

The Economy in Perspective

Fiscal policy in the balance... Earlier this month, President Clinton signed into law two bills that collectively aim to balance the federal budget and slash the public's tax obligations by the year 2002. This legislation caps a long march toward fiscal equilibrium that began—depending on one's partisanship—sometime in the 1980s.

Many people oppose large budget deficits because they believe that fiscal imbalances soak up savings from a limited national pool—savings that would otherwise be directed toward private capital formation. Deficits have also been unpopular because they represent a federal government whose operations have expanded over time yet gone unchecked by any fiscal discipline. Now that the deficit is poised to disappear in a few years, at least some perennial budget critics may be able to sleep more soundly. Others, however, are having bad dreams over the budget deal, and economists are prominent among the insomniacs.

Most economists have long believed that national tax and spending policies affect the economy in two distinct ways: by affecting the overall level of economic activity, and by affecting the allocation of resources at any given level of activity. While most textbooks still claim that major changes in the government's fiscal position can have stimulative or contractionary effects on the level of economic activity, economists are becoming increasingly skeptical about their significance under ordinary circumstances. More and more, the profession is coming to believe that the most important budgetary effects stem from the allocative impact of fiscal policy.

Individual policies create incentives and penalties for engaging in particular kinds of activities. Activities that are heavily taxed are discouraged, while those that are subsidized become more attractive. Federal spending or credit programs also channel more resources in specific directions. Economists refer to these many and varied effects on resource utilization as allocative effects. Governments can induce allocative effects through regulation, without taxing or spending per se. The federal budget

can be in balance at either high or low levels of activity, meaning that the size of the deficit says little about the size of government and its overall allocative impact.

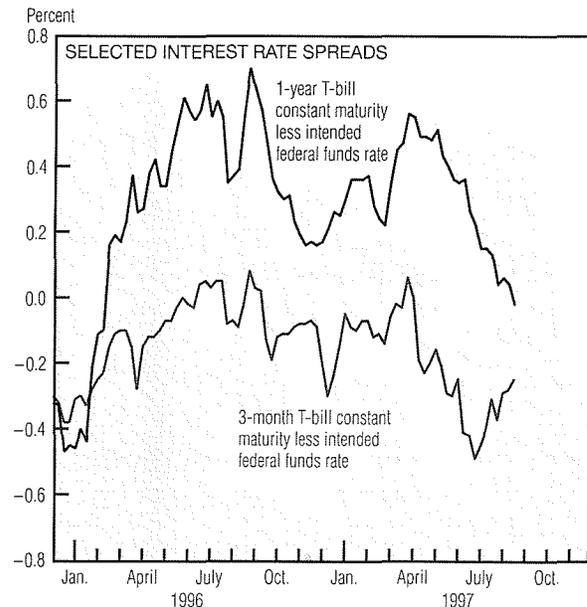
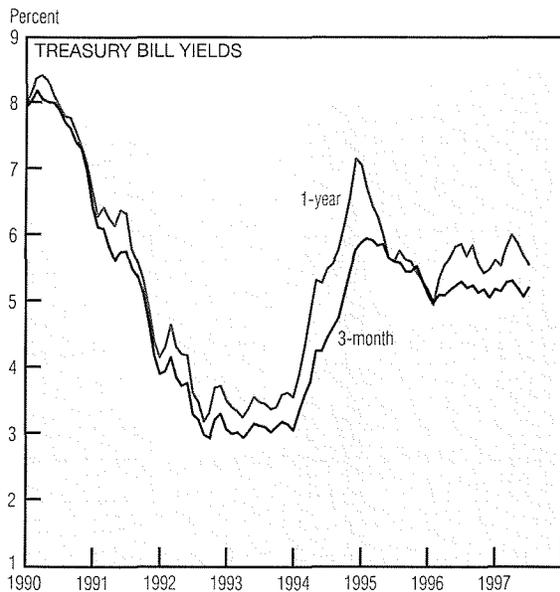
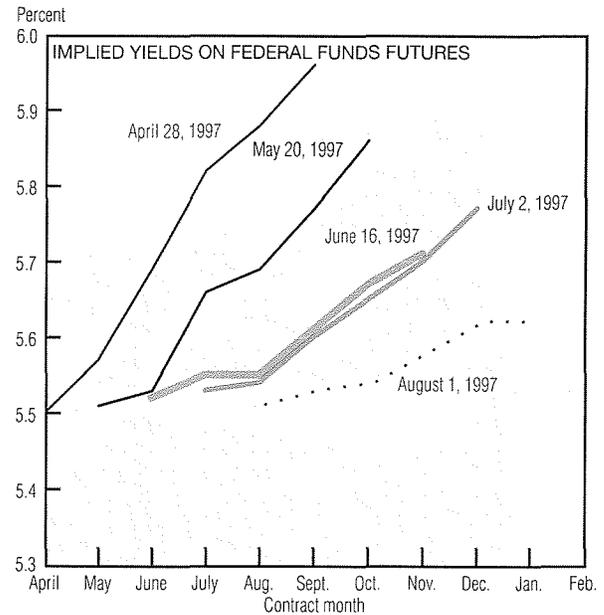
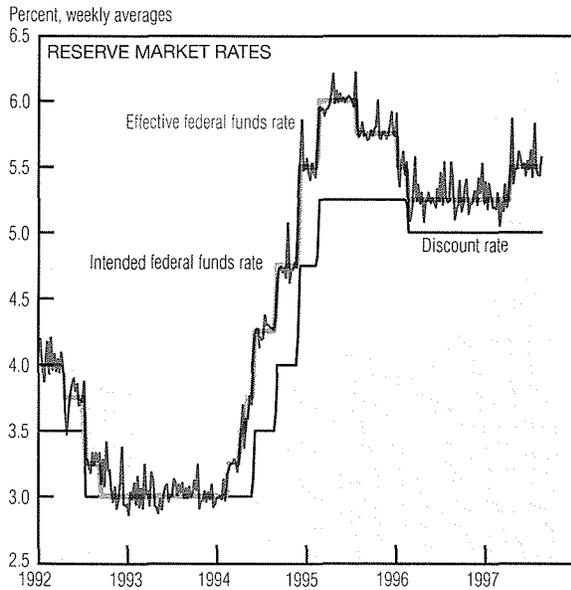
Any set of fiscal policies gives rise to aggregate revenue and spending streams, with the difference indicating whether the government must borrow or retire outstanding debt. These streams include pure transfer programs (like Social Security) as well as direct purchases of goods and services. Deficits require the government to finance its current activities by drawing on the savings of others (through debt issuance)—savings that would have been channeled elsewhere, likely adding to private capital formation.

Fiscal policy changes enacted in 1990 and 1993 laid the foundation for a balanced budget. Indeed, the tax receipts being generated by our currently booming economy have already driven deficits as a share of GDP below 1 percent. Consequently, the 1997 budget plan required less "heavy lifting" than many realize. The macroeconomic effects of this budget plan are not very significant. The allocative effects are an entirely different matter.

The budget legislation contains hundreds of pages, setting forth a host of complex tax credits, deductions, and rate changes, along with spending caps on a variety of federal programs. Each of these changes will affect the public's behavior and lead to a sequence of other consequences. To name just one, college tuition credits will likely encourage more spending on higher education, perhaps boosting tuition for all students. They may also reduce the number of people interested in pursuing skilled trades. The legislation's allocative effects will spread slowly and will play out in complex ways that are now only dimly understood.

Clearly, the new budget package is not a step in the direction of tax simplification for individuals or corporations. Nor does it tackle the impending Social Security or Medicare shortfalls in any substantive way. Here, reform will still have to wait for the political scales to come into balance.

Monetary Policy



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

The semiannual Federal Reserve System monetary policy testimony to Congress, delivered by Chairman Greenspan on July 22, along with the Board of Governors' report, summarizes the Fed's view of current economic conditions and monetary policy as well as its outlook for economic performance through 1998.

Chairman Greenspan reported that "the recent performance of the economy, characterized by strong growth and low inflation, has been exceptional—and better than most anticipated." He noted that the Board, as well as many observers,

have been puzzled by the combination of an economy operating at high levels of real activity and low inflation.

Since the February report on monetary policy, the central tendency of forecasts by the Board of Governors and the Reserve Bank presidents has increased to 3%–3¼% for real output growth, and has fallen to 2¼%–2½% for inflation. The central tendency forecasts for 1998 are 2%–2½% for real GDP and 2½%–3% for inflation.

The intended federal funds rate has remained at 5½% since late March, when the Federal Open

Market Committee (FOMC) raised it from 5¼% because, as the Board report explained, "the Committee was concerned about the risk that if the outsized gains in real output continued, pressures on costs and prices would emerge that could eventually undermine the expansion."

While the federal funds rate has been steady, interest rates have fallen. Since late April, the 1-year Treasury constant maturity rate has fallen more than 50 basis points, while the 3-month constant maturity rate has declined 9 basis points. Some perceive an implicit tightening

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Monetary Policy (cont.)

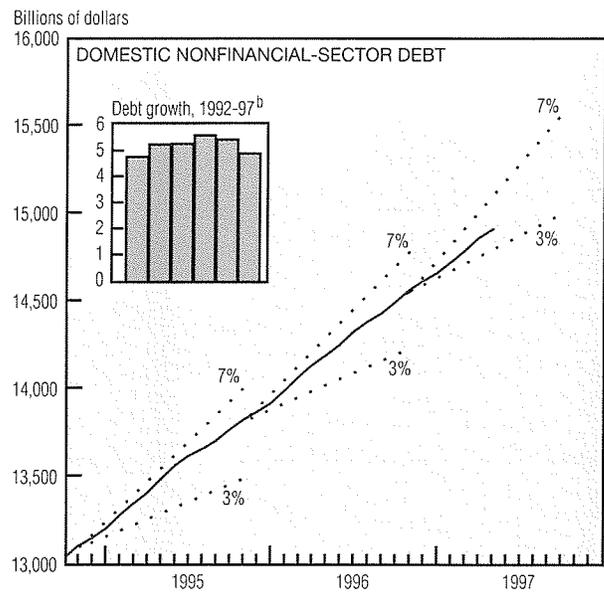
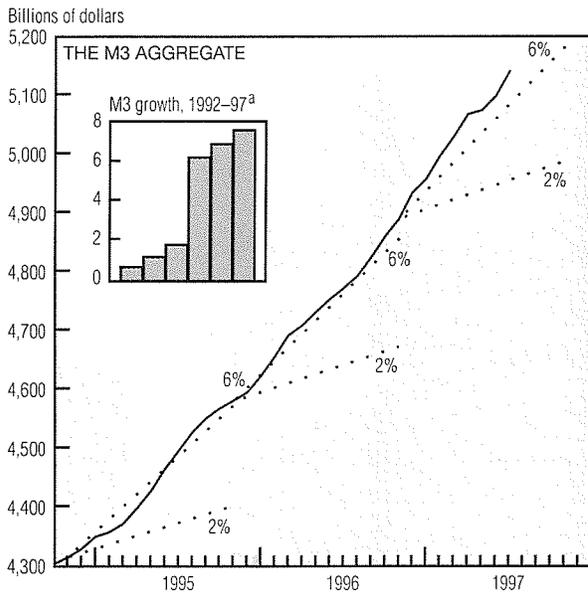
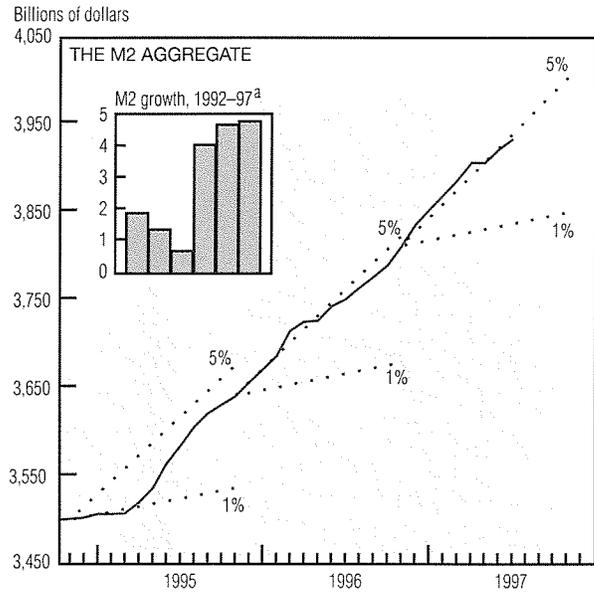
MONETARY AGGREGATES

M1 = Currency
+ Traveler's checks
+ Demand deposits
+ Other checkable deposits

M2 = M1
+ Savings deposits
+ Small-denomination time deposits
+ Retail money market mutual funds

M3 = M2
+ Large-denomination time deposits
+ Institutional money market mutual funds
+ Repurchase agreement liabilities
+ Eurodollars

Debt = Outstanding credit-market debt of the domestic nonfinancial sectors



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 July over 1996:IVQ basis.

b. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1997 is calculated on a preliminary May over 1996:IVQ basis.

