

I

The Economy in Perspective

Les Misérables ... A few decades ago, during a period of slow economic growth and high inflation, the economist Arthur Okun added together the unemployment and inflation rates and dubbed the sum the Misery Index. Okun, a keen marketer of economic concepts, recognized the communication value of having a quick and dirty indicator of economic conditions at one's disposal. In 1960, the Misery Index stood at 7.2%; in 1970 at 10.6%; in 1980 at 20.6%; in 1990 at 10.9%; and today it registers about 8.2%. With so much misery having been wrung out of the economy lately, you might think people would be fairly pleasant about the subject, if not borderline blissful.

Au contraire. Apparently, there is still plenty to be miserable about. Many people are understandably disconsolate about employment upheavals in business firms—restructurings driven by a desire to cut costs and reposition the companies. Interestingly, although widely publicized layoffs by large, well-known companies have captured the public's attention during the past several years, employment overall has been expanding fairly rapidly, and the unemployment rate stands at just 5.2%. Moreover, if corporate labor-force retrenchments are making households more cautious, why do national statistics show growing consumer confidence, lower saving rates, and increased debt finance during the past few years? Although it is clear why layoffs would affect the behavior of those directly harmed, large spillovers are not evident.

Some people are glum about what they regard as the inadequate pace of economic growth. Real GDP has been advancing at an average 2.75% rate for the past five years, a tempo that most economists regard as slightly better than what the nation should expect, considering labor force and productivity trends. The critics' impatience stems from a conviction that changes in certain national economic policies could boost the economy's growth rate considerably, to 3.5% per year or more.

Different economic policies could, possibly, lead to a faster growth track. To reach this objective, economists typically recommend policies that encourage saving, enhance capital formation, reduce regulatory taxes, and promote free trade. Consequently, many would like to see our income-based tax system replaced by a consumption-based one, and would urge reconsideration of tax preferences and other government programs that encourage spending on housing.

In discussing capital formation, most people ignore housing, although it actually forms the largest component of our capital stock. Without altering the size of that stock, the nation could develop a more productive capital base by changing the mix of housing and business capital. Nevertheless, despite the disproportionate share of housing-related tax preferences accruing to the wealthiest households, government programs that support housing expenditures remain quite popular.

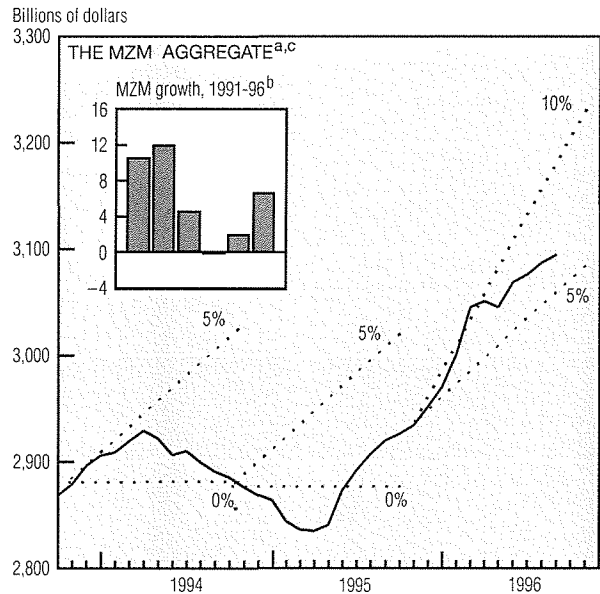
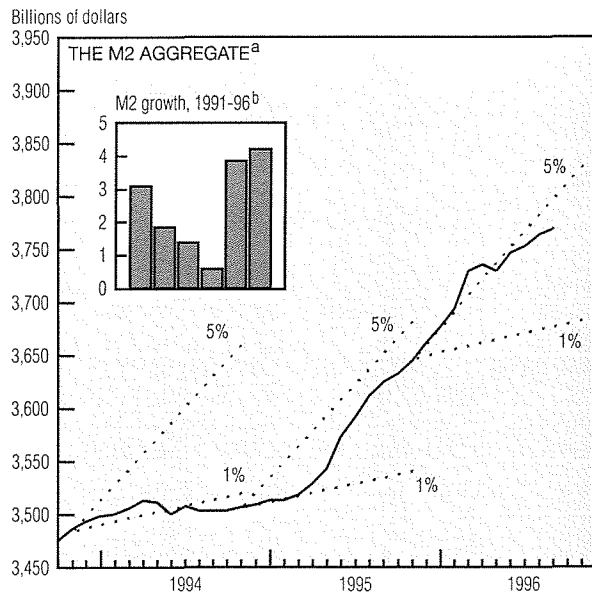
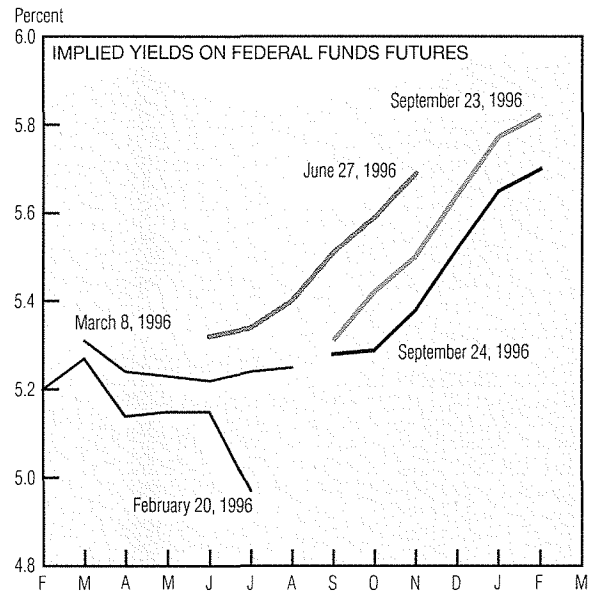
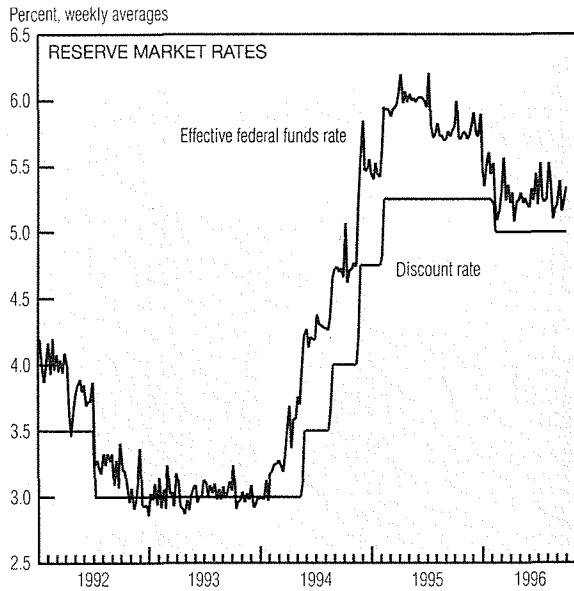
Free-trade agreements, on the other hand, are difficult to sell to the public, despite their often-demonstrated ability to improve national living standards over time. Public debates over free-trade agreements tend to focus on the jobs that will be lost relative to those that will be gained in the agreement's wake. A nation is considered a winner if it gains more jobs than it loses, but this elementary arithmetic misses the real point.

Trade agreements should enable nations to compete on the basis of their comparative advantages so that both parties benefit, whatever the outcome for jobs. For example, South American countries enjoy summer when it is winter in the United States. Permitting them to export more fresh fruits and vegetables to this country gives U.S. consumers a wider food selection all year. In return, our exporters could get cheaper access to markets for manufactured products. In this example, the U.S. growing and packaging industries might lose jobs as consumers substitute fresh food for packaged, but our manufacturing sector would gain jobs. The essential point, however, is that both nations' productivity would increase.

Many economists also suggest Social Security reform. This program provided generous benefits to current and past generations of the elderly, but demographic trends and slowing productivity growth make its prognosis bleak. Even more problematic, the rate of return to contributions has been declining for some time, and currently is far below what a person could receive by investing in privately issued securities. The net effect of the program has been to boost national consumption at the expense of national saving.

Public office holders find it difficult to champion open trade agreements, consumption-based taxes, curbs on housing investment, or Social Security reform. Although movement in these directions carries the promise of higher living standards, the status quo is *de rigueur*. Misery, after all, loves company.

Monetary Policy



a. Last plot is estimated for September 1996.
 b. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on an estimated September over 1995:IVQ basis.
 c. MZM is an alternative measure of money that includes M1 plus institutional money market mutual funds less small time deposits.
 NOTE: All data are seasonally adjusted. Dotted lines represent growth ranges and are for reference only.
 SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

The Federal Open Market Committee (FOMC) left the intended federal funds rate unchanged at its September 24 meeting. The Committee last altered the intended funds rate in February, lowering it from 5.5% to 5.25%. The federal funds rate is the interest rate that banks pay on overnight loans to one another, and it forms an anchor for other short-term rates. Banks can also obtain reserves temporarily by borrowing from the Federal Reserve System,

which last lowered the rate charged on such loans—the discount rate—from 5.5% to 5.0% in February.

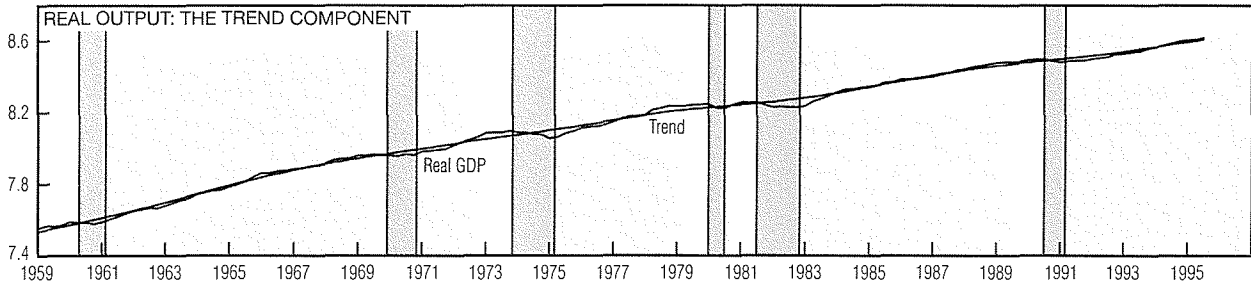
As the upward trajectory of implied yields on federal funds futures suggests, financial markets have been expecting the Fed to raise interest rates since June. On September 23, just prior to the FOMC meeting, the federal funds futures market seemed to expect an increase of 50 basis points in the funds rate by year's end. The shift

in the implied yield curve immediately following the meeting indicates that the market revised the timing—but not the direction—of its forecast.

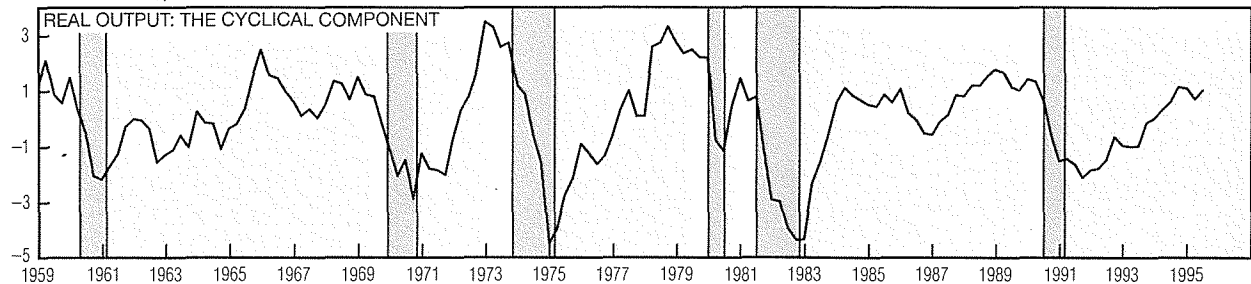
This year's increase in interest rates, which raised the opportunity cost of holding money, has slowed the growth of M2 and MZM. Through September, these measures of money have grown 4.2% (M2) and 6.6% (MZM) above their 1995:IVQ levels.

