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December 1996
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The Economy in Perspective

'Twas the day before Christmas, when all through the land
Forecasts converged and the outlook was grand.
For growth was expected to be at potential
And continued expansion seemed most evidential.

Our staff was debating with habitual fervor
Which measure worked better—fixed-weight or deflator,
While at my PC with equations quadratic
I was searching for money demand inelastic.

When off down the hall there arose such a clatter,
I sprang from my chair to see what was the matter.
Away to the TV I flew like a flash,
Praying I wouldn't meet news of a crash.

The glow of the monitor piercing our crowd
Showed why they were leaping and shouting aloud.
For what should my wondering eyes then see
If not Alan Greenspan and the FOMC!

More solemn than judges his colleagues they came,
As he gaveled the meeting and called them by name:
"Now McTeer and McDonough! Now Jordan and Lindsey!
On, Meyer! On, Phillips! On, Hoenig and Boehne!

"Now Melzer and Broaddus! Guynn, Yellen, and Kelley!
On, Moskow! On, Stern! Rivlin, Minehan, Parry!
Take your seats at the table! To your seats! Do not stall!
Opine away! Opine away! Opine away all!"

They talked about houses, both permits and starts.
They talked about blouse sales at Saks and Kmarts.
Next came the dollar in round-the-world trading
And what could be learned from a ship's bill of lading.

Car sales (of course) received strictest attention,
And truck orders also did not escape mention.
LCD panels for laptops were rare if
The importing country imposed a stiff tariff.

Corn prices were up, making beef prices fall,
But that was not all, oh no, that was not all.
Herd liquidation would make cattle dear,
Driving prices back up. Now, isn't that clear?

Credit extended by U.S. bank lenders
Was fueling the habits of freewheeling spenders.
Though bankers were worried about bankruptcies
They covered their risks with credit card fees.

Labor markets were tight and shops paid a bonus
To find someone willing to punch holes in donuts.
Though inflation seemed low and few saw it surging
There was talk of what forces might prompt an emerging.

Predictions were premised on different decisions
Made by the Committee, and on data revisions.
Was policy easy, too firm, or just right?
Could the Committee agree without having a fight?

And then, during a lull, I heard a voice rise
From the head of the table in masterful guise.
It cut through the chatter, exuding élan,
Who else could it be but Chairman Greenspan?

He had a bright face and no sign of a belly
And began with a joke about Governor Kelley.
Then he warmed to his purpose and couldn't be franker
About what concerned him, this shrewd central banker.

"How can we know that our measures are true
When accounting's at cash, but obligations accrue?
When satellites send electronic bits floating
But we dutifully track every railroad car loading?

"Inputs make outputs in quite different ways
Than they did, and they still do not cease to amaze.
We *must* be producing more than we can count:
A statistics-improving campaign we must mount.

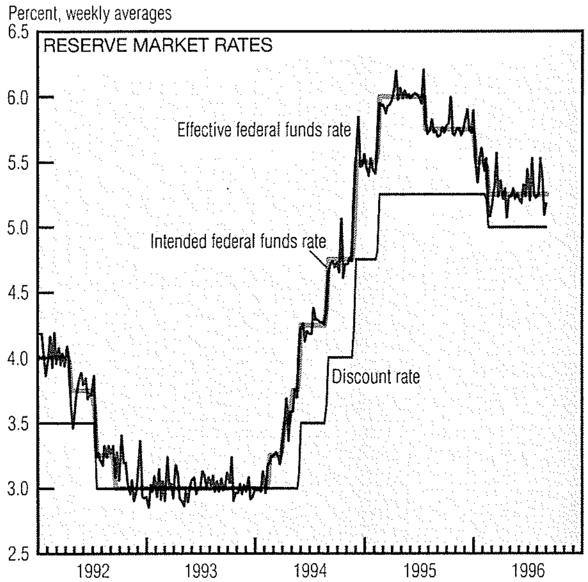
"For if it's the case there's more stuff in our nation
Then it follows we must chalk up less to inflation.
Please allow me to add, I can't be more precise,
But alternative measurements sure would be nice."

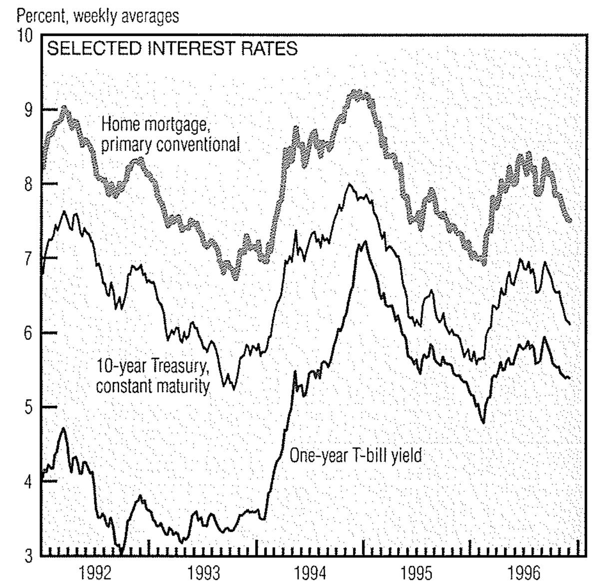
A wink of his eye and a twist of his head
Soon gave me to know we had nothing to dread,
For this imprecision showed no loss of nerve;
From his avowed course he never would swerve!

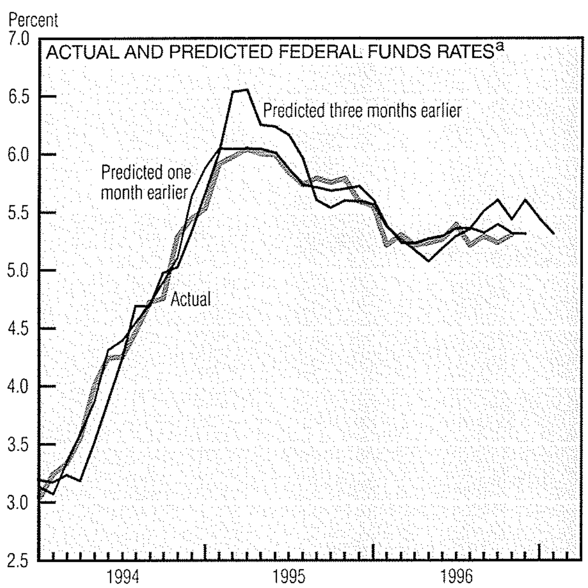
He crafted his words with great erudition
And set forth his tune like a Julliard musician.
Put it to the vote, and carried the day.
Then the meeting adjourned and all went away.

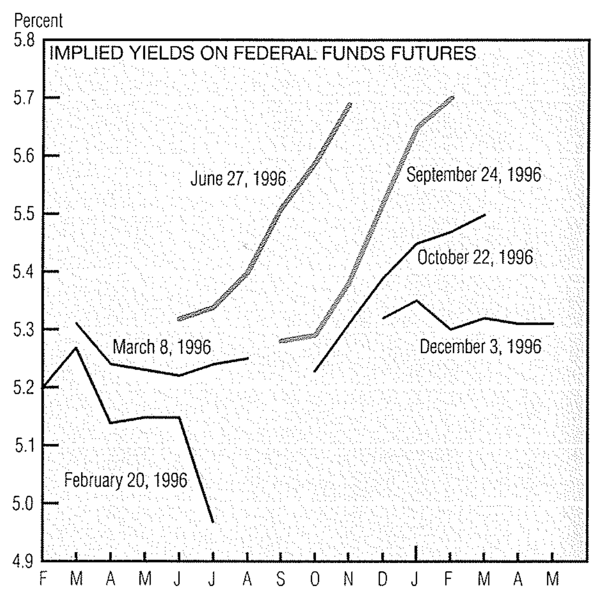
But I heard him exclaim, as he summed up the stakes,
"Stable prices to all, and low interest rates!"

Monetary Policy









a. Predicted rates are federal funds futures.
SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

It has been more than 10 months since the Federal Open Market Committee (FOMC) last changed the intended federal funds rate. That action, a 25-basis-point cut, followed an equal reduction at the group's December meeting. Over the balance of 1996, market expectations vacillated regarding the direction of the next policy move.

The one-year Treasury-bill yield moved up sharply early in the year as prospects for further rate cuts diminished and ultimately reversed. Longer-term rates rose even more dramatically, then swung substantially over the summer months as market commentary revealed a growing sentiment for a policy tightening. Home mortgage rates rose almost 150 basis points from early 1996 to early summer. Since then, all rates have receded somewhat.

Most futures contracts are drawn on commodities or financial instruments whose price or yield is determined in competitive markets. The federal funds rate, on the other hand, is essentially determined by a deliberative decision of the FOMC. The fed funds futures market is thus a place where one can place a bet as to what future monetary policy will be. The implied yields of these futures prices serve as a reasonably unbiased predictor over horizons of three months or less.

By early March, the implied futures yields revealed that expectations of another rate cut had vanished. At midyear, the economy appeared to be stronger than expected, and these yields indicated that a fed funds rate increase was imminent. Expectations of a change in policy climaxed right before the September meeting. Recently, the implied yields have indicated that participants in this market do not expect a policy action before spring.

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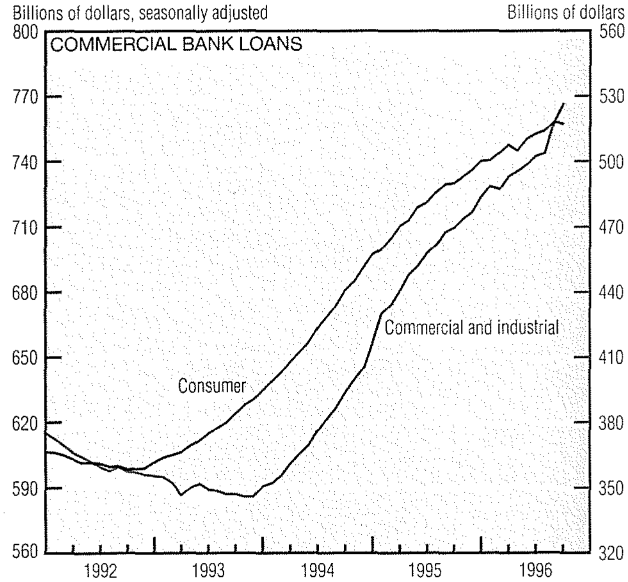
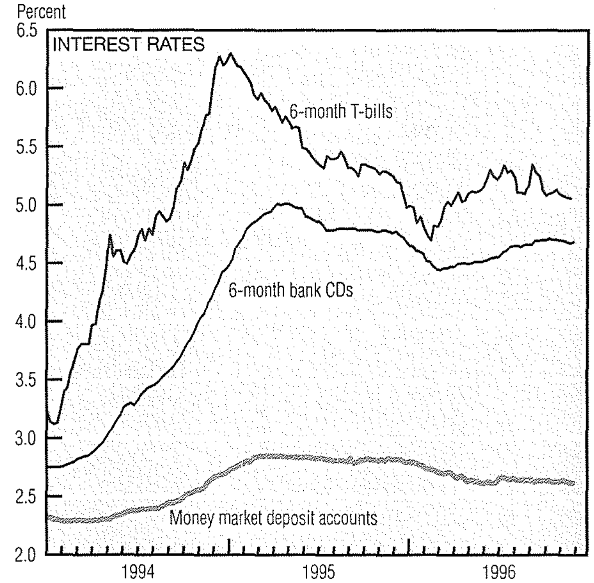
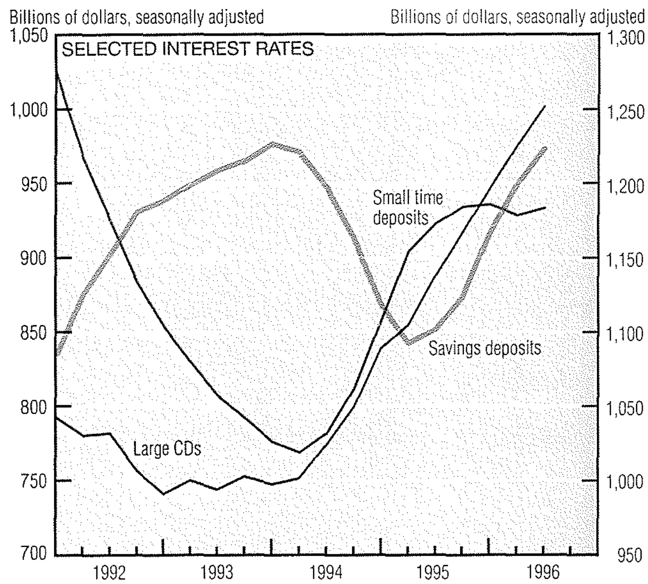
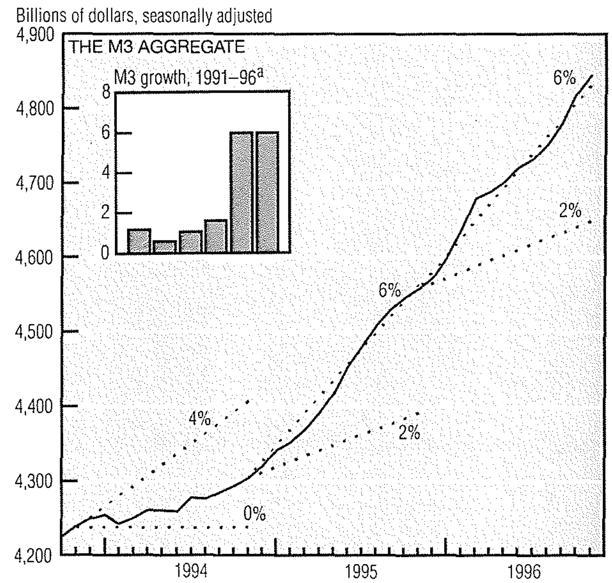
Monetary Policy (cont.)









