

## *The Economy in Perspective*

*Hear ye, hear ye, hear ye...* Ladies and gentlemen of the jury, the question before us is a simple one: Do overabundant money and credit creation threaten the U.S. economy with accelerating inflation and below-par performance? You have heard me present the prosecution's argument, and you have heard the case of Ms. Rose Glass, counsel for the defense. You have also weighed a great quantity of evidence and listened to expert witnesses for both sides. Just a few minutes ago, Ms. Glass summarized the defense position. Now, before you withdraw for final deliberations, I would like to review the prosecution's case.

Certain facts are not in dispute. The U.S. economy has been expanding continuously since 1991, and, far from slowing, its growth rate has accelerated in each of the last two years. Capacity utilization rates seem high throughout the economy. The nation's unemployment rate, which stood at nearly 8 percent early in this business cycle, has fallen steadily and has registered less than 5 percent for the last nine months. Add to these excellent conditions the facts that the producer price level held steady last year and consumer prices increased less than 2 percent.

Now, ladies and gentlemen, Ms. Rose Glass would have you believe that the U.S. economy has achieved price stability and that resisting an upsurge of inflation is inadvisable today because inflation is already so low. This is where she and I part company. Many people think that inflation is whatever the Consumer Price Index records as the rate of price change from one year to the next. But, as I have shown you, inflation is a decline in the purchasing power of money that results from a *persistent* increase in the general level of prices. Last year's 1¾ percent CPI increase and the even better performance so far this year are lower than the rates that prevailed during most of this economic expansion, and, I maintain, lower than those we will see going forward.

I have laid out our evidence that inflation's underlying rate easily surpasses 2 percent. For example, last year's CPI excluding food and energy expanded 2¼ percent, and the median CPI—an even better measure of core inflation—grew 2¾ percent. These core measures averaged between 2¾ percent and 3 percent over the last five years,

suggesting that the economy's recent inflation performance has not moved off this trend. Energy prices on average have barely risen for six years.

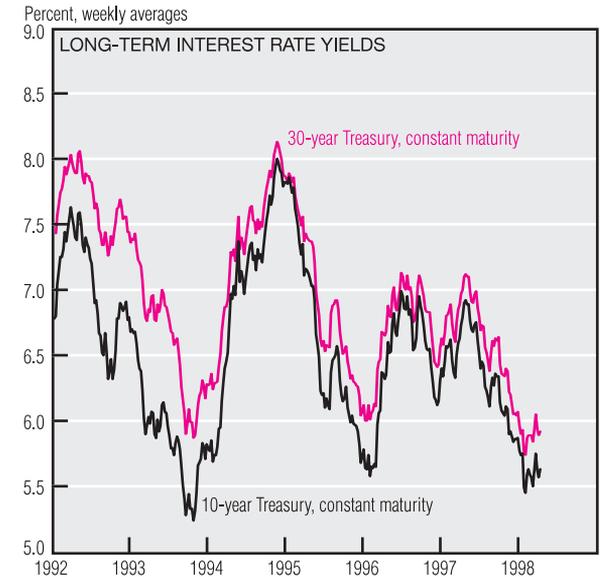
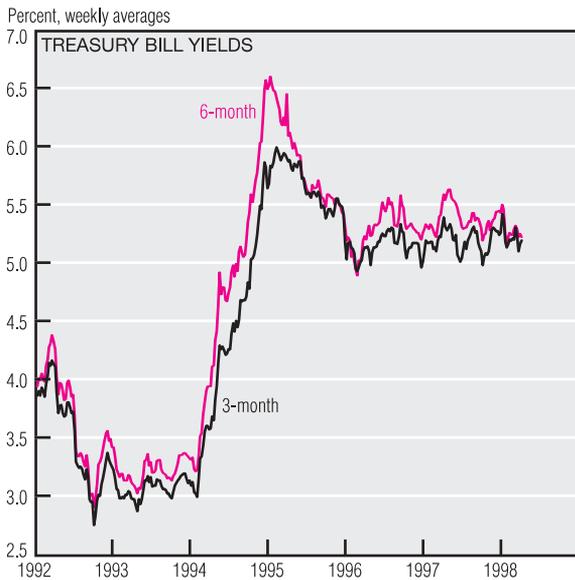
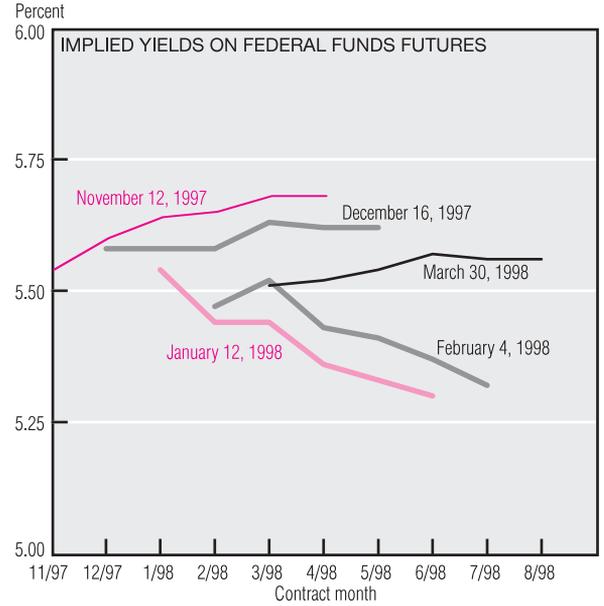
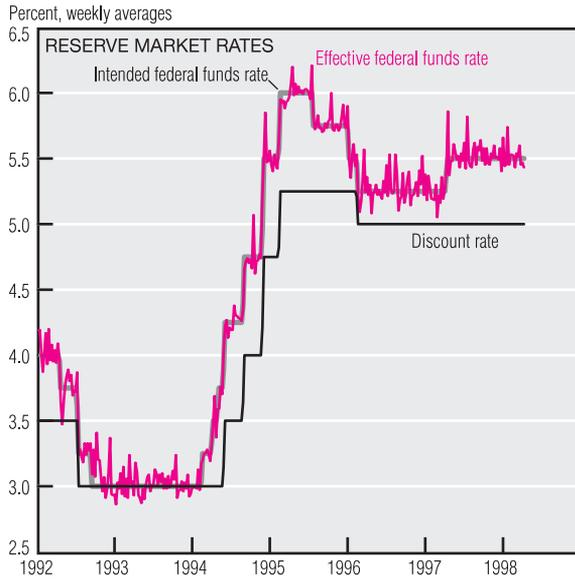
We know that inflation is a monetary phenomenon which escalates when the amount of money supplied exceeds the demand. Ms. Glass' experts have told you that there is no positive way to determine when too much money has been created, but that is irrelevant. You are not required to know beyond any doubt, but only to judge whether there is a preponderance of evidence. On this score, I have presented some compelling facts. Since 1959, the U.S. economy has had four distinct periods of persistently accelerating inflation. Before each of these episodes, it enjoyed two years of strong output and employment growth. In addition, the growth rate of the monetary base rose steadily over the four years prior to each inflationary run-up, especially during the six to 12 months just before inflation began to accelerate.

And what do we see today? Most money measures have been accelerating during the past few years, with annualized growth rates early this year reaching 8 percent for the monetary base and M2—and hitting 12 percent for M3. Even 3 percent inflation is unlikely to be sustainable unless these money growth rates slow down.

