

## *The Economy in Perspective*

*Ex uno plura* ...Voters in Quebec recently indicated their opposition to seceding from the rest of Canada. The outcome of the referendum was extremely close, however, and the separatists vow to continue their campaign until they are successful. Commentators report that an actual separation would require extensive negotiations over borders, treaties, claims to natural resources, and a host of other property-rights concerns. Discussions surrounding this issue elicit deep emotional responses: People clearly have strong feelings about living in a place whose values reflect their own sense of identity.

The Canadians are not the only people re-examining the meaning of government in their lives. Citizens of regions that formerly made up the Soviet Union are exploring new forms of government and new relationships with Russia. Though some of these situations are being handled peacefully, others have involved protracted military conflict. And in places like Northern Ireland and the Middle East, blood has been spilled over questions of boundaries and sovereignty for decades or centuries.

Two aspects of this soul-searching merit attention. There are many examples of large countries splitting into several smaller ones, with Germany being the notable exception. Whether the process is called secession, separation, or partition, the catalyst is largely the same. Within a country, a group of people begin to feel alienated from a government they believe is treating them unfairly, and they yearn for a new regime that will respect them and protect their values. To reduce the tensions that can arise from having to share a common government, one group begins the process of separating from the other.

A second trend can be seen in nations where pressures exist to limit the role of all levels of government, but especially the central government. Here, the frustrations are less a matter of one group against another than of widespread discontent about government itself. In the United States, Congress is considering eliminating or reducing the constraints it now places on states and local governments as conditions for receiving federal funds. The ascendant philosophy holds that government decisions should be made at levels closest to the citizen. One-size-fits-all programs invented in Washington are

giving way to customized local solutions.

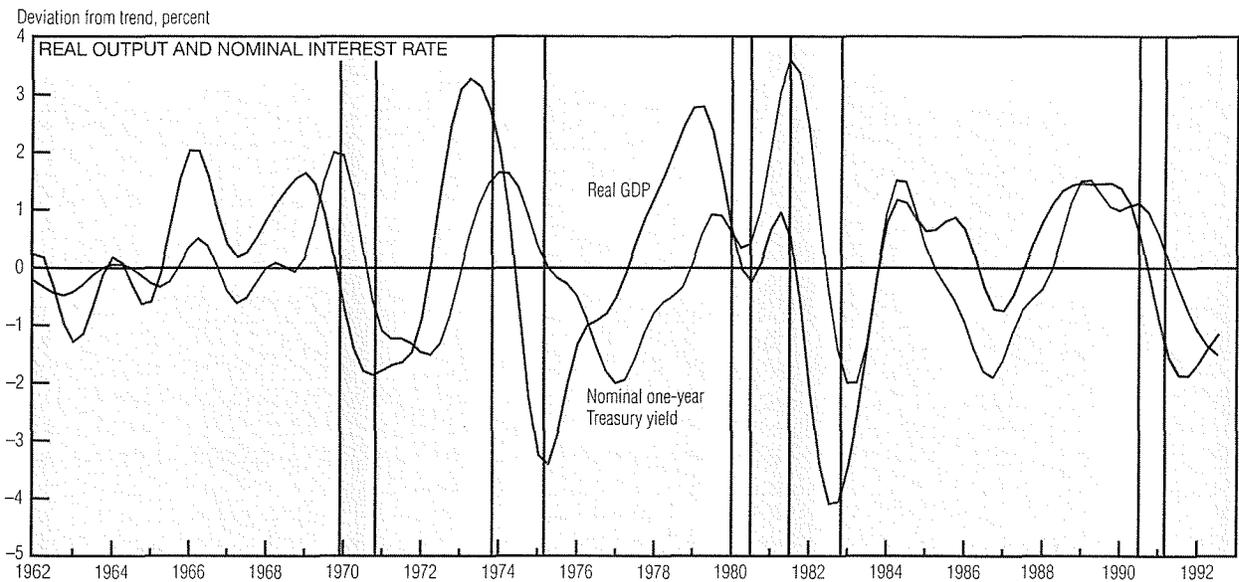
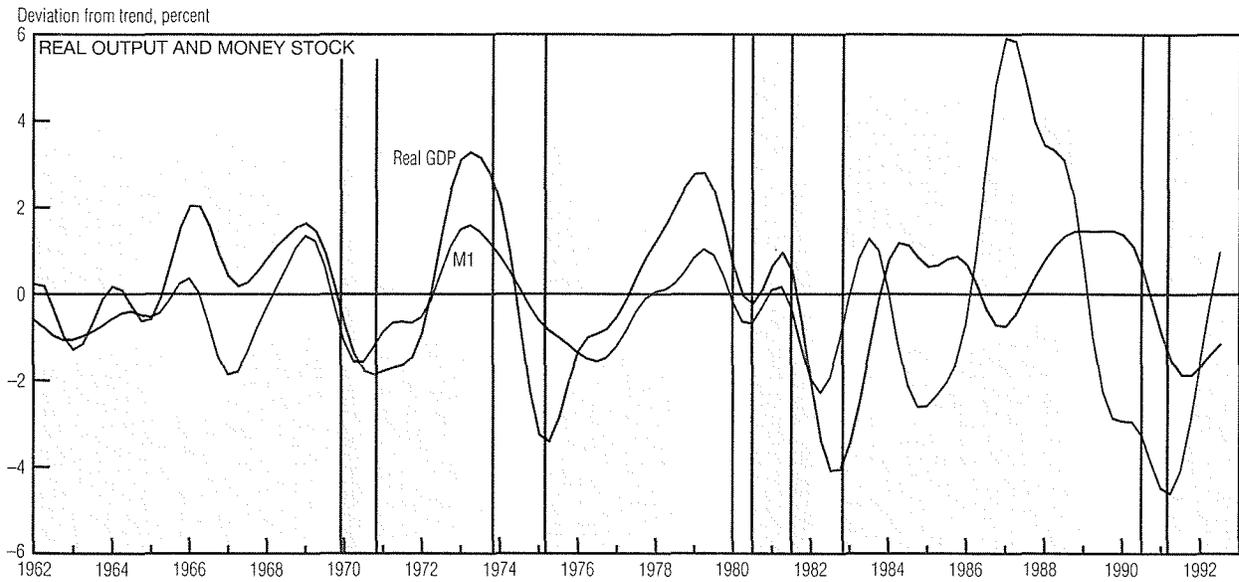
All of these developments — from dissolution to devolution — should cause us to ponder what we expect from government in the twenty-first century. What is left of our concept of government after we outsource street cleaning, park services, and the like? After we replace public education with a voucher-driven system of competitive schools? After we privatize prisons and Social Security? Once we vent our frustration about how poorly governments perform, what exactly do we want our governments to do? There is genuine confusion about the answer, because governments are no longer the most obvious solution to some of society's economic problems.

The essence of government authority is the ability to force people to follow the law. Ironically, though, the state's coercive power is a double-edged sword. One side of the blade can be used to promulgate regulations and policies that transfer wealth from some people to others, but that do not enhance society's welfare as a whole. Some view these activities as legalized theft, while others regard them as a source of social equity.

The other side of the state's coercive blade can be used to provide public goods that markets would not provide on their own. Traditionally, these have included lighthouses, bridges, public health services, and national defense. But governments that worry about caring for sick or destitute citizens could also force people to join health care groups, or to pay into unemployment insurance funds, in ways that truly diversify the risks of catastrophe. That is, governments can force risk-sharing in situations where private insurance markets may not function well. These are welfare-enhancing activities.

Government's role in society has two distinct dimensions. When governments provide goods and services, including risk-bearing services, they may improve the nation's social welfare. But what made sense for a government yesterday may not make sense tomorrow. Governments also manifest a set of values regarding the rights of their citizens. Here, too, we should expect change. But isn't it odd that as the nations of the world move toward more openness in their relationships, groups of citizens within countries seek more distance from one another?

# Monetary Policy



NOTE: Shaded areas indicate recessions. All data in the Monetary Policy section represent deviations from long-run trend in percent. The trend is defined using a two-sided filter with 12 leads and lags. For further details on this topic, see R. King and M. Watson, "Money, Prices, Interest Rates, and the Business Cycle," Federal Reserve Bank of Chicago, Working Paper 95-10, July 1995.

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

The link between money, prices, interest rates, and the business cycle is the subject of considerable debate among policymakers and economists. Researchers continue to strive for a coherent, tractable model to help them understand the precise mechanism by which monetary policy affects the macroeconomy. Before setting out to develop such a model, researchers must un-

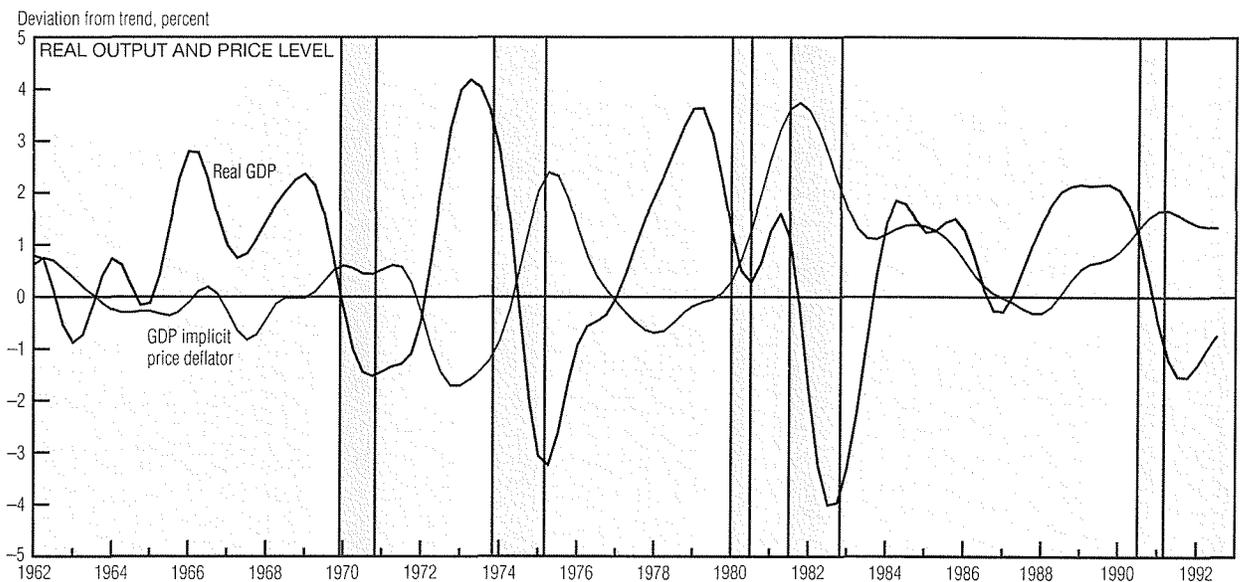
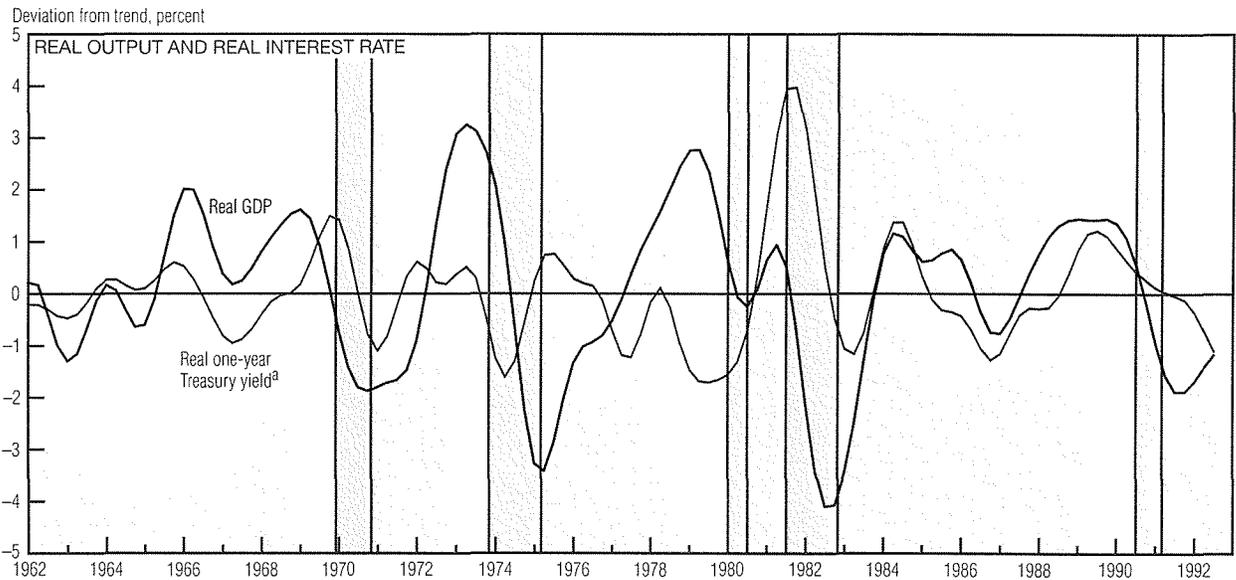
dertake a thorough study of the available data to identify the key features and regularities that a successful model must incorporate.