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

NOTE: Dotted lines represent growth ranges and are for reference only.

SOURCES: Board of Governors of the Federal Reserve System; and *Bank Rate Monitor*, various issues.

Given the environment of continued economic expansion with low or moderate inflation, commercial banks have faced relatively strong demand for commercial and industrial (C&I) loans. In September and October, C&I loans shot up at an annual rate of more than 19%, compared with 8% over the previous year. Preliminary data for November reveal that C&I loan growth is moderating.

Consumer loans at commercial banks have been relatively flat in recent months. Apparently, consumers are becoming more cautious about the amount of additional credit they are willing to take on. While much attention has been given to increased delinquency rates, the state of consumer credit at commercial banks is not alarming. Nevertheless, continued moderation in consumer loan growth will help assuage fears about credit quality.

Since mid-1994, banks have tended to finance much of their loan growth by issuing large certificates of deposit (CDs), which have increased at double-digit rates throughout the period. The rates paid on these deposits are determined in the CD market. Persistently strong gains in large CDs have been the major source of strength in M3, which for two years has consistently run at or above the upper end of its growth ranges.

Unlike the case with large CDs, banks post the rates they are willing to pay for small time deposits and money market deposit accounts (MMDAs). If posted rates are competitive, these instruments attract funds. During 1996, the rates offered by banks on small time deposits have generally been attractive enough only to maintain the level of these deposits.

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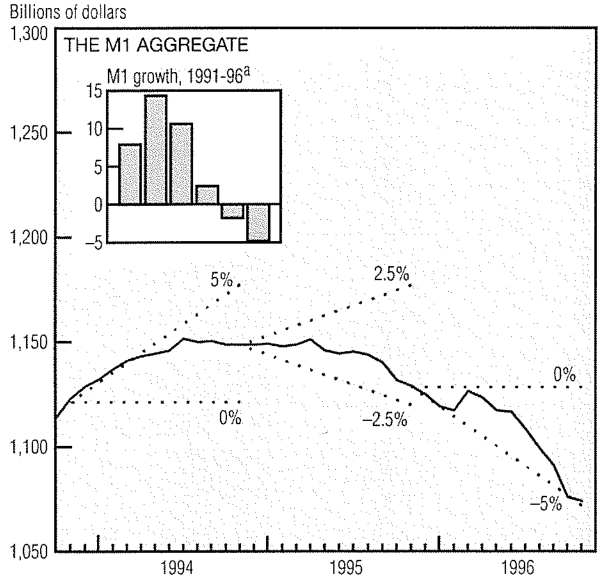
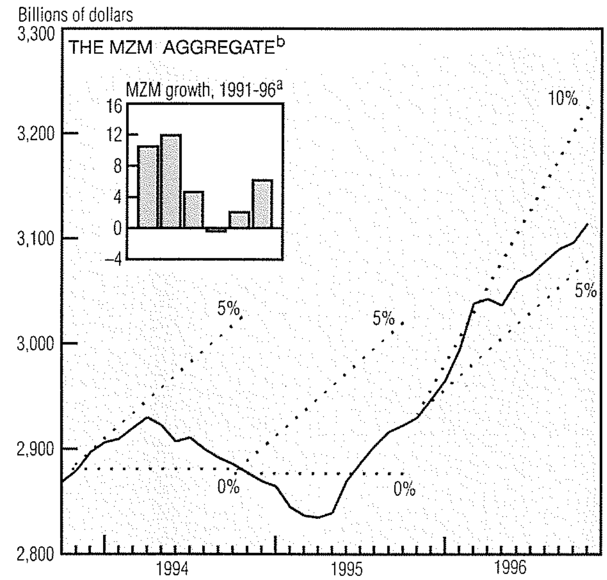
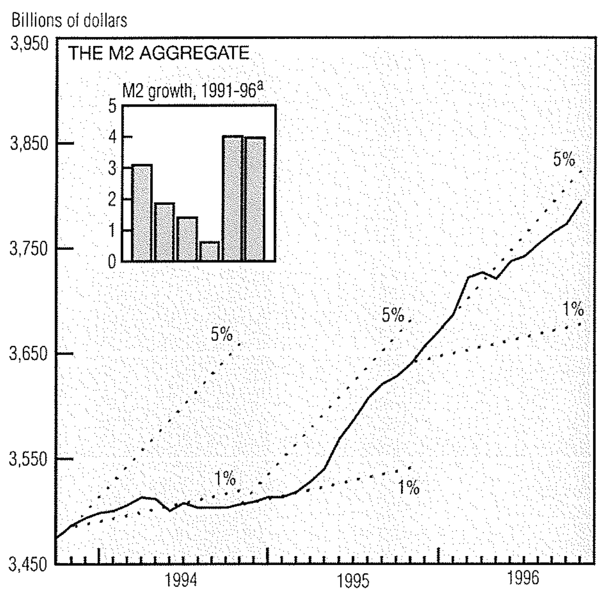
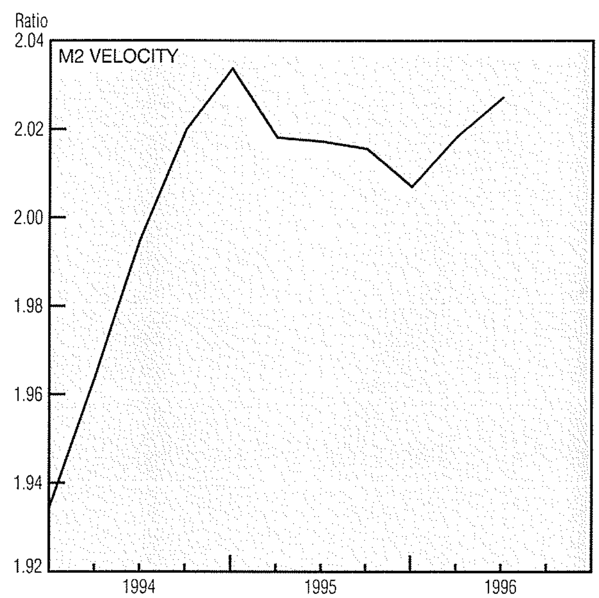
Monetary Policy (cont.)









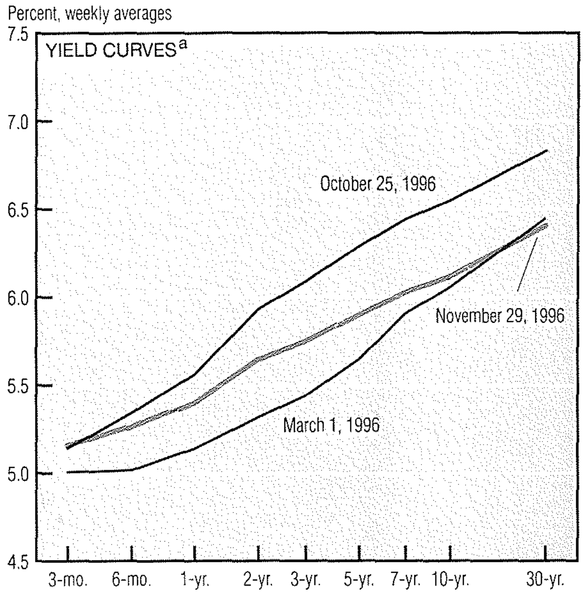
a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1996 is calculated on a November over 1995:IVQ basis.
b. MZM is an alternative measure of money that is equal to M2 plus institutional money market funds less small time deposits.
NOTE: All data are seasonally adjusted. Dotted lines represent growth ranges and are for reference only.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

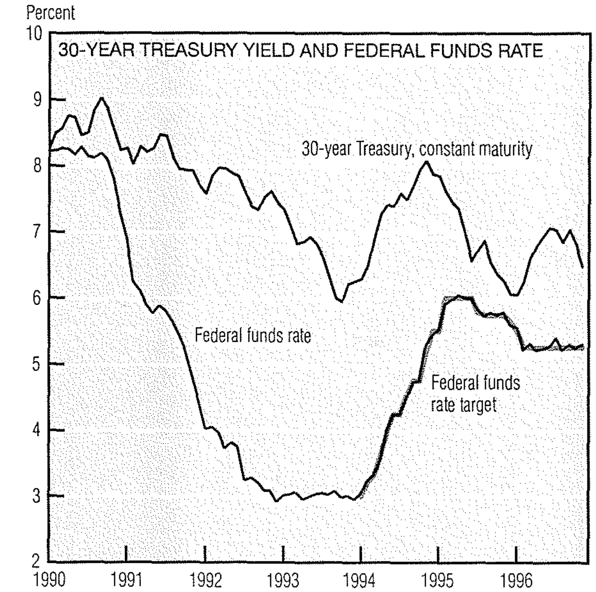
MMDAs have grown even though rates paid on these deposits declined in the face of rising short-term market rates. This growth largely reflects the impact of the implementation of sweep accounts, which banks have initiated over the past few years to economize on reserve balances. These arrangements "sweep" excess household checkable deposits, which are reservable, into MMDAs, which are not. Thus, the implementation of these arrangements accounts for the unexplained strength in MMDAs and the weakness in M1, which includes checking accounts but not MMDAs.

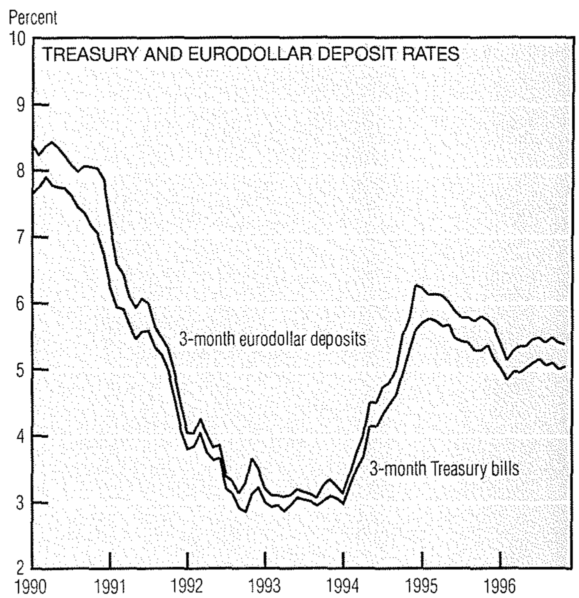
The impact of sweeps washes out in broader aggregates such as M2 and MZM, which include both instruments. The MZM measure of money comprises instruments that have zero maturity and hence are redeemable at par on demand. As short-term market rates began to rise relative to rates paid on MZM deposits, MZM growth moderated from its rapid pace earlier in the year. In light of the recent stability of short-term rates, MZM is expected to continue expanding near its recent moderate pace.

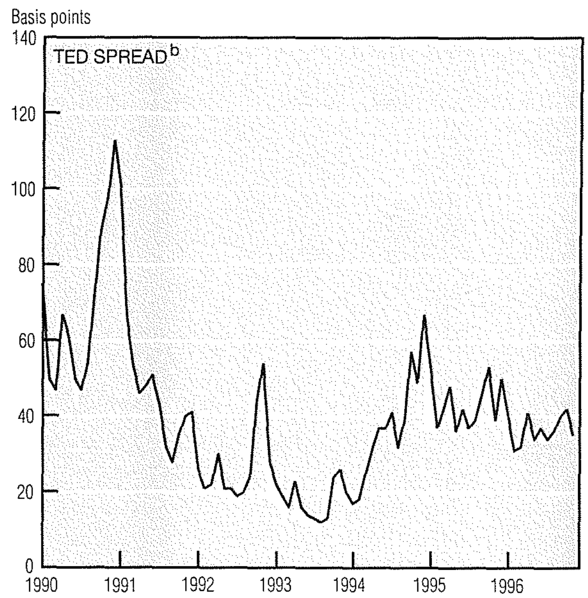
M2 growth also slowed in response to the turnaround in interest rates. This aggregate appears to be responding more consistently with its historical pattern, after behaving atypically in the early 1990s. It appears as though M2 velocity (the ratio of nominal GDP to M2) has stabilized at a new higher level. As Federal Reserve Chairman Alan Greenspan noted during his midyear congressional testimony, the relationship linking M2 to its opportunity cost has "reasserted itself." Nevertheless, given the limited experience and the contained nature of inflation, it seems unlikely that M2 will fully regain its lost status any time soon.

Interest Rates









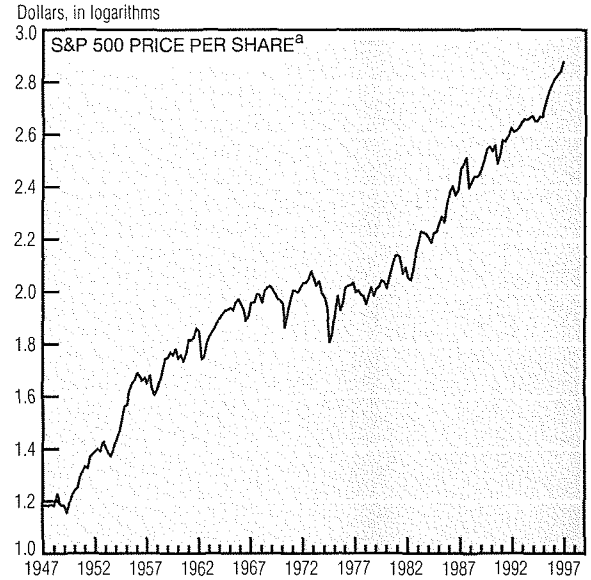
a. All instruments are constant-maturity series.
b. The TED spread is the 3-month eurodollar rate minus the 3-month Treasury bill rate.
SOURCE: Board of Governors of the Federal Reserve System.

