

The Economy in Perspective

With a little help from our friends ... The United States continues to import more goods and services than it sends abroad, and by a wide margin. According to preliminary estimates, the real trade deficit amounted to approximately \$30 billion in the first quarter. During the past several years, our real net export deficit has been running about \$100 billion annually, up sharply from the pace established earlier in the decade, but still below rates recorded in the mid-1980s. While some people regard this persistent trade imbalance as a threat to national welfare, others view it as a boon to consumers. Few people, however, think about the connection between trade flows and capital formation.

When Americans consume and invest more than they produce, the extra resources are obtained from abroad. U.S. businesses pay for imports by either purchasing foreign exchange with dollars or directly remitting dollars to the seller. In either case, Americans receive goods and services, and foreign parties acquire dollars, which they invest in various ways. These dollar-denominated investments are essentially IOUs given to our trading partners for future redemption. Their ultimate value stems from foreigners' claims on goods and services produced in the United States.

For their part, foreign citizens collectively are producing more goods and services than they are using at home, and are sending the extra production to us. They are sacrificing the current use of these resources for greater consumption in the future, when they redeem their IOUs. Foreign citizens are saving and exporting capital, while U.S. residents are dissaving and importing capital.

The U.S. current account balance represents the trade balance plus net income from foreign investments plus unilateral transfers; a positive value means that we are generating net claims against the rest of the world, and a negative value means that we are generating net claims against ourselves. The U.S. capital account records the net flow of investment funds between the United States and our trading partners. The current account and capital account must mirror each other at all times: When the current account indicates that we are importing on net, the capital account must show an equal net generation of dollar claims against us.

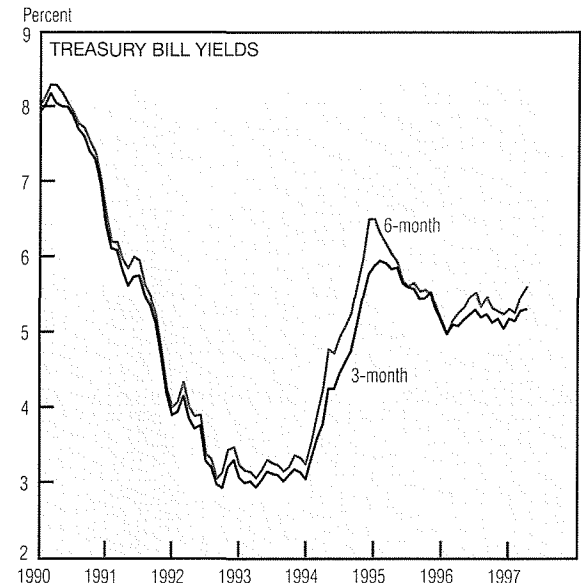
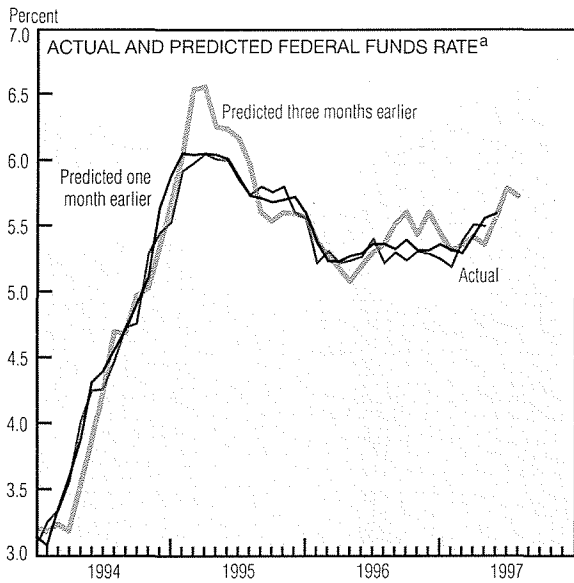
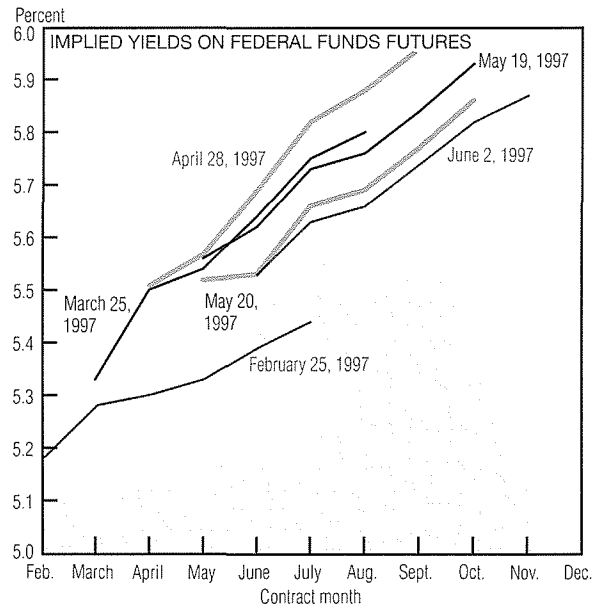
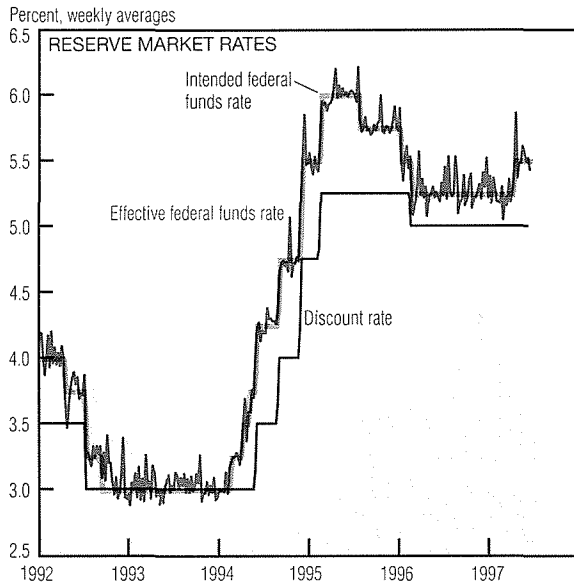
According to popular opinion, international transactions are driven by international trade flows, that is, foreign saving positions adjust passively to accommodate the movement of goods and services. But this need not be so. If foreigners view the United States as a safe haven for their investment funds and have confidence in the purchasing power of the dollar, they may be willing to slow their consumption and place some of their savings in the debt and equity offerings of U.S. businesses, and in U.S. Treasury instruments. A strong demand for these investment vehicles will strengthen the dollar's value in foreign exchange markets, which in turn will lower the import price of foreign goods and services in dollar terms. Through this channel, the capital account can actually drive the current account.

The U.S. international investment position, which indicates our net creditor/debtor status, represents the sum of all past current account balances (plus adjustments for changing asset values). In 1982, the U.S. current account began a shift into the deficit position that has continued to the present day. Consequently, our international investment position, which had been registering around 10 to 15 percent of GDP between 1978 and 1983, began to reverse. In 1995, our net foreign indebtedness reached nearly \$1 trillion, or 11 percent of GDP.

This means that foreign residents are enabling Americans to invest and to consume at a greater pace than otherwise would have been possible. Without the net savings inflow, U.S. interest rates certainly would have been higher during this extended period, as the demands for consumption and investment competed for the more limited pool of domestic savings. Had we saved more in response to higher interest rates, consumption would have been curtailed. During the past few years, net foreign investment coming into the United States has accounted for more than half of all domestically generated personal saving and for about 13 percent of gross domestic investment.

So the next time you purchase an imported car from Japan, coffee from Brazil, or toys from China, silently thank the people of those countries for their willingness to delay their gratification. They are partners in America's future, and they have \$1 trillion worth of reasons to hope that our good fortune continues.

Monetary Policy



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

At its May 20 meeting, the Federal Open Market Committee (FOMC) decided to maintain the existing degree of pressure on the federal funds rate, expecting it to remain around 5.5%. The rate was last increased 25 basis points to its current level at the March 25 meeting, after staying unchanged for nearly 14 months. Financial markets, as represented by the federal funds futures market, had been anticipating another rate increase of 25 points by July, and many market participants had expected an uptick to be announced at the FOMC's May meeting.

The implied yields on federal funds futures prices are reasonably unbiased predictors over horizons of three months or less. The rather abrupt shift in implied yields following the May meeting suggests that the FOMC's decision was a surprise to some. Since then, expectations of a rate increase have shifted outward, and financial markets now expect a 25-basis-point rise by September. The FOMC will reconvene July 1.

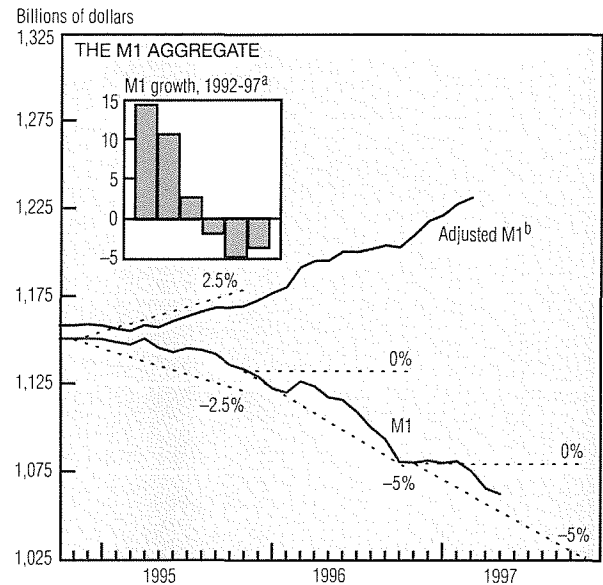
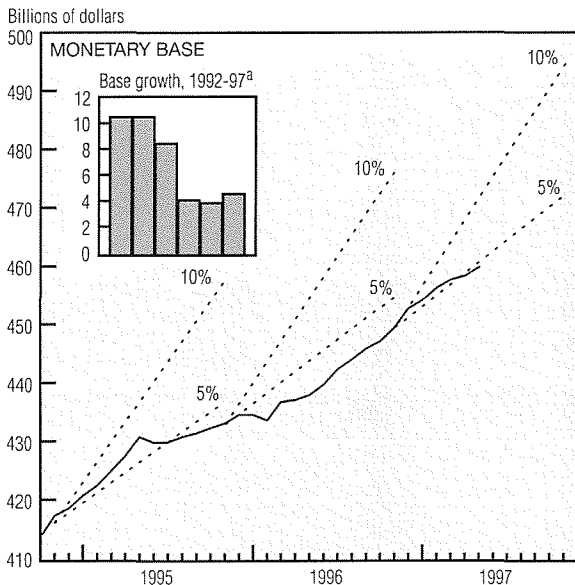
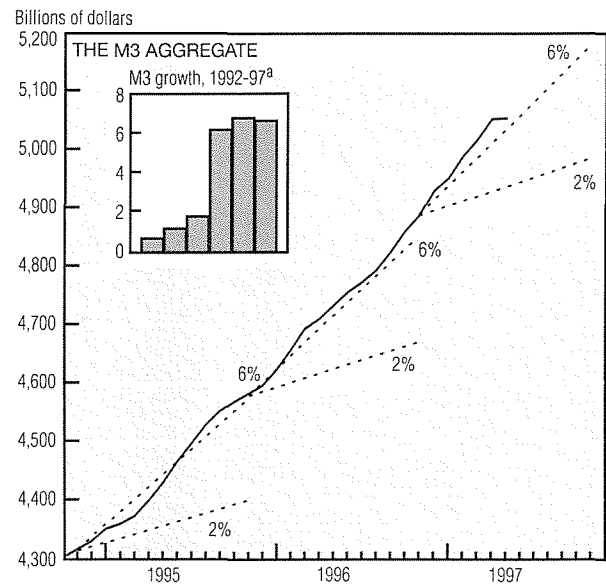
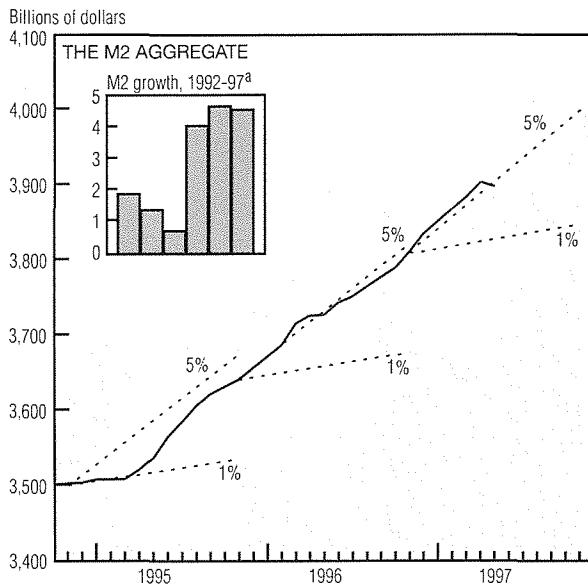
Treasury bill yields have edged up since the beginning of the year, with the 3-month and 6-month yields standing at 5.3% and 5.6%, respectively. This is above levels

seen in the second half of 1992 and in 1993, but well below those that prevailed early in the decade.

