

The Economy in Perspective

Taxing matters ... I was far too busy to travel, so I had to settle for a video conference with my old friend André. He and I met years ago, when the future—and its possibilities—seemed endless. Politics meant nothing to either of us then, but it has now become another strand in the rope that binds us together. André is Minister of Finance in Nedlaw, a country of mythical wealth and enchantment on the other side of the globe. I have never been there, but his descriptions over the years have been so vivid that I feel I could traverse that fabulous nation blindfolded.

No time for reminiscing today, however. I have just signed on as campaign manager for Webster Paige, a presidential aspirant in my own land, who will announce his candidacy in a few weeks. André's insights would be invaluable, especially in fashioning Paige's economic policy positions. According to my previous conversations with André, Nedlaw's economic policies enjoy widespread popular support. I explained my predicament to André, who quickly swallowed the last vestiges of his lunch, shoved the plates aside, and cleared his throat.

"Listen up," he said. "The first thing you have to square away is your tax policy. People want to know what you are going to do for them."

"We're way ahead of you, André," I chuckled. "Although it appears to tax upper-income earners at progressively higher rates, our system is nearly proportional because of all the deductions taxpayers claim. By instituting a flat tax, we can eliminate the distortions caused by the current system; we just don't know what tax rate to set. Another candidate claims that a 15% flat rate tax, with no deductions, could yield as much revenue as our current system. He says people will generate enough extra income to make up for the lower rate. What do you think?"

André reclined patiently in the high-backed chair behind his desk. "In Nedlaw," he said, "We have a 10% flat tax rate, provide a seven-year depreciation for new home purchases, and give tax credits for each pet owned."

I was speechless. Surely there was some logic to this tax system, but it was not obvious.

Seeing my bewilderment, André seemed quite pleased with himself. Then he hunched forward and became serious. "You have two choices," he said. "You can begin with the facts and go where they take you, or you can begin with the voters and go where they want to be taken. Nedlawians want a government that understands them. Don't forget the old proverb: 'He who takes high road falls off bridge.'"

"Nedlaw," he continued, "was founded in the year 1010, so Nedlawians regard the number 10 as having mystical properties. The 10% tax rate has been wildly popular. Home ownership is everyone's dream, and since the average Nedlawian stays in a home for seven years, we have

a depreciation schedule to match the citizens' preferences. This aspect of our tax code is an obvious success. Houses have become so desirable that their prices just keep escalating. What a terrific investment! Encouraging people to keep pets promotes the kind of values that we favor, since pet owners are a peaceful, nurturing lot. Taking care of their animals keeps people off the streets at night, if you know what I mean." He gave me a wink.

"But André," I protested, "in my country that sort of housing allowance would cause people to build houses like crazy, diverting funds from sorely needed new equipment and businesses. Our productivity growth trend has been slowing as it is!"

"Our neighboring countries provide all the businesses and jobs Nedlawians need; why should we put up with the pollution and congestion?" André smugly folded his arms across his chest. "Besides," he intoned, "the pet credit has engendered a horse-breeding industry. Nedlawians can quite cheaply gallop off to work!"

"Incredible," I exclaimed, striking my forehead with an open palm. I was finally beginning to see the inner workings of Nedlaw's wealth machine. No wonder André was regarded as a genius. Yet somehow I could not make all the pieces fit.

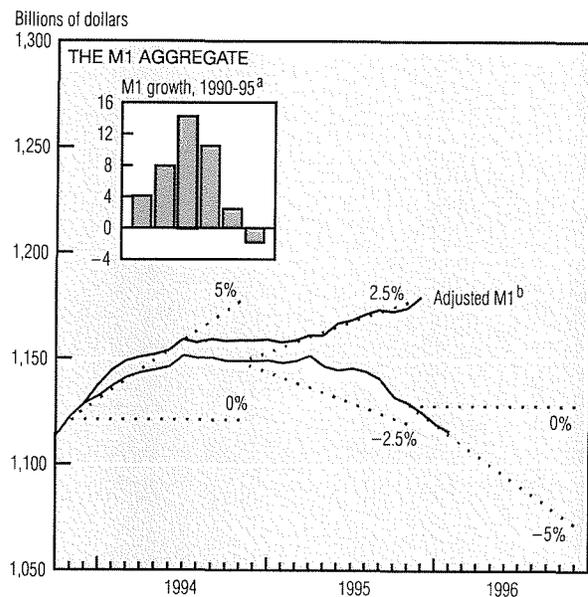
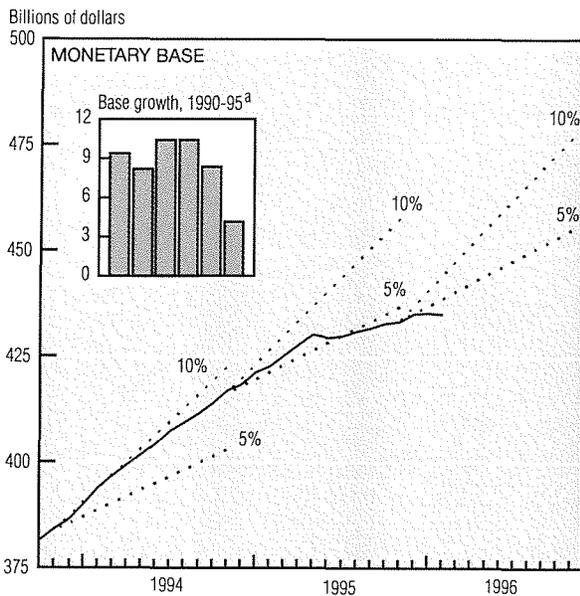
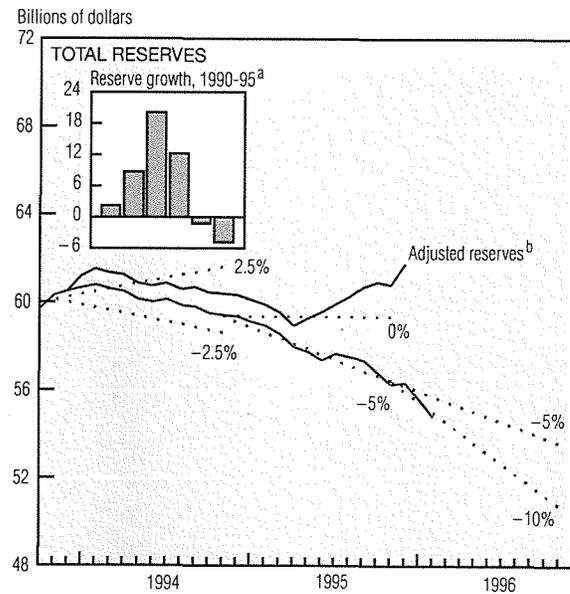
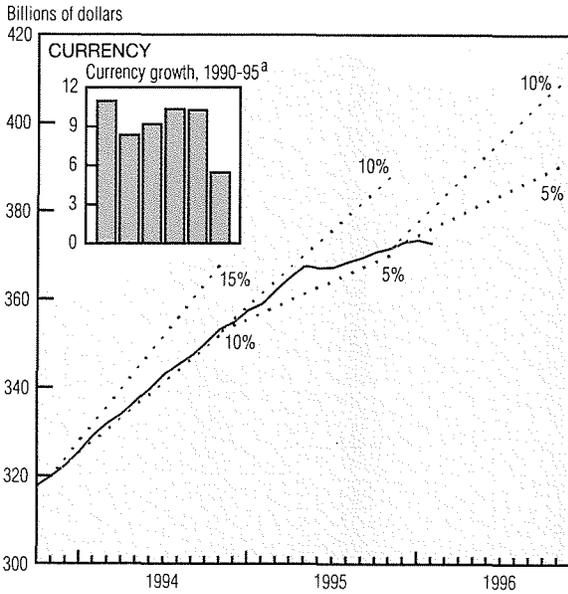
"André," I ventured, "Can you balance your budget with this taxation system?"

"Darn close," he crowed. "Privatization, that's the answer!"

"Of course," I shouted. This time I slapped my forehead with both palms. "You just unload all those pork barrel programs. If people want services, let them pay for them directly!"

"Well, there is some of that," André mused. "But we don't want Nedlawians to go without certain necessities. We simply passed laws requiring that people and companies purchase these socially justified goods and services in specified quantities from the private sector. Once we did that, we could reduce government spending. Take Nedlaw's retirement program, for example. For their own good, our citizens have to contribute to a privately operated retirement plan. All we do is make sure the plan is being operated safely, which we accomplish by requiring it to invest exclusively in official obligations of our government. People now recognize that it makes sense to have some Nedlaw debt generated every year."

If I closed my eyes, I could see Webster Paige making those "V" signs with his upstretched arms on election night. My hands furiously scribbled notes, but my mind drifted to Nedlaw's motto, emblazoned on the banner hanging behind André's desk: "Nedlaw — Where the sun never sets on a good idea!"



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
 b. Adjusted for sweep accounts.
 NOTE: All data are seasonally adjusted. Last plot is estimated for February 1996. Dotted lines represent growth ranges and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

All of the narrow measures of money fell last month. Currency declined at a 2.5% rate, total reserves plunged 15.4%, the monetary base (which measures currency in the hands of the public plus reserves and currency held by banks) was down 1.0%, and M1 (which includes both currency and checkable deposits) dropped 3.9%. In January, currency increased 1.3% and the monetary base was up a meager 0.4%, while M1 and total reserves fell 3.9% and 15.7%, respectively.

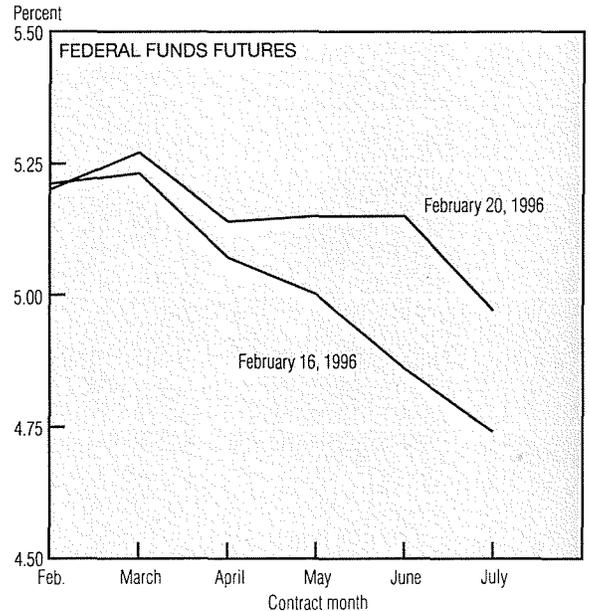
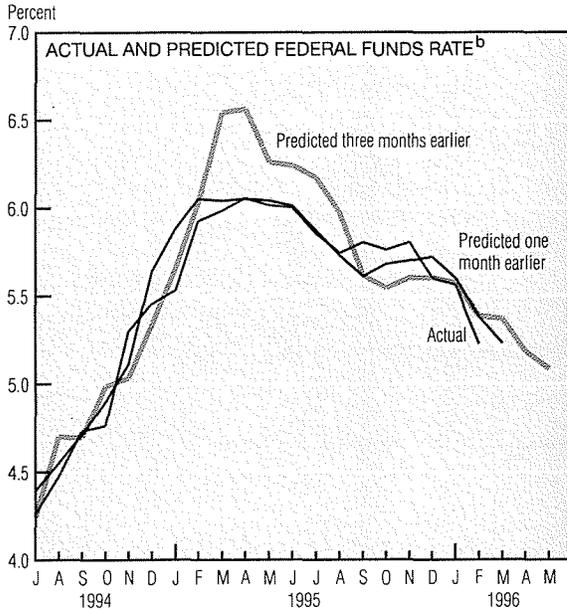
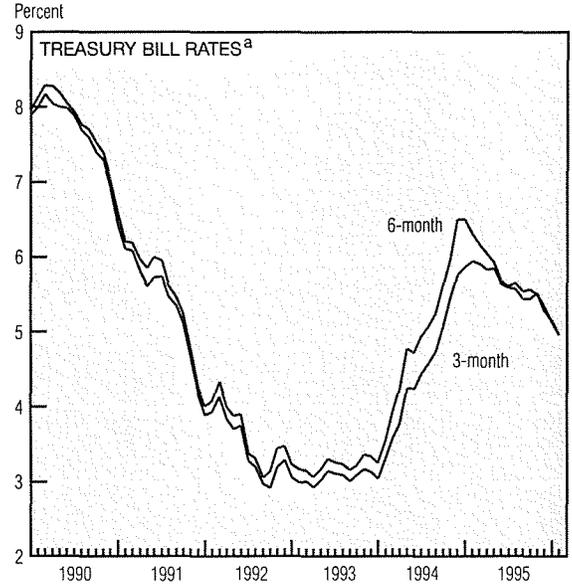
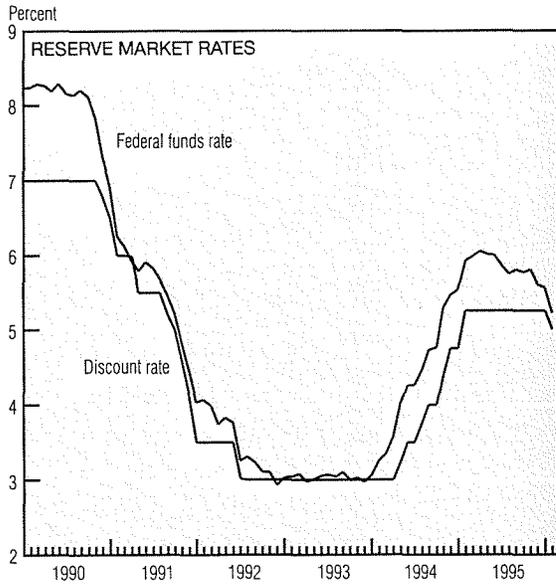
One factor that is depressing both total reserves and M1 is the emergence of sweep accounts, which banks have initiated over the past few years in order to economize on their reserves. These arrangements "sweep" excess household checkable deposits, which are reservable, into money market deposit accounts, which are not. Analysts have estimated that absent these sweep accounts, total reserves would have expanded 1.3% over the past calendar year, instead of the sharp 4.9% decline that was actually posted. M1

would have grown 1.5% over the same period, instead of falling 1.8%.

