

The Economy in Perspective

*Pump up the volume...*The Bureau of Labor Statistics' report on November employment, released December 4, indicated that nonfarm payroll employment expanded by 267,000 people, more than double analysts' typical estimate. Miscues of such magnitude are not rare; in this case, though, the discrepancy prompted a 136-point rally in the Dow Jones average because most observers had expected the employment report to confirm a *downshift* in U.S. economic growth. After all, jobs growth was stronger in the first half of this year than in the second half, and the figures for September and October showed successive declines from the gains posted for August.

Moreover, observers had been expecting that weakness in the nation's manufacturing sector would continue to plague labor markets. On this score, they were right (manufacturing jobs dropped by 47,000 last month), but service sector gains more than made up for that decline. The November data, including an unemployment rate of 4.4% and a near-record employment-to-population ratio of 64.1%, suggest that labor market conditions remain on par with those for the year as a whole.

The labor market report was not the only recent statistical surprise. A few weeks earlier, the Commerce Department had published its preliminary third-quarter estimates, showing far stronger growth for the quarter than its previous report had indicated. Consumer spending accounted for most of the difference. Along with this information came news of accelerating productivity growth in the nonfarm business economy as a whole, as well as within the manufacturing sector. October housing starts, for example, were announced shortly after the GDP report. Specialists had forecast that single- and multifamily housing starts would sum to about 1.60 million units (at an annual rate), an increase of only 1%. Instead, the Commerce Department reported a figure of 1.65 million units, representing a 7% annualized gain over September.

Adding to the stock of data revisions, last month the Federal Reserve released new information on industrial production and capacity utilization from 1992 to the present. It shows that beginning around 1996, industrial production actually accelerated more rapidly than earlier reports had indicated, and that capacity utilization

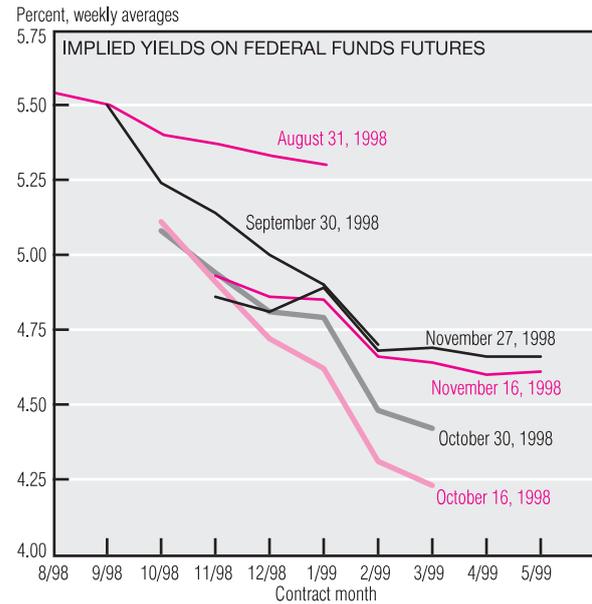
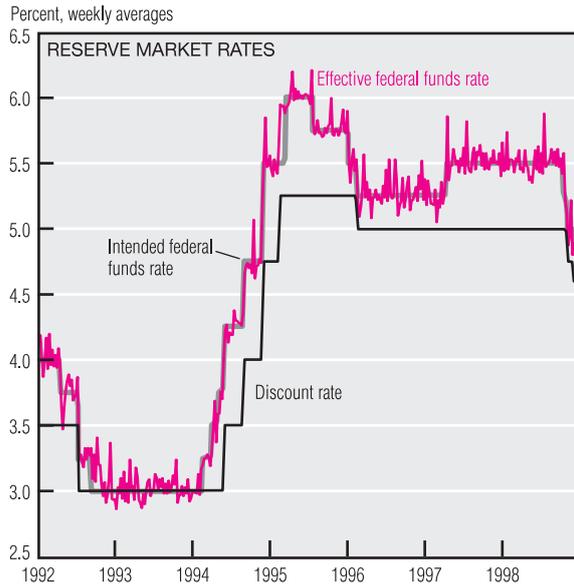
rates were slightly greater. These new figures may help explain why, when compared with previous economic expansions, labor market tightness appeared out of synch with capacity utilization rates.

What do we learn from the new statistics and data revisions? With the exception of manufacturing, the pace of economic activity appears to be strong and labor markets remain very tight. We also know that consumers—perhaps encouraged by a rebounding stock market—have been raising their debt levels to support their spending activities. At the same time, corporate profitability has been slowing. One reason may be that real wages have recently been accelerating farther beyond the growth in labor productivity than they had earlier in the expansion, pushing unit labor cost increases up by a wider margin. Since 1997, unit labor costs have been outpacing inflation, evidence that further price and profit pressures lie ahead.

Most analysts expect that the rate of economic growth will shift down considerably in 1999 to something like 2%, much slower than its latest four-quarter change of 3.5%. This is important, certainly, but why should it be considered the single most interesting topic of economic speculation? After all, it does seem likely that sluggish foreign demand will hamper U.S. manufacturing activity and cause our trade deficit to expand. However, the nation's economy demonstrated impressive capacity for growth in the mid-1980s, despite deterioration in its export markets and manufacturing sector. As long as household spending remains strong and foreigners are willing to finance our consumption, the expansion can endure.

More important than the expansion's *rate* of growth will be whether it follows a path that puts continuity at risk. For example, will further expansion bring a stronger dollar, lower interest rates, and very low inflation—or a depreciating dollar, rising interest rates, and accelerating inflation? Will expansion be accompanied by further outsized gains in equity prices—or by temperance? Sustainable economic growth requires more than just posting big GDP numbers on the scoreboard; sometimes it calls for old-fashioned moderation.

Monetary Policy



a. Constant maturity.

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

On November 17, the Federal Open Market Committee (FOMC) again lowered its target for the federal funds rate. On the same day, the Board of Governors approved Reserve Banks' requests to lower their discount rates. In each case, the drop was 25 basis points, bringing the federal funds rate target to 4.75% and the discount rate to 4.50%. This was the third reduction in policy rates since the August FOMC meeting.

Evidence from the federal funds futures market suggests that its participants do not expect significant

rate cuts to follow. Futures for March 1999 were trading at an implied yield just below 4.25% after the unexpected easing of rates on October 15. On November 27, 1998, however, the implied yield for the March 1999 contract had increased to just under 4.7%, indicating that futures market participants no longer anticipated further significant easing of the federal funds rate by the end of 1998:IIQ. In fact, indications from the futures market are that the federal funds rate will change very little through the middle of 1999:IIQ; the implied yield for the May 1999 contract was

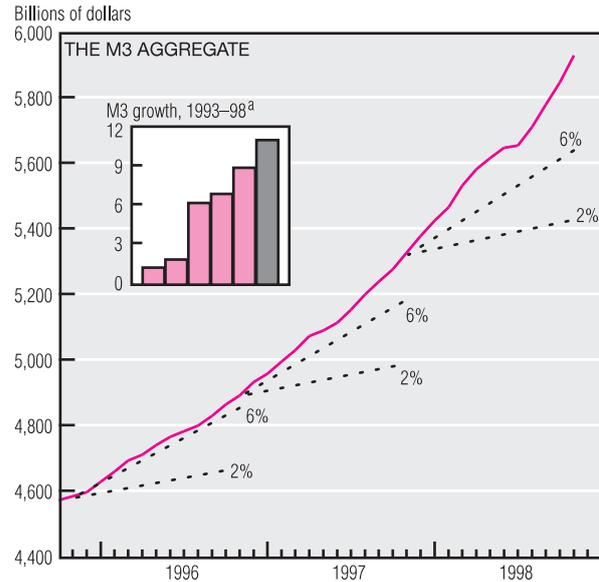
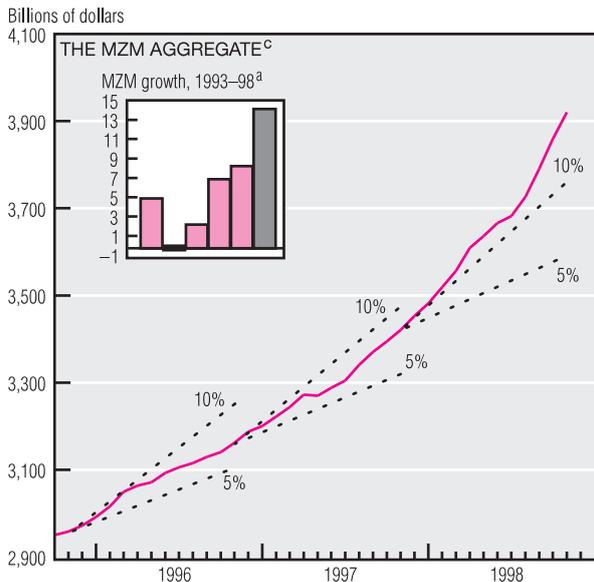
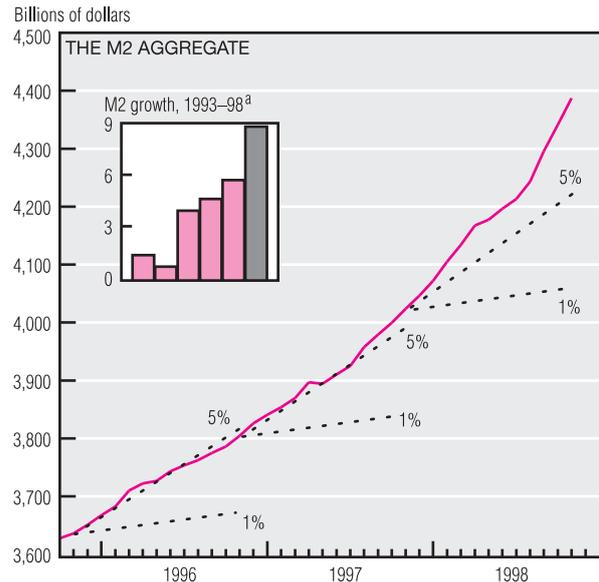
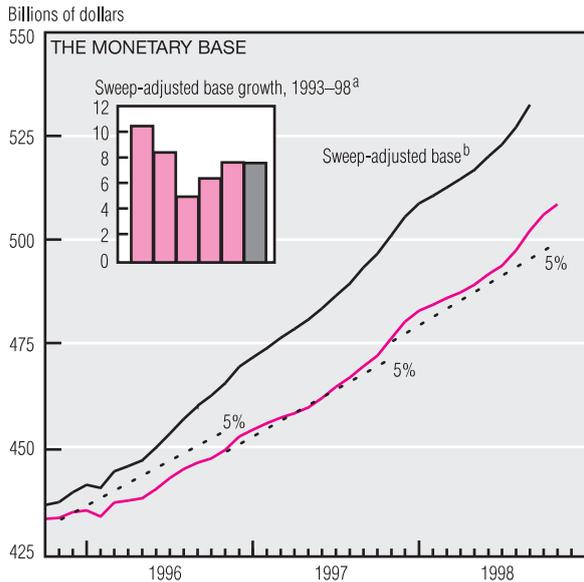
4.66% on November 27, 1998.

Other short-term interest rates have moved down with the funds rate target and the discount rate. The average 3-month T-bill rate fell below 4% in the week ended October 16, 1998, for the first time since April 29, 1994. The average 1-year T-bill rate declined to 4.14% for the same week.

Long-term interest rates also declined through early October, but have risen since then. The weekly averages for both 30-year Treasury and conventional mortgage rates

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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized 1998 growth rates for M2, MZM, and M3 are calculated on an estimated November over 1997:IVQ basis; for the sweep-adjusted base, 1998 growth is calculated on a September 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.
 c. MZM is an alternative measure of money that is equal to M2 plus institutional money market mutual funds less small time deposits.
 NOTE: Data are seasonally adjusted. Last plots for M2, MZM, and M3 are estimated for November 1998. Dotted lines for M2 and M3 are FOMC-determined provisional ranges. Dotted lines for the monetary base and MZM represent growth in levels and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

have rebounded about 30 basis points from their October lows.

