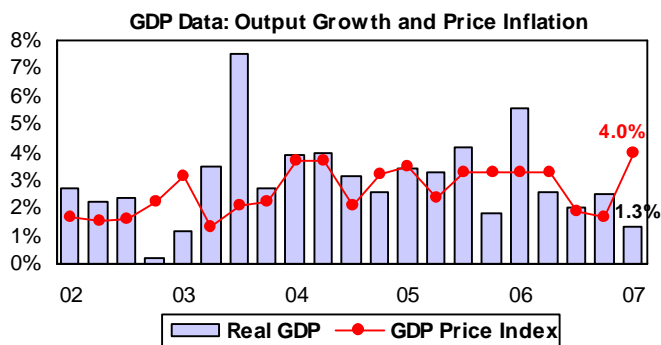




Diverging Regional Economies: Another Dilemma for the Fed

Nobody told Ben Bernanke that his job would be easy. During his early days as the Federal Reserve Board chairman, people pointed out that many things—including the ballooning current account deficit, a housing bubble, and high energy prices—could put the United States into an economic crisis.

Fortunately, those dire predictions have proved to be wrong. The latest Gross Domestic Product (GDP) data show that the U.S. economy expanded at an annualized rate of 1.3% during the first quarter of 2007. (See the chart below.) It was the smallest gain since the first quarter of 2003. Not a strong number in any sense, but consumer spending remained robust, growing at 3.8% on an annualized basis. As long as consumption, which accounts for 72% of GDP, is growing at a solid pace, the possibility of the economy sliding into a recession seems limited.



Percent change from preceding period. Seasonally adjusted at annual rates.
Source: Bureau of Economic Analysis (BEA).

Behind this strong consumer spending is a very tight labor market. The U.S. unemployment rate in March was 4.4%, among the lowest rates we have seen in more than fifteen years. Feeling secure about their jobs, consumers are still busy shopping.

The most important vote of confidence for the Fed's economic management recently came from the stock market, when the Dow Jones Industrial Average closed above the 13,000 mark for the first time. This development must have been particularly sweet for Chairman Bernanke, because just two months earlier, his predecessor sent the stock market into a tailspin by mentioning the dreaded "R" word: recession.

Risk of inflation is still on the Fed's mind.

The Fed has kept the short-term interest rate unchanged since last June, but that does not mean that the economy is

left on autopilot. Far from it, because the Fed now must perform a delicate balancing act between slowing output growth and a stubbornly high inflation rate.

In fact, the Price Index based on the GDP data rose 4.0% during the first quarter, up from 1.7% in the fourth quarter of 2006. This index is the broadest indicator of price inflation available. Much of this increase came from higher prices of energy and food items during the first quarter, but the "core" index, excluding these items, still rose 2.2% in the first quarter, up from 1.8% during the preceding quarter.

Accelerated price inflation typically calls for a cooling effect of higher interest rates, while slower output growth suggests that lower rates are in order. Which way is the Fed to go? Obviously, this is the biggest dilemma currently faced by the Federal Reserve.

Regional economies are another dilemma for the Fed.

The monetary policy, by nature, is a national policy. Rate hikes or cuts can equally and simultaneously affect the entire country. It's impossible to differentiate interest rates from region to region. However, that may be what is needed now, because of diverging regional economic trends.

The map on the following page shows growth in state personal income between 2005 and 2006. The states are divided into quintiles: the states with the fastest growth are colored in dark blue and those with the slowest growth in darker brown.

Interestingly, the country can be neatly divided into two parts by drawing a single line through it. The states that are above and to the right of the line are all growing more slowly than the national average (+6.3%), with the sole exception of Delaware (+6.7%), while growth is uniformly stronger in the West and the South.

The region suffering most at this time is the Great Lakes region—including Michigan (+3.1%, slowest in the nation), Ohio (+4.7%), and Indiana (+5.1%)—which is also known as the Industrial Midwest. Losses of automotive jobs are hindering growth there. The performance of New England states is also lackluster, partly because the region's technology sector has been slow to recover from the tech recession of 2001–04.

