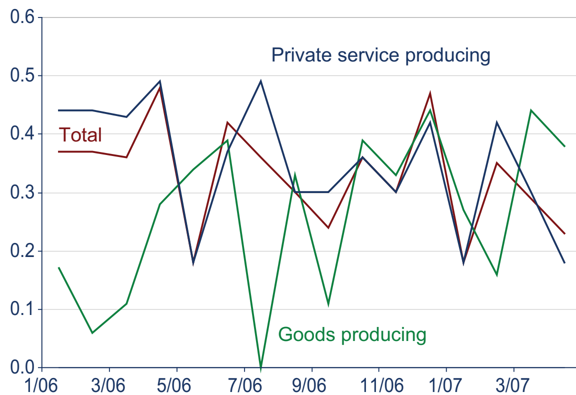
numbers are still suffering from the lack of strength in the professional business services sector, which increased only by 24,000 jobs this month. Retail trade and financial activities also put a damper on the report by losing 28,000 and 11,000 jobs, respectively. The financial activities sector experienced its weakest growth in over two years.

The driver for job growth this month was education and health services, with an increase of 53,000 jobs that accounted for almost half of the growth in the service sector. The government sector helped pick up some of the slack, adding 25,000 jobs.

Average hourly earnings slowed, and the 0.2 percent increase in the series was the lowest monthly change since the beginning of the year. Earnings were up 3.7 percent from 12 months ago, but down from March's 4.0 percent rate. Private service-providing industries influenced the easing of wage pressures more than goods-producing industries this month, but the two have varied widely since the beginning of 2006. Employees earn an average $17.25 per hour.

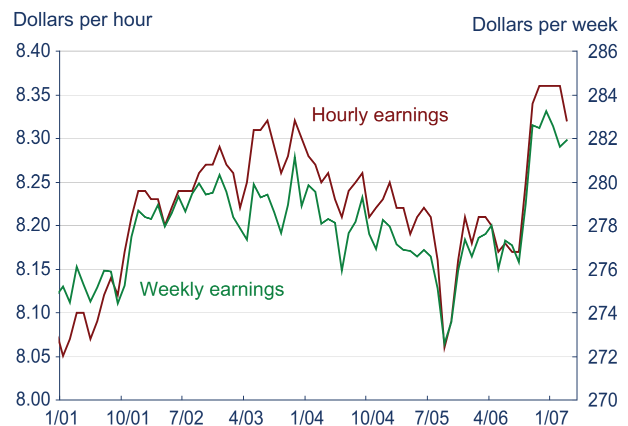
Real average nonfarm earnings—both weekly and hourly rates—have moderated, as well. However, the dollars per hour and per week remain high relative to recent trends. In real terms, nonfarm employees earn an average $8.32 per hour and $281.92 per week (1982 dollars).

Percent Change in Average Nonfarm Hourly Earnings



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

Real Average Nonfarm Earnings



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

Employment Flows and Firm Size

05.02.07

by Tim Dunne and Brent Meyer

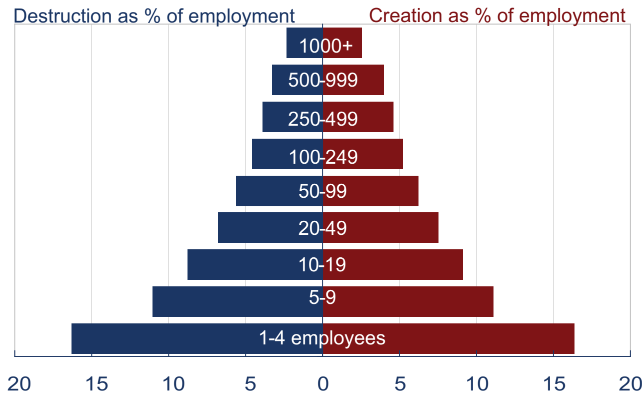
In the second quarter of 2006, private business employment grew by 466 thousand jobs. Underlying this net gain of 466 thousand jobs was the creation of 7.76 million jobs and the concurrent destruction of 7.30 million jobs. The amount of gross job creation and destruction always greatly exceeds the net flows, as some firms expand their employment levels while other firms are contracting theirs.

While all of this labor market churning is driven by differences between companies and the unique set of circumstances that each faces, generally speaking, job creation and job destruction rates decline sharply as firm size increases. For instance, job creation and destruction rates for firms with more than a thousand employees were 2.5 percent and 2.3 percent in the second quarter of 2006. Corresponding rates for the smallest firms—those with one to four employees—were 16.4 percent and 16.3 percent. Does this mean that large firms are unimportant in accounting for overall job flows? No, it doesn't.

Large firms may create and destroy jobs at low rates, but they employ a large percentage of all private sector workers (34 percent), which makes them an important source of aggregate employment flows. Firms with more one to four workers, in contrast, employ 8 percent of all private sector workers.

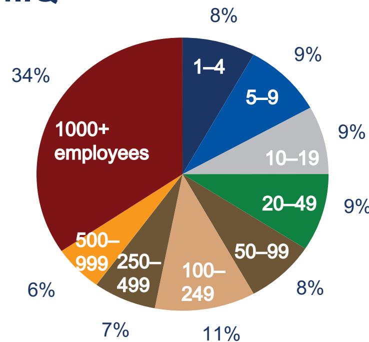
One significant difference between large and small firms is in the way jobs are created and destroyed. For the smallest firms, over half of job creation and job destruction comes through firm openings and closings, whereas in larger firms almost all job creation and job destruction occurs through changes in firm size.

