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The Economy in Perspective

Sentimental fools? … According to the Conference Board's Survey of Consumer Sentiment, U.S. households are now more confident about the economy's health than at any time since 1969. This should be sobering news to those who remember what followed in the 1970s (three recessions, double-digit inflation, gasoline pump queuing, severe slumps in productivity growth and stock prices, and soaring interest rates) and in the 1980s (the less-developed-country debt crisis, soaring federal budget and trade deficits, sharp appreciation and depreciation of the U.S. dollar's foreign exchange value, and the collapse of the thrift industry). What went wrong, and how relevant are these events today?

During the 1960s, inflation was low and economic growth was exceptionally vigorous. But the government discounted the dangers of inflation and became fixated on managing the business cycle by fine-tuning monetary and fiscal policy. In the latter half of the 1960s, a confluence of political pressures and economic doctrine eventually produced an escalating inflation rate—one that would last for another decade despite attempts to arrest it through various means, including wage and price controls.

Inflation control became more challenging during the 1970s because many of the world's largest oil exporting countries formed a cartel that significantly raised the price of crude oil several times. Although these circumstances affected all oil importing countries to some extent, they had a dramatic impact on the United States, since our energy imports were large, our energy efficiency was low, and our commitment to price stability was weak.

The industrialized countries at that time had organized an international monetary system based on a gold standard, but employing the U.S. dollar as a reserve currency. Other countries managed their domestic monetary policies to maintain some stability in relation to the U.S. dollar, although the degree of stability varied from time to time and from country to country. When the United States inflated its money supply and depreciated its own currency's domestic purchasing power, it also threatened the stability of the foreign exchange rate system by increasing the likelihood that the dollar might be devalued. In response, some other industrialized countries expanded their money supplies as well, dampening the exchange rate consequences, but at the cost of importing U.S. inflation.

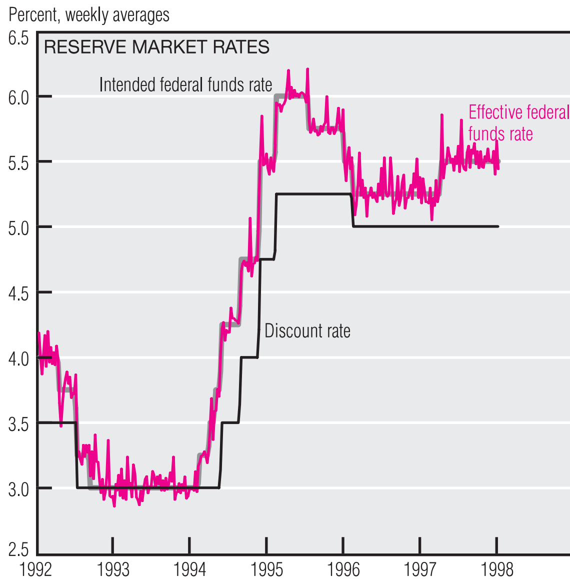
The United States suffered from its decision to tolerate inflation in a number of ways, each initially unforeseen. First, it discouraged investment in productivity-enhancing capital and encouraged speculation in housing, precious metals, art, and other similar assets. This development compromised longer-term growth. Second, the dollar became less trusted as a currency that would hold its value over time, and the terms of trade shifted against the United States. In effect, Americans had to export more goods and services to obtain a given amount of imports.

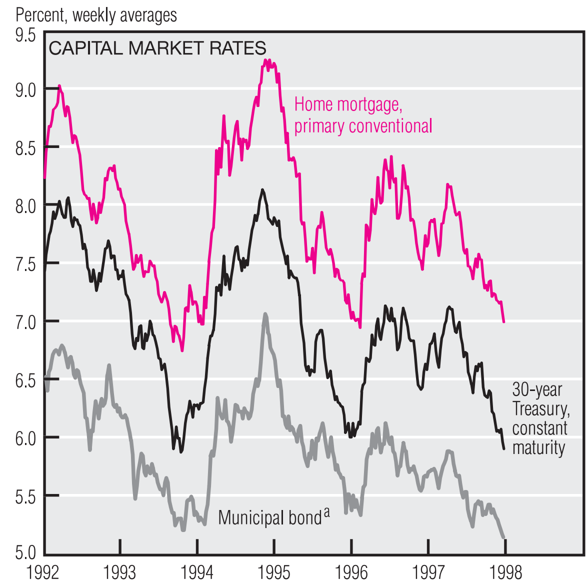
Finally, poor U.S. economic performance and uncertainty about future economic policies contributed to a belief among global investors that opportunities abroad, particularly in Mexico and South America, would now provide acceptable risk/reward trade-offs. These areas were regarded as a new source of oil and other natural resources thought to be in perennially short supply. Capital flows from the rest of the world to these parts of the Western Hemisphere expanded in the latter part of the 1970s, but within a few years it became evident that this speculative fervor was misplaced. As inflation rates declined around the world, commodity prices collapsed, and the developing nations struggled to repay their significant debts.

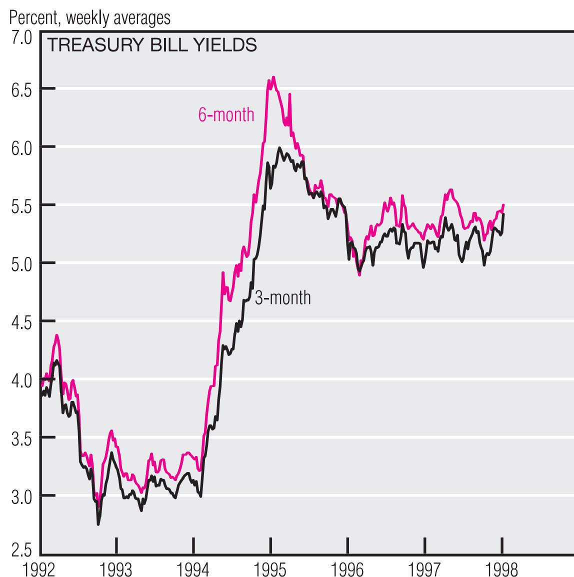
More than a decade has passed since then. In the United States, inflation and federal budget deficits have been nearly eliminated. Yet, the international trading and financial systems on which we depend are clearly unsettled. The latest round of difficulties, exposing severe problems in an arc from Indonesia to Japan, provides yet another reminder of how interconnected markets have become: The collapse of the South Korean won may prove more important to U.S. consumers than would a shortage of freight cars in Kansas.

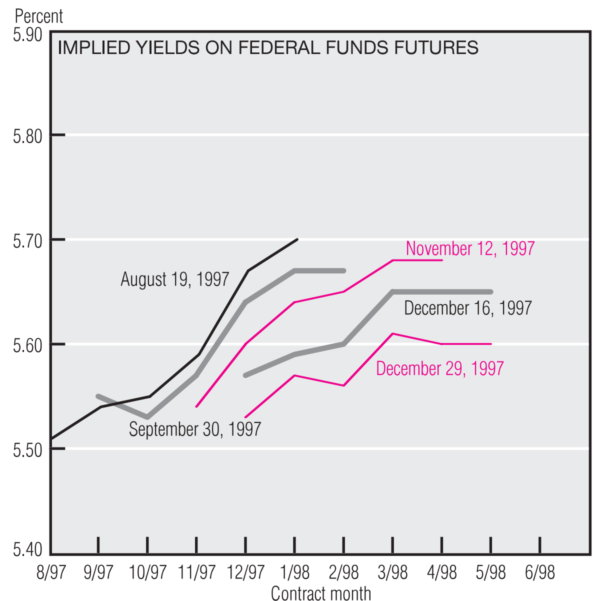
The U.S. commitment to price stability, prudent fiscal policy, and free trade will almost certainly be tested in the coming decade; in some respects, it is being challenged today. Have we learned that abandoning our economic principles in the face of unforeseen events will likely bring unforeseen consequences as well? Are we as confident about our economic prospects today as we were 30 years ago because we have learned so much, or because we have learned so little?

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 December 16 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged at 5.5%. This decision had been widely anticipated by financial markets in the weeks leading up to the meeting. Most analysts believed that the FOMC would not act in the immediate wake of the Asian financial crisis. The FOMC will reconvene for a two-day meeting beginning February 3.

Long-term interest rates continued to decline in December. The 30-year Treasury yield fell to levels not seen in more than four years. Since the end of November, it has dropped 16 basis points and now stands at 5.9%. Conventional home mortgage rates fell below 7% for the first time in two years. Since the end of November, mortgage rates have decreased 18 basis points and now average 6.99%. Municipal bond yields fell 15 basis points in December and currently stand at 5.14%.

Short-term Treasury yields continued to increase in December. The three-month yield rose 15 basis points to 5.42%, while the six-month yield was up six basis points to 5.5%.

Implied yields on federal funds futures have flattened considerably since August. Federal funds futures allow people to hedge against or speculate on the FOMC's monetary policy stance. The contract is based on the monthly arithmetic average of the daily effective federal funds rate. Because the effective funds rate does not always hit the target, small differences can arise between the settlement price of the contract and the targeted funds rate.

In August, there was an implied yield of 5.7% for the January contract. By the end of December, that yield had fallen to 5.57%. Participants in the fed funds futures market currently see very little chance of the FOMC changing the funds rate

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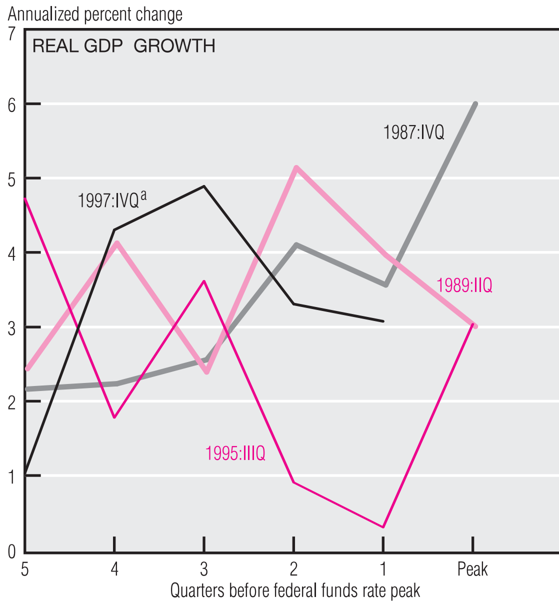
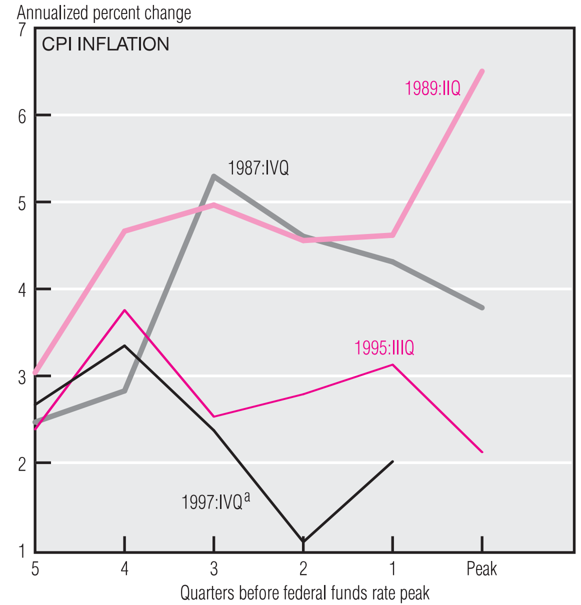
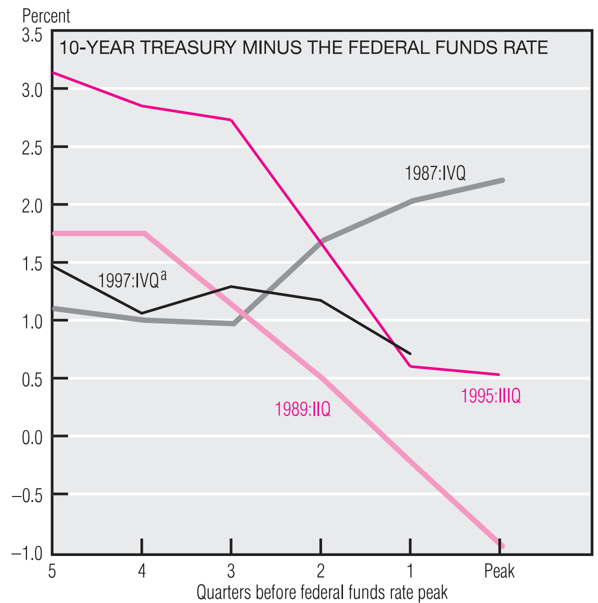
Monetary Policy (cont.)





Federal Funds Rate Tightening Cycles (Trough to peak)

Trough	Duration (months)	Number of changes	Basis points
1986:IVQ	7	8	150
1988:IQ	14	16	330
1994:IQ	17	7	300
1997:IQ (present cycle)	9	1	25



a. 1998:IQ is treated as a peak for comparative purposes only.