Financial markets are providing lavish credit to private borrowers. Mortgage debt outstanding has increased nearly 25 percent in just four years. Short-term bank financing, combined with nonfinancial issuance of commercial paper, soared last year and is still accelerating. Corporations are also raising large sums through bond issuance and equity sales.

Make no mistake, ladies and gentlemen of the jury; excess money and credit creation are serious threats to our economy and must not go unchecked. In the last four episodes, painful economic adjustments had to be made when inflation and inflation expectations accelerated rapidly. Inflation distorts economic decisions, and the greater the distortions, the more costly the correction. I therefore ask you to make the only responsible decision and return a guilty verdict—before the Rose Glasses of our society color our economic judgment.

# Monetary Policy



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

The past two years have been characterized by relatively stable interest rates. At its March 31 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate target unchanged, a decision that was widely anticipated in financial markets. That meeting marked the one-year anniversary of the latest rate change, a 25-basis-point increase to 5.5% on March 25, 1997. The discount rate has stayed the same over an even longer period, its last move being a decrease of 25 basis points to 5% in February 1996. The FOMC will reconvene on May 19.

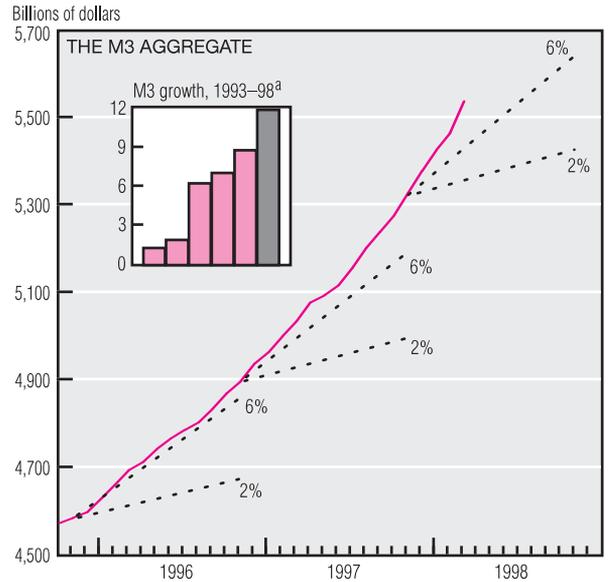
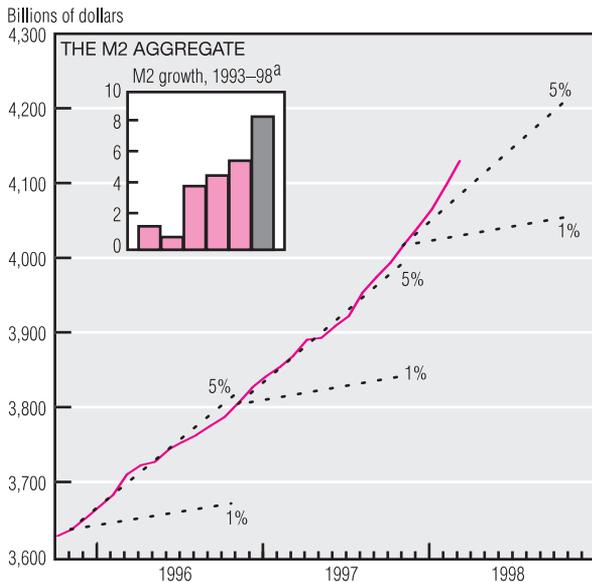
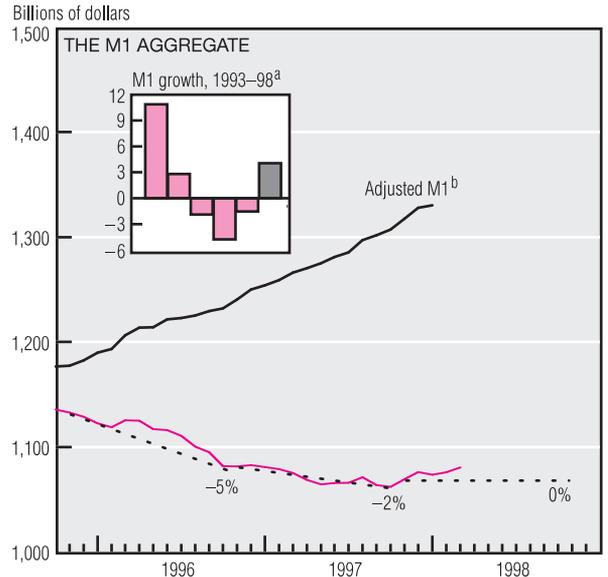
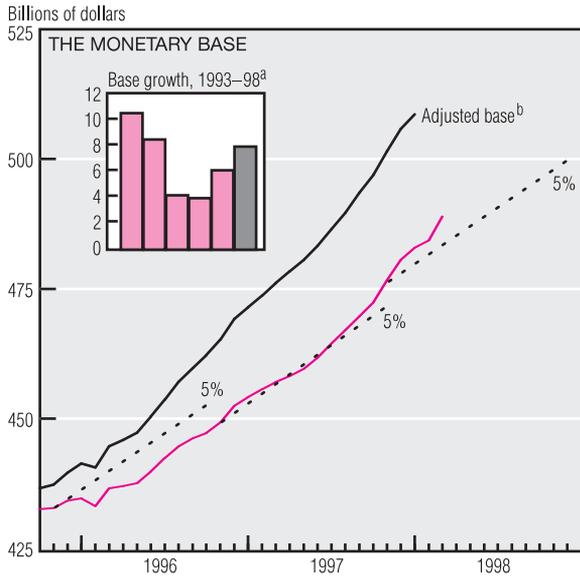
The implied yields on federal funds futures are fairly constant over the next several months, increasing only slightly. Fed funds futures allow market participants to hedge against or speculate on future changes in the federal funds rate. Implied yields show where market participants expect the federal funds rate to be in the coming months. The yields' downward slope in January and February signaled participants' belief that the rate was more likely to decrease than to increase. As of March 30, this expectation was replaced by a more symmetric belief that rates are about equally likely to

increase or decrease, with an increase slightly more probable.

Short-term interest rates have fluctuated within a fairly narrow range since the beginning of 1996. The weekly average yield on 3-month Treasury bills traded in the secondary market has fluctuated by only 50 basis points (between 4.93% and 5.42%) over this period, and stood at 5.19% for the week ended March 27. This differs starkly from the experience of 1994, when 3-month Treasury bill yields increased from 2.99% to 5.86% in just a year.

*(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 1998 is calculated on an estimated March over 1997:IVQ basis.  
 b. Adjusted for sweep accounts.  
 NOTE: All data are seasonally adjusted. Last plot is estimated for March 1998. For M2 and M3, dotted lines are FOMC-determined provisional ranges. For M1 and the monetary base, dotted lines represent growth rates and are for reference only.  
 SOURCE: Board of Governors of the Federal Reserve System.

Long-term interest rates have likewise varied over a relatively limited range. The weekly average yield on the 30-year Treasury constant-maturity rose from 6.00% at the beginning of 1996 to 7.13% in the middle of that year, but has since sunk back below 6.00%. As of the week ended March 27, the 30-year yield stood at 5.92%. In contrast, the 30-year yield increased from 6.24% to 8.13% in 1994, and fell again to 6.00% by the end of 1995.

