The Economy in Perspective

On the outs ... It has long been conventional in politics to portray oneself as an outsider. At one time, referring to a government official as an insider was a supreme compliment, but when the public became dissatisfied with government's performance, insiders recognized that they carried too much baggage. Insiders then campaigned as outsiders, but little actually changed.

When the insiders ran government, they never seemed sufficiently bothered by persistent budget deficits or generational fiscal imbalances to endure the short-run pain required for the long-run gain. They devised plans to curb the imbalances, but always scheduled the pain to occur in the outlying years, beyond the next election. Successive waves of outsiders came to Washington to reverse that result, only to become next year's insiders.

In the U.S. fiscal arena, the electorate now seems to have developed such an appetite for change that many ideas previously regarded as out-of-bounds are finally receiving serious attention. Although a concrete federal budget accord remains elusive, the broad outlines of an agreement are taking shape. In some fashion, the growth in spending on entitlement programs will slow down. The government will offer fewer services and outsource others.

The tax side of the equation will not be forgotten. It is far too soon to think that the progressive income tax system will be swept away, but alternatives such as the flat tax and consumption tax are no longer dismissed as politically outrageous. In fact, these ideas are likely to receive more serious scrutiny in the next several years than ever before. Even funding Social Security through individually managed investment accounts, instead of through a government fund invested in Treasury securities, will likely get a hearing.

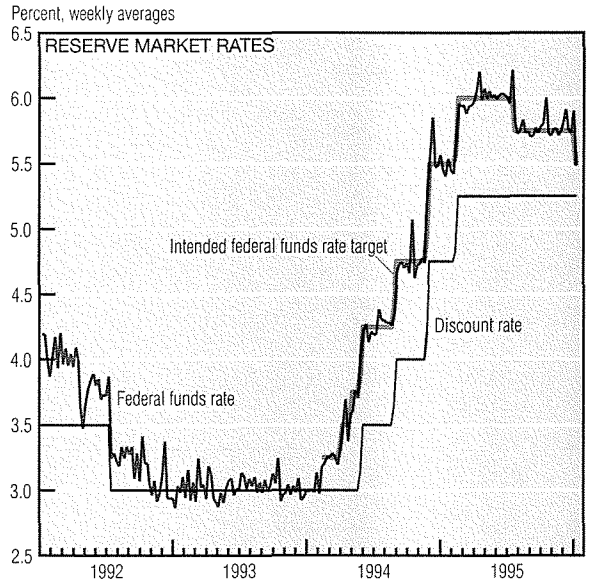
Although congressional reformers are turning the budget process inside out, they may soon attempt to revise some aspects of monetary policy. Congress amended the Federal Reserve Act in 1977 to require the central bank to promote maximum employment, stable prices, and moderate long-term interest rates. The following year, through the Full Employment and Balanced Growth Act, Congress required the Fed to report semiannually on its projections for economic output, the price level, and the level of unemployment, as well as to announce its plans for the growth of money and credit in the year ahead.

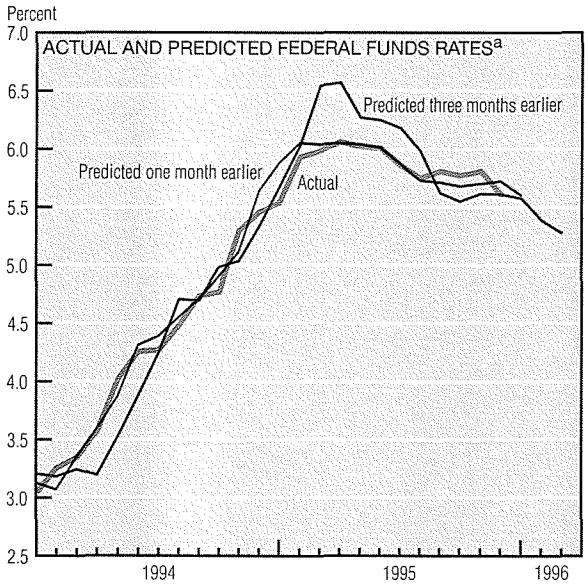
Although inflation has been trending downward since the early 1980s, it is not clear how much, if any, of the credit belongs to the legislative framework crafted nearly 20 years ago. At certain times during this period, knowledge of the future money supply would not have helped to predict anything. Moreover, many scholars have pointed out that by requiring the Fed simultaneously to promote several outcomes that may conflict, Congress is not providing enough direction to the monetary authority. A reasonable conclusion is that the Fed's recent outstanding inflation performance has been achieved largely independent of the existing statutes.

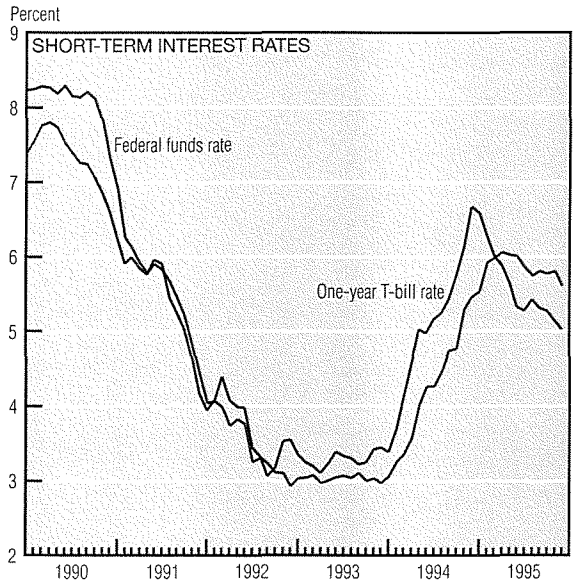
Now a group of outspoken lawmakers, led by Senator Connie Mack, proposes to out-and-out discard the Full Employment and Balanced Growth Act. As introduced in the Senate last September, the Economic Growth and Price Stability Act of 1995 would direct the Federal Reserve to promote price stability as its primary long-term goal. References to maximum employment and moderate long-term interest rates are stripped out to enable the Fed to focus more clearly on the price stability objective when it formulates and implements monetary policy. The bill also directs the Fed to establish a numerical definition of price stability and to report to Congress semiannually on its plans for achieving that objective.

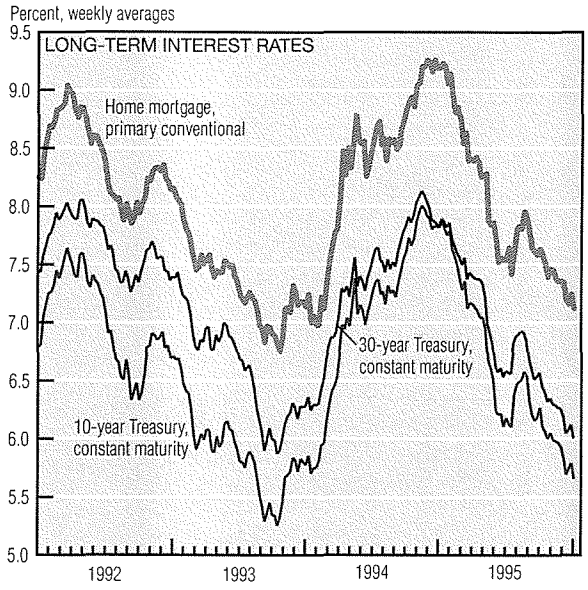
It remains to be seen how much support this effort will eventually garner, and what changes may prove necessary to gain enactment. As the budget battle illustrates, when various interest groups seek to outwit, outflank, and outsell one another, the process can get out of control. But the potential gains from a stronger legal mandate for price stability justify the struggle. To prevent inflation from once again becoming out of sight, it is best to keep infeasible objectives out of mind.

Monetary Policy









a. Predicted rates are federal funds futures.
SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

"Since the last easing of monetary policy in July, inflation has been somewhat more favorable than anticipated, and this result, along with an associated moderation in inflation expectations, warrants a modest easing in monetary conditions."

This statement by Federal Reserve Chairman Greenspan accompanied the December 19 announcement that the Federal Open Market Committee (FOMC) had decided to lower the intended federal funds rate by 25 basis points, to 5.5%. It now seems likely that actual inflation in 1995, as measured by the Consumer Price Index, will end the year below the 3% to 3½% range expected by the FOMC in July.

Although the timing of the recent policy move may have caught some market participants by surprise, a reduction in the fed funds rate had been anticipated for months. Indeed, since last year's first rate cut in July, fed funds futures prices have implied an expectation of additional cuts. Another slight reduction in the intended fed funds rate is anticipated in early 1996. Since February, the rate on one-year Treasuries has been below the fed funds rate, also suggesting further policy actions throughout the coming year.

Declining inflation expectations contributed to at least part of the overall drop in interest rates last year. The 30-year Treasury bond fell below 6% in the final days of December, approaching the cyclical trough recorded in October 1993.

In the 26 months following that trough, long-term rates rose sharply, induced both by a strong economy that increased the rate of return on new business investment and by

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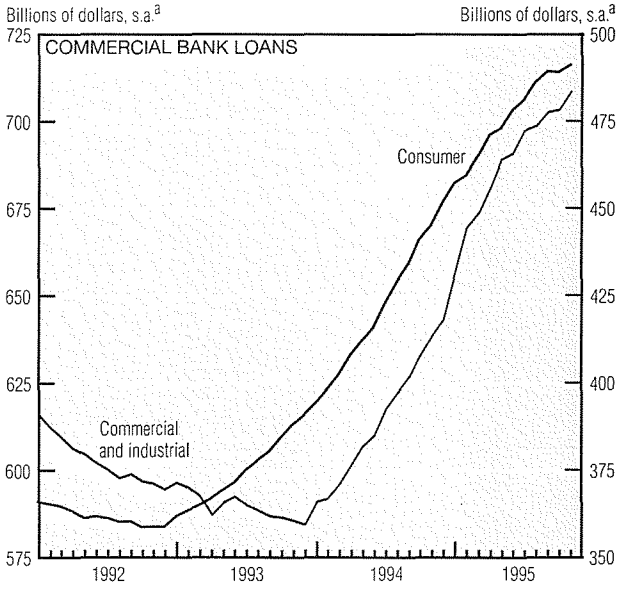
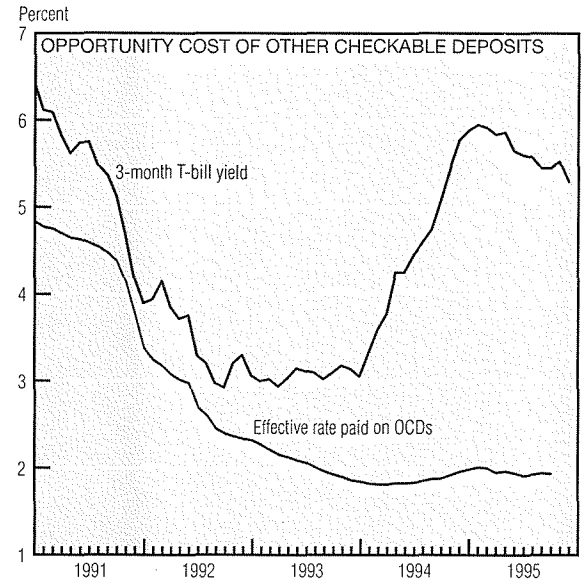
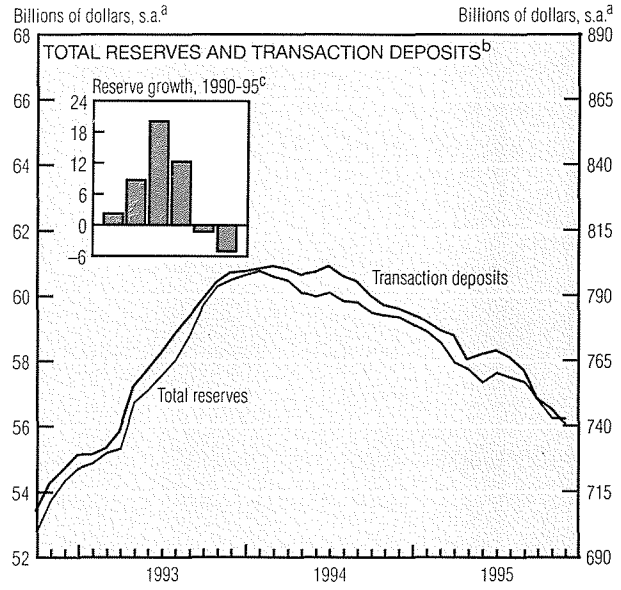
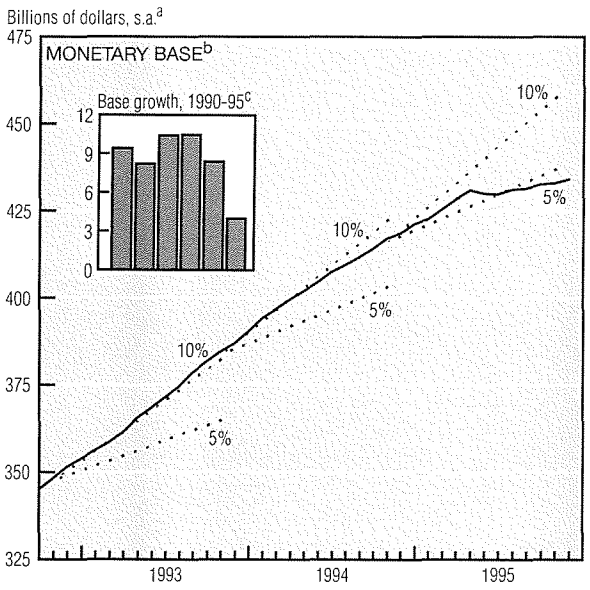
Monetary Policy (cont.)









a. Seasonally adjusted.
b. Last plot is estimated for December 1995.
c. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1995 is calculated on an estimated 1995:IVQ over 1994:IVQ basis.
NOTE: Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

fears that inflationary pressures might lead to higher trend inflation. Since the peaks in capital market rates just over a year ago, inflation has been steady and business investment—while still strong—has moderated. Bank loans to consumers and businesses grew rapidly over this period, but have decelerated in recent months.

