

The Economy in Perspective

On the road (again) . . . America, it is said, is a nation that keeps reinventing itself. By committing themselves to respect free speech, private property, and unimpeded commerce, our immigrant founders declared that a democratic process was more important than enshrining privileges for any particular group or region. They established certain protections for the rights of all citizens to minimize the likelihood that minority interest groups would be tyrannized by the majority. And over time, the spirit of that bold experiment led to expanding the voting franchise to groups of people who had once been excluded.

America's history can be told through the experiences of ordinary people who set about to improve their lives. Their journeys have taken this country through several phases of economic development, shifting patterns of population mobility, and changing attitudes about the role of government in society.

These changes have not always been embraced enthusiastically, nor with unanimity. But Americans have always displayed a remarkable willingness to change their jobs, their residences, and even their attitudes about government—as long as they believed that they were building wealth and improving the lot of future generations. We need to recognize, however, that movements from one accepted way of life to another required courage, sacrifice, and the passage of real time to allow for debate and assimilation.

We find ourselves again in the midst of a national soul-searching about the role of government in our society in general, and in our economy in particular (although some would argue that in the United States, the two are virtually synonymous). For the last 50 years, government has been trying to fulfill expectations forged from the trials of the Great Depression and World War II. Interestingly, even the dismal economic performance of the 1970s, characterized by rampant inflation and multiple recessions, did not lead to a fundamental questioning of the government's economic and social policies, although some seeds of doubt were sown.

Voices in the debate have become louder and shriller in recent years because Americans have come to doubt the federal government's ability to do what had been expected of it over more prolonged periods: to provide, at reasonable cost, income security for the aged, medical treat-

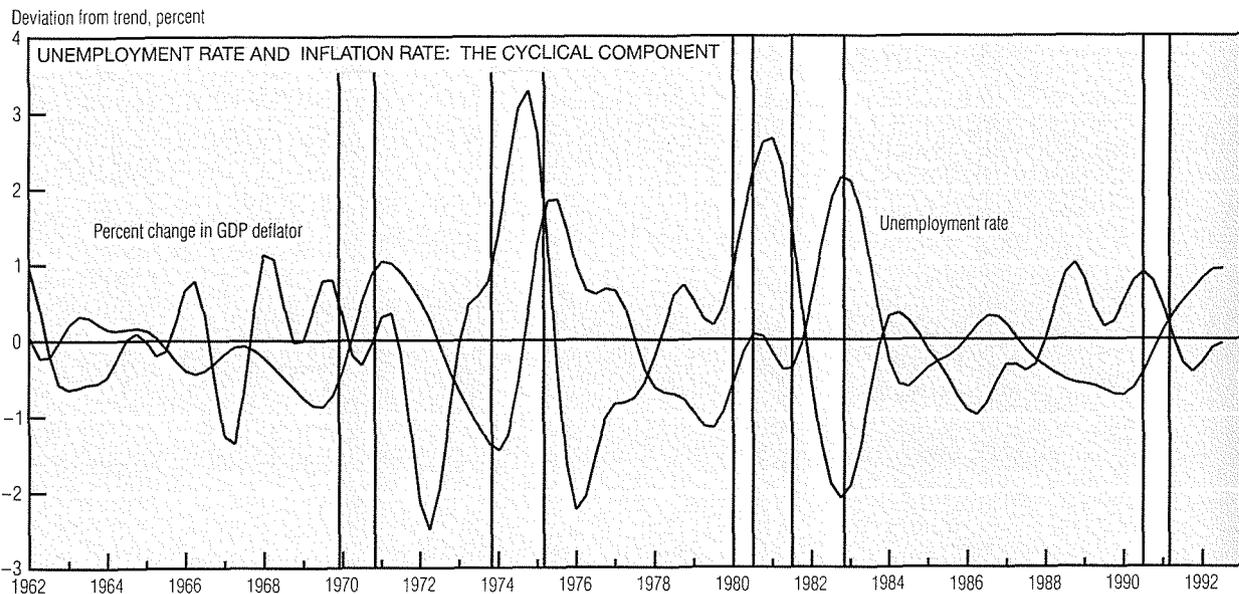
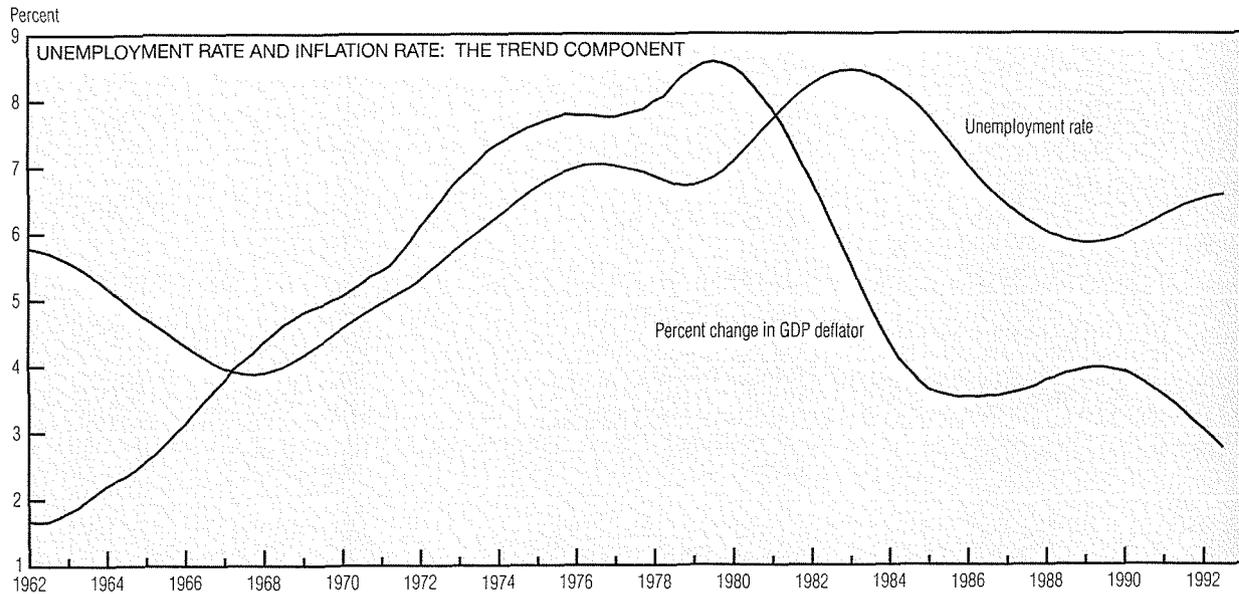
ment for the poor, job security for the employable, poverty reductions for the unfortunate, and violent crime reductions for all. Disillusionment with government stems in part from performance expectations that have been raised beyond the capacity of any government to deliver, and in part from the public's unwillingness to foot the bill for what might in fact be feasible.

There was a time in our history, of course, when the federal budget was in balance, federal debt was minimal, and governments were not expected to provide much beyond a legal system and national defense. People dealt with what life dished out by relying on their friends, relatives, and neighbors. Those looking for more than they had did not look to government—they took to the open road. Our country became wealthier through increased domestic and international trade, but this expansion of economic borders brought with it more reliance on a strong federal government. As our nation came of age, its citizens found that "United" began to mean more to them than "States."

Nostalgia for the past appears to be an important element in the current debate on the scale and scope of government. Politicians sense the appeal of imbuing campaigns with the imagery of whistle stops and road trips through the heartland. People understandably want a government that is more intimate, more human, and more responsive to their needs. Surely big government has not been our salvation. But nostalgia alone cannot obliterate the real choices that must be made: How much responsibility should healthy, comfortable Americans bear for ameliorating the misfortunes of others, and through what means should the assistance be provided? What is feasible, and what is reasonable?

From the nature of our recent political discourse, one might imagine that Americans are experiencing a national midlife crisis. Here we are, feeling obligated to shoulder so many responsibilities, when all we really want to do is put down the top of a convertible and chase the sun against the sky; to trade in that station wagon and dump the excess baggage over the side. Which bags to pack, and which to leave behind, are the subject of political debates being held all across America. Pundits say that our nation is at a crossroads. But in truth, we are only preparing to travel down the road not taken when last we passed this way.

Monetary Policy



NOTE: Shaded bars indicate recessions. The trend and cyclical components are defined using a two-sided approximation to a band pass filter, with 12 leads and lags. The trend excludes all fluctuations less than 32 quarters; the cyclical component includes fluctuations between six and 32 quarters. For further details, see M. Baxter and R. King, "Measuring Business Cycles: Approximate Band Pass Filters for Economic Time Series," National Bureau of Economic Research, Working Paper No. 5022, 1995.

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

Economists generally accept that monetary policy determines the rate of inflation, but they continue to debate whether it can affect real variables, such as the level of employment and the rate of economic growth. During the early 1960s, many policymakers believed they could routinely exploit a stable trade-off between inflation and unemployment. This trade-off, summarized by the so-called Phillips curve, implied that monetary policy could permanently lower unemployment by generating higher inflation.

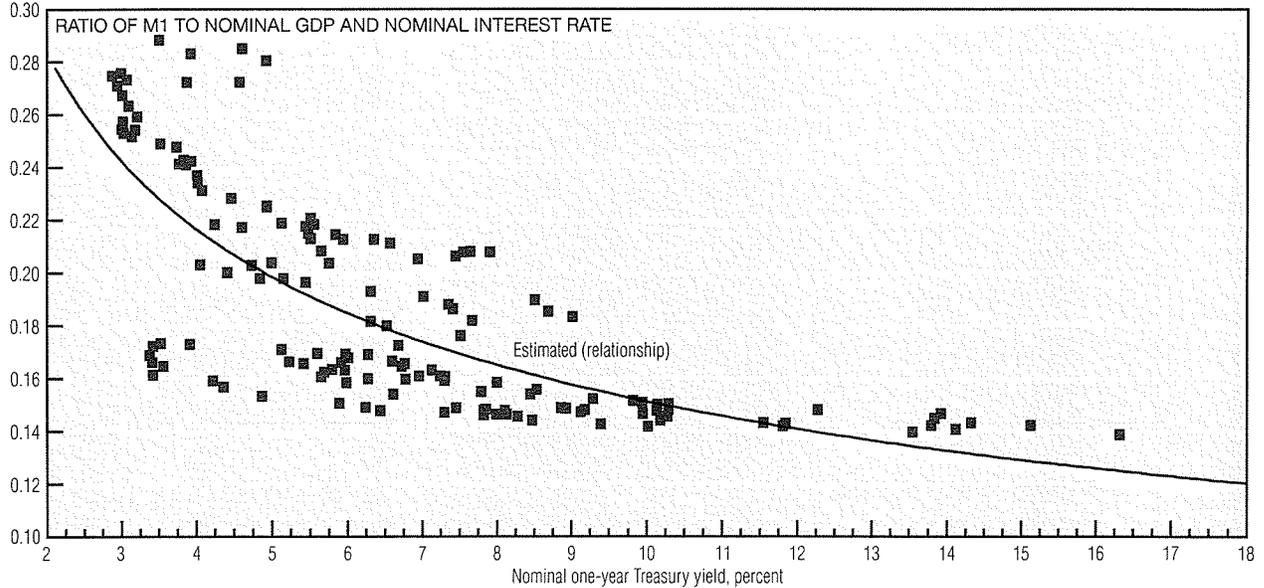
Two economists, Milton Friedman and Edmund Phelps, showed that this trade-off was illusory. In the long run, monetary policy could not move unemployment away from its natural rate. The Friedman-Phelps argument left open the possibility that policymakers might exploit a short-term trade-off in order to smooth business cycle fluctuations. Indeed, many people continue to believe strongly in a short-term trade-off—to the point where quarterly changes in unemployment are thought to contain information about

future inflation. A careful examination of the data suggests a much less precise view of any relationship, however.

