

## *The Economy in Perspective*

*Sigmund Freud has said that every normal person, in fact, is only normal on the average. So it is with business cycles...*

Sooner or later, something will throw the U.S. economy off the brisk growth trajectory it has followed since 1995. Reverberations from the collapse of East Asian economies might do it, despite the apparent durability of the U.S. until now. Or the financial sector might seize up, notwithstanding the as-yet-unshakable support of stock market investors. Perhaps it will be something more traditional, like tight monetary policy chasing after accelerating inflation. Whatever the cause, lately it seems that everyone on the planet is anxiously awaiting the economy's return to normal behavior. Human beings (especially the economists among them) can tolerate ambiguity only so long.

Recent statistical reports present an enviable picture: Output expanded at an annual rate of 5.6% in real terms last quarter, more than double the pace expected by many forecasters only a few months before. Job growth continues at a healthy clip, holding the unemployment rate at a 28-year low. Never before has such a large proportion of working-age Americans been employed. Because consumer prices are barely increasing, working people continue to enjoy strong gains in their standard of living. In fact, consumer sentiment remains so positive that economy-wide household spending now matches income, with saving coming only through increases in the value of assets. What's wrong with this picture? Everything! It's not undesirable, just unjustifiable.

Doubtless the exuberance expressed since 1995 has been unusual. But how many people recall that this beautiful swan of an economy began its life as an ugly duckling? In the first several years of the expansion, economic activity's pace was feeble in comparison with many previous expansions. Progress in new job creation was particularly slow. Federal Reserve Board Chairman Alan Greenspan acknowledged the presence of strong "headwinds" that seemed to be restraining the expansion.

Soon enough, the pace of activity quickened. Recognizing that the federal funds and discount rates were set at zero (inflation adjusted), the Federal Reserve boosted its policy rates about 300 basis points in 1994 and early 1995. By 1996, the unemployment rate had fallen to 5.5%, a point that mainstream economists believed was at or below the level where inflation would accelerate.

Many urged that the Federal Reserve should raise policy rates to preempt further inflation. Others, expecting labor compensation's surge to precede inflation's swell, opposed any additional monetary tightening.

Needless to say, inflation did not accelerate. Indeed, deviating even further from the textbook script, inflation actually declined as labor markets strengthened. With each additional ¼% drop in the unemployment rate below 5½%, warnings were issued and then proven false. Today, with employment sitting near 4¼%, labor compensation rates finally have bestirred themselves, but only slightly. Yet those who preached labor markets' usefulness in predicting inflation have been so thoroughly discredited that few have strength left for wagging their fingers.

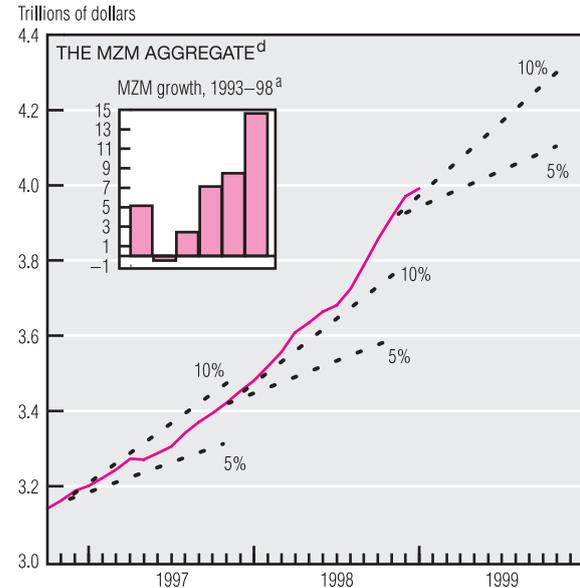
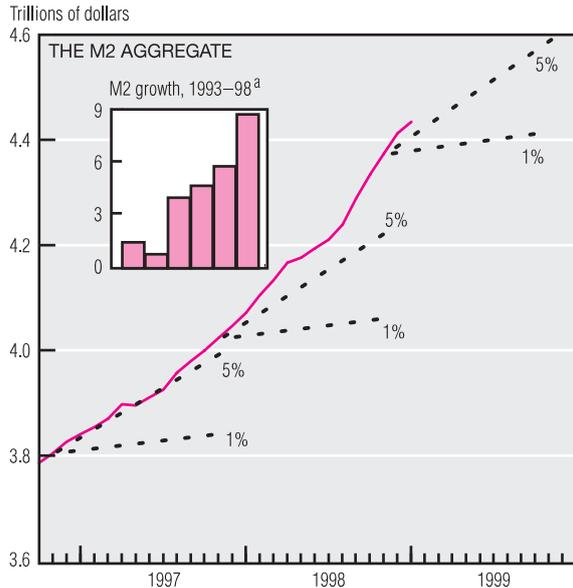
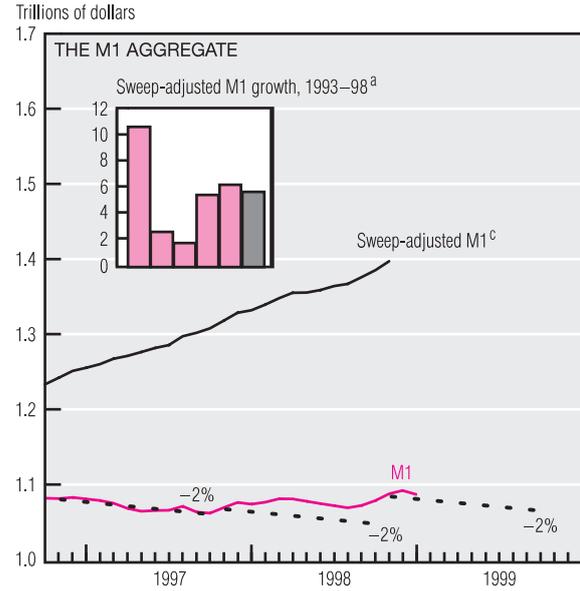
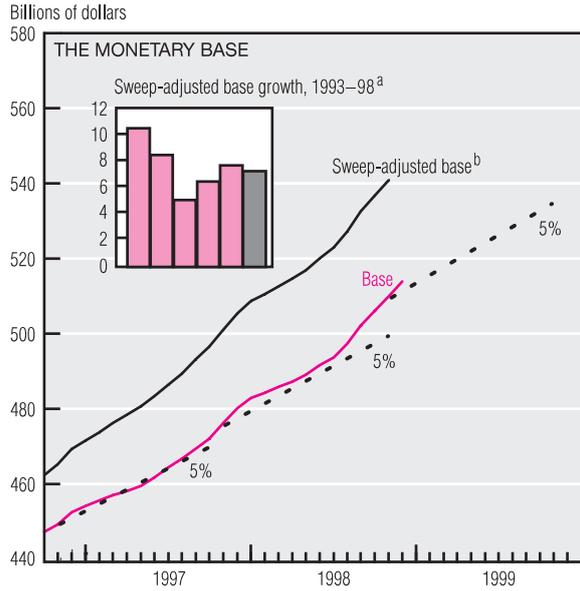
The seemingly inexplicable odyssey of equity prices has been chronicled many times by now. True, equity price movements can be explained through adjustments to standard equity-valuation models: Capital gains taxes have been lowered over time, and people accept risk more readily. But these adjustments are merely rationalizations after the fact. The reality is that the old norms no longer provide sufficient guidance.

Some observers regard the economy as surreal and dwell on its inevitable comeuppance, while others extoll the glories of a New Age. The first group, expecting familiar economic relationships to re-emerge, wants the Fed poised for restraint. The second, envisioning eternal, inflation-free expansion, desires a perennially accommodative monetary policy. Neither faction is likely to be satisfied.

Monetary policy is a blunt instrument; it cannot be used to manage the economy's short-term behavior precisely. Models based on previous experience are rough approximations of economic relationships and policy frameworks that change through time. Business cycle dynamics are simply tough to pin down and even harder to generalize. Attempts to smooth out all fluctuations might cause further instability. Appropriate interventions are those that keep price levels—and price expectations—stable. But not even a stable-price policy is an infallible guarantee against recession.

It stands to reason that monetary policy will be harder to conduct when established guideposts provide so little direction. Having fewer guideposts, however, is not the same as having no destination.

# Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. 1998 growth rates for sweep-adjusted base and M1 calculated on a November 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. Sweep-adjusted M1 includes an estimate of balances temporarily shifted from M1 to non-M1 accounts.

d. 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 monthly and seasonally adjusted. Last plots for M1, M2, and MZM are estimated for January 1999. Dotted lines for M2 are FOMC-determined provisional ranges. All other dotted lines represent growth in levels and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

The rate of money growth is a matter of concern because, as Milton Friedman aptly stated, “inflation is always and everywhere a monetary phenomenon.” Sweep-adjusted M1 growth appears to have slowed slightly last year (5.6% through November 1998, compared to 6.1% in 1997). Yet, compared to GDP growth, even this lower level is problematic. Although data on sweep-adjusted M1 growth since November are not yet available, non-sweep-adjusted M1 fell 6.2%

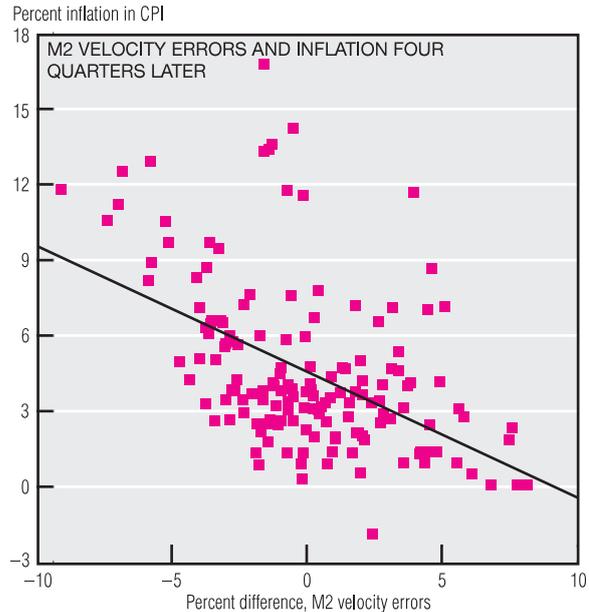
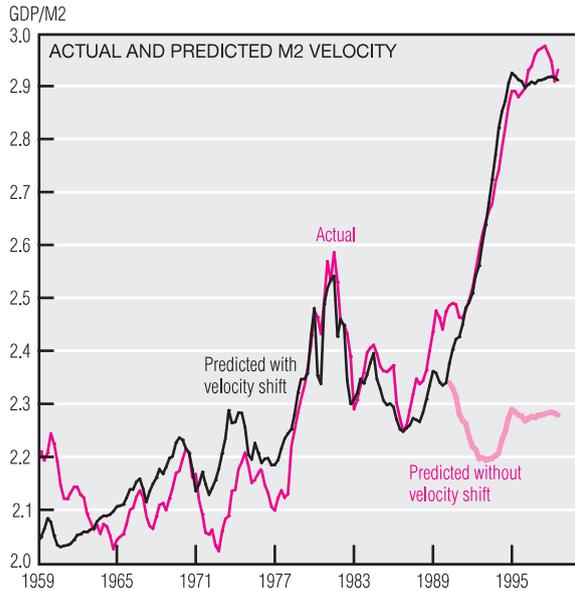
from November to December, much slower than its 1.6% average increase in 1998. Unless sweep activity spurted in December, sweep-adjusted M1 also is likely to show sharply slower growth. The broader monetary aggregates, however, showed significantly higher growth levels in 1998 than did these narrower aggregates.

For example, two such aggregates, M2 and MZM, registered faster growth than either base or M1 in 1998. What is more alarming is that

they accelerated sharply from their 1997 growth rates. M2 increased 8.7% last year, far outdistancing its 1997 growth of 5.7% and exceeding any growth seen since 1995. MZM’s growth rate for 1998 was even more robust (14.3%), substantially higher than its 8.2% growth in 1997. Compared to the GDP’s nominal growth in 1998 (4.9%), rapid growth in these aggregates raises fears that the economy is poised for an increase in inflation.

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Monetary Policy (cont.)



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

In stating that inflation is always and everywhere a monetary phenomenon, Milton Friedman professed a long-held belief that the cause of inflation is too much money chasing too few goods. This theory has merit in the long run because velocity remains fairly constant (an exception being a one-time shift in velocity that occurred in the early 1990s). Over the short term, however, inflation may deviate substantially from this prediction.

