

## *The Economy in Perspective*

*The price of success...* The Federal Open Market Committee voted on February 2 to increase the federal funds target  $\frac{1}{4}$  percentage point, to  $5\frac{3}{4}$  %. The federal funds target (the price of overnight Federal Reserve credit that depository institutions charge one another) now stands a full percentage point above its level last June.

Many financial market analysts have remarked on the number and timing of these policy actions: February's funds rate target increase was the latest in a series of four upward adjustments, made in quick succession. Fewer commentators note, however, that today's federal funds and discount rates are broadly similar to those prevailing from 1995 to mid-1998, a period when the funds rate ranged between  $5\frac{1}{4}$  % and 6%, averaging  $5\frac{1}{2}$  %. This stability was also evident in most other U.S. interest rates.

In market economies, prices equilibrate the interests of buyers and sellers. An interest rate balances the willingness of sellers, who consume less today in the expectation of enhanced future consumption, with buyers, who wish to shift some of their anticipated future consumption to the present. Ignoring the effects of inflation and inflation expectations, rising interest rates signify that people want to shift relatively more future consumption to the present—and that they must compensate savers more handsomely to get the wished-for resources immediately.

A number of factors affect borrowers' and lenders' behavior. If some people suddenly expect to be wealthier in the future, they may wish to begin consuming some of their anticipated wealth right away. In these circumstances, they will reduce their saving and perhaps even borrow against future income. If many of a country's people simultaneously try to alter the time patterns of their consumption in this way, the additional resources needed will have to come from abroad and the real interest rate will usually rise, encouraging lenders to defer their own consumption. But other circumstances can counteract these fundamental influences.

For instance, market-driven U.S. interest rates plunged in the latter half of 1998 as investors around the world, seeking refuge from turbulent international financial markets, rushed to purchase U.S. dollar-denominated financial instruments. As international economic prospects gradually improved in 1999, this extraordinary demand for dollar liquidity receded, causing market-driven interest rates to move back up toward their pre-panic levels. Federal Reserve-controlled interest rates matched these developments.

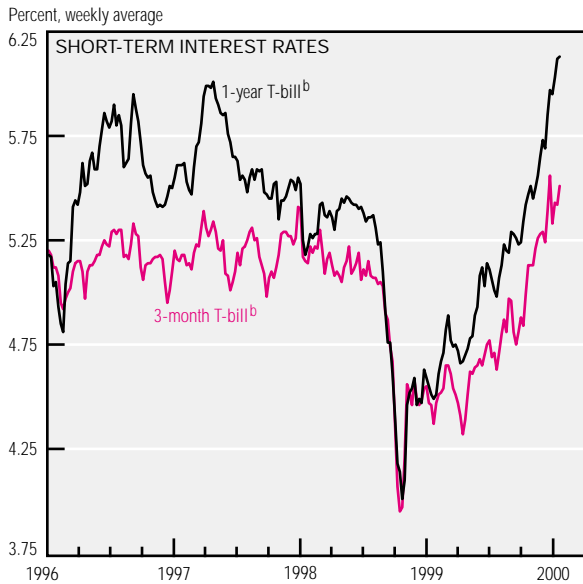
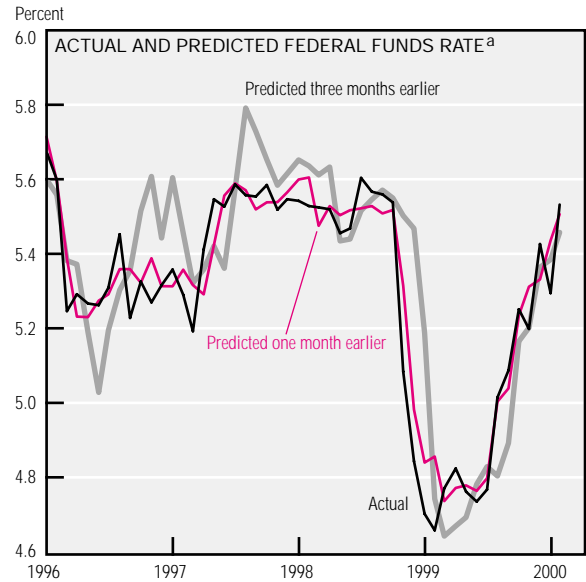
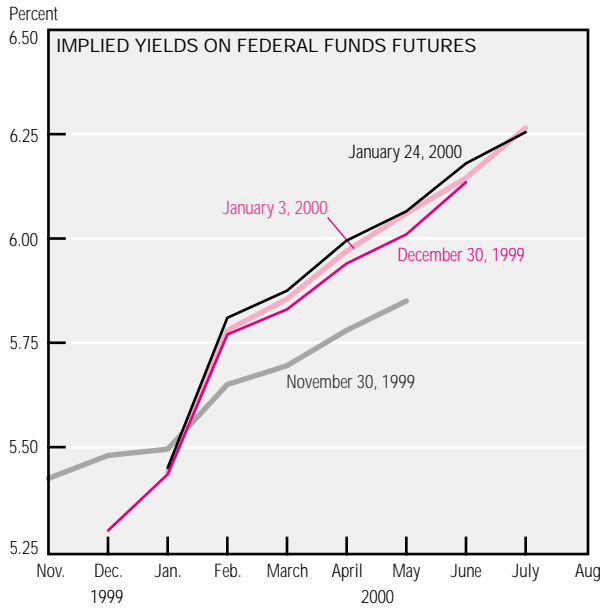
All this activity occurred against a backdrop of very large capital inflows to the United States for nonliquidity purposes. Seeing good prospects for continued strong economic growth, together with low inflation, foreign investors have joined their U.S. counterparts in financing a capital spending and stock market boom. The influx of foreign capital also is reflected in our foreign trade accounts. Foreigners acquire dollar-denominated assets by exporting goods and services to the United States and investing the sales receipts rather than spending them on U.S.-produced items (that is, they are lending us what would otherwise be their current consumption). Since increased demand for dollar-based assets strengthens the dollar's foreign exchange value, making imports more attractive to U.S. consumers, the capital inflow and merchandise import processes complement and reinforce one another.

The most dramatic divergence between domestic spending and domestically generated income in this expansion has taken place in the last several years, as foreign economic activity languished and demand for dollar assets surged. With international financial jitters calmed and activity in many large foreign economies reviving, it seems reasonable to expect that global investors will broaden their portfolios beyond dollar-denominated assets, and that foreign markets will come to absorb a larger fraction of global resources than they have for several years. Should these patterns emerge, it would also be reasonable to expect market-driven interest rates to firm, reflecting a more intense global pressure for additional investment and consumption spending.

Monetary policy affects economic activity through a variety of channels that are not completely understood or predictable. Movements in the overnight federal funds rate reflect changes in the supply and demand for account balances at the Federal Reserve. How funds rate fluctuations affect other interest rates depends on several factors, including inflation expectations. When savers expect inflation to rise, they add a premium to the rate they charge borrowers, because they believe that future dollars will purchase fewer goods and services.

If market participants think that the Federal Reserve will persistently oversupply liquidity to financial markets by keeping the funds rate too low, longer-term interest rates could rise even while the funds rate holds fixed. If the Fed has credible inflation goals, however, increases in the funds rate can actually reduce longer-term rates. So far during this expansion, funds rate movements have been followed by more prosperity.

# Monetary Policy



a. Predicted rates are 1-month and 3-month federal funds futures lagged one and three months, respectively.  
 b. Constant maturity.  
 SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

Implied yields on federal funds futures are often used to gauge market participants' expectations for the future path of policy. Since late December, market participants consistently have priced in a 25 basis point (bp) increase for February and at least one more such increase by June.

Historically, federal funds futures do a fair job of predicting movements in the effective federal funds rate. Generally speaking, when the fed funds rate rises, futures tend to

underpredict the rate's level; when the rate falls, futures tend to overpredict. The average error for January 1996 to January 2000 is 13 bp for the 3-month future and 6 bp for the 1-month future.

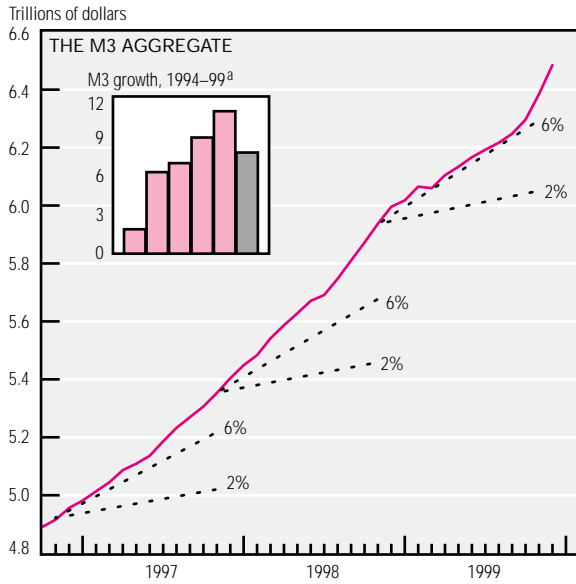
Short-term interest rates continue to rise briskly. The 3-month Treasury bill rate ended 1999 at 5.33%, up 75 bp on the year. Similarly, the 1-year Treasury bill rate finished at 5.95%, a substantial 135 bp increase. From year's end through the week ending January 21, the 3-month and

1-year Treasury bill rates made identical 18 bp gains. The recent rise of short-term interest rates may have reflected the market's anticipation of February federal funds rate increases.

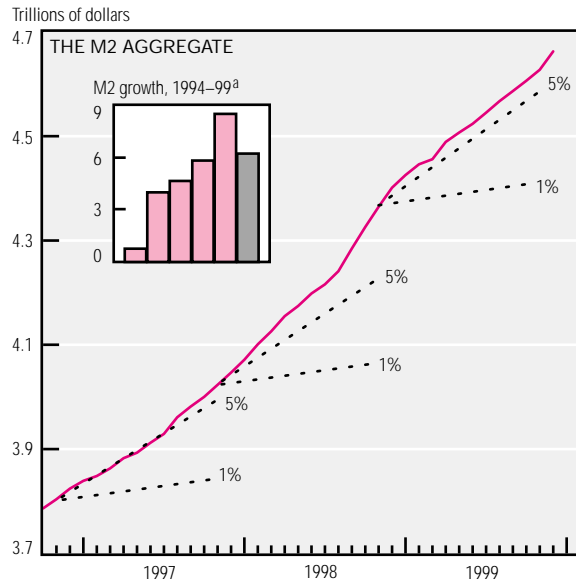
Long-term interest rates display a similar pattern. The 10-year and 30-year Treasury rates ended the year at 6.41% and 6.46%, increases of 171 and 134 bp, respectively. Gains since January 1 are 36 bp for the 10-year rate and 27 bp for the 30-year rate.

The Board of Governors of the  
*(continued on next page)*

# Monetary Policy (cont.)



Component	Percent of M3	Percent of change
M2	71.9	35.3
Large time deposits	11.0	30.2
Repurchase liabilities	5.1	12.3
Eurodollars	2.6	4.4
Institutional money-market mutual funds	9.4	17.9



Component	Percent of M2	Percent of change
M1	24.1	48.4
Savings deposits	37.3	-9.6
Small time deposits	20.4	15.3
Retail money-market mutual funds	18.2	45.9

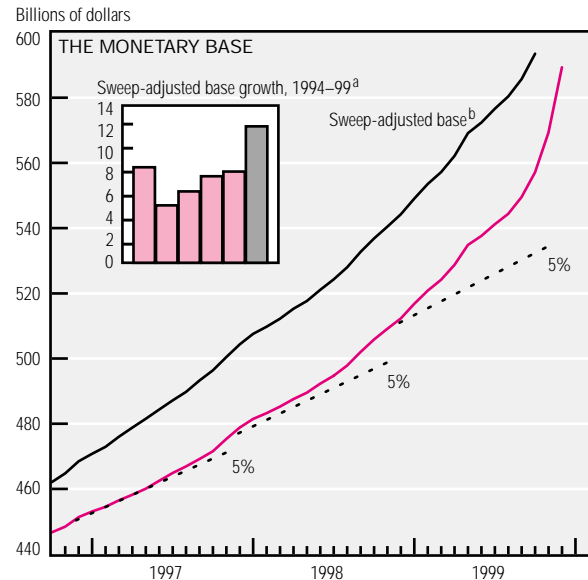
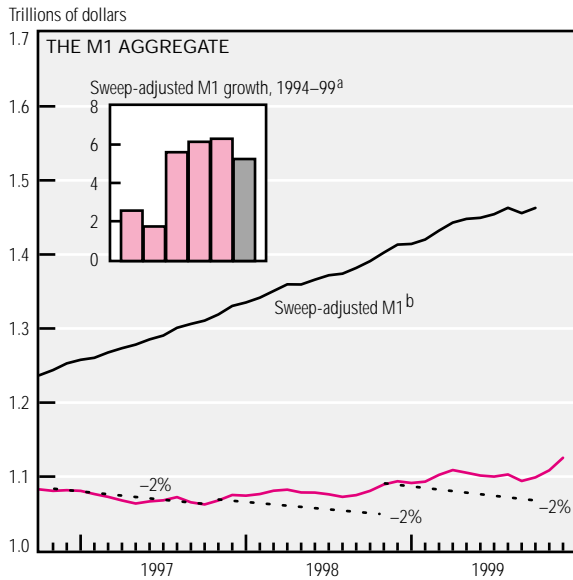
a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.  
 NOTE: Data are seasonally adjusted. Last plots for M2 and M3 are December 1999. Dotted lines for M2 and M3 are FOMC-determined provisional ranges.  
 SOURCE: Board of Governors of the Federal Reserve System.

