

The Economy in Perspective

By the sweat of our brow ... Everyone knows the story: U.S. agricultural employment has plummeted since the 1920s, when farm jobs made up about 20% of total U.S. employment. Today, that share is only 2%. For almost 30 years now, the absolute number of agricultural jobs in this country has changed little, but overall employment has expanded significantly. Yet early in the century, farm output swelled as farm jobs declined; in the last three decades, output doubled as employment held steady. This reveals the key role of productivity gains in the evolution of the agricultural sector.

Thirty years ago, the goods-producing sector accounted for one-third of all U.S. nonfarm employment, with the service-producing sector contributing the remaining two-thirds. Today, the goods-producing sector accounts for 20% of total employment, having slipped from 22% when the current expansion began. So far during this expansion, the U.S. economy has generated 20 million net new jobs, of which only 1.5 million came from the goods-producing sector. Employment in this sector today stands at the same absolute level it hit 20 years ago. Many of us still have not gotten used to the idea that goods-producing employment in the United States is declining as a share of total employment. How much more difficult will it be to get used to a goods-producing sector that (like farming) has peaked out in terms of absolute employment as well?

Goods-producing employment's share of the U.S. labor market has diminished, but the importance of goods production has not. Roughly the same percent of value added comes from the goods-producing sector today as 20 years ago—just under 40%. But the composition and strategic role of goods production is changing rapidly. According to Federal Reserve statistics, computers, communications equipment, and semiconductors accounted for about 8% of total industrial production last year. However, production of these materials has increased almost 600% since 1992, while overall industrial production advanced only 35%. From another perspective, the average annual growth rate of U.S. manufacturing capacity from 1975 to 1999 was 3.2%, while the comparable figure for the high-tech sector was 19.3%. Growth in manufacturing capacity excluding this sector would have been only 1.9% per year on average. So not only does the high-tech sector account for ever greater shares of output; the creation of its

infrastructure accounts for expanding shares of the nation's labor and capital resources as well.

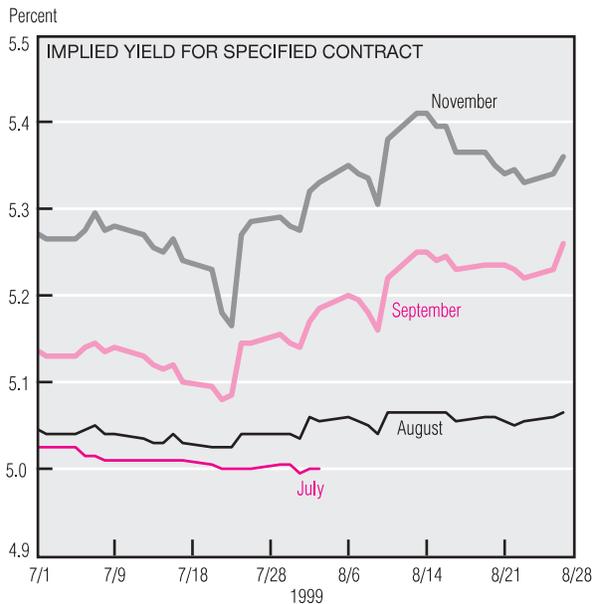
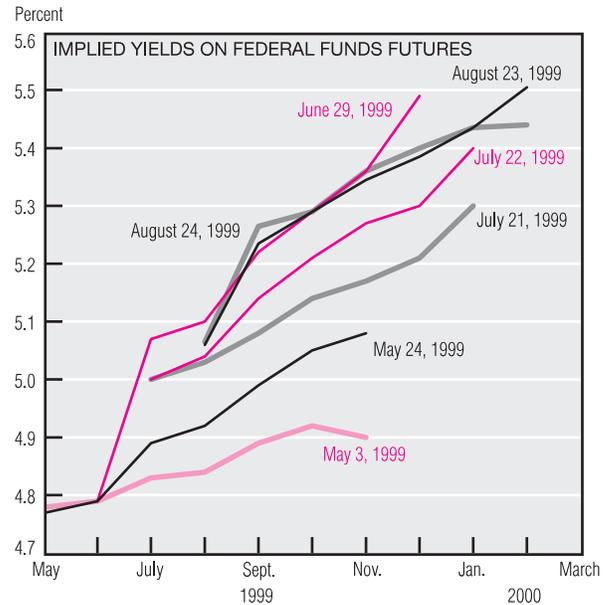
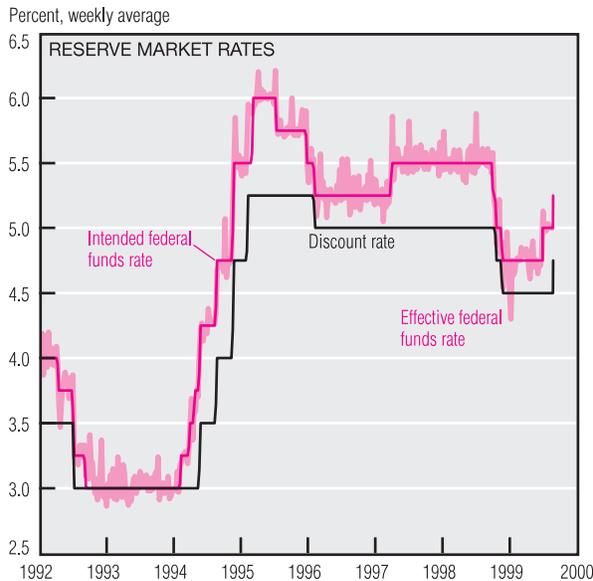
As the composition of U.S. goods production has been changing, the importance of foreign trade has been expanding. Thirty years ago, U.S. imports and exports combined amounted to roughly 10% of the size of the economy (as measured by GDP); today the combined total has grown to nearly 30% of the economy's size. The explosion of both import and export volumes over the years need not have had any implication for the trade balances or net international investment position of the United States. However, the nation's current account has persistently been in deficit for nearly 20 years. Our net international investment position has declined as well, from approximate balance to substantial deficit about \$1.5 trillion.

The velocity of these trends intensified during the current economic expansion; recent estimates of our 1999 current-account deficit are in the \$300 billion range. The U.S. net investment deficit has grown so large that our trade deficit, which used to be partially offset by positive net income from foreign investment, is now augmented by net payments made to foreigners as investment income.

Despite its improved productivity and product innovation, the United States has continued to import more than it exports. U.S. current-account deficits have persisted because the rest of the world has been willing to finance them by accumulating U.S. dollar-denominated assets, either in the form of a financial instrument or a physical asset. These assets provide the foreign owner with future consumption in exchange for goods and services provided to U.S. residents today. The current U.S. investment boom has been partly supported by foreign participants and accompanied by dollar appreciation. Should foreign residents conclude that they can get better returns elsewhere, or should they desire to step up the pace of their own consumption, we can expect the dollar to depreciate and the cost of capital to rise.

Longer-term trends make it clear that changes in the composition of domestic production, along with a steady reliance on foreign capital inflows, have far-reaching implications for U.S. economic performance. We may lead the world in the production of advanced technology products, but if we want to continue consuming more than we produce, we still have to pay for the privilege.

Monetary Policy



a. Constant maturity.

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

On August 24, the Federal Open Market Committee (FOMC) raised the intended federal funds rate and the discount rate by 25 basis points each—to 5.25% and 4.75%, respectively. Although financial markets generally had anticipated the move just prior to the FOMC decision, expectations about the future path of the federal funds rate had fluctuated substantially since the Committee's previous meeting.

In light of the tilt announced in the May directive, market participants had expected the increase at

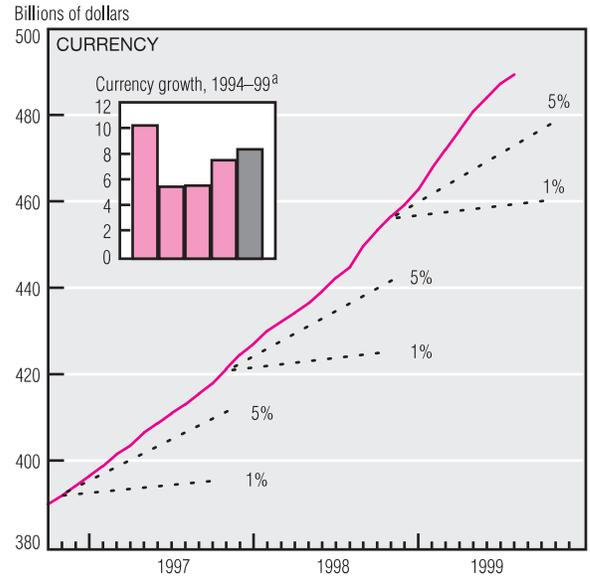
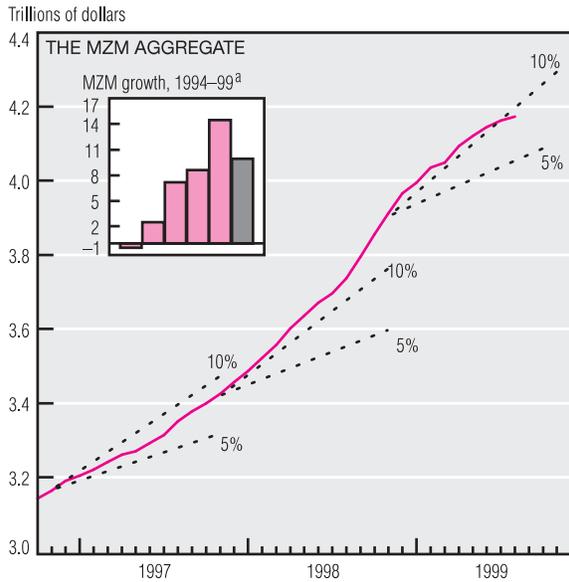
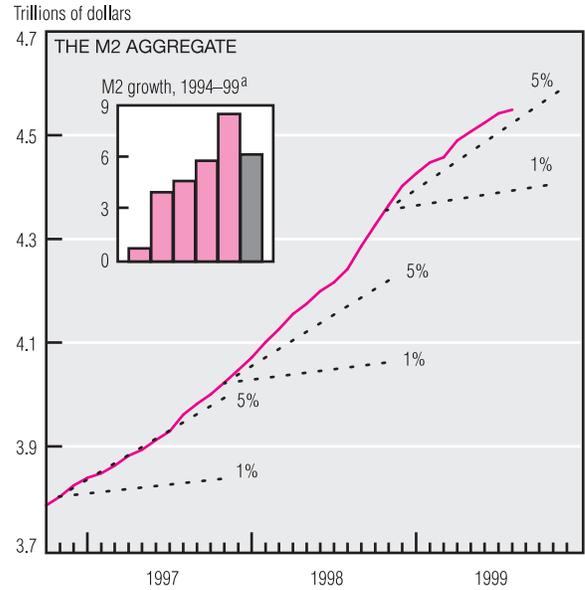
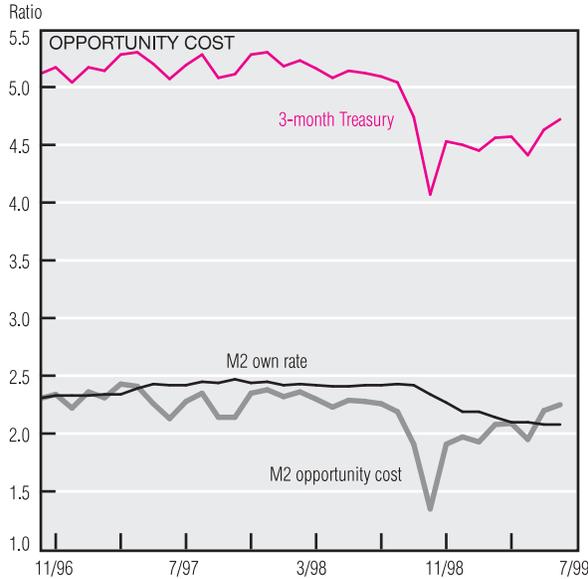
the June 29 meeting; however, adoption of a neutral directive at that meeting seemed to come as a surprise. In the wake of the June announcement, implied yields on fed funds futures dropped sharply across contract months.

The expected funds rate trajectory began drifting upward after Chairman Alan Greenspan's testimony to Congress on July 22, which emphasized the FOMC's resolve to preempt inflation by acting "promptly and forcefully so as to preclude imbalances." The effect is clearly evidenced by the sharp

break in the September and November contracts at this date. Subsequent data appeared to convince market participants that inflationary pressures were building, particularly in the labor market, and implied yields continued to drift upward as the meeting date neared. The policy announcement of rate increases had virtually no impact in this market. Consistent with rising expectations for policy firming, short-term rates rose over the period between meetings.

