

The Economy in Perspective

The Big Chill... The Soviet Union was officially dissolved on December 26, 1991, one day after the resignation of Mikhail Gorbachev. The Cold War was over. Ever since, the countries that made up the former U.S.S.R. have been struggling to govern themselves and to find their places in the world.

The United States has reacted to these developments on two levels. Military bases are closing and spending for national defense is shrinking. New relationships among the United States and the emerging nations are expanding, promising greater trade and employment opportunities. These are the more immediate, visible adjustments, but broader forces are working beneath the surface.

The manifest threat of nuclear attack by the Soviet Union brought a high degree of cohesion to U.S. foreign and defense policies. The vacuum created by the collapse of the "evil empire" is prompting questions that are still largely unanswered. Do we have any enemies now, and what do they want? What are our obligations to protect other nations, and how far should we go to fulfill them? By what means can we best achieve our objectives? How much will these efforts cost? In a dangerous world, how much risk should we bear? There are choices to make, and each comes at a price.

In 1979, the United States initiated a hot war against another seemingly implacable foe—inflation. President Carter appointed Paul Volcker to head the Federal Reserve, giving him a mandate to eliminate double-digit inflation. This effort relied on a demonstrably tight monetary policy and the public's willingness to suffer casualties. Inflation had become so intolerable that having a numerical goal was unimportant; all that mattered was reducing it. With support from President Reagan, the Volcker Fed continued using heavy artillery to break inflation's back, reducing the core rate from 11% to 5% by 1983.

Under the leadership of Alan Greenspan since 1987, the Federal Reserve continued its war against inflation, which it described as a campaign for price stability. Having reduced inflation's imminent threat to economic progress, the Federal Reserve could more gradually squeeze it from the U.S. economy. Initially, the Greenspan Fed followed a course of limited aggression, marked by an occasional preemptive strike and persistently combative rhetoric. This strategy finally paid off in 1991. As Boris Yeltsin faced down the tanks in the Kremlin, the U.S.

inflation trend collapsed from 5% to 3%, the spoils of a seven-year siege. Backing its words with action, the Greenspan Fed cut inflation to levels not seen since Sputnik.

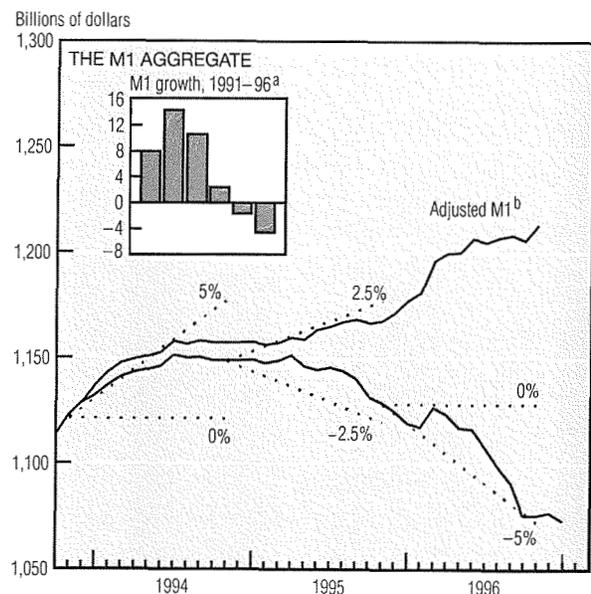
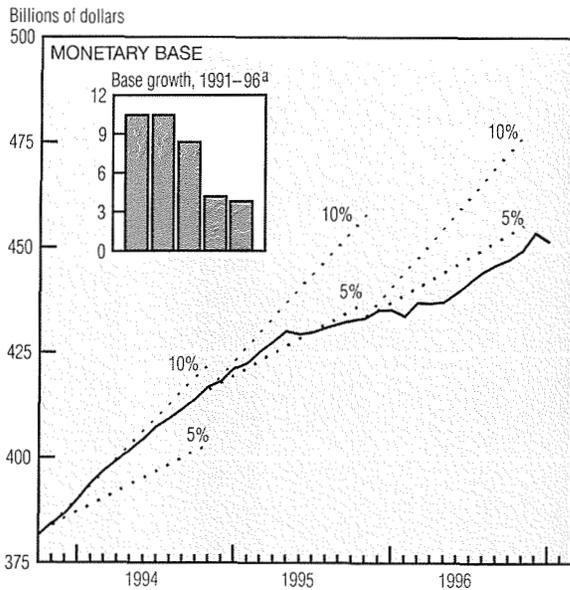
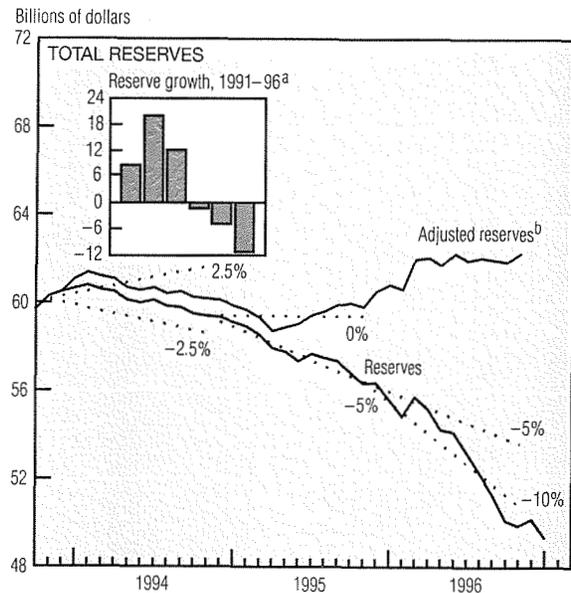
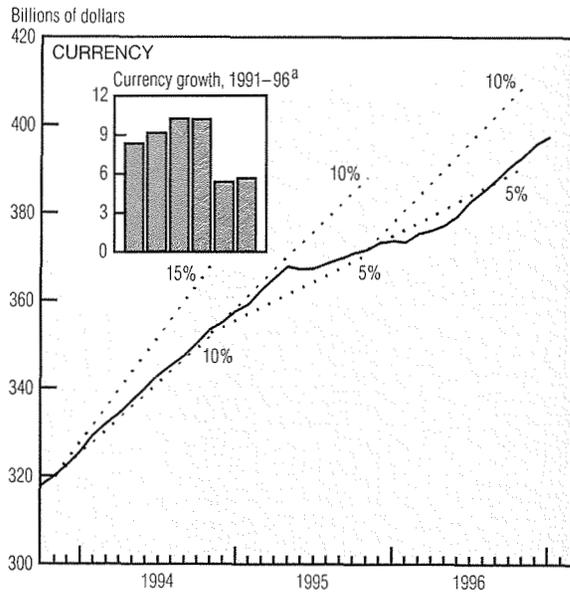
Once again, however, broader forces started working beneath the surface. With inflation lower than it had recently been, voices were heard pronouncing it dead. The economy's pace faltered after the Gulf War, and national attention was focused on expansion and employment, not inflation. Whenever Federal Reserve officials spoke about their commitment to achieving price stability, critics said the Fed was fighting the last war. The Soviet Union was imploding, and the public was tired of combat.

In a sense, people know exactly what they want: peace at *no* price. But on a very practical level, our nation has no clearer idea about what it wants from the Federal Reserve than from the Pentagon or the State Department.

How does an honorable monetary authority achieve a responsible peace with inflation? A workable compromise requires that the public and its central bank understand one another's aspirations and limitations. After all, nations create independent central banks to prevent the popular wish for easy money from running amok. An unduly restrictive monetary policy will eventually lose popular support, but so will policies of appeasement. Although there is ample room for misunderstanding and mischief in the goal-setting process, an honorable monetary authority attempts to be as transparent as possible about its intent and operations. Transparency, alas, does not always equal precision.

"Price stability" has been described as inflation so low that it doesn't enter into people's thinking about economic decisions. So defined, this monetary policy goal does not lend itself to numerical accountability. Some decry this imprecision as a shortcoming of the current monetary policy regime and argue that it lessens the Fed's credibility. Perhaps so. But if the Federal Reserve's aggressive war against inflation has ended, it has been replaced by its own Cold War strategy, designed to attain its goal through less overt means than sustained combat. To keep inflation out of economic decisions, the Federal Reserve must be successful at persuasively shaping inflation expectations. Although a clearly articulated theoretical framework would enhance its actions, this Fed's inflation policy is *realpolitik*. It recognizes that détente does not mean peace.

Monetary Policy



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for January 1997. Dotted lines represent growth ranges and are for reference only.
SOURCE: Board of Governors of the Federal Reserve System.

Every narrow money measure except currency fell in January. Currency grew 4.7%, which was slightly slower than its 1996 average rate of 5.7%. Unadjusted total reserves fell 19.4%, substantially more than last year's annual percentage loss of 11.4%. The monetary base declined 5.3% after rising 3.8% in 1996. The 4.5% drop in unadjusted M1 is in line with last year's 4.7% decrease.

Both M1 and total reserves were

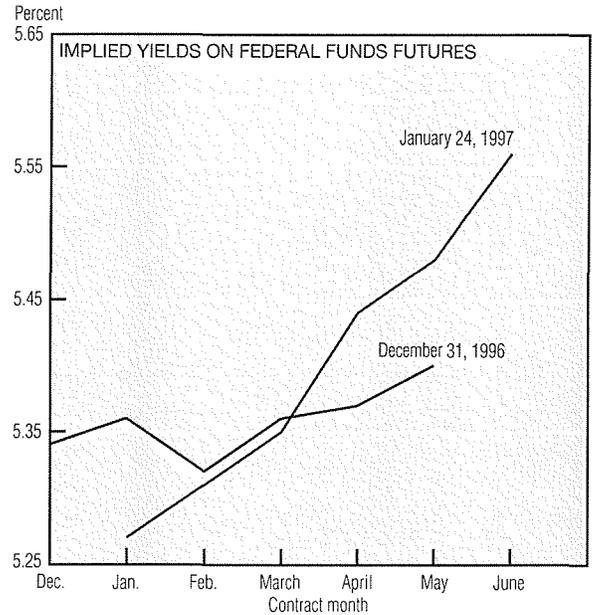
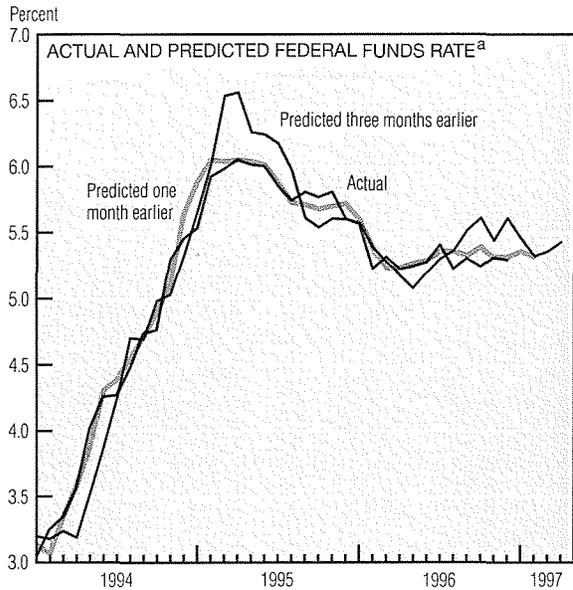
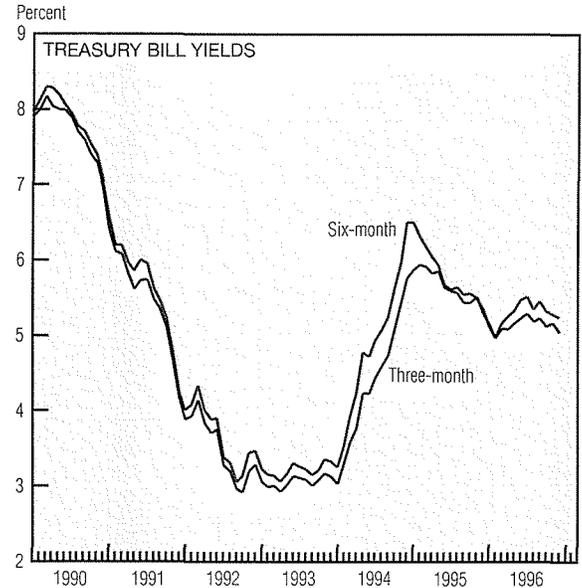
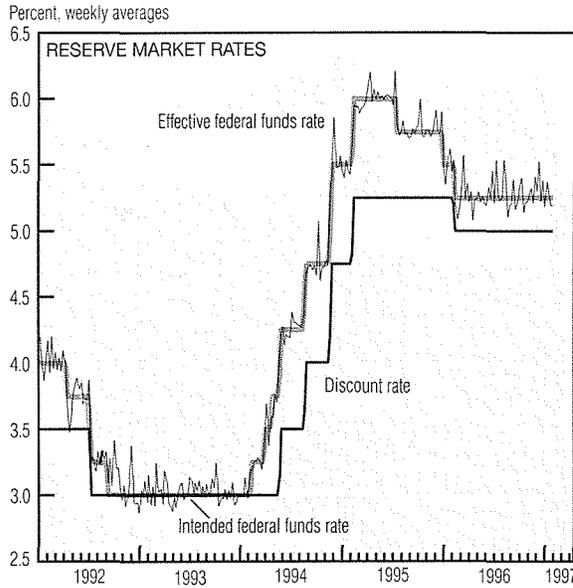
beginning to moderate at the end of 1996, convincing some analysts that sweep accounts were becoming saturated. These accounts, initiated in late 1993 as a way for banks to economize on their reserves, "sweep" excess household checkable deposits, which are reservable, into money market deposit accounts, which are not. Sweep accounts are believed to be responsible for the sharp declines in M1 and

total reserves in recent years; however, even when these measures are adjusted for sweeps, they still show anemic growth.