Banks for the most part financed their strong loan demand with nondeposit liabilities and large time deposits. As a consequence, pricing of other checkable deposits (OCDs) and money market deposit accounts (MMDAs) was not very aggressive. Indeed, the rate paid on OCDs hardly budged in the face of rising interest rates. Thus, OCD opportunity cost (measured here as the difference between the 3-month Treasury bill yield and the effective rate paid on OCDs) rose sharply, which in turn damped household demand for OCDs.

As short rates fell in 1995, so too did the opportunity cost of OCDs and non-interest-bearing transaction deposits. Historical relationships suggested that transaction deposits would begin to grow during the year. This did not happen, largely because of the widespread implementation of sweep arrangements that economize on bank reserves. These arrangements "sweep" excess OCDs, which are reservable, into MMDAs, which are not reservable, thereby reducing a bank's required reserves.

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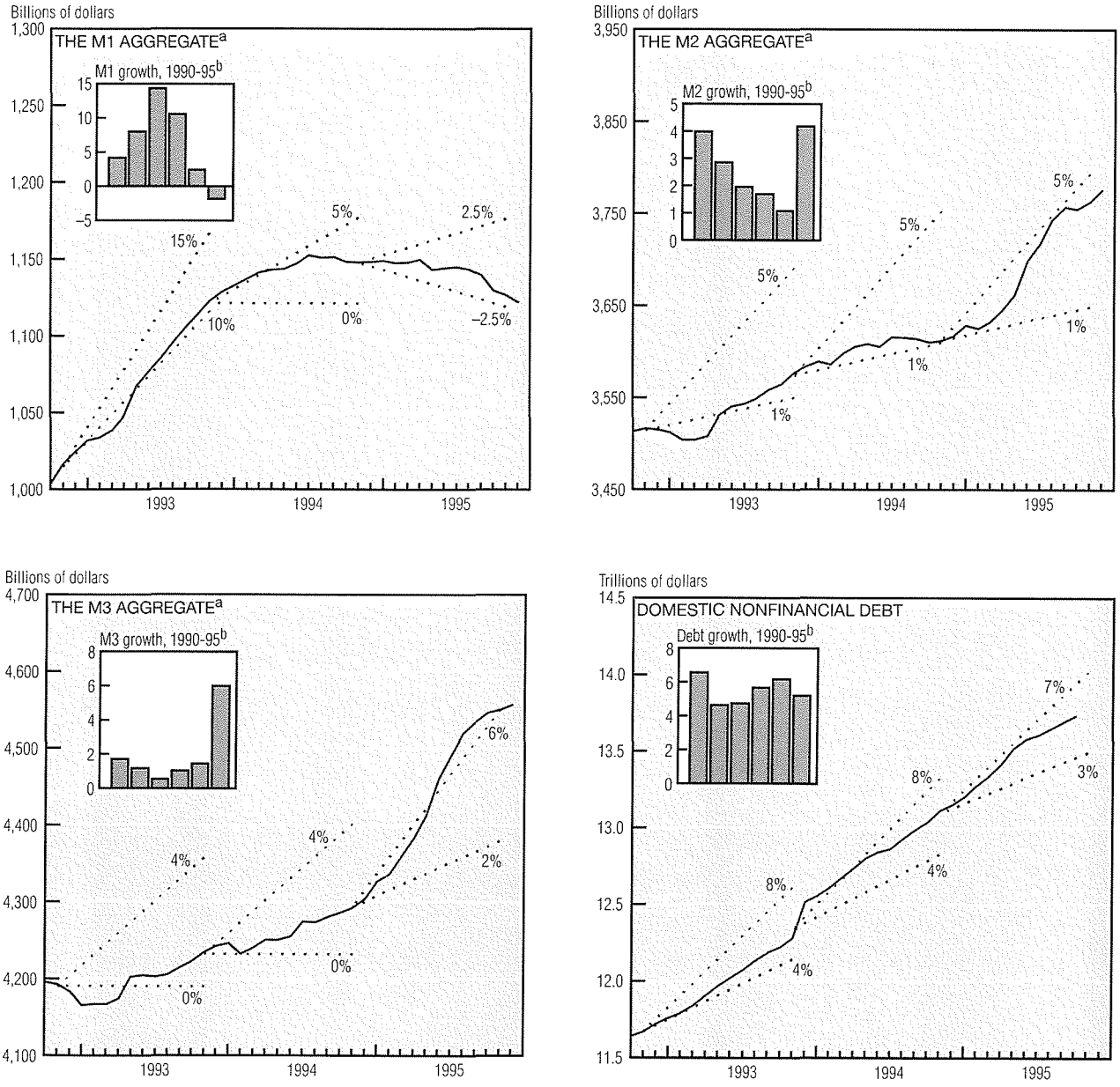
Monetary Policy (cont.)



a. Last plot is estimated for December 1995.

b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1995 is calculated on an estimated 1995:IVQ over 1994:IVQ basis for M1, M2, and M3, and on an October over 1994:IVQ basis for domestic nonfinancial debt.

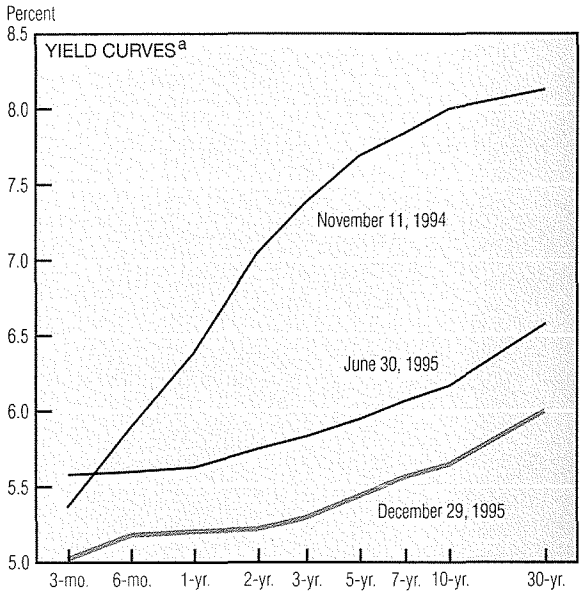
NOTE: All data are seasonally adjusted. Dotted lines for M1 represent growth ranges and are for reference only. Dotted lines for M2, M3, and domestic nonfinancial debt are target ranges.

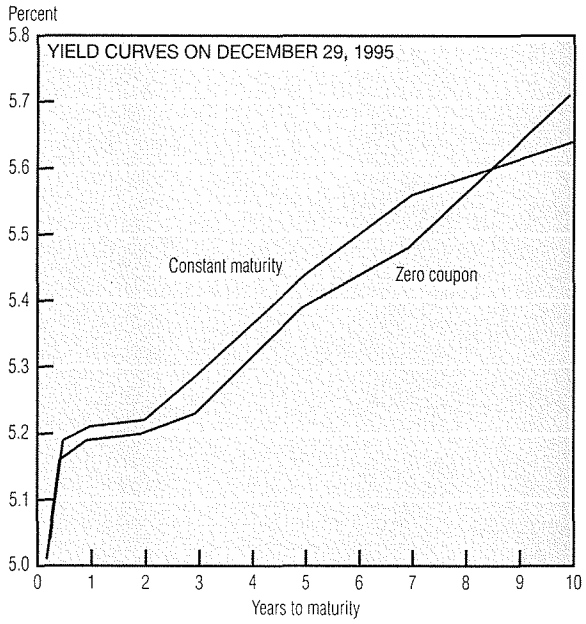
SOURCE: Board of Governors of the Federal Reserve System.

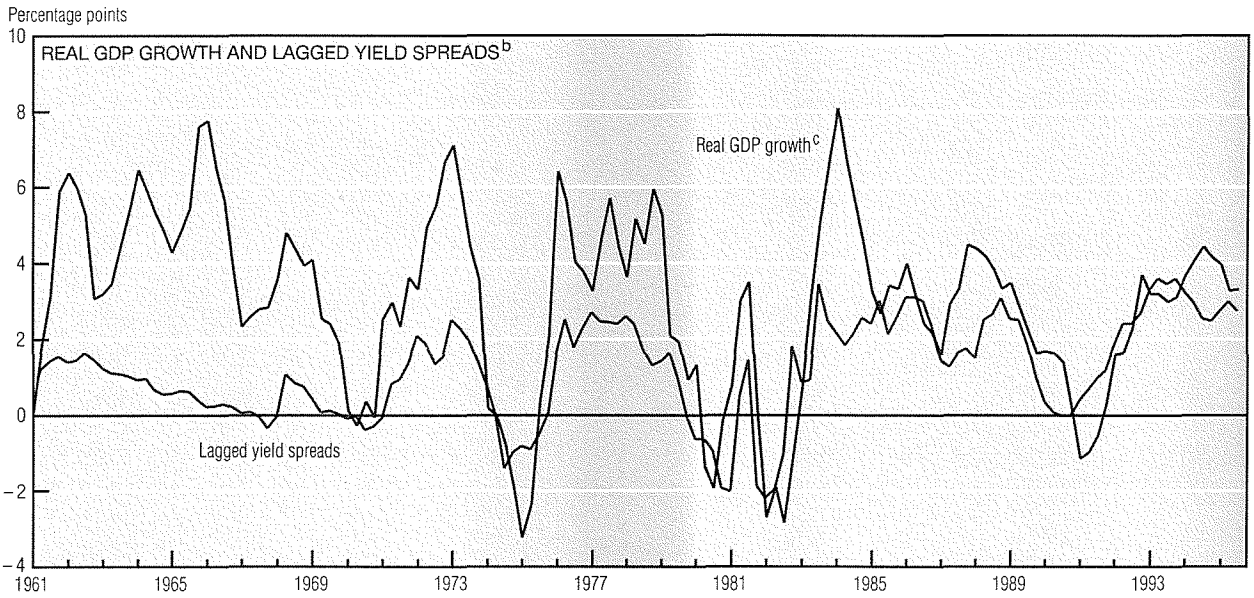
It is estimated that sweep accounts alone depressed transaction deposit growth by about 4½% in 1995. Because transaction deposits are the only reservable deposit, the growth rate of total reserves was restrained almost proportionately. The monetary base, which comprises total reserves and currency held outside banks, was also affected. Its growth rate, however, is dominated by its currency component, which slowed sharply in the spring. Analysts believe that diminished currency growth is related to foreign investors' concerns about the exchangeability of their current holdings once the newly designed $100 bill is introduced. It is also estimated that the M1 monetary aggregate, which includes both currency and transaction deposits, would have grown in 1995 in the absence of sweep accounts.

Despite considerable uncertainty about the future relationships of money and debt to fundamental policy objectives, the FOMC continues to set growth ranges for M2, M3, and domestic nonfinancial debt. The Humphrey-Hawkins Act of 1978 mandates that the Federal Reserve report these ranges to the U.S. Congress. It is perhaps ironic that although little attention is paid to these measures, they all ended the year within their specified range. M2, which includes both OCDs and MMDAs, was impervious to the implementation of sweep arrangements. The strength in M3 largely reflected banks' tendency to finance loan growth by issuing large CDs.

Interest Rates







a. Three-month, six-month, and one-year instruments are quoted from the secondary market on a yield basis; all other instruments are constant-maturity series.
b. The yield spread is defined as the 10-year Treasury yield minus the 3-month Treasury yield, and is lagged one year.
c. Year-over-year change.
SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of the Treasury; and U.S. Department of Commerce, Bureau of Economic Analysis.

Interest rates continue to fall. Rates at all maturities have dropped roughly half a point since late June. Long-term rates have fallen by 2 percentage points since their cyclical peak in November 1994, and more recently, short-term rates have also headed lower. The sharp decline in medium-term rates has not only flattened the yield curve, but has given it an uncharacteristic shape: steeper at the long end.

