

Economic Trends

January 2010 (December 9, 2009 to January 12, 2010)

In This Issue:

Inflation and Prices

- November Price Statistics

Financial Markets, Money and Monetary Policy

- An Update on the High-Yield Corporate Bond Spread and Economic Activity
- The Yield Curve, December 2009
- Treasury Deposits and Excess Bank Reserves

Economic Activity

- Real GDP: Third-Quarter 2009 Third Estimate
- The Employment Situation, December 2009

International Markets

- The Dollar Carry Trade

Regional Activity

- Fourth District Employment Conditions

Banking and Financial Institutions

- An Update on Bank Commercial Real Estate Exposure

FEDERAL RESERVE BANK
of CLEVELAND

November Price Statistics

12.22.09

by Brent Meyer

November Price Statistics

	Percent change, last					2008 average
	1mo. ^a	3mo. ^a	6mo. ^a	12mo.	5yr. ^a	
Consumer Price Index						
All items	4.9	3.4	3.2	1.8	2.5	0.3
Less food and energy	0.4	1.5	1.5	1.7	2.2	1.8
Median ^b	0.2	0.6	0.8	1.3	2.6	2.9
16% trimmed mean ^b	0.2	1.5	1.3	1.3	2.4	2.7
Producer Price Index						
Finished goods	24.4	6.3	8.3	2.4	3.0	0.2
Less food and energy	5.8	-0.7	0.7	1.2	2.2	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.

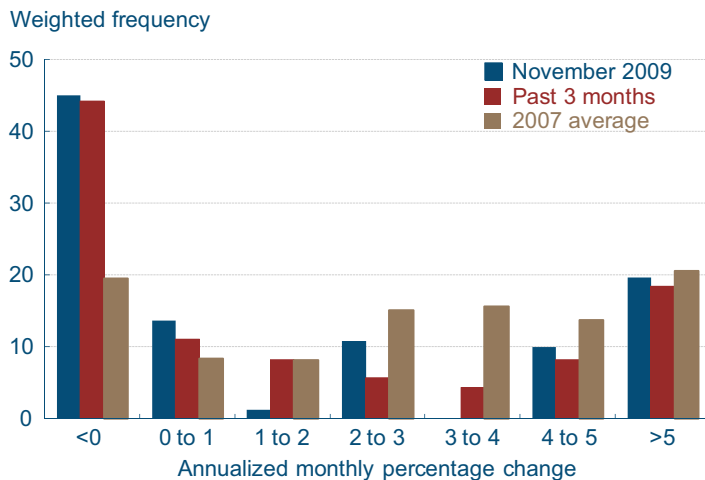
The CPI rose 4.9 percent (annualized rate) in November, largely on a sizeable jump in energy prices (up 62.7 percent). However, the core CPI was virtually unchanged, rising just 0.4 percent, following a 2.2 percent increase in October. The Federal Reserve Bank of Cleveland’s measures of underlying inflation trends—the median CPI and 16 percent trimmed-mean CPI—remained soft in November, increasing a slight 0.2 percent and 1.4 percent, respectively. Over the past three months, the median CPI is up a mere 0.6 percent, while the trimmed-mean measure has risen 1.5 percent.

In the price-change distribution of the underlying components of the CPI, a significant mass of the overall index continues to fall in the lower tail. In November, 45 percent of the consumer market basket (by expenditure weight) exhibited outright price decreases and, over the past three months, that lower tail has held an average of 44 percent of the overall index. For context, in an average month in 2007 just 19 percent of the market basket posted price decreases. Perhaps the most striking pattern in the distribution lately is the absence of mass near the center of the distribution. Only between 1 percent and 4 percent of the components exhibited price changes in this area. In November, just 12 percent of the index earned that distinction, down from 18 percent over the past three months and well beneath the 2007 average of 39 percent.

On the upper end of the price-change distribution, used car prices continued to post double-digit price increases, jumping up 26.7 percent in November. Over the four months since the CARS program came and went, used auto prices have risen a whopping 29.8 percent (their highest growth rate since October 1981).

As expected, rents are still coming in soft, with the rent of primary residence falling 0.9 percent in November, and owner’s equivalent rent (OER) falling 1.5 percent. On a year-over year basis, rents

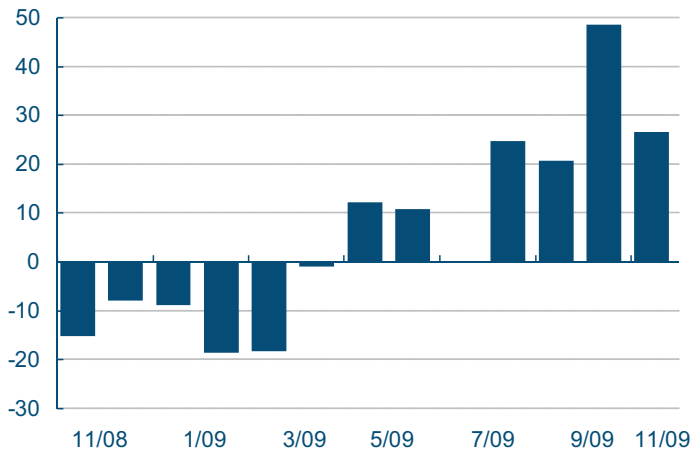
CPI Component Price Change Distribution



Source: Bureau of Labor Statistics.

Used Cars and Trucks Prices

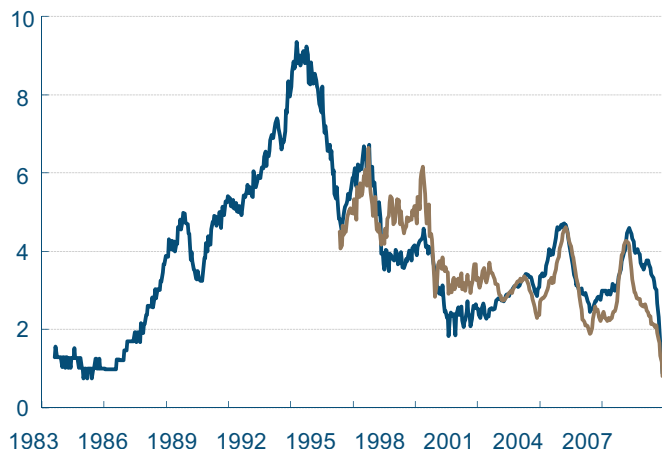
Annualized percent change



Source: Bureau of Labor Statistics.

Rents

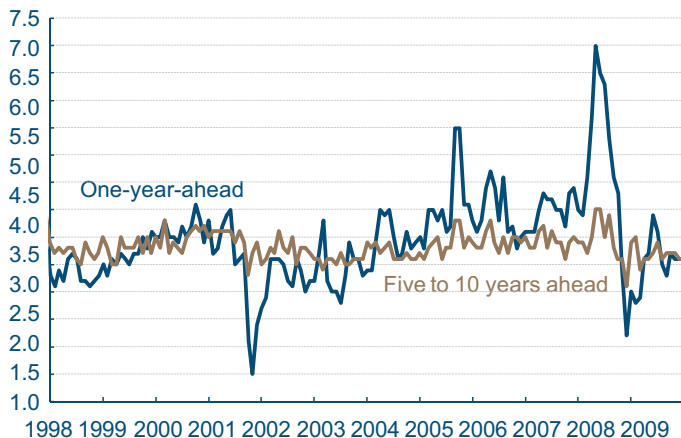
12-month percent change



Source: Bureau of Labor Statistics.