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Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rates for M2, MZM, and currency are calculated on an estimated July over 1998:IVQ basis.
 NOTE: Data are seasonally adjusted. Last plots for M2, MZM, and currency are estimated for August 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 demand for M2 is inversely related to the opportunity cost of holding M2—commonly measured as the difference between the three-month Treasury bill rate and the average of own rates paid on M2 components. Since M2 own rates respond only sluggishly to market conditions, M2 opportunity cost initially moves in tandem with market rates. Thus, the three consecutive FOMC rate cuts last fall sharply reduced M2 opportunity cost, inducing an increase in M2 growth around

year's end. The recent upward drift in opportunity cost associated with the reversal in market rates is beginning to dampen M2 growth.

The MZM money measure equals M2 minus small time deposits but includes institutional money-market mutual funds. It is similarly affected by changes in short-term interest rates. Because it comprises relatively safe, liquid instruments, it has served as a haven for funds, particularly during periods of heightened uncertainty such as last fall. Cur-

rency growth is expected to remain strong over the rest of the year, as the public prepares for contingencies related to Y2K.

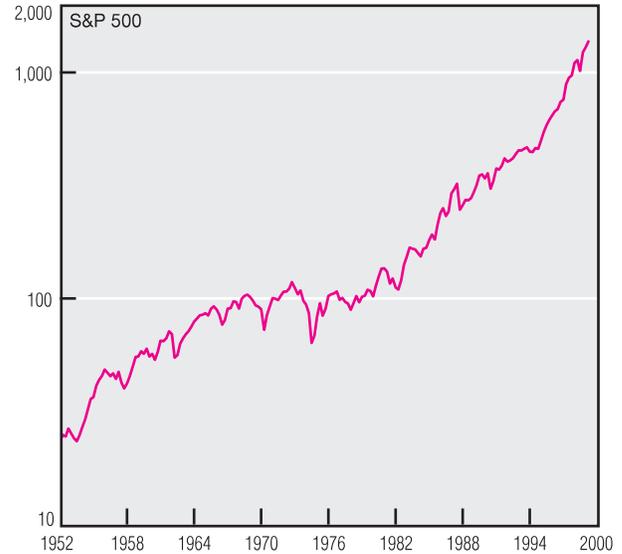
When policy changes direction, capital markets often become unsettled. In February 1994, for example, the FOMC initiated a series of fed funds rate increases after several years of stable or falling target levels. Long-term interest rates jumped sharply—almost 200 basis points in early 1994. The two recent changes
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Monetary Policy (cont.)

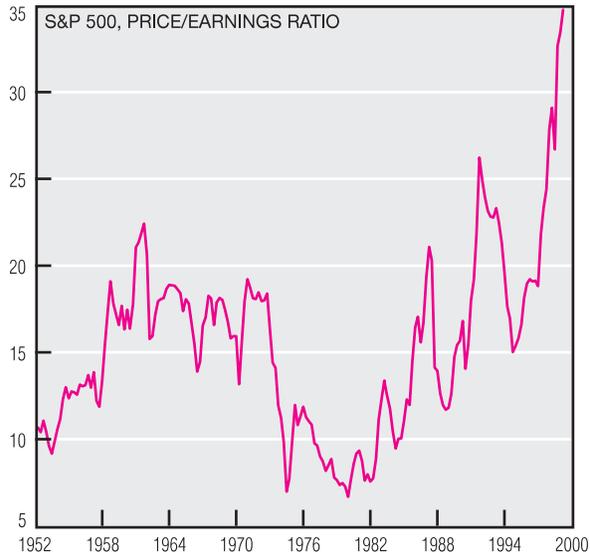
Percent, weekly average



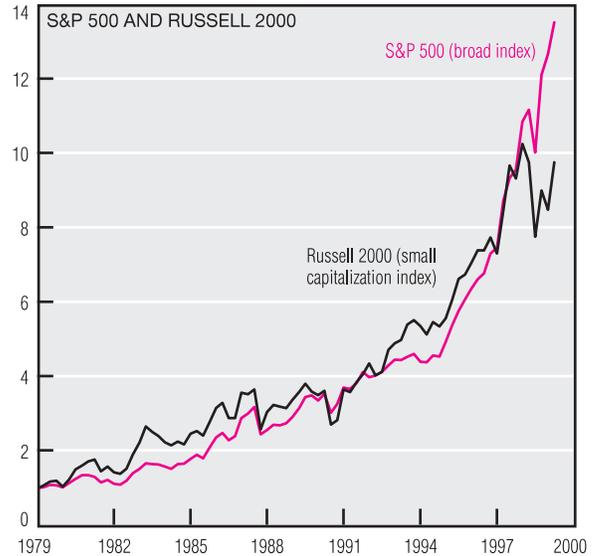
Index, 1941–43 = 10 (log scale)



Ratio



Index, January 1979 = 1



a. Constant maturity.

SOURCES: Board of Governors of the Federal Reserve System; Standard & Poor's Corporation; and Bloomberg Financial Information Services

in the intended fed funds rate were the first consecutive increases in more than four years. Though long-term interest rates increased, the effect has been relatively muted.

Nevertheless, long rates have drifted up substantially. Perhaps surprisingly, the upward drift in yields on fixed-income securities has not affected the stock market adversely. To some extent, stock prices have been bolstered by good news on profits. Fundamentally, a stock's price is determined as the dis-

counted value of its expected future dividends. Future dividends, in turn, derive from future earnings.

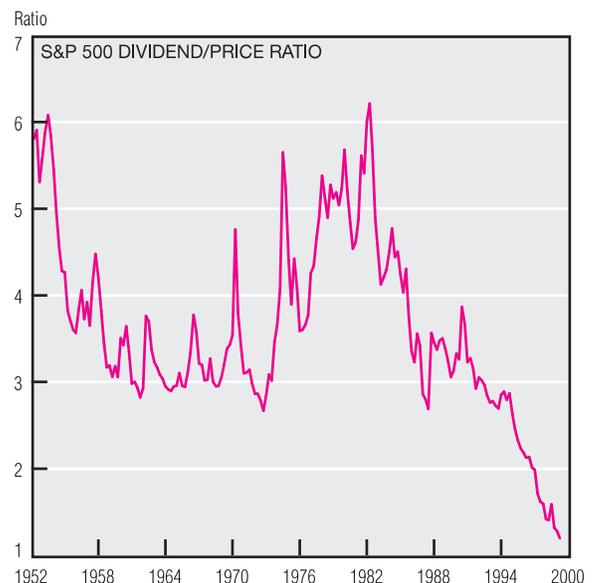
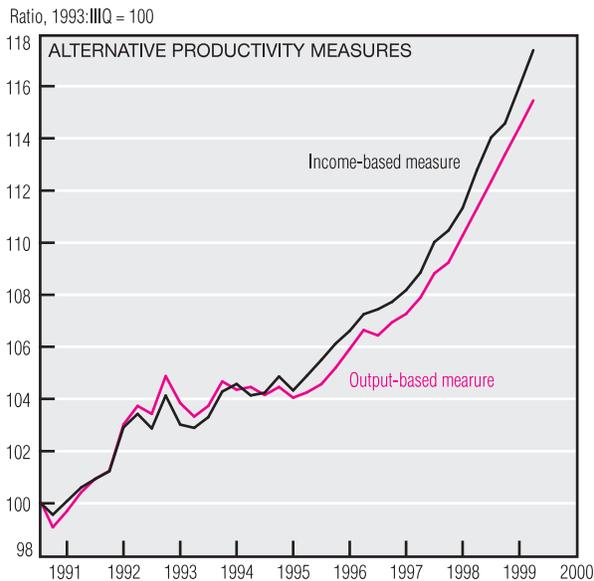
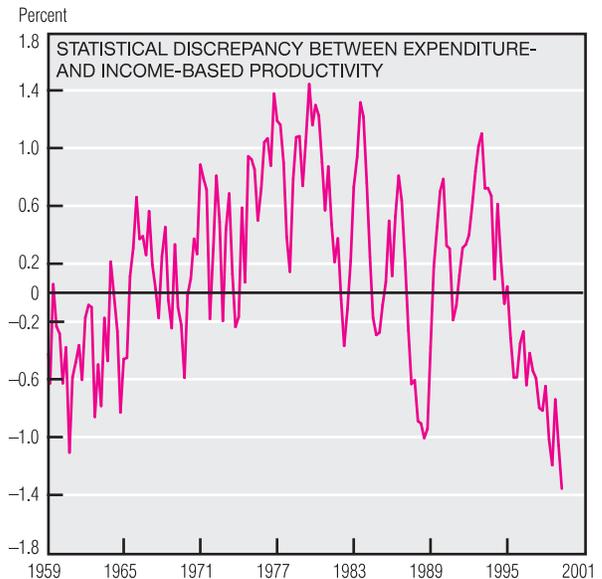
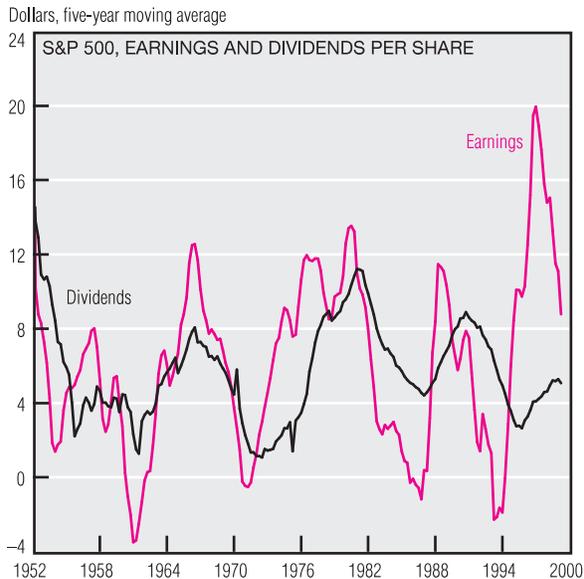
When prospects for earnings growth are good, stock prices tend to rise. The price/earnings (P/E) ratio—simply the stock price divided by earnings per share—gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and hence the more earnings growth they are expecting. The P/E of S&P 500 stocks has been

rising over the past two years, approaching historically high levels.

The one clearly extraordinary fact associated with the rise in stock prices has been the sustained earnings growth over much of the decade. Analysts' earnings projections reveal an expectation of continued benefits from corporate cost cutting and innovation. Moreover, it is argued that a large portion of business outlays, currently expensed, should be amortized so that

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Monetary Policy (cont.)



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Standard & Poor's Corporation; and Bloomberg Financial Information Services.

the returns that they produce would be more accurately reflected as earnings over time. If the trend in expensed items that should be capitalized is growing faster than reported earnings, capitalizing these items will generally accelerate measured earnings.

