The Daily Spin

"Putting the Economy in Perspective"

May 15, 2001

Mother Nature

Town Loses Bet on Bridge

GAMBLER'S FALLS, OHIO—Gambler's Falls just lost a big wager, and it's likely to be a long time before the town bets against Mother Nature again.

Last spring, after three consecutive years of earthquake tremors and minor damage, the town council rejected a proposal to strengthen the bridge spanning the Wattasuccor River. Erected by the town fathers in 1907, Bettor's Bridge has been the gateway to Gambler's Falls for nearly a century. Many tremors threatened to drop the bridge into the Wattasuccor over the years, but the structure always held.

Nevertheless, state officials repeatedly warned that Bettor's Bridge was showing its age and that the time had come to rebuild. They feared that the next big tremor would topple the trestle. The city council, however, rejected the project because the state's new infrastructure program would have required the town to pay half the cost, in this case about $25 million. Mayor Dewey Cheatum thought he could get the state and private developers to foot the entire bill as part of a riverfront casino and professional sports complex that he planned to pitch to the state legislature.

State Superintendent of Public Works A. Bert Aynstine said that the town's refusal to bolster the elevated structure "was like playing Lincoln Logs with the universe." Mayor Cheatum retorted that "the risk of quake damage is being exaggerated by my enemies, who refuse to recognize that times have changed. Gambler's Falls is now a service-based economy without heavy truck traffic. Besides, higher speed limits minimize the danger because cars cross over so quickly."

Needless to say, yesterday's 5.5 quake and 4.0 aftershock provided ample proof for Superintendent Aynstine's prediction. Fortunately, no one was injured, but the loss of Bettor's Bridge means severe economic losses for the town. While the bridge is being rebuilt, traffic will be routed through the neighboring village of Cold Comfort.

Fed Blasted by Civic Group

WASHINGTON, D.C.—The Federal Reserve has been receiving sharp reprimands from several big-business CEOs and a few former U.S. Congressmen for its decision to increase a key interest rate by ¼ percentage point.

The complaints, lodged by a group calling itself Genuine Americans for a Fast Forward Economy (GAFFE), stem from a belief that the Fed's monetary policy action will prevent inflation at the expense of economic growth. GAFFE's criticism comes at a time when the U.S. economy is thriving. The nation has been expanding for 18 of the last 19 years. Unemployment rates have been between 4.5% and 5% for several years, with inflation in the 2.5% to 3% zone.

Most private economists point to considerable historical evidence that boom conditions are associated with rapid money growth, higher inflation, and speculation in housing, gold, art, and farm land. Eventually, spending becomes so distorted and speculative that the economy turns weak and recession-prone. Inflation becomes costly to unwind.

Nevertheless, the FOMC's last action does not sit well with some. "The Fed's fighting the last war," howled GAFFE chief Rhett Orick. "They can't seem to recognize that the U.S. economy has changed." Other angry words came from former Representative Betsy Rantche, who declared that "people want faster growth, and they know the economy can do better."

For their part, Federal Reserve officials are surprised and delighted with the economy's performance. However, resource utilization levels are extremely high by historic measures, and money growth has been accelerating. According to most Fedwatchers, by traditional standards the FOMC should have reacted sooner and more aggressively to these trends than it has so far. Commenting on the Fed's recent rate hike, Tawkin Hedd, chief economist for Zed Bank, said that "the FOMC was merely trying to take a modest, prudent step in the right direction."

Finance

New Wave Bank Capsizes

NEW YORK—In a stunning blow that shook financial markets, New Wave Bank announced yesterday that its capital had been wiped out by the massive foreign real estate loans it made during the past two years. The $80 billion giant, touted as a strong buy as late as yesterday by Wall Street gurus, has been taken into receivership by the Federal Deposit Insurance Corporation and is receiving emergency liquidity support from the Federal Reserve. Although insured depositors will be made whole, the outlook for other creditors appears bleak.

New Wave, which only five years ago was a $20 billion regional retail bank, grew rapidly through acquisitions and plunged into several new enterprises. Foreign commercial real estate lending became a lucrative profit center, accounting for nearly one-third of the bank's profits last year. This new activity meant more risk for New Wave, but bank managers exuded confidence.

At a meeting with security analysts last November, some investors questioned New Wave's ability to manage the risks associated with overseas property lending. However, Knute D. Versified, chairman of the bank's Risk Management Committee, boasted that analysts were "too hung up on the past. Banking is about risk management, and we're about banking. We didn't get where we are by not knowing how to manage risk. Banks today are more sophisticated than they were 25 years ago. It's a big, global world and there are many opportunities overseas to ride the New Wave."

Conversations with senior banking officials confirmed that New Wave's collapse could be traced to a huge concentration of real estate loans in Shardul, which was overrun last week by rebel forces. "Nothing ever changes," said FDIC Chairman Shel N. Outcash. "Someone always goes too far, thinking they've discovered a new formula for eliminating risk and refusing to believe anything bad could happen on their watch," Outcash lamented. "Then we have to go in and clean up their mess."

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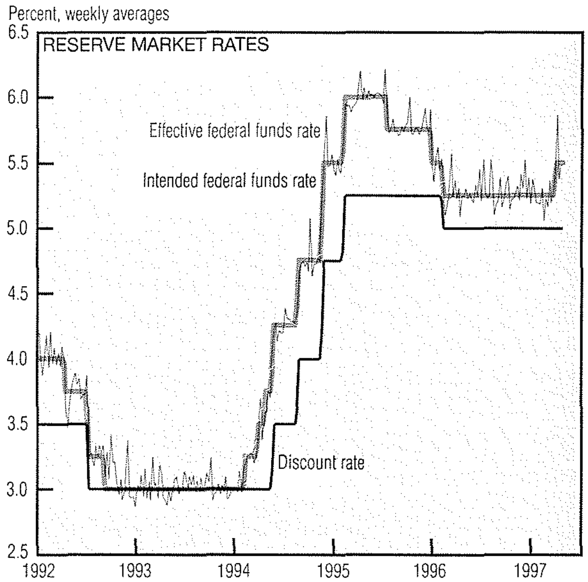
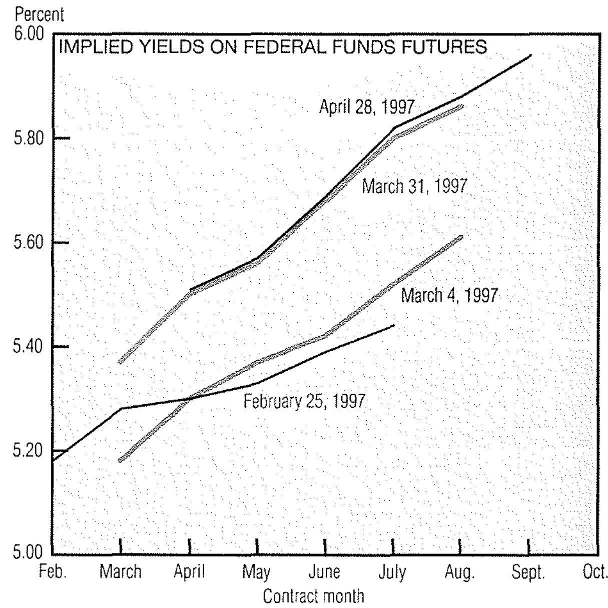
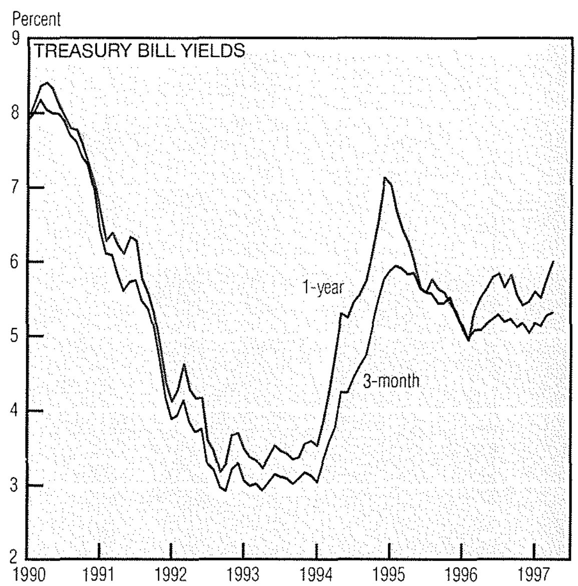
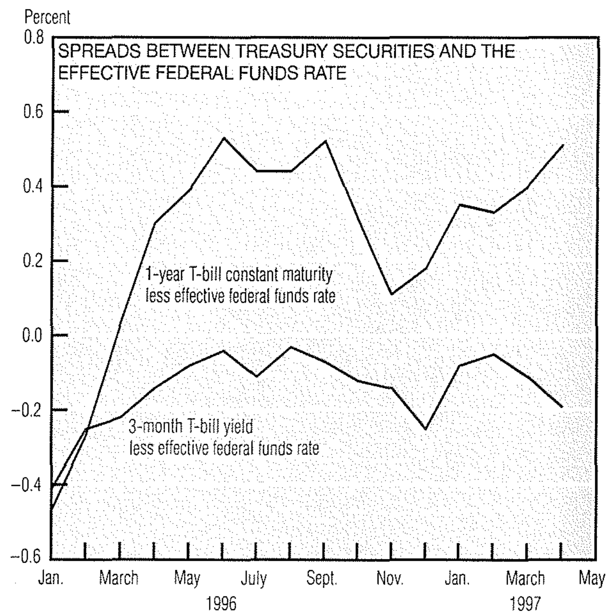
Monetary Policy









SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

Since the Federal Open Market Committee (FOMC) announced an expected ¼-percentage-point increase in the federal funds rate at its March 25 meeting, short-term interest rates have changed very little. As of April 29, the three-month Treasury constant-maturity yield had fallen five basis points (b.p.) from its March 28 level, while the yield on one-year maturities had declined two b.p. Long-term interest rates were also relatively constant over this period.

In contrast, the month leading up to the FOMC's March meeting was characterized by a notable increase in interest rates. From February 21 to March 21, the yields on three-month and one-year Treasury constant maturities rose 20 and 34 b.p., respectively, while the yield on the 30-year long bond moved up 37 b.p.

A common interpretation of the FOMC's latest policy move is that the Federal Reserve sought to tighten money market conditions slightly by driving up interest rates to head off future inflation. However, movements in short-term rates during the past few months suggest another interpretation. If one accepts that interest rates are influenced by a variety of factors apart from the actions of the Federal Reserve, then the recent funds rate increase may be viewed as an effort to keep it in line with other market interest rates, rather than to tighten monetary policy.