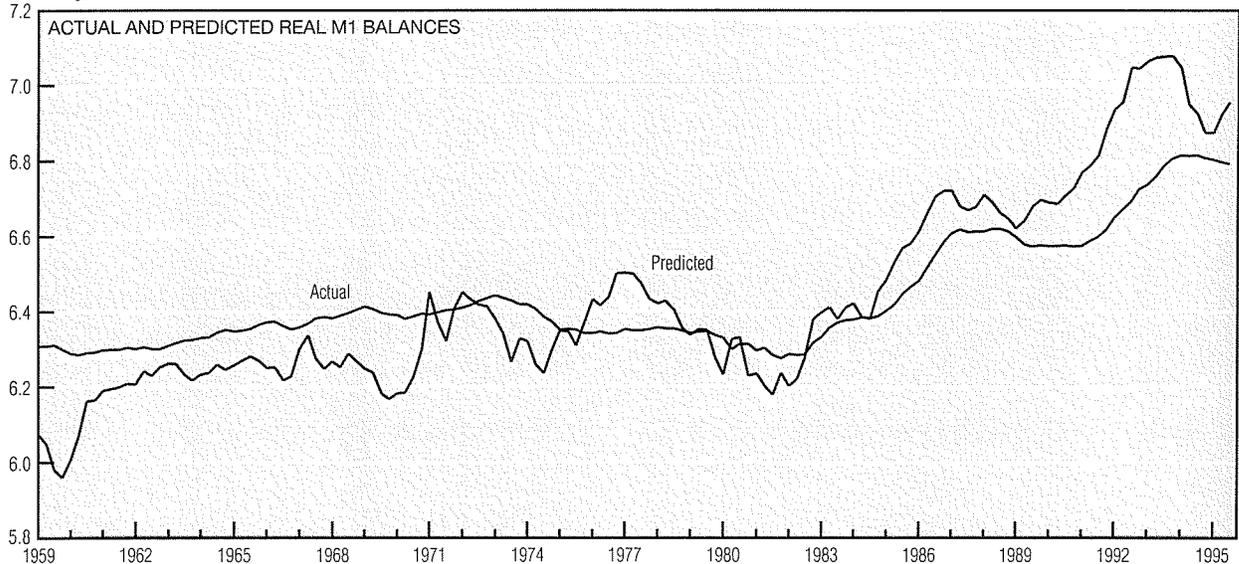
The inflation and unemployment series can be decomposed into a trend (long-run) component and a cyclical (short-run) component. Over the last 30 years, the trend components display a weakly positive, but erratic, correlation. This highlights the failure of the original Phillips-curve hypothesis, just as predicted by Friedman and Phelps. The trends
(continued on next page)

Monetary Policy (cont.)

Ratio of M1 to nominal GDP



Natural logarithm, billions of 1987 dollars



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

do move in opposite directions during the early 1960s, however, explaining why the Phillips curve was accepted for a time.

The cyclical components display a more consistent pattern. Over the entire sample, the two series are negatively correlated. One must be careful in interpreting this result, however. The association observed in the data tells us nothing about causation—whether a change in inflation is responsible for movements in unemployment. Indeed, many economists argue that both series are simply responding to forces that

drive the business cycle. Recessions, for instance, are characterized by layoffs that raise unemployment. At the same time, incomes decline, reducing the demand for money. This may lower inflation because the money stock can grow only as fast as the rate at which people are willing to hold it.

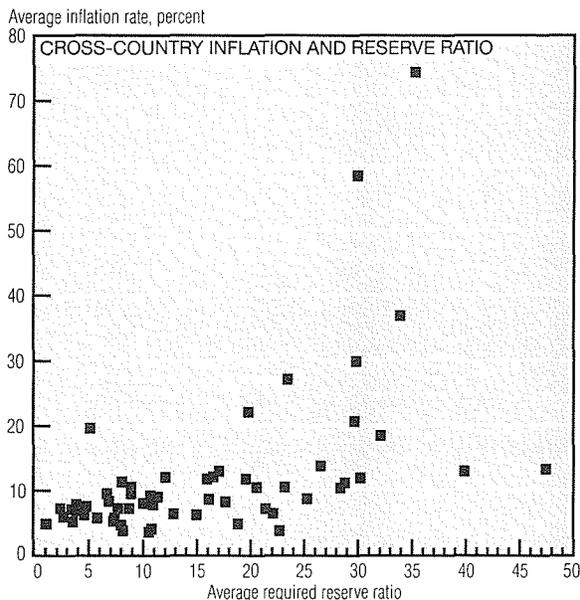
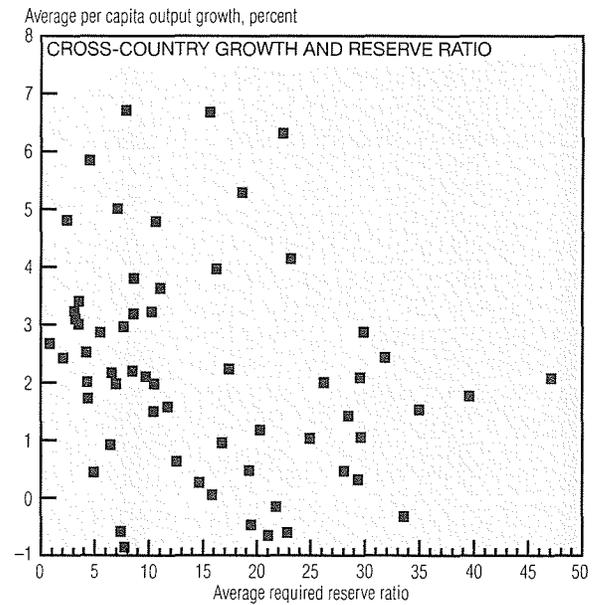
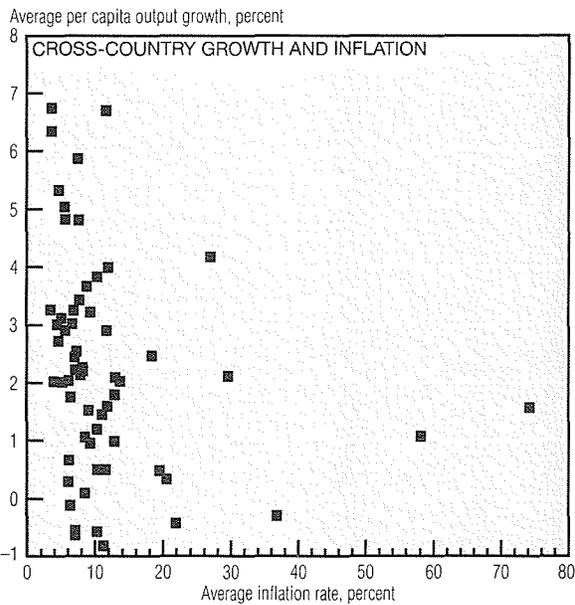
Money demand is also affected by nominal interest rates. As interest rates rise, the opportunity cost of holding money goes up, making people less willing to hold non-interest-bearing cash. When plotted against the one-year Treasury rate, the ratio of the M1 money stock to

nominal GDP reveals a downward-sloping money demand curve, just as theory predicts. Over time, the behavior of real M1 balances is predicted reasonably well by an estimated version of this simple money demand function.

Apart from any effect on unemployment, inflation is harmful because it acts like a tax on real money balances. As prices rise, the real value of money in people's wallets falls, just as if the individual were being taxed. Higher inflation usually leads to higher nominal interest

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Monetary Policy (cont.)



Summary Statistics across Countries^a (Percent)

High-reserve-requirement countries (12):

Mean reserve requirement ratio	30.0
Mean output growth	1.5

Low-reserve-requirement countries (10):

Mean reserve requirement ratio	3.4
Mean output growth	2.9

High-inflation countries (9):

Mean inflation rate	33.9
Mean output growth	1.2

Low-inflation countries (12):

Mean inflation rate	4.6
Mean output growth	3.9

a. High-reserve-requirement countries are those with average reserve requirement ratios above 26.1%; low-reserve-requirement countries are those with average ratios below 4.5%. High-inflation countries are those with average inflation rates above 18%; low-inflation countries are those with average rates below 5.9%.

NOTE: All data represent 1965–1990 averages for 60 countries.

SOURCE: J. Haslog, "Monetary Policy, Banking, and Growth," Federal Reserve Bank of Dallas, Working Paper 95-15, October 1995.

rates, making people less willing to hold money. Thus, inflation distorts people's behavior and wastes resources as they take steps to avoid the tax.

Tax policy is often viewed as an avenue by which the government can influence economic growth. In general, higher taxes reduce incentives to work and invest, and may contribute to lower growth. It is conceivable, therefore, that monetary policy might affect growth through the inflation tax. A broader notion of monetary policy also includes finan-

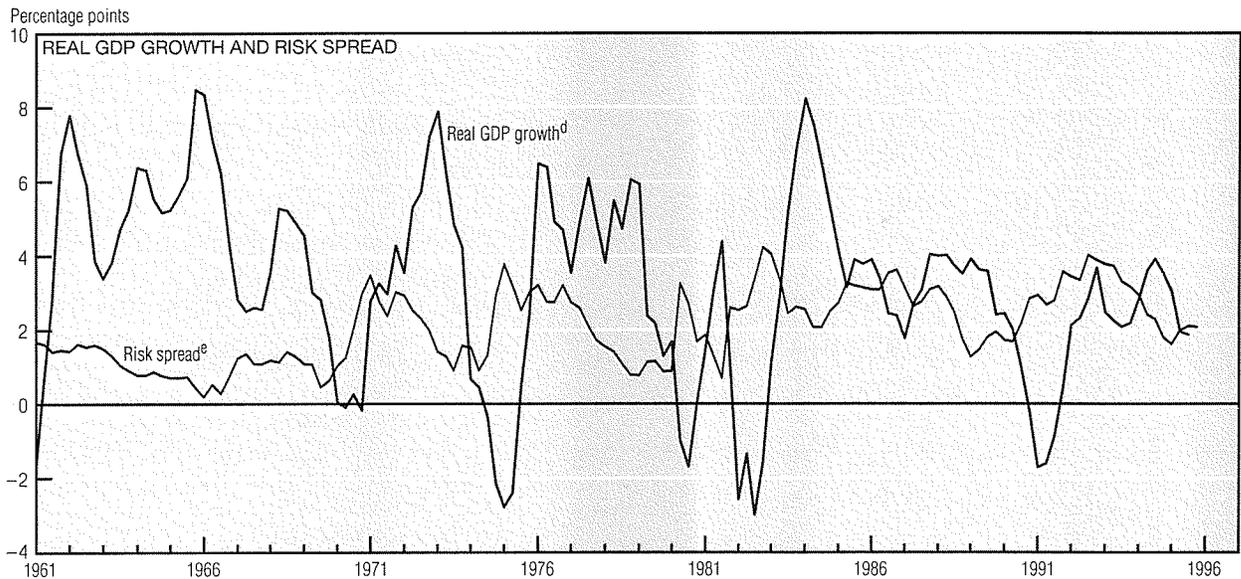
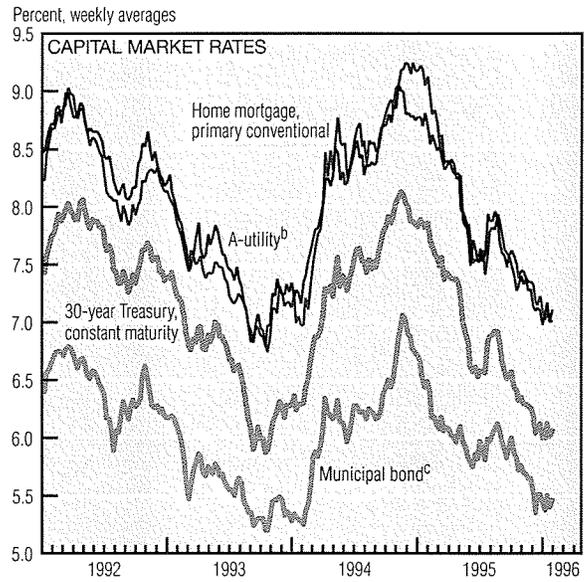
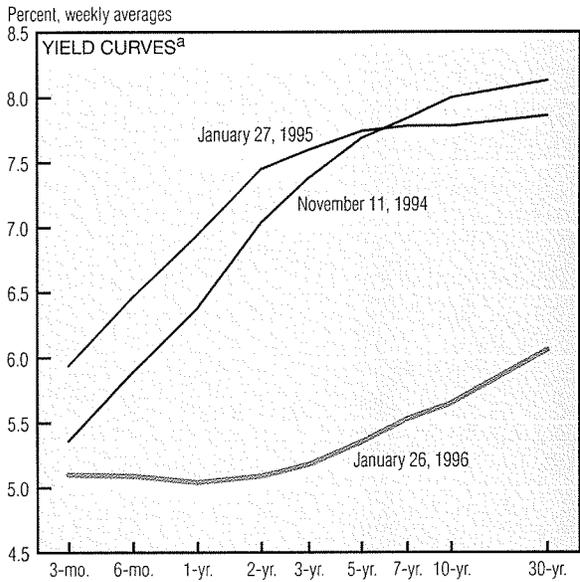
cial regulations, which govern the amount of non-interest-bearing reserves that banks must hold against deposits. Higher reserve requirements imply that a larger fraction of the bank's assets are exposed to the inflation tax.

