Economic Trends

May 2010 (April 9, 2010 to May 13, 2010)

In This Issue:

FEDERAL RESERVE BANK
of CLEVELAND

Prices are Falling, Prices are Falling!

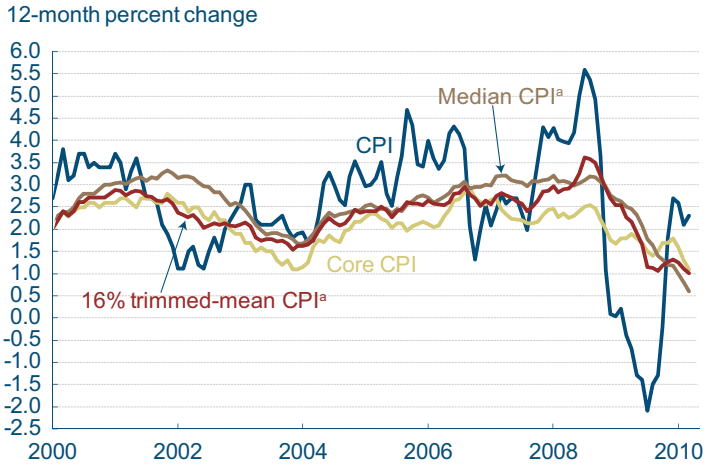
04.29.10
by Brent Meyer

March Price Statistics

	Percent change, last					
	1mo.[a]	3mo.[a]	6mo.[a]	12mo.	5yr.[a]	2009 average
Consumer Price Index						
All items	0.8	0.9	1.7	2.3	2.4	2.8
Less food and energy	0.5	−0.2	0.6	1.1	2.0	1.8
Median[b]	−0.2	0.0	0.4	0.6	2.4	1.2
16% trimmed mean[b]	0.3	0.6	0.9	1.0	2.3	1.3

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



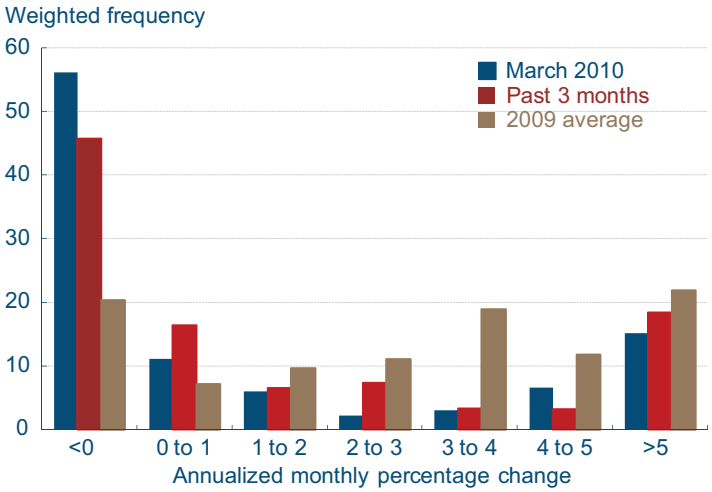
a. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics, Federal Reserve Bank of Cleveland.

Given the recent low readings on inflation, it wouldn't be too surprising to hear warnings of an impending deflation. But is there cause for alarm? A quick examination of the incoming data may help to discern whether it's time to panic.

The Consumer Price Index (CPI) ticked up a slight 0.8 percent (annualized rate) in March, largely driven by a spike in fresh fruits and vegetables prices (up 72 percent at an annualized rate). Measures of underlying inflation been relatively subdued lately. The core CPI (excludes food and energy prices) was virtually unchanged during the month. In fact, the core CPI hasn't moved much recently; the index is actually down 0.2 percent over the past three months and up only 0.6 percent over the past six months. The measures of underlying inflation produced by the Federal Reserve Bank of Cleveland, the median CPI and 16 percent trimmed-mean CPI, have behaved similarly. The median CPI was virtually unchanged in March, slipping down 0.2 percent after a 0.3 percent decline in February, and has been flat over the past three months. The 16 percent trimmed-mean CPI increased 0.3 percent in March, somewhat lower than its 6-month growth rate of 0.9 percent.

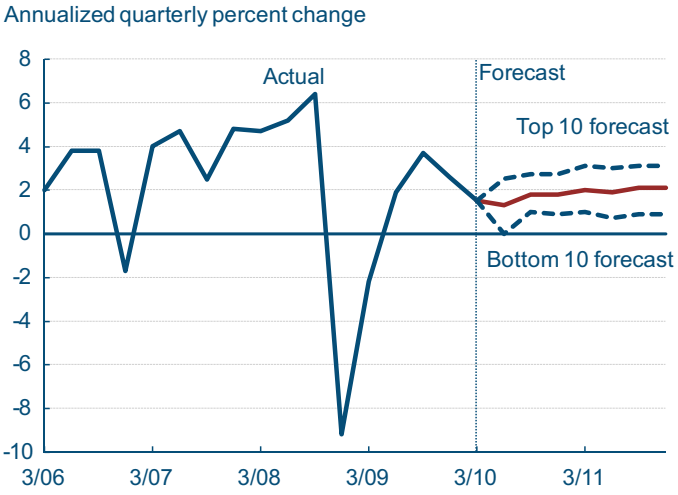
Over a longer time horizon (the past 12 months), the headline CPI is up 2.3 percent, though this largely reflects the path of energy prices. On the other hand, measures of underlying inflation have been slowing. The core CPI is up just 1.1 percent over the period, and the 16 percent trimmed-mean measure has edged up 1.0 percent. Perhaps more striking is that the 12-month growth rate in the median CPI has fallen from a recent high of 3.2 percent in September of 2008 to an all-time low of 0.6 percent (the series goes back to 1968). The longer-term trends in these inflation measures are consistent with a marked disinflation (or a slowing in the rate of price increases) but not a deflationary episode yet.

CPI Component Price Change Distribution



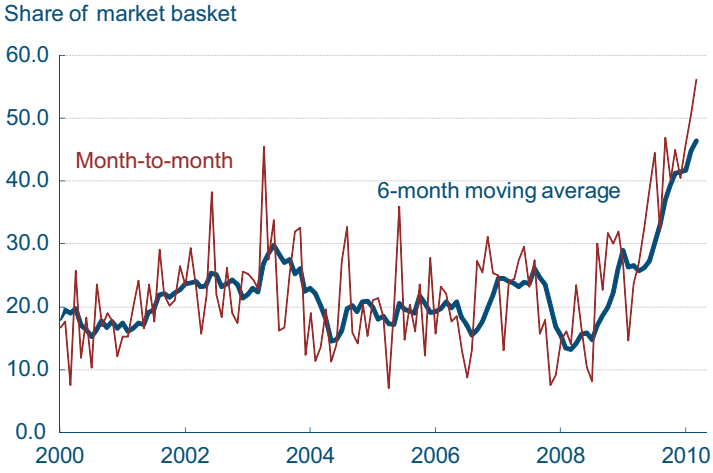
Source: Bureau of Labor Statistics.

CPI and Forecasts



Sources: Blue Chip's *Economic Indicators*, April 2010; Bureau of Labor Statistics.

Share of CPI Components Decreasing



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

Perhaps there is something in the component price-change distribution that would give cause for concern. The distribution does reveal a downward shift in retail prices. In March, a majority (56 percent) of the consumer market basket (by expenditure weight) exhibited outright price decreases, compared to 46 percent over the prior three months, and an average of just 20 percent in 2007. Outside of this most recent episode, the last time the share in that lower tail even broached 40 percent was in 2003, and that was only for one month (hitting 45 percent in April 2003). Taking a 6-month moving average (for a smoother trend), reveals that the share of the overall index exhibiting falling prices has risen steadily from a trough near 15 percent in July 2008 to 46 percent in March. However, some prices in the market basket are increasing, and those increases are more than offsetting the price declines in the aggregate (hence, the CPI rose 0.8 percent in March). Roughly 25 percent of the overall index increased at rates greater than 3.0 percent in March, though this is about half as much as a typical month in 2007.

While the latest readings on underlying inflation are near zero, a significant deflationary episode would likely require rampant and sustained price decreases. Looking forward, it seems that professional forecasters haven't put much weight on that scenario. The Blue Chip Panel of Forecasters sees inflation rates stabilizing near 2.0 percent by the end of 2011. Even the most pessimistic bunch (the bottom-ten average) does not see deflation on the horizon. They expect retail prices to hover a little under 1.0 percent over the forecast horizon.

In summary, a brief look at retail prices shows that the underlying inflation rate has slowed significantly over the past year or so, but a significant deflation has yet to materialize. Moreover, inflation expectations (from forecasters at least) seem relatively stable, which is important. If people expect future prices to be lower than today's prices, that would likely influence their behavior today, and deflation would become a self-fulfilling process. So far, it doesn't seem like that has happened.

The Yield Curve, April 2010

04.23.10
by Joseph G. Haubrich and Kent Cherny

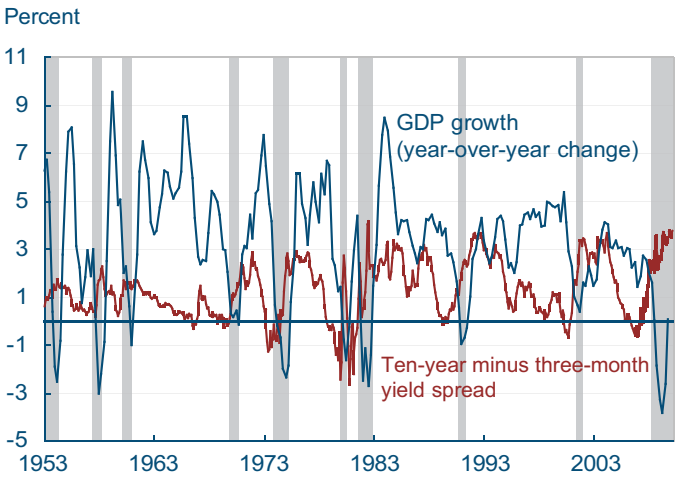
In the past two months, the yield curve has moved up and gotten steeper, with long rates rising a bit more than short rates. The difference between these rates, the slope of the yield curve, has achieved some notoriety as a simple forecaster of economic growth. The rule of thumb is that an inverted yield 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.

