



Economic Trends

January 2009

(Covering December 12, 2008 to January 8, 2009)

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November Price Statistics

12.18.08
by Brent Meyer

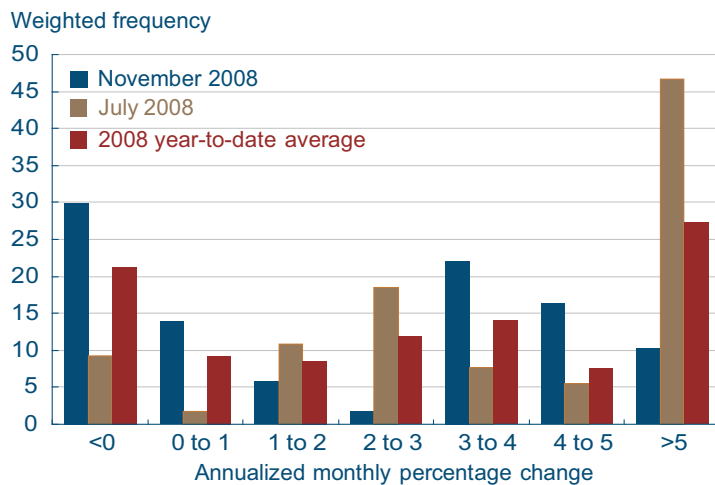
November Price Statistics

	Percent change, last					
	1mo. ^a	3mo. ^a	6mo. ^a	12mo.	5yr. ^a	2007 avg.
Consumer Price Index						
All items	-18.4	-10.2	-1.9	11	2.9	4.2
Less food and energy	0.3	0.4	1.9	2.0	2.2	2.4
Median ^b	2.6	2.4	3.3	3.1	2.9	3.1
16% trimmed mean ^b	0.0	0.2	2.4	2.7	2.6	2.8
Producer Price Index						
Finished goods	-23.5	-19.5	-6.6	0.2	3.6	7.1
Less food and energy	1.4	3.9	4.4	4.2	2.4	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.

The CPI fell further than expected, posting a record decrease of -18.4 percent (annualized rate) in November. As you may have guessed, rapidly falling energy prices (down 89.3 percent at an annualized rate), accounted for a large part of the decrease. Outside of energy prices, there was a rather curious uptick in owners' equivalent rent (OER)—it increased 3.4 percent in November. OER is basically the implicit rent that the home-owner would pay to rent his or her home. Given the recent economic environment and the outlook for housing services, it seems unlikely that OER would continue to increase that rapidly. Excluding food and energy prices (core CPI), the index was virtually unchanged, ticking up a slight 0.3 percent in November. Over the past three months, the core CPI is only up 0.4 percent. The median CPI actually rose 2.6 percent in November, up from 1.8 percent in October, while the 16 percent trimmed mean was unchanged during the month.

CPI Component Price Change Distributions



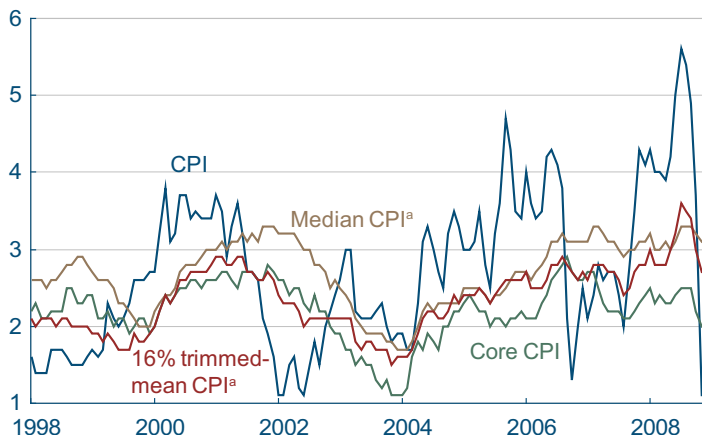
Source: Bureau of Labor Statistics.

Parsing through the distribution of price changes yields some interesting facts. First, 30 percent of the index (by expenditure weight) exhibited price decreases, down slightly from 33 percent last month. Also, the percentage of the index in the tails of the distribution (<0 or >5) declined to 40 percent from 51 percent in October. Both of those may be very tentative signs that prices are starting to gravitate toward the center of the distribution. However, suppose you take a broad definition of price stability—say a distribution centered on increases in the range of 1 percent and 3 percent. It turns out that just 5 of the 45 components we use in the median calculation, with a combined relative importance value of 7.6 percent, were in that range in November. This figure is down from 17 percent in October and 29 percent if you go back to July.

The longer-term trend (12-month growth rate) in the CPI fell to 1.1 percent in November, compared to 5.6 percent just four months ago. Measures of

CPI, Core CPI, and Trimmed-Mean CPI Measures

12-month percent change



a. Calculated by the Federal Reserve Bank of Cleveland.

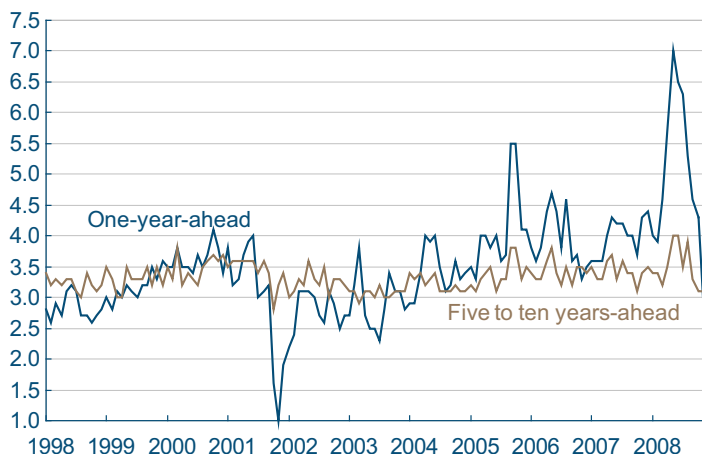
Sources: U.S. Department of Labor, Bureau of Labor Statistics, and the Federal Reserve Bank of Cleveland.

underlying inflation (core, median, and trimmed-mean CPI measures) all edged down in November and are ranging between 2.0 percent and 3.1 percent.

Just as headline inflation measures have decreased rapidly in the past few months, so have average one-year-ahead inflation expectations. These fell to 1.9 percent in December, from 2.9 percent last month. The longer-term (5-year and 10-year) average inflation expectations decreased 0.4 percentage point to 2.7 percent during the month, a record low (the series goes back to April 1990).

Household Inflation Expectations

12-month percent change



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

Source: University of Michigan.