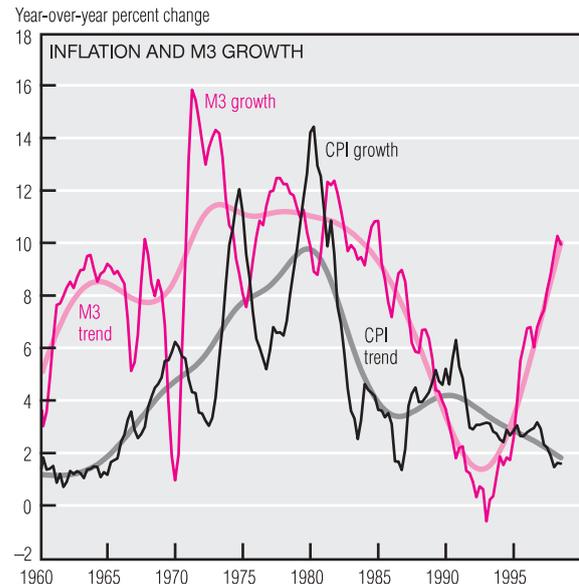
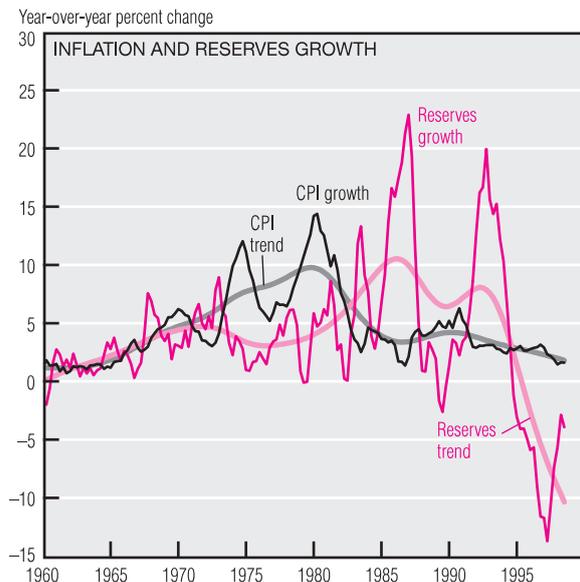
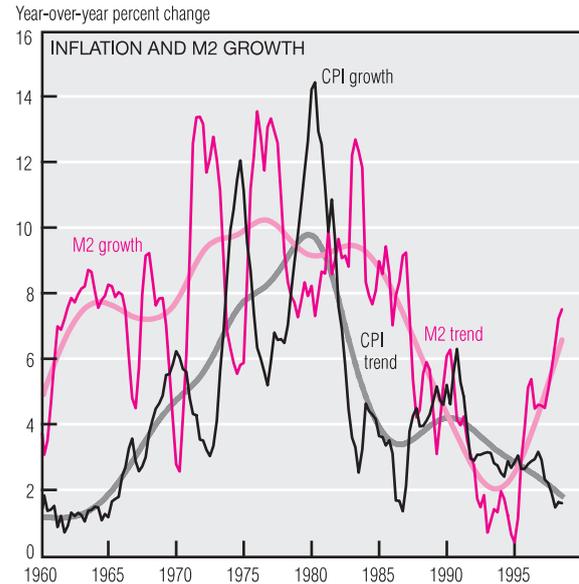
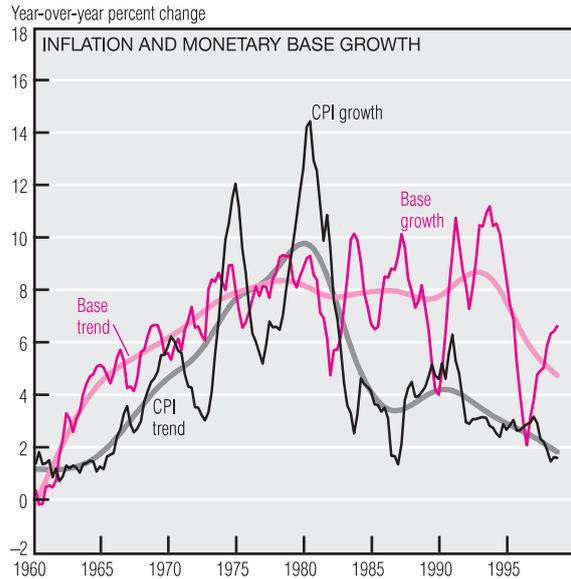
Monetary aggregates continue to grow at a relatively rapid pace, a trend that shows little sign of easing as the holiday season approaches. While the growth rate of the monetary base itself appears to be tapering off, the growth rate of the more relevant sweep-adjusted base continues to rise, having increased at about a 7.5% rate for the year to date, the same growth rate as for 1997.

Growth rates of M2, MZM, and M3 remain more robust than for the narrower monetary base aggregate. Annualized monthly growth rates for M2 were 14.8% in September and 12.7% in October. Year-to-date M2 growth of more than 8.75% is well above the FOMC-determined provisional range of 1% to 5% and appears to be climbing. Year-to-date growth for MZM has topped 14%, with recent annualized monthly increases as high as 21% (in both September and October). M3, the

broadest of the money measures charted here, also is growing rapidly. With year-to-date growth nearing 11%, M3 seems likely to exceed its previous year's growth rate for the sixth consecutive time. Even if M3 stabilized at its preliminary November 16 level, 1998 growth would exceed that of 1997 by more than five percentage points. It is examples like these that some view as warning signals of future inflation.

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Monetary Policy (cont.)



NOTE: All trends are calculated using the Hodrick–Prescott filter.

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

Milton Friedman’s statement that “inflation is always and everywhere a monetary phenomenon” is often quoted, but what do contemporary data tell us about this relationship?

Little systematic relationship appears between narrow money growth and inflation, either for long-term trends or for quarter-to-quarter movements. From 1960 to 1980, base growth rose in advance of inflation. However, inflation in the 1980s fell sharply with no corresponding drop in base growth. The behavior of M1 (not shown) is generally similar. Reserves growth followed that of inflation in the 1960s,

but trended downward in the 1970s as inflation took off, then trended upward as inflation moderated in the 1980s.

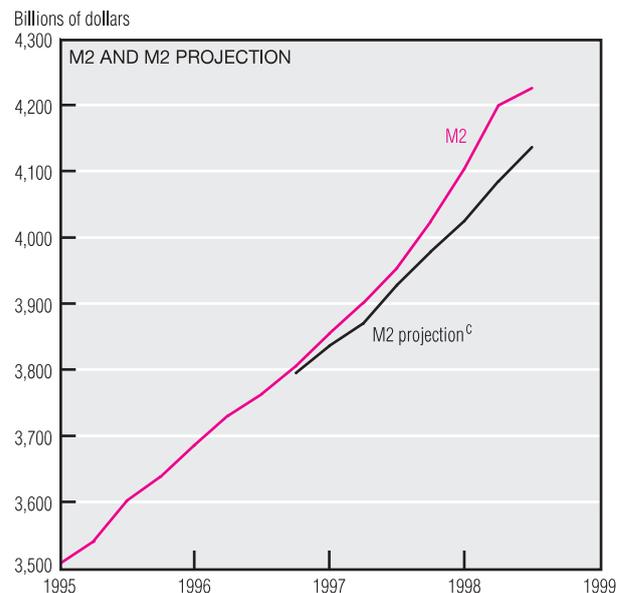
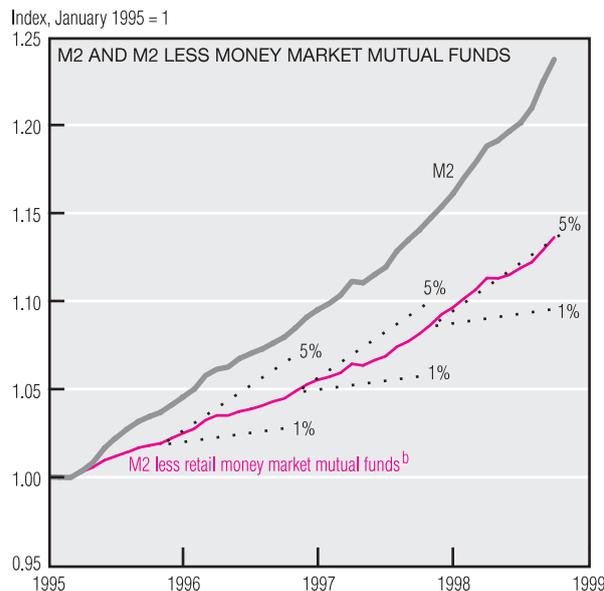
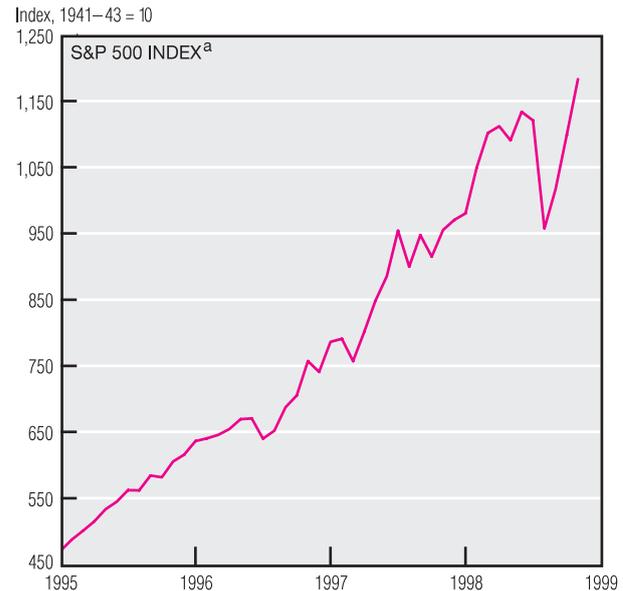
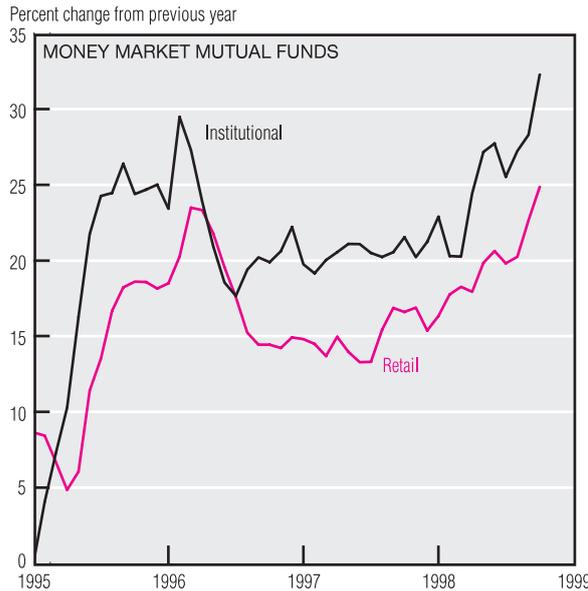
The broader aggregates provide even less support for a story of tight money growth and inflation. High M2 growth in 1972–73 led the 1974–75 inflation spike, and high M2 growth in 1975–76 led another inflation spike in 1979–80. However, lower M2 growth in the 1980s followed the decline in inflation. The behavior of M3 is similar to that of M2.

The increase in inflation in the 1970s might be attributed to high

money growth, probably with some lag. Yet in the early 1980s, growth in all of the monetary aggregates continued apace as inflation was falling. This evidence makes it difficult to know how to interpret current high growth rates in the monetary aggregates.

Of course, this broad-brush analysis omits several potentially important factors. Variations in real output growth might cause money growth and inflation to diverge. Likewise, changes in interest rates and financial technology can affect money demand and so money growth.

Money Growth and Stock Market Volatility



a. The data are end-of-month closing values. The last point is the closing value of the index on November 24, 1998.

b. Dotted lines correspond to FOMC-determined provisional ranges for M2 and are for reference only.

c. M2 projection is an out-of-sample estimate from a quarterly model that includes an estimated effect of positive and negative movements in the S&P 500 Index, using data from 1964:1Q through 1996:1Q.

NOTE: Money market mutual funds and M2 data are seasonally adjusted.