Increases in both output and nominal interest rates are associated with velocity—and thus prices—over the short run. Yet basing

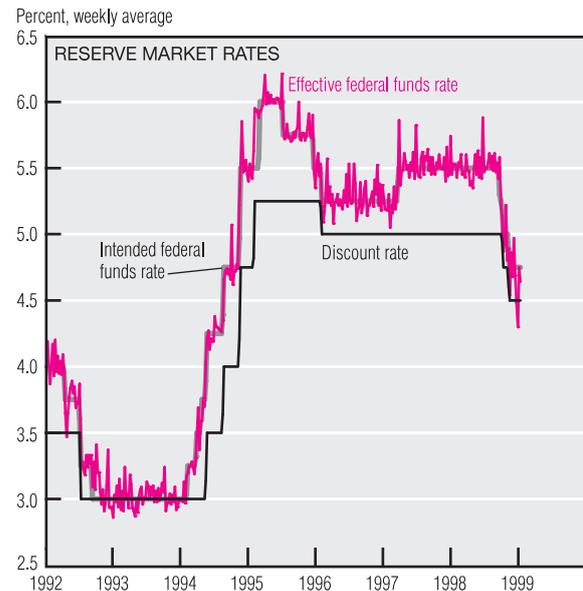
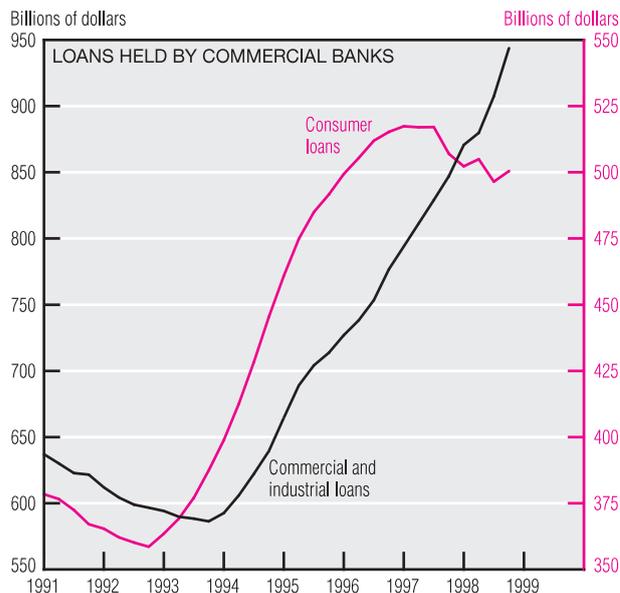
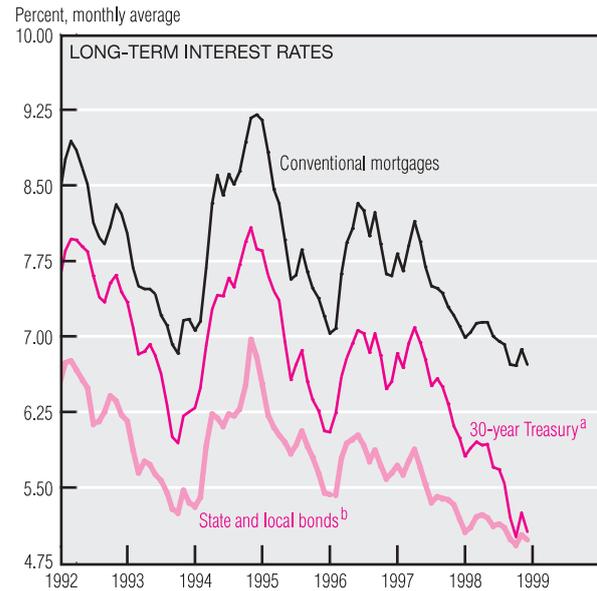
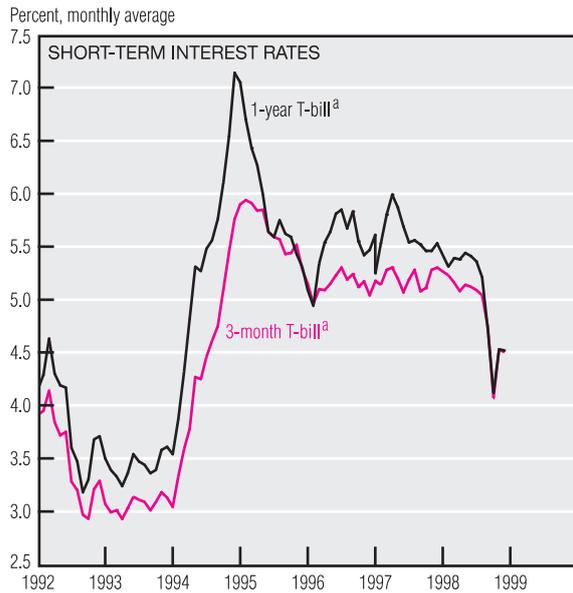
velocity predictions on movements in output and interest rates is tricky. At the end of 1997, for example, actual velocity was more than 2% higher than would have been predicted from output and interest rates alone. If these money-demand or velocity errors were largely self-correcting, actual velocity would tend to return to its predicted level. This would mean that today's velocity errors could help predict inflation four quarters from now. The 2% difference between actual and predicted velocity levels at the end of 1997 implies that inflation was about 1% lower than it otherwise would

have been at the end of 1998. Given that actual and predicted velocity levels have now converged, this suggests that inflation may tick up about 1% over 1999.

Short-term interest rates rose sharply at year's end. The weekly average 1-year and 3-month T-bill rates exceeded 4.5% in the weeks ending December 25, 1998 and January 1, 1999. These changes represent increases of 35 and 52 basis points from the final week of October for the 3-month and 1-year T-bills, respectively. To a lesser degree, longer-term interest rates also

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## Monetary Policy (cont.)



a. Constant maturity.

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

SOURCE: Board of Governors of the Federal Reserve System.

increased over the same period. State and local bonds with a 20-year maturity and the 30-year Treasury both increased roughly 10 basis points in December 1998. Conventional mortgage rates held fairly stable at a low level.

Recent interest rate movements could reflect weakness in consumer loans, which shrank almost 0.5% in 1998. Commercial and industrial loans, however, were far more robust, having grown slightly more than 8.25% in 1998. As Chairman Greenspan observed in his State of the Economy testimony before the House Ways and Means Committee

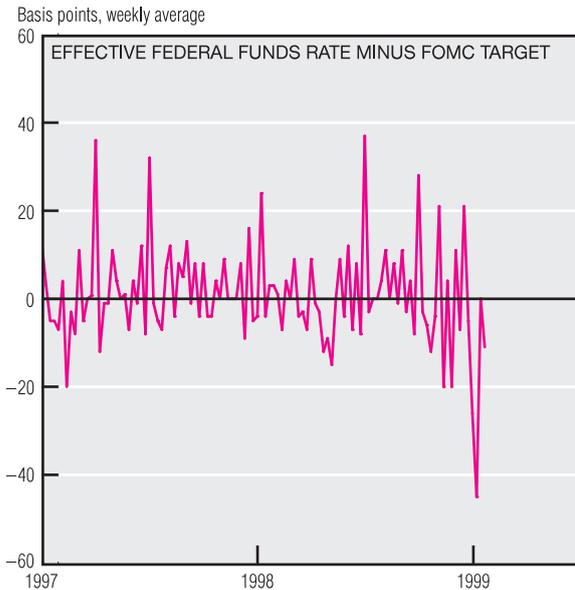
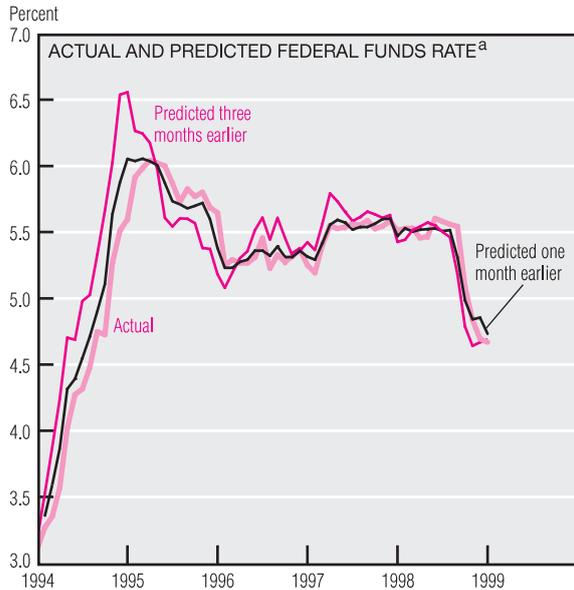
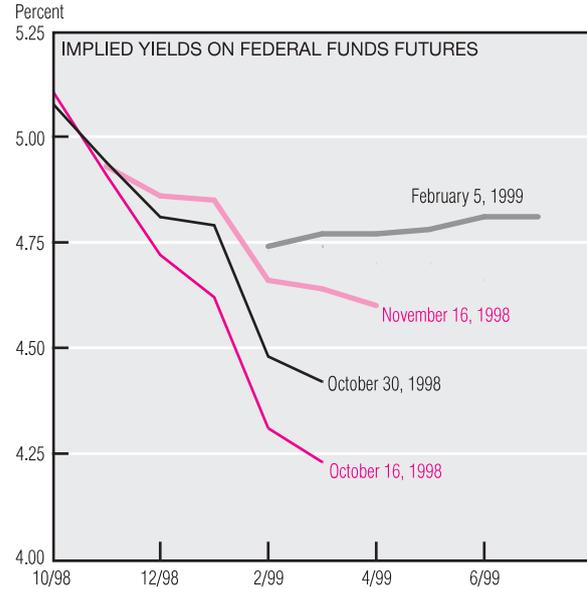
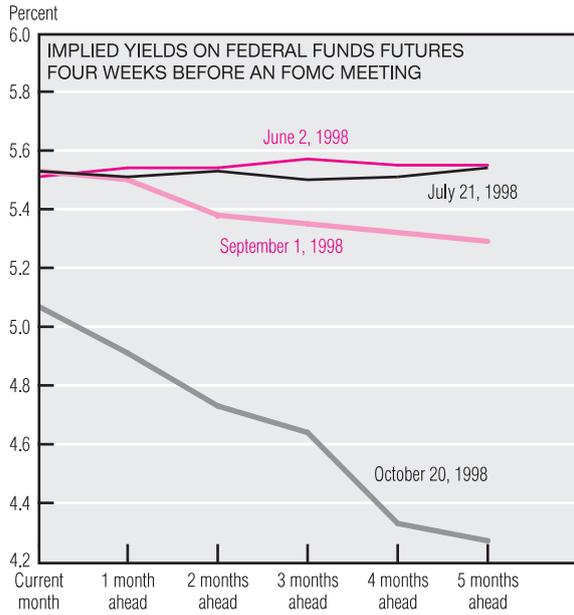
on January 20, 1999, “there is decided softness in a number of manufacturing industries,” which he attributed to foreign developments. He concluded by saying that, “with corporations already relying increasingly on borrowing to finance capital investment, any evidence of a marked slowing in corporate cash flow is likely to induce a relatively prompt review of capital budgets.”

The Federal Open Market Committee (FOMC) did not change either the discount rate (4.5%) or the target funds rate (4.75%) at its February meeting. In the near term,

market participants seem to anticipate no movement in the federal funds rate target. In early February, they predicted that the June 1999 funds rate would be 4.81%, which is nearly identical to its current level.

A look at implied yields on federal funds futures four weeks prior to FOMC meetings shows that market participants did not foresee the policy easing that occurred at the FOMC’s September 29 meeting. Until then, the market had expected the funds rate to remain fairly constant. Just after the largely unforeseen intermeeting policy easing  
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Monetary Policy (cont.)



a. Predicted rates are federal funds futures.  
 SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

of October 16, the market began to anticipate future rate cuts, looking for a further funds rate reduction of more than 75 basis points by March. Subsequently, expectations of further target rate cuts decreased steadily, and by November 16 the market was anticipating the rate cut of 25 basis points that transpired the next day with little indication of any future easing. Since then, the market has anticipated that the funds rate would continue trading near its current 4.75% target.