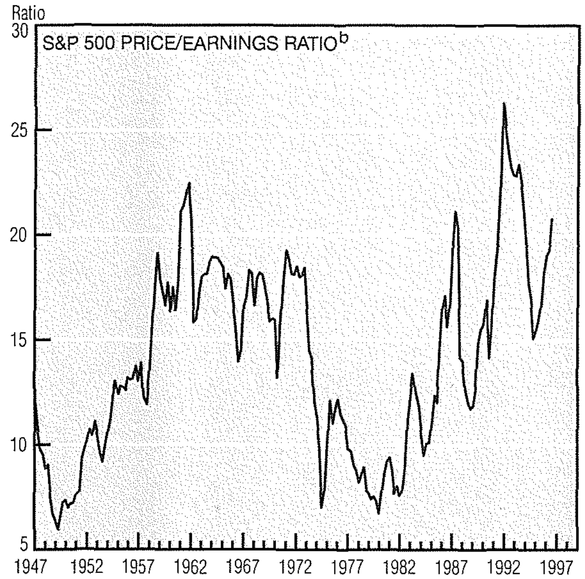
The yield curve on U.S. Treasuries has flattened noticeably since last month, with long rates falling but short rates remaining steady. Among the closely watched spreads, the 3-year, 3-month spread has dropped to 59 basis points, below its 30-year average of 80 basis points, and the 10-year, 3-month spread has fallen to 96 basis points, below its average of 120. The flattening of the 10-year, 3-month spread also portends a slowdown (though not a recession) in real economic growth.

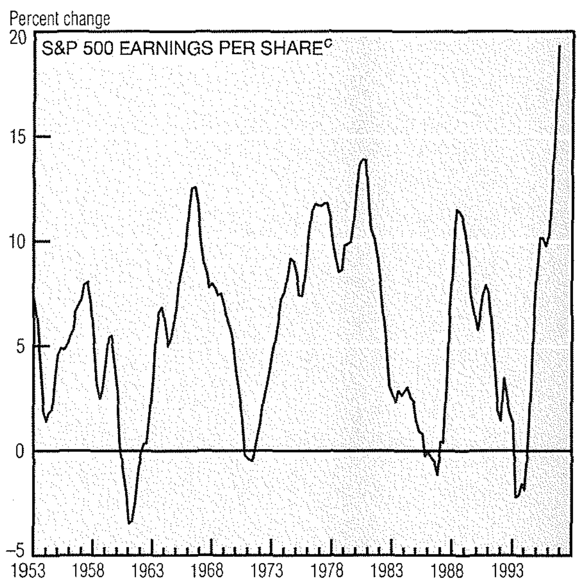
Looking more closely at the extremes of the yield curve—30-year bonds and overnight federal funds—we see the pattern of declining long rates and flat short rates repeated. This occurred despite no change in "policy," if the federal funds rate in fact indicates policy. Of course, expectations about future rates may change even if today's rate doesn't. The recent flattening could also reflect reduced inflation fears, greater confidence that the Federal Reserve will keep rates low, or decreased uncertainty over the future course of the economy.

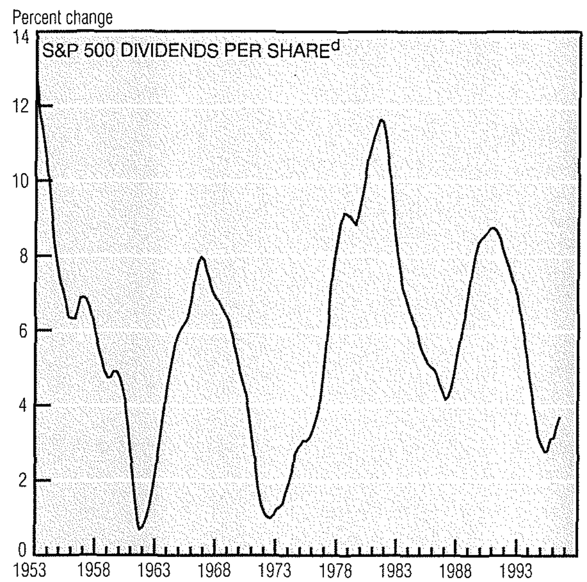
Another closely watched indicator is the TED spread, the difference between interest rates on Treasury securities and eurodollar instruments of the same maturity. Eurodollar rates are generally higher, since they embed the default risk of the issuing bank. The TED spread thus acts as an indicator of investors' relative confidence, which in turn links it to gold prices and exchange rates, two measures that also reflect concerns about confidence.

The Stock Market









a. Last plot is the December 2 closing price.
b. Last plot is the December 2 closing price over preliminary 1996:IIIQ earnings.
c. Last plot is preliminary 1996:IIIQ earnings.
d. Last plot is preliminary 1996:IIIQ dividends.
NOTE: Growth rates are five-year moving averages of the four-quarter sum.
SOURCE: DRI/McGraw-Hill.

In recent months, much attention has been given to the stupendous ascent of the stock market. The rise in the Standard & Poor's (S&P) 500 index of more than 60% since December 1994, however, is not unprecedented in the post–WWII period. Between September 1953 and September 1955, for example, the S&P index increased more than 90%.

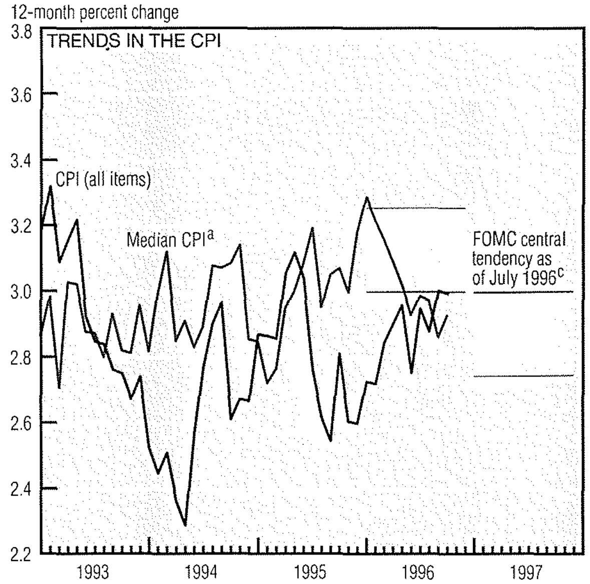
Fundamentally, a stock's price is determined by the discounted value of its expected future dividends. Future dividends ultimately derive from future earnings. When prospects for earnings growth are good, stock prices tend to rise. The price/earnings ratio (P/E)—simply the stock price divided by earnings per share—gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and hence the more earnings growth they are expecting. Although the P/E of S&P 500 stocks has been rising over the past two years, it is not unusually high.

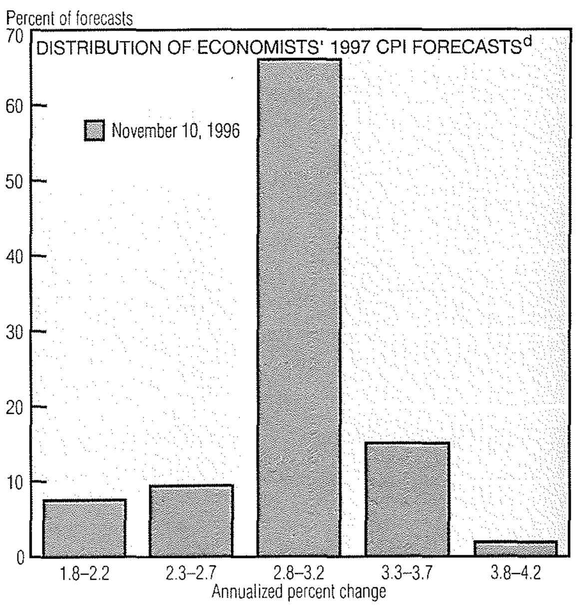
The one clearly extraordinary fact has been the phenomenal earnings growth over the past five years, which is viewed largely as a product of corporations' widespread efforts to cut costs and become more efficient. Current stock prices suggest that although earnings growth may slow, prospects remain good. This reflects an underlying expectation that economic expansion is sustainable with low inflation. Strong growth in private domestic investment in recent years has created a foundation on which to base such beliefs. Moreover, yields on fixed-income securities, such as Treasury bonds, suggest that inflation expectations are well contained. Historically, low inflation has been associated with balanced economic growth and a strong stock market.

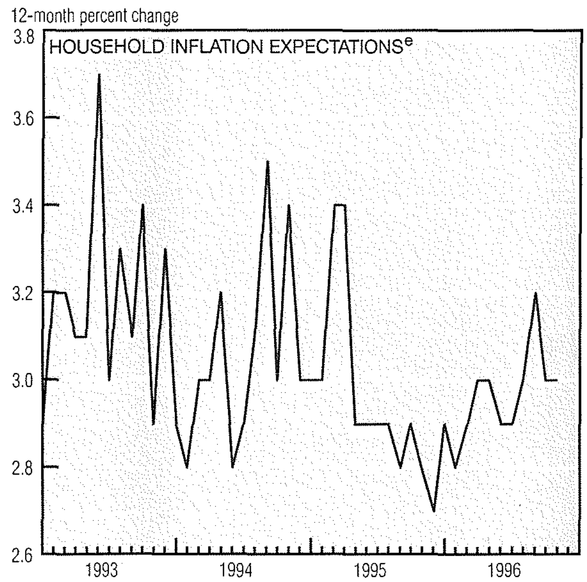
Inflation and Prices

October Price Statistics

	Annualized percent change, last: 1 mo.	10 mo.	12 mo.	5 yr.	1995 avg.
Consumer Prices					
All items	3.9	3.3	3.0	2.9	2.6
Less food and energy	2.9	2.8	2.6	3.0	3.0
Median[a]	4.3	2.9	2.9	3.0	3.2
Producer Prices					
Finished goods	4.7	2.5	3.0	1.6	2.1
Less food and energy	−3.3	0.4	0.9	1.4	2.6
Commodity futures prices[b]	−8.0	0.1	1.5	2.4	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.
e. Median expected 12-month change in consumer prices as measured by the University of Michigan's Survey of Consumers.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; University of Michigan; and *Blue Chip Economic Indicators,* November 10, 1996.

The monthly price statistics took an unexpected jump in October, spurred mostly by higher food and energy prices. Producer prices increased at an annualized rate of nearly 5% during the month; however, excluding a temporary (and probably reversible) spike in food and energy prices, they actually fell 3.3% in October. At the retail level, October prices increased at about a 4% pace, but a percentage point less after food and energy goods are factored out.

For the year to date, consumer prices increased at an annualized rate of about 3%, which is virtually identical to their average over the past five years. Still, this year's retail price performance is coming in at the lower end of the range projected by Federal Reserve policymakers last July (3% to 3¼%), but at the high end of their expectation for consumer price increases in 1997 (2¾% to 3%).

Indeed, looking forward, few economists expect inflation to deviate much from its recent 3% trend. Nearly 70% of those polled in November predicted a Consumer Price Index (CPI) increase of 2.8% to 3.2% between this year and next. Similarly, surveys of households indicate that the median consumer expects prices to rise 3% over the next 12 months.

The CPI represents changes in the cost of a representative basket of goods in 85 urban areas. For any particular year, retail price changes

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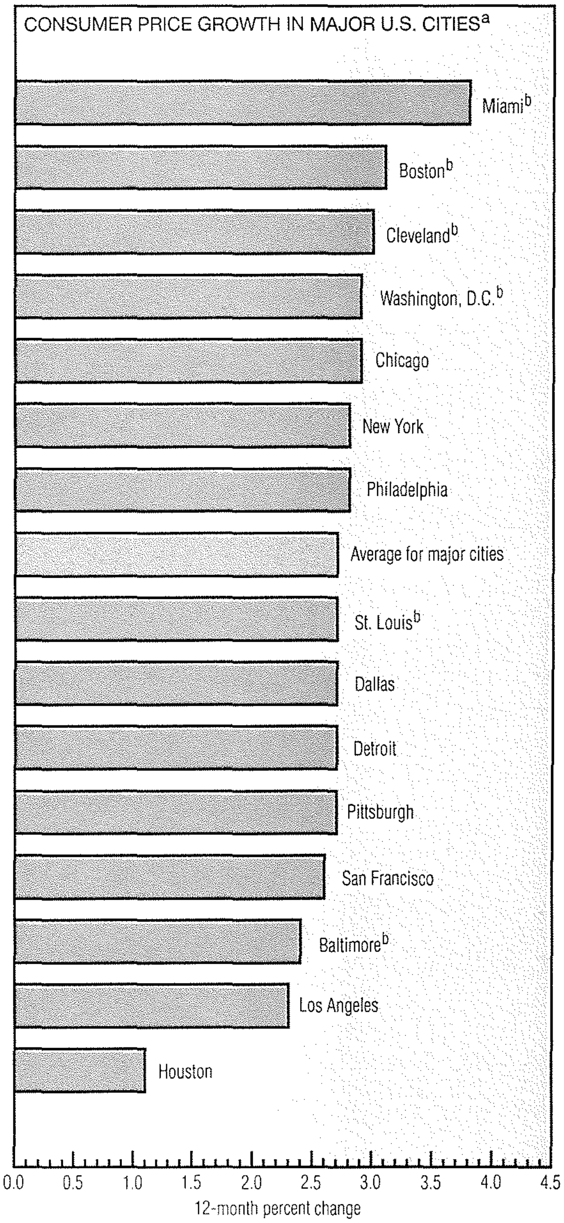
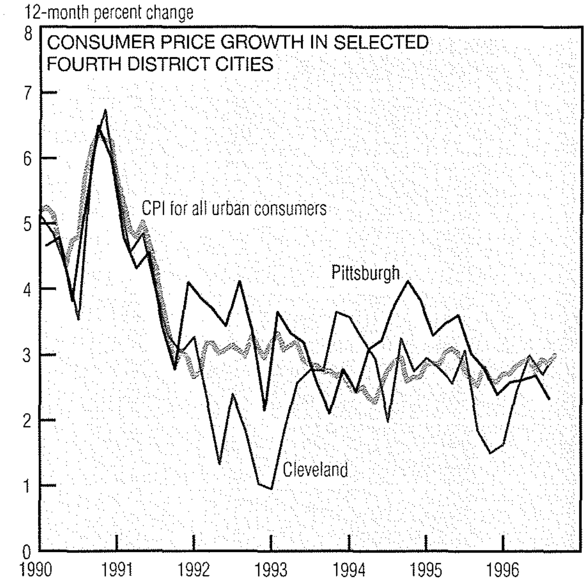
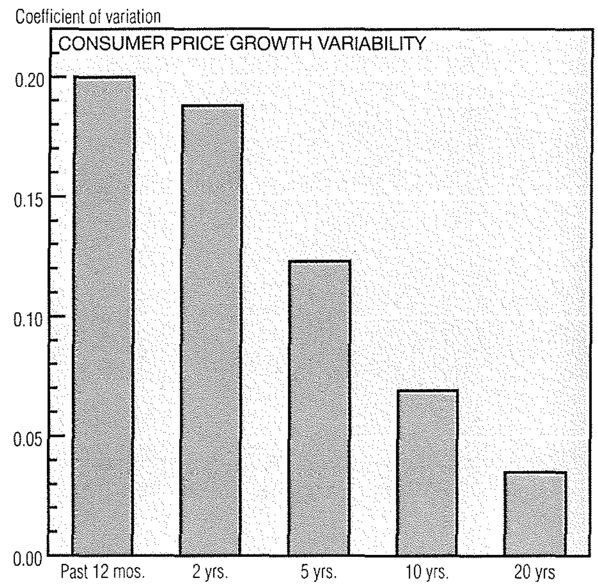
Inflation and Prices (cont.)







