

## The Economy in Perspective

*Second guessing* ... With all the buzz about U.S. economic statistics in recent public discourse, one might almost believe that the ocean's tides are now governed by the waxing and waning of the business cycle. Every statistic is analyzed not only for revelations about economic performance, but also for its likely effect on the Federal Reserve's *attitude* about economic performance, partly because many people think the economy is at a turning point. Greater interest in economic life is certainly heartening, but this frenzy seems unwarranted.

The current economic expansion has just entered its eighth year and shows every sign of continuing. Production of goods and services increased at roughly a 4 percent annual rate in real terms last quarter, and domestic purchases excluding inventory adjustments rose at a 6 percent clip. Second-quarter data show that the U.S. manufacturing sector may finally be getting some fallout from Southeast Asia, but these effects do not yet seem overwhelming. Moreover, as we anticipated, the weakness in tradable goods is being countered by added buoyancy from interest-sensitive sectors like housing and automobiles. Consumers, confident that the expansion will continue, are picking up the pace of their retail spending. The unemployment rate hit a 28-year low in April, and earnings are climbing.

Inflation? What inflation? Wholesale prices, on average, have been steady for a few years now, and consumer prices advanced less than 2 percent during the last 12 months. Even making allowances for large, temporary declines in food, energy, and other items, consumer price inflation has not accelerated for several years. The median CPI, for example, has been recording 12-month changes within a narrow range (around 3 percent) for about five years. Since the 1950s, inflation has accelerated over the course of business expansions, often peaking at a higher rate than it reached at the previous cycle's peak. In the current cycle, the core inflation rate has been nearly constant or on a slightly downward trajectory.

There are, of course, risks to consider. Continuing economic problems in Japan could combine with Southeast Asia's travails to weaken exports even further. An inventory correction could depress manufacturing activity. Labor shortages could lead to compensation increases large

enough to reduce corporate profits. Lending by financial institutions may overreach the bounds of good judgment, causing a retrenchment in credit extensions that impairs economic activity. Any number of possible events *could* reverse the economy's forward momentum. And then there is the Federal Reserve.

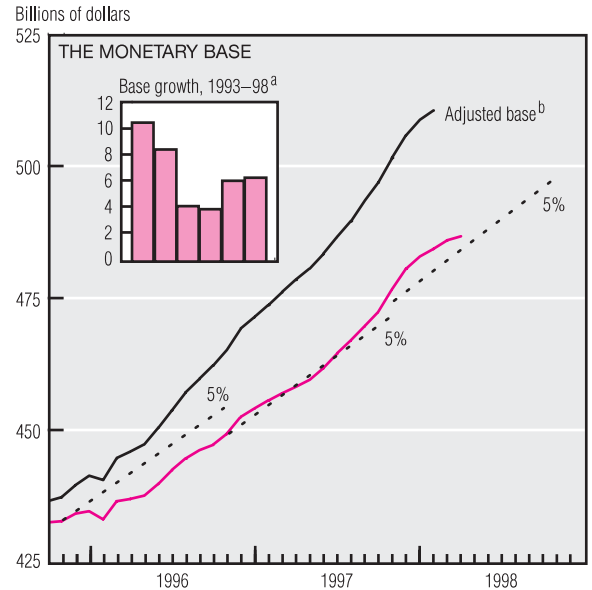
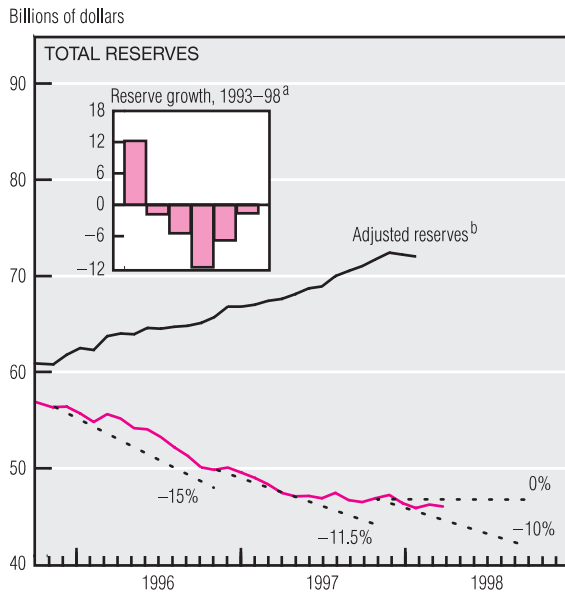
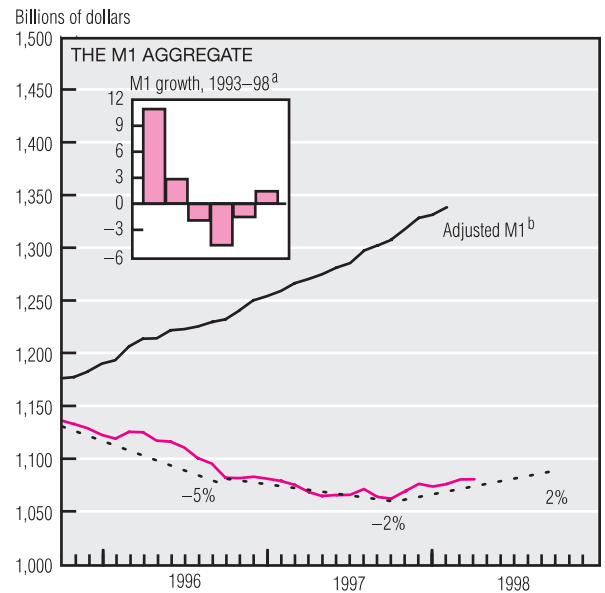
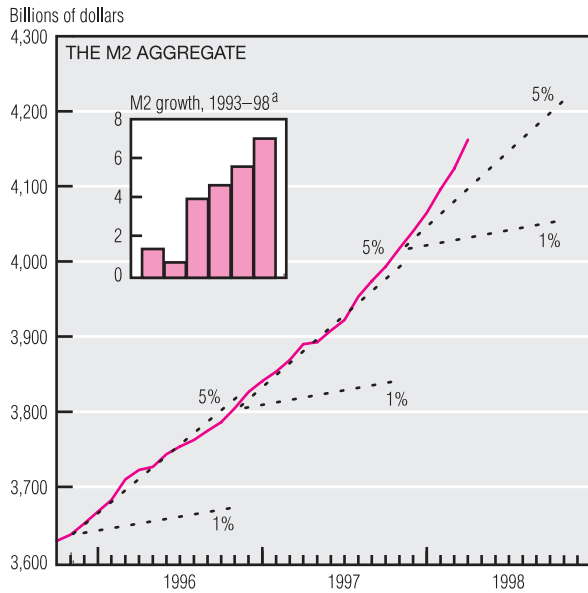
Throughout this expansion, the Federal Open Market Committee (FOMC) has been willing to supply whatever reserves the banking system has demanded, at a predetermined federal funds rate. Nevertheless, using the funds rate to judge the stance of monetary policy can be misleading. The intended funds rate, which the FOMC can achieve almost precisely, may lie either above or below the unobservable noninflationary equilibrium rate. If the demand for bank credit shifts with economic circumstances, an unchanged funds rate would alter the degree of pressure on bank reserves and would consequently affect the growth rates of money, credit, and output.

Early in the expansion, the FOMC pushed the funds rate down to 3 percent (where it stood for nearly two years), to provide the liquidity needed to spark a pickup in economic activity. Though successful, when this policy stance threatened to rekindle inflation, the FOMC decisively raised the funds rate a total of 300 basis points (to 6 percent) between January 1994 and February 1995. The FOMC has since lowered the funds rate to 5¼ percent for a year, then raised it to 5½ percent last March.

Unless substantial shocks hit the economy, real interest rates are unlikely to make sudden jumps. Consequently, it would be unusual for small changes in the federal funds rate—amounting to less than 100 basis points within a 12-month period—to represent a significant change in the thrust of monetary policy. Indeed, small movements may occasionally be necessary to prevent the funds rate from drifting too far from market-determined rates and fostering undesirable money and credit conditions.

In January, market sentiment favored a funds rate cut; today, the balance of opinion has shifted to the opposite side. Since the expansion has already withstood a 300-basis-point increase in the funds rate, the small rise anticipated by financial markets should not be as electrifying as some commentators would have it.

# Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1998 growth rate is a year-over-year percent change.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for April 1998. For M2, dotted lines are FOMC-determined provisional ranges. For M1, the monetary base, and total reserves, dotted lines represent growth rates and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

Growth in the monetary aggregates was mixed last month, with the narrow measures of money slowing and the broadest aggregate, M2, expanding at a brisk 11.8% annual rate. The rapid growth in M2 followed an 8.3% increase in March and was markedly above the 7% rise posted over the last 12 months. Both numbers are well outside the Federal Open Market Committee's (FOMC) 5% provisional range, a fact that has many analysts worried that higher inflation may be just around the corner. Others are more san-

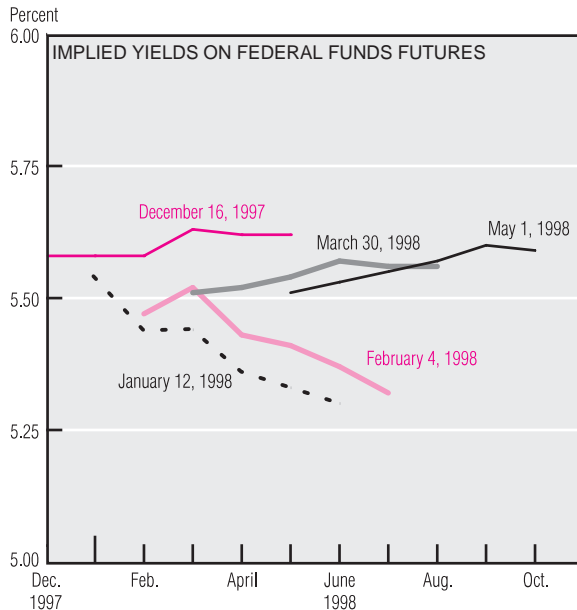
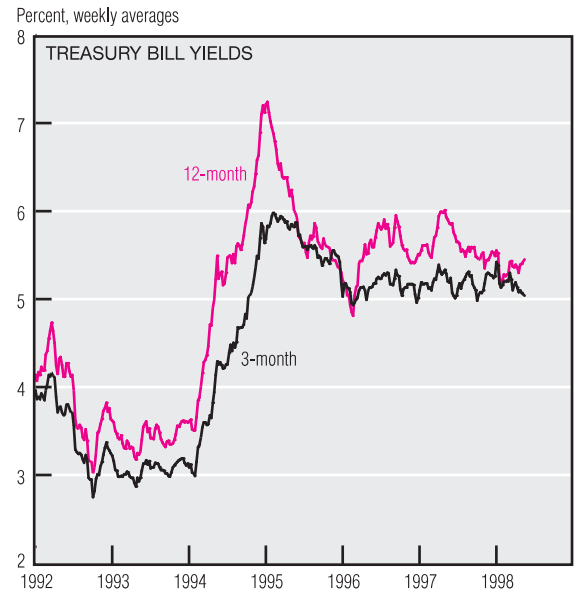
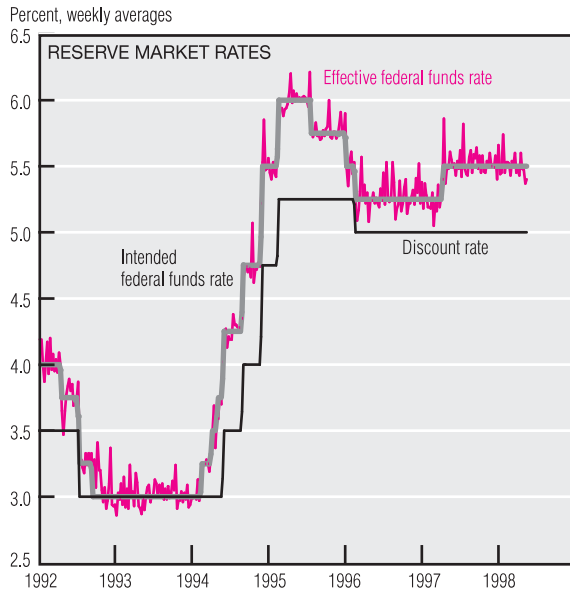
guine, however, noting that the bulk of the M2 surge reflects continued vigorous growth in real GDP, not an "easy money" stance on the part of the Fed.

