The Economy in Perspective

Two thumbs up … Judging by the pandemonium breaking loose in financial markets and the headline coverage it is receiving, one would think the world as we knew it had come to an end. Well, in a way it has, because the world as we knew it had come to be regarded as one of infallible progress and unbounded prosperity. The world as we knew it had become an economic utopia, the promised land where debtors never default, recessions no longer happen, and nations can expand output at high rates forever. World economic prowess had become a tale of epic proportions, a story never before told, a fasten-your-seat-belt blockbuster.

There is little question that profound scientific, industrial, and political forces are at work around the globe, creating the elements of large-scale drama. The silicon chip is to today's economy what the combustion engine and electric motor were to previous epochs. With Europe uniting, the Soviet Union disintegrating, Southeast Asia transforming, and China emerging, it is undeniable that the future of human civilization around the globe offers many intriguing plot lines. Among these, of course, is the happy prospect of unprecedented global prosperity.

Now *here* is a heartwarming script if ever there was one, and very marketable too. After decades of Cold War espionage thrillers, atrocity chillers, and New Age terrorist dramas, the time had come for a feel-good story. What could appeal more to the "me generation" than a plot that makes this global rags-to-riches tale come true within our lifetime, before our very eyes? Not only that, but how about making the world safe for democracy by transforming the whole world into a democracy? What an image: Developing nations tumbling to free-market economics as easily as we once imagined them falling like dominos to Communism!

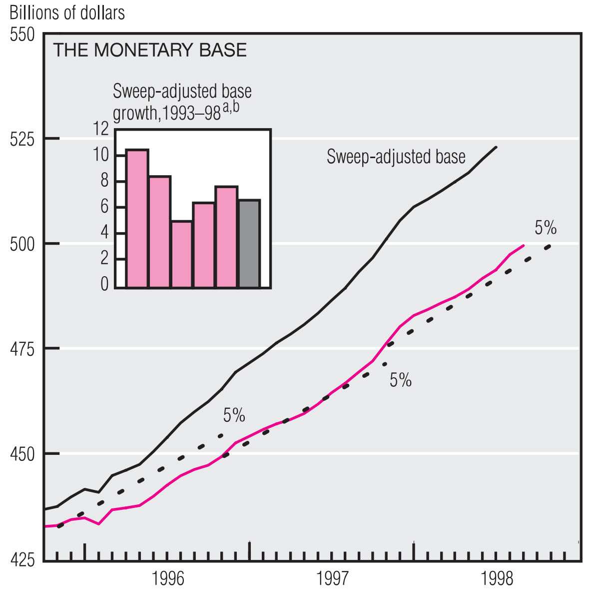
The economic world as it had come to be imagined made for good box office, but its run has ended. The world economy as it actually exists is a far less predictable and comfortable place than that dreamy celluloid depiction. What made that show such a hit was people's very human tendency to fantasize about life, confounding what we wish reality to be with reality itself, forgetting that movies regularly rely on stunt doubles and special effects. Economic booms and busts arise mostly from human fallibility, which creates scenes that cannot simply be re-shot when the action disappoints the director's vision.

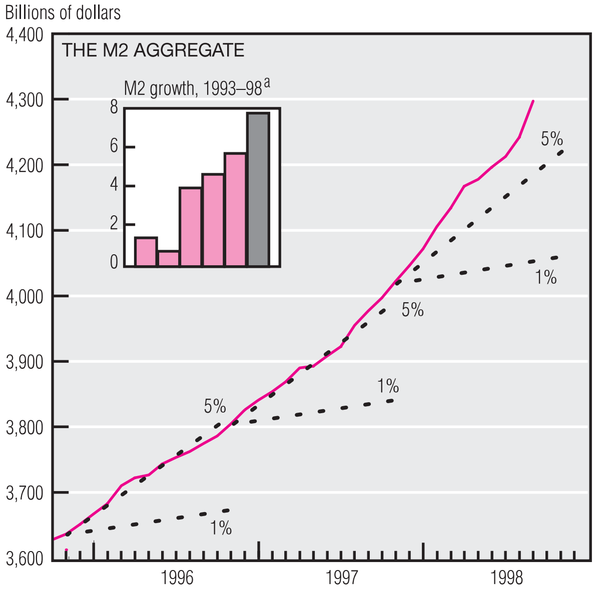
Monetary policymakers, like everyone else, would prefer light-hearted scripts and happy endings. But while others have license to suspend disbelief and reach for the popcorn as the lights dim, policymakers do not. They can't get so comfortable in their seats that they forget to be skeptical about what they are viewing. Americans sometimes regard this skepticism warily, as one might look askance at the fellow who doesn't cheer with the rest of the audience. And, yes, central bankers can become so self-conscious about not enjoying the show that they lose their objectivity and succumb to human error, too.

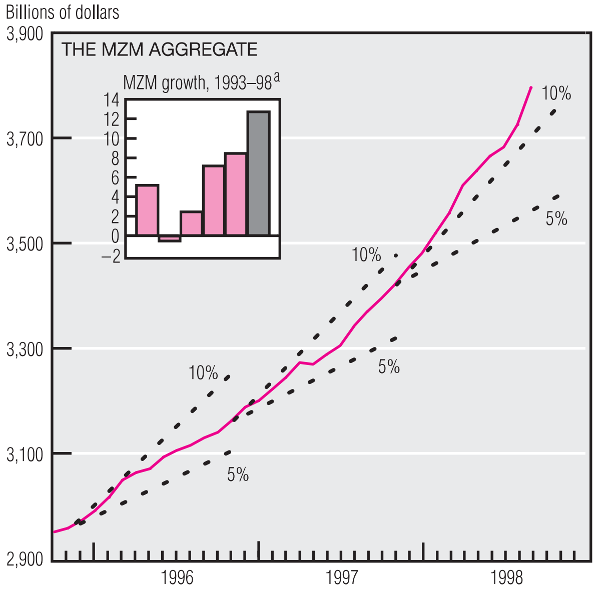
The Federal Reserve has not been following the script consistently throughout this economic expansion. Early on, the Fed fostered monetary conditions that were initially thought to be too easy for an inflation fighter. During 1994, according to those in the mainstream, it tightened too much and too quickly. Yet, the expansion unfolded and inflation did not accelerate. According to conventional wisdom, the Fed should have tightened policy throughout 1996 to head off inflationary pressures. But the Fed did not follow conventional wisdom, the expansion's tempo quickened, and the expected pressures failed to materialize. When the Chairman of the Federal Reserve Board spoke of irrational exuberance in the stock market, he was "shushed" for talking too loudly just as the action was reaching fever pitch.

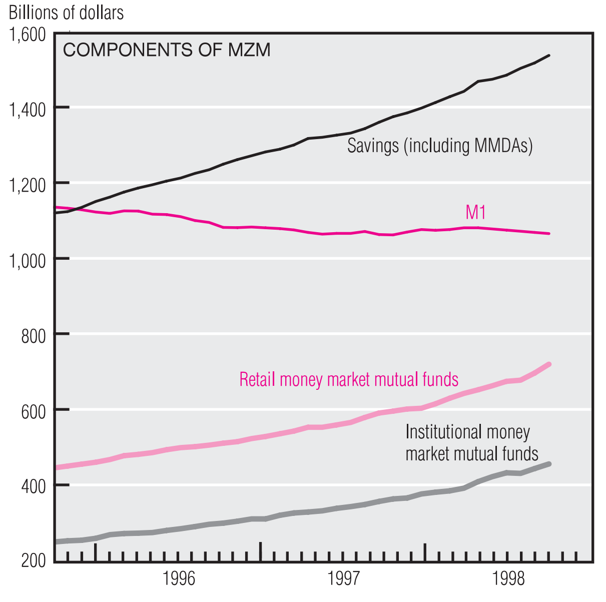
Right now, according to the script, the Federal Reserve should be easing monetary policy aggressively to combat a global economic Armageddon. The next scene calls for our central-bank action heroes to bring law and order to Russia, reinvigorate Asia, and protect Latin America, all without letting the U.S. economy miss a beat. That's a tall order for any movie star. Come to think of it, though, people have gotten used to seeing a few villains left standing when the picture ends; they know that a sequel is already on the way.

Monetary Policy









a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for M2 and MZM in 1998 is calculated on an estimated September over 1997:IVQ basis; for the sweep-adjusted base, 1998 growth is calculated on a July over 1997:IVQ basis.

b. The sweep-adjusted base includes an estimate of required reserves saved when balances are temporarily shifted from reservable to nonreservable accounts.

NOTE: Data are seasonally adjusted. Last plots for M2 and MZM are estimated for September 1998. Dotted lines for M2 and the monetary base are FOMC-determined provisional ranges. Dotted lines for MZM represent growth in levels and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

The monetary base continues to grow at a rate slightly higher than its FOMC-determined provisional growth range of 5%. When adjusted for sweep accounts, which move balances automatically into money market deposit accounts (MMDAs) to avoid reserve requirements on transactions deposits, the base has grown at a 6.5% annual rate through July (the most recent month for which sweep-account data are available). No provisional range is set for this measure of the base, but its growth rate is slightly lower than the 7.6% growth of 1997.

M2 growth continues to outstrip the upper bound of its 1% to 5% provisional range, having grown year-to-date (using its September estimated value) at a 7.75% annualized rate.

MZM has grown at a rate exceeding 12% year-to-date through September; it has also approached growth of more than 17% (annualized rate) from August to September, after growing at a 14% annual rate from July to August. MZM's rapid growth from August to September is attributable to increases in savings deposits and money market mutual funds. Increased savings deposits, in turn, may result from the high volatility and precipitous fall of equity prices in recent months. Savings deposits are certainly a more stable short-term location for one's money than the stock market. Similar justification could be given for the rise in money market mutual funds. These funds have been called a parking lot for money taken out of the stock market. It can also be argued that an increase in money market accounts has been

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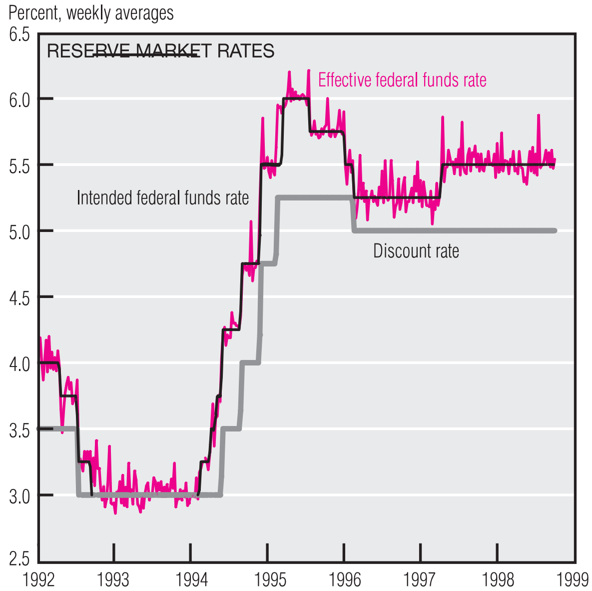
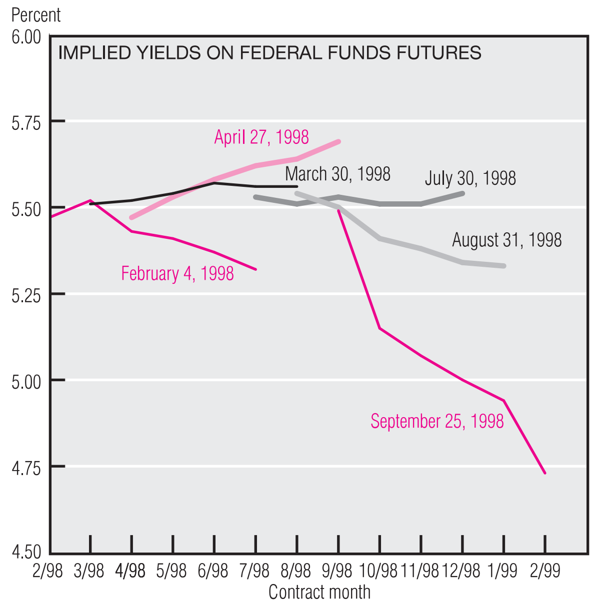
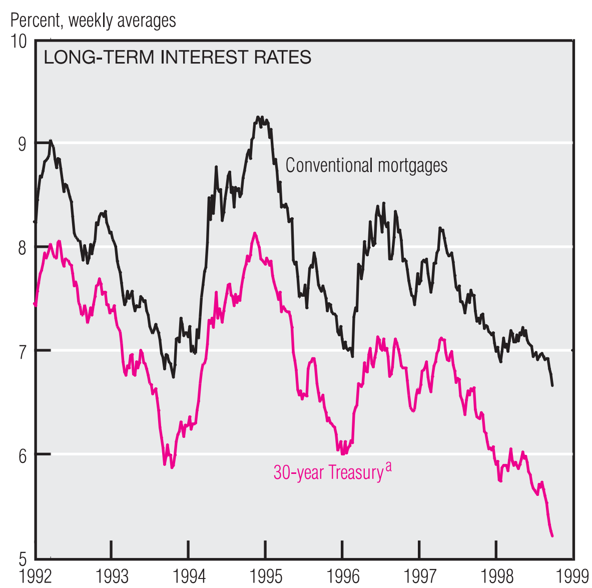
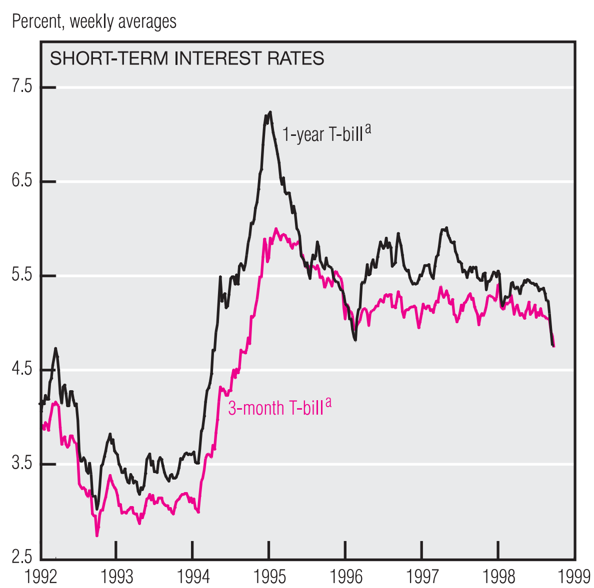
Monetary Policy (cont.)









a. Constant maturity.