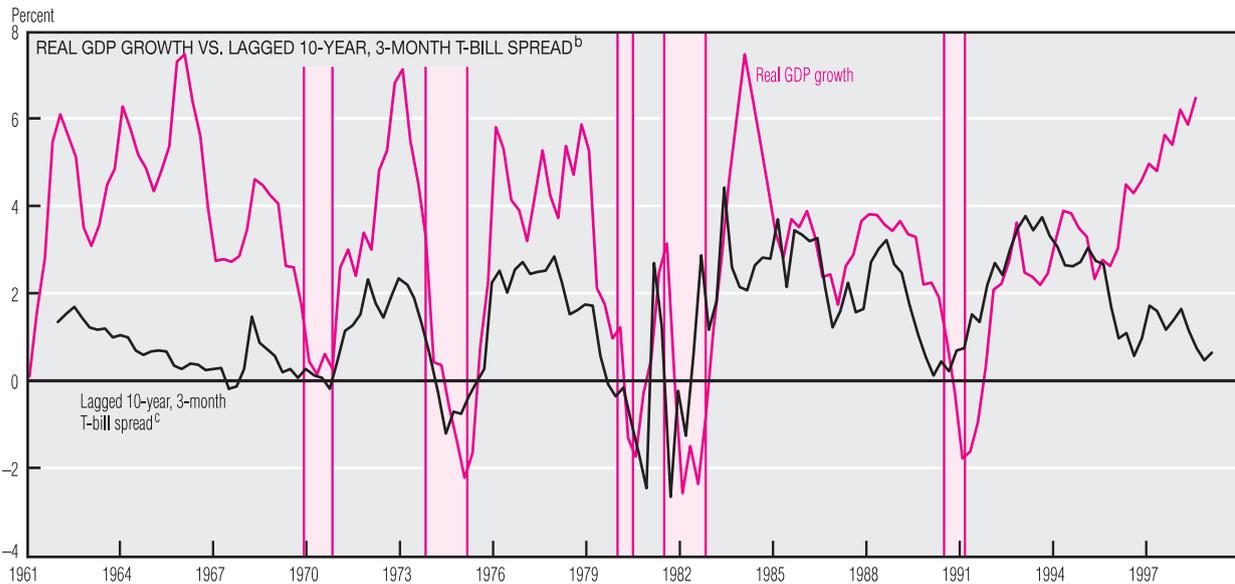
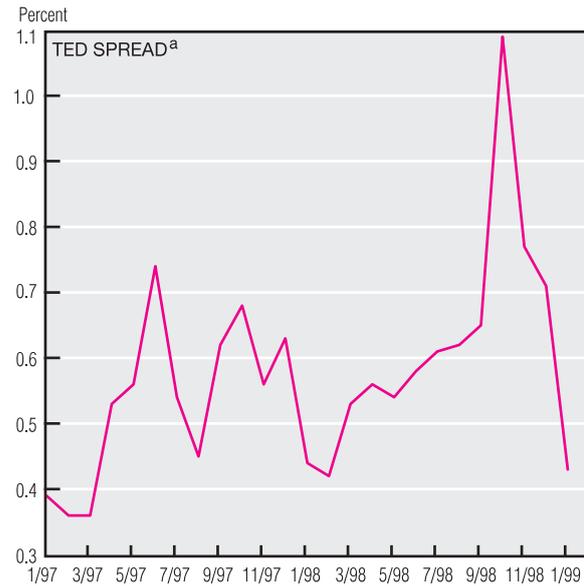
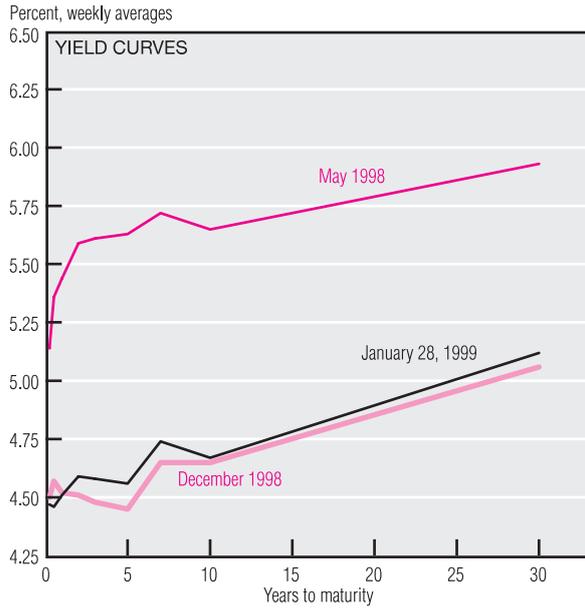
The fed funds futures market is not a perfect tool for predicting the precise timing of policy changes. It

is, however, a reasonable indicator of the average future federal funds rate. A plot showing predictions with one- and three-month lead times, along with the actual federal funds rate, shows that when the rate is rising (that is, when policy is tightening), predictions tend to err on the high side. The opposite occurs when the rate is falling. Overall, the futures series follow the actual funds rate reasonably well.

The federal funds rate chosen by the FOMC is a target rate. Reserves are added to or drained from the system on a daily (Monday through Friday) basis in order to achieve this

target. Misses from the target rate generally tend to be quite small, averaging one-tenth of a percentage point in 1998. The miss in the last week of 1998 was unusually large (45 basis points) but it was short-lived, since the rate hit the target straight on just one week later. That big December miss was probably the product of many factors, including recent longer-term repurchase operations by the trading desk, doubts associated with the introduction of the euro, and the notorious seasonal uncertainty that occurs at the end of every year.

# Interest Rates



a. The spread between the 3-month Eurodollar deposit rate and the 3-month Treasury-bill rate.  
 b. Shaded areas indicate recessions.  
 c. 10-year, 3-month spread lagged four quarters.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System, statistical releases.

The yield curve remains rather flat, having shown little movement since last month. At the long end, rates on 30-year bonds increased a scant six basis points; at the short end, three-month rates dropped three basis points.

The introduction of the euro, heralded by some as the dawn of a new era, was decryd by others as a doomed experiment. By one measure, the Treasury-to-Eurodollar (TED) spread, the experiment seems a success. The spread continued its downward trend from its

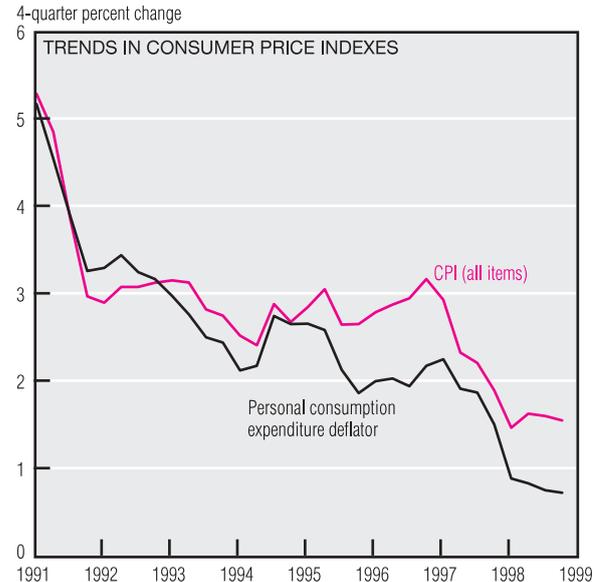
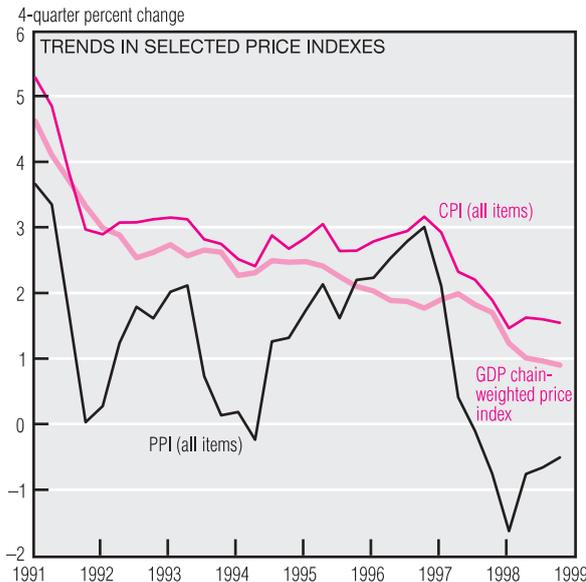
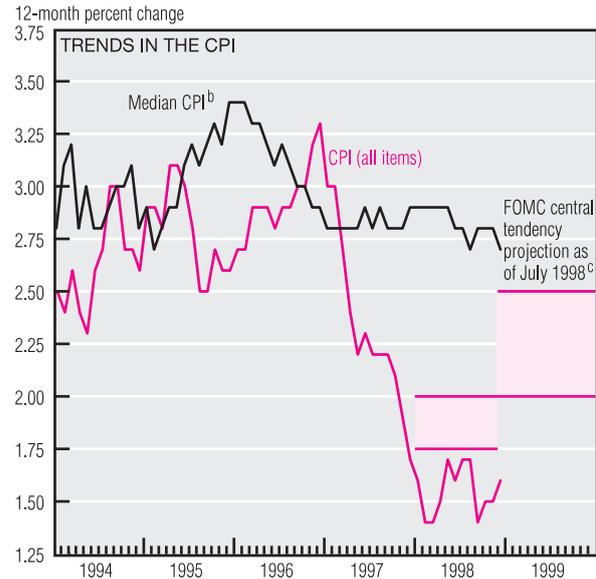
peak of 109 basis points in October, a sign that the flight to quality, so evident after the turmoil in Russia and East Asia, was slowing. Now, at 44 basis points, the spread has returned to its pre-crisis level. This seems to indicate that the market, at least, did not believe that the euro placed any unbearable strains upon the European banking system.

One classic application uses spreads in the yield curve to predict future economic activity. In the simplest approach, a yield-curve inversion signals a recession; more gener-

ally, the size of the spread provides information about future growth. The standard story here is that the 10-year, 3-month spread predicts growth over the next four quarters. Since late 1995, however, this relationship has become suspect because a relatively flat yield curve has persisted in the face of robust growth. The spread currently stands at a rather low number, though recent experience suggests it may not be a cause for great concern.

# Inflation and Prices

	Percent change, last:				1997 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>Consumer prices</b>					
All items	1.5	2.2	1.6	2.4	1.7
Less food and energy	3.5	2.5	2.5	2.6	2.2
Median <sup>b</sup>	2.4	2.4	2.7	2.9	2.9
<b>Producer prices</b>					
Finished goods	4.7	1.9	-0.2	1.1	-1.2
Less food and energy	12.3	4.8	2.4	1.4	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. SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and the Federal Reserve Bank of Cleveland.

Retail price increases remained generally modest in December, as the Consumer Price Index (CPI) increased an annualized 1.5% to finish the year with a 1.6% gain—0.1 percentage points less than 1997's low rate. Price increases were larger at the wholesale level in December, although the Producer Price Index (PPI) showed essentially no change for the year as a whole.

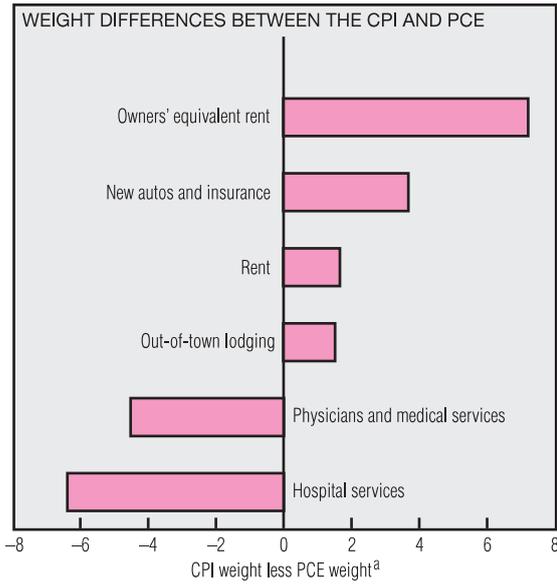
The 12-month CPI trend finished the year under the lower end of the index's central tendency projection,

set by the FOMC at midyear. The median CPI, an alternative measure of the inflation trend, remained steady and considerably higher, however, averaging 2.7% in 1998. These two inflation estimates have followed widely divergent trends over the past few years.

