The Economy in Perspective

Swelling up … We made it! The economy just completed its seventh year of expansion, entering month 85 with no sign of major trouble. Just the opposite, in fact. The latest labor market report revealed that employers added 310,000 new jobs to their payrolls in February, the fourth consecutive month that jobs growth has topped 300,000. Nearly 1.5 million new jobs have been created since last November. What's more, the unemployment rate fell to 4.6 percent last month, its lowest reading since 1970.

We could try to whip everyone into a frenzy over inflation, but who would listen? After all, inflation remains at rates not seen since the early 1970s, in the days before the U.S. economy turned itself upside down. Fine, you say, but what about future inflation? The growth of the M2 money supply has been accelerating for a year, reaching an annualized rate of 8 percent last month. Potentially disturbing, but hasn't money been an unreliable predictor of inflation for many years now?

There are signs that labor compensation rates are picking up, but there are also reasons to think that the true rate of productivity growth is doing the same. As long as these forces keep pace with one another, price pressures are likely to stay in check, despite concern about labor market tightness. Capital spending remains vigorous, outpacing the growth of total output and suggesting that capacity and productivity will continue to expand.

No matter how you slice it, we have to be feeling pretty good about the U.S. economy right about now. And, as if we didn't have enough intrinsic evidence that our economic system is a lean, mean, growth machine, we now can pit our statistics against those of almost any nation in the world and come away the winner. Amazing, isn't it, that only a few years ago we worried about being eclipsed by Japan and other Asian countries? The U.S. economy has been restored to its rightful place in the pantheon of nations.

Time to come back down to earth. Sure, our economy seems to be in excellent health. Yes, consumers and businesses register great confidence in the future. Banks undeniably hold a lot of capital and have sustained few loan losses. Granted, the Federal Reserve has shown its willingness to act preemptively against inflation, and the federal government has finally demonstrated some fiscal restraint. But even with all of these positive signs, we still have economic concerns to address.

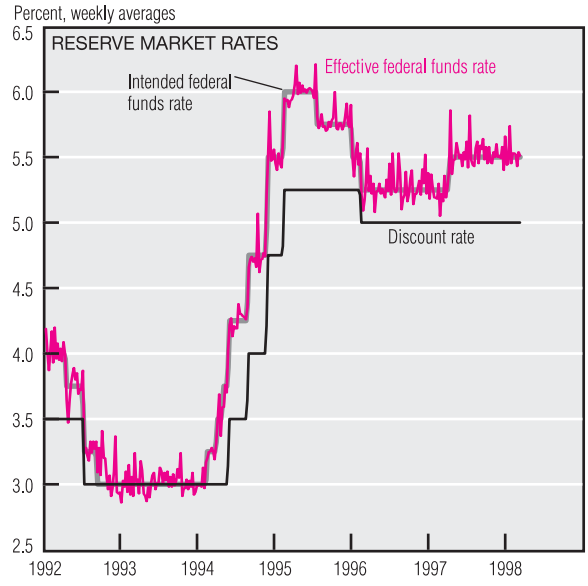
The length and strength of the current expansion notwithstanding, the business cycle has not been abolished. We cannot know when the next recession will hit—although private forecasters put the odds near zero for the next 12 months—but destructive excesses and imbalances can build up for many reasons. For example, long expansions increase the temptation to take on more debt to finance acquisitions, but those who do so will be particularly vulnerable in the next downturn.

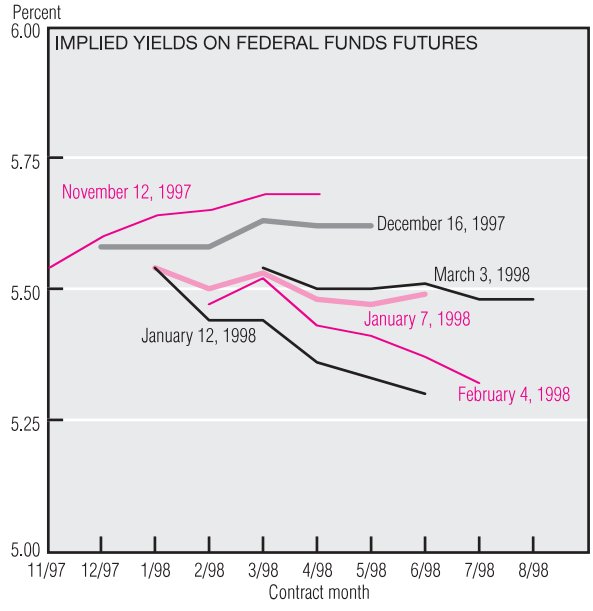
There is also the risk that inflation will accelerate again, contrary to the widely held view that it is no longer a threat. The Consumer Price Index probably understates fundamental price pressures in today's markets because the food and energy components have a moderating influence. Trimmed CPI measures—estimates designed to minimize the influence of extremely large or small price changes on core inflation—have been tracking about one-half to one whole percentage point above the official CPI. Should these transient factors reverse course, we could see inflation quicken just when business cycle dynamics are intensifying price pressures.

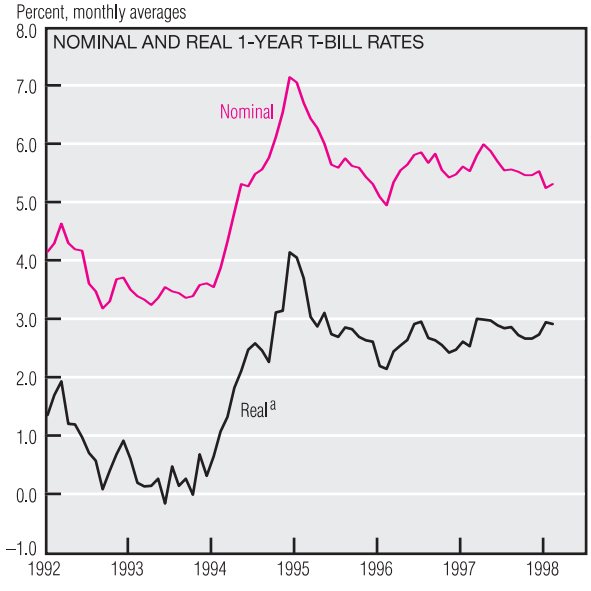
We also face dangers other than cyclical fluctuations. In the longer term, we must recognize that our nation's Social Security program is not structured appropriately. The large surplus that the Social Security Trust Fund now carries will evaporate in about 20 years. Many proposals have been advanced to meet this impending crisis, from small changes in tax rates and retirement ages to privatizing some or all of the Social Security System. Whatever course we choose, the importance of making changes immediately should be clear: The longer we postpone needed reforms, the more likely that when corrections do come, their economic impacts will be bigger than they would be today.

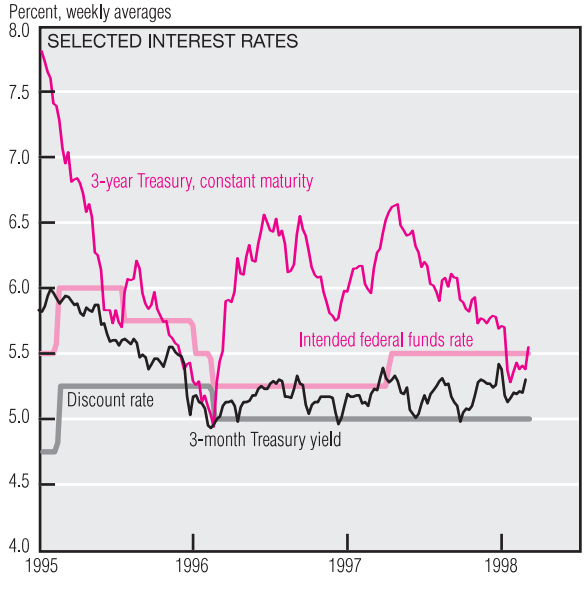
For the past 50 years, the U.S. economy has shown itself capable of responding well to the disturbances that inevitably accompany modern life. Nonetheless, we have sometimes flirted with the notion that competing economic systems might hold more promise than our own. Looking around the world today, our confidence renewed, let's not allow success to swell our heads.

Monetary Policy









a. Nominal 1-year Treasury less 1-year inflation expectations as measured by the University of Michigan's Survey of Consumers.
SOURCES: Board of Governors of the Federal Reserve System; the University of Michigan; and the Chicago Board of Trade.

At the conclusion of its February meeting, the Federal Open Market Committee (FOMC) indicated that no action had been taken to change the intended federal funds rate. Since February 1996, the Committee has altered the funds rate only once—a 25-basis-point increase (from 5¼% to 5½%) in March 1997.

The relative absence of deliberative action in recent years does not necessarily mean that policy has been unchanged. Indeed, gauging the Fed's policy stance on the basis of interest rates is a tricky business. Since early 1996, for instance, inflation expectations have been trending down. This implies that even though nominal interest rates have remained relatively steady, real interest rates (the nominal rate less expected inflation) have been drifting up.

Furthermore, the upward shift in real interest rates by itself need not indicate that policy has become more restrictive. Real interest rates can rise when the economy faces a surge in investment opportunities that boosts the rate of return on new business investment. The economy's recent strength has been characterized by just such a situation. A tremendous increase in business investment in recent years has raised the demand for credit, putting upward pressure on real interest rates. Thus, higher interest rates may be interpreted as being associated with an *accommodative* policy.

The federal funds futures market reveals expectations about the level of the fed funds rate for a given contract month. As of early March,

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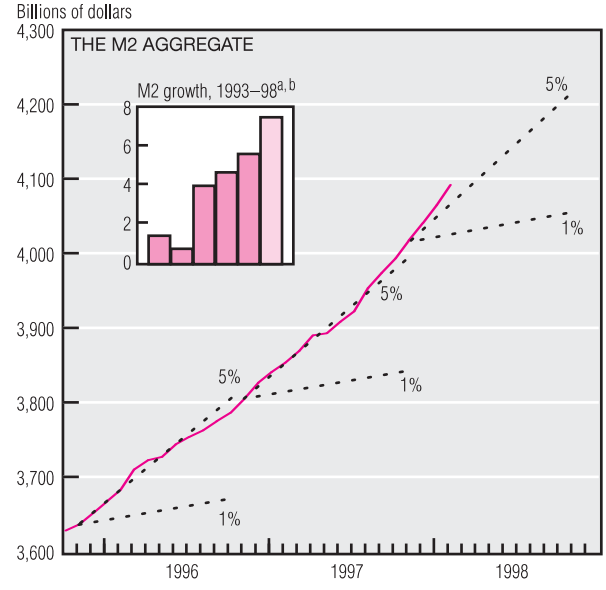
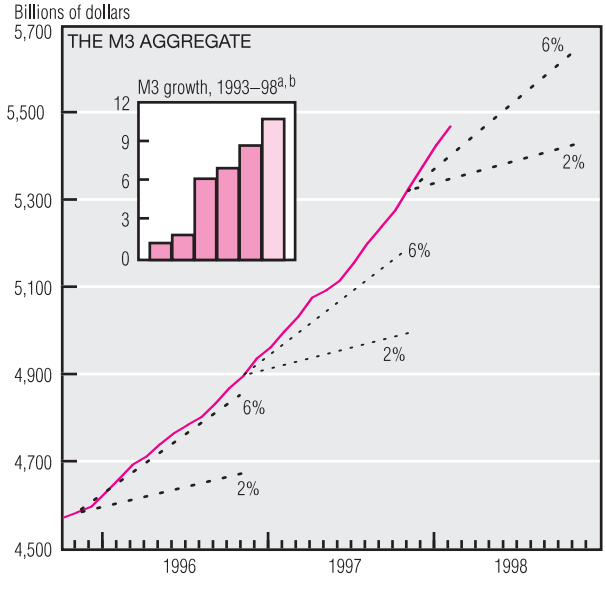
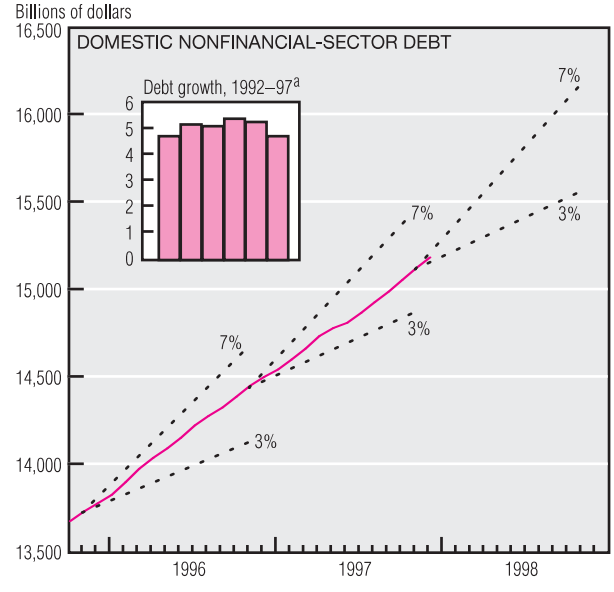
Monetary Policy (cont.)

