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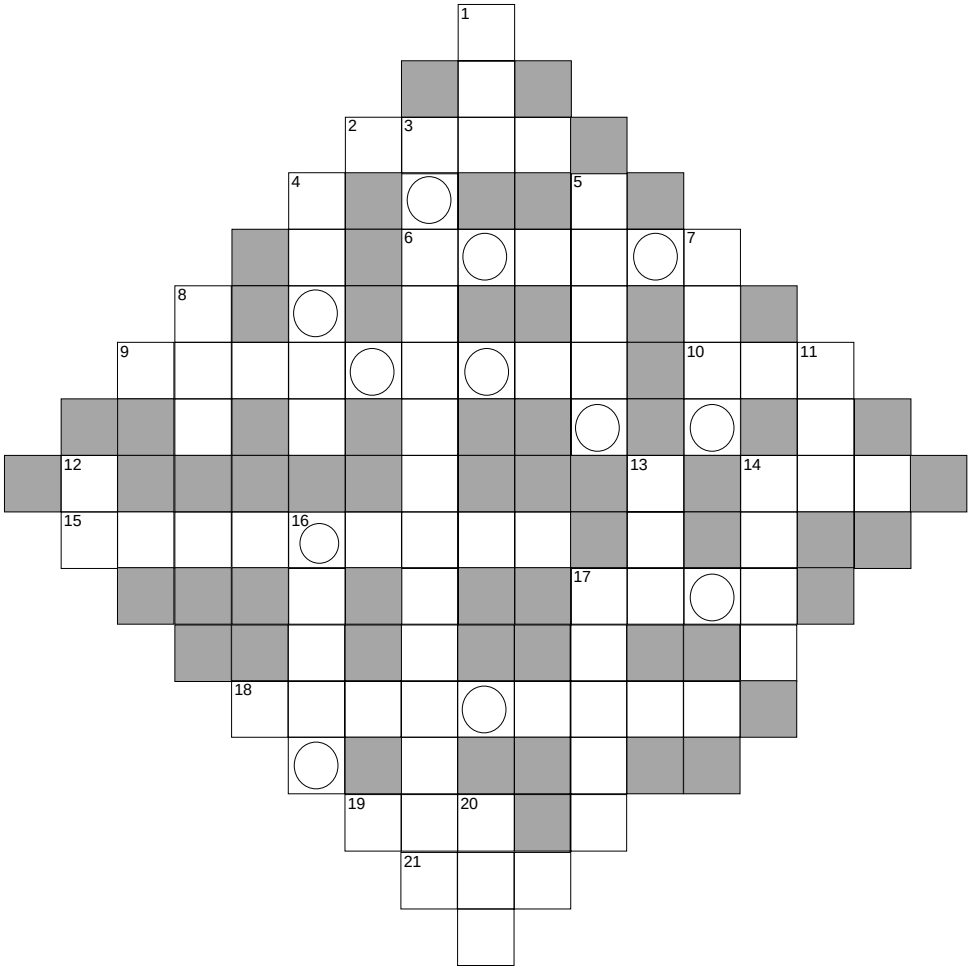
The Economy in Perspective



SOLUTION: ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___

This puzzle is designed to help our readers test their economics I.Q. as they lounge in a hammock or lie on the beach. After completing the puzzle, unscramble the circled letters to identify the economist of the season. Answers will appear on our Web site at **www.clev.frb.org** and in next month's issue.

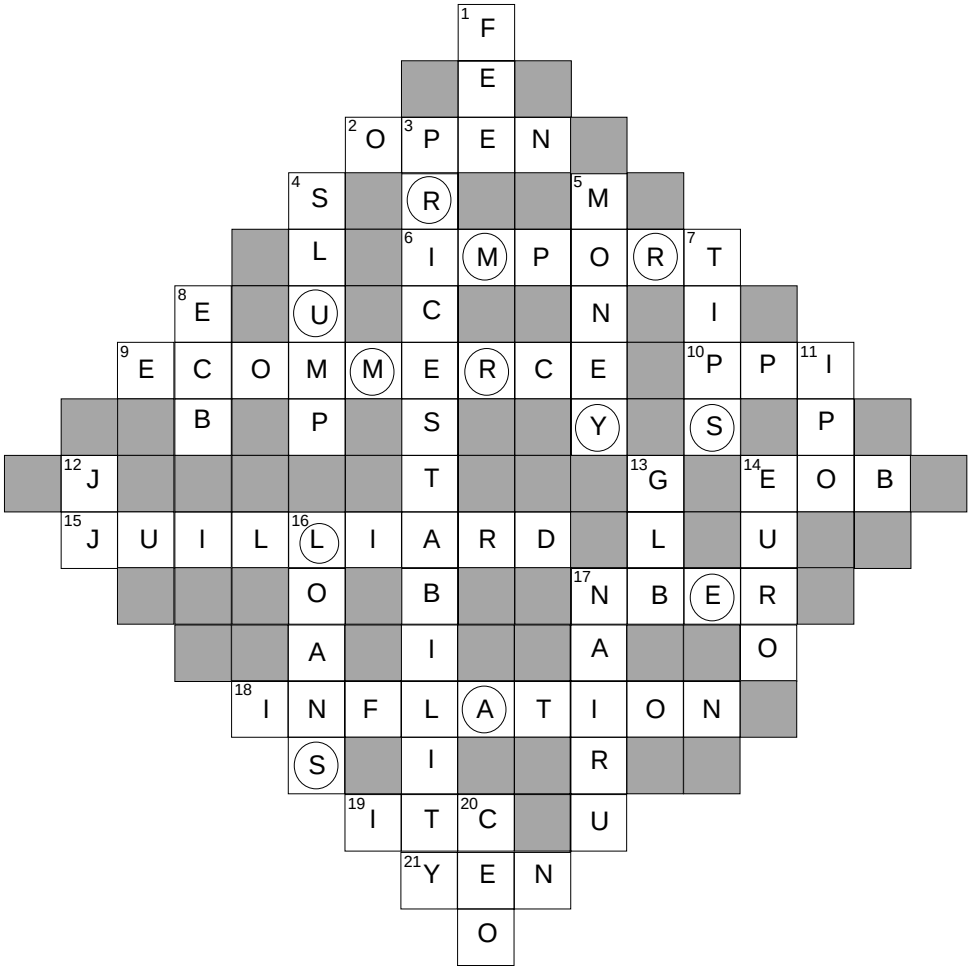
Across

2 Trade agreements do this to borders
6 Obtain from abroad
9 Business on the Net
10 Measures wholesale prices (abbr.)
14 Old Lady of Threadneedle Street, backwards (abbr.)
15 Greenspan alma mater
17 Official arbiter of business cycles (abbr.)
18 Declining purchasing power of money
19 Adjudicates dumping accusations (abbr.)
21 Currency, in Kyoto

Down

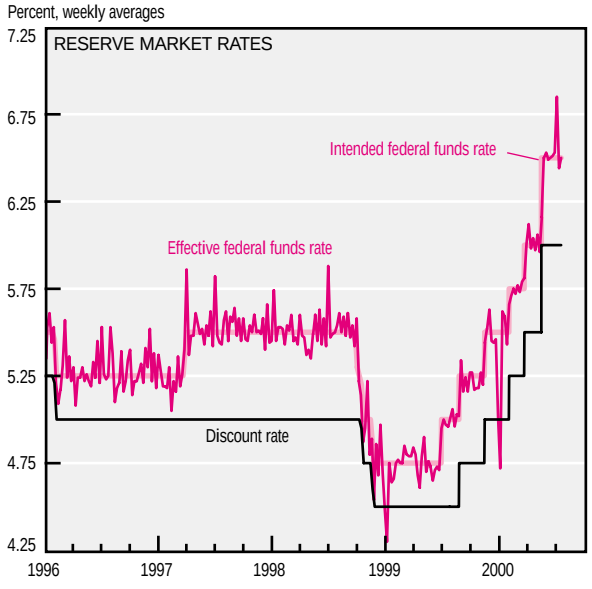
1 Banks want more revenue of this type
3 Prime goal of every central bank
4 Condition describing Japanese economy
5 Too much of this causes 18 across
7 Buying these protects against 18 across (abbr.)
8 The Fed, in Frankfurt (abbr.)
11 A coming out, of sorts (abbr.)
12 Represents Fourth District on FOMC (init.)
13 Sponsors of financial reform law (abbr.)
14 Currency, on the Continent
16 Bankers say the worst of these are made in the best of times
17 Hypothesized link between unemployment and inflation (abbr.)
20 Top dog (abbr.)

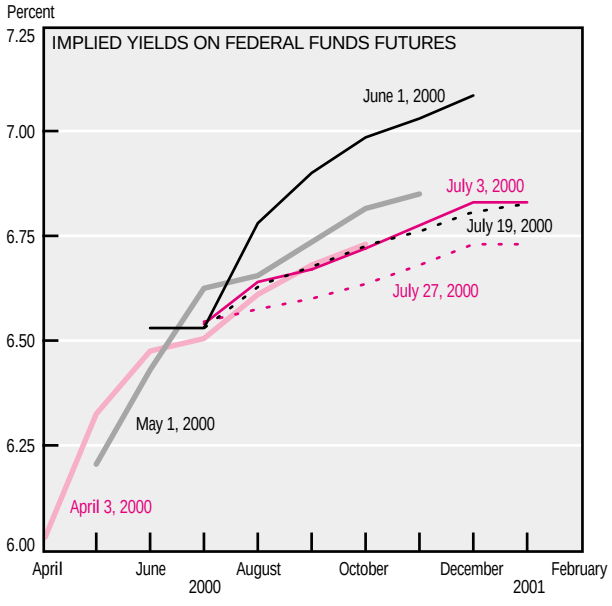
Answers to August 2000 Economic Trends Puzzle



SOLUTION: L A R R Y S U M M E R S

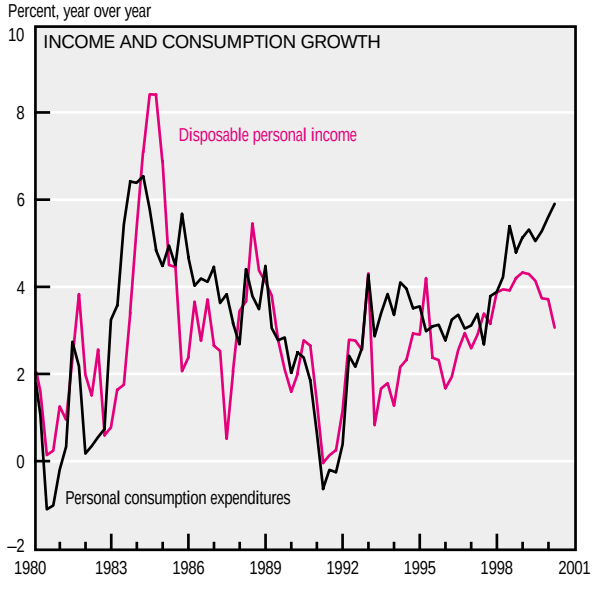
Monetary Policy





Economic Projections, 2000 and 2001 (percent)[a]

	Federal Reserve governors and Reserve Bank presidents		Administration
	2000		
	Range	Central tendency	
Nominal GDP	6.00–7.25	6.25–6.75	6.0
Real GDP[b]	3.75–5.00	4.00–4.50	3.9
PCE prices	2.00–2.75	2.50–2.75	3.2
Civilian unemployment	4.00–4.25	About 4	4.1[c]
	2001		
	Range	Central tendency	
Nominal GDP	5.00–6.25	5.50–6.00	5.3
Real GDP[b]	2.50–4.00	3.25–3.75	3.2
PCE prices	1.75–3.00	2.00–2.50	2.5
Civilian unemployment	4.00–4.50	4.00–4.25	4.2[c]



a. Civilian unemployment rate projection is the average level for the fourth quarter. All other projections are percent changes, fourth quarter over fourth quarter.
b. Chain-weighted.
c. Projection is for the Consumer Price Index.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress; and Chicago Board of Trade.

After the Federal Open Market Committee (FOMC) decided in June to leave the intended federal funds rate unchanged, and a subsequent data release showed that the economy may be slowing, market participants lowered their expectation that the rate would be increased at the FOMC's August 22 meeting. On June 1, the August contract was trading 28 basis points (bp) above the current federal funds target rate of 6.5%, indicating that market participants considered a rate increase likely. By July 3, the implied yield on the August contract had dropped to 6.64%, 14 bp above the target rate; it hovered near there until July 20, when FOMC Chairman Alan Greenspan appeared before Congress. As of July 27, the August contract was trading at 6.58%, only 8 bp above the target rate.

In past years, Chairman Greenspan has appeared before Congress every February and July to testify on the state of the American economy and the outlook for monetary policy, as mandated by the Full Employment and Balanced Growth Act of 1978. That legislation (also called the Humphrey–Hawkins Act, after its sponsors) has expired; however, Mr. Greenspan continues to provide biannual briefings and the Board of Governors' Monetary Policy Report to the Congress. The first such briefing since the expiration of Humphrey–Hawkins occurred, much as before, on July 20.

