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The Economy in Perspective

Good news bears ... Financial markets were rocked on July 5 when the Bureau of Labor Statistics (BLS) released its report on labor market conditions for June, along with revised data for April and May. The Bureau reported a 239,000 net increase in June employment as measured by the survey of employers' payrolls, plus a combined upward revision of 45,000 for April and May. Average earnings expanded by 9 cents per hour in June, the largest monthly gain ever reported. Moreover, the BLS household survey registered a decline in the national unemployment rate to 5.3%.

Despite weak trading over the holiday period, the stock market took a sharp hit that Friday (115 points on the Dow Jones Industrial Average), and U.S. Treasury bond prices plummeted. The yield on a 10-year Treasury bond jumped from 6.77% to 7.06% during the day.

Long-term bond yields have been on a roller-coaster ride for the past few years. The pace of economic activity quickened during 1994, putting pressure on capital market interest rates. At the same time, concerns about accelerating inflation prompted the Federal Reserve to slow the rate at which it was supplying reserves to the banking system. The federal funds rate rose from 3.0% to 5.5% during the year.

Capital market rates declined during 1995, as market participants expected growth to gear down a bit to keep pace with additions to productive capacity. By year's end, in fact, capital market rates had fallen about 200 basis points from the beginning of the year, and some analysts spoke of a recession in the latter half of 1996. Last January, the Federal Reserve reduced the federal funds and discount rates to keep them in line with open market rates, and in anticipation of a decline in inflationary pressures. However, the BLS reported a strong employment gain for February, and subsequent economic data have convinced most economists to expect moderate economic growth to continue for the next year or so. Before BLS's July report, capital markets had retraced about 100 basis points from their 1995 low point, and the July 5 news accounted for another 25 to 30 points.

Interest rates have been volatile because market participants are responding to underlying forces which themselves are volatile. People revise their plans for saving, investment, and consumption as they adjust their views of future economic activity. These revisions, in turn, affect the real interest rate prevailing in capital markets. People also may change their view of the inflation rate they expect to prevail over the next several years. Although the inflation rate as measured by the Consumer Price Index has been following a 3% trend during the past several years, many observers believe the trend will be strongly influenced by the pace of economic activity. Since by most accounts the economy has been operating at very high rates of capacity utilization for the past year or two, financial market participants are especially leery of an acceleration in the price level.

The association of economic growth with inflation, sometimes referred to as the Phillips curve, stems from positive correlations between changes in the unemployment rate and unanticipated inflation observed during business cycles—particularly before 1981. This has encouraged some analysts to think that policymakers can alter inflation's trend by affecting the unemployment rate, that is, by designing policy so as to speed up or slow down the pace of economic activity. The non-accelerating inflation rate of unemployment (NAIRU) is thought to keep the prevailing inflation rate steady. If NAIRU is 6%, for example, unemployment rates below 6% will likely generate accelerating inflation.

Econometric estimates of Phillips curves and NAIRU reveal that the relationships between inflation and economic growth are not very stable. Moreover, since the early 1980s, inflation has declined during a prolonged period of economic expansion, at apparent odds with predictions from standard Phillips curve models. At the outset of this decade, mainstream estimates of NAIRU centered on 6%, but this figure is now widely regarded as 5.75%, or even 5.5%. If the inflation trend continues to hold this year, we may see estimated NAIRU fall to 5.25%.

Those who forecast inflation from a Phillips curve view have occupied the high ground in the media during the last few years, even though this approach has been overpredicting the amount of economic slack required to reduce inflation. The Phillips curve/NAIRU framework puts policymakers in the position of being responsible for fluctuations in economic growth on a year-to-year basis, when their more likely objective is to maximize employment and promote price stability over business cycles. Excessive *money* growth, not economic growth, creates inflation. Though rapid economic growth may sometimes accompany excessive money growth, the good news need not bear bad tidings.

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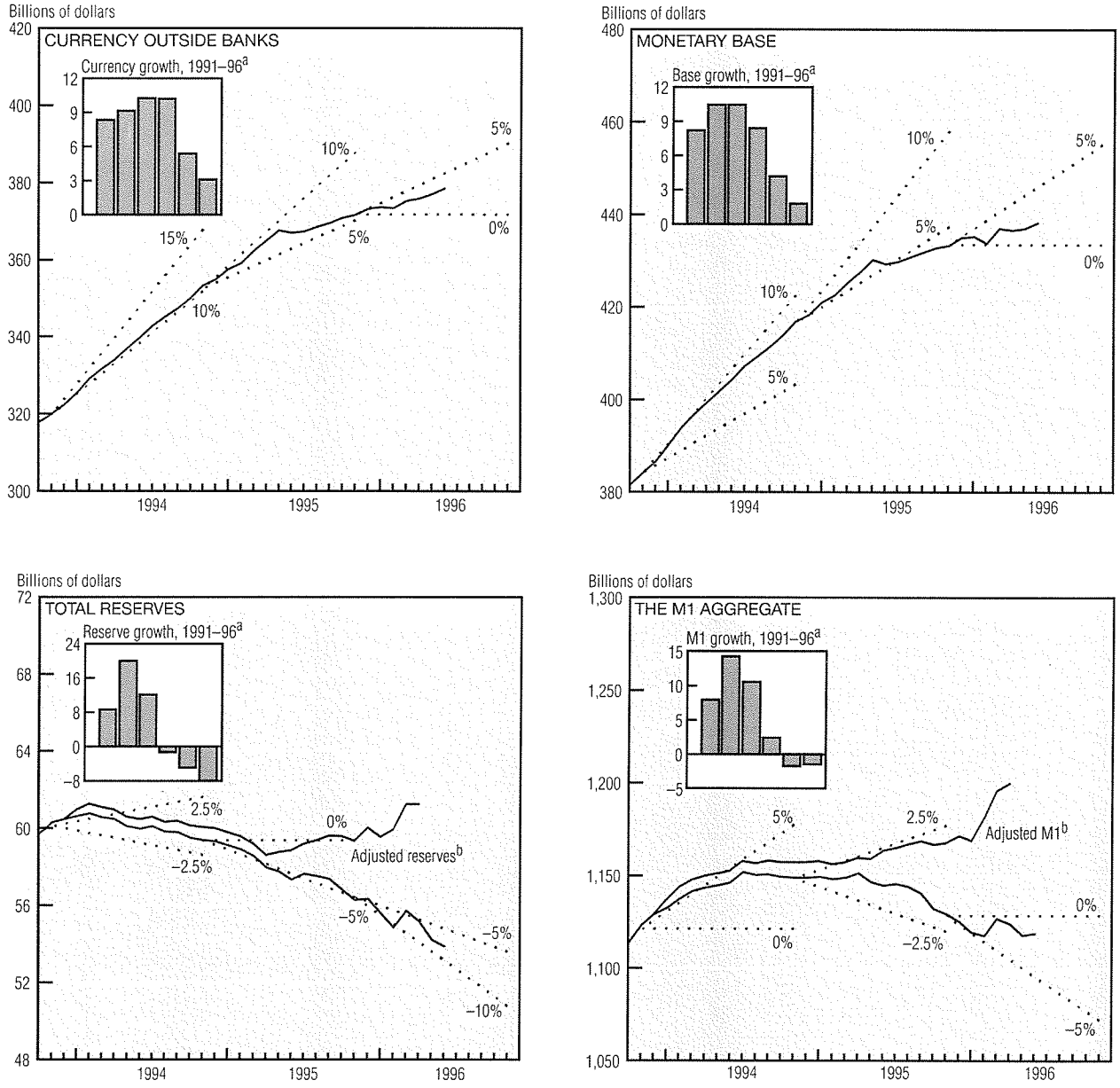
Monetary Policy



a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on an estimated June over 1995:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for June 1996. Dotted lines represent growth ranges and are for reference only.

SOURCE: Board of Governors of the Federal Reserve System.

So far this year, the narrow monetary aggregates continue to be rather weak. Currency, which has expanded at an average annual rate of nearly 8½% over the past 22 years, is growing only around 3%. The slowdown is believed to be caused by a drop in foreign demand. With as much as 70% of all U.S. currency held abroad, any change in foreign demand will have a pronounced effect on the aggregate's growth.

The slower growth of currency is partly responsible for the sluggish performance of the monetary base, which has expanded at an annual rate of only 1.8% since January. The base comprises currency held outside banks, surplus vault cash, and total reserves, but is dominated by its currency component.

Base growth is also being affected by the decline in total reserves due to widespread implementation of sweep accounts. These accounts enable depository institutions to shift funds from other checkable deposits, which are reservable, to money market deposit accounts, which are not. Without this reserve avoidance technique, it is estimated that total reserves would have been increasing since January.

The implementation of sweep accounts and the slowdown in currency growth have also influenced M1, which fell at a 1.5% annual rate through June. However, adjusting for the impact of sweep accounts, it is estimated that M1 would have expanded at a moderate rate.

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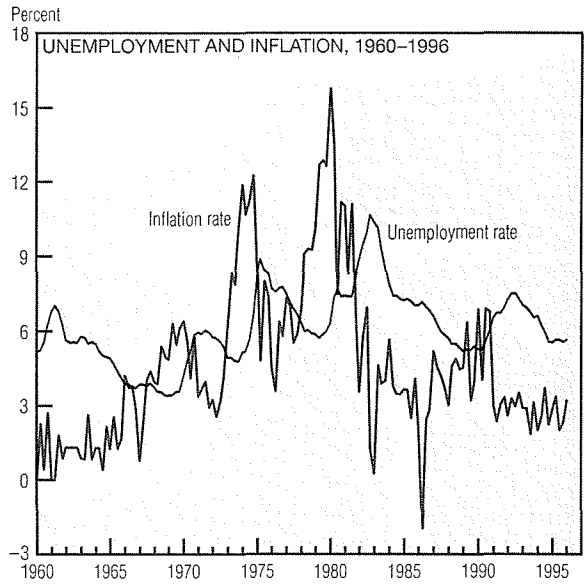
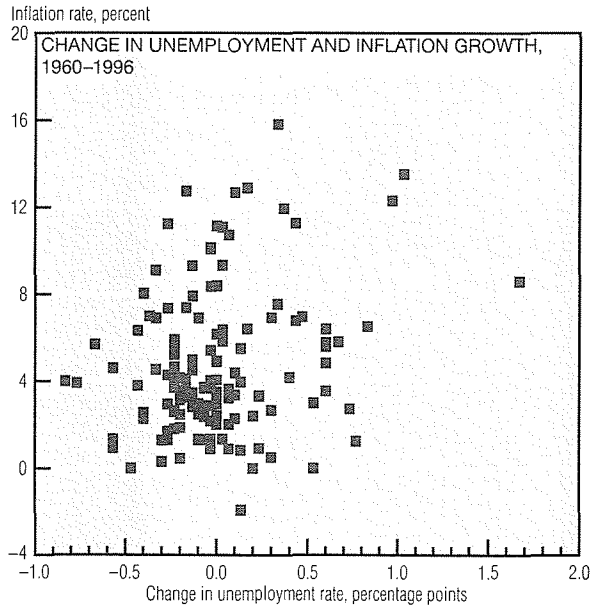
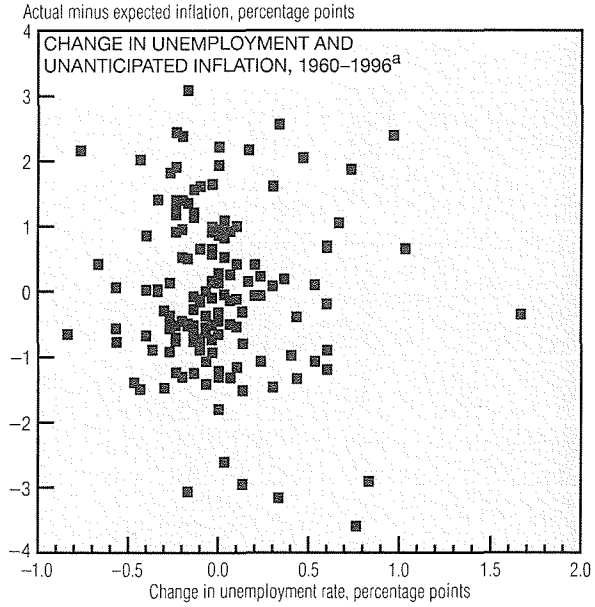
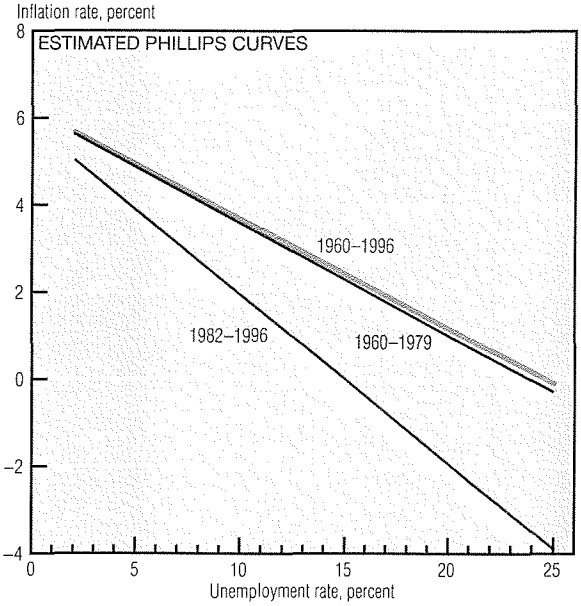
Monetary Policy (cont.)









a. Unanticipated inflation is the difference between actual inflation and its expected value, where expected inflation is based on past inflation rates.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

The relationship between inflation and unemployment is often taken (if only implicitly) to be one of the most reliable in macroeconomics. Everyone knows that rising unemployment means lower inflation, and falling unemployment means higher inflation.