Economic Projections for 1998
(Percent)

Indicator	FOMC Range	FOMC Central tendency	Administration
Change, IVQ over IVQ			
Nominal GDP	3½–5	3¾–4½	4.0
Real GDP	1¾–3	2–2¾	2.0
Consumer Price Index	1½–2½	1¾–2¼	2.2
Average level, IVQ			
Civilian unempl. rate	4½–5	≈ 4¾	5.0







a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
b. Annualized growth rate for 1998 is based on an estimated February over 1997:IVQ basis.
NOTE: All data are seasonally adjusted. Last plot is estimated for February 1998. Dotted lines represent FOMC-determined provisional ranges.
SOURCE: Board of Governors of the Federal Reserve System.

these futures prices implied an expectation of no change in the funds rate through this summer. During 1998, the Blue Chip consensus forecast calls for a slowdown in economic activity from last year's vigorous 3.9% pace. This suggests that the public interprets the stance of policy as consistent with a deceleration in output.

In his February 24 testimony before Congress, Federal Reserve Chairman Alan Greenspan presented the FOMC's economic projections for 1998. The Committee expects a moderation in real GDP growth to around 2⅜%, while inflation is seen rising slightly from its 1997 pace to around 2%. The slowdown in economic activity is largely attributed to the financial turmoil in Southeast Asia, which is expected to dampen foreign demand for U.S.-produced goods. At the same time, sharply lower Asian currency prices are expected to counteract domestic price pressures, both directly—through declining import prices—and indirectly—through competition in the traded-goods sector.

In establishing provisional ranges for the monetary and debt aggregates, the FOMC recognized the considerable uncertainty surrounding the velocities of these measures. Historically, M2 velocity—simply the ratio of nominal GDP to M2—has tended to return to some modestly increasing trend level. This implies that over long periods, nominal GDP tends to grow at approximately the

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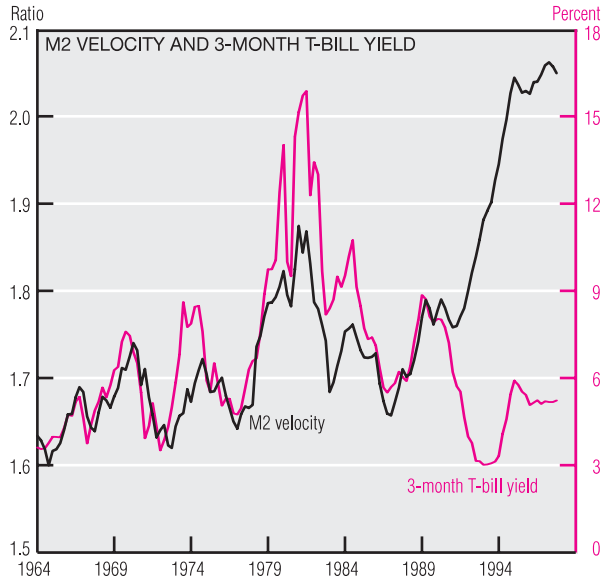
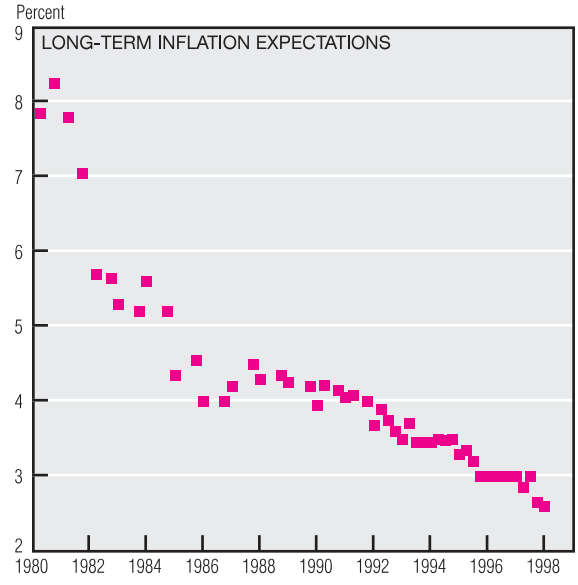
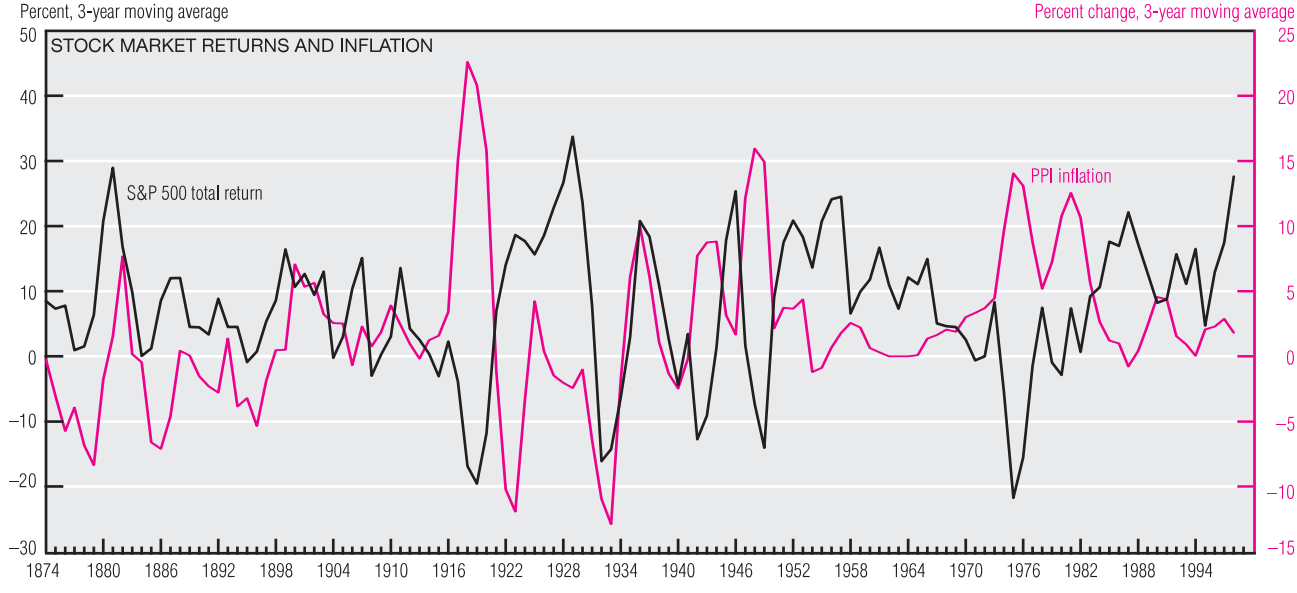
Monetary Policy (cont.)







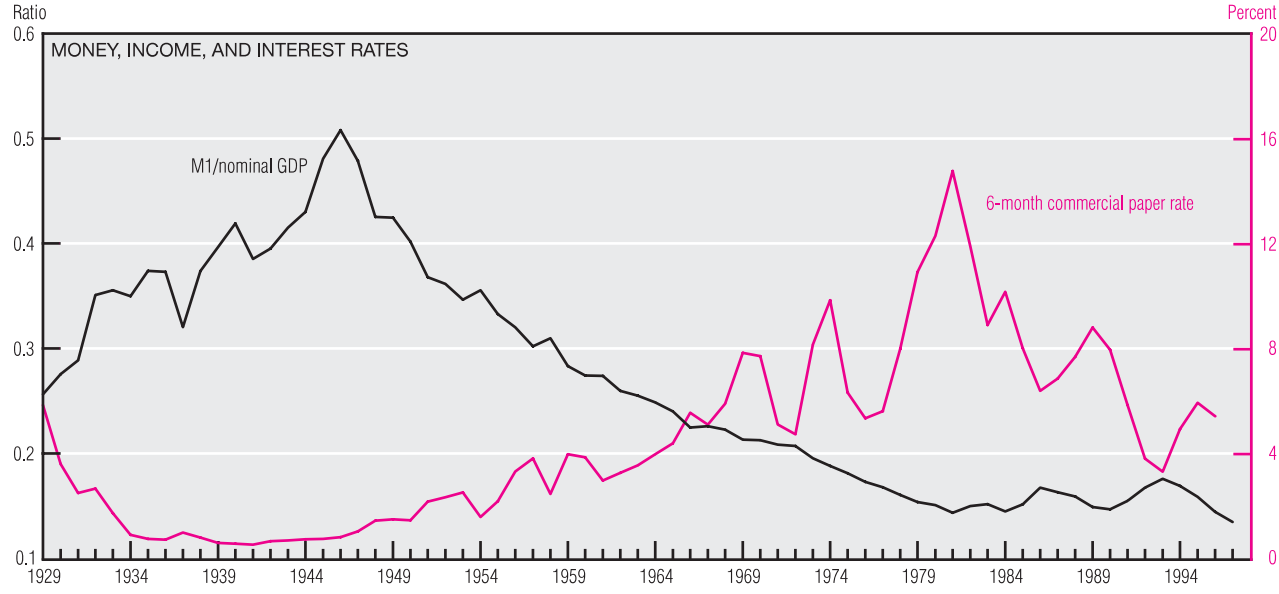
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; and Standard & Poor's Corporation.

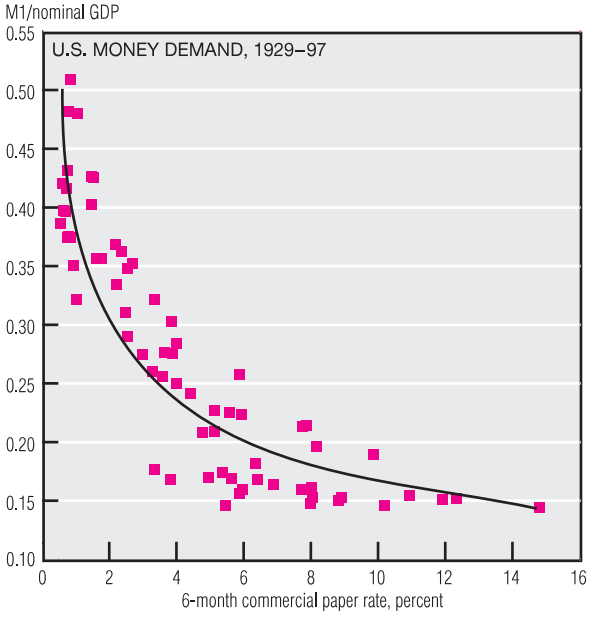
same rate as M2. In the short run, by contrast, velocity tends to vary with interest rates. The early 1990s witnessed a different pattern, however. M2 velocity rose unexpectedly, although there was no commensurate increase in interest rates. This anomaly persisted until 1994, when M2 resumed behavior consistent with its historical relationship to spending. In light of the uncertainty surrounding the velocity of money, the FOMC sets ranges not as projections for expected money growth, but rather as benchmarks for M2 and M3 behavior consistent with sustained price stability, assuming velocity moves in line with its pre-1990 experience.

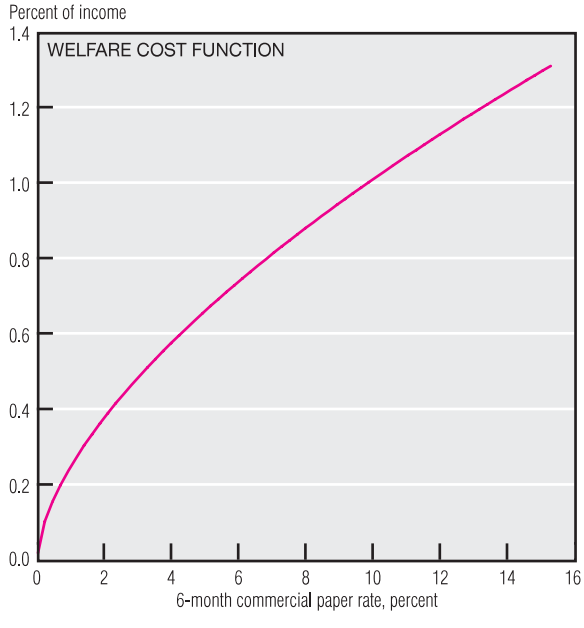
Despite the difficulties the Committee faces in determining the stance of policy, it has made substantial progress in achieving its long-standing goal of price stability. Since 1980, inflation has declined from double-digit rates to less than 2%. Furthermore, survey data reveal that the FOMC has earned substantial credibility in its fight to maintain lower inflation over the long term.

Progress in achieving price stability laid the foundation for the recent sustained period of economic prosperity. Indeed, total stock market returns have been spectacular since 1995. This seems less surprising when we observe the historical relationship between stock prices and inflation. The stock market tends to perform best when inflation is moderate. By contrast, poor stock market performance is associated with high inflation or extreme deflation.