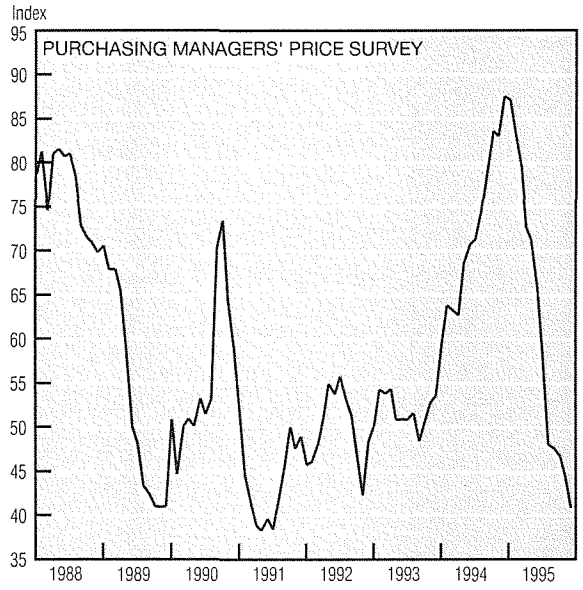
Care must be taken in interpreting yield curves. The standard constant-maturity data put out by the Treasury Department are only an estimate of yields, because it is rare to find bonds maturing in exactly seven years, for example. In addition, these yields are for coupon bonds, including twice-yearly coupons. The yields on zero-coupon bonds provide a somewhat cleaner measure, despite the complications of tax differences and lower market liquidity. The two curves are similar, although the zero-coupon curve is somewhat steeper and generally lower.

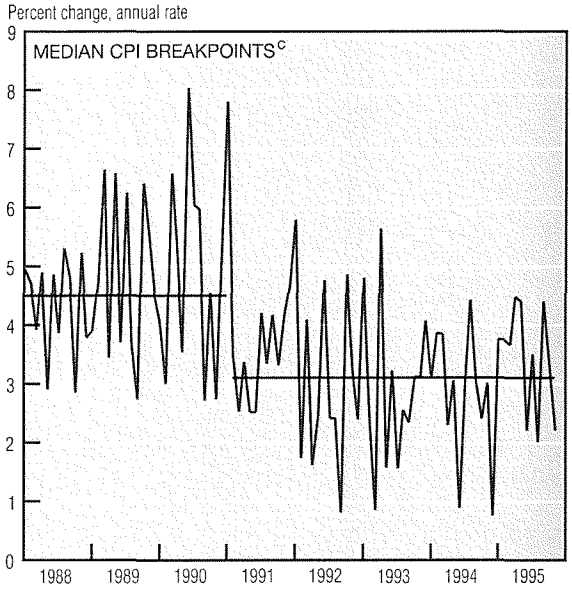
Yield spreads, particularly inversions, are often used to forecast recessions. Plotting the lagged spread between 10-year and 3-month Treasuries and the growth rate of real GDP shows that inversions often do precede recessions, but that the relationship is also broader. Low spreads indicate low real growth and high spreads indicate high real growth. The relationship is neither one-to-one nor completely precise, however, so caution in using it is warranted.

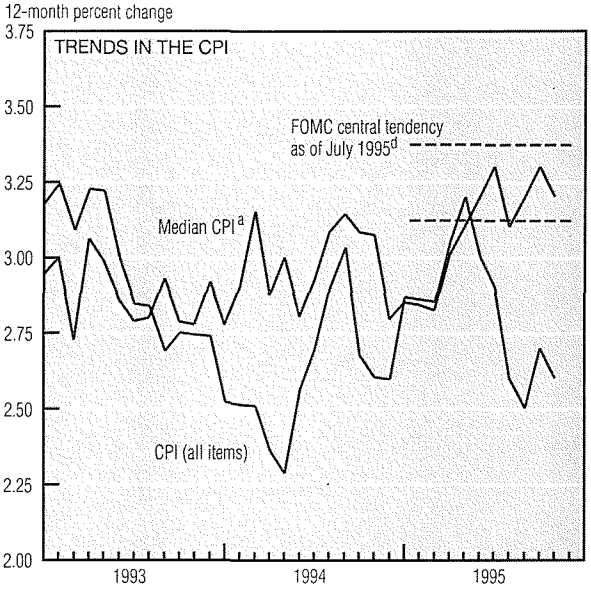
Inflation and Prices

November Price Statistics

	Annualized percent change, last: 1 mo.	11 mo.	5 yr.	1994 average
Consumer Prices				
All items	0.0	2.6	2.8	2.6
Less food and energy	0.7	3.1	3.4	2.7
Median[a]	2.2	3.4	3.2	2.8
Producer Prices				
Finished goods	5.8	1.8	1.0	1.8
Less food and energy	5.2	2.6	1.9	1.6
Commodity futures prices[b]	8.6	5.1	1.4	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 3.25 for 1996.
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 National Association of Purchasing Management.

The Consumer Price Index (CPI) showed no change in November, contributing to the measure's lowest six-month growth rate in nearly 10 years. The core inflation indexes, which include the CPI less food and energy and the median CPI, both posted only slight increases for the month—an annualized 0.7% and 2.2%, respectively.

As measured by the behavior of producer prices, the inflation indicators were less encouraging in November. The annualized one-month changes in the Producer Price Index (PPI) and the PPI less food and energy were 5.8% and 5.2%, respectively. Motor vehicles accounted for three-fourths of this increase. Still, data from the National Association of Purchasing Management suggests that better producer price reports may be on the way. The purchasing managers' price index dropped from 44.5 in November to 40.8 in December—its lowest level since July 1991. Only 10% of those polled reported facing higher supply prices, down from 16% in November.

The recent 12-month trend in the CPI stood at only 2.6%, identical to the relatively low inflation recorded in 1994. However, as measured by the median CPI, inflation reached 3.2% over the last 12 months, prompting the question: "Which is the 'true' inflation rate?"

Measuring monetary inflation represents an enormous challenge to economists. Some of the difficulty stems from the fact that transient

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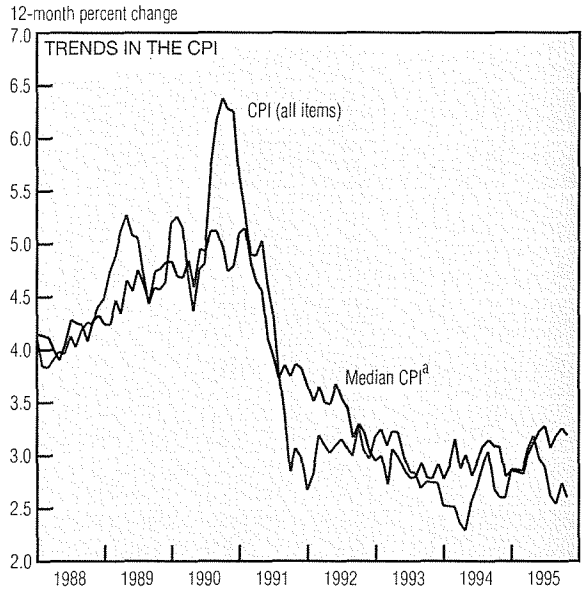
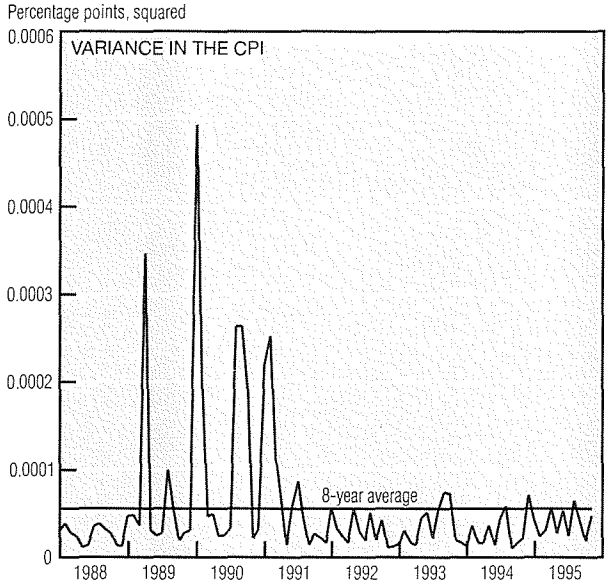
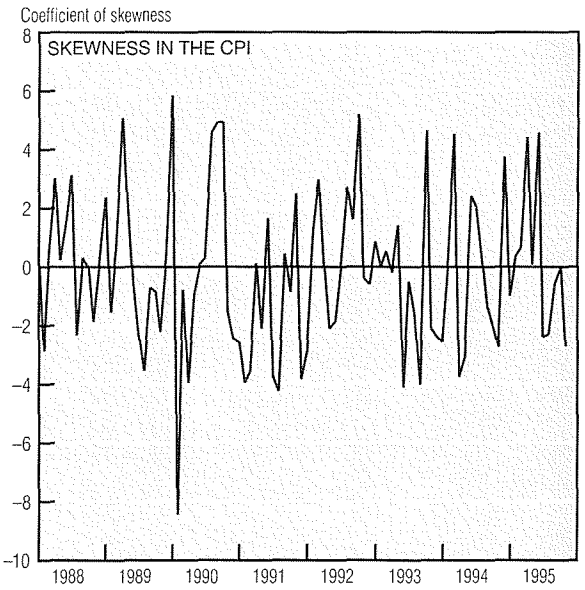
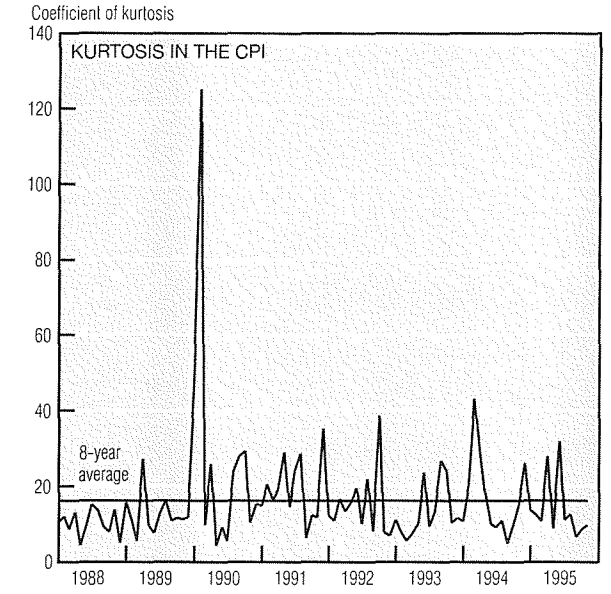
Inflation and Prices (cont.)









a. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

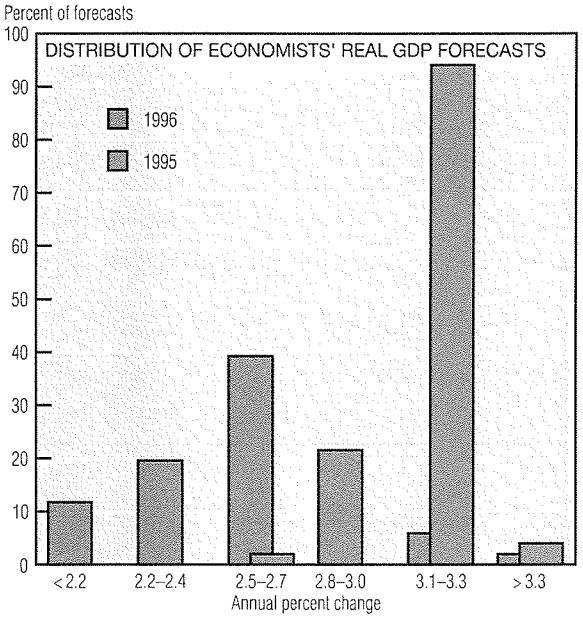
events, such as a drought that reduces the supply of crops, can temporarily skew the price data and substantially alter a weighted-average index like the CPI. Such price-index movements are generally not considered "inflationary," a phenomenon most economists attribute to monetary causes.

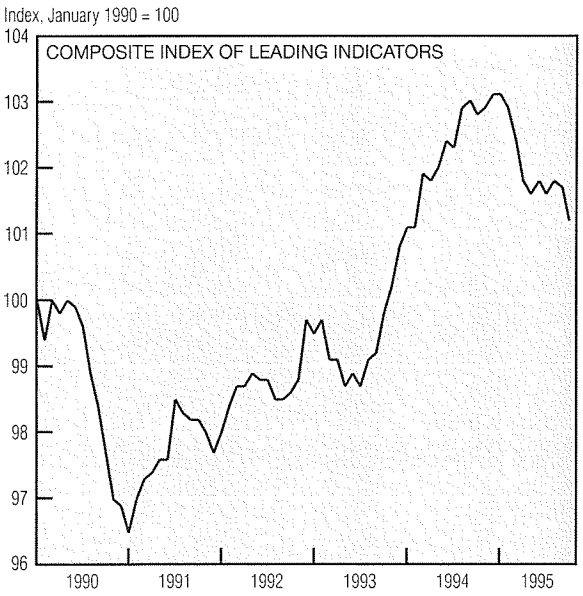
For a time, then, the price aggregate may falsely indicate a change in inflation as it reacts to a transitory shock; that is, a majority of price movements will be markedly above or below the rate recorded by the CPI. One method of eliminating the influence of these transitory events is to trim the outlying portions of the cross-sectional distribution of the CPI's components. What remains is the center of the price change distribution, or the median change. Indeed, research at the Federal Reserve Bank of Cleveland indicates that when the trend in the CPI is below the trend in the median CPI (as it has been over the past several quarters), we would generally expect the CPI to rise rather than the median to fall.

