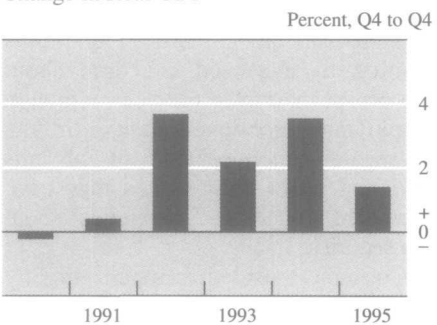
The Economy in 1995

According to estimates that were available as of mid-March 1996, real gross domestic product increased slightly less than 1½ percent over the four quarters of 1995 after a gain of 3½ percent in 1994. The 1995 rise in aggregate output was accompanied by an increase in payroll employment of 1¾ million, and the unemployment rate, after having fallen sharply in 1994, held fairly steady over the course of 1995, keeping to a range of about 5½ percent to 5¾ percent. Consumer prices, as measured by the CPI for all items, rose 2¾ percent over the four quarters of 1995, an increase that was virtually the same as those of the two previous years.

Growth of output during the past year was slowed in part by the actions of businesses to reduce the pace of inventory accumulation after a burst of stockpiling in 1994. Final sales—a measure of current output that does not end up in inventories—rose at an average rate of about 2 percent over the four quarters of 1995 after an increase of 3 percent during 1994. The slowing of final sales was largely a reflection of a downshifting in growth of the real outlays of households and businesses, from elevated rates of increase in 1994 to rates that are more sustainable. Real government outlays for consumption and investment fell about 1¼ percent during the year. Increases in exports and imports of goods and services were smaller in real terms than the increases of 1994, and their combined effect on GDP growth was slightly positive.

Change in Real GDP



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

The Household Sector

Real personal consumption expenditures rose about 2 percent during 1995 after having risen 3 percent over the four quarters of 1994. The reduced rate of rise in consumption spending this past year came against the backdrop of moderate gains in employment and income. The financial wealth of households surged, but the impetus to spending from this source evidently was countered by other influences, such as increases in debt burdens among some households and a rise, according to survey data, in consumers' concerns about job security.

Real consumer expenditures for durable goods increased 2 percent during 1995, a slower rate of rise than in other recent years. Consumer expenditures for motor vehicles declined about 3 percent after having moved up nearly 20 percent over the three previous years. A variety of price concessions to motor vehicle buyers probably gave some lift to sales in 1995; however, pent-up demand, which had helped to boost sales earlier in the expansion, probably was no longer an important factor.

Real outlays for durable goods other than motor vehicles continued to rise at a brisk pace in 1995 but not so rapidly as in other recent years. Spending for furniture and household equipment hit a temporary lull in the first part of 1995 but picked up again over the next three quarters, lifted in part by a rebound in the construction of new houses. Spending for home computers and other electronic gear, which has been surging in recent years, continued to move up rapidly in 1995.

Consumer expenditures for nondurables increased less than 1 percent, in real terms, during 1995 after a larger-than-average gain in 1994. The growth of real expenditures on apparel slowed sharply after three years of sizable advances, and outlays for food registered only a small gain in real terms.

Real expenditures for services—which account for more than half of total consumer outlays—increased 2½ percent during 1995, a moderately faster pace than in either 1993 or 1994. After declining in 1994, outlays for energy services increased sharply in 1995. Spending gains for other categories of services proceeded at an average rate of slightly less than 2½ percent over the four quarters of 1995, just a touch faster than the rate of rise in the two previous years.

Real disposable personal income grew nearly 3 percent during 1995, a slightly larger gain than in the previous year. Nominal personal income increased slightly faster in 1995 than it did in 1994, and growth of nominal disposable income, which excludes income taxes, held close to its 1994 pace. Inflation continued to take only a moderate bite from increases in nominal receipts.

After little change during 1994, the real value of household wealth surged in 1995. The value of assets was boosted substantially by huge increases in the prices of stocks and bonds. Liabilities continued to rise fairly rapidly but at a rate well below the rate of increase in household assets; the rapid growth of consumer credit was again the most notable feature on the liability side. Behind these aggregate measures of household assets and liabilities was some wide variation in the circumstances of individual households. Appreciation of share prices and the rally in the bond market provided a substantial boost to the wealth of households holding large amounts of those assets, but households holding few such assets benefited little from the rally in securities prices. Some households also began to experience greater financial pressure in 1995. Overall, however, the incidence of financial stress appears to have been limited, as sustained increases in personal income helped to facilitate timely repayment of obligations.