The usefulness of available sweep account data is limited, because depositories are not required to disclose the size of their programs. This means that sweep account activity can be estimated only by using the daily-average effect of new sweep programs on the monthly average

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Monetary Policy (cont.)



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

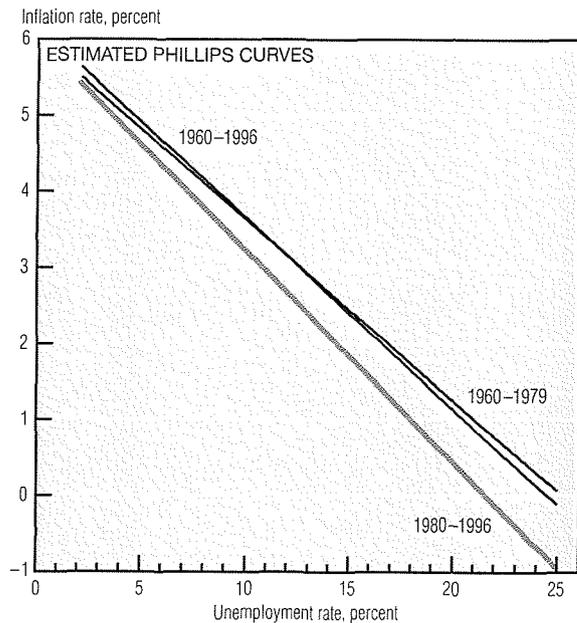
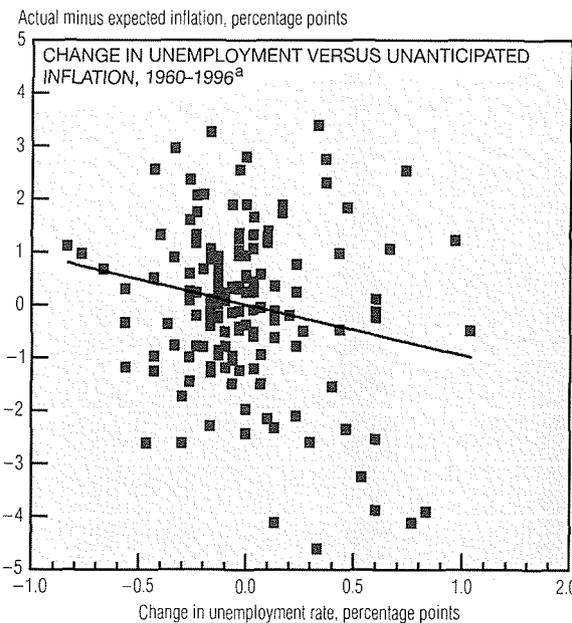
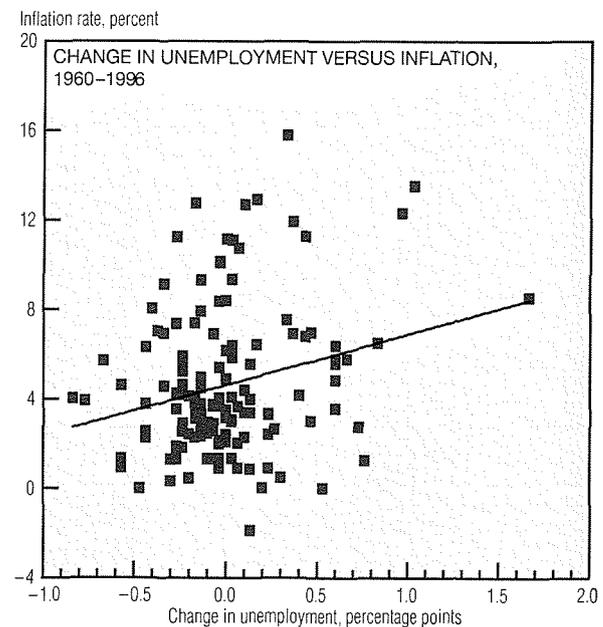
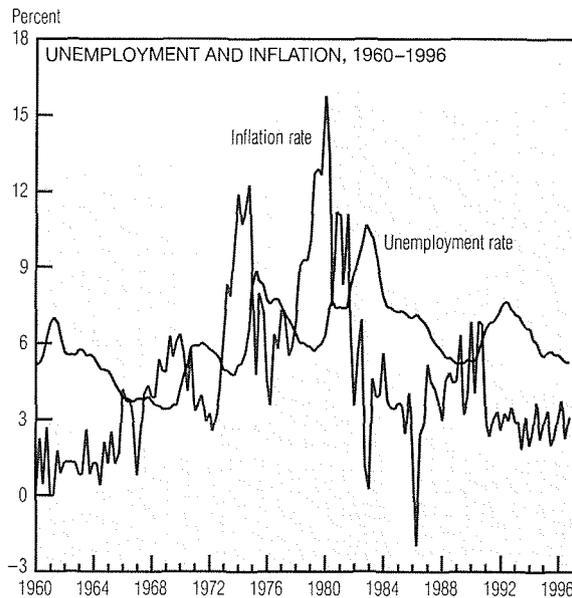
level of other checkable deposits. The Federal Open Market Committee (FOMC) reconvened in early February and reportedly took no action on the federal funds rate. A full year has passed since policymakers approved a reduction (25 basis points). Since that time, the economy has continued to grow at a moderate pace and inflationary pressures have been kept in check. Although the funds rate has re-

mained constant, yields on short-term Treasury securities have tapered off in recent months. Current T-bill yields are 5.0% on the three-month bill and 5.2% on the six-month. Although short-term yields are below their historical averages, they are about 2% above 1993 levels. Federal Reserve Chairman Alan Greenspan appeared satisfied with the current state of the economy when he testified before the Senate Budget Committee in January, but

he observed that if the U.S. labor market continues in its current state, workers are likely to start demanding higher wages. The federal funds futures market, which reflects participants' expectations of future FOMC actions, seems to concur with the Chairman, and has built a moderate increase into the funds rate by late in the second quarter of 1997. This is a distinct change from last December, when market participants were

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Monetary Policy (cont.)



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

expecting policy to remain neutral until May.

The unemployment rate is currently 5.4%, well below what many analysts consider consistent with low inflation. They contend that rising unemployment leads to lower inflation and falling unemployment leads to higher inflation. Although this relationship (called the "Phillips curve") is thought to be one of the most reliable in macroeconomics, the current prolonged period of low inflation and

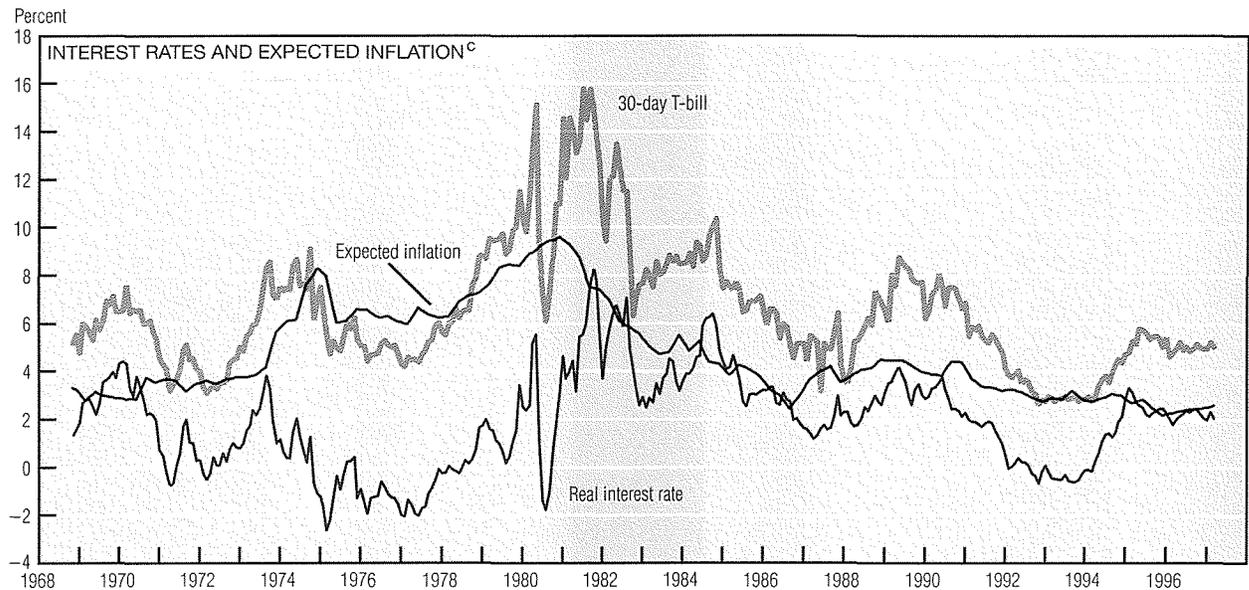
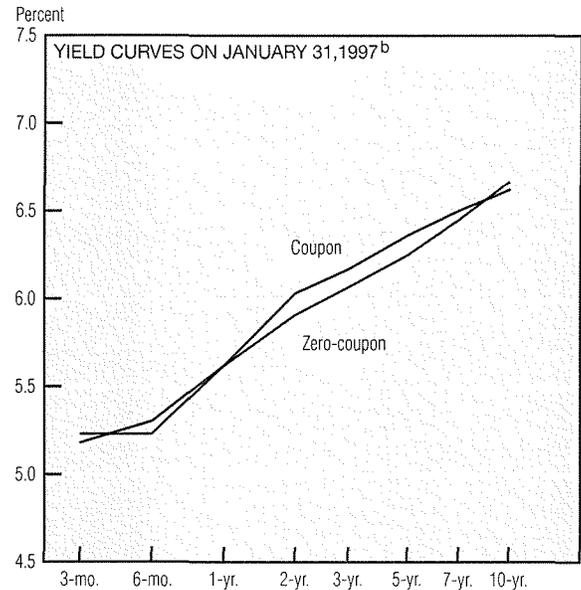
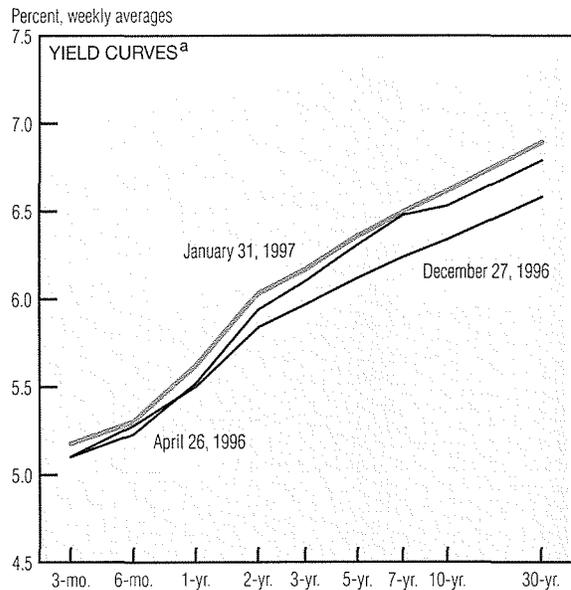
low unemployment raises doubts about its validity.

Indeed, in examining the data, one might at first believe that a slight positive relationship exists, a view that is confirmed when one plots the inflation rate against the change in the unemployment rate. Analysts generally resolve the apparent conflict between the Phillips curve and the data by focusing on the change in unemployment and the deviation of inflation from the level expected by the market. With this modification, the data more readily reveal a

negative correlation between price changes and unemployment.

Clearly, the relationship between unemployment and inflation should be regarded with some skepticism. After all, a negative correlation is one thing, but a stable relationship is quite another. Evidence shows that simple estimates of the Phillips curve based on available data may shift over time. Thus, although the Phillips curve remains a focal point for policy discussions, a cautious application seems warranted.

Interest Rates



- a. All instruments are constant-maturity series.
b. The coupon yield is a weekly average and the zero-coupon yield is a daily number.
c. The real interest rate and expected inflation rate are calculated from the Survey of Professional Forecasters using the 30-day T-bill rate.

SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia; and *The Wall Street Journal*, various issues.

