Economic Trends

July 2009 (Covering June 12, 2009, to July 9, 2009)

In This Issue:

FEDERAL RESERVE BANK
of CLEVELAND

May Price Statistics

06.25.09
By Brent Meyer

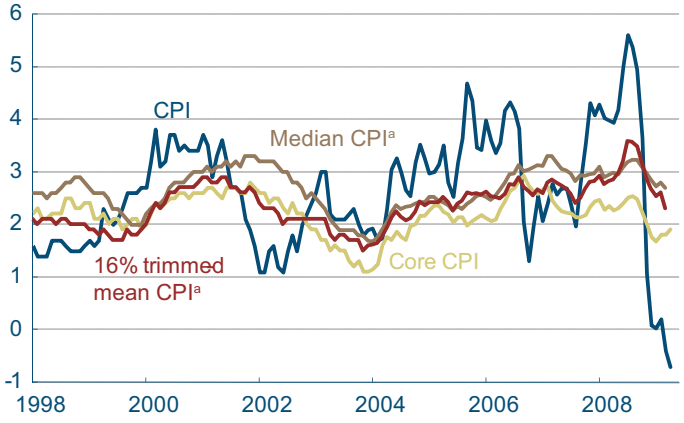
May Price Statistics

	Percent change, last					
	1mo.[a]	3mo.[a]	6mo.[a]	12mo.	5yr.[a]	2008 average
Consumer Price Index						
All items	1.2	−0.2	−0.4	−1.3	2.5	0.3
Less food and energy	1.7	2.3	1.9	1.8	2.2	1.8
Median[b]	06	1.6	1.8	2.4	2.7	2.9
16% trimmed mean[b]	1.1	0.8	1.3	1.9	2.5	2.7
Producer Price Index						
Finished goods	2.9	−2.5	−3.0	−4.7	2.8	0.2
Less food and energy	−0.7	0.0	1.5	3.0	2.4	4.3

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

CPI, Core CPI, and Trimmed-Mean CPI Measures

12-month percent change



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

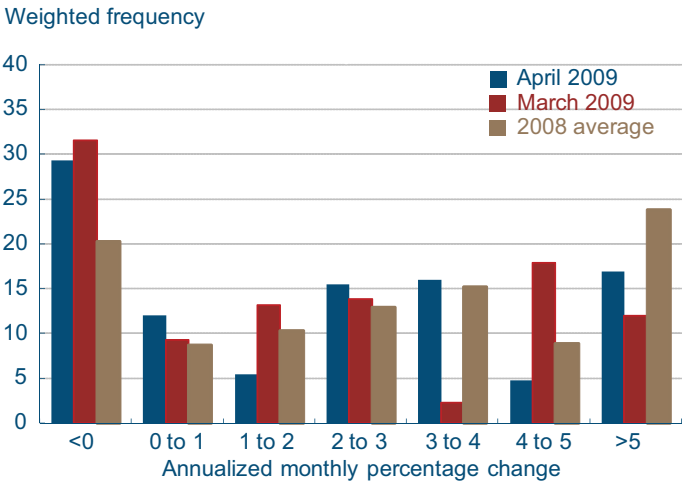
The CPI rose at an annualized rate of 1.2 percent in May, rebounding somewhat after two consecutive monthly decreases. Still, its 12-month growth rate slipped even further into the red, falling from –0.7 percent in April to –1.3 percent in May. While motor fuel prices jumped up 37.0 percent (annualized rate) in May, other energy prices (such as fuel oil, natural gas, and electricity) continued to decline during the month. Food prices fell for the fourth consecutive month, decreasing 2.4 percent.

Excluding food and energy prices (core CPI), the index rose just 1.7 percent in May, compared to 2.3 percent over the past three months and 1.8 percent over the past year. Alternative measures of underlying inflation trends—the median CPI and the 16 percent trimmed-mean CPI—increased 0.6 percent and 1.1 percent, respectively in May. The sluggish gain in the median CPI was the smallest increase in the measure since April 2003. The longer-term (12-month) trends in the underlying inflation measures all ticked down in May and are now ranging between 1.8 percent and 2.4 percent.

The price-change distribution revealed a somewhat striking shift toward the downside in recent months. Roughly 55 percent of the consumer market basket (by expenditure weight) rose at rates of less than 1.0 percent in May (the highest percentage since April 2003), compared to 38 percent over the prior three months and an average of 29 percent in 2008. Moreover, one-third of the index exhibited outright price decreases in May. Also, just 30 percent of the expenditure-weighted CPI posted increases greater than 3.0 percent in May, down dramatically from an average near 50 percent in 2008.

The Owners' Equivalent Rent (OER) of primary residence component—a measure of the opportunity cost owners face living in their homes as opposed to renting them—has been trending down lately. OER increased just 1.8 percent in May, compared

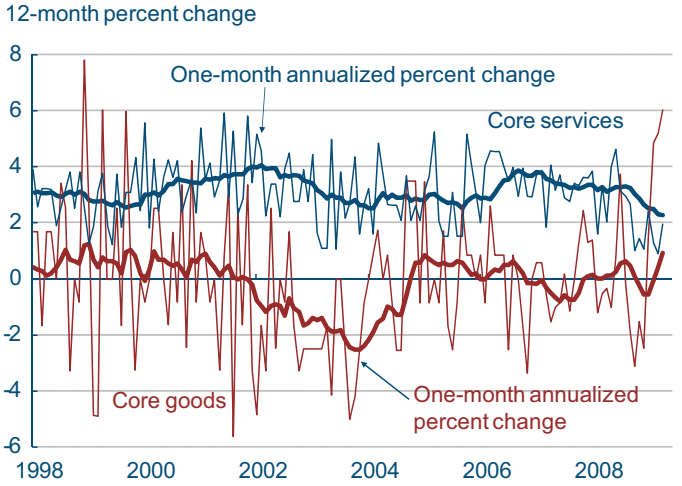
CPI Component Price Change Distribution



Source: Bureau of Labor Statistics

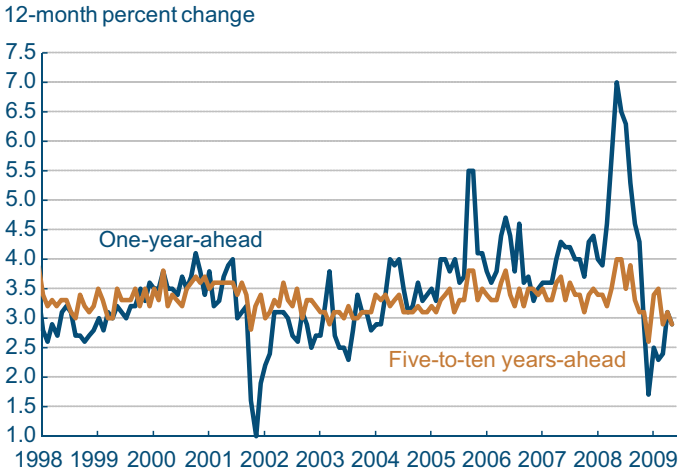
to a 12-month growth rate of 2.1 percent and an annualized growth rate of roughly 2.8 percent over the past five years. The OER component accounts for nearly one-quarter of the CPI market basket. It is computed from six-month rent changes, a procedure that reduces its monthly volatility but also causes the measure to exhibit some persistence, leading to a relatively large influence over the direction of the overall CPI.