NOTE: Curve labels refer to the quarter in which the federal funds rate peaks. A peak occurs when the federal funds rate falls after a series of increases. All data are seasonally adjusted.

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

in the foreseeable future. Concerns that the "Asian flu" could be contagious and spread to other developing countries are thought by many to negate the possibility of future rate hikes. A small upward bias remains in the yields, however, indicating that slightly more market participants attach a higher probability to a rate hike than to a cut.

The last change in the federal funds rate, a 25-basis-point increase last March, followed a round of easing that lasted six quarters. Guided by history, market participants at that time had expected the next change in the funds rate to be another rise, since initial rate hikes have always been followed by additional bouts of tightening. This sentiment was reinforced by growing concerns about both strong economic growth and mounting inflationary pressures.

Recently, however, the mood has begun to shift, and some analysts now expect the next rate change to be a cut. According to estimates, the Asian crisis could lower U.S. economic growth by half a percentage point. Many expect this and lower import prices to mitigate inflationary pressures. Usually, inflation eases before rates are cut. If such a policy move did occur, the current 5.5% rate would represent a relative peak in the funds rate—one that is only 25 basis points higher than its previous trough. This would be unprecedented, since a typical round of tightening usually lasts more than a year, with cumulative rate hikes exceeding 300 basis points.

In addition to the Asian situation,

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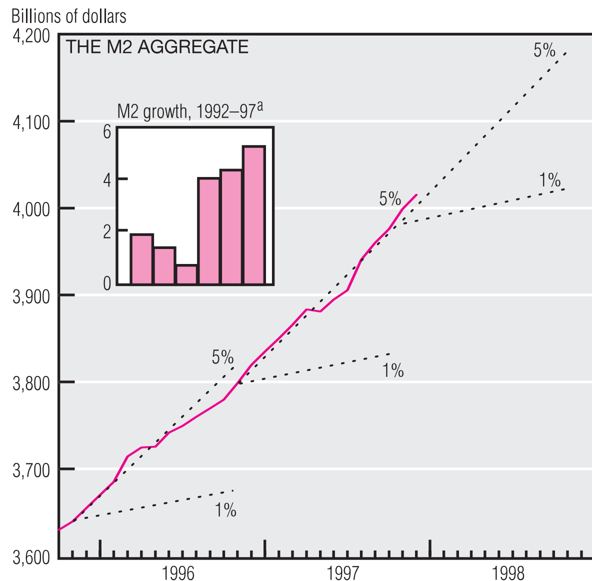
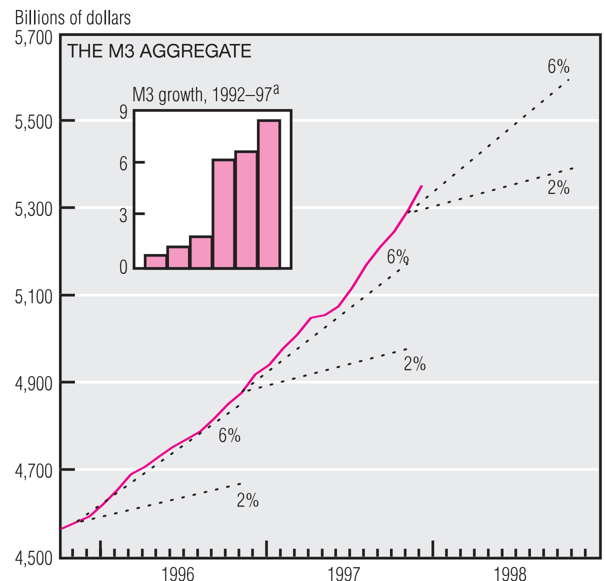
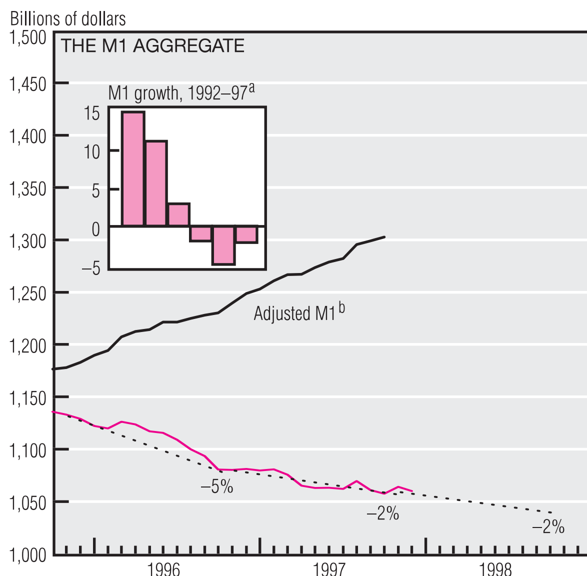
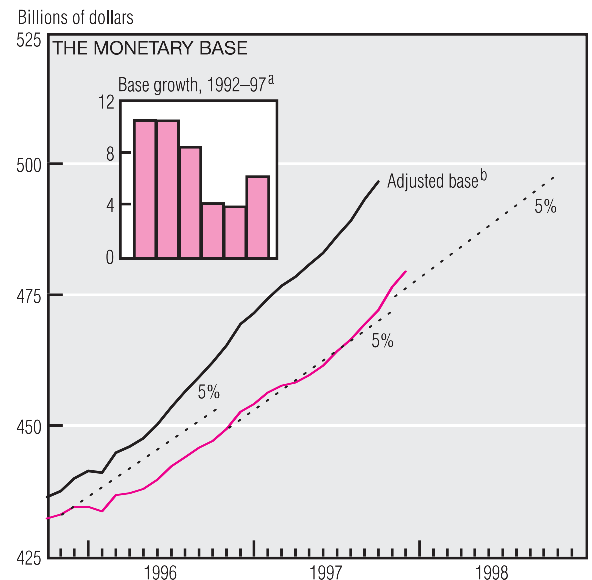








a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated December over 1996:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for December 1997. For M2 and M3, dotted lines are FOMC-determined provisional ranges. For M1 and the monetary base, dotted lines represent growth rates and are for reference only.

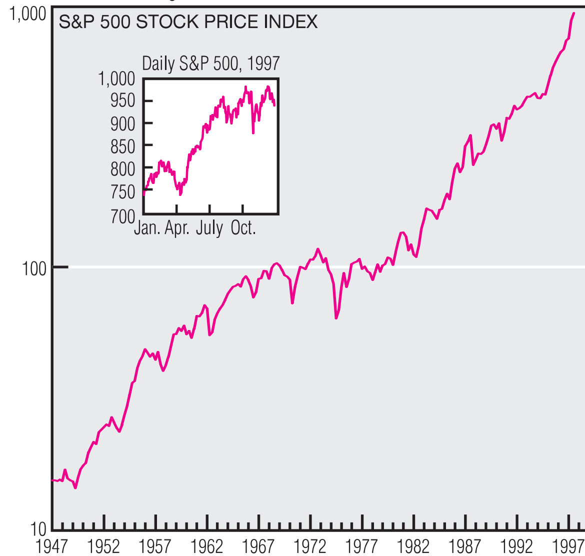
SOURCE: Board of Governors of the Federal Reserve System.

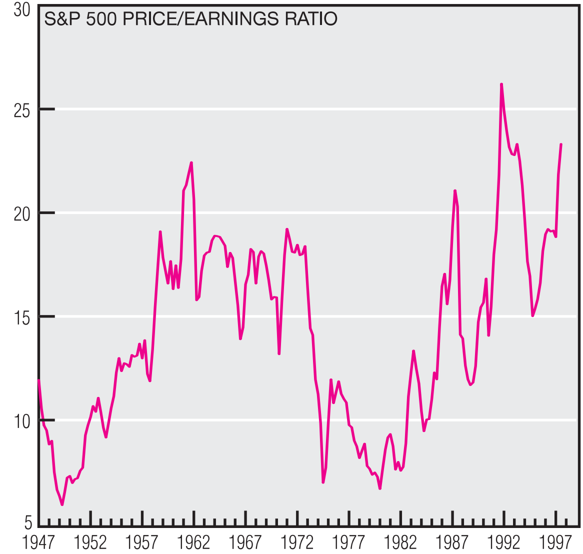
the recent change in policy expectations may reflect the flattening of the yield curve. Prior to recessions, long-term Treasury bonds frequently dip below the federal funds rate, a so-called inversion of the yield curve. Currently, this spread is similar to its level preceding the funds rate decrease in July 1995. Caution, however, should be exercised in interpreting movements in the yield curve—especially in comparing levels across time. Flat yield curves need not indicate a slowing economy, but may reflect an increased belief that the Fed will keep inflation low.

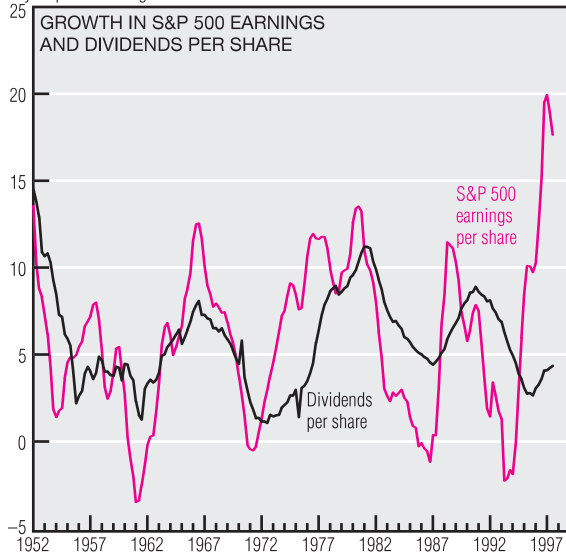
The M2 and M3 aggregates continued to accelerate at year's end. M2 grew at a 7% rate in November, and estimates show it expanding about 4.9% in December. The comparable figures for M3 are 11% and 12.8%. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 grew 5.2%, while M3 expanded 8.4%. Both aggregates grew faster than the provisional ranges set by the FOMC in July.

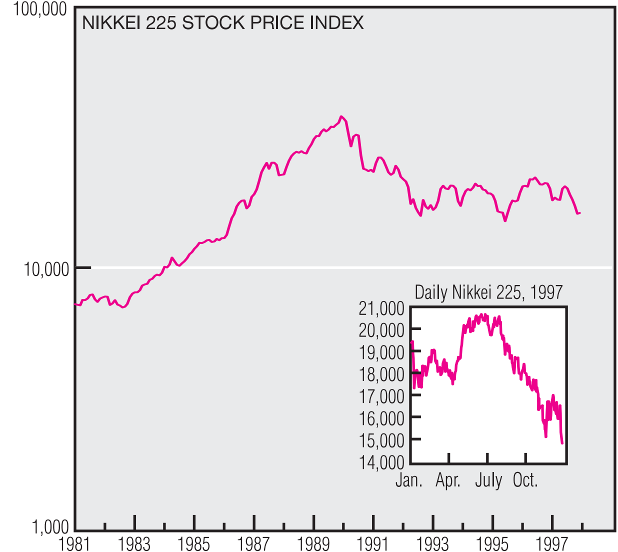
M1 climbed 7.5% in November, but is estimated to have fallen about 4% in December. For the year, it has declined 1.8%. When adjusted for sweep accounts, however, M1 grew about 5.6% through October. The monetary base expanded 11.3% in November, and estimates place its December growth rate at about 7.5%. For the year, the base grew 5.8%. It too is affected by sweep accounts, so that figure is probably understated. Indeed, through October, the sweep-adjusted monetary base was up approximately 7.3% over 1997.

The Stock Market









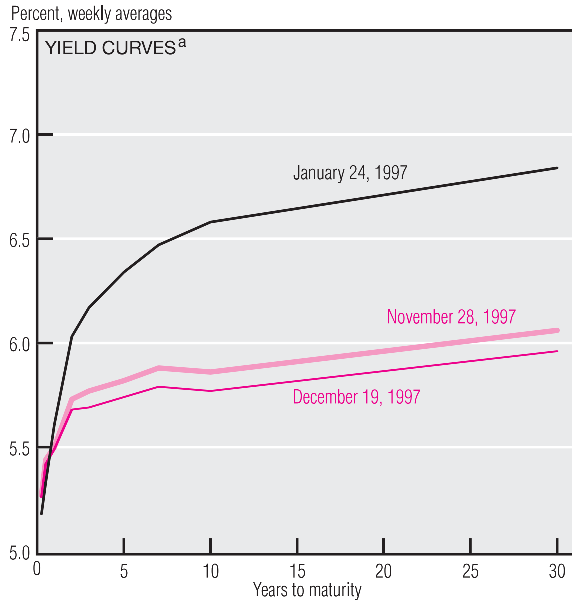
SOURCES: Standard & Poor's Corporation; and DRI/McGraw–Hill.

