

The Economy in Perspective

Think globally, obstruct locally... Protests against the latest round of negotiations sponsored by the World Trade Organization have thrust international trade into the headlines. Trade, perhaps the most fundamental economic activity, enables people to improve their well-being merely by exchanging some of what they already have. One might think that trade must be more complicated when it occurs between domestic and foreign partners, but geography really doesn't matter at all. The economic value of a transaction is the same whether the border that separates trading partners is national, state, or city.

Regardless of geographic location, voluntary exchange enables each trading partner to become better off. Despite this simple fact, new trade relationships are not always welcomed into a community or country, because they have the potential to displace existing suppliers. Trade's costs are palpable when friends and neighbors are adversely affected, but trade's benefits often go unrecognized because they are widely distributed as small gains to each of many people.

From this perspective, trade's role in improving welfare doesn't seem much different from that of plain, old-fashioned competition, and it really isn't. Consumers always benefit from competition among goods and services producers. Even when a market has few active competitors, consumers are less likely to be victimized if the market is easily entered by potential competitors. Trade—any exchange across a border—should be seen as protecting consumers by enlarging the set of competing suppliers for goods and services. And ordinarily, consumers instinctively accept competition's benefits as well worth the costs.

Although trade upholds consumers' interests, it can be made to seem suspect. One reason is that open markets may undermine the strength of incumbent producers and those associated with them. Incumbents have powerful incentives to label other producers as unfair competitors, appealing to consumers' sense of justice or patriotism to compensate for the lower prices or higher quality they would otherwise receive. For their part, consumers may choose not to patronize merchants or producers whose business practices they find unacceptable. Sometimes, however, incumbents reach beyond consumers and pressure legislators to ban or tax commerce from "outsiders."

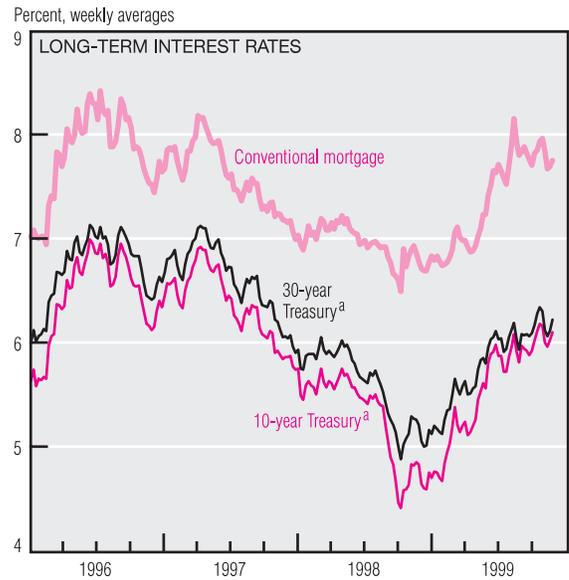
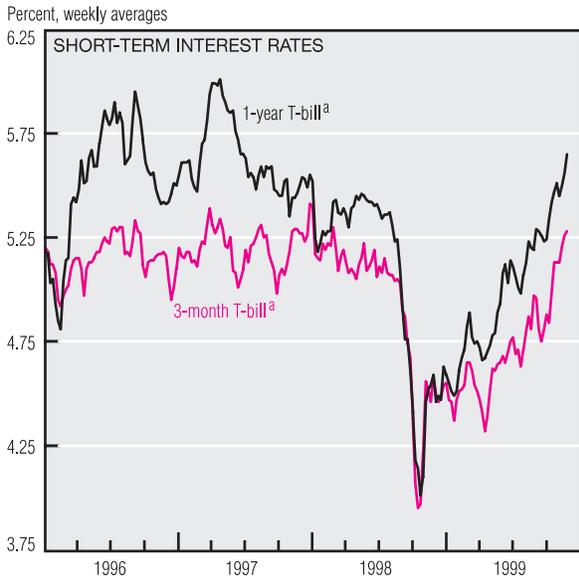
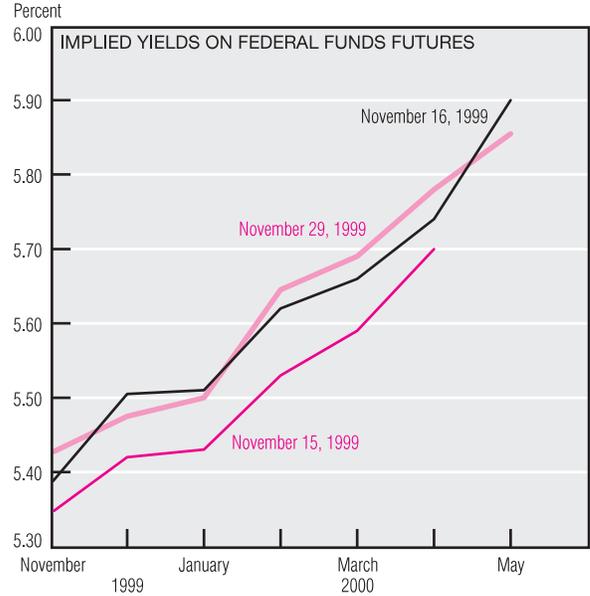
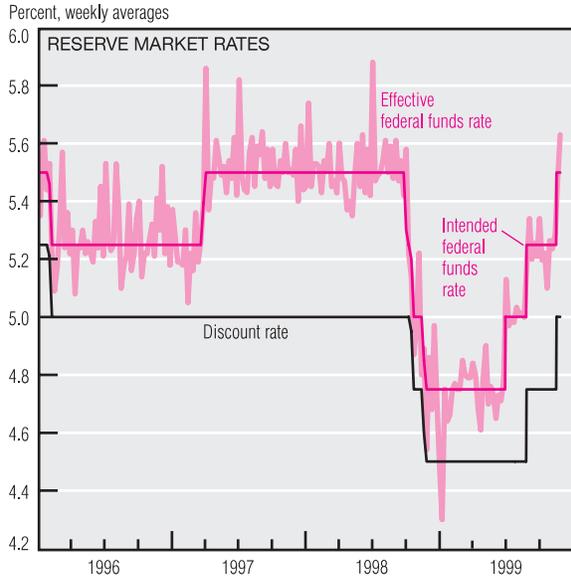
Trade protection is nothing new. In fact, nations have constructed entire economic strategies around it. Adam Smith, the originator of market economics, wrote *The Wealth of Nations* to explain why such trade barriers are actually counterproductive to society's welfare. Mercantilism, which relies on maximal exports and minimal imports, enriches incumbent producers by forcing all consumers to purchase from them, no matter how expensive or shoddy their products may be. Our founding fathers regarded trade barriers as so antidemocratic and divisive that the U.S. Constitution prohibits states from restricting trade among themselves.

There can be no denying that producer and merchant practices vary considerably, both within a country and across nations. Producers legitimately complain when they are denied access to markets on equal terms with their competitors, and they seek remedies through trade talks. Moral and ethical differences can also be addressed through this channel, but doing so gives foreign governments a voice in others' domestic social policies. As the recent World Trade Organization impasse illustrates, not all governments agree on the extent to which this expanded set of issues should even be part of international trade discussions in the future.

While the world's nations continue to debate the scope and content of trade agreements, the cost of existing trade barriers remains high. Every time a nation imposes trade penalties on its foreign competitors, it is really taxing its own citizens by forcing them to purchase from established incumbents at home. Simultaneously, foreign competitors are denied the opportunity to expand their own employment and sales through access to cross-border markets.

If economic history unfolds as it has in the past, nations will improve their standards of living most rapidly wherever economic and political freedoms thrive. The more a nation is exposed to trade and other forms of competition, the less protected its entrenched interests tend to be and the more empowered its consumers. Nations enhance economic freedom most durably through the political actions of their own citizens. And even though many foreign-trade reformers may indeed mean well, others may merely be looking out for their own self-interest.

Monetary Policy



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

On November 16, the Federal Reserve System raised both the discount rate and the federal funds rate by a quarter point. The discount rate stands at 5%, while the federal funds rate target is 5.5%.

Implied yields on federal funds futures suggest that the November 16 moves were not entirely unforeseen. Just prior to the meeting, yields were roughly halfway between the previous target and the new target. Looking to next year,

market participants anticipate further increases in the target. An additional quarter-point increase is expected by April 2000, with yet another increase foreseen later in the year.

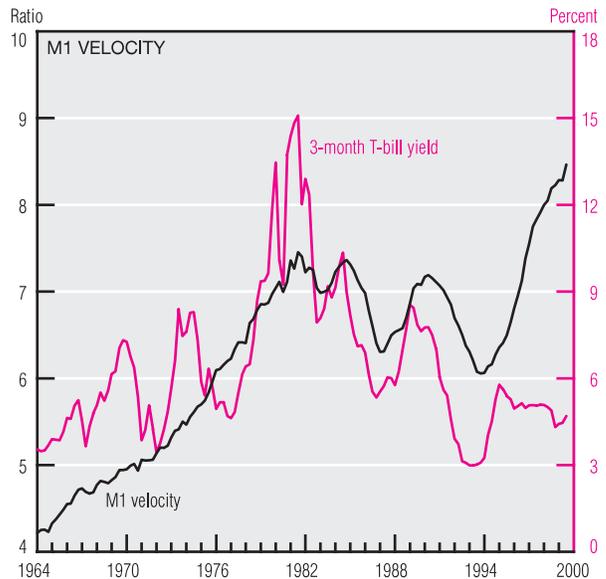
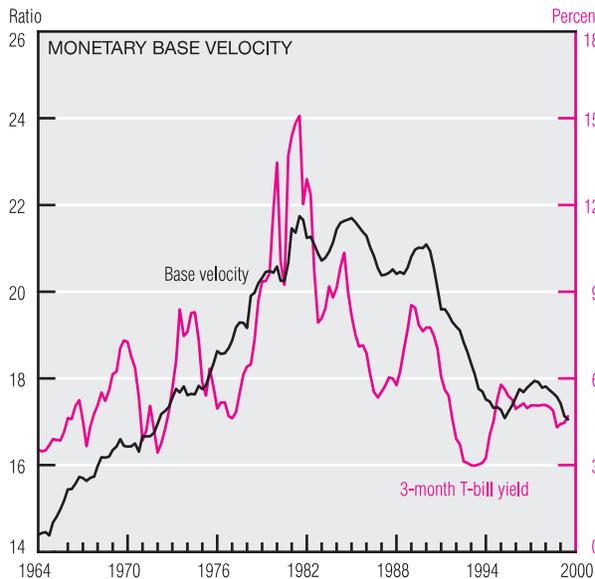
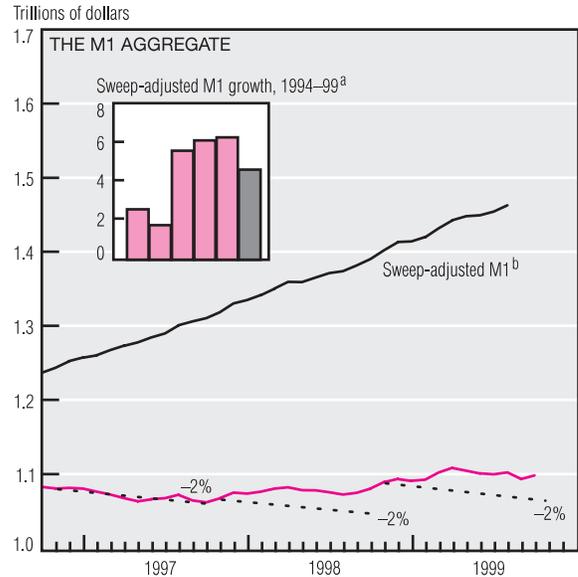
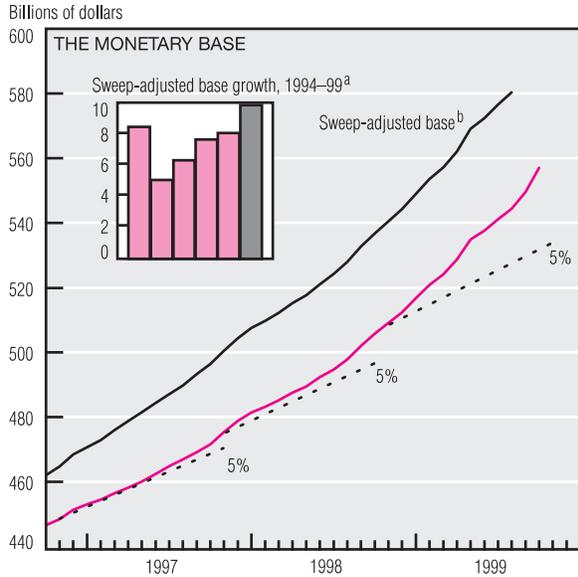
This November, short-term interest rates continued the increase they have exhibited throughout 1999. Between the last week of October and the week ending November 26, the 1-year Treasury-bill rate had increased 14 basis points (bp) to

5.65, while the 3-month T-bill rate stood at 5.28, an increase of 15 bp for November.