Core CPI Goods and Core CPI Services



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

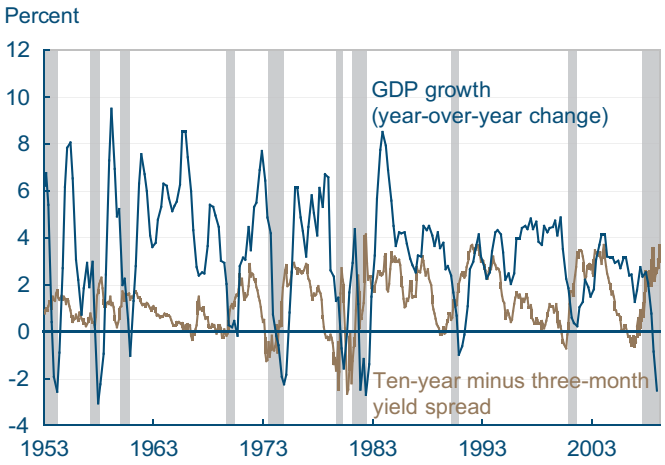
Household Inflation Expectations



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

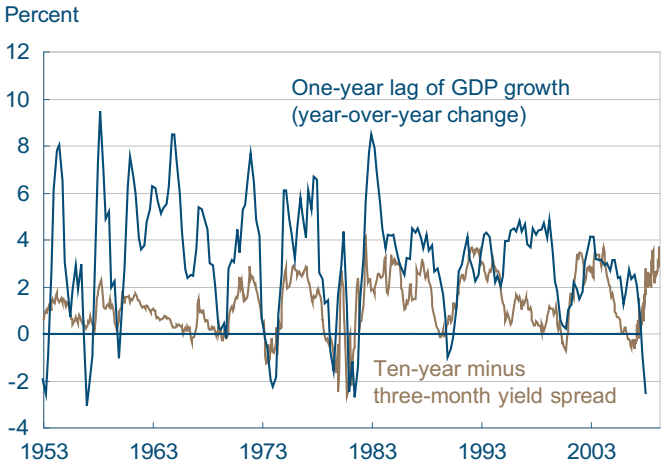
The Yield Curve, June 2009

Yield Spread and Real GDP Growth



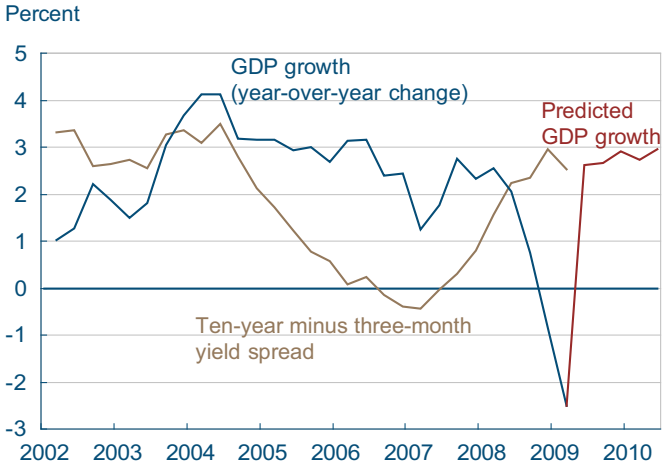
Note: Shaded bars indicate recessions.
Source: Bureau of Economic Analysis, Federal Reserve Board.

Yield Spread and Lagged Real GDP Growth



Source: Bureau of Economic Analysis, Federal Reserve Board.

Predicted GDP Growth and Yield Spread



Source: Bureau of Economic Analysis, Federal Reserve Board, authors' calculations.

06.30.09

by Joseph G. Haubrich and Kent Cherny

Since last month, the yield curve has become noticeably steeper, with long rates rising dramatically. The difference between short and long rates, 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 seven recessions (as defined by the NBER). In particular, the yield curve inverted in August 2006, a bit more than a year before the current recession started in December 2007. There have been two notable false positives: an inversion in late 1966 and a very flat curve in late 1998.

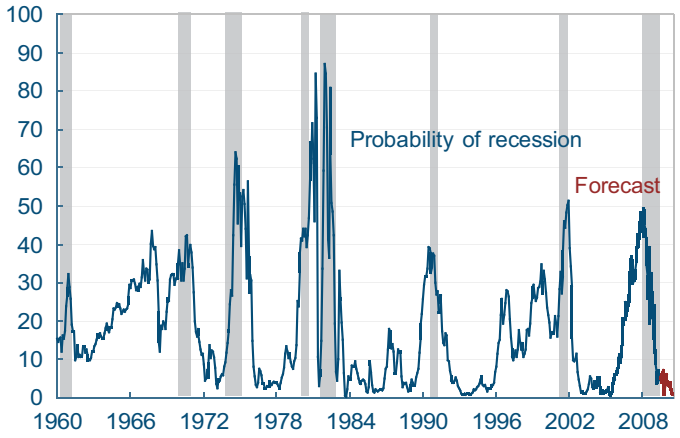
More generally, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between ten-year Treasury bonds and three-month Treasury bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

Since last month the three-month rate has held steady at a low 0.18 percent (for the week ending June 19). The ten-year rate increased a full 61 basis points, from 3.14 percent to 3.75 percent. This increased the slope to 357 basis points, a major jump from May's 296 basis points, and well above April's 283. Part of the increase may reflect a reduction in the flight to quality and less turmoil in the financial markets. 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 is not that far from other forecasts.

While this 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

Probability of Recession based on the Yield Curve

Percent probability, as predicted by a probit model



Note: Shaded bars indicate recessions.
Sources: Bureau of Economic Analysis, Federal Reserve Board, authors' calculations.