a. 12-month percent change covers the period beginning October 1995 and ending October 1996, unless otherwise noted.
b. Covers the period September 1995 to September 1996.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

can vary substantially from region to region. For example, over the past 12 months, consumer price increases among 15 major cities were highest in Miami (3.8%) and lowest in Houston (only 1.1%). Other major cities that posted larger-than-average retail price gains during that period were Boston (3.1%) and Cleveland (3.0%), while Los Angeles (2.3%) and Baltimore (2.4%) showed smaller-than-average increases. To some extent, disparities among regions' year-to-year retail price increases probably reflect the measurement errors that creep into the regional data because of their relatively small sample. Still, some of the difference may represent varying degrees of prosperity. For example, in recent years Los Angeles and Houston have almost certainly experienced greater economic distress than Miami, Boston, or Cleveland, and this may partly account for their more moderate cost-of-living growth.

However, differences in the cost-of-living increase across major urban areas have tended to diminish over time, presumably because sampling errors are erased and economic growth differences lessen. In fact, cost-of-living increases for 15 major U.S. cities varied about 40% less over the past five years than over the past 12 months. That variability is further reduced as the time span is increased; thus, over the past 20 years, variation in the cost-of-living increase among major U.S. cities has been quite small relative to any particular year.

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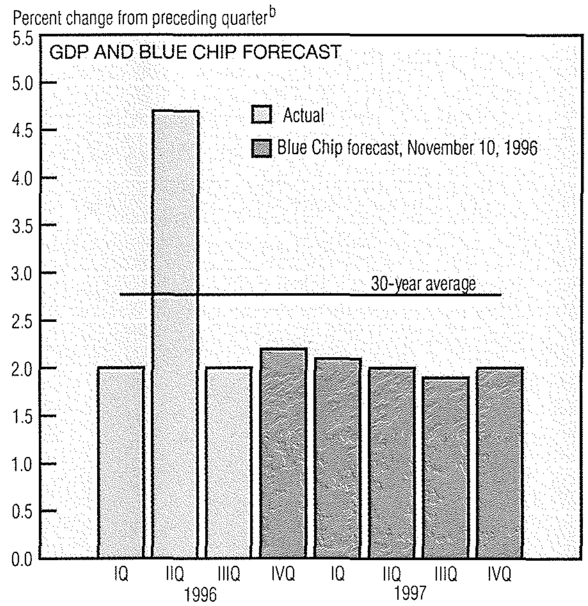
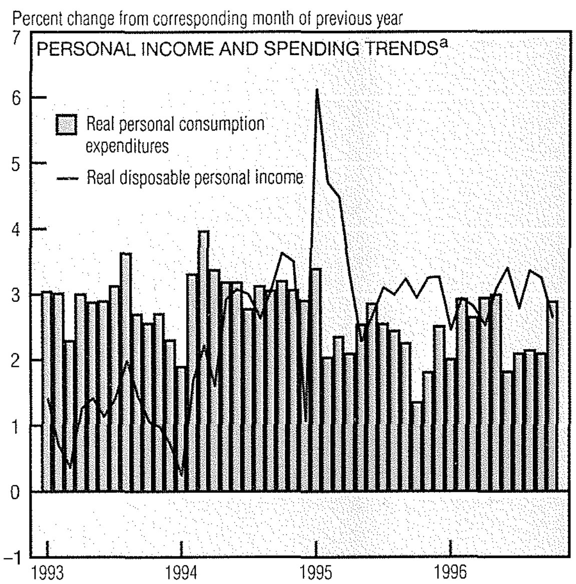
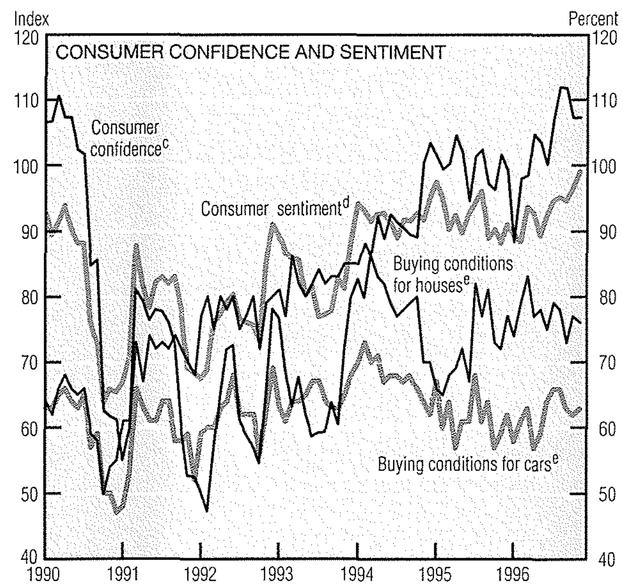
Economic Activity

Real GDP and Components, 1996:IIIQ[a]
(Preliminary estimate[b])

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	33.6	2.0	2.2
Consumer spending	6.7	0.6	2.1
Durables	−3.1	−2.0	4.0
Nondurables	1.1	0.3	1.2
Services	8.4	1.3	2.2
Business fixed investment	29.9	16.9	8.5
Equipment	26.8	20.3	10.6
Structures	3.4	7.6	3.0
Residential investment	−4.2	−5.8	5.8
Government spending	−0.8	−0.3	1.1
National defense	−4.3	−5.3	−1.3
Net exports	−24.1	—	—
Exports	−1.8	−0.9	4.2
Imports	22.2	9.9	7.9
Change in business inventories	25.7	—	—







a. Chain-weighted data in 1992 dollars.
b. Seasonally adjusted annual rate.
c. Index, 1985 = 100; seasonally adjusted.
d. Index, February 1966 = 100.
e. Percent of University of Michigan survey respondents reporting that now is a good time to buy.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; The Conference Board; the University of Michigan; and *Blue Chip Economic Indicators*, November 10, 1996.

The Commerce Department recently pared its estimate of third-quarter economic growth from 2.2% to 2.0%. Downward adjustments to the overall pace of inventory accumulation and to net exports dominated the revisions, but were partially offset by upward corrections to business fixed investment and state and local government spending. Although the 2.0% growth rate is below the exceptional second-quarter rate of 4.7%, it is consistent with estimates of U.S. potential economic growth, which generally range from 2.0% to 2.3%.

Consumer expenditures, accounting for approximately two-thirds of GDP, slowed in the third quarter. Throughout the summer months, consumers augmented their savings, but October's data suggest a return to the brisker spending pace seen earlier this year. Real personal consumption expenditures increased 2.9% (year over year) in October, exceeding the 2.6% gain in real disposable income. Measures of consumers' overall confidence in the economy are at the highest levels yet reached in the current expansion.

Building permits and housing starts, both fairly volatile on a month-to-month basis, have declined markedly since last May and

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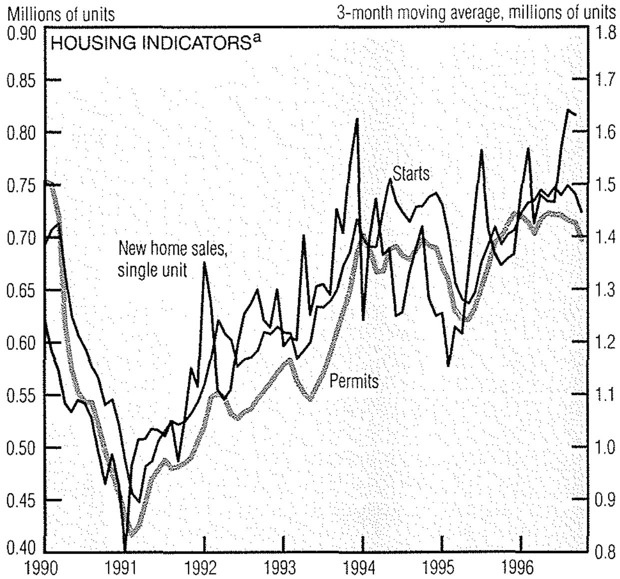
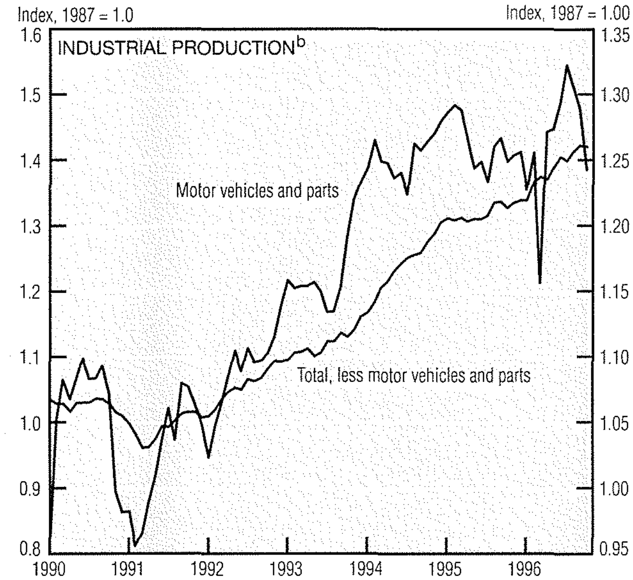
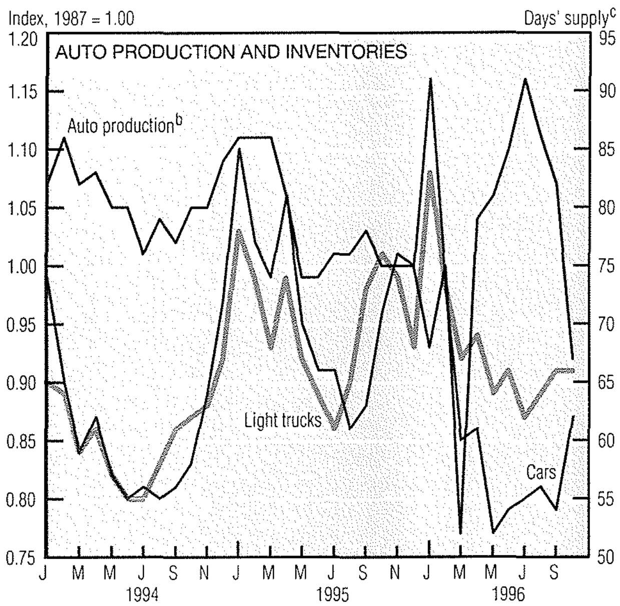
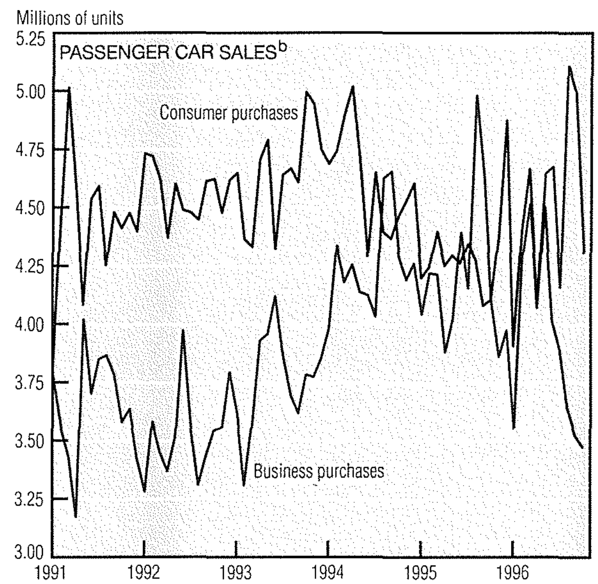
Economic Activity (cont.)