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.

are up less than 0.9 percent, putting both series at (or near) historic lows (note the OER series only goes back to 1982). Generally, rents exhibit relatively low volatility, partly due to the fact that they are surveyed only twice a year, which yields some persistence in the measure.

Looking forward, long-run (5- to 10-year-ahead) average inflation expectations from the University of Michigan's Survey of Consumer Sentiment have been relatively "well-anchored" over the next 12 months; ranging between 2.9 percent and 3.4 percent. That said, there was an interesting development in the December (preliminary) data. The average expectation ticked down 0.1 percentage point to 3.1 percent in December, while the median long-run expectation fell by 0.4 percentage point to 2.6 percent, suggesting that there may be some sort of "bimodal" expectations by participants. In other words, that pattern may suggest that a majority of survey participants' expectations are either remaining stable or slipping down slightly, but a smaller group of participants may have intensified their expectations to the upside (something like the so-called "Bill Gates effect" on average local-area income).

An Update on the High-Yield Corporate Bond Spread and Economic Activity

12.22.09

by Timothy Bianco and Mehmet Pasaogullari

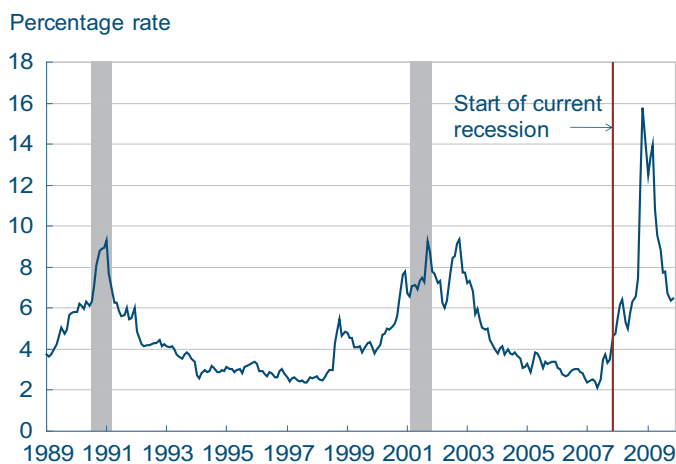
The financial crisis has brought into focus the importance of financial markets to a properly functioning economy. These markets help the economy allocate resources and shape the investment and saving decisions of the society. One important financial market is the corporate bond market. A look at current conditions in it can shed some light on ongoing financial market stabilization.

The spreads between the bonds of companies with different credit ratings indicate investors' attitudes toward risk and may contain valuable information about the state of economy. The high-yield spread is a corporate bond spread that might be particularly good to look at for this kind of information. The high-yield spread is the spread between the yields of high-yield (or junk) bonds and higher-grade bonds (say, AAA corporate bonds). The yields of junk bonds are especially sensitive to the default probabilities of firms, which varies over business cycle, so these yields are likely to be a good predictor of future economic activity.

There is a negative relationship between economic activity and the high-yield spread. This can be seen in the relationship between the high-yield spread (defined here as the spread between the yield of the Merrill Lynch High Yield Master II Index and the Merrill Lynch AAA corporate bond index) and GDP growth or the output gap.

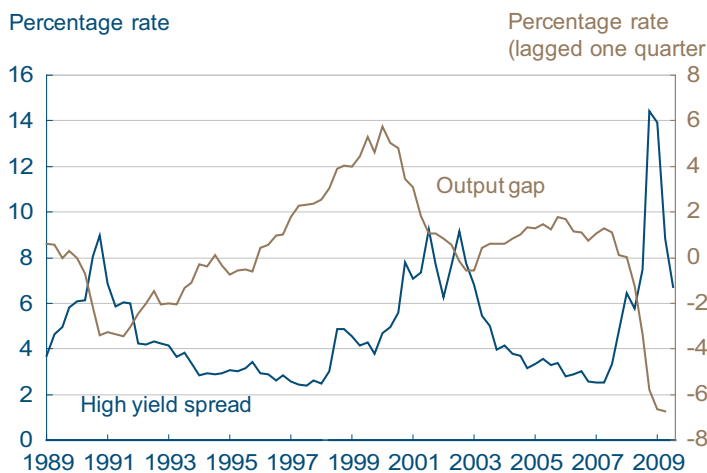
Increases in this spread have preceded recessions. This pattern was also observed in the most recent recession: The high-yield spread started increasing in June 2007, about two quarters before the start of the recession. Since March 2009 the high-yield spread has steadily come down, parallel to the developments in other financial markets. The spread moved down to 6.4 percent at the end of October after a seven-month steady decline from a high of 14 percent at the beginning of April 2009.

High Yield Spread



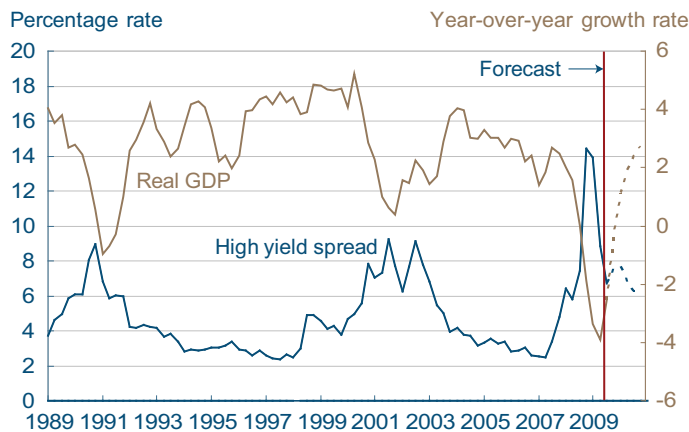
Note: Shaded bars indicate recessions.
Source: Merrill Lynch

High Yield Spread and Output Gap



Sources: Merrill Lynch, Congressional Budget Office, NBER.

Forecasts of High Yield Spread and Real GDP



Sources: Merrill Lynch, Bureau of Economic Analysis, authors' calculation.

The high-yield spread increased 0.1 percent in November, since the AAA corporate bond yield declined by about 0.3 percent, whereas the high-yield bond yield declined about only 0.2 percent. However, in the first half of December, the AAA corporate bond yield increased 0.3 percent whereas the high-yield bond yield continued to decline. By December 15, the spread had declined to 5.8 percent.

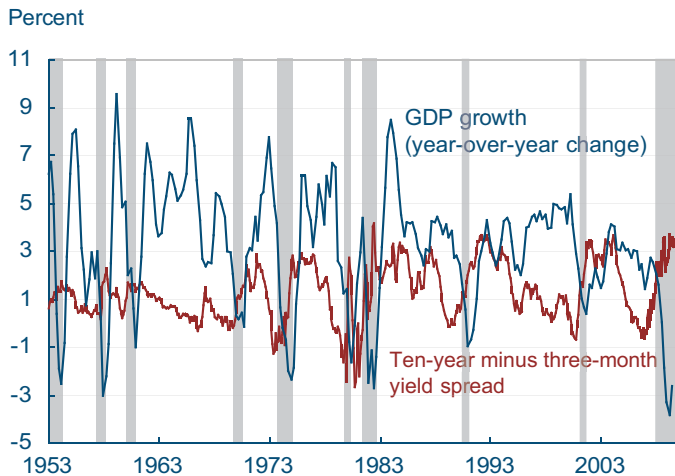
Employing a simple empirical model of GDP and the high-yield spread, we forecast that real GDP will grow 2.7 percent in 2010. This is 0.1 percent lower than October's forecast using the same method. The difference mainly reflects the downward revision to GDP in the third quarter of 2009. It should be noted that estimates from such a simple model should be approached cautiously since the model utilizes only one of the many possible indicators of future economic activity. Still, the forecasted trend is in line with most other forecasts in predicting an upward trend in the annual growth of real GDP in 2010.