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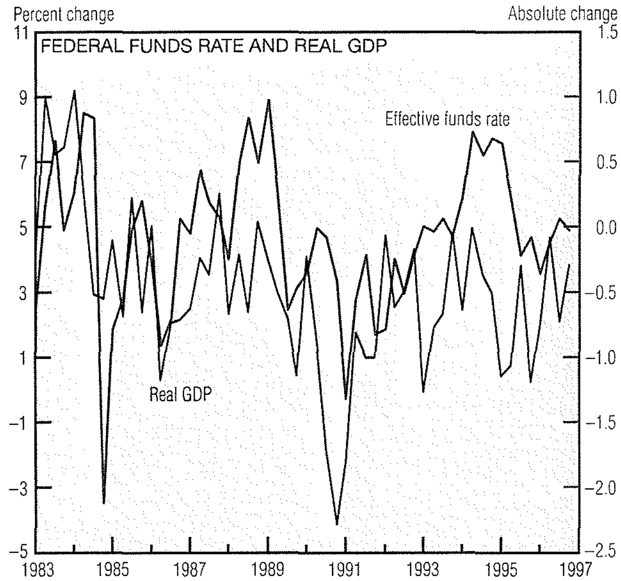
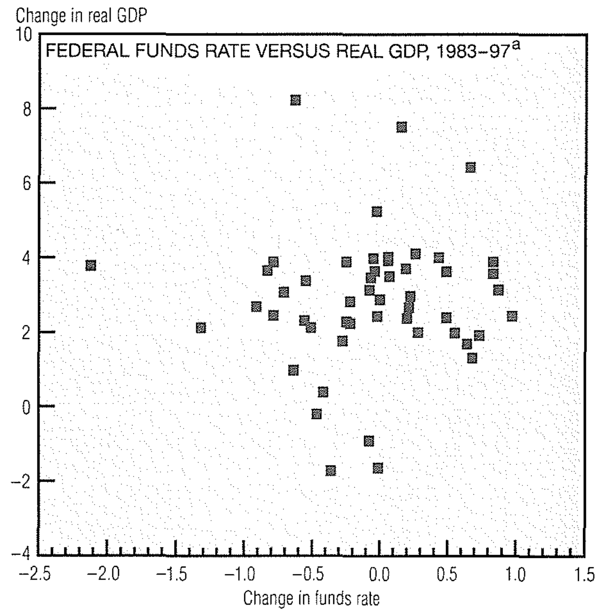
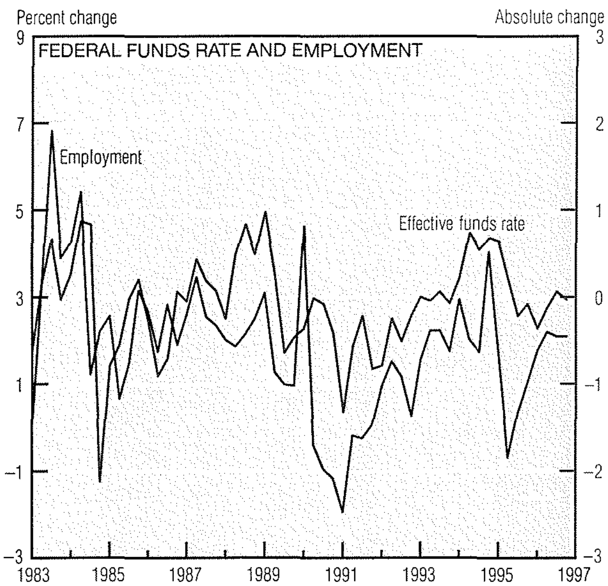
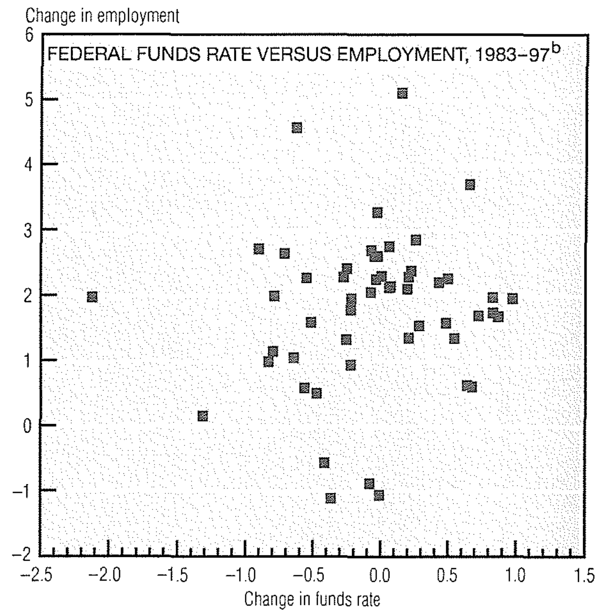
Monetary Policy (cont.)









a. Points show the relationship between a quarterly change in the federal funds rate and the percent change in GDP over the next four quarters.
b. Points show the relationship between a quarterly change in the federal funds rate and the percent change in employment over the next four quarters.
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Department of Labor, Bureau of Labor Statistics.

One could even argue that a constant funds rate over this period would have represented a slight easing of policy.

Implied yields on federal funds futures, which reflect expectations of future policy, suggest that market participants anticipate further increases in the funds rate over the next several months. Expectations of future policy seem to have changed little over the past month.

Another widespread interpretation of the March policy move is that the Fed is sacrificing output and employment growth to attain its goal of price stability. While there is little doubt that a large and sudden increase in the funds rate can have substantial negative effects on these two measures (as witnessed by the experience of the early 1980s), it is much less clear that relatively moderate changes in the funds rate lead to opposite movements in output and employment.

Consider the past 14 years, a period largely without sudden and substantial movements in the federal funds rate. During these years, there has been no clear relationship between changes in the funds rate, employment, and output. In particular, quarter-to-quarter increases in the funds rate have not been associated with declines in either output or employment over the following year.

Although this fact does not imply that moderate changes in the funds rate have no impact, it does suggest that the relationship between these variables is less obvious than some

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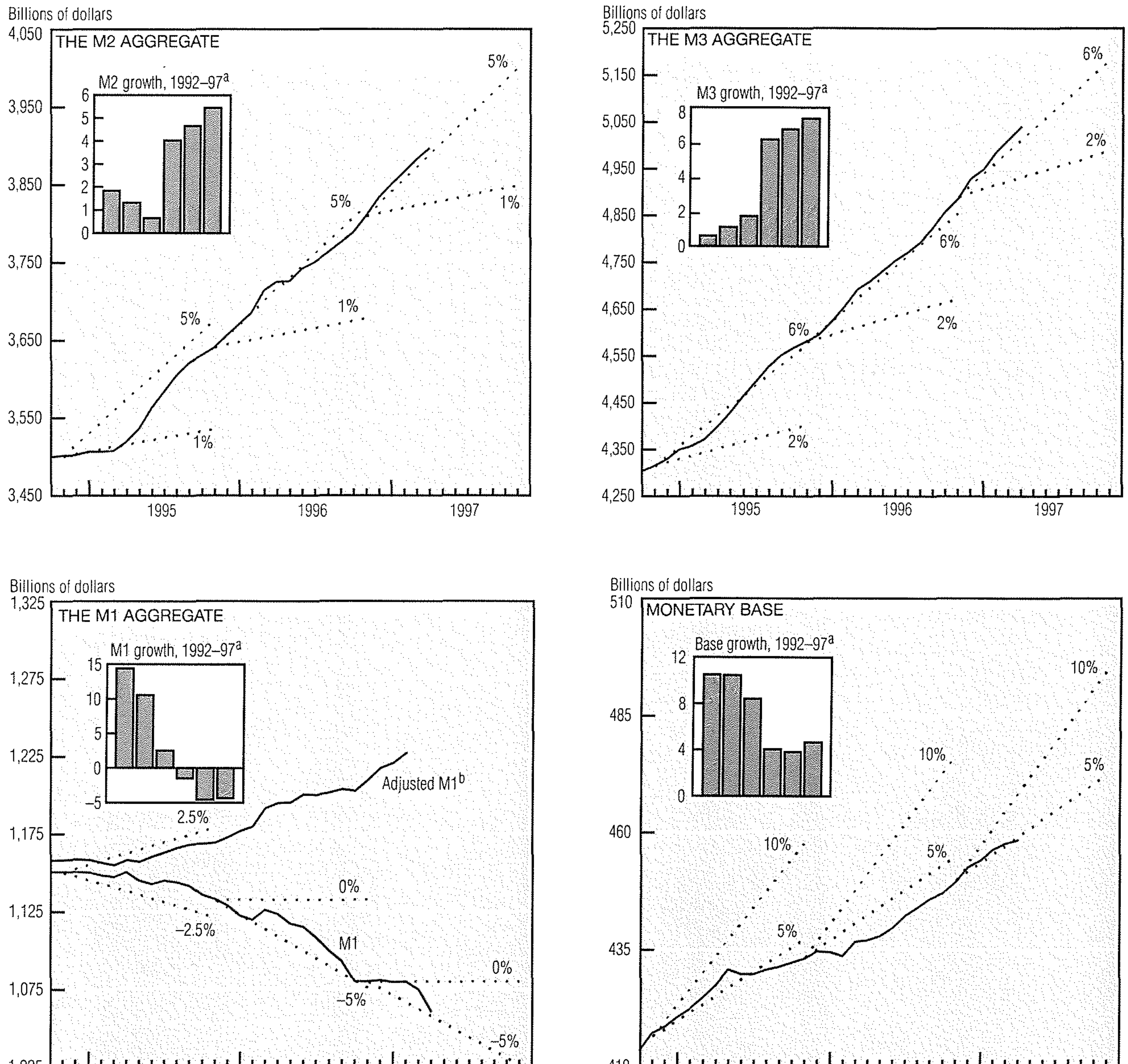
Monetary Policy (cont.)



a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on an estimated April over 1996:IVQ basis.
b. Adjusted for sweep accounts.
NOTE: All data are seasonally adjusted. Last plot is estimated for April 1997. For M1 and the monetary base, dotted lines represent growth ranges and are for reference only. All other dotted lines are FOMC-determined provisional ranges.
SOURCE: Board of Governors of the Federal Reserve System.

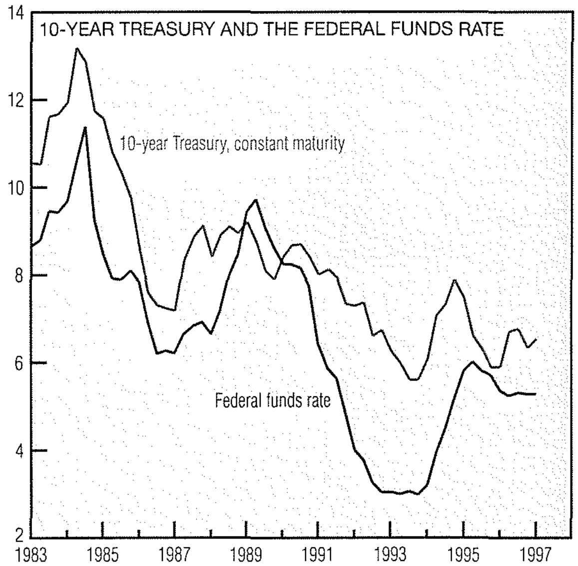
reports have stated. Over the last 14 years, fluctuations in output and employment likely resulted in large part from factors other than monetary policy, including changes in fiscal policy, legal regulations, and technology.

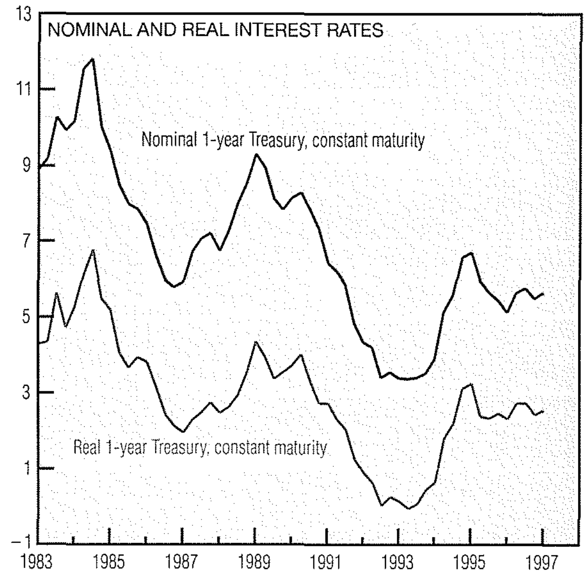
Turning to growth in the money stock, the broader aggregates continue to exceed the upper bound of the FOMC's provisional ranges for 1997. From March 1995 to March 1997, M2 and M3 grew at annual rates of 5.2% and 7.1%, respectively.

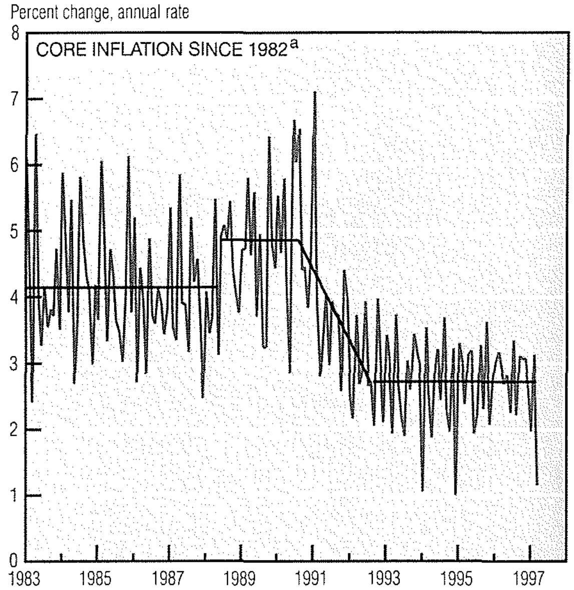
The monetary base, a narrower measure of money that comprises currency held by the public plus bank reserves, increased 5.7% during the first quarter, up slightly from the roughly 4% pace of 1995 and 1996. However, all of this growth was due to an increase in currency holdings, as total reserves continued its downward trend and fell at an 8.1% annual rate.

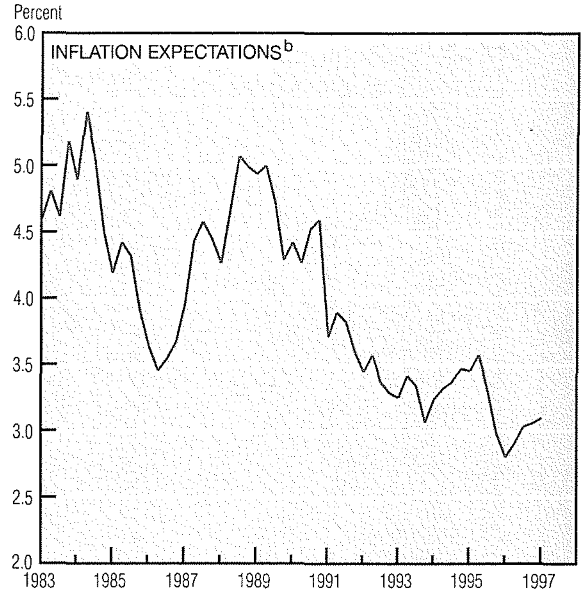
M1, which consists primarily of currency and checkable deposits, has continued to fall in recent weeks after leveling off in late 1996 and early 1997. The declines in both M1 and total reserves over the past few years have generally been attributed to the development of sweep accounts. (These accounts allow banks to lower their required reserves by short-term "sweeping" of deposits from accounts that require reserves to those that do not.) When the M1 data are adjusted to account for sweep activity, the downward trend in the nonadjusted data disappears.