The Cost of Inflation







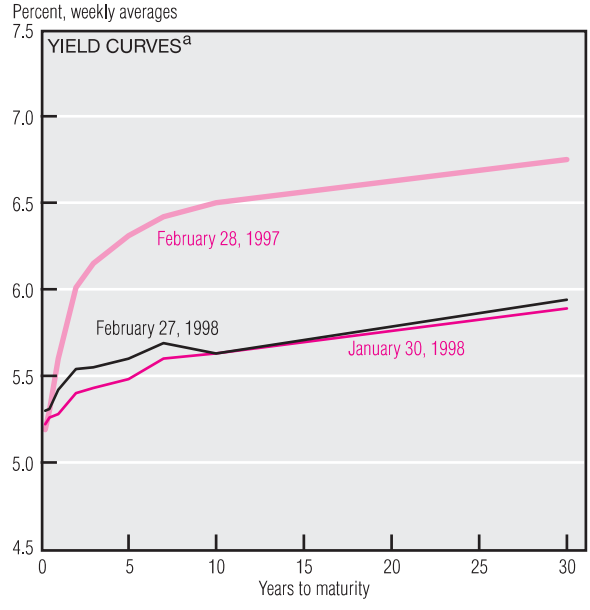
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Robert E. Lucas, "Inflation and Welfare," *Econometrica* (forthcoming); and Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960*, Princeton, N.J.: Princeton University Press, 1963, pp. 708–22.

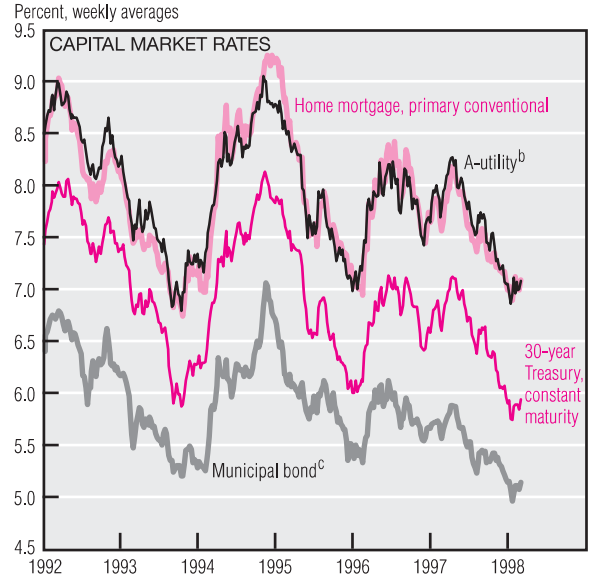
Historically, there has been a negative relationship between interest rates and the ratio of money to nominal GDP. This means that during periods of high interest rates, like the early 1980s, individuals attempt to shed money balances that are not earning interest. The opportunity cost of money is the interest forgone by not holding funds in an interest-bearing account. It is not surprising, therefore, that between the mid-1940s, when interest rates averaged less than 1%, and the early 1980s, when they approached 15%, the ratio of M1 to GDP dropped approximately threefold.

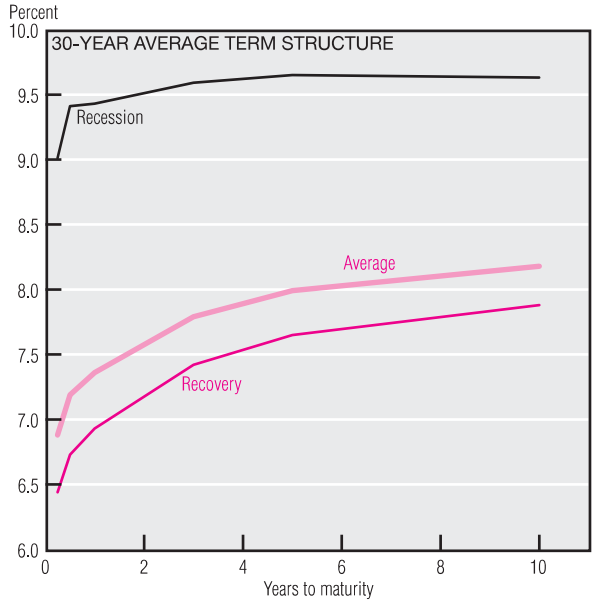
Because lenders seek compensation for any erosion in the purchasing power of the funds they provide, inflation rates eventually become fully reflected in interest rates. When inflation rises, interest rates and the opportunity cost of maintaining cash balances also increase, so people attempt to economize on their cash holdings. The time and resources devoted to this pursuit—a cost that society pays for higher inflation—are wasted in the sense that they produce no consumable output. As a nation, we spend millions of hours and employ thousands of people in this endeavor.

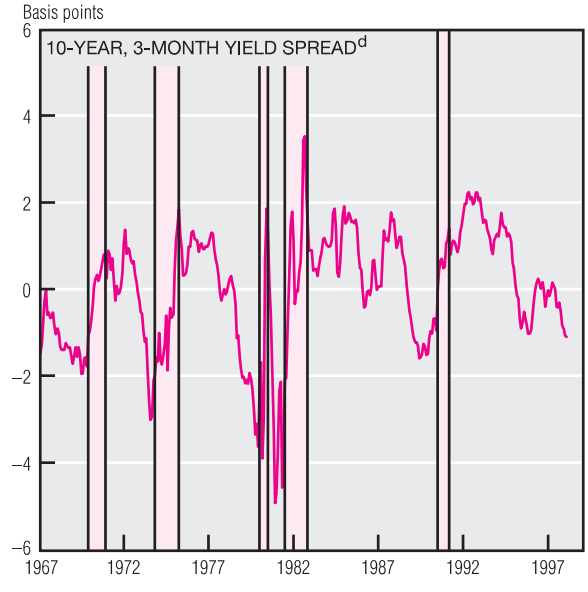
According to a standard estimation technique, a one-time, 1% increase in inflation from its current level translates into a 0.7% loss in annual output, or approximately $6.1 billion per year. A permanent 1% increase in inflation is thus equivalent to society throwing away $203.3 billion over time. Clearly, vigilance against rising inflation is a policy with obvious and tangible results.

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. Constant-maturity 10-year Treasury bond yield minus the secondary market 3-month Treasury bill yield minus the 30-year average of the spread during recoveries or recessions.
NOTE: Shaded areas indicate recessions.
SOURCE: Board of Governors of the Federal Reserve System.

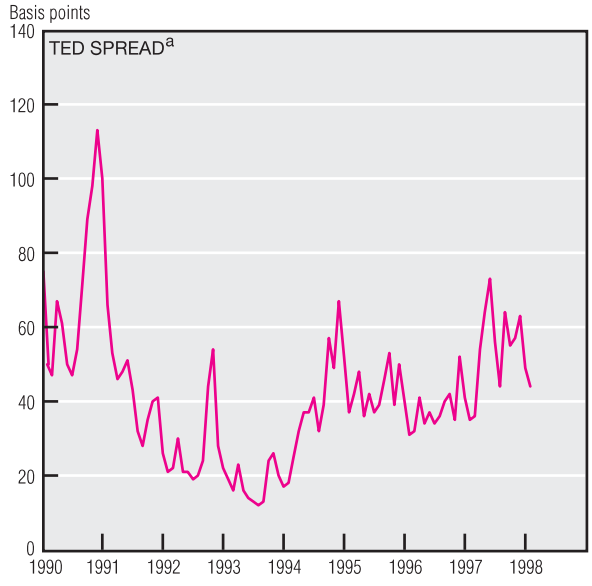
The yield curve has shifted up a bit since last month, with most of the change coming at the short end. It is also somewhat bumpier than usual, with 7-year rates above 10-year rates.

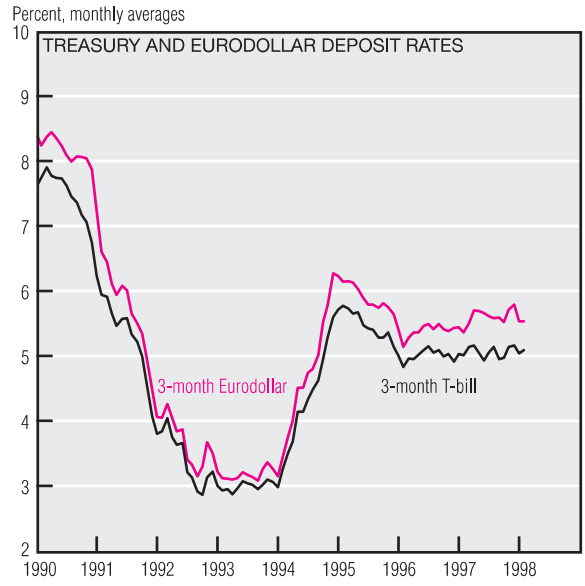
Overall, the yield curve remains flat by recent experience. The 3-year, 3-month spread stands at 25 basis points (b.p.), and the 10-year, 3-month spread is at 33 b.p., both below their historical averages of 85 and 120, respectively. The longer-term capital market rates show small but steady changes, trending up about 20 basis points since the middle of January. Municipal and Treasury bond rates rose slightly less (18 and 19 b.p.), while utility bond rates rose a bit more (22 b.p.).

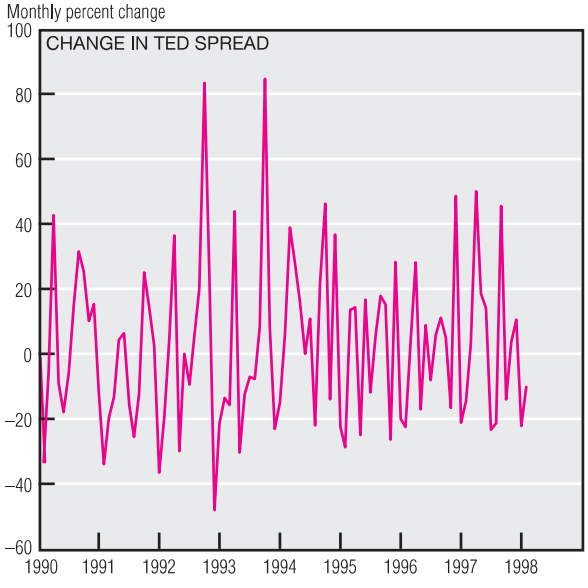
Average yield spreads sometimes provide misleading benchmarks, because average rates and spreads differ considerably between expansions and recessions. Over the past 30 years, interest rates have generally been higher during recessions, while spreads have been lower. The 10-year, 3-month spread averages 144 b.p. in recovery periods, but only 62 b.p. in recessions. Things are even flatter at the longer ends, with the spread between 10-year and 1-year rates averaging only 20 b.p. during downturns, as opposed to 95 b.p. in recoveries.

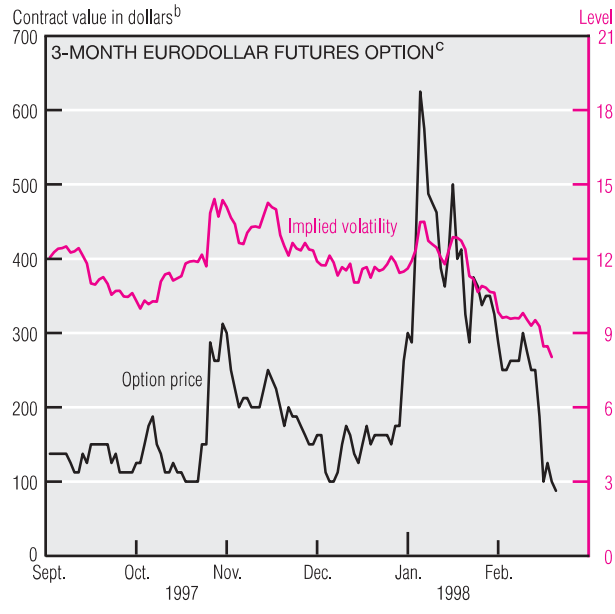
These numbers shed some light on recent economic history. During most recoveries, spreads start above the recovery mean, but end below it. Recessions show an inverse pattern, with spreads starting below the recession mean and ending above it. (There are notable exceptions, however, including the 1990–91 downturn.)

The TED Spread









a. 3-month Eurodollar rate minus 3-month Treasury bill rate.
b. Price of the futures option times $2,500, the value of one point.
c. For June 1998 at a strike price of 94.5.
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

With Southeast Asia's financial woes looming large in the minds of economists, the TED spread—the difference between interest rates on Treasury securities and Eurodollar instruments of the same maturity—has become an attractive measure of international financial uncertainty. This spread reflects the risk surrounding overseas deposits, without the complication of exchange rate risk. The Eurodollar embeds the default risk of the issuing bank and is generally higher than the corresponding U.S. Treasury security.

