

## *The Economy in Perspective*

*Wear sunscreen* ... The Federal Reserve raised the target federal funds rate one-quarter of a point to 5% at its June policy meeting. This action, however widely expected, was not universally endorsed. Immediately before the Federal Open Market Committee meeting, some observers questioned the need for a rate hike. After all, inflation has been fairly stable during the past year, and has actually declined on average over the past several years. The April CPI report flashed caution, but May's release restored a sense of calm. And some analysts claimed that the combination of vigorous economic growth and low unemployment—which was associated with accelerating inflation during some earlier expansions—no longer posed a clear and present danger.

What, then, accounts for the precaution? The FOMC's press release stated that last fall the Committee "...reduced interest rates to counter a significant seizing-up of financial markets in the United States. Since then, much of the financial strain has eased, foreign economies have firmed, and economic activity in the United States has moved forward at a brisk pace. Accordingly, the full degree of adjustment is judged no longer necessary." The "full degree of adjustment" refers to last fall's 75-basis-point cut, which also went against the grain of the Committee's then-established bias toward raising the funds rate.

The current economic climate in the United States still shows the same torrid conditions that prevailed when the FOMC met in March and May of 1998. At that time, virtually all sectors of the economy were expanding rapidly, especially sales to domestic purchasers. Imports were streaming into the country to satisfy demand that was not met through domestic production. Credit availability in all sectors was judged ample. As it does now, the unemployment rate stood at 4.3% in May 1998. Moreover, according to the Committee's minutes, "The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow considerably during the next few quarters and remain moderate in 1999." We know now that the shift to a more temperate climate did not occur.

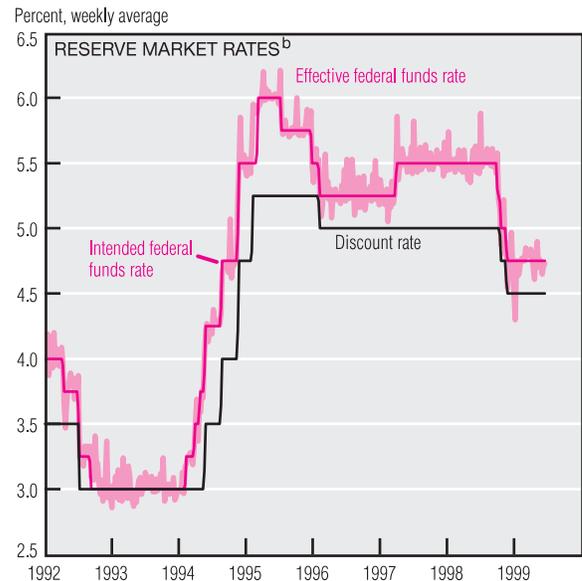
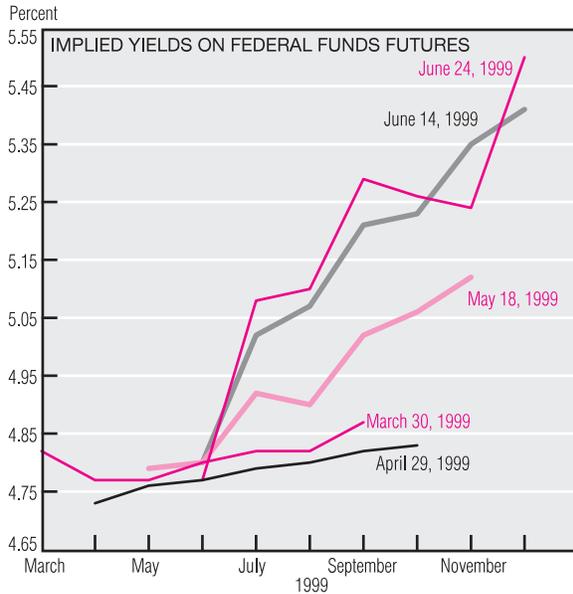
These considerations, and others like them, led the Committee last year to adopt asymmetric directives in favor of a higher funds rate, both in March and in May, when the funds rate stood at IPF (Inflation Protection Factor) 5½%. In fact, two FOMC members dissented at the May meeting, seeking the shade of a funds rate hike immediately. That meeting's minutes make it clear that the Committee was entirely comfortable at the time with a more restrictive policy stance than prevails today, even after the recent funds rate hike of 25 basis points.

Critics of last week's rate hike argue that now is not the time to block the rays of our economic sun even slightly, for either of two reasons. Some allege that a higher IPF monetary policy will necessarily diminish the pace of economic activity. One response to such a contention is to agree with it. Just as a body can be exposed to too much sun, an economy may not be able to absorb too much activity without suffering side effects like inflation, poor credit decisions, and inflated asset prices. The more layers of skin are burned, the riskier the corrective treatment. Monetary policymakers have learned that it is better to act early than to rely on aggressive therapy later on. The success of this reasoning should be self-evident to observers of this long and prosperous expansion.

Others accept the FOMC's logic, but still consider its most recent action premature. Those who fault the Committee for raising the funds rate at its last meeting point to all of its previous decisions to forbear at seemingly similar times. They remind us that this willingness to apply a low-grade IPF has supported strong economic performance thus far. That may well be so, but monetary policy always requires a balancing of risks. As its actions last fall indicated, the FOMC is willing and able to adjust tactics in cloudy weather. When the clouds recede and the hot rays return, restraint always seems more objectionable because it is equated with the end of the expansion. The fallacy of this logic too should be self-evident.

But trust me on the sunscreen.

# Monetary Policy



a. Constant maturity.

b. Last data plotted for the week ending June 25, 1999.

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

The Federal Open Market Committee (FOMC) changed the federal funds rate target at its June 29 meeting to 5.00%, an increase of 25 basis points. The discount rate remained unchanged at 4.5%. The change in the federal funds rate target was the first since last fall, when the FOMC lowered rates 75 basis points in response to threatening financial market conditions.

Financial market participants generally anticipated the increase in the federal funds rate. Implied yields on

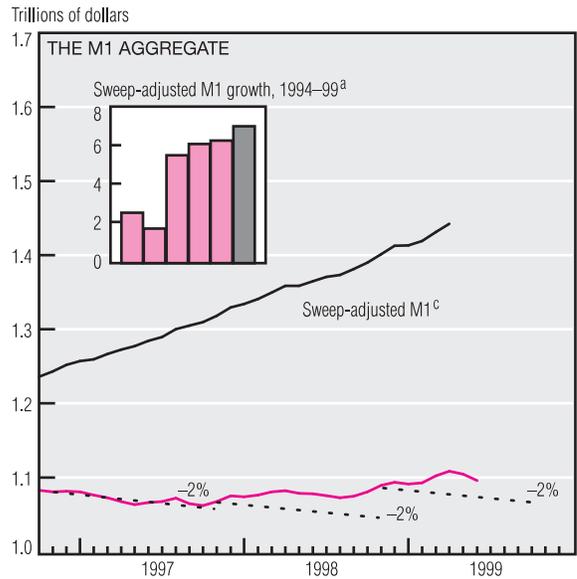
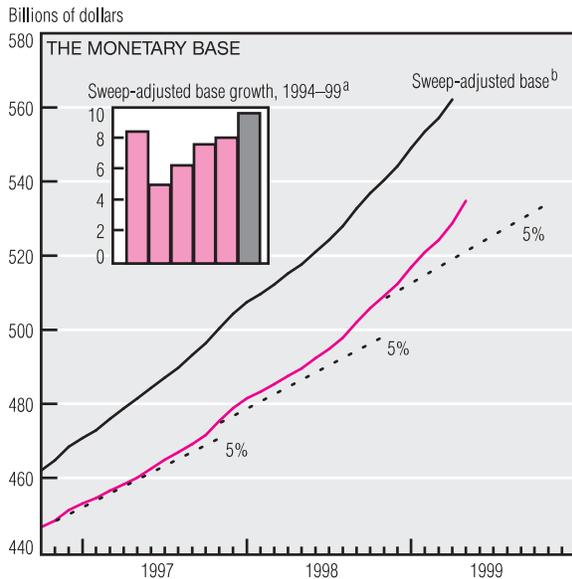
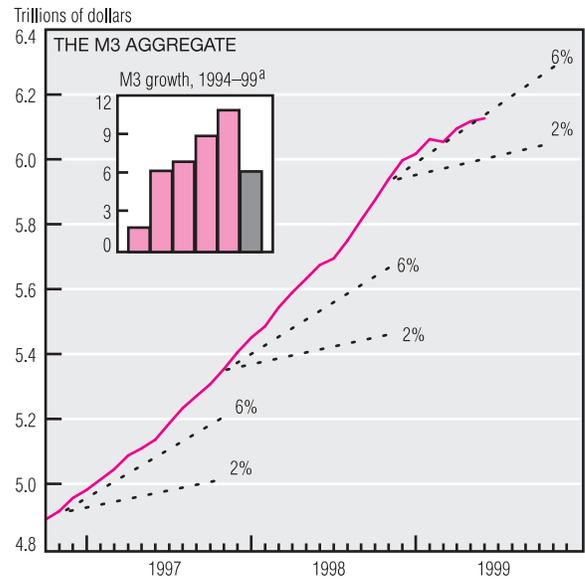
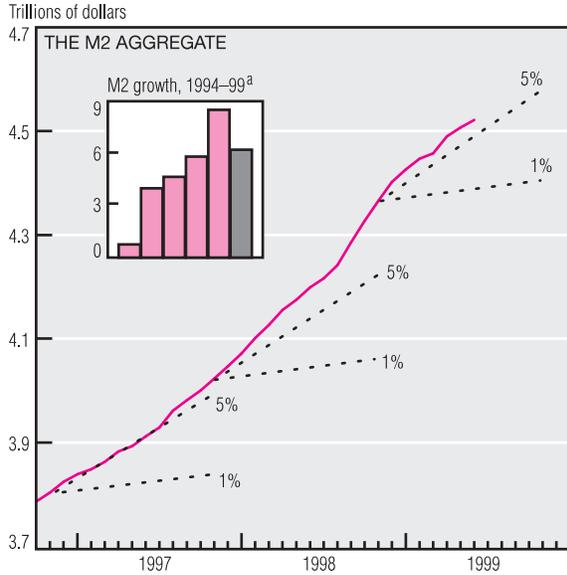
federal funds futures had steepened substantially between the end of April and the June meeting. These yields indicate the direction that market participants believe the federal funds rate will take in the coming months. As of April 29, these futures were trading at about 4.85% for October 1999. By June 24, the October 1999 futures rate had increased to about 5.25%. Based on these yields, the federal funds rate is now expected to climb to 5.5% by the end of this year, indicating that further rate increases are anticipated.

Both short- and long-term interest rates have increased steadily over the past six months, and that trend continued during June. For the week ending June 18, yields on 3-month and 1-year Treasury bills averaged 4.68% and 5.02%, respectively; these were higher than the 4.48% yield on both maturities six months ago, and up slightly from a month earlier.

Long-term interest rates have increased more noticeably. The rate on

*(continued on next page)*

# Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rate for adjusted M1 and the adjusted base are calculated on an April over 1998:IVQ basis. The 1999 growth rates for M2 and M3 are calculated on an estimated June over 1998: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 reservable M1 accounts to non-M1 accounts.  
 NOTE: Data are seasonally adjusted. The last plots are June for M1, M2, and M3; May for the base; and April for the adjusted base and adjusted M1. Dotted lines for M2 and M3 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.

conventional home mortgages stood at 7.65% for the week ending June 18, an increase of roughly 40 basis points from a month earlier and almost 100 basis points over the past six months. Similarly, the 30-year Treasury constant-maturity yield of 6.05% is up 20 basis points from a month earlier and more than 100 basis points from six months earlier.