Interest rates have moved up since last month, and the yield curve has steepened. The yield on 30-year bonds has increased 31 basis points, (to 6.89%); the 3-year, 3-month spread stands at 99 basis points, and the 10-year, 3-month spread is at 144.

The yields on zero-coupon bonds continue to closely track the yields on coupon bonds. This month, however, the yields on 2-, 3-, 5-, and 7-year notes exceed that of same-maturity zeroes. This is surprising, because the shorter dura-

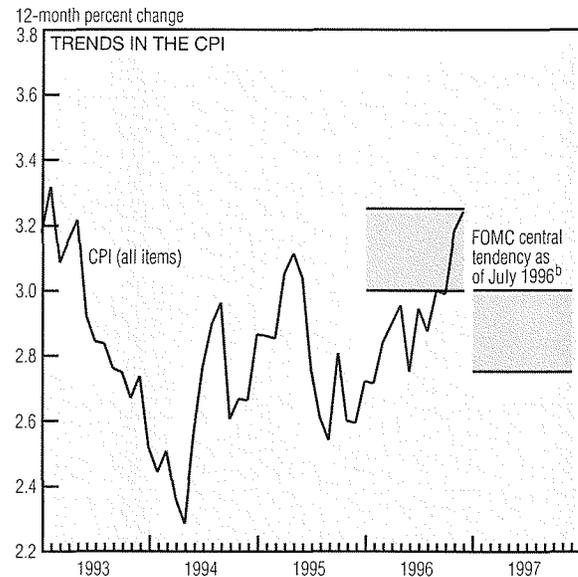
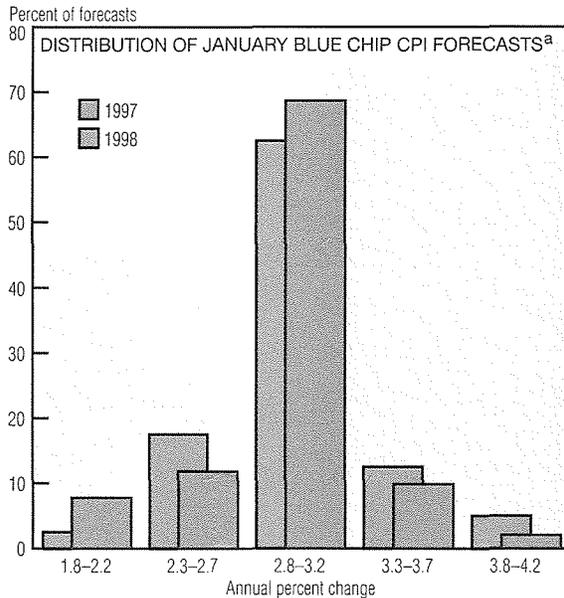
tion of the notes usually leads to a lower yield. It also serves as a reminder that other factors, such as market liquidity, do matter.

Nominal interest rates depend both on expected inflation and on real (inflation-adjusted) rates; uncertainty also has an effect. Prior to maturity, a bond's yield can be adjusted for expected inflation, giving an estimate of the real interest rate. In the bottom chart, which shows such a breakdown for the 30-day T-bill rate, several relationships stand out. From 1990 to late 1995, expected in-

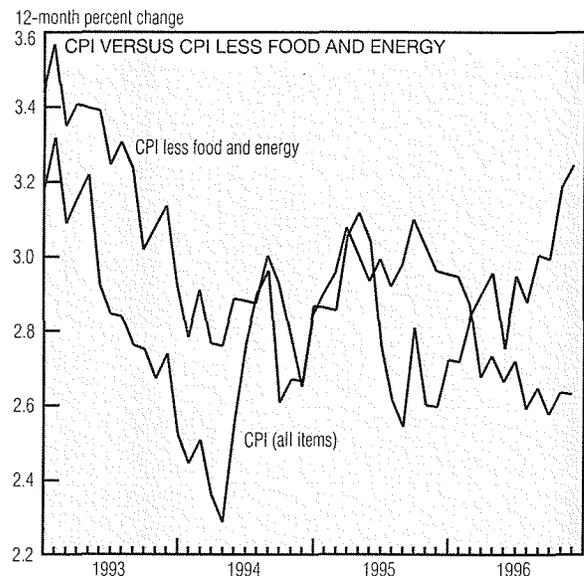
flation rates declined fairly steadily. Since then, expected inflation has inched higher for 14 consecutive months.

Expected inflation does not account for most of the variation in nominal rates, however, at least since the mid-1980s. Changes in the underlying real rate have been more important. Careful observers may note that the real rate and expected inflation do not add up to the nominal rate; the difference is the risk premium that investors demand for bearing uncertainty about inflation.

Inflation and Prices



	Annualized percent change, last:				1995 avg.
	1 mo.	6 mo.	12 mo.	5 yr.	
Consumer Prices					
All items	3.1	3.0	3.2	2.8	2.6
Less food and energy	1.4	2.4	2.6	3.0	3.0
Median ^c	2.1	2.8	2.9	2.9	3.2
Producer Prices					
Finished goods	6.5	3.7	3.0	1.8	2.1
Less food and energy	1.7	0.6	0.6	1.5	2.6
Commodity futures prices^d					
	3.0	-5.6	-0.7	2.9	5.4



a. Forecast of the Blue Chip panel of economists.

b. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.

c. Calculated by the Federal Reserve Bank of Cleveland.

d. 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.

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 10, 1997.

Economists' 1997 projections for retail price inflation are narrowly distributed. Nearly 70% of those polled in January's Blue Chip survey expected the Consumer Price Index (CPI) to rise between 2.8% and 3.2% this year, very close to its average increase for the past five years (2.8%). More than 60% of the Blue Chip economists expected the CPI to remain in this narrow range in 1998, and less than 10% saw inflation falling below 2.3% or rising above 3.7%.

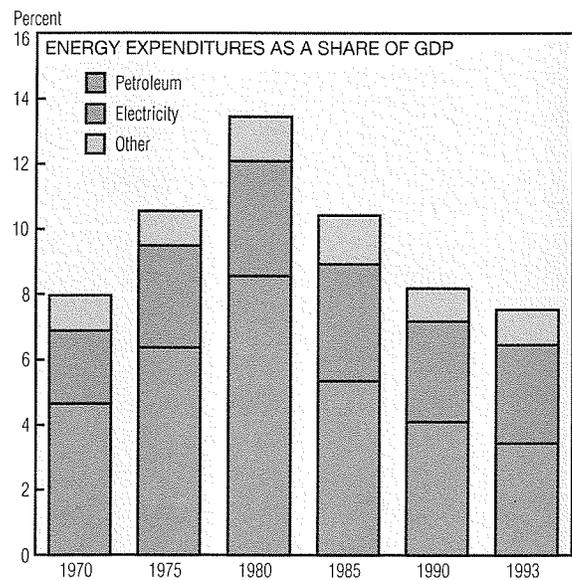
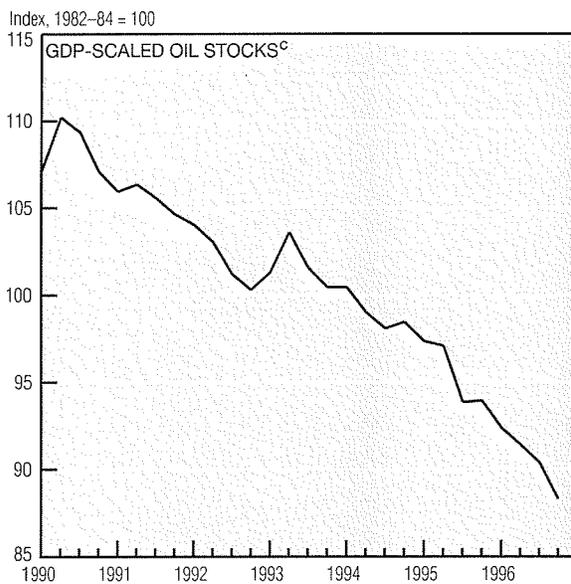
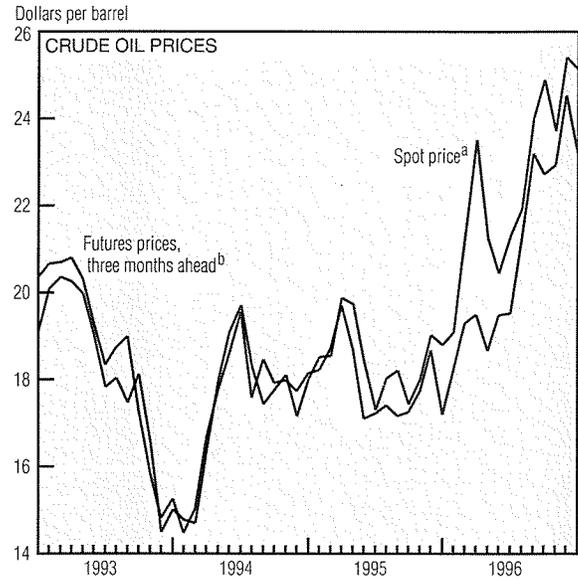
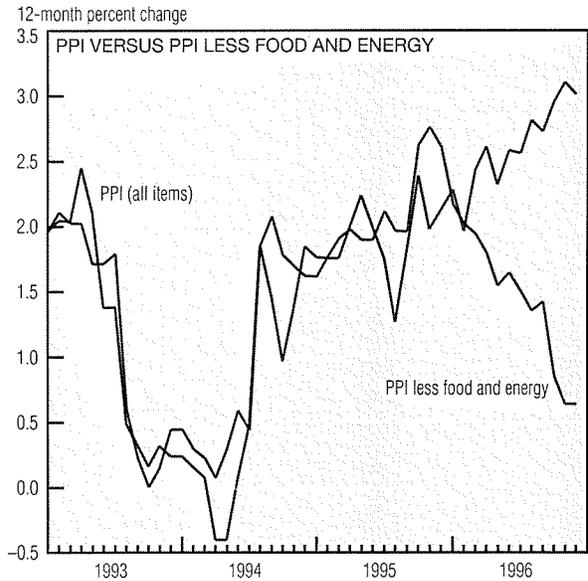
After trending beneath the central tendency projection of the Federal Open Market Committee (FOMC) during most of 1996, the CPI's growth rate was pushed to the projection's extreme upper limit (3.2%) by a surge in consumer prices at year's end. In fact, the CPI's 12-month growth rate has been trending upward ever since reaching its recent low of about 2.6% at the end of 1995.

Much of the recent acceleration in

retail prices seems centered in only a handful of components, particularly food and energy items—two areas that had a moderating influence on the CPI for most of the past five years. If we exclude these components, the CPI appears to have been trending downward over the past year or so: After reaching about 3% in mid-1995, its 12-month growth rate fell to only 2.6% by the end of 1996. This matches 1994's record as

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Inflation and Prices (cont.)



a. West Texas intermediate.

b. As measured by the KR-CRB composite futures index. Data reprinted with permission of the Commodity Research Bureau, a Knight-Ridder Business Information Service.

c. Ratio of barrels of oil to dollars of real GDP.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; the Commodity Research Bureau; DRI/McGraw-Hill; and U.S. Energy Information Administration, *State Energy Price and Expenditure Report*.

the smallest annual increase in the index for more than 30 years.

Wide swings in food and energy prices were also major contributors to last year's jump in producer prices. The Producer Price Index for finished goods (PPI) increased 3% over the 12 months ending in December, about a percentage point higher than in 1995 and the strongest rise in six years. Nonetheless, after adjusting for changes in food and energy prices, the PPI was

a substantial two percentage points lower in 1996 than in 1995, and nearly one percentage point below its five-year average increase.