Although long-term interest rates have generally risen through 1999, they fell slightly in November. The 10-year Treasury yield slipped 6 bp to 6.10, and the 30-year Treasury yield fell 8 bp to 6.22. While mortgage rates have also risen in 1999, they peaked in mid-August and have since fallen 40 bp.

(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 rates for the monetary base and M1 are calculated on an estimated November over 1998:IVQ basis. The 1999 growth rates for the sweep-adjusted base and M1 are calculated on a September over 1998:IVQ basis.

b. The sweep-adjusted base and sweep-adjusted M1 contain an estimate of balances temporarily moved from M1 to non-M1 accounts.

NOTE: Data are seasonally adjusted. Last plots for the monetary base and M1 are estimated for November 1999. Last plots for the sweep-adjusted base and M1 are for September 1999. Dotted lines represent growth rates and are for reference only.

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

The monetary aggregates continue to exhibit strong growth. The sweep-adjusted monetary base has grown at an annualized rate of 10% through 1999, while sweep-adjusted M1 growth has been a somewhat more moderate 4.6%. Of the broader monetary aggregates, M2 growth through 1999 has been more moderate than that of M3 (5.6% versus 7.4%).

The typical reason some economists worry about a high money

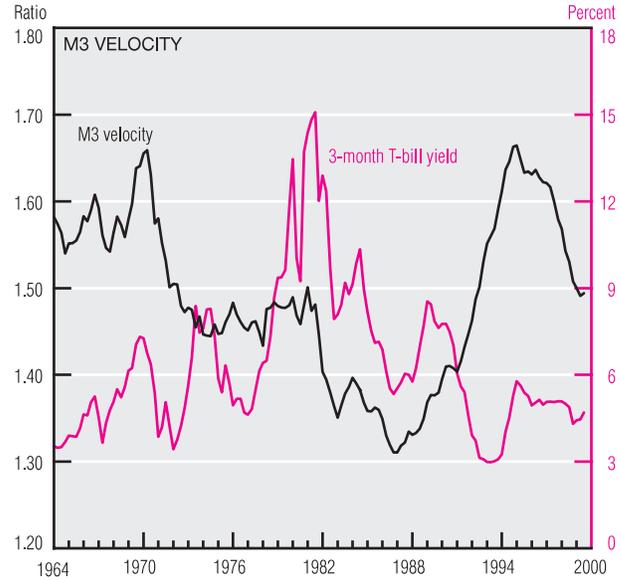
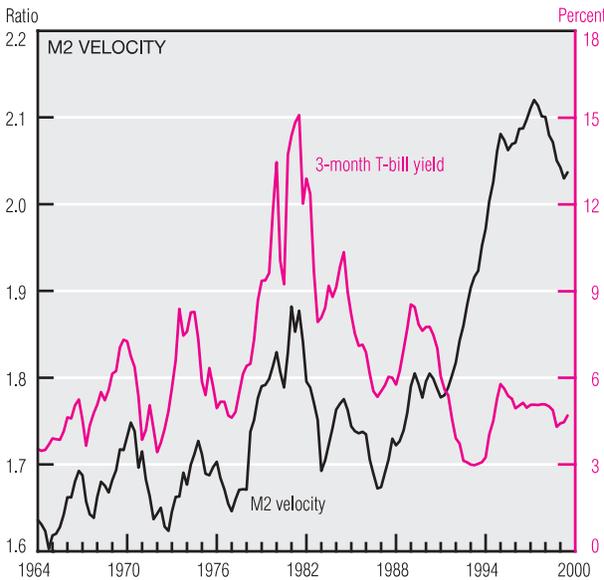
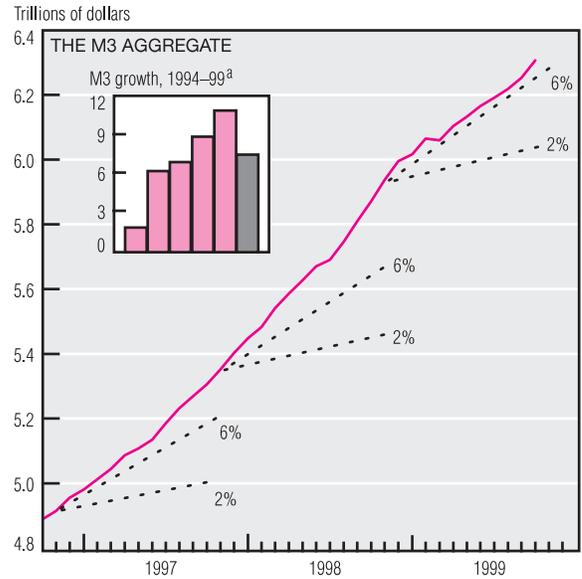
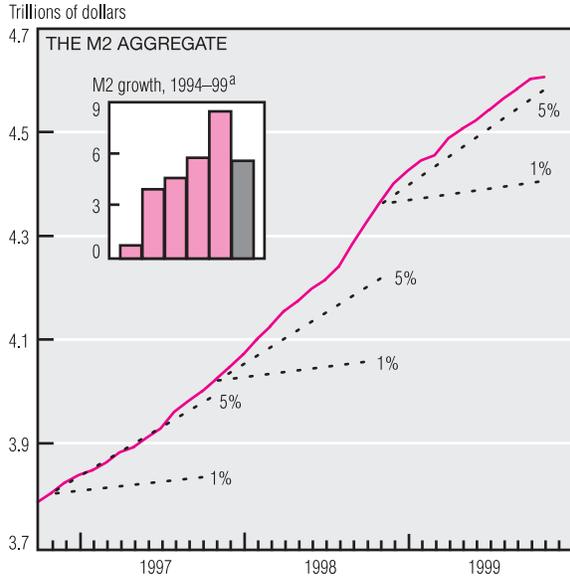
growth rate is that it is often a harbinger of higher inflation. This concern becomes particularly acute when money growth outstrips that of nominal output. Through 1999:IIIQ, nominal output has risen 6.7%, well below the growth rates of sweep-adjusted base and M3.

While some of the more recent growth in the monetary base may be attributed to people stockpiling currency in anticipation of the cen-

tury date change, this is a less likely explanation of strong M3 growth. To start, currency is a smaller component of the broader aggregates than of the monetary base. Furthermore, survey evidence suggests that any currency hoarding is occurring at the expense of other bank deposits, leaving aggregates like M2 and M3 unaffected.

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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 and M3 are calculated on an estimated November over 1998:IVQ basis.
 NOTE: Data are seasonally adjusted. Last plots for M2 and M3 are estimated for November 1999. Dotted lines are FOMC-determined provisional ranges.
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

One measure of the changing link between money growth and nominal output growth is velocity, which is calculated as the ratio of nominal output to the money stock. Velocity may be thought of as a measure of how hard a unit of money must work to generate one dollar of output.

The opportunity cost of holding a unit of money is the interest that could be earned by holding some other asset, compared with the re-

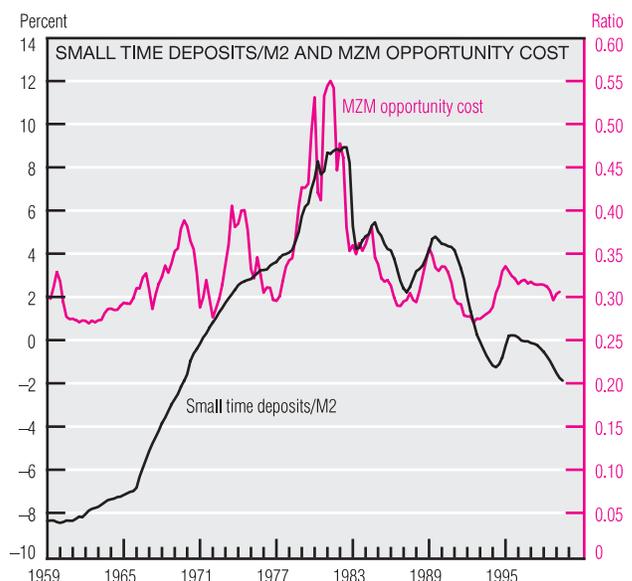
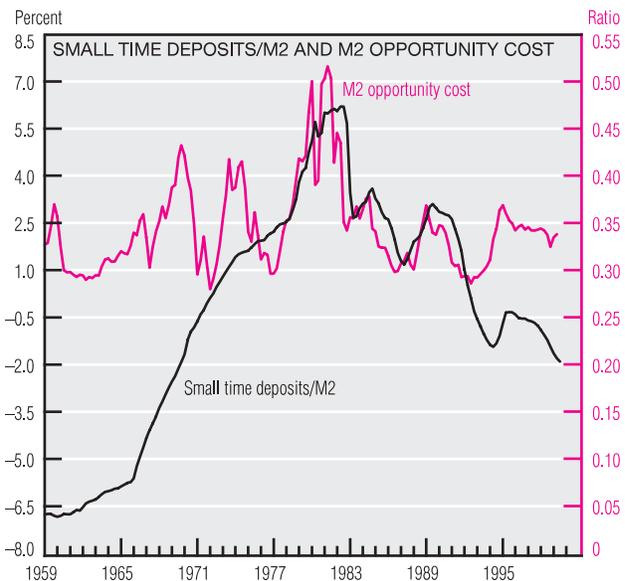
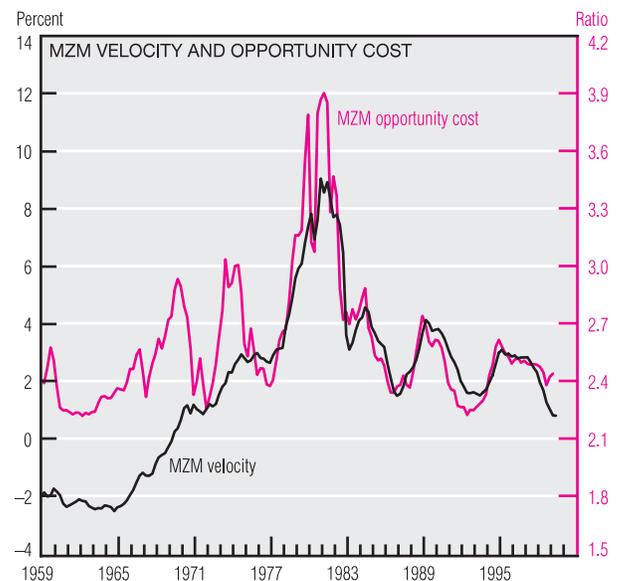
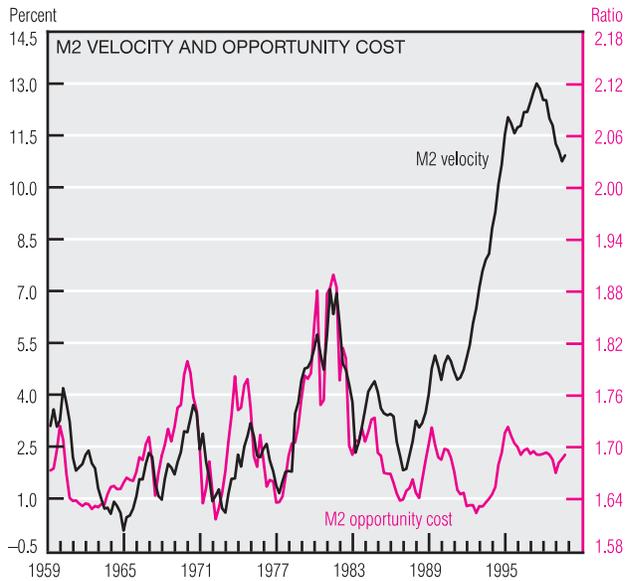
turn earned by holding money. We would expect velocity to rise with the opportunity cost of money, since people will want to reduce their money holdings, preferring to hold higher-return assets instead.

Suppose that we measure the opportunity cost of money by the three-month Treasury-bill yield. As the charts above show, the tightest relationship between this interest rate and velocity is obtained by M2 velocity. This association is fairly

good through the early 1990s, at which time M2 velocity rose sharply in the face of a falling T-bill yield. Secular movements in base velocity seem to follow those of the T-bill yield. However, it is difficult to discern much coherence between this interest rate and movements in either M1 or M3 velocity.

An alternative measure of opportunity cost is that constructed by the Board of Governors of the Federal *(continued on next page)*

Monetary Policy (cont.)



