

The Economy in Perspective

Dead reckoning ... The beginning of a new year always brings increased attention to the economic outlook, as though the prospect of another lap around the sun endows economists with fresh insights about more earthly navigation. This is the time of year when we dismal scientists are conscripted for forecasting speeches, panels, and polls. So—whar' does she blow?

Surveys indicate that, on average, private forecasters expect real output to increase at a 2% pace in 1997, extending an already long expansion by another year. Inflation forecasts are clustering around a 3% rate, which, if attained, would represent no acceleration from the 1991–96 trend. Unemployment is predicted to remain at or below 5.5%, and the employment/population ratio should hover around record-high levels. Although investment spending is likely to slow, as is spending on consumer durable goods, no serious imbalances except high levels of credit card debt are thought to threaten continued economic growth. The pros say that the U.S.S. *Economy* is shipshape and blessed with favorable winds.

With smooth sailing ahead, monetary policy would seem to enjoy an enviable position. Shouldn't the Federal Reserve just chart a neutral course, leaving the federal funds rate unchanged and thereby promoting steady economic conditions? The answer to this question depends on the definition of "neutral course." During the past six years, the Federal Open Market Committee (FOMC) has raised and lowered the federal funds rate and left it unchanged over prolonged periods (it has not been altered since January 1996). Likewise, the various money-stock measures have fluctuated considerably. The expansion got under way slowly, but strong winds eventually filled her sails; inflation, seeming to defy Neptune, has not surged along in her wake.

The orientation of post-1979 monetary policy bears closer scrutiny. Unquestionably, the events of the 1970s—when a progrowth, proinflation course was charted—powerfully influenced subsequent monetary policy. As we know, the ship, lured by the Sirens of faster economic growth, went aground on the rocks of rising inflation. One interpretation of monetary policy in the mid-1980s is that the FOMC set a course for credibility with one objective—to preserve the disinflation it had achieved by 1983. By showing its willingness to curtail liquidity at critical junctures, the FOMC not only earned credibility, but also enabled households and businesses to coordinate their plans and actions more easily, which prevented serious disruptions of overall economic progress. Credibility strengthened economic stability. By the end

of the 1980s, in the midst of a long expansion, the FOMC could talk convincingly about its intention to change its bearings and set sail for price stability.

What are the map coordinates of price stability, and what instrument settings will hold the economy on course? Should the primary emphasis be on stating more clearly the longitude and latitude by which price stability shall be known and by announcing the journey's intended length? Or should the FOMC heed warnings that it is now sailing into heavy swells that threaten to swamp the ship? Perhaps a meandering cruise would be more comfortable. And, as a practical matter, can the FOMC successfully control inflation by managing aggregate demand?

Accurate estimates of "potential output" or "full employment" underlie the aggregate demand management framework. To avoid the shoals, the helmsman must know what limits of real economic activity are consistent with no change in inflation. How reliable is the NAIRU compass, an instrument that purports to inform us of the nonaccelerating inflation rate of unemployment? And how reliable are the cables that set the federal funds rate sails to catch the winds of aggregate demand?

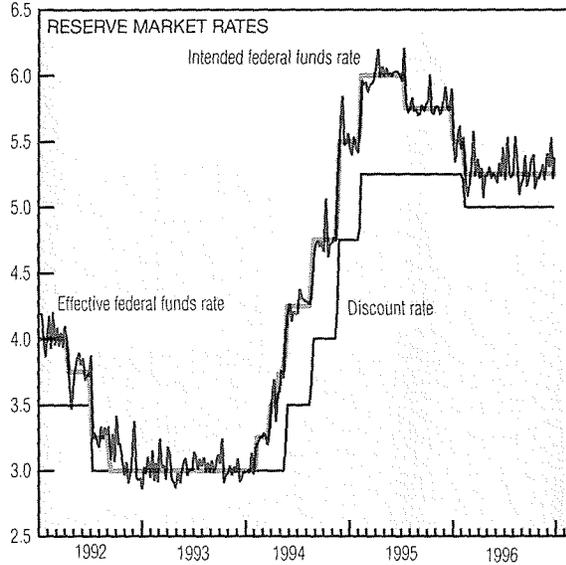
Conventional NAIRU compasses operate through labor market demographics. The old captains thought they could tell what unemployment rates would mark "full employment" for different age and sex subgroups. The NAIRU is a weighted average of the subgroup-specific "full employment" unemployment rates; the weights change over time as the subgroups' shares of the labor force change. For example, teenagers have larger unemployment rates than adults, and as they become a smaller fraction of the labor force, the NAIRU declines.

Unfortunately, the NAIRU compass needle appears confused. When the U.S.S. *Economy* left port in 1991, old salts estimated NAIRU at 6% to 6.5%. During the voyage, as the ship plowed the waves with greater speed than seemed possible without generating more inflation, NAIRU estimates have been continuously revised downward. Some hands judge it to be as low as 5%. Then again, the NAIRU compass may be broken. Relying on old relationships between unemployment rates and inflation could be like using an old map in territory where the land masses have shifted and water channels have altered through the years.

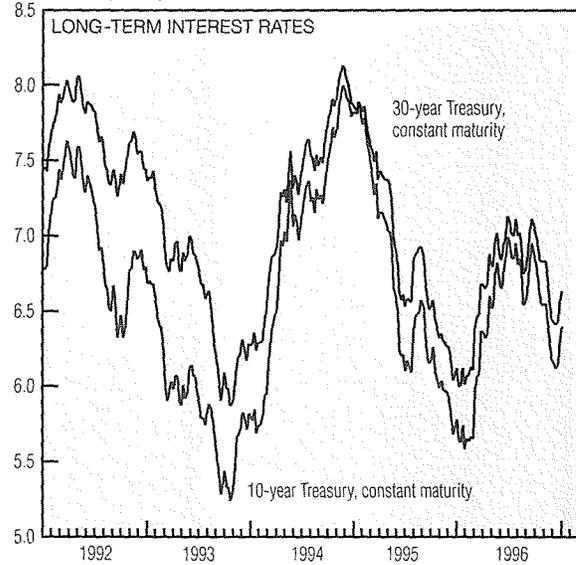
One thing that has not changed is the desire of passengers and crew to know where they are bound. Is it better to define monetary policy by its instrument settings, or by a course plotted, declared, and steadfastly pursued?

Monetary Policy

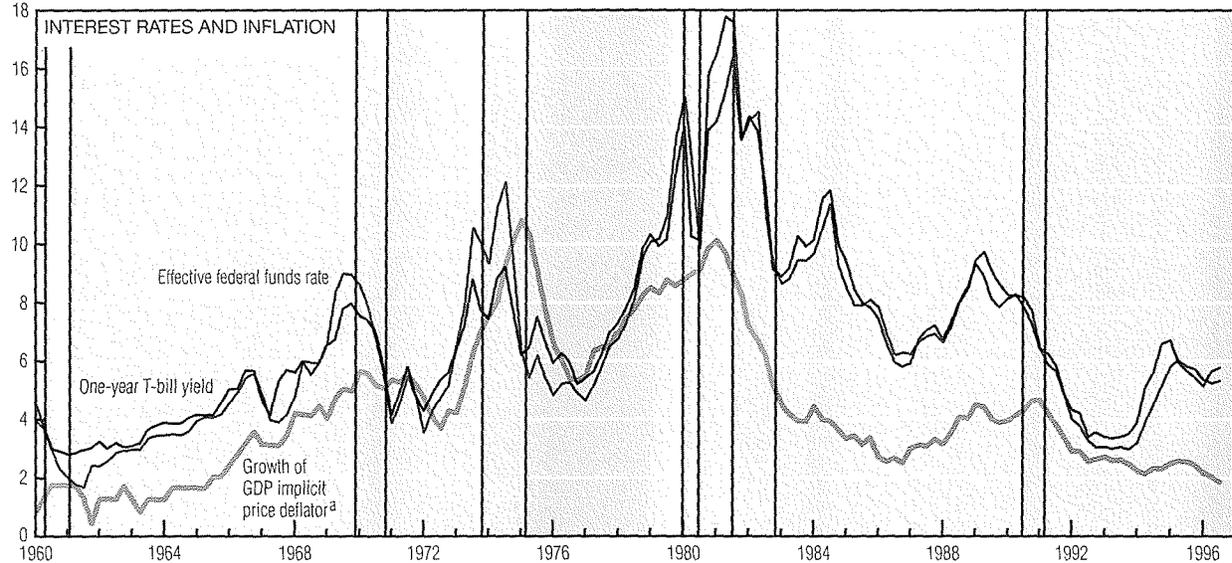
Percent, weekly averages



Percent, weekly averages



Percent



a. Four-quarter growth rate.

NOTE: Shaded areas indicate recessions.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

At its December 17 meeting, the Federal Open Market Committee again left the intended federal funds rate unchanged at 5.25%. It is now approaching one year since the Committee last altered its federal funds rate objective, a 25-basis-point reduction that occurred following its January 31, 1996 meeting.

While the federal funds rate has remained constant, long-term interest rates have varied somewhat over

the past year. The 30-year Treasury constant-maturity rate reached a 1996 high of 7.28% during the week of June 6, before falling to its current level of around 6.5%.

Although short-term interest rates have risen relative to their levels in early 1993, they remain low relative to their averages over the last two decades. In fact, one must go back to the mid-1960s to find a period of sustained low short-term rates

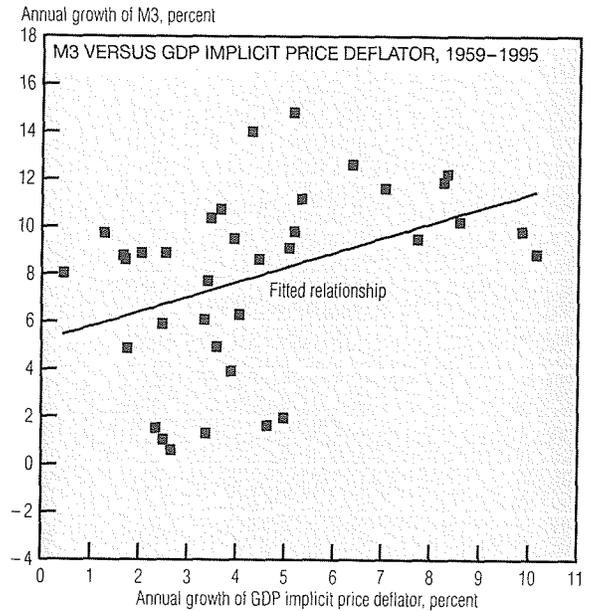
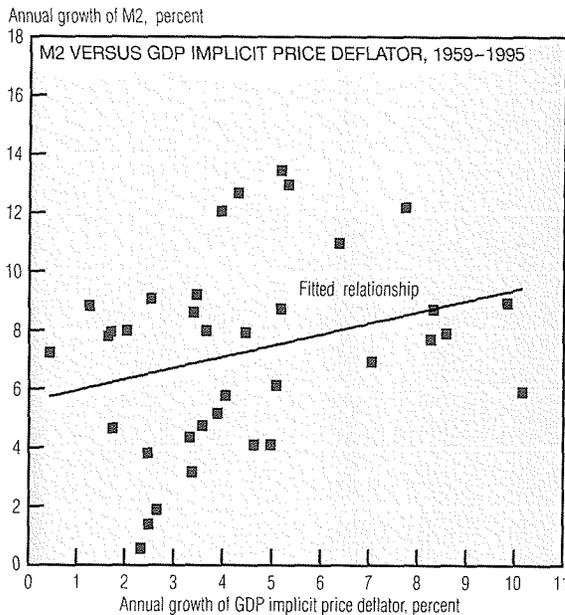
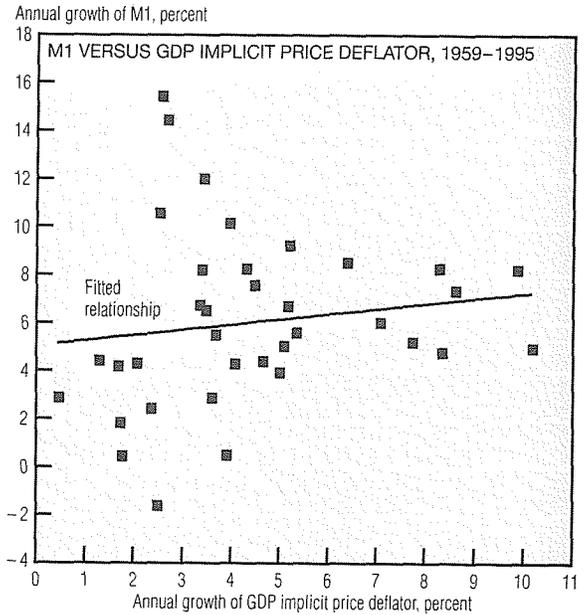
matching the average level posted over the last four years. Not coincidentally, one must also go back to the 1960s to find a sustained period of low inflation comparable to the average inflation rate over the past 10 years.