The 3-month rate rose to 0.16 percent (for the week ending April 16), up from February's 0.10 percent. The 10-year rate increased to 3.85 percent, up from February's 3.74 percent. The slope, already quite high, nudged up a bit to 369 basis points, up from February's 364 basis points. Projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a 1.17 percent rate over the next year, essentially unchanged from February. Although the time horizons do not match exactly, this comes in on the more pessimistic side of other forecasts, although, like them, it does show moderate growth for the year.

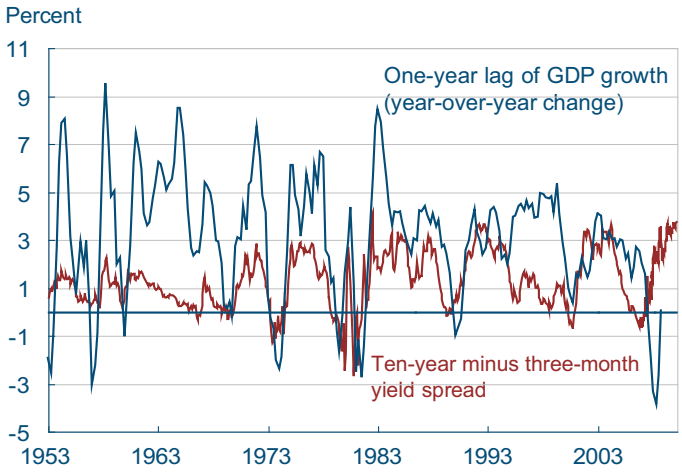
While such an approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in the case of recessions. Thus, it is sometimes preferable to

Yield Curve Spread and Real GDP Growth



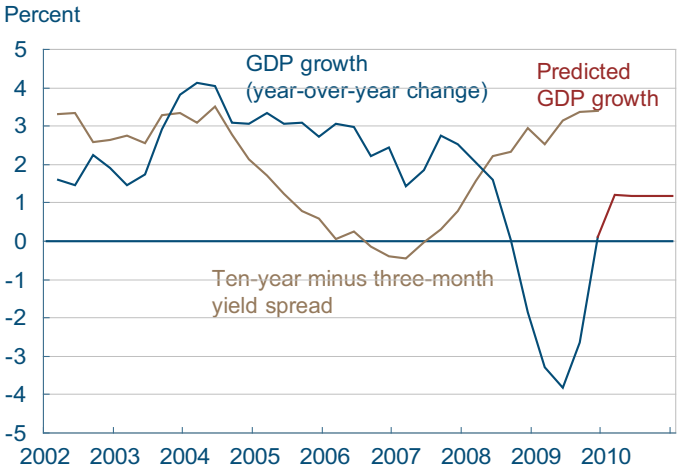
Note: Shaded bars indicate recessions.
Source: Bureau of Economic Analysis, Federal Reserve Board.

Yield Spread and Lagged Real GDP Growth



Sources: Bureau of Economic Analysis, Federal Reserve Board.

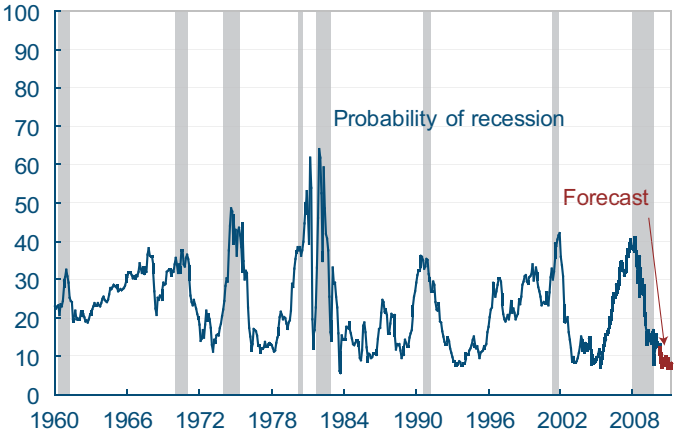
Yield Curve Predicted GDP Growth



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.

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 April is 7.1 percent, just up from February's estimate of 6.3 percent.

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?"

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

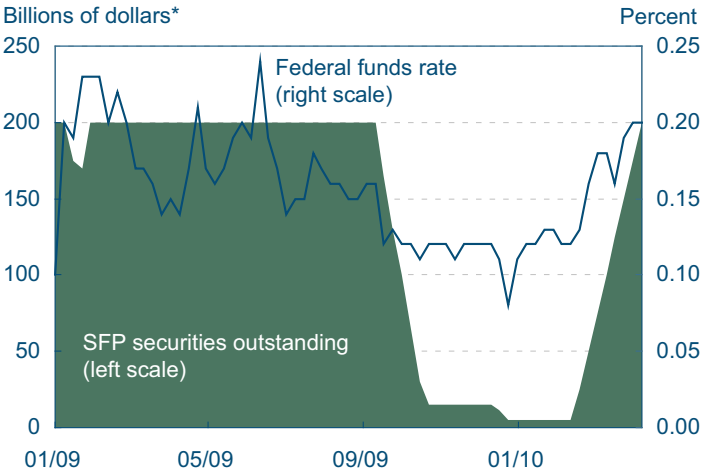
For Paul Krugman's column:
http://krugman.blogs.nytimes.com/2008/12/27/the-yield-curve-wonkish/

"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

Recent Firming in the Federal Funds Market

04.30.2010
by John Carlson and John Lindner

Debt Outstanding and the Federal Funds Rate



*Seasonally adjusted.
Source: Federal Reserve Board.

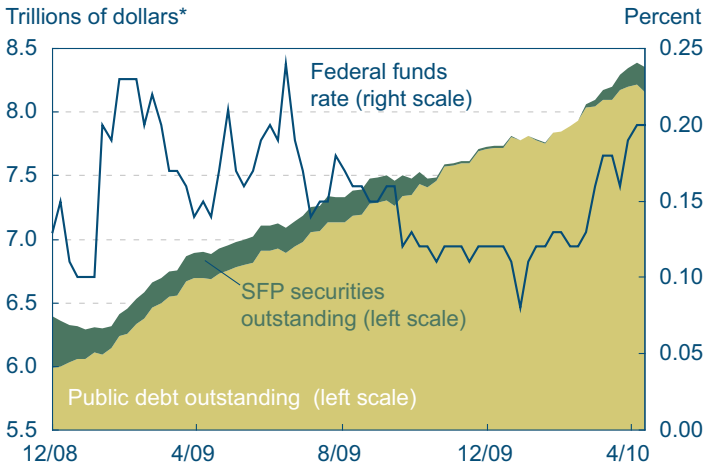
Starting at the end of February 2010, the effective federal funds rate has seen a persistent firming in daily average rates, where firming refers to a higher rate, closer to the floor established by the interest rate on reserves. This rise in the funds rate began following the announcement by the Treasury to revive its Supplemental Financing Program (SFP) on February 23. Specifically, the Treasury announced that it would issue $200 billion in SFP debt and deposit the funds in its account at the Fed. This action removes reserves from the banking system and could put upward pressure on the federal funds rate. The SFP-related reserve draining is illustrative of the kind of effect the Federal Reserve expects from the implementation of its own newly designed reserve-draining tools.

While it is tempting to attribute the firming in observed rates to the revival of the SFP, it may not be possible to separate the effects of the SFP from other events that have occurred recently. For example, the discount rate increased from 50 basis points to 75 basis points on February 18, after which markets may have altered their assumptions about the future path of the federal funds rate and started to trade funds at a higher rate.

Another factor adding to upward pressure on the federal funds rate was an increase in new Treasury debt issues around the April tax deadline. Because the new issues become collateral for borrowers of funds, they can generate so-called collateral effects. As firms vie for the funds in secured money markets (repo markets, for example), an abundance of longer-term collateral can be used to obtain overnight funds. The issuance of a larger amount of attractive collateral by the Treasury thus often pushes up rates in secured money markets, as Treasury security holders bid the rates up. These rates put pressure on unsecured (federal funds) markets, which are close substitutes for repos.

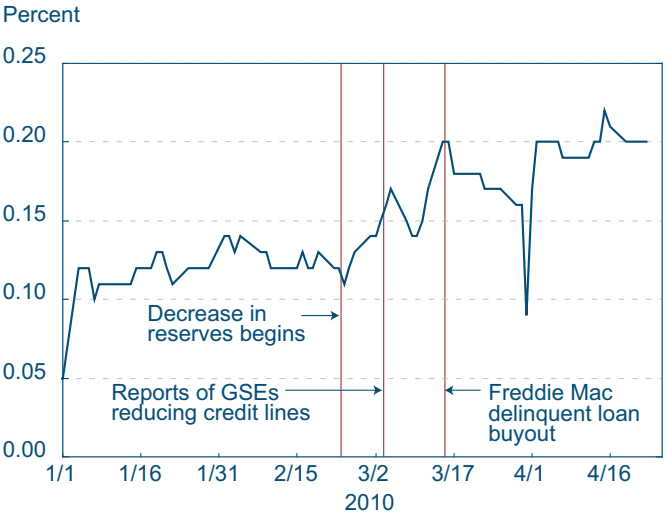
Since the first settlement of the revived SFP auc-

Debt Outstanding and the Federal Funds Rate



*Seasonally adjusted.
Sources: Federal Reserve Board; Treasury Department.