Job Creation and Destruction by Firm Size, 2006:IIQ



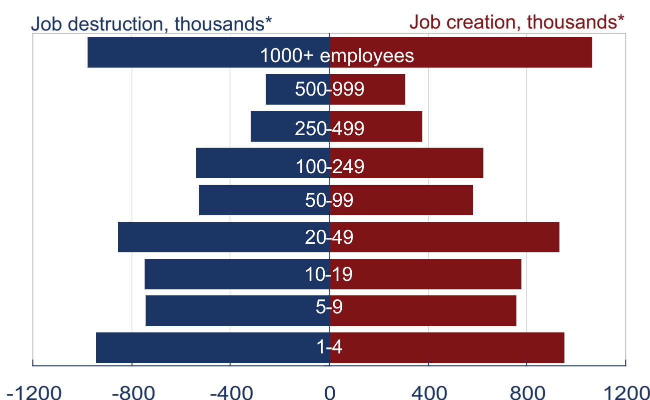
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Business Employment Dynamics*.

Employment Shares by Firm Size, 2006:IIQ



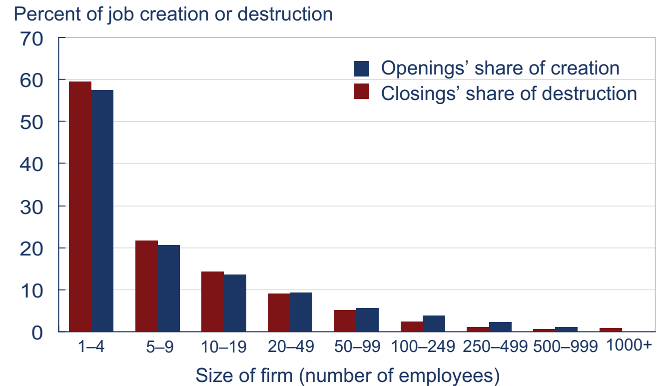
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Business Employment Dynamics*.

Job Creation and Destruction by Firm Size, 2006:IIQ



*Seasonally adjusted.
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Business Employment Dynamics*.

Openings and Closings as a Share of Job Changes, 2006:IIQ



Source: U.S. Department of Labor, Bureau of Labor Statistics, *Business Employment Dynamics.*

Economic Activity and Labor

Real GDP Growth

05.01.07
by David E. Altig and Brent Meyer

Real GDP grew 1.3 percent (annualized) in the first quarter of 2007, according to the advance release by the Bureau of Economic Analysis. This was a substantial decline from last quarter's 2.5 percent (annualized) growth, and the slowest pace of expansion in the U.S. economy since the first quarter of 2003.

International trade was a big part of the story, as exports fell considerably, from 10.6 percent (annualized) growth in the fourth quarter of 2006 to –1.2 percent (annualized) in the first three months of this year. (That decline represents the weakest quarterly growth rate since the second quarter of 2003). Import growth compounded the issue, increasing at an annual rate of 2.3 percent after posting a decrease of 2.6 percent last quarter.

Real personal consumption expenditures (PCE) growth decelerated slightly from 4.2 percent (annualized) last quarter to 3.8 percent, as growth in nondurables fell 3 percentage points (from 5.9 percent to 2.9 percent). In contrast, PCE durables increased from 4.4 percent (annualized) last quarter to 7.3 percent.

While up slightly from last month, residential investment continues to contract. In contrast, business fixed investment posted growth 15 out of the

Real GDP and Components, 2007:QI (advance estimate)

	Change, billions of 2000 $	Annualized percent change: Current quarter	Annualized percent change: Over same period 1 year ago
Real GDP	**36.1**	**1.3**	**2.1**
Personal consumption	77.7	3.8	3.4
Durables	21.6	7.3	4.5
Nondurables	17.2	2.9	2.9
Services	41.6	3.7	3.4
Business fixed investment	6.5	2.0	3.2
Equipment	4.9	1.9	0.8
Structures	1.5	2.1	9.4
Residential investment	-24.6	-17.0	-16.7
Government spending	4.7	0.9	1.7
National defense	-8.5	-6.6	0.4
Net exports	-15.2	—	—
Exports	-4.2	-1.2	5.5
Imports	10.9	2.3	1.6
Change in business inventories	-7.6	—	—

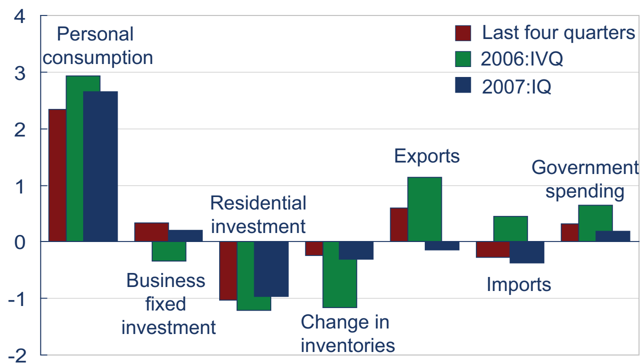
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

last 16 months. That includes the first quarter of this year, though the pace of nonresidential investment was sluggish.

