The Economy in Perspective

Are we there yet?... The constant dollar value of goods and services produced in the United States increased for the fifth consecutive year in 1995. By the reckoning of most professional forecasters, the nation's economy will expand further this year and next. If this prediction proves correct, only 2 of the 60 quarters in the 1983–97 period will have recorded outright declines in total output. In real terms, the economy will have produced $7.1 trillion in 1997, a 53% increase over its 1982 level.

Moreover, by most conventional measures, the economy is operating at high levels of resource utilization. Capacity utilization in the goods-producing sector registers close to its average for postwar economic expansions, having recently eased back from even higher rates. Considering the rapid pace of business fixed investment during the past few years, the continued activity of the enlarged capital stock testifies to the strength of demand. Labor markets have also been tight. Although payroll reductions in some large firms have attracted attention, labor demand has been growing. Since the labor force has been expanding only slowly, even moderate increases in labor demand have served to keep pushing the national average unemployment rate down toward 5.5 percent (the 1996:IQ average was 5.6 percent). The ratio of employment to working-age population is near its all-time peak of 63.2 percent.

One remarkable aspect of this expansion has been inflation's extraordinary performance. The inflation trend was negatively sloped during the 1983–95 period, although its actual path was marked by episodic ups and downs. According to the cost-push model that seems to dominate the popular press, economic expansions create a scarcity of resources, which in turn raises material and labor costs. Before long, inflation intensifies. Adherents of this view often prescribe monetary or fiscal restraint, thinking that inflation will slow when the demand for goods and services slackens.

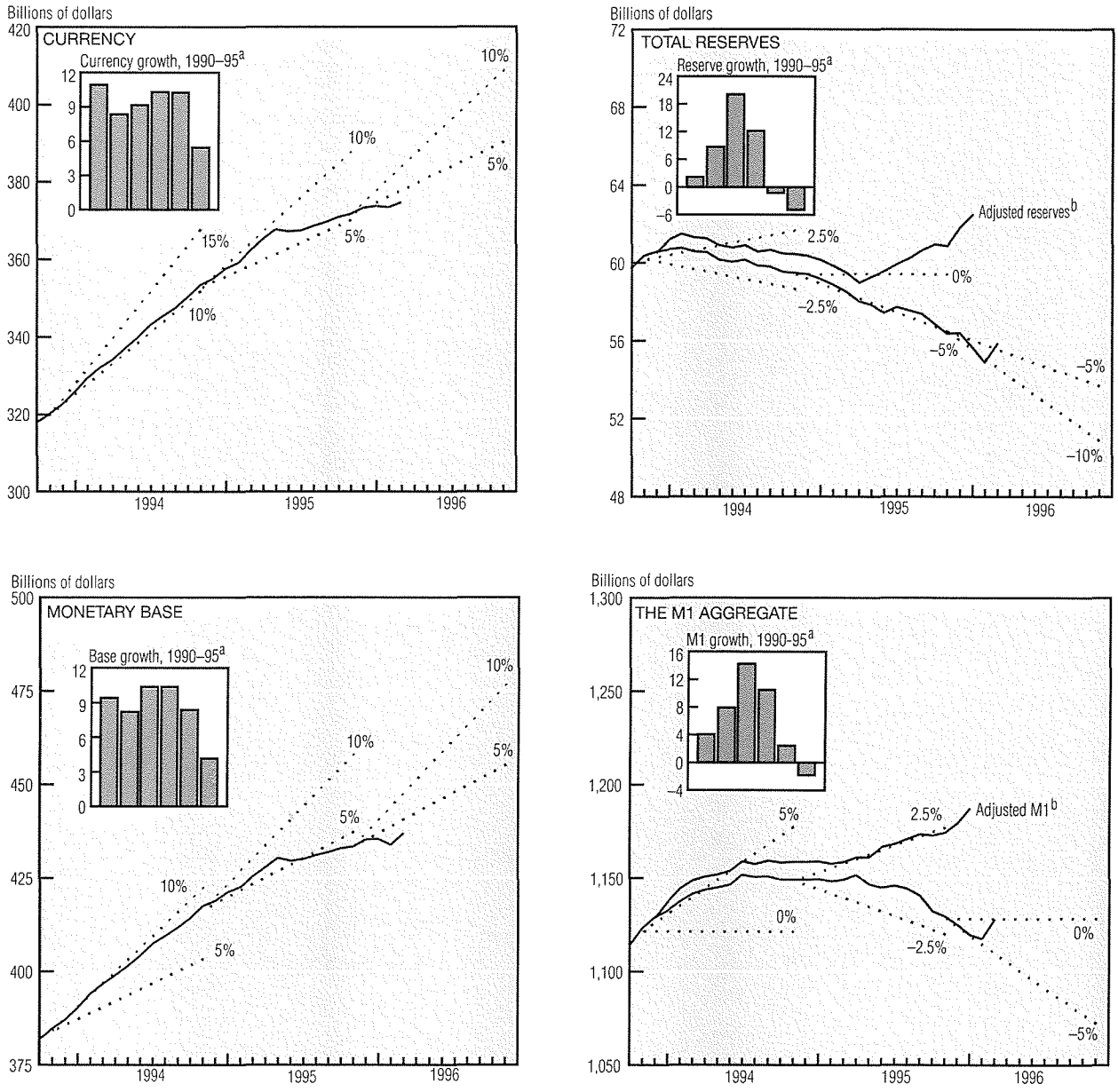
If conventional measures of resource utilization are reasonably accurate, why aren't price pressures in the economy more visible? Does more capacity exist than is readily apparent? Maybe. The concept of physical capacity, though appealing, doesn't easily lend itself to practical measurement. Even relative to 30 years ago, our economy produces a greater proportion of its output in the form of services than goods. Self employment and part-time employment have become more commonplace, increasing labor force flexibility. Innovations in transportation, communication, and information management have changed not only the mix of goods and services, but also the means of their production. Resources can now be obtained more quickly, and from more locations, than at any time in the past. It is by no means clear that we can confidently measure economic capacity. To the extent that increases in demand put upward pressure on prices, individual firms and markets may be more capable of deflecting those forces than ever before.

The dynamics of price-level movements may also differ from those implied by the cost-push model. Inflation—sustained increases in the price level—stems from excessive money creation. Over a few years, the price level may be buffeted by a variety of transitory or even cyclical factors. Over longer periods, however, monetary policy determines the price-level trend. When the money supply grows faster than the rate necessary to complete transactions at current prices, the prices of all goods and services rise to absorb the excess money stock. If the stock of money and its rate of turnover remain fixed, the price level can actually decline as real output expands. In other words, economic growth can proceed, even with a declining aggregate price level, in the presence of a stable monetary policy. (Such an episode occurred in the late 1800s.) Fears that economic growth will necessarily cause inflation are based on an unwarranted extrapolation of the cost-push model, a lack of confidence in monetary policy, or both.

The pace of economic activity ebbs and flows over time within industries, regions, and nations in response to a variety of factors. Greater coordination among households and firms yields less volatile fluctuations. Market economies excel at coordinating plans, and they contain self-equilibrating mechanisms to resolve errors. Serious disruptions to economic expansions are usually the result of unusual events such as oil price shocks, wars, or gross economic policy errors. Economic policies can actually strengthen the coordination process if their fundamental design supports efficient resource allocations and if their objectives are well understood.

In the aftermath of an inflation upheaval during the 1970s, monetary policy has been geared toward restoring a climate of price-level stability. Since 1983, while overall economic growth has generally been quite favorable, inflation has trended gradually downward. The Consumer Price Index (CPI) increased less than 3% in each of the last three years, as economic activity continued to be strong. Goods prices have actually been increasing far more slowly than have services prices (roughly 2 percent versus 3.5 percent annually during the last five years). Using a ballpark estimate of 1 percent as the size of total measurement bias in the CPI, and noting the already low rate of change in goods prices, it is easy to see why people increasingly indicate that inflation is no longer a factor in their economic decisions.

Monetary Policy



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 March 1996. Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

In the past year, the Federal Open Market Committee has thrice voted to lower its key federal funds rate target: from 6% to 5.75% in July, to 5.5% in December, then to 5% in January. The funds rate—the interest rate paid on overnight loans of reserves between banks—represents the key information guiding open-market operations for control of bank reserves. Because reserves are the raw material for the creation of monetary assets by the banking system, their control is the channel through which central bank operations affect the supply of money in the economy.

In essence, the federal funds rate is the price of obtaining reserves. Thus, when demand for reserves exceeds supply, the rate tends to rise, and vice versa. All else being equal, then, maintaining a lower funds-rate target implies a greater supply of reserves by the monetary authority and, presumably, a more rapid expansion of money.

Of course, all else is not always equal, and blanket interpretations of rising and falling funds-rate targets are ill-advised. Still, the past year's coincidence of falling rates and slow growth or outright declines in the narrow money measures—total reserves, the monetary base, and M1—can't help but be puzzling to most observers.

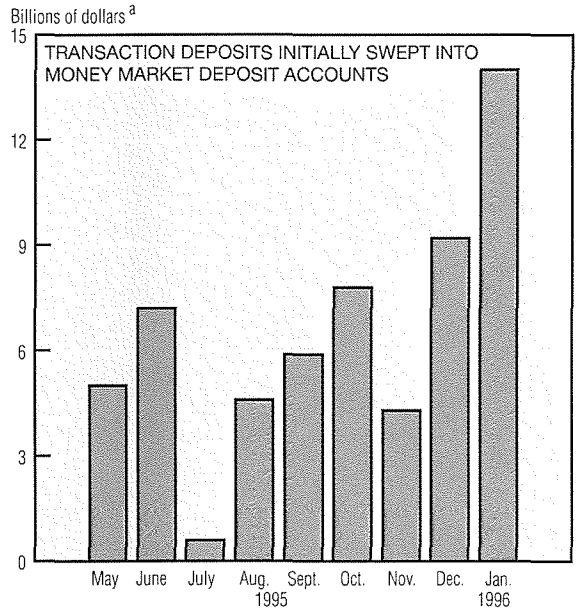
The resolution of the puzzle seems to be found in sweep

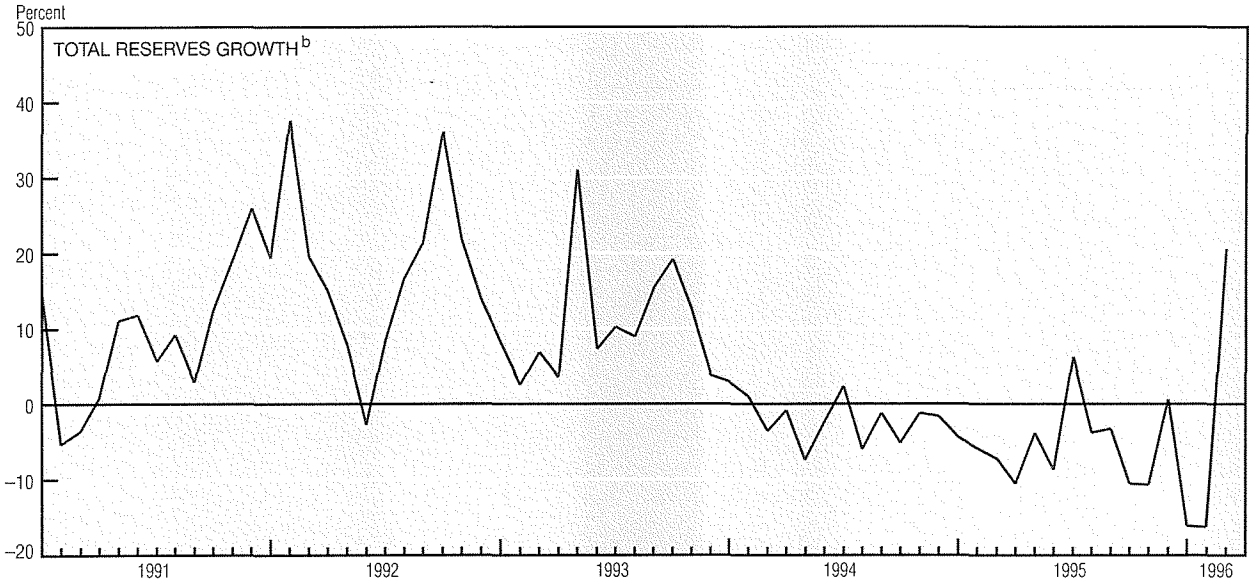
(continued on next page)

Monetary Policy (cont.)