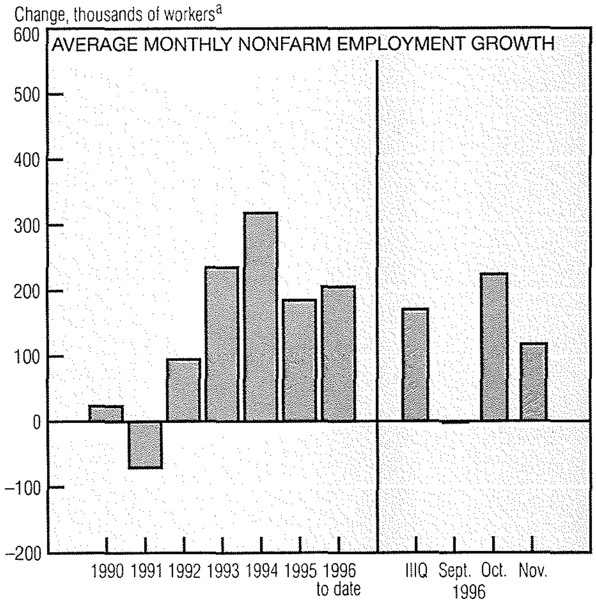
a. Seasonally adjusted annual rate.
b. Seasonally adjusted.
c. U.S. dealers' current stock as a share of daily average sales (includes domestic and imported vehicles).
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and *Ward's Automotive Reports.*

August, respectively. Nevertheless, sales of new single-unit homes remain brisk. Although consumer attitudes about home buying have deteriorated over the year, approximately 76% of respondents to the University of Michigan's survey believe that conditions for purchasing a home are good.

Industrial production, which increased an average 0.3% per month this year, fell 0.5% in October, largely because of labor disputes in the automobile industry. (The Canadian Auto Workers returned to work on October 24, after a 21-day work stoppage, and the United Auto Workers ended brief, localized strikes on October 29.) Nonautomotive industrial production also declined slightly in October, due primarily to reduced output of consumer durable goods.

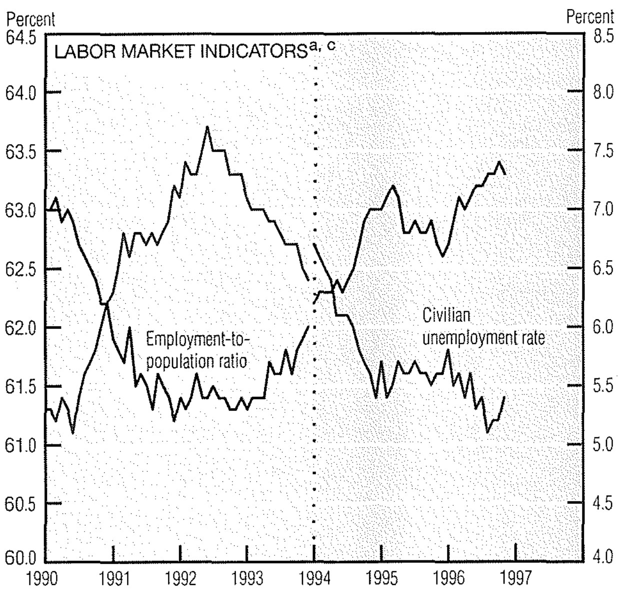
With labor issues resolved, auto production will probably rebound in the coming months, but manufacturers are not likely to make up all their lost output. Consumer purchases of new cars have declined sharply this year, reaching 3.47 million units in October, the lowest level in more than 10 years. Business purchases of new cars, which now exceed consumer acquisitions, also declined in September and October. Despite the strike-induced disruption of supply, dealers' current stocks of cars and light trucks seem adequate.

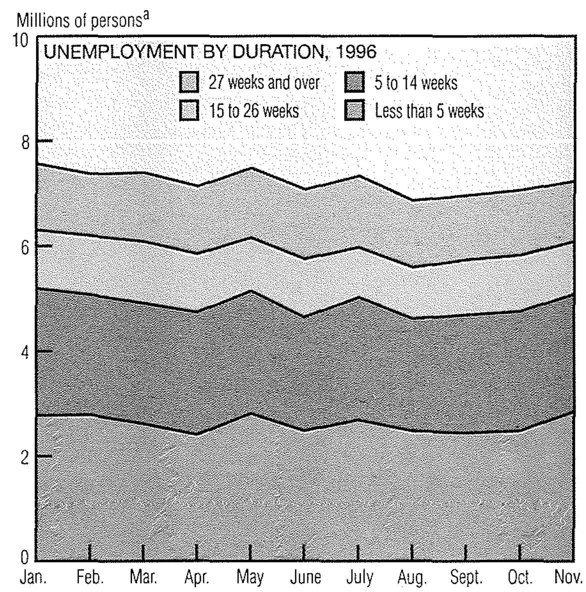
Labor Markets



Labor Market Conditions[a]

	Average monthly change (thousands of employees)				
	1995	1996			
	Year	IIIQ	Sept.	Oct.	Nov.
Payroll employment	185	171	−2	224	118
Goods-producing	−5	−6	−41	20	22
Manufacturing	−12	−19	−50	9	9
Construction	9	16	12	12	14
Service-producing	190	177	39	204	96
Services	110	76	75	88	70
Health services	26	19	30	14	32
Personnel supply services	10	14	−5	4	−28
Government	9	24	−87	−8	−22
Household employ.	34	253	313	259	−30
	Average for period				
Civilian unemploy. rate (%)	5.6	5.2	5.2	5.2	5.4
Nonfarm workweek (hours)[b]	34.5	34.4	34.7	34.3	34.5





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.

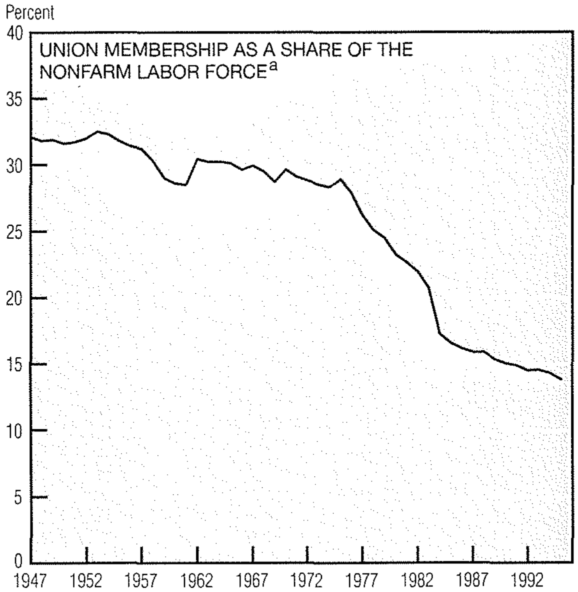
Civilian unemployment rose to 5.4% in November, an uptick from its August low of 5.1%, but still consistent with a robust labor market. The employment-to-population ratio, at 63.3% last month, is little changed from its record high of 63.4% in October.

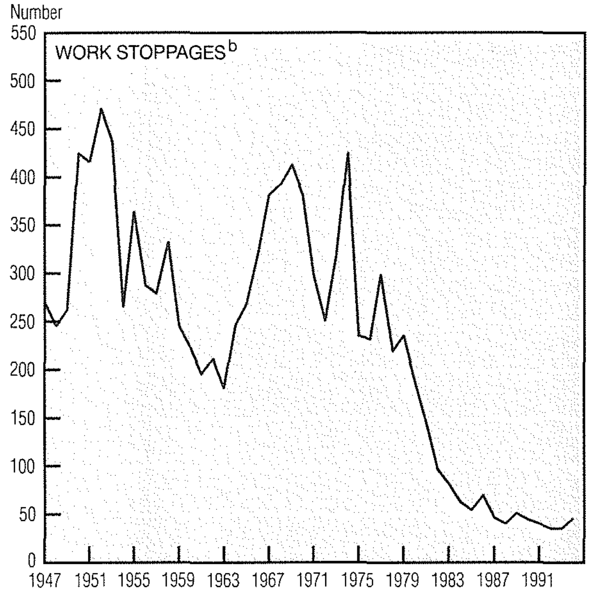
Employment growth was relatively flat last month. According to the establishment survey, the economy added 118,000 new jobs in November. This is somewhat off the average pace for the year, but monthly data exhibit substantial variation and are subject to revision. As has been the case throughout 1996, most of the gains came in the service-producing sector.

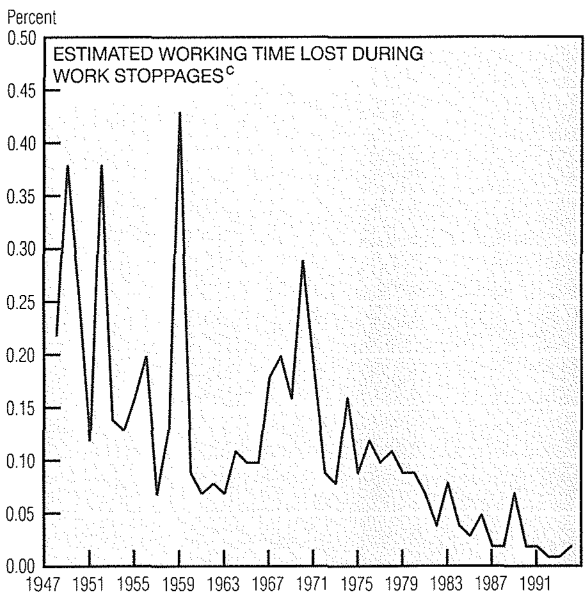
Manufacturing payrolls, which have followed a downward trend since March 1995, rose for the second consecutive month in November. In contrast to the establishment estimates, the household survey showed a slight decline in total employment last month. These surveys frequently diverge on a month-to-month basis, but tend to move together over longer periods.

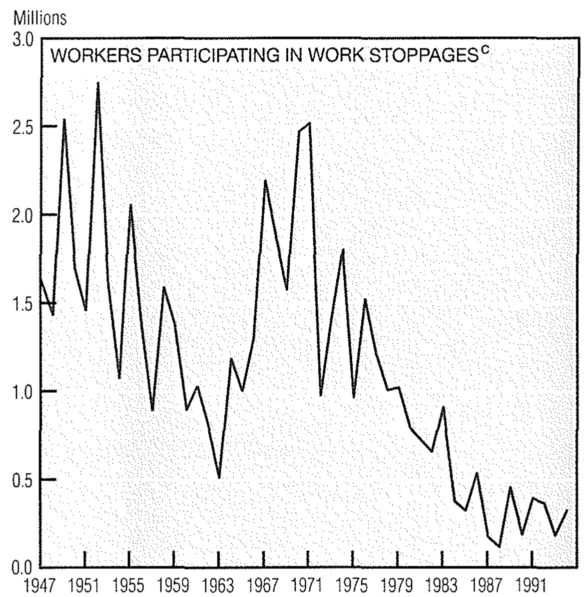
Since August, unemployment lasting less than 27 weeks has picked up slightly. By contrast, long-term joblessness has been falling since June, and the median duration of unemployment dropped to 7.7 weeks in November, down from 8.3 weeks the month before.

Work Stoppages









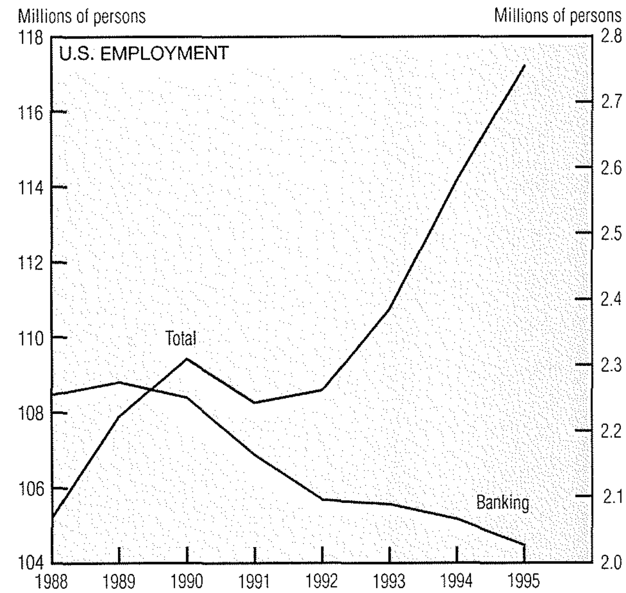
a. Data for 1947–83 are not strictly comparable with those for 1984–94 because of different sources.
b. Refers to stoppages that began in each year.
c. Includes agricultural and government employees; excludes private household, forestry, and fishery workers.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Barry T. Hirsch and John T. Addison, *The Economic Analysis of Unions: New Approaches and Evidence,* Boston: Allen and Unwin, 1986, p. 47, table 3.1.

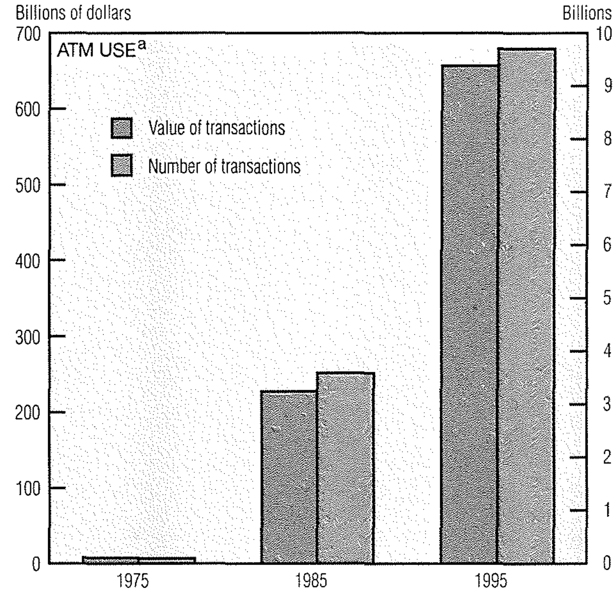
Union membership in the U.S. grew considerably during the first half of this century, from about 4% in 1901 to a peak of about 33% in the early 1950s. Since then, membership has trended down, prompting unions to focus on increasing their ranks, in some cases by consolidating with other unions into larger and perhaps more powerful organizations. Today, only about 14% of the U.S. workforce is unionized.