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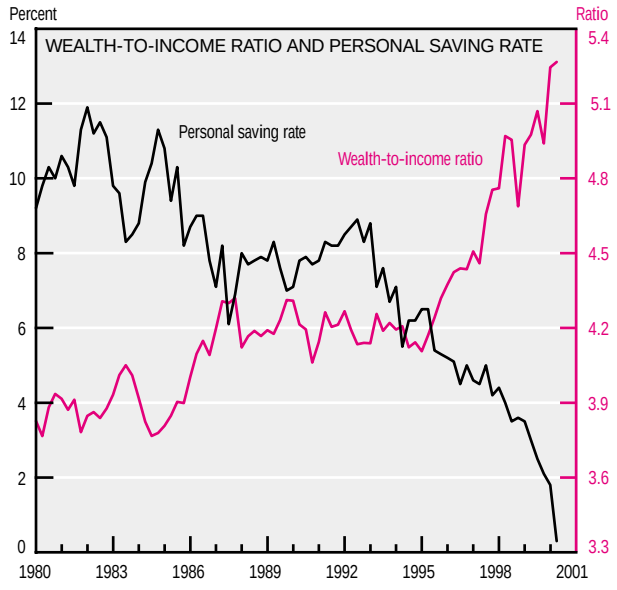
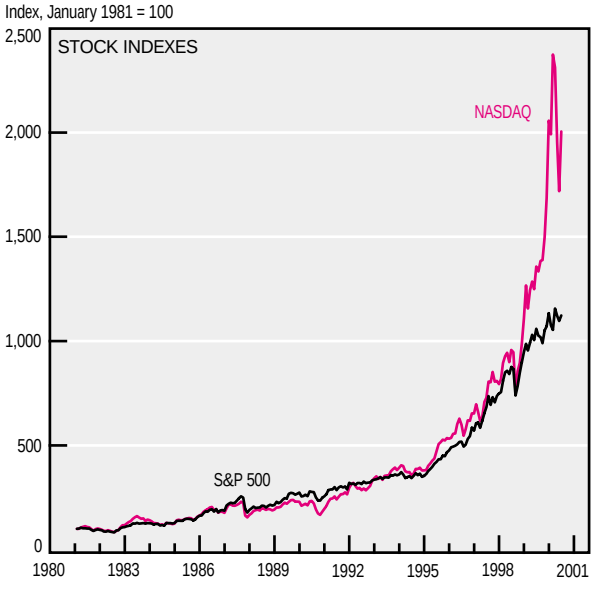
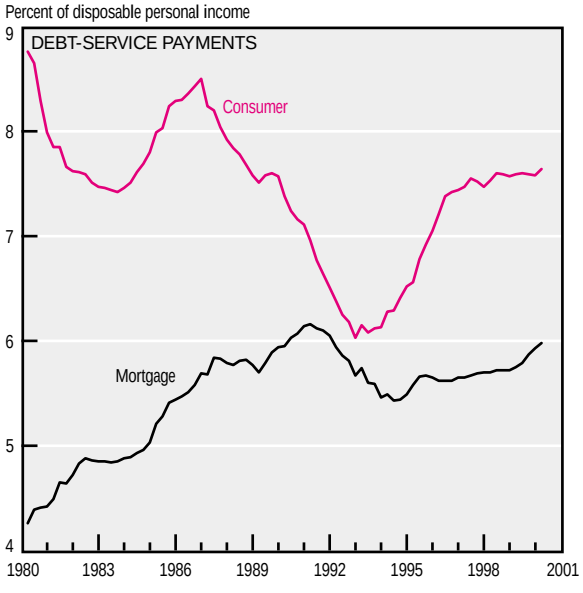
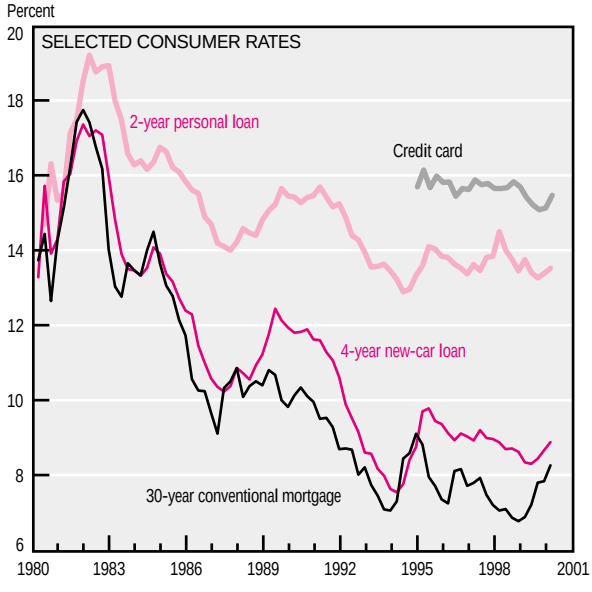
Monetary Policy (cont.)









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

The report contains the Board of Governors' and Federal Reserve Bank presidents' economic projections for 2000 and 2001. The central tendency of projections for real GDP growth in 2000 was revised from 3½–3¾% in the February report to 4–4½%. Similarly, the central tendency for inflation (as measured by the Chain-Type Price Index for personal consumption expenditures) increased from 1¾–2% to 2–2¾%. The projection of the fourth-quarter unemployment rate (about 4%) did not change significantly. Projections for 2001 show a decrease in the growth rates of GDP and inflation and a very slight increase in the unemployment rate.

Proponents of the prevailing market view—that the current rate of real growth is unsustainable and ultimately inflationary—may welcome a slowdown. Several economic indicators had given cause for concern. The growth rate of personal consumption expenditures had exceeded that of disposable personal income. In other words, consumers' earnings increased, but their spending increased even faster. Even as the personal saving rate was declining, the wealth-to-income ratio was rising; this fueled fears that the so-called wealth effect could create disruptive imbalances. Recently, the stock market's growth has slowed, which should diminish the wealth effect. Furthermore, rising consumer interest rates have increased the cost of servicing debt, making it less attractive to finance current consumption through borrowing. In fact, recently released figures reveal that

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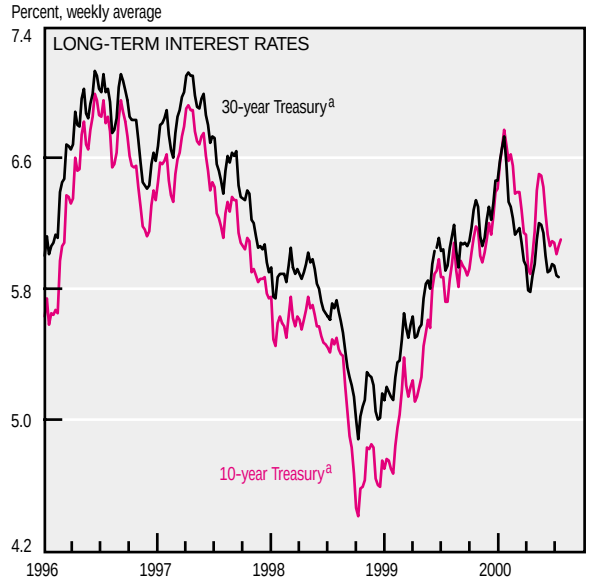
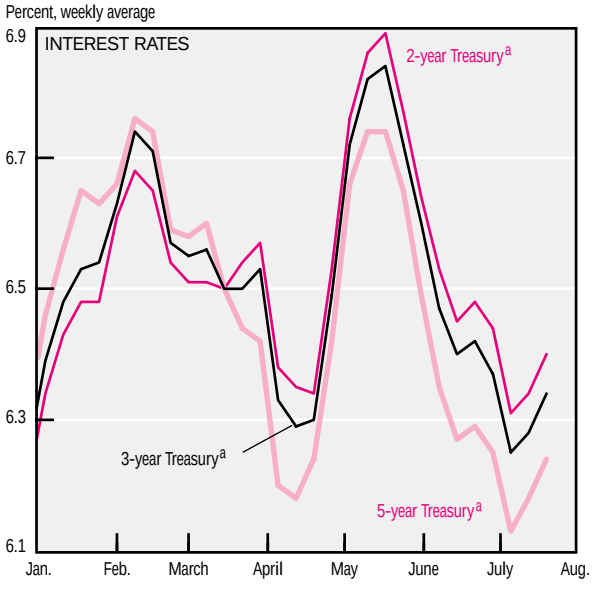
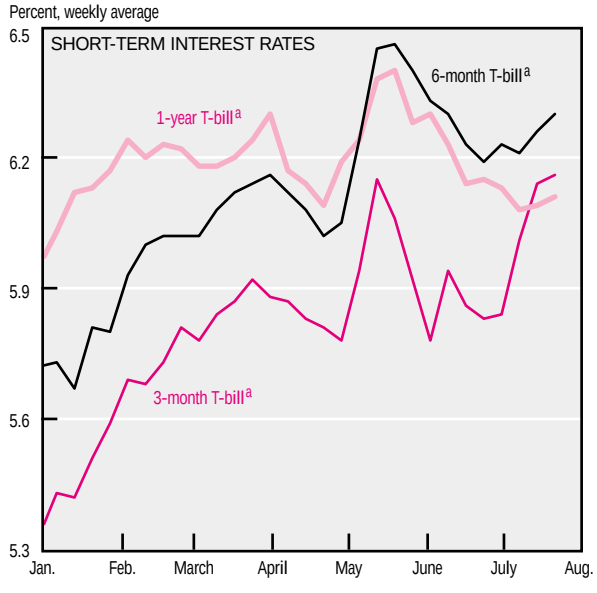
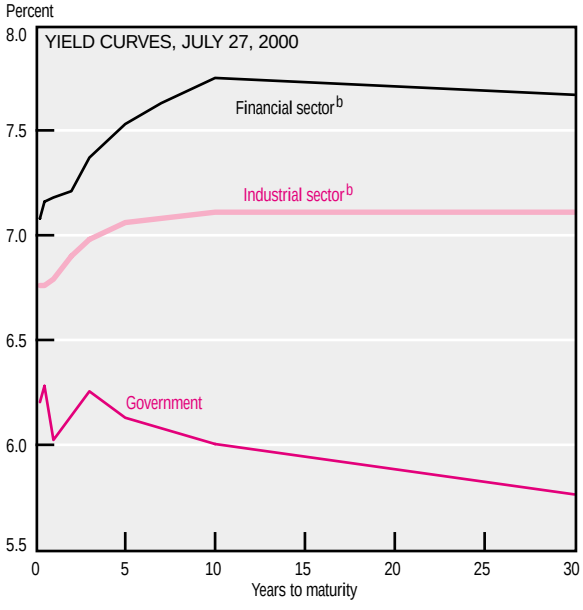
Monetary Policy (cont.)









a. Constant maturity.
b. Option-adjusted yield curves are constructed by taking all bonds that fall into a given category (U.S. AAA industrial, for example), stripping away the portion of prices associated with embedded options such as puts, calls, and sinks, and then drawing a best-fit curve through the adjusted prices. Ratings are a weighted average of Moody's (60%) and Standard & Poors' (40%).
SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg Financial Information Services.

annualized personal consumption expenditure growth fell from 11.3% in the first quarter of 2000 to 5.4% in the second quarter.

For some time, the yield on the 10-year Treasury bond has been higher than that of the 30-year Treasury—an event termed an inversion of the yield curve. Supply factors, driven by federal budget surpluses and the U.S. Treasury Department's related debt-buyback program, have caused investors to bid up the price of long-term government debt, distorting the normal pattern of yields. Over the last few months, continued concern about declining supplies, strong economic activity, and rising short-term rates have led to a sharp yield-curve inversion, beginning at the 2-year Treasury note. At the short-term end of the maturity spectrum, the 1-year T-bill yield dropped below the 6-month T-bill at the beginning of May and dropped below the 3-month T-bill in early July.

In contrast, the yield curves on high-quality corporate debt have generally not inverted, although they are fairly flat; this suggests that the inversion in the yield curve for public debt may be due to special circumstances. When there are no atypical supply and demand factors, an inverted yield curve is often thought to signal an economic downturn, and a flat yield curve is deemed consistent with an outlook for moderate, noninflationary growth. The short-term portion of the corporate yield curve retains a strong upward slope.

