

The Economy in Perspective

My dinner with André ... “Of course. I’d be delighted to come to Washington for dinner. I’ll take the afternoon train and meet you at the Meniscus at 7:00.” I knew better than to pepper André with questions over the telephone; there would be time enough that evening to discover why my old friend—now finance minister of Nedlaw—had so unpredictably appeared.

As I left Penn Station, my thoughts turned to André and to Nedlaw, where he was leading a charmed life, rising to his exalted post after several minor government positions and some vaguely defined business endeavors. André enjoys traveling, and for many years had been urging his country to expand its trade with the rest of the world. As its economic development reached fever pitch, Nedlaw joined the “High Rollers,” a group of seven neighboring countries that were enjoying enormous growth. Despite financial instability in other regions, Nedlaw and her neighbors were still riding the crest.

Long the choice of the discerning, the Meniscus occupies a dark corner on a side street not far from Dupont Circle. His Excellency was perusing the wine list when I arrived. We exchanged greetings, and I knew at once that the evening would be exceptional in every respect: My friend is a gourmet, a raconteur, and a visionary. “I’ve given certain instructions to the chef,” he informed me. “I trust you will not be disappointed.”

Over country duck paté, he recounted the blunders of his peers at various finance ministers’ meetings. The schemes of several well-known Brazilian businessmen tumbled out during a salad of greens, goat cheese, and walnuts. But he did not divulge the purpose of his visit to Washington until the filet de boeuf had been set between us. “You have heard, my friend, of our country’s good fortune these past few years? I am here to see that it continues: I meet tomorrow with International Monetary Fund officials to safeguard Nedlaw against economic collapse.”

What foresight! Before the first hint of a problem, André was demonstrating his leadership and wisdom. Filled with awe (or possibly paté), I asked, “How do countries embroil themselves in these difficulties in the first place? And how have you avoided falling victim?”

Spooning béarnaise sauce over his asparagus, André looked smug. “Countries get themselves into trouble by tolerating unsustainable economic growth and permitting reckless speculation. Nedlaw has been careful to keep real economic growth to a mere 8 to 10 percent per year, and has encouraged allocation of credit in land development and commercial real estate. When existing banks reach their limits, we simply charter new ones! We also limit our own exposure by encouraging foreign capital to find a home in Nedlaw. Let the other guy take a chance, if you catch my drift!”

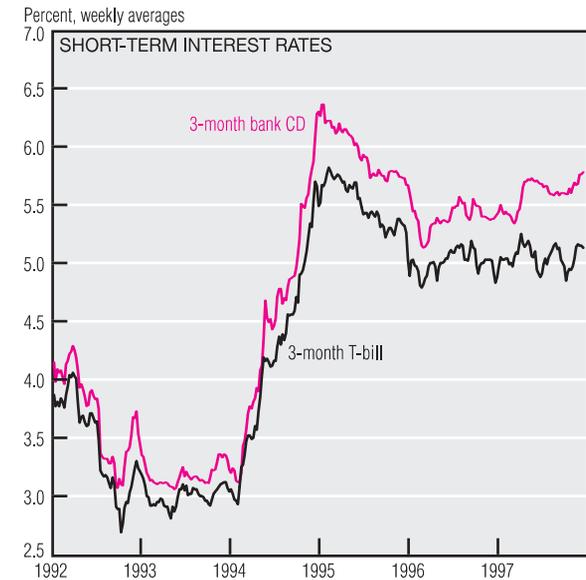
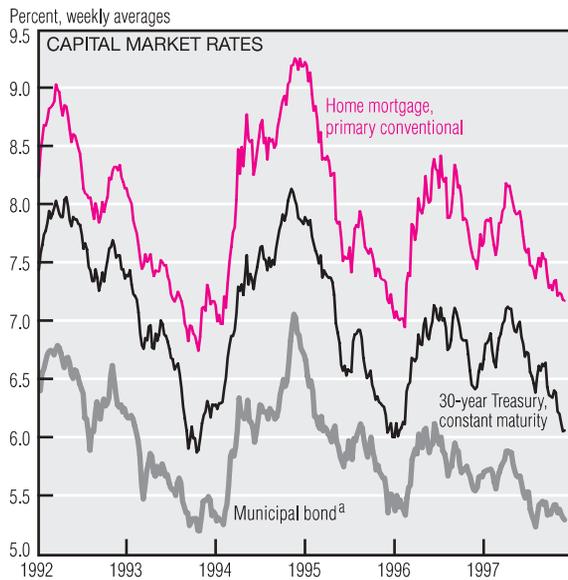
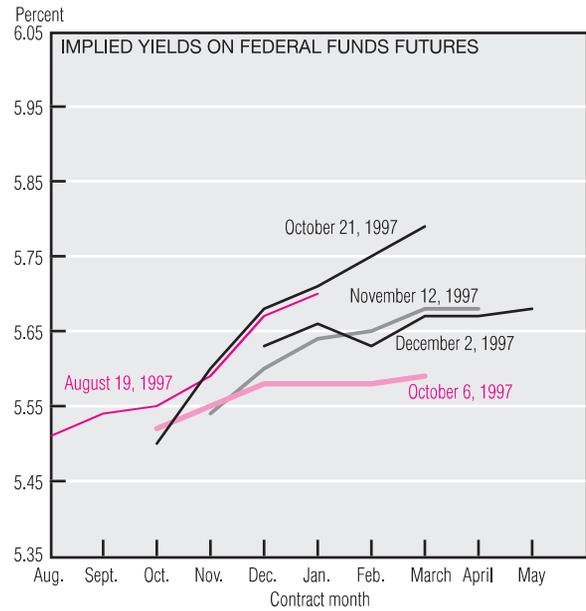
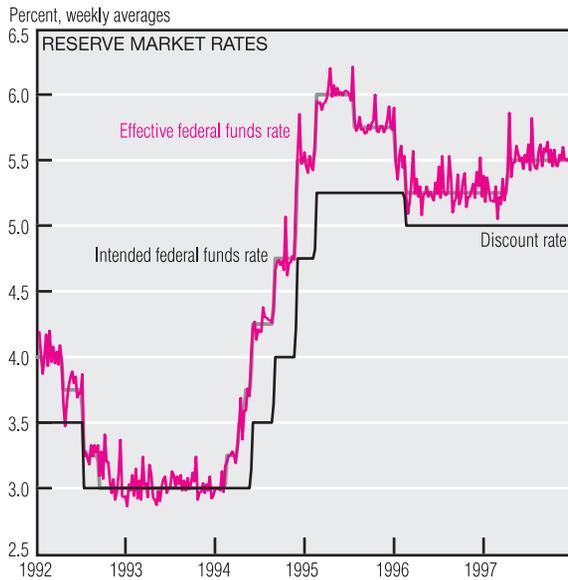
“I’m confused,” I admitted. “Those growth rates seem extraordinarily high. Isn’t real estate development the most risky kind of lending? Aren’t new banks likely to make poor lending decisions? And aren’t you worried that foreign investors might be more skittish than your own citizens? They could pull out their funds on a moment’s notice.”

André just laughed. “If you think logically, it all fits together. Firms borrow money to clear land and erect buildings. People occupy the buildings and conduct business. When Nedlawian companies export products, they get paid in foreign currencies, which they exchange at the central bank in return for Nedlawian façados. The central bank keeps creating all the façados that native and foreign borrowers need to finance transactions in Nedlaw. The more foreign capital flows in, the more façados we print; that guarantees us a stable exchange rate. The buildings keep going up, the exports keep steaming out, and the credit process lubricates all the wheels. Everyone is working, and many people are becoming rich. It’s a beautiful thing, my friend.”

“But André,” I asked, “what if some of those office buildings stay empty? What if your trading partners won’t buy dehydrated kale, three-wheeled autos, and solar-powered ice cream makers? What if hundreds of thousands of tourists don’t flock to Nedlaw World? What will happen then?”

“That’s why I’m going to the IMF tomorrow,” André beamed, winking at me as he raised his dessert spoon. “When the world hears about the backup line of credit I negotiated, confidence in Nedlaw will rise like this rum soufflé. I just hope you’re not too late to get in on the ground floor, if you know what I mean.”

Monetary Policy



a. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

At its November 12 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at 5.5%. The decision was widely anticipated by financial markets because of the sell-off in U.S. equity markets. The FOMC has maintained the 5.5% target at each of its last five meetings.

Implied yields on federal funds futures have been flattening over the last couple of months. The expectations of a rate increase that existed in mid-October have diminished substantially. One possible reason for this change is market participants'

belief that recent stock market events and economic turmoil abroad have made a rate increase less likely. The fact that the implied yields remain consistently above the current federal funds rate indicates that participants still believe that the rate is more likely to increase than to decrease.

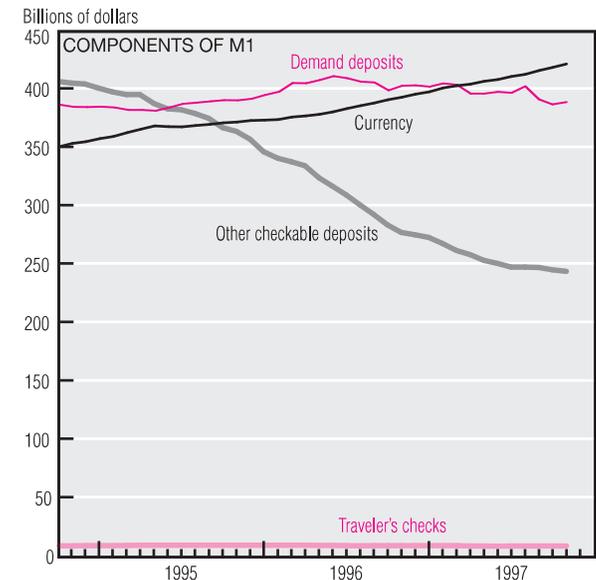
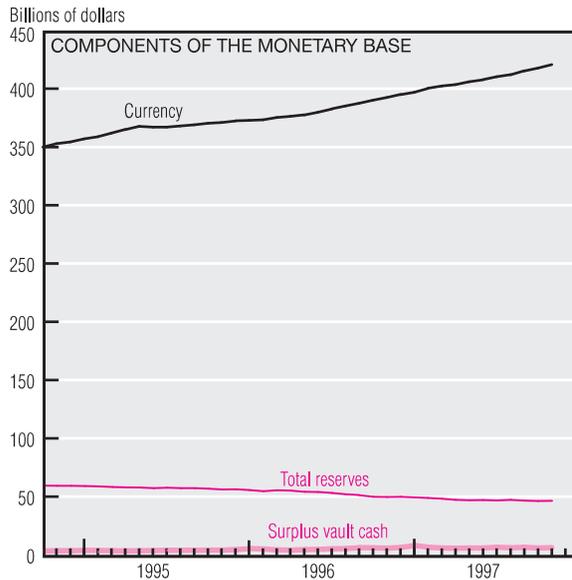
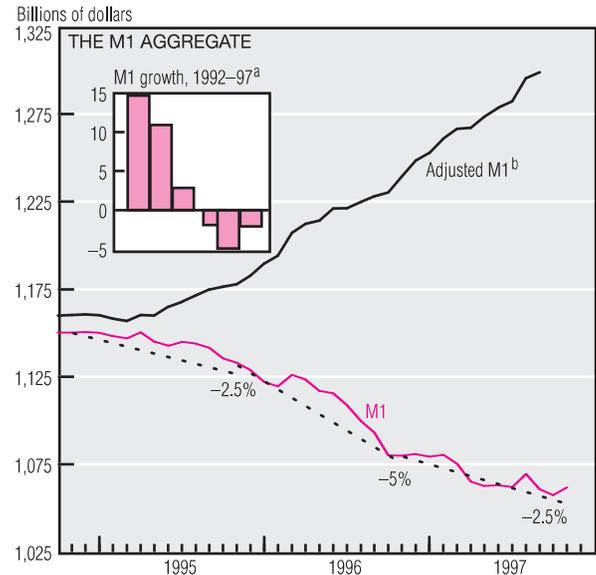
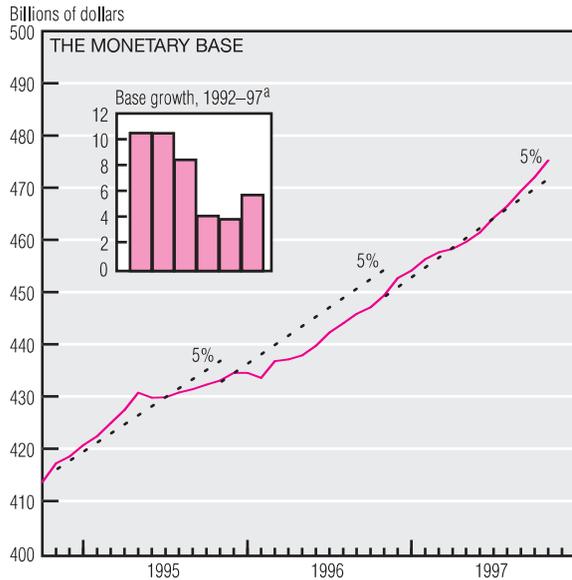
Long-term interest rates have been falling fairly steadily since April. Conventional home mortgage rates have dropped a full percentage point, reaching an average of 7.17% for the week ending November 28. Over the same period, the 30-year Treasury yield fell 106 basis points

to 6.06%, and municipal bond yields dropped 59 basis points to 5.29%.