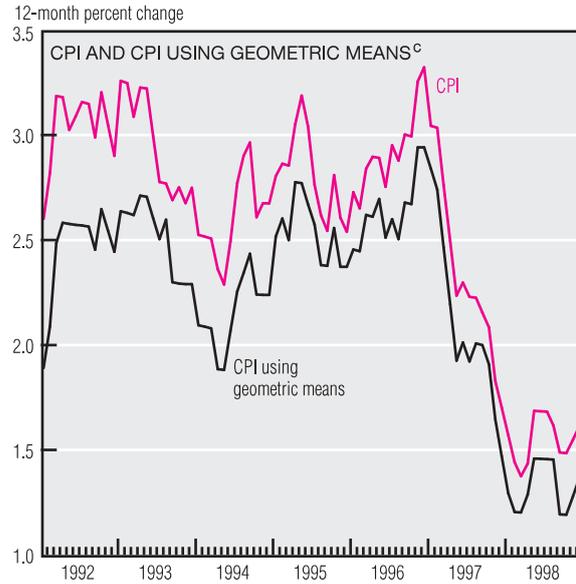
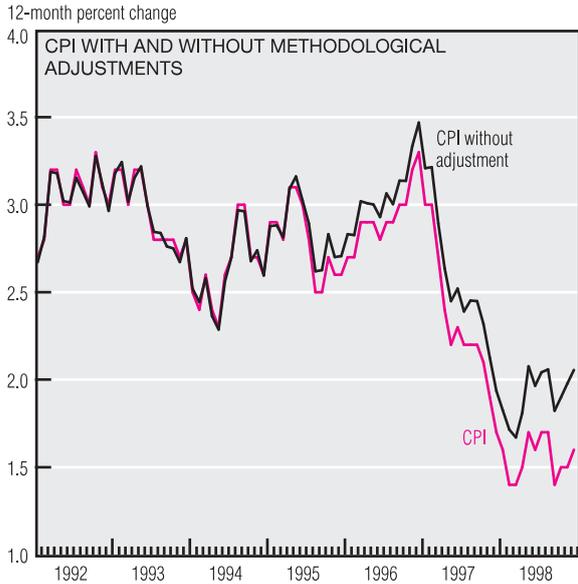
Measuring inflation is surprisingly difficult in both theory and practice, and no single measure of prices can claim the title of the U.S. "inflation" rate. While the CPI is undoubtedly the best-known and most widely

used inflation estimate, this statistic does not include capital goods or other items purchased by businesses. Such items are part of the PPI, but that price index does not include services—a major segment of the CPI. An even broader index, the GDP chain-weighted price index, covers virtually all goods and services sold in the economy, including those purchased by the government and foreigners. This measure has tended to fall somewhere between the CPI and  
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# Inflation and Prices (cont.)



Components affected by methodology change	Year introduced	Percentage point effect on: CPI percent change
<b>Pre-1999</b>		
Generic prescription drugs	1995	-0.01
Food at home	1995	-0.04
Home ownership	1995	-0.10
Rent	1995	0.03
All items (store sample)	1996	-0.10
Hospital services	1997	-0.06
Personal computers	1998	-0.06
All items (updated market basket)	1998	-0.15
<b>1999 proposed</b>		
All items (averaging technique)	1999	-0.20
All items (item sample)	1999	-0.05
<b>Total</b>		<b>-0.74</b>



a. Percentage-point difference.  
 b. Data from the U.S. Department of Labor, Bureau of Labor Statistics; and 1998 *Economic Report of the President*.  
 c. Data are not seasonally adjusted.  
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and 1998 *Economic Report of the President*.

the PPI in recent years—a bit under 1% over the past four quarters.

Even within the retail category, there are many ways to measure aggregate price increases, and different methods can yield very different inflation rates. For example, like the CPI, the personal consumption expenditure (PCE) deflator used in the national income and product accounts tries to gauge the rate at which consumer prices are rising. But there are significant differences in how these two price indexes are computed. To begin with, the two inflation measures differ greatly in

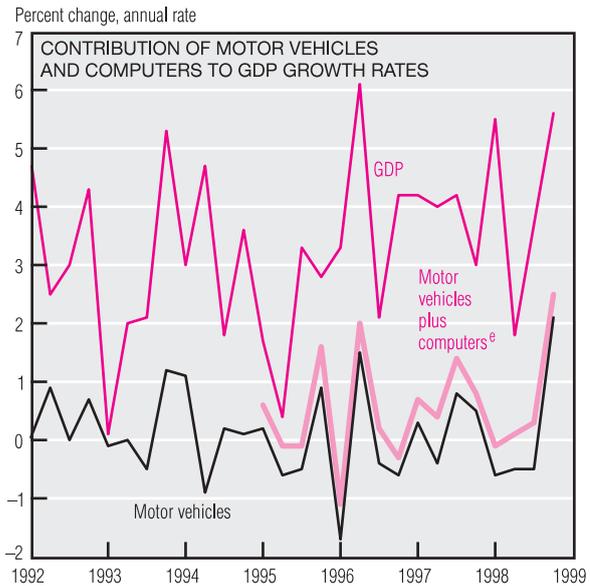
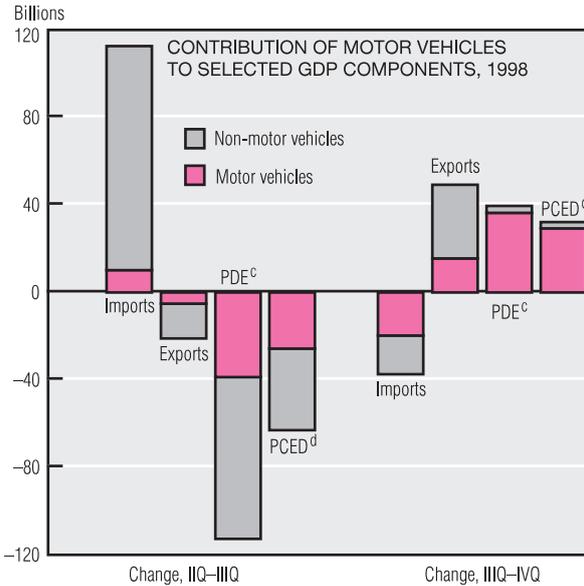
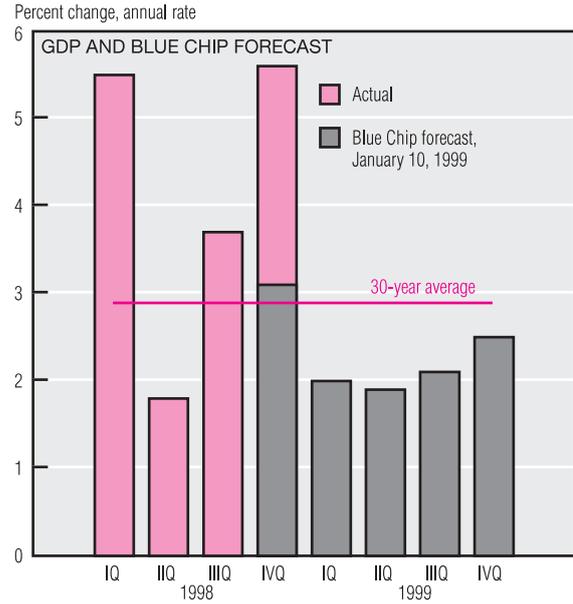
their weighting of certain items; housing components get considerably more weight in the CPI, while the PCE deflator gives much more weight to medical care items. The two inflation measures also use different methods for collecting certain prices and for computing price changes. The combined influence of these differences has caused the PCE measure of retail price growth to track about ¾ percentage point below the CPI over the past four years or so.

Perhaps because of its wide use in government contracts, such as So-

cial Security, the CPI has come under increased pressure to improve its methodology; indeed, the methods used to construct the index have changed already. Between 1995 and 1998, the CPI incorporated eight major methodological adjustments which, according to Department of Labor estimates, have reduced the index's measured trend by about ½ percentage point. This year, the CPI will undergo two additional changes that Labor Department statisticians project could trim another ¼ percentage point off its trend.

# Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter, annual rate	Four quarters
<b>Real GDP and Components, 1998:IVQ<sup>a,b</sup></b>			
<b>(Advance estimate)</b>			
Real GDP	103.5	5.6	4.1
Consumer spending	56.0	4.4	5.2
Durables	36.4	21.4	12.5
Nondurables	12.3	3.2	4.5
Services	12.0	1.7	4.0
Business fixed investment	37.8	16.7	12.4
Equipment	37.5	21.0	17.5
Structures	2.8	5.7	-0.4
Residential investment	7.7	10.1	12.6
Government spending	13.1	4.1	1.8
National defense	1.0	1.3	-1.4
Net exports	-3.9	—	—
Exports	42.4	18.8	0.9
Imports	46.3	16.0	10.7
Change in business inventories	-6.8	—	—



a. Chain-weighted data in billions of 1992 dollars.  
 b. Components of real GDP need not add to totals because current dollar values are deflated at the most detailed level for which all required data are available.  
 c. Producers' durable equipment.  
 d. Personal consumption expenditures on durable goods.  
 e. Computer series not available before 1995.  
 NOTE: All data are seasonally adjusted.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, January 10, 1999.

As of January 10, the Blue Chip consensus forecast was a solid growth rate of 3.1% in 1998:IVQ. However, advance estimates released at the end of January indicate that GDP grew at a 5.6% annual rate, far above Blue Chip analysts' expectations. The 5.6% advance estimate is remarkably strong, amounting to double the U.S. economy's 30-year average growth rate.

A major growth source in the fourth quarter was motor vehicle

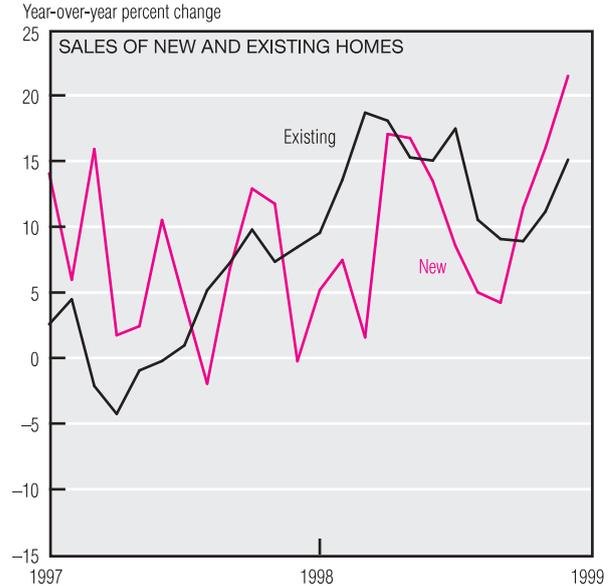
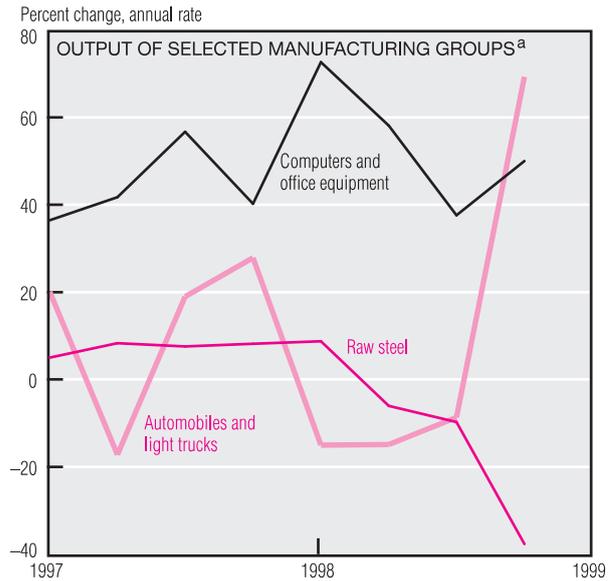
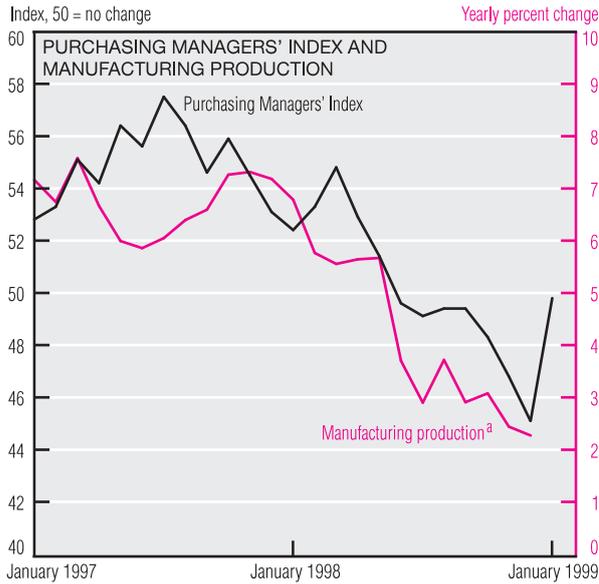
production, which accounted for 2.1 percentage points of the 5.6% GDP increase. This was reflected in a rebound in the motor-vehicle-related components of personal consumption expenditures for durable goods, producers' purchases of durable equipment, and by exports and imports. Last summer's General Motors strike had held down those sectors in the second and third quarters because its effects were focused in June and July. Much of the fourth-quarter strength in automotive components

probably reflects production to satisfy backlogs in addition to resumption of normal production.