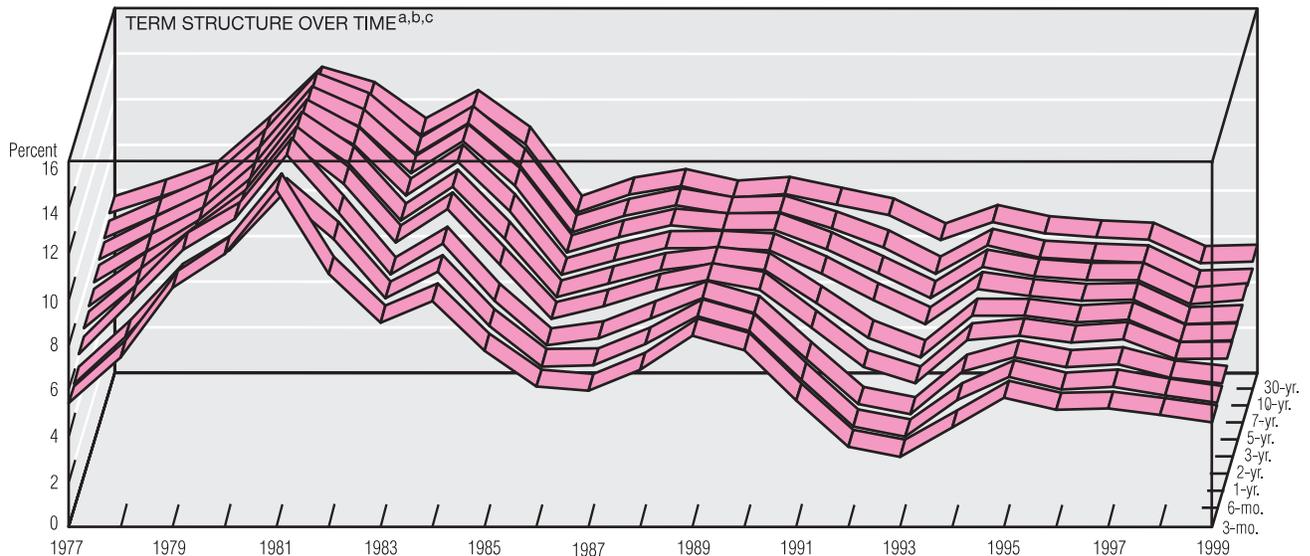
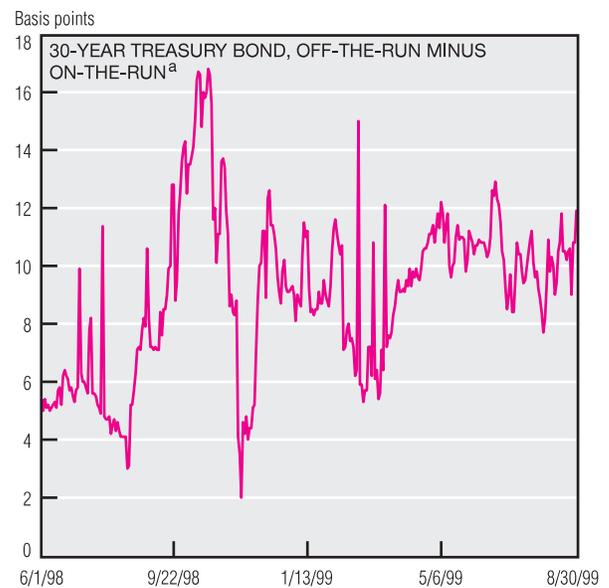
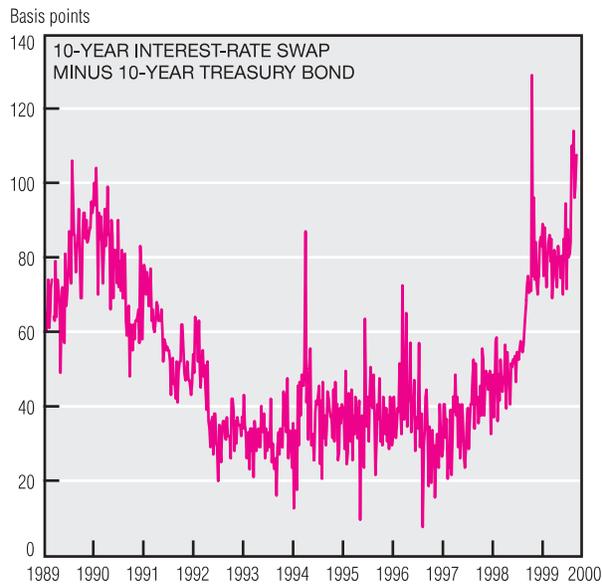
Pessimists about the sustainability of such strong earnings point to measured productivity growth which, while strong, is less extraordinary than earnings. Optimists argue that traditional measures understate true productivity growth and point to statistical discrepancies.

One source of potential error is the official measure of gross domestic product (GDP), which is obtained by summing the dollar value of expenditures on consumption, investment, government purchases, and the value of net exports. It is conceivable that some nominal expenditures are not recorded.

As a cross-check, the Commerce Department's Bureau of Economic Activity (BEA) calculates both expenditure- and income-based measures. The BEA designates the expenditure-side estimate as the official one but publishes the discrepancy between

the two measures. Since the last business-cycle peak, the income-based measure of productivity expanded about 0.2% faster per year than the official measure. Optimists also argue that imperfections in price measurement tend to understate true productivity. As Chairman Greenspan recently noted, "We no longer have the luxury to look primarily to the flow of goods and services, as conventionally estimated, when evaluating the macroeconomic environment in which monetary policy must function."

Interest Rates



a. All yields are from constant-maturity series.

b. 12-month averages except 1999 data, which represent the average of the first seven months.

c. The data for three- and six-month bills before 1982 are 12-month averages of secondary market yields.

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

One closely watched interest-rate spread has been making news lately as it moves to historically high levels. The yield spread between 10-year interest-rate swaps and 10-year Treasury bonds has risen to 108 basis points (bp), a noticeable increase from the range of 75–85 bp seen earlier this year and well above the 20–40 bp rate that prevailed for most of this decade. The widening spread between a risky instrument (swaps) and a safe instrument (T-bonds) has resurrected

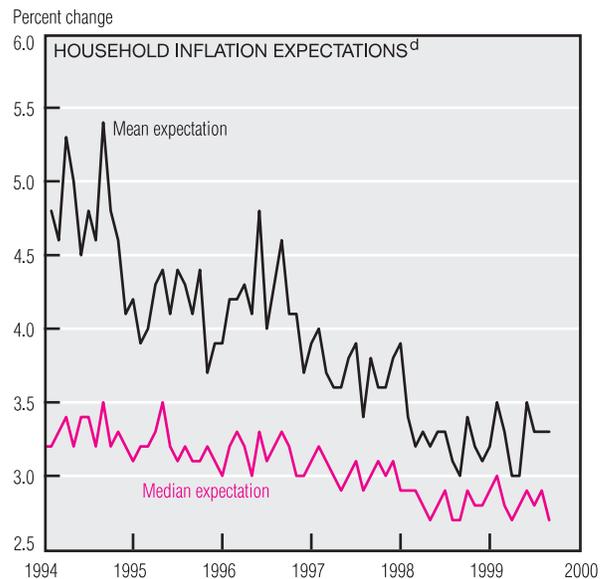
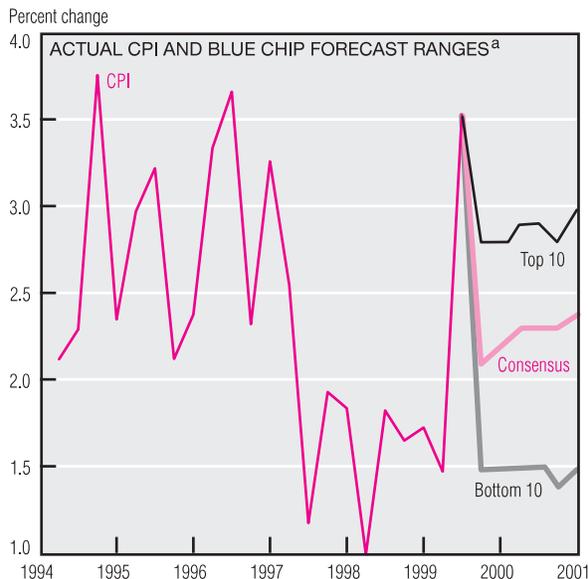
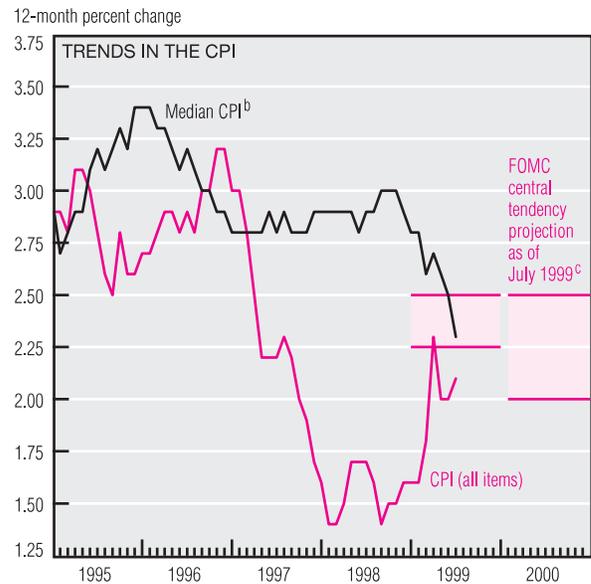
fears of a credit crunch and possible increased market volatility.

Another popular yield spread, though, seems not to indicate such troubles. The spread between on-the-run (the most recently issued) and off-the-run 30-year T-bonds has shown only modest movement in 1999. A nascent credit crunch, accompanied by a flight to liquidity, would be expected to drive down yields on the very liquid on-the-run bonds and thus widen the spread. This occurred in the fall of 1998, but is not apparent now.

Spreads or snapshots of the yield curve often bring out important elements of the data, but they do a poor job of describing how the whole yield curve evolves through time. A bird's-eye view of the past two decades emphasizes the relative placidity of the recent bond market. Compared to the beginning of the year, the yield curve seems to have made some significant jumps and twists, but its movements look much less impressive when placed in historical context.

Inflation and Prices

	Percent change, last:				1998 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
July Price Statistics					
Consumer prices					
All items	3.7	1.2	2.1	2.3	1.6
Less food and energy	2.1	1.4	2.0	2.5	2.5
Median ^b	1.3	1.7	2.3	2.9	2.9
Producer prices					
Finished goods	2.8	1.2	1.5	1.1	-0.1
Less food and energy	0.0	-0.5	1.4	1.2	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.

d. Expected 12-months-ahead change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; University of Michigan, Survey Research Center; and *Blue Chip Economic Indicators*, August 1999.

Prices in July were subdued on the whole, although anxiety about a re-ignition of inflation reportedly remains the focal point of any further adjustment to Federal Reserve policy. The CPI jumped an annualized 3.7% during the month, mostly as the result of an upward spike in energy prices. Excluding food and energy, the CPI rose 2.1% in July.

Another measure of core inflation, the Federal Reserve Bank of Cleveland's median CPI, posted only a 1.3% July gain, identical to its June advance. In fact, as the CPI trend has

accelerated over the past six months or so, the median CPI has been moving lower, and the 0.2-percentage-point difference separating the 12-month growth rates of these two inflation indicators is the smallest in more than two years.

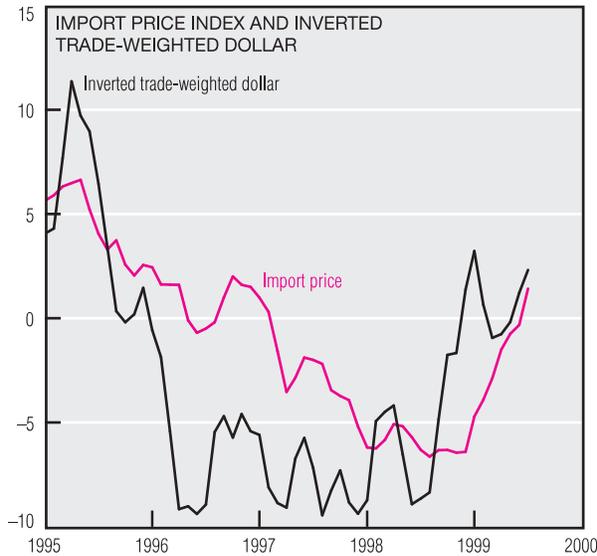
Economists seem unusually divided in their projections for retail prices over the rest of this year and next. The consensus forecast (as compiled by *Blue Chip Economic Indicators*) shows the CPI falling to a 2% pace this quarter and gradually rising to about a 2½% growth rate by

the end of 2000. Inflation pessimists, however, see retail price increases remaining in the 2¾% to 3% range over the coming year, while inflation optimists expect retail price growth to fall back to the 1½% level—similar to the low inflation readings for 1998. Survey data reveal that U.S. households' year-ahead inflationary expectations have held relatively steady in the past year, generally in the range of 2¾% to 3¼%, depending on the measure used.

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Inflation and Prices (cont.)