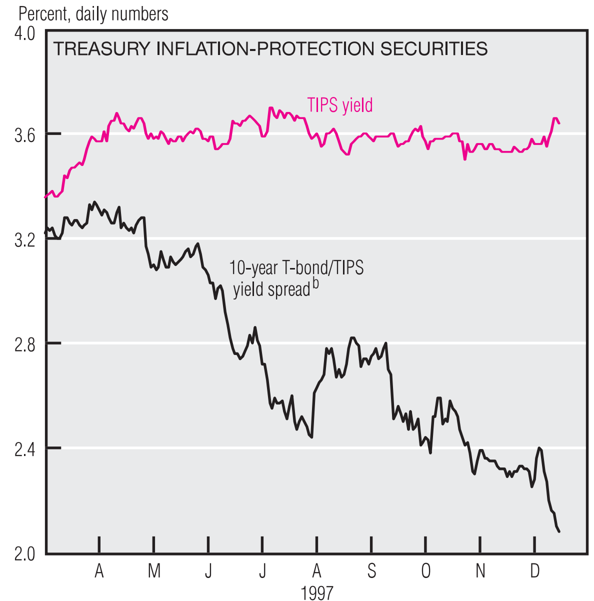
After climbing more than 25% between January and July 1997, the S&P 500 index swung widely over the balance of the year. A sharp drop in stock prices on October 28 marked the largest single-day decline since October 1987. Within a month, however, the market reversed the loss. This recent increase in stock price variability was triggered by the heightened uncertainty associated with turmoil in Asia's financial markets. The Nikkei 225 stock price index in Japan, for example, has fallen about 25% since midyear.

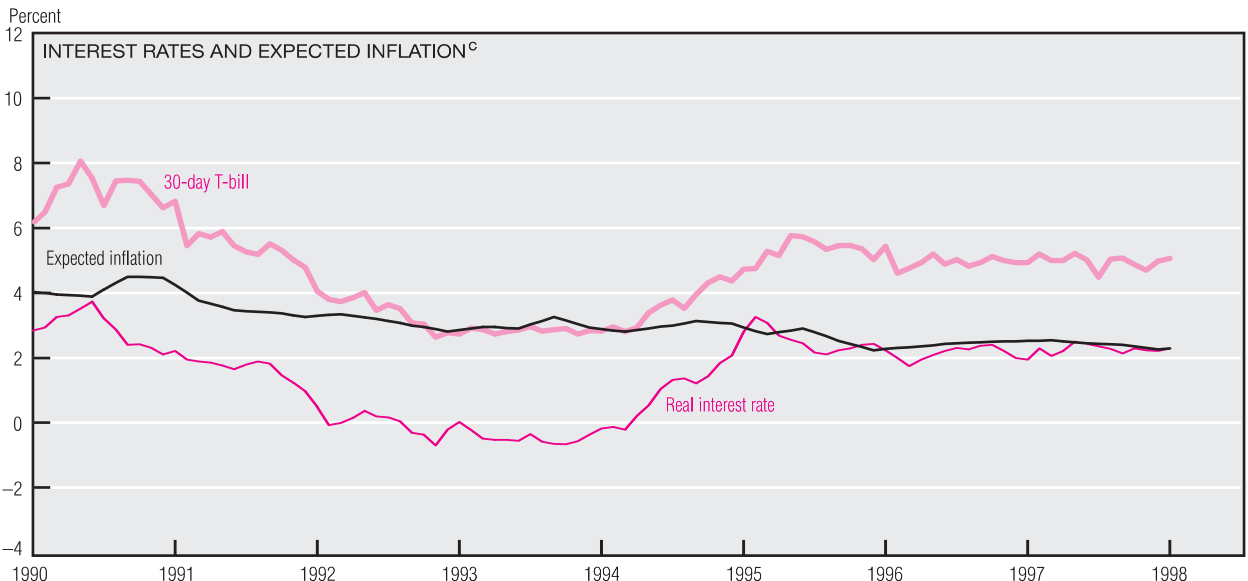
Fundamentally, a stock's price equals the discounted value of its expected future dividends. Future dividends, in turn, derive from future earnings. When prospects for earnings growth are good, stock prices tend to rise. The price/earnings (P/E) ratio—simply the stock price divided by earnings per share—gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying and hence the more earnings growth they are expecting. Earnings growth has been extraordinary in recent years, and reports in the first half of 1997 indicated that analysts expected profits to accelerate in 1998.

Asia's financial crisis has raised questions about the level of optimism embedded in U.S. equity prices. Recent actions taken in Asian countries, designed to correct excesses, will ultimately reduce the demand for U.S. goods. Thus, many analysts have begun to scale down their earnings forecasts for U.S. companies that export to Asia. Nevertheless, American firms remain in strong financial shape.

Interest Rates







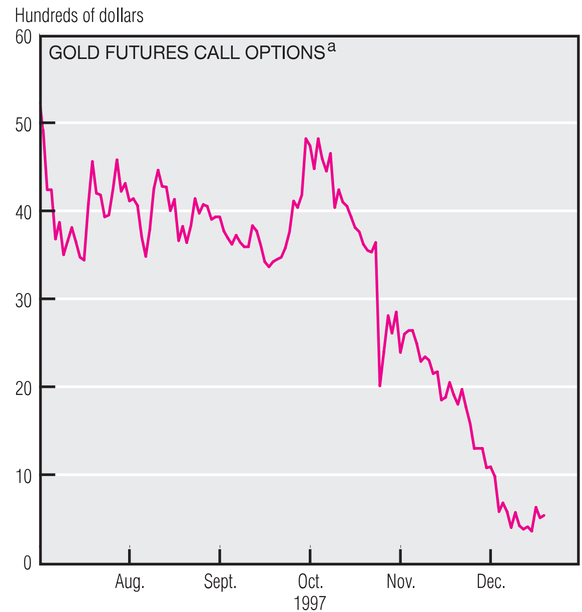
a. All instruments are constant-maturity series.
b. 10-year Treasury bond constant-maturity yield minus the yield quote for the Treasury Inflation-Protection Securities found in Bloomberg information services.
c. Real interest rate and expected inflation rate are from the Survey of Professional Forecasters and are calculated using the 30-day T-bill rate.
SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia; Bloomberg information services; and *The Wall Street Journal,* various issues.

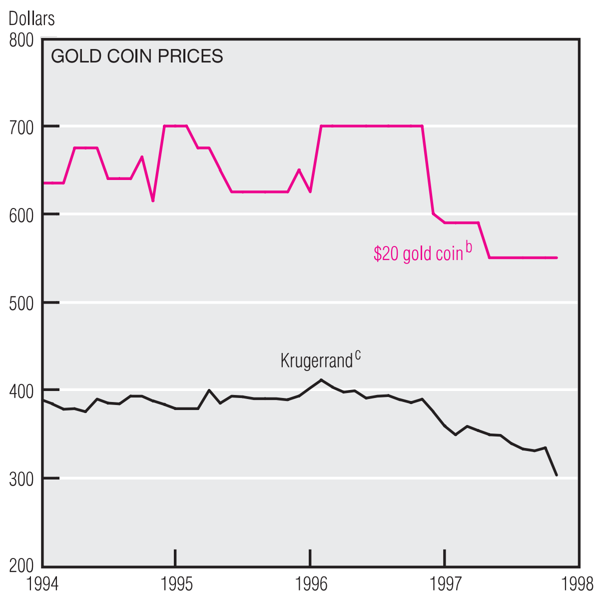
The yield curve flattened again last month as long rates continued to drop. Between November 28 and December 19, the spread between 3-year rates and 3-month rates narrowed from 50 to 43 basis points, and the gap between 10-year rates and 3-month rates shrank from 59 to 51 basis points. The contrast with the week ending last January 24 is more stark, with the same spreads changing from 99 and 140 basis points, respectively.

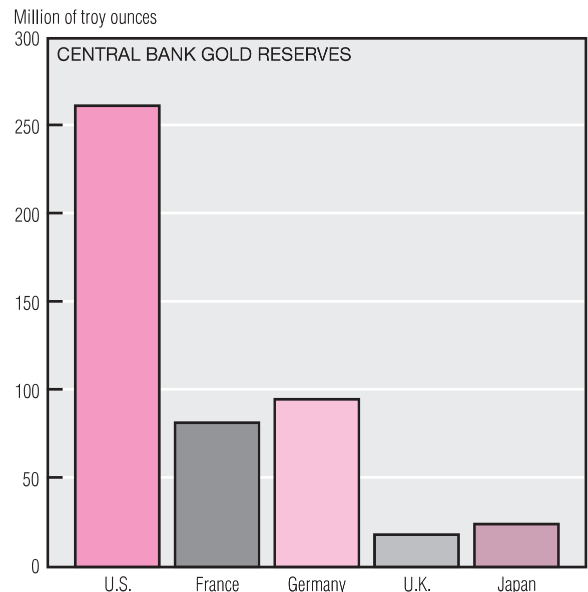
Much of the discussion about this flattening has focused on the yield curve's ability to predict real economic growth. The flatter yield curve predicts slower future growth, but because it is far from an inversion (where short rates exceed long rates), it is not signaling a recession.

Interest rates are also used to reveal inflation expectations. Subtracting the yield on 10-year Treasury Inflation-Protection Securities (TIPS) from that on 10-year nominal Treasury bonds provides one measure of the inflation expected by market participants over the next 10 years, though changing tax policies, liquidity differences, and risk premiums cloud its accuracy. According to this calculation, expected inflation has dropped substantially since May, decreasing a full 32 basis points (to 2.08%) in December alone. A more sophisticated analysis of short-term inflationary expectations using 30-day T-bills and professional forecasts shows only a minor pickup of five basis points, to 2.30%. The real interest rate also edged up eight basis points and now stands at 2.30%.

Gold Markets







a. For February 1998 at a strike price of 290.
b. U.S. 1926 $20 double eagle, Saint–Gaudens type, MS 63.
c. South African Krugerrand in dollars per troy ounce.
NOTE: All gold prices are in dollars per troy ounce.
SOURCES: Bloomberg information services; Coin World; DRI/McGraw–Hill; International Monetary Fund, *International Financial Statistics*, December 1997; and World Gold Council, *Gold Demand Trends*, November 1997.

Gold prices have continued to slide, hitting $290 per ounce on December 22. Since February 1996, the price has fallen more than $115, with $34 of that amount coming in the last two months.

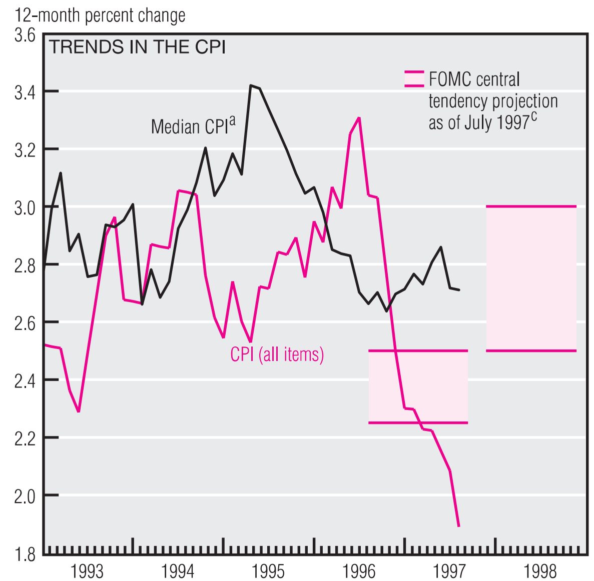
Much of this downturn is mirrored in the options market. The February 1998 290 call gives the owner the right, but not the obligation, to buy a futures contract at $290 per ounce. This contract expires in January, and its declining price shows that investors find the odds of gold prices remaining much above $290 increasingly slim. Of course, along with the trends and variability of gold prices, the falling price of the February option reflects the diminishing time left to exercise it. As that period shortens, there is less time for the price to move above $290, or for the option to move into the money. Prices of gold coins—whether the bullion sort valued mainly for their metallic content, like Krugerrands, or those with collectible value, like U.S. $20 gold pieces—have also dropped off.

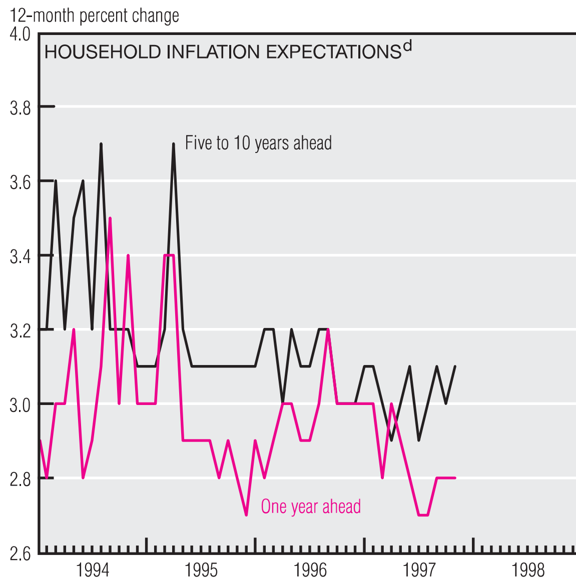
Much of the decline in gold prices has been attributed to sales by central banks, which hold nearly one-third of the world's stock. Argentina sold 125 tons in early 1997 (exercising put options), Australia announced a sale of 167 tons in July, and Switzerland revealed its plan to sell 1,400 tons in 2000. There is also some question about the European Central Bank's demand for gold, and many believe that the recent price slide can be traced to this uncertainty. Jewelry demand, another major source of the demand for gold, is also expected to drop off as a result of Asia's economic woes.