Federal Reserve System constructs several different measures of the amount of money existing in the U.S. at any given time. The broad monetary aggregates (M2 and M3) include less liquid assets than do the narrow components. Growth rates for virtually all the monetary aggregates spiked in December. This is not terribly surprising, in view of the public concern that surrounded the century date change. Furthermore, careful examination of which components contributed to this growth suggests

that much of the change, especially in the narrow monetary aggregates, can be attributed to Y2K. Annualized monthly growth of the M3 monetary aggregate soared to 18.8% in December; calculated on a fourth-quarter over fourth-quarter basis, it was a modest 7.6%. It is difficult to discern a clear pattern in the growth of M3 components. Annualized monthly M2 growth reached 9.1%, driven by nearly equal growth in M1 and retail money-market mutual funds, with offsetting

changes in savings deposits and small time deposits. One would expect savings deposits to decrease if individuals withdrew cash in preparation for possible Y2K disruptions. Bear in mind that these data are seasonally adjusted—that is, they already account for the normal fluctuations associated with holiday shopping. (It may be helpful to think of increases in the monetary aggregates around Y2K as a fluctuation that cannot be accounted for by *(continued on next page)*

# Monetary Policy (cont.)

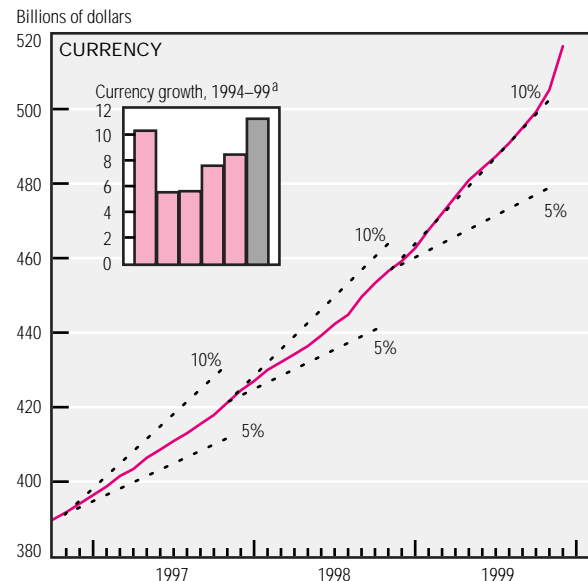


## Breakdown of Recent Changes in M1

Component	Percent of M1	Percent of change
Currency	45.9	68.4
Traveler's checks	0.7	0
Demand deposits	31.9	9.9
Other checkable deposits	21.5	21.6

## Breakdown of Recent Changes in the Monetary Base

Component	Percent of base	Percent of change
Currency	87.6	55.9
Total reserves	7.0	1.6
Surplus vault cash	5.4	42.5



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rates for sweep-adjusted M1 and the sweep-adjusted base are calculated on a November over 1998:IVQ basis.

b. Sweep-adjusted M1 contains an estimate of balances temporarily moved from M1 to non-M1 accounts. The sweep-adjusted base contains an estimate of required reserves saved when balances are shifted from reservable to nonreservable accounts.

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

SOURCE: Board of Governors of the Federal Reserve System.

cause it is a one-time event.) In addition, growth in FDIC-insured small time deposits would be consistent with a desire to earn interest in an essentially risk-free environment—just in case Y2K had brought major problems.

Turning to narrower measures of money, we can see a clearer pattern of increased volume in highly liquid assets. Annualized monthly M1 growth leapt to 18.4% for December, spurred by an increase in the currency component. Currency con-

tributed nearly 70% of growth for the month, although it accounts for only 45.9% of total M1.

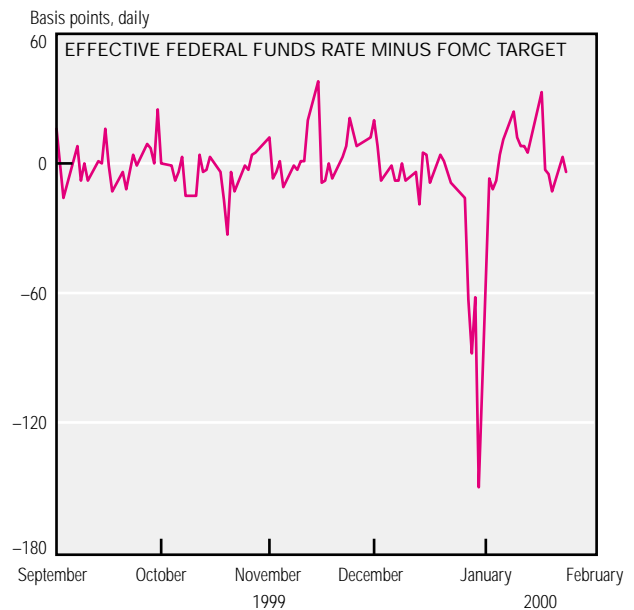
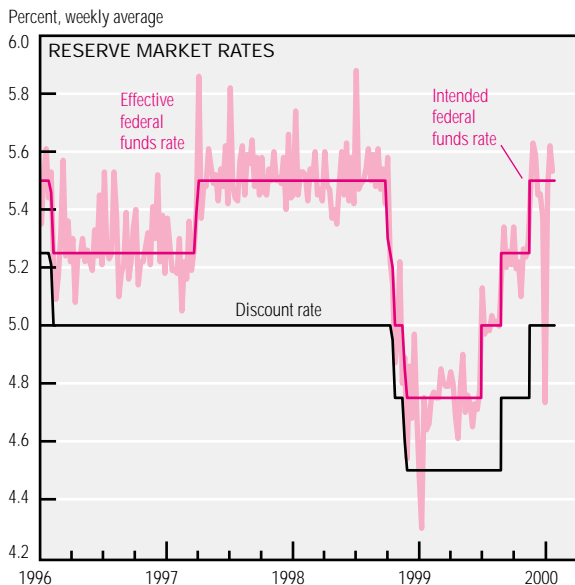
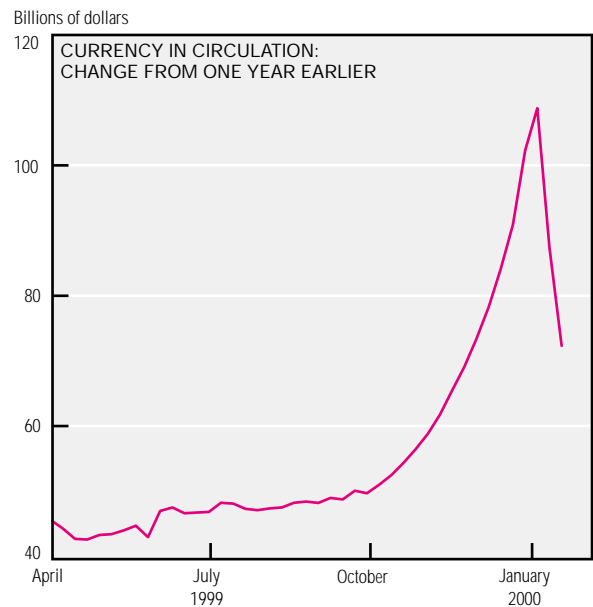
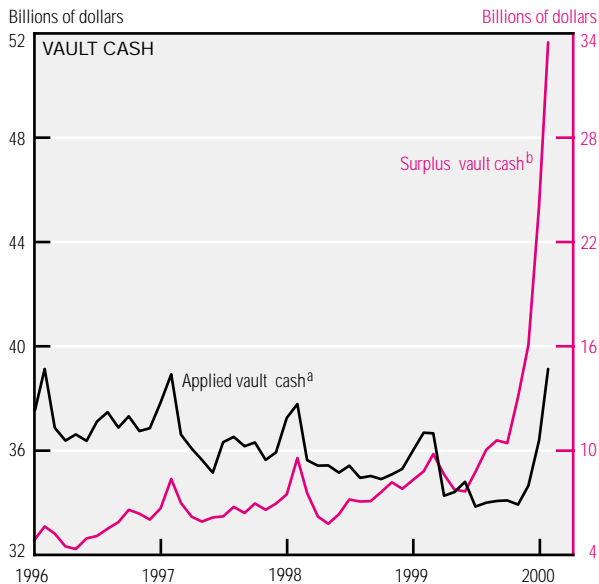
The most striking information comes from the monetary base, whose annualized monthly growth rate soared to 44.2% in December. Although currency contributed substantially (55.9%) to the change on the month, banks' surplus vault cash contributed almost as much (42.5%) yet accounts for only about 5% of the monetary base.

In 1998, the Federal Reserve, an-

ticipating heightened demand for currency around the century date change, prepared by ordering \$50 billion of extra currency to be printed in 1999. It injected the extra currency into the system during the rollover period to ensure that supplies would be sufficient to cover any surge in withdrawals. Currency did jump during December, with the annualized monthly growth rate reaching 27.8%.

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## Monetary Policy (cont.)



a. Vault cash held by banks whose reserve requirements exceed their vault cash plus the amount used to satisfy requirements by banks whose vault cash exceeds their reserve requirements.

b. Vault cash minus the amount used to satisfy reserve requirements.

NOTE: Data are not seasonally adjusted.

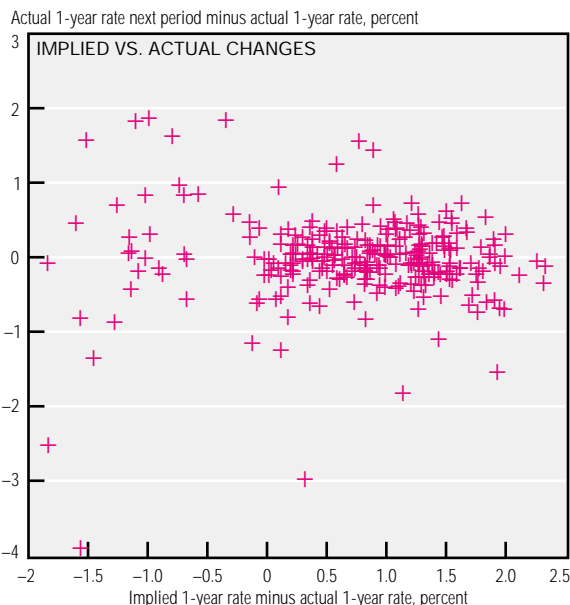
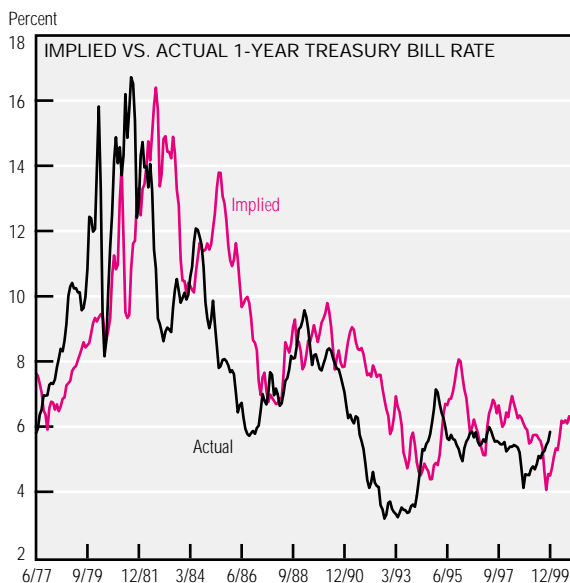
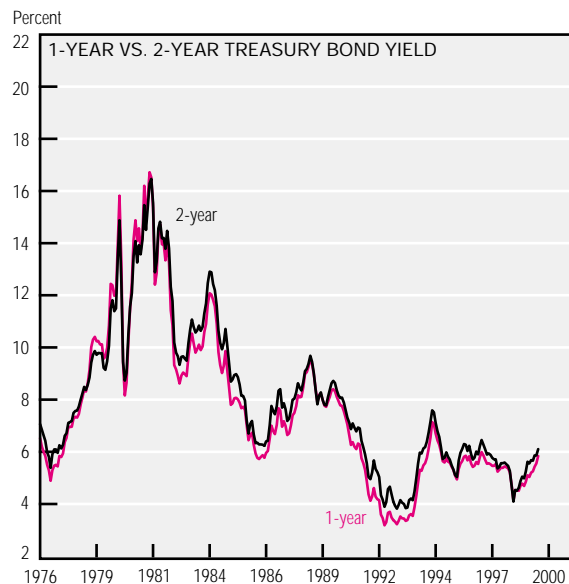
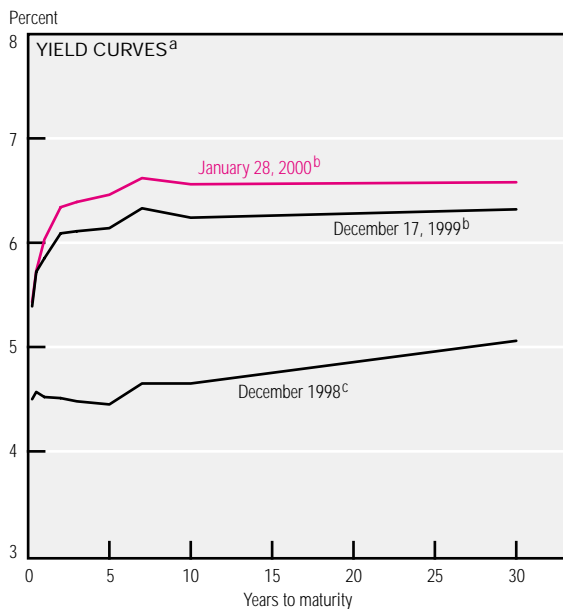
SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