NOTE: All data are seasonally adjusted. For M2 and M3, the last plot is estimated for July 1997. For domestic nonfinancial-sector debt, the last plot is preliminary for May 1997. Dotted lines are FOMC-determined provisional ranges.

SOURCE: Board of Governors of the Federal Reserve System.

of policy when market interest rates are falling and the intended federal funds rate is held constant.

At the same time that short-term rates have declined, the implied yield on federal funds futures has flattened out, indicating that earlier expectations of an increase in the federal funds rate have greatly diminished.

The Federal Reserve Board's report to Congress also provides provisional ranges for the monetary aggregates for 1997 and 1998. At its meeting in early July, the FOMC

reaffirmed the 1997 growth ranges for the monetary aggregates and domestic nonfinancial debt that it had set in February. These ranges are 1%–5% for M2, 2%–6% for M3, and 3%–7% for debt. Provisional ranges for 1998 were set at the same levels.

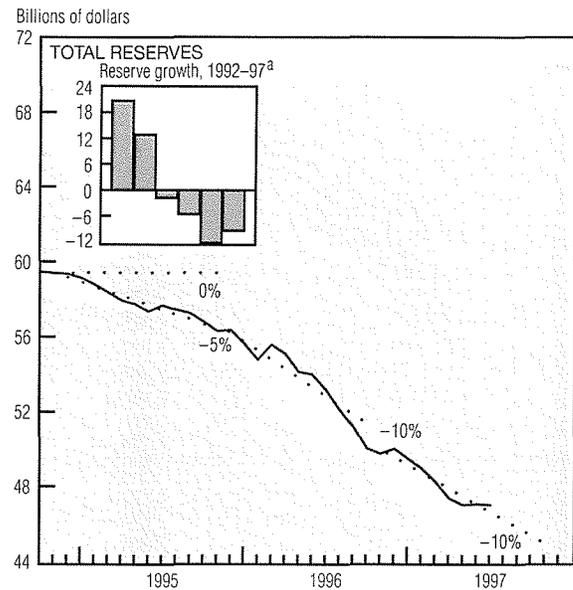
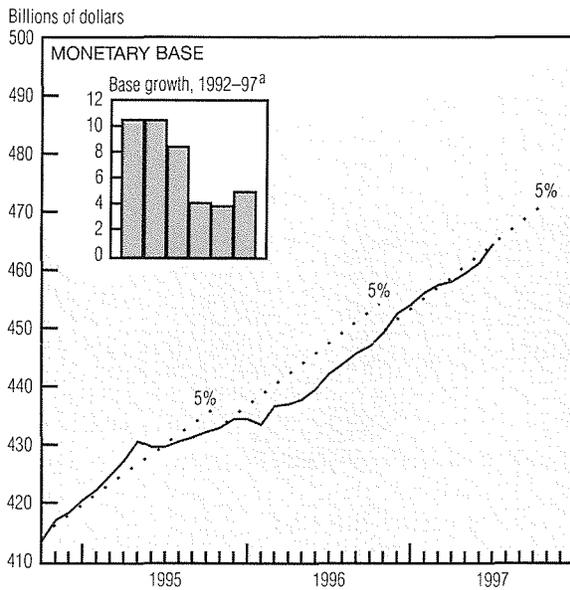
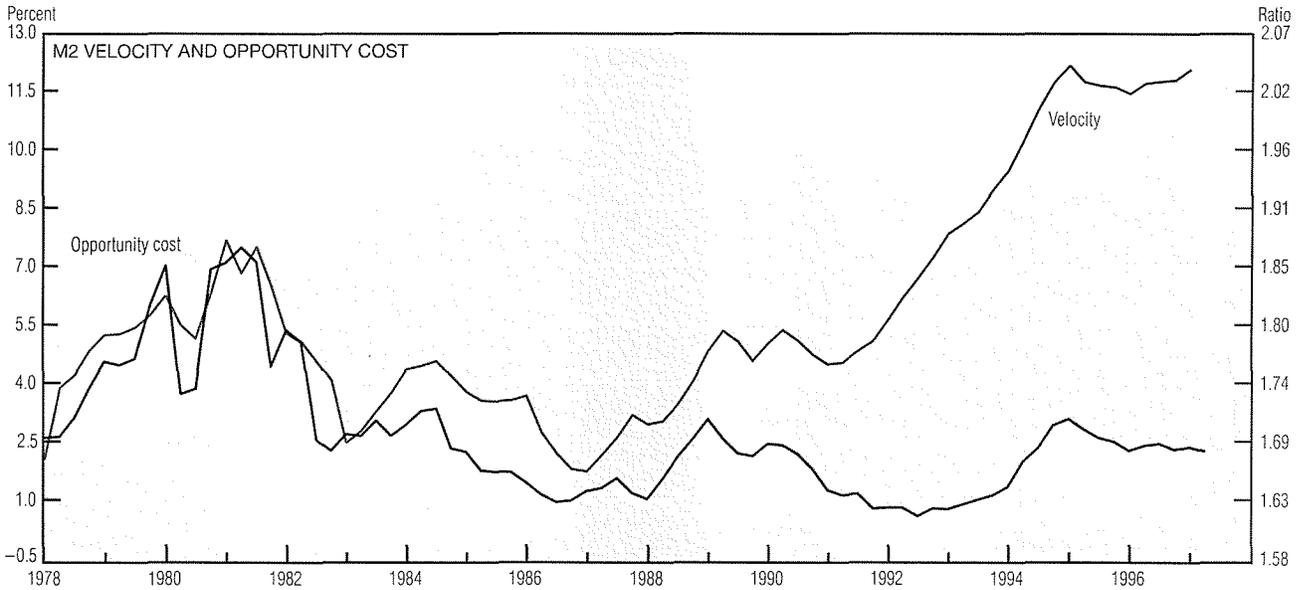
From 1996:IVQ through June 1997, M2 grew at a 4.9% annual rate, just below the upper bound of its range, while M3 expanded at an annual rate of 7.1%, well above its upper bound. Through May, domestic nonfinancial debt increased at a 4.8% annual rate over its

1996:IVQ level, near the center of its range.

In evaluating the policy significance of growth in the monetary aggregates, the Board's report noted that "the correspondence between changes in M2 velocity and in opportunity cost during recent years may represent a return to the roughly stable relationship observed for several decades until 1990—albeit at a higher level of velocity." However, Chairman Greenspan testified that "sufficient evidence has

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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 July over 1996:IVQ basis.

NOTE: All data are seasonally adjusted. Last plot is estimated for July 1997. Dotted lines represent growth rates and are for reference only.

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

not yet accumulated” to put more weight on such monetary quantities in conducting policy.

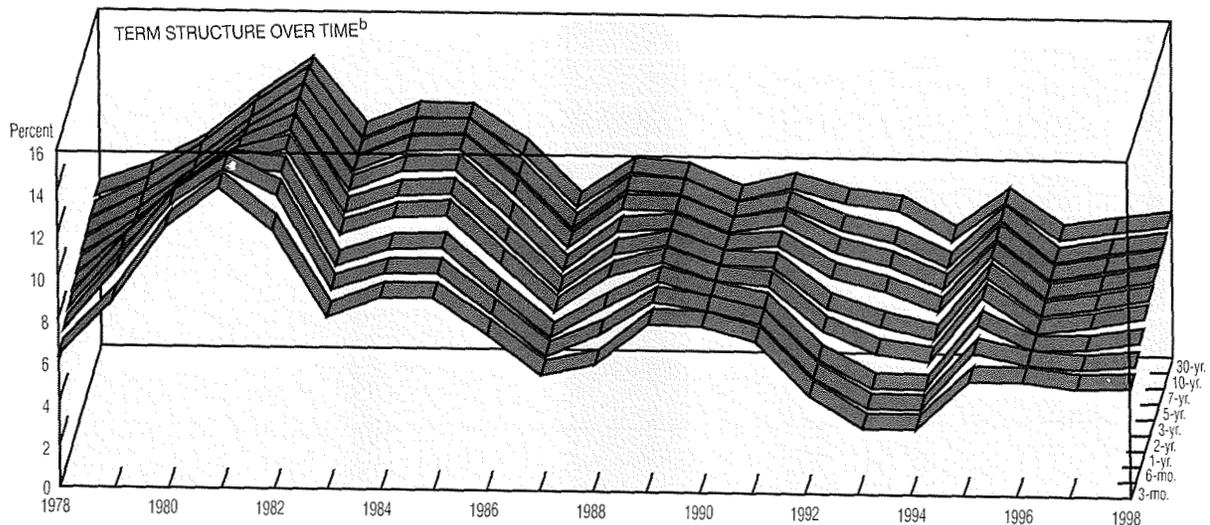
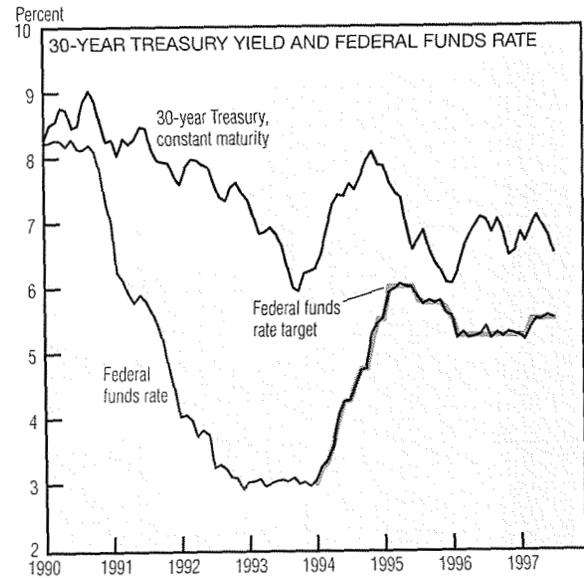
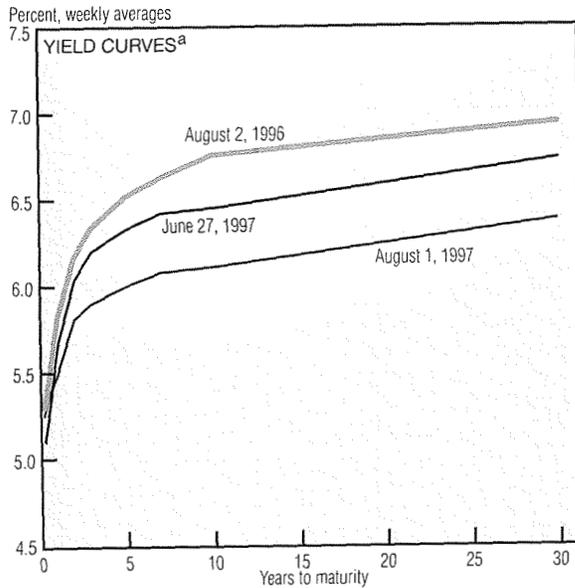
Finally, the Board’s report noted that M1 continued to contract between 1996:IVQ and June 1997, falling at an annual rate of 2.7%. It stated that this decline is probably due to depository institutions’ continuing tendency to “sweep” balances in transaction accounts, which are subject to reserve requirements, into savings accounts, which are

not. The decline in the quantity of deposits held in transaction accounts led total reserves to fall at a 9.8% annual rate. But because of substantial growth in currency holdings, the monetary base (which equals currency plus reserves) increased at an annual rate of 4.5%.

The report sounded a warning about this decline in reserves, stating that “further reductions in required reserves have the potential to diminish the Federal Reserve’s ability to control the federal funds rate closely

on a day-to-day basis.” Moreover, the report argues that “the decline in required reserves over the past several years has not created serious problems in the federal funds market, but funds-rate volatility has risen a little, and the risk of much greater volatility would increase if required reserves were to fall substantially further.” It warns that additional increases in volatility could have negative consequences for the performance of the economy.

Interest Rates



a. All instruments are constant-maturity series.
 b. End-of-period quarterly averages of daily data. All observations are fourth-quarter data except the final one, which is for 1997:IIQ.
 SOURCE: Board of Governors of the Federal Reserve System.