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

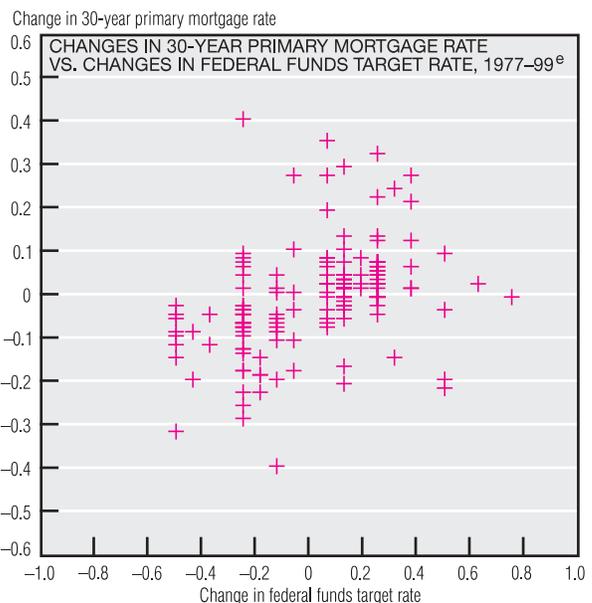
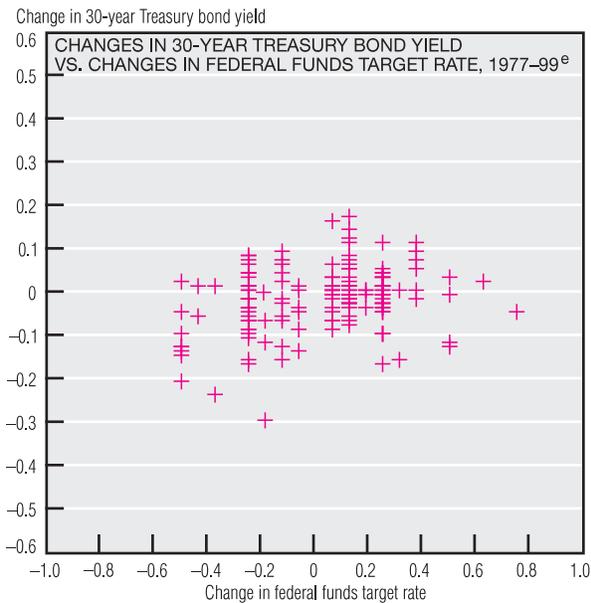
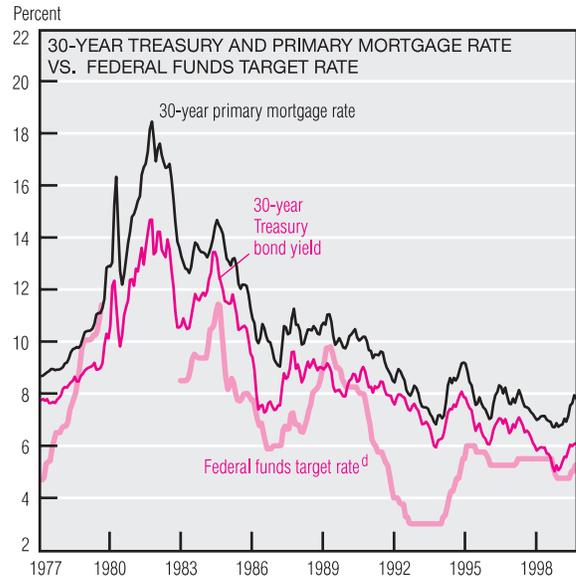
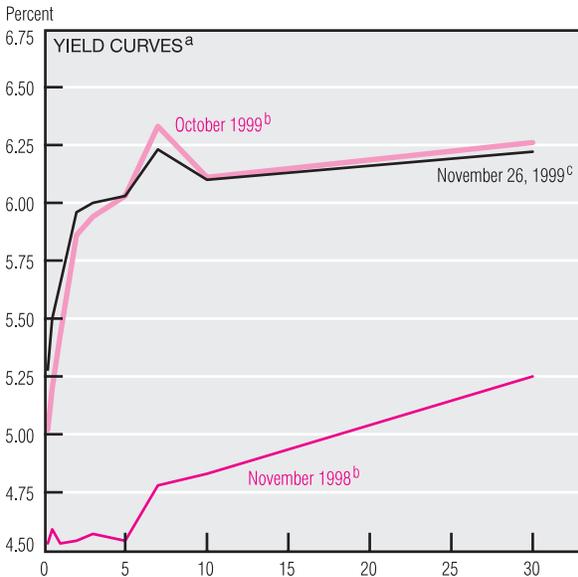
Reserve System. From the mid-1960s through the early 1990s, a very tight relationship existed between M2 velocity and the Board's measure of M2 opportunity cost. The breakdown in this association, which occurred in the early 1990s, was concentrated primarily in small time deposits. As a share of total M2, small deposits fell sharply in the early 1990s, a phenomenon sometimes attributed to a shift in balances to stock and bond mutual funds.

However, the behavior of small time deposits is not the whole story of the changing relationship between M2 velocity and its opportunity cost. Since 1997, M2 velocity has fallen sharply. At the same time, its opportunity cost has been fairly stable, while the share of small time deposits has continued to fall. In light of what happened in the early 1990s, one would have expected M2 velocity to increase further.

Since 1975, the fit between MZM

(money of zero maturity) velocity and its opportunity cost has been quite tight. Because MZM excludes time deposits, it is unaffected by their behavior. The rise in MZM velocity leading up to 1975 can be attributed to a shift of funds from savings deposits to small time deposits, a phenomenon captured by small deposits' rising share in M2. MZM velocity has stabilized since then and now displays a tight connection with its opportunity cost.

Interest Rates



a. All yields are from constant-maturity series.

b. Monthly averages.

c. Average for the week of November 26, 1999.

d. Between October 1979 and January 1983, the policy target was a quantity of money, not an interest rate.

e. Percentage point change for the week in which the federal funds target rate was changed.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Glenn D. Rudebusch, "Federal Reserve Interest Rate Targeting, Rational Expectations, and the Term Structure," *Journal of Monetary Economics*, vol. 35, no. 2 (April 1995), pp. 245-74.

The long end of the yield curve has shifted downward slightly since last month, whereas the short end has shifted upward. For the last full week of November, the 3-month and 6-month Treasury bill rates were 26 and 30 basis points (bp) higher than their October values. The 3-year, 3-month spread is down to 72 bp from 92 in October, and the 10-year, 3-month spread is down to 82 bp from 109. Although their predictive power is somewhat limited, these spreads indicate some concern about inflation over the short run.

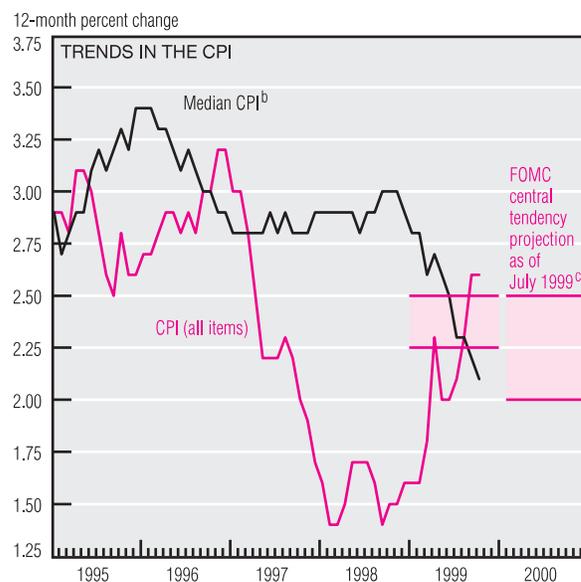
On November 16, 1999, the Federal Open Market Committee announced an increase of 25 bp in the federal funds target rate. Many commentators argue that increases in the target rate cause long-term capital market rates to rise, thus driving out potential borrowers. Since April 1977, the FOMC has raised the target rate 99 times and lowered it 65 times. To these 99 increases, the 30-year Treasury bond rate responded positively 51 times and negatively 34 times; the 30-year primary mortgage rate responded positively 63 times

and negatively 18 times. In response to the 65 rate cuts, the 30-year Treasury bond rate moved in the same direction 41 times and in the opposite direction 24 times; the 30-year primary mortgage rate moved in the same direction 52 times and in the opposite direction 13 times.

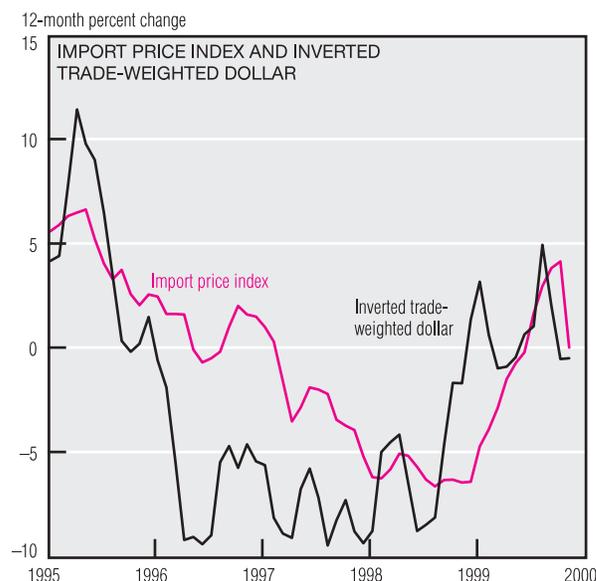
Thus, although these rates show a moderate tendency to move together, the numbers do not support the argument that a higher target rate always means higher long-term capital market rates.

Inflation and Prices

	Percent change, last:				1998 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
October Price Statistics					
Consumer prices					
All items	2.2	3.5	2.6	2.4	1.6
Less food and energy	2.0	2.5	2.1	2.5	2.5
Median ^b	1.9	2.1	2.1	2.8	2.9
Producer prices					
Finished goods	-1.8	5.9	2.7	1.4	-0.1
Less food and energy	3.3	3.9	1.9	1.4	2.5



Component	Relative importance ^d	Percent change in price	
		1998	1999 ^e
Processed fruits and vegetables	0.33	2.00	3.41
Alcoholic beverages	0.97	1.82	2.72
Tenants' and household insurance	0.37	-0.10	3.22
Fuel oil and other fuels	0.23	-11.65	18.46
Gas (piped) and electricity	3.57	-3.64	2.25
Car and truck rental	0.14	1.50	2.77
Motor fuel	2.49	-16.52	36.65
Public transportation	1.35	1.40	4.48
Personal care products	0.74	2.34	3.87



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. Percent of CPI (all items) as of December 1998.

e. Year to date.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; International Monetary Fund, *International Financial Statistics*; and Organisation for Economic Co-operation and Development, *World Economic Outlook*.

After accelerating sharply over the summer, consumer price increases moderated to a 2.2% annualized pace in October—under their 12-month trend (2.6%). Two measures of so-called core inflation, the CPI excluding food and energy and the median CPI, both rose about 2% (annualized) during the month, also slightly under their recent trends. Still, on average, the rise in consumer prices this year has topped its 1998 pace by about a percentage point, heightening worries about a long-anticipated inflationary upturn. The 12-month trend in the CPI