Movements in macroeconomic variables can be broken down into two broad categories. The cyclical, or high-frequency, component measures the short-run fluctuations of a given variable from quarter to quarter or from year to year. The trend, or low-frequency, component meas-

ures the variable's long-run behavior. For these purposes, economists typically define short-run movements as those lasting less than 32 quarters. In contrast, the trend component captures movements over many decades. The trend component of a data series can be identified using statistical techniques to draw a smooth line through the

*(continued on next page)*

## Monetary Policy (cont.)



a. The real one-year Treasury yield is the nominal one-year Treasury yield minus one-year mean inflation expectations as measured by the University of Michigan's Survey of Consumers.

NOTE: Shaded areas indicate recessions.

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

central tendency of the data. At each point in time, the cyclical component is defined as the deviation of the variable from its long-run trend.

Focusing our attention on the cyclical components of the data reveals some interesting regularities. First, except for a period in the mid-1980s, there is a relatively strong correlation between movements in output (as measured by real GDP) and the nominal money stock (as

measured by the M1 aggregate). Moreover, changes in the money stock tend to precede changes in real output, suggesting that the money stock may be a useful leading indicator.

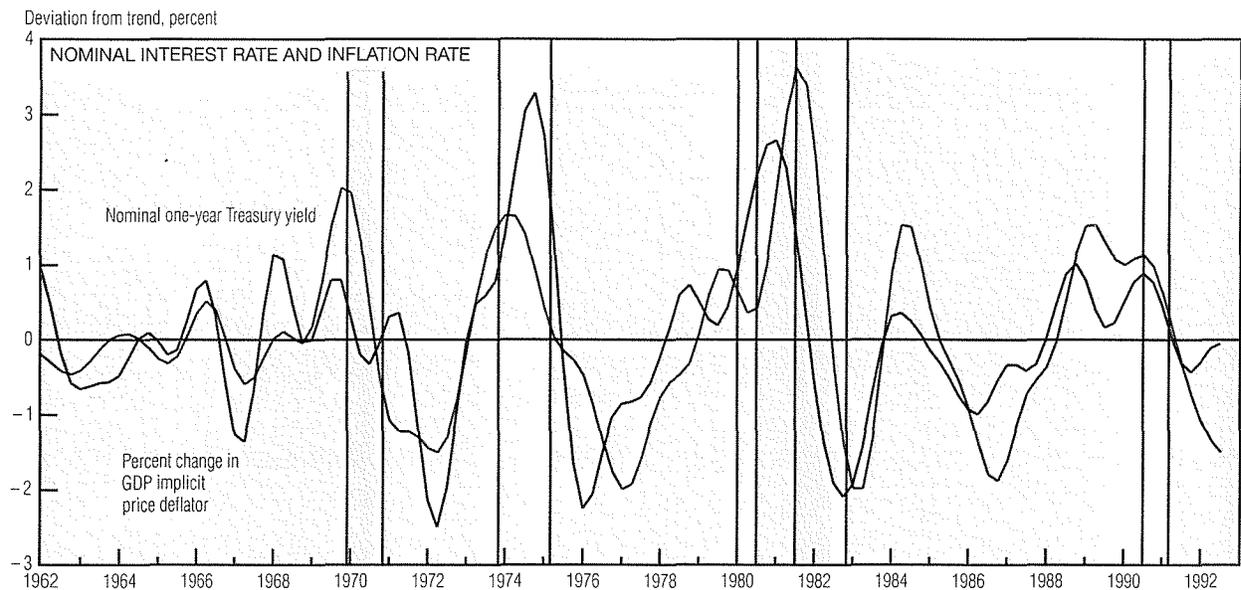
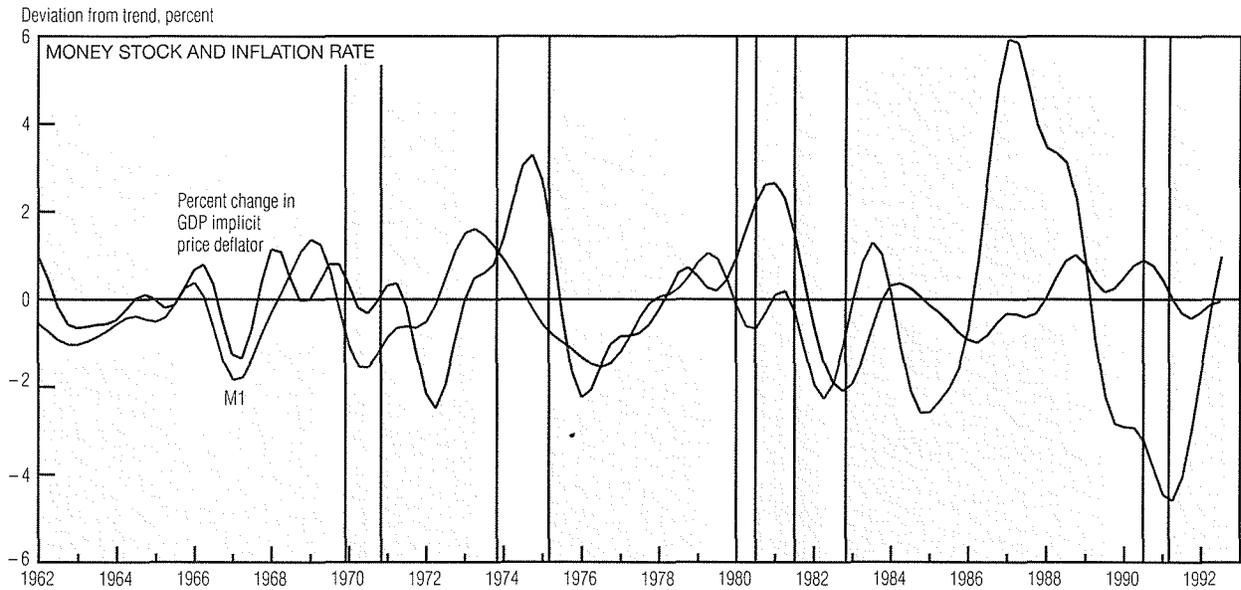
Notice that each of the last five recessions was preceded by a period when the money stock declined relative to trend. But it is important to note that the comovement of money and output need not imply the existence of a causal relationship run-

ning from money to output. Indeed, many researchers argue precisely the reverse—that the level of real output determines just how much money people are willing to hold.

A second observation is that interest rates, both nominal and real, tend to rise prior to recessions and thus also behave like leading indicators. Third, the overall level of prices (as measured by the GDP

*(continued on next page)*

## Monetary Policy (cont.)



NOTE: Shaded areas indicate recessions.

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

implicit price deflator) tends to move opposite to the direction of real output over most of the sample period. This countercyclical behavior of prices is consistent with the view that output fluctuations are largely caused by supply-side disturbances that shift the economy's aggregate supply curve back and forth along a downward-sloping aggregate demand curve.

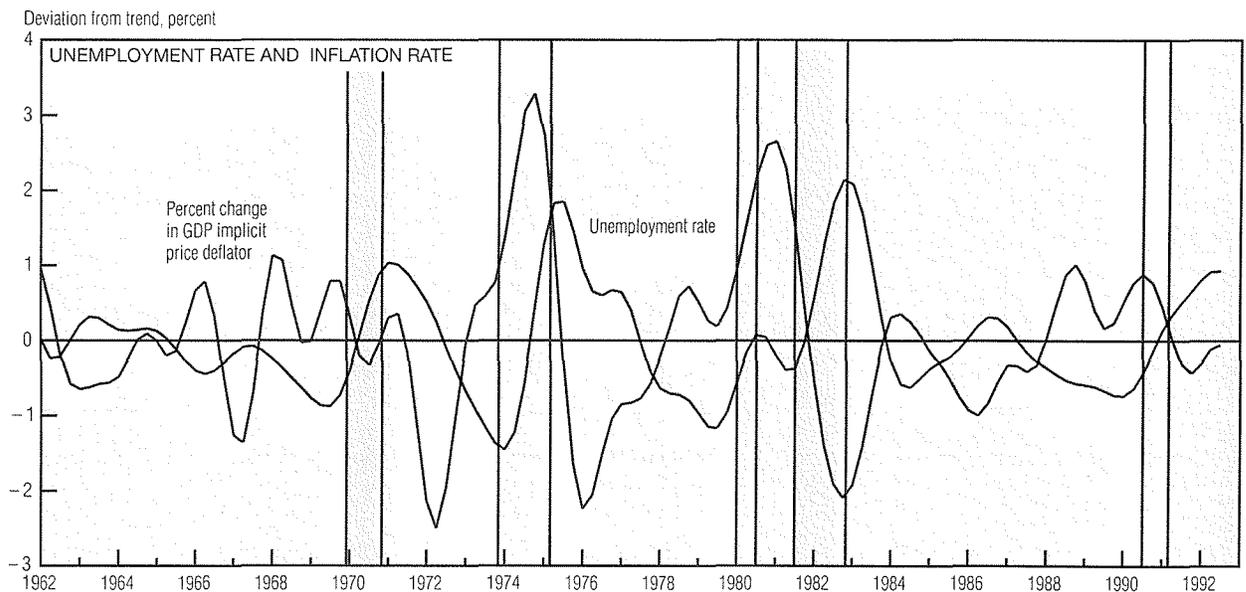
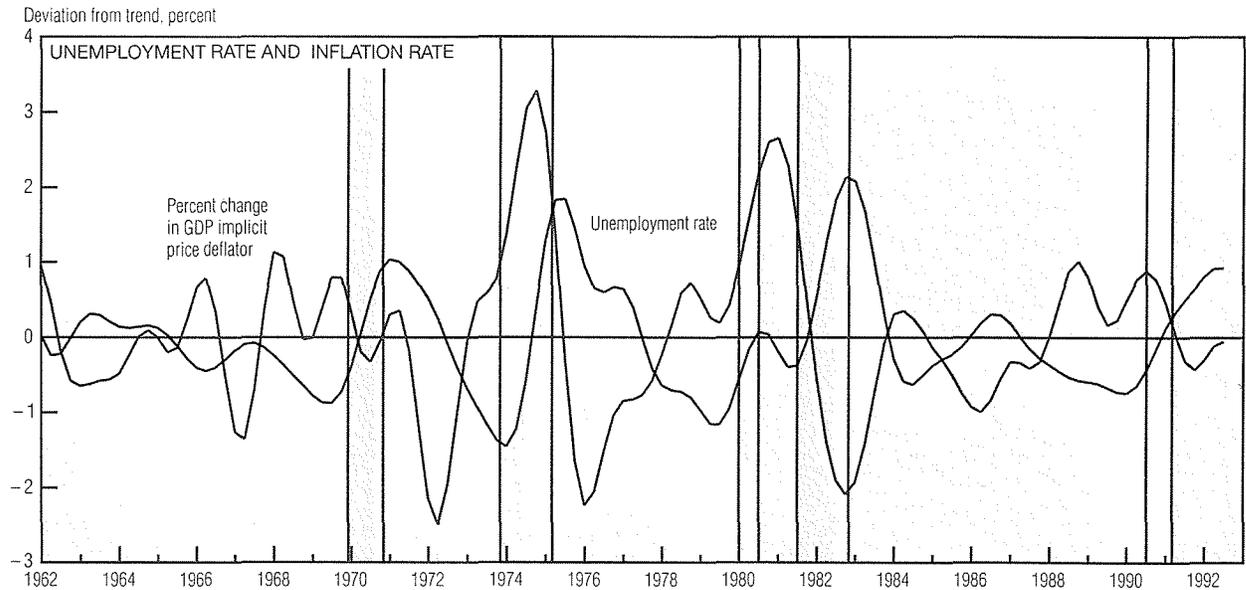
Countercyclical prices are particularly evident during the 1974 and 1980 recessions. These periods coincided with sharp increases in oil prices, which economists generally interpret as representing large supply shocks.