M1, a narrower definition of money, includes currency and checkable deposits. Unlike M2, its growth rate slowed last month to a meager 0.2%—down dramatically from 4.9% in March and also below the 1.1% pace recorded over the past 12 months. The slowdown can be traced primarily to two factors: a drop-off in the rate of home refi-

nancing and the distorting effects of sweep accounts. Over the past year, sweep-adjusted M1 growth has run nearly 6.9 percentage points above the nonadjusted measure. Total reserves also fell in April, contracting 4.8% and partly reversing March's 10% rise. Because reserves are held only on checkable deposits, these changes largely reflect the same factors that are driving M1 growth.

The monetary base, which includes currency and reserves, inched up at an annual rate of 1.9%  
(continued on next page)

## Monetary Policy (cont.)



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.

in April, down from 4.1% in March and 6.2% over the past 12 months. Because the monetary base consists of Federal Reserve liabilities, many economists believe that it is the best indicator of the thrust of monetary policy.

Rather than controlling the monetary base directly, the Fed increases or decreases the supply of reserves to ensure that the federal funds rate hits its target. Although the current 5.5% target has not been altered for more than a year, the thrust of monetary policy can

change with the underlying pressures on short-term interest rates. For example, if real interest rates declined, putting downward pressure on the 3-month Treasury bill, fewer reserves would be needed to keep the funds rate constant. A constant federal funds rate target would then imply a tightening in monetary base growth.

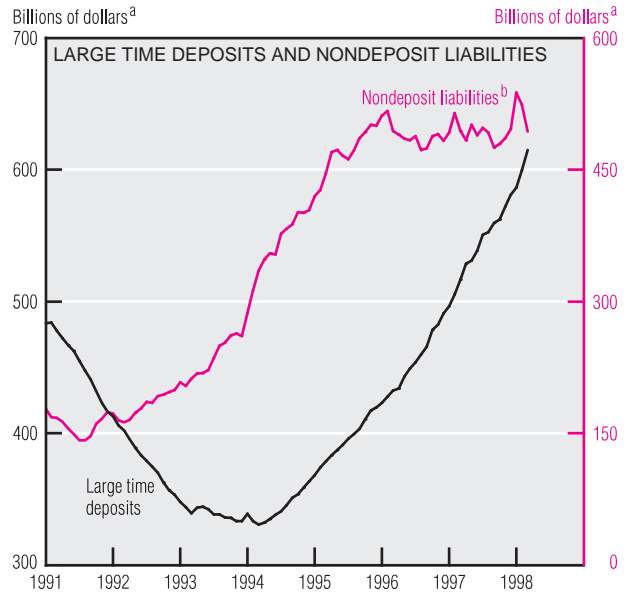
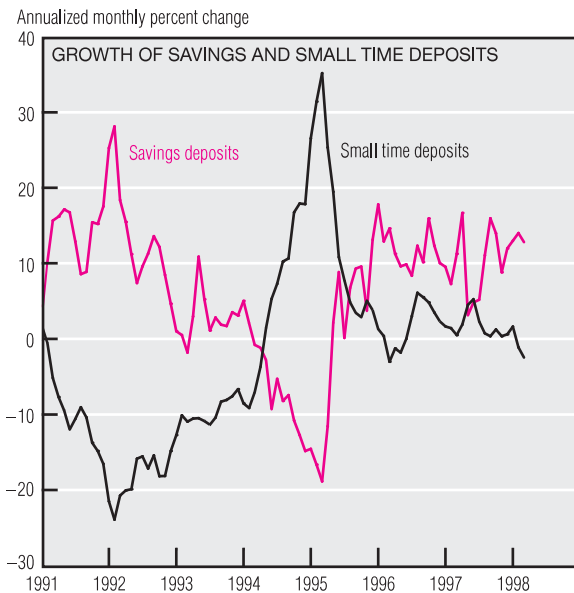
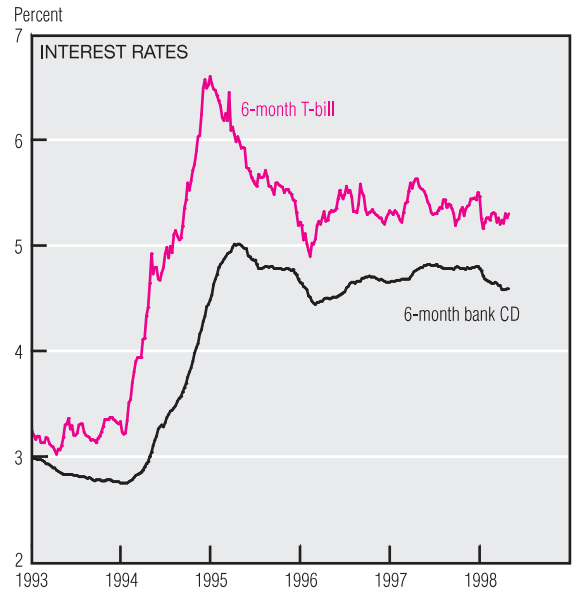
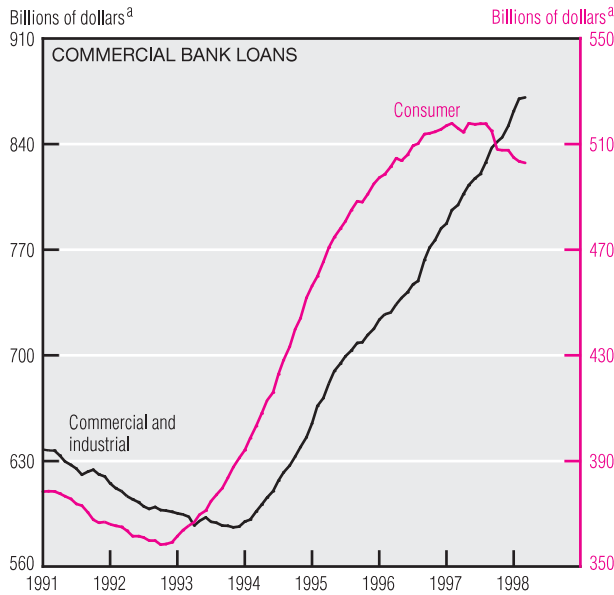
The 3-month Treasury now stands at 5.0%, down 9 basis points from last month and 25 basis points from a year ago. Although this falloff is consistent with the theory

that monetary policy has tightened slightly, the change is rather small and probably means that policy is fairly constant.

The federal funds futures market indicates that most market participants now believe the Federal Reserve will maintain the 5.5% funds rate target over the next six months. Two months ago, however, the market was betting that the next move would be a lowering of the funds rate.

In contrast to short-term interest  
*(continued on next page)*

## Monetary Policy (cont.)



a. Seasonally adjusted.

b. Nondeposit liabilities at commercial banks are total liabilities minus deposits and borrowings from banks in the U.S.

SOURCES: Board of Governors of the Federal Reserve System; and *Bank Rate Monitor*, various issues.

rates, longer-term rates have inched up slightly over the past month. The 30-year Treasury bond now stands at 6.0%, up 13 basis points from March's level. That rise, however, is swamped by the 100-basis-point decline experienced during the past year. The downward drift reflects the market's belief that the Federal Reserve will not allow inflation to increase much over the long term.

Home mortgage rates remain at historically low levels, although they have crept up since the beginning of the year. The current 30-year

fixed rate is 7.2%, about 0.25% higher than January's average.

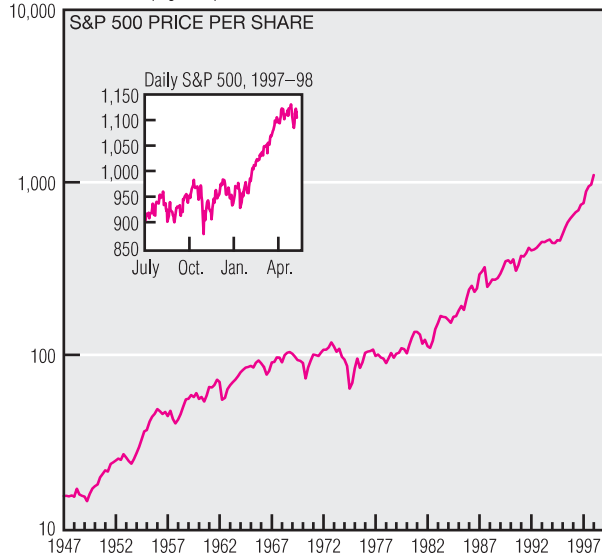
The number of consumer loans extended fell 1.4% in March, continuing a yearlong descent. The reasons for this downturn are unclear. Some believe that instead of reflecting a fundamental softening in demand, the decline may be due to the cash that many lenders provide to homeowners who refinance their mortgages for amounts greater than their previous loans. Commercial and industrial lending also stalled in March, increasing a slight 1.2% — well below the 12.0% pace recorded

over the last 12 months. Although a one-month respite is certainly no cause for alarm, it does stand out as one of the few slowdowns since the series' frenzied increase began in 1994.

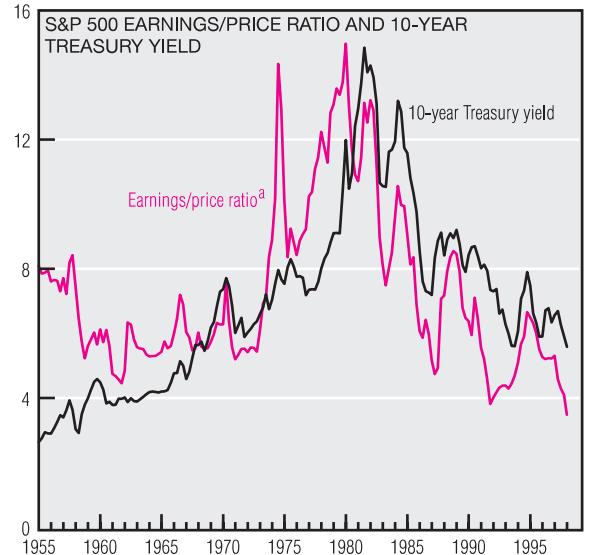
The spread between market rates and bank CD rates has remained nearly constant since mid-1996, a pattern mirrored by stabilization in the growth of small time deposits and savings deposits. To finance customers' credit demand, banks are increasingly relying on large time deposits rather than on their nondeposit liabilities.

# The Stock Market

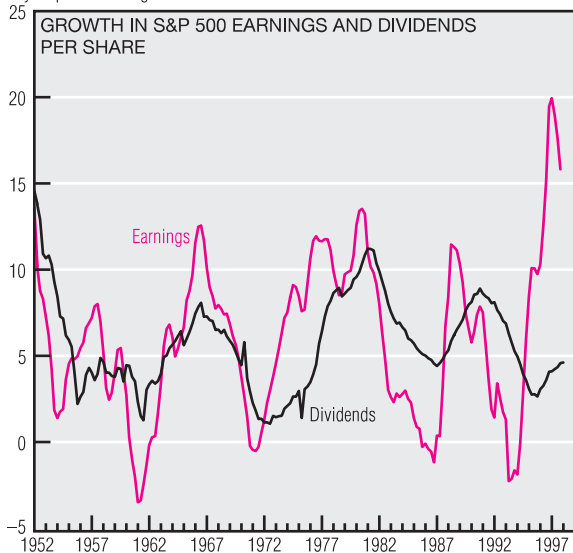
Index, 1941-43=10 (log scale)



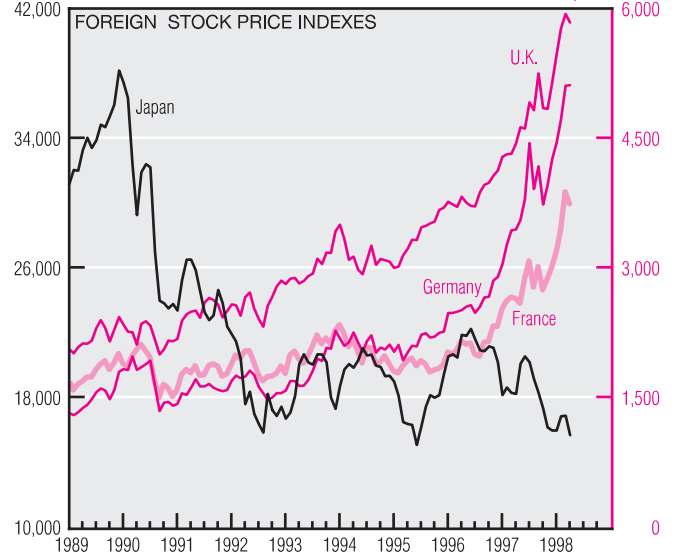
Percent



5-year percent change



Nikkei index



a. The final earnings/price ratio observation is a preliminary estimate.