In contrast, short-term interest rates have increased slightly since late September. As of the week ending November 28, the three-month T-bill rate had risen 28 basis points to 5.13%, and CD rates had risen 19 basis points to 5.78%.

The ultimate goal of monetary policy is to raise the standard of living for all U.S. citizens by maintaining a stable currency. To meet this goal, the Federal Reserve alters liquidity in financial markets, primarily
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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated November over 1996:IVQ basis.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for November 1997. Dotted lines represent growth rates and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

through open-market sales or purchases of Treasury securities. Before taking any action, the Fed considers an array of economic and financial indicators, including the monetary aggregates, which provide a measure of the amount of liquidity in the economy and an insight into the current stance of policy.

Unfortunately, no one definition of money can completely characterize either liquidity or policy, so the Fed tracks several alternative definitions, which differ in the types of assets they include.

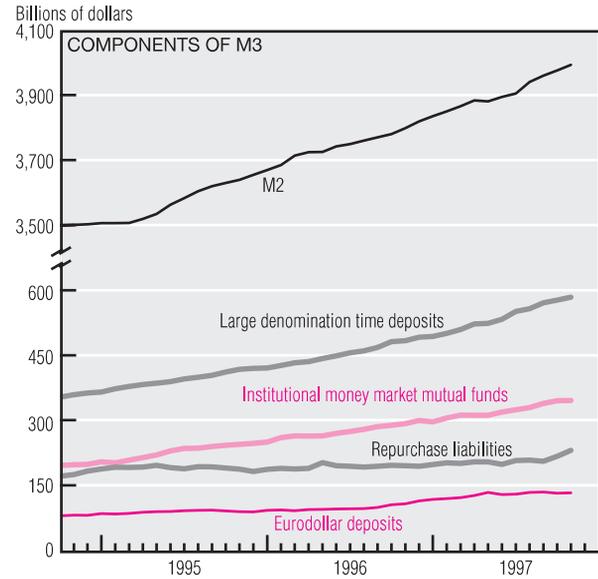
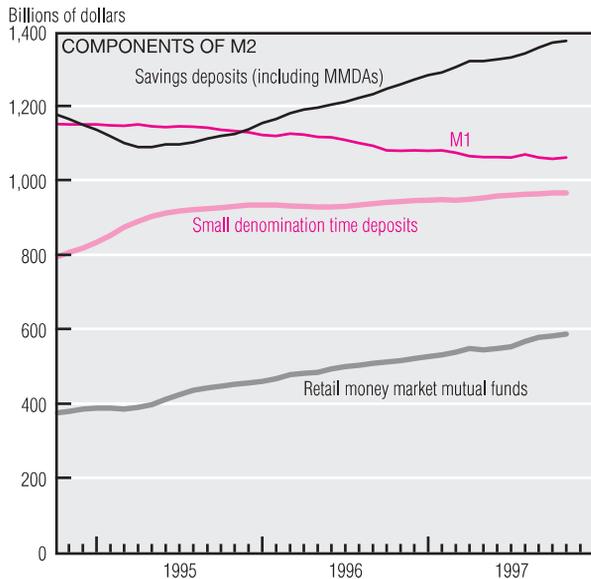
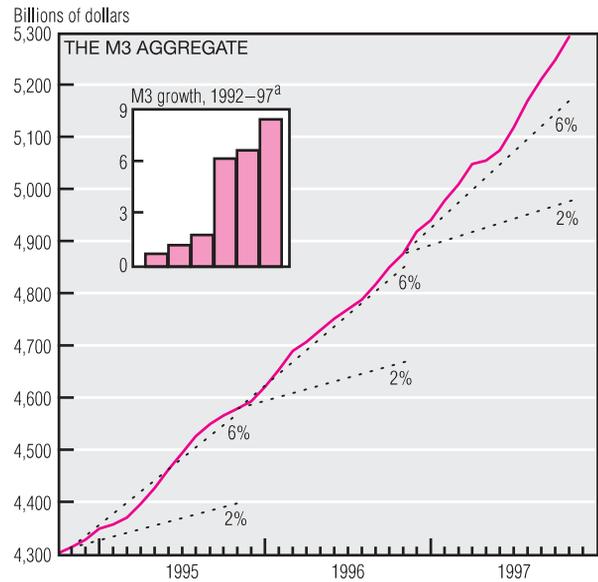
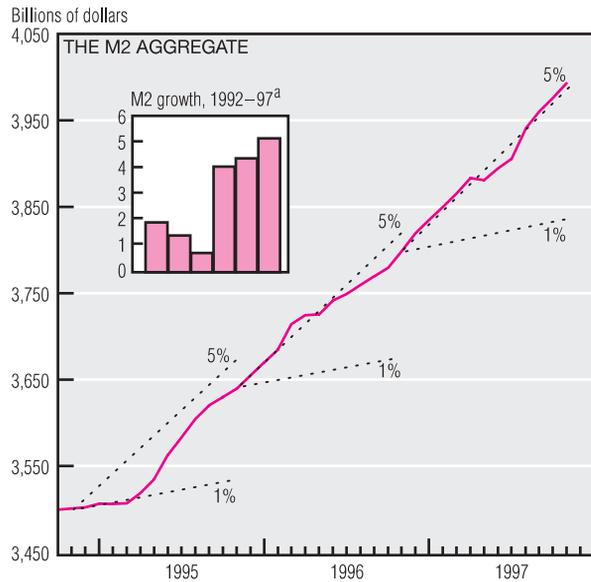
The monetary base, a narrow measure of money, consists of currency in the hands of the public, total reserves, and vault cash not used to satisfy reserve requirements. Growth in the monetary base has been about 5.7% year to date. The currency component, which now makes up almost 90% of the total, has accounted for expansions in base money over this period and for the past several years. However, since as much as two-thirds of the U.S. currency in circulation is held

abroad, this growth may not reflect an increase in the currency available to the domestic financial system.

A decline in total reserves in recent years has partly offset the increase in currency. The drop-off may be traced to the proliferation of sweep accounts, which allow banks to economize on reserves by "sweeping" funds from accounts that are reservable into money market deposit accounts (MMDAs), which are not.

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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated November over 1996:IVQ basis.
NOTE: All data are seasonally adjusted. Last plot is estimated for November 1997. Dotted lines are FOMC-determined provisional ranges.
SOURCE: Board of Governors of the Federal Reserve System.

The M1 aggregate, a slightly broader definition of money, includes currency, demand deposits, other checkable deposits (OCDs), and traveler's checks. Since 1996:IVQ, M1 has fallen at a 1.7% annual rate. The drop-off largely reflects the continued dramatic decline in OCDs, which consist of negotiable order of withdrawal (NOW) accounts, automatic transfer service accounts, credit union share draft accounts, and demand deposits at thrift institutions. Demand deposits have also fallen somewhat over this period. Like the shrinkage in total reserves, the de-

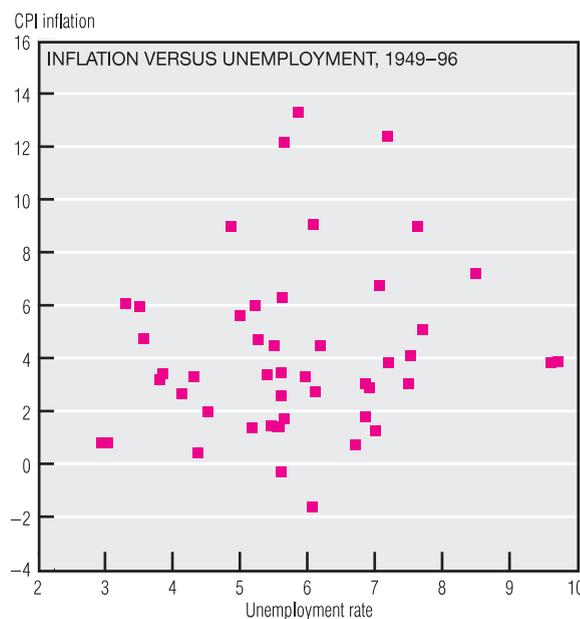
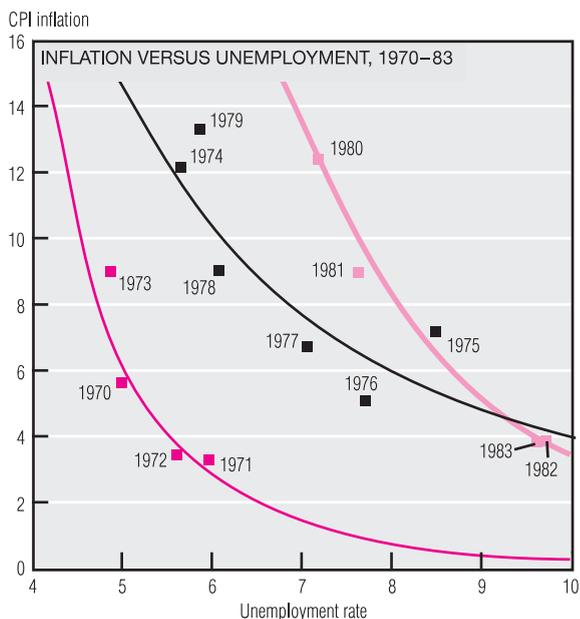
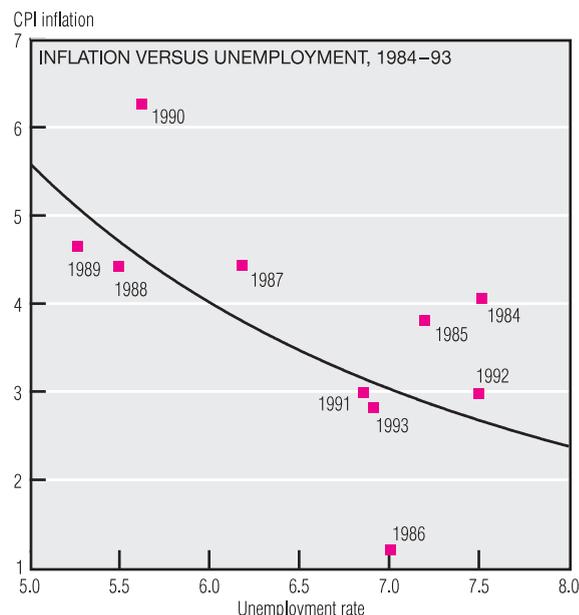
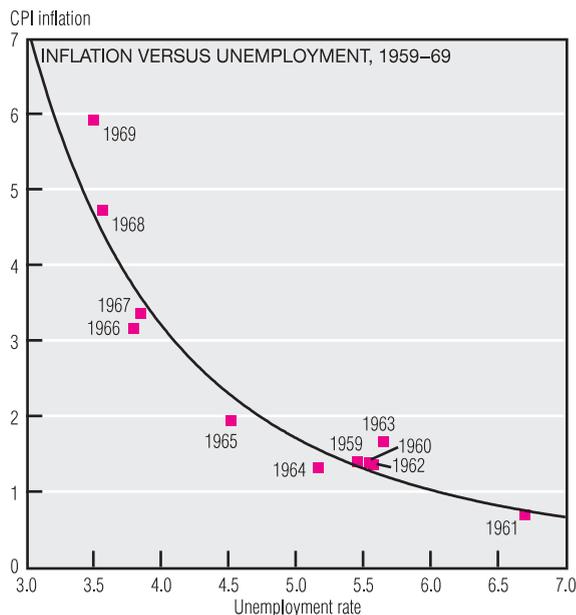
cline in OCDs and demand deposits is commonly attributed to the use of sweep accounts. As of the end of October, M1 adjusted for sweep activity has grown roughly 5.8%.