The money stock and the rate of inflation display strong comovement until 1984, after which the inflation rate stabilized and the

money stock experienced large swings above and below trend. This behavior is often attributed to regulatory changes and financial innovations that blurred the distinction between money and other financial assets, thereby affecting people's willingness to hold money. One factor that influences the desire to hold money is the nominal interest rate,

*(continued on next page)*

## Monetary Policy (cont.)



NOTE: Shaded areas indicate recessions.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

which is highly correlated with the rate of inflation over the entire sample period. This suggests that investors quickly adjust their required rate of return to compensate for the effects of inflation.

Many analysts believe that short-term movements in real GDP and the unemployment rate contain information about the future course of inflation. However, the cyclical patterns in the data tend to be erratic,

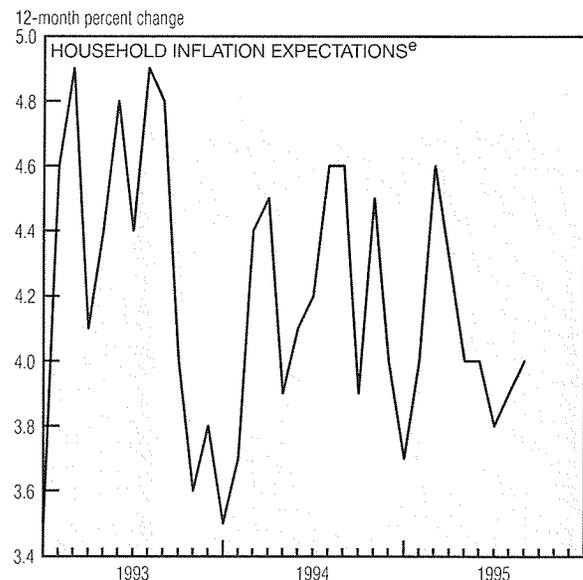
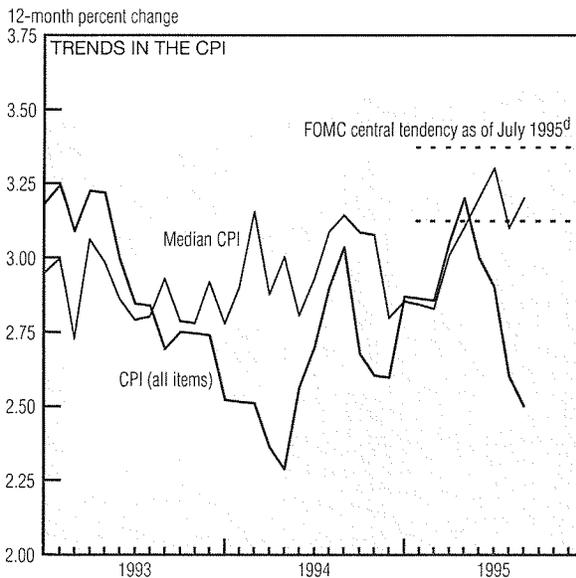
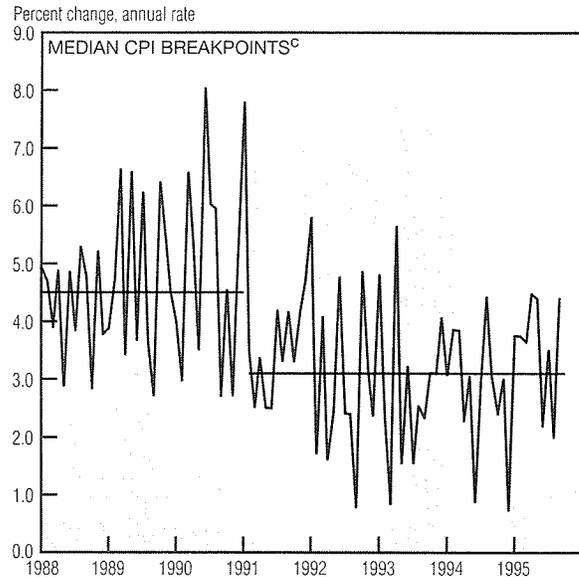
shedding some doubt on the validity of this hypothesis. During recessions, the cyclical component of real GDP always declines, while the cyclical component of the unemployment rate always rises. Indeed, these tend to be the defining characteristics of a recession. In contrast, the cyclical component of inflation has been observed to rise, fall, or even change direction during recessions. Thus, the data do not support

the notion that there is a consistent trade-off between inflation and unemployment.

Empirical relationships in economics are often imprecise and subject to change. Nevertheless, broad regularities appear in economic data. A knowledge of the cyclical regularities among money, prices, interest rates, and output is necessary both for formulating and for understanding monetary policy.

# Inflation and Prices

September Price Statistics	Annualized percent change, last:			
	1 mo.			1994 average
	9 mo.	5 yr.		
<b>Consumer Prices</b>				
All items	1.6	2.8	2.9	2.6
Less food and energy	3.0	3.3	3.4	2.7
Median <sup>a</sup>	4.4	3.6	3.3	2.8
<b>Producer Prices</b>				
Finished goods	3.8	1.7	1.2	1.8
Less food and energy	2.6	2.6	1.9	1.6
<b>Commodity futures prices<sup>b</sup></b>				
	32.6	5.7	0.4	3.5



a. Calculated by the Federal Reserve Bank of Cleveland.

b. As measured by the KR-CRB composite futures index, all commodities. Data reprinted with permission of the Commodity Research Bureau, a Knight-Ridder Business Information Service.

c. Horizontal lines represent trends.

d. 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. As of July, the stated range (fourth-quarter to fourth-quarter percent change) is 3.125 to 3.375 for 1995 and 2.875 to 3.250 for 1996.

e. Mean expected 12-month 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; the Federal Reserve Bank of Cleveland; Board of Governors of the Federal Reserve System; the Commodity Research Bureau; and the University of Michigan.

The inflation indicators were mixed in September. The Consumer Price Index (CPI) continued to rise at August's meager 1.6% annualized rate, contributing to its best five-year performance since the late 1960s. Other inflation measures were not quite as encouraging, however. The Producer Price Index rose at an annual rate of 3.8% during the month, and the median CPI—a measure of core inflation—climbed 4.4%, somewhat higher than the 3% level it has aver-

aged over the last three years.

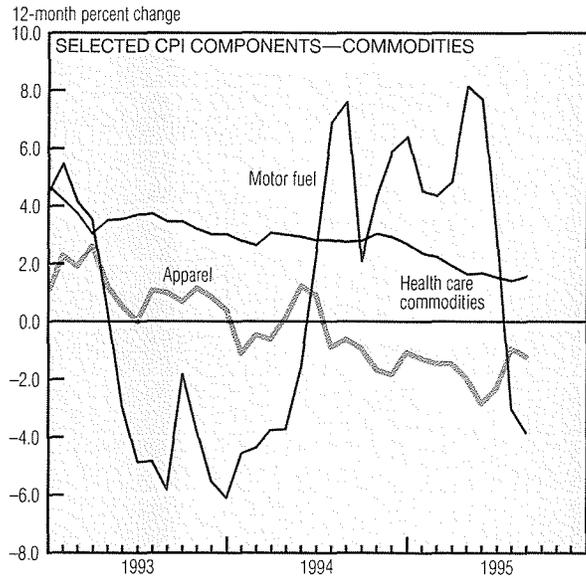
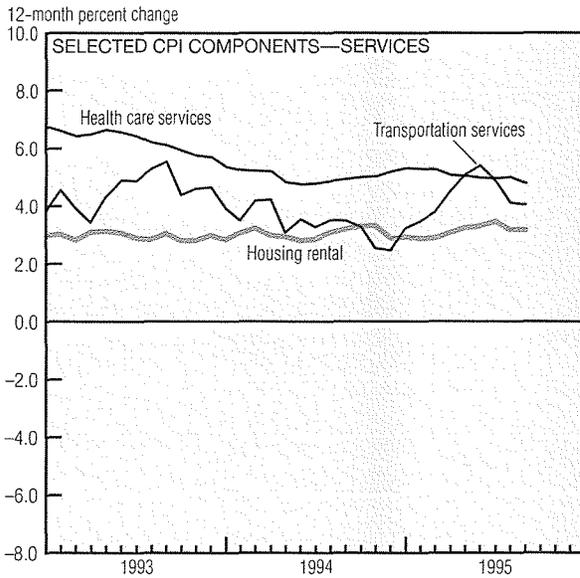
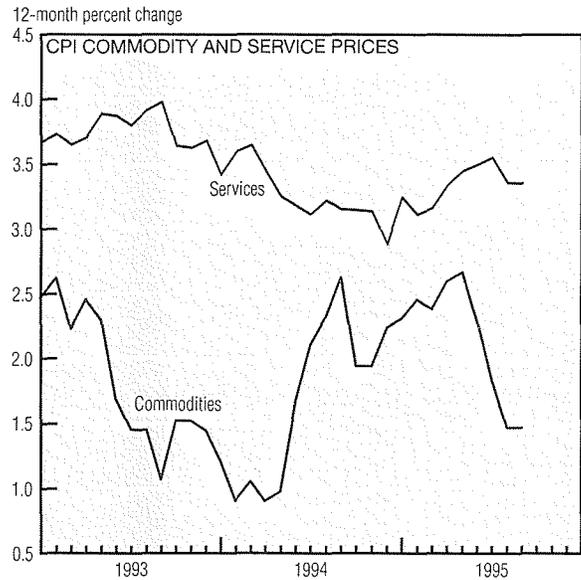
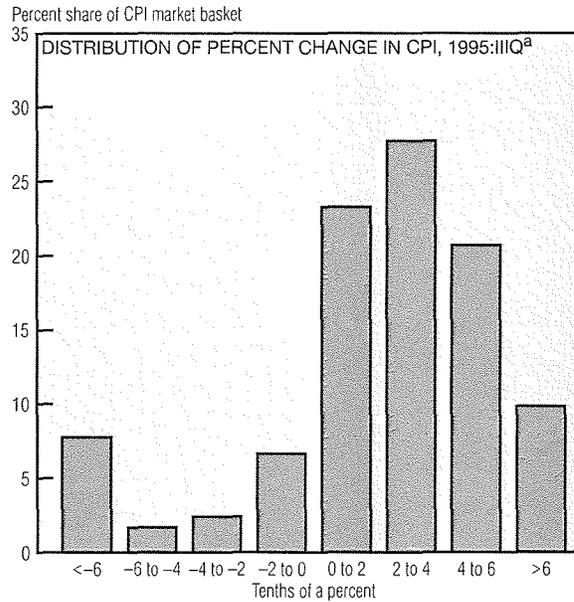
The 12-month rate for the median CPI remains within this year's CPI central tendency range projected by the Federal Open Market Committee (FOMC) last July, while the 12-month change in the standard CPI is well below the FOMC's projections.

Households are on the more pessimistic end of the spectrum. According to survey data, the average U.S. household expects inflation to rise 4% over the next 12 months,

more than 1% above the CPI's average since 1990 (2.9%).

Commodity prices, as measured by the Commodity Research Bureau's composite futures index, increased at an annualized rate of 32.6% in September, spurred by wheat, corn, and soybean prices. Still, the year's cumulative gain of 5.7% is far less ominous. During the 1970s, increases in commodity prices tended to be followed by higher  
*(continued on next page)*

# Inflation and Prices (cont.)



a. Weighted distribution of percent change across goods, using the same 36 CPI components and respective CPI weights employed in the Federal Reserve Bank of Cleveland's median CPI computation.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

consumer prices. Recent statistical tests, however, show little evidence of this relationship after 1985.

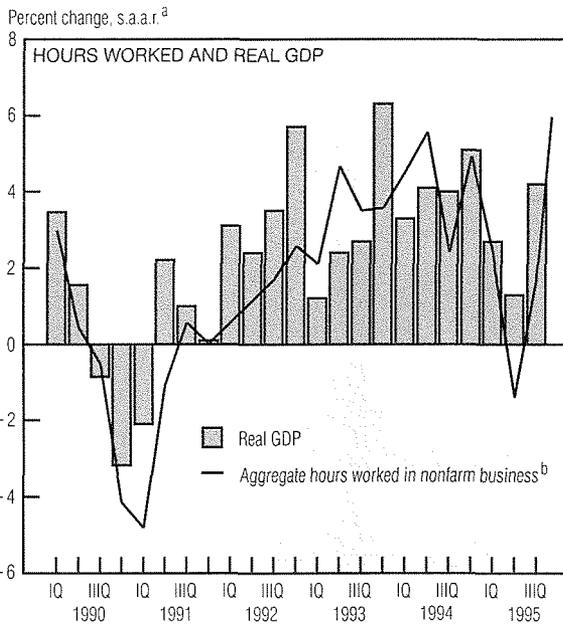
Much of the downward pressure on the CPI came from the motor fuel and energy services components. Motor fuel prices declined at an annual rate of nearly 20% in September, while energy services prices dropped 19%. This explains much of the disparity between the CPI and the median CPI. The median measures core inflation by focusing on the center of the weighted distribution of price changes. Unlike a weighted average, such as the stan-

dard CPI, the median is not influenced by large changes at either end of the distribution. On the other hand, the median may fail to account for the tangible impact of such an increase or decrease on consumers' budgets and on the cost of living.