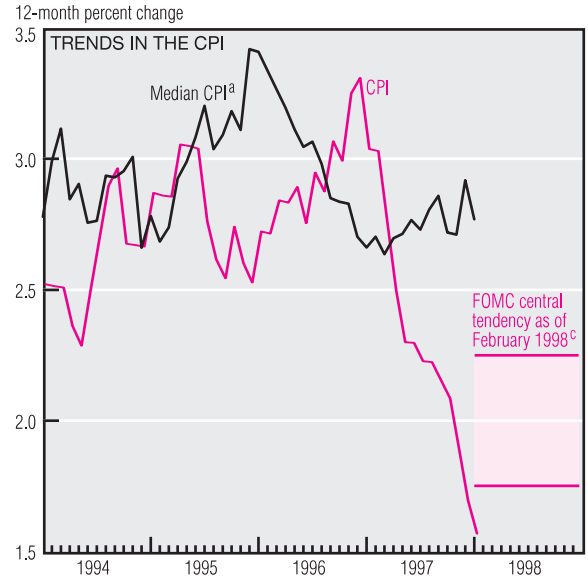
At first glance, Treasury and Eurodollar rates appear to track each other closely, but further observation reveals an active spread between them. The Gulf War produced a large gap in 1990–91, while last year's spikes have been attributed to introduction of the Euro, transfer of power in Hong Kong, and the Southeast Asian financial crisis. The variability of the spread also fluctuates, having shown a marked increase in 1992–93.

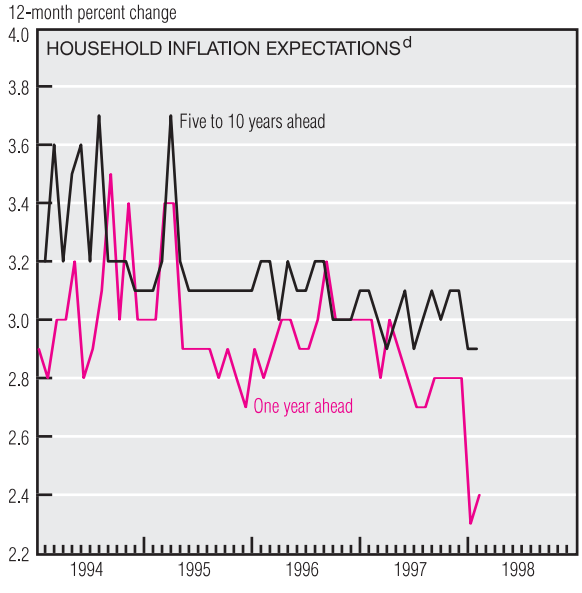
One of the many ways investors can protect themselves from uncertainty is by entering the options market. The June 1998 call, at 94.5, gives the investor the right, but not the obligation, to purchase a Eurodollar futures contract at 94.5 (out of 100). For a buyer to land "in the money," the contract price would have to exceed that amount at expiration.

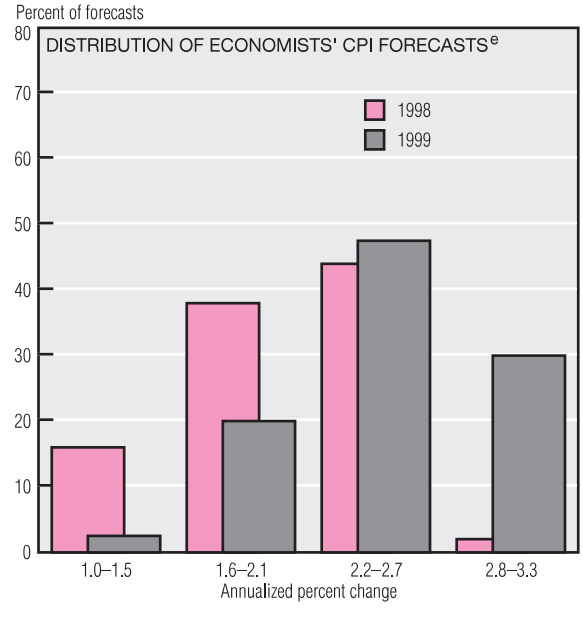
Inflation and Prices

January Price Statistics

	Annualized percent change, last: 1 mo.	6 mo.	12 mo.	5 yr.	1997 avg.
Consumer prices					
All items	0.0	1.6	1.6	2.5	1.7
Less food and energy	2.1	2.0	2.2	2.7	2.2
Median[a]	1.4	2.6	2.8	2.9	2.9
Producer prices					
Finished goods	–7.9	–0.8	–1.9	1.0	–1.5
Less food and energy	–1.7	0.3	–0.1	1.0	0.0
Commodity futures prices[b]	–23.5	–6.0	–5.2	2.6	–3.5







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,* February 10, 1998.

The Consumer Price Index (CPI) remained unchanged in January, while the Producer Price Index (PPI) fell an annualized 7.9%. Both indexes were heavily influenced by falling energy prices. With the volatile food and energy components removed, the CPI climbed 2.1% for the month, while the PPI declined a much smaller 1.7%.

At its February meeting, the Federal Open Market Committee (FOMC) lowered its 1998 central tendency projection for the CPI, a reflection of the past year's declining inflation numbers. Still, the central tendency remains above the current CPI, implying that energy prices are expected to rebound in 1998. The CPI energy index fell 1.8% in December, then slid another 2.4% in January. The median CPI climbed a slight 1.4% in January, within the July 1997 central tendency range but well above the February revision.

Consumers and private forecasters continue to expect only a moderate rate of inflation in 1998. Consumers' median projection rose slightly from December and now stands closer to the median CPI than to the all-inclusive index. Consumer expectations have dropped about half a point since the first quarter of 1997. Economists participating in the latest Blue Chip survey revised their 1998 inflation expectations downward for the third straight month, although over the longer term, they expect the inflation rate to move toward its current five-year average of 2.5%.

(continued on next page)

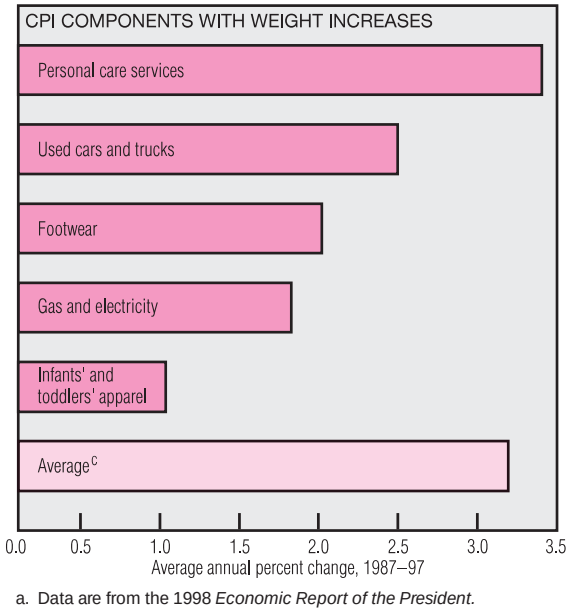
Inflation and Prices (cont.)

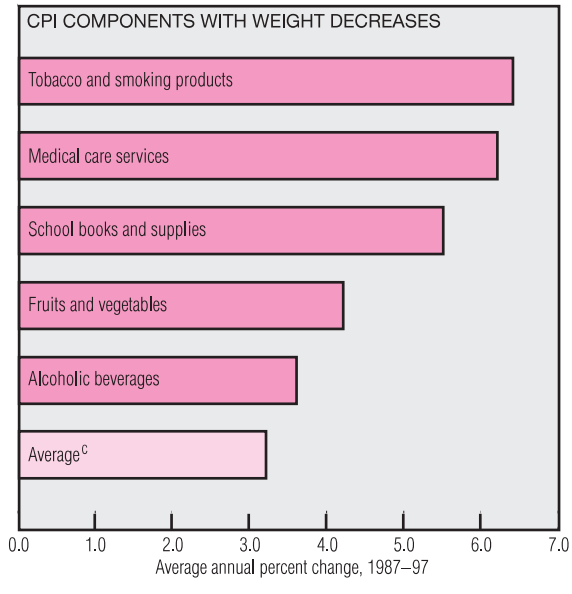
Effects of CPI Revision on Total Index[a]

Affected CPI components	Year introduced	Percentage-point effect on CPI percent change
Pre-1998		–0.28
Generic prescription drugs	1995	–0.01
Food at home	1995	–0.04
Home ownership	1995	–0.10
Rent	1995	0.03
All items (store sample)	1996	–0.10
Hospital services	1997	–0.06
1998 and after		
Personal computers	1998	–0.06
All items (updated market basket)	1998	–0.15
All items (averaging technique)	1999	–0.15
All items (item sample)	1999	–0.05
Total		–0.69

1998 CPI Revision

Component	Weight after revision[b]	Percent change in weight
Personal care services	0.963	70.9
Infants' and toddlers' apparel	0.268	63.0
Used cars and trucks	1.880	57.4
Footwear	0.895	24.5
Gas and electricity (energy services)	3.757	10.5
Medical care services	4.392	–28.5
School books and supplies	0.194	–28.9
Fruits and vegetables	1.394	–29.7
Alcoholic beverages	0.983	–37.7
Tobacco and smoking products	0.894	–47.0





a. Data are from the 1998 *Economic Report of the President.*
b. Weights for all items sum to 100.
c. Includes 36 individual average price changes.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and 1998 *Economic Report of the President.*

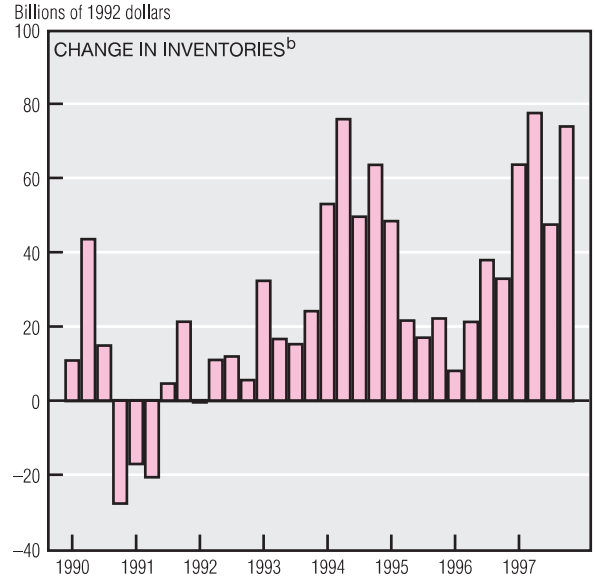
Every 10 years, the Bureau of Labor Statistics (BLS) releases a major revision of the CPI. Although the latest revision has several facets, the new consumer market basket of goods is the most noteworthy. Based on the BLS's 1993–95 Consumer Expenditure Survey, the updated market basket is expected to lower the published CPI by 0.15%. Other changes include a new major expenditure group—education and communication—and a general reclassification of many items. Additional revisions will be made through 1999 and are expected to further decrease the reported rate of price inflation.

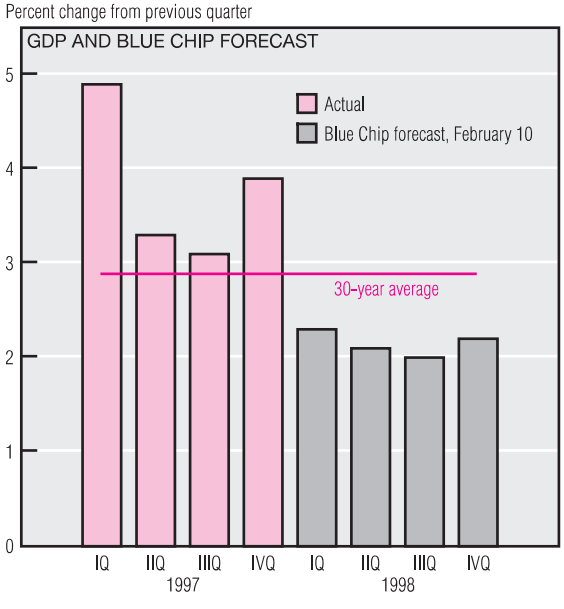
One result of the revised market basket is a reweighting of the components of the CPI. For example, the weight associated with tobacco and smoking products plummeted 47%, while the weight assigned to personal care services rose 70.9%. These revisions reflect an economic fact of life: People tend to shift their spending away from goods whose prices rise rapidly toward goods whose prices are more stable. Nearly all of the items assigned significantly higher weights experienced lower-than-average price growth over the last 10 years, while nearly every item given a lower revised weight had higher-than-average price growth over the same period. The market basket revision will thus reduce the upward bias in the CPI.