It is important to note that levels of surplus vault cash were elevated relative to the previous year and remained so into January. Following the century date change, currency in circulation decreased as cash flowed back to banks. In fact, the Federal Reserve Board announced in August 1999 that it would be unnecessary to print new \$50 or \$100 bills for the coming year because sufficient inventories already would exist.

The need to provide extraordinary liquidity around the century date change caused the Federal Open Market Committee to err on the side of caution by injecting surplus bank reserves. Briefly put, the FOMC selects a target federal funds rate, then adds or drains reserves from the system on a daily basis to match the effective federal funds rate to the target rate. Normally, the effective federal funds rate is very

close to the target rate, but during the final week of 1999, the actual fed funds rate missed its target by an average of 76 bp, including a hefty 150 bp miss on December 31. In retrospect, one might argue that the Federal Reserve should have supplied less liquidity; paradoxically, however, by purposely supplying excess liquidity, the Fed may have helped prevent a currency crisis.

# Interest Rates



- a. All yields are from constant-maturity series.  
 b. Weekly averages.  
 c. Monthly averages.

SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15.

The yield curve has moved upward and steepened since last month. The 3-month rate moved up 20 basis points (bp); the 5-year rate increased fully 49 bp. The 10-year, 3-month spread now stands at 109 bp, up from 85 bp last month. Traditional factors such as expected inflation and future real activity may be influencing the yield curve. In addition, the supply of some maturities is declining as the Treasury Department begins to retire debt.

A common question regarding the term structure of interest rates is

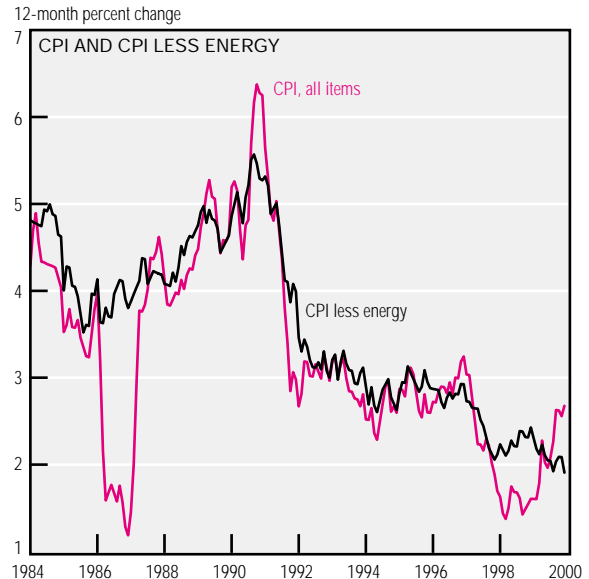
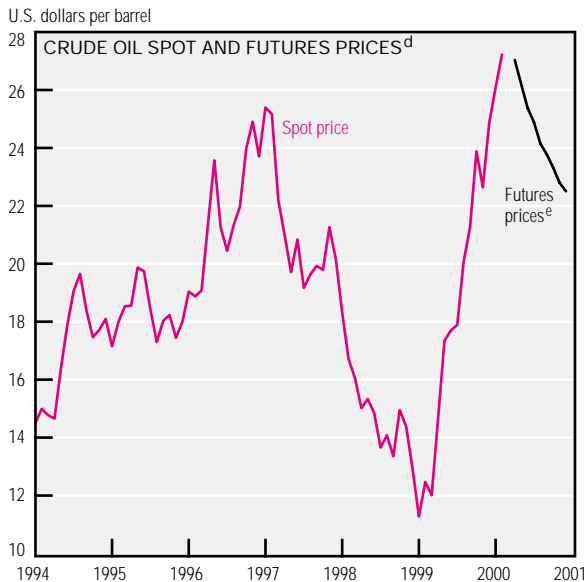
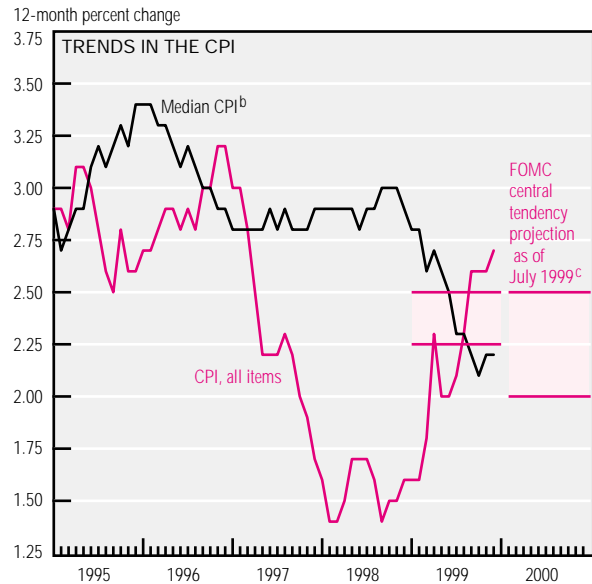
the extent to which implied forward rates predict future interest rates. This question arises from the expectations hypothesis of the term structure, which posits that long-term rates are the average of expected future short-term rates. A look at 1- and 2-year T-bond rates shows that the two move together closely. Plotting implied rates with actual rates apparently shows that a high implied rate reflects high current rates more often than it does high future rates. Extracting such information can be tricky, however, because interest rates have high serial correla-

tion—that is, high rates today generally imply high rates tomorrow.

Another approach is to look at changes: If the implied future rate exceeds the current rate, it predicts that the rate will increase. If the implied future rate is below the current rate, it predicts that the rate will decrease. Plotting the actual change against the predicted change indicates how well the prediction does. In the case of 1-year T-bill rates, the prediction works poorly. At this time horizon, at least, the expectations hypothesis does not do so well.

# Inflation and Prices

	Percent change, last:				1998 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>December Price Statistics</b>					
<b>Consumer prices</b>					
All items	2.9	2.2	2.7	2.4	1.6
Less food and energy	1.4	2.0	1.9	2.4	2.5
Median <sup>b</sup>	2.5	2.8	2.2	2.9	2.9
<b>Producer prices</b>					
Finished goods	3.6	1.5	3.0	1.3	-0.1
Less food and energy	1.6	1.6	0.9	1.3	2.5



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.

d. West Texas Intermediate crude oil.

e. As of January 31, 2000.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; Bloomberg Financial Information Services; and Dow Jones Energy Service.

Monthly inflation data continued to point higher at year's end, evidenced by a nearly 3% annualized rise in the Consumer Price Index (CPI) in December. For 1999 as a whole, the CPI rose 2.7%, more than a percentage point higher than its 1998 increase. Indeed, last year's CPI performance was about  $\frac{1}{4}$  percentage point above the upper end of the FOMC's projected growth range for 1999. However, the 1999 run-up in retail price growth does not appear to have been broad-based. The median CPI, which re-

duces the influence of extreme price movements, moderated in 1999 (up 2.2% compared to 2.9% in 1998).

Perhaps the single most influential price development in 1999 was the dramatic (140%) spike in crude oil prices, which greatly affected energy-related expenditures. Excluding energy items in the CPI, retail price increases were actually a bit lower last year than in 1998. The impact of energy costs on prices this year is still very uncertain. Higher energy costs will likely affect a broader range of consumer goods prices, at least temporarily. But a reading of the crude

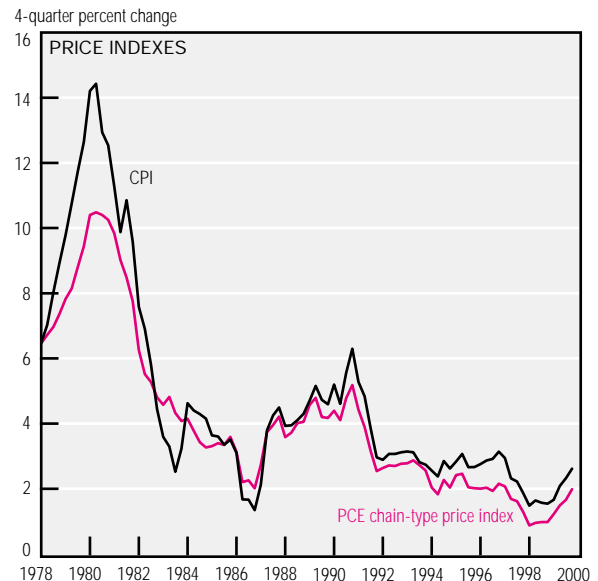
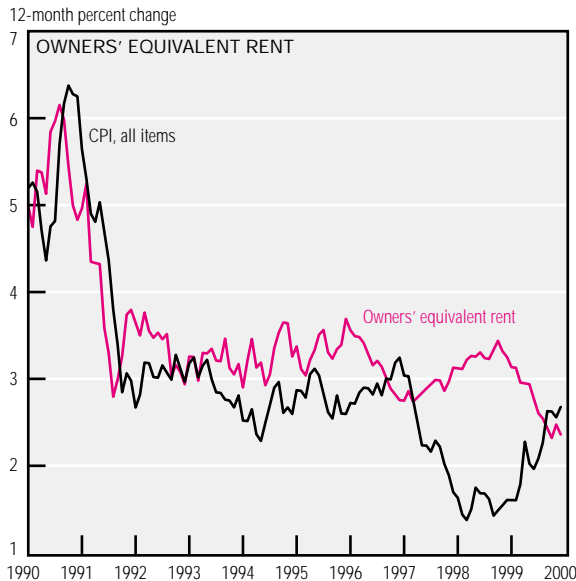
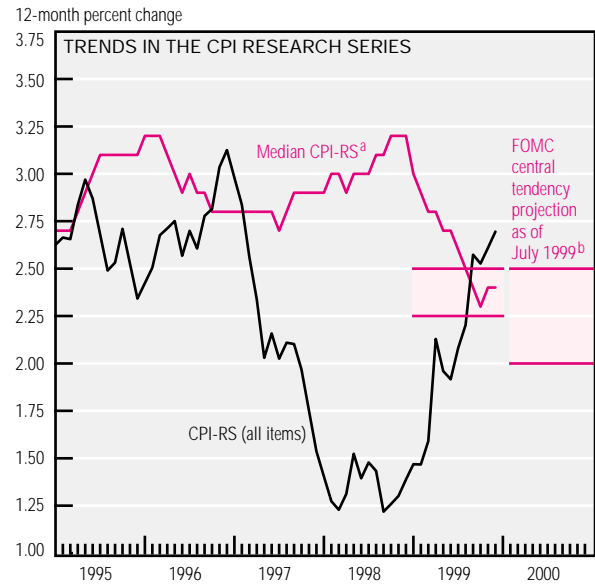
oil futures market suggests that these effects are likely to be short-lived, as investors have priced in a nearly 20% drop in crude oil costs over the course of 2000.