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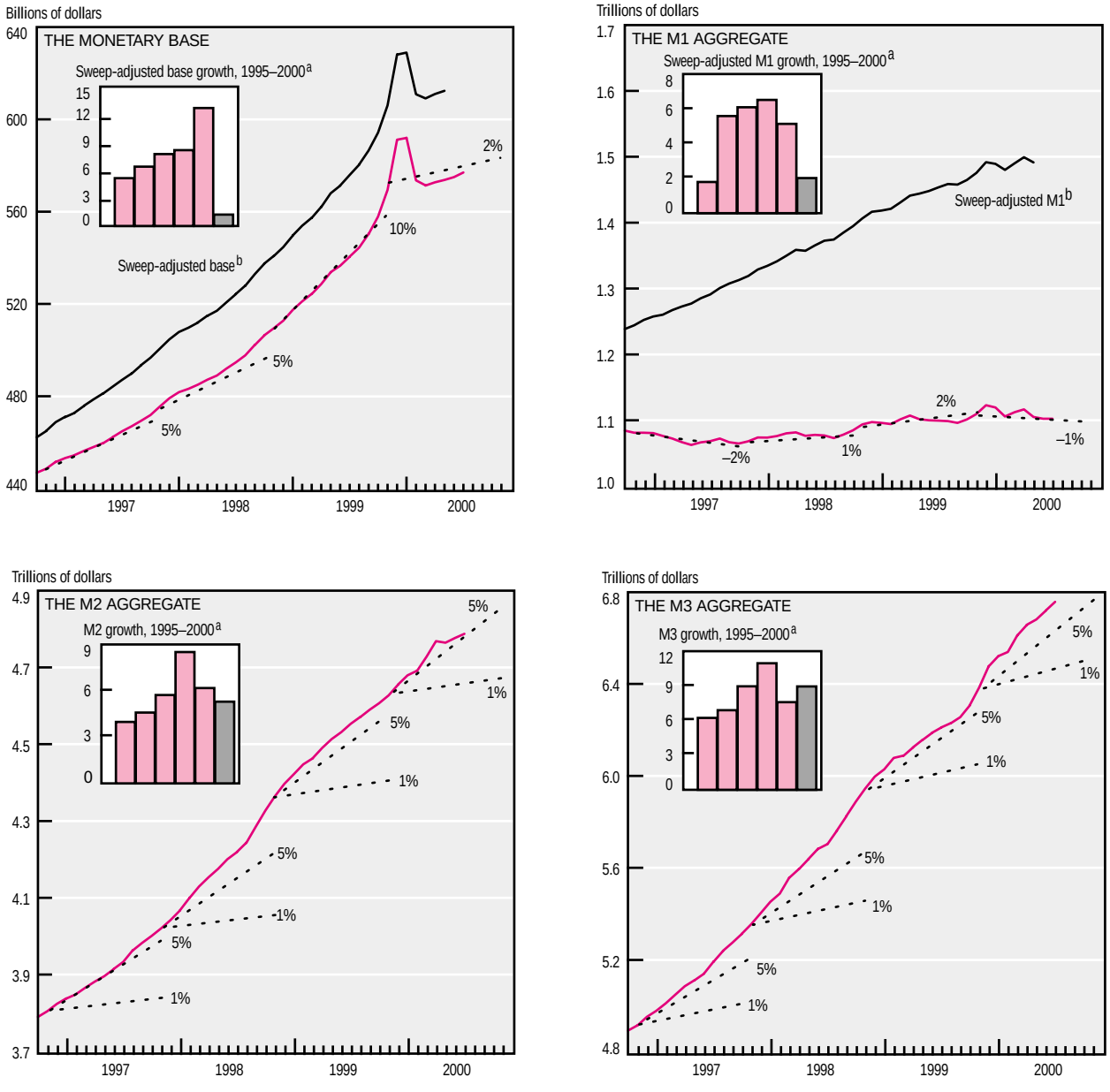
Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 2000 growth rates for M2 and M3 are calculated on an estimated July over 1999:IVQ basis. The 2000 growth rates for sweep-adjusted base and sweep-adjusted M1 are calculated on a May over 1999: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.

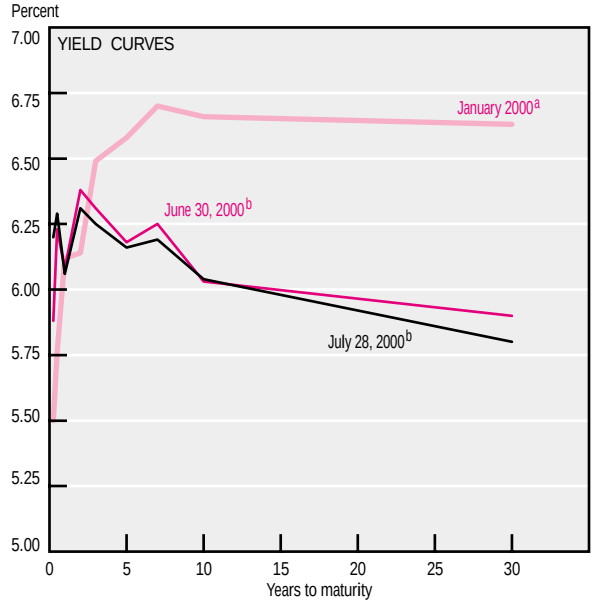
NOTE: Data are seasonally adjusted. Last plots for the monetary base, M1, M2, and M3 are estimated for July 2000. Last plots for the sweep-adjusted base and sweep-adjusted M1 are May 2000. Dotted lines for M2 and M3 are FOMC-determined provisional ranges (current ranges established February 2000). All other dotted lines represent growth rates and are for reference only.

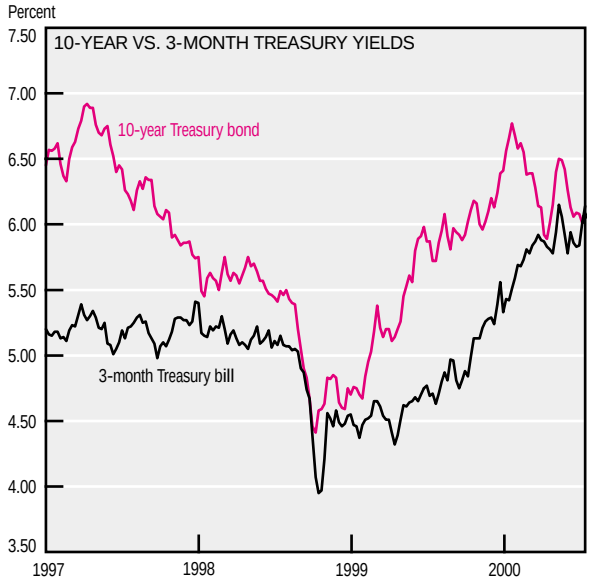
SOURCE: Board of Governors of the Federal Reserve System.

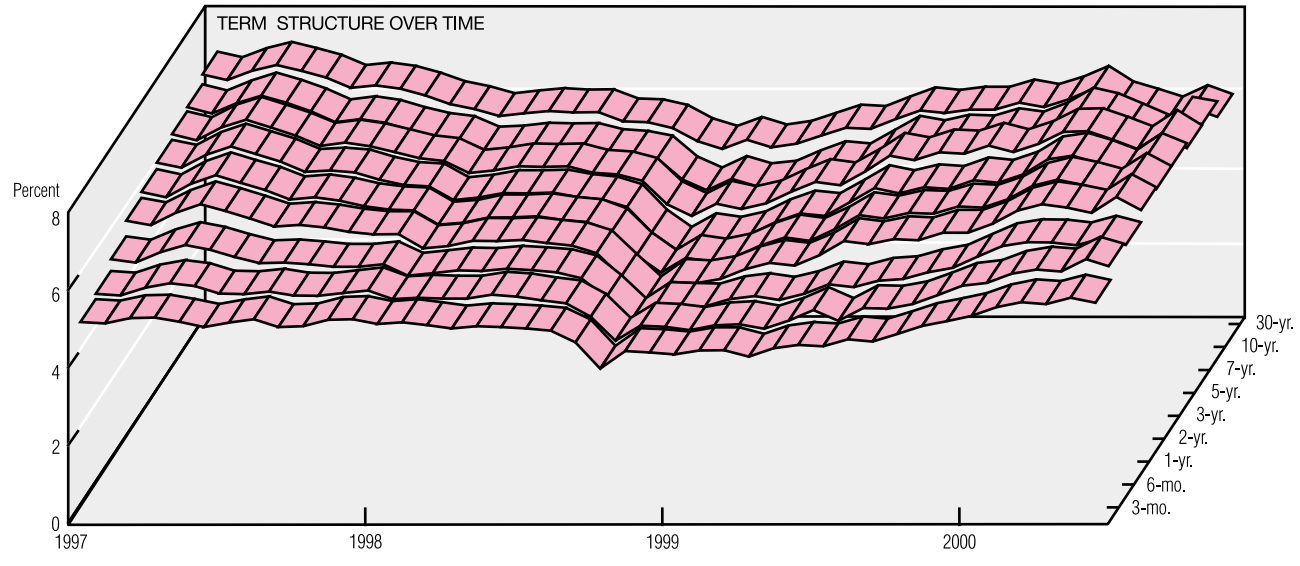
The Monetary Policy Report did not discuss FOMC-determined ranges for growth of the monetary and debt aggregates, a change which reflects the termination of Humphrey–Hawkins. "The legal requirement to establish and to announce such ranges had expired," the Report notes, "and owing to uncertainties about the behavior of the velocities of debt and money, these ranges for many years have not provided useful benchmarks for the conduct of monetary policy." The FOMC will no longer establish explicit ranges for money growth, but it "believes that the behavior of money and credit will continue to have value for gauging economic and financial conditions."

Growth in the narrow monetary aggregates continues to be well below that of the last several years. Annualized year-to-date growth for the sweep-adjusted base and sweep-adjusted M1 were 1.0% and 1.9% through May, respectively, compared to 9.7% and 5.1% at the same time last year. Growth in the broad monetary aggregates is mixed. Annualized year-to-date growth of 5.2% for M2 in July was more than a full percentage point below the 6.5% recorded in July 1999. In contrast, annualized year-to-date growth of 8.9% for M3 in July is almost two percentage points above the 6.8% posted through July 1999.

Interest Rates







a. Monthly average.
b. Average for the week ending on this date.
NOTE: All yields are from constant-maturity series.
SOURCE: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases,* H.15.

What is the best way to illustrate interest rate movements? One possibility is to represent different interest rates at a point in time. This is the familiar yield curve, which makes it easy to spot the shift from an upward-sloping curve in January to the current humped shape.

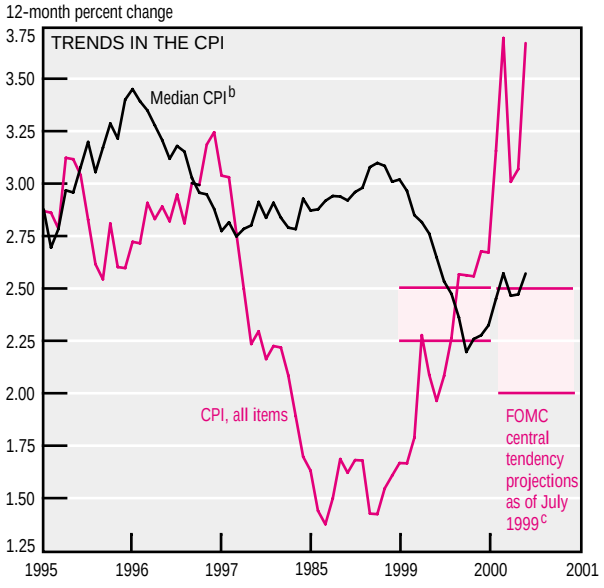
One may also look at one or two rates over time, an approach that brings out temporal patterns. For example, an upward trend in short rates met a downward trend in long rates, moving the 10-year, 3-month spread from an above-average 126 basis points (bp) in late January to an inverted –16 bp at the end of July. This is a classic response to Fed tightening, as higher short-term rates reduce inflationary expectations. Whether this inversion will also be followed by a recession remains to be seen. By focusing on only two rates, however, the time-series plot excludes some important information that is shown in the full yield curve: Another classic recession indicator, the 3-year, 3-month spread, remains positive, contraindicating a recession in the near future.

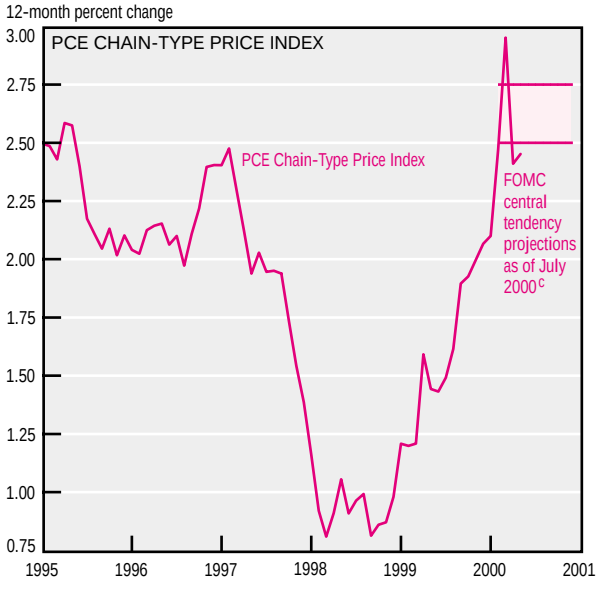
It is also possible to plot the entire yield curve over time, producing a three-dimensional chart, of which the previous two charts are sections along different axes. This method highlights broad trends across many interest rates. The flight to quality of late 1998, a response to the Russian default and the Long Term Capital Management debacle, shows up clearly, as does the general increase in rates since then.

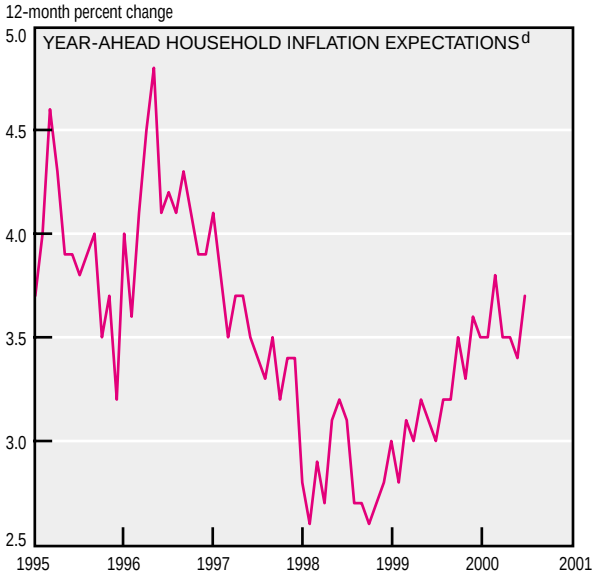
Inflation and Prices

June Price Statistics

	Percent change, last:				1999
	1 mo.[a]	3 mo.[a]	12 mo.	5 yr.[a]	avg.
Consumer prices					
All items	7.2	2.6	3.7	2.5	2.7
Less food and energy	2.0	2.0	2.4	2.4	1.9
Median[b]	3.1	2.5	2.6	2.8	2.3
Producer prices					
Finished goods	7.2	1.2	4.3	1.6	2.9
Less food and energy	–1.6	0.8	1.3	1.1	0.8







a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
c. Upper and lower bounds for inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
d. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers.*
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

Is "inflation" worsening? Retail prices, as measured by the Consumer Price Index (CPI), posted a steep gain of 0.6% in June (or 7.2% annualized), compared to May's 0.1% increase. And over the past 12 months, retail prices rose more sharply than they did in all but one other 12-month period since 1991. (The sharpest increase since 1991 came earlier this year.) The latest year-over-year increase in the PCE Chain-Type Price Index shows a similar pattern; it too is near its highest point in several years. Nevertheless, it's unlikely that inflation is worsening much.