Supply Effects on the Effective Federal Funds Rate



Source: Federal Reserve Board.

tions on February 25, the funds rate has increased steadily and persisted above levels that had not been reached since before September 2009, when the Treasury decided to reduce its SFP balance. Firm conclusions are hard to draw from this observation, though, because reserve balances have declined as well and the flow effects of subsequent auction settlements have been inconsistent in their influence on the funds rate.

Beginning on February 24, the balance of excess reserves in the system has been in constant decline, and thus funds available in the federal funds market have been scarcer. However, not all declines in reserves have corresponded to a rise in the federal funds rate, suggesting that the flows of funds are being counteracted by other market forces. On March 4, government-sponsored enterprises (GSE) began tightening their credit lines, effectively offering less cash in the funds market, which should have had a persistent firming effect on the funds rate. This firming, however, is dependent on the demand for funds, which may be distorted by calendar effects (like ends of quarters and tax day) and collateral availability. These types of distortions were evident on March 16, when Freddie Mac completed a delinquent loan buyout and removed some of its lendable federal funds. In an action that should have firmed the market, rates dropped 2 basis points, part of a continual tumble toward the end of the first quarter.

The one sharp deviation in the upward rise in the federal funds rate occurred at the end of the first quarter, when the effective funds rate dropped to 0.09 percent. Such quarter-end deviations often occur as firms try to clean up their balance sheets.

What should be learned from these observations is not that reserve draining may be futile and unpredictable, but that the market for federal funds is complex. Movements and trends in the prevailing rate often cannot be attributed to a single event, and constant monitoring of the supply and demand for federal funds will be essential in maximizing the potential of the reserve draining tools available to the Federal Reserve.

The Recovery So Far

05.11.10
by Pedro Amaral

Contributions to Output Growth

	2009:Q3-2010:Q1	2001:Q4-2002:Q2	1983:Q1-1983:Q3	1975:Q2-1975:Q4
Output	3.66	2.33	7.49	5.09
Consumption	1.89	2.23	4.13	3.53
Investment	2.19	−0.31	4.11	1.34
Net exports	−0.38	−0.65	−1.73	−0.38
Government expenditures	−0.03	1.03	0.95	0.57

Source: Bureau of Economic Analysis; authors' calculations.

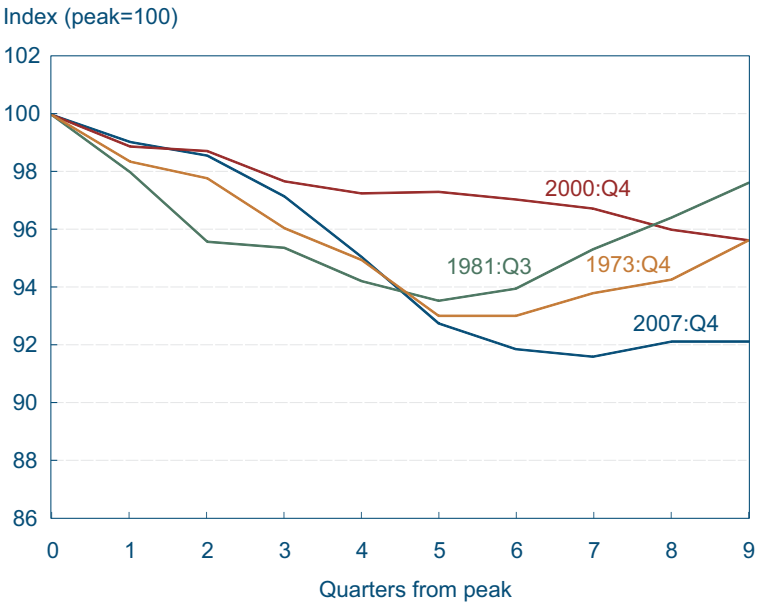
According to the Bureau of Economic Analysis's latest estimate, real GDP increased at a 3.2 percent annualized rate in the first quarter of the year. This increase was fueled by private consumption, which increased 3.6 percent, the largest quarterly growth in this category since the first quarter of 2007. Private investment also increased at a healthy clip (14.8 percent), albeit much lower than the previous quarter, when it increased 46.1 percent mainly because of inventories. This is the third consecutive quarter in which real GDP registered positive growth, an opportune time to start talking about the recovery.

Although the NBER committee that sets the official recession dates has not, as of yet, announced an ending date for the latest downturn, most economists would agree that it was sometime around the end of the second quarter of 2009. That being the case, the recovery period is now just a little over three quarters old. Let's take that point as a given and assess how this recovery compares, so far, to previous ones.

Centering our attention first on the relative strength of the recovery, we note that real GDP increased at an annualized rate of 3.6 percent over the last three quarters. Looking over all the recessions since World War II, we see that this is faster than the last two recessions, but slower than all the others. Compared to this one, though, the last two recessions were mild. In fact, this was the deepest of all postwar recessions, so another way to compare the strength of the recovery is to measure how far the economy is from its "trend."

The trend is computed by taking the peak GDP prior to the recession and extrapolating what its path would have been if growth had been the same as the average growth throughout the post-WWII period (roughly 0.8 percent per quarter). To compare deviations from the trend across recessions, we index recessions by their peaks, as in the chart be-

Recessions Relative to Trend Growth



Source: Bureau of Economic Analysis; author's calculations.

low. By this yardstick, the recovery up to this point seems feeble at most, but not the worst on record; that would be the 2001 recession.

As for the composition of output, two things have struck economists' attention regarding the current recovery. The first one is the behavior of inventories, which gave rise to the spectacular increase in private investment last quarter, and which Ken Beauchemin discussed in a Trends article last month; the second and most recent surprise was the strength of consumer expenditures in the first quarter of 2010, as described in the opening paragraph. This puzzled economists because employment numbers remain weak, at best, and disposable personal income did not grow at all in real terms during that quarter.

The table below tries to put this in perspective by looking at the three recovery quarters so far (not just at the first quarter of 2010) and comparing it to past recoveries. The first row presents the annualized output growth rates, while the subsequent rows present the contribution of each component. What is striking is just how weak consumption's contribution has been compared to other recoveries. This should help dispel the notion that consumption increases are driving the recovery, but it still leaves this recent spurt unexplained.

Inquiring a little bit deeper into personal consumption expenditures shows that the driver for the recent increase was durable goods purchases, which increased 11.3 percent. In contrast, nondurables and services increased only 3.9 percent and 2 percent, respectively. This is not surprising, as durables are households' physical investments (things like cars, TVs, and computer equipment), and as such are much more volatile than the other consumption components and thus tend to increase a lot faster than output (or overall consumption for that matter) during recoveries.

Why did durables consumption increase so much in the first quarter of 2010 when real personal disposable income was unchanged? The answer here is threefold. First, after having peaked at 5.4 percent in the second quarter of 2009, savings as a percentage of disposable income are down to 3.1 percent. Second, but not unrelated, interest rates

are as low as they have ever been. The proliferation of financing deals on big-ticket items (zero percent financing anyone?) means households have very little immediate out-of-pocket expenses. Finally, the relative price of durables has been falling for three quarters, making buying that big-screen TV look like an increasingly better deal than splurging at the movie theater.

For the Federal Reserve Bank of Cleveland's *Economic Trends* page "An Immoderate Inventory Cycle" visit http://www.clevelandfed.org/research/trends/2010/0410/01gropro.cfm

Household Finances and a Sustainable Recovery

04.21.10
by O. Emre Ergungor and Kent Cherny

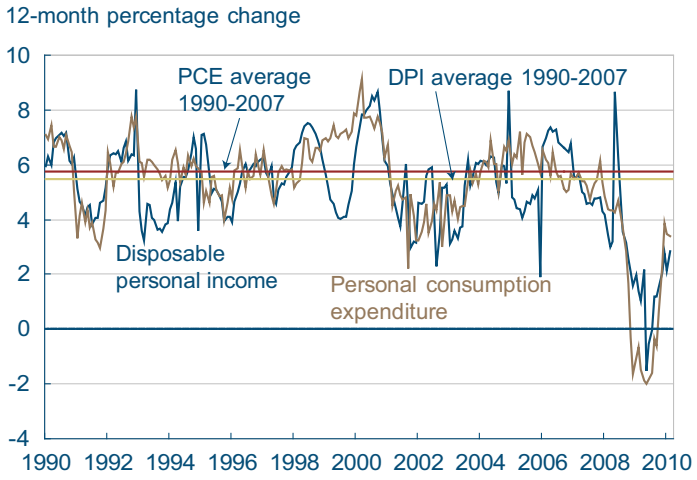
Consumption accounts for roughly 70 percent of the country's gross domestic product. Consequently, a sustainable economic recovery depends on a recovery in household consumption.

To get a handle on prospects for near-term household consumption, we consider three indicators likely to affect individuals' propensity to consume—disposable income growth, existing debt burdens, and overall household balance sheets—within the context of historical averages taken prior to the current recession (for income) and prior to the housing boom (for debt and balance sheets). In this manner, we can examine current household financial resources relative to periods when they were not inflated by a housing-dependent economy or undergoing sharp rebalancing in a deep recession.

In thinking about household finances, the obvious primary resource available for new consumption is disposable personal income. Between 1990 to 2007, annual changes in personal income fluctuated within a range of roughly 2 percent to 8 percent, with personal consumption expenditures almost always tracking closely along. However, the recession and financial crisis in 2008 pushed both negative for the first time in over 20 years. Though they have since turned positive again, both still remain 2-3 percent below their long-run growth averages.