The increase in market interest rates over the past six months suggests that by holding the federal

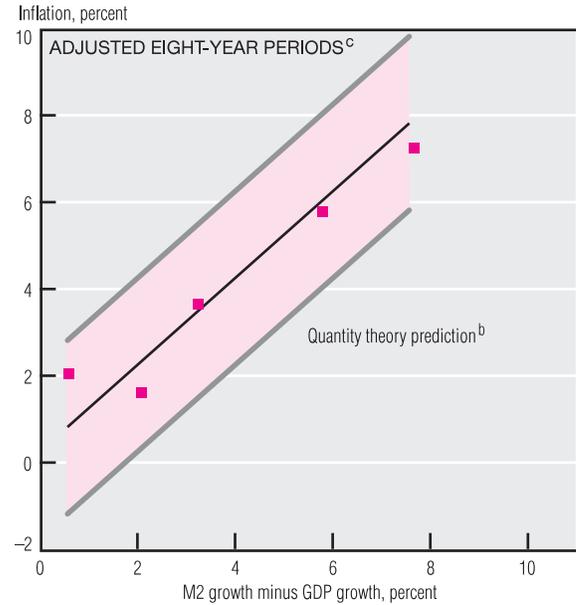
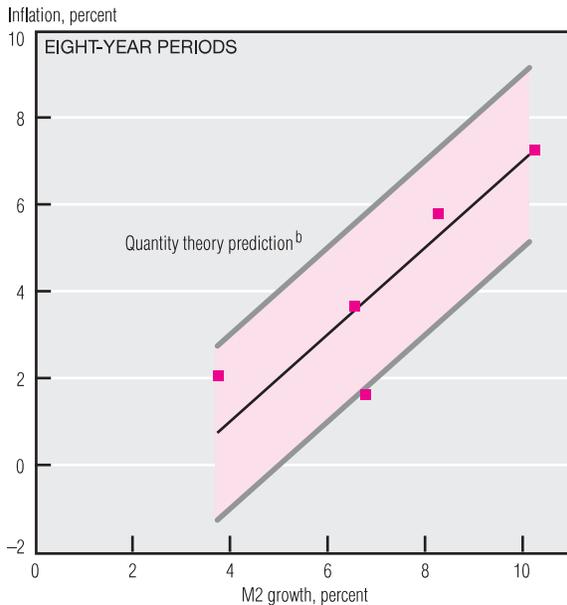
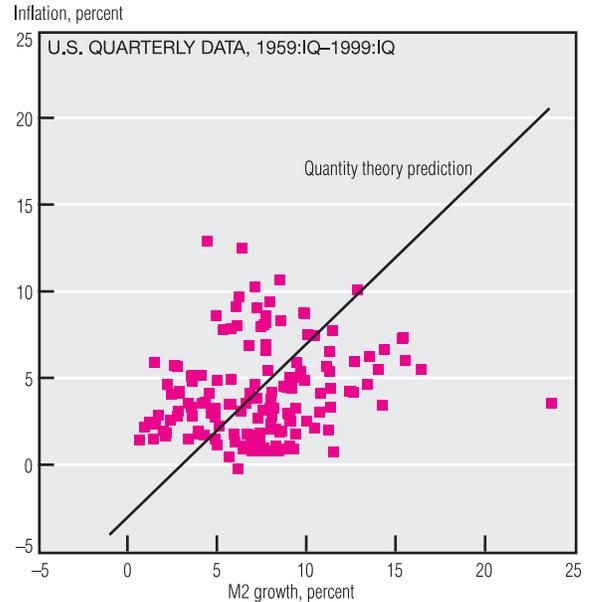
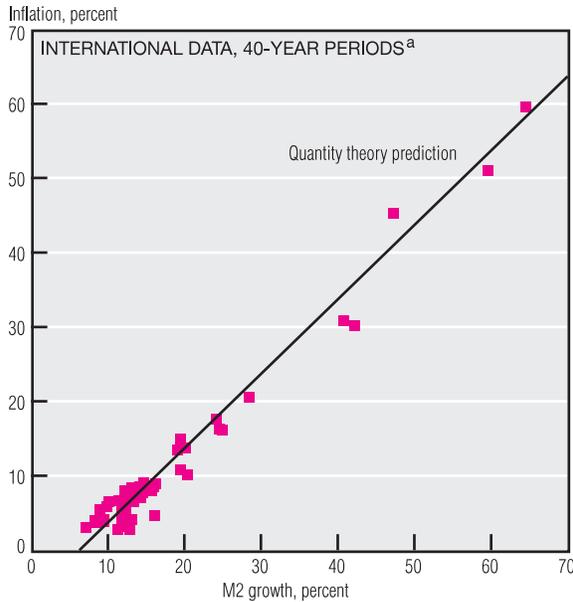
funds rate constant over this period, the Federal Reserve has implicitly eased monetary policy. In this light, the recent increase in the federal funds rate may be viewed as a neutral policy response.

Growth rates of the broad monetary aggregates have shown signs of slowing. Year-to-date M2 and M3 growth through May continues at or above the upper limit of the provisional range set by the FOMC. However, growth rates in these aggregates are substantially lower than

the strong rates experienced in 1998, and data for early June suggest that growth rates continue to slow.

In contrast to the broad monetary aggregates, growth in the narrow aggregates remains strong. Year-to-date growth in the sweep-adjusted monetary base and in M1 is faster than that experienced in 1998. If the current growth rates in these narrow aggregates continue throughout 1999, this will be their fourth consecutive year of acceleration.

# Money Growth and Inflation



a. Includes 49 nations for which at least 40 years of continuous data are available in *International Financial Statistics*.

b. The shaded region represents the quantity theory prediction, a 45-degree line through the grand mean of the data, plus or minus 2%.

c. Adjusted for GDP growth.

NOTE: Data are annual except where noted.

SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

One of the Federal Reserve's principal objectives in conducting monetary policy is to maintain low inflation. The Fed's main instrument for achieving that objective is its control of the nation's money supply. To the extent that there is a strong link between inflation and money supply growth, the low-inflation objective can be readily achieved.

The quantity theory of money provides a clear prediction about the relationship between money growth and inflation, asserting that money supply growth is the primary factor determining the inflation rate.

In its strictest form, the theory holds that inflation increases one-for-one with money growth.

Over long-term horizons, the quantity theory has been an empirical success. The average rates of money growth and inflation over long periods of time and across many countries show a striking one-to-one connection between money growth and inflation, as predicted by the quantity theory.

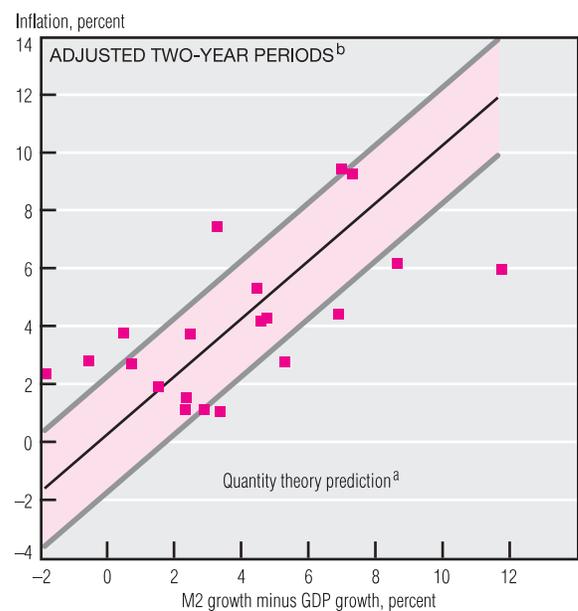
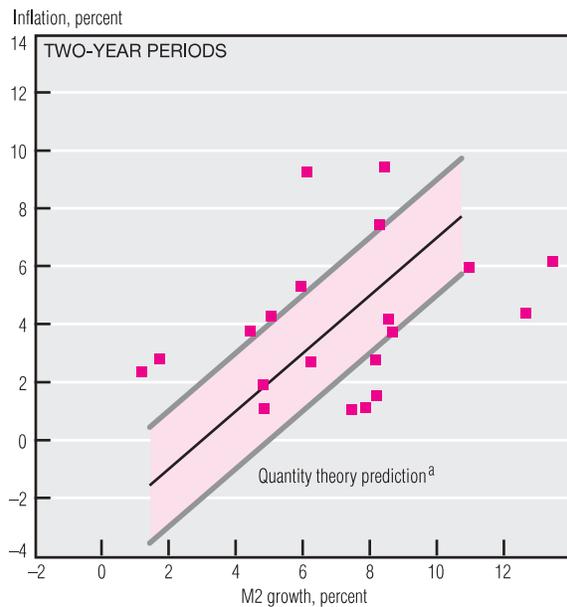
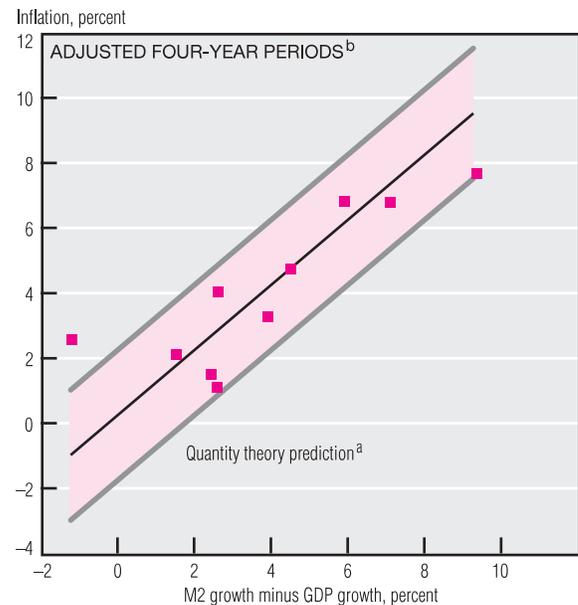
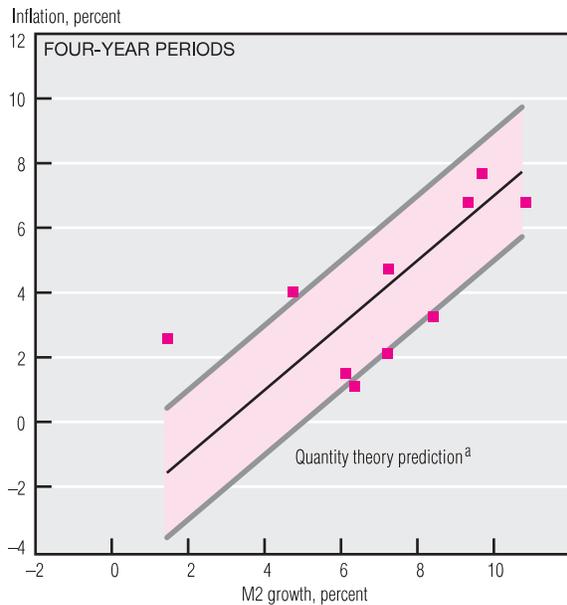
Unfortunately, this connection is not clear for short-term horizons—periods, such as a quarter or a year, over which the Federal Reserve

might seek to maintain low inflation. Suppose, for instance, that inflation averaged 3% in the long run but bounced between 20% and -14% from year to year. Few people would consider this scenario desirable.

How long a horizon, then, is required for the quantity theory to hold? To answer that question, one may compare the average annual growth rates of the money supply and the price level over different time horizons, averaging money growth and inflation data from 1959 through 1999 over periods of eight,

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## Money Growth and Inflation (cont.)



a. The shaded region represents the quantity theory prediction, a 45-degree line through the grand mean of the data, plus or minus 2%.

b. Adjusted for GDP growth.

NOTE: Annual data.

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

four, and two years. Charts drawn from these data suggest that although there is a positive relationship between money growth and inflation at each of these intervals, none of the relationships is especially close. One might conclude, however, that the quantity theory holds reasonably well over eight-year periods.