Consumers maintained relatively upbeat perceptions of current and future economic conditions during 1995. The measure of consumer confidence that is prepared by the Conference Board held fairly steady at a high level. The index of consumer sentiment compiled by the University of Michigan Survey Research Center edged down a little, on net, from the end of 1994 to the end of 1995, but its level also remained relatively high. By contrast, some survey questions dealing specifically with perceptions of labor market conditions pointed to increased concerns about job prospects during the year; although employment continued to rise in the aggregate, announcements of job cuts by some major corporations may have rekindled consumers' anxieties about job security.

Consumers tended to save a slightly higher proportion of their income in 1995 than they had in 1994. Large increases in financial wealth usually

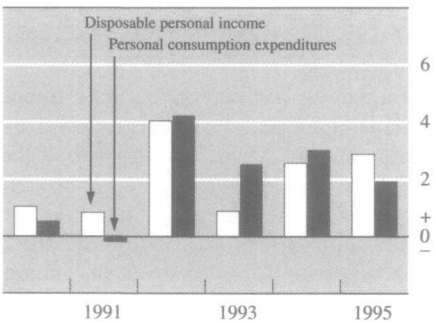
cause households to spend a greater share of their current income, thereby reducing the share of income that is saved. However, rising debt burdens and increased nervousness about job prospects would work in the opposite direction, and these influences may have offset the effect of increases in wealth. Some households also may have started focusing more intently on saving for retirement, especially in light of increased political debate about curbing the growth of entitlements provided under government programs. Nonetheless, the personal saving rate for all of 1995, while moving up a little, remained in a range that was relatively low by historical standards.

Residential investment fell in the first half of 1995 but turned up in the second half. Both the downswing in the first half and the subsequent rebound after midyear appear to have been shaped, at least in a rough way, by swings in mortgage interest rates. Although housing activity had been slow to respond to increases in mortgage interest rates through much of 1994, sizable declines in sales of new and existing homes started to show up toward the end of that year, and by early 1995, permits and starts also were dropping. However, the decline in activity proved to be relatively short and mild. By March, mortgage interest rates already were down appreciably from the peaks of late 1994, and midway through the second quarter, most indicators of housing activity were starting to rebound. Sales of new homes surged to especially high levels during the summer, and permits and starts of single-family units rose appreciably. In the autumn, sales retreated from their midyear peaks. Starts also slipped back somewhat during the autumn, but permits continued to firm, climbing to a yearly high in December.

The intra-year swings in the various housing indicators left the annual totals for these indicators at fairly elevated levels. Sales of existing homes in 1995 were well above the annual average for the 1980s, even after adjusting for increases in the stock of houses. Starts and sales of new single-family dwellings in 1995 were about one-tenth higher than their averages for the 1980s. So far in the 1990s, demographic influences have been less supportive of housing activity than in the 1980s; the rate of household formation has lagged, in part because many young adults have delayed setting up their own domiciles. However, offsetting impetus to demand has come from the improved affordabil-

Change in Real Income and Consumption

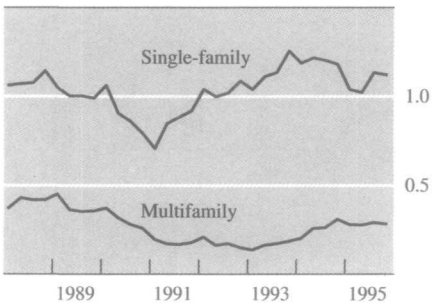
Percent, Q4 to Q4



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

Private Housing Starts

Millions of units, annual rate



NOTE. The data are seasonally adjusted and come from the Department of Commerce.

ity of housing, brought about in particular by declines in mortgage interest rates.