Substantial differences in price changes are observed not just between individual CPI components, but also between component groups. For example, there is a wide and persistent difference in the growth rate of goods and services prices — a disparity that remains an important

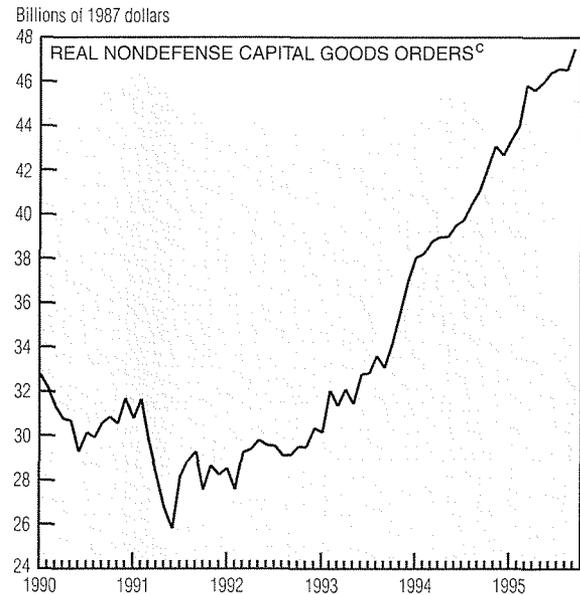
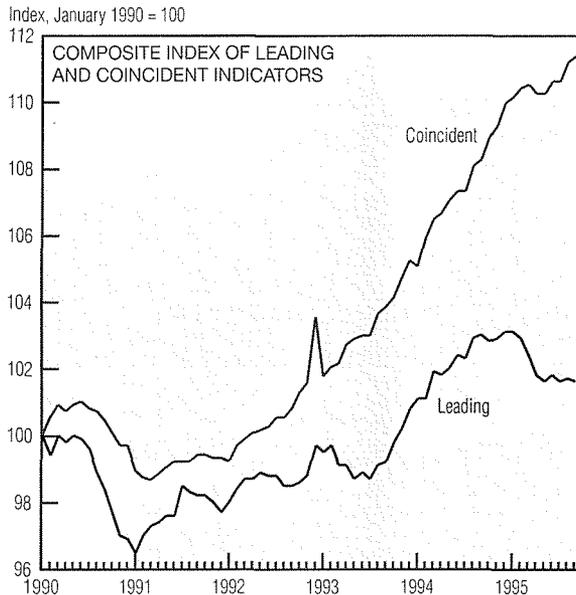
point of contention among economists attempting to define price stability. Many believe that the price differential simply reflects the mis-measurement of services. For example, neither the quality of a service nor the productivity of the service sector is easily measured, and to the extent that either is underestimated, we will necessarily overestimate its rate of price increase. But it may be that the "maturing" U.S. economy simply demands more services than it does goods, and that the steeper rise in services prices merely reflects this relative change.

# Economic Activity



**Real GDP and Components, 1995:IIIQ**  
(Advance estimate, s.a.a.<sup>a</sup>)

	Change, billions of 1987 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	56.8	4.2	4.3
Consumer spending	26.8	2.9	4.0
Durables	15.6	11.7	9.2
Nondurables	0.2	0.1	2.7
Services	11.0	2.2	3.4
Business fixed investment	15.3	8.3	18.4
Equipment	14.0	9.7	21.2
Structures	1.4	3.5	9.1
Residential investment	5.8	10.9	-2.9
Government spending	7.0	3.1	1.2
National defense	1.1	2.1	-4.4
Net exports	0.9	—	—
Exports	18.3	10.6	14.3
Imports	17.5	8.6	14.1
Change in business inventories	1.0	—	—



- a. Seasonally adjusted annual rate.  
b. 1995:IVQ consists of October data only.  
c. Three-month moving average of seasonally adjusted data.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

Advance estimates of real GDP suggest that the economy rebounded in the third quarter from its lackluster performance in 1995:IIQ. The 6% increase in hours worked for October is equally encouraging and is indicative of continued strides in output growth in the coming months. Increases in government spending and consumer durables, up 3.1% and 11.7%, respectively, were major

sources of strength. Investment activity, particularly in equipment, also improved. Residential investment, while still off slightly for the year, maintained the strong advances observed in recent months.

The index of coincident indicators rose an annualized 2% in September, continuing the trend that started at the beginning of the expansion. The flat movements in the composite index of leading indicators, however, suggest a possible

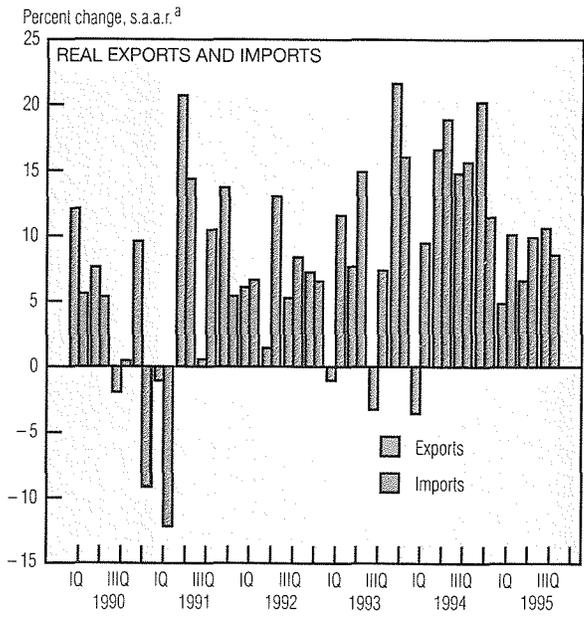
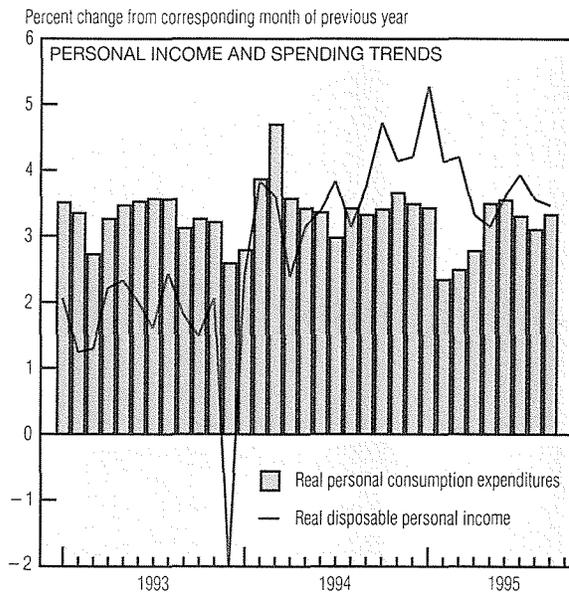
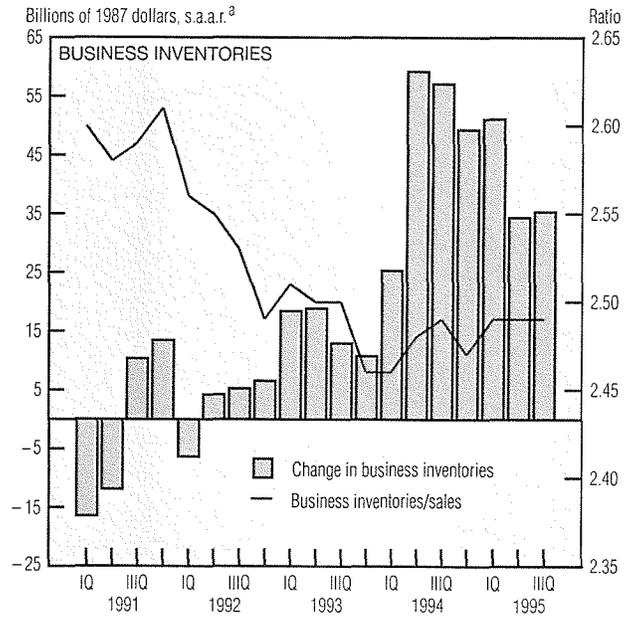
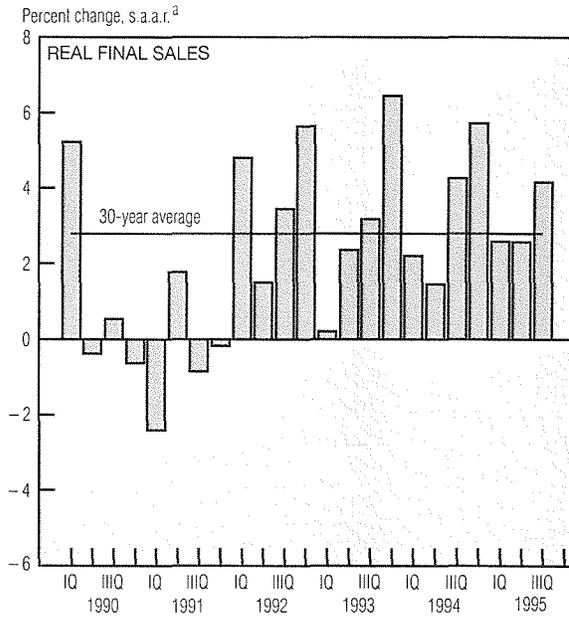
leveling off in overall economic activity in the months ahead.

By contrast, real nondefense capital goods orders made solid gains in September, increasing at an annual rate of 29%. This bodes well for future business activity.

Improvement in the economy's growth rate was evident across various sectors. Real final sales, a good proxy for aggregate demand,

*(continued on next page)*

# Economic Activity (cont.)



a. Seasonally adjusted annual rate.  
 SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

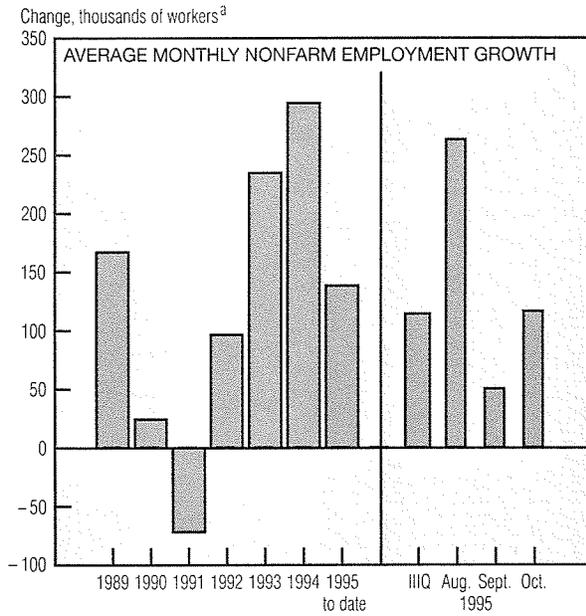
advanced an annualized 4.2% in the third quarter, up nearly 1½ percentage points from its 30-year average. This suggests that the increase in activity resulted from underlying demand and not from any significant inventory accumulation. Businesses accumulated over \$35 billion in inventories last quarter (1987 dollars), \$1 billion more than in 1995:IIQ. The second-quarter slowdown appears to have been a

temporary adjustment. Moreover, businesses have maintained a relatively constant inventory/sales ratio this year, with only slight increases over 1994 levels.