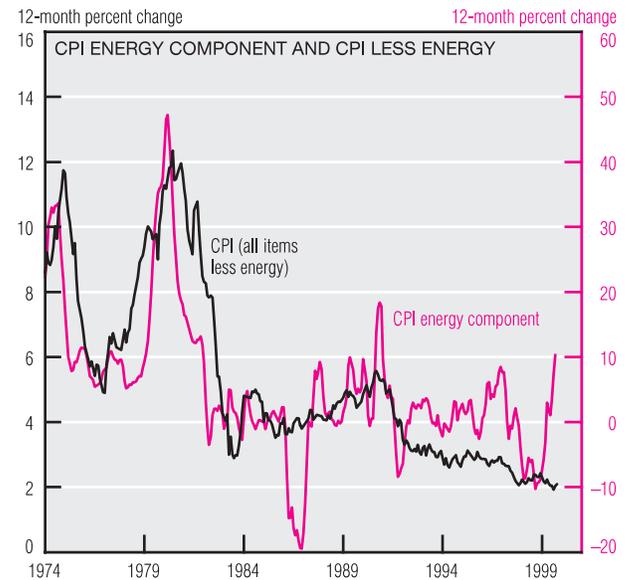
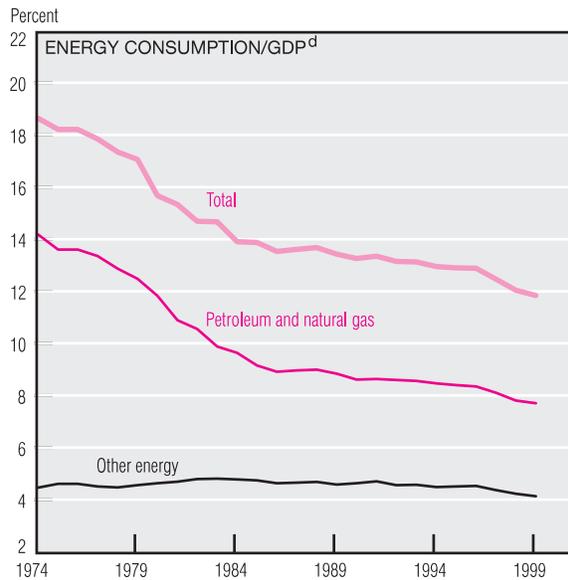
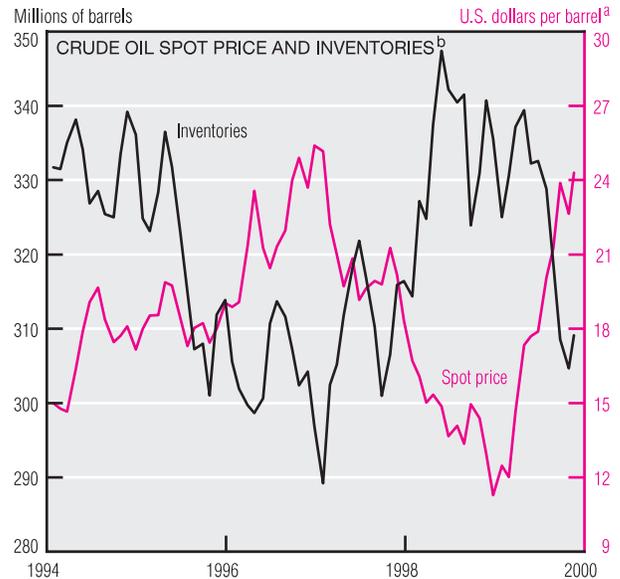
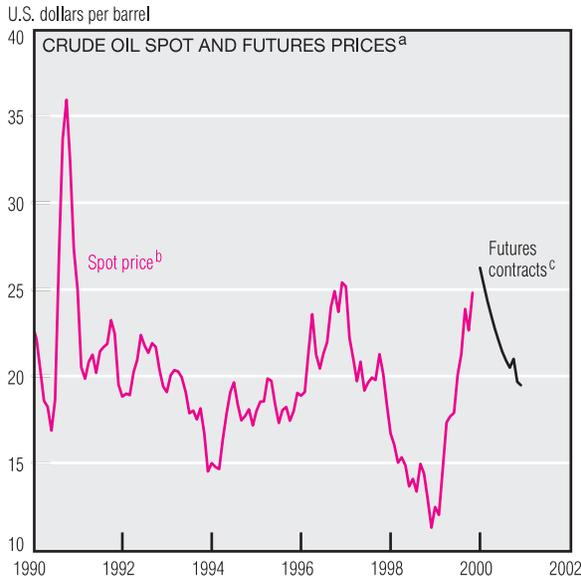
growth rate is now slightly above the upper end of the range projected for 1999 and 2000 by the Federal Open Market Committee.

While the sharpness of this year's jump in retail prices came as something of a surprise, a turnaround in the inflation trend has been widely anticipated. This expectation probably arises partly from the belief that the observed inflation numbers were artificially low—temporarily restrained by short-lived events. Indeed, the same nine components that cumulatively reduced the CPI by about ½ percentage point in 1998

have combined to help push the index upward by slightly more than a percentage point this year. Topping the list of items contributing to this year's swing in retail inflation numbers are energy goods like home heating oil and gasoline. Other contributors to faster CPI growth this year are fruits and vegetables, alcoholic beverages, and home insurance.

Imported goods are notably absent from this year's turnaround in retail prices. In fact, many items thought to consist largely of imports, *(continued on next page)*

Inflation and Prices (cont.)



a. West Texas intermediate crude oil.

b. Data for November 1999 are estimated.

c. Closing price on November 29, 1999.

d. Observations for 1999 are based on two quarters of data.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Energy, *Monthly Energy Review*, October 1999; American Petroleum Institute; Bloomberg Financial Information Services; and Dow Jones Energy Service.

such as apparel, new vehicles, and electronic equipment, are still exerting downward pressure on the CPI. It may very well be that the dollar's fall during the second half of 1999 is not yet reflected by the index.

The most dramatic price development this year has been the sharp rise in oil prices. Since January, the spot price of crude oil has more than doubled (from about \$12 per barrel to \$25), pushing the nominal price of oil close to its nine-year high. Industry analysts have attributed the recent ascent in oil prices partly to sharply reduced stockpiles worldwide, reportedly caused by

stricter adherence to OPEC production quotas. For example, U.S. oil inventories, which reached almost 350 million barrels two years ago, have since fallen by about 11%. But investors seem unconvinced that these developments will continue to exert upward pressure on oil prices; a reading of recent futures prices shows that oil prices are expected to fall back below \$20 per barrel by the middle of next year.

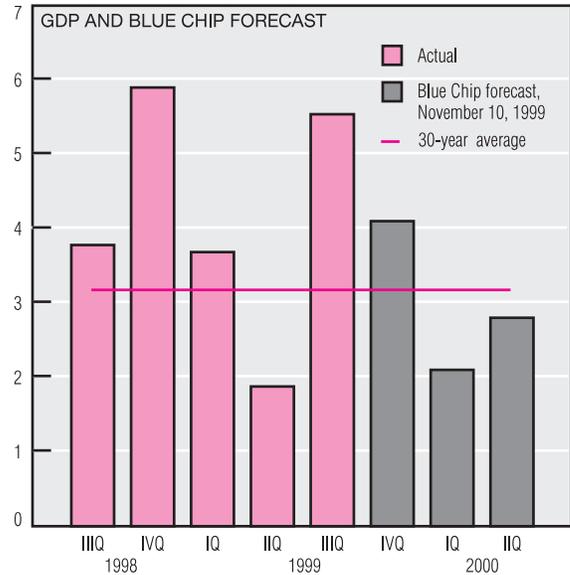
The impact of higher oil prices on the overall CPI is unclear, especially relative to historical experience. Energy use accounts for a substantially smaller share of national output

today than at any time in the recent past. Furthermore, monetary policy may not accommodate current and future oil price hikes as readily as in the past. During the 1970s, surging oil prices were accompanied by price hikes for a broad range of nonenergy goods. These increases may have resulted from an expansionary monetary policy that allowed oil price increases to spark a generalized inflation. Energy price fluctuations in the 1980s and 1990s (albeit of smaller magnitude), have not been accompanied by widespread inflationary movements.

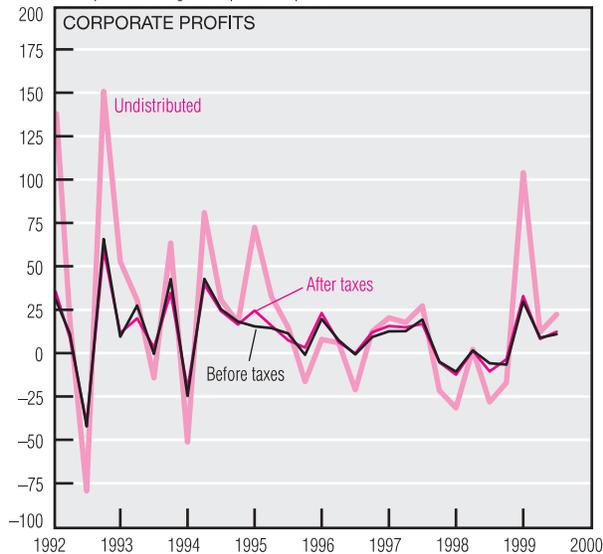
Economic Activity

Real GDP and Components, 1999:IIIQ ^{a,b} (Preliminary estimate)	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	119.1	5.5	4.2
Consumer spending	67.0	4.6	5.2
Durables	15.1	7.7	12.3
Nondurables	15.1	3.5	5.1
Services	37.5	4.5	3.9
Business fixed investment	38.1	13.3	10.8
Equipment	41.0	18.2	15.1
Structures	-1.0	-1.6	-1.8
Residential investment	-4.7	-4.9	5.6
Government spending	15.9	4.3	3.4
National defense	9.3	11.4	0.3
Net exports	-17.7	—	—
Exports	28.8	11.7	6.3
Imports	46.5	14.6	13.1
Change in private inventories	19.9	—	—

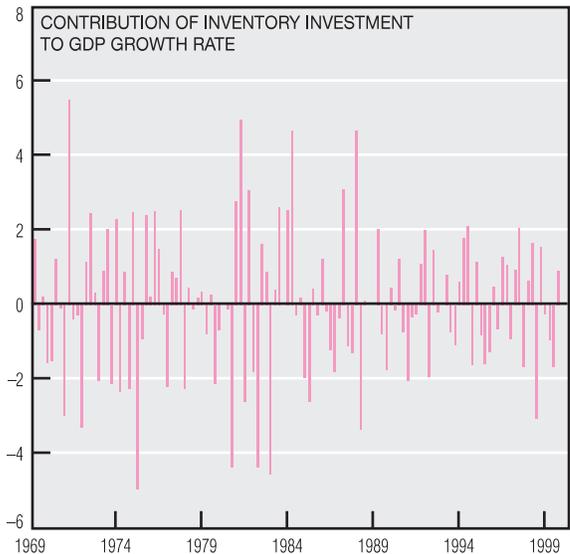
Annualized percent change from previous quarter



Annualized percent change from previous quarter



Percent



a. Chain-weighted data in billions of 1996 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 *Blue Chip Economic Indicators*, November 10, 1999.

By November's preliminary estimate, gross domestic product grew at an annualized rate of 5.5% in 1999:IIIQ. This was stronger than expected and stronger than October's 4.8% estimate. Most of the upward revision can be traced to reduced estimates of imports and increased estimates of private inventory accumulation. The overall shape of the economy did not change, however; it showed very robust growth of both nonresidential investment in equipment and

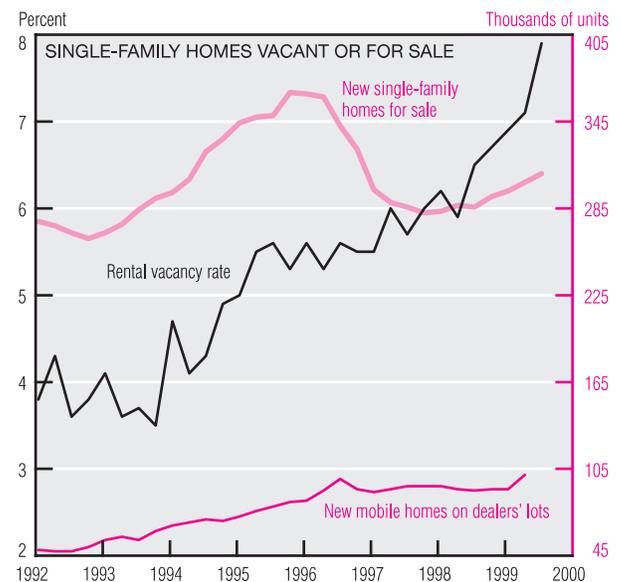
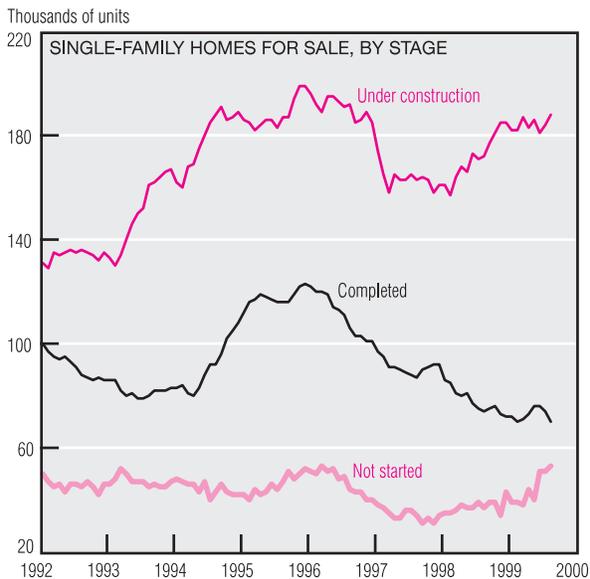
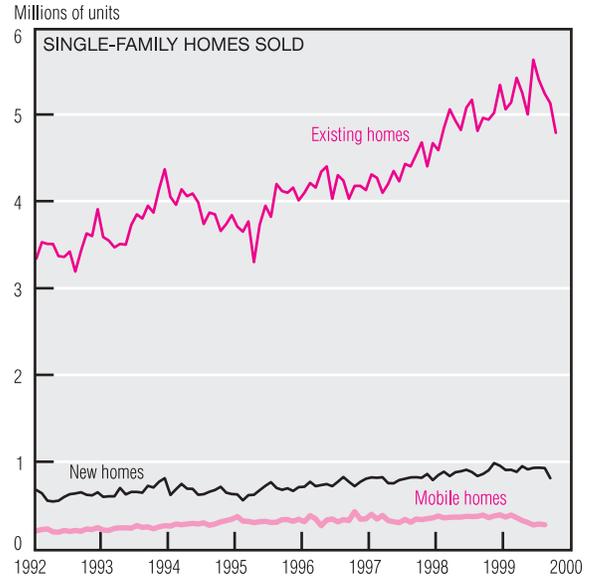
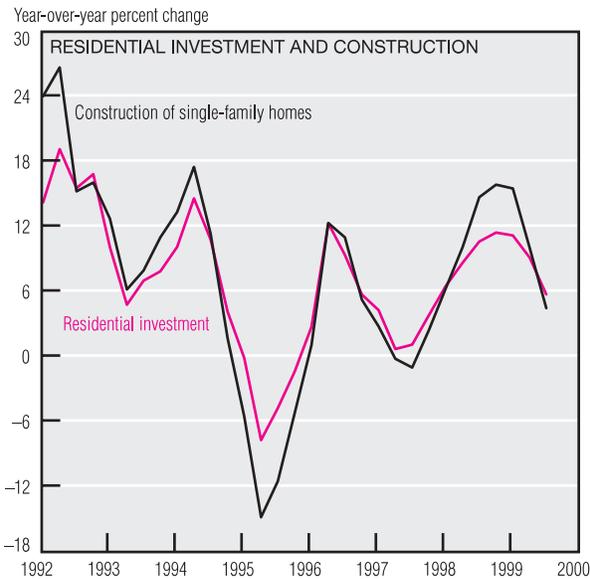
software and consumer spending on durables. These were offset only partially by reduced expenditures on residential and nonresidential structures and by more rapid growth of imports than exports.