It is a widely accepted view in economics that over long periods, growth in the supply of money determines the inflation rate and has

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Monetary Policy (cont.)

	1959–1995	1959–1969	1969–1982	1982–1995
M1	6.0	3.8	6.7	6.9
M2	7.2	7.0	9.5	5.1
M3	7.9	7.5	11.2	4.9
Nominal GDP	7.7	6.9	9.6	6.4
Real GDP	3.1	4.3	2.4	3.0
GDP deflator	4.4	2.5	7.0	3.3



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

little effect on the real growth rate of the economy. However, there is some evidence linking lower inflation with higher real growth. From 1959 to 1995, M1, M2, and M3 grew between 6% and 8% per year, while real GDP increased at a 3.1% annual rate. This growth in the monetary aggregates led to a 4.4% increase in inflation as measured by the GDP implicit price deflator.

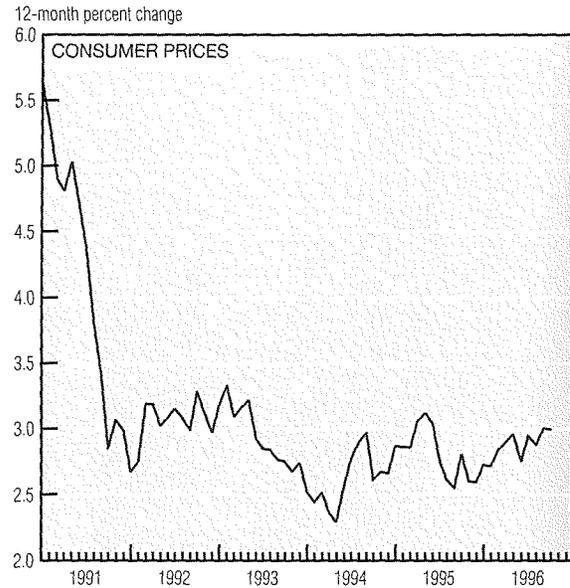
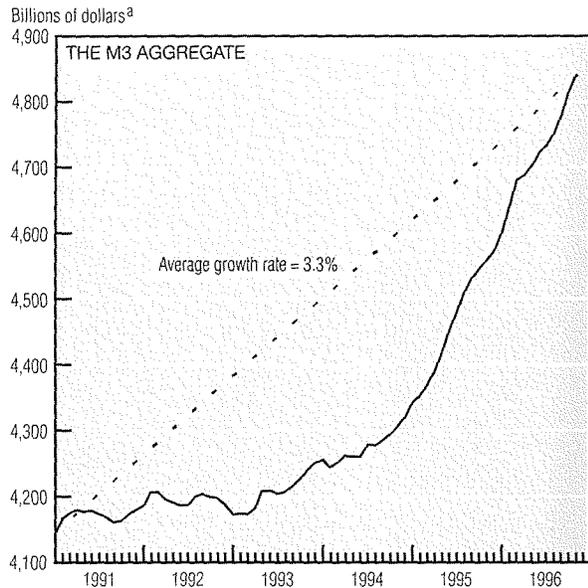
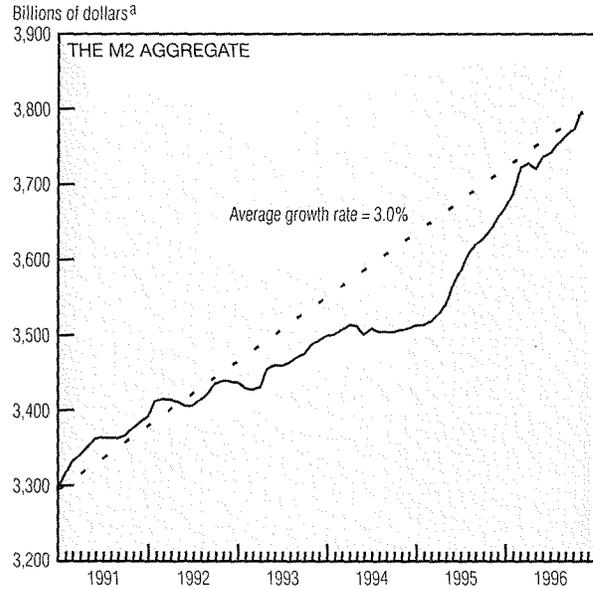
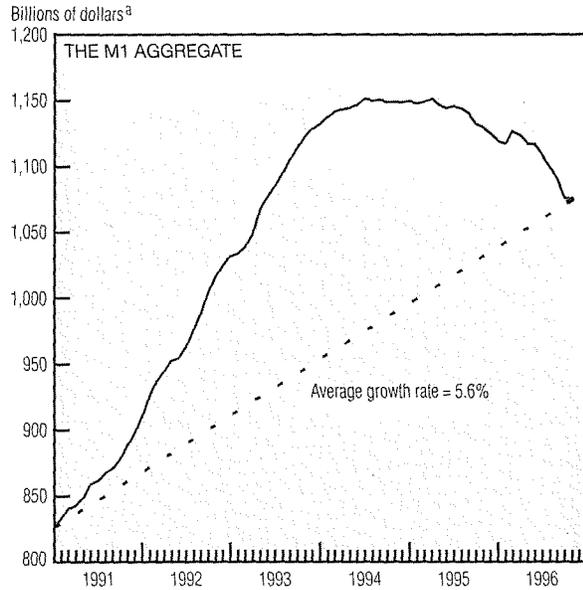
Over this period, inflation rates were highest from 1969 to 1982. Average annual inflation stood at 2.5% from 1959 to 1969, at 7.0% from 1969 to 1982, and at 3.3% from 1982 to 1995. A natural question, then, is whether the 1969–82 period was also characterized by faster-than-average growth in the monetary aggregates.

The answer is a qualified yes. Both M2 and M3 displayed much

faster growth during these years than in the earlier and later periods. While M1 increased substantially from 1969 to 1982 compared to the earlier period, it again rose slightly between 1982 and 1995. It is interesting to note that during these three periods, average real GDP growth was inversely related to the average rate of inflation.

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Monetary Policy (cont.)



a. Seasonally adjusted.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

Although growth in the money supply and inflation have a fairly close relationship over the long term, this relationship is much less reliable over shorter periods. Plots of the monetary aggregates' annual growth rates against annual inflation rates from 1959 to 1995 illustrate that the connection between money growth and inflation is not very precise over short periods, although a

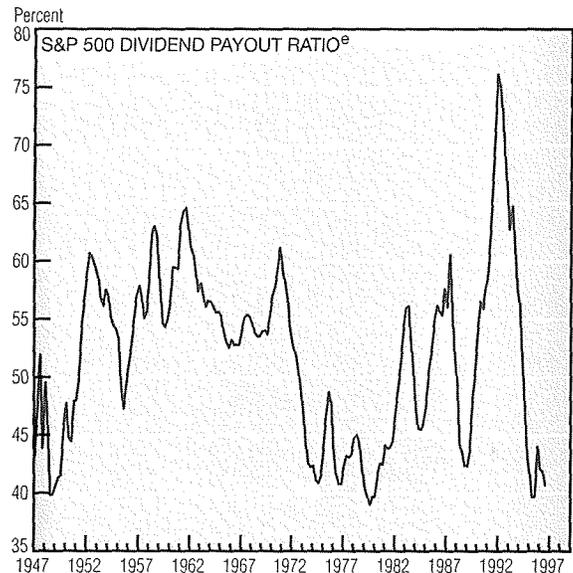
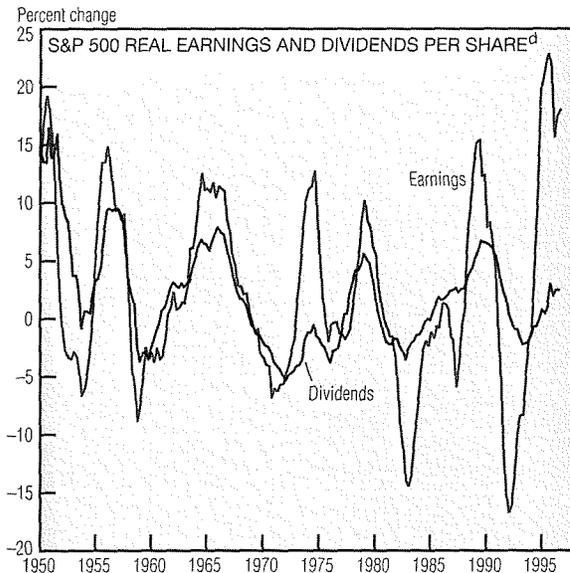
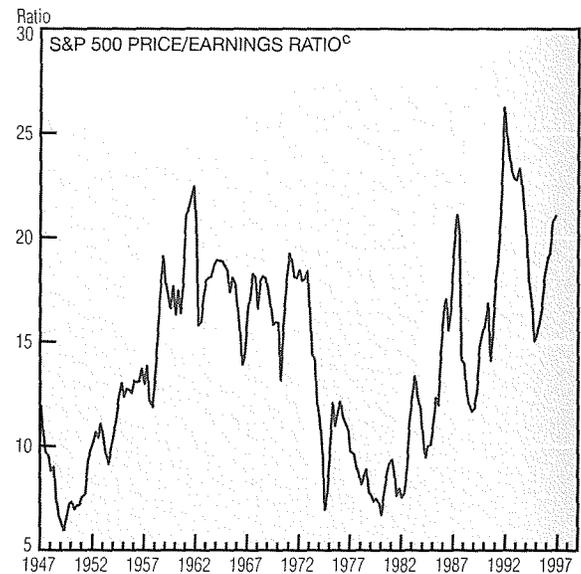
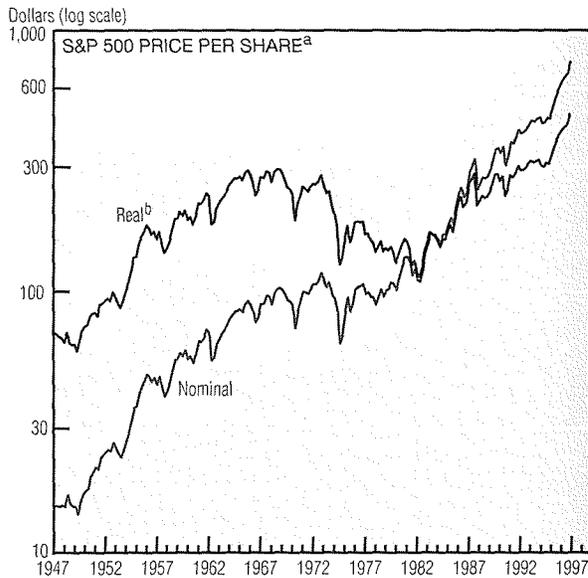
positive relationship does exist.

Because of this imprecision, recent data (up to one year) on the growth of the monetary aggregates provide little insight on the inflation rate. In contrast, looking back over five years may shed some light on recent and expected future levels of inflation.

Since the beginning of 1991, M1 has grown at an average annual rate

of 5.6%, while M2 and M3 have climbed 3.0% and 3.3%, respectively. The relatively low average annual inflation rate (3.1%) posted during this period is not surprising in light of these subdued money growth rates. To the extent that the monetary aggregates continue to expand at similar rates, we can expect long-term inflation to continue its downward trend.

The Stock Market



- a. Last plot is the December 31 closing price.
 b. Real S&P 500 is the nominal S&P 500 divided by the Consumer Price Index.
 c. Last plot is the December 31 closing price over 1996:IIIQ preliminary four-quarter total earnings.
 d. In 1983 dollars. Last plot is 1996:IIIQ preliminary earnings and 1996:IIIQ dividends. Real earnings growth is the compounded growth rate of four-quarter total real earnings divided by four-quarter total real earnings three years earlier. Real dividend growth is the compounded growth rate of the current-quarter real dividend divided by the real dividend three years earlier.
 e. Last plot is 1996:IIIQ dividends over 1996:IIIQ preliminary earnings.
 SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Although volatile, stock prices have been trending upward since 1982. The Standard & Poor's (S&P) 500 index stood at 741 on December 31, 21% above its year-end 1995 level. Measured in constant-dollar terms, the index has risen 54% since 1994, compared with an ascent of 91% in the two-year period ending September 1955.