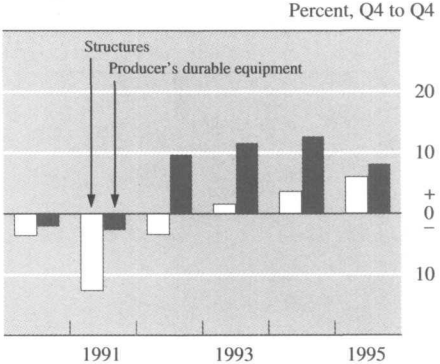
The construction of multifamily units, after taking a notable step toward recovery in 1994, exhibited little momentum in 1995. For the year as a whole, starts of multifamily units amounted to about 280,000, compared with a tally of about 260,000 in 1994 and a low of about 160,000 in 1993. Financing for the construction of new multifamily projects appeared to be readily available in 1995. However, the national vacancy rate for multifamily rental units, while down from the peaks of a few years ago, remained relatively high, and increases in rents apparently were not sufficient to stimulate a significant gain in the construction of new units.

The Business Sector

Most indicators of business activity remained favorable in 1995, but strength was less widespread than it had been in 1994, and growth overall was less robust. The output of all nonfarm businesses rose slightly less than 2 percent over the four quarters of 1995 after a gain of 4 percent in 1994—the latter pace of growth could not have been sustained given already high operating levels. Inventory problems cropped up in some lines of manufacturing and trade in 1995 and prompted production adjustments. Scattered structural problems were apparent as well, especially in parts of retail trade in which intense competition for market share caused financial losses and eventual bankruptcy for some enterprises. More generally, however, businesses continued to profit from strategies that have served them well throughout the 1990s—most notably, tight control over costs and the rapid adoption of new technologies achieved through heavy investment in high-tech equipment.

Change in Real Business Fixed Investment

Percent, Q4 to Q4



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

In total, real business fixed investment increased 7½ percent during 1995 after a gain of 10 percent in 1994. Growth in business spending for equipment continued to outpace the growth of investment in structures even though the latter scored its largest gain of the past several years. On a quarterly basis, investment remained very strong through the first quarter of 1995. After slowing sharply in the spring, it then picked up again in the third and fourth quarters but did not reach the pace seen early in the year.

Businesses continued to invest heavily in computers in 1995. In real terms, these expenditures rose nearly 40 percent over the year, an increase that was even larger than those of other recent years.

Excluding computers, real investment outlays increased less rapidly, on balance, than in 1994, and growth after the first quarter was quite small. In the equipment category, outlays for information-processing equipment other than computers moved up at an annual rate of about 13 percent in the first half of 1995, fell back a little in the third quarter, and turned back up again in the

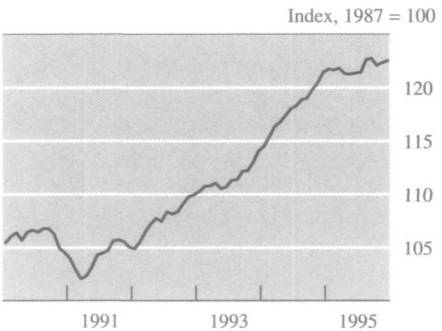
year's final quarter. Spending for industrial equipment also rose sharply in the first half of the year; it then fell moderately in the second half. Real outlays for transportation equipment followed a choppy pattern that resulted in little net gain over the year as a whole. Real investment in nonresidential structures moved up in each quarter, with gains cumulating to an annual rise of 6 percent; 1995 brought increased construction of most types of nonresidential buildings.

In the industrial sector, elevated levels of investment in equipment and structures led to a gain of about 4 percent in industrial capacity. However, in a turnabout from the outcome of the previous year, output of the industrial sector rose considerably less rapidly than capacity: A gain of 1½ percent in total industrial production over the four quarters of 1995 was a sharp slowdown from a 1994 rise of more than 6½ percent. Production of consumer goods followed an up-and-down pattern during 1995 and rose less than ½ percent over the year as a whole, the smallest annual increase of the current expansion. The output of business equipment advanced in each quarter, but a cumulative gain of 4½ percent for this category was smaller than the increases of other recent years. Production of materials faltered temporarily in the second quarter, but production gains resumed thereafter, leading to a rise of about 2½ percent over the four quarters of the year.

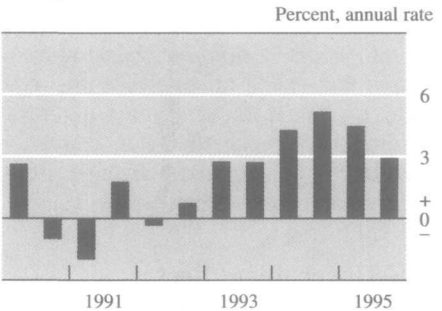
With capacity expanding rapidly and production growth slowing, the rate of capacity utilization in industry turned down sharply in 1995, backing away from the high operating rates of late 1994. As of December 1995, the utilization rate in manufacturing was about ½ percentage point above its long-term average.

