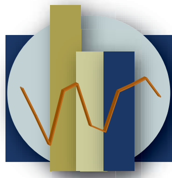

Economic Trends

May 2008
(Covering April 10, 2008, to May 9, 2008)

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March Price Statistics

05.01.08
Michael F. Bryan and Brent Meyer

March Price Statistics

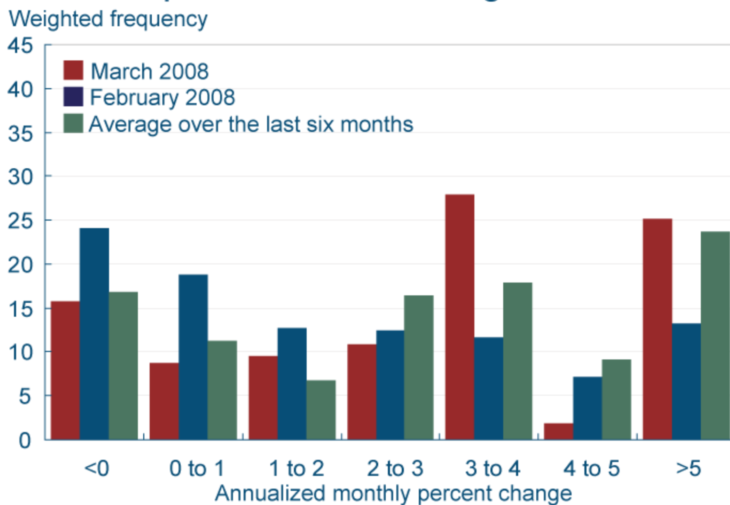
	Percent change, last					
	1 mo.[a]	3 mo.[a]	6 mo.[a]	12 mo.	5 yr.[a]	2007 avg.
Consumer Price Index						
All items	4.2	3.1	4.6	4.0	3.0	4.2
Less food and energy	1.8	2.0	2.3	2.4	2.2	2.4
Median[b]	3.1	2.9	3.2	3.0	2.7	3.1
16% trimmed mean[b]	3.7	3.0	3.1	2.8	2.5	2.8
Producer Price Index						
Finished goods	13.9	10.2	10.8	6.9	4.1	7.1
Less food and energy	3.0	5.0	3.6	2.8	1.9	2.9

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

The Consumer Price Index (CPI) rose at an annualized rate of 4.2 percent in March, returning to its recent elevated trend after a respite in February, when it increased only 0.3 percent (annualized rate). The CPI is up 4.6 percent over the past six months. Contrasting the rather sizeable increase in the overall CPI, the CPI excluding food and energy (core CPI) increased only 1.8 percent during the month.

Some analysts may point to March's relatively subdued increase in the core CPI and see inflation as contained (especially when you factor in February's 0.5 percent increase). Unfortunately, last month's relatively tranquil core CPI seems to be an aberration. Nearly 55 percent of the components of the CPI index rose in excess of 3.0 percent in March, compared to 32 percent in February, and roughly 50 percent on average over the past six months.

CPI Component Price Change Distributions



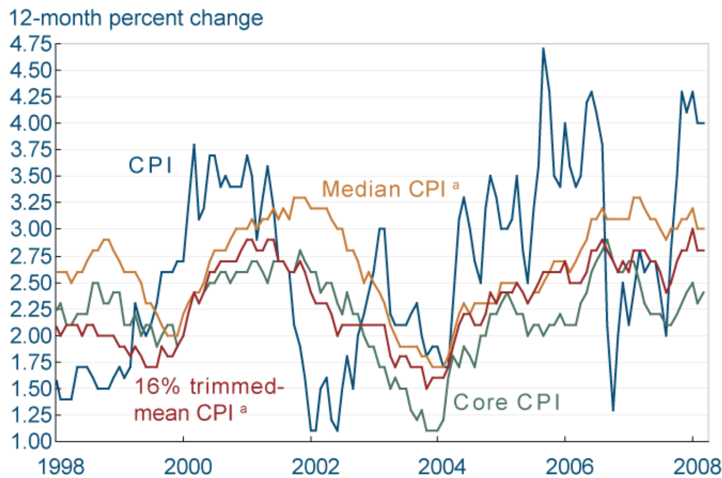
Sources: U.S. Department of Labor and Bureau of Labor Statistics.

The core CPI was pulled down by a near 10-year record decrease in apparel prices (14.4 percent) in March. Excluding just food and energy components makes the core CPI vulnerable to large transitory price swings in other components, which is why trimmed means offer a less biased estimation of inflation. The median and 16 percent trimmed-mean CPI measures, which track underlying inflation trends, rose 3.1 percent and 3.7 percent, respectively. Over the past six months, both trimmed-mean inflation indicators have risen in excess of 3.0 percent. There has been similar pressure on producer prices recently. The Producer Price Index (PPI) has risen 10.8 percent in the past six months, and that price pressure did not ebb in March, as the PPI increased 13.9 percent. Even when highly variable food and energy prices are excluded, the PPI has averaged 3.6 percent over the past six months, and 5.0 percent over the past three months.

Longer-term trends in consumer inflation data have remained elevated for all measures of consumer prices. The 12-month growth rate in the CPI was 4.0 percent in February, unchanged from last

CPI, Core CPI, and Trimmed-Mean CPI Measures

12-month percent change

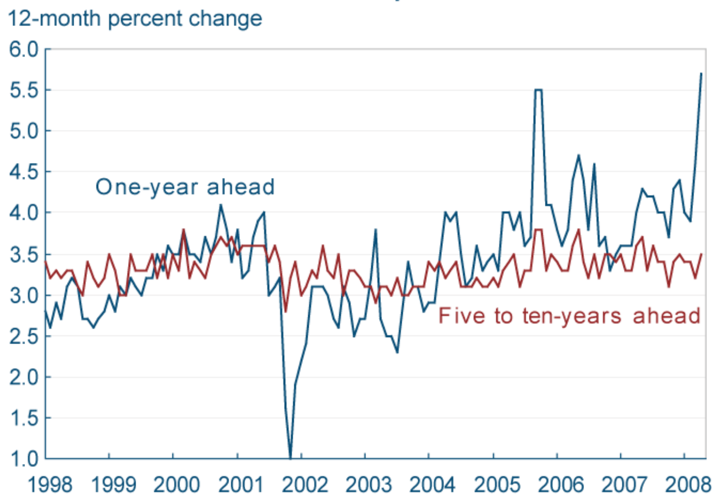


a. Calculated by the Federal Reserve Bank of Cleveland.

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

Household Inflation Expectations*

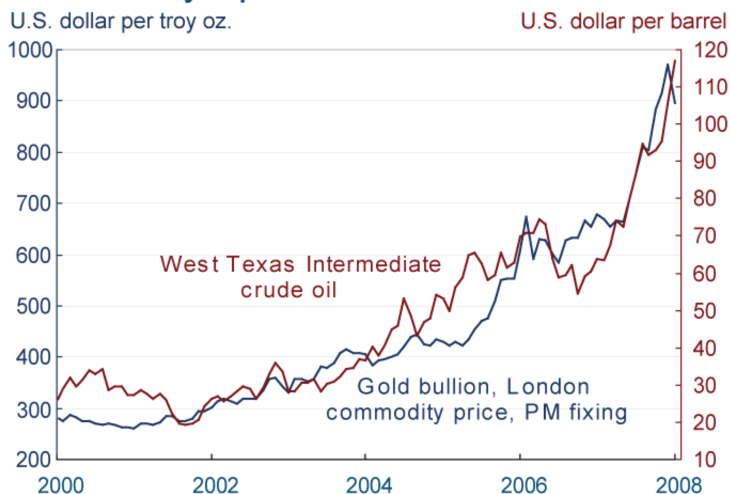
12-month percent change



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

Source: University of Michigan.

Commodity Spot Prices



Source: Wall Street Journal, last observation 4/24/2008.

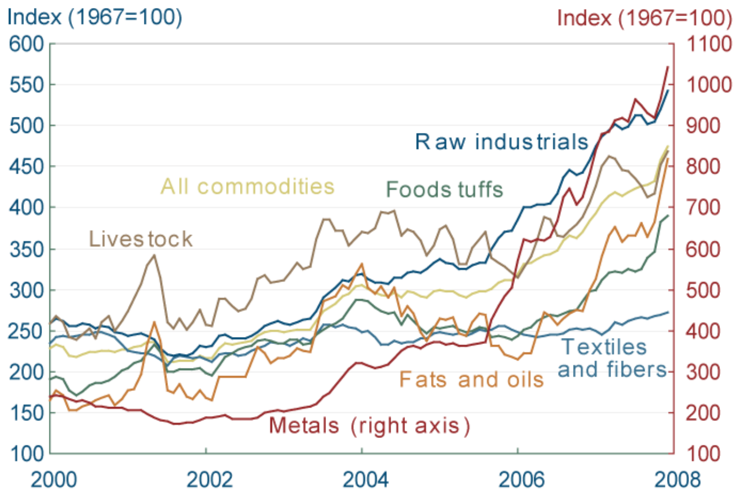
month, while the longer-term trend in the core CPI ticked up slightly. Both the 16 percent trimmed-mean and median CPI measures were unchanged at 2.8 percent and 3.0 percent, respectively.

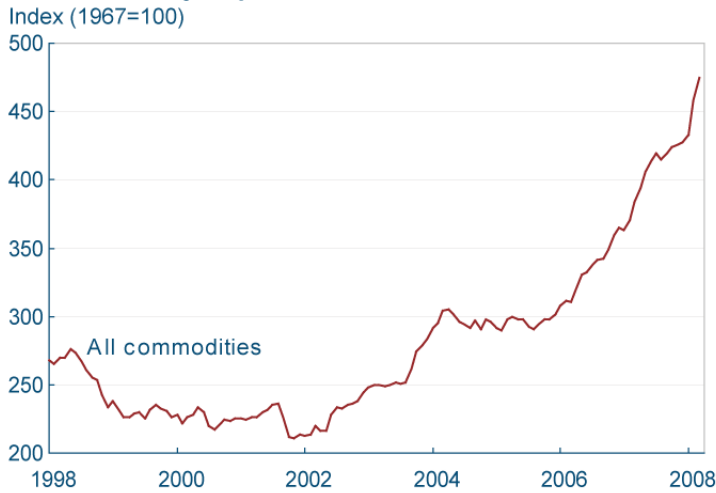
According to the April University of Michigan's Survey of Consumers, near-term (one-year ahead) household inflation expectations spiked up to 5.7 percent in April, jumping 1.1 percentage points over March's value and rising to their highest rate since October 1990. Expectations over the longer term (5 to 10 years) ticked up to 3.5 percent in April, from 3.2 percent in March, but remain within the narrow range that they have fluctuated within over the past 10 years.

Undoubtedly, rising food and fuel prices are factoring into the recent jump in near-term consumer inflation expectations. The price of oil has practically doubled in the past year. Gold prices—seen as an inflation hedge to some investors—are up $262 per ounce from January 2007. However, surging prices are not just limited to these two commodities.

The Commodity Research Bureau's Spot Price Index is an unweighted geometric mean of individual commodity price indexes—ranging from textiles and foodstuffs to metals and industrial materials excluding energy goods—has risen 23.6 percent over the past 12 months. All the subindexes that comprise the spot price index (with the exception of the textiles and fibers index) have experienced a double-digit 12-month growth rate. Since January 2006, the metals index (copper, lead, steel, tin, and zinc) has jumped up 127.7 percent, while the fats and oils index is up 98.8 percent over the same time period.