SOURCES: The Federal Reserve Bank of Cleveland; Standard & Poor's Corporation; DRI/McGraw-Hill; and Bloomberg information services.

The U.S. stock market continues to amaze most observers. Early April was characterized by a number of record highs for the major stock indexes, including the S&P 500. Although reported first-quarter earnings have increased only modestly, optimism abounds for horizons over a year or two. Recently, however, some nervousness has surfaced.

Pessimists fret that the earnings/price ratio (E/P) has fallen to a record low. Optimists, however, note that the decline in the E/P since 1982 largely mirrors the downward trend in

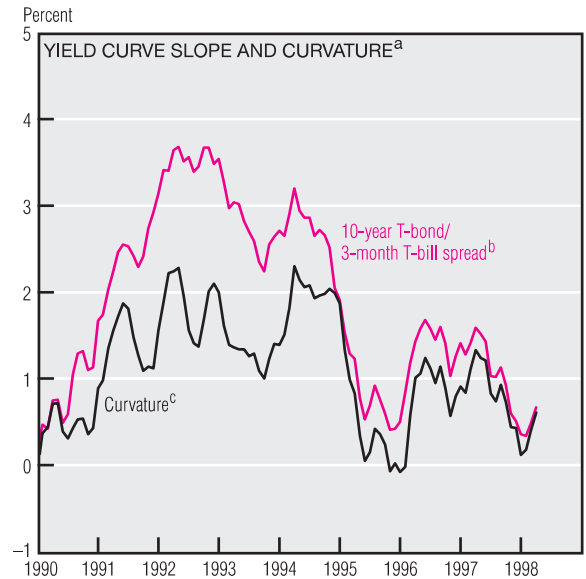
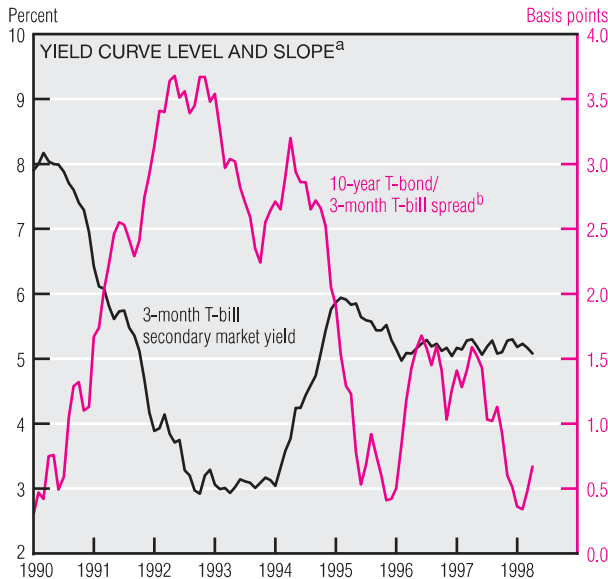
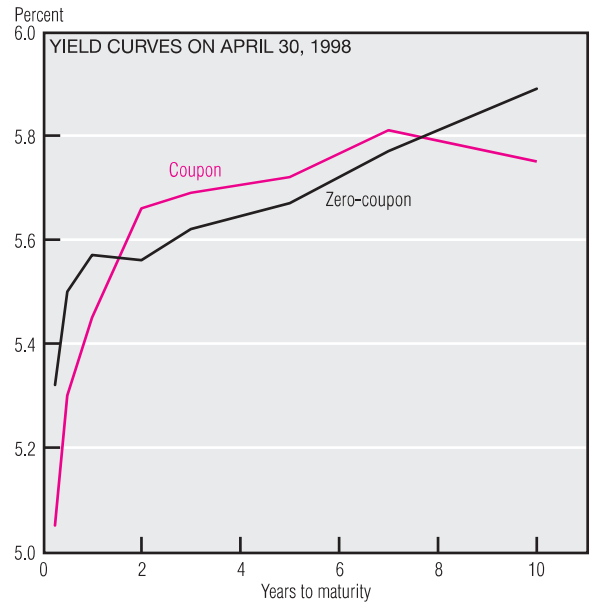
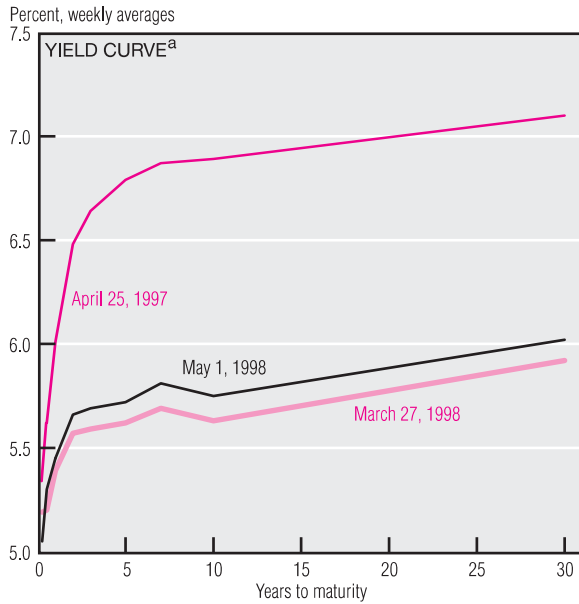
bond yields, which is based in falling inflation expectations. Declining expected inflation effectively produces higher stock prices for a given level of earnings and hence has been a key element in the 16-year bull market. Continued low inflation is essential to support the current E/P.

A low E/P may also reflect an expectation of high earnings growth. The stock market's extraordinary performance in recent years reflects pervasive optimism about higher future earnings—a belief that has been largely validated since 1994. Recent

skittishness in the market can be attributed to both concerns about rising bond yields and moderation in expected earnings growth.

In today's global economy, capital moves much more freely than in earlier years. Financial troubles in Southeast Asia have led many investors to redirect their capital from Asian to U.S. markets, thus supporting higher U.S. stock prices. Improving economic conditions in Europe, however, could make those capital markets even more attractive.

# Interest Rates



a. All instruments are constant-maturity series.

b. Constant-maturity 10-year Treasury bond yield minus the secondary market 3-month Treasury bill yield.

c. Curvature equals the 5-year Treasury note yield minus the secondary market 3-month Treasury bill yield, less the 10-year Treasury bond yield minus the 5-year Treasury note yield.

SOURCE: Board of Governors of the Federal Reserve System.

The yield curve has shifted only slightly in the last month. At the short end, the 3-month rate has moved down just 14 basis points, while at the long end, the 30-year rate has increased only 10 basis points. Overall rates and the yield curve slope (or steepness) remain below levels seen at this time last year. The often-watched 3-year, 3-month spread stands at 64 basis points, while the 10-year, 3-month spread is at 70 basis points, below both their historical averages and last year's 130 and 155 basis-point spreads.

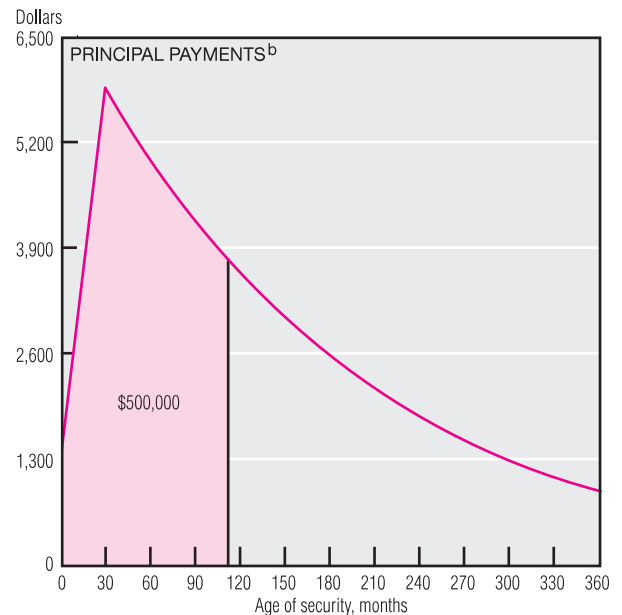
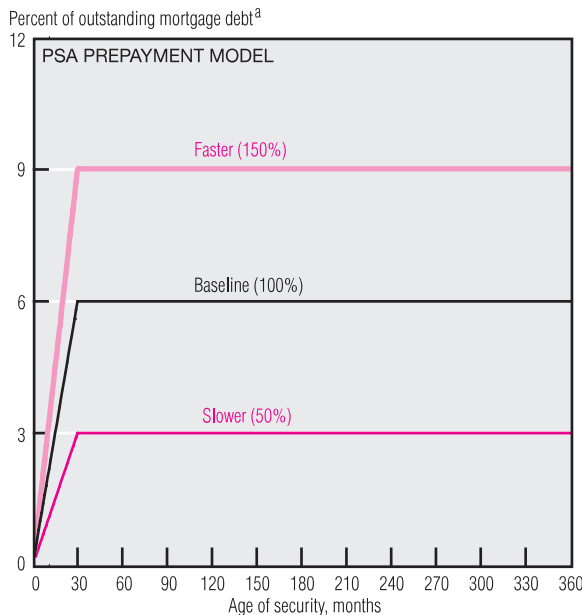
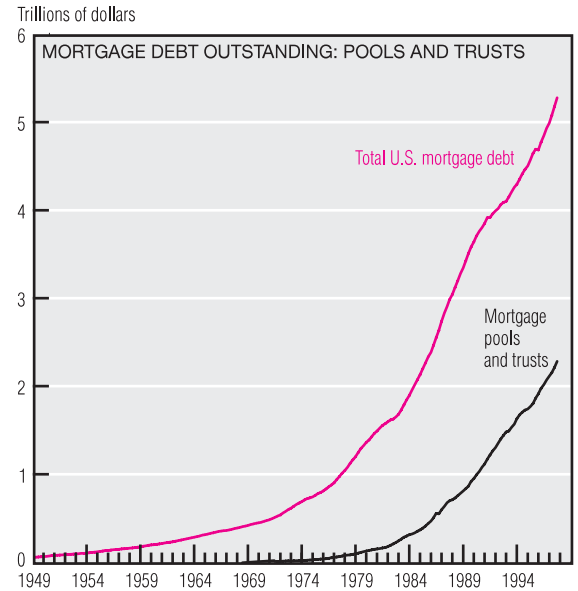
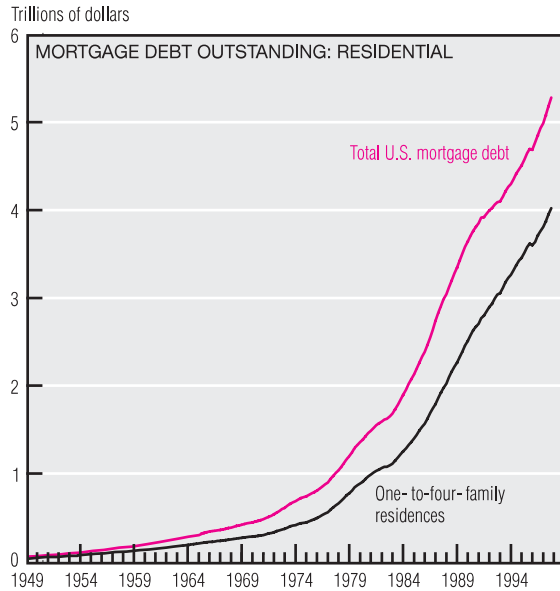
The yields on zero-coupon bonds seem to have diverged from those on coupon bonds even more than usual in the past month: With a flatter yield curve, liquidity differences between the markets may become more apparent.