The Yield Curve, December 2009

01.05.10

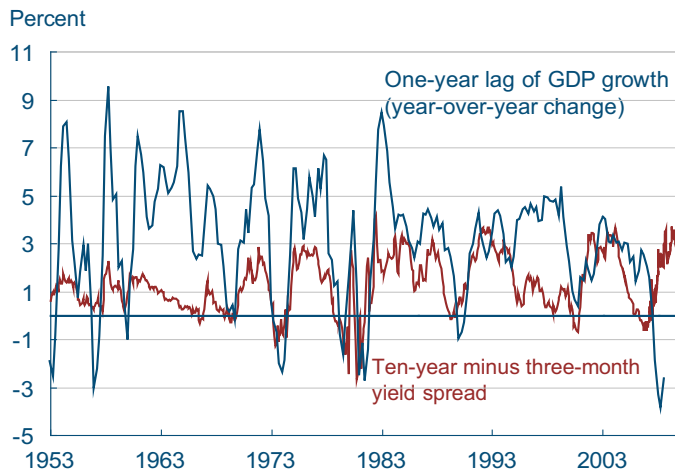
by Joseph G. Haubrich and Kent Cherny

Yield Curve 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



Sources: Bureau of Economic Analysis, Federal Reserve Board.

Since last month, the yield curve has gotten a bit steeper, with long rates moving up as short rates held steady. The difference between these 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.

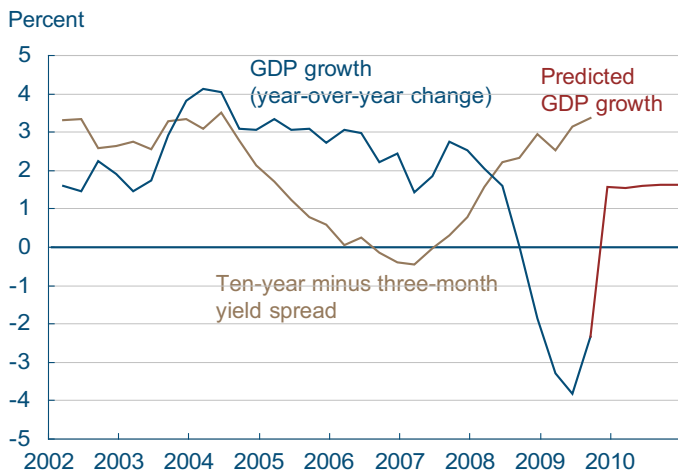
More generally, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year Treasury bonds and 3-month Treasury bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

Since last month, the 3-month rate held constant at 0.04 percent (for the week ending December 18). At that rate, 100 dollars invested for a year would earn 4 cents. This is down from October's already very low 0.07 percent.

The 10-year rate increased to 3.56 percent, up from November's 3.35 percent, and even above October's 3.43 percent. The slope increased to 352 basis points, up from November's 331 basis points, and from October's 336 basis points. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 1.62 percent rate over the next year. This is about equal to the 1.65 percent predicted last month. Although the time horizons do not match exactly, this month's estimate comes in somewhat below other forecasts.

While such an approach predicts when growth is above or below average, it does not do so well in

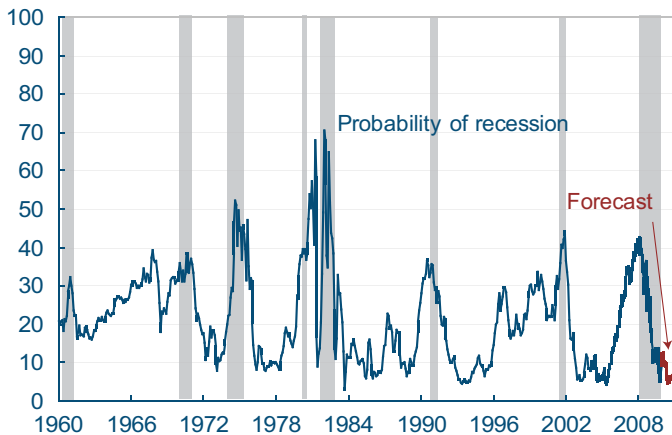
Yield Curve Predicted GDP Growth



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

Recession Probability from 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.

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 December is 5.5 percent, up a bit from November's 4.7 percent, and from October's 3.9 percent, but still, of course, very low.

The probability of recession coming out of the yield curve is low, and this accords with many forecasts that suggest we have already come out of recession—and remember that the forecast is for where the economy will be in a year.

Of course, it might not be advisable to take these 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, 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 read more on other forecasts:
http://www.econbrowser.com/archives/2008/11/gdp_mean_estima.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>

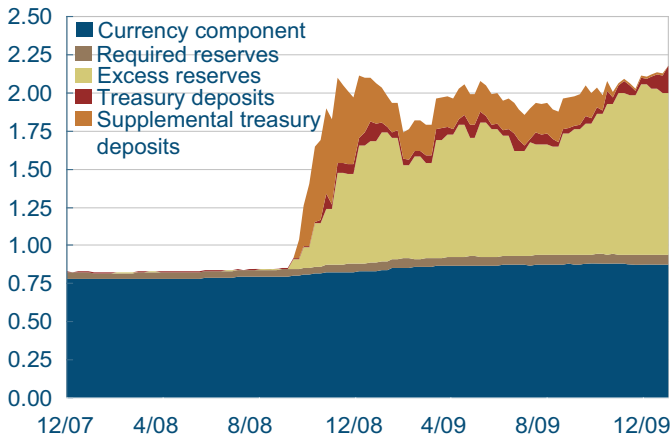
Treasury Deposits and Excess Bank Reserves

01.12.10

by John B. Carlson and John Lindner

Federal Reserve Liabilities

Trillions of dollars, SA

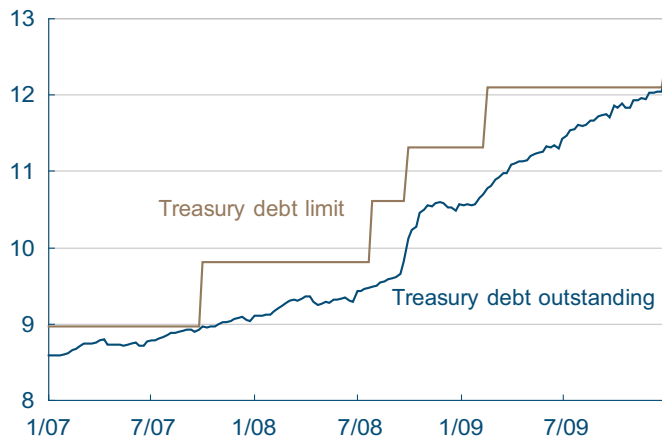


Note: Liabilities do not include reverse repos, Treasury cash holdings, foreign official deposits, service-related balances and adjustments or other liabilities and capital.