To be sure, such a negative relationship—referred to as the "Phillips curve"—is not always easy to see in the data. Although specific episodes over the past 35 years are characterized by movements of the inflation and unemployment rates in opposite directions, others are not. In fact, the general pattern of inflation and unemployment changes appears to trace out a positive relationship.

Analysts generally resolve this contradiction of the "Phillips curve" relationship by focusing not on the level of inflation and unemployment changes, but rather on unemployment changes and the deviation of inflation from the level that market participants expect. Viewed with this modification, the data more readily reveal the negative correlation between price changes and unemployment that so many commentators take for granted.

Still, the connection between the two variables should be viewed with some skepticism: A negative correlation is one thing, but a stable relationship is quite another. Evidence shows that simple estimates of the Phillips curve based on available data may shift over time.

Nonetheless, the Phillips curve

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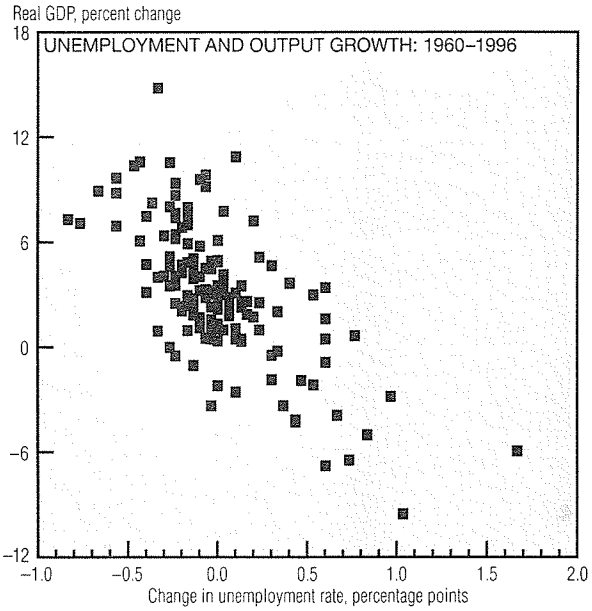

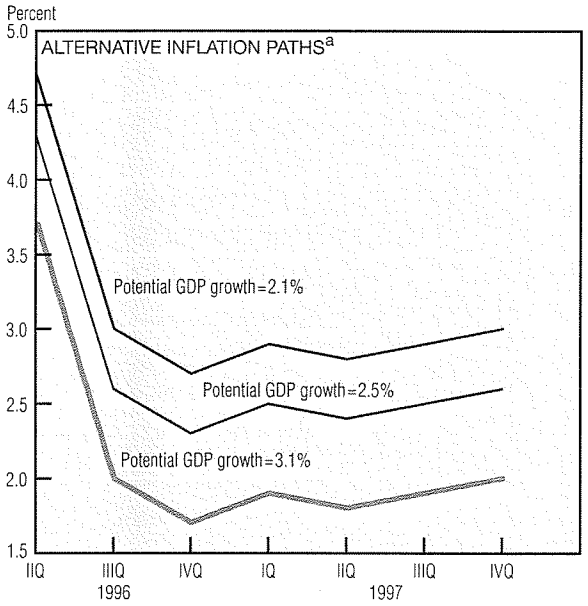

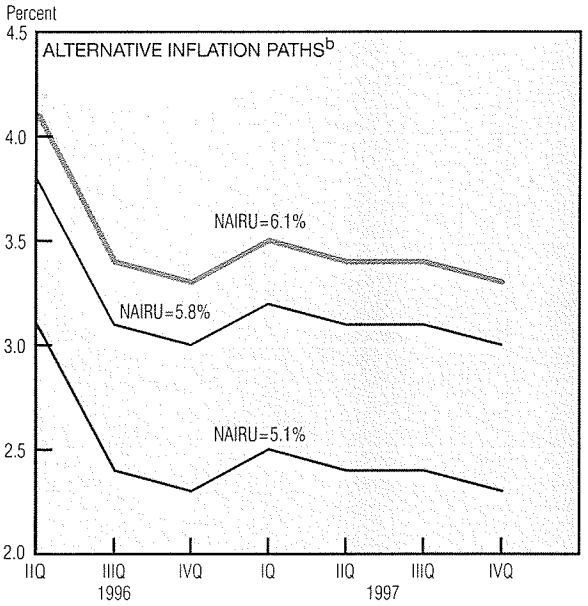

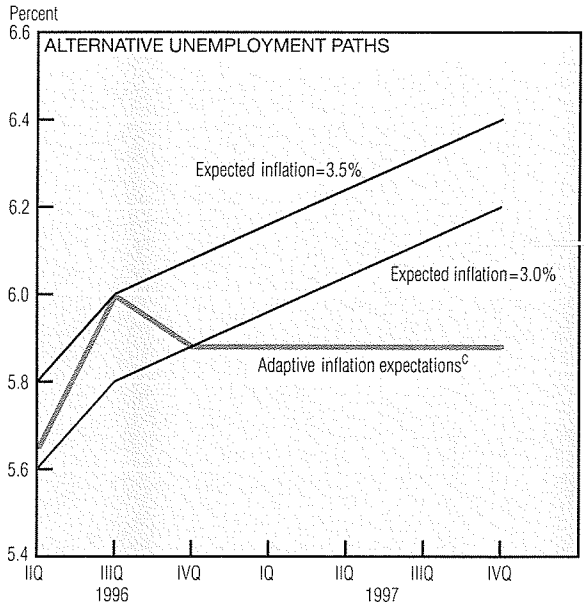

a. Model assumes that NAIRU = 5.8%.
b. Model assumes that potential real GDP growth = 2.1%.
c. Adaptive expectations are based on past inflation rates.
NOTE: NAIRU is defined as the non-accelerating inflation rate of unemployment.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; and the Federal Reserve Bank of Cleveland.

remains a focal point for policy discussions. Part of the reason is that more sophisticated statistical treatments appear to provide a reasonably stable unemployment/inflation connection. The virtue of hunting for such stability is in turn reinforced by the ease with which inflation can be connected to output growth through the fairly striking negative relationship between unemployment and output growth, a correlation generally known as "Okun's law."

The Phillips curve, together with Okun's law, essentially codify much of the conventional wisdom about monetary policy in a formal statistical way. Intimately linked to this framework are the concepts of NAIRU (the unemployment rate below which inflationary pressures build), potential GDP growth (the long-run sustainable rate of output expansion), and inflationary expectations.

Unfortunately, the measure of our ignorance about these important variables is large indeed, and the magnitudes really matter. Simple back-of-the-envelope calculations illustrate that the future paths of inflation under current policy, or a particular monetary policy's effect on unemployment, or myriad other important policy questions, are quite sensitive to assumptions about NAIRU, potential GDP growth, and the formation of inflation expectations. To consumers of policy analysis, the best advice is always "let the buyer beware."

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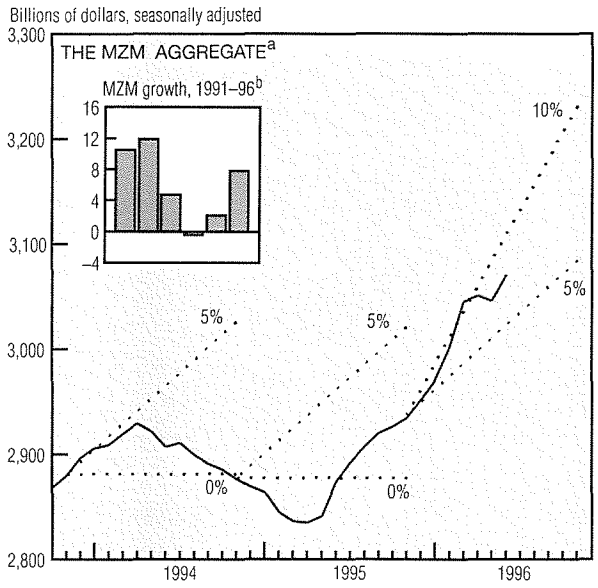
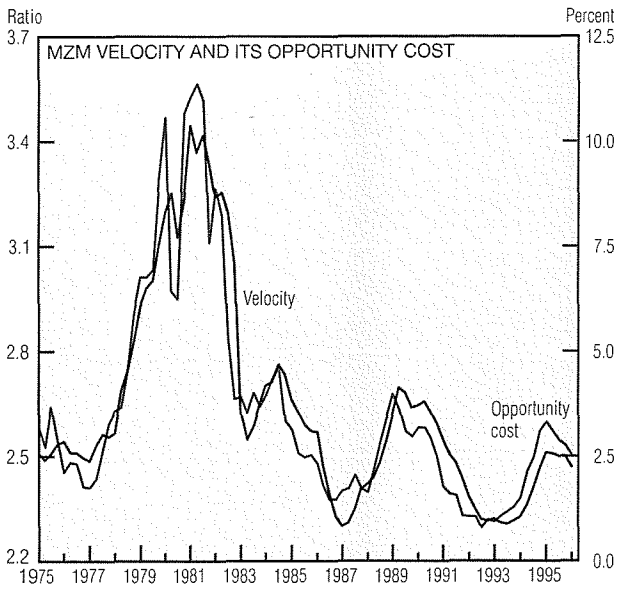
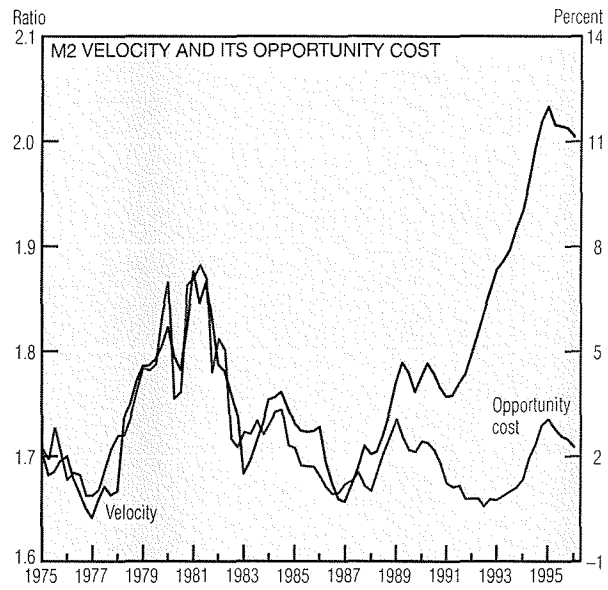
An Alternative Measure of Money

Measures of Money

M1	=	Currency
	+	Demand deposits
	+	Other checkable deposits
	+	Traveler's checks
M2	=	M1
	+	Savings deposits
	+	Small time deposits
	+	Retail MMMFs
MZM	=	M2
	+	Institutional MMMFs
	–	Small time deposits







a. Last plot is estimated for June 1996. Dotted lines represent growth ranges and are for reference only.
b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on an estimated June over 1995:IVQ basis.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

In recent years, deregulation and financial innovation have wreaked havoc on relationships between traditionally defined measures of money—M1 and M2—and economic activity and interest rates. When these relationships break down, analysts often propose new monetary aggregates. One such measure, MZM, comprises all monetary instruments that have zero maturity and hence are redeemable at par on demand. Included are M1, savings deposits, and all money market mutual funds (MMMFs).

MZM's immunity to recent deregulation and financial innovation is evident in the relationship between MZM velocity (the ratio of nominal GDP to MZM) and its opportunity cost (defined here as the difference between the 3-month Treasury yield and the share-weighted average of yields paid on MZM components). While essentially trendless since 1974, MZM velocity varies systematically with its opportunity cost. It is estimated that a one-percentage-point increase in its opportunity cost eventually lowers the level of MZM demanded by more than four percentage points.

In contrast, the relationship between M2 velocity and its opportunity cost broke down in the 1990s, when M2 velocity persistently rose in the face of falling opportunity cost. This distortion is believed to be a consequence of the proliferation of bond and equity mutual funds, which grew largely at the expense of small time deposits. Because MZM does not include small time deposits, it was not affected by the widespread substitution of bond and equity funds for bank deposits.