Monetary Policy: A Long-Term Perspective









a. Core inflation is measured as the 15% trimmed mean of the Consumer Price Index. Green lines represent trends.
b. Data are from the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters and reflect year-ahead expectations.
SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia; and the Federal Reserve Bank of Cleveland.

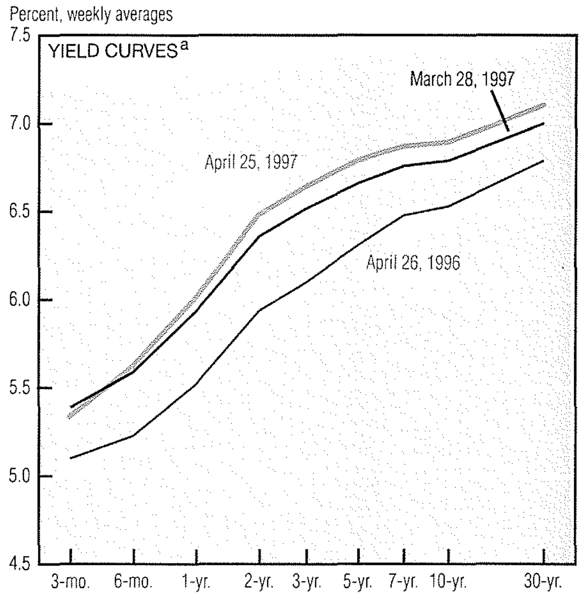
The financial press has given much attention to the 25-basis-point increase in the federal funds rate on March 25. The reports have tended to concentrate on how near-term economic growth might be affected by the latest rise and by possible future increases. It is constructive, however, to consider the Fed's recent action in a longer-run context.

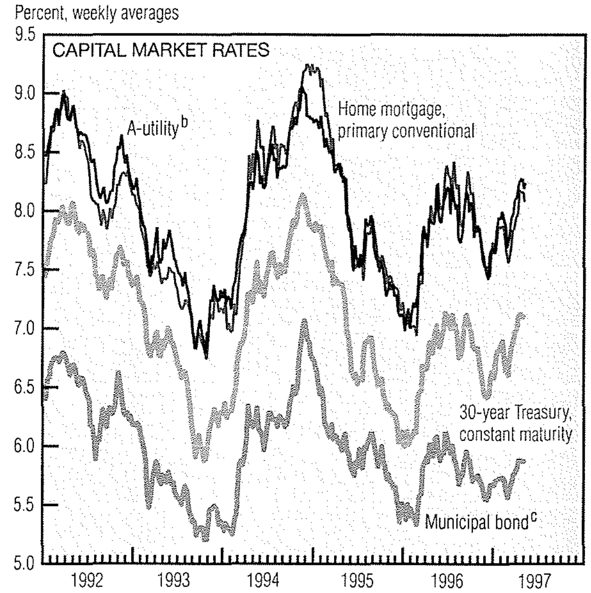
Since 1982, there have been three episodes when the funds rate was increased over sustained periods: 1983:IQ to 1985:IIIQ, 1988:IIQ to 1989:IIQ, and 1994:IQ to 1995:IQ. Between April 29 and October 8, 1987, the rate was pushed from 6% to 7-3/8%. However, this course was reversed sharply in October in the face of dramatically declining stock prices. A series of increases resumed in April 1988, but not in time to head off a somewhat discrete jump in the trend of core inflation. Thus, the policy increases that occurred over the course of the following year were largely directed at reversing an acceleration in the price level.

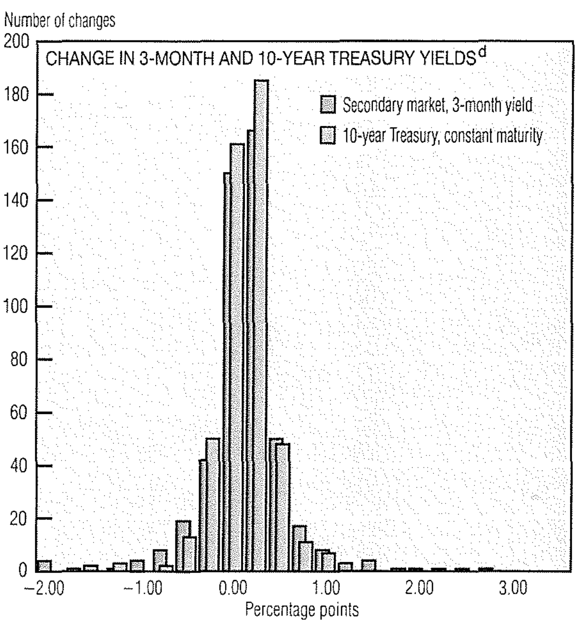
A recession (beginning in 1990) followed the 1988–89 funds rate increases, suggesting that once inflationary imbalances are in place, their elimination may entail a risk of output declines. Moreover, a series of funds rate decreases just months prior to the recession could not head it off.

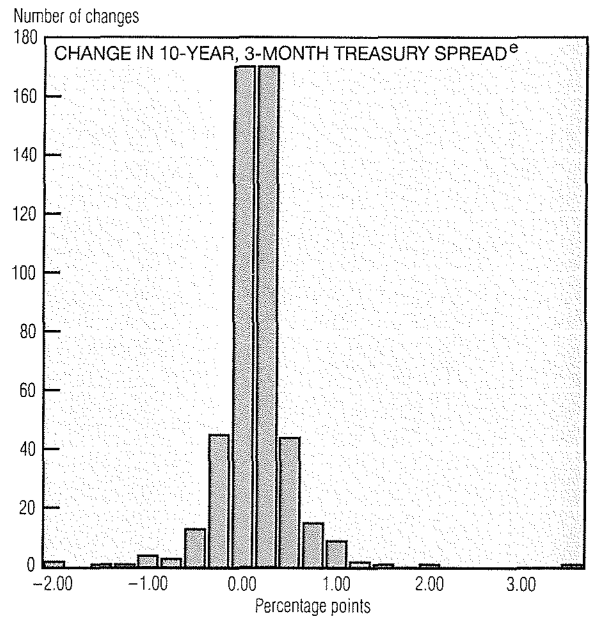
Neither the first nor the third episode was associated with output declines; thus, both are examples of preemptive disinflation policies. Indeed, the last episode has been followed by robust economic conditions. Since 1983, preemptive policy actions have been associated with a decline in inflation expectations and hence a lower level of interest rates.

Interest Rates









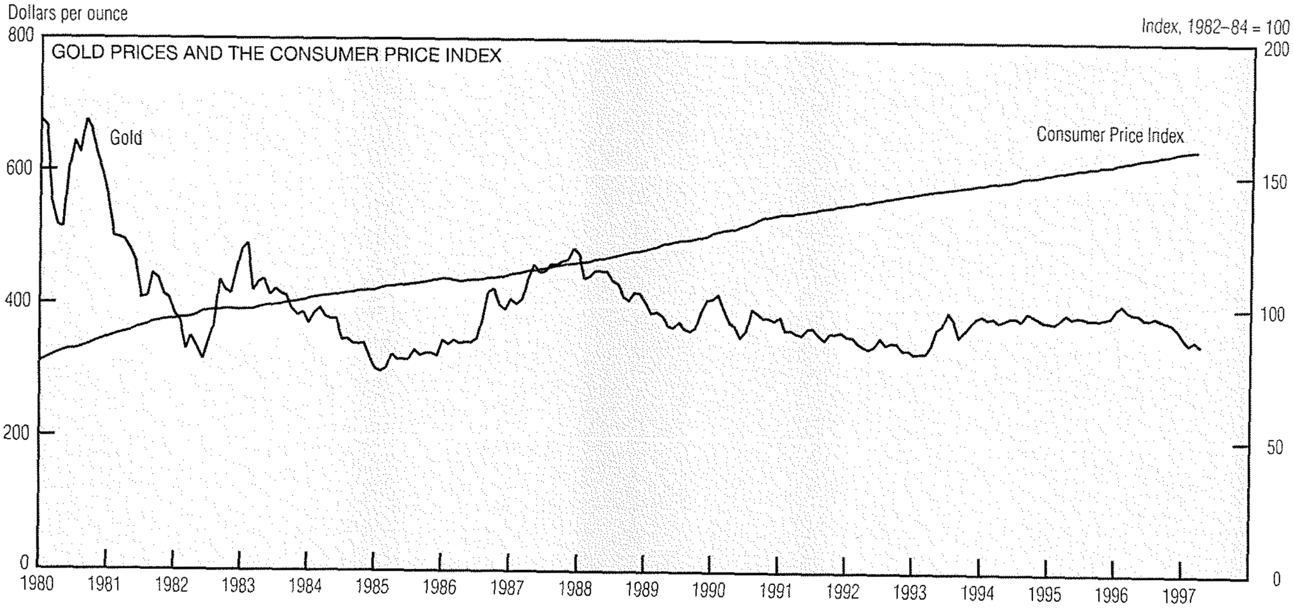
a. All instruments are constant-maturity series.
b. Estimate of the yield on a recently offered, A-rated utility bond with a maturity of 30 years and call protection of five years.
c. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
d. Change is the difference between the security's yield and the same security's yield one month prior.
e. Spread is the 10-year Treasury constant-maturity yield less the 3-month yield. The change in the spread is relative to one month prior.
SOURCE: Board of Governors of the Federal Reserve System.

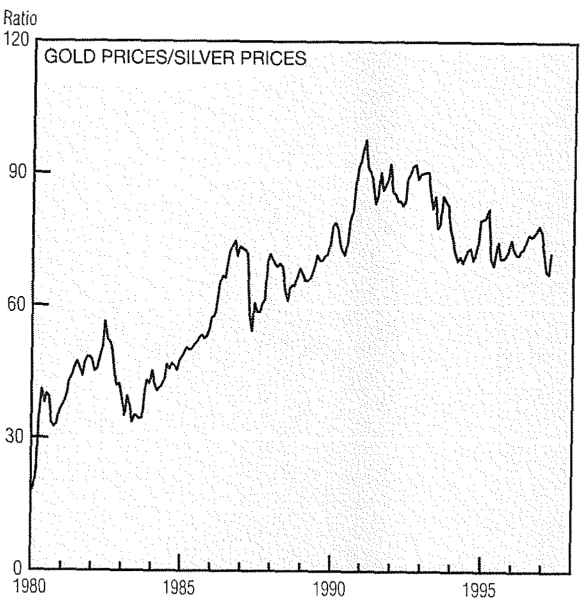
The yield curve has steepened slightly since last month, with short rates falling and long rates rising. Yield spreads have correspondingly opened up. The 3-year, 3-month spread widened from 113 to 130 basis points (b.p.), and the 10-year, 3-month spread grew from 140 to 155 b.p.

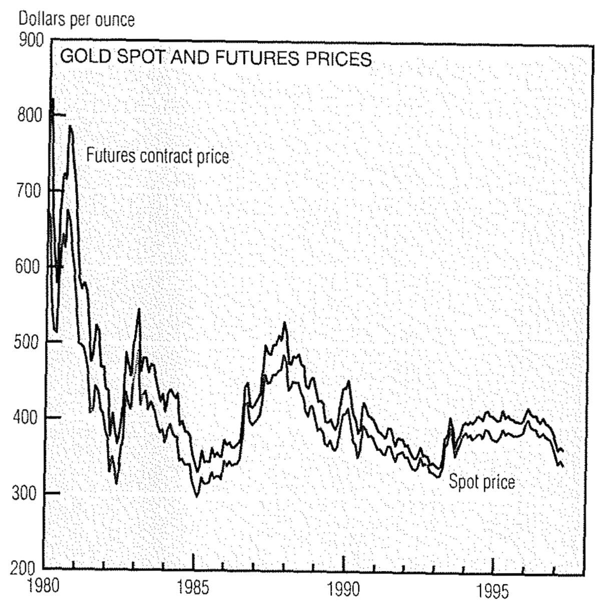
Relative to last year, the yield curve is about 25 b.p. higher, but has approximately the same slope. The 30-year long bond rate has edged up to 7.1%, a shift that is reflected in other capital market rates. Since the end of February, Treasury bonds, municipal bonds, and utility bonds have all increased (by 35, 22, and 30 b.p., respectively). Mortgage rates moved up 43 b.p. over the same period, partially closing the gap with utility rates.