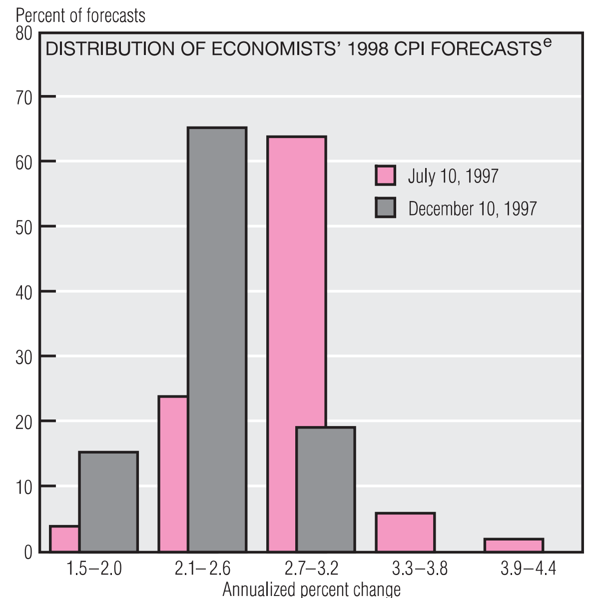
Inflation and Prices

November Price Statistics

	Annualized percent change, last: 1 mo.	6 mo.	12 mo.	5 yr.	1996 avg.
Consumer prices					
All items	1.5	2.3	1.6	2.6	3.3
Less food and energy	1.4	2.1	2.0	2.7	2.6
Median[a]	2.7	2.4	2.8	2.9	2.7
Producer prices					
Finished goods	−1.8	1.5	-0.9	1.2	2.9
Less food and energy	−0.8	2.0	0.2	1.1	0.7
Commodity futures prices[b]	−16.4	−1.5	−0.7	3.5	−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. Median expected change in consumer prices as measured by the University of Michigan's Survey of Consumers.
e. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; the University of Michigan; and *Blue Chip Economic Indicators*, July 10 and December 10, 1997.

The monthly price statistics continued to rise at a relatively subdued pace in November, virtually guaranteeing that 1997's inflation rate will be the lowest since 1986. As in 1986, last year's modest inflation was heavily influenced by falling energy prices. Still, after excluding food and energy goods, the Consumer Price Index's (CPI) rise—near 2.0%—was its smallest advance since 1965, the last year this measure dipped below 2%. The Producer Price Index (PPI) less food and energy will show virtually no increase in 1997, the third time in the past five years that this measure has grown less than 1%.

Looking to 1998, the Federal Open Market Committee (FOMC) expects consumer prices to accelerate to within a central tendency range of 2½% to 3%, although the sharp undershoot of the actual CPI from the Committee's 1997 projection may cause the group to revise this forecast downward at its February meeting.

Private forecasters, who last July also foresaw a substantial jump in consumer price growth in 1998, have reduced their forecasts sharply. Last July, nearly 65% of all economists participating in the Blue Chip survey expected consumer prices to rise between 2.7% and 3.2% this year. As of December, less than 20% held that view. Sixty-five percent now see consumer prices increasing between 2.1% and 2.6% in 1998, and 15% are projecting a rise of 2% or less.

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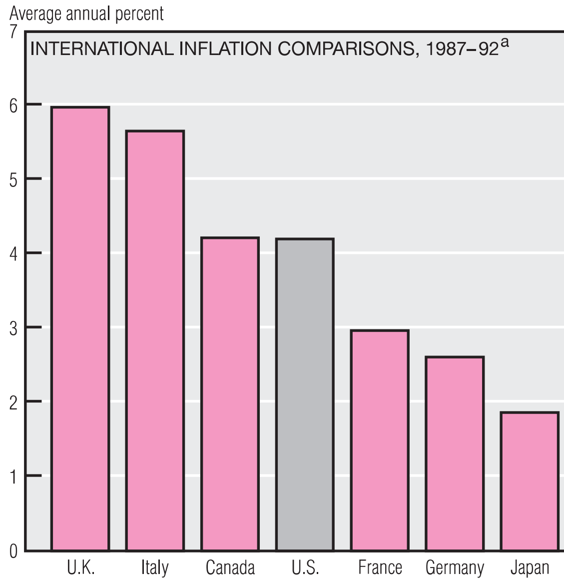
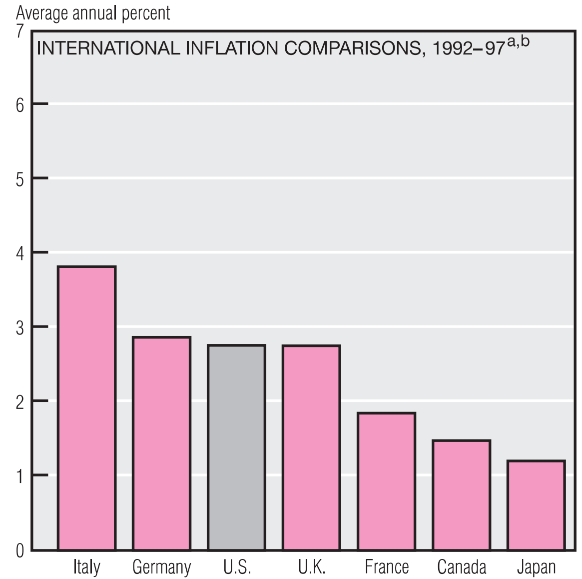
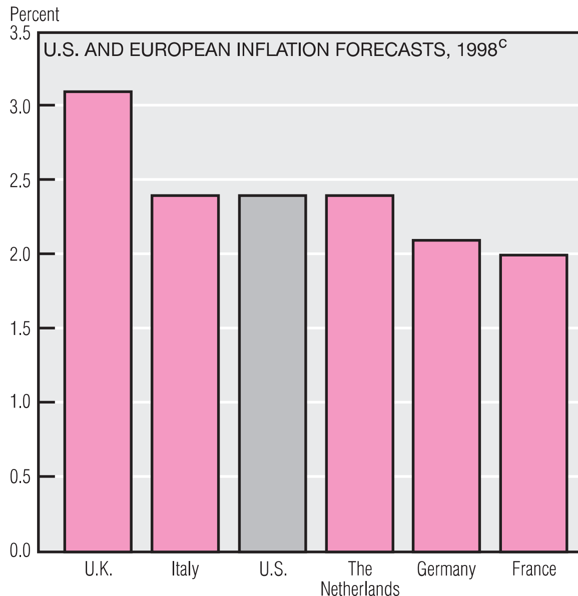
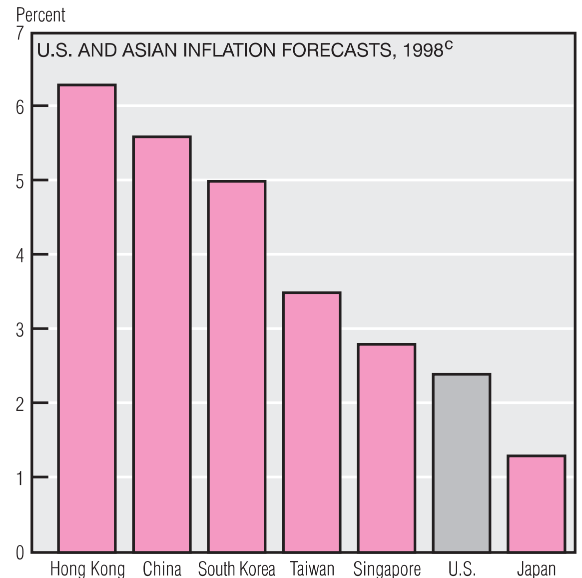
Inflation and Prices (cont.)









a. Based on yearly CPI data reported by the International Monetary Fund.
b. Data for 1997 are through November.
c. Consensus forecast of the Blue Chip panel of economists.
SOURCES: *Blue Chip Economic Indicators*, December 10, 1997; International Monetary Fund, *International Financial Statistics*; and DRI/McGraw–Hill.

The most pessimistic views about this year's inflation come from surveys of U.S. consumers. In December, households surveyed by the University of Michigan expected consumer prices to advance 2.8% over the next 12 months. Over the next five to 10 years, the same group sees prices picking up slightly, to more than 3% annually.

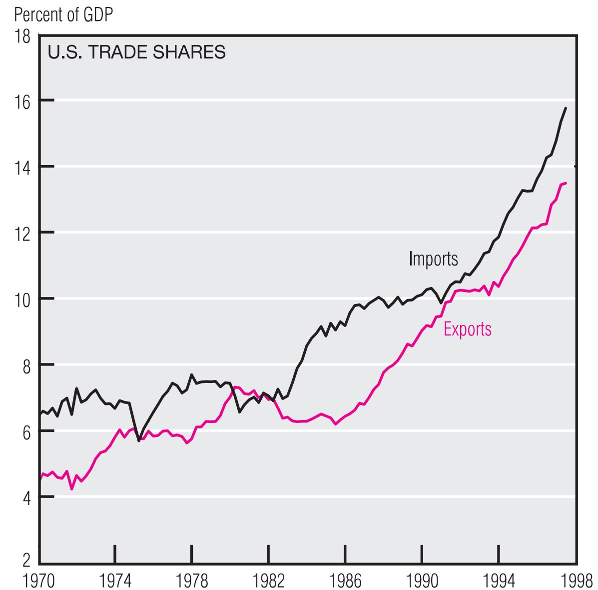
The easing of U.S. consumer price increases is comparable to what has been seen globally. In the past five years, many major economies have watched their inflation rates come down by a percentage point or more from the 1987–92 period. The most dramatic improvements have occurred in two nations where inflation targeting has recently been made a central bank priority—the U.K. and Canada. In the U.K., consumer prices rose about 3¼% per year less between 1992 and 1997 than in the preceding five-year period. In Canada, the inflation reduction has been about 2½% annually. In fact, of the major industrialized nations, only Germany showed an acceleration in consumer prices between the two periods.

Looking ahead, economists are projecting that U.S. inflation will mirror the rates seen in the major European economies, most of which have inflation forecasts between 2% and 2½% for 1998. Somewhat higher and more varied inflation rates are projected for Asia (with the notable exception of Japan, where consumer prices are expected to rise less than 1½% next year).

Economic Activity

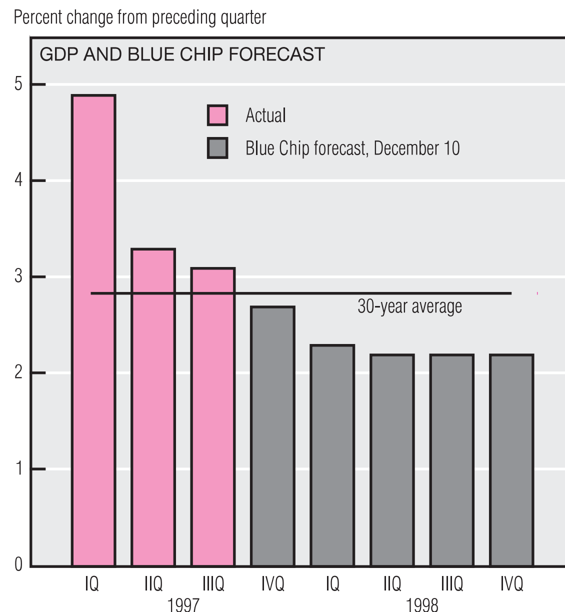
Real GDP and Components, 1997:IIIQ
(Final estimate[a,b])

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	54.4	3.1	3.9
Consumer spending	66.8	5.6	2.4
Durables	27.1	18.4	7.2
Nondurables	15.5	4.3	2.2
Services	26.3	3.9	3.9
Business fixed investment	37.5	19.2	10.8
Equipment	36.0	24.1	13.7
Structures	3.2	6.8	3.5
Residential investment	1.9	2.8	2.2
Government spending	3.3	1.0	0.9
National defense	0.9	1.2	–2.8
Net exports	–27.5	—	—
Exports	10.5	4.4	14.3
Imports	38.0	14.6	14.8
Change in business inventories	–30.1	—	—



U.S. Trade with Asia

	Percent of U.S. exports	Percent of U.S. imports
Japan	10.8	14.4
China	1.9	6.7
Hong Kong	2.2	1.3
Indonesia	0.6	1.1
Korea	4.3	2.8
Malaysia	1.4	2.2
Philippines	1.0	1.0
Singapore	2.7	2.5
Taiwan	3.0	3.8
Thailand	1.2	1.4
Total	29.1	37.3[c]



a. Seasonally adjusted annual rate.
b. Chain-weighted data in billions of 1992 dollars.
c. Column does not add because of rounding.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; the Federal Reserve Bank of St. Louis; and *Blue Chip Economic Indicators,* December 10, 1997.