The M2 and M3 aggregates decelerated noticeably from the end of April through the first few weeks of May. This brought M2 growth below its provisional range of 5%, which was announced in February during Chairman Alan Greenspan's semi-annual report to Congress (the Humphrey-Hawkins testimony). Although the M3 aggregate has slowed significantly since April, it continues to exceed its provisional range of 6%. The 1997 annualized growth rates for

(continued on next page)

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 May over 1996:IVQ basis.

b. Adjusted for sweep accounts.

NOTE: All data are seasonally adjusted. Last plot is estimated for May 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.

M2 and M3 are currently 4.5% and 6.6%, respectively. Just last month, annualized growth rates stood at 5.8% for M2 and 7.9% for M3.

The deceleration resulted from the settling of tax liabilities that were due in April. The recent bull market in stocks, which created a windfall for investors in 1996, forced them to build up payments accounts early this year to cover larger-than-normal tax bills. The March federal funds rate increase, combined with the release of deposits held to meet tax li-

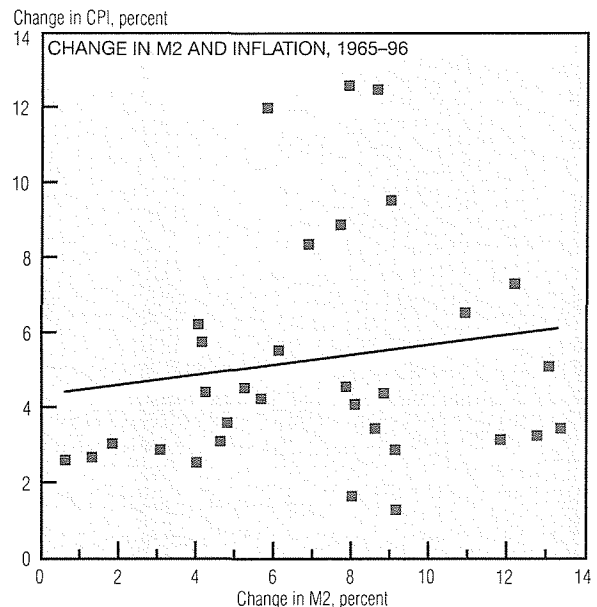
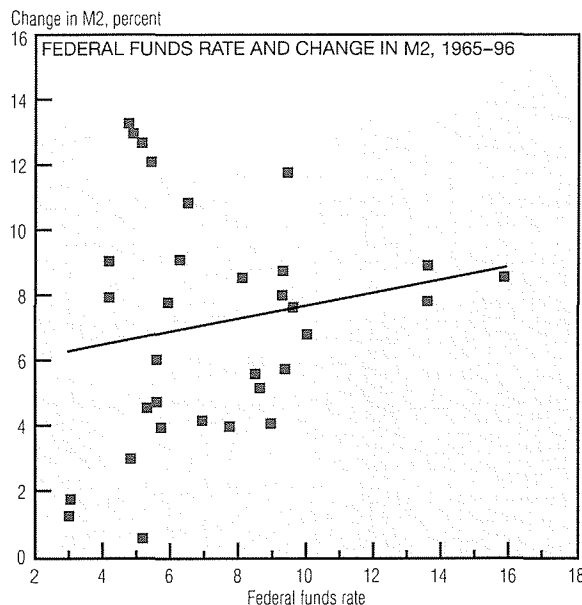
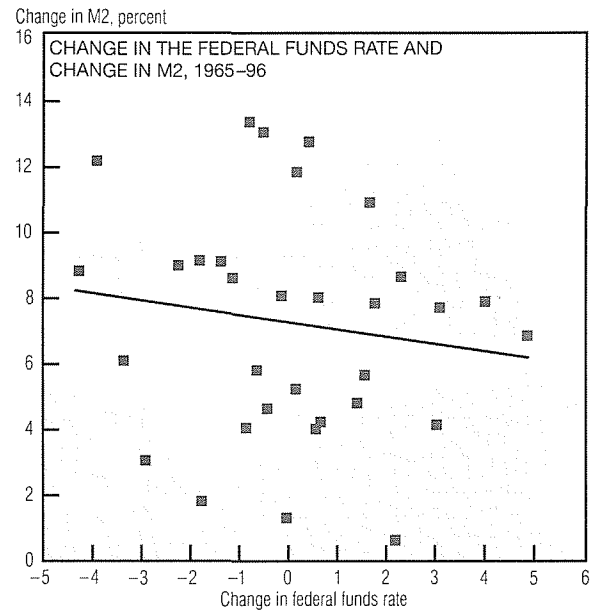
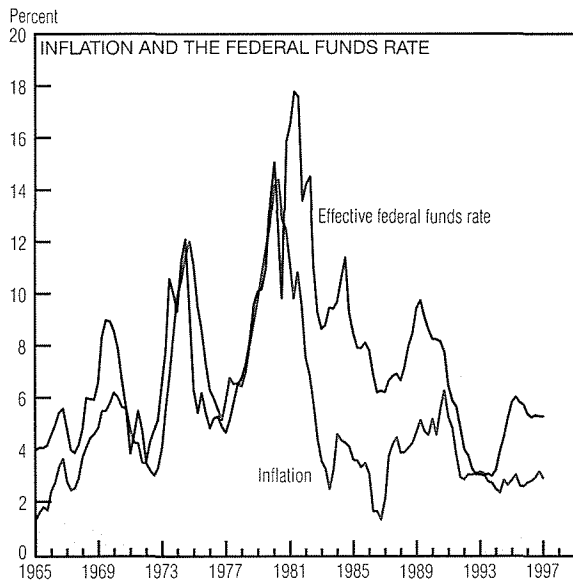
abilities, should allow M2 growth to finish the year within its provisional range and should help bring M3 growth more into line with its provisional range.

Growth in the monetary base, a narrower measure consisting of currency held by the public plus bank reserves, slowed from a 4.6% annualized rate in April to May's 4.5% rate. The M1 aggregate continues to fall at a 3.4% annualized rate. The stabilization of M1 between 1996:IVQ and 1997:IQ convinced

many that sweep accounts were becoming saturated. However, money market deposit accounts (MMDAs) continue to grow with the proliferation of sweep accounts. These allow banks to economize on reserve balances by "sweeping" excess household checkable deposits (which are reservable) into MMDAs (which are not). These arrangements account for the continued unexpected strength in MMDAs and the weakness in M1, which includes checking

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Monetary Policy (cont.)



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

accounts but not MMDAs. When adjusted for sweep accounts, M1 continues to rise.

It is generally believed that the federal funds rate must be increased if inflation is to be lowered. Yet the correlation between inflation and the funds rate is positive, suggesting a more complicated connection. The reasons for this positive relationship are that the federal funds rate is also positively related to money (M2) growth—and faster money growth is a causal factor in future inflation.

How, then, can increasing the federal funds rate lower inflation? The

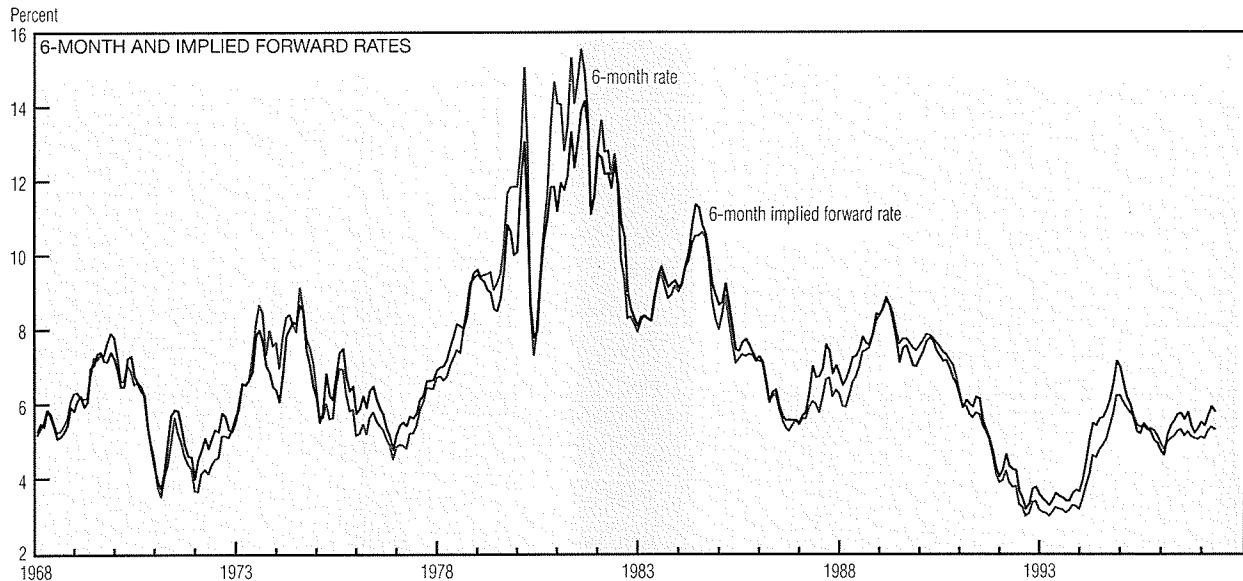
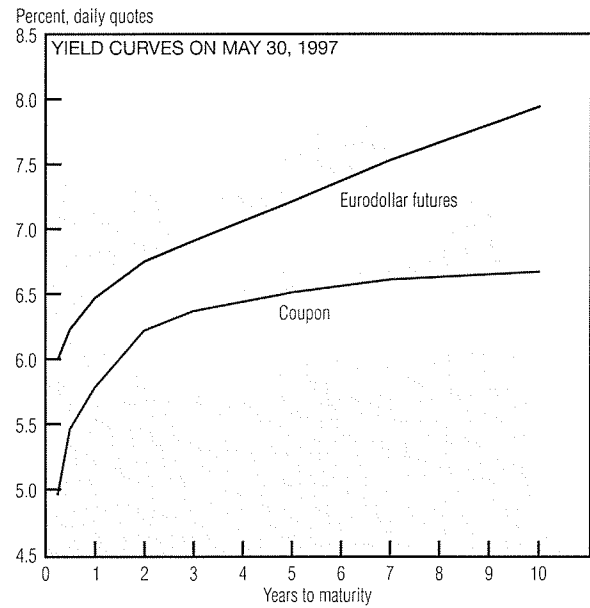
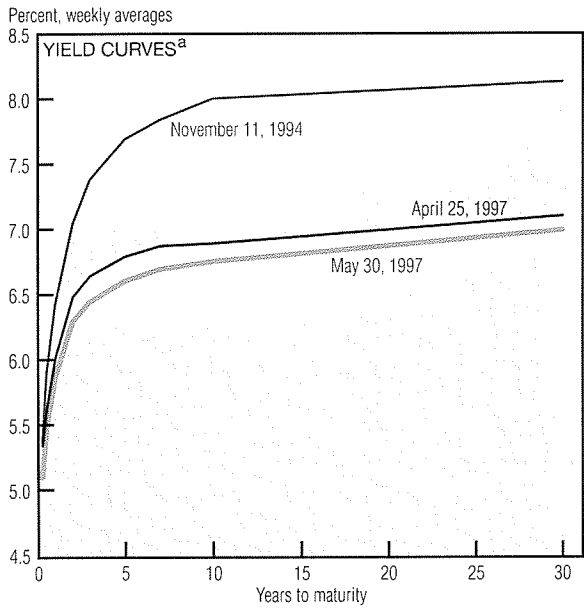
answer is that while the level of the funds rate is associated with high inflation, increases in this interest rate are associated with lower M2 growth. Although raising the funds rate lowers inflation, once inflation has decreased, the funds rate must be brought back down.

Like all nominal interest rates, the federal funds rate consists of both a real rate and an expected inflation component. In the short term, expectations are fixed, and the monetary authority controls the funds rate by changing the real rate. To increase the real—and hence the nominal—funds rate,

money growth is slowed, which brings down inflation.

Yet, in the long term, everything is reversed, since ultimately the only way the monetary authority can control the funds rate is by changing expected inflation. Therefore, to permanently reduce inflation, the monetary authority should follow the initial round of tightening with reductions in the funds rate, as inflation starts to fall. The timing of these subsequent reductions is crucial: If they are not anticipated, money growth will increase, undermining policymakers' anti-inflation efforts.

Interest Rates



a. All instruments are constant-maturity series.

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

Since April, interest rates have shifted downward. The bellwether 30-year rate dropped below 7%, and shorter rates responded similarly. Between April and May, the yield curve also steepened somewhat, with the 3-year, 3-month spread widening from 130 basis points to 135, and the 10-year, 3-month spread moving from 155 basis points to 166.