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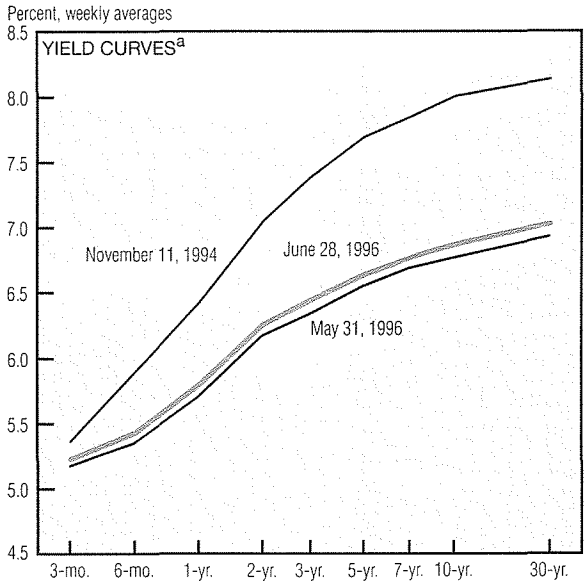
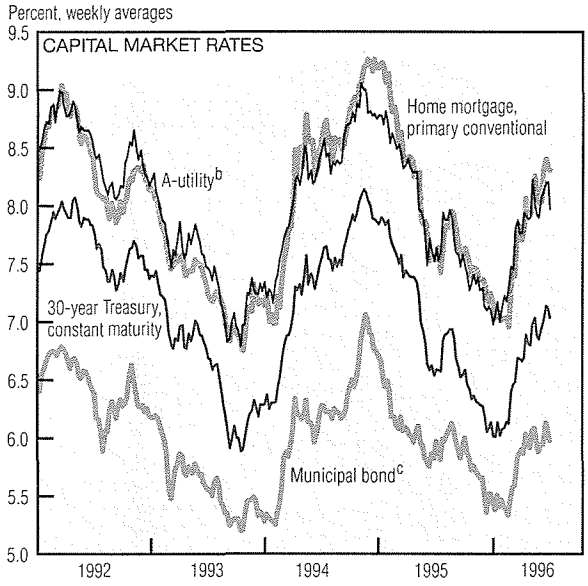
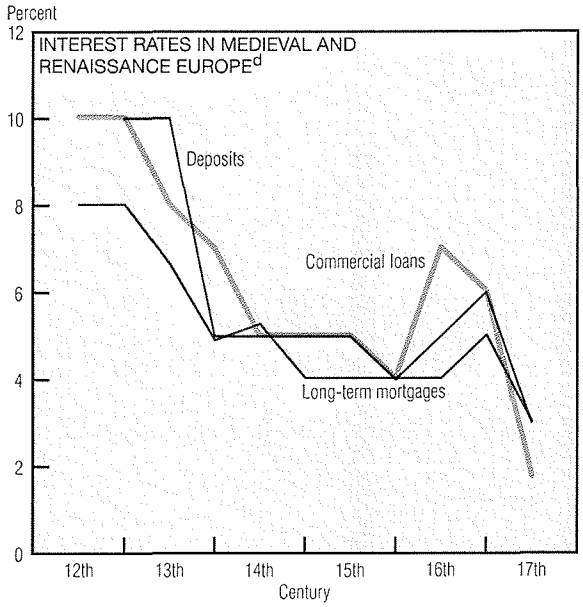
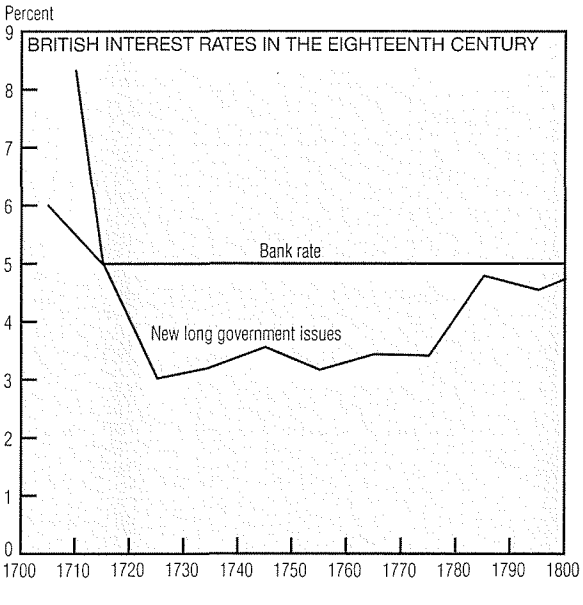
Interest Rates









a. Three-month and six-month instruments are quoted from the secondary market on a yield basis; all other instruments are constant-maturity series.
b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
d. Rates are the lowest reported during each half century for each type of credit, regardless of location.
SOURCES: Board of Governors of the Federal Reserve System; and Sidney Homer and Richard Sylla, *A History of Interest Rates,* 3d ed. New Brunswick, N.J.: Rutgers University Press, 1991.

The yield curve has changed little since last month. Daily and weekly shifts have occurred at both the long and short ends, depending on the market's assessment of the economy's strength and the chances of the Federal Reserve raising or lowering rates. The closely watched 3-year, 3-month spread and 10-year, 3-month spread stand at 122 and 164 basis points, respectively. Long rates have generally continued the upward path they began early in the year, although they remain a point below the levels of late 1994 and early 1992.

Interest rates can provide a fascinating historical perspective, as records for Medieval and Renaissance Europe exist as far back as the twelfth century. They can also provide some important lessons for today. Even on a long time scale, interest rates show tremendous variation: One century's average interest rate is easily double that of another. Great Britain demonstrates that 60 years of rates near 3% can be followed by 20 years of rates near 5%. These figures should make analysts think twice before calling a 7% long bond rate "unsustainable."

Still, the downward trend as Europe developed and industrialized may presage a pattern for countries now going through the same process. It is significant that the lowest interest rates appear in seventeenth century Holland, a country with a financial system advanced enough that government bonds (and tulip futures) traded on an exchange. The data even hold a warning about the dangers of inflation: The high rates in the sixteenth and seventeenth centuries arose from the oversupply of gold and silver brought back from the New World.

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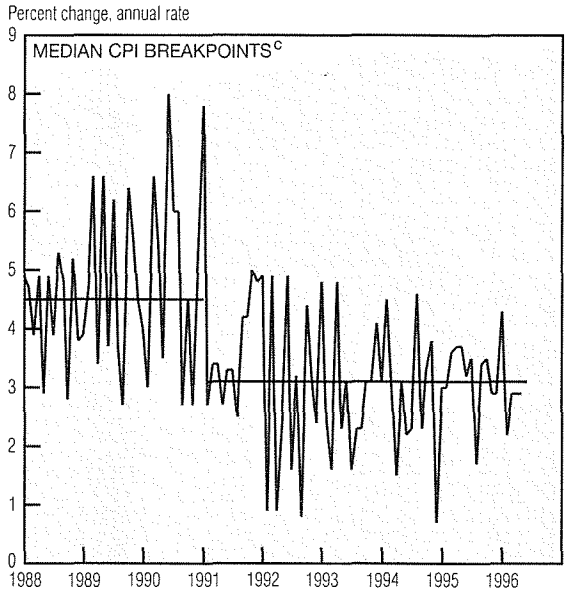
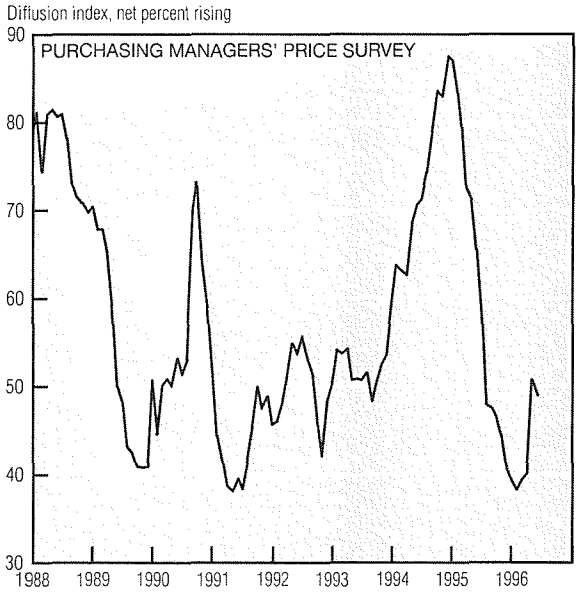
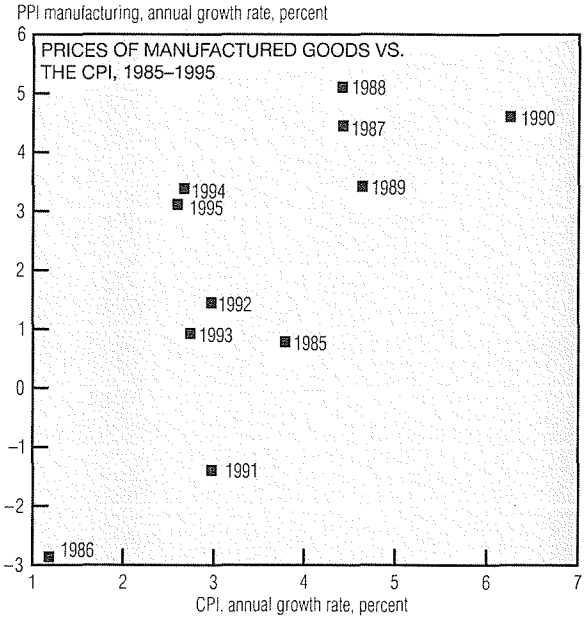
Inflation and Prices

May Price Statistics

	Annualized percent change, last: 1 mo.	5 mo.	12 mo.	5 yr.	1995 avg.
Consumer Prices					
All items	3.9	4.1	2.9	2.9	2.6
Less food and energy	3.0	3.0	2.7	3.2	3.0
Median[a]	2.9	3.0	3.0	3.1	3.2
Producer Prices					
Finished goods	−0.6	2.6	2.3	1.5	2.1
Less food and energy	−0.4	0.3	1.5	1.7	2.6
Commodity futures prices[b]	0.0	13.8	10.5	3.6	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. Horizontal lines represent trends.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Cleveland; National Association of Purchasing Management; and the Commodity Research Bureau.

The Consumer Price Index (CPI) continued to accelerate in May, rising at an annual rate of 3.9% and contributing to a year-to-date increase of 4.1%. This represents a substantial deterioration from the 2.6% rate observed in 1995. However, much of the uptick has been attributed not to actual underlying inflation, but to transitory shocks in the typically volatile energy and food components. When these items are excluded from the index, its annualized, year-to-date growth is identical to 1995's rate. The median CPI through May is actually below last year's posting, but shows no clear signs of straying from the 3.1% path it has followed for the last five years.

Producer-level prices provide a more optimistic picture of current inflation. The Producer Price Index (PPI) and the purchasing managers' price index both suggest only moderate upward pressure. The PPI and the PPI less food and energy each receded slightly in May, and when food and energy items are excluded, the index has remained essentially unchanged this year. In addition, the PPI growth rate is more than two percentage points below last year's rate. Similarly, purchasing managers have generally reported prices to be falling or holding steady since late last year.

Recent moderate price behavior at the industrial level probably reveals more about conditions specific

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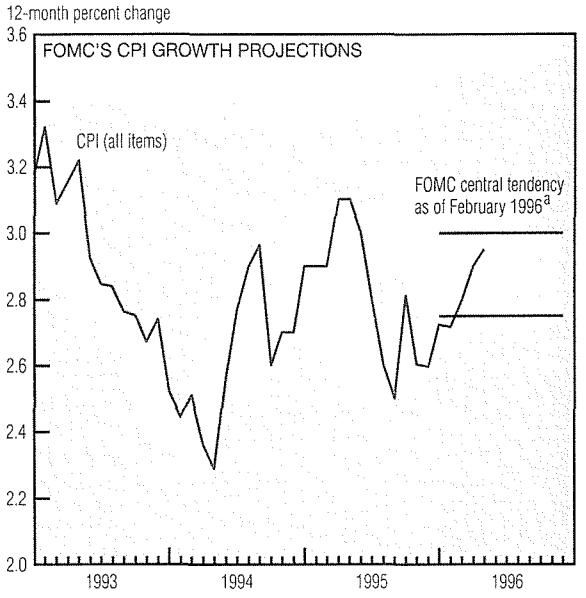
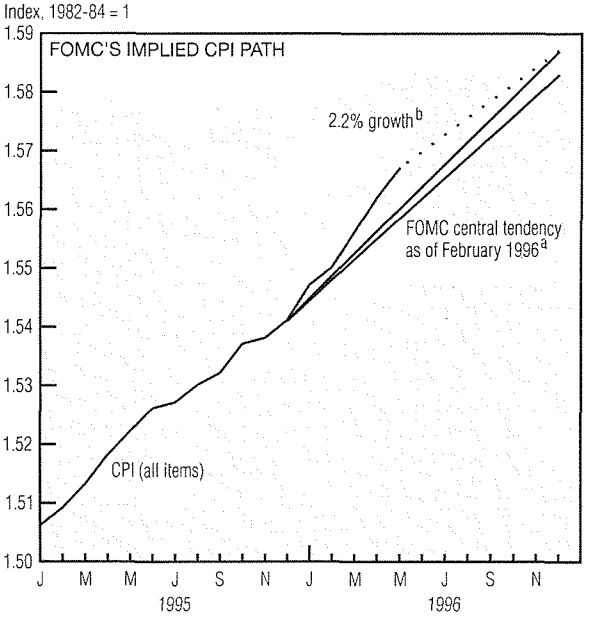
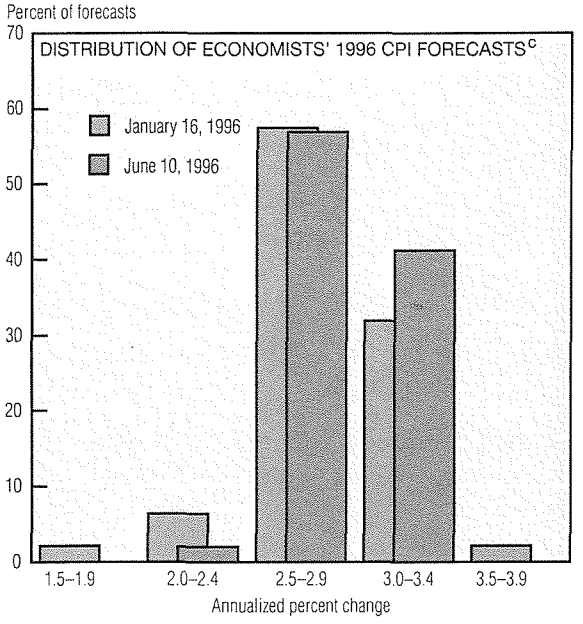
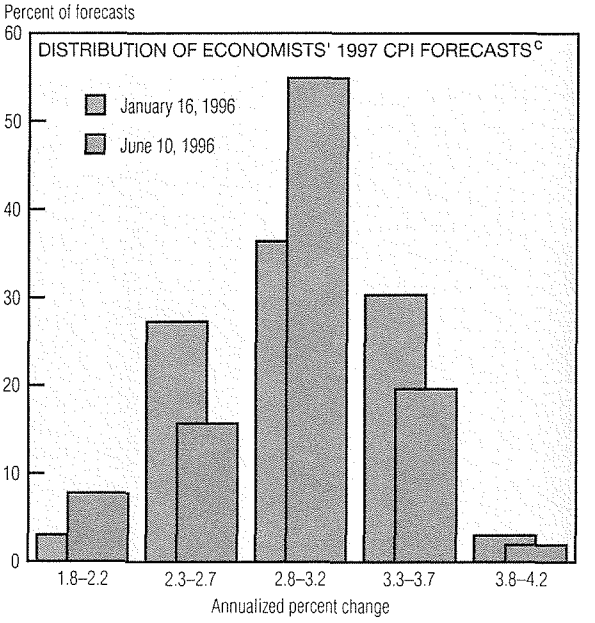
Inflation and Prices (cont.)