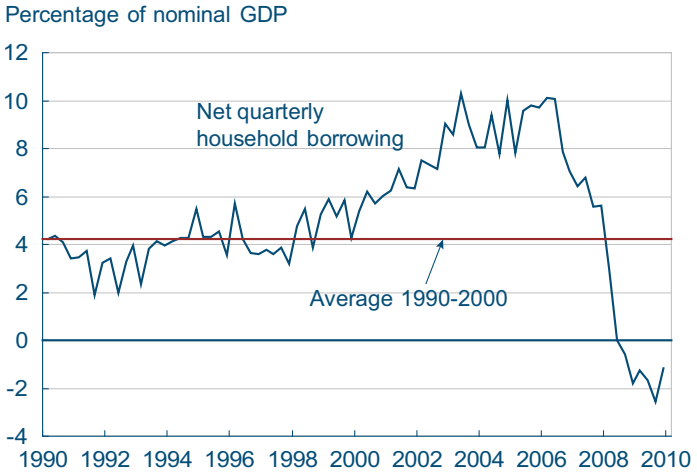
Household consumption spending can also be funded through debt. New individual borrowing as a percentage of GDP has been negative in recent quarters, though, meaning that on a net basis loans are either being paid off (and not renewed) or are defaulting, or a combination of the two. For a sense of historical perspective, consider that the average borrowing level from 1990 to 2000—before the loose loan underwriting environment of the 2000s set in—was about 4 percent of GDP. That current levels are so far below this trend indicates that a fundamental rebalancing of household debt burdens is taking place. Personal savings rates show

Personal Income and Consumption



Source: Bureau of Economic Analysis.

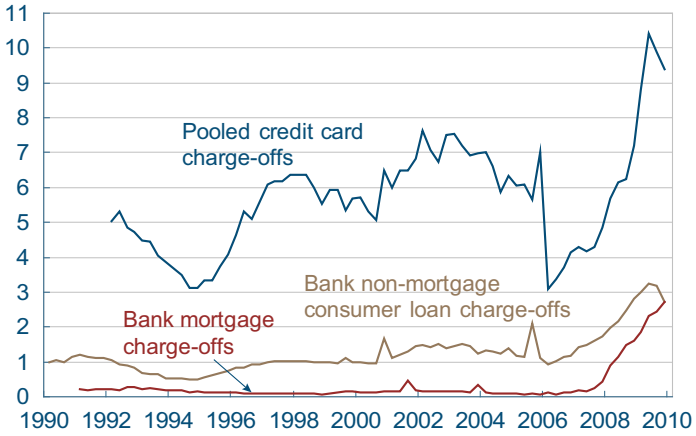
Household Borrowing



Source: Bureau of Economic Analysis, Federal Reserve Board.

Consumer Debt Charge-Offs

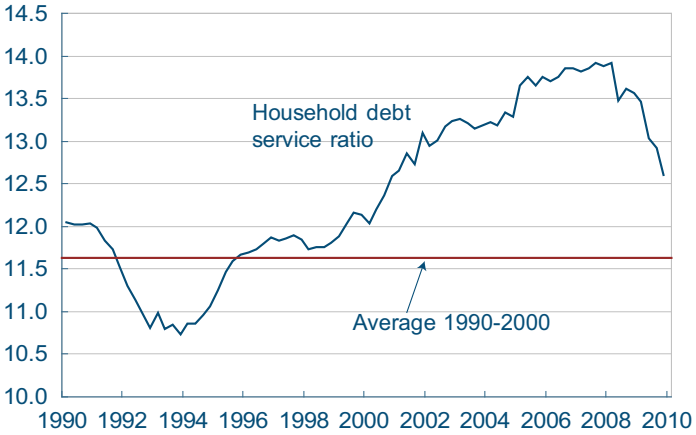
Percentage of average loan balances



Source: Federal Reserve Board, Standard & Poor's.

Household Debt Burden

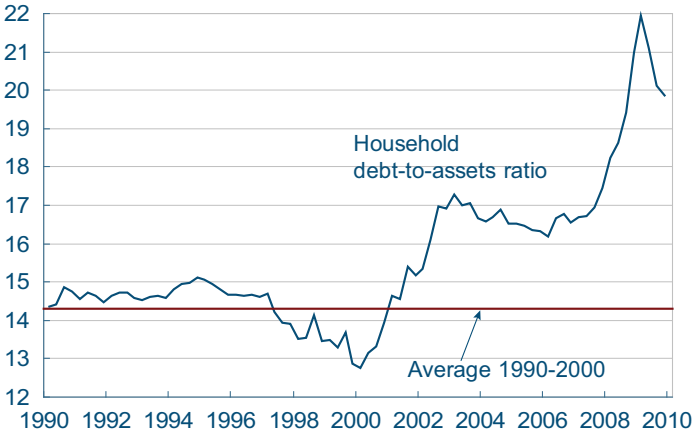
Percentage of disposable personal income



Source: Federal Reserve Board.

Household Balance Sheets

Percent



Source: Federal Reserve Board.

that households are indeed saving more, explaining part of the aggregate loan shrinkage.

Some of the contraction in household borrowing can be explained by higher-than-average defaults on mortgages, consumer loans, and credit cards. Whether consumers are paying down existing debt through savings or banks are writing bad loans off, less aggregate debt in the financial system results in either case.

The household debt service ratio, which measures repayments as a percentage of income, has been consistently falling since the third quarter of 2008. As debt levels shrink, consumers are spending less of their disposable income on repayments related to mortgages and consumer loans. A good deal of falling payments can also likely be traced to historically low interest rates, which lower debt service requirements on new debt, refinanced debt, or debt that carries floating interest rates. Still, the debt service ratio needs to fall at least 1 percent more to reach the average levels seen from 1990 to 2000.

Finally, households are unlikely to consume at high levels if their debt liabilities are high relative to their assets. Consumers borrowed money aggressively from 2000 to 2008, pushing their debt-to-assets ratio from below 13 percent in 2000 to a peak of 22 percent in 2008. Some of that leverage has disappeared as loans have been paid down or charged off, but both the sheer amount of debt accumulated in recent years and the declining value of many household assets (namely homes) will continue putting downward pressure on consumer wealth—and therefore the propensity to consume—for potentially years to come.

What does all of this bode for a recovery of consumption, the primary driver of the U.S. economy? The data shown here point to a long road ahead for a sustainable recovery. Consumers are paying down loans or defaulting, and those looking for new consumer loans are likely to find that banks are still pulling back on lending, though individuals who can secure a loan face historically low interest rates. Given the hangover of outstanding debt and recent memories of shrinking asset values, consumers may not be motivated to ramp up their expenditures. Rather, consumption will likely recover slowly as

households save more and await the return of an improved labor market and the sustainable source of funding—disposable income—that it typically provides for consumption.

For more on personal savings rates:
http://www.clevelandfed.org/research/trends/2010/0410/01ecoact.cfm

For more on credit cards:
http://www.clevelandfed.org/research/trends/2009/1009/01banfin.cfm

For more on commercial bank lending:
http://www.clevelandfed.org/research/trends/2010/0410/01banfin.cfm

The Credit Crunch in Commercial Loan Syndication

04.21.10
by Jian Cai and Kent Cherny

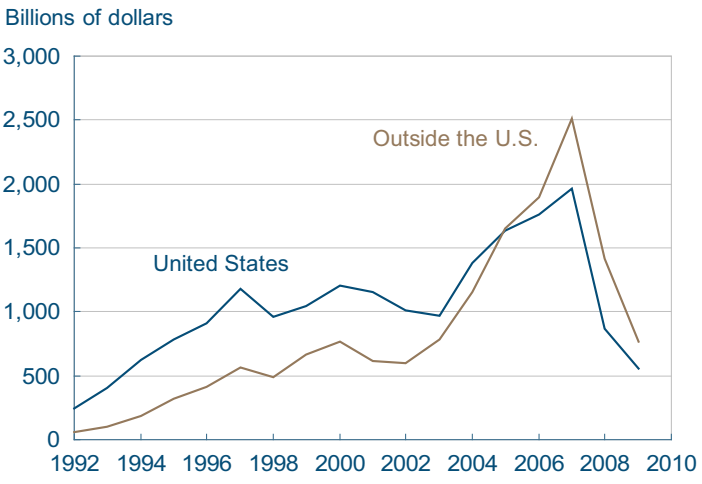
Commercial lending by banks has fallen to double-digit, negative growth rates, both on- and off-balance-sheet. The current financial crisis has also impacted the market size and composition of syndicated loans, which are a unique type of commercial loans.

A syndicated loan is a credit facility arranged for a commercial borrower, by a group ("syndicate") of banks. Member banks within the syndicate share the lending commitments, risk exposure, fees and interest revenues. Through syndication, banks are able to comply with regulatory limits on risk concentration (such as a minimum capital-asset ratio and a maximum size of a single loan relative to a bank's equity capital) and avoid excessive exposure to individual companies. Meanwhile, participating in syndicated loans gives banks opportunities to diversify their loan portfolios and maintain or develop relationships with greater numbers of corporate borrowers.

Providing many benefits to both lending institutions and borrowing firms, the syndicated loan market has experienced tremendous growth since the early 1990s and is now one of the most significant sources of corporate finance. According to loan origination data from Thomson Reuters DealScan, the amount of newly originated syndicated loans in the U.S. market increased 7 times over between 1992 and 2007, from $242 billion to nearly $2 trillion. The increase outside the U.S. was even more dramatic, growing 42 times in volume over the same period. However, syndicated loans were down sharply in 2009, with only about $1.3 trillion originated worldwide that year, from a peak of $4.5 trillion just two years prior. This 70 percent decline shows that this market was every bit as susceptible to the reassessment of risk as other credit markets following the financial crisis.