Yet, even when the emergence of sweeps is taken into account, the narrow aggregates have all continued to show anemic growth over the past year. This has puzzled some observers, since the Federal Reserve has steadily decreased the funds rate target from 6.0% a year ago to 5.25% today. These apparent "easings" should have caused quicker growth in the narrow aggregates.

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Monetary Policy (cont.)



a. Quoted from the secondary market on a yield basis.
 b. Predicted rates are federal funds futures.
 SOURCES: Board of Governors of the Federal Reserve System; and Chicago Board of Trade.

However, it may be a mistake to characterize the Fed's actions as an overt easing in monetary policy. Cuts in the federal funds rate for the most part followed reductions in other short-term interest rates. The 3-month T-bill yield has fallen from 5.9% a year ago to just under 5% today. Similarly, the 6-month T-bill yield has dropped from 6.3% to just under 5%.

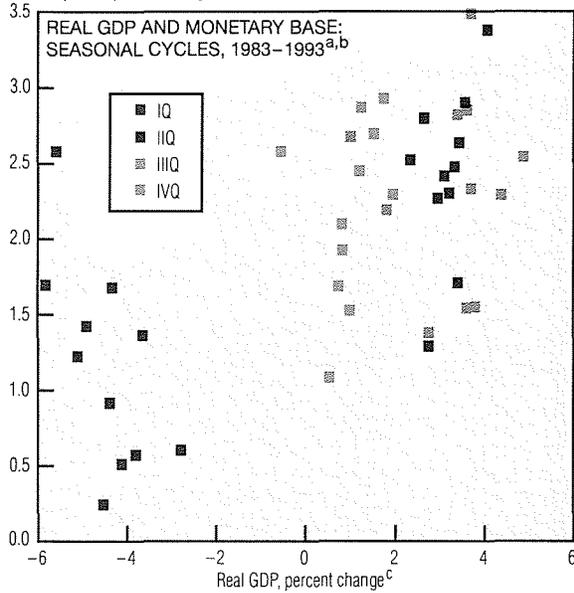
There is evidence that the market is expecting further decline in the federal funds rate. The average fed

funds futures rate over the past month suggests that market participants foresee that the funds rate will be trading at 5.1% by May. The anticipated decline, however, has become less pronounced following Chairman Greenspan's Humphrey-Hawkins testimony on February 20. Four days earlier, the market had been expecting the fed funds rate to be trading at 4.74% by July—50 basis points lower than its current target. After the Chairman appeared before Congress, that figure was revised to 4.97%.

Monetary policy has always been difficult to implement. For guidance, the preamble to the Federal Reserve Act states that one of the Fed's goals is "to furnish an elastic currency." An elastic currency is one that can be expanded or contracted quickly. This elasticity manifests itself across seasonal cycles. For instance, during the December holiday season and in the spring—when GDP growth is at its peak—money growth also reaches its highest point, limiting
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Monetary Policy (cont.)

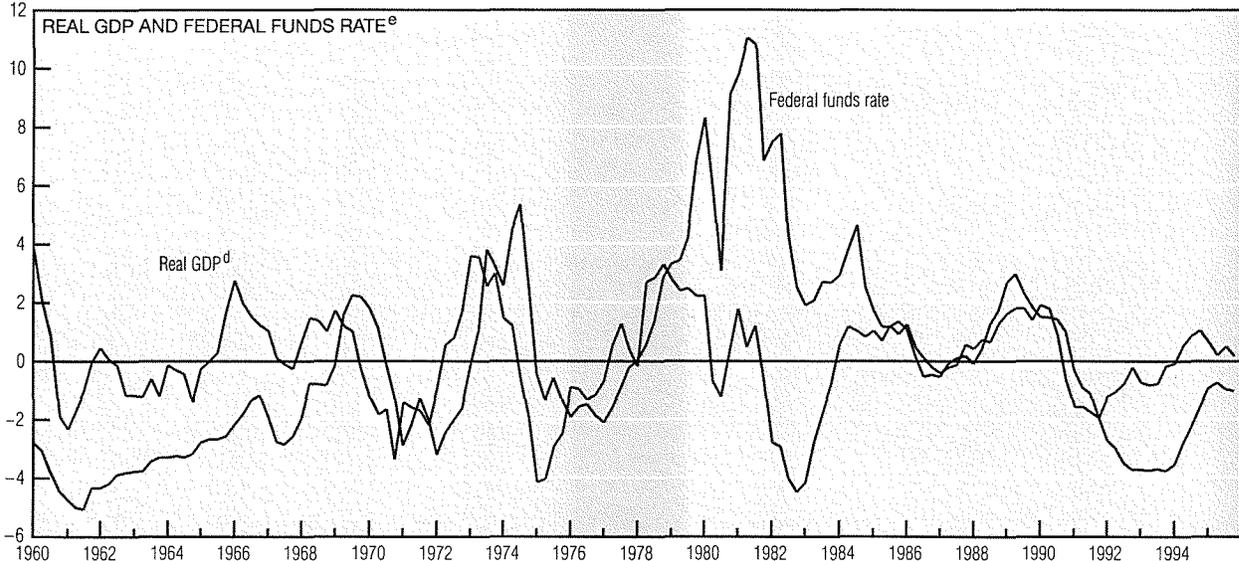
Monetary base, percent change



**The Impact of Real GDP's Components
(Percent contribution to change in real GDP)**

	Business cycles ^d (average)	Seasonal cycles ^{b,c} (median)
Nondurables and services	16	28
Durables	18	22
Business fixed investment	35	26
Change in inventories	39	14
Government spending	4	20
Net exports	-14	-6

Deviation from trend, percent



a. 1983 to 1993 data are calculated as an annualized quarterly change.

b. Not seasonally adjusted.

c. Real GDP is defined as nominal GDP deflated by the CPI.

d. Seasonally adjusted.

e. The trend GDP is defined using a Hodrick- Prescott filter. The trend federal funds rate is defined as its average from 1960 to 1995.

SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and Robert Barro, *Macroeconomics*, fourth edition, New York: John Wiley & Sons Inc., 1993.

seasonal variation in interest rates.

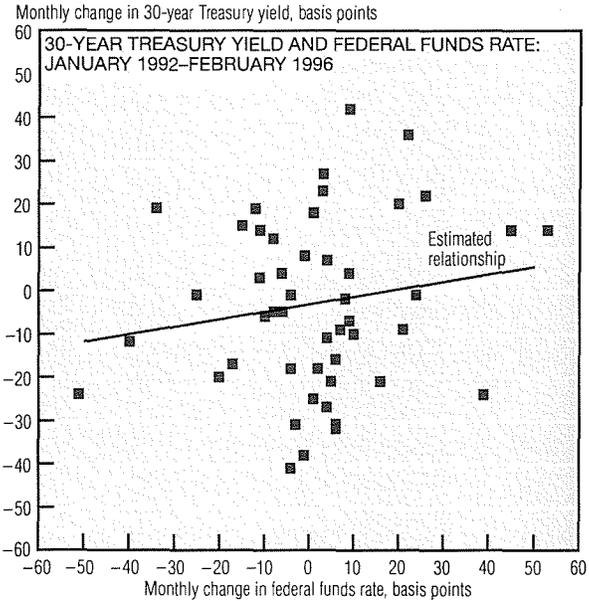
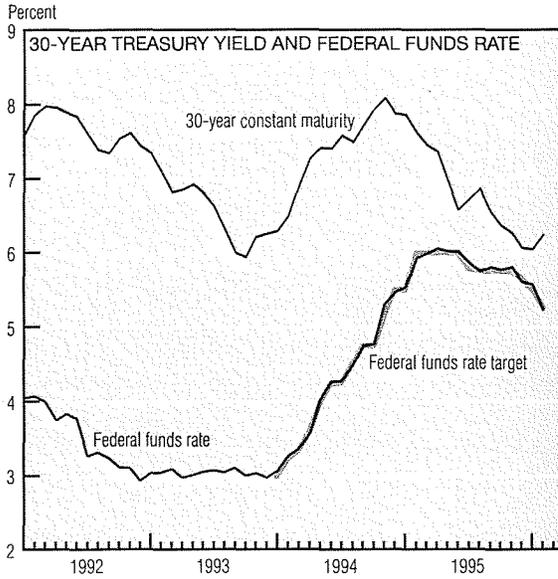
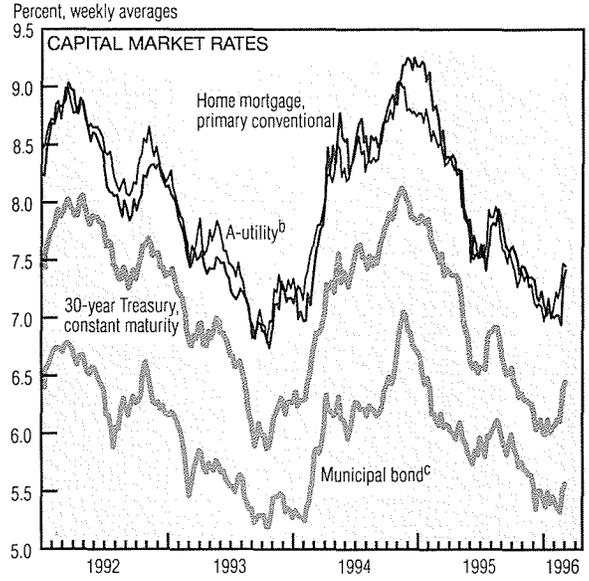
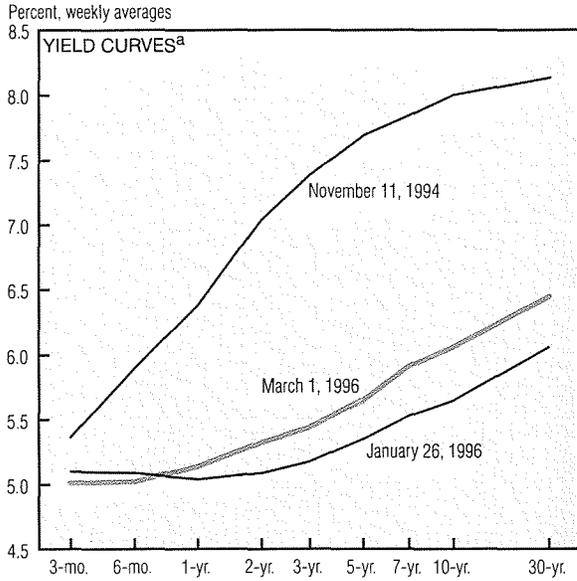
Why is there general agreement that interest-rate variation should be held constant across the seasons, but not across the business cycle? This question is especially puzzling because evidence suggests that the seasonal and business cycles are quite similar. For example, the fraction of the change in GDP stemming from changes in durable-goods consumption, business fixed investment, and net exports is about the

same for both cycles. The major difference can be found in the behavior of inventories, which should come as no surprise given that firms can predict seasonal cycles.

Even if one grants that the sources of shocks for the two cycles are different, recent economic research implies that it is still important for monetary policy to furnish an elastic currency across business cycles. Since households may be unwilling or unable to adjust their sav-

ing behavior quickly, this nominal sluggishness prevents cash from flowing to the banking sector during expansions. This suggests that money should be increased during expansions in order to supply needed reserves to the banking sector, which would in turn minimize business cycle variations in nominal interest rates. Although such a policy would lead to short-term variations in inflation, in the long term, inflation would be constrained by

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.
 SOURCE: Board of Governors of the Federal Reserve System.