Transaction Deposits Initially Swept into Money Market Deposit Accounts
(Billions of dollars[a])

	Quarterly averages	Cumulative total
1994:IQ	7.5	7.5
1994:IIQ	0.0	7.5
1994:IIIQ	1.5	9.0
1994:IVQ	0.9	9.9
1995:IQ	0.0	9.9
1995:IIQ	12.2	22.1
1995:IIIQ	11.1	33.2
1995:IVQ	21.3	54.5
January 1996	14.0	68.5





a. Not seasonally adjusted.
b. Last plot is estimated for March 1996.
SOURCE: Board of Governors of the Federal Reserve System.

accounts. Created to help banks economize on the reserves that are required to support demand deposits, these accounts involve the very short-term "sweeping" of checkable deposits into money market deposit accounts. These activities are essentially invisible to the households that own checkable deposits, and so have little impact on true transaction balances. However, sweep activities can, and apparently do, significantly depress reserves and other narrow money measures.

Sweep accounts began appearing on the monetary radar screen in 1994 and have grown in importance since then. From the first quarter of 1994 through the fourth quarter of 1995, the cumulative total of transaction deposits initially swept into money market deposit accounts has risen more than sevenfold. At the same time, the disparity between narrow-money growth rates before and after adjusting for sweeps has increased. Throughout most of 1995, unadjusted total reserves and unadjusted M1 actually declined, while adjusted measures grew.

These circumstances suggest potentially large changes in the way we "read" monetary developments. Attendant to any such changes is the question of how these developments alter the central bank's ability to exercise monetary control.

Fortunately, there is thus far little evidence that the sweep account

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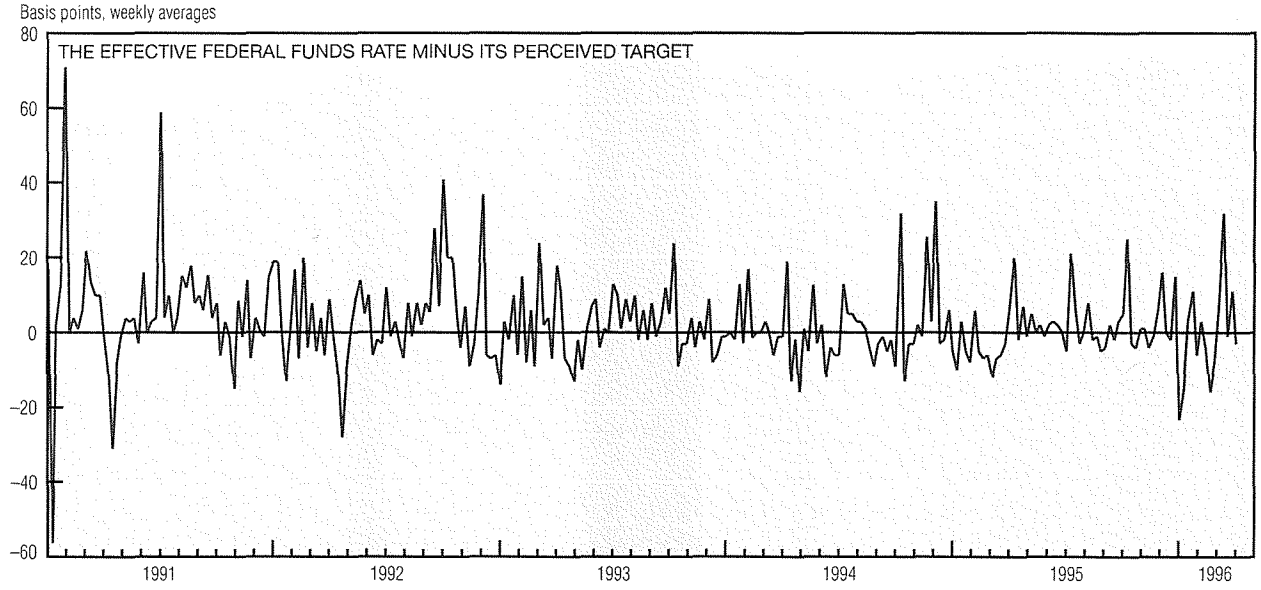
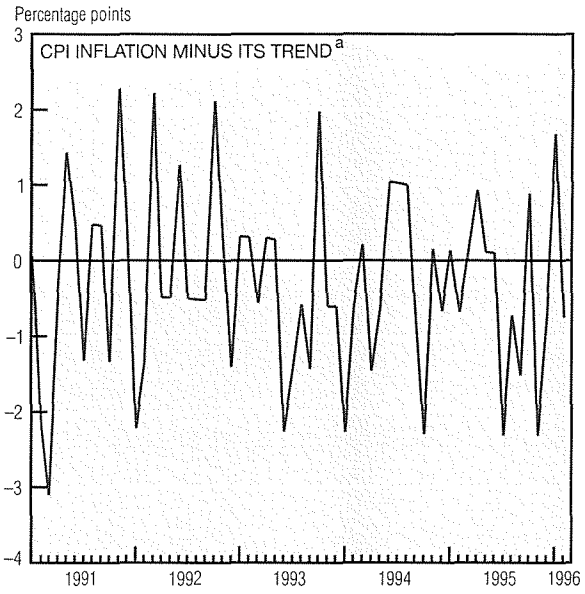
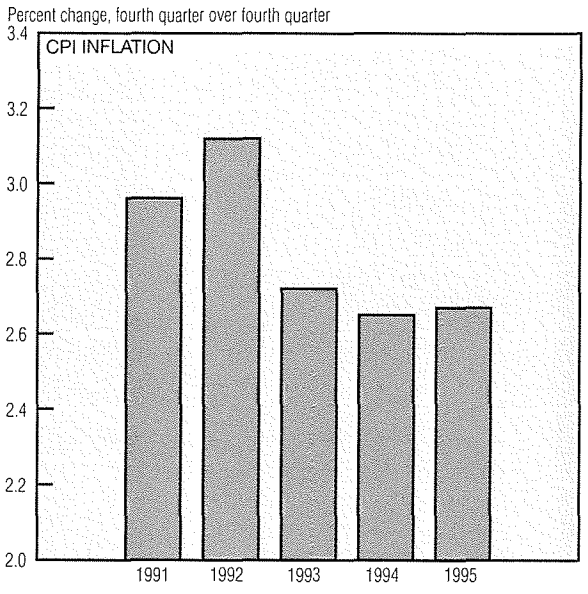
Monetary Policy (cont.)







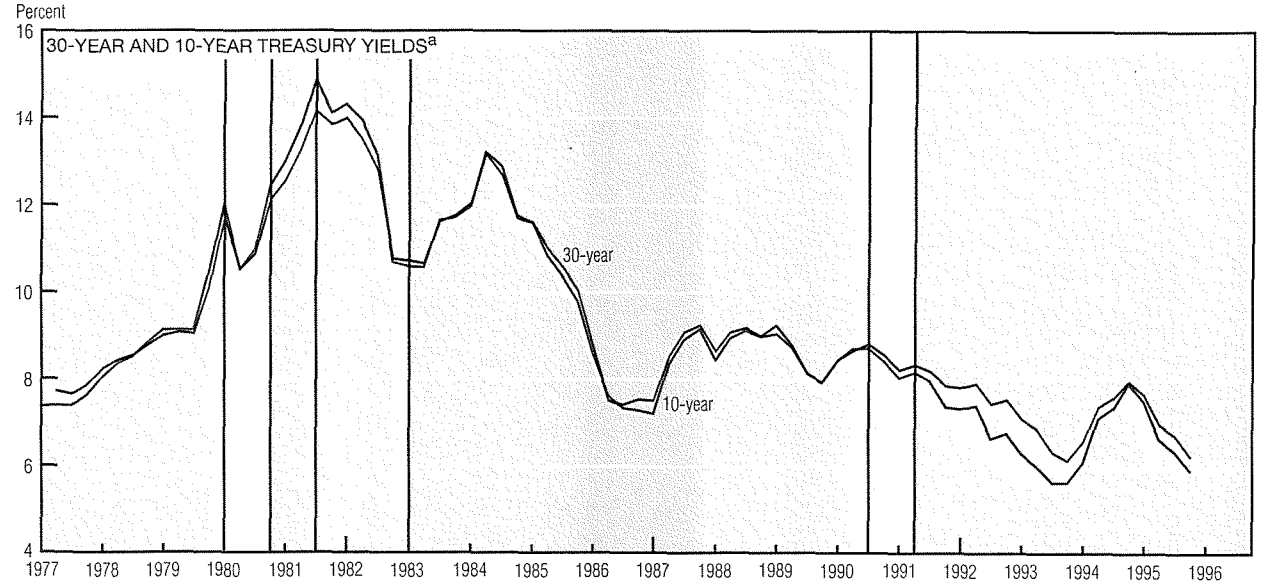
a. Trend CPI inflation is defined using median CPI breakpoints.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and Board of Governors of the Federal Reserve System.

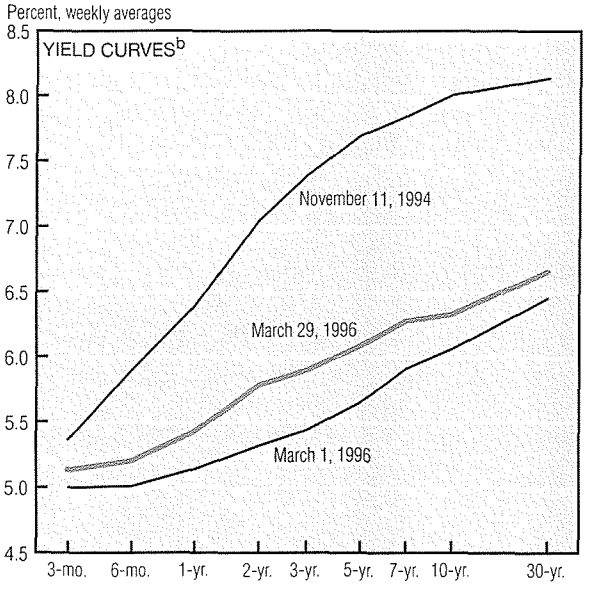
phenomenon has substantially affected the key aspects of monetary operations. Although the level of total reserves has certainly been altered by sweep activities, the volatility of reserves appears unchanged. Similarly, the variability of the federal funds rate about the announced or perceived targets has not been greater in the two years since sweeps were introduced than it was in the two years before their creation. In fact, the standard deviation of the rate from implied targets in the 1991–93 period was actually greater than deviations from the target in the period since the first quarter of 1994.

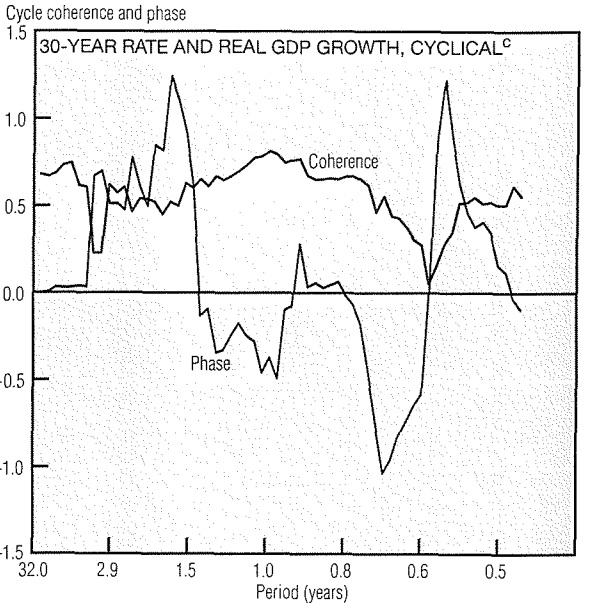
The funds rate is, of course, not an end in itself. The same can be said of monetary growth. They are merely instruments for the conduct of monetary policy, the ultimate aim of which involves broader macroeconomic performance. Price-level or inflation outcomes are particularly important. There can be little solace in the fact that financial market developments like sweep accounts do not much affect the central bank's ability to control, say, the federal funds rate, if at the same time inflation rises or becomes significantly more volatile.

Fortunately, there is again no evidence of unusual monetary policy behavior in the period since the beginning of 1994. Inflation has been roughly constant for three years running, as has been the standard deviation about trend. In this important respect, the introduction of sweep accounts has been a nonevent.

Interest Rates







a. Shaded bars indicate recessions.
b. Three-month and six-month instruments are quoted from the secondary market on a yield basis; all other instruments are constant-maturity series.
c. Coherence measures the correlation at each frequency; its values range from 0 to 1. Phase measures the leads and lags between cycles. A positive or negative value indicates that interest rates lead or lag real growth, respectively. Larger positive or negative phase values imply longer leads or lags.
SOURCES: Board of Governors of the Federal Reserve System; and U.S. Department of Commerce, Bureau of Economic Analysis.