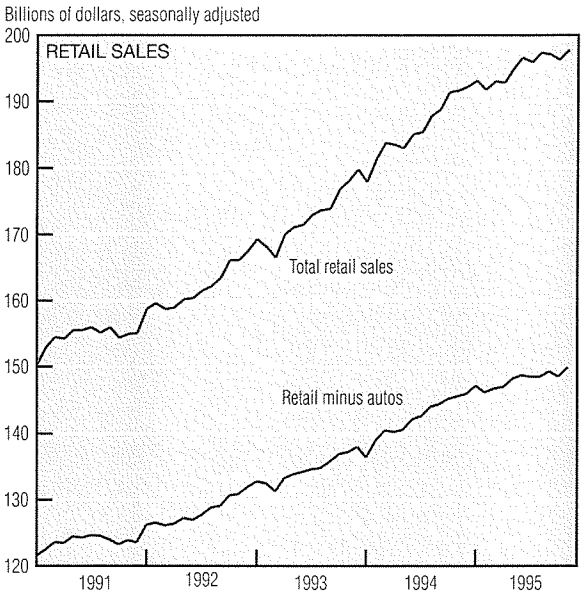
Skewness is one of several measures that can help us judge whether the CPI is being influenced by any unusual price disturbances. Another, CPI variance, measures the dispersion of consumer price changes and kurtosis, which is an indicator of how "peaked" the distribution of price changes is. Neither of these measures suggests any unusual underlying behavior in the recent price data: CPI variance is slightly narrower, and distribution is slightly less peaked, than their eight-year averages.

Real GDP and Components, 1995:IIIQ
(Advance estimate, s.a.a.r.[a])

	Change, billions of 1987 $	Percent change, last: Quarter	Four quarters
Real GDP	56.8	4.2	3.3
Consumer spending	26.8	2.9	3.2
Durables	15.6	11.7	7.7
Nondurables	0.2	0.1	1.8
Services	11.0	2.2	2.8
Business fixed investment	15.3	8.3	14.6
Equipment	14.0	9.7	16.3
Structures	1.4	3.5	8.7
Residential investment	5.8	10.9	−1.4
Government spending	7.0	3.1	−0.4
National defense	1.1	2.1	−7.3
Net exports	0.9	—	—
Exports	18.3	10.6	10.4
Imports	17.5	8.6	10.0
Change in business inventories	1.0	—	—







a. Seasonally adjusted annual rate.
SOURCES: *Blue Chip Economic Indicators,* December 10, 1995; and U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

According to the Blue Chip panel of economists, U.S. economic activity is likely to slow this year from an anticipated 3.3% increase in 1995. Growth forecasts for 1996 center on a range of 2.5% to 2.7%, but exhibit a fairly wide dispersion.

The slower growth forecast is based largely on an expected softening in the consumer sector, which accounts for approximately two-thirds of total output. Despite a sharp increase in the preliminary data for November, retail sales appear to have dropped off in recent months. Total retail sales have advanced at a 2.9% annual rate since last May, compared with 6.5% over the previous 12 months. Early (and sketchy) evidence suggests that December's holiday spending was weaker than anticipated.

In assessing household spending patterns, analysts frequently cite consumers' sentiment about both the overall economy and future job prospects. Each measure showed a general deterioration over 1995, but both tend to be rather volatile. Actual employment growth slowed, but the employment-to-population ratio remained near its record peak.

Most of the recent concern about consumers has focused on their debt burdens—particularly that portion associated with credit

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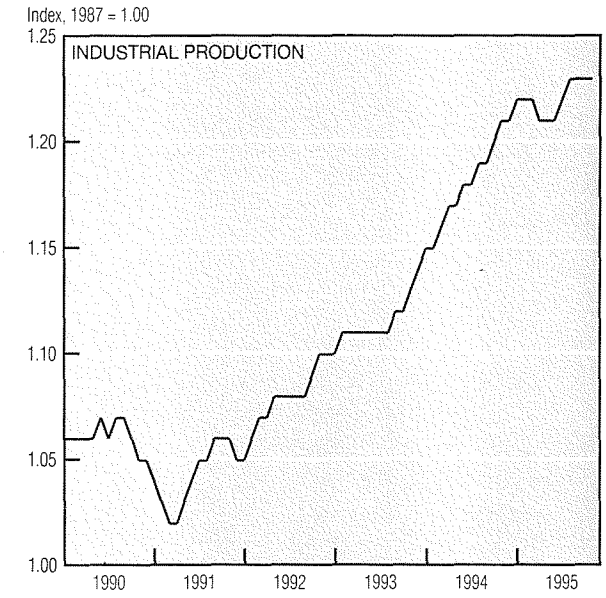
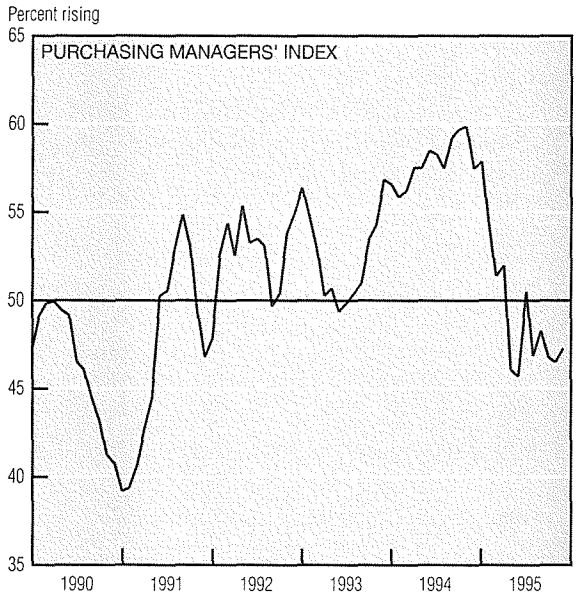
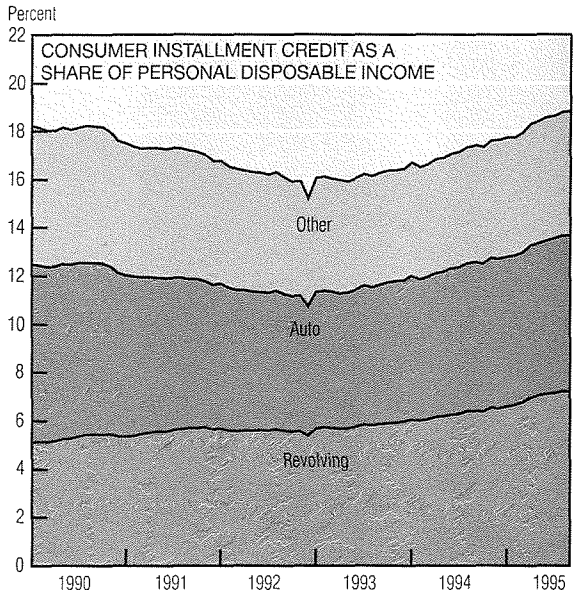
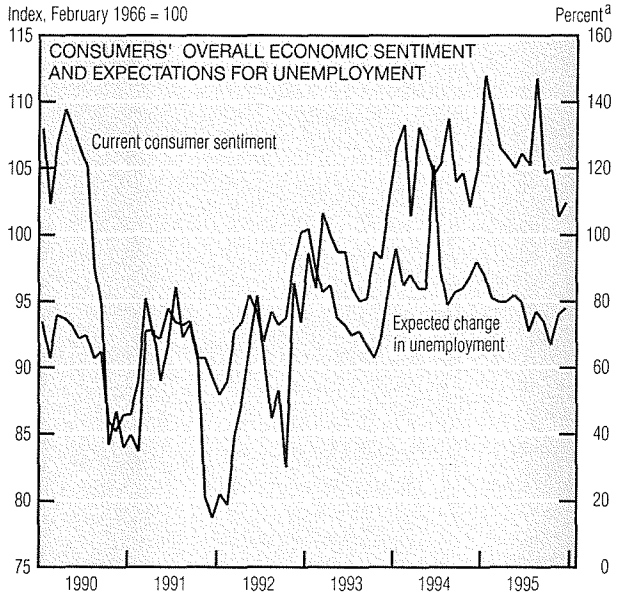
Economic Activity (cont.)









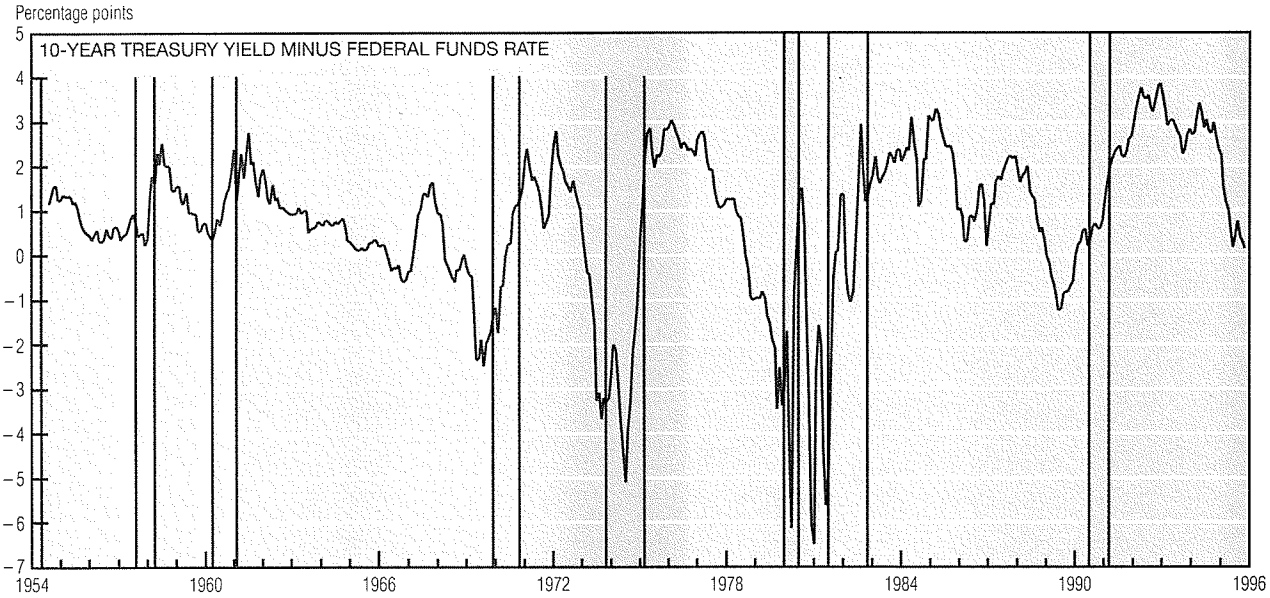
a. Percent of respondents expecting improvement less percent expecting worsening, plus 100.
SOURCES: Board of Governors of the Federal Reserve System; National Association of Purchasing Management; U.S. Department of Commerce, Bureau of Economic Analysis; and the University of Michigan.

cards. Although the ratio of consumer installment debt to disposable income has picked up since late 1992, there is little evidence that consumers' liquidity is constrained. The delinquency rate on consumer installment debt has risen, but it remains extremely low by historic standards.

The industrial sector also shows some signs of softening, but no evidence of an overall decline. Industrial production, while generally up for the year, has remained flat in recent months. The purchasing managers' index came in at just under 50% last year, implying about equal proportions of managers reporting growth and declines. The industrial sector accounts for only about 20% of national output, but it is a pivotal component of the business cycle.

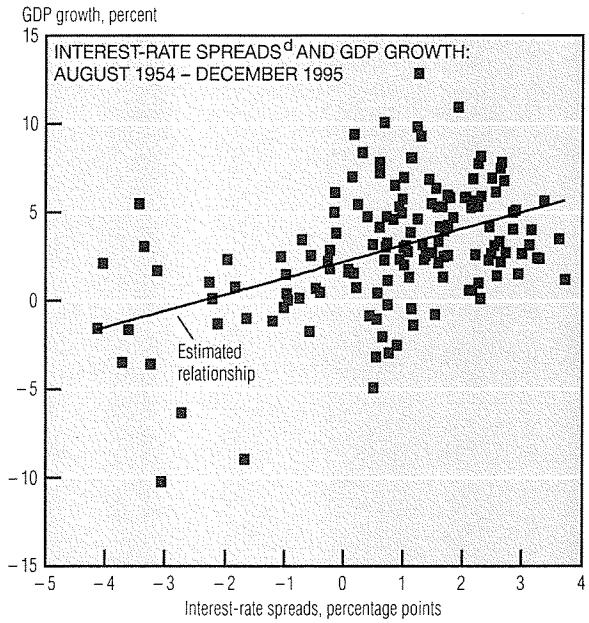
Despite the chance for some near-term slowing in U.S. economic activity, evidence increasingly suggests that our long-range growth potential is strengthening. Business fixed investment as a share of GDP reached record levels in 1994 and 1995, and productivity growth is above trend. The Standard & Poor's 500 advanced more than 30% in 1995, compared with an average increase of 3.4% over the previous two years. These strong gains—far in excess of the inflation rate—imply that the market may be raising its expectations for future real earnings and economic growth.