a. 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.
b. 2.2% annualized growth represents a reference point between current CPI growth and the upper bound of the FOMC central tendency.
c. Consensus forecast of the Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and *Blue Chip Economic Indicators*, January 16 and June 10, 1996.

to manufacturers than about general inflationary trends. Indeed, since 1990, the correlation between manufacturing prices and retail prices has been weak. While CPI growth has hovered around 2½% to 3%, manufacturing prices have fluctuated widely, from a low of about –1½% in 1991 to nearly 3% last year.

The CPI continues to climb toward the upper bound of the central tendency range projected by Federal Reserve officials for 1996. When the range was announced in February, an upper limit of 3.0% appeared much less optimistic than it does today. An annualized growth rate of no more than 2.2% for the remainder of 1996 would be required for the CPI to end the year within the Fed's projected range.

It appears that many economists have become more pessimistic about price trends for 1996. In January, approximately 65% of the Blue Chip panel expected the rate of retail price increases to remain below 3% this year. By June, only 59% held that view. The percentage anticipating that the inflation rate would stay below 2.5% dropped from 8.5% to less than 2% over the same period.

This increased pessimism has not, however, been as clearly reflected in the forecasts for 1997. In June, more than half of the Blue Chip economists predicted that the CPI would fall into the 2.8% to 3.2% range next year, compared with only 36% in January. The ranks of those expecting growth above 3¼% and those who anticipate less than a 2¾% rise have both dwindled since January.

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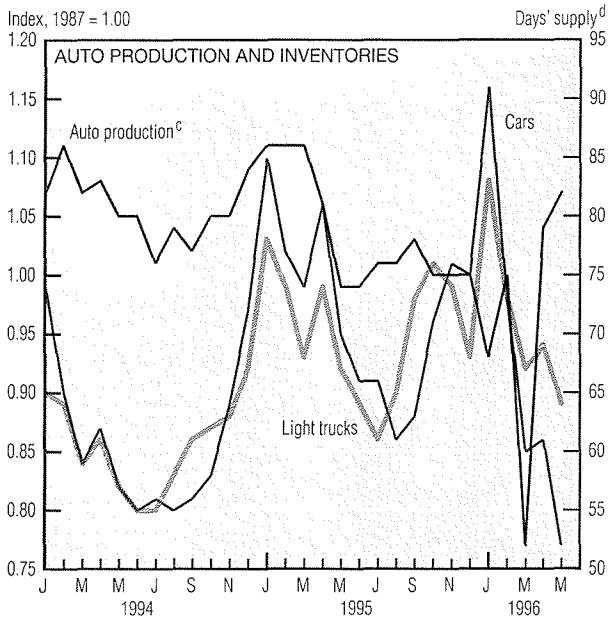
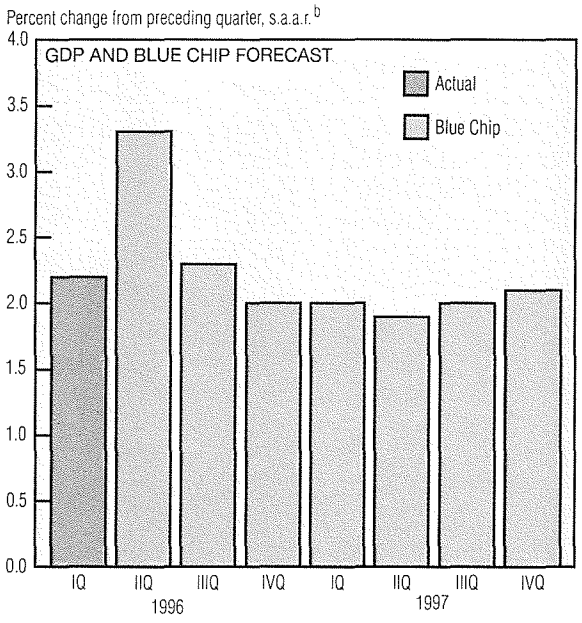
Real GDP and Components, 1996:IQ[a]
(Final estimate, s.a.a.r.[b])

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	36.2	2.2	1.7
Consumer spending	40.9	3.6	2.7
Durables	12.1	8.5	6.2
Nondurables	12.7	3.6	1.4
Services	16.4	2.5	2.7
Business fixed investment	21.5	12.4	6.0
Equipment	18.2	14.1	6.6
Structures	3.5	7.9	4.5
Residential investment	4.8	7.4	2.0
Government spending	4.9	1.6	−0.6
National defense	2.9	3.8	−4.0
Net exports	−18.0	—	—
Exports	4.0	2.0	6.4
Imports	22.0	10.2	5.0
Change in business inventories	−18.6	—	—

Revision to Real GDP and Components, 1996:IQ[a]
(Billions of 1992 dollars, s.a.[c])

	Final level	Revisions: Second	First
Real GDP	6,812.7	−2.8	−8.1
Consumer spending	4,655.0	−0.1	1.6
Durables	602.2	0.6	1.4
Nondurables	1,436.9	−0.4	2.1
Services	2,616.8	−0.2	−1.9
Business fixed investment	746.8	0.2	0.3
Equipment	561.7	1.1	−1.6
Structures	186.6	−0.7	1.6
Residential investment	271.2	0.5	1.4
Government spending	1,255.3	−3.3	2.5
National defense	312.2	−2.7	0.0
Net exports	−114.6	−4.0	0.4
Exports	803.8	−5.5	4.1
Imports	918.4	−1.5	3.7
Change in business inventories	−2.1	3.6	−13.6





a. Chain-weighted data in 1992 dollars.
b. Seasonally adjusted annual rate.
c. Seasonally adjusted.
d. U.S. dealers' current stock as a share of daily average sales (includes domestic and imported vehicles).
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; *Blue Chip Economic Indicators*, June 10, 1996; and *Ward's Automotive Reports*.

According to the Commerce Department's final figures, the economy expanded at a 2.2% annual rate in 1996:IQ. The initial estimate of 2.8% was revised downward primarily because of a massive drawdown of inventories.

In the first quarter, nearly all broad sectors of the economy registered faster growth than they did over the past year. The most notable exception was inventories. After a $16.5 billion increase in 1995:IVQ, businesses drew down their stockpiles at a $2.1 billion annual rate in the first quarter. Much of this reflected a strike-induced reduction in automobile stocks.

Although the drop in inventories was a drag on first-quarter GDP, it also represents brightened prospects for near-term growth. Much of the anticipated acceleration in second-quarter output reflects an expected rebound in motor vehicle production as manufacturers attempt to rebuild stocks and meet strong sales demand.

Most economists participating in the June Blue Chip survey look for a temporary surge in second-quarter activity, largely based on the rebuilding of inventories. Through the remainder of 1996 and in 1997, they foresee the economy expanding at about a 2% clip. This moderation is consistent with recent estimates of the nation's potential growth—a

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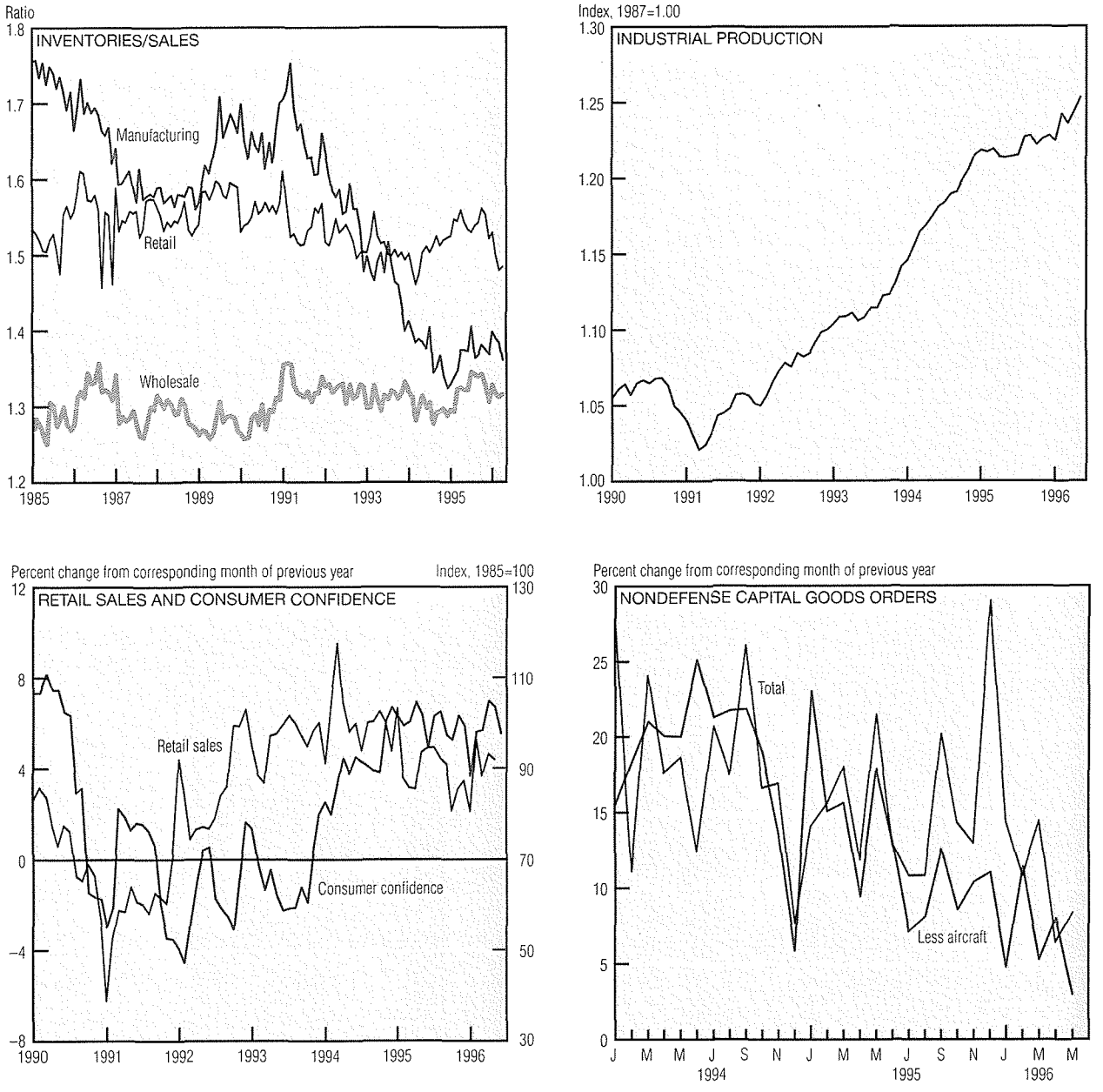
Economic Activity (cont.)



NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System; and The Conference Board.

rate that is sustainable at high levels of resource utilization.

Businesses at all stages of production and trade have managed to lower their inventory-to-sales ratios, even exclusive of automobiles. Further trimming of stocks seems unlikely, and in some sectors, inventories appear lean. Industrial production increased 0.7% in May for the second consecutive month, but whereas April's gains were largely concentrated in autos, May's were more broadly based. The nation's manufacturers, utilities, and mines operated at 83.2% of capacity in May, somewhat higher than in 1995:IVQ.