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

required to provide the necessary liquidity for the higher volume of equity trading.

The federal funds rate has remained relatively stable around the target effective rate of 5.5% set in March 1997. However, the notion that a funds rate drop will be enacted in the foreseeable future seems to be widespread. Implied yields on federal funds futures indicate that traders in that market anticipate a softening of policy on the order of 50 basis points by the end of the calendar year and more than 75 basis points before the end of 1999:IQ.

Both long- and short-term interest rates have fallen off recently. During the week of August 18, the weekly average interest rate on the 30-year Treasury bond (constant maturity) fell below 5.5% for the first time since the constant maturity measure's inception in 1977. In that same week, conventional mortgage rates dropped beneath their previous low of 6.74%, which was reached the week of October 22, 1993.

Although they are not approaching such record-low levels, short-term interest rates have been falling quickly as well. The constant maturity rates on the 1-year and 3-month Treasury bills converged at a level of about 4.75%. This represents a drop-off in the weekly average of over 60 basis points in seven weeks for the constant-maturity, 1-year T-bill rates, and a fall of almost 35 basis points in the same period for the weekly average of constant-maturity, 3-month T-bill rates.

Some observers claim that over the past year or so, the Federal Reserve has effectively tightened monetary policy by leaving the federal funds rate unchanged in the face of a drop in inflation. That is, the Fed has allowed an increase in the real interest rate—the nominal interest rate less inflation. It is cer-

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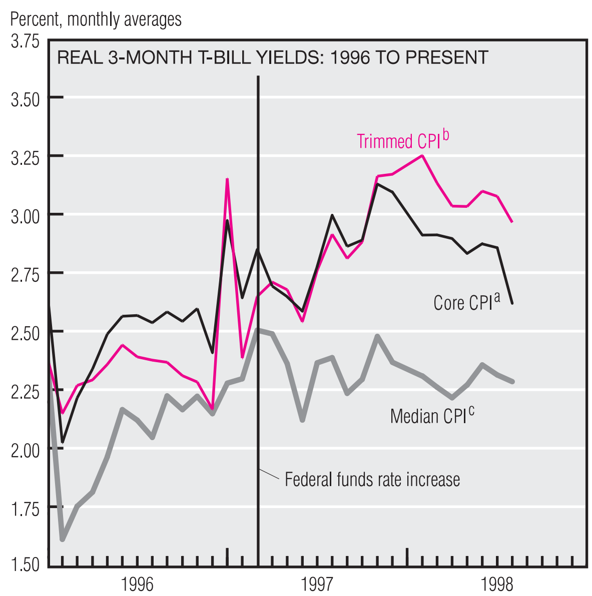


Comparison of Real 3-Month T-Bill Yields
(Percent, monthly averages)

Average for	Core[a]	Trimmed[b]	Median[c]
1998	2.73	2.96	2.15
1968–98	1.31	1.54	1.43
1988–98	1.77	1.97	1.80
Difference, 1998 versus			
1968–98	1.42	1.42	0.72
1988–98	0.96	0.99	0.35

a. CPI less food and energy.
b. 16% trimmed mean CPI.
c. Weighted median CPI.
SOURCE: Board of Governors of the Federal Reserve System.

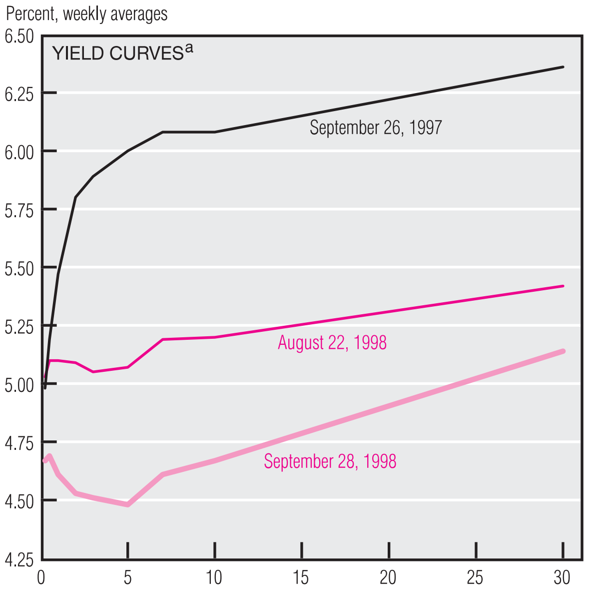
tainly clear that the real interest rate tends to be low during periods of loose monetary policy (for example, the mid- to late 1970s) and high when policy is tight (the early to mid-1980s).

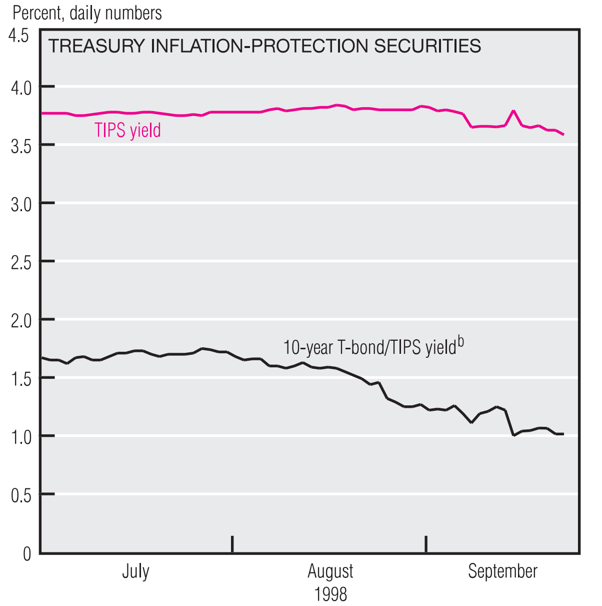
However, using the real interest rate to argue that the Fed has recently tightened policy depends crucially on how inflation is measured. For example, using the core CPI (CPI excluding food and energy) to measure inflation shows a run-up in the real interest rate following the last federal funds rate increase in March 1997. For 1998, this measure of the real interest rate is 1.42 percentage points higher than its average value for the 1968–98 period and 0.96 percentage point above its average for the 10 years ending August 1998.

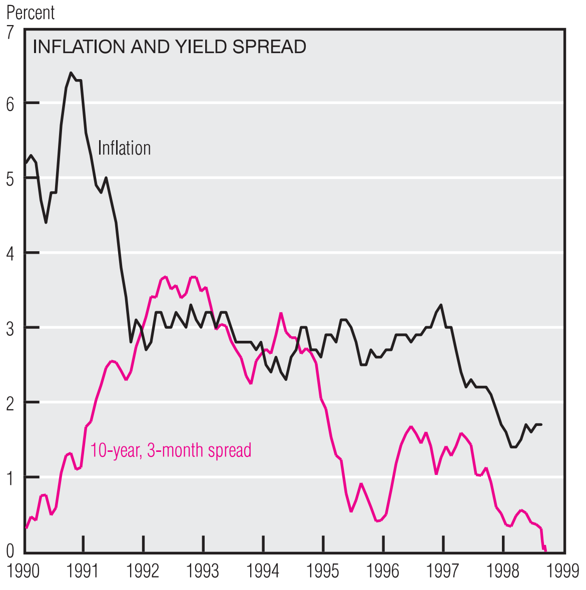
Like the core CPI, the 16% trimmed mean CPI excludes the CPI's more volatile components. Again, the increase in the real interest rate following the federal funds rate increase in March 1997 can be readily seen. The behavior of this real interest rate is generally similar to that of the core CPI.

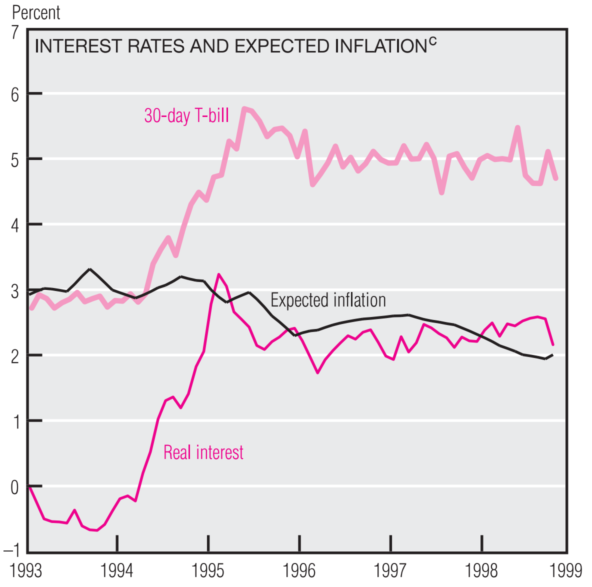
Research at the Cleveland Fed indicates that the median CPI is a better measure of the underlying inflationary process than either the core CPI or the 16% trimmed mean CPI. Since March 1997, this measure of the real interest rate has been relatively unchanged. Furthermore, its average value for 1998 is 0.72 percentage point higher than its average for 1968–98 (half that of the other measures) and only 0.35 percentage point higher than its average for the past 10 years (roughly one-third of the other measures). On the basis of the median CPI, it would be difficult to argue that policy has tightened over the past year and a half.

Interest Rates









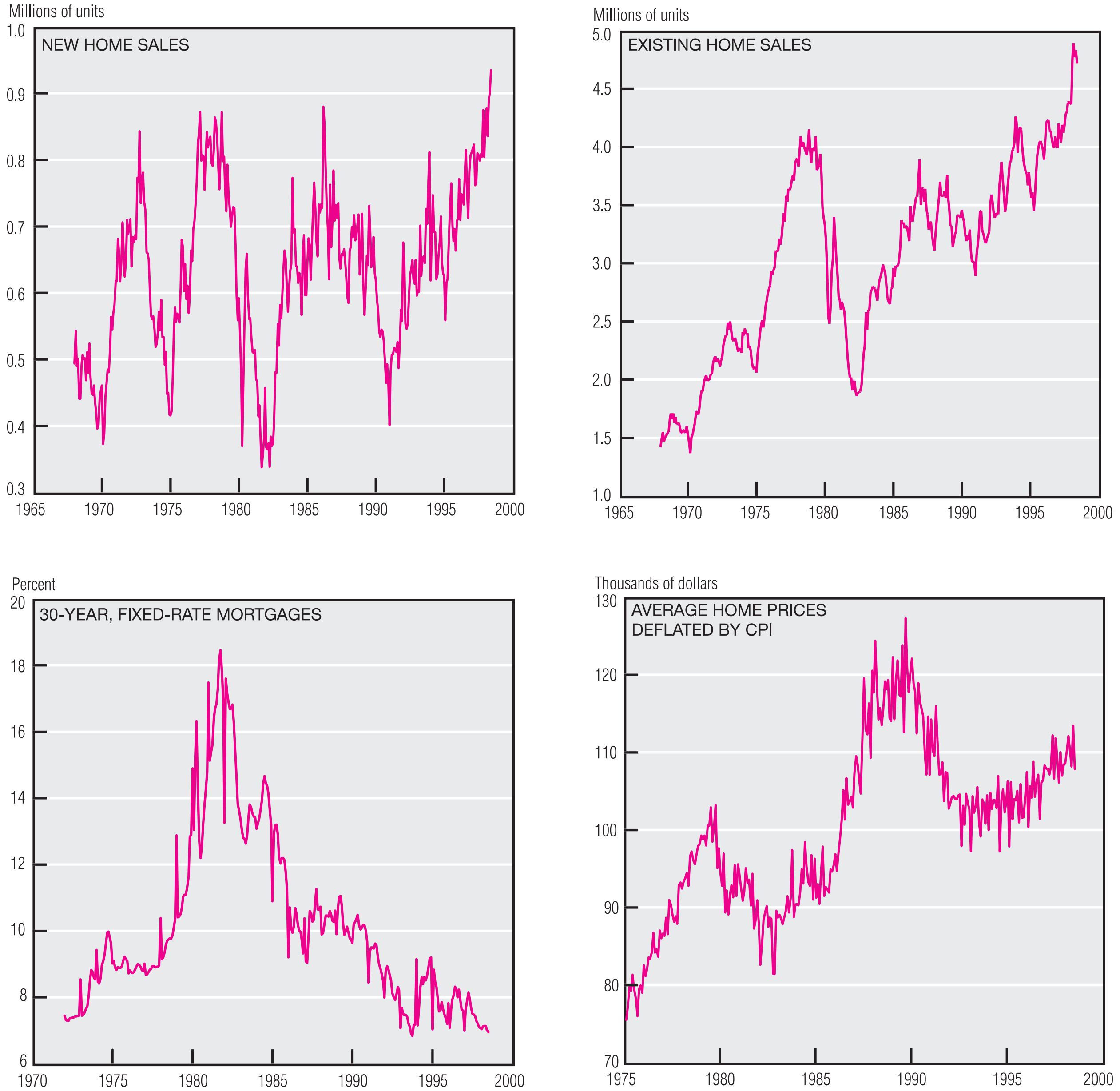
a. All instruments are constant-maturity series.
b. 10-year Treasury constant-maturity bond yield minus market yield on 10-year TIPS bond.
c. The real interest rate and the expected inflation rate, from the Survey of Professional Forecasters, are calculated using the 30-day T-bill rate.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Bloomberg information services; and *Wall Street Journal*, various issues.