After rising rapidly during 1994, business inventories continued to build at a substantial pace in the early part of 1995. By the end of the first quarter, real inventories of nonfarm businesses were about 5½ percent above the level of a year earlier. Meanwhile, strength that had been evident in final sales during 1994 gave way to more subdued growth in the first quarter of 1995, and the ratio of inventories to sales rose. In the second and third quarters, the growth of inventories slowed appreciably, and another sharp downward step in the rate of inventory accumulation took place in the fourth quarter. At year-end, significant imbalances probably were present in only a few industries. The potential for wider inventory problems appears to

Industrial Production



Change in Real Business Inventories



NOTE. Total nonfarm sector. The data are seasonally adjusted, derived from chained (1992) dollars, and come from the Department of Commerce.

have been contained through a combination of production restraint late in 1995, caution in ordering merchandise from abroad, and discounting by some retailers during the holiday shopping season.

Business profits rose further over the first three quarters of 1995. Economic profits of all U.S. corporations increased at an annual rate of nearly 11 percent, a pace similar to that seen over the four quarters of 1994. The profits of corporations from their operations in the rest of the world moved up sharply, on net, and earnings from domestic operations also continued to advance. The strongest gains in domestic profits came at financial corporations and reflected, in part, an increased volume of lending by financial institutions, reduced premiums on deposit insurance at commercial banks, and rising profits of securities dealers.

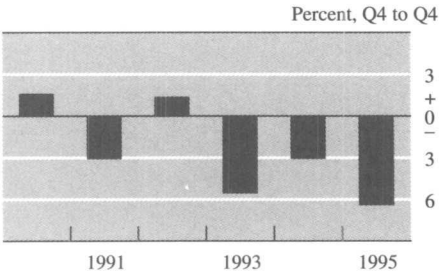
The economic profits earned by nonfinancial corporations from their domestic operations rose at an annual rate of about 3½ percent over the first three quarters of 1995 after three years in which the annual increases were 15 percent or more. A moderation of output growth and a flattening of the rise in profits per unit of output both worked to reduce the rate of growth in nominal earnings at nonfinancial corporations in 1995. Nonetheless, with unit costs also moving up at a moderate pace, the share of the value of nonfinancial corporate output that ended up as profits changed little, on net, in the first three quarters, holding in a range that was relatively high in comparison to the average profit share over the past couple of decades.

The Government Sector

At the federal level, combined real outlays for investment and consumption fell nearly 6½ percent over the four quarters of 1995, dropping by the fourth quarter to a level about 15 percent below the level in 1990. Both investment and consumption were cut back. Outlays for defense continued to contract, and nondefense expenditures turned down, more than reversing their moderate increase over the four quarters of 1994.

Federal outlays in the unified budget, which covers transfers and grants as well as consumption and investment expenditures other than the consumption of fixed capital, rose 3¾ percent in nominal terms in fiscal 1995, matching almost exactly the percentage rise of the previous fiscal year. Nominal outlays for defense declined 3¼ percent in both fiscal 1995 and fiscal 1994. Outlays for social security increased about 5 percent in both years. Spending for Medicare and Medicaid continued to rise at rates appreciably faster than the growth of nominal GDP. Net interest payments jumped in fiscal 1995 after three years of relatively little change, but working in the other direction, net outlays for deposit insurance were more negative than in 1994 (that is, revenues from premiums and other sources exceeded the payout for losses by a larger amount). Proceeds from auctions of spectrum rights also helped to hold down expenditures; like the premiums

Change in Real Federal Expenditures on Consumption and Investment



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

for deposit insurance, these proceeds enter the budget as a negative outlay. In the first three months of fiscal 1996—that is, the three-month period ended in December 1995—federal outlays were about 1 percent lower in nominal terms than in the comparable period of fiscal 1995. Nominal outlays for defense continued to trend down, and the spending restraint embodied in continuing budget resolutions translated into sharp cuts in some nondefense outlays.