The yield curve has flattened since last month, with long rates falling and short rates rising. The often-watched 3-year, 3-month spread and 10-year, 3-month spread stand at 65 and 86 basis points, below their historical averages of 80 and 125. This flattening suggests a slowdown of real economic growth over the next year, although the yield curve is still far from an inversion (short rates above long rates), which would signal recession. A look at the very long and very short rates confirms a pattern—that long

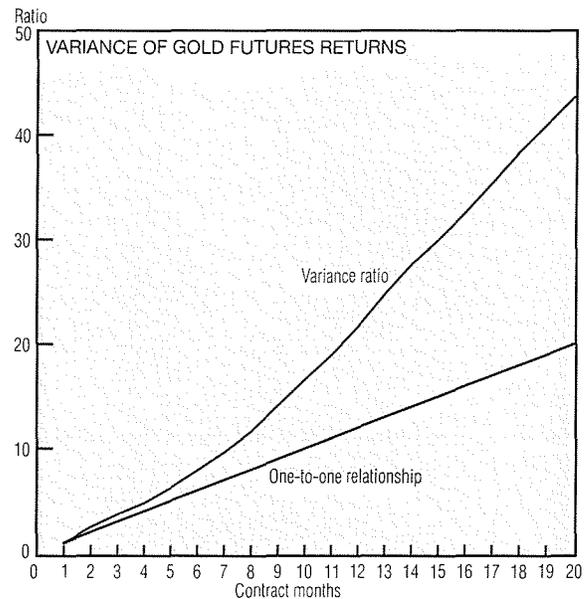
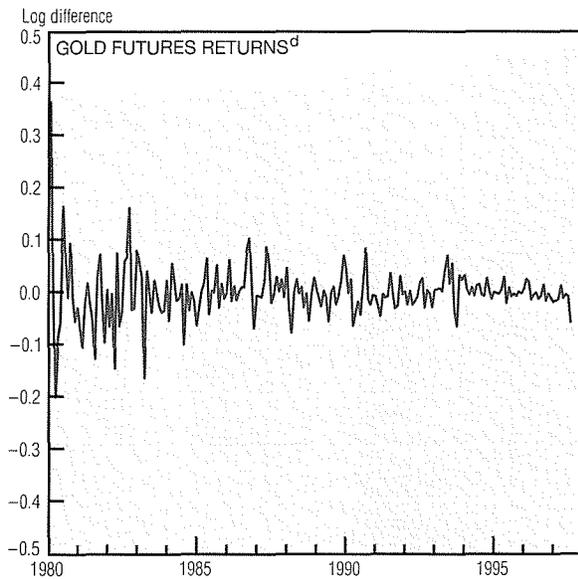
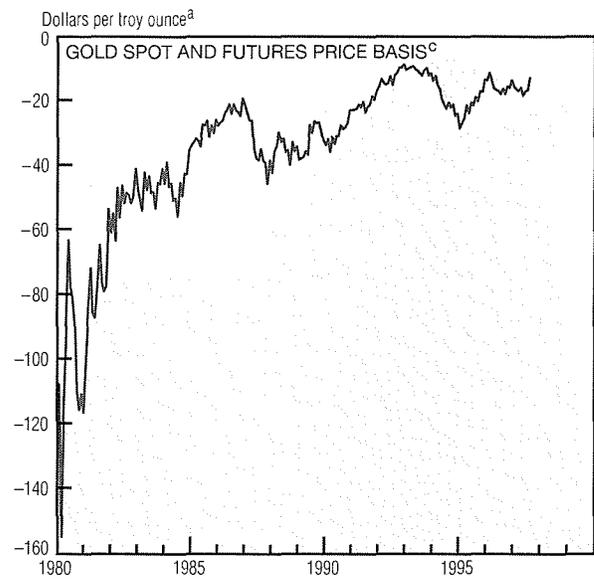
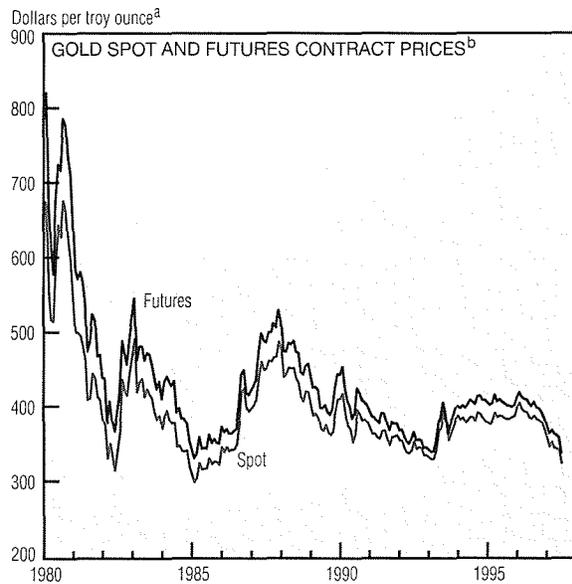
rates account for most of the change in the spread. Continuing the trend begun in April, the federal funds rate remains slightly above its target value of 5.50%.

Tracking spreads is convenient, but it fails to capture the true three-dimensional nature of the yield curve over time. Shifts in the curve are rarely parallel: They also involve twists, because maturities rise and fall at different rates. Did interest rates peak in 1981 or 1982? It depends on whether one looks at long rates or short. The inversion of 1981

occurred when all rates were rising rapidly, but the 1989 inversion saw long and short rates moving in opposite directions.

Finance experts disagree on how best to characterize the twists and turns of the yield curve. Most think that three numbers are needed: level, steepness, and curvature. This three-dimensional perspective emphasizes the relative tranquility of rates since 1994, with twists and turns that look tame compared to the gyrations of more turbulent times.

Gold Futures, January 1980–July 1997



- a. Monthly averages of daily data.
b. Gold futures contracts have settlement dates at least seven months in the future.
c. The basis is the spot price of gold less the futures contract price.
d. Continuously compounded.
SOURCE: DRI/McGraw-Hill.

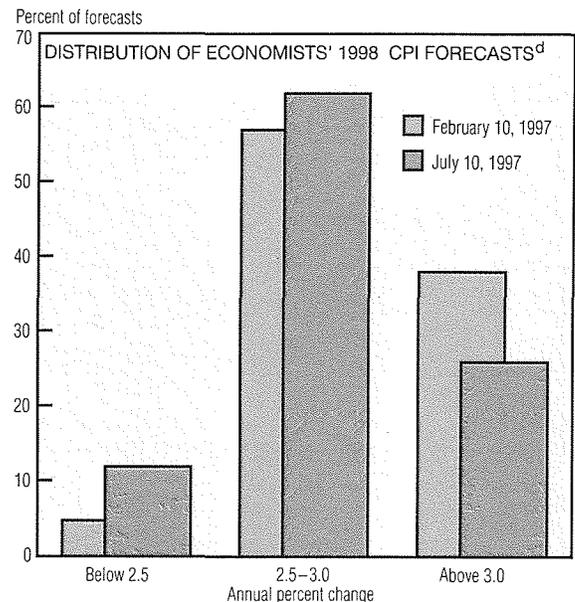
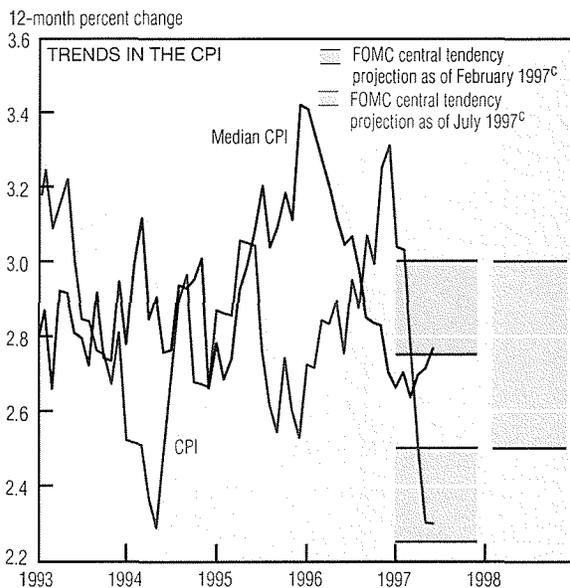
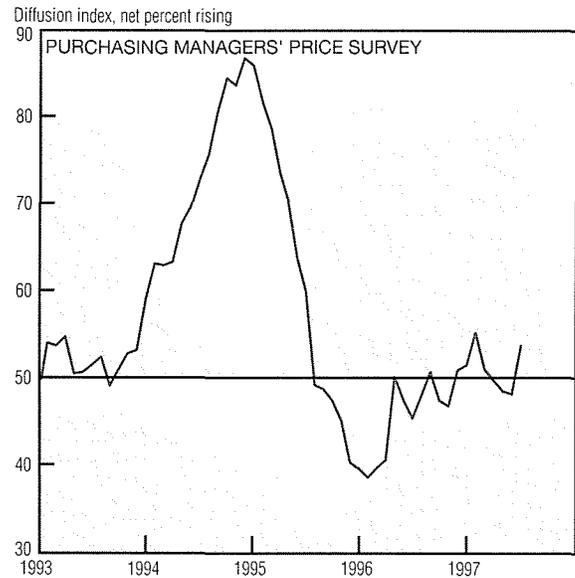
Both spot and futures prices of gold have been declining fairly steadily since March, dropping to levels not seen since the first months of 1993. While this may indicate a sanguine attitude among international investors (gold being a traditional safe-harbor asset in stormy times), it may also reflect the strength of alternatives such as dollar-denominated assets and world stock markets. The basis—the difference between spot and futures prices—remains negative, but it too has been diminishing since April.

One enduring question about any asset price (gold futures included) concerns predictability: Do prices follow a random walk? The answer boils down to two different possibilities: Price *changes* (or returns, which are the log of changes) may have an identical and independent distribution each period, or they may be uncorrelated over time. A chart of gold futures returns strongly discredits the first possibility, because gold returns' variability seems to have changed over time, markedly decreasing since the

1980s. One way to assess the correlation of returns is to look at the *variance ratio*. If returns are uncorrelated—if prices follow a random walk—yearly returns should have 12 times the variance of monthly returns, six times the variance of two-month returns, and so on. In the actual data, however, the variance of yearly returns is closer to 21 times that of monthly returns, suggesting a correlation. This evidence indicates that gold prices are at least partially predictable.

Inflation and Prices

	Annualized percent change, last:				1996 avg.
	1 mo.	6 mo.	12 mo.	5 yr.	
June Price Statistics					
Consumer Prices					
All items	1.5	1.4	2.3	2.7	3.3
Less food and energy	1.4	2.4	2.5	2.9	2.6
Median ^a	2.8	3.0	2.8	2.9	2.7
Producer Prices					
Finished goods	-0.9	-3.4	-0.1	1.2	2.9
Less food and energy	1.7	-0.3	0.1	1.2	0.7
Commodity futures prices^b					
	-27.7	1.0	-2.4	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.

d. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; the National Association of Purchasing Management; and *Blue Chip Economic Indicators*, February 10 and July 10, 1997.

In June, the Consumer Price Index (CPI) rose at a mere 1.5% annualized rate, nearly the same pace it has followed since last December. Indeed, the six-month average rise in the CPI (1.4%) is the lowest six-month posting in almost 11 years.

Price increases further down the production chain have also been very subdued. Over the past year, the Producer Price Index has remained essentially unchanged, and reports from purchasing managers hint that little upward pressure will

be coming from industry in the immediate future.