Durations of Yield Curve Inversions and Recessions

Recessions	Duration (months)	
	Recessions	Yield curve inversion (before and during recession)
1970	11	11
1973-1975	16	15
1980	6	17
1981-1982	16	11
1990-1991	8	5
2001	8	7
2008-present	17 (through May 2009)	10

Note: Yield curve inversions are not necessarily continuous month-to-month periods.
Source: Bureau of Economic Analysis, Federal Reserve Board, and authors' calculations.

economy being in a recession next June stands at a very low 0.8 percent, down even from May's 1.8 percent, and from April's 1.9 percent.

The probability of recession predicted by the yield curve is very low, but remember that the forecast is for where the economy will be in a year, not where it is now. However, consider that 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.

Of course, it might not be advisable to take this number quite so literally, for two reasons. (Not even counting Paul Krugman's concerns. 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, they should be interpreted with caution.

Another way to get at the question of when the recovery will start is to compare the duration of past recessions with the duration of the interest rate inversions that preceded them. The chart below makes the comparison for the recent period. The 1980 episode is anomalous, but in general, longer inversions tend to be followed by longer recessions. According to this pattern, the current recession is already longer than expected.

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 read more on other forecasts:
http://www.econbrowser.com/archives/2008/11/gdp_mean_estima.html

Econbrowser's The Administration's Economic Forecast against Updated Alternatives:
http://www.econbrowser.com/archives/2009/05/the_administrat_2.html

For Paul Krugman's column:
http://krugman.blogs.nytimes.com/2008/12/27/the-yield-curve-wonkish/

"Does the Yield Curve Yield 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

A Global Fiscal Crisis?

06.30.09

by Owen F. Humpage and Michael Shenk

The financial crisis and accompanying recession have had a severe impact on government budgets, raising the specter of huge government debt burdens down the road. Large government debt burdens are not just a fiscal problem. They can become a monetary problem, since boosting inflation above the level embedded in the current interest rate on government debt is one way to trim the debt burden.

Recessions automatically trim tax revenues and pump up government expenditures for such things as unemployment benefits and other social needs. On top of these automatic effects, many governments have provided large dollops of aid to their financial sectors in response to the crisis and have undertaken substantial discretionary budget initiatives in an attempt to get economic activity rolling again.

Government Debt Projects

	Percent of GDP				
	2007	2008	2009	2010	2014
Advanced G-20 countries	77.6	83.4	97.7	106.4	114.1
France	63.9	67.3	74.9	80.3	89.7
Germany	63.6	67.2	79.4	86.6	31.0
Italy	103.5	105.8	115.3	121.1	129.4
Japan	187.7	1963	217.2	227.4	234.2
United Kingdom	44.1	51.9	62.7	72.7	87.8
United States	63.1	70.5	87.0	97.5	106.7

Sources: International Monetary Fund, *World Economic Outlook*, April 2009.

The International Monetary Fund estimates that the financial crisis, the recession, and the associated fiscal initiatives will push the debt burden of the 10 largest developed countries from about 78 percent of GDP in 2007 to 106 percent of GDP in 2010, when a tentative economic recovery is likely. Moreover, under the IMF's most likely scenario, this debt burden will rise to 114 percent of GDP by 2014.

To reduce their debt burdens, advanced countries need to run substantial budget surpluses, but the prospect for quickly doing so are not good. While most economists anticipate that a recovery will begin before the year's end, many expect a long slog before economic growth returns to its potential rate. Automatic stabilizers will revert as economic growth heads back to its potential, but much of the fiscal expansion—especially in the United States—was discretionary. These items could prove difficult to unwind or offset elsewhere in the budget. Moreover, unfunded liabilities associated with aging populations in many advanced countries are likely to put increased pressure on fiscal balances.

The IMF projects that absent serious fiscal measures to trim spending and raise revenue, almost all of the advanced countries will not stabilize their government debt burdens by 2014. The outstanding debts will remain so large that their interest costs alone will propel them upward despite renewed economic growth. That's when the inflation option could get attractive.

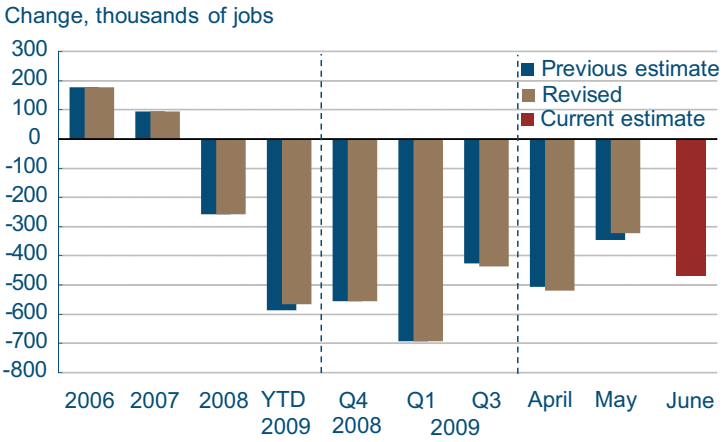
To read the IMF's *Fiscal Implications of the Global Economic and Financial Crisis:*
http://www.imf.org/external/pubs/ft/spn/2009/spn0913.pdf

The Employment Situation, June 2009

07.03.09
by Yoonsoo Lee and Beth Mowry

The decline in nonfarm payroll employment picked up pace again in June, as losses were a greater-than-expected 467,000. While worse than May's estimate of –322,000, June's payroll losses were smaller than average monthly losses during the fourth quarter of 2008 or the first quarter of 2009 (–553,000 and –691,000, respectively). Revisions to April and May added a net 8,000 jobs to the estimates for those months, which brought their respective losses to 519,000 and 322,000. Cumulative employment losses in this recession now total 6.5 million, setting total employment back to its level in 2000.

Average Nonfarm Employment Change



Source: Bureau of Labor Statistics.

The Diffusion Index of Employment Change, which tracks the percentage of industries with increasing employment, receded slightly from 31.0 to 28.6 last month but remains above its cyclical low of 19.6 in March. While this is an improvement over the first quarter's average reading of about 20, it still sits well below the threshold of 50 that indicates an equal balance of industries with expanding and contracting employment.

Payroll losses in June were broadly spread across goods-producing industries (223,000) and service-providing industries (244,000). Within goods-producing industries, construction jobs declined by 79,000, which was greater than May's loss but less than any other month so far this year. Manufacturing jobs declined by 136,000, with 27,000 of those occurring in motor vehicles and parts manufacturing.

Within service industries, trade, transportation, and utilities shed 51,000 jobs in June, with 21,000 of those in retail trade. Motor vehicle and parts dealers alone accounted for half of the retail losses alone. Information services shed 21,000 jobs, roughly in line with recent months, and leisure and hospitality shed 18,000 jobs after an equal but opposite gain in May. Financial activities (–27,000) posted the smallest loss since October 2008, a considerable improvement over the sector's average decline of

about 50,000 each month in the first quarter.