Source: Federal Reserve Board

Treasury Balances

Trillions of dollars



Source: Department of the Treasury.

An interesting development on the Federal Reserve's balance sheet is a decline in excess bank reserves. This decline has occurred despite an increase in the overall size of the Fed's balance sheet. The key factor accounting for the decline in excess reserves is a substantial increase in U.S. treasury deposits at the Fed, which were made as a consequence of having issued new debt. When the treasury issues debt to the public and deposits the proceeds at the Fed in its general account, bank reserves decline. In normal times, the treasury typically holds some proceeds in Treasury Tax and Loan accounts at commercial banks, which keeps reserves in the banking system. This arrangement helps maintain a steady supply of reserves—a desirable outcome for when the Fed sought to keep the fed funds rate near a target rate.

Following the collapse of Lehman Brothers in September 2008, the Federal Reserve instituted a number of policies that sharply increased bank reserves in excess of required levels. Initially, the Fed sought to absorb most of the new reserves in order to keep the fed funds rate near its target rate. To help in this effort, the treasury issued short-term debt at special auctions (called the Supplementary Financing Program or SFP) and placed the proceeds in a new supplemental treasury account at the Federal Reserve. Still, the amount of reserves absorbed could not keep up with the amount of bank reserves that were being created with the Fed's new credit policies. Subsequently, the fed funds target was lowered to zero, and the immediate need to absorb reserves abated.

In late 2009 the total level of treasury debt approached the limit authorized by Congress. As the SFP issues matured, the SFP deposits were used to redeem them, and excess reserves increased. In December Congress raised the debt ceiling, allowing the treasury to issue new debt. This time, the treasury deposited much of the proceeds into its general account with the Fed, which caused the observed decline in excess reserves.

Real GDP: Third-Quarter 2009 Third Estimate

01.06.10

by John Lindner

Real GDP and Components, 2009:Q3 Third Estimate

	Quarterly change (billions of 2000\$)	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	71.5	2.2	-2.6
Personal consumption	63.6	2.8	-0.2
Durables	51.0	20.4	-1.5
Nondurables	7.6	1.5	-0.9
Services	11.8	0.8	0.3
Business fixed investment	-19.4	-5.9	-19.6
Equipment	3.3	1.5	-17.9
Structures	-19.8	-18.4	-22.9
Residential investment	15.2	18.9	-18.9
Government spending	16.9	2.7	1.9
National defense	14.1	8.4	5.0
Net exports	-27.0	—	—
Exports	59.3	17.8	-10.7
Imports	86.4	21.3	-14.0
Private inventories	-139.2	—	—

Source: Bureau of Economic Analysis.

Third-quarter GDP growth was revised down again in the third estimate. The annualized growth rate has dropped in successive estimates from 3.5 percent to 2.8 percent to 2.2 percent, the latest. This most recent revision was greater than expected (the consensus expectation was for 2.7 percent growth). The four-quarter percent change also fell 0.1 percentage point to -2.6 percent.

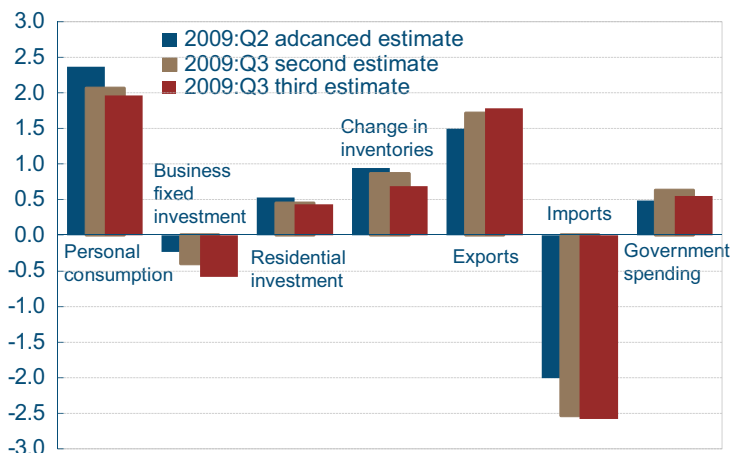
The downward revision was largely driven by an additional 1.8 percentage point (pp) decrease in business fixed investment and smaller reductions in personal consumption and private inventories. Other declines occurred in government spending and residential investment. Government spending dropped some of the gain ascribed to it in the second estimate, falling from a 3.1 percent increase to a 2.7 percent increase in the third estimate. Residential investment continued its downward path of revision since the advanced estimate, dropping another 0.6 pp to end at 18.9 percent growth. These losses were offset only by a positive revision to exports, which added 0.8 pp to its annualized growth from last quarter.

Personal consumption remained the largest contributor to the growth in real GDP, adding 2.0 pp (which is smaller than the 2.1 pp of the second estimate). The largest revisions occurred in business fixed investment and the change in inventories, and together these revisions subtracted an additional 0.4 pp from real growth. Business fixed investment accounted for 0.2 pp of the additional subtraction and the change in inventories accounted for the other 0.2 pp. Following both third-quarter revisions, the additional decline in business fixed investment now totals 0.4 pp. The estimate for the change in inventories was unchanged in the second estimate.

The Blue Chip consensus forecast for 2009 real GDP slipped back to -2.5 percent in the December survey, after having climbed 0.1 pp to -2.4 percent

Contribution to Percent Change in Real GDP

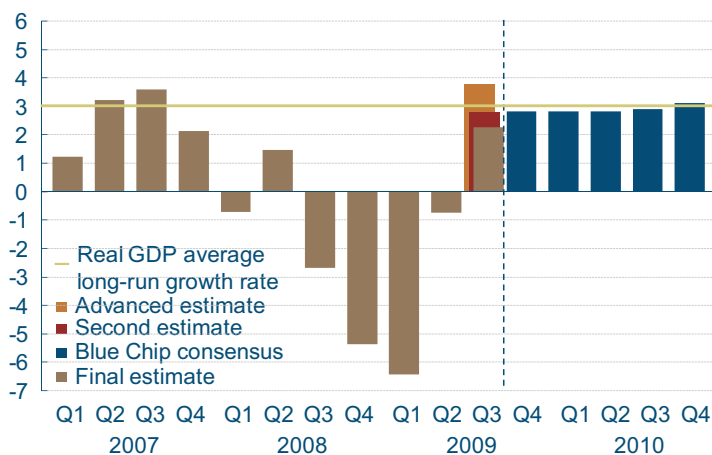
Percentage points



Source: Bureau of Economic Analysis.