The growth rates of the monetary aggregates accelerated in 1998:1Q,

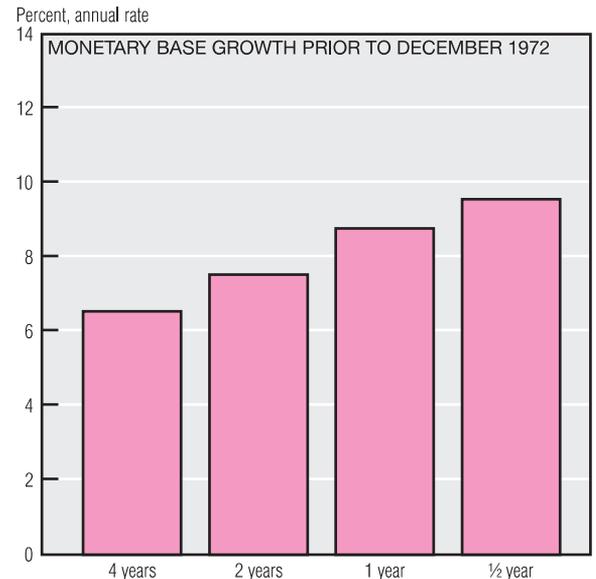
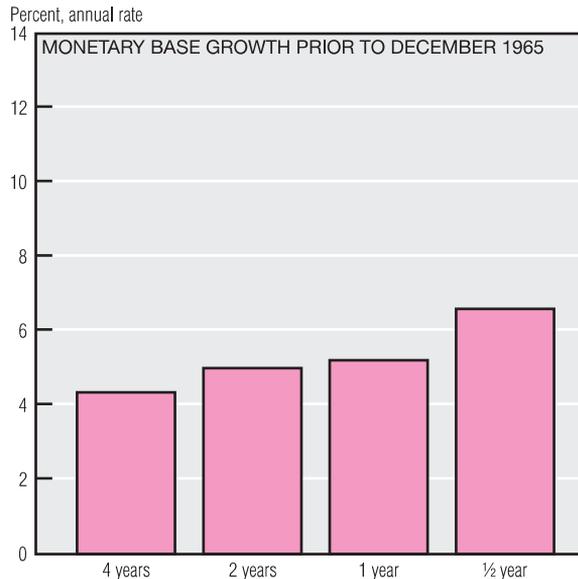
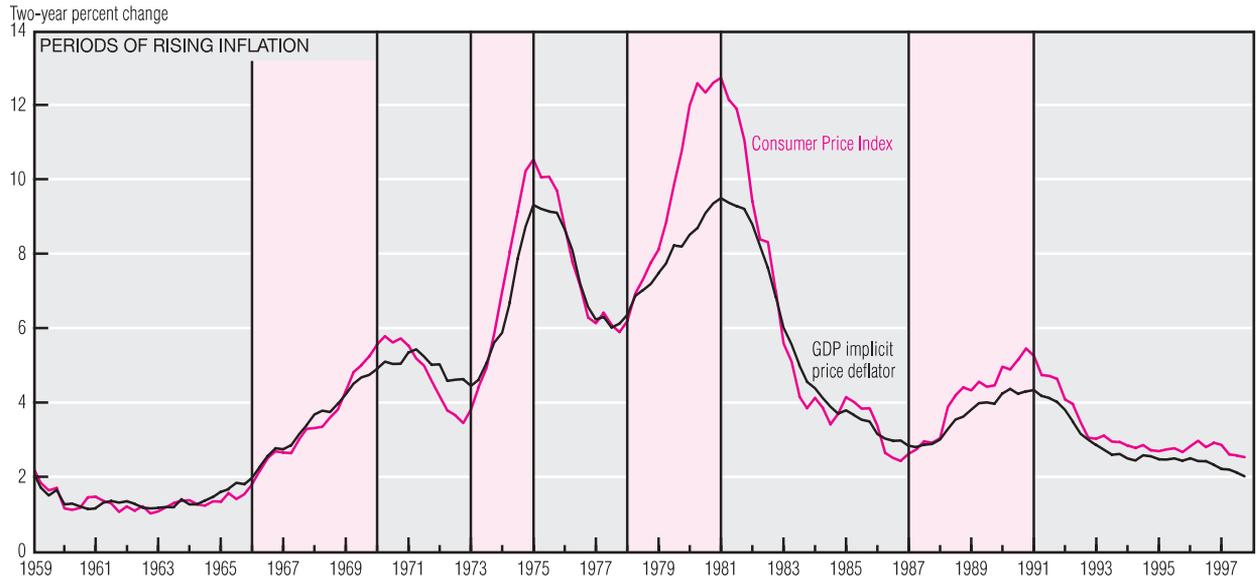
leaving M2 and M3 substantially above the provisional ranges set by the FOMC. These aggregates' relatively rapid growth has caught the attention of some policymakers, because sustained money growth may herald an inflation rate increase.

The monetary base rose an estimated 11.5% in March, and has expanded 7.8% since 1997:IVQ. Adjusted for sweep accounts, which banks use to "sweep" money from reservable to nonreservable accounts, the base increased 8.7% from 1997:IVQ through January

(estimates of sweep activity are lagged one to two months). Growth through March in the adjusted base will be at least as large as in the non-adjusted base.

The M2 and M3 aggregates, which are unaffected by sweep activity, increased substantially in early 1998. M2 rose an estimated 9.8% in March, and about 8.4% from its 1997:IVQ level, while M3 increased roughly 16.0% in March and about 11.8% since 1997:IVQ. These growth rates are well above the ranges set by the FOMC.

# Rising Inflation



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

Since 1959, there have been four distinct periods of persistently accelerating inflation. Although it is difficult to date their beginnings and ends, they correspond roughly to the years 1966–70, 1973–75, 1978–81, and 1987–91. In each of these periods, the inflation rate was substantially higher at the end than at the beginning.

The dominant issue facing monetary policymakers today is whether action is necessary to prevent yet another period of accelerating infla-