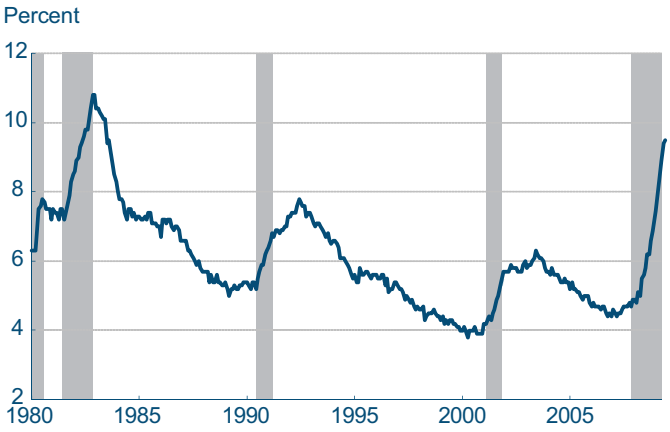
The 118,000 payroll decline in professional and business services was far worse than May's decline of 48,000 but smaller than any other month since October 2008. Much of the decline in this sector was attributable to administrative and support services, specifically temporary help services. The 37,600 loss in temporary help services was much greater than its previous loss of just 8,100 in May. Education and health services, a sector that has not posted a loss since 2004, did not disappoint, adding 34,000 jobs. Government payrolls, however, recorded a rare and surprising loss of 52,000, partly due to the layoff of temporary Census workers.

Labor Market Conditions and Revisions

	Average monthly change (thousands of employees, NAICS)				
	April current	Revision to April	May current	Revision to May	June 2009
Payroll employment	−519	−15	−322	23	−467
Goods-producing	−267	7	−215	10	−223
Construction	−103	5	−48	11	−79
Heavy and civil engineering	−21.7	−4	−8	0	−16
Residential[a]	−39.9	6	−12	8	−31
Nonresidential[b]	−41.7	2	−28	4	−32
Manufacturing	−150	4	−156	0	−136
Durable goods	−130	5	−128	3	−112
Nondurable goods	−20	−1	−28	−3	−24
Service-providing	−252	−22	−107	13	−244
Retail trade	−33	4	−18	0	−21
Financial activities[c]	−46	−1	−30	0	−27
PBS[d]	−127	−16	−48	3	−118
Temporary help services	−54	1	−8	−2	−38
Education and health services	17	4	47	3	34
Leisure and hospitality	−34	4	18	15	−18
Government	73	−19	−10	−3	−52
Local educational services	3	−1	−1	−3	3

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.

Unemployment Rate



Note: Seasonally adjusted rate for the civilian population, age 16+.
Source: Bureau of Labor Statistics.

The unemployment rate crept up from 9.4 to 9.5 percent, rising just 0.1 percentage point after six consecutive increases of 0.4 percentage point or greater. The employment-to-population ratio slipped to 59.5 percent in June, its lowest level since April 1984.

Real GDP: First-Quarter 2009 Final Estimate

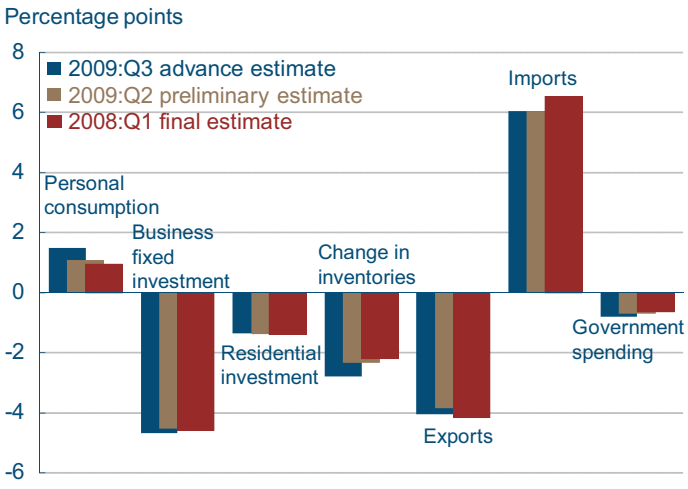
07.03.09
by Brent Meyer

Real GDP and Components, 2009:Q1 Final Estimate

	Quarterly change (billions of 2000$)	Annualized percent change, last: Quarter	Four quarters
Real GDP	−161.6	−5.5	−2.5
Personal consumption	27.5	1.4	− 1.4
Durables	25.5	9.5	−8.3
Nondurables	−2.2	−0.4	−3.4
Services	11.1	0.9	0.8
Business fixed investment	−147.7	−37.3	−16.1
Equipment	−94.8	−33.7	−19.6
Structures	−44.4	−42.9	−9.5
Residential investment	−38.3	−38.8	−23.4
Government spending	−16.3	−3.1	1.9
National defense	−9.6	−6.7	5.1
Net exports	67.7	—	—
Exports	−127.2	−30.6	−11.5
Imports	−194.8	−36.4	−17.2
Private inventories	−87.1	—	—

Source: Bureau of Economic Analysis.

Contribution to Percent Change in Real GDP



Source: Bureau of Economic Analysis.

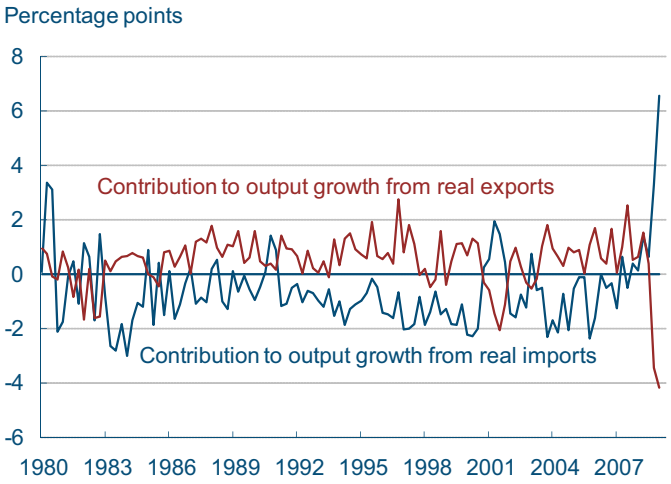
The final estimate for real GDP growth in the first quarter of 2009 came in at –5.5 percent, 0.2 percentage point above the preliminary estimate and 0.6 percentage point higher than the advance estimate (a relatively large advance-to-final revision by historical standards, but nowhere near the advance-to-final revision in the previous quarter of –2.5 percentage point).