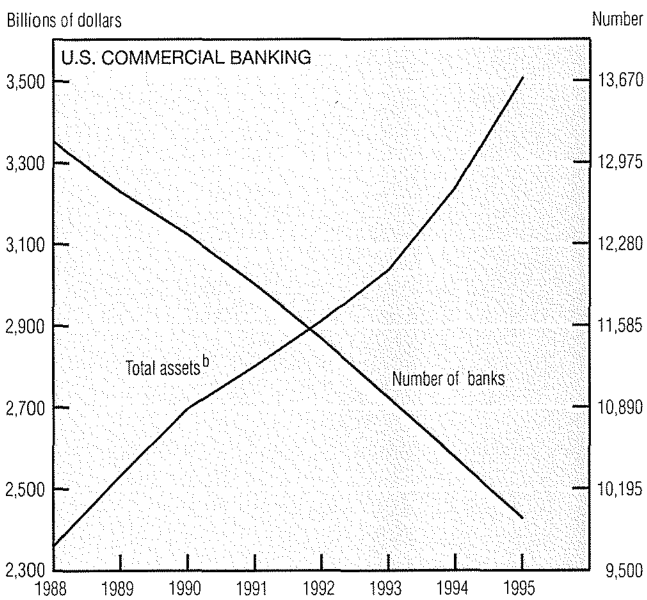
Although unions have been able to bargain on behalf of workers to obtain higher wages, better working conditions, age restrictions, and so on, the benefits have not come without cost. Often, bargaining between workers (not necessarily unionized) and firms breaks down, resulting in strikes or lockouts. Such work stoppages reduce output. The October 1996 strike at GM, for example, resulted in a loss of approximately 183,000 cars and trucks.

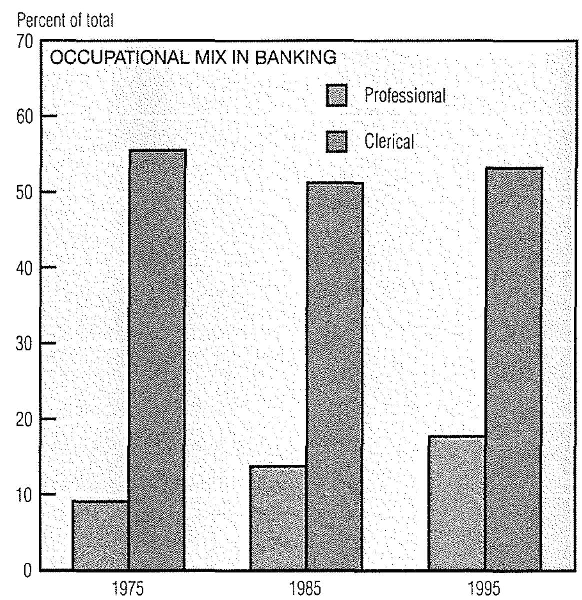
The number of work stoppages averaged about 300 per year between 1947 and 1980. Between 1981 and 1994, that average fell to about 60 per year, and in the 1990s, it dropped to about 40 per year. Declines have also occurred in the number of participating workers, the number of idle days, and the percentage of work time lost.

Banking Industry Employment









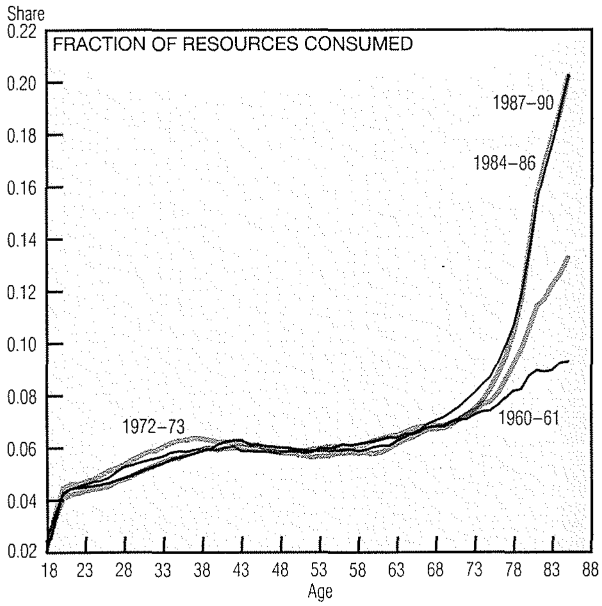
a. Based on Federal Reserve System estimates.
b. Includes total loans and securities; seasonally adjusted data.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and U.S. Equal Employment Opportunity Commission.

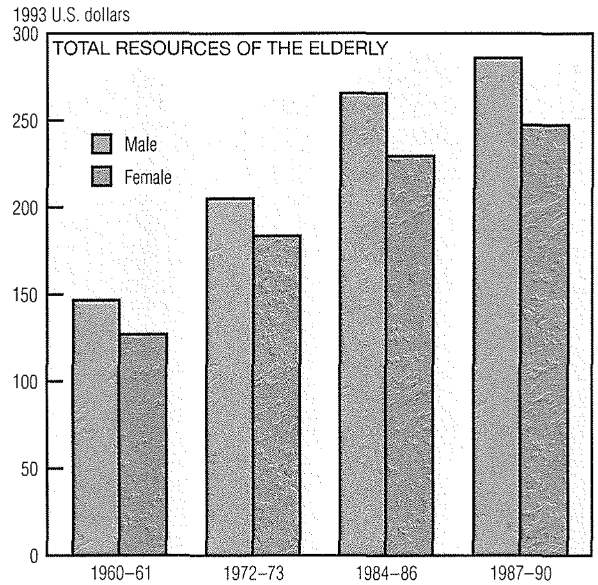
Until recently, the U.S. banking industry provided employment that was relatively free from the uncertainties that affected other industries, such as steel. However, banking employment is now falling; indeed, some analysts predict that the industry will lose 400,000 jobs in the next decade, despite increased supply and demand for many banking products.

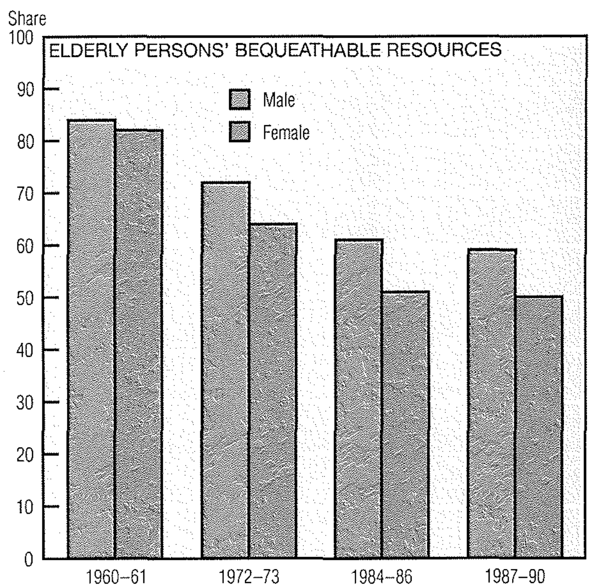
Why would employment fall? The answer probably lies in two recent changes in the banking sector. First, new technology allows machines to be used for tasks that were formerly performed by unskilled labor. The most dramatic example is the rapidly increasing use of ATMs, which has resulted in a sparsely staffed modern bank branch that looks very different from the bank of 20 years ago. Other new technologies, such as electronic scanners and improved bookkeeping programs, are replacing workers who once performed these duties by hand.

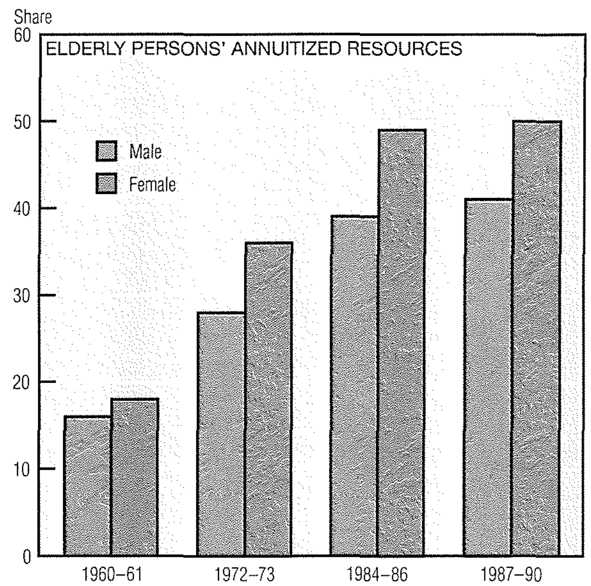
The effects of the second change are not limited to unskilled labor. Recent industrywide consolidation has meant shutting down departments and branches. When a merger transforms two separate departments into one, duplicate tasks are often eliminated. Some mergers also entail a purge of middle-management positions. The net effect of these two changes has been to raise the skill level of the banking industry's labor force.

Resource Annuitization and Consumption









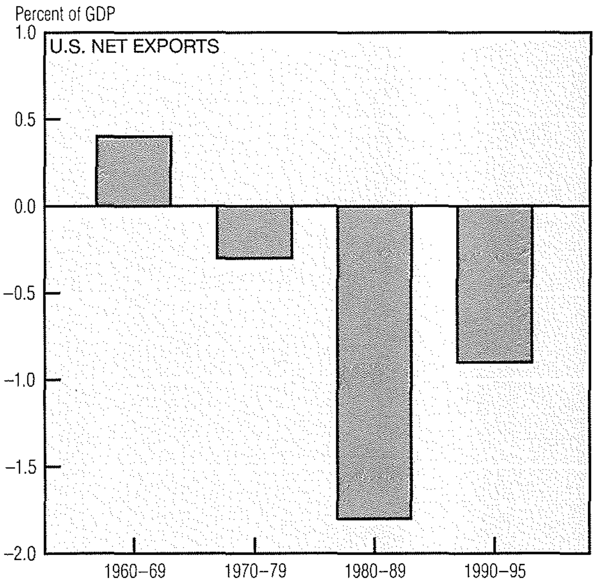
NOTE: Resources are defined as net worth plus the present value of labor earnings, pension benefits, and transfer receipts, minus the present value of taxes.
SOURCE: Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *Brookings Papers on Economic Activity*, no.1 (1996), pp. 315–407.

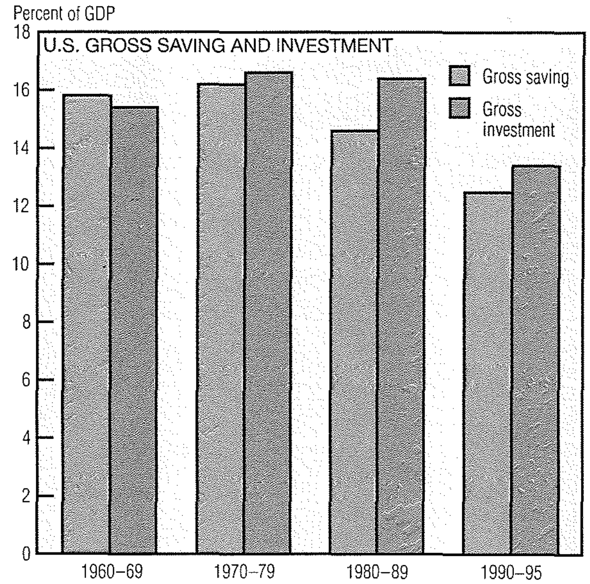
From the early 1960s to the late 1980s, the fraction of resources consumed annually has remained more or less steady for all U.S. age groups except retirees, for whom this fraction increased dramatically. What might be the underlying reason for such impressive growth in older generations' "propensity to consume"?

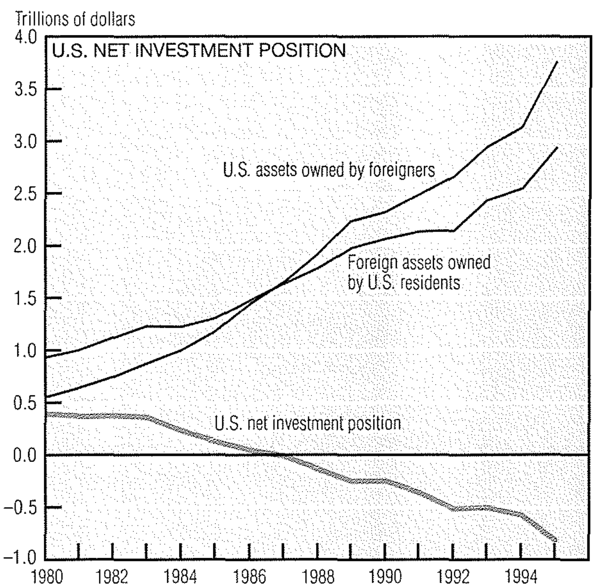
By the late 1980s, the resources of the elderly (those aged 65–89) were almost double what they had been in the early 1960s. Moreover, the composition of these resources had changed significantly. At the beginning of this period, almost four-fifths of older Americans' resources were made up of bequeathable assets—bank deposits, CDs, stocks, bonds, and so forth; by its end, this share had fallen to just over half. The declining share of bequeathable resources was mirrored by a rising share of resources in annuitized form—monthly benefit payments from Social Security, private pensions, and (for those in poor health) regular benefits from Medicare and Medicaid.