The Yield Curve



Interest-Rate Spreads and Recessions

Recession dates[a]	Average spread prior to recession[b]	Lead time of yield-curve inversion[c]
January 1970–November 1970	−1.54	12
December 1973–March 1975	−1.53	9
February 1980–July 1980	−1.92	17
August 1981–November 1982	−2.99	10
August 1990–March 1991	−0.14	20



a. Month following cyclical peak to cyclical trough, as determined by the National Bureau of Economic Research.
b. Average percentage-point spread between 10-year Treasury constant maturity and effective federal funds rate for 12 months prior to recession.
c. Number of months between first inversion and onset of recession.
d. Difference between 10-year Treasury constant maturity and effective federal funds rate.
NOTE: Shaded bars indicate recessions.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and National Bureau of Economic Research.

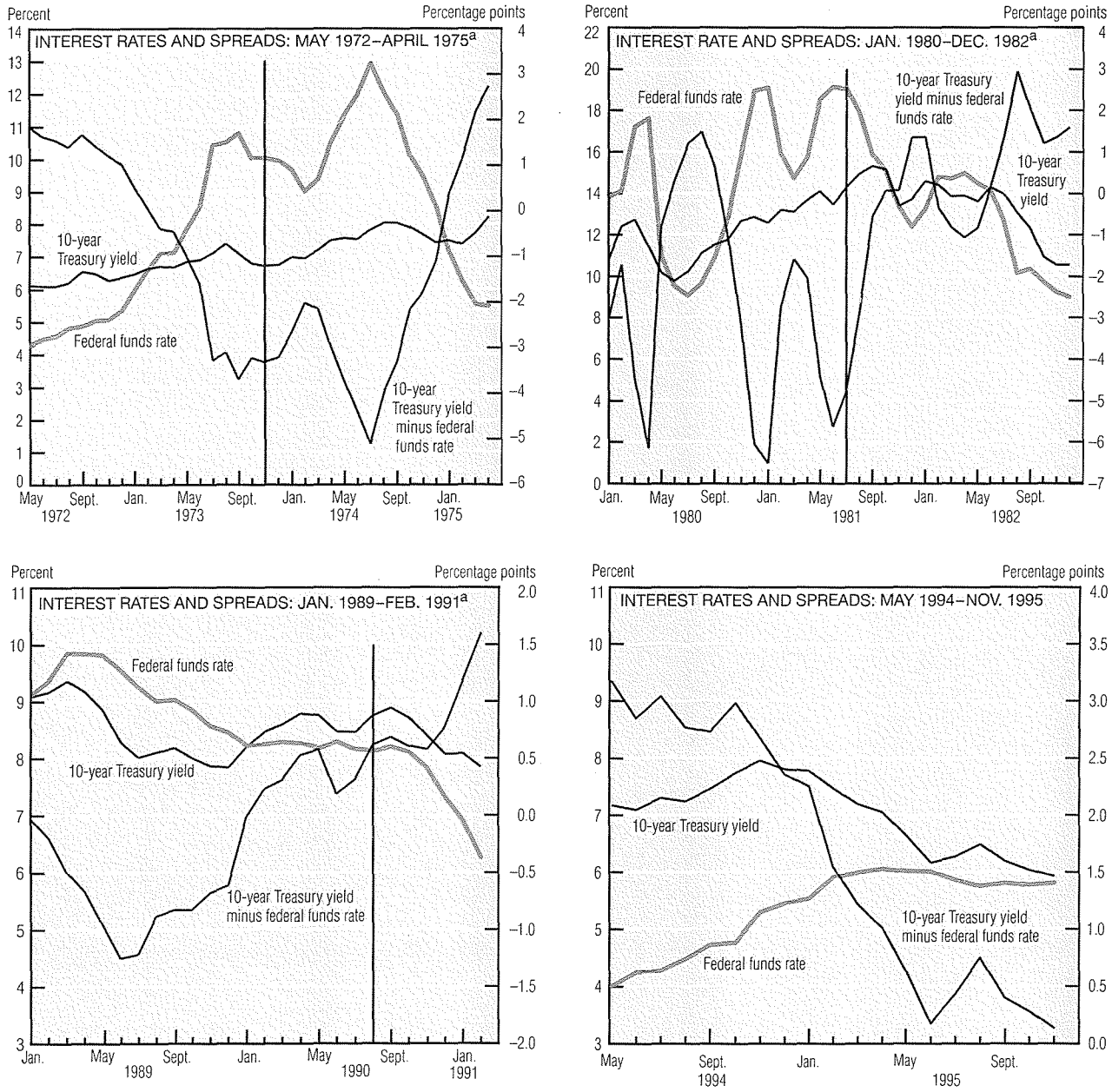
The yield curve on Treasury securities—which describes rates of return at different maturities in ascending order—has flattened dramatically since the third quarter of 1994. At the end of December, the difference between the 10-year Treasury yield and the effective federal funds rate was less than 20 basis points (a basis point represents 1/100 of a percentage point). To provide some perspective on this difference, the spread has averaged nearly 100 basis points in nonrecession years since 1954.

Based on past experience, this decline in the rate spread between short-term and long-term interest rates has raised some concern about the prospects for the U.S. economy over the coming year: Nearly all post–1950s recessions were preceded by significant declines in the difference between, for instance, the 10-year Treasury rate and the federal funds rate. In all but one instance, this spread was actually *negative* prior to the downturn. Thus, although the magnitude and timing of so-called yield-curve inversions have differed before the onset of recessions, conventional wisdom holds that negative, or very low, interest-rate spreads are harbingers of tough economic times.

Changes in long-term less short-term interest rates depend, of course, on the behavior of rates at each maturity. Before becoming too

(continued on next page)

The Yield Curve (cont.)



a. Vertical line represents business cycle peak.
SOURCES: Board of Governors of the Federal Reserve System; and National Bureau of Economic Research.

alarmed at the messages read from yield-curve tea leaves, it is instructive to examine the components of rate spreads more closely.

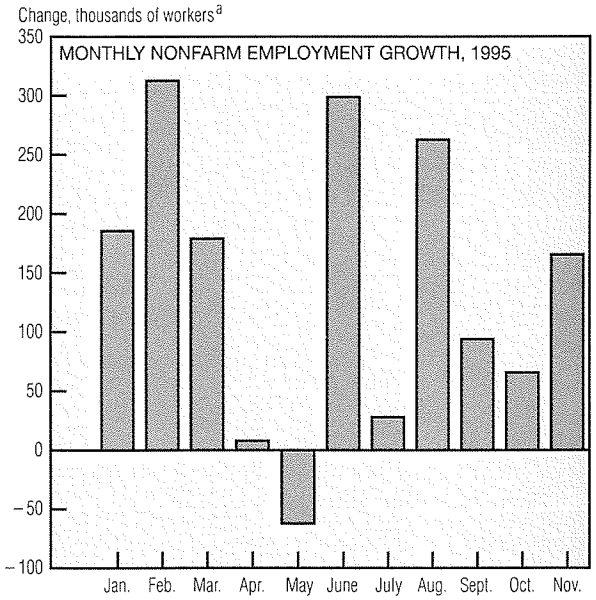
The recessions of 1973–75 and 1981–82 are typical of most downturns in the past 35 years. In both of these episodes, the 10-year Treasury/funds-rate spread fell precipitously and inverted some months before the recession began. These declines occurred even though long-term rates were steady or rising. The sinking rate spreads, therefore, were largely a result of fairly steep increases in the federal funds rate.

A similar pattern can be found before the 1960–61, 1970, and 1980 contractions. A notable exception was the 1990–91 recession. Not only was the yield inversion smaller in magnitude and longer in lead time than during earlier episodes, but the negative 10-year/funds-rate spreads had disappeared six months before the downturn began.

With the possible exception of this latest contraction, the current fall in rate spreads is unlike the declines that preceded earlier recessions. In contrast to constant or rising 10-year yields combined with a rising funds rate, last year witnessed a slightly falling funds rate combined with significant declines in longer-term rates.

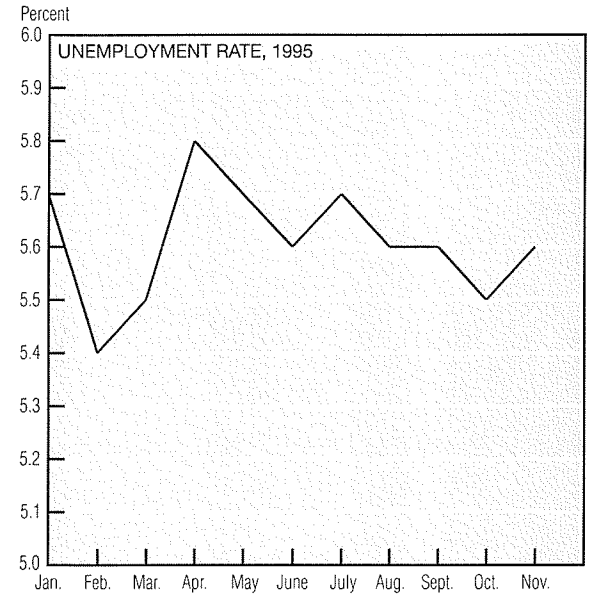
Being doomed to repeat history does imply that history repeats itself. A deeper look into the recent yield-curve declines suggests that the source of similar behavior in the past—behavior that did not ultimately bode well for short-term economic growth—may be absent in the current environment.

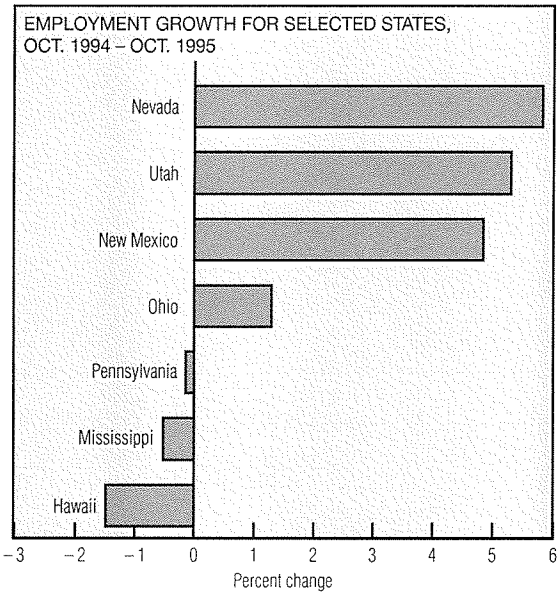
Labor Markets



Employment Growth by Industry
(Thousands of employees[a])

	1995				
	IQ	IIQ	IIIQ	IVQ[b]	Total
Total nonfarm	678	245	385	232	1,540
Goods-producing	140	−130	−83	−29	−102
Manufacturing	53	−97	−106	−51	−201
Nondurables	−6	−61	−81	−28	−176
Durables	59	−36	−25	−23	−25
Construction	90	−26	32	27	123
Service-producing	538	375	468	261	1,642
Wholesale and retail trade	59	71	127	102	359
FIRE[c]	7	−8	27	33	59
Transportation and public utilities	54	17	14	27	112
Services	389	260	263	123	1,035
Computer	26	28	27	17	98
Health	76	56	71	66	269
Government	29	35	37	−24	77





a. Seasonally adjusted.
b. December data not included.
c. Finance, insurance, and real estate.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

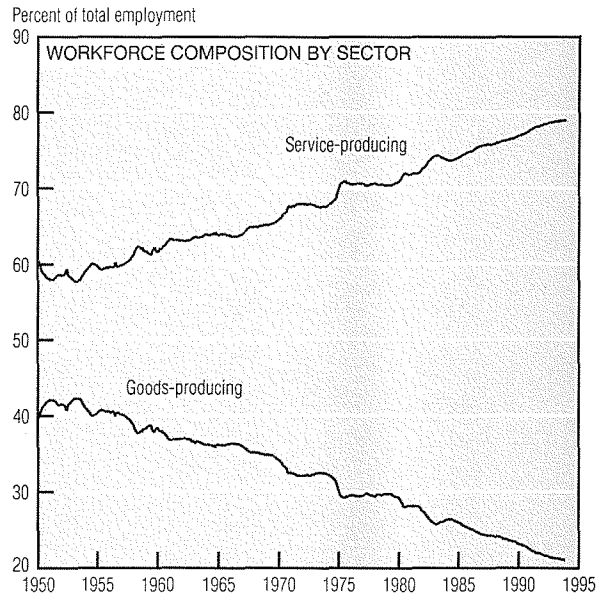
Labor markets were solid but not spectacular in 1995, as the nation posted a yearlong employment gain of 1.5 million jobs. Although December data are not included in the tally, this figure puts last year's net job creation at roughly half the 1994 total (3.5 million).