Output, Inflation, and Unemployment

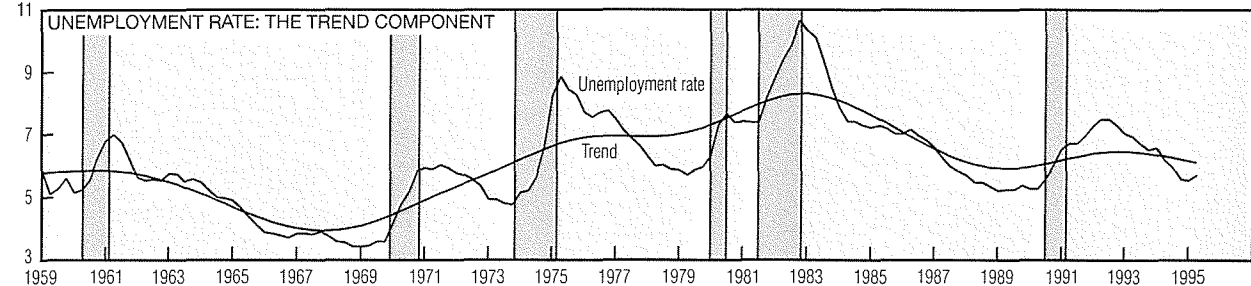
Real GDP in logarithms



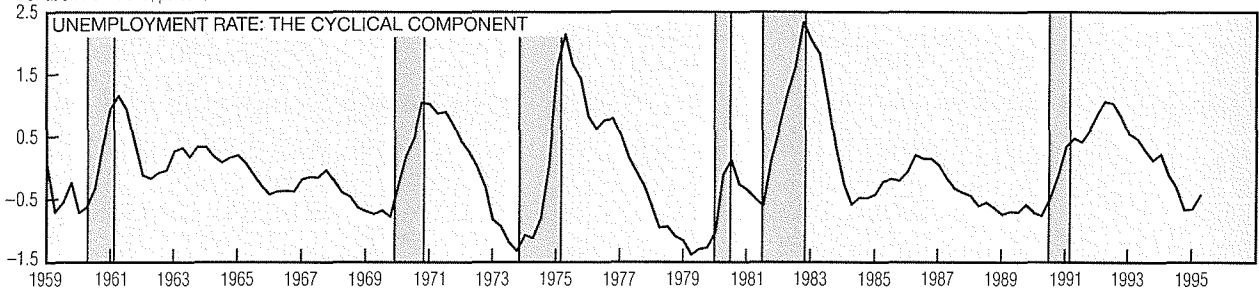
Deviation from trend, percent



Percent



Deviation from trend, percent



NOTE: Shaded areas indicate recessions. All trends are calculated using the Hodrick-Prescott filter. This technique minimizes the sum of the squared differences between the series and the trend line, subject to a constraint on the size of the second differences. A weight of 1,600 is assigned to the constraint, which is appropriate for quarterly data. See Edward C. Prescott, "Theory ahead of Business Cycle Measurement," Federal Reserve Bank of Minneapolis, *Quarterly Review*, Fall 1986, pp. 9-22.

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

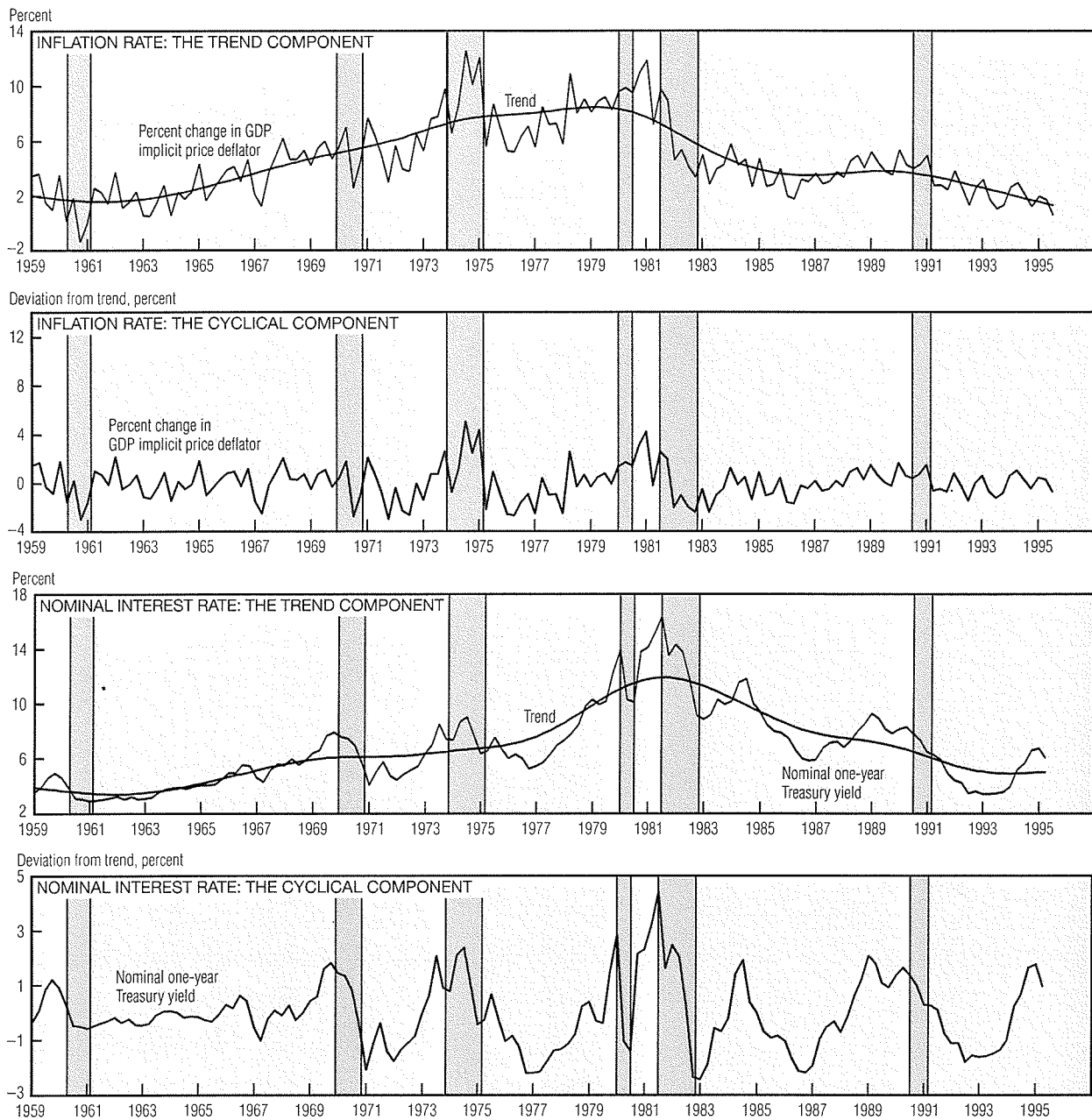
Monetary policymakers are concerned with the relationships among real GDP, the unemployment rate, and inflation. Information about these relationships can be uncovered by separating the data into two distinct components: trend and cyclical. The trend component can be defined by statistical techniques that draw a smooth line through the central tendency of the data. The cyclical component is then measured as the deviation of the variable from its trend.

During recessions, real GDP is typically below trend, which implies that the cyclical component exhibits a negative deviation. During booms, the opposite is true, that is, real GDP is above trend and the cyclical component exhibits a positive deviation. As one would expect, the unemployment rate increases during a recession. Near the end of a recession (and hence the start of a recovery), unemployment is typically well above trend.

The behavior of inflation is more erratic. During most recessions, it has been observed to fall below trend. However, during the recessions of 1974 and 1980, inflation increased sharply above trend as the economy suffered from supply-side oil shocks.

The nominal interest rate on a one-year Treasury security is heavily influenced by Federal Reserve policy actions that determine the level
(continued on next page)

Output, Inflation, and Unemployment (cont.)



NOTE: Shaded areas indicate recessions. All trends are calculated using the Hodrick–Prescott filter. This technique minimizes the sum of the squared differences between the series and the trend line, subject to a constraint on the size of the second differences. A weight of 1,600 is assigned to the constraint, which is appropriate for quarterly data. See Edward C. Prescott, "Theory ahead of Business Cycle Measurement," *Federal Reserve Bank of Minneapolis, Quarterly Review*, Fall 1986, pp. 9–22.

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

of the federal funds rate. Notice that each of the last six recessions was preceded by a period when the one-year Treasury yield was above trend. This suggests that nominal interest rates are leading indicators of recessions. Once a slowdown begins, nominal interest rates start to fall—partly because the Fed typically responds to a sluggish economy by lowering the federal funds rate.

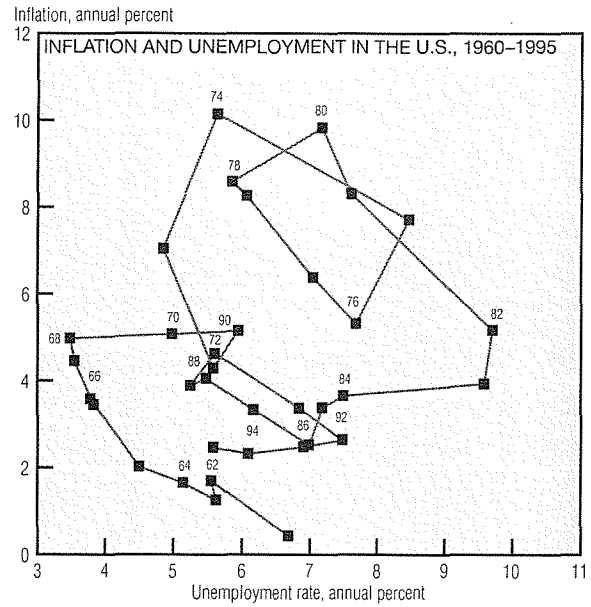
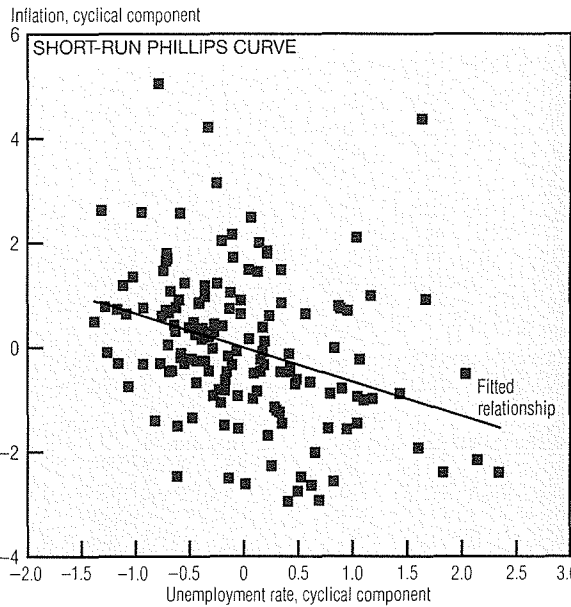
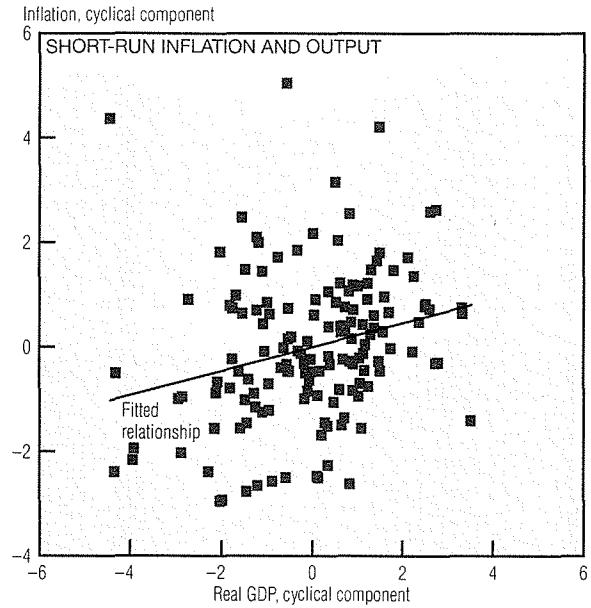
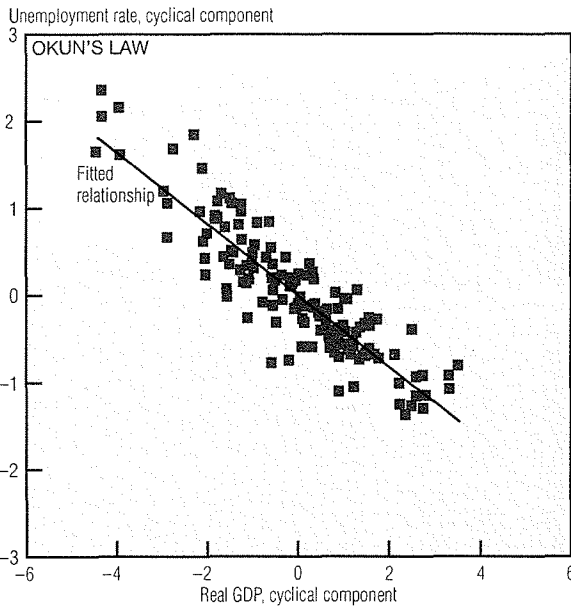
A scatterplot (page 5) reveals a negative relationship between the cyclical components of real GDP

and the unemployment rate. This relationship, known as Okun's Law, provides us with the following rule of thumb: A 1% increase in real GDP relative to trend is typically associated with a 0.4-percentage-point decline in the unemployment rate (again relative to trend). Okun's Law simply reflects the idea that additional production of goods and services requires more employed workers. As production goes up, workers are drawn into the labor force, thereby reducing unemployment.

Quarterly changes in real GDP growth are often thought to provide information about the future course of inflation. Conventional wisdom holds that if the economy grows too fast, there is a danger of higher inflation. A scatterplot of the cyclical components of real GDP and the inflation rate provides some support for this idea. When real GDP is high relative to trend—indicating brisk economic growth—the inflation rate also tends to be above its trend value. Although there is evidence of a weak positive

(continued on next page)

Output, Inflation, and Unemployment (cont.)



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 the Federal Reserve Bank of Cleveland.

relationship, the link between the two variables is much less precise than the one observed for Okun's Law. For example, the recessions of 1974 and 1980 violated the conventional wisdom because real GDP was low relative to trend, while inflation was very high.