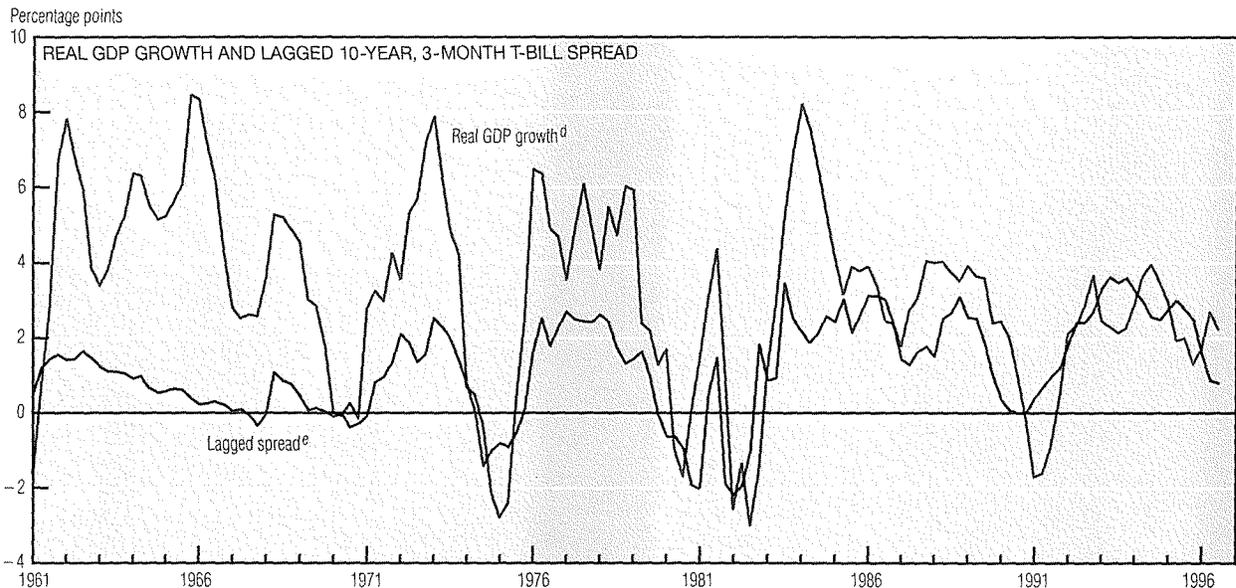
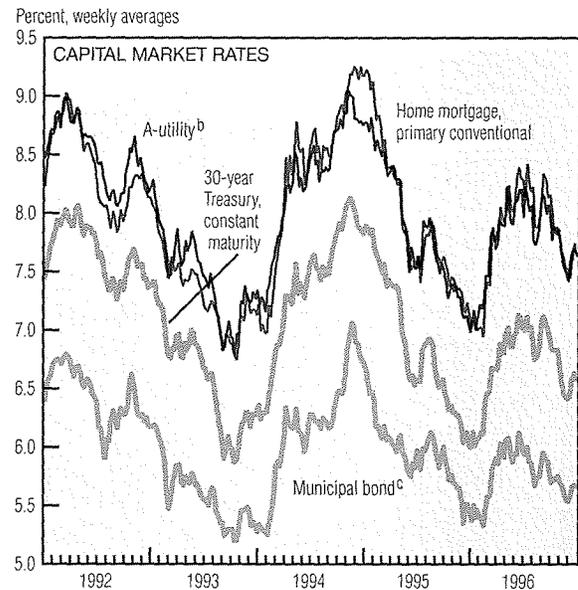
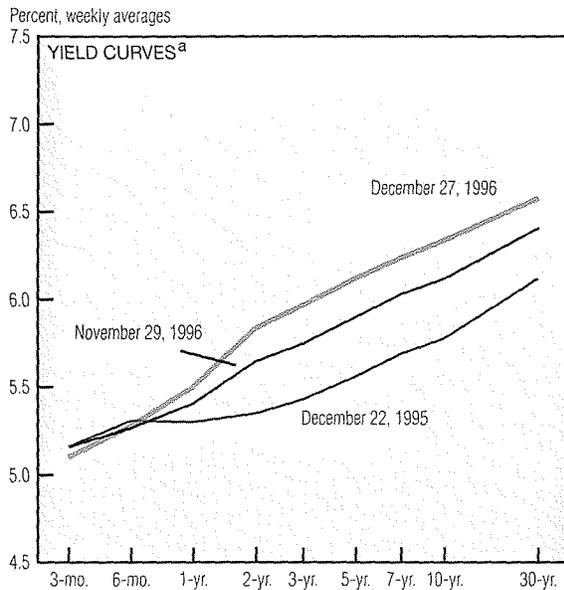
The recent surge in stock prices has been associated with especially strong earnings growth. Fundamentally, a stock's price is determined as the discounted value of its ex-

pected future dividends, which ultimately derive from future earnings. When prospects for earnings growth improve, stock prices tend to rise. The recent price/earnings level of the S&P 500 suggests that investors expect the strength in earnings to persist.

Since 1980, the variability of earnings growth has increased substantially, while the variability of dividend growth has remained essentially unchanged. Consequently, the dividend payout ratio (measured as dividends per share divided by

earnings per share) has swung widely in recent years. It now stands near its post-World War II low of 0.41, falling from a period high of 0.76 in 1992. Even if earnings growth moderates, dividend growth could accelerate if the payout ratio returns to its postwar average. Moreover, many firms have used earnings to buy back shares in lieu of paying dividends. This would explain part of the increase in earnings per share. It also bodes well for future dividends, because future earnings will be distributed among fewer shareholders.

Interest Rates



- a. All instruments are constant-maturity series.
 b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
 c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
 d. Percent change from corresponding quarter of previous year.
 e. Constant-maturity 10-year Treasury bond yield minus constant-maturity 3-month Treasury bill yield, lagged four quarters.
- SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

The yield curve has steepened over the last month and remains steeper than at this time last year, being higher at the long end and lower at the short. Two closely watched spreads, the 3-year, 3-month and the 10-year, 3-month, stand at 87 and 124 basis points, at or slightly above their 30-year averages of 80 and 125 basis points.

Long-term capital rates reflect the increase in long-maturity Treasuries. Home mortgage rates began their upturn a bit later, and have

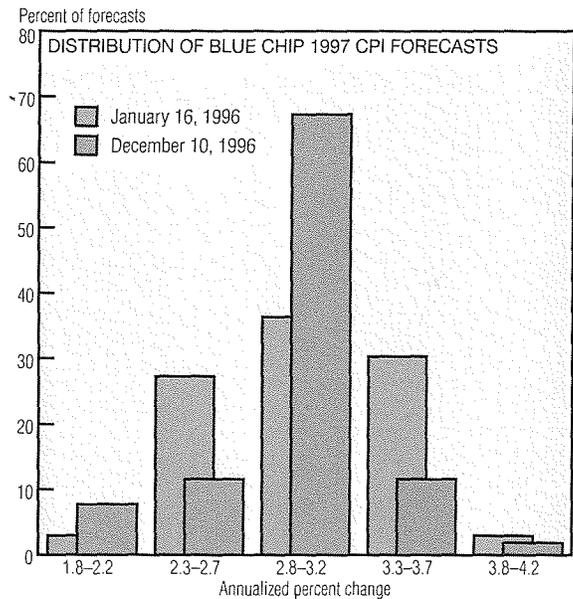
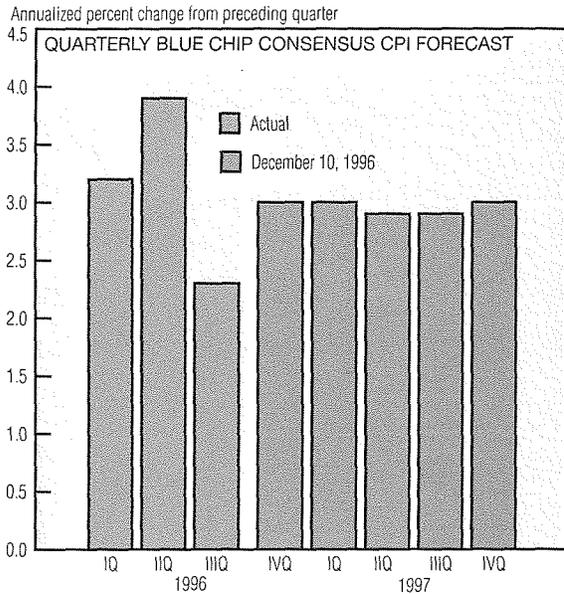
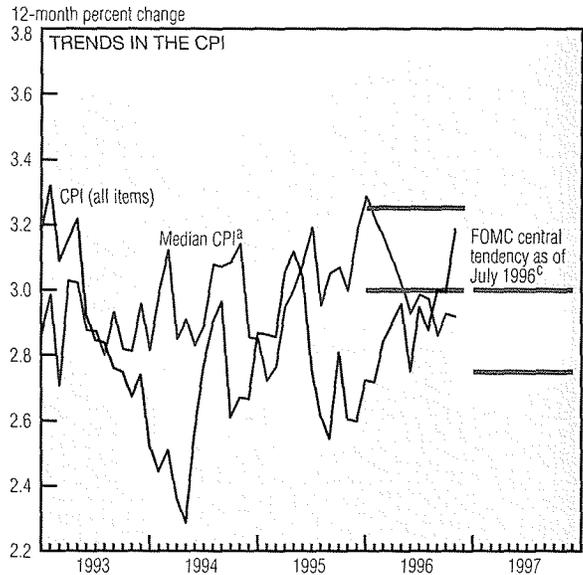
moved slightly less, than 30-year Treasuries, utility bonds, and municipal bonds.

People commonly use term structure to predict future GDP growth, but they disagree over why it should do so—whether it anticipates future policy actions, reacts to shocks more quickly than does the real economy, or both. However, the emerging consensus is that the yield curve does indeed predict future real activity. Most dramatically, yield curve inversions (where the spread goes

negative as short rates exceed long rates) often herald recessions, whereas steep yield curves indicate strong economic growth. This relation is particularly apparent in the chart comparing real GDP growth with the 10-year, 3-month spread one year (four quarters) in the past. This suggests that the current above-average spread portends robust growth over the next year, but variability in the chart also means that there is no guarantee.

Inflation and Prices

	Annualized percent change, last:				1995 avg.
	1 mo.	6 mo.	12 mo.	5 yr.	
November Price Statistics					
Consumer Prices					
All items	3.1	2.6	3.2	2.8	2.6
Less food and energy	2.2	2.6	2.6	3.0	3.0
Median ^a	2.8	2.8	2.9	3.0	3.2
Producer Prices					
Finished goods	4.6	2.8	3.1	1.6	2.1
Less food and energy	1.7	0.8	0.6	1.4	2.6
Commodity futures prices^b					
	-12.1	-12.0	-0.3	2.4	5.4



a. Calculated by the Federal Reserve Bank of Cleveland.
 b. As measured by the KR-CRB composite futures index, all commodities. Data reprinted with permission of the Commodity Research Bureau, a Knight-Ridder Business Information Service.
 c. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; and *Blue Chip Economic Indicators*, January 16 and December 10, 1996.

The Consumer Price Index (CPI) rose 3.1% in November, just a bit under its average increase of the last 12 months. The median CPI, a measure of core inflation, advanced at a slightly slower pace.

Neither economists nor policymakers foresee the CPI's growth rate changing much between 1996 and 1997. At its July meeting, the Federal Open Market Committee projected that the index would rise between 2¾% and 3% this year, not much different from the 2.8% to 3.2% range anticipated by more than 65% of the

economists responding to December's Blue Chip survey.

Recently, a fair amount of controversy has surfaced over the CPI's ability to accurately measure changes in the average cost of living. The major measurement problems underlying the index have been reasonably well understood since the first "fixed market basket" indexes were constructed. However, because the CPI is the basis for adjusting roughly one-third of all federal expenditures, CPI "bias" has recently prompted a more focused discussion of "correcting" the index in order to ease the

federal government's fiscal problems.

A recent report to the Senate Finance Committee (produced by the Advisory Commission to Study the Consumer Price Index) puts the total annual CPI bias at 1.1%. The components of this bias are believed to be changes in the market basket due to relative price changes (substitution bias, 0.4%), changes in the quality of goods or the introduction of new ones (0.6%), and changes in where goods are purchased (outlet bias, 0.1%).

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Inflation and Prices (cont.)