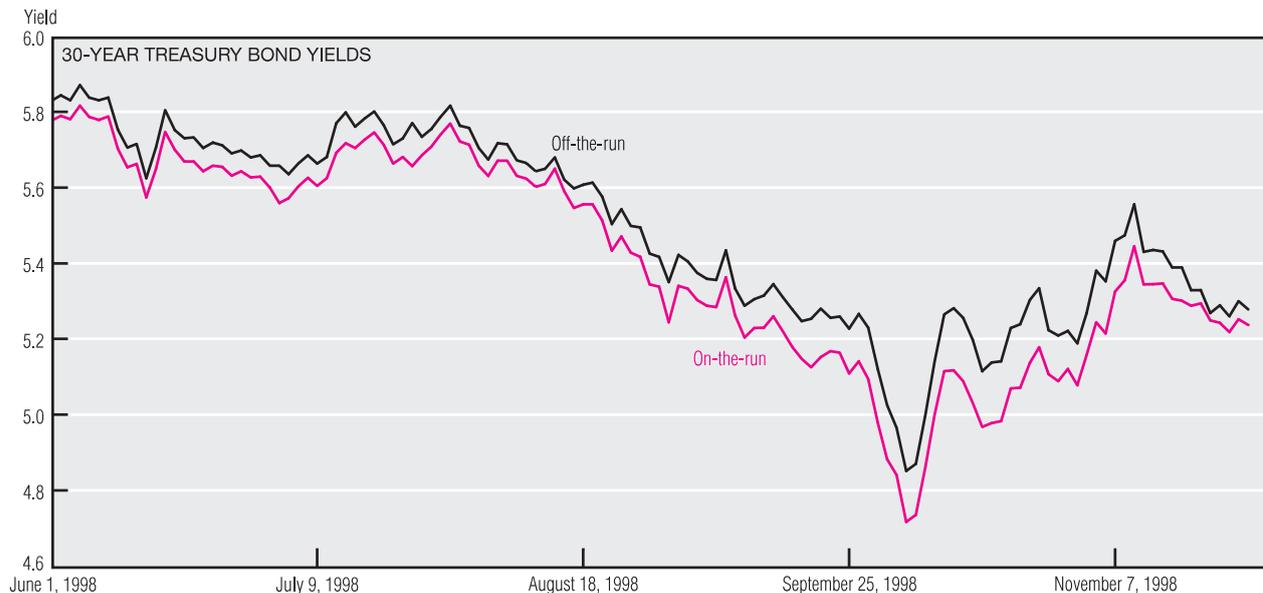
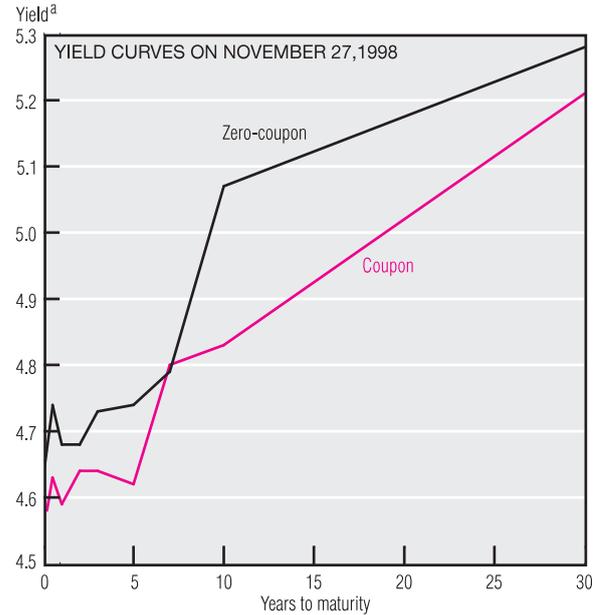
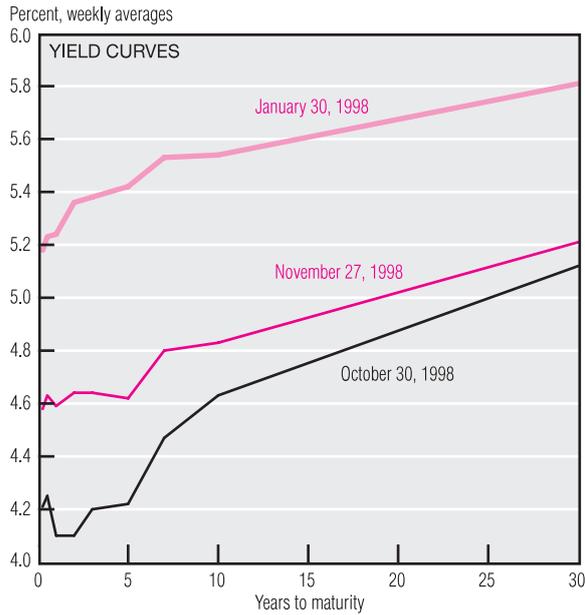
SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland; Standard and Poor's Corporation; and DRI/McGraw-Hill.

Rapid money-supply growth in recent years has received scant attention in the financial press. Since 1996, the M2 measure of money has increased at an average annual rate of more than 7%. With little or no evidence of accelerating inflation, strong money growth has been eclipsed by concerns that troubled foreign markets could undermine domestic economic conditions. Policy actions seem to have focused on assuaging fears that financial market disruptions in Asia and Eastern Europe could continue to spread.

But what accounts for the strength in money? One hypothesis is that households and investors typically increase their holdings of money market funds when equity prices and transaction volume swing sharply. Both retail and institutional money funds serve as a temporary parking lot for funds associated with stock transactions, and retail funds are included in M2. Moreover, skittishness about stock prices leads to increased demand for relatively safe assets during periods of turbulence.

Preliminary research suggests that large movements in stock prices, whether up or down, are indeed associated with rapid money-fund growth. Since money funds comprise more than 28% of M2, much of the M2 bulge has been attributed to recent stock market conditions. Estimates of the direct effect of stock prices on M2, however, are less supportive of the hypothesis. Although statistically significant, such effects do not account for all the strength in M2. Thus, much of the recent strength in money remains a puzzle.

Interest Rates



a. For zero-coupon bonds, the yield is the average of yields on zero-coupon Treasury bonds maturing in the same month, as of November 27, 1998.
 SOURCES: Board of Governors of the Federal Reserve System, "Federal Reserve Statistical Release H.15: Selected Interest Rates," November 30, 1998, <http://www.bog.frb.fed.us/releases/H15/>; the *Wall Street Journal*, November 30, 1998; and Bloomberg information services.

Over the past month, interest rates on Treasury securities have shifted higher across the board. This has moved the yield curve upward, although it remains well below its position at the start of the year. The curve has also become somewhat smoother, with the 3-year, 3-month spread increasing from -11 to +1 basis points, and the 10-year, 3-month spread decreasing from 42 to 25 basis points.

The somewhat jagged short end of the curve is reflected in the yield

curve for zero-coupon bonds as well. Compared to early this year, however, the zero curve has resumed its classic position. Rates on short-term zeroes exceed those for Treasuries of comparable maturities, as one would expect of less liquid securities. For long bonds, coupon payments effectively shorten the duration on Treasuries, so that an upward-sloping curve produces a higher yield on zeroes.

Recent concern about "flight to liquidity" and hedge-fund invest-

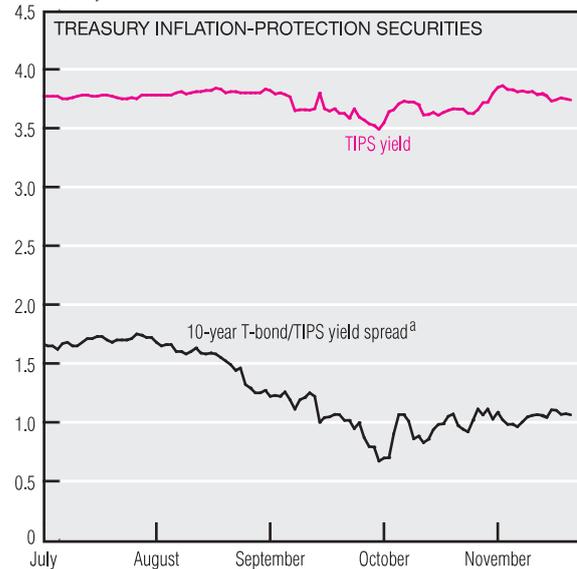
ments has focused attention on the spread between *on-the-run* and *off-the-run* Treasury bonds. The on-the-run, 30-year bond is the most recently issued, and it is the most liquid. Other bonds, called off-the-run, are less liquid and hence less desirable. They sell for a lower price and consequently show a higher yield. In early summer, the spread between the two types of bonds stayed around 50 basis points, but the collapse of the
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Interest Rates (cont.)

Percent, weekly averages



Percent, daily numbers



Percent, weekly averages



a. 10-year Treasury bond constant-maturity yield minus the yield quote for the TIPS-adjusted series.

b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.

c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.

SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

Russian ruble in August caused the spread to double and then triple, peaking at a high of 168 basis points in late October. Since then, spreads have returned to the neighborhood of 40 basis points; one explanation for their return is that liquidity concerns have abated.

Quality spreads have not completely readjusted. Although the spread between corporate Baa bonds and 10-year Treasuries decreased by nine basis points this month, it remains well above its

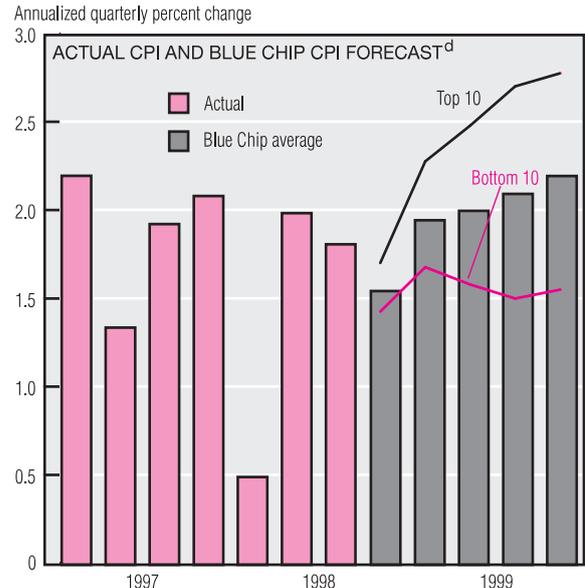
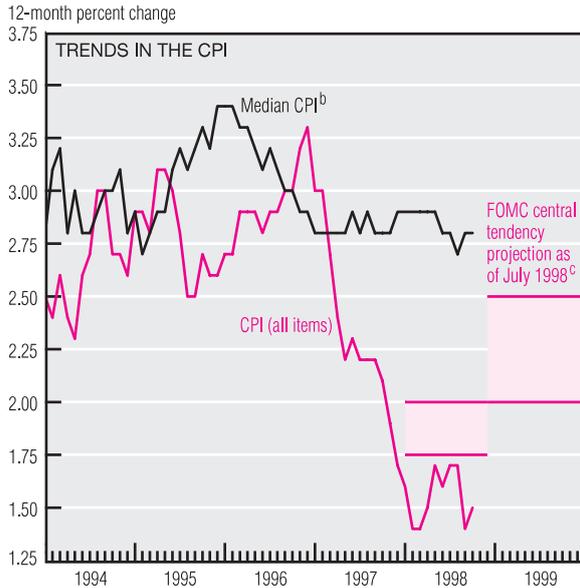
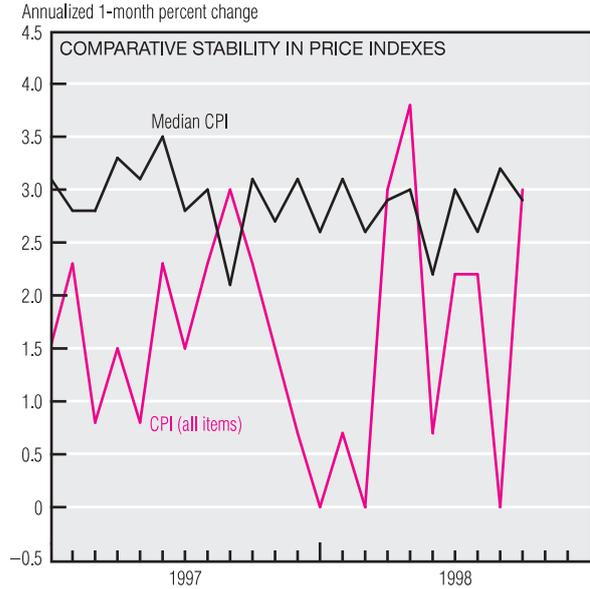
levels earlier in the year.

Other spreads suggest that the flight to quality is reversing. With the exception of Treasury yields, capital market rates have remained flat from the previous month. The 30-year Treasury bond's spreads below A-rated utilities and conventional mortgages have narrowed by seven and 13 basis points, respectively, while its spread above municipal bonds has widened by eight basis points. Flight to quality is still an issue.