Possibly the relationship between money and inflation over these horizons is not especially close because real output growth varies across periods. Economic theory says that periods of high real output growth will be periods of high money

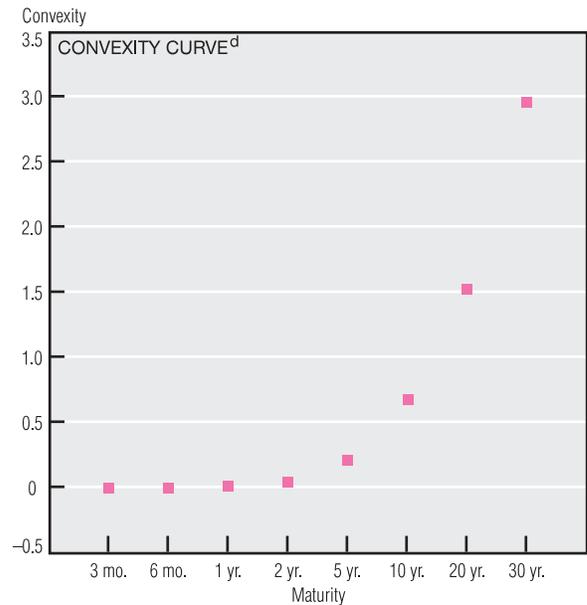
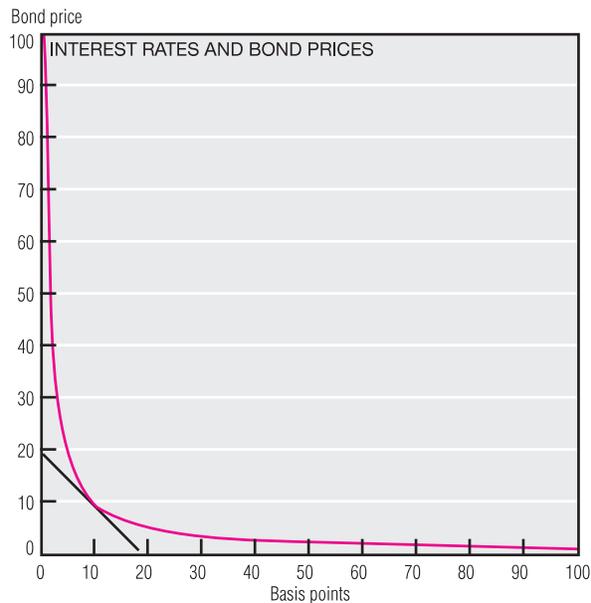
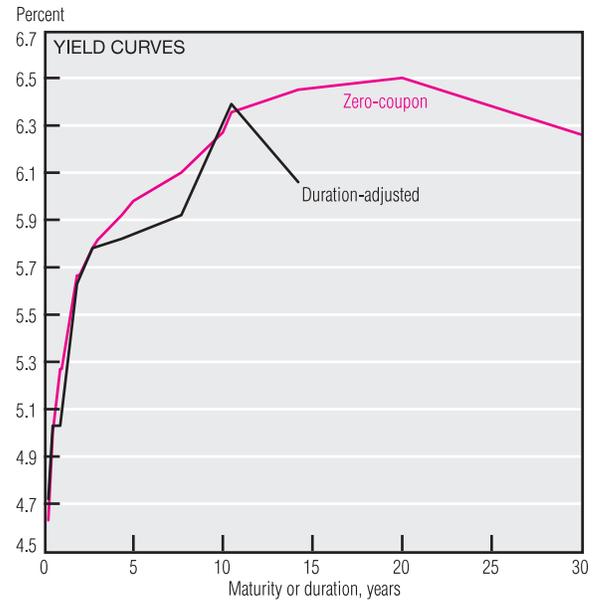
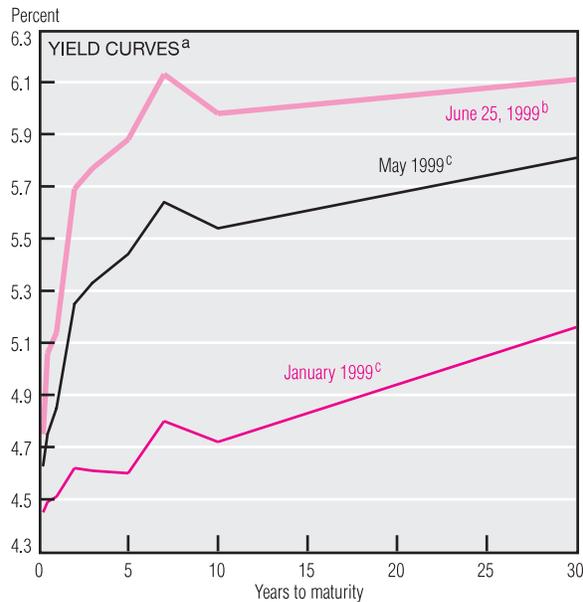
demand growth and thus of lower inflation. One way to adjust for differences in real GDP growth across periods is simply to subtract output growth from money supply growth. This produces a measure of the “excess” growth in money supply above that justified by output growth.

Adjusting for differences in real output growth substantially tightens the relationship between money growth and inflation over all time horizons. Over eight-year and four-year periods, the relationship is close to the 45-degree line predicted by the quantity theory. And while the two-year relationship is not

especially tight, there is a clear positive association.

These results accord with the current view that quarterly or even annual growth rates in the monetary aggregates provide limited information as to inflation’s short-term behavior. However, the findings do suggest that relatively strong money growth rates exceeding GDP growth for periods of four years—and perhaps as short as two years—should concern policymakers. Whether the money growth rates experienced in the last two years fit this pattern remains to be seen.

# Interest Rates



a. All yields are from constant-maturity series.

b. Weekly average rates for the week of June 25, 1999.

c. Monthly averages.

d. For U.S. Treasury securities as of June 30, 1999.

NOTE: Duration and convexity are from Bloomberg Financial Information Services.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Bloomberg Financial Information Services; and the *Wall Street Journal*.

Since last month, interest rates have risen across the board, with a surge in long rates steepening the yield curve. The 3-year, 3-month spread has increased from 70 to 102 basis points, finally moving above its long-run average of 80 basis points. Rates have shown an even larger change since the beginning of the year, with the 30-year rate rising 95 basis points since January. Many press accounts attribute these moves to expectations of Fed tightening, though Fed rate hikes generally flatten the yield curve, as long rates rise less than short rates.

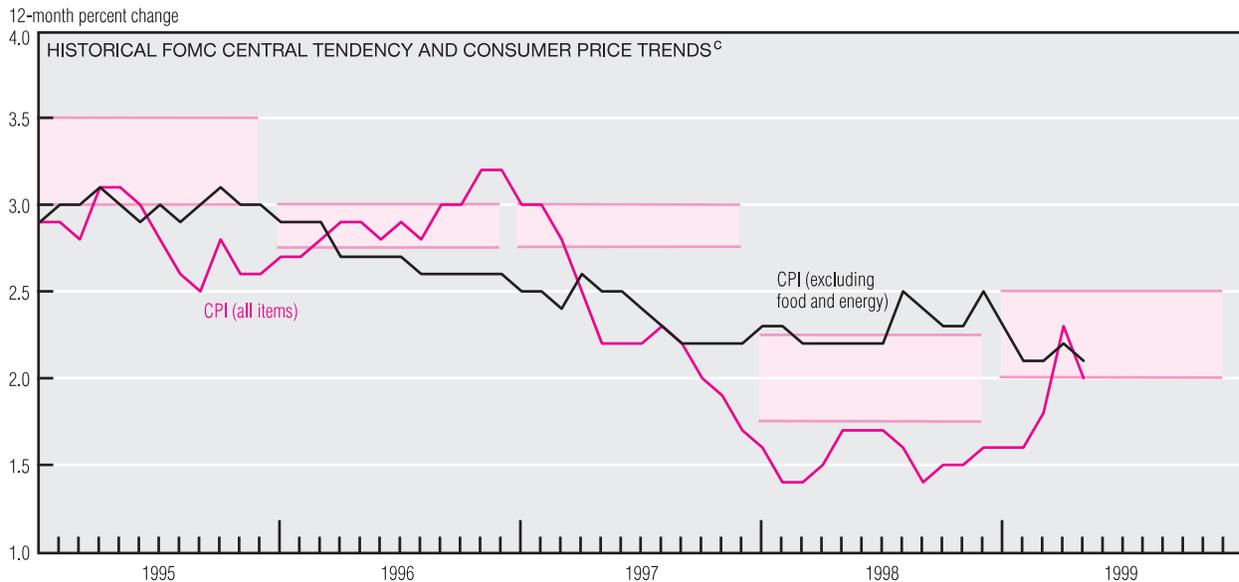
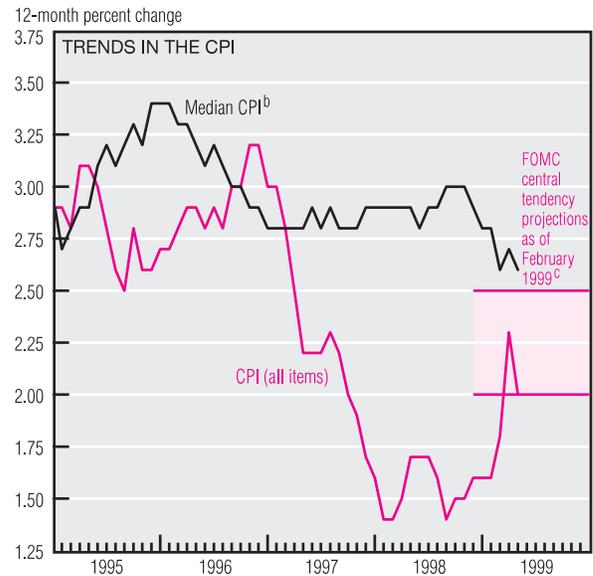
Coupon payments mean that a bond is, in effect, a portfolio of many bonds, and the yield a corresponding average of yields on many maturities. One way to get a clearer view of the relation between yield and maturity is to look at zero-coupon bonds. Another way is to adjust the maturity of the bond to be an average of the principal and coupon payment dates, calculating the asset's duration. This allows a plot of yield against duration. The two approaches are similar but not identical: Both measures emphasize the hump in the yield curve, but they

place it in different areas.

Duration also measures how a permanent change in interest rates will affect the price of a bond. If one plots the bond price against interest rates (the chart shows this for a simple consol), the slope of that plot at a specific rate gives a good idea of the duration. The relation between price and rate is nonlinear, though, so that duration changes with the rate: The way it changes is a bond's *convexity*. Long bonds have significantly higher convexity than short bonds.

# Inflation and Prices

	Percent change, last:				1998 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>May Price Statistics</b>					
<b>Consumer prices</b>					
All items	0.0	3.7	2.0	2.4	1.6
Less food and energy	1.4	2.5	2.1	2.5	2.5
Median <sup>b</sup>	2.5	2.4	2.6	2.9	2.9
<b>Producer prices</b>					
Finished goods	1.8	3.4	1.3	1.1	-0.1
Less food and energy	0.8	0.6	1.7	1.3	2.5



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 as of each February charted.

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

After a blistering 0.7% rise in April, the Consumer Price Index (CPI) held steady in May (somewhat below analysts' expectations). Still, over the past three months, the CPI has grown an annualized 3.7%, two percentage points above its average for 1997-98.

The median CPI averaged 2.4% between March and May, about  $\frac{1}{4}$  percentage point under its recent growth trend. This small downward move, however, probably reflects

statistical rather than economic developments, as it corresponds to the Bureau of Labor Statistics' estimate of how methodological changes in CPI construction, made early this year, are likely to affect the index's growth trend.