On a year-over-year basis, retail sales (adjusted for inflation) have been increasing at a healthy 4% rate. Revised figures for personal consumption expenditures, a broader measure of consumer outlays, have also shown moderately strong growth since February, often exceeding advances in real disposable income. However, while consumption rose about 3% in May, real disposable income increased slightly faster, at about 3.1%. Although consumer attitudes appear fairly erratic on a month-to-month basis, they remain at a favorable level. While debt-servicing burdens and delinquency rates have picked up, gains in stock and housing prices have bolstered household wealth.

Business fixed investment spending, though still strong, may soon begin to moderate. New orders for nondefense capital goods jumped 9.6% in May, due mainly to an increase in expenditures for commercial aircraft. However, even excluding this volatile sector, orders have recently been declining on a year-over-year basis.

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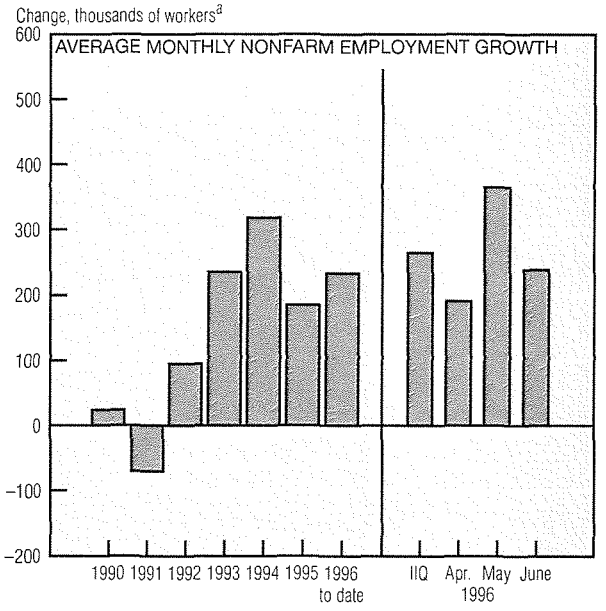
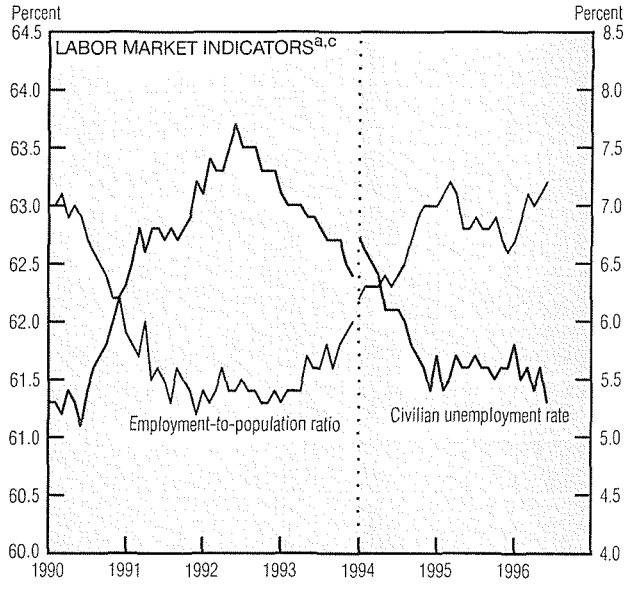
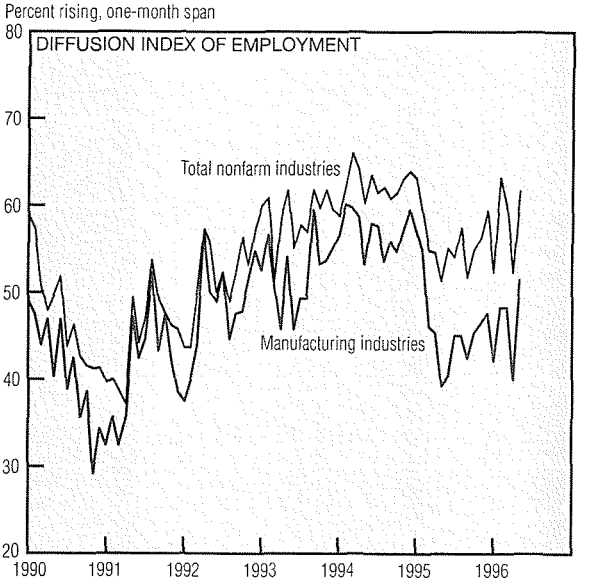
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
	1995	1996			
	Year	IIQ	April	May	June
Payroll employment	185	265	191	365	239
Goods-producing	-5	26	13	49	16
Manufacturing	-12	3	1	16	-7
Construction	9	22	13	30	23
Service-producing	190	239	178	316	223
Services	110	111	79	156	99
Computer	11	13	14	15	9
Retail trade	36	68	79	51	75
Federal govt.	-5	-6	-3	-2	-13
	Average for period				
Civilian unemployment rate (%)	5.6	5.4	5.4	5.6	5.3
Average hourly earnings (dollars)[b]	11.5	11.8	11.7	11.7	11.8
Mfg. workweek (hours)[b]	34.5	34.4	34.3	34.2	34.7





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.

June was characterized by widespread strength in the nation's labor markets, as nonfarm payrolls added 239,000 workers. That expansion pushed jobs growth for the first six months of the year above the 1.3 million mark, slightly better than 1995's first-half posting of 1.2 million. June's diffusion index of employment (61.7%) reveals that the increase was distributed among a wide variety of industries. Likewise, the Bureau of Labor Statistics reported that both the rise in the nonfarm workweek and the record increase in average hourly earnings reflected broad-based gains.

The service-producing sector led the June advance, creating 223,000 new jobs on net. Growth in the narrow services industries was slightly below average, while retail trade establishments added 75,000 workers, nearly half of whom were hired by restaurants and bars. The goods-producing sector posted a small net increase of 16,000, although manufacturing employment was negative. The federal government continued to trim payrolls, cutting 13,000 workers during the month.

Household survey data also pointed to strength in the nation's labor markets. The unemployment rate dropped to 5.3% in June—its lowest level in six years. In addition, the employment-to-population ratio rose once again, edging up to 63.2%.

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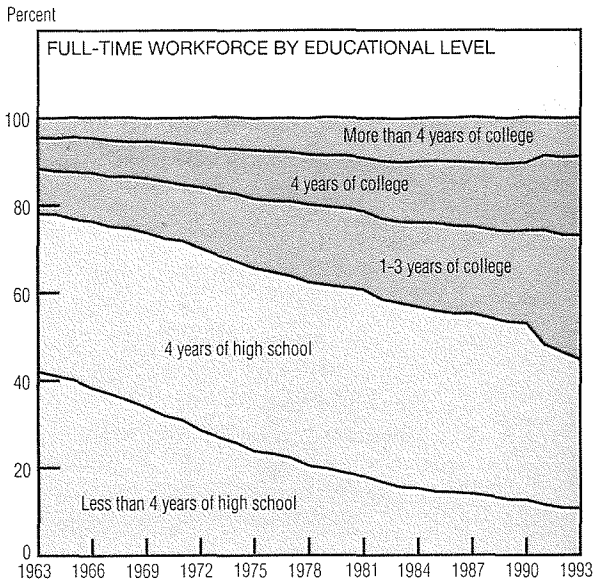
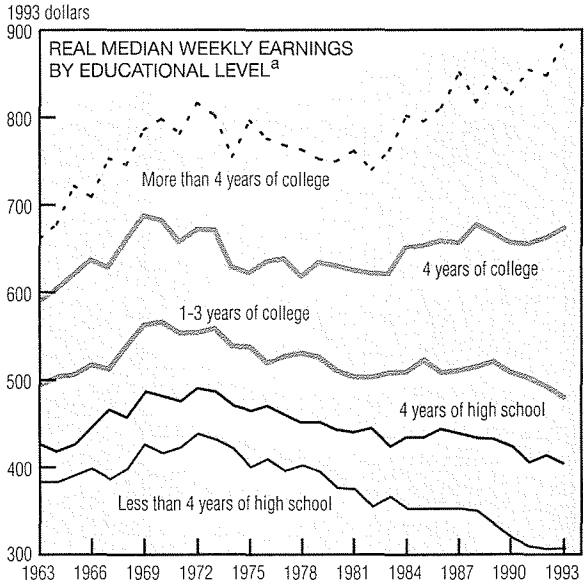
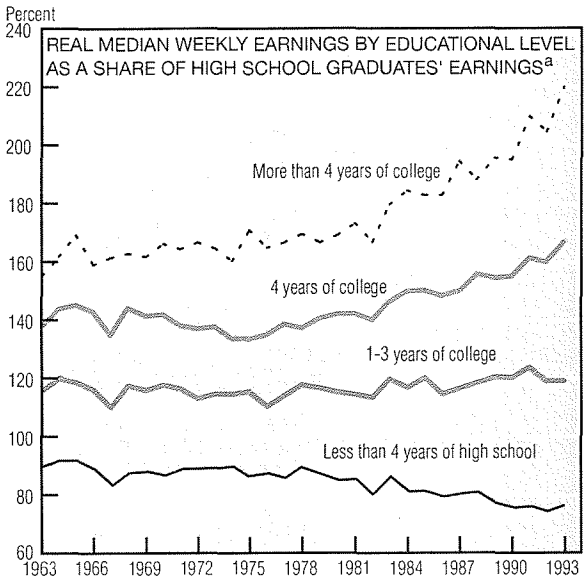
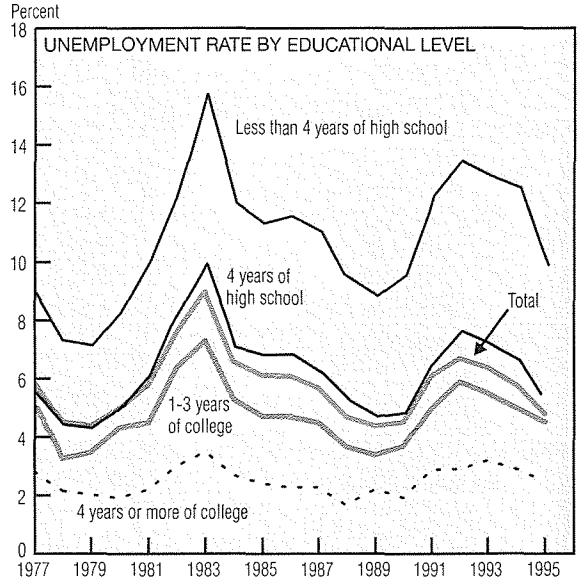
Education and Earnings









a. Refers to full-time workforce.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census.

American workers are becoming more educated. Between 1963 and 1993, the fraction of the full-time workforce without a high school diploma fell from about 40% to around 10%, while the share of college graduates rose from approximately 10% to about 25%.

Weekly median earnings vary widely by educational group, reinforcing the common belief that more schooling means larger paychecks. While the real (inflation-adjusted) median weekly earnings of those with less than a college degree have been falling since the early 1970s, the opposite is true for those who have earned at least a bachelor's degree.

Moreover, the earnings disparity between college graduates (including those with advanced degrees) and other workers has widened. In the early 1960s, the median earnings of a person who continued past college were about 1.6 times more than those of an individual with less than four years of high school. By 1993, that gap had more than doubled.

Earnings differences across educational groups, however, reveal only part of the variation in gross returns from education. Substantial differences also exist in unemployment rates. Workers who failed to finish high school are roughly five times more likely to be jobless than those who continued their education past college. In other words, higher education leads to both higher wages and a better probability of being employed.