In recent weeks, the yield curve (particularly the long end) has shifted upward. Good news for the economy is often deemed bad news for long-term bonds, since robust growth leads bond prices to fall and interest rates to rise. Do long-term interest rates show such a cyclical pattern? A look at the relation between 10- and 30-year bonds and recessions since 1977 indicates that interest rates rose prior to each recession and then fell during each downturn. The economy's cyclical peak, which corresponds to the onset of the recession, also coincides with the peak in interest rates. On the other hand, interest rates sometimes increase in a recession, and often rise and fall in a recovery.

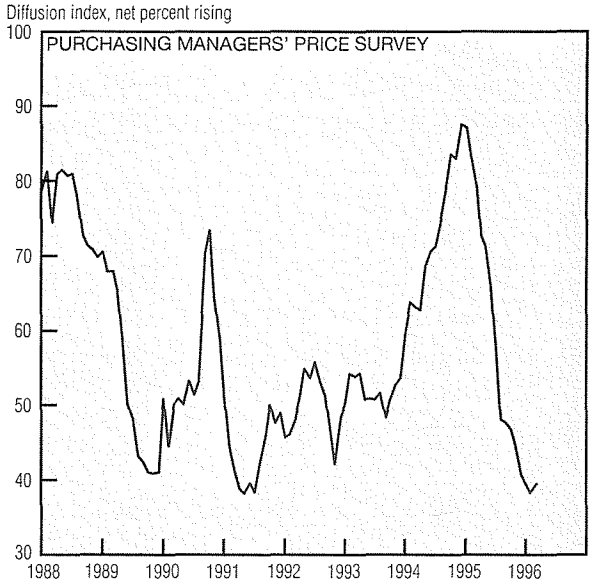
A closer look at the cyclical relation between real GDP growth and 30-year interest rates supports this. We can think of interest rates and the real economy as being composed of cycles of many frequencies, from a daily one (because markets close at night) to weekly and seasonal frequencies, to business cycles of three to five years, to longer-term secular variation. The relation between interest rates and real GDP then varies with the period of the cycle.

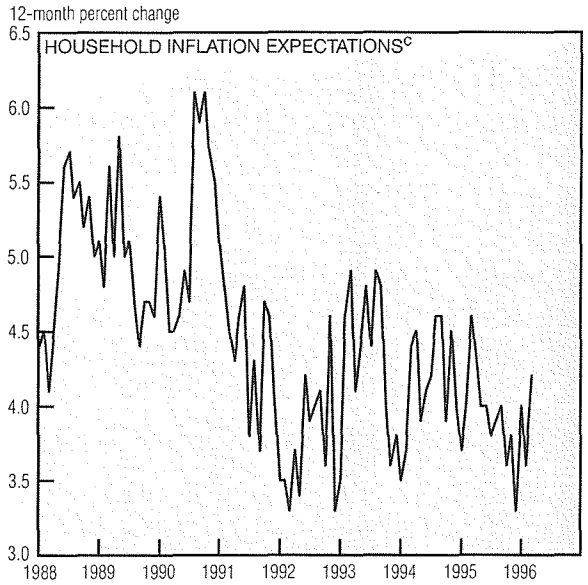
Coherence measures the degree of correlation at each frequency. The lower right chart indicates high coherence (that is, comovement) in the three- to five-year range and in the range around one year. *Phase* measures whether one cycle leads or lags the other. During business cycles, interest rates tend to lead, rising and falling before real growth does.

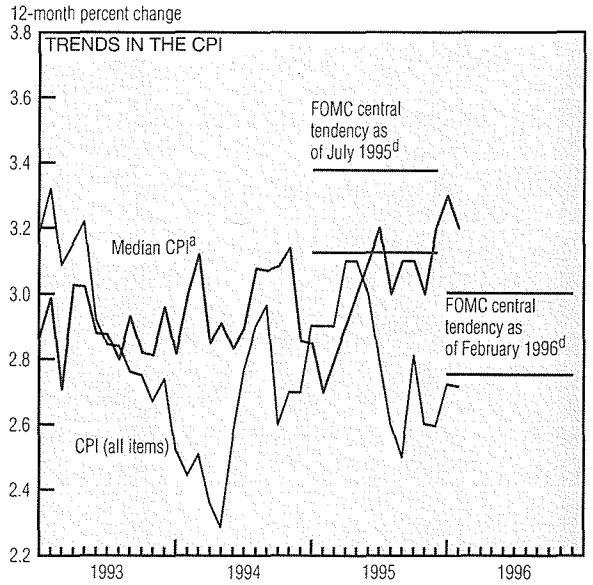
Inflation and Prices

February Price Statistics

	Annualized percent change, last: 1 mo.	12 mo.	5 yr.	1995 average
Consumer Prices				
All items	2.4	2.7	2.8	2.6
Less food and energy	3.0	2.9	3.2	3.0
Median[a]	2.2	3.2	3.1	3.2
Producer Prices				
Finished goods	–1.8	2.0	1.3	2.1
Less food and energy	0.9	2.0	1.7	2.5
Commodity futures prices[b]	30.3	6.3	3.1	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. Mean expected 12-month change in consumer prices as measured by the University of Michigan's Survey of Consumers.
d. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.
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; and the University of Michigan.

Taken as a whole, the inflation indicators were fairly benign in February. Producer prices for finished goods actually fell at an annualized rate of 1.8%. Even after factoring out declining food and energy prices, the Producer Price Index advanced just 0.9% at an annualized rate. Indeed, survey data from purchasing managers continue to suggest only slight price pressure from industry: Just 10% of respondents reported higher prices in March.

At the retail level, the Consumer Price Index (CPI) rose 2.4% in February. Its core measures, the CPI less food and energy and the median CPI, increased 3.0% and 2.2%, respectively, both under their five-year trend growth rates.

One negative sign in recent months has been a small upturn in household inflation expectations. According to the University of Michigan's Survey of Consumers, the public's outlook for inflation over the next 12 months is back above 4%—its highest reading in about a year. However, according to the Federal Open Market Committee (FOMC), the chief policymaking arm of the Federal Reserve, consumer price increases are expected to hold in the 2¾% to 3% range, a bit below the inflation rate indicated by the core consumer price measures in 1995.

Economists generally concur that monetary authorities ultimately determine the purchasing power of their nations' money stock—the inflation trend. In a very rough sense,

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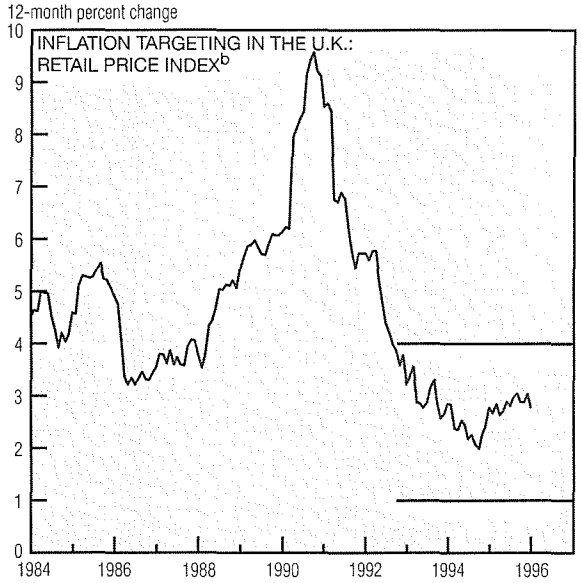
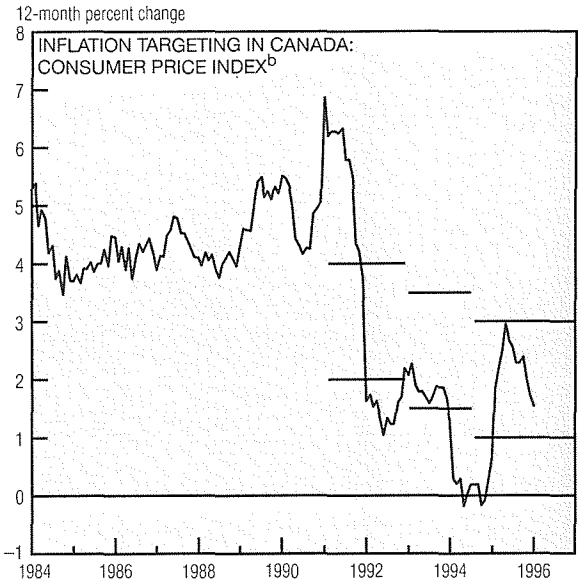
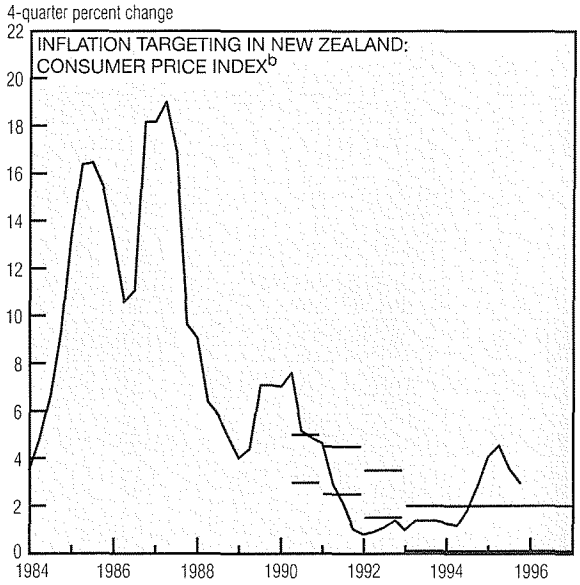
Inflation and Prices (cont.)

Inflation Objectives in Selected Countries

Country	Objective[a]	Exemption
Australia	2% to 3%	Mortgage interest, government controlled prices, energy prices
Canada	1% to 3%	Indirect taxes, food, energy
Finland	About 2%	Housing prices, indirect taxes, government subsidies
Israel	8% to 11%	None
New Zealand	0% to 2%	Interest and credit charges, commodity prices, government controlled prices
Sweden	1% to 3%	None
U.K.	1% to 4%	Mortgage interest







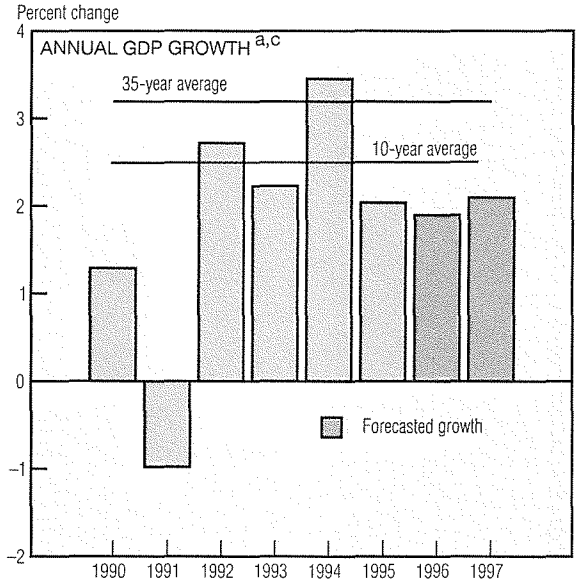
a. Objectives are based on CPI-measured inflation with the exception of the United Kingdom, which uses a retail price index.
b. Bars represent upper and lower bounds of each country's stated inflation objective.
SOURCES: International Monetary Fund; and J. Ammer and R.T. Freeman, "Inflation Targeting in the 1990s: The Experiences of New Zealand, Canada, and the United Kingdom," *Journal of Economics and Business,* vol. 47, no. 2 (May 1995), pp. 165–92.

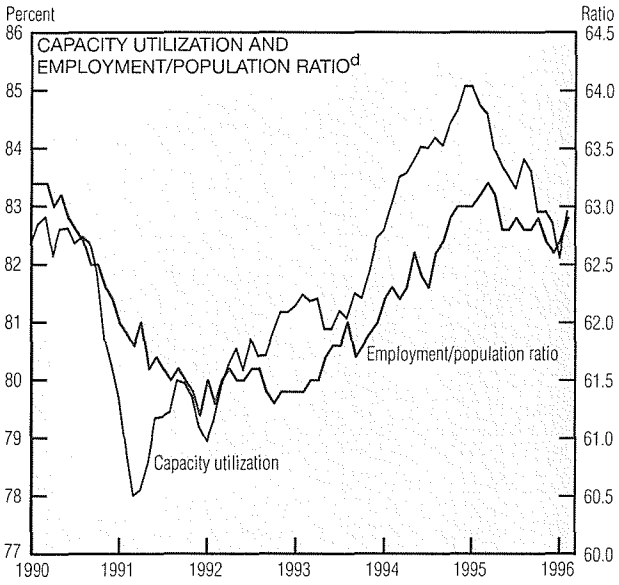
then, the FOMC's annual inflation projections might be considered the inflation *objectives* of the U.S. central bank. However, lags in the transmission between monetary policy and inflation are presumed to be considerably longer than the Committee's year-ahead projections. Moreover, in establishing its policies, the Federal Reserve now considers multiple goals. Perhaps chief among them is the state of the economy, as revealed by such indicators as the growth rate of real GDP or the unemployment rate. The FOMC's inflation projections are thus considerably less than a commitment by the Federal Reserve to achieve a particular inflation outcome.