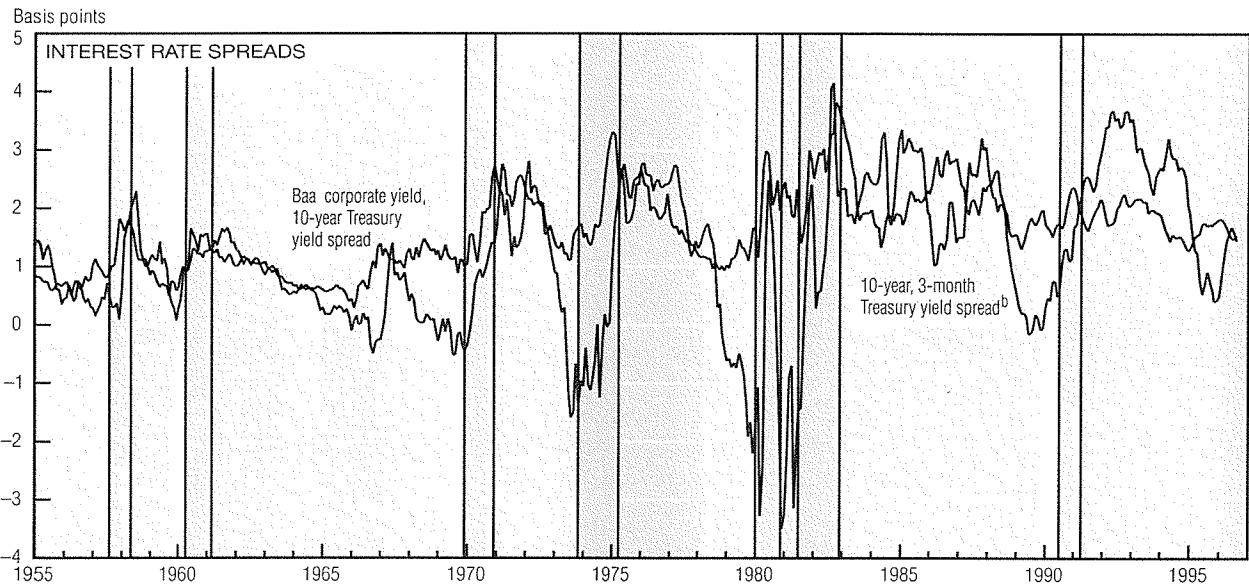
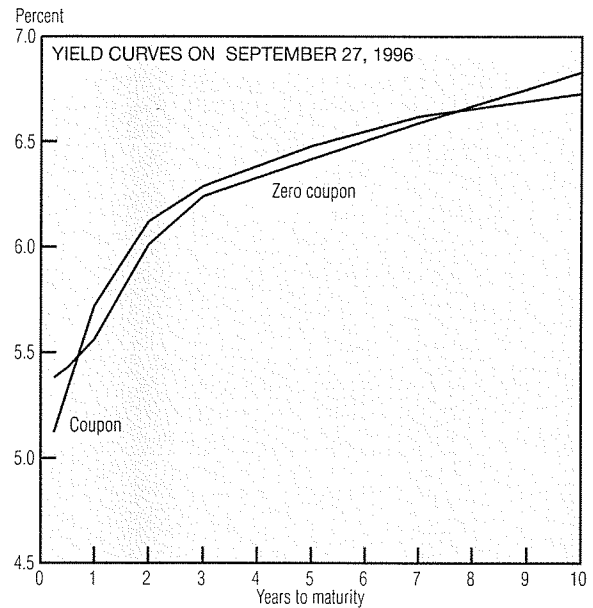
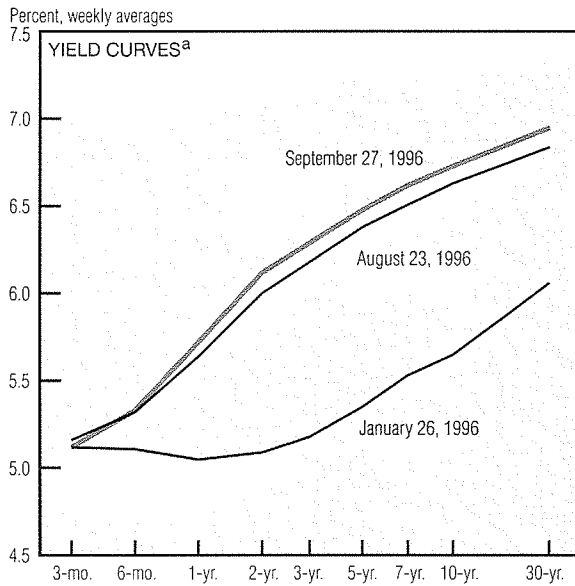
A scatterplot of the cyclical components of inflation and unemployment provides evidence of a short-run trade-off between the two variables. This trade-off, known as the short-run Phillips curve, suggests that by accepting higher inflation

levels, the Fed can use monetary policy to stimulate the economy temporarily in order to reduce unemployment. Some economists and policymakers feel that the Fed should exploit this short-term trade-off to smooth business cycle fluctuations. In particular, they believe that monetary policy should be used to keep real GDP and unemployment close to their trend levels at all times.

However, there is no *long-run* trade-off between inflation and unemployment. People eventually adjust their expectations to take into

account the Fed's policy actions, and unemployment returns to its long-run trend level. Tracing the history of inflation-unemployment combinations over the last three decades bears this out. We can see that the data spiral around a long-run Phillips curve that is thought to be very nearly vertical. This implies that monetary policy cannot permanently reduce unemployment below its long-run trend level. Attempts to do so will inevitably lead to higher inflation.

Interest Rates



a. All instruments are constant-maturity series.

b. Three-month instrument is quoted from the secondary market on a yield basis; 10-year instrument is a constant-maturity series.

NOTE: Shaded areas indicate recessions.

SOURCES: Board of Governors of the Federal Reserve System; and *The Wall Street Journal*.

In the last month, the yield curve has shifted upward and steepened somewhat, with long rates pushing to 6.95%. Since the beginning of the year, the curve has become noticeably steeper; in fact, two-year rates have increased more than 30-year rates. The 3-year, 3-month spread has increased from six basis points to 117 (the average is 80), and the 10-year, 3-month spread has increased from 43 basis points to 161 (the average is 120). The fears expressed early this year about a sustained inversion have not been confirmed.

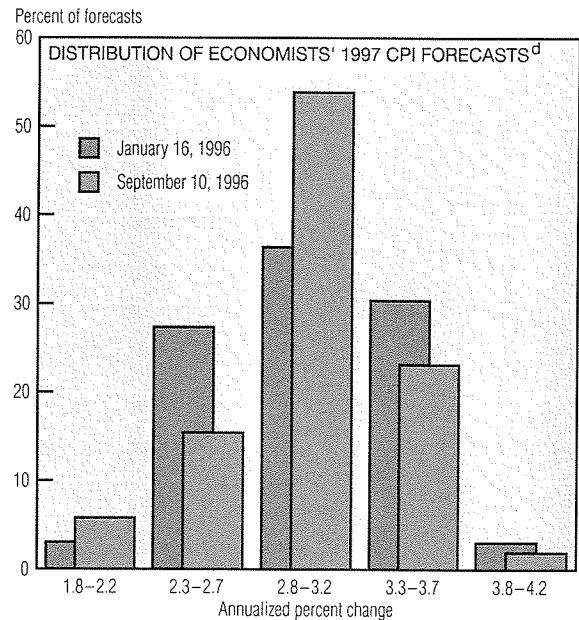
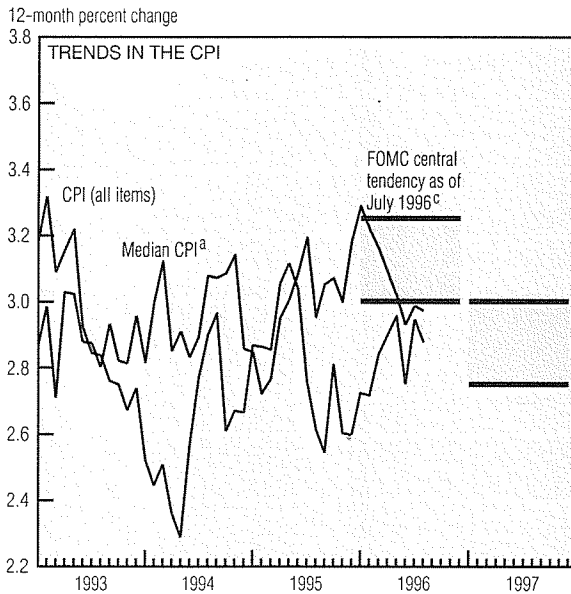
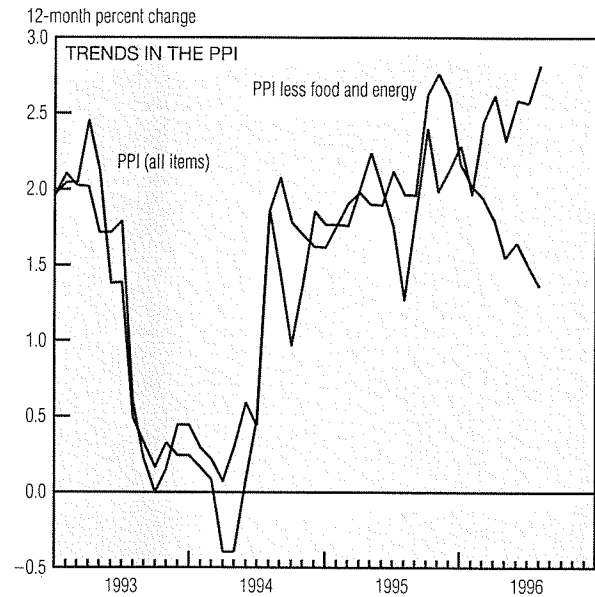
Not unexpectedly, the coupon yield curve and the zero-coupon yield curve continue to track one another closely. Zeros generally have the higher rate, because the coupons give the other bonds a shorter duration—and hence a lower yield, given the upward tilt to the term structure. For shorter maturities, where this is less of a problem, the coupon yields exceed the zero yields, though only by a few basis points. Even at 10 years, however, the spread is no more than 10 basis points.

This year's increase in the 10-year,

3-month yield spread contrasts with another spread that is often looked to for predictions—the one between corporate Baa bonds and 10-year Treasuries, which has narrowed by nearly 30 basis points since January. Overall, this risk spread shows less volatility than the yield spread, partly because it does not turn negative. Its most pronounced historical feature is a tendency to spike upward in recessions, reflecting the heightened chance of corporate bankruptcy and default on the bonds in times of stress.

Inflation and Prices

	Annualized percent change, last:				1995 avg.
	1 mo.	8 mo.	12 mo.	5 yr.	
August Price Statistics					
Consumer Prices					
All items	1.5	3.2	2.9	2.9	2.6
Less food and energy	0.7	2.7	2.6	3.0	3.0
Median ^a	1.5	2.9	3.0	3.1	3.2
Producer Prices					
Finished goods	4.0	2.2	2.8	1.6	2.1
Less food and energy	-0.8	0.5	1.4	1.6	2.6
Commodity futures prices^b					
	12.3	2.4	5.2	3.4	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. 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.
 d. Consensus forecast of the Blue Chip panel of economists.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; and *Blue Chip Economic Indicators*, January 16 and September 10, 1996.

After accelerating during the first five months of the year, the inflation indicators slowed substantially through August. Inflation for the year to date is comparable to its 1995 pace—3% or so.

The most notable deceleration has occurred at the wholesale level. While the Producer Price Index (PPI) has risen at an annualized 2.2% rate since December (an increase similar to last year's and about half a percentage point higher than its five-year trend), vir-