A central feature of interest rate movements is their randomness. Next month's yield curve is unknown today, and a major goal of researchers and speculators is to better understand that uncertainty. One way to characterize this randomness is to look at the (unconditional) distribution of interest rate changes. Monthly movements tend to be relatively small, with the majority of changes falling between 25 b.p. up or down. Some differences between maturities also appear. Ten-year rates are more centrally clustered: 72% of all observations lie between -0.25 and 0.25, and none fall outside the -1.85 to 1.75 range. Three-month rates show a wider dispersion, ranging from -4.6 to 2.6, and only 66% lie between -0.25 and 0.25. Since extreme 3-month and 10-year changes often do not affect their spread, the distribution shows an even tighter clustering around the mean.

Precious Metal Prices







NOTE: All precious metals prices are in dollars per troy ounce.
SOURCE: DRI/McGraw-Hill.

Although the U.S. is no longer on a gold or silver standard, the prices of these precious commodities still command widespread attention. One reason is that the price of gold is often considered an indicator of inflation. Over the past decade, however, gold prices have held steady or declined in the face of a slowly rising price level. As the pattern of the early 1980s demonstrates, gold prices can show substantial fluctuations unrelated to movements in the Consumer Price Index. In part, gold reacts to inflationary expectations, industrial demand and supply, and fears of political instability overseas.

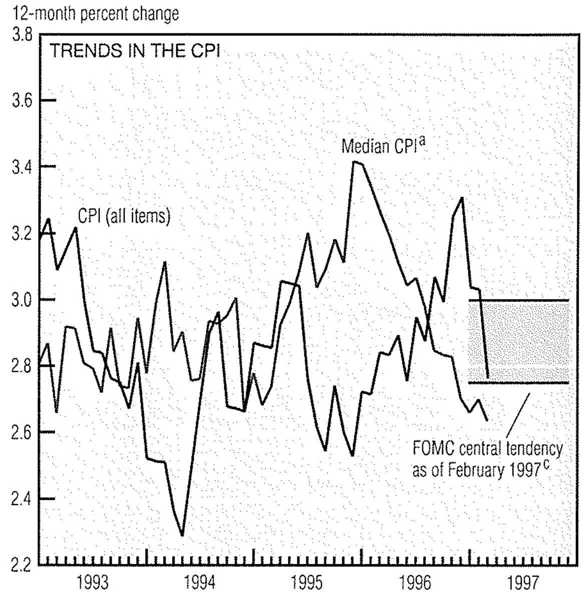
Silver, another precious metal often used in monetary systems, should respond to many of the same general influences as gold. Surprisingly, though, gold has become relatively more valuable in recent times. Between 1980 and 1991, the ratio of gold to silver prices surged from below 30 to above 90; since then, it has stabilized at around 70.

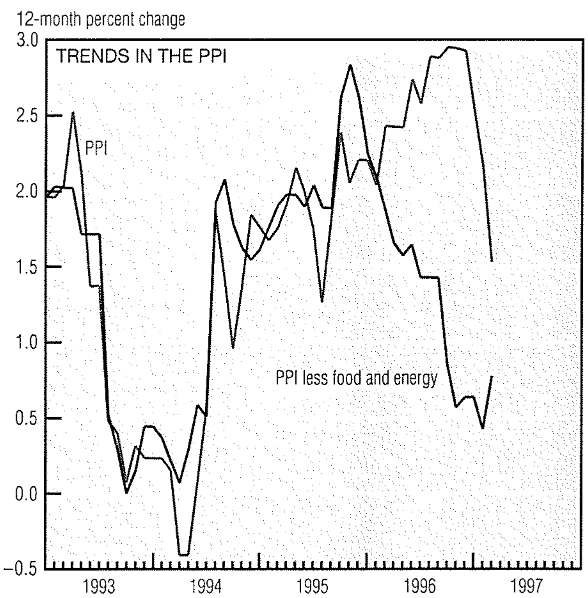
Precious metals can also be traded on futures exchanges, where investors agree to purchase (or deliver) metals on a given date sometime in the future. The futures price depends on investors' expectations of future spot prices, their attitude toward risk, and the cost of storing the commodity. Thus, the price of six-month gold futures provides an estimate of the spot price six months from now. The futures price generally follows the spot (current) price quite closely, but the numbers are rarely identical, and the gap (formally known as the *basis*) shows some variation over time.

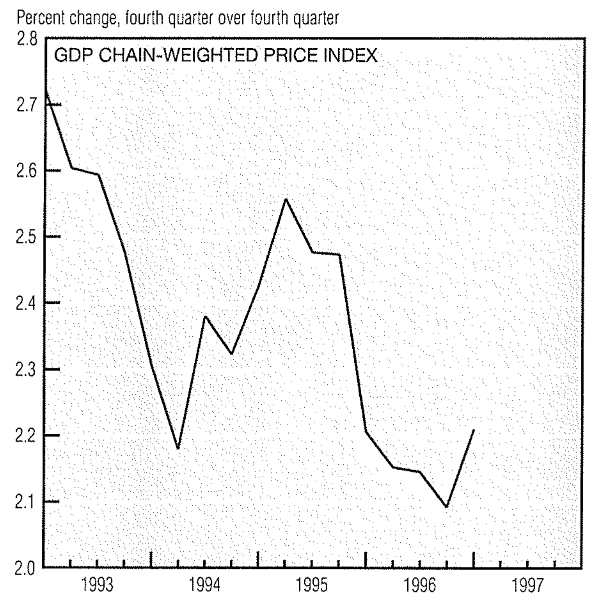
Inflation and Prices

March Price Statistics

	Annualized percent change, last:				
	1 mo.	**3 mo.**	**12 mo.**	**5 yr.**	**1996 avg.**
Consumer Prices					
All items	0.8	1.8	2.8	2.8	3.3
Less food and energy	2.9	2.4	2.5	2.9	2.6
Median[a]	2.1	2.9	2.6	2.9	2.7
Producer Prices					
Finished goods	−0.9	−3.0	1.5	1.6	2.9
Less food and energy	4.3	0.8	0.8	1.4	0.6
Commodity futures prices[b]	31.5	4.6	−1.2	3.0	−0.7







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.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; and U.S. Department of Commerce, Bureau of Economic Analysis.

The monthly inflation indicators moderated considerably in March. The Consumer Price Index (CPI) rose a mere 0.8% (annualized rate) during the month, and the Producer Price Index for finished goods (PPI) declined an annualized 0.9%. The median CPI, a measure of core inflation, advanced at a faster pace (2.1%), but also fell below its recent 12-month trend (2.6%). Indeed, the current inflation trend, as measured by retail prices, appears to be running near (or slightly below) the Federal Open Market Committee's 2¾% to 3% central tendency projection for 1997.

Other measures of aggregate price behavior have been equally subdued. The 12-month trend in producer prices is about ¾ percentage point lower than at this time last year, and the core PPI (less food and energy) is roughly two percentage points lower.

When we combine the price data from the CPI and the PPI, a clearer picture of the economy's recent inflation pattern emerges. One such measure, the GDP chain-weighted price index, is calculated using price data from retail, wholesale, and a variety of other sources. Over the past year, it has increased about 2.2%—a small uptick from its trend a quarter before, but still down a bit from trend rates posted earlier in the expansion.

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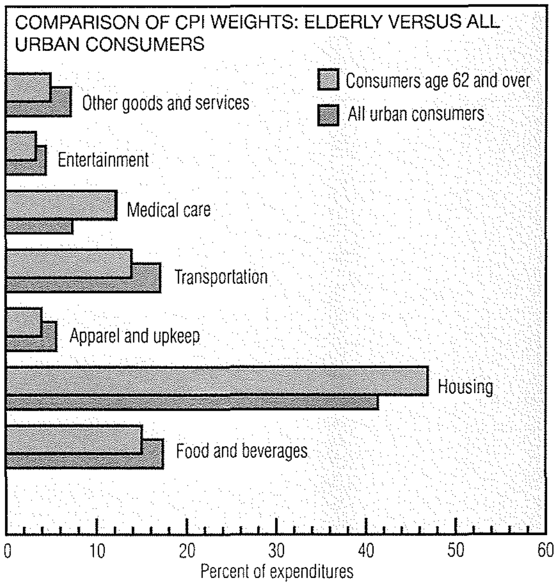
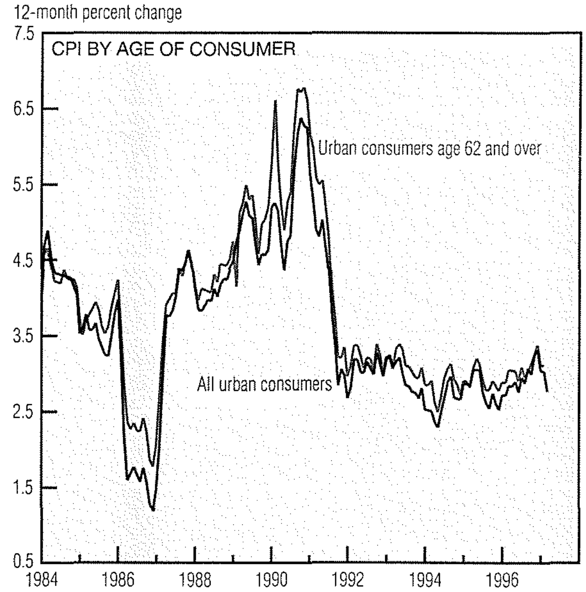
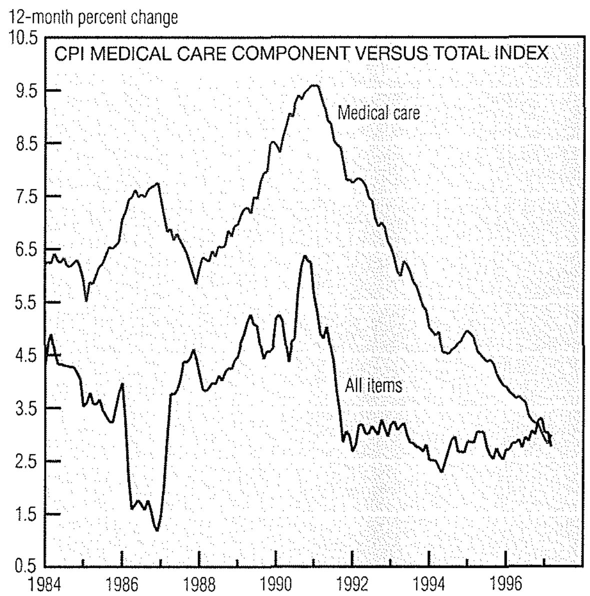
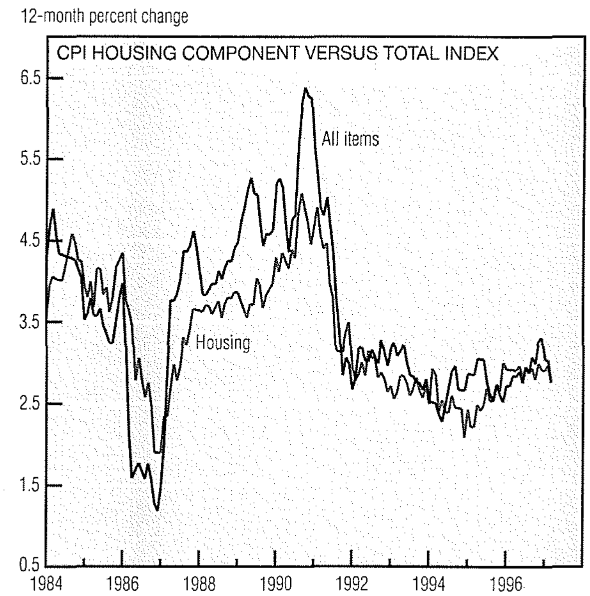
Inflation and Prices (cont.)









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

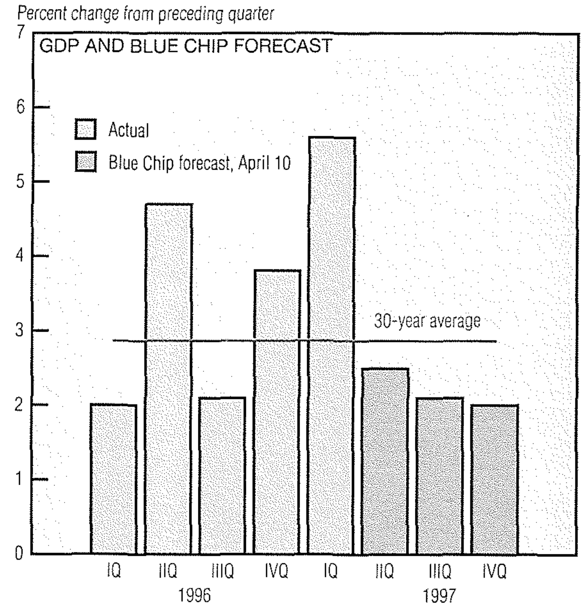
Which price statistic owns the right to the title "U.S. inflation rate" is a subject of heated controversy among economists and economic policymakers alike. Indeed, each measure has its strengths—and weaknesses. In recent months, the most critical focus has been on shortcomings in the construction of the CPI, although it is arguably one of the most carefully crafted of all economic statistics. The criticism may be related largely to the index's prominence. Among its many applications, the CPI serves as an escalator for Social Security benefits and has become a focal point in federal budget debates. Unfortunately, the index was never designed to serve as an escalator for the cost-of-living changes faced by older Americans.

