The Economy in Perspective

My dinner with André ... I really didn't mind that my friend was already 25 minutes late, or that the restaurant he had chosen was in a desolate section of the city. André is consistently 30 minutes behind schedule, and his taste in dining is impeccable. What worried me was the newspaper coverage: Despite his brilliance and charm, I was concerned that he had finally bitten off more than he could chew. According to published reports, André, the economic minister of Nedlaw, had come to lecture U.S. leaders on how to create jobs. How preposterous! With employment expanding so rapidly and our jobless rate at a 25-year low, what's left to say?

I heard the sirens and knew from their intensity that André would arrive in moments. But imagine my surprise when he turned the corner in a rickshaw pulled by a trio of gasping Nedlawnians! Alighting with characteristic grace, he motioned me inside the restaurant, The Sweaty Brow.

"André," I asked, "what's with the rickshaw?"

"Oh that," he said, as he scanned the menu for appetizers. "By traveling like that, I demonstrate how easy it is to create jobs. A cab would have required only one person's labor; the rickshaw needs three!"

I understood instantly. Always the showman, he knew how dramatic his entrance would be.

"Nice touch," I said, with a trace of envy. "Where did you find the rickshaw?"

"Brought it with me on the steamer. Rickshaws and bicycles have become the dominant modes of transportation since I restricted the use of motor vehicles in Nedlaw. By the way, I picked this restaurant because everything is so authentic. I hope you can spare about six hours for dinner."

"André," I asked, "I know that since becoming economic minister, you've been emphasizing jobs, but why restrict the use of cars and trucks? They are so much more productive than human-powered transport."

"I take the direct approach," he replied, "and it works. Everyone in Nedlaw is employed, and I'm proud to say that they work long hours! Pass me the mortar and pestle, would you? I'd like to start on that pesto."

"How do you create jobs?" I asked suspiciously. "Do you just put people to work for the government?"

"Absolutely not!" he protested. "That tactic is passé. We look for opportunities to protect jobs from being lost and for attracting others. For example, your agricultural industries are extremely productive, but you have hardly any farmers left. I've even read that some of your people worry about farmland being turned into housing developments and shopping centers. We don't have those problems in Nedlaw because farming makes up about 20 percent of employment, compared to your 2 percent. Nedlaw's government keeps agriculture attractive by paying farmers high—but fair—prices for their output. The program is so successful that it employs all the Nedlawnians who used to make and service cars!"

"But how can you afford to subsidize so many farmers?" I asked.

"We collect funds through a payroll deduction program called Jobs 4 All," said André. "Hey, I'll trade you that potato ricer for this shrimp deveiner. Speaking of trade, here's an example of being alert to its dangers: Our neighboring country, Sergorp, wanted to create a free-trade zone with Nedlaw. But we were afraid that policy would put many of our farms out of business, so we declined. We saved tons of jobs!"

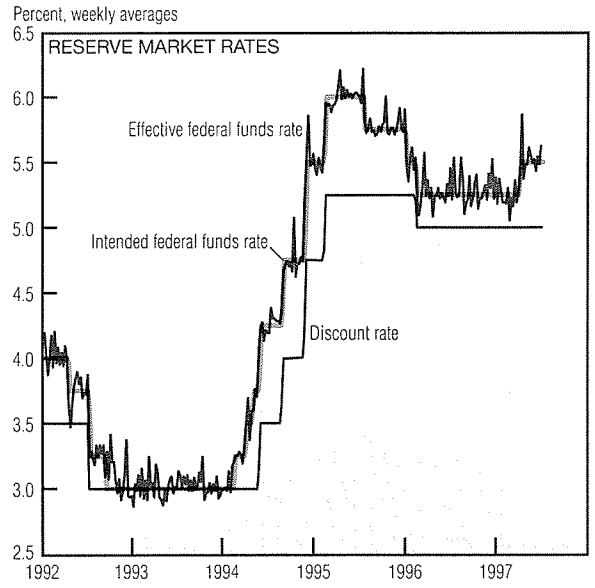
"Wouldn't Nedlaw have benefited in any way from more trade?" I wondered.

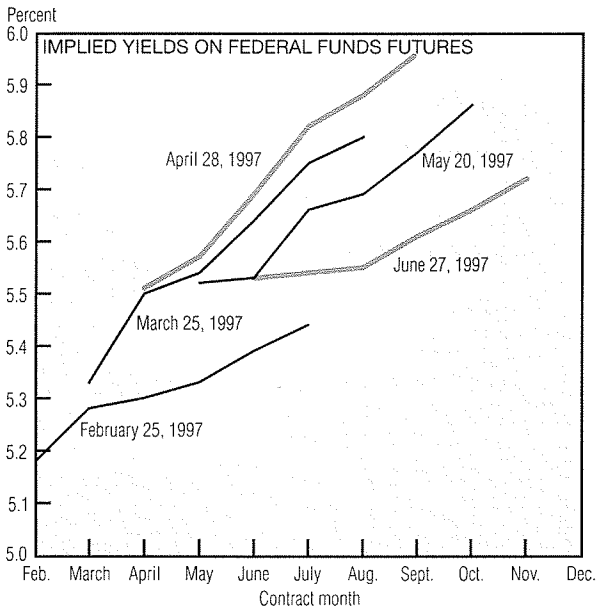
"Theoretically yes," my friend sighed. "We are sure that companies in Sergorp would have had to buy construction equipment, engineering know-how, and architectural services from Nedlaw. But you're missing the point. We don't know who would get those jobs, but we do know all the farmers. Besides, the people who can produce what the Sergorpians want already have jobs. In fact, they're the highest-paid workers in Nedlaw! They're much too busy to satisfy any more Sergorpian needs."

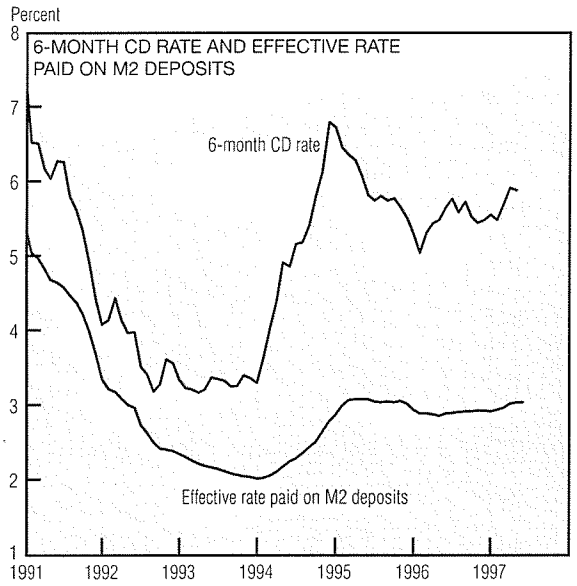
"André," I cried, "I hope you can make our leaders see the light. We are so backward that we only pay attention to productivity, thinking good jobs and economic growth will follow. Tell me, what will your next initiative be?"

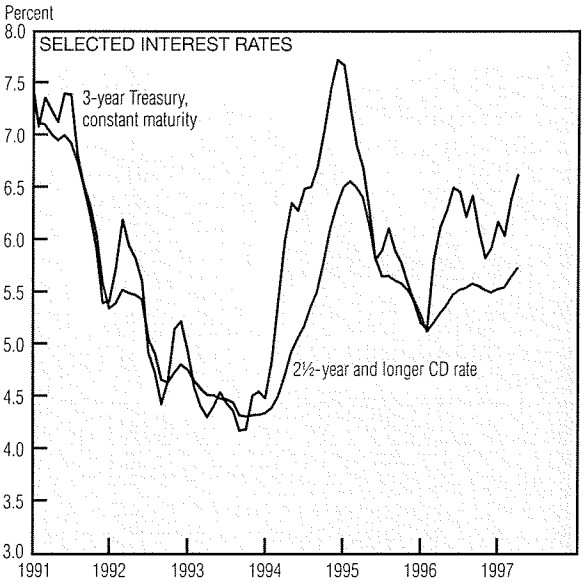
Moving away from the hearth where he had been turning the spit, he mopped his forehead. "Next," he exclaimed triumphantly, "I will raise Nedlaw's standard of living. Why must I come to your country for a dining experience like this?"

Monetary Policy









SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

It has been more than three months since the Federal Open Market Committee (FOMC) raised the intended federal funds rate from 5¼% to 5½%. This rate hike was the first policy move in 14 months and the first increase in more than two years. By taking this action, the FOMC served notice that it stood ready to address incipient inflationary pressures.

In announcing the rate increase, the Committee stated that "... the slight firming of monetary conditions is viewed as a prudent step that affords greater assurance of prolonging the current economic expansion by sustaining the existing low inflation environment through the rest of this year and next. The experience of the last several years has reinforced the conviction that low inflation is essential to realizing the economy's fullest growth potential."

The policy move was no surprise to financial markets. The federal funds futures market, for instance, had come to anticipate the rate increase in the weeks before the meeting. In the period immediately following the Fed's action, futures prices revealed that investors were expecting another rate hike by midyear. Since then, however, the inflation news has been favorable, and futures prices currently suggest that no imminent policy move is anticipated.

Money market interest rates rose in concert with the increased federal funds rate. Because the interest rate paid on bank deposits tends to respond slowly to changes in market rates, the opportunity cost of deposits (the interest forgone on holding deposits compared with a market alternative) has risen. For example, the 3-year Treasury note

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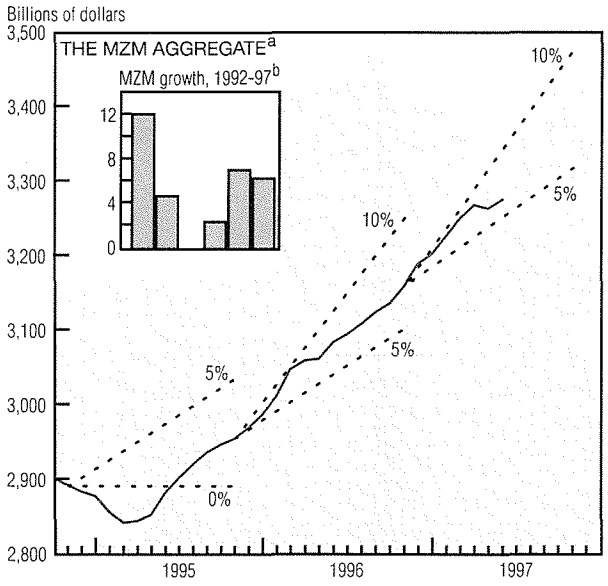
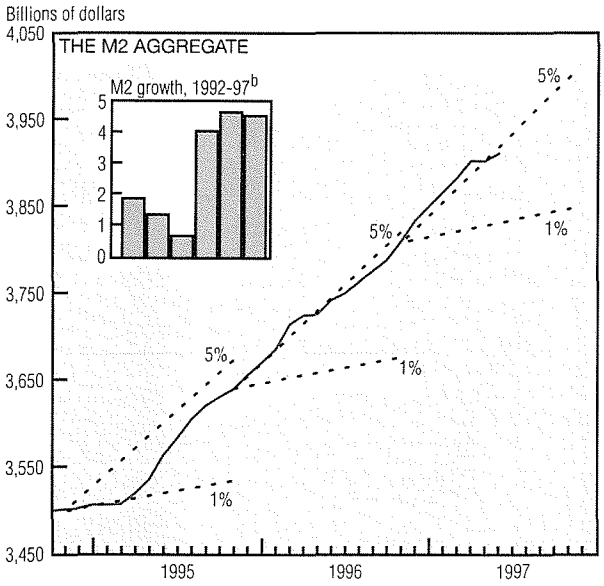
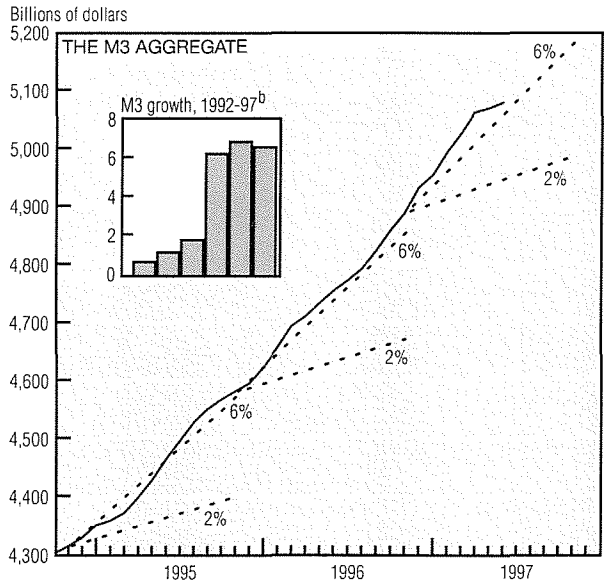
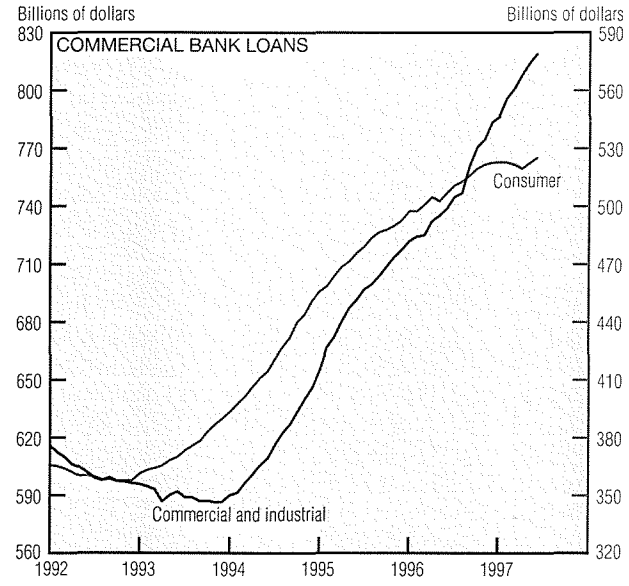
Monetary Policy (cont.)