Real GDP Growth

Annualized quarterly percent change



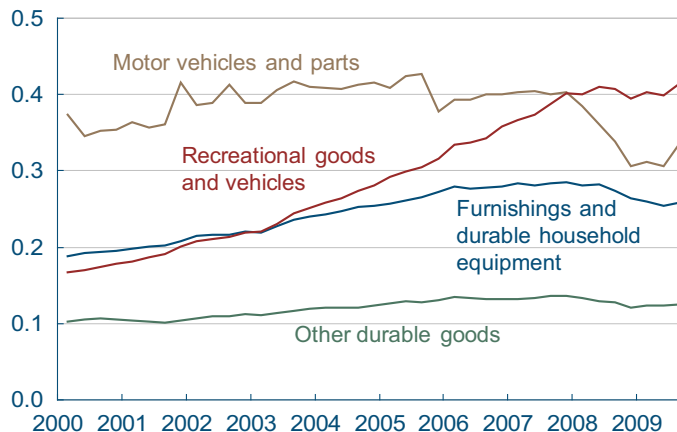
Sources: Blue Chip *Economic Indicators*, December 2009; Bureau of Economic Analysis.

in November. Larger-than-expected downward revisions to the third-quarter estimate may put more downward pressure on the consensus forecast for 2009 in the January survey. The consensus estimate for 2010 growth remained steady in December at 2.7 percent, breaking a string of consecutive upward revisions. According to forward-looking forecasts, real GDP growth is first expected to reach its long-run trend again in the fourth quarter of 2010. Looking ahead through the rest of the year, even pessimists are predicting GDP growth of over 1.5 percent for the rest of this year and through 2010.

Third-quarter real growth was largely dependent upon the return of consumer spending. The Cash for Clunkers program added a tremendous lift to the economy, with initial estimates crediting close to 1.5 percentage points of real growth to the program. Consumption of durable goods other than motor vehicles also increased in the third quarter. While the motor vehicles and parts category rose nearly 9.5 percent from the second to the third quarter, recreational goods and vehicles increased over 4 percent, and household durables jumped over 1.5 percent. These improvements were accompanied by a rise in nonrevolving consumer credit, even amidst the massive deleveraging occurring in the economy. In the fourth quarter, personal consumption may be expected to continue on an upward trend, as tax credits may induce more spending on home improvements, and holiday shopping may boost spending on services and nondurables.

Durable Goods

Trillions of dollars



Source: Bureau of Economic Analysis.

The Employment Situation, December 2009

01.12.10

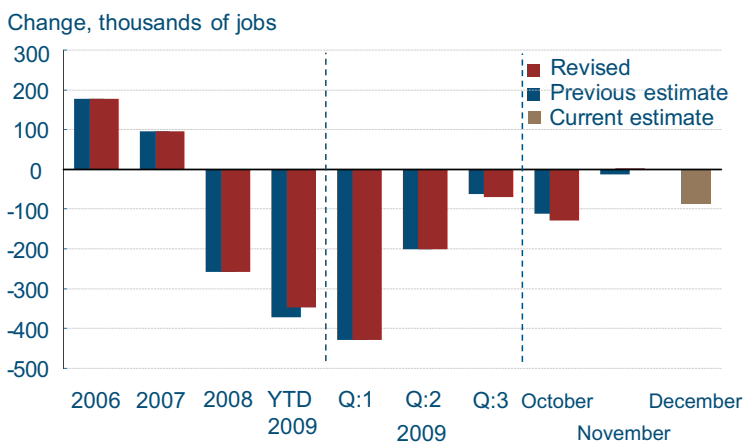
by Murat Tasci and Beth Mowry

Nonfarm payroll employment came in weaker than expected, dropping 85,000 jobs in December to conclude a year totaling nearly 4.2 million net job losses. Downward revision to October's figure roughly cancelled out the upward revision made to November's preliminary estimate, leaving those months' respective employment change at -127,000 and 4,000. With the exception of November, the U.S. economy has lost jobs consistently all the way back to December 2007, but the losses have steadily slowed over much of 2009. Average losses lessened from 428,000 in the second quarter to 199,000 in the third quarter, and now to 69,000 in the final quarter of the year. The unemployment rate was unchanged at 10.0 percent. However, since labor force participation fell precipitously and 661,000 people exited the labor force, the unemployment rate is surely underestimating labor market slack. The employment-to-population ratio continued its long decline, slipping from 58.5 percent to 58.2 percent in December, its lowest since August 1983. It has now dropped 4.5 percentage points since the start of the recession.

Goods-producing industries shed 81,000 jobs on net in December after dropping by 58,000 in November. Construction shed 53,000 jobs, roughly shared between the residential and nonresidential sides. The manufacturing industry had its best month since December 2007 while still losing a massive 27,000 jobs. In terms of absolute losses, manufacturing continues to be one of the main drags on the overall employment count, but it is also one of the most improved industries since the beginning of the year.

Employment in service-providing industries declined mildly, by 4,000 jobs, after seeing a strong November gain of 62,000. The largest increase within services came from the professional and business services industry, which contributed 50,000 jobs after adding an even heftier 89,000 the previous month. It has been the strongest industry

Average Nonfarm Employment Change



Source: Bureau of Labor Statistics.

in the past couple of reports and has also seen great improvement since the start of 2009, when it had lost as many as 176,000 workers in a single month. Most of the industry's strength over the past several reports has stemmed from temporary help services, which added 46,500 jobs last month and has seen five consecutive gains. A possible explanation for this is that employers may be looking to see whether a recovery will indeed materialize, choosing to increase production with part-time workers before committing to full-time hires. Other industries contributing positively last month include education and health, which gained 35,000, and financial activities, which added 4,000 jobs in its first increase since July 2007. Healthcare is the only sector not to see any net job losses the entire duration of the recession.

Labor Market Conditions and Revisions

	Average monthly change (thousands of employees, NAICS)				
	October current	Revision to October	November current	Revision to November	December current
Payroll employment	-127	-16	4	15	-85
Goods-producing	-109	4	-58	11	-81
Construction	-56	0	-27	0	-53
Heavy and civil engineering	-14.2	-1	2	-3	-18
Residential ^a	-13.5	-5	-4	-1	-19
Nonresidential ^b	-28.3	6	-25	4	-17
Manufacturing	-48	3	-35	6	-27
Durable goods	-35	2	-29	4	-16
Nondurable goods	-13	1	-6	2	-11
Service-providing	-18	-20	62	4	-4
Retail trade	-40	5	-14	1	-10
Financial activities ^c	-6	4	-6	4	4
PBS ^d	33	-5	89	3	50
Temporary help services	44	0	55	3	47
Education and health services	36	-4	37	-3	35
Leisure and hospitality	-42	-6	-13	-2	-25
Government	36	-10	4	-3	-21
Local educational services	31	-2	15	3	-1

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.

The main negatives within services came from trade, transportation, and utilities (-37,000), leisure and hospitality (-25,000), government

(-21,000), and information (-6,000). Retail trade gave its best performance since January 2008, losing a much smaller 10,000 jobs compared to losses nearing six digits last November. Government-sector activity has been sporadic this past year, seeing as many months of gains as losses. Losses trumped, however, totaling 205,000 during 2009, while gains amounted to only 140,000.