The spread between yields on 10-year Treasury bonds and 10-year Treasury inflation-protected securities (TIPS) has not changed recently, although both yields have increased slightly. One might attribute November's rise in longer-maturity Treasury rates to higher inflation expectations after the Fed lowered the federal funds rate, but the relatively constant spread of the longer-term rates over the TIPS yield contradicts this explanation.

Inflation and Prices

	Percent change, last:				1997 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	3.0	1.7	1.5	2.4	1.7
Less food and energy	2.1	2.3	2.3	2.6	2.2
Median ^b	2.9	2.9	2.8	3.0	2.9
Producer prices					
Finished goods	2.8	0.6	-0.7	1.1	-1.2
Less food and energy	0.8	1.7	1.1	1.3	0



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 c. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
 d. Blue Chip panel of economists.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; and *Blue Chip Economic Indicators*, November 10, 1998.

The Consumer Price Index (CPI) increased at an annualized 3% rate in October, twice its average pace for the past year. However, there was no change in September, and the CPI has risen at an annualized pace of only 1.7% over the last three months.

The recent wide swings in inflation as reported by the CPI are typical of this relatively volatile index, which has fluctuated between 0% and 3¼% over the past year. While much of this volatility has resulted

from wide variations in the price of petroleum products, several other items have also shown large price swings. The median CPI, however, which filters out such extreme price readings, has followed a steadier path, varying within a range of 2¼% to 3¼% during the same period.

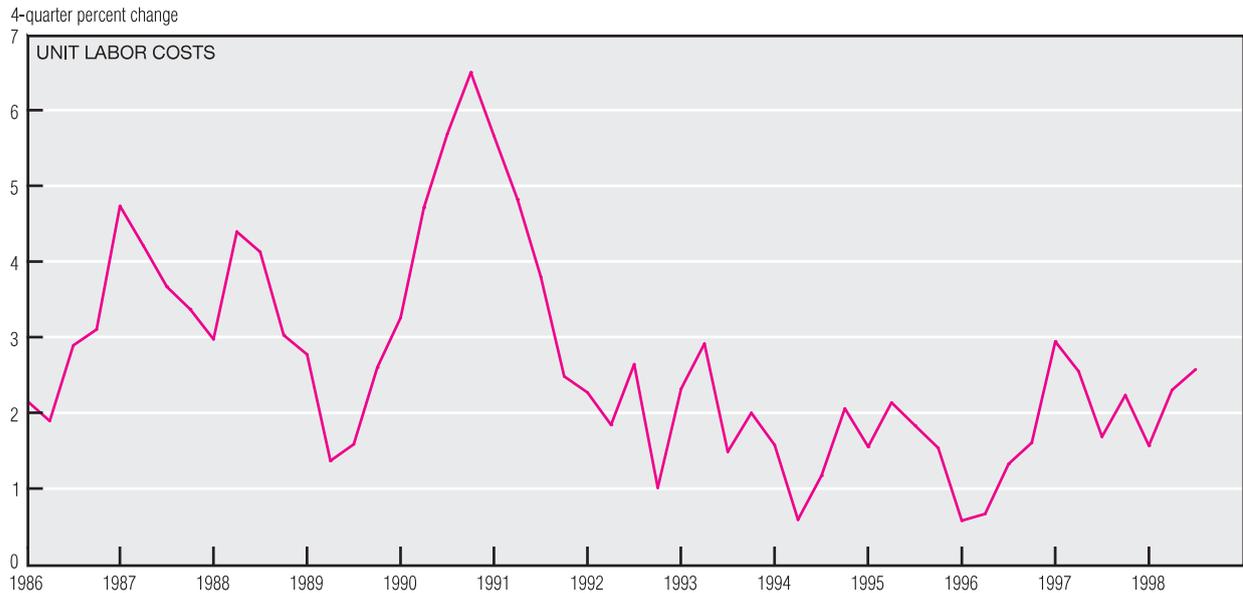
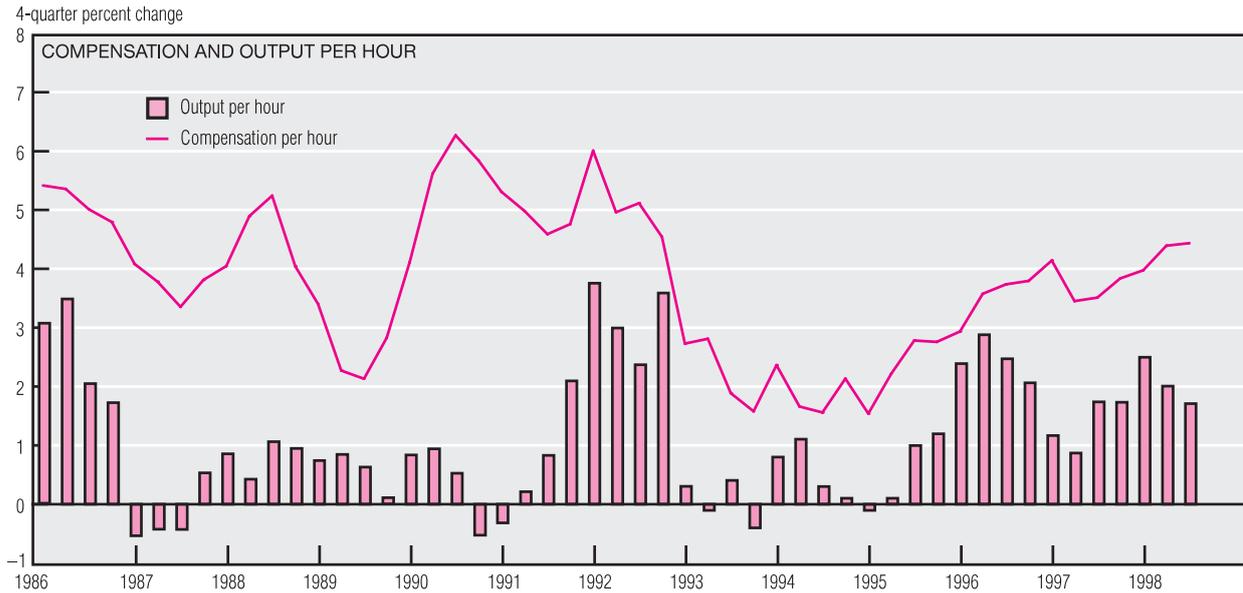
Besides being less volatile, the median CPI has been tracking at a much higher level than the overall CPI; indeed, it has been more than one percentage point higher for the past 12 months. Which of these two

trends more accurately represents the economy's inflation path is still unknown. The CPI is currently running well below the Federal Open Market Committee's 1998 and 1999 projections for the index, and the median CPI is considerably above that range.

According to many economists, the inflation trend as measured by the CPI is headed higher; not surprisingly, however, there is a wide range of opinion on its trajectory.

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Inflation and Prices (cont.)



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

Inflation optimists do not expect the CPI trend to stray far from its recent 1½% level, while inflation pessimists expect it to move sharply higher, reaching 2¾% by the end of next year.

Inflation pessimists have been especially attentive to the gradual but persistent rise in the rate of labor compensation. Indeed, the growth rate of compensation per hour, which held steady at around 2% over the three-year period ending in 1995, began picking up in 1996 and has continued to climb since then. Over the past four quarters, the

growth rate of hourly compensation in the nonfinancial business sector reached about 4½%, a level not seen since 1992.

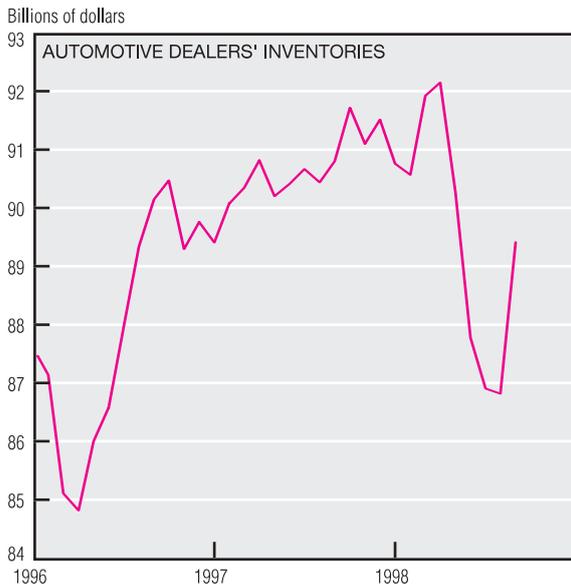
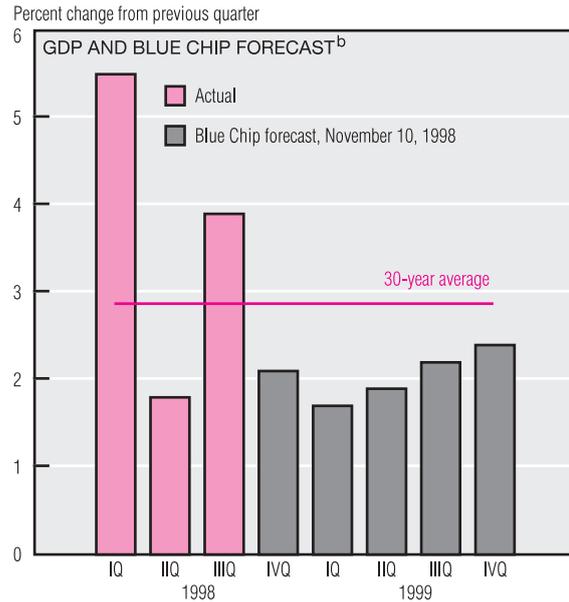
Higher labor compensation does not necessarily imply a potential for more inflation, as long as it is accompanied by higher worker productivity. In 1992, for example, the growth rate of output per hour averaged about 3% per year, a relatively high level. In 1995, when compensation began to move higher, it too was accompanied by increased worker productivity. But in recent quarters, the gap in the

trend rates of compensation growth and output-per-hour growth have been widening.

By subtracting the growth rate of productivity from that of labor compensation, economists get *unit labor costs*, an alternative measure of inflationary pressure. Unit labor costs have been relatively subdued over the current economic expansion, hovering mostly in the range of 1% to 2%. Since 1997, though, unit-labor-cost increases have been in the 2% to 3% range, lending support to the inflation pessimists' position.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	71.4	3.9	3.5
Consumer spending	51.7	4.1	4.7
Durables	4.2	2.3	7.9
Nondurables	8.0	2.1	3.6
Services	38.2	5.4	4.7
Business fixed investment	-3.0	-1.2	8.5
Equipment	-2.2	-1.1	12.7
Structures	-0.7	-1.4	-1.9
Residential investment	6.4	8.5	11.8
Government spending	5.2	1.6	0.9
National defense	3.3	4.5	-2.1
Net exports	-8.7	—	—
Exports	-4.7	-1.9	-2.1
Imports	4.0	1.3	8.0
Change in business inventories	18.4	—	—



a. Data in billions of chained 1992 dollars. Changes over time in chained-type detailed components of GDP need not sum to changes in more aggregated values.
 b. Blue Chip panel of economists.
 NOTE: All data are seasonally adjusted.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and *Blue Chip Economic Indicators*, November 10, 1998.