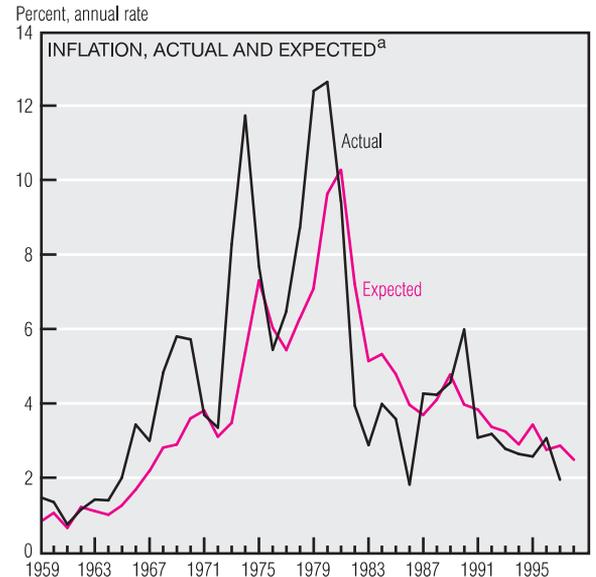
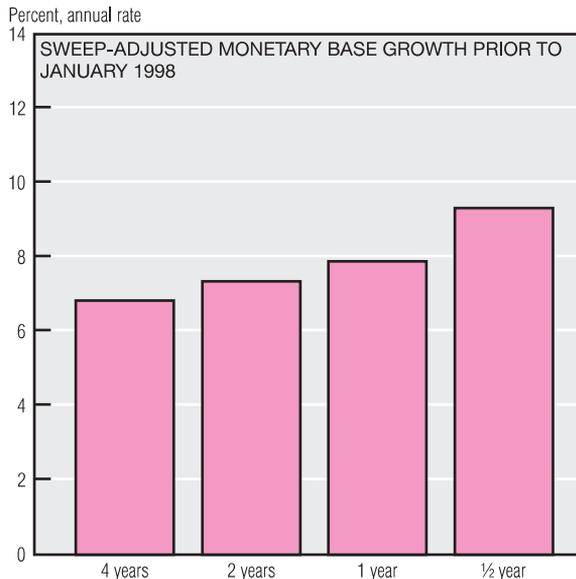
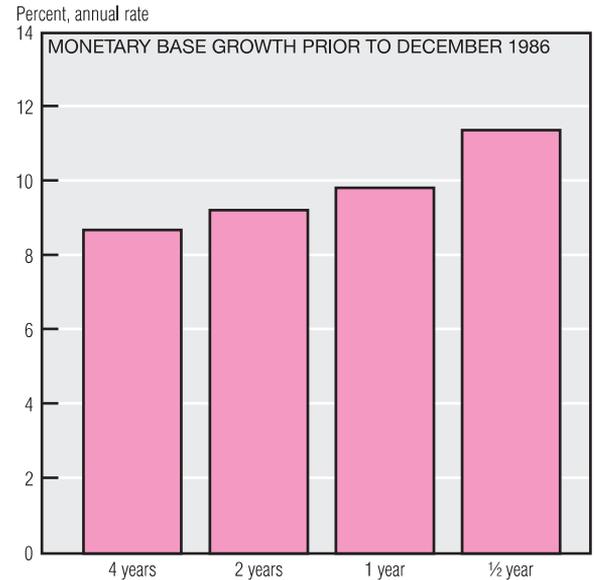
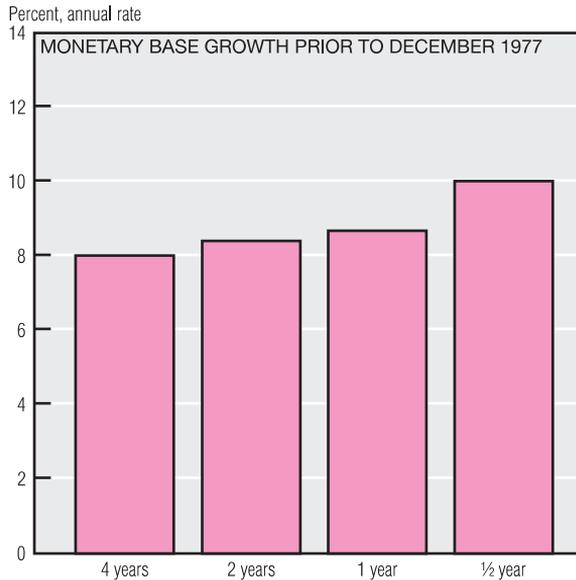
tion. In the light of past episodes, two natural questions arise: Have the years preceding each earlier period of accelerating inflation shown a characteristic pattern? And if so, does the recent performance of the economy fit that pattern?

The answer to the first question is yes, there have been broad similarities among the economy's performances before periods of accelerating inflation. The two years preceding each of the four earlier run-ups were characterized by strong output and

employment growth. In addition, the growth rate of the monetary base had been rising steadily over the four years prior to each period, most notably in the six to 12 months just before inflation began to accelerate.

These similarities do not imply that strong economic growth causes rising inflation, or that accelerating money growth necessarily results in spiraling prices. The crucial point is whether money supply growth exceeds the increase in a strong  
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## Rising Inflation (cont.)



a. The actual and expected inflation for a given year correspond to the increase and expected increase in the Consumer Price Index for all urban consumers (CPI-U) from October of the previous year through December of the given year.

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

economy's demand for money. The periods discussed do suggest that robust growth has frequently been accompanied by overexpansion in the money supply.

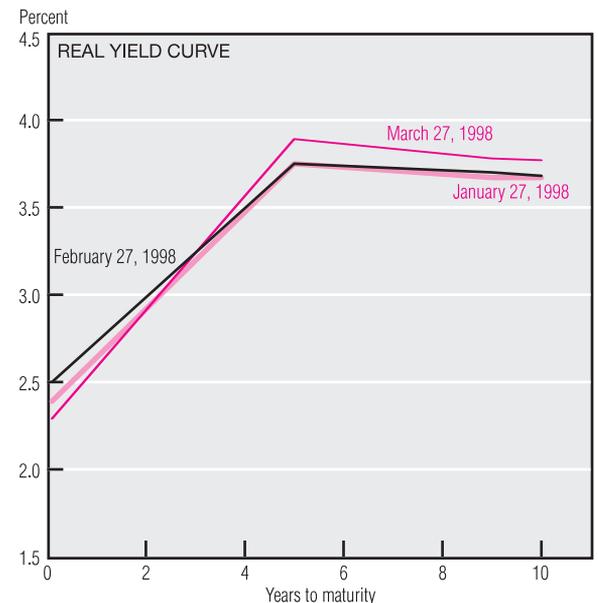
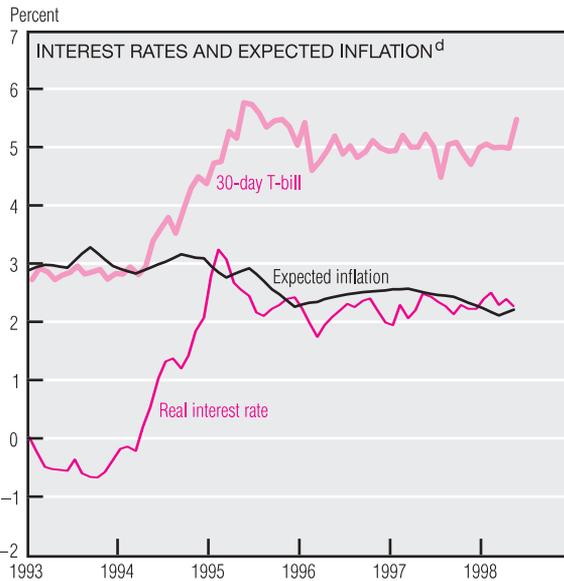
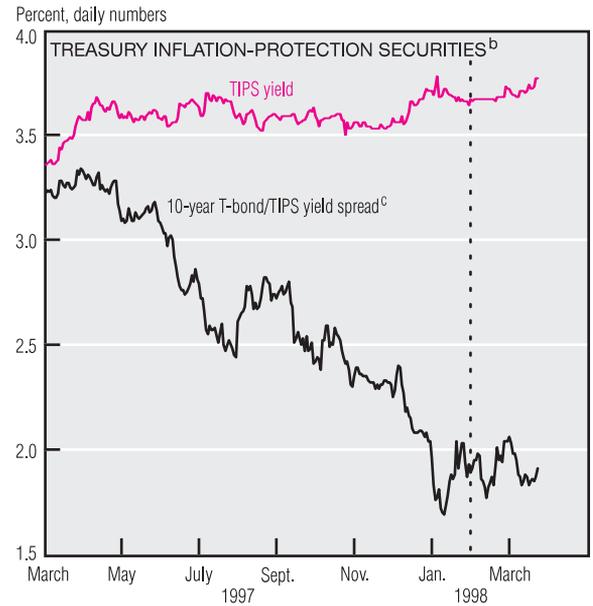
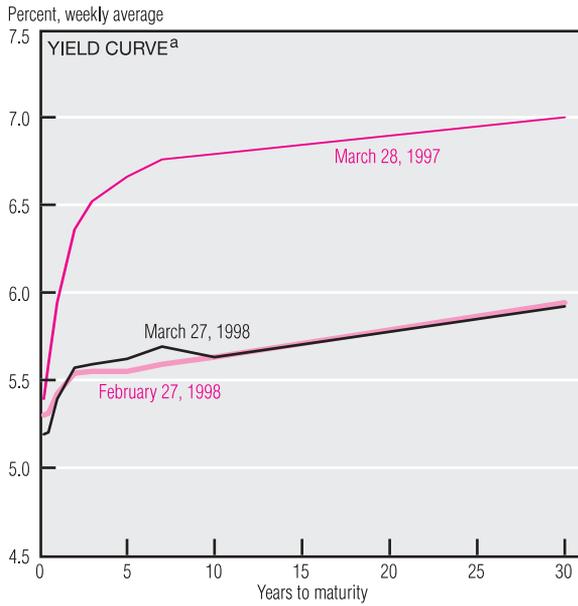
Does the economy's recent performance fit the pattern of those earlier periods? From a very general perspective, the answer is yes. Output and employment growth during the past two years have been strong, and the growth rate of the sweep-adjusted monetary base has increased steadily. Recent years' similarities to earlier preacceleration