The economy grew 3.1% in the third quarter, according to the Commerce Department's final estimates. Economists participating in December's Blue Chip survey currently anticipate real growth of 2.7% in the fourth quarter. Given November's strong labor report, this estimate may be low. The Blue Chip forecasters predict that economic activity will slow in 1998 to a rate consistent with current estimates of the country's long-term growth potential.

The ramifications of the Asian financial crisis for the U.S. economic outlook are fairly straightforward, but their magnitude is anybody's guess. As capital flows from Asia to the U.S., the dollar should appreciate and the U.S. trade deficit should expand. Anecdotal evidence currently suggests that U.S. firms are delaying plans to increase exports and investments into Asia and are bracing for more intense competition from that continent. U.S. imports and exports equal 15.8% and 13.5% of GDP, respectively. The developing Asian economies account for only about one-fifth of U.S. trade.

Any inflow of foreign capital should also lower real U.S. interest rates, thereby boosting investment and consumption spending here. However, the prospects for lower interest rates may hinge on the exposure of U.S. financial institutions both to Asia and to U.S. firms that are weakened through trade.

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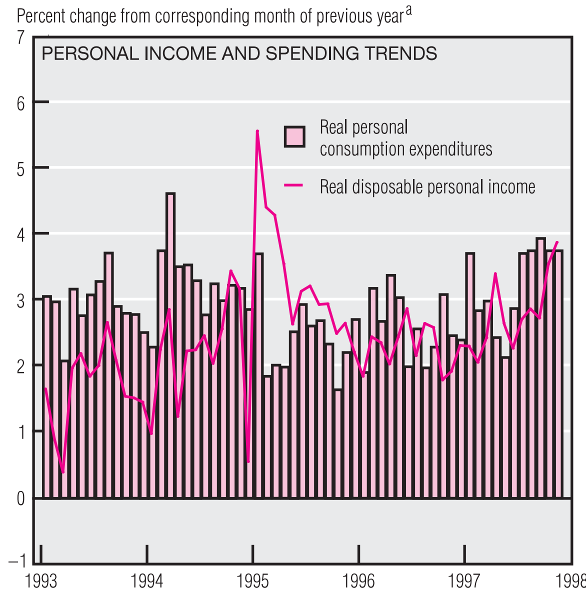
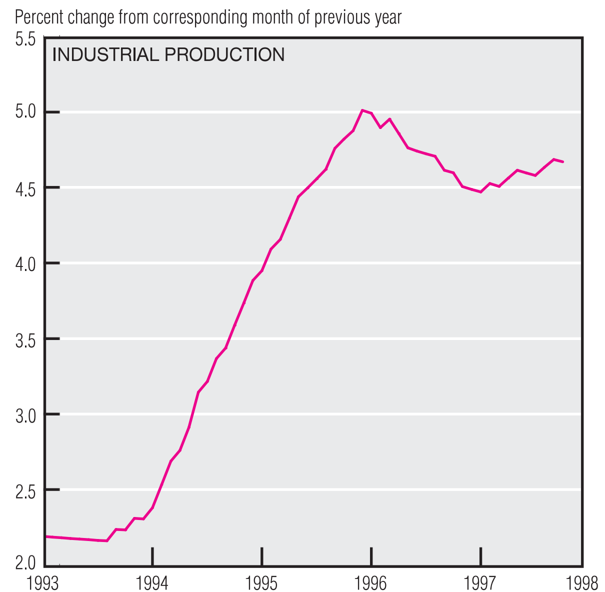
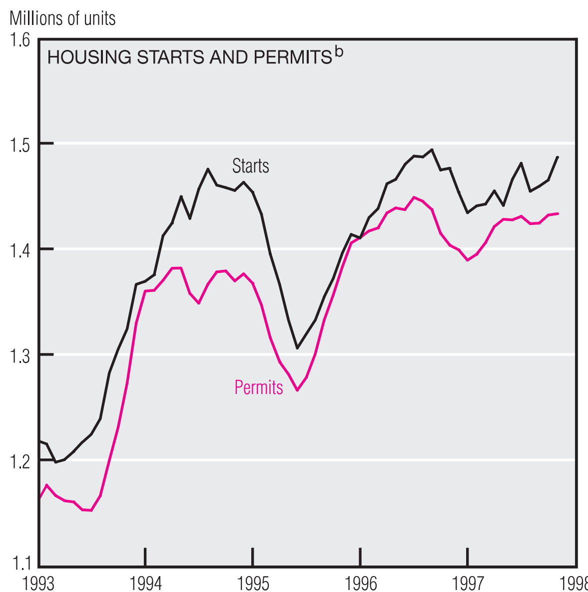
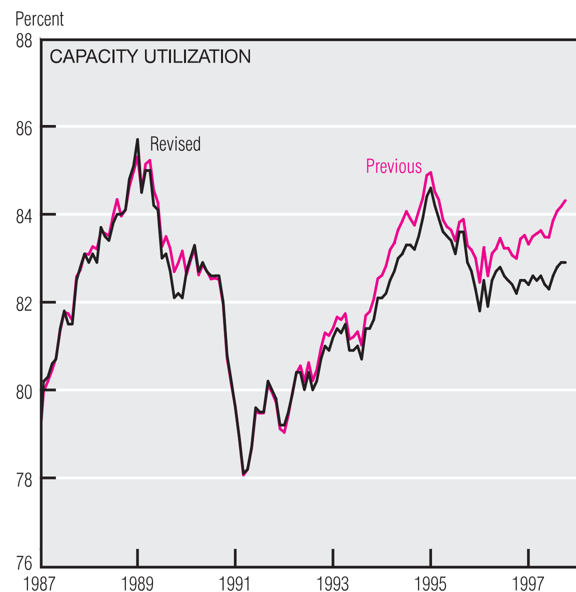
Economic Activity (cont.)









a. Seasonally adjusted annual rate.
b. Six-month moving average.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

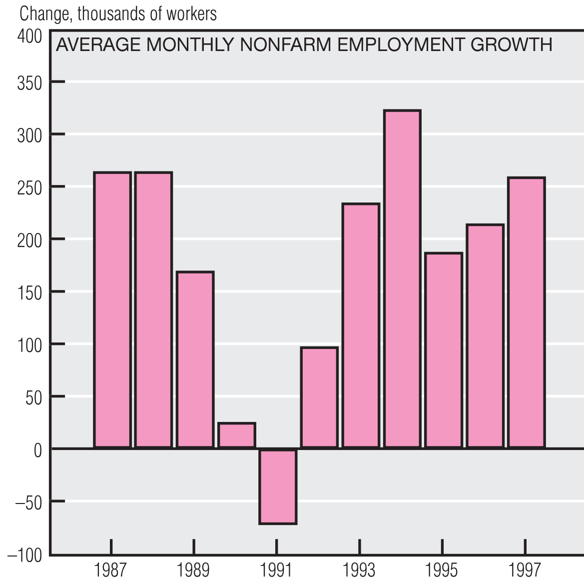
While unknown, these risks do not seem overwhelming.

Real personal consumption expenditures (measured on a year-over-year basis) increased a healthy 3.5% in October and 3.8% in November. Real disposable personal income gains were equally strong. Consumer sentiment weakened a bit in early December, perhaps reflecting the recent declines in stock prices, but the index remains at an extraordinarily high level.

Industrial production rose a very respectable 0.8% in November. Production gains were broad-based throughout the manufacturing sector, with noteworthy advances in automobile assemblies, information processing equipment, and semiconductors. An anticipated slowing in motor vehicle production in December and recent orders data suggest a more moderate—but still favorable—pace of industrial production over the coming months.

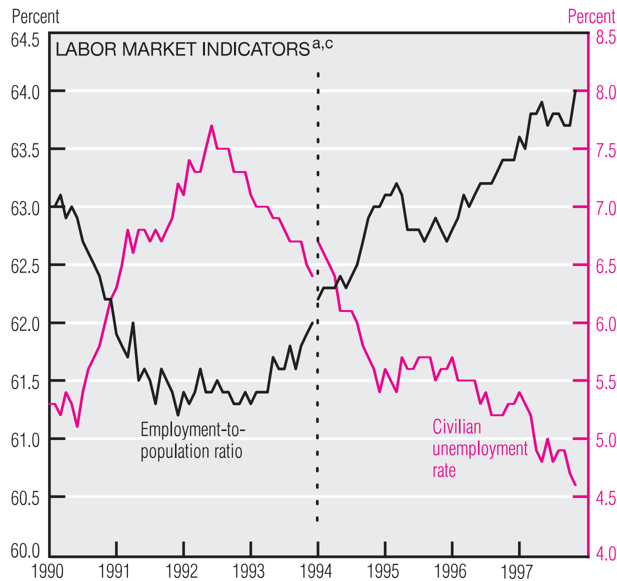
The housing sector remains solid, with total starts reaching 1.53 million units in November. Since 1994, most of the growth in starts has been attributable to multifamily units, whose construction soared in October. Vacancy rates for these dwellings have been falling, but remain high. Starts of single-family homes have remained fairly stable at high levels since 1994. Although sales of new homes slipped a bit in October, overall sales of new and existing homes remain brisk. Consumer attitudes about home buying are favorable, and mortgage applications are strong.

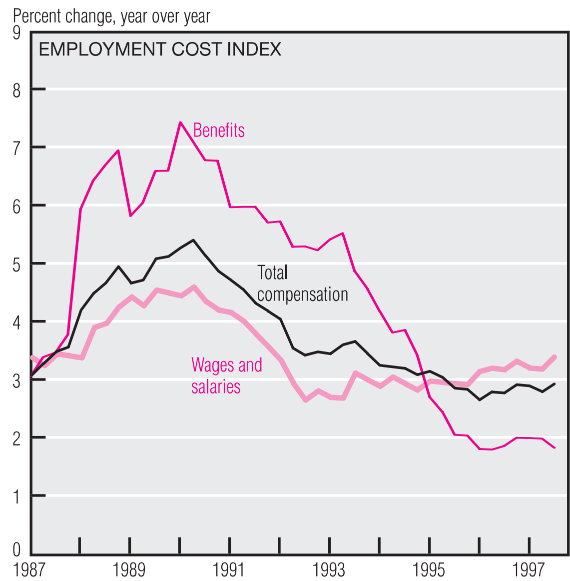
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
	1993	1994	1995	1996	1997 to date
Payroll employment	235	318	184	212	257
Goods-producing	28	57	7	19	32
Manufacturing	4	33	–1	–5	17
Construction	25	25	10	24	14
Service-producing	207	261	177	192	225
Services	100	134	113	98	114
Retail trade	50	70	37	48	40
Government	20	23	9	14	20
	Average for period				
Civilian unemployment rate (%)	6.8	6.1	5.6	5.4	5.0
Manufacturing workweek (hours)[b]	41.5	42.0	41.6	41.5	41.9





a. Seasonally adjusted.
b. Production and nonsupervisory workers.
c. Vertical line indicates break in data series due to survey redesign.
NOTE: 1997 data are through November.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

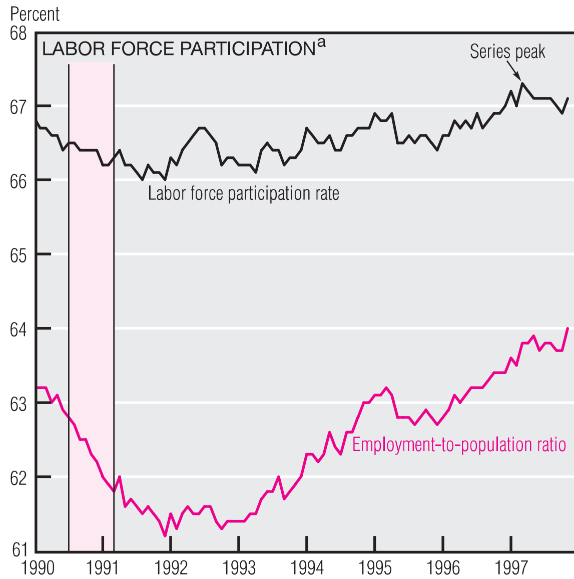
With the unemployment rate hitting a 24-year low in November, the employment-to-population ratio at a historic high, and reports of scattered labor shortages on the rise, analysts are increasingly characterizing the labor market as “tight.” But tightness is not apparent in the pace of labor compensation.