While headline inflation figures have skyrocketed over the past several months, much of the increase has been energy related. In the latest report, three-fourths of the CPI increase resulted from rising energy costs. The median CPI, a measure of core inflation, remains near its lowest point in nearly a decade, as measured by year-over-year percent changes. While the recent spike in energy prices undeniably cuts into disposable incomes and puts pressure on businesses' profits, it need have no lasting impact on inflation. And although inflationary expectations have risen a bit from their lows, they remain below their expansion average.

Perhaps, however, we should be concerned about rising wages, which could presage an inflationary upturn. Indeed, the last two year-over-year increases in the Employment Cost Index (ECI) have been the sharpest since the current expansion began. This year, the ECI

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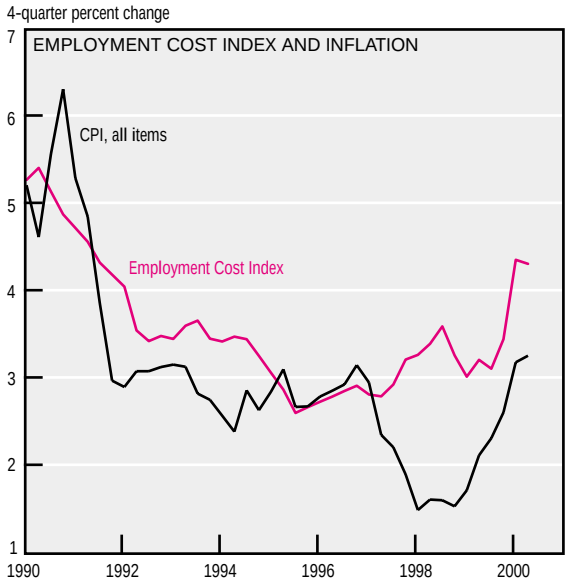
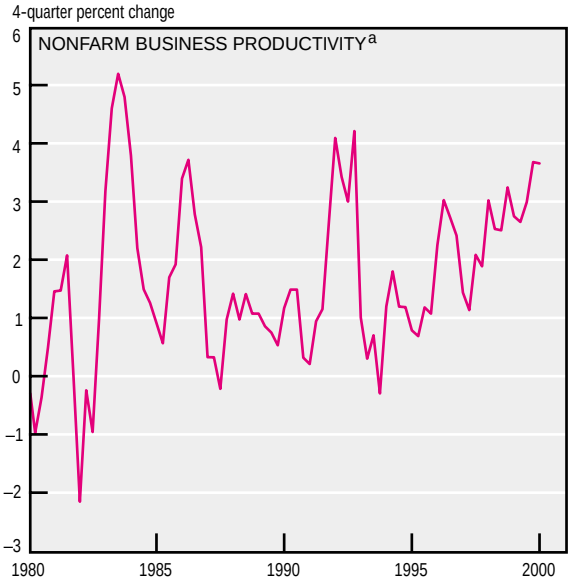
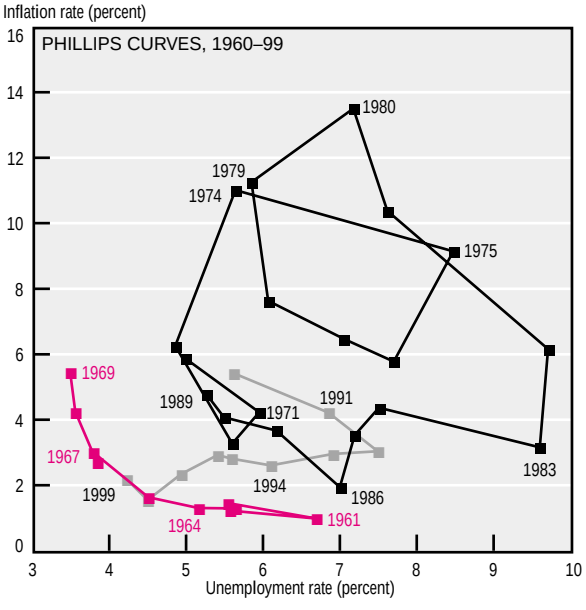
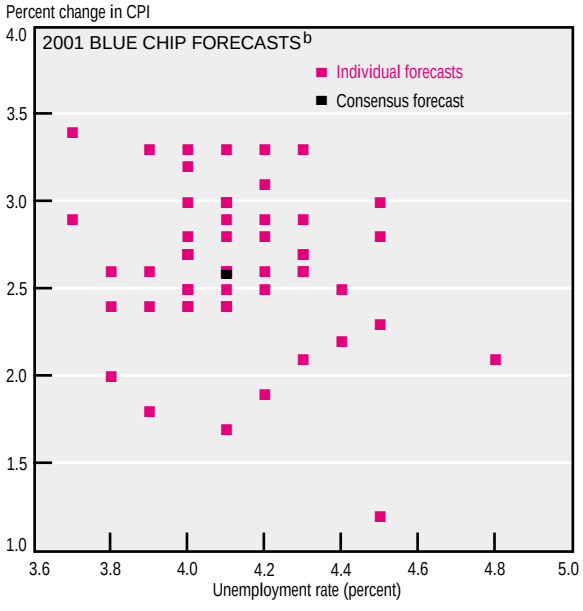
Inflation and Prices (cont.)









a. Measured as output per hour.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Blue Chip Economic Indicators,* July 10, 2000.

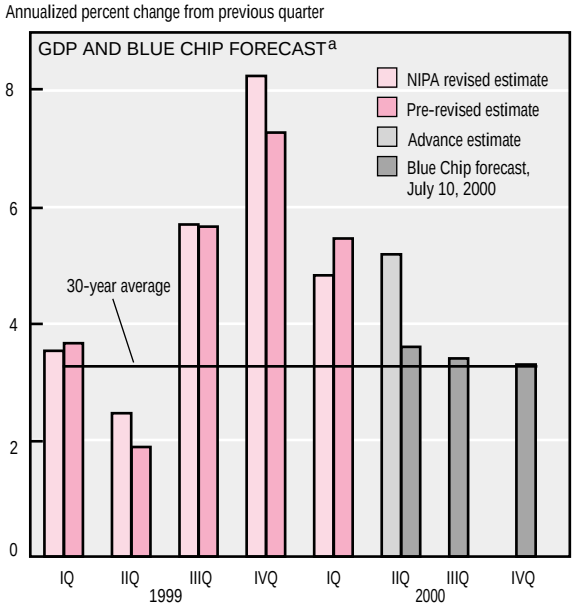
rose 4.4% in the first quarter and 4.3% in the second. But productivity growth in recent quarters is also near its expansion-era highs, and has been trending upward over the last half-decade, an indication that any inflationary "push" from wages has been modest (if it exists at all).

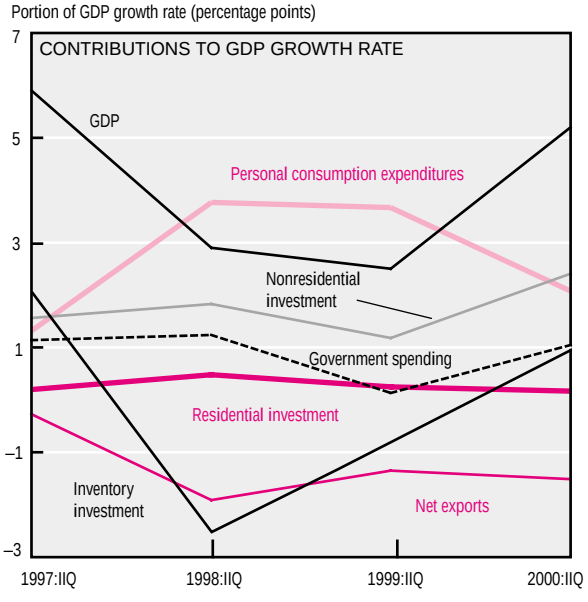
Is it reasonable to think that wages will soon accelerate faster than productivity gains due to persistently tight labor markets? The unemployment rate touched a 30-year low in April, and has now remained below 4.5% for more than 18 months. However, historical support for the proposition that low unemployment is accompanied by rising inflation is weak, particularly over the last several decades. In fact, recent unemployment declines have been accompanied by falling, rather than rising, inflation. From 1991 to 1999, for example, the unemployment rate fell almost three percentage points, but it was accompanied by a decline of nearly two percentage points in the inflation rate, contrary to the intuition of the so-called Phillips Curve. Indeed, recent forecasts show a distinct lack of consensus among economists concerning the connection between inflation and unemployment (if such a connection exists). They seem to consider an unemployment rate no greater than 4%, for instance, to be consistent with inflation rates ranging all the way from 1.7% to 3.4%.

Economic Activity

Real GDP and Components, 2000:IIQ[a,b]
(Advance estimate)

	Change, billions of 1996 $	Percent change, last: Quarter	Four quarters
Real GDP	117.0	5.2	6.0
Consumer spending	46.1	3.0	5.4
Durables	−8.8	−3.9	9.7
Nondurables	16.1	3.5	5.4
Services	36.4	4.2	4.5
Business fixed investment	62.7	15.3	11.6
Equipment	53.8	21.0	17.2
Structures	8.5	13.0	9.2
Residential investment	3.6	3.9	1.1
Government spending	23.1	6.0	4.5
National defense	13.8	17.2	4.4
Net exports	−39.3	—	—
Exports	19.4	7.3	8.5
Imports	58.6	17.0	14.1
Change in private inventories	23.7	—	—





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 and annualized.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, July 10, 2000.

Gross domestic product increased at a surprisingly strong 5.2% annual rate in 2000:IIQ, according to the advance estimate. The Blue Chip median forecast had been only 3.6%, and it continues to predict growth in the 3% range for the second half of the year.

The July GDP release also reflects revisions to national income and product account (NIPA) estimates from 1997:IQ onward. Economic growth for 2000:IQ is now placed at 4.8% (annualized), down from the 5.4% annualized rate previously reported. However, the 1999:IVQ rate after revision is almost a full point higher, at 8.25%. On the whole, the revision increased GDP $43 billion. The lion's share of the increase came from nonresidential fixed investment, which was matched by a net increase in income going to capital.

As expected, consumer spending moderated significantly in the second quarter, contributing only two percentage points to GDP growth —three full percentage points less than in the first quarter. Net exports showed a half-percentage-point reduction. These two weaknesses were offset by volatile government spending and inventory accumulation, which together contributed about two percentage points. Residential and nonresidential fixed investment continued to grow at a nearly unchanged pace.

Much has been made of the computer revolution and its impact on economic conditions over the

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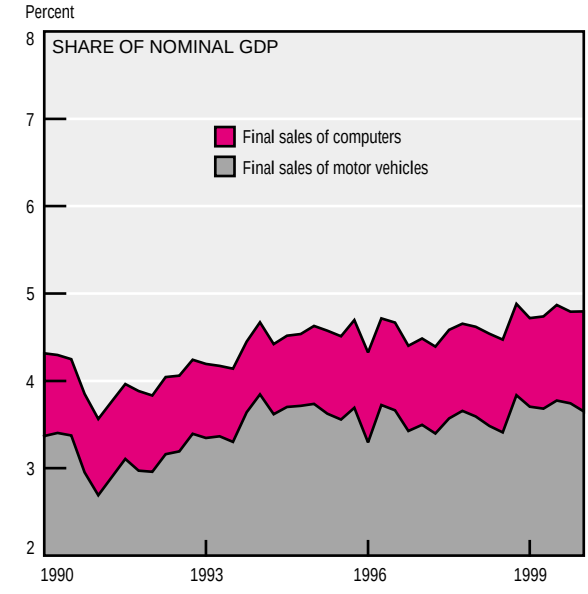
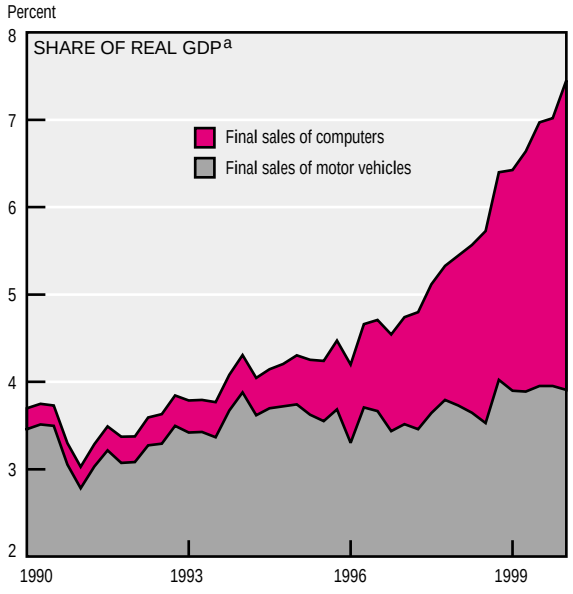
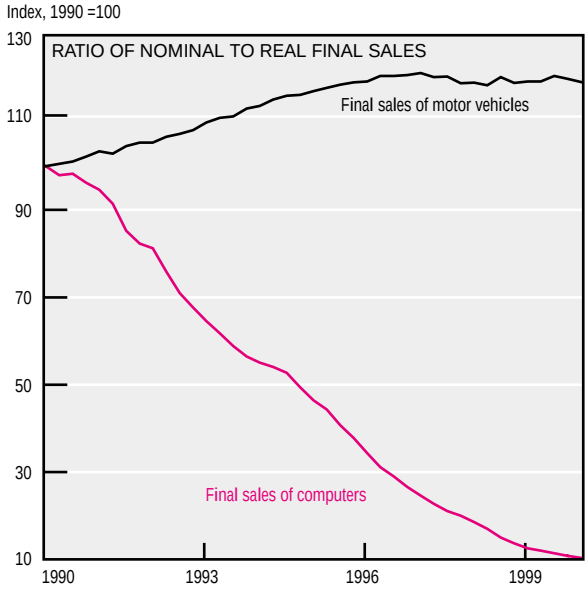
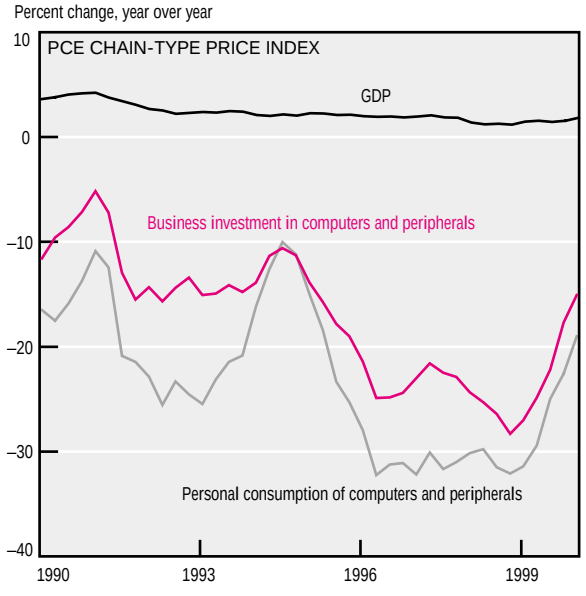
Economic Activity (cont.)