A natural and common way to compare yield curves is to look at their level, their slope, and their curvature. Level and slope moved in opposite directions over most of the 1990s. As short rates rose or fell, long rates changed less than proportionately. Relative stability in the yield

curve's level since 1996, however, has not created equal stability in its slope. Most of the recent reduction in slope has occurred at the long end of the curve.

Slope and curvature show a closer connection, with both measures declining as the yield curve has flattened since early 1997. This may indicate that investors expect the stable interest-rate environment to continue as medium and long rates converge, or that they perceive less risk in holding long- and medium-term bonds.

# Mortgage-backed Securities



a. Annualized monthly prepayment rate.

b. Based on the PSA model.

SOURCE: Board of Governors of the Federal Reserve System, Mortgage and Consumer Finance Section, *Mortgage Debt Outstanding*.

There are several reasons why the American dream of home ownership has become a reality for so many people. One of them is growth and innovation in the mortgage market. Although mortgages on commercial property and apartment buildings make up an important part of the market, the bulk of mortgages are for family residences—more than \$4 trillion of the \$5.3 trillion total.

A large share of U.S. mortgage debt is not held by the originator. Rather, it is bundled into pools or trusts and used to collateralize

mortgage-backed securities (MBS). These securities allow investors to reduce their risks (buying one share in an MBS backed by thousands of mortgages is less risky than buying a single mortgage that might default). Standardizing such securities also makes them more salable and liquid.

A prime risk in the MBS market arises from individuals prepaying their mortgages, perhaps to refinance or to move. Valuing MBSs means making assumptions about prepayment rates. A baseline industry standard is the Public Securities

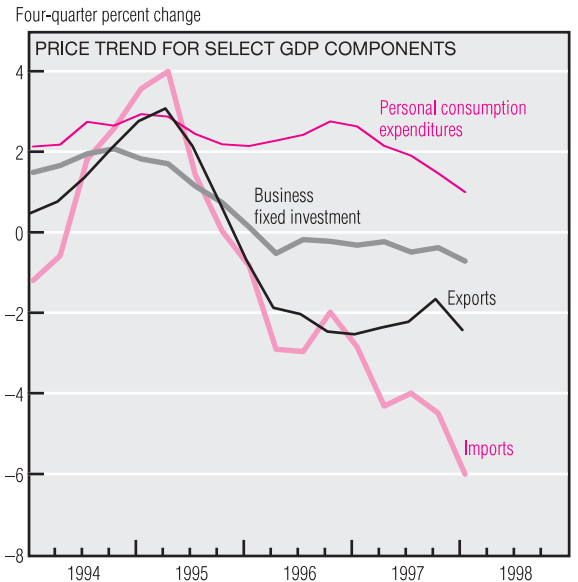
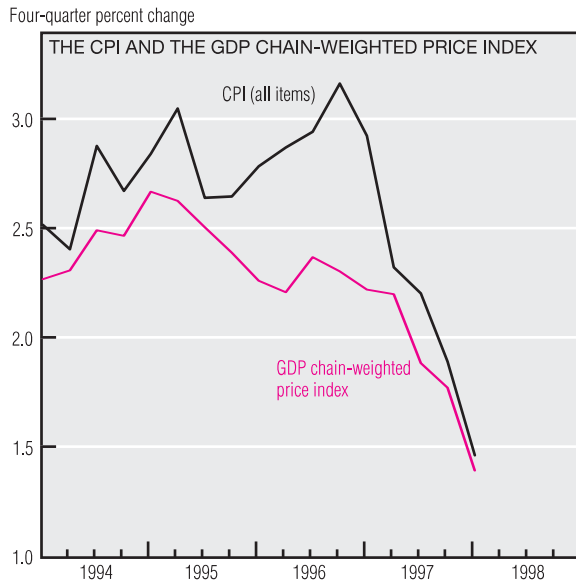
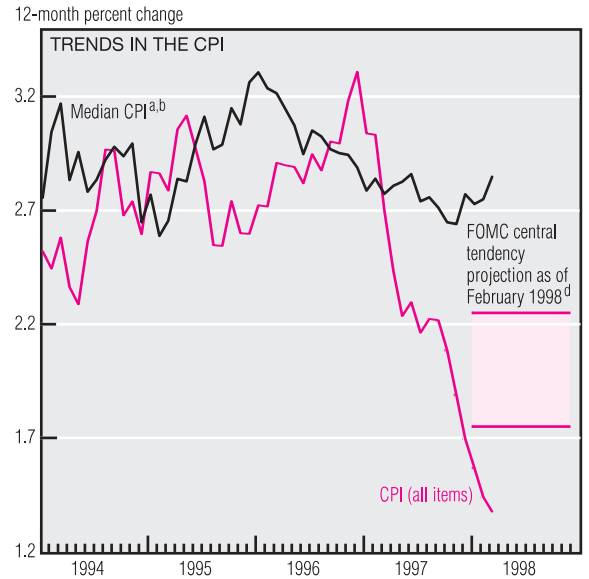
Association (PSA) model, which assumes that prepayments rise linearly to 6% at 30 months and then level off. Faster or slower prepayments are expressed as a percentage of PSA.

The prepayment pattern determines the flow of principal payments to the MBS. These are often assigned to different securities. For example, one MBS may get all of the principal payments until those payments reach \$500,000. Another may get only interest payments until that amount is paid off, and then receive principal payments.



# Inflation and Prices

March Price Statistics	Annualized percent change, last:				1997 avg.
	1 mo.	3 mo.	12 mo.	5 yr.	
<b>Consumer prices</b>					
All items	0.0	0.2	1.4	2.5	1.7
Less food and energy	1.4	2.4	2.3	2.7	2.2
Median <sup>a,b</sup>	4.0	3.2	2.8	2.9	2.8
<b>Producer prices</b>					
Finished goods	-3.6	-4.2	-1.8	0.8	-1.2
Less food and energy	0.0	0.0	-0.1	0.9	0.1
<b>Commodity futures prices<sup>c</sup></b>					
	-8.4	-5.7	-8.0	1.5	-5.6



a. Calculated by the Federal Reserve Bank of Cleveland.

b. Revised since January 1993 to reflect new BLS seasonal factors.

c. As measured by the KR-CRFB composite futures index, all commodities. Data reprinted with permission of the Commodity Research Bureau, a Knight-Ridder Business Information Service.

d. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents. SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; and the Commodity Research Bureau.

The Consumer Price Index (CPI) remained unchanged in March, bringing the past year's inflation rate down to a scant 1.4%. Energy costs, which fell 1.2% during the month (the fourth straight monthly decline) again played a prominent role in the favorable consumer inflation performance. Excluding the food and energy components, prices rose an annualized 1.4%, still below the trend established in 1997. The median CPI, an alternative measure of inflation that also excludes energy

prices, was up a much higher 4.0% for the month and 3.2% during the first quarter.

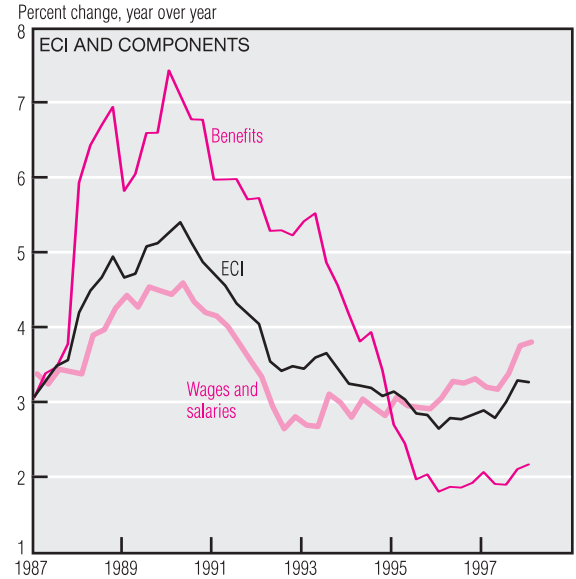
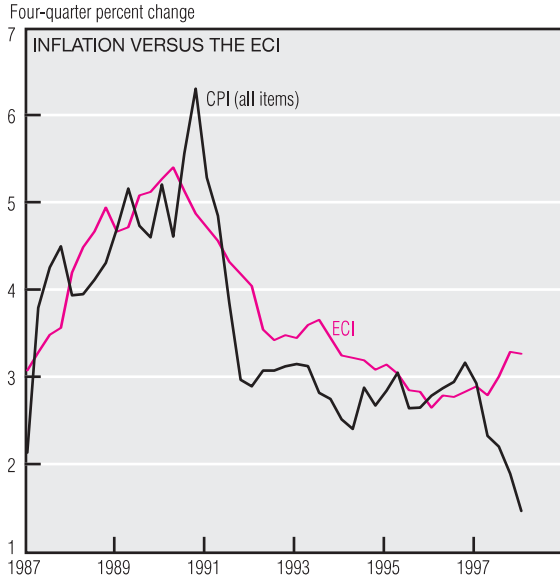
The Producer Price Index (PPI) was also influenced by the continuing slide in energy costs. Minus that volatile component, the index remained unchanged; with energy prices factored in, it fell 3.6%.

Another gauge of price movements, the GDP chain-weighted price index, measures inflation in the National Income and Product Accounts. Because personal consumption expenditures amount to

only about 68% of total GDP, the influence of consumer prices on this index is weighted similarly. In addition, the GDP chain-weighted measure incorporates the prices of investment goods, exports, and government purchases. In recent years, these sectors have typically shown more moderate price movements than have consumer goods. Like the CPI, the GDP index also shows a sharp reduction in inflation over the past year.



# The Employment Cost Index



	Annualized percent change, last:		
	Quarter <sup>a</sup>	1 yr.	3 yr.
Private industry	3.6	3.5	3.1
Construction	2.8	2.7	2.5
Manufacturing	3.3	2.9	2.6
Transportation and public utilities	4.9	3.4	3.1
Wholesale trade	7.9	3.6	3.8
Retail trade	4.3	3.6	3.3
Finance, insurance, and real estate	6.7	6.3	4.4
Services	2.1	3.1	2.8
State and local government	3.3	2.5	2.6

	Annualized percent change, last:		
	Quarter <sup>a</sup>	1 yr.	3 yr.
Occupation			
White-collar	3.6	3.5	3.1
Blue-collar	2.4	2.6	2.5
Service	3.9	3.7	3.1
Region			
Northeast	3.0	2.9	3.0
South	2.7	3.6	3.4
Midwest	4.2	3.8	3.4
West	5.5	3.8	3.6

a. Annualized data.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and the Federal Reserve Bank of Cleveland.

The Employment Cost Index (ECI) measures U.S. firms' total compensation costs (wages plus benefits). Similar to the way the Consumer Price Index (CPI) measures product prices, the ECI summarizes the cost of procuring a workforce with a fixed set of occupations. Because workers and firms generally try to maintain the real (inflation-adjusted) value of compensation, the ECI and CPI typically track each other closely. In periods when productivity growth is high, however, the ECI tends to exceed the CPI.