The trends in educational attainment by various race and sex

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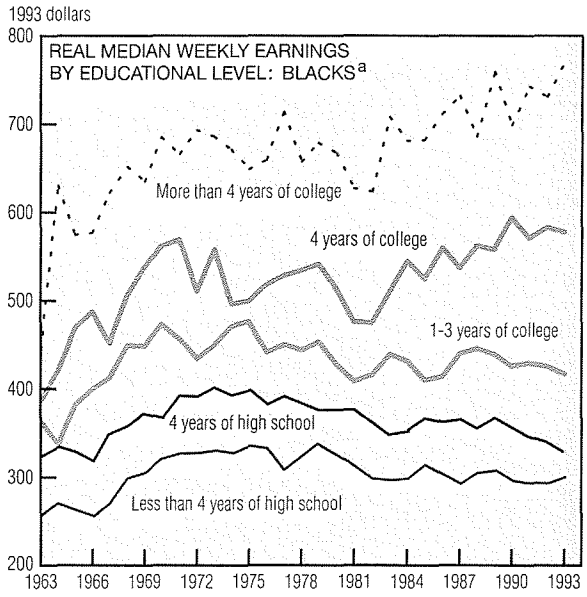
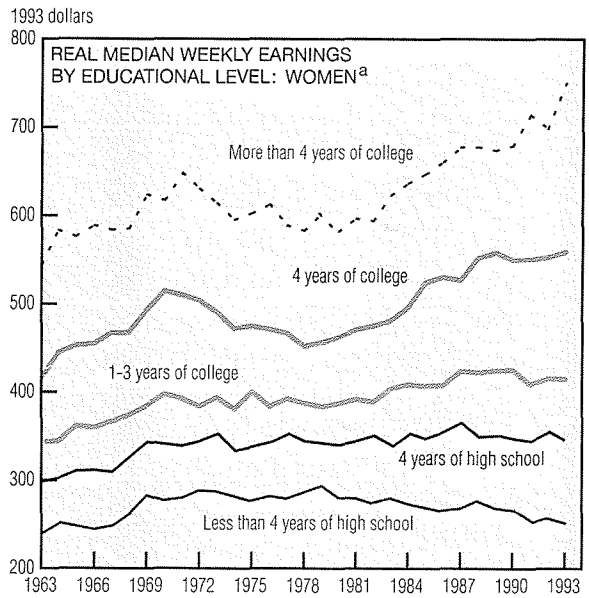
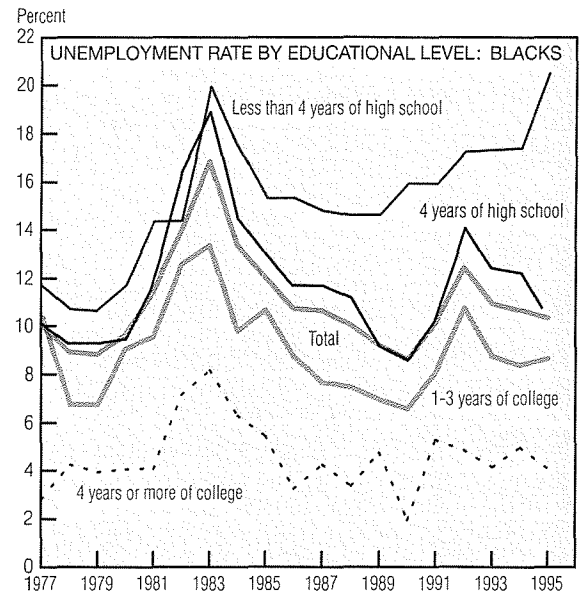
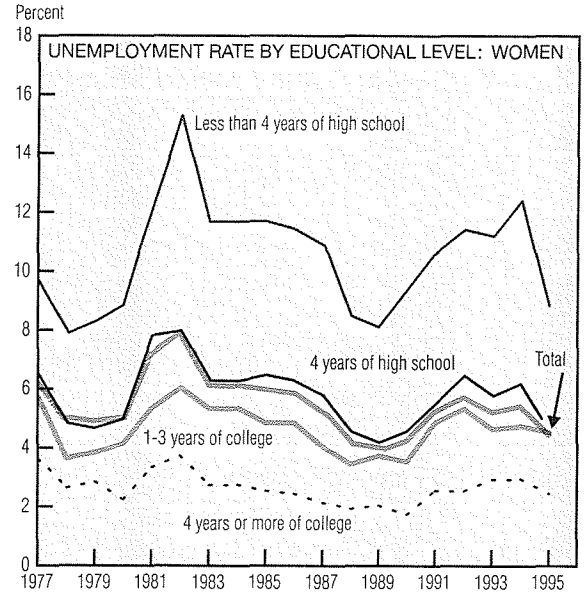
Education and Earnings (cont.)









a. Refers to full-time workforce.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and U.S. Department of Commerce, Bureau of the Census.

groups follow much the same pattern. Over the past three decades, more full-time workers have completed high school, and more have at least some college credits. However, there are notable differences in the effect of education on both the earnings and unemployment level of blacks and females.

For the entire full-time workforce, the earnings gap between "more than college" and "less than high school" was about double in 1993. For blacks, however, the difference was already nearly double in 1963 and was even higher in 1993 (about 2.6 times). As the median weekly earnings of those with advanced degrees approached $800 (in 1993 dollars), workers lacking a high school diploma were taking home about $300. For females, the difference is larger yet. Note also that the disparity is still increasing for both of these groups. For blacks and women, the wage premium due to education is greater than it is for white males.

This education premium for blacks and females does not show up as strongly in unemployment rates. Here again, persons who never graduated from high school are about four times more likely to find themselves without a job than those who hold at least a bachelor's degree. Furthermore, since the mid-1980s, unemployment rates for women and blacks with a college degree or postgraduate work have been much less volatile than for those who never finished high school.

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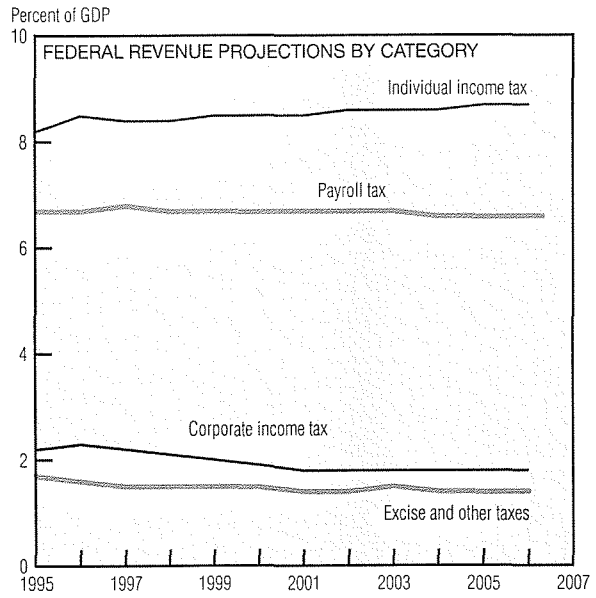
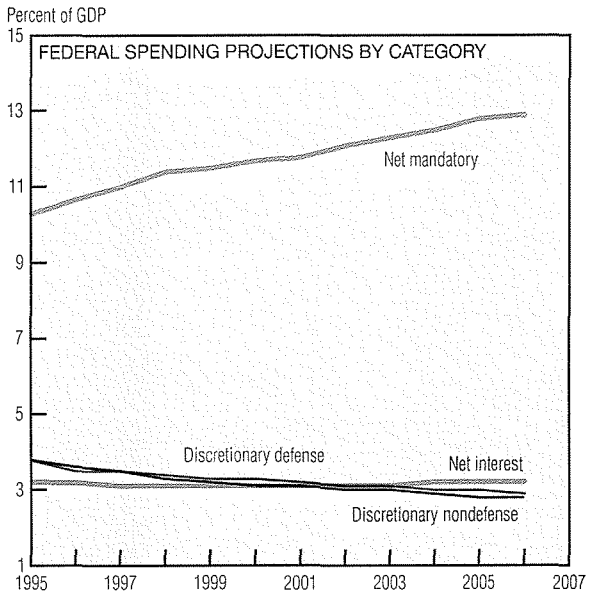
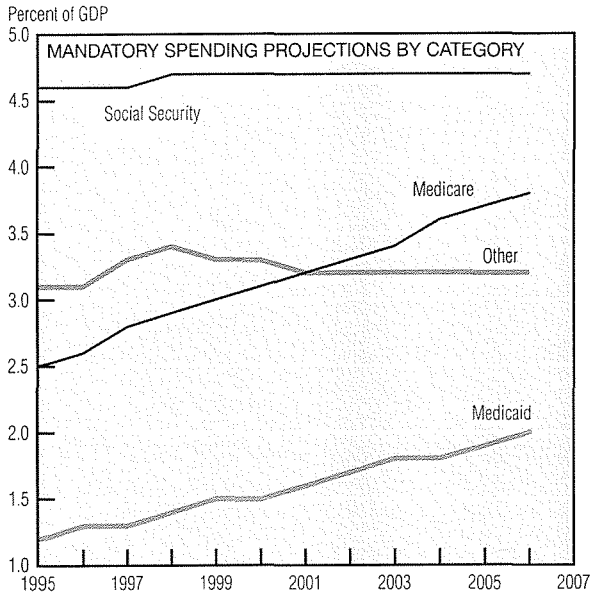
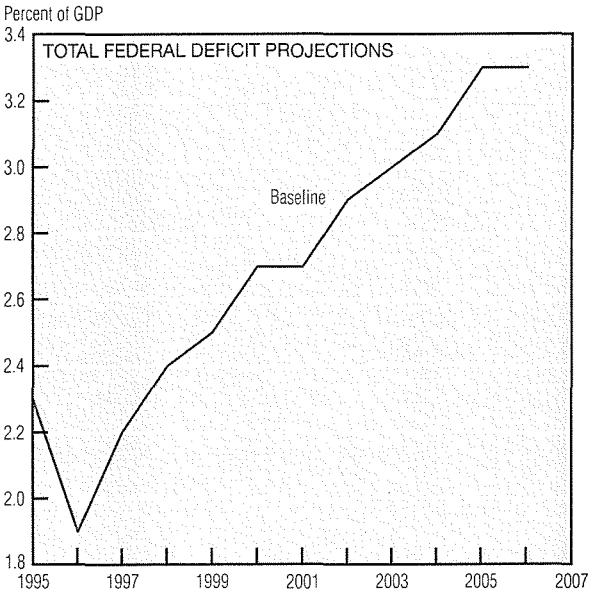
Federal Budget Projections









NOTE: Dates are CBO fiscal years. 1995 data are actual.
SOURCE: Congressional Budget Office.

Congressional Budget Office (CBO) projections show that, under current fiscal policies, total federal revenue as a share of GDP will decline from 18.9% in 1995 to about 18.5% in 2001, and will remain at that level through 2006. Over this period, the only revenue category expected to pick up as a share of national output is the individual income tax (8.2% to 8.7%). Payroll taxes should hold steady at around 6.6%, while corporate taxes and excise and other taxes are seen as edging down. These trends reflect a continuation of those observed in the past, except for payroll tax revenues, whose share of GDP has increased consistently over the last four decades.

The upward trend in projected federal spending continues to be dominated by increased mandatory outlays. Excluding offsetting receipts, mandatory spending is expected to grow from 10.3% of GDP in 1995 to 12.9% in 2006, mainly as a result of increased health care costs. Medicare's share of national output is seen as rising 1.3 percentage points over the next decade, while Medicaid is projected to expand 0.8 percentage point. In contrast, the CBO anticipates net interest outlays will remain unchanged, while defense and nondefense discretionary spending are each expected to fall about 1.0 percentage point relative to output.

As a result, the baseline federal deficit is on course to jump from 2.3% of GDP in 1995 to 3.3% in 2006. However, despite the attention the deficit receives in the media and on the campaign trail, what the government spends our money on and how it taxes us to pay for that spending are more important than the size of the overall deficit.

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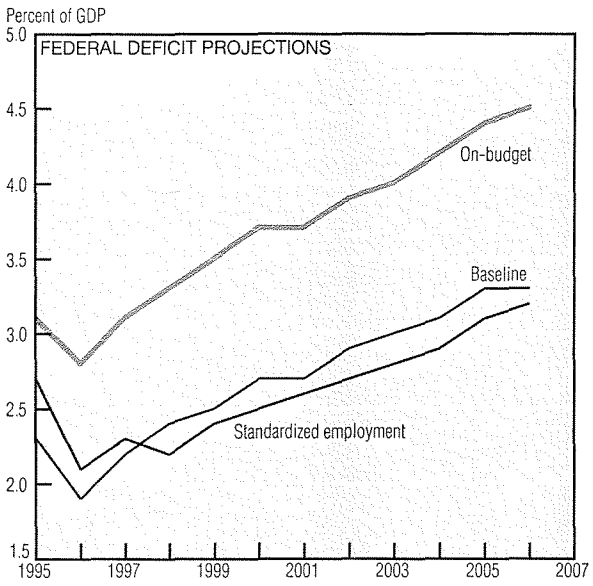
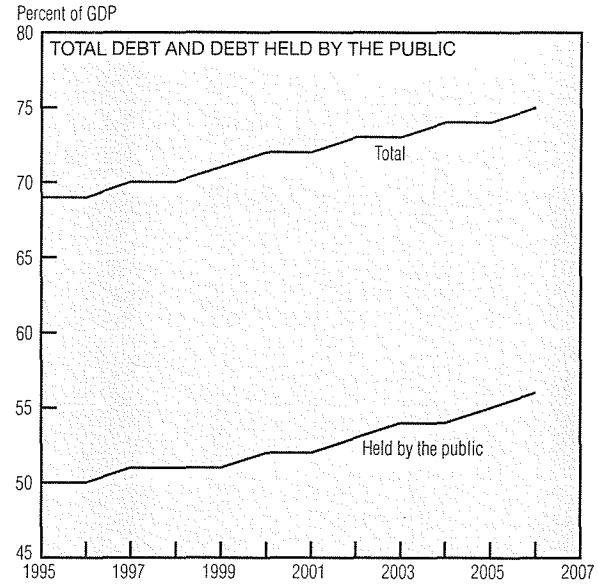
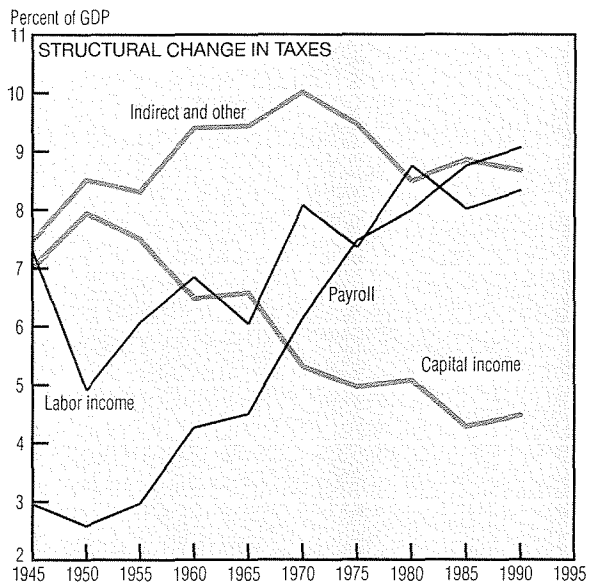
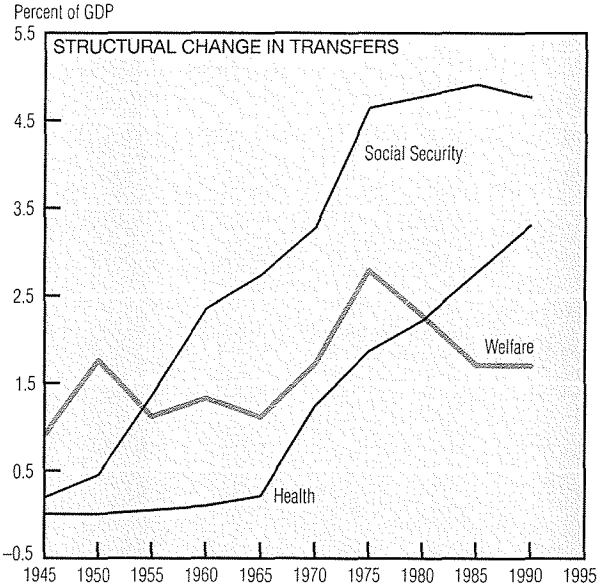
Federal Budget Projections (cont.)