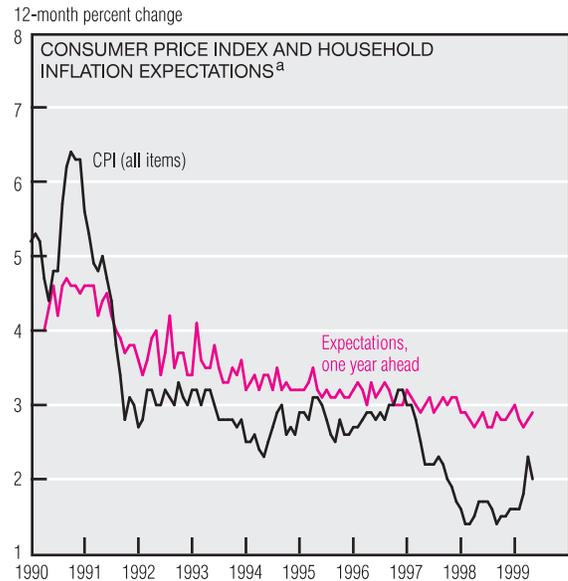
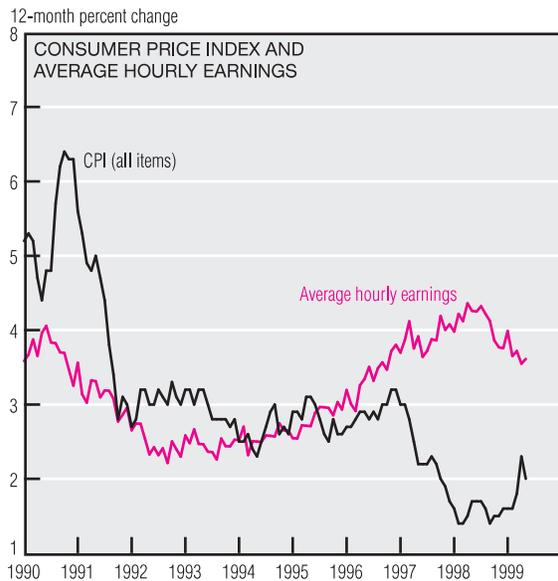
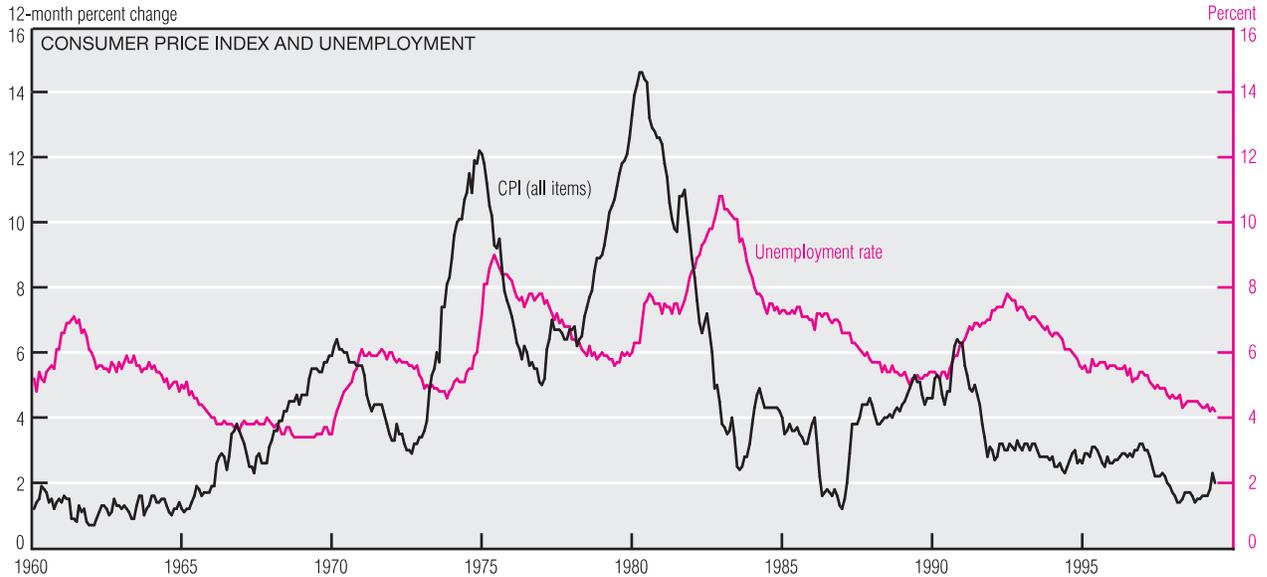
The strong upward movement in the CPI growth trend this year puts the retail inflation estimate just within the lower bound of the index's 1999 central tendency range as established by the Federal Open

Market Committee in February. In other words, the CPI is finally behaving as most policymakers have long anticipated. It had been tracking considerably under the FOMC's central tendency projection for a period stretching back to early 1996.

Persistent overestimation of the economy's inflation trend has characterized virtually every economic forecast of the past few years. Although a variety of special factors,

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## Inflation and Prices (cont.)



a. 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; and the University of Michigan.

like falling import and oil prices, have contributed to the unexpectedly favorable inflation reports of recent years, it is also clear that most forecasters have misjudged the degree to which tight labor markets would trigger higher costs. After peaking at about 7¾% in the early 1990s, the civilian unemployment rate has steadily fallen and has recently approached 4%, a threshold that it has not crossed in nearly 30 years.

As the rate of joblessness has dropped, expectations that “tight” labor markets would kindle an inflationary episode became more prevalent. In the 1970s, for example, the inflation trend began to accelerate whenever the unemployment rate dipped below 6%, and many forecasters assumed that it would do so again. In the latter half of the 1990s as well, wage growth generally rose when unemployment trended under 6%. Even so, the belief that tight labor markets would

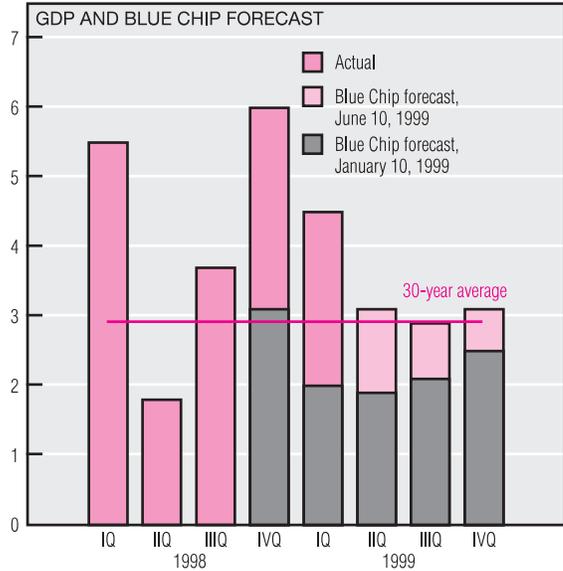
trigger an inflationary upturn has not been confirmed thus far. Recently, wage pressures seem to have subsided a bit, despite continued low joblessness.

Nevertheless, there remains a widespread expectation that the inflation rate in our future is likely to be higher than in our recent past. According to survey data of households, price increases will be just under 3% this year, about a percentage point above their most recent 12-month trend.

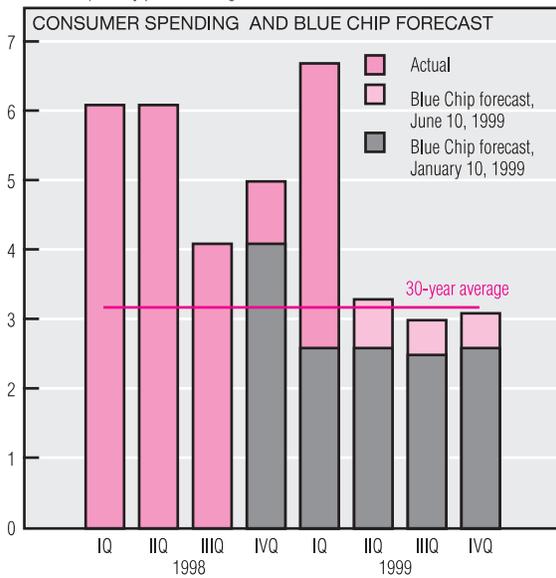
# Economic Activity

Real GDP and Components, 1999:IQ <sup>a,b</sup> (Final estimate)	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
		Real GDP	81.9
Consumer spending	85.9	6.7	5.5
Durables	23.9	12.9	12.5
Nondurables	35.5	9.4	5.2
Services	29.6	4.1	4.2
Business fixed investment	20.3	8.4	8.6
Equipment	18.3	9.5	11.0
Structures	2.8	5.6	2.3
Residential investment	11.8	15.4	12.5
Government spending	13.6	4.2	3.2
National defense	-5.2	-6.7	2.1
Net exports	-53.6	—	—
Exports	-13.1	-5.1	0.5
Imports	40.5	13.5	9.2
Change in business inventories	-5.5	—	—

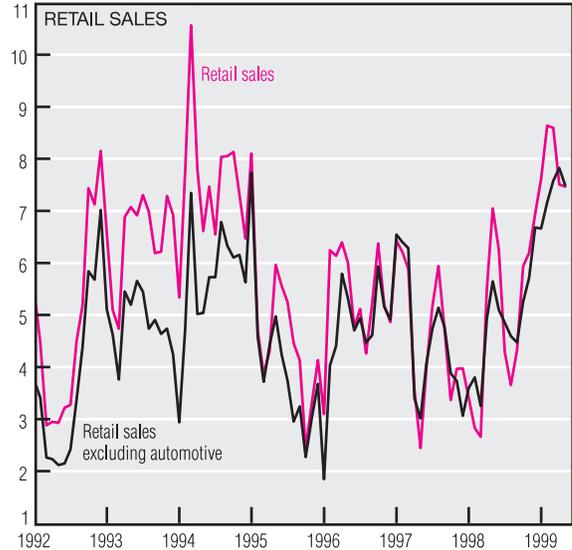
Annualized quarterly percent change



Annualized quarterly percent change



Year-over-year percent change



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.

NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; *Blue Chip Economic Indicators*, January 10 and June 10, 1999.

The 4.3% final GDP estimate for 1999:IQ fell midway between the 4.5% advance estimate and the 4.1% preliminary estimate. The upward revision to the preliminary estimate resulted mostly from an upward revision to exports and a downward revision to imports.

Although the pace of economic growth in 1999:IQ slowed from the breakneck speed of 6.0% seen in 1998:IVQ, the 4.3% estimate is still quite strong and is considerably above our historic average growth rate of around 3.0%. The brisk pace

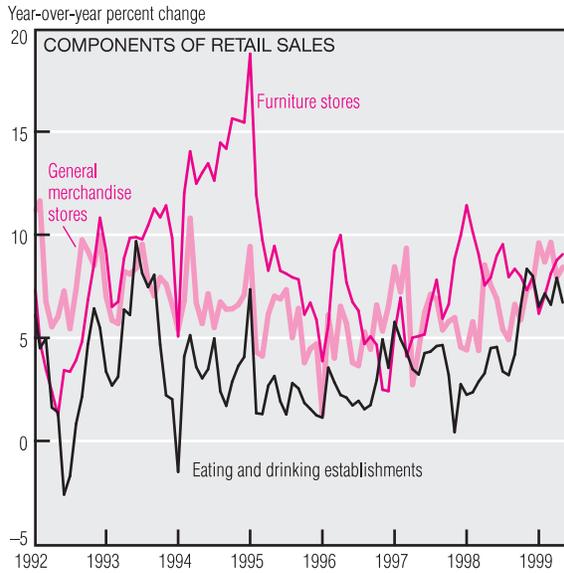
of growth is even more impressive considering that we are in our eighth year of economic expansion and that many economists had expected growth to slow this year (as is evident in the January Blue Chip forecasts). Since January, growth forecasts have been steadily climbing, and the most recent June predictions show the average growth rate for 1999 above 3% (whereas January's prediction average was closer to a 2% annual growth rate).

A driving factor behind the recent economic growth has been an acceleration in consumer spending, a

component that most economists had expected to slow in 1999, according to Blue Chip consensus forecasts of consumer spending. In 1998:IVQ, spending grew at a strong 5.0%; in 1999:IQ, the pace strengthened to 6.7%. In 1999:IIQ, retail sales showed a solid gain in April and a strong increase in May. Therefore, strong consumer spending numbers are also likely to be present in the forthcoming advance GDP estimate for 1999:IIQ, to be released at the end of July.

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## Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Release*, Z.1.; The Conference Board, Inc.; and National Association of Realtors.

What are consumers buying? Auto sales have shown the largest gains in the retail sector. May auto sales were up 2.5% (35.3% annualized) from April and 8% over the same month last year. Furniture is also selling quite well, up 1.1% (14% annualized) from April to May and 9% over May 1998. General merchandise stores have seen sales gains similar to those in furniture sales, and consumers are also spending heavily in restaurants and pubs.

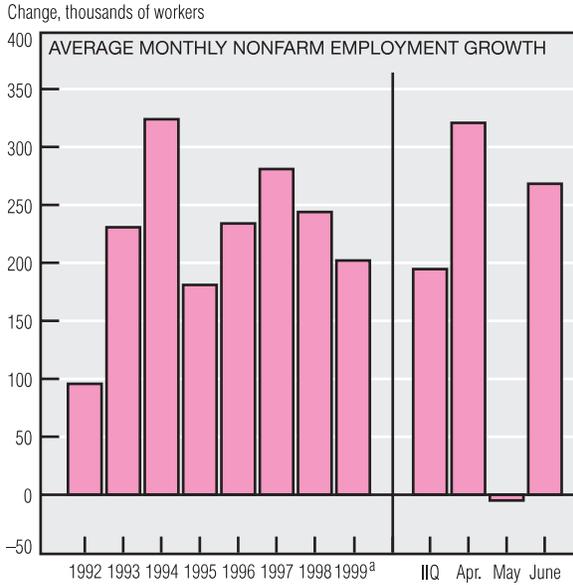
Home sales (both new and existing) were quite strong in the latter half of 1998, as low interest rates

made financing affordable for many people. Recently, however, home sales have slowed, particularly sales of new homes. It is not clear whether this is a temporary pause to allow builders to catch up on residential construction projects or whether activity is slowing in the residential real estate markets.