Financial Markets, Money and Monetary Policy

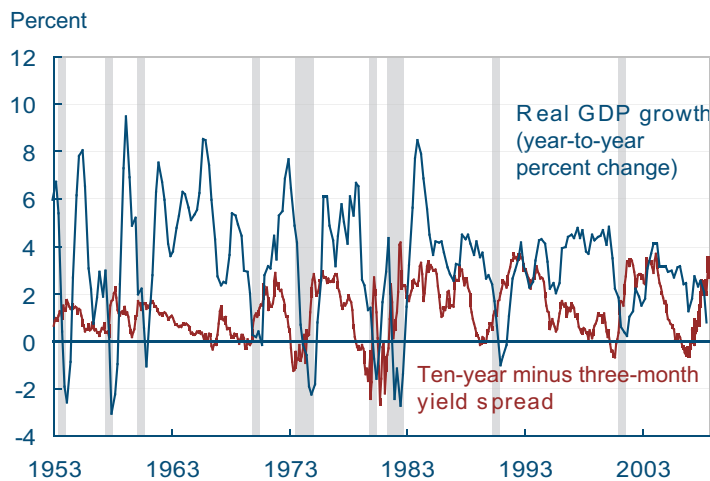
The Yield Curve, December 2008

12.17.08

by Joseph G. Haubrich and Kent Cherny

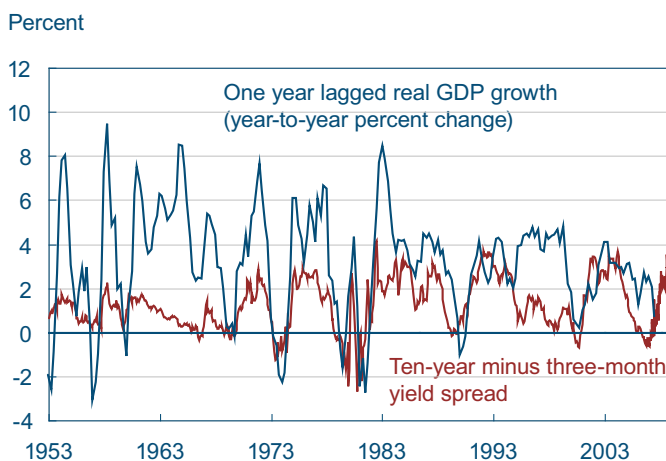
In the midst of the horrendous economic news of the last month, the yield curve might provide a slice of optimism. Though the yield curve has flattened since November, with long rates falling more than

Yield Spread and Real GDP Growth



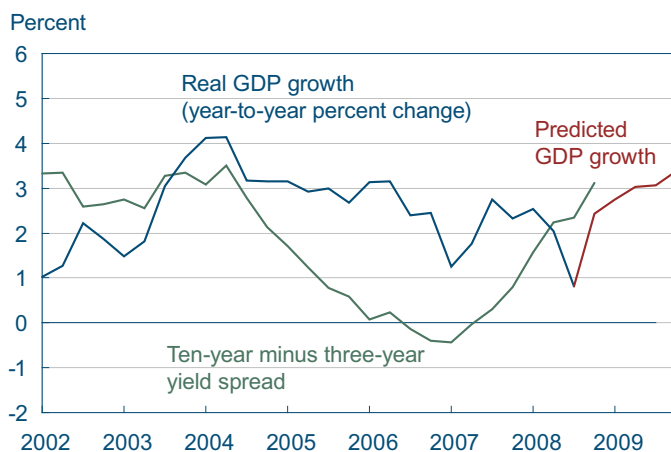
Note: Shaded bars represent recessions
Sources: Bureau of Labor Statistics and the Federal Reserve Board.

Yield Spread and One-Year Lagged Real GDP Growth



Sources: Bureau of Economic Analysis and the Federal Reserve Board.

Yield Spread and Predicted GDP Growth



Sources: Bureau of Economic Analysis and the Federal Reserve Board.

short rates, the difference between the rates remained strongly positive.

This difference, 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. Yield curve inversions have preceded each of the last seven recessions (as defined by the NBER), the current recession being a case in point. The yield curve inverted in August 2006, a bit more than a year before the recession started in December 2007. Two notable false positives include an inversion in late 1966 and a very flat curve in late 1998. More generally, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year Treasury bonds and 3-month Treasury bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

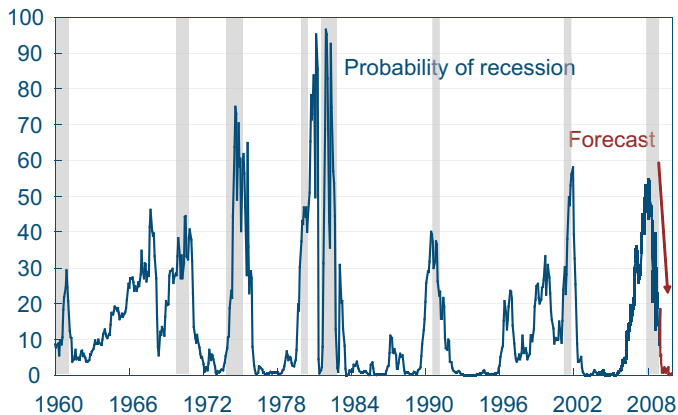
The financial crisis showed up in the yield curve, with rates falling since last month as investors fled to quality. The 3-month rate dropped from an already tiny 0.07 percent down to a miniscule 0.02 percent (for the week ending December 12), the lowest level since the Treasury constant maturity series started in 1982.

The 10-year rate dropped from 3.38 percent to 2.67 percent. Consequently, the slope decreased by 66 basis points to 265 basis points, down from November's 331, and October's 360. The flight to quality and the turmoil in the financial markets may affect the reliability of the yield curve as an indicator, but projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 3.0 percent rate over the next year. This remains on the high side of other forecasts, many of which are predicting reductions in real GDP.

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

Probability of Recession Based on the Yield Spread

Percent



Note: Estimated using probit model.

Sources: Bureau of Economic Analysis, the Federal Reserve Board, and authors' calculations.

of the economy being in a recession next December stands at a low 0.5 percent, up a bit from November's miniscule 0.05 percent.

Loyal readers may note the chart above looks a bit different this month; with the NBER declaring a recession, the model now has additional recession points to work with.

The probability of recession coming out of the yield curve is very low and may seem strange in the midst of recent financial news, but one aspect of those concerns has been a flight to quality, which lowers Treasury yields. Furthermore, both the federal funds target rate and the discount rate have remained low, which tends to result in a steep yield curve. Remember also that the forecast is for where the economy will be next December, not earlier in the year. Again, though, in the spring of 2007, the yield curve was predicting a 40 percent chance of a recession in 2008, something that looked out of step with other forecasters at the time.

To compare the 0.5 percent 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?"

To see other forecasts of GDP growth:
http://www.cbo.gov/ftpdocs/89xx/doc8979/02-15-EconForecast_ConradLetter.pdf

To see other probabilities of recession:
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aEX73qWiBrb4>

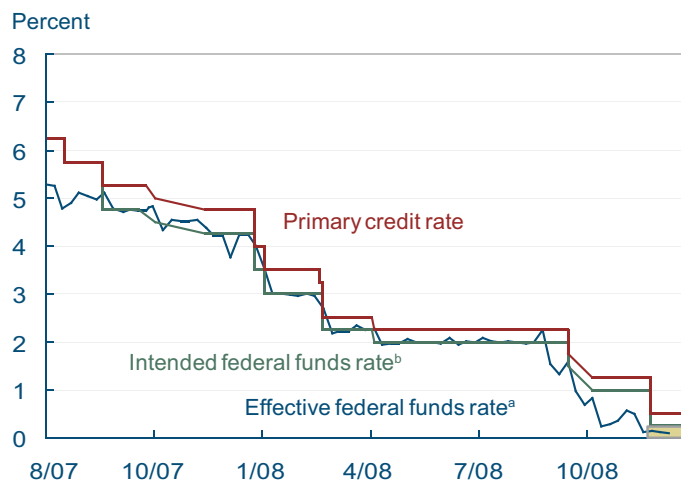
Econbrowser blog is available at:
http://www.econbrowser.com/archives/2008/02/predicting_rece.html

Does the Yield Curve Signal Recession?," by Joseph G. Haubrich, 2006. Federal Reserve Bank of Cleveland, Economic Commentary, is available at:
<http://www.clevelandfed.org/Research/Commentary/2006/0415.pdf>

Financial Markets, Money and Monetary Policy

A Focus on Quantitative Easing

Reserve Market Rates



a. Weekly average of daily figures.
 b. As of December 16, 2008, defined as range of 0 to 0.25 percent.
 Sources: Board of Governors of the Federal Reserve System, "Selected Interest Rates," Federal Reserve Statistical Releases, H.15.