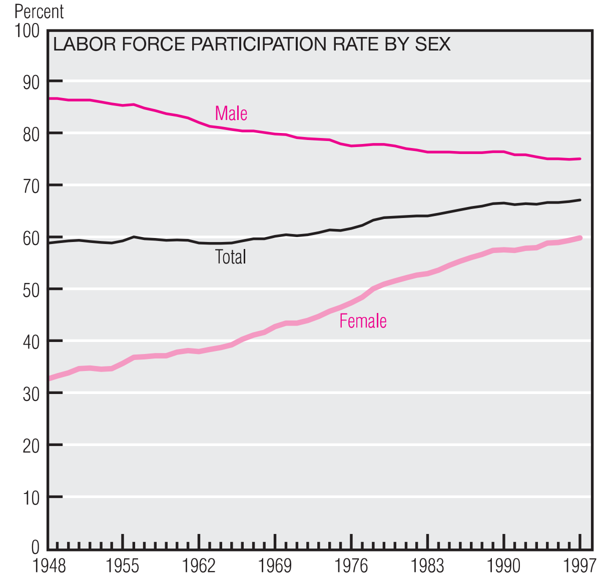
During the first 11 months of 1997, the U.S. economy created an average of 257,000 jobs per month—not atypical compared with other recent expansions. In September, October, and November, however, employment gains averaged an extraordinary 330,000. The service-producing sector added the greatest number of positions in 1997, but the goods-producing sector showed strong percentage gains. Jobs growth slowed in the retail and construction industries.

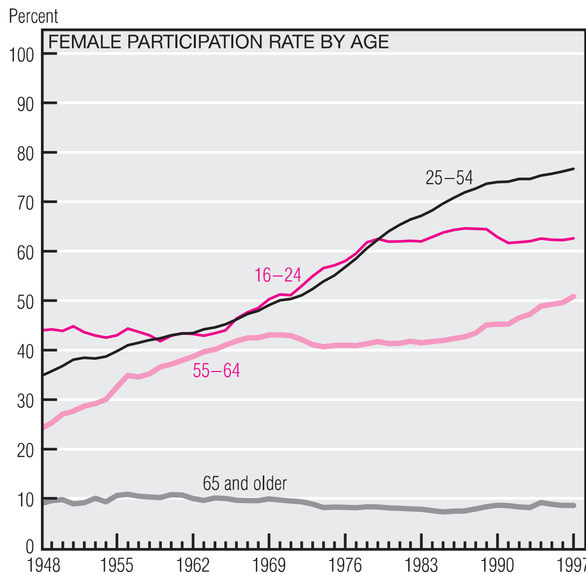
In addition to overall strength in manufacturing employment, the average workweek advanced to 42.1 hours in November from 41.7 hours one year ago.

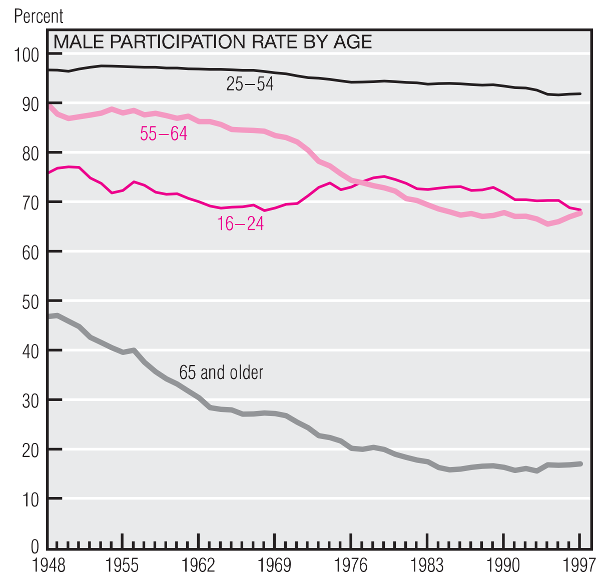
Although gains in wages and salaries accelerated to 3.4% between 1995 and 1997:IIIQ, benefits rose a fairly stable 2%. Total labor compensation has continued to increase at a pace consistent with the underlying rate of inflation, approximately 3%.

Labor Force Growth and the Unemployment Rate









a. Shaded area indicates recession.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Will strong employment growth alone push the unemployment rate to zero? The unemployment rate measures the number of jobless persons actively seeking work, divided by the total number of working-age persons participating in the labor force. (The labor force consists of individuals who are either employed or seeking work). Hence, the unemployment rate can change in response to employment trends or to changes in the labor force. Because population growth is fairly stable, the participation rate largely determines the number of individuals in the labor force.

Although participation rates rise and fall with the business cycle, demographic changes are the key determinant. The participation rate reached a record high of 67.3% in March 1997, primarily because of the growing share of women in the U.S. workforce. The participation of women from nearly all age categories has been rising since at least 1948, when the Bureau of Labor Statistics began reporting the data. The increase is most striking for women between the ages of 25 and 54, traditionally the active work years for both men and women. These are also the primary years of child rearing, suggesting that children are now less of an impediment to workforce participation. Participation rates

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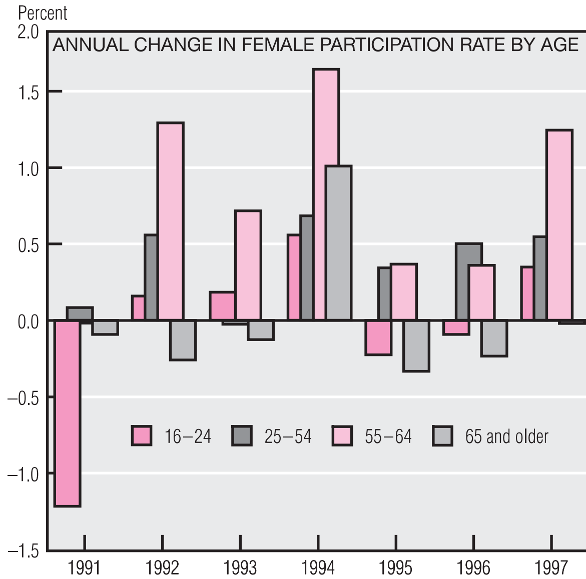
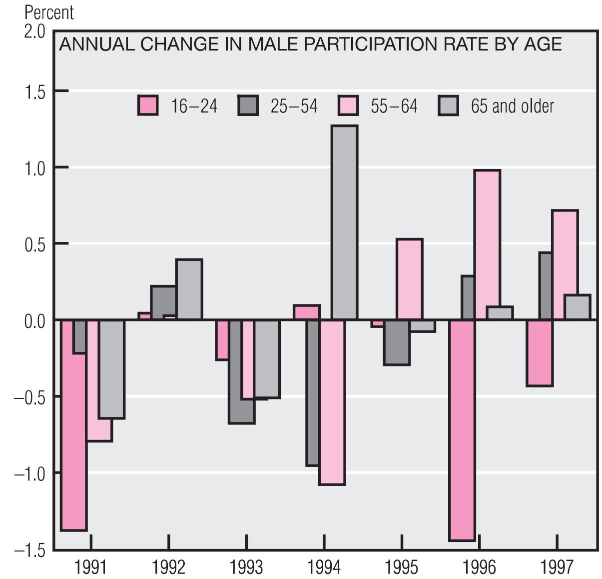
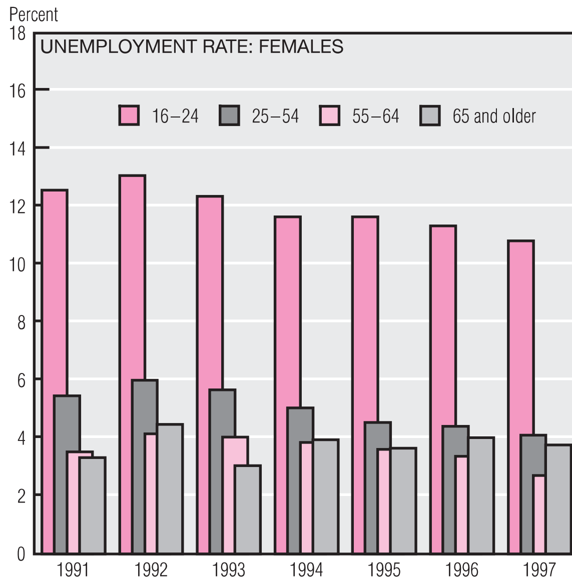
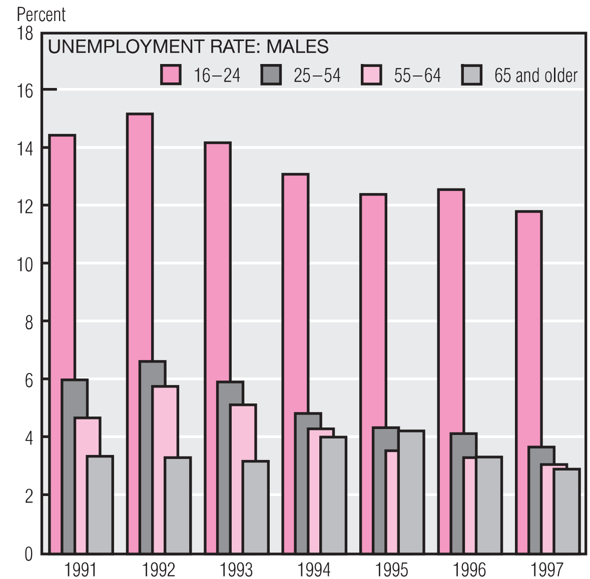
Labor Force Growth and the Unemployment Rate *(cont.)*









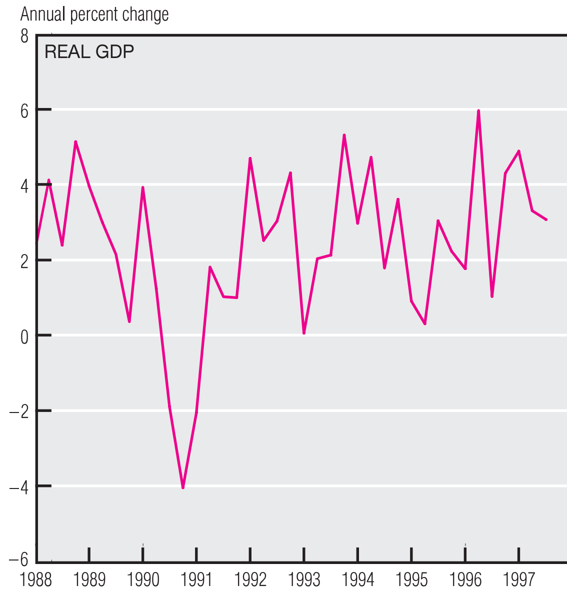
NOTE: All data are seasonally adjusted. Data for 1997 do not include December.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

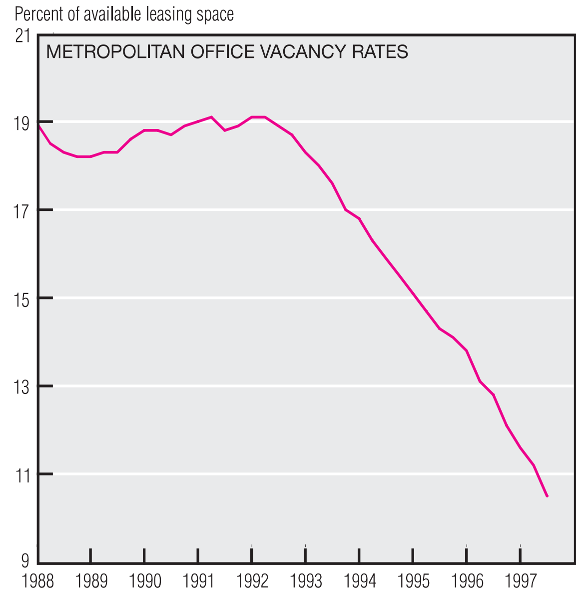
for women are apparently continuing to advance. Moreover, long histories of employment among today's younger women will probably boost the participation rates of older women in the years to come.

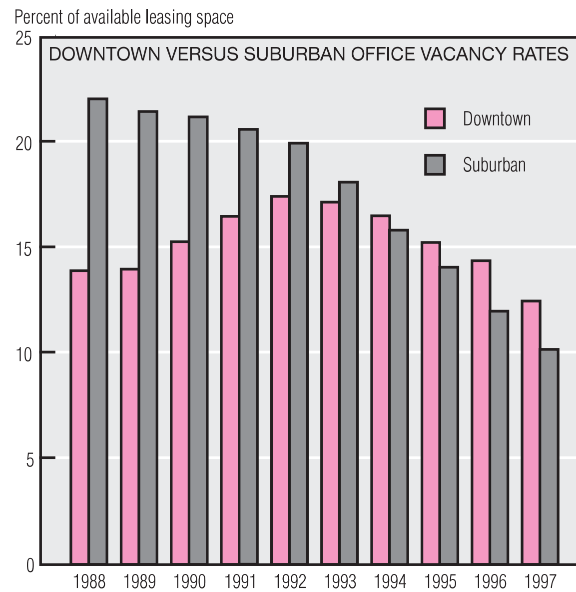
The other important demographic trend affecting U.S. labor force participation rates is the long-term decline in men's involvement, especially older men. In 1948, nearly half of all men over age 64 continued to participate in the labor force. By 1997, this rate had dropped to 15%. Despite news reports to the contrary, the evidence supporting a reversal of this trend is meager at best. Somewhat more apparent is the change in the labor force participation rate of men between the ages of 55 and 64. The recent strength of the labor market appears to be offsetting a decades-long tendency toward early retirement. The unemployment rate for males between 55 and 64 fell from 5.8% in 1992 to 3.1% in 1997.