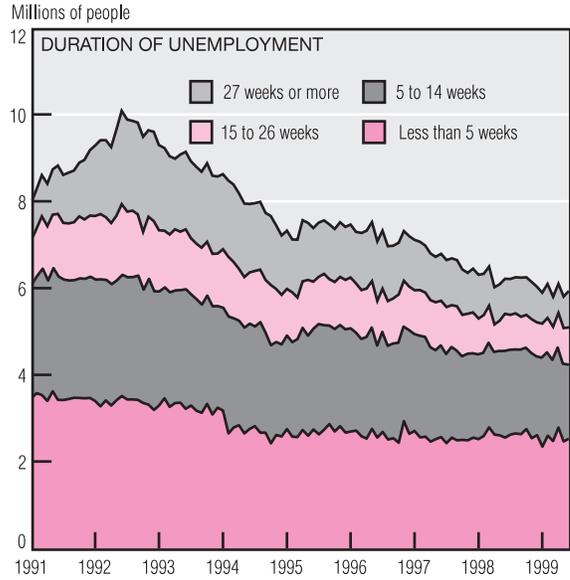
The consumer confidence index advanced again in June to the level it had reached at this time last year, before the financial crisis. Confident consumers are likely to keep spending, propelling economic growth in upcoming months.

This spending spree has been accompanied by a decline in the personal saving rate, which has remained negative throughout 1999, implying that consumers are spending more disposable income than they have. This measure of savings, however, does not take into account the appreciation in equity holdings. Movements in equity prices, when expressed as a percent of disposable personal income, have averaged 10% since the first quarter of 1992. The strong consumer spending of late is likely attributable to this appreciation.

# Labor Markets



	Average monthly change (thousands of employees)				
	1999				
	1996	1997	1998	YTD <sup>a</sup>	June
Payroll employment	234	281	244	202	268
Goods-producing	32	48	8	-28	-12
Mining	1	2	-3	-7	-3
Construction	28	21	30	15	26
Manufacturing	3	25	-19	-37	-35
Durable goods	10	27	-9	-20	-13
Nondurable goods	-7	-2	-10	-17	-22
Service-producing	202	233	235	230	280
TPU <sup>b</sup>	8	16	18	17	29
Retail trade	43	24	32	44	49
FIRE <sup>c</sup>	14	20	26	17	24
Services	117	141	119	118	151
Household employment	228	235	157	151	208
	Average for period (percent)				
Civilian unemployment	5.4	4.9	4.5	4.3	4.3



a. Year to date.  
 b. Transportation and public utilities.  
 c. Finance, insurance, and real estate.  
 d. 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.

June employment bounced back from losses in May, adding 268,000 jobs. Despite the rosier overall picture, manufacturing and mines continued to cut their payrolls. Manufacturing has lost nearly half a million jobs since employment peaked in March 1998. Mining has lost more than 10% of its jobs (65,000) in the last year.

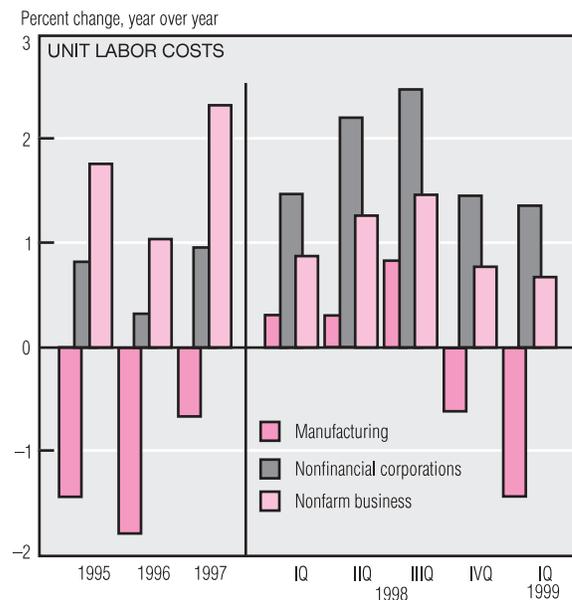
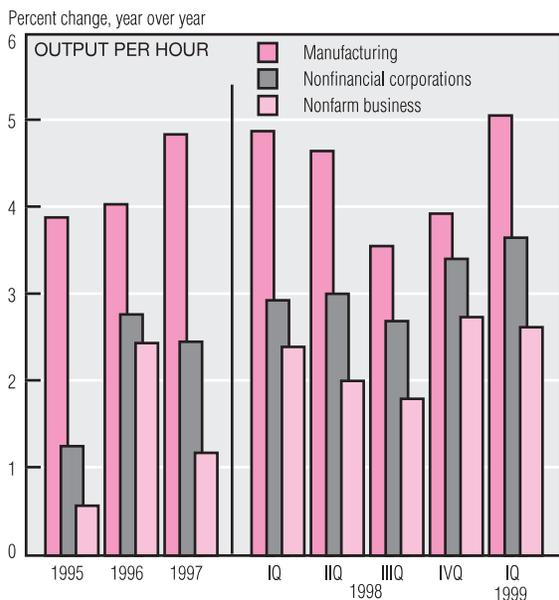
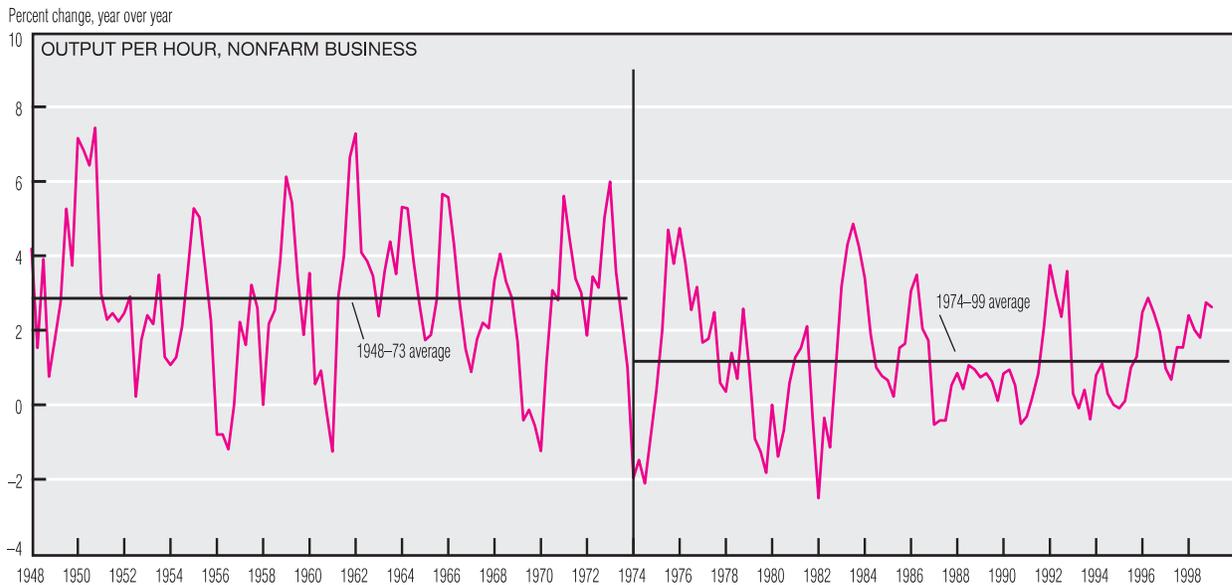
Declining employment among goods producers is offset by an array of service-sector industries. This month's standouts were gains in temporary-employment agencies

(23,000), amusement and recreation services (20,000), and engineering and management services (18,000). The smallness of many service-sector industries makes it easy to miss these sources of growth. For example, transit agencies added another 7,000 workers in June, contributing to an annual gain of nearly 5% in an industry not usually known for growth.

While the industrial distribution of jobs continues to shift, employment prospects for the workforce as a whole remain strong. The unemployment rate was essentially un-

changed at 4.3%, up only one-tenth of a percent from recent lows. New entrants to the labor market and other unemployed workers continue to be absorbed rapidly. Of the nearly 6 million jobless in the U.S., 42.6% have been looking for work less than five weeks. While the number of long-term unemployed (those who have been looking for 27 weeks or more) has increased over the last year from 808,000 to 844,000, that figure pales when compared with 2 million at the start of the current recovery.

# Labor Productivity



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

A three-year surge in productivity growth underlies the current robust state of the U.S. economy. Some commentators have cited the recent strength of productivity numbers as evidence that the U.S. has entered a “new economy.” If one looks at labor productivity (typically measured as real, nonfarm output per hour of work) across a longer span, however, the current data—while strong—do not appear exceptional.

Quarterly productivity growth figures are extremely variable, even on a year-over-year basis. Only now,

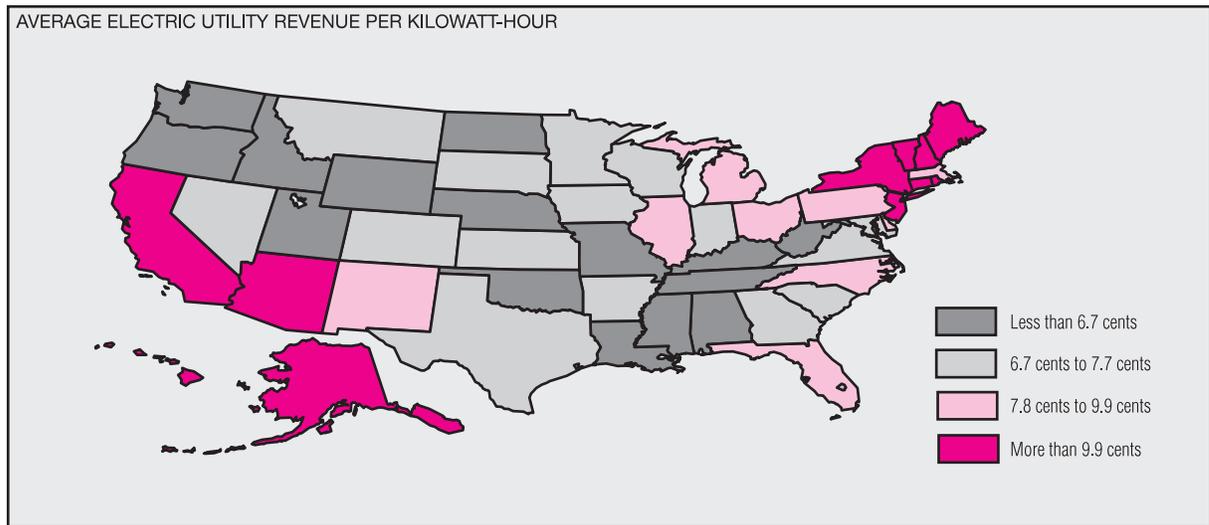
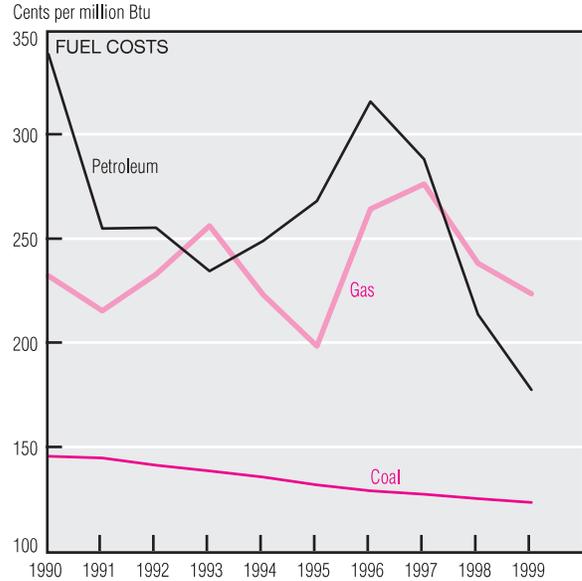
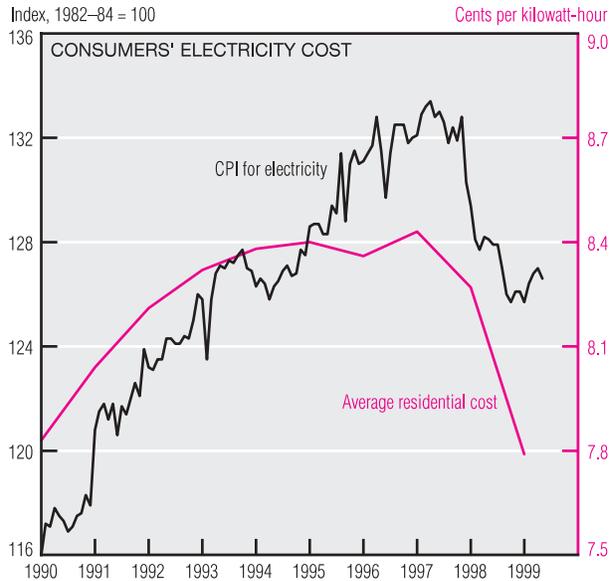
with the string of strong productivity numbers lengthening to 14 quarters, does the higher level become statistically significant.