Long-term interest rates have increased in the past month, leading to a steepening in the Treasury yield curve. A slight drop in short-term rates also contributed to the rise. Popular explanations for this development vary. Some contend it reflects a stronger economy, while others fear rising inflation—whether tied to monetary policy or to the expressions of presidential hopefuls. In any case, the development shows that bond markets incorporate ex-

pectations about future economic activity and inflation.

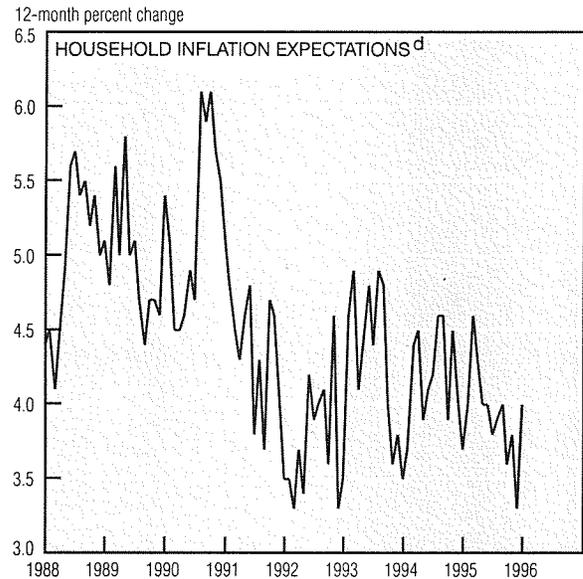
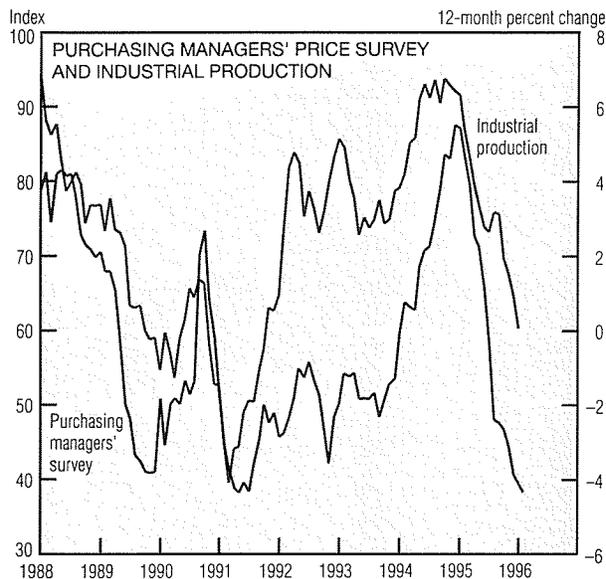
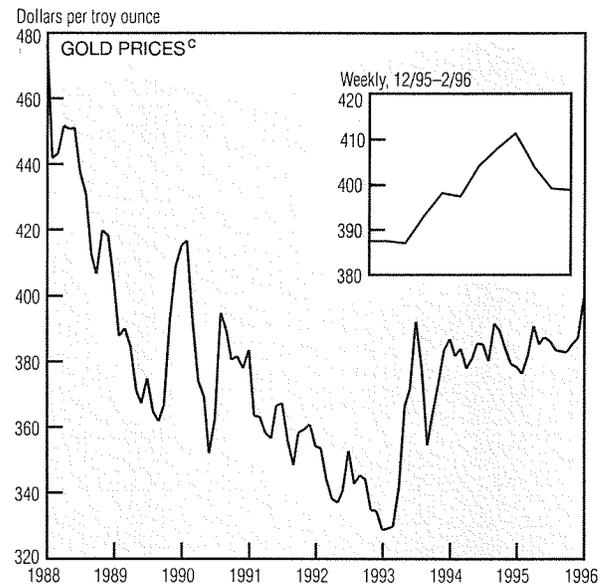
When considering the influence of monetary policy on long-term interest rates, one should examine the historical relationship between the federal funds rate (the Federal Reserve's short-term target rate) and the 30-year Treasury bond rate (traditionally thought to be a bellwether of inflation). In 1993, the federal funds rate held steady but the long rate fell, narrowing the spread between the two from 450 to 300 basis

points. The spread continued to shrink through most of 1994 as both rates rose, but as the year came to an end, long rates headed down once again. Since December 1995, rates have diverged, and the spread has more than doubled.

In short, the Treasury yield spread can be affected by influences exerted at either end. A plot of monthly changes in both the federal funds rate and the 30-year Treasury rate illustrates a weak connection at best.

Inflation and Prices

	Annualized percent change, last:			1995 average
	1 mo.	12 mo.	5 yr.	
January Price Statistics				
Consumer Prices				
All items	4.8	2.7	2.8	2.6
Less food and energy	3.7	3.0	3.2	3.0
Median ^a	4.3	3.4	3.1	3.4
Producer Prices				
Finished goods	3.8	2.3	1.2	2.1
Less food and energy	-0.8	2.2	1.8	2.5
Commodity futures prices^b				
	-5.2	3.5	2.2	5.4



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. Mean expected 12-month change in consumer prices as measured by the University of Michigan's Survey of Consumers.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; Board of Governors of the Federal Reserve System; the National Association of Purchasing Management; *Metals Week*; and the University of Michigan.

The CPI made an unexpected jump in January (4.8% at an annualized rate), following a string of very moderate increases leading back to mid-1995. Although energy items accounted for a share of January's cost-of-living rise, the core inflation measures—the CPI excluding food and energy goods and the median CPI—also rose sharply, by 3.7% and 4.3%, respectively.

The monthly price data are extremely volatile, and it is unlikely that the January retail price increase marks the beginning of a higher inflationary trend. Still, the recent

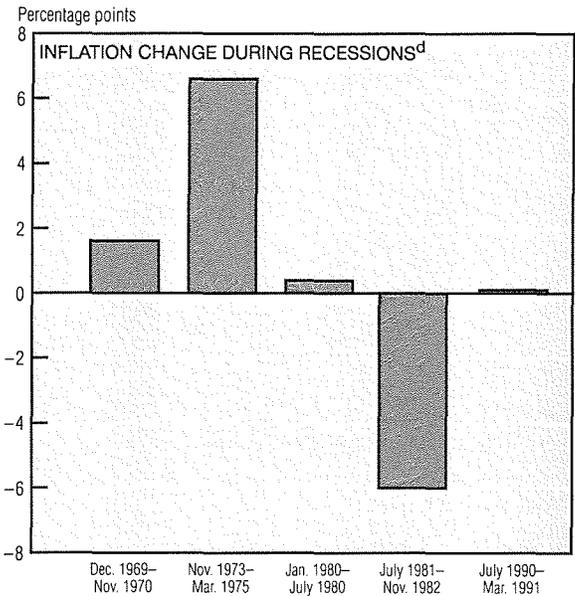
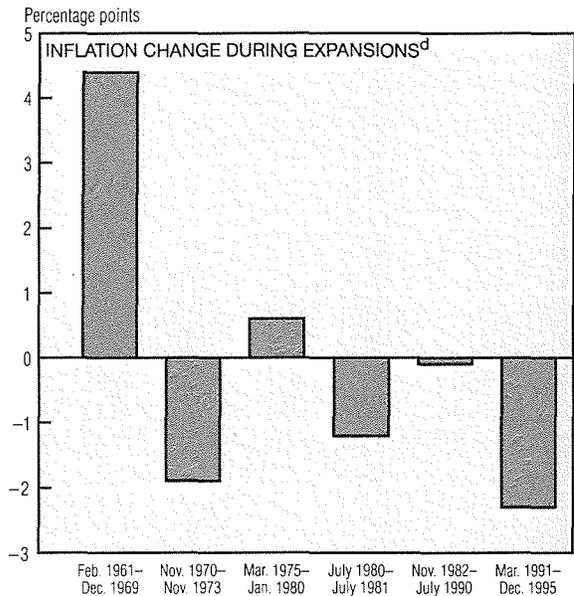
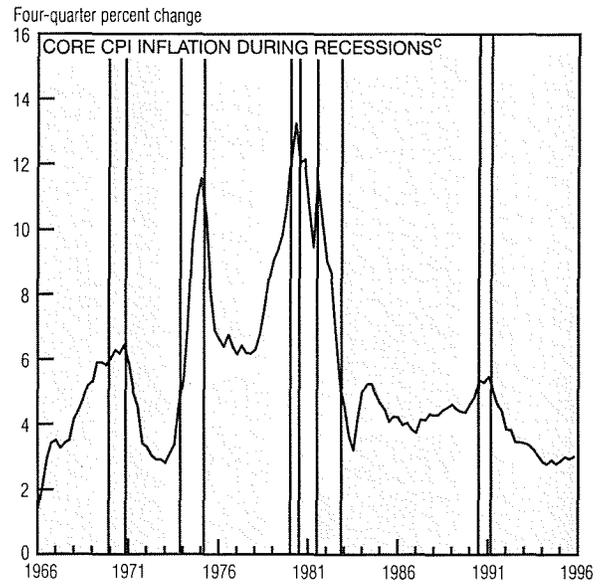
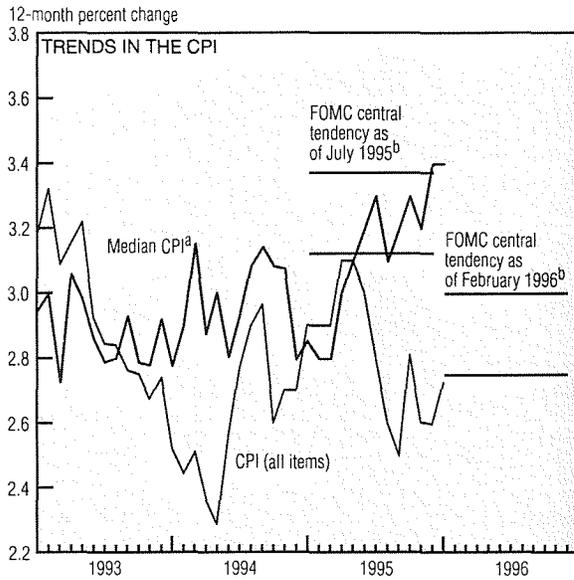
price jump has certainly dampened hopes that inflation was on the verge of moving to a substantially lower trajectory.

The behavior of the leading inflation indicators has been less ominous and is generally suggestive of continuing low inflation. Gold prices, which were rising at year's end and crossed the \$400 per ounce threshold early this year, have very recently begun to moderate once again. Moreover, as industrial production growth slowed last year, so did the cost pressures noted by purchasing managers. In fact, the net

proportion of purchasing managers reporting price increases set a recent low in January, dropping past this group's previous low inflation reading during the 1990–91 recession. Interpreting the inflationary expectations of households is more difficult, but these projections have generally been more favorable recently than they were earlier in the expansion.

The inflation projections of policymakers were presented by Federal Reserve Chairman Greenspan in his semiannual report to Congress in February. The central-
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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) was 3.125 to 3.375 for 1995 and 2.875 to 3.25 for 1996. In February, the range for 1996 was revised to 2.75 to 3.0.
 c. Shaded bars indicate recessions.
 d. Change in the 12-month inflation trend, as measured by the CPI less food and energy items.
 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.

tendency CPI projection by members of the Federal Open Market Committee and nonvoting Federal Reserve Bank presidents was 2.75% to 3.0% for 1996. This is nearly half a percentage point lower than the group's inflation projection for last year, but just slightly above the actual 2.6% CPI rise. Chairman Greenspan noted that 1995 was the fifth consecutive year with a CPI increase below 3%, illustrating that "an extended period of growth with low inflation is possible." However, he also cautioned that price stability

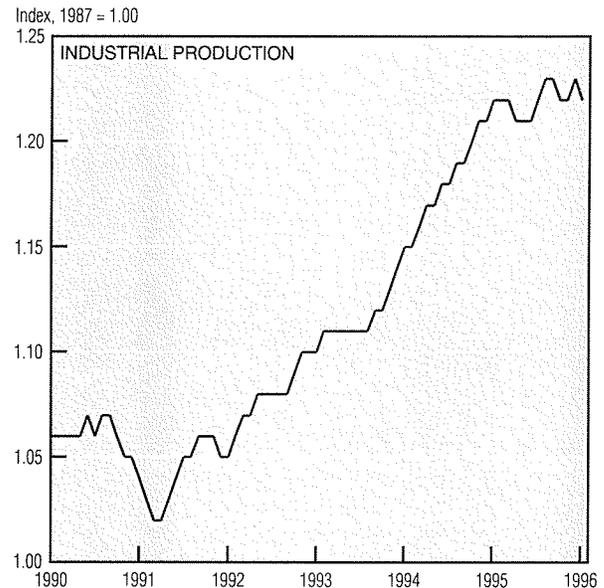
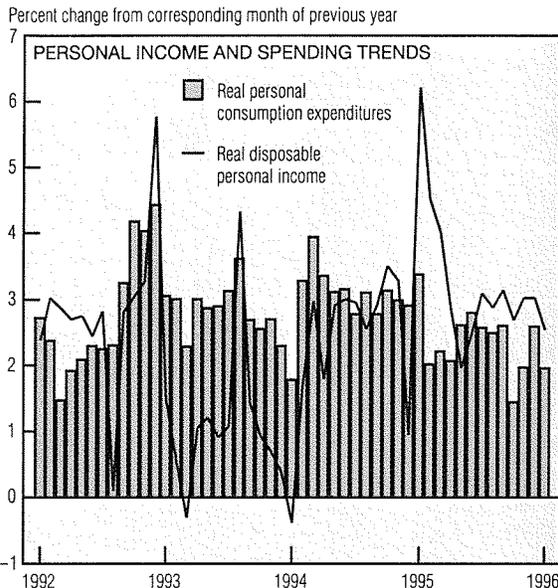
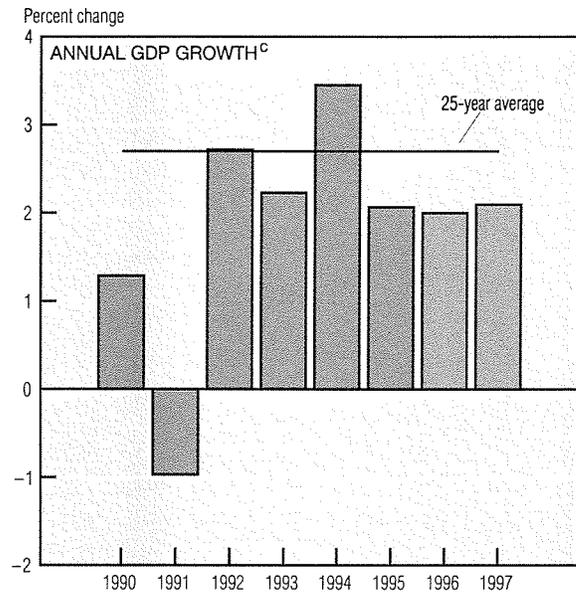
has yet to be achieved.