Last summer's events—the strike as well as financial turmoil abroad—are frequently cited as causes of a weakening manufacturing sector, indicated by the slower growth of industrial production in 1998. The overall slowing, however, obscures the strong performance of some sectors. A breakdown of the manufac-

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Economic Activity (cont.)



a. Data are from the Federal Reserve Board's Industrial Production Index.  
 NOTE: All data are are seasonally adjusted.  
 SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System; National Association of Purchasing Management; and National Association of Realtors.

turing component of industrial production shows great variance among sectors. Most notably, the computers and office equipment sector grew at annual rates of 40% and higher for most of 1997 and 1998. In 198:IVQ, combined computer and motor vehicle production accounted for 45% of GDP growth.

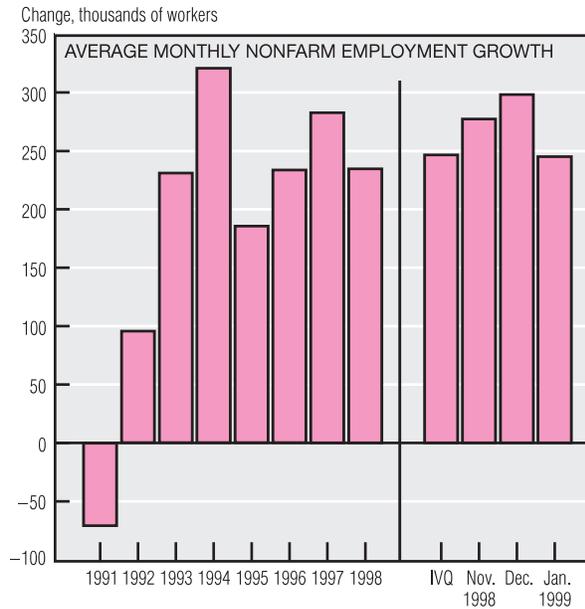
The fourth-quarter surge in automotive production corresponded with a flood of steel imports from countries affected by last summer's financial turmoil. A sharp decline in steel prices, resulting from the large amount of imported steel, was associ-

ated with a decline in U.S. raw steel production. Thus, despite the surge in auto-related production, growth in industrial production as a whole continued to slow through December.

Purchasing managers also were indicating softness in the manufacturing sector. The Purchasing Managers' Index (in which executives indicate whether business has slowed, picked up, or remained the same) dropped precipitously in the latter months of 1998. In January, however, the Index recovered all the ground it had lost, a sign that business was improving.

Construction and real estate activity continue to be very strong. Residential investment has been a consistently vigorous component of GDP growth throughout 1998. Construction activity continues to show healthy growth levels. A revival in housing starts and permits since September points toward continued growth in 1999 residential construction. This seems to be confirmed by evidence of lively demand in the real estate market. New home sales are growing very strongly, while sales of existing homes broke records in December.

# Labor Markets

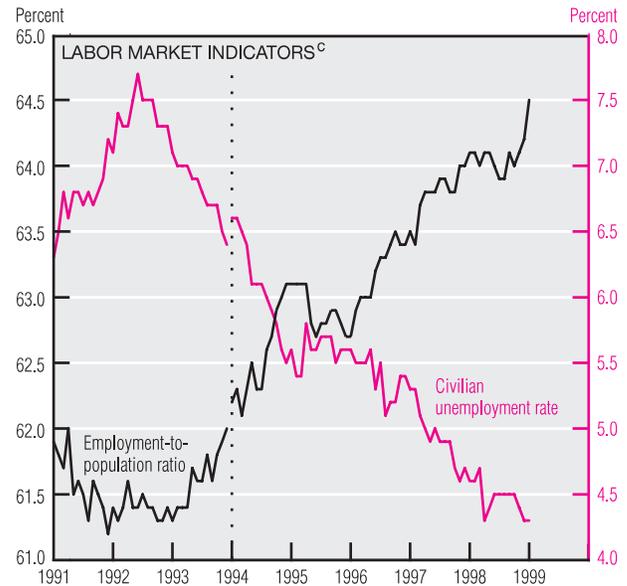
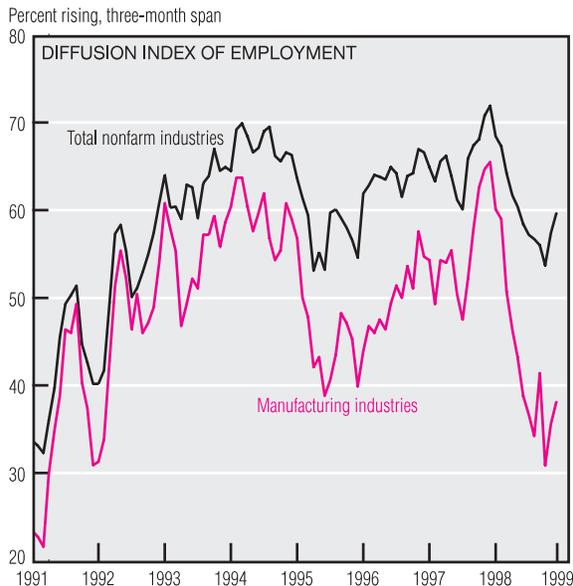


## Labor Market Conditions

	Average monthly change (thousands of employees)				
	1995	1996	1997	1998	Jan. 1999
Payroll employment	185	233	282	234	245
Goods-producing	8	31	42	6	-7
Mining	-2	1	1	-3	-9
Construction	10	28	20	28	15
Manufacturing	-1	3	21	-20	-13
Service-producing	178	202	240	229	252
Retail trade	37	42	34	39	30
FIRE <sup>a</sup>	-1	14	17	22	22
Services	112	117	142	112	114
Business Services	38	45	61	39	48
Government	9	9	20	28	36
Household employment <sup>b</sup>	30	228	235	157	814

	Average for period (percent)				
	1995	1996	1997	1998	1999
Civilian unemployment	5.6	5.4	4.9	4.5	4.3



a. Finance, insurance, and real estate.

b. January change in household employment reflects an adjustment by the Bureau of Labor Statistics.

c. 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.

Robust labor market growth continued unabated in the first month of 1999, contrary to early predictions of slowing. Nonfarm payrolls increased 245,000, which is just above 1998's average monthly payroll growth and about equal to the average for 1998:IVQ.

Once again large gains in the service-producing sector compensated for small declines in the goods-producing sector. Both mining and manufacturing lost jobs, while construction remained strong despite unfavorable weather in the

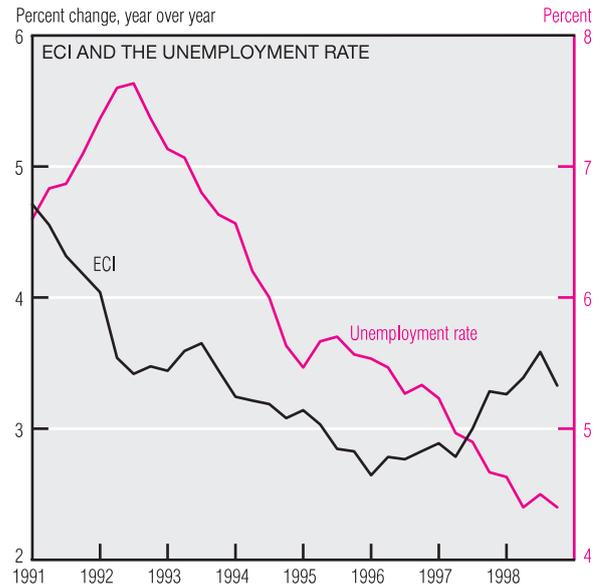
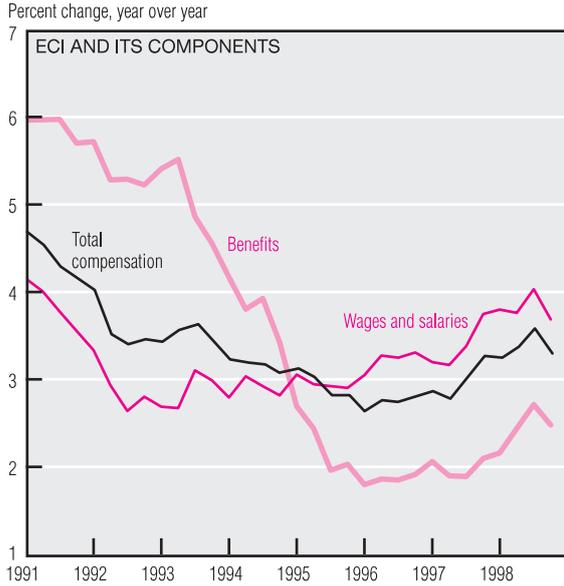
Midwest and Northeast. The construction industry has added 284,000 new jobs in the last 12 months. Services added 114,000 new jobs in January, with business services experiencing an above-average gain of 48,000.

The January employment report also revealed greater breadth in employment growth, as measured by the fraction of industries in which employment is rising. For the three months ending January 1999, 60% of the 349 detailed industries that were surveyed had increased their

employment. However, within manufacturing, just over 60% of the industries surveyed had decreased their employment.

The unemployment rate held steady at 4.3%, a 28-year low, although there was a substantial jump in household employment. The percent of the working-age population that is employed rose to 64.5% in January, making it the second straight month of record highs in the employment-to-population ratio. The labor force participation rate of 67.4% also was a record high.

# Employment Cost Index



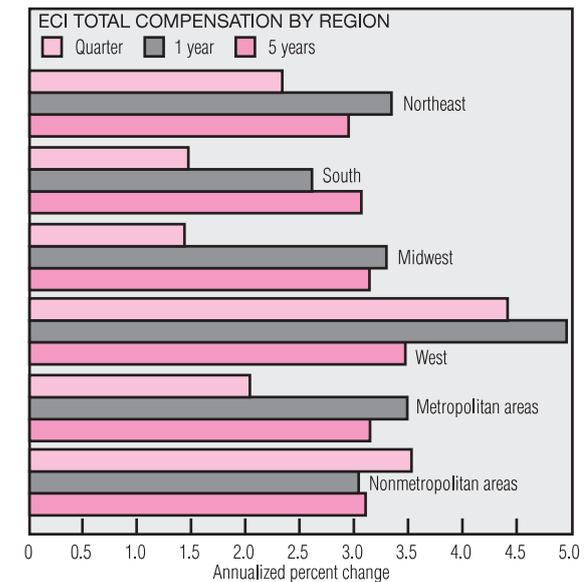
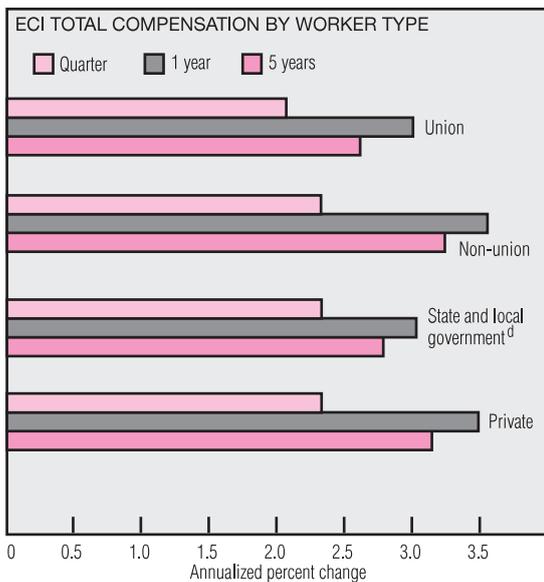
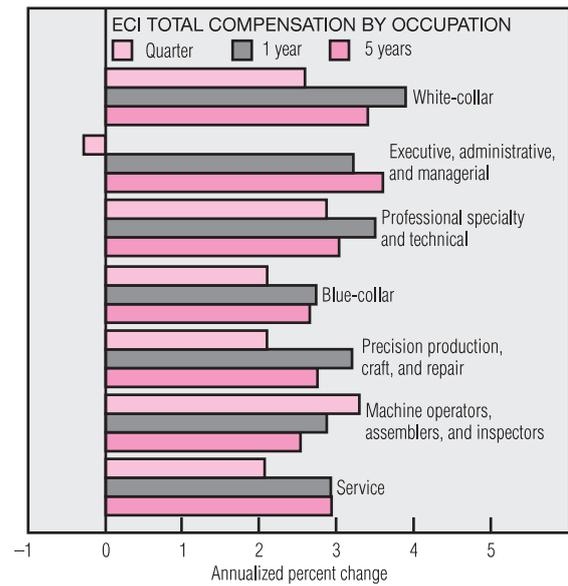
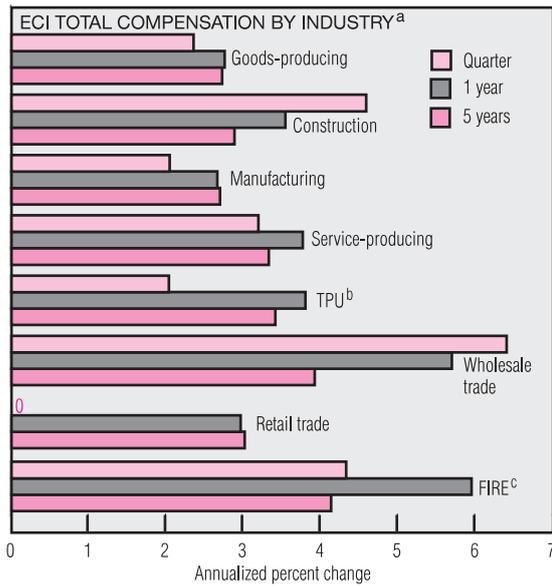
a. Both compensation measures are for private-sector workers.  
 b. Production and nonsupervisory workers.  
 NOTE: Unless otherwise noted, data are seasonally adjusted and apply to all civilian workers.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