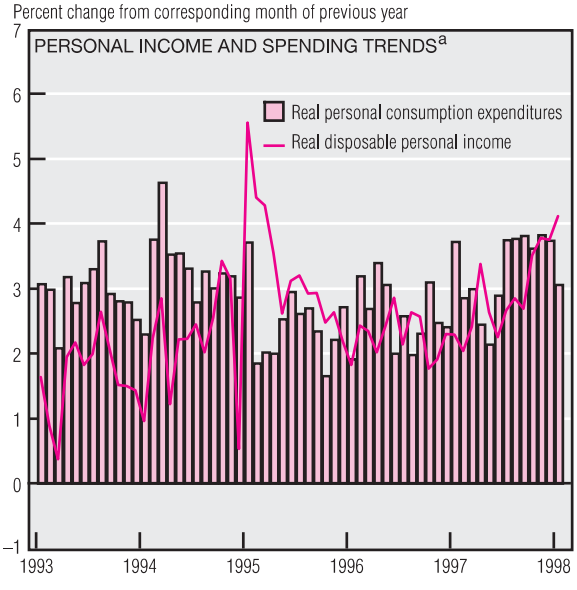
Economic Activity

Real GDP and Components, 1997:IVQ
(Preliminary estimate[a,b])

	Change, billions of 1992 $	Percent change, last: Quarter	Percent change, last: Four quarters
Real GDP	69.3	3.9	3.8
Consumer spending	37.3	3.1	3.7
Durables	2.8	1.7	6.8
Nondurables	–3.6	–1.0	1.4
Services	36.8	5.4	4.3
Business fixed investment	–8.0	–3.6	8.2
Equipment	–5.6	–3.2	12.0
Structures	–2.2	–4.4	–1.2
Residential investment	6.6	9.8	5.8
Government spending	1.3	0.4	1.0
National defense	1.0	1.3	–0.7
Net exports	5.6	—	—
Exports	23.4	10.0	10.6
Imports	17.8	6.4	14.7
Change in business inventories	26.5	—	—







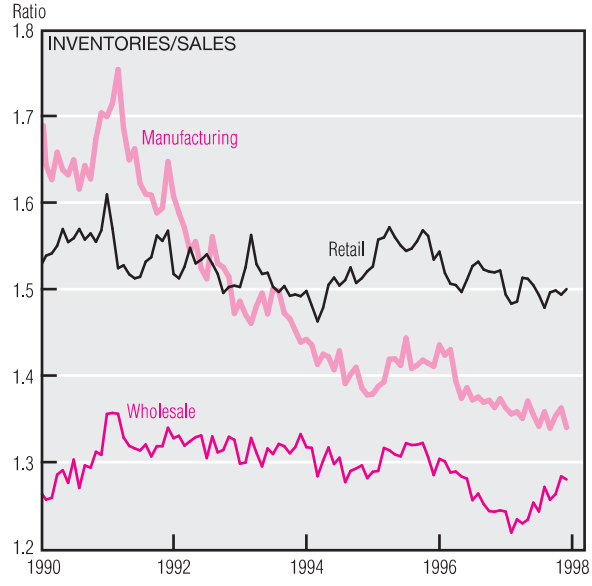
a. Seasonally adjusted annual rate.
b. Chain-weighted data in billions of 1992 dollars.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, February 10, 1998.

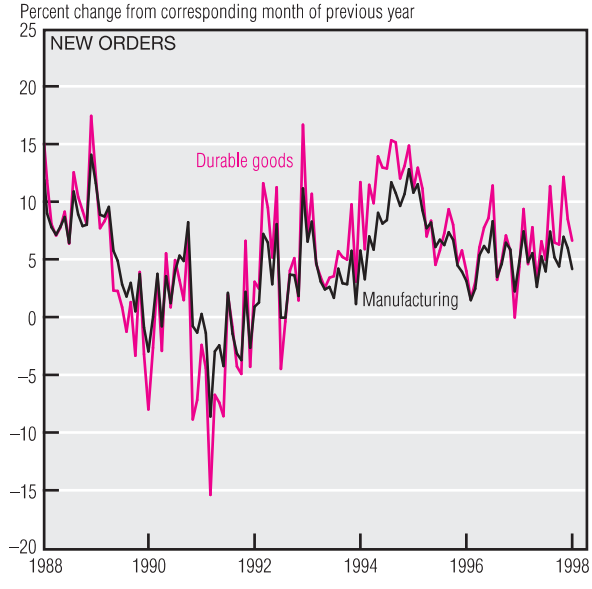
The growth of a country's labor force, the expansion of its capital stock, and the pace of its technological improvement determine its capacity for economic advancement over the long term. To be sure, calculating such a path is difficult and imprecise work. Recent estimates generally put the U.S. growth potential at 2% to 2.5% per year—somewhat below our 30-year average. Economists believe that this rate is consistent with the full employment of both labor and capital. Year by year, the actual pace of economic activity may exceed or fall short of its potential rate, but when this happens, forecasters generally expect that the deviation will be short-lived. A slowing in the pace of economic activity that brings growth into line with its potential need not upset a nation's prosperity. In fact, it may *prolong* the business expansion.

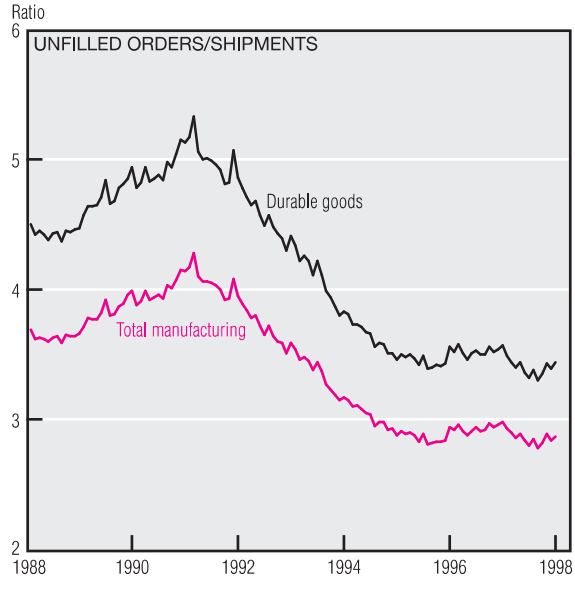
Economists participating in the latest Blue Chip survey generally expect economic activity to slow in the current quarter and throughout 1998 until it reaches a pace consistent with the economy's potential. A year ago, the prognosis for 1997 was similar, with quarterly growth projections falling between 1.8% and 2.1%. Actual GDP growth for the year far exceeded these projections, however, reminding forecasters of their craft's precarious nature.

(continued on next page)

Economic Activity (cont.)







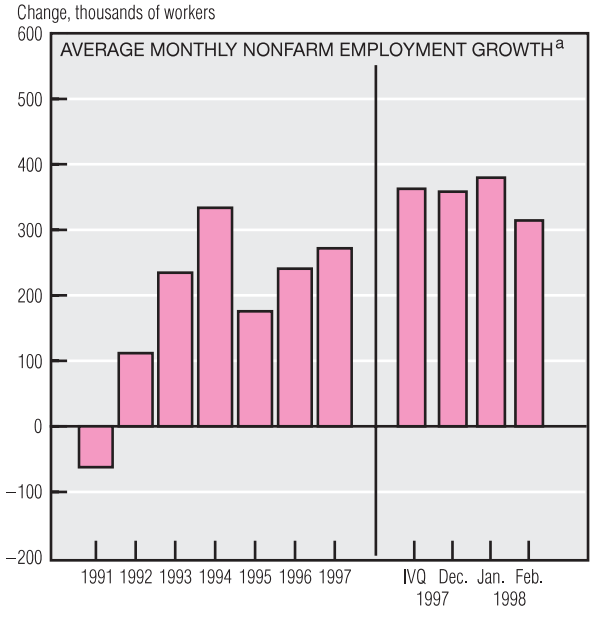
SOURCES: U.S. Department of Commerce, Bureau of the Census; and Board of Governors of the Federal Reserve System.

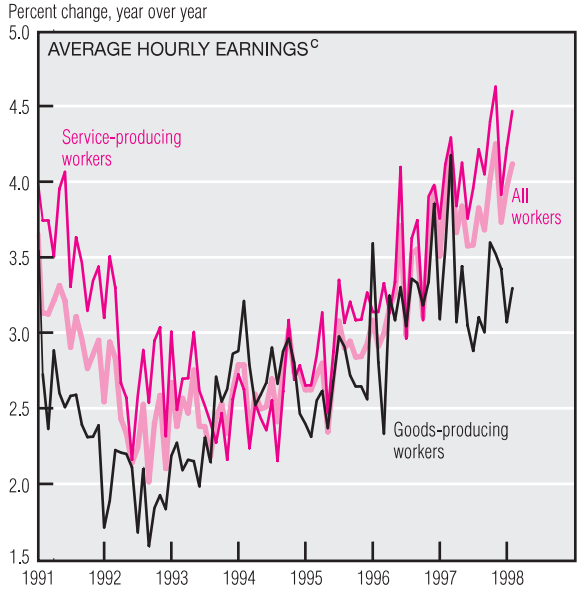
The Commerce Department lowered its assessment of fourth-quarter real GDP growth from 4.3% to 3.9%. Its decision was based on a large upward revision in imports coupled with small downward adjustments to consumer spending, residential investment, government spending, and exports. Business inventories did jump substantially, but not enough to offset these negative factors.

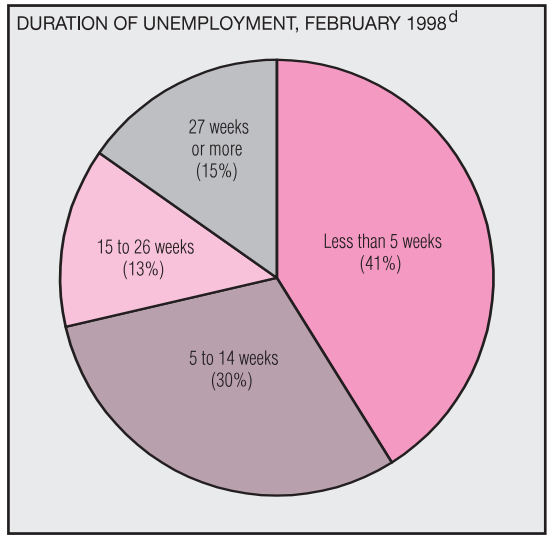
The manufacturing sector, which traditionally accounts for about 18% of total GDP, demonstrated strong growth in 1997. Overall industrial production rose 5.5% last year, with the manufacturing subcategory advancing nearly 6.3%. (The total index includes production at mines and utilities.)

At year's end, the manufacturing sector seemed well poised for sustained growth in 1998. Despite the fourth-quarter advance in business inventories, the level of stocks does not seem inordinate when compared to sales. Only at the wholesale level has the inventory-to-sales ratio been rising, but it remains below typical levels. New orders for manufactured goods were strong throughout last year, especially for durables. Moreover, the ratio of unfilled orders to shipments has held steady. Manufacturers now hold just under three months' worth of orders, and durable-goods producers are operating with slightly more.

Labor Markets







a. Seasonally adjusted.
b. Vertical line indicates break in data series due to survey redesign.
c. Production and nonsupervisory workers on private nonfarm payrolls.
d. Figures do not sum to 100 due to rounding.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The economy continued to strengthen in February, with nonfarm employment expanding by 310,000. Since last October, 1.76 million new jobs have been added, the best five-month posting since the middle of 1994. Leading last month's advance were the service and construction sectors, which added 273,000 and 41,000 jobs, respectively.

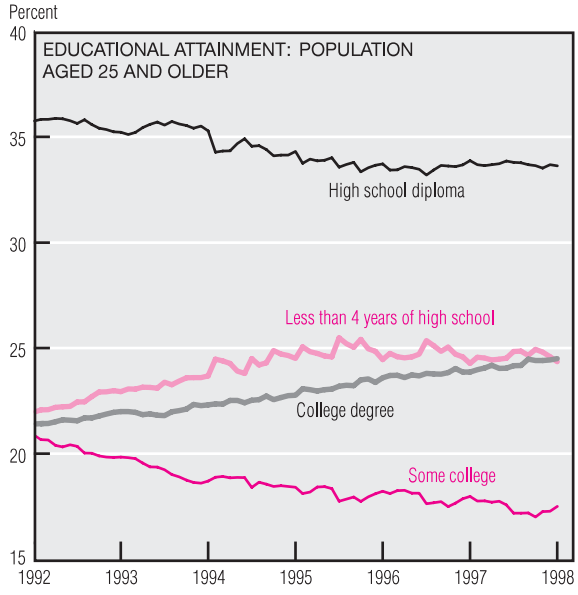
The service sector's strong performance was boosted by a 52,000-job increase at temporary firms, while construction's strength was attributed to storm damage on the west and northeast coasts and unseasonably warm weather in most of the country. One sector that did not contribute to February's gains was manufacturing, which lost 2,000 jobs after growing rapidly for the past four months.