Estimated GDP growth was 3.6 percentage points higher in 1999:IIIQ than in 1999:IIQ. Fully two-thirds of that increase can be attributed to a strong swing toward more rapid inventory accumulation. This was substantially underestimated in last month's advance GDP

estimate, especially at the wholesale level. The significance of the change should not be exaggerated, however, for inventories' contribution to GDP growth was well within the normal range of experience.

Preliminary GDP data include first estimates of corporate profits for 1999:IIIQ. These indicate that corporate profits (both before- and after-tax) grew at an annualized rate of nearly 3% in the third quarter, reaching levels about 10% higher than
(continued on next page)

Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and National Association of Realtors.

those of a year earlier. Dividend payouts increased more slowly than this, however, so undistributed profits rose 5% to a level more than 20% higher than a year earlier.

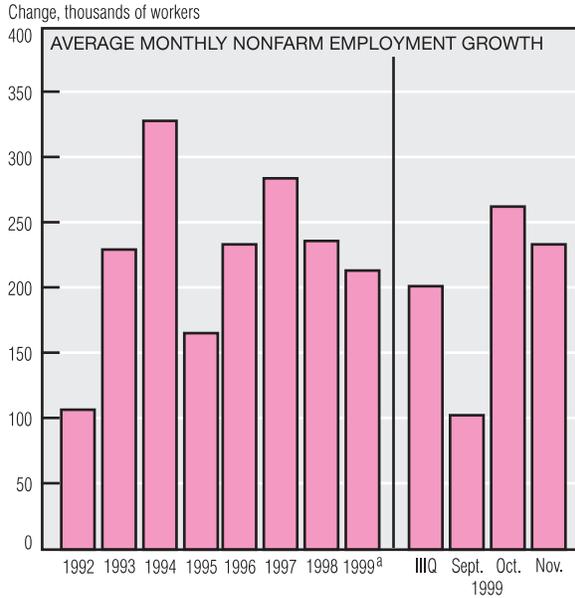
Residential construction expenditures declined in 1999:IIIQ. The impetus for the slowdown comes from the market for single-family homes, both traditional and mobile. Sales of existing homes declined over the three months ending in September, bringing sales 3% below the level of

the previous quarter. Only in the West did sales continue to increase. Similarly, sales of new homes declined in the third quarter at a rate of 16.5% before rebounding in October. The number of new single-family homes for sale has been increasing at about an 8% rate for the past two quarters. Completed houses for sale declined during the summer, but those under construction increased, while those not yet started increased very rapidly. Mobile-home sales

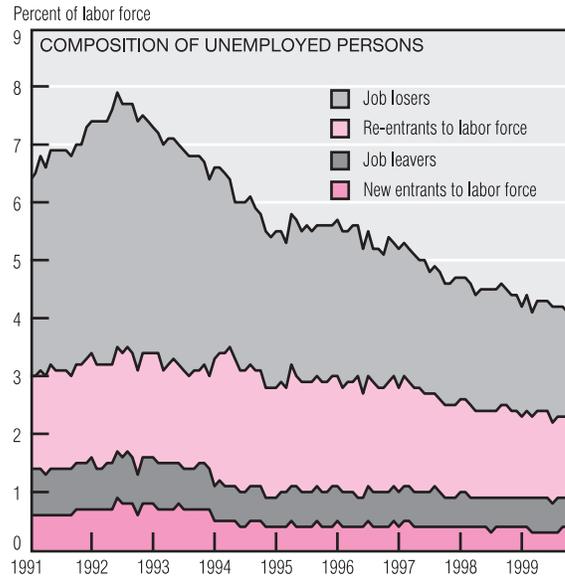
have been declining since February.

Vacancy rates for rental housing are relatively high, particularly for single-family homes. The inventory of new single-family homes for sale has been increasing for about two years. The number of mobile homes on dealers' lots has reached an all-time high, after extraordinarily rapid increases. As a whole, the evidence points to a slowdown in the residential housing industry.

Labor Markets



	Average monthly change (thousands of employees)				
	1996	1997	1998	YTD ^a	Nov.
Payroll employment	234	281	244	214	234
Goods-producing	32	48	8	-10	53
Mining	1	2	-3	-4	0
Construction	28	21	30	18	55
Manufacturing	3	25	-19	-24	-2
Durable goods	10	27	-9	-12	-6
Nondurable goods	-7	-2	-10	-12	-4
Service-producing	202	233	235	224	181
Retail trade	43	24	32	32	1
FIRE ^b	14	20	26	12	8
Services	117	141	119	122	120
Health services	20	17	9	11	14
Government	11	17	27	27	31
	Average for period (percent)				
Civilian unemployment	5.4	4.9	4.5	4.3	4.1



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.
 SOURCES: U.S. Department of Labor, Employment and Training Administration and Bureau of Labor Statistics.

The labor market continues to show steady growth. Over the past 12 months, the economy has added jobs at the rate of about 225,000 per month. November maintained the trend, with nonfarm payrolls adding 234,000 workers. Although payroll figures for September and October were revised, average monthly job growth over this two-month period is effectively unchanged.

The unemployment rate remained at a 30-year low of 4.1% in November. Nevertheless, wage growth remains muted, with the increase in

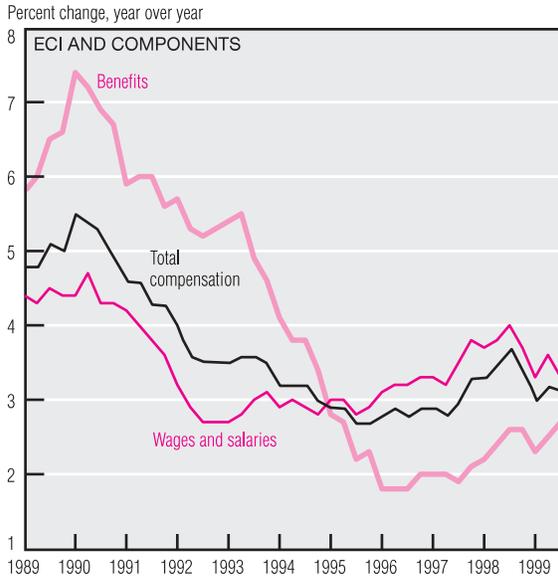
average hourly earnings slowing to 0.2% from October's 0.3%. In absolute terms, earnings rose 2 cents in November, compared with a 4-cent increase in October.

Despite the labor market's continuing strength, however, employment growth was not the rule across all sectors. Employment rose for service producers and in construction, but was practically unchanged in manufacturing and retail trade. Construction's strength was attributed to unseasonably warm temperatures and dry weather. Weakness in

the manufacturing of machinery, motor vehicles, aircraft, and apparel persists, though the rate of job loss for factory workers has generally slowed since midyear.

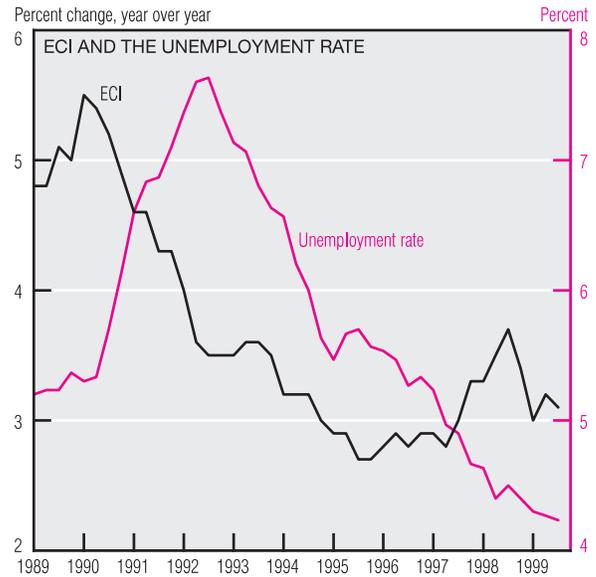
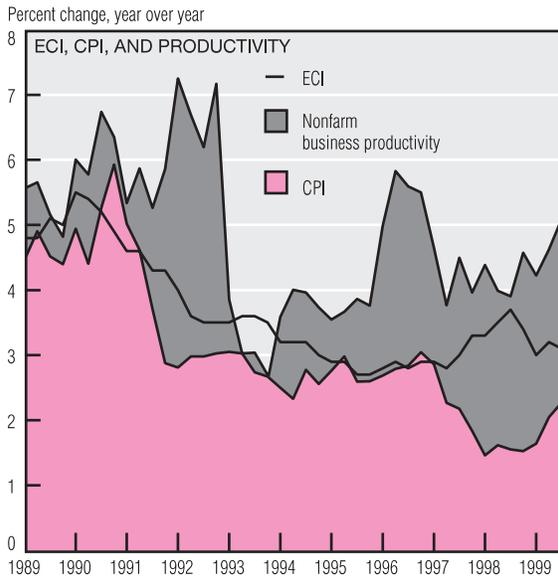
An interesting feature of the current labor market is the composition of unemployed persons. The unemployment rate seems to have fallen as far as it has primarily because fewer people have lost their jobs, not because fewer people have left their jobs voluntarily or entered (or re-entered) the workforce.

The Employment Cost Index



ECI Wage and Salary Growth by Industry and Region, 1999^a

Industry	Average annual percent change, last:		
	1 yr.	3 yrs.	6 yrs.
Manufacturing	3.1	3.1	3.0
Construction	3.2	3.3	2.9
TPI ^b	2.5	2.9	3.0
Wholesale and retail trade	3.2	3.6	3.3
FIRE ^c	4.4	5.2	4.1
Services	3.3	3.5	3.2
Region			
Northeast	3.2	3.1	3.0
South	2.9	3.5	3.2
Midwest	3.3	3.6	3.4
West	3.7	3.9	3.4



a. Workers in private industry.
 b. Transportation and public utilities.
 c. Finance, insurance, and real estate.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Employment Cost Index (ECI), an important measure of compensation growth, gauges changes in employers' labor costs. Just as the Consumer Price Index (CPI) tracks prices for a fixed market-basket of goods, the ECI charts compensation of workers in a fixed set of industries and jobs within industries. Because it is not affected by shifts in occupation composition, the ECI can effectively measure labor costs for the same jobs over time.