While a deceleration in GDP growth was expected, consensus expectations from Moody's.com were for GDP to grow at an annual rate of 1.9 percent. The Blue Chip panel of economists also overshot the advance estimate, forecasting first-quarter real GDP growth at 2.1 percent in their April 10 report. Looking forward, the Blue Chip panel remains optimistic: The consensus view as of April 10 had GDP growth returning to 3 percent by the end of the year.

Contribution to Percent Change in Real GDP

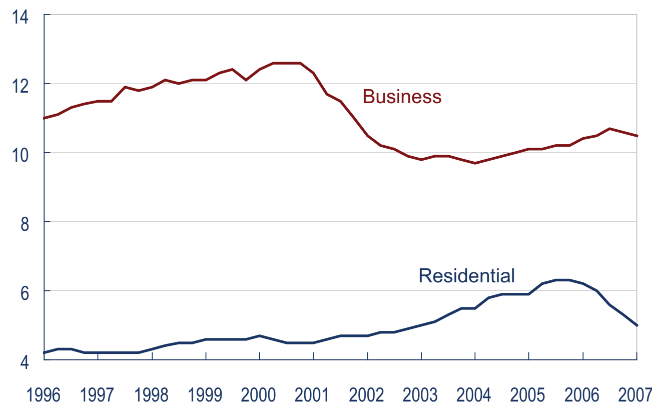
Percentage points



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

Fixed Investment

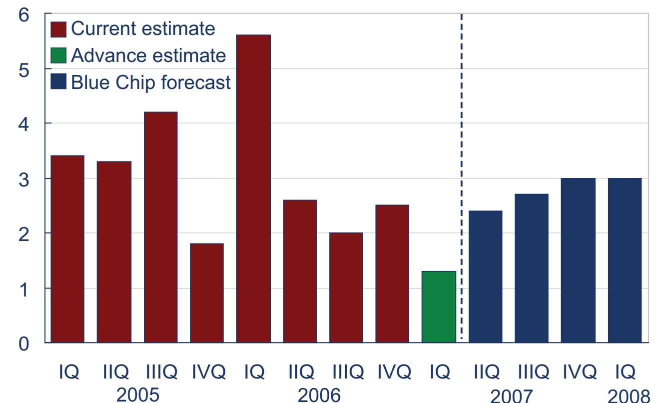
Percent of GDP



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

Real GDP Growth

Annualized quarterly percent change



Source: Blue Chip Economic Indicators, April 2007; U.S. Department of Commerce, Bureau of Economic Analysis.

Economic Activity and Labor

Labor Costs

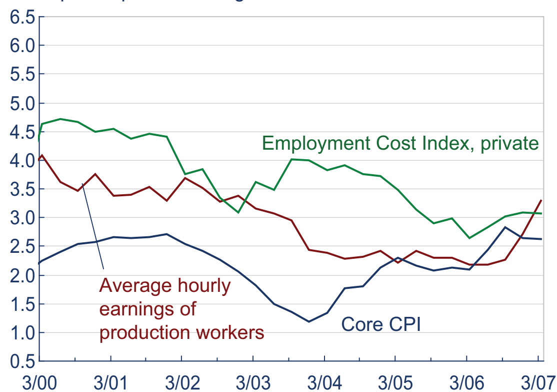
05.01.07

by Murat Tasci and Cara Stepanczuk

Compensation costs, as measured by the Employment Cost Index (ECI), had been rising at a slower pace since early 2005, but since the first quarter of 2006, this slowdown reversed itself; during the entire course of 2006, the pace of ECI growth sped up. Data on production workers' hourly earnings suggest that the ECI's wages and salaries component is responsible for the acceleration: this component has been increasing relatively faster since the first quarter of 2006. Economists usually worry that higher growth rates in the cost of employment might increase inflationary pressures. Indeed, a