The yield curve has continued to move down and flatten, showing an inversion at some rates. The shift is quite noticeable in comparison to the yield curve of one year ago, which was itself slightly flat by historical standards. The closely watched 3-year, 3-month and 10-year, 3-month spreads stand at –16 and zero basis points. Such a flat yield curve traditionally has indicated either slow economic growth or low expectations of inflation. Certainly in the 1990–92 period, real factors proved more important, and the spread widened despite a sustained fall in inflation. Inflation has dominated more recently, although in 1998 inflation and the spread have again moved in opposite directions.

The spread between nominal 10-year Treasury bonds and 10-year Treasury inflation-protection securities (TIPS) provides a more direct measure of inflationary expectations than does the yield spread. TIPS yields have declined slightly in September, but the steeper drop in Treasuries has decreased the spread from 175 basis points in July to 101 basis points in late September. This may indicate a reduced fear of inflation, but it may also reflect a flight to quality in safe, liquid Treasuries, which do not include the relatively illiquid TIPS.

A shorter-term measure of real rates and expected inflation can be uncovered by combining nominal rates with professional forecasts of inflation. Such results (which must be used cautiously) show a steady decline in expected inflation since early 1997, with a barely noticeable upturn in the most recent month.

Home Ownership: The American Dream



SOURCES: Freddie Mac; and DRI/McGraw–Hill.

Despite recent setbacks in the stock market, low mortgage rates and high consumer demand continue to make 1998 a banner year for home sales. Early this summer, the National Association of Home Builders announced that new home sales had reached the highest point in more than 20 years. Sales of previously owned homes have been especially strong, with a projected volume of 4.77 million units. If the current rate continues, total home sales for 1998 are projected to reach 5.65 million, higher than any year on record.

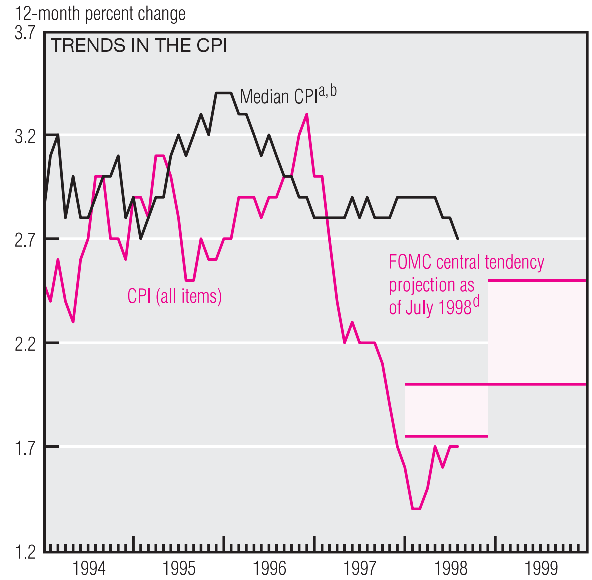
The interest rate on a 30-year, fixed-rate mortgage has declined dramatically since the early 1980s, and the average rate is now 6.66%. Comparatively low rates and a strong employment market have made homes affordable for more Americans, and intense demand is driving up home prices; in some areas, such as Florida's western coast, they have risen as much as 20% over last year's levels. Even in the staid Midwest, 9% increases over 1997 prices have occurred in cities like Detroit.

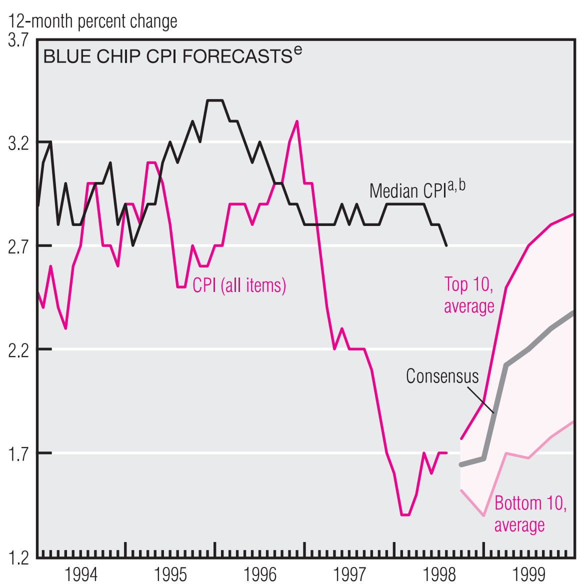
Low mortgage rates, gains from stock market investments, and a general perception of economic well-being have also redesigned homes. Today's dream house differs substantially from 1975's and costs much more, partly because added amenities are now considered "basic." More bedrooms and bathrooms, gourmet kitchens, and other luxuries have raised the average price of a new home to more than $175,000 in current dollars.

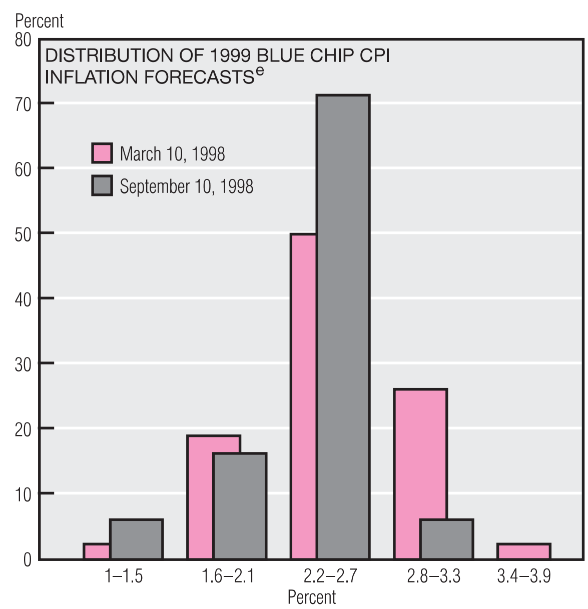
Inflation and Prices

August Price Statistics

	Annualized percent change, last: 1 mo.	3 mo.	12 mo.	5 yr.	1997 avg.
Consumer prices					
All items	2.2	1.7	1.7	2.5	1.7
Less food and energy	2.8	2.1	2.4	2.6	2.2
Median[a,b]	2.6	2.6	2.7	3.0	2.9
Producer prices					
Finished goods	–4.5	–0.9	–0.8	1.0	–1.2
Less food and energy	–0.8	1.1	0.9	1.2	0.0
Commodity futures prices[c]	–0.4	–19.4	–16.6	–1.2	–3.5







a. Calculated by the Federal Reserve Bank of Cleveland.
b. In May 1998, the median CPI component structure and market basket were updated, and the weighting scheme was revised.
c. 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.
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.
e. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; Commodity Research Bureau; and *Blue Chip Economic Indicators,* March 10 and September 10, 1998.

Consumer prices increased an annualized 2.2% in August, yielding a 12-month percent change that continues to hover just under the lower bound of the Federal Open Market Committee's (FOMC) central tendency range for the year (1.75%). The median CPI, an alternative measure of inflation, increased an annualized 2.6% in August. Price declines outweighed price increases as the Producer Price Index (PPI) fell an annualized 4.5% for the month. Food and energy prices continued their slide, but the PPI excluding these volatile components also dropped an annualized 0.8%. Commodity futures prices held steady in August, after falling 36.5% (annualized) in July.

Economists responding to September's Blue Chip Survey forecast that the consumer price trend will increase significantly from its current mark. The CPI is running close to the consensus forecast for the beginning of 1999, but is expected to be rising at a 2.1% annualized rate by 1999:IIQ and at a 2.4% pace by the end of the year. However, the distribution of responses to the most recent Blue Chip CPI forecast shows over 70% predicting that consumer prices will increase between 2.2% and 2.7% in 1999. This is a substantial shift from the March 10 survey, in which far more forecasts called for inflation in excess of 2.7%.

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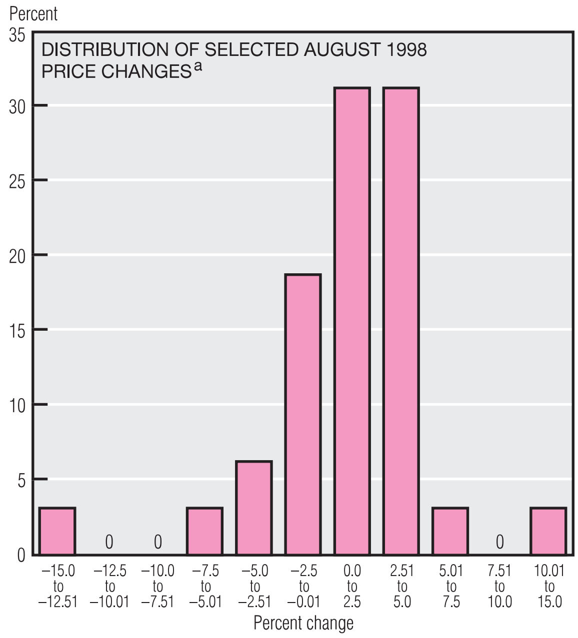
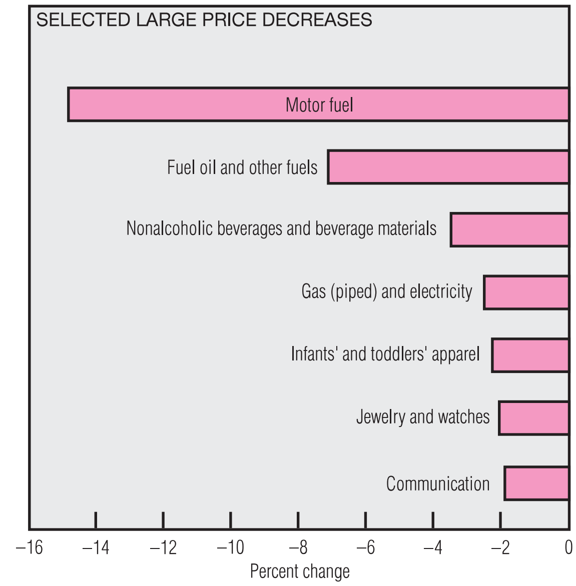
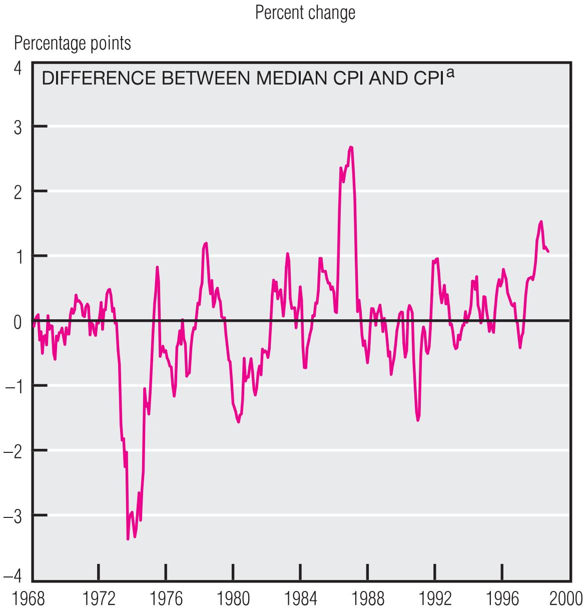
Inflation and Prices (cont.)