One component of the ECI is growth in wages and salaries, which

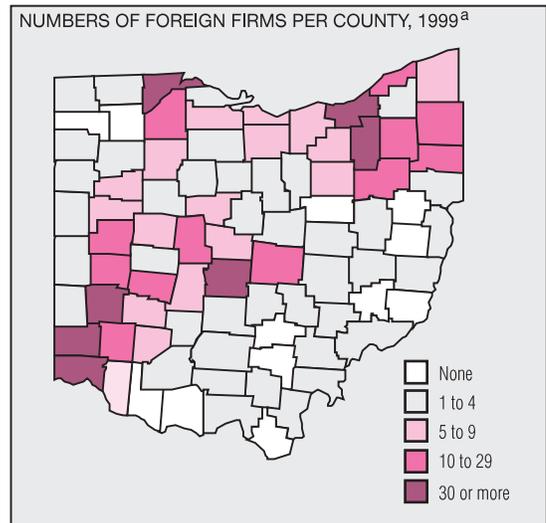
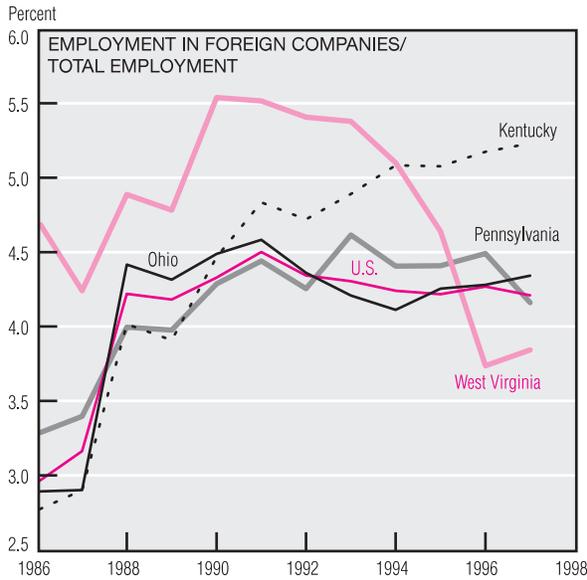
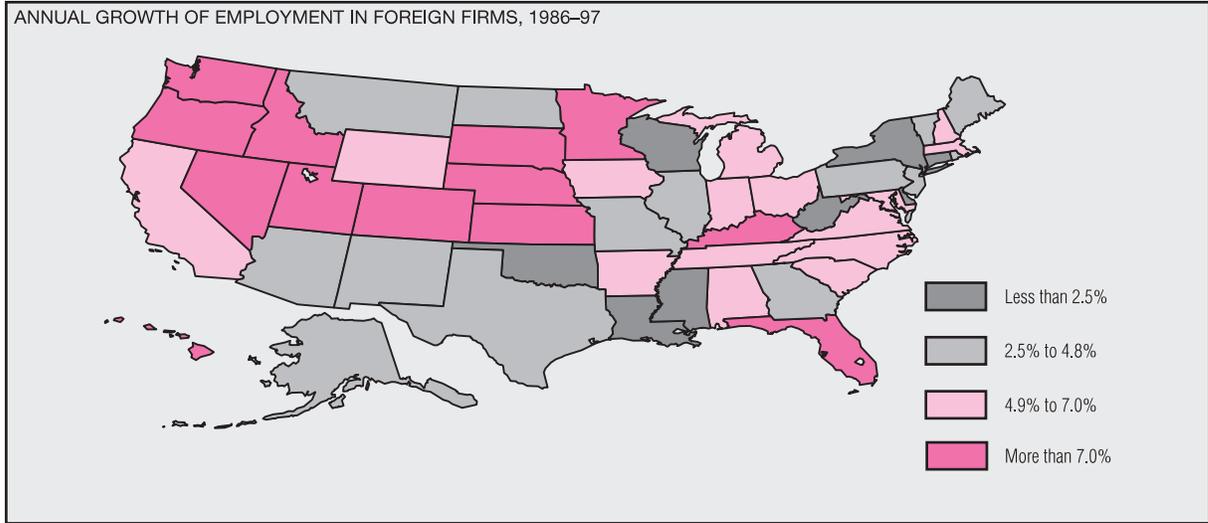
has increased more rapidly than total compensation in recent years. Another component is growth in benefits, which has slowed significantly throughout the decade but has moderated in the last few years. For most groups of workers (by industry or by region), wage growth in 1999 was comparable to rates in recent years.

During the current expansion, ECI growth and inflation slowed together until 1997. In that year, the two measures began to diverge, as the ECI rose rapidly while falling oil prices caused the CPI to drop sharply.

These measures have begun to reconverge in 1999.

ECI and CPI growth patterns for this decade were similar until recently, but the causes are unclear. Inflation could rise if wage growth is not matched by productivity gains. Productivity has grown substantially in the past several years, permitting compensation to increase without sparking inflation. Although the unemployment rate over this decade has fallen and ECI growth has slowed, the correlation between these two measures is also uncertain.

Foreign Firms



a. As of August.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Ohio Department of Development, Office of Strategic Research, *Foreign Companies with Operations in Ohio*, September 1999.

Foreign firms operating in the U.S. play an important economic role in the nation and Fourth District states. The U.S. Department of Commerce classifies a firm as a U.S. affiliate of a foreign firm if at least 10% of the voting securities are controlled by a single foreign entity. In 1997, roughly 4% of all U.S. workers were employed by U.S. affiliates of foreign firms, up from about 3% of all workers in 1986.

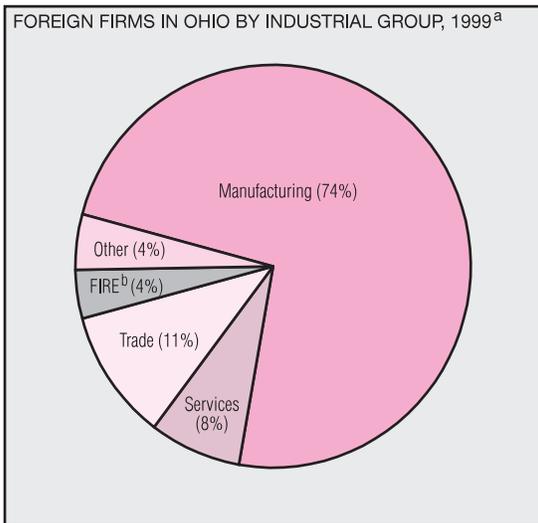
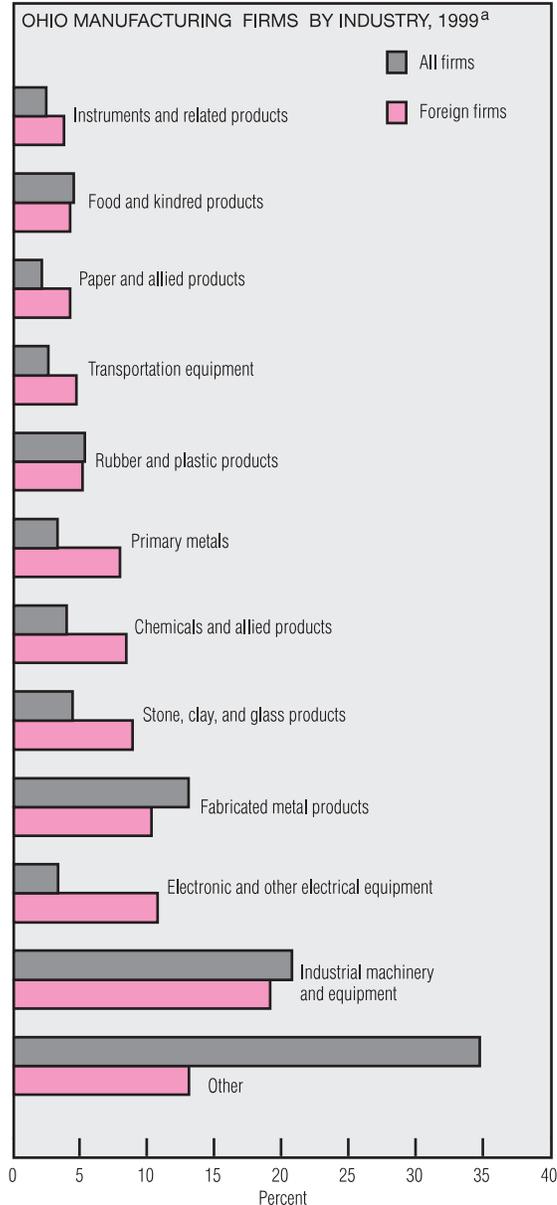
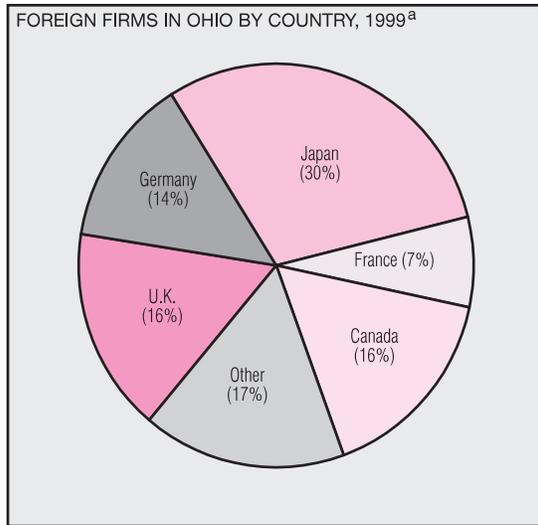
From 1986 to 1997, foreign firms'

strongest employment growth occurred in the West and the Great Plains states. The least growth was seen in the Northeast and along the Mississippi River. In the Fourth District, West Virginia was the only state to experience declining employment by foreign firms. Kentucky, by contrast, posted one of the highest growth rates in foreign employment of any state. From 1986 to 1997, employment by U.S. affiliates of foreign firms in Kentucky grew at an aver-

age annual rate of 8.0%, almost double the U.S. rate of 4.8%. In Ohio, foreign firms' growth rates were slightly higher than the national average.

The pattern of foreign firms' employment shares in Ohio and Pennsylvania mirrors that of the U.S. as a whole: A powerful surge in foreign firms' employment growth in the late 1980s was followed by a period of stable ratios between foreign and
(continued on next page)

Foreign Firms (cont.)



a. As of August.

b. Finance, insurance, and real estate.

SOURCES: Ohio Department of Development, Office of Strategic Research, *Foreign Companies with Operations in Ohio*, September 1999; and Harris InfoSource, *Ohio Industrial Directory 2000*.

domestic employment growth. In Kentucky, however, the share of jobs provided by foreign firms continues to rise, while the portion of foreign firms' employment in West Virginia has been declining since 1994.

The location of foreign firms within Ohio closely tracks the patterns of interstate highways and major population centers. Most of the state's foreign firms are on the edges of a triangle that is roughly bounded by Interstates 71 and 75 and by the Ohio Turnpike, with

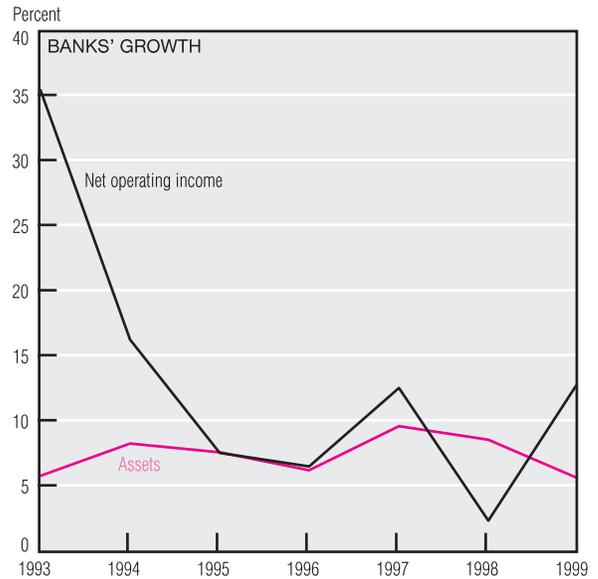
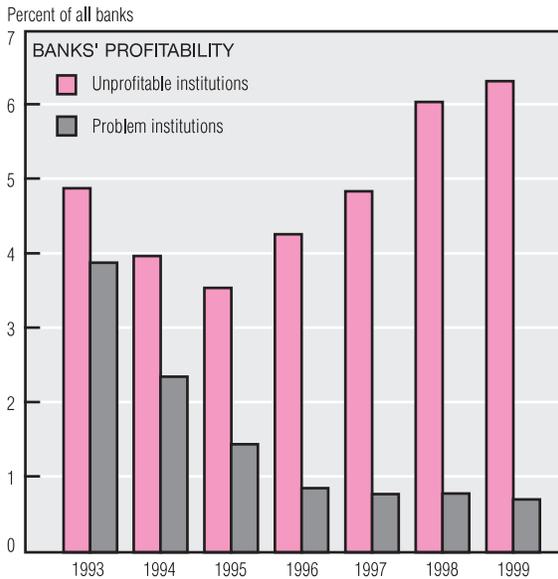
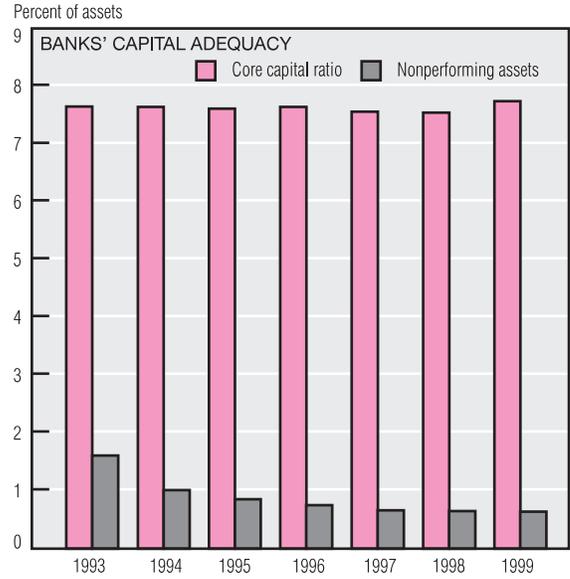
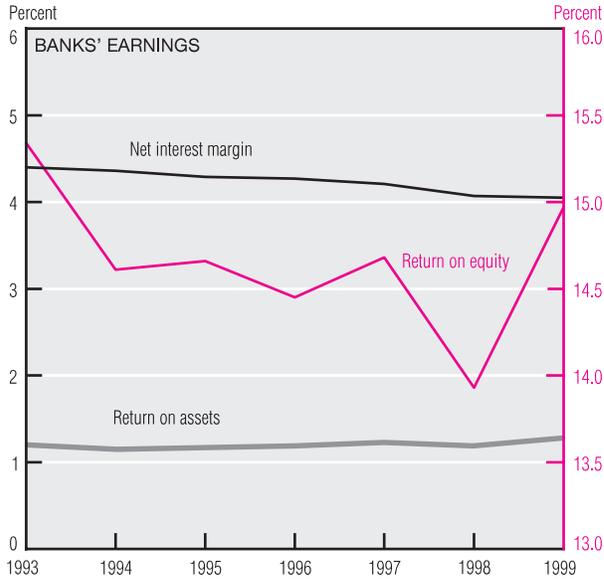
Cleveland, Cincinnati, and Toledo at the points. Few foreign firms are found in the Appalachian counties of southern Ohio. Cuyahoga County, including the city of Cleveland, has the most foreign firms of any Ohio county (145), followed by Franklin County, including the city of Columbus (93 firms).