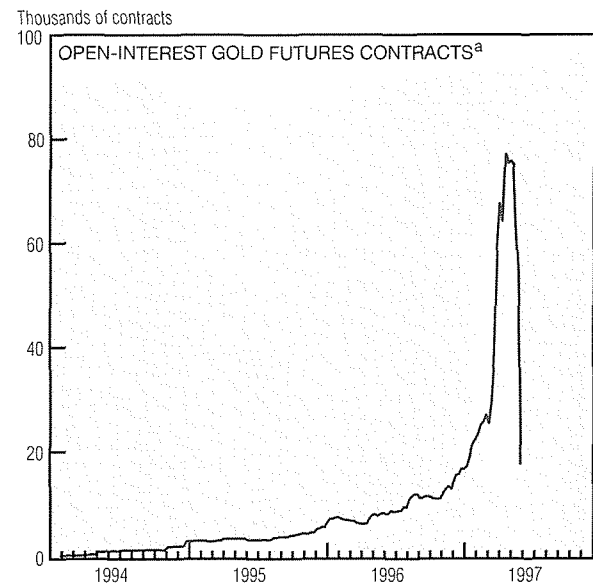
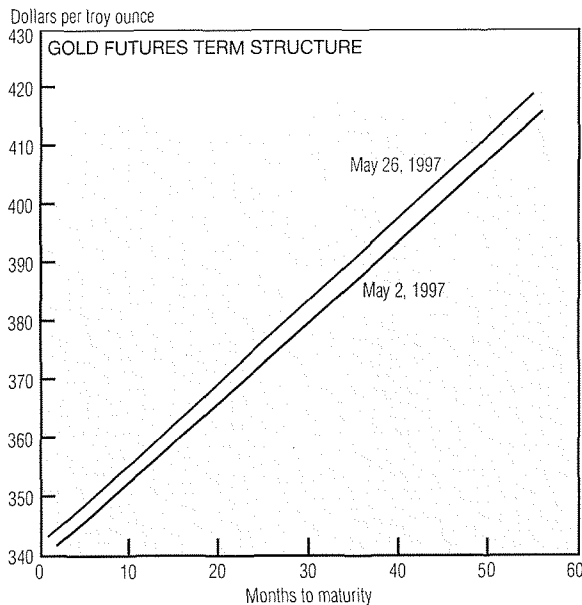
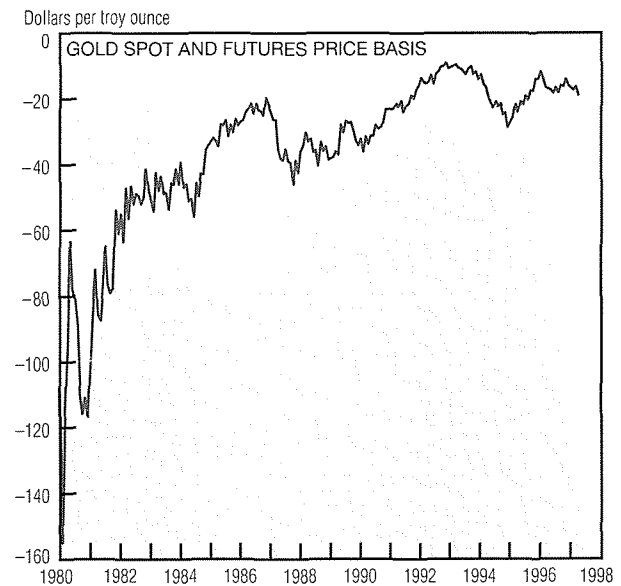
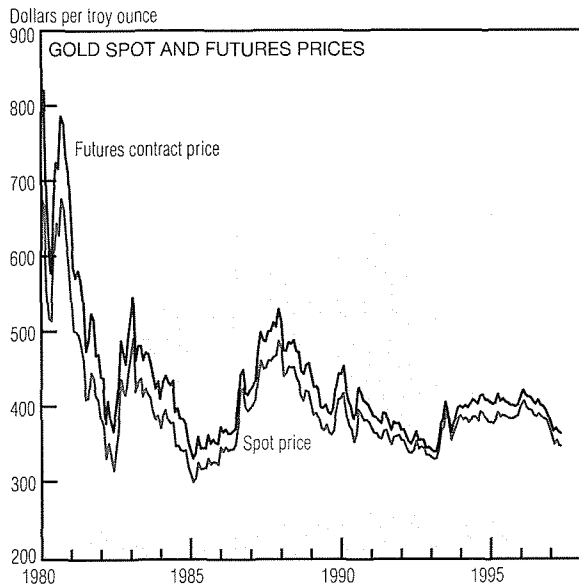
Although these spreads remain higher than average, they are still well below those of November 1994, when they stood at 202 and

264 basis points, respectively. An alternative yield curve, Eurodollar futures contracts, shows a different aspect of the market. Based on the London Interbank Offered Rate, which includes default risk, this alternative is higher than the Treasury yield curve. It is also steeper, with a 10-year, 3-month spread of 194 basis points.

The expectations hypothesis tries to explain the yield curve as an average of today's short rate and *expected* future short rates. If this is so, the yield curve should predict

future short rates. The expected future interest rate derived in this manner is called the *implied forward rate*. As a predictor of future rates, the 6-month implied forward rate does not do so well. Generally, the forward rate rises with current rates rather than with future rates. This suggests that long-term bonds pay high rates, not because rates are expected to rise in the future, but because the return to holding bonds is high. For example, people may demand such long-term bonds for retirement or college tuition.

Gold Markets



a. Contracts are for July 1997.

SOURCES: DRI/McGraw-Hill; and *The Wall Street Journal*, various issues.

Having long ago settled down after the turmoil of the early 1980s, gold prices have continued to decline steadily from their recent peak of February 1996, as have prices on the futures market. The difference between the spot and futures price, called the basis, has shown less movement (as expected), although the futures price has exceeded the spot price by a wider margin since late 1996. Normally, the ease of storage and large outstanding stock of gold make it a full-carry market, that is, one in which the futures price equals the spot price plus the cost

of carry (storage and financing). This implies that futures prices exceed spot prices, producing a negative basis, a situation known to futures traders as a contango.

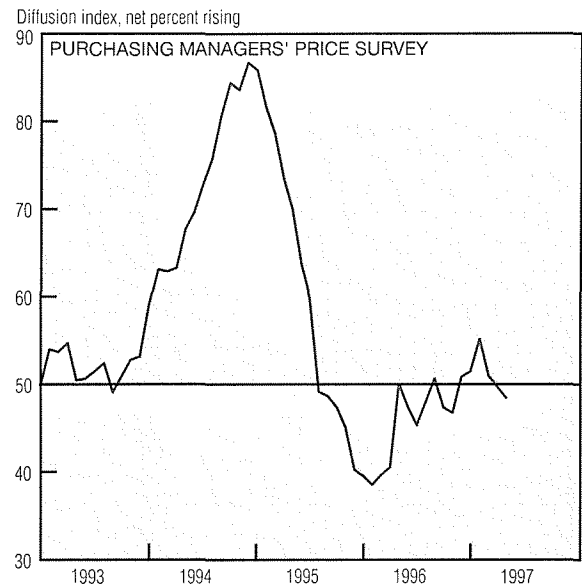
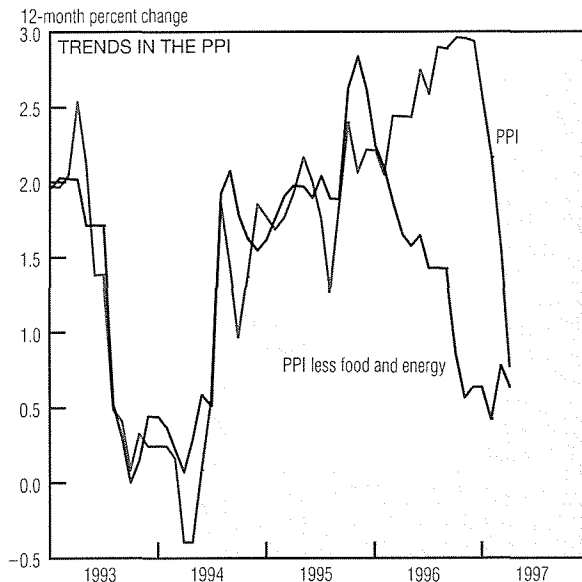
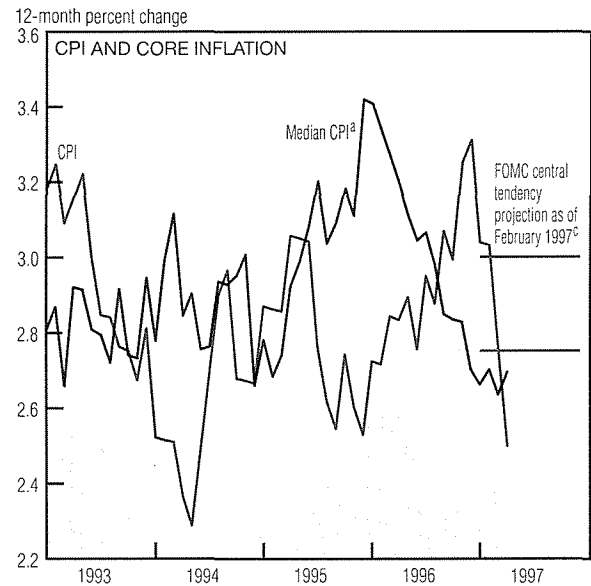
Despite the contango, other gold futures indicate a normal market, where longer futures contracts have higher prices. This term structure of gold futures remains quite linear (compared with that of interest rates) and has recently shifted upward. The shift represents an increase in the spot price of gold since early May, although this is not apparent from the monthly averages of

the first chart. The spot price increase dominated falling interest rates (which reduce the cost of carry, since storage rates are unlikely to change much).

One important measure of activity in any futures market is open interest—the number of contracts for which delivery is obligated. Open interest builds slowly, reaching its peak about three months before expiration of the contract for delivery in July 1997. The decline occurs when traders close out their positions to avoid taking delivery.

Inflation and Prices

April Price Statistics	Annualized percent change, last:				1996 avg.
	1 mo.	4 mo.	12 mo.	5 yr.	
Consumer Prices					
All items	0.8	1.5	2.5	2.8	3.3
Less food and energy	3.6	2.7	2.6	2.9	2.6
Median ^a	3.6	3.0	2.7	2.9	2.7
Producer Prices					
Finished goods	-7.0	-4.0	0.8	1.4	2.9
Less food and energy	-1.7	0.2	0.6	1.3	0.6
Commodity futures prices^b					
	-4.1	2.3	-5.2	3.4	-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; National Association of Purchasing Management; and the Commodity Research Bureau.

Retail prices inched up in April at an annualized 0.8%, while wholesale prices actually declined 7.0%. Indeed, the April numbers extend the generally moderate growth rate of prices seen since the beginning of the year. Year to date, the Consumer Price Index (CPI) is up an annualized 1.5%—less than half its 1996 average increase (3.3%).

A substantial share of this year's downward pressure on prices, both retail and wholesale, originated in the highly volatile food and energy areas, both of which showed net