While the current numbers are high compared to recent expansions, U.S. productivity growth averaged 2.9% per year prior to the 1974 productivity slowdown. After 1974, it averaged only 1.2%. Productivity growth has averaged 2.0% since 1996, but only 1.5% for the current recovery. Is the three-year surge in productivity growth well above average? The answer depends on

whether one includes data prior to the 1974 slowdown, a phenomenon that remains largely unexplained.

A final weakness of productivity data is the inherent difficulty of quantifying output in many industries (legal services and health care are prime examples). Throughout the current recovery, alternative productivity measures have tended to be substantially higher than the headline number. In manufacturing, where measurement is easiest, productivity growth has been consistently higher.

# Electricity Deregulation



SOURCES: U.S. Department of Energy, Energy Information Administration; and U.S. Department of Commerce, Bureau of Labor Statistics.

The prospect of electricity deregulation has already caused several mergers in the utility industry and may bring substantially lower costs to Fourth District consumers. On June 22, 1999, the Ohio Senate passed a bill allowing consumers to choose their power providers beginning in 2001. Distribution and billing would continue to be handled by the current provider, but customers could choose the company supplying their power, much as they choose their long-distance

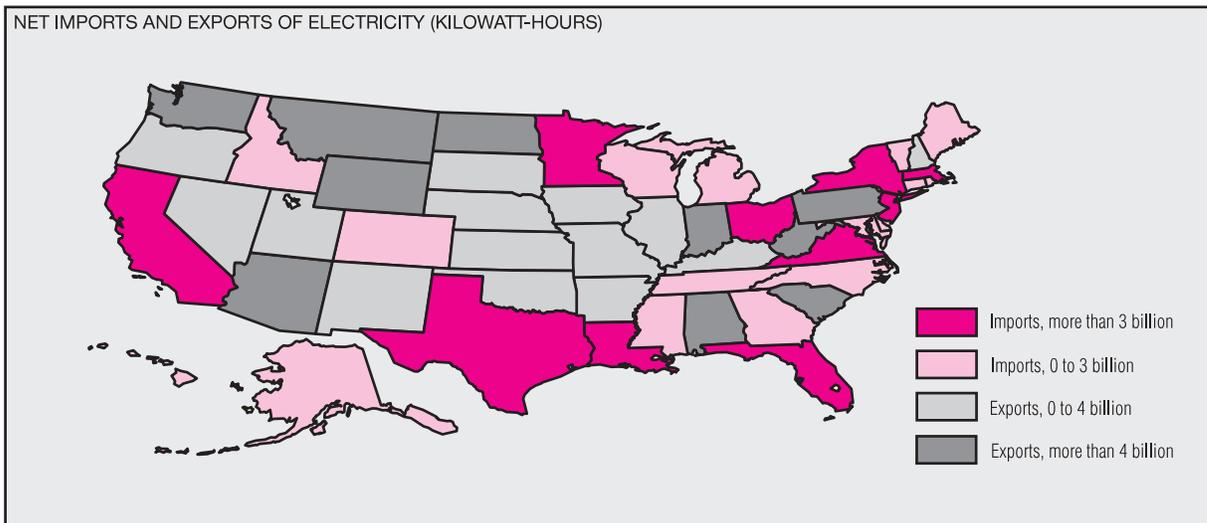
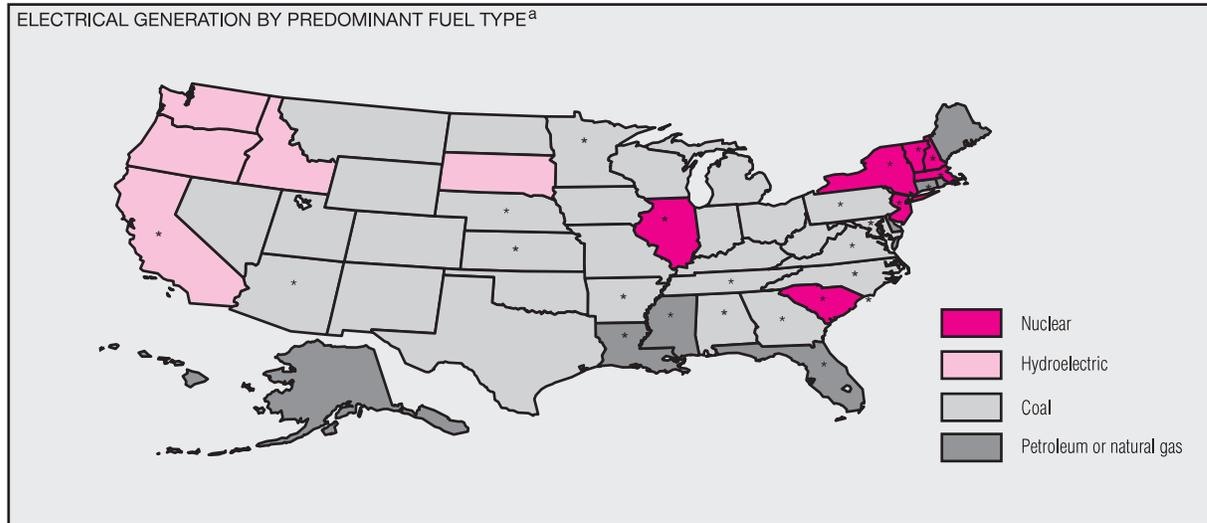
telephone service. The current bill, which was backed by the governor, followed several unsuccessful state deregulation efforts in Ohio. Pennsylvania enacted similar legislation in 1996; by January 2000, all Pennsylvanians will be able to choose their power source.

Deregulation efforts, which focus on bringing down the cost of electricity to consumers, have been led by states where power costs are high. Over the last few years, consumer power costs have fallen sub-

stantially. The electricity component of the consumer price index (CPI) has dropped 5% from its 1997 peak (based on cost to the typical urban consumer). The Department of Energy's estimate of average cost per kilowatt-hour has fallen more than 7% in the last two years for residential consumers.

Part of this decline was caused by recent reductions in oil and other energy prices; however, the price of coal (the fuel source for more than *(continued on next page)*

## Electricity Deregulation (cont.)



a. Asterisks indicate states where more than 20% of electrical generation is from nuclear energy.  
SOURCE: U.S. Department of Energy, Energy Information Administration.

half of all electricity generated in the U.S.) has been falling throughout the decade. Competition—and the prospect of future competition—among electricity producers have certainly contributed to this decline and are conservatively forecast by the Department of Energy to yield 1% annual reductions in consumers' real cost of electricity through 2020.

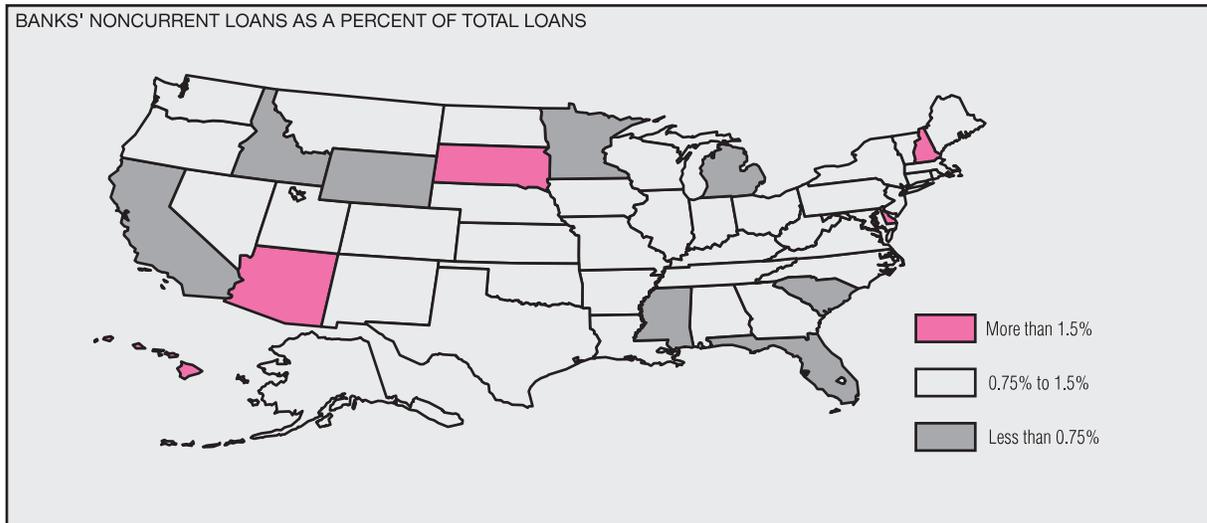
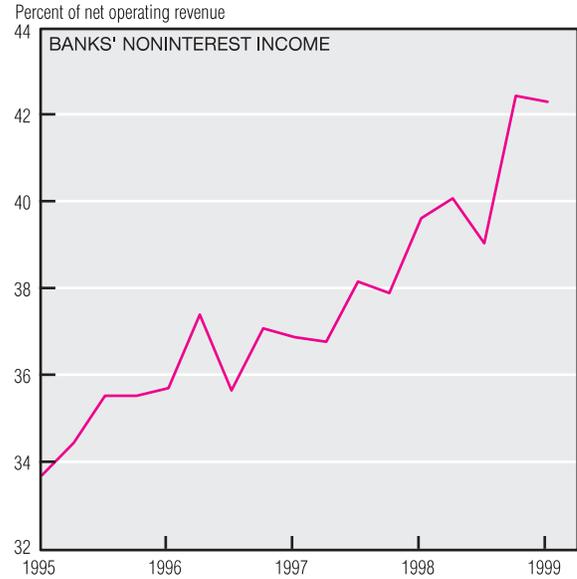
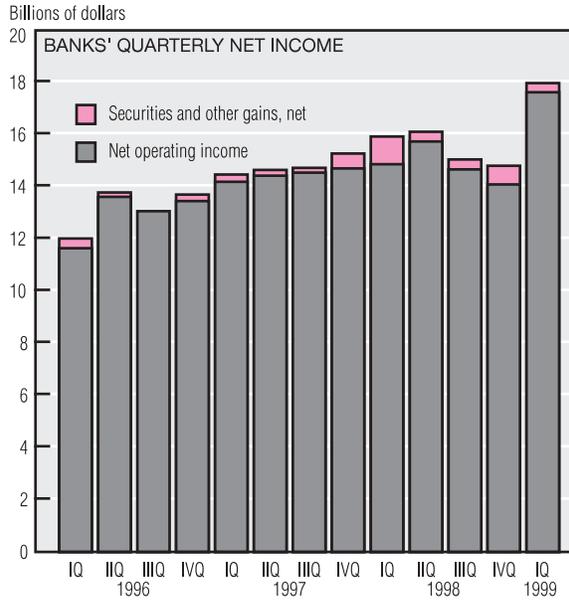
Areas with higher electricity prices benefit most because price differentials result primarily from past investment in unusually expensive gener-

ating facilities. In the long run, these plants will be at least partly written off, and the cost of generating electricity will be determined by the current state of technology. These facilities remain the source of the “stranded costs” that have been deregulators' thorniest problem. Nuclear power plants are notable for having capital and operations costs that far exceed the expected wholesale price of electricity. Ohio's deregulation bill has left this issue for the Public Utilities Commission to

resolve, but solutions elsewhere typically involve additional consumer payments for a limited number of years to cover part of utility shareholders' capital losses.