A downward revision to real imports (which adds to real GDP growth) was the largest change from the previous estimate, adding 0.5 percentage point to real GDP growth. That gain was partially offset by a downward revision to real exports and a reduction of the contribution of real consumption, which together subtracted an additional 0.4 percentage point from growth. The first-quarter sell-off in private inventories was reduced from –$91.4 billion to –$87.1 billion (down from –$103.7 billion in the advance release), tacking on an additional 0.1 percentage point. The investment picture remained virtually unchanged in the revision.

As the U.S. economy has taken a turn south, global trade has diminished dramatically, in part as due to fallout of the financial crisis rippling across the globe. Exports decreased by a whopping 30.6 percent in the first quarter, their steepest quarterly decrease since 1969. Imports declined even further (down 36.4 percent), their most precipitous quarterly fall since 1947.

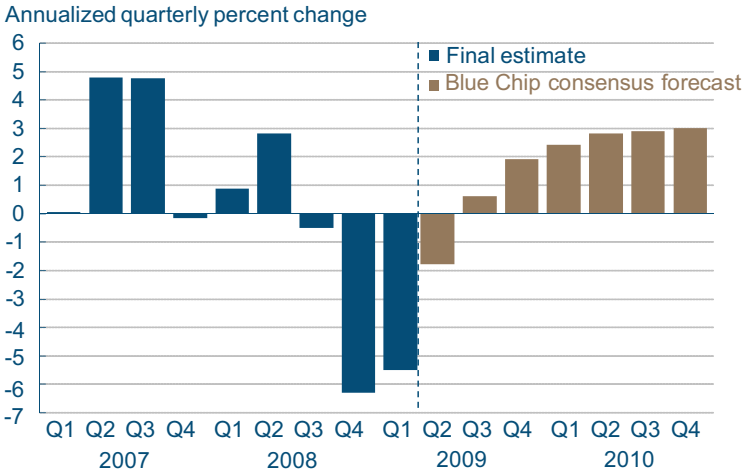
The quarterly declines in imports and exports resulted in rather dramatic contributions to real GDP growth in the first quarter, with imports (which enter in as a subtraction in real GDP growth accounting) adding 6.6 percentage points and exports subtracting 4.2 percentage points. Before the start of the recession, the average effect of imports on growth since 1980 was a subtraction of three-quarters of a percentage point, while exports averaged a 0.6 percentage point boost to output growth. These typical effects led to a slightly negative contribution from net exports over the past 27 years or so.

Real Export and Import Contributions



Source: Census Bureau.

Real GDP Growth Forecasts

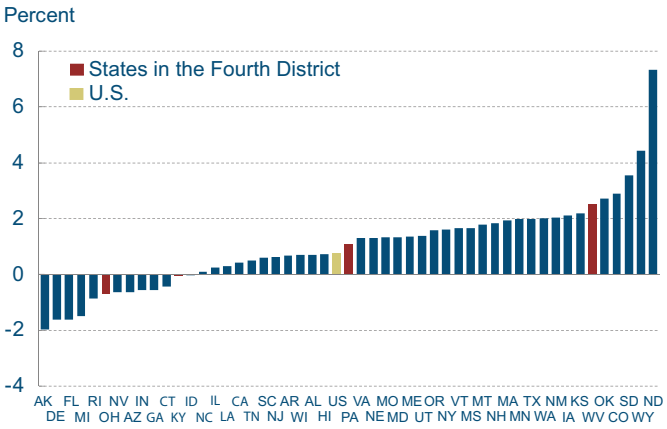


Source: Blue Chip *Economic Indicators*, June 2009; Bureau of Economic Analysis.

Roughly 40 percent of the panelists on the Blue Chip survey revised up their estimate of real GDP growth for 2009, resulting in an upward revision to the consensus estimate for 2009 (from -2.8 to -2.7 percent), according to the June survey. On the other hand, the consensus estimate for 2010 growth ticked up 0.1 percentage point to 2.0 percent, its second consecutive upward revision. In a special question, the panelists were asked when the NBER will date the trough of the cycle (the end of the recession). Almost every respondent expects that the recession will have abated by the end of 2009. However, a couple of the respondents anticipate a much longer recession, projecting that it will not end until the second quarter of 2010.

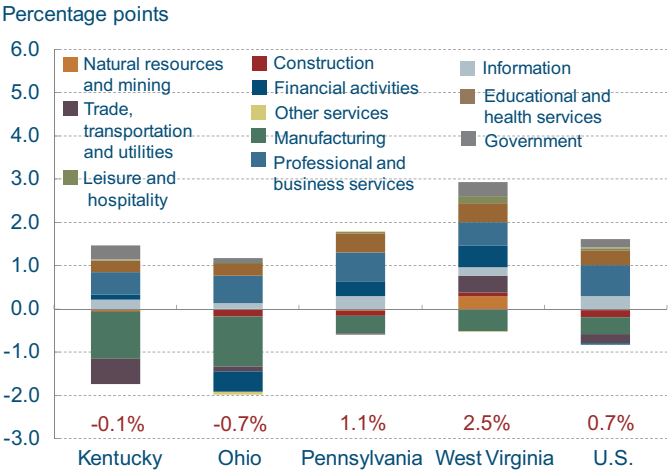
Gross Domestic Product Growth across States

Real GDP Growth, 2008



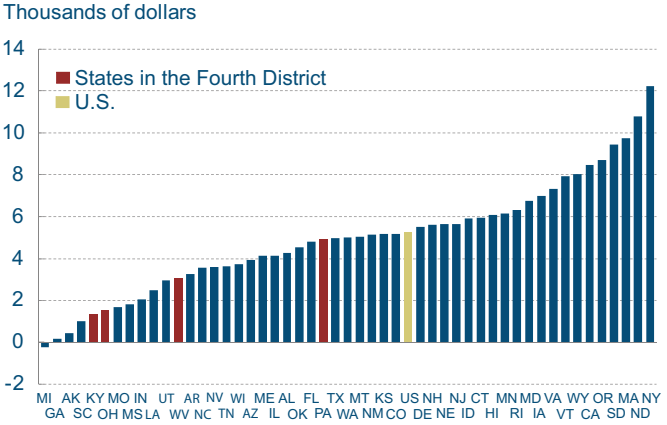
Source: Bureau of Economic Analysis.

Contribution to Percent Change in GDP, 2008



Note: Percentages in red represent the net contribution of the state to the percent change in GDP.
Source: Bureau of Economic Analysis.

Change in Real GDP per Capita:1998 to 2008



Source: Bureau of Economic Analysis; Census Bureau.