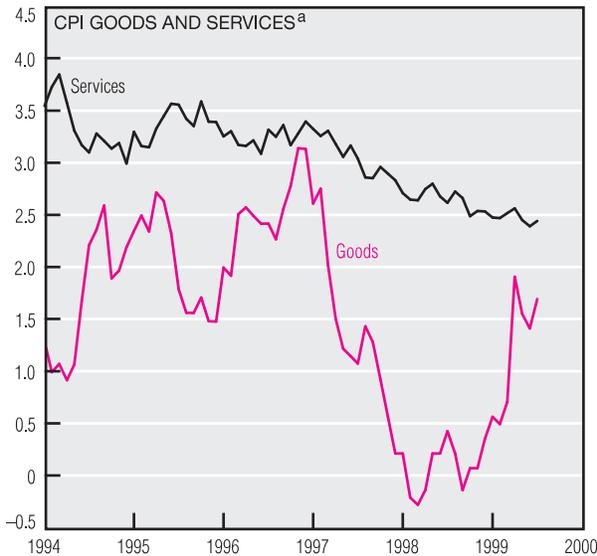
12-month percent change



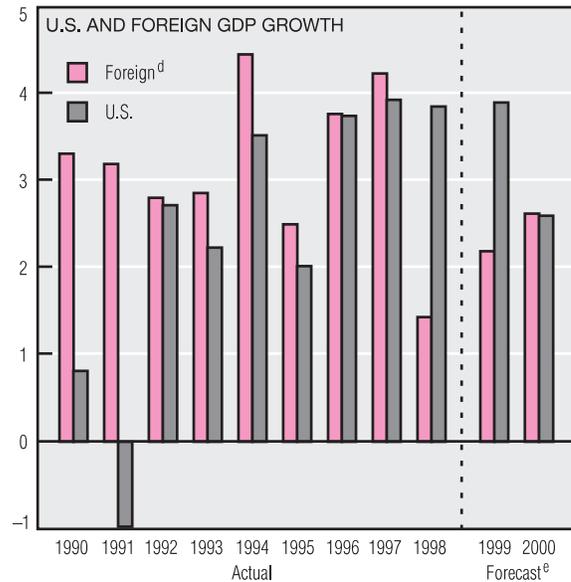
Consumer Prices and Imports

	Percent of CPI	Percent of imports ^a	Percent change in prices (past 24 months) ^b
CPI (all items)	—	—	1.88
Autos	5.53	42.9	-0.63
Apparel	3.57	14.9	-1.20
Footwear	0.88	2.7	-0.28
Jewelry ^c	0.32	4.5	-1.59

12-month percent change



Percent



- a. Consumer goods imports plus autos (excluding food), January–June 1999.
 b. Annualized.
 c. Excluding watches.
 d. Trade-weighted average of the top 15 U.S. trading partners.
 e. *Blue Chip Economic Indicators*, August 1999.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics*; Organisation for Economic Co-operation and Development, *World Economic Outlook*; and *Blue Chip Economic Indicators*, August 1999.

Among the factors that could quickly turn a favorable inflation outlook unfavorable is the volatile and largely unpredictable international environment. Clearly, a strong dollar and falling import prices have helped keep U.S. retail prices flat.

The impact of falling import prices on the CPI is difficult to judge precisely, but there are indications that it is substantial. For example, four categories that account for a large share of U.S. consumer goods imports—autos and auto parts, apparel, footwear, and jewelry—have all

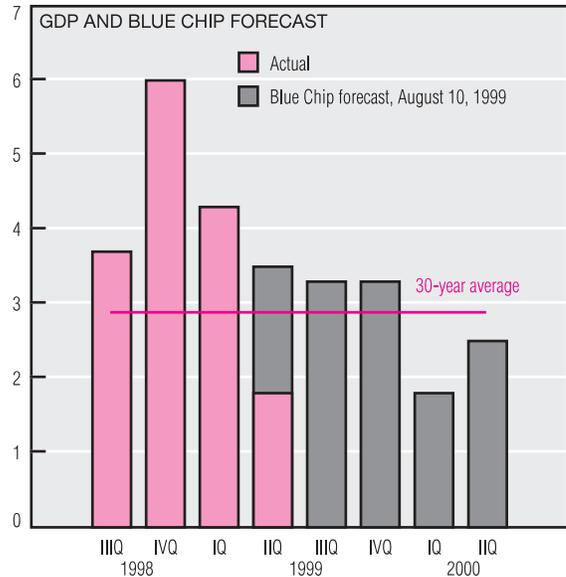
posted price declines, on average, over the past two years. Cumulatively, these goods represent more than 60% of consumer goods imports into the U.S. and about 10% of all retail prices. Similarly, goods prices in the CPI for 1998 showed essentially no increase on average, while services prices were rising at about a 2¾% pace. One likely explanation for this divergence is that a large proportion of goods are either imported or compete directly with imports, whereas services are predominantly domestic in origin.

The key uncertainty is the impact of a strengthening world economy on U.S. retail prices. As foreign economies gain momentum and greater demands are placed on their resources, downward pressure could be felt on the U.S. dollar and import price pressure could grow. Indeed, a strengthening world economy may already have begun to push foreign goods prices upward, and this effect could intensify as we move into 2000, when many nations' economies are expected to expand at a pace similar to that of the U.S.

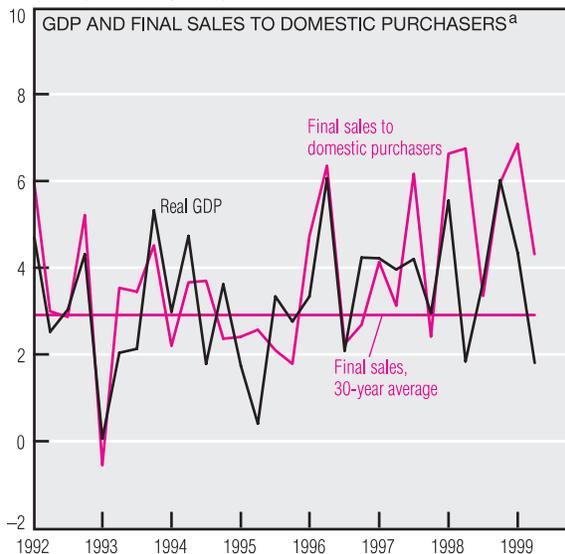
Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	34.7	1.8	3.9
Consumer spending	59.9	4.6	5.1
Durables	18.3	9.5	12.0
Nondurables	11.8	3.0	4.7
Services	31.4	4.3	3.9
Business fixed investment	27.2	11.2	8.2
Equipment	30.8	15.9	10.3
Structures	-0.6	-1.1	2.6
Residential investment	6.3	7.7	10.7
Government spending	-5.5	-1.7	1.8
National defense	-2.6	-3.4	-1.2
Net exports	-33.8	—	—
Exports	10.6	4.3	3.6
Imports	44.4	14.4	10.4
Change in business inventories	-26.6	—	—

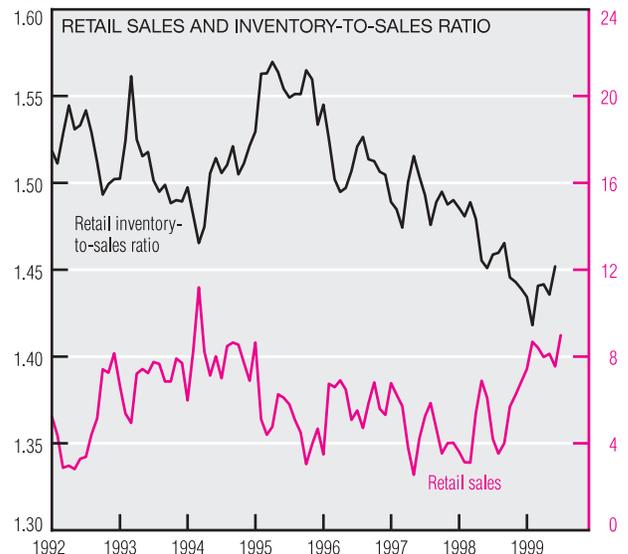
Annualized percent change from previous quarter



Annualized percent change from previous quarter



Ratio



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; and *Blue Chip Economic Indicators*, August 10, 1999.

GDP growth in 1999:IIQ has been revised downward from an advance estimate of 2.3% to a preliminary estimate of 1.8%, which primarily reflects a higher estimate of imports and a lower estimate of business inventories, factors that more than offset an upward revision of personal consumption expenditures.

Strong consumer spending has persisted from late 1998 into 1999 and has been a driving force of GDP growth. Final sales to domestic purchasers, a measure of total domestic demand, has outpaced GDP growth

since 1997. In several quarters, including 1999:IQ, final sales grew more than 6%, more than double its 30-year average.

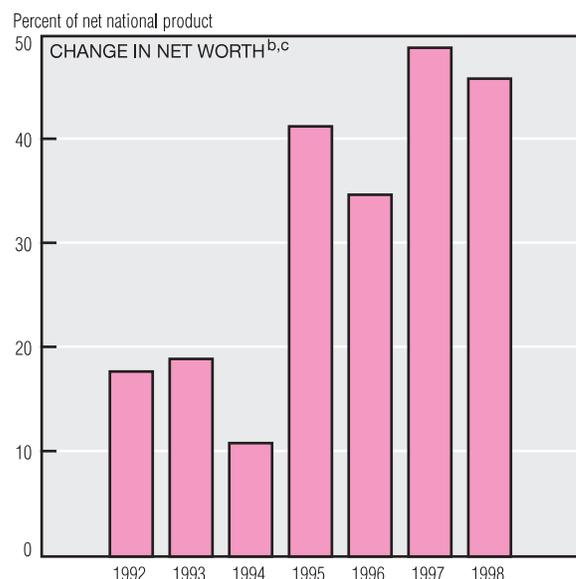
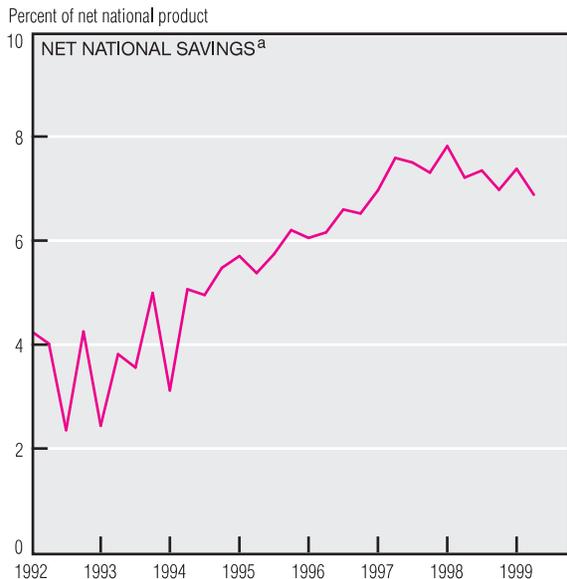
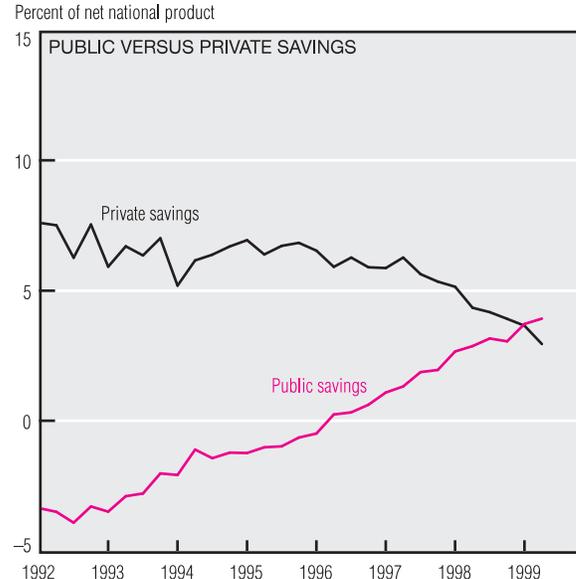
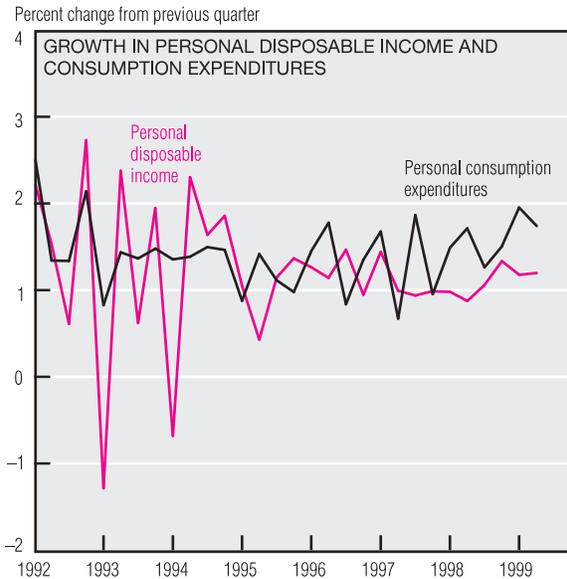
The continued strength of consumer spending is also apparent in strong retail sales increases (roughly 8% over last year). Many retailers' inventories are at record lows. In May, the inventory-to-sales ratio hit its lowest level in 15 years.

Since 1997, personal consumption expenditures have grown faster than personal disposable income, producing a negative personal saving rate.

This suggests that people are consistently spending more than they earn. The definition of income used to measure the personal saving rate excludes capital gains, however, and payroll contributions to Social Security are treated as taxes rather than as a component of household savings. This may be inappropriate, since such contributions qualify the individual for additional retirement and other benefits.

In addition to personal savings, the U.S. total includes business and
(continued on next page)

Economic Activity (cont.)



a. Net national savings is calculated as personal disposable income less personal outlays plus undistributed corporate profits and public savings.

b. Data are not seasonally adjusted.

c. Data include both households and nonprofit organizations.