The M2 aggregate expands upon the M1 definition of money by adding savings deposits (including MMDAs), small time deposits, and retail money market mutual funds. M2 is currently growing at about 5.1% year to date. Because M2 includes MMDAs, it is not prone to distortions from sweep account activity. Growth in savings deposits and retail money funds have ac-

counted for most of the growth in M2 over the last few years.

The M3 aggregate, the broadest measure of money discussed here, equals M2 plus several smaller components. M2 currently makes up roughly 75% of M3. Growth in M3 has been about 8.4% this year, substantially higher than the 5.1% pace of M2. The larger growth in M3 reflects relatively fast growth in the smaller (non-M2) components, notably large denomination time deposits and institutional money market mutual funds.

Inflation, Unemployment, and the Phillips Curve



NOTE: All data are average annual percents.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Phillips curve—a statistical relationship between inflation and unemployment—is central to much of macroeconomic thought. Over the 1959–69 period, inflation and unemployment exhibit a negative relationship, tracing a nearly perfect curve. More recently (1984–93), the fit between them is somewhat looser, but still negative. To many economists, the Phillips curve suggests a trade-off between inflation and unemployment: A

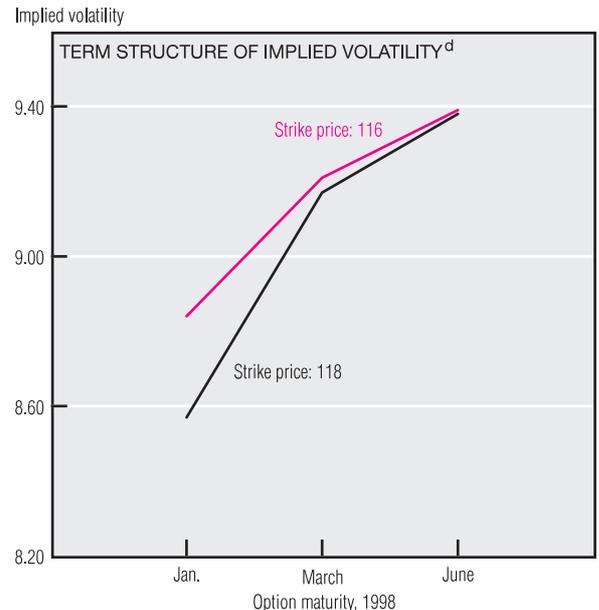
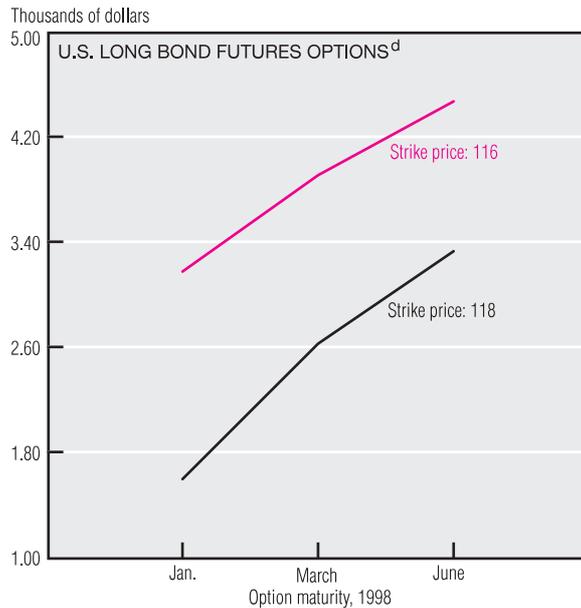
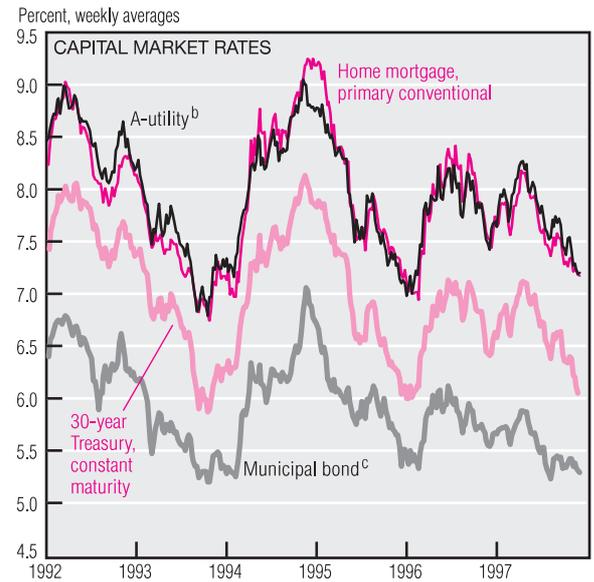
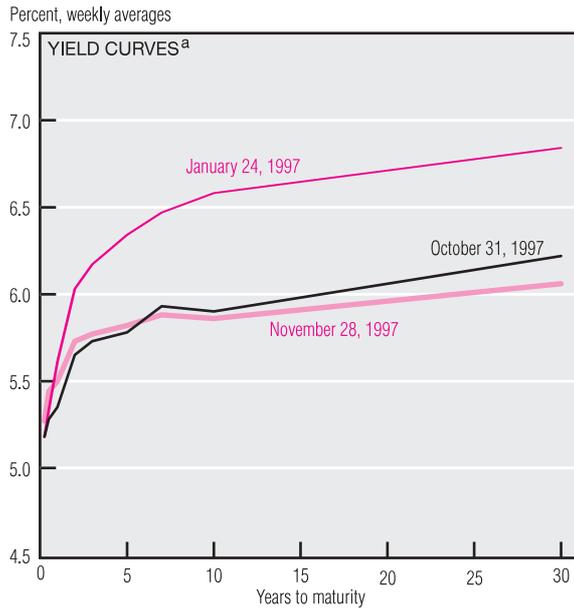
lower unemployment rate can be “bought” at the cost of somewhat higher inflation, and vice versa. This has aroused concern that the recent low jobless rates will raise inflation.

If the Phillips curve is to be interpreted as a trade-off, the relationship between inflation and unemployment must surely be stable over time. It is not. For example, the 1970–83 period includes at least three distinct curves: 1970–73, 1976–79, and 1980–83. At best,

there is a stable short-run curve that shifts over time. One explanation of these movements is that the location of the short-run Phillips curve depends on the *expected* inflation rate. This view is consistent with the rightward shifts of the 1970s and 1980s (as inflation rose, so did expected inflation).

In the long run (see the bottom right chart), there is no apparent relationship between inflation and unemployment.

Interest Rates



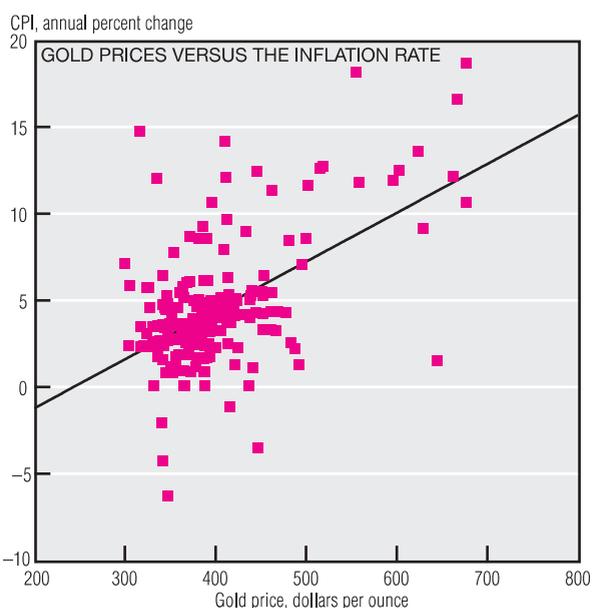
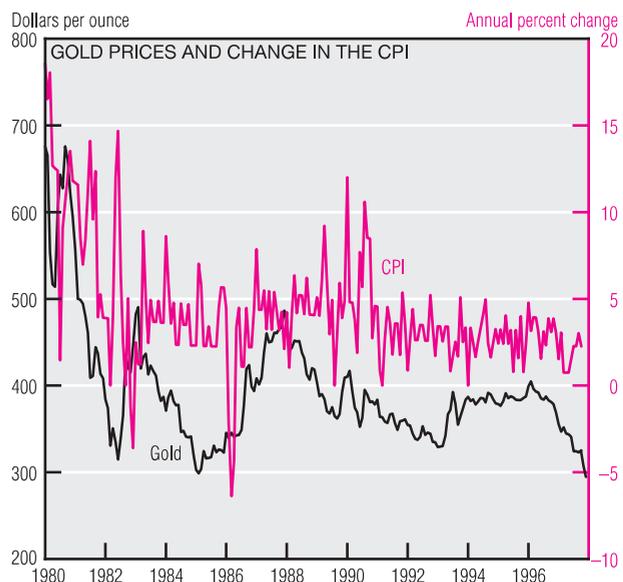
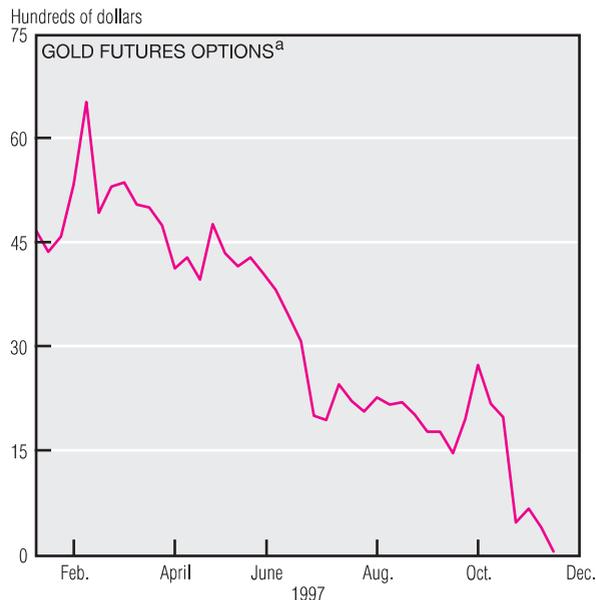
a. All instruments are constant-maturity series.
 b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
 c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
 d. Call futures options for November 28, 1997.
 SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

The yield curve has flattened since last month, with short rates up and long rates down. The shift in the weekly averages of constant-maturity rates was not large, however. The 3-year, 3-month spread decreased only five basis points (from 55 to 50), and the 10-year, 3-month spread shrank only 13 basis points (from 72 to 59). These spreads are narrower than their historical means of 85 and 120 basis points, respectively. Both medium and long rates remain well below

their levels at the start of 1997, while short rates are slightly higher. The downward trend in long rates has been accelerating in recent months. Municipal bond rates have held up the best, losing only seven basis points since the end of September. Mortgage rates have fallen 11 basis points, utilities are down 24, and 30-year Treasuries lost a full 30 basis points. An increasingly important part of the fixed-income market is not the bonds themselves but their deriva-

tives—contracts whose price depends on interest rates. One popular derivative is the option on the T-bond future. The *call* gives the owner the right to buy a futures contract on the bond at a specified price (the *strike price*). Any given option price is associated with an *implied volatility* for the underlying instrument. This enables us to chart the term structure, which shows how implied volatility changes as the maturity lengthens.