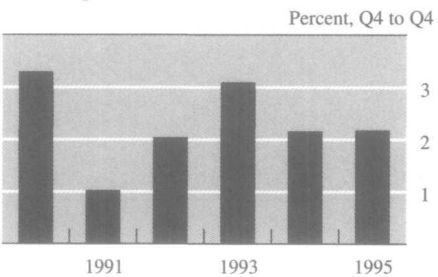
Federal receipts rose 7½ percent in fiscal 1995 after having increased 9 percent in fiscal 1994. In both years, categories of receipts that are most closely related to the state of the economy showed sizable increases. With receipts moving up more rapidly than spending in fiscal 1995, the federal budget deficit fell for a third consecutive year, to $164 billion. Progress in reducing the deficit in recent years has come from cyclical expansion of the economy, tax increases, nonrecurring factors such as the sale of spectrum rights, and adherence to the budgetary restraints embodied in the Budget Enforcement Act of 1990 and the Omnibus Budgetary Reconciliation Act of 1993.

The economic expansion also has helped to relieve budgetary pressures that many state and local governments were experiencing earlier in the 1990s. Excluding social insurance funds, surpluses in the combined current accounts of state and local governments were equal to about ½ percent of nominal GDP in the first three quarters of 1995; this figure was more than double the average for 1991 and 1992, when budgetary pressures were most severe.

Even so, state and local budgets remain at the center of strongly competing pressures, with the demand for many of the services that these governments typically provide continuing to rise at a time when the public also is pressing for tax relief. Although states and localities have responded to these pressures in different ways, the aggregate picture is one in which expenditures and revenues have continued to rise faster than nominal GDP—but by smaller margins than in the early part of the 1990s. In total, the current expenditures of state and local governments, made up mainly of transfers and consumption expenditures, were equal to about 12½ percent of nominal GDP in 1995, up slightly from the percentages of the two previous years and about 1¾ percentage points higher than the comparable figure for 1989. Total receipts of state and local governments were equal to about 13¾ percent of nominal GDP in the first three quarters of 1995, a little above the comparable percentages of the two previous years and about 1¼ percentage points higher than the percentage in 1989.

State and local outlays for consumption and investment—the expenditures that are included in GDP—have been rising less rapidly than the current expenditures of these jurisdictions because GDP excludes transfer payments, which have been growing faster than other outlays. In real terms, combined state and local outlays for consumption and investment increased about 2¼ percent

Change in Real State and Local Expenditures on Consumption and Investment



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

over the four quarters of 1995. Real investment expenditures, which consist mainly of outlays for construction, moved up almost 6 percent. By contrast, consumption expenditures, which are about four times the size of investment outlays, rose less than 1½ percent in real terms.

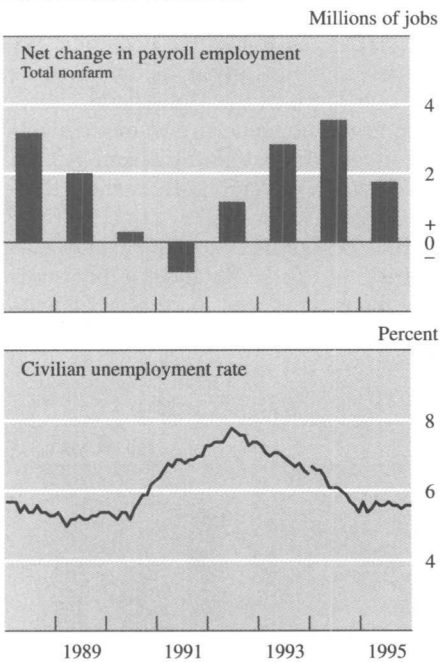
Labor Markets

The number of jobs on nonfarm payrolls increased 1¾ million, or 1.6 percent, over the twelve months ended in December 1995. After a sharp rise during 1994, gains in employment began to slow in the first quarter of 1995, and the second-quarter gain was relatively small. Thereafter, increases picked up somewhat. Nearly 450,000 jobs were added in the final three months of the year, a rate of gain that was about equal to that for the year as a whole.