a. MZM is an alternative measure of money that is equal to M2 plus institutional money market funds less small time deposits.
b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated June over 1996:IVQ basis.
NOTE: All data are seasonally adjusted. Last plot is estimated for June 1997. For MZM, dotted lines represent growth ranges and are for reference only. All other dotted lines are FOMC-determined provisional ranges.
SOURCE: Board of Governors of the Federal Reserve System.

now yields almost 100 basis points more than a deposit of comparable term. The spread between the 6-month Treasury bill and the share-weighted average of rates paid on M2 deposits also widened substantially.

The higher opportunity cost of deposits reduces their attractiveness relative to market alternatives. Thus, the rise in opportunity cost has been associated with a slowdown in the growth rate of all the monetary aggregates. Early this year, M2 exceeded the 5% upper bound of its FOMC-determined provisional range. In May, M2 decelerated and now stands within the specified range. The MZM aggregate, which had been expanding at nearly a 9% pace in the first few months of the year, declined in May and is expected to follow a flatter trajectory over the balance of 1997.

The recent deceleration in M2 and MZM reflects more than the increase in their opportunity costs. The unexpected strength in economic activity led to larger-than-expected tax payments, which were accumulated in bank deposits. As payments cleared in May, the bulge in the aggregates dissipated.

Banks continue to find robust demand for commercial and industrial loans. To a great extent, these loans have been financed with negotiable CDs, which are included in M3 but not in M2. Hence, M3 continues to expand more rapidly than M2 and remains above the upper bound of its specified range.

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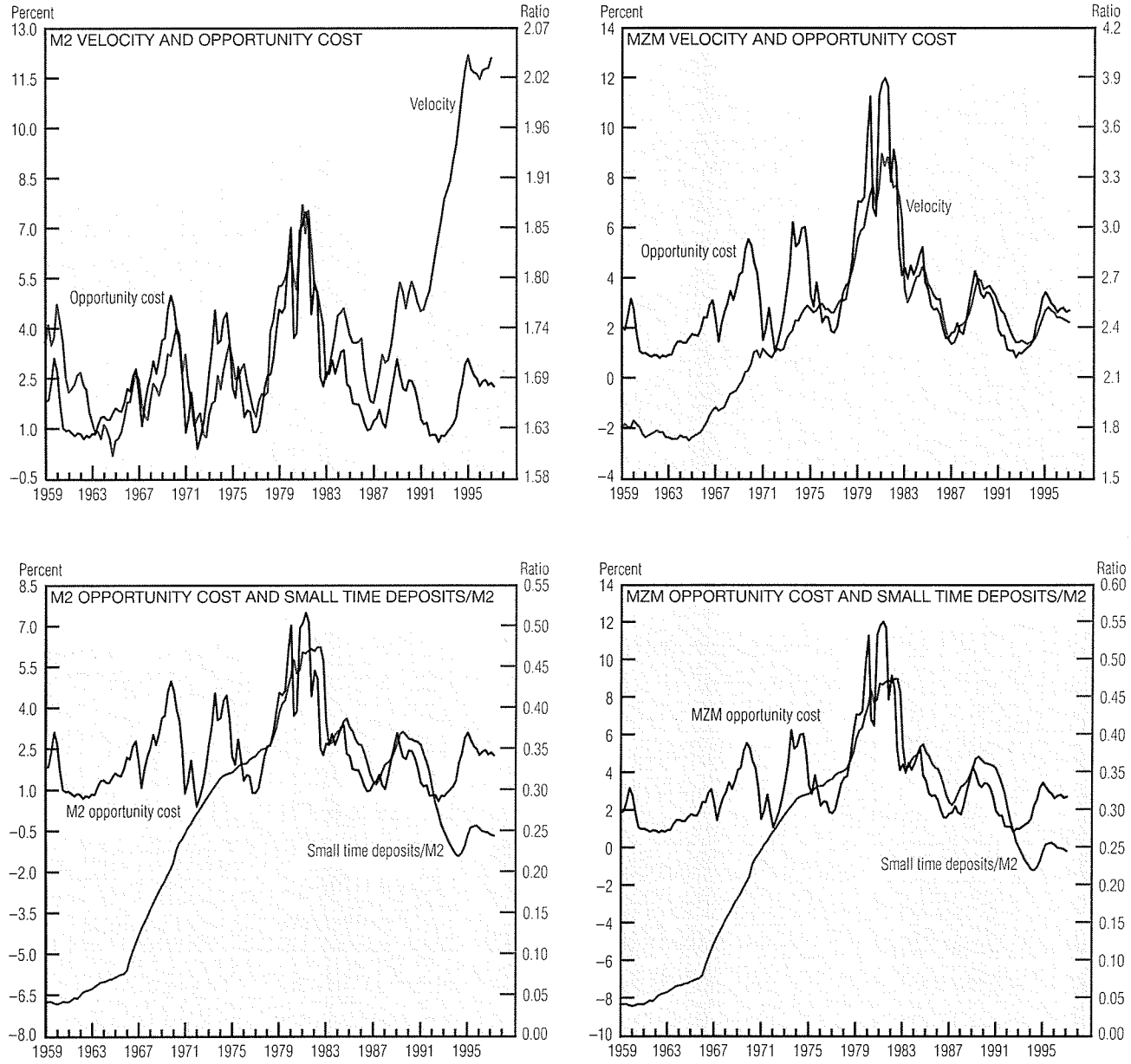
Monetary Policy (cont.)



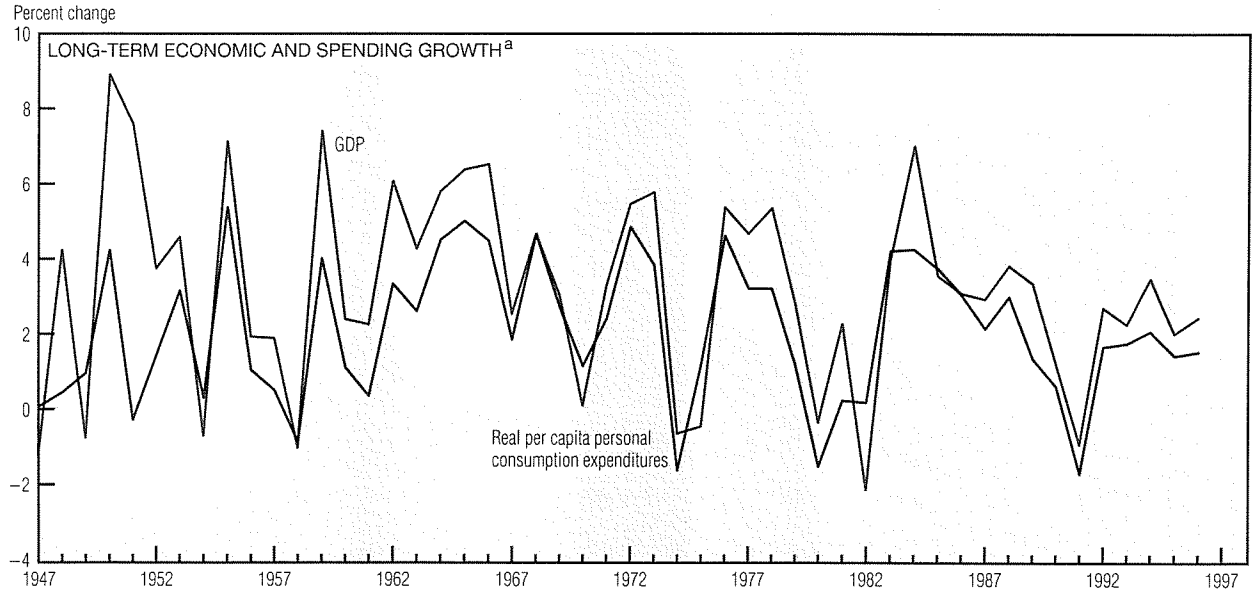
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

Since July 1993, the FOMC has not paid a great deal of attention to the growth rate of the monetary aggregates. At that time, M2 was downgraded as a reliable indicator of monetary policy. The breakdown in its relationship with economic activity is reflected in a change in the relationship between M2 velocity—the ratio of GDP to M2—and its opportunity cost. Before 1990, M2 velocity tended to vary directly with opportunity cost. In 1990, however, velocity jumped sharply despite a fall in opportunity cost.

The discrepancy was largely concentrated in small time deposits, which plummeted as a share of M2. Balance holders transferred a large share of their funds to stock and bond mutual funds, which expanded markedly over this period. Since about 1994, however, the old relationship has begun to reemerge. M2 velocity again varies directly with opportunity cost, but around a much higher average level.

MZM does not include time deposits. Thus, MZM velocity was unaffected by the shift from small time deposits to stock and bond funds, as is evident in the relationship between the aggregate's velocity and its opportunity cost. Prior to 1975, however, velocity grew rapidly as funds were transferred from savings deposits to small time deposits, which *are* included in M2. The consequent shift in MZM velocity stabilized and has remained intact for more than 20 years.

Real GDP: Trend and Cycles



Economic Expansions

Trough to peak	Number of quarters	Average annual growth rate
1949:IVQ–1953:IIQ	14	7.5
1954:IIQ–1957:IIIQ	13	3.9
1958:IQ–1960:IQ	8	6.4
1960:IVQ–1969:IIIQ	35	4.9
1970:IVQ–1973:IVQ	12	5.2
1975:IQ–1980:IQ	20	4.2
1980:IIIQ–1981:IIIQ	4	4.2
1982:IIIQ–1990:IIQ	31	3.8
1991:IQ–1997:IQ	24	2.7

Economic Contractions

Peak to trough	Number of quarters	Average annual growth rate
1948:IIIQ–1949:IVQ	5	−1.2
1953:IIQ–1954:IIQ	4	−2.6
1957:IIIQ–1958:IQ	2	−7.6
1960:IQ–1960:IVQ	3	−2.4
1969:IIIQ–1970:IVQ	5	−0.5
1973:IVQ–1975:IQ	5	−3.0
1980:IQ–1980:IIIQ	2	−4.9
1981:IIIQ–1982:IIIQ	4	−3.0
1990:IIQ–1991:IQ	3	−2.7

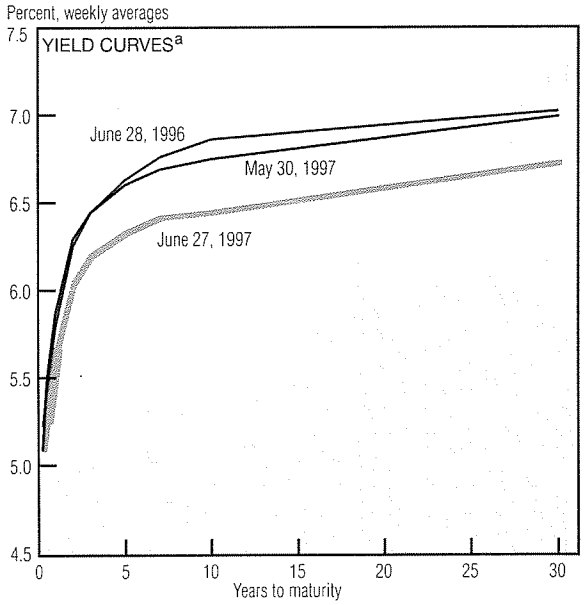
a. Chain-type quantity index; 1992 = 100.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

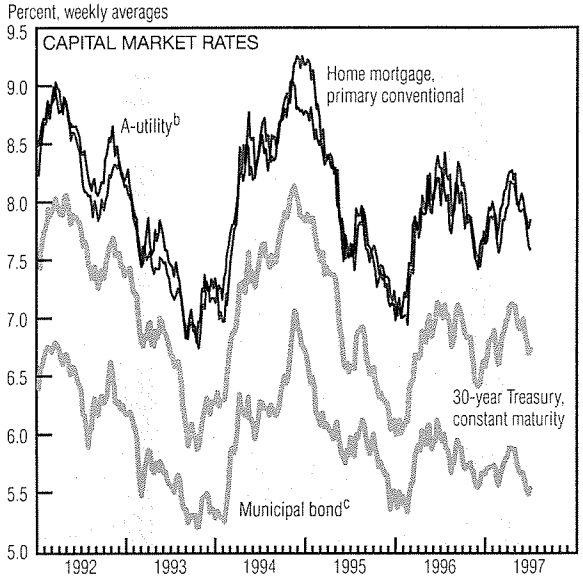
History is the standard (a tenuous one at best) by which we often measure current macroeconomic performance. According to the Commerce Department's recently released output indexes, long-term growth in the U.S. slowed from an average annual rate of 4.2% between 1950 and 1973 to 2.5% between 1974 and 1996. Growth in our standard of living, measured in terms of real per capita personal consumption expenditures, also decelerated, from 2.6% per year to 1.9% over the same time frames.