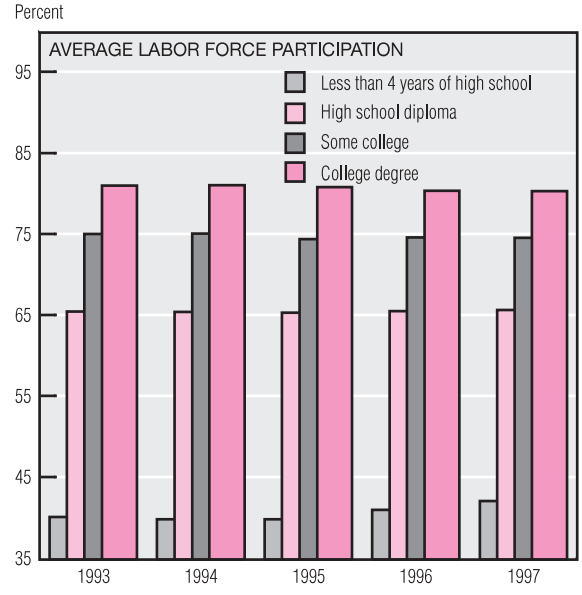
The unemployment rate fell slightly to a cyclical low of 4.6%, while the employment-to-population ratio held steady at 64.2%—a record high. The lack of available labor has put upward pressure on wages and led to shortened spells of unemployment.

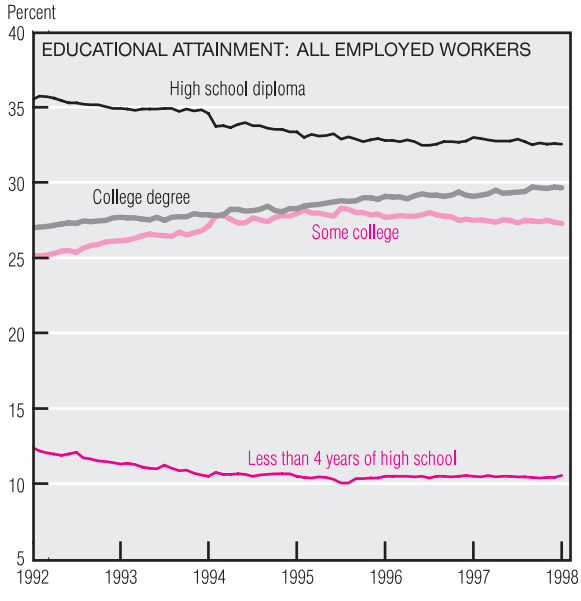
Average hourly earnings of nonsupervisory, nonfarm workers rose eight cents in February, up 4.1% from one year ago. The increase was driven largely by service-sector wages, which have risen 4.5% since February 1997. Wages for goods-producing workers were up 3.3%.

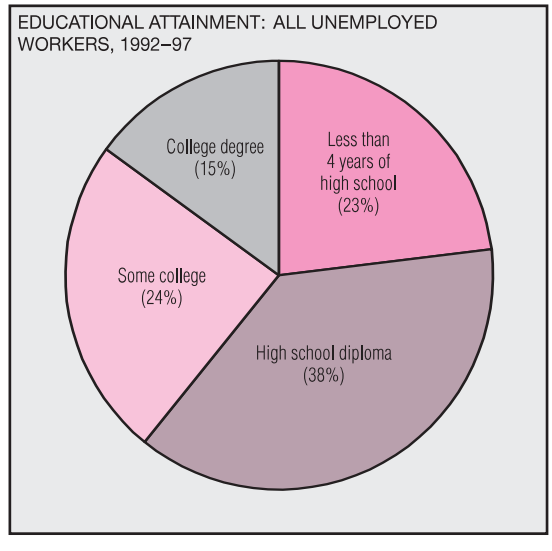
The average unemployment spell stood at 16 weeks in February, down one week since 1991. The largest share of jobless people (41%) have been out of work less than five weeks.

Education and the Labor Force









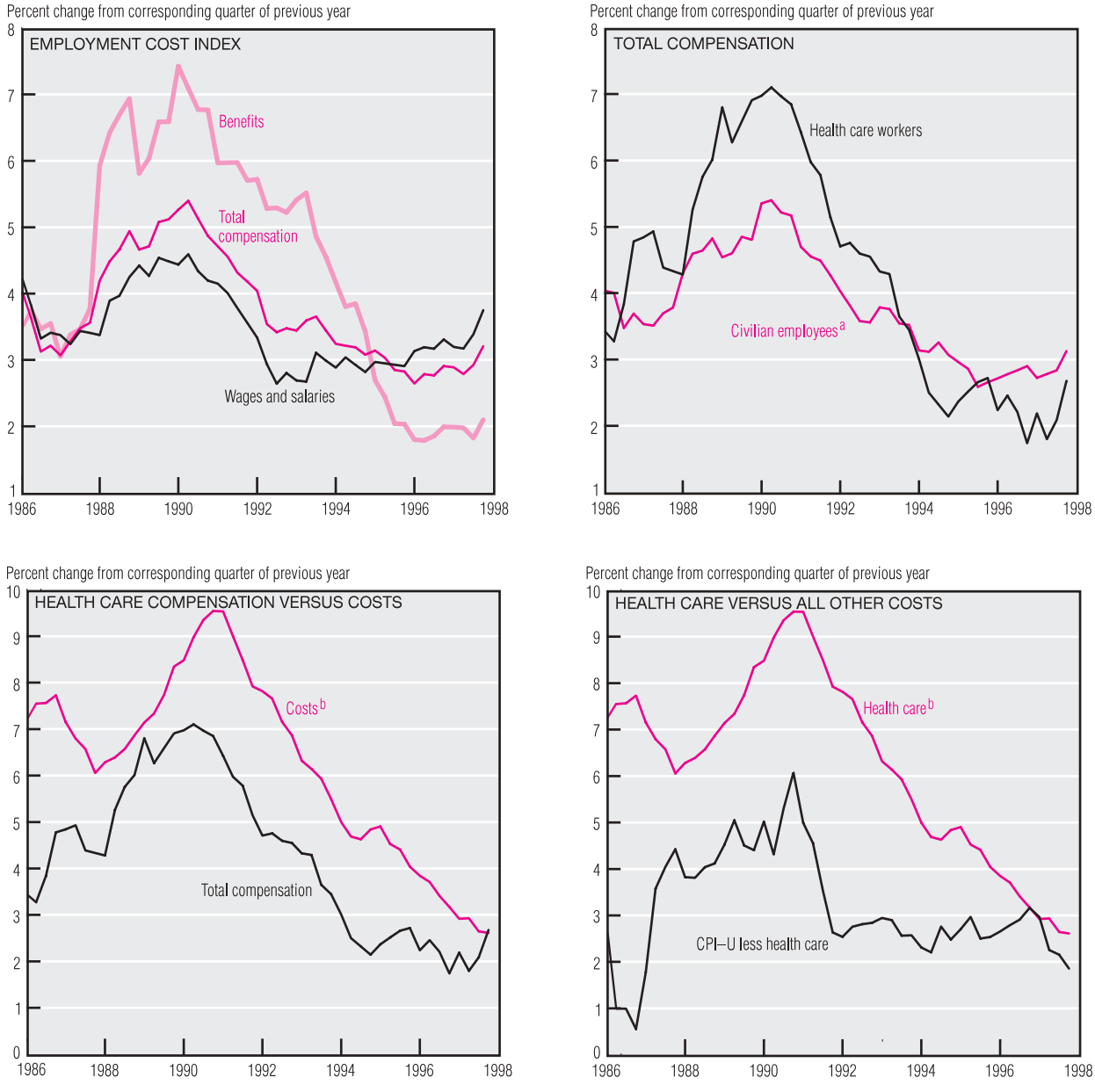
NOTE: "High school diploma" includes equivalency certificate, and "some college" includes associate's degree. All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The last quarter of the twentieth century has seen an industrial revolution of sorts, led by the advance of computers and other high-tech equipment. Many analysts worry, however, that this technological progress is outpacing the workforce's ability to adapt. If their fears are realized, society will not reap the full benefit of these advances, or will do so only with a lag.

At the end of 1997, 24.5% of Americans aged 25 or older held a four-year college degree. These individuals' labor force participation rate is substantially higher than that of any other educational group (the labor force includes people who are either employed or seeking work).

High school graduates make up the largest share of employed workers, but college graduates have been closing the gap in recent years. In the five years ended in 1997, the fraction of employed workers holding a college degree grew from about 27% to almost 30%, while the share with a high school diploma decreased from 36% to 33%. Over the same period, high school graduates accounted for 38% of all unemployed workers, while college graduates made up just 15% of the jobless ranks.

Worker Compensation and Health Care Costs



a. Excludes sales occupations.
b. As measured by the CPI-U.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

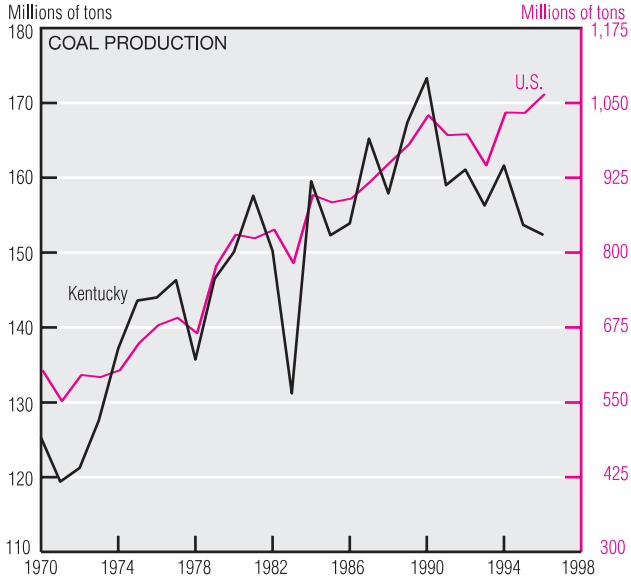
For a year now, labor markets have been characterized as tight. When the unemployment rate remains low over a long period, wages are expected to increase as employers compete to hire the small number of available workers. Why, then, did the Employment Cost Index (ECI), which measures the cost of total worker compensation, increase only a moderate 3.1% in 1997?

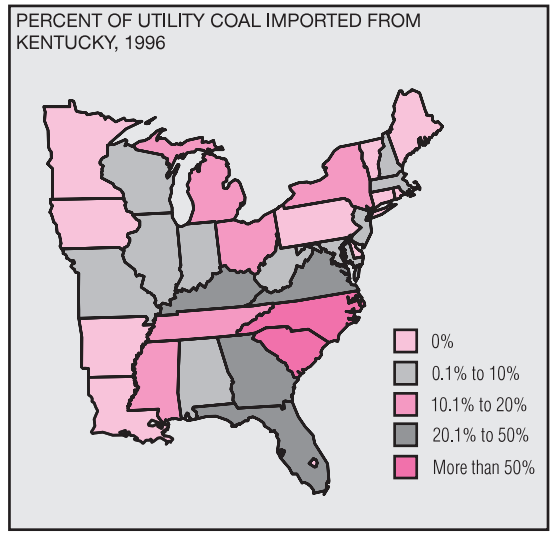
It appears that total compensation costs were held in check by slow growth in the cost of benefits. While several factors, including subdued overall price increases, may have caused this deceleration in benefit costs, one likely contributor is the slowing growth of wages in the health care industry.

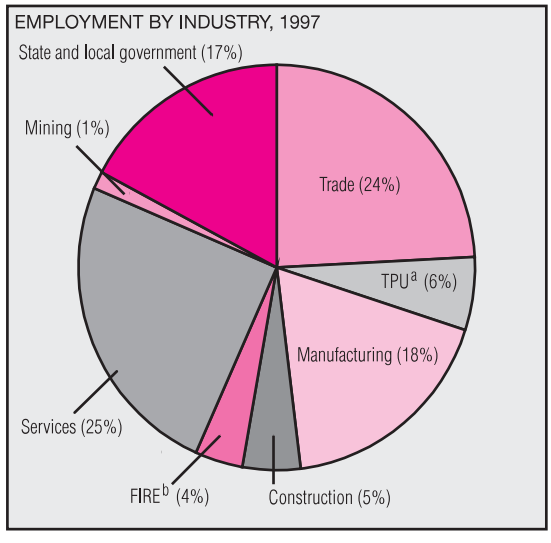
For most of the past 10 years, health care workers' wages have grown faster than those of other civilian employees. From 1987:IIIQ to 1995:IQ, total compensation (as measured by the ECI) increased at an average rate of 4% for all civilian workers, while workers in the health care industry saw a 5% rise. In 1997, however, health care compensation grew at a much slower pace, increasing just 2.6%, compared to 3.1% for other workers.