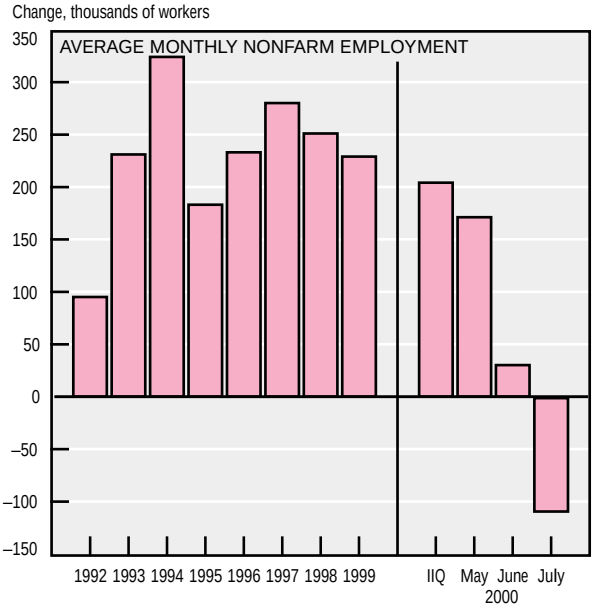
a. Chain-weighted data in billions of 1996 dollars.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

last 10 years. Final sales of computers have doubled in nominal terms over the decade; however, computer expenditures are still less than one-third of motor vehicle expenditures. In real terms, though, the pattern is drastically different. While nominal expenditures on computers grew modestly, the real value of these purchases has increased dramatically. In real terms, final computer sales are virtually equal to final motor vehicle sales.

As the ratio of nominal to real expenditures shows, the real price of computing has continued to drop precipitously for the past decade, primarily because of computers' increased quality or ability rather than nominal price declines. The typical computer chip could process 25 million instructions per second in 1990, whereas today it can process more than 500 million ips.

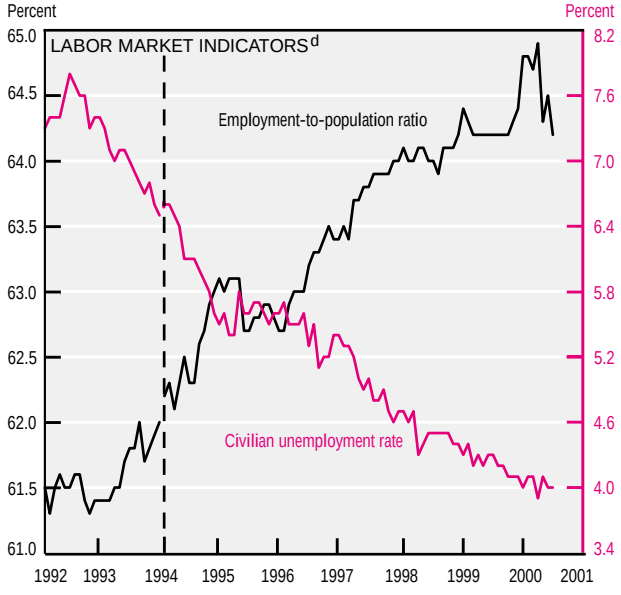
The chain-weighted price deflators for personal and investment expenditures on computers and peripherals confirm this trend: While the GDP price index has grown more than 2% annually over the decade, the personal-consumption and business-investment computer price indexes have dropped 23% and 17% on average, respectively. Perhaps most intriguing is the cyclical trend found in the computer price deflation: Two spikes, in 1991 and 1994, may mark innovations in computer-processing speed.

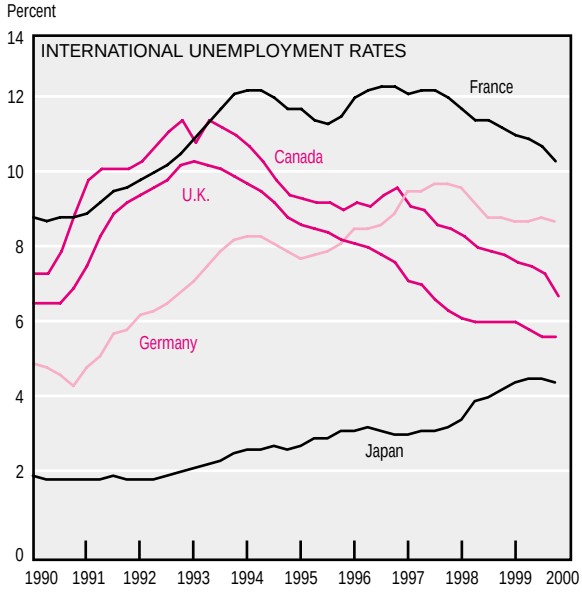
Labor Markets



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1997	1998	1999	YTD[a]	July 2000
Payroll employment	280	251	229	211	–108
Goods-producing	48	22	4	27	53
Mining	1	–3	–3	1	1
Construction	21	37	25	17	6
Manufacturing	25	–12	–18	8	46
Durable goods	27	–2	–6	10	37
Nondurable goods	–2	–11	–12	–1	9
Service-producing	232	229	225	183	–161
TPU[b]	16	20	16	13	20
Retail trade	24	30	36	32	49
FIRE[c]	21	22	10	–2	7
Services	141	120	124	97	–1
Government	17	28	28	35	–246
	Average for period (percent)				
Civilian unemployment	4.9	4.5	4.2	4.0	4.0





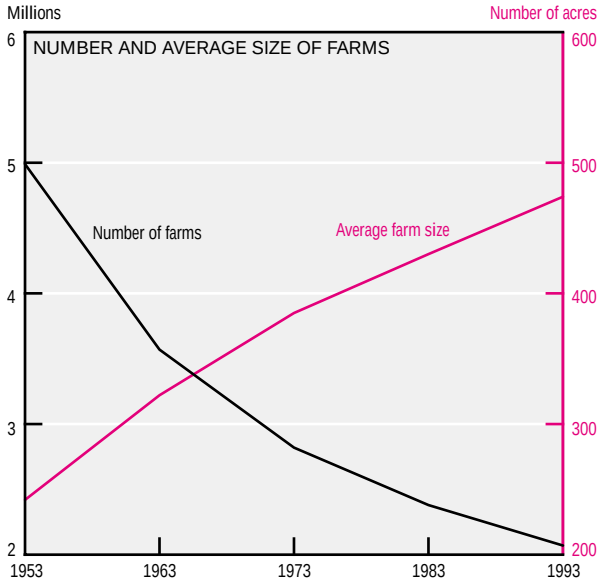
a. Year to date.
b. Transportation and public utilities.
c. Finance, insurance, and real estate.
d. Vertical line indicates break in data series due to survey redesign.
NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Shrinking government payrolls and slower private-sector employment growth caused total nonfarm employment to fall 108,000 jobs in July, the first monthly decline since January 1996. The Census Bureau has continued to lay off temporary workers en masse (290,000 in July and 428,000 since May). Moreover, private-sector employment posted a net gain of only 138,000 jobs in July, compared to the monthly average of 182,000 workers over the first half of the year. Despite the employment decline, the unemployment rate remained at 4.0%, which suggests that most laid-off census workers may have left the labor force and so are not considered unemployed. Declining employment has caused the employment-to-population ratio to slip from its all-time high of 64.9% in April to 64.2% in July.

Employment growth was concentrated mainly in durable-goods manufacturing and retail trade. After two years of consistent declines, durable-goods manufacturing posted slow but steady employment growth in 2000, with a healthy net gain of 37,000 in July. Total employment in services was unchanged last month; service industries averaged monthly gains of 109,000 workers over the first half of the year.

The U.S. unemployment rate has fallen steadily since 1992 and is now at a 30-year low. Is this true for other large countries? Canada and the U.K. have shared the downward trend in unemployment; however, Japan's rate has risen steadily since 1992. In France and Germany, Europe's two largest economies, unemployment increased significantly until 1998 and only then began to drop.

Farm Employment



Distribution of Farm Employment by Sex, Race, and Educational Attainment (percent)

	Men	Whites	African Americans	Hispanics[a]
1963 total	81.3	84.5	15.5	—
Farmers and managers	94.5	93.0	7.0	—
Laborers	65.3	74.3	25.7	—
1973 total	83.0	91.6	7.2	6.2
Farmers and managers	93.8	96.3	3.1	0.5
Laborers	69.8	85.8	12.3	13.2
1983 total	82.3	92.4	5.9	7.7
Farmers and managers	87.9	97.9	1.3	0.8
Laborers	75.6	85.9	11.3	16.0
1993 total	83.0	95.1	3.4	13.9
Farmers and managers	85.7	98.6	0.9	2.4
Laborers	79.4	90.6	6.8	29.4

	Less than 4 years of high school	4 years of high school	1 to 3 years of college	4 years of college or more
1976 total	43.6	37.7	10.4	8.3
1983 total	28.8	44.4	15.1	11.7
1993 total	17.8	46.9	21.3	14.1

a. Census data classify Hispanics as a subset of whites.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, *Current Population Survey;* and U.S. Department of Agriculture, National Agricultural Statistics Service.

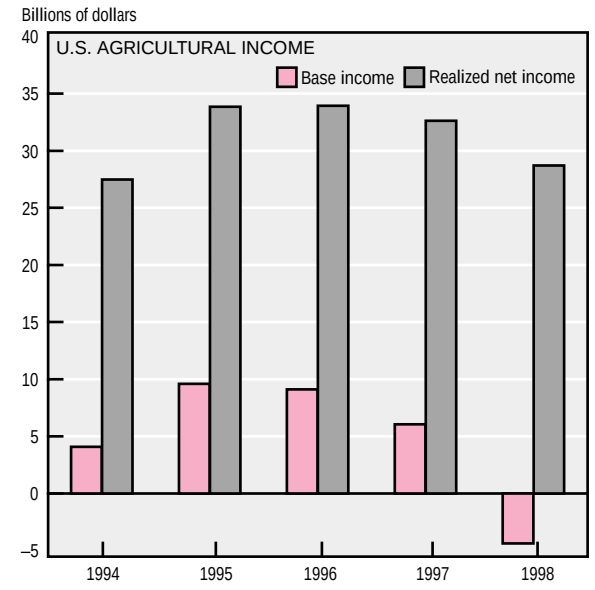
As the U.S. economy industrialized, farm employment's share of the workforce plummeted. In the post–World War II period, its share continued to fall from roughly 12% of the workforce in 1950 to 1.5% by 1990. (Farm employment includes farm operators, managers, and laborers working directly to produce food and fiber products. It is part of a larger category, agricultural employment.)

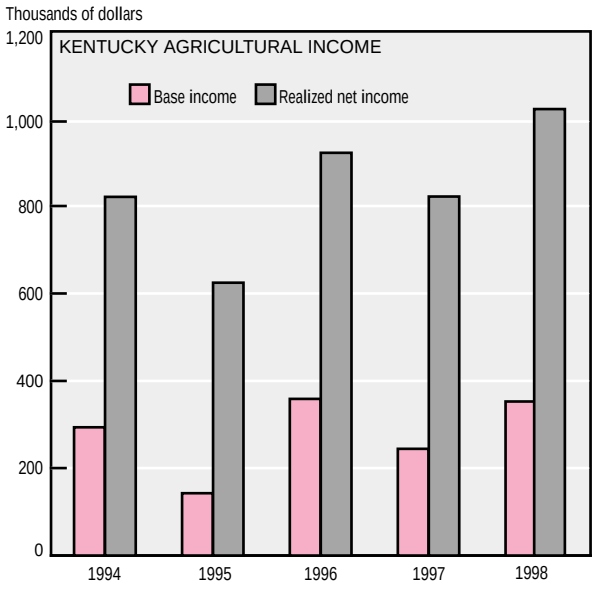
The primary cause of farm employment's precipitous drop has been the dramatic technological progress in areas such as cultivation equipment, fertilization, and irrigation, which have made farming less labor intensive. These advances also increased yields significantly (50% between 1963 and 1993), even as employment was halved.