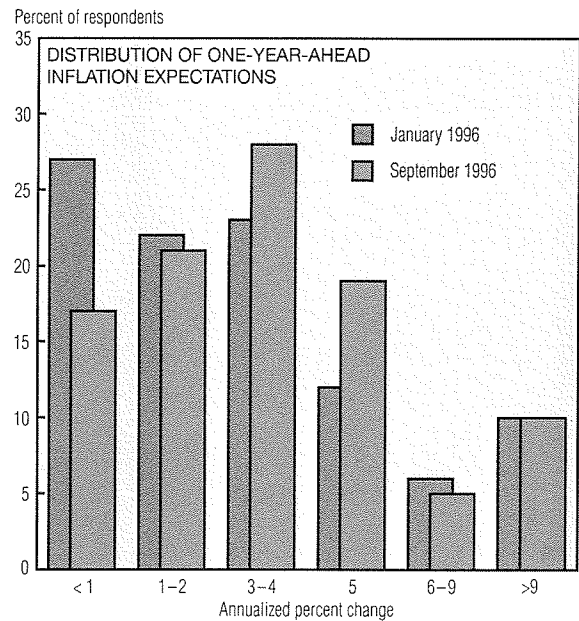
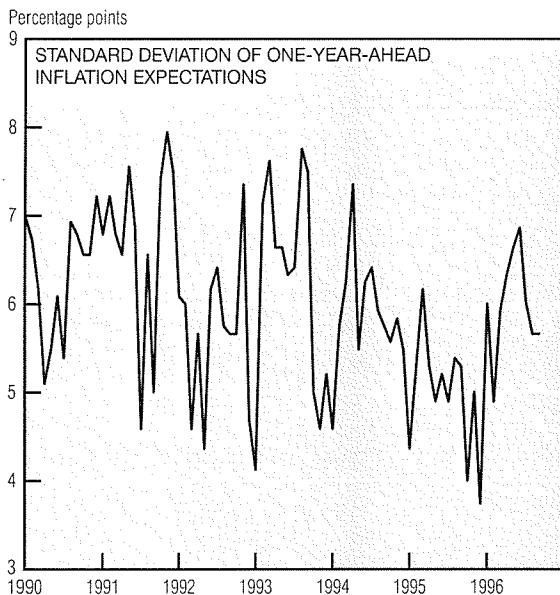
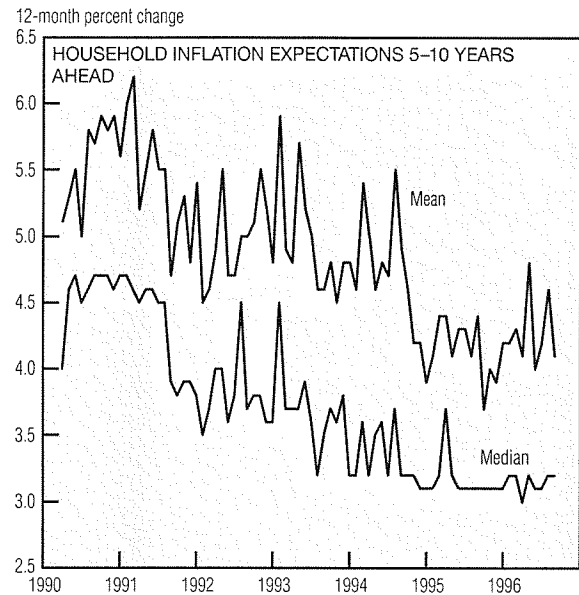
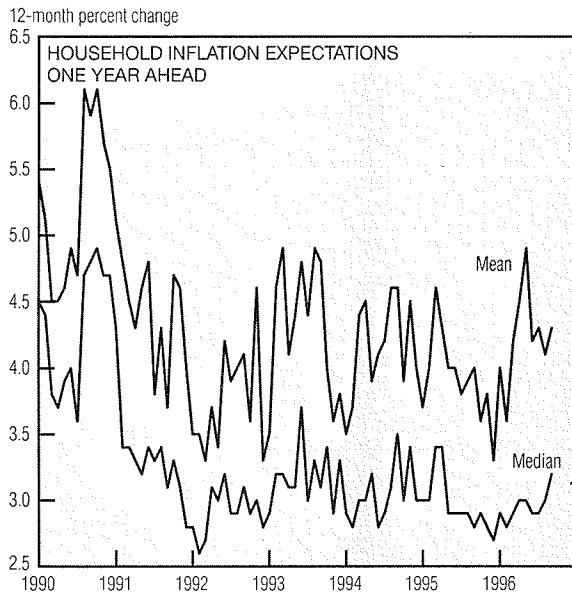
tually all of the upward pressure has come from food and energy items. Excluding these two volatile components, the PPI's increase was about two percentage points below last year's rate.

Price increases at the retail level continue to outpace cost pressures from producers. The Consumer Price Index (CPI) has climbed one percentage point faster than the PPI to date in 1996. Since last December, the core retail price indexes—the median CPI and the CPI less food

and energy—have outpaced the core PPI by more than two percentage points.

Overall, the recent slowing in the inflation indicators has helped calm analysts' fears that, after holding around the 3% level since 1991, inflation had ratcheted up. In fact, the CPI is actually tracking at, or slightly below, the lower end of the Federal Open Market Committee's midyear projection. According to that projection, the CPI should remain at, or
(continued on next page)

Inflation and Prices (cont.)



SOURCE: University of Michigan, Survey of Consumers.

slightly below, 3% in 1997. September's Blue Chip survey of economists also suggests that next year's CPI inflation will hold around 3% on average. Moreover, the proportion of economists who anticipate a significant increase in inflation (about 25%) is only marginally greater than the share expecting a significant slowdown (about 21%).

Tracking inflation expectations is important for several reasons. Many believe that monetary policy affects most prices only after a long and variable lag, implying that policymakers need to consider future—

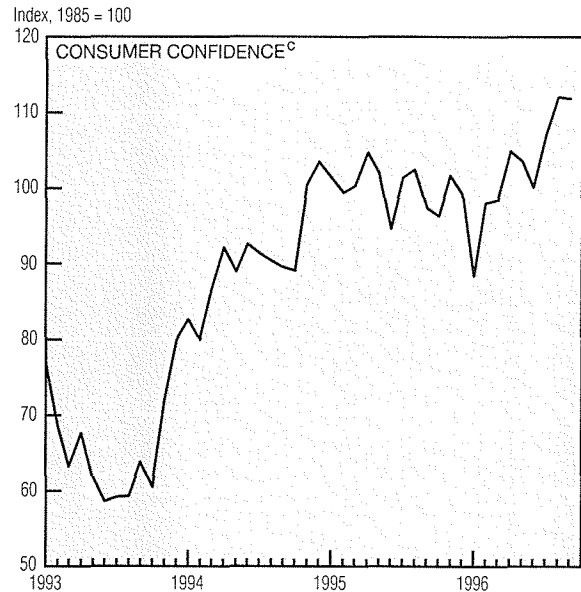
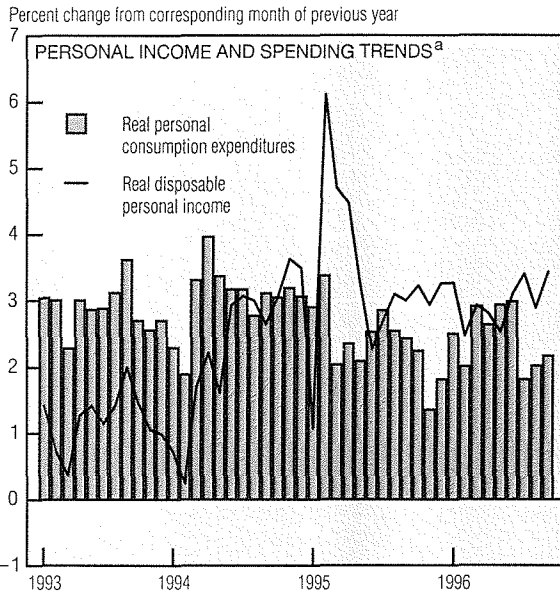
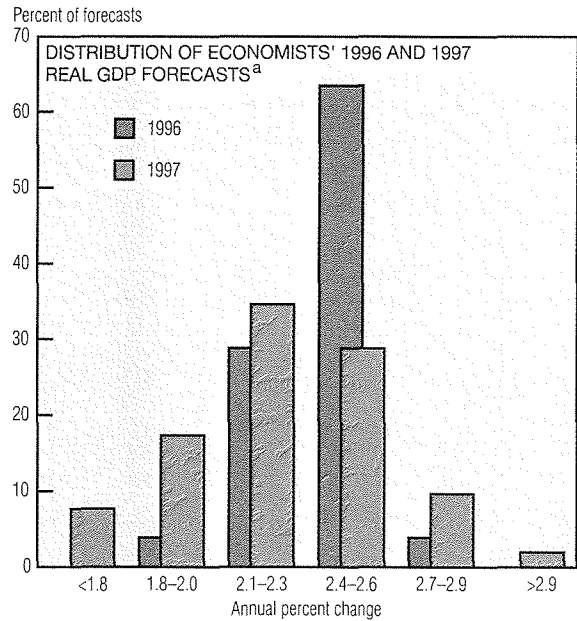
not current—inflation when deliberating about potential policy actions. Further, Federal Reserve Chairman Greenspan has defined "price stability" as an environment where inflation does not enter into the decisions of households and firms.

In addition to economists' forecasts, inflation expectations can be gauged from household surveys. One of these, the University of Michigan's Survey of Consumers, has shown an upward trend in the average inflation expected by households over the next 12 months as well as five to 10 years into the

future. That view seems to reflect growing uncertainty over the future trend in prices (as evidenced by an upturn in the standard deviation of year-ahead inflation expectations). The breakdown of households' inflation expectations also reveals considerable dissipation of the optimism expressed earlier this year. In January, about 50% of all households expected that inflation would be 2% or less over the next 12-month period. By September, fewer than 40% held that view.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	78.3	4.7	2.7
Consumer spending	38.5	3.4	2.6
Durables	16.4	11.4	6.8
Nondurables	4.8	1.3	1.3
Services	17.6	2.7	2.4
Business fixed investment	7.0	3.8	5.6
Equipment	9.2	6.8	6.7
Structures	-1.7	-3.6	2.7
Residential investment	10.4	16.3	9.7
Government spending	23.5	7.7	1.0
National defense	7.5	10.0	-1.9
Net exports	-10.7	—	—
Exports	11.2	5.7	7.2
Imports	21.9	10.0	5.4
Change in business inventories	10.1	—	—



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

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; The Conference Board; and *Blue Chip Economic Indicators*, September 10, 1996.

The Commerce Department's final GDP estimate for 1996:IIQ put real economic growth at 4.7%, substantially above the first quarter's 2.0% rate. Anticipating a slowdown in personal consumption expenditures, residential construction, and federal government spending, economists responding to September's Blue Chip survey see the economy expanding 2.5% in the third quarter and 2.2% in the final quarter of this year.

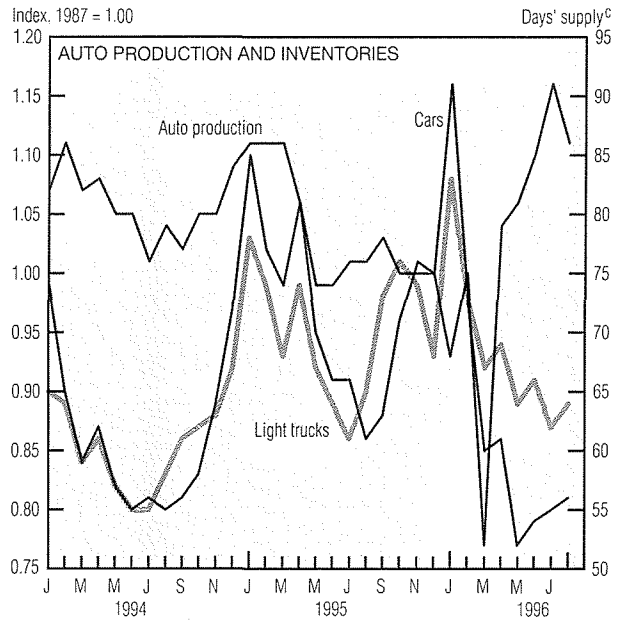
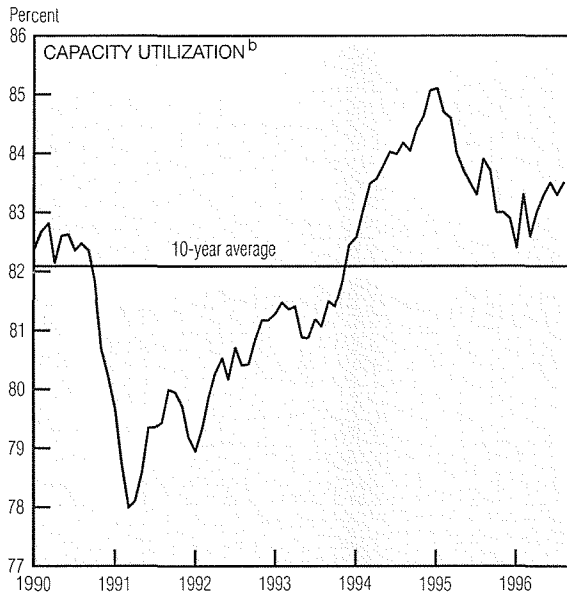
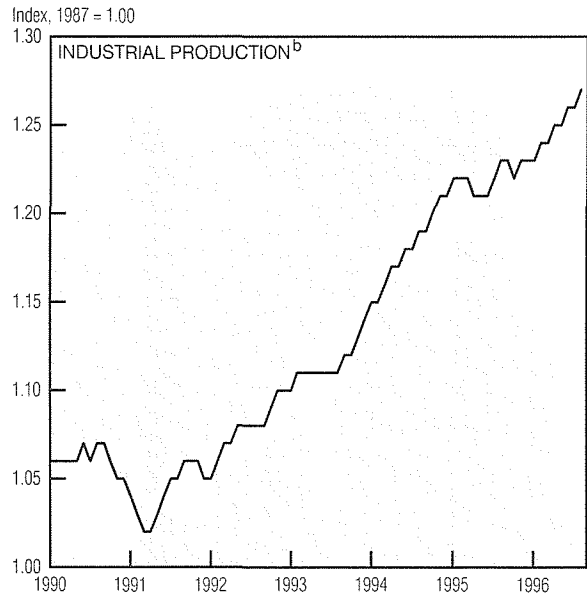
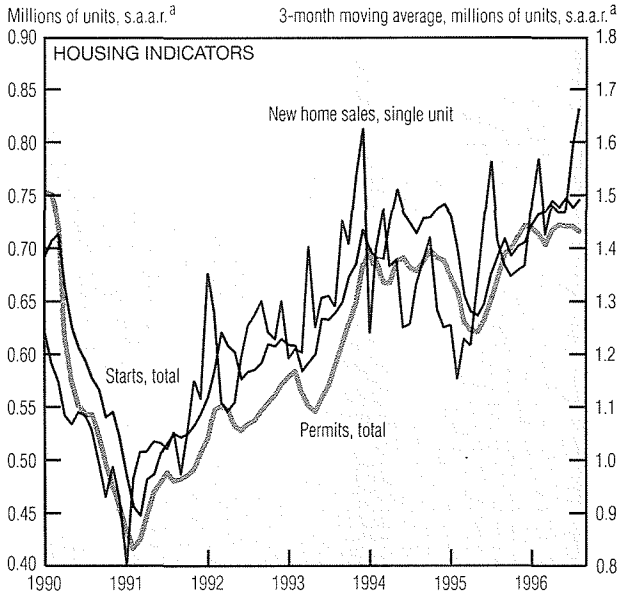
For all of next year, the mean prediction is a 2.2% growth rate, but a substantial number of respondents anticipate a slightly faster pace. Many economists view long-term growth of 2%—or slightly faster—as sustainable indefinitely at high levels of resource usage.