Real gross domestic product increased at a 3.9% annual rate in 1998:IIIQ, according to preliminary estimates released in late November. This was stronger than both the 3.3% advance estimates released a month earlier and the 2.1% Blue Chip forecast of sluggish-but-strengthening growth through the end of next year. Consumption spending and inventory investment accounted for the bulk of the increase, with smaller additions to residential investment and government spending. Expenditures on producers' durable equipment

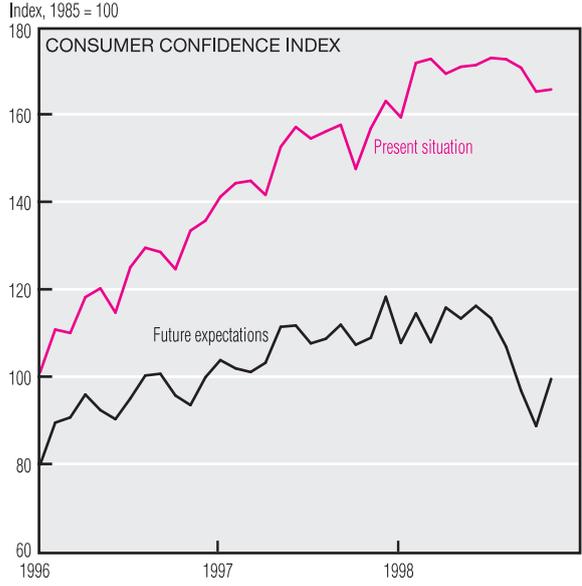
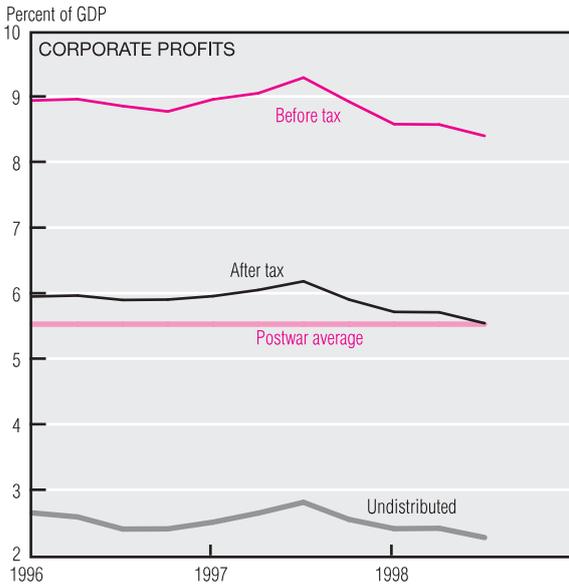
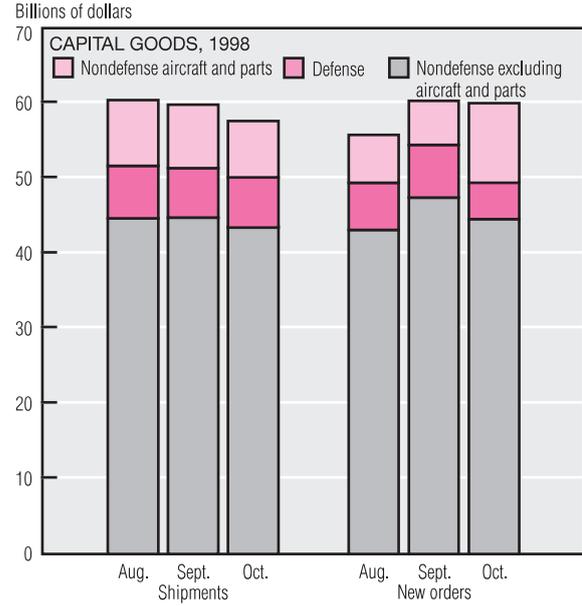
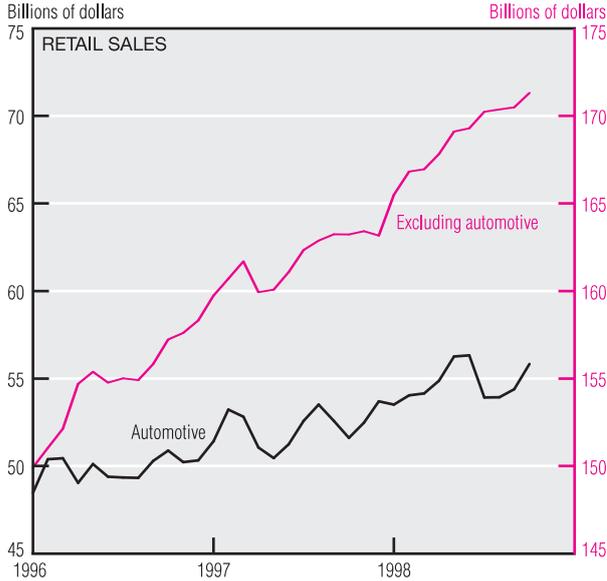
declined very slightly, business investment in structures fell for the third consecutive quarter, and net exports continued to recede.

The substantial amount of inventory investment could have included unintended accumulations if aggregate demand were waning because of uncertainties surrounding foreign and financial market disturbances. Alternatively, accumulations in 1998:IIIQ could have been intended to offset the previous quarter's low level, which reflected strikes at some General Motors parts plants in June and July. Dealers' inventory levels

dropped sharply from April through July before rebounding in September. Unfortunately, changes in these monthly observations don't reconcile with the record of quarterly inventory changes in the GDP accounts, which show continued decumulation in the third quarter. In any case, automotive-related inventory investment does not dominate recent inventory behavior. Nonautomotive inventories showed an identical, but larger, swing in the second and third quarters.

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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 The Conference Board, Inc.

Strength in consumption spending apparently has continued into the current quarter. Retail sales, both automotive and nonautomotive, rose smartly in October. Consistent with this spending increase, personal saving out of disposable personal income (not shown here) was negative for the second consecutive month. Households financed purchases with even more borrowing and asset drawdowns than in September.

Weakness in business fixed investment seems persistent. Capital goods shipments and new orders showed no sign of strengthening in October.

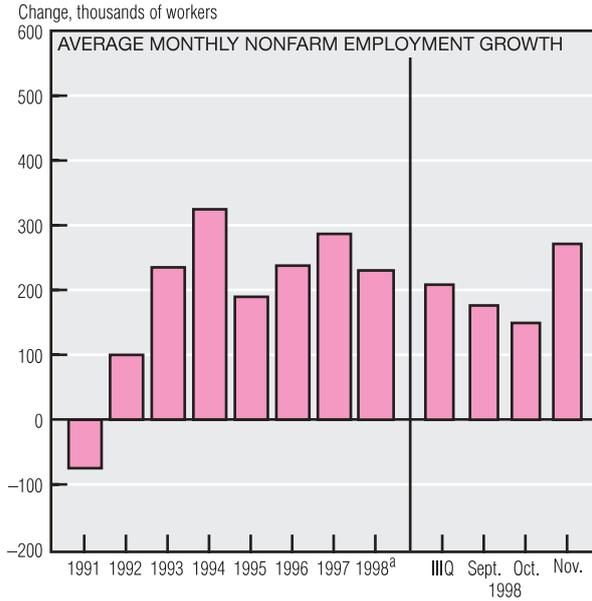
Shipments of nondefense capital goods declined in both the nonaircraft and the more volatile aircraft sectors. New orders, which increased more than 40% in the nondefense aircraft sector, were offset by declines in the remaining nondefense and defense sectors.

Profitability plays a critical role in investment, of course. The preliminary GDP release included the first estimate of corporate profits for 1998:IIIQ. In current dollars, profits (including inventory valuation adjustment and capital consumption allowance) declined somewhat, both before and after taxes, as well as

after distributions. As a share of GDP, after-tax profits have dropped about 10% from a year ago to the level of their long-run average for the years since World War II.

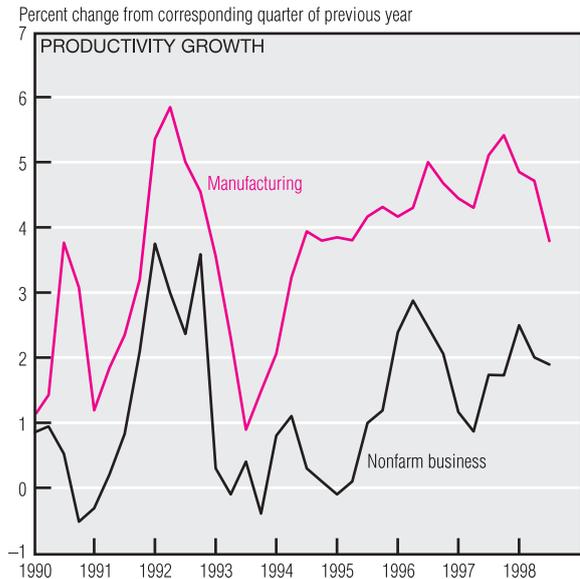
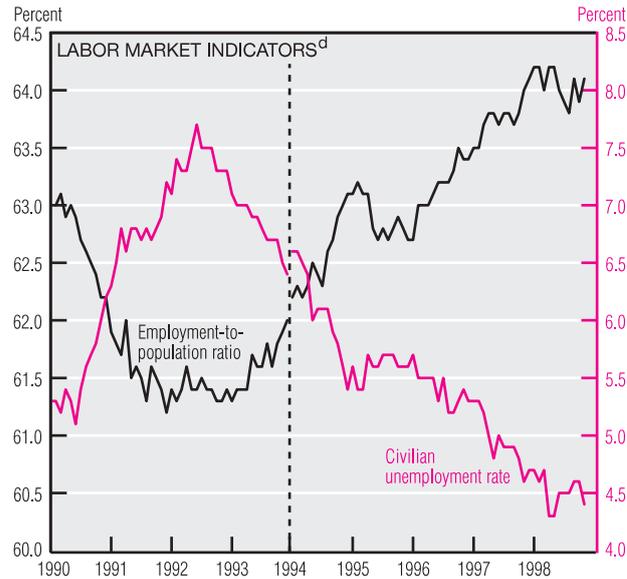
Consumer confidence seemed to have been battered by the summer stock market sell-off and the Russian financial collapse. Despite September's hedge fund difficulties, however, consumers expressed no less confidence about the present situation in October than they had a month earlier, while their confidence in the future was considerably stronger.

Labor Markets



Employment	Average monthly change (thousands of employees)				
	1995	1996	1997	YTD ^a	Nov. 1998
Payroll employment	185	233	282	226	267
Goods-producing ^b	8	31	42	1	-3
Manufacturing	-1	3	21	-19	-47
Construction	10	28	20	23	47
Service-producing	178	202	240	225	270
Business services	38	45	61	40	55
Retail trade	37	42	34	38	65
Department stores	2	3	5	6	19
FIRE ^c	-1	14	17	22	23
Household employment	32	232	240	125	477

	Average for period (percent)				
Civilian unemployment	5.6	5.4	5.0	4.5	4.4



NOTE: All data are seasonally adjusted.
 a. Year to date.
 b. Includes other industries not listed separately.
 c. Finance, insurance, and real estate.
 d. Vertical line indicates break in data series due to survey redesign.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Labor markets showed renewed signs of strength in November. The unemployment rate dropped to 4.4%, ending its steady increase from the 28-year low achieved in May. Nonfarm payrolls rose sharply compared to the tepid increases of September and October. Productivity for the summer was revised upward.

Businesses increased payrolls 267,000 in November, a strong gain that pushed total job creation to about 2.5 million for the year so far. A considerable increase in service-