There are many different (and possibly related) postulates to explain the run-up in commodity prices; resource pressures caused by increased global demand; speculation; subsidized ethanol production; low real interest rates; and dollar depreciation. Regardless of the cause, higher food and energy prices increase the costs of doing business and may affect inflation expectations, especially if these commodity prices remain relatively high. In a speech* in early March, Federal Reserve Vice Chairman Donald L. Kohn outlined the risks that higher commodity prices pose on the outlook. "In these circumstances, policymakers must be mindful of the uncertainties

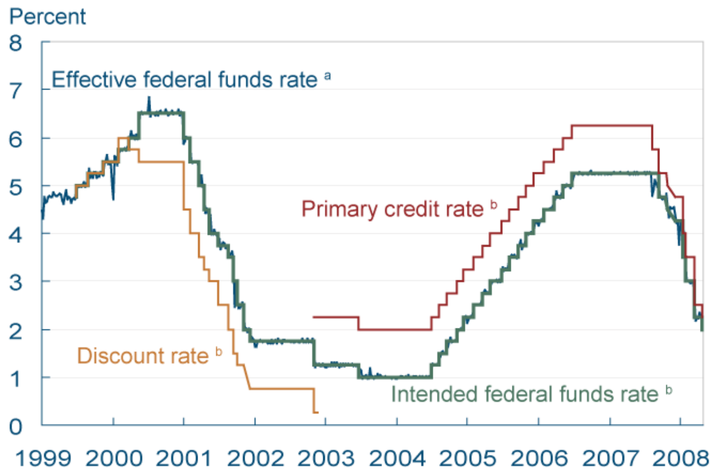




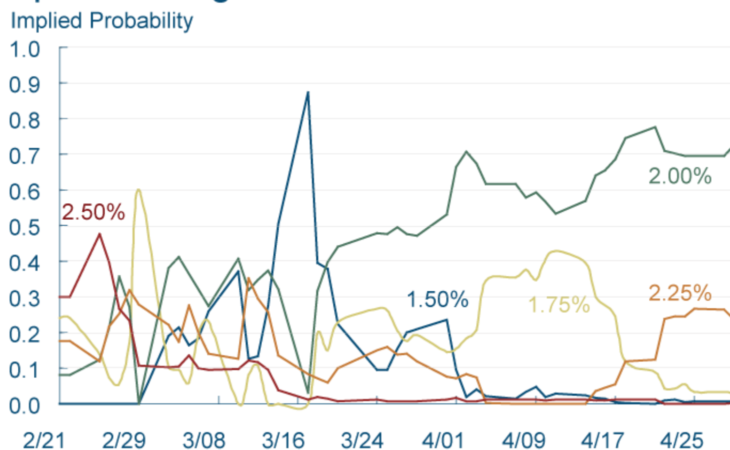
surrounding the outlook for commodity prices and the risk that past or future increases in these goods could yet embed themselves in higher long-run inflation expectations and a persistently faster rate of overall price increases."

*"Implications of Globalization for the Conduct of Monetary Policy," by Donald L. Kohn. Speech given at the International Symposium of the Banque de France, Paris, France, on March 7, 2008.

Supplying Liquidity: The Tried and True and the New



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.



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

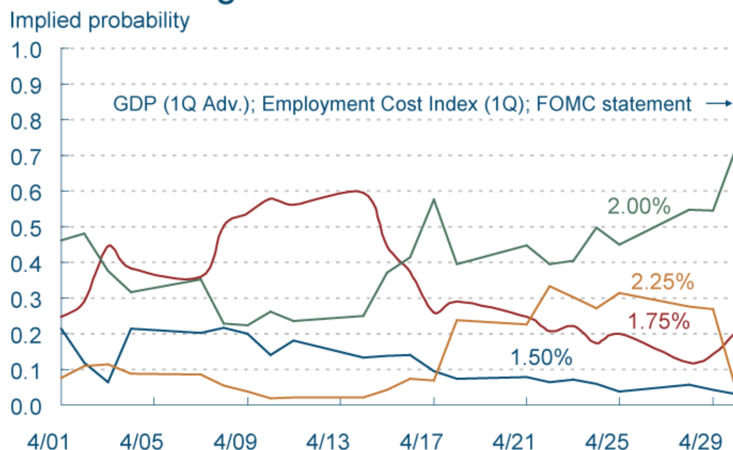
05.02.08
Bruce Champ and Sarah Wakefield

On April 30, 2008, the Federal Open Market Committee (FOMC) voted to lower its target for the federal funds rate by 25 basis points to 2 percent. Since this latest round of rate cuts began in September 2007, the federal funds rate has been lowered a total of 3.25 percent. The FOMC's statement noted that "economic activity remains weak" and that "financial markets remain under considerable stress." The committee also pointed to some improvement in core inflation but cautioned that "energy and other commodity prices have increased, and some indicators of inflation expectations have risen in recent months." Richard Fisher and Charles Plosser preferred no change in the funds rate and voted against the committee's action.

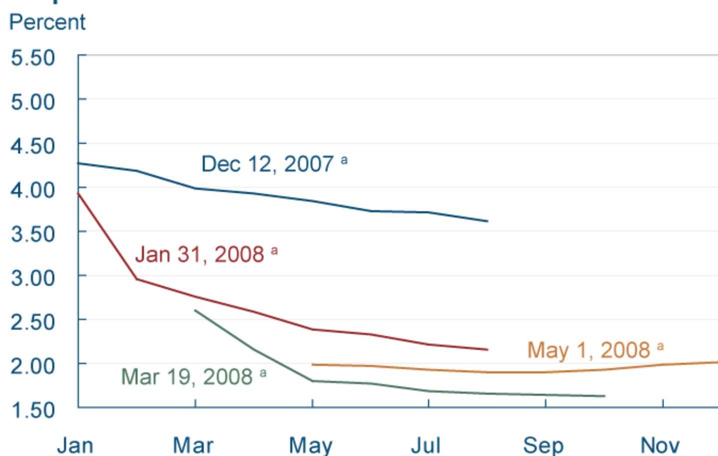
In the days prior to the meeting, participants in the Chicago Board of Trade's federal funds options markets placed around a 70 percent probability on a 25 basis point cut at the April meeting. Nearly a 25 percent probability was placed on no change.

The options market places over a 70 percent probability on a pause at the June meeting. Looking further ahead, participants in the federal funds futures market have raised their projected path of the funds rate in recent weeks. Currently, participants in the futures market foresee little change in the funds rate over the next few meetings.

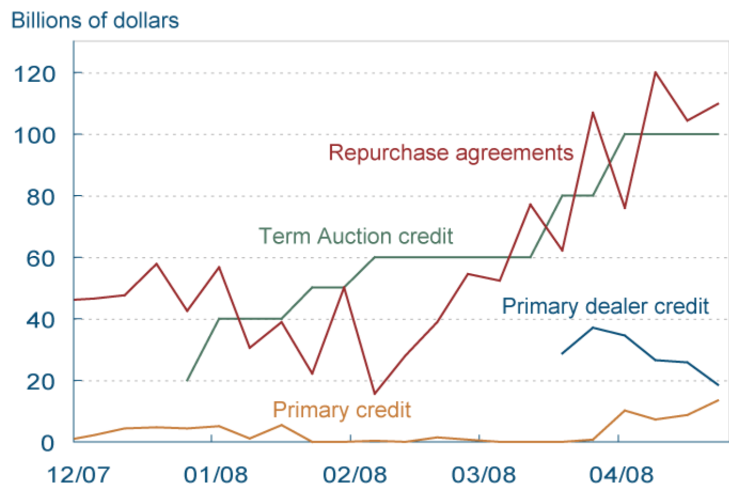
With the onset of financial turmoil in the fall of 2007, the Federal Reserve has implemented a number of facilities to enhance market liquidity and the functioning of financial markets. December brought the introduction of the Term Auction Facility (TAF), which auctions a predetermined amount of funds to depository institutions that are eligible for primary credit. Total bids for TAF funds continue to exceed the amount offered by nearly 2 to 1, even though the biweekly auction sizes were increased to $50 billion in March. In contrast, the April 10 and April 24 Term Securities Lending Facility's (TSLF) auctions of securities were under-



Notes: Probabilities are calculated using trading-day closing prices from options on federal funds futures that trade on the Chicago Board of Trade; Vertical bar refers to the end of the day values.
Source: Chicago Board of Trade and Bloomberg Financial Services.



a. One day after FOMC meeting.
Source: Chicago Board of Trade and Bloomberg Financial Services.



Source: Federal Reserve Board.

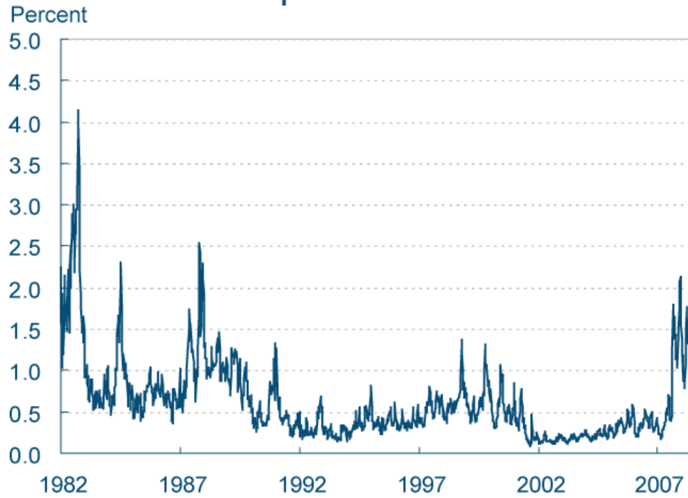
subscribed, with bids totaling less than the amount offered. Under the TSLF, which was introduced in March, the Trading Desk of the New York Fed lends liquid Treasury securities to primary dealers in exchange for a broader set of collateral. On May 2, the Federal Reserve announced changes to the TAF and TSLF facilities. Beginning May 5, the size of the biweekly TAF auctions will be increased from $50 billion to $75 billion. In addition, securities eligible as collateral for Schedule 2 TSLF auctions will be expanded to also include AAA/Aaa-rated asset-backed securities.

On March 16, the Federal Reserve announced a new lending facility "to improve the ability of primary dealers to provide financing to participants in securitization markets." The Primary Dealer Credit Facility (PDCF) went into operation on March 17 for a period of at least six months. Under the PDCF, the Fed makes loans to primary dealers at the primary credit rate. These loans are collateralized by a wide range of investment-grade securities. Primary dealer credit outstanding peaked at nearly $40 billion at the end of March but has since declined to under $20 billion. There also has been substantial use of the discount window by depository institutions in recent weeks, with primary credit outstanding averaging around $10 billion during April. In contrast, primary credit outstanding has averaged $400 million since the facility was introduced in January 2003.

Despite the new liquidity-providing facilities, measures of liquidity pressures remain elevated. One such measure is the spread between the three-month Libor rate, the rate at which banks lend to each other in the wholesale London money market, and the rate on a comparable 90-day Treasury security. This spread has been volatile throughout this year and is currently at historically high levels.