Real personal consumption spending stalled over the summer months, with actual declines spread through many purchase categories. On a year-over-year basis, consumer

spending grew at an average pace of 2% in June, July, and August, compared with 2.7% over the first five months of 1996. Despite this apparent slowdown in spending, overall consumer confidence in the economy remains bright, and real disposable income growth continues above 3%. Consumers may be attempting to improve their balance sheets.

(continued on next page)

Economic Activity (cont.)



a. Seasonally adjusted annual rate.
 b. Seasonally adjusted.
 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 the Census; Board of Governors of the Federal Reserve System; and *Ward's Automotive Reports*.

When smoothed to eliminate month-to-month volatility, the trajectories of housing starts and building permits suggest some slowing in the pace of residential construction. Nevertheless, sales of new homes were very strong in July and August, and consumers' attitudes toward home buying remain favorable.

Industrial production increased 0.5% in August, following on the solid 5.3% average annual pace it has maintained since January. Pro-

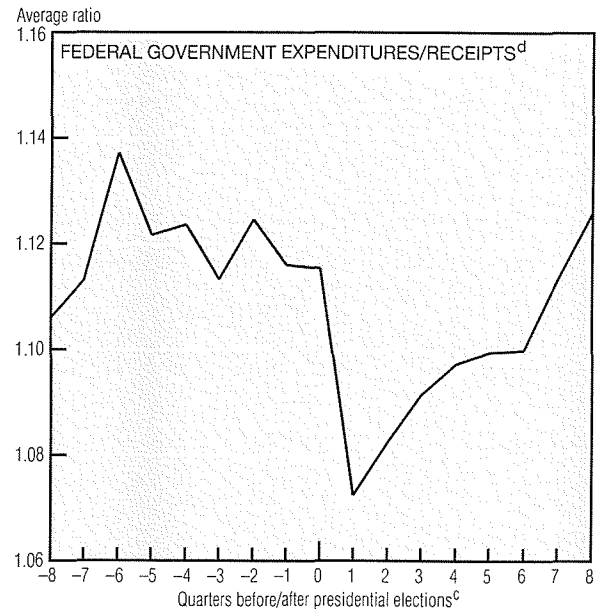
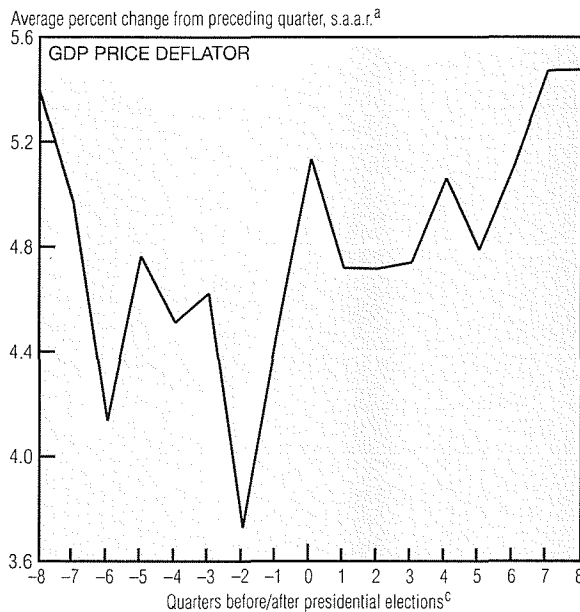
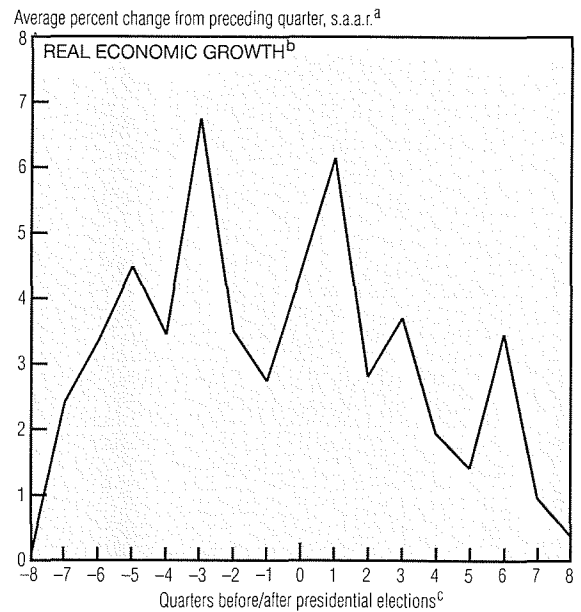
duction of business equipment and defense and space equipment was especially strong in August, but production of consumer goods and motor vehicles and parts fell. The nation's industrial sector operated at 83.5% of measured capacity in August. While this rate of utilization is below 1995's peak, it remains well above the 10-year average.

The UAW reached a tentative three-year agreement with Ford and Chrysler whereby the automakers provide job guarantees for 95% of

their workforce over the life of the contract, unless there is an industry-wide downturn. The UAW and its Canadian counterpart must still reach an agreement with General Motors, which is trying to increase the outsourcing of its production by selling its parts plants. Although auto production declined somewhat in August, it remained at high levels. Dealers held 56 days' supply of cars and 64 days' supply of light trucks.

Political Business Cycles

Election year	Real growth ^{a,b}		Presidential incumbent's party	Majority congressional party
	Years prior to election			
	1 year	2 years		
1964	5.2	5.2	Win	Win
1968	4.9	3.7	Loss	Win
1972	7.2	5.7	Win	Win
1976	4.7	3.5	Loss	Win
1980	0.0	0.6	Loss	Win
1984	5.2	6.1	Win	Win
1988	3.5	3.8	Win	Win
1992	3.7	2.0	Loss	Win



- a. Seasonally adjusted annual rate.
b. Chain-weighted data in 1992 dollars.
c. Includes all presidential elections since, but not including, 1960.
d. Ratio of expenditures to receipts; seasonally adjusted data.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Bureau of the Census, *Statistical Abstract of the United States: 1995*, table 436; and *The World Almanac and Book of Facts: 1995*, Mahwah, N.J.: Funk & Wagnalls.

The 1980 returns exemplify how the state of the economy before a presidential election can affect an incumbent's ability to stay in office. Moreover, at times presidents might attempt to use their fiscal prerogatives to court reluctant constituencies or to win highly contested regions of the country. These two observations, however, do not readily translate into a political theory of business cycles, as some analysts have alleged.

Rationales for a political business cycle have existed at least since

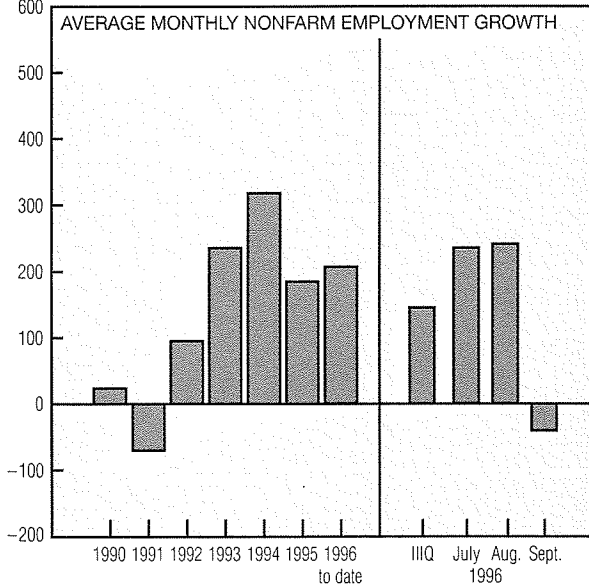
Marx and encompass many variations. The simplest modern version of the theory argues that an incumbent president will use expansionary fiscal policies and exert pressure on the Federal Reserve to pump up the economy prior to an election. Then, once secure in office, the administration will act to cool down the overheated economy that it has theoretically created.

One strongly predisposed toward a political view of the world might point to the pattern of GDP and fiscal policy, but the theory requires several questionable assumptions

about voters and policymakers. As an explanation for economic fluctuations, it requires that citizens have short memories and base their expectations solely on their immediate experiences. It does not consider that rational voters will understand the relationship between elections and economic activity, thereby negating the strategy's political usefulness. In addition, the theory of a political business cycle credits policymakers with greater ability to micromanage the economy than experience warrants.

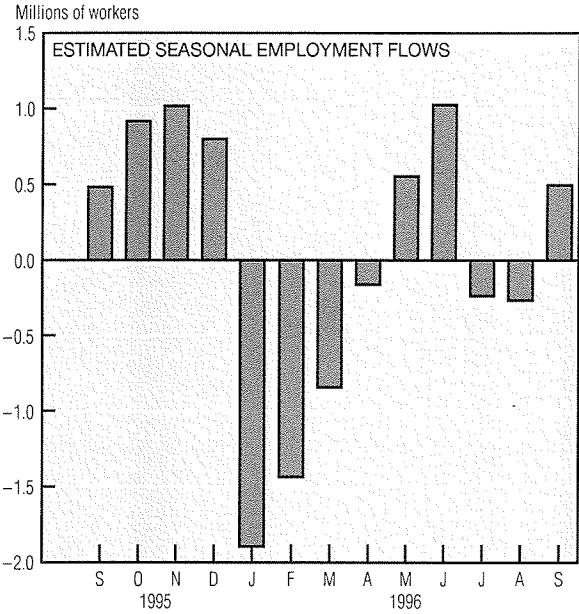
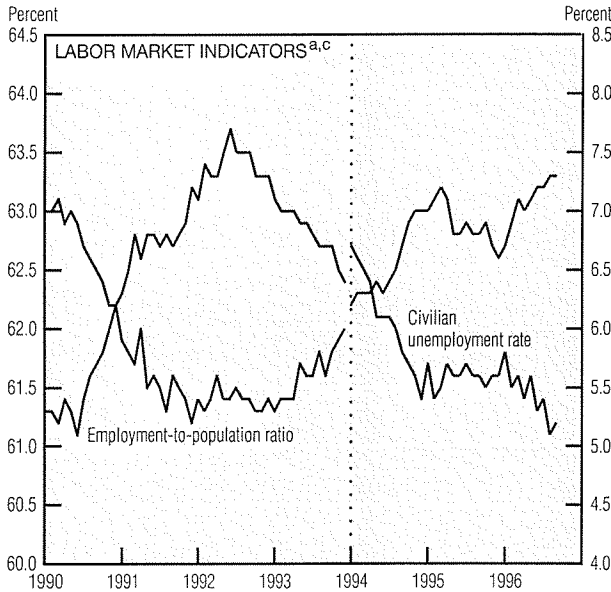
Labor Markets

Change, thousands of workers^a



Labor Market Conditions^a

	Average monthly change (thousands of employees)				
	1995	1996			
		Year	IIIQ	July	August
Payroll employment	185	145	235	240	-40
Goods-producing	-5	-10	-10	30	-50
Manufacturing	-12	-23	-29	18	-57
Construction	9	15	24	11	9
Service-producing	190	155	245	211	10
Services	110	68	80	69	54
Computer	11	10	11	12	8
Retail trade	36	41	97	4	22
Government	9	20	31	109	-81
Household employ.	34	253	274	171	313
	Average for period				
Civilian unemployment rate (%)	5.6	5.2	5.4	5.1	5.2
Nonfarm workweek (hours) ^b	34.5	34.5	34.2	34.7	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.

The September jobs picture, though fuzzy, seems to show little overall change from August. There was a small (0.1%) rise in the civilian unemployment rate.