07.01.09
by Kyle Fee

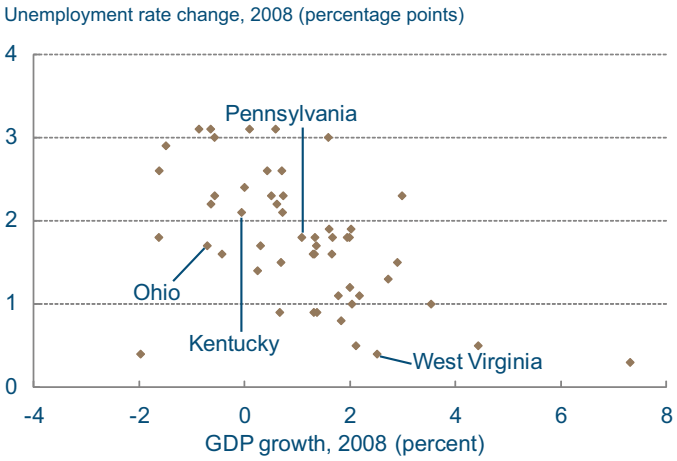
The Bureau of Economic Analysis recently released its annual report documenting patterns of gross domestic product (GDP) growth across states. Real GDP growth slowed in 38 states in 2008.

In states with counties in the Fourth District (Ohio, Kentucky, West Virginia, and Pennsylvania) real GDP growth varied markedly in 2008. West Virginia's growth rate (2.5 percent) was the highest of the four District states and the sixth-highest in the nation. Ohio's (–0.7 percent) was the sixth-lowest of all the states. Pennsylvania's real GDP growth was 1.1 percent, while Kentucky's was essentially flat. States that were in the upper tail of the distribution in 2008 tend to be located in the Plains Region or near the Rocky Mountains and to have significant resource extraction industries. States in the lower tail of the distribution are those with heavy-manufacturing industries, such as Michigan, Indiana, and Ohio.

Specific industrial sectors contributed systematically to differences in real GDP growth across states in 2008. Manufacturing and construction generally reduced GDP growth in Fourth District states and the United States as a whole, while professional and business services, education and health services, and the information sector raised growth. The drag of manufacturing on Ohio's and Kentucky's real GDP growth is quite substantial and reflects, in part, the weak performance of automotive-related industries. One difference between Ohio and the other states in the Fourth District and U.S. is the relative weak performance of the financial services sector. Financial services in Ohio lowered state GDP by 0.5 percentage point.

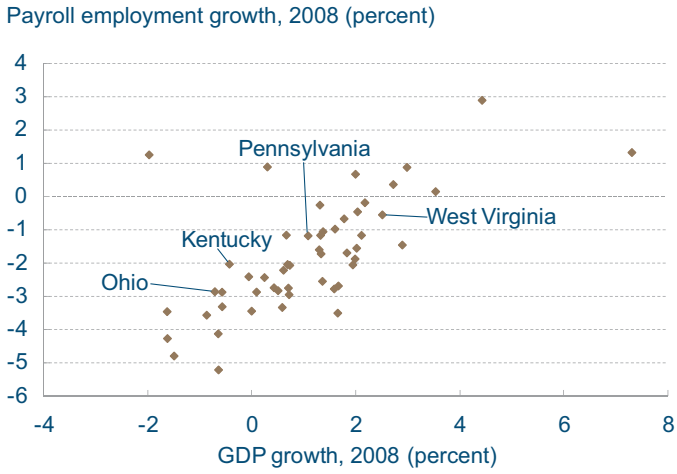
All four Fourth District states lagged the nation in per capita GDP growth. This was particularly true of Kentucky and Ohio, where GDP per capita rose roughly $1,300 and $1,500, respectively, over the past decade. In comparison, national per capita GDP rose $5,250 over the same period.

GDP Growth and Unemployment Rate Change, 2008



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics.

GDP Growth and Payroll Employment Growth, 2008



Source: Bureau of Economic Analysis; Bureau of Labor Statistics.

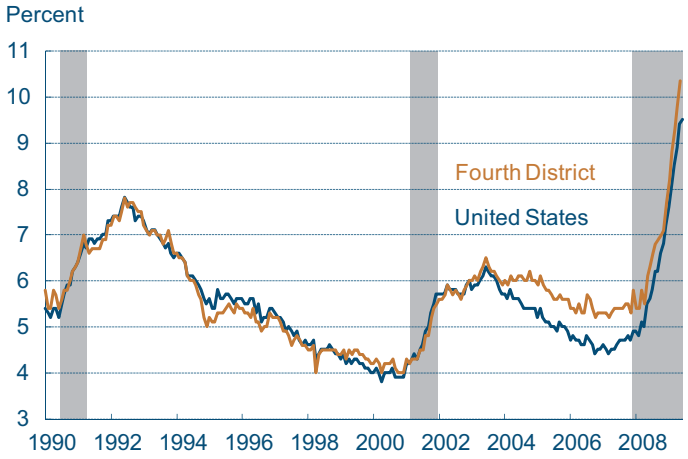
Not surprisingly, there is an overall negative relationship between a state's GDP growth and changes in its unemployment rate. States with low GDP growth experienced, on average, more substantial rises in unemployment rates, though, to be sure, there is substantial variation in the relationship across states. For example, seven states experienced a rise in the unemployment rate of roughly 3 percentage points in 2008. The real GDP growth rate of these states in 2008 varied from a little above –2.0 percent to a little below 2.0 percent.

Likewise, those states with the largest declines in payroll employment growth from January 2008 to December 2008 tend to have lower GDP growth. This relationship is somewhat more pronounced than the one between unemployment and GDP growth. Again, this is not too surprising as a state's production of goods and services is directly related to labor usage.