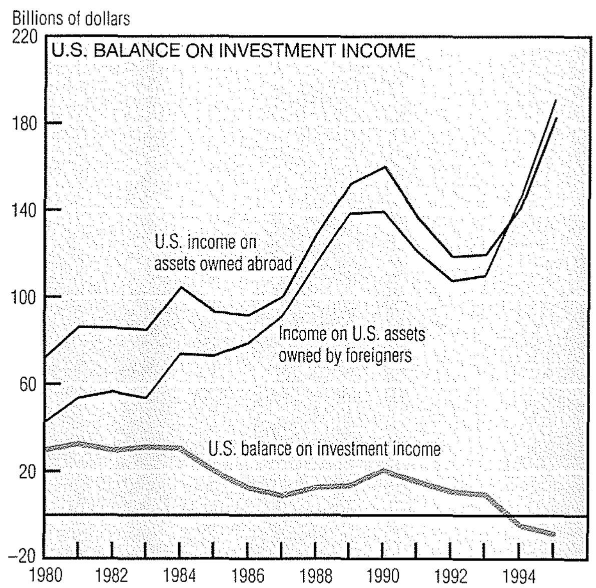
Two aspects of this change in resource composition may explain the higher consumption propensities of the elderly during the late 1980s. First, Medicare and Medicaid benefits are paid in kind and therefore must be consumed. Second, annuitized benefits provide insurance against uncertainty about one's longevity. Resources in bequeathable form encourage caution in the speed of consumption because people fear running out of money in old age. On the other hand, the annuitization of resources guarantees economic security no matter how long one lives, thereby providing an incentive to consume at a faster rate.

Trade Deficits and National Saving









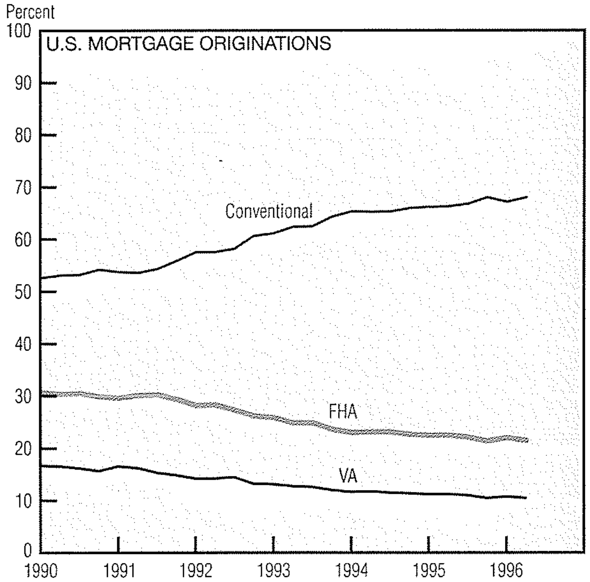
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

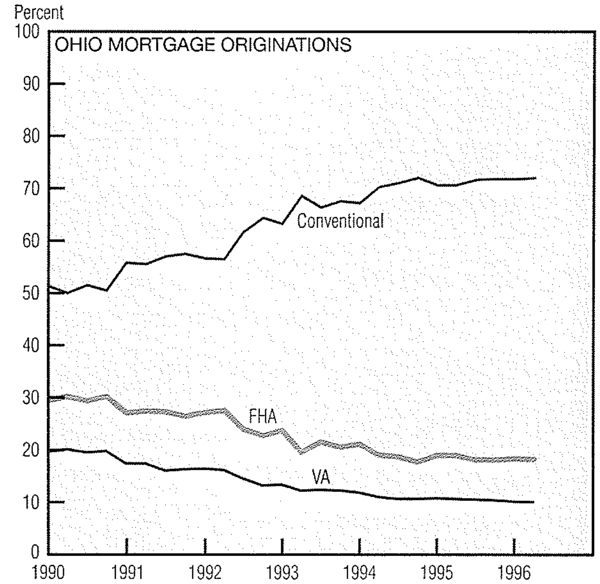
The U.S. trade balance has been in deficit, on average, for the last 25 years. This is reflected in the behavior of U.S. gross saving and investment. During the 1960s, gross saving surpassed gross private investment, and the excess saving was invested abroad.

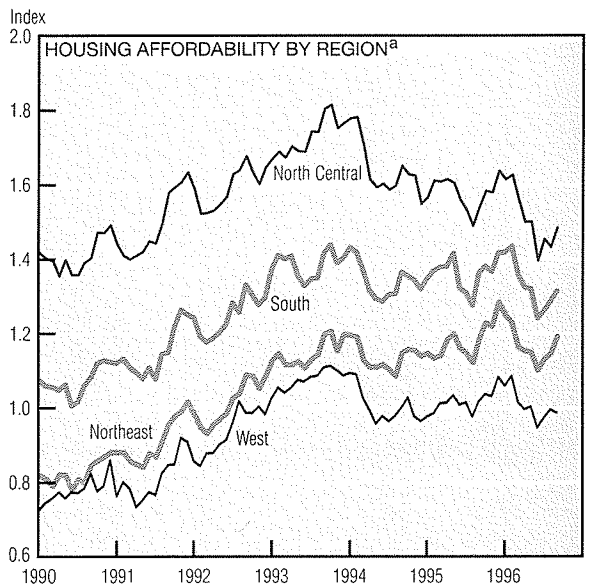
National saving began to decline in the 1970s. The gross saving rate dropped 3.7 percentage points between the 1970s and the first half of the 1990s, but gross private domestic investment fell less. The shortfall in saving was covered by foreign capital inflows—a necessary counterpart of our current account deficits. The long-term decline in U.S. national saving has thus been associated with a secular swing, from positive to negative, in the nation's net investment position. Since 1987, foreign ownership of assets in the U.S. has exceeded ownership by U.S. residents of assets located abroad.

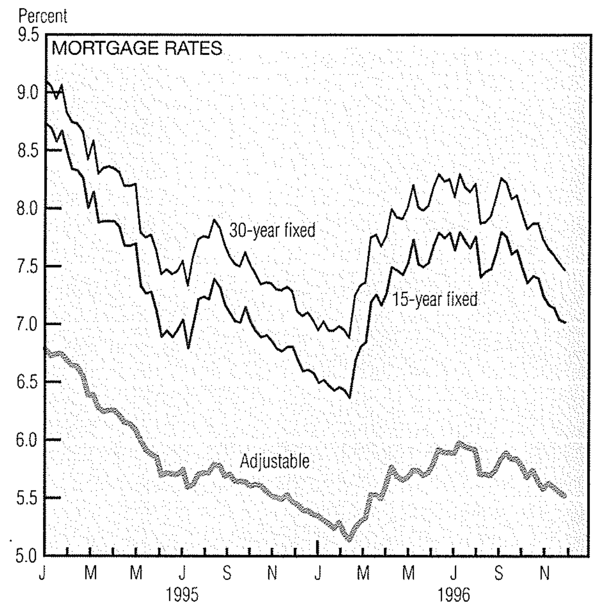
Although foreigners' willingness to invest in the U.S. helps sustain domestic investment, productivity, and ultimately living standards, an expanding foreign debt also increases the burden of servicing it. Foreign income on U.S. assets has recently begun to exceed U.S. income on assets owned abroad. Moreover, should foreigners become less willing to invest here, the debt would have to be repaid by running current account surpluses—that is, by exporting more than we import. In that case, maintaining domestic investment will necessitate an increase in national saving.

Housing Finance







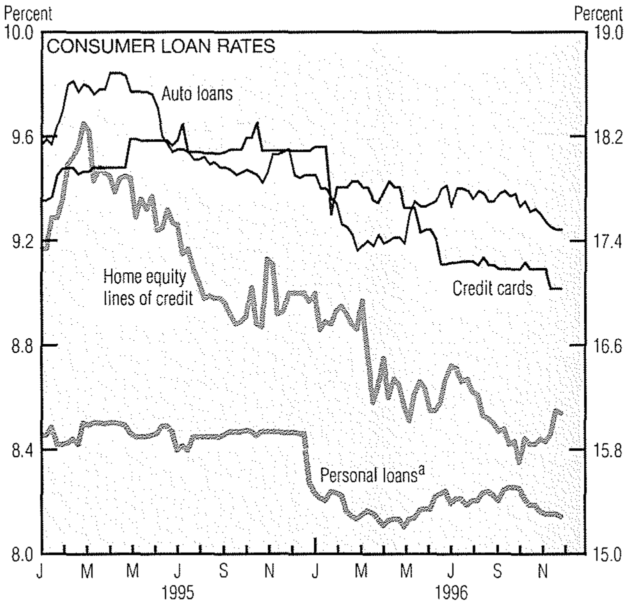


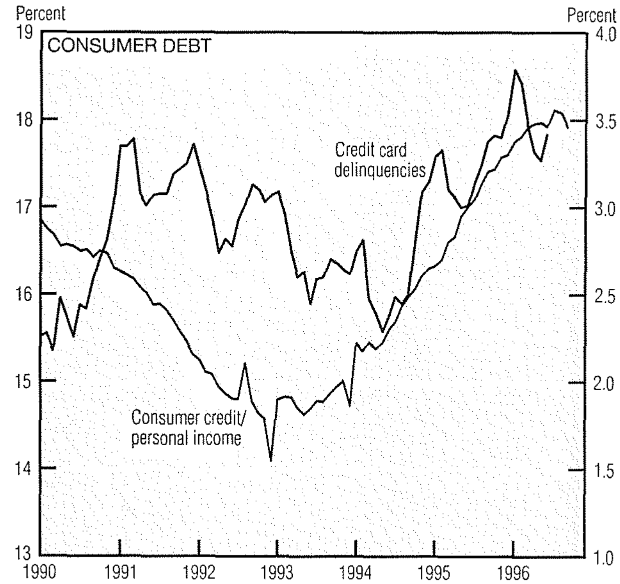
a. The housing affordability index considers median income, median home prices, and interest rates. When the index is at 100, a family earning the median income can afford a medium-priced home with a conventional financial arrangement. A higher index indicates a more affordable housing market.
SOURCES: *Bank Rate Monitor*, various issues; National Association of Realtors, *Real Estate Outlook, Market Trends, and Insights*; and Mortgage Bankers Association of America, National Delinquency Survey.

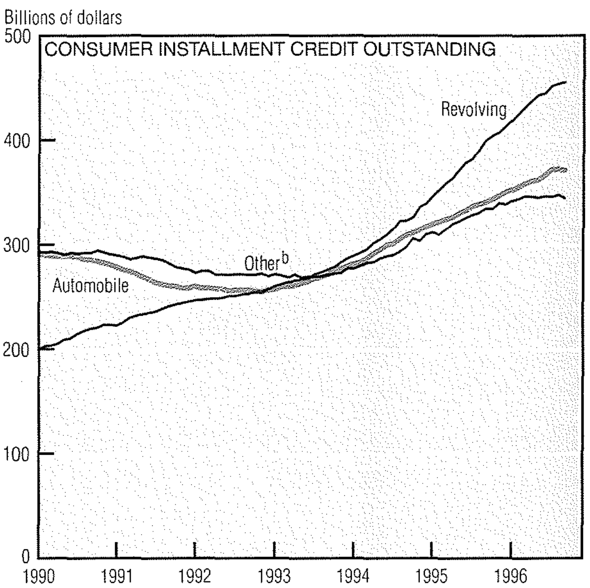
One of the most interesting trends in housing finance throughout the 1990s has been the declining importance of government insurance in the mortgage market. Early in the decade, the Federal Housing Authority (FHA) and the Veterans Administration (VA), by far the largest two federal programs, guaranteed loans in nearly half of all U.S. mortgage originations. By the second quarter of this year, however, federally insured mortgages constituted only 31.9% of new originations. This general trend has been even more pronounced in Ohio.

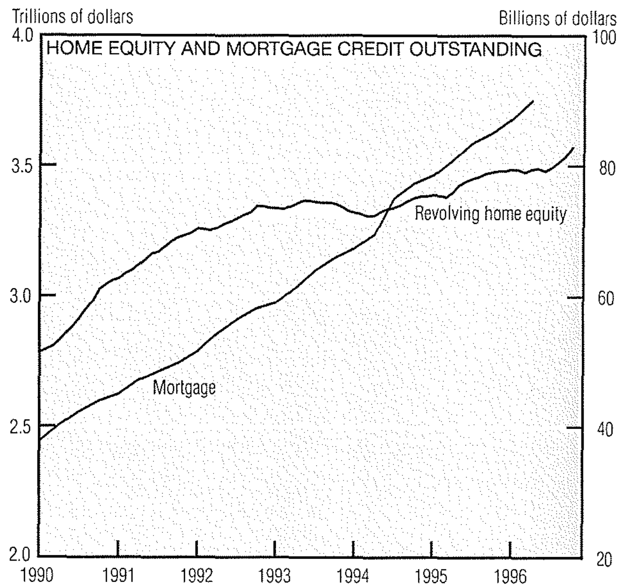
The change is attributable to several factors. First, private mortgage insurance has become much more flexible over the last several years. For example, loan-to-value ratios of 95%, once unthinkable without federal guarantees, are now regularly approved by private insurers. Second, the combination of low mortgage rates and increasingly affordable housing in the U.S. has enabled more borrowers to forgo federal programs for less costly private insurance. Finally, the recent explosion of banks offering special loan programs for low- and moderate-income borrowers (often with special rates and terms) has probably helped reduce the volume of federally guaranteed loans, because these bank programs offer such borrowers a private, more attractive, alternative.