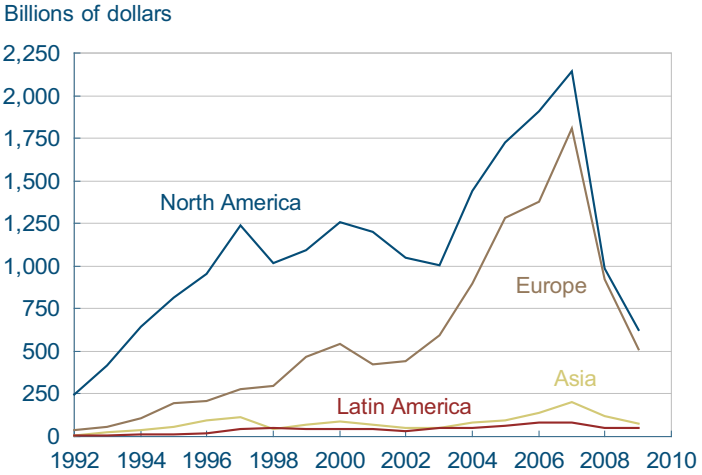
Commercial loan syndication worldwide is concentrated primarily in North America (nearly 95

Syndicated Loan Origination



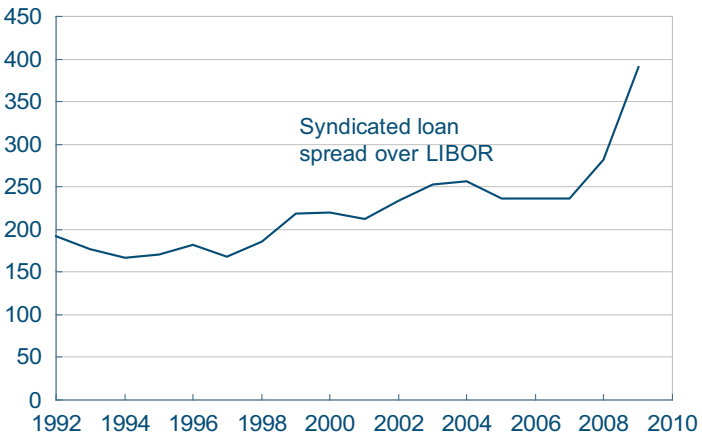
Source: Thomson Reuters DealScan.

Syndicated Loan Origination by Region



Source: Thomson Reuters DealScan.

Syndicated Loan Rates



Source: Thomson Reuters DealScan.

percent of it in the U.S.) and Europe, with both markets having recently experienced the same boom and bust. The Asian market also fell to less than 40 percent of its 2007 peak, though this market utilizes syndicated loans to a far lesser extent than either the U.S. or Europe.

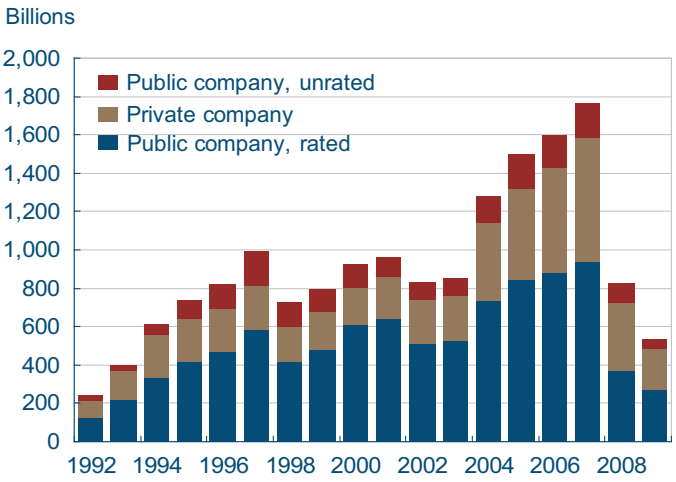
As U.S. volumes have fallen, banks have also been charging significantly higher interest rates in the syndicated market. Risk spreads—measured over LIBOR, the cost of funds for banks borrowing among themselves—were on average flat at 236-237 basis points during 2005-2007, before jumping nearly 20 percent to 282 basis points in 2008 and then almost another 40 percent in 2009, to 391 basis points. Because these are spreads over LIBOR, the increase can be attributed to a distinct reassessment of risk within the syndicated loan market itself, not simply to an increase in arranging banks' cost of funds.

The kinds of companies that receive syndicated loans have actually been fairly constant over the past five years, although absolute levels of credit extended have dropped off. Typically, about half of syndicated loans flow to public companies that are rated by the major rating agencies. These tend to be larger firms with a lot of publicly available information. A significant share (30-40 percent) also goes to privately held companies. A small share of loan syndication credit goes to unrated, public companies. Following the crisis, credit extension contracted more sharply for public, rated companies than for private companies.

Interest rates rose as syndicated loan originations fell. Historically, the spreads on these loans have been correlated to the amount of monitoring a lender would have to do to limit its credit exposure. Private companies generally are subject to the fewest requirements for providing standardized financial documentation, and so are generally charged the highest interest rate. Publicly owned companies must meet a minimum of documentation requirements, and therefore are easier to analyze and monitor (which means a lower interest rate).

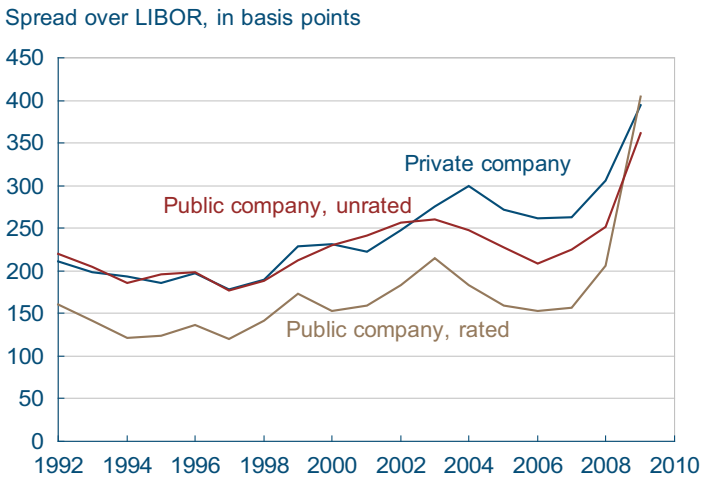
Interestingly, those companies that produce voluminous amounts of required financial statements

Syndicated Loans by Borrower Type



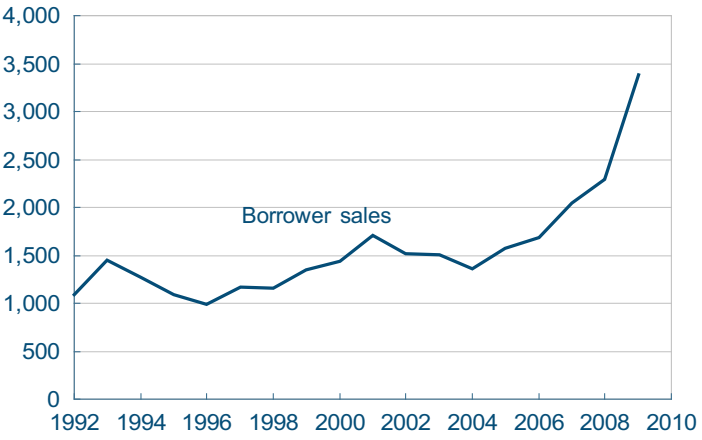
Source: Thomson Reuters DealScan.

Syndicated Loan Rates by Borrower Type



Source: Thomson Reuters DealScan.

Syndicated Loan Borrower Size



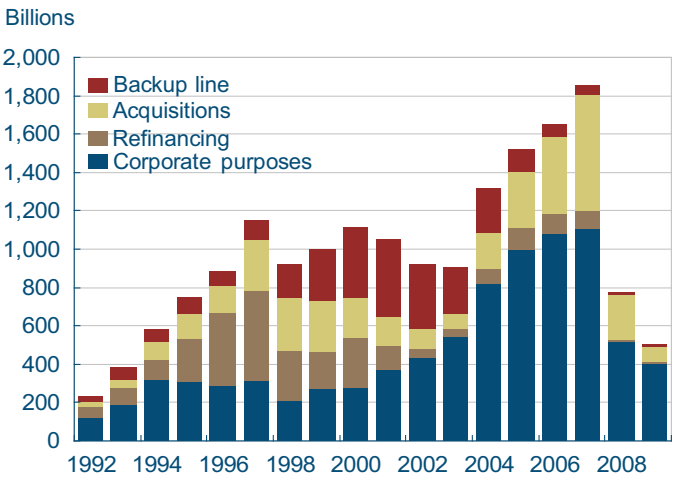
Source: Thomson Reuters DealScan.

and carry an outside credit risk grade—public, rated companies—saw the biggest spike in their interest rates following the crisis, even exceeding private and public, unrated companies in 2009. Although all companies saw their perceived riskiness reassessed upward in 2008 and 2009, the marked leap in interest rates for public, rated companies may have been due to concern about the ratings themselves, which came under closer scrutiny following the torrent of mortgage security downgrades. If official ratings were called into question, their contribution to lowering interest rates would have to have been partially or completely withdrawn.