He suggested a strategy for attaining price stability, whereby policymakers restrain inflation during economic expansions to permit a gradual ratcheting down of inflation over the course of successive business cycles. Presumably, progress toward price stability is made during contractions in business activity. Indeed, one dramatic downward "adjustment" in inflation occurred during the 1981–82 recession, when the trend in the core CPI fell 6 percentage points from business cycle peak

to trough. Moreover, in none of the recent expansions has the inflation trend been substantially higher at the peak than it was at the previous trough. It is surprising, though, when viewed strictly from a business cycle perspective, that in only one expansion of the past 35 years (1961–69) was the inflation trend much higher at the end of the expansion than it was at the beginning. In two recessions (1969–70 and 1973–75), the inflation trend actually rose significantly between the business cycle peak and its subsequent trough.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	15.5	0.9	1.4
Consumer spending	9.3	0.8	1.9
Durables	1.5	1.0	1.9
Nondurables	-5.1	-1.4	0.8
Services	12.5	1.9	2.5
Business fixed investment	11.0	6.3	7.5
Equipment	9.0	6.9	8.1
Structures	2.1	4.7	6.0
Residential investment	2.9	4.5	-1.9
Government spending	-11.9	-3.7	-1.2
National defense	-9.7	-11.6	-6.5
Net exports	20.2	—	—
Exports	20.5	10.9	6.5
Imports	0.3	0.1	4.3
Change in business inventories	-12.8	—	—



a. Chain-weighted data in 1992 dollars.
b. Seasonally adjusted annual rate.

c. 1996 and 1997 estimates are from *Blue Chip Economic Indicators*, February 10, 1996.

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

Real GDP grew 0.9% in 1995:IVQ, substantially off the pace set in 1995:IIIQ. The fourth quarter witnessed a slowing in consumer spending, with purchases of nondurables actually falling. Businesses ran down inventories, and federal purchases continued to decline. Export growth accelerated, while imports were nearly flat.

The economy expanded 2.1% for all of 1995. Economists surveyed for *Blue Chip Economic Indicators* pro-

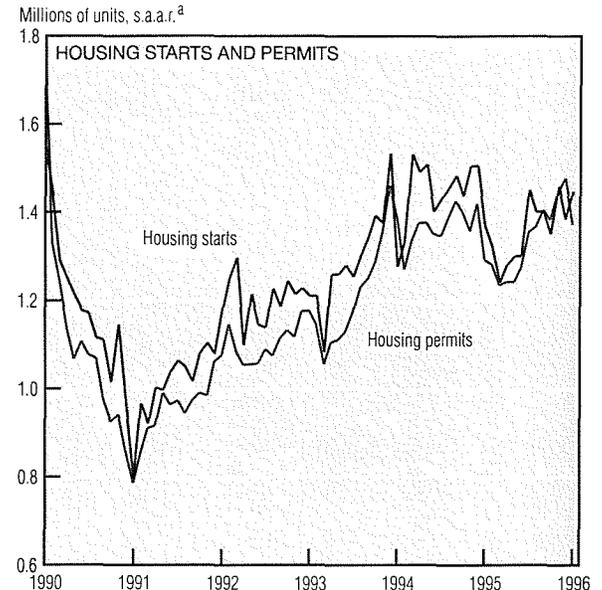
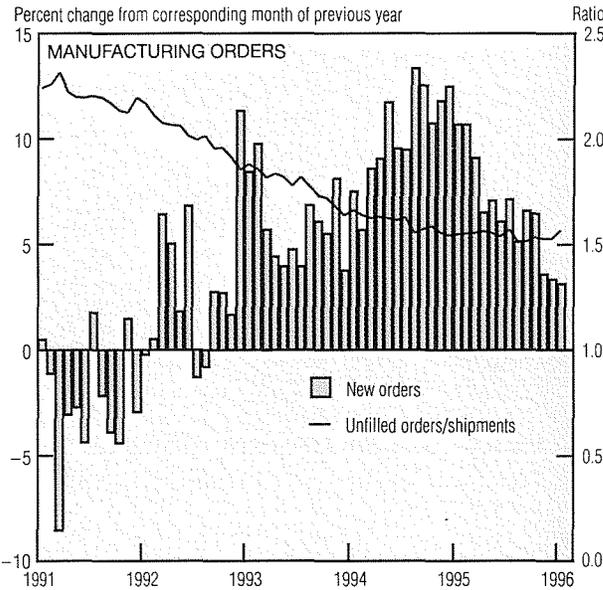
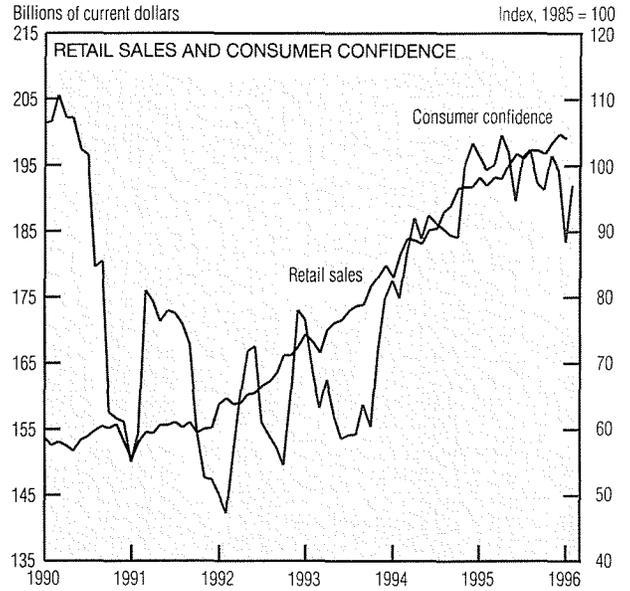
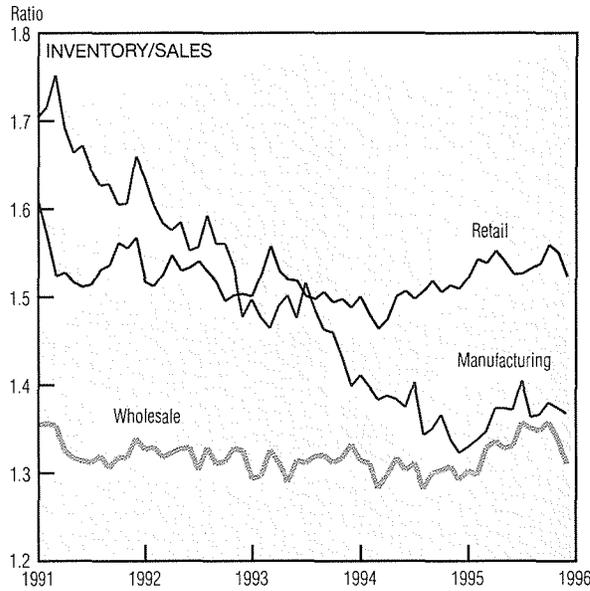
ject real economic growth of approximately 2% for this year and next. Although some economists have warned of a possible recession, none of the *Blue Chip* respondents did so. A 2% rate of expansion is consistent with some estimates of the economy's potential—a sustainable rate of growth at full resource utilization. Nevertheless, 2% is clearly below historical U.S. growth norms. Over the past 25 years, real growth has averaged 2.7%. Over

longer time frames, a 3.2% growth rate has prevailed.

Consumer spending fell in January, reflecting weather-related distortions in the data. Personal income rose slightly, largely on the strength of transfer payments. On a year-over-year basis, however, real personal income increased 2.5% in January, a rate consistent with moderate real economic growth.

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Economic Activity (cont.)



a. Seasonally adjusted annual rate.
 SOURCES: U.S. Department of Commerce, Bureau of the Census; and The Conference Board.

Indexes of overall consumer confidence advanced sharply in February, reversing January's steep decline. Large swings in this series are common. Retail sales (nominal) fell 0.3% in January, but retail sales excluding automobiles remained flat. Sales of cars and light trucks rose 5.6% in February after January's decline. Over the past year, the Big Three automakers gained market share relative to imports.

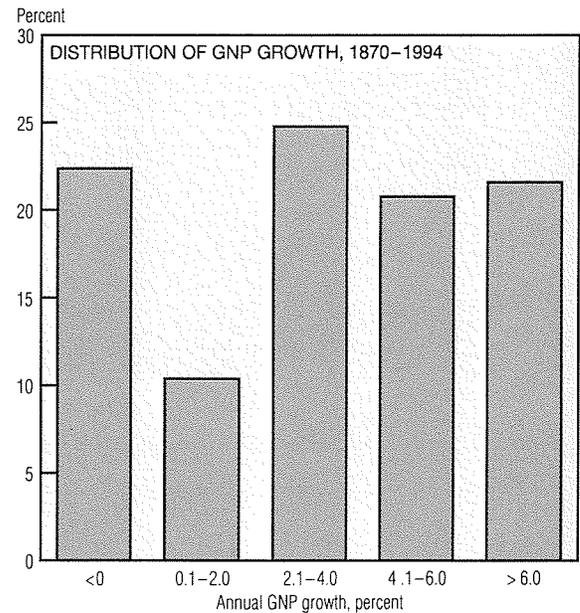
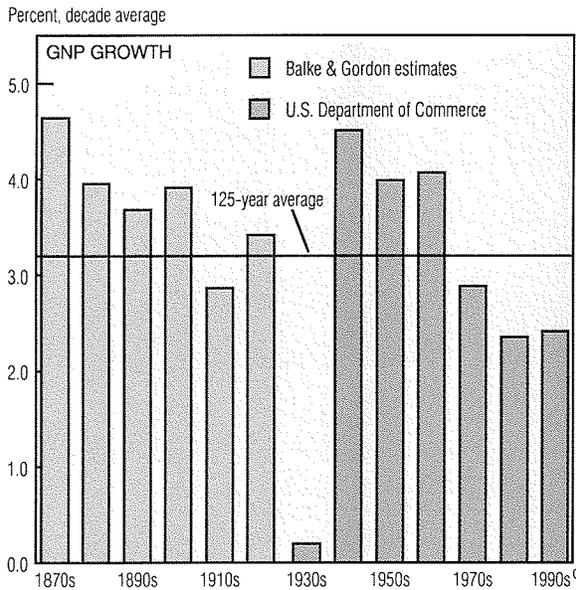
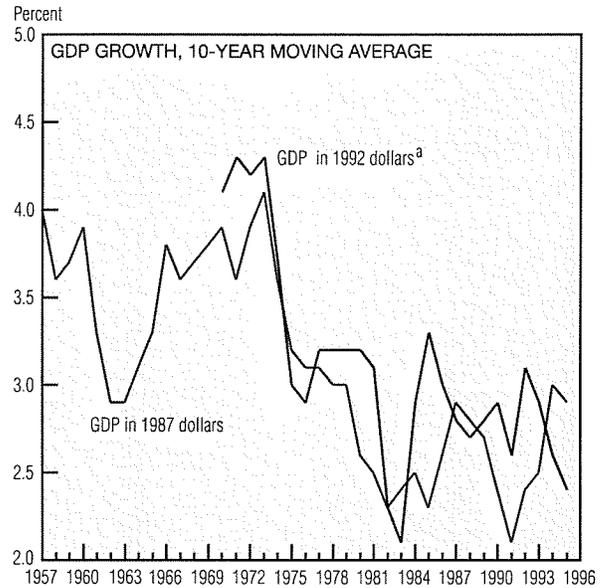
The manufacturing slowdown

continued in January, with industrial production falling 0.6%. Industrial production has remained essentially flat since early 1995. As the year progressed, analysts became concerned about the buildup of inventories, particularly at the manufacturing and wholesale levels. Manufacturers, retailers, and wholesalers have been trimming excess stocks, and their inventory-to-sales ratios have recently declined. It is not clear that further cuts in manufacturers' and wholesalers' inventories are immi-

nent. The purchasing managers' index rose in February after five months of decline, but remains at a level that implies a slowdown in industrial performance. Factory orders increased 0.5% in January, with the gains fairly broad-based across durable and nondurable components. On a year-over-year basis, however, orders remain weak. Order backlogs rose sharply in January.