Funds supplied by the Term Auction Facility, primary credit, and the Primary Dealer Credit Facility provide reserves to the banking system and can therefore potentially affect the federal funds rate. In order to keep the funds rate at the target set by the FOMC, the Trading Desk must drain reserves to offset the impact of those facilities. This has not come from a reduction in repurchase agreements

(repos) conducted by the Desk. Repos remain elevated due to the introduction of single-tranche-term repos on March 7. This represented another effort to increase liquidity in term funding markets. However, the Desk has drained reserves through outright sales and redemptions of Treasury securities. Since the beginning of December 2007, total outright holdings of securities in the Fed's System Open Market Account (SOMA) have fallen over $230 billion. The mix of securities in the portfolio has also changed due to the liquidity facilities' provisions. The proportion of highly liquid Treasury bills in the Fed's portfolio has fallen from 34 percent to 13 percent since the beginning of December 2007.



Notes: Libor spread is the 3-month Libor minus the 3-month T-Bill; Weekly data.
Source: Federal Reserve Board.

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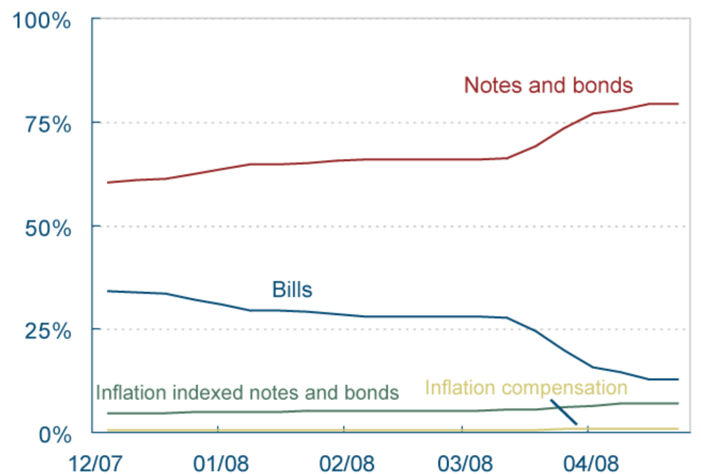
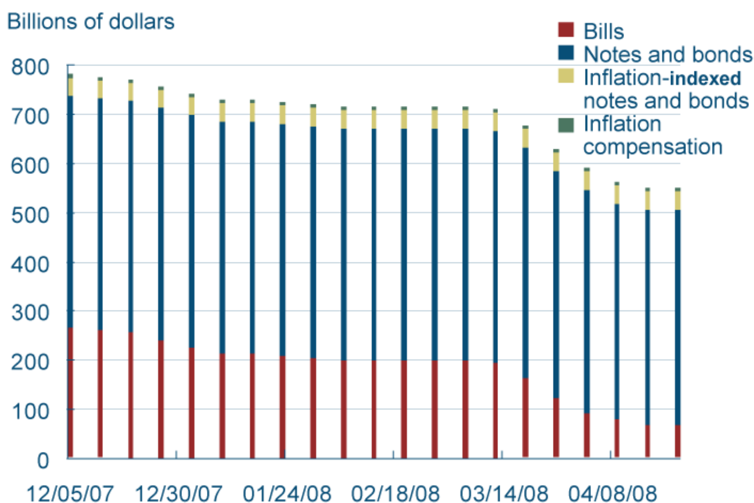
Source: Federal Reserve Board.



Source: Federal Reserve Board.



Source: Federal Reserve Board

The Yield Curve

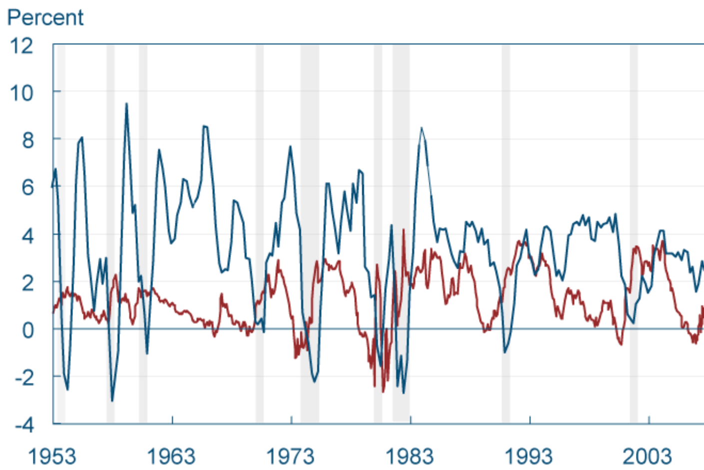
04.15.08
Joseph G. Haubrich and Katie Corcoran

Since last month, the yield curve has gotten steeper, with long-term interest rates rising and short term interest rates falling. One reason for noting this is that the slope of the yield curve has achieved some notoriety as a simple forecaster of economic growth. The rule of thumb is that an inverted yield curve (short rates above long rates) indicates a recession in about a year, and yield curve inversions have preceded each of the last six recessions (as defined by the NBER). Very flat yield curves preceded the previous two, and there have been two notable false positives: an inversion in late 1966 and a very flat curve in late 1998. More generally, though, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year bonds and 3-month T-bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

The yield curve steepened slightly since last month, with long rates edging up and short rates edging down. The spread remains positive with the 10-year rate moving up 3 basis points to 3.54 percent, while the 3-month rate dropped 4 basis points to 1.33 percent (both for the week ending April 11). Standing at 221 basis points, the spread inched up from March's 214 basis points, and is well above February's 144 basis points. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 2.8 percent rate over the next year. This is on the high side of other forecasts (see this Congressional Budget Office memo)).

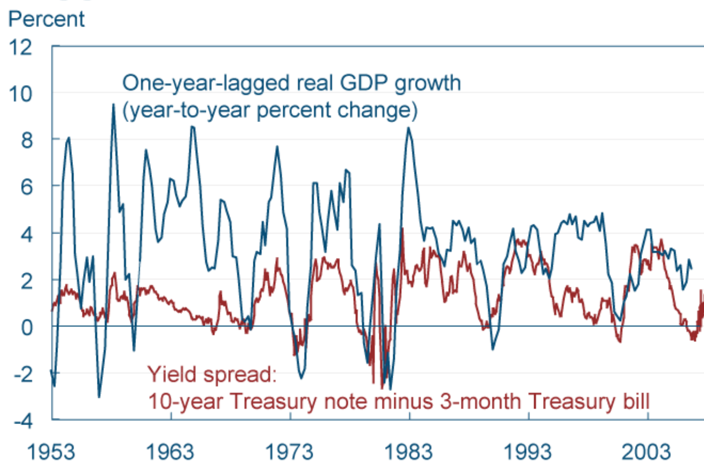
While such an approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in the case of recessions. Thus, it is sometimes preferable to focus on using the yield curve to predict a discrete event: whether or not the economy is in recession.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

Yield Spread and Real GDP Growth*



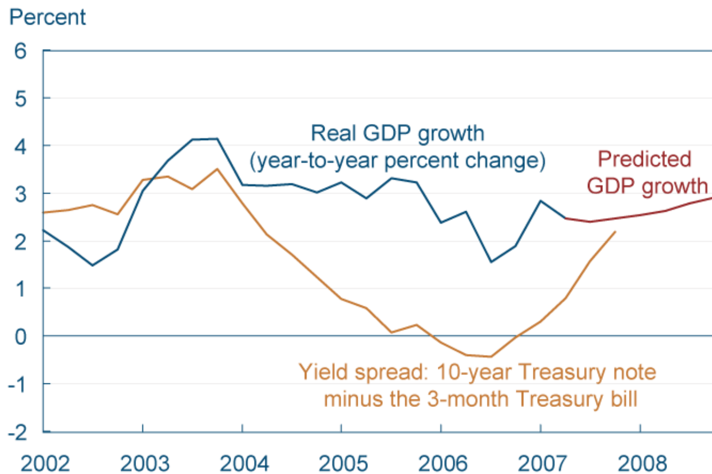
*Shaded bars indicate recessions.
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Yield Spread and Lagged Real GDP Growth



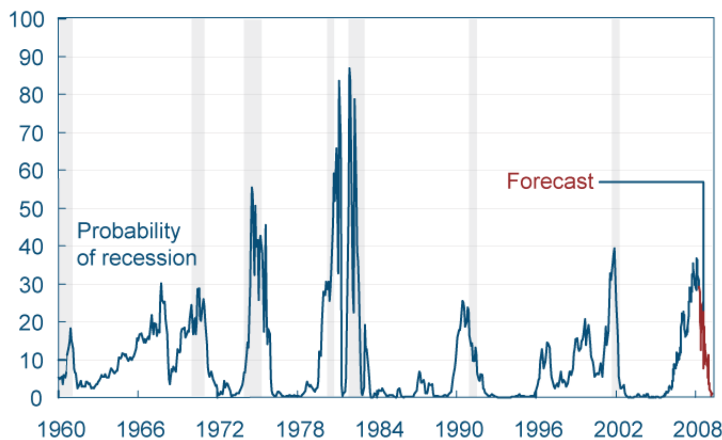
Sources: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Predicted GDP Growth and the Yield Spread



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

Probability of Recession Based on the Yield Spread



stands at 1 percent, down from March's 2.7 percent, and from February's already low 3.7 percent.

This probability of recession is below several recent estimates and perhaps seems strange the in the midst of recent financial concerns, but one aspect of those concerns has been a flight to quality, which lowers Treasury yields. Also related is the reduction of the federal funds target rate and the discount rate by the Federal Reserve, which tends to steepen the yield curve. Furthermore, the forecast is for where the economy will be next April, not earlier in the year.

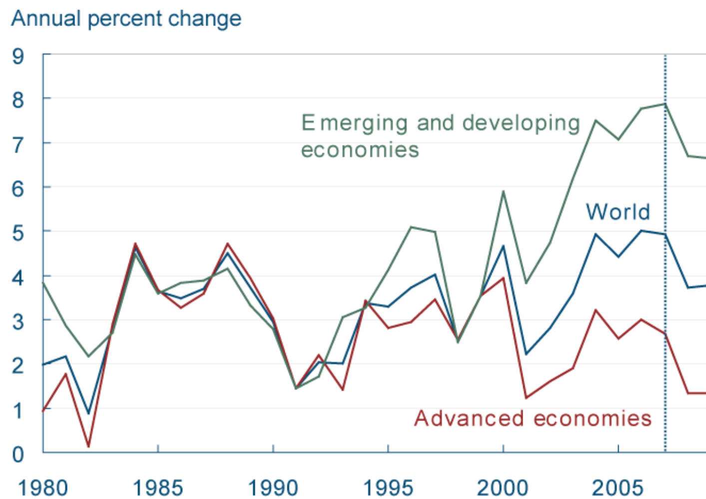
On the other hand, a year ago, the yield curve was predicting a 46 percent chance that the U.S. economy would be in a recession in March, 2008, a number that seemed unreasonably high at the time.