Gold Prices



a. For December 1997 at a strike price of 310.
NOTE: All gold prices are in dollars per troy ounce.
SOURCES: Bloomberg information services; and DRI/McGraw-Hill.

The price of gold has declined through most of 1997, dipping below \$300 per ounce in early December. While industrial and jewelry demand remains high, central bank sales more than offset it. The strength of the dollar is increasing fears that still more gold will leave central bank vaults as foreign countries demand more U.S. currency. Strong stock markets, by providing a very attractive alternative asset, have also reduced the private demand for gold. Financial turmoil in Asia may eventually enhance gold's attraction, but the

effects are not yet apparent.

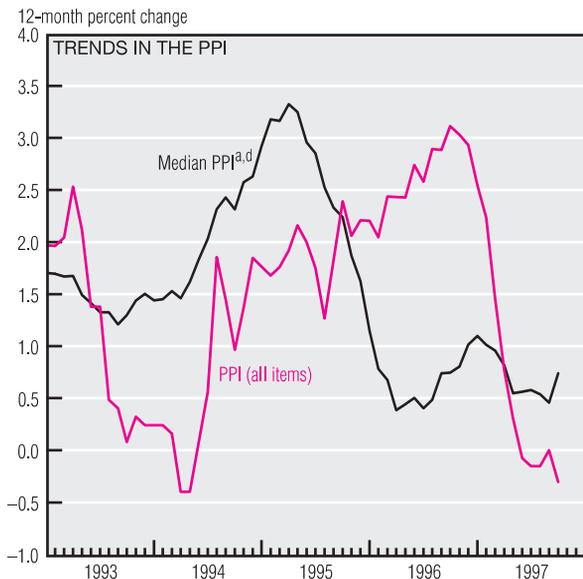
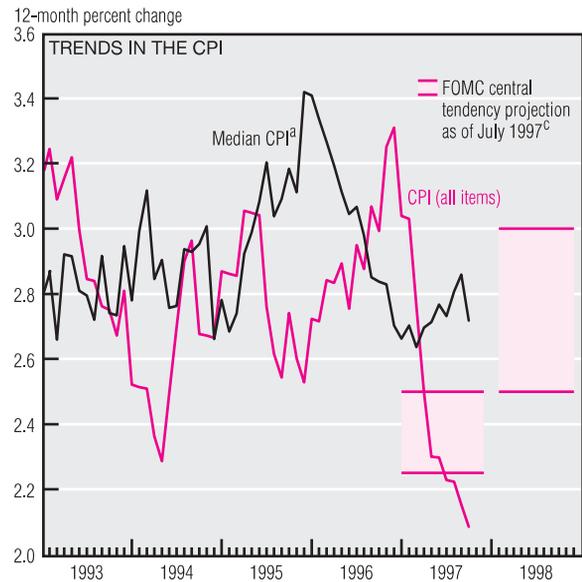
In a related market, the option on gold futures with a strike price of 310 and an expiration date of November 14, 1997, plummeted to only \$10 just before expiration. As the option moved from *in the money* (spot price of gold above \$310) to *out of the money* (spot price below \$310), it became worth less. The chances of gold rebounding decreased as the expiration date approached, and the option lost even more value.

Gold prices have no discernible

relationship to the Consumer Price Index (CPI), which has climbed steadily throughout a decade of gold price gyrations. A somewhat closer relationship exists between gold prices and the inflation rate (the rate of change in the CPI). There is a lot of noise in this relationship, but it does seem to capture big moves; both measures decreased sharply in the early 1980s. A scatter plot shows this positive relationship more clearly. Statistically, gold prices can explain about 30% of the variation in CPI inflation since 1980.

Inflation and Prices

	Annualized percent change, last:				1996 avg.
	1 mo.	3 mo.	10 mo.	5 yr.	
October Price Statistics					
Consumer prices					
All items	2.3	2.5	1.7	2.6	3.3
Less food and energy	2.9	1.9	2.1	2.8	2.6
Median ^a	1.8	2.3	2.8	2.9	2.7
Producer prices					
Finished goods	0.9	3.4	-0.8	1.2	2.9
Less food and energy	0.0	1.4	0.3	1.1	0.7
Commodity futures prices^b					
	7.2	13.3	1.0	3.9	-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. 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.

d. Based on the PPI for all items.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; and the Commodity Research Bureau.

The monthly price data continue to point toward only modest inflationary pressure. In October, the Consumer Price Index (CPI) rose at a 2.3% annualized pace, about ½ percentage point above its year-to-date annualized average (1.7%), but a percentage point lower than last year's rate (3.3%). The median CPI increase was only 1.8% for the month, its smallest uptick since August 1996. Still, year to date, the median CPI has risen at a 2.8% annualized rate, nearly identical to both

last year's increase and the average increase since 1992.

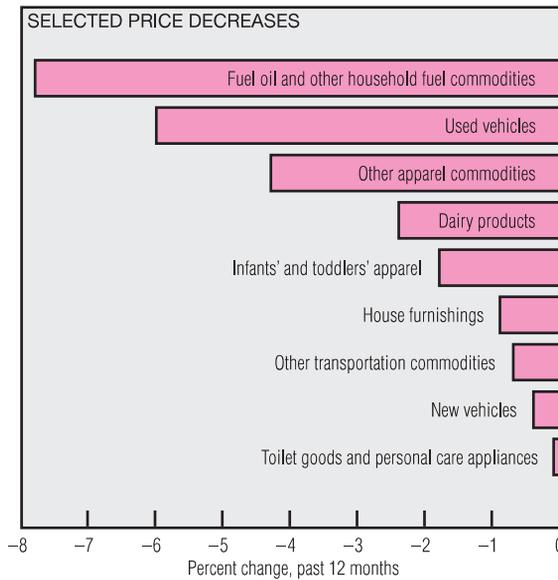
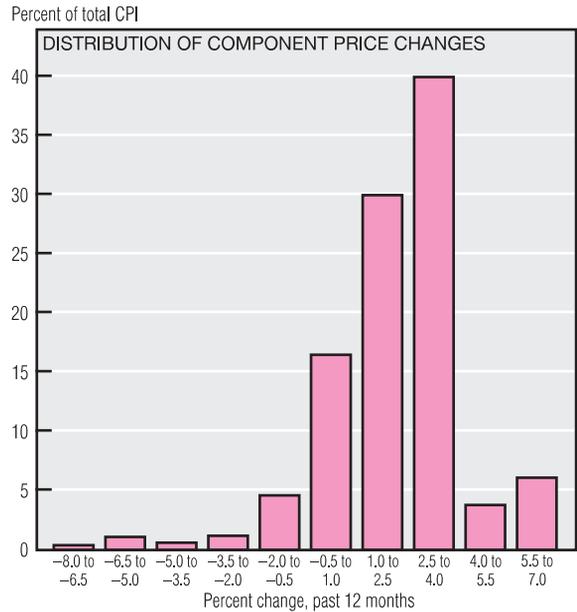
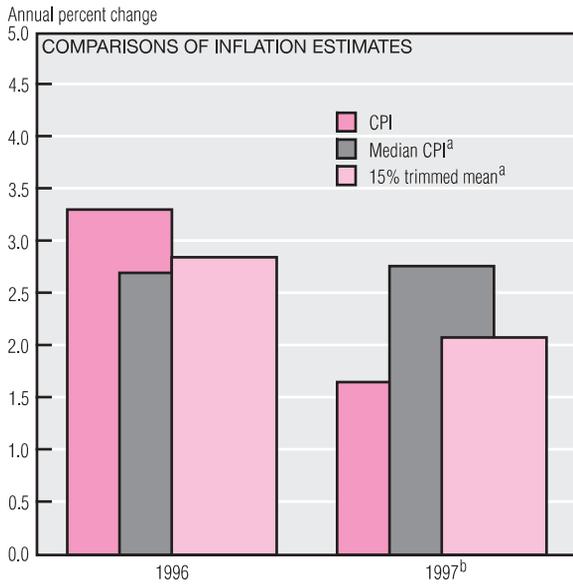
The recent trend in the rate of consumer price increases is now well below the Federal Open Market Committee's (FOMC) 1997 central tendency projection (2¼% to 2½%) and more than ½ percentage point below the midpoint of the group's 1998 projection (2¾%).

Price patterns at the firm level show similar moderation. The Producer Price Index (PPI) for all goods has actually declined about 1% over

the past 12 months and now stands about three percentage points below its 1996 average. The median PPI, however, has shown more steady (and moderate) trends, growing at an average rate of ½% to 1% since February 1996. Reports from purchasing managers suggest some firming in producer prices, but not much. In October, only a slightly greater proportion of the managers surveyed reported prices rising compared to prices falling.

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Inflation and Prices (cont.)



a. Calculated by the Federal Reserve Bank of Cleveland.
 b. December 1996 through October 1997, annual rate.
 c. Includes sugar and sweets, fats and oils, nonalcoholic beverages, and other prepared food.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

The relatively large discrepancy between the CPI and the median CPI increases suggests that prices have been rising very unevenly across the various components of consumer spending. While the CPI has fallen sharply this year from last, the median CPI has risen at a nearly identical rate. The 15% trimmed mean (which excludes the highest and lowest 7½% of the price change distribution) lies between these two extremes.

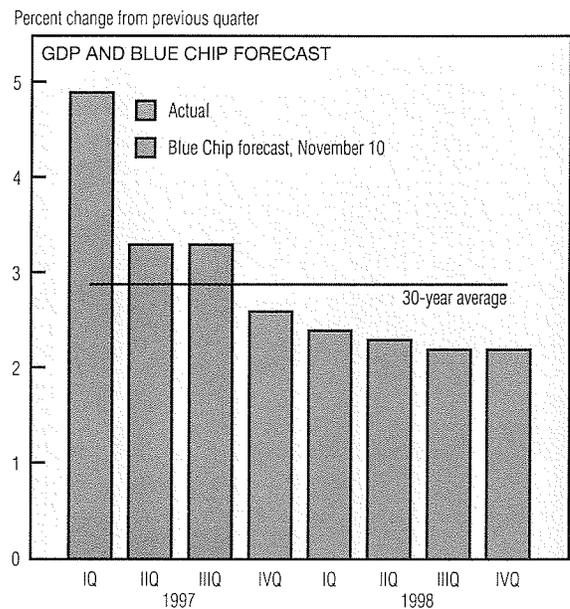
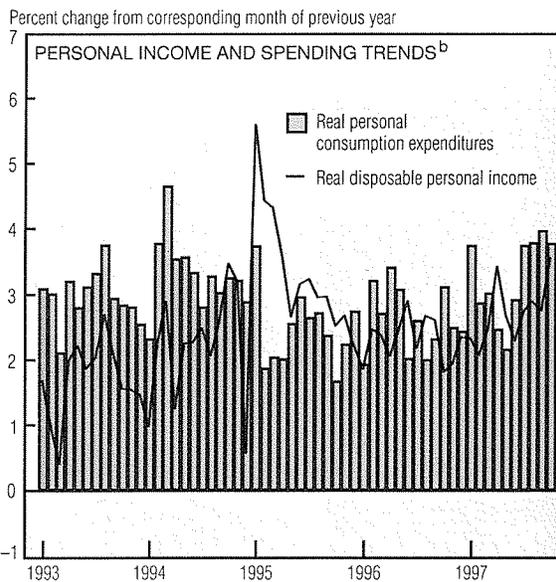
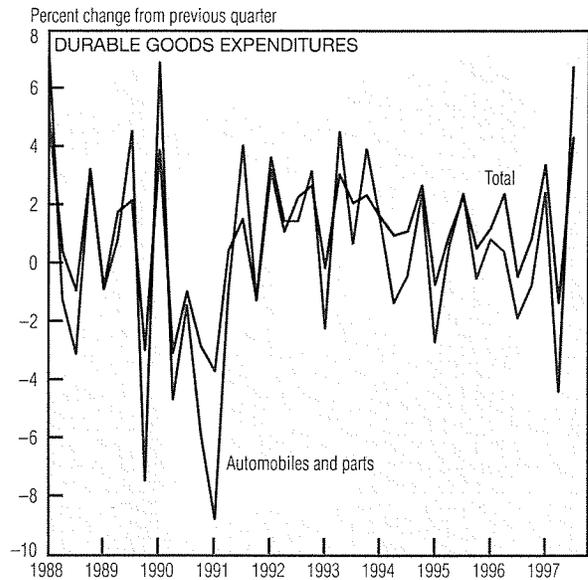
An examination of the distribution of price changes over the past year

shows why these three inflation estimates differ. The largest share of price increases in the CPI (40%) has been in the 2½% to 4% range, much higher than the “average” price increase. That means that there have been some extreme price declines in the CPI that have helped to restrain the index. Among the items showing the largest price declines this year were fuel oil (down nearly 8%), used vehicles (down 6%), miscellaneous apparel (down about 4%), and dairy products (down about 2½%).