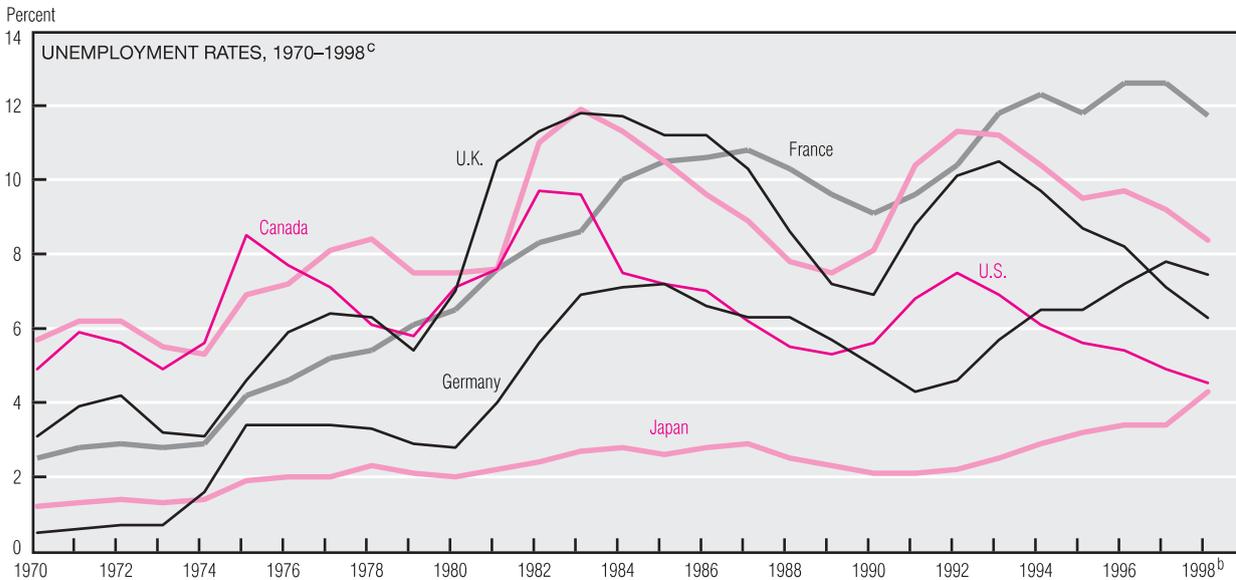
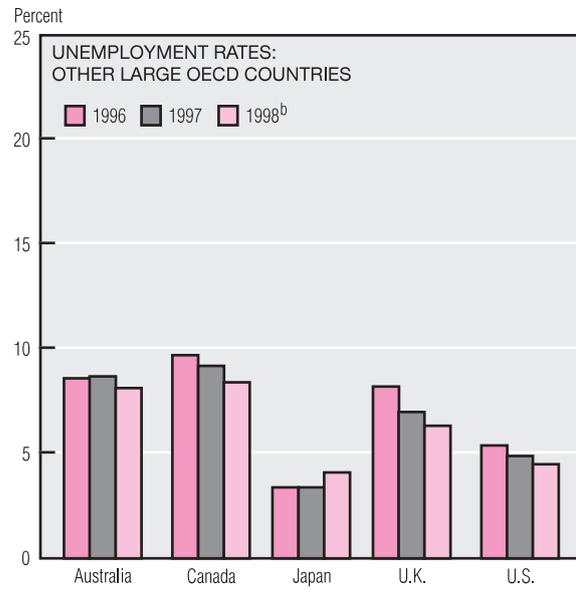
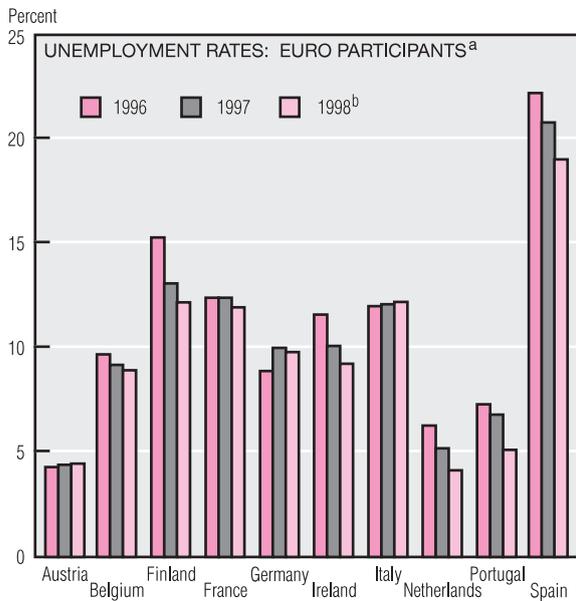
producing jobs was offset slightly by job losses in manufacturing. Led by declines in industrial machinery and electronic equipment, manufacturing payrolls fell 47,000. Gains in service-producing jobs were led by business services, retail trade, and finance, insurance, and real estate.

Employment increased 477,000, as measured by the household survey; unemployment fell 200,000, pushing the unemployment rate down to 4.4%. For the previous two months, the rate had held steady at 4.6%. The percent of the population

employed increased to 64.1%, approaching the record high (64.2%) attained this January.

Although employment growth in the third quarter was slow, output per worker grew substantially. Nonfarm business productivity, which measures average hourly output per worker, grew at an annual rate of 3.0% in 1998:IIIQ, and by 1.9% from 1997:IIIQ. The manufacturing sector, which suffered job losses of 49,000 in 1998:IIIQ, showed a productivity increase of 3.8% from 1997:IIIQ.

International Unemployment Rates



a. All participants except Luxembourg.
 b. Year to date.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Organisation for Economic Co-operation and Development (OECD).

The imminent European currency unification has focused more attention on the relative performance of various countries' economies. Substantial differences in unemployment rate levels among Euro participants have continued, despite attempts to harmonize their economies. Even their recent unemployment trends differ substantially: rates in Germany, France, Austria, and Italy show little improvement, while the labor-market conditions of

other Euro participants have improved noticeably.

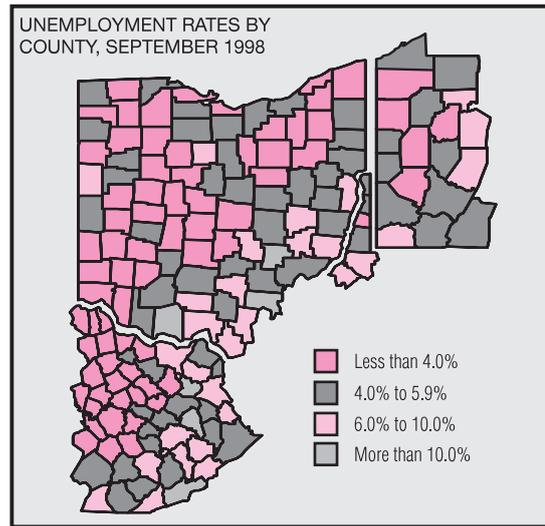
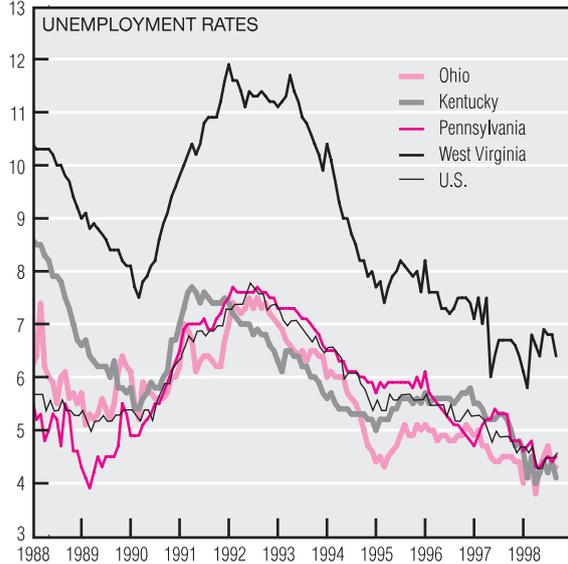
Other major economies also exhibit meaningful differences in the levels and trends of their unemployment rates. These countries allow their exchange rates to fluctuate against their trading partners and thus may be able to use monetary policy for economic stabilization. As Canada and the U.S. amply demonstrate, however, exchange-rate flexibility need not eliminate substantial unemployment rate differences, even

in economies with close trade links.

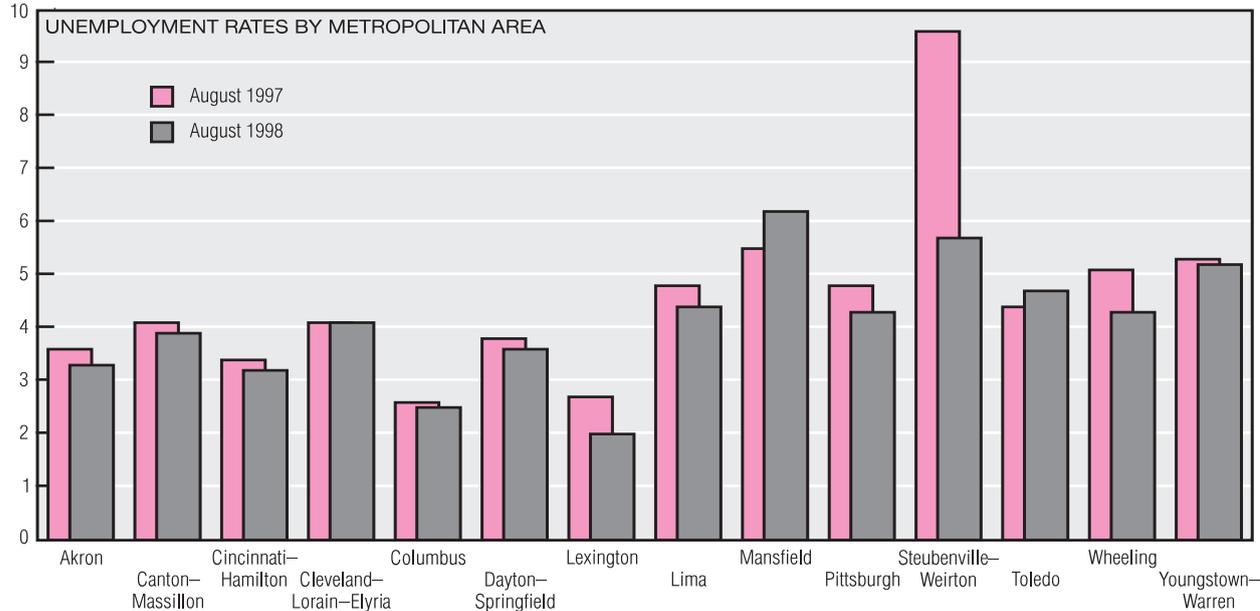
For comparisons over the long run, the U.S. Bureau of Labor Statistics maintains a data series on relative unemployment rates which attempts to account for differences between U.S. and foreign methodologies. This series shows very persistent differences in international unemployment rates, pointing to long-run factors such as national unemployment compensation systems or cultural attitudes toward the unemployed.

Fourth District Unemployment

Percent of labor force, seasonally adjusted



Percent



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; 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.

Over the last year, unemployment has been dropping steadily in most of the Fourth Federal Reserve District. Kentucky and Pennsylvania have shown the most improvement, with unemployment down 1.1% and 0.8%, respectively, since September 1997. Unemployment rates declined in all but two of the District's metropolitan areas (Mansfield and Toledo) over the year ended September 1998. Nearly half the counties in the District have unemployment rates below 4.0%, and rates in Ohio, Kentucky,

and Pennsylvania are below the national average.

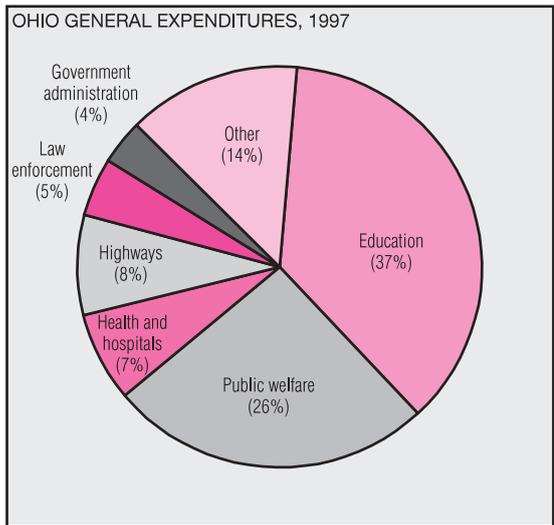
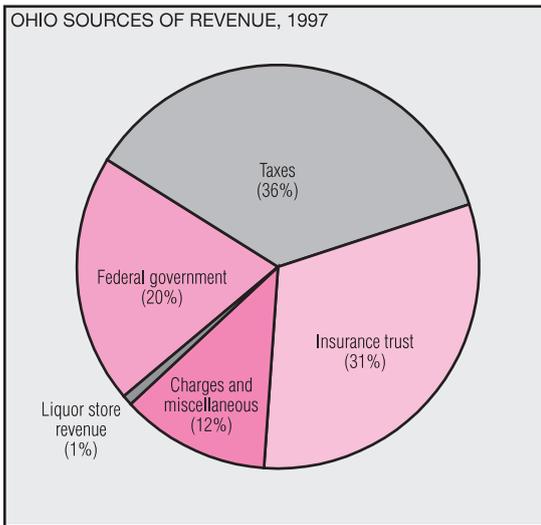
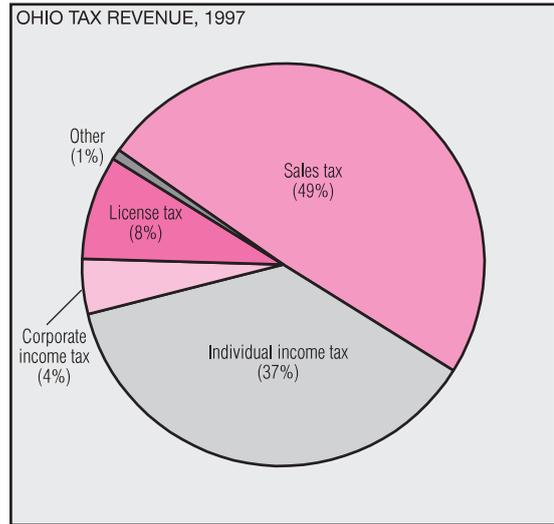
Despite the bright outlook for most of the District, there is wide variation in unemployment rates among different areas. Kentucky is a prime example. In several counties near Lexington, unemployment has dipped below 2.0%, and rates are quite low in the entire I-75 corridor, which traces the Fourth District's western boundary. However, this current wave of prosperity has missed several of the counties near Kentucky's eastern

border. Magoffin County recorded a September unemployment rate of 13.3%, while Harlan County posted a rate of 11.7%.