NOTE: All data are seasonally adjusted, unless otherwise noted.

SOURCES: U.S. Department of Commerce, Bureau of the Economic Analysis; and Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Release*, B.100.

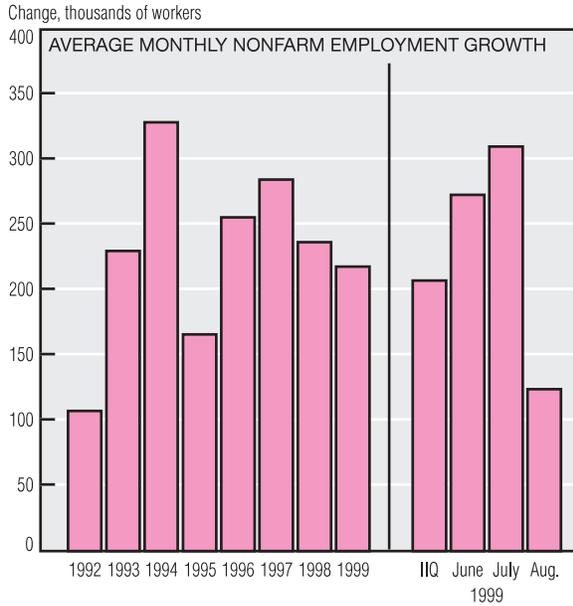
public savings. Business savings can be measured by the value of undistributed corporate profits (with adjustments for inventory valuation and capital consumption). Business savings and household savings combined equal private savings, which have declined slightly in 1998 and 1999. Public savings has been rising over the past six years, as federal, state, and local budgets have moved from deficits to surpluses. Large increases in public savings have offset moderate declines in private savings.

Thus, national savings, the sum of private and public savings, is increasing. Net national savings, which rose steadily from 1994 to 1998, have held constant around 7% since 1998.

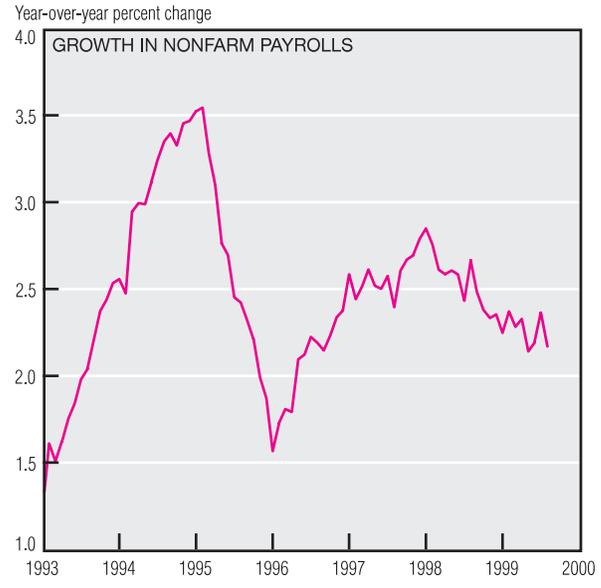
Overall, the U.S. savings picture is less alarming than it might seem if one considered only the narrow measure derived from personal savings as a percent of disposable income. Other measures provide a more complete picture. One indicator of whether households are consuming or saving is the change in

their net worth, which captures capital gains and losses. This measure of savings has increased substantially since 1995. A saving rate of 40% to 50% may seem extraordinary, but it includes the current value of new assets minus new liabilities, plus estimated capital gains and losses on both financial and nonfinancial assets. Capital gains can be substantial because the value of the underlying assets is easily many times the value of the net national product.

Labor Markets



	Average monthly change (thousands of employees)				
	1996	1997	1998	YTD ^a	Aug.
Payroll employment	234	281	244	218	124
Goods-producing	32	48	8	-25	-95
Mining	1	2	-3	-6	-3
Construction	28	21	30	9	-29
Manufacturing	3	25	-19	-28	-63
Durable goods	10	27	-9	-12	-38
Nondurable goods	-7	-2	-10	-16	-25
Service-producing	202	233	235	240	219
Retail trade	43	24	32	46	-3
FIRE ^b	14	20	26	14	11
Services	117	141	119	119	132
Help-supply svcs.	19	28	10	14	9
Health services	20	17	9	12	19
	Average for period (percent)				
Civilian unemployment	5.4	4.9	4.5	4.3	4.2



a. Year to date.
 b. Finance, insurance, and real estate.
 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.

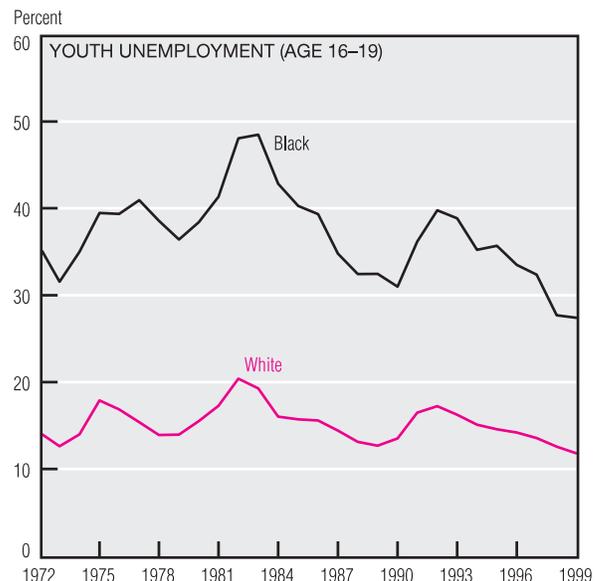
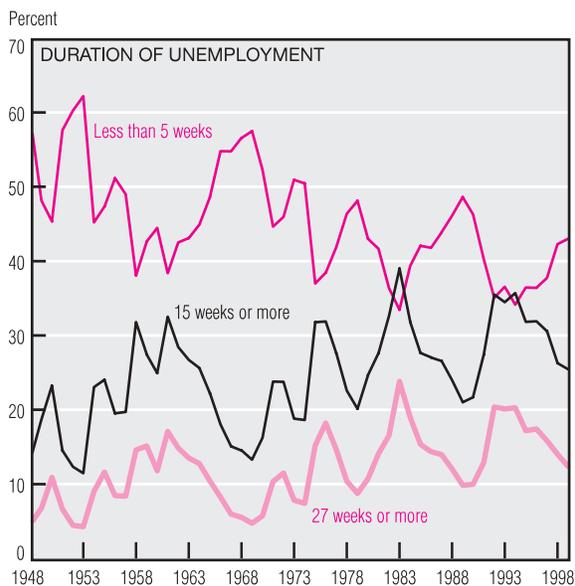
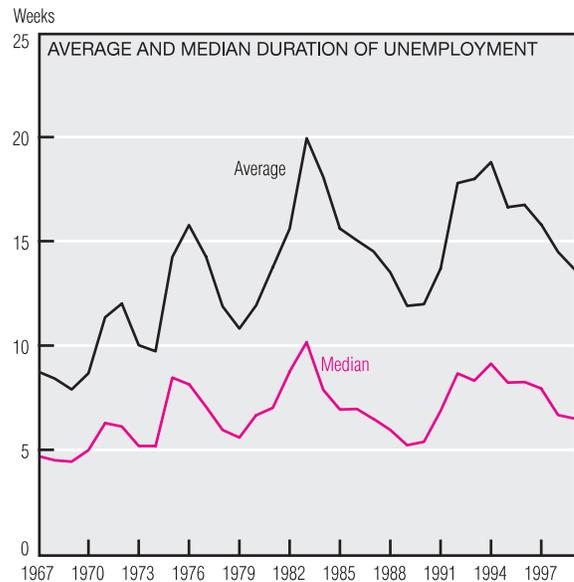
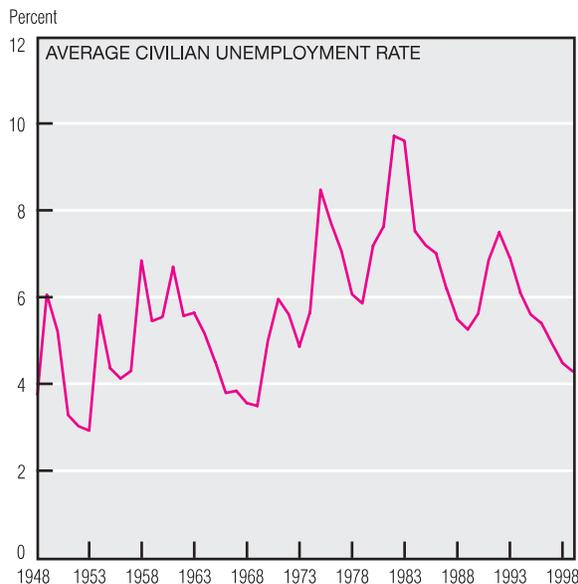
Despite a slowing in employment growth, labor markets generally remained strong in August. The unemployment rate fell to a 29-year low of 4.2%. Employment growth declined significantly from a healthy 310,000 jobs in July to only 124,000 in August. Although it fell short of expectations, employment growth has increased by over 2% for the last two months, suggesting that the economy will remain robust.

Manufacturing employment re-

turned to its yearly trend by decreasing 63,000 jobs in August, following a significant July increase. Declining employment in apparel and industrial machinery contributed to the August contraction, which was double the 1999 monthly average. However, motor vehicle and electrical equipment manufacturing have added 14,000 and 8,000 jobs, respectively, to their payrolls over the last two months. Construction employment decreased by 29,000 jobs,

nearly as many as had been added in the previous two months. Most employment growth came from the service-producing sector. The slightly above-average increase in narrow services (132,000 jobs) was buoyed by strong increases in computer and health services. Years of solid employment growth have yielded a strong employment-to-population ratio, which remained unchanged at 64.1%.

Unemployment



NOTE: All data are annual averages of monthly data.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The civilian unemployment rate has declined to levels not seen for 30 years. This rate, which reached a post-World War II peak of just over 10% during parts of 1982 and 1983, now hovers around 4.3%.

The average duration of unemployment, however, has not declined. In fact, it has risen from just under 10 weeks in the late 1960s to about 15 weeks in the late 1990s. On the other hand, the median duration has shown a smaller increase, implying that the difference be-

tween the average duration of unemployment and the median is larger today than it was 30 years ago; that is, the distribution of the duration has become more skewed.

The percentage of unemployed workers who have been out of work less than five weeks has declined sharply. In the early 1950s, roughly half the unemployed were jobless for less than five weeks. In the early 1990s, that number was closer to 35%; today it is roughly 40%.

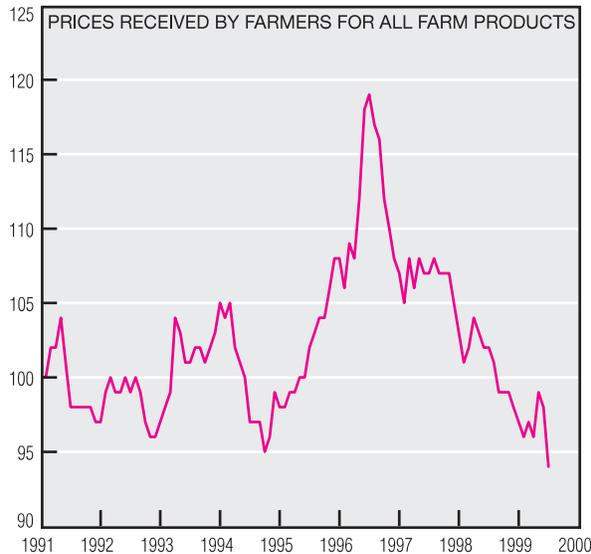
In contrast, the fraction of people who experience long-term un-

employment has been rising. In the early 1950s about 15% of them went without work for 15 weeks or more; today that statistic is closer to 25%.

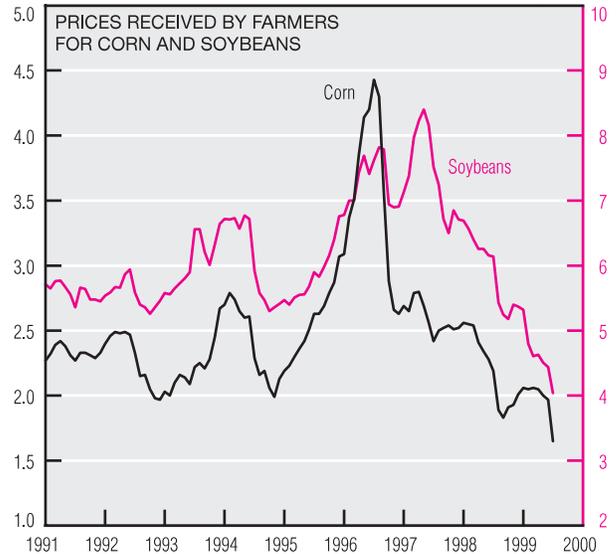
In addition, the economic recovery of the 1990s has gradually decreased unemployment among young people. The unemployment rate for blacks aged 16-19 has fallen below 30%, reaching its lowest level since the early 1970s. The rate for whites aged 16-19 has also been declining and is the lowest it has been since 1972.