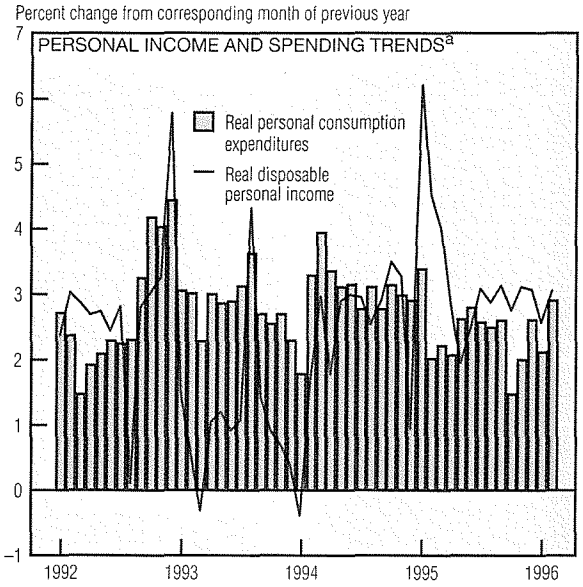
Recently, however, a number of foreign central banks have begun to establish *specific* inflation objectives for their monetary authorities. For example, Canada, Finland, New Zealand, Sweden, and the U.K. have all instituted official inflation targets in the past five years. In each case, the central bank has chosen to target the trend growth in core consumer prices within a specified range. The U.K. has established one of the least ambitious targets, holding the trend in retail prices less mortgage interest within a fairly wide 1% to 4% band. The Bank of Canada targets its CPI less food, energy, and indirect taxes. Currently, the Canadian inflation target is between 1% and 3%, down from a 2% to 4% range in the early 1990s. Perhaps most rigorous is New Zealand's objective, which hopes to hold core consumer prices within a tight 0% to 2% range.

Real GDP and Components, 1995:IVQ[a]
(Final estimate, s.a.a.r.[b])

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	8.2	0.5	1.3
Consumer spending	13.7	1.2	2.0
Durables	0.4	0.3	1.8
Nondurables	−1.2	−0.3	1.1
Services	14.1	2.2	2.6
Business fixed investment	5.6	3.1	6.7
Equipment	5.3	4.0	7.3
Structures	0.4	0.9	5.0
Residential investment	4.1	6.4	−1.4
Government spending	−13.2	−4.1	−1.3
National defense	−10.0	−12.0	−6.6
Net exports	17.7	—	—
Exports	20.7	11.1	6.5
Imports	3.0	1.3	4.6
Change in business inventories	−16.7	—	—







a. Chain-weighted data in 1992 dollars.
b. Seasonally adjusted annual rate.
c. 1996 and 1997 estimates are from *Blue Chip Economic Indicators,* March 10, 1996.
d. Seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and *Blue Chip Economic Indicators.*

Winter's recession fears have melted away, but forecasted growth rates—approximately 2% this year and next—remain below historic norms. Many economists, however, regard this rate as compatible with sustained expansion in an economy operating at high levels of industrial capacity and employment.

Downward adjustments in business fixed investment, smaller inventory accumulation, and higher imports pared real GDP growth in 1995:IVQ to 0.5% from 0.9%. The revisions, however, included higher estimates of consumer spending. Real GDP grew 2.0% for all of 1995.

The outlook for consumers is cautiously optimistic. Real disposable income increased 3.1% in February and supported a rise in real personal consumption expenditures. With income generally growing faster than consumption last year, consumers were able to improve their balance sheets. Household financial net worth showed a sharp rise, largely on the strength of equity market gains (see page 10). Overall consumer confidence, which sagged in late 1995, seems to be recovering. Estimates suggest that real retail

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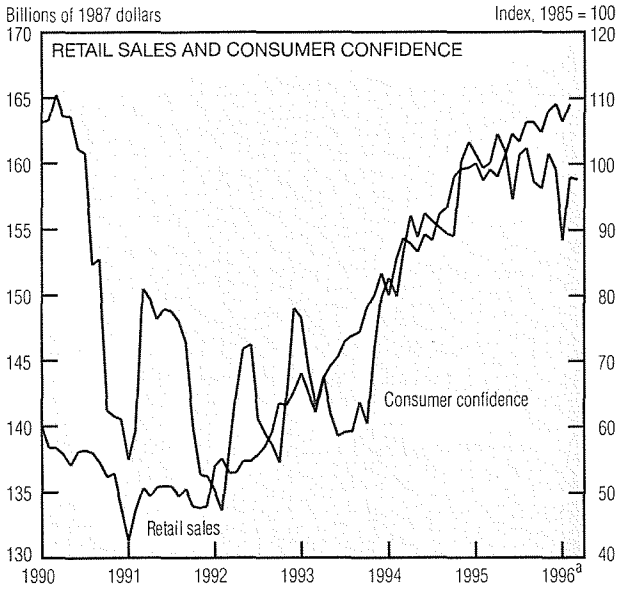
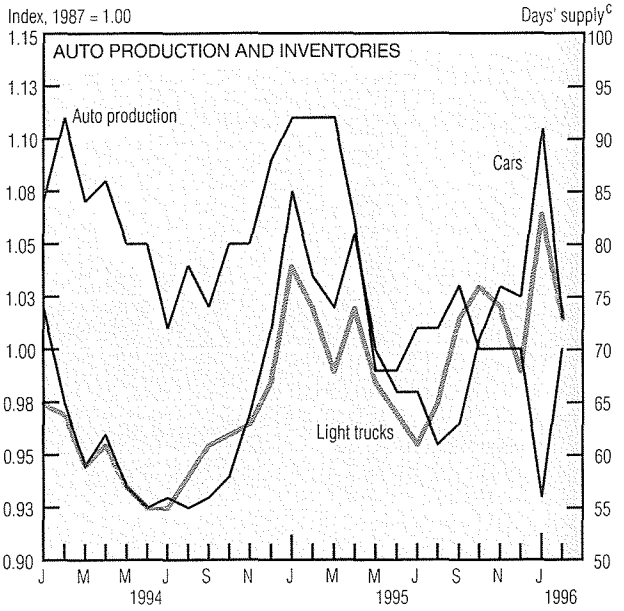
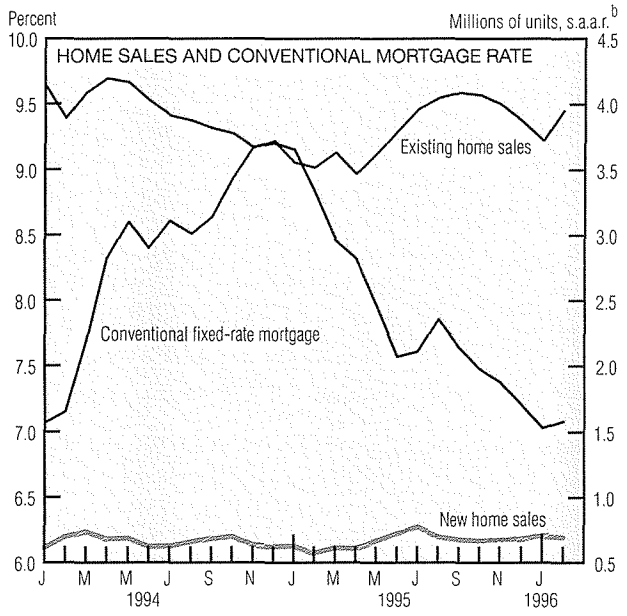
Economic Activity (cont.)



Industrial Production
(Percent change, s.a.a.r.[b])

	Dec. 1994–Dec. 1995	1995:IIIQ–1995:IVQ	Dec. 1995–Feb. 1996
Total index	1.5	0.6	5.0
Consumer goods	0.4	–0.6	–0.5
Durable	–0.9	3.6	–7.4
Nondurable	0.8	–1.5	1.6
Business equipment	4.5	0.2	23.2
Defense and space equipment	–9.1	–16.1	–1.9
Intermediate products	–0.1	1.5	0.0
Materials	2.4	2.0	4.3





a. February data are estimated by deflating nominal retail sales by the Consumer Price Index for commodities.
b. Seasonally adjusted annual rate.
c. 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 and Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; The Conference Board; Board of Governors of the Federal Reserve System; the National Association of Realtors; the Federal Home Loan Mortgage Corporation; and *Ward's Automotive Reports*.

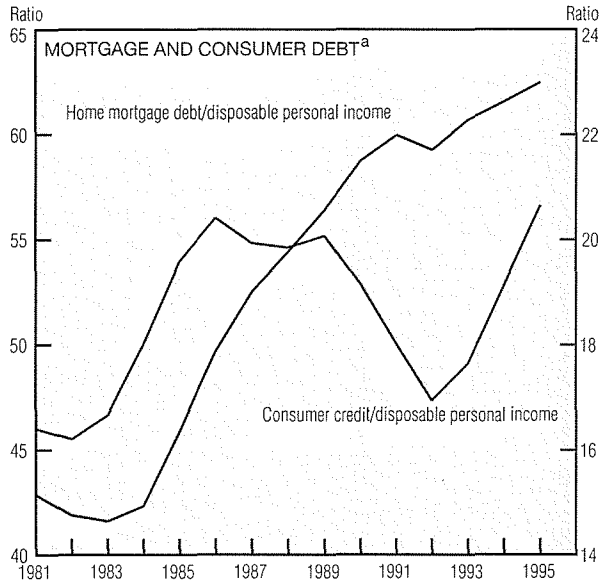
sales rose 0.8% in February.

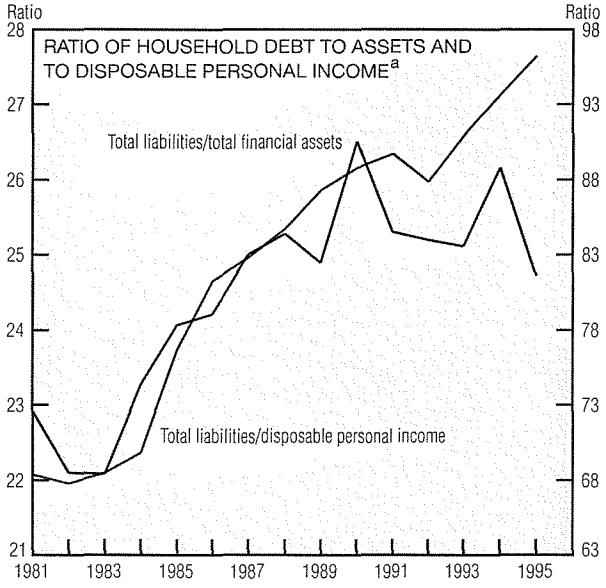
Industrial production surged in February, with growth in many categories offsetting January declines. Strong gains in the production of business equipment have led the index since December, but could diminish during the year if businesses follow through with plans to trim capital spending. The General Motors strike, which ended on March 22, will have some short-term ripple effects on output, but should have no lasting impact on the pace of economic activity.

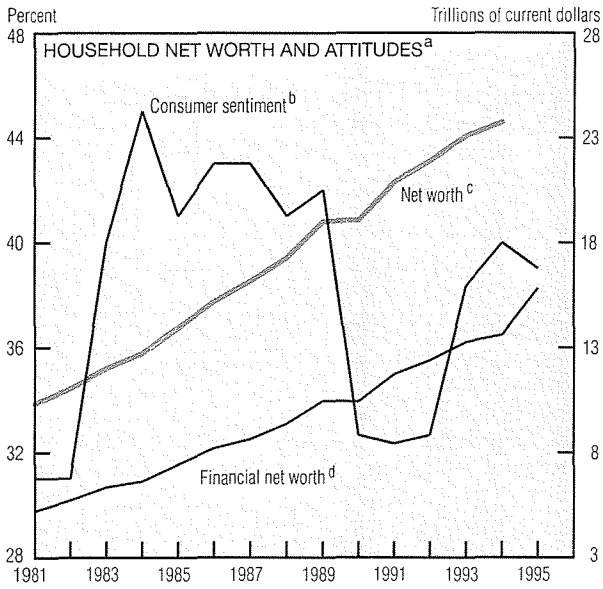
Sales of light vehicles (at 15.8 million units) advanced 7.8% in February from year-ago levels, and the industry trimmed its inventories and increased production. Although production remains relatively weak, it could get a boost in April from strike-related inventory reductions in March.