Fourth District Employment Conditions

07.08.09
by Kyle Fee

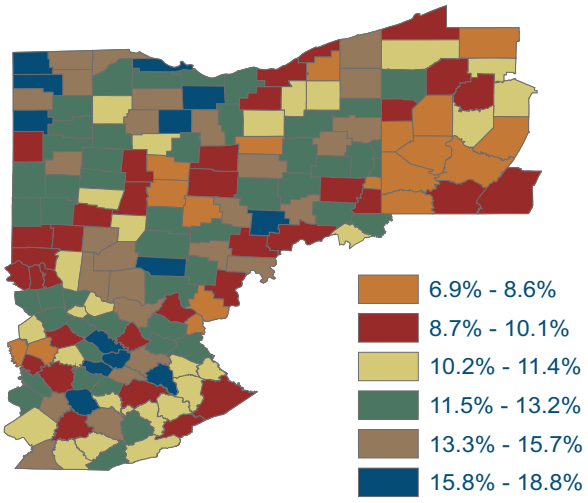
Unemployment Rate



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

County Unemployment Rates

U.S. unemployment rate = 9.4%



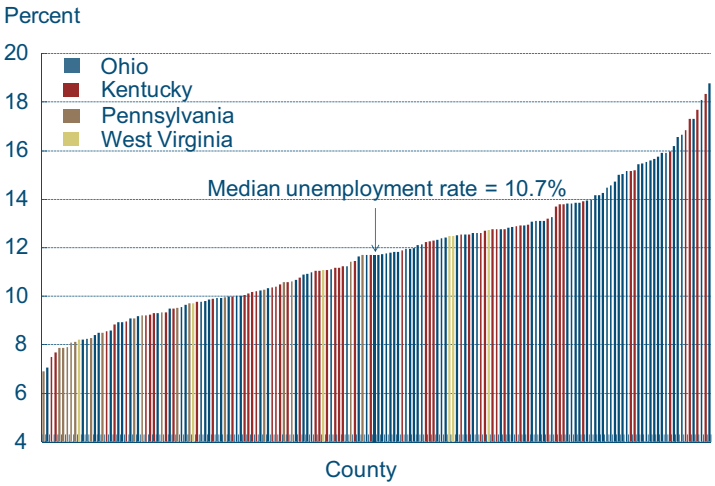
Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Sources: U.S. Department of Labor, Bureau of Labor Statistics.

The District's unemployment rate jumped 0.6 percentage point to 10.3 percent for the month of May. The increase is attributed to an increase of the number of people unemployed (6.1 percent) and a decrease in the number of people employed (-0.3 percent). The District's unemployment rate was again higher than the nation's (by 0.9 percentage point), as it has been since early 2004. Since the recession began, the nation's monthly unemployment rate has been 0.7 percentage point lower on average than the Fourth District's unemployment rate. Since this same time last year, the Fourth District's rate has increased 4.2 percentage points,and the nation's has increased 3.9 percentage points.

There are significant differences in unemployment rates across counties in the Fourth District. Of the 169 counties that make up the District, 63 had an unemployment rate below the national rate in May and 106 counties had a higher rate. There were 121 District counties reporting double-digit unemployment rates in May. Large portions of the Fourth District have high levels of unemployment. Geographically isolated counties in Kentucky and southern Ohio have seen rates increase, as economic activity is limited in these remote areas. Distress from auto-industry restructuring can be seen along the Ohio-Michigan border. Outside of Pennsylvania, lower levels of unemployment are limited to the interior of Ohio or the Cleveland-Columbus-Cincinnati corridor.

The distribution of unemployment rates among Fourth District counties ranges from 6.9 percent (Allegheny County, Pennsylvania) to 18.8 percent (Williams County, Ohio), with the median county unemployment rate at 10.7 percent. Counties in Fourth District Pennsylvania generally populate the lower half of the distribution, while the few Fourth District counties in West Virginia moved to the middle of the distribution. Fourth District Kentucky and Ohio counties continue to dominate the upper half of the distribution. These county-level

County Unemployment Rates

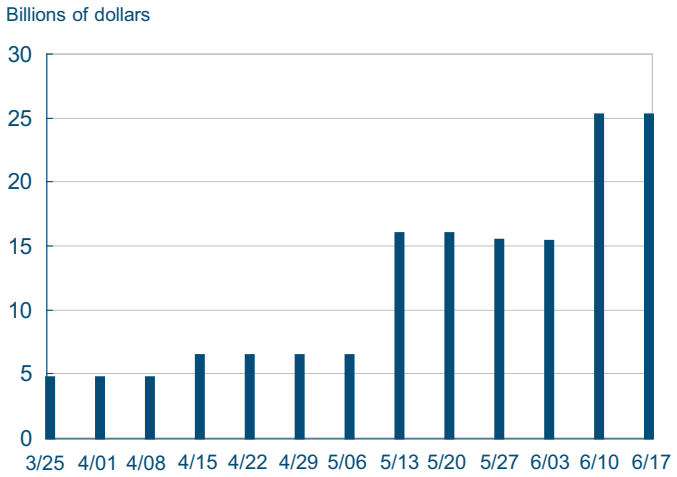


Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Sources: U.S. Department of Labor, Bureau of Labor Statistics.

patterns are reflected in statewide unemployment rates, as Ohio and Kentucky have unemployment rates of 10.8 percent and 10.6 percent, respectively, compared to Pennsylvania's 8.2 percent and West Virginia's 8.6 percent.

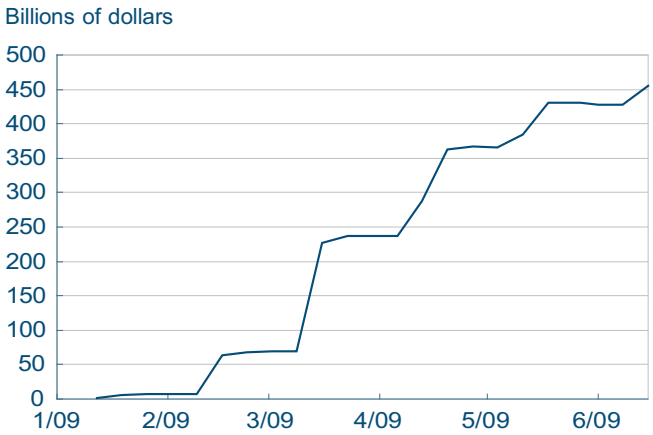
Consumer Credit Markets

TALF Funds Lent



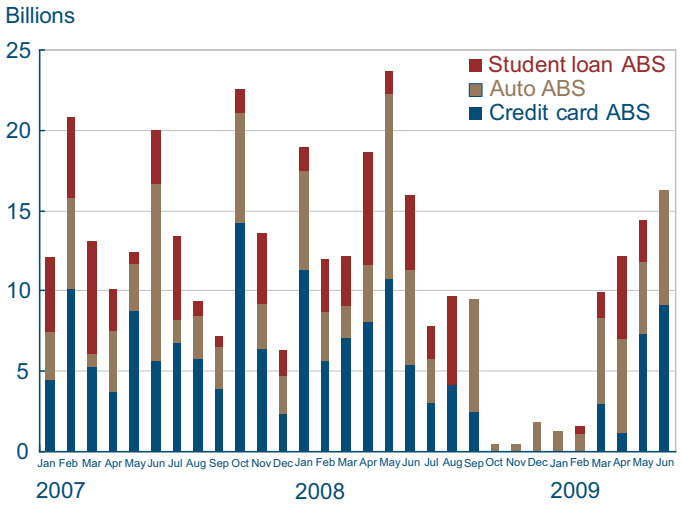
Source: Federal Reserve Board.

Mortgage-Backed Securities Purchased by Federal Reserve



Source: Federal Reserve Board.