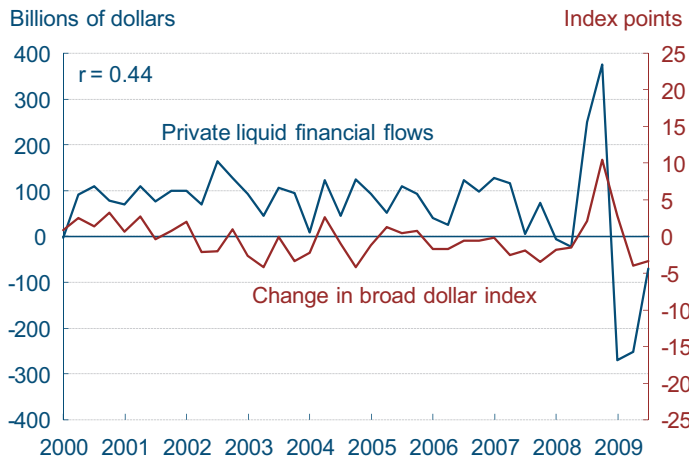
The Diffusion Index of Employment Change, which tracks the percentage of industries with increasing employment, slipped 2.4 points, from 42.4 to 40.0. While still beneath the expansionary threshold of 50, the index has primarily expanded since April and has climbed from its record low of 19.6 in March.

The Dollar Carry Trade

01.05.10

by Owen F. Humpage and Caroline Herrell

Private Liquid Financial Flows versus the Change in the Broad Dollar Index



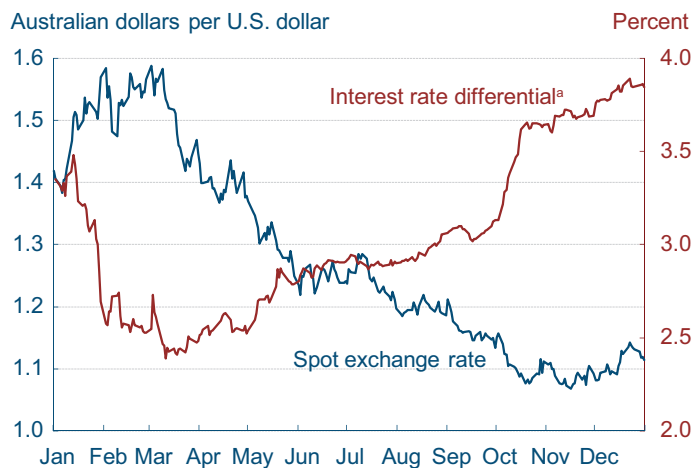
Sources: Bureau of Economic Analysis; Federal Reserve Board.

The dollar has depreciated roughly 10 percent from its recent peak in March 2009, on a broad trade-weighted basis against the currencies of our key trading partners. Many attribute the dollar's recent decline to a relatively easy U.S. monetary policy that is fueling a dollar carry trade. The dollar carry trade refers to a set of foreign-exchange transactions that seem to exploit an economic anomaly and entail substantial risk. Perhaps that is why some people fear that the carry trade could unwind quickly and pose adverse consequences for global currency markets.

Although investors can structure dollar-carry-traded transactions in a couple of different ways, at root, they proceed as follows: International investors borrow dollars at very low interest rates and invest the funds in a higher yielding, foreign-currency asset. The investors typically do not cover the transaction by selling the projected foreign-currency payout in the forward market, which would lock in a known return in dollars. Instead, investors bet that the dollar will continue to depreciate, or at least not appreciate to such an extent as to wipe out their gains on the interest differential. Because carry-traders remain exposed to foreign-exchange risk, many observers fear that these investors will run for cover at the first sign that the outlook is not as they anticipated.

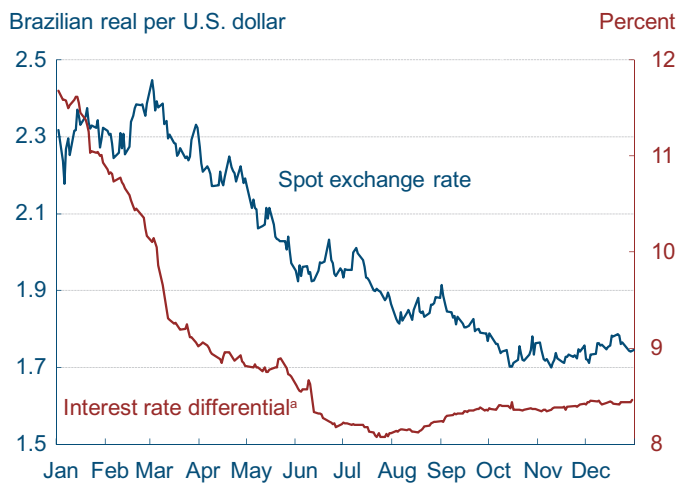
Theoretically, such activity should be short-lived. The underlying arbitrage should quickly eliminate the international return differentials by narrowing interest-rate spreads and encouraging the foreign currencies to appreciate in the spot market, and depreciate in the forward market, relative to the dollar. Yet, absent a reversal in the underlying monetary policies, this does not seem to happen. The currencies of countries with low interest rates tend to depreciate, or to not appreciate sufficiently to offset arbitrage opportunities. Persistently low U.S. interest rates and dollar depreciation are consistent with an ongoing carry trade.

Australian Dollar versus U.S. Dollar, 2009



a. The three-month London interbank offered rate based on Australian dollars minus the three-month London interbank offer rate based on U.S. dollars.
Sources: The Financial Times, British Bankers' Association, Bloomberg Financial Information Services.

Brazilian Real versus U.S. Dollar, 2009



a: The three-month Brazilian interbank rate minus the three-month London interbank offer rate based on US dollars.

Sources: The Financial Times, Bloomberg Financial Information Services.

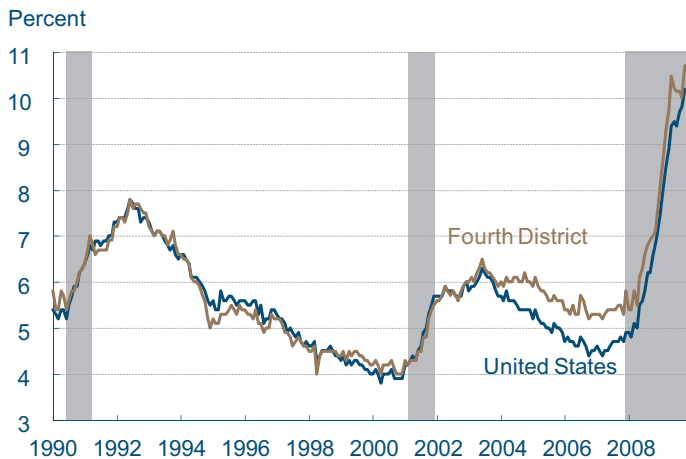
Measuring the carry trade is difficult. Recent U.S. balance-of-payments data seem compatible with the carry-trade claim but suggest that the effect may be dampening. In recent years, the United States has typically experienced a net inflow of private liquid funds, but between the first and third quarters of 2009, the U.S. experienced a sharp outflow of private liquid funds. (The U.S. also experienced small outflows of private liquid funds in the first two quarters of 2008.) In the third quarter of 2009, however, the net outflow of private liquid funds slowed sharply, according to preliminary data.

Dollar exchange rates against key carry-trade target currencies—the Australian dollar and the Brazilian real—seem to tell a similar tale. The dollar depreciated sharply against both of these high-interest rate currencies through the second and third quarters of 2009, but the dollar has shown little movement vis-à-vis either of these currencies since the end of September.