Accounting of Large Median CPI Gaps[a]

Peak date	Gap	Inflation at gap: CPI	Inflation at gap: Median	Gap closed	Inflation at close: CPI	Inflation at close: Median
1/74	–3.3	9.6	6.3	13 mo.	11.2	11.0
5/76	–1.2	6.1	5.1	4 mo.	5.5	5.3
4/78	1.2	6.5	7.7	5 mo.	8.5	8.7
3/80	–1.6	14.6	13.0	23 mo.	7.6	7.6
11/86	2.7	1.3	4.0	5 mo.	3.8	3.9
11/90	–1.5	6.3	4.7	4 mo.	4.9	4.8
3/98	1.5	1.4	2.9	5 mo.[b]	1.7	2.8

a. All data are based on 12-month percent changes.
b. Through August 1998.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

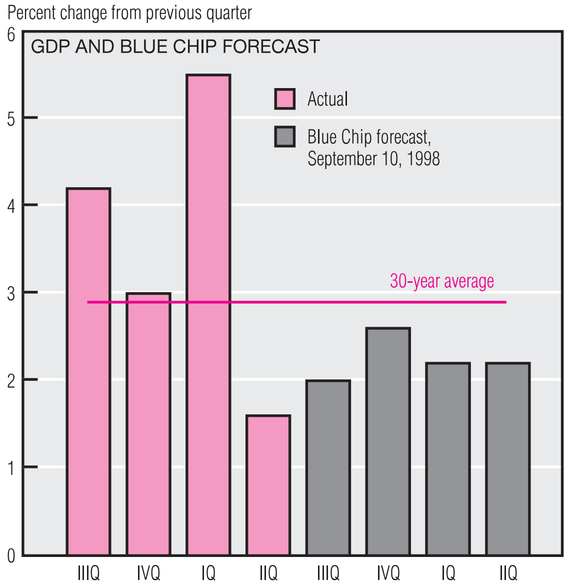
Over the 12 months ending in August, consumer prices have varied substantially. Forty percent of the component consumer price indexes have increased outside a relatively wide range of 0–5%. Interestingly, 30% of consumer prices have fallen. Energy prices have exhibited an especially large decline over the past 12 months; motor fuel prices have fallen 14.8% since August 1997.

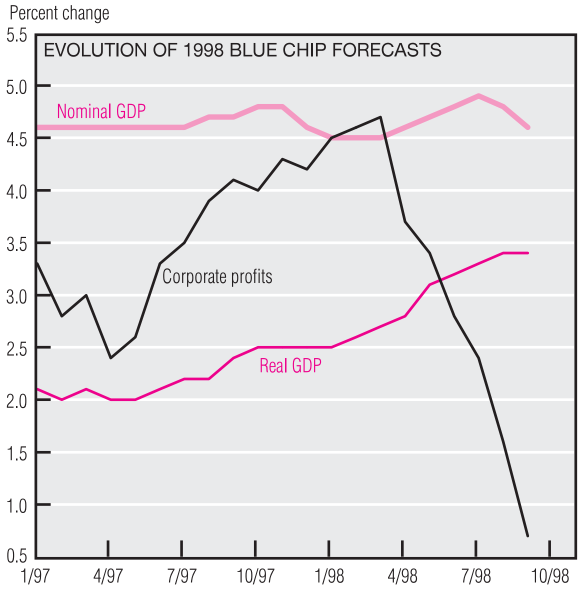
The CPI has reported low inflation rates since early 1997 and is currently running significantly below its five-year trend. The issue is whether these declines reflect the onset of a lower inflation trend or merely a transitory disturbance. Historical data show that since 1968, the CPI and median CPI have followed the same trend. Currently, however, the median CPI is running about 1.1 percentage points higher than the CPI. A closer look shows that the median CPI tends to be relatively stable while the CPI shows more overall variation. Once the difference becomes as large as or larger than the current one (which has happened six times since 1968), it is usually the CPI that adjusts to close the gap. One notable exception is the January 1974 gap: Both the median CPI and the CPI rose, but the greater increase came from the median CPI. Responses to the September 10 Blue Chip Survey suggest that this most recent gap may be closed by increases in the CPI.

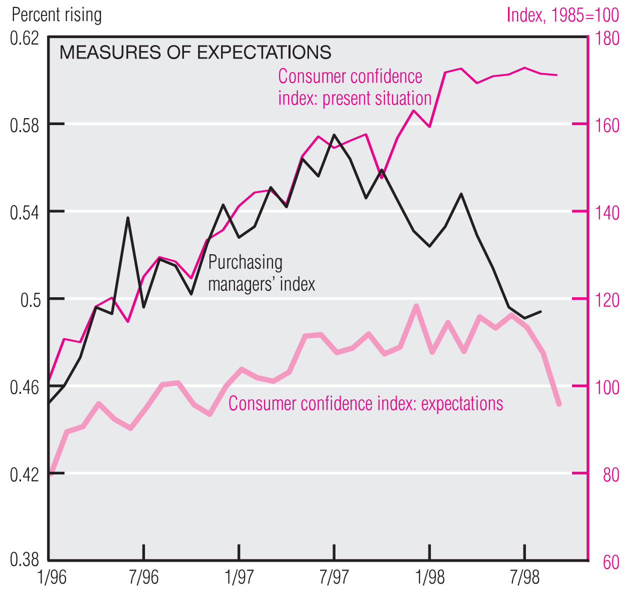
Economic Activity

Real GDP and Components, 1998:IIQ[a]
(Final estimate)

	Change, billions of 1992 $	Percent change, last: Quarter	Percent change, last: Four quarters
Real GDP	33.9	1.8	3.6
Consumer spending	75.1	6.1	5.3
Durables	19.1	11.2	11.6
Nondurables	19.7	5.3	4.3
Services	37.5	5.4	4.5
Business fixed investment	28.5	12.8	13.2
Equipment	32.5	18.8	18.0
Structures	−1.2	−2.3	1.3
Residential investment	10.6	15.0	9.4
Government spending	11.8	3.7	0.8
National defense	7.0	9.9	−3.7
Net exports	−46.7	—	—
Exports	−19.8	−7.7	0.9
Imports	26.9	9.4	11.1
Change in business inventories	−53.2	—	—







a. Chain-weighted data in billions of 1992 dollars.
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; The Conference Board, Inc.; National Association of Purchasing Management; and *Blue Chip Economic Indicators,* September 10, 1998.

The revised estimate of real gross domestic product (GDP) for the second quarter was only 0.2 percentage point higher than last month's preliminary estimate. The resulting annualized growth rates of GDP (1.8%) and real final sales (4.6%) contained no surprises.

Forecasters expect growth in future quarters to be somewhat higher, but below the 30-year average. For 1998 as a whole, however, they anticipate that real GDP will be almost 3.5% above last year's level. Their estimates of 1998 growth have increased almost continuously over the past two years to a level that is currently more than 60% higher than it was at the beginning of last year. In contrast, the forecast of nominal GDP growth is exactly the same as it was then. The entire difference is accounted for by forecasters' recognition of the surprising slowdown in the measured rate of inflation. Downward pressure on prices also shows up in persistent reductions in the forecast growth rate of corporate profits, now expected to be less than 1% above last year's level.

Deterioration of economic and financial conditions abroad has led to concern for the continuation of economic expansion at home, especially in the wake of the August break in stock prices and the subsequent exposure of financial difficulties at a huge eastern investment fund. Indexes of producer and consumer sentiment might provide the most timely, though probably not the most reliable, indications of movements in the economy, but they send no clear message. What is plain is that consumers are becoming more worried about the future. The expectations portion of the September consumer confidence index dropped sharply and at an even faster rate than in the

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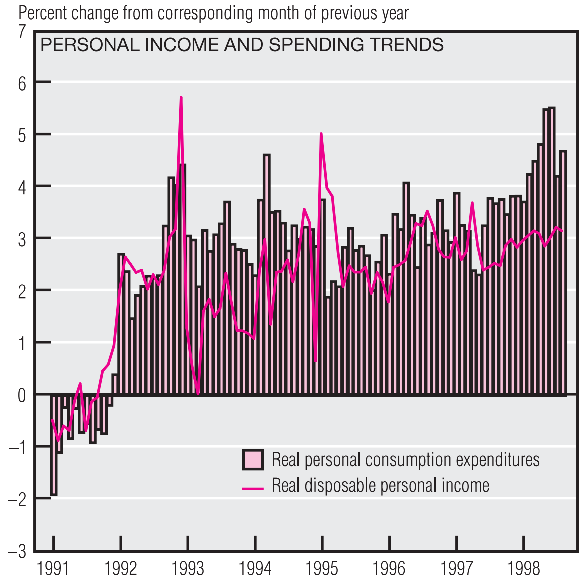
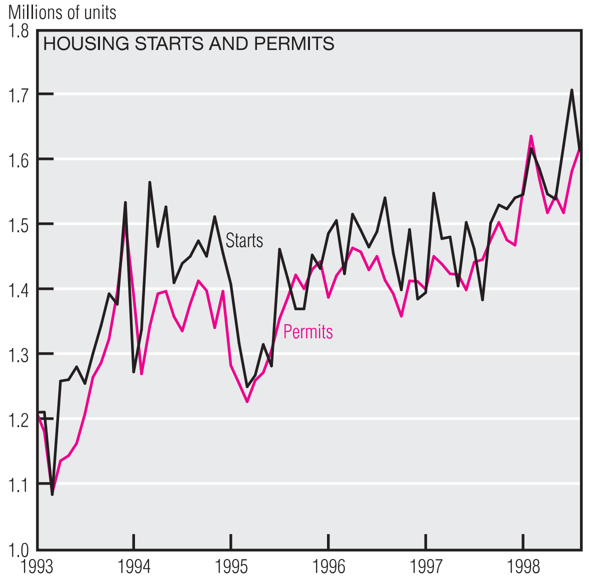
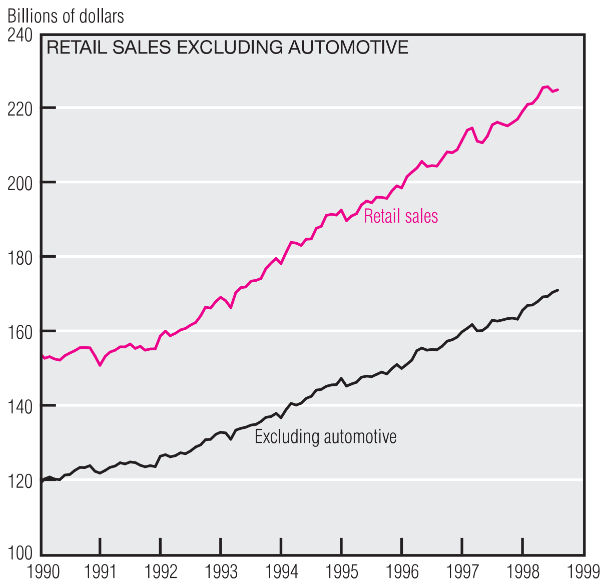
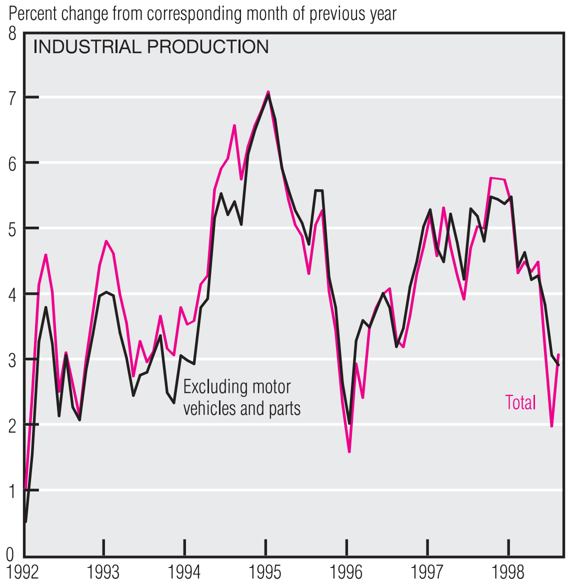
Economic Activity (cont.)









NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and Board of Governors of the Federal Reserve System.

previous two months. Worries are not apparent, however, in the present-conditions portion of the index, which declined only slightly. A more positive view of the situation came from the purchasing managers' index, which stabilized in August after declining throughout most of the year.