Estimates of Annual CPI Bias (Percentage points)

Senate Advisory Commission

Substitution bias	0.4
New product/quality change	0.6
Outlet bias	0.1
Total bias	1.1

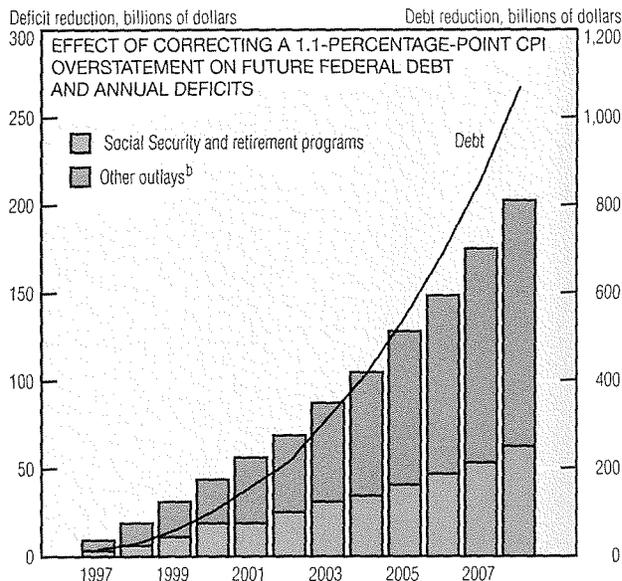
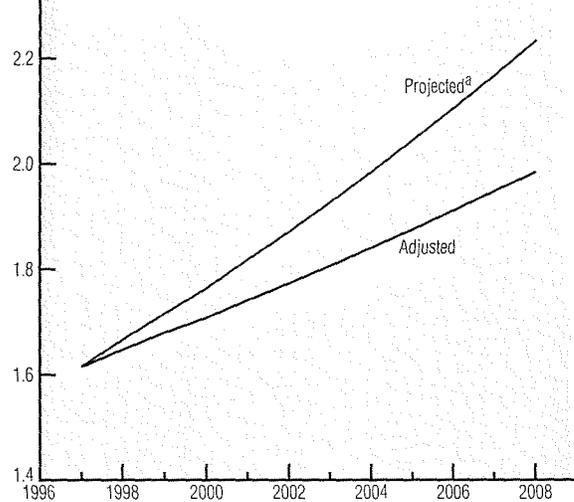
Range of plausible estimates 0.8 to 1.6

Consensus view of economists* 0.8

* Blue Chip panel of economists, July 10, 1995.

Index, 1982-84 = 1.0

EFFECT OF CORRECTING A 1.1-PERCENTAGE-POINT CPI OVERSTATEMENT ON PROJECTED CPI GROWTH



Estimates of Annual New Products/ Quality Bias, by Selected Component^c

Component	Weight (percent)	Bias (percentage points)
Fresh fruits/vegetables	1.3	0.60 (1967-96)
Appliances	0.8	3.6 (1973-94) 5.6 (1994-96)
Apparel and upkeep	5.5	-0.95 (1965-85) 1.00 (1985-96)
New vehicles	5.0	0.00 (1970-83) 0.59 (1983-96)
Public transportation	1.5	2.66 (1972-77) 4.60 (1977-82) 0.00 (1982-96)
Professional medical and hospital services	5.7	3.00

a. Consensus forecast of the Blue Chip panel of economists, October 10, 1996.

b. Includes reduction in deficits due to revenues, change in debt service, and other outlays.

c. Dates in parentheses represent estimation period.

SOURCES: *Toward a More Accurate Measure of the Cost of Living*, final report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, Michael J. Boskin, Chairman; and *Blue Chip Economic Indicators*, July 10, 1995 and October 10, 1996.

While the overall bias seems small, its impact on the CPI could be huge if accumulated over several years. If we adjust the CPI's projected growth rate downward by the Commission's bias estimate, the index rises about one-third less than what is currently projected by economists. According to the Congressional Budget Office, a potential overstatement of this magnitude would cause the federal government to exceed its budget by about \$200 billion in the year 2008, cumulatively adding more than \$1 trillion to federal government debt over the

11-year period.

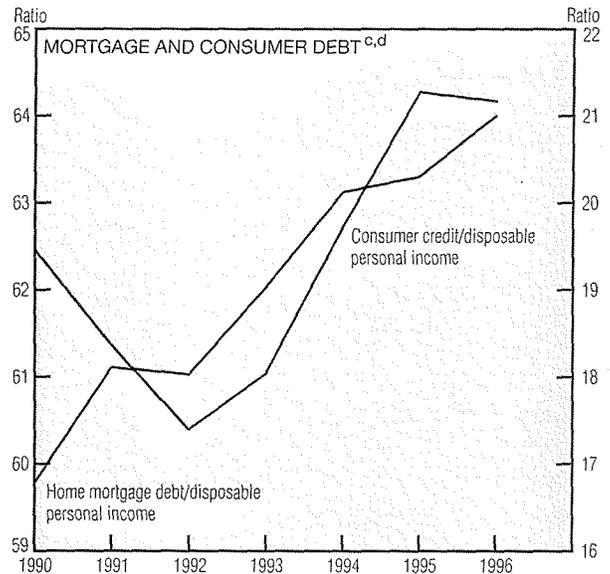
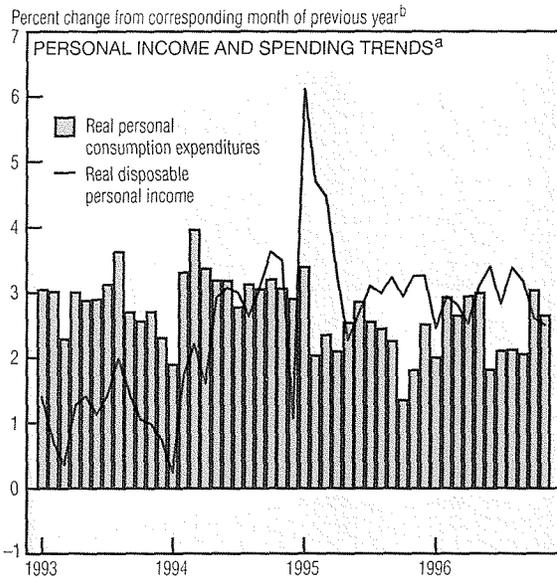
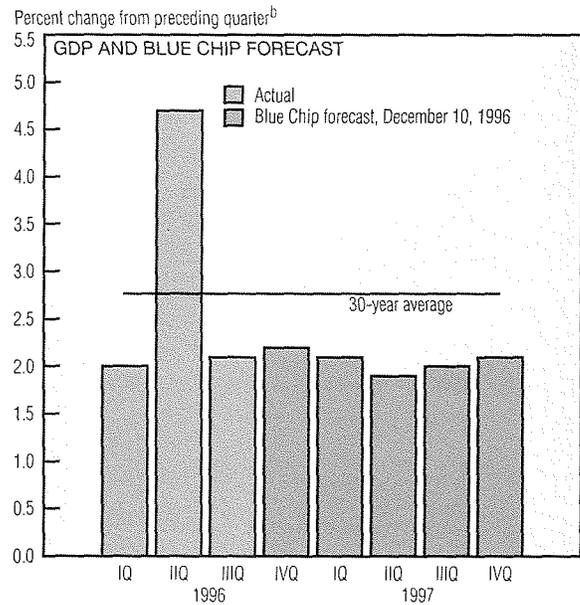
The Commission's report has received a certain amount of criticism and, at the very least, should be considered speculative. The potentially largest bias in the index comes from mismeasurement of quality changes and the introduction of new goods, areas that economists have identified as having the potential to cause inaccuracies, but for which very little broad-based evidence has been collected. In its report, the Commission indicated wide variation in the amount of quality bias by component. How-

ever, these estimates can change sharply from period to period and may, in certain cases, be negative.

For the moment, the Bureau of Labor Statistics (the government agency that oversees the construction of the CPI) is unlikely to make any substantial changes in the index. Besides its use as a federal budget escalator, the CPI is used in labor and other private contracts covering millions of workers. Making permanent alterations without thoroughly understanding their implications could create more problems than it solves.

Economic Activity

	Change, billions of 1992 \$	Percent change, last	
		Quarter	Four quarters
Real GDP and Components, 1996:IIIQ^a (Final estimate ^b)			
Real GDP	35.8	2.1	2.2
Consumer spending	5.9	0.5	2.1
Durables	-4.0	-2.6	3.8
Nondurables	1.3	0.4	1.2
Services	8.3	1.3	2.2
Business fixed investment	30.9	17.5	8.7
Equipment	27.5	20.8	10.7
Structures	3.7	8.2	3.2
Residential investment	-3.7	-5.2	5.9
Government spending	-2.1	-0.7	1.0
National defense	-4.5	-5.5	-1.3
Net exports	-22.7	—	—
Exports	-1.8	-0.9	4.2
Imports	20.9	9.3	7.8
Change in business inventories	27.4	—	—



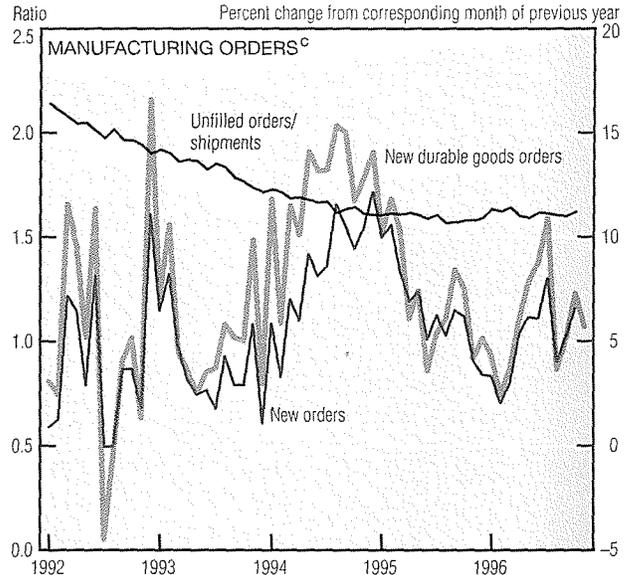
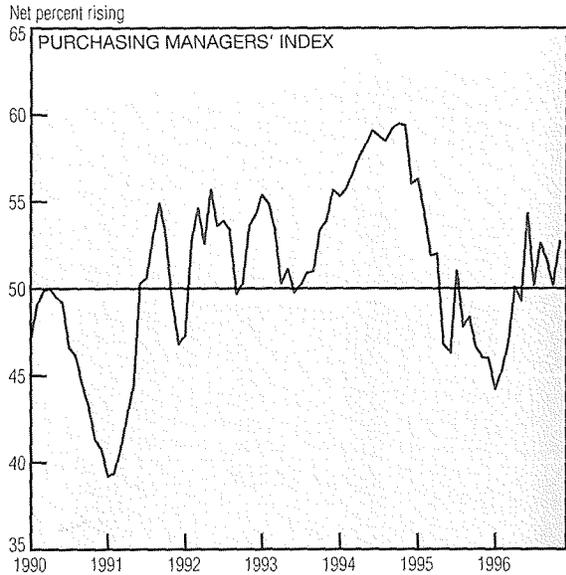
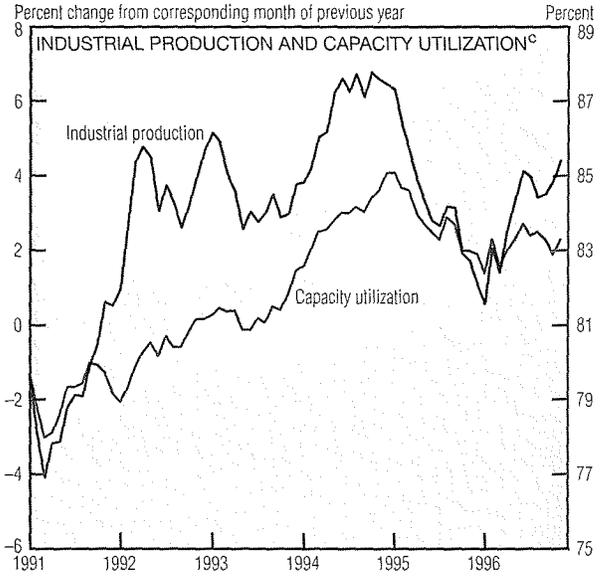
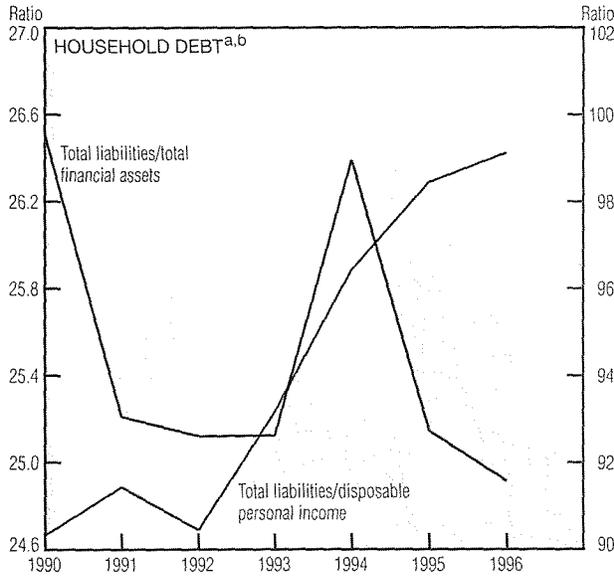
a. Chain-weighted data in 1992 dollars.
 b. Seasonally adjusted annual rate.
 c. All data include households and nonprofit organizations and are measured at year end.
 d. Disposable personal income data are through November 1996; home mortgage debt and consumer credit are through 1996:IIIQ.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and *Blue Chip Economic Indicators*, December 10, 1996.