Employment Cost and Inflation

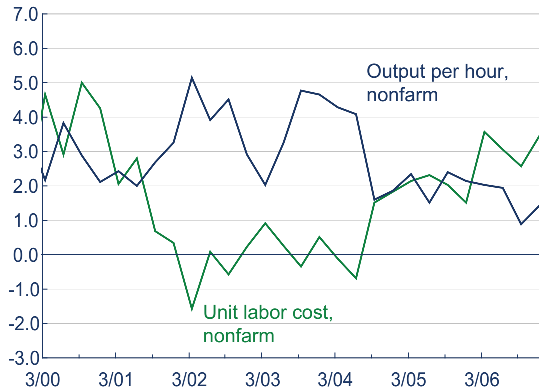
Four-quarter percent change



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

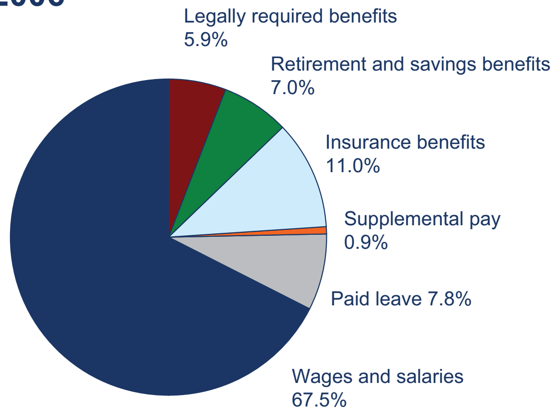
Productivity and Unit Costs

Four-quarter percent change



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

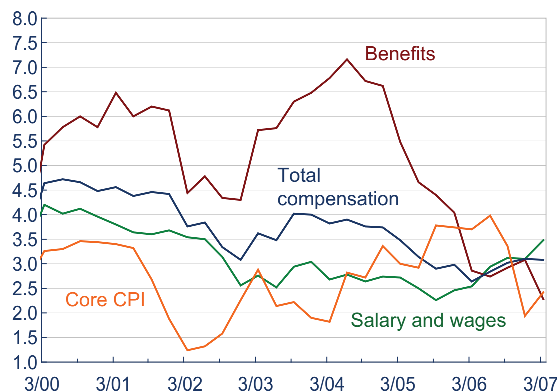
Distribution of Total Compensation, 2006



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

Components of Employment Compensation and Inflation

Four-quarter percent change



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

faster pace of core CPI growth has accompanied the higher growth rates of both the ECI and hourly earnings.

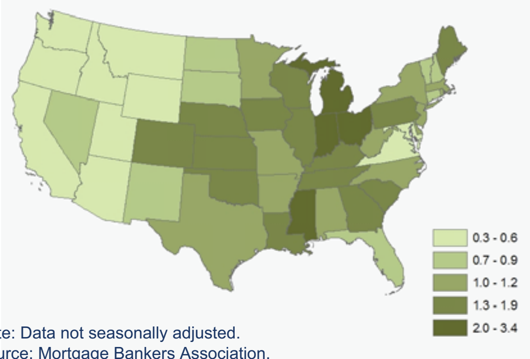
Of course, workers might be compensated more just because they are producing more, but this does not appear to have been the case over the past couple years. While unit labor costs (a productivity-adjusted measure of employment costs), have gained some momentum since the second half of 2004, the changes have been negatively correlated with changes in output per hour in the nonfarm business sector. This has been especially true since 2000. Hence, relatively higher growth in unit labor costs has coincided with relatively smaller gains in output per hour in the nonfarm business sector.

In 2006, almost 68 percent of the total compensation costs for service-providing workers consisted of wages and salaries. (This was very similar in the goods-producing sector.) The next-largest components were insurance benefits (11 percent), paid leave (7.8 percent), and retirement and savings benefits (7 percent). Growth in benefits was usually so high that it led to a greater increase in total compensation even when wages and salaries did not grow at a faster pace. This was the story between the fourth quarter of 2002 and the first quarter of 2006. But even though benefits have historically increased at a rate higher than wages and salaries, since the first quarter of 2006, all components of compensation have grown at a similar pace.

Foreclosures in Ohio

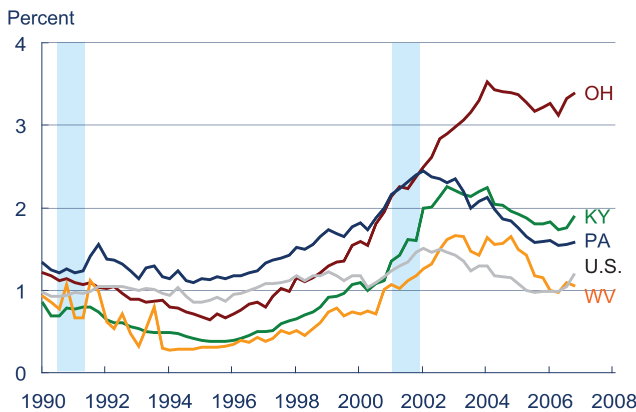
05.11.07
by Yoonsoo Lee and Brian Rudick

All Loans in Foreclosure, 2006:QIV



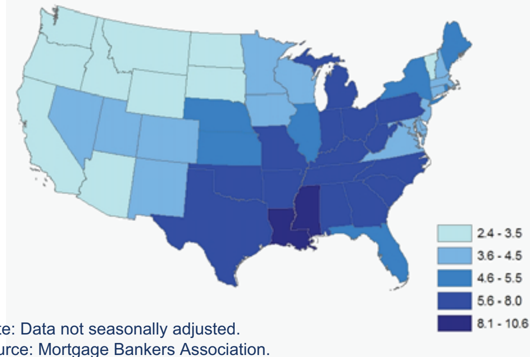
Note: Data not seasonally adjusted.
Source: Mortgage Bankers Association.

All Loans in Foreclosure



Note: Data not seasonally adjusted. Shaded bars indicate recessions.
Source: Mortgage Bankers Association.

All Loans Past Due, 2006:QIV



Note: Data not seasonally adjusted.
Source: Mortgage Bankers Association.

The fourth quarter of 2006 saw a record number of new foreclosures in the United States, according to the latest National Delinquency Survey from the Mortgage Bankers Association. Nationally, 0.57 percent of all outstanding loans were foreclosed in the last three months of the year, up from 0.42 percent a year ago and resulting in 1.19 percent of all mortgages in the U.S. currently in foreclosure. The increase was driven by all major loan types, although subprime (high-risk) and FHA loans stood out.