periods indicate that present concerns about inflation are not unfounded. Furthermore, the fact that inflation is widely expected to remain low cannot comfort those who observe that a similar expectation prevailed before previous run-ups.

As mentioned earlier, similarities between today and earlier preacceleration periods do not guarantee that rising inflation is at hand. There have also been instances in which strong economic growth and rising monetary base growth were *not* followed by increasing inflation.

In the most recent example, base growth accelerated briskly through 1992, a year of fairly strong output growth, yet inflation did not subsequently increase. This may have been the result of an effective monetary policy strategy that responded to current conditions and prevented base growth from exceeding money demand. Moreover, some of the increase in the monetary base may have reflected factors, such as larger currency holdings abroad, which have little connection with domestic economic activity.

# Interest Rates



a. All instruments are constant-maturity series.

b. Vertical line marks the change from the TIPS series that is due to mature in 2007 to the series due to mature in 2008.

c. 10-year Treasury bond constant-maturity yield minus the yield quote for the TIPS-adjusted series.

d. The real interest rate and expected inflation rate, from the Survey of Professional Forecasters, are calculated using the 30-day T-bill rate.

SOURCES: Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Bloomberg information services; and *The Wall Street Journal*, various issues.

The yield curve remains flat relative to its historical shape, with the benchmark 3-year, 3-month and 10-year, 3-month spreads at 40 and 44 basis points, respectively. The flatness is particularly noticeable at the long end. Since last month, the curve has steepened slightly because of lower 3-month rates and higher rates on maturities of two to 10 years. The yield curve continues to show a rather bumpy shape over those years.

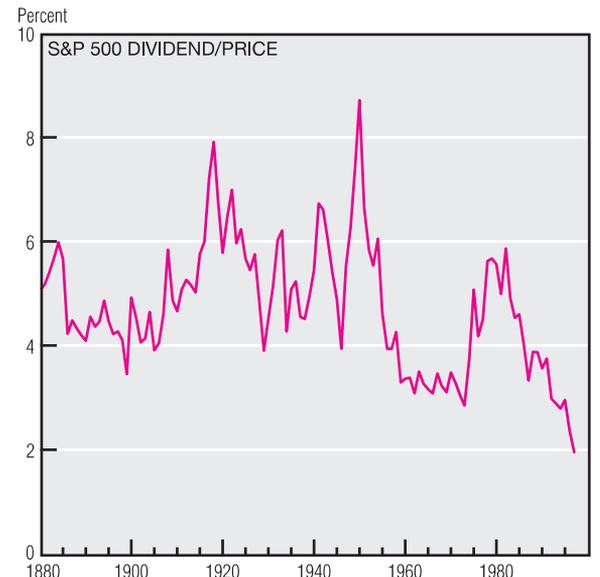
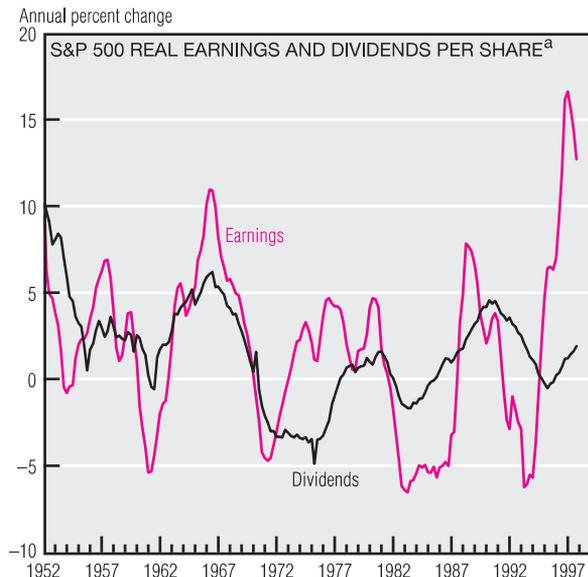
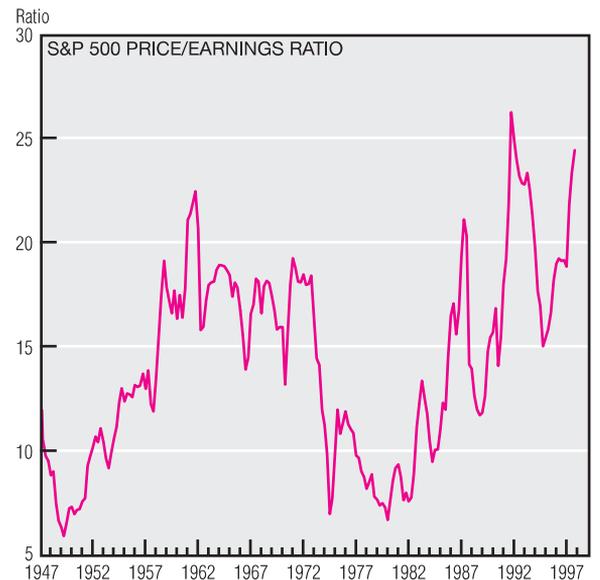
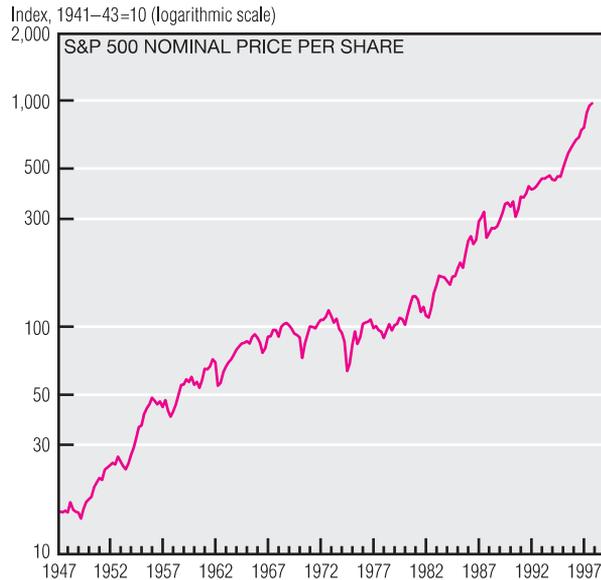
The recent introduction of Treasury Inflation-Protection Securities (TIPS) makes it easier to use the

yield curve to discern future inflation trends. One simple measure of expected inflation subtracts the interest rate on TIPS from the standard nominal (not inflation-protected) Treasury. This assumes that the nominal interest rate is the sum of the real rate and expected inflation—ignoring risk premiums, liquidity differences, and tax effects—but it probably suffices for a first look. The resulting measure of expected inflation has fluctuated, but has shown no discernible trend since January and now stands at 1.9%. A more sophisticated procedure using short-term rates and a survey of profes-

sional forecasters yields 2.16% expected inflation for the month of April, with a 1-month real interest rate of 2.39%.