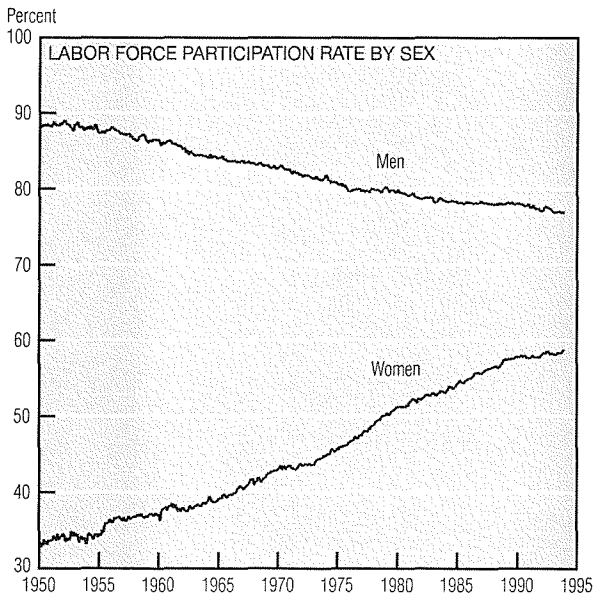
Employment took a turn for the worse in the goods-producing sector, shedding 102,000 workers compared to a gain of 696,000 in 1994. One significant factor in this loss was the bleak employment situation in manufacturing, where a number of industries, notably transportation equipment and fabricated metals, experienced consistent cutbacks.

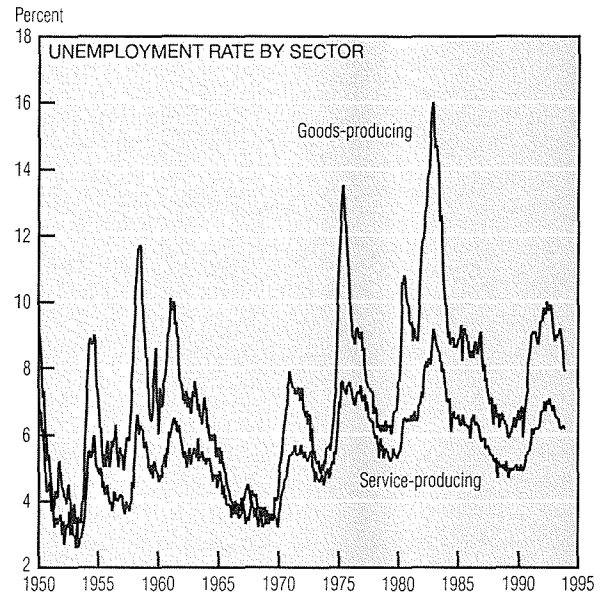
Most service-producing categories added fewer workers in 1995 than in 1994. One exception was the computer and data processing industry, which posted a 10% employment gain over the course of the year. This translated into 98,000 new jobs added to the economy.

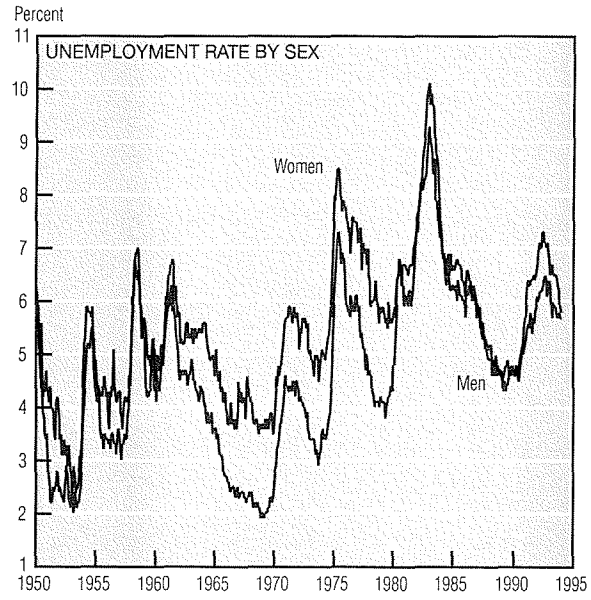
The monthly unemployment figures fluctuated quite a bit during 1995, but the average for the year (5.6%) came in far below the 1994 rate of 6.1%. At the regional level, the employment news was mixed. Mountain states like Nevada, Utah, and New Mexico exhibited strong growth, while industrial hubs (including Ohio) finished in the middle of the pack. In addition, a rising number of states posted net employment declines compared to 1994.

Labor Market Trends









SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

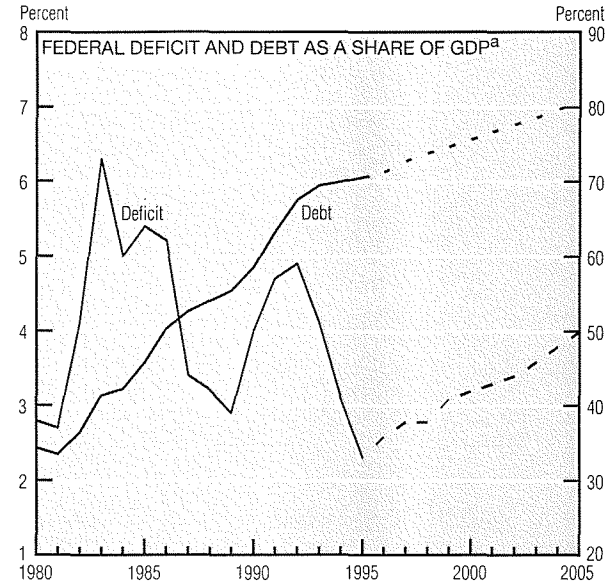
The U.S. workforce has undergone dramatic changes since World War II. The share of workers employed in the goods-producing sector has steadily declined, from 40% in 1950 to 21% in 1993. The shifts between manufacturing (the most cyclically sensitive industry in the goods-producing sector) and services have been the most pronounced.

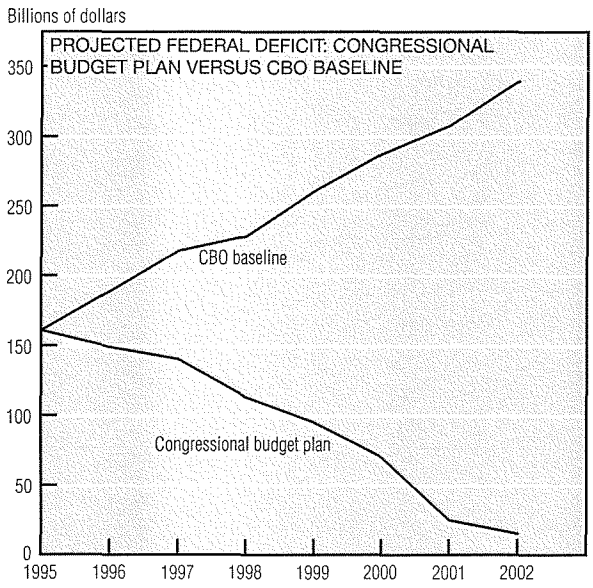
The jobless rate in the goods-producing sector typically exceeds that of the service-producing sector. While unemployment in the service industries demonstrates a strong cyclical pattern, its cyclical variability is less than that of the goods-producing sector.

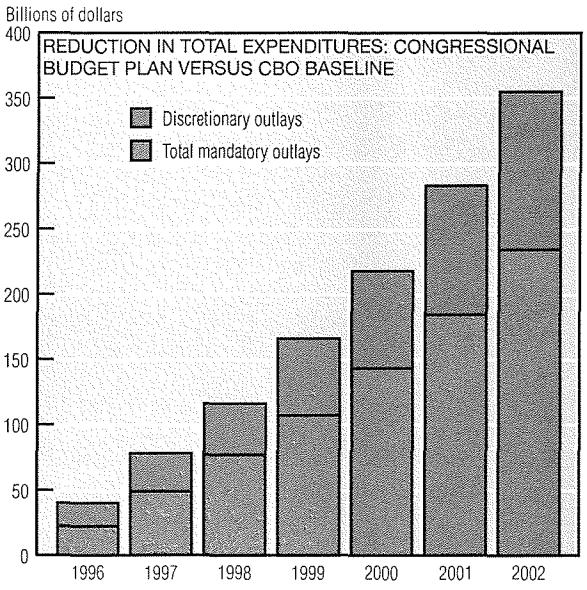
A second fundamental labor market shift has occurred in the participation rates of males and females. Over the last 45 years, the share of women in the workforce has risen from approximately 33% to about 59%, while the fraction of men has fallen roughly 12 percentage points.

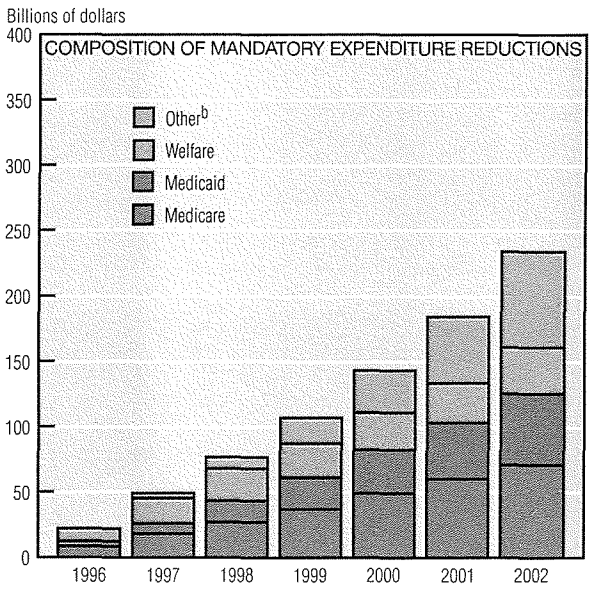
During the 1960s and 1970s, as the pace at which women entered the labor force quickened, the jobless rate for women rose above that for men. If this was part of an adjustment process, it seems to have ended. Since the early 1980s—as in the 1950s and early 1960s—the two series have tracked much more closely.

The Federal Budget









a. Dotted lines represent CBO baseline projections.
b. "Other" includes net interest and offsetting receipts.
NOTE: All data are for fiscal years.
SOURCE: Congressional Budget Office.

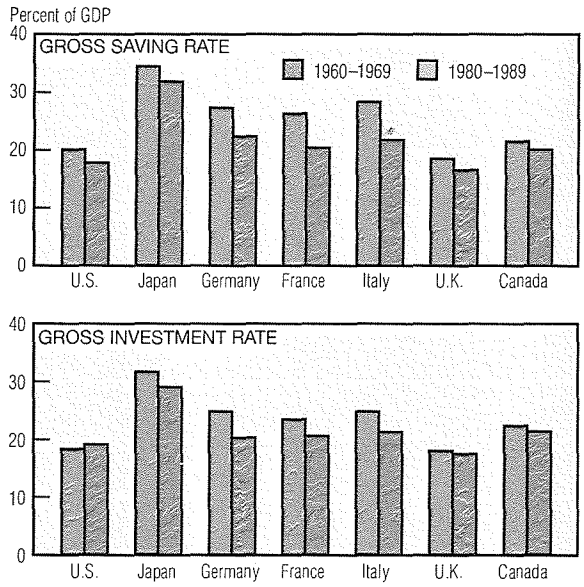
National debt doubled from about 35% of gross domestic product in 1980 to more than 70% in 1995. Although the Congressional Budget Office (CBO) predicts the 1995 federal deficit will come in at only 2.3% of GDP—the lowest since 1979—CBO projections based on current policy show that it will rise to 4.0% of GDP by 2005. Rapid increases in projected retirement and health benefits for the baby-boom generations are expected to push these ratios still higher in the first two decades of the next century. Moreover, the Medicare program is projected to be bankrupt by 2002 under current rules. This scenario has proved alarming enough to warrant agreement between Congress and the administration on the need to achieve a balanced budget by that year.

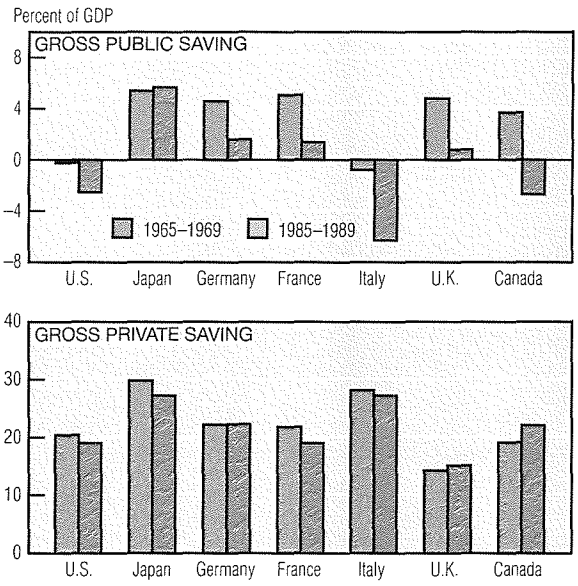
Despite such goodwill, however, issues about the nature of expenditure cuts and possible tax reductions remain unresolved. Congress wishes to enact significant cuts in discretionary spending; reduce Medicare growth by increasing premiums and encouraging the use of HMOs; pare Medicaid spending and shift the primary responsibility for this program to the states; and shrink outlays on government research, food stamps, education, and other welfare programs. The administration, however, prefers to retain the two health-care programs in their current form and to expand expenditures on education, provide more for environmental protection, and boost outlays on government research.