The strong U.S. employment growth experienced since 1992 has produced a dramatic decline in the jobless rate. This growth in employment, however, would have resulted in a 3% unemployment rate had the labor force participation rate remained at its 1992 level (66%) instead of rising to 67%.

Office Vacancy Rates







NOTE: Real GDP and commercial construction are seasonally adjusted; remaining data are not.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and CB Commercial/Torto Wheaton Research.

As the current business expansion enters its eighth year of growth above the economy's long-term potential, capacity constraints are becoming an increasing concern. Office vacancy rates provide one early indicator of emerging growth limitations.

When economic activity slowed in the late 1980s and during the 1990–91 recession, vacancy rates remained high. Suburban rates hovered around 20%, and downtown vacancies gradually rose to 17.6% in 1992. Since July 1992, total metropolitan office vacancy rates have fallen steadily because, despite expanding business activity, little new office space has become available. Both the downtown and the suburban indexes began to decline precipitously after 1993, with suburban rates dropping the fastest. By 1996, the suburban rate stood at 12.0%—a whopping 3.7 percentage points lower than in 1994. Over the same two-year interval, downtown vacancy rates fell 1.9 percentage points to 14.4%.

The relatively stronger demand for suburban office space seems to reflect advances in telecommunications. New communications technology allows firms to move parts of their operations to distant locations offering higher worker productivity and lower costs.

Over the past year, however,

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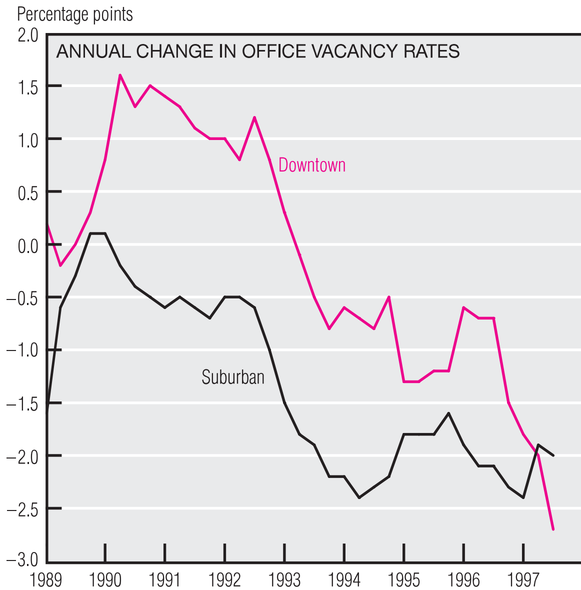
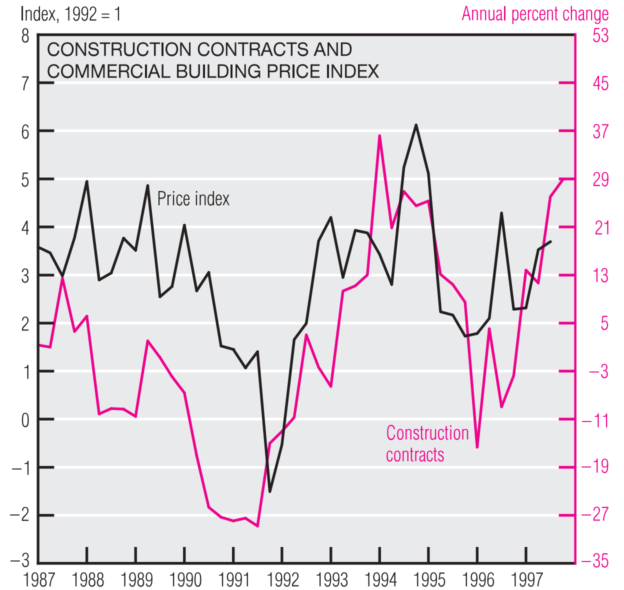
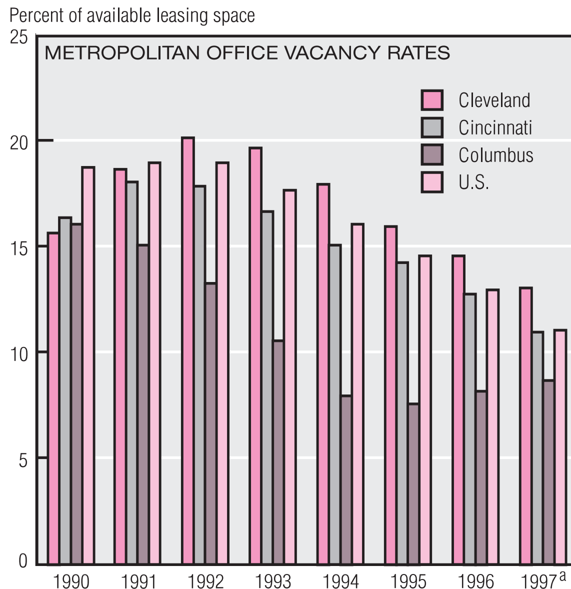
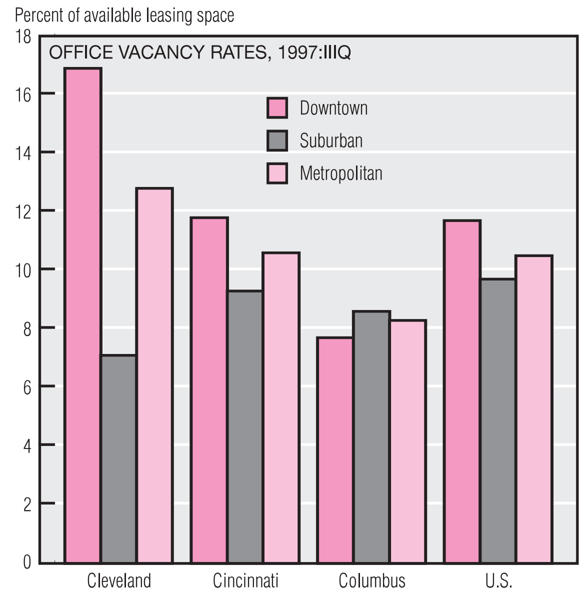
Office Vacancy Rates (cont.)









a. Average of first three quarters.
NOTE: Construction contracts and commercial building price index are seasonally adjusted; remaining data are not.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and CB Commercial/Torto Wheaton Research.

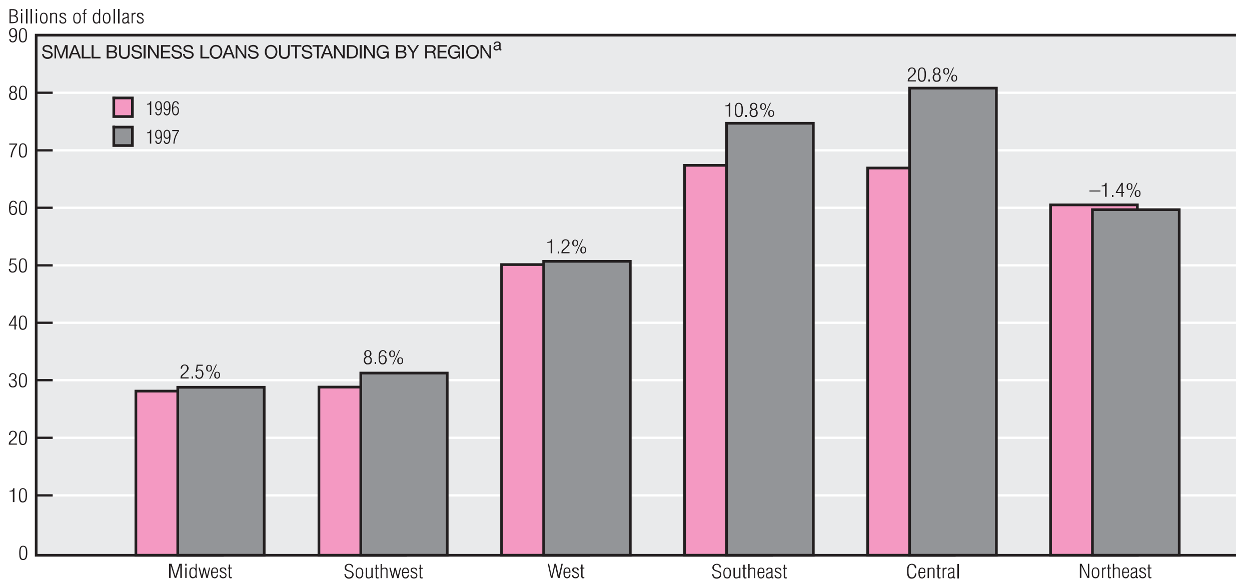
downtown vacancy rates have fallen faster than suburban rates, suggesting that businesses' flight out of the central city may be slowing. Suburban space is becoming scarcer and more expensive, forcing some tenants back into the downtown area.

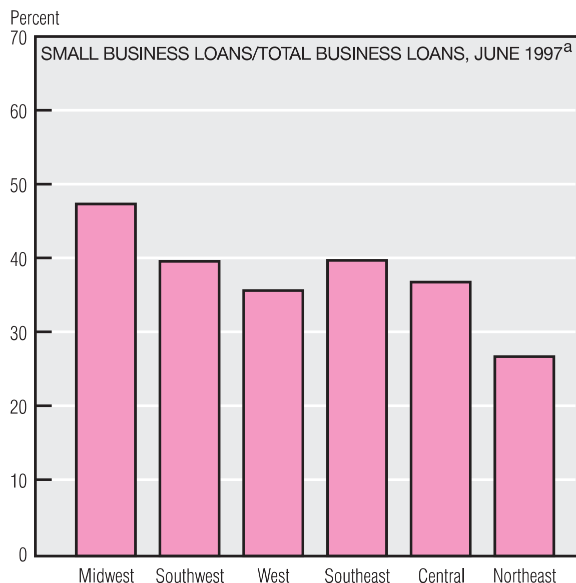
The rising price of office space has also piqued the interest of builders. In the second quarter of 1996, the index for commercial property began to approach levels that would turn a profit for developers. Since that time, new construction contracts have risen 36.6%, but for the most part, the rental space is not yet available.

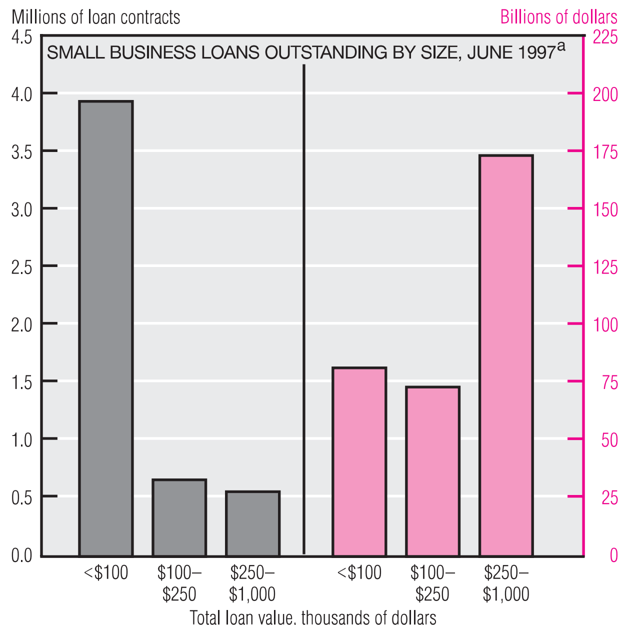
Nationally, metropolitan vacancy rates stood at only 10.5% in 1997:IIIQ, 2.3 percentage points below 1996's level, and suburban vacancy rates dipped to 9.7%. Downtown vacancy rates fell to 11.7% for the quarter, the lowest posting in 12 years.

Vacancy rates in Ohio's three most heavily populated metropolitan areas have generally followed national patterns. Columbus has the lowest overall vacancy rate (8.3%), with its downtown faring better than its suburbs. Cincinnati mirrors the national average. In Cleveland, the downtown rate has fallen faster than the suburban rate in recent months. Although the city's overall metropolitan vacancy rate is not out of line with the U.S. average, its downtown rate far surpasses the national rate as well as its own suburban rate.