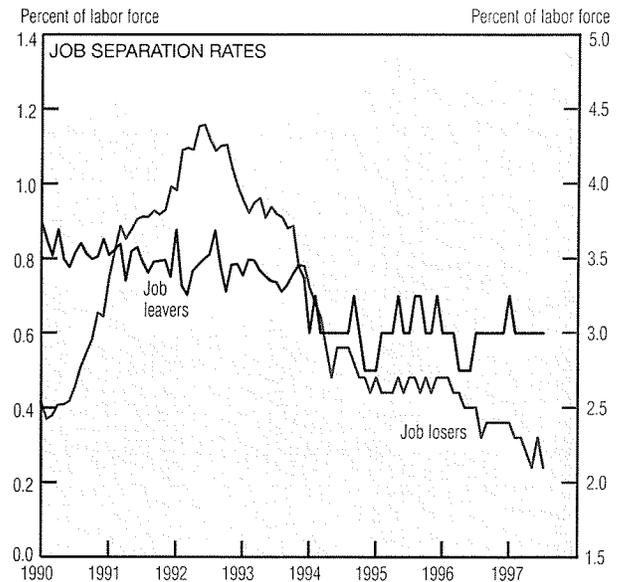
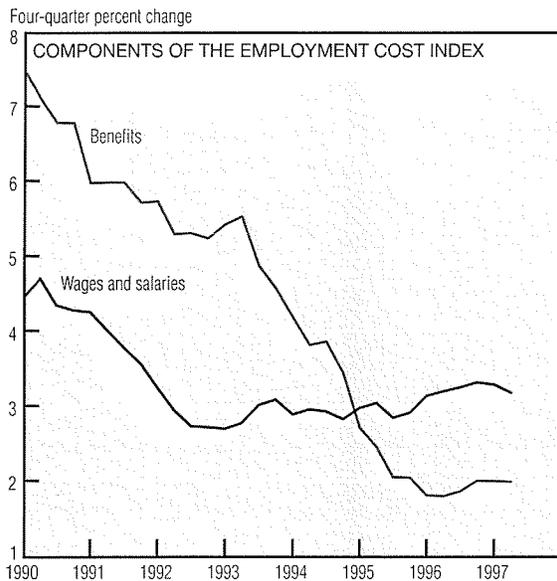
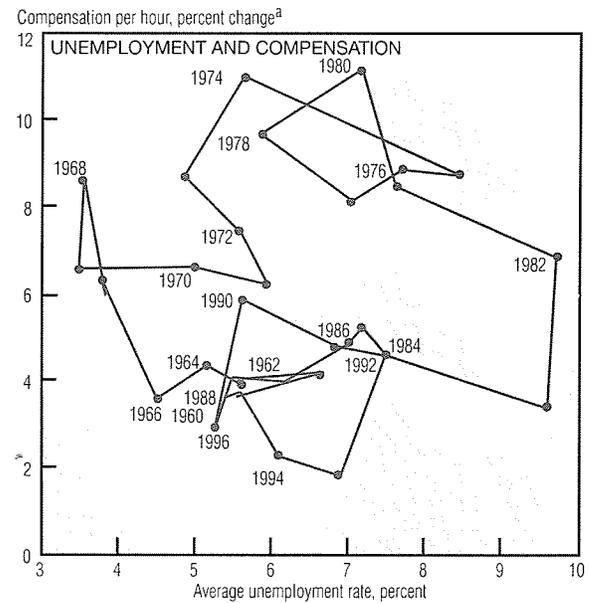
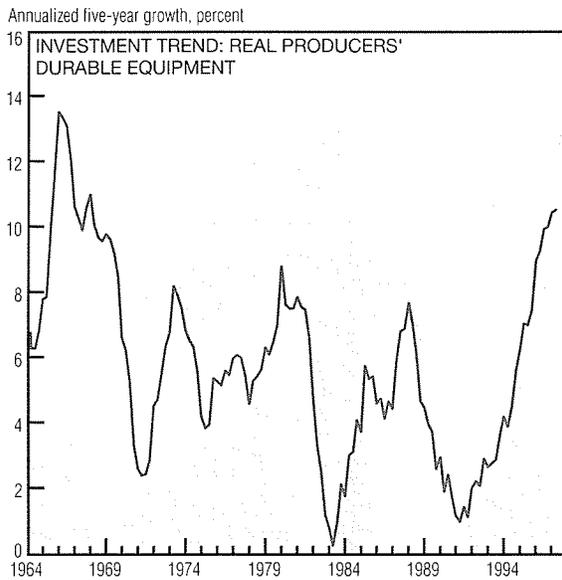
The moderate rate of price increase this year prompted the Federal Open Market Committee (FOMC) to revise downward its central tendency forecast for the 1997 CPI growth rate—from 2¾%–3% last February, to 2¼%–2½% in July. For next year, the FOMC sees the rate of CPI increase in the 2½%–3% range.

Economists participating in the Blue Chip survey have also reduced

their expectations for inflation. Last February, about 38% of them predicted that the CPI would increase more than 3% in 1998, compared to only 5% who expected growth below 2½%. In July, the share of economists projecting that 1998's CPI growth rate would exceed 3% had fallen to 26%, while the proportion expecting less than a 2½% increase had risen to about 12%.

In his July semiannual report to Congress, Federal Reserve Chairman
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Inflation and Prices (cont.)



a. Fourth quarter over fourth quarter.

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

Greenspan noted that monetary policymakers "have been puzzled about how an economy, operating at high levels and drawing into employment increasingly less experienced workers, can still produce subdued... inflation rates."

Although the relationship between the unemployment rate and the rate of compensation growth has been erratic since 1960, the jobless rate for 1996 (just above 5%) is associated with one of the lowest rates of compensation growth in the past 35 years (about 2¾%). In 1964, for example, when unemployment was also around 5%, compensation growth topped 4%. In 1970, a similar

jobless rate coincided with compensation growth of more than 6%, and in 1974, 5½% unemployment was associated with a compensation growth rate of about 11%.

The Chairman noted that several factors may be helping to hold down wage and price increases. Firms appear to be profiting from unusually strong productivity gains, which may have resulted from the capital investment surge of recent years. Growth in business purchases of equipment during the past five years has exceeded 10% annually—its best performance since the 1960s.

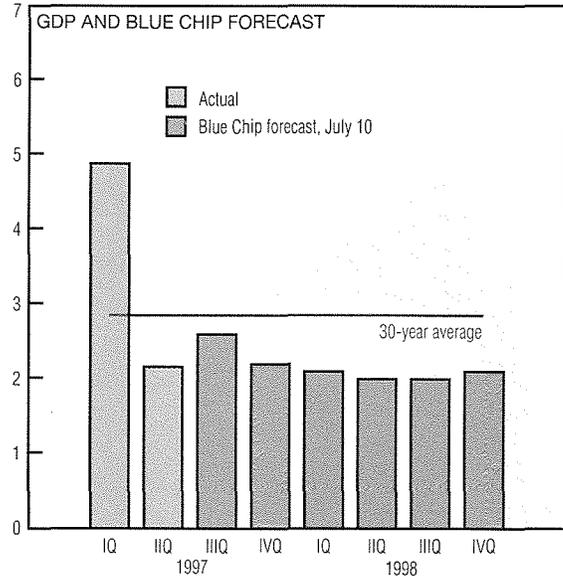
"Certainly," he said, "changes in the health care industry and the

pricing of health services have greatly contributed to holding down growth in the cost of benefits, and hence overall labor compensation." He also observed that job insecurity is probably helping to subdue wage demands and cited several indicators, including the fact that "the number of workers voluntarily leaving their jobs to seek other employment has not risen in this period of tight labor markets." The caution here is that to the extent that these forces are temporary, "cost and price pressures would tend to reemerge," a situation the Federal Reserve "plans to monitor closely" this year and next.

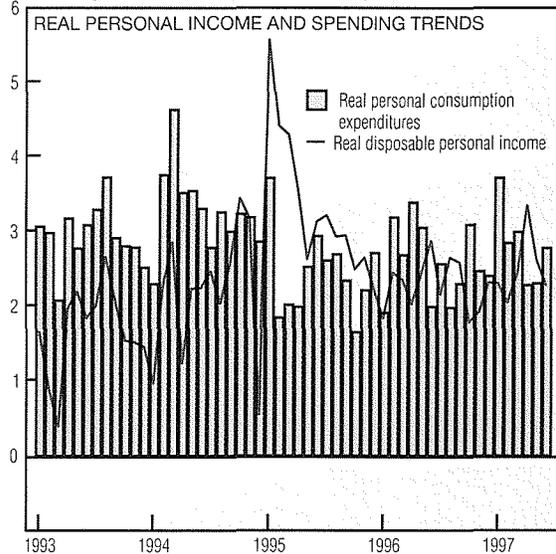
Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	38.1	2.2	3.1
Consumer spending	9.8	0.8	2.5
Durables	-9.3	-5.7	2.2
Nondurables	-7.7	-2.1	1.3
Services	24.9	3.7	3.1
Business fixed investment	31.9	12.4	7.3
Equipment	29.3	20.4	11.9
Structures	1.1	2.3	6.1
Residential investment	3.8	5.7	0.0
Government spending	11.8	3.8	0.6
National defense	7.5	10.2	-3.7
Net exports	-21.6	—	—
Exports	31.4	14.3	12.6
Imports	53.1	21.8	14.8
Change in business inventories	3.1	—	—

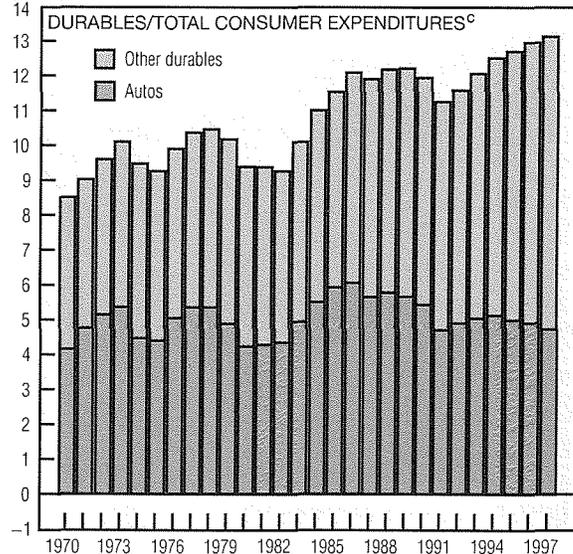
Percent change from preceding quarter



Percent change from corresponding month of previous year



Percent



- a. Chain-weighted data in billions of 1992 dollars.
b. Seasonally adjusted annual rate.
c. 1997 data represent the average of the first two quarters.

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*, July 10, 1997.

As expected, the pace of economic activity slowed in 1997:IIQ. Preliminary estimates show that the economy grew 2.2% in the second quarter (down from a revised 4.9% the previous quarter). Second-quarter growth was led by investment in producers' durable equipment, exports, and federal government spending. Offsetting these effects was a decline in consumer spending for motor vehicles and parts and an increase in imports. Over the

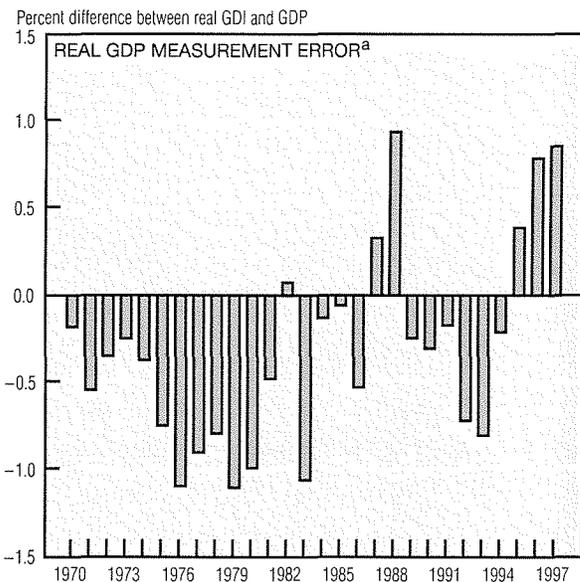
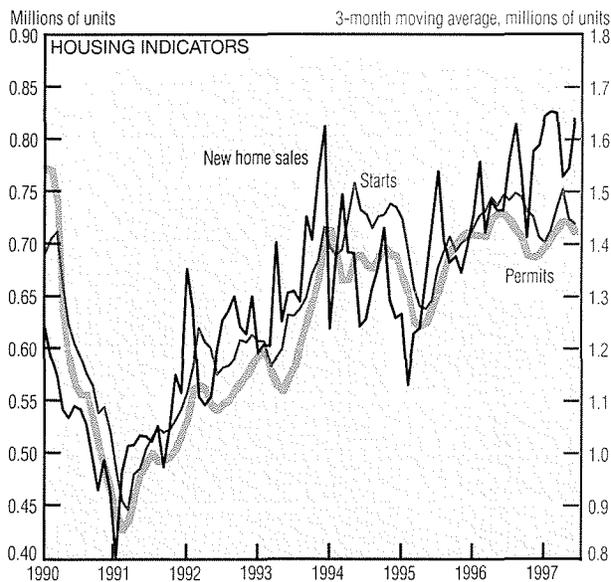
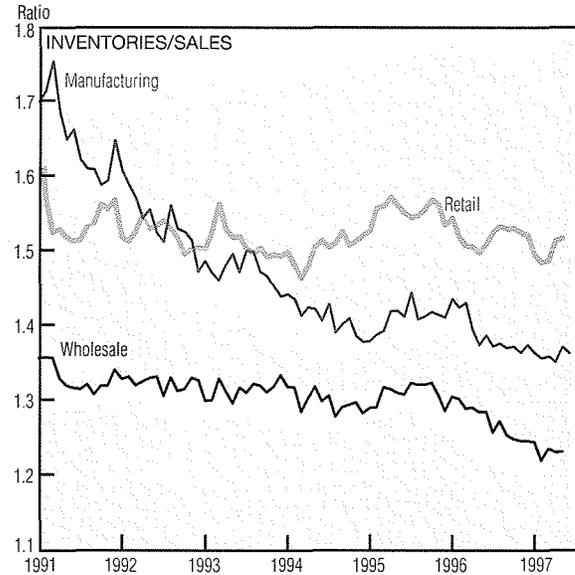
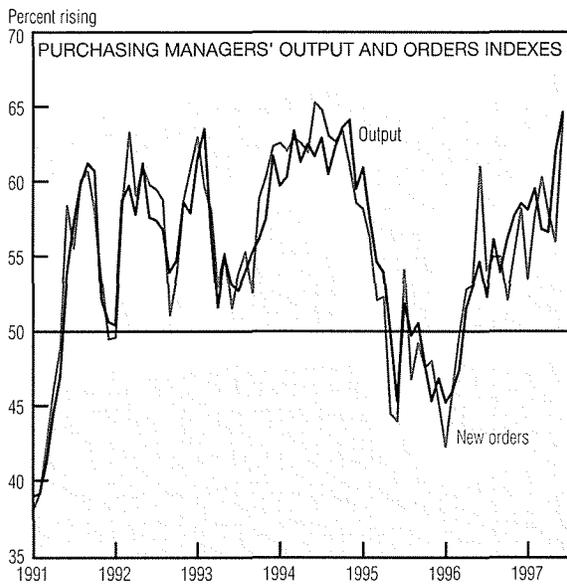
four quarters ended in 1997:IIQ, the economy grew at a strong 3.1% clip.