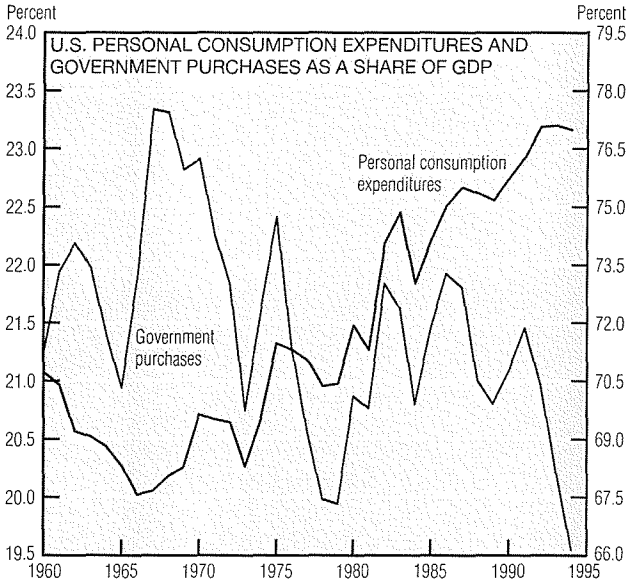
International Saving Trends

Real Interest Rates in the World's Seven Largest Developed Countries
(Percent)

	1960–1969	1980–1989
United States	2.5	4.5
Japan	3.7	4.0
Germany	4.1	4.6
France	2.3	4.4
Italy	2.1	2.8
United Kingdom	3.2	3.9
Canada	3.3	4.7







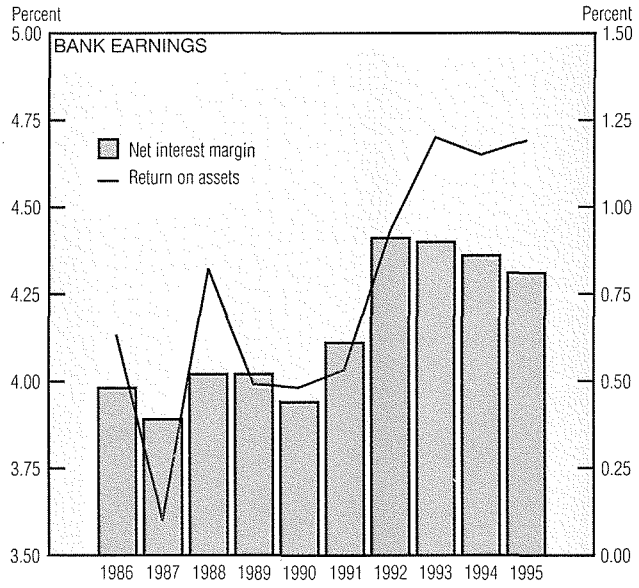
SOURCES: Organisation for Economic Co-operation and Development; International Monetary Fund; Bank of England; National Income and Product Accounts; and Deputies of the Group of 10 Countries.

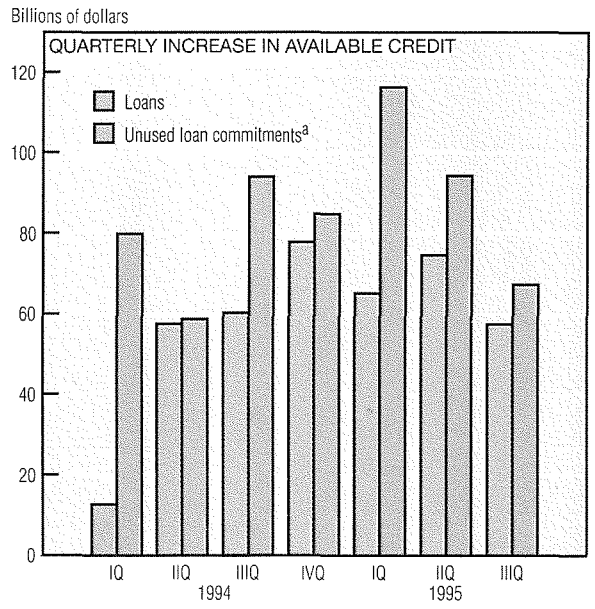
Measured real interest rates have increased in developed countries over the last 30 years. Among the seven largest developed nations, the upticks were steepest in France (210 basis ponts) and the U.S. (200 basis points). This trend may be attributed to a long-term decline in saving in most developed economies. Indeed, both saving and investment moved distinctly lower during this period.

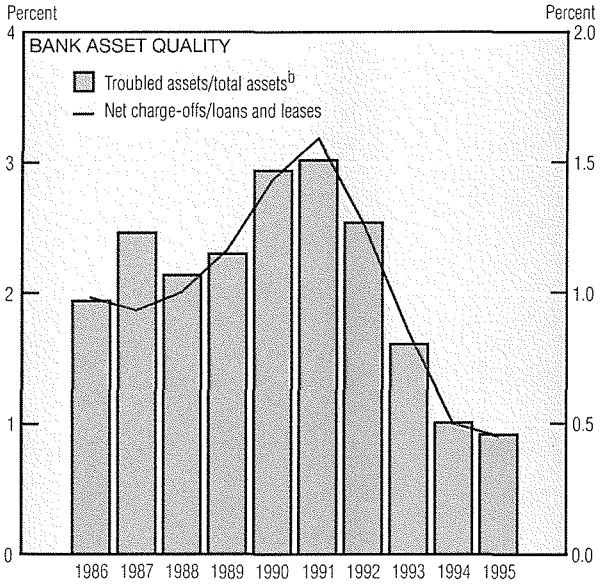
Aggregate saving is conventionally separated into public saving (the government's budget surplus) and private saving (saving out of personal disposable income, or national income less net taxes). Under this method, contributions for social insurance are included in direct taxes, not in disposable income. Because these contributions are deposited in a trust fund and are associated with expected future benefits, individuals may consider them part of their own saving, and their existence may affect saving out of disposable income. Whether such contributions should be classified under public or private saving is, therefore, debatable.

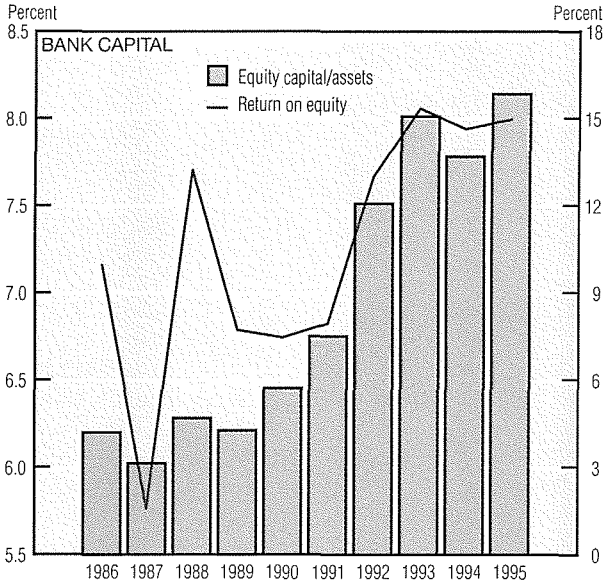
The conventional method of determining aggregate saving suggests that greater fiscal deficits are the main cause of lower saving and higher interest rates. In the U.S., however, changes since the 1960s in private and government consumption expenditures as a share of national output point to the opposite conclusion: The steep increase in private consumption is primarily responsible for low national saving rates in the 1980s.

Banking Conditions









a. Includes credit card lines, home equity lines, commitments for construction loans, loans secured by commercial real estate, and unused commitments to originate or purchase loans.
b. 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 three quarters of the year and are annualized where appropriate.
SOURCE: Federal Deposit Insurance Corporation.

Commercial bank earnings soared to a record high of $13.8 billion in the third quarter, spurred by strong loan growth, stable net interest margins, and reduced deposit insurance premiums. Bank earnings have now surpassed $10 billion for 11 consecutive quarters.

The industry's return on assets rose to a record 1.32% in 1995:IIIQ, bringing the average for the first three quarters of the year to 1.19% —more than twice the level seen only four years ago. Although the net interest margin has declined from its 1994 average, it has not fallen since the first quarter of 1995 and remains above pre-1992 levels. Banks have increased the fraction of loans in their portfolios, allowing higher returns even though the net interest margin has remained flat.

Growth of unused loan commitments continues to outpace the rise in bank loans. This suggests that lending standards are relatively relaxed and that changes in demand may be the prevailing factor for changes in credit.

The quality of commercial bank assets remained strong in 1995:IIIQ, as the ratio of troubled assets to total assets continued to decline. Net charge-offs as a share of loans and leases increased slightly in the July-to-September period, but the average for the first three quarters of 1995 remained below 1994's

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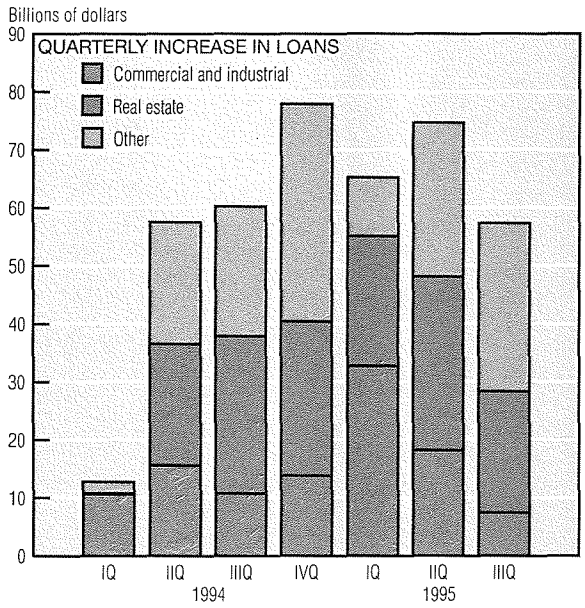
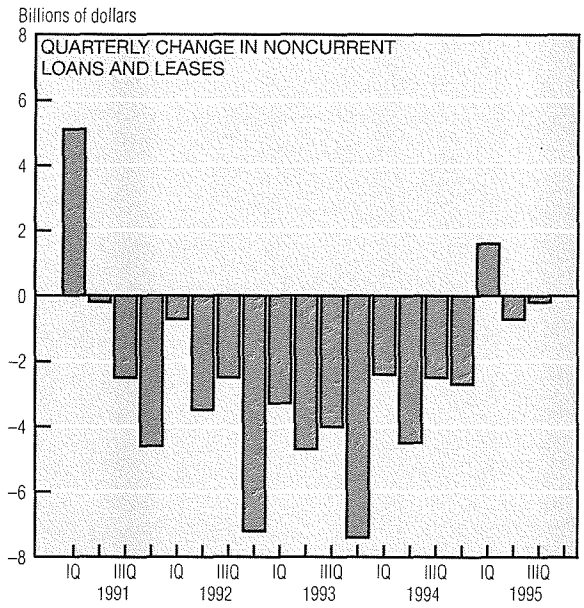
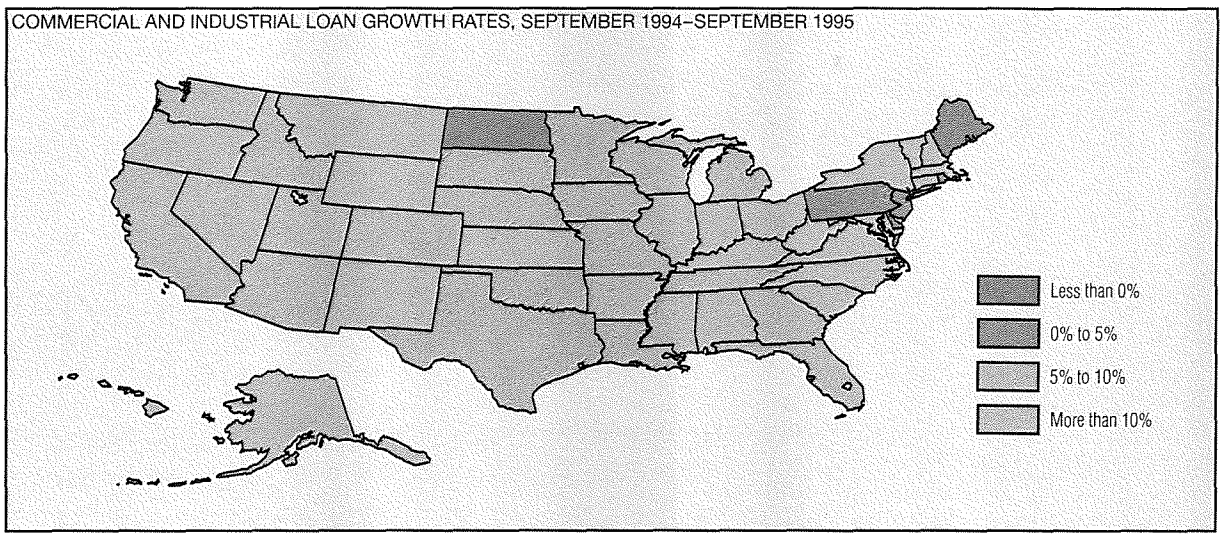
Banking Conditions (cont.)







NOTE: All data are for FDIC-insured commercial banks.
SOURCE: Federal Deposit Insurance Corporation.