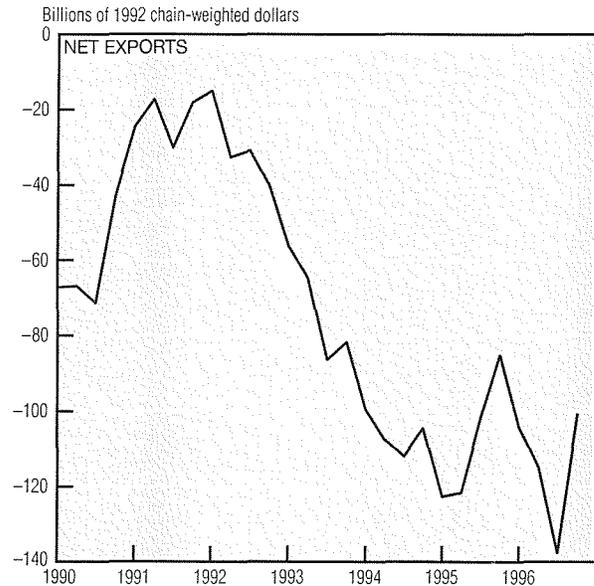
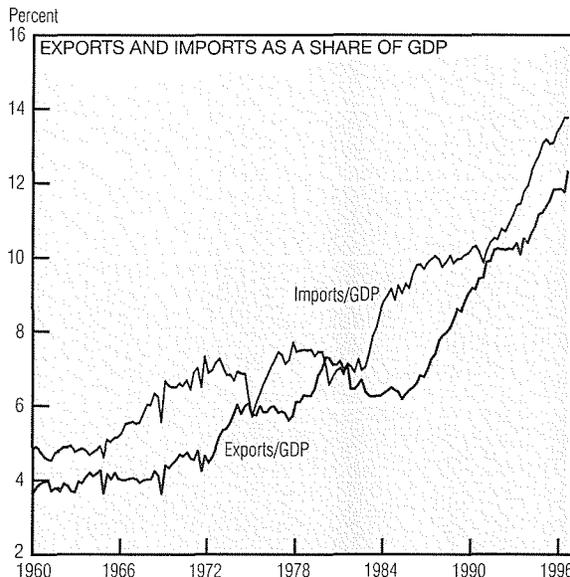
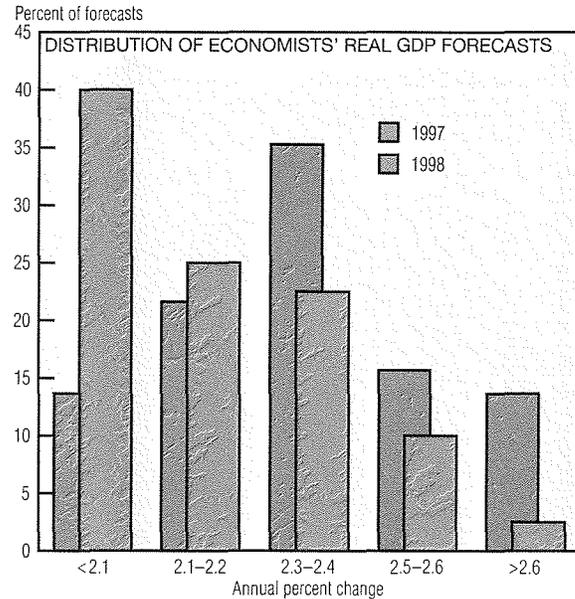
The 1996 rise in energy prices broke a string of generally moderate increases for this important commodity dating back to the Gulf War. Several factors, including severe winter weather in Europe, contributed to the price surge and accelerated the downward trend in U.S. crude oil stocks that began in 1990. Commod-

ity market participants apparently do not expect these effects to linger very long. A reading of oil futures suggests that oil prices could come down by the end of spring.

Moreover, improved energy efficiency appears to have reduced the role of oil in the economy. Expenditures on petroleum accounted for less than 4% of GDP in 1993—nearly a full percentage point less than in 1970.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	80.3	4.7	3.4
Consumer spending	38.8	3.3	2.7
Durables	8.1	5.4	5.5
Nondurables	6.0	1.7	1.8
Services	24.6	3.8	2.5
Business fixed investment	8.0	4.2	9.1
Equipment	-2.5	-1.7	9.4
Structures	9.9	22.7	8.4
Residential investment	-0.9	-1.3	4.0
Government spending	2.2	0.7	2.3
National defense	-1.4	-1.8	1.5
Net exports	36.7	—	—
Exports	47.7	25.5	7.6
Imports	11.0	4.7	8.6
Change in business inventories	-2.6	—	—



NOTE: All data are in chain-weighted 1992 dollars, seasonally adjusted annual rate.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, January 10, 1997.

In like a lamb, out like a lion. According to advance estimates, real GDP grew an exceptionally fast 4.7% in 1996:IVQ, with gains in exports and personal consumption expenditures leading the way. Inventory accumulation slowed slightly. Last quarter's growth rate compares with 2.1% in 1996:IIIQ, 4.7% in 1996:IIQ, and 2.0% in 1996:IQ. The fourth-quarter figure, however, is subject to revision as more complete data become available.

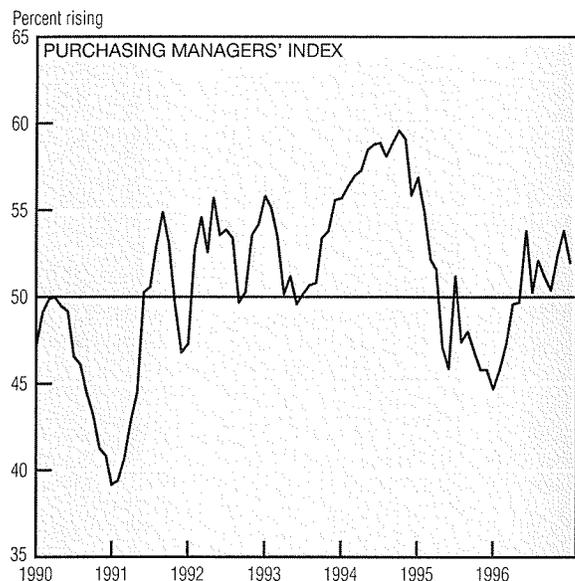
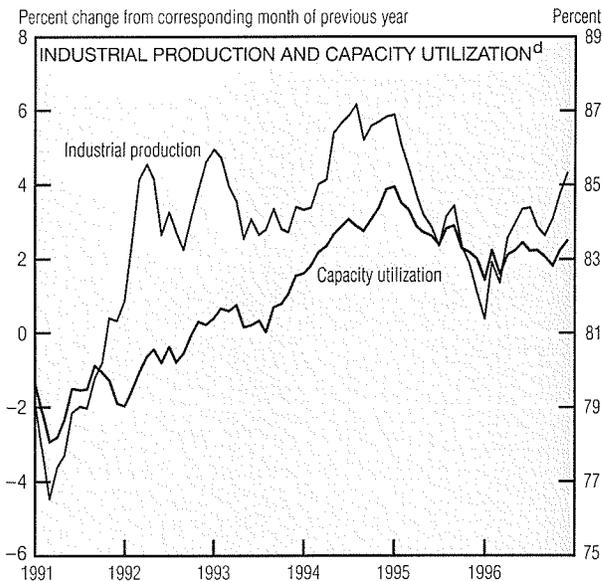
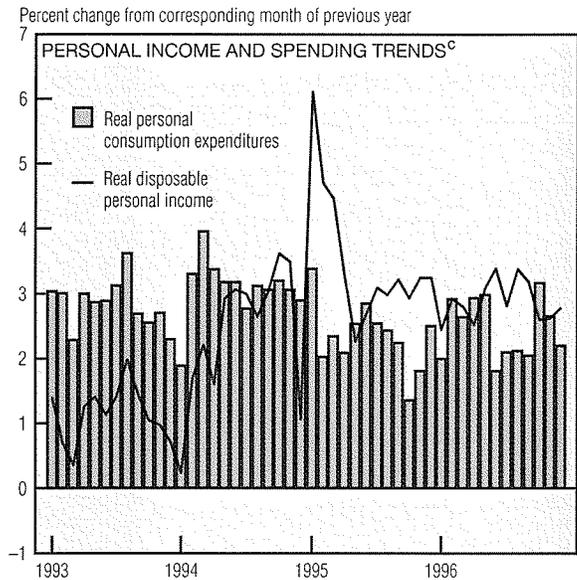
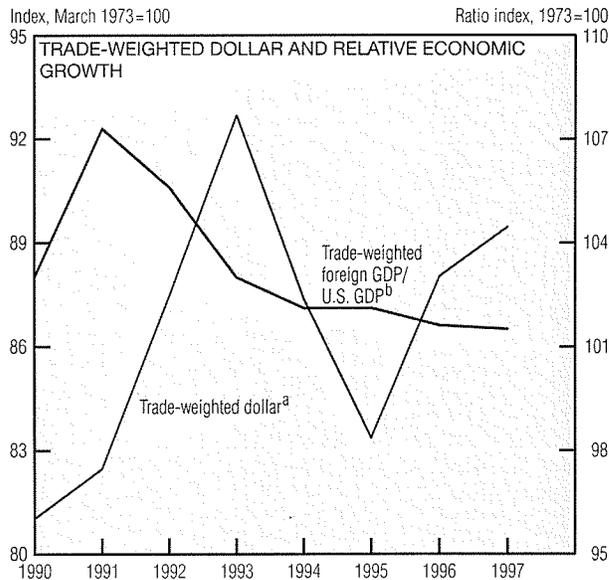
In the sixth year of the current business expansion, output grew 2.5%, up from 2.0% in 1995 and well above last winter's pessimistic projections of 2.0%. Future prospects also seem good. On average, economists participating in the January Blue Chip survey, which preceded the release of the most recent GDP numbers, forecast real economic growth of 2.3% in 1997 and 2.1% in 1998.

The recent GDP release highlights the growing importance of trade to

the U.S. economy. Exports and imports together now equal approximately 26% of GDP, up from 9% in the early 1960s. Last quarter's export gains accounted for 59% (\$47.7 billion) of the rise in total output. Although the data are incomplete, this sharp increase in exports seems to have come primarily from shipments of computers, aircraft, semiconductors, and telecommunications equipment. Imports increased \$11 billion,

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Economic Activity (cont.)



- a. December data, except for 1997, which covers only January.
b. 1996 and 1997 data are based on *The Economist* poll of forecasters.
c. Chain-weighted data in 1992 dollars, seasonally adjusted annual rate.
d. Seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; the National Association of Purchasing Management; and *The Economist*, January 18-24, 1997.

substantially off the pace that prevailed earlier this year.

Despite the fourth-quarter improvements, our overall net export position worsened in 1996. This follows a trend toward growing trade deficits that began in 1990. During the current business expansion, U.S. output growth has exceeded that of most of our major trading partners. In addition, the dollar's exchange rate index—adjusted for inflation differentials among countries—has

appreciated 10.4% since 1990. These relative growth and exchange rate patterns seem likely to persist throughout 1997, suggesting that our net export position will not improve before 1998.

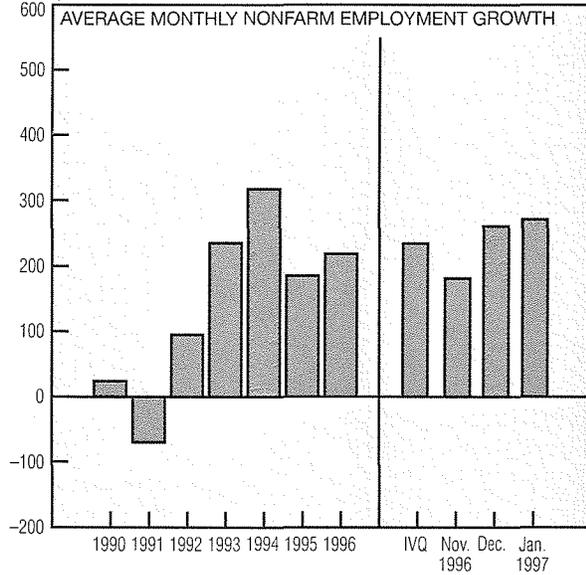
Approximately half of the 1996:IVQ rise in real GDP stemmed from stronger consumer spending, much of it for nonautomotive durable goods. Real disposable personal income rose 2.8% in December from 12 months earlier, and real personal

consumption expenditures increased 2.2%. Although consumer debt burdens have gone up in recent years, the current level is actually below that of 1989.

Industrial production increased 4.3% on a year-over-year basis in December, and capacity utilization rose to 83.5%. The National Association of Purchasing Management's index indicates that 52% of managers are reporting growth in their firms.