The final chart combines the 1-month results with TIPS bonds of five, nine, and 10 years to construct a yield curve of real interest rates. It clearly indicates that the slope of the yield curve depends on more than inflationary expectations; in fact, at the short end, the real yield curve is steeper than the nominal curve, with a 5-year, 1-month spread of 160 basis points. This exceeds the nominal curve's spread of 62 basis points.

# Equity Prices



a. Real earnings growth is the compounded growth rate of four-quarter total real earnings divided by four-quarter total real earnings four years earlier. Real dividend growth is the compounded growth rate of the current-quarter real dividend divided by the real dividend four years earlier.  
 SOURCES: Robert J. Shiller, *Market Volatility*. Cambridge, Mass.: MIT Press, 1989; and Standard & Poor's Statistical Service, *Security Price Index Record*, various issues.

The stock market is again hitting new highs almost daily. Some analysts think this means a bubble is about to burst, while others believe it heralds a "new economy" of strong growth with low inflation. A closer look suggests that evidence can be marshaled on both sides.

Plotting the Standard & Poor's (S&P) 500 index on a logarithmic scale underscores the bias that high levels can impart to changes: A 100-point increase means much

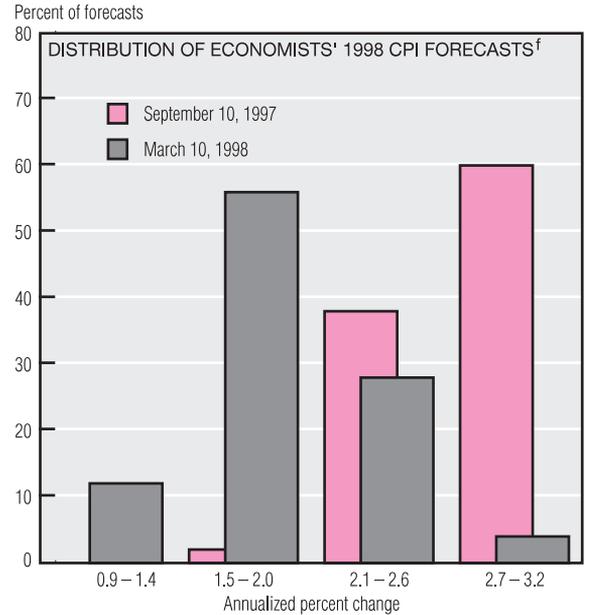
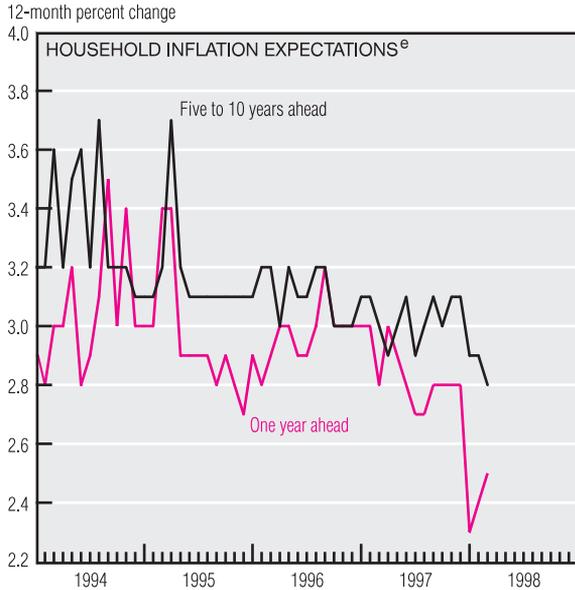
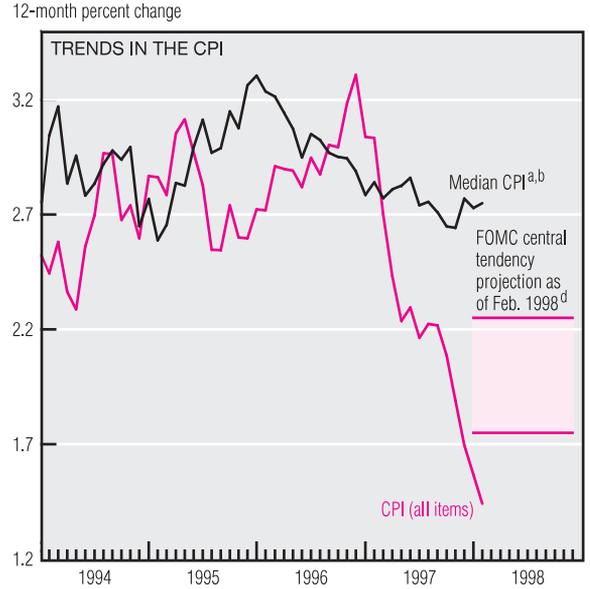
less when the index stands at 1,000 than when it stands at 100. Nonetheless, doubling from 500 to 1,000 in only three years is impressive on any scale.

Pessimists point to very high price/earnings (P/E) ratios—which are approaching post-World War II records—and predict that prices will come back into line with earnings. Optimists believe current P/E ratios are justified by strong earnings growth, which they expect to con-

tinue despite some slackening in recent quarters. More of the earnings do seem to be passed on to shareholders via dividends, but share repurchases might have the same effect. The dividend/price ratio, often an accurate predictor, is signaling low expected returns to equity holdings. Whether this means a permanently higher plateau for prices, a bear market, or just a mistake, remains to be seen.

# Inflation and Prices

February Price Statistics	Annualized percent change, last:				1997 avg.
	1 mo.	6 mo.	12 mo.	5 yr.	
	Consumer prices				
All items	0.7	1.4	1.4	2.5	1.7
Less food and energy	3.6	2.5	2.3	2.7	2.2
Median <sup>a,b</sup>	3.1	2.7	2.7	2.9	2.8
Producer prices					
Finished goods	-0.9	-1.4	-1.7	0.9	-1.5
Less food and energy	1.7	0.4	0.1	1.0	0.0
Commodity futures prices <sup>c</sup>	8.9	-8.4	-3.8	2.7	-3.5



a. Calculated by the Federal Reserve Bank of Cleveland.  
 b. Revised since January 1993 to reflect new Bureau of Labor Statistics seasonal factors.  
 c. 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.  
 d. 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.  
 e. Median expected change in consumer prices as measured by the University of Michigan's Survey of Consumers.  
 f. 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 University of Michigan; and *Blue Chip Economic Indicators*, September 10, 1997 and March 10, 1998.