A simple cross-country comparison of average growth rates and inflation suggests, at best, a weak negative association. Countries with higher reserve ratios also seem to experience lower growth rates—and higher inflation rates. This suggests that higher reserve ratios may

amplify the tax aspects of inflation and the potential growth effects of monetary policy.

The historical perspective for the U.S. is less supportive of an inflation–growth connection. Data over the last 100 years reveal that the trend of per capita growth has been surprisingly stable despite tremendous changes, such as the inception of the federal income tax, the founding of the Federal Reserve System, and the occurrence of large swings in inflation during the 1970s and 1980s.

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. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
 c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
 d. Percent change from corresponding quarter of previous year.
 e. Yield on Moody's seasoned Baa-rated corporate bonds minus yield on three-year Treasury, constant maturity.
 SOURCES: Board of Governors of the Federal Reserve System; and U.S. Department of Commerce, Bureau of Economic Analysis.

Interest rates across the board have come down sharply in the past year, but this drop has not been completely even, as the flattening of the yield curve shows. Medium-term rates have dropped more than long- and short-term rates. The extreme steepness of the yield curves of late 1994 and early 1995 dramatizes the flatness of the current yield curve: The spread between 10-year and 3-month yields is now 55 basis points, less than half the 35-year average of 120 basis points, and far below the

264 points of November 1994. The slight inversion at shorter rates has some people worried about a recession and others happy about successful inflation control.

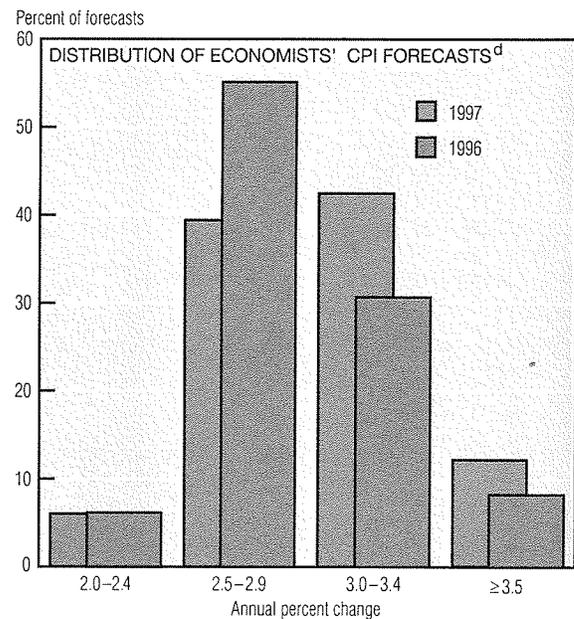
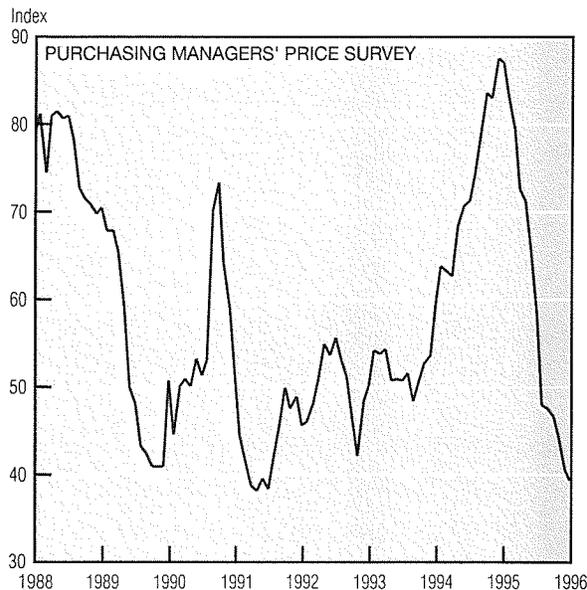
Rates have fallen across asset classes as well as maturities. Rates on home mortgages, utility bonds, and municipal bonds have all dropped in step with the long Treasury bond. Again, although the drop looks dramatic, a similar one occurred in 1992-93.

Along with the term structure, an-

other useful indicator is the risk structure of interest rates—the difference in yield between bonds of differing riskiness. The bottom chart plots the spread between Baa-rated corporate bonds and 3-year Treasury notes, as well as real GDP growth. The so-called “risk spread” serves more as an indicator of recessions and negative growth than as a predictor. In the 1990s, even this relation has become suspect, perhaps because of deepening in the financial markets.

Inflation and Prices

	Annualized percent change, last:			1994 average
	1 mo.	12 mo.	5 yr.	
December Price Statistics				
Consumer Prices				
All items	2.4	2.6	2.8	2.6
Less food and energy	1.5	3.0	3.3	2.7
Median ^a	2.9	3.4	3.2	2.8
Producer Prices				
Finished goods	6.3	2.2	1.2	1.8
Less food and energy	2.2	2.6	1.9	1.6
Commodity futures prices^b				
	2.6	4.9	1.9	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. Handy and Harman base price, New York.

d. Consensus forecast of the Blue Chip panel of economists, January 16, 1996.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; the National Association of Purchasing Management; *Metals Week*; and *Blue Chip Economic Indicators*, January 16, 1996.

Retail prices increased at an annualized rate of 2.4% in December, just a shade under their average increase for the whole of 1995. However, inflation signals from the core measures were mixed. The CPI less food and energy moderated to a 1.5% annualized rate for the month, while the median CPI continued to show price pressure of around 3%. Still, for the year overall, both core inflation measures stood at about 3%, a small rise from 1993 and 1994 levels.

Two presumed leading indicators of inflation have shown generally

contradictory patterns in recent months. After inching down in the first three quarters of 1995, gold prices began to rise by year's end and, in January, topped the \$400 per ounce threshold for the first time in over five years. However, purchasing managers are increasingly reporting more moderate price increases. In December, about 10% noted that prices were moving higher, the lowest proportion since mid-1991.

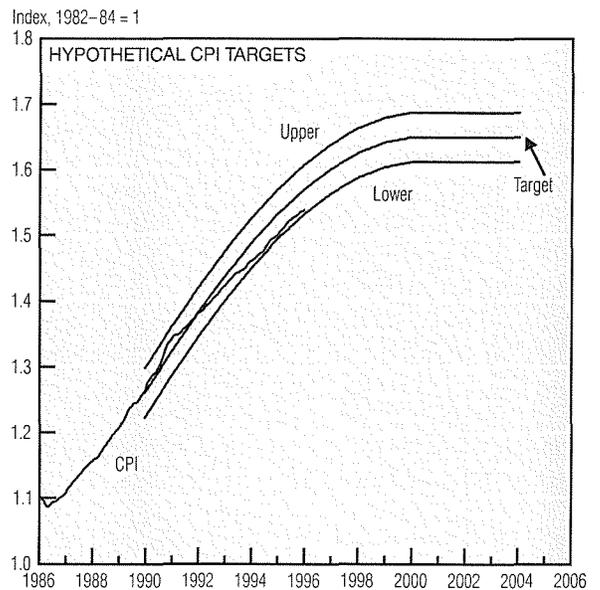
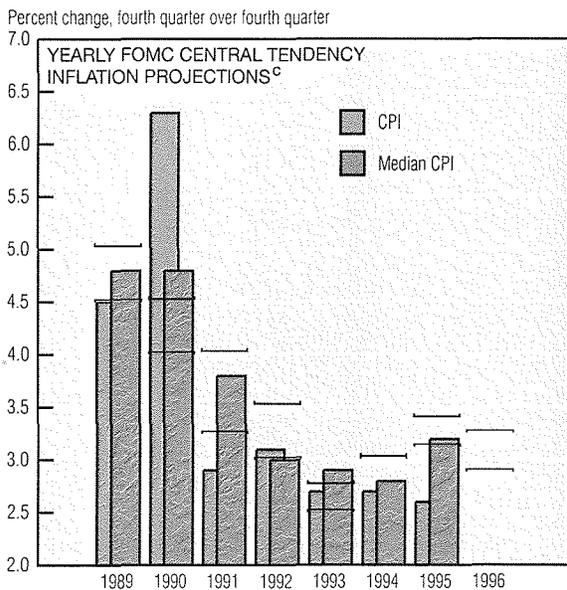
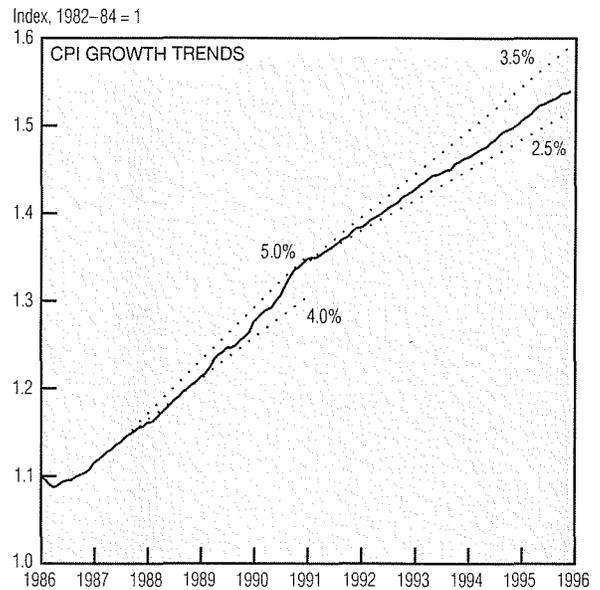
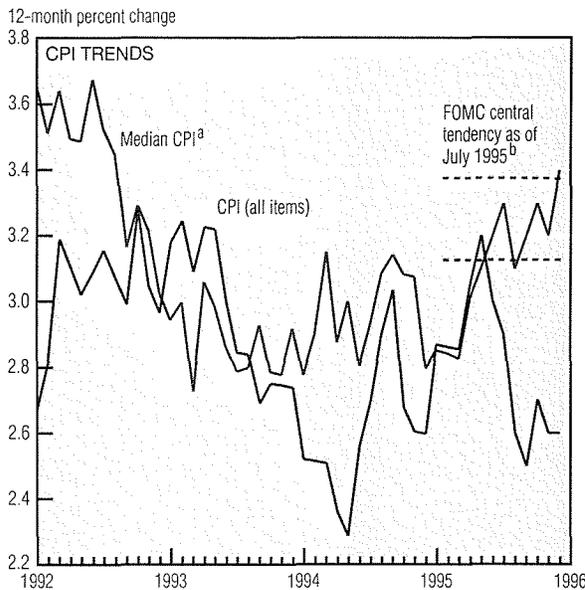
According to the Blue Chip panel of economists, the U.S. is likely to see slightly higher inflation this year

and next. Most of the panel believes that inflation will fall into the 2½% to 3% range this year, with a substantial minority (30%) anticipating a 3% to 3½% rate. For 1997, the proportion pegging inflation at or above 3% is somewhat larger than the share expecting a milder rise (54% and 46%, respectively).

From the perspective of monetary policymakers, the CPI's 1995 performance came as somewhat of a surprise. At 2.6%, last year's rise was ½ percentage point below the lower

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Inflation and Prices (cont.)



a. Calculated by the Federal Reserve Bank of Cleveland.
 b. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents. 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.
 c. Brackets represent upper and lower bounds of the central tendency growth ranges issued each February. Bars represent actual inflation.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; and Board of Governors of the Federal Reserve System.

end of the Federal Open Market Committee's central tendency projection issued at midyear (3.1%), but nearly on target for the core inflation measures. In fact, the economy appears to have been on a 3% inflation trend over much of the past five years, well below the 5% average growth rate posted during the 1986-90 period.