A few goods, however, registered substantial price increases over the past 12 months. For example, the price of tobacco and smoking products moved up 6%, and school books/supplies and personal/educational services increased substantially. Moreover, there was a wide range of commodities whose prices rose almost 3%, including shelter, men's and boys' apparel, and entertainment services.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	58.0	3.3	3.9
Consumer spending	68.5	5.8	3.8
Business fixed investment	35.5	18.1	10.5
Equipment	36.0	24.1	13.7
Structures	2.0	4.2	2.9
Residential investment	2.6	3.8	2.4
Government spending	3.5	1.1	1.0
National defense	1.0	1.3	-2.8
Net exports	-26.3	—	—
Exports	10.2	4.3	14.2
Imports	36.6	14.0	14.7
Change in business inventories	-28.1	—	—



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

The Commerce Department lowered its estimate of real GDP growth from 3.5% to 3.3% in 1997:IIIQ. Downward revisions to exports, business inventories, and spending on nonresidential structures more than offset further gains in producers' durable equipment and personal spending on durable goods.

Much of the third quarter's robust growth is traceable to the strength

of durable goods spending, which reached its highest point (4.3%) since the beginning of 1988. Expenditures for automobiles led the advance, jumping 6.7%—the biggest gain in seven and a half years and a welcome reversal of the second quarter's 4.4% decline. Overall consumption rose 5.8%, its highest rate in more than five years.

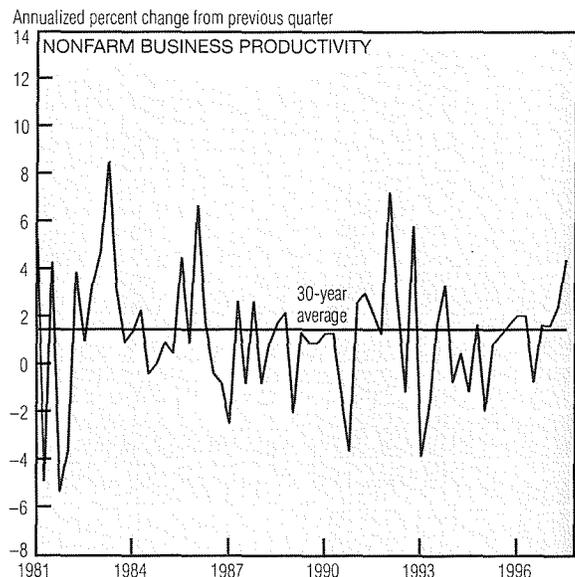
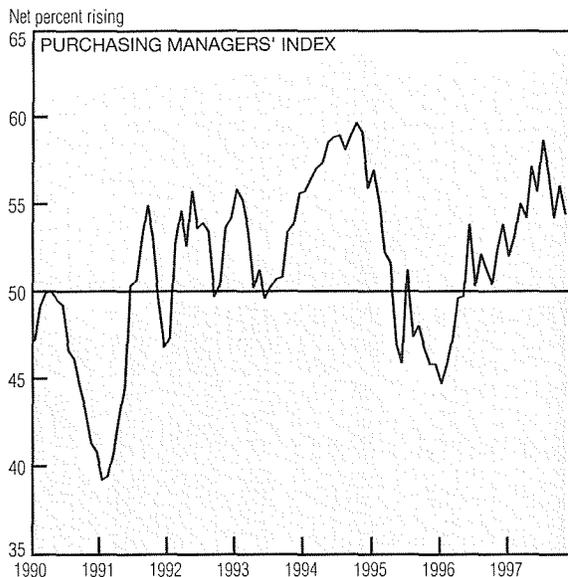
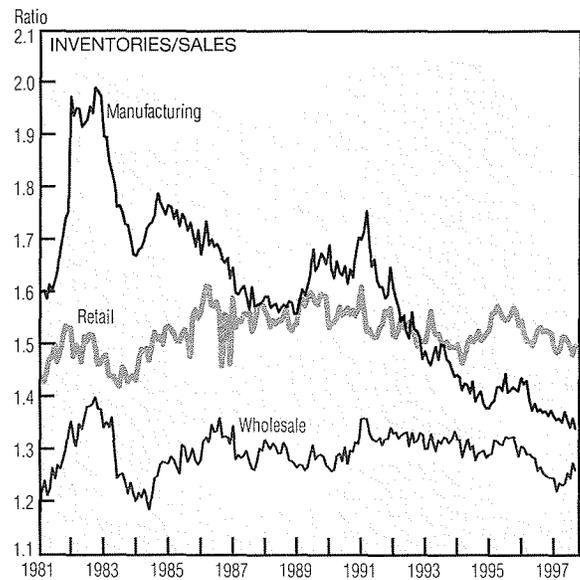
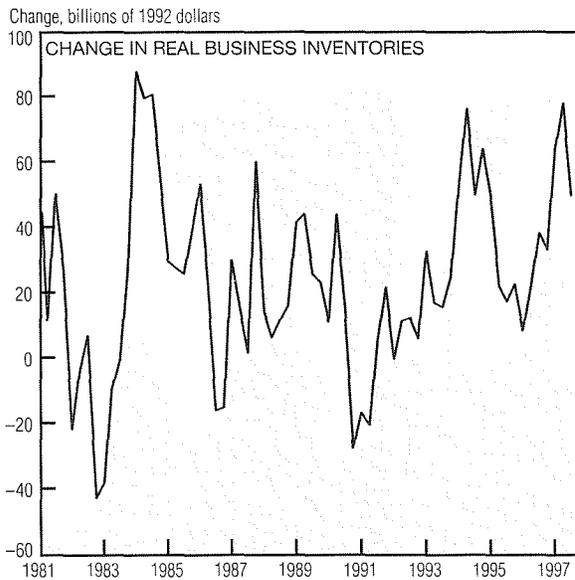
The brisk pace of consumer

spending seems to be continuing. On a year-over-year basis, real personal consumption spending in October mirrored the third-quarter gain. Real disposable personal income growth also remained brisk.

The consensus of economists participating in November's Blue Chip survey is that economic growth will moderate to 2.6% in the

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Economic Activity (cont.)



SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and National Association of Purchasing Management.

fourth quarter. This implies a full-year growth rate of 3.5%. Most of the respondents are projecting slower growth in 1998.

As expected, businesses curbed inventory accumulation in 1997:IIIQ. The \$49.5 billion (1992 dollars) addition to stocks last quarter, although down from \$77.6 billion in 1997:IIQ, still seems substantial. Nevertheless, the overall inventory-to-sales ratio decreased slightly (to 1.36) in Sep-

tember. No imbalances are apparent at the manufacturing, wholesale, or retail level.

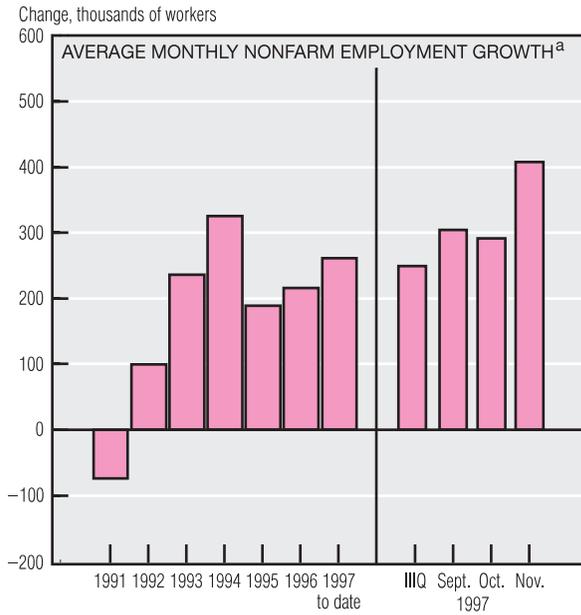
Economic activity within the industrial sector continues to be solid. The National Association of Purchasing Management's November index remained above 50, where it has been for the past year and a half. A reading below 50 indicates contraction.

Productivity, the ratio of output produced to labor hours worked,

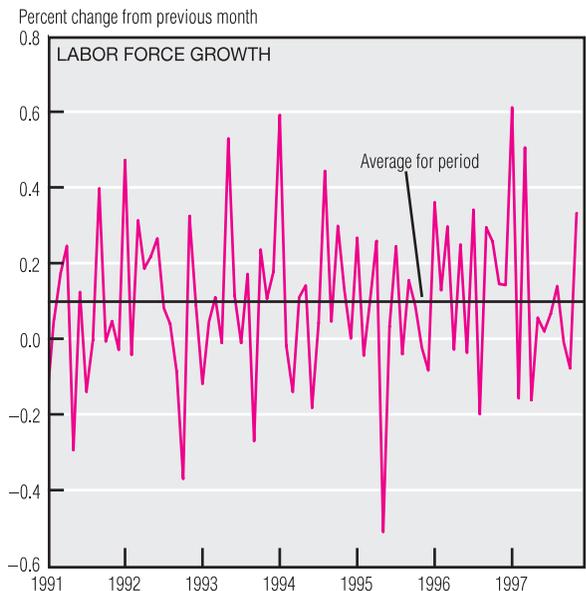
continues to advance. Nonfarm business productivity grew at a 4.3% annual rate in the third quarter, a five-year high.

Productivity has an important effect on a nation's standard of living. When workers increase their hourly output, real wages rise. Many analysts have downplayed the recent productivity gains, however, regarding them as largely cyclical and transitory rather than sustainable.

Labor Markets



	Average monthly change (thousands of employees)				
	1996	1997			
	Year	IIIQ	Sept.	Oct.	Nov.
Payroll employment	212	245	300	287	404
Goods-producing	19	19	6	44	72
Manufacturing	-5	12	-2	38	44
Construction	24	7	5	8	29
Service-producing	192	226	294	243	332
Services	98	109	148	106	180
Retail trade	48	45	26	34	105
Eating and drinking estab.	6	10	8	-3	30
Government	14	25	-90	30	-5
Local	19	30	-80	21	-2
		Average for period			
Civilian unemployment rate (%)	5.4	4.9	4.9	4.7	4.6
Manufacturing workweek (hours) ^b	41.5	41.8	41.9	42.0	42.1



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

The unemployment rate reached a 24-year low in December, as strong jobs growth outpaced an expanding labor force. Nonfarm payrolls were up 404,000, pushing the unemployment rate to 4.6%, a level not seen since October 1973.