From the firm's perspective, the cost of employing workers extends substantially beyond the wages and salaries paid to those workers. Benefits packages represent 28% of employment costs. The Bureau of Labor Statistics publishes a quarterly Employment Cost Index (ECI) measuring changes in compensation costs including wages, salaries, and employee benefits. The benefits included in the ECI are diverse: vacations, health care insurance, and pension benefits, as well as mandated benefits like employer contributions to Social Security and unemployment insurance. In addition, the

ECI covers the full range of the workforce, unlike the average hourly wage rate, which applies only to production workers. Despite an exceptionally strong labor market, employment costs continue to grow only moderately. In 1998, overall employment costs rose 3.4%, held down by an increase in benefits costs of only 2.6%. The limited increase in benefits costs was surprising, given widespread concerns that health care costs were set to go up substantially. However, unemployment insurance systems have been reducing their employer contributions

due to low unemployment rates, and growth in the value of pensions' stock holdings have limited the need for further contributions. From the worker's perspective, 1998 was a good year for real wage growth, as the ECI exceeded inflation by the largest margin since 1983. Inflation was only 1.6% for 1998, versus compensation growth of 3.4% or wage and salary growth of 3.7%. Recent low unemployment rates may be part of the story, although the relationship between unemployment rates and the ECI has not been tight during the 1990s. Some workers  
*(continued on next page)*

## Employment Cost Index (cont.)



a. Seasonally adjusted.  
 b. Transportation and public utilities.  
 c. Finance, insurance, and real estate.  
 d. Government workers are not in the private sector.  
 NOTE: All data are for private-sector workers unless otherwise noted.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

have had larger or smaller gains than average, reflecting the relative demand for different types of labor.

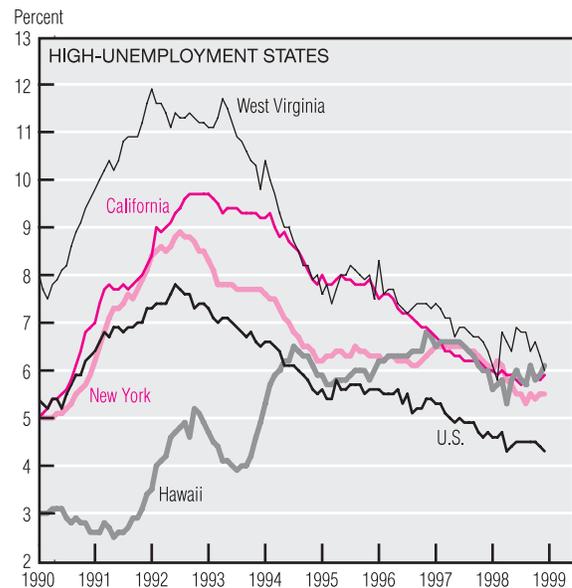
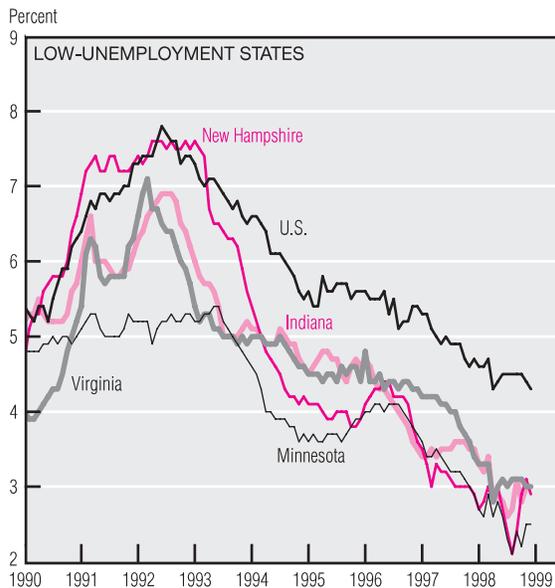
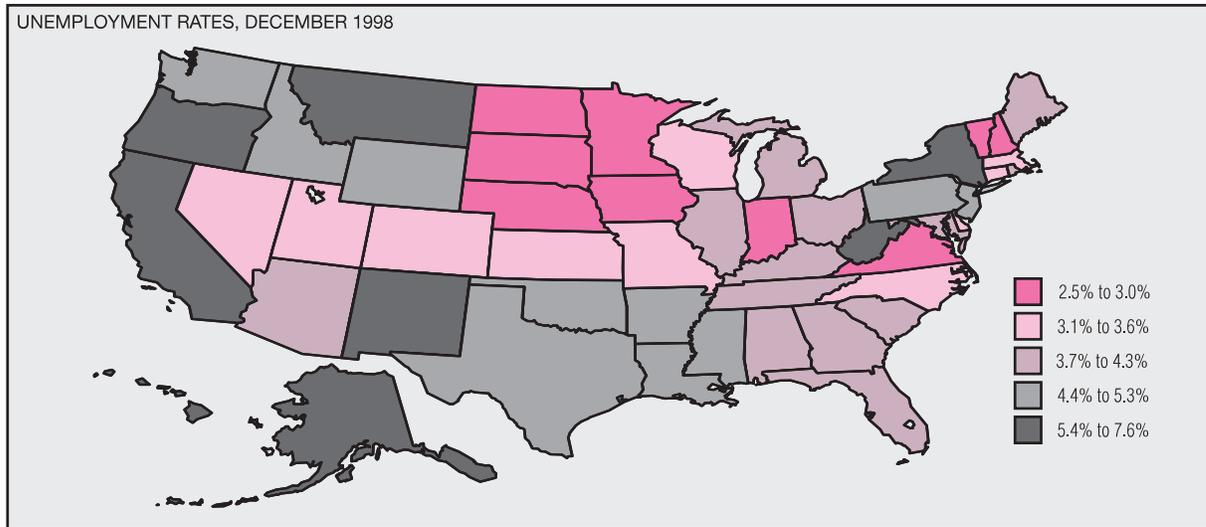
Sorted by industry, compensation growth has been strongest in wholesale trade and in finance, insurance, and real estate. Pay is flexible in many finance industry jobs where bonuses are common, so it is not unusual for that industry to have outsize quarterly gains; however, it has shown faster-than-average compensation growth during the last five years. Recent gains in construction

point to accelerating compensation in a sector that has not historically kept up with the average.

Other distinctions surface by occupation and by region. White-collar workers' gains continue to outpace those of blue-collar workers. The latest quarter showed unusually weak gains in the bonus-oriented executive ranks, but white-collar compensation still rose more than a percentage point faster in 1998 and more than half a percentage point faster per year since 1993. Similarly, some

regions have had substantially stronger compensation growth than others. Notably, the ECI for the West rose much more sharply in 1998 and has maintained its relative strength over the last five years. These repeated small differences in compensation growth can alter relative pay differentials. For example, the data indicate that the premium for union or government work is being reduced, while education-intensive occupations are moving further ahead.

## Unemployment Rates



NOTE: All data are seasonally adjusted  
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

A seven-year economic expansion has brought U.S. unemployment to 4.3%, its lowest rate since the 1960s. The change has been felt throughout the nation. When the economy began its current expansion in March 1991, the vast majority of states (39) had unemployment rates of 5.4% or higher, while only two had unemployment rates at or below 3%. By the end of 1998, only eight states had unemployment rates at or above 5.4%, while nine had rates of 3% or lower. This general decline in unemployment rates is not purely a business-cycle phenomenon. Even at the peak of

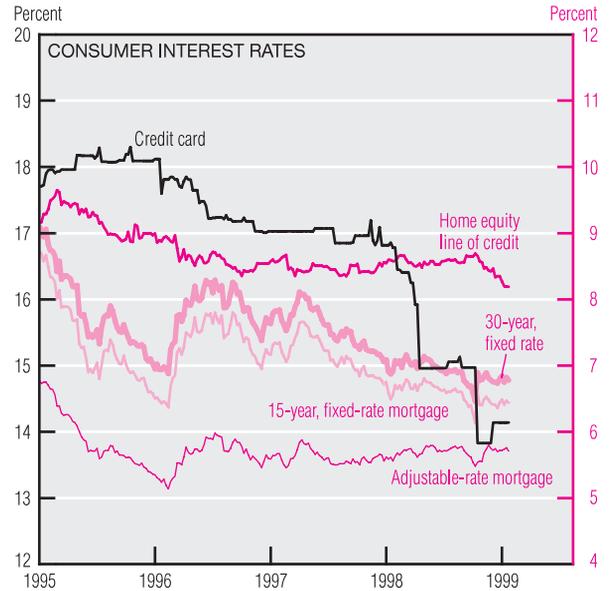
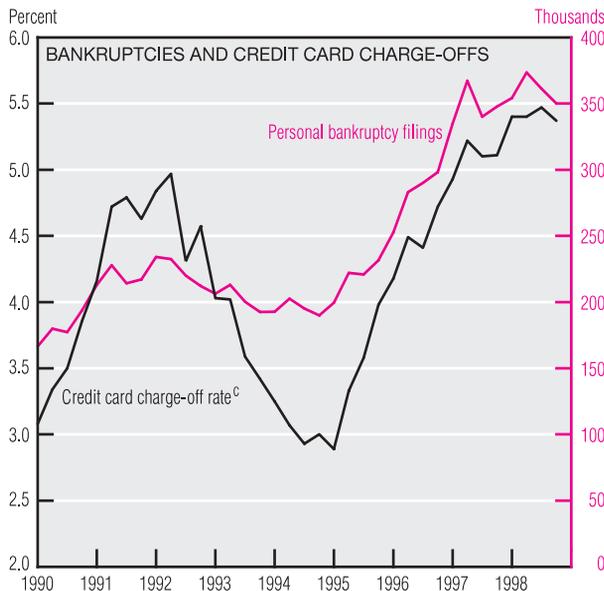
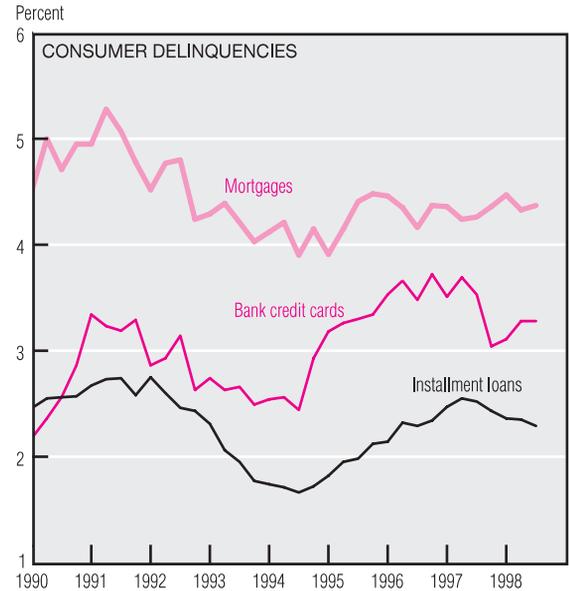
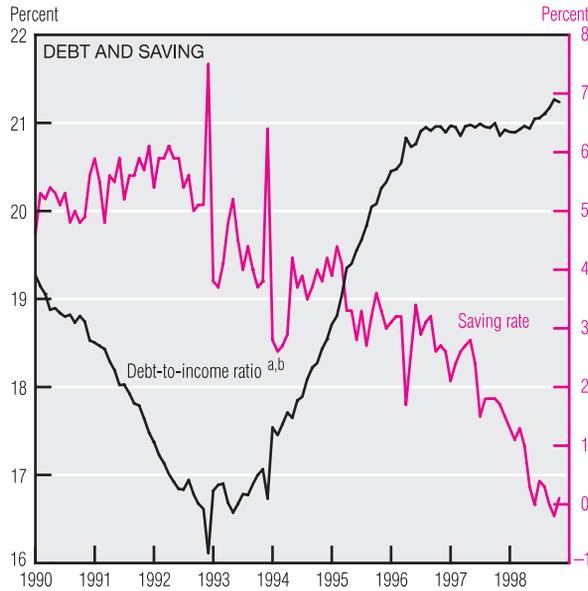
the previous expansion (at that time the longest peacetime expansion on record), 27 states had unemployment rates at or above 5.4%.