Economic Growth

Real Gross Domestic Product (Percent change, annual rate)		
	GDP 1987	GDP 1992 ^a
1948-1959	3.7	n.a.
1960-1969	4.1	4.6
1970-1979	2.9	3.2
1980-1989	2.5	2.8
1990-1995	2.3	1.8
1948-1995	3.2	n.a.
1961-1995	3.2	3.2
Peak to peak ^b	2.8	1.3



a. Chain-weighted. GDP series begins in 1960.
 b. Average growth as measured from business cycle peak to business cycle peak.
 c. Data end in 1994.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Nathan S. Balke and Robert J. Gordon, "The Estimation of Prewar Gross National Product: Methodology and New Evidence," *Journal of Political Economy*, vol. 97, no. 1 (February 1995), pp. 38-92.

Economic growth exhibits both a cyclical pattern and a long-term trend. Over a generation, small changes in the trend rate of output growth can have important implications for the standard of living. Consequently, economists worry as much about the trend rate of output growth as about the business cycle. During the 1970s and the 1980s, trend economic growth appeared to slow, and questions have emerged about what constitutes a sustainable long-term growth rate.

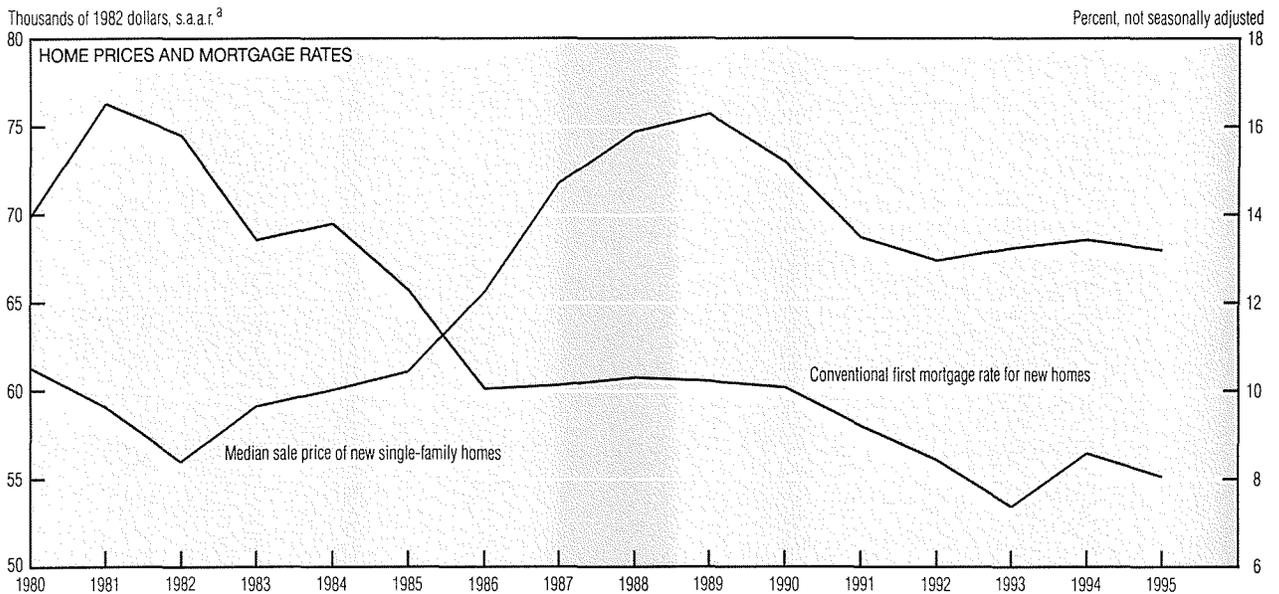
One measure relates potential output to the full use of the economy's major inputs (labor and capital), allowing technological progress to filter through productivity growth. Most of the results of this measure suggest that a sustainable rate of output growth is roughly 2.0%-2.5%. Average peak-to-peak growth often proxies for a potential growth measure. However, measures of potential seem uniformly low relative to actual long-term rates of GDP (or GNP) growth. When measured over

long periods—from 1869, 1947, or 1960—the economy's growth rate averages 3.2%.

Economists attribute long-term growth primarily to increases in employment and educational attainment, expansion of the productive capital stock, and improvements in technology. Another important factor is the expansion of markets, which promotes resource allocation through specialization and encourages technological transfers across nations.

Annual family income	Percent owning family residence	Percent of wealth attributable to housing
Less than \$10,000	38.8	90.3
\$10,000 to \$24,999	54.2	68.5
\$25,000 to \$49,999	68.8	52.0
\$50,000 to \$99,999	84.2	40.5
\$100,000 and over	87.6	17.0

Annual family income (in thousands)	Tax returns			
	Percent itemized	Percent with mortgage deductions	Tax saving (millions)	Percent of total tax saving
Below \$10	0.7	0.1	\$47	0.1
\$10 to \$19	3.5	1.6	\$173	0.3
\$20 to \$29	9.9	6.6	\$685	1.2
\$30 to \$39	21.0	16.0	\$1,919	3.3
\$40 to \$49	34.2	28.1	\$3,270	5.6
\$50 to \$74	55.7	48.1	\$11,005	18.9
\$75 to \$99	79.0	71.5	\$12,253	21.0
\$100 to \$199	89.7	77.8	\$16,359	28.0
\$200 and over	93.7	82.5	\$12,624	21.6



a. Seasonally adjusted annual rate.
 SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development; Board of Governors of the Federal Reserve System; 1992 Survey of Consumer Finances; and U.S. Congress, Joint Committee on Taxation.

Recent calls for simplifying the U.S. tax code have sparked heated debate about the relative merits of consumption-based taxes and flat tax rates. A particular concern in those debates is removal of the mortgage interest deduction, which many fear will depress housing prices.

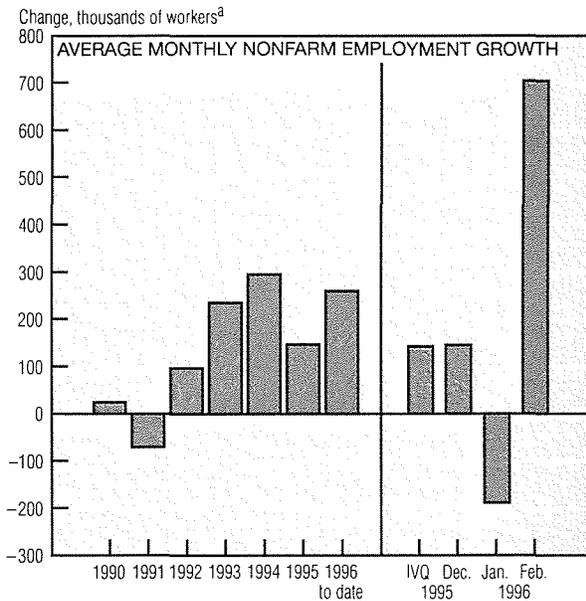
Home ownership rises with income. Almost 40% of families making less than \$10,000 a year own their own homes, compared to 84%

of those earning more than \$50,000. However, nearly all the wealth of families earning less than \$10,000 is in their homes, while housing accounts for only 40% of the wealth of families earning over \$50,000.

Very few families in the lower income categories benefit from the interest deduction, because few itemize on their income tax returns. For families who do itemize, however, the overall effect on wealth also depends on how the tax revision affects prices of both housing

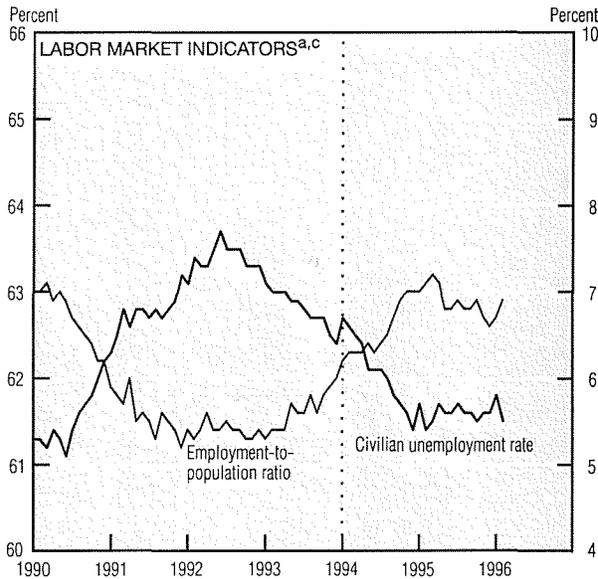
and nonhousing assets. Since housing as a fraction of wealth declines with income, a flat tax system would offset wealth losses to the extent that it causes the value of other assets to rise. Further, the large decrease in marginal income tax rates in 1981 did not depress housing prices, contrary to what might have been expected. Normal fluctuations in the housing market may swamp changes brought on by such revisions in the tax code.

Labor Markets



Labor Market Conditions (Seasonally adjusted)

	Average monthly change (thousands of employees)				
	1995			1996	
	Year	IVQ	Dec.	Jan.	Feb.
Payroll employment	144	142	145	-188	705
Goods-producing	-5	6	39	-59	153
Manufacturing	-14	-5	35	-75	26
Construction	11	12	2	17	121
Service-producing	149	136	106	-129	552
Services	93	67	63	-44	287
Business services	26	19	34	-31	126
Retail trade	19	27	-8	-60	166
Eating and drinking establishments	8	7	17	-36	62
	Average for period				
Civilian unemployment rate (%)	5.6	5.6	5.6	5.8	5.5
Nonfarm workweek (hours)	34.5	34.4	34.3	33.7	34.5
Mfg. workweek (hours) ^b	41.6	41.4	41.2	39.9	41.6



Duration of Unemployment (Seasonally adjusted)

	Percent of total unemployed persons			
	Less than 5 weeks	5 to 14 weeks	15 to 26 weeks	27 weeks and longer
1995				
September	38.3	30.3	14.3	17.1
October	37.2	31.8	13.7	17.2
November	37.1	32.0	14.2	16.7
December	36.4	32.5	14.5	16.6
1996				
January	36.8	31.9	14.8	16.5
February	37.8	30.9	15.3	16.0

a. Seasonally adjusted.

b. Production and nonsupervisory workers.

c. Vertical line indicates break in data series due to survey redesign.

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

Rarely has employment shown such wide month-to-month swings as in the first two months of 1996. Following January's revised decline of 188,000, nonfarm payrolls soared by 705,000 in February—the largest monthly gain since September 1983, when they rose 1.1 million. Factoring in the December figure brings net job additions to an average rate of 220,000 per month for the past three months.