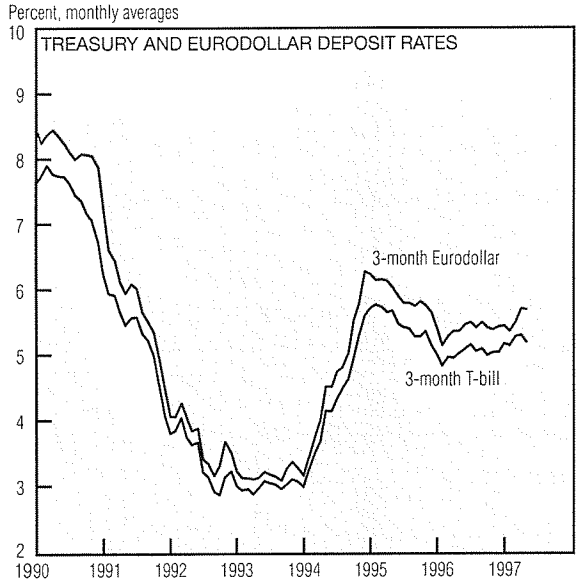
The composition of GDP has changed as well. In 1952, for example, exports and imports each accounted for slightly more than 4% of total output. By 1996, those shares had risen to 12.0% and 13.6%, respectively. Although personal consumption expenditures have remained a fairly constant two-thirds of GDP since 1952, the fraction of that spending devoted to services has ballooned from one-third to more than one-half.

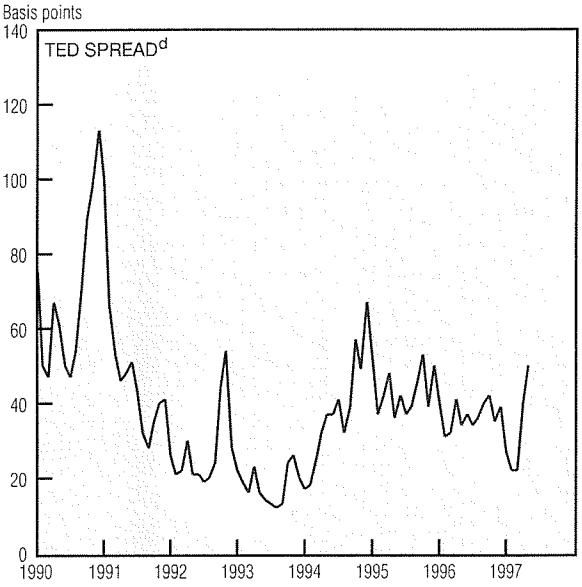
The U.S. has experienced nine economic downturns since 1948. Although differing substantially in depth and duration, these contractions have averaged nearly four quarters, with a 3.1% annual output loss. The correlation between the duration of a contraction and the accompanying output loss suggests that mild downturns are generally longer lived. Expansions last longer than recessions—almost 18 quarters on average—with an average annual growth rate of 4.8%. Long recoveries appear to proceed more slowly.

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. The TED spread is the 3-month Eurodollar rate minus the 3-month Treasury bill rate.
SOURCE: Board of Governors of the Federal Reserve System.

The yield curve has flattened noticeably since last month. Although rates have fallen at all maturities, longer rates have dropped more, tightening up spreads. The 3-year, 3-month spread declined from 135 to 110 basis points, and the important 10-year, 3-month spread fell even further, from 166 to 135 basis points.

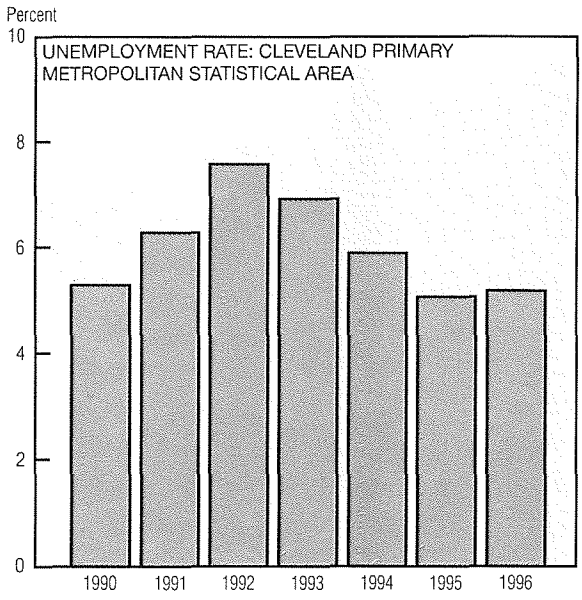
Longer-term capital market rates have also headed down, with mortgage, utility, and 30-year Treasury bond rates all falling roughly 30 basis points and narrowing their spreads against municipal bonds. One possible explanation for the decline in long rates is reduced inflation expectations, but lower long-term real rates could also be caused by decreased uncertainty about future economic growth.

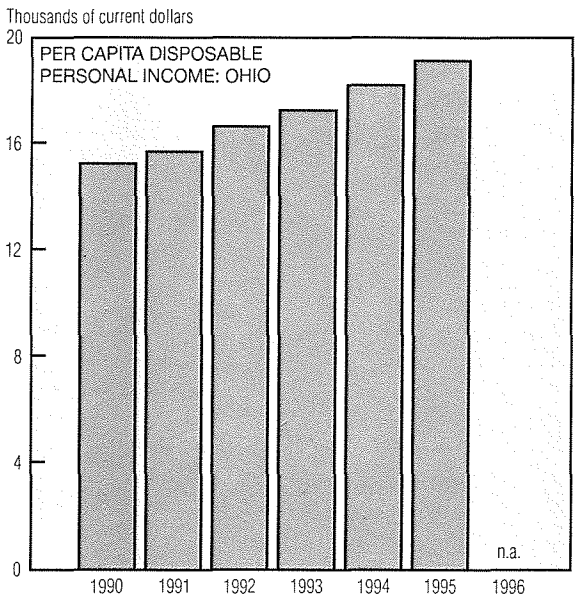
In addition to term spreads, or differences in the yields on bonds of different maturities, investors and market analysts also watch risk spreads, or differences between bonds with different risks. One of the most closely watched risk spreads is between Treasury and Eurodollar rates, known as the TED spread. Part of this measure's attractiveness is that it reflects risk and uncertainty about overseas deposits without the complication of exchange rate risk. A casual glance suggests that Treasury and Eurodollar rates track each other closely, but a more thorough examination of the data reveals an active spread. (Note, for instance, the large spike around the onset of the Gulf War.) The TED spread has been widening in 1997, perhaps reflecting the international financial uncertainty caused by disputes over the introduction of the Euro or the transfer of Hong Kong to Chinese rule.

Mortgage Lending in Cleveland

Conventional Home Loan Denial Rates by Race:
Cleveland–Lorain–Elyria Primary Metropolitan Statistical Area
(Percent of applications denied, by racial category)

	1990	1991	1992	1993	1994	1995
American Indian/Native Alaskan	11.46	8.43	13.58	11.59	9.02	13.74
Asian or Pacific Islander	8.59	10.12	6.06	4.56	5.18	4.96
Black	28.05	26.33	24.46	20.06	18.01	15.91
Hispanic	24.16	18.32	20.28	16.83	11.13	12.10
White	7.66	8.04	7.68	6.29	6.62	7.51





SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Financial Institutions Examination Council.

Since the early 1990s, tremendous strides have been made in improving minority access to mortgage credit. Based on data made available through the Home Mortgage Disclosure Act (HMDA), raw denial rates of black and Hispanic mortgage applicants in the Cleveland area were nearly halved between 1990 and 1995, the latest year for which data are available.

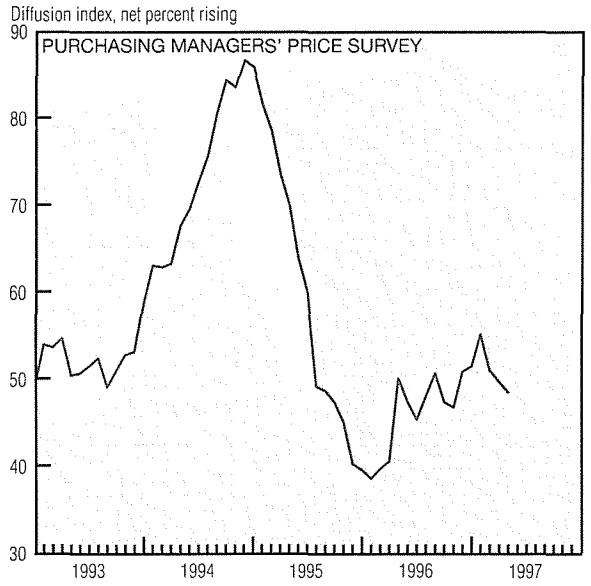
Of course, these raw denial rate disparities tell only part of the story. A lender's decision to accept or reject a loan depends on many factors not included in the HMDA data, several of which are correlated with race. Thus, while the HMDA figures do indicate that rather substantial (albeit smaller) denial rate disparities still exist, they cannot tell us whether these disparities are the result of legitimate differences in creditworthiness across racial groups.

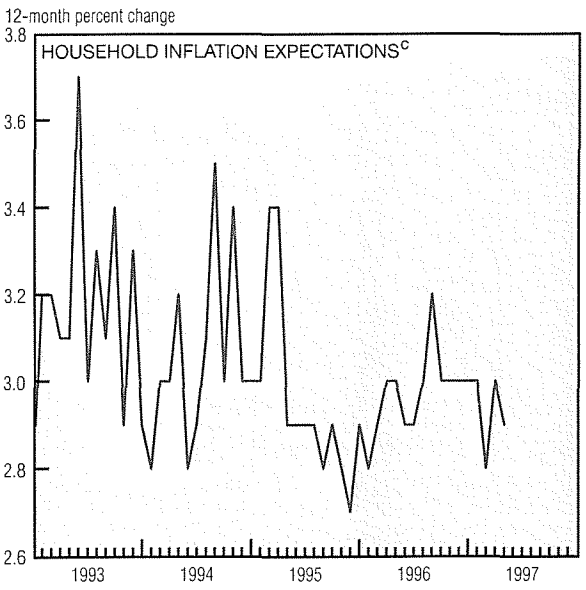
Perhaps the most important factor behind minorities' increased access to mortgage credit has been the health of the overall Cleveland economy in the last several years. Since the beginning of the decade, Ohio residents' per capita disposable personal income has risen approximately 25%, to $19,123, while Cleveland unemployment rates have settled near 5%. At the same time, mortgage interest rates have fallen dramatically, from above 10% in 1990 to below 8% over the last few years. Both of these trends have contributed to making home loans more affordable for those who were previously squeezed out of the market.