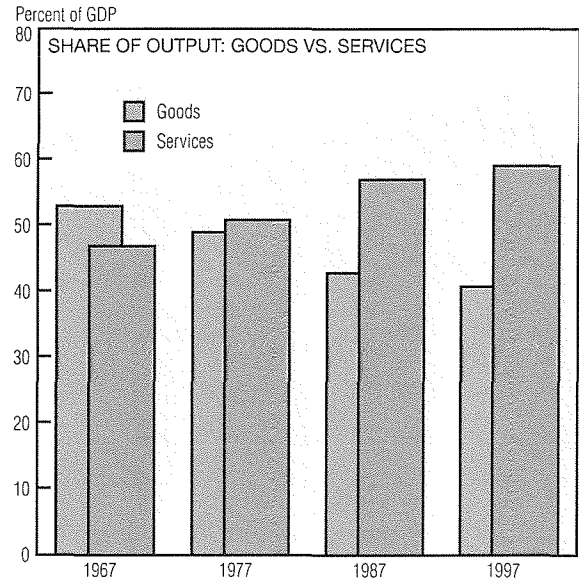
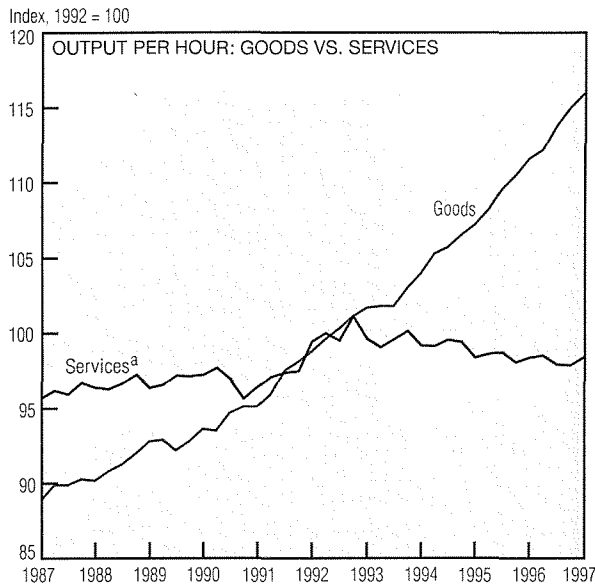
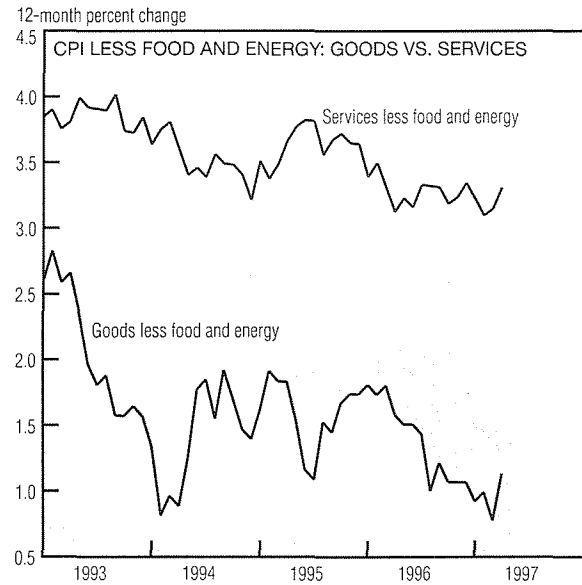
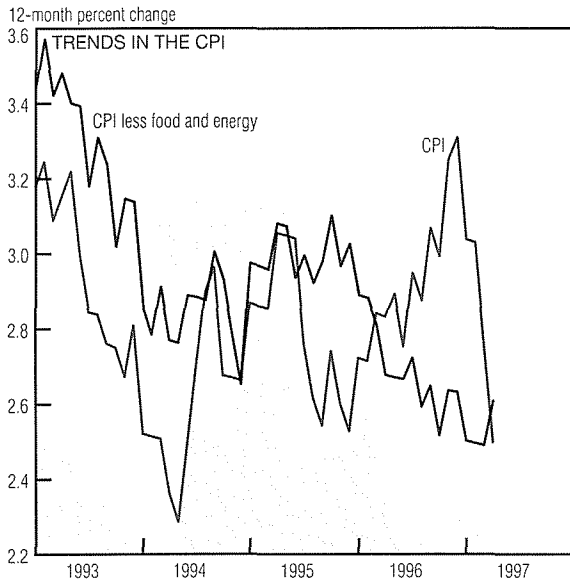
declines during the first four months of 1997. This has obviously been a welcome trend for U.S. households and businesses. Still, the drops in food and energy costs, which will not continue indefinitely, mask the broadly based inflation that the Federal Reserve hopes to control.

It is difficult to gauge the amount of underlying or "core" inflationary pressure in the economy; however, two measures, the CPI less food and energy and the median CPI, are rising at nearly the same pace in 1997 as they averaged in 1996 (around

2.75%). Earlier this year, the Federal Open Market Committee, the chief policymaking arm of the Federal Reserve System, projected consumer price increases between 2.75% and 3% for 1997.

How one judges the economy's inflationary trend depends on one's particular vantage point—price increases in the manufacturing sector seem significantly less than those in the nonmanufacturing economy. Reports from purchasing managers have failed to reveal any net upward
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Inflation and Prices (cont.)



a. Services productivity is output per hour in the nonmanufacturing sector, calculated by Heinemann Economic Research, Great Neck, N.Y.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Heinemann Economic Research.

movement in prices for about two years, and that impression is largely supported by the slight overall rise in the Producer Price Index less food and energy over the expansion. Likewise, price increases for goods continue well below those for services. At the retail level (excluding food and energy), the rise in goods prices has been running several percentage points below that for service prices.

The large discrepancy is something of an enigma for economists—

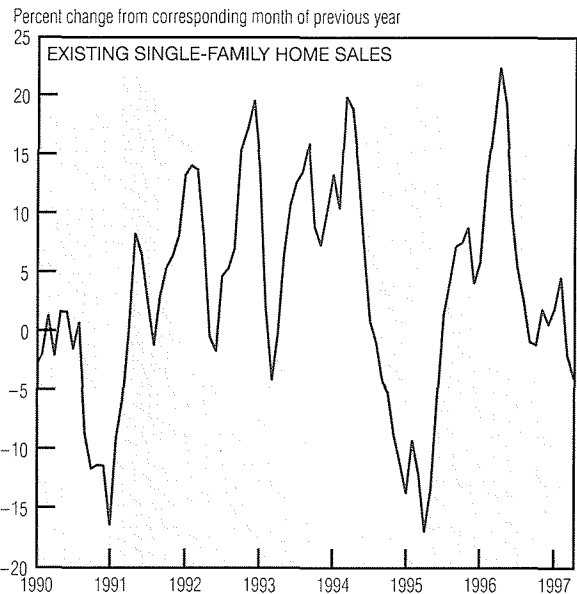
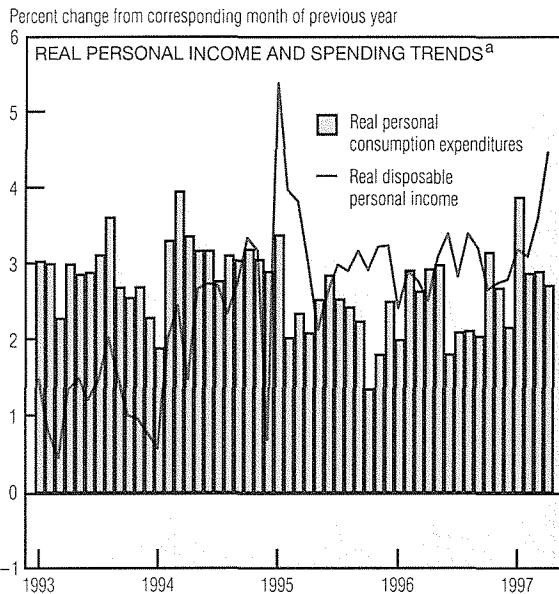
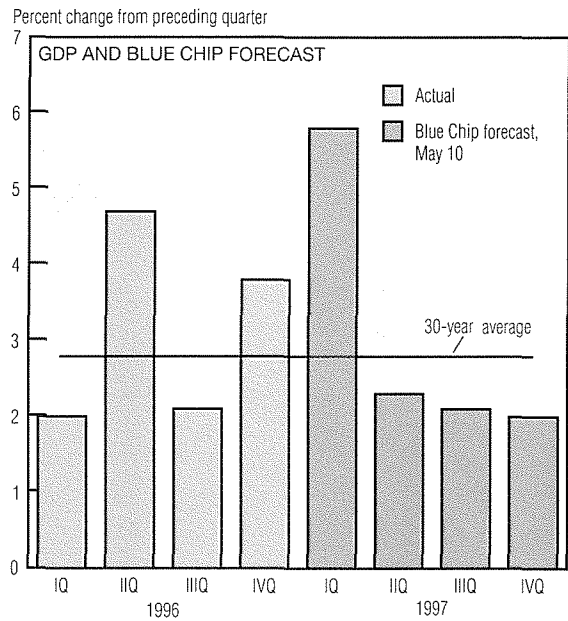
and a problem for policymakers. It may be that the economic fundamentals between these two broad classifications are different, so that goods are actually becoming less expensive relative to services. This difference may also reflect a measurement problem: The price of a good may be much easier to measure than the price of an intangible service. The challenge for policymakers is that if we are overestimating the prices of services, we must be underestimating their production, which suggests that U.S. inflation is

lower—and U.S. growth higher—than the official statistics state.

It is certainly curious that reported productivity in the goods sector continues to show impressive gains, while productivity growth in the service sector has languished. This potential measurement error may represent a growing inaccuracy in gauging U.S. economic performance. Thirty years ago, the service side of the economy accounted for less than 50% of national output; today, that share is almost 60%.

Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	98.8	5.8	4.1
Consumer spending	66.2	5.7	3.2
Durables	28.0	19.4	8.0
Nondurables	17.4	4.9	2.1
Services	21.6	3.3	2.8
Business fixed investment	21.8	11.5	9.5
Equipment	18.9	13.4	9.7
Structures	3.1	6.4	8.7
Residential investment	4.0	5.9	3.5
Government spending	0.2	0.1	1.5
National defense	-8.1	-10.1	-3.4
Net exports	-28.4	—	—
Exports	23.1	11.1	9.8
Imports	51.6	23.3	11.2
Change in business inventories	34.3	—	—



a. Chain-weighted data in billions of 1992 dollars.

NOTE: All data are seasonally adjusted.

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

Preliminary estimates show that the economy grew 5.8% in the first quarter, slightly faster than previously reported. Upward revisions to inventory accumulation and exports partially offset a small downward adjustment to consumer spending. The first quarter's overall strength reflects advances in personal consumption, inventory accumulation, exports, and producers' durable equipment.

Economists participating in the

Blue Chip survey anticipate growth will be approximately 2.3% in the current quarter and will taper off to 2.0% by year's end. Forecasts of economic growth usually revert to a 2% trend—a rate that many believe reflects the economy's underlying growth potential. Recent evidence on labor force participation, capital accumulation, and productivity growth, however, suggests that 2% may be an underestimate. In fact, U.S. economic growth has averaged

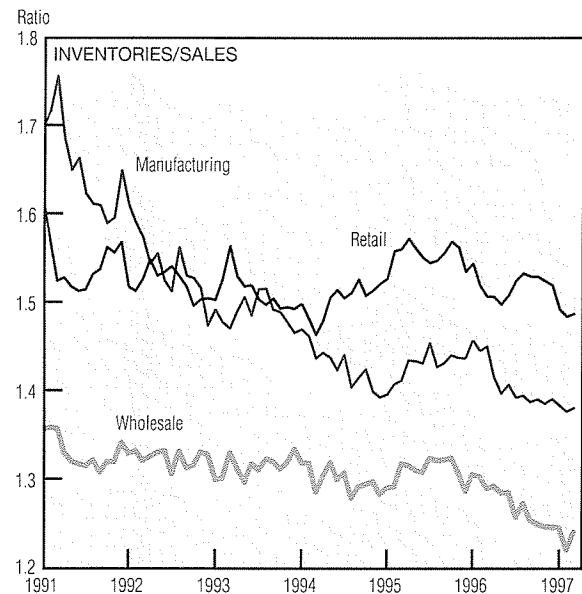
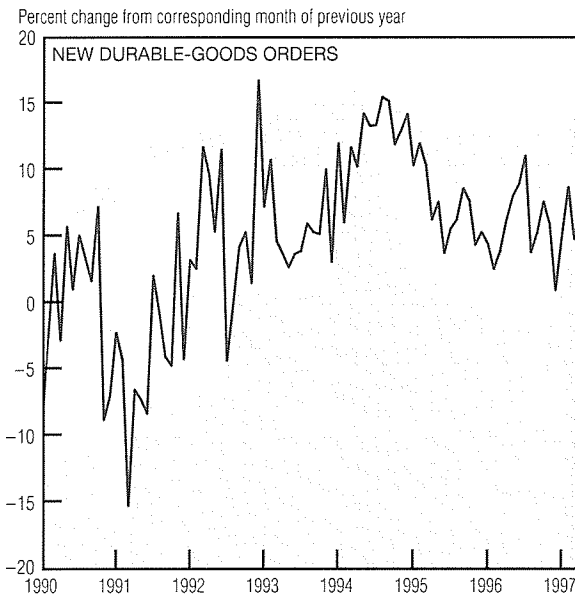
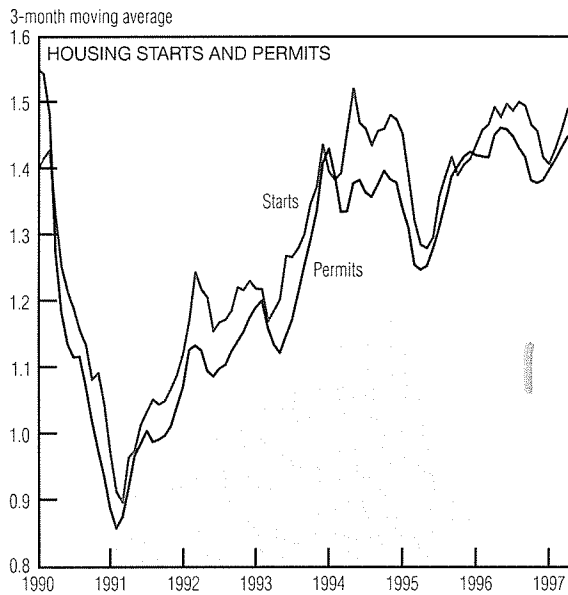
2.8% over the past 30 years.

The consumer sector remained robust in April. Real disposable personal income grew at its fastest year-over-year pace since January 1995 (up 4.5%), while real personal consumption expenditures continued to be healthy.