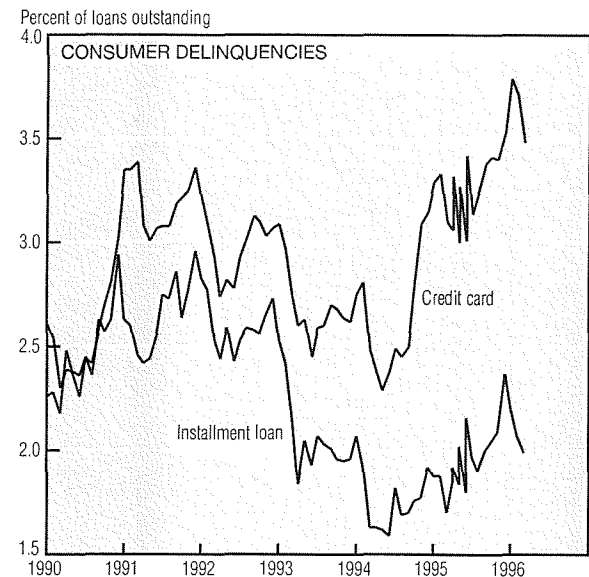
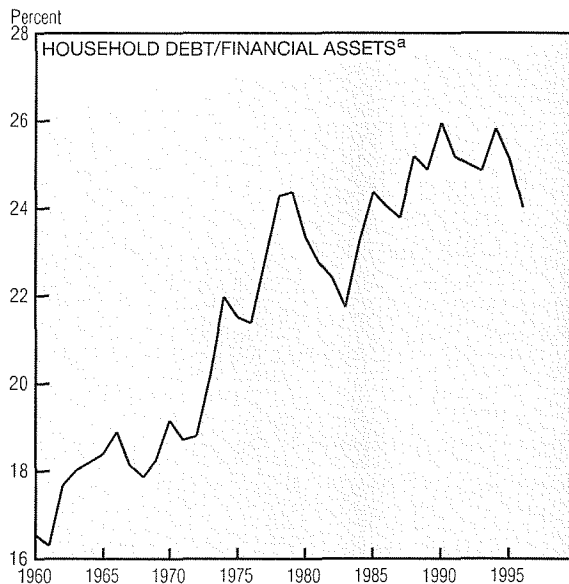
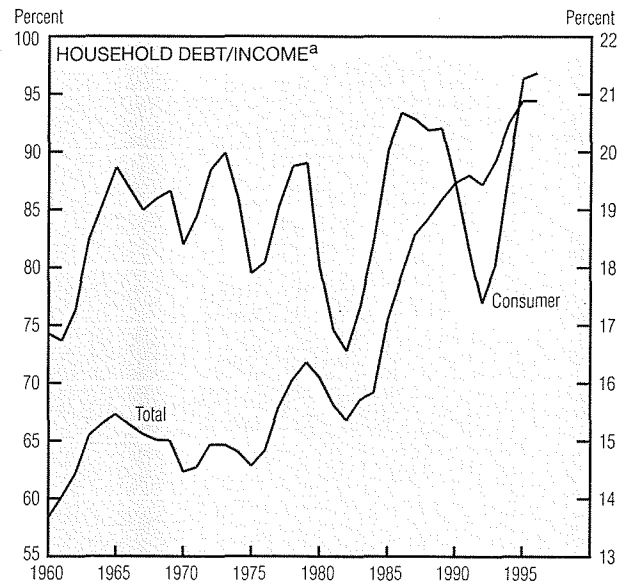
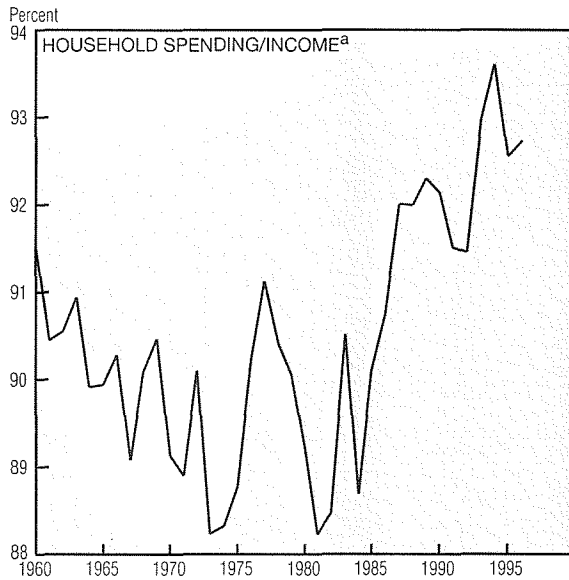
According to household survey data, the economy added 313,000 net new jobs in September, a solid increase from the previous month's moderate increase of 171,000. Survey data from establishments, however, showed the opposite pattern: August's 240,000 net jobs gain was followed by a net decline of 40,000

jobs in September. Such large swings and discrepancies in the monthly jobs reports are common and certainly understandable in light of the huge U.S. labor force. The Bureau of Labor Statistics reports that sampling error alone can account for a swing of 376,000 jobs in the monthly household survey estimate. On a quarterly basis, the two surveys show more comparable trends, with the household survey indicating an average monthly gain of 237,000 jobs last quarter, and the establishment survey showing a

221,000 increase.

By industry, employment changes were mixed in September, but generally small in either direction. Many manufacturing industries showed small net declines, while services posted mostly small increases. Service employment would have been stronger were it not for a 67,000-job drop in local education—a seasonal adjustment made because teachers went back to work a month early and were counted in the August jobs report.

Consumer Indebtedness



a. 1996 data are based on second-quarter estimates.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and American Bankers Association, *Consumer Credit Delinquency Bulletin*.

Consumer spending relative to income has been on an upward trend since the early 1980s. Over the past 15 years, households have increased the share of their income that they spend by four percentage points—to about 92.5%.

Higher levels of spending relative to income have generally been funded with increased debt. Indeed, while spending relative to income has moved higher in the past 15 years, the ratio of debt to income has climbed about 25 percentage points over the same period—a remarkable rise. The prolonged accu-

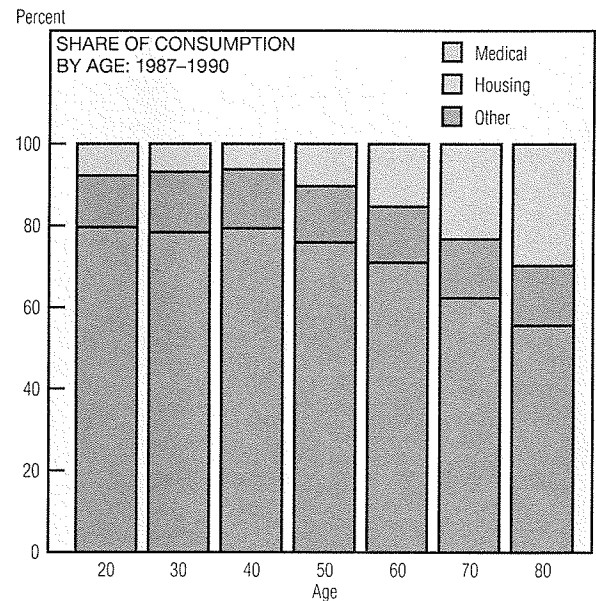
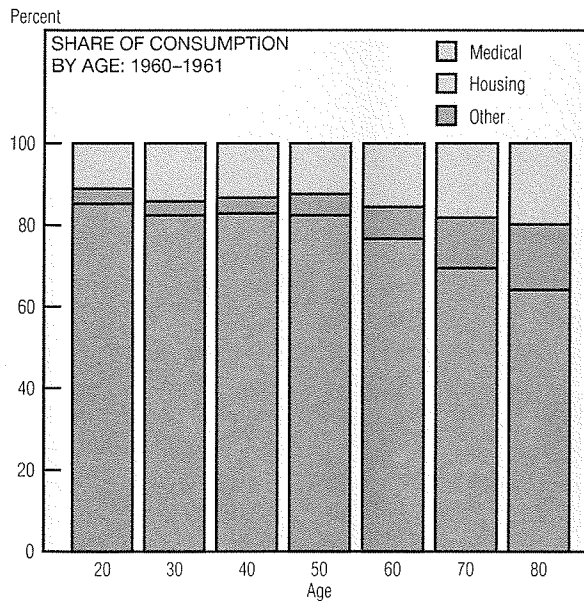
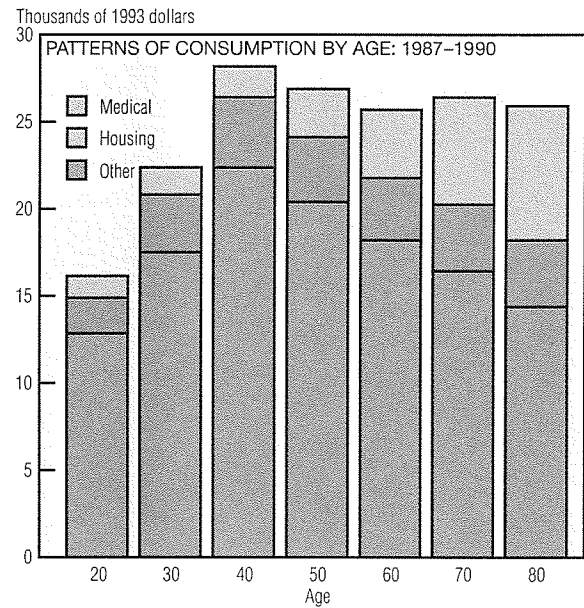
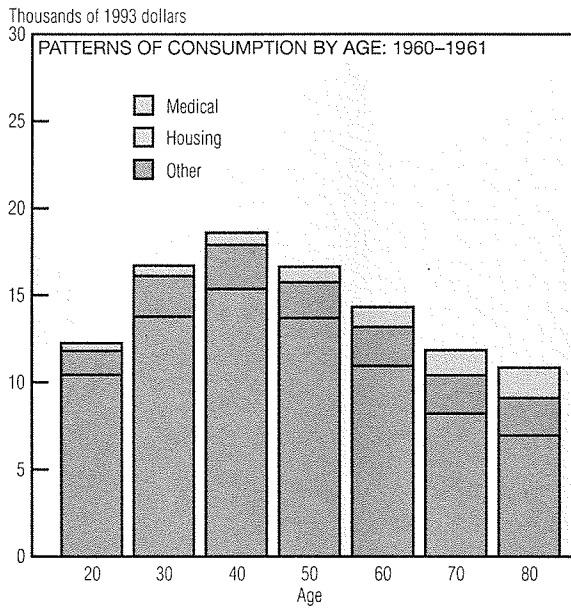
mulation of debt by U.S. households is a source of concern to many business analysts. Higher debt levels, if poorly managed, may affect the health of the economy.

Upon closer inspection, however, the credit position of U.S. households may not be as dire as the broad statistics would suggest. Much of the run-up in household debt has been in the mortgage credit area, which means it may be largely financing investments that promote economic growth. Consumer debt relative to income has trended only marginally higher over the past

decade or so. Furthermore, the ratio of debt to assets, perhaps a better indicator of households' balance-sheet health, has been holding fairly constant for the past 10 years.

Perhaps the best sign that U.S. household debt levels are, on average, sustainable, is the relatively low rate of credit delinquencies. While the delinquency of credit card debt has been on the rise in recent years, delinquencies for most other types of consumer credit—including installment debt—remain quite low by historical standards.

Consumption Trends



SOURCE: Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *Brookings Papers on Economic Activity*, vol. 1, 1996, pp. 315-407.

Both the amount and the pattern of consumption by different age groups has undergone a substantial change in the U.S. Total consumption per capita for all ages was much higher in the 1980s than in the early 1960s. In the late 1980s, however, retirees' consumption was roughly twice that of their counterparts in the early 1960s, whereas middle-aged and younger individuals had increased their consumption by only about a third. Clearly, much of the relative increase in older generations' consumption

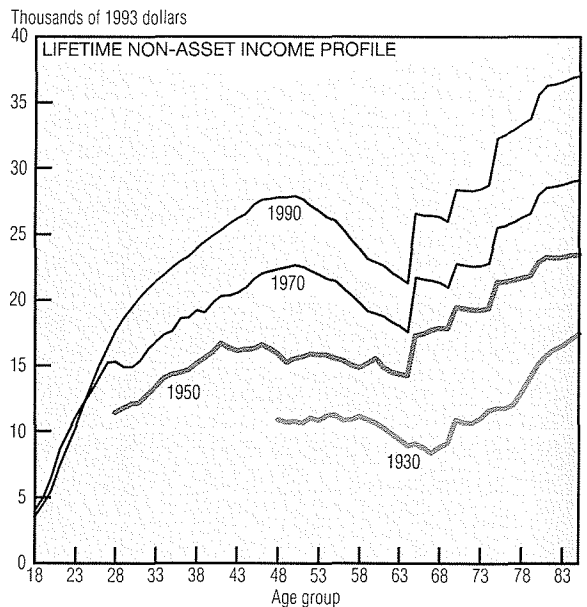
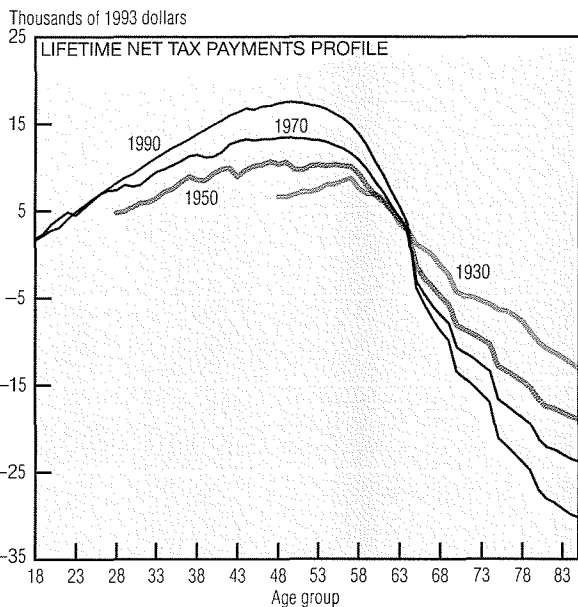
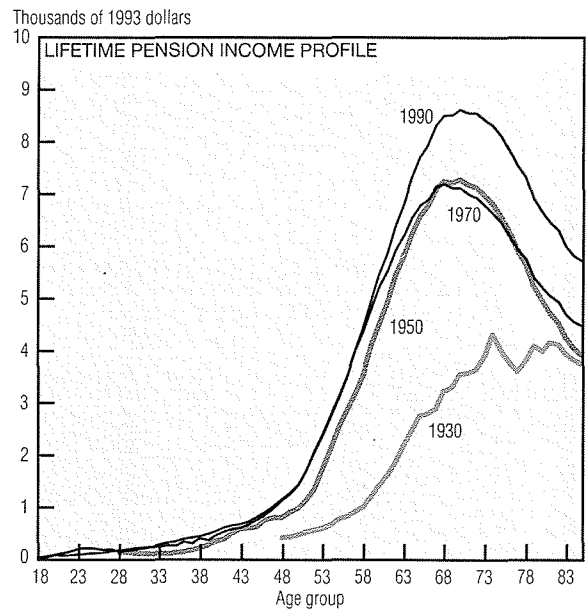
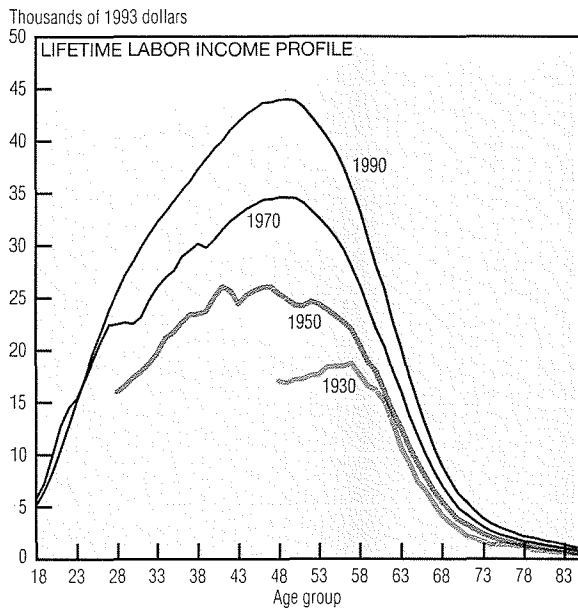
is due to a sizable rise in their medical spending. However, older age groups' larger relative increases in consumption are also discernible in nonmedical (housing plus other) spending.