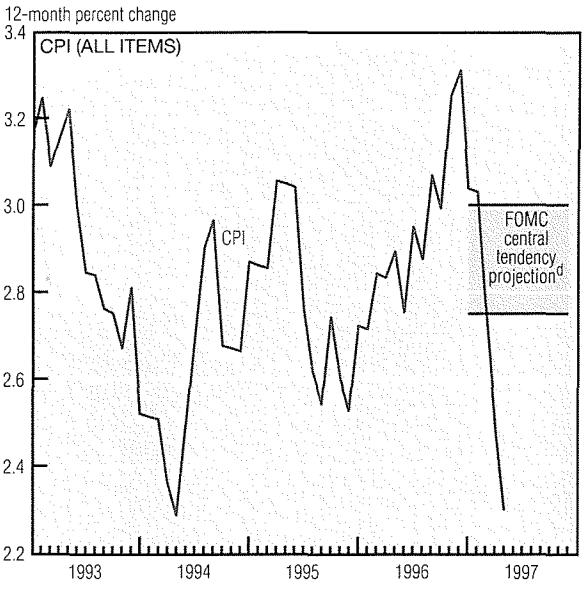
Inflation and Prices

May Price Statistics

	Annualized percent change, last:				1996
	1 mo.	5 mo.	12 mo.	5 yr.	avg.
Consumer Prices					
All items	0.8	1.4	2.3	2.7	3.3
Less food and energy	2.1	2.6	2.5	2.9	2.6
Median[a]	3.1	3.0	2.7	2.9	2.7
Producer Prices					
Finished goods	−3.6	−3.9	0.3	1.3	2.9
Less food and energy	−3.3	−0.5	0.1	1.1	0.6
Commodity futures prices[b]	32.5	8.0	−2.9	3.8	−0.7







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. Median expected 12-month change in consumer prices as measured by the University of Michigan's Survey of Consumers.
d. 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 University of Michigan; and the Commodity Research Bureau.

May marked the third consecutive month that the Consumer Price Index (CPI) rose at an annual rate of just 0.8%, bringing the year-to-date average increase to 1.4%. Over the first five months of the year, the CPI is tracking almost 2 percentage points below its 1996 average. However, other measures of retail price movements have been substantially higher. The CPI less food and energy goods is up 2.6% for the year, and the median CPI has increased 3.0%—approximately the same rates as last year.

Price behavior at the wholesale level has been even more subdued than the CPI. The Producer Price Index (PPI) declined at a 3.9% annual rate during the first five months of 1997, following a 2.9% increase in 1996. Even excluding food and energy goods, wholesale prices are down 0.5% since last December.

Survey data show the same basic patterns. The University of Michigan's survey of households indicates that consumers expect retail prices to jump about 3% over the next 12 months, roughly the same increase they were projecting at this time last year and not much different from the current trend in the "core" retail price measures. What's more, households see inflation holding steady at this rate over the next five to 10 years.

On the other hand, reports from purchasing managers continue to reveal little upward pressure on industrial prices. The National Association of Purchasing Management's price index has been hovering around the 50 mark for most of the past year,

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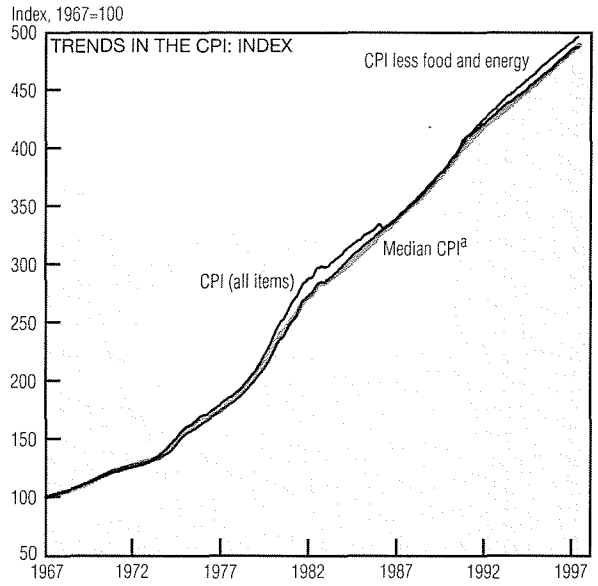
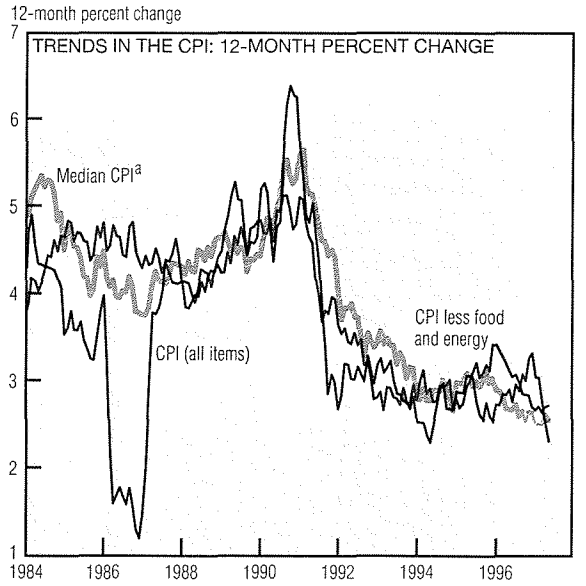
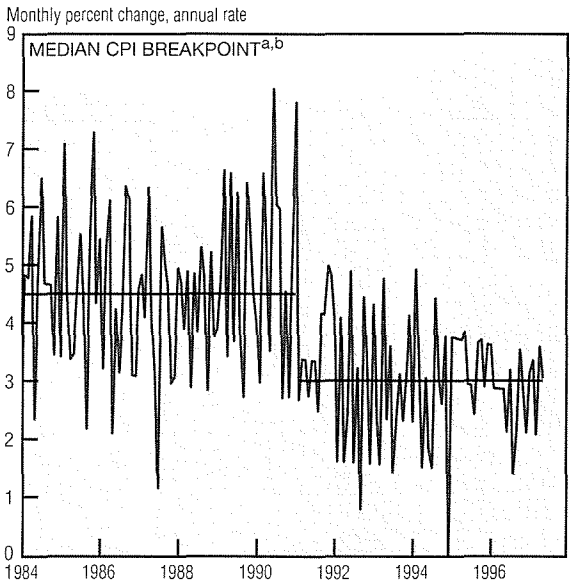
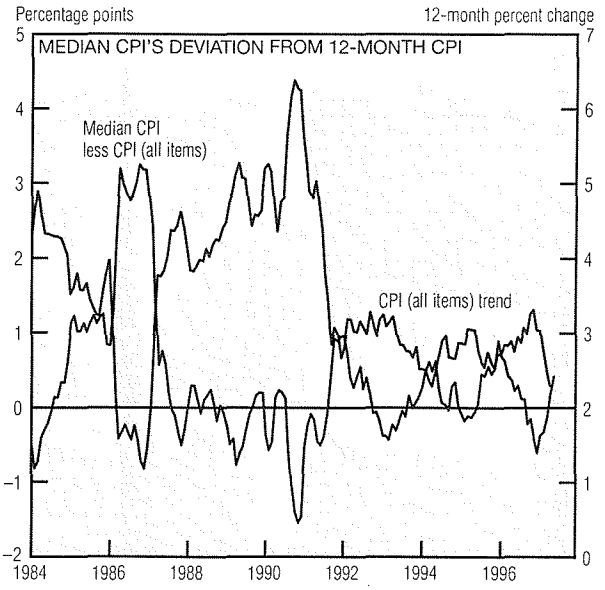
Inflation and Prices (cont.)









a. Calculated by the Federal Reserve Bank of Cleveland.
b. Horizontal lines represent trends.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

indicating that roughly the same percentage of buyers are reporting higher prices as lower ones.

This year's CPI performance has come as a bit of a surprise to inflation forecasters, including the Federal Reserve. The recent 12-month trend increase in the index, at only 2.3%, is almost ½ percentage point below the bottom end of the 1997 range projected by the Federal Open Market Committee (FOMC) in February. A key question facing the FOMC is whether this year's unexpectedly low CPI increase is the beginning of a new, lower inflation trend, or merely a transitory dip in the data that will ultimately turn upward again.

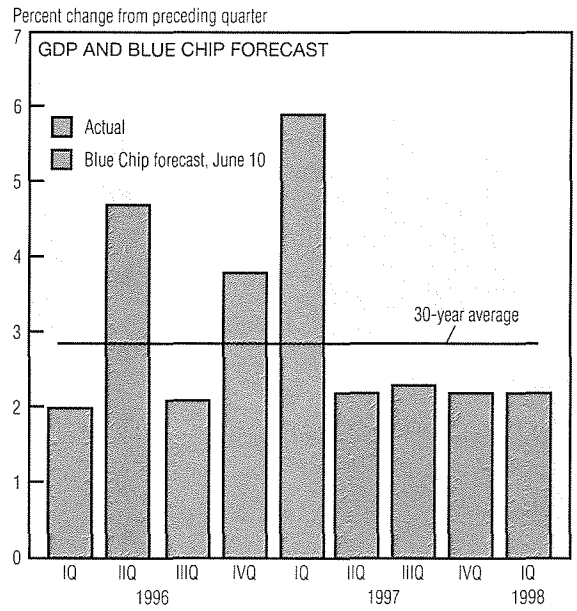
This is exactly the question that the "core" inflation statistics are designed to address. For example, the median CPI is constructed to follow the same trend as the CPI over long periods, although at any particular moment it should reveal a more accurate—and more stable—reading of the inflation trend.

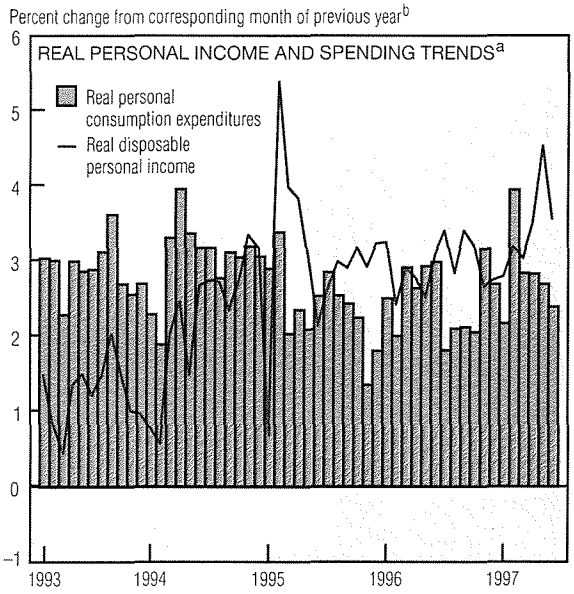
Consider the most recent 12-month period. The rise in the median CPI since last year has exceeded the downward-moving CPI by 0.4 percentage point. In fact, the median measure appears to have been following a nearly steady 3% growth trend since early 1991. In light of this divergence—and considering that over long horizons these two indexes tend to follow the same path—is it more likely that the CPI will accelerate or that the median CPI will fall? Historical experience favors the former. In 1987, 1992, 1994, and 1996—four recent episodes when the CPI fell relative to the median CPI—the CPI tended to accelerate over the subsequent 12-month period.

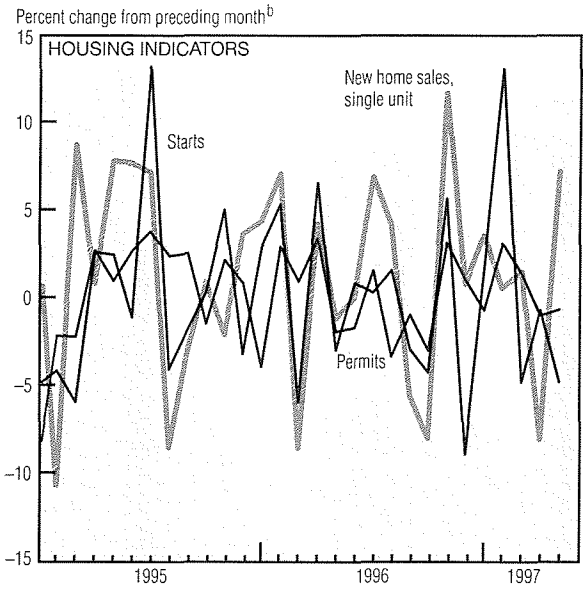
Economic Activity

Real GDP and Components, 1997:IQ[a]
(Final estimate, s.a.a.r.[b])

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	101.1	5.9	4.1
Consumer spending	65.5	5.7	3.2
Durables	27.3	18.8	7.9
Nondurables	16.3	4.6	2.0
Services	22.6	3.4	2.8
Business fixed investment	21.0	11.0	9.3
Equipment	18.0	12.7	9.6
Structures	3.2	6.6	8.8
Residential investment	4.5	6.7	3.7
Government spending	0.4	0.1	1.5
National defense	−8.2	−10.2	−3.4
Net exports	−22.3	—	—
Exports	22.4	10.8	9.7
Imports	44.7	19.9	10.5
Change in business inventories	31.5	—	—







a. Chain-weighted data in billions of 1992 dollars.
b. Seasonally adjusted annual rate.
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and *Blue Chip Economic Indicators,* June 10, 1997.