New single-family home sales plunged 7.7% in April, the biggest drop in six months. Much of this decline came from a 16.5% fall in

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Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of the Census; and Board of Governors of the Federal Reserve System.

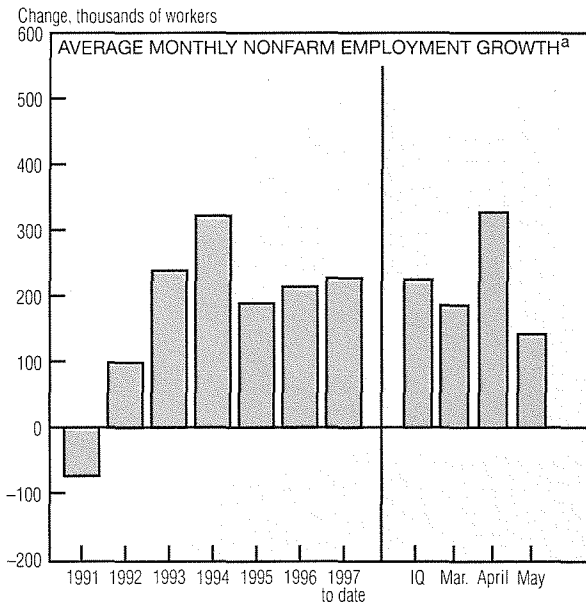
the West. Sales fell 6% in the South and 2.9% in the Midwest, but the Northeast held steady. Sales of existing homes also slipped in April (down 2.4%). In contrast, a surge in construction of multifamily homes pushed housing starts up 2.6% for the month. Both starts and permits have advanced fairly steadily this year and remain vigorous.

Industrial production was unchanged in April because of a sharp decline in motor vehicle and parts production, more than half of which

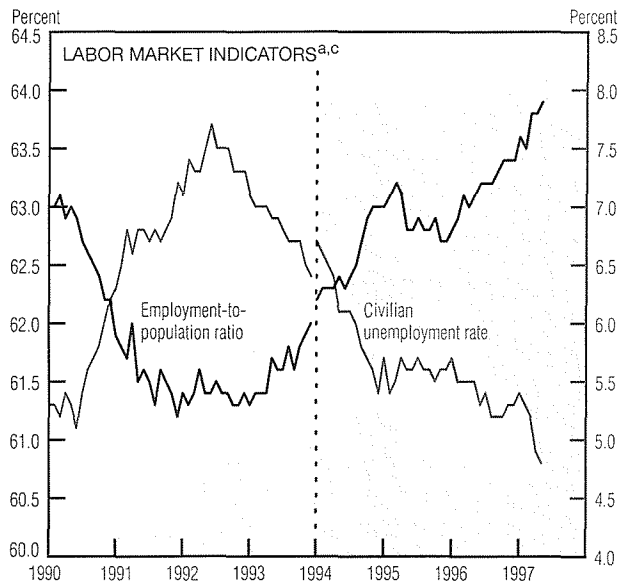
was attributable to strikes. Excluding autos, the index advanced 0.3% for the month, following a 0.5% gain in the overall March index. On a year-over-year basis, industrial production continues to advance at a good clip, with especially strong gains in business equipment. Since December 1996, production of business equipment has advanced 10.2% (annual rate), three times the rate of the overall index. A rebound in transportation helped push April orders for durable goods up 1.3%, slightly

more than many observers expected. This was the third advance in orders in the past four months.

Business inventories grew 0.3% in March, with most of the gains coming at the wholesale level. Contrary to some recent news accounts, an inventory correction does not seem imminent. Inventory-to-sales ratios at the manufacturing, wholesale, and retail levels remain favorable and substantially below the levels of a year ago.

Labor Market Conditions^a

	Average monthly change (thousands of employees)				
	1996	1997			
	Year	IQ	March	April	May
Payroll employment	212	228	182	323	138
Goods-producing	19	43	17	-7	20
Manufacturing	-5	14	14	2	-5
Construction	24	29	5	-10	23
Service-producing	192	185	165	330	118
Services	98	97	85	146	125
Business services	33	47	56	16	8
Retail trade	48	11	23	91	-4
Government	14	10	-2	33	-28
Household employment	232	440	745	209	255
Average for period					
Civilian unemployment rate (%)	5.4	5.3	5.2	4.9	4.8
Manufacturing workweek (hours) ^b	41.5	41.9	42.1	42.1	42.0



- a. Seasonally adjusted.
b. Production and nonsupervisory workers.
c. Vertical line indicates break in data series due to survey redesign.
d. Shares are adjusted for minor discrepancies in reported data.
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Temporary Help Services

Occupation	Share of temporary employment ^d	Average hourly earnings
Total	100	\$ 7.74
White-collar	52	9.37
Professional specialty	3	24.11
Technical	4	12.60
Executive, administrative, and managerial	1	17.22
Clerical and administrative support	41	7.96
Blue-collar	42	6.02
Machine operators, assemblers, and inspectors	11	6.26
Service	5	6.28

Nonfarm payrolls grew by 138,000 in May, a smaller-than-expected gain that masked an otherwise robust labor market. The weak performance was due in part to substantial upward revisions in the March and April employment figures. Meanwhile, the unemployment rate continued its downward trend, falling from 4.9% in April to 4.8% last month—the lowest level since October 1973. The employment-to-population ratio edged up 0.1% over the same period, to a record high of 63.9%, and average hourly earnings

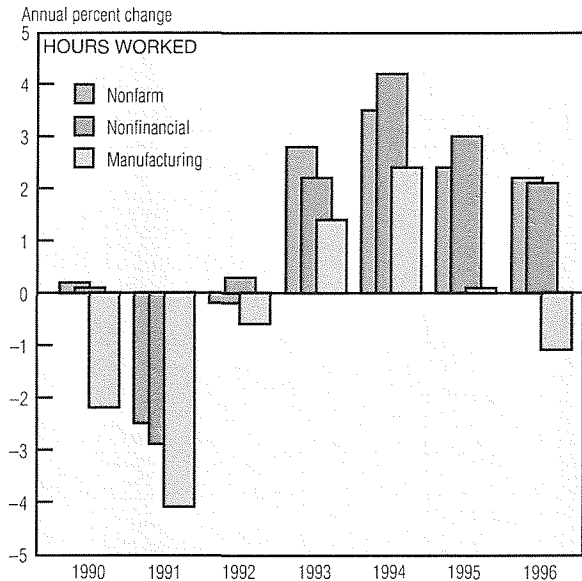
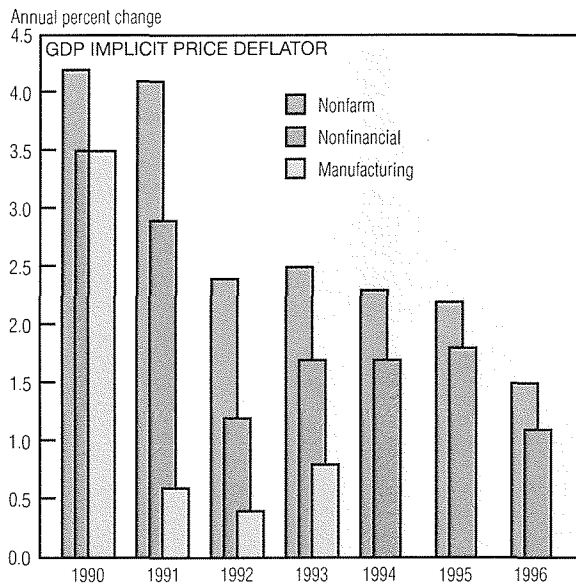
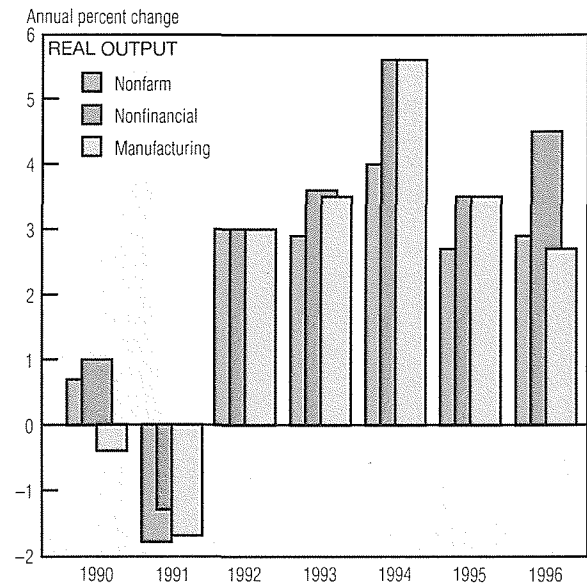
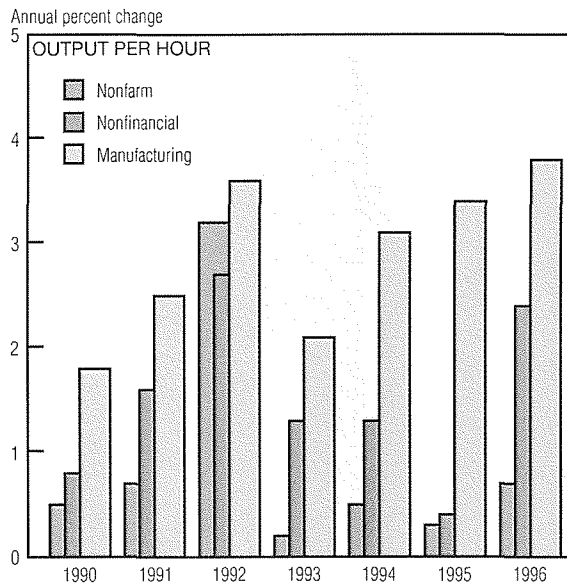
rose 4 cents to \$12.19, 3.8% above last May's level.

The goods-producing sector added 20,000 new jobs in May, more than offsetting April's 7,000 loss and eclipsing March's 17,000 gain. The construction industry also fared well, picking up 23,000 jobs. Once again, however, the service-producing sector led the nation's overall employment growth, adding 118,000 new jobs in May. The most notable gain came in the narrow services category, which added 125,000 workers to its payrolls. In

contrast, government trimmed its workforce by 28,000 last month, with declines concentrated primarily at the state (-13,000) and federal (-11,000) levels.

Over the last few years, temporary help services have experienced a prolonged boom in employment. The recent tightness in the labor market appears to have turned this around, however. In April, 38,000 temporary positions were eliminated, and in May, 17,000 more were cut.

Labor Productivity



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

Growth in labor productivity (typically measured as real output per hour of work) is critical to economic health because it is the primary source of real wage growth. Unusually strong output (GDP) in the first quarter of 1997 led to a 2% increase in nonfarm business productivity, the largest of the last three years. Nonfarm business productivity has inspired some controversy because, unlike less closely followed measures, it has shown little annual growth throughout this recovery.

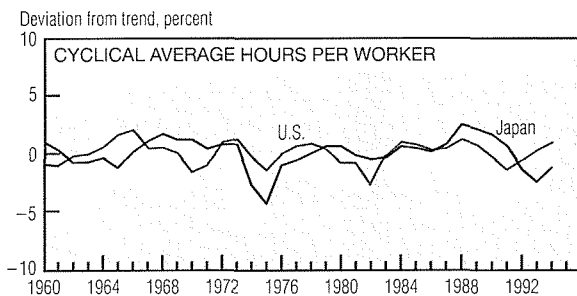
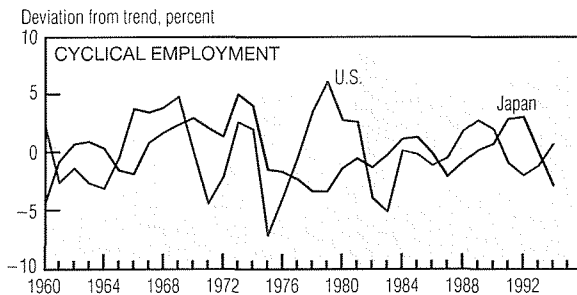
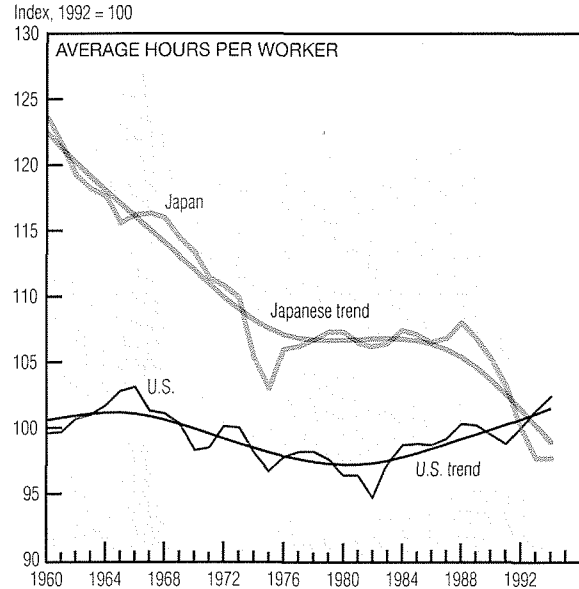
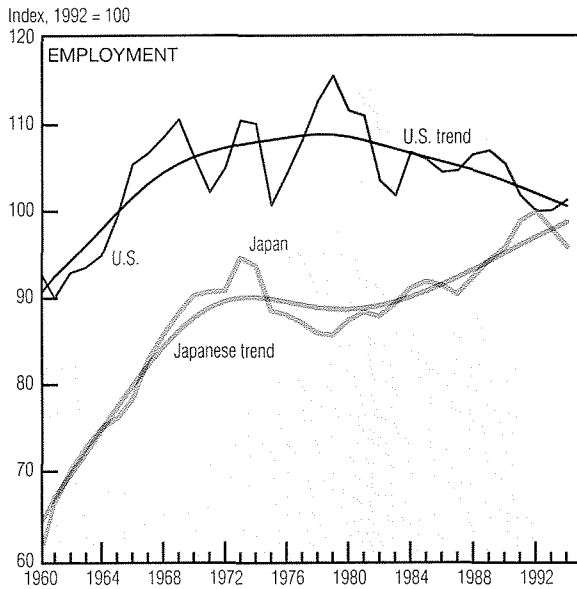
The nonfinancial business productivity series differs from the nonfarm series primarily because it is based on the income rather than the output side of the National Income and Product Accounts. Such differences are unexpected: In theory, the two sides of the account should balance.