The CPI's behavior last year was also influenced by recent changes in its construction. Since 1978, 20 adjustments to the index have been made, including three major revisions to its market basket. At least six alterations have occurred in just the last three years, the cumulative impact of which is estimated to have

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## Inflation and Prices (cont.)

Effects of Recent Revisions on the CPI		
Components affected by methodology change	Year introduced	Effect on CPI growth rate (percentage points)
Generic prescription drugs	1995	-0.01
Food at home	1995	-0.04
Home ownership	1995	-0.10
Rent	1995	0.03
All items (store sample)	1996	-0.10
Hospital services	1997	-0.06
Personal computers	1998	-0.06
All items (updated market basket)	1998	-0.15
All items (averaging technique)	1999	-0.20
All items (item sample)	1999	-0.05
<b>Total</b>		<b>-0.74</b>



a. Calculated by the Federal Reserve Bank of Cleveland.

b. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.  
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Reserve Bank of Cleveland.

reduced the CPI growth rate by about 0.6 percentage point per year.

To better distinguish changes in the construction of the CPI from changes in actual inflation, the Bureau of Labor Statistics recently introduced the CPI Research Series—a retail price index dating back to 1978 that is based on current methodology. According to this measure, the recent 12-month trend in retail prices has reverted to its 1995–96 growth rate. A slightly different interpretation of the inflation trend is reflected in a methodologically consistent median CPI. According to this measure,

retail price increases are tracking about  $\frac{1}{2}$  percentage point under their 1995–96 average.

Recent changes in CPI methodology appear to have been motivated, in part, by growing criticism from government officials and economists. Chairman Alan Greenspan has been one critic of the index, most recently questioning the weights the index assigns to certain items. These weights are derived from survey data in which consumers may under-report spending on some items (like tobacco and alcohol) and over-report spending on other items,

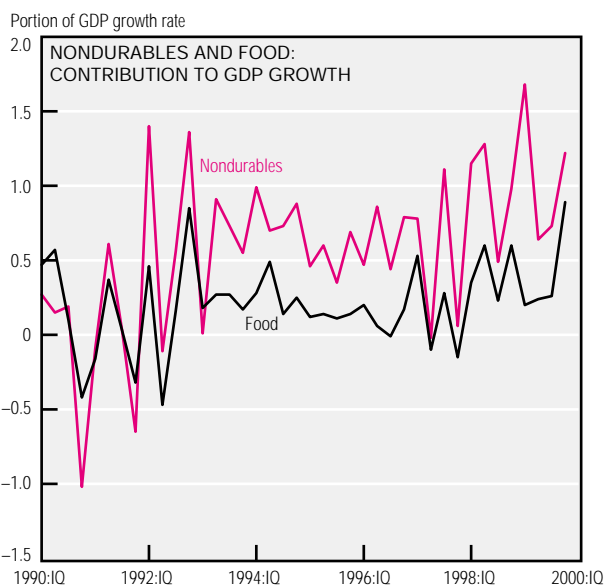
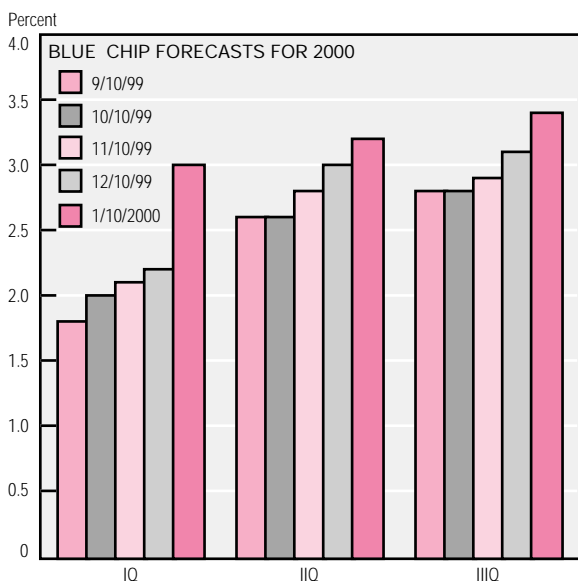
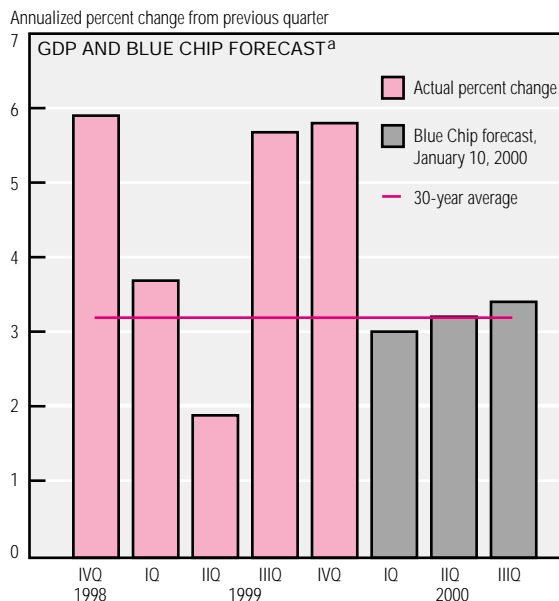
notably housing. This latter component was a major contributing force in the upward movement of the CPI between 1997 and 1998.

An alternative inflation measure, called the Chain-type Price Index for Personal Consumption Expenditures, is constructed by the Bureau of Economic Analysis based on the spending patterns reported by businesses. Because this index gives less weight to housing costs (among other methodological differences), it has tended to track about  $\frac{1}{2}$  percentage point below the CPI since 1994.



# Economic Activity

Real GDP and Components, 1999:IVQ <sup>a,b</sup> (Advance estimate)			
	Change, billions of 1996 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	126.3	5.8	4.2
Consumer spending	77.9	5.3	5.4
Durables	23.3	11.8	10.2
Nondurables	26.6	6.1	5.4
Services	30.0	3.5	4.5
Business fixed investment	7.6	2.5	7.0
Equipment	12.1	4.9	11.0
Structures	-3.3	-5.3	-5.0
Residential investment	-1.1	-1.2	3.1
Government spending	31.2	8.4	4.8
National defense	15.4	18.9	5.5
Net exports	-17.9	—	—
Exports	17.6	6.8	4.0
Imports	35.6	10.6	13.1
Change in private inventories	27.4	—	—



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*, January 10, 2000.

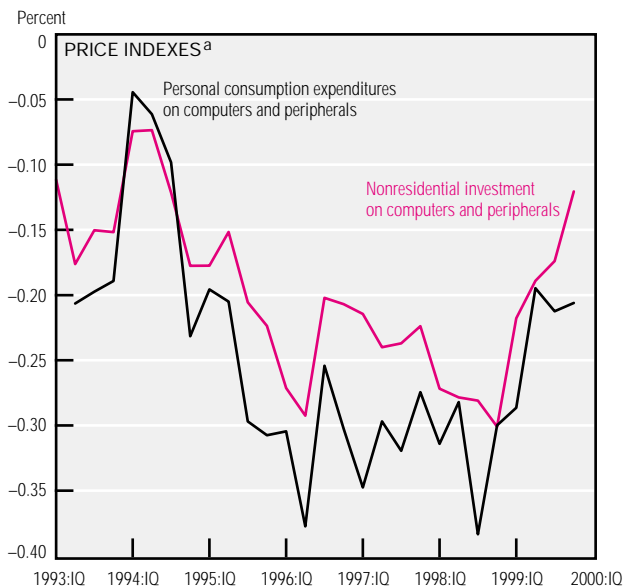
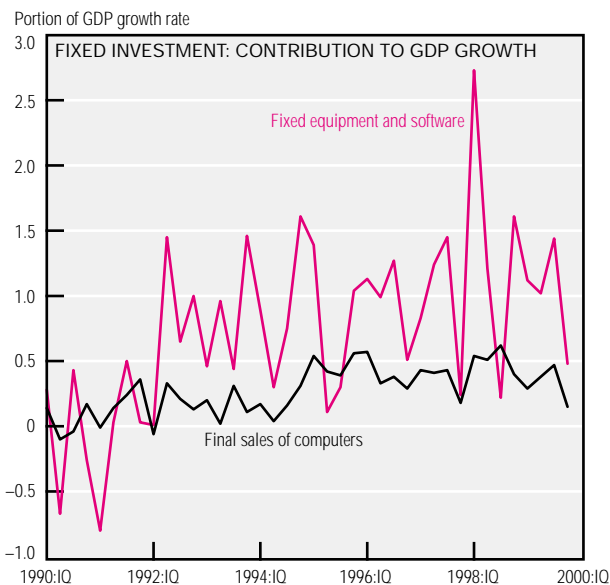
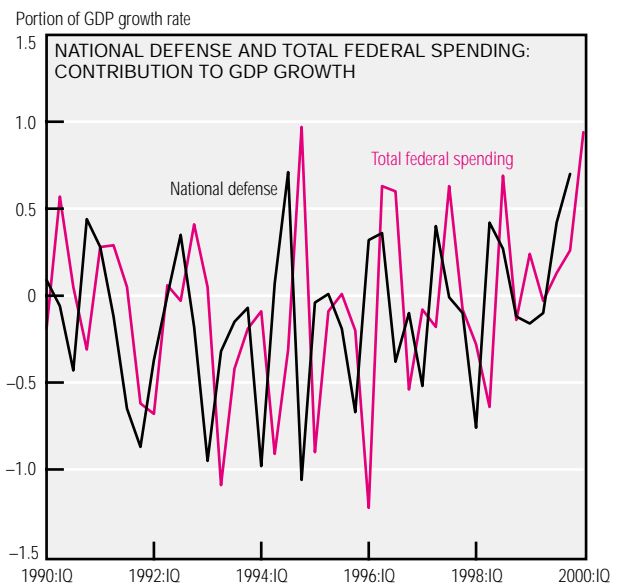
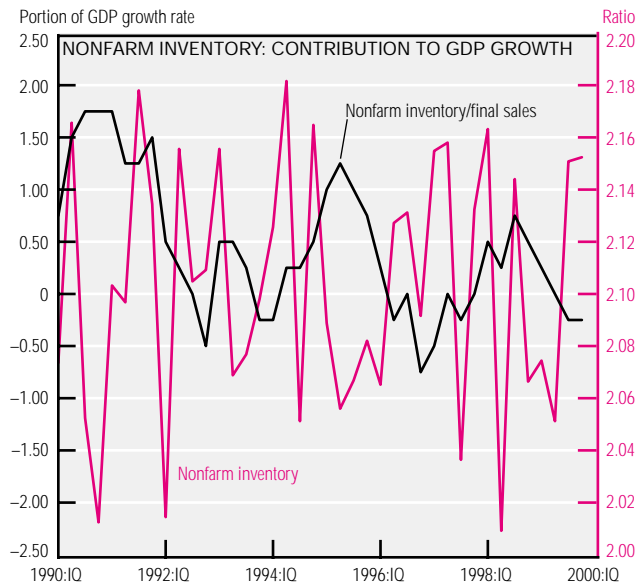
Gross domestic product (GDP) increased at a 5.8% annual rate in 1999:IVQ, according to the advance (first) estimate, released late in January. Most analysts were surprised at the strength of this measure of domestic real output, although many had raised their forecasts ahead of the release. Also, the back-to-back 5.7% and 5.8% growth rates of the past two quarters intensified the anxiety of those who suspect that, in this unprecedented ninth year of continuous economic expansion,

the U.S. economy might soon be pushing the unknown limits of non-inflationary output growth. Advance estimates often change significantly—upward or downward—as more complete information is incorporated into the preliminary and final estimates released over the succeeding two months. However, 90% of the time, changes fall within a range of -1.0 to +1.6 percentage points, so revisions are unlikely to alter the perception that strong economic growth persisted through the end of 1999.

Some of the apparent sources of GDP strength in 1999:IVQ are probably one-time events. In their absence, growth should ease off to a less sizzling pace in 2000, as forecasts now suggest. For example, the nondurable component of personal consumption expenditures, in which food plays a prominent part, is unlikely to continue contributing more than 1 percentage point to GDP growth rates. Likewise, inventory accumulation may not persistently

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## Economic Activity (cont.)



a. Annualized percent change.