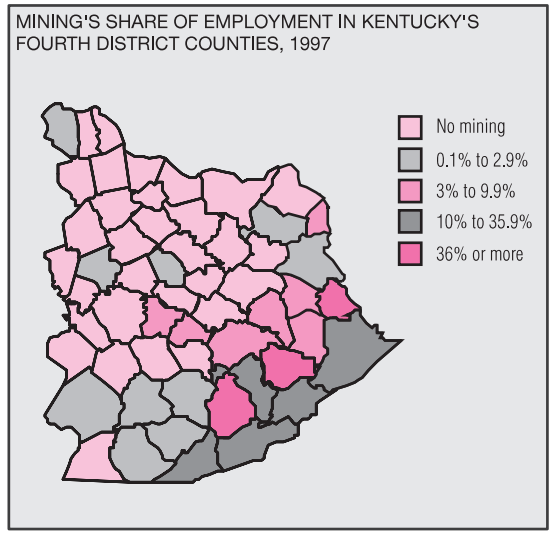
Not surprisingly, the cost of health care, as measured by the Consumer Price Index for all urban wage earners (CPI-U), tends to move with health care wages. Between 1987 and 1994, a period when the industry's wages shot up rapidly, health care costs increased at an average annual rate of 7%. In 1997, health care costs rose only about 3%.

Kentucky's Coal Industry









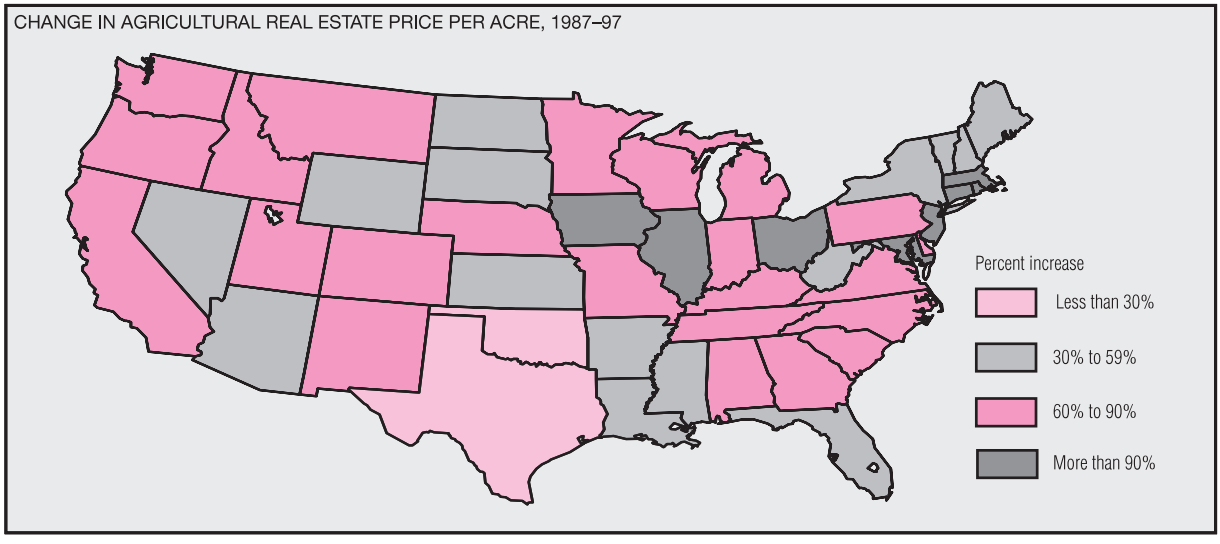
a. Transportation and public utilities.
b. Finance, insurance, and real estate.
NOTE: Data are not seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Kentucky Department for Employment Services, Labor Force Estimates Division; and Kentucky Coal Marketing and Export Council and the Kentucky Coal Association, "Kentucky Coal Facts," 1997–98.

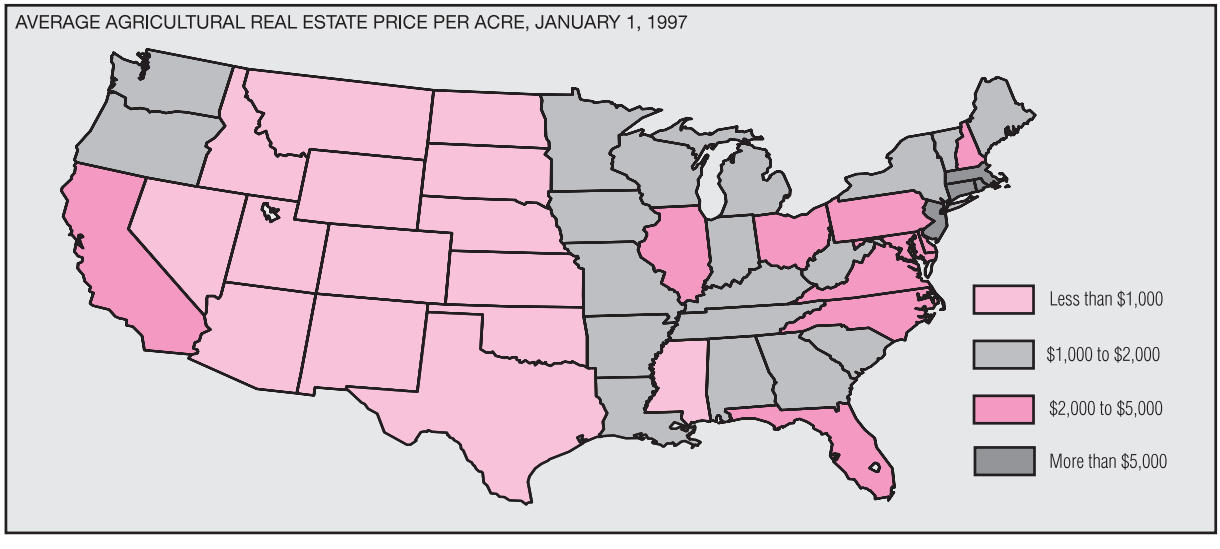
Historically, Kentucky has been a major player in the coal production industry, which provides more than half of the electric power used in the U.S. In 1996, the state ranked third (surpassed only by Wyoming and West Virginia) in total domestic coal production, extracting 152.4 million tons (about 14% of the U.S. total). Approximately 85% of Kentucky's coal is sold to out-of-state electric plants, primarily on the eastern seaboard.

About 1.3% of Kentucky's nonfarm jobs are in mining, 0.8 percentage point above the national average. Coal production in the state is region-specific, with the eastern counties employing nearly 71% of the mining workforce. Not surprisingly, the fate of many rural counties is tied closely to the mining industry. While only 2% of the state's total wages come from mining, that share jumps to 13% in the eastern mining counties.

According to the Kentucky Coal Association, state coal production has declined slightly in recent years because of increased competition from states west of the Mississippi. In Kentucky, the cost of extracting a ton of coal is about $25; in Wyoming, that figure is only $4. Because large operations can compete effectively with western rivals, Kentucky has seen increased consolidation in the industry over the last several years.

Ohio Farmland Prices





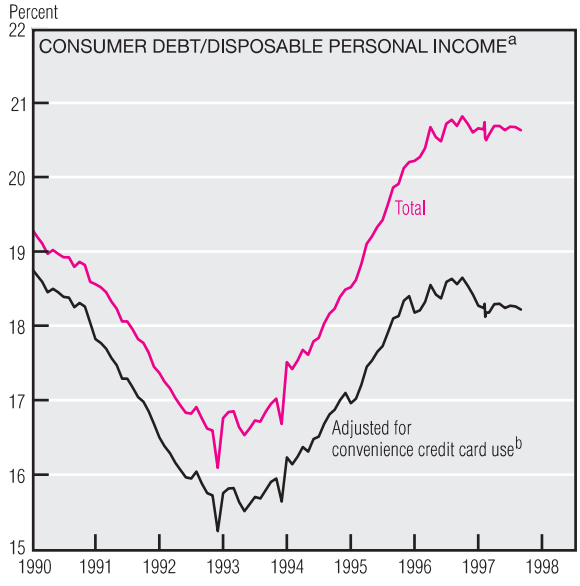
SOURCE: U.S. Department of Agriculture, Economic Research Service, *Agricultural Outlook*, December 1997.

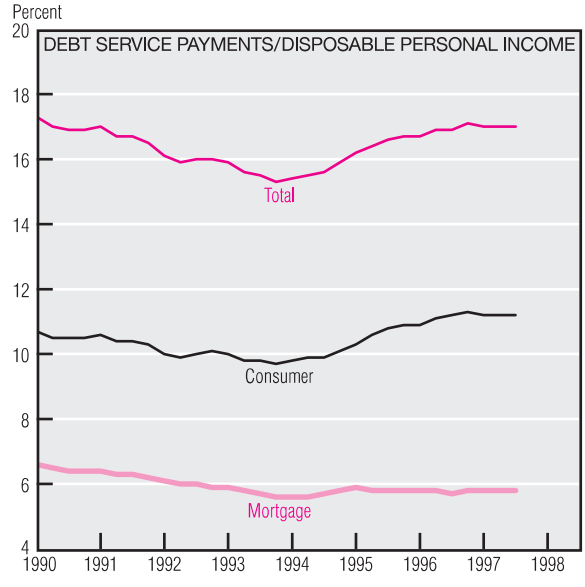
Over the last 10 years, the price of Ohio farmland has shot up approximately 90%, substantially more than in neighboring states and well above the national increase of 57%. Over the same period, Ohio's housing price index advanced 77%.

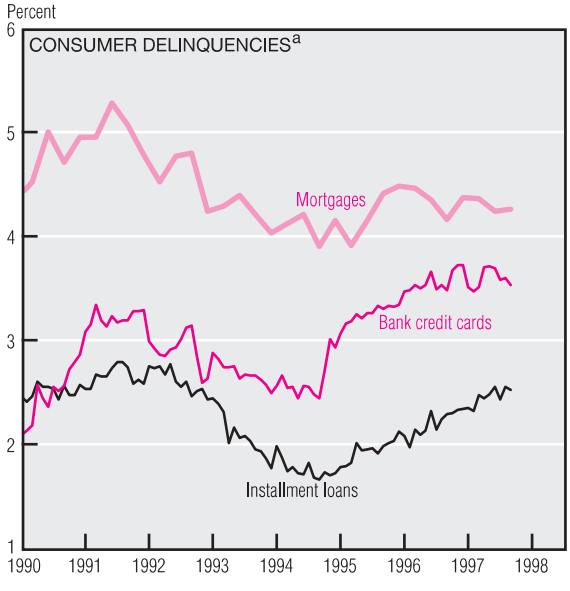
At $2,110 per acre, the cost of Ohio farmland ranked twelfth in the nation last year. The highest prices were found in the industrial states on the eastern seaboard: New Jersey ($8,290), Rhode Island ($7,900), Connecticut ($7,500), and Massachusetts ($6,200). Farmland in the Fourth District states ranged from $1,000 per acre in West Virginia to $2,630 in Pennsylvania. The national average was $942.

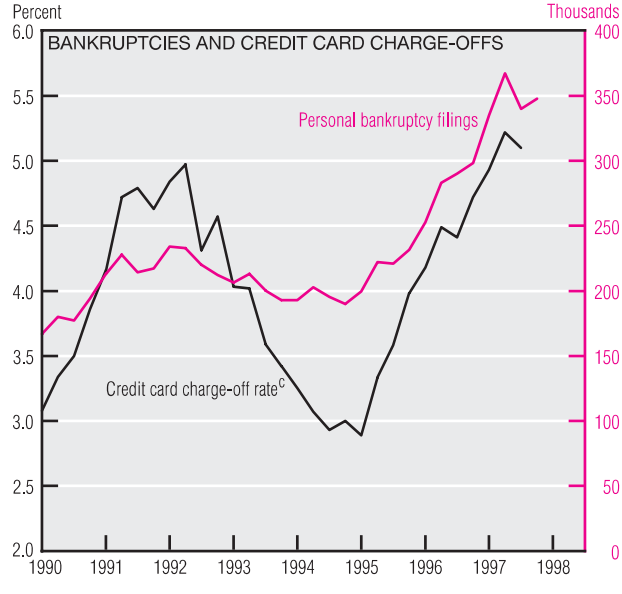
Geographical differences are not the only influence on farmland prices: Shifts in the market for specific agricultural products also play a role. According to the USDA, the increase in Corn Belt land values can be traced in part to a strong and growing foreign demand for grains. Population growth and densities also seem key, as evidenced by the nationwide pattern of land values. Anecdotal reports indicate that urban sprawl in Ohio has greatly contributed to the state's rapidly rising farmland prices. Regional variations in government agricultural payments and subsidies may also have had an effect, albeit a smaller one.

Household Financial Conditions









a. Seasonally adjusted.
b. Adjusted consumer debt includes only the estimated portion of bank card debt accruing finance charges.
c. Net charge-off rate is the percentage of total credit card debt that banks remove from their balance sheets because of uncollectibility, less amounts recovered on credit cards previously charged off, expressed as an annual rate.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Administrative Office of the U.S. Courts; American Bankers Association, *Consumer Credit Delinquency Bulletin*; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*; Mortgage Bankers Association of America, National Delinquency Survey; and Ram Research Group, Bankcard Update/Bankcard Barometer.