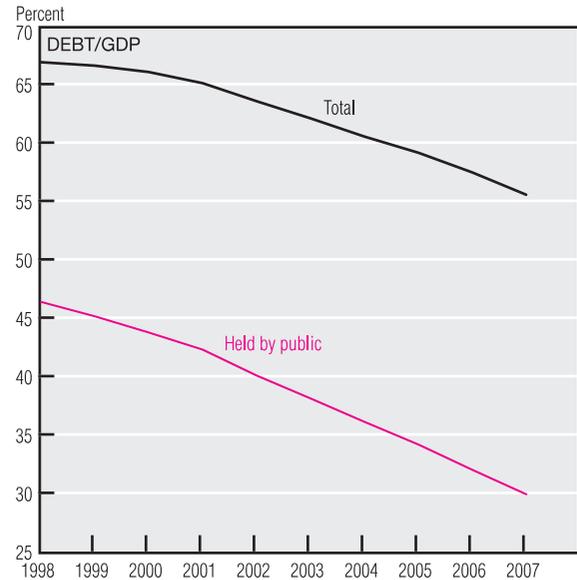
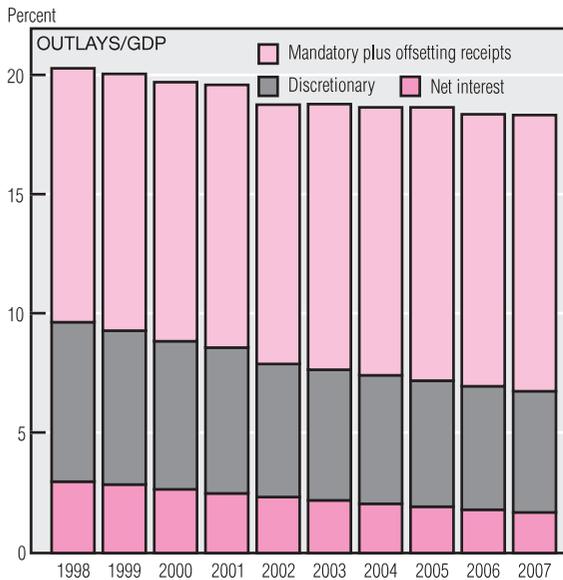
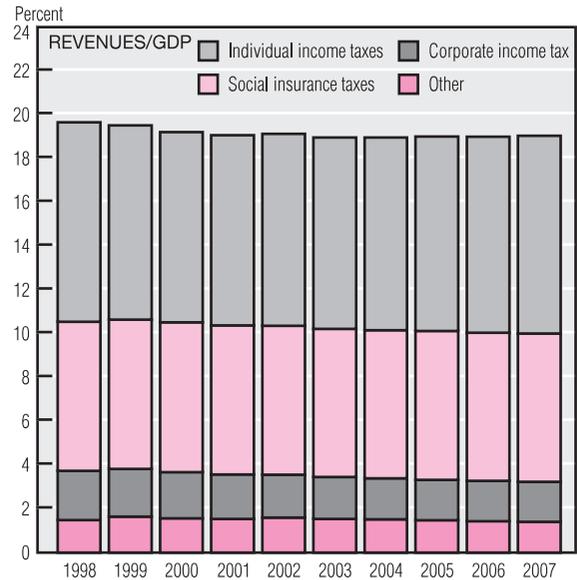
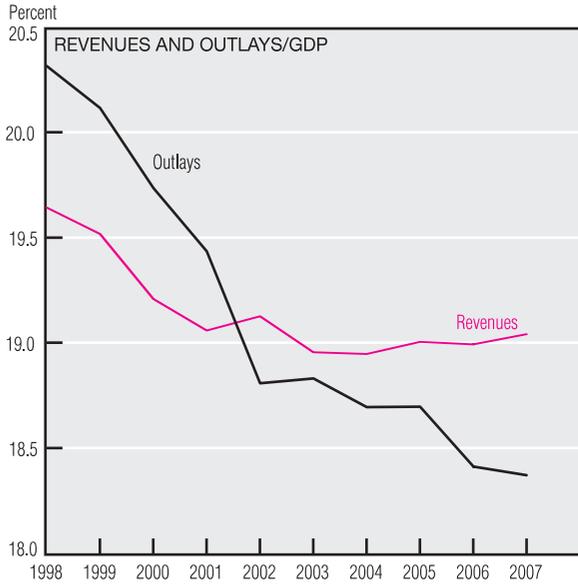
Increases were notably large in the services, retail trade, and manufacturing sectors. With the holiday shopping season approaching, retailers added 105,000 jobs to their

payrolls in November, building on October's revised 34,000 gain. Restaurants accounted for a substantial portion of retail employment growth. Payrolls in the narrow services sector rose 180,000 following October's revised 106,000 gain, with 29% of the increase coming from temporary agencies. Manufacturing and construction also turned in strong performances in November, but government em-

ployment fell somewhat.

The labor force expanded last month, at a pace well above its recent trend. Although highly variable on a month-to-month basis, labor force growth throughout much of this year has been below trend. As a result of these strong employment and labor force gains, a record 64% of working-age Americans now have jobs.

Federal Budget Projections



SOURCE: Congressional Budget Office.

The Congressional Budget Office projects that federal outlays as a share of GDP will decline from more than 20% to about 18.5% by the year 2007. Federal revenues will fall from almost 20% to 19%.

The recent increase in national output has boosted revenues and depressed spending on income-assistance programs. The federal deficit is expected to grow in 1998 because of discretionary spending increases and revenue reductions enacted for that fiscal year. Thereafter, it is expected to decline and become a surplus by 2002. The principal risks to these projections are a weaker-than-expected econ-

omy, which could lead to lower revenues, an unexpected surge in mandatory spending, or a failure to resist discretionary outlay increases from today's near-freeze level.

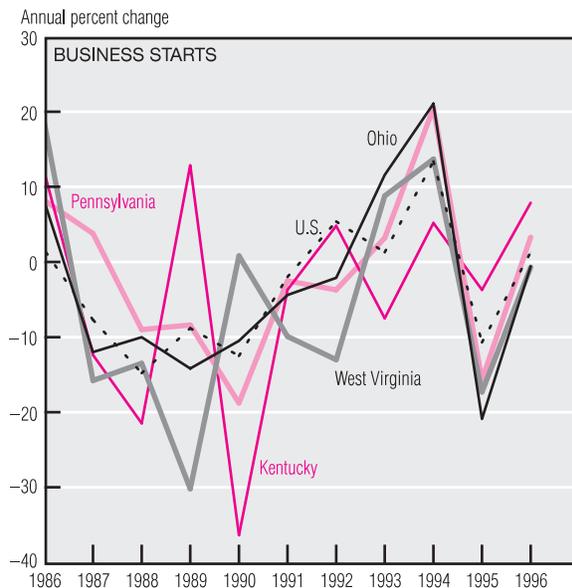
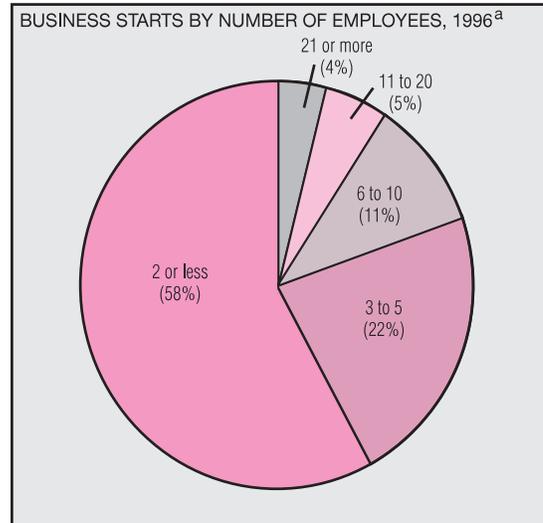
The government's two leading revenue sources—individual income taxes and social insurance taxes—are expected to remain roughly constant as fractions of GDP. Income taxes' share is expected to decline in the short term (reflecting a reversal of transient factors that caused revenue growth to exceed its long-term trend over the last four years) and then to rise again toward the end of the projection period. On the outlay side, although discretionary spend-

ing and net interest payments will decline as percentages of GDP, mandatory outlays are expected to increase continuously.

The lower deficits projected through 2002 and the surpluses projected thereafter would produce steady declines over the next 10 years in both total debt and publicly held debt as shares of GDP. However, total outstanding public debt reflects only part of federal liabilities. Implicit commitments to pay Social Security and health benefits in excess of projected payroll-tax revenues represent an additional burden that someone must bear.

New Business Formation

	Number of firms		Percent change
	1995	1996	
New England	9,250	8,960	-3.1
Middle Atlantic	30,011	30,137	0.4
East North Central	23,465	23,280	-0.8
West North Central	8,731	8,390	-3.9
South Atlantic	32,195	32,142	-0.2
East South Atlantic	7,643	7,994	4.6
West South Central	16,435	17,240	4.9
Mountain	11,115	12,262	10.3
Pacific	29,313	30,070	2.6
Total	168,158	170,475	1.4



Business Starts by Industry, 1985-95
(Percent, average over period)

	KY	OH	PA	WV	4D ^b	U.S.
Agriculture, forestry, fishing	1.7	1.6	1.5	1.1	1.5	1.5
Mining	3.4	0.5	0.4	7.6	1.2	0.6
Construction	12.8	15.3	17.3	11.5	15.7	12.7
Manufacturing	7.7	10.1	7.8	6.2	8.6	8.7
TPU ^c	4.1	4.3	3.1	3.8	3.7	3.8
Wholesale/retail trade	43.6	34.4	35.1	41.0	36.2	37.6
FIRE ^d	4.3	5.9	5.8	4.1	5.6	6.4
Services	20.8	23.7	24.2	21.1	23.5	24.3
Unclassifiable	1.6	4.0	4.7	3.8	4.0	4.3

a. Percent of starts is shown in parentheses.
b. Fourth Federal Reserve District.
c. Transportation and public utilities.
d. Finance, insurance, and real estate.
SOURCE: Dun & Bradstreet.

In 1996, more than 170,000 new businesses were formed in the U.S., up 1.4% from the previous year. The increase, however, was not uniformly distributed. In fact, the number of regions experiencing declines nearly equaled the number that saw gains. Regional variations may reflect the disparate influences of economic shocks and disturbances.

Most new businesses start very small. In 1996, nearly 60% involved no more than two individuals, and

80% consisted of five employees or less. Nonetheless, the cumulative economic impact of these firms is important. A back-of-the-envelope calculation suggests that start-ups created approximately 750,000 new jobs last year. This does not imply that employment in the entire economy increases by an equal amount, however. Many jobs created through business formations draw workers away from other sectors of the economy. Presumably, though, new

business formation enhances overall worker productivity, because newly created jobs replace those using older, less efficient technologies and those in declining industries.

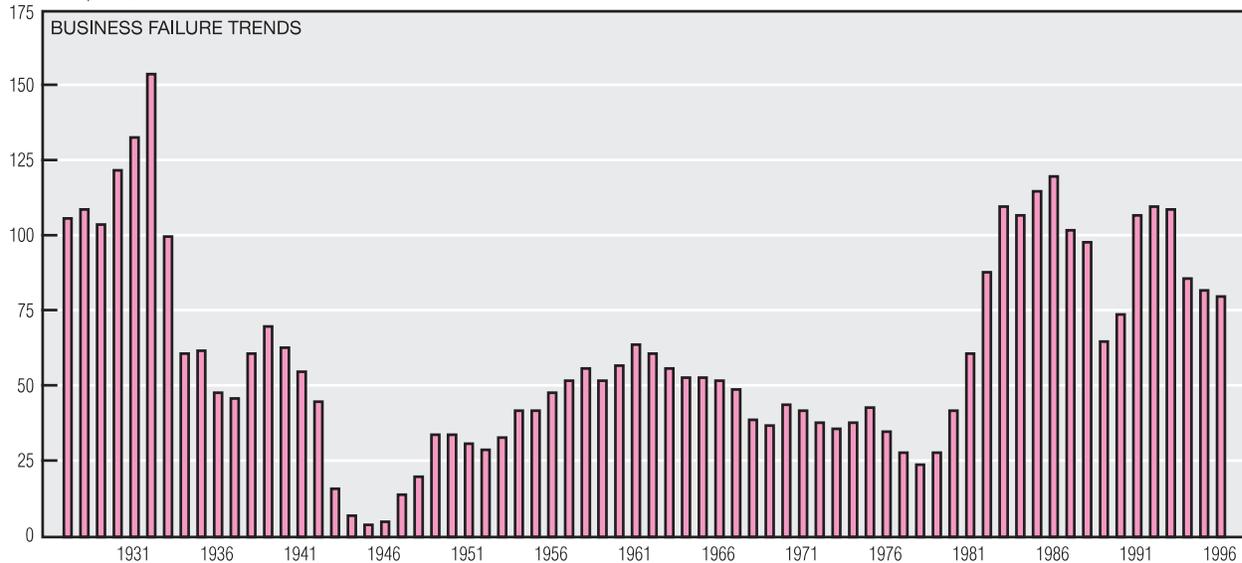
Business starts in the Federal Reserve's Fourth District have been quite variable in the last decade or so, especially in Kentucky and West Virginia. Overall, however, business formation in the District mirrors national trends.