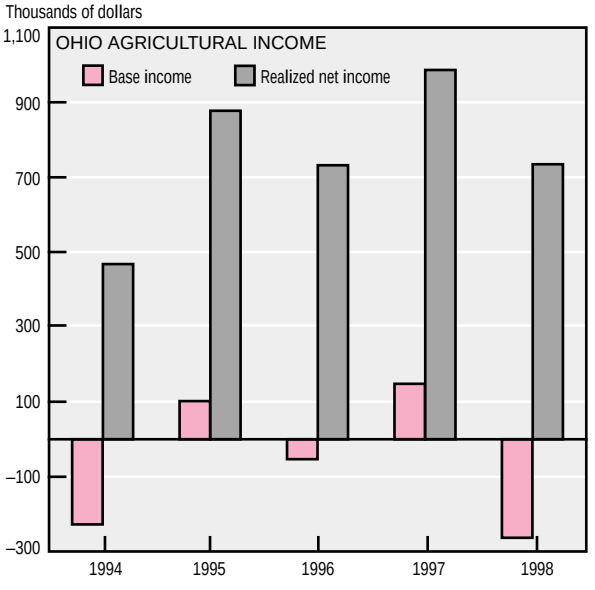
Many small farmers, however, found these capital-intensive advances prohibitively expensive. They also discovered that their operations were too small to exploit economies of scale. Thus, throughout the postwar period, the number of farms was cut in half, while the average size more than doubled.

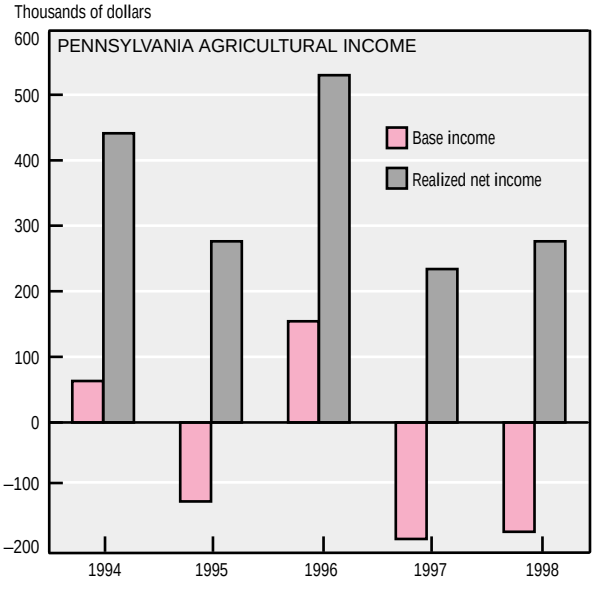
Farm workers' demographics have also shifted dramatically. In the early 1960s, African Americans made up more than a quarter of all farm laborers and more than 15% of total farm employment; by 1993, these figures had fallen to roughly 7% and 3%. Currently, Hispanics account for almost 30% of laborers and roughly 14% of total employment. Another trend is farm workers' rising educational attainment. The percent with some college more than doubled between 1976 and 1993, and the share with at least a college degree almost doubled.

Agricultural Income









NOTE: Base income equals all cash receipts minus total production costs. Realized net income reports all sources of income, including imputed income and government payments, minus production costs. Income data for 1998 are the latest available.
SOURCES: U.S. Department of Agriculture, *Annual Report of the Secretary of Agriculture*, FY 1999; and U.S. Department of Commerce, Bureau of Economic Analysis.

More than 290,000 people in Kentucky, Ohio, and Pennsylvania rely on agriculture for their livelihood. While farmers in some areas of the Fourth District are cautiously optimistic about their income for 2000, others are bracing themselves for a worse year than the last two. In 1999, American farmers suffered their second straight year of economic hardship. Four consecutive years of record worldwide production, coupled with weak demand in Asian and other markets, kept commodity prices low—in some cases, the lowest in 30 years. Unfavorable weather devastated local crop yields, compounding the effect of globally depressed commodity prices.

Agricultural income at the state level is volatile, being dependent on both commodity yields and market prices. Production varies widely from region to region because weather patterns determine when and how much farmers can plant, how well the crops grow, and when they can be harvested.

The agricultural sector has fared better in Kentucky than in Ohio or Pennsylvania; in 1998, Kentucky's base farming income was positive, despite reported losses in all of the surrounding states and at the national level. Kentucky farmers enjoyed positive returns because the prices of their primary commodities, tobacco and livestock, have not been hurt by international competition. Farmers in Ohio and Pennsylvania have been less fortunate. Ohio's primary commodities, corn and soybeans, are highly vulnerable to foreign competition, and their market prices have fallen

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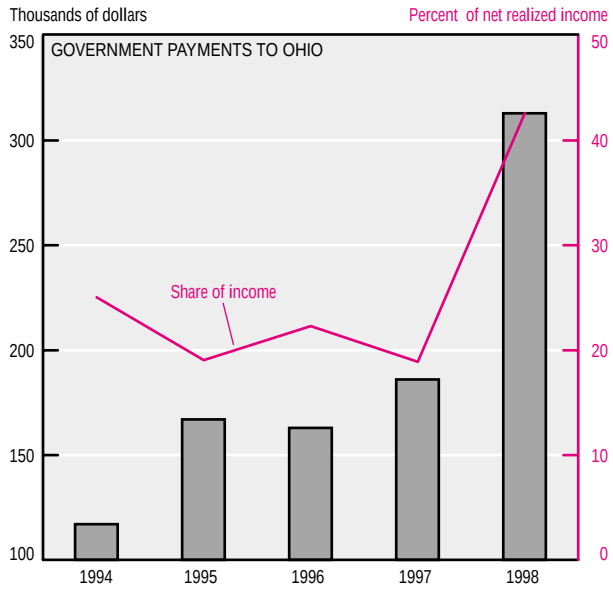
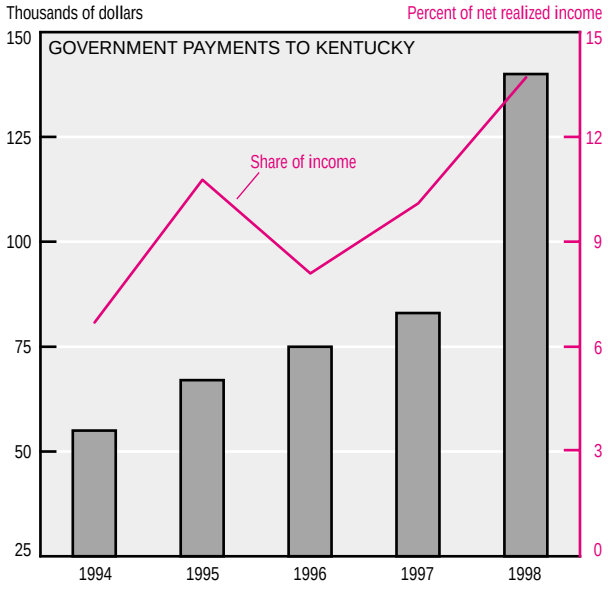
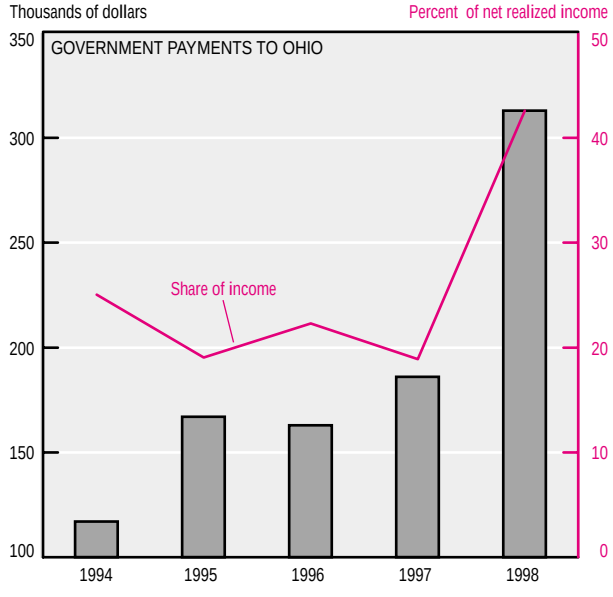
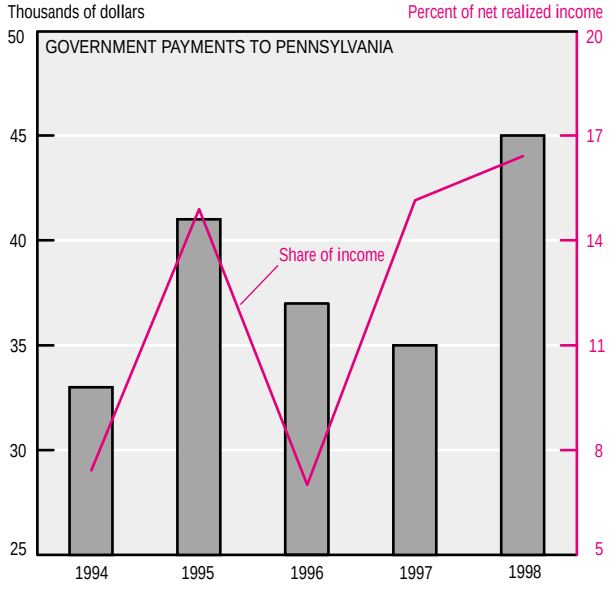
Agricultural Income (cont.)









SOURCES: U.S. Department of Agriculture, *Annual Report of the Secretary of Agriculture, FY 1999*; and U.S. Department of Commerce, Bureau of Economic Analysis.

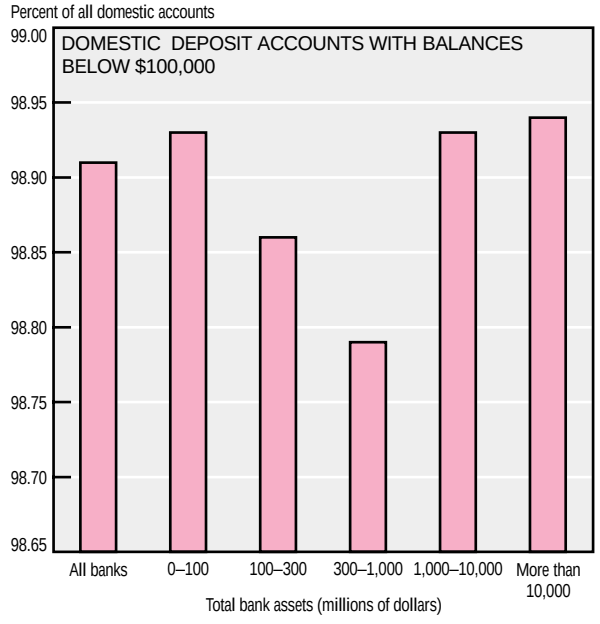
since 1997, making it difficult for base income to keep pace with rising production costs.

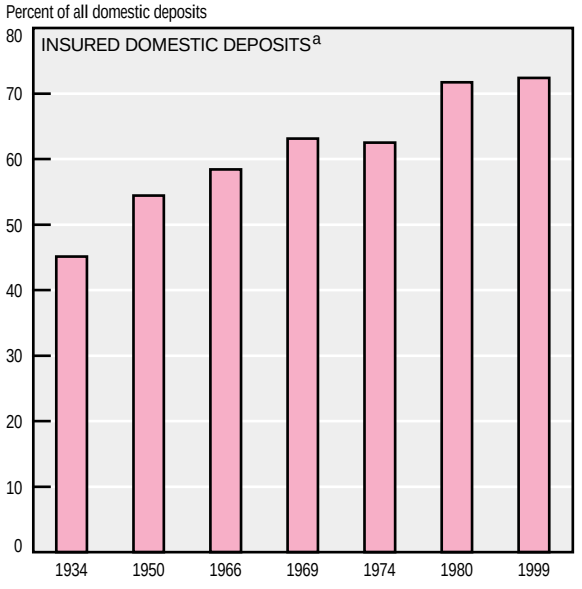
With cash receipts no longer covering production costs, farmers are depending more on other income sources to sustain their businesses. Imputed and miscellaneous income, along with government payments, have allowed the agricultural sector to report positive net income figures despite rising production costs and falling commodity prices.

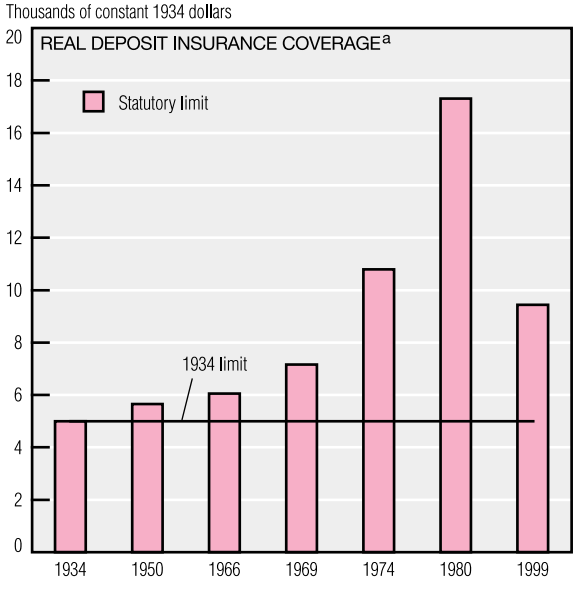
Government payments, in the form of crop insurance, price supports, and farm subsidies, increased moderately from 1995 to 1997. Because payments depend on both yield and prices, a disastrous production year and low prices in 1998 caused a 63.0% increase in government payments nationwide, providing 43.4% of realized net income in the agricultural sector. Government payments remained high in 1999 and most likely will increase this year: The Omnibus Consolidated Appropriations Act of 2000 allotted a total of $1.386 billion for the Crop Disaster Program alone.