West Virginia's unemployment rate continues to exceed rates in other District states. However, the West Virginia counties that are part of the Fourth District appear to be doing better than the rest of the state. The high unemployment rate in the Steubenville–Weirton metropolitan area has eased over the last year, while Wheeling's rate has fallen to 4.3%.

Ohio's Budget

	Per capita rank	Per capita tax revenues (dollars)	Tax revenues/ Total personal income (percent)
Alaska	1	2,659	10.9
Hawaii	2	2,601	10.4
Connecticut	3	2,491	7.5
Minnesota	4	2,395	9.4
Delaware	5	2,381	8.7
Ohio	35	1,468	6.2
U.S. average	—	1,660	6.9



NOTE: Shares do not sum to 100 due to rounding.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

In 1997, Ohio's state government collected \$16 billion in tax revenues. This came to \$1,468 per person, a little less than the national average of \$1,660, and put Ohio in 35th place among the states. As a share of personal income, Ohio's state taxes amounted to 6.2%, compared to the national average of 6.9%.

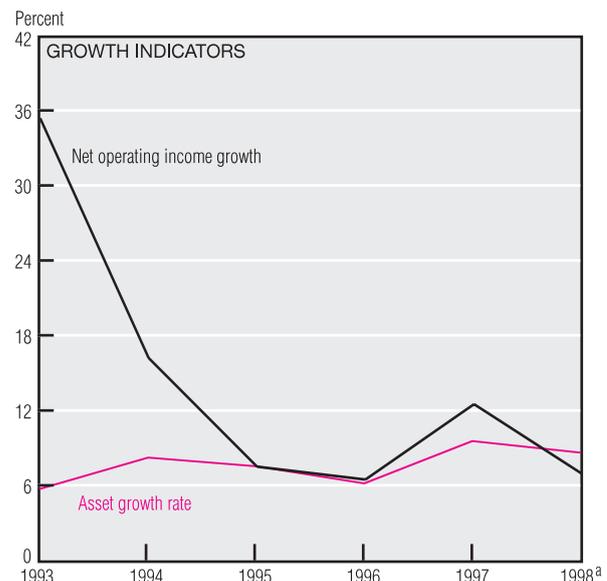
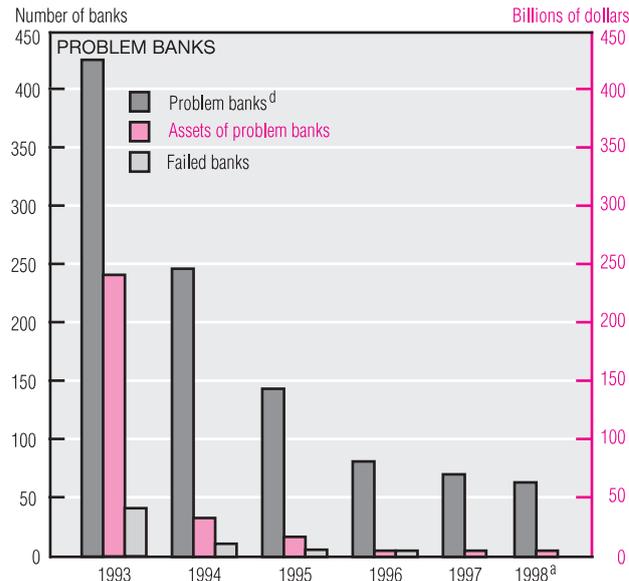
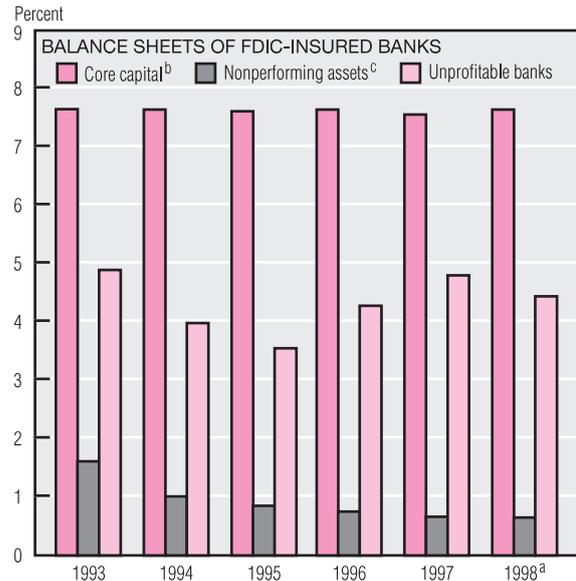
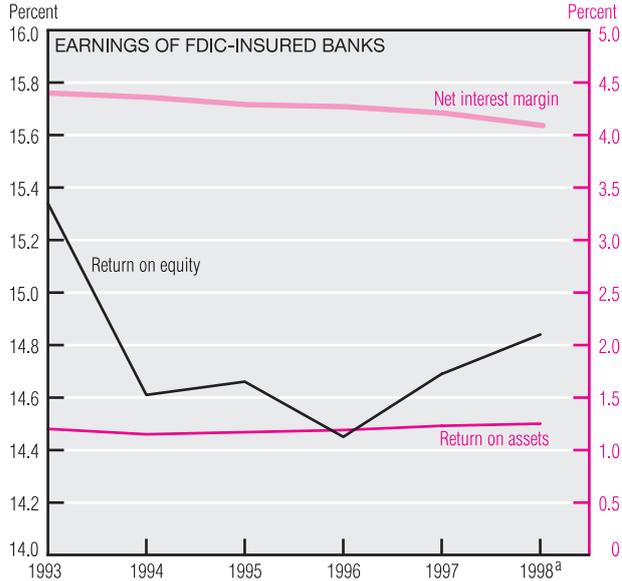
About half of Ohio's tax revenue comes from sales taxes. Individual income taxes are the second-largest source, bringing in about 37% of all tax revenue.

The state also collects revenue from many nontax sources. In fact, taxes provide only 36% of Ohio's total revenue of \$45 billion, while federal funds supply \$9 billion, or 20% of the total. Revenue from state insurance trusts like employee retirement funds, workers' compensation, and unemployment compensation brings in another 31%, almost as much as taxes provide. Other sources include various charges and fees as well as liquor store revenue.

The Ohio government's largest expenditure is education, which accounts for 37% of general state spending. The second-largest expenditure is welfare, which takes another 26% of the budget. All told, Ohio spent \$30 billion on general expenditures in 1997, and a total of \$37 billion.

There is a difference of about \$8 billion between total revenue and total expenditures, but the difference is almost entirely accounted for by a buildup in state insurance trusts to fund future obligations.

Banking Conditions



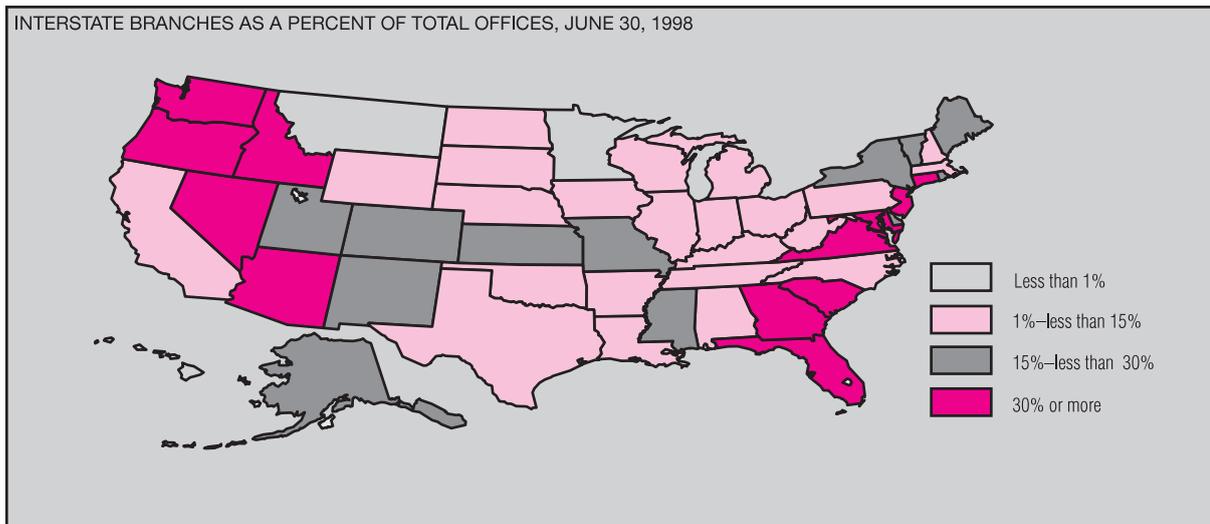
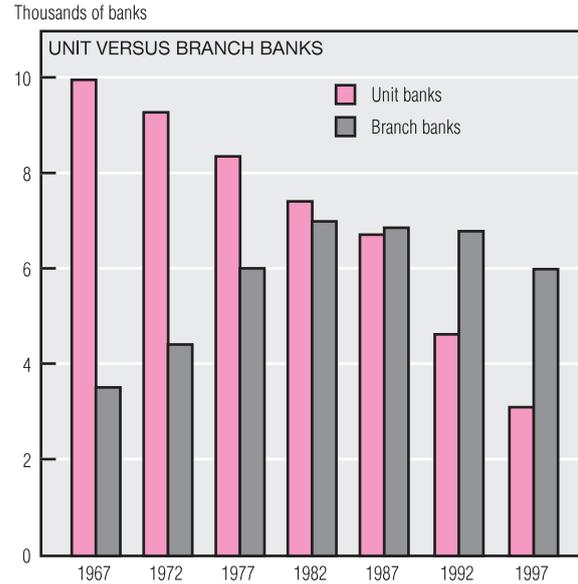
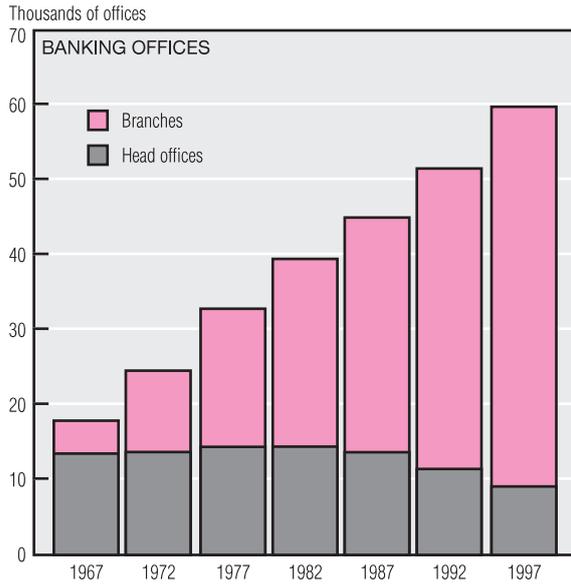
a. Data are for first half of 1998.
 b. Common equity capital, noncumulative perpetual preferred stock, and minority interest in consolidated subsidiaries, less goodwill and other ineligible intangible assets, as a percent of total assets.
 c. Noncurrent assets plus other real estate owned as a percent of total assets.
 d. Banks defined by the FDIC as having financial, operational, or managerial weaknesses that threaten their continued financial viability.
 NOTE: All data are for FDIC-insured commercial banks.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, June 1998.

Balance sheets of insured banks show continued health. During the first half of 1998, bank profitability remained strong, with the net interest margin hovering above 4% and return on equity exceeding 14.8%. For the same period, more than 95% of commercial banks posted positive profits. Core bank capital is another indicator of strength: For the fifth straight year the core capital ratio—defined as common equity capital, noncumulative perpetual

preferred stock, and minority interest in consolidated subsidiaries, less goodwill and other intangible assets, as a percent of total assets—exceeded 7.5%. Asset quality also appears to be improving, with nonperforming assets falling to 0.65% of total assets. Another sign of a robust banking industry is the decline in problem banks. From 1993 to 1998, the number of such banks declined from 426 to 64. Over the same period, assets held by problem banks fell from

\$242 billion to \$5 billion. There have been virtually no bank failures for the past three years. Finally, for the same three-year period, bank assets and net operating income have grown 6% to 12% annually. The banking sector should continue to grow at current rates without compromising the recent trend in profitability or, more importantly, the improved quality of its assets.
(continued on next page)

Banking Conditions (cont.)