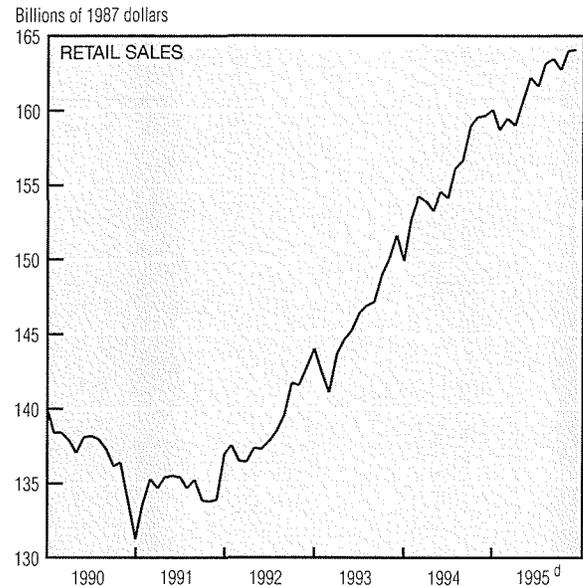
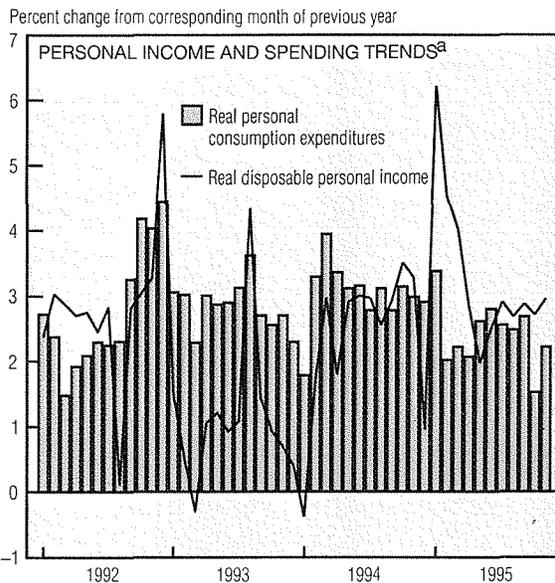
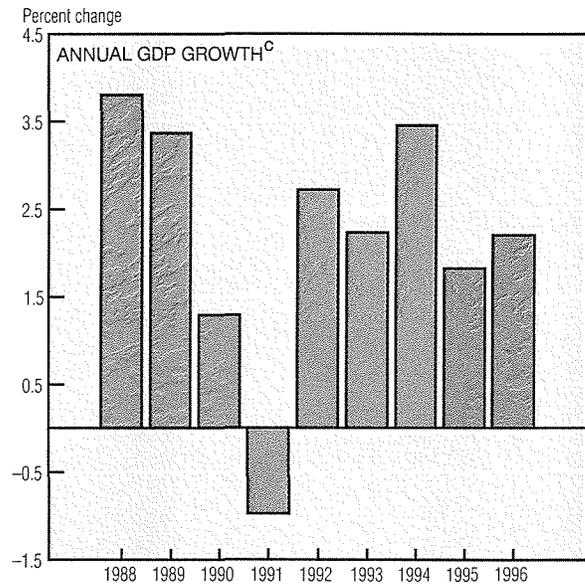
There seems to be little consensus among economists that the CPI is following a path that will lead to successively lower inflation. However, legislation pending in Congress would make price stability the pri-

mary long-term goal of the Federal Reserve. Presumably, such a legal mandate would include a timetable for achieving that objective.

To some, such a proposal would bind policymakers such that they would not have sufficient liberty to respond to financial or other economic calamities should they arise. In 1990, the Cleveland Federal Reserve Bank proposed a program for achieving price stability that would have gradually reduced inflation (at that time around 5%) by ½ percentage point per year until a stable price environment was reached in the year

2000. That inflation target included a relatively wide 3-percentage-point band on both sides of the target price level to ensure that policy would not be inhibited from responding to near-term problems. Indeed, had such a policy been adopted, the monetary authorities might have found themselves with a considerable margin to work with today: The downshift in the inflation trend over the past five years has put the price level at the very bottom of the target ranges that the proposed policy envisioned.

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	53.8	3.2	1.9
Consumer spending	32.3	2.9	2.6
Durables	13.2	9.5	4.8
Nondurables	1.8	0.5	2.0
Services	17.3	2.7	2.4
Business fixed investment	9.2	5.3	9.0
Equipment	6.7	5.1	9.4
Structures	2.4	5.4	7.9
Residential investment	5.2	8.4	-3.1
Government spending	-1.4	-0.4	-0.5
National defense	-6.3	-7.5	-7.6
Net exports	12.7	—	—
Exports	15.4	8.3	7.6
Imports	2.7	1.2	6.7
Change in business inventories	-3.5	—	—



a. Chain-weighted data in 1992 dollars.
b. Seasonally adjusted annual rate.
c. 1995 and 1996 estimates are from *Blue Chip Economic Indicators*, January 16, 1996.
d. October, November, and December data are estimated by deflating nominal retail sales by the Consumer Price Index for commodities.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*.

Recent data—though sketchy and tentative—and anecdotal accounts indicate that economic activity weakened in the last months of 1995. The final numbers are expected to put growth for all of last year at approximately 1.8%. Nevertheless, contributing factors, including severe weather and the federal government shutdown, generally seem isolated or transitory. Viewing the recent evidence of downside risks against the back-

drop of a very strong investment sector, the Blue Chip panel of economists currently foresees 2.2% growth in 1996. None of the members anticipates a recession.

Much of the uncertainty about economic activity has centered on the consumer sector. Real consumer spending grew a moderate 2.2% in November following a 1.5% advance in October, despite relatively strong and steady gains in real disposable income. Moderate consumption patterns, together with

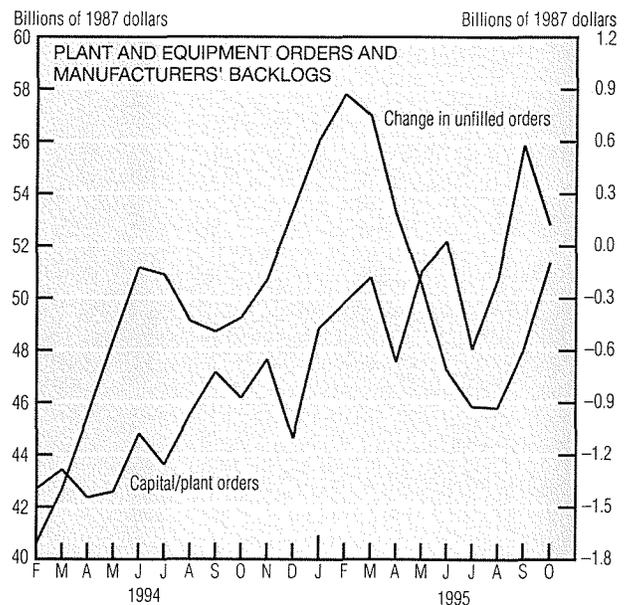
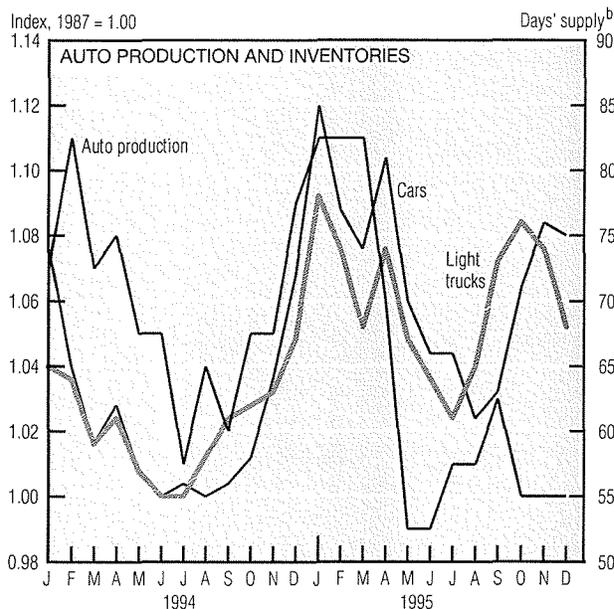
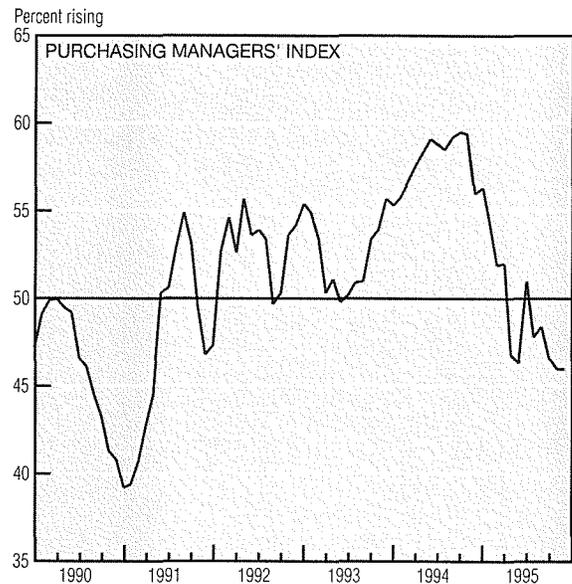
high levels of credit card debt, raised concerns about holiday spending. Many retailers reported disappointing December sales, with heavy discounting and some inventory accumulation.

Advance estimates of real retail sales for December—adjusted for price changes—registered virtually no increase. Unit sales of motor vehicles rose sharply in December, but sales at general merchandise stores

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Economic Activity (cont.)

Industrial Production (Percent change, s.a.a.r. ^a)		
	1994:IVQ- 1995:IVQ	Sept. 1995- Dec. 1995
Total index	1.6	0.0
Consumer goods	0.4	-2.1
Durables	-0.9	2.2
Nondurables	0.8	-3.5
Business equipment	4.8	1.5
Defense and space equipment	-8.8	-15.6
Intermediate products	-0.2	0.4
Materials	2.6	1.6



a. Fourth-quarter data are preliminary estimates; seasonally adjusted annual rate.
 b. U.S. dealers' current stock as a share of daily average sales (includes domestic and imported vehicles).
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; National Association of Purchasing Management; and *Ward's Automotive Reports*.

and apparel stores fell slightly. Nevertheless, the continued tightness of labor markets bodes well for the consumer sector, and despite high levels of credit card debt, evidence of liquidity problems is lacking.

The near-term outlook for the industrial sector, which accounts for approximately 20% of total GDP, remains a second area of concern. Industrial production was flat in 1995:IVQ. Production of nondurable consumer goods fell, as did output

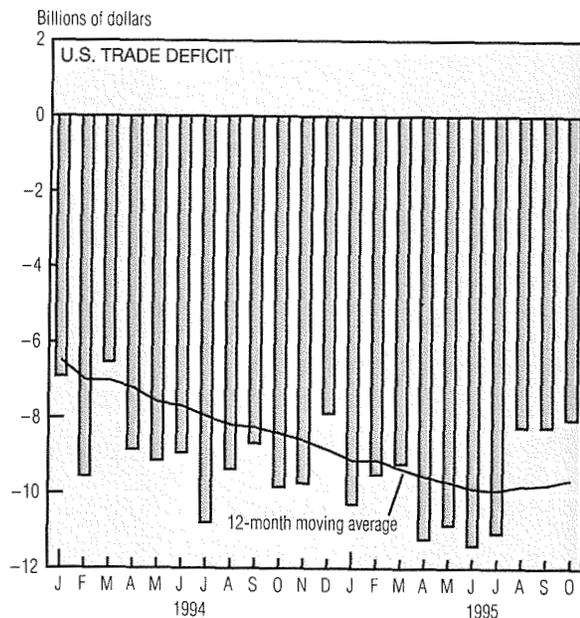
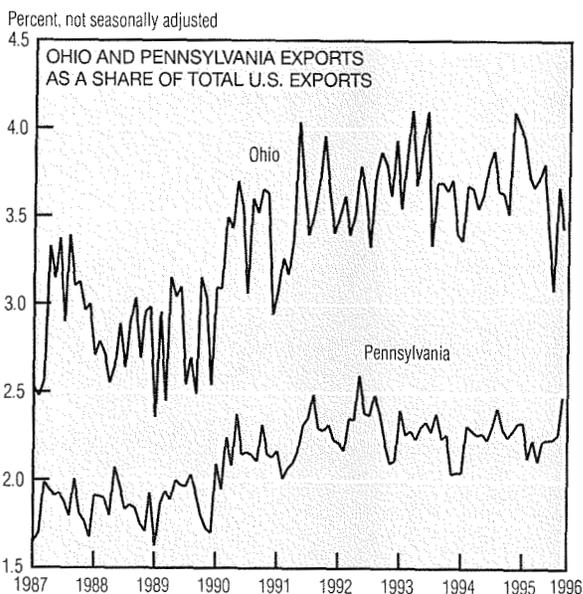
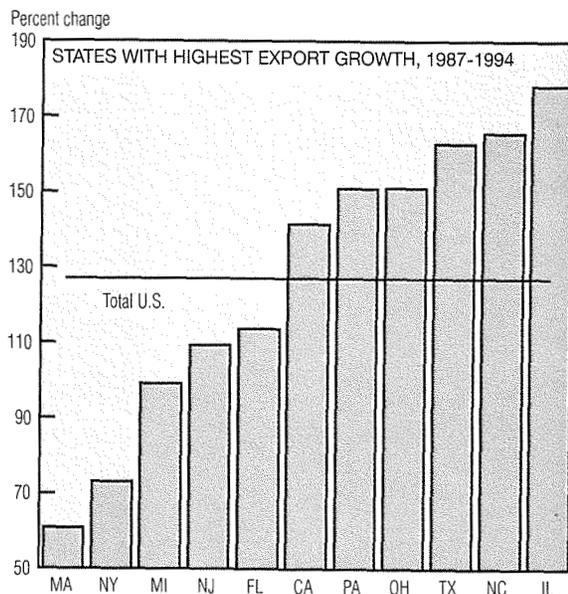
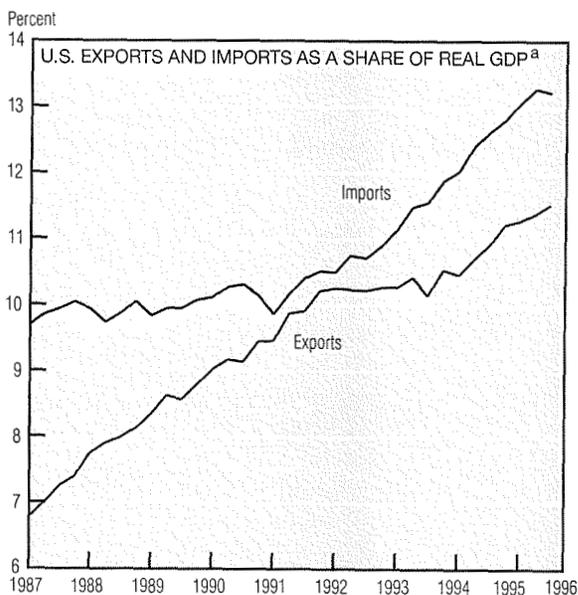
of defense-related goods. Business-equipment production slowed in the fourth quarter, but remains strong relative to a year ago.