Revised Commerce Department estimates indicate that real GDP grew 2.1% in 1996:IIIQ, down from an atypically high 4.7% the previous quarter. Advances in producers' durable equipment (mainly computers) and inventory accumulation more than accounted for the third-quarter increase. Economists participating in December's Blue Chip survey expect continued economic growth of approximately 2.0% throughout 1997. Although lower

than the historical norm, this figure is consistent with current estimates of U.S. potential economic growth. Consumer outlays, which slowed during the third quarter, have since picked up. Real personal consumption expenditures increased a solid 2.6% (year over year) in November, following a 3.0% advance the month before. Both of these increases exceeded gains in real disposable personal income, which has moderated somewhat in recent months but remains healthy. Anec-

dotal evidence suggests that holiday spending was fair. Concern that high levels of household debt may crimp consumer spending and weaken the overall economy persists, but may be overblown. Household debt as a share of disposable personal income has generally risen over the last 30 years, with most of the runup reflecting higher levels of mortgage debt. The upward trend in consumer debt
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Economic Activity (cont.)



a. All data include households and nonprofit organizations and are measured at year end.
 b. Disposable personal income data are through November 1996; total liabilities and total financial assets are through 1996:IIIQ.
 c. Seasonally adjusted.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and the National Association of Purchasing Management.

has been quite modest. At 21.2%, consumers' recent debt-to-income ratio is only slightly above its previous peak of 20.4% in 1986. Moreover, the ratio of consumer debt to financial assets suggests that households' balance sheets are healthier now than in 1990. Perhaps reflecting favorable balance sheets, measures of consumers' overall confidence in the economy remain strong.

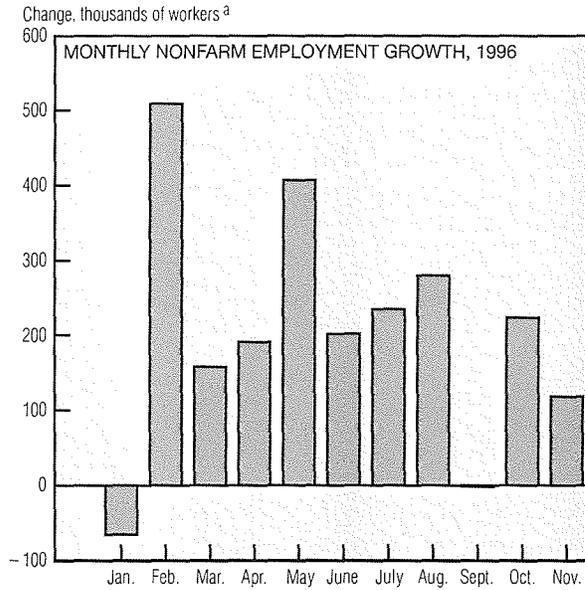
Recent data show a surprisingly large surge in industrial production.

The total index increased more than 0.9% in November. Analysts expected a post-strike rebound in the automotive industry, but non-automotive industries accounted for much of the overall gain. Measured on a year-over-year basis, industrial production has grown at a healthy pace this year, with U.S. mines, utilities, and manufacturing plants continuing to operate at high levels of capacity utilization. The National Association of Purchasing Manage-

ment's index indicates that a slight majority of managers are reporting growth in their firms. The industrial sector accounts for only about 20% of national output, but it is a pivotal component of the business cycle.

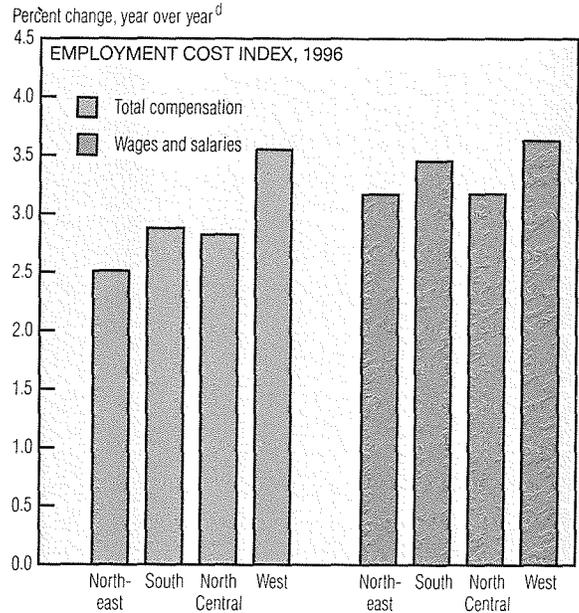
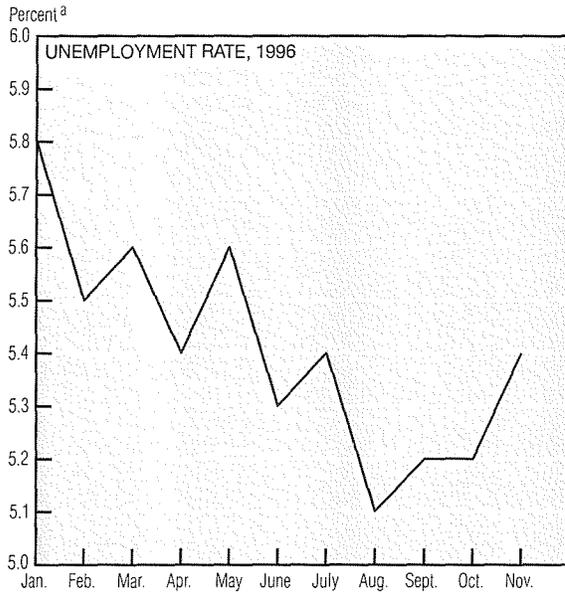
New orders for durable goods increased a substantial 5.7% (year over year) in November, and new orders for all manufactured goods advanced 6.6% in October (latest data). The ratio of unfilled orders to shipments has remained steady.

Labor Markets



Employment Growth by Industry, 1996
 (Thousands of employees^a)

	IQ	IIQ	IIIQ	IVQ ^b	Total
Total nonfarm	601	800	513	342	2,256
Goods-producing	36	78	-17	42	139
Manufacturing	-85	16	-57	18	-108
Nondurables	-41	-57	-36	1	-133
Durables	-44	73	-21	17	25
Construction	117	61	48	26	252
Service-producing	565	722	530	300	2,117
Wholesale and retail trade	59	252	178	128	617
FIRE ^c	45	35	42	32	154
Transportation, public utilities	40	40	8	12	100
Services	374	343	229	158	1,104
Computer	18	40	31	27	116
Health	87	66	56	46	255
Government	47	52	73	-30	142



a. Seasonally adjusted.
 b. December data are not available.
 c. Finance, insurance, and real estate.
 d. Through 1996:IIIQ.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Labor markets remained solid in 1996, with 2.3 million jobs being added to the nation's payrolls. Through November (December data are not yet available), the number of net jobs created was slightly higher than the 2.2 million created in 1995.

The goods-producing sector added 139,000 workers over the first 11 months of the year, with strength in the construction industry more

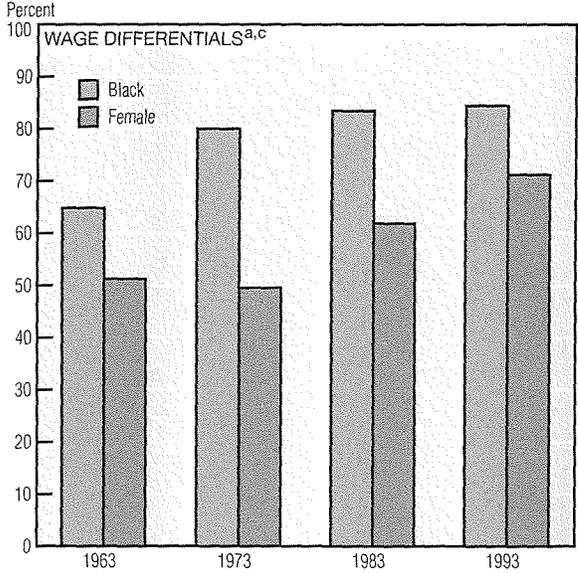
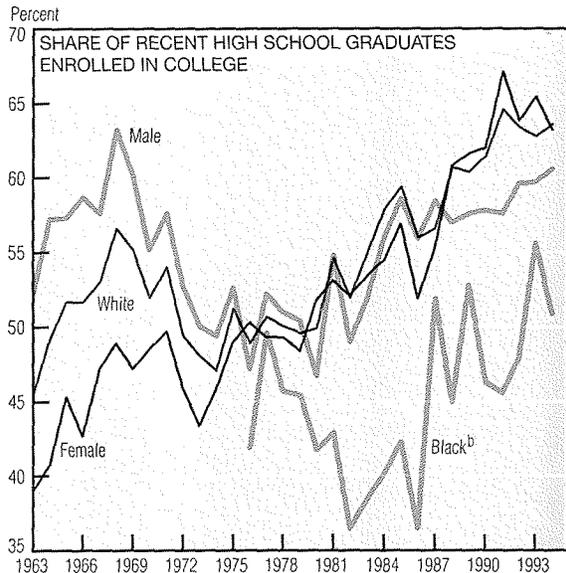
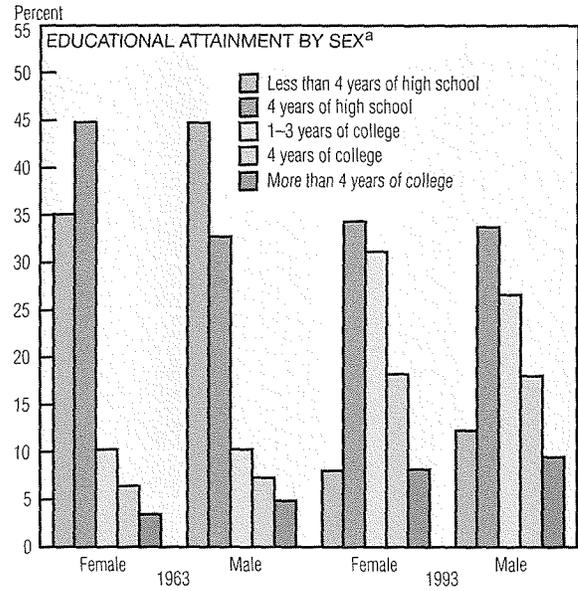
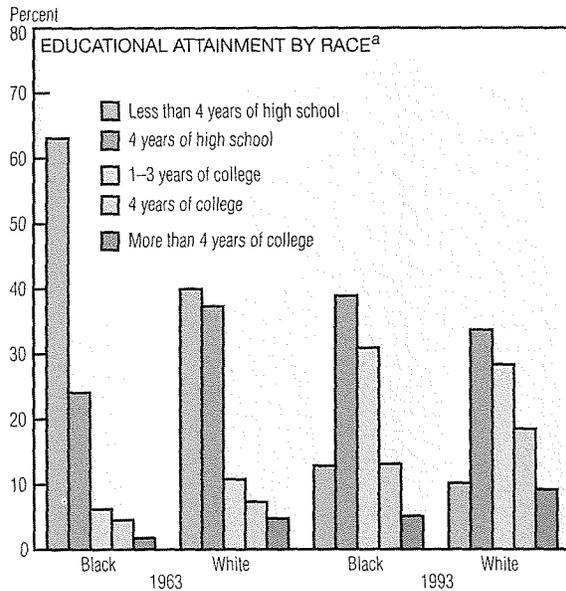
than offsetting a contraction in manufacturing. Most service-producing categories saw about the same increase in 1996 as in 1995. One dramatic exception was the finance, insurance, and real estate industry, which more than tripled its 1995 growth. This translated into 154,000 new jobs.

Despite fluctuations in the monthly data, unemployment followed a downward trend in 1996. November's jobless rate, at 5.4%,

stood 0.4 percentage point below the January figure. Additionally, average unemployment for the year (5.4%) was below the 1995 average (5.6%).

Wages and total compensation (which includes benefits) grew a moderate 3.4% and 3.0%, respectively, close to the rate of inflation. Tighter labor markets in the western states were evident in the region's more rapid wage and salary growth.

The U.S. Workforce



a. Refers to full-time workforce.
 b. Data not available before 1976.
 c. As a percentage of average earnings for white males.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; and *Statistical Abstract of the United States: 1996*, table 279.