The states with the lowest unemployment rates in 1998 typically have had lower-than-average rates for extended periods. Several of these states are in the upper Midwest, where moderate employment growth has been matched with even lower growth in the working-age population. In contrast, Virginia has relied on robust jobs growth to keep its unemployment rate low while its population expanded.

Even states with historically

higher unemployment rates have seen sizable reductions, with the exception of Hawaii, which was adversely affected by the weak Japanese economy. West Virginia is a good example: Despite having one of the highest unemployment rates in the country, it had the third-largest unemployment rate decline during this period, almost six percentage points. Even California and New York, states where the previous recession lingered long beyond its official trough, have almost regained their pre-recession unemployment rates.

# Household Financial Conditions



a. Ratio of total consumer credit to disposable personal income.  
 b. Seasonally adjusted.  
 c. Net charge-off rate is the percentage of total credit card debt that banks remove from their balance sheets because of uncollectibility, less amounts recovered on credit cards previously charged off, expressed as an annual rate.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*; American Bankers Association, *Consumer Credit Delinquency Bulletin*; American Bankruptcy Institute; Mortgage Bankers Association of America, *National Delinquency Survey*; and *Bank Rate Monitor*.

Household consumer debt levels rose again (to 21.24% of disposable personal income last November), after remaining stable since the beginning of 1996. This renewed acceleration in household debt burdens is all the more striking when viewed against the backdrop of a domestic personal saving rate that turned negative, the only time this has occurred since the figure was first calculated.

Such trends concern many ana-

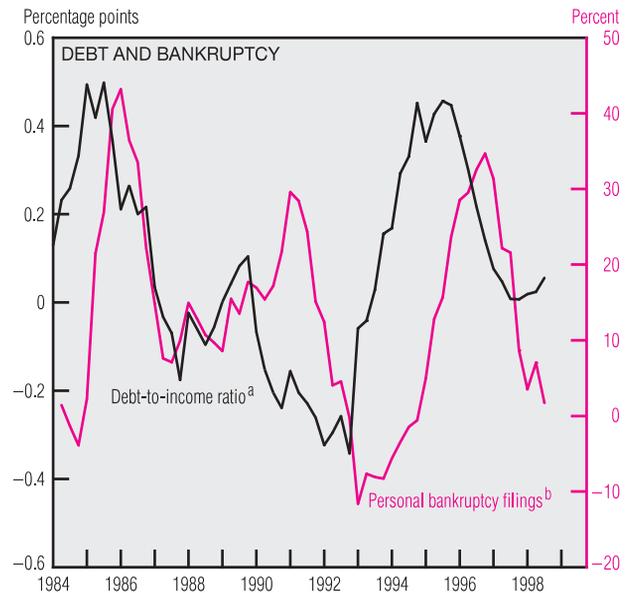
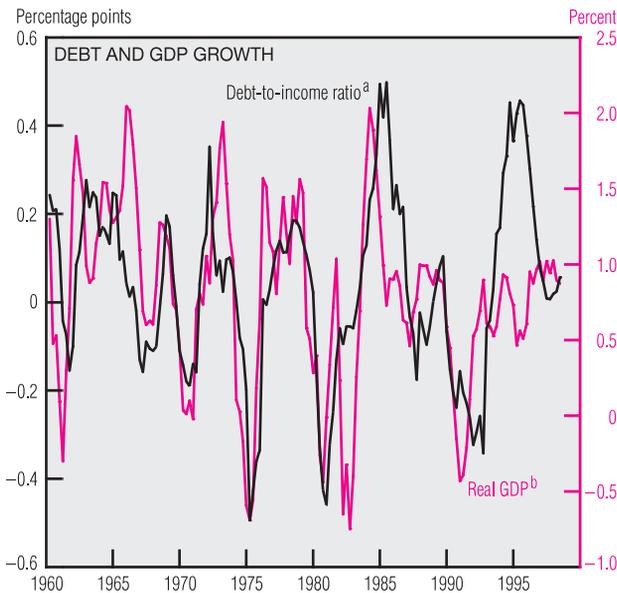
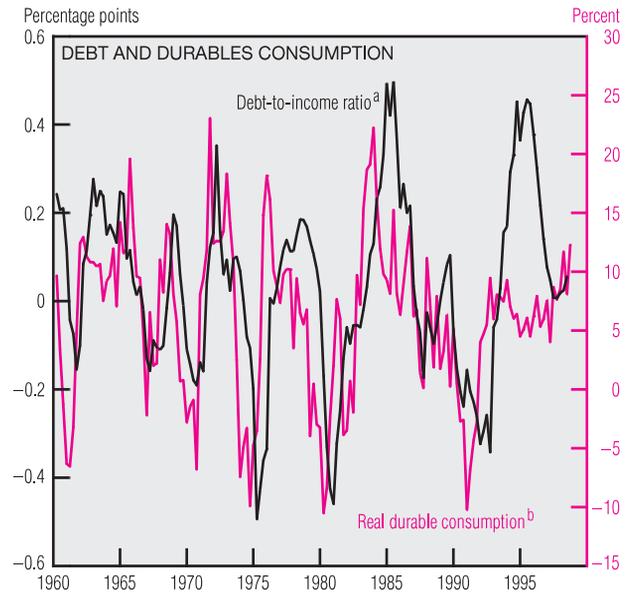
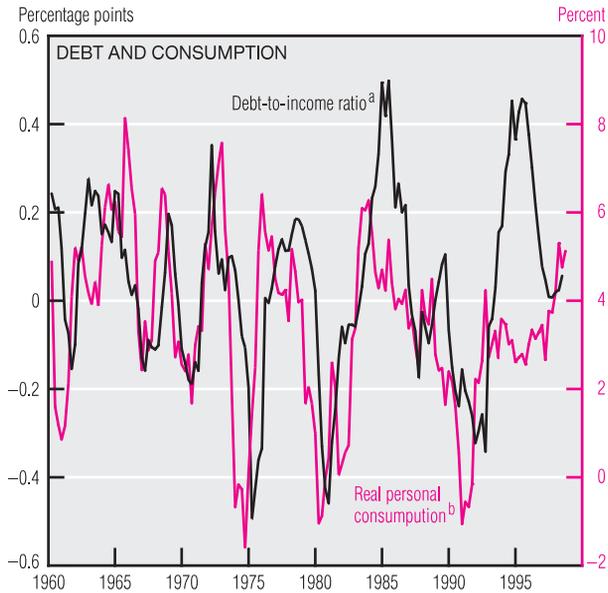
lysts because personal consumption expenditures account for nearly two-thirds of the GDP. As a result, the story goes, if household accounts get too far out of balance, consumption growth may taper off and pull the economy into a recession.

Beyond the raw debt numbers, however, other indicators of household financial distress do not appear to foreshadow impending doom. For example, after rising dramati-

cally through the middle part of the decade, delinquency rates on various types of consumer and mortgage debt have held steady or even fallen since 1996. Similarly, the growth in personal bankruptcy filings and credit card charge-off rates that was so notable beginning in 1994 has slowed over the past two years.

In addition, the steady decline of mortgage rates since early 1997, not  
*(continued on next page)*

## Household Financial Conditions (cont.)



a. Ratio of total consumer credit to disposable personal income.

b. Annualized percentage change.

NOTE: All data are four-quarter moving averages of quarter-over-quarter changes.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and American Bankruptcy Institute.

to mention the dramatic drop in average credit card rates over last year, has served to lower the overall fraction of household income needed to service these higher debt levels. As a consequence, households may rationally desire to hold higher debt balances than they did during periods of higher interest rates.

A more fundamental reason to question the above story about the danger of high debt burdens is that it assumes a causal link between debt levels and real economic vari-

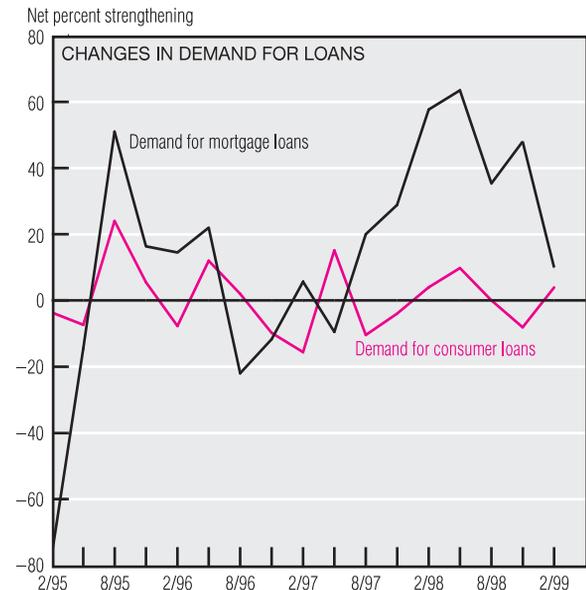
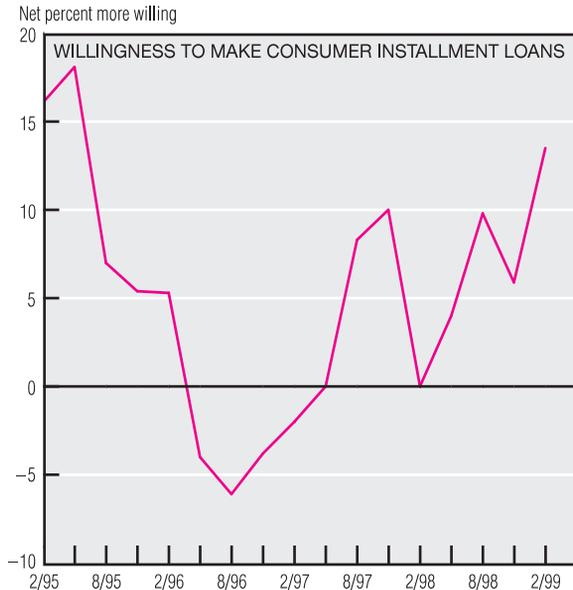
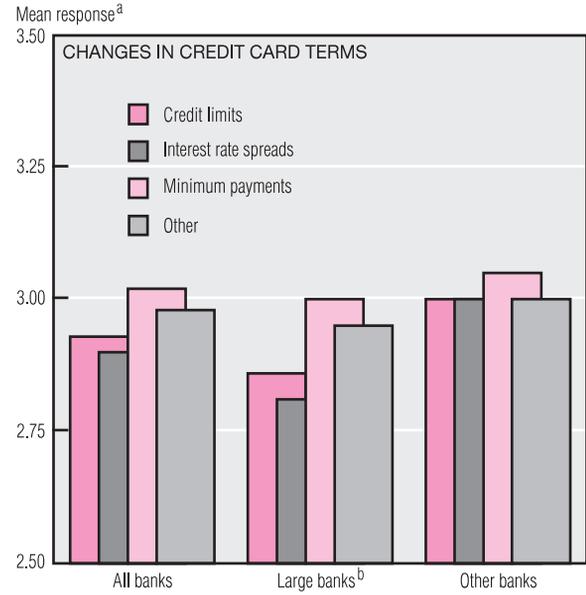
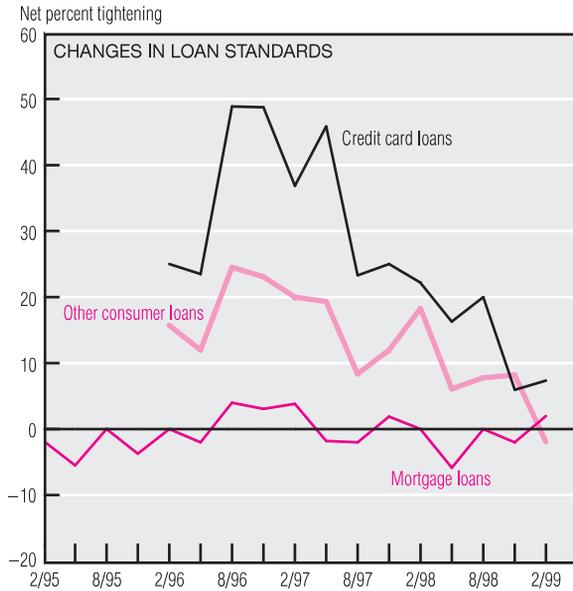
ables that doesn't appear to exist. In particular, those who are concerned about increases in the debt-to-income ratio implicitly assume that debt burdens either cause or predict future consumption expenditures.