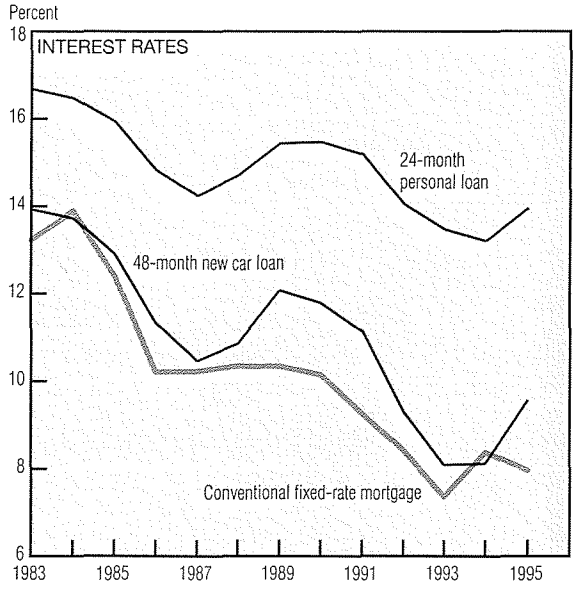
New home sales fell 1.3% in February following three consecutive monthly gains. All of the decline was concentrated in the Midwest. Sales of existing homes jumped 6.5%, however—the first increase since September. Housing starts continued to rise in February. Although multi-unit housing starts improved, high vacancy rates seem to be holding them at low levels.

The Household Balance Sheet









a. All data are measured at end of year.
b. Percent of respondents reporting that their current financial position is better than their position last year.
c. Includes tangible assets. Latest available data are for 1994.
d. Total financial assets less total liabilities.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Federal Home Loan Mortgage Corporation; and the University of Michigan.

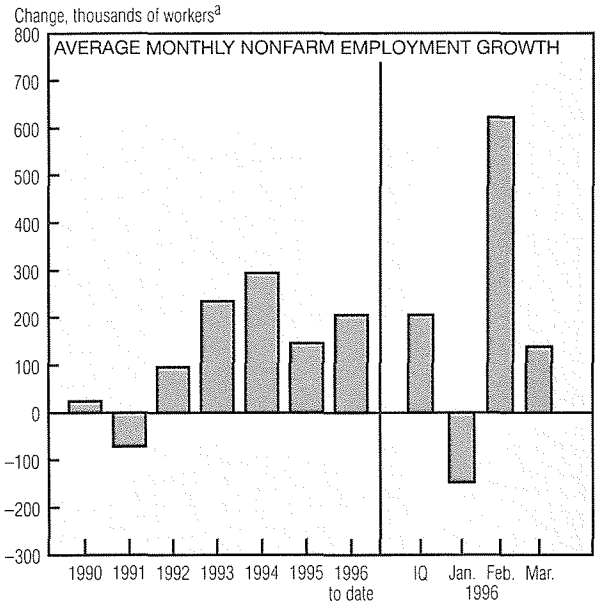
Consumer debt as a share of income, which has risen sharply since 1992, has reached a historic peak. This development—together with a more gradual rise in the ratio of mortgage debt to income—has increased concerns that debt-burdened consumers might soon retrench and hinder the expansion. Though reasonable, such fears seem largely indifferent to historic consumer-debt patterns and to developments on the asset side of the household ledger.

In the short run, the household sector's ability to service its debts depends on the amount of debt relative to household income and assets. The debt-to-income ratio, however, has been rising for at least the past 45 years—a trend more reflective of financial innovation and credit availability than the profligacy of consumers. The current cyclical increase does not appear exceptionally rapid compared to its pace in the previous expansion. The overall growth of household assets, moreover, has exceeded the growth of liabilities. Primarily due to a rise in equities, household debt-to-asset ratios fell in 1995.

In the long term, the household sector's ability to pay off its debts depends on its solvency, or net worth. Last year, financial net worth (less tangible assets) rose sharply.

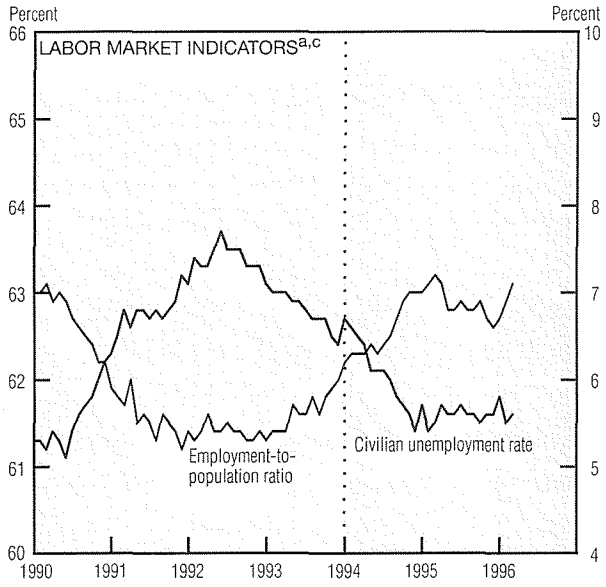
The delinquency rate for consumer loans increased in 1995, but remains low. The uptick in interest rates on standard consumer loans could increase the difficulty of servicing them. Nevertheless, serious consumer liquidity problems are not imminent.

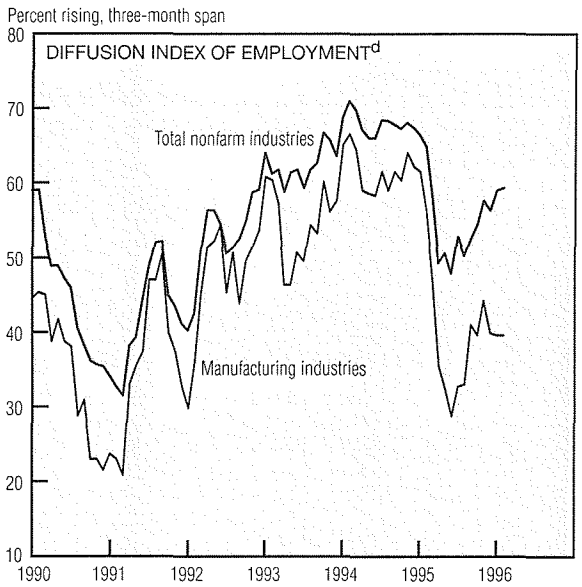
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
	1995	1996			
	Year	IQ	Jan.	Feb.	Mar.
Payroll employment	144	206	–146	624	140
Goods-producing	–5	6	–57	146	–72
Manufacturing	–14	–36	–72	27	–62
Motor vehicles	0	–13	–8	2	–33
Construction	11	39	17	114	–13
Service-producing	149	200	–89	478	212
Services	93	126	–16	263	131
Health services	24	24	5	37	30
Government	9	8	–37	36	25
	Average for period				
Civilian unemployment rate (%)	5.6	5.6	5.8	5.5	5.6
Nonfarm workweek (hours)	34.5	34.3	33.8	34.6	34.5
Mfg. workweek (hours)[b]	41.6	41.0	39.9	41.6	41.4





a. Seasonally adjusted.
b. Production and nonsupervisory workers.
c. Vertical line indicates break in data series due to survey redesign.
d. The diffusion index represents the percent of industries with increasing employment plus one-half of the industries with unchanged employment.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Nonfarm employment moved ahead at a moderate pace in March, rising by 140,000. This latest figure brings average monthly jobs growth to 206,000 for the first quarter of 1996, compared to 142,000 in the fourth quarter of 1995. The total nonfarm and manufacturing diffusion indexes have reversed their downward paths, signaling that a growing number of industries have been reporting employment gains over the past few months.

Net declines in both construction and manufacturing led to a 72,000-worker drop in the goods-producing sector last month. Manufacturing employment has experienced a downward trend for quite some time, although a strike by GM workers exacerbated last month's decline of 62,000. Service-producing industries added 212,000 workers during March—a fairly robust figure for this sector. This increase was buoyed by an above-average employment rise in the narrow services category (131,000), which stemmed from scattered gains in a number of component industries, including health, business, and computer/data processing services.

The jobless rate remained essentially unchanged last month at 5.6%, while the employment-to-population ratio (the proportion of the working-age population holding a job) once again jumped above the relatively high 63% mark.

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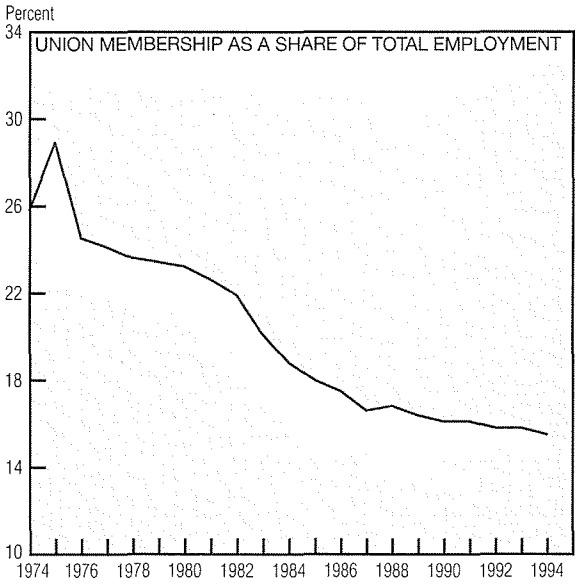
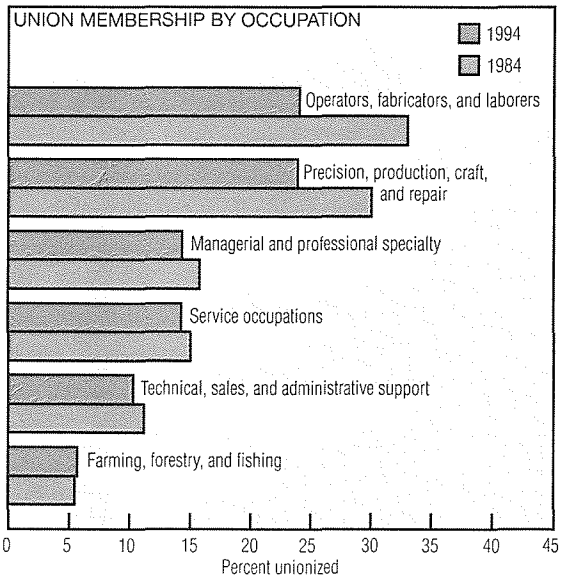
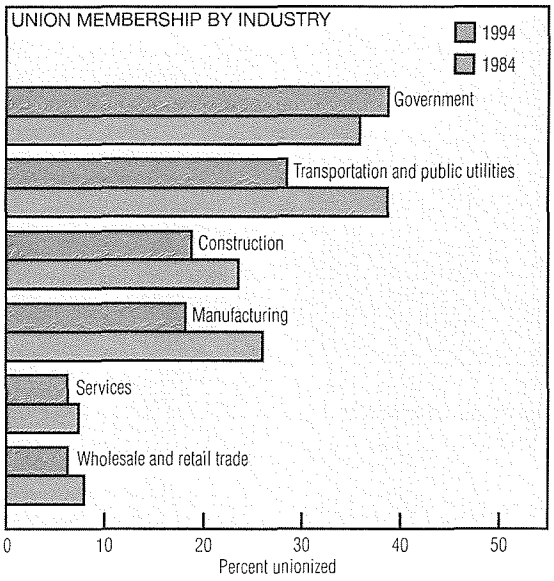
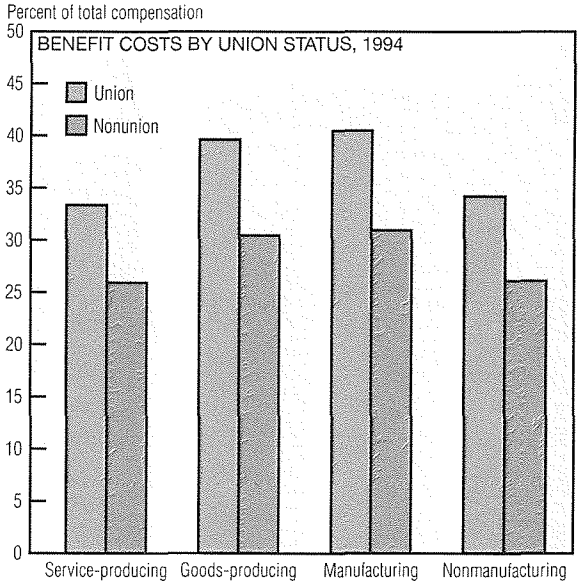
Labor Markets (cont.)









SOURCES: The Bureau of National Affairs, Inc.; and U.S. Department of Labor, Bureau of Labor Statistics.