Consumer prices edged up an annualized 0.7% in February, resulting in a 12-month change of only 1.4%, down from the 1997 average of 1.7%. Excluding food and energy components, however, prices rose at a 3.6% annualized rate, well above the five-year average of 2.7%. The median Consumer Price Index (CPI), an alternative inflation measure, advanced 3.1% in February and

is tracking close to its five-year average. The CPI for all items remains below the Federal Open Market Committee's (FOMC) central tendency projection, partly because of the continuing slump in energy prices.

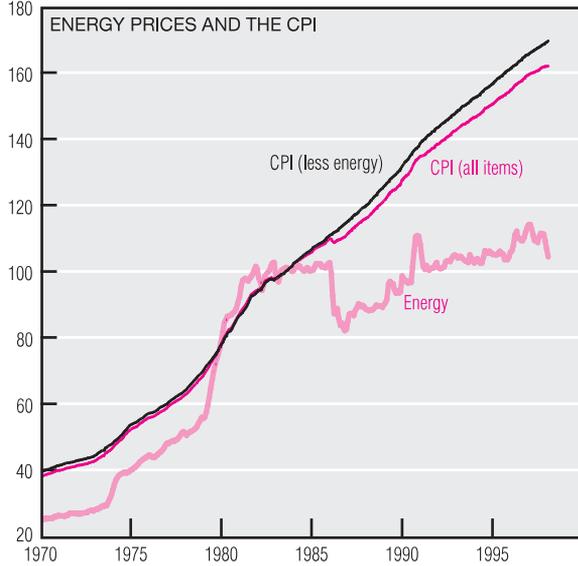
Producer prices declined again in February, with the Producer Price Index (PPI) for all items falling at a 0.9% annualized rate. Here, too, a

closer look reveals that declining energy prices are responsible for the drop, since the PPI less food and energy climbed at a 1.7% annualized rate during the same period.

Consumer expectations for inflation one year ahead rose this month to 2.5%, the second straight increase in their median response. Over the longer term, consumers continue to *(continued on next page)*

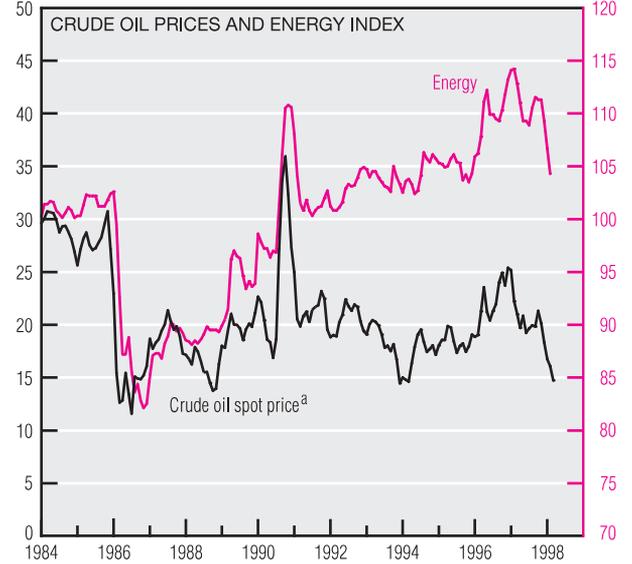
## Inflation and Prices (cont.)

Monthly index, 1982–84 = 100

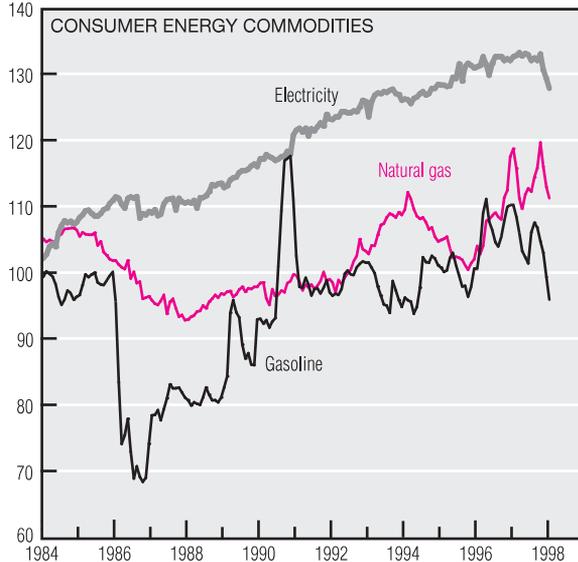


Dollars per barrel

Monthly index, 1982–84 = 100

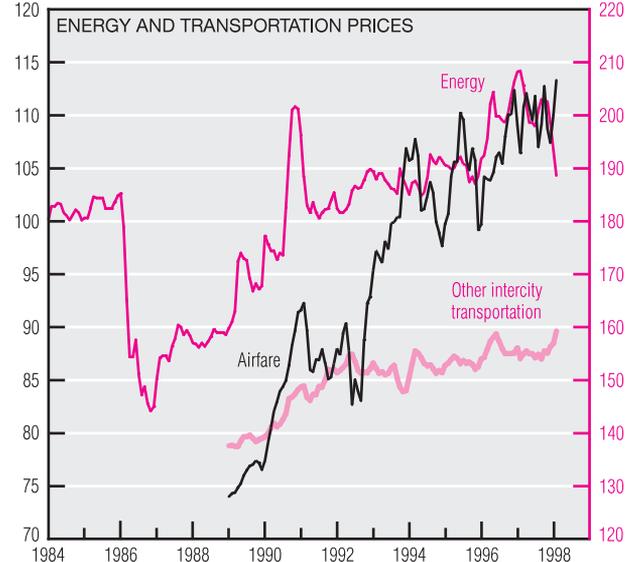


Monthly index, 1982–84 = 100



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Monthly index, 1982–84 = 100



a. West Texas Intermediate.

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

expect a 2.8% rate of inflation, which is roughly the same as the five-year trend in the median CPI. Economists participating in the latest Blue Chip survey revised their 1998 inflation expectations downward for the fourth straight month, with 56% now expecting inflation in the 1.5% to 2.0% range. This represents a drop of more than one full percentage point since September 1997, when 60% of participating economists expected inflation of 2.7% to 3.2%.

Energy prices have restrained increases in the overall CPI since their sharp decline early in 1986. Since

December 1997, energy prices have been decreasing monthly.