The moderate second-quarter growth rate was in line with the consensus of economists participating in the Blue Chip survey. They foresee that a rebound in consumer spending could produce an uptick in 1997:IIIQ growth, but they expect a return to the 2% GDP growth range through 1988.

Real personal consumption expenditures were flat in the second

quarter. Strong advances in services spending offset sharp declines in purchases of motor vehicles and nondurables. Labor disputes that limited supplies of popular vehicles may have affected car sales. Real disposable personal income growth was healthy in the second quarter, the employment situation stayed strong in July, and consumer sentiment remains upbeat.

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Economic Activity (cont.)

a. 1997 data refer to first quarter only.

NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; and the National Association of Purchasing Management.

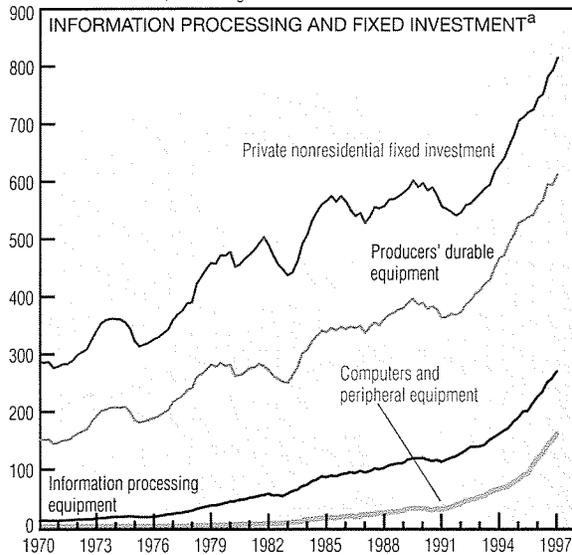
Consumers continue to devote a growing share of their total spending to durables. The proportion has risen from approximately 8.5% in 1970 to more than 13% in the first half of 1997. The percentage spent on motor vehicles and parts, however, has remained fairly stationary (around 5%). The relative gain in durables has come at the expense of nondurable goods sales. Service's share of total consumer spending has also grown.

Industrial production continued to post strong gains in June, led by high-tech durables and commercial aircraft. Production of motor vehicles and parts also advanced in June, but was off sharply for the quarter. The National Association of Purchasing Management's July indexes of output and new orders continued to reveal a strong manufacturing sector. Inventory-to-sales ratios picked up in May, but are still low by historic standards.

The value of a nation's output (GDP) should equal the income paid to all who produced it (gross domestic income or GDI). Since 1995, U.S. GDI has exceeded GDP, leading some to speculate that the Commerce Department may be underestimating output. The magnitude of the recent discrepancy, however, is not unparalleled, and persistence in the signs of errors (albeit negative) is not uncommon.

Durable Equipment Investment

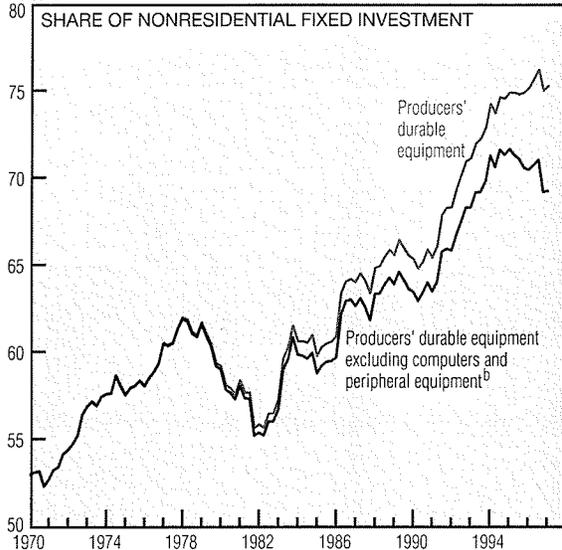
Billions of 1992 dollars, chain-weighted



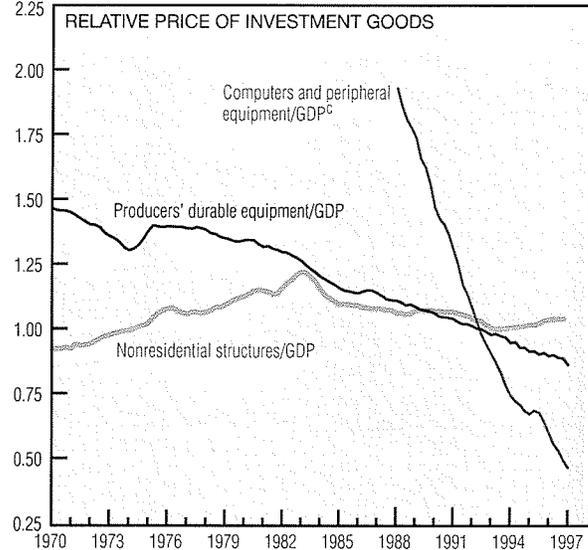
Investment Growth (Percent, annual rate)

	1970-1989	1990-present
Private nonresidential fixed investment	3.63	4.55
Producers' durable equipment	4.74	6.57
Computers and peripheral equipment	35.65	25.49
Private nonresidential fixed investment less computers and peripheral equipment	3.36	2.21
Producers' durable equipment less computers and peripheral equipment	4.31	3.40

Percent



Index, 1992 = 1



a. Private nonresidential fixed investment is composed of producers' durable equipment and nonresidential structures. Producers' durable equipment includes industrial equipment and transportation and related equipment, in addition to information processing and related equipment.

b. Computers and peripheral equipment have been removed from both the numerator and the denominator.

c. The relative price of computers and peripheral equipment has fallen extremely rapidly from a 1970 value of 130.

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

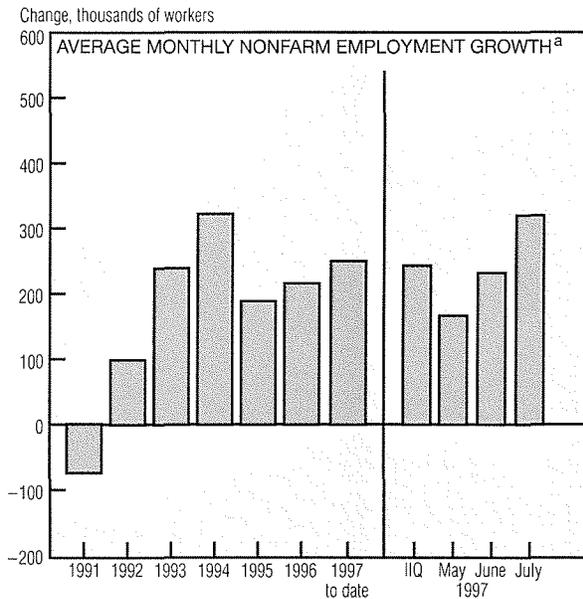
During the 1990s, nonresidential fixed investment (producers' durable equipment plus nonresidential structures) has surged. The increase can be traced to durable equipment sales, with 57% of all fixed investment gains coming from computer and peripheral equipment purchases. However, durable equipment sales began to grow long before computer sales became significant. Since 1970, durables investment has increased from 53% to 75% of total nonresidential fixed investment. Over the

same period, the relative price of durables has fallen 42%, and the relative price of structures has climbed 13%. The drop in durables' prices, accompanied by an increase in their share of total investment, indicates that investment patterns have been dominated by supply-side factors.

Since 1990, investment in computers has risen from 8% to 25% of all durable equipment. This growth also seems to be fueled by supply-side factors, given the steady decline in the relative price of computers.

In the past six months, investment has increased 8% for structures and 2.7% for durable equipment, causing durables' share of investment to fall slightly. However, durable equipment has been outpacing structures since 1990, even when computers are excluded. In fact, overall investment in structures has declined 1%. The steady drop in computer and durable equipment prices suggests that both will continue to increase as a share of total nonresidential fixed investment.

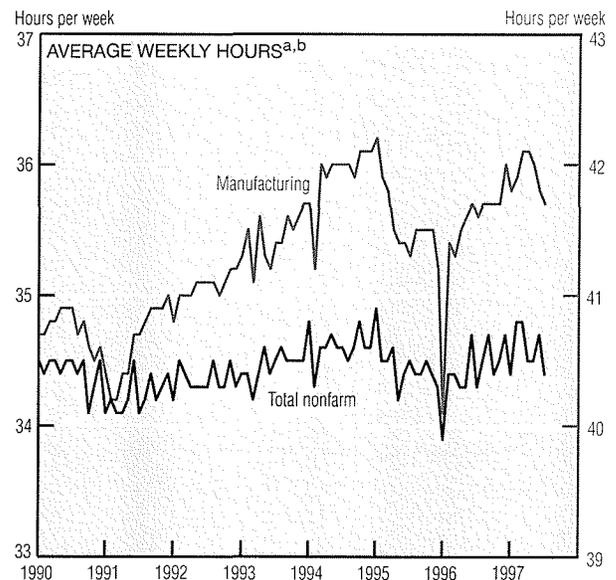
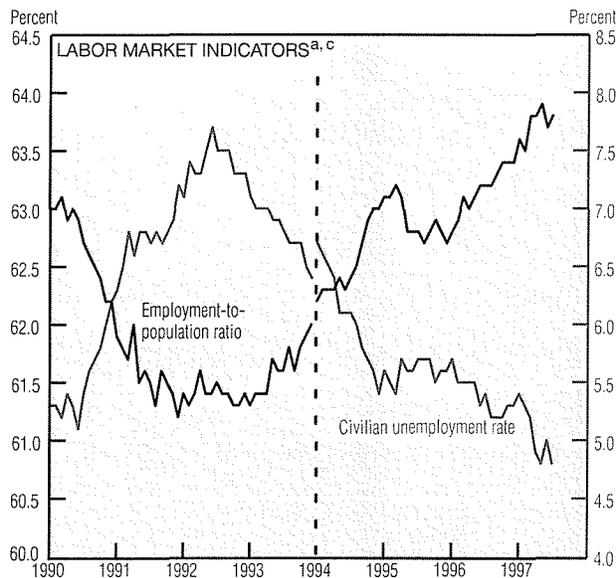
Labor Markets



Labor Market Conditions^a

Average monthly change (thousands of employees)

	1996	1997			
	Year	IIQ	May	June	July
Payroll employment	212	239	163	228	316
Goods-producing	19	17	35	18	-4
Manufacturing	-5	10	3	22	-5
Service-producing	192	223	128	210	320
Services	99	115	117	70	113
Business services	33	23	24	27	30
Retail trade	48	44	-3	51	65
Government	14	32	-14	77	56
Local government	19	33	-10	88	44
Household employ.	232	63	255	-275	344
Average for period					
Civilian unemployment rate (%)	5.4	4.9	4.8	5.0	4.8
Mfg. overtime (hours) ^b	4.5	4.8	4.8	4.7	4.6



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

The nation's labor markets showed robust growth in July, with nonfarm payrolls posting a higher-than-expected gain of 316,000 workers. The civilian unemployment rate returned to its May level of 4.8%—the lowest since November 1973—and the employment-to-population ratio edged up 0.1% over the same period, reaching 63.8%. Meanwhile, average hourly earnings remained unchanged at \$12.23, and nonfarm employees' average workweek fell