Fourth District Employment Conditions

01.08.10
by Kyle Fee

Unemployment Rate

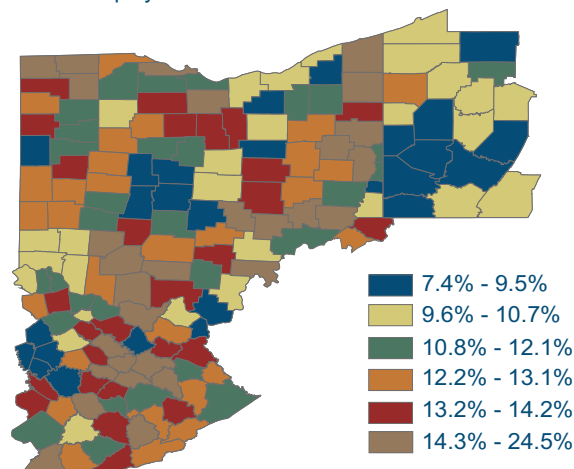


Notes: Shaded bars indicate recessions. Seasonally adjusted using the Census Bureau's X-11 procedure. Some data reflect revised inputs, reestimation, and new statewide controls. For more information, see <http://www.bls.gov/lau/launews1.htm>. Sources: U.S. Department of Labor, Bureau of Labor Statistics.

The District's unemployment rate remained at 10.7 percent for the month of November. Compared to the national rate, the District's unemployment rate was 0.7 percentage point higher. The District's unemployment rate has been consistently higher than the nation's since early 2004. Since the start of the recession, the nation's monthly unemployment rate has averaged 0.6 percentage points lower than the Fourth District unemployment rate. Since this same time last year, the Fourth District unemployment rate has increased 3.6 percentage points and the national unemployment rate has increased 3.2 percentage points.

County Unemployment Rates

U.S. unemployment rate = 10.0%

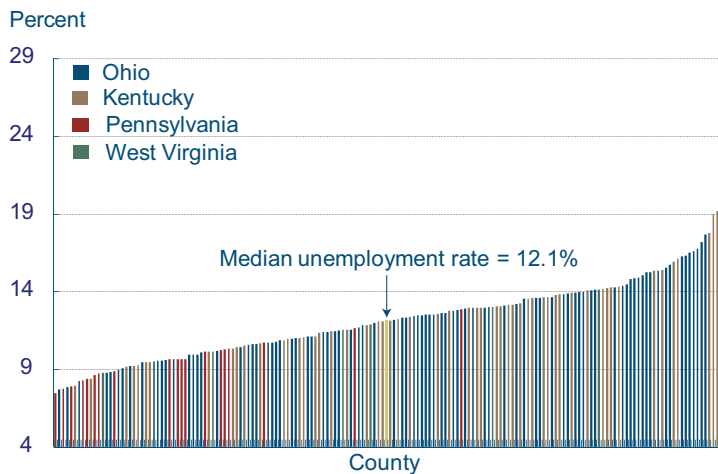


Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure. Sources: U.S. Department of Labor, Bureau of Labor Statistics.

There are significant differences in unemployment rates across counties in the Fourth District. Of the 169 counties that make up the District, 37 had an unemployment rate below the national rate in November and 132 counties had a rate higher than the national rate. There were 132 District counties reporting double-digit unemployment rates in November, indicating 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 the 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 7.5 percent (Butler County, Pennsylvania) to 24.5 percent (Magoffin County, Kentucky), with the median county unemployment rate at 12.1 percent. Counties in Fourth District Pennsylvania generally populate the lower half of the distribution, while the few Fourth District counties in West Virginia are scattered across the distribution. Fourth District Kentucky continues to dominate the upper half of the distribution, with Ohio counties becoming

County Unemployment Rates

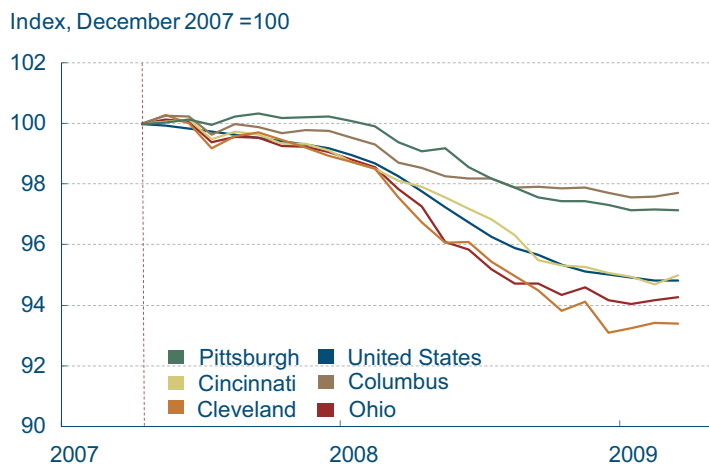


Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Sources: U.S. Department of Labor, Bureau of Labor Statistics.

more dispersed throughout the distribution. These county-level patterns are reflected in statewide unemployment rates, as Kentucky and Ohio have unemployment rates of 10.6 percent and 10.6 percent, respectively, compared to Pennsylvania's 8.5 percent and West Virginia's 8.4 percent.

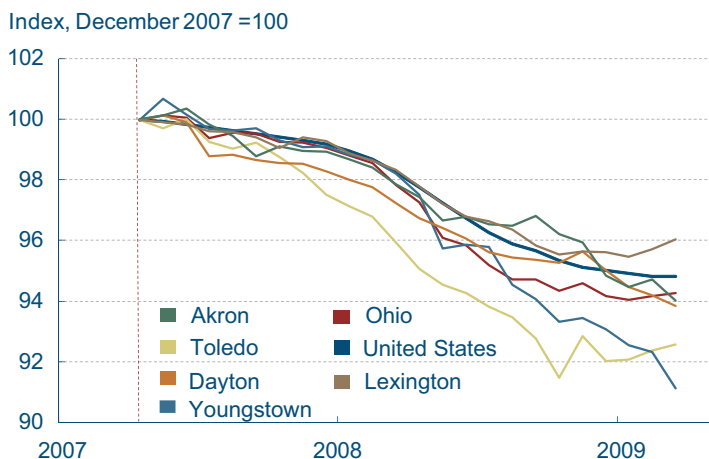
Similar to the national payroll employment situation, Ohio and large metropolitan statistical areas (MSAs) in the Fourth District have recently seen payroll employment begin to bottom out. However, smaller MSAs in the District are still experiencing declines in payroll employment.

Payroll Employment, Large MSAs



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

Payroll Employment, Smaller MSAs



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

An Update on Bank Commercial Real Estate Exposure

01.12.10

by Kent Cherny and Yuliya Demyanyk

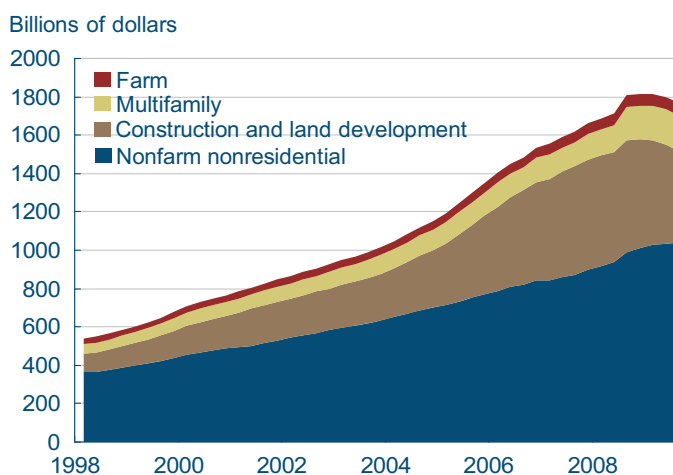
Since our summary of banks' commercial real estate (CRE) exposure last August, mortgages backed by commercial property have continued to experience weakness in the form of delinquencies and defaults. A handful of factors are perpetuating the stress on nonfarm-nonresidential mortgages and construction loans, in particular. First, the fragility of the economy itself has led to high rates of unemployment, which necessarily decreases the demand for commercial space.