The economy shot up 5.9% in the first quarter, according to the Commerce Department's final appraisal. The slight uptick from the previous estimate resulted from weaker-than-expected growth in imports. The exceptional first-quarter performance—the best in nine years—reflected advances in personal consumption, inventory accumulation, exports, and producers' durable equipment.

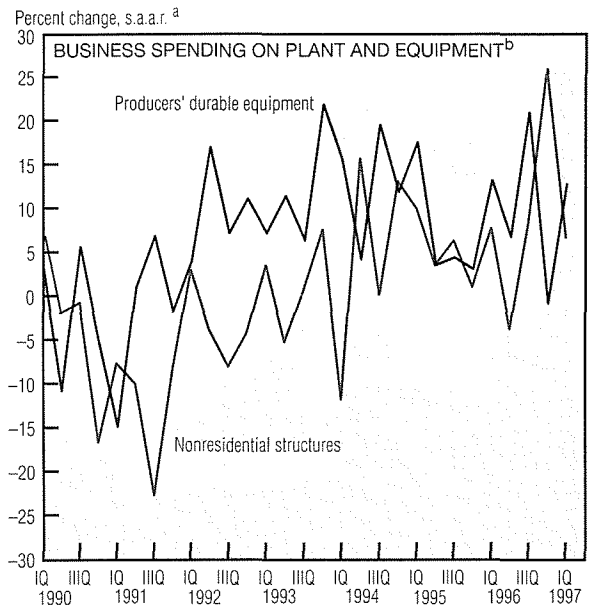
Economists participating in the June 10 Blue Chip survey expect the expansion to ease back into a pace more consistent with the economy's underlying growth potential. They foresee real GDP expanding 2.3% in the current quarter and throughout the remainder of 1997, then tapering off to 2.0% by the last half of 1998.

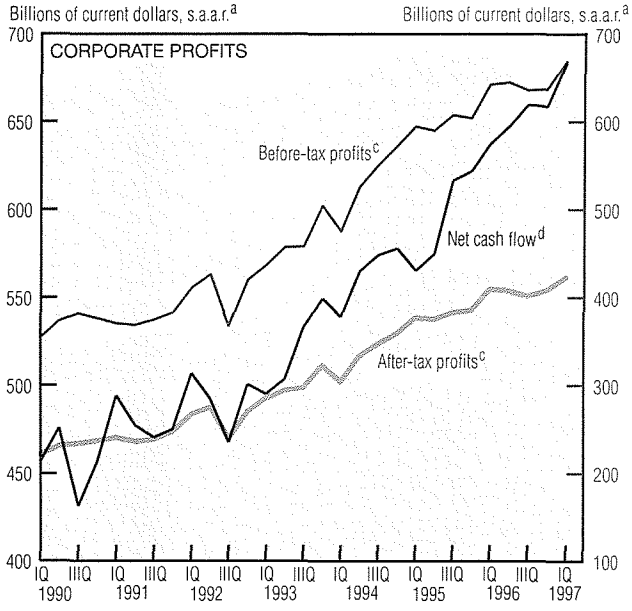
Forecasters believe that consumers will tighten their belts somewhat in the current quarter. (Consumer spending typically accounts for about two-thirds of GDP.) During April and May, real personal consumption expenditures rose at a 2.3% annual rate—somewhat off the first-quarter pace, but still relatively strong. Growth in real disposable personal income remains solid, although it also ratcheted down a bit in May.

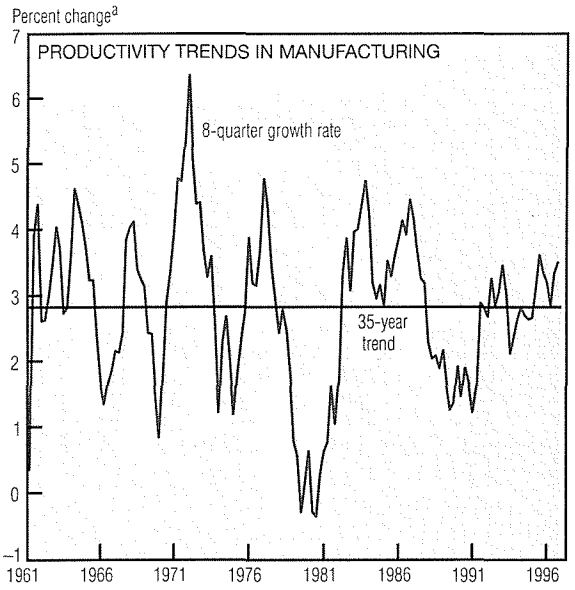
Month-to-month changes in standard housing indicators usually contain more noise than information, and individual series often move in opposite directions. May's 4.8% decline in housing starts is not particularly noteworthy when compared with the recent behavior of this index, but it did mark the third consecutive monthly decline. While an extended drop in starts is not unprecedented in an expansion, it is relatively rare. Nevertheless, both

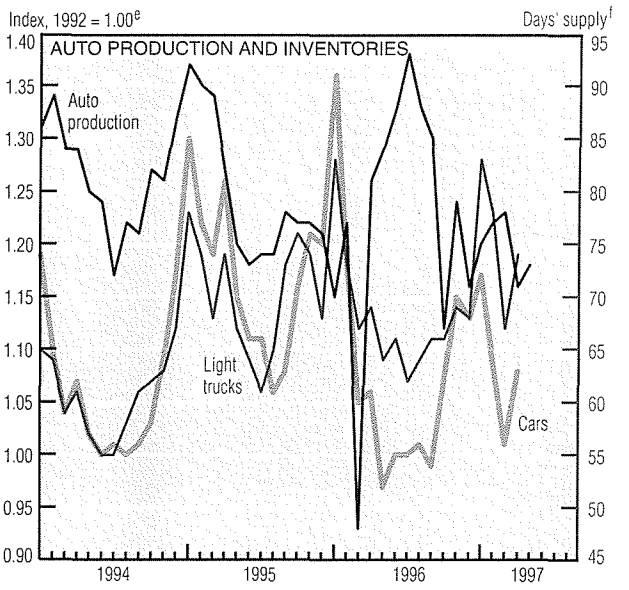
(continued on next page)

Economic Activity (cont.)









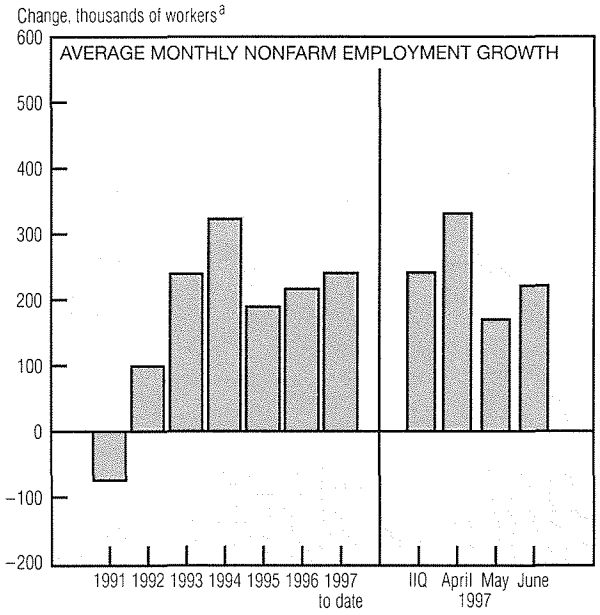
a. Seasonally adjusted annual rate.
b. Chain-weighted data in 1992 dollars, seasonally adjusted.
c. Excludes inventory valuation adjustment.
d. Includes inventory valuation and capital consumption adjustment.
e. Seasonally adjusted.
f. U.S. dealers' current stock as a share of daily average sales (includes domestic and imported vehicles).
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and *Ward's Automotive Reports*.

building permits and starts remain at relatively high levels, and anecdotal evidence suggests that the housing sector remains strong. Builders report that new home sales are rising, mortgage applications continue to stream in, and consumers' attitudes about home buying are widely characterized as upbeat.

Business fixed investment, particularly for computers and other information equipment, has increased at a rapid clip throughout the current expansion. More recently, investment in nonresidential structures also seems to have fallen in line. Business investment helps boost worker productivity, which is necessary if workers are to see their real wages rise. Moreover, productivity advances are an important source of long-term economic growth. Since 1991, productivity gains in the manufacturing sector have accelerated. In fact, they have exceeded their 35-year trend since 1995. The continued strong performance of corporate profits, relatively high levels of capacity utilization, low interest rates, and the booming stock market all bode well for continued strength in plant and equipment spending.

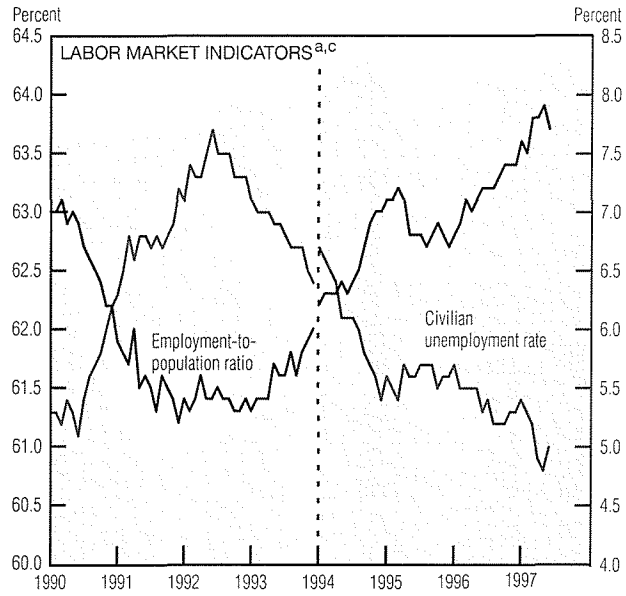
Production of motor vehicles and parts rebounded somewhat in May, as the strike against Chrysler ended. Although inventories of cars and light trucks increased sharply in April, they do not appear to be at unusually high levels.

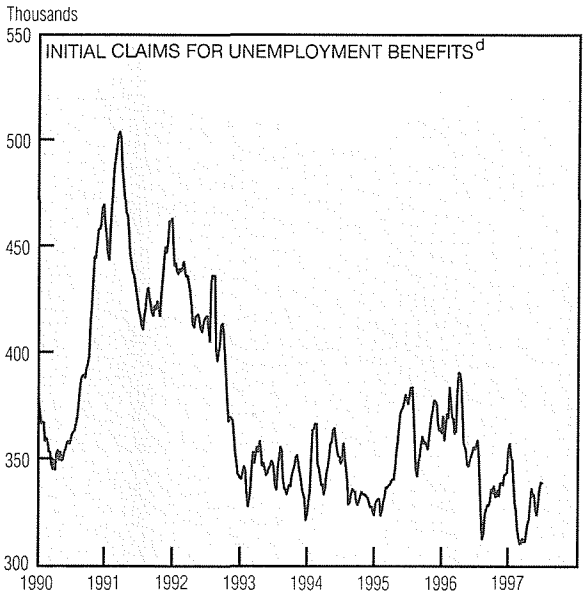
Labor Markets



Labor Market Conditions[a]
(Seasonally adjusted)

	Average monthly change (thousands of employees)				
	1996	1997			
	Year	IIQ	April	May	June
Payroll employment	212	237	327	166	217
Goods-producing	19	14	−3	34	12
Manufacturing	−5	8	6	5	14
Service-producing	192	222	330	132	205
Services	99	117	158	130	63
Business services	33	19	17	13	28
Retail trade	48	44	84	−9	58
Government	14	29	34	−14	66
Local	19	31	22	−6	78
Household employment	232	63	209	255	−275
	Average for period				
Civilian unemployment rate (%)	5.4	4.9	4.9	4.8	5.0
Manufacturing workweek (hours)[b]	41.5	42.0	42.1	42.0	41.9





a. Seasonally adjusted.
b. Production and nonsupervisory workers.
c. Vertical line indicates break in data series due to survey redesign.
d. Four-week lagged average of seasonally adjusted data.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

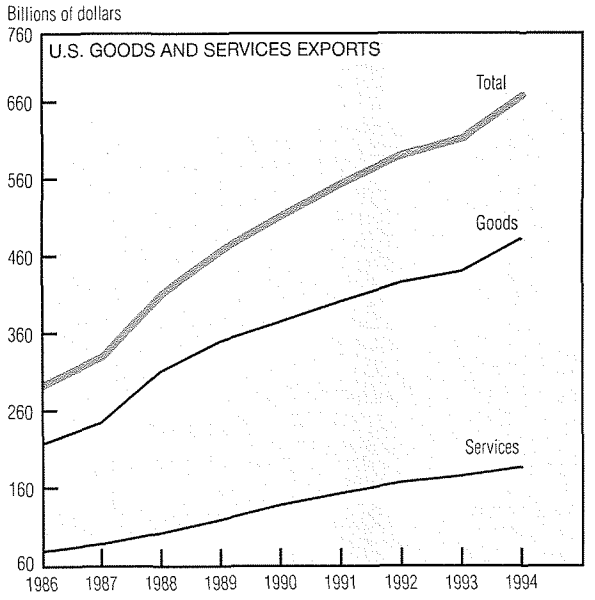
Although the overall unemployment rate edged up to 5.0% in June, the most recent employment statistics continue to portray a robust labor market. Nonfarm payrolls were up a healthy 217,000 for the month, maintaining this year's vigorous average pace.