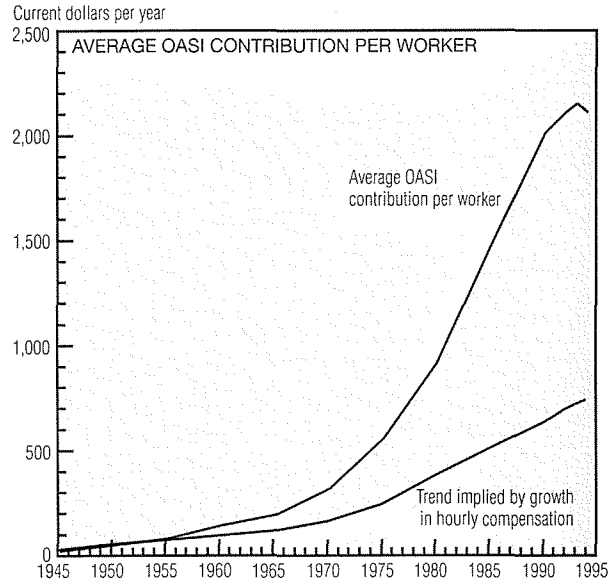
The recent General Motors strike brought the power of unions back into the national spotlight. While the UAW won some concessions in that strike, the overall health of unions is poor. Union membership as a share of total employment has fallen more than 10 percentage points in the past 20 years, reaching a low of 15.5% in 1994.

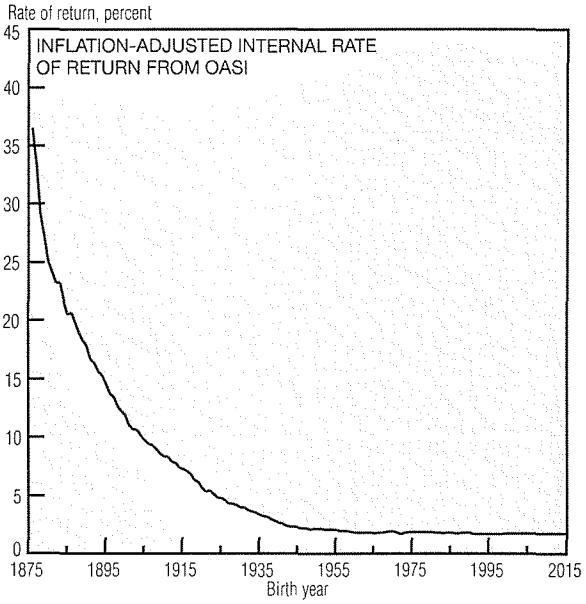
The only industry sector to become more unionized in the past 10 years is the government, where union rolls increased a slight 2.9%. In most of the unions' traditional strongholds, membership is down sharply. In transportation and public utilities, it has declined by more than 10 percentage points, and in the manufacturing sector it has fallen nearly 8%.

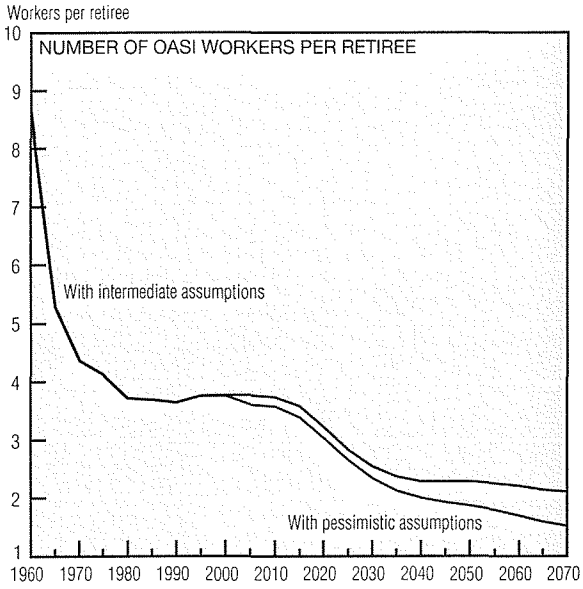
The image of the blue-collar union member is fast disappearing. Not even a quarter of operators, fabricators, and laborers or of precision, production, craft, and repair workers are unionized today. While other occupations that have traditionally been less unionized (managerial, service, and technical occupations) seem to be holding steady, their union membership rates are all below 15%.

In fact, some have argued that the focus of unions is not on the future, but on taking care of today's union member, an older worker who is nearing retirement. If this is so, it is not surprising that unions seem to pay more attention to retirement and health benefits than to wage gains and new membership.

Social Security







Historical Minimum Returns over Various Time Horizons[a] (Percent)

Asset type	Time horizon 5 years	10 years	15 years	20 years
Small company stocks	−27.5	−5.7	−1.3	5.7
S&P 500 stock index	−12.5	−0.9	0.6	3.1
Long-term government bonds	−2.1	−0.1	0.4	0.7
Intermediate-term government bonds	1.0	1.3	1.5	1.6

a. Figures are based on 1926–94 data and represent the minimum observed compound rates of return, before adjusting for inflation, for a series of overlapping holding periods, each spanning the specified number of years.

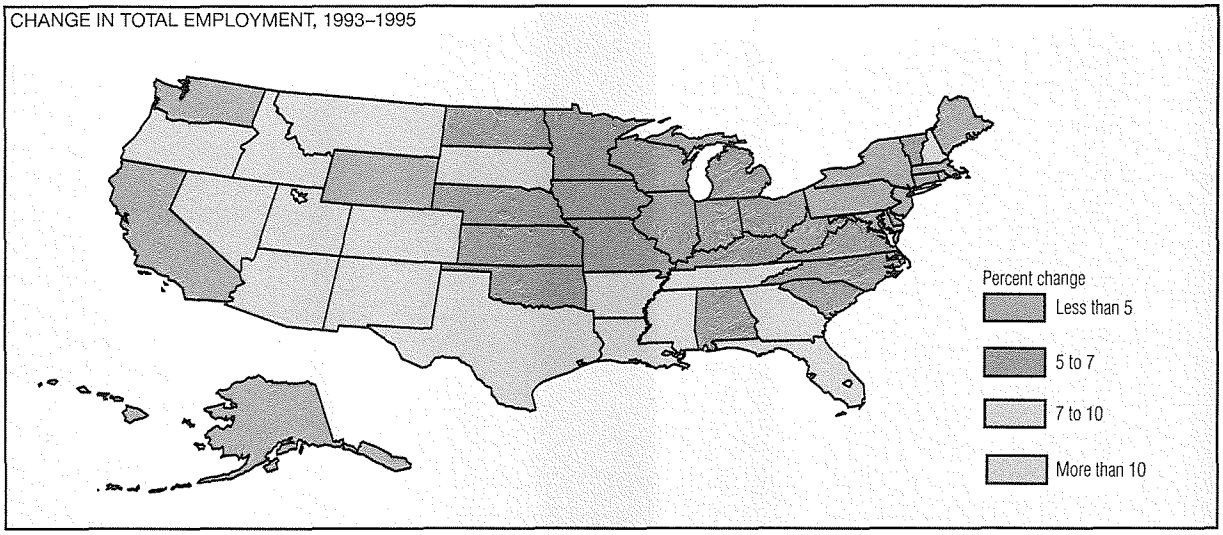
SOURCES: *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Fund,* April 3, 1995; *Economic Report of the President, 1995*; Dean R. Leimer, "Cohort-Specific Measures of Lifetime Net Social Security Transfers," Social Security Administration, Office of Research and Statistics, Working Paper No. 59, February 1994; and *Stocks, Bonds, Bills, and Inflation 1995 Yearbook,* Chicago: Ibbotson Associates, 1995.

Since World War II, average Old-Age and Survivors Insurance (OASI) contributions per worker have grown much faster than average hourly compensation. Large benefit expansions during the 1950s, 60s, and 70s meant generous rates of return for those born before 1930. However, current rules and demographics make it likely that workers born after 1945 will reap extremely low returns.

Because of the postwar benefit expansions, the OASI trust fund has accumulated less money to finance future benefits. Moreover, from 1937 to 1989, returns on the trust fund portfolio (required by statute to contain government securities exclusively) averaged only 0.6% per year after inflation—a poor return compared to common stocks. Finally, because they are either transferred to older generations as benefits or are lent to the government, *all* current contributions are consumed rather than invested in income-generating assets. Therefore, the contributions are actually investments in claims on future workers' earnings. Moreover, the baby boomers' impending retirement will significantly lower the future earnings base by reducing the number of workers per retiree. Thus, maintaining current benefit levels would mean imposing tax rates that are economically and politically infeasible. Reduced benefits for future retirees seem unavoidable.

Today's workers would probably be better off investing in private capital markets. Indeed, historical data suggest that this might cut their risk, since the *minimum* returns on investments in U.S. common stocks held for 20 years or more have been higher than those on long- and intermediate-term government bonds.

Regional Conditions



Projected U.S. Employment Declines by Manufacturing Sector, 1995–2005

Industry	Thousands of workers: 1995 actual	2005 projected	Percent change
Industrial machinery	2,042	1,868	–8.5
Fabricated metals	1,434	1,196	–16.6
Primary metals	715	618	–13.5
Stone, clay, and glass	541	437	–19.2
Electronic equipment	1,624	1,354	–16.6
Lumber, wood, and furniture	1,257	1,213	–3.5
Food and kindred products	1,685	1,648	–2.2
Textiles and apparel	1,572	1,331	–15.3
Miscellaneous	393	334	–15.1

Projected U.S. Employment Increases by Manufacturing Sector, 1995–2005

Industry	Thousands of workers: 1995 actual	2005 projected	Percent change
Rubber, plastics, and leather	1,080	1,137	5.3
Transportation equipment	1,745	1,765	1.2
Chemicals and refining	1,189	1,218	2.4
Paper products and printing	2,244	2,480	10.5
Instruments	844	887	5.1

NOTE: All historical employment data are seasonally adjusted.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, *Statistical Abstract of the United States: 1995.*

Total employment in the U.S. rose a solid 5.3% from 1993 to 1995. The largest gains occurred in the Southwest: Nevada (17%) and Arizona (12%). The Midwest and the Great Lakes states experienced moderate jobs growth of roughly 5% to 7%. Nationwide, only the District of Columbia (–4.0%) and Hawaii (–1.2%) saw employment declines.

Over the past two years, employment in the manufacturing sector grew only about a third as fast as it did in the service sector—1.8% versus almost 6%. Projections for the year 2005 call for just 5 of 14 manufacturing industries to post employment gains. Paper products and printing is the only category slated to reach above 10% growth. Conversely, two-thirds of those manufacturing industries projected to suffer employment declines in the next decade show double-digit losses.

Although 1993–1995 employment growth in Ohio was just average compared to gains in other states, Ohio led the nation by a large margin in the number of new facilities and expansions. Roughly 2,500 new projects began in Ohio during this time span, with Texas a distant second at about 1,600. Most of the top 10 states in new project starts, however, were in the South. Ohio's growth was thus somewhat remarkable, since the only other "Rust Belt" state in the top 10 was Illinois, with

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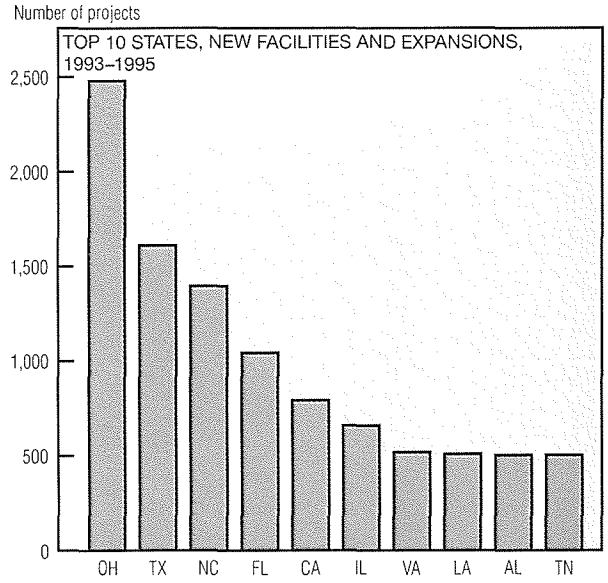
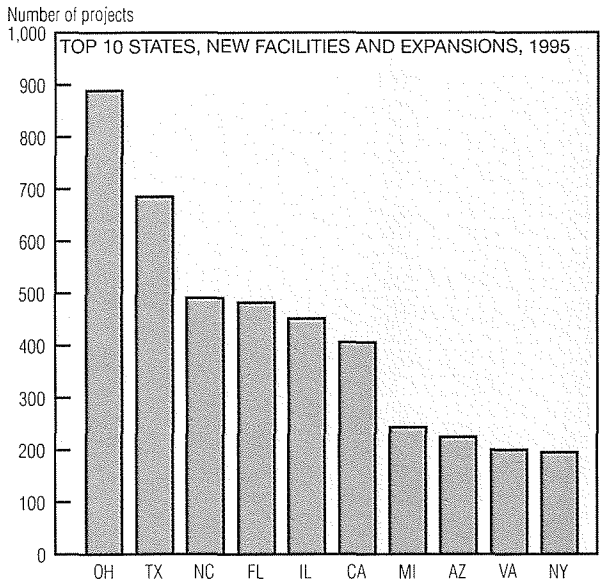
Regional Conditions (cont.)