In addition to restricting credit through higher interest rates and lower volumes, syndicates are also offering credit primarily to larger borrowers than in the past. Since loan volumes are falling and the value of real annual sales by syndicated loan borrowers is rising quickly, the average company size per loan must be rising. Larger, more established companies may give lenders more confidence about repayments, and their business models and financial conditions are likely to be better known and understood than those of smaller firms.

Finally, we ask where the funds from syndicated loans are being put to use in the economy. Over at least the past five years, the majority of loan proceeds have been used for "corporate" purposes, which means for working capital and general business operations. In the late 1990s and early 2000s, a lot of these loans were used for refinancing arrangements, such as restructuring a firm's balance sheet (for example, by adding a new source of debt or buying back shares) and rolling over or paying down other debt. This practice has declined in past years with the continued development of the corporate bond market—including the high-yield ("junk") market—which serves as a financing alternative to commercial loan syndication. Historically, syndicated loans were also used as a form of credit enhancement, standing behind commercial paper and other loans as a source of payment if the borrower defaulted. Loans for that purpose have all but disappeared in the last two years. Acquisition loans—used to finance the takeover or merger of another firm by the borrower—experienced booms first during the late-90s Internet bubble

Syndicated Loan Purposes



Source: Thomson Reuters DealScan.

and again from 2004 to 2008 at the height of the credit bubble. They have since been reined in, and today most syndicated loans (over 70 percent) are going to companies planning to use the money for general business purposes.

In summary, banks use syndicated loans to limit their credit exposure to a single firm or market while still meeting their clients' borrowing needs. This loan category—like every other credit market—swelled in the mid-2000s, but the credit crunch and its attendant risk environment led to a contraction in this type of credit. The contraction has come in the form of lower volumes, higher interest rates, and an emphasis on lending only to large firms. Meanwhile, borrowers in the syndicated loan market have moved away from more aggressive or speculative ventures like mergers and acquisitions, and are now using loan funds primarily to operate and develop existing businesses.

For more on commercial bank lending: http://www.clevelandfed.org/research/trends/2010/0410/01banfin.cfm

Global Imbalances

04.23.10

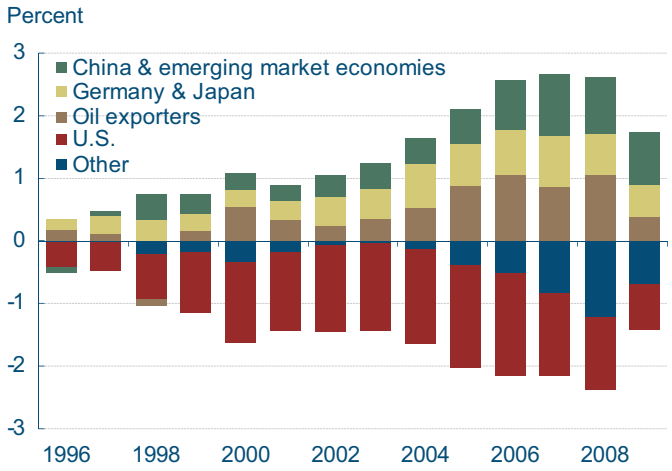
by Owen F. Humpage and Caroline Herrell

We have never quite understood the pejorative connotation associated with "global imbalances." Every day people around the world choose how much of their income to spend or save and what types of goods—domestic or foreign—to buy. Some also select the kinds of things, and how much of them, to produce. People make these choices solely with the intent of improving their own lives, and by and large they seem pretty successful at it. Current-account deficits or surpluses merely aggregate these individual choices. How can this be a bad thing?

Some believe that current-account deficits and surpluses have simply grown too large, but what exactly do they mean? Since the early 1980s, nations have generally loosened restrictions on cross-border financial flows, allowing savers to seek out higher, safer returns abroad. While this benefits both savers and investors, it naturally produces bigger, more persistent current-account surpluses and deficits. An increase in real business fixed investment, financed in part with foreign funds, has accompanied the persistent U.S. current-account deficits since the early 1980s with few, if any, adverse consequences. Size alone cannot matter.

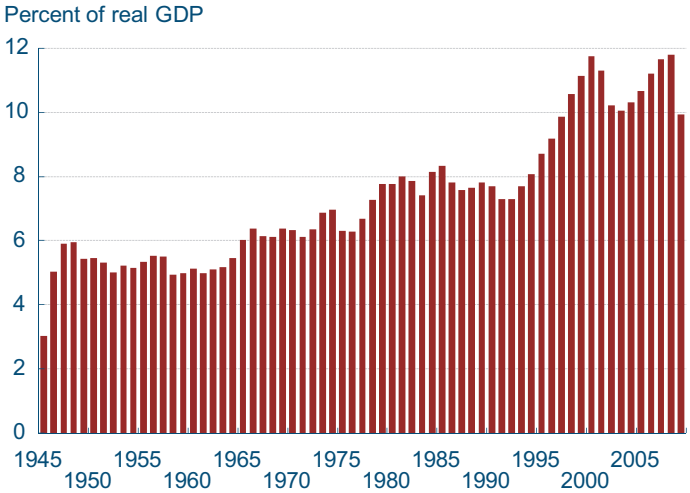
Others worry about the sustainability of large current-account deficits. To be sure, a current-account deficit cannot rise indefinitely relative to a nation's GDP, a proxy for its ability to service and eventually to pay down the associated debts. At some point, international investors will balk at holding these debts, possibly resulting in a sharp depreciation and a wrenching increase in interest rates. Emerging-market and developing countries, which must finance their current-account deficits by issuing claims denominated in foreign currencies, do sometimes encounter adjustment problems, but developed countries, which finance their deficits in their own currencies, so far have weathered current-account reversals without serious consequences.

Global Imbalances: Current Account Balance in Percent of World GDP



Source: International Monetary Fund.

Real Business Fixed Investment



Source: Bureau of Economic Analysis.

Maybe current-account imbalances are only a problem when governments meddle with the aforementioned individual choices. China, for example, interferes with the adjustment of its real exchange rate by limiting private financial flows and by sterilizing the impact of its reserve accumulation on its monetary base. This helps prop up their current-account surplus relative to the United States. When markets cannot function freely, the outcomes can be unwelcome. In that case, cursing current-account surpluses and deficits seems a little like blaming the sneeze instead of the cold.

For more on sustainability:
http://www.clevelandfed.org/research/trends/2007/0107/01intmar.cfm

For more on China's exchange-rate policies:
http://www.clevelandfed.org/research/trends/2009/1209/01intmar.cfm

Homeowner and Rental Vacancy Trends in the Fourth District

04.14.10
by Stephan Whitaker and Rob Pitingolo

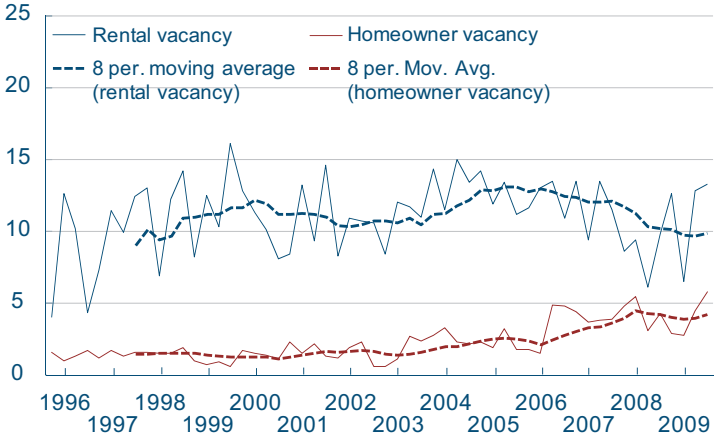
The recent housing boom drew high levels of investment into construction and created excess supply. When demand faltered, prices and sales volumes dropped, leading to increased housing vacancy nationwide. This is a concern to bankers because a vacant home is often associated with a loan in delinquency. Rising vacancy rates cause falling values for any asset associated with residential real estate.

Financial professionals, academic researchers, and the national media have focused attention on the housing "crisis," with elevated vacancy a key part of the discussion. Now that we are over two years into the crisis, it seems like a good time to return to the data on vacancy and answer some critical questions. Is vacancy still a problem? Is it rising? Are the attention to vacancy and efforts to lower it still justified? In particular, what are the trends in the Fourth District's housing markets?

The vacancy data presented here are released quarterly by the Census Bureau. They are estimates of the percentage of all rental units and all nonrental units (called homeowner units in the data) in a metro area or state that are vacant at the time of the survey. The quarterly observations are quite volatile, so we have added an eight-quarter moving average to reveal the long-term trends.

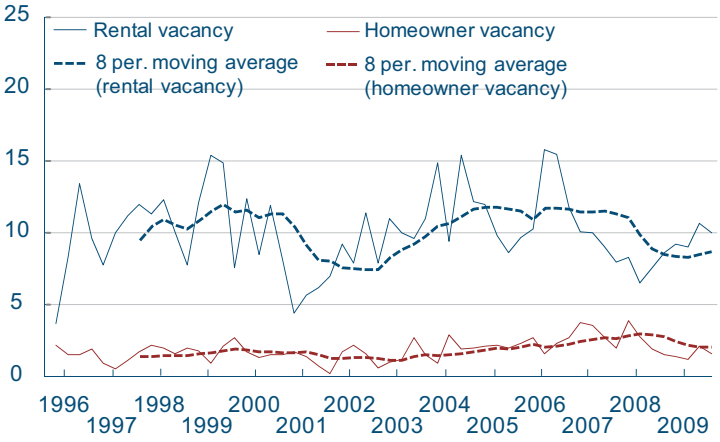
Two of the large metro areas in the Fourth District, Cincinnati and Pittsburgh, show relatively little change in their rental vacancy from the mid-1990s through last year. Their homeowner vacancy, however, has increased. In Cincinnati, homeowner vacancy was around 2 percent at the beginning of the 2000s and has risen to around 4 percent. In both MSAs, the rise seems to have ended in the last year. A two percentage point increase in vacancy may not sound like a reason for concern. However, framed differently, this is a 100 percent increase in vacancy, involving tens of thousands of housing units.