Nothing is more certain than change, particularly economic change. The last 30 years have witnessed a dramatic transformation in the educational attainment of the U.S. workforce, along with a narrowing of race- and sex-related pay disparities.

As recently as 1963, 42% of all working Americans dropped out of high school, but by 1993 that number had fallen to 11%. Over the same period, the share of high school graduates attending college rose from 45% to 62%; the proportion of undergraduate college students who

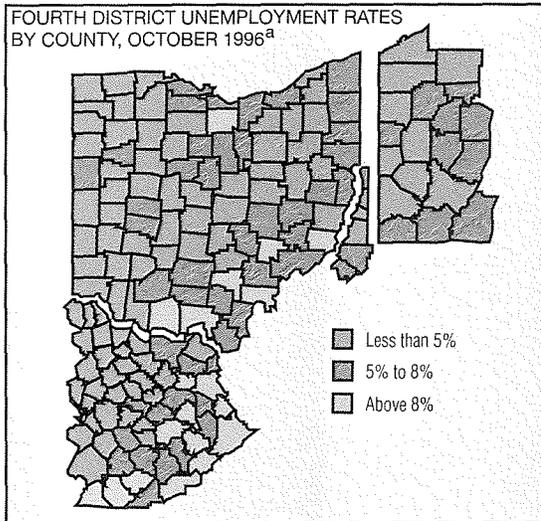
earned a degree increased from 7% to 18%, and the share of college graduates with two or more years of post-graduate education tripled from 3% to 9%.

In addition, the data reveal a notable coalescence in educational attainment among race and sex groups. Between 1963 and 1993, the share of black workers who had completed less than four years of high school plummeted to a proportion nearly equal to that of white workers, while the fraction of working women who had dropped out of

high school actually fell below that of men.

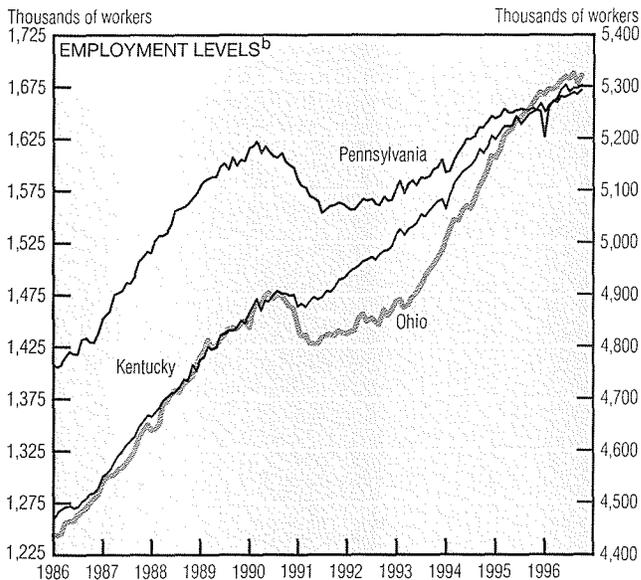
Over this same 30-year period, the share of women in the workforce ballooned from roughly 28% to 42%, and the male-female pay disparity narrowed. In 1963, a woman earned about half as much as a man. By 1993, that figure had risen to 70%. Although the percentage of blacks in the labor force has changed little over the last three decades, the earnings disparity between blacks and whites narrowed from 65% in 1963 to 85% in 1993.

Regional Conditions



Unemployment Rates by Metropolitan Area^a (Percent of labor force)

	October 1996	October 1995
Akron	4.1	4.1
Canton–Massillon	4.6	4.6
Cincinnati	3.7	4.2
Cleveland–Lorain–Elyria	4.8	4.9
Columbus	2.8	3.0
Dayton–Springfield	4.0	3.8
Hamilton–Middletown	3.6	3.8
Lima	5.5	5.7
Mansfield	5.3	6.0
Pittsburgh	4.6	5.7
Steubenville–Weirton	5.5	5.8
Toledo	4.1	4.3
Youngstown–Warren	5.3	7.0



Ohio Employment by Industry (Number of workers)

	1996:IIQ	1996:IQ
Total	5,184,202	5,021,011
Agriculture, forestry, and fishing	47,792	33,375
Mining	14,128	13,365
Construction	227,832	188,560
Manufacturing	1,103,076	1,090,693
Durables	739,889	734,641
Nondurables	356,512	356,233
Transportation	222,638	219,162
Trade	1,309,620	1,272,671
FIRE ^c	272,129	265,985
Services	1,358,366	1,304,640
Government	628,621	632,560

a. Not seasonally adjusted.

b. Seasonally adjusted.

c. Finance, insurance, and real estate.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Ohio Bureau of Employment Services, Labor Market Information Division.

Although more than half of the Fourth Federal Reserve District's counties posted unemployment rates at or below the national average in October, many others continued to exceed it, one by as much as 8.8 percentage points (Knox County, Kentucky). Morgan County recorded Ohio's highest jobless rate (11.6%), while Franklin and Delaware counties, in the Columbus metropolitan area, shared the state's lowest posting (2.7%).

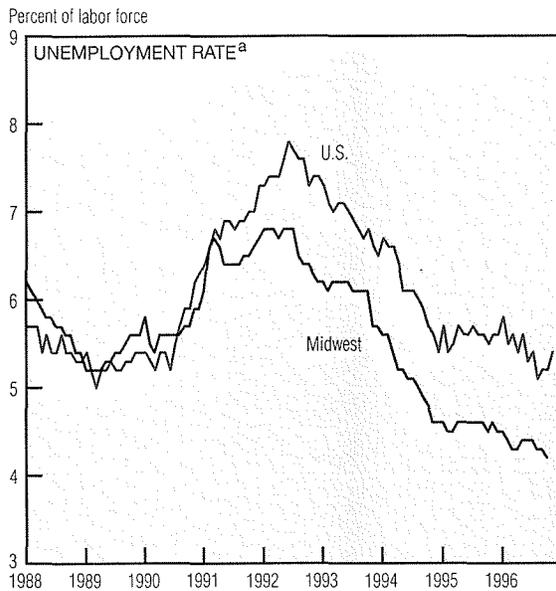
October unemployment rates in

the District's metropolitan areas were comparable to those of October 1995. Cincinnati, Cleveland, Columbus, and Pittsburgh all saw their rates go down. The largest improvement came in the Youngstown–Warren area, which cut its jobless rate from 7% in October 1995 to 5.3% a year later.

In recent years, Pennsylvania has seen less robust jobs growth than Ohio and Kentucky. In fact, Pennsylvania employment is only slightly higher now than in 1990, whereas Ohio and Kentucky have posted

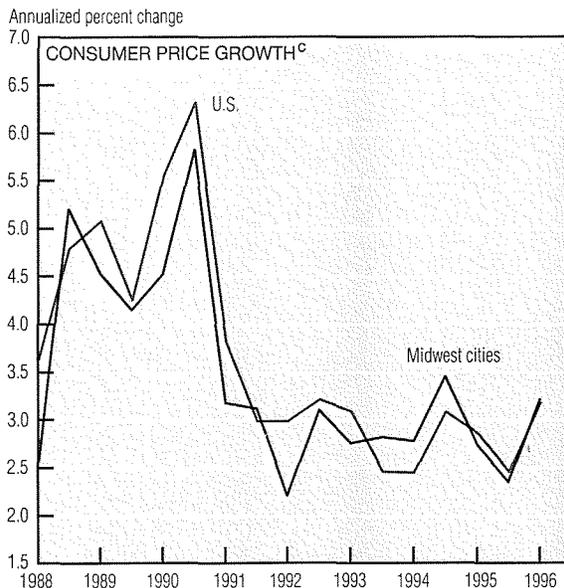
gains of about 6% and 12%, respectively.

Ohio's quarterly employment figures show an increase in total employment between the first and second quarters of 1996. Gains occurred in every sector except government, which lost almost 4,000 workers. The biggest quarterly improvement came in services, which added more than 53,000 jobs, but large increases were also seen in construction and in wholesale and retail trade (up nearly 40,000 and 37,000, respectively).



Selected Statistics for Midwest and U.S. Economies^b

	Midwest	U.S.
Population (thousands)	61,394	260,341
Manufacturing output (\$ billions)	940.4	3,003.5
GDP (\$ billions)	1,374.5	6,244.4
Percent of population holding a bachelor's degree	11.4	12.3



a. Seasonally adjusted.
 b. Population data are for 1994; manufacturing output (measured in value of shipments) and GDP data are for 1992; and educational attainment data are for 1990.
 c. All data are semiannual.
 d. All data are third quarter over third quarter.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.

Some policymakers view the concept of NAIRU, the non-accelerating inflation rate of unemployment, as consistent with an equilibrium unemployment rate. Although it is often associated with full employment, the NAIRU is not zero because even in equilibrium, an adjusting economy experiences some unemployment due to natural turnover and job-seeking.

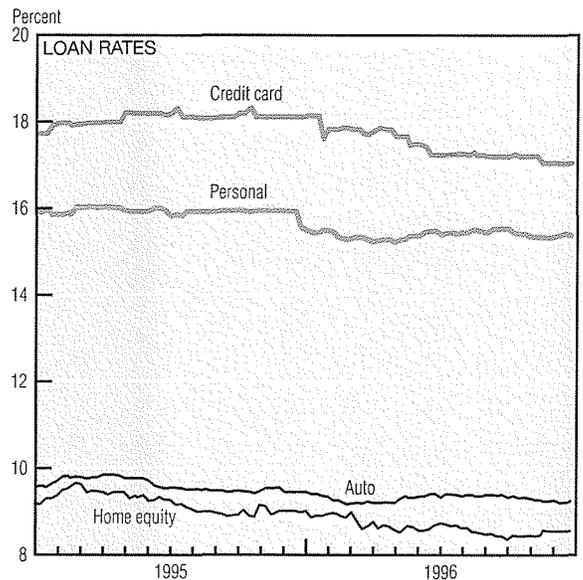
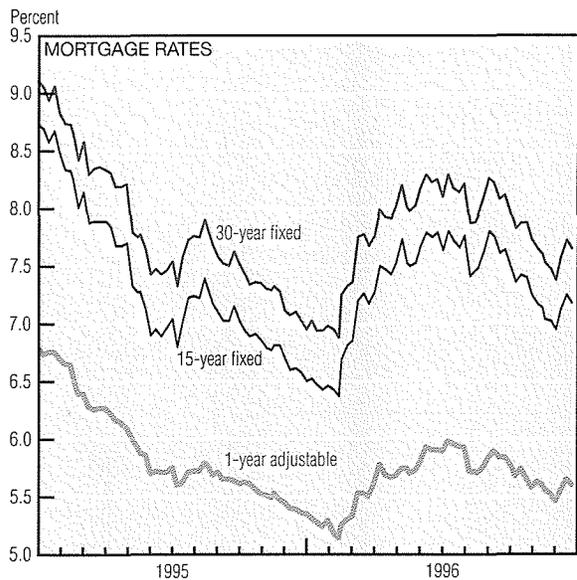
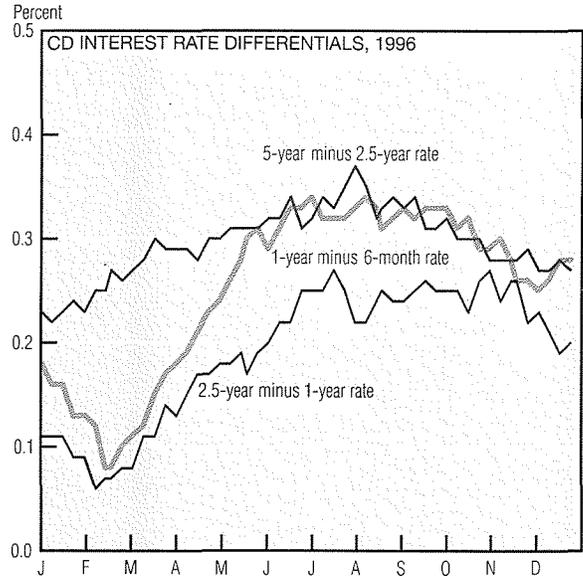
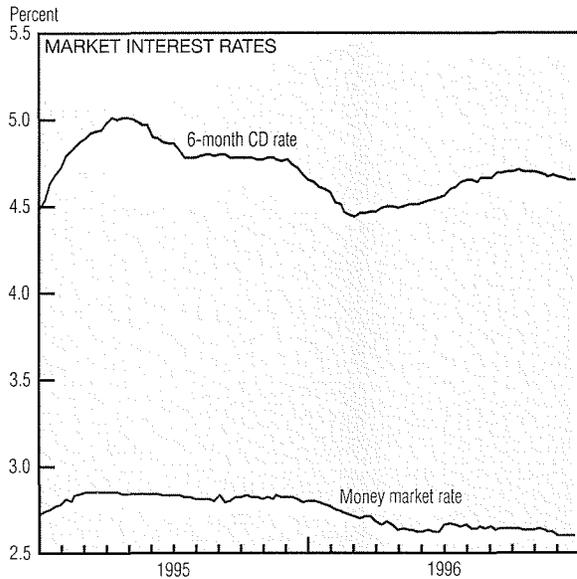
Certain economists feel that any unemployment rate above (below) the NAIRU portends an inflation decrease (increase). Unfortunately, the

NAIRU is not measured directly, but must be inferred from past price and unemployment data, so there is considerable uncertainty about the rate's value at any given time. Some economists have begun to suggest that the U.S. rate has fallen from 6% to 5.5%, with significant implications for current policy.