The share of medical consumption was roughly similar for all age groups in the early 1960s. In the late 1980s, however, this share declined for younger groups and increased for older ones. The pattern of change in housing consumption by age is the opposite of that in medical consumption: Relative to the elderly,

younger households allocated a smaller share of total consumption to housing in the earlier period.

Although consumption patterns evolve over time in response to many factors, recent research suggests that the pattern observed in the U.S. may have resulted largely from fiscal policies that, through programs like Social Security and Medicare, redistributed sizable amounts of resources from young and unborn generations toward older ones.

Lifetime Non-Asset Income Profiles



NOTE: Each line traces the lifetime profile for the group that reached age 18 in the stated year.

SOURCE: Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *Brookings Papers on Economic Activity*, vol. 1, 1996, pp. 315-407.

At any given moment, those who work and earn income do not necessarily have all of it available for their use. A part of current labor earnings is diverted as contributions to private pension plans and social insurance programs like Social Security and Medicare. Another part is paid as taxes to finance government purchases and welfare payments.

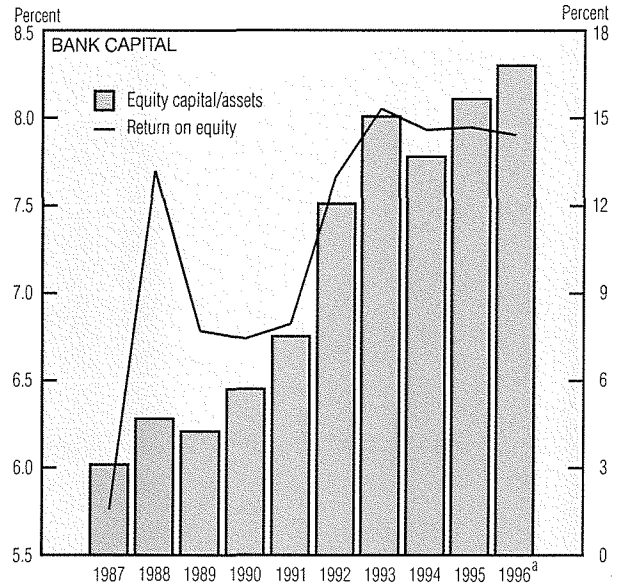
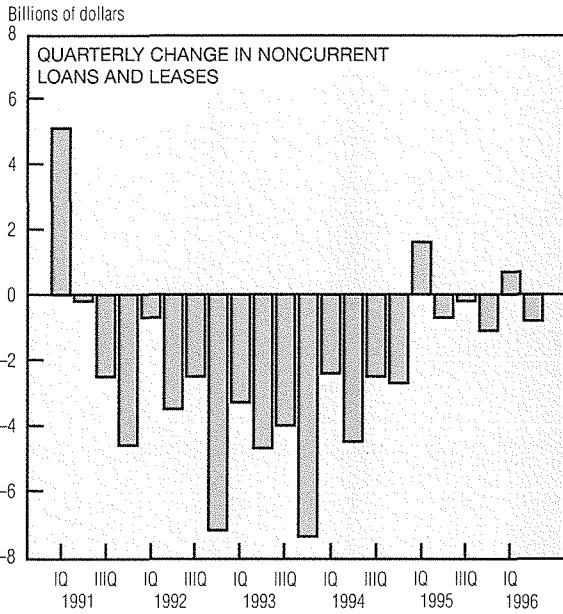
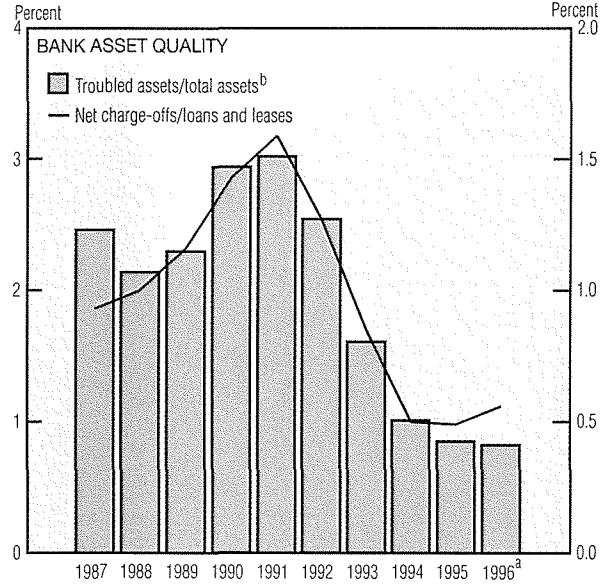
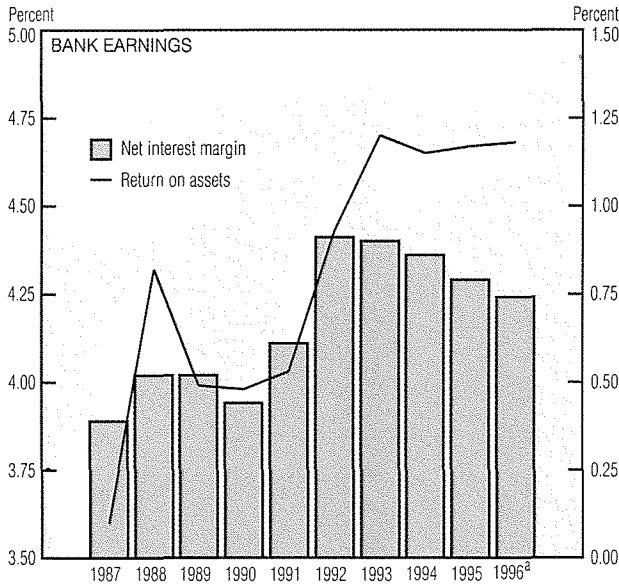
On the other hand, those who are not currently working receive income by way of pensions, social insurance, and welfare benefits. If labor productivity enjoys sustained growth, or if private pension plans, social insurance programs, and gov-

ernment tax and spending policies undergo significant changes over time, profiles for lifetime non-asset income (labor income plus pension income minus net taxes) would look very different for generations born at different times.

This is, indeed, the case in the U.S. Profiles of lifetime per capita labor income have the expected hump shape because each generation's earnings are highest during middle age. These profiles have steepened over time because of increases in wages and salaries stemming primarily from secular growth in labor productivity. Similarly, growth in the

size and coverage of private pension programs has also led to steeper lifetime pension income profiles. More striking, however, is that generations that reach their peak earning years later in time pay substantially more in net taxes than those that reach these years earlier. Similarly, generations that retire later in time receive much larger government transfers than do those that reach retirement earlier. Hence, total non-asset income is projected to rise significantly after retirement for each generation, far exceeding the levels attained during that generation's peak years of labor earnings.

Banking Conditions



a. Ratios are annualized.
 b. 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 their second-highest level of total quarterly earnings for 1996:IIQ—\$13.78 billion, just below the \$13.83 record set in 1995:IIIQ. These earnings were accompanied by the third-highest return on assets (ROA) in the industry's 14 years of quarterly earnings reports. More than 70% of all banks reported ROAs above 1%, and over 95% reported positive earnings. Only two federally insured commercial banks failed in the second quarter, bringing to three the total for 1996.

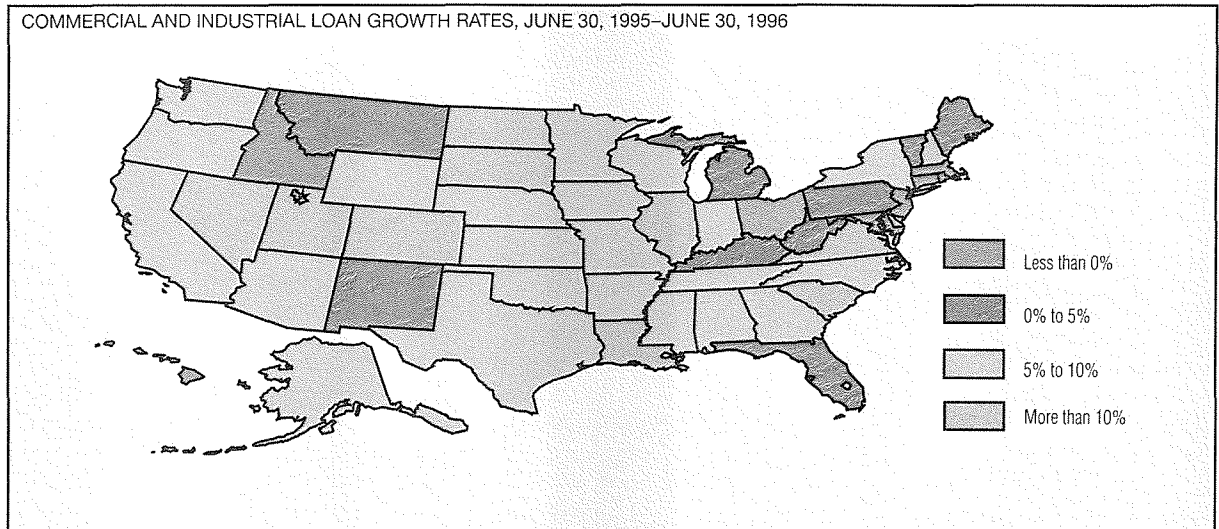
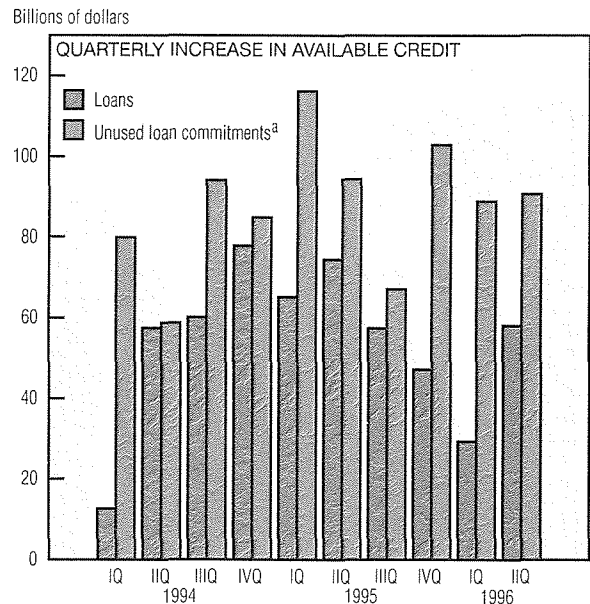
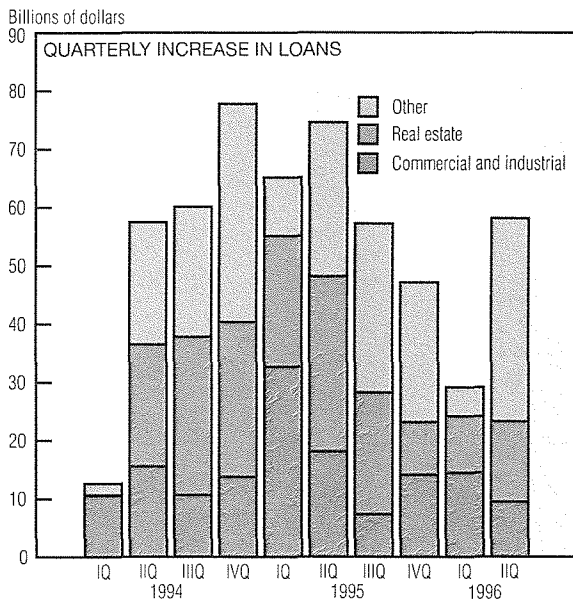
The vigorous performance derived from a record level of non-interest income, coupled with lower non-interest expenses and an increased net interest margin—only the second such increase in the last seven quarters. The net interest margin widened as funding costs fell faster than asset yields.