Agricultural Prices

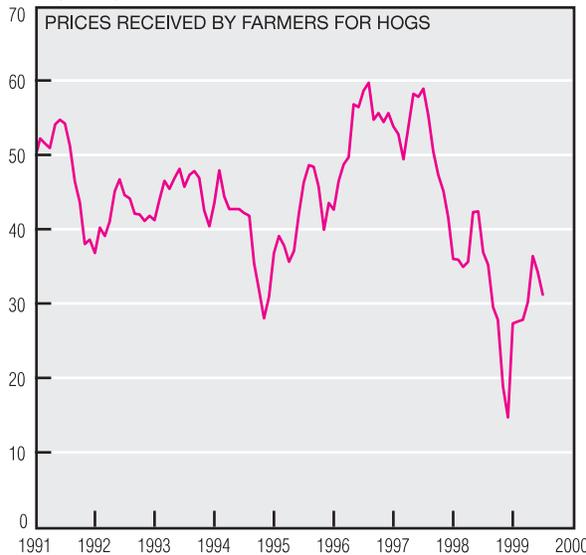
Index, 1990-92 = 100



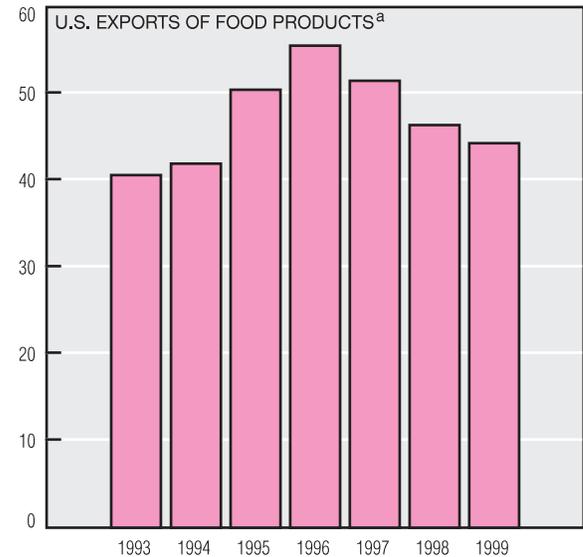
Dollars per bushel



Dollars per 100 pounds



Billions of dollars



a. 1999 data are annualized for January through June.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Agriculture, National Agricultural Statistics Service.

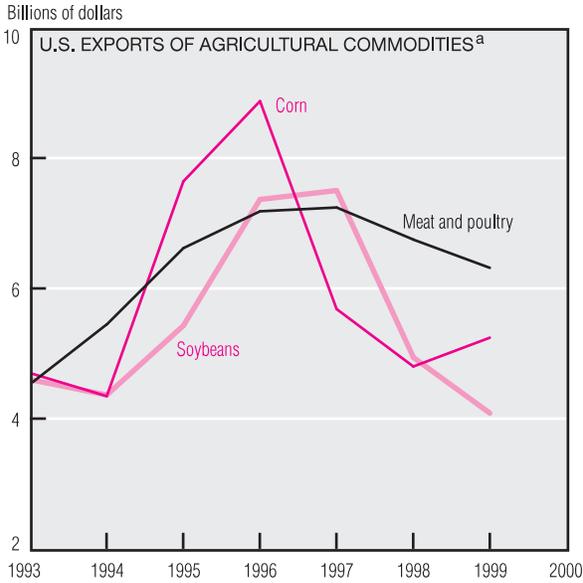
Since their record highs of 1996, agricultural prices as a whole have fallen about 21%. This has created difficulties for farmers throughout the nation, including the Fourth District. Prices for two of the District's most important commodities, corn and soybeans, have dropped even more than the all-product average in the last few years. Since their high point in 1997, soybean prices have fallen 52%; corn prices have gone down 63% since their 1996 high.

A still steeper drop occurred in hog prices, especially last year, when price declines for hogs quickly outpaced drops in feed-grain prices. From their high point in August 1996, hog prices plunged 75% to their low point in December 1998. Although they have rebounded slowly, hog prices remain lower than those of the previous few years.

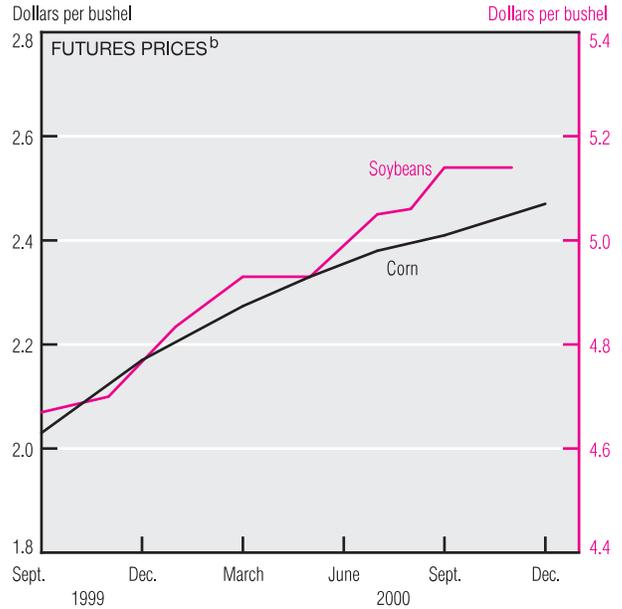
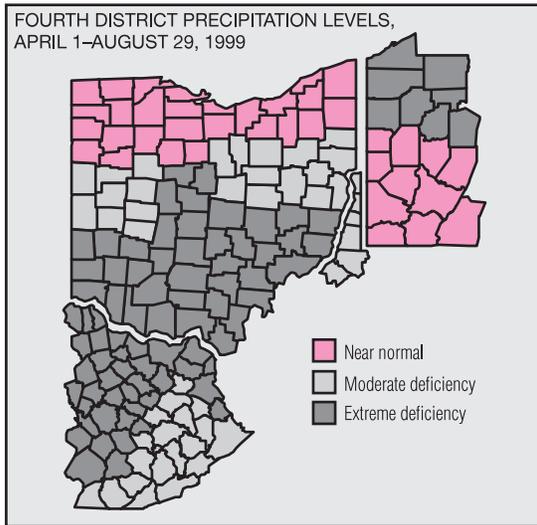
One reason agricultural prices have declined so sharply in recent years is the drop in exports of agri-

cultural products, particularly to Asia. From 1996 to 1998, U.S. exports of all food products fell about 16%. On the basis of data for the first half of the year, food exports overall are expected to post even lower levels for 1999. Over the 1996-98 period, exports of corn and soybeans showed exceptionally sharp declines, plunging 46% and 33%, respectively. Exports of meat and poultry also declined slightly. If trends in the first half of 1999 continue for the rest of *(continued on next page)*

Agricultural Prices (cont.)



	Value of exports (millions of dollars)	Percent of value of all agricultural products sold
Kentucky	67.9	2.2
Ohio	97.4	2.1
Pennsylvania	120.2	3.0
West Virginia	8.0	1.8



a. 1999 data are annualized for January through June.

b. Futures quotes on August 31, 1999.

SOURCES: U.S. Department of Commerce, Bureau of the Census and International Trade Administration; U.S. Department of Agriculture, Census of Agriculture and National Agricultural Statistics Service; Chicago Board of Trade; and University of Kentucky, College of Agriculture.

the year, corn exports will rebound, while exports of soybeans and meat and poultry will continue to decline.

Although reduced exports have had a major effect on agricultural prices, direct exports of farm products from the Fourth District are relatively insignificant. In 1997, exports accounted for only 1% to 3% of all agricultural product sales in each Fourth District state.

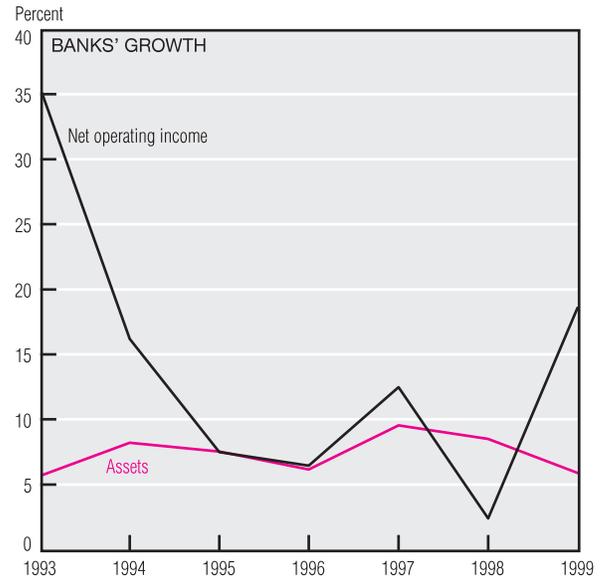
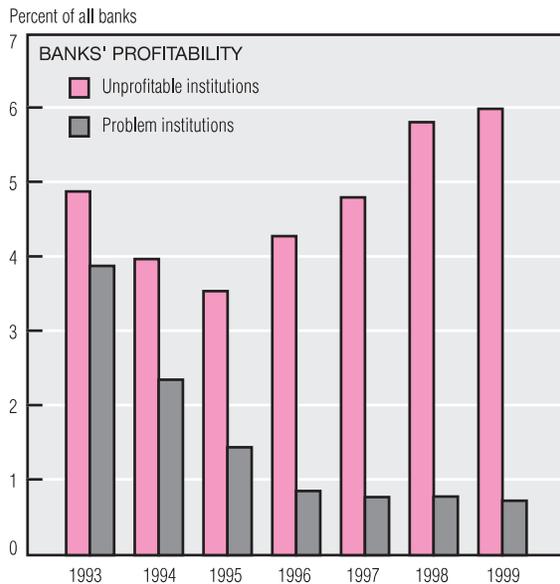
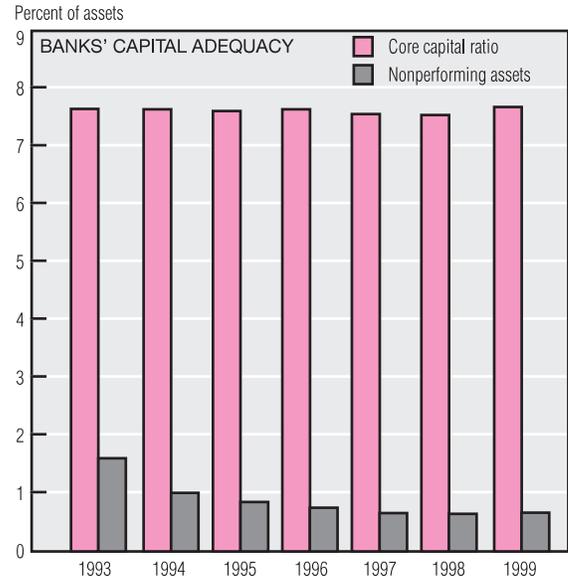
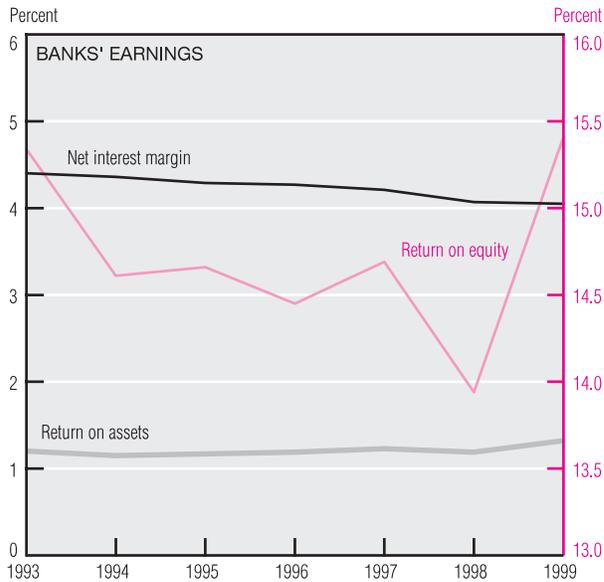
This year's severe drought has compounded the problems of Fourth

District farmers. Pastures have become so dry that most farmers have been forced to start feeding their cattle hay, and some have begun selling off their herds. Moreover, much of the District's corn and soybean crop is reportedly in poor condition, and low yields are expected. Drought conditions are worst in the southern part of the District, with some areas of northern Kentucky showing a rainfall deficit of more than eight inches between April 1 and August 29. Certain areas of the District have

recently begun to receive more rain, but the drought has already caused severe damage.