(continued on next page)

New Business Formation (cont.)

Business Failures, 1995 (Percent)										
Age of business	Agriculture, forestry, fishing	Mining	Construction	Mfg.	TPU ^a	Wholesale trade	Retail trade	FIRE ^b	Services	Total
1 year or less	7.9	7.0	4.4	6.6	9.0	5.8	9.6	7.5	9.9	7.9
2 years	6.5	7.0	5.3	7.8	8.7	8.4	10.6	6.7	8.1	8.2
3 years	5.4	9.2	6.9	9.2	8.5	9.2	9.8	6.2	8.5	8.6
4 years	4.3	5.6	6.4	8.9	8.7	8.7	9.3	7.1	8.3	8.2
5 years	4.4	7.8	7.1	6.9	7.6	6.9	7.2	6.1	6.9	7.0
Total 5 years or less	28.5	36.6	30.1	39.4	42.5	39.0	46.5	33.6	41.7	39.9
6 years	5.5	2.1	7.0	7.3	5.6	6.9	6.5	5.3	6.3	6.5
7 years	5.5	4.9	6.1	5.2	5.7	5.1	5.7	6.5	5.4	5.6
8 years	4.7	6.4	5.6	5.5	5.0	4.7	4.9	6.0	5.7	5.3
9 years	3.4	3.5	5.3	4.4	5.2	4.3	4.4	6.0	4.4	4.6
10 years	3.9	4.9	4.6	3.7	5.0	5.1	3.7	5.9	4.1	4.3
Total 6-10 years	23.0	21.8	28.6	26.1	26.5	26.1	25.2	29.7	25.9	26.3
Over 10 years	48.5	41.6	41.3	34.5	31.0	34.9	28.3	36.7	32.4	33.8

Failure rate per 10,000 listed concerns



a. Transportation and public utilities.

b. Finance, insurance, and real estate.

SOURCE: Dun & Bradstreet.

Since 1985, more than 60% of all U.S. business formations have occurred in two industries: services and wholesale/retail trade. Although the industrial composition of Fourth District start-ups is similar to that of the nation as a whole, mining starts are twice the U.S. average. In West Virginia and Kentucky, mining accounts for nearly 8% and 3.4%, respectively, of all business starts. Nationwide, this share is only 0.6%. Both Ohio and Pennsylvania far exceed the national average for busi-

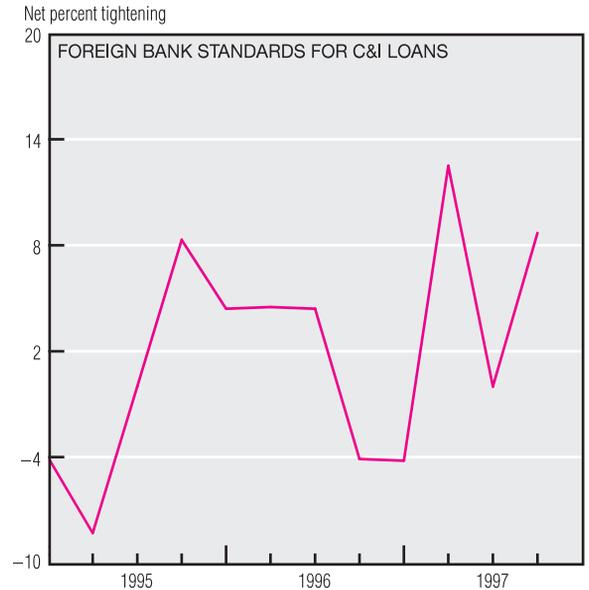
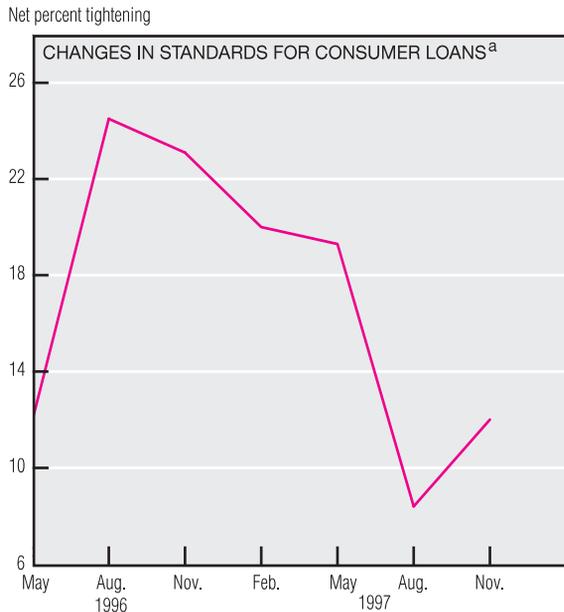
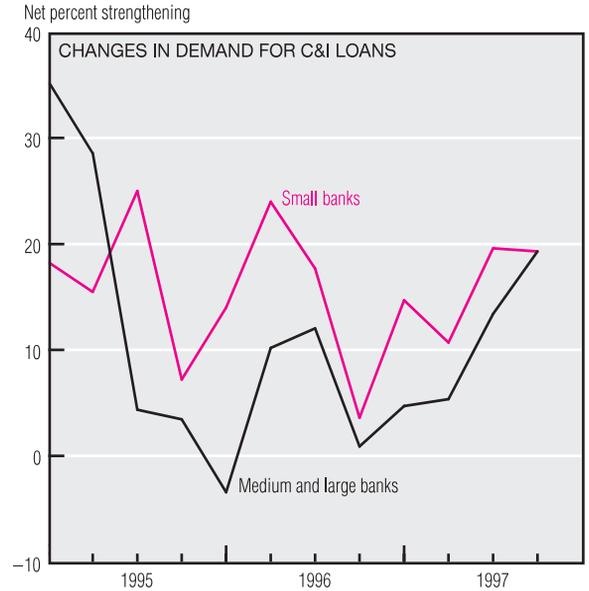
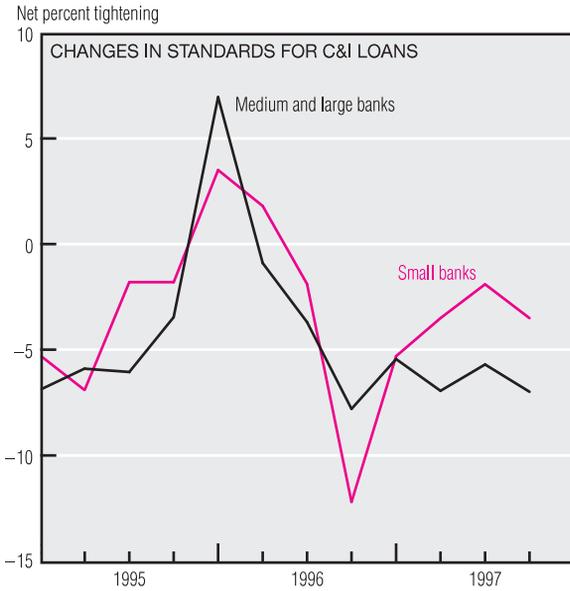
ness starts in construction.

Business failures often accompany business formations, and most new enterprises, especially in retail trade and services, die young. Nearly 40% of all new businesses fold within five years, and fully two-thirds founder within 10.

Broad cyclical movements appear in the pattern of business failures. Failure rates went from a historic high of more than 150 per 10,000 listed concerns in 1932, during the depths of the Great Depression, to a

historic low of less than five by the end of World War II. After remaining fairly stable for 30 years, failure rates rose dramatically in the early 1980s and now stand at levels similar to those of the 1920s and 1930s. These numbers must be put into proper perspective, however. The structure of today's economy seems more flexible than 60 years ago, in that it is capable of accommodating a greater number of start-ups and failures without calamity.

Bank Lending in the U.S.



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

The Senior Loan Officer Opinion Survey on Bank Lending Practices provides insight into changes in the markets for lending by domestic banks and by branches and agencies of foreign banks operating in the U.S. Thus, it helps answer two questions: First, is bank liquidity adequate for loan demand? Second, are foreign banks transmitting their financial problems to the U.S. through their operations here?

In the November survey, roughly 5% of domestic banks reported easing their standards on commercial

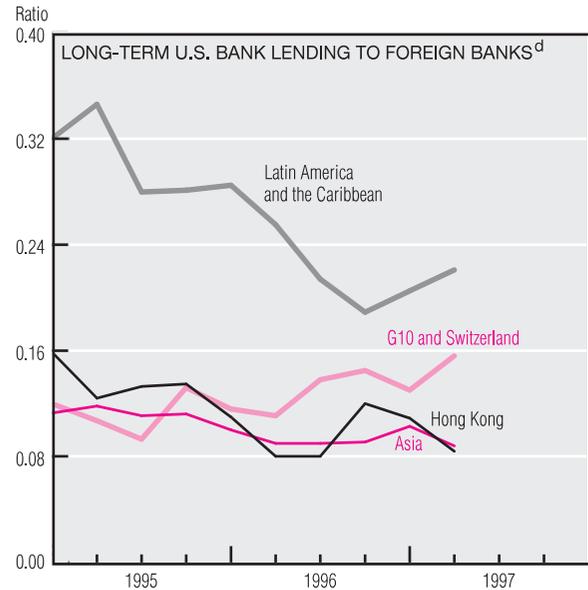
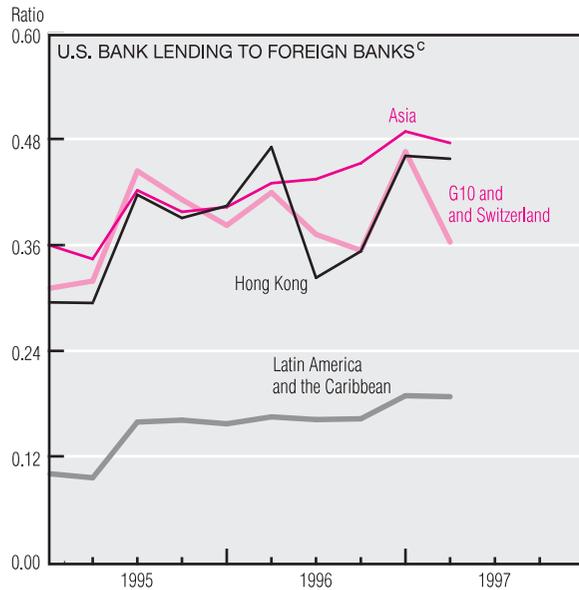
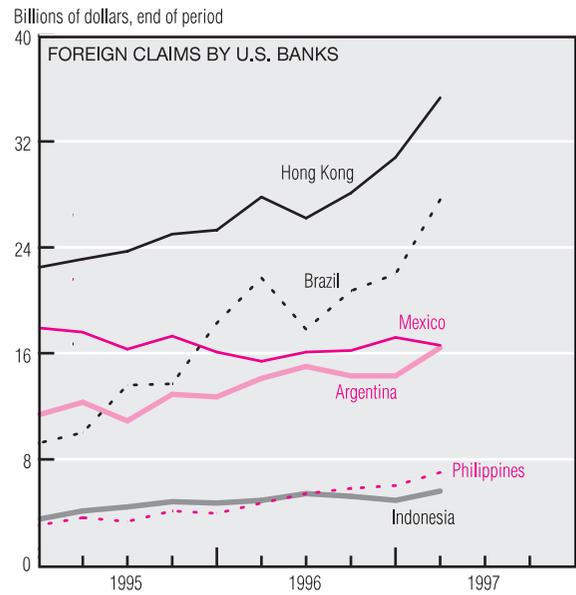
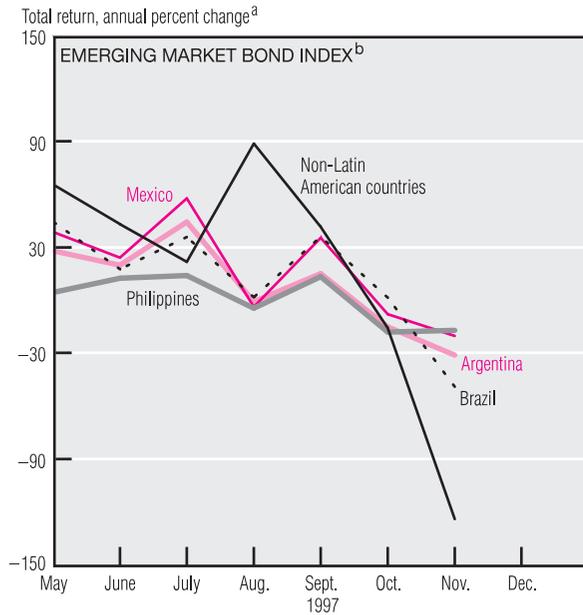
and industrial (C&I) loans, and about 40% reported narrowing spreads over costs of funds. On the other hand, roughly 20% of domestic banks reported stronger demand for C&I loans, largely for financing plant and equipment expenditures and for mergers and acquisitions. Since the end of 1996, a trend toward tighter standards and stronger demand has confirmed the picture of a strong economy.