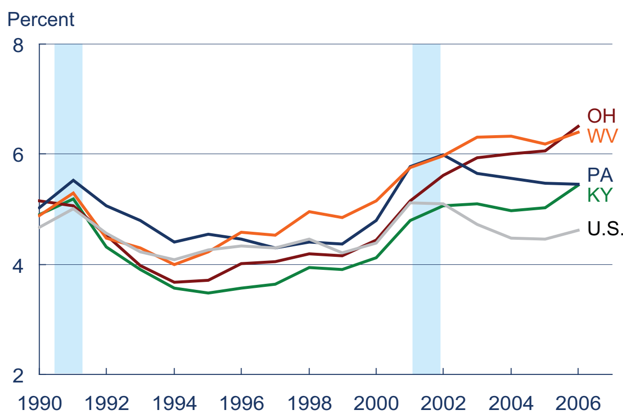
Ohio, with 3.38 percent of all loans in foreclosure, has the highest percentage of foreclosures of any state in the nation. In addition, Ohio's percentage of loans in foreclosure is almost three times as high as the national average (1.19 percent) and is well above that of any other state in the Fourth Federal Reserve District. Of all the 50 states, only Ohio, Michigan, Mississippi, and Indiana have more than 2 percent of loans in foreclosure.

Ohio hasn't always led the pack in foreclosures. In fact, Ohio had a smaller percentage of them than the nation as recently as 1998. But foreclosures across the U.S., including Fourth District states other than Ohio, have been falling since the last recession, while Ohio's have stayed substantially higher.

Delinquencies, or loans past due, are related to foreclosures, but not perfectly correlated. This is because not all delinquencies turn into foreclosures, and those that do take time to make the transition. With 7.25 percent of all loans past due, Ohio had the ninth highest percentage of delinquencies of all U.S. states in the fourth quarter of 2006. This was up from 6.67 percent a year ago.

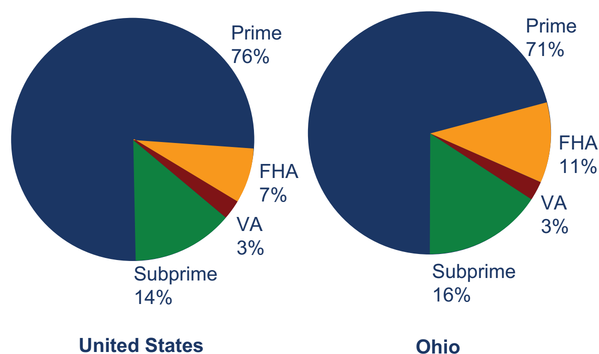
In the mid-1990s, Ohio had a smaller percentage of loans past due than the U.S. and most Fourth District states. Currently, however, Ohio has a higher percentage of delinquent loans than any other District state. Note that West Virginia had a higher percentage of delinquencies than Ohio over the past few years, but this did not result in a higher percentage of foreclosures.

All Loans Past Due



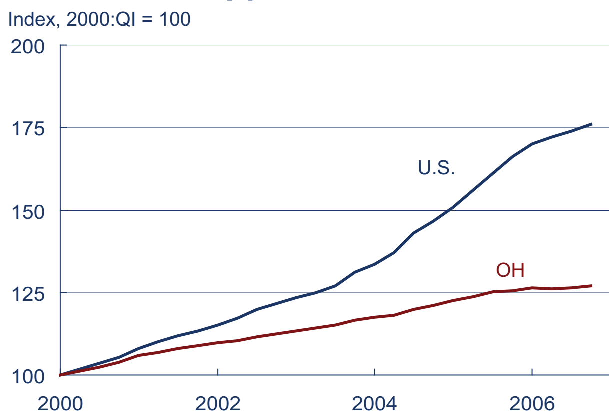
Note: Data not seasonally adjusted. Shaded bars indicate recessions.
Source: Mortgage Bankers Association.

Share of Total Loans, 2006



Source: Mortgage Bankers Association.

Home Price Appreciation



Source: Office of Federal Housing Enterprise Oversight.

Ohio Delinquencies and Foreclosures Higher in all Loan Categories

As foreclosures have increased over the past year, a lot of attention has focused on the subprime market. Subprime mortgages are more prone to delinquent payments and foreclosure due to their risky nature. In addition, if interest rates increase, subprime loans are more likely to be severely affected, because a higher percentage of subprime loans have adjustable rates. Ohio's share of subprime loans (16 percent) was the fifth highest of all the states in 2006, behind states such as Nevada, Arizona, and Florida. Despite this small share, subprime loans accounted for about half of all foreclosures in Ohio, and the U.S. in 2006. If measured in dollar value, however, the percentage would be smaller.

That said, Ohio's foreclosure and delinquency problems may not just be due to the subprime market. Indeed, Ohio has higher delinquencies and foreclosures in every loan category (prime, subprime, adjustable, fixed) compared to the U.S as a whole.

Economic fundamentals, such as housing trends and labor market conditions, also play a large part in the number of loans that go into foreclosure and delinquency. When home values fall, borrowers who need to sell or refinance to avoid foreclosure have a harder time doing so because their property is not worth what is owed. If people lose their jobs and are out of work, they may have a hard time keeping up with their mortgage payments. In Ohio, home prices haven't appreciated as fast as they have nationally, and in many metro areas lately, values have even declined. Ohio's unemployment rate has been higher than the nation's since 2003 as well.