NOTE: All data are seasonally adjusted.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

contribute more than 1¼ percentage points to growth as it has in the past two quarters, although the aggregate inventory/sales ratio does not seem particularly high. In addition, both defense and nondefense spending by the federal government happened to hit high quarterly levels, providing almost 1 percentage point of GDP growth.

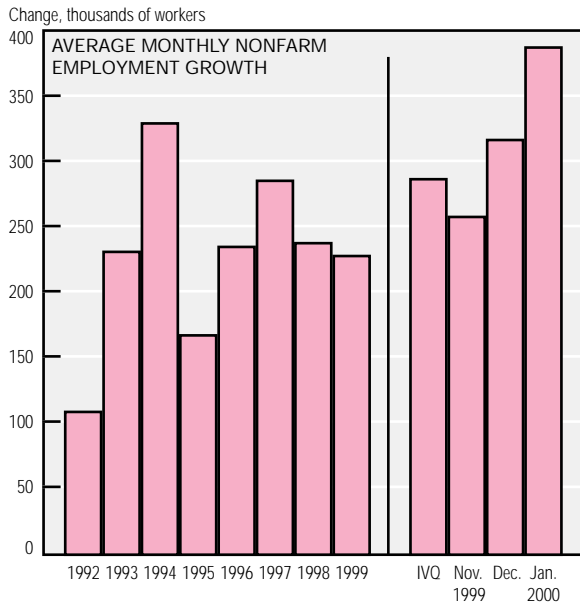
Of course, anomalies in other sectors of the economy may have dampened growth, and their reversal

will contribute to continued strength in 2000. Computer sales are a frequently cited example of this. Growth in personal consumption expenditures on computers and peripherals fell by half between the first and fourth quarters of 1999, although retail holiday spending on personal computers was reportedly very strong. Also, fixed investment expenditures on computers and peripherals weakened in 1999:IVQ, with businesses said to have post-

poned computer expenditures in order to focus on Y2K preparedness.

Firming price conditions also may have played a role. The price index for fixed investment in computers and peripherals declined at only a 12% annual rate in 1999:IVQ, less than half the rate of decline registered between 1994 and early 1999. A similar pattern is apparent for the analogous component of personal consumption expenditures.

# Labor Markets



	Average monthly change (thousands of employees)				
	1996	1997	1998	1999	Jan. 2000
Payroll employment	234	281	244	227	387
Goods-producing	32	48	8	-7	131
Mining	1	2	-3	-3	2
Construction	28	21	30	18	116
Manufacturing	3	25	-19	-21	13
Durable goods	10	27	-9	-10	10
Nondurable goods	-7	-2	-10	-11	3
Service-producing	202	233	235	233	256
TPU <sup>a</sup>	8	16	18	18	16
FIRE <sup>b</sup>	14	20	26	12	-9
Retail trade	43	24	32	38	43
Services	117	141	119	121	152
Government	11	17	27	29	35
Average for period (percent)					
Civilian unemployment	5.4	4.9	4.5	4.3	4.0



a. Transportation and public utilities  
 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.

Payroll employment continued to surge in January, recording a net increase of 387,000 jobs. The proportion of the population with jobs increased 0.4%, reaching a record 64.8%. The unemployment rate fell 0.1% to hit 4.0%, its lowest level since January 1970. Average hourly earnings rose 6 cents to \$13.50, a 3.5% increase since January 1999.

Buoyed by strong gains in construction, employment in the goods-producing sector, which had average monthly losses of 7,000 in 1999, increased 31,000 last month. Because

of unseasonably warm weather during the survey reference period, construction employment increased 116,000 in January. Employment growth in the goods-producing sector was not limited to construction, however; the manufacturing sector gained 13,000 jobs last month.

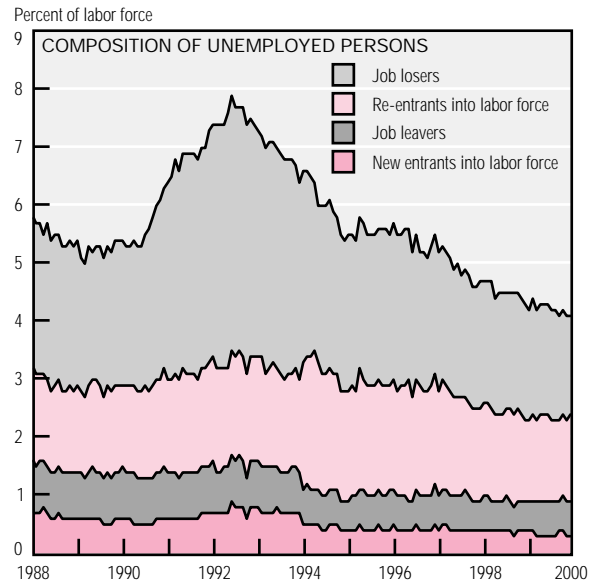
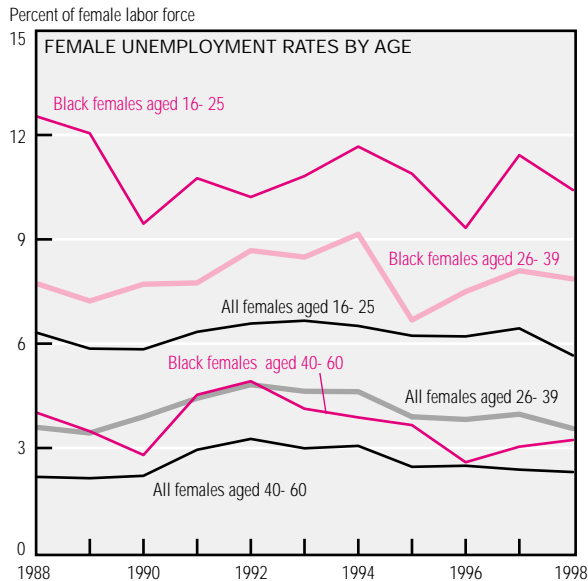
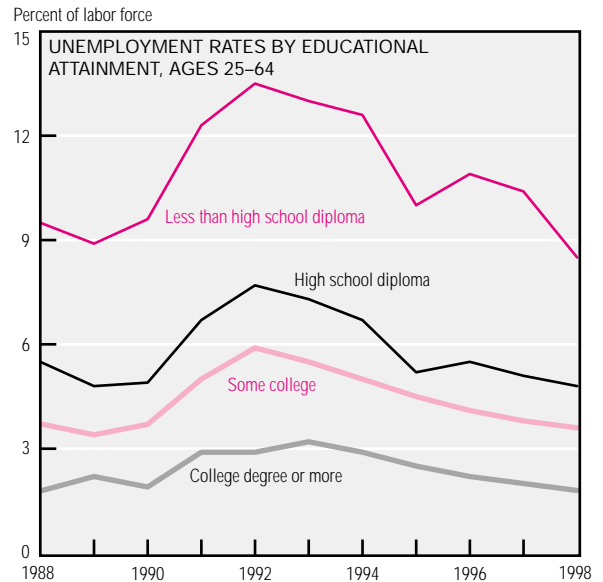
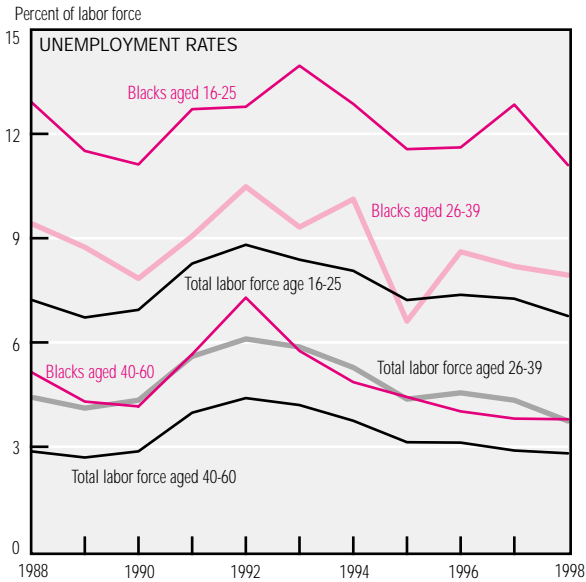
Rapid employment growth continued in the service-producing sector. Despite a significant drop in department store employment, there was a net increase of 43,000 jobs in retail trade. Following four months of stagnant growth, business

services also posted strong gains, adding 63,000 jobs in January.

Many analysts express increased concern about impending labor shortages. The tight labor market is reflected in the unemployment rate and in the pool of available workers, which has shrunk from about 16 million in 1992 to fewer than 10 million today. This count includes individuals aged 16 to 64 who are either unemployed or not in the labor force, but who report that they want jobs.

*(continued on next page)*

## Labor Markets (cont.)



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of U.S. Labor Statistics*; and Bureau of the Census, *Current Population Survey*.

The unemployment rate is at a 30-year low, but it varies with demographic factors like age, race, sex, and education. Young workers, who have less experience, predictably have much higher unemployment rates than older cohorts. Just as predictably, those with more education have significantly lower unemployment rates. In 1998, people who had not finished high school had quadruple the unemployment rate of those with four years of college or more. Females

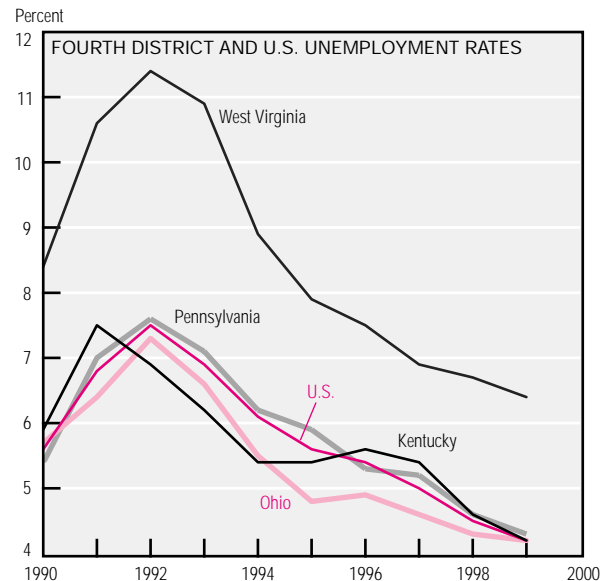
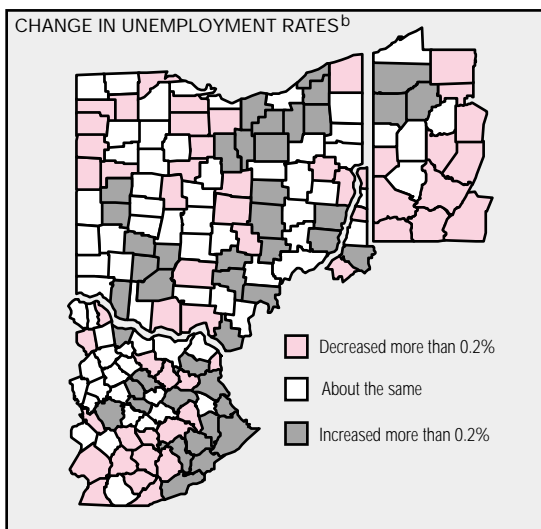
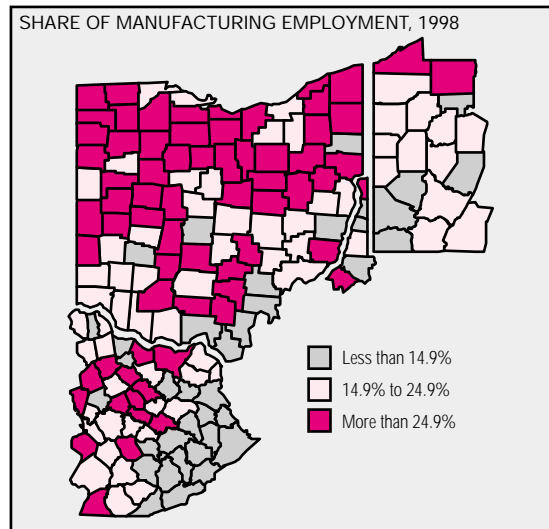
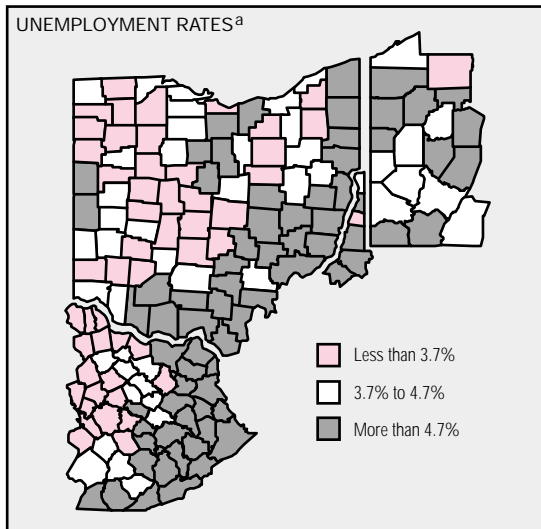
have slightly lower unemployment rates than males, while whites have significantly lower rates than African Americans.