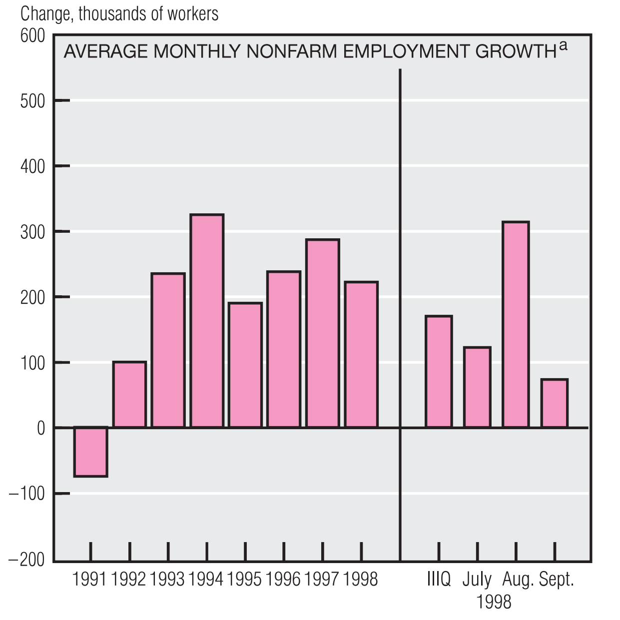
No slowing is evident in consumers' incomes. Real disposable personal income grew at a 4.3% annualized rate in August, above its 3.1% rate for the most recent 12 months. Consumption growth has receded from the high rates seen earlier in 1998, but consumers continue to increase spending by more than the increase in their real disposable personal incomes, a pattern that has prevailed for over a decade.

Housing permits increased sharply over July and August, with the number of permits only 3,000 lower than the number of starts in the latter month. Over the past five years, starts typically have exceeded permits, suggesting a gradual reduction in the backlog of intended construction. So far in 1998, however, the number of new housing starts has been only 7,000 above the number of new housing permits. This may indicate stabilization of the backlog and portend increased sensitivity of housing starts and construction activity to the number of new permits.

Retail sales moved up in August toward their previous peak. Nonautomotive retail sales have maintained a steady pace of growth, unlike the automotive-related sector, where sales have rebounded slowly since the General Motors strike.

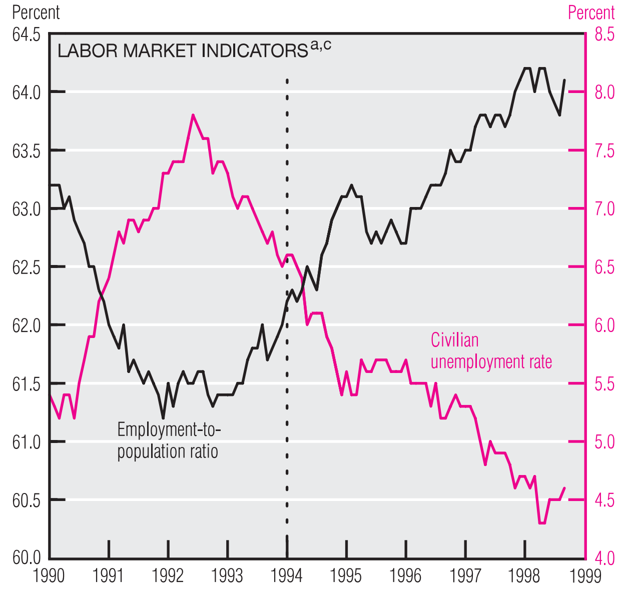
Industrial production increased sharply in September from its low August level, as settlement of the GM strike renewed automotive activity. Growth of nonautomotive production, however, continued to moderate.

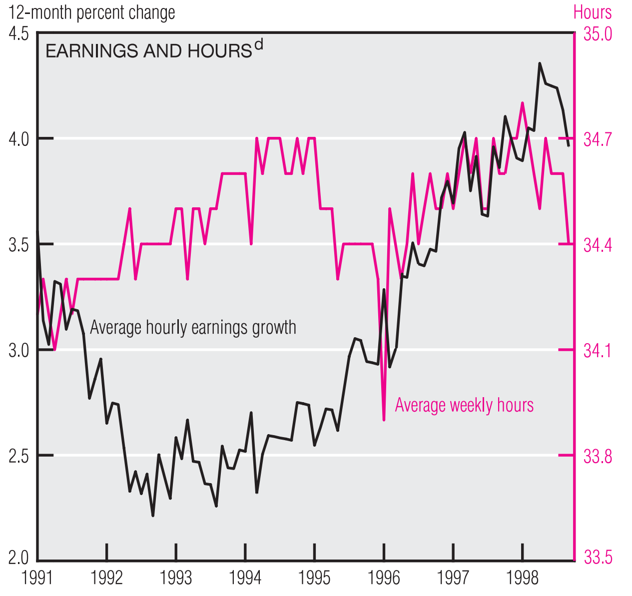
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
				1998	
	1995	1996	1997	YTD[b]	Sept.
Payroll employment	185	233	282	218	69
Goods-producing	8	31	42	3	–36
Manufacturing	–1	3	21	–13	–16
Electronic equipment	4	2	4	–3	–7
Industrial machinery	7	2	6	–2	–8
Construction	10	28	20	18	–20
Service-producing	178	202	240	215	105
Services	112	117	142	102	24
Personnel supply services	10	19	28	3	–37
	Average for period				
Civilian unemployment rate (%)	5.6	5.4	5.0	4.5	4.6
Household employment	32	232	240	110	579





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

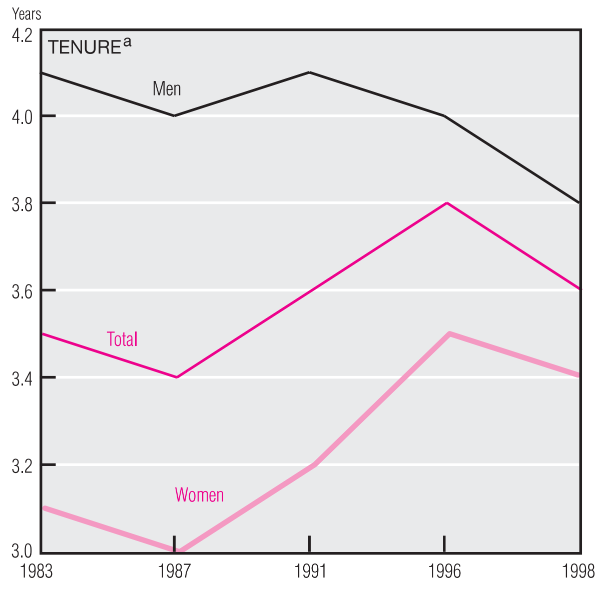
Evidence of a moderating labor market continued to mount in September. Job growth was at its lowest level since January 1996. The unemployment rate crept upward, while weekly hours worked declined.

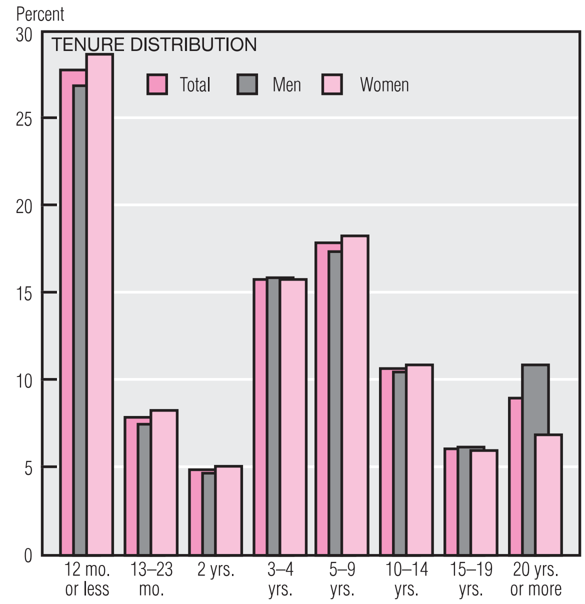
Nonfarm payroll employment increased just 69,000. Average monthly job growth for the year to date is off last year's pace by about 65,000 jobs. Increases in the service-producing sector did little to offset declines in the goods-producing sector. Service-sector payrolls rose just 105,000 for September, compared to an average monthly increase of 228,000 for the first eight months of 1998. In the goods sector, employment declined in both manufacturing and construction. Two trade-sensitive manufacturing industries, electronic equipment and industrial machinery, reduced their workforces.

The unemployment rate inched up one-tenth of a percentage point to 4.6%, a level not seen for six months. The rate has been increasing gradually since hitting a 28-year low of 4.3% in April and May. The share of the population employed grew to 64.1%, nearing the expansion high of 64.2% reached earlier this year.

The average workweek shortened to 34.4 hours from 34.6 hours in August. Even with this most recent decline, hours per week are hovering around their expansion average of 34.5. Average hourly earnings increased 1 cent to $12.86, the smallest monthly increase in 2½ years. Even with last month's slight decrease, earnings are 4% above last year's level.

Job Tenure





Tenure and Education

Education	Years
Less than a high school diploma	4.0
High school graduate, no college	4.9
Some college, no degree	4.6
Associate degree	4.6
College graduate	4.8
Bachelor's degree	4.4
Master's degree	6.0
Doctoral or professional degree	5.3

Years with Current Employer

Occupation	1983	1987	1991	1996	1998
Managerial and professional specialty	4.8	5.0	5.2	5.1	4.8
Technical, sales, and administrative support	3.1	2.9	3.2	3.4	3.2
Service occupations	2.2	2.0	2.3	2.4	2.4
Precision production, craft, and repair	4.8	4.7	4.8	4.9	4.6
Operators, fabricators, and laborers	3.9	3.4	3.5	3.2	3.2
Farming, forestry, and fishing	2.3	2.4	2.7	3.7	2.8

NOTE: All tenure data are median.
a. Data are available only for the years shown.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

During an economic expansion, new job opportunities appear, not only for the unemployed but also for those who already have jobs. This means that workers might seek alternative employment, but it also means that businesses might try harder to keep their current workforces as the pool of available labor begins to run dry.

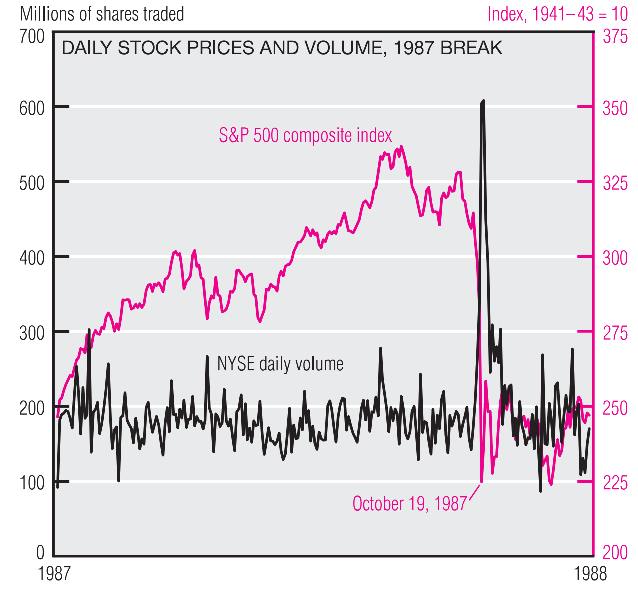
During a recession, as jobs become hard to find, workers tend to stay in their current jobs, but firms seek to reduce their workforces.

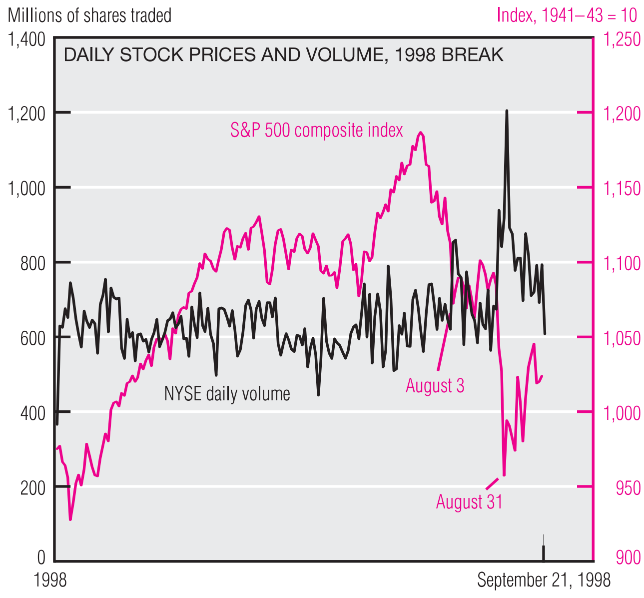
Therefore, during both expansions and contractions, forces are at work pushing the job tenure rate in opposite directions. While the tenure rate does, in fact, move over the cycle, it does not appear to have any clear business-cycle pattern.