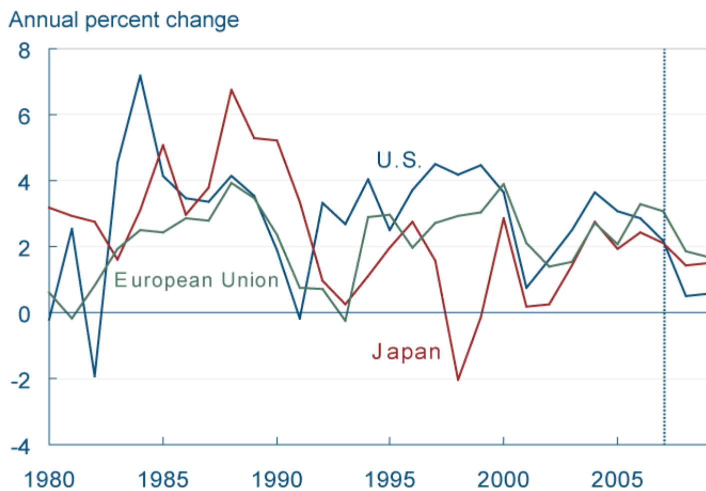
To compare the 1 percent chance of recession to some other probabilities and learn more about different techniques of predicting recessions, head on over to the Econbrowser blog.

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?"

Bifurcation?





05.09.08

Owen F. Humpage and Michael Shenk

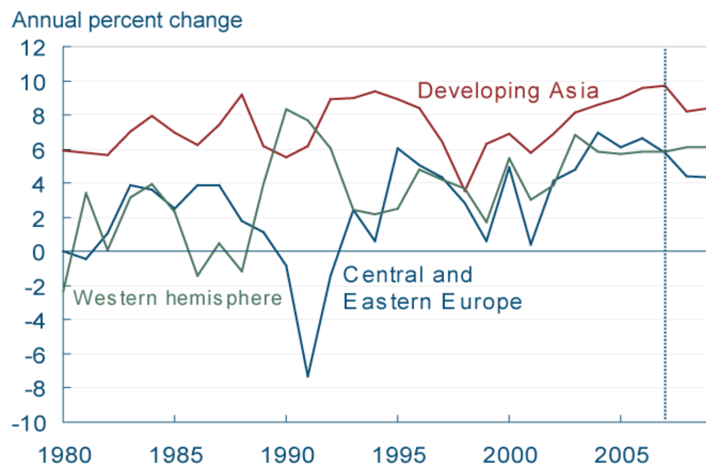
In its April World Economic Outlook*, the International Monetary Fund (IMF) lowered its projections for world economic growth. No surprise there! But, the report also suggested that the traditional correlation between growth in advanced-developed countries and growth in developing countries was weakening. Global trade gains and macroeconomic policy improvements have reduced—but not eliminated—the developing countries' dependency on the developed world. Now that's interesting!

The IMF now believes that the pace of world output will slow from 4.9 percent in 2007 to 3.7 percent in 2008 and to 3.8 percent in 2009. All things considered, the slowdown is not that bad, but the IMF cautions that the risks to growth remain weighted on the downside, reflecting primarily the likelihood that further financial turmoil could impair credit availability. This slowdown follows five consecutive years of strong, broadly shared world economic growth.

Notwithstanding attempts to infuse financial markets with liquidity, the IMF expects ongoing spillovers from problems in the U.S. subprime market to constrain credit availability and economic growth in advanced-developed countries. The United States will bear the brunt; it is likely to experience a mild recession in 2008 and a tepid recovery in 2009, even after allowing for recent cuts in the federal-funds-rate target and income-tax rebates. Economic growth in other advance economies, particularly Western Europe, will fall short of potential, but will not contract.

The distinguishing characteristic of the IMF's recent outlook is how surprisingly well the developing and emerging-market countries are expected to perform despite the weakness in the advanced-developed world. Growth in emerging and developing countries will almost certainly moderate this year to around 6.7 percent from a phenomenally strong

Emerging and Developing Economies' Growth*



* Estimates after 2007
Source: International Monetary Fund, *World Economic Outlook Database*, April 2008.

7.9 percent pace in 2007 and will most likely weaken further to 6.6 percent in 2009. Nevertheless, relative to its historic performance, real economic growth among the emerging and developing countries will remain quite strong.

Since 2004, economic growth has been particularly robust across all regions of the developing world, including Africa and Latin America. China alone has accounted for approximately one quarter of the world's overall growth rate, while Brazil, China, India, and Russia have accounted for approximately one-half, according IMF estimates.

The IMF credits the recent resilience of the emerging and developing countries largely to the productivity gains that these countries have acquired through integrating with the broader global economy. Market reforms within a broad range of developing countries and technological advances have encouraged global companies to unbundle production processes and to access underutilized labor resources in the developing world. These patterns seem particularly strong in China, India, and Eastern Europe. As a consequence, developing and emerging countries are increasingly important competitors in world markets. The IMF estimates that they now account for roughly one-third of all global trade and for more than one-half of the increase in global import volumes since 2000. Moreover, despite recent global financial stresses, trade between the developed and developing world has not dropped off much.

The unbundling of production is also changing the pattern of global trade. Roughly one-half of emerging and developing counties' exports are now going to other such countries, according to the IMF. This is especially true within Asia. While the IMF expects that exports from Asia to the United States and Europe will slow, the effect will be less debilitating than during previous downturns, because intra-Asia trade is rising relative to trade with the West. As a consequence, even though the emerging and developing countries are opening up, the business fluctuations in advanced economies may now have less of an impact on them than in the past.

The IMF also credits recent strong growth among emerging and developing economies to their

improved macroeconomic-policy performance. Country-to-country variation notwithstanding, emerging and developing countries have generally cooled their inflation rates and corralled their fiscal deficits. Public (and private) balance sheets have strengthened. While official and private financial flows into these countries generally have remained strong, many emerging and developing countries have reduced their reliance of foreign borrowing, and their ability to accumulate official foreign-exchange reserves provides them an insurance pool against financial turmoil.

Despite the optimistic outlook for the emerging and developing world as a whole, the IMF does sound an important cautionary note. Although these countries are reducing their business-cycle dependency on the advanced world, they have not completely broken it. Spillover effects are still significant and, as the IMF emphasizes, they may be 'nonlinear.' That is, they may be fairly benign when economic growth in the advanced counties slows, but wickedly severe when the developed world slips into recession.

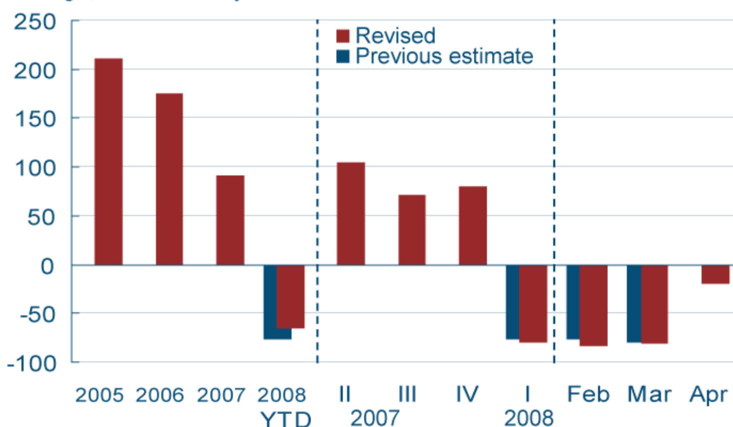
*See: http://www.imf.org/external/pubs/ft/weo/2008/01/index.htm.

Economic Activity and Labor Markets

The Employment Situation

05.08.08

Yoonsoo Lee and Beth Mowry



The April Employment Report came in better than anticipated, with a total loss of just 20,000 nonfarm jobs from payrolls. Revisions to February and March numbers increased the losses in those months by just 8,000. The unemployment rate edged slightly lower, from 5.1 percent to 5.0 percent over the month.

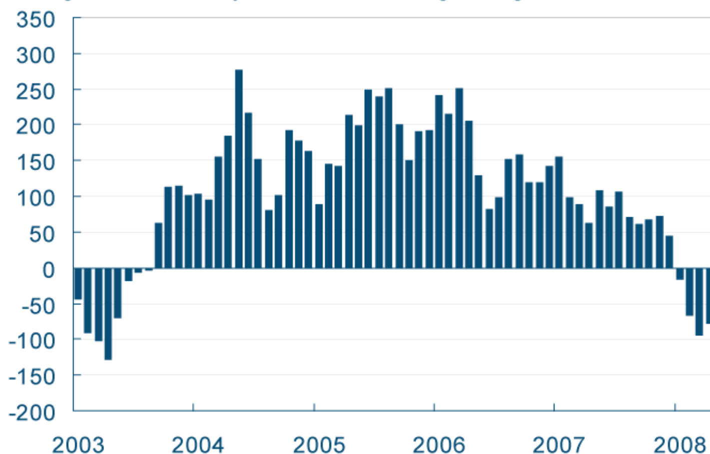
While this month's Employment Report paints a less bleak picture than recent months, it is still indicative of a weak labor market in many areas. The goods-producing sector as a whole continued its 13-month decline, losing 110,000 jobs, its largest loss since February 2007. Service-providing industries, however, created 90,000 jobs, an impressive gain compared with March's very modest 7,000 gain.

Labor Market Conditions

	Average monthly change (thousands of employees, NAICS)				
	2005	2006	2007	YTD 2008	April 2008
Payroll employment	211	175	91	−65	−20
Goods-producing	32	3	−38	−90	−110
Construction	35	13	−19	−48	−61
Heavy and civil engineering	4	3	−1	−9	−15.7
Residential[a]	11	−2	−10	−32	−33.1
Nonresidential[b]	4	7	1	−7	−12.6
Manufacturing	−7	−14	−22	−44	−6
Durable goods	2	−4	−16	−33	−43
Nondurable goods	−8	−10	−6	−11	−3
Service-providing	179	172	130	25	90
Retail trade	19	5	6	−26	−26.8
Financial activitiesc	14	9	−9	−6	3
PBS[d]	56	46	26	−16	39
Temporary help services	17	1	−7	−19	−9.3
Education and health services	36	39	44	48	52
Leisure and hospitality	23	32	29	15	18
Government	14	16	21	13	9
Local educational services	6	6	5	5	−0.7
	Average for period (percent)				
Civilian unemployment rate	5.1	4.6	4.6	5.0	5.0

a. Includes construction of residential buildings and residential specialty trade contractors.
b. Includes construction of nonresidential buildings and nonresidential specialty trade contractors.
c. Includes the finance, insurance, and real estate sector and the rental and leasing sector.
d. 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: Bureau of Labor Statistics.

Private Sector Employment Growth



Source: Bureau of Labor Statistics.

Within the goods-producing sector, manufacturing accounted for 46,000 of the payroll losses, and construction accounted for 61,000. Durable goods manufacturing fared far worse than nondurable, losing 43,000 versus just 3,000. Within durables, transportation equipment (-19,000) and fabricated metal products (-11,300) fared the worst. Food manufacturing was the most positive influence on nondurable goods, adding 1,700 jobs.

The largest contributors to gains in the service industry were education and health professions; professional and business services; and leisure and hospitality. Most of the 52,000 job gain in education and health professions came on the health care end (36,900). This is even larger than last month's gain of 43,000 and represents the sector's best performance since August of last year. The 39,000 payroll gain in professional and business services pulled the sector out of its three-month-long slump, and was largely due to solid gains in professional and technical services (26,800) and computer systems design (10,200). Leisure and hospitality's 18,000 gain was led by food services and accommodation (20,000). It is worth noting that financial activities, although a small source of April's service-industry payroll gains, came in positive for the first time since last July, adding 3,000 jobs.