One way to gain a clearer picture of the NAIRU is by examining regional evidence. For example, the Midwest's economy accounts for more than a quarter of all U.S. output. More important, its labor force

does not differ much from that of the nation as a whole. In recent years, midwestern unemployment rates have consistently been well below the U.S. average. However, the region's prices have risen at about the same average rate as the nation as a whole, as have its labor costs, which form the largest share of its business expenses. Thus, the Midwest evidence suggests that even if the NAIRU is a useful concept, the rate may be far lower than many observers believe.

Banking Conditions



SOURCE: *Bank Rate Monitor*, various issues.

Short-term bank deposit rates have declined slightly since October. Although business's demand for bank loans was strong in September and October, their increased utilization of alternative funding sources may portend a weakening in this area. Weaker loan demand would increase the pressure on banks to lower their deposit rates.

Since June, yield curve differentials have declined, consistent with expectations of lower interest rates. The widening between one-year and six-month CD rates since October

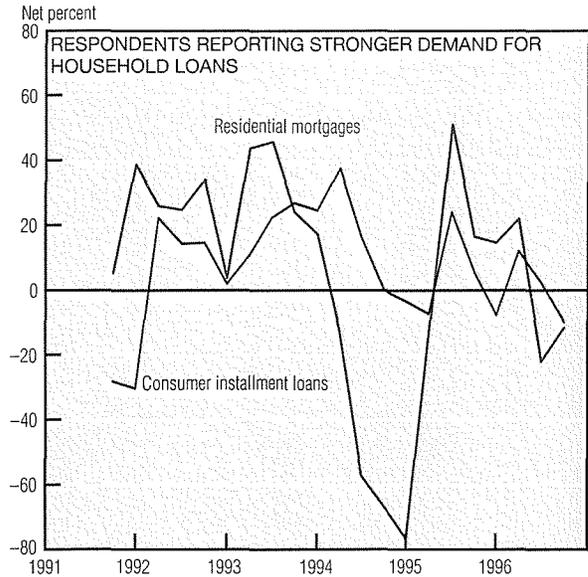
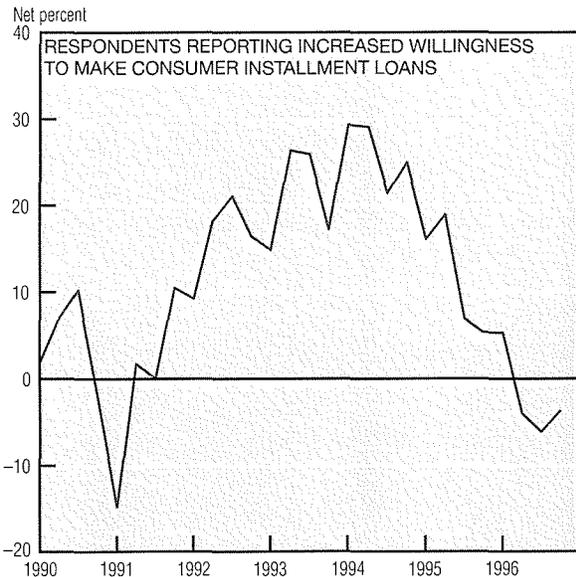
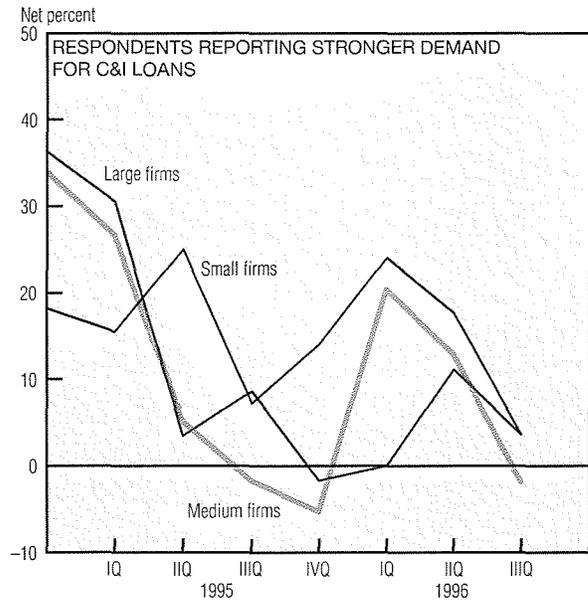
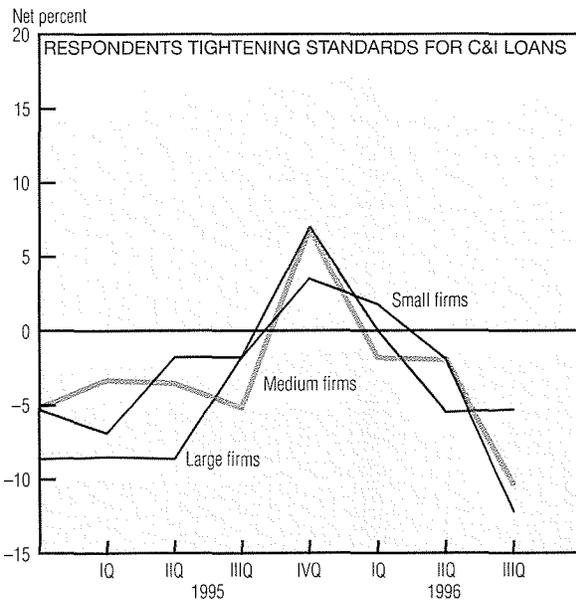
suggests that market participants might expect a temporary firming. However, such interpretations are problematic, in part because each yield curve segment may temporarily reflect supply and demand factors specific to particular portions of the market.

Mortgage rates have shown a slight firming, possibly because the volume of mortgages demanded may have responded to the lower rates witnessed since midyear. However, some reports indicate that demand is concentrated in refinancing rather than in new home loans.

Consumer loan rates (credit cards, auto loans, and personal loans) have been declining since last fall. Although delinquency rates on credit cards and closed-end consumer loans fell for the first time in two years, concerns are still being voiced about the quality of outstanding consumer loans and the debt burden facing American households. Bankruptcy filings for the 12 months ended September 30 reached a record high. On the other hand, high levels of credit card portfolio sales have enabled banks to shed

(continued on next page)

Banking Conditions (cont.)



SOURCE: Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices.

some of their riskier consumer debt and thus lower their rates.

The November Senior Loan Officer Opinion Survey on Bank Lending Practices revealed that several banks reduced standards for business loans and eased terms. However, many also raised standards for credit card lending and other types of consumer loans.

Compared to the previous survey in August, there has been a slight easing of standards for business loans. The number of banks that reported easing terms for large and

small firms rose to 40% and 30%, respectively. An often-cited explanation was competition from either other banks or nonbanks. Reported increased sensitivity of loan demand to changes in bank terms was greatest for medium-size firms.

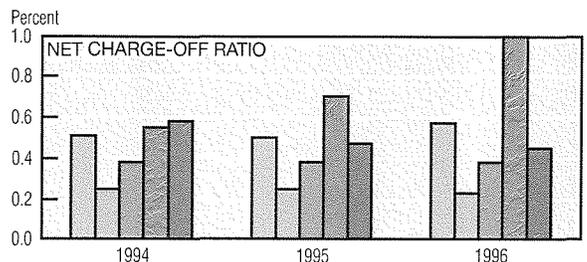
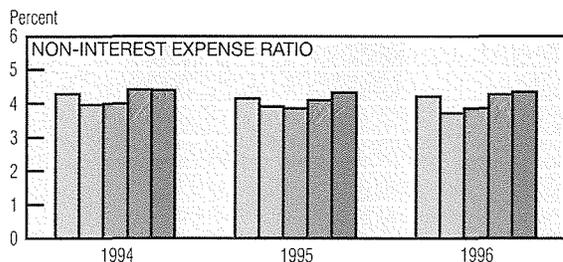
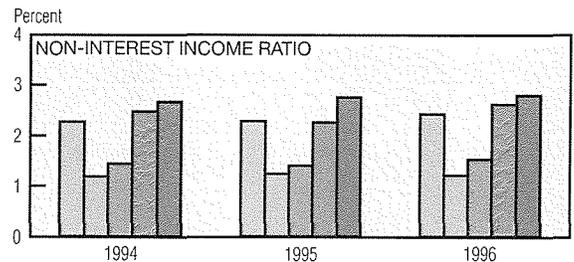
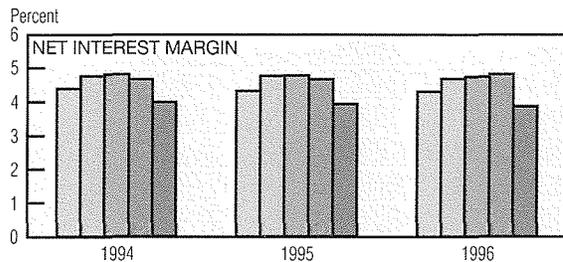
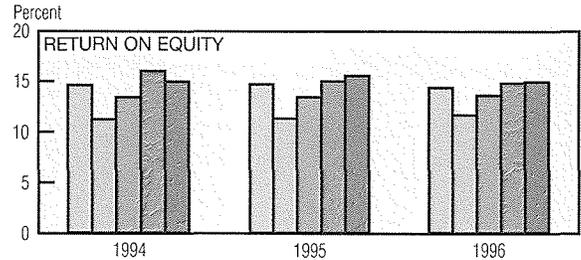
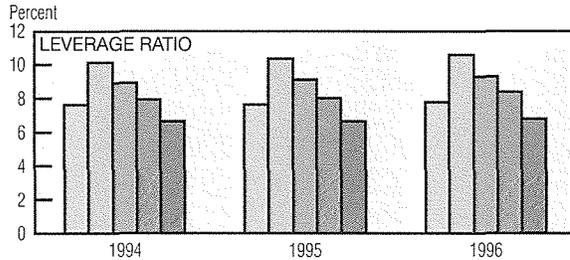
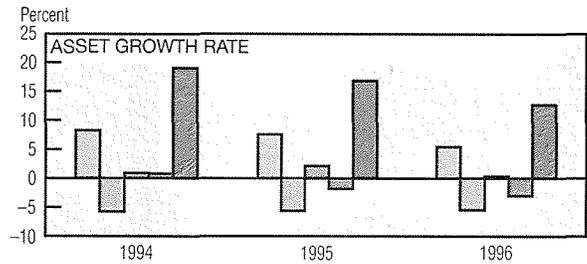
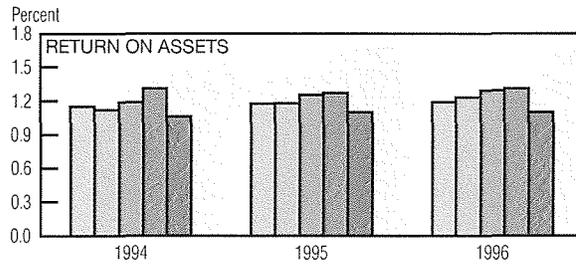
Although the volume of commercial and industrial (C&I) loans at commercial banks grew rapidly in November, little change in the demand for such loans was noted over the September–November period. Only a slightly greater percentage of respondents reported increased de-

mand for commercial real estate loans.

The survey also found continued evidence of tighter consumer lending practices, consistent with the deceleration in consumer credit in the third quarter. Similar to the results of the August survey, roughly 50% of respondents tightened credit card standards, and 25% tightened standards on other consumer loans. Standards on home equity loans were eased by 20%, although a few banks tightened standards on home mortgage applications.

(continued on next page)

Banking Conditions (cont.)



All institutions
 Less than \$100 million in assets
 \$100 million to \$1 billion in assets
 More than \$1 billion in assets

NOTE: Data for 1996 are for the first three quarters. All percent changes are year over year.
 SOURCE: Federal Deposit Insurance Corporation.