Factory operating rates, while still generally high, have declined somewhat over the year. In October (latest available data), factory orders fell as backlogs increased. Anecdotal evidence about factory orders, while mixed and inconclusive, suggests some pockets of weakness and inventory correction. In December, the purchasing managers' index of over-

all manufacturing activity stood at 46, its fifth consecutive reading below 50—a point generally consistent with a flat industrial performance.

Dealers' supplies of cars and light trucks rose sharply in the late summer and early fall, but strong incentive programs and reduced orders to producers have helped lower inventories somewhat. Automotive production, which was flat in 1995:IVQ, is likely to remain weak in the early months of 1996.

Foreign Trade



a. Chain-weighted data in 1992 dollars.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

International trade is becoming increasingly important to the U.S. economy. Since 1987, exports have grown from less than 7% of GDP to more than 11%, while imports as a share of output have expanded 3 percentage points. The U.S. trade deficit narrowed through 1991, but has generally widened ever since.

While significant for the nation, international trade is becoming proportionally even more meaningful to

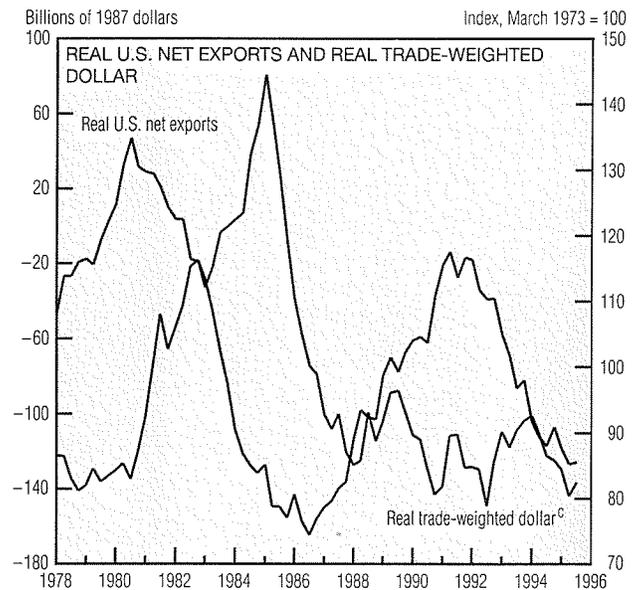
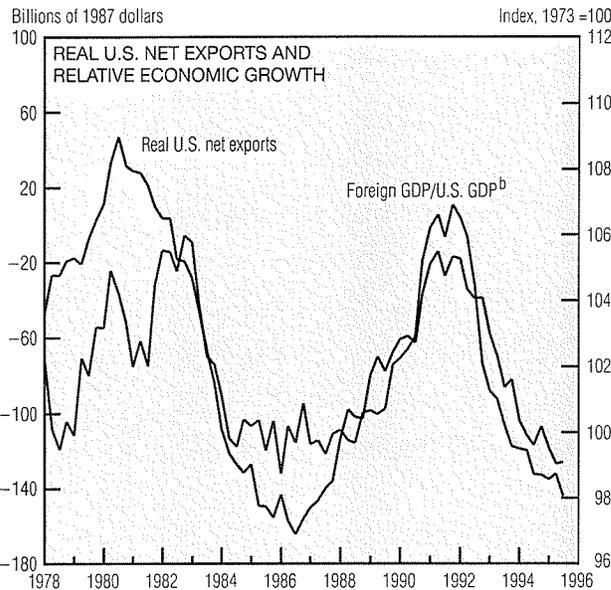
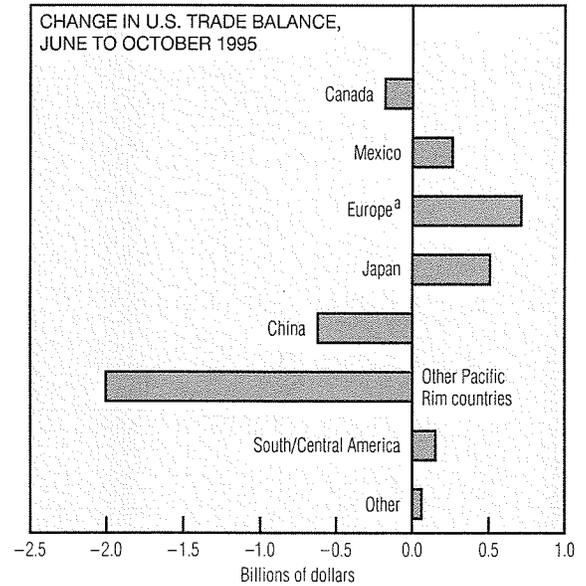
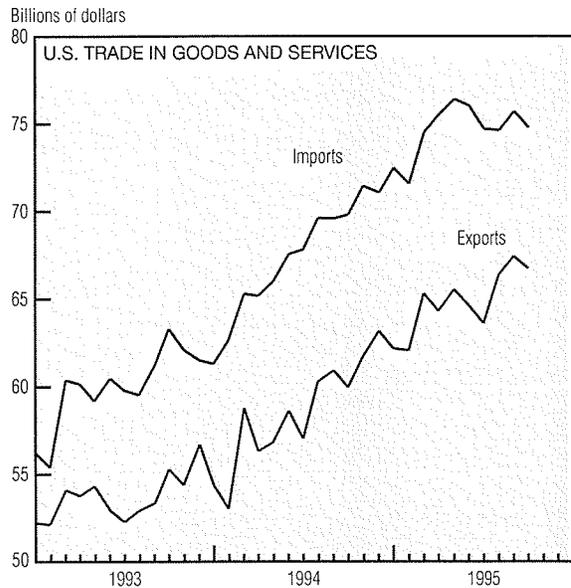
Ohio and Pennsylvania. Between 1987 and 1994, exports from each of these states grew 151% (compared to 127% for the nation), with Ohio accounting for approximately 3½%, and Pennsylvania for about 2¼%, of U.S. shipments abroad.

In October (the latest month for which data are available), the U.S. trade deficit declined slightly as imports fell somewhat more than exports. Since its June high, the trade deficit for goods and services has

narrowed by \$1.3 billion. The U.S. saw a substantial improvement in its trade balances with Japan, Europe, and Mexico over this period, but our trade deficit with China and other Pacific Rim countries deteriorated. Despite the marked improvement since June, full-year data will probably show that our overall trade position has worsened since 1994.

The U.S. trade deficit—on both a
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Foreign Trade (cont.)



a. Includes former Soviet Bloc countries.
 b. Foreign GDP growth is the average for 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.
 c. 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; and the Federal Reserve Bank of Cleveland.

nominal and a real basis—has widened since 1991, as economic growth at home has outpaced growth abroad. Foreign economic activity, which advanced rapidly in 1994, paused in 1995. In fact, Canada, France, Germany, and the U.K. are all likely to see their growth rate halved relative to 1994. Japan, on the other hand, recorded a slight improvement.

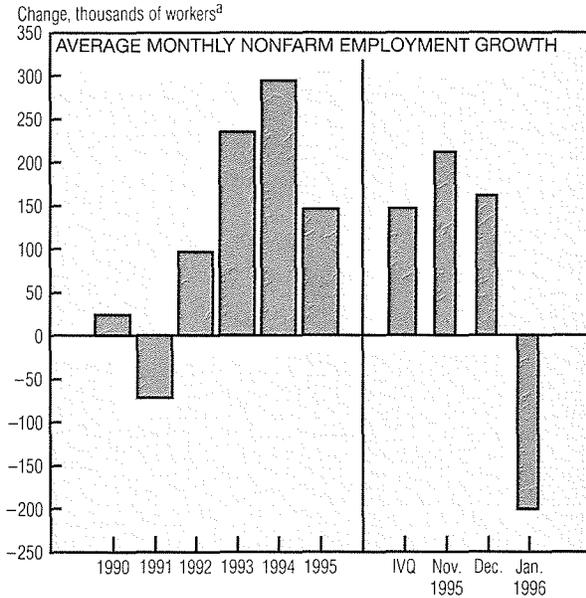
Most economists foresee foreign

economic growth accelerating again in 1996. If their projections are correct, this will contribute to further U.S. export growth. However, with U.S. economic activity also expected to remain fairly brisk in 1996, not much change is anticipated in our overall trade deficit.

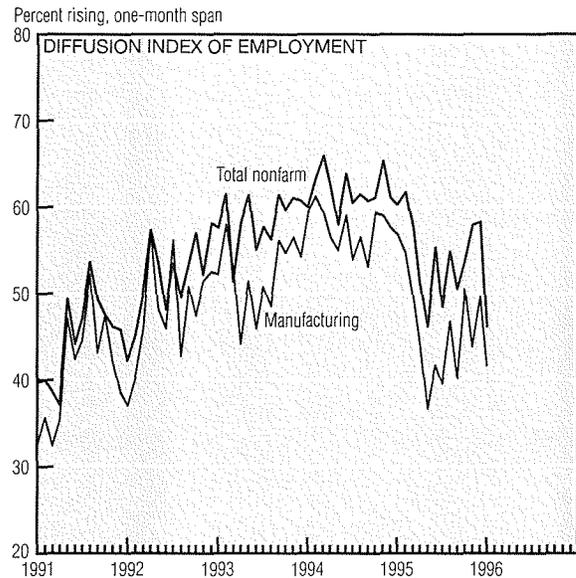
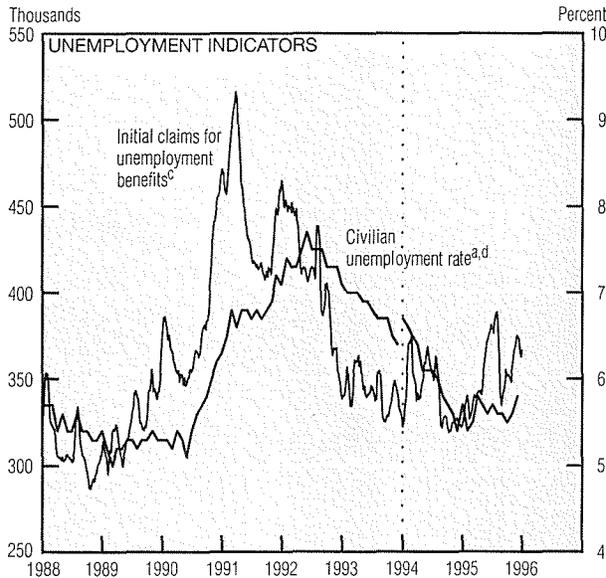
The relationship between the real trade balance and the real trade-weighted dollar is not as tight as many analysts suggest. When more

complete data become available, the real trade-weighted dollar will probably prove to have exerted little influence on the 1995 trade balance. The nominal dollar depreciated somewhat over the year, but U.S. inflation was slightly higher than that of our key trading partners. With international inflation rates seeming to converge at low levels, large swings in the dollar appear less likely.