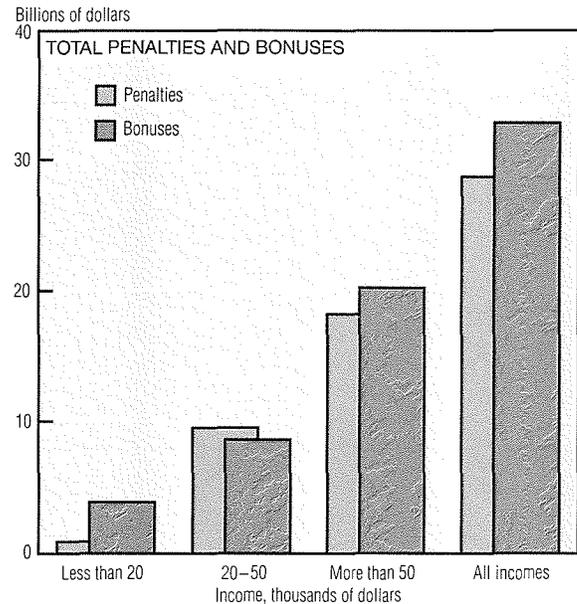
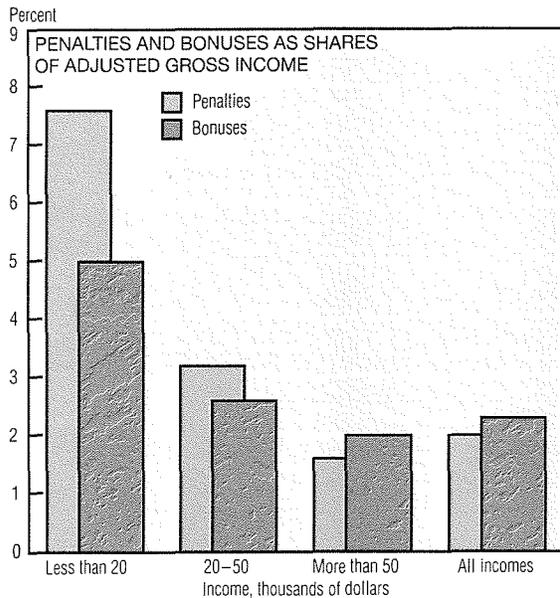
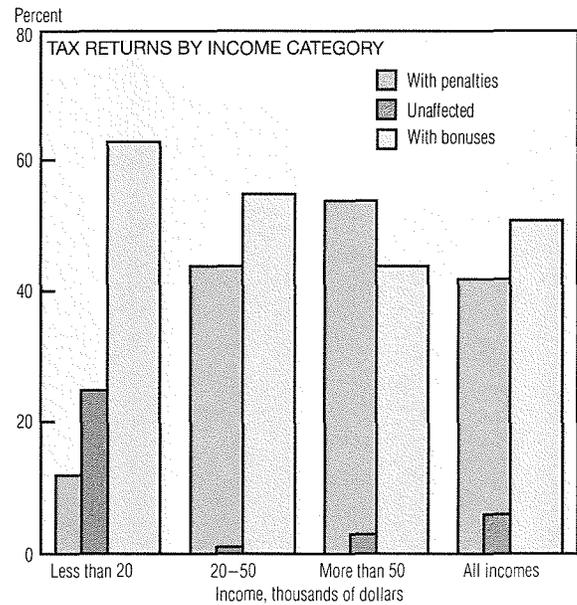
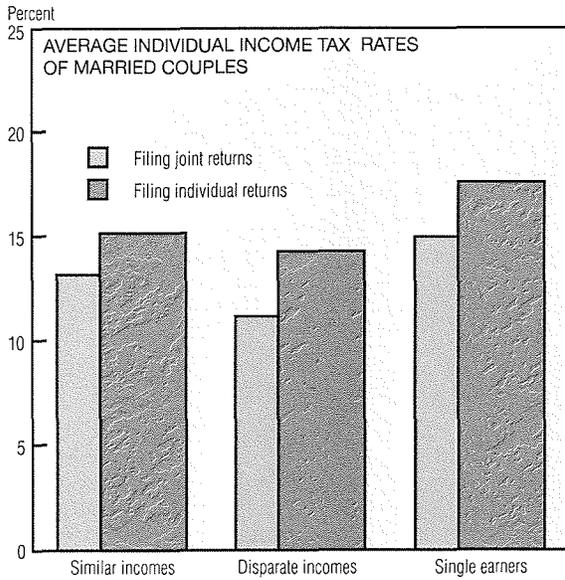
to 34.4 hours (down 0.3 hour). Household survey data, which are more variable than establishment data, also point to strength in the labor markets—an estimated addition of 344,000 workers.

In the goods-producing sector, manufacturing showed a net employment decline for the month (down 5,000 jobs) as durable-goods payrolls added 20,000 jobs and nondurable goods lost 25,000. Average weekly hours of work and overtime hours both continued

their recent downward trends. The average manufacturing workweek stood at 41.7 hours in July, down 0.1 hour from a month earlier. Factory overtime also shortened by 0.1 hour to 4.6.

Jobs in the service-producing sector grew at a healthy clip last month. Employment in retail trade advanced 65,000, buoyed by a rise in restaurant jobs (up 35,000). Government continued to expand its payrolls, adding 56,000 workers in July.

Marriage Penalties and Bonuses



NOTE: All charts show projected data for 1996.
 SOURCE: Congressional Budget Office.

Several features of the current income tax code result in marriage “penalties” and “bonuses.” Single-earner couples who file jointly pay lower average tax rates than those filing individually, and two-earner couples with spouses earning similar-sized incomes face higher average tax rates than couples earning dissimilar incomes.

Marriage penalties and bonuses arise because of separate rate schedules and standard deductions for married versus single filers and because the earned income tax credit (EITC) is applied irrespective of marital status. Generally, couples earn-

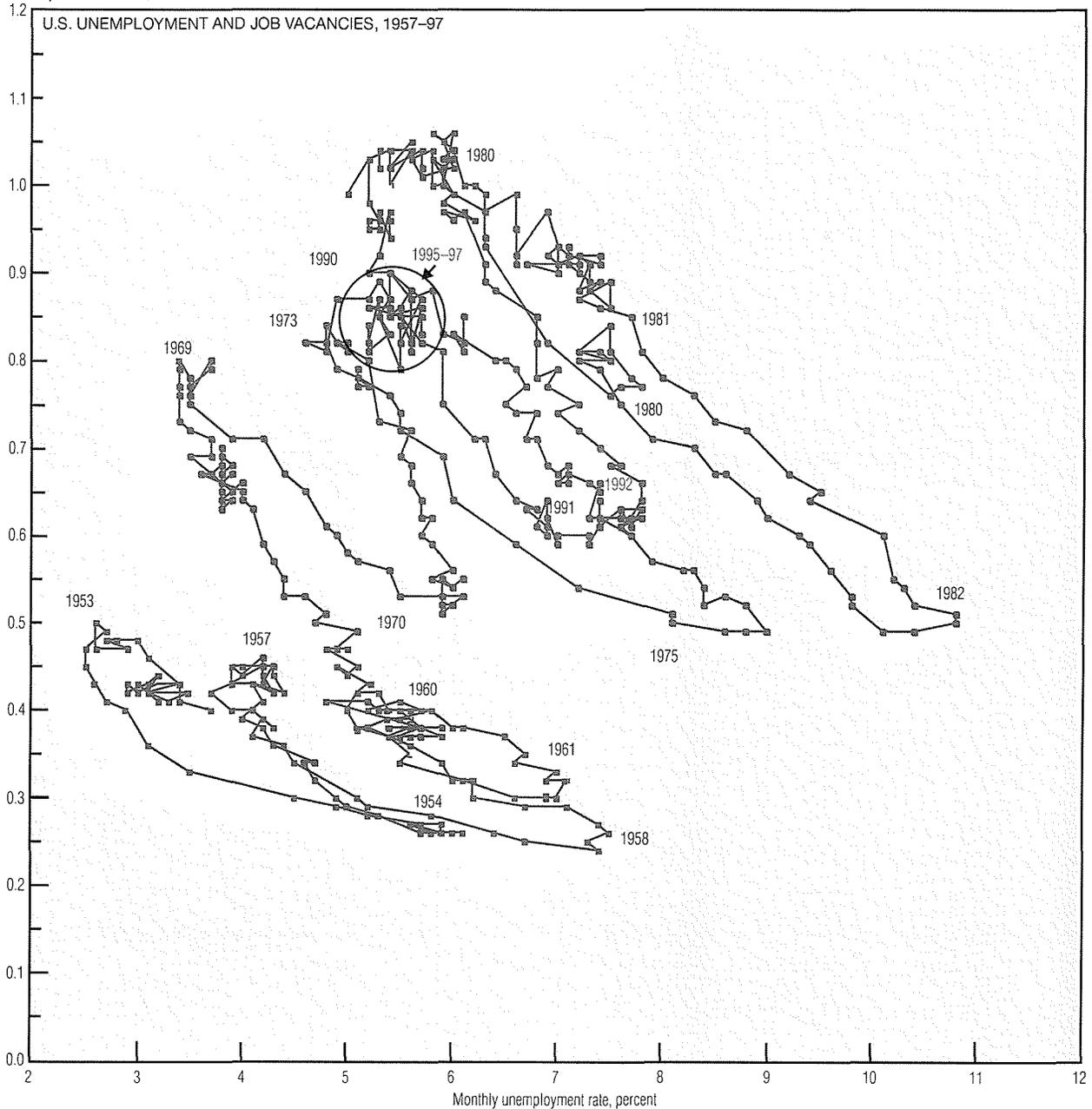
ing similar incomes take lower deductions, pay higher marginal and average tax rates, and lose a major portion of their EITC. Such issues can affect individual behavior regarding labor force participation, hours of work, marriage, and divorce.

Today, more married couples are subject to marriage penalties than ever before. The reason? Despite a decline in the share of married couples among all family and individual tax units, the share of two-income couples among all married people has increased. Also, a larger fraction of two-income couples have spouses with similar incomes.

For 1996, the share of households facing marriage penalties is projected to increase with household income, whereas the share enjoying bonuses should be greater for lower-income households. Both penalties and bonuses are a larger fraction of income for the lowest-income families than for the more affluent. Although a larger number of families are subject to marriage penalties, the Treasury still loses more money on bonuses than it makes on penalties: Projections show that tax-code features generating marriage penalties and bonuses will cost about \$4.1 billion in 1996.

Unemployment and Job Vacancies

Monthly vacancies index, 1987 = 1.0



NOTE: All data are seasonally adjusted. Years are labeled at the approximate month of the trough or peak.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and the National Bureau of Economic Research.

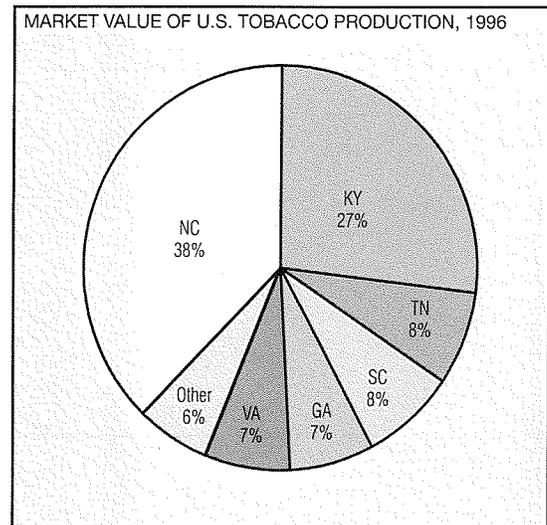
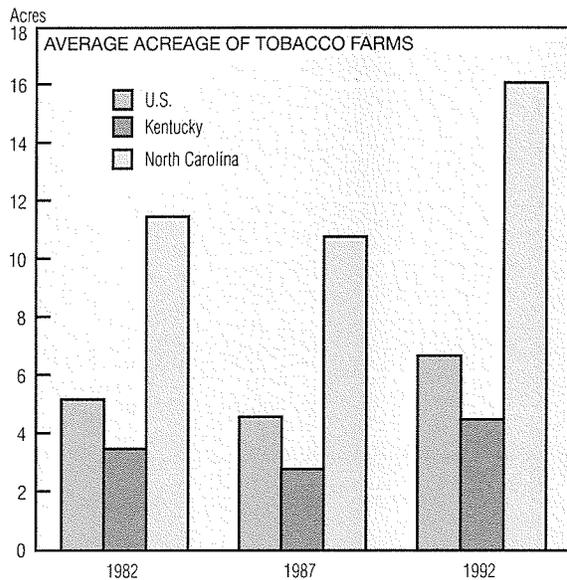
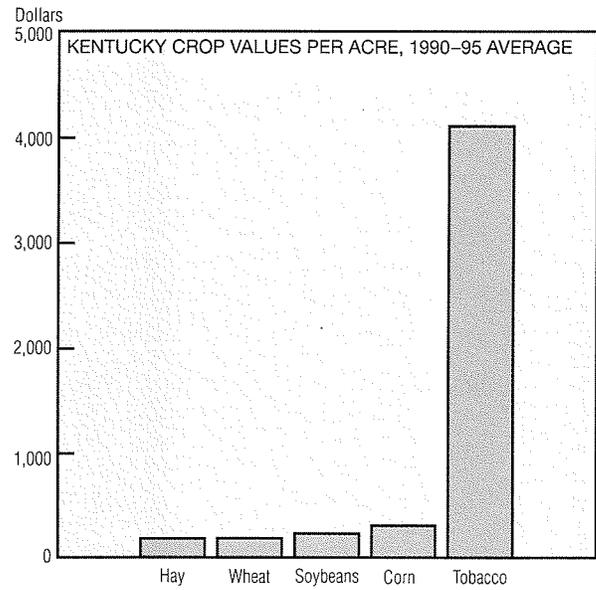
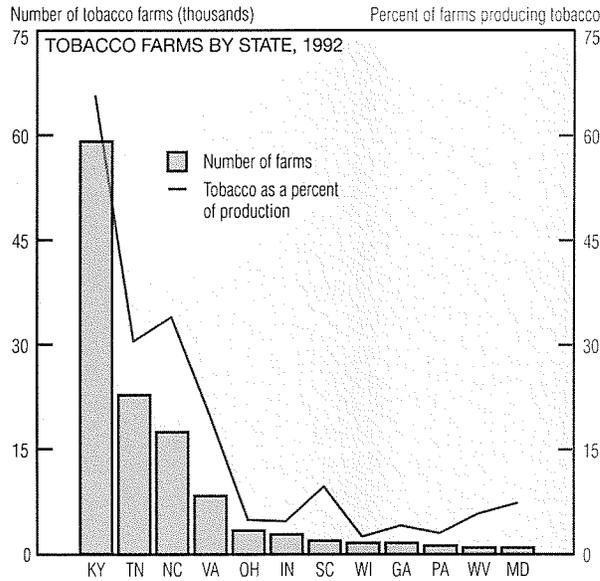
The U.S. labor market is characterized by tremendous churning, with approximately 7 million people entering or leaving in a single month. In addition to people moving between jobs, substantial numbers of jobs are created or destroyed each month. Both kinds of changes occur during cyclical upswings as well as downturns. This suggests that at any given time, unemployed workers coexist with unfilled job vacancies.