Consumer activity remained healthy in September, due in part to solid gains in real disposable personal income (up 3.5%). This rise helped to spur a 3.3% increase in consumer spending for the month. Real net exports made equally

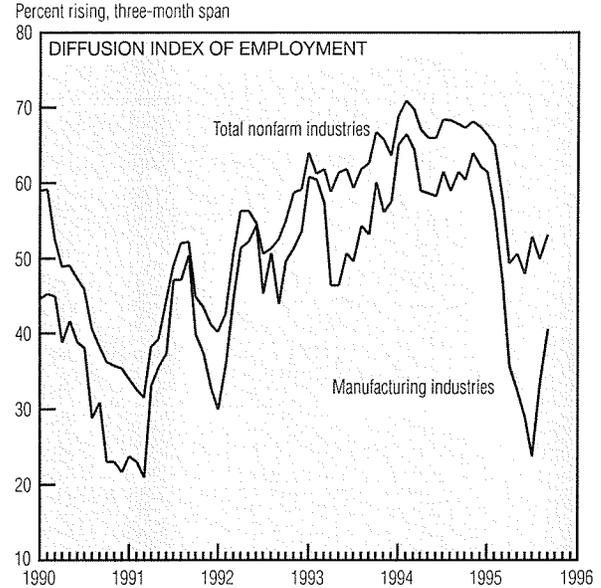
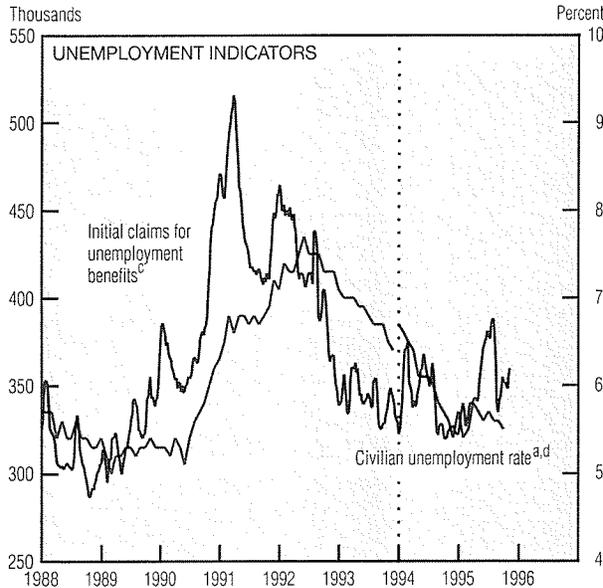
strong gains in the third quarter, with exports increasing at a 10.6% annual rate while imports rose 8.6%. Strength in real exports stemmed mostly from merchandise trade, which rose nearly 15% in the July-September period, while exports of services were relatively flat. Overall, however, real imports exceeded real exports by \$125.8 billion, an improvement of less than \$1 billion.

# Labor Markets



**Labor Market Conditions**  
(Seasonally adjusted)

	Average monthly change (thousands of employees)				
	1994	1995			
	Year	IIIQ	Aug.	Sept.	Oct.
Payroll employment	294	114	263	50	116
Goods-producing	58	-30	9	-15	4
Construction	30	9	7	25	28
Manufacturing	30	-36	4	-38	-21
Service-producing	236	144	254	65	112
Services	117	90	166	67	57
Business services	46	53	81	68	-1
Finance, insurance, and real estate	4	9	9	9	18
		Average for period			
Civilian unemployment rate (%)	6.1	5.6	5.6	5.6	5.5
Mfg. workweek (hours) <sup>b</sup>	42.0	41.5	41.5	41.7	41.5



a. Seasonally adjusted.  
 b. Production and nonsupervisory workers.  
 c. Four-week lagged average of seasonally adjusted data.  
 d. Vertical line indicates break in data series due to survey redesign.

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

The nation's labor markets continued to grow at a slow and steady pace in October, with nonfarm payroll employment rising by 116,000. Year-to-date figures for 1995 show average monthly jobs growth of 138,000 — slightly less than half the 1994 rate.

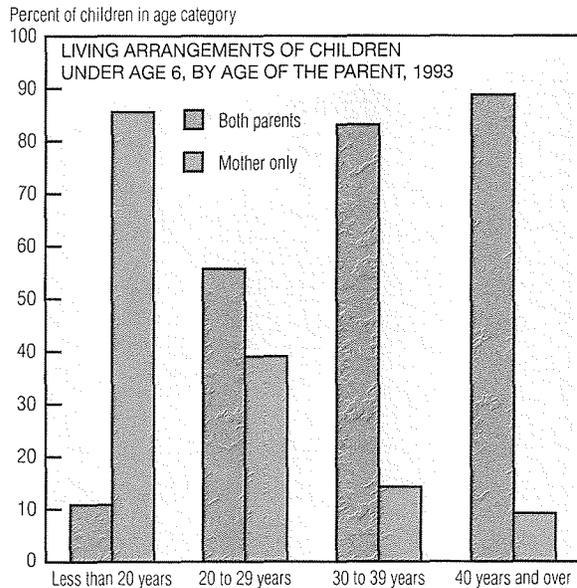
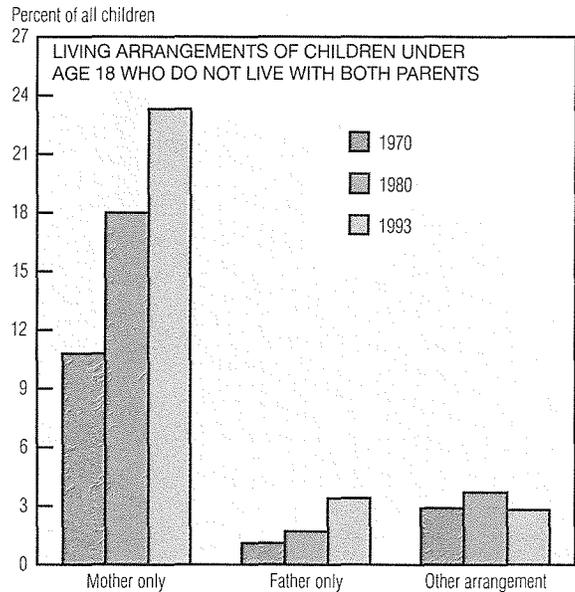
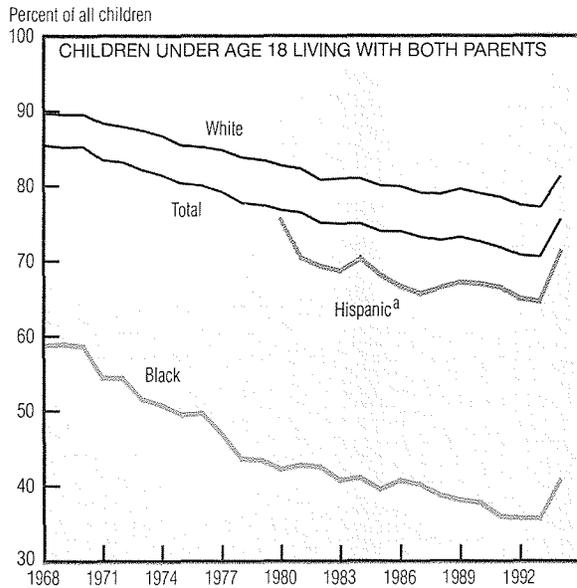
The goods-producing sector experienced a small net upturn in jobs following a decline in September. Manufacturing employment tumbled by 21,000, partly as a result of strikes in the aircraft industry and cutbacks in instruments-

related products and apparel. After falling sharply for the better part of this year, the diffusion index of manufacturing employment has rebounded somewhat. Even so, a mere 40% of detailed industries within this sector have reported job gains over the past few months.

Service-producing firms added 112,000 workers last month, although the rise in the narrow services category was below average. Indeed, net jobs growth in business services turned negative for

the first time in four years, as declines in the typically robust personnel supply component erased gains in computer and data processing services. Finance, insurance, and real estate employment was up 18,000 in October, with notable contributions from real estate and mortgage banking. Meanwhile, the unemployment rate remained little changed last month, and initial claims for unemployment insurance continued to hover around 350,000.

# Labor Markets (cont.)



Family income	Percent of children living with:		
	Both parents	Mother only	Father only
Under \$10,000	21.6	73.3	5.0
\$10,000-\$14,999	47.7	47.5	4.8
\$15,000-\$19,999	61.3	33.7	5.0
\$20,000-\$24,999	66.1	27.7	6.2
\$25,000-\$29,999	73.3	22.1	4.6
\$30,000-\$39,999	82.3	14.1	3.6
\$40,000-\$49,999	88.4	8.6	3.1
\$50,000 and over	94.6	3.9	1.5
<b>Average income</b>	<b>\$49,971</b>	<b>\$17,859</b>	<b>\$29,494</b>

a. Data not available prior to 1980.  
 SOURCE: U.S. Department of Commerce, Bureau of the Census.

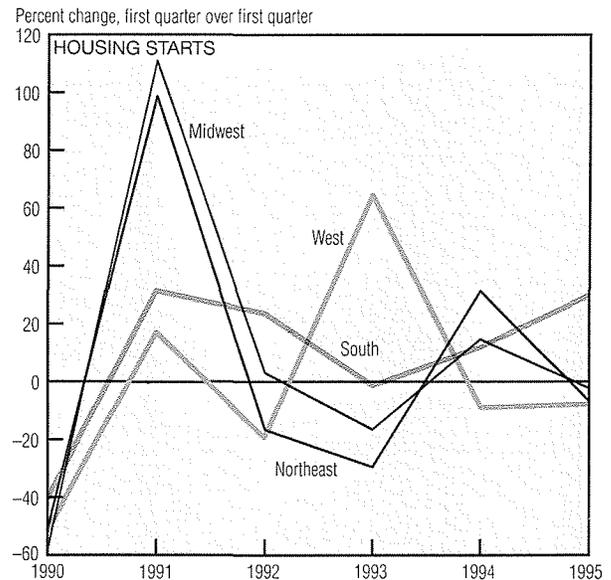
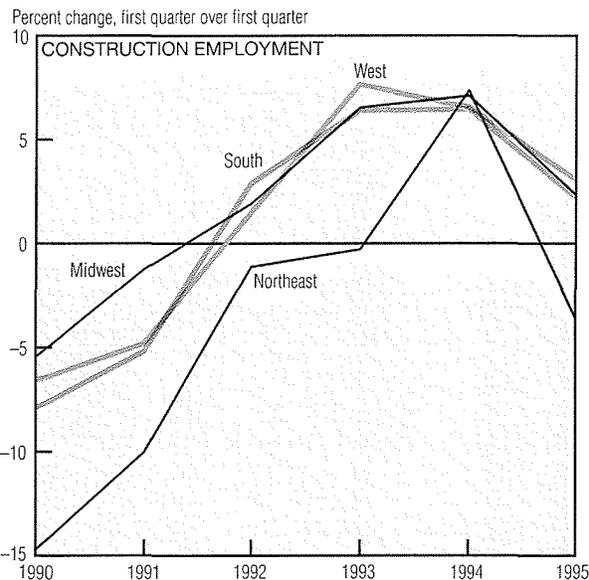
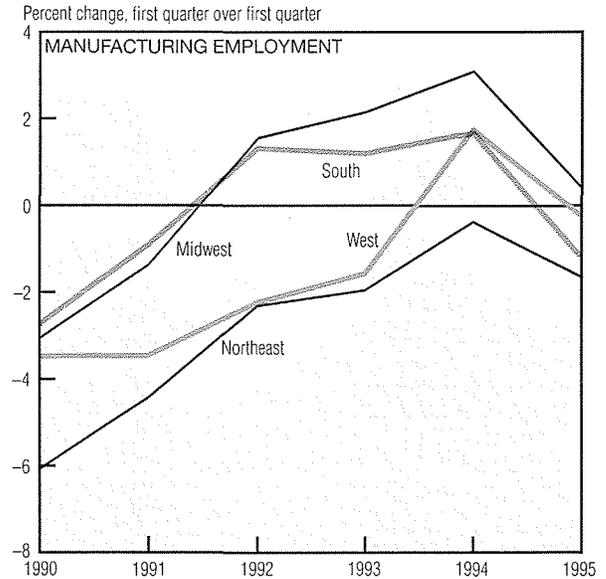
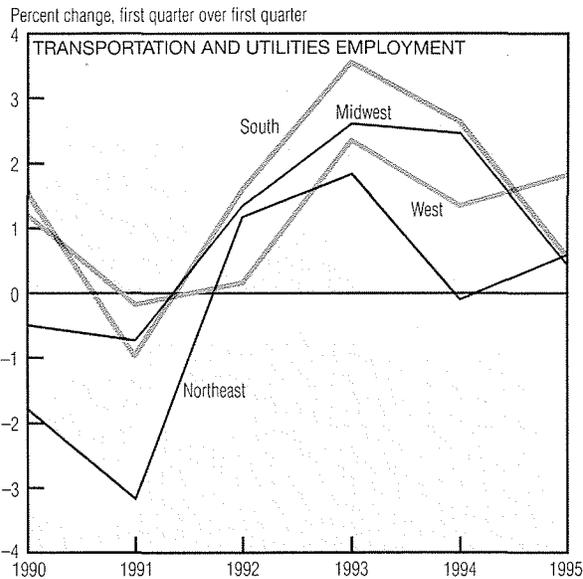
A nation's standard of living depends heavily on its ability to build human capital—a process that starts with its children's welfare. For the first time in 30 years, the percentage of American children living in two-parent families has risen. In 1970, 85% of children under the age of 18 lived with both parents. By 1993, that figure had dropped to 72%, its lowest level. The decline was sharpest during the 1970s and has stabilized in recent years.