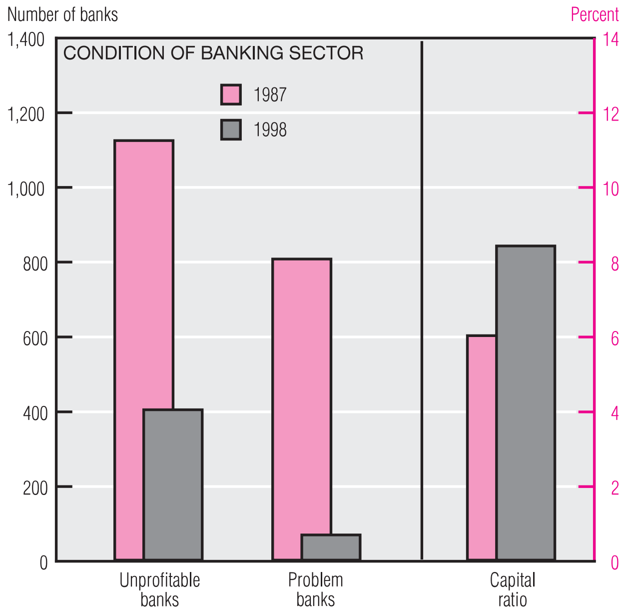
However, the pattern of tenure rates across different groups is quite revealing. Older workers have longer tenure because they have more labor market experience and have been able to settle into a job after a youthful period of searching. People who have more education and occupations with higher skill requirements, such as professional workers, also have longer tenure.

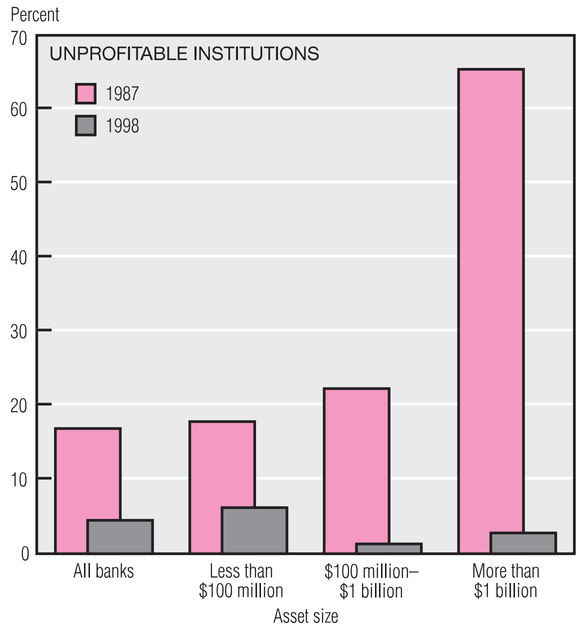
Service-sector jobs turn over rapidly, as shown by their very low median tenure: only 2.4 years compared to 4.8 years for professional and managerial jobs.

Banking and the Stock Market









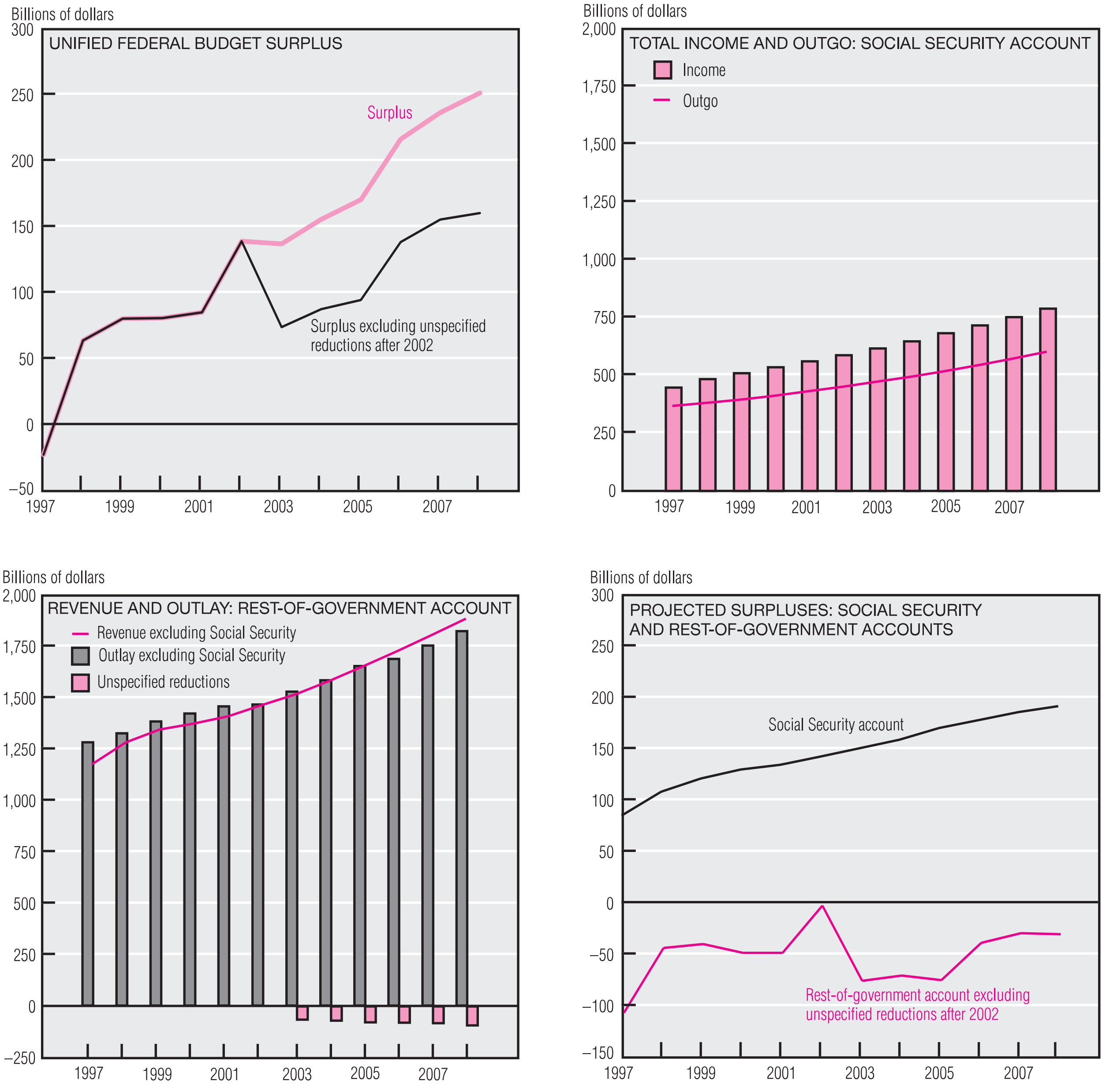
SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* 1987:IIQ and 1998:IQ; New York Stock Exchange, http://www.nyse.com/public/market/2c/2cix.htm; and Standard and Poor's Corporation.

The Dow industrial average dropped 512.61 points on August 31 and has been volatile since then. Setting aside speculation regarding motivations for the sell-off, people quickly drew comparisons between this episode and the stock-market crash of October 19, 1987, when the Standard and Poor's (S&P) 500 composite index dropped 25%, and the New York Stock Exchange (NYSE) reported roughly triple the usual daily trade volume.

This time around, the same measures show a somewhat less severe drop. On August 31, the S&P 500 composite index fell 15%, while the NYSE reported about double the usual daily trade volume.

One difference between the two market breaks is that healthier conditions prevail in the banking sector now than in 1987. The earlier break occurred in a banking environment that may have contributed to a more general nervousness about whether financial stability could be sustained. For example, there were almost three times as many unprofitable banks in 1987 as there are today, and more than 12 times as many problem banks. Banks' capital ratios were more than two percentage points lower than now. Questions were being raised about the condition of several large money-center banks. In fact, over 65% of banks with more than $1 billion in assets were unprofitable.

Today, however, far fewer unprofitable institutions can be found in every asset class than in 1987. The current health of financial institutions may have prevented a more serious erosion of confidence in the equities market.



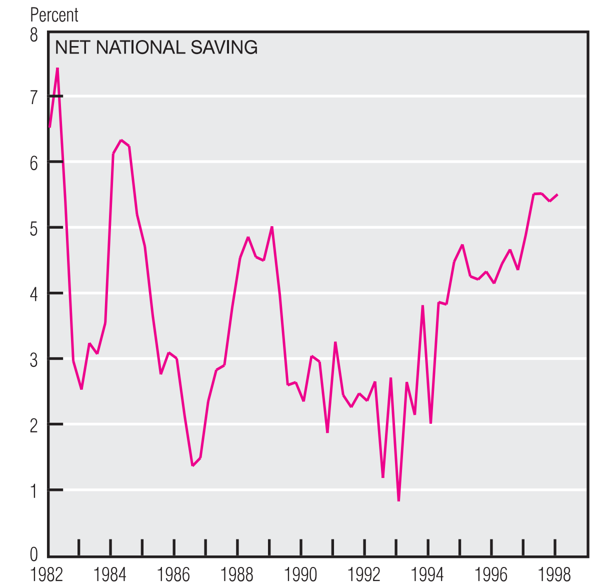
NOTE: Data are for fiscal years.
SOURCES: Congressional Budget Office; and Social Security Administration.

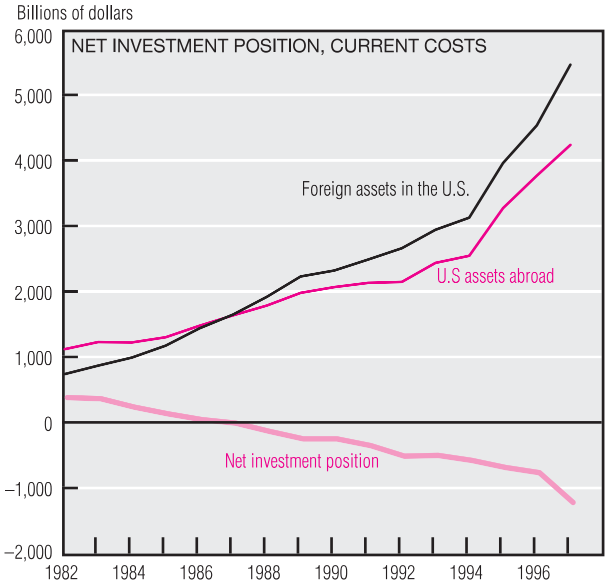
In his State of the Union address, President Clinton urged that prospective budget surpluses be reserved for rescuing Social Security. At that time, the projected cumulative surplus for 1999–2008 was $660 billion. The latest Congressional Budget Office projections show a cumulative surplus of $1.6 trillion over the same period. One might be tempted to conclude that budget surpluses and the President's exhortation to devote them to restoring Social Security's solvency herald a more responsible fiscal policy. Unfortunately, such a conclusion would be premature.

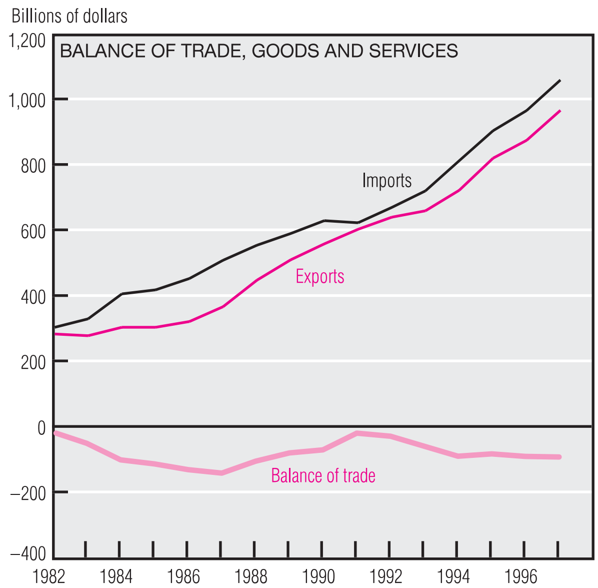
The latest budget projections assume that caps will be extended through 2008 to keep federal discretionary spending constant in real terms. However, the 1997 amendment to the Balanced Budget and Emergency Deficit Control Act of 1985 extends these limits only through 2002. The post-2002 unspecified reductions built into the projections are quite large relative to the surpluses. For example, excluding the unspecified reductions drops the year-2008 unified surplus from $251 billion to only $160 billion.

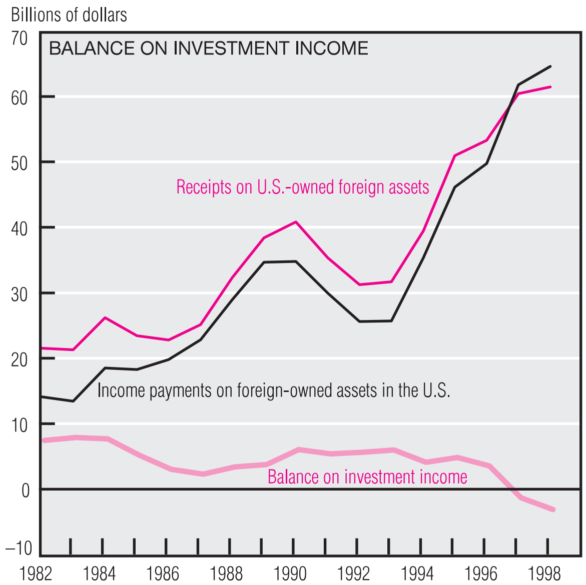
Separating Social Security's budget from the rest-of-government account shows that Social Security itself supplies more than the entire unified budget surplus. This surplus was designed to fund future Social Security benefits. If we exclude unspecified reductions after the year 2002, the rest-of-government account remains in deficit. According to the projections, there is no budget surplus exceeding that already reserved for funding future Social Security benefits. Unless discretionary spending limits are extended beyond 2002, the rest-of-government account will continue to siphon off part of Social Security's annual surplus to finance its own shortfall through the next decade.