Nonfinancial productivity growth has led nonfarm business productivity growth because the numerator of the former—measured real income growth—has exceeded the numerator of the latter—measured real

output growth. When the income-based measure is used, a substantial fraction of the higher income results from lower implied inflation rates.

Manufacturing, where productivity is easier to measure, has shown consistently stronger growth, supported mostly by slower increases in labor input, which enters as the denominator. The implied inflation rate for manufacturing, available only through 1993, has also been persistently lower than that of the economy as a whole.

Employment Variability



Cyclical Behavior of Manufacturing Sectors, 1960-94

(Standard deviation, percent)

	Total hours	Employment	Hours per worker
U.S.	3.6	3.1	1.0
Japan	2.7	2.2	1.4
Belgium	2.8	2.5	1.4
Denmark	3.4	3.2	1.3
France	2.1	1.6	0.9
Germany	3.0	2.8	0.9
Italy	3.2	2.7	1.5
Netherlands	2.3	2.3	1.1
Norway	2.2	2.1	0.9
Sweden	3.0	3.0	1.0
U.K.	3.5	3.0	1.0

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

Conventional wisdom says that Japanese workers tend to experience less volatility in employment than do Americans, partly because many workers in Japan's largest firms have what amounts to a lifetime employment contract. One might expect, then, that total employment over the business cycle would vary less in Japan than in the U.S., and that Japanese firms would respond to cyclical fluctuations with larger changes in hours per worker.

Data for manufacturing employment and hours per worker show

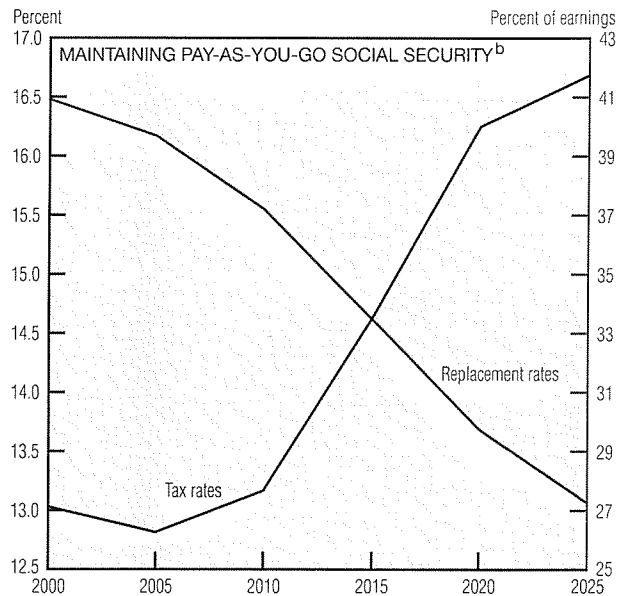
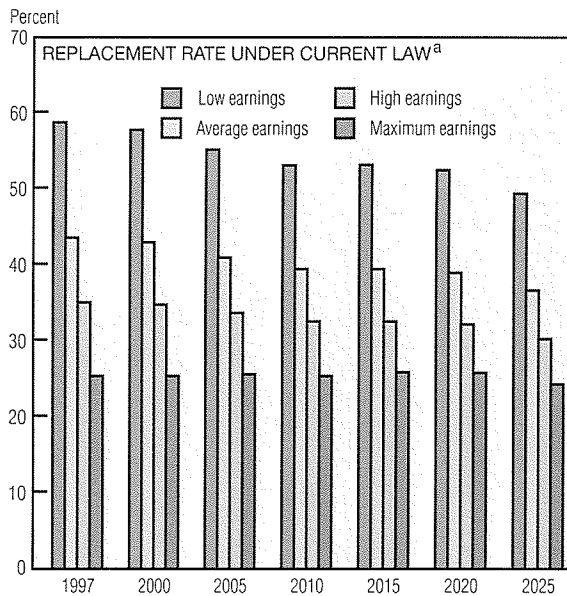
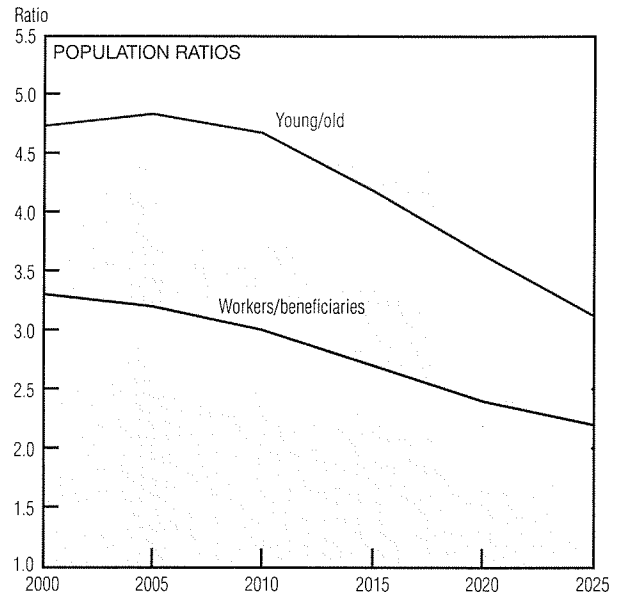
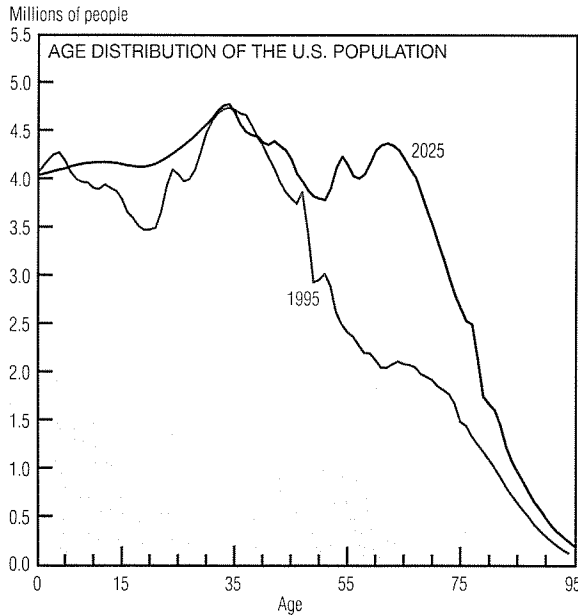
that employment does indeed vary less around its long-run trend in Japan than in the U.S., and hours per worker vary more. These effects do not cancel each other out, and total manufacturing hours per year vary substantially less in Japan.

There are also several reasons to expect employment to be less variable in Europe than in the U.S. Many European countries have regulations, such as relatively large legislated severance payments and laws restricting plant closings, that make it costly for firms to adjust the num-

ber of workers they employ. In addition, the unemployment insurance systems of several European countries encourage firms to reduce hours per worker instead of laying off employees.

Again, manufacturing data show that employment varies less around its long-run trend in most of Europe than in the U.S. Although hours per worker vary more in some European countries, the U.S. has the greatest variability in total manufacturing hours.

Social Security—A Problem



a. Percent of annual earnings replaced by Social Security benefits.

b. Indicates the tax rates or benefit reductions required to maintain pay-as-you-go Social Security.

SOURCE: 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., April 24, 1997.

Demographic projections indicate that the number of elderly retirees will grow sharply by 2025, but the number of young, working-age individuals will increase only slightly. This implies a steep decline in the ratio of contributing workers to retired beneficiaries in the Social Security system—from 3.3 today to 2.2 by 2025. Such a sharp swing in the proportion of workers to beneficiaries will devastate a pay-as-you-go system in which workers' contributions are immediately

and directly transferred to retirees as benefits.

When we have fewer workers per beneficiary, we will need either a tax increase or a benefit cut to preserve the solvency of pay-as-you-go Social Security. With 3.3 workers per beneficiary, a payroll tax rate of 12.4% produces enough annual revenue to replace 41% of annual earnings with retirement benefits. If the ratio falls to 2.2, a 12.4% tax rate would replace only 27.3% of annual earnings. Maintaining the replacement rate at 41%

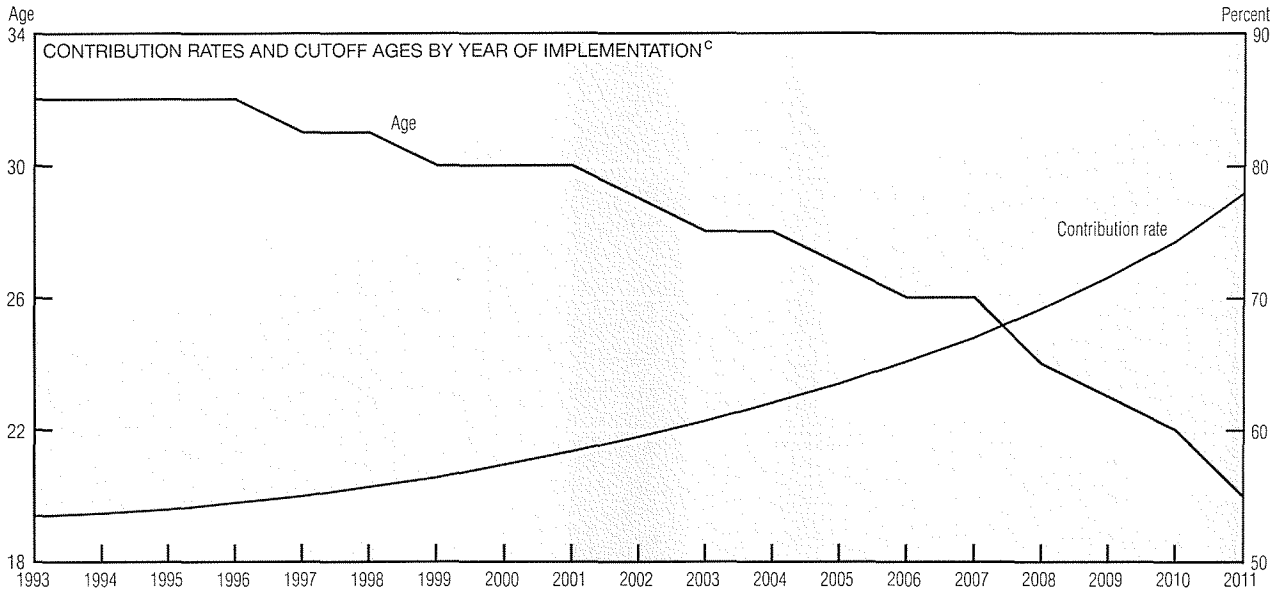
would require a payroll tax rate of 18.6%—1.5 times the present rate.

Under current rules, the replacement rate is already projected to decline for all income groups. For individuals with average earnings, it will fall from 44% today to about 37% by 2025. Thus, to preserve benefit levels under the pay-as-you-go structure of Social Security, payroll tax rates must gradually rise to about 16.7% by that year. Payroll tax rates would have to increase 2.2 percentage points now to maintain the system's long-term solvency.