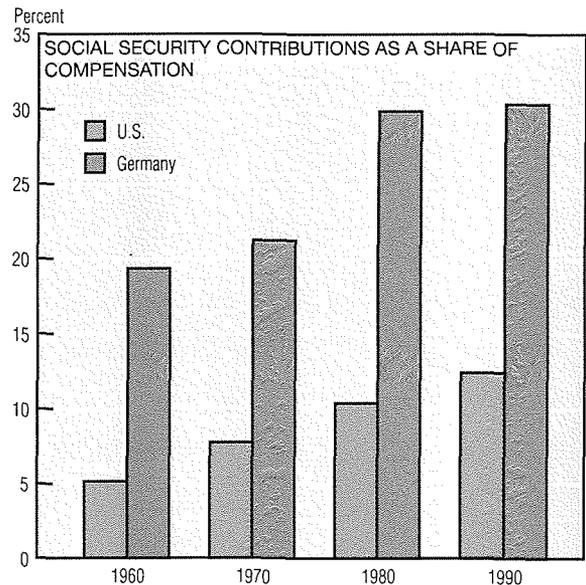
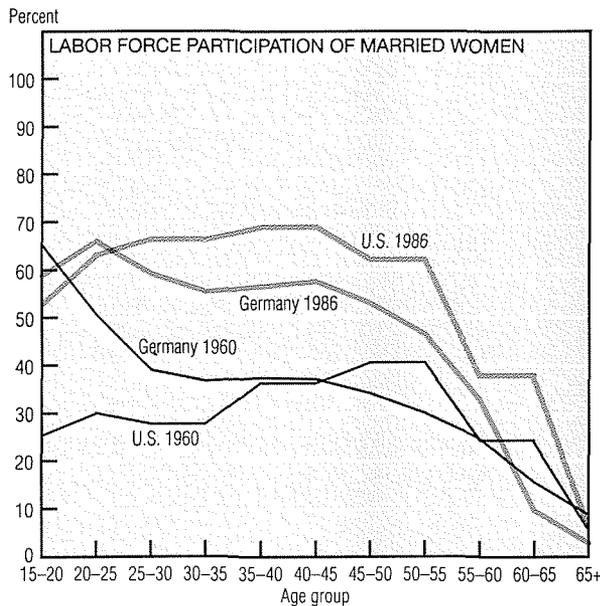
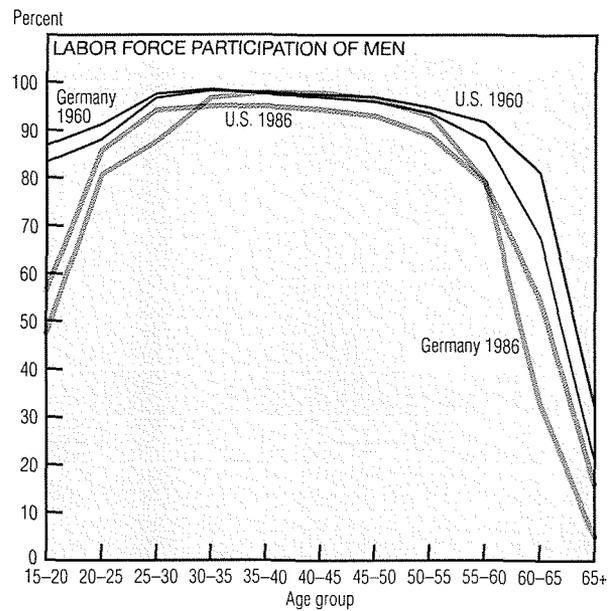
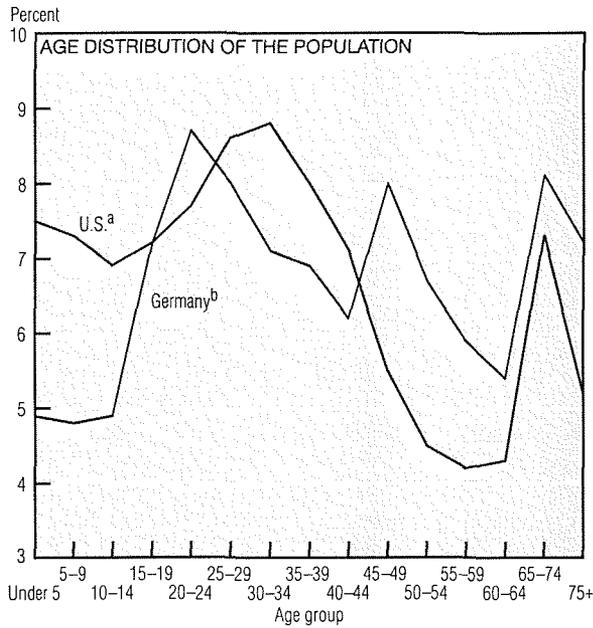
Goods-producing employment rose 153,000, due mostly to a

weather-related rebound in construction, although manufacturing did post a small gain (26,000). The service-producing sector showed a net increase of 552,000 jobs, partly as a result of snapbacks in industries where employment levels had been depressed by January's inclement weather. Almost all of the 166,000-worker gain posted by retail trade occurred in industries where employment changes have been relatively flat (or even negative)—restaurants, bars, and department stores. The narrow services category

turned around last month, gaining 287,000 jobs, about half of them concentrated in business services.

The February unemployment rate pointed to strength in the labor markets, falling to 5.5% from 5.8% in January. The share of long-term joblessness (the proportion of people unemployed for 27 weeks or more) has declined in recent months. Half of all jobless persons currently face an unemployment spell of eight weeks or less, which is relatively short by historical standards.

West German Demographics and Social Security



a. 1990 data.
 b. 1987 data.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of the Treasury; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Organisation for Economic Co-operation and Development; United Nations *Statistical Yearbook*, New York, 1995; and Wolfgang Franz, *Arbeitsmarkt-Ökonomik*. Heidelberg: Springer-Verlag, 1991.

Many U.S. policymakers are worried about the effect of changing demographics on the Social Security system. Because the number of elderly Americans is increasing relative to the number of working-age people who can support them, either benefits must decrease or the Social Security tax must increase if the system is to remain solvent. Both of these options are politically unpopular.

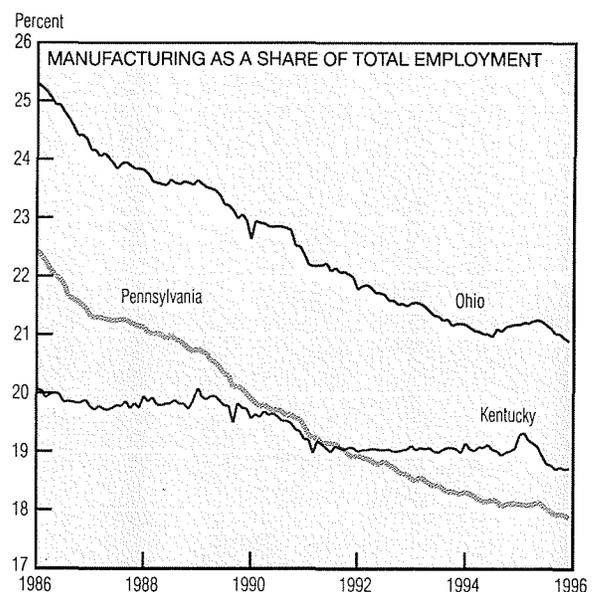
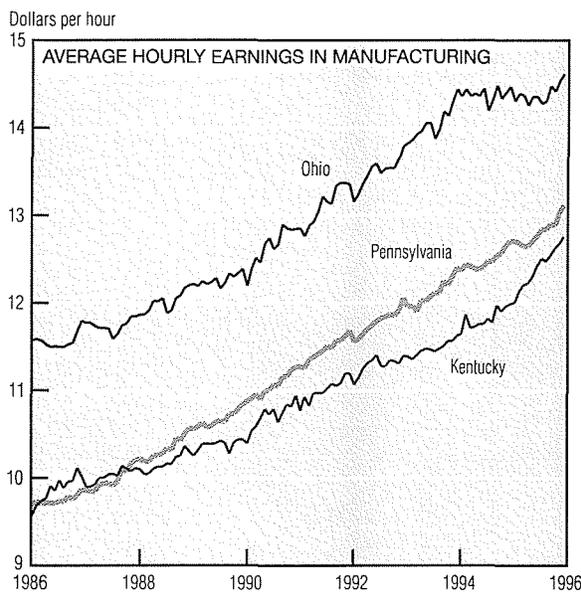
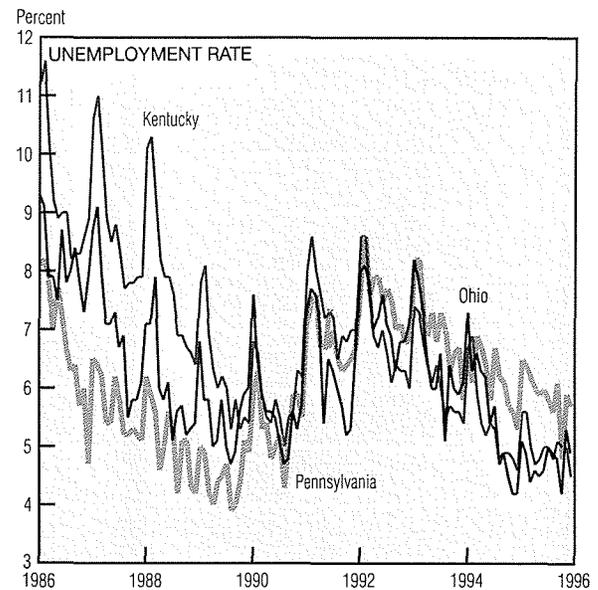
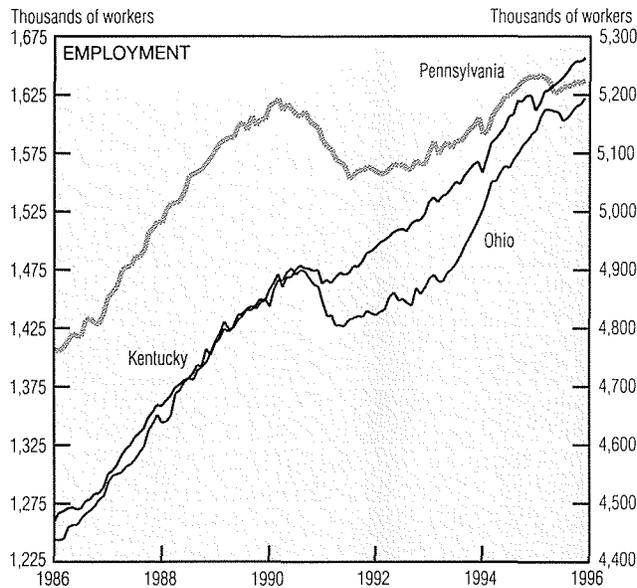
The problems in Germany are similar, but they seem to be accelerating at a faster rate. Because its

population is older than that of the U.S., Germany already has proportionately more elderly citizens to support. Further, because German birth rates are so low, the already high proportion of elderly will continue to increase and will remain above that of the U.S. well into the next half century.

The social security system is more generous in Germany than in the U.S. Indeed, private pension programs represent a small portion of Germans' savings because the public pension is so generous. Moreover, full benefits start at age 61.

Compared to Americans, German men and women leave the labor force at a much earlier age, greatly increasing the ratio of retirees to the working population. Also, because Germany has not experienced the degree of labor force participation among married women that the U.S. has had in recent years, there are relatively fewer workers to tax. So far, the German people have opted to keep their current system. This system comes at a price: Germans pay nearly a third of their labor compensation to fund it.

Regional Conditions



NOTE: All data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Recent labor market trends in Ohio, Kentucky, and Pennsylvania seem to reflect the slowing in national economic activity, but the regional picture—like the national one—is mixed and difficult to interpret.

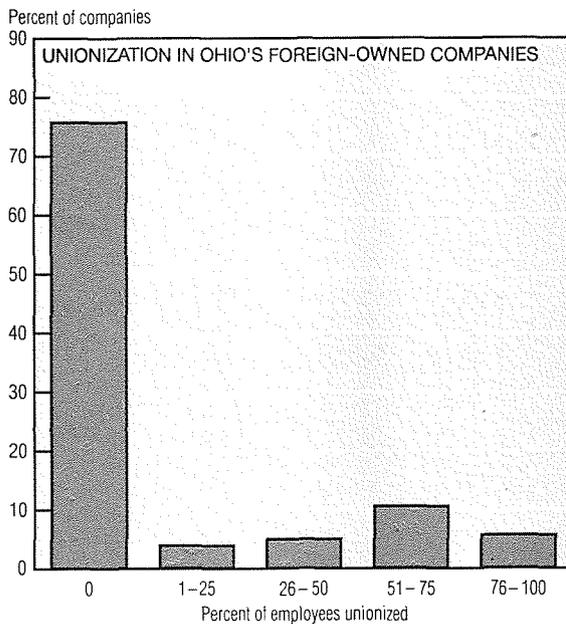
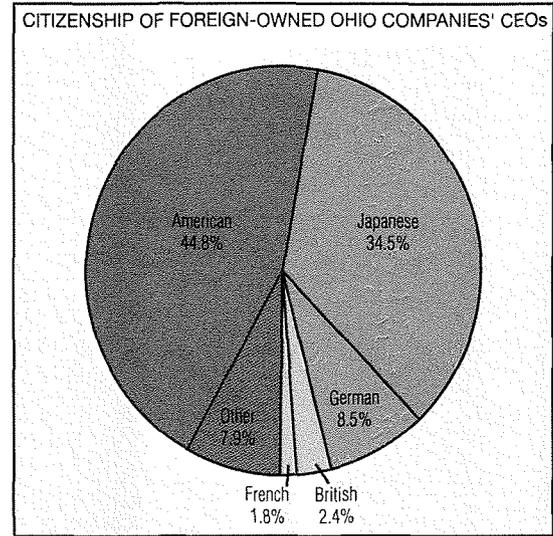
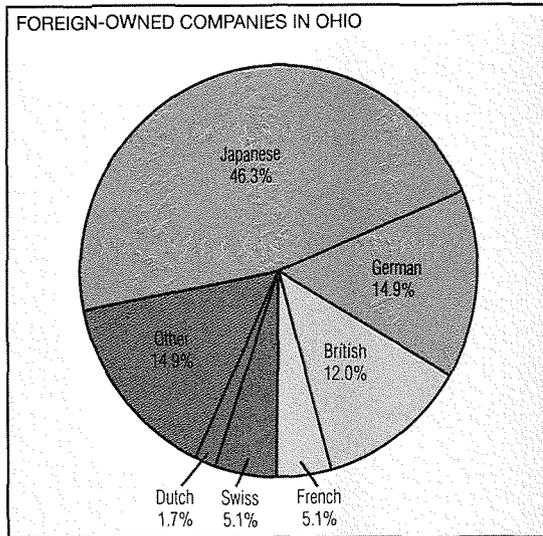
In Kentucky, employment continues to expand briskly. Ohio's employment, which slowed in 1995, has picked up somewhat in recent months, while Pennsylvania's remains below year-ago levels. Slower growth in Ohio and Pennsylvania, however, has not contributed to an

obvious rise in unemployment rates. The current jobless rates in Ohio, Kentucky, and Pennsylvania—4.9%, 4.5%, and 5.7%, respectively—are all low relative to historical averages. Further, many of the seasonal variations that caused wide swings in the states' unemployment rates seem greatly attenuated. Pennsylvania's unemployment is now higher than both Ohio's and Kentucky's, a situation that reverses trends prior to the 1990 recession.