Delinquencies and Foreclosures, 2006:QIV

	Loans past due (%)		All loans in foreclosure (%)	
	Ohio	U.S.	Ohio	U.S.
Prime ARM	5.0	3.7	2.9	0.9
Prime FRM	3.7	2.5	1.3	0.4
Subprime ARM	18.9	15.5	14.1	5.6
Subprime FRM	13.1	10.8	9.0	3.2

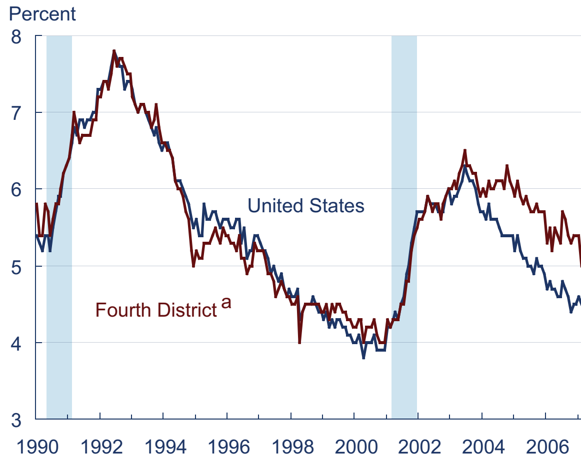
Source: Mortgage Bankers Association.

Fourth District Employment Conditions

04.10.07

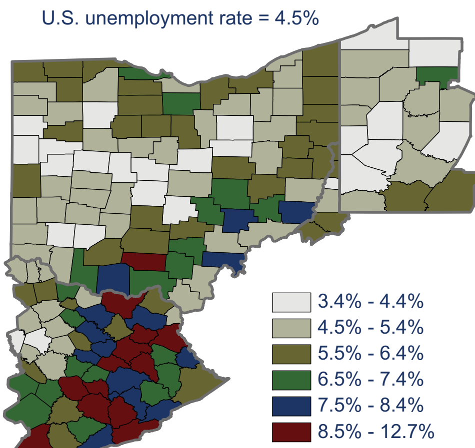
by Christian Miller and Paul Bauer

Unemployment Rates*



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

Unemployment Rates, February 2007*



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

The Fourth District unemployment rate stayed at 5.4 percent in January 2007, the same as in the previous month. Though the rate did not change, the number of unemployed workers crept up slightly (0.57 percent). Because the unemployment rate is the ratio of unemployed workers divided by workers in the labor force, one would expect this outcome if the number of those in the labor force had risen as well. However, the labor force participation rate actually fell slightly (-0.12 percent) in January. What explains this month's odd outcome is a byproduct of rounding: the changes in the numbers of those in the labor force and those working were relatively small, and after rounding the resulting rate was the same in December and January. Nationally, the unemployment rate rose to 4.6 percent in January, up a bit from 4.4 percent in the previous month.

Most counties in the Fourth District reported unemployment rates above the national average (145 out of 169). Unemployment rates rose in 83 counties since December 2006 but fell in 76 counties and remained the same in 10 counties. In comparison with a year ago at this time, 85 counties now have higher rates of unemployment, 65 have lower rates, and 19 have approximately unchanged rates. Holmes County, Ohio, had the lowest unemployment rate at 3.7 percent; on the opposite end of the field, Jackson County, Kentucky, had the highest rate with 12.7 percent unemployment.

Over the past year, payroll employment levels fell in Cleveland, Dayton, and Toledo, but in Pittsburgh and Lexington, they posted gains of 1 percent or more. Goods-producing industries continued to slow employment growth in the Ohio MSAs. In service-providing industries, on the other hand, employment was either flat or positive. Education and health services registered positive employment growth across the board, while the other service industries had more mixed growth across MSAs. Information and leisure and hospitality grew more

than 6 percent in Lexington. The greatest growth in the number of jobs created occurred in Pittsburgh in the education and health services industry, which added 6,100 jobs over the past year.

Payroll Employment by Metropolitan Statistical Area

	12-month percent change, January 2007							
	Cleveland	Columbus	Cincinnati	Dayton	Toledo	Pittsburgh	Lexington	U.S.
Total nonfarm	**-0.2**	**0.7**	**0.1**	**-0.7**	**-0.3**	**1.0**	**2.2**	**1.7**
Goods-producing	-1.7	-1.4	-1.3	-4.5	-1.6	1.1	0.0	0.3
Manufacturing	-2.6	-1.5	-1.6	-5.3	-1.4	0.1	-0.3	-0.6
Natural resources, mining, and construction	1.6	-1.1	-0.6	-1.4	-2.1	5.6	0.8	2.1
Service-providing	0.1	1.0	0.4	0.1	0.0	1.0	2.7	1.9
Trade, transportation, and utilities	-0.4	0.6	-0.3	-2.4	-0.6	-0.6	-2.6	0.8
Information	-2.6	-3.7	-2.5	-0.9	0.0	0.0	6.5	0.7
Financial activities	-0.1	-0.1	0.0	1.5	-3.1	-0.9	3.7	2.1
Professional and business services	0.3	2.5	0.7	0.6	-1.5	2.1	5.4	3.0
Education and health services	2.3	1.4	2.6	-0.2	0.8	2.8	1.3	2.7
Leisure and hospitality	0.7	2.3	-0.4	3.9	2.0	1.5	7.6	3.6
Other services	0.2	-0.3	0.0	0.6	0.7	0.2	-3.0	0.4
Government	-1.7	0.4	0.1	0.3	0.6	0.6	5.3	1.3
January unemployment rate, seasonally adjusted (percent)	**5.5**	**4.6**	**5.0**	**6.1**	**6.8**	**4.7**	**4.2**	**4.6**