The *unemployment rate* is the number of unemployed as a percent of the civilian labor force. The *unemployed* are those who were available for—and made specific efforts to find—work in the four weeks prior to the monthly survey. Persons *not in the labor force* include those 16 years and older who are in school, retired, unable to work (due to conditions like

disability or illness), homemakers, and *workers marginally attached to the labor force*. People in the last category, who totaled 1.2 million in January, are available for work and have sought it in the prior 12 months. Marginally attached workers are not counted in the labor force, so they do not affect the unemployment rate.

Unemployment fell during the 1990s, primarily because the number of people who lost jobs decreased steadily from 1992 onward.

## Employment in the Fourth District



a. Average for August through October 1999.

b. Difference between 1998 and 1999 averages for August through October.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Ohio Bureau of Employment Services; Kentucky Department for Employment Services; Pennsylvania Department of Labor and Industry; and West Virginia Bureau of Employment Programs.

Recent Fourth District unemployment rates show a distinct geographic pattern. Unemployment in the District's southern and eastern counties generally exceeds the national average of 4.2%, while counties in the north and west have below-average rates. This may be related to shares of manufacturing employment, which follow roughly the opposite pattern. Counties in the south and east of the District tend to have lower shares of manufacturing employment (manufacturing calculated as a percent of total

employment) than counties in the north and west.

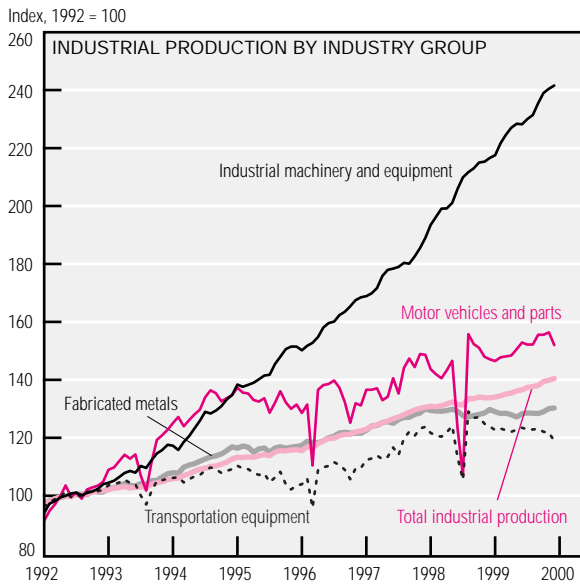
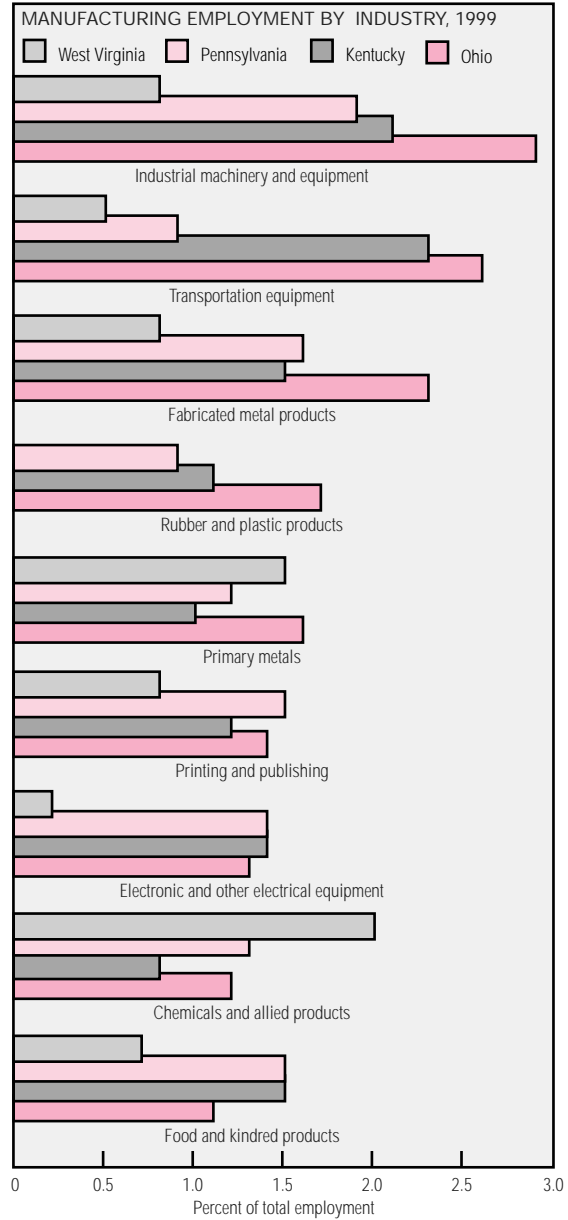
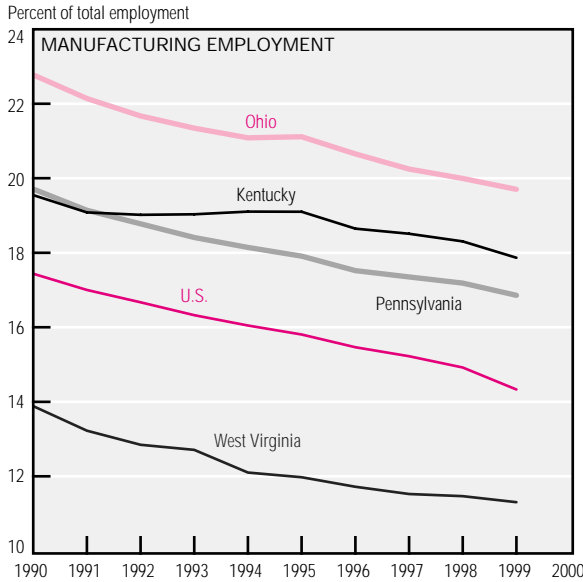
The greatest variance in unemployment rates was seen in Kentucky, which had the lowest—as well as the highest—county unemployment rate in the District. The Lexington suburbs of Jessamine and Woodford counties both had an extremely low unemployment rate (1.6%). The highest unemployment rate (12.9%) was in Harlan County, located in the Appalachian Mountains along the Virginia border.

For unemployment rate changes,

the geographic pattern is less clear. In counties where unemployment rates are currently low, there was not much change from the previous year. The largest changes, both negative and positive, were posted in counties that currently have high unemployment rates. The largest decrease occurred in Mercer County, Ohio, while the largest increase was seen in Letcher County, Kentucky.

Throughout the 1990s, unemployment rates for Kentucky, Ohio, and Pennsylvania were fairly close to the *(continued on next page)*

# Employment in the Fourth District (cont.)



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

national average. In 1999, these rates converged at about 4.2%. West Virginia's unemployment rate remains significantly higher (about 6.4%). However, from its peak in the early 1990s, West Virginia's rate has fallen by a much higher amount than rates in other Fourth District states.

The majority of the District's counties have manufacturing shares that far exceed the U.S. average of 14.9%. (As we have seen, most of the counties with below-average manufacturing shares are in southern Ohio and eastern Kentucky.)

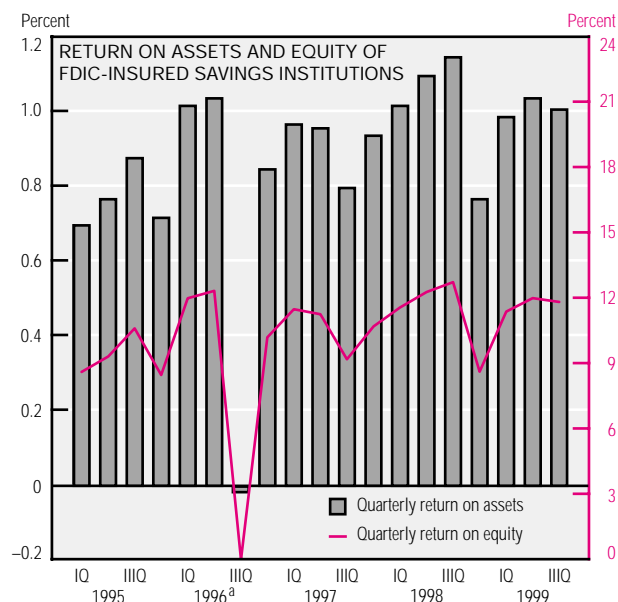
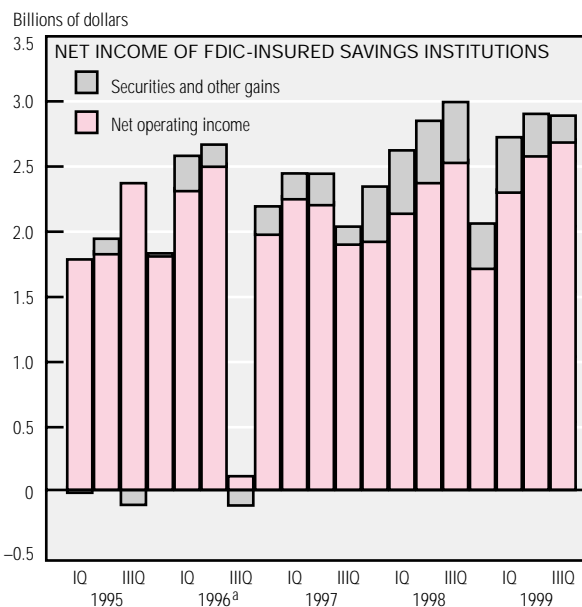
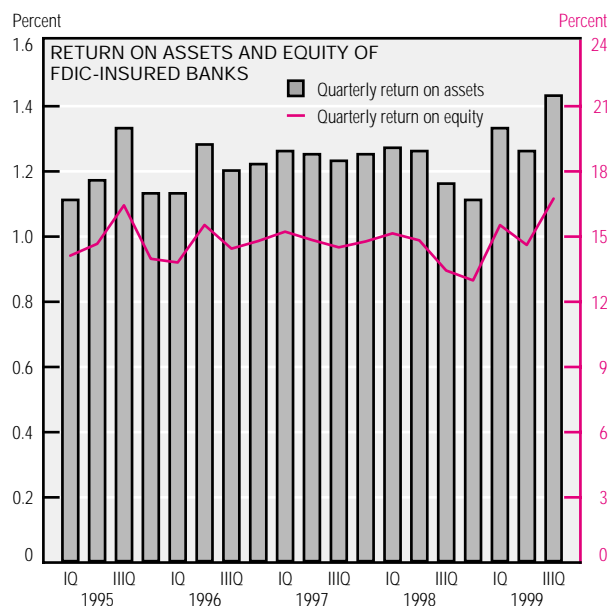
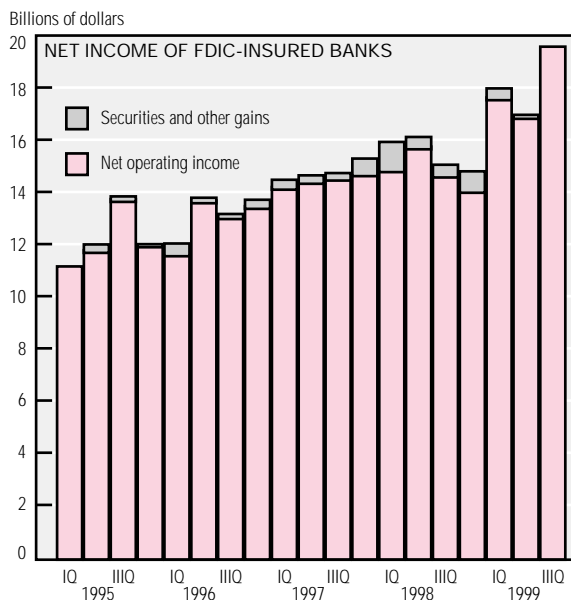
The largest shares of manufacturing employment are found in Union County, Ohio, and Scott County, Kentucky (both about 54%). Each of these counties is home to an automobile assembly plant.

During the 1990s, the manufacturing share of employment declined in every Fourth District state, which was consistent with the national trend. Only West Virginia has a share that lags the national average.