Retail lost 26,800 jobs in April, continuing its negative trend begun in December. In particular, building materials stores and department stores lost the most jobs within the industry. Food and beverage stores lost jobs (4,400) for the first time since last April. Temporary help services, which is often regarded as a leading indicator of overall employment conditions, lost just 9,300 payrolls, compared to March's larger loss of 25,000.

The three-month moving average of private sector employment growth inched up from -94,000 in last report to -78,000 in this report. This measure can provide a cleaner read of labor market conditions because it removes some of the monthly volatility and the consistent boost provided by the government. Due to the government's positive contribution of 9,000 jobs last month, April's private nonfarm payroll change actually looks less optimistic than the total nonfarm payroll change. Private

nonfarm payrolls declined by 29,000 in April. The diffusion index of private employment fell from 48 to 45.4, meaning that even more private employers cut back payrolls in April than in March.

Real GDP 2008:Q1 Advance Estimate

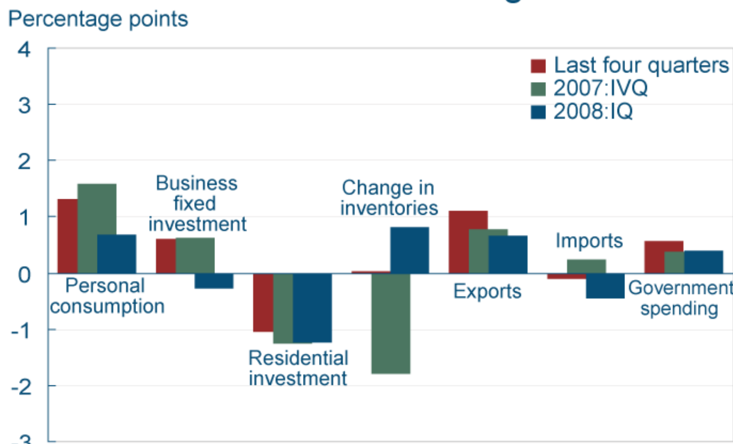
05.06.08
Brent Meyer

Real GDP and Components, 2008: Q1 Advance estimate

	Quarterly change (billions of 2000$)	Annualized percent change, last: Quarter	Four quarters
Real GDP	17.4	0.6	2.5
Personal consumption	20.0	1.0	1.9
Durables	-19.4	-6.1	0.4
Nondurables	-7.9	-1.3	0.4
Services	39.8	3.4	2.8
Business fixed investment	-9.0	-2.5	5.8
Equipment	-1.9	-0.7	3.3
Structures	-5.1	-6.2	11.5
Residential investment	-32.1	-26.6	-21.2
Government spending	10.1	2.0	2.9
National defense	7.5	6.0	5.9
Net exports	7.3	—	—
Exports	19.7	5.5	9.5
Imports	12.4	2.5	0.7
Change in business inventories	20.1	—	—

Source: Bureau of Economic Analysis.

Contribution to Percent Change in Real GDP

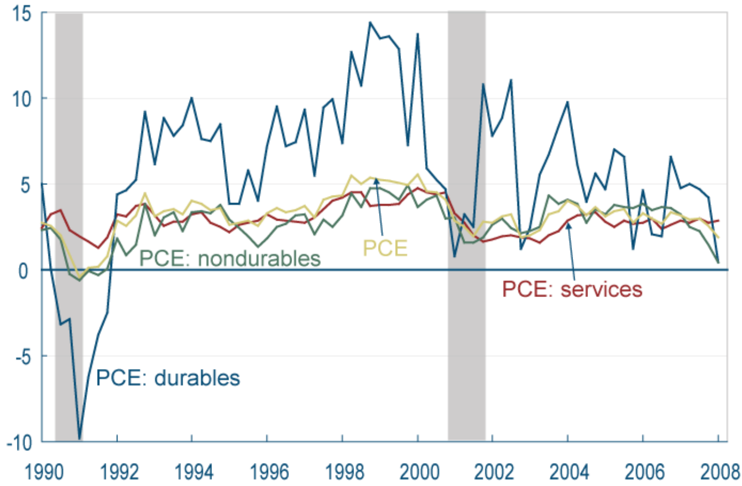


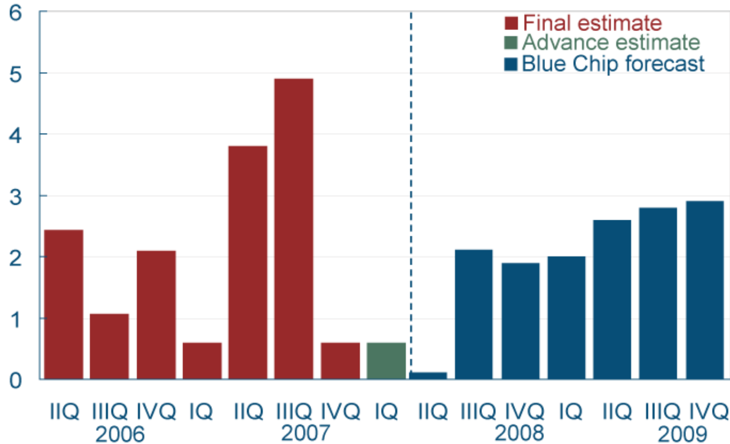
Source: Bureau of Economic Analysis.

Real GDP grew at an annualized rate of 0.6 percent in the first quarter of 2008, the same growth rate as last quarter, according to the advance release by the Bureau of Economic Analysis. Over the past four quarters, real GDP has increased 2.5 percent, slightly below its long term (30-year) average of 3.0 percent. Growth in the first quarter was primarily due to increases in exports and private inventories, which were partly offset by a decrease in private investment and an increase in imports (which subtract from real GDP). While headline growth remained at 0.6 percent, growth among the components varied significantly from last quarter.

Real personal consumption increased 1.0 percent (annualized rate) in the first quarter, compared to 2.3 percent last quarter. Spending on consumer durables, which posted a small increase in the fourth quarter of 2007, fell 6.1 percent in the first quarter of 2008. Real business fixed investment decreased 2.5 percent during the quarter, actually taking away 0.3 percentage point from real GDP growth, compared to an average contribution of 0.6 percentage point over the last four quarters. Residential investment continued to fall, tumbling 26.6 percent (at an annualized rate) in the first quarter, and is now down 21.2 percent on a year-over-year basis. Inventories added 0.8 percentage point to real GDP growth after taking away 1.5 percentage points last quarter. Exports continued to perform well, rising 5.5 percent in the first quarter, while imports showed a somewhat surprising gain of 2.5 percent, given the backdrop of recent dollar depreciation and weak consumer sentiment.

Over the past few quarters, consumer spending on services has continued to rise slightly, while spending on both durable and nondurable goods has





begun to drop off. The four-quarter growth rate in services consumption was 2.8 percent, according to the first-quarter advance estimate, while growth in both durable and nondurable goods consumption fell to 0.4 percent. The decline in the four-quarter growth rate for durable goods was somewhat dramatic, falling from 4.2 percent to 0.4 percent in the first quarter, their lowest growth rate since the fourth quarter of 1991. Looking ahead to the second quarter, the fiscal stimulus rebate checks have already begun to be distributed and that may stave off further deterioration in goods consumption. Estimates of how much of the nearly $120 billion stimulus will be spent by consumers over the next two or three quarters vary dramatically and depend largely on how many people they predict will exhibit income smoothing behavior (and save a large portion of the rebate check).

The Blue Chip consensus economic forecast is predicting that the economy will grow a shade above zero next quarter, snap back in the third quarter,

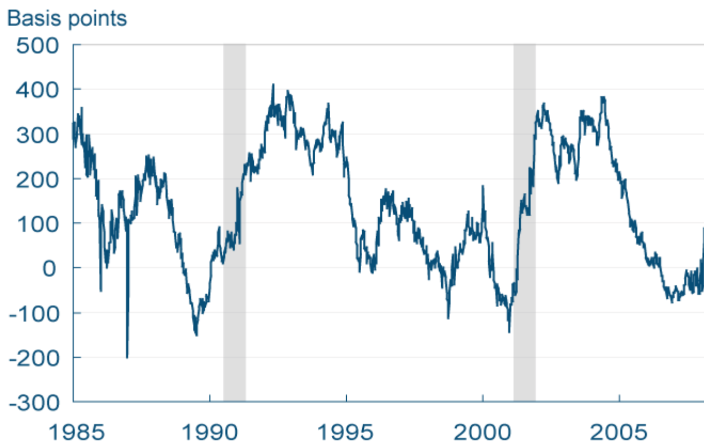
and rise to near-trend growth by the end of 2009.

Economic Activity and Labor Markets

What Interest Rate Spreads Can Tell Us about Mortgage Markets

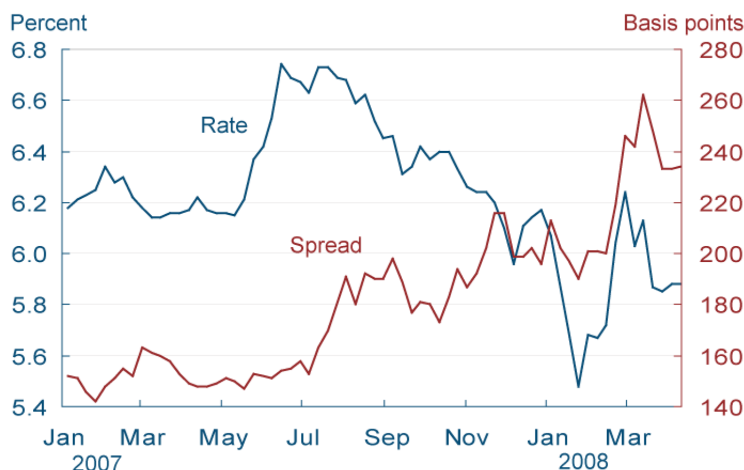
04.30.08
By Andrea Pescatori and Beth Mowry

Spread between Treasuries and Federal Funds



Notes: The spread is between the 10-year Treasury note rate and the fed funds effective rate; Data are weekly; Shaded bars indicated recessions.
Source: Federal Reserve Board.

Mortgage Rates and the Spread between Mortgages and Treasuries



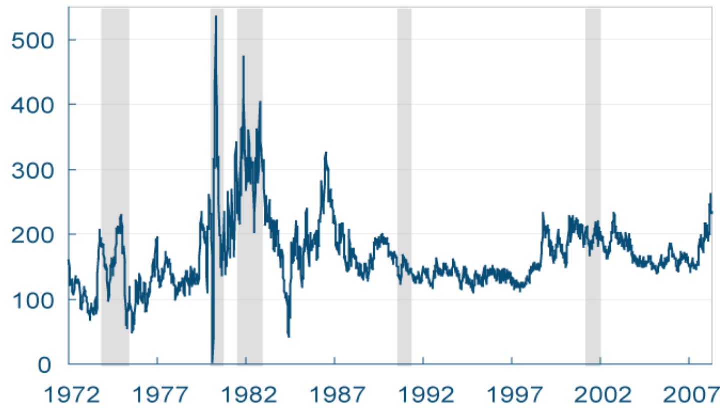
Note: The spread is between the rate on the prime, conforming fixed-rate mortgage and the rate on the 10-year Treasury note, Data are weekly.
Sources: Freddie Mac Primary Mortgage Market Survey; Federal Reserve Board.