This phenomenon has been observed across many ethnic groups. Black children, in particular, are now much less likely to be reared in two-parent families than they were in 1970. Moreover, the vast majority of children not brought up by both parents are cared for by the mother alone. While the percentage of children living with only their father has increased, it remains under 4%.

Children under age six who live with only their mother are much

more likely to be reared by a younger parent than are children living with both parents. Indeed, 85% of the children brought up by teenage parents live solely with their mother. These children are also much more likely to grow up in poorer families, since there is only one income to go around and because the average earning potential of young, less educated women is very low.

## Regional Conditions



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, and U.S. Department of Commerce, Bureau of the Census.

For the first time since the recovery began in the early 1990s, regional employment and housing data are offering some signs that the expansion may be cooling. In all regions of the nation, the growth rate of employment in construction, manufacturing, and the transportation and utilities sectors has continued its downward trend. Although growth rates may decline from year to year, actual employment numbers still increase as long as the growth rate is positive.

In the last year, every region had

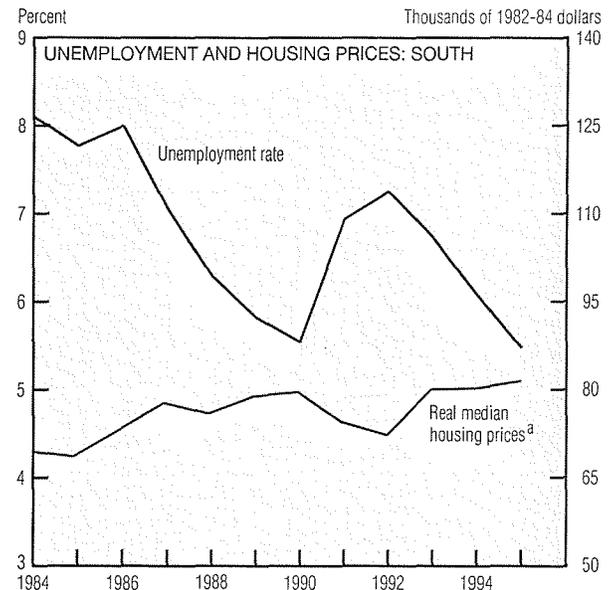
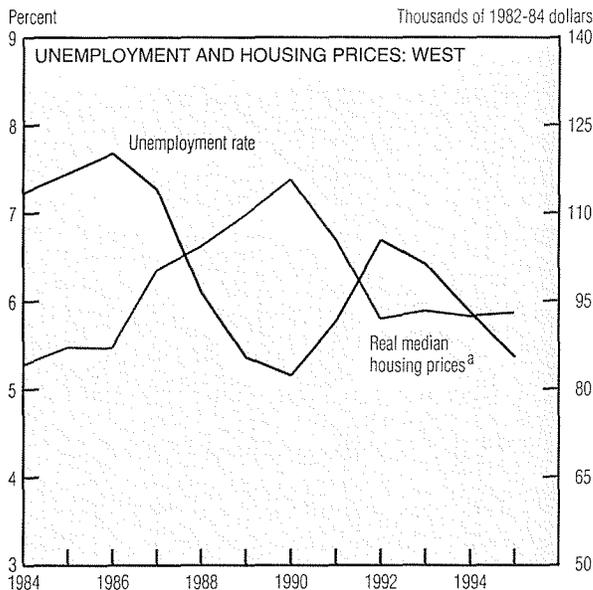
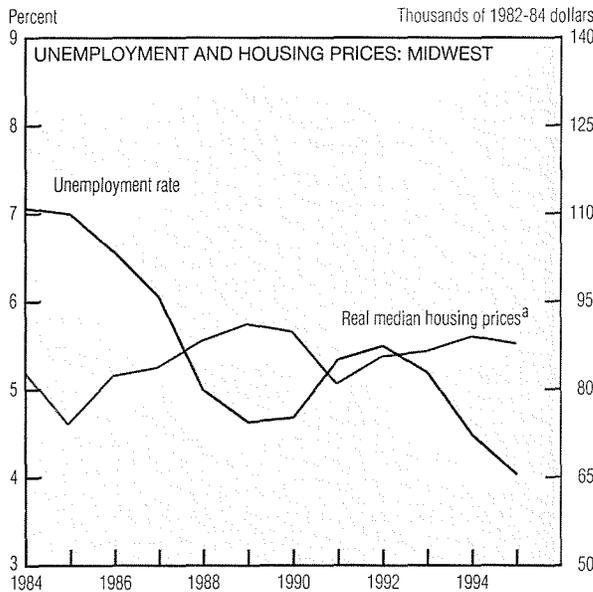
a positive growth rate in transportation and utilities employment, but other sectors have not fared as well. Manufacturing employment retained a positive growth rate in the Midwest, but experienced an actual decline in every other region. In the construction industry, employment growth increased between 1992 and 1994 in all regions before dropping off. While the South, West, and Midwest merely slowed their rate of increase in construction employment, the Northeast lost 3.6% of its employed construction workforce after reaching a peak growth rate of 7.2%

between 1993 and 1994.

The extreme volatility of housing starts experienced in the early part of the decade has eased somewhat. Since the beginning of 1994, the South has been the only region to show continued growth in the rate of new starts, which expanded nearly 30% between 1994:IQ and 1995:IQ. Despite the decreasing growth rates in most regions, the nation has shown an overall rise in housing starts during the past six months.

*(continued on next page)*

## Regional Conditions (cont.)



a. Real median sales prices of new single-family houses sold, not seasonally adjusted.

NOTE: All data are for the second quarter.

SOURCES: U.S. Department of Housing and Urban Development, U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics.

The unemployment rate is frequently used as a measure of economic conditions. As the charts show, the unemployment rate tracks the business cycle quite well, rising during the economic downturn of 1990-91, for example, and falling during the current recovery. Apart from the cyclical variability of unemployment, there is also a trend component. The Midwest, West, and South show a downward trend, while the Northeast exhibits a slight upward trend.

Unemployment, however, is not all bad. Part of it results from work-

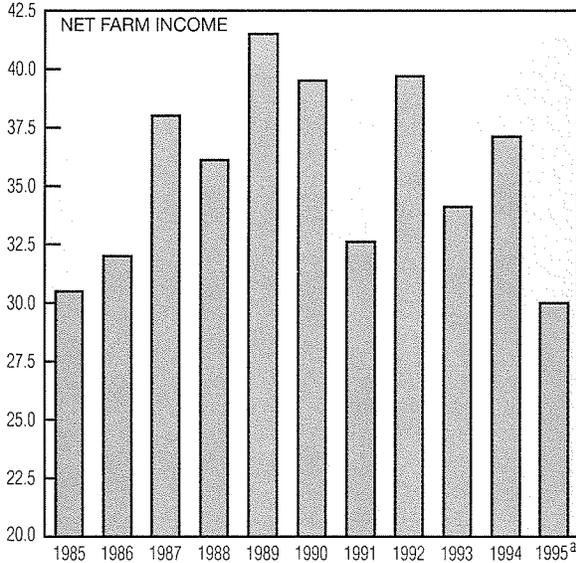
ers searching for new and better jobs. The normal churning of the labor market may help re-sort some workers to better job matches and hence higher wages. For others, however, unemployment means a reduction in lifetime earnings that leaves them worse off.

Along with unemployment, the charts show real median prices for housing, which is typically a homeowner's largest asset. Although the trend in housing prices across all regions is up, there are times when housing prices are not rising as fast as previously or are actually falling.

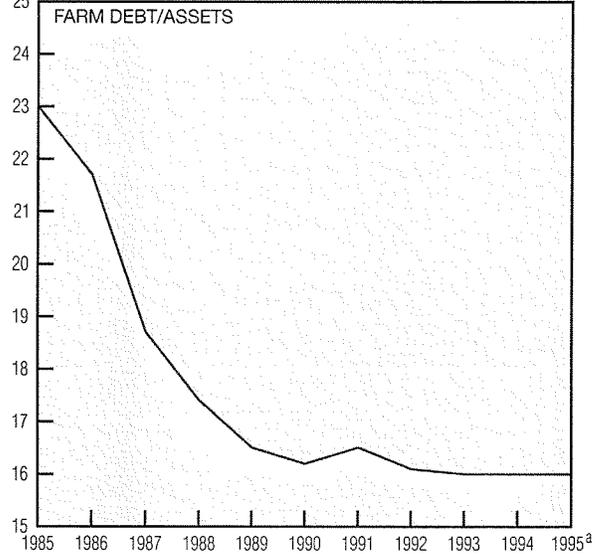
These times match up well with underlying economic conditions. During bad times, when unemployment is high, housing prices taper off or drop. This implies that individuals not only suffer losses during times of high unemployment (months when they are out of work, for example), but may also face a reduction in real wealth when their homes lose value. During good times, some of these losses may be recouped; however, in the West and Northeast, housing prices have yet to regain their previous growth rates.

# Agricultural Policy

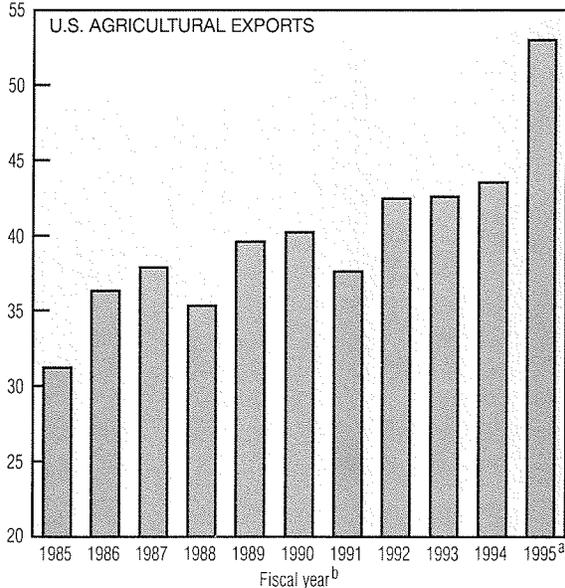
Billions of 1987 dollars



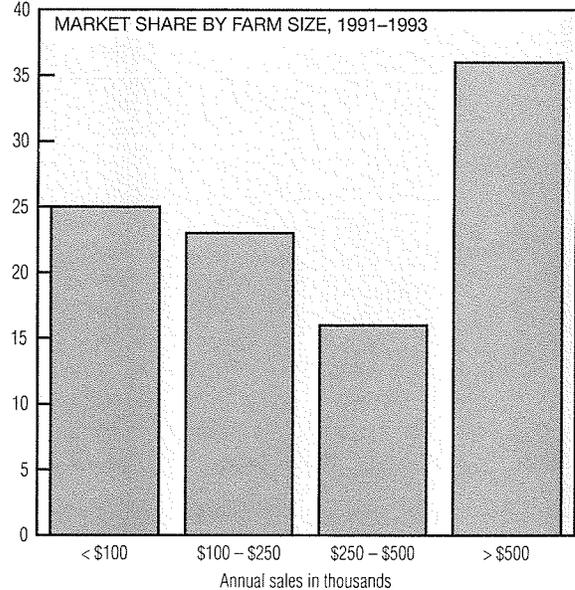
Ratio



Billions of dollars



Share of total farm sales



a. U.S. Department of Agriculture forecast (average if range is given).

b. Twelve months beginning in October of the preceding calendar year.

SOURCES: U.S. Department of Agriculture; and Mark Drabenstott and Alan Barkema, "A New Vision of Agriculture Policy," Federal Reserve Bank of Kansas City, *Economic Review*, vol. 80, no. 3 (Quarter 3 1995), pp. 63-77.

Since their inception in the 1930s, U.S. agricultural policies have been aimed at stabilizing the domestic food supply and farmers' incomes. Congress is currently scrutinizing these policies with an eye to deficit reduction, but broad economic trends offer more fundamental reasons for charting a new course.