Ohio Manufacturing Employment, 1995–2000, and Change in Ohio Manufacturing Projects, 1993–1995

Industries with projected employment increases

	Thousands of workers		Percent change in projects, 1993–95
	1995 actual	2000 projected	
Rubber, plastics, and leather	94.9	99.8	4.7
Paper products and printing	113.5	121.0	23.1
Food and kindred products	59.7	60.0	–62.0
Instruments	27.4	28.5	7.7

Industries with projected employment declines

	Thousands of workers		Percent change in projects, 1993–95
	1995 actual	2000 projected	
Industrial machinery	165.0	157.1	54.8
Fabricated metals	131.7	118.0	–7.4
Primary metals	96.6	89.8	37.5
Transportation equip.	138.9	130.5	–24.1
Chemicals and petroleum	66.4	66.2	–11.4
Stone, clay, and glass	44.2	41.6	47.4
Electronic equipment	75.2	73.0	3.8
Lumber, wood, and furniture	43.6	38.1	14.3
Miscellaneous	15.0	14.6	–31.3

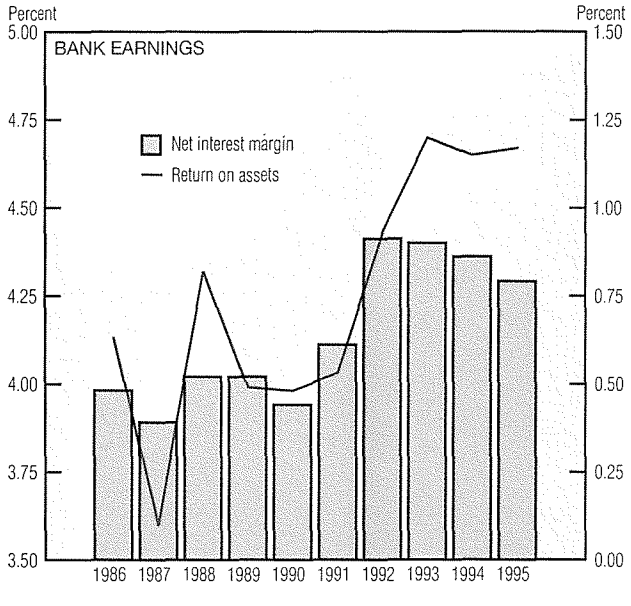
NOTE: All historical employment data are seasonally adjusted.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Ohio Department of Development, *Data Line Ohio,* vol. 4, no. 3 (March 1996); and Ohio Bureau of Employment Services, *Ohio Labor Market Projections: 1991–2000.*

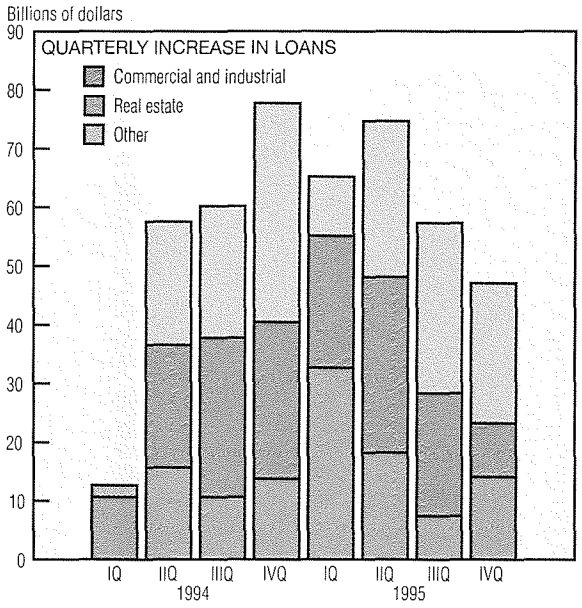
about 660 new project starts. For 1995, Ohio also led the nation with 888 new facilities and expansions, followed by Texas at 685.

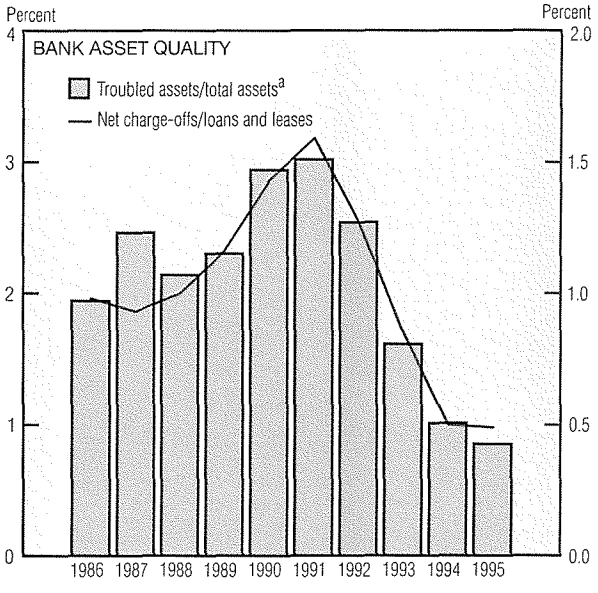
Though it may seem natural that Ohio's new project starts and employment gains would coincide, employment growth and project starts moved in opposite directions in about a third of the manufacturing industries. For example, fabricated metals and transportation equipment saw jobs growth of about 9% and 6.5%, respectively, yet new project starts in these industries fell 7% and 24% over the two-year period.

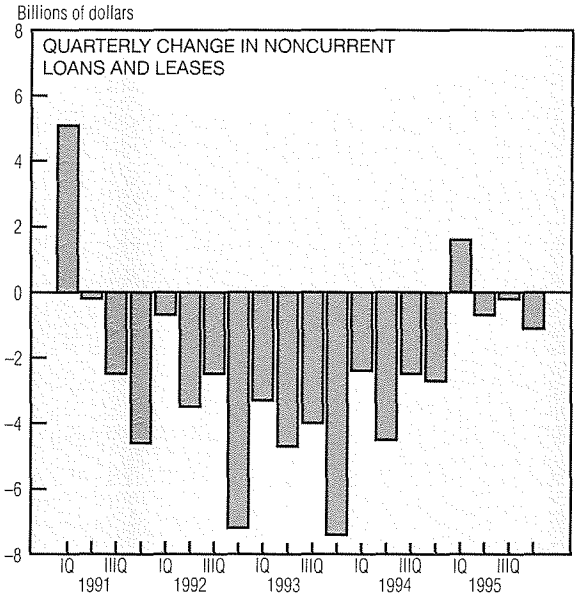
Evidently, most of the growth in today's new project starts is coming from industries with projected declines in employment. For example, employment in both the industrial machinery and the stone, clay, and glass industries is expected to drop significantly in the next decade; yet, new projects and expansions have mushroomed by 55% in the industrial machinery sector and by 47% in the stone, clay and glass category over the past two years. Indeed, even the industry with the largest projected percentage decline in employment—lumber, wood, and furniture—has seen new projects grow by 14% from 1993 to 1995.

Banking Conditions









a. Troubled assets include noncurrent loans and leases plus other real estate owned.
NOTE: All data are for FDIC-insured commercial banks.
SOURCE: Federal Deposit Insurance Corporation.

Insured commercial banks reported a near-record income of $12.1 billion in 1995:IVQ and set a yearly record for total income of $48.8 billion. Nearly 97% of all banks reported positive earnings for the year, and 68% saw higher incomes than in 1994. The good times were spread nationwide and across both big and small banks. This health was reflected in banks' return on assets, which came in above 1% for the third year in a row.

Several components contributed to the record earnings. Banks' net interest margin remained solid despite a slight decline, with increased earning assets, particularly loans, taking up the slack. Real estate loan growth, often volatile, slowed somewhat in the fourth quarter, increasing only $4.1 billion. Commercial and industrial loans advanced a healthy $14.1 billion and other loans rose $15.2 billion, led by credit card loans. Overall, 1995 saw the highest share of loan growth since 1984 and the largest dollar gains ever. Higher fee income, lower insurance assessments, and profitable sales of investment securities completed the rosy earnings picture.

An absence of serious problems also helped. Although loan-loss provisions rose for the year (the first time since 1991), net charge-offs held steady and troubled assets fell. The fourth-quarter numbers could portend trouble, however: Net

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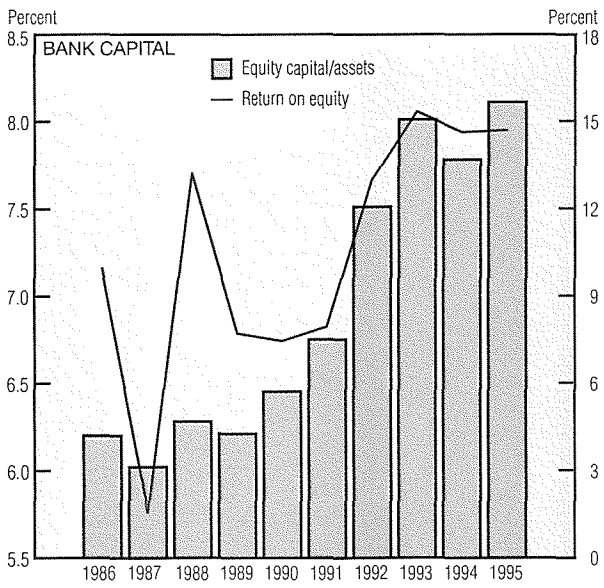
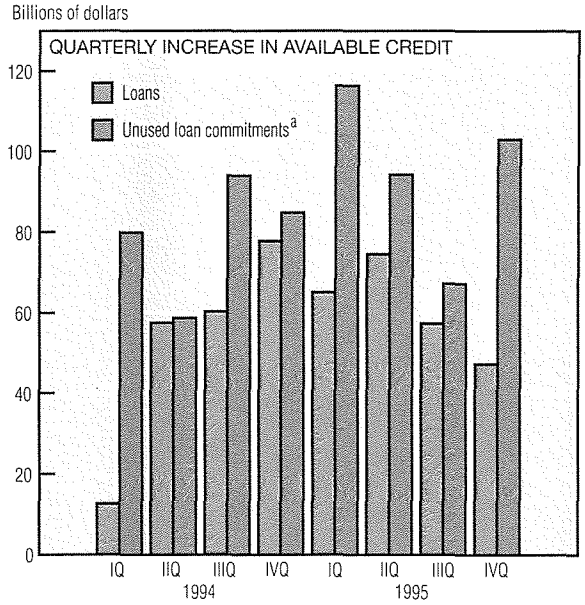
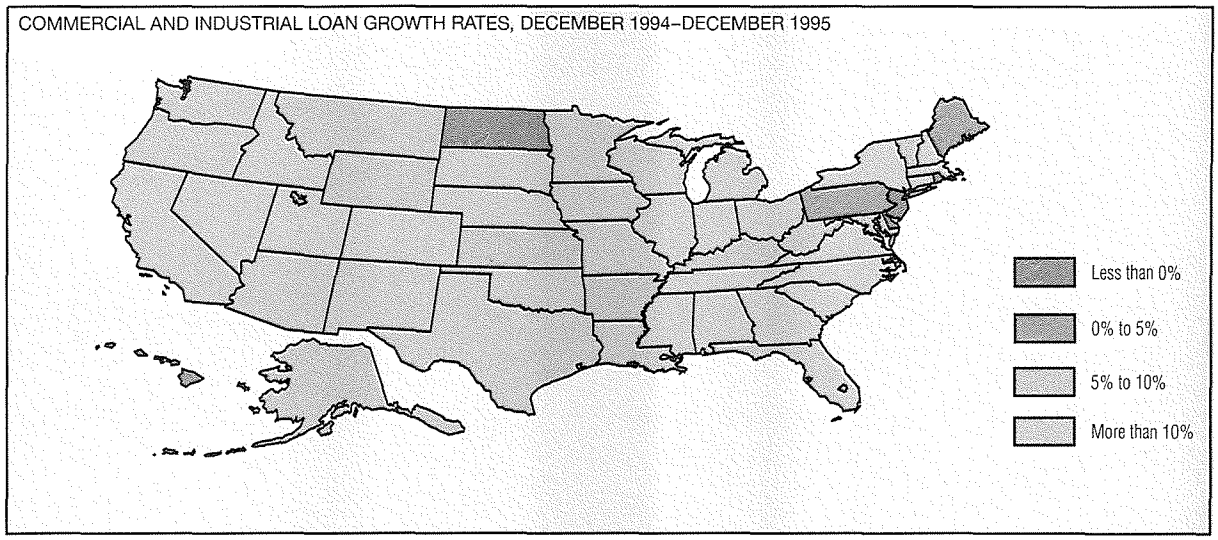
Banking Conditions (cont.)







a. Includes credit card lines, home equity lines, commitments for construction loans, loans secured by commercial real estate, and unused commitments to originate or purchase loans.
NOTE: All data are for FDIC-insured commercial banks.
SOURCE: Federal Deposit Insurance Corporation.