The largest proportions of Fourth District manufacturing workers are employed in the production of in-

dustrial machinery, transportation equipment, and fabricated metals. The production of industrial machinery has grown more than twice as fast as total industrial production since 1992, while that of transportation equipment and fabricated metals has grown a bit more slowly than total industrial production. However, growth in the production of motor vehicles and parts, which makes up the bulk of the Fourth District's transportation equipment industry, has proceeded at a faster rate than total industrial production.

## Earnings of Banks and Savings Institutions



a. The sharp decline in 1996 was driven in part by a special insurance assessment on the deposits of savings institutions.

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

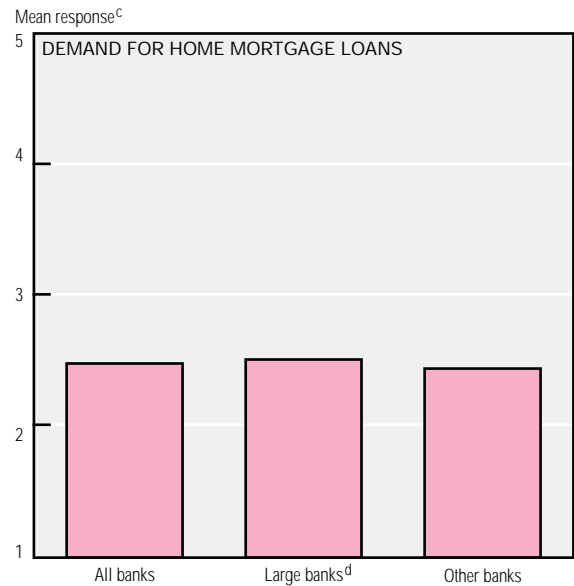
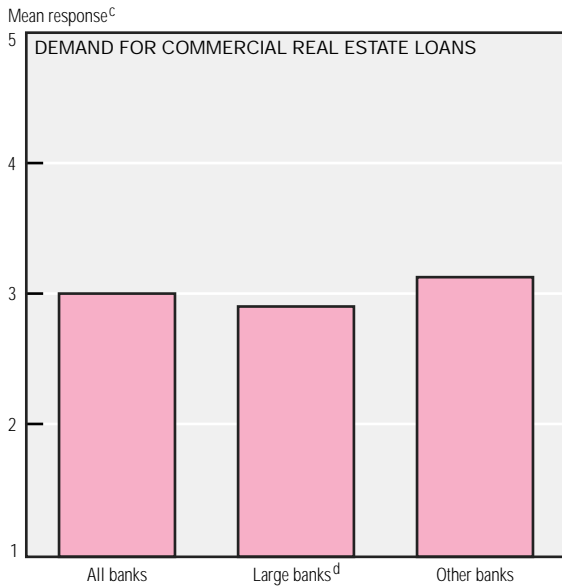
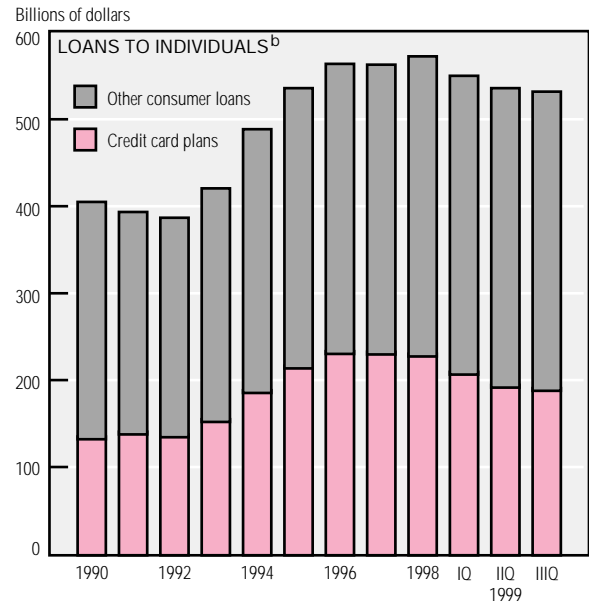
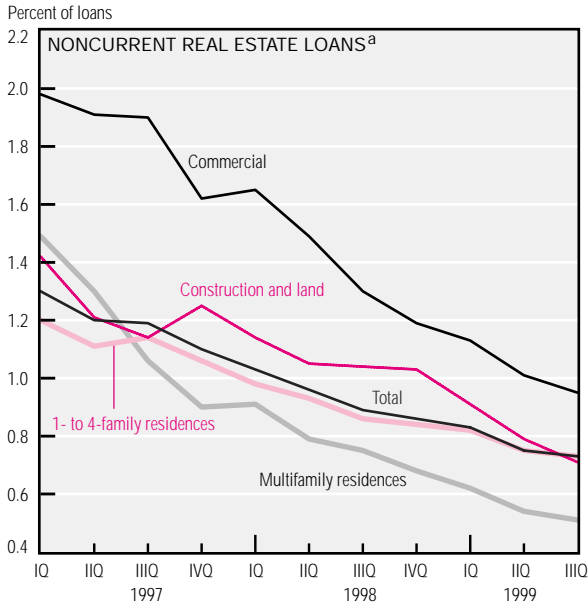
Third-quarter earnings for FDIC-insured commercial banks reached record levels. For 1999:IIIQ, commercial banks' net income rose to \$19.4 billion, surpassing the previous quarterly record of \$18.0 billion, set in 1999:IQ. Third-quarter profits were \$4.4 billion stronger than the previous quarter. The FDIC attributes the rise in profits to strong revenues in noninterest income and to containment of overhead expenses,

resulting in the best efficiency ratio on record for banks.

For the third quarter of 1999, both the average return on assets (ROA) and the rate of return on equity reached record levels (1.42% and 16.62%, respectively). The largest banks experienced the most dramatic improvements in profitability. However, nearly two-thirds of all banks reported ROAs exceeding 1% for the quarter.

FDIC-insured savings institutions reported slightly lower earnings in 1999:IIIQ; the decrease is attributed to reduced gains from securities sales. Savings institutions recorded a third-quarter ROA of 1%, down from the record 1.14% reported a year ago. Nonetheless, approximately 60% of savings institutions experienced increases in earnings over a year ago, and nearly one-third reported ROAs of more than 1%.

# Real Estate Loans



a. Noncurrent loans represent the percent of loans in each category that are past due 90 days or more or are in nonaccrual status.  
 b. As of December for each year except 1999; data for 1999 are quarterly.  
 c. Mean response of banks where 1 = substantially weaker; 2 = moderately weaker; 3 = about the same; 4 = moderately stronger; and 5 = substantially stronger.  
 d. Total domestic assets of \$20 billion or more.  
 SOURCES: Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Lending Practices*; and Federal Deposit Insurance Corporation, *Quarterly Banking Profile*.

The continued downward trend in noncurrent real estate loans is another indication of health in the banking system. However, noncurrent loans of all types witnessed a minor increase (from 0.94% in the second quarter of 1999 to 0.96% in the third quarter). Total assets in the banking system grew at the slowest

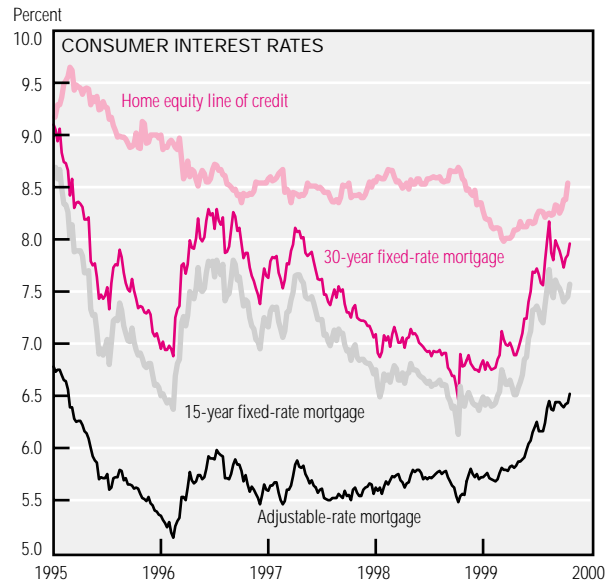
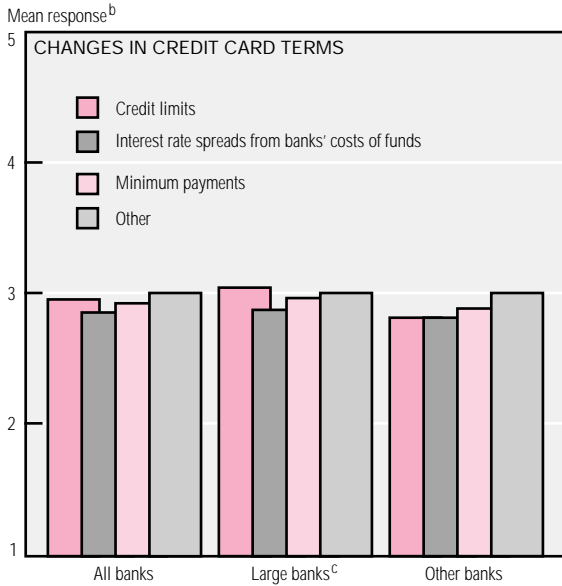
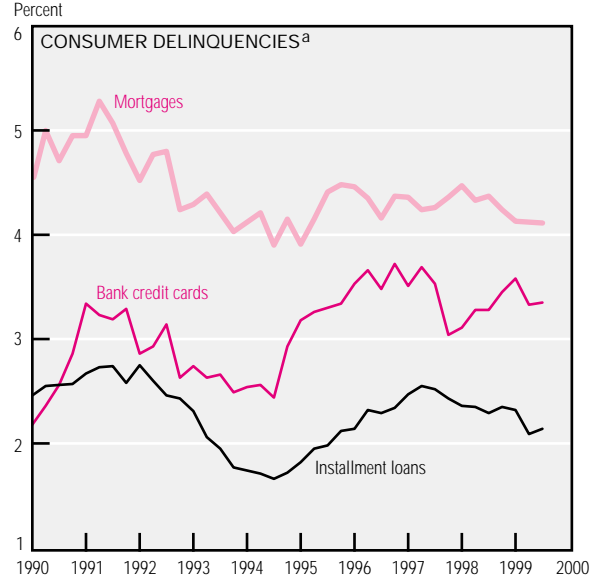
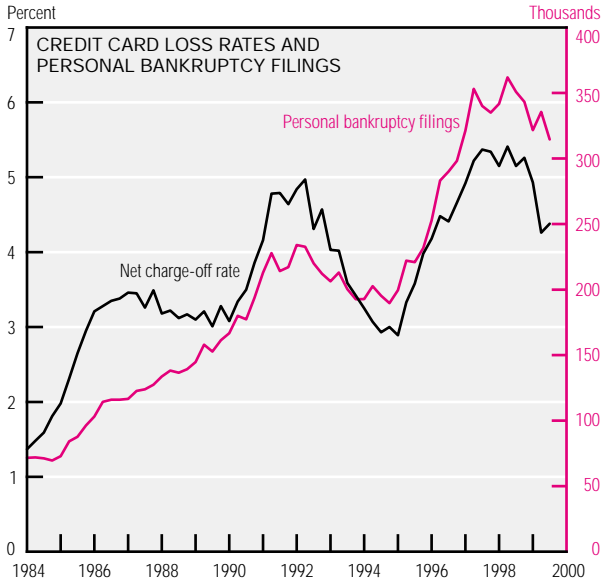
rate reported in five years. Although total loans to individuals fell for the third straight quarter, commercial real estate loans rose slightly.

The Federal Reserve's quarterly *Senior Loan Officer Opinion Survey*, updated in November, substantiates these findings. Loan officers indicated little change in demand for

commercial real estate loans, but reported a slight decrease in the demand for home mortgage loans. This represents the second consecutive quarter in which loan officers reported a softening of home mortgage loan demand. Loan officers also indicated a moderate weakening of demand for consumer loans.