The relationship between unemployment and job vacancies is

shown in the Beveridge curve, which is useful for understanding how well the labor market matches unemployed workers with openings. The curve for the U.S. reveals several downward-sloping, counter-clockwise loops. Evidently, these loops trace out a business cycle whose nadir roughly corresponds to the most southeasterly points. Since 1992, we have been moving northwest, and the past three years suggest that we may have reached the peak of the cycle.

Notice also that there seem to be many different Beveridge curves, shifting out and right until the mid-to-late 1980s and then shifting back toward the origin. As the curve shifts to the right, the unemployment rate is higher for any given level of vacancies. This may reflect a worsening job-matching process, slow adjustments to a changing mix of industries, or possibly an increase in unemployment insurance benefits. The opposite would be true of shifts toward the origin.

Kentucky Tobacco Farming



SOURCES: U.S. Department of Agriculture, Economic Research Service; U.S. Department of Commerce, Bureau of the Census; and Will Snell and Stephan Goetz, "Overview of Kentucky's Tobacco Economy," University of Kentucky, Kentucky Cooperative Extension Service, June 1997.

Tobacco is nothing to sneeze at in Kentucky, which is home to half of the nation's 124,270 tobacco farms. In fact, 66% of Kentucky's farmers grow tobacco, making the state's agricultural economy the most tobacco dependent in the Union.

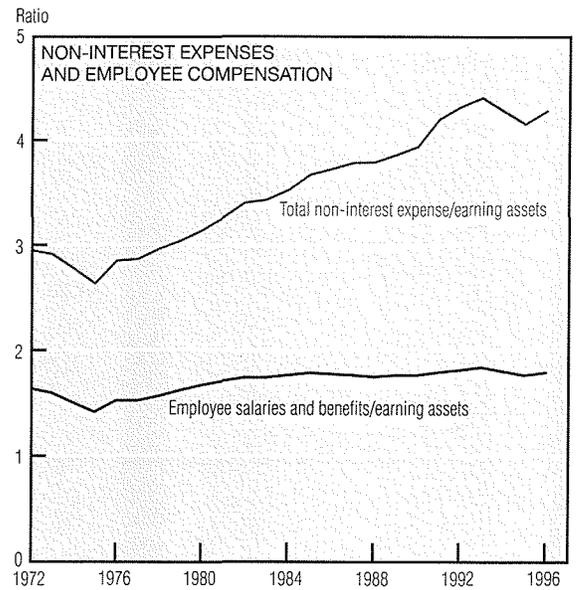
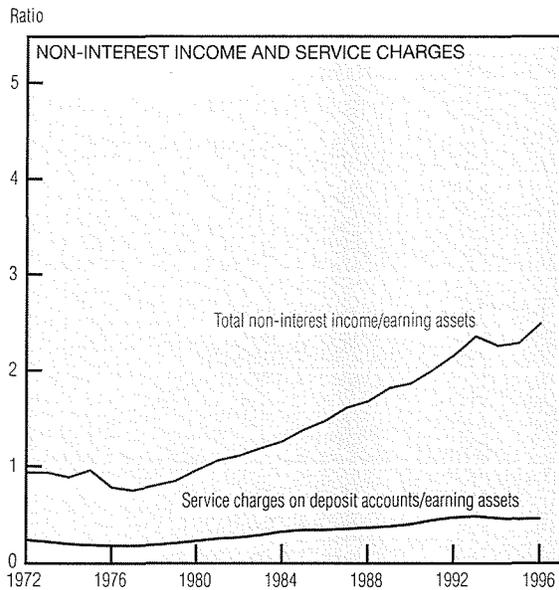
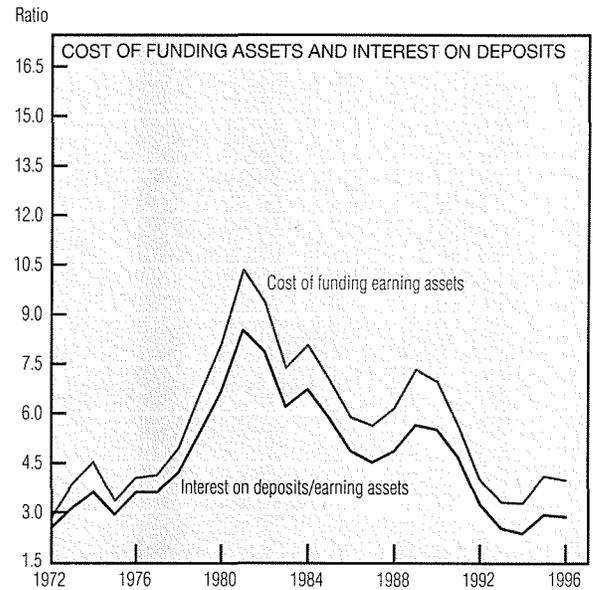
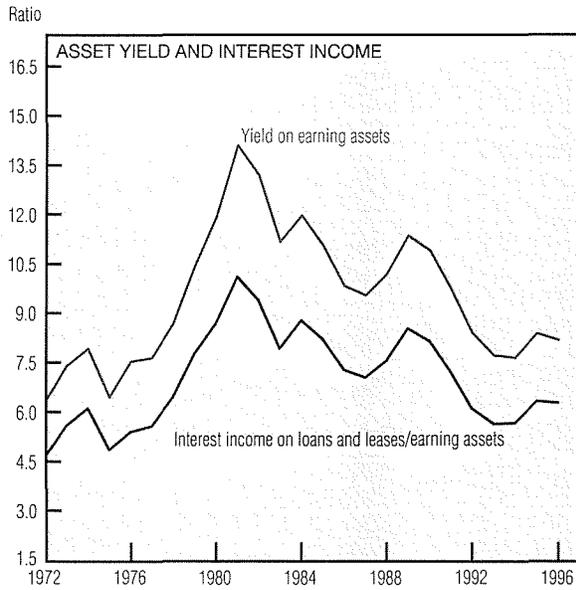
Tobacco production accounts for about 50% of the state's crop receipts and 25% of its agricultural cash. An acre of tobacco averages

\$4,000 in gross returns to the Kentucky farmer, far surpassing returns on the state's other traditional crops. Several counties derive more than 10% of their total personal income from tobacco farming.

Historically, tobacco farms are small-scale operations. In 1992, the median size of a U.S. tobacco farm was 6.7 acres, versus the national average for all crops of 491 acres per

farm. In North Carolina, the nation's top tobacco producer, farms planted in this crop average 16.1 acres, nearly four times the 4.2-acre average of Kentucky's tobacco farms. This size difference can be attributed to Kentucky's topographic limitations and its labor-intensive methods. North Carolina's vast, capital-intensive tobacco farms give it an edge over Kentucky in total output.

Banking Conditions



NOTE: All data are for FDIC-insured commercial banks.
 SOURCE: Federal Deposit Insurance Corporation.

Deregulation, new financial products, and new competitors are some of the explanations for the significant changes that have occurred in the U.S. banking industry. These changes have altered the relative importance of industry profitability components.

The main components usually considered in evaluating banks' profits are asset yields, the cost of funding earning assets, non-interest income, and non-interest expense.

These variables have shown two clear trends in the recent past: Since the early 1970s, the non-interest components of banks' profits have become more significant. Starting in 1981, the importance of the interest components—the yield on assets and the cost of funding earning assets—has been declining.

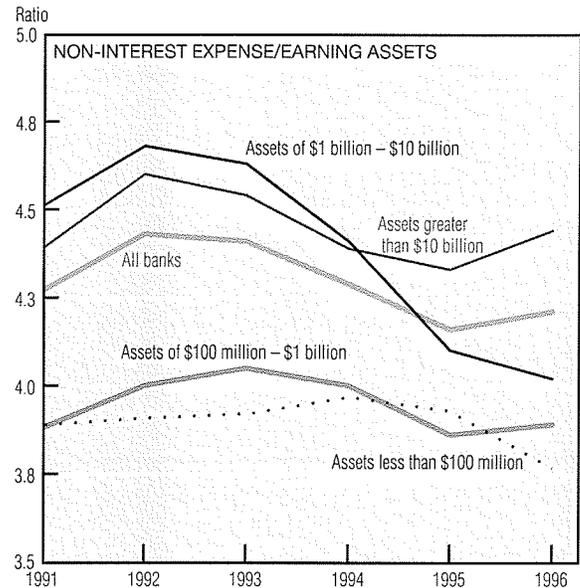
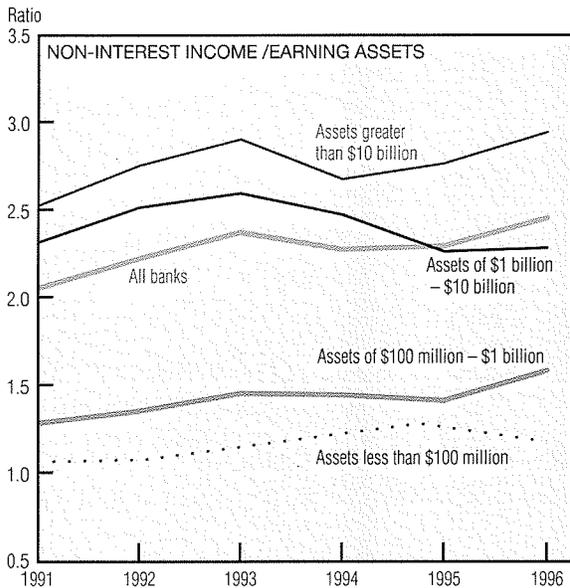
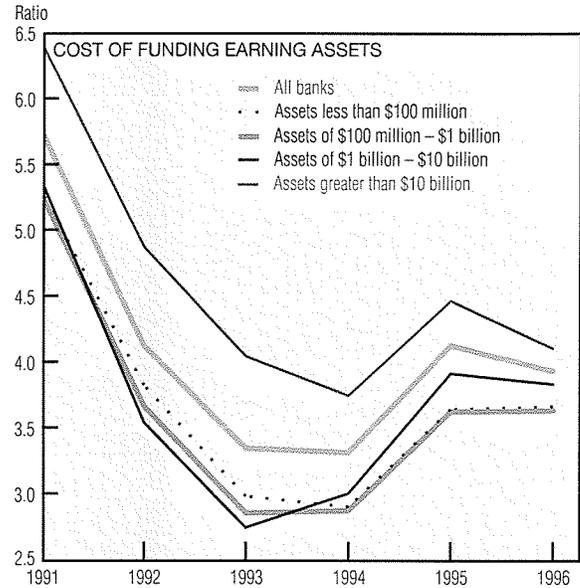
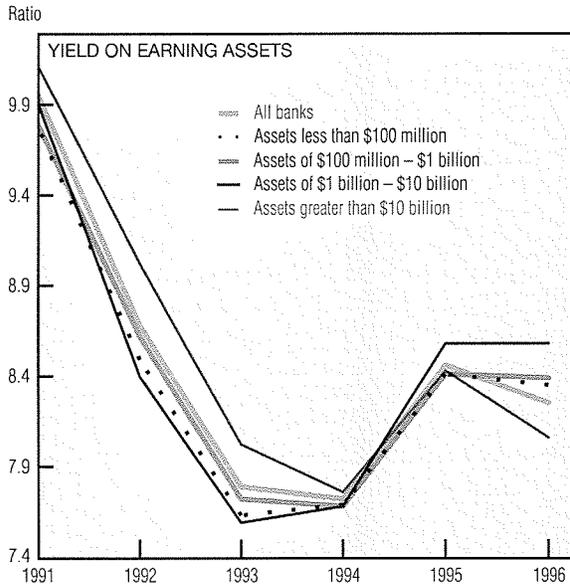
The yield on earning assets and the cost of funding earning assets have followed a common pattern, determined largely by market inter-

est rates. The same is true of the variables' main components—the interest income on loans and leases and the interest on deposits. These variables reached their highest values in 1981, when the yield on earning assets was 14.1% and the cost of funding assets was 10.4%. By 1996, these variables had fallen to 8.2% and 4.0%, respectively.