Nonetheless, agricultural prices are expected to remain low, since the drought is affecting only the eastern U.S. and not the major agricultural areas of the Great Plains. Futures markets predict slightly higher prices over the next year, but the rise will be gradual and prices will remain low compared to those of a few years ago.

Banking Conditions



NOTE: All data are for FDIC-insured commercial banks. 1999 data are for the first quarter.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, March 1999.

Commercial banks' balance sheets showed continued signs of health through the first quarter of 1999. After slowing down in 1998, profits picked up again in 1999:1Q, with a return on assets of 1.32% and a return on equity of 15.41%. Core earnings stayed strong as the net interest margin remained above 4%. Moreover, 94% of all commercial banks posted positive profits.

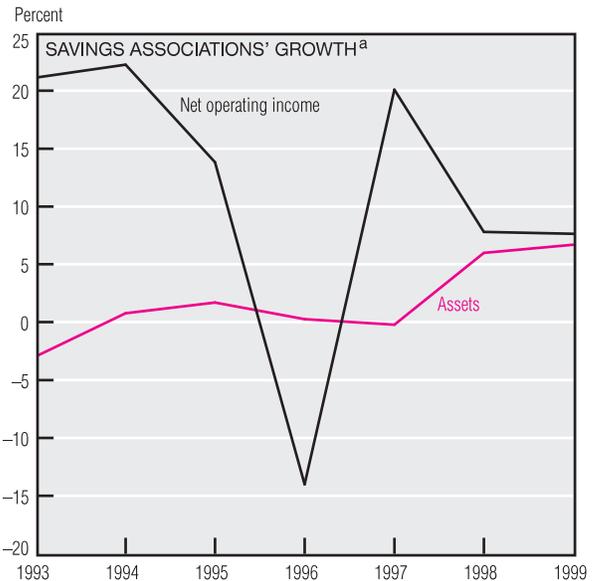
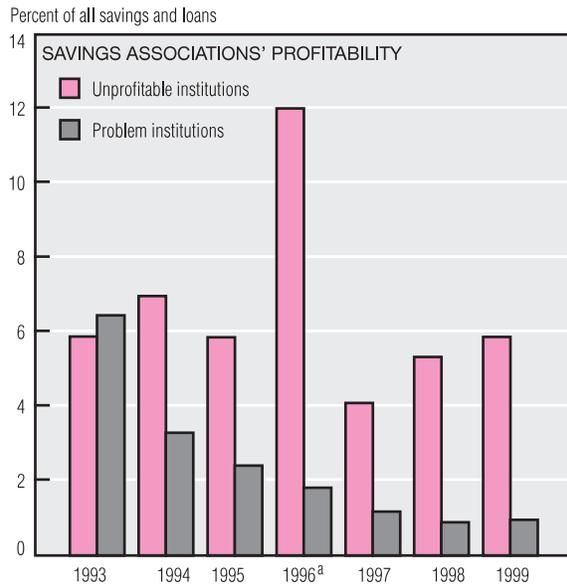
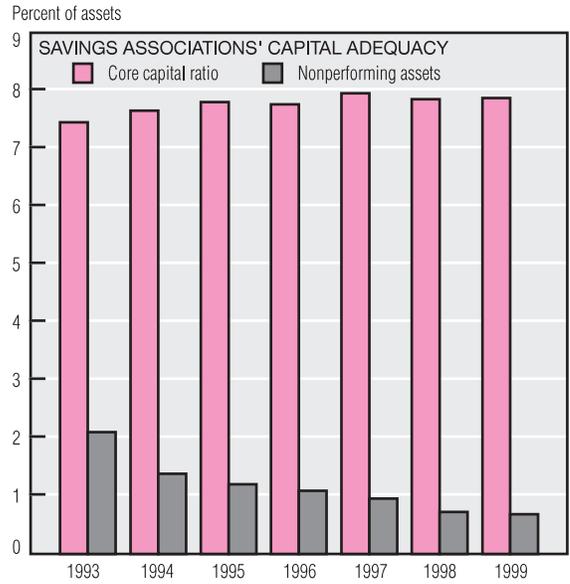
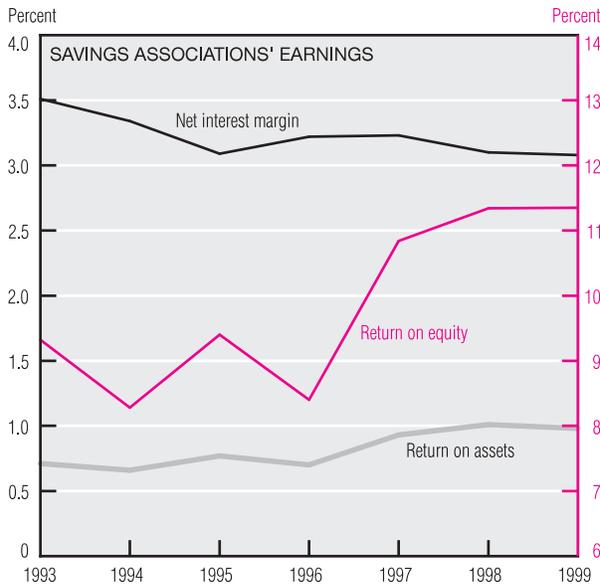
Banks' strong balance sheets are reflected in core bank capital, which, at 7.68% of assets, is high by historical standards. In addition, asset-quality problems are not yet evident; nonperforming assets, having

increased very slightly from 1998, are only 0.67% of total assets. Further evidence of strength in the banking sector is the continued downward trend in the percent of banks rated as problem institutions—from 3.89% in 1993 to 0.73% in 1999:1Q. Finally, banks' asset growth over the last 12 months slowed to 5.88%. During the same period, however, net operating income grew 18.58%, sharply higher than the 2.39% growth rate for 1998. Overall, the banking sector has exhibited steady growth without compromising its profitability or, more importantly, the quality of its assets.

Savings associations performed steadily throughout 1999:1Q, and the industry posted quarterly earnings of \$2.7 billion. Return on assets for the quarter was 0.98%, down slightly from its 1998 historical high of 1.01%. Further, at 11.35%, return on equity was at its highest level since 1985. Unlike the 1985 peak, however, return on equity in 1999 was generated by the robust return on assets just mentioned and by a steady net interest margin of 3.08%. However, the increase in the percent of savings associations reporting losses—from 4.1% in 1997 to 5.87%

(continued on next page)

Banking Conditions (cont.)



NOTE: All data are for FDIC-insured savings associations. 1999 data are for the first quarter.
 a. The sharp decline in operating income growth in 1996 was partly due to a special deposit insurance assessment on savings and loans.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, March 1999.

in 1999:1Q—shows the need for caution in interpreting the otherwise positive earnings trends.

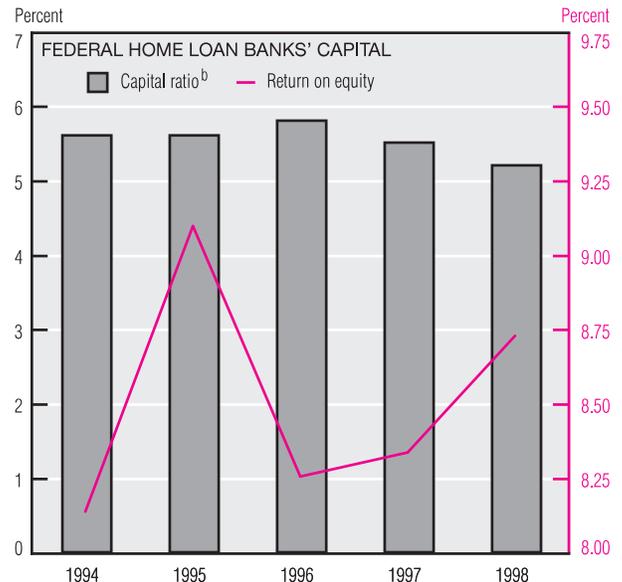
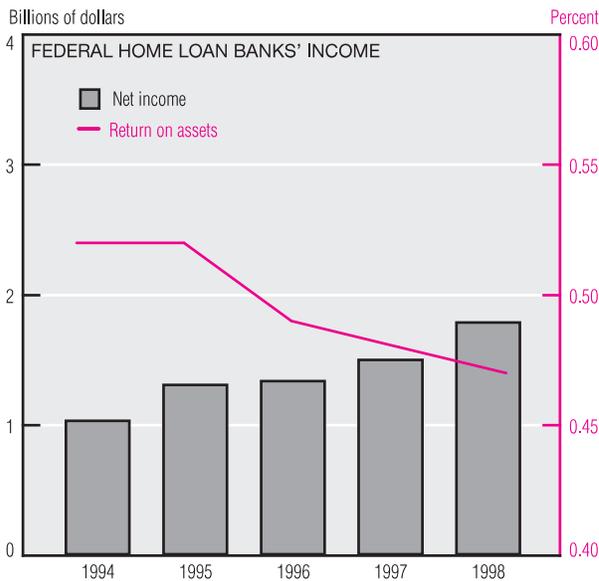
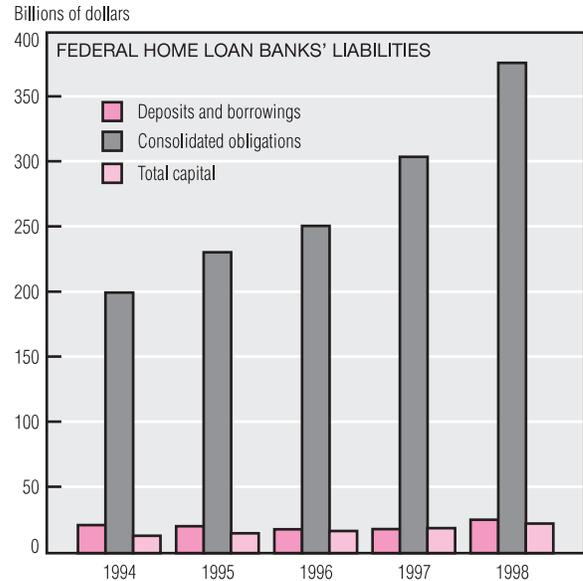
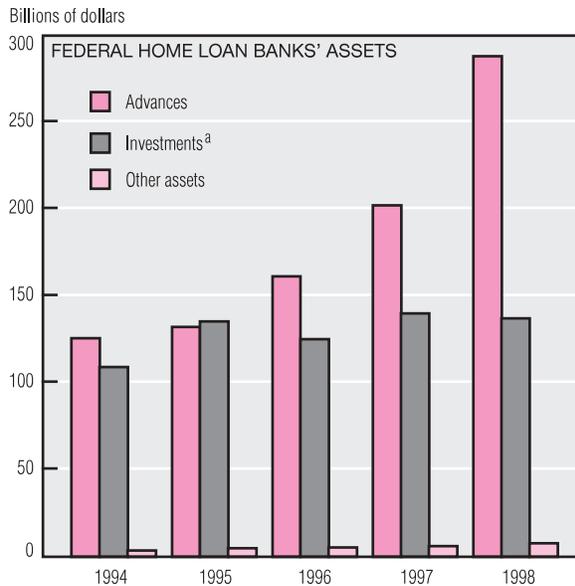
The asset quality of savings associations' balance sheets improved, as nonperforming assets fell to 0.68% of total assets, the lowest level in the last six years. Core capital remained a healthy 7.87% of total assets, a slight increase from 1998. Moreover, despite a small rise in the number of savings associations that had substandard examination ratings, problem institutions remained less than 1% of the total.

Twelve-month asset growth through 1999:1Q was 6.7%, slightly higher than 1998's rate of 6.05%. The increase of just less than 8% in operating income during the same period suggests that assets did not grow at the expense of profit margins in 1999. Overall, recent industry performance suggests that specialized housing lenders, such as savings associations, will continue to thrive, although their economic role is likely to be less important than it was in the past.

The 12 Federal Home Loan Banks

are stock-chartered, government-sponsored enterprises; their main purpose is to provide liquidity to specialized housing finance lenders. Federal Home Loan Bank advances, which represent an important source of funding for member institutions' mortgage portfolios, increased from \$202.3 billion at the end of 1997 to \$288.2 billion at the end of 1998. This record increase in advances reflects the favorable funding costs afforded members as the result of the low long-term interest
(continued on next page)

Banking Conditions (cont.)



a. Investments include federal funds sold.

b. Total capital ratio is capital stock plus retained earnings as a percentage of total assets at year end.