01.12.09

by John Carlson and Sarah Wakefield

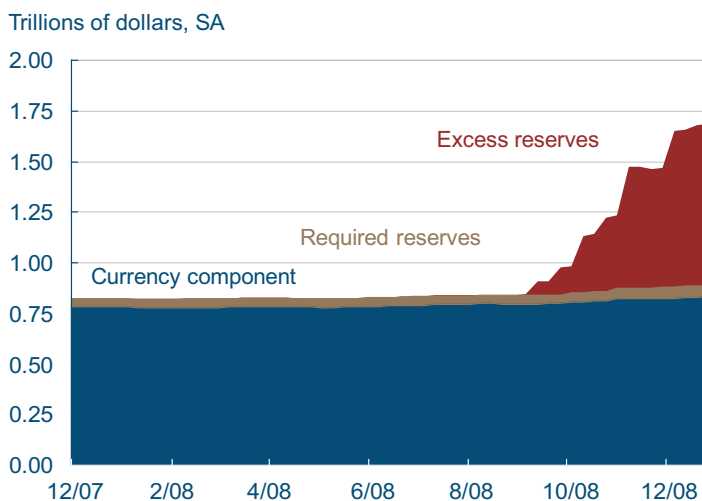
In an unprecedented move at its December 16 meeting, the Federal Open Market Committee (FOMC) decided to establish a target range for the federal funds rate of 0 to ¼ percent. The Board of Governors also reduced the primary credit rate to ½ percent.

Recognizing that interest rate policy reductions had essentially reached a zero bound, the Committee stressed that the "Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability." Further, the Committee stated that the focus of "policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level."

Open market operations and other measures have added greatly to the supply of the monetary base, which jumped from around \$850 billion in late August to nearly \$1.7 trillion on December 31. The doubling of the monetary base in such a short time highlights the fact that the Federal Reserve had already employed other available tools in dramatic fashion to support the functioning of financial markets.

It is apparent from the explosion of the excess-reserves component that the surge in total bank reserves has not been associated with a commensu-

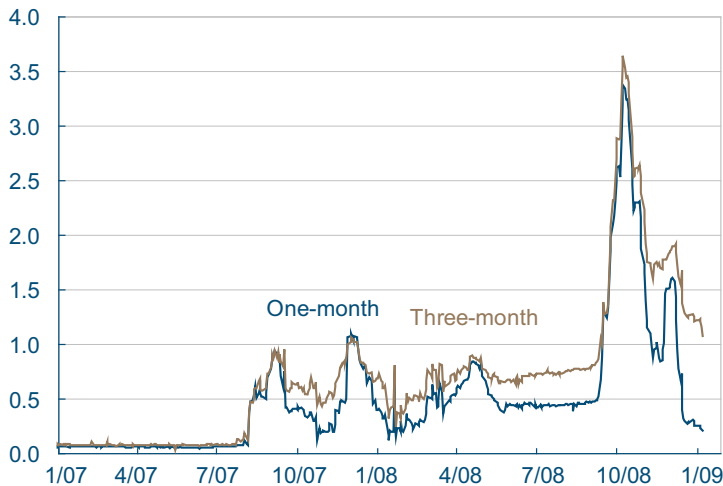
Components of the Monetary Base



Source: Federal Reserve Board

Libor-OIS Spread

Percentage points



Sources: Bloomberg Financial Services, Financial Times.

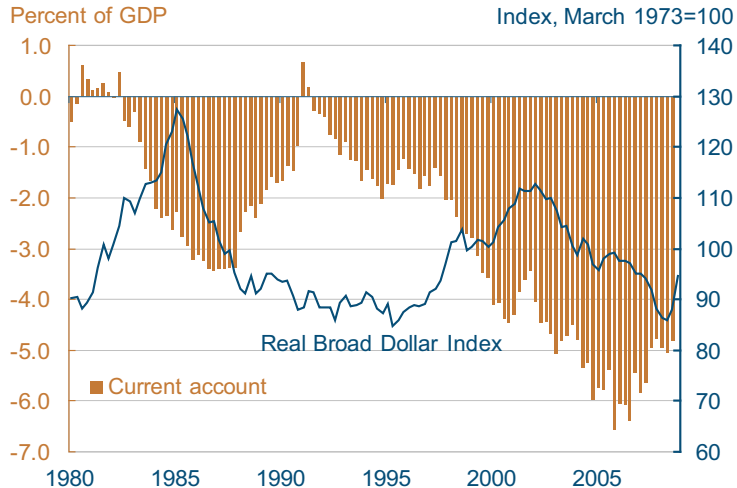
rate surge in bank loans. Rather than lending the additional reserves, many banks have held on to them in an effort to improve their balance sheets.

The additional reserves have been associated with some positive signs for liquidity. A key indicator of liquidity is the spread between the London Interbank Borrowing Rate (Libor) on a term loan and the interest rate paid on an Overnight Index Swap (OIS) for a comparable maturity. The Libor-OIS spreads on both one-month and three-month maturities jumped to record levels in September, but have receded substantially as the monetary base has expanded.

International Markets

The Ups and Downs of Current-Account Deficits

Current Account Balance



Sources: Bureau of Economic Analysis, Board of Governors of the Federal Reserve System.

01.06.09

by Owen F. Humpage and Michael Shenk

After reaching a record deficit of nearly \$825 billion (annual rate) or 6½ percent of GDP in the fourth quarter of 2005, the U.S. current-account deficit has since narrowed. By and large, our current-account balance reflects trade patterns, with a deficit indicating that the United States imports more goods than it exports. The connection between current-account deficits and trade patterns, however, does not mean that Americans spend too much and save too little. Maybe America is just a good place to invest.

Over the past 25 years, different underlying developments have contributed to the U.S. current-account deficit. Some of these developments reflected trade decisions; some reflected investment decisions. Between 1995 and 2002, for example, the U.S. current-account deficit rose from roughly 2 percent of GDP to slightly more than 4 percent of GDP because of an influx of global savings. America was a good place to invest. As foreigners sought dollar-denominated investments in the United States, they bid up the dollar's exchange value. The dollar appreciated on a real (inflation adjusted)

basis, raising the foreign-currency prices of U.S. goods, lowering the dollar prices of foreign goods, and thereby shifting worldwide demand away from U.S. goods and services. This pattern seemed to end with the dot-com bust in 2001.

The U.S. current-account deficit, however, continued to grow as a percent of GDP until it reached its 2005 high. This expansion reflected strong U.S. aggregate demand growth after the 2001 recession. As U.S. residents bought foreign goods and services, they supplied dollars to the exchange market and bought foreign currencies. The dollar depreciated on a real basis against the currencies of our major trading partners. The dollar's depreciation increased the attractiveness of investing in the United States, but trade decisions were the driving force.

Beginning in 2005, foreign investors became increasingly reluctant to hold dollar-denominated assets. As investment flows into dollar assets slowed, the dollar depreciated on a real basis. The depreciation shifted world demand, which at the time was going gangbusters, to U.S. products. The current-account deficit narrowed to just below 5 percent in the first three quarters of 2008. Once again, investment decisions held sway.