National Saving and International Trade









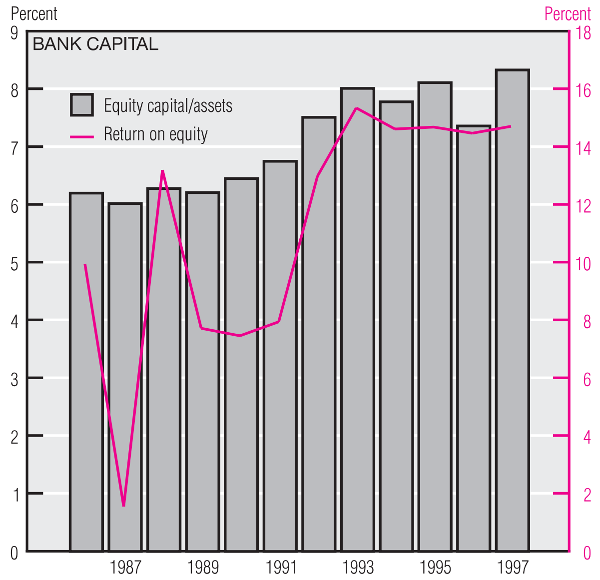
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

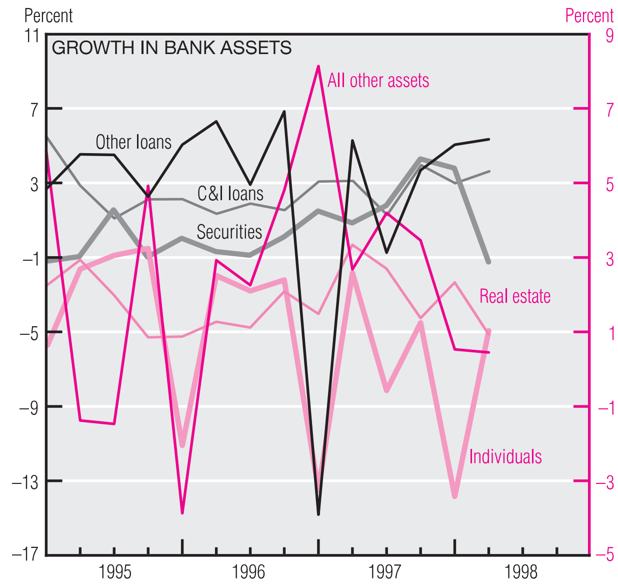
The pattern of capital flows and international asset ownership is intimately related to international saving patterns and investment opportunities. In the face of low national saving, domestic investment can be maintained only by reliance on additional foreign borrowing. The U.S. is a case in point. As its national saving declined in the 1980s, this country became a net importer of goods and services. A negative trade balance ultimately resulted in the U.S. becoming a debtor nation. Since the mid-1980s, foreign claims on assets in this country have exceeded U.S. residents' claims on assets located abroad.

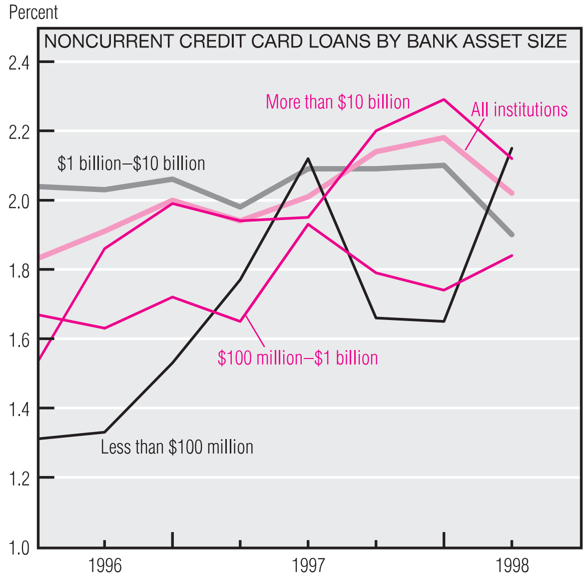
Trade deficits and the associated capital inflow increase the share of domestic capital owned by foreigners, but also help maintain workers' productivity by equipping them with more machines, tools, and skills. This keeps domestic incomes at higher levels than would be possible without the imported capital. Nevertheless, as our debt expands, so does the service charge—dollar payments of income to foreigners.

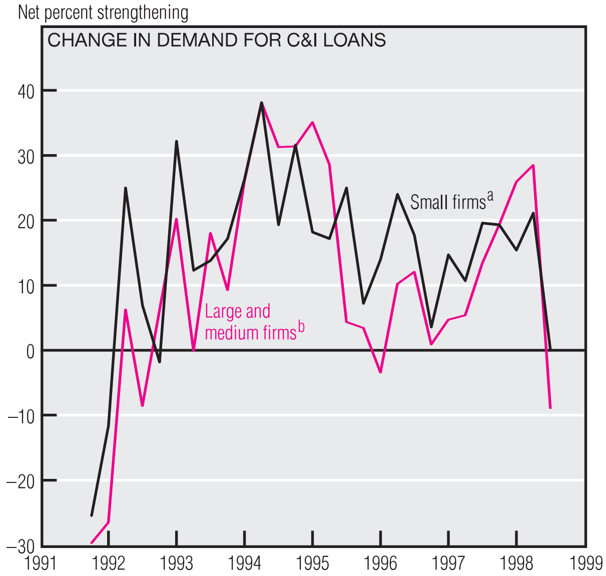
Foreigners are willing to invest in the U.S., probably because it offers them better investment opportunities than those available in other countries and because they have confidence in the stability of the dollar's international value. As long as foreigners' investments in the U.S. continue to exceed their investment income on assets held here, domestic investment will continue to outstrip U.S. national saving. However, a capital inflow cannot persist indefinitely because the rate of return on investment in the U.S. must eventually fall. When this happens, Americans will have to service the debt by running a trade surplus—that is, by exporting more than they import.

Banking Conditions









a. Less than $50 million in annual sales.
b. $50 million or more in annual sales.
SOURCES: Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, August 1998; and Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* various issues.

Commercial banks continued to post strong performances in 1998:IIQ as earnings rose for the eighth consecutive quarter, topping $16 billion and setting their sixth consecutive quarterly record. What's more important for shareholders, commercial banks' profitability continued to be high, with return on equity running at 14.8%. As the economic environment becomes more volatile, banking regulators can take some comfort from the continued high ratio of equity capital to assets.

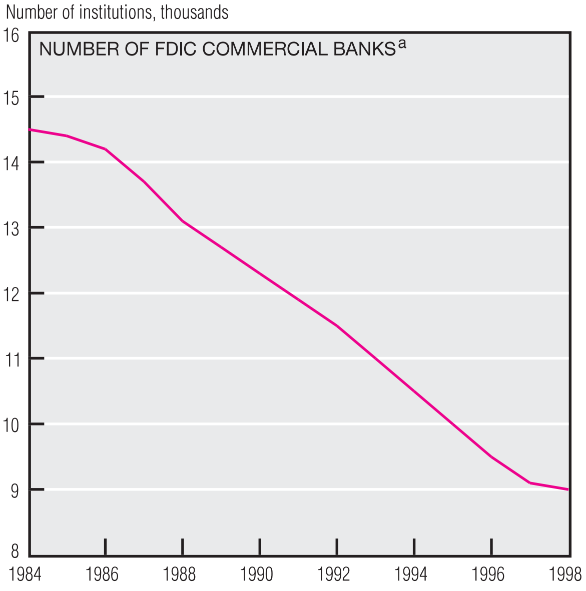
Income rose and profitability remained high, even though net interest margins declined slightly. The yield on earning assets held steady, but the cost of funding earning assets rose two basis points. One reason for banks' continued strong performance is that noninterest income rose sharply—up 21.3% over the last year—and now accounts for a record 40.2% of banks' net operating revenue.

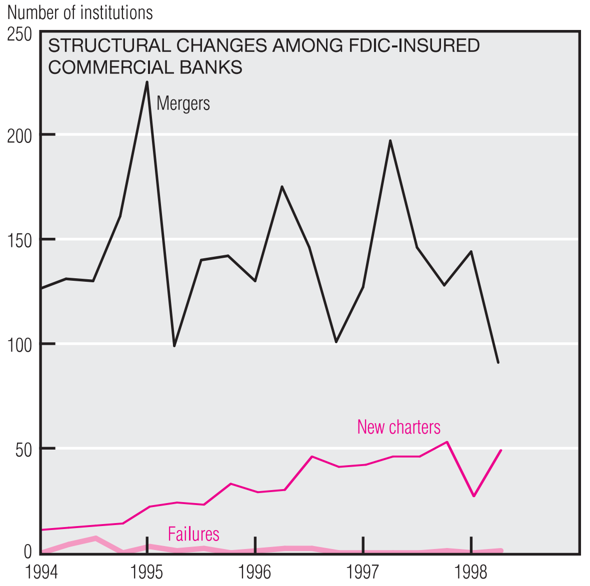
Growth in bank assets slowed from 1.9% to 1.4% between the first and second quarters, although commercial and industrial (C&I) loans and other loans and leases continued their recent strong growth rates. Most other asset categories saw a decline in growth rates. Banks' securities holdings actually declined 1.2% after growing strongly over the previous three quarters.

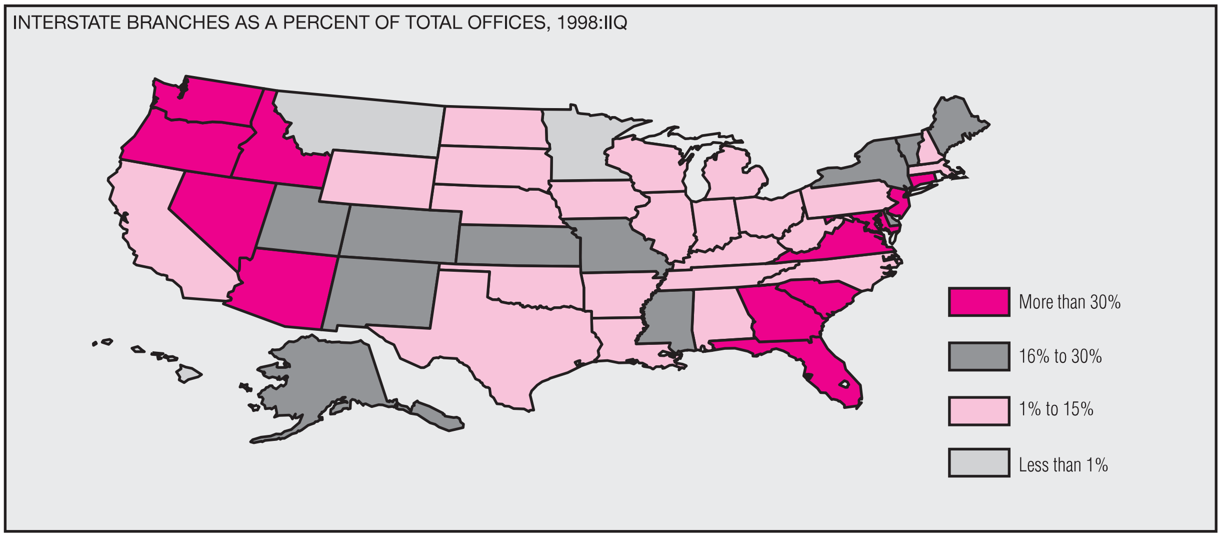
For the most part, the industry benefited from slower growth in domestic credit-loss provisions, even though new accounting rules expanded the coverage of this expense item in 1998. Credit card charge-offs accounted for over 60% of the $5.3 billion in loss provisions during the second quarter. While noncurrent credit card loans declined for banks overall, they rose sharply for institutions with fewer than $100 million in assets.

(continued on next page)

Banking Conditions (cont.)