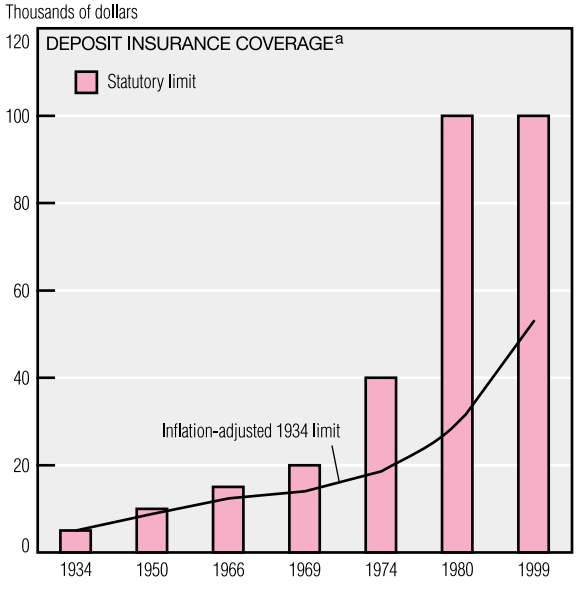
By July 20 of last year, the Secretary of Agriculture had declared 636 U.S. counties to be disaster areas (eligible for assistance under the Crop Disaster Program); this year, the number already has reached 859. Every county in the Fourth District was eligible for emergency assistance in 1999 and most retained their eligibility into 2000.

Deposit Insurance









a. The years shown are those in which the statutory limit was changed.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Financial Institutions Examination Council, *Reports of Condition and Income.*

The Financial Modernization Act of 1999 created the most sweeping banking reforms since the Great Depression. But even as regulators, financial institutions, and policymakers have worked to implement this act, its critics have called for additional reforms. In particular, the Federal Deposit Insurance Corporation has initiated a study to reexamine and restructure federal deposit insurance; this would include doubling the deposit insurance limit. While raising the limit might benefit insured banks and thrifts, it appears to offer most depositors little or no benefit. After all, balances fall within the current $100,000 limit for more than 98% of insured banks' domestic deposit accounts (regardless of a bank's size).

While the level of real deposit insurance coverage at the end of 1999 was only about half that in 1980, it remains high by historical standards. Deflated to 1934 prices, it is nearly double the level guaranteed when the FDIC began operations. In today's prices, the 1934 deposit insurance limit is around $53,000. Moreover, despite the decline in real deposit insurance coverage since 1980, the insured portion of total domestic deposits has increased slightly, from 71.7% to 72.4%.

Community banks have argued that increasing the deposit insurance limit would level the playing field between small depository institutions and large banking organizations that may be perceived as "too big to let fail," a status that they say would effectively give large banks 100% insurance on all deposits. Hence, community banks maintain that a sizeable increase in the insurance limit is needed to make the current system more fair. The interests of depositors and taxpayers do not figure in this debate; however,

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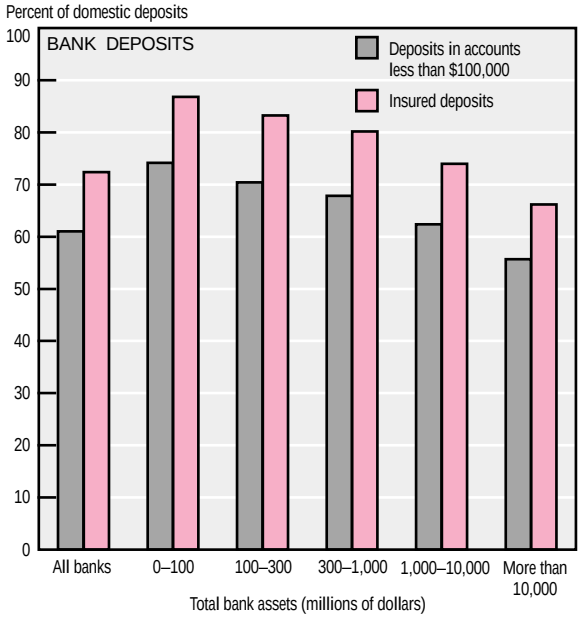
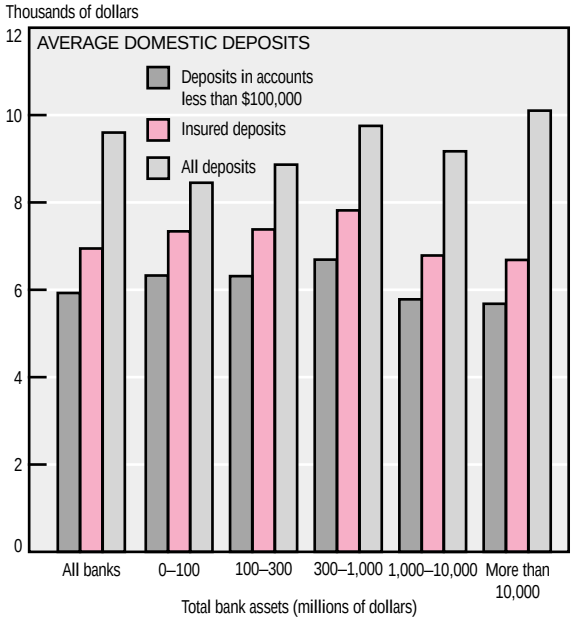
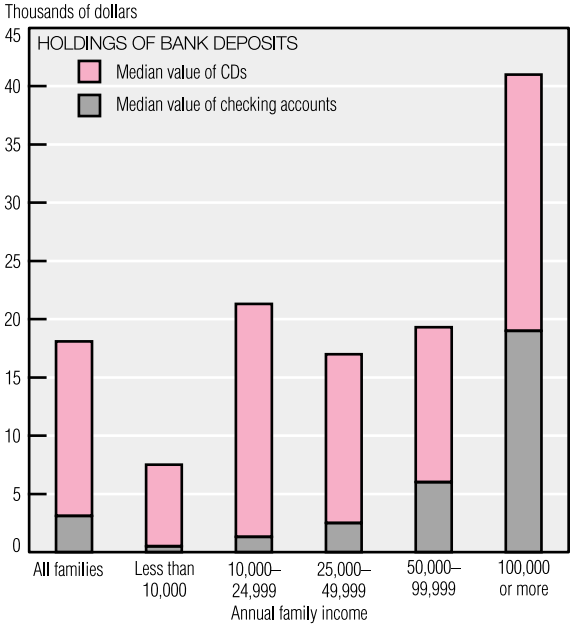
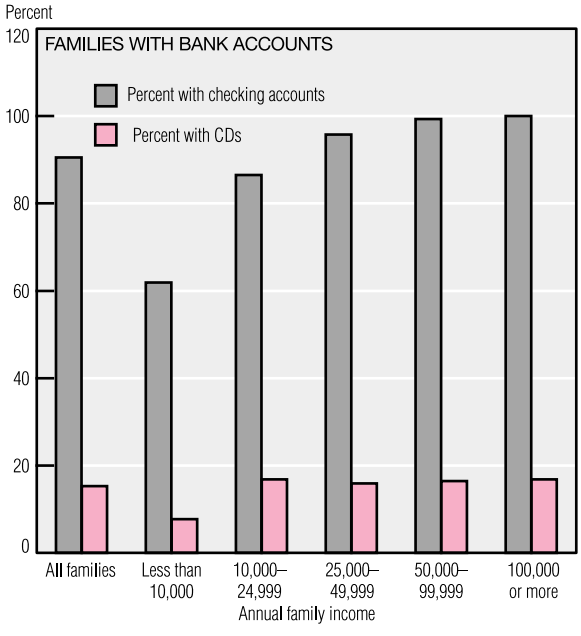
Deposit Insurance (cont.)









SOURCES: Federal Financial Institutions Examination Council, *Reports of Condition and Income*; and "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," in *Federal Reserve Bulletin*, vol. 86 (January 2000), pp.1–29.

any proposal to reform the deposit insurance system must be fair to them as well as to banks of all sizes. Around 60% of domestic deposits are in accounts with balances below the $100,000 insurance ceiling, and more than 70% of all domestic deposits are insured. In the two categories of banks with the smallest assets, more than 80% of deposits are insured. The average deposit balance in banks of all sizes is well below the $100,000 insurance limit. This is true for the average deposit in accounts under $100,000, the average insured deposit, and the average domestic deposit.

The adequacy of the current deposit insurance ceiling might also be judged by considering family income in relation to bank deposits. Not surprisingly, survey evidence shows that families whose incomes exceed $100,000 hold the largest bank accounts. Yet even for these families, the current level of deposit insurance is more than double the combined median value of bank certificates of deposit and checking accounts, and nearly five times that of any other income group.

Finally, it is interesting to note the relationship between income and the share of families with bank accounts. While 98% of families with annual incomes over $50,000 have checking accounts, only 40% of those with incomes under $10,000 do. This makes it difficult to rationalize raising the insurance limit on the grounds of providing safe vehicles for small savers.

The FDIC's Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) continued stable in 2000:IQ. BIF and SAIF reserves are 1.35% and 1.44% of insured deposits, well above the 1.25% target set by Congress in the Financial Institution Reform, Recovery, and

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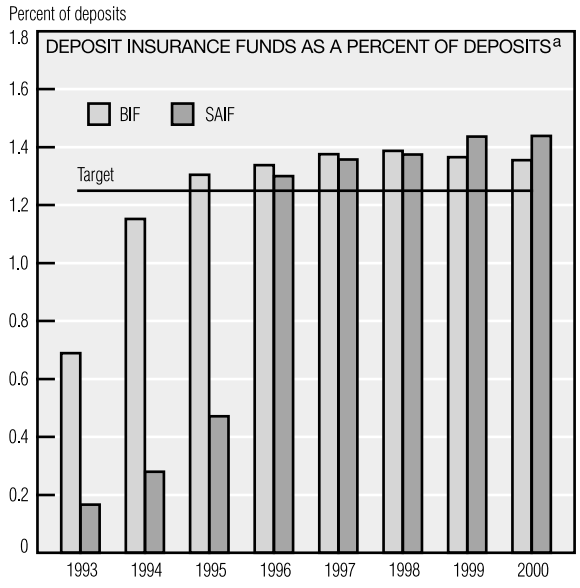
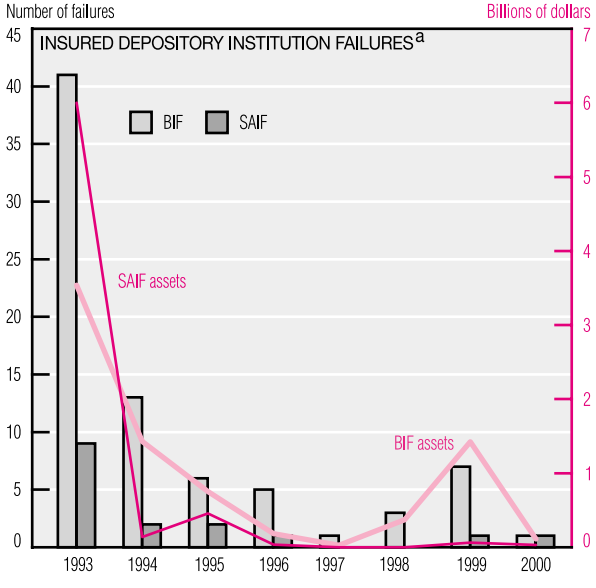
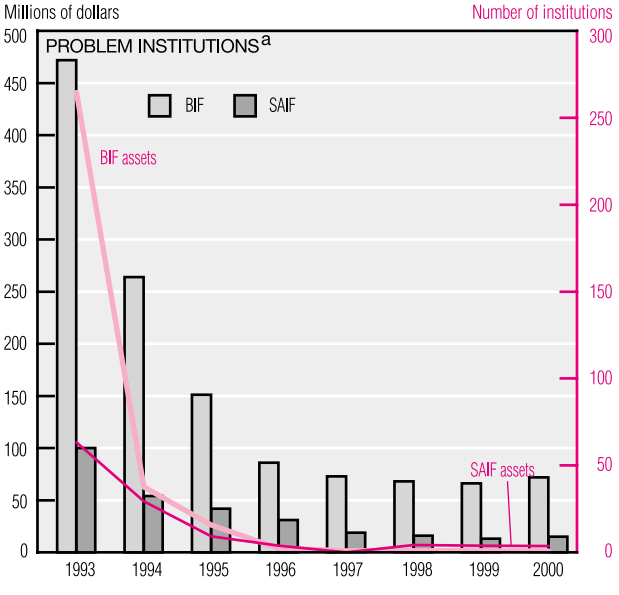
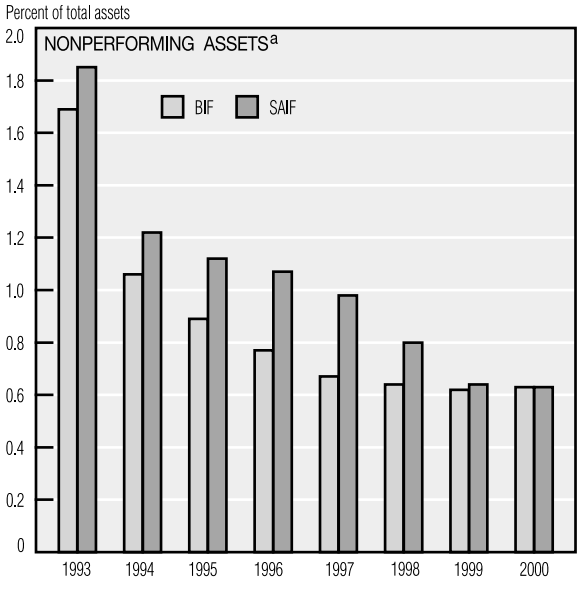
Deposit Insurance (cont.)