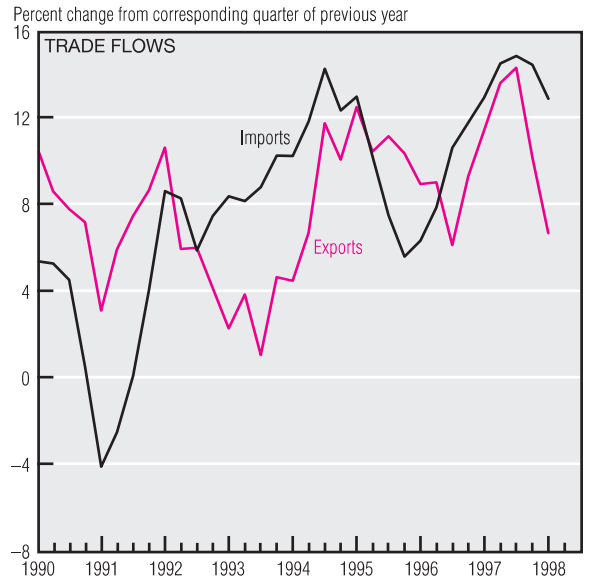
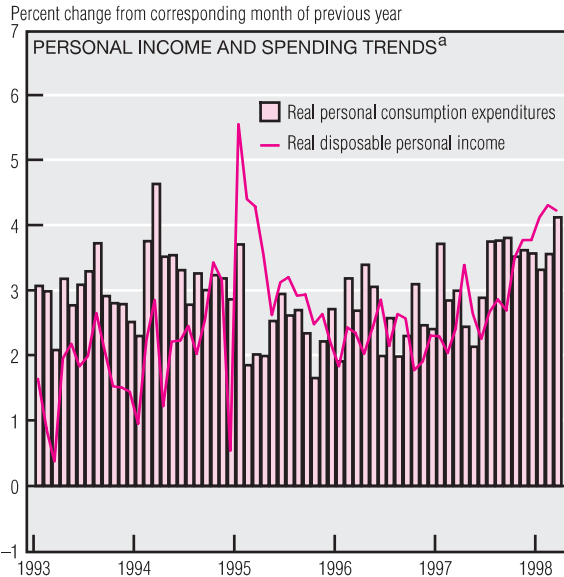
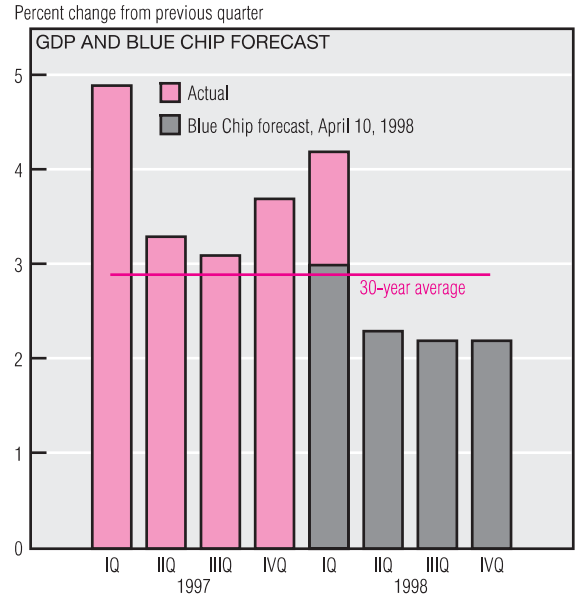
Even if benefit costs rise more slowly than consumer prices, it does not necessarily follow that the real value of those benefits to employees has declined. The benefits package measured by the ECI is diverse: Vacations, health care insurance, pensions, and mandated benefits like overtime pay and employer contributions to the Social Security and unemployment insurance funds are all included. When the unemployment rate is low, for example, firms' payments to the unemployment insurance fund drop. This pushes the ECI down, but the benefit to employees

—insurance coverage—does not change. Likewise, employers' cost of providing health care benefits can decline without affecting the quality of workers' health care coverage.

Even in a period that is generally positive for workers, some employees gain more than others. Last year, for instance, white-collar and service-sector workers enjoyed higher compensation increases than blue-collar workers. Compensation growth also continues to be particularly strong in the finance, insurance, and real estate industries.

# Economic Activity

Real GDP and Components, 1998:IQ (Advance estimate <sup>a,b</sup> )			
	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	76.0	4.2	3.6
Consumer spending	68.5	5.7	3.7
Durables	28.4	18.4	7.8
Nondurables	18.7	5.2	1.5
Services	24.1	3.5	3.9
Business fixed investment	36.0	17.5	12.3
Equipment	44.7	28.8	18.3
Structures	-4.5	-8.9	-2.5
Residential investment	11.9	17.7	9.1
Government spending	-6.3	-2.0	0.6
National defense	-13.9	-16.7	-2.2
Net exports	-40.6	—	—
Exports	-8.6	-3.4	6.7
Imports	32.0	11.6	12.9
Change in business inventories	3.0	—	—



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*, April 10, 1998.

The U.S. economy grew much faster in the first quarter than most analysts anticipated. According to the Commerce Department's advance estimates, real GDP rose an annualized 4.2%, primarily because of increased residential investment, solid spending on business equipment, and continued growth in consumer spending. Most economists participating in the April 10 Blue Chip survey were anticipating growth of about 3.0%.

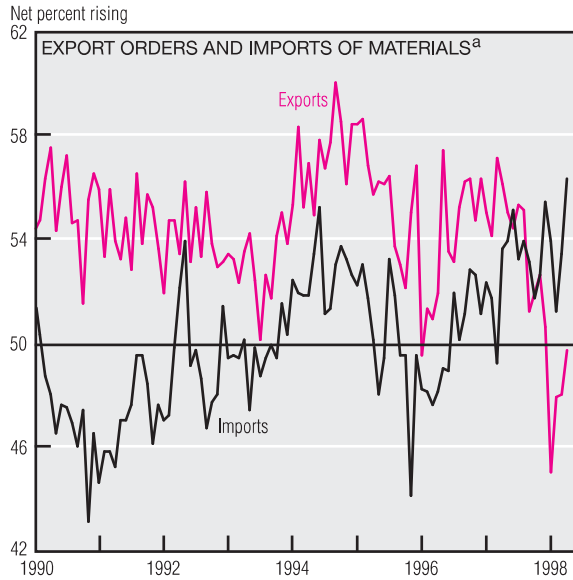
Real personal consumption expenditures jumped 4.1% in March, the steepest gain since 1994. One reason Americans relaxed their grip on their wallets was a hefty 4.2% gain in real disposable personal income. Consumer confidence continued to climb in April, indicating that households expect the economy to remain strong in the months ahead.

Signs of the Asian crisis were evident in the first-quarter GDP report. Exports slipped 3.4%, while imports

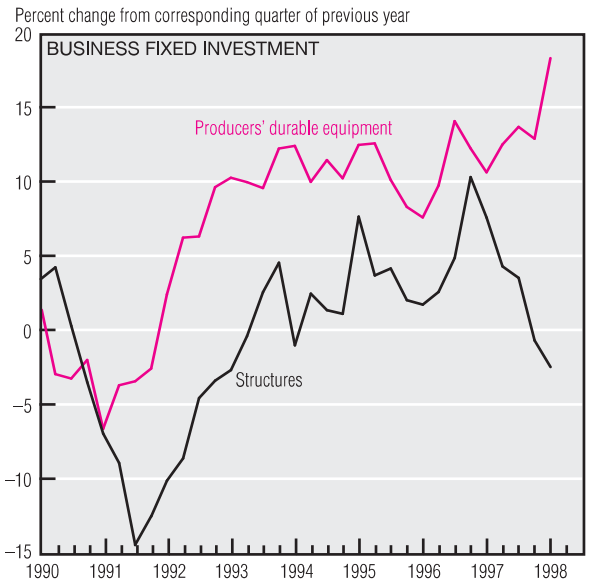
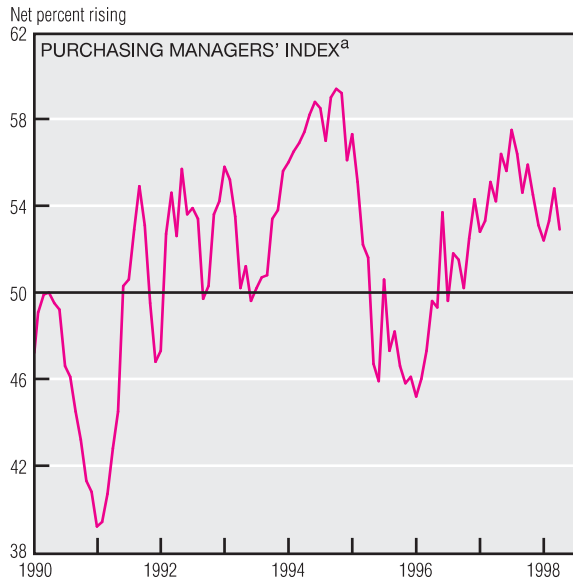
were up 11.6%. Forecasters expect the decline in net exports to continue over the next few quarters, dampening real economic growth. The National Association of Purchasing Management (NAPM) index of new export orders suggests that foreign demand for U.S.-manufactured goods contracted in April for the fourth consecutive month. (NAPM indexes indicate expansion when their value exceeds 50% and contraction when

*(continued on next page)*

# Economic Activity (cont.)



	1997		1998		
	IIIQ	IVQ	Jan.	Feb.	Mar.
Total index	6.8	7.3	-1.9	-1.9	1.9
Manufacturing	6.0	9.0	0.9	-2.7	-2.8
Durable goods	9.0	11.5	-3.2	0.0	-2.4
Computer and office equipment	41.3	25.0	39.4	28.9	25.6
Motor vehicles and parts	26.5	15.4	-67.9	-5.2	-7.0
Nondurable goods	2.9	6.1	3.2	4.3	-5.3
Excluding motor vehicles and parts	5.1	8.4	4.6	-1.8	-2.8
Mining	3.0	-3.0	19.3	-1.1	2.2
Utilities	15.1	-2.7	-45.1	1.1	57.8



a. National Association of Purchasing Management indexes.

b. Seasonally adjusted annual rate.

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

they fall below that figure.) Imports of materials grew faster in April than in March.

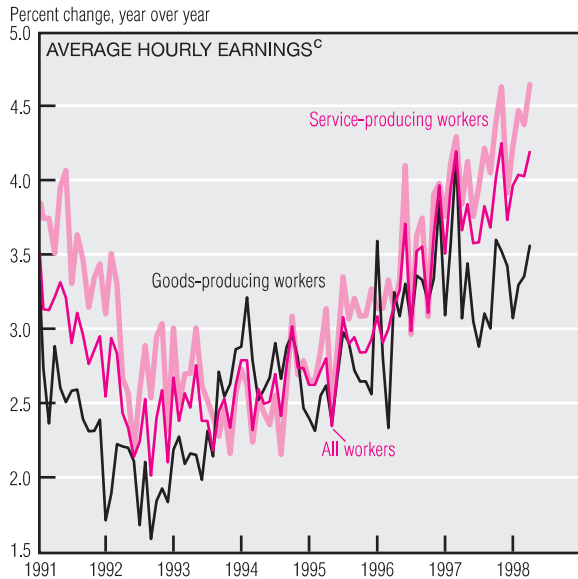
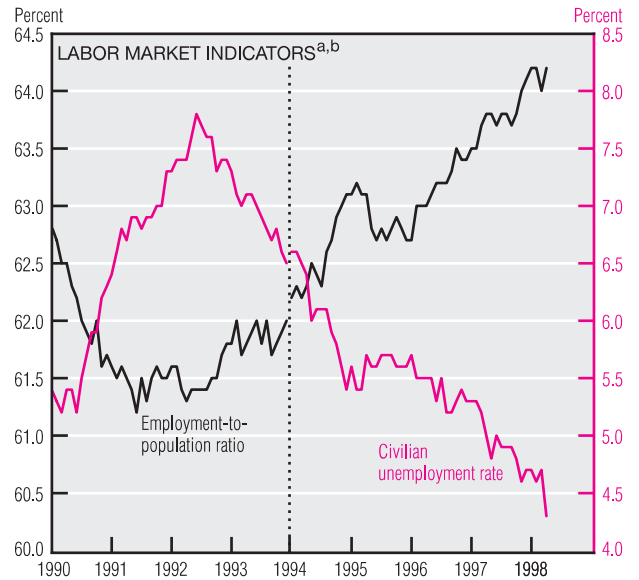
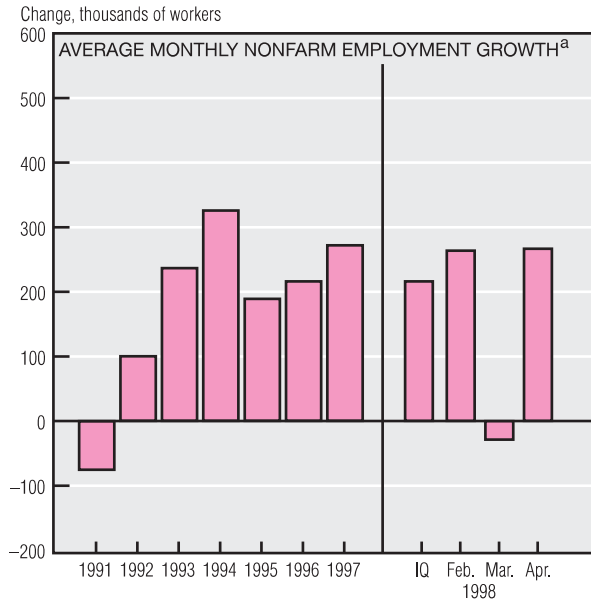
The industrial production index gained some ground in March after edging down in the first two months of the year. A return to more normal weather led to a strong jump in the utilities component, and computer and office equipment production remained exceptionally strong. Manu-

facturing activity declined for the second month in a row, however, with sharp reductions in motor vehicle and parts production. Capacity utilization also fell, slipping 0.1 percentage point to 82.2%.