Vacancy Rates, Cincinnati-Middletown MSA



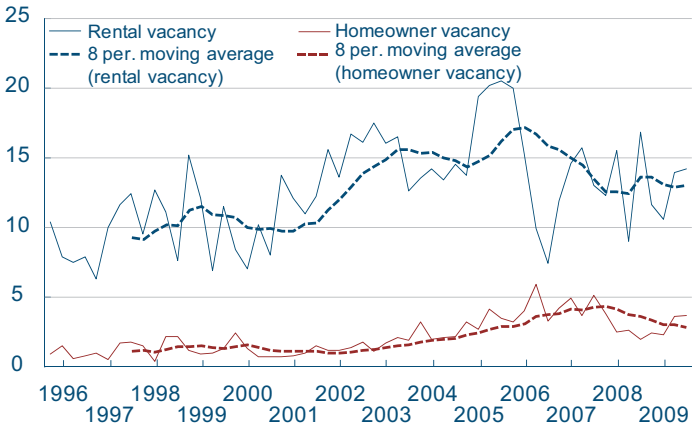
Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

Vacancy Rates, Pittsburgh MSA



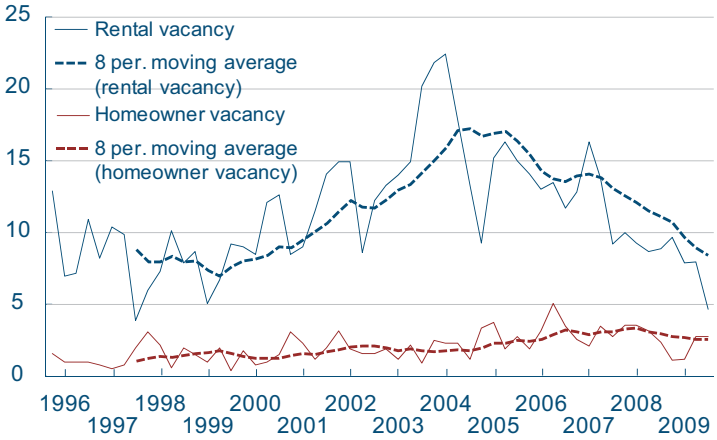
Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

Vacancy Rates, Cleveland-Elyria-Mentor MSA



Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

Vacancy Rates, Columbus MSA



Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

A change that large could depress rents and home prices.

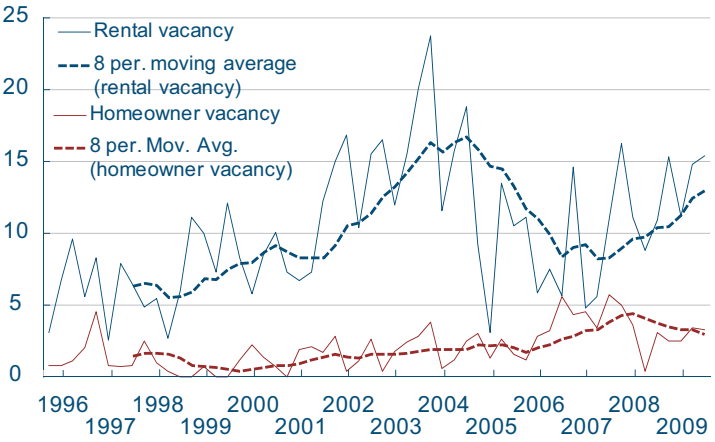
The other two large MSAs, Cleveland and Columbus, have experienced substantial movements in the measures, particularly in rental vacancy. In the Cleveland area, rental vacancy rose from around 10 percent in the late 1990s to over 15 percent in 2006. In the last three years, that figure has come back down to around 13 percent. In Columbus, the rental vacancy rate started lower, at around 7 percent in 1999, and rose above 15 percent by 2005. Since then, Columbus's rental vacancy has declined back below 10 percent and appears to be on a downward trajectory. The homeowner vacancy trends in Cleveland and Columbus follow the same pattern as those in Cincinnati and Pittsburgh. They have drifted upward by 1-2 percentage points since the year 2000 but have recently flattened or declined.

In one of the Fourth District's smaller MSAs, Akron, the pattern seen in Cleveland and Columbus is repeated with a bit of a twist. Akron's homeowner vacancy rose between 2000 and 2008 and then declined. Its rental vacancy rate also started off low in 1999, just above 5 percent, and climbed above 15 percent. Rental vacancy there turned down in 2005 and dipped below 10 percent by 2007. The twist is in the last two years of the data. The rental vacancy has turned up again, with the moving average suggesting a 4 or 5 percentage point increase.

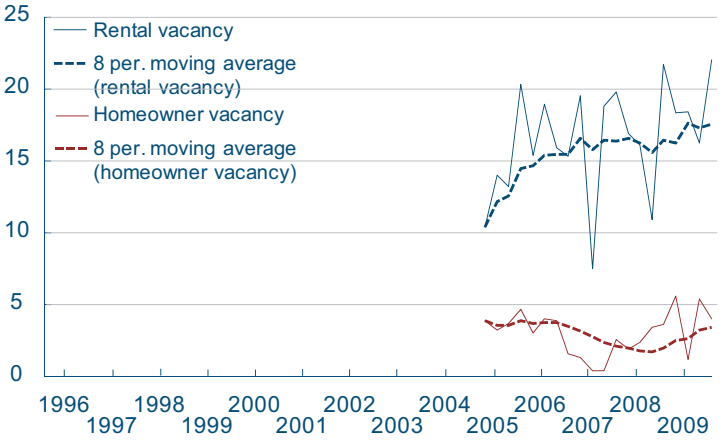
The data series for Dayton and Toledo are only available for the last five years. Since 2005, it appears that rental vacancy in Dayton rose, while homeowner vacancy fell and then rose. In Toledo, both rental and homeowner vacancy might be higher in 2009 than in 2005, but the difference is not large enough to be significant.

While aggregating across an entire state does not represent a housing market, it could be of interest for an investor who holds mortgages or properties across the state. In rental vacancies, all four states experienced rises in rental vacancy between the late 1990s and mid-2000s. The upturn ended earliest in West Virginia, perhaps in 2003. Pennsylvania had a decline in rental vacancy until 2003 and then an increase until 2005. The rental vacancies have

Akron, OH

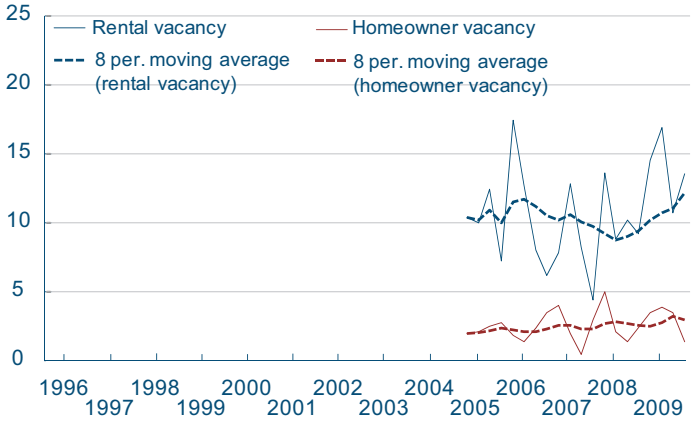


Vacancy Rates, Dayton MSA



Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

Vacancy Rates, Toledo MSA



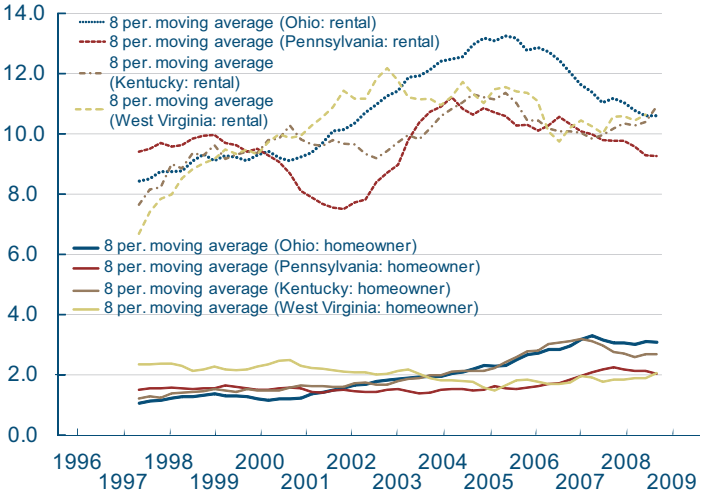
Note: Metropolitan Statistical Areas (MSAs) are defined by the U.S. Office of Management and Budget.
Source: U.S. Census Bureau.

drifted down for Pennsylvania, Kentucky, and West Virginia since 2005. Ohio's rise in rental vacancy was more or less steady for an entire decade before turning down in 2006. Since then, Ohio's rental vacancy has dropped quickly to meet Kentucky and West Virginia at 11 percent.

In the homeowner vacancy rates, West Virginia and Pennsylvania have converged at around 2 percent. Kentucky and Ohio both began lower in this series, rose between 1998 and 2008, and then turned down in the last two years.