Consumer ABS Issuance



Source: Bloomberg L.P.

07.03.09
by Timothy Bianco and O. Emre Ergungor

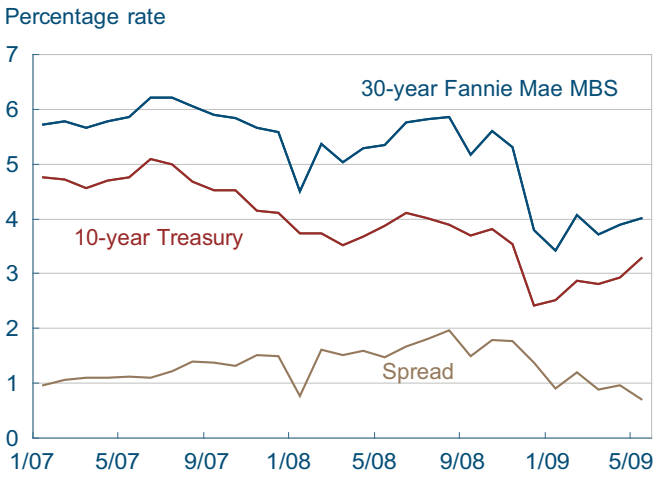
Since November 2008, the Federal Reserve has taken decisive actions to unfreeze consumer credit markets. A major challenge has been to revive lenders' funding sources so that they can in turn make credit available to consumers.

Particular effort has been focused on stimulating securitization, which for the past few decades has provided lenders with a large portion of their funding and enabled a vast expansion of credit to consumers, but which the financial crisis brought to a near standstill. Reviving the securitization activity is seen as an important step in reviving lending for education, automobiles, credit cards, and homes. For this reason, the Fed introduced several new lending programs designed to stimulate securitization.

The Term Asset-Backed Securities Loan Facility (TALF) lends to investors against their AAA-rated asset backed security (ABS) collateral. These securities are backed by credit card loans, autos loans, student loans, and different types of business loans, just to name a few. TALF lending began in March 2009 and now totals over $25 billion. The liquidity generated by the TALF is expected to enable financial institutions to increase the credit they extend to consumers for these kinds of purchases.

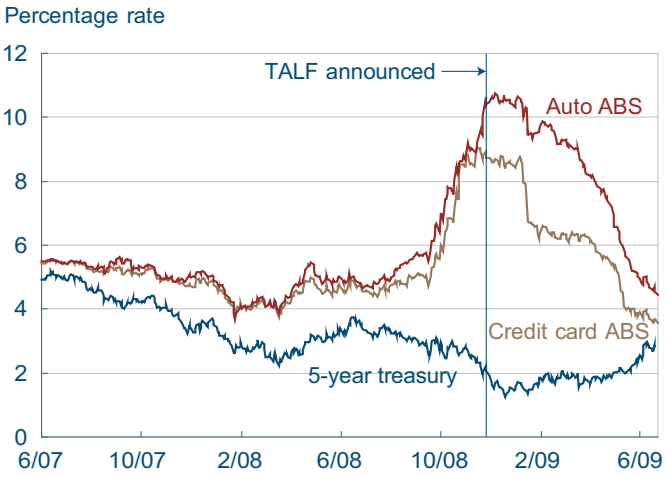
Indications so far suggest that the TALF is having a positive impact on consumer credit markets. In September 2008, the market for consumer ABS effectively shut down. This was particularly true for student loan ABS and credit card ABS. After the introduction of the TALF, the market began to revert to levels seen before the market's collapse. For instance, total consumer ABS issuance in November was merely $0.5 billion, while six months later it had risen to $14.4 billion. This increase was not due entirely to Federal Reserve actions—the total increase in ABS issuance was larger than the amount lent under TALF. This would imply that banks are becoming less risk averse as they once again engage in securitization.

Security Yields



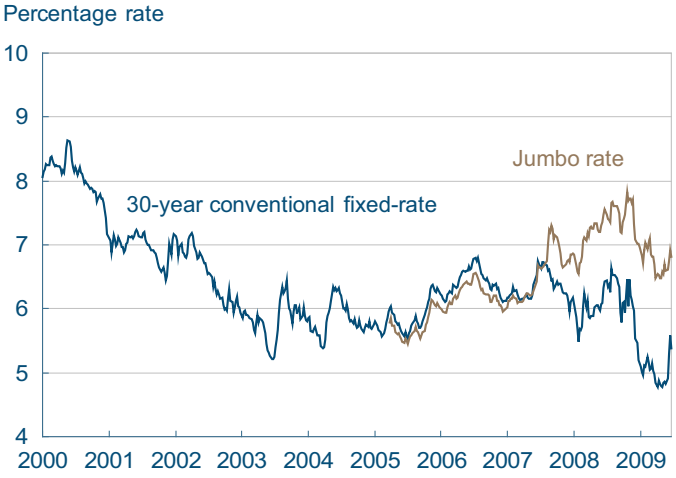
Source: Federal Reserve Board, Merrill Lynch.

Asset-Backed Security Rates



Source: Federal Reserve Board, Merrill Lynch.

Residential Mortgage Rates



Source: Federal Reserve Board, *Wall Street Journal*.

ABS yields, which capture the lenders' cost of funds, had increased sharply in the weeks following the failure of Lehman Brothers. Those yields have essentially plummeted since the Federal Reserve started lending under the TALF. When the TALF was announced, the spread between credit card ABS and 5-year Treasury yields was 7 percent, and the spread between auto ABS and Treasury yields stood at 9 percent. Recently, those spreads declined to less than 2 percent, implying a fall in the perceived risk of those asset-backed securities.

To further increase lending, the Fed is purchasing mortgage-backed securities (MBSs) directly. Purchasing began in January 2009 and now totals over $450 billion. Through these purchases and the purchase of US Treasury bonds, the Federal Reserve is applying downward pressure on Treasury bond yields and the yields on the mortgage-backed securities. These efforts may have paid off, as the Treasury yields as well as the spread between Fannie Mae MBSs and Treasury securities have declined in recent months.

With more securitization, consumers ought to have easier access to credit since banks can raise their funds more easily and at a lower cost. Some evidence suggests that this is happening. Along with the thawing of securitization markets in recent months, we have experienced a significant decline in mortgage rates. The 30-year conventional fixed-rate has decreased from well above 6 percent near the end of 2008 to its current level of 5.38 percent. This is higher than the 4.78 percent of the previous month, but this latest rise in mortgage rates is likely due to an uptick in long-term Treasury bond yields caused by higher inflation expectations.

Economic Trends is published by the Research Department of the Federal Reserve Bank of Cleveland.

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ISSN 0748-2922