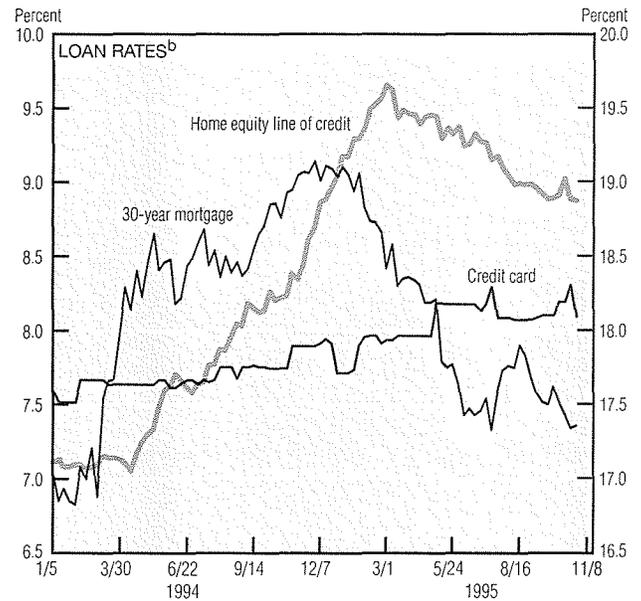
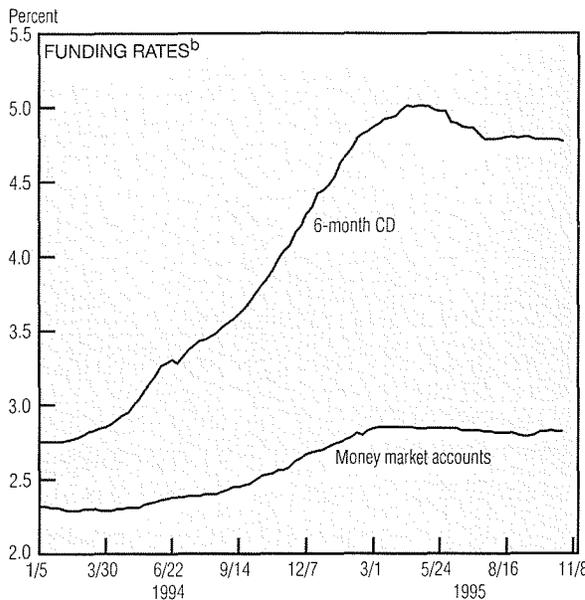
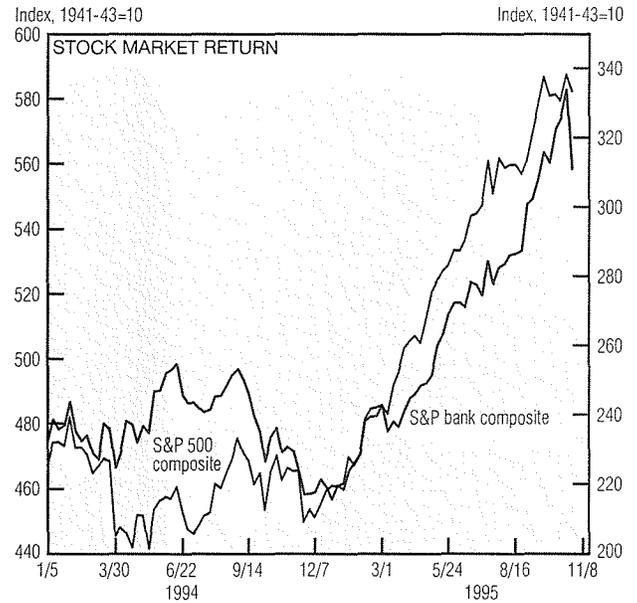
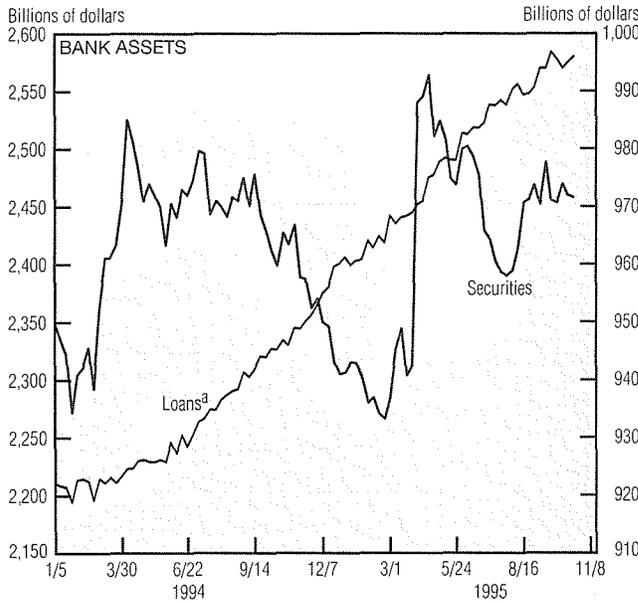
Originally, rural welfare was an important objective of the nation's agricultural policies, but the eco-

nomie base of most rural communities has since broadened, and agriculture is no longer their leading industry. The composition of U.S. agriculture has also changed dramatically, with large farms now dominating the industry. Through vertical integration, capital-intensive methods, and product specialization, large farms achieve substantial efficiencies and are better poised to withstand market adversities than are small farms. Nevertheless, large

operations receive a substantial portion of U.S. farm-support payments.

Designed for a domestically focused industry, U.S. agricultural policies raise a number of issues regarding our international competitiveness. Price supports can exceed global levels, rigid crop patterns prevent quick adaptation to changing markets, and foreign producers seize the opportunity created by idled U.S. capacity.

# Banking Conditions



a. All data are pro rata monthly averages of Wednesday values.  
 b. Bank Rate Monitor national indexes for depository institutions.  
 SOURCES: Board of Governors of the Federal Reserve System; Standard & Poor's Corporation, and Bank Rate Monitor.

Loans by commercial banks continue to expand at a steady pace, up 10.5% over a year ago. By contrast, banks have seen low growth in their securities holdings which, despite some ups and downs, remain very close to their levels of late August.

The growth in loans does not seem to be a reaction to major changes on either the demand or the supply side of the banking market. While the 30-year mortgage rate has dropped from 9.14% last November to 7.36% now, its current level is just slightly above the rate

posted in mid-July. Rates on home equity lines of credit show a similar but much more attenuated pattern: The current level of 8.87% represents a drop of only 78 basis points (1/100 of 1%) from its peak in March. As expected, credit-card rates remain fairly steady.

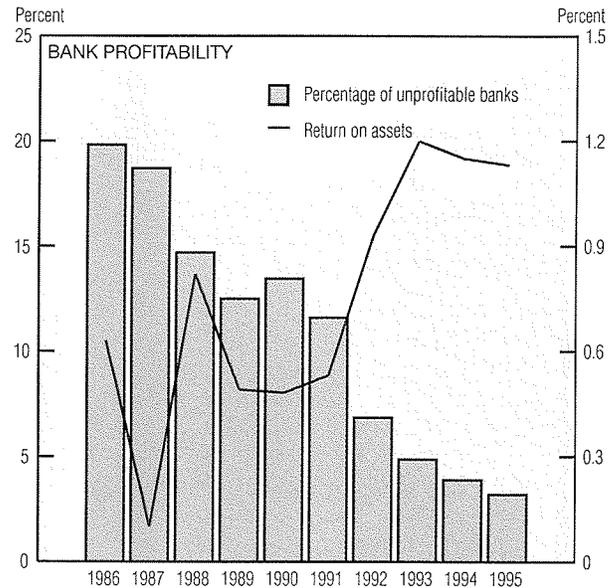
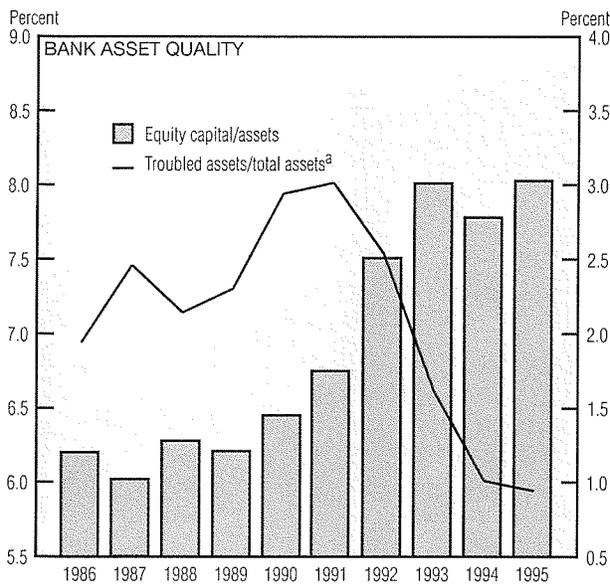
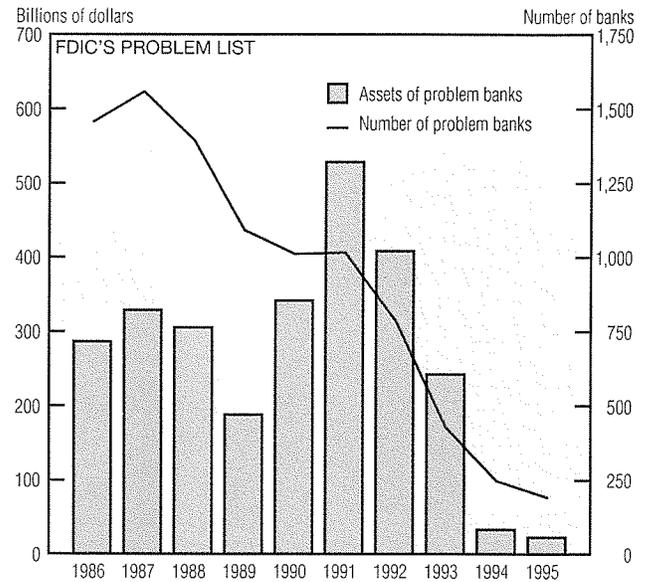
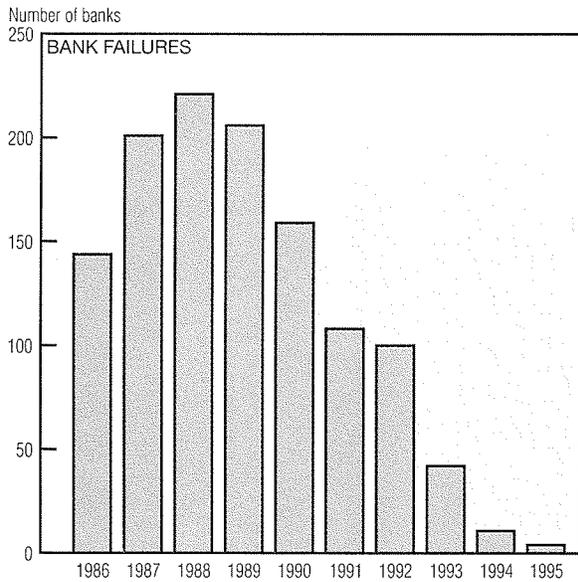
On the supply side, the rates banks pay for funds have entered a stable pattern not observed in a while. The six-month CD rate has dropped only one basis point (to 4.77%), the first decrease since September, and remains almost identical to the July rate (4.78%). Money mar-

ket accounts show even more stability, with the current 2.82% rate almost even with late February's 2.83%.

The market for bank stocks took the continued increase in loans at steady or slightly tightening margins as good news, increasing in tandem with the Standard & Poor's 500 Composite. More recently, however, bank stocks have dropped sharply, perhaps reflecting uncertainty about how long profitable loan growth can continue.

*(continued on next page)*

## Banking Conditions (cont.)



a. Troubled assets include noncurrent loans and leases plus other real estate owned.

NOTE: All data are for FDIC-insured commercial banks. 1995 data are for the first half of the year and are annualized where appropriate.

SOURCE: Federal Deposit Insurance Corporation.

Midyear data also indicate a continued overall healthy performance by the commercial banking sector. Only four commercial banks were shut down during the first half of 1995, the same number as were closed during the first half of 1994.