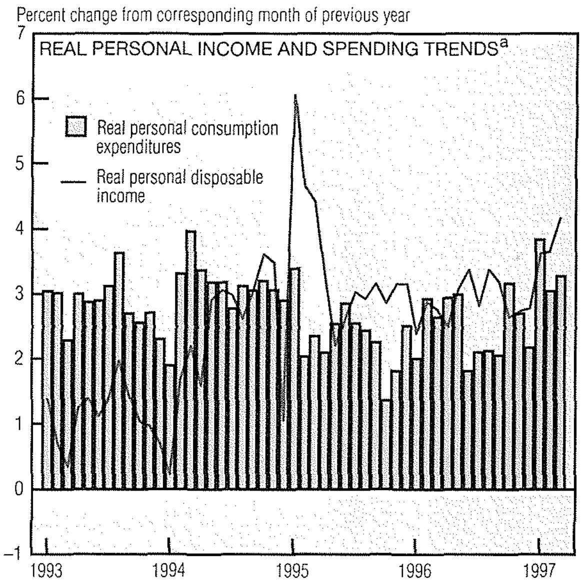
Economists at the Bureau of Labor Statistics, who produce the CPI, are attempting to improve the index. To date, they have constructed several experimental adjustments. In one case, the CPI has been reweighted to better reflect the spending habits of the elderly (currently, it is weighted on the basis of expenditure patterns for all urban consumers). In the new index, medical care and housing costs are more heavily emphasized, while the importance of transportation and food expenditures is reduced. These seemingly small adjustments appear to have a significant impact on the resulting price statistic: Medical-care cost increases have traditionally been among the highest in the index, and housing cost increases have been among the most stable.

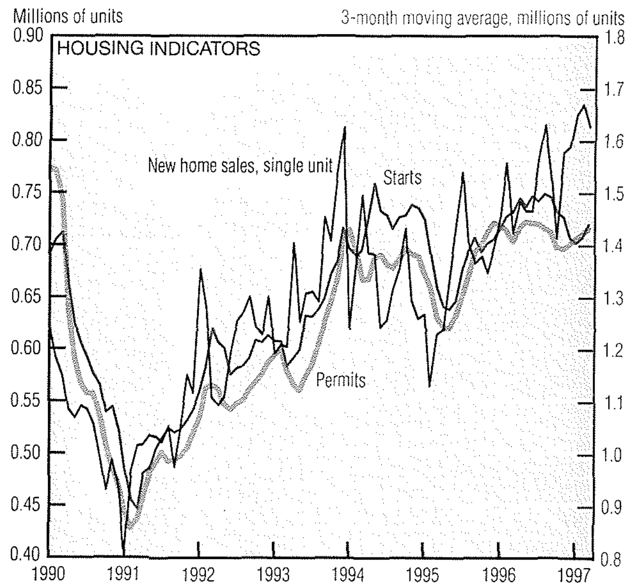
Economic Activity

Real GDP and Components, 1997:IQ[a]
(Advance estimate)

	Change, billions of 1992 $	Percent change, last: Quarter	Four quarters
Real GDP	96.1	5.6	4.0
Consumer spending	73.5	6.4	3.4
Durables	28.8	19.9	8.1
Nondurables	22.3	6.3	2.4
Services	23.4	3.6	2.8
Business fixed investment	22.6	11.9	9.6
Equipment	18.2	12.8	9.6
Structures	4.6	9.5	9.5
Residential investment	3.7	5.5	3.4
Government spending	−1.8	−0.6	1.3
National defense	−8.1	−10.1	−3.4
Net exports	−31.9	—	—
Exports	17.0	8.1	9.1
Imports	48.8	21.9	10.9
Change in business inventories	29.0	—	—







a. Chain-weighted data in billions of 1992 dollars.
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, April 10, 1997.

Advance estimates released by the Commerce Department in late April show real GDP rising 5.6% in the first quarter—the largest gain in nearly 10 years and one that substantially exceeded expectations. Economists participating in April's Blue Chip survey were anticipating a 3.1% growth rate. Although the Commerce Department's advance estimates are constructed with preliminary and incomplete data, an analysis of past GDP revisions suggests that the reestimate of the first-quarter growth rate (to be released in May and June) will not fall below 5.0%.

Consumer spending, inventory accumulation, and business fixed investment led the first-quarter advance. Although exports rose sharply, imports increased at an even faster rate, and the trade deficit widened. Government spending continued to contract.

Looking ahead, most analysts now expect the economy's growth rate to slow to 2.0% by the end of the year. Forecasts tend to revert to that rate because many economists believe it is consistent with patterns of U.S. labor force participation, capital accumulation, and productivity gains over the past decade or so. Some observers, however, are beginning to question whether these estimates of the economy's growth potential are too low.

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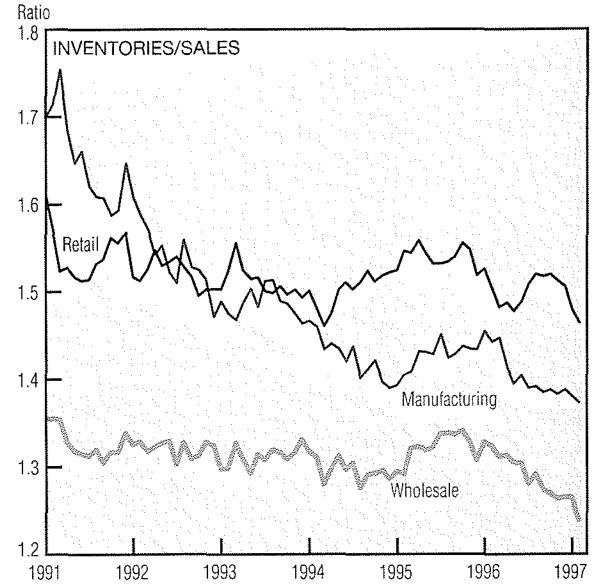
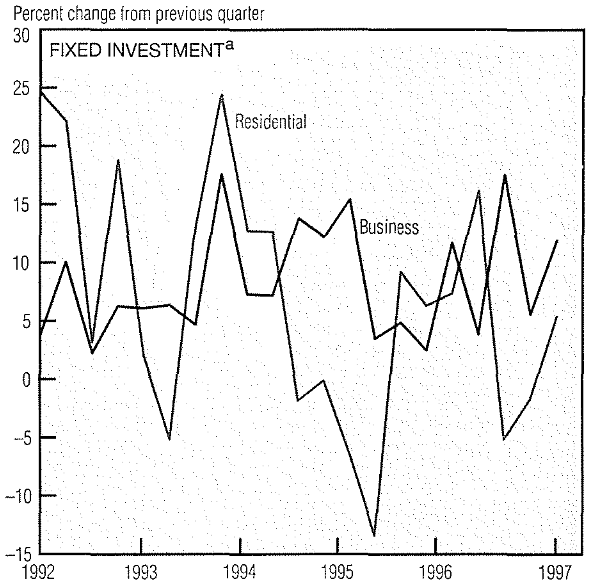
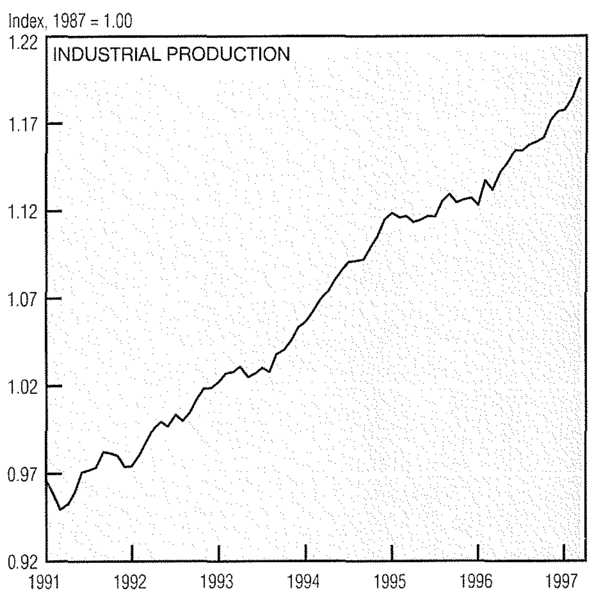
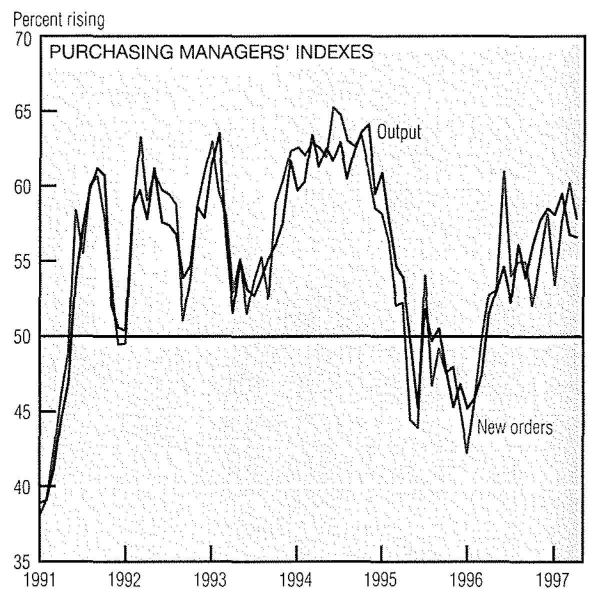
Economic Activity (cont.)









a. Chain-weighted data in billions of 1992 dollars.
NOTE: All data are seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and the National Association of Purchasing Management.

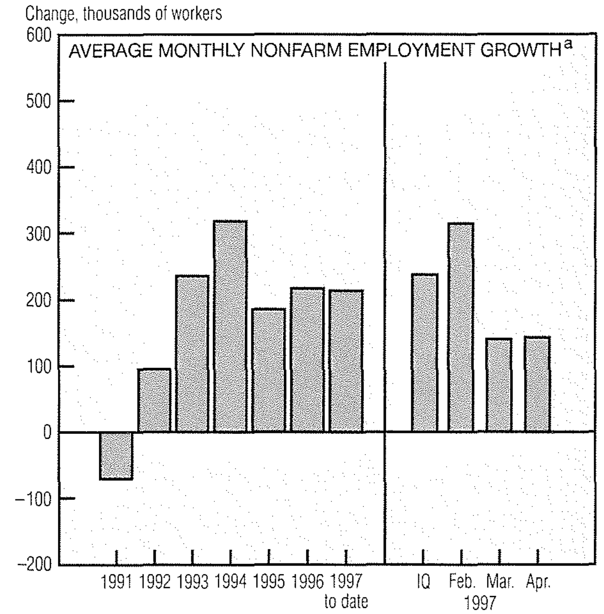
Consumer outlays accounted for most of the first-quarter surge. Real personal disposable income increased at a healthy year-over-year clip during the winter months, fueling strong expenditure growth as well as some improvement in household balance sheets. New home sales declined slightly in March, but remain at high levels and continue to show strong year-over-year gains (9.4%). Housing starts and building permits also remain at healthy levels.

Another major component of the first quarter's favorable growth performance was inventory accumulation. February's inventory-to-sales ratios (the latest available data) appeared low at the manufacturing, wholesale, and retail levels. Any subsequent buildup is likely to have been intended and should not hamper near-term growth.

Business fixed investment bounded ahead in the first quarter at twice the rate of total GDP, continuing the investment boom that started in 1991. Computers and related products accounted for most of this gain. Residential investment reversed a two-quarter decline.

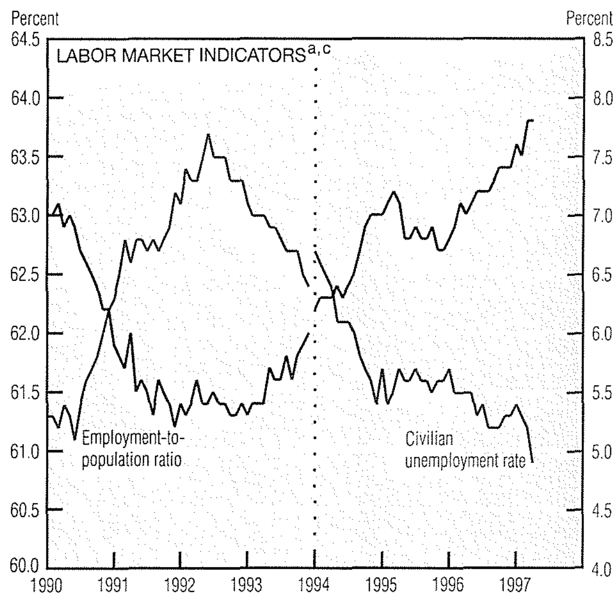
Industrial production jumped approximately 0.9% in April, with gains in every component. The industrial sector, which has demonstrated particularly strong growth since early 1996, is operating at 84.1% of capacity, a two-year high. The latest purchasing managers' survey also confirms the strength of the nation's industries. More than 54% of the respondents reported higher output and orders growth in April, marking the eleventh consecutive monthly reading above 50%.