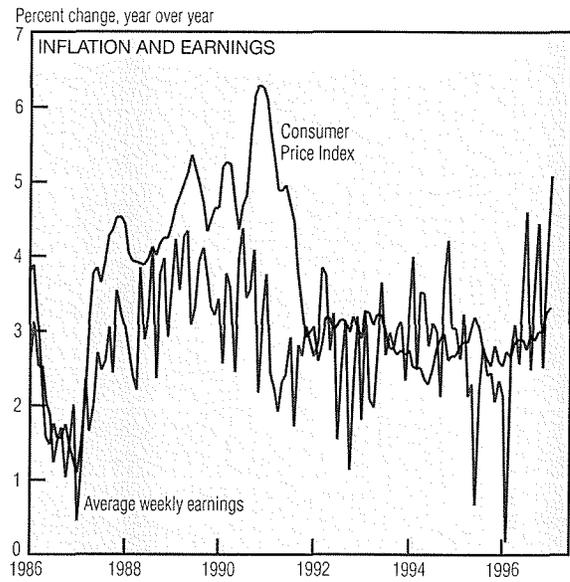
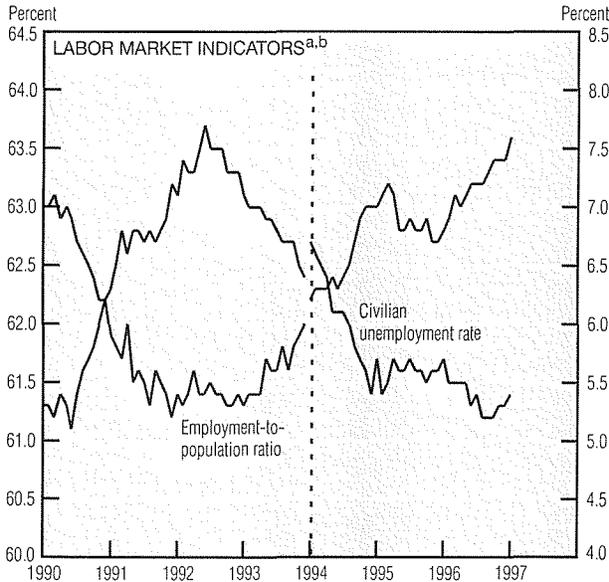
Labor Markets

Change, thousands of workers^d



Labor Market Conditions^a

	Average monthly change (thousands of employees)				
	Year	1996			1997
		IVQ	Nov.	Dec.	Jan.
Payroll employment	218	234	181	261	271
Goods-producing	17	34	35	40	32
Manufacturing	-8	12	8	14	18
Construction	25	23	27	28	14
Service-producing	202	200	146	221	239
Services	102	91	71	100	167
Business services	30	18	-7	36	70
Retail trade	50	76	54	73	19
	Average for period (percent)				
Civilian unemployment rate	5.4	5.3	5.3	5.3	5.4
Employment/population ratio	63.2	63.4	63.4	63.4	63.6
Labor force participation rate	66.8	66.9	66.9	67.0	67.2



a. Seasonally adjusted.
b. Vertical line indicates break in data series due to survey redesign.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

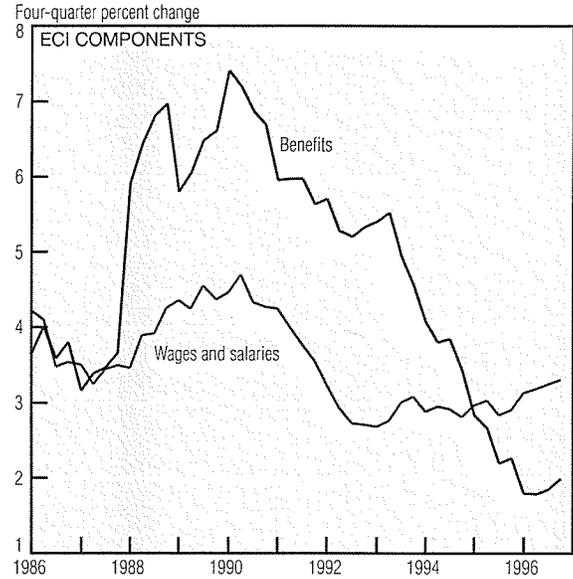
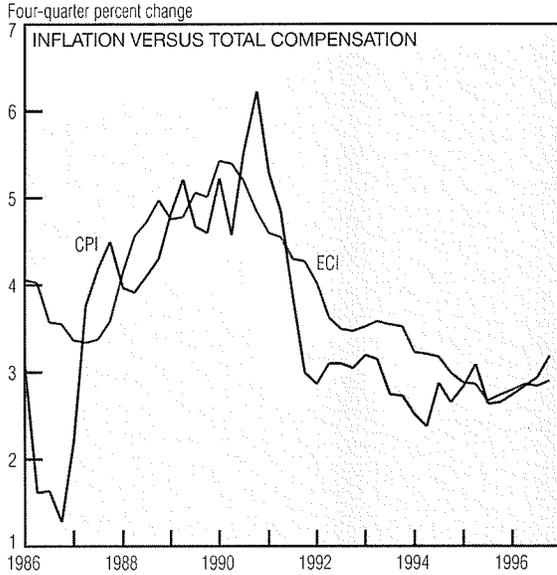
Nonfarm payrolls grew by 271,000 in January, continuing the fourth quarter's string of vigorous increases. The gain was broad-based, with every major sector of the economy adding to its payrolls. Services continued to expand as a fraction of total employment, while manufacturing advanced a solid 2.1% on an annual basis. Strong growth in business services was led by continued expansion of the nation's temporary help agencies.

Although overall employment rose, the jobless rate increased slightly for the month, from 5.3% to 5.4%, a statistically insignificant change. The source of this apparent conflict can be traced to the increasing number of people looking for work who previously were neither employed nor searching for a job. While an influx of people into the labor market is expected when employment prospects are good, the

current business expansion has yielded particularly large inflows. Both the employment-to-population ratio and the labor force participation rate stand at record highs.

Average weekly earnings increased moderately in 1996, up 3.2% over 1995's level and only slightly above the 1996 inflation rate. The January numbers did not break with this pattern, as average hourly pay rose only 1 cent, to \$12.06.

Employment Cost Index



ECI Wage and Salary Growth by Occupation and Region, 1996

Occupation	Average annual percent change, last:		
	Average annual percent change, last:		
	1 yr.	3 yr.	6 yr.
Professional specialty/technical	3.57	3.04	3.42
Executive	3.77	3.44	3.45
Administrative support	3.12	3.14	3.50
Service occupations	3.40	3.14	3.25
Blue-collar occupations	3.04	3.01	3.16
Region			
Northeast	3.32	2.96	3.24
South	3.76	3.16	3.28
Midwest	3.32	3.20	3.45
West	3.10	3.11	3.34

ECI Wage and Salary Growth by Industry, 1996^a

	Average annual percent change, last:		
	Average annual percent change, last:		
	1 yr.	3 yr.	6 yr.
Manufacturing	3.30	3.15	3.48
Construction	2.90	2.91	2.75
Transportation and public utilities	2.67	3.35	3.57
Wholesale and retail trade	3.84	3.35	3.38
FIRE ^b	3.21	2.75	2.77
Services	3.57	3.04	3.42
Business	4.67	4.15	3.52
Health	2.34	2.39	3.30
Educational	3.40	3.56	3.57

a. Private industry workers.
 b. Finance, insurance, and real estate.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The Employment Cost Index (ECI) is the best measure of compensation (wages and benefits) growth available to labor analysts. Like the Consumer Price Index (CPI), it relies on a fixed basket of items—in this case, occupations. This prevents shifts in the occupational composition of the workforce from appearing as wage gains, as they do in average hourly earnings data. Because the ECI includes overtime payments

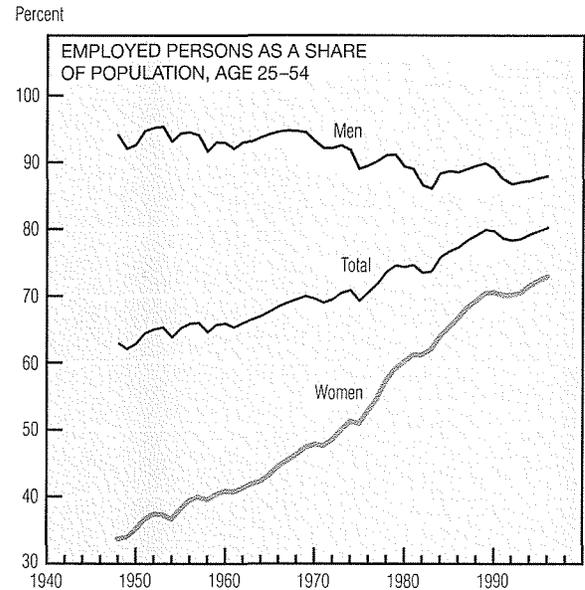
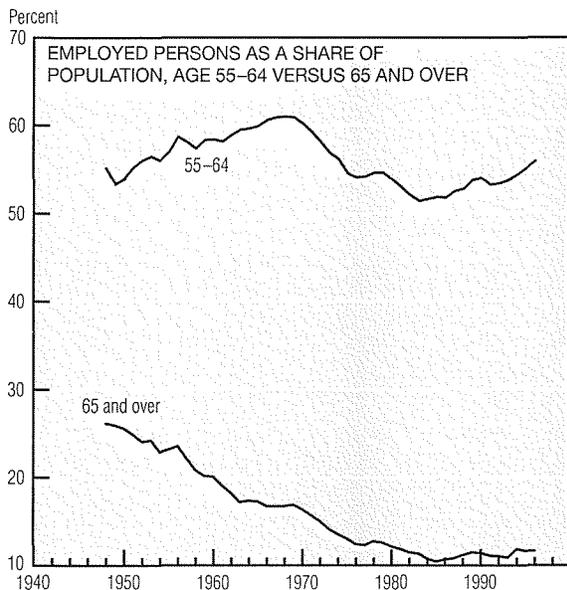
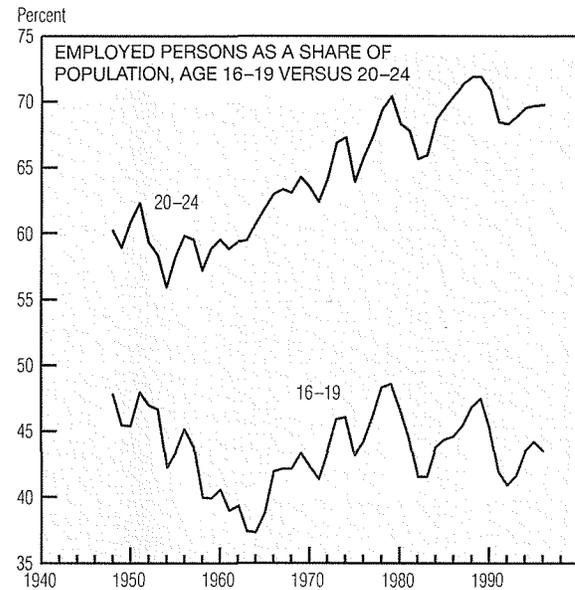
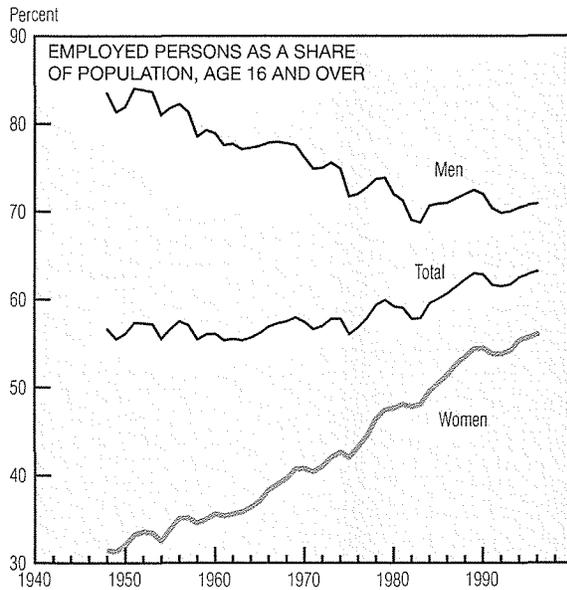
as a fixed increment to wages, short-term increases in overtime will not alter the index.

A long period of low unemployment rates has led many analysts to seek evidence of “excessive” wage increases, but wage growth has remained moderate; it has been further offset by slower growth in benefit costs over the last two years. For most groups of workers (occupations, industries, or regions), 1996

wage growth was comparable to the rates of the past several years.

Although the ECI and the CPI have shown similar growth patterns in recent years, the direction of causality is unclear. Firms could be adjusting wages to keep pace with inflation or adjusting prices to keep up with wage growth. Both explanations are consistent with the correlation between the CPI and the ECI.

Employment Trends



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

Despite periodic fluctuations in the pace of U.S. economic activity, the percentage of working-age Americans who are employed has risen steadily since the early 1970s and now stands at a record 63.4%. Because employment changes play an important role in determining overall economic growth, it is useful to explore the source of the employment rate increase to see whether this trend may continue.