A foreign capital inflow must accompany any expansion in the nation's trade deficit, with positive effects for U.S. investment. The interest-sensitive sectors were indeed

strong performers in the first quarter. Business investment in new equipment shot up 28.8%, the biggest gain since 1983, and residential investment soared 17.7%. Spending on consumer durables—expensive items often purchased on credit—jumped 18.4%. One notable exception to this pattern was business investment in structures, which shrank 8.9%.

# 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.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

April was a record-setting month for many labor market indicators. The unemployment rate fell to levels not seen since 1970, the employment-to-population ratio matched the record high set at the beginning of this year, and hourly earnings posted the largest gain in more than a year.

The economy added 262,000 jobs in April after a slight setback the previous month. Service-producing industries accounted for most of

the gain, boosting their payrolls by 241,000. The construction sector added 35,000 more jobs, rebounding from April's 85,000 loss. So far this year, the economy has added an average 224,000 jobs per month, down somewhat from last year's 267,000 posting.

The unemployment rate, which measures the number of unemployed workers relative to the total labor force, fell to 4.3% in April, a

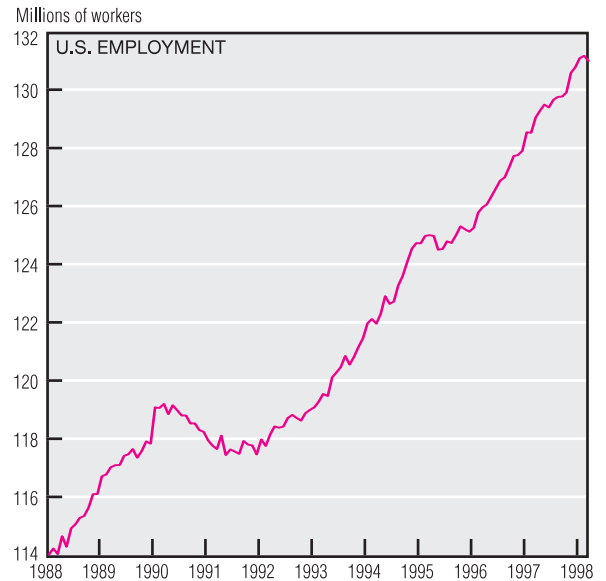
28-year low. Both components declined, but the 2½% drop in the labor force was not enough to offset a substantial contraction in the number of jobless persons. The employment-to-population ratio returned to 62.4%.

Average hourly earnings rose to a record \$12.68—the largest year-over-year increase since the beginning of 1997. Average weekly earnings fell, however, the result of a decline in average hours worked.

# Skills and Unemployment

	1992	1997
No high school	28.1	32.8
High school diploma	41.3	35.1
Some college <sup>a</sup>	21.8	23.5
College degree	7.0	6.5
Postgraduate degree	1.9	2.1

	1992	1997
16 to 24	24.6	32.1
25 to 34	32.1	26.6
35 to 44	22.5	22.9
45 to 54	13.4	12.3
55 to 65	7.5	6.2



a. Includes an associate's degree.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, March 1997 Current Population Survey; and the Federal Reserve Bank of Cleveland.

The economy's recovery from the 1990–91 recession has brought with it very low unemployment levels reminiscent of those seen 40 years ago. But the tight labor market has created another kind of problem: Many employers are struggling to find appropriately skilled workers. As the pool of unemployed workers dries up, the skilled proportion also recedes.

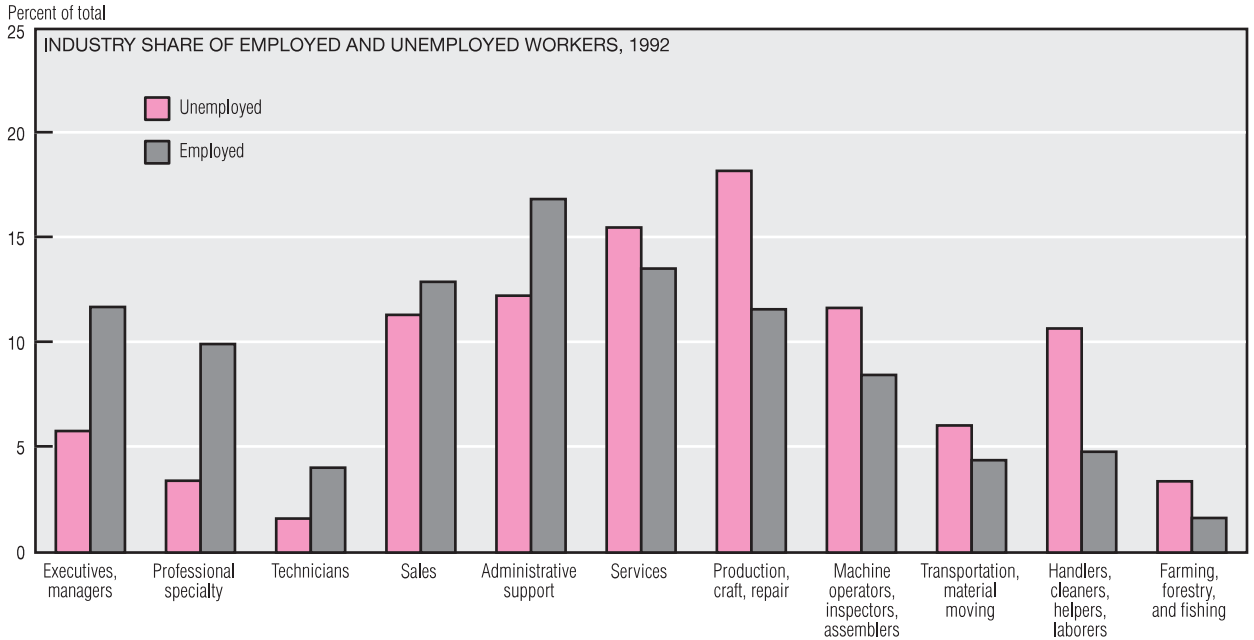
This trend is most obvious in the

changing education levels and age composition of the unemployed. Between 1992 and 1997, the share of jobless persons without a high school education rose from 28% to 33%, while the share in the overall workforce remained around 15%. The fraction of unemployed workers with high school diplomas declined over the same period, while the share with at least some college stayed constant. Another indicator

of the skilled worker shortage is the growing share of the unemployed aged 16 to 24—32% today versus 25% in 1992.

Comparing the occupational composition of the employed and unemployed provides further evidence about which jobs are hardest to fill in today's labor market. Administrative support personnel, for example, make up 14% of the workforce but *(continued on next page)*

# Skills and Unemployment (cont.)



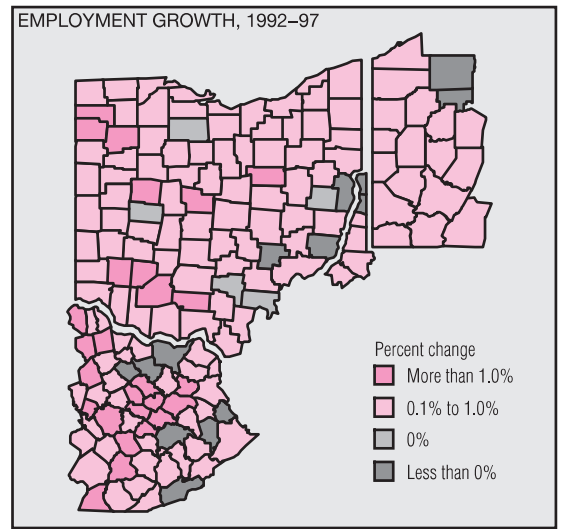
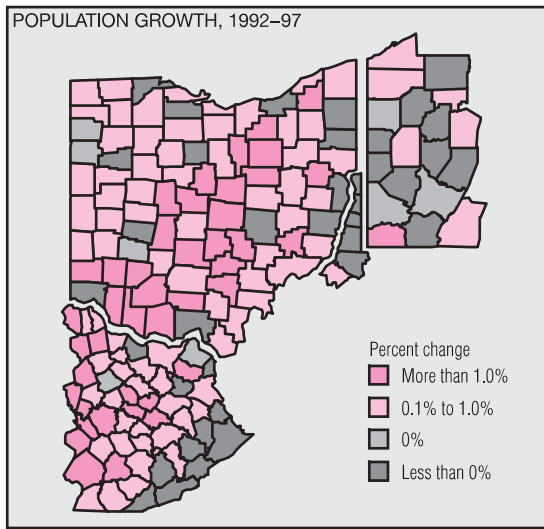
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, March 1997 Current Population Survey; and the Federal Reserve Bank of Cleveland.

only 10% of the unemployed. Just after the last recession, 12% of the jobless fell into the administrative support category. These figures suggest that further jobs growth in this area will be hard to accommodate from the existing pool of unemployed. People qualified for production, craft, and repair work may also be increasingly difficult to find in today's job market. In 1992, workers

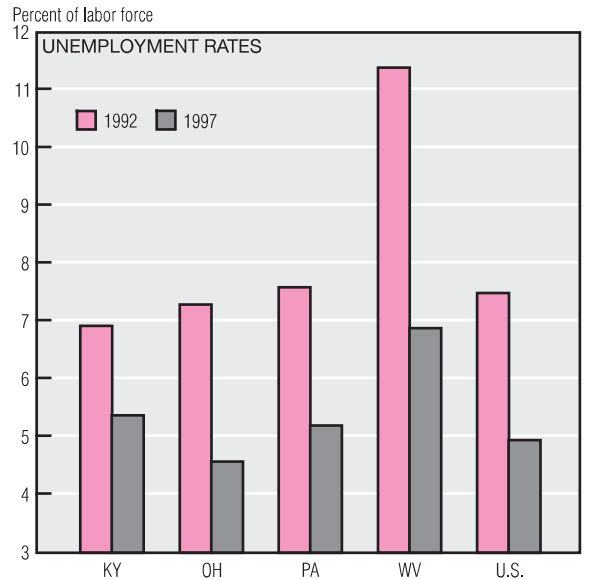
with these skills accounted for 18% of the unemployed; last year, that figure fell to 12%. On the other hand, workers engaged in services now make up 20% of the jobless ranks, up from 13% in 1992. (Often, these are the younger, less skilled workers mentioned above.) The service component of the workforce is fairly stable, however, so service jobs should be easy to fill from the existing pool of unemployed.

With unemployment at its lowest point in more than a decade, fewer workers of all proficiency and skill levels are seeking jobs. However, the composition of the unemployed has changed over the course of the expansion. The current pool includes a greater share of unskilled workers, adding to the burden of employers who have skilled positions to fill.

# Fourth District Employment and Population Trends



	KY	OH	PA	WV
Mining	-0.7	-0.1	-0.1	-1.4
Construction	0.3	0.5	0.2	0.6
Manufacturing	-0.6	-1.7	-1.3	-1.3
Durables	0.5	-0.8	-0.4	-0.3
Nondurables	-1.1	-0.9	-0.9	-1.0
TPU <sup>a</sup>	0.3	0.0	0.0	-0.5
Trade	0.4	0.0	-0.1	0.0
FIRE <sup>b</sup>	-0.1	0.0	-0.1	0.2
Services	1.5	1.8	2.0	3.4
Government	-1.1	-0.6	-0.6	-1.0



a. Transportation and public utilities.  
b. Finance, insurance, and real estate.