Consumer lending shows a slightly different picture, with standards still tightening, presumably in response to performance problems.

Consumer loan demand, however, was slightly weaker than in the previous report.

Unlike domestic banks, foreign banks reported tighter standards on C&I loans, tempting analysts to conclude that financial problems abroad are already affecting the U.S. However, these banks' tighter C&I loan standards and slower loan growth predated their parent countries' problems. Moreover, many survey responses were completed before the late November declines in the U.S. stock market.

U.S. Bank Lending Abroad



a. Based on last weekly percent change in each month.

b. J.P. Morgan Emerging Bond Index Plus.

c. Dollar share of U.S. bank loans to foreigners that are held by foreign banks.

d. Dollar share of U.S. bank loans to foreigners that have a maturity of more than five years.

SOURCES: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, various issues; Federal Financial Institutions Examination Council, Country Exposure Lending Survey; and American Banker, Inc., *Emerging Markets Debt Report*, various issues.

Late October's financial crises in Southeast Asia have rocked U.S. equity markets and created fears of a possible decline in exports. U.S. banks are vulnerable to this chain of events because of their lending to U.S. exporters as well as their direct lending abroad.

Not surprisingly, loans from U.S. banks have increased as part of the influx of foreign capital that contributed to these countries' present fragility. It is still unclear how far the value of their bank claims have dropped. Emerging market bond

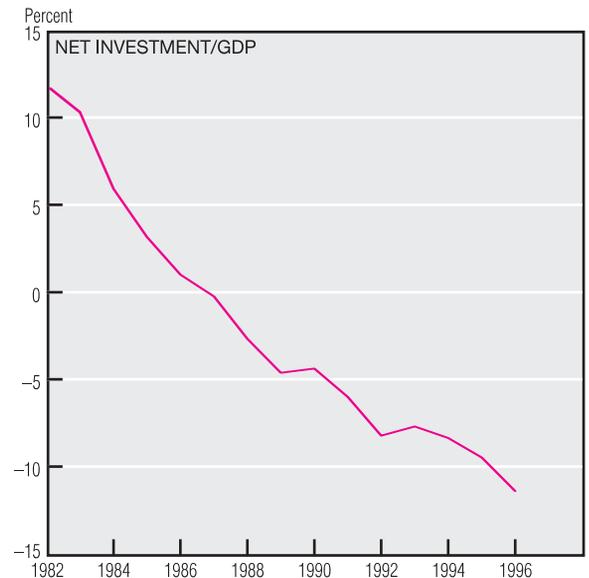
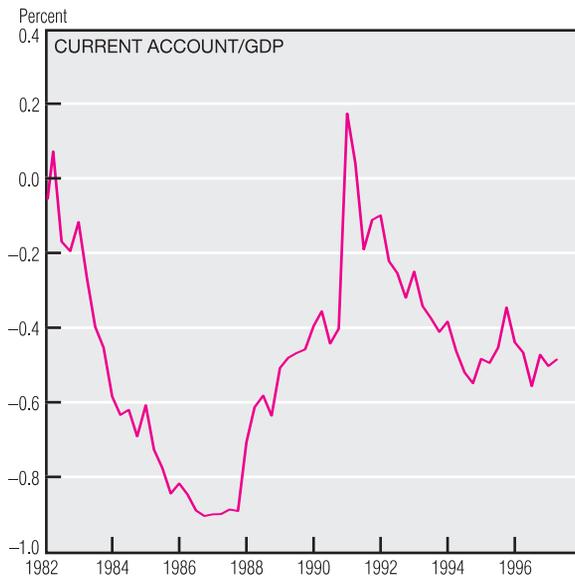
prices, however, began a sharp decline for Southeast Asia in August, and for most other regions in September. The current position of U.S. banks is similarly indistinct, but plainly, their exposure in Hong Kong and Brazil broadened greatly earlier this year.

The share of U.S. bank lending to foreign banks has generally been growing since at least 1995. U.S. banks are said to be more involved than others in using interbank balances for such trading strategies as exploiting differentials between do-

mestic and foreign interest rates.

The declining share of longer-term U.S. lending may reflect a shift toward off-balance-sheet business. Some analysts contend that longer-term loans' relatively small share of total lending is an important factor in currency crises. Shorter-maturity claims lose less of their value when interest rates rise, and also might tend to be withdrawn more quickly. Heavier reliance by developing countries on longer-term lending would probably indicate a more sophisticated financial infrastructure.

Saving, Investment, and the Current Account



a. Income receipts (interest and dividends) from U.S. assets abroad and payments on foreign assets in the U.S.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The U.S. current account deficit requires an influx of foreign capital. In other words, we finance our surfeit of imports by giving foreigners claims on our future output. Persistent deficits have made us a debtor country since 1987. This year, the annual cost of servicing these debts has surpassed the income earned on all U.S. assets held abroad.

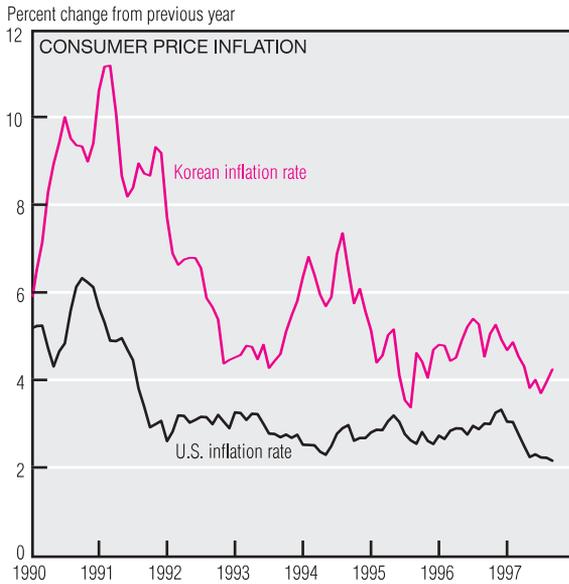
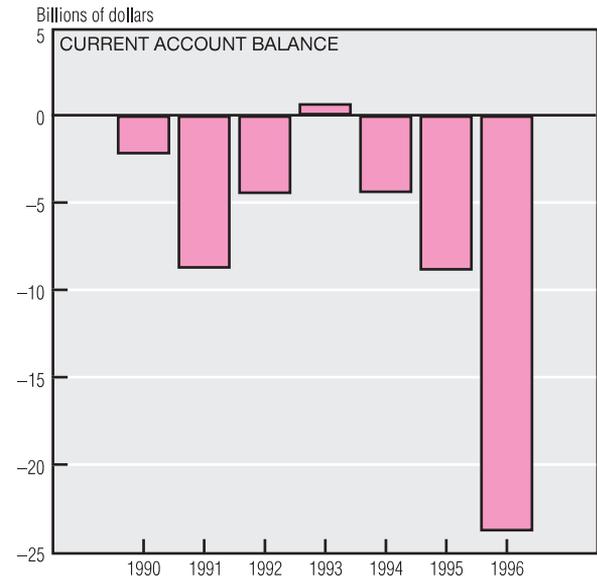
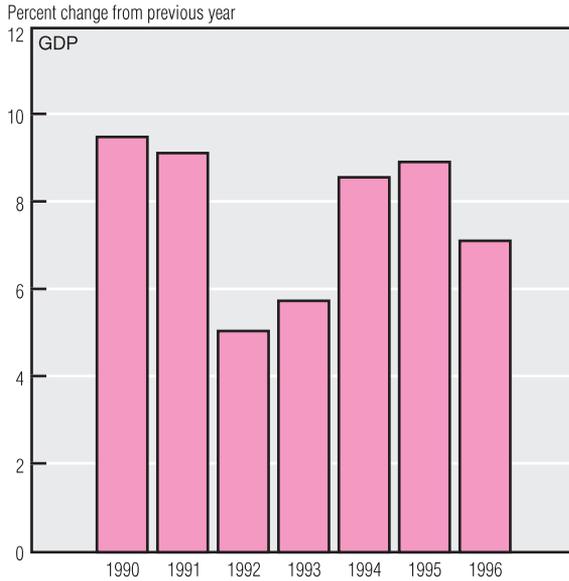
The nation's ability to sustain a current account deficit depends largely on its use of incoming funds. A debtor country that uses foreign

capital for financing expanded investment, rather than private consumption or government spending, stands a good chance of servicing its debts without harming its future standard of living.

Comparing saving and investment patterns with the trade deficit reveals three distinct episodes: Between 1982 and 1987, as the U.S. current account expanded dramatically, our gross saving and gross investment fell relative to GDP. During this period, the nation relied on an

expanding inflow of foreign saving to help support its private consumption, government spending, and investment. From 1987 to 1991, the current account deficit narrowed. A smaller capital inflow filled the void between gross saving and gross investment. Since 1990, the current-account deficit has widened once again. This time, however, gross investment as a share of GDP is expanding faster than saving, with capital inflow supporting an investment boom.

Korean Financial Turmoil



SOURCE: International Monetary Fund, *International Financial Statistics*, various issues.

The recent wave of Southeast Asian financial problems broke against Korean shores in November, sending the country's currency and stock market swirling. Like many nations in the region, Korea built a solid macroeconomic performance on a weak financial foundation and shielded much of its economy from the full force of market competition.

Korea's real economic growth has

averaged 7.4% per year since 1990. This is not all that surprising. Most economic models suggest that emerging market economies—those with low, but growing, capital-to-labor ratios—will expand faster than those that are capital-rich. Like most developing countries, Korea has financed its growth with foreign capital. Its current account deficit, the mirror image of its capital flows, grew sharply last year to \$23 billion.

The country also added approximately \$1.3 billion (equivalent) to its \$33.2 billion (equivalent) portfolio of foreign exchange reserves in 1996.

Korean inflation, although higher than in the U.S., is fairly moderate. The won's depreciation against the dollar should be sufficient to offset this inflation differential. The U.S. accounts for approximately half of Korea's trade.