Historical experience, however, calls this assumption into question. In fact, changes in real economic variables such as personal consumption expenditures, durable goods consumption, and GDP typically precede changes in the debt-to-income ratio by as much as two or three quarters. In other words,

changes in consumption output tend to predict changes in consumer debt levels, not the other way around.

An alternative story can be told to demonstrate the reasonableness of such a pattern. When households experience a negative shock to their incomes, the debt-to-income level naturally rises for two reasons: First, of course, is the direct effect of lower disposable personal incomes. Simultaneously, however, households may increase  
*(continued on next page)*

## Household Financial Conditions (cont.)



a. Mean response of banks using the following scale: 1 = tightened considerably, 2 = tightened somewhat, 3 = remained basically unchanged, 4 = eased somewhat, and 5 = eased considerably.  
 b. Total domestic assets over \$15 billion.  
 SOURCE: Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Bank Lending Practices*.

their indebtedness in order to smooth their consumption patterns, if they perceive the shock to be temporary. Such smoothing is not complete, however, so that consumption expenditures, particularly for durables, decline in the face of this income shock. As a result, the real economic variables of interest decline in advance of, not following, a decline in household debt levels. Most importantly, by the time we observe changes in debt levels that might portend lower economic growth, that lower growth already has occurred.

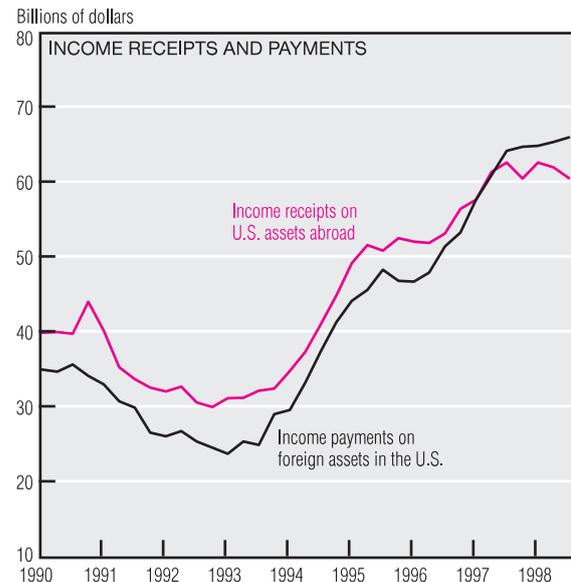
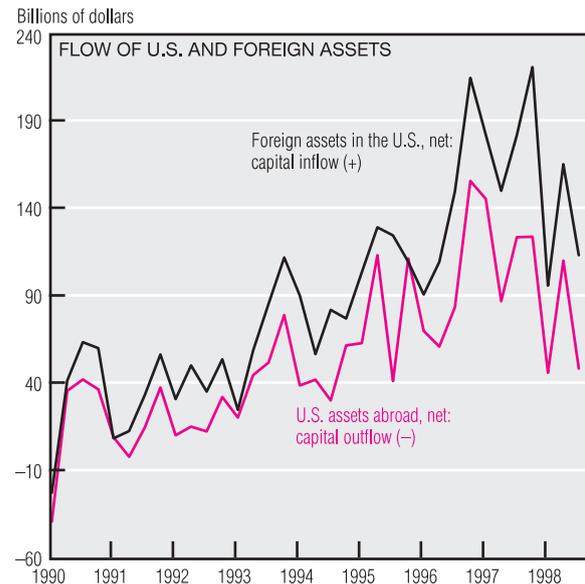
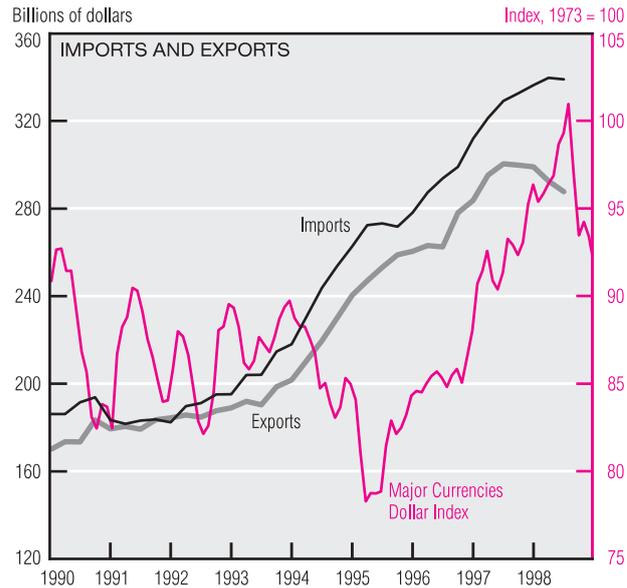
Additional insight into household financial conditions can be gleaned from the Federal Reserve's quarterly *Senior Loan Officer Opinion Survey on Bank Lending Practices*. According to the latest survey, conducted last month, the trend toward tighter loan standards that has prevailed over the last three years for credit card lending and other consumer loans appears to be moderating, while mortgage loan standards continue their steady track.

The same patterns are evident in the changing terms of credit card

loans. Although credit limits and interest rate spreads are slightly less favorable than they have been in the past (due primarily to the influence of large banks), minimum payment requirements and other credit card terms are virtually unchanged.

Despite this tightening of standards, senior loan officers continue to report a strong and growing willingness to make consumer installment loans. Taken together, these trends suggest that creditworthy borrowers are having little trouble in gaining access to credit.

# Trade Deficits



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

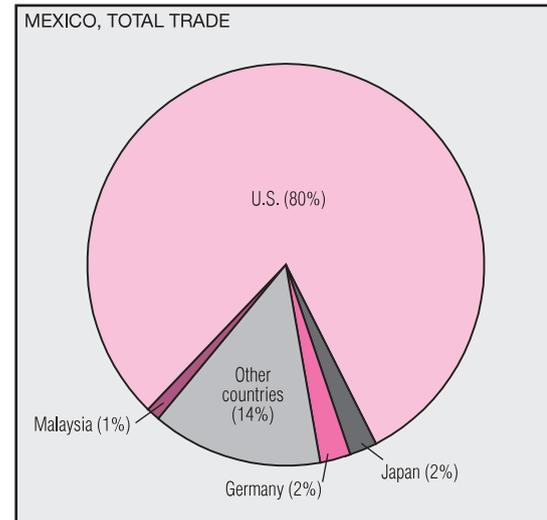
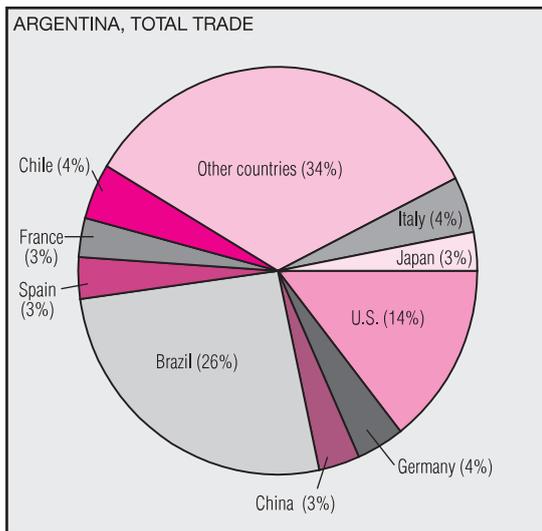
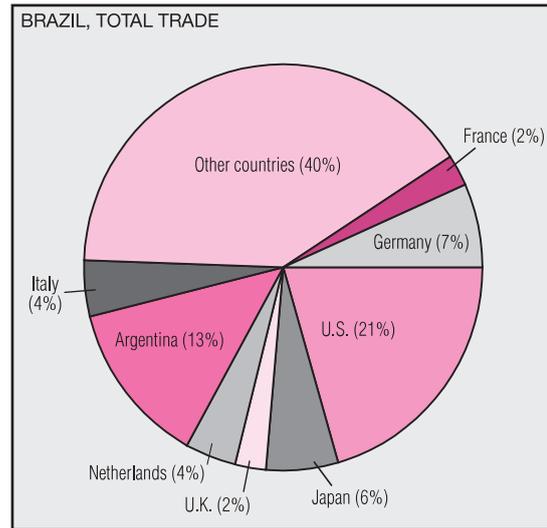
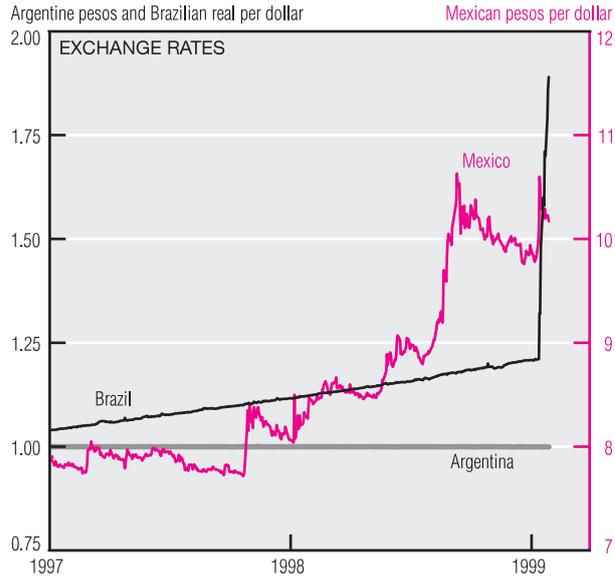
Increased concerns about the widening U.S. trade deficit can be understood by examining the 1998:IIIQ data on international transactions from different perspectives. The increased gap between imports and exports of goods, services, and income may reflect a relative increase in the disposable income of U.S. citizens, or an increased attractiveness of investing in the U.S. On the other hand, it could be seen as the U.S. economy's increased vulnerability to withdrawals of foreign funds.

Net capital inflow, the increase in foreign holdings in the U.S., continues to exceed net capital outflow.

However, the accounting requirement that a current-account deficit must be balanced by capital flow does not mean that the current-account deficit *causes* the capital flow—the sequence could be reversed. The form taken by the inflow might be important in this regard. Direct foreign investment (DFI) in the U.S., which involves ownership control rather than portfolio design, now exceeds U.S. DFI abroad. Fluctuations in DFI have been much more moderate than those shown by other components of capital flow, suggesting that at least part of the increased net capital inflow will not quickly reverse direction.

A country relying on capital inflow may see it turn to outflow unless the capital is invested wisely. In addition, since the services provided by capital imply payments to the lenders, a long period of net capital inflow might lead to an increase in the burden of such payments. The most recent data show an increase in the excess of payments on foreign assets in the U.S. over income receipts on U.S. assets abroad. However, the debt burden facing the U.S. does not approach the levels typically found in countries that subsequently experience significant net capital outflow.

Brazil



SOURCES: Federal Reserve Bank of New York; International Monetary Fund, *Direction of Trade Statistics*; and Morgan Stanley Capital International.

On January 13, Brazil devalued its currency, the *real*, creating further turmoil in world financial markets. By January 22, the real had fallen 29% despite large expenditures of dollar reserves by Brazil's central bank. It was unclear whether planned fiscal reforms would be sufficient to slow the currency's fall, and reliance on further interest rate increases might not be credible given their probable negative effects on the Brazilian economy.

The decline in the value of the real and the weakening of Brazil's economy are concerns for its trading partners. In particular, Argentina main-

tains the value of its currency against the U.S. dollar. The real's decline against the dollar increases the cost to Brazil of Argentinian exports. Although the U.S. accounts for the largest share of Brazil's trade (21%), Brazil is Argentina's largest partner (26%). Argentina already has begun to consider cutting some import taxes to lessen the impact on industries that depend on Brazilian trade.

Other Latin American economies could be influenced as well. Commerce between Brazil and Argentina accounts for most of the trade within Mercosur, the South American trading bloc that also includes Paraguay

and Uruguay. The continued fragility of the Mexican banking system and the peso's weakness in 1998 suggest that the decline of the real could affect Mexico significantly. Mexico has little trade with either Brazil or Argentina, but Brazil's problems could hamper the economic growth of other countries which in turn would reduce their trade with Mexico. Or a pure contagion effect could occur whereby investors pull back from an entire group of countries. To date, however, there is little evidence of significant consequences for Mexico.