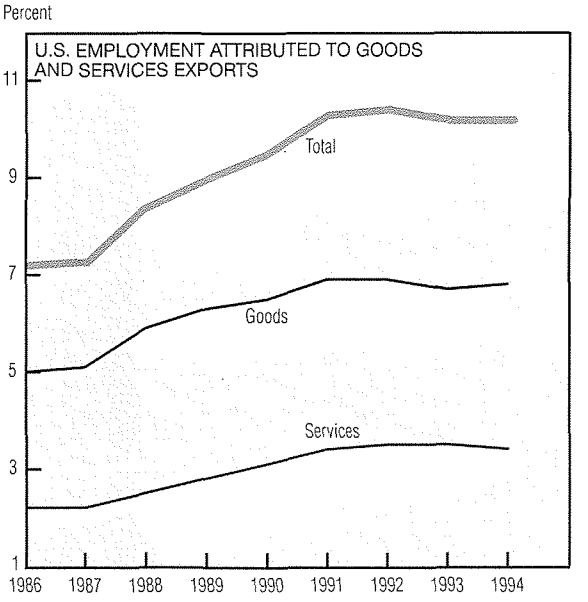
The service-producing sector accounted for the vast majority of the jobs gain, adding 205,000 new positions in June. Within that category, education played a significant role (+49,000), partly because of shorter summer vacations and seasonal adjustment factors. Retail trade (+58,000) and local government (+78,000) were also major contributors to June's advance. In contrast, employment in the goods-producing sector slowed from May's pace.

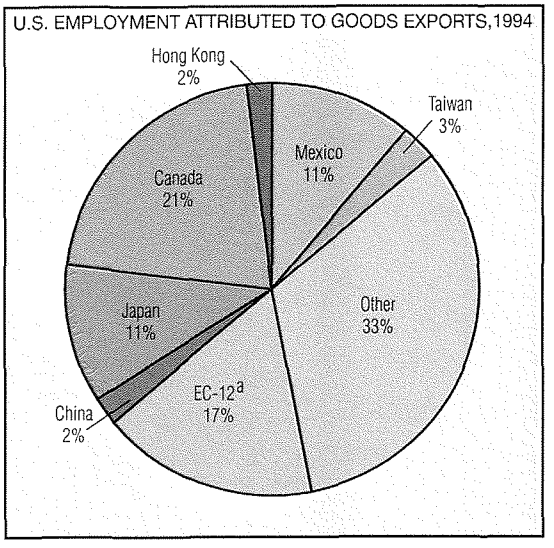
While the payroll employment numbers for June paint a rosy picture, household survey results show a loss of 275,000 jobs. This month-to-month divergence in the data is not unusual; over time, however, the two measures provide a consistent employment picture.

New jobless claims rose 5,000 in the week ended June 28, to 337,000. Although claims have inched up this year, the overall number of unemployed workers applying for benefits remains low.

Exports and Employment







Change in U.S. Employment Attributed to Goods Exports

Foreign market	Thousands of workers 1986	1994	Percent change
Total	4,385	6,836	56
Canada	1,040	1,460	40
Mexico	250	729	192
Other Latin America	308	504	64
Japan	485	754	55
EC-12[a]	766	1,133	48
China	64	138	116
Hong Kong	57	151	165
Taiwan	104	229	120
Other	1,311	1,738	33

a. The EC-12 countries comprise Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the U.K.
SOURCE: Lester A. Davis, "U.S. Jobs Supported by Goods and Services Exports, 1983–94," U.S. Department of Commerce, Research Series OIMA-1-96, November 1996.

As the U.S. economy opens up to more international trade, the popular press has tended to focus on the loss of American jobs associated with increasing imports. However, exports are also growing and are providing employment opportunities for U.S. workers—a fact that is often overlooked.

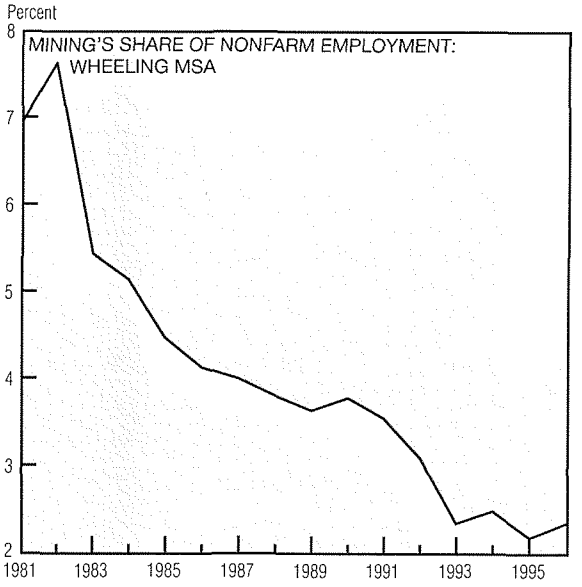
Commerce Department data show that U.S. exports have expanded much faster than the economy over the last decade. As exports have grown, so has the share of the labor force devoted to their production. However, while the value of international trade has climbed steadily over the last 10 years, the share of employment devoted to exports flattened out after 1991. The sharp increase prior to that time reflects the impact of the 1990 recession, when the demand for U.S. export goods rose and domestic demand weakened. The flattening out is the result of the recovery of domestic demand.

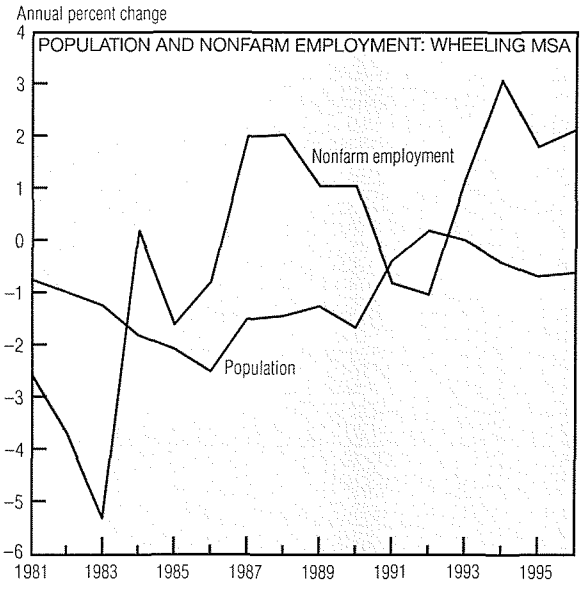
Now, more than 10% of all U.S. working hours are spent producing items that are consumed abroad. For whom are these goods and services produced? America's two largest trading partners, Mexico and Canada, together account for almost a third of our export-driven employment. Other Latin American countries, Japan, and Europe are responsible for most of the remaining jobs. However, this is changing. While employment during the 1986–94 period grew most rapidly for goods and services shipped to Mexico, the next-fastest growth was spurred by exports to Hong Kong, Taiwan, and China.

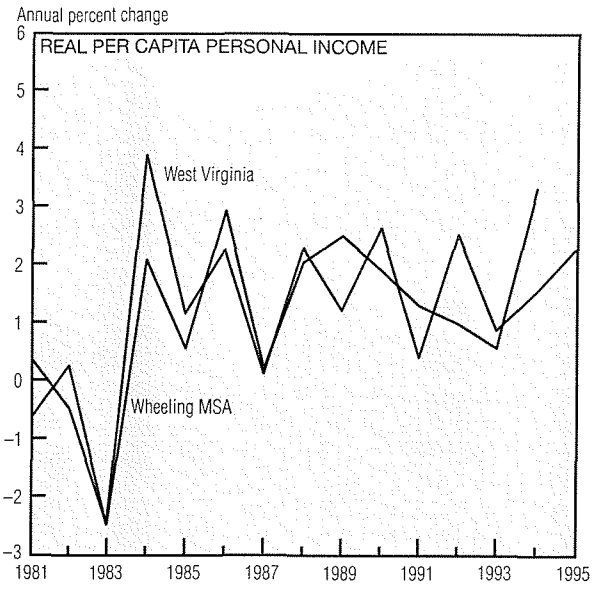
Regional Update: Wheeling, W. Va.

Industry Share of Total Nonfarm Employment
(Percent)

	Wheeling MSA		West Virginia		U.S.	
	1986	1996	1986	1996	1986	1996
Mining	4.1	2.3	6.8	3.7	0.8	0.5
Construction	3.1	3.6	3.8	4.9	4.8	4.5
Manufacturing	12.2	9.6	14.5	11.7	19.1	15.4
Durables	5.7	3.5	8.2	6.9	11.3	9.0
Nondurables	6.5	6.1	6.3	4.8	7.8	6.4
TPU[a]	5.5	4.9	6.2	5.6	5.3	5.2
Trade	26.7	25.2	22.9	22.9	23.8	23.5
FIRE[b]	4.6	4.2	4.0	3.9	6.3	5.8
Services	27.3	34.0	20.3	27.4	23.1	28.8
Government	16.5	16.1	21.6	19.9	16.8	16.3







a. Transportation and public utilities.
b. Finance, insurance, and real estate.
NOTE: The Wheeling Metropolitan Statistical Area comprises Belmont County, Ohio; Marshall County, W. Va.; and Ohio County, W. Va.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; and West Virginia Bureau of Employment Programs.

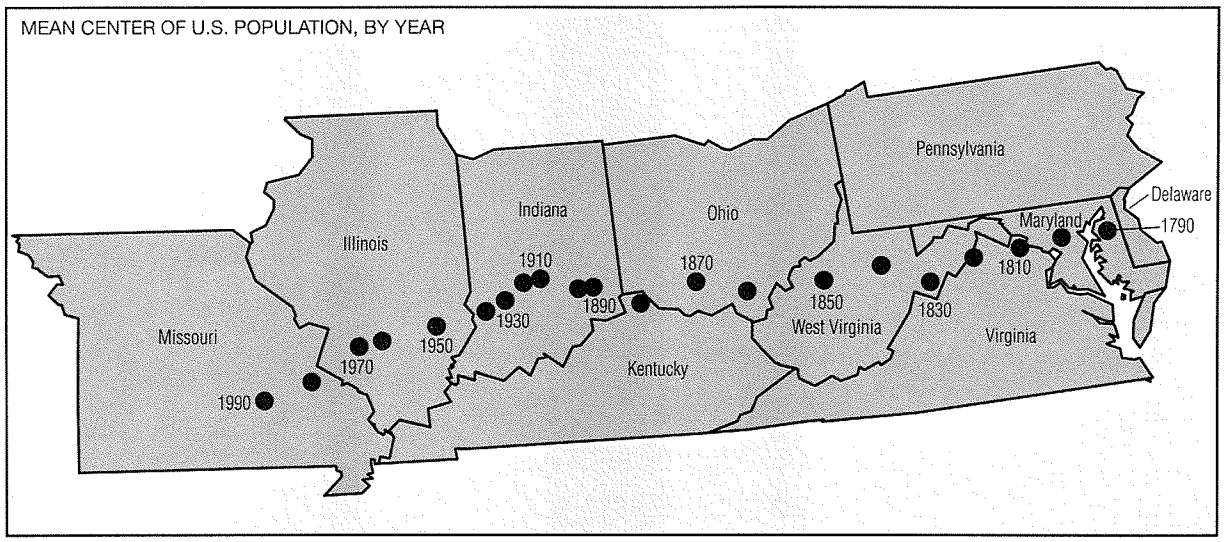
The coal mining industry—historically a predominant feature of the Wheeling, W. Va., area—is becoming an increasingly less important part of its economic landscape. Between 1986 and 1996, mining employment in the city and its environs declined at an average annual rate of 4.4%. Manufacturing jobs also shrank (about 1.1% per year) and now account for less than 10% of the area's total nonfarm employment.