Hourly earnings in manufacturing

provide little evidence of a sustained slowdown. Ohio's nominal earnings growth flattened over the last two years, but the level remains high compared to the other two states. Some unsettling news comes from manufacturing employment, which has fallen in all three states. While this generally follows a longer-term pattern, it is a trend that appeared to have run its course by mid-1994. In Ohio and Kentucky, manufacturing as a share of total employment actually increased during early 1995.

Foreign-Owned Ohio Firms



	All Ohio companies	Foreign-owned Ohio companies
Total exports	\$14.8 billion	\$11.7 million
Total sales	\$75.2 billion	\$57.4 million
Exports as a share of sales	19.8%	20.4%
Percentage of exports going to parent country	n.a.	49.0%

SOURCES: Milton Wolf, "A Profile of Direct Foreign Investment in Ohio: A Nonparametric Statistical Approach," Case Western Reserve University, Ph.D. thesis, May 1993; and U.S. Department of Commerce, Bureau of the Census.

One consequence of the U.S. current-account deficit since 1982 has been an increase of foreign-owned firms operating in this country. A 1991 survey of about 200 foreign-owned Ohio companies offers some interesting facts. First, the parent company is quite likely to be Japanese, a reflection of the large influx of Japanese investment into the U.S. during the 1980s. Japan accounts for almost half of all foreign companies operating in Ohio, while several European nations make up the rest.

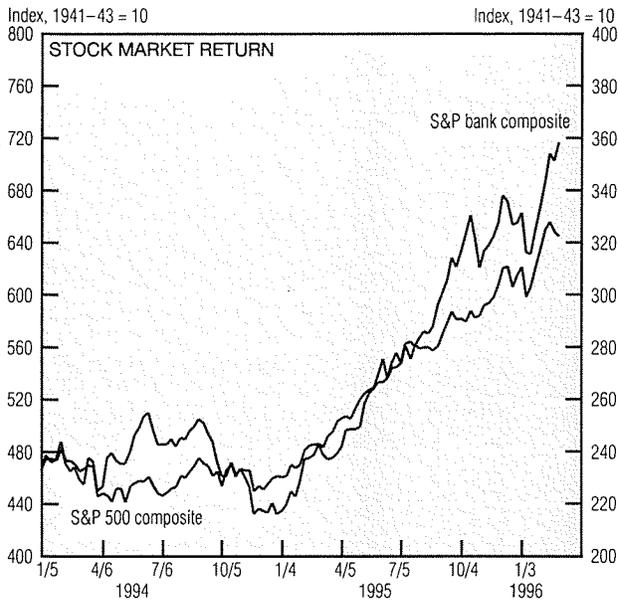
The fact that a local company is

owned abroad does not necessarily mean that control of the operation passes overseas. In nearly half of the cases, the Ohio CEO is an American. Although the Japanese tend to retain more control, there are no Swiss or Dutch CEOs, despite the large extent of the Ohio investment relative to the parent country's GNP.

What are the companies' characteristics? For the most part, they are nonunion. In Ohio's private-sector labor force as a whole, union membership was 21% in 1989, but the vast majority of foreign companies reported a smaller percentage. This

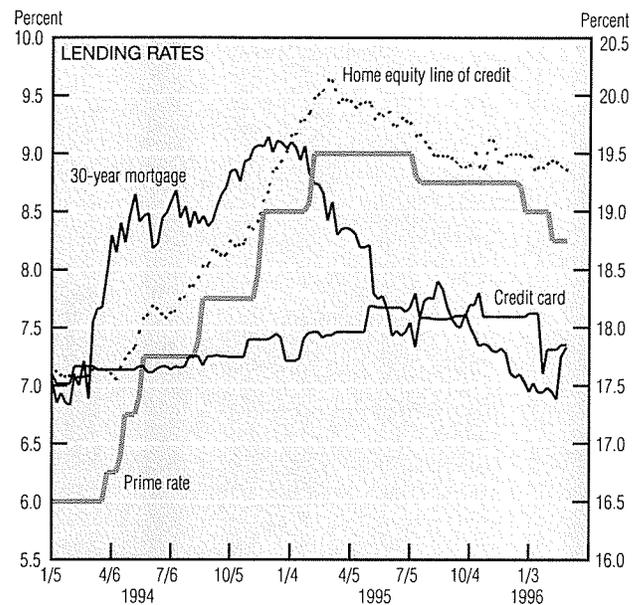
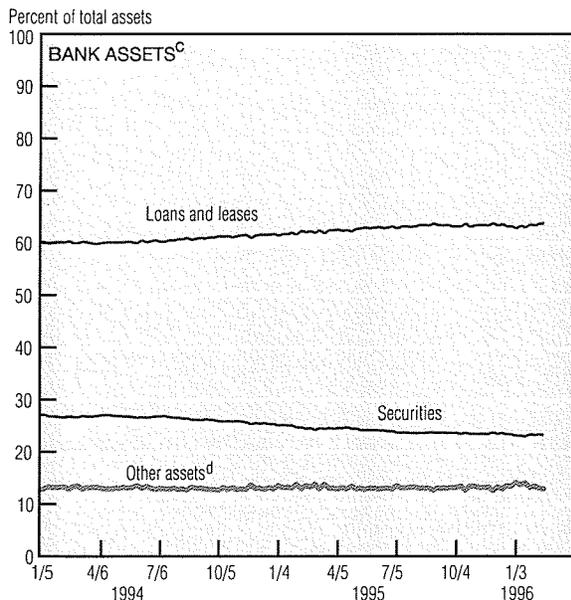
is surprising, because the same survey reported that low union activity was not a major reason for locating the company in Ohio. Foreign-owned companies in Ohio export about the same share of their output as do Ohio companies as a whole. Indeed, much of the export is between Ohio and the company's home country. It is clear that foreign investment offers a method by which the foreign company's goods can be sold in America, but it may also provide a means by which goods made in Ohio are sold in the parent company's country.

Banking Conditions



Selected Bank Performance Indicators^a (Percent)

	1995 ^b	1994
Return on assets	1.19	1.15
Return on equity	14.96	14.61
Net interest margin	4.31	4.36
Net charge-offs to loans	0.45	0.50
Asset growth rate	7.81	8.21



a. Data are for FDIC-insured commercial banks.

b. 1995 data are for the first three quarters of the year and are annualized.

c. Data are for domestically chartered commercial banks in the U.S.

d. Includes interbank loans, cash assets, and all other assets.

SOURCES: Standard & Poor's Corporation; Federal Deposit Insurance Corporation; Board of Governors of the Federal Reserve System; and *Bank Rate Monitor*.

The market return on bank stocks grew at a breakneck pace in 1995, with the Standard & Poor's bank composite index increasing a whopping 52.57% for the year; in comparison, the overall S&P 500 composite index rose 34.86%. Several standard commercial-bank performance indicators also paint a picture of a healthy financial sector. Average return on assets and average return on equity both remain strong, while preliminary data indi-

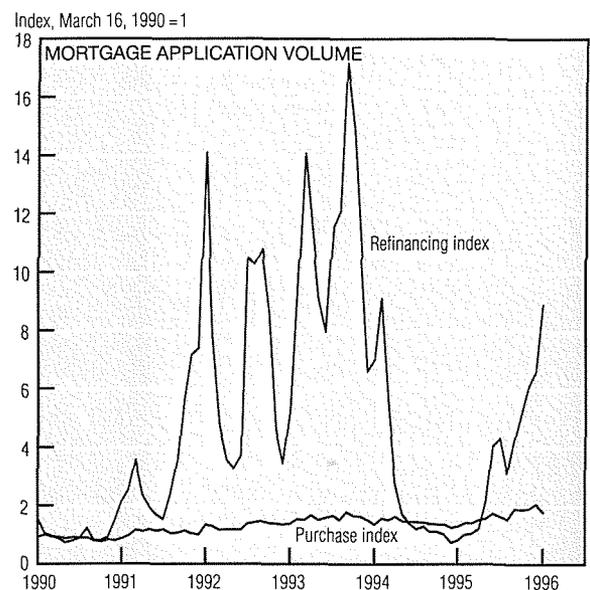
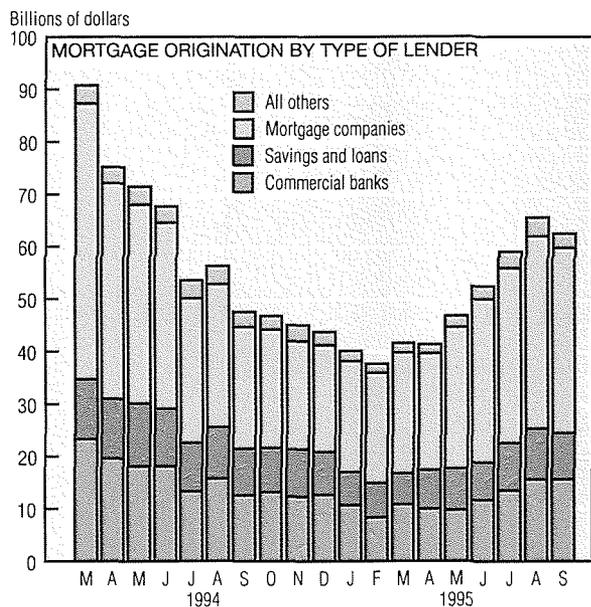
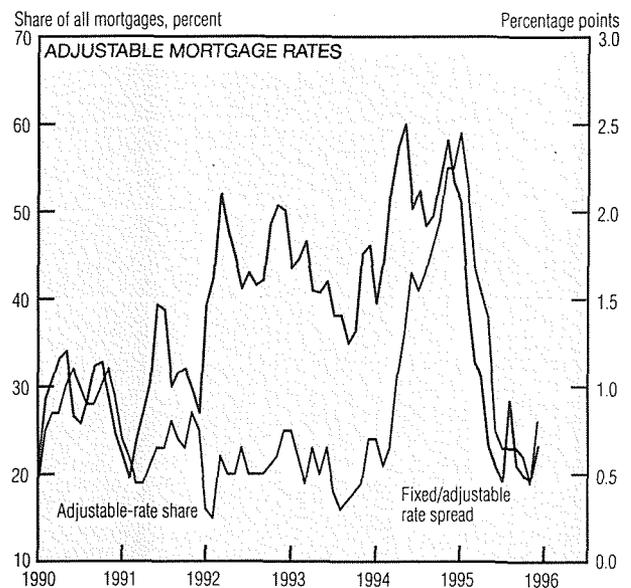
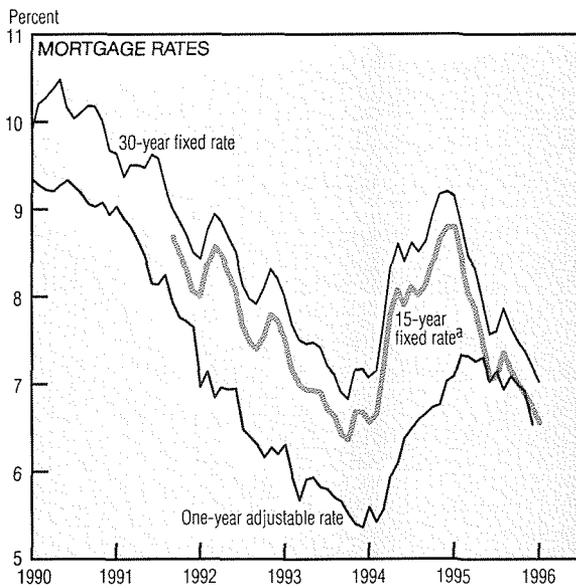
cate that the ratio of net charge-offs to loans fell 10% from 1994. Bank assets continued to expand at a healthy pace, if somewhat more slowly than last year.