SOURCES: U.S. Department of Commerce, Bureau of the Census; Kentucky Department for Employment Services, Labor Force Estimates Division; Ohio Bureau of Employment Services, Labor Market Information Division; Pennsylvania Department of Labor and Industry, Bureau of Research and Statistics; and West Virginia Bureau of Employment Programs, Labor Market Information.

Employment growth in the Fourth Federal Reserve District has been closely associated with population change. Sometimes, job opportunities may encourage workers to move to areas with high employment; other times, it seems that population loss is reflected in lower numbers of people working.

The greatest population gains have occurred in the areas surrounding Columbus, the suburban counties of Cleveland and Cincinnati, and the counties in Kentucky that border I-75. To some extent, this reflects a

change in residential preference, as people move from the inner-ring suburbs to areas further from downtown. However, it also represents an increase in the availability of durable manufacturing jobs along the so-called auto corridor of I-75, as well as a growing number of light manufacturing jobs in the Columbus area.

Continuing trends that began in the 1970s and 1980s, the greatest population loss is seen in the mountainous coal mining regions of the District and in western Pennsylvania more generally. The population loss

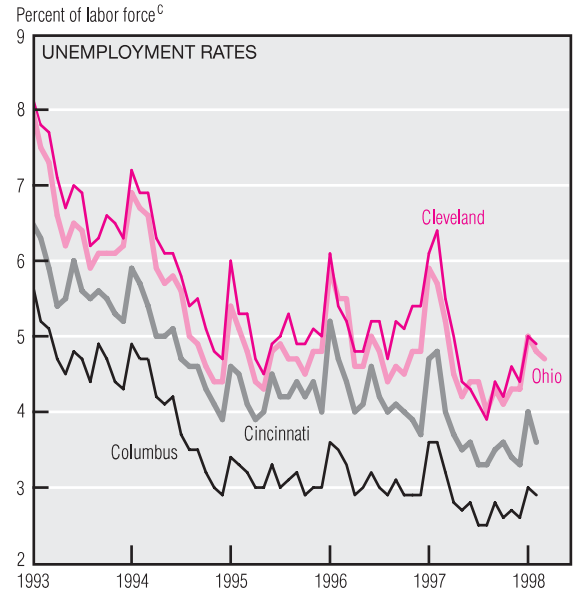
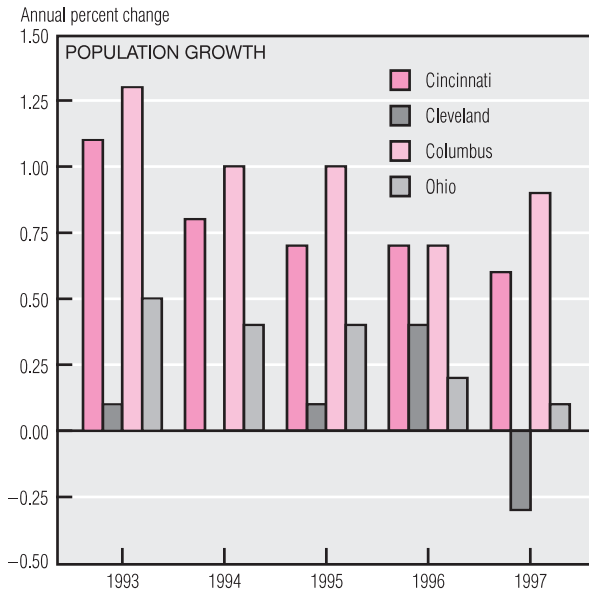
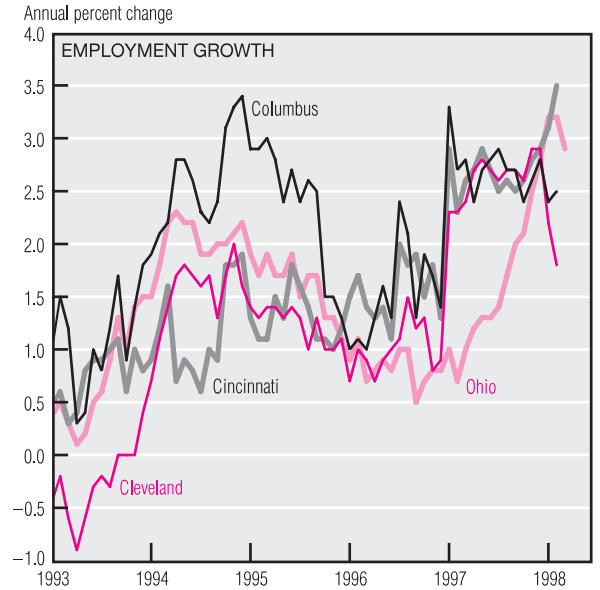
in the western counties of Pennsylvania may stem in part from the demise of employment opportunities in the area's once-prevalent heavy manufacturing industries.

Despite the lack of population growth in large pockets of the region, employment growth has been impressive throughout the Fourth District. Even in the counties where manufacturing is declining or expanding only slowly, jobs growth has outpaced increases in labor force participation, producing impressive dips in unemployment.



# Ohio Employment and Population Trends

Industry Share of Total Nonfarm Employment (Percent)						
	Cincinnati		Cleveland		Columbus	
	1992	1997	1992	1997	1992	1997
Construction	4.4	4.6	3.4	3.9	3.8	4.3
Manufacturing	19.2	16.6	21.4	19.6	12.9	11.4
TPU <sup>a</sup>	5.3	5.2	4.2	4.0	4.2	4.4
Trade	25.5	25.8	23.5	23.9	25.8	26.3
FIRE <sup>b</sup>	5.9	6.3	6.2	6.5	8.3	8.7
Services	26.7	29.6	27.9	29.5	26.5	28.1
Government	13.1	11.8	13.5	12.7	18.4	16.8



- a. Transportation and public utilities.
- b. Finance, insurance, and real estate.
- c. Not seasonally adjusted.

NOTE: Cleveland and Cincinnati data are for the primary metropolitan statistical area. Columbus data are for the metropolitan statistical area.

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

Employment in Cincinnati, Cleveland, and Columbus, Ohio's largest cities, is increasing at similar rates and in step with the state's overall performance. The cities have comparable workforce compositions, with two notable exceptions: Columbus, the state capital, has a larger share of government and financial services workers, and Cleveland has a slightly higher share of manufacturing employees. Business cycle events should have about the same influence on all three cities, and this in fact seems to be the case. Since 1993, each has

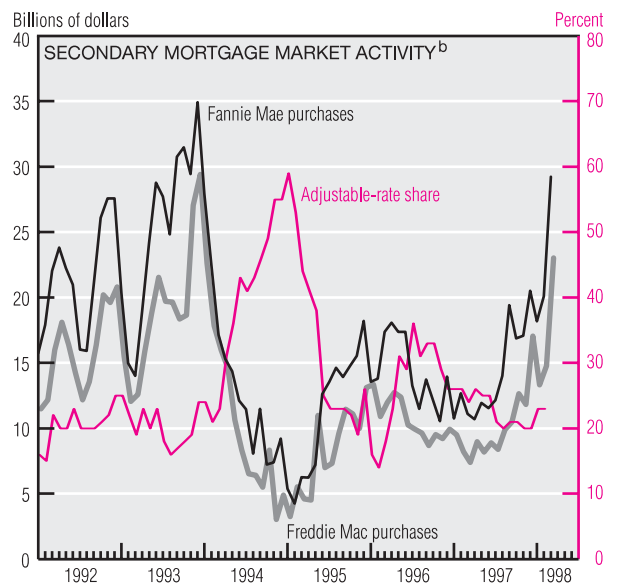
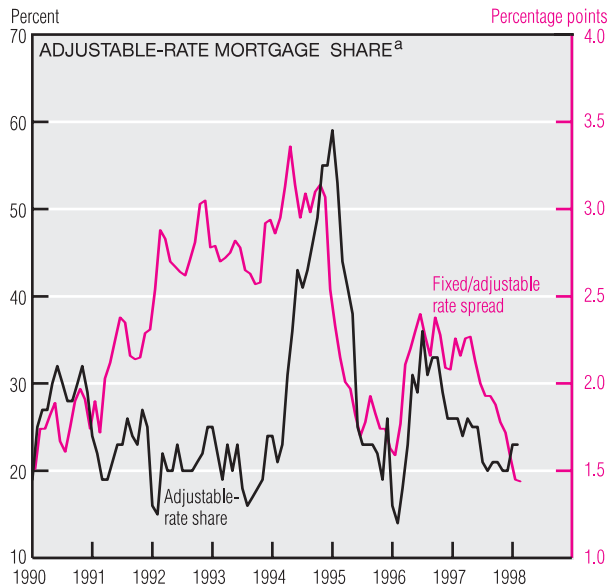
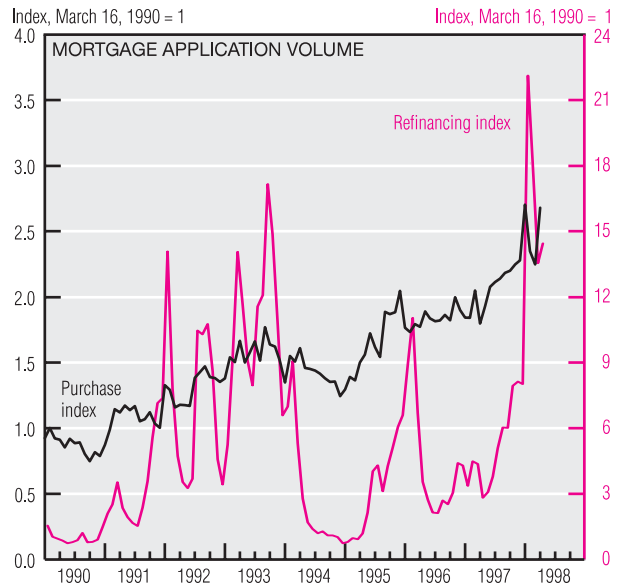
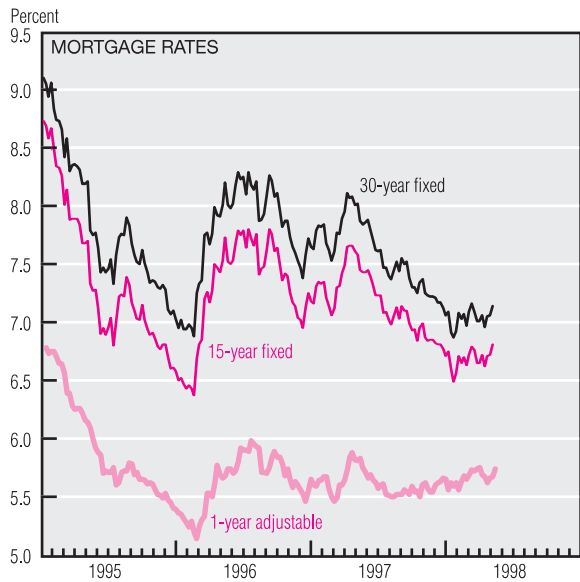
experienced a 2-percentage-point decline in manufacturing employment, matched by a similar increase in service-sector jobs.

Despite these parallels, employment growth in the Cleveland area has lagged that of Columbus and Cincinnati over the current business expansion. Columbus has added 83,500 new jobs since 1993, a 2.3% average annual increase, while Cleveland saw only a 1.5% rise. Most of Columbus's growth has occurred in the service industries (particularly business, health, and education) and in engineering. The

capital city historically has enjoyed a low unemployment rate, but since 1993, Cleveland's jobless measure (which tends to follow the state average) has demonstrated the greatest improvement.

Population change has followed a pattern not unlike that of employment growth. Columbus once again led the way with a 1.0% annual increase, while Cincinnati posted an uninspiring 0.7% gain. Cleveland's population growth has been stagnant since 1993, and actually declined 0.3% last year.

# Housing Finance



a. Percent of new conventional mortgage originations with adjustable rates.  
 b. Purchase data include conventional and government-insured mortgages.

SOURCES: U.S. Department of the Treasury, Office of Thrift Supervision; Federal National Mortgage Association; Federal Home Loan Mortgage Corporation; Mortgage Bankers Association of America; and *Bank Rate Monitor*, various issues.