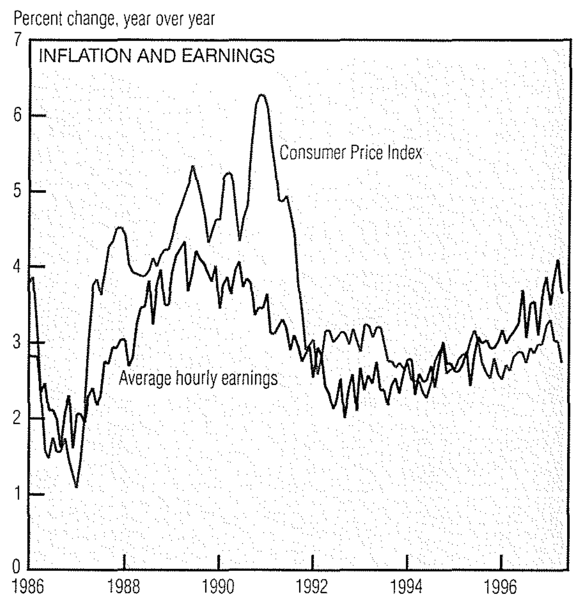
Labor Markets



Labor Market Conditions[a]

	1996 Year	1997 IQ	1997 Feb.	1997 Mar.	1997 Apr.
	Average monthly change (thousands of employees)				
Payroll employment	216	237	314	139	142
Goods-producing	16	48	109	−9	−57
Manufacturing	−8	15	3	17	−14
Construction	25	31	104	−25	−44
Service-producing	199	190	205	148	199
Services	100	103	86	72	93
Retail trade	50	21	18	53	32
Government	15	9	33	−27	32
Household employment	232	440	−150	745	209
	Average for period				
Civilian unemployment rate (%)	5.4	5.3	5.3	5.2	4.9
Manufacturing workweek (hours)[b]	41.5	41.9	41.9	42.1	42.2
Manufacturing overtime (hours)[b]	4.5	4.8	4.7	4.9	5.0





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.

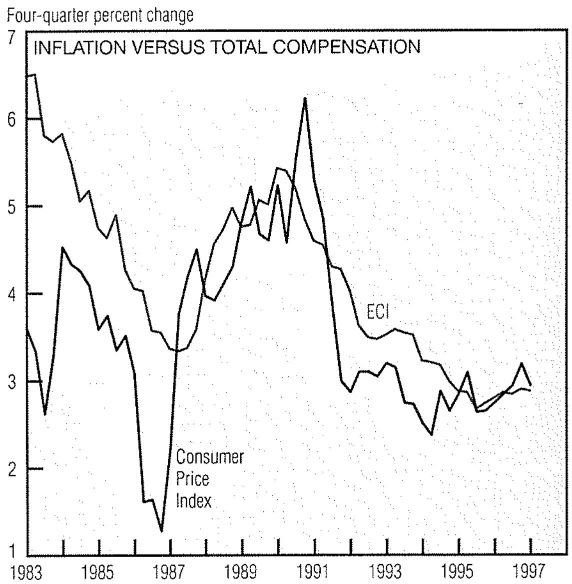
Labor market growth in April matched March's slow pace, with nonfarm payroll employment rising 142,000. Although this figure was weaker than expected, overall indicators continue to show strength. The unemployment rate fell from 5.2% to 4.9%—its lowest level in more than 23 years—while the employment-to-population ratio was unchanged from March's record high.

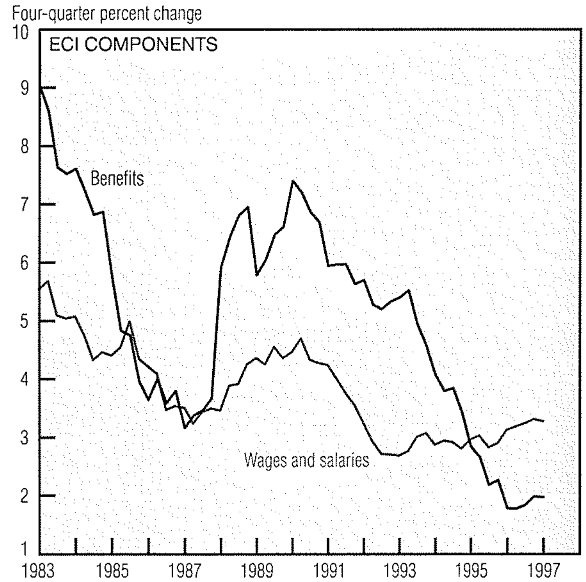
The large drop in the goods-producing sector (−57,000 jobs) last month can be accounted for by declines in the construction industry (−44,000) due to bad weather and in the motor vehicles industry (−13,000) because of layoffs and strikes. Despite an overall downturn in manufacturing jobs, the length of the workweek and overtime both increased slightly (0.1 hour). Indeed, manufacturing overtime in April reached a record high of 5.0 hours.

Of the total jobs created last month, 199,000 were in the service-producing sector. Much of this growth stemmed from employment in business and health services (up 53,000) and eating and drinking establishments (up 46,000), two usually robust industries. In addition, government rebounded from its March downtick, adding 32,000 net new jobs last month.

Average hourly pay fell slightly in April, down 1 cent to $12.14, for an annual increase of 3.6%.

Employment Costs





ECI Total Compensation by Occupation and Region

	Average annual percent change, last: Quarter[a]	1 year	3 years
Occupation			
White-collar workers	3.4	3.1	3.1
Blue-collar workers	1.2	2.4	2.6
Service occupations	3.5	3.1	2.9
Region			
Northeast	n.a.	2.6	2.9
South	n.a.	3.0	3.0
Midwest	n.a.	2.9	2.9
West	n.a.	3.5	3.0

ECI Total Compensation by Industry

	Average annual percent change, last: Quarter[a]	1 year	3 years
Private industry	2.5	3.0	2.9
Construction	2.2	2.3	2.4
Manufacturing	0.6	2.6	2.7
Transportation and public utilities	1.2	2.7	3.4
Wholesale trade	6.9	4.2	4.2
Retail trade	3.5	3.2	3.1
FIRE[b]	8.5	3.3	3.1
Services	2.7	3.0	2.7
State and local governments	2.1	2.5	2.9

a. Seasonally adjusted annualized data.
b. Finance, insurance, and real estate.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

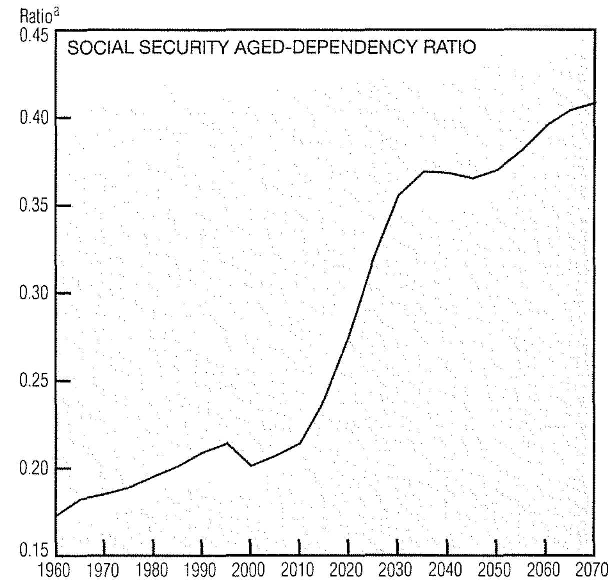
Concerns about inflationary pressures in the labor market have made the Employment Cost Index (ECI) one of the most anticipated economic indicators. However, the 1997:IQ release showed little indication of any labor market overheating.

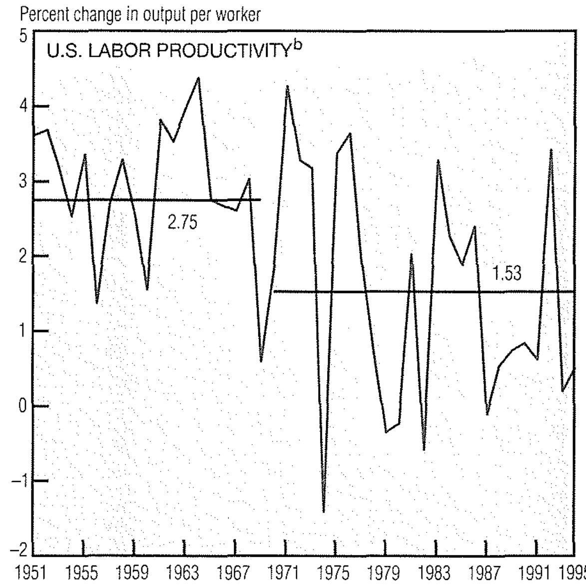
Total compensation was up just 0.6% in the first quarter, bringing the total gain over the last year to only 2.9%. Wage and salary growth continued to increase at a slightly stronger clip (3.3% in the last year), but benefits rose only 2.0%. The benefits index measures the price of a fixed benefits package. When the cost of providing benefits slows, employers can offer the same package and higher salaries without raising their total labor costs.

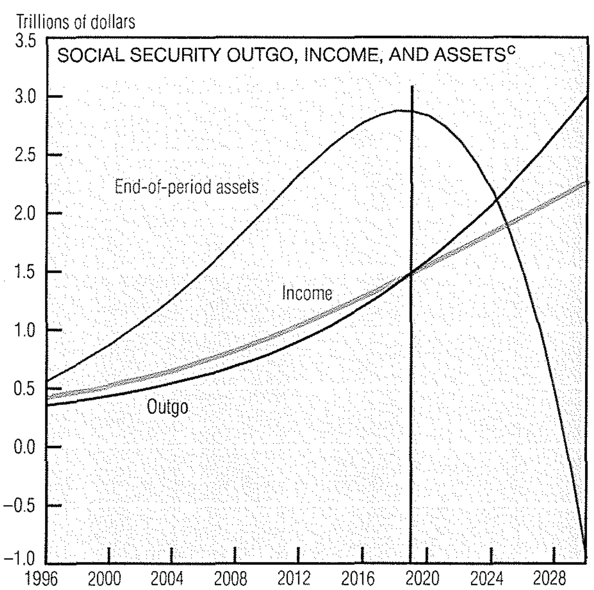
Although overall compensation growth has been restrained, relative gains or losses are evident for certain groups. Compensation growth was particularly slow for blue-collar workers in the first quarter (1.2%), although this was partly due to a reduction in benefit costs for this group. The industries that typically employ blue-collar workers (construction and manufacturing) also reported minimal increases, again in part because of falling benefit costs.

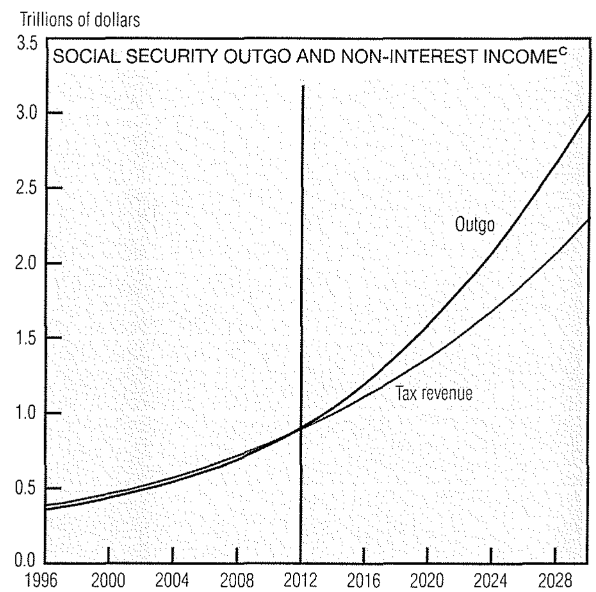
Workers in the wholesale and retail trades and in the finance, insurance, and real estate industries continue to enjoy higher-than-average compensation growth. Regionally, the reinvigorated western states are reporting the highest overall compensation gains.