SOURCE: Federal Home Loan Bank System, 1998 Financial Report.

rates that prevailed in 1998. It also reflects housing lenders' perception that the Federal Home Loan Bank advances are a more stable source of funding than money markets, which were disrupted by the 1998 financial troubles in Asia, Latin America, and Russia and by the highly publicized problems of Long Term Capital Management.

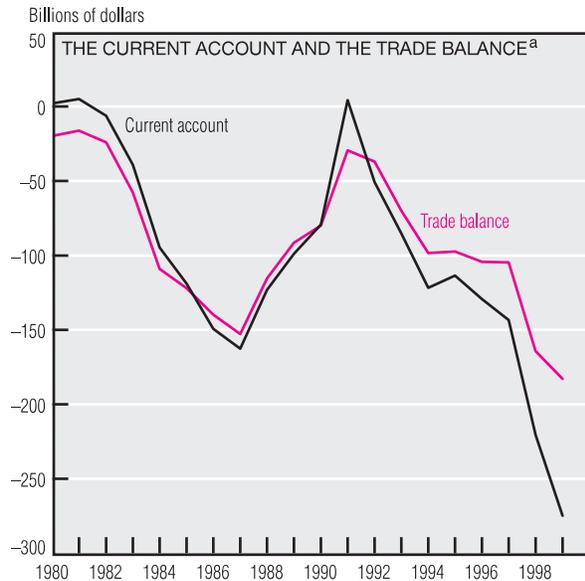
Collectively, the Federal Home Loan Banks reduced their investment portfolios by \$2.9 billion in 1998, an indication of their increased lending opportunities during the year. The lion's share of

funding for Federal Home Loan Bank assets is the \$376.7 billion in consolidated obligations of the Federal Home Loan Bank System—bonds issued on behalf of the 12 Federal Home Loan Banks collectively. Member institutions' deposits and short-term borrowings provided another \$25.8 billion in funding and equity capital supplied \$22.8 billion, both figures up slightly over previous years.

The tremendous growth in Federal Home Loan Banks' assets has had a negative impact on profitability. Despite steady increases in net

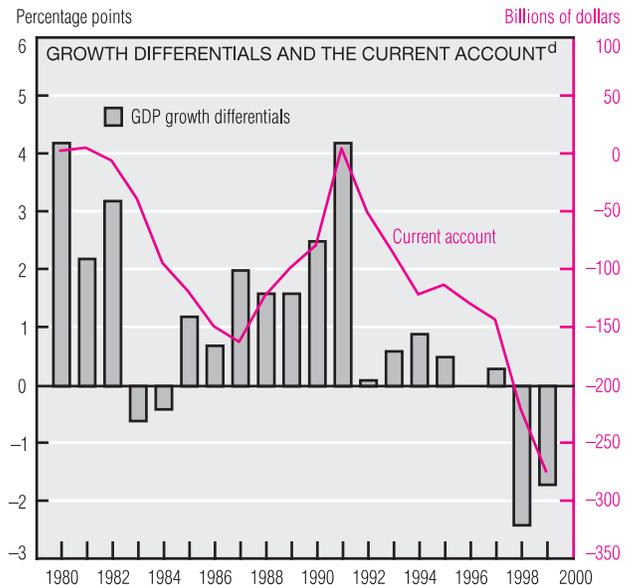
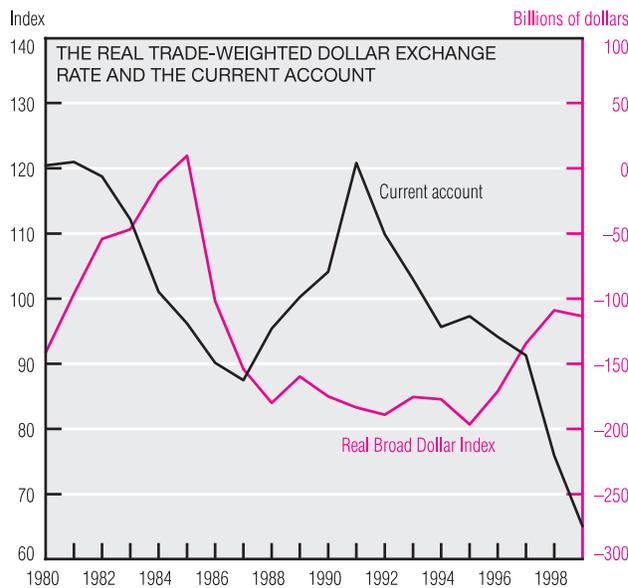
income from 1994 to 1998, return on assets has fallen steadily—from 52 basis points in 1995 to 47 basis points in 1998. Moreover, asset growth has led to a decrease in the capital-to-assets ratio from 5.8% in 1996 to 5.2% at the end of 1998. This increase in leverage is responsible for the rise in return on equity from 8.26% in 1996 to 8.73% in 1998. Overall, the Federal Home Loan Banks' performance last year suggests that they remain an important source of funding for the housing finance industry.

Current-Account Developments



U.S. International Transactions (Billions of dollars)^b

	Seasonally adjusted annual rate	
	1998	1999:1Q ^{b,c}
Current-account balance	-220.6	-274.4
Goods and services	-164.3	-215.2
Income	-12.2	-18.8
Unilateral transfers	-44.1	-40.4
Capital-account balance	210.5	336.4
Official	-28.9	51.2
Direct investment	60.6	} 285.2
Portfolio investment	178.8	
Statistical discrepancy	10.1	-62.0



a. Includes 1991:1Q at annual rate.

b. Seasonally adjusted annual rates.

c. Preliminary breakdown of data on direct and portfolio investment is unavailable.

d. The growth differential equals the trade-weighted average growth rate for the top 15 U.S. trading partners in 1992-97 minus the U.S. growth rate. Projections for 1999-2000 utilize various sources.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; Organisation for Economic Co-operation and Development, *World Economic Outlook*; *Blue Chip Economic Indicators*, August 1999; and DRI/McGraw-Hill.

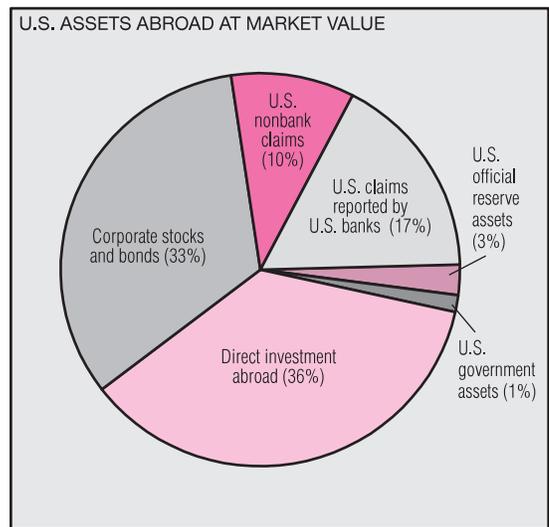
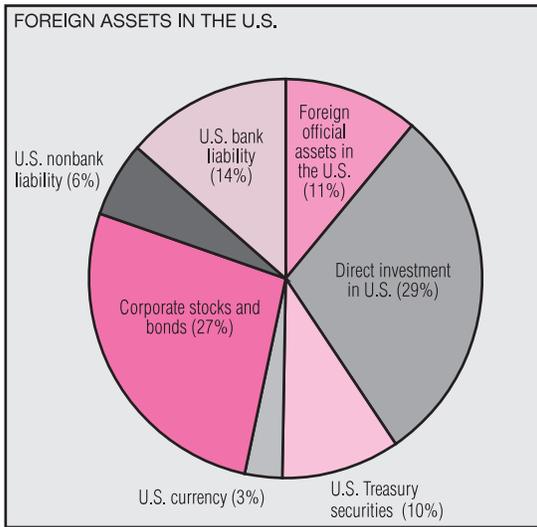
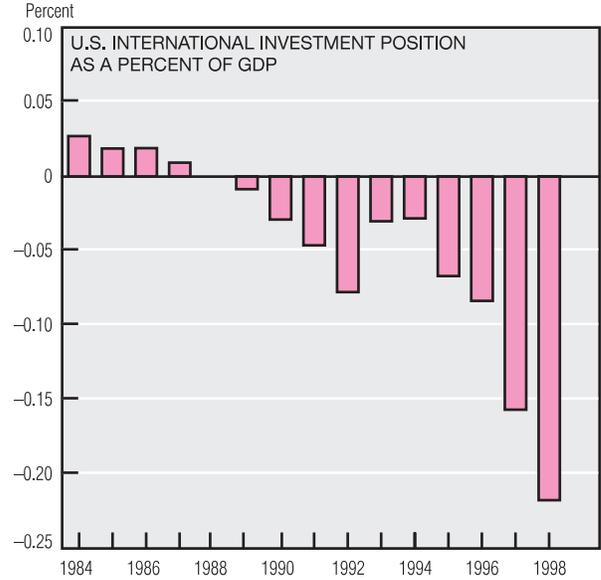
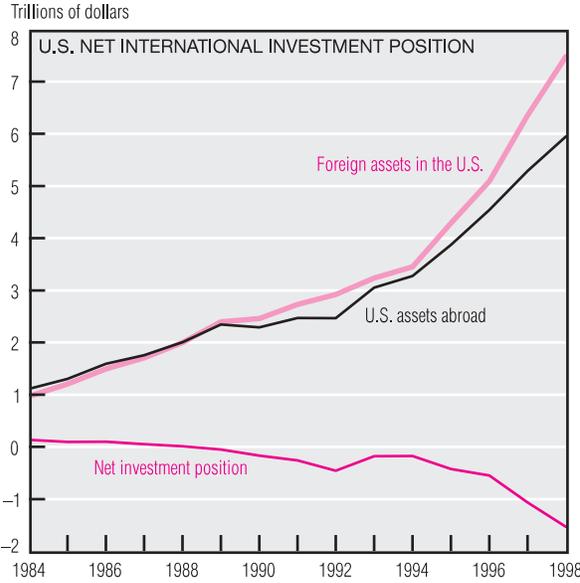
The U.S. current-account deficit, which expanded sharply in 1999:1Q, is likely to reach \$310 billion by year's end. Since 1997, our trade shortfall has increased dramatically as foreign economic growth slowed in the wake of worldwide financial crises. Now, however, the worst has passed, and the enormous differential between U.S. and foreign rates of economic growth seems likely to disappear by 2000.

In addition, the dollar has begun to depreciate over the past year, reversing its previous 3½-year trend.

Movements in dollar exchange rates help ensure that an inflow of foreign capital always accompanies a current-account deficit, and offer important insights into the underlying causal events. The dollar, for example, appreciates as the current-account deficit expands, when an inflow of foreign capital initiates events. As foreign investors place their funds in dollar assets, they bid up the dollar's foreign currency price. This adversely affects the trade balance. Between 1995 and 1998, inflows of foreign capital—often flee-

ing turmoil in global financial markets—widened our current-account deficit. The dollar, however, depreciates as the current-account deficit grows, when expanding aggregate demand in the U.S. pulls in imports. As consumers buy foreign goods, they depress the dollar. This, however, entices foreign capital inflows by improving the return on dollar-denominated assets in the U.S. The dollar's recent shift in direction implies a change in the underlying nature of our current-account deficit.

The U.S. as a Debtor Nation



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

An inflow of foreign capital has accompanied the persistent string of U.S. current-account deficits since 1982. Essentially, we have financed a surfeit of imports by issuing financial assets that represent a foreign-held claim on future U.S. output. As a consequence, we became a net debtor nation in 1988 when foreign-owned assets in the U.S. began to exceed U.S.-owned assets in the rest of the world.

Currently, U.S. international debts amount to \$1.5 trillion.

Because nearly all of this debt is denominated in U.S. dollars, it does not expose the country to exchange-rate risk, the Achilles heel of many indebted developing economies. Economists often evaluate the indebtedness of developed countries relative to their GDP, which acts as a proxy for their ability to meet their debt-service obligations. At 22% of output, the U.S. debt seems high, but other countries, notably Canada and Australia, have sustained much higher debt

ratios for long periods with no apparent adjustment problems.

The foreign portfolio consists mainly (56%) of direct investments in the U.S.—implying a degree of company control—and U.S. corporate stocks and bonds. Another 10% of the portfolio is held in U.S. Treasury securities. Official dollar assets account for 10% of the portfolio, and a small portion (3%) consists of currency. In contrast, almost 70% of the stock of U.S.-owned foreign assets consists of direct investments or corporate stocks and bonds.