At the same time, loans made near the peak of the credit boom (especially those related to construction) are deteriorating in quality rapidly, largely because of economic weakness as well as loan terms with low levels of borrower equity. The latter has become a problem as CRE property values have fallen roughly 35 percent overall from their peak in mid-2007. Finally, as noted in the August article, many CRE loans do not pay down principal (amortize) fully over the course of the loan term. As a result, loans that come up for renewal or restructuring often do not have sufficient borrower equity to be refinanced prudently. As a result, borrowers and/or banks must put up additional capital to ward off default.

As the charts below indicate, banks at the national level are seeing their overall CRE portfolio decline due to a contraction in construction and land-development loans. These loans are typically short in nature and are likely defaulting or not being refinanced because of poor market conditions. Construction loans for new projects would have declined for the same reason.

Commercial real estate loans that are thirty or more days past due (and still accruing interest) ticked up in the third quarter of last year. A clear majority of problem CRE loans are concentrated in commercial mortgages and construction loans, and about \$16 billion and \$22 billion, respectively, fall into this thirty-days-and-accruing category. Past-due

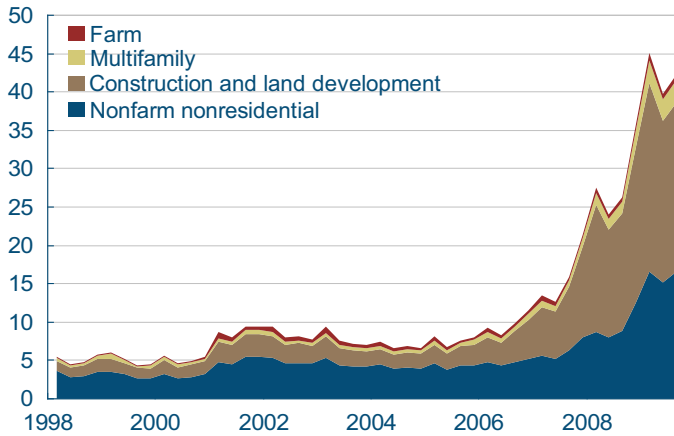
Banks' Outstanding CRE by Loan Type



Source: Bank Call Reports.

Banks' Past-Due CRE Loans

30+ days delinquent and accruing, in billions of dollars



Source: Bank Call Reports.

CRE loans swelled in the last quarter of 2008, and because the volume of problem loans has continued to remain elevated, these loans must be staying delinquent in the months up to default—as opposed to being restructured or becoming current again—and/or additional loans must be entering the pool of problem loans. Either way, this figure suggests that CRE delinquencies are worsening or, at best, stabilizing.

Delinquent loan volumes still do not give us a sense of the scale of the problem for bank viability. For that, we can look at the ratio of problem loans to banks' equity capital buffer at the bank-holding-company level. The figure below shows that CRE delinquencies are nearly twice as severe as they were in the 10 years leading up to the financial crisis. To stabilize the situation, banks will have to count on a reduction in past-due loans, raise additional capital, or both.

Delinquencies can be prevented or mitigated by restructuring loans already in the portfolio, but this usually requires new capital to be put up by banks or borrowers, and thus reduces their equity available for other loans and losses. However, such an equity injection may help avoid a default, which would be more destructive for both borrower and lender. In the worst case, a bank simply refinances an irredeemable loan, which forestalls an inevitable default and locks up capital that could otherwise be used to make better loans in the near term.

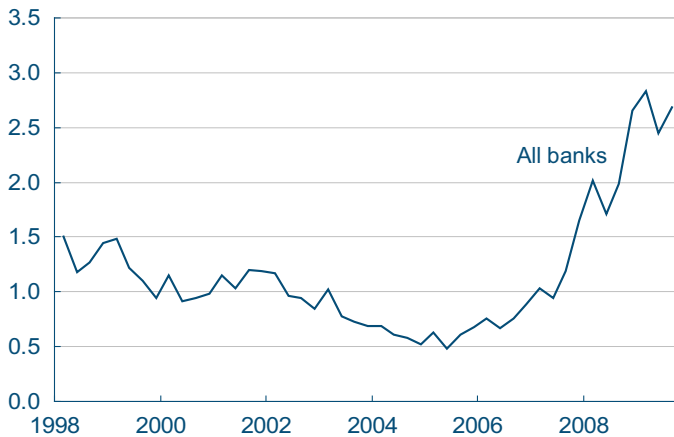
Historically, employment has been closely linked to the demand for commercial real estate. When people are out of work, employers no longer need as much space for employees and equipment.

Consequently, commercial vacancies rise, property values fall, and property owners have a more difficult time meeting their mortgage payments. Stabilization of the unemployment rate would help provide a demand floor for commercial properties and the bank loans that rely on them.

Banks across the nation continue to grapple with past-due CRE loans at levels far higher than at any time in the past decade, both in terms of volume and relative to equity capital. As a result, the total amount of bank CRE credit in the economy has

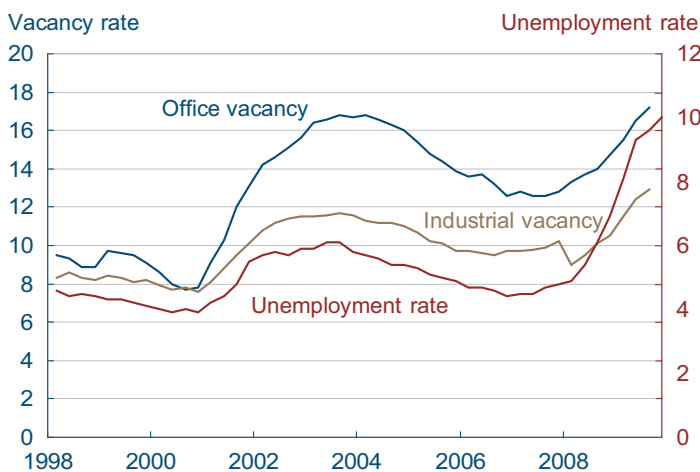
Past-Due CRE Loans to BHC Capital

Percentage of equity capital



Source: Bank Call Reports.

Property Vacancies and Unemployment



Sources: Bureau of Labor Statistics, CB Richard Ellis.

shrunk by about \$45 billion from its peak. A majority of problem loans are related to commercial properties in use or still under construction. Because these types of loans usually do not amortize fully, a number of them may require additional equity from borrowers (putting up bigger down-payments for a roll-over), lenders (via principal reductions or defaults), or new investors with their own capital. Finally, this deleveraging process must be accompanied by stabilization, and eventually growth, of the labor force in order for property demand to return and banks' CRE portfolios to be sound again.

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