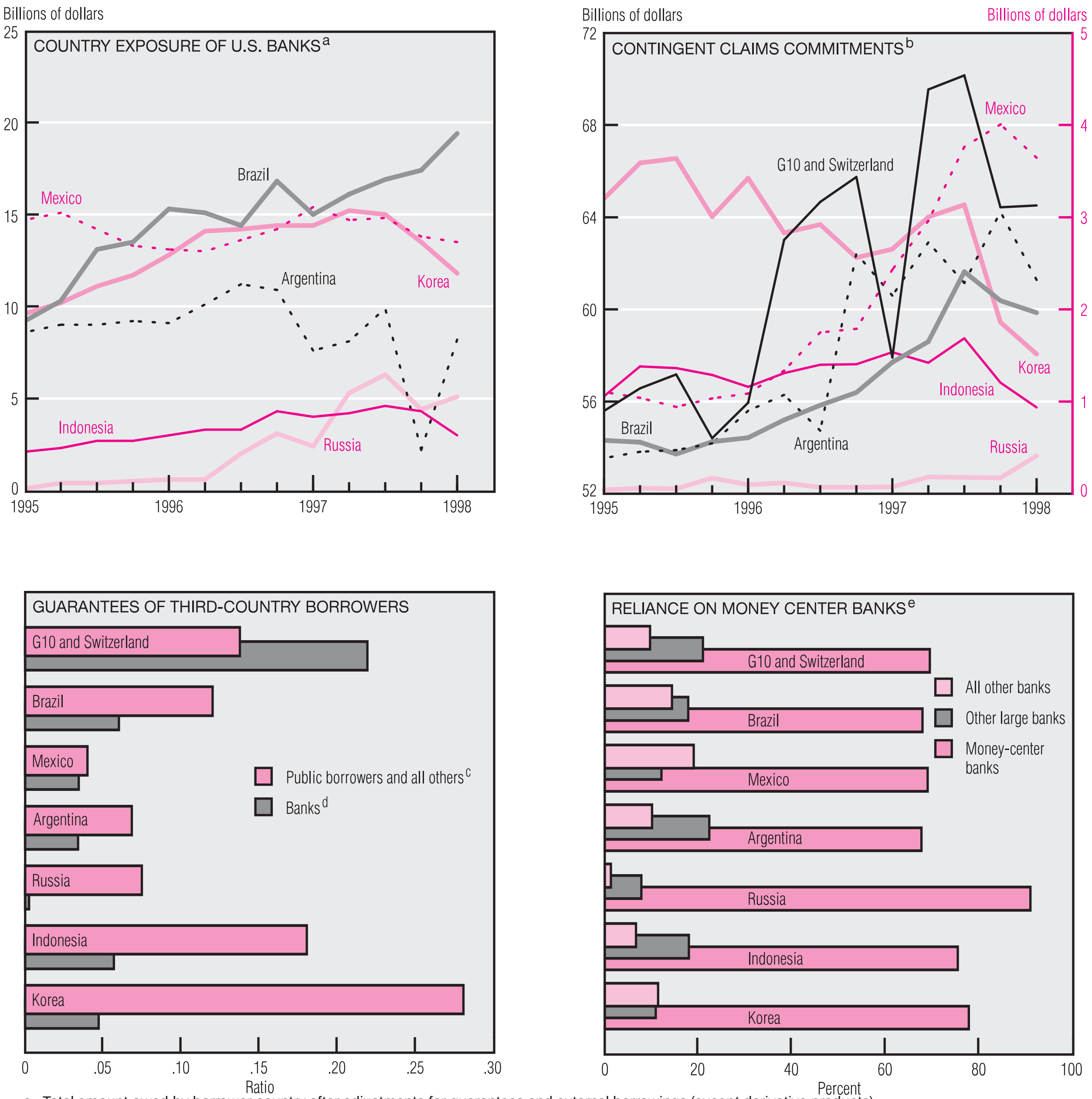
a. Through 1998:IIQ.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* 1998:IIQ.

Standards for C&I loans, an important category, remained relatively unchanged last quarter as the spreads of loan rates over banks' cost of funds continued to narrow. A possible sign of weakening in the economy is that the net percentage of domestic respondents reporting stronger demand for C&I loans declined for the first time since 1996.

Last quarter saw the earliest indication that the decline in the number of FDIC-insured commercial banks may be slowing. Their numbers have fallen by about 500 institutions every year since 1986, but fell by only 40 institutions in 1998:IIQ. Merger activity absorbed 91 banks, the lowest number since the most recent peak in 1997:IIQ. The recent general decline in stock prices may further dampen merger activities. New charters continued to be issued at a relatively brisk rate (49 in the last quarter). Only one institution failed.

Interstate branching has led to very different effects across states, as measured by interstate branches' share of total offices. The Southeast and the Pacific West (except for California) have the highest share of interstate offices. The District of Columbia (90.2%), Idaho (80.6%), and Oregon (70.5%) have the highest degree of interstate branch penetration, while Montana (0.6%), Hawaii (0.5%), and Minnesota (0.1%) have the lowest. Within the Fourth District, Kentucky (12.8%), Pennsylvania (12.4%), and West Virginia (10.9%) all have similar shares of interstate branches. Ohio's share, 3.1%, is significantly lower than that of other states in the District.

Foreign Lending Exposure



a. Total amount owed by borrower country after adjustments for guarantees and external borrowings (except derivative products).
b. Commitments of cross-border and nonlocal-currency contingent claims after adjustment for guarantees.
c. The ratio between a country's public and other nonbank borrowers' guarantees of third-country borrowing from U.S. banks and the total exposure of U.S. banks to that country's borrowers and guarantors.
d. The ratio between a country's banks' guarantees of third-country borrowing from U.S. banks and the total exposure of U.S. banks to that country's borrowers and guarantors.
e. Share of the total amounts owed U.S. banks after adjustments for guarantees and external borrowing (except derivative products).
SOURCE: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*, various issues.

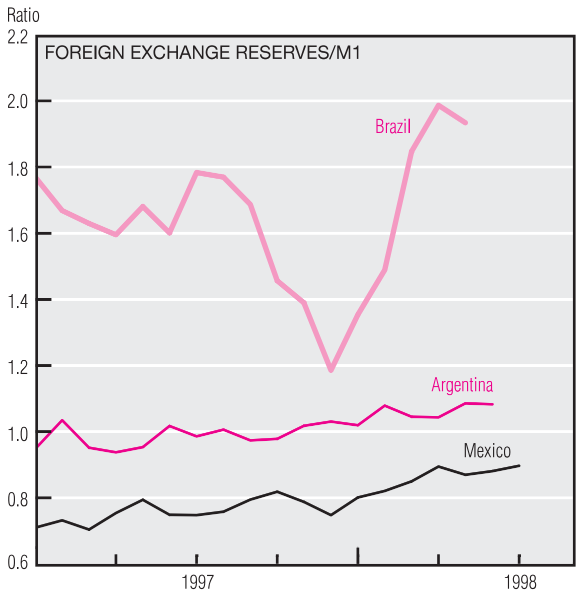
Economic and financial distress abroad raise questions about foreign exposure of U.S. banks. The most recent data, for March, show either an increase or no clear decline in exposure to Argentina, Brazil, and Russia. Exposure to Indonesia, Korea, and Mexico began declining around the time of last summer's financial crises. The extent to which U.S. banks reduce their exposure to South America and Russia may depend on the particulars of proposed reforms.

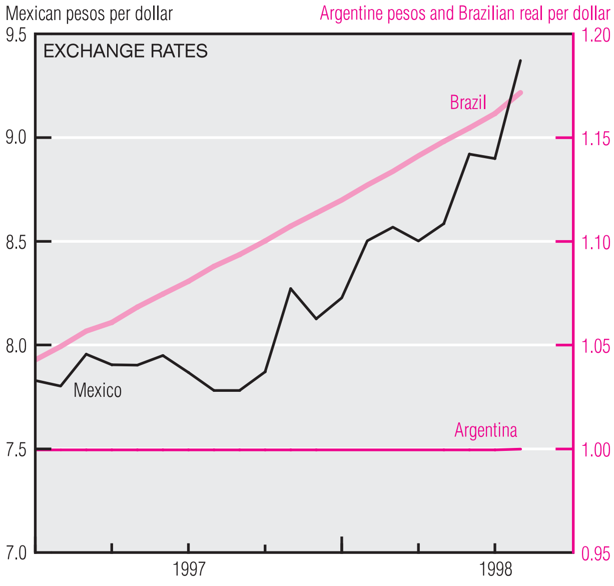
A key provision of economic reform packages is the degree of reliance on private-sector rather than official initiatives. One aspect of private initiatives is the development and use of contingent claims, whose profitability might be stimulated by a riskier environment. Markets, however, must be large enough to provide sufficient liquidity. The use of such instruments has been trending upward, despite having fallen since mid-1997 as part of a general pullback in foreign lending.

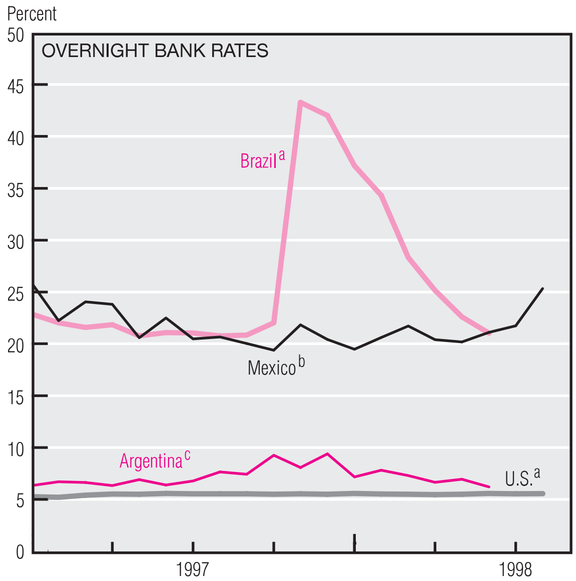
Official initiatives include providing various guarantees, although private parties also offer guarantees and insurance. March data show that guarantees of third-country borrowing amounted to about 36% of U.S. banks' exposure to the G10 countries and Switzerland. Such guarantees are less prominent in South American countries and Russia. Nonbank guarantees are more extensive in Indonesia and Korea, a difference consistent with the perception of greater government involvement in those economies.

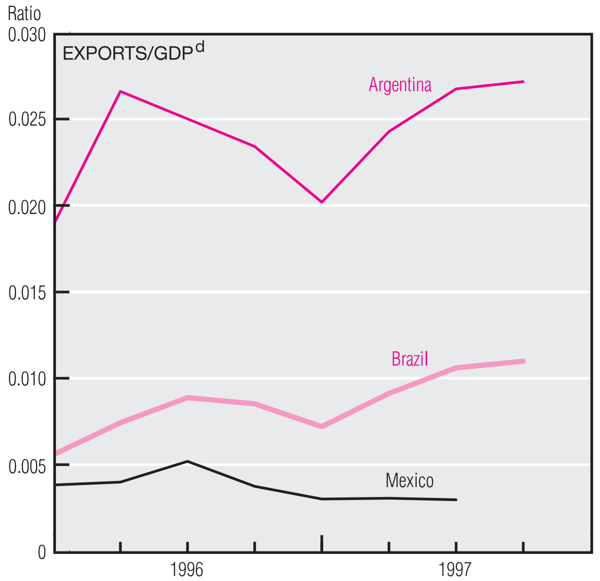
Reliance on money-center banks is relatively uniform across the economies of established—as well as developing—countries.

Latin American Economies









a. Federal funds rate.
b. Interbank interest rate.
c. Call money, private banks.
d. Data include only exports to each of the other two countries shown in the chart.
NOTE: Different end dates reflect differences in data availability among countries.
SOURCES: Board of Governors of the Federal Reserve System; Banco Central de la Republica Argentina; Banco Central do Brasil; Banco de Mexico; and International Monetary Fund, *Direction of Trade Statistics and International Financial Statistics*, various issues.

Successive Asian and Russian crises have focused attention on the economies of Latin America. Brazil, the largest of these, has experienced capital outflows that reached almost $2 billion (U.S.) on September 11. To some extent, this represents “contagion”—investors’ presumption that all emerging markets are shaky. However, recent data have revealed that Brazil’s public-sector deficit is larger than previously thought.

The impact of having a central-government deficit depends partly on the exchange-rate regime. Brazil utilizes a “crawling peg” that allows the dollar value of its currency, the *real*, to decline gradually (at 7% per year); Argentina has adopted a currency board that fixes the dollar value of its peso; and Mexico has allowed its currency to float, albeit with occasional interventions.

Although Brazil’s decision to adopt a crawling peg against the dollar initially reduced its inflation rate, lack of progress in reducing the public-sector deficit has hurt investors’ confidence in the real, necessitating higher domestic interest rates to defend the peg. This in turn has raised the cost of financing the deficit and increased the stock of government debt. The immediate alternative to higher rates is devaluation.

The three economies are linked financially because the U.S. dollar is used as an alternative to the currency of each. Even in Argentina’s banking system, which permits clients to use either dollars or pesos, interest rates on pesos have recently risen along with Brazilian rates. Export dependence among the three countries appears limited. Trade between Brazil and Argentina constitutes a significant proportion of each country’s exports, but not of their GDPs. Mexican trade is heavily weighted toward the U.S.