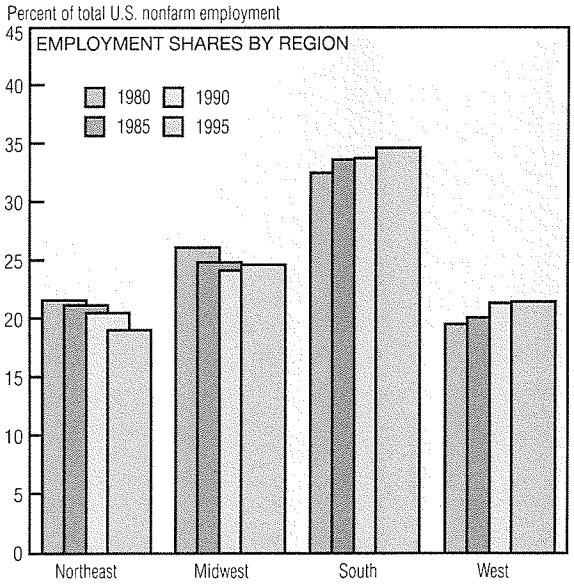
Despite the downturns in mining and manufacturing, Wheeling's total nonfarm employment increased about 1.3% annually over the last decade. Service industry employment, led by the area's expanding medical facilities, accounted for a large part of the overall gain. Service-sector payrolls now represent 34% of the area's total employment, compared to 27.3% in 1986.

While more jobs have become available, Wheeling's population has declined over the last 10 years, the result of a net outmigration of workers and a relatively slow rate of family expansion. In 1990, about 18% of the area's residents were over the age of 65, compared to 12% nationwide.

Still, the city and its surrounding communities have experienced strong income growth. Since 1993, real per capita personal income has risen at an average rate of about 3.3% per year, more than a percentage point above the state average. Although the region's unemployment rate is still relatively high, it has been receding in recent years and is approaching the national average.

Population and Employment Patterns





Changes in Industry Shares of Regional Nonfarm Employment, 1982–96
(Percentage points)

	Northeast	South	Midwest	West
Mining	−0.2	−1.9	−0.3	−0.9
Construction	0.1	−1.0	0.7	0.6
Manufacturing	−8.5	−4.4	−4.6	−4.7
TPU[a]	−0.3	−0.6	−0.5	−0.6
Trade	0.9	0.5	0.5	0.2
FIRE[b]	0.3	−0.4	−0.1	−0.6
Services	8.5	8.7	6.1	7.6
State and local governments	−0.8	−1.0	−1.9	−1.5

a. Transportation and public utilities.
b. Finance, insurance, and real estate.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States: 1996.

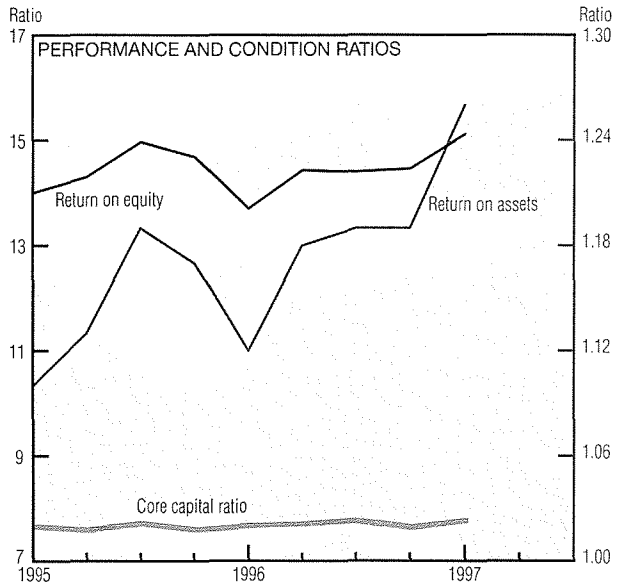
As Americans have migrated to the West and South, so have their jobs. Along the way, the composition of these jobs has changed. The exact causal relationship between the composition of employment and the location of the population is impossible to decipher, but the correlation is intriguing.

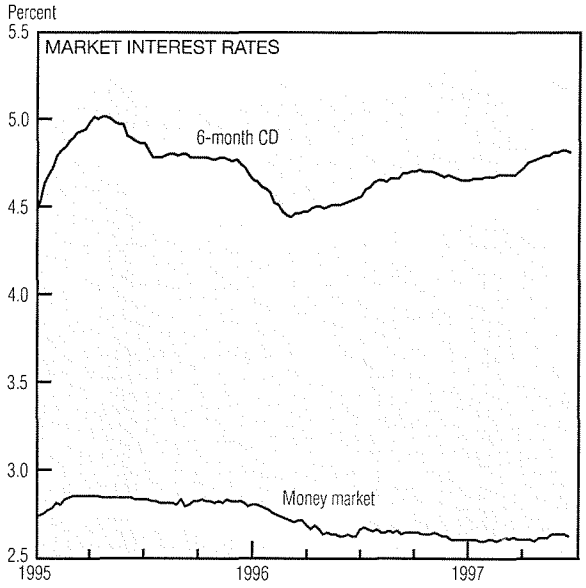
Over the past 40 years, the population center has begun to drift toward the South and West, away from the regions traditionally associated with the nation's industrial base. The South and the West have shown the greatest gains in employment shares. In 1996, 56% of all U.S. nonfarm jobs were located in these areas—a 4-percentage-point rise from 15 years earlier. This gain came at the expense of employment shares in the Northeast and Midwest.

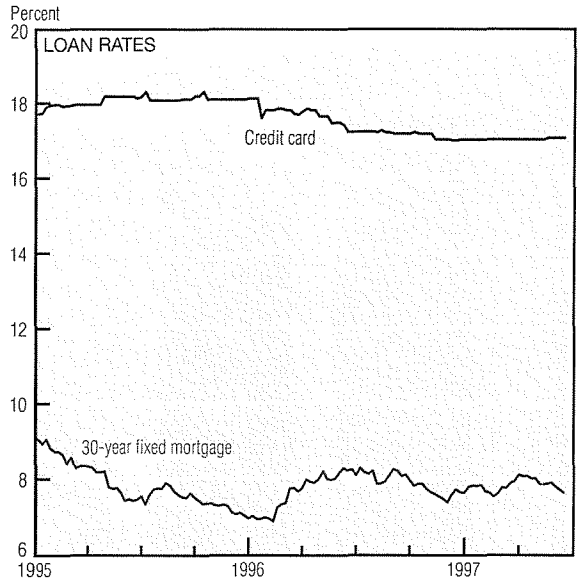
Part of this movement may reflect the changing composition of employment. The major increases in jobs growth—in all regions—are centered in the burgeoning services sector. The share of workers employed in retail trade has also increased nationwide. When manufacturing and mining industries were a dominant force in the U.S. economy, the population was centered more toward the Northeast and Midwest, where these industries were concentrated.

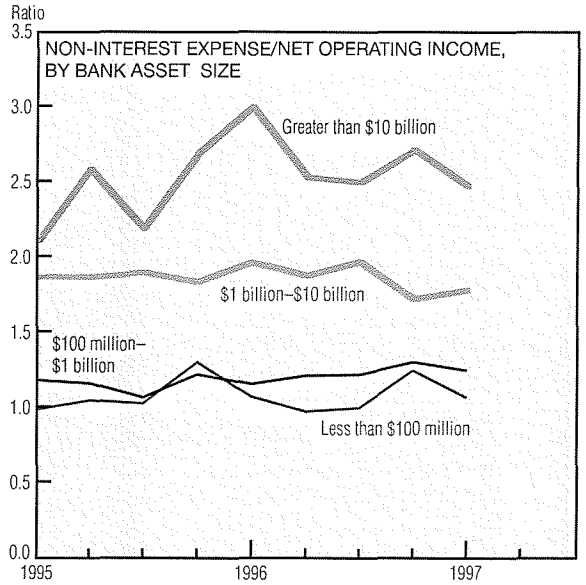
In the Fourth Federal Reserve District states (Kentucky, Ohio, Pennsylvania, and West Virginia), only construction, retail trade, and services have gained employment shares since 1982. Increases in these states' share of construction and retail trade jobs have outpaced the national average, but growth in the service share has fallen short.

Banking Conditions









SOURCES: Federal Deposit Insurance Corporation; and *Bank Rate Monitor,* various issues.

Insured commercial banks reported record levels of net income in the first quarter, which translated into the fourth-highest return on assets (ROA) ever. Non-interest income was up 11.6% over last year's level and was largely responsible for the increase in ROA.

Higher fee income accounted for half of the rise in non-interest income. Net-interest income was boosted by growth in interest-earning assets, despite a decline in the net-interest margin associated with those assets. Rates of return on earning assets (such as credit cards and loans) have weakened recently, while indicators of the cost of bank funds (such as money market rates and rates on 6-month CDs) have been rising.

One of the dimensions along which large and small banks differ is their reliance on non-interest income. Banks with less than $100 million in assets gain roughly 20% of their net revenues from this source, compared to almost 40% for larger banks. Net revenues at both the largest (over $10 billion) and smallest (under $100 million) institutions have also been boosted by declines in non-interest expenses.

Loan-loss provisions totaling $4.3 billion cut into banks' first-quarter earnings, as did net charge-offs of $4.0 billion. The credit card component of net charge-offs continues to be problematic. Credit card charge-offs were up $560 million over last year's level, while all other categories of charge-offs fell $113 million.

May's Senior Loan Officer Survey indicates that since February, banks have become more accommodating to businesses but have tightened credit for households.

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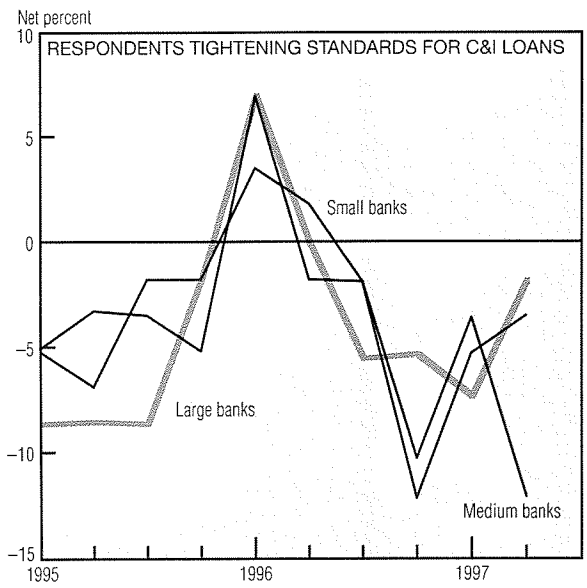
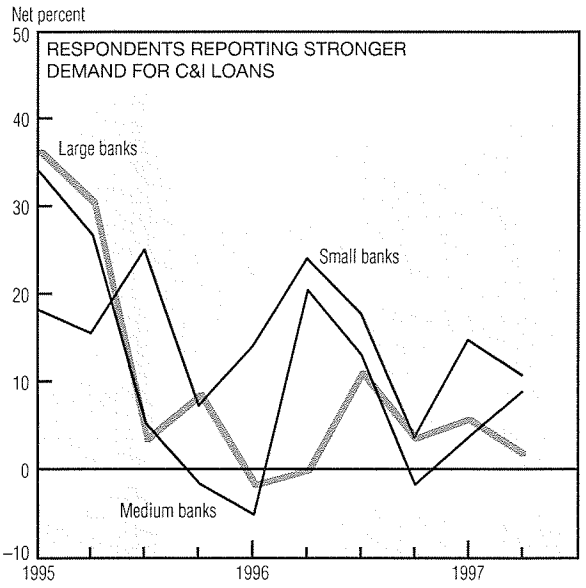
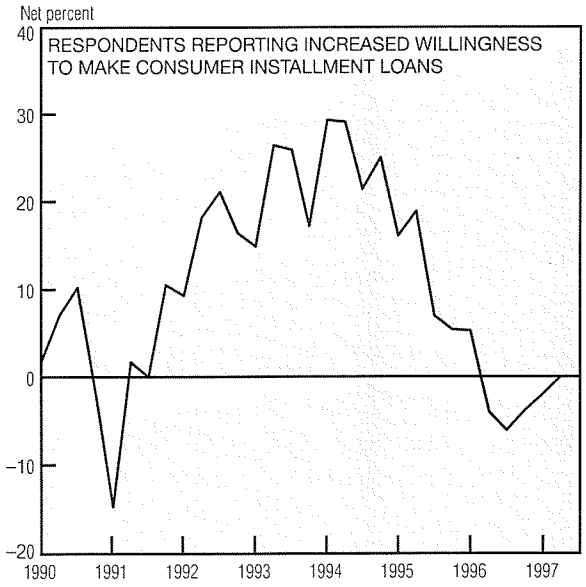
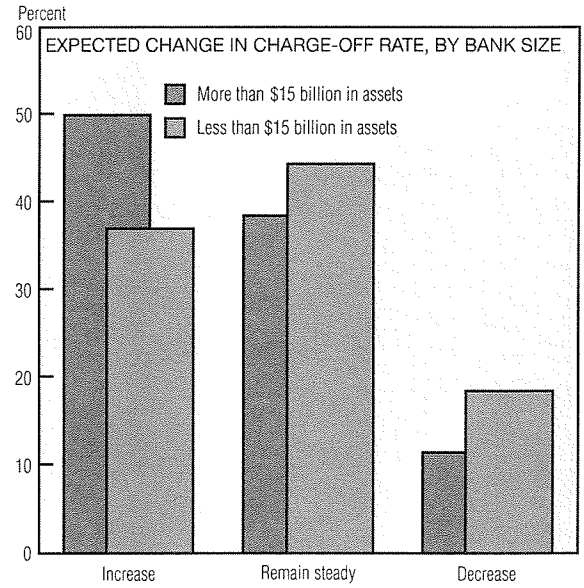
Banking Conditions (cont.)