All-encompassing explanations for the various levels of the U.S. current-account deficit, like "Americans spend too much," rarely offer much traction. Current-account and exchange-rate patterns reflect myriad and changing economic decisions.

Economic Activity

Labor Costs

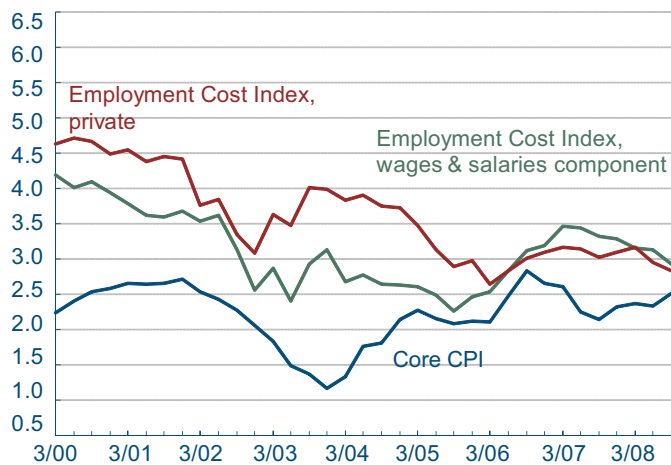
12.23.08

by Murat Tasci and Beth Mowry

Growth in compensation costs is monitored by economists as an indicator of future inflationary pressures (compensation costs include employers' costs for wages, salaries, and employee benefits). As measured by the employment cost index (ECI), cost growth has leveled off and begun to slowly recede during the second and third quarters of 2008. In these two quarters, the four-quarter percentage

Employment Cost and Inflation

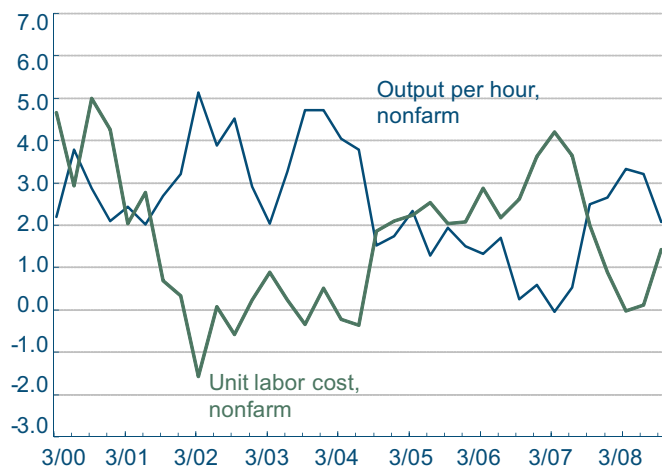
Four-quarter percent change



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

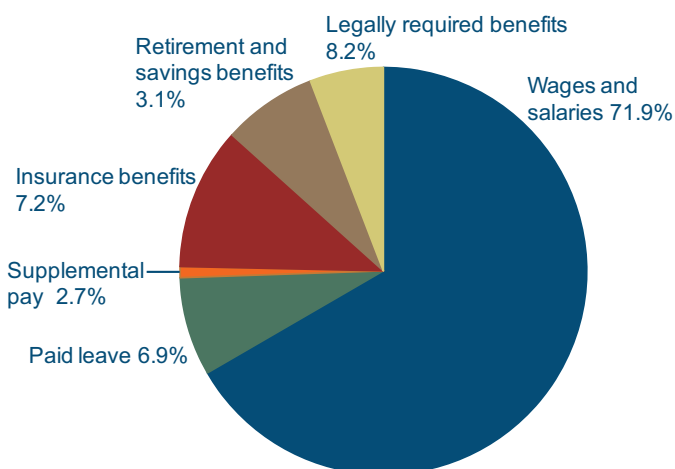
Productivity and Unit Costs

Four-quarter percent change



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

Distribution of Total Compensation 2007



Note: Data include private service-providing industry workers.

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

change in the index dipped below 3 percent for the first time since the second quarter of 2006. This moderation comes after solid gains in index growth throughout 2006 and early 2007. Wages and salaries account for roughly 70 percent of total worker compensation, and this component has steadily declined since the second quarter of 2007, suggesting it is largely responsible for the decline in the overall ECI.

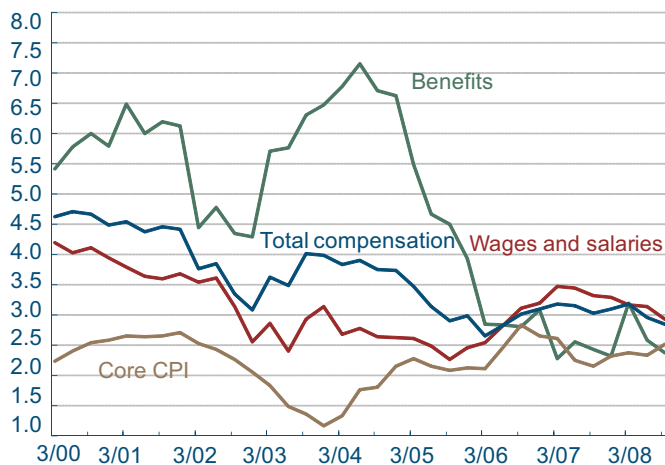
Of course, workers might be compensated less simply because they are producing less, but this does not appear to have been the case recently. While unit labor costs (a productivity-adjusted measure of employment costs) started to lose momentum in the first quarter of 2007, changes in this measure have been negatively correlated with changes in output per hour in the nonfarm business sector. This pattern in the two measures has been especially visible since 2000, and the relatively slower growth in unit labor costs coincided with relatively larger gains in output per hour in the nonfarm business sector.

In 2007, almost 72 percent of the total compensation cost for private service workers consisted of wages and salaries. (For workers in goods-producing industries, the figure was 67 percent.) The next-largest components were legally required benefits (8.2 percent), insurance benefits (7.2 percent), and paid leave (6.9 percent).

Even though benefits account for just 30 percent of total compensation, swings in benefits growth have often been large enough to noticeably influence growth in total compensation, particularly when growth in wages and salaries was nearly stagnant. For example, between the fourth quarter of 2002 and the second quarter of 2004, wages and salaries moved from 2.6 percent to just 2.8 percent (in terms of four-quarter percent change), but total compensation growth climbed from 3.1 percent to 3.9 percent because benefits growth shot up from 4.3 percent to 7.2 percent. A similar interaction in the opposite direction was taking place up until the first quarter of 2006: Benefits and total compensation growth both fell, and wages and salaries growth sat tight. The last couple of years, though, have seen a convergence of growth rates, leaving

Components of Employment: Compensation and Inflation

Four-quarter percent change



Note: Colored boxes highlight the following time periods referred to in the text: Q4 2002-Q2 2004, Q2 2004-Q1 2006, and Q1 2007-Q3 2008.

Sources: Department of Labor, Bureau of Labor Statistics.

them much more in line with core CPI growth.