Expanded deregulation may benefit many Fourth District utilities whose generating costs are low because the plants are close to major coal-producing regions. Indeed, with the exception of Ohio, Fourth District states are already substantial net exporters of power.

# Banking Conditions



SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, March 1999.

Net income at insured commercial banks surged to \$18.0 billion in 1999:IQ, easily surpassing the previous record of \$16.1 billion set in 1998:IIQ. Bankers were cheered by the rise in average return on assets (ROA) to 1.32%, equaling the previous high that was set in 1995:IIIQ. There was a small dark cloud: A majority of banks with less than \$100 million in assets reported lower earnings than a year ago.

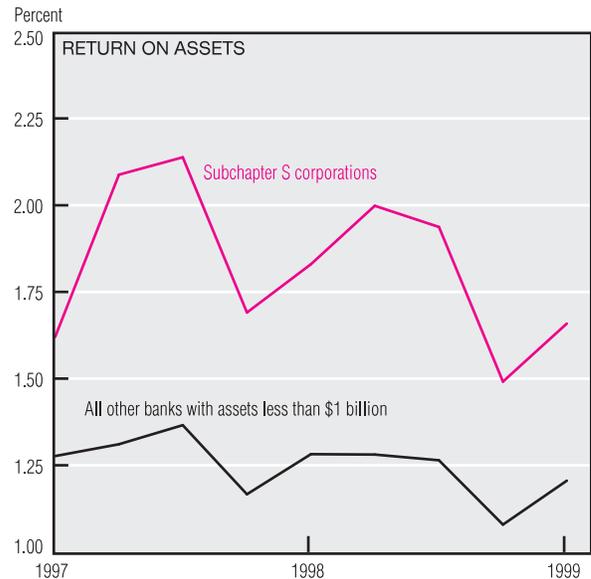
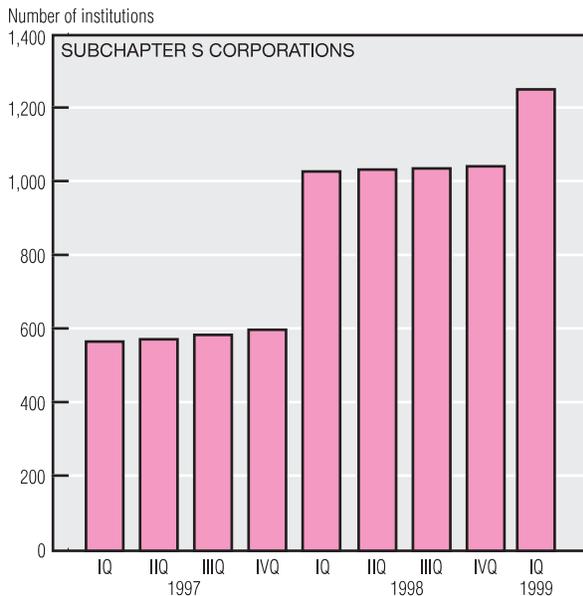
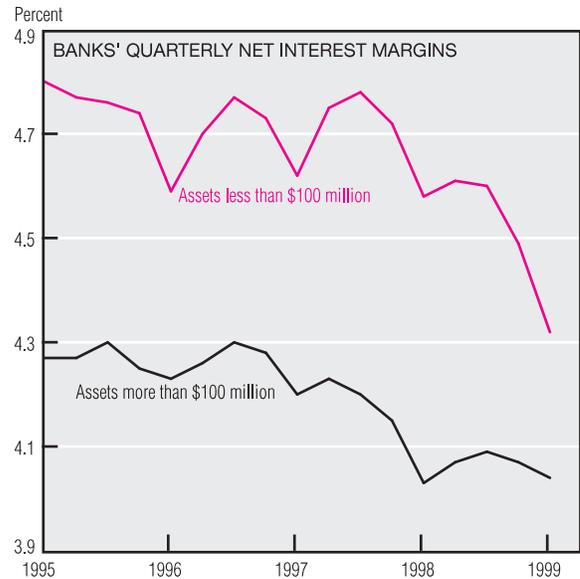
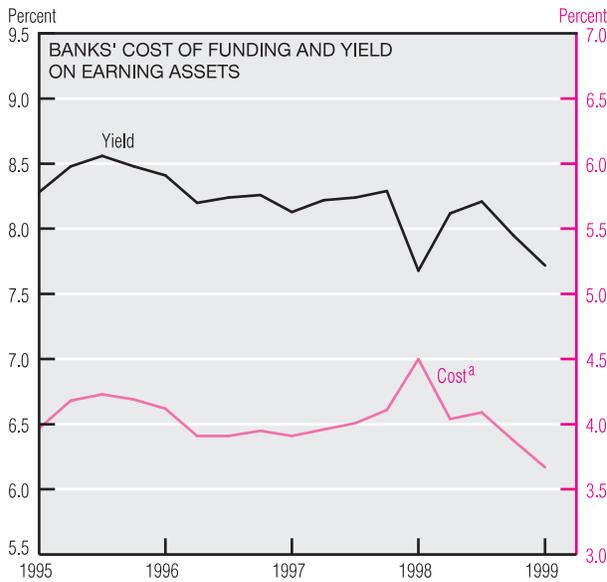
These generally rosy results stem from increases in net operating income. The strongest-growing component of operating income over

the last year remained noninterest income, which has jumped 19.5% since 1998:IQ. Growth in the share of this component continues a long trend that has accelerated in recent years. Another source of improvement is the rebound in international operations' contribution to bank earnings, which has held close to pre-Asia crisis levels in percentage terms over the last two quarters.

Both the cost of funding and the yield on earning assets declined over the last two quarters, yet the industry's net interest margin remained roughly constant at 4.05%. Again,

this seeming stability in the industry average masked divergent trends in the margins of larger and smaller banks. Average margins at banks with less than \$100 million in assets fell 26 basis points over the last year, reaching their lowest level in eight years. By contrast, margins at banks with assets of more than \$100 million remained virtually unchanged. Average asset yields declined faster at smaller banks than large ones, while the decline in their average funding costs was more gradual. Because net interest income represents *(continued on next page)*

# Banking Conditions (cont.)



a. The cost of funding on earning assets is defined as the total interest paid on deposits and other borrowed money as a percent of average earning assets.  
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, March 1999.

a larger share of revenues at smaller banks, margin erosion causes these banks relatively more pain.

The geographic distribution of noncurrent loan rates now shows no distinct regional pattern. Most states have rates well below 1.5%, and eight have rates below 1%. These high-performing states were scattered across the country. Only five states, Arizona (2.0%), Hawaii (2.0%), South Dakota (1.5%), New Hampshire (1.8%), and Delaware (2.1%) had noncurrent loan rates at or above 1.5%. This lack of geo-

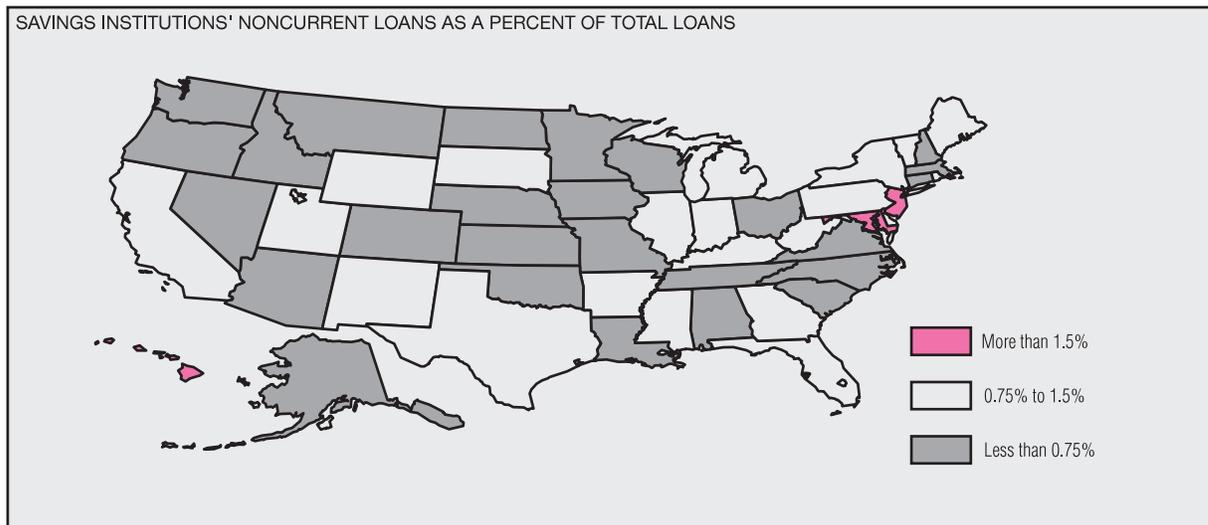
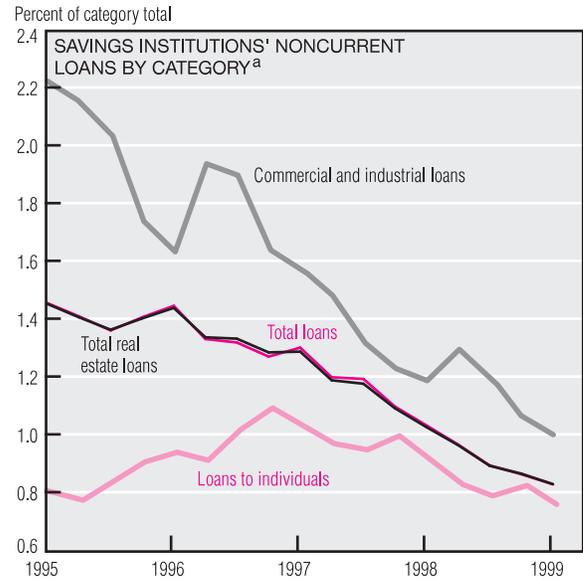
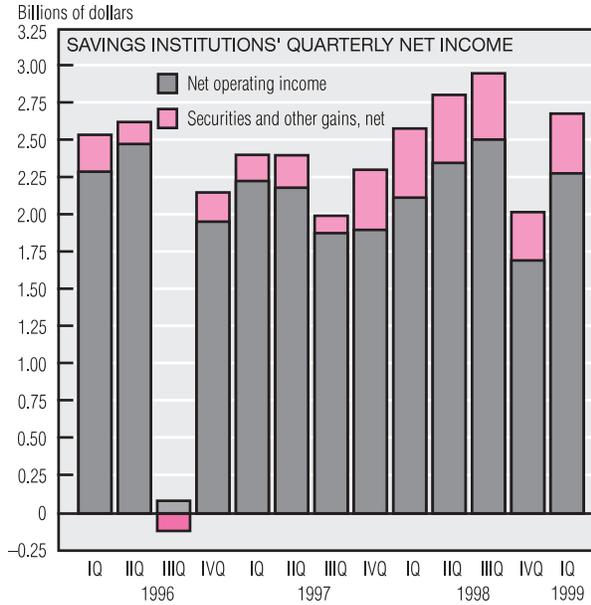
graphic pattern indicates that, at least by this measure, broad regions of the U.S. are experiencing good economic times.

Banking industry observers should note one developing trend. By changing the Internal Revenue code to allow financial institutions to elect Subchapter S corporation status, the Small Business Job Protection Act of 1996 makes comparing large and small banks difficult. Since 1997, 18% of banks with less than \$100 million in assets have elected Subchapter S status. Like partnerships, these pass-through

entities are not generally subject to any federal income taxes at the corporate level. Taxable income flows through them to their shareholders in proportion to their stock ownership. As a result, banks that do elect Subchapter S status report earnings as much as one-third higher than comparable banks that do not. If Subchapter S corporations are excluded, the return-on-assets gap between smaller and larger banks in 1999:1Q increases from 22 basis points to 33 basis points.

(continued on next page)

# Banking Conditions (cont.)



a. Noncurrent loans as a percent of category totals.  
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, March 1999.

Savings institutions also saw strong earnings growth in 1999:IQ, up \$661 million from 1998:IVQ to \$2.7 billion. Not quite a record, but still the third-highest quarterly earnings reported by the industry. Unlike banks, where securities and other gains made up less than 2% of industry net income, for savings institutions the share was 8%.