Consumer Debt









a. Includes two-year unsecured loans of up to $3,000.

b. Includes mobile-home loans and all other loans not included in automobile or revolving credit, such as loans for education, boats, or vacations. These loans may be secured or unsecured.

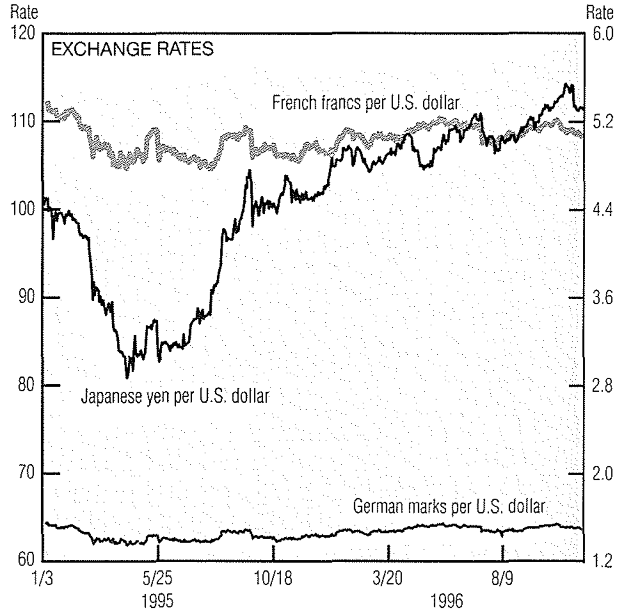
SOURCES: *Bank Rate Monitor*, various issues; American Bankers Association, *Consumer Credit Delinquency Bulletin*; U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

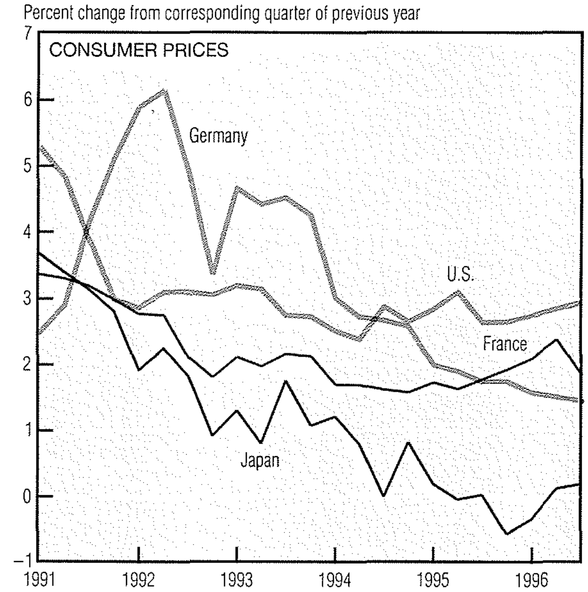
Attention has been lavished on the recent rise in consumer debt levels, and in fact, household debt of all types has increased rapidly throughout the 1990s. For example, mortgage debt has grown more than 50% since the beginning of the decade (to $3.75 trillion by the first quarter of 1996), while revolving credit has increased a whopping 127% (to $456 billion by September).

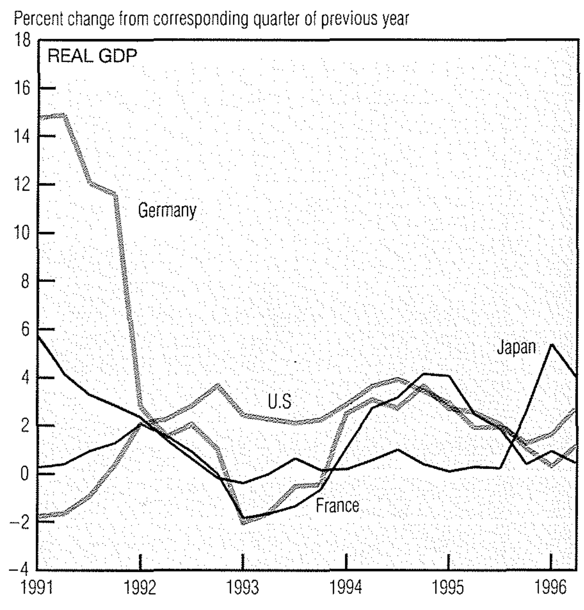
Perhaps more troubling, however, is that the ratio of consumer debt to personal income has risen dramatically over the last several years, from a low of 14.10% in December 1992 to a high of 18.11% last July. High ratios of debt to personal income can foreshadow future defaults. Indeed, the rate of credit card delinquencies, although highly volatile, typically follows the debt-to-income ratio with a lag. Considering that we have yet to see a decrease in this ratio, we may reasonably expect the consumer delinquency rate to continue rising in the near future.

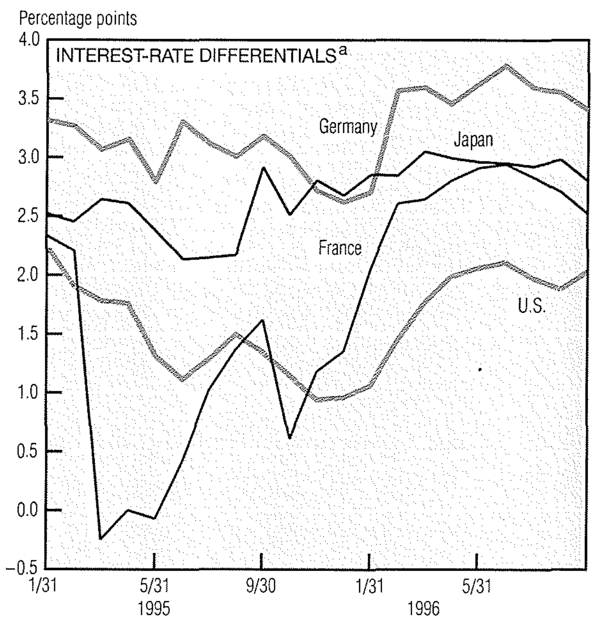
Despite these indicators, it may be premature to raise the alarm for overburdened households. Because interest rates, particularly for mortgages and home equity loans, are at historically low levels, households can manage higher debt levels at any given income.

International Developments









a. 10-year minus 3-month interest rate.
NOTE: Prior to January 1991, German data represent West German figures.
SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Overall, the international value of the dollar has changed little over the last month, despite the fact that both short-term and long-term interest rates have fallen more in the U.S. than in most industrialized countries. Market observers attribute the strengthening of the dollar against the yen to disappointment about the prospects for Japanese monetary tightening. This in turn is related to the perception that the new Japanese government is less likely to soften the existing proposals for fiscal contraction.

In several industrialized countries, high levels of unemployment coexist with subdued consumer price inflation. Despite the previous depreciation of the yen, which would be expected to boost domestic prices, the 12-month Japanese inflation rate is near zero. Unexpected upward price pressure would increase the perceived likelihood of monetary tightening in any nation and thus would boost the value of its currency.

Recent indicators point to continued economic growth in Germany and Japan. However, the Bundesbank has indicated that monetary easing is not imminent, despite an unemployment rate of 10.4% in unified Germany. This, in combination with subdued inflation numbers, might explain the drop in German long-term interest rates. Although long-term rates fell even more in Japan, growth there may be boosted as the yen depreciation enhances net exports.

The French economy surged temporarily in the third quarter, but consumer confidence is low, partly because of the nation's 12.6% jobless rate—a post-WWII high. French short-term rates have been allowed

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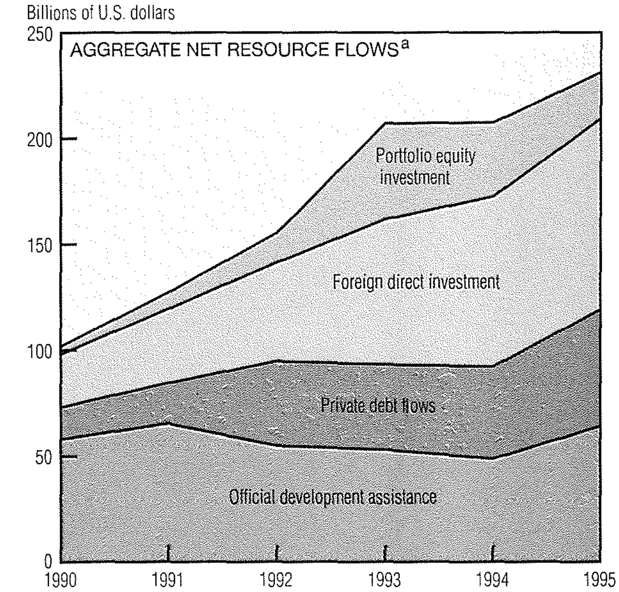
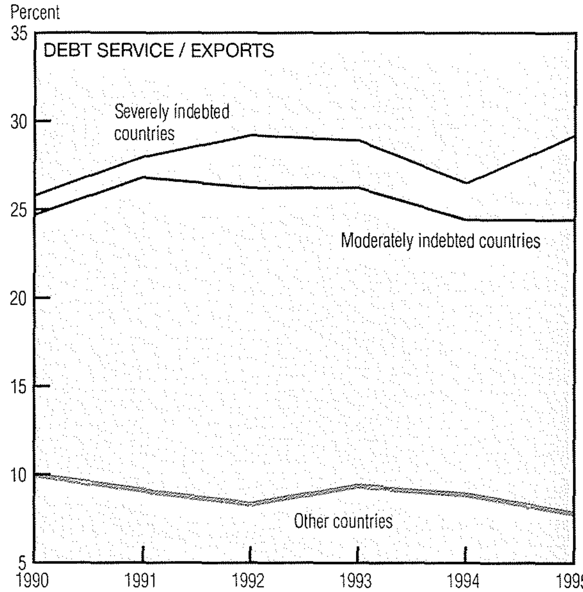
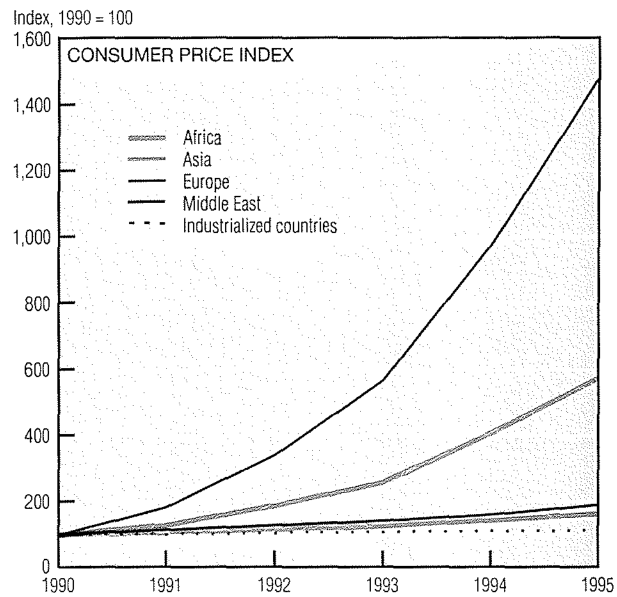
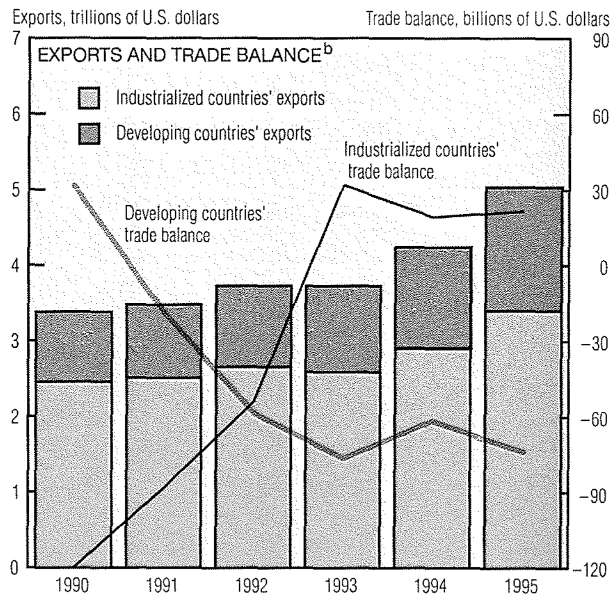
International Developments (cont.)









a. Aggregate net resource flows equal loan disbursements minus principal repayments plus foreign direct investment, portfolio equity flows, and official grants.
b. The trade balance is calculated as merchandise exports minus imports.
SOURCES: International Monetary Fund, *International Financial Statistics*; and The World Bank, *World Debt Tables: 1996*, vol. 1.

to fall more than those of Germany or Japan.

World Bank data indicate that aggregate net resource flows to developing countries continued to advance rapidly in 1995, increasing 11.5%. Excluding the financial aid given to Mexico, however, growth in official development assistance slowed. Smaller increases in private flows are mainly due to declining portfolio equity investment. However, foreign direct investment continued a steady upward trend.

The decline in equity flows has been attributed to three major factors: the increase in U.S. interest rates, the so-called "tequila effect," whereby the Mexican economic crisis led to a deterioration in investors' confidence in other developing countries, and the runup in the U.S. stock market. However, equity flows to developing countries are expected to rebound, though not necessarily to rates reached in 1990–93, when they increased tenfold.

The strength in foreign direct investment, which includes investment in productive capacity, may well continue, as it is part of the globalization of production. A continuation of privatization efforts supports this trend. The decline in official assistance, on the other hand, is a serious concern—especially for countries perceived as poor credit risks, since they cannot shift from official to private sources of finance.

In some nations, soaring inflation rates may indicate that policy reforms are required before private flows can be increased. However, a variety of official actions, including debt rescheduling or debt forgiveness, might facilitate the implementation of effective policy reforms in debtor countries.