Labor Markets



	Average monthly change (thousands of employees)				
	Year	1995		1996	
		IVQ	Nov.	Dec.	Jan.
Payroll employment	146	147	212	161	-201
Goods-producing	-4	9	-25	50	-60
Manufacturing	-13	-2	-29	44	-72
Construction	11	13	8	7	13
Service-producing	150	138	237	111	-141
Services	93	68	109	65	-83
Business services	26	18	17	30	-75
Retail trade	18	23	42	-20	-41
Average for period					
Civilian unemployment rate (%)	5.6	5.6	5.6	5.6	5.8
Nonfarm workweek (hours)	34.5	34.4	34.4	34.3	33.7
Mfg. workweek (hours) ^b	41.6	41.4	41.5	41.2	39.8



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 U.S. employment situation was off to an unusual start in 1996 as nonfarm payrolls tumbled by 201,000 in January. The “blizzard of the century” has been blamed for much of this unexpected decline, making it difficult to determine the underlying trends in the labor market. Indeed, the widespread impact of the storm is evident in the sharp drop in the diffusion indexes of employment. The January figure for total nonfarm industries indicates that more than half of the nation’s

detailed industries reported zero or negative jobs growth over the month. Meanwhile, the civilian unemployment rate made its first significant jump in several months, rising to 5.8% in January.

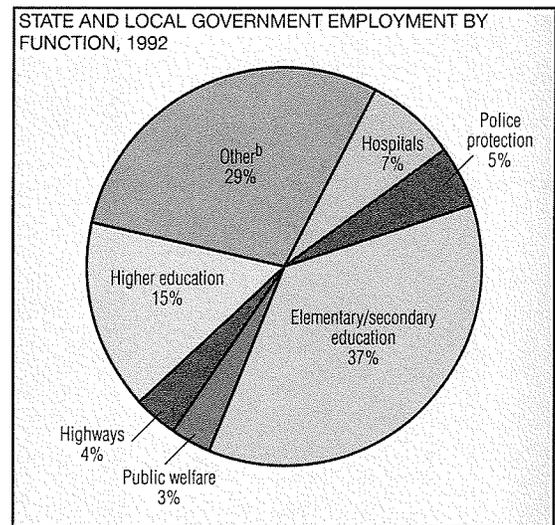
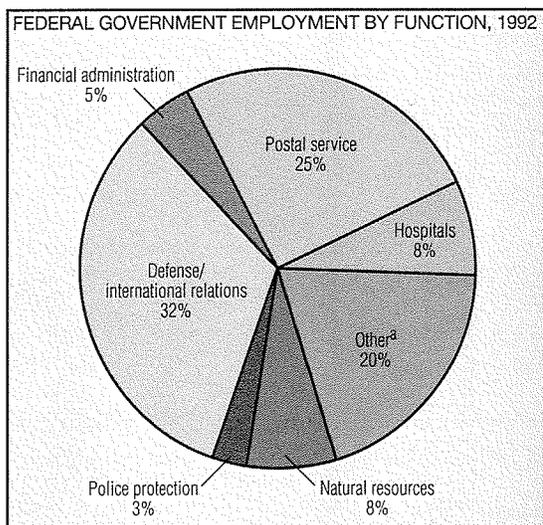
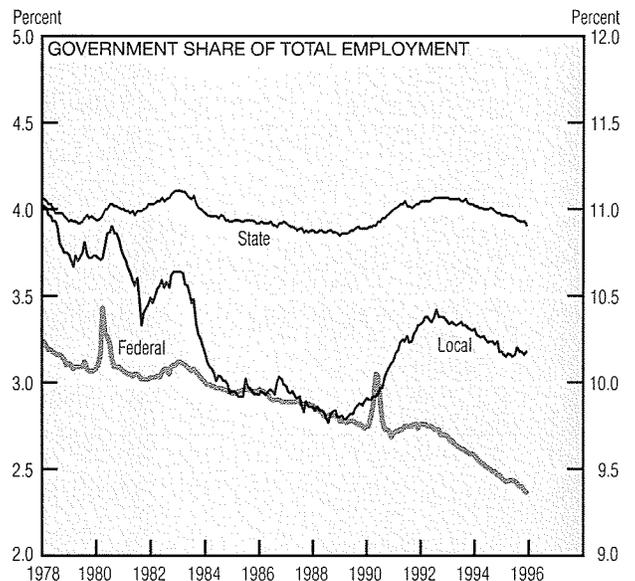
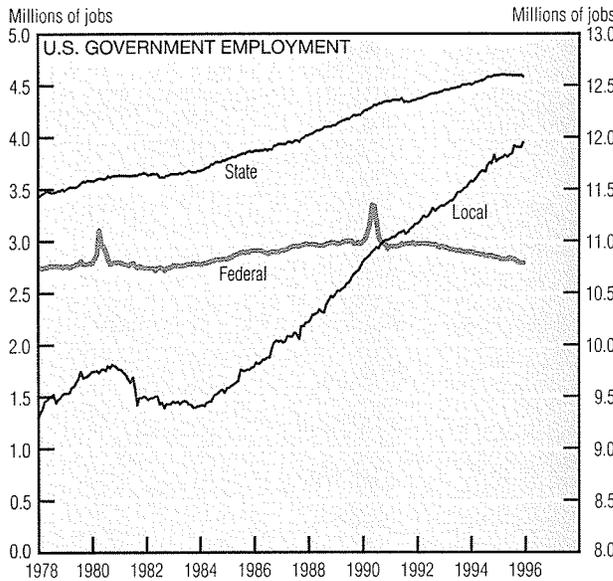
Construction employment remained positive despite the weather, since job additions in warmer parts of the country offset losses on the East Coast. On the other hand, manufacturing posted a loss of 72,000 workers in January. The blizzard most likely worsened this decline, in

addition to causing the factory workweek to fall below 40 hours for the first time in 12 years.

Service-producing employment was in the red last month (down 141,000)—a direct result of unusual losses in typically robust component industries. Hardest hit was business services, where harsh weather, coupled with a strike by building services workers in New York City, contributed to net job deletions totaling 75,000.

(continued on next page)

Labor Markets (cont.)



a. Includes health, social insurance administration, air transportation, judicial and legal services, other government administration, and unallocable employment.
 b. Includes corrections, utilities, health, other government administration, financial administration, fire protection, judicial and legal services, parks and recreation, natural resources, and unallocable employment.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census.

Despite recent concerns about the ever-expanding size of government, civilian government employment as a fraction of total employment has been falling at the federal, state, and local levels.

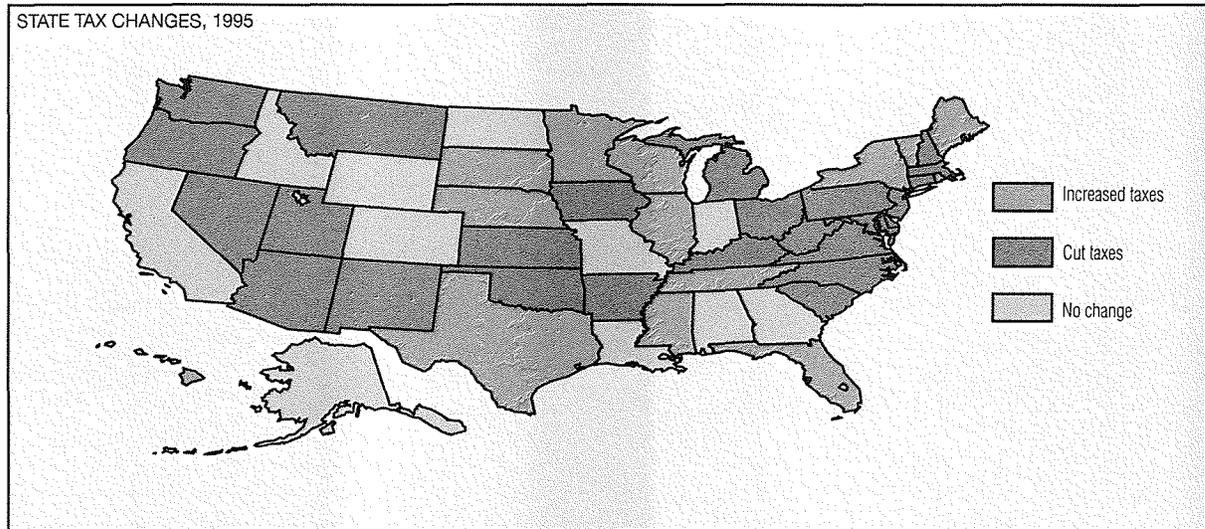
Federal employment has been declining as a share of total employment since the 1970s, with temporary spikes associated with the hiring of additional census workers every 10 years. Unlike state- and local-level government, federal employment has actually fallen on an absolute basis from its non-census

peak in 1989 (3 million workers). Since the beginning of 1990, the far-larger local government sector alone has added more than 1 million employees. However, in the current expansion, even state and local government employment have fallen relative to the faster-growing private sector.

While data on the functions of government employees have not been updated recently, the general composition of government employment has generally been stable. Federal employment is dominated by

defense and the postal service, which together account for more than 50% of all federal jobs. Cutbacks in these two areas were responsible for the bulk of the decline in federal employment between 1990 and 1992. State and local government employment is concentrated primarily in education, with a substantial number of jobs in hospitals and police forces. These categories—and many other local government functions—tend to grow as the populations they serve expand.

Regional Conditions



States that Cut Taxes in 1995 (Millions of dollars)			
North Carolina	363	Montana	31
Pennsylvania	281	Virginia	26
Oregon	266	Arkansas	25
New Jersey	260	New Mexico	25
Michigan	245	Delaware	18
Arizona	104	Nevada	15
Washington	103	Connecticut	11
New Hampshire	86	South Carolina	5
Utah	84	West Virginia	3
Ohio	68	Maryland	2
Kentucky	34	Oklahoma	2
Iowa	32	Massachusetts	1
Kansas	31		

States that Increased Taxes in 1995 (Millions of dollars)	
New York	285
Illinois	257
Tennessee	103
Hawaii	65
Rhode Island	56
Vermont	55
Wisconsin	30
South Dakota	27
Minnesota	8
Texas	7
Mississippi	6
Florida	4
Maine	4
Nebraska	4

SOURCE: National Conference of State Legislatures.

While politicians in Washington make painfully slow progress toward resolving their battle over the size of government, state legislatures have apparently committed themselves to making do with less. This past year—for the first time in a decade—the total value of state tax cuts exceeded the value of state tax increases.

The National Conference of State Legislatures reports that 25 states cut taxes by a combined total of