The number of banks now classified as "problem institutions" has shown a marked decline—to 190, down from 247 at the end of 1994. The assets of these troubled banks have also fallen, from \$33 billion to

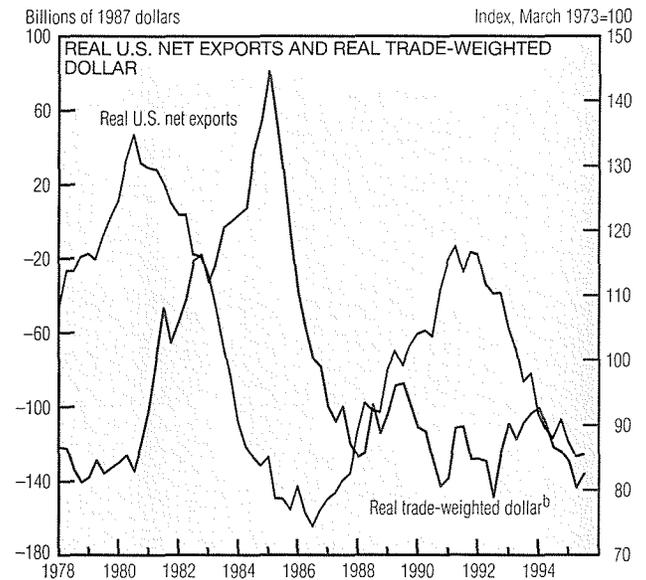
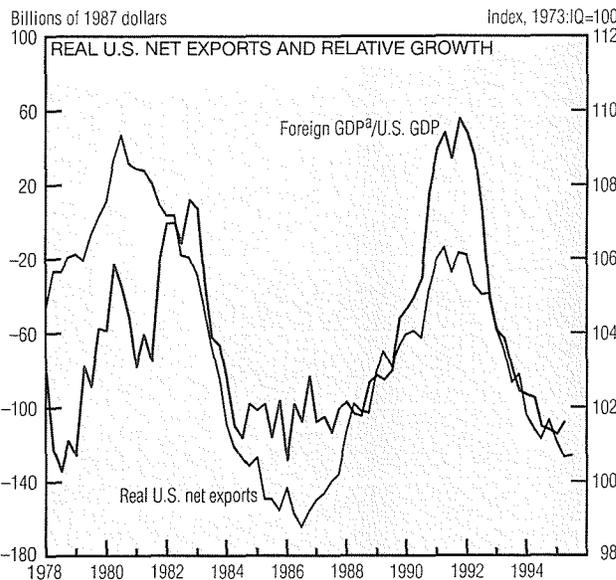
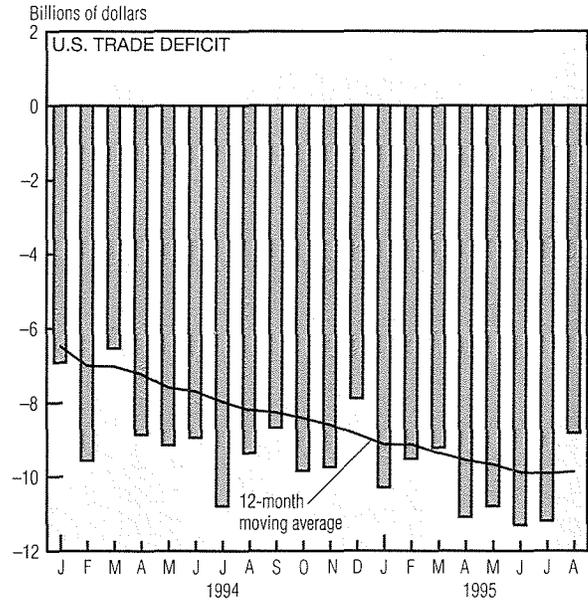
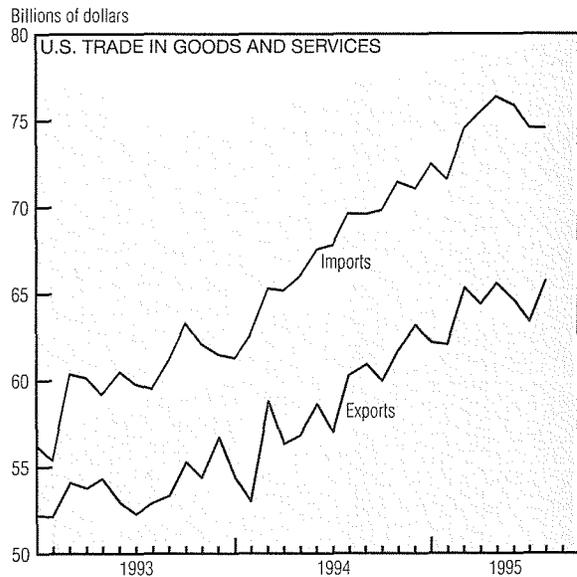
\$23 billion, reflecting a decrease in the average size of the institutions as well as the dropoff in their number.

The quality of commercial bank assets has also continued to show significant improvement. Equity capital as a percentage of total assets reached 8.03% at midyear 1995, up from 7.83% one year earlier, as equity capital growth outpaced an increase in assets. Nonperforming assets, which stood at 1.27% of total assets in mid-1994, declined to

0.94% of total assets.

As the health of the commercial banking sector continues to improve, so does the profitability of commercial banks. The percentage of unprofitable banks fell to 3.20% at midyear 1995, down from 3.89% at the end of last year. Return on assets, although down slightly from last year's performance, remains above 1%, almost twice the level of 1989–91.

# International Trade



a. Average GDP growth in Germany, Japan, France, the U.K., Canada, Italy, the Netherlands, Belgium, Sweden, and Switzerland, weighted by trade shares. Annual data for Belgium are interpolated to a quarterly series. Data extended using growth rates from national accounts and the International Monetary Fund's 1995 forecasts for Belgium, Sweden, and Switzerland.  
 b. Weighted average of dollar exchange rates against the above-listed countries, adjusted for inflation differentials.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; International Monetary Fund; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of New York; and the Federal Reserve Bank of Cleveland.

Unexpectedly strong U.S. export growth in August narrowed our trade deficit to \$8.8 billion. This was the second consecutive monthly decline in a deficit that has generally expanded this year.

The U.S. trade deficit is sensitive to differences between our rate of economic growth and that of our major trading partners. In the late 1980s, the relatively early onset of

the U.S. recession narrowed the trade shortfall. In the 1990s, our relatively quick recovery and the speed of our subsequent economic growth widened our trade deficit. Early evidence now suggests that foreign economic growth is again catching up.

Swings in real exchange rates also affect our net exports, but often with a substantial lag. Although the real trade-weighted dollar has depreci-

ated 3.4% since early 1994, it has fluctuated, without any underlying direction, since 1990.

At best, these are only proximate determinants of our trade balance. A nation experiencing a trade shortfall is not generating sufficient savings to finance its investments. Ultimately, the factors that affect our saving and investment decisions determine our trade balance.

# Global Savings and Investment

Measured Real Interest Rates <sup>a</sup> (Percent)								
	1960s	1970s	1980s	1990s <sup>b</sup>	1992	1993	1994	1995 <sup>c</sup>
U.S.	2.5	0.7	4.5	3.3	3.2	2.9	4.1	3.4
Japan <sup>d</sup>	3.7	0.7	4.0	3.2	2.7	2.7	3.4	2.6
Germany	4.1	3.2	4.6	4.2	4.0	2.3	3.3	3.8
France	2.3	1.1	4.4	5.8	6.0	4.7	5.5	5.7
Italy	2.1	-1.4	2.8	6.6	7.6	6.2	6.1	6.9
U.K.	3.2	-1.0	3.9	3.8	3.1	3.5	5.3	5.0
Canada	3.3	1.3	4.7	5.7	5.0	6.1	7.5	6.3
G10 average <sup>e</sup>	2.9	0.1	4.2	4.0	3.8	3.4	4.4	3.9

Savings and Fixed Investment (Percent of GDP)								
	Gross savings				Gross fixed investment			
	1960s	1970s	1980s	1990s <sup>b</sup>	1960s	1970s	1980s	1990s <sup>b</sup>
U.S.	20.1	19.8	17.8	15.4	18.3	19.1	19.0	16.0
Japan	34.4	35.3	31.8	33.5	31.6	33.1	29.1	30.6
Germany	27.3	24.4	22.4	22.2	24.8	22.6	20.3	22.3
France	26.3	25.9	20.4	20.1	23.4	24.1	20.6	20.0
Italy	28.3	26.0	21.8	18.4	24.8	24.0	21.3	18.5
U.K.	18.5	17.9	16.5	13.7	18.0	19.2	17.5	16.4
Canada	21.5	22.4	20.1	14.2	22.4	22.8	21.4	19.1
G10 average <sup>e</sup>	24.5	24.1	21.4	20.0	22.6	22.9	21.2	20.0

a. A two-year backward-moving average of inflation is used to proxy inflation expectations.

b. 1990 through 1994.

c. For September 29, 1995. Based on inflation through 1995:IIQ.

d. The table uses the average return on Japanese long-term telephone and telegram coupon bonds from 1961 through 1979. From 1980 to 1984, yields on government bonds and telephone bonds were essentially identical.

e. Weighted by GDP fixed weights. The foreign G10 countries comprise Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the U.K.

SOURCES: Organisation for Economic Co-operation and Development (OECD); International Monetary Fund; and Bank of England.

As global capital markets become increasingly integrated, worldwide influences on savings, investment, and real-interest-rate patterns will tend to dominate country-specific developments, according to a recent study by the Group of Ten (G10) countries. Integration should permit a growing divergence between savings and investment in any single country, and consequently should accommodate wider, more persistent current account imbalances than in the past. Though capital

markets are far from completely integrated, real-interest-rate movements around the globe are becoming more closely correlated.

Over the past 35 years, countries have experienced a small increase in real long-term interest rates. The G10 concluded that these higher rates reflect a decline in global saving rates, which stems mainly from a deterioration in the fiscal positions of industrialized countries. The drop in saving rates outpaced a decrease in investment, which the G10 attrib-

uted to slower labor-force growth and reduced productivity gains.

While the rise in real capital market rates has been small, the outlook for future saving patterns in developed countries creates uncertainties about their future growth rates and about sustained development in emerging and transitional economies. The fiscal positions of most countries may be slow to improve. Traditionally, a clear link between deficits, or government debt, and

*(continued on next page)*

*Global Savings and Investment (cont.)*

General Government Fiscal Balance and Net Debt (Percent of GDP) <sup>a</sup>								
	Fiscal Balance <sup>b</sup>				Net debt <sup>c</sup>			
	1960s	1970s	1980s	1990s <sup>d</sup>	1960s <sup>e</sup>	1970s	1980s	1990s <sup>d</sup>
U.S.	-0.1	-1.0	-2.5	-3.1	38.3	24.1	25.6	35.4
Japan	1.0	-1.7	-1.5	0.5	-5.7	0.0	22.0	6.8
Germany	0.7	-1.7	-2.1	-2.8	-12.6	0.1	19.4	29.0
France <sup>f</sup>	0.0	-0.4	-2.1	-4.0	n.a.	-0.2	7.7	23.0
Italy	-2.4	-8.6	-11.0	-9.8	31.2	49.5	76.6	110.2
U.K. <sup>f</sup>	-0.3	-2.4	-2.0	-4.9	75.9	60.2	43.5	36.2
Canada	-0.3	-0.8	-4.5	-6.0	21.4	9.4	28.7	55.4
G10 average <sup>g</sup>	0.0	-1.8	-3.0	-3.3	25.3	19.1	29.1	36.3

Current Account Balance (Percent of GDP) <sup>a</sup>								
	1977- 1979	1980- 1982	1983- 1985	1986- 1988	1989- 1991	1992	1993	1994
U.S.	-0.7	0.0	-2.3	-3.2	-1.2	-1.1	-1.6	-2.3
Japan	0.8	0.0	2.8	3.5	1.8	3.2	3.1	2.8
Germany	0.5	-0.5	1.7	4.3	2.2	-1.2	-0.8	-1.1
France	0.8	-1.2	-0.6	-0.2	-0.8	0.3	0.8	0.7
Italy	1.6	-2.2	-0.5	-0.2	-1.7	-2.3	1.2	1.3
U.K.	0.2	1.9	0.7	-1.6	-3.0	-1.7	-1.9	-0.1
Canada	-1.9	-0.7	0.1	-2.3	-3.9	-4.0	-4.3	-3.3
G10 average <sup>g</sup>	-0.2	-0.8	0.5	0.5	-0.3	-0.5	0.5	0.8

a. OECD definitions.

b. Negative numbers represent a deficit.

c. Net financial liabilities as defined in the System of National Accounts.

d. 1990 through 1994.

e. 1964-1969 for Japan and Italy, 1966-1969 for the U.K., and 1961-1969 for Canada.

f. Fiscal balance figure is for 1963-1969.

g. The foreign G10 countries comprise Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the U.K.

SOURCE: Organisation for Economic Co-operation and Development.

real long-term interest rates has remained elusive. Many economists contend that the borrowing implications of government deficits may be less intrusive than the distortionary effects of individual tax-and-spend programs. In a global market, however, the individual efforts even of large countries may have little impact on real long-term interest rates. The challenge is to foster public savings worldwide.

Population trends may also adversely affect saving rates in devel-

oped countries. Demographers expect dependency ratios—the percentage of young and elderly in a country relative to its working-age population—to rise in industrial countries. Other things equal, nations with high dependency ratios have lower saving rates.

Although unexpected changes in monetary policy may affect real interest rates in the short run, monetary policy—even on a global scale—cannot determine real interest rates. Countries with higher infla-

tion rates experience higher long-term nominal interest rates. The G10 study also finds that in many countries, financial markets set inflation premiums with long memories about past price performance. Monetary credibility may be slow to build and quick to crumble. Monetary authorities contribute to long-term economic growth and development only by consistently fostering price stability.