This strong performance has come in spite of generally declining interest rates and a falling net interest margin. Following sharp increases throughout 1994, rates on 30-year mortgages and home equity lines of credit both decreased steadily throughout 1995. The prime rate has

also fallen 75 basis points from its February 1995 high of 9%. As is typical, credit card rates have remained relatively steady.

These lower rates have contributed to strong loan growth, with net loans and leases expanding 12.3% between the third quarters of 1994 and 1995. As a result, the composition of bank assets has recently shifted toward loans and leases and away from securities and other assets.

Housing Finance



a. The 15-year fixed-rate mortgage index begins in September 1991.
 SOURCES: U.S. Department of the Treasury, Office of Thrift Supervision; U.S. Department of Housing and Urban Development; and Mortgage Bankers Association of America.

Despite the recent jump in 30-year fixed mortgage rates—45 basis points during the last half of February (not shown in chart)—housing finance activity has demonstrated strong growth over the last year. Indeed, the recent rate jumps have generally been viewed as a short-term correction, and most analysts expect rates to continue their downward trend during the next several months. Overall, long-term mortgage rates fell 200 basis points between December 1994 and Decem-

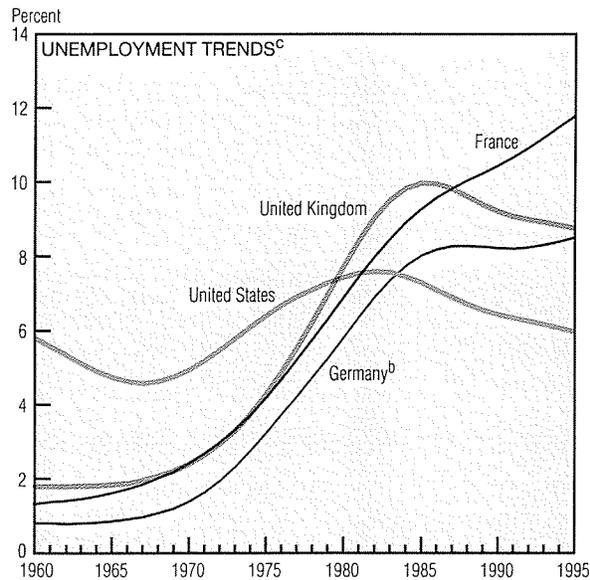
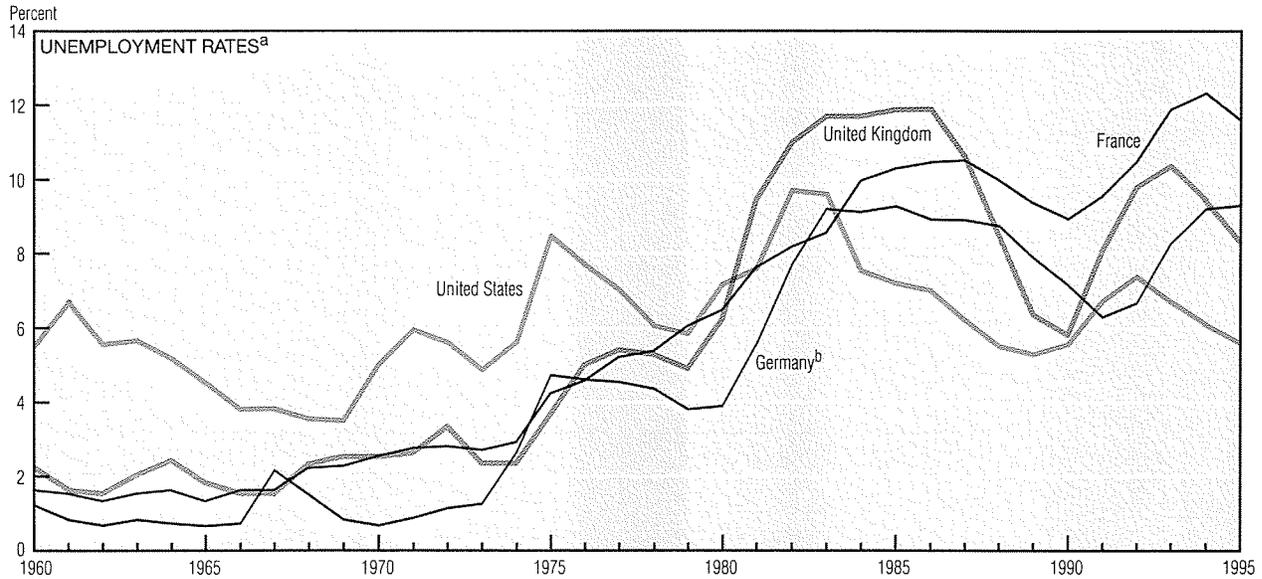
ber 1995, while one-year adjustable rates (ARMs) dropped 49 basis points over the same period.

With these lower rates, mortgage originations increased during the second and third quarters of 1995, reaching levels not seen since the last refinancing boom ended in April 1994. Not surprisingly, the vast majority of these originations were refinancings; the volume of conventional home purchases has been less affected by recent rate movements. With this increased emphasis on refinancings, mortgage compa-

nies have seen their market share increase to the level of early 1994.

Continued low 30-year mortgage rates, as well as the narrower spread between fixed and adjustable rates, have spurred most borrowers to select fixed-rate mortgages (74% of the market in December 1995). Unless fixed mortgage rates rise dramatically or, alternatively, ARM rates drop low enough to widen the fixed/adjustable rate spread considerably, this trend should continue in the near future.

International Developments



Total Growth, 1960-1994 (Percent)^d

	Labor force	Working-age population	Employment
France	34.8	43.3	19.5
Germany	14.8	27.9	8.5
United Kingdom	17.3	15.9	8.4
United States	88.2	67.9	87.1

a. Unemployment rates are as reported by the originating country.

b. All data labeled Germany refer to western Germany.

c. Trends are computed using the Hodrick-Prescott filter.

d. Employment, labor force, and population data have been adjusted by the BLS to approximate U.S. definitions more closely.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Data Resources International.

Since 1960, most European countries' unemployment rates have trended steadily upward, while U.S. unemployment has shown virtually no trend increase. Average 1995 unemployment rates in France, Germany, and the U.K. were 6 to 10 percentage points higher than 1960 rates, while the 1995 jobless rate in the U.S. was roughly equal to the 1960 rate.

Unemployment rates are affected not only by changes in the employment level, but also by fluctuations

in population size and in labor-force participation rates. Rising unemployment rates may reflect lower employment levels with a relatively steady labor-force size. Alternatively, higher unemployment rates may reflect a labor force enlarged by increases in the population or in labor-force participation rates. If increases in employment levels do not keep up with growth in the labor force, unemployment will rise.

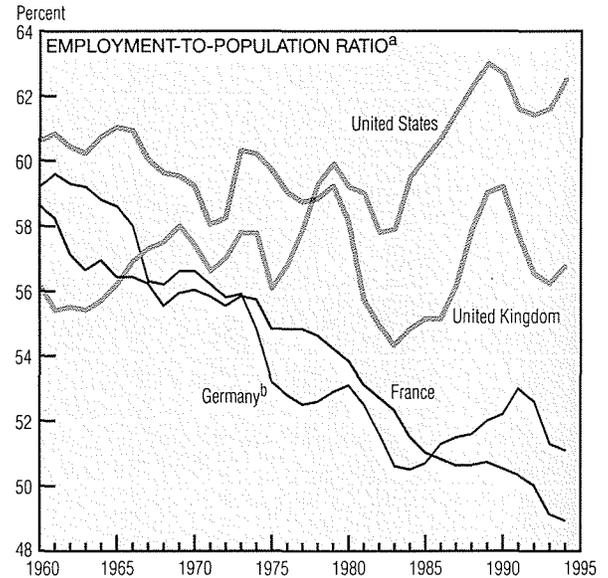
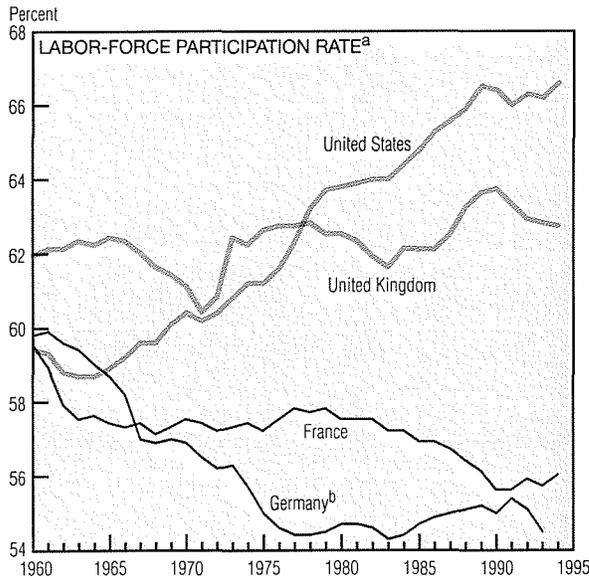
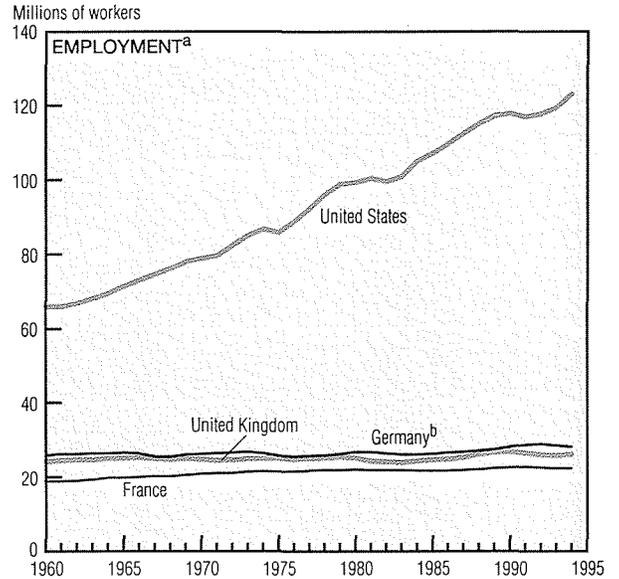
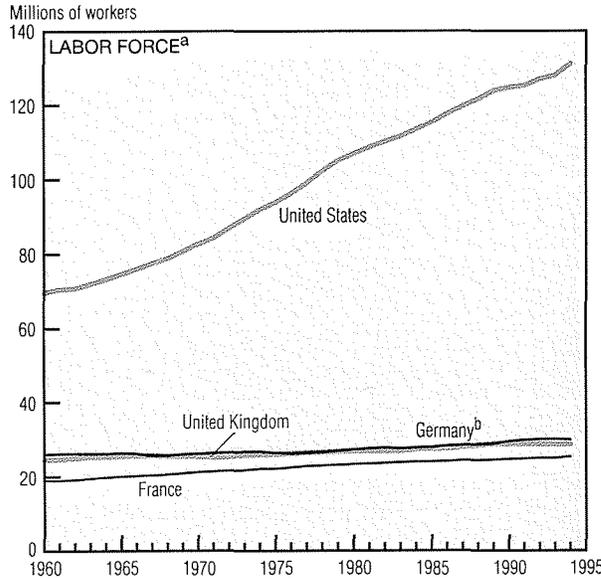
Before looking at the data, then, one might expect to find that coun-

tries with relatively large increases in population or labor-force participation rates would have experienced growing unemployment. In fact, just the opposite is true of the four countries examined here.

Over the 1960 to 1994 period, both the labor-force participation rate and the total population grew substantially more in the U.S. than in France, Germany, or the U.K., resulting in an 88% increase in the U.S. labor force. In comparison, the labor

(continued on next page)

International Developments (cont.)



a. Employment, labor force, and population data have been adjusted by the BLS to approximate U.S. definitions more closely.
 b. All data labeled Germany refer to western Germany.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Data Resources International.

forces of France, Germany, and the U.K. grew by 35%, 15%, and 17%, respectively. Yet the U.S. was the only country without a notable increase in its unemployment rate over the period, reflecting substantially larger employment-level increases than in the three European countries.

The trend in labor market participation rates has differed greatly among these countries. U.S. participation rates have climbed steadily since the early 1960s, increasing by more than 7 percentage points from

1960 through 1994. In contrast, participation rates in Germany and France declined over this period, falling by roughly 5 percentage points and 3 percentage points, respectively, while the U.K. participation rate has increased by less than 1 percentage point.

The trend in employment-to-population ratios has also varied. Germany, France, and the U.K. have seen their employment-to-population ratios fall by 8, 10, and 4 percentage points, respectively.

In comparison, the U.S. posted an increase of roughly 6 percentage points from 1960 to 1994.

Attempts to explain the lack of employment growth in Europe have largely focused on the regulatory environment. Research suggests that labor market regulations like legislated severance payments, plant closing legislation, and advance notice requirements may play a key role in explaining many European countries' disappointing employment growth.