Social Security—A Solution

Rate of return on private capital	Benefit discount rate			
	5%	6%	7%	8%
6%	26	26	26	27
7%	30	29	29	30
8%	33	32	32	32
9%	35	34	34	34
10%	37	36	36	36

Rate of return on private capital	Benefit discount rate			
	5%	6%	7%	8%
6%	51	49	50	50
7%	50	47	47	46
8%	50	46	45	44
9%	50	46	44	43
10%	51	46	43	42



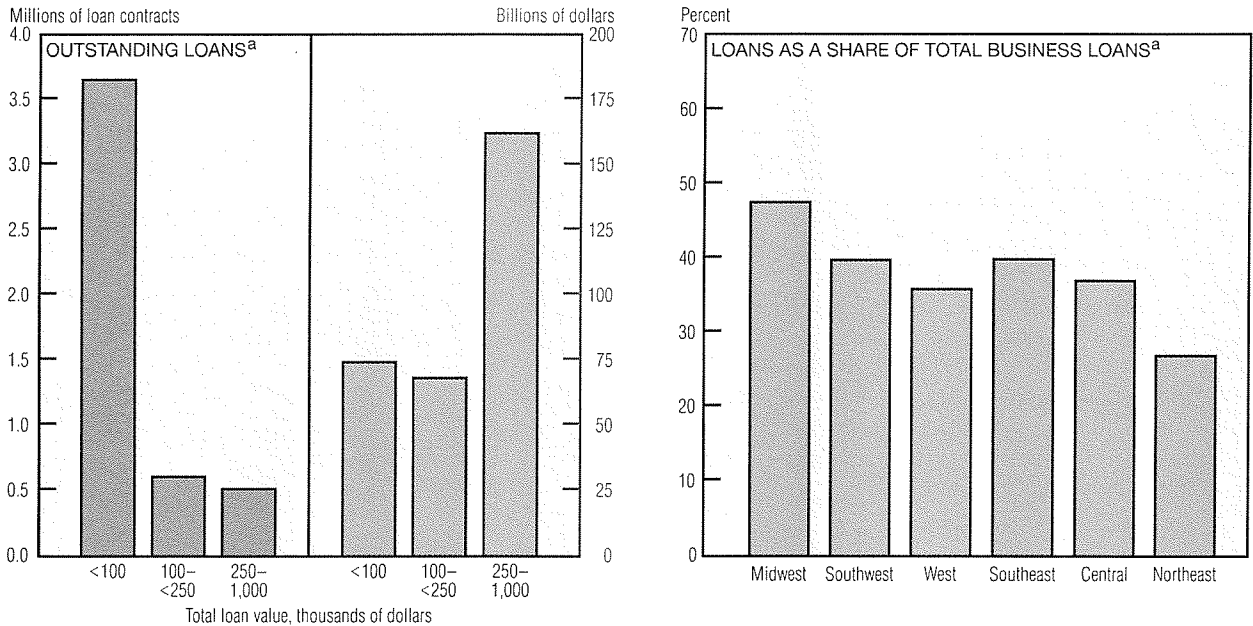
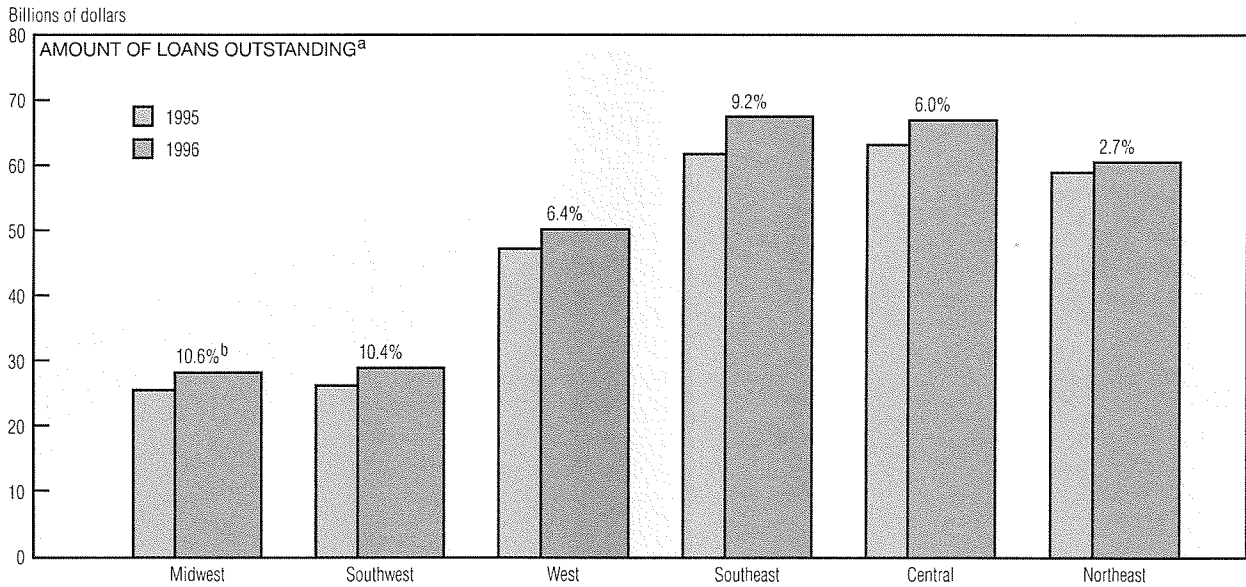
a. Maximum age for shifting workers to the proposed plan.
 b. Indicates the percent of contributions of those shifted that can be invested in private capital markets.
 c. Shows the contribution rate and tax rate necessary to fulfill the current system's liabilities.
 SOURCE: David Altig and Jagadeesh Gokhale, "Social Security Privatization: One Proposal." The Cato Project on Social Security Privatization, SSP No. 9, Washington, D.C., May 29, 1997.

Raising taxes and cutting benefits are politically unpopular options for restoring solvency to the Social Security system. Tax hikes would increase disincentives to work and save. Benefit cuts would be unfair to those who have worked and saved with the expectation of receiving current levels of benefits. There is, however, a third option that would retain the benefits of retirees and older workers, and impose no higher taxes on young and future generations. It would also make Social Security sustainable and provide the present level of benefits to young and future work-

ers. This plan involves gradually investing current contributions in private capital markets. Assuming reasonable private market rates of return (8%) and benefit discount rates (6%), calculations suggest that workers 32 and younger could shift to a privatized system. Of their total contributions, 46% could be deposited in privately managed accounts. The remainder could be used to pay off the old system's liabilities—benefit obligations to those older than 32. This reform would gradually eliminate the current system's work and saving disincentives and improve

output growth. Because it would preserve the benefits of the elderly without increasing the tax burden on the young, it should be politically feasible. Moreover, because it would generate greater retirement income for young and future generations, it would be economically sustainable. The window of opportunity for such a reform is narrow, however. Waiting even a few years to implement it would require lowering the cutoff age and increasing the share of young people's contributions needed to pay off the current system's liabilities to older generations.

Small Business Lending



a. Small business loans secured by nonfarm, nonresidential properties plus commercial and industrial loans to U.S. addressees. Small business loans are those for \$1 million or less.
 b. Percent changes represent the year-over-year growth in small business loans outstanding.
 NOTE: All data are for FDIC-insured domestic commercial banks.
 SOURCE: Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income*, June 1995 and 1996.

Between June 1995 and June 1996, small business lending grew a healthy 6.9% nationwide, to \$301.8 billion outstanding. Loan growth was robust in all regions although, as in the past, the Northeast (2.7%) lagged somewhat behind the rest of the nation. The region's weaker performance may partially reflect the fact that small business lending is a less important component of total business lending there. Nevertheless, even this small gain was

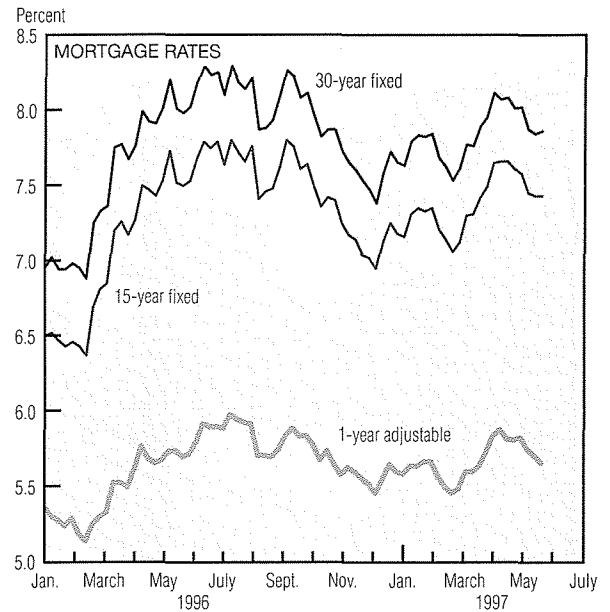
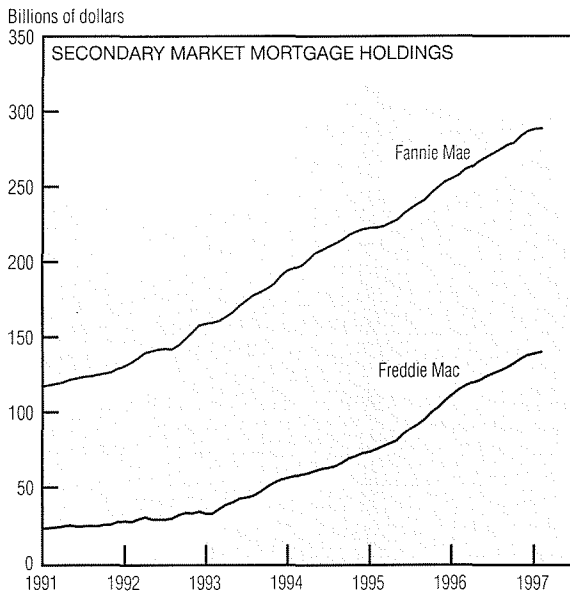
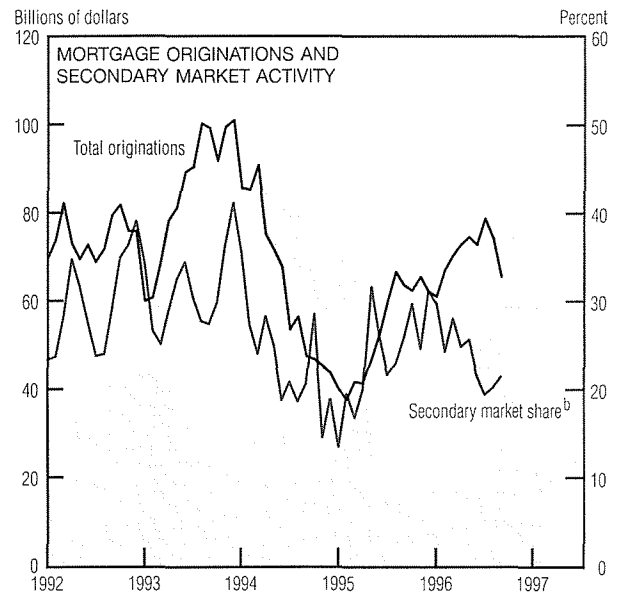
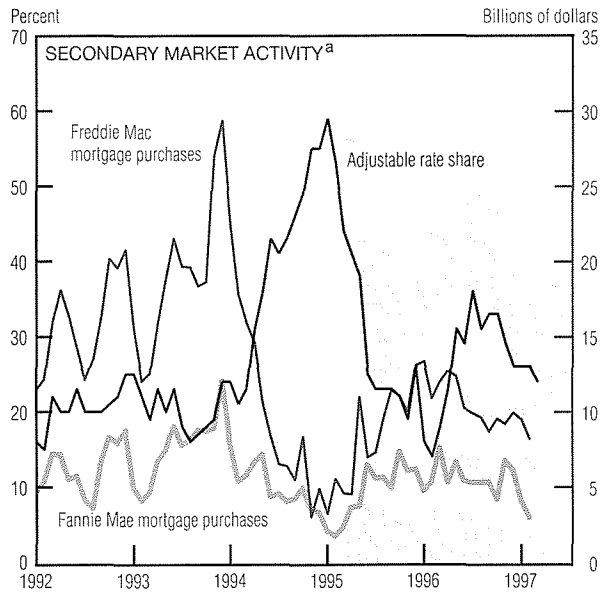
notable following the 13.9% decline a year earlier.

As in the past, the total dollar volume of small business lending was lowest in the Midwest in 1996 (only \$28.1 billion), yet such lending constitutes a much larger share of overall business lending activity in this region (47.3%) than it does in other parts of the country. In contrast, small business lending in the Northeast represents a relatively minor fraction of its total business lending (26.6%), even though the region

was third largest in terms of total dollar volume of loans in 1996 (\$60.5 billion).

The composition of small business lending held relatively constant in 1996. As formerly, the vast majority of contracts were for amounts of less than \$100,000 (77.0%, slightly above the 1995 figure of 76.8%). At the same time, loans that exceeded \$250,000 still accounted for more than half of all dollars committed to small business lending.

Secondary Mortgage Market Activity



a. Purchase data include conventional and government-insured mortgages. Adjustable rate share is the percent of new conventional mortgage originations with adjustable rates.

b. Represents secondary market purchases by Fannie Mae and Freddie Mac as a fraction of total mortgage originations.