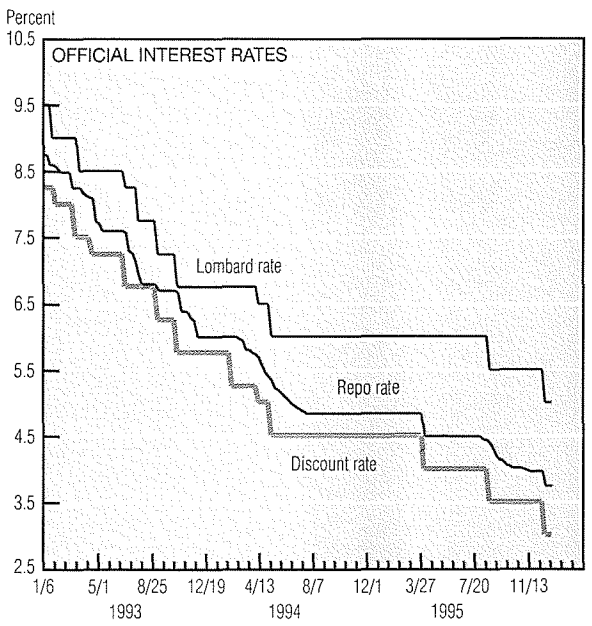
level. The banking industry's return on equity set a new record of 16.30% in the third quarter. The previous high—16.13%—was set in the third quarter of 1993. The ratio of equity capital to assets continued to firm during the first nine months of the year, with a 10.4% increase in equity capital overshadowing a 7.8% rise in assets.

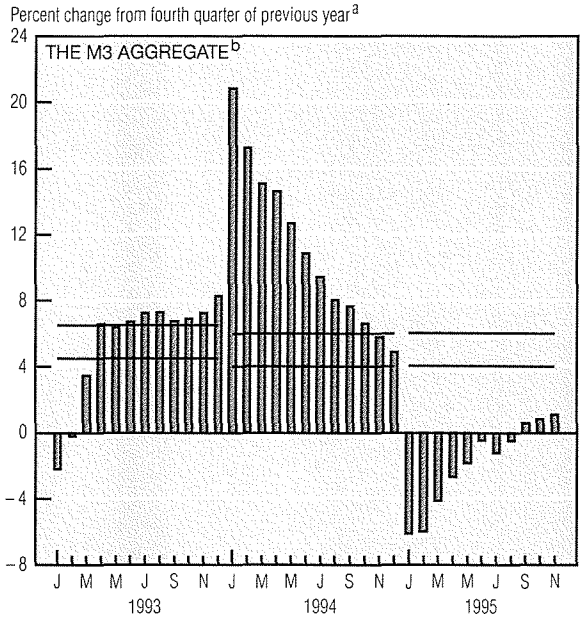
The quality of commercial bank loans remained strong in the third quarter, although delinquency and net charge-off rates picked up slightly. More than half of the $57.4 billion increase in loans was traceable to real estate loans and loans to consumers. Loans to commercial and industrial (C&I) borrowers showed their smallest quarterly rise in two years.

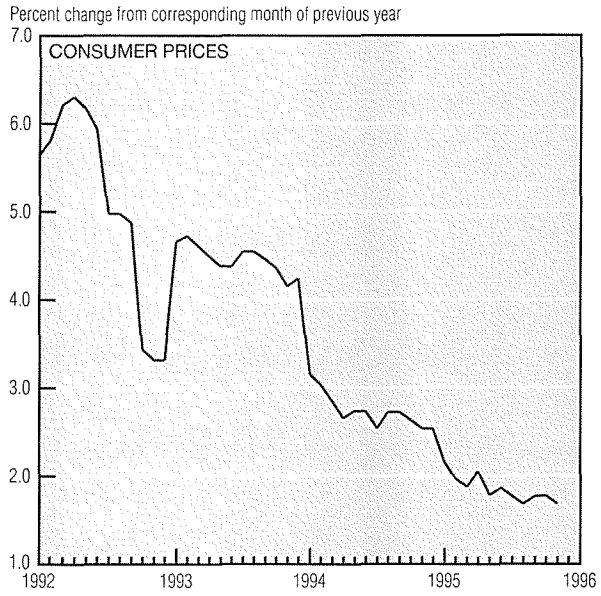
Noncurrent loans (those 90 days or more past due) continued to decline. At the end of the third quarter, noncurrent loans stood at $31.5 million, $1.9 billion below the year-ago level. However, delinquent loans (those 30 to 89 days past due) increased during the third quarter, possibly suggesting higher future levels of noncurrent loans.

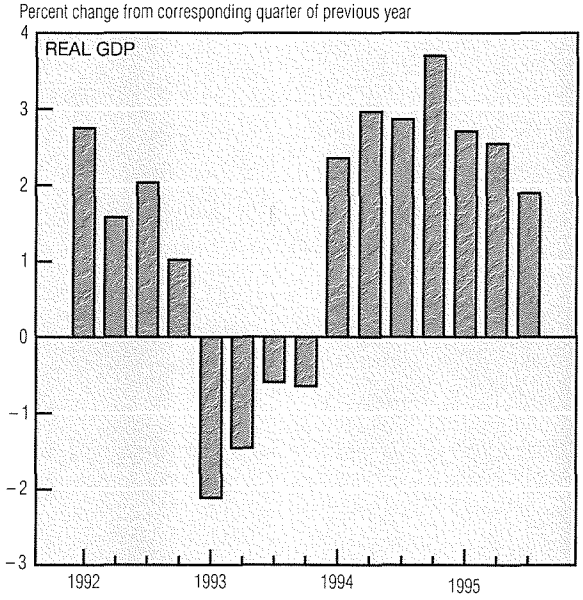
Despite sluggish third-quarter growth, C&I borrowing in September was up 12.5% over year-ago levels, with strong loan growth in every region of the country. Only four states saw a decrease in these types of loans.

The German Economy









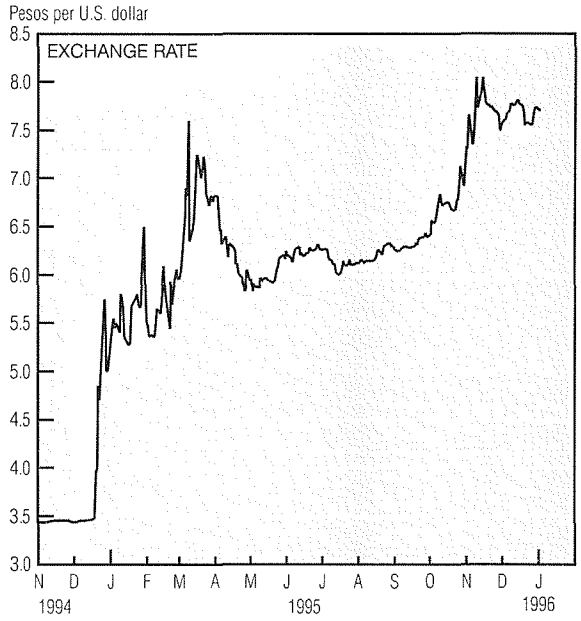
a. Annualized and seasonally adjusted.
b. Horizontal lines represent the Bundesbank's M3 target for 1993, 1994, and 1995. Each target's base period is the fourth quarter of the previous year.
SOURCES: Deutsche Bundesbank; and DRI/McGraw-Hill.

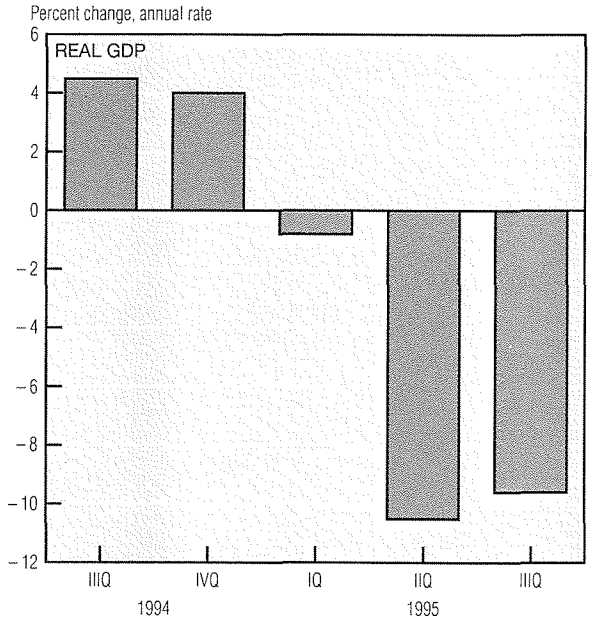
When the Bundesbank cut official interest rates on December 14, other European central banks quickly followed suit. Observers, noting below-target German money growth and low inflation, anticipate further German interest-rate cuts.

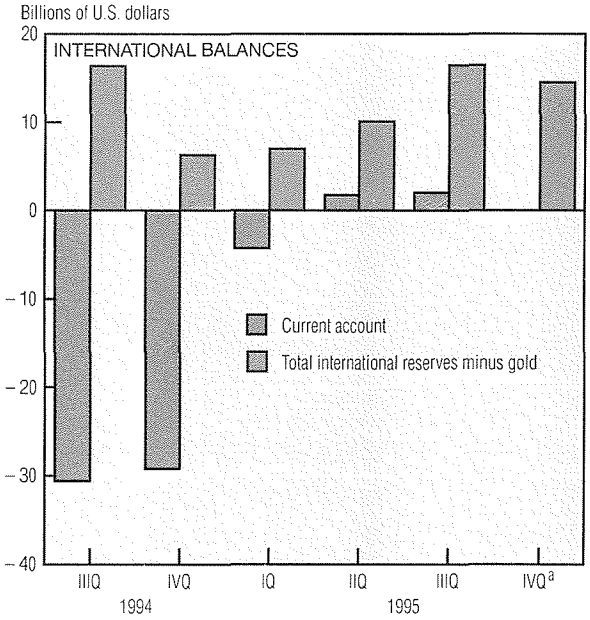
The Bundesbank Act requires the German central bank to maintain the "stability of the currency." The monetary authorities traditionally seem to interpret an inflation rate below 2% as being consistent with this mandate. Germany's inflation rate, which rose sharply following unification, dropped below 2% early this year and has continued to moderate. In November, consumer prices were up 1.7% over year-ago levels.

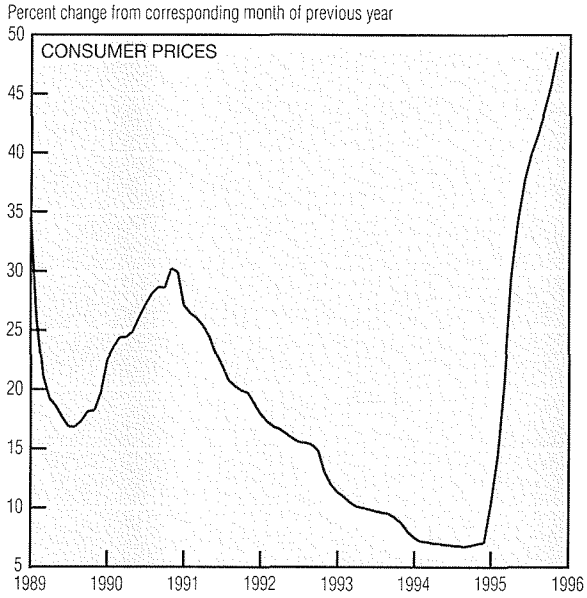
Real German GDP growth slowed over the first three quarters of 1995, but remained fairly strong. Many economists, however, fear that real economic activity will stall or possibly contract in 1995:IVQ. Real manufacturing orders fell sharply in October, and industrial production has been weak. December's disruptions in shipments — stemming from French rail strikes — further darkened the business outlook. Business confidence has ebbed, suggesting that capital spending may slow. A substantial weakening in German economic activity could dampen growth throughout Europe.

The Mexican Economy









a. Current account data are not available. International reserves data are through October 1995.
SOURCES: DRI/McGraw–Hill; International Monetary Fund; and Board of Governors of the Federal Reserve System.

A year after Mexico's disastrous peso depreciation, the worst of the matter may be over. Mexico's prospects—particularly its access to international capital markets—will depend on the government's capacity to sustain a stabilization program in the face of weak economic activity and a shaky financial sector. Financial market jitters in October and November (which have since calmed) quickly sent Mexican interest rates higher and the peso lower.

Mexico's GDP has contracted sharply since 1994:IVQ. More moderate declines in real economic activity since 1995:IIIQ, coupled with improvements in the nation's export industry, offer some hope that the recession has hit bottom. Nevertheless, the prospects for a rapid recovery this year remain few.

The peso's depreciation and the recession have eliminated Mexico's current account deficit. In October, imports stood 6.7% below year-ago levels, while exports were 35.7% higher. The current account shifted from a $29 billion (annual rate) deficit in 1994:IVQ to a $2 billion surplus in 1995:IIIQ. International reserves, which fell to $6.3 billion by the end of 1994, have since risen to $14.5 billion, although largely from inflows of official funds.

Mexico probably will not sustain a current account surplus once the recent crisis has passed. Countries importing foreign capital for development typically run current account deficits.