Another troubled region is the Gulf Coast, including Louisiana (+19.7%) and Mississippi (+6.0%), which suffered extensive hurricane damage in 2005. Because personal income of the hurricane-affected areas plummeted

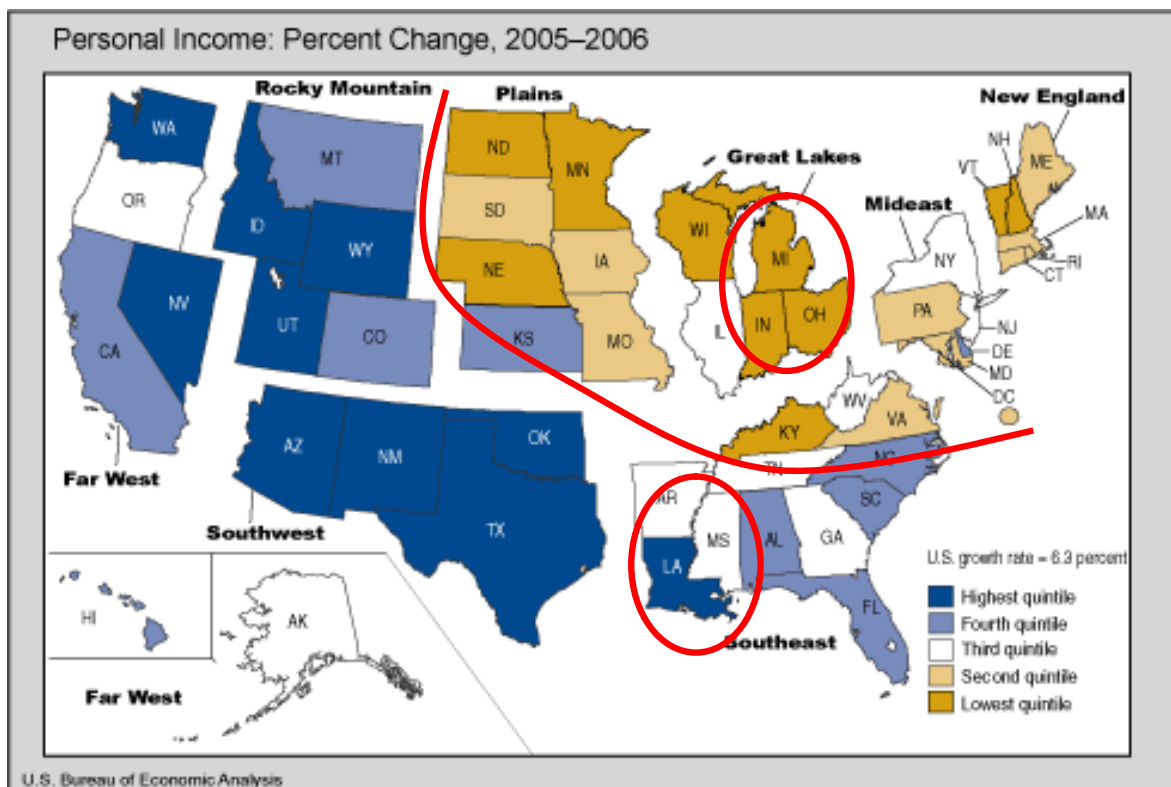
in 2005, some recovery experienced in 2006 pushed up income growth rates there. The underlying economic fundamentals of the region, however, are still weak. Not surprisingly, the Industrial Midwest and the Gulf Coast (both marked by ovals in the map) are where subprime mortgage delinquency ratios are highest in the country.

If the Fed decides to hike the policy rate to combat accelerated inflation, those troubled regional economies can hardly withstand the negative effect of such a policy. Conversely, any stimulus coming from a rate cut can

overheat the West and some of the Southern states. This is the second dilemma faced by the Fed.

How do you conduct a unified monetary policy in a country markedly divided by regional economic performance? The answer is, "Very carefully." This dilemma makes Chairman Bernanke's job even more difficult, as it can potentially land our central bank in some political hot water.

*Keitaro Matsuda, Senior Economist
Union Bank of California, NA*



Source: BEA. The line and ovals added by Union Bank of California.

Economic Forecasts – May 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	3.2	3.3	2.2	3.1
Unemployment (%)	5.1	4.6	4.6	4.8
Payroll Employment Growth (%)	1.7	1.9	1.4	0.9
CPI Change (%)	3.4	3.2	2.3	2.3
Federal Funds (%)	3.2	5.0	5.2	4.8
Housing Starts (millions)	2.07	1.82	1.51	1.60
Car/Lt. Truck Sales (millions)	16.9	16.5	16.5	16.7

Bold: Actual.

The information in this report is based on data available as of April 30, 2007, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.