Preliminary data for the first three quarters of 1996 show that commercial banks insured by the Federal Deposit Insurance Corporation (FDIC) recorded an average return on assets of 1.19%. Third-quarter net income of \$13.2 billion was the third-highest posting in history. Compared to 1995, however, asset growth dipped, although increases occurred in credit card and commercial loans. Asset quality indicators are positive, with the proportion of bank loans that are at least 90 days past due falling to the lowest level in 15 years.

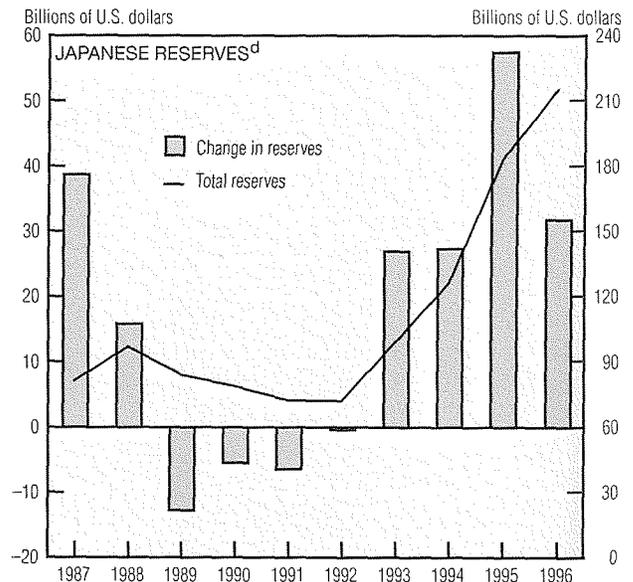
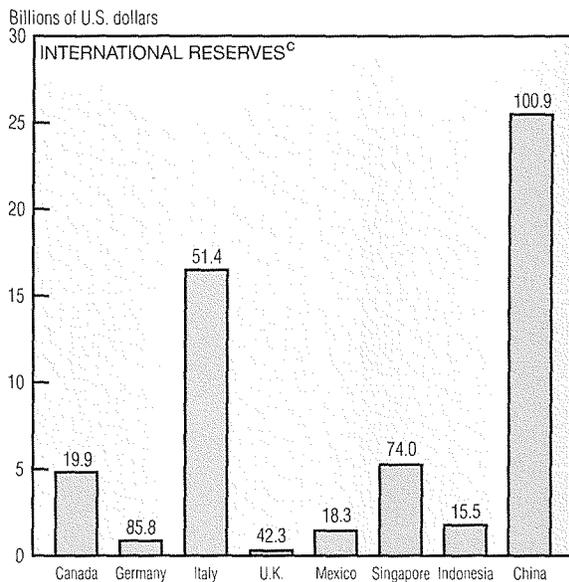
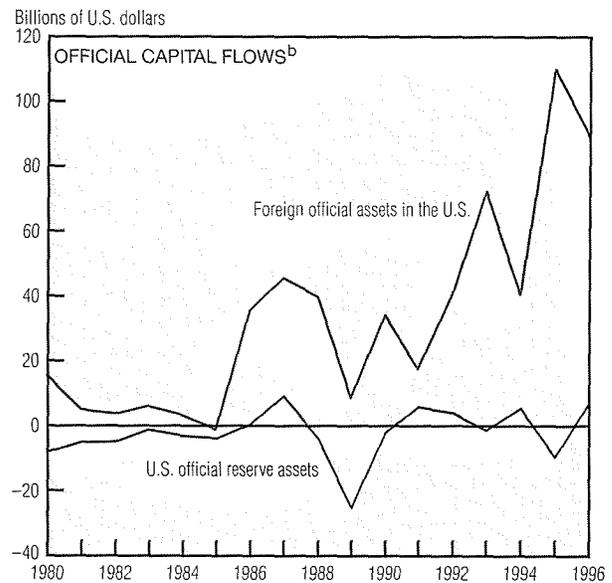
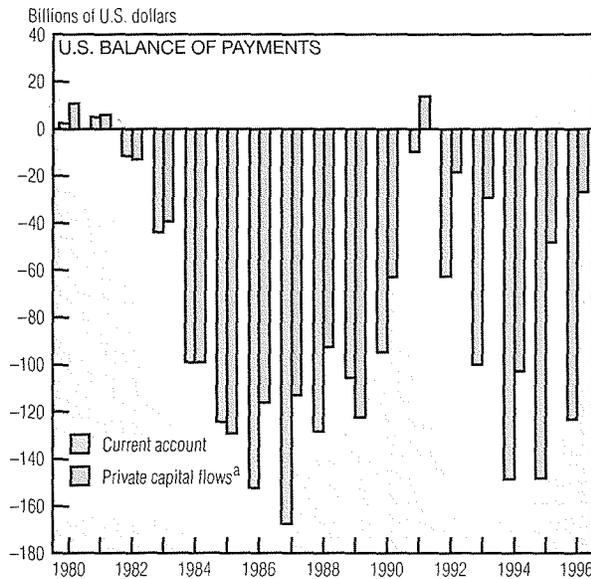
Although the leverage ratio rose slightly, equity as a percentage of assets climbed to its highest level in half a century. As a ratio of the book value of debt to the book value of assets, the leverage ratio does not directly reflect either the market's evaluation of the quality of bank assets or the likelihood that bank debt will be repaid.

Bank profitability remains sound despite a decline of 4.8% relative to one year ago. Virtually all of the downturn was related to the requirement that the industry con-

tribute \$1 billion toward recapitalizing the Savings Association Insurance Fund (SAIF). Commercial banks hold more than 10% of the deposits insured by the SAIF.

As a signal of the soundness of the banking industry, the FDIC announced that the 94% of banks in the lowest risk category will no longer be required to pay premiums for maintaining the Bank Insurance Fund (BIF). Furthermore, banks with SAIF-insured deposits will no longer have to pay higher premiums now that the SAIF is fully capitalized.

Official Foreign Capital Flows



a. Private capital flows have signs reversed and include the statistical discrepancy as unrecorded capital flows. Positive values represent a capital inflow.
 b. Positive values represent a capital inflow.
 c. Latest data are for October 1996, except for the U.K. and Singapore (September) and Indonesia (August). Columns show change from December 1995. Numbers above each column are total reserves in billions of U.S. dollars.
 d. Latest observation is October 1996.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

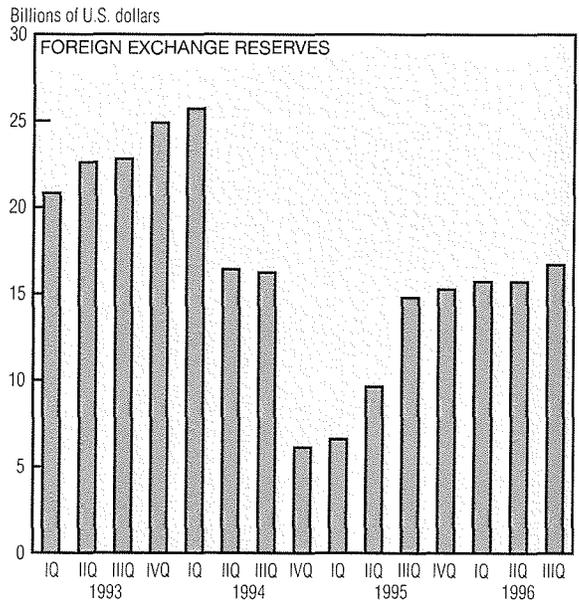
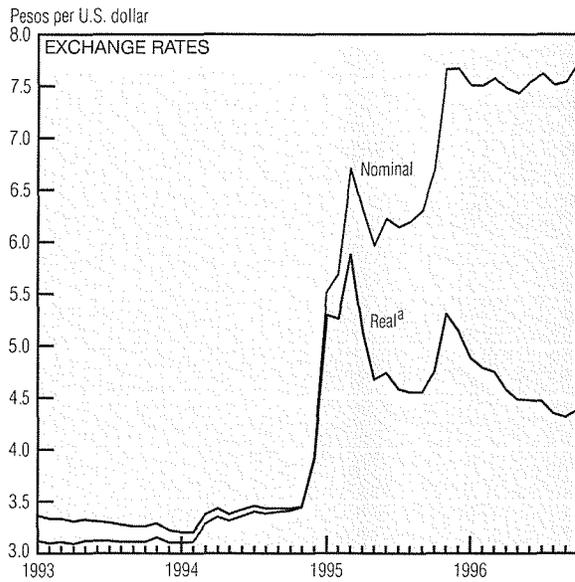
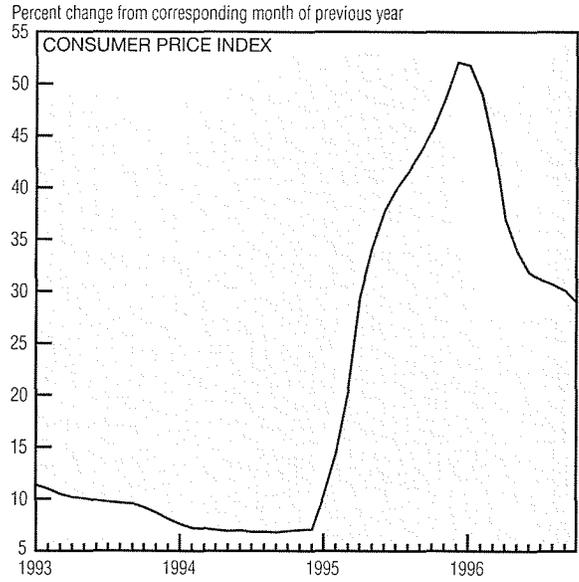
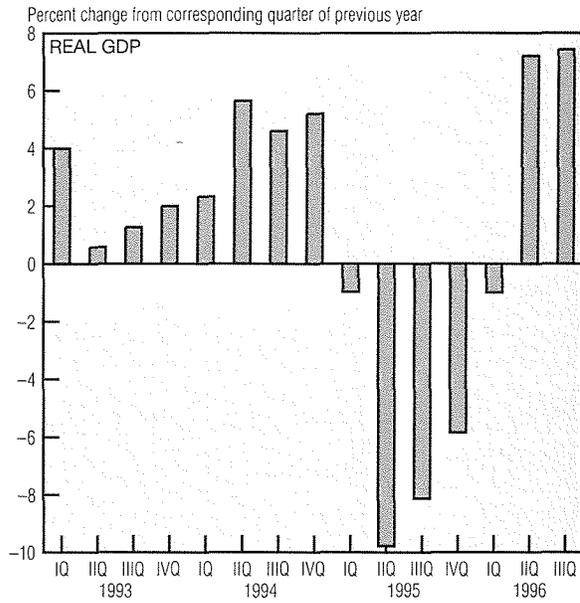
Over the first three quarters of 1996, the U.S. current account deficit grew at a \$123 billion annual rate, somewhat slower than in the previous two years. Official and private capital inflows of \$96 billion and \$27 billion, respectively, have financed this deficit. Since 1991, net official capital inflows have accounted for a growing share of our tap on the world's savings, as foreign governments and official agencies have acquired dollar-denominated assets.

Separate data on countries' holdings of international reserves show that Japan and China have greatly increased their portfolios. Although these data include assets denominated in other currencies, much of the increase probably represents dollars, since both countries maintain trade surpluses with the U.S.

Countries' current and capital account balances must exactly offset each other. Changes in economic variables, primarily exchange rates, interest rates, and prices, automati-

cally correct any divergence between the two accounts. International reserves, however, can provide countries with a bit of a buffer against sharp adjustments. When a surplus country (like Japan) acquires dollars, its money stock grows, other things being equal. An unexpected monetary expansion can check a currency appreciation, but because it also promotes inflation, monetary ease cannot indefinitely secure a current account surplus.

The Mexican Economy



a. The real exchange rate is calculated using consumer prices for both the U.S. and Mexico. The base period is November 1994.
 SOURCES: Banco de Mexico; and International Monetary Fund, *International Financial Statistics*.

Two years after the disruptive peso depreciation, the outlook for Mexico is brightening. Our NAFTA partner has regained access to international capital markets and can now repay its creditors. Of continuing concern, however, are uncertainties associated with real currency appreciation and with the fragility of the banking sector.

After declining sharply in 1995, real economic activity has rebounded. Much of the growth has

been in the export and investment sectors; consumer spending remains weak. Inflation moderated from an annual rate of 52% in late 1995 to approximately 28% last November.

Mexico's relatively high inflation rate vis-à-vis the U.S. has eroded much, but not all, of the price advantage that the peso depreciation conferred on Mexican goods. That the nominal exchange rate remains fairly stable despite continuing price

differentials attests to growing confidence in Mexican monetary policy, which has remained contractionary. Foreign capital inflows are returning, and Mexico's international foreign currency reserves, when valued at current exchange rates, exceed its monetary base. The quality of bank assets, however, remains poor despite efforts at financial reorganization and attempts to boost liquidity and improve capital.