Economic Activity

Real GDP: Third-Quarter Final Estimate

Real GDP and Components, 2008:Q3 Final Estimate

	Quarterly change (billions of 2000\$)	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	-15.0	-0.5	0.7
Personal consumption	-80.7	-3.8	-0.2
Durables	-48.2	-14.8	-5.5
Nondurables	-44.4	-7.1	-0.9
Services	-0.8	-0.1	1.1
Business fixed investment	-6.1	-1.7	1.6
Equipment	-20.7	-7.5	-3.1
Structures	7.9	9.6	11.2
Residential investment	-15.9	-16.1	-20.6
Government spending	29.2	5.8	3.1
National defense	22.3	18.0	7.7
Net exports	28.2	—	—
Exports	11.4	3.0	6.1
Imports	-16.9	-3.5	-3.5
Private inventories	-29.6	—	—

Source: Bureau of Economic Analysis.

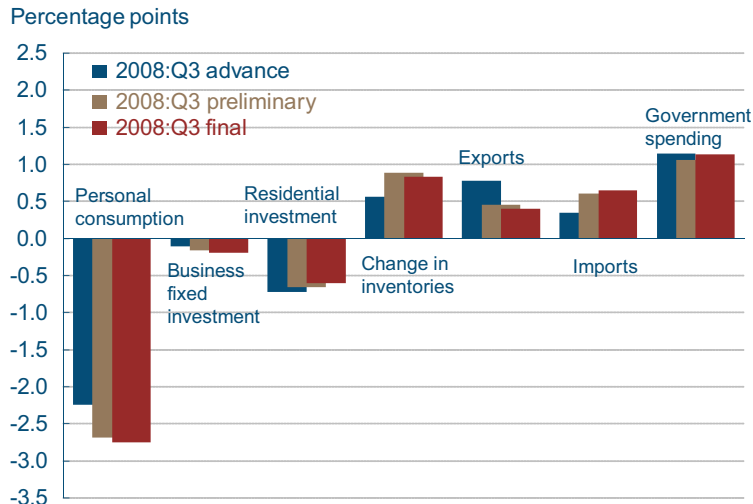
01.06.09

by Brent Meyer

Real GDP decreased at an annualized rate of 0.5 percent in the third quarter of 2008 (unchanged from the preliminary estimate), according to the final estimate released by the Bureau of Economic Analysis. Personal consumption expenditures were revised down 0.1 percentage point to -3.8 percent, reflecting downward adjustments to both nondurables and services consumption, which were partially offset by an upward revision to durables consumption. Business fixed investment was largely unchanged during the revision. However, residential investment was revised up from -17.6 percent to -16.1 percent. Export growth in the third quarter was revised down again, increasing only 3.0 percent, compared to 3.4 percent in the preliminary release and 5.9 percent in the advance estimate. Imports were revised down to -3.5 percent from -3.2 percent in the preliminary release and -1.9 percent in the advance estimate.

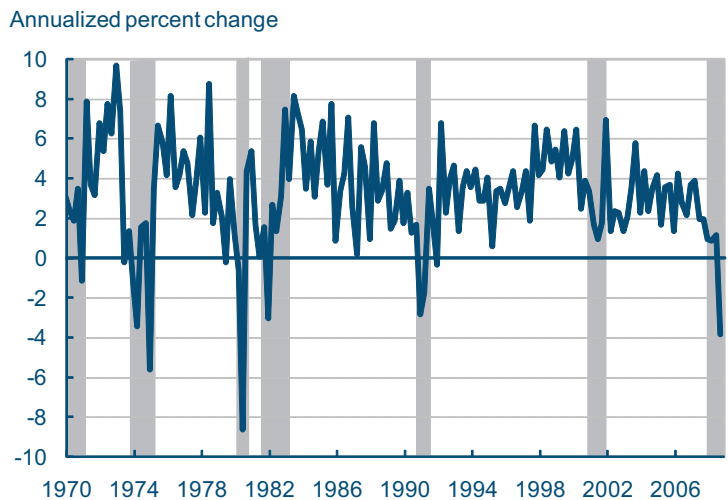
Personal consumption expenditures, which last quarter added 0.9 percentage point to real GDP growth, subtracted 2.8 percentage points in the

Contribution to Percent Change in Real GDP



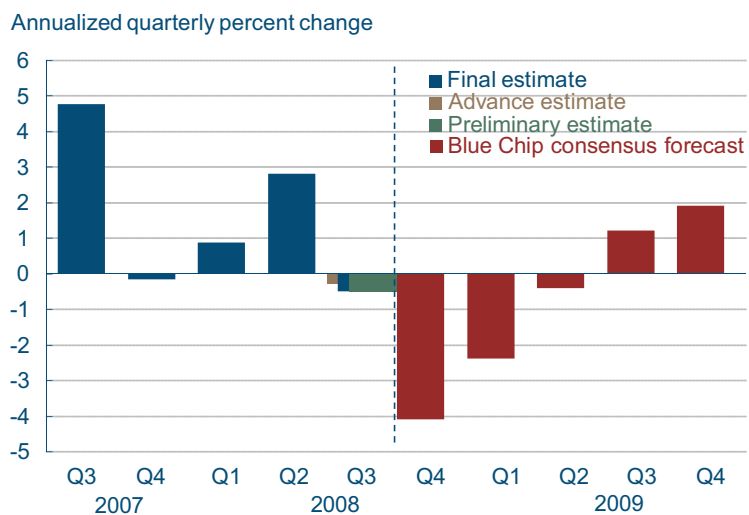
Source: Bureau of Economic Analysis.

Real Personal Consumption Expenditures



Source: Bureau of Economic Analysis

Real GDP Growth



Source: Blue Chip Economic Indicators, December 2008; Bureau of Economic Analysis.

third quarter, marking the first time this component has subtracted from growth since the fourth quarter of 1991. Net exports added 1.1 percentage points to growth in the third quarter, following a 2.9 percentage point addition in the second quarter and a 1.4 percentage point addition over the past four quarters. The contribution from private inventories in the third quarter was revised up from 0.6 percentage point in the advance release to 0.8 percentage point in the final estimate (though this is down 0.1 percentage point from the preliminary estimate). Government spending added 1.1 percentage points to real GDP growth during the quarter, outpacing the this component's average contribution over the past four quarters of 0.6 percentage point. Much of the increase was due to a jump in national defense spending, which added 0.9 percentage point to growth in the third quarter, compared to 0.4 percentage point last quarter.

Personal consumption decreased at an annualized rate of 3.8 percent in the third quarter of 2008, its steepest decline since 1980. The latest indicators of monthly personal consumption show a 5.5 percent decrease in October, followed by a 6.9 percent increase in November. However, it may not mean that consumers are headed to the mall just yet. Prices plummeted in November, outpacing the decline in nominal consumption, which led to the net increase. Nominal personal consumption (unadjusted for price effects) declined 11.5 percent in October and 6.5 percent in November.

The latest Blue Chip consensus forecast is for real GDP to drop 4.1 percent in the fourth quarter of 2008, marking the economy's worst performance since the 1982 recession. The estimate fell 1.3 percentage points from the November forecast. Also, it seems that the 2009 outlook has darkened considerably, as nearly every panelist revised down his or her respective 2009 growth estimate from the last report. The 2009 consensus estimate fell from -0.4 percent in November to -1.1 percent in December.

Ohio's Business Cycle

01.07.09
by Kyle Fee

The National Bureau of Economic Research (NBER) has designated December 2007 as the starting point of the current recession. However, the recession referred to is the nation's as a whole—individual states vary with respect to the timing of their business cycles as well as in the severity of their recessions. For instance, according to a 2006 report by the Federal Reserve Bank of Philadelphia (“What a New Set of Indexes Tells Us about State and National Business Cycles,”) about only half of the states experienced all four of the national recessions that occurred between 1979 and 2006.