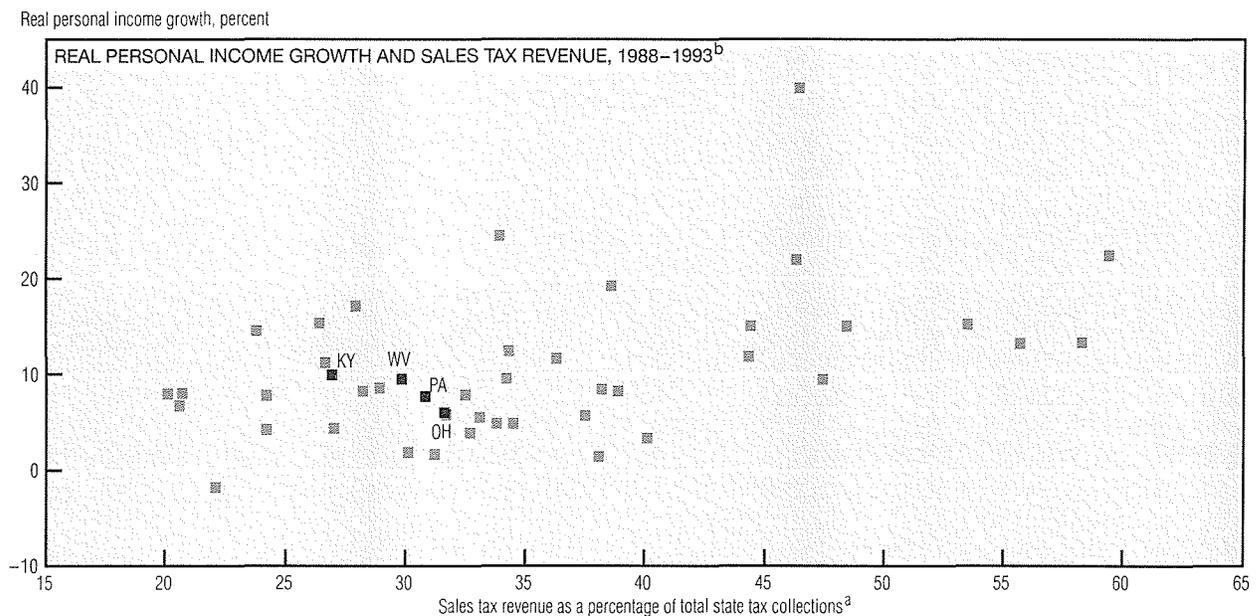
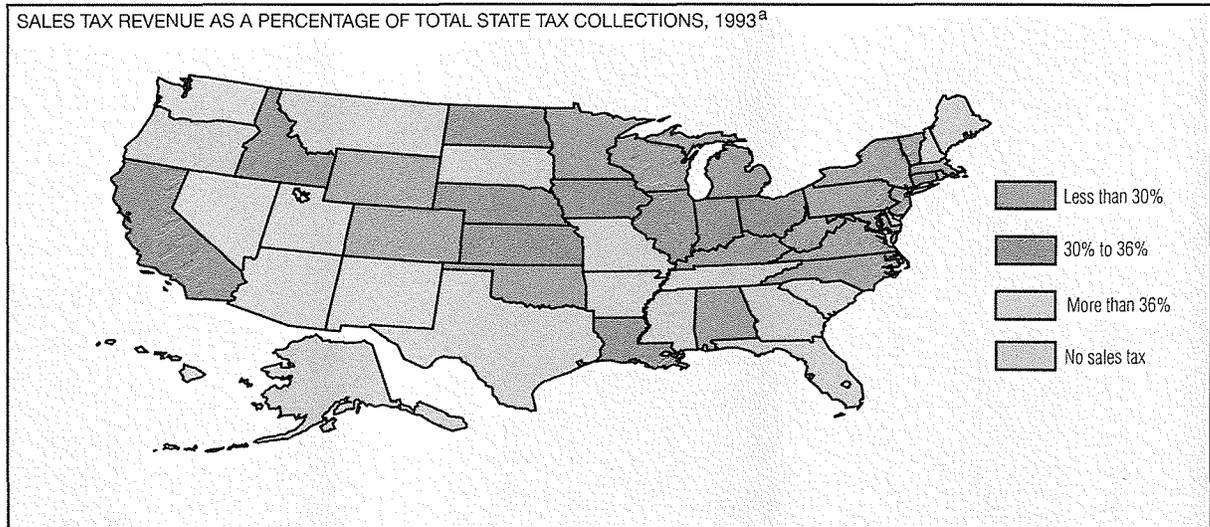
\$2.1 billion, while 14 states boosted taxes by a combined total of \$910 million. Most of the increase was concentrated in taxes on hospitals, nursing homes, and other health care providers, as states use these revenues to pay their share of Medicaid, one of the fastest-growing state budget items. The largest cuts occurred in North Carolina, Pennsylvania, Oregon, and New Jersey, each of which reduced taxes by more than \$250 million. In contrast,

New York (which anticipates a substantial loss of Medicaid funds if federal block grants are enacted) and Illinois each raised taxes by more than \$250 million.

Whether some states will ultimately regret such bold moves will not be revealed until the federal government decides whether to give them long-promised block grants and increased autonomy over spending on various programs.

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Regional Conditions (cont.)



a. Sales tax revenue includes general sales and gross receipts.

b. Excludes states with no sales tax.

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

Another area in which state policy may presage federal policy is the structure of the tax system. For instance, there has been much debate about whether the federal tax code discourages saving and work effort. Many economists have suggested that a uniform national sales tax would be a more efficient way to raise needed tax revenues and encourage saving. They believe that the additional saving would result in greater investment, enhancing the

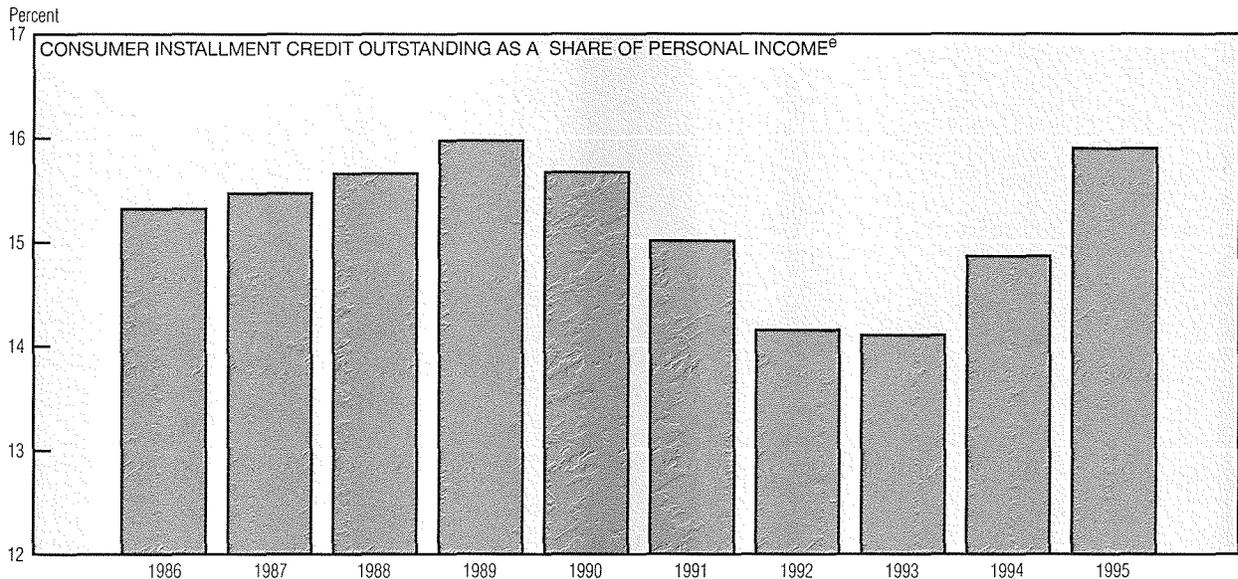
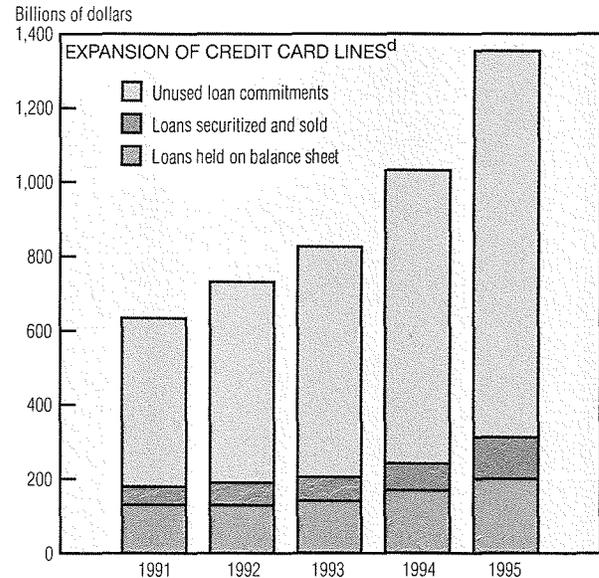
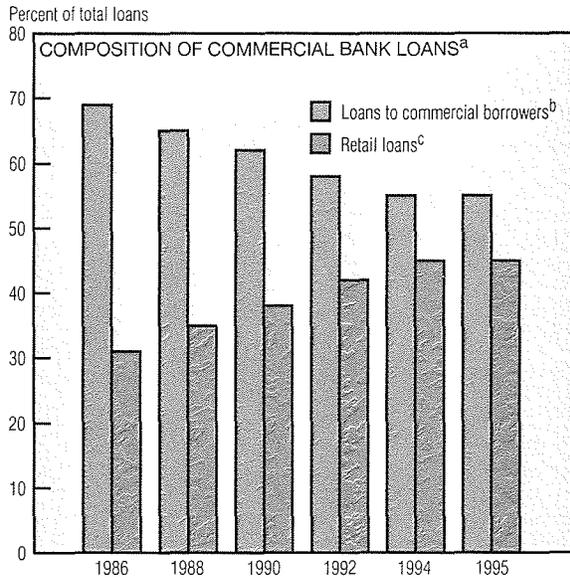
productivity of workers and raising their earnings.

States' tax codes exhibit varying degrees of reliance on sales taxes and thus may suggest how increasing taxes on consumption could affect economic growth. In 1993, 33% of total state revenues were generated by sales taxes, a figure virtually unchanged from 1988. The proportion of state revenues raised by a sales tax in 1993 ranged from zero (in Alaska, Delaware, Montana,

Oregon, and New Hampshire) to a high of 60% in Washington state, with the median state garnering 31% of its revenues from a sales tax.

There is no obvious connection between reliance on sales taxes and growth, however. From 1988 to 1993, residents of states that relied more heavily on sales taxes did not experience greater overall growth in real personal income than did residents of other states.

Banking Conditions



a. Figures are for December of years shown, except for 1995, which is for September. Data are for FDIC-insured commercial banks.

b. Includes commercial and industrial loans, multiple mortgages, commercial real estate, construction, and agricultural loans.

c. Includes consumer and credit card loans, one- to four-family residential mortgages, and home equity loans.

d. Figures are for September of years shown and are for FDIC-insured commercial banks.

e. 1995 figure is through August.

SOURCES: Federal Deposit Insurance Corporation; and U.S. Department of Commerce, Bureau of Economic Analysis.

Since 1986, commercial banks have been substituting retail loans for loans to commercial borrowers. Although the trend appears to have stopped in 1995, this does not imply a reduction in the credit available to consumers, who experienced an expansion of their credit lines.

As reported on bank balance sheets, consumer credit rose \$57.6 billion in the 12-month period ended September 30, 1995—an increase identical to that posted over

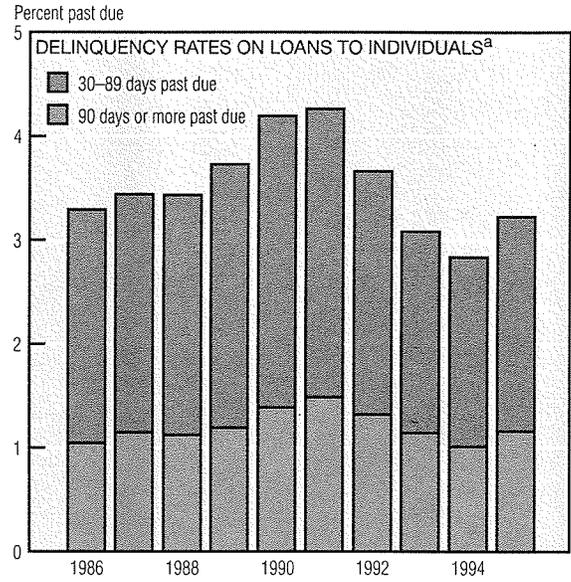
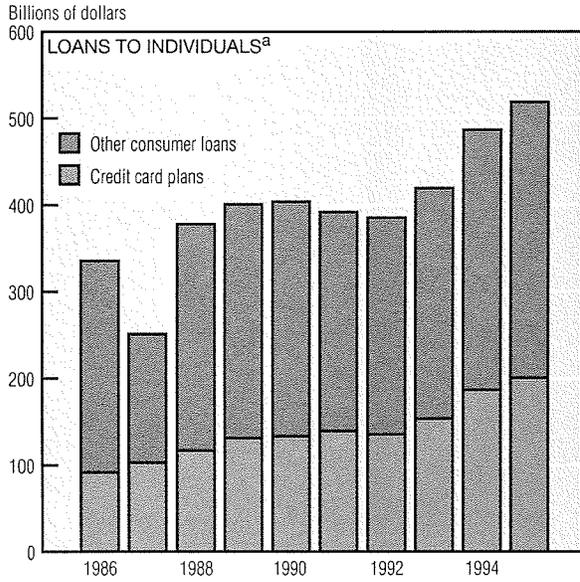
the prior 12 months. On-balance-sheet figures, however, mask much of the growth in consumer credit. More than two-thirds of the consumer credit available at the end of September appeared as off-balance-sheet items, primarily unused loan commitments (unused lines of credit extended to credit card customers) and outstanding credit card loans that have been securitized and sold to others.

The value of unused loan commit-

ments to credit card holders was up \$252.1 billion in the 12 months ended September 30, 1995, a significant increase from the previous 12-month period, when a \$168.3 billion gain was reported. Over the latest 12 months, the increase in credit card loans securitized and sold also escalated, up \$38.8 billion, compared with only \$8.6 billion in the prior 12-month period.