Asset quality, as measured by noncurrent loans, continued to improve from already healthy levels. Overall, noncurrent loans declined 3.5 percentage points to 0.83% from 1998:IVQ. Since 1998:IQ, these

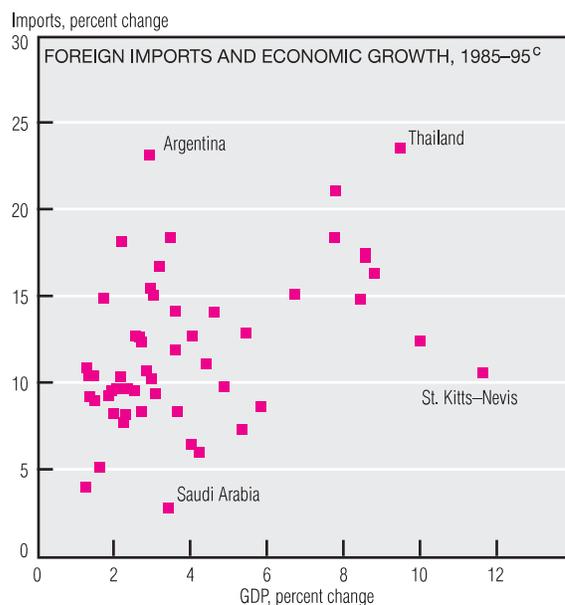
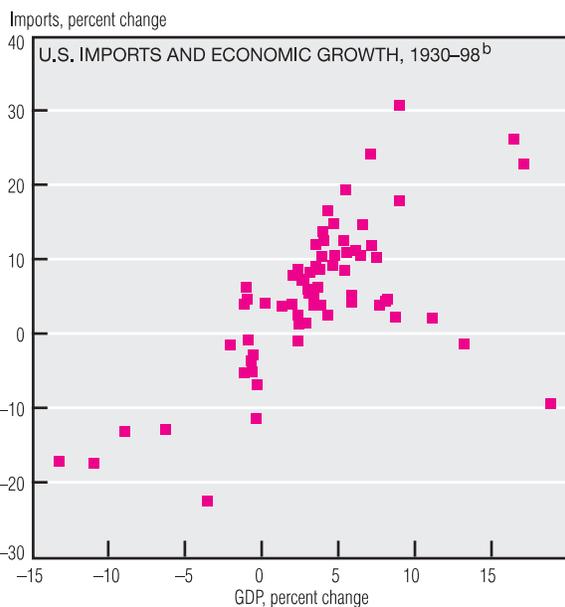
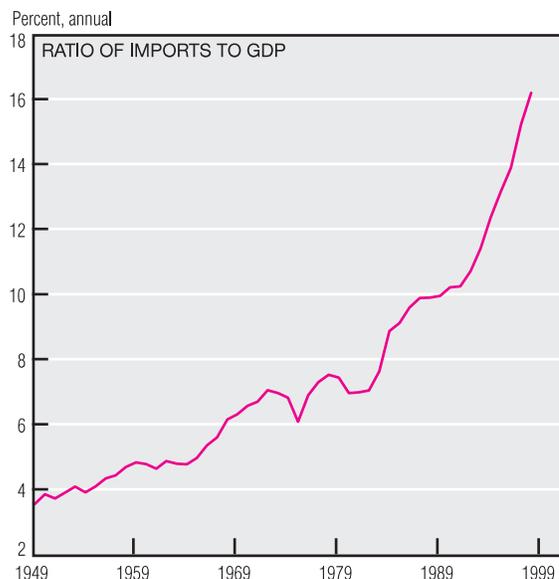
loans have fallen nearly 20 percentage points. The improvement is broad-based: It has occurred for all loan types, commercial and industrial, loans to individuals, and real estate loans.

For savings institutions, as for banking institutions, noncurrent loan rates display no striking geographic pattern. Even more puzzling, they do not seem to be closely related to noncurrent loan rates for banks. Few banks had rates over 1.5%. Only Hawaii (2.1%) had the misfortune to make both the bank and savings institution lists. Given its weak economy in recent years,

Hawaii's status is not too surprising. In other states with poorly performing savings institutions, New Jersey (2.8%), Maryland (2.4%), and the District of Columbia (1.8%), banks had relatively healthy noncurrent loan rates. By this measure, savings institutions were healthier than banking institutions: 27 states had savings institutions with noncurrent loan rates of less than 0.75%, but only eight states had banks with such rates. Once more, the lack of geographic pattern suggests that broad regions of the country are enjoying robust economic conditions.

## Imports and Economic Growth

GDP and Its Components, 1999:1Q		
	Current dollars (billions)	1992 dollars (billions) <sup>a</sup>
Gross domestic product	8,808.70	7,759.60
Personal consumption expenditures	6,050.60	5,331.90
Gross private domestic investment	1,417.40	1,388.50
Government consumption expenditures and gross investment	1,537.50	1,323.90
Exports	962.70	996.50
Imports	-1,159.60	-1,300.10



a. Components of GDP need not add to totals because current dollar values are deflated at the most detailed level for which all required data are available.

b. Annual percent change.

c. Average annual percent change for 54 countries.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and International Monetary Fund, *International Financial Statistics*.

Every news account of the GDP figures—or so it seems—reinforces the common misperception that import spending lowers output. The source of the fallacy is understandable: Imports enter the GDP tally with a negative sign. Because GDP measures the aggregate value of goods and services produced in the U.S., items bought abroad must be taken out. Imports, however, do not reduce GDP.

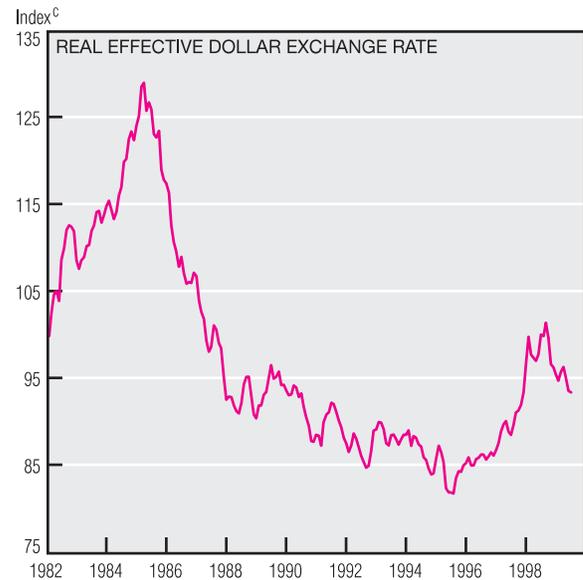
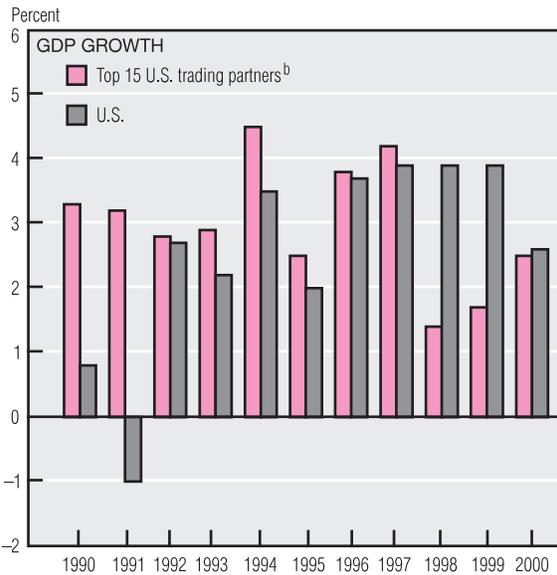
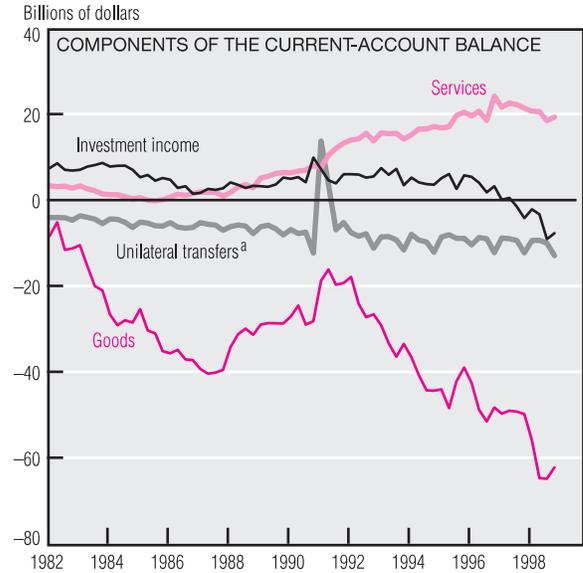
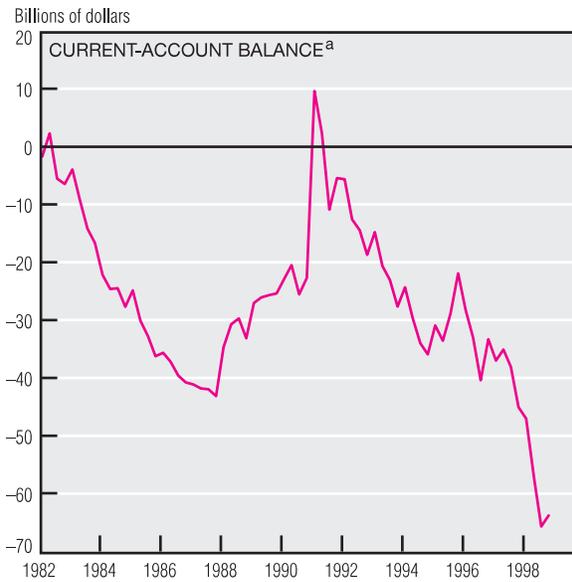
We pay for our foreign purchases by exporting, by reducing our financial claims on foreigners, or by

giving foreigners claims on our future output. In the first case, imports do not lower GDP, because they are accompanied by exports. If one rises (or falls), so does the other. In the latter two cases, we incur a trade deficit, and an inflow of foreign capital accompanies the imports. This capital inflow finances domestic investment, government spending, private consumption spending, or some combination of them. In all cases, the act of paying for the foreign goods contributes to domestic output.

The persistent myth of imports

and economic growth belies their historic relationship. Although foreign purchases have risen fairly dramatically as a share of GDP since World War II, economic growth has not faltered. Instead, the data reveal a positive relationship between year-to-year GDP growth and the corresponding percent change in U.S. imports. A similar pattern emerges from a longer-term, cross-country comparison of imports and economic growth. Imports—or so it seems—promote growth.

## The Current Account



a. The surplus recorded for 1991 reflects allies' payments to the U.S. in conjunction with Operation Desert Storm.

b. The top 15 U.S. trading partners in 1992–97 were Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, Netherlands, and Brazil. Projections for 1999–2000 utilize various sources.

c. Board of Governors of the Federal Reserve System, Broad Index.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Organisation for Economic Co-operation and Development, *Main Economic Indicators*; International Monetary Fund, *International Financial Statistics*; and *Blue Chip Economic Indicators*, June 10, 1999.

Analysts often refer to the current account as a broad measure of our country's international trade position, although it includes a few non-trade items. Trade flows still make up its largest category by far, and our current-account deficit tends to mimic the shortfall in our goods trade. By contrast, the U.S. maintains a \$20 billion surplus in services trade. After expanding between 1988 and 1994, this surplus flattened out. The persistent small deficit in unilateral transfers, which are essentially gifts, reflects our country's

largesse. Investment receipts, the final category within the current account, shifted into deficit in 1997, a sign that interest and dividend payments on U.S. obligations to foreigners exceed earnings on our holdings of foreign obligations.

The U.S. current-account deficit is likely to widen further this year and next. Although most of the enormous differential between U.S. economic growth and that of our major trading partners will disappear next year, foreign economies must generally expand nearly two percentage

points faster than the U.S. if our trade deficit is to narrow.

The dollar has depreciated almost 8% on a real basis over the past year. Because a real depreciation incorporates both nominal exchange-rate movements and cross-country inflation differentials, its presence suggests that U.S. goods and services are becoming more price-competitive in world markets. This recent movement only partly offsets the dollar's 24% real appreciation between June 1995 and August 1998.