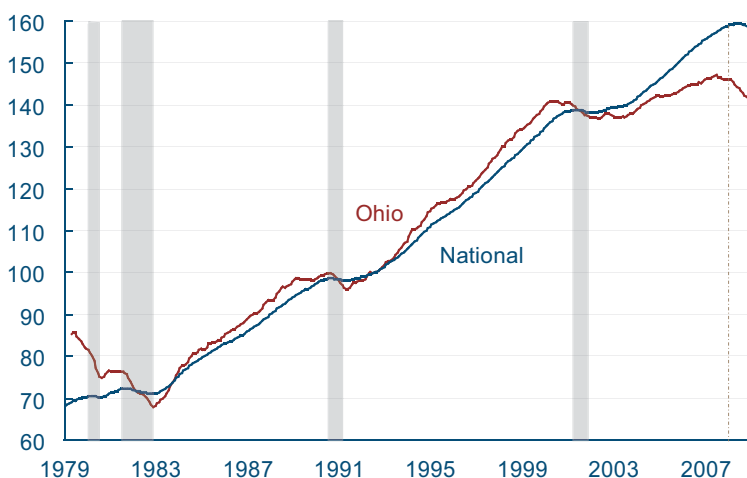
To see how Ohio's business cycle compares to those of other states and the nation, we examine the state coincident indexes published by the Federal Reserve Bank of Philadelphia. These indexes combine non-farm employment, average hours worked in manufacturing, the unemployment rate, and real wages and salaries into a composite measure of economic activity.

Several patterns stand out when comparing Ohio's coincident index and the national index. First, Ohio's index declined during the five national recessionary periods that have occurred since the late 1970s, including the current recession. Second, Ohio's index falls more sharply and for a longer period of time during recessionary periods than the national index. This likely reflects the fact that Ohio has a larger share of cyclically sensitive industries, such as manufacturing, compared to the nation as a whole. Third, while the coincident index for Ohio generally tracks the national index between the early 1980s and the early part of this decade, the indexes diverge in the recovery cycle after the 2001 recession. Ohio's economy has clearly underperformed the national economy, as Ohio generated particularly weak employment growth over this period.

A closer look at more recent levels of the indexes reveals slightly different patterns across states head-

Economic Activity Index: January 1979 –November 2008

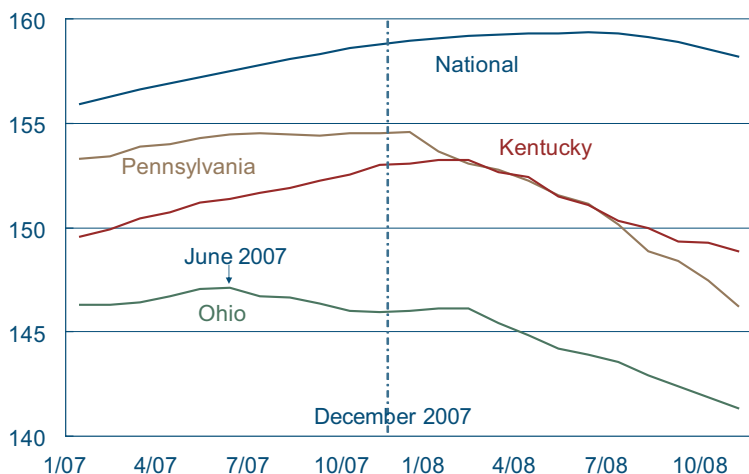
Index, July 1992 = 100



Note: Shaded areas are NBER designated recession dates.
Source: Federal Reserve Bank of Philadelphia.

Economic Activity Index: January 2007–November 2008

Index, July 1992 = 100



Note: Dashed line is NBER designated recession date.
Source: Federal Reserve Bank of Philadelphia.

ing into the current recession. Ohio's economy appeared to weaken earlier than those of Kentucky and Pennsylvania. Ohio's economy peaked in June 2007 and declined moderately between June 2007 and March of 2008. Kentucky's and Pennsylvania's economic activity continued to expand through early 2008. In early 2008, all three states' economic activity began to fall at a sharper rate. As of November of 2008, Ohio's index had declined 3.9 percent from its peak, while Kentucky's and Pennsylvania's had fallen 2.8 percent and 5.4 percent from theirs, respectively. It is interesting to note that the national coincident index did not turn down until August 2008. This delay relative to Fourth District states reflects the fact that real GDP growth in the first two quarters of 2008 was still positive.

Comparing the dates of the peaks and troughs of Ohio's business cycle with those of the nation (NBER) shows that Ohio has typically entered periods of declining economic activity earlier than the nation and that the declines have persisted longer. On average, Ohio's economic activity slowed down 5.5 months prior to the typical national recession and lasted 1.3 months longer. When compared to the Philly Fed's coincident index for the nation, Ohio enters periods of declining economic activity even earlier (7.3 months) than the nation. While Ohio's coincident index is subject to revision, a peak date of June 2007 for the current cycle is not out of the question, based upon previous business cycle data.

Business Cycle Peaks and Troughs

Cycle	Ohio (Philly Fed Index)		Nation (Philly Fed Index)		Nation (NBER)	
	Peak	Trough	Peak	Trough	Peak	Trough
1	May 1979	August 1980	March 1980	July 1980	January 1980	July 1980
2	March 1981	November 1982	August 1981	November 1984	July 1981	November 1982
3	June 1990	May 1991	September 1990	April 1991	July 1990	March 1991
4	June 2000	January 2002	May 2001	January 2002	March 2001	November 2001
5	June 2007	--	June 2008	--	December 2007	--

Source: The Federal Reserve Bank of Philadelphia.

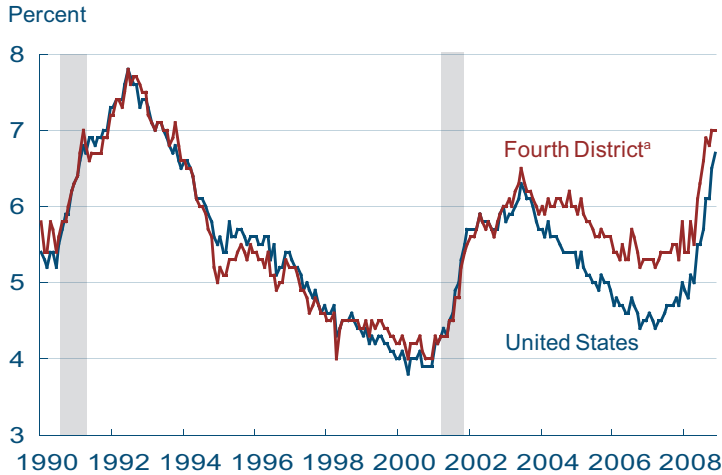
To see read the Philadelphia Fed's 2006 report "What a New Set of Indexes Tells Us about State and National Business Cycles":

http://www.philadelphiafed.org/research-and-data/publications/business-review/2006/q1/Q1_06_NewIndexes.pdf