More than 80% of all foreign firms in Ohio are from only five countries: Japan (which alone accounts for nearly a third of these firms) is first, followed by Canada, Germany,

France, and the U.K. The rest of the state's foreign firms come from 20 other countries.

The overwhelming majority of Ohio's foreign firms (74%) are in the manufacturing sector. They tend to be concentrated in a much narrower range of industries than Ohio manufacturers as a whole. Industries with a particularly high concentration of foreign firms include electrical equipment; stone, clay, and glass products; chemical products; and primary metals.

Bank Performance



NOTE: All data are for FDIC-insured commercial banks through 1999:IIQ.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 1999:IIQ.

The balance sheets of U.S. commercial banks showed continued signs of health through 1999:IIQ. After a slowdown in 1998, profits picked up again, with a return on assets of 1.28%. Return on equity for the second quarter was 14.97%. Core earnings remained strong, and the net interest margin remained above 4%. Moreover, nearly 94% of all commercial banks posted positive profits.

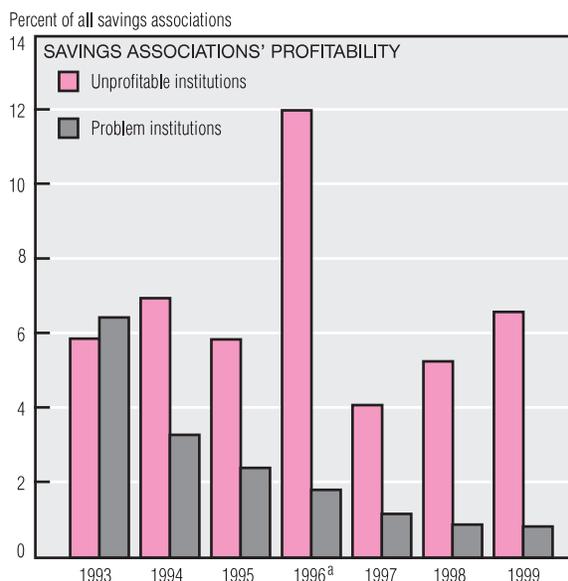
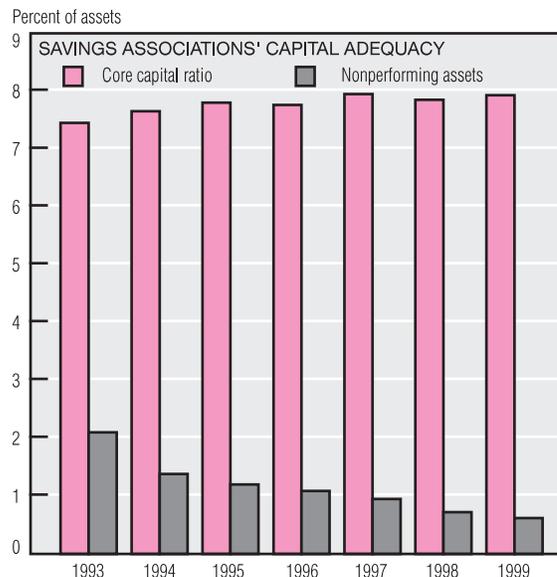
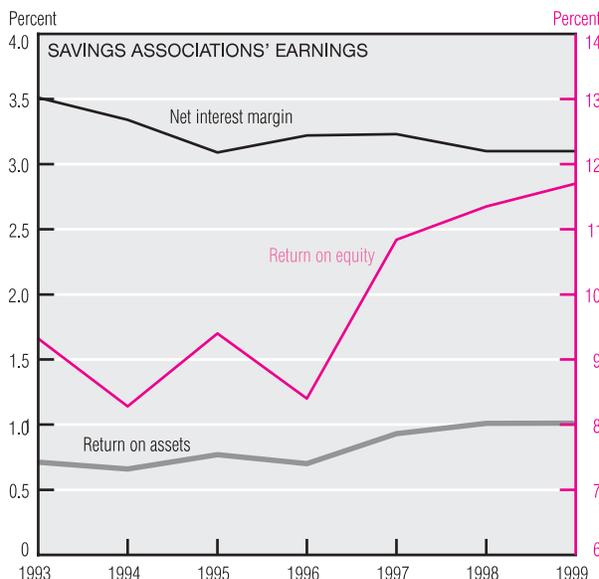
Strong bank balance sheets were

reflected in core bank capital, which, at 7.74% of assets, was high by historical standards. In addition, asset quality problems were not evident. Nonperforming assets settled back to their 1998 level (only 0.64% of total assets).

Further evidence of strength in the U.S. banking sector was the continued downward trend in the percentage of banks rated as problem institutions—from 3.89% in 1993 to 0.71% in 1999:IIQ.

Finally, bank asset growth over the 12 months ending in June 1999 slowed to 5.52%. Nonetheless, net operating income grew 12.89% over the same period, sharply higher than the 2.39% growth rate for 1998. Overall, the banking sector has exhibited steady growth without compromising profitability or, more importantly, the apparent quality of its assets.

Savings Association Performance



a. The sharp 1996 decline in operating income growth resulted partly from a special insurance assessment on savings and loans deposits.

NOTE: All data are for FDIC-insured savings associations through 1999:IIQ.

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

U.S. savings associations' performance held steady in 1999:IIQ, with second-quarter earnings for the industry reaching \$2.86 billion. Return on assets for the quarter was back at its historically high 1998 value of 1.01%. Further, return on equity, at 11.70%, was at its highest level since 1985; but in 1999, unlike 1985, it was generated by a robust return on assets and a steady net interest margin of 3.10%. However, the percentage of savings associations reporting losses increased from 4.1% in 1987 to 6.6% in 1999:IIQ, adding a note of

caution to interpretations of otherwise positive earnings trends.

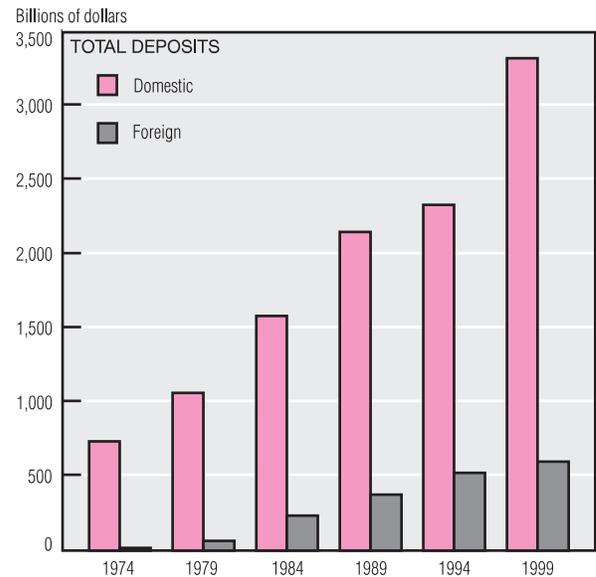
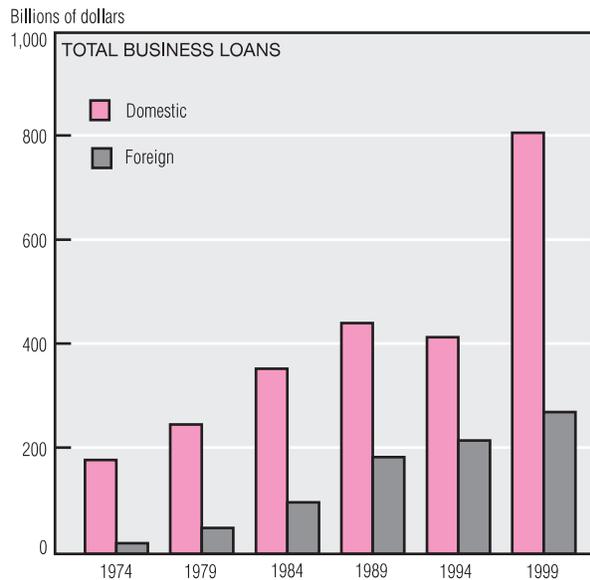
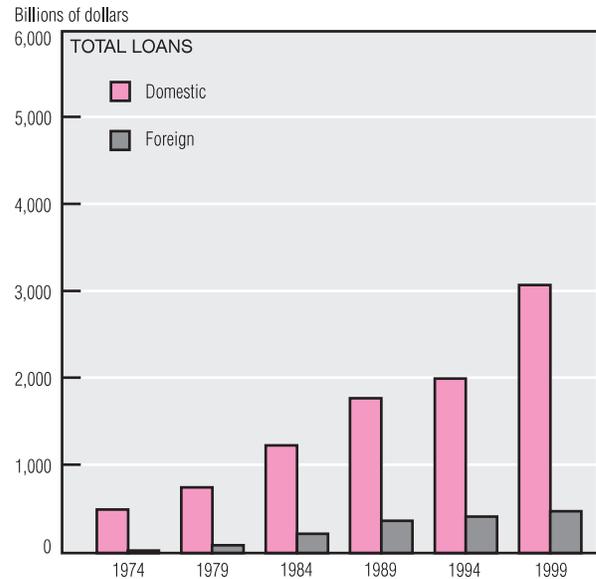
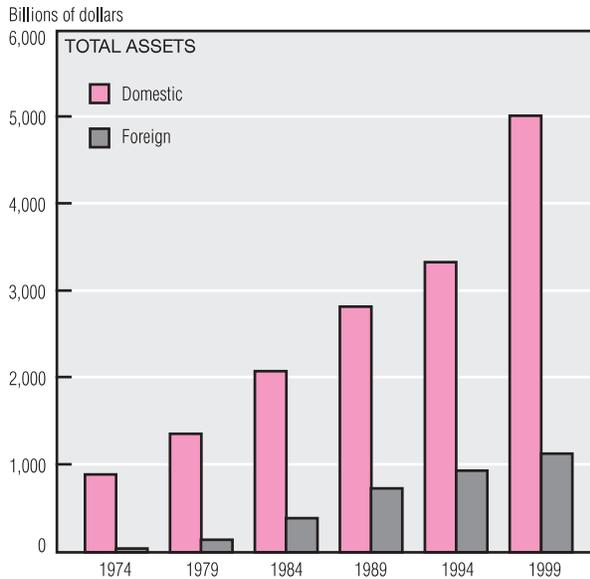
Savings associations' balance sheets showed improved asset quality, as nonperforming assets fell to 0.62% of total assets, the lowest in the last six years. Core capital remained a healthy 7.93% of total assets, a small increase from 1998. Moreover, despite a small increase in the number of savings associations with substandard examination ratings, problem institutions remained below 1% of the total.

Twelve-month asset growth

through 1999:IIQ was 7.74%, nearly two percentage points higher than the 6.05% asset growth during 1998. The 8.69% growth in operating income during the same period suggests that asset growth in the first half of 1999 did not come at the expense of profit margins.

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.

Foreign Banking Organizations



NOTE: Domestic banks exclude commercial banks in which foreign banks have more than 25% ownership but include international banking facilities as well as banks owned by nonbank foreigners. The data exclude Edge Act and agreement corporations, U.S. offices of banks in Puerto Rico, the U.S. Virgin Islands, and other U.S.-affiliated island areas, and foreign bank offices in U.S.-affiliated island areas. Foreign banks are those owned by institutions located outside the U.S. and its affiliated island areas.

SOURCE: Board of Governors of the Federal Reserve System, "Structure and Share Data for U.S. Offices of Foreign Banks," *Federal Reserve Statistical Releases*, September 1999.

Nowhere is the impact of the increasing globalization of financial markets more evident than in the U.S. banking industry. The numbers clearly show the importance of foreign banks, whose total assets have risen steadily from \$46 billion in 1974 to nearly \$1,137 billion at mid-1999. This represents an increase from 4.88% to 18.45% in the share of assets held by foreign banking organizations.