SOURCES: Board of Governors of the Federal Reserve System; Office of Thrift Supervision; U.S. Department of Housing and Urban Development; and *Bank Rate Monitor*, various issues.

Mortgage originators tend to sell their fixed-rate loans to secondary-market agencies, while holding adjustable-rate mortgages in their portfolios. As a result, secondary market activity generally drops off when adjustable-rate mortgages gain popularity.

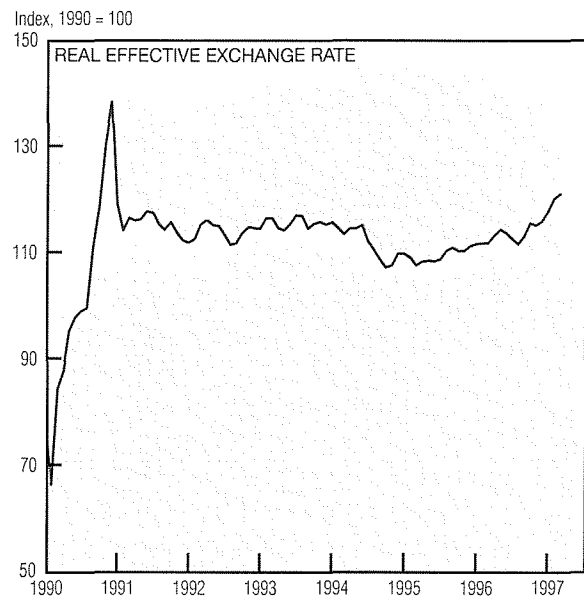
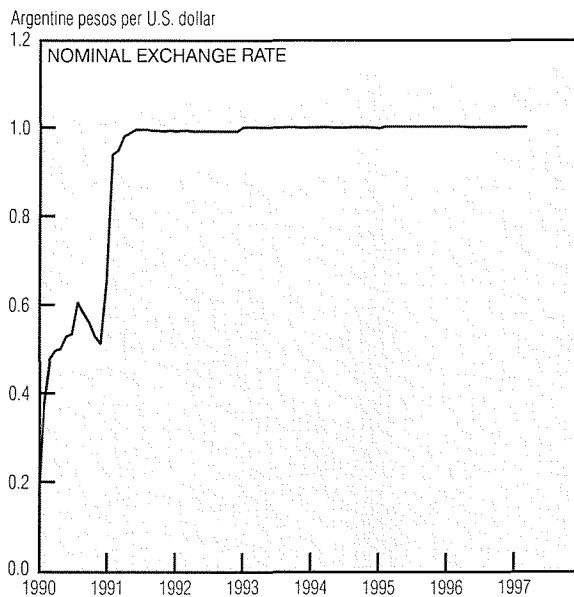
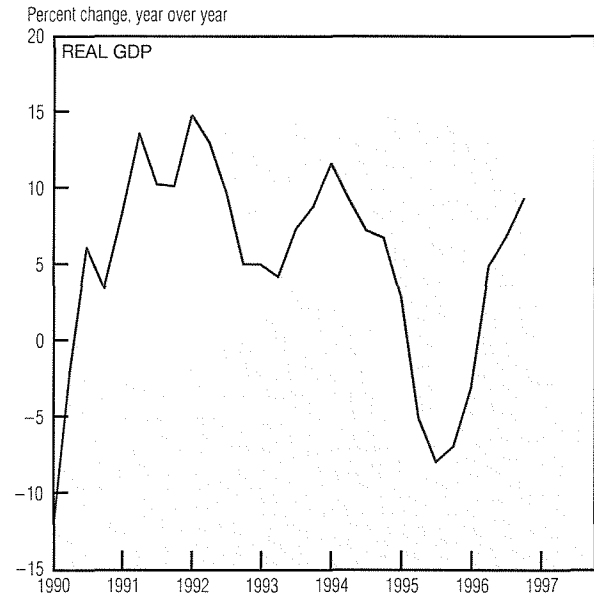
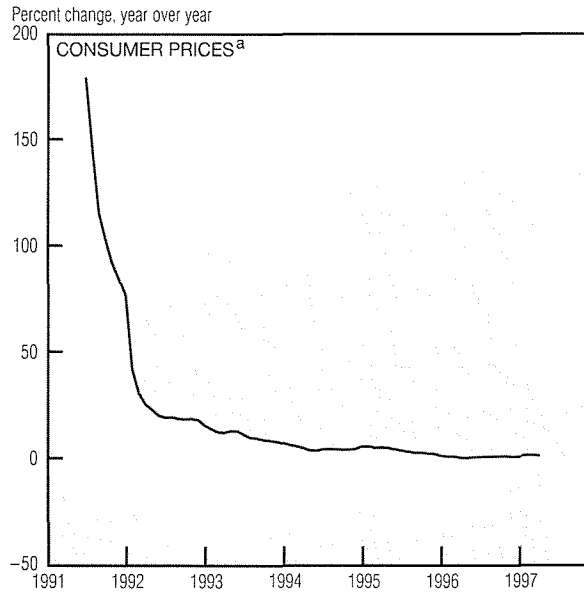
This pattern appeared to hold through 1996. Consequently, although the holdings of the sec-

ondary market's two major players—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—continued to rise, the rate at which they purchased loans declined somewhat over the past year.

This pattern can also be seen in the secondary market's share of total mortgage originations, which fell over the first part of 1996, reaching a

low of less than 20% of all originations in July. Although 1997 data are not yet available, one would expect secondary market activity to have picked up over the first few months of the year. Typically, consumers see rising mortgage rates as a sign of things to come, and attempt to lock in relatively favorable fixed-rate mortgages when rates start to climb.

The Argentine Economy



a. The average inflation rate between January 1990 and June 1991 was 4,816%.

SOURCE: Fundación de Investigaciones Económicas Latinoamericanas (Foundation for Latin-American Economic Research).

Economists' continuing debate about the merits of fixed and floating exchange rates has led them to compare economic developments in Mexico and Argentina. The former country recently abandoned fixed exchange rates; the latter embraces them.

In April 1991, Argentina adopted the Convertibility Plan to reduce its four-digit annual inflation rate. In addition to extensive fiscal and structural reforms, the plan sought to secure monetary policy credibil-

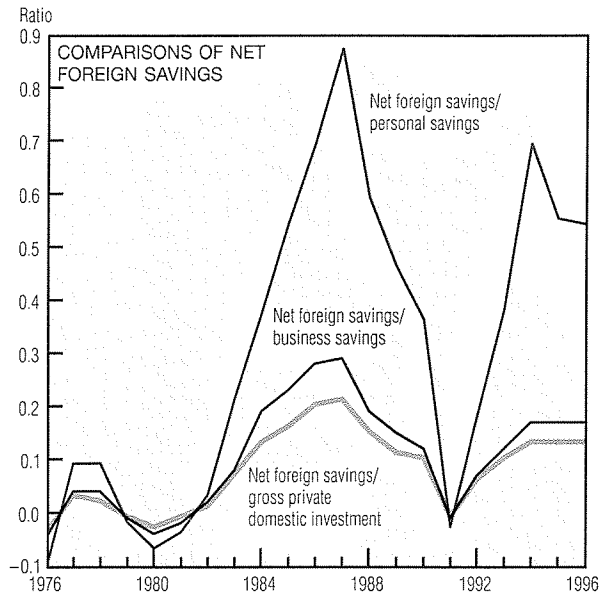
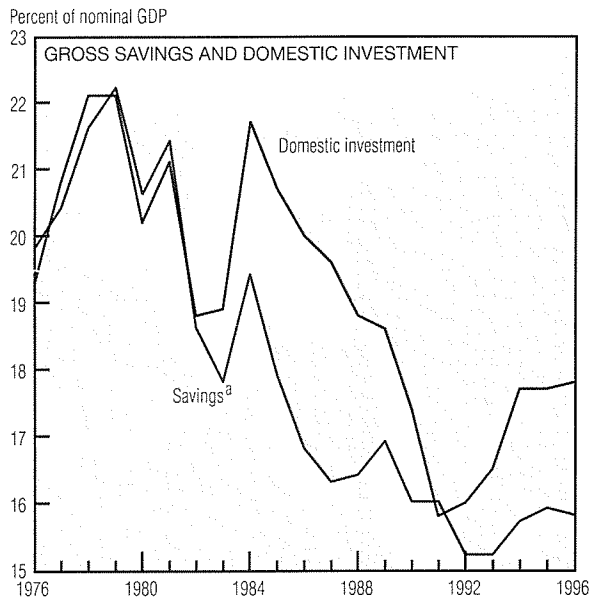
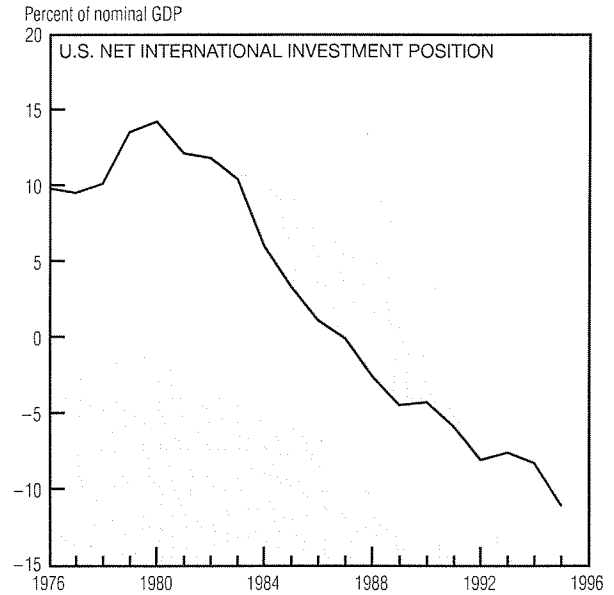
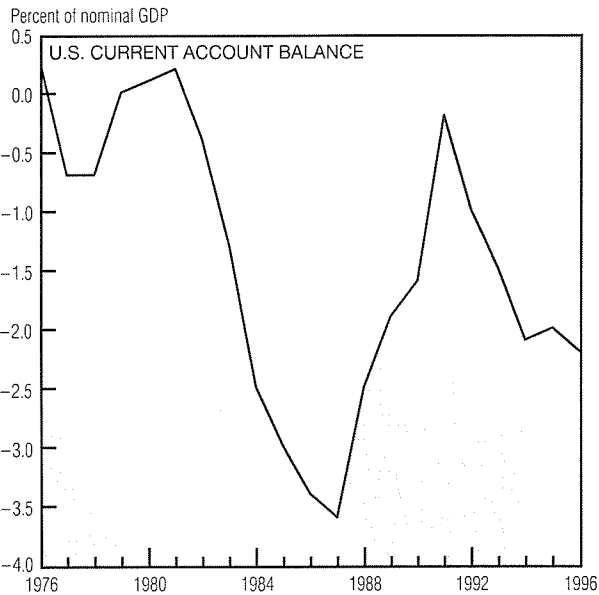
ity by imposing the rigors of a currency board. This required Argentina to fix its peso to the dollar and to maintain dollars on reserve against expansions of its monetary base. The system forced the nation's money growth closely into line with that of the U.S. and successfully lowered Argentina's inflation rate to under 2% by late 1995. The economy grew at an 8% average annual clip between 1991 and 1994.

The December 1994 collapse of the Mexican peso exchange-rate

peg sent ripples of uncertainty through the financial sectors of developing countries, particularly in South America. Following the bank runs and financial institution failures of 1995, Argentine economic growth fell and unemployment soared to 18%.

Economic growth improved last year, but unemployment remains around 17%. An additional cause for concern is the recent appreciation of Argentina's real effective peso exchange rate, up 8.5% since last August.

International Capital Flows



a. The statistical discrepancy is recorded as a part of gross savings.
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

In 1982, the U.S. current account balance shifted into a deficit, which by 1987 had widened to \$167 billion, an amount equivalent to 3.6% of GDP. Although the deficit has since narrowed to 2.2% of GDP, its stubborn persistence is more troubling to many observers than its magnitude. For most of the last 50 years, the U.S. has maintained a small current account surplus.

The necessary counterpart to a current account deficit is a net capital inflow of equal magnitude. In

running a current account deficit, the U.S. exports financial claims (securities and bank deposits) in exchange for its imports. By the late 1980s, foreign claims on U.S. assets exceeded U.S. claims on foreign assets, implying that we had become a debtor nation. Our international investment position, which indicates our debtor/creditor status, is the sum of all past current account balances plus certain adjustments for changing asset values. In 1995, our international indebtedness

amounted to \$816 billion, or 11.2% of GDP.

Many observers regard our chronic current account deficit and our debtor status as inconsistent with our position as one of the world's wealthiest nations, but such a judgment may be unfounded. The foreign capital inflow finances the difference between our savings and investment. In recent years, other things being equal, gross private domestic investment would have been approximately 13% lower in the absence of foreign capital inflows.