As in 1994, increases in payroll employment in 1995 came mainly in the private sector of the economy, but gains there were more mixed than those of 1994. In manufacturing, employment fell about 165,000 over the twelve months ended in December, reversing almost half of the previous year's gain. Losses were concentrated in industries that produce nondurables. A decline this past year in the number of jobs at apparel manufacturers was one of the largest ever in that industry. Sizable reductions in employment also were reported by manufacturers of textiles, tobacco, leather products, and petroleum and coal. In many of these industries, cyclical deceleration of the economy in 1995 compounded the effects of adjustments stemming from longer-run structural changes. In contrast to the widespread contraction in employment among producers of nondurables, employment at the manufacturers of durable goods increased slightly during 1995. Hiring continued to expand briskly at firms that produce business equipment. Metal fabricators also sustained growth in employment but at a slower pace than in 1994. The number of jobs in transportation equipment declined, on net.

In most other sectors of the economy, employment rose moderately last year. The number of jobs in construction increased 130,000 over the twelve months ended in December, a rise of more than 3 percent. In the private service-producing sector, which now accounts for about three-fourths of all jobs in the private sector, employment increased 1.7 million in 1995 after having advanced 2.6 million in 1994. Establishments that are involved in wholesale trade continued to boost payrolls at a

Labor Market Conditions



NOTE. The data are from the Department of Labor. The department introduced a new survey of households in January 1994; unemployment data from that point on are not directly comparable with those of earlier periods.

relatively brisk pace in 1995. Retailers also added to employment but at a considerably slower rate than in 1994; within retail trade, employment at apparel outlets fell substantially last year, and payrolls at stores selling general merchandise dropped moderately after a large increase in 1994. Providers of health services added slightly more jobs than in other recent years. At firms that supply services to other businesses, employment growth was sizable again in 1995 but less rapid than in either of the two previous years; in this category, providers of computer services expanded their job counts at an accelerated pace in 1995, but suppliers of personnel—a category that includes temporary help agencies—added jobs at a much slower rate than in other recent years.

Results from the monthly survey of households showed the civilian unemployment rate holding in a narrow range throughout 1995, and the December rate—5.6 percent of the labor force—was near the midpoint of the range.

The proportion of working-age persons choosing to participate in the labor force edged down slightly, on net, over the course of 1995. It has changed little, on balance, since the start of the 1990s. By contrast, the two previous decades had brought substantial net increases in labor force participation, although longer-term trends during that period were interrupted at times by spells of cyclical sluggishness in the economy. Two or three years ago, cyclical influences also seemed to be a plausible explanation for the lack of growth in the participation rate in the current business expansion. But with the sluggishness persisting as job opportunities have continued to expand, the evidence is pointing increasingly toward a slower rate of rise in the trend of labor force participation. Slower growth in participation will tend to limit the growth of potential output, unless an offsetting rise is forthcoming in the trend of productivity growth. So far in the current expansion, measured increases in productivity seem to have followed a fairly typical cyclical pattern, with larger increases early in the expansion and smaller gains, on average, in subsequent years. Overall, however, this pattern has not yielded evidence of a significant pickup in the longer-term trend of productivity growth.

The average unemployment rate for all of 1995 was about ½ percentage point below the average for 1994, and it was only a little above the levels to which the unemployment rate fell in the latter stages of the long business expansion of the 1980s. The low unemployment rates reached then proved to be unsustainable, as they eventually were accompanied by a significant step-up in the rate of inflation, brought on in part by faster rates of rise in hourly compensation and unit labor costs.

Similar inflation pressures have not emerged in the current expansion. The employment cost index for hourly compensation of workers in private nonfarm industries rose only 2.8 percent over the twelve months ended in December, the smallest annual increase on record in a series that goes back to 1980. Hourly wages increased 2.8 percent during the past year, the same relatively low rate of increase as in 1994. The cost of fringe benefits, prorated to an hourly basis, rose only 2.7 percent last year, the smallest annual rise on record. With many firms still undergoing restructurings and reorganizations, many of which have involved permanent job losses, workers probably have been more reluctant to press for wage increases than they normally would have been during a period of tight labor markets. Also, firms have been making unprecedented

efforts to gain better control over the rate of rise in the cost of benefits provided to employees, especially those related to health care. Although some of these efforts may have only a one-time effect on the level of benefit costs, groundwork also seems to have been laid for slower growth of benefits over time than would otherwise have prevailed.