A similar pattern emerges when

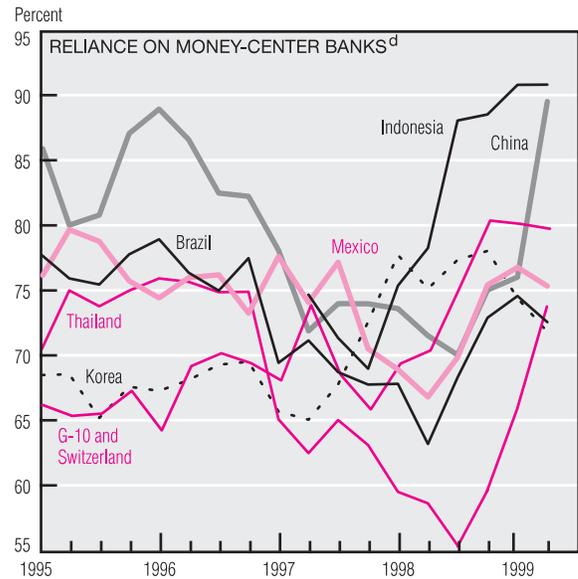
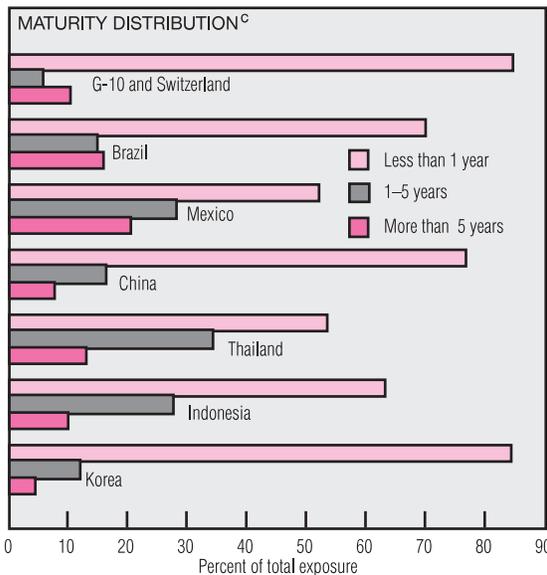
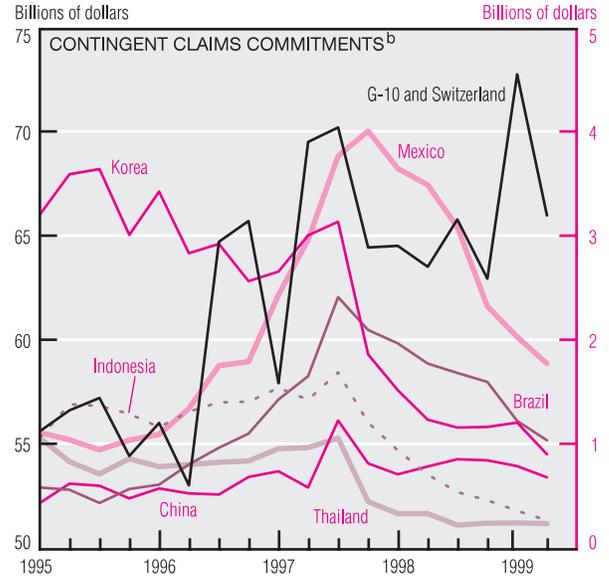
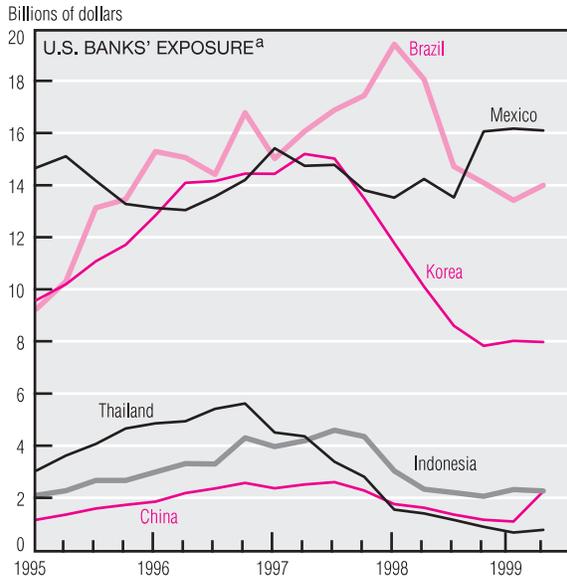
we look at foreign banking organizations' market share of loans and deposits. The increase in these organizations' holdings of total loans—from \$27 billion in 1974 to \$477.8 billion in 1999—amounts to an increase in the share of total loans from 5.15% to 13.43%, a much slower growth rate than for total assets.

On the other hand, foreign banking organizations increased their holdings of business loans from \$18.8 billion in 1974 to \$272 billion

in 1999, representing an increase in share from 9.46% to 25.21%. Foreign banking organizations' larger share of business loans relative to their share of total loans and total assets reflects these organizations' focus on commercial lending.

Finally, the \$595 billion in deposits they hold (a 15.19% deposit share) suggests that foreign banking organizations will remain important competitors in the U.S. banking system.

Foreign Lending Exposure



- a. Total owed by borrowers in a country after adjustment for guarantees and external borrowing (except derivative products).
 b. Commitments of cross-borrower and nonlocal-currency contingent claims after adjustment for guarantees.
 c. Maturity distribution of total owed to U.S. banks after adjustment for guarantees and external borrowing (except derivative products).
 d. Money-center banks' share of the total owed to U.S. banks after adjustment for guarantees and external borrowing (except derivative products).
 SOURCE: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*.

Changes in political, social, and economic environments abroad can affect U.S. banks' foreign lending exposure. If, for example, our trading partners experience the increased economic growth that is currently forecast, U.S. banks may be inclined to increase their exposure.

Data for 1999:IIQ already reveal that the decline in U.S. banks' exposure to key developing countries has stopped. Exposure to Brazil has increased slightly, following the sharp

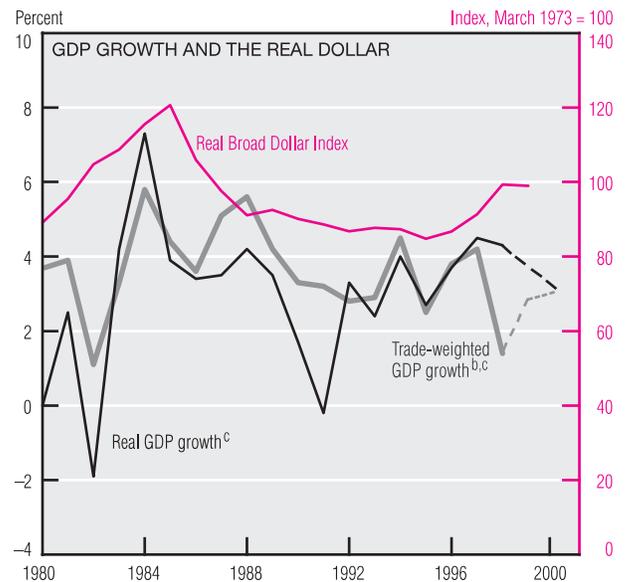
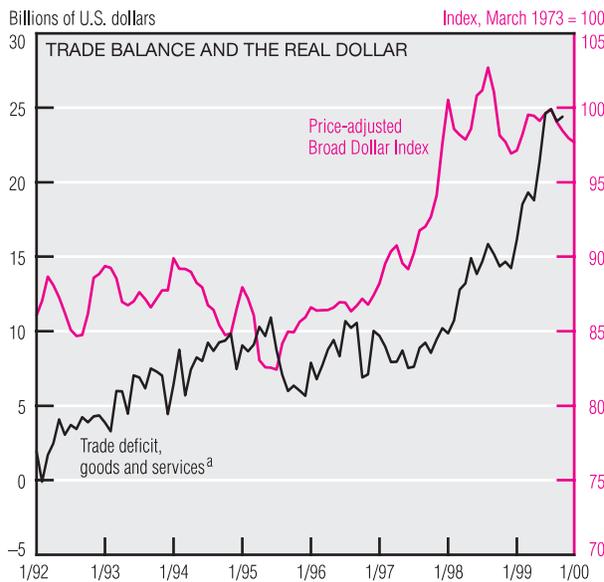
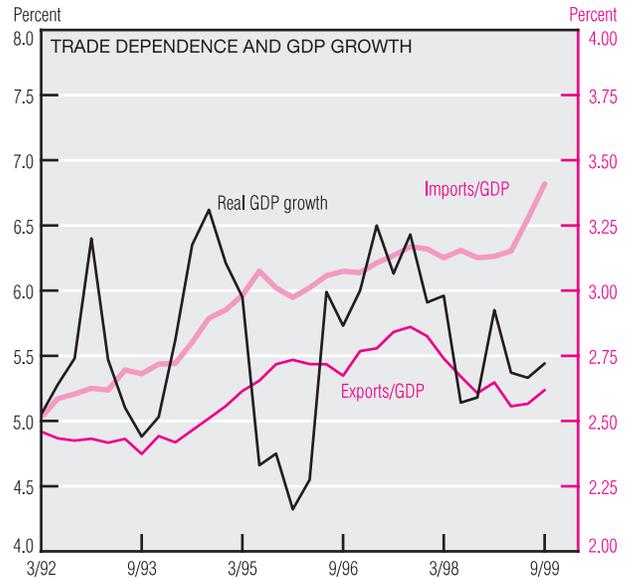
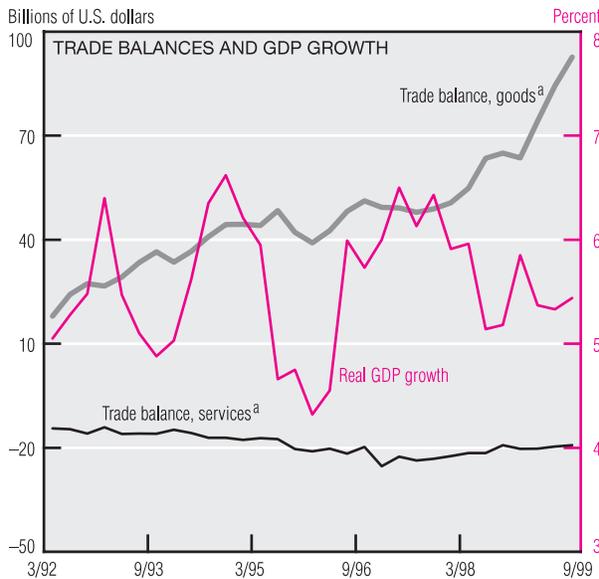
1998 decline associated with that country's fiscal policy changes and currency devaluation. Exposure to China has increased 56%, reversing a steady decline that began in 1997.

Use of contingent claims commitments (including legal commitments to extend credit, forward contracts, and guarantees) declined sharply for the G-10 countries and Switzerland, despite increased U.S. exposure there. Use of such commitments showed moderate declines for other countries as well.

For all countries, the maturity of exposure is primarily short term. This is inconsistent with the widely accepted notion that the depth of longer-term capital markets is a measure of sophistication in financial development.

Money-center banks continue to dominate other U.S. banks, large and small, in all nations. However, money-center banks may participate jointly with other banks in providing credit to developing countries.

The U.S. Trade Balance



a. Calculated on a balance-of-payments basis, seasonally adjusted.

b. GDP growth for the top 15 U.S. trading partners in 1992-97: Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, Netherlands, and Brazil. Projections for 1999-00 utilize several data sources.

c. Dashed lines indicate projections for 1999-00.

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*, October 10, 1999.

The nominal U.S. trade balance on goods and services widened slightly in September. A closer look, however, shows that the goods deficit has widened significantly over the past year, while the services surplus has changed little. There appears to be little correlation between the growth rates for real GDP and the two balances since 1992. The growth rate of real GDP also seems unrelated to the ratios of nominal exports or imports to real GDP.

Movements in nominal exports and imports combine changes in

quantity and changes in export and import prices. Changes in dollar export and import prices, in turn, reflect both domestic price changes and changes in the nominal dollar exchange rate. The real dollar combines changes in the nominal exchange rate and changes in prices within the U.S. and other countries.

A stronger real dollar implies that U.S. products are less competitive internationally. The strengthening of the real dollar after mid-1995 was accompanied by a continued deterioration in the nominal current-account balance. This supports the

idea that the rising current-account deficit resulted partly from capital flows into the U.S., which boosted the dollar. However, since mid-1998, the real dollar has weakened, while the current-account deficit has continued to grow.

The relative economic strength of the U.S. and its trading partners is a major influence on the dollar. Recent forecasts are for strengthening of foreign economies relative to the U.S. If U.S. capital moves abroad, the dollar may weaken and thus help reduce our deficit.