After dropping more than 100 basis points through the last three quarters of 1997, long-term mortgage rates have remained relatively steady at around 7% since January. The stabilization may be due in part to factors external to the mortgage market. With the effects of the Asian financial crisis becoming clearer, there appears to be a general market perception that short-term interest rates will not decline again in the near future.

Mortgage market factors are also

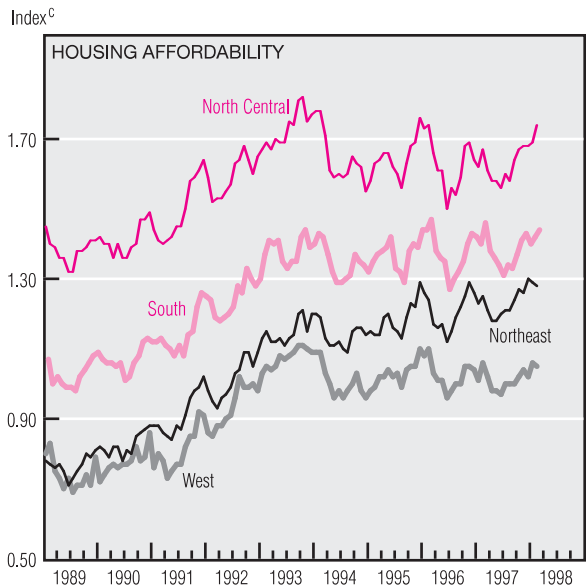
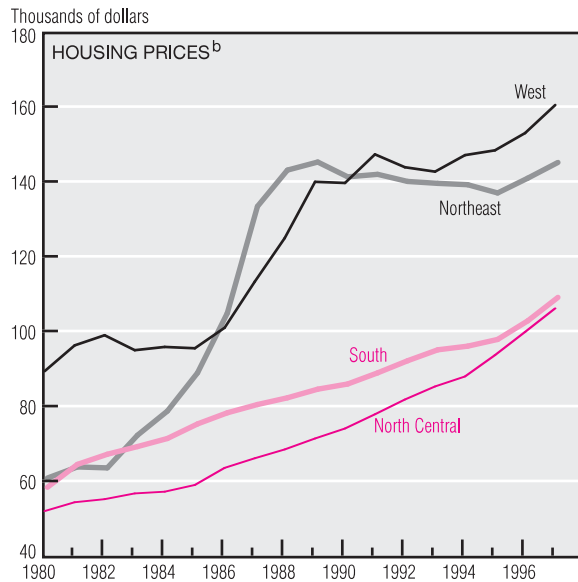
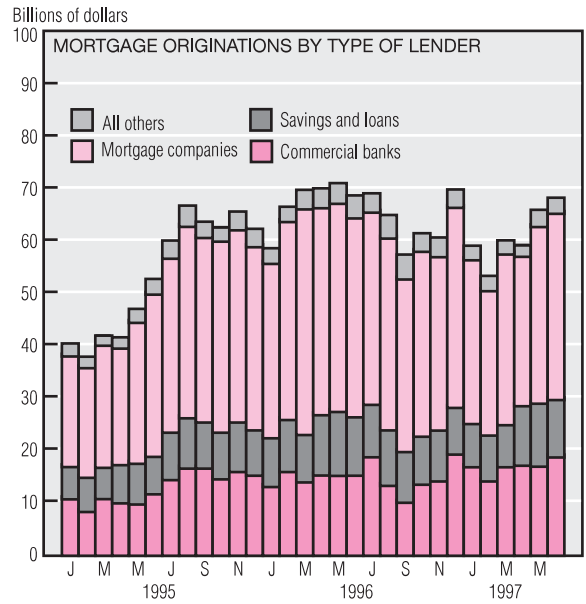
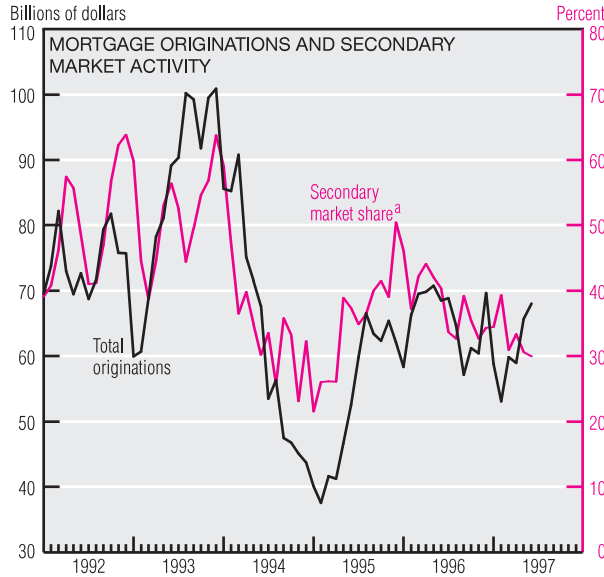
important, however. Indeed, recent rises in application volumes may have mitigated any remaining downward pressure on long-term mortgage rates. Last January, the refinancing index hit 22.13, its highest level since the index was created and 29% above its peak during the 1993 refinancing boom. Similarly, the purchase index was up 47% over the course of 1997, confirming anecdotal reports of strong housing markets.

In contrast to long-term mortgage rates, one-year adjustable rates have risen at a moderate pace since the

middle of last year, up just 25 basis points since July. As a consequence, the spread between fixed- and adjustable-rate mortgages has dropped to its lowest level this decade. This in turn has led to a sharp reduction in the share of mortgage loans with adjustable rates. As has been true when the adjustable-rate share has declined in the past, secondary mortgage market activity picked up substantially over the last part of 1997.

*(continued on next page)*

# Housing Finance (cont.)



a. Secondary market purchases by Fannie Mae and Freddie Mac as a fraction of total mortgage originations.  
 b. Median sale price of existing single-family homes.  
 c. Measures whether a family with the median family income can qualify for a 20%-down-payment mortgage on an existing, median-priced, single-family home.  
 SOURCES: U.S. Department of Housing and Urban Development; National Association of Realtors; Federal National Mortgage Association; and Federal Home Loan Mortgage Corporation.

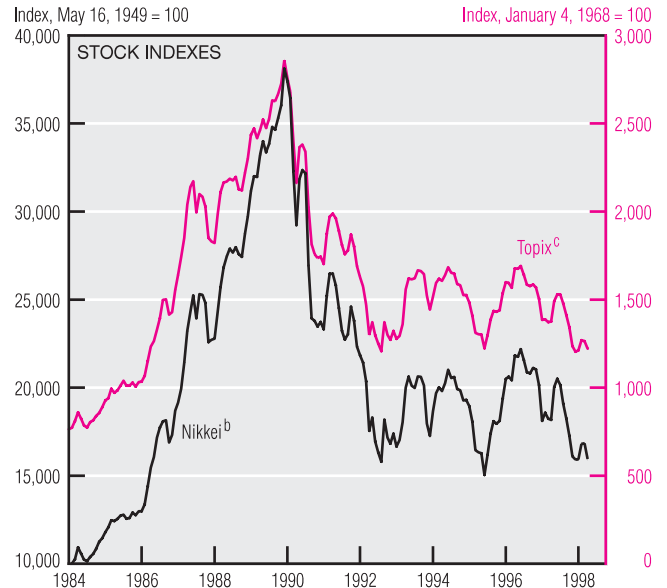
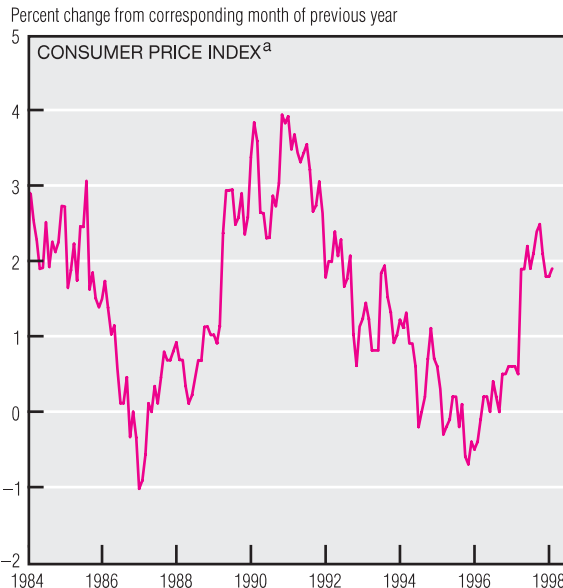
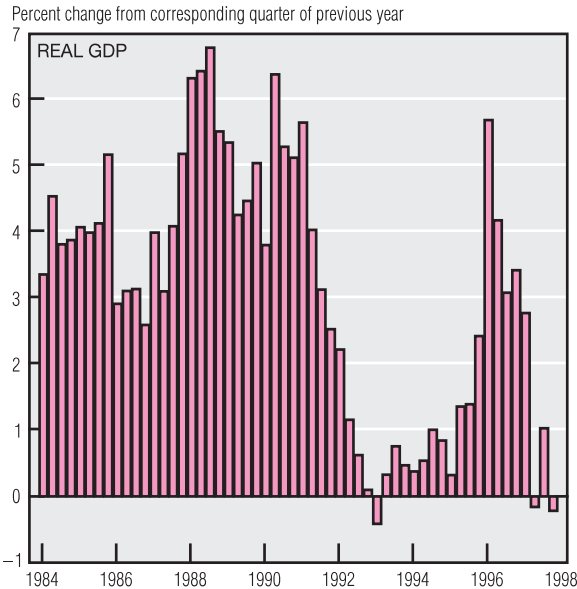
The most recent data on mortgage originations cover only the first two quarters of last year. Nevertheless, past trends may give us some insight into how mortgage originations will play out over the final half of the year. Historically, the secondary market's total share of mortgage originations has risen in tandem with overall mortgage market activity. This has been particularly true during periods when the fraction of loans with adjustable rates was relatively low. As a consequence, third- and fourth-quarter

data should reveal a marked uptick in the secondary market share of total origination activity. At the same time, the fraction of total mortgages originated by mortgage banks will likely have risen substantially in the last half of 1997.

Consistent with the underlying strength of the mortgage market, housing prices rose steadily throughout the country in 1997, with median home prices climbing more than 6% in the South and North Central regions. Although the West and Northeast did not see the dramatic

increases posted in the mid-1980s, last year's appreciation stands in marked contrast to the sluggishness of the past several years. Despite this rise in prices, housing affordability remained relatively steady throughout most of the country in 1997, with the strongest gains in the North Central region—the area with the steepest growth in housing prices. This suggests that overall income growth may be responsible for much of the acceleration in median home prices over the course of last year.

# The Japanese Economy



a. Sales taxes imposed in April 1997 account for the recent jump in year-over-year price changes.

b. Index of 225 stocks listed in the first section of the Tokyo Stock Exchange.

c. Index of all stocks (1100+) listed in the first section of the Tokyo Stock Exchange.

SOURCES: Bank of Japan; Statistical Bureau of the Prime Minister (Japan); and DRI/McGraw-Hill.

Constrained by the weak state of its financial sector, Japan's recovery from the recession of 1992 has been tenuous at best. The recent financial crisis in Southeast Asia has imposed additional economic burdens by reducing Japanese exports to that region and by further weakening the position of Japanese banks with heavy exposures there.

Japan's GDP contracted 0.2% between the fourth quarters of 1996 and 1997, and most economists expect virtually no growth this year and very little in 1999. Economic activity, particularly industrial pro-

duction and household spending, remains weak. The nation's trade surplus has risen despite the drop-off in exports to Asia, with shipments to the U.S. and Europe taking up most of the slack.

The Japanese unemployment rate jumped to 3.9% in March from its previous record high of 3.6% in February. The magnitude of the one-month increase was unprecedented. And the news gets worse. Some economists are now predicting that the jobless rate will reach 4.5% this year and will rise above 5% in 1999.

Inflation remains nil. The current

2% reading (measured on a year-over-year basis) largely reflects the effect of sales taxes instituted in April 1997.

In an effort to regain its former strength, Japan recently unveiled a package of economic reforms that includes more than \$91.5 billion of direct fiscal stimulus (temporary income tax cuts being one component). In addition, the government has taken measures to increase the deposit insurance subsidy and improve the capital base of the country's financial institutions.