The target for the federal funds rate has been slashed three full percentage points since September, from 5.25 to 2.25 percent. Yet, despite this steep drop, the average interest rate on 30-year fixed-rate mortgages has fallen only about half a percentage point—from about 6.4 to about 5.9 percent—over the same time span. Why has the central bank's aggressive action had such a small impact on these mortgage rates, and what does this mean?

The Fed does not set mortgage rates, but it does set a nominal target for the federal funds rate, the rate at which depository institutions lend their reserve balances to one another, usually overnight (a very short maturity). The fed funds rate in turn directly affects the price of other fixed-income assets of similar maturities and quality (measured in terms of default risk and liquidity); this is the case for short-term Treasury securities, for example. However, as the maturity of an asset gets longer, the link between its price and the funds rate becomes more tenuous. This is because the price of a long-term bond incorporates not just recent changes in the short-term rates of all relevant assets but their expected future short-term rates as well. For example, the spread between the interest rate on a 10-year Treasury note and the federal funds rate has risen recently because the future path of the federal funds rate is expected to go up.

Once we control for maturity, the spread between securities should tell us something about the role that liquidity and risk are playing in pricing the assets. A good benchmark for the 30-year fixed-rate mortgage is the 10-year Treasury note, because 30-year mortgages usually get paid off in 10 years. The spread between the average prime conforming mortgage rate and the 10-year Treasury note has been heading north since the summer of 2007, reflecting turbulence in the mortgage-backed security

Spread between Rates on Mortgages and Treasuries



Note: The spread is between the rate on the prime, conforming 30-year fixed-rate mortgage and the rate on the 10-year year Treasury note. Data are weekly.
Sources: Freddie Mac Primary Mortgage Market Survey; Federal Reserve Board.

market, a secondary market for mortgages. With the housing meltdown, pricing mortgage-backed securities, especially the more sophisticated ones, has become even harder, as risk has increased, and liquidity in the mortgage-backed security market has dried up (just think about the billions of dollars in write-downs). An illiquid mortgage-backed security market, in turn, makes the repackaging of mortgages more difficult. Because mortgages are more difficult to repackage, mortgages themselves become less liquid for mortgage originators, who then seek higher compensation for the loss of liquidity. In fact, although the average 10-year Treasury yield has fallen 93 basis points to 3.59 percent since September (when the Fed started cutting the fed funds rate), the average yield for 30-year fixed-rate mortgages has fallen only 50 basis points to 5.88 percent. As a result, the spread between the average 30-year mortgage and the 10-year Treasury note has widened about 60 percent over the past year. The spread stood at 148 basis points in April 2007 and now stands at 233 basis points, having reached its peak of 262 basis points in March at the time of the Bear Stearns bailout. The risk of a financial meltdown clearly affected the prime conforming mortgage rate and even caused its level to increase. More recent data, though, show the spread retreating from its peak, suggesting that the risk of a financial crisis has decreased (as other indexes also indicate).

Compared to the 1990s, the spread between mortgage rates and treasuries is elevated, which suggests that financial markets are still working through their prior excesses. To find levels higher than the current ones, we have to go back to the 1980s, in particular to the early part of the decade, when the spread reached its historic high. This was a time of great economic turmoil, with a high rate of inflation, two back-to-back recessions, and banking deregulation.

Given the excesses that occurred in the housing and mortgage markets, it is not surprising that market participants are being more cautious. Some potential home buyers are holding back, and lenders have implemented tougher lending standards and are charging more for loans. From January 1972 to April 2008 the median weekly spread is about

160 basis points between the 30-year fixed-rate mortgage and the 10-year Treasury note. If this more normal spread prevailed, fixed-rate mortgages would be around 5 percent today, instead of the current 5.88 percent. Until market participants regain confidence, rate spreads are likely to continue to deviate from their historical norm. Had the Fed not lowered the funds rate, mortgage rates would likely be even higher. Assuming there are no more large shocks, it is likely that the spread will ease back to more normal levels, providing a boost to home buyers, who, after all, care about their mortgage rate, not the fed funds rate.

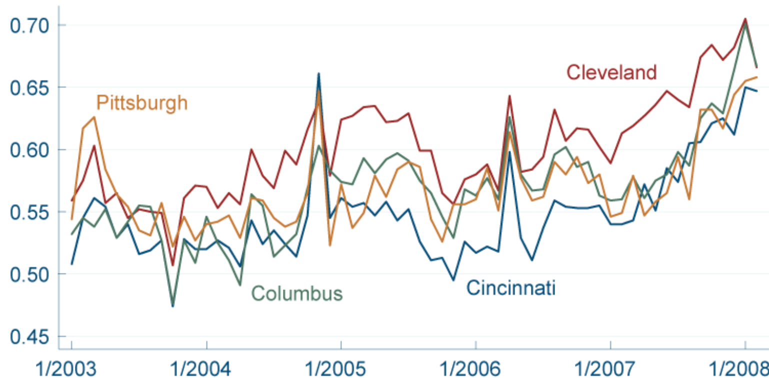
Regional Activity

Mortgage Delinquencies in Fourth District Metropolitan Areas

4.28.08

By Tim Dunne and Guhan Venkatu

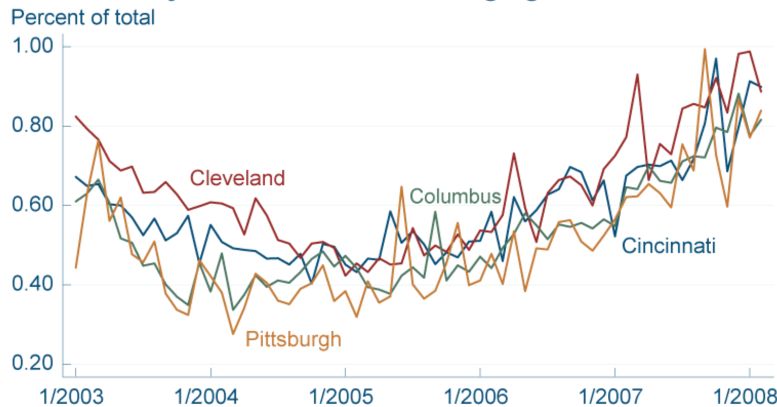
The U.S. housing market continued to be under considerable stress in the first quarter of 2008. Recent data from the Census Bureau show that building permits and housing starts are still falling, and a recent report by Equifax and Moody's Economy.com indicates that mortgage delinquency rates rose again in the first quarter. Mortgage delinquency rates measure the percent of mortgage holders who are past due on their payments and also represent the pool of mortgages at risk of entering foreclosure.



Note: The data presented in the charts have been seasonally adjusted using the Census Bureau's X-11 procedure.
Source: LoanPerformance.

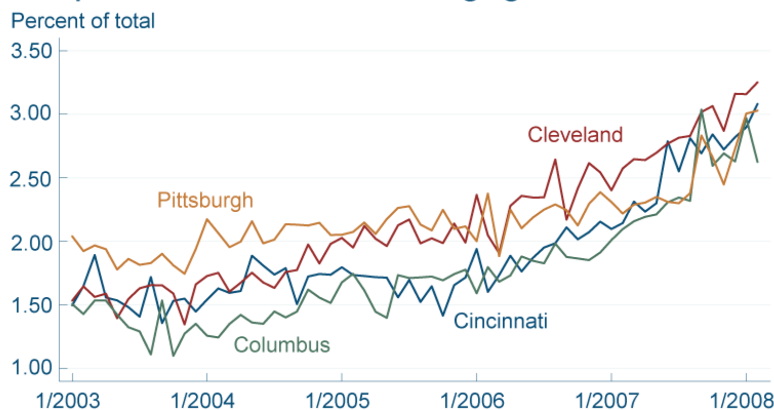
It is well documented that Midwestern states such as Michigan, Indiana, and Ohio have experienced relatively high rates of mortgage delinquency and foreclosure. In fact, the rise in delinquency and foreclosures rates in these states preceded that of the nation as a whole. But what is happening at the metro-area level? We looked at delinquency rates from January 2003 to February 2008 in the major metropolitan areas of the Fourth District to discern the trends for a range of mortgage types. We focused on 60-day mortgage delinquency rates in Cincinnati, Cleveland, Columbus, and Pittsburgh, the four largest metropolitan areas of the District. The 60-day delinquency rate reports the percentage of loans for which payments are more than 60 days late but less than 90 days late. The reason to focus on 60-day delinquencies is that they give us a

60−Day Delinquency Rates: Prime, Adjustable−Rate Mortgages



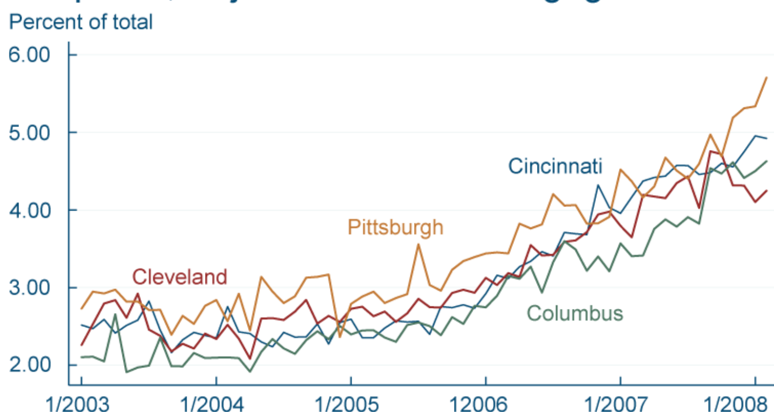
Note: The data presented in the charts have been seasonally adjusted using the Census Bureau's X-11 procedure.
Source: LoanPerformance.

60−Day Delinquency Rates: Subprime, Fixed−Rate Mortgages



Note: The data presented in the charts have been seasonally adjusted using the Census Bureau's X-11 procedure.
Source: LoanPerformance.

Sixty−Day Delinquency Rates: Subprime, Adjustable−Rate Mortgages



Note: The data presented in the charts have been seasonally adjusted using the Census Bureau's X-11 procedure.
Source: LoanPerformance.

look at loans that are entering into the delinquency process but also have multiple missed payments.

The data we examined come from LoanPerformance, a company that collects information on the payment status of mortgages from a large number of loan-servicing firms. LoanPerformance estimates that the data it collects from these servicing firms include roughly 75 percent of outstanding prime mortgages and 40 percent of outstanding subprime mortgages. The loans are categorized by the type of servicing firm that made the loan, those that focus on subprime mortgages or those that focus on prime rate mortgages, as well as by whether the loan has a fixed or adjustable rate. (Note that the distinction between prime and subprime is based on the servicer and not the borrower.)

Prime, fixed-rate loans currently account for about 65 percent of all outstanding loans according to the Mortgage Bankers Association. There has been a steady increase in delinquency rates for this type of loan across all four major Fourth District metro areas since the beginning of 2007. More troubling is the fact that the delinquency rates for prime, fixed-rate loans appeared to jump sharply toward the end of 2007 in all four metropolitan areas. The average went from 0.56 percent in January 2007 to 0.66 percent in February 2008. Cleveland's delinquency rate for prime, fixed-rate loans has tended to be higher than the other three Fourth District metro areas, though in January Columbus's 60-day delinquency rate approached Cleveland's rate before moving back closer to the rates for Cincinnati and Pittsburgh.