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

FDIC Funds

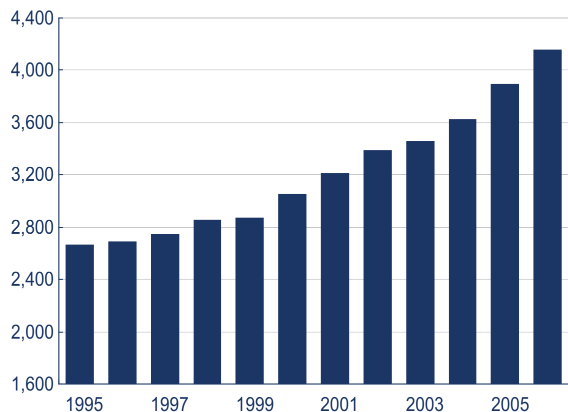
04.18.07
by O. Emre Ergungor and Cara Stepanczuk

FDIC-insured deposits grew 6.7 percent in 2006. The fund's reserve-to-deposit ratio fell to 1.21 percent, partly because insured deposits increased after the retirement account ceiling was raised from $100,000 to $250,000 in April. The reserve-to-deposit ratio remained in the target range, which changed to 1.15 percent–1.5 percent that month.

Bank failures since 1995 have been miniscule in terms of both the number of institutions and their total assets. No FDIC-insured institution failed in 2006; in fact, the fourth quarter of 2006 was the tenth consecutive quarter without any failures, the longest such period in the history of federal deposit insurance.

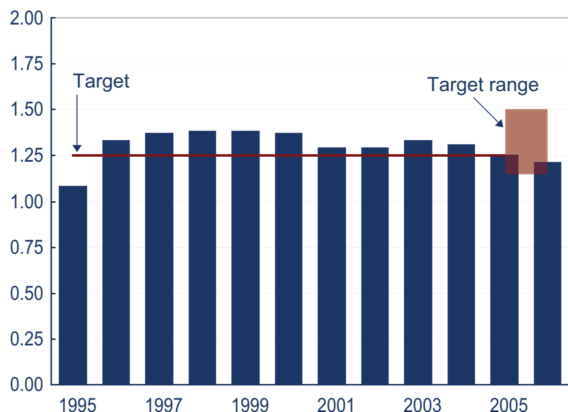
By the end of 2006, the number of problem institutions (those with substandard examination ratings) had dropped to 50, the lowest in the 36 years for which data are available. However, their total assets increased from $7 billion to $8.3 billion over the same period. Still, the low number of problem institutions and the low value of their assets suggest that the FDIC's losses will remain low in the near future.

FDIC-Insured Deposits



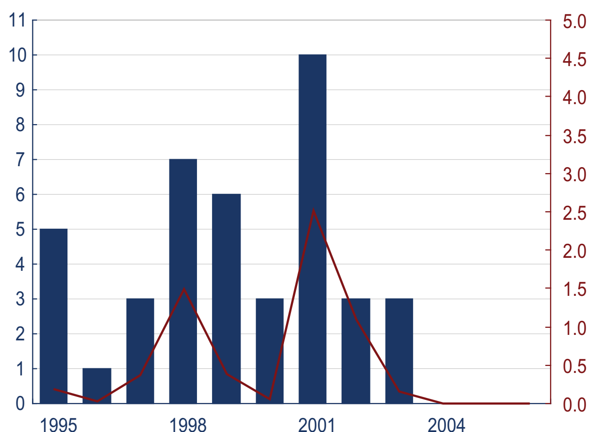
Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.

Fund Reserve Ratio



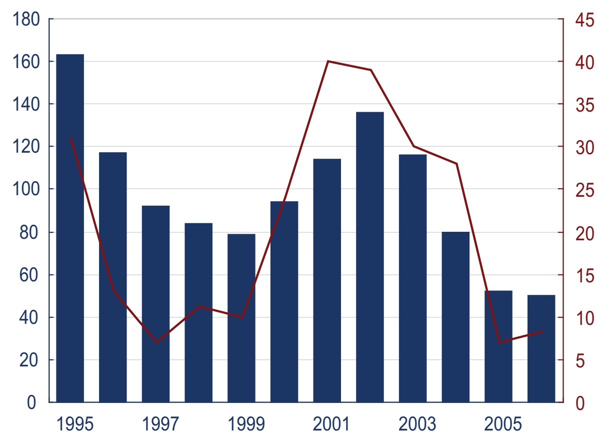
Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.

Failed Institutions*



*A bank with $16 million in total assets and $12 million in deposits failed in February 2007.
Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.

Problem Institutions



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.