The rise in the employment-to-population ratio since the early 1970s reflects a substantial increase

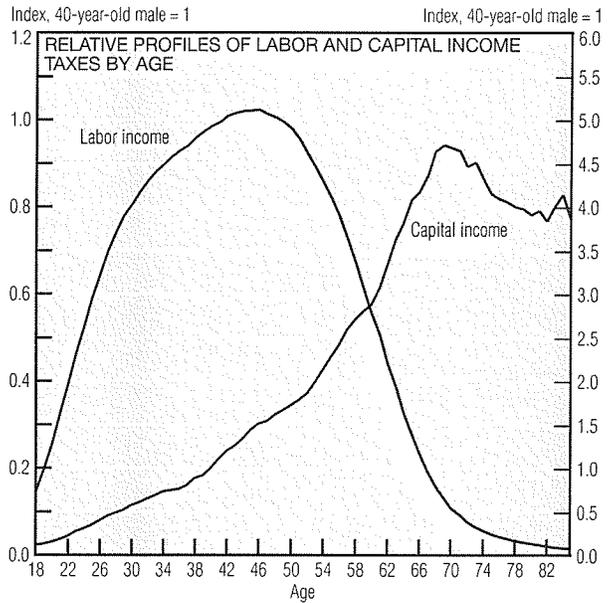
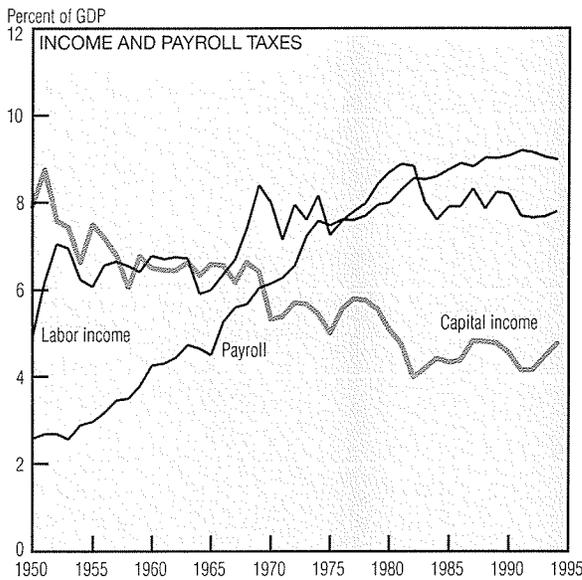
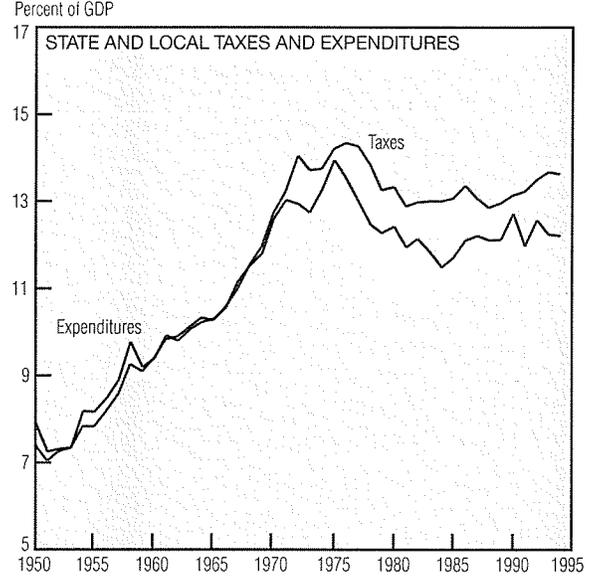
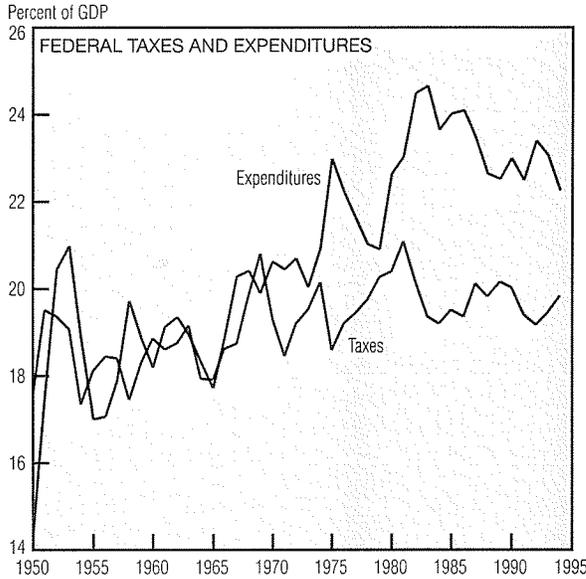
in women's employment rates, a trend which began much earlier. The overall employment ratio rose, despite a substantial decline in the employment rates for men and people 55 and over. (Early-retirement programs, initiated in the 1970s, contributed to this decline.) Teenagers' employment rate was roughly unchanged over the period.

It follows that the dramatic increase in overall employment rates was driven by an even more dramatic rise in the employment rates of prime-age workers (25 to 54).

Growth within this group resulted exclusively from the increase in women's employment.

It is unlikely that the employment of prime-age women will keep rising at the same rate over the next decade. If substantial growth in the overall employment percentages is to continue, it will likely require increases in the employment rates of men and people over 54. However, a more likely scenario is that growth in the percentage of Americans who are employed will slow greatly in the coming years.

Structural Changes in U.S. Fiscal Policy



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and University of Michigan, Survey Research Center.

Federal spending has consistently outpaced federal revenues since the 1970s. Although the opposite is true for the sum of state and local budgets, the total national debt (both nominal and inflation-adjusted) has mushroomed over the last 25 years.

Many analysts view the higher level of explicit debt as an indication of how far the burden of paying for current government spending has been shifted onto future generations. Some suggest that the level of explicit debt alone underestimates the extent of such burden-shifting, citing the government's implicit So-

cial Security and Medicare liabilities to current generations, which future generations of workers will have to pay. However, the payment burden on future generations has increased in a third way—through structural changes in fiscal policy.

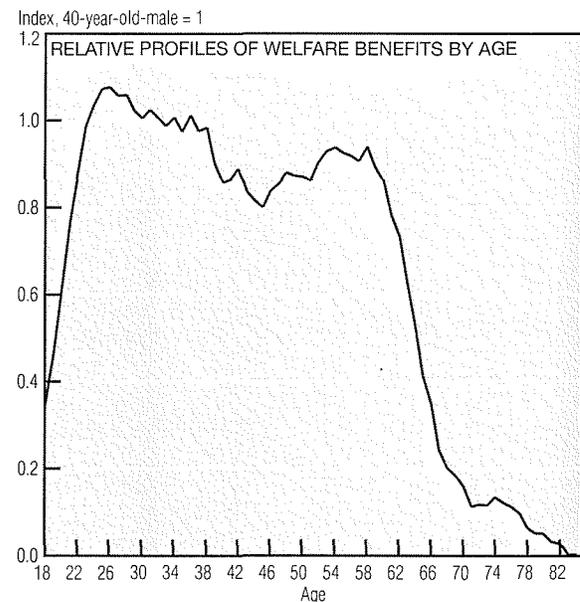
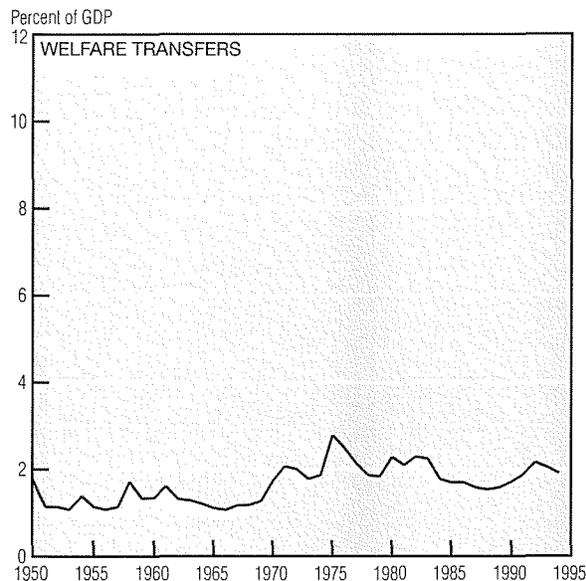
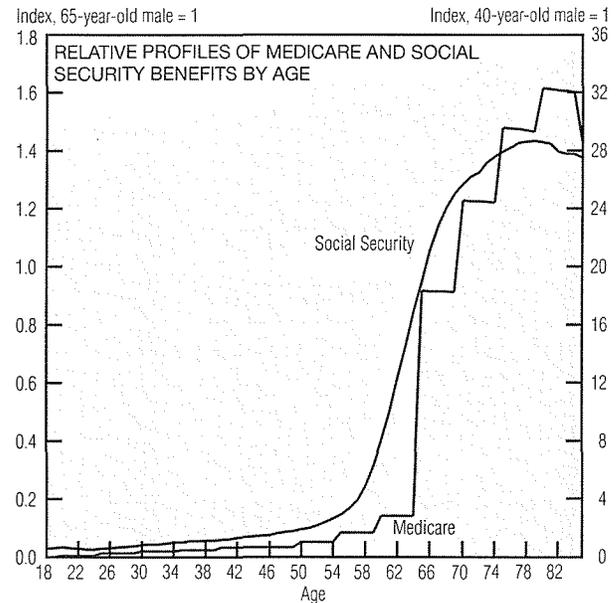
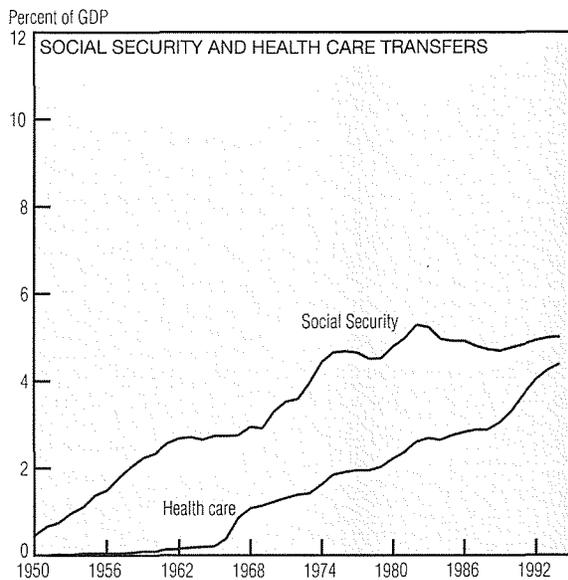
The government has many fiscal instruments at its disposal. It obtains revenue through taxes on labor and capital income, payroll taxes, and indirect (sales and excise) taxes, among others. Apart from spending to purchase goods and services for its own operation and to provide public goods like national defense, it

also makes Social Security, Medicare, Medicaid, and welfare transfers.

A glance at the components of aggregate taxes and transfers is sufficient to convince anyone of the significant structural changes in postwar U.S. fiscal policy. As a share of GDP, labor income taxes and payroll taxes (which also fall on workers) have trended upward. Because younger generations work more than retirees, their taxes have increased more. On the other hand, taxes on capital income have declined over this period, reducing the taxes of older genera-

(continued on next page)

Structural Changes in U.S. Fiscal Policy (cont.)



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Social Security Administration; and Mark McClellan and Jonathan Skinner, "The Distribution of Medicare Benefits: A Lifetime Perspective," Stanford University, unpublished manuscript, April 1996.

tions, who own most of the economy's physical capital.

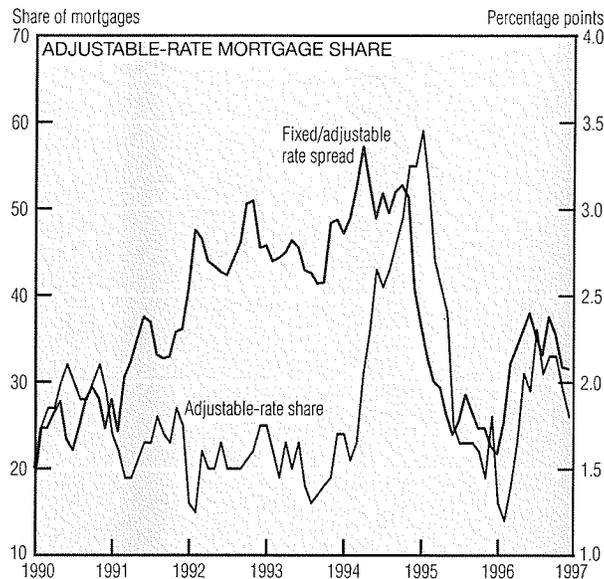
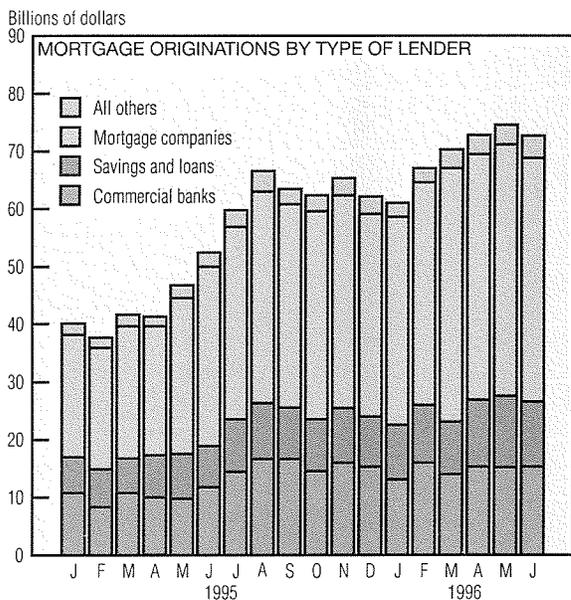
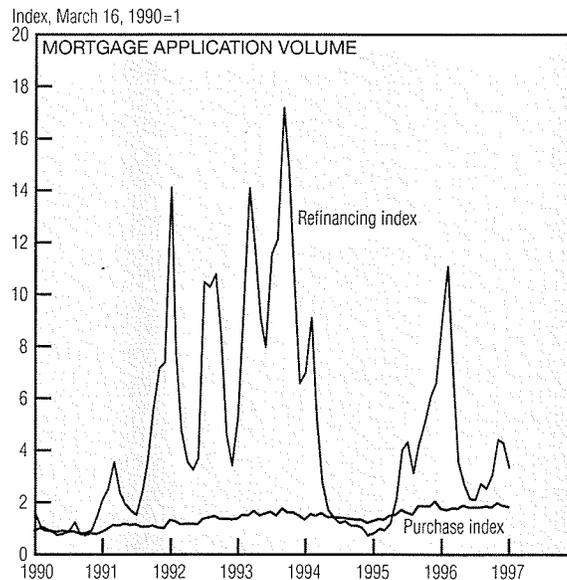
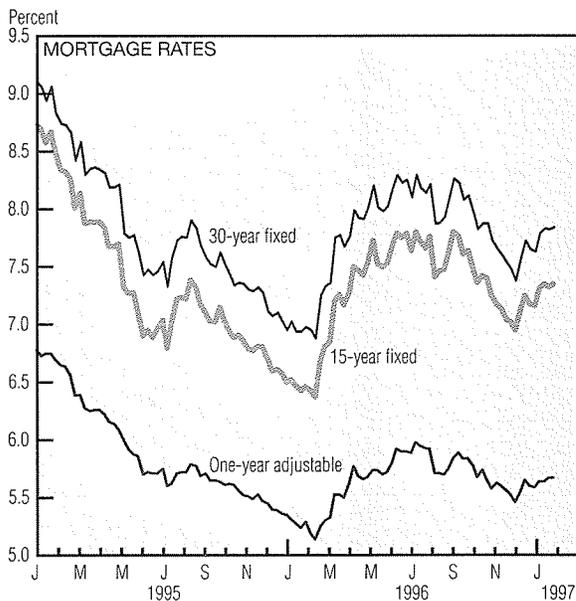
Further, Social Security and health care transfers have risen rapidly as a share of GDP, implying a decline in the net tax burdens of older generations, who make up a significant majority of recipients. However, the increase in these transfers implies a smaller decline in the net burdens of younger and unborn generations, who will receive them in the distant future, and then only after making substantial payroll contributions