Fourth District Employment Conditions

01.07.09
by Kyle Fee

Unemployment Rates

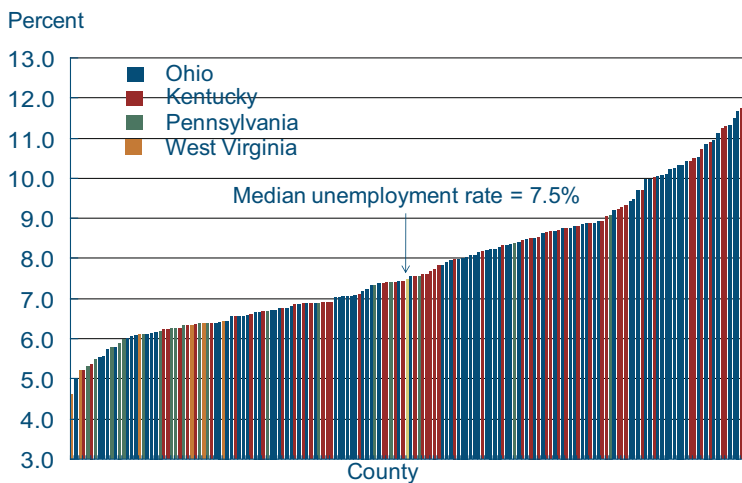


a. Seasonally adjusted using the Census Bureau's X-11 procedure.
Notes: Shaded bars represent recessions; Some data reflect revised inputs, reestimation, and new statewide controls. For more information, see <http://www.bls.gov/lau/launews1.htm>.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

The District's unemployment rate remained steady at 7.0 percent for the month of November. The stable unemployment rate reflects an increase of the number of people unemployed (0.5 percent), a decrease in the number of people employed (-0.4 percent) and a decrease in the labor force (-0.4 percent). As it has consistently been since early 2004, the District's unemployment rate was higher than the nation's (0.3 percentage point). Since this time last year, the Fourth District's unemployment rate has increased 1.7 percentage points, while the nation's has increased 2.0 percentage points.

There are considerable differences in unemployment rates across counties in the Fourth District. Of the 169 counties that make up the District, 50 had an unemployment rate below the national average in October and 119 counties had rate higher than the national average. There were 24 District counties that reported double-digit unemployment rates, while only one county had an unemployment rate below 5.0 percent. Rural Appalachian counties continue to experience higher levels of unemployment, as do counties along the Ohio-Michigan border.

County Unemployment Rates



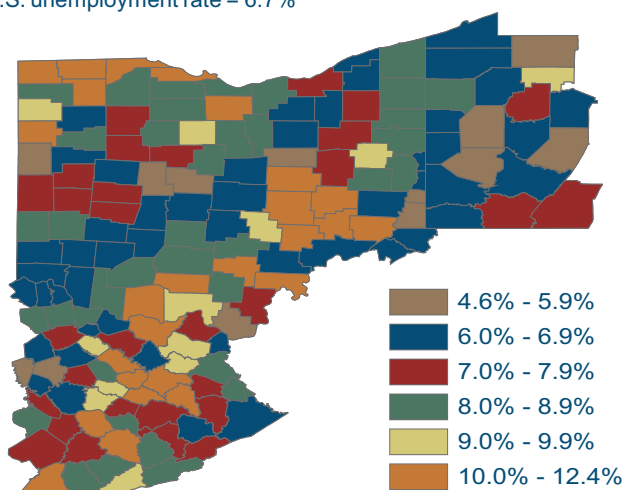
Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

The distribution of unemployment rates among Fourth District counties ranges from 4.6 percent to 12.4 percent, with a median county unemployment rate of 7.5 percent. Counties in Fourth District West Virginia and Pennsylvania generally populate the lower half of the distribution, while Fourth District Kentucky and Ohio counties are dominant in the upper half of the distribution. These county-level patterns are reflected in state-wide unemployment rates. The states of Ohio and Kentucky have unemployment rates of 7.3 and 7.0 percent, respectively, compared to Pennsylvania's 6.1 percent and West Virginia's 4.6 percent.

Continued unemployment insurance claims serve as an alternative measure of local labor market conditions and reflect the number of persons receiving

County Unemployment Rates

U.S. unemployment rate = 6.7%

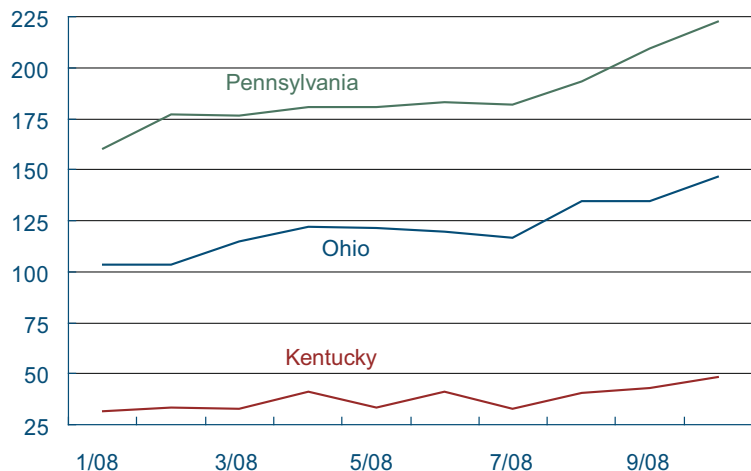


Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

unemployment benefits. At the national level, average weekly claims have increased 33.1 percent since the beginning of 2008. However, Fourth District states have seen continued unemployment insurance claims grow at an even faster pace. Kentucky has seen the largest increase (54.6 percent), while Ohio's and Pennsylvania's growth in continued claims has been somewhat slower (41.8 percent and 38.5 percent, respectively). Moreover, much of the rise in continued claims has occurred in the past four months, indicating an increase in the rate of deterioration of Fourth District labor markets.

Unemployment Insurance: Continued Claims

Weekly average, thousands



Source: U.S. Department of Labor.

Banking and Financial Institutions

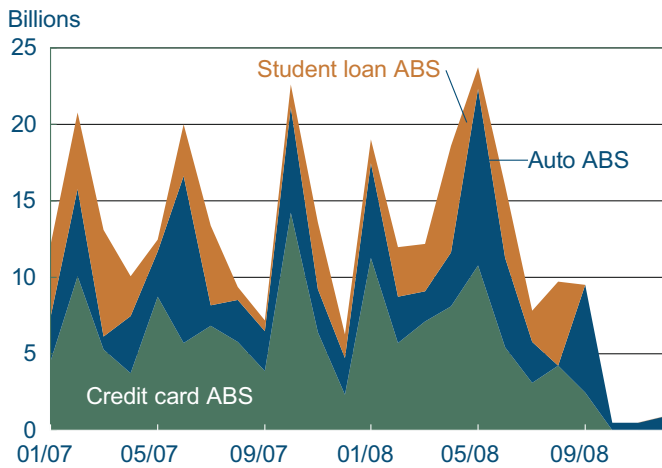
The Changing Face of Consumer Finance

12.23.08

by O. Emre Ergungor and Kent Cherny

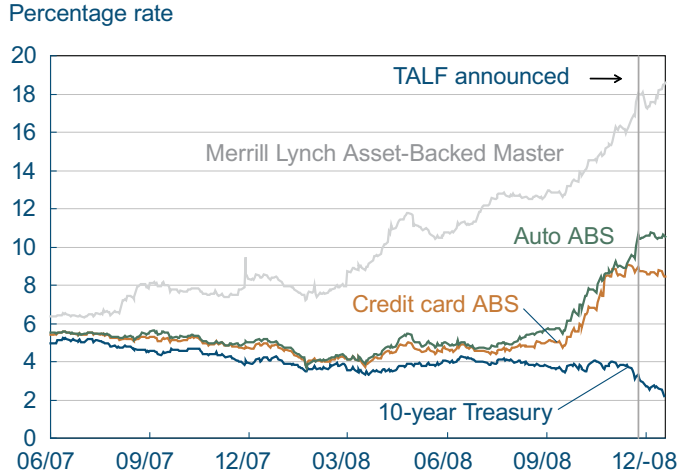
Distressed credit markets are changing the look of consumer finance for financial institutions and consumers alike. While the nonmortgage consumer loan assets of commercial banks have grown by roughly 25 percent over the past three years, the re-

Consumer ABS Issuance



Source: Bloomberg.