Over the last few years, many analysts have voiced concern about the ongoing stability of household finances, particularly given the high debt and delinquency levels observed during this time of strong economic growth. Despite such concerns, many indicators of household financial health have improved over the last year.

For example, total consumer debt as a share of disposable personal income remained relatively steady at about 20.6% throughout 1997, while the fraction of income devoted to servicing that debt has stayed at 17% for nearly a year. In addition, the third quarter saw the smallest annual increase in credit card charge-off rates since early 1995, while personal bankruptcy filings fell for the first time in two years. Finally, the recent rise in credit card delinquency rates appears to have slowed. Taken as a whole, current trends in these indicators suggest that fears about households on the verge of financial ruin may have been overstated.

Of course, to truly grasp what these data have to say about the current financial status of U.S. households requires an understanding of what caused the improvement. The Senior Loan Officer Opinion Survey on Bank Lending Practices, conducted quarterly by the Federal Reserve Board of Governors, can provide some insight. Its results suggest that the recent moderation in credit

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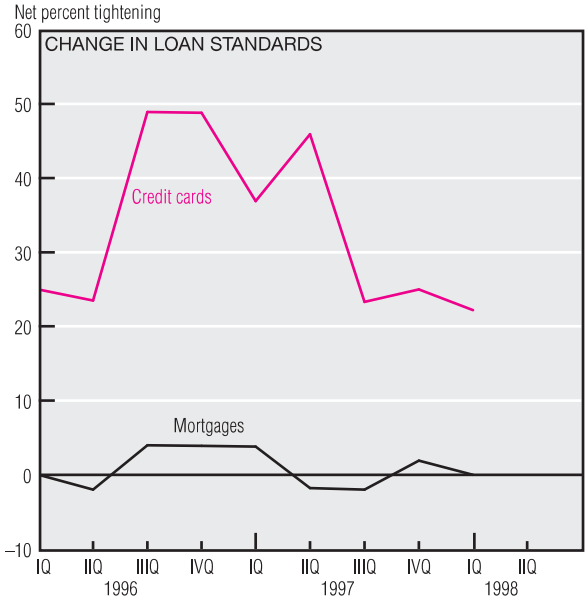
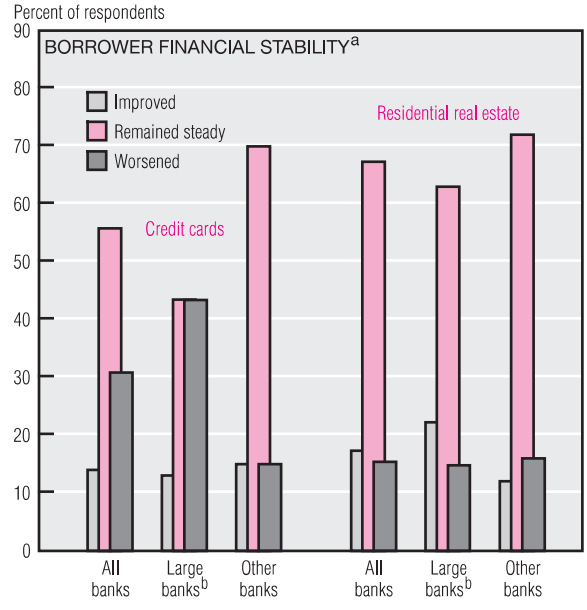
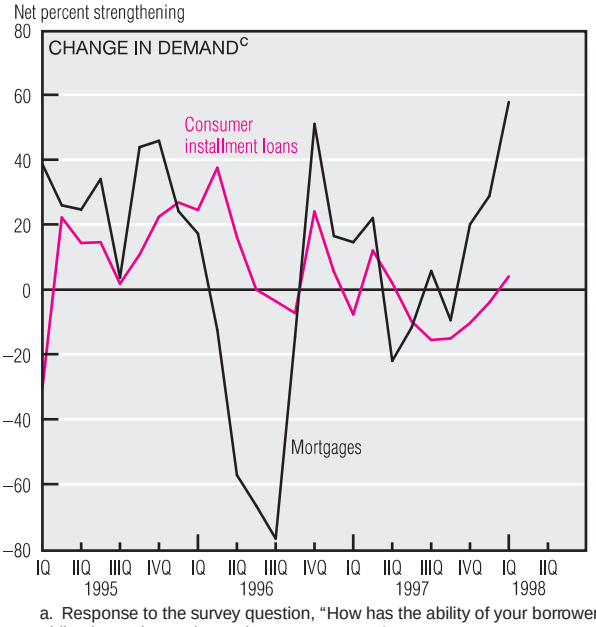
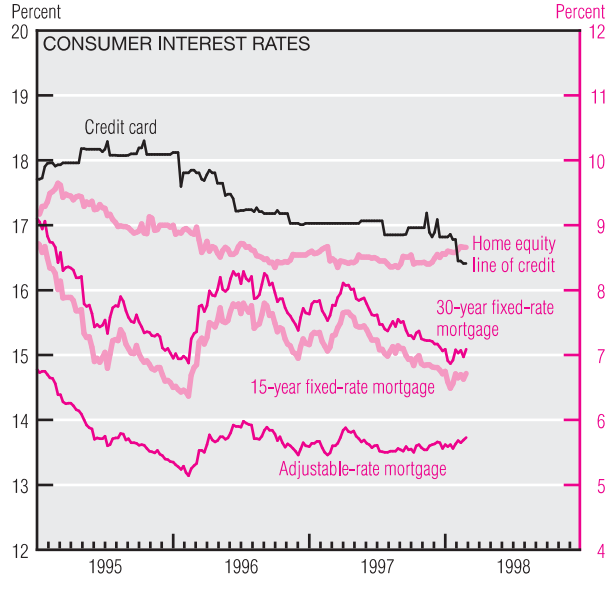
Household Financial Conditions (cont.)









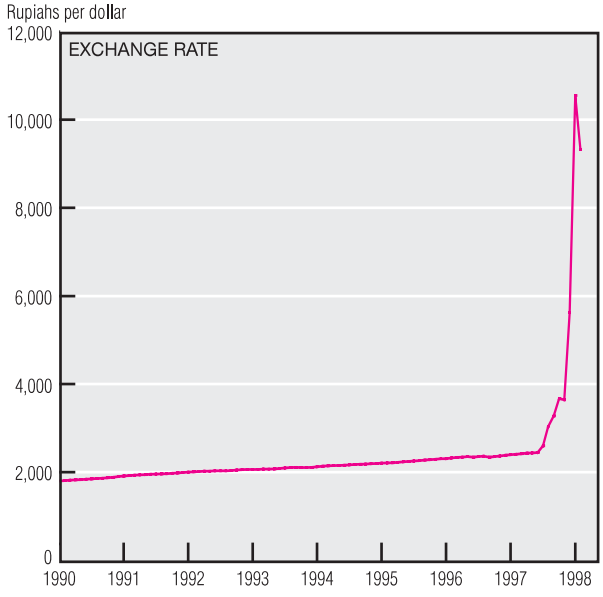
a. Response to the survey question, "How has the ability of your borrowers to weather a period of economic weakness, in terms of meeting all of their cash flow obligations, changed over the past two years?"
b. Total domestic assets of more than $15 billion.
c. Response to the survey question, "Over the past three months, has demand for mortgages to purchase homes and for consumer loans of all types changed?"
SOURCES: Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices, various issues; and *Bank Rate Monitor*.

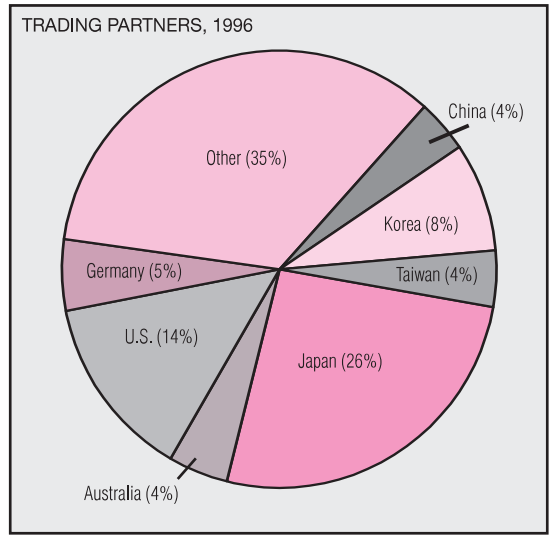
card delinquency and charge-off rates may stem partly from banks' decisions to tighten lending standards through 1996 and early 1997. Nevertheless, the current report reveals that banks are still wary of their credit card borrowers, with more than 30% of respondents reporting a worsening of their borrowers' abilities to weather an economic downturn. As such, it is not surprising that we continue to see some tightening in credit card lending standards.

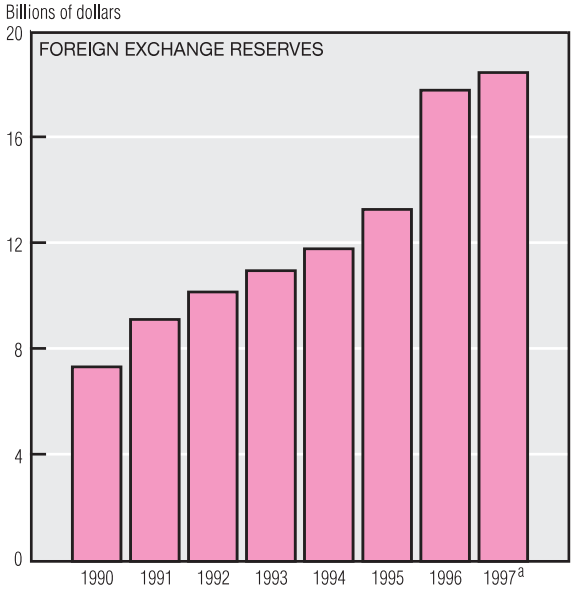
In contrast to unsecured credit card lending, residential mortgage lending appears to be on a strong footing. On net, banks believe that their borrowers' financial health remains stable, and consequently do not appear to be tightening their underwriting standards. It is worth noting, however, that delinquency rates on residential mortgages never experienced the sharp rise seen in other types of consumer debt.

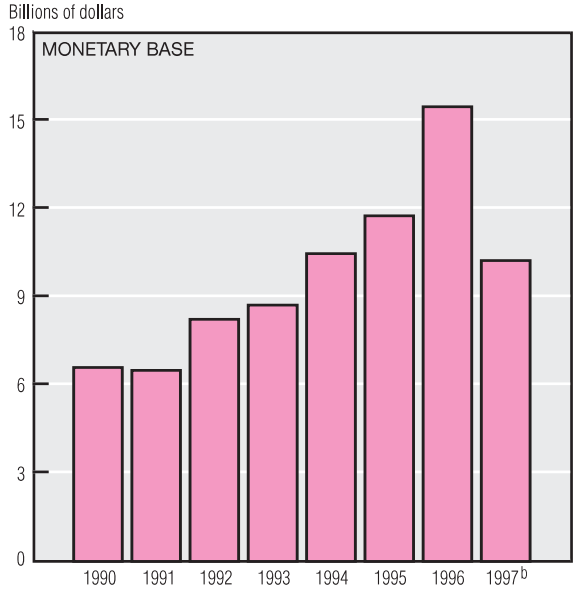
Likewise, the percentage of senior loan officers reporting a strengthening of demand for mortgage loans has risen tremendously over the last year, perhaps in response to the continued decline in long-term mortgage rates. On the other hand, the demand for consumer installment loans has remained more subdued, with nearly as many banks reporting weakening demand as strengthening. Once again, this may be consistent with the view that households are taking a respite from the debt acquisition of recent years.

An Indonesian Currency Board?









a. Through October 1997.
b. Through November 1997.
SOURCES: International Monetary Fund, *International Financial Statistics* and *Direction of Trade Statistics*; and *The Wall Street Journal*, various issues.

Indonesia recently considered establishing a currency board, which would exchange rupiah notes for U.S. dollars on demand, with no restrictions. The country would insure this offer by fully backing the rupiah monetary base with dollars and by fixing the exchange rate as a matter of public law. An irrevocable dollar peg with full rupiah convertibility would automatically link Indonesia's money stock to that of the U.S. By precluding Indonesia from engaging in discretionary monetary policy, this arrangement would enhance the credibility of the rupiah's purchasing power.

Doubts about the safety and soundness of the banking industry—not uncertainty about monetary policy—seem to be the key factor driving Indonesia's capital flight. But a currency board cannot remedy a banking crisis quickly. Because it never holds domestic assets of any kind, a currency board cannot act as a lender of last resort (LLR) or otherwise inject funds into the banking system. While an independent LLR is conceivable, its inability to create reserves limits its scope.

Under a fixed peg, any dollar appreciation could reduce Indonesia's trade balance. As this happened, the nation's money stock would contract, prices and wages would fall, and interest rates might rise. When the exchange rate is set, prices and wages must bear the full burden of reestablishing a nation's competitiveness.