Prime, adjustable-rate loans have higher delinquency rates than prime, fixed-rate mortgages and currently average 0.86 across the four metropolitan areas. Delinquency rates for these loans began to trend up noticeably in early 2006, about a year in advance of what we observe with prime, fixed-rate products.

Nevertheless, despite these recent increases, 60-day delinquency rates for prime loans are still about one-fifth to one-sixth that of the current delinquency rates for subprime loans, depending on whether one compares fixed- or adjustable-rate loans. Delinquency rates for both subprime fixed- and

adjustable-rate products have risen markedly since 2005. In the latest month of data (February 2008), delinquency rates for subprime fixed-rate mortgages were between 2.6 and 3.3 percent, and for subprime adjustable-rate mortgages, between 4.2 and 5.7 percent, across the four metropolitan areas.

Interestingly, while Cleveland's 60-day delinquency rate for most of these types of loans tends to be worse than the other metros areas, the pattern for subprime, adjustable-rate mortgages is an exception. In fact, in recent months, Cleveland's delinquency rate on this type of mortgage has been below that of the three other metro areas. This is somewhat surprising since Cleveland has a much higher foreclosure rate for subprime adjustable-rate mortgages than do the other three metropolitan areas. For example, Pittsburgh's foreclosure rate for these loans in February was 9.4 percent, while Cleveland's was 18.4 percent. This suggests, and some preliminary analysis of the data appears to support the conjecture, that a loan with 60-day delinquency in Cleveland had a substantially higher likelihood of going into foreclosure than one in Pittsburgh.

That conjecture aside, the bottom line is that across all four different loan types delinquency rates are either rising or remain relatively elevated in the Fourth District's major metropolitan areas.

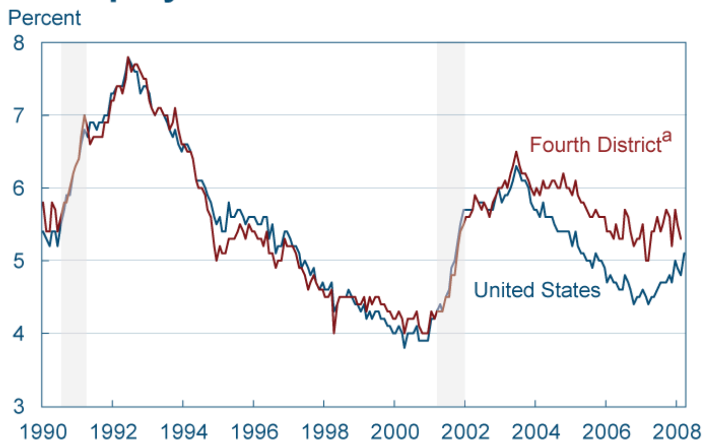
Regional Activity

Fourth District Employment Conditions

04.18.08
Tim Dunne and Kyle Fee

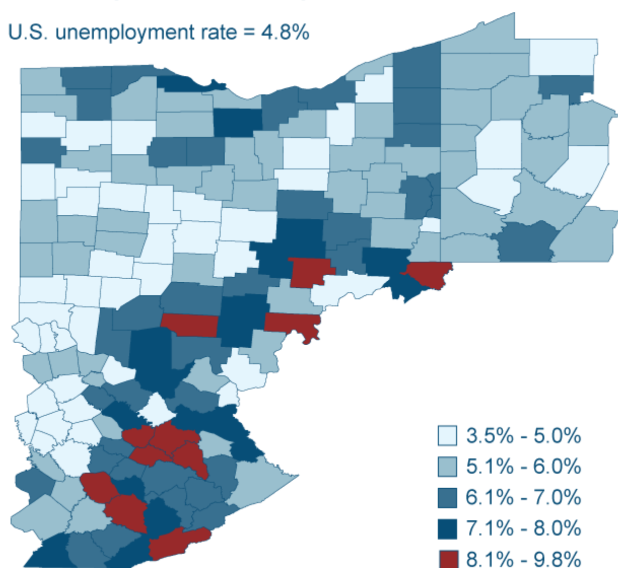
The district's unemployment rate dropped 0.2 percent to 5.3 percent for the month of February, following January's downward revision to 5.5 percent. The decrease in the unemployment rate can be attributed to decreases in the number of people unemployed (–3.8 percent) and the labor force (–0.1 percent) and no change in the number of people employed. The district's unemployment rate was again higher than the nation's in February (by 0.5 percent), as it has been since early 2004. Since this time last year, the Fourth District's unemployment rate increased 0.3 percentage point, while the

Unemployment Rates



Notes: 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.
a. Seasonally adjusted using the Census Bureau's X-11 procedure.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

County Unemployment Rates



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

national rate increased 0.6 percentage point.

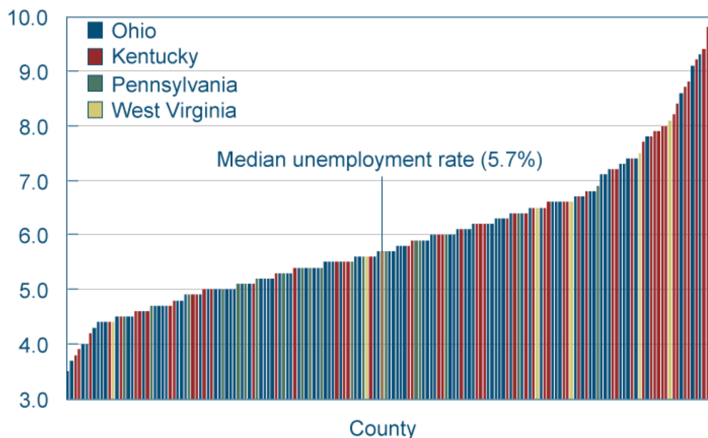
County-level unemployment rates vary throughout the district. Of the 169 counties in the Fourth District, 29 had an unemployment rate below the national average in February and 140 had one higher. Rural Appalachian counties continue to experience higher levels of unemployment.

The distribution of unemployment rates among Fourth District counties ranges from 3.5 percent to 9.8 percent, with the median county unemployment rate at 5.7 percent. Pennsylvania counties tend to populate the middle to lower half of the distribution, while Ohio and Kentucky counties span the entire range.

The distribution of monthly changes in unemployment rates shows that the median county's unemployment rate declined 0.17 percentage point from January to February. The county-level changes indicate that a substantial number of Ohio counties experienced declines in unemployment rates that exceeded 0.3 percentage point. However, almost all

County Unemployment Rates

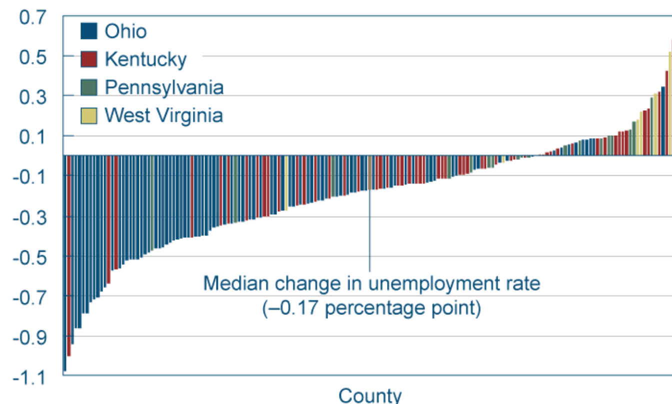
Percent



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

Change in County Unemployment Rates, January 2008–February 2008

Percentage points



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

the West Virginia counties in the Fourth District (six counties) saw their unemployment rates increase.

Banking and Financial Institutions

Fourth District Bank Holding Companies

04.16.08

Joseph G. Haubrich and Saeed Zaman

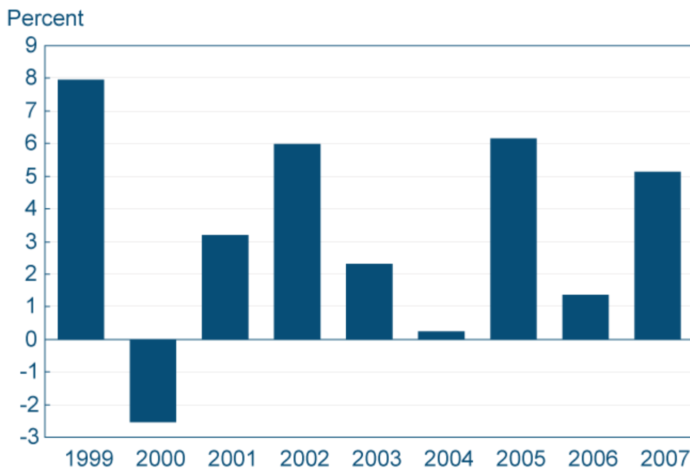
A bank holding company (BHC) is an organizational form that consists of a parent company that owns one or more commercial banks, other depository institutions and nonbank subsidiaries. While BHCs come in all sizes, we focus here on BHCs with consolidated assets of more than $1 billion. There are 21 BHCs headquartered in the Fourth District that meet this definition, including five of the top fifty BHCs in the United States, as of the fourth quarter of 2007.

The ongoing consolidation of the banking system nationwide is evident in the Fourth District. Despite the decline in Fourth District BHCs with assets over $1 billion (from 24 to 21 since the beginning of 1999 through the end of 2007), their total assets increased every year except 2000. In that year, assets held by Fourth District BHCs declined, reflecting the acquisition of Charter One Financial by Citizens Financial Group (which is headquartered in the First Federal Reserve District).

The largest five BHCs in the Fourth District rank in the top 50 of the largest banking organizations in the nation. Fourth District BHCs of all asset sizes account for roughly 4.6 percent of BHC assets nationwide, and BHCs with over $1 billion in assets make up the majority of the assets held by Fourth District BHCs.