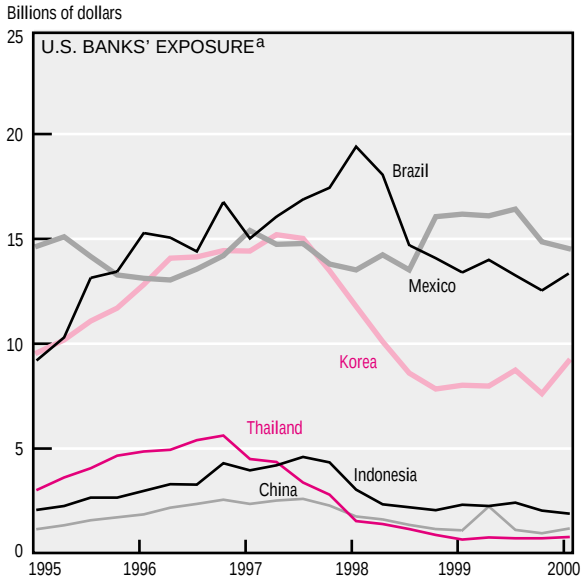
a. Data as of March 2000.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*.

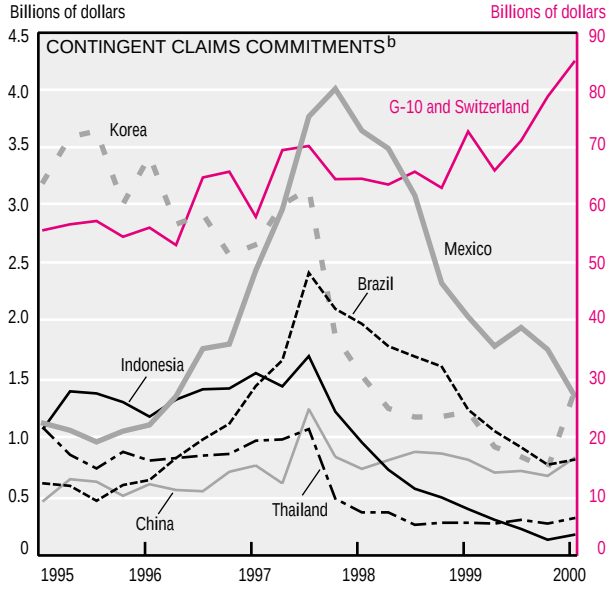
Enforcement Act of 1989. Moreover, while BIF's reserves are down slightly from their peak of 1.39% of insured deposits, SAIF's ratio of reserves to insured deposits is at an all-time high.

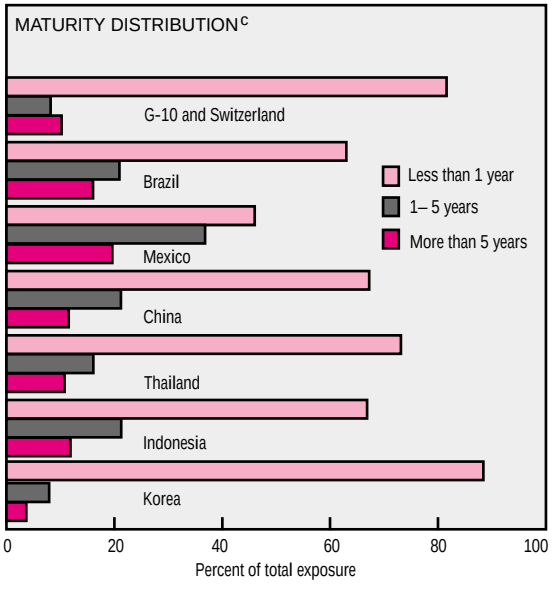
The solid position of the two FDIC funds is evidenced by the stability of the banking and thrift industries. Failures of BIF members in 1999 reached their highest level since 1994 in terms of number (seven institutions) and total assets ($1.4 billion). The failure of one SAIF member in 2000:IQ matches the total number of SAIF-insured institution failures over the last three years. The dearth of thrift institution failures over the second half of the 1990s contrasts starkly with the solvency problems that plagued the industry throughout the 1980s. And although the number of bank failures has increased lately, the total still represents a tiny percent of FDIC-insured institutions in terms of number of firms and total assets.

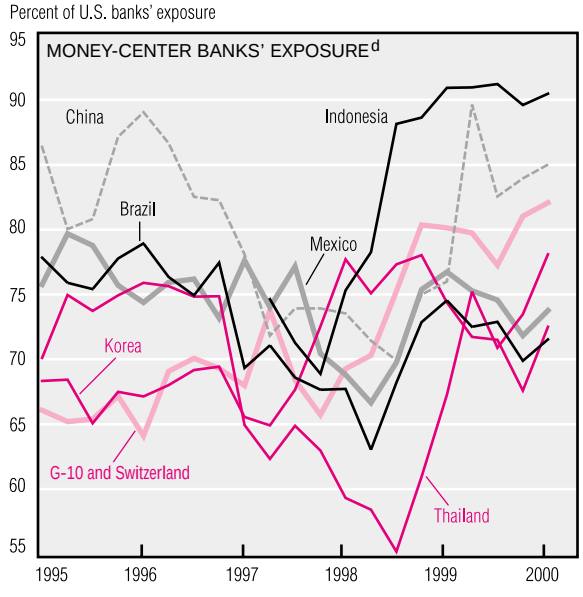
Problem institutions (those with substandard examination ratings) rose from 66 to 72 for the BIF and 13 to 15 for the SAIF during 2000:IQ. However, while the increase in BIF problem institutions was matched by an increase in problem banks' assets, the increase in SAIF-insured problem institutions was accompanied by a decrease in their assets, indicating a decrease in the average size of problem thrifts. For both funds, the continued low number of problem institutions and the smallness of their assets suggests that losses to the insurance fund will remain low in the near future. This conjecture is supported by the low levels of nonperforming assets as a percent of total assets on the books of BIF and SAIF members.

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.*

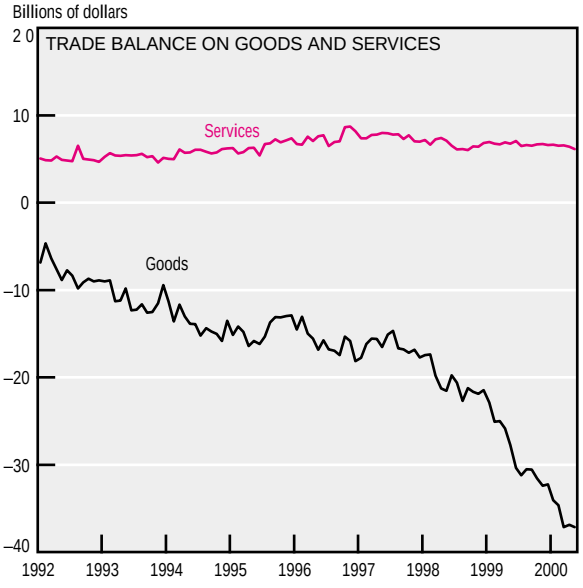
U.S. banks' loans to developing countries have not yet returned to their early-1997 levels, probably because of these countries' economic weakness as well as more favorable prospects for economic growth elsewhere. Many analysts view developing countries' financial fragility as the main cause of the 1997–98 crises, but several studies have suggested that interest rate changes in developed countries also played a role.

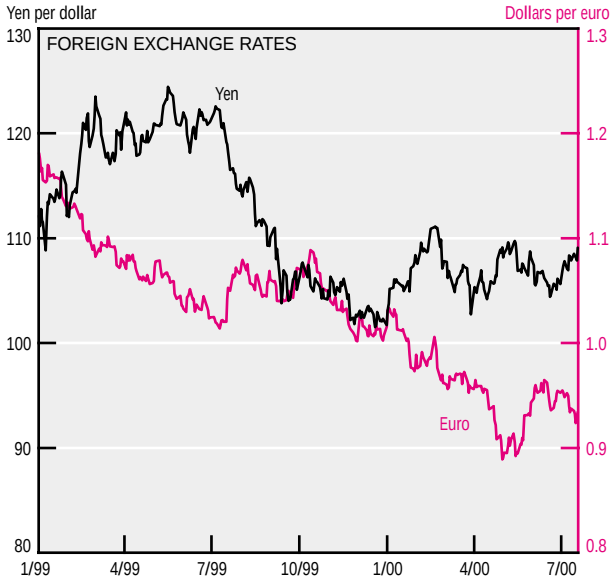
U.S. banks' use of contingent claims commitments in developing countries has declined roughly in tandem with their exposure there. Banks use contingent claims (contracts whose value varies with an uncertain outcome) to help manage risk. An example is a futures contract on an exchange rate; a bank could buy or sell such a contract to reduce the risk associated with its foreign-currency position. The simultaneous decline of U.S. banks' exposure and their use of contingent claims commitments in developing countries is consistent with a correlation of contingent claims commitments to the volume—and not to the average risk—of exposure.

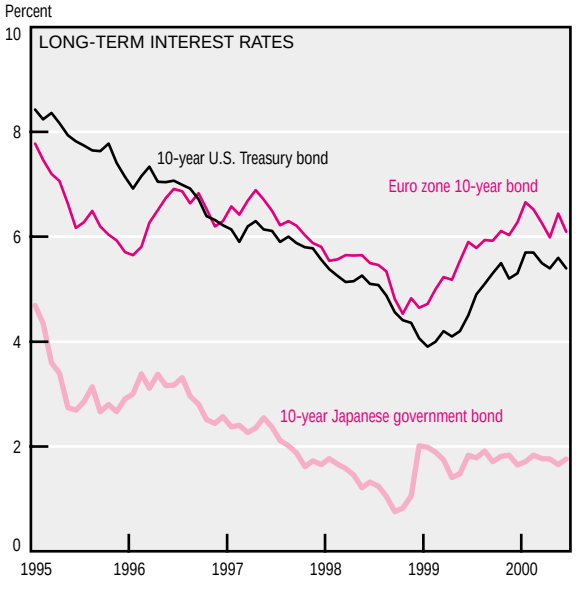
Reliance on short-term lending has been implicated in the Mexican and East Asian crises. However, short-term credits continue to dominate those of longer maturity, even for the G-10 and Switzerland. Lending to Mexico shows the highest share of longer-term loans (20% at five years or more).

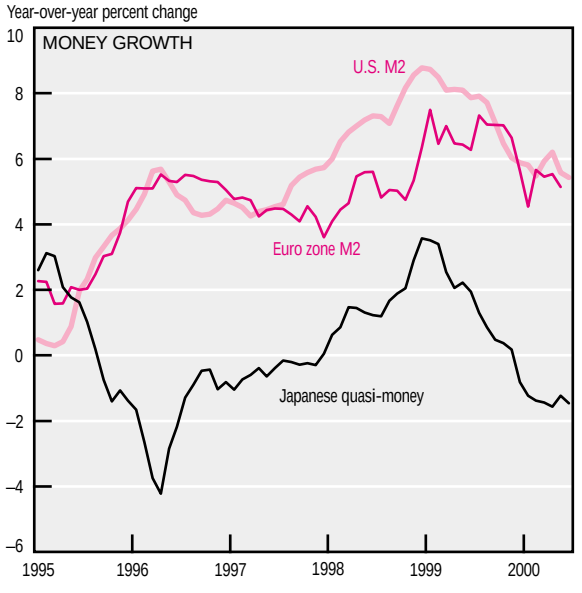
Money-center banks' share of U.S. banks' exposure to developing countries has increased since late 1997 or early 1998. This might reflect a general trend, given these banks' increased share of total exposure, including that to the G-10 countries and Switzerland.

The Dollar and International Trade









SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Japan Securities Dealers Association; and Statistical Office of the European Communities.

The U.S. goods deficit increased $0.3 billion in May, reaching $37.2 billion, while the services surplus decreased $0.3 billion to $6.1 billion. Goods exports decreased more than goods imports, with capital goods accounting for most of the decline. The decrease in the services surplus resulted mainly from declines in travel and other transportation.

The dollar has held firm against the yen since March because of the fragility of Japan's economic recovery. The dollar has weakened against the euro since May but seems to have been supported by market sentiment in favor of a "soft landing" scenario for the U.S. economy. While long-term interest rates in the euro zone exceed those in the U.S., and money growth rates for the two regions are tracking closely, expectations for higher money growth and inflation in Europe could support the dollar.

Continued weakness in Japan's economy dampens hopes for higher interest rates there that might support the yen. However, capital inflows could increase if there were news of renewed economic vigor and higher rates. Although Japan's energy import prices have risen, its overall inflation picture remains unclear; this bears on the assessment of the current monetary policy stance.