Banks' healthy income showings offset an increase in their loan-loss expenses in the second quarter; the \$3.8 billion in charge-offs (loans removed from the balance sheet be-

cause they could not be collected) was the second in over two years. Losses on credit card debt accounted for most (61%) of the charge-offs. This gives 1996 a higher net charge-off ratio to date than 1995 or 1994. It also puts a negative interpretation on the decrease (both absolute and as a fraction of total assets) in non-current loans, because it means that instead of recovering, many of these ill-paying loans became uncollectable.

(continued on next page)

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.

Strong earnings also mean that, despite the higher charge-offs, bank capital has remained strong, rising to 8.3% through June. Return on equity (ROE) stays high at 14.43%, and follows the pattern of ROA. The influx of equity is evidently not seriously diluting earnings. The increase in the capital/asset ratio lies behind the slight divergence between ROA and ROE.

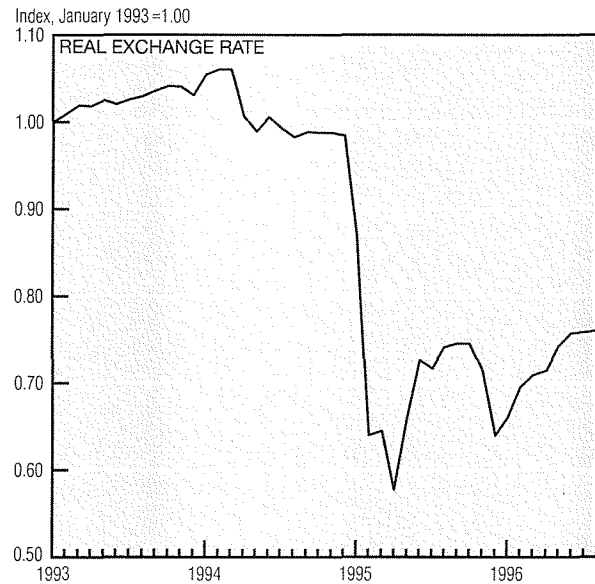
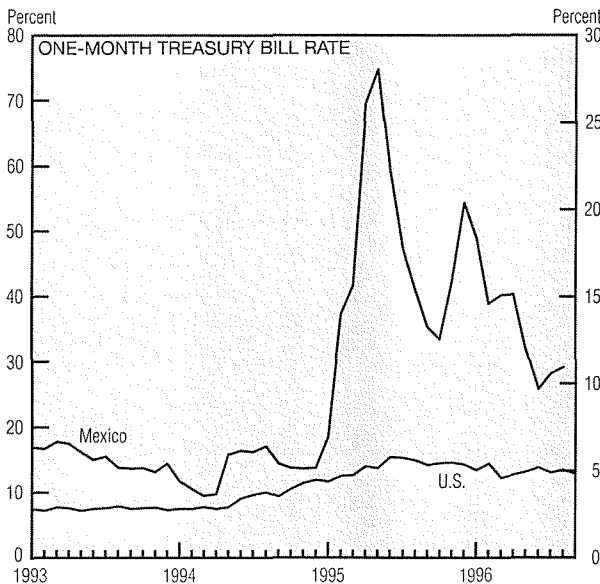
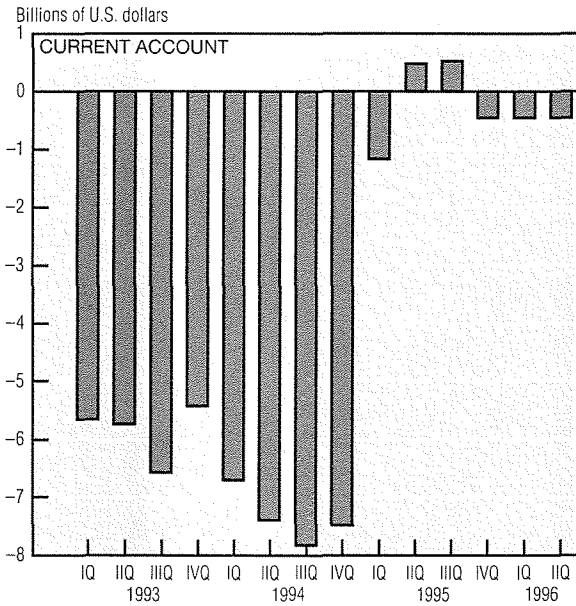
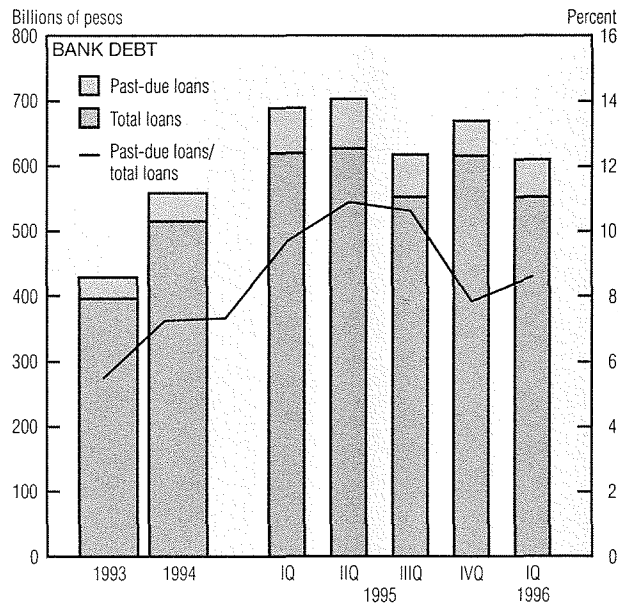
Healthy loan growth in the second quarter also accompanied the favorable earnings performance.

While real estate and commercial and industrial loans showed real but modest gains, loans classified as "other" (including consumer loans and farm loans) grew much faster, to almost seven times the first quarter's increase. Despite the acceleration in loan growth, unused loan commitments still increased faster than loans, which seems to indicate that credit remains readily available to businesses and consumers.

This improvement is widely distributed across the country, as states

with high loan growth (above 10%) appear in the Northeast, South, Midwest, and West. The primary exception is the northeast corridor from Maryland to Massachusetts, which shows a disproportionate concentration of states with a decrease in loan volume. This should serve as another reminder that even with near-record overall earnings, some banks can fail, and strong nationwide loan growth may mask regional imbalances.

The Mexican Economy



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; the Federal Reserve Bank of Dallas; International Monetary Fund, *International Financial Statistics*; and *The Wall Street Journal*.

Analysts now expect Mexico's economy to expand by 4% in 1996, although even the Mexican government's stated goal of 3% was previously viewed with skepticism. Such growth in spending would ease pressure on banks and consumers who are still struggling with high levels of past-due loans.

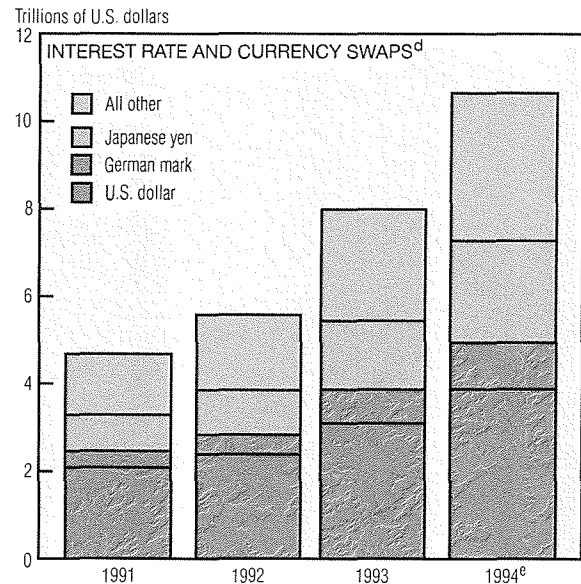
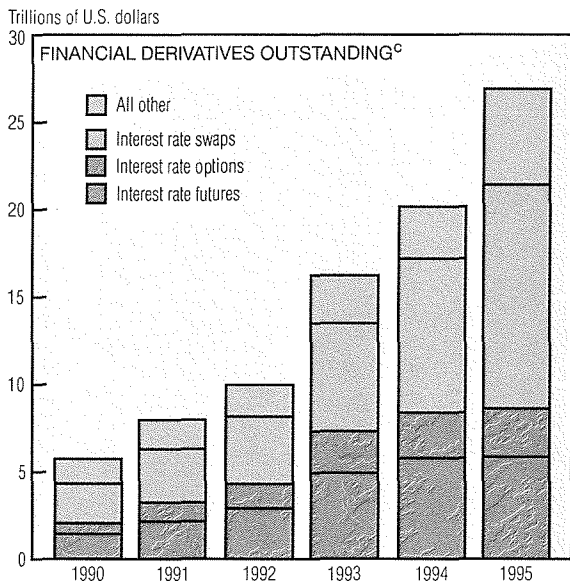
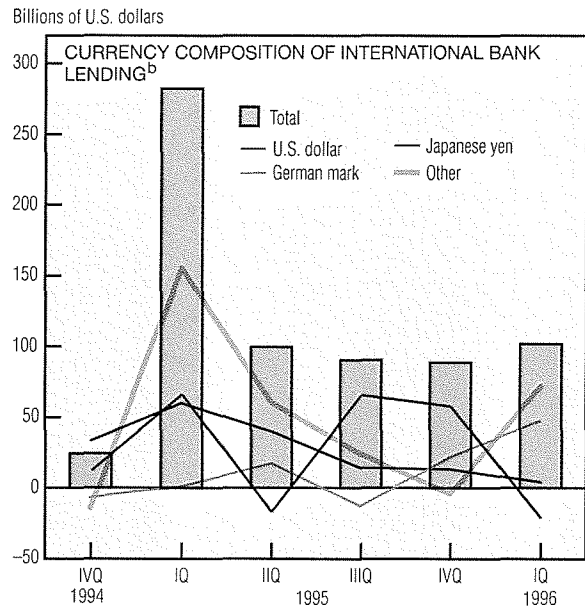
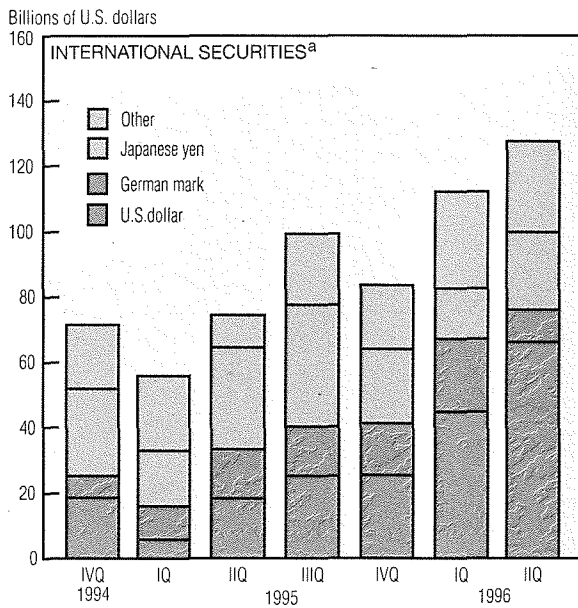
An array of government programs have been developed to repurchase past-due loans from banks, encourage injection of new capital,

and facilitate restructuring of loans. Although the Mexican financial system has been somewhat stabilized by these programs, its continued improvement is closely related to macroeconomic developments. In particular, lower interest rates would make it easier for Mexican debtors to refinance or repay their loans.

Capital inflows, which reflect foreigners' willingness to invest in Mexico, could help to lower interest rates and stabilize the peso. However,

monetary policy must prevent such inflows from increasing the Mexican money supply if the current account balance is to continue improving. An increased money supply would lead investors to expect higher inflation and higher interest rates, and thus could lower expenditures on productivity-enhancing investments. This in turn would endanger improvement in export competitiveness and threaten a loss of confidence in Mexico's recovery.

International Finance



- a. By currency.
- b. Changes in amounts outstanding excluding exchange rate valuation effects.
- c. Notional amounts outstanding at end of year.
- d. Notional principal.
- e. Latest available data.

SOURCE: Bank for International Settlements, *International Banking and Financial Market Developments*, Basel, August 1996.

According to the Bank for International Settlements, net new issues of international debt securities reached a record high in the second quarter. Although corporate borrowing in the major industrial countries remained subdued, the markets absorbed a record volume of debt issues from developing countries and governments of developed countries. Declining volatility in both interest rates and exchange rates may have lowered the perceived risk to investors.

In the first quarter, the currency

composition of international bank lending shifted away from the Japanese yen and U.S. dollar toward the German mark, as Japanese banks continued their retreat from international credit markets. Net new bank lending to developing countries dropped off, partly due to heavy repayments of loans by Argentina and Mexico. However, overall capital flows to such countries have been maintained by increased securities issues.

Survey data for 1995 show that the amount of financial derivatives

outstanding continues to grow rapidly. However, there has been a surprisingly strong movement from the organized exchanges to over-the-counter (OTC) trading. Some of the weakness in the exchange-traded contracts stems from a moderation in corporate hedging. In response to competitive pressures from the OTC market, exchanges have heightened their efforts to develop new instruments, especially those designed to manage the risk associated with equities and emerging market securities.