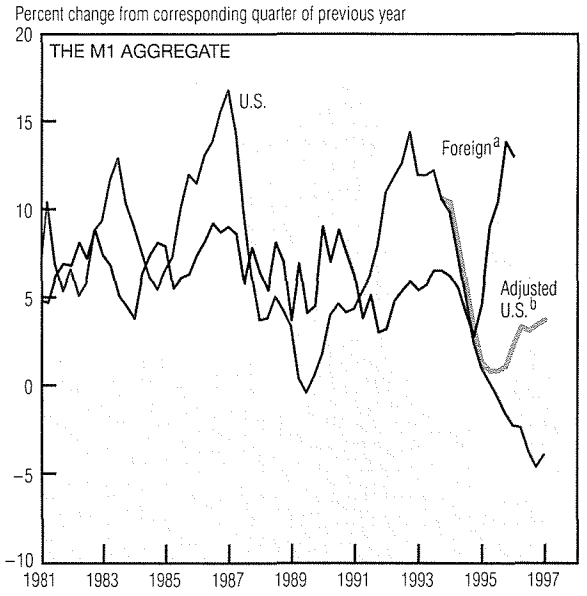
SOURCE: Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices.

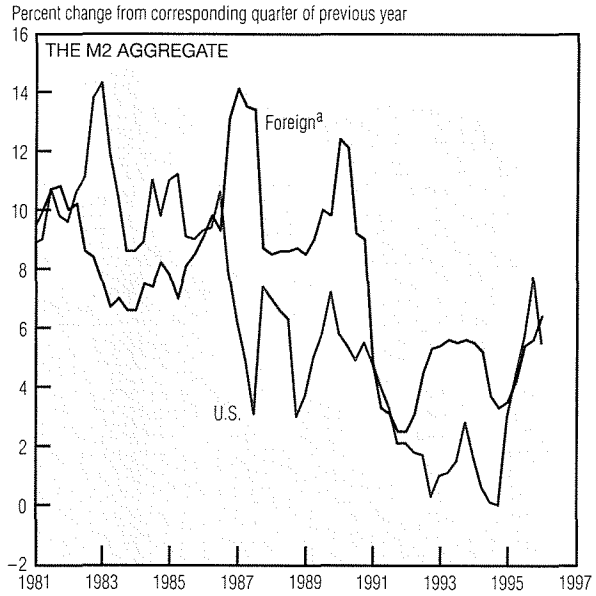
Banks that eased their terms on commercial and industrial (C&I) loans indicated that they had done so in response to competition from other banks as well as nonbank lenders. In regard to C&I loans to large- and middle-market borrowers, one-third of the domestic respondents indicated that they had reduced their rate spread over market rates, while one-fourth lowered the cost of their credit lines. Small-market borrowers were less likely to experience an easing of terms. In fact, foreign banks' branches and offices, representing almost 30% of the respondents, tightened terms somewhat on these loans. The survey showed no strong indication of either weaker or stronger demand for C&I loans.

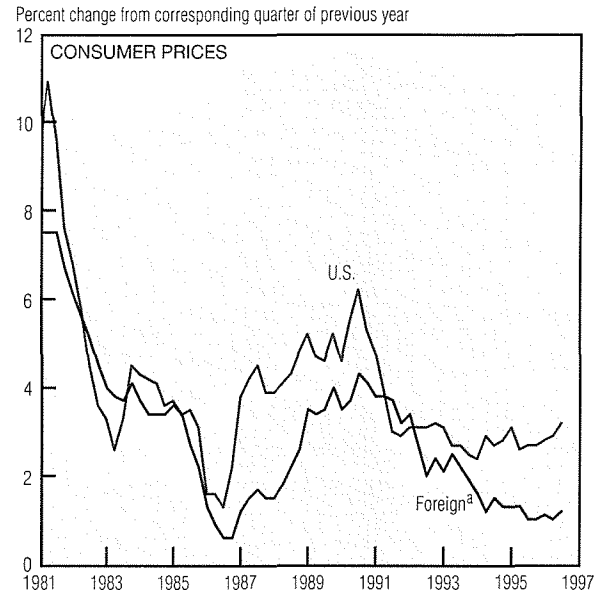
A significant fraction of banks continue to report tighter standards on consumer loans. Indeed, nearly half reported raising their terms on new credit card accounts. However, banks' willingness to make consumer loans is essentially unchanged since the previous survey.

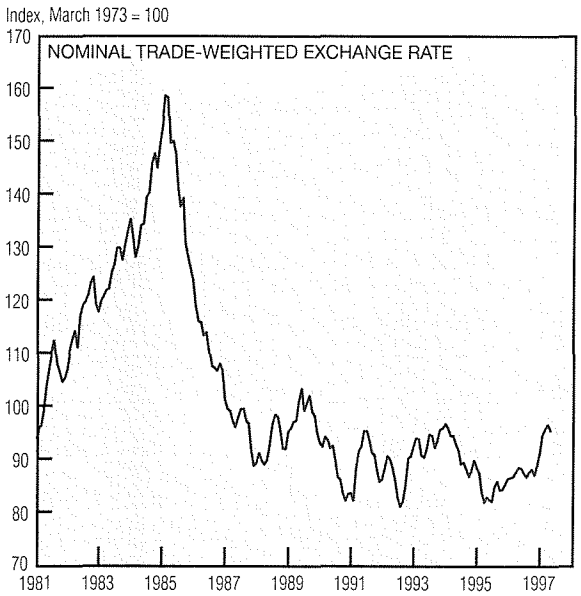
The May report also included a new set of questions regarding loan officers' expectations of changes in charge-off rates on consumer and C&I loans for the rest of 1997. One-third of the respondents noted that they foresee charge-off rates on consumer loans rising as a result of the presumed increase in households' willingness to declare bankruptcy. One-fourth anticipate higher charge-off rates on C&I loans because of an easing of standards and a deterioration in both business financial conditions and the general economic outlook.

Money, Inflation, and Exchange Rates









a. Trade-weighted average.
b. Quarterly average of monthly data, adjusted for sweep accounts.
SOURCES: Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

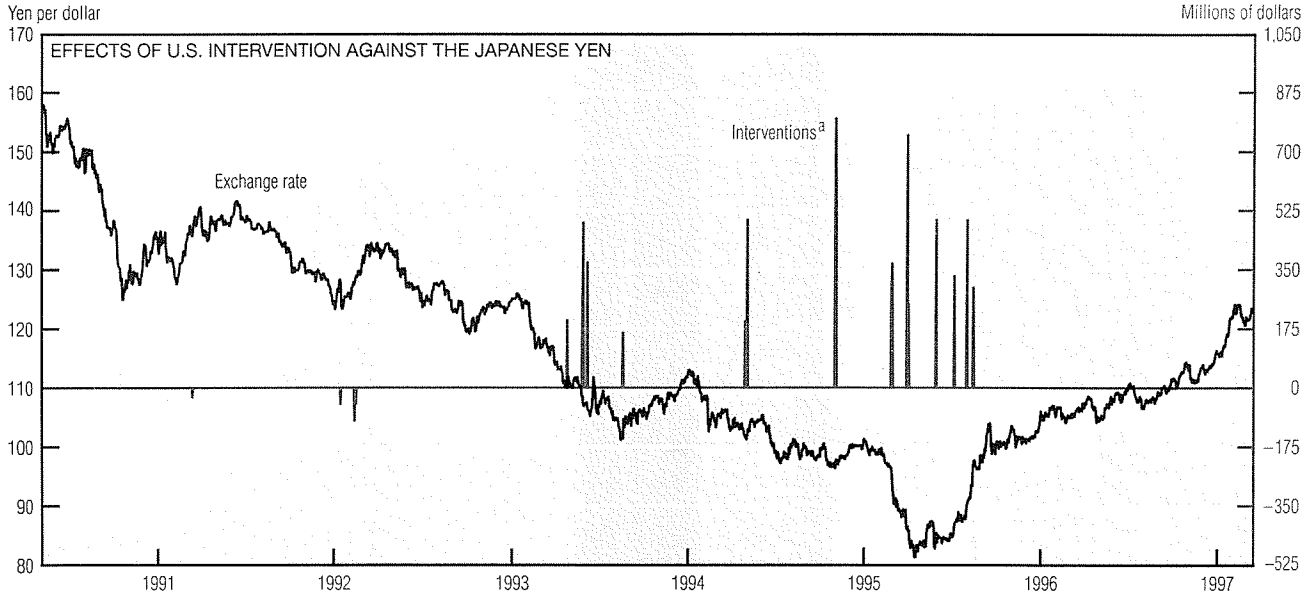
Money, inflation, and exchange rates are all linked, but the connections are relatively complicated. Inflation occurs when a nation's central bank attempts to supply a greater quantity of money than the public desires to hold. Rising prices help balance the amount of money demanded and supplied.

Conventional money measures like M1 and M2 show only the stock of money that results from this equilibrating process. Consequently, the near-term connection between small fluctuations in money measures and prices depends on whether the observed changes in the money stock reflect growth in money demand holding supply fixed, or an expansion of the money supply holding demand fixed.

A country that creates an excessive amount of money will experience inflation, but how its exchange rate responds depends on the inflation rates of other nations. Countries with relatively high inflation rates experience currency depreciations. Hence, the effect of a nation's money creation on its exchange rate depends on both money demand at home and the relative growth of money supply and demand abroad.

All of these factors help explain why economists have trouble developing simple monetary models of exchange rates. Generally, these models perform worse than a simple projection of today's exchange rate.

Exchange Rate Policy



Intervention Amounts and Frequencies[b]
(May 1, 1990 to March 19, 1997)

	Absolute value	Sales of yen	Purchases of yen
Count	21	17	4
Mean	331.6	396.1	57.5
Standard deviation	215.5	186.2	29.9
Minimum	30	165	30
Maximum	800	800	100

Successful Interventions
(May 1, 1990 to March 19, 1997)

	Sales of yen	Purchases of yen
Number of interventions	17	4
Successful interventions	12	3
Percent of successful interventions	70.6	75.0
Expected successes[c]	11	3
Standard deviation[c]	2	1
Probability of more successes[c]	0.23	0.18

a. Positive values are official sales of yen; negative values are purchases of yen.
b. "Count" is in number of days; all other figures are in millions of dollars.
c. Based on a binomial distribution in which the probability of an individual success is 65%.
SOURCES: Federal Reserve Bank of Cleveland; Federal Reserve Bank of New York; and Board of Governors of the Federal Reserve System.

The U.S. Treasury and the Federal Reserve seem increasingly hesitant to intervene in foreign exchange markets, and for good reason. Since 1990, U.S. interventions have often seemed ineffectual in stabilizing key dollar exchange rates.

U.S. interventions against the Japanese yen offer an example, but similar results can be seen for actions against the German mark. Since May 1, 1990, the U.S. has sold yen on 17 days and purchased yen on four days. The average amount of these sales was equivalent to approximately $396 million, which is high by previous norms. The average amount of the yen purchases, however, was low—about $58 million.

Of the yen sales, 12 seemed successful in that they were associated with an immediate dollar appreciation or a smaller depreciation. Similarly, of the official intervention purchases, three were successful. A 70% to 75% success rate seems considerable, but it is not large enough to rule out the possibility that the results occurred randomly.

The Federal Reserve routinely neutralizes any effects that U.S. intervention might have on the intended federal funds rate. This closes an important channel through which intervention might affect exchange rates. Some have speculated that U.S. interventions could still influence exchange rates by offering the market new or better information. However, as the results above suggest, monetary authorities may not regularly possess better information than market participants.