Social Security Insolvency









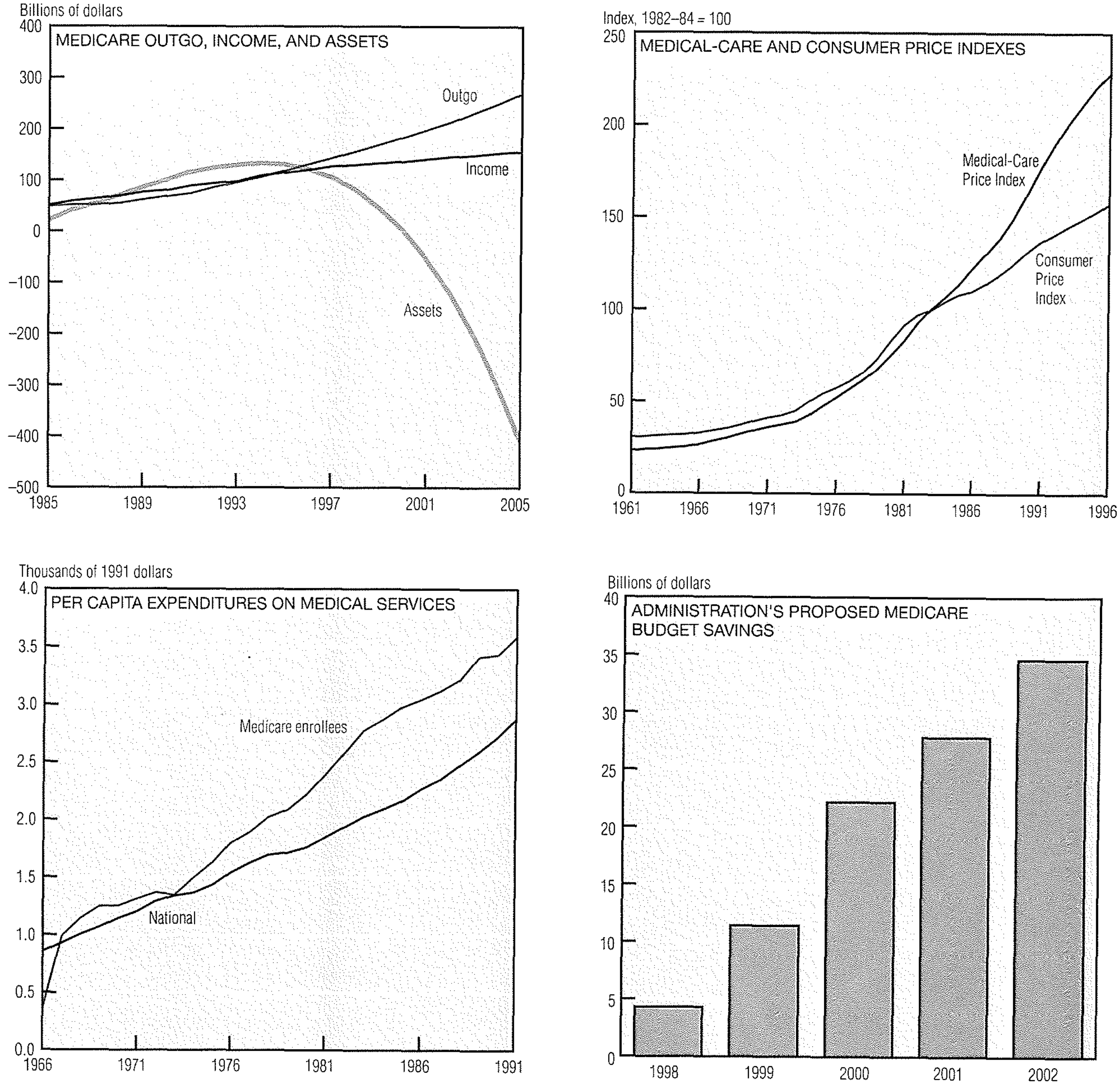
a. Population age 65 and over divided by population age 20-64.
b. Green lines represent average growth rates.
c. Vertical line represents point at which outgo begins to exceed income.
SOURCES: *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds;* and *Economic Report of the President,* 1995 and 1997.

The surge in U.S. birth rates between the mid-1940s and mid-1960s implies that an increasing share of the population will be retired in the coming decades. The so-called aged-dependency ratio is projected to rise 66% by 2030 and to double between now and 2070. Thus, maintaining retirees' living standards will require higher output per worker and/or redistribution of a larger share of output toward the nonworking elderly.

Unfortunately, labor productivity has fallen since the early 1970s. If current trends continue, increases in output will not be sufficient to maintain retirees' living standards without redistributing a greater share of output toward them. The major channel for doing so is the U.S. Social Security System. Official projections suggest that under current payroll tax and benefit rules, the Social Security trust fund will be broke by the year 2029. Total Social Security income will begin to fall short of total outgo in 2019. Thereafter, trust fund assets will be able to maintain benefits at current levels until the date of insolvency.

Social Security assets, however, are "invested" exclusively in government securities, with the interest financed out of non-payroll taxes. Once payroll tax revenue falls short of mandated benefit payments, non-payroll tax revenue will have to be tapped to cover the difference. Hence, the date of Social Security's insolvency should be based on the date when payroll tax revenue can no longer cover current benefits, not when trust fund assets are exhausted. Under current projections, the former will occur in the year 2012—just four years after the oldest baby boomers retire.

Medicare Insolvency



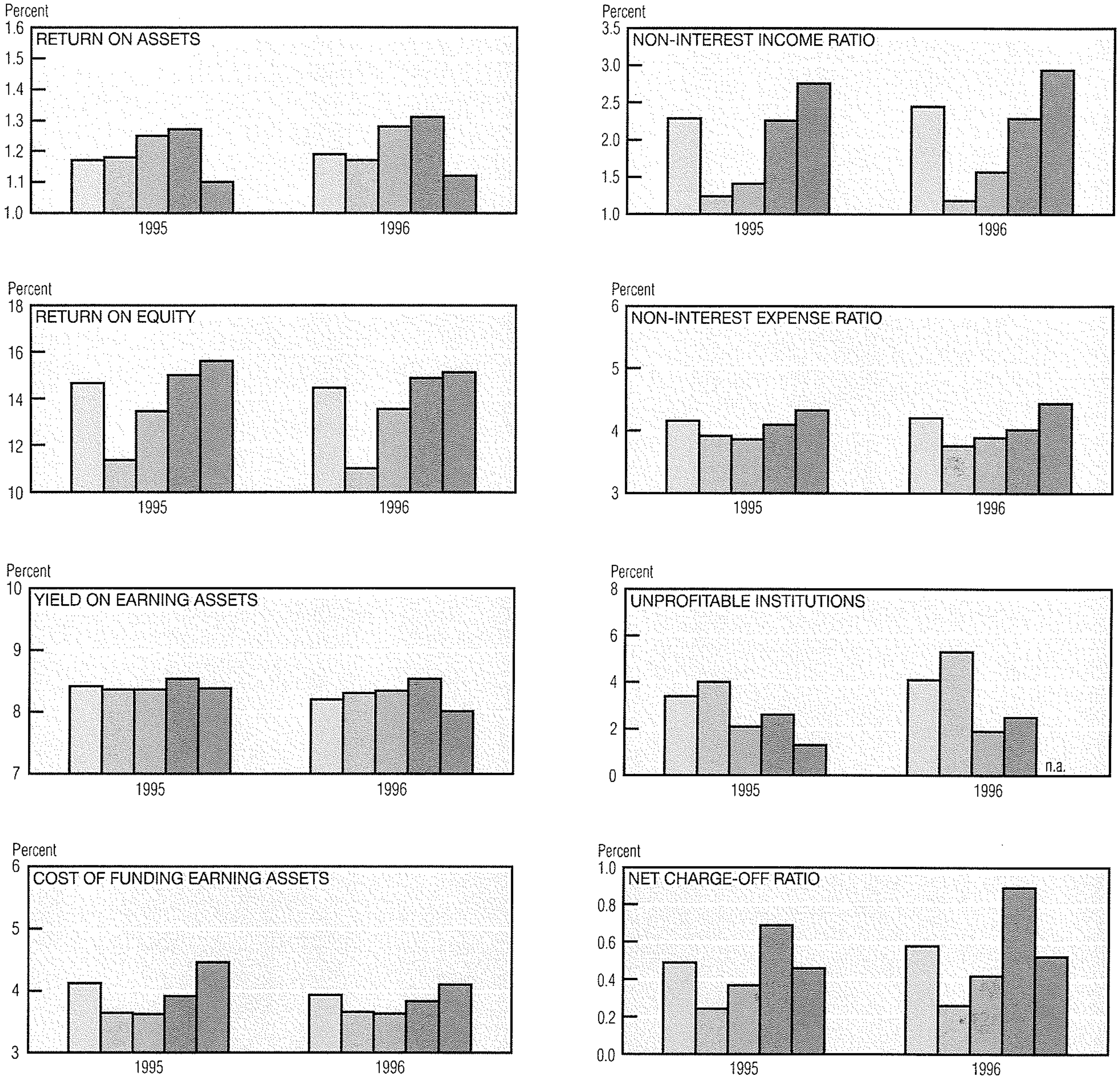
SOURCES: Health Care Financing Administration; Congressional Budget Office; and Office of Management and Budget.

The Hospital Insurance trust fund (Medicare—Part A), which covers hospital services, home health care, hospice stays, and skilled nursing services for the elderly, is in much deeper trouble than Social Security. Like Social Security, the Medicare trust fund holds government securities in its portfolio. These "assets" are projected to be exhausted by the year 2001. However, the fund's total annual income is already lower than annual outgo, implying that some non-payroll taxation is already being devoted to redemption of government securities held in the trust fund's portfolio.

The shortfall in Medicare's finances has been caused, in large part, by escalating health care prices. Since 1983, the Medical-Care Price Index has increased much faster than the general price level. One factor that helps to explain this trend is higher demand for medical services: Real per capita spending on these services has risen dramatically over the last two decades.

The Clinton administration's budget for fiscal year 1998 proposes lowering reimbursements for health care providers and reforming the payment system for home health care and skilled nursing services. Administration officials project that this would save \$100 billion over five years, extending Medicare's solvency until 2007. More than 85% of the reductions, however, are scheduled to occur in the year 2000 or later.

Banking Conditions



All institutions
Less than $100 million in assets
$100 million to $1 billion in assets
$1 billion to $10 billion in assets
More than $10 billion in assets

SOURCE: Federal Deposit Insurance Corporation.

The latest statistics on insured U.S. commercial banks confirm the industry's strength. In 1996, banks' $52.4 billion earnings produced a 1.19% return on assets (ROA), the second-highest annual posting ever and just below 1993's record high 1.20%. In 1995, banks earned $48.8 billion, which resulted in a 1.17% ROA. The improvement in banks' profitability can be traced mainly to non-interest income. Between 1995 and 1996, the ratio of non-interest income to total assets increased from 2.29% to 2.45%. Banks' profits were affected only slightly by the lower yield on earning assets because their cost of funding fell by nearly an equal amount.

The improved profitability statistics, however, hide two potential problems—the first in the small bank community and the second in the industry's asset quality. From 1995 to 1996, the number of unprofitable banks rose significantly—the result of a deteriorating performance by the nation's small banks (those with assets below $100 million). Of the 6,659 small banks in existence in 1995, 4.0% were unprofitable. By 1996, the number of these institutions had fallen to 6,205, but the unprofitable share had ballooned to 5.3%.