Business Loan Markets

04.18.07

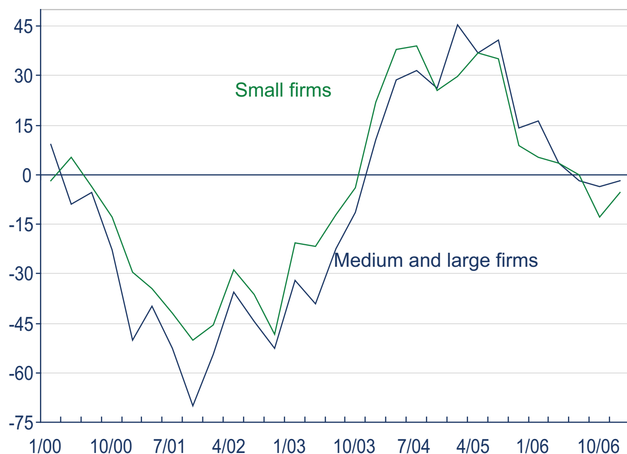
by O. Emre Ergungor and Cara Stepanczuk

The Federal Reserve Board's January 2007 survey of senior loan officers (covering the months of November, December, and January), found essentially no change in credit availability for businesses. After three years of easing standards, domestic banks reported that their lending standards for commercial and industrial loans (for borrowers of all sizes) had changed little over the period surveyed. Banks continued to narrow their lending spreads of loan rates over the cost of funds, attributing their decisions to more aggressive competition from other banks and nonbank lenders, and a more favorable economic outlook. By contrast, foreign banks increased the maximum size of credit lines, eased loan covenants, and narrowed spreads of loan rates over their cost of funds. They reported that their decisions were based on increased liquidity of business loans due to a deeper secondary market and increased tolerance for risk.

Demand for commercial and industrial loans has continued to weaken over the past three months, albeit at a slower rate than reported in the October survey. Those who reported weaker demand said decreased financing needs for accounts receivable and competition from other credit sources were responsible, while those who reported stronger demand cited an increase in mergers and acquisitions. The effect of companies' investment in plants and equipment was mixed, as it was implicated in both increased and decreased loan demand.

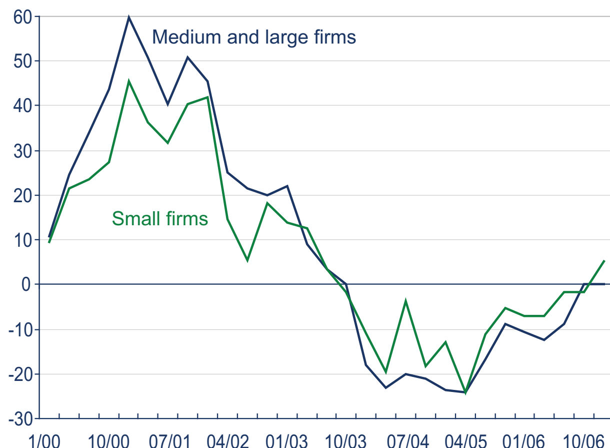
Banks' increasing unwillingness to further ease their lending standards and businesses' declining appetite for bank loans have yet to be reflected on bank balance sheets. The $33 billion increase in bank and thrift holdings of business loans in the fourth quarter of 2006 marks the eleventh consecutive quarter of increases in 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-

Domestic Banks Reporting Stronger Demand



Source: Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices, December 2006.

Domestic Banks Reporting Tighter Credit Standards



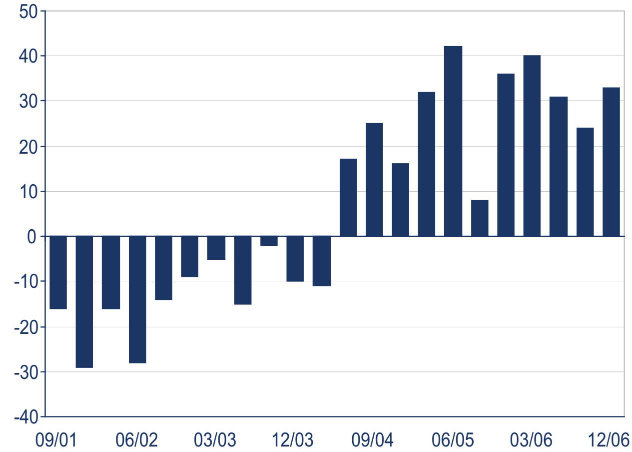
Source: Board of Governors of the Federal Reserve System, Senior Loan *Officer Opinion Survey on Bank Lending Practices*, December 2006.

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) edged down to 36.1 percent of total commitments, potentially indicating the declining importance of bank credit to commercial borrowers as a result of easier access to capital markets. This is another piece of evidence suggesting that business credit is readily available.

Quarterly Change in Commercial and Industrial Loans

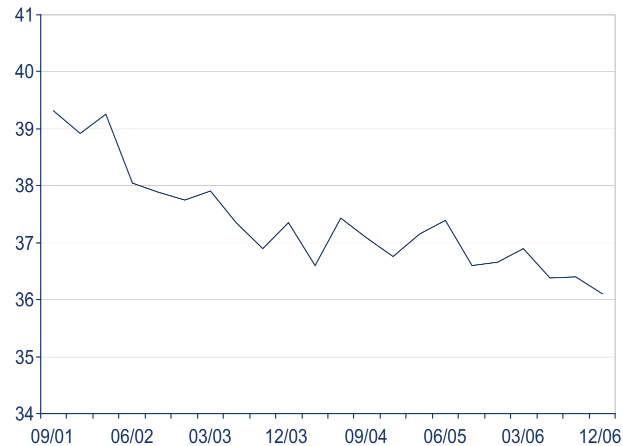
Billions of dollars



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.

Utilization Rate of Commercial and Industrial Loan Commitments

Percent of loan commitments



Source: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 2006.