NOTE: Dates are calendar years. 1995 data are actual.
SOURCES: Congressional Budget Office; and U.S. Department of Commerce, Bureau of Economic Analysis.

Baseline deficit and debt numbers are widely used to measure the budget's impact on national saving and on the extent to which current government purchases will have to be paid for by future generations. Analysts use several measures to address these concerns. For example, the "standardized employment deficit" refers to the amount of public borrowing that would occur if the economy were operating at full potential. The "on-budget" deficit refers to general government operations, arbitrarily excluding Social Security and Postal Service accounts.

In general, however, deficits are inadequate measures of how fiscal policies shift the burden of taxes and expenditures from older to younger generations, and of how that shift affects interest rates and national saving. For example, structural changes in taxes and transfers may leave debt and deficit levels untouched, yet transfer burdens from older Americans to younger and future generations, thereby affecting U.S. saving.

Some dramatic structural changes in taxes and transfers have taken place during the postwar period: Labor income and payroll taxes—paid by younger, working generations—have increased as a share of GDP, whereas taxes on capital income—paid mostly by older individuals—have dropped substantially. Moreover, Social Security, Medicare, and Medicaid transfers, which go mainly to older Americans, have skyrocketed relative to national output, while welfare transfers, which mainly benefit younger individuals (especially single mothers), have remained nearly constant.

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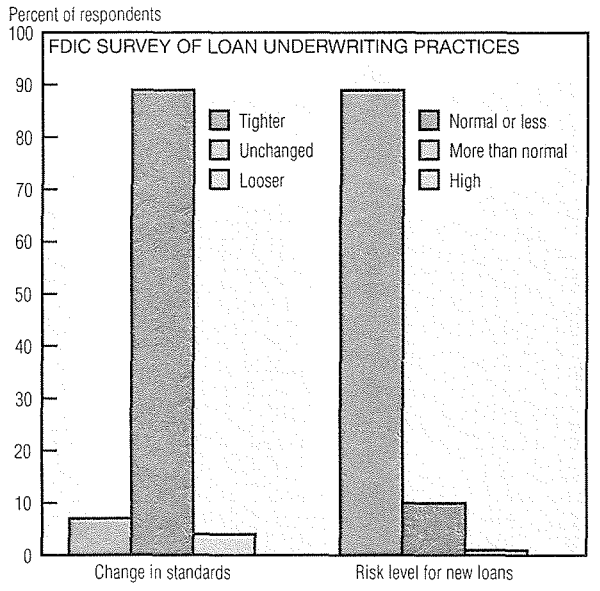
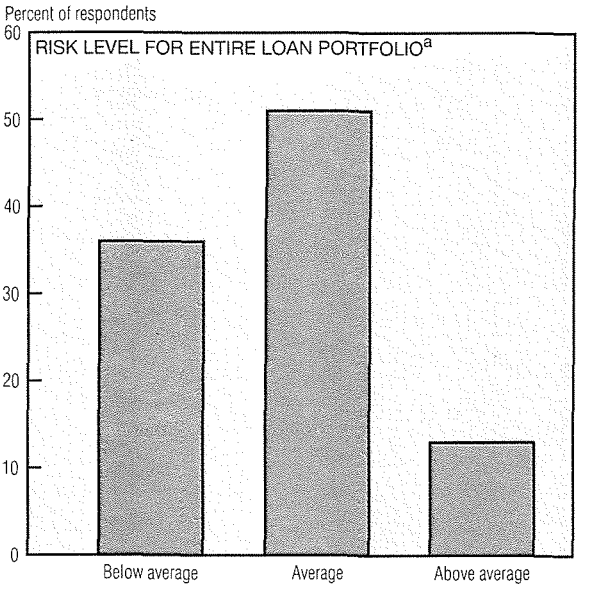
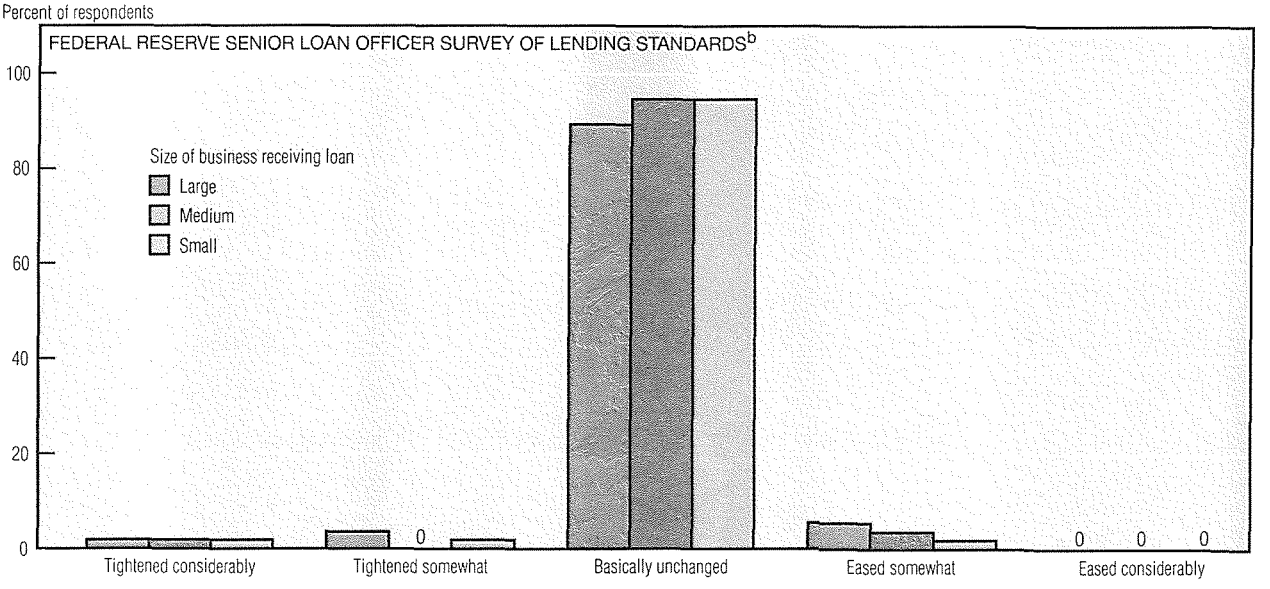
Bank Lending Standards







a. Includes old loans.
b. Survey was conducted in May 1996 for the previous three-month period. Includes commercial and industrial loans and credit lines.
SOURCES: Federal Deposit Insurance Corporation Report on Underwriting Practices; and Federal Reserve Senior Loan Officer Survey, May 1996.

Banks face a delicate trade-off in making loans. On the one hand, if they lend only to undeniably safe and secure creditors, then lending, profits, and perhaps economic growth will suffer. If they relax their standards and lend to a broader spectrum of creditors, then defaults may increase, threatening profits from the other side. Furthermore, what is appropriate at the depths of a recession may differ from what's best during a strong recovery.

One measure of how banks are responding to the challenge comes from a recently released report on bank lending standards. The Federal Deposit Insurance Corporation surveyed examiners of 2,000 banks on loan underwriting practices. Most banks reported no change in lending standards; of those that did note changes, nearly twice as many tightened as eased. The number of banks that raised their standards roughly corresponds to the number reporting above-average risk on new loans. When characterizing the risk of their entire portfolio (including old loans), most banks again noted average or below-average risk. Some states had more than the usual number of banks reporting above-average risk, notably California (38%), Louisiana (25%), and New York (24%).

Another measure of bank loan standards comes from the Federal

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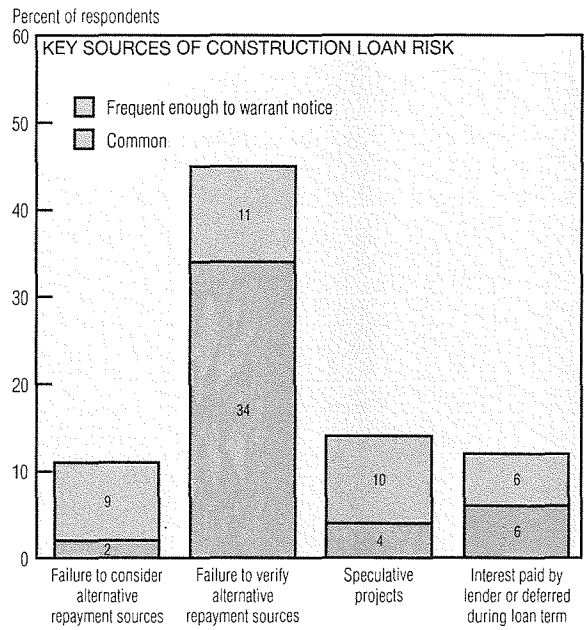
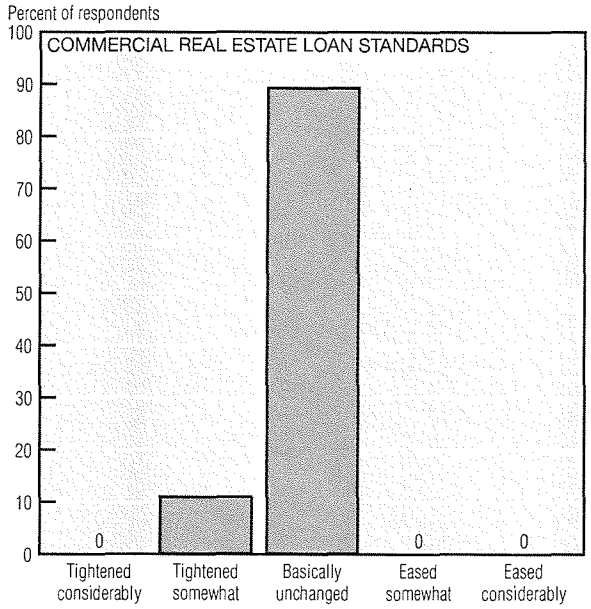
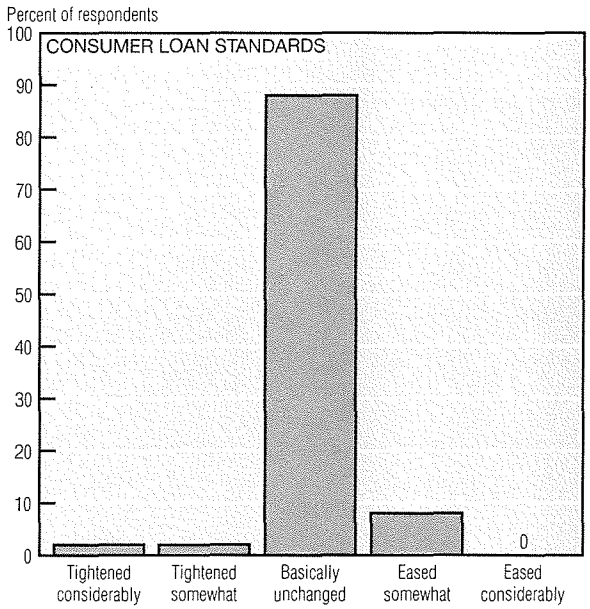
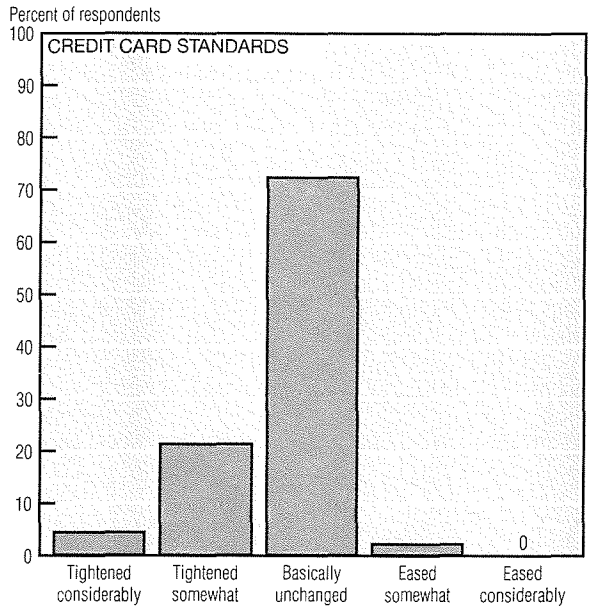
Bank Lending Standards (cont.)