while working. The share of welfare transfers that accrue mainly to young, poor individuals—single mothers and the unemployed—has also increased, but at a much slower pace than Social Security and health care transfers.

The government's choice of a particular mix of taxes, spending, and transfers determines the distribution of net payment burdens (taxes net of transfer receipts) among current and future generations. A structural change in the mix of these instru-

ments may not much affect overall revenue and spending numbers—that is, annual deficits may remain unchanged. It may nevertheless significantly alter the generational distribution of net payment burdens. Because different generations have dissimilar saving patterns and inclinations to participate in the workforce (depending on their age), changes in this distribution are likely to affect the nation's overall economic performance.

Housing Finance



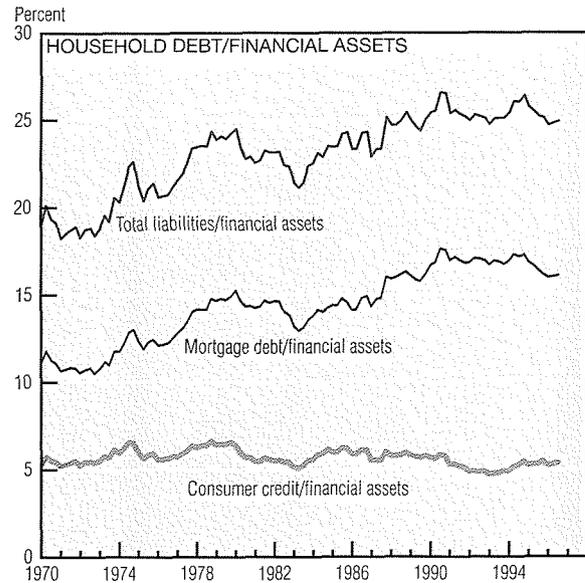
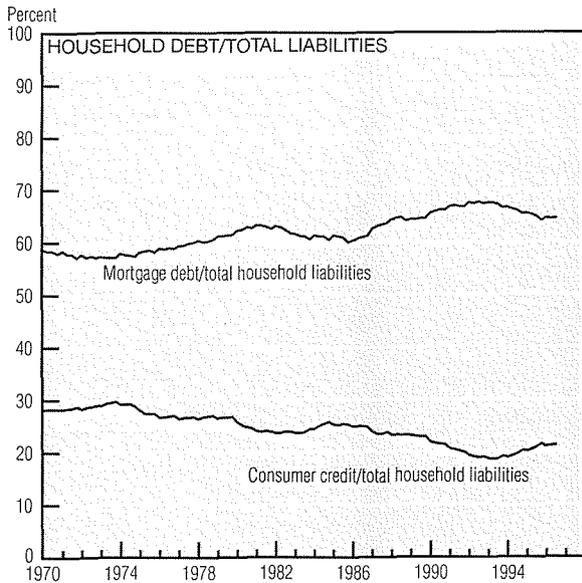
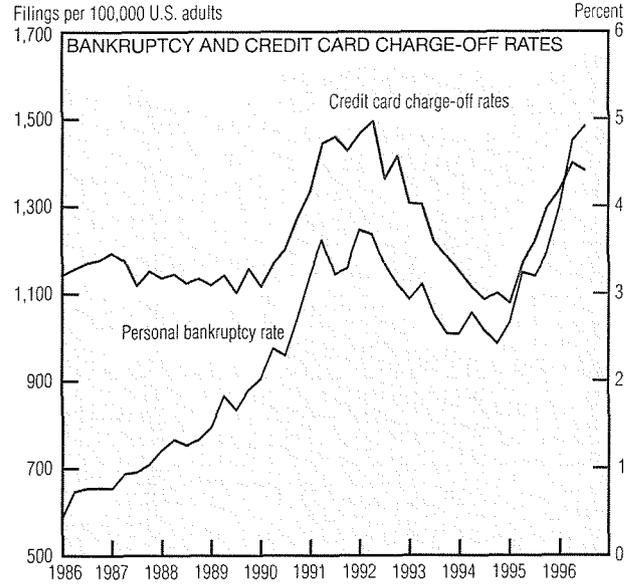
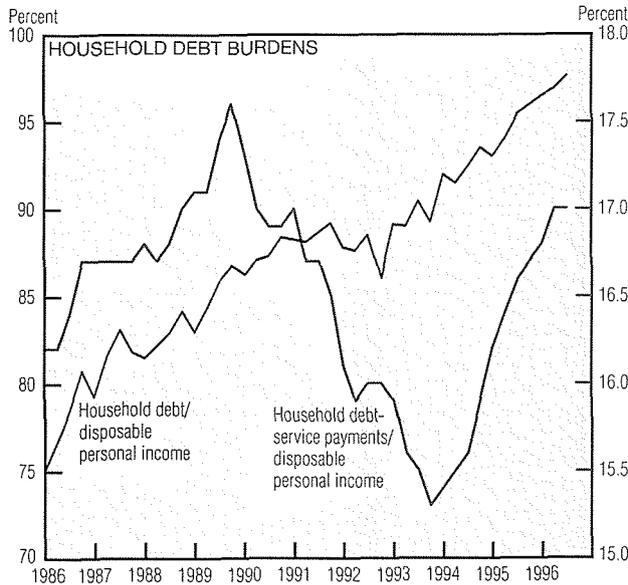
SOURCES: U.S. Department of Housing and Urban Development; Federal Home Loan Mortgage Corporation; Office of Thrift Supervision; Mortgage Bankers Association of America; and *Bank Rate Monitor*.

After declining steadily since September 1996, 30-year fixed mortgage rates have jumped 40 basis points from December's low of 7.38%. Fifteen-year fixed rates have followed a similar pattern, while one-year adjustable rates have risen somewhat less. Nonetheless, analysts generally agree that this recent upward trend will not continue indefinitely if economic growth remains relatively stable and inflation moderates.

Although these rates are still low compared to those of the last 20 years, the 1993 refinancing boom and the boomlet at the end of 1995 left many mortgage holders with even lower rates than those prevailing today. Thus, while the volume of home-purchase applications has continued to grow steadily, refinancing activity is less pronounced. Nevertheless, mortgage originations remained strong through the first half of 1996.

The reduced refinancing demand also helps to explain why the share of adjustable-rate mortgage originations is once again moving in tandem with the spread between fixed- and adjustable-rate mortgages. When long-term rates were at historically low levels in 1993, many borrowers locked in those favorable terms, even though the spread between fixed and adjustable rates was unusually wide.

Household Debt and Delinquencies



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; American Bankruptcy Institute; and FDIC Statistics Branch.

Over the last few years, the ratio of household debt to disposable personal income has reached historically high levels, raising concerns about the financial stability of U.S. households. The record number of personal bankruptcy filings (1996:IIIQ alone saw more than 290,000), along with increases in credit card charge-offs (which reached 4.49% of total credit card debt outstanding in 1996:IIQ), has further heightened this concern.

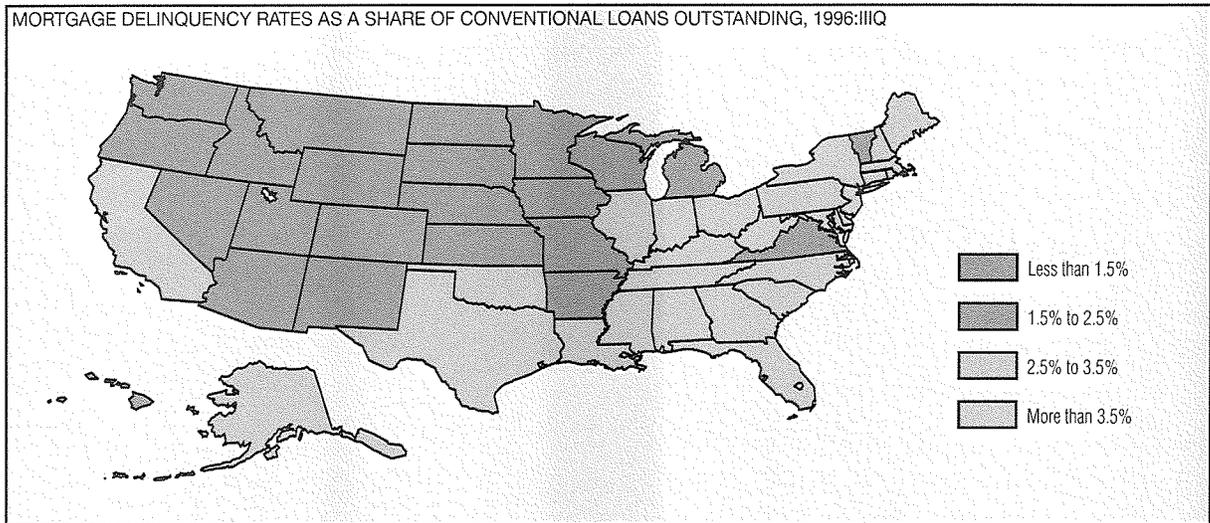
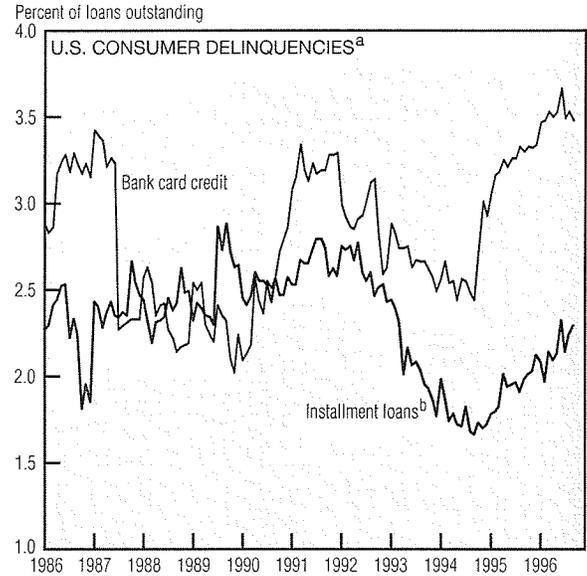
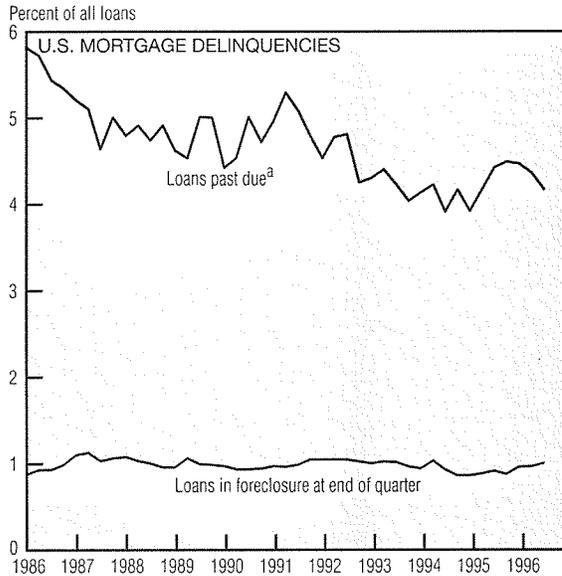
A better indicator of households' true financial health is the proportion of disposable personal income that must be used to service this debt. After all, the general decline in interest rates during the 1990s has made it much easier for households to manage greater debt levels. As a fraction of disposable personal income, estimated debt-service payments have been rising over the last few years, but their level is still consistent with that of the late 1980s

and is well below its 17.6% high of 1989:IVQ.