# Household Financial Conditions



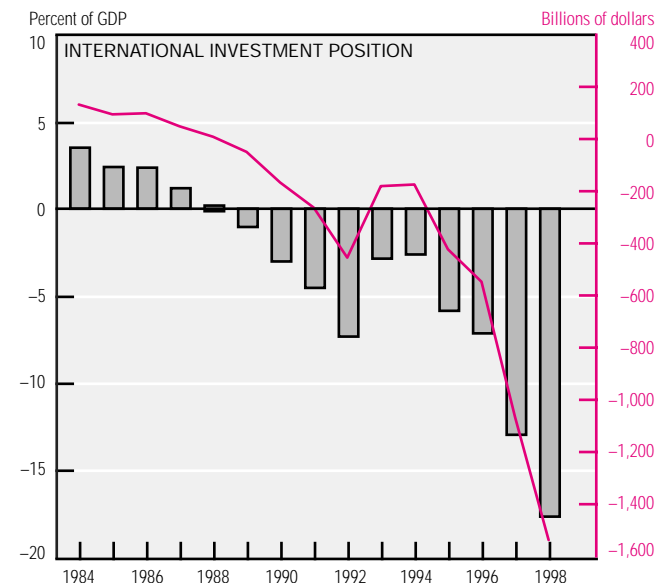
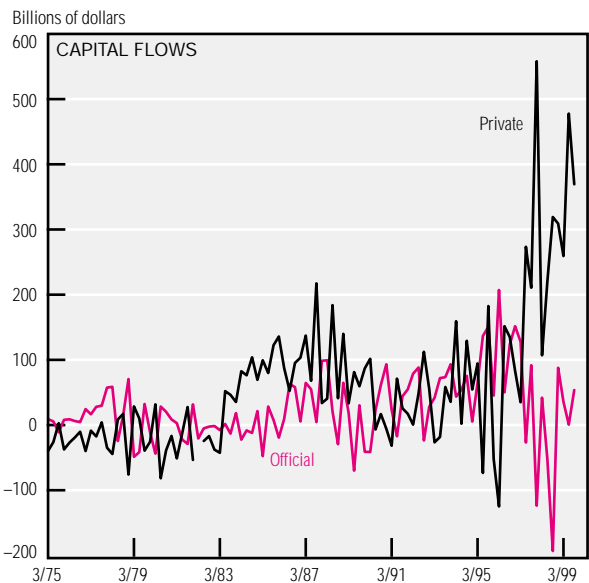
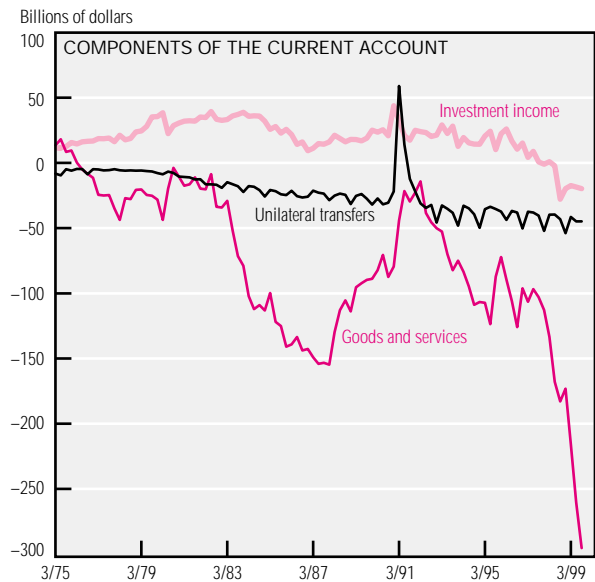
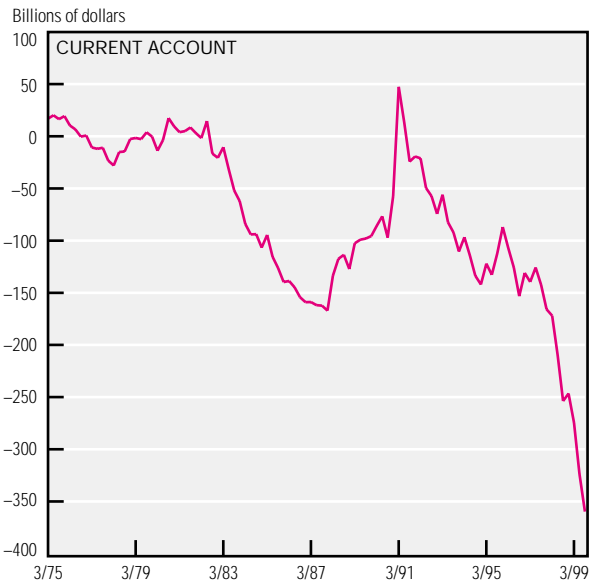
a. Loans past due 30 days or more as a percentage of loans outstanding.  
 b. Mean response of banks where 1 = substantially weaker; 2 = moderately weaker; 3 = about the same; 4 = moderately stronger; and 5 = substantially stronger.  
 c. Total domestic assets of \$20 billion or more.  
 SOURCES: Board of Governors of the Federal Reserve System, *Senior Loan Officer Opinion Survey on Lending Practices*; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*; American Bankers Association, *Consumer Credit Delinquency Bulletin*; Mortgage Bankers Association of America, *National Delinquency Survey*; and *Bank Rate Monitor*.

Household financial indicators show little change compared to previous months. Personal bankruptcy filings declined slightly, dropping 21,014 to 314,564, while credit card loss rates increased somewhat to 4.38%. Consumer delinquencies on bank credit cards and installment loans scarcely increased. Late payments on mortgage loans showed no change from previous figures.

Bank loan officers indicated a minor tightening in the credit card terms offered to customers. Credit limits remained steady at large banks and tightened slightly at other banks. Minimum payments on credit cards displayed a minor increase. Interest rates increased slightly relative to the cost of funds at all reporting banks. During the last few weeks of 1999, interest rates on home mortgages

continued the upward trend seen throughout 1999. The overall increase during 1999 in 15- and 30-year home mortgage rates was approximately 130 basis points (bp). During the same period, one-year adjustable-rate mortgages increased approximately 100 bp, whereas interest rates on home equity lines of credit rose nearly 50 bp.

# The Current-Account Deficit



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The U.S. current-account deficit has increased sharply since 1997 and is likely to top \$360 billion (approximately 3.5% of GDP) when final data for 1999 become available. Most economists expect the deficit to rise further this year and next.

For the most part, the deficit in the U.S. current account moves in tandem with the deficit in our country's goods and services trade, but a growing shortfall in our net investment income could quickly become

another important element. This shortfall results from the financing of trade deficits.

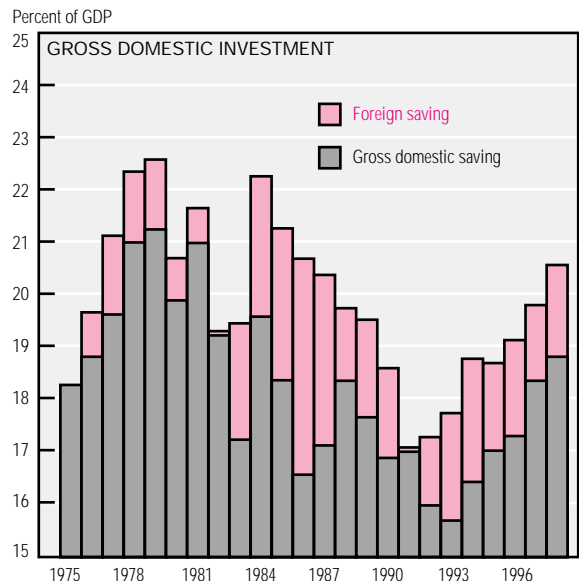
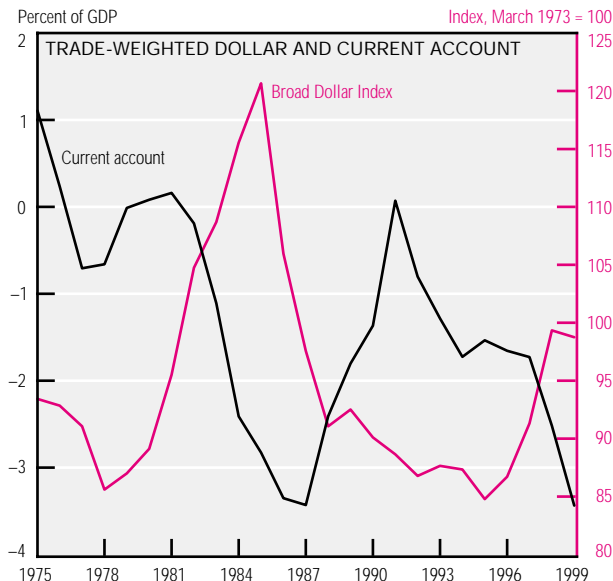
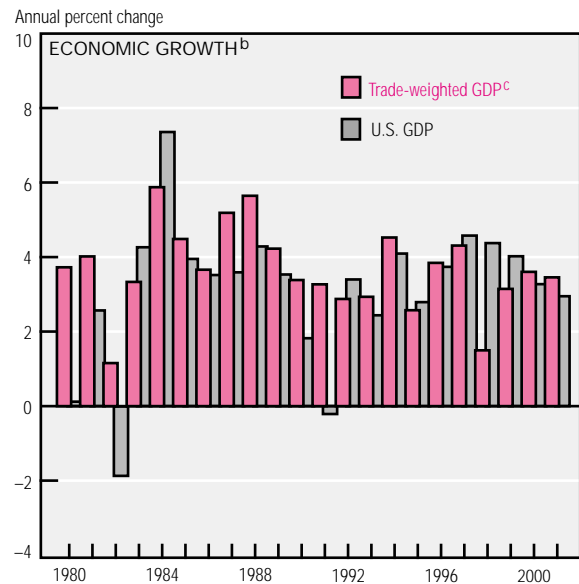
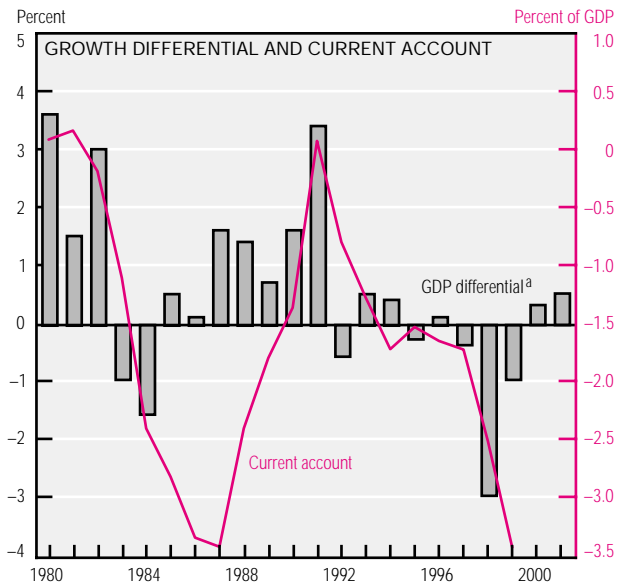
The U.S. has been importing more than it exports and has been paying for the surfeit by issuing securities, such as bonds and stocks, that give foreigners a claim on our future income. The process requires an inflow of foreign capital to the U.S. Since 1997, private—rather than official—capital inflows have risen dramatically. In 1988, foreign

claims on the U.S. exceeded this country's claims on foreigners, making ours a debtor country. By the end of 1998, our international indebtedness totaled \$1.5 trillion (17.5% of GDP).

As our indebtedness grew, so did our interest and dividend payments to foreigners. By 1997, they exceeded U.S. earnings from foreign investments, creating a shortfall in the investment-income component of

*(continued on next page)*

## The Current-Account Deficit (cont.)



a. The GDP differential equals the difference between foreign and U.S. GDP growth.

b. Projections for 1999–2001 utilize various sources.

c. The top 15 U.S. trading partners in 1992–97 were Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, Netherlands, and Brazil.

d. Gross domestic investment is the sum of gross domestic saving and foreign saving.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; *Blue Chip Economic Indicators*, January 10, 2000; and *The Economist*, January 21–27, 2000.

the current account. If interest payments on our foreign indebtedness were to exceed GDP growth, our international indebtedness would grow even if the trade deficit vanished.

Prospects for narrowing the trade deficit depend, in large measure, on our major trading partners' prospects for economic growth. Economists expect foreign economic growth, at approximately 3.5%, to outpace U.S. growth next year. Although rapid foreign eco-

nomical growth favors U.S. export expansion, the small differential will have little effect on the current-account deficit overall. Typically, foreign economic growth must exceed U.S. growth by 1½ to 2 percentage points before the trade deficit begins to narrow. There is no such growth differential in the immediate outlook.

Most people consider the current-account deficit detrimental to economic welfare, but they fail to appre-

ciate the benefits of the associated foreign-capital inflow. Since the early 1990s, the inflow of foreign capital to the U.S. has helped finance an investment boom, with interest rates below what they otherwise might have been. The ratio of investment to GDP has risen from 17.5% to 20.3%. To the extent that this investment increase supports a higher standard of living, the U.S. will be able to service its international debts without reducing consumption.