SOURCES: Federal Deposit Insurance Corporation Report on Underwriting Practices; and Federal Reserve Senior Loan Officer Survey, May 1996.

Reserve's Senior Loan Officer Survey. For the broad category of business loans, banks reported almost no change in lending standards over the last three months, with a slight bias toward tightening.

Commercial real estate loans, which include construction and land development loans and loans secured by nonfarm, nonresidential land, can be risky because such projects typically do not produce an immediate return for the borrower. Banks mitigate this risk by modifying the terms of the loan contract, but some practices that have led to problems in the past remain common. Of these, the most prevalent is banks' failure to check the quality of alternative repayment sources. This concern, which showed up most often in New England, may be the source of the slight tightening in standards for a minority of commercial real estate loans.

The consumer lending side follows a broadly similar pattern, with most banks reporting little or no change in standards. About 10% of the respondent banks expressed concern over collateral quality and repayment ability, but this seems not to have filtered down into major changes in behavior. Standards for credit card loans are tightening, however, with more than a quarter of reporting banks raising standards, some considerably.

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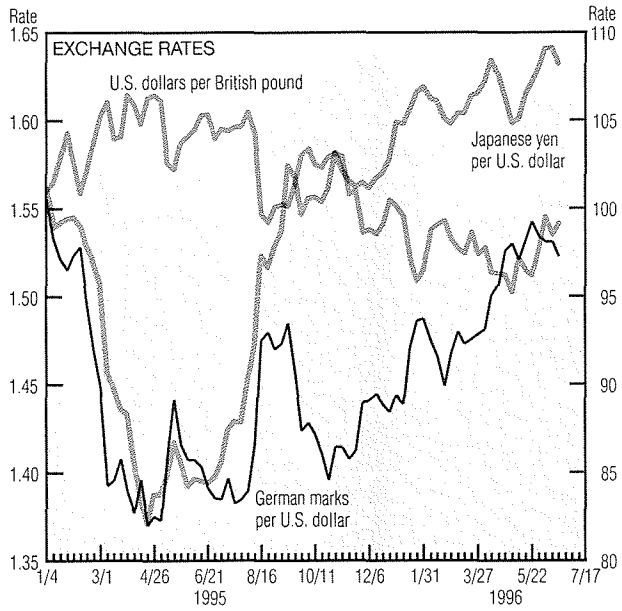
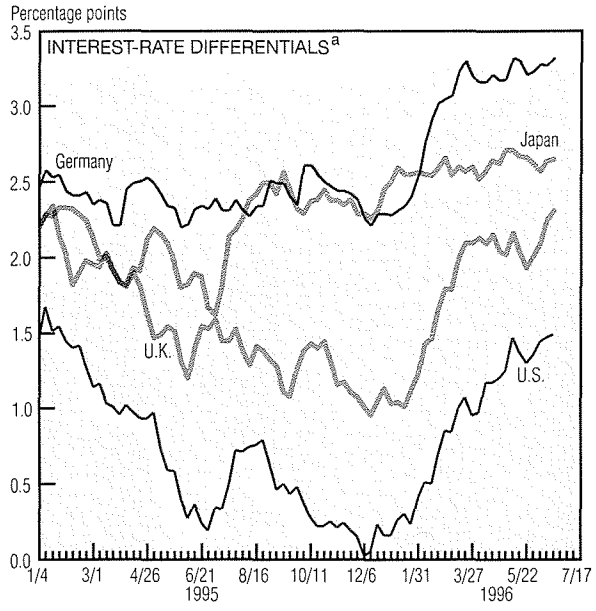
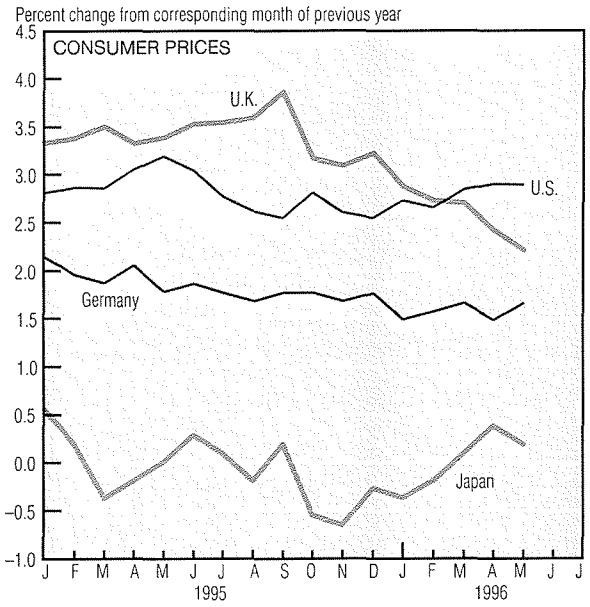
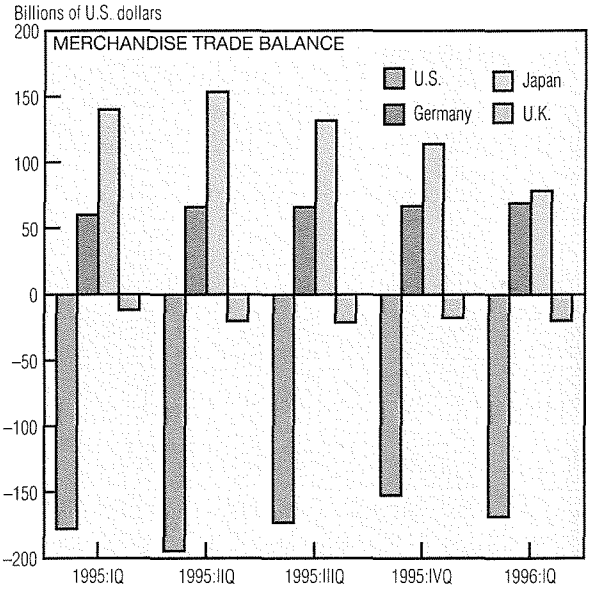
International Developments









a. 10-year minus 3-month interest rate.
SOURCES: Board of Governors of the Federal Reserve System; and DRI/McGraw-Hill.

The spread between long-term and short-term interest rates has expanded during most of 1996 in the U.S., Germany, and the U.K. Over the last month, this widening has stemmed from higher long rates, reflecting signs of economic strength and perhaps higher expected short rates. Despite some evidence of renewed vigor in Japan, interest rates have not increased during this same period. The dollar has gained ground against the yen in spite of periodic expectations of Japanese monetary tightening. Recent statements suggest that Japan's central bank is still attempting to sustain the nation's recovery with low rates.

The dollar has generally risen against the German mark this year on signs of a strengthening U.S. economy, but recently dropped in the wake of reports showing renewed German growth. The recent appreciation of the British pound can be partially explained by the nation's continued moderate expansion. Short-term interest rates have fallen over the past month, and the inflation rate continues to decline.

Inflation pressures generally remain subdued. Consumer prices in Japan fell over much of the last year, but have been rising since January. Inflation in Germany remains stable, and the U.S. has seen only a slight uptick.

Foreign exchange rates react to news about both trade balances and economic strength or weakness, while trade balances are in turn influenced by exchange rates. However, these reactions often take time and are complicated by the uncertainty surrounding future economic policies. Thus, it is not surprising that the Japanese trade surplus has declined despite weakness in the yen, while a first-quarter deterioration in the U.S. balance has accompanied strength in the dollar.

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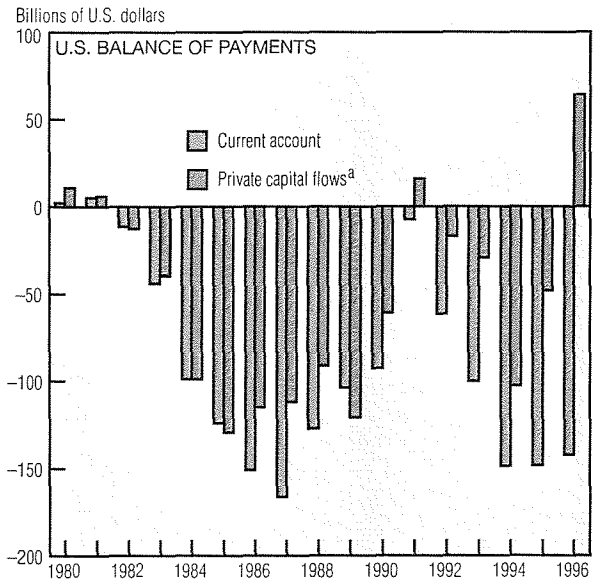
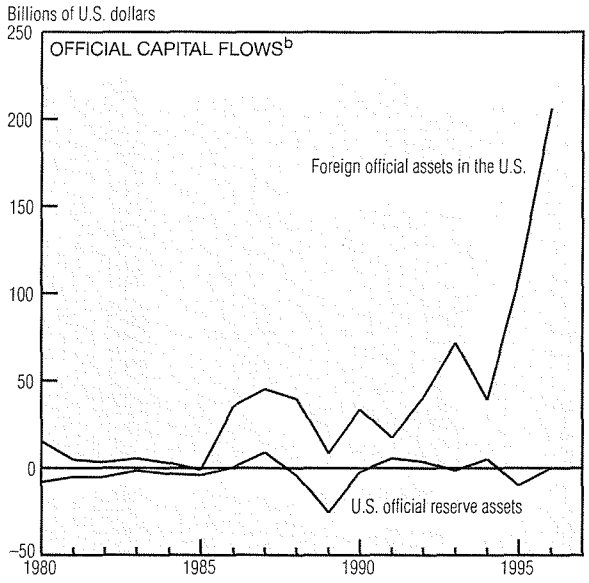
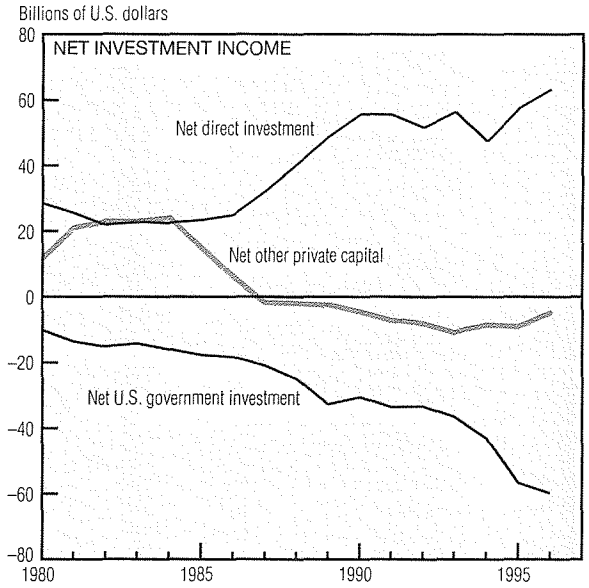
Balance-of-Payments Trends





U.S. Current Account: Savings and Investment
(Percent of GDP)

	1993	1994	1995	1996
Gross saving	14.3	15.2	15.8	16.2
Private	14.7	14.5	14.7	15.1
Government	-0.4	0.7	1.1	1.1
Foreign capital inflow[c]	1.5	2.2	2.1	1.9
Gross domestic investment	16.5	17.7	17.8	17.4
Statistical discrepancy	-0.7	-0.3	0.1	0.7



a. Private capital flows have signs reversed and include the statistical discrepancy as unrecorded capital flows. Positive values represent a capital outflow.
b. Positive values represent a capital inflow.
c. Foreign capital inflows are the current account deficit with the sign reversed.
NOTE: All 1996 data are annualized first-quarter figures.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and the Federal Reserve Bank of New York.

Preliminary data show the U.S. current account deficit running at a $142 billion annual rate in 1996:IQ. The current account includes trade in goods and services, net investment income, and unilateral transfers. Most economists expect this year's current account deficit to exceed last year's $148 billion posting somewhat.

A country running a current account deficit is applying more of the world's output to its own consumption and investments than it is producing. To finance its imports, the U.S. must export financial assets—claims on our nation's future production—and a net inflow of foreign capital must occur. Any tendency for the foreign capital inflow not to match the current account deficit will initiate changes in interest rates, exchange rates, and other economic variables to restore balance. Interestingly, a net private capital outflow accompanied the 1996:IQ current account deficit. The requisite net capital inflow came when foreign governments added $206.5 billion (annual rate) to their official holdings. Often, foreign governments will make such a move to avoid adjustments in the exchange rate.

A country's ability to service future foreign claims on its output without a decline in its standard of living depends on whether it uses foreign capital to finance consumption or investment. Apparently, recent net foreign-capital inflows have supported U.S. investment.