To understand households' financial well-being, it is also important to notice that the composition of household debt has been changing since the mid-1970s, with home mortgages accounting for a larger share of total household liabilities and consumer debt becoming relatively less important. In contrast, there has been a relative increase in

(continued on next page)

Household Debt and Delinquencies (cont.)



a. Seasonally adjusted data.
 b. Based on the "summary of accounts (closed-end only)" data reported in the American Bankers Association's *Consumer Credit Delinquency Bulletin*.
 SOURCES: American Bankers Association, *Consumer Credit Delinquency Bulletin*; and Mortgage Bankers Association of America, National Delinquency Survey.

the importance of consumer debt over the last couple of years. The most recent ratio of consumer credit to total household liabilities (21.3% in 1996:IIIQ), however, is still lower than it was at the beginning of the decade (21.7% in 1990:IIIQ). These trends look much the same when we focus on the ratios of consumer credit and mortgage debt to total financial assets.

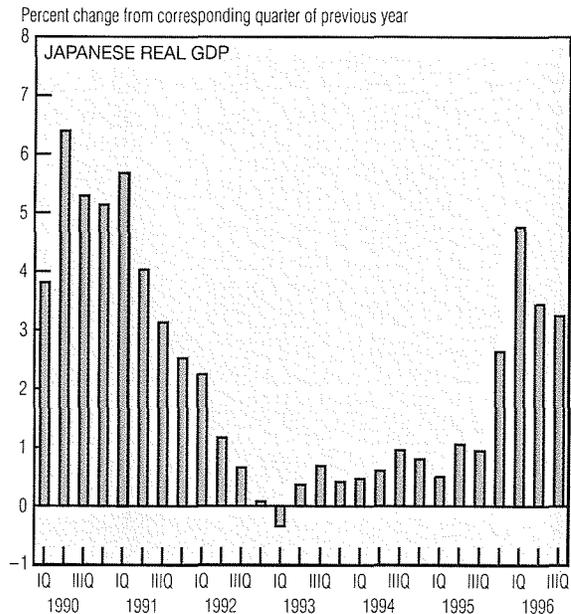
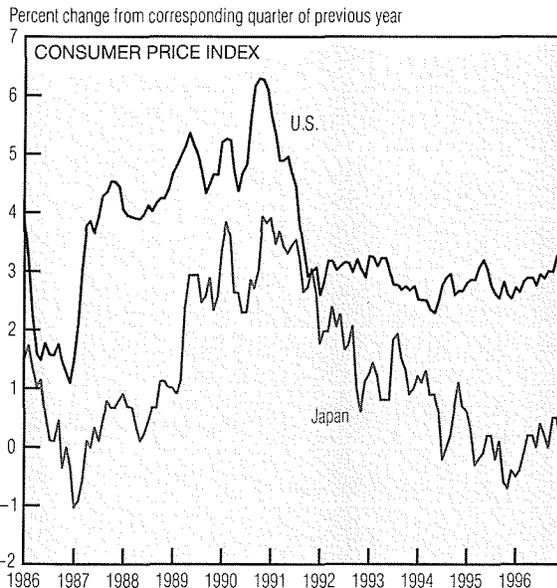
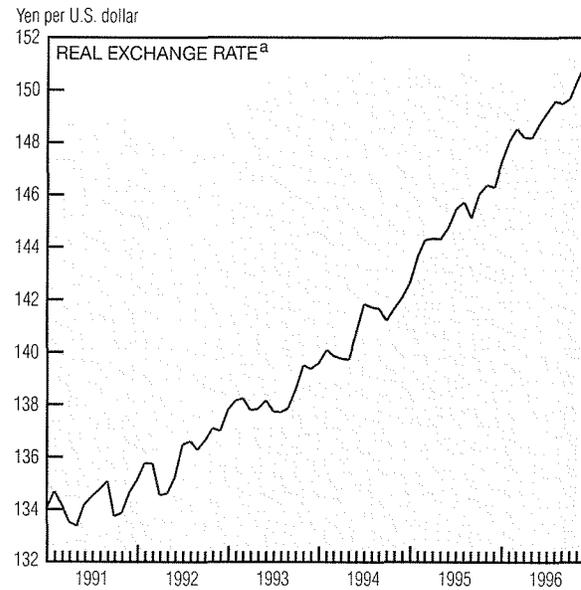
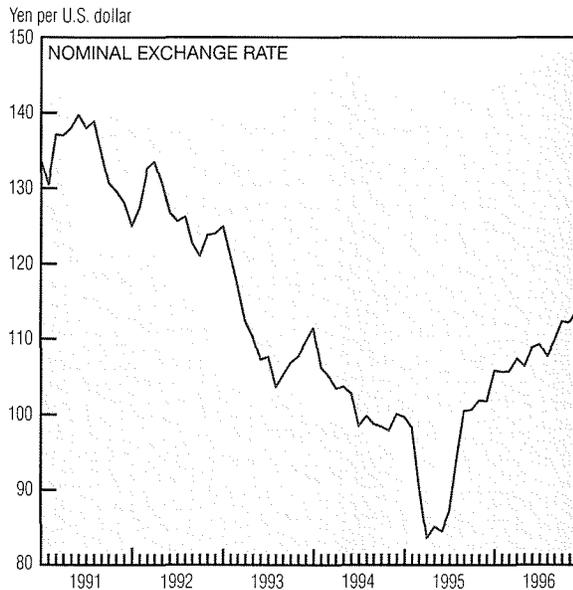
Of course, household debts cannot be analyzed in isolation from

the assets that they may support. Indeed, the ratio of total household debt to financial assets has remained relatively constant over the last decade, and has even fallen somewhat in the last two years. Once again, this suggests that fears about overburdened households may be exaggerated.

Finally, it is significant that, while mortgage debt has recently become a more important feature of house-

hold debt, mortgage delinquencies have been trending downward for over a decade. In addition, the fraction of loans in foreclosure has remained relatively constant during the last 10 years. Similarly, although bank card delinquencies recently were at a historically high level, the delinquency rate of other types of consumer installment credit is still below its level in the late 1980s and early 1990s.

Monetary Policy and Global Competition



a. The real exchange rate is calculated using consumer prices for both the U.S. and Japan. The base period is November 1991.
SOURCES: Bank of Japan; and the Statistics Bureau of the Japanese Prime Minister's Office.

The dollar's recent sharp rise against the yen has intensified long-held concerns about Japanese manufacturers' competitive edge in U.S. markets. Since March 1995, the dollar has appreciated about 35% against the yen, and many analysts anticipate further advances this year.

When one also weighs the persistent inflation differentials between the two countries, the competitive implications of the dollar's rise seem more challenging. On a real basis, the dollar has appreciated nearly 13% against the yen

since 1990. Can policy moves make a difference?

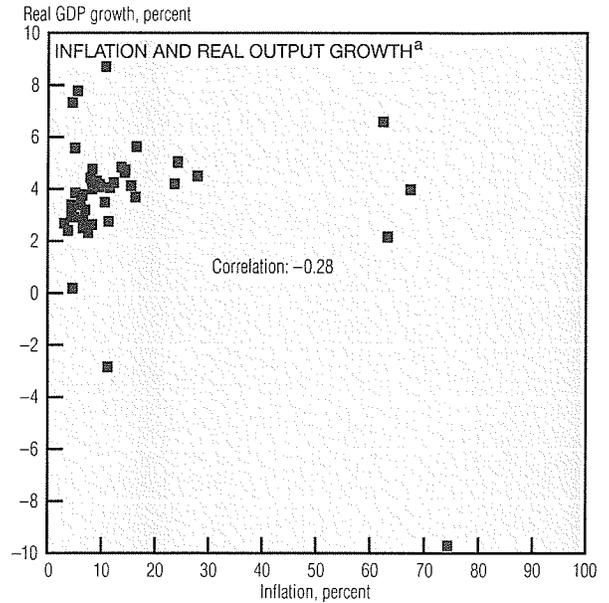
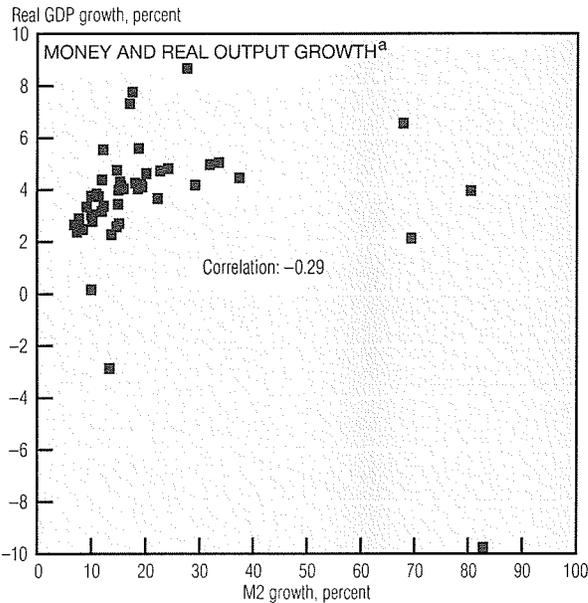
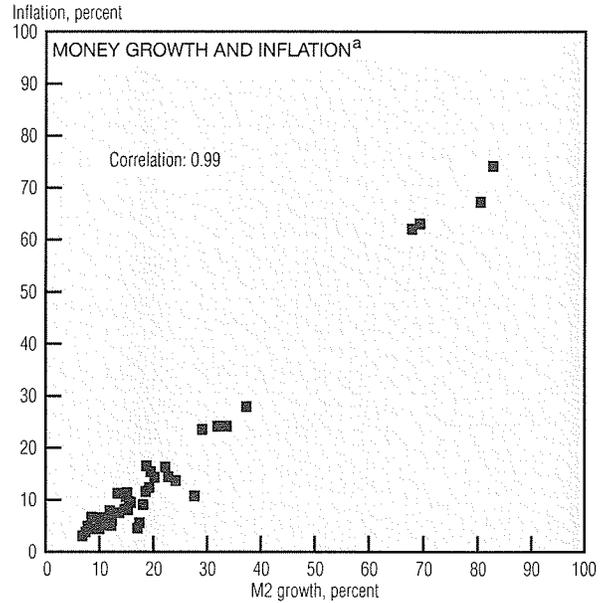
Foreign exchange intervention can send ripples through the market. Much like a rock tossed into a swift river, however, intervention offers no fundamental force with which to alter a market's current. Because success depends on changing traders' perceptions and expectations of events, rather than directly changing fundamentals, intervention's influence is at best fleeting.

Alternatively, the Federal Reserve could ease monetary policy when

the Bank of Japan tightened its money supply. This would promote a dollar depreciation at the expense of higher inflation in the U.S. and deflation in Japan. Since exchange rates often respond more quickly than prices, our competitive position might show a temporary improvement that would last only until prices responded fully to monetary pressures. Ultimately, countries cannot improve their competitive position through monetary policy.

Monetary Policy and Economic Growth

Short-run Growth of Money and Output (Correlation, year-over-year percent change)		
	M2 lagged one year	M2 lagged two years
Canada	-0.17	-0.11
France	0.17	0.06
Germany	0.74	-0.13
Italy	0.62	0.42
Japan	0.72	0.51
U.K.	0.18	-0.19
U.S.	0.35	0.16



a. Average annual percent change.

NOTE: The sample includes 45 countries. All have at least 15 years of available data, and most have 35 years. See George T. McCandless, Jr. and Warren E. Weber, "Some Monetary Facts," Federal Reserve Bank of Minneapolis, *Quarterly Review*, Summer 1995, pp. 2-11.

SOURCE: International Monetary Fund, *International Financial Statistics*.

Although most economists will concede that monetary policy can affect real economic growth over the short run, many caution against attempting to manage business cycles through policy manipulation. Indeed, in most large industrial countries, faster money growth seems to precede faster economic growth by one year.

A causal connection between money and growth, however, requires that information about policy-induced price changes be imperfect.

This may happen if some sectors of the economy have embedded outdated price expectations in binding contracts, if certain groups have better access to current price information than others, or if people generally have good information about the wages they earn and the prices they charge, but not about other prices.

In the long run, when information is complete and contracts can adjust, faster money growth increases neither output nor employment. As cross-country correlations reveal, faster

money growth contributes only to inflation. Some economists warn that higher inflation may slow growth. If the public questions the stability of a currency's purchasing power, they will expend more time and energy protecting their financial wealth from inflation. Society will devote more resources to financial services and to the prompt adjustment of prices, while fewer resources will go toward capital accumulation and investments that enhance productivity.