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Banking Conditions (cont.)



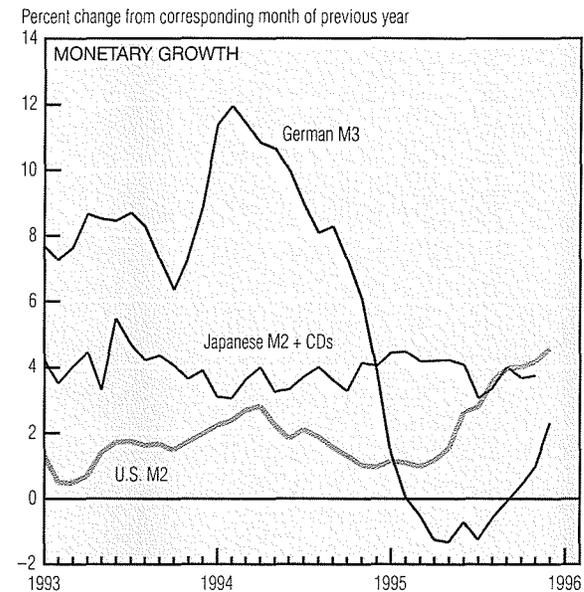
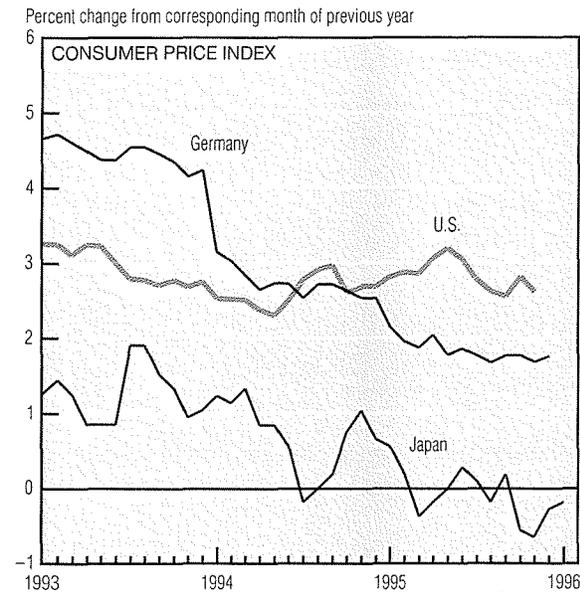
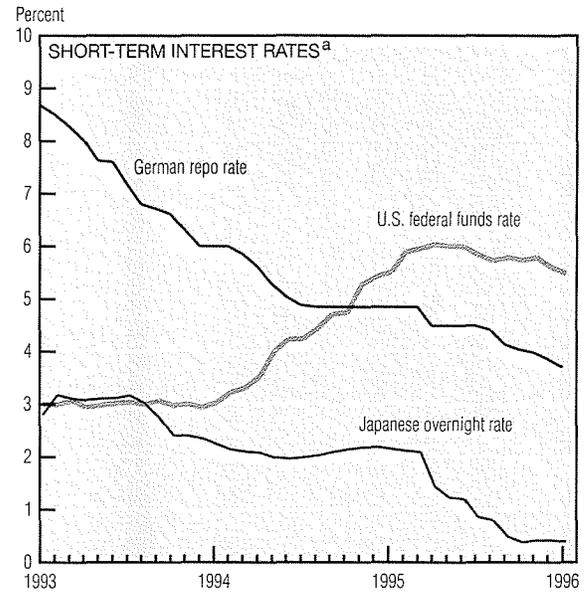
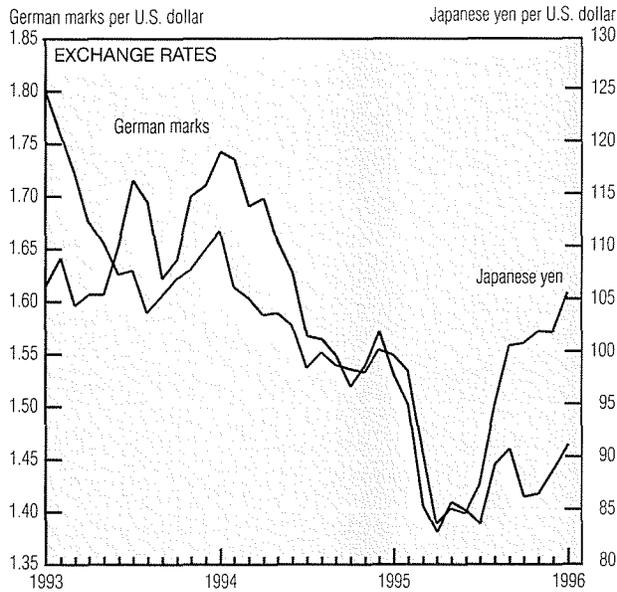
a. Figures are for December of years shown, except for 1995, which is for September.
 NOTE: All data are for FDIC-insured commercial banks.
 SOURCE: Federal Deposit Insurance Corporation.

The rapid growth in loan commitments made available to consumers has been motivated by the high yields associated with credit card loans. In the first three quarters of 1995, credit card loans accounted for only 7.8% of total bank lending, but were responsible for 12.2% of the loan income that banks received. Credit card lending remained a highly concentrated business: The 50 largest credit card

lenders owned almost 80% of all credit card loans. The sustainability of credit card loan profits has been questioned because of the increase in delinquency rates observed in the first three quarters of 1995. Furthermore, the rapid growth in loan commitments may also be a sign of increased competition, which could have a negative impact on the attractive yields that banks are currently receiving on credit card loans.

Some bank industry observers have expressed concern about the rise in credit card delinquencies and the growing level of consumer debt. With the ratio of outstanding consumer installment credit to personal income only slightly below its 1989 peak, there is some question about the implications for bank credit quality. As yet, however, overall bank asset quality and capital remain strong.

International Developments



a. Monthly averages of daily rates for the U.S. and Japan; monthly average of weekly rates for Germany.
SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; and DRI/McGraw-Hill.

The dollar has strengthened against both the German mark and the Japanese yen over the last month. Evidence of weak economic growth in Germany and elsewhere in Europe has led market observers to anticipate further European interest rate cuts, which would be expected to pull funds into U.S. dollar assets. Though Japanese economic growth has picked up, unexpected weak-

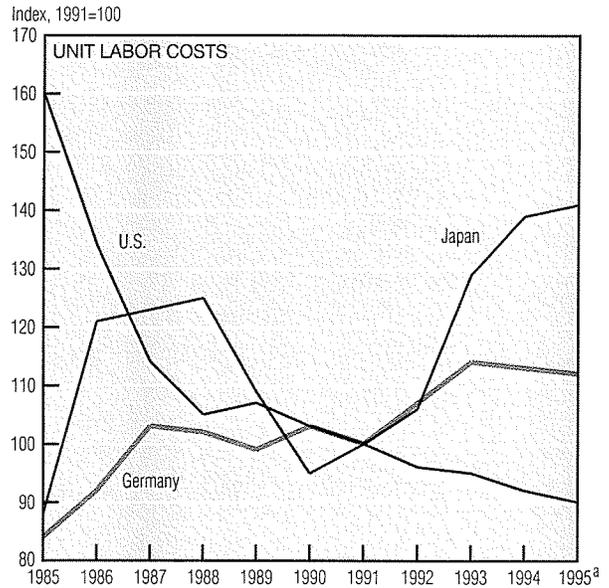
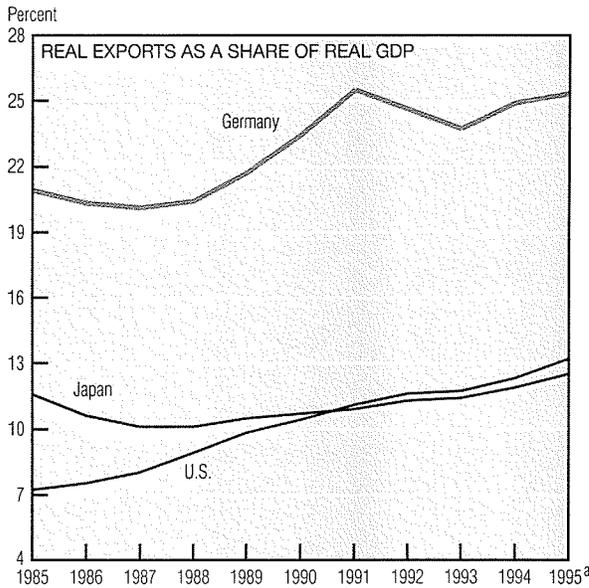
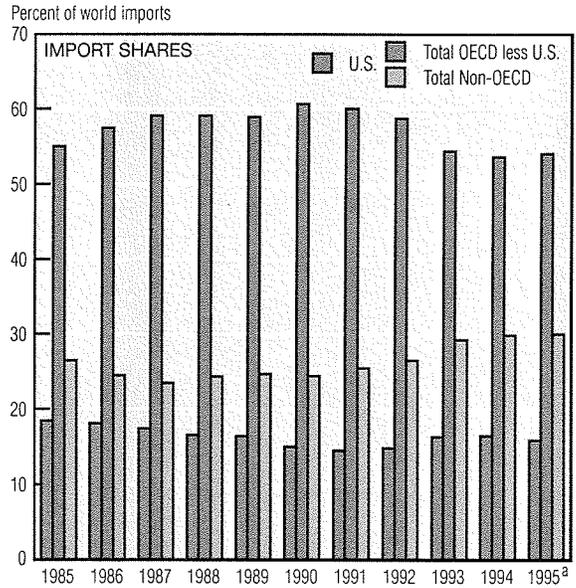
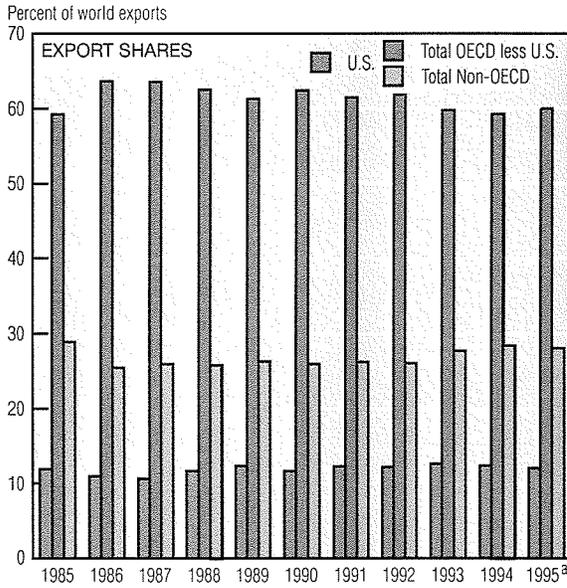
ness in the Japanese trade surplus may be partly responsible for the increase in the yen-dollar rate, just as a worsening U.S. trade balance might move the dollar lower.

Short-term interest rates have recently edged down in the major industrial countries. The decline in German short-term rates has followed weakness in M3, the Bundesbank's targeted monetary aggregate. Economists generally focus on

short-term interest rate differentials as determinants of short-term swings in exchange rates.

Inflation rates remain moderate in Germany and the U.S. Prices continue to fall in Japan, but economic activity there has recently shown signs of reviving. The last half of 1995 saw German economic growth fall to 1.9% and the nation's budget deficit widen.

World Trade Patterns



a. OECD forecast.
 SOURCES: Organisation for Economic Co-operation and Development (OECD); and DRI/McGraw-Hill.

According to the Organisation for Economic Co-operation and Development (OECD), the U.S. share of the world's export trade has inched up over the last decade. U.S. shipments amounted to approximately 11% of total export trade between 1985 and 1987, and to more than 12% between 1993 and 1995. Over this same period, the export share of other OECD countries (relatively developed nations) fell from 62% to under 60%, and the export share of

non-OECD countries (developing nations) expanded from 27% to 28%.
 Despite the growing U.S. trade deficit, our share of world imports actually declined over the past 10 years, falling from 18% to 16% between 1985 and 1995. Similarly, the share of other OECD countries dropped from 57% to 54%. Thus, developing countries' share rose from 25% to nearly 30% over this period.
 As the U.S. has captured a larger share of the world markets, exports

have become more important to our economic performance. In 1995, exports accounted for 13.2% of U.S. GDP, up from 7.2% in 1985. This puts us roughly on a par with Japan, where exports account for 12.5% of total output, but below Germany, where exports make up 25% of GDP.
 In part, our export gains may reflect trends in U.S. labor costs—a major factor in international competitiveness. Over the last 10 years, U.S. labor costs have fallen 15.9%.