Small Business Lending







a. Small business loans secured by nonfarm, nonresidential properties, plus commercial and industrial loans to U.S. addressees. Small business loans are those for $1 million or less. Numbers over bars are year-over-year percent changes.

NOTE: All data are for FDIC-insured domestic commercial banks.

SOURCE: Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income,* June 1996 and June 1997.

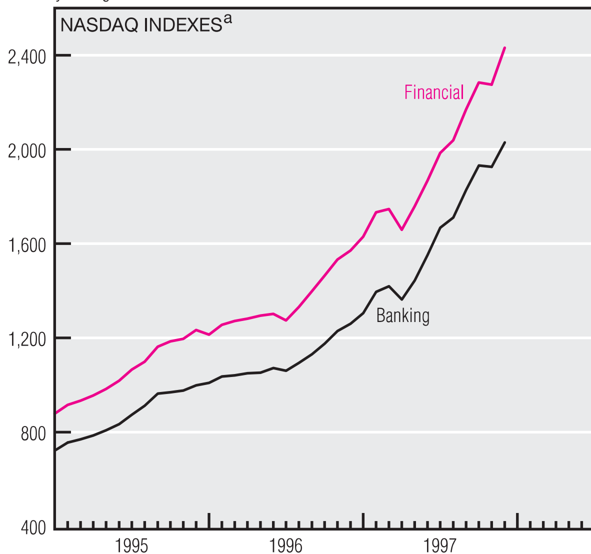
Between June 1996 and June 1997, small business lending grew a healthy 7.99% nationwide, to $325.9 billion outstanding. This growth was stronger than in the previous year (6.9%), but was not uniform throughout the country. Although the South turned in a solid performance, it was the Central region's stellar 20.8% growth that compensated for the lackluster showing in the rest of the country; indeed, its $80.8 billion of small business loans outstanding now exceeds every other regional posting.

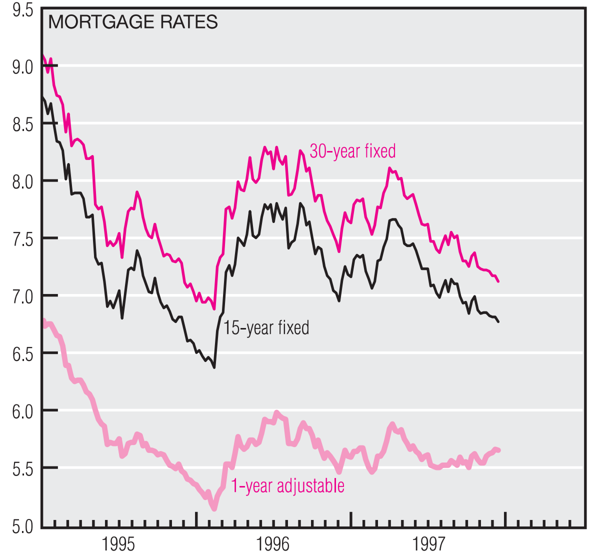
Following its pattern of the last three years, the Northeast had the poorest numbers, with small business lending declining 1.4% to $59.7 billion. One reason for the weaker performance of this region may be that small business lending is a less important component of total business lending there.

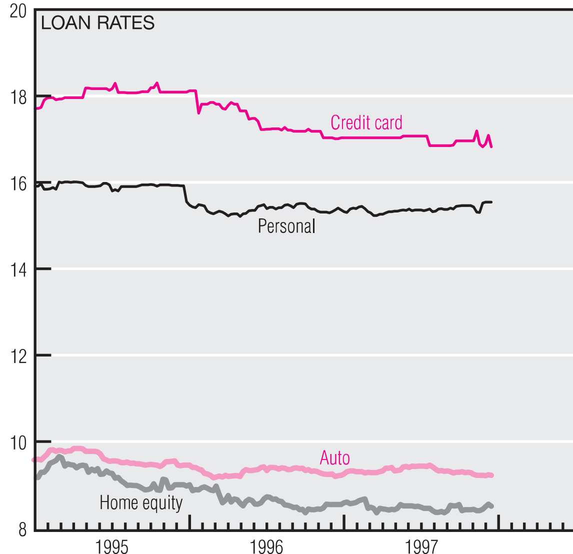
As in the past, the total dollar volume of small business lending is lowest in the Midwest (only $28.8 billion), yet such lending constitutes a larger share of overall business lending activity in this region (48.9%) than it does in other parts of the country. In contrast, small business lending in the Northeast represents a relatively minor fraction of total business lending in that region (25.2%), despite the fact that it is the third largest region in terms of total dollar volume of loans.

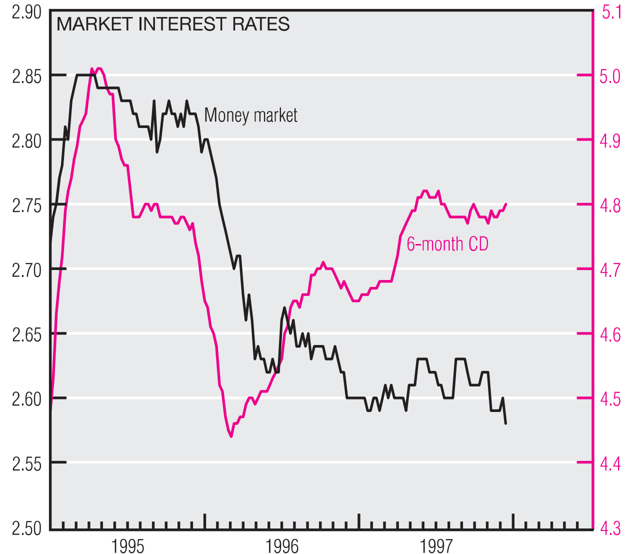
The composition of small business lending remained relatively constant in 1997. As in the past, the vast majority of small business loan contracts were for less than $100,000 (76.9%, versus 77.0% in 1996). At the same time, loans for more than $250,000 still account for over half of all dollars committed to small businesses.

Banking Conditions









a. Last data point for both series is a daily quote for December 19, 1997.
SOURCES: DRI/McGraw–Hill; and *Bank Rate Monitor*, various issues.

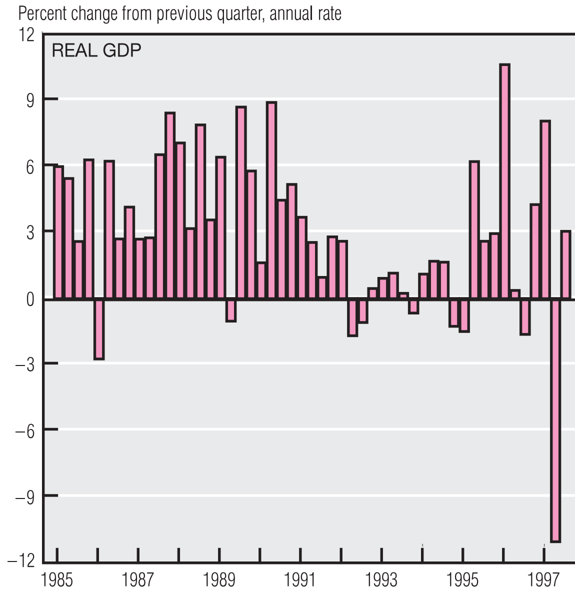
Early last year, concerns about the possibility of future rate increases may have contributed to a falloff in bank share prices. Since then, however, the Federal Open Market Committee has held its core rates constant, and bank share prices have accelerated again, with the NASDAQ banking index rising 49% since April.

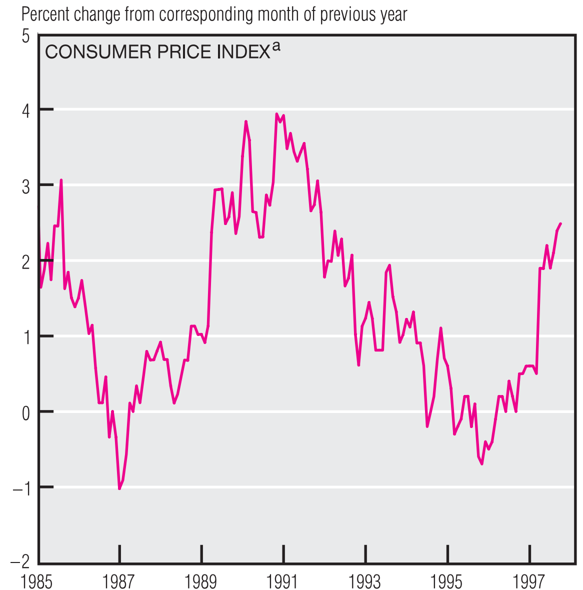
A favorable interest rate environment may help explain the good fortune enjoyed by bank investors. Consistent with declining inflation expectations, long-term mortgage rates fell throughout 1997, with 30-year rates dropping nearly 100 basis points after peaking at 8.11% in April (15-year rates are down 89 basis points from their 1997 high of 7.66%).

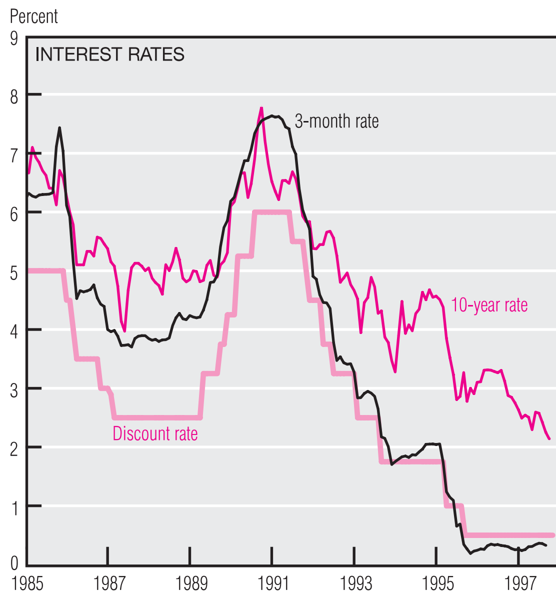
In contrast, short-term rates varied little over the last part of the year. Other consumer loan rates also remained relatively constant over 1997. Although down 21 basis points from their level at the beginning of the year, credit card rates held steady for most of 1997, following a dramatic 109-basis-point decline in 1996.

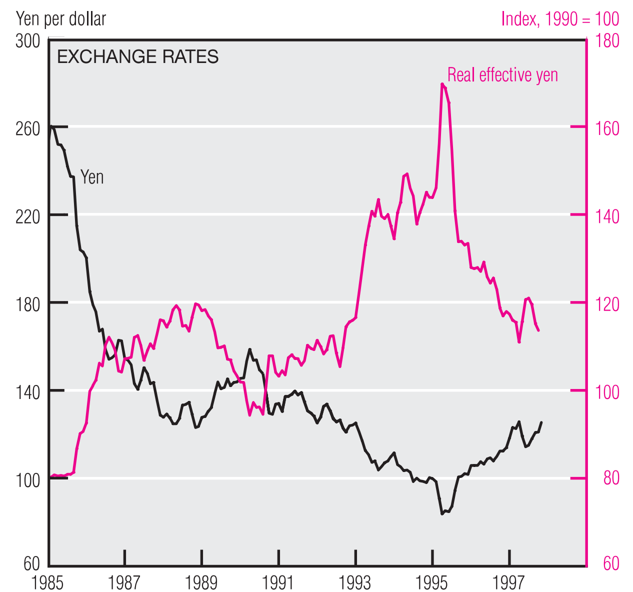
On the funding side, 6-month CD rates have hovered around 4.8% since the middle of 1997, following a 14-basis-point increase between March and June (from 4.68% to 4.82%). In contrast, money market rates have declined somewhat over the last few months.

Japan's Economic Recovery









a. Sales taxes imposed in April 1997 account for the recent jump in year-over-year price changes.
SOURCES: International Monetary Fund, *International Financial Statistics*; and DRI/McGraw–Hill.

The Asian financial crisis has cast a pall over Japan's already fragile economic prospects. Most directly, the Asian problem will crimp the demand for Japanese exports. Approximately 40% of Japan's overseas shipments go to its newly industrialized neighbors. Less directly—but just as importantly—exposures in these countries may force Japanese banks to restrict their domestic lending.

Since the onset of recession in 1992, the Japanese economy has grown at an average annual rate of only 1.2%, less than half the pace experienced between 1984 and 1991. This year's third-quarter rebound was smaller than expected, and residential investment plummeted. Although net exports declined slightly, the effects of Asia's financial problems have hardly had time to filter into the data. Inflation is essentially nonexistent, and interest rates are at unprecedented lows.

The slow pace of recovery owes much to the weak state of the financial sector. Japanese banks remain reluctant to write down or to provision against the problem loans that continue to haunt their portfolios. Furthermore, they now face added burdens from their exposure to neighboring countries' financial troubles and from the spillover effects on their own economy. The capital ratios of Japanese banks, already low by international norms, could weaken further.