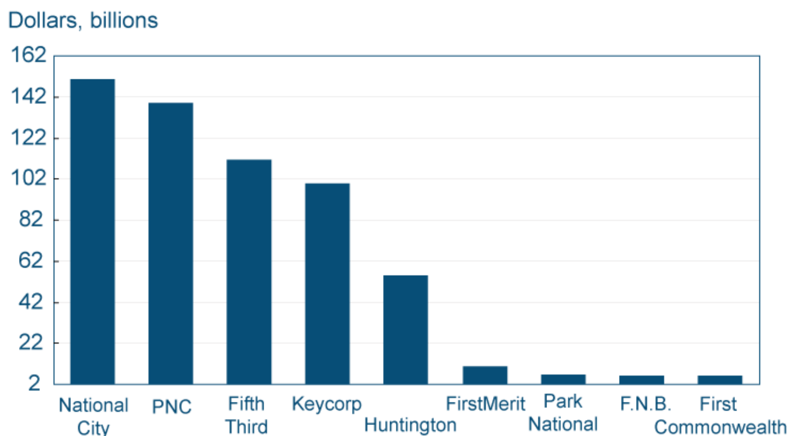
The income stream of Fourth District BHCs deteriorated somewhat in 2007. The return on assets—measured by income before taxes and extraordinary items because a bank's extraordinary items can distort the true earnings picture—declined sharply to 0.98 percent, its lowest level in almost 10 years. This decrease has coincided with a weakening of net interest margins (interest income minus interest expense divided by earning assets). Currently at 2.89 percent, the net interest margin is at its lowest

Annual Asset Growth



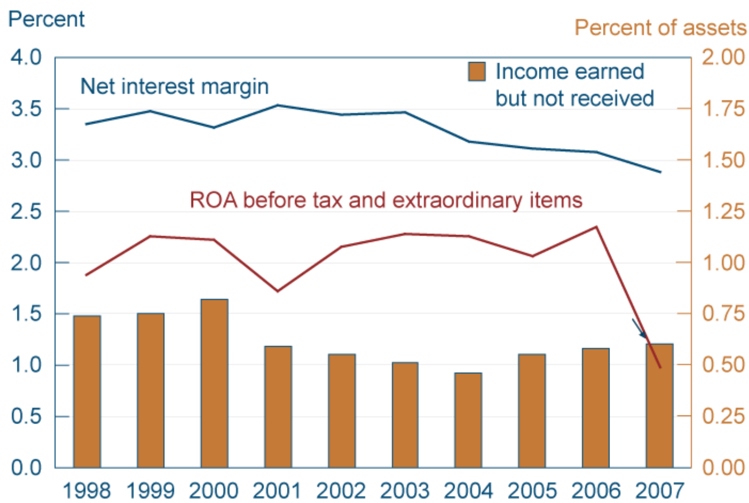
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Largest Fourth District Bank Holding Companies by Asset Size*



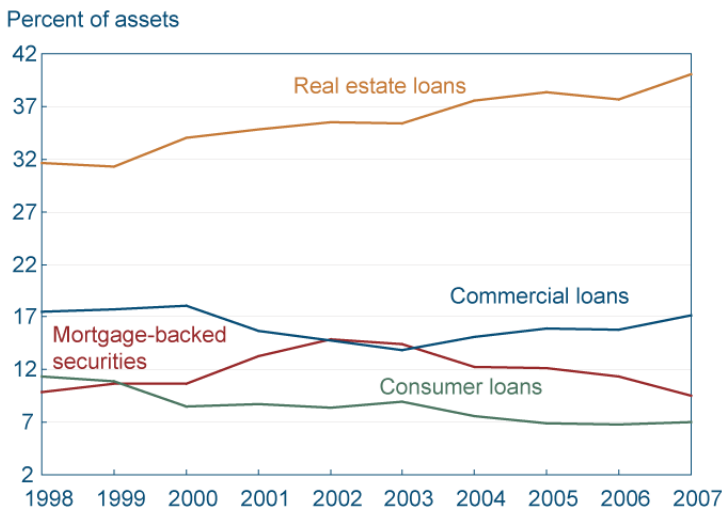
*Rank is as of fourth quarter 2007.
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Income Stream



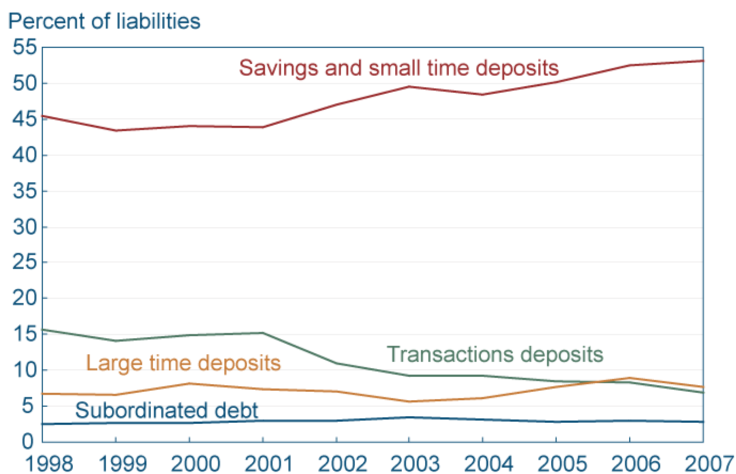
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Balance Sheet Composition



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Liabilities



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

level in over 9 years.

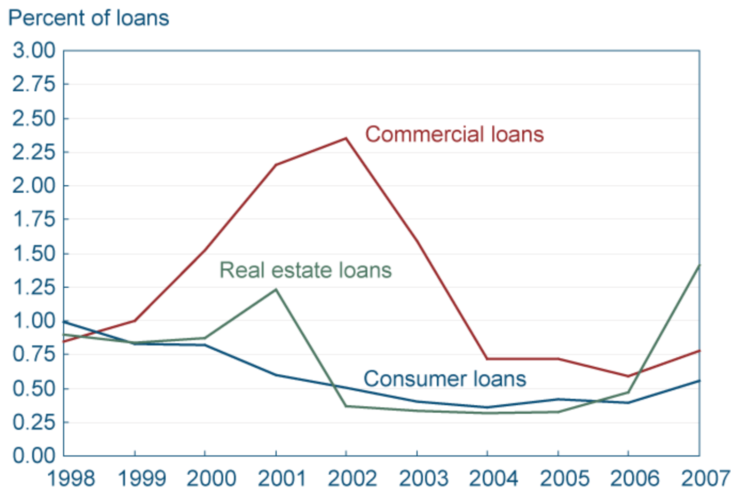
Another indicator used to measure the strength of earnings is the level of income earned but not received. The level has been low for some time for Fourth District BHCs. If a loan allows the borrower to pay an amount that does not cover the interest accrued on the loan, the uncollected interest is booked 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. Despite a slight rise over the past 3 years, income earned but not received in the fourth quarter of 2007 (0.60 percent) is well below the recent high of 0.82 percent, which was recorded at the end of 2000.

Fourth District BHCs are heavily engaged in real estate related lending. As of the fourth quarter of 2007, about 40 percent of their assets are in loans secured by real estate. Including mortgage-backed-securities, the share of real estate-related assets on the balance sheet is 50 percent.

Deposits continue to be the most important source of funds for Fourth District BHCs. Savings and small time deposits (time deposits in accounts less than $100,000) made up 53 percent of liabilities in the fourth quarter of 2007. Core deposits, the sum of transaction, savings, and small time deposits, made up 60 percent of Fourth District BHC liabilities as of the fourth quarter 2007, the highest level since 1998. Finally, total deposits made up about 70 percent of funds in 2007. Despite the requirement that large banking organizations have a rated debt issue outstanding at all times, subordinated debt represents only 2.8 percent of funding. As with large holding companies outside the Fourth District, BHCs in the Fourth District rely heavily on large negotiable certificates of deposit and nondeposit liabilities for funding.

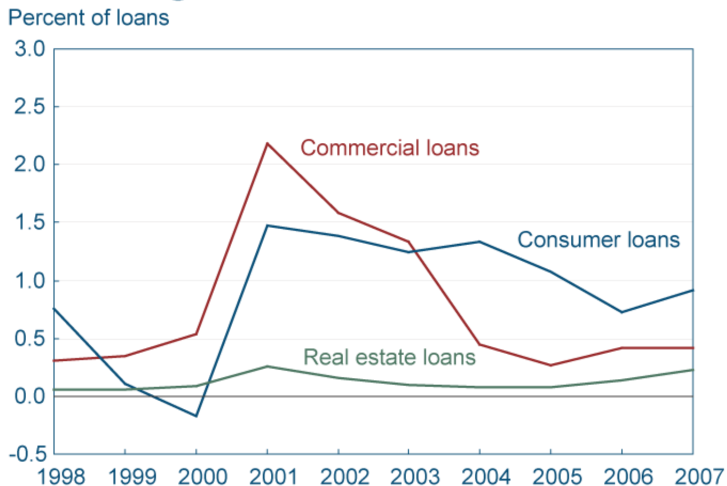
Problem loans are loans that are more than 90 days past due but are still receiving interest payments, as well as loans that are no longer accruing interest. Problem commercial loans rose sharply starting in 1999, peaked in 2002, and settled below 0.75

Problem Loans



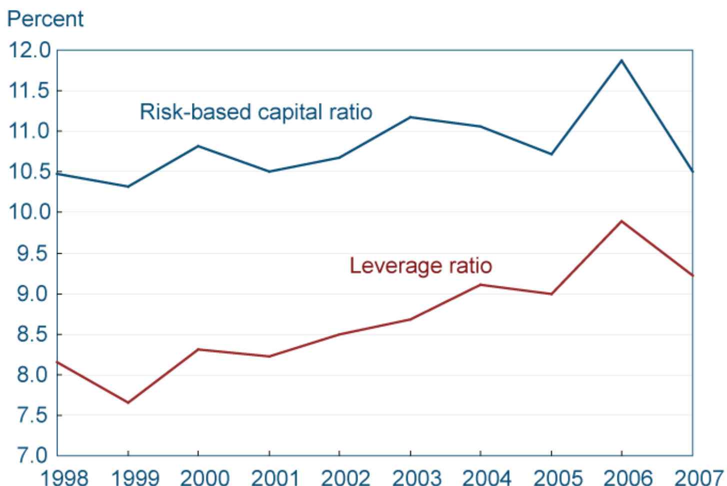
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Net Charge-Offs



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

Capitalization



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2007.

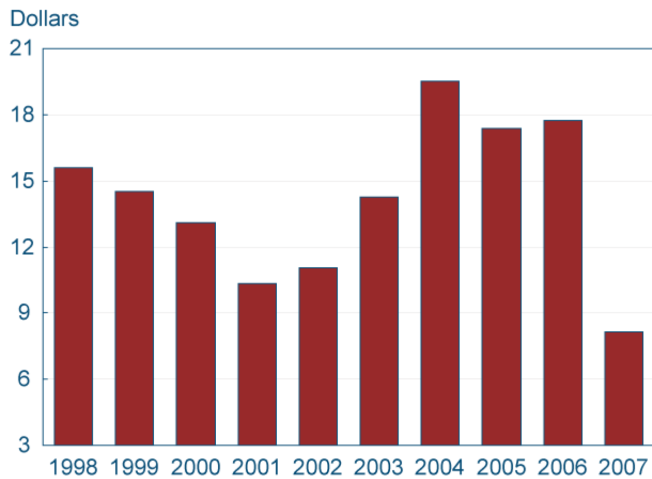
percent of assets in 2004, thanks in part to the strong economy. In the fourth quarter of 2007, 0.78 percent of all commercial loans were problem loans. Problem real estate loans, which have been creeping upward since 2005, jumped to their highest level (1.4 percent) at the end of 2007. Problem consumer loans (credit cards, installment loans, etc.) edged up slightly to 0.55 percent in the fourth quarter of 2007.

Net charge-offs are loans removed from the balance sheet because they are deemed unrecoverable, minus the loans that were deemed unrecoverable in the past but have been recovered in the current year. Net charge-offs for consumer loans and real estate loans increased slightly in the fourth quarter of 2007, and for commercial loans they remained flat. Net charge-offs in the fourth quarter of 2007 were limited to 0.42 percent of outstanding commercial loans, 0.91 percent of outstanding consumer loans, and 0.23 percent of outstanding real estate loans.

Capital is a bank's cushion against unexpected losses. The risk-based capital ratio (a ratio determined by assigning a larger capital charge on riskier assets) for Fourth District BHCs fell sharply from its peak in 2006 to 10.5 percent in 2007. The lower the capital ratio, the less protected is the bank. The leverage ratio (balance sheet capital over total assets) edged down to 9.2 percent from its recent peak of 9.9 percent in 2006.

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 fourth quarter of 2007, Fourth District BHCs have $8.14 in capital and reserves for each dollar of problem assets, the lowest level in almost 10 years.

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, Fourth Quarter 2007.

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