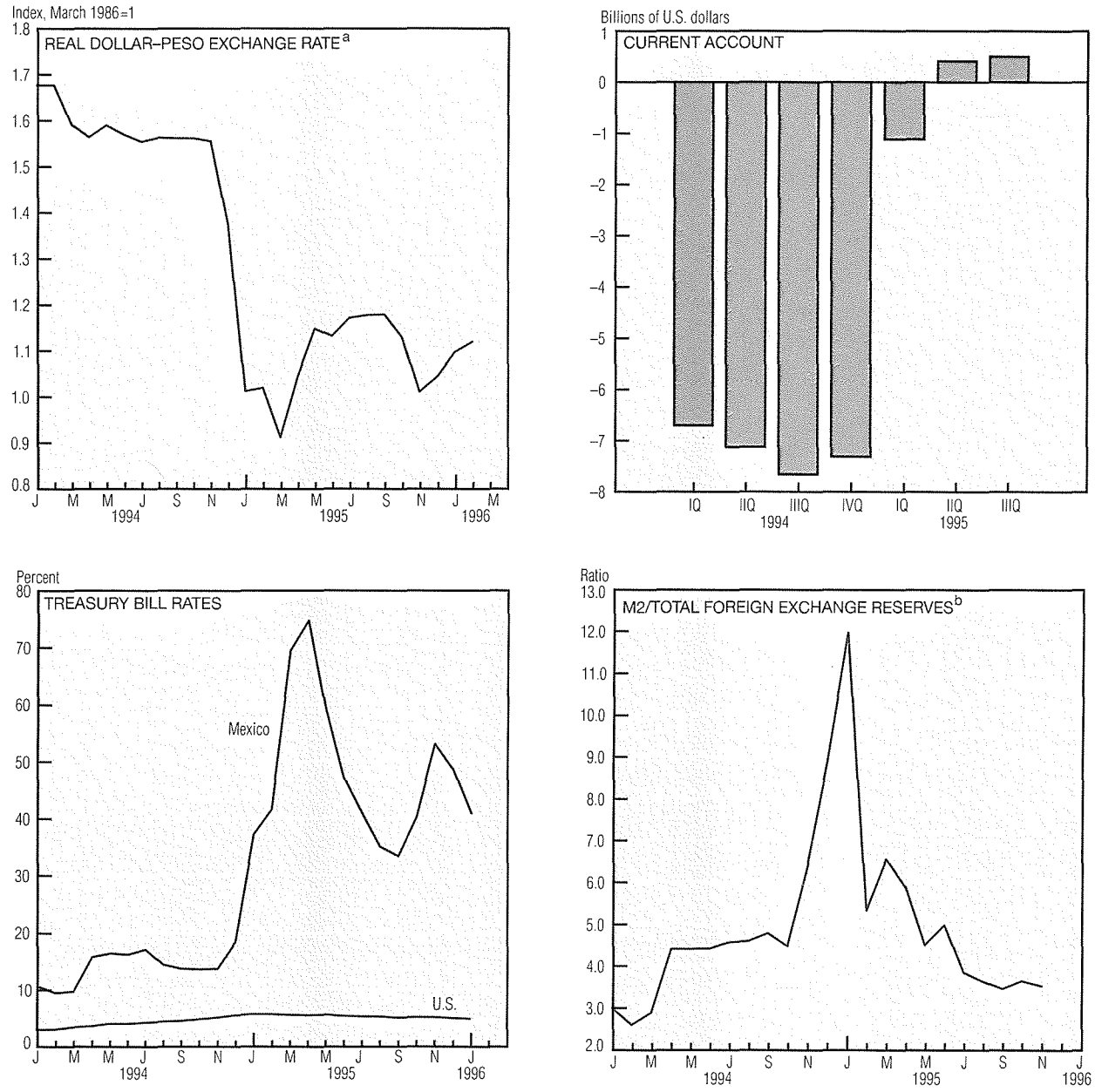
charge-offs rose for the second consecutive quarter, delinquent consumer loans increased $1.2 billion, and credit card delinquencies rose to their highest level in two years. Overall, though, noncurrent loans and leases posted a decline, for the eighteenth time in twenty quarters.

The good news paid off handsomely on the equity side, with banks reporting an impressive 14.68% return on equity. At this rate of return, a dollar will double in less than five years. Small banks lagged somewhat, earning 11.4%. One sign of banks' strong profitability and continued good health is that despite growth in assets, the ratio of equity capital to assets surged above 8%.

From the borrower's perspective, available credit abounded, reflecting growth in both loans and unused lines of credit. In the fourth quarter, unused lines increased by more than twice as much as actual loans. Businesses and consumers apparently wanted to position themselves to take advantage of even faster growth, and banks seemed willing to lend. The continuing economic recovery has indeed bolstered banks' balance sheets, but some observers have cautioned that banks may be overlending in good times.

Strong loan growth across the country last year obscures a minor banking milestone: For the first time in recent history, the number of commercial banks dropped below 10,000.

The Mexican Economy



a. Adjusted for the inflation differential between the U.S. and Mexico.

b. Foreign exchange reserves were converted to Mexican pesos using average monthly exchange rates. M2 is the sum of lines 34 and 35 in the International Monetary Fund's *International Financial Statistics*.

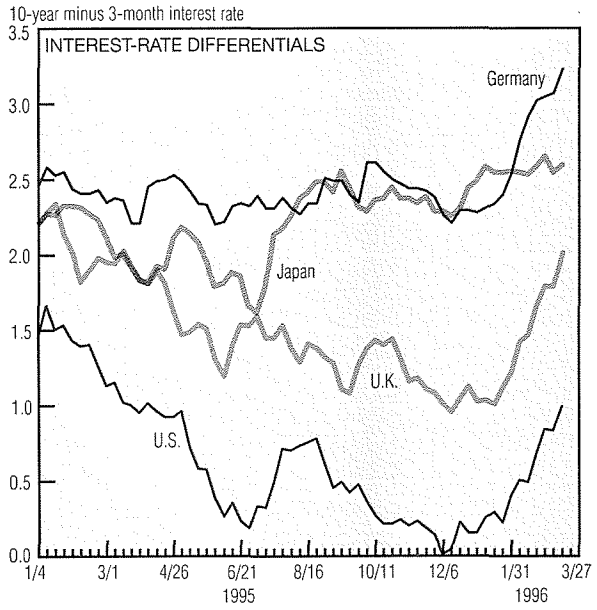
SOURCE: International Monetary Fund.

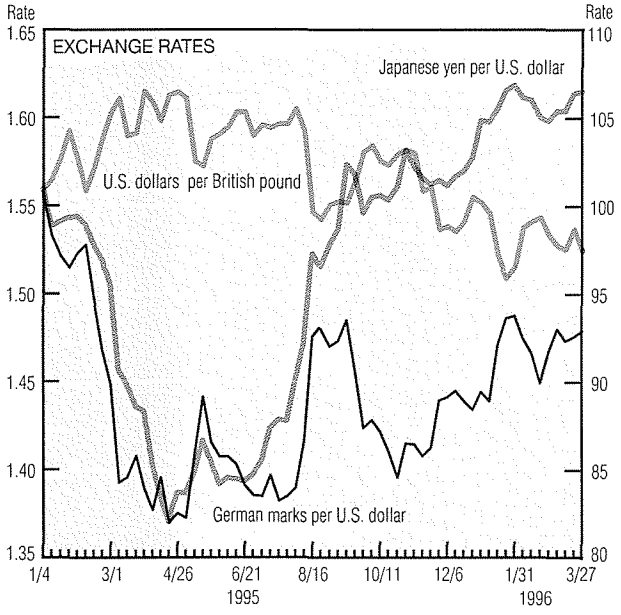
Macroeconomic conditions in Mexico seem to have stabilized, and concerns about growth have become focused on the condition of the banking system. The peso's real exchange rate, which combines information about the nominal exchange rate and the inflation rates in the U.S. and Mexico, was greatly reduced by the devaluation of the peso in December 1994, boosting Mexican competitiveness and exports.

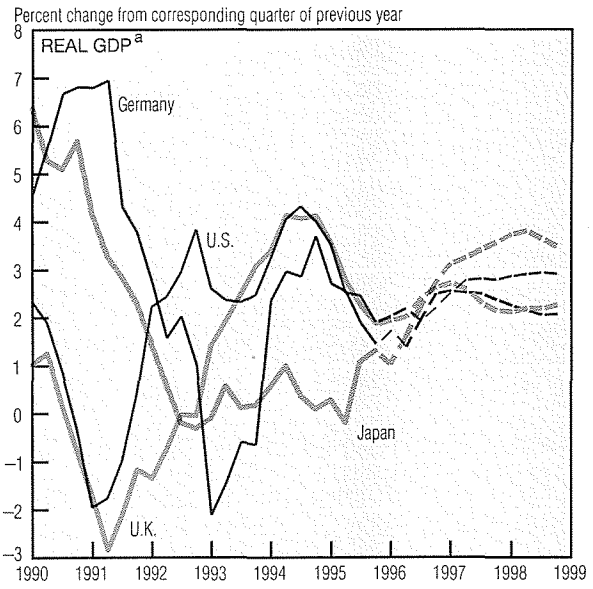
However, high interest rates in Mexico, which result from capital outflows, persist. They increase the cost of efforts by the Mexican government and international financial agencies to help banks and borrowers cope with increased debt burdens and with lower domestic spending. Most observers are now confident that the banking system is recovering, but the ultimate cost to the government is unclear.

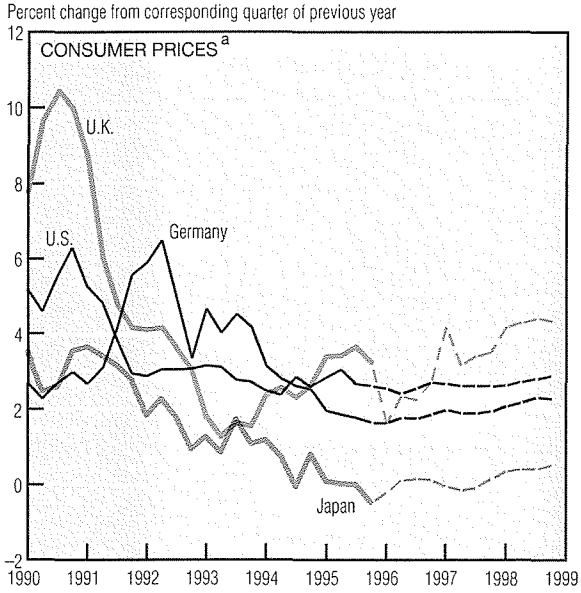
The Bank of Mexico is no longer required to intervene in defense of the peso, as it was under the previous exchange-rate regime. However, events in late 1995 demonstrated a continuing potential conflict between exchange-rate policy and the recovery of the banking system and real spending. In order to defend the peso, interest rates were increased sharply in November, further weakening the prospects for banking recovery. Investors worry that continuing problems in the banking sector may create a temptation to abandon inflation control as the guiding principle of monetary policy. Athough foreign exchange reserves need no longer be large enough to maintain the exchange rate, they must be capable of meeting capital outflows whose potential magnitudes are related to the size of monetary aggregates.

Exchange Rates and Interest Rates









a. Dashed lines represent DRI forecasts as of March 1996.
SOURCES: DRI/McGraw–Hill; and Board of Governors of the Federal Reserve System.

Since the end of 1995, the difference between long- and short-term interest rates has been widening in the U.S., Japan, Germany, and the U.K., possibly because short-term rates are expected to rise in all these countries. Higher short-term rates could result from stronger real economic activity or from a general tightening of monetary policy. However, although recent preliminary signs of economic strength in Japan and Germany led some observers to expect short-term rates to tighten, subsequent data releases indicated weaker conditions.

Higher anticipated inflation is another possible reason for the widening gap between long- and short-term interest rates, but inflation has been, and continues to be, low in all four countries.

Short-run movements in exchange rates should be related to changes in short-term interest rates; however, over longer periods of time, exchange-rate movements should be related to underlying factors (referred to as fundamentals). Since April 1995, the yen has been weakening against the dollar, possibly because Japan's current account balance with the U.S. has fallen. Although Japan's growth rate in real GDP is now the lowest of the four countries, it is forecast to improve markedly over the next three years. On the other hand, the inflation rate for Japanese consumer prices is expected to remain low.