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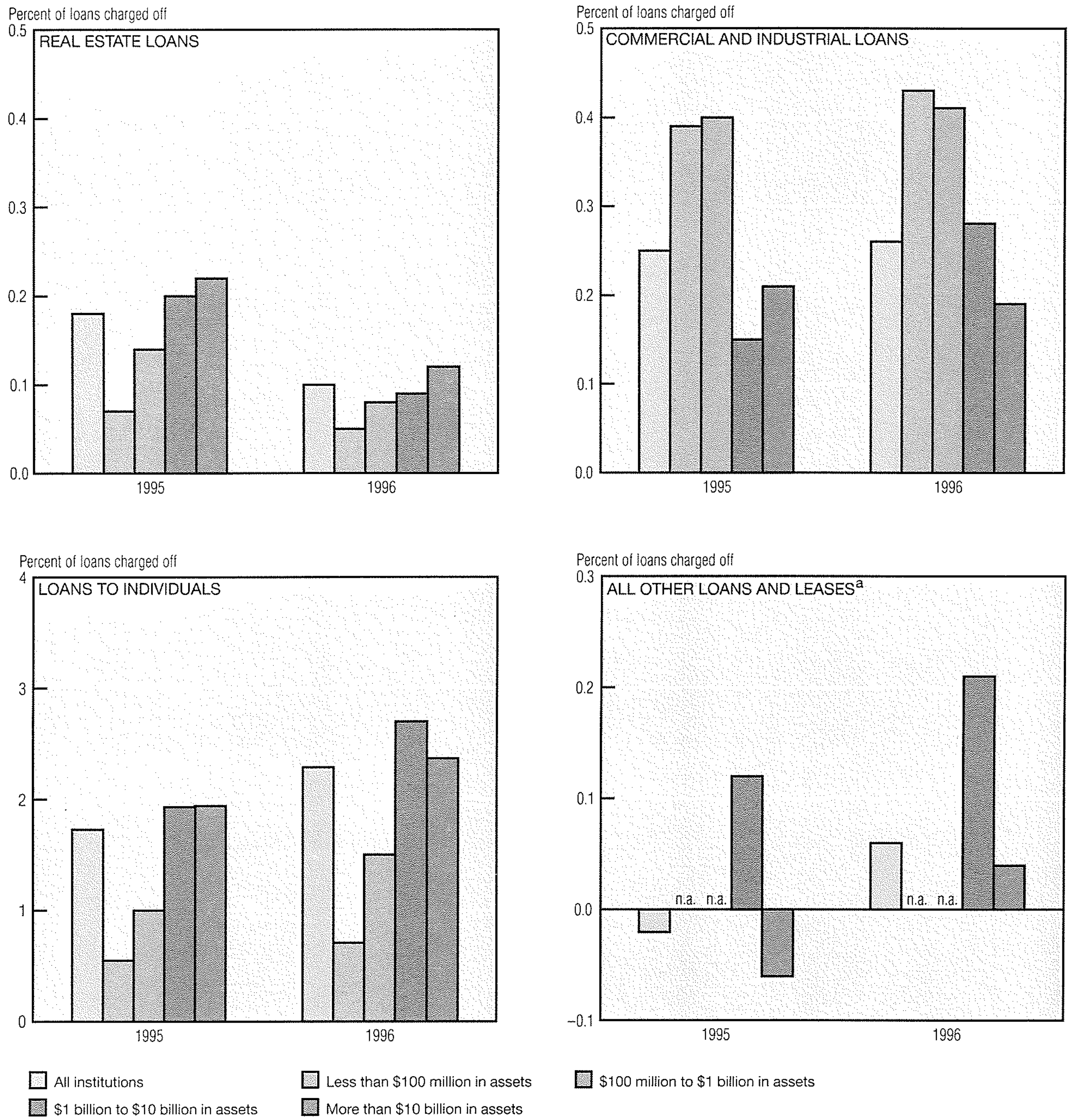
Banking Conditions (cont.)



a. Includes farm loans.
SOURCE: Federal Deposit Insurance Corporation.

The number of unprofitable small institutions was reflected in the group's ROA, which dropped from 1.18% in 1995 to 1.17% in 1996. This reduction, though negligible, becomes more meaningful when compared with the increase in ROAs posted by the three categories of larger banks. Non-interest income and the cost of funding earning assets were the primary contributors to small banks' poorer performance.

Last year also saw a deterioration in one important indicator of bank asset quality—the ratio of net charge-offs to loans and leases. Net loan charge-offs were $3.3 billion higher in 1996 than in 1995, growing from 0.49% to 0.58%. Although all four bank size groups reported higher ratios, the largest uptick occurred in banks with assets between $1 billion and $10 billion. Small banks posted the lowest increase.

The deterioration in loan quality was largely concentrated in loans to individuals. The ratio of consumer loans charged off to total assets climbed from 1.73% in 1995 to 2.29% in 1996. Again, the largest increase was reported by the group of banks with assets between $1 billion and $10 billion.

Worsening consumer loan quality stems mainly from problems with credit card loans. Between 1995 and 1996, net charge-offs of these loans grew by $2.7 billion. As a result, they accounted for 61.1% of all loans charged off last year.

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The Benefits of NAFTA

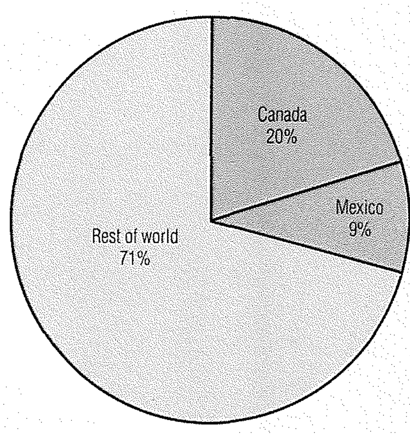
Long-run Effects of NAFTA
(Percent deviation from pre-NAFTA steady state)

	Canada	Mexico	U.S.	Rest of world
Welfare	0.01	0.96	0.12	0.01
Real GDP	0.11	3.26	0.24	0.01
Real consumption	0.08	2.52	0.25	0.01
Labor hours	0.07	1.99	0.14	0.00
Real wages	0.09	2.12	0.25	0.01
Capital investment	0.16	5.05	0.37	0.01
Imports	0.29	12.47	1.40	0.14
Exports	0.37	13.87	1.46	0.02

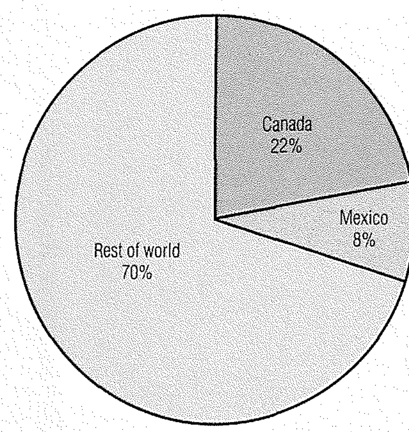
NAFTA: A Prisoners' Dilemma Game[a]

		Mexico: Status quo	Mexico: Liberalize trade
U.S.	Status quo	0, 0	0.4, −2.7
U.S.	Liberalize trade	−0.2, 3.5	0.1, 1.0

DESTINATION OF U.S. EXPORTS PRIOR TO NAFTA (1992)



ORIGIN OF U.S. IMPORTS PRIOR TO NAFTA (1992)



a. Columns and rows list strategies. Payoffs (net welfare gains) are for U.S. on the right and Mexico on the left.
SOURCE: Michael A. Kouparitsas, "A Dynamic Macroeconomic Analysis of NAFTA," Federal Reserve Bank of Chicago, *Economic Perspectives*, January/February 1997, pp. 14–35.

The North American Free Trade Agreement (NAFTA), which took effect on January 1, 1994, will curtail most barriers to trade and investment between Canada, Mexico, and the U.S. by the time it is fully implemented in 2004. Although economists generally expect that the increased specialization and trade associated with the agreement will confer significant benefits on all participating countries, most studies have shown these gains to be relatively small. However, this research does not incorporate the impact of the trade agreement on the pace of capital accumulation.

An important new study of NAFTA (by Michael Kouparitsas of the Federal Reserve Bank of Chicago) adjusts for this deficiency and reports output and consumption gains that are approximately twice as large as most previous estimates. However, it also finds that the overall welfare gains (the utility associated with consumption and leisure) are comparatively small because NAFTA raises work effort. Perhaps further extensions that accommodate population growth and trade-induced productivity advances will uncover larger welfare gains.

While demonstrating that free trade will make Mexico, the U.S., and Canada better off, Kouparitsas shows that no country benefits from unilateral trade liberalization. Formal agreements like NAFTA are necessary to resolve the prisoners' dilemma game inherent in trade liberalizations and to secure the benefits of free trade.

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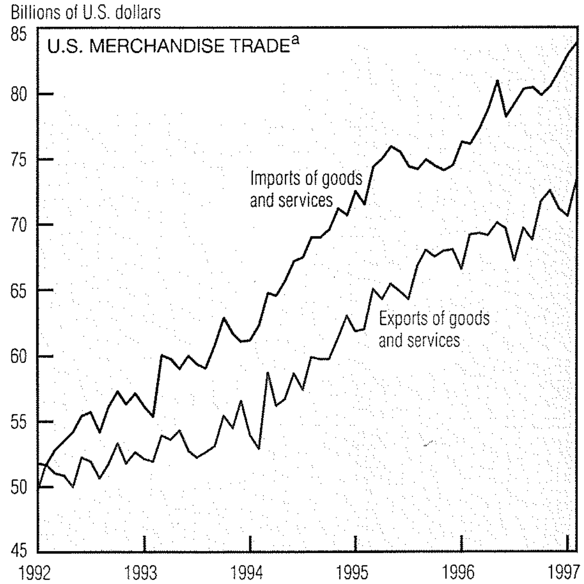
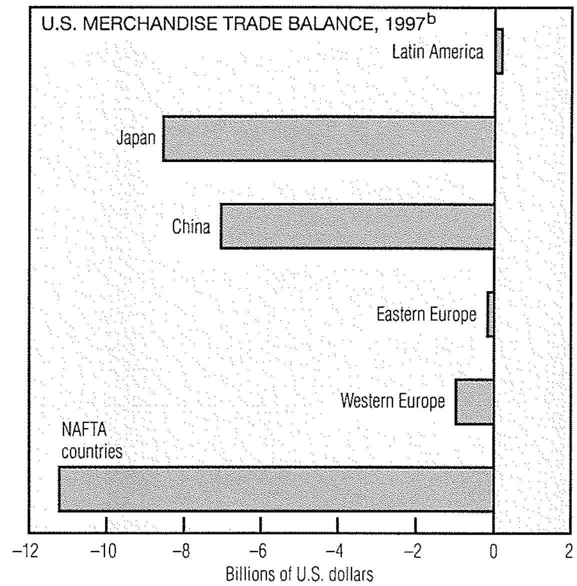
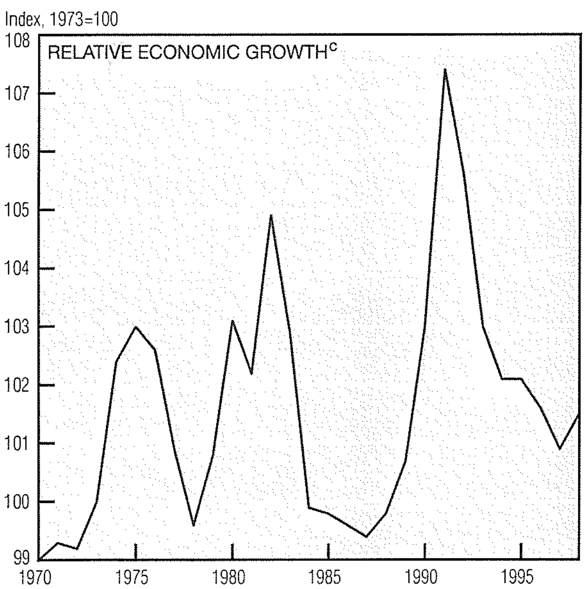
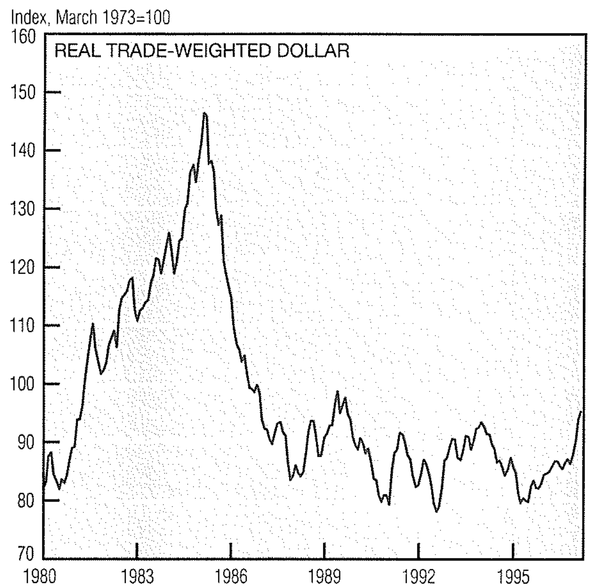
International Trade









a. Seasonally adjusted data.
b. Year to date.
c. Ratio of foreign real GDP or GNP to U.S. real GDP. Foreign countries and trade weights are those used to construct the Federal Reserve Board's trade-weighted dollar index. Projections for 1997 and 1998 are from *The Economist,* April 26–May 2, 1997.
SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of the Census; International Monetary Fund, *International Financial Statistics;* and *The Economist,* April 26–May 2, 1997.

The U.S. merchandise trade deficit narrowed to $10.4 billion in February, but has clearly widened over the current business expansion. The U.S. maintains deficits with nearly all regions of the globe.

Trade balances ultimately reflect countries' saving and investment decisions. Deficit countries consume more resources than they produce and pay for these resources by borrowing from foreigners. Thus, economic factors that affect the trade balance must also alter saving and investment decisions.

Although their direct connections to saving and investment seem remote and tenuous, relative rates of economic growth and real exchange rates often act as proximate—though imprecise—determinants of the trade balance. Holding other factors constant, estimates suggest that U.S. exports keep pace with imports only when foreign economies expand at twice the U.S. rate. Over the next two years, growth patterns will probably not meet this condition. Economists expect foreign economic activity to expand approximately 2.3% and 2.7%, respectively, during 1997 and 1998, while U.S. economic growth is projected to rise 2.8% and 2.0% over the same years. This year's sharp appreciation of the real trade-weighted dollar (8%) compounds the implication of these economic growth projections for the U.S. trade deficit.