NOTE: All data are for FDIC-insured commercial banks.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, June 1998.

Passage of the 1994 Reigle–Neal Interstate Banking and Branching Efficiency Act has further accelerated the banking industry’s consolidation. The number of U.S. banks has declined from 13,506 in 1967 to 9,125 in 1997. Yet, even as that number has fallen, the number of banking offices has risen from 30,371 to 68,898. This tally does not include alternative vehicles for delivering banking services, such as automated

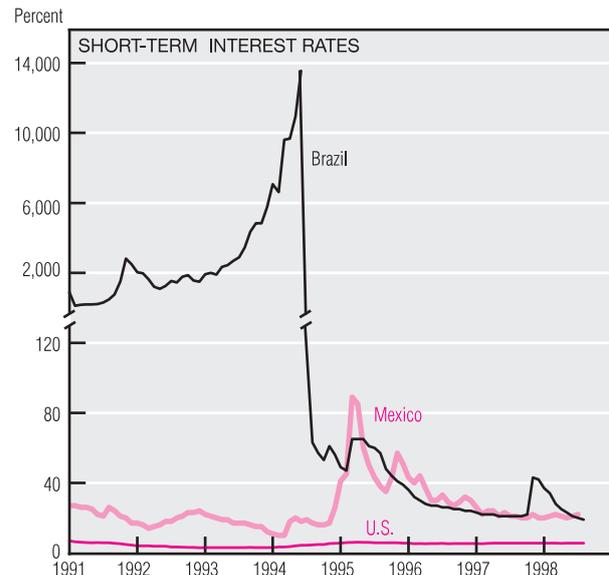
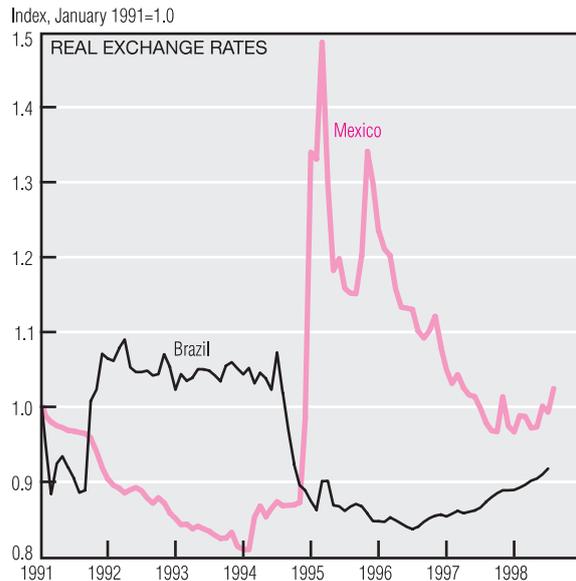
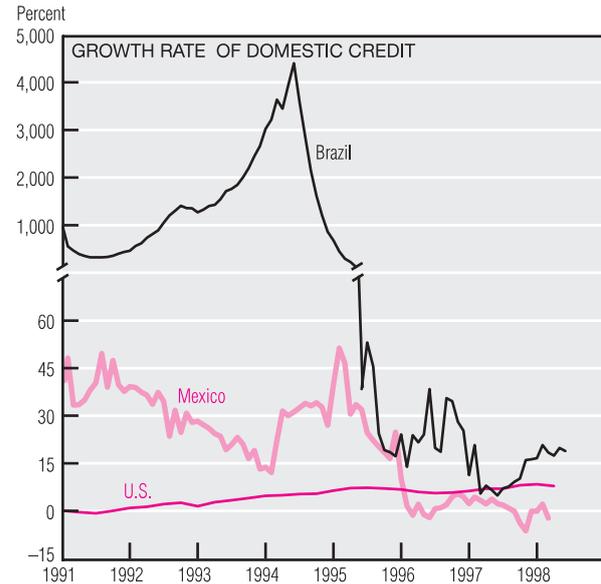
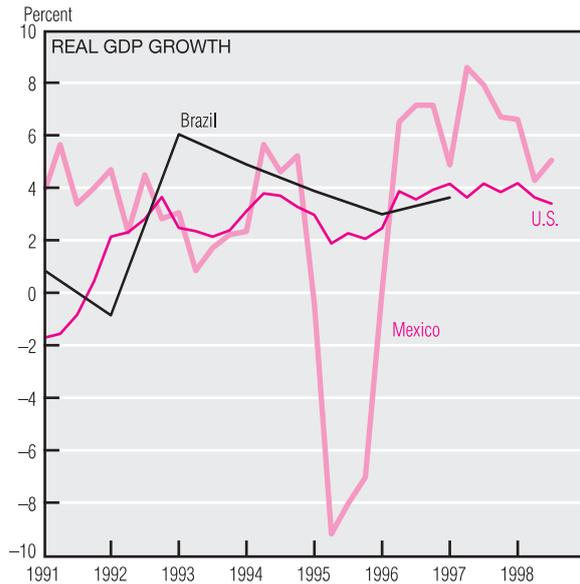
teller machines, telephone banking, and online banking. Thus, while the number of banks continues to decline, the availability of banking services arguably has increased for the average consumer.

Despite the relaxation of intrastate and interstate restrictions over the past two decades, unit banks continue to play an important role as an organizational form in the banking industry. Of the 9,125 banks in existence in 1997, over one-third had

only a single banking office.

However, consolidation continues apace elsewhere in the industry, as evidenced by the large number of states reporting that more than 15% of their bank branches belong to out-of-state banks. This number undoubtedly will continue to grow as institutions such as Bank of America and NationsBank, both prominent interstate players, continue to consolidate.

International Developments



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

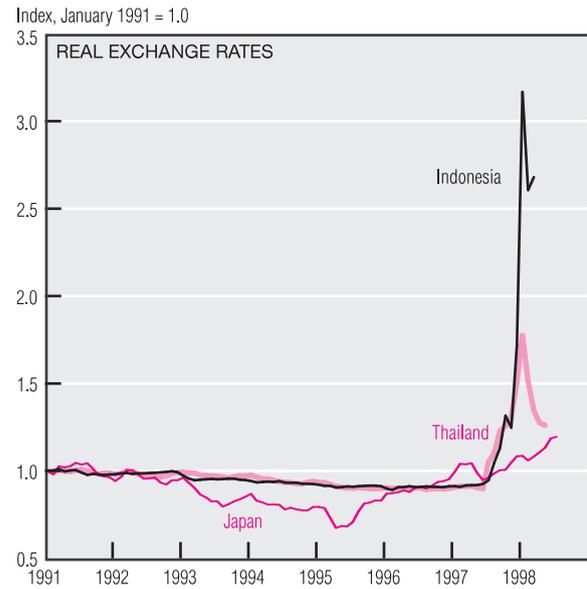
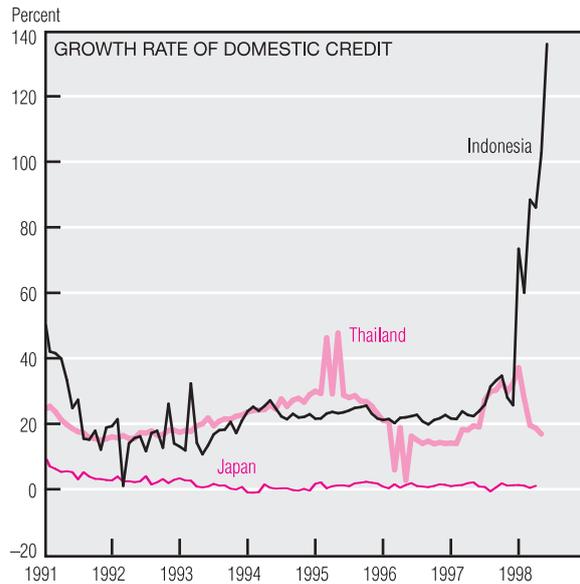
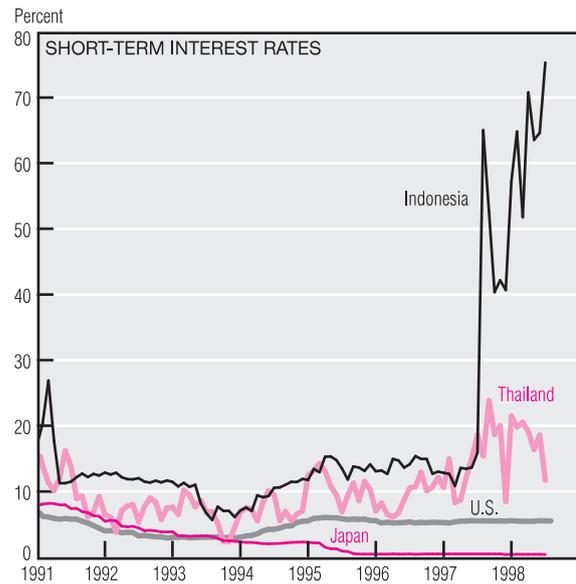
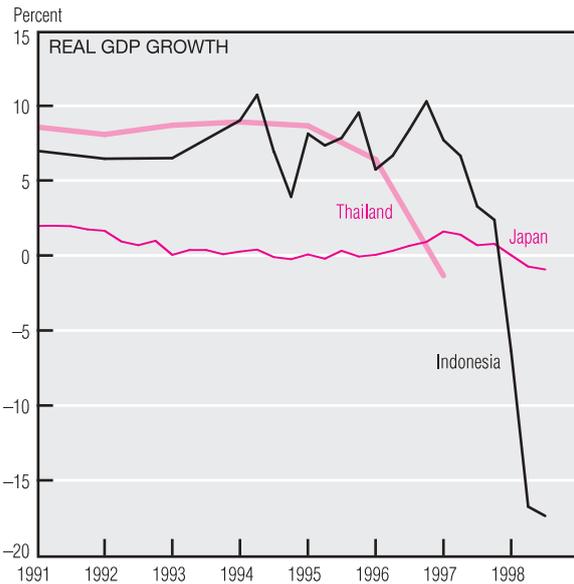
It is tempting to apply lessons from the Mexican currency crisis of 1994–95 to the Asian crises of 1997. A key factor in both regions was the inability of banking supervisors and regulators to pinpoint buildups in bad loan portfolios. High growth rates of domestic credit facilitate these buildups, creating vulnerability to interest rate increases. Such increases might be used to defend a currency against capital outflows, highlighting the role of domestic monetary policy and the exchange rate regime.

A fixed exchange rate requires the central bank to sell its own currency during capital inflows and to buy it during capital outflows. Either way, the impact on the domestic money supply and the banking system must be gauged. A floating exchange rate permits monetary policy independence from the rest of the world but implies riskier foreign exchange markets. Logically, the choice of the exchange rate regime might be linked to the strength of domestic banking supervision and regulation.

External developments also play a key role in currency and banking crises. For example, interest rate increases in industrialized countries contribute to currency crises by stimulating capital outflows. Either a depreciation in the dollar value of the currency or an increase in the foreign inflation rate implies a loss of export competitiveness, with negative implications for real growth. This is consistent with the finding that a slowdown in growth is a useful predictor of currency crises.

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International Developments (cont.)



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

Mexico's GDP growth had been strengthening prior to its currency crisis, but in early 1994 domestic credit grew sharply and the real exchange rate for the peso deteriorated. Higher U.S. interest rates pressured the Bank of Mexico to defend its exchange rate vis-à-vis the dollar. Mexican interest rates eventually were allowed to increase, and the peso was allowed to float. Although by many measures the Mexican economy has rebounded (with the help of a multinational financial aid package engineered largely by the U.S.), the real exchange rate remains

higher than it was before the crisis. Although domestic credit growth has slowed, observers remain concerned about the condition of the Mexican banking system.

Similarly, Brazilian credit growth and interest rates skyrocketed in the early 1990s as real growth slowed. Currency revaluations in 1994 put Brazil on a more stable path, and its currency is now tied to the U.S. dollar by means of a "crawling peg."

The currencies of both Thailand and Indonesia were also tied to the dollar, creating dynamics similar to those in Mexico. Although declining

U.S. interest rates in 1992 might have influenced the credit buildup in East Asia, no sudden increase in U.S. rates can be blamed for the capital outflows of 1997.

The proximity of the U.S. to Latin America and of Japan to East Asia suggests that each superpower might lower interest rates to stimulate its neighbors. However, Japanese rates cannot be lowered further. While cutting U.S. rates might help East Asia, the region's recovery will still be heavily influenced by economic events in Japan.