In contrast to downward trends in the yield on assets and the cost of

(continued on next page)

Banking Conditions (cont.)



NOTE: All data are for FDIC-insured commercial banks.
 SOURCE: Federal Deposit Insurance Corporation.

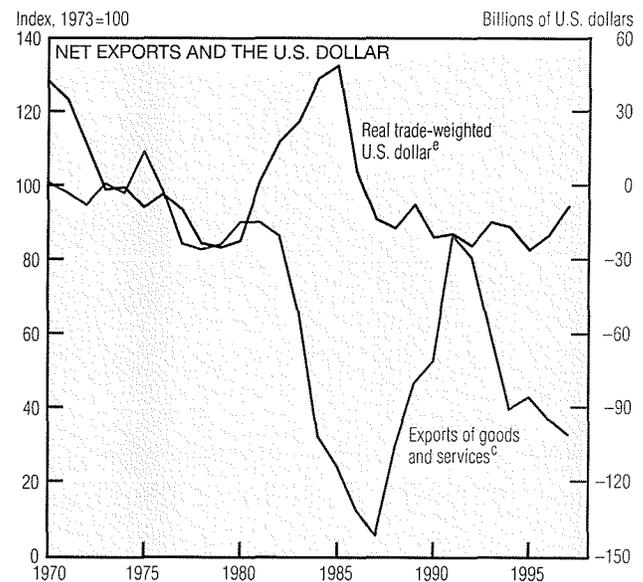
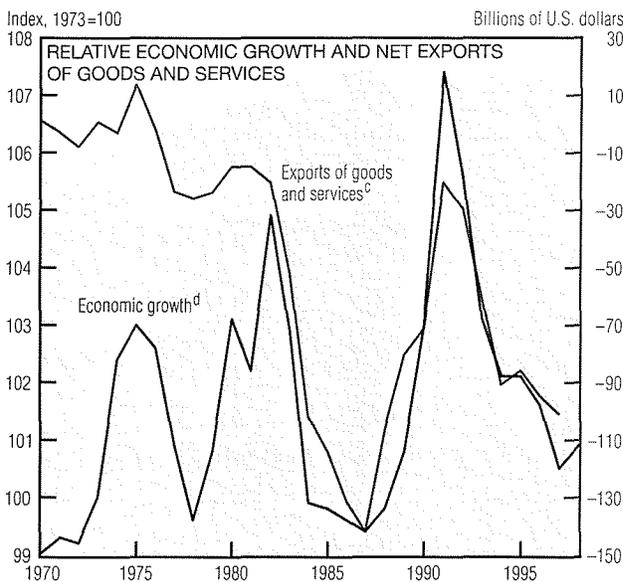
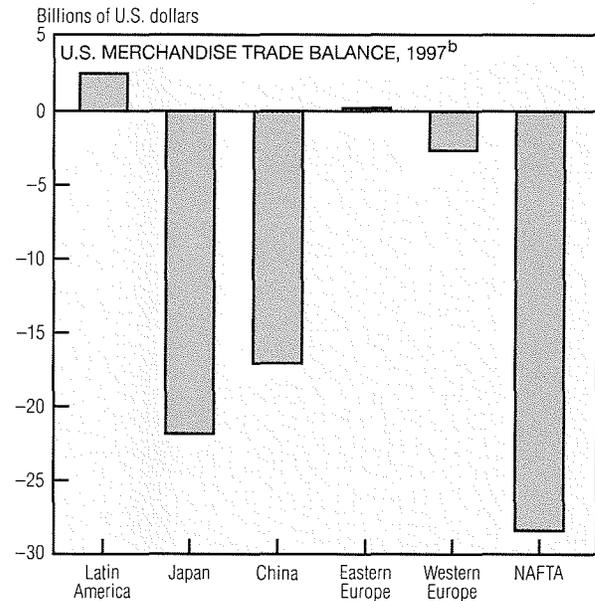
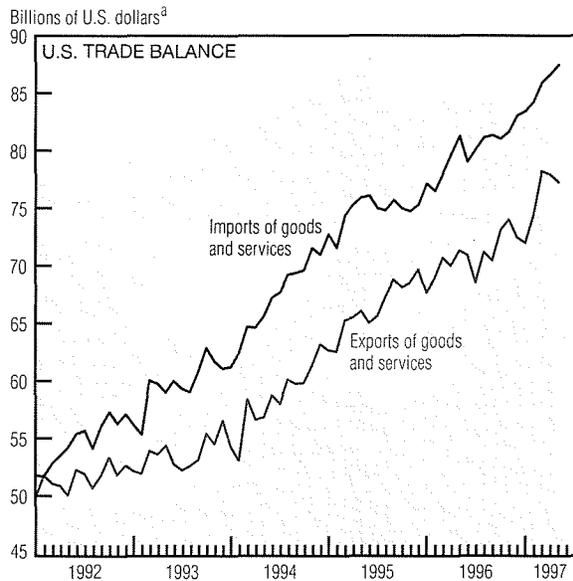
funding is the growing importance of the non-interest components. The ratio of non-interest income to earning assets jumped from 0.9% in 1972 to 2.5% in 1996. During the same period, the ratio of non-interest expense to earning assets rose from 3.0% to 4.3%. Note that these increases occurred despite the steadiness of the variables' main components—service charges on deposit

accounts and the cost of employee salaries and benefits, respectively.

The change in the components of profits varied with the size of the bank. Between 1991 and 1996, the variation in interest components had a similar pattern for all banks. Furthermore, the value of these components did not differ significantly with institution size except in the case of the largest banks, which had a

higher cost of funding earning assets throughout the entire period. The evolution of non-interest components, however, depended more heavily on bank size, as did their values at each point in time. One clear difference among banks of different sizes is that non-interest income and non-interest expense are far less important for smaller banks than for larger ones.

U.S. Trade Balance



a. Seasonally adjusted.

b. Through May.

c. 1997 plot is an average of the first two quarters of the year.

d. 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*, August 2-8, 1997.

e. Annual average of monthly data; 1997 plot is an average of the first five months of the year.

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*, August 2-8, 1997.

The U.S. trade deficit has widened since 1991. Over the first five months of this year, the shortfall was \$48.1 billion. Our largest deficits are with Japan, China, and our NAFTA partners.

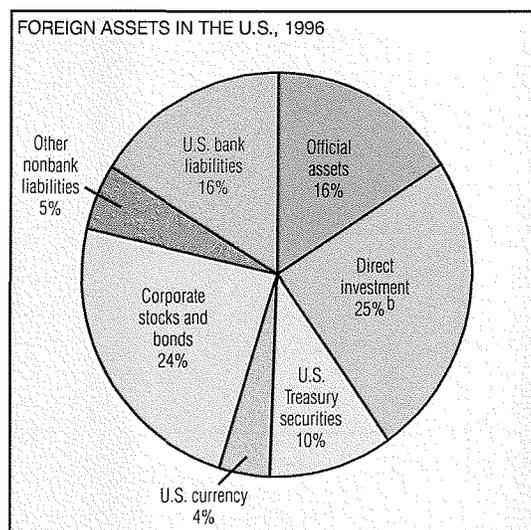
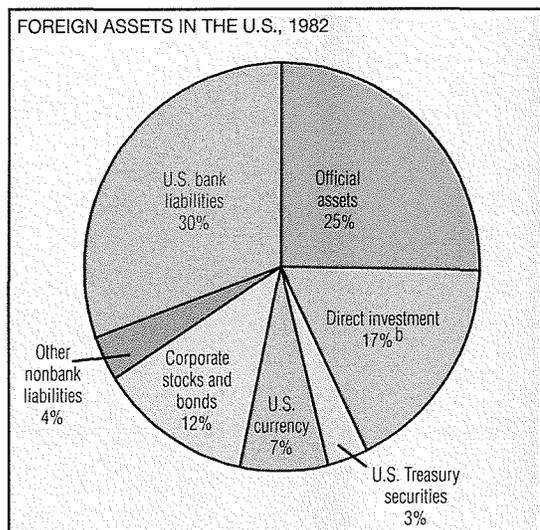
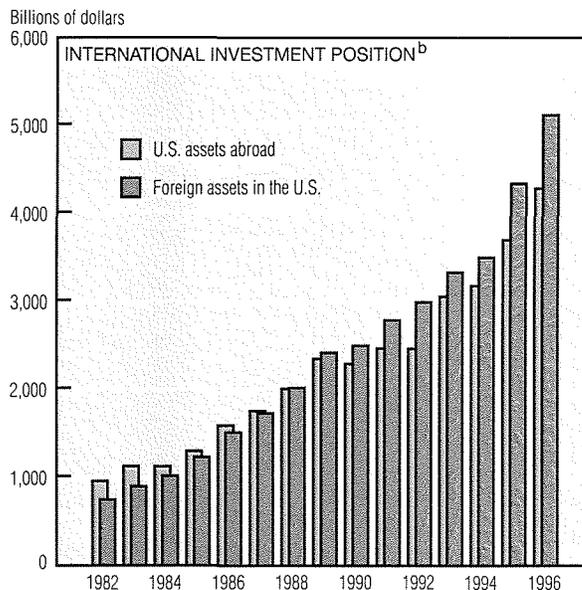
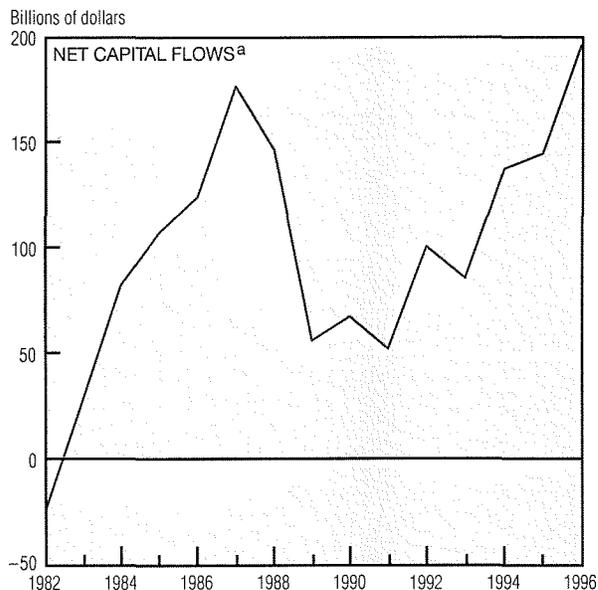
The deterioration in the U.S. trade balance over the current business expansion largely reflects the more rapid pace of economic growth in the U.S. than abroad. Since 1991, the major industrialized countries have seen their output climb 1.5%

on a trade-weighted basis, while the U.S. economy expanded 2.5% (average annual rates). Our faster economic growth has attracted foreign savings and financed domestic investment at levels unsustainable through domestic savings alone. Other things being equal, foreign economies must grow at about twice the domestic rate in order to reverse this pattern and narrow the U.S. trade deficit. Although analysts expect foreign economic growth to

accelerate to 2.3% in 1997 and 2.7% in 1998, it will not surpass projected U.S. growth (3.5% in 1997 and 2.3% in 1998) by the requisite margin.

The relationship between exchange rates and the trade deficit is even more tenuous than that between growth rates and trade, but a dollar appreciation can widen the deficit. The dollar's 14.4% real appreciation since 1995 has not favored a narrower trade deficit.

The U.S. International Investment Position



a. Positive values indicate a net capital inflow.
 b. Includes direct investment at market value.
 SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The U.S. current account deficit has increased thirteenfold since 1982, reaching \$148 billion in 1996 and nearly \$164 billion (annual rate) in 1997:1Q. Our nation has financed the surfeit of imports by selling assets and issuing debt instruments to foreigners. This generates an inflow of foreign capital, but it also gives the rest of the world a claim on our future output.

In the late 1980s, when the stock

of foreign assets held in the U.S. exceeded our assets held abroad, we became a debtor country. The U.S. international investment position—our balance sheet with the rest of the world—reflects the history of our capital flows as well as changes in the value of our external assets and liabilities.

Nearly 25% of the assets that foreigners hold in the U.S. are direct investments, which entail some control over the management of

American businesses. The biggest stakeholders are the U.K., Japan, the Netherlands, and Canada. Another 24% of foreign-held U.S. assets are in corporate stocks and bonds, which do not confer any significant degree of managerial control. This is the share that has expanded the most since 1982, but foreigners have also increased the portion of their U.S. assets held in Treasury securities.