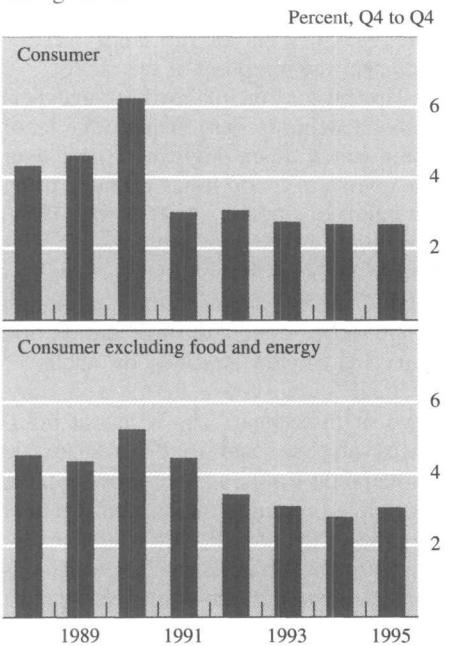
Prices

Early in 1995, inflation pressures that had started building in 1994 seemed to be gaining intensity. Indexes of spot commodity prices continued to surge in the early part of last year, and in the producer price index, materials prices recorded some exceptionally large increases. Consumer prices also began to exhibit some upward pressure, with the index for items other than food and energy moving up fairly rapidly over the first four months of the year.

The surge in inflation proved to be relatively short-lived, however. The spot prices of industrial commodities turned down in the spring of the year and fell further, on net, after midyear. Price increases for intermediate materials slowed in the second and third quarters of 1995, and by the final quarter of the year these prices also were declining. Monthly increases in the CPI excluding food and energy slowed in May; increases in this indicator of core inflation generally were small over the remainder of the year. The slowing of the economy after the start of the year appears to have cut short the buildup of inflationary pressures before they could have much effect on the underlying processes of wage and price determination. In the end, the rise in the core CPI from the final quarter of 1994 to the final quarter of 1995 amounted to 3 percent, an increase that differed little from those of the two previous years. The increase in the total CPI in 1995 came in at 2¾ percent, the third consecutive year in which it has been less than 3 percent.

In the aggregate, rates of price increase held fairly steady for both goods and services this past year. The CPI for commodities other than food and energy rose 1¾ percent over the four quarters of 1995 after increases of 1½ percent in both 1993 and 1994. The last three-year period in which prices of these goods rose by such small amounts came in the middle part of the 1960s. Apparel prices continued to decline last year but not so rapidly as in the previous year. Price increases for vehicles moderated. The 1995 rise in the CPI for services other than energy was 3¾ percent; although this increase exceeded the 1994 rise by a slight amount, the results for both years were among the smallest

Change in Prices



NOTE. Consumer price index for all urban consumers. Based on data from the Department of Labor.

increases for this category in the last three decades.

Trends in food prices and energy prices remained favorable to consumers in 1995. The rise in food prices from the final quarter of 1994 to the final quarter of 1995 was slightly more than 2½ percent, almost exactly the same as the increases of the two previous years. The last yearly increase in food prices in excess of 3 percent came in 1990. In 1995, weather problems led to a decline in crop production and to a surge in the prices of some crops, but this surge did not bring about widespread increases in food prices at the retail level. Livestock production continued to advance, helping to restrain price increases for meats and dairy products. Also, moderate rates of increase in the costs of nonfarm inputs that contribute heavily to value added continued to be an important anchor in the setting of food prices at the consumer level.

In the energy area, prices at the consumer level fell 1¾ percent, on net, over the four quarters of 1995, more than reversing a moderate 1994 increase. Gasoline prices dropped nearly 5 percent, on net, over the four quarters of the year, and consumer prices of natural gas also declined appreciably. However, some upward pressures developed late in 1995, partly in response to unexpectedly cold temperatures that boosted fuel requirements for winter heating.

All told, the price developments of 1995 appear to have left a favorable imprint on expectations of future rates of inflation, if results from various surveys of consumers and forecasters are an accurate reflection of the views held by the broader public. Monthly responses to the surveys tend to bounce around somewhat, but over 1995 as a whole, average readings of anticipated price increases one year into the future were slightly lower than those of 1994, and survey responses about inflation prospects over the longer term came down more substantially. Although the responses regarding expected inflation still tended, on balance, to run to the high side of actual rates of price increase, the easing of inflation expectations this past year provided another encouraging sign that inflation processes that helped to undermine other recent business expansions were in check as 1995 drew to a close. ■