Asset-Backed Security Rates



Source: Federal Reserve Board; Merrill Lynch.

ness and the lack of easy bank financing may slow or halt this trend.

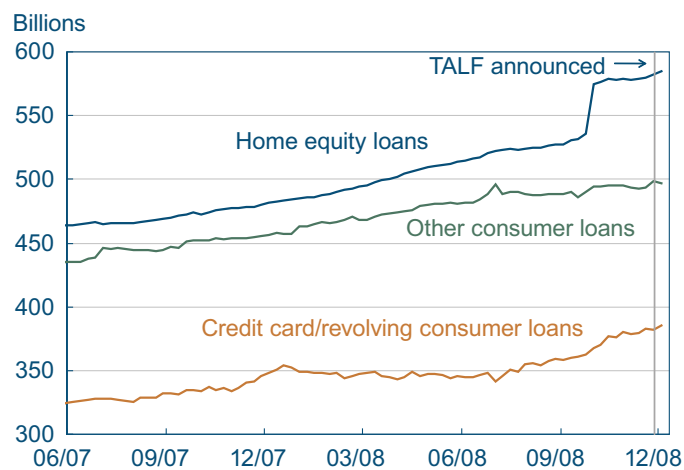
One factor weighing heavily on the supply of consumer credit is the frozen asset-backed securities (ABS) market. Credit cards and student loans (and a fair amount of auto loans) are typically packaged together into a trust by financial institutions, who then sell securities representing ownership interests on the trust to sophisticated investors. In the recent past, ABS issuance allowed banks to extend a great deal of credit since the securities were often not kept on their balance sheets, freeing up additional money to lend. Following the credit panic of mid-September and its roots in residential mortgage securities, investors have fled all ABSs, putting substantial pressure on a major source of consumer loan funds.

As the chart below shows, the issuance of new consumer ABSs all but dried up in the fourth quarter. Securities backed by credit cards have not been issued since September, and no new student loan securities have been sold since August. As a result, risk-aversion by banks and investors is affecting the supply of credit that individuals use to finance large purchases (automobiles and higher education) and for monthly cash management (credit cards).

Similarly, the repricing of risk in the ABS market has sent rates on outstanding securities significantly higher relative to most other asset classes. To help unfreeze the market for consumer credit, the Federal Reserve Board announced on November 25 that it will create a facility—the Term Asset-Backed Securities Loan Facility (TALF)—that will lend to purchasers of AAA-rated credit card, auto, SBA, and student loan securities. The announcement immediately arrested the run-up of rates on credit card and auto ABSs, though the facility will not be operational until early 2009. Consumer ABS rates remain 6-8 percentage points above those of 10-year Treasury securities, though other ABS rates are considerably higher.

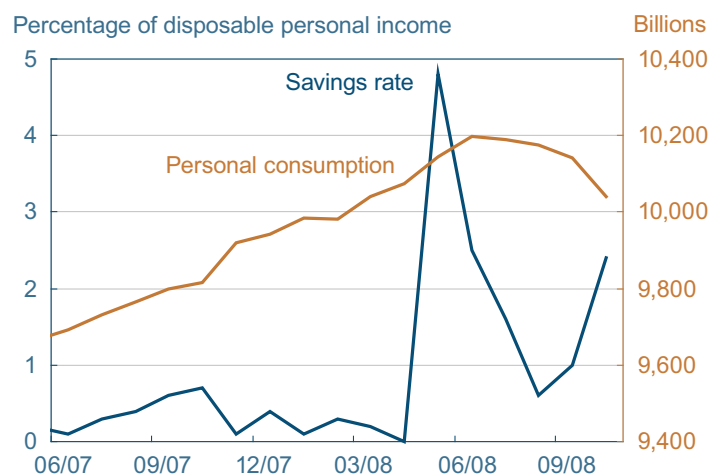
Meanwhile, consumers themselves have changed their saving and borrowing habits in response to both the shortage of credit and economic conditions generally. First, they have begun saving a larger portion of their income. A steep rise in sav-

Banks' Consumer Loan Assets



Source: Federal Reserve Board.

Savings and Consumption



Source: Bureau of Economic Analysis.

ings in June reflects the economic stimulus package enacted in early 2008. Then, following the events of mid-September, individuals decreased consumption (an almost unprecedented change in trend) and increased personal savings, which had previously been about zero.

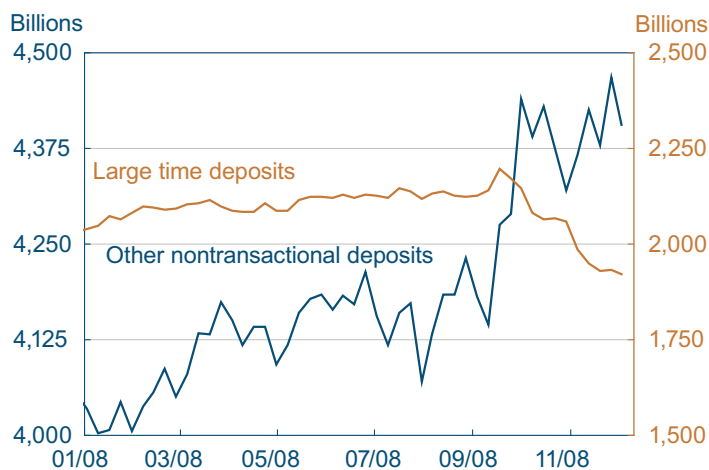
Consumers haven't completely retreated from the debtor role, however. Amid the uncertainty of September, home equity loans increased dramatically. This might have occurred if, for example, consumers foresaw a tightening of the economy and credit going forward, and consequently preferred to hold their homes' equity value in cash for transactional purposes.

The flight to safety away from securities and into cash is evident when looking at commercial banks' deposits in the last few months as well. Depositors have added more than half a trillion dollars to their accounts since September and have shown a marked shift out of extended time deposits, preferring to hold more of their savings in more readily accessible vehicles like traditional savings and checking accounts. Banks had a hand in the move to deposits as well: In the absence of interbank and capital market funding, larger commercial banks aggressively priced interest rates to lure new deposits, a more stable source of funding.

In short, the events of the third and fourth quarters have been accompanied by an extreme aversion to risky assets, which in turn has begun to change the dynamics of the consumer credit market. Asset-backed securities have fallen heavily out of favor, with issuance in important sectors of the market (like credit cards and student loans) disappearing altogether. However, the Federal Reserve's TALF program has been announced in an effort to return these markets to functionality.

Consumers have hunkered down as well, boosting their cash savings, avoiding deposit investments with long durations, and when necessary, extracting the equity from their homes to make purchases that consumer installment loans may have funded in the past. It is far too early to judge the likelihood that these trends represent a long-term shift to higher savings versus merely being the necessary reconfigurations in an environment with credit scarcity

Commercial Bank Deposits



Source: Federal Reserve Board.

and rapidly declining personal wealth (due to falling asset values). What is clear is that at a time of widespread illiquidity in numerous asset classes, consumers are rapidly acting to make their own financial position as liquid as possible.

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