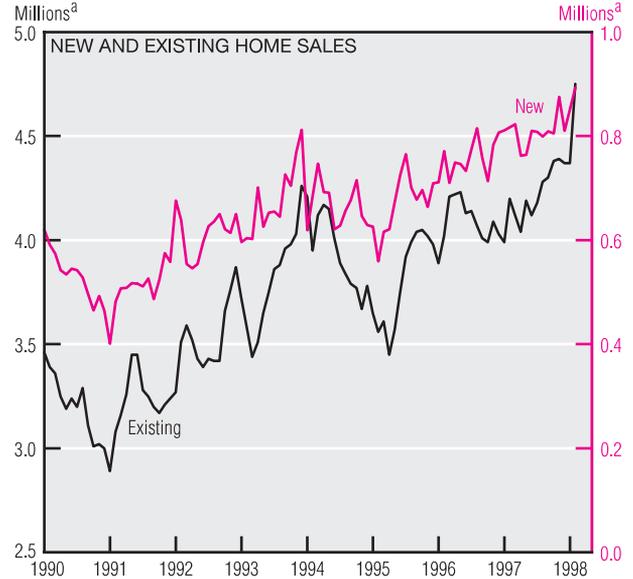
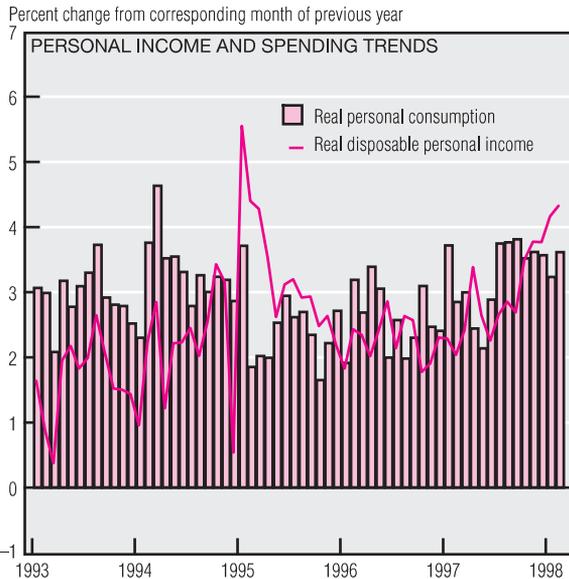
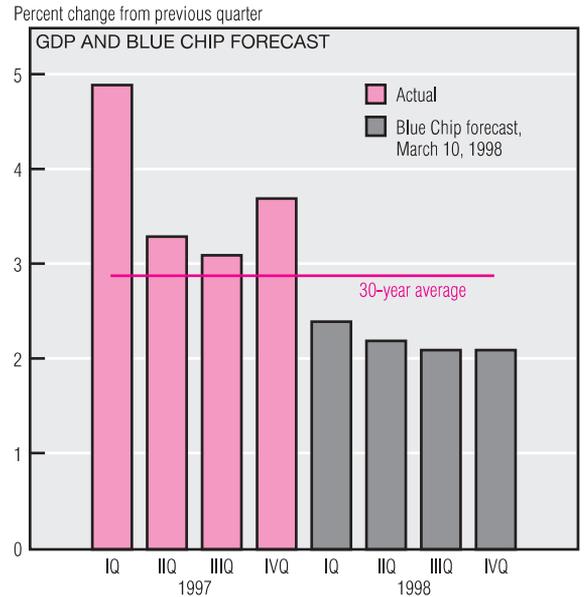
The energy index of the CPI measures price changes in fuel oil, household fuel commodities, piped gas, electricity, and motor fuel, items that account for 3.3% of the typical consumer's budget. The energy index is heavily influenced by the price of oil. While both the energy index as a whole and the spot price for intermediate crude oil show considerable volatility over time, since 1984 the crude oil spot price has led movements in the energy index, although it does not dictate the trend in energy prices.

Gasoline closely follows the price patterns of intermediate crude oil. Natural gas follows oil prices rather loosely, while electricity is influenced only by large oil price swings.

Other consumer areas, such as transportation services, rely heavily on energy. Although airfares exhibit more variability than the energy index, they often mirror its pattern. Apart from the cost of flying, intercity transportation is only weakly related to the energy index and tends to be relatively stable. While swings in oil prices clearly affect a household's cost of living, they do so mostly through direct purchases of gasoline and other oil products.

# Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	66.0	3.7	3.7
Consumer spending	29.9	2.5	3.6
Durables	3.2	2.0	6.8
Nondurables	-4.6	-1.2	1.4
Services	30.3	4.4	4.0
Business fixed investment	-1.8	-0.8	9.0
Equipment	-0.5	-0.3	12.9
Structures	-1.2	-2.4	-0.7
Residential investment	6.2	9.2	5.6
Government spending	1.0	0.3	1.0
National defense	0.8	1.0	-0.8
Net exports	5.0	—	—
Exports	19.7	8.3	10.2
Imports	14.7	5.3	14.4
Change in business inventories	26.5	—	—



a. Seasonally adjusted annual rate.  
 b. Chain-weighted data in billions of 1992 dollars.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; National Association of Realtors; and *Blue Chip Economic Indicators*, March 10, 1998.

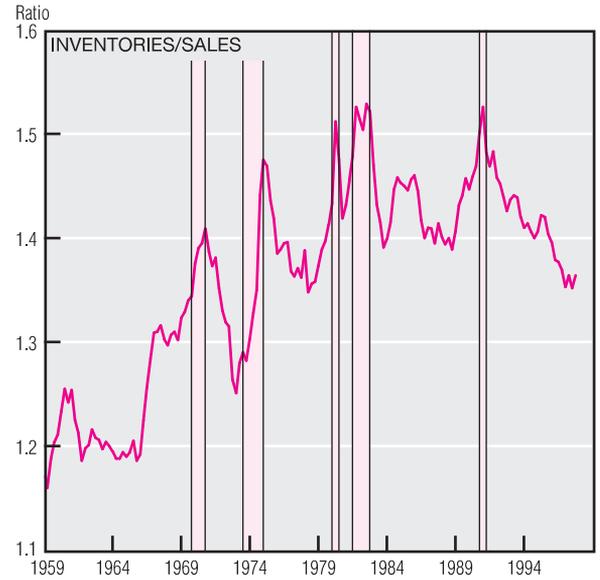
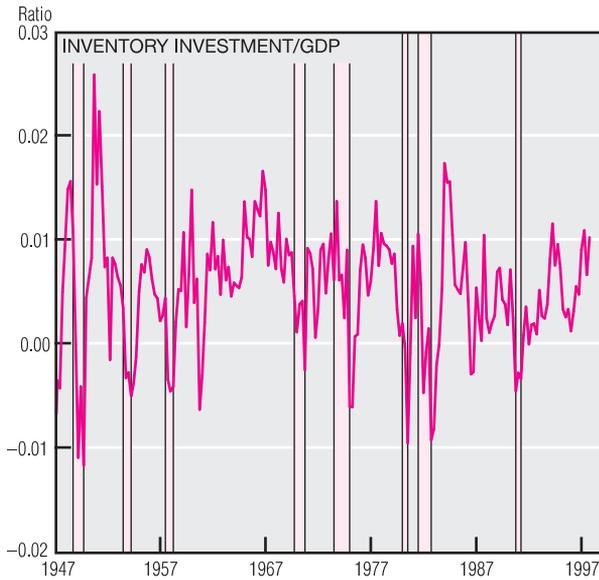
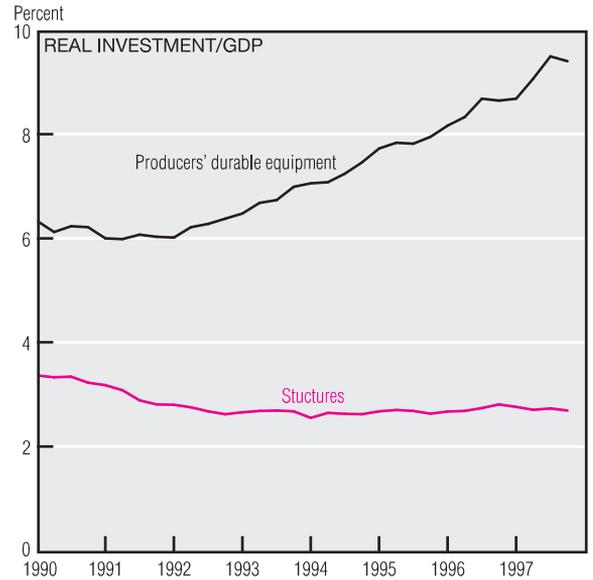
Economic activity remains solid. The median forecast of economists participating in the Blue Chip survey is that real economic growth will slow from 3.7% in 1997:IVQ to a still healthy 