In a troubled housing market during a weak economic period, the bad news is that homeowner vacancy in the Fourth District is higher than it was before the housing boom and bust. The good news is that homeowner vacancy is level or falling in most regions of our district. Rental vacancy, too, is down in five of the seven Fourth District MSAs in the data and two of the District's four states. Overall this suggests that our housing stock and prices are partway through an adjustment to the new economic conditions. Our continued attention will be warranted until vacancy returns to historical norms, or the market dictates that the new, higher levels of vacancy are the norm for our region.

Vacancy Rates, Fourth District

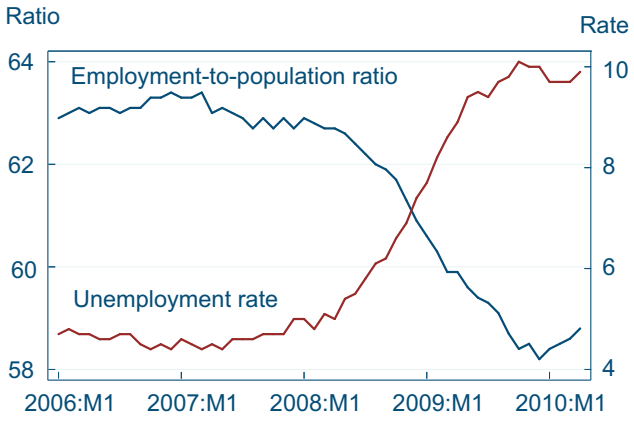


Source: U.S. Census Bureau.

Some Popular Locales Now Facing Gloomier Labor Market

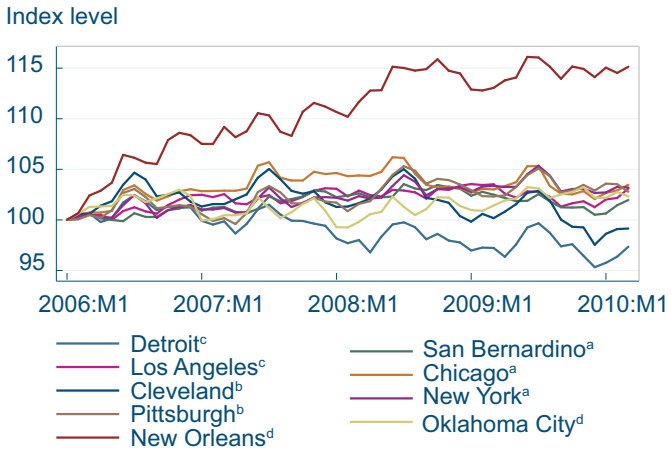
05.14.10
by Daniel Hartley

National Employment Figures



Source: Bureau of Labor Statistics.

MSA Labor Force Index



a. MSAs with the largest population as of the 2000 Census.
b. MSAs in the fourth Federal Reserve District.
c. MSAs with the highest unemployment rates in March 2010.
d. MSAs with the lowest unemployment rates in March 2010.

Source: Bureau of Labor Statistics.

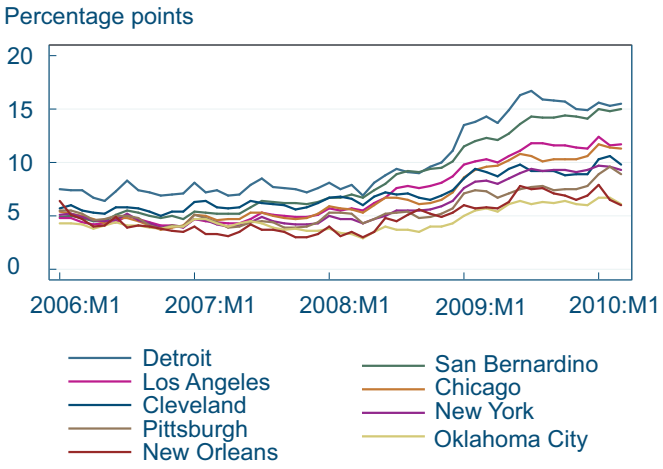
While the national employment numbers give the most up to date reading of the employment situation in the nation, they mask a lot of variation in employment conditions at the local labor market level. This variation has increased dramatically during the recent recession.

The national employment numbers released on May 7, 2010 reveal that while the unemployment rate increased from 9.7 percent in March to 9.9 percent in April, the employment to population ratio increased from 58.6 percent in March to 58.8 percent as well. While the employment to population ratio and the unemployment rate usually move in opposite directions, they can both increase if the number of people employed increases but the size of the labor force increases at a faster rate.

Simply looking at the national average of the unemployment rate masks the fact that there is a large amount of variation in unemployment rates at the Metropolitan Statistical Area (MSA) level. MSAs are the typical geographical entity that defines a local labor market. As of March (the most recently available month of data at the MSA level), the unemployment rates in MSAs with at least one million people ranged from a low of 6.1 percent in the Oklahoma City MSA to a high of 15.5 percent in the Detroit-Warren-Livonia MSA. A sample of other MSAs—those with the highest and lowest unemployment rates in March of 2010, those with the largest population as of the 2000 Census, and two in the fourth Federal Reserve District—gives an idea of the variation since January 2006.

The variation in unemployment rates across MSAs increased markedly beginning around January 2009. This increase is reflected in the entire set of 46 MSAs with a 2000 population above one million. While the mean unemployment rate of that set of MSAs changed from 4.6 percent to 10.0 percent from March 2006 to March 2010, the standard deviation also increased from 0.9 percent

MSA Unemployment Rate



Source: Bureau of Labor Statistics.

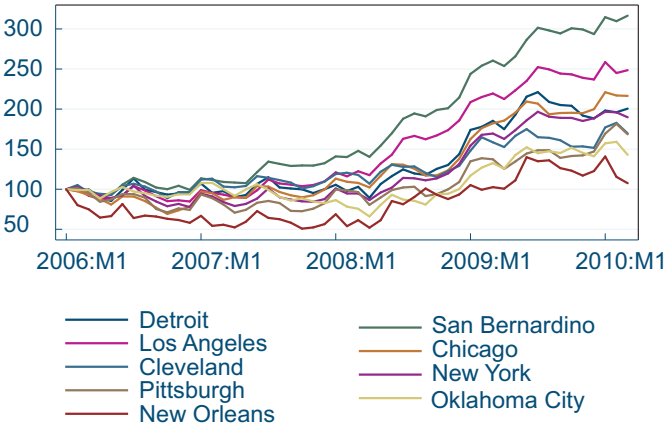
to 2.2 percent during that time period. In all MSAs with a population greater than one million, the unemployment rate increased from March 2006 to March 2010. Remarkably, the largest increase (10.2 percent in Riverside-San Bernardino-Ontario) was almost an order of magnitude larger than the smallest increase (1.3 percent in New Orleans- Metairie-Kenner). MSAs in the Fourth District (Pittsburgh, Cleveland, Columbus, and Cincinnati) saw below average increases in the unemployment rate during this period. Thus despite having higher than average unemployment rates before the most recent recession, Fourth District MSAs with populations greater than one million currently have unemployment rates that are average or slightly below average.

While this may sound like a relative improvement for the region, it is important to consider whether the improvement in Fourth District MSAs unemployment rates relative to other MSAs was achieved through a relative decrease in the number of unemployed people or a relative decrease in the size of the labor force. In fact, the size of the labor force in the Cincinnati, Columbus, and Pittsburgh MSAs grew slightly from January 2006 to March 2010. The size of the labor force in the Cleveland MSA fell, but only slightly. The main reason why the unemployment rate of Fourth District MSAs improved relative to other MSAs over this period is that the number of unemployed people grew at a slower rate in Fourth District MSAs than in many other MSAs.

Across MSAs, the relative contribution of each of these factors to the unemployment rate has varied quite a bit. On one extreme is the Riverside-San Bernardino-Ontario MSA, where the labor force grew by about 15 percent from January 2006 to March 2010. Almost all of this growth occurred between January 2006 and mid-2008. Around mid-2008 the unemployment rate began rising quickly in the MSA, implying that the number of unemployed people began rising. The other extreme case is the Detroit-Warren-Livonia MSA, where the labor force shrank by about 2.5 percent from January 2006 to March 2010. Thus some fraction of the increase in the unemployment rate in the Detroit-Warren-Livonia MSA came from the fall in the size

MSA Number Unemployed Index

Index level



Source: Bureau of Labor Statistics.

of the labor force. The Cleveland-Elyria-Mentor MSA also saw a declining labor force from January 2006 to March 2010, but only by about 1 percent. Finally, the other MSAs plotted all saw about a 2 percent to 4 percent increase in the size of their labor force over this period.

Meanwhile, the number of unemployed people tripled in the Riverside-San Bernardino-Ontario MSA from January 2006 through March 2010 and grew by about 2.5 times in the Los Angeles-Long Beach-Santa Ana MSA. In the Chicago-Naperville-Joliet, Detroit-Warren-Livonia, and New York-Northern New Jersey-Long Island MSAs , the number of unemployed roughly doubled from January 2006 to March 2010. However, in the Fourth District MSAs of Cleveland-Elyria-Mentor and Pittsburgh the number of unemployed grew by about 75 percent over this period.

One possible explanation for patterns observed above is that warmer climate MSAs that experienced large housing booms may have attracted population during the boom and are now saddled with much greater unemployment in the wake of the bust. However, MSAs in the Fourth District where house price increases were more modest, have moved from being relatively high unemployment rate MSAs to being average unemployment rate MSAs in the wake of the recession, due to slower relative growth of the number of unemployed people in these MSAs. Of course, this is only good news for Fourth District MSAs relative to other MSAs as the national unemployment rate has just about doubled from 4.7 percent to 9.9 percent during this period. Being an average MSA in March 2010 means having substantially higher unemployment than being a high unemployment MSA in January 2006.

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