The Economy in Perspective

The Policy Road Not Taken

(*with apologies to Robert Frost*)

Two roads diverged, the Committee stewed;
And sorry they could not travel both
And make no blunders, long they stood
And looked down both as far as they could
To gauge future economic health.

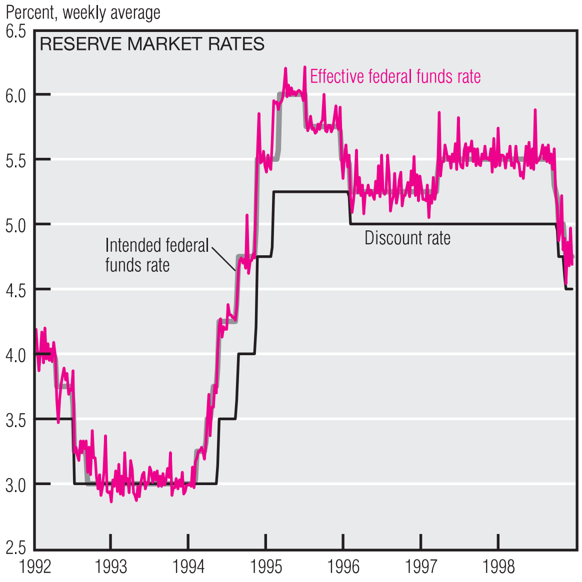
With money and credit expanding fast
And asset prices bubbling higher,
They saw dark specters from nations' past.
But today's demands mold policy's cast,
And history yields to human desire.

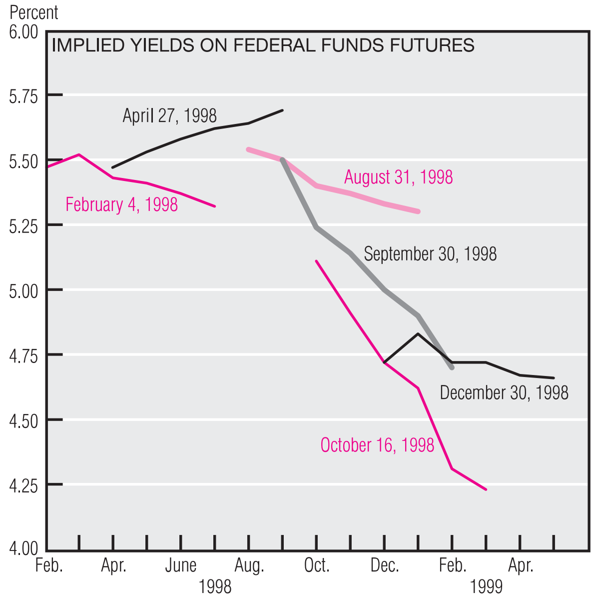
They eased down the fork with the lower rate,
Thinking it had the better claim
Of sustaining growth with no abate;
And fearing that to hesitate
Would bring catastrophe and blame.

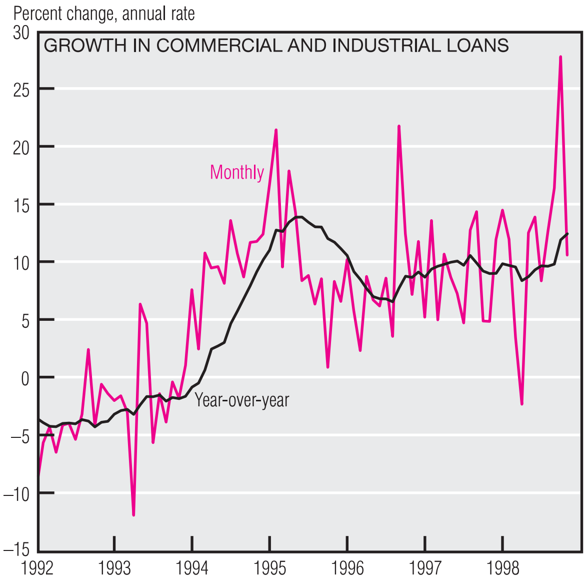
Monetary restraint they kept at bay
For inflation's face had not loomed clear;
That course was reserved for another day!
But output always verges on decay
(Or else financial strains rouse fear).

Sages may tell this with a sigh
Somewhere ages and ages hence:
Two paths diverged and, danger nigh,
They took the one more traveled by,
And that made all the difference.

Monetary Policy







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

The autumn of 1998 was the most active season for monetary policy in several years. In the span of seven weeks, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate in three decrements of 25 basis points each—two at scheduled meetings in September and November and one in the intermeeting period. The latter two changes were coupled with commensurate reductions in the discount rate. At its last meeting on December 22, the FOMC did not alter the intended fed funds rate.

The spate of policy actions was not fully anticipated. In April, the predominant expectation was that the FOMC's next move would be to increase the funds rate. By late August, futures prices of fed funds implied an expectation that the next policy move would be a decrease, but the immediacy of the three actions was a surprise, even by late September.

Evidence of surprisingly strong domestic spending in early 1998 suggested that the potency of U.S. domestic spending was sufficient to offset any threat posed by the economic turmoil in Asia. Over the summer, however, signs of the mid-August financial crisis in Russia began to emerge and led to growing concern that Russia's problems would spread to emerging markets. By early September, FOMC Chairman Alan Greenspan warned, "it is just not credible that the United States economy can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

Fears about potential contagion effects of the Russian political and economic turmoil, particularly on

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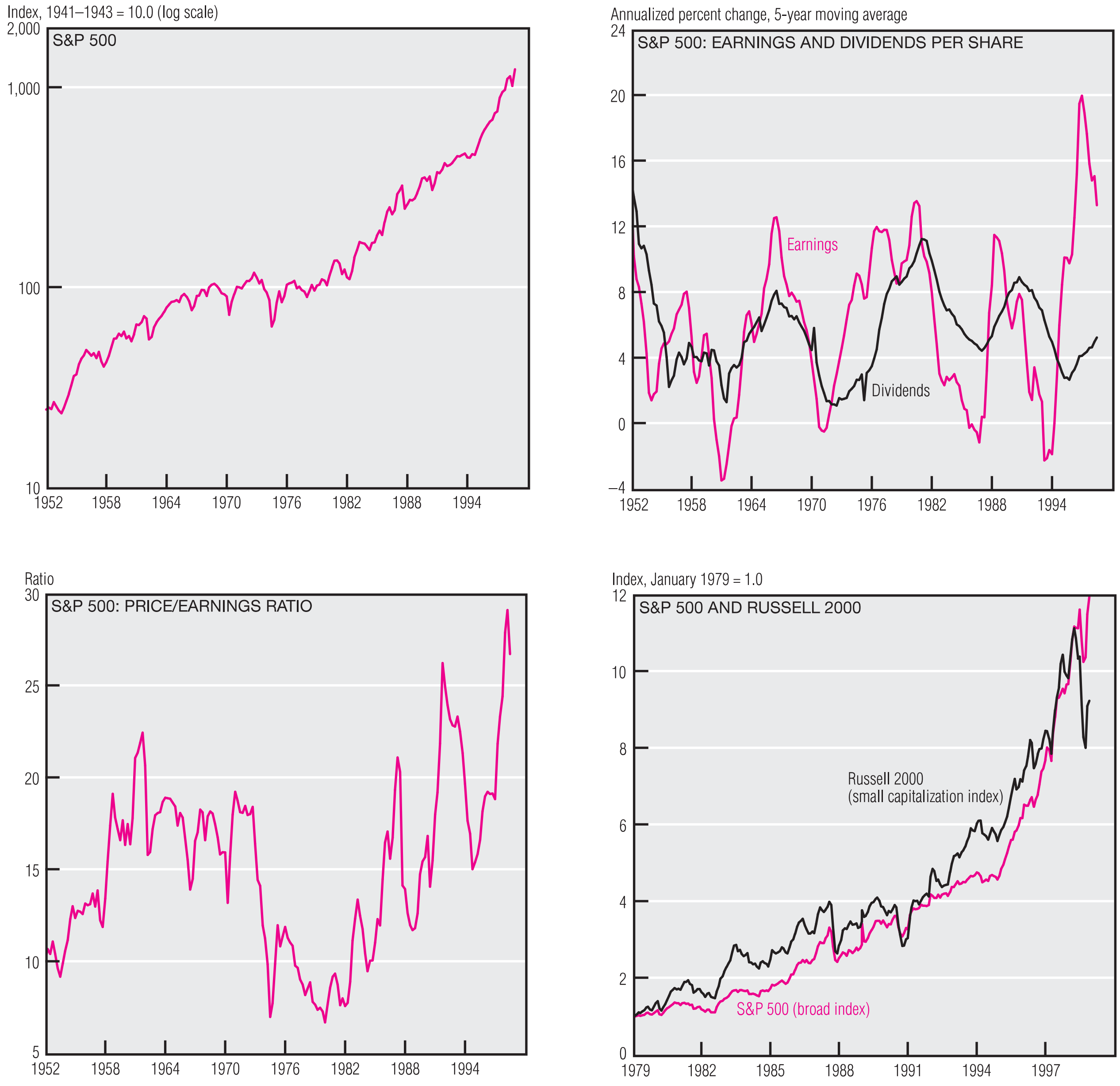

SOURCES: Standard and Poor's Corporation; and DRI/MCGraw–Hill.

Latin American markets, induced a flight to quality. Increased foreign demand for U.S. Treasury securities depressed rates paid on these instruments. Liquidity concerns in the commercial paper market forced many U.S. firms to draw on their lines of bank credit.

On August 31, the S&P 500 plunged 69.86 points, its worst single-day point decline ever. The index found a new low in early fall after news emerged about liquidity problems experienced by a high-profile hedge fund, but then it staged an astounding comeback. On December 29, the S&P 500 ended the year up 26.7% at 1,229.23. The autumn policy actions appear to have assuaged the worst fears in financial markets.

Current levels of U.S. stock prices indicate a degree of optimism some find difficult to reconcile with the state of the world economy. Fundamentally, a stock's price equals the discounted value of its expected future dividends. Because future dividends derive from future earnings, expected earnings must be very strong. The price/earnings ratio—simply the stock price divided by the earnings per share—gives investors an idea of how much they are paying for a company's earning power. The recent record-high P/E for the S&P 500 index suggests that investors expect strong earnings growth to continue well into the future for the largest U.S. companies.

The Russell 2000 index of stocks with capital values under $1.4 billion, however, barely recouped its August and autumn losses and was down slightly for the year. Thus, investors remain concerned, at least at this level. Moreover, broad measures of earnings, such as after-tax profits of nonfarm corporations, also reveal a less sanguine picture. Over the past several years, such profits have helped

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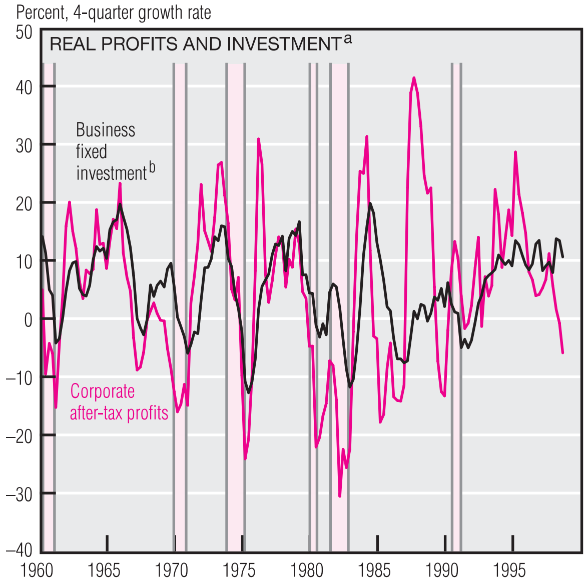
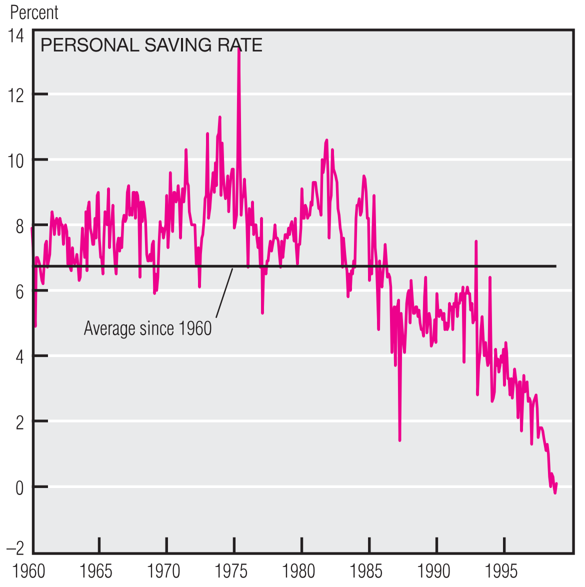
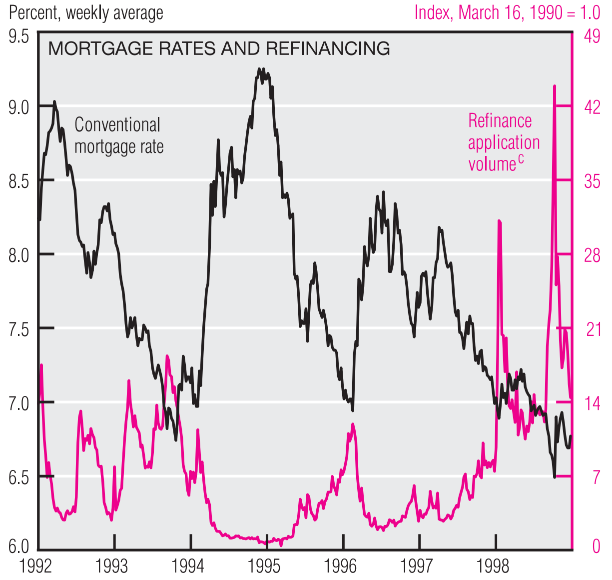
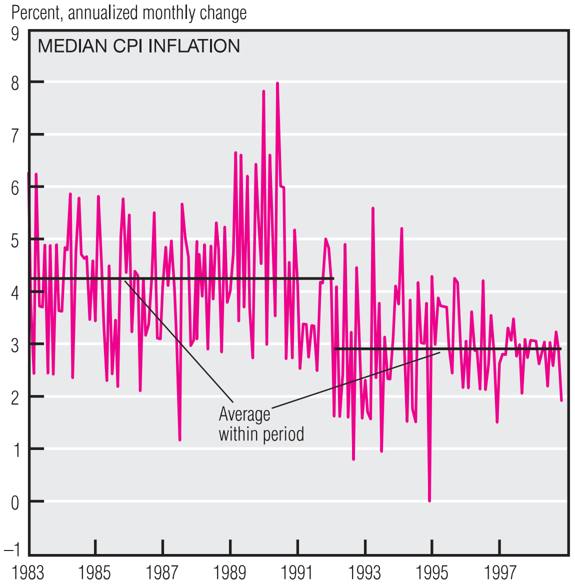
Monetary Policy (cont.)









a. Shaded areas indicate recessions.
b. Business fixed investment of nonfarm nonfinancial corporations, adjusted by 1992 chain-weighted implicit price deflator for nonresidential fixed investment.
c. Seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and DRI/McGraw–Hill.

to finance an investment boom, but recent declines have raised questions about the continuation of strong investment spending. Business fixed investment growth has exceeded profit growth over the past year. Such conditions are often associated with economic downturns.

Questions about the sustainability of consumer spending are also a source of concern. Consumer confidence is believed to be driven largely by increased employment opportunities and large wealth gains attributable to elevated equity values. By one measure—the personal saving rate—households are so confident that they are willing to spend more than their earned income. In October and November, the personal saving rate was negative for the first time ever. If stock prices were to tumble and then remain low, it is doubtful that consumers would continue this trend.

A chief source of liquidity for households has been home equity: Falling mortgage rates have induced many families to refinance their homes, and lower mortgage rates allow them to tap into home equity without adding to mortgage payment flows. This source of liquidity would diminish if inflation were to accelerate, thereby leading to higher long-term interest rates.

Indeed, a key factor accommodating continued expansion is the absence of clear signs of accelerating inflation despite rapid money growth. Thus far, it is difficult to refute those pundits who consider recent economic performance a permanent con-

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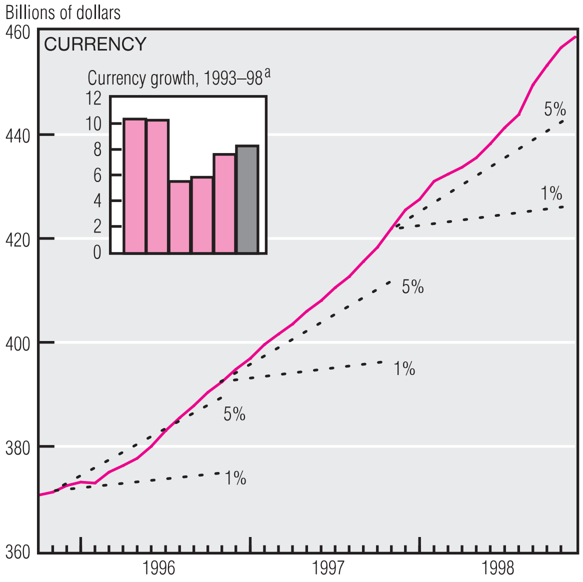
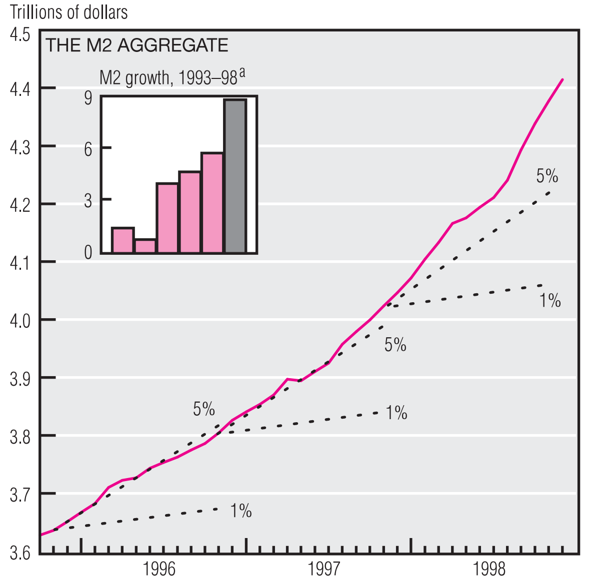
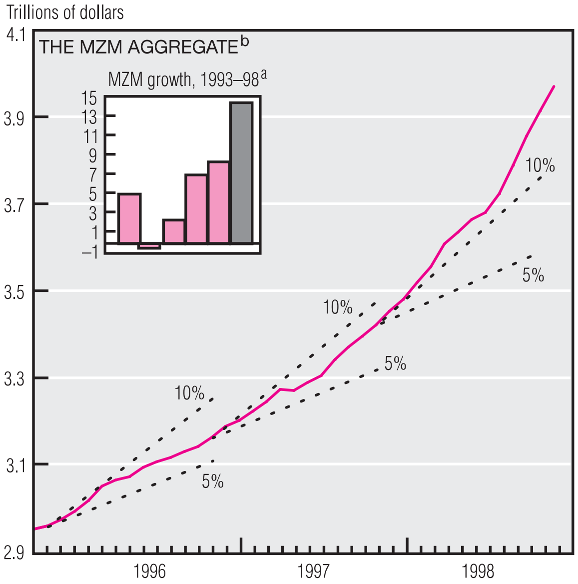
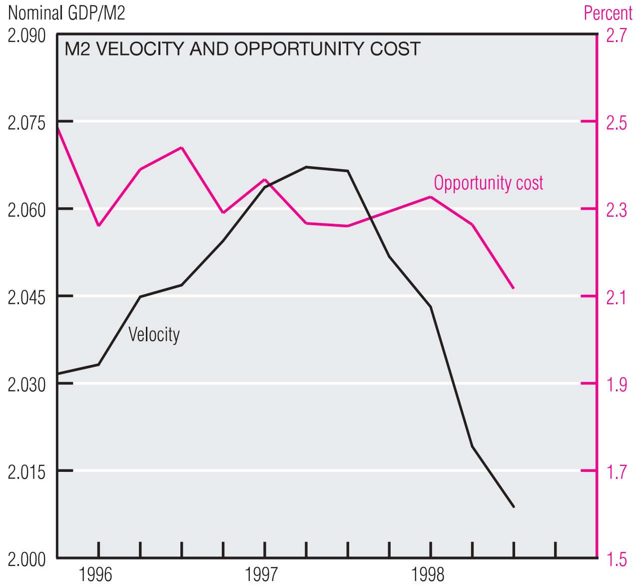








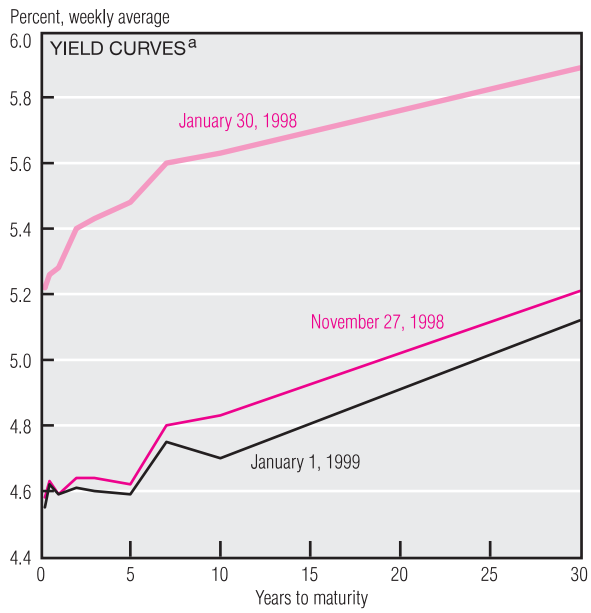
a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. 1998 growth rates calculated using 1998:IVQ with estimated December data.
b. MZM is an alternative measure of money that is equal to M2 plus institutional money market mutual funds less small time deposits.
NOTE: Data are seasonally adjusted. Last plots for M2 and MZM are estimated for December 1998; last plot for currency is an average of weekly figures available for December 1998. Dotted lines for M2 are FOMC-determined provisional ranges. Dotted lines for currency and MZM represent growth in levels and are for reference only.
SOURCES: Board of Governors of the Federal Reserve System.

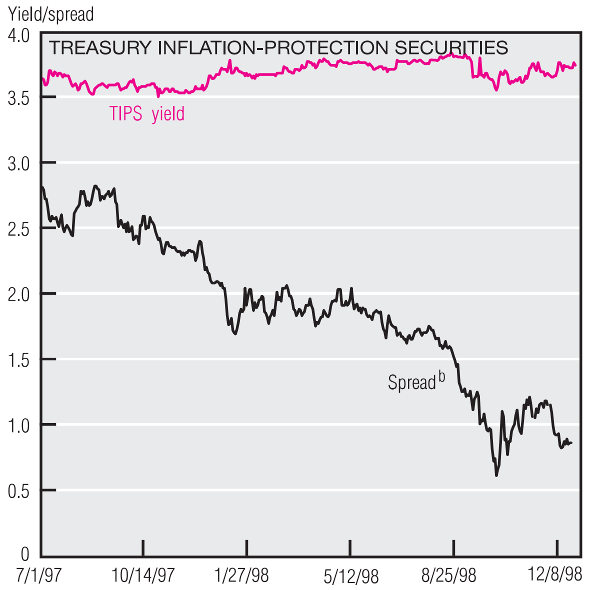
dition of more rapid output supply. Evidence is found in rapid productivity growth, averaging about 2¼% over the past three years, and in workers' willingness to increase hours for moderate gains in compensation. How long these positive supply surprises will continue is a critical issue for enduring optimism.

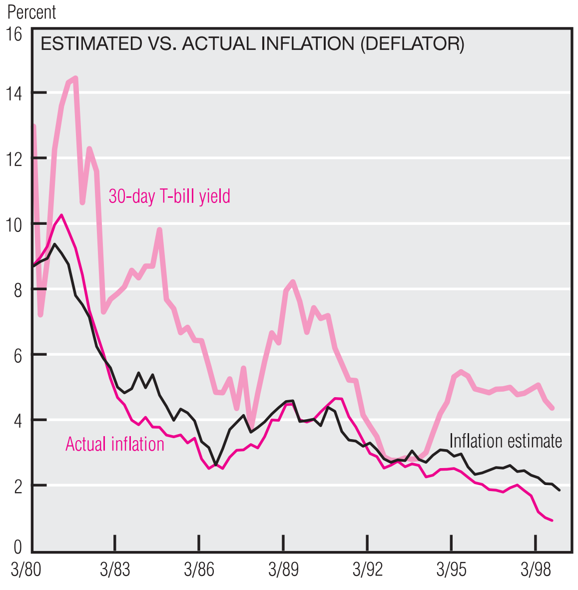
Regardless, money measures like M2 and MZM continue to grow at rates exceeding nominal output. This has led some observers to speculate that rapid money growth is financing a stock market bubble. Nobel laureate Milton Friedman, for example, finds it hard to believe that stock prices are sustainable at current levels. Price measures that include asset prices rather than just goods and services have accelerated to higher growth rates since 1995, suggesting that acceleration in money growth may be inducing inflated asset prices.

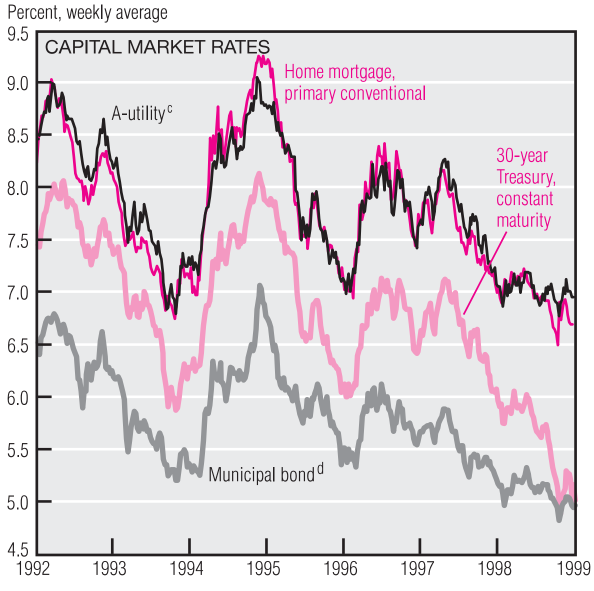
A more hopeful explanation for the recent surge in money growth is that it reflects increases in the demand for money. Some research shows that investors demand more liquidity during periods of stock price variability comparable to that experienced over the past year. More specifically, investors use money market mutual funds (MMMFs) as a gateway for financial transactions, swelling MMMF growth during such periods. Mortgage refinancings are also associated with transitory increases in money growth. If these explanations are correct, then one might expect to see money growth drop sharply in 1999. Only time will resolve the puzzle concerning the ultimate outcome of recent money growth.

Interest Rates









a. All instruments are constant-maturity series.
b. 10-year Treasury bond, constant-maturity yield, minus the yield quote for the TIPS-adjusted series.
c. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
d. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
SOURCES: Board of Governors of the Federal Reserve System, "Statistical Releases, H15: Selected Interest Rates"; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters,* http://www.phil.frb.org/econ/spf/median.dat; Bloomberg information services; and *The Wall Street Journal*.

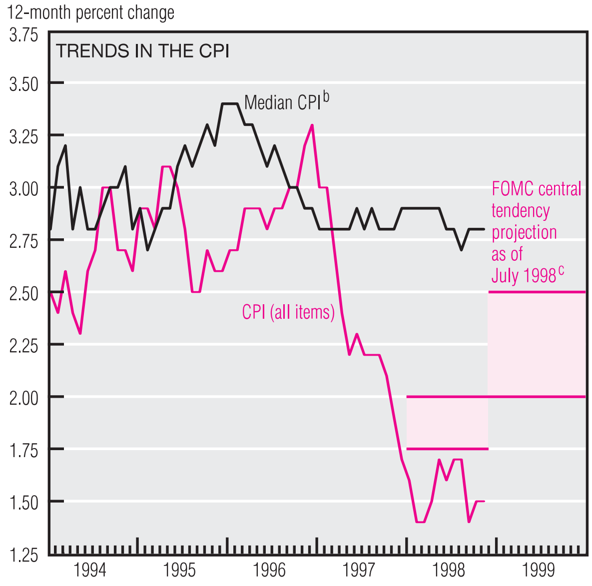
The new year begins with interest rates noticeably below their levels at the start of 1998. The Treasury yield curve has shifted lower by about 60 basis points. It has also flattened out, with the 3-year, 3-month spread decreasing from 21 to five basis points, and the 10-year, 3-month spread decreasing from 20 to 15 basis points. The yield curve has also taken on a more jagged appearance, showing inversions between six and 12 months, two and five years, and seven and 10 years. It would be difficult to concoct a simple story that would justify such a curve; quite possibly it reflects some combination of short-term confidence, uncertainty over the medium run, and long-run confidence about price stability. Rates on long-term corporate bonds and mortgages have seen less of a decrease because those securities did not benefit from the flight to quality after the Asian crises and Russian default.

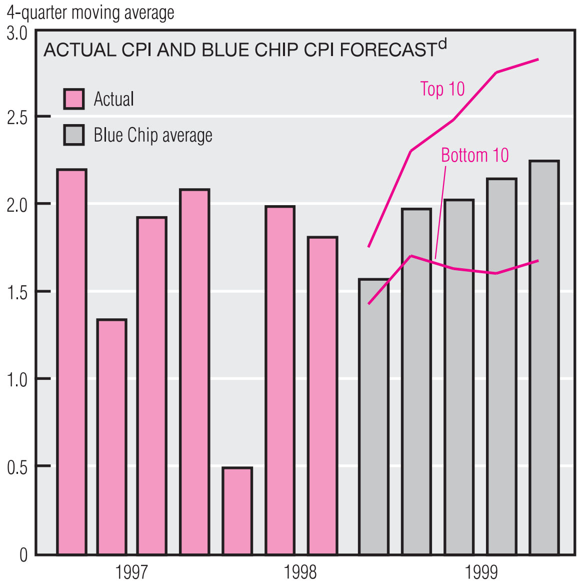
A key question is always how to apportion the change in nominal interest rates between real rates and expected inflation. By one measure, the underlying real interest rate has not shifted much over the year: The 10-year Treasury inflation-protection securities (TIPS) yield, which started the year at 3.71%, has moved to 3.74%, with highs and lows for the year of 3.84% and 3.55%. The spread between nominal 10-year Treasuries and 10-year TIPS, a rough gauge of expected inflation, has dropped from 2.04 to 0.86. A more direct estimate of inflationary expectations, from the *Survey of Professional Forecasters*, confirms that expectations of inflation have come down over the year, from 2.23% to 1.85%.

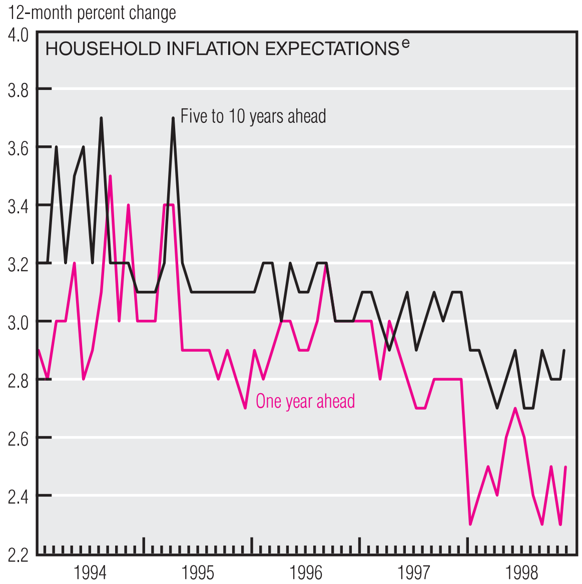
Inflation and Prices

November Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	1997 avg.
Consumer prices					
All items	2.2	1.7	1.5	2.4	1.7
Less food and energy	2.1	2.1	2.4	2.6	2.2
Median[b]	1.9	2.7	2.8	3.0	2.9
Producer prices					
Finished goods	–1.8	1.5	–0.7	1.0	–1.2
Less food and energy	1.7	2.5	1.3	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.
e. Median expected change in consumer prices as measured by the University of Michigan's Survey of Consumers.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; *Blue Chip Economic Indicators,* December 10, 1998; and the University of Michigan's Survey Research Center.

The Consumer Price Index (CPI) rose an annualized 2.2% in November, a small uptick from its 12-month increase of 1.5%, but still moderate by the standards of the past 10 years or so. The median CPI was also up a modest 1.9% in November, or about ¾ percentage point below its 12-month trend of 2.8%.

Last year's impressive inflation performance builds upon an equally modest 1997 inflation and comes as a pleasant surprise to both economists and monetary policymakers. Even as late as July, the FOMC central tendency projection for the 1998 CPI was 1.75% to 2%. It now seems very likely that retail price increases for the year will come in under the low end of that range.

Most subscribe to the belief that our surprisingly modest inflation numbers will worsen in 1999. For example, the Blue Chip economists' consensus is that the CPI will inch up to a 2% growth rate in the first half of 1999 and to a 2.25% pace by the end of the year. Likewise, survey data from the University of Michigan show that households are projecting prices to rise 2.5% over the next 12 months, and at an even faster rate over the next five to 10 years.

Yet this small upward march in the expected inflation numbers masks a persistent downward revision in the inflation outlook over the past several years. In other words, inflation anxiety seems to be retreating. Households' current long-run inflation projection is roughly 2.75%, but that's about ½ percentage point below its 1994–95 levels.

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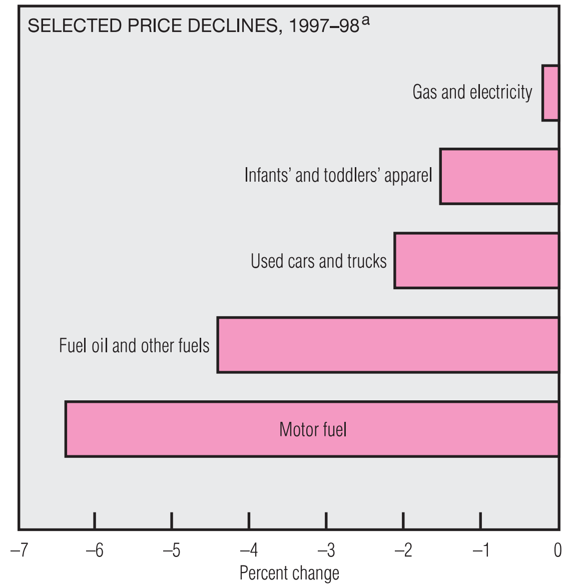
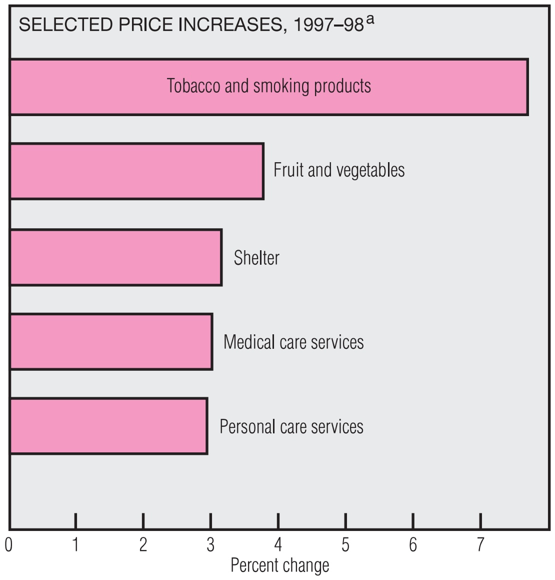
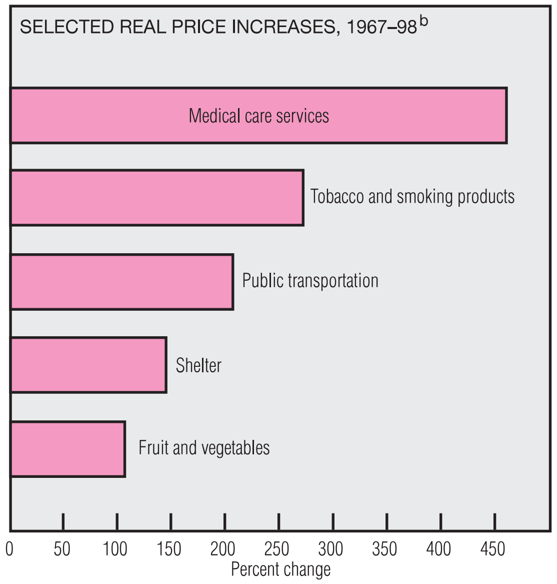
Inflation and Prices (cont.)







a. Average annual rate of change, 1997–98.
b. Total percent change minus CPI inflation, 1967–98.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

A number of factors have collaborated to hold down the average rate of price increase during the past few years. Gasoline prices in particular have declined more than 6% per year since 1996, as have prices for fuel oils and other fuels, which have fallen about 4.5% annually over the past two years. At the other end of the price spectrum, relatively large increases have been seen in tobacco and smoking products, for which retail prices have risen more than 7.5% since 1996. Fruit and vegetable prices have increased almost 4% per year over the same period.

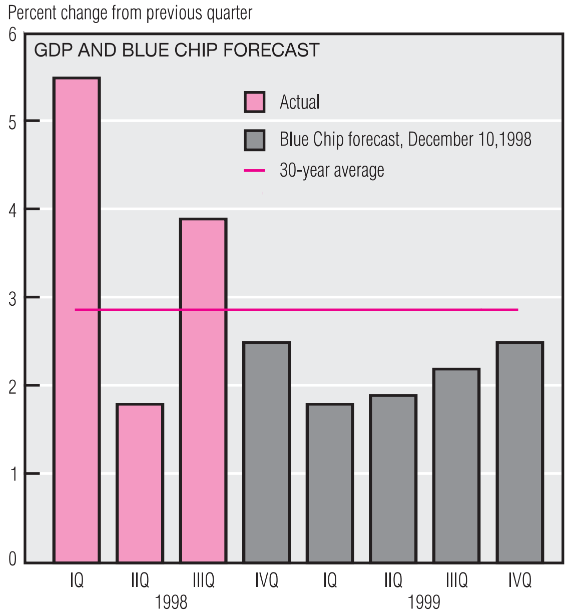
In a dynamic, growing economy, we would expect wide variations in price performance by commodity—this is how market economies allocate their scarce resources. Taking a longer perspective can provide interesting insights into the direction of the U.S. economy. After adjusting for inflation, apparel goods prices have dropped sharply since 1967—more than 200% in most cases. New car prices have fallen, in "real" terms, an equally large amount. In these instances, foreign competition likely played an important role in the price declines, as did the commodities' diminished importance in the domestic economy.

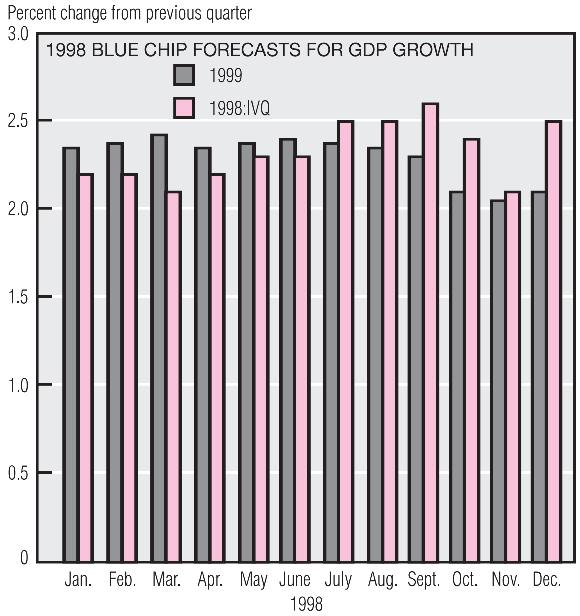
Price advances have been much stronger in services areas, however, where resources have increasingly been directed. After adjusting for inflation, prices for medical care services have risen more than 450% since 1967. Public transportation and shelter costs have also seen relative price increases over the same period of roughly 200% and 150%, respectively.

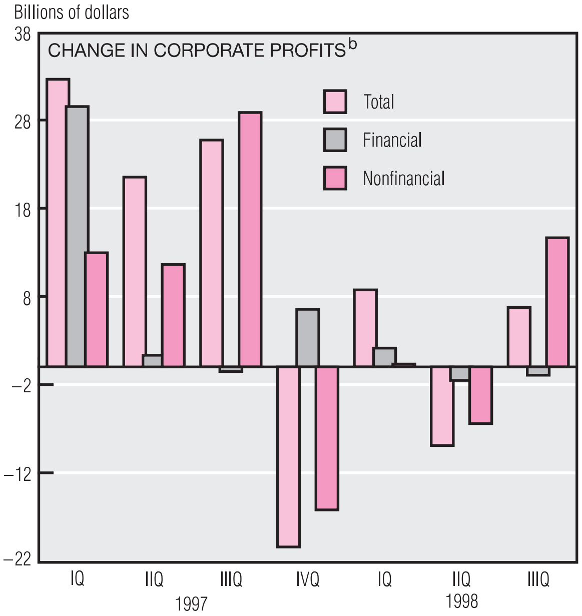
Economic Activity

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

	Change, billions of 1992 $	Percent change, last: Quarter	Percent change, last: Four quarters
Real GDP	67.9	3.7	3.5
Consumer spending	51.6	4.1	4.7
Durables	4.3	2.4	8.0
Nondurables	8.2	2.1	3.6
Services	38.0	5.4	4.7
Business fixed investment	−1.7	−0.7	8.7
Equipment	−2.0	−1.0	12.7
Structures	0.1	0.2	−1.6
Residential investment	7.4	9.9	12.1
Government spending	4.8	1.5	0.8
National defense	3.2	4.3	−2.2
Net exports	−13.8	—	—
Exports	−6.8	−2.8	−2.3
Imports	7.0	2.3	8.3
Change in business inventories	17.5	—	—







a. Data in billions of chained 1992 dollars.
b. Total includes rest of world. Financial and nonfinancial are domestic only.
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*, December 10, 1998.

The gross domestic product (GDP) grew at a 3.7% seasonally adjusted annual rate in the third quarter of last year, adjusted for price changes. This final estimate is only slightly lower than the 3.9% preliminary estimate of November, reflecting slightly lower exports and higher imports. Indeed, third-quarter growth was surprisingly strong. As recently as September, analysts had forecast growth of about 2.0%, comparable to the second-quarter rate of 1.8%. Strength in third-quarter growth came mainly from personal consumption expenditures and inventory investment; small gains in residential investment and government spending were offset by declines in business fixed investment and net exports. The December Blue Chip consensus forecast for 1998:IVQ remains at about 2.5%.

August and September 1998 included the Russian financial crisis and the collapse of a major U.S. hedge fund, with the seemingly disastrous repercussions in equity market valuations that might have shaken the U.S. real economy. Recent economic data, however, seem to belie that outcome.

Forecasts for 1999 real GDP began slipping at the beginning of the global economic turmoil in July. After that, Blue Chip forecasts of 1999 real GDP growth were marked down steadily each month until December. This most recent forecast shows renewed confidence in the U.S. economy for 1999, as well as a more positive outlook for fourth-quarter GDP growth.

Revised estimates of corporate profits increased in the third quarter. Profits from current production

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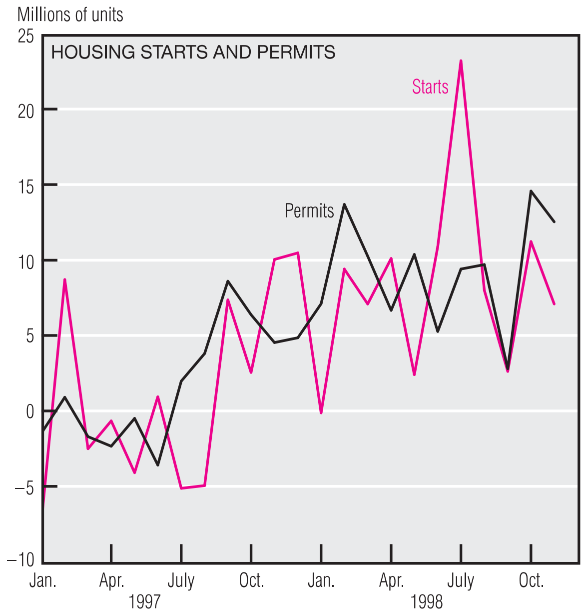
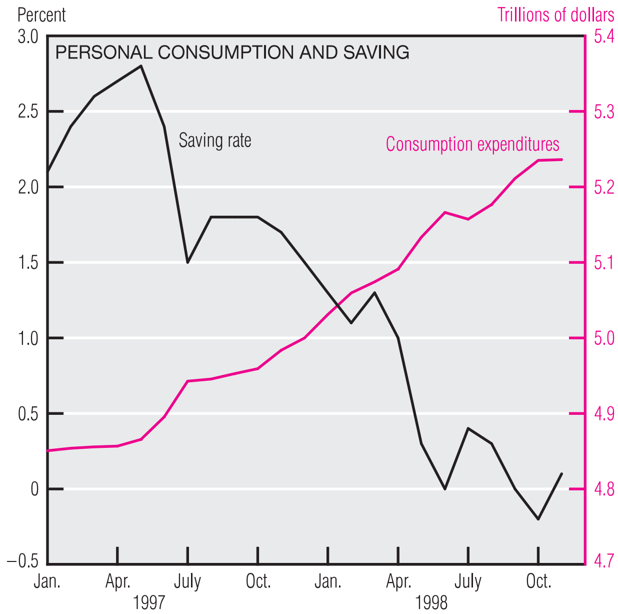
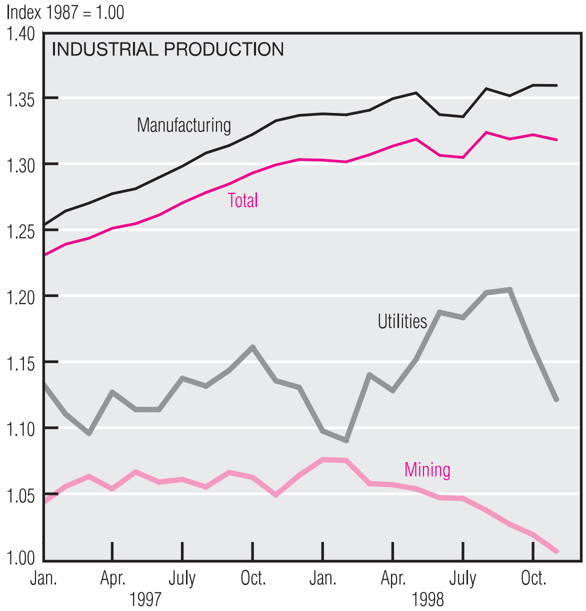
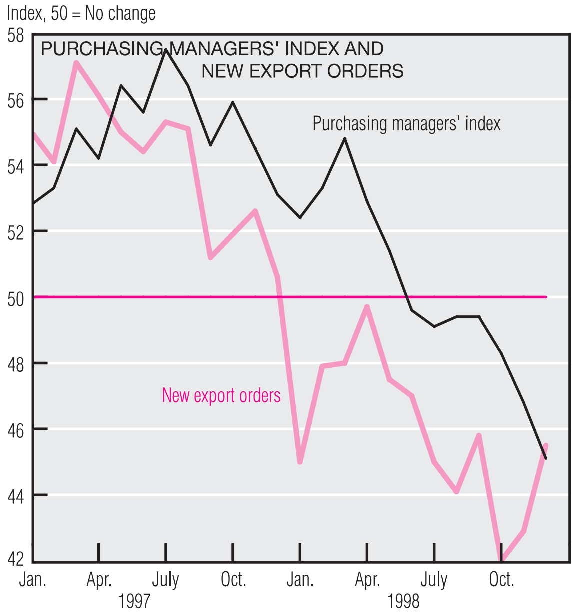
Economic Activity (cont.)









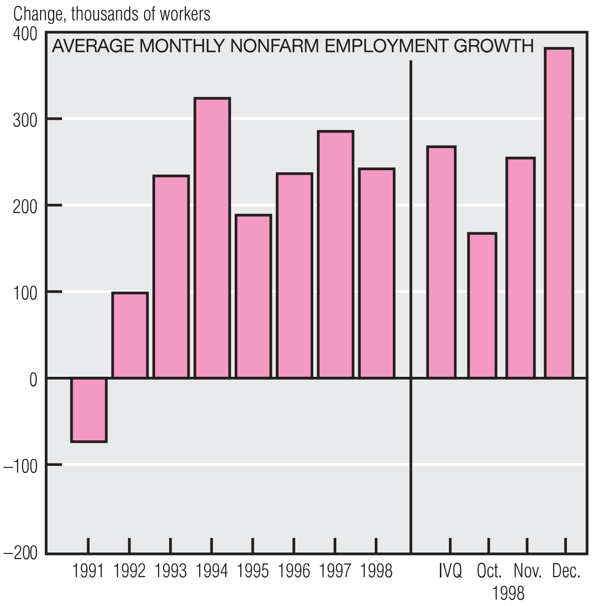
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Board of Governors of the Federal Reserve System; and National Association of Purchasing Management.

increased $6.4 billion, in contrast to an $8.6 billion decrease in the second quarter. Financial corporations still suffered from the summer's catastrophes, but the $0.6 billion third-quarter decline in domestic profits for these institutions was only half the $1.2 billion second-quarter loss. Domestic profits of nonfinancial corporations, which also had declined ($6.1 billion) in the second quarter, showed a strong $14.3 billion rebound in the third quarter.

Housing construction activity has held up since summer despite a decline in both starts and permits from October to November. Consumer spending, the driving force in the economy as some other sectors started to slow, has remained strong. Measured personal saving was negative in both October and November: Households maintained spending levels that presumably reflected wealth gained from equity markets before the July break, and more than regained since the October market trough.

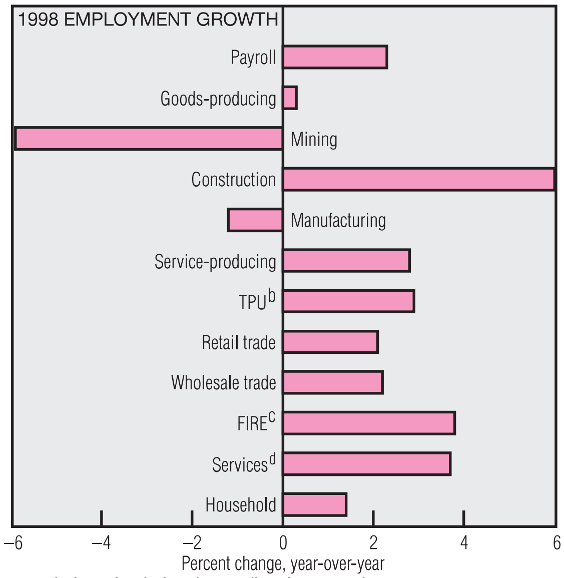
Industrial production growth slowed in 1998. Since September, growth rates have been lower than the 3.8% 50-year historic average. Last fall's unseasonably warm weather contributed to the slowdown and was reflected in the utilities portion of the index. The manufacturing component of industrial production slowed slightly in 1998, but remained reasonably strong. Also, the purchasing managers' index (in which executives indicate whether business has slowed, picked up, or remained the same) has been falling for seven months and in December reached its lowest level since May 1991, partly because of declining export orders.

Labor Markets



Labor Market Conditions

Employment	Average monthly change (thousands of employees) 1995	1996	1997	1998	Dec.
Payroll employment	185	233	282	239	378
Goods-producing[a]	8	31	42	7	88
Manufacturing	–1	3	21	–20	–13
Construction	10	28	20	29	104
Service-producing[a]	178	202	240	232	290
Business services	38	45	61	39	49
Retail trade	37	42	34	39	53
TPU[b]	9	8	14	16	32
FIRE[c]	–1	14	17	23	28
Household employment	30	228	235	157	413
	Average for period (percent)				
Civilian unemployment	5.6	5.4	4.9	4.5	4.3



a. Includes other industries not listed separately.
b. Transportation and public utilities
c. Finance, insurance, and real estate.
d. Includes service-producing categories not listed elsewhere.
e. Vertical line indicates break in data series due to survey redesign.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

December's labor market data continued to indicate strength, closing out an impressive year. In 1998, job creation was above trend, the unemployment rate fell to its lowest annual average in more than 35 years, and the employment-to-population ratio reached an all-time high.

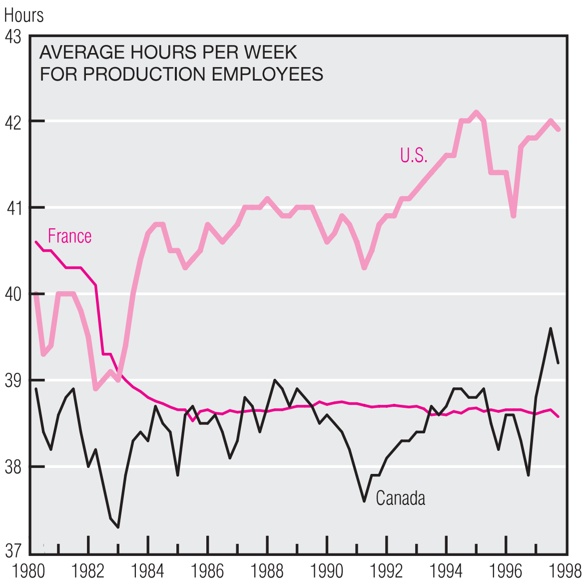
Employment as reported by establishments posted its largest 1998 increase in December, with 378,000 new jobs added to the economy. Payrolls were up 2.9 million for the year, slightly higher than the expansion annual average of 2.2 million. December's hefty increase reflected large gains in construction employment, attributable to unseasonably warm weather and low interest rates.

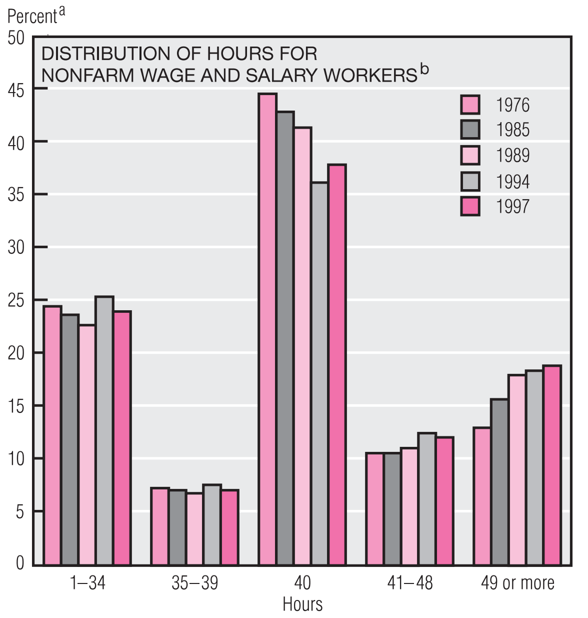
Increases in construction employment and widespread gains in the service sector were offset slightly by continued job losses in manufacturing. Service-sector employment was up 290,000 in December, with especially large gains in transportation and retail trade. Business service employment increased 49,000. Personnel supply, which includes temporary employment services, experienced its largest increase since August.

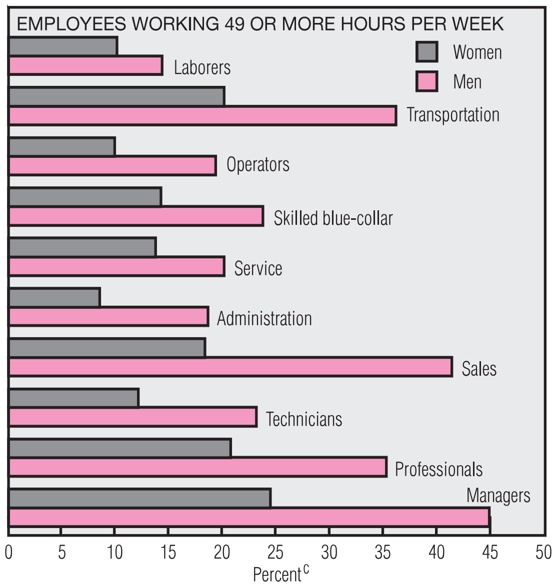
For the year as a whole, goods-producing industries grew at the slow rate of 0.3%. Construction was the only major goods-producing industry with a positive growth rate, increasing 6.0%. Service-producing industries grew 2.8%, with strong increases in transportation, finance, and services.

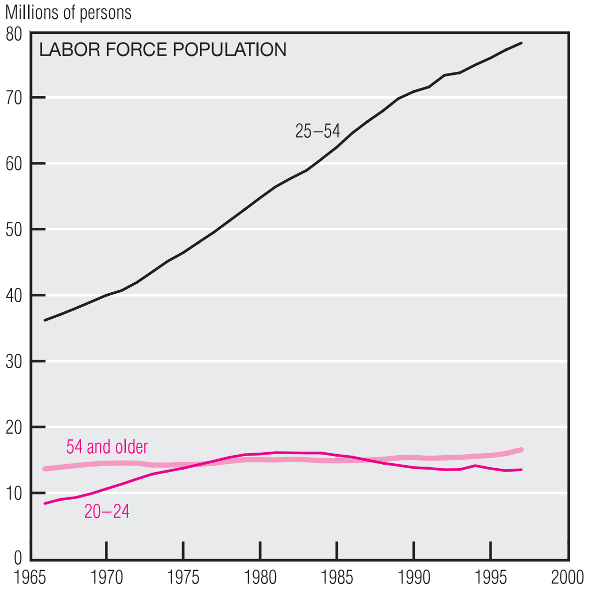
The unemployment rate dipped slightly to 4.3% from November's 4.4% rate. The 1998 average unemployment rate was 4.5%; this was the lowest peacetime rate since 1957 and the lowest rate overall since 1969, the height of the Vietnam War. The employment-to-population ratio hit an all-time high of 64.2%, breaking the record set earlier this year.

Workweek Changes









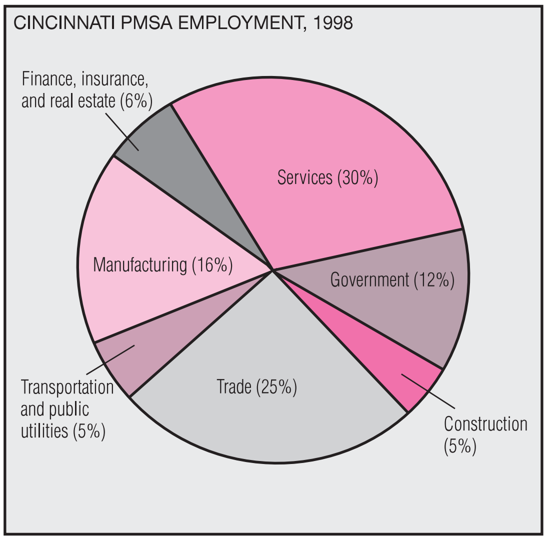
a. Percent of persons in the labor force.
b. Data from January 1994 forward are not comparable to those for earlier years due to survey redesign.
c. Percent of persons working full time.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, *Current Population Survey*; and Philip L. Rones, Randy E. Ilg, and Jennifer M. Gardner, "Trends in Hours of Work Since the Mid-1970s," *Monthly Labor Review*, vol. 120, no. 4 (April 1997), pp. 3–14.

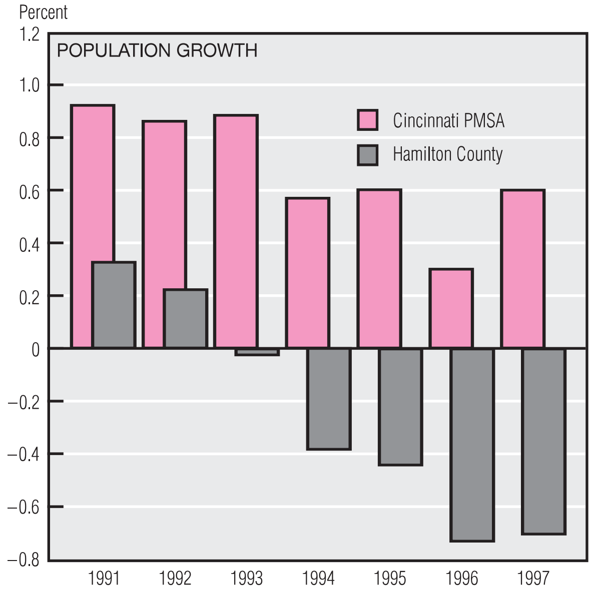
The French National Assembly recently reduced the standard workweek from 39 hours to just 35. France followed the Netherlands, which began a program in 1988 to reduce the workweek to a mere 36 hours in certain sectors. In addition, there is proposed legislation to install workweek constraints in the European Economic Community.

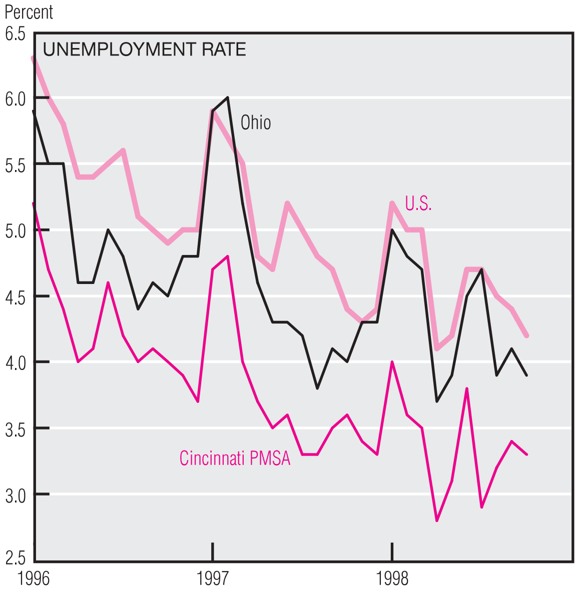
In the United States, since passage of the Fair Labor Standards Act of 1938, the average length of the workweek has not changed drastically. The distribution of workers around the average, however, has changed, quite noticeably in recent years. The number of persons working 49 hours or more has increased, while the number of those working the standard 40 hours a week has declined. In addition, there are large differences in the average workweek across occupations—meaning that any attempts to establish hours constraints in the U.S. would affect occupations and sectors differently.

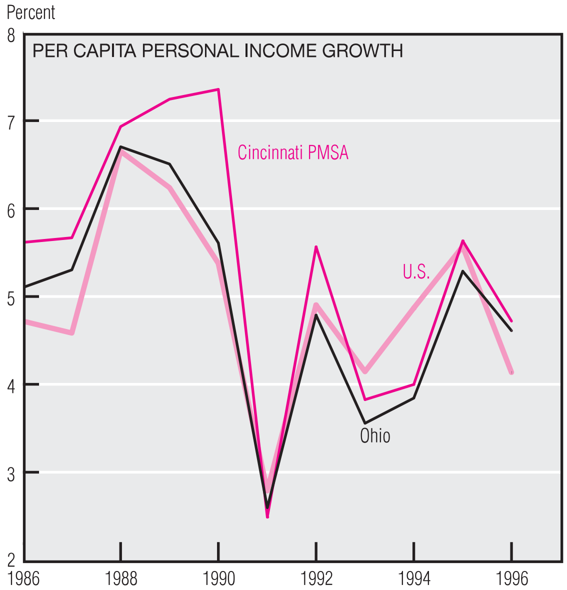
One factor leading to the increase in hours is the influx of baby boomers into the labor force. This generation has moved into the prime working age range of 25 to 54. Individuals in this age group are more likely to work full time, in contrast to younger and older workers who tend to occupy more part-time positions.

Regional Conditions









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

The Cincinnati primary metropolitan statistic area (PMSA) has a population of almost 1.6 million (1997 data) and an employment distribution quite similar to the nation's. The PMSA's service sector is dominated by health, education, and other professional services, as are many other large urban areas. Recent data for Hamilton County (which includes the city of Cincinnati but excludes part of the PMSA) show that its economy has a smaller government sector and larger manufacturing sector than the nation—an industrial composition typical of the Fourth District.

Over the past five years, population has declined in both the city (down an average of about 0.9% annually) and Hamilton County (about 0.5% annually). Although the city's population has declined, the PMSA's population has risen about 0.6% annually on average. This pattern, which is common in major urban areas, almost certainly reflects continued outmigration to the suburbs.

Employment in the Cincinnati PMSA rose about 2.3% over the last year, exceeding Ohio's employment growth of 1.4%. The region's unemployment rate is consistently lower than that of the state or the nation, a trend which has persisted for several years. The combined influence of continued employment growth and lower-than-average unemployment has helped bolster area incomes. In fact, on a per capita basis, personal income growth in the Cincinnati

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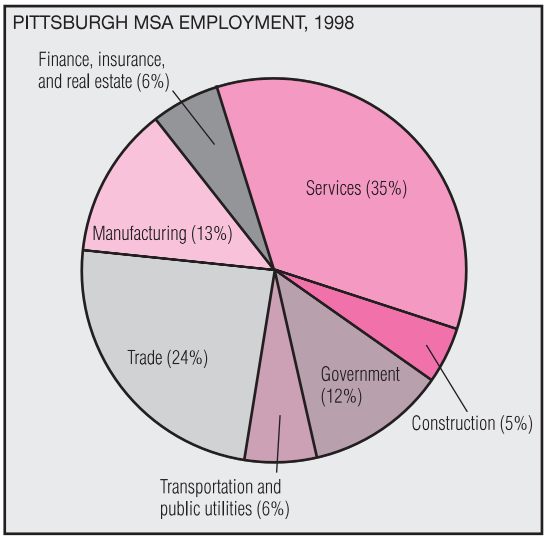
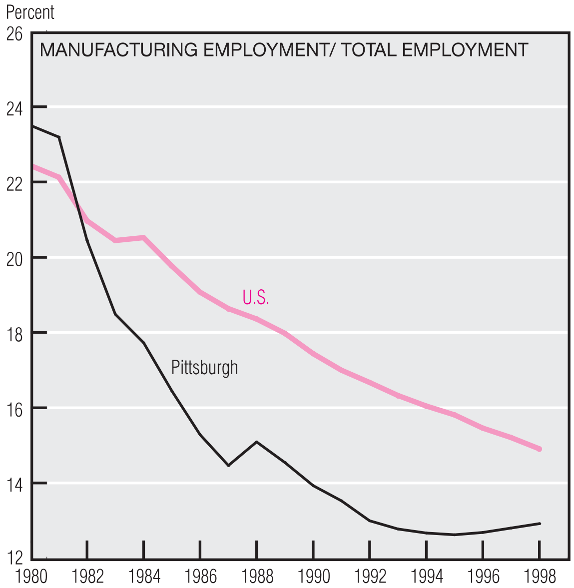
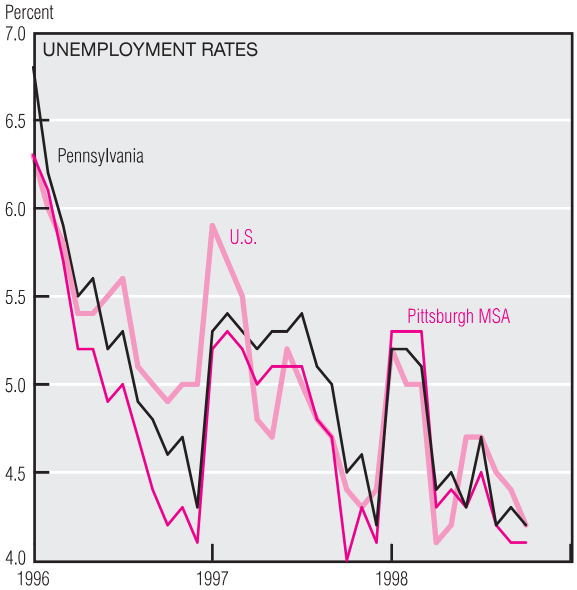
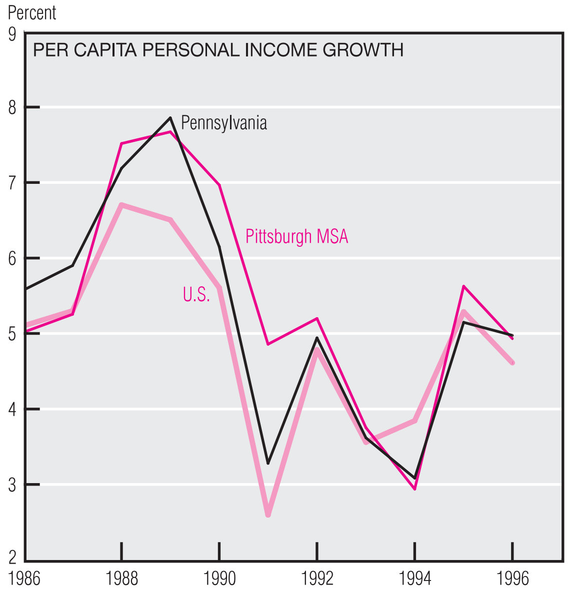
Regional Conditions (cont.)









SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Pennsylvania Department of Labor and Industry, Bureau of Research and Statistics.

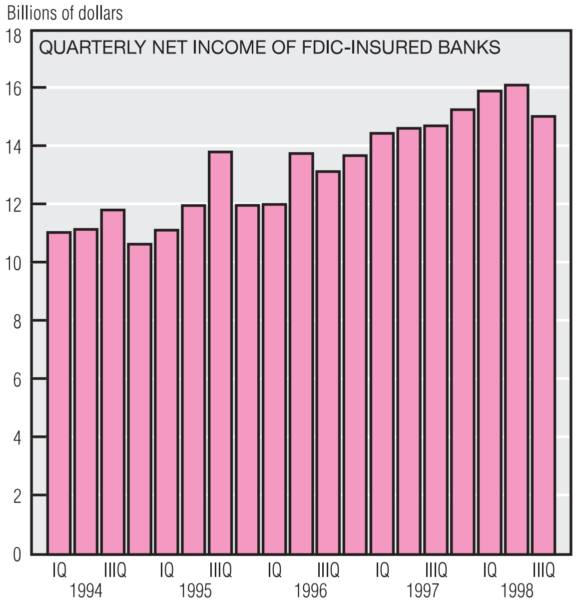
area has tended to exceed national rates by half a percentage point annually for the past 10 years—a very strong growth rate. The area's per capita personal income was $25,359 in 1996, compared to $24,436 for the U.S. and $23,493 for Ohio.

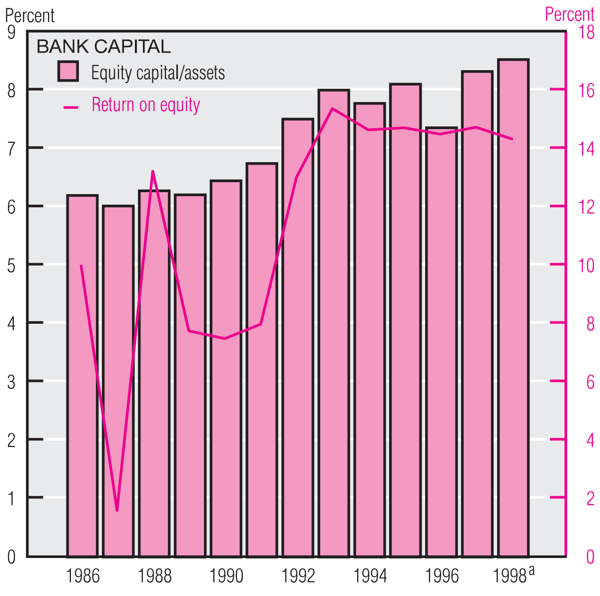
In 1998, about one-third of the workforce in the six-county Pittsburgh metropolitan statistical area (MSA) was concentrated in services and one-quarter in trade. The area has a relatively small manufacturing sector (13%, compared to Pennsylvania's 18% and the nation's 15%). Until its huge losses in the 1980s, Pittsburgh's manufacturing sector was larger than that of the nation as a whole. During the last few years, however, manufacturing as a share of total employment has gained slightly in Pittsburgh, while it continues to decline in the rest of the U.S.

Employment trends in the Pittsburgh MSA have been modestly positive. Unemployment rates tracked state and national averages closely in 1998. Pittsburgh's average unemployment rate was 4.6%, identical to both Pennsylvania and the U.S. However, employment in the MSA rose only 0.2% during the same period.

The Pittsburgh MSA's income level exceeds that of the state and the nation and is indentical to that of Cincinnati. Its average per capita personal income reached approximately $25,359 (current dollars) in 1996, compared to $24,803 for Pennsylvania and $24,436 for the U.S. Over the 10 years ending in 1996, per capita income showed an average annual growth rate of 5.5% in the MSA, compared to 5.2% for Pennsylvania and 4.9% for the U.S.

Banking Conditions





Growth in Bank Assets
(Percent)

	Loans secured by real estate	Loans to individuals	All other assets	Commercial and industrial loans	Securities	Other
1995:IQ	2.24	0.57	5.87	5.56	–1.17	2.67
1995:IIQ	2.93	2.69	–1.37	2.92	–0.92	4.54
1995:IIIQ	1.99	3.05	–1.47	1.15	1.60	4.51
1995:IVQ	0.85	3.24	4.92	2.18	–0.93	2.27
1996:IQ	0.87	–2.05	–3.87	2.18	0.07	5.05
1996:IIQ	1.28	2.52	2.92	1.40	–0.64	6.31
1996:IIIQ	1.12	2.10	2.26	1.94	–0.85	2.91
1996:IVQ	2.09	2.40	4.81	1.59	0.15	6.85
1997:IQ	1.49	–3.25	8.13	3.13	1.53	–14.81
1997:IIQ	3.34	2.58	2.68	3.16	0.91	5.28
1997:IIIQ	2.70	–0.57	4.19	1.32	1.84	–0.75
1997:IVQ	1.37	1.25	3.46	4.01	4.35	3.68
1998:IQ	2.33	–3.42	0.54	3.05	3.84	5.05
1998:IIQ	0.93	1.03	0.45	3.69	–1.21	5.34
1998:IIIQ	1.22	1.38	0.29	2.77	3.25	1.81

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

The banking industry's string of six consecutive quarters of record earnings ended in 1998:IIIQ as earnings dropped to $15.0 billion. Industry profits were $1.1 billion less than in 1998:IIQ. Despite this setback, return on equity remained above 14% and equity capital increased $11.4 billion to $457.4 billion (8.68% of industry assets), its highest percentage since 1941. In addition, the industry's "coverage ratio" rose to a record $1.94 in reserves for every $1.00 of noncurrent loans. Consequently, banks appear well positioned to weather any potential reversal of fortune. One cloud in this otherwise bright sky is that the net charge-off rate on all commercial bank loans rose to 0.73% in 1998:IIIQ, the highest rate reported by the industry since 1993:IVQ.

Commercial banks' assets increased $86.4 billion in 1998:IIIQ and $400 billion (8.2%) in the 12 months ending September 30. Much of the quarter's growth was in loans to commercial borrowers (up $23.6 billion), loans for commercial real estate properties (up $9.3 billion) and construction (up $6.7 billion), and consumer loans other than credit cards (up $8.3 billion). Banks' on-balance-sheet portfolios of credit card loans, residential mortgage loans, and home equity loans all declined during 1998:IIIQ. The amount of credit card loans that were securitized and sold off-balance-sheet increased $13.9 billion. Banks continued to reduce their holdings of U.S. Treasury securities (down $25.1 billion), while increasing their mortgage-backed securities (up $40.6 billion). Total securities increased $29.1 billion. Intangible assets registered their smallest quarterly increase in two years, reflecting slower growth in merger-related goodwill and a reduction of $244

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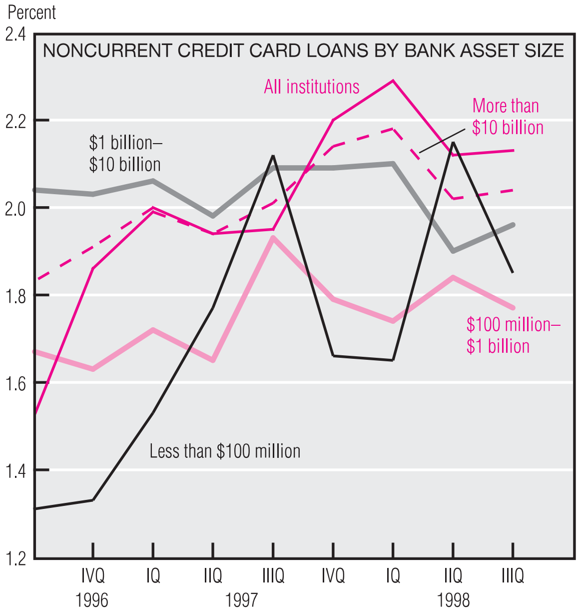
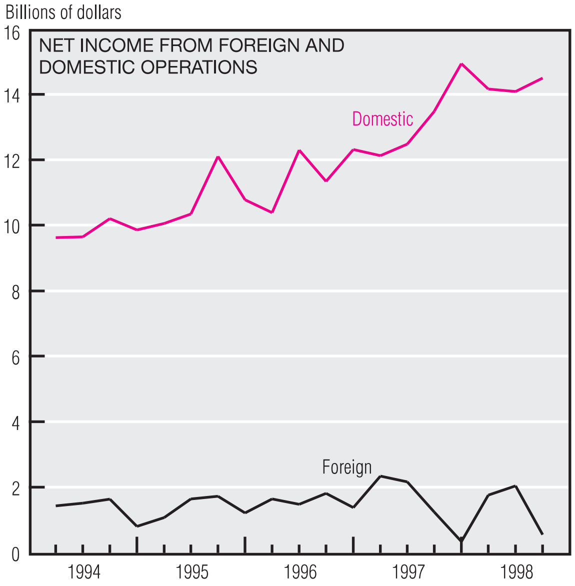
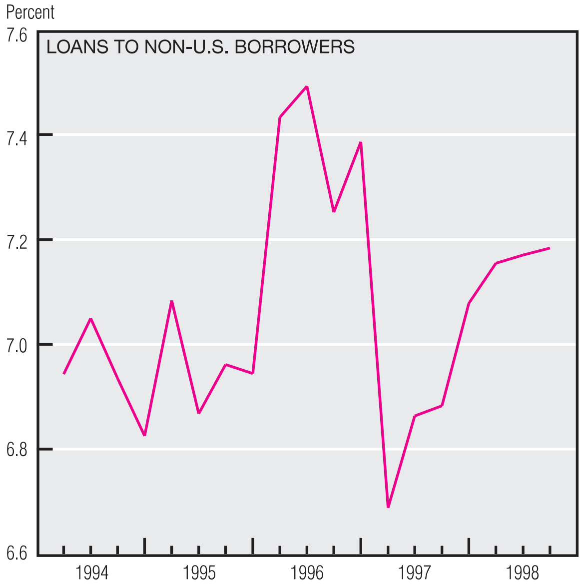
Banking Conditions (cont.)







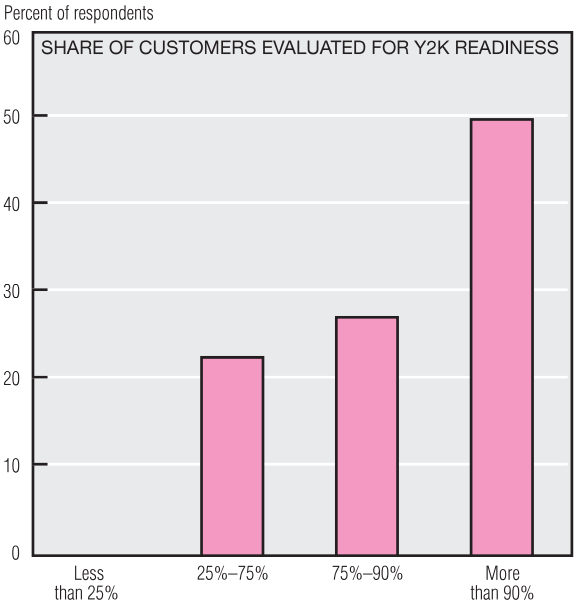
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 1998:IIIQ.

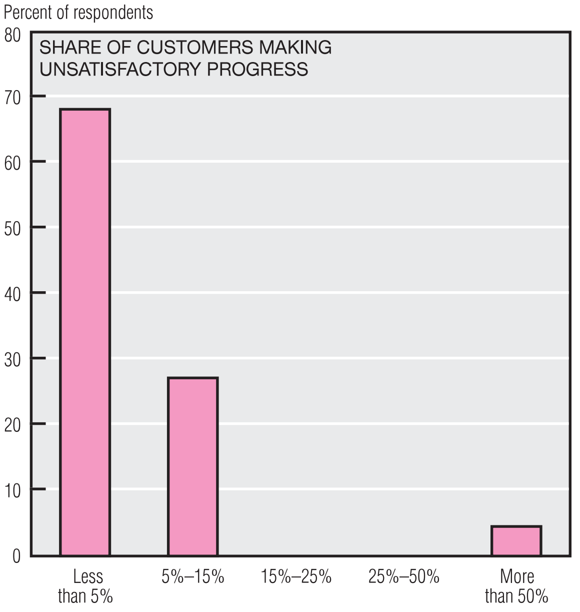
million in mortgage-servicing assets as mortgage prepayments increased. Banks' off-balance-sheet derivatives contracts rose $4.6 trillion during the quarter, more than double the previous largest quarterly increase, partly because of turmoil in overseas financial markets.

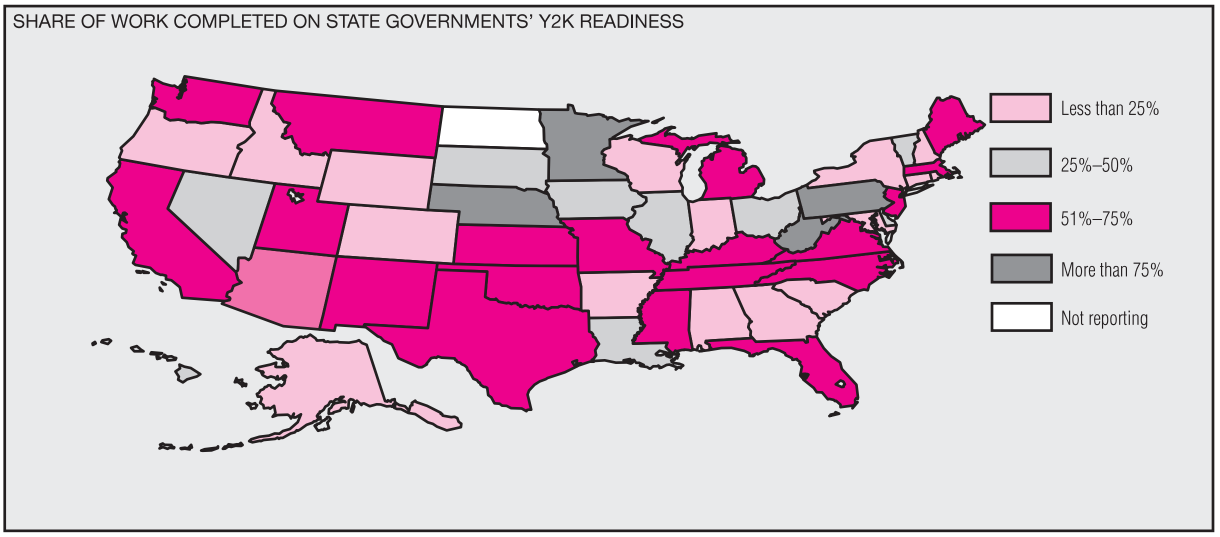
Banks' international operations continue to create uncertainty for the industry. While net income from domestic operations remained relatively strong, income from foreign operations declined significantly in 1998:IIIQ. Banks' earnings from domestic operations were $429 million (3.1%) higher than in 1998:IIQ. The percentage of earnings from international operations, which had been in the 10%–14% range over the last few years, has fallen to 2%–4% in two of the last four quarters. U.S. banks' exposure to foreign lending (measured by the percent of loans to non-U.S. borrowers) has been rising sharply since 1997:IQ after falling sharply throughout 1996.

The greatest drag on industry earnings came from large banks' trading activities, which produced $1.9 billion less pretax revenue in 1998:IIIQ than in the previous quarter. This was partly a reflection of international operations, which contributed $1.5 billion less to bottom-line profits than in 1998:IIQ. Loss provisions for foreign operations increased $203 million, while domestic loan-loss provisions grew $1.2 billion. These negative factors were more than offset by a $1.3 billion decline in income taxes and a $792 million increase in net interest income. Net interest margins improved slightly, averaging 4.12% for the quarter, up from 4.10% in 1998:IIQ. A year ago, the industry's margin was 4.24%.

Y2K Readiness







SOURCES: Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Banking Lending Practices,* November 1998; and National Association of State Information Resources Executives, *Year 2000 Remediation Results.*

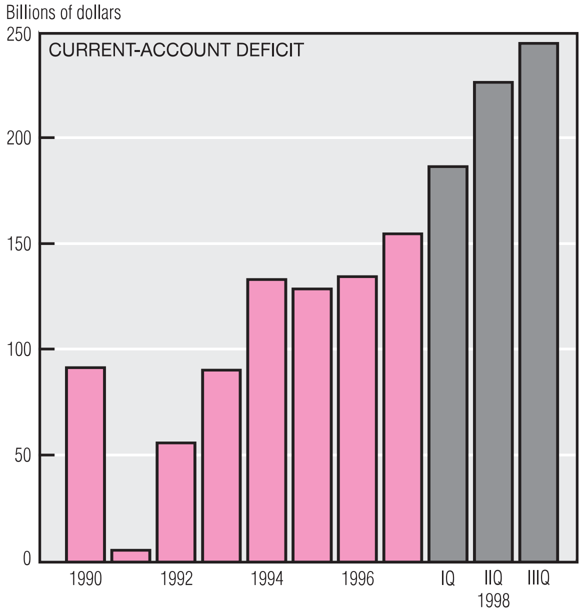
With less than 12 months to go, computer users around the world are scrambling to prepare for Year 2000. The problem? Software designed to save storage costs by using only two digits in year-date fields will have trouble interpreting "00." That software unfortunately survived much longer than expected, and reprogramming now will cost billions. September 9 may be a Y2K dress rehearsal because some older programs use "9-9-99" as a code for invalid or missing data. February 29, 2000 (a leap day) also may confuse older programs.

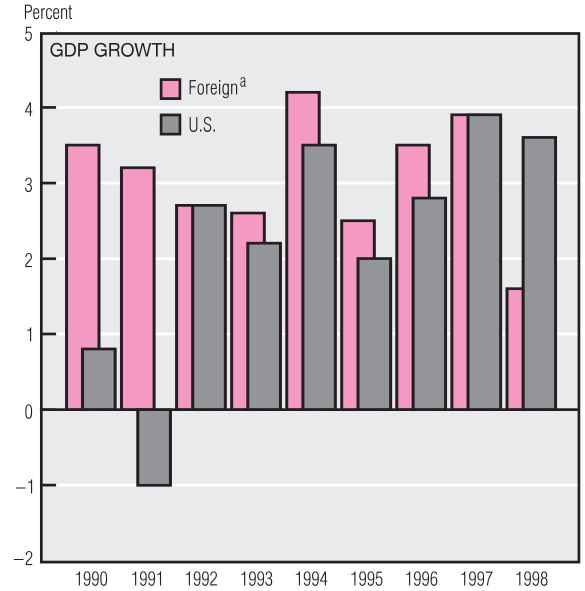
To be prepared, banks must ensure the readiness not only of their computer systems and applications but also of their suppliers and the businesses to which they have made loans. This, of course, means that those businesses' suppliers must be ready too.

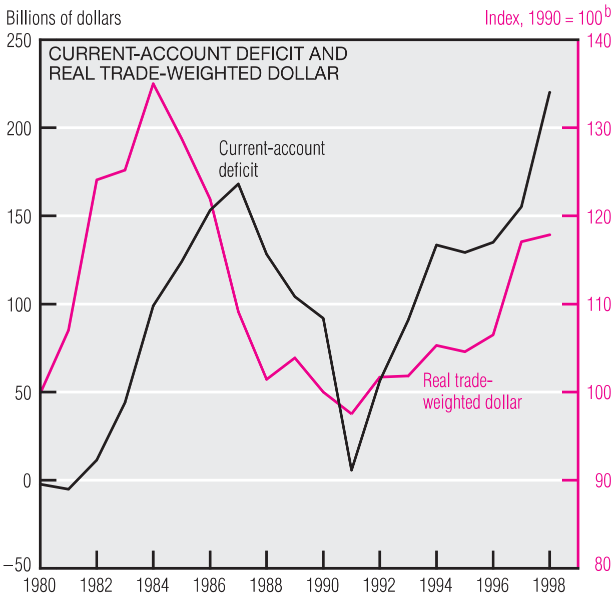
Although these problems have received increasingly strident press coverage, hard data on how well they are being addressed are scarce. A recent survey provides some evidence. Most responding banks said they had evaluated more than 75% of their material business customers. Most also claimed that less than 5% of their customers were making unsatisfactory progress when evaluated. Finally, 95% of respondents had downgraded less than 1% of their material business customers because of inadequate preparation. While these results suggest that the Y2K problem is under control, only half of the banks contacted answered the survey questions.

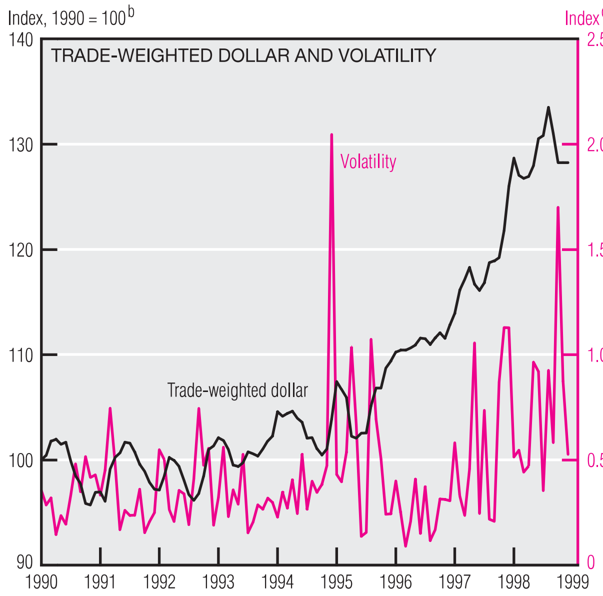
Businesses' overall readiness may mirror that of state governments. Some states, especially the Fourth District's Pennsylvania, have already implemented more than 99% of their corrections. Others have not progressed at all. One thing is sure: An ounce of Y2K prevention—or, at this late stage, contingency planning—is worth a pound of cure.

International Developments









a. Foreign GDP growth is the weighted average of GDP growth for countries included in the trade-weighted dollar index.

b. The trade-weighted dollar index includes the top 15 trading partners of the U.S. in the years shown: Canada, Japan, Mexico, Germany, U.K., Taiwan, China, South Korea, France, Singapore, Italy, Hong Kong, Netherlands, Belgium, and Malaysia.

c. Standard deviation of daily values of the trade-weighted dollar index for each month.

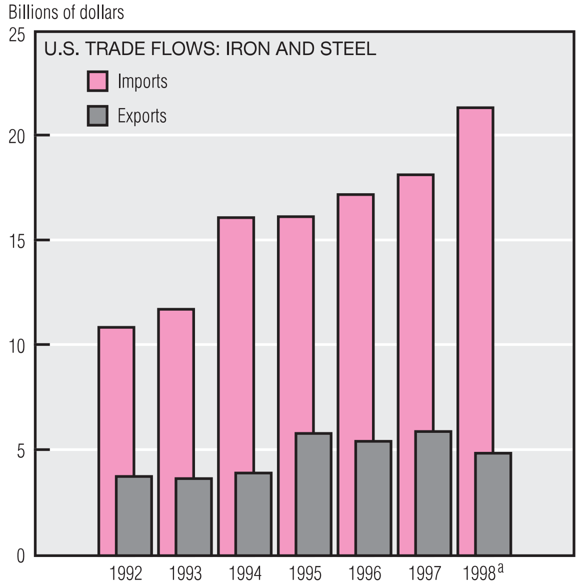
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; Organisation for Economic Co-operation and Development, *Economic Outlook*; DRI/McGraw–Hill; and *Blue Chip Economic Indicators*, December 10, 1998.

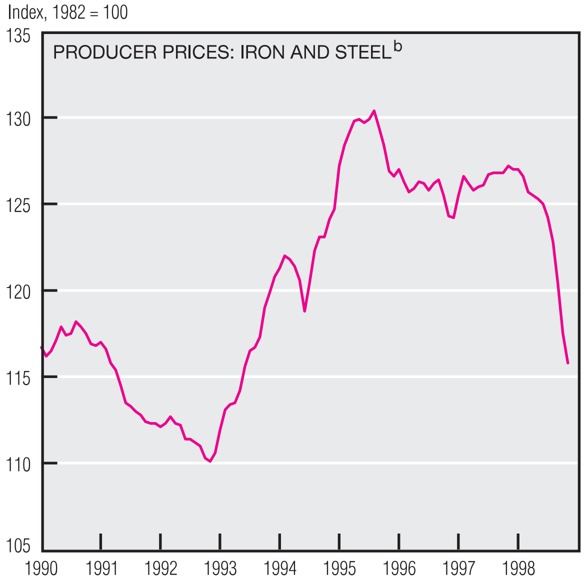
The U.S. current-account deficit reached an annualized $245 billion in 1998:IIIQ, a rise of $18.4 billion over 1998:IIQ. The expansion of the current-account deficit in the third quarter reflects increases of $7.5 billion in the trade deficit, $8.3 billion in net interest and dividend payments to foreigners, and $2.6 billion in unilateral transfers to foreigners. The shortfall is likely to grow even more in 1998:IVQ, resulting in a deficit of $225 billion to $230 billion for 1998 as a whole.

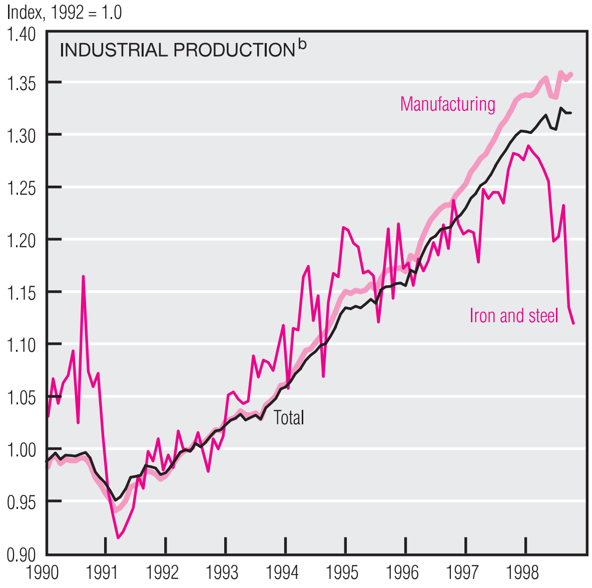
In large measure, the widening current-account deficit reflects a growing divergence between U.S. and foreign economic growth. Economists expect U.S. output to expand 3.6% in 1998, fully two percentage points more than that of our top 15 trading partners. Growth in Europe and Canada, while still fairly strong, is likely to slow. Growth in Japan and the emerging-market Asian economies will decline, but their prospects seem less bleak than they did a month ago.

The continued rise of the real trade-weighted dollar last year—which brought its cumulative appreciation since 1991 to 32.3%—has also contributed to our expanding trade deficit. Since August, the nominal trade-weighted dollar has depreciated approximately 5% in fairly volatile markets. Recently, that volatility has abated somewhat, suggesting that fewer risks and uncertainties are associated with international commerce.

Steel Imports







a. Data for first 10 months, expressed as an annual rate.
b. Seasonally adjusted
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

The dollar's strong appreciation since 1991 and recent global economic turmoil have dramatically intensified the rivalry between domestic and foreign steel producers for U.S. market share. Iron and steel imports reached $21 billion (annual rate) in the first 10 months of 1998, surpassing the total for any previous year. Last year's 17.6% gain exceeded even the recent strong pace of these imports. Since 1992, U.S. purchases of foreign iron and steel products have increased at a 12.5% average annual clip; in contrast, our iron and steel exports have remained flat.

U.S. manufacturers contend that imports have unfairly depressed domestic prices. Iron and steel producer prices slumped approximately 9% over the year ending November 1998, while the overall producer price index dipped only 0.7% for the same period.

With market share trimmed and prices dropping, domestic production has fallen 12.6% over the past year, most precipitously since May. Employment in the industry, which has been waning since 1991, tumbled 4% over the six months ending in November. Labor agreements prohibiting furloughs before July 1999 have forestalled further layoffs.

Domestic steel makers and unions recently petitioned for U.S. trade restraints on hot-rolled steel products from Brazil, Japan, and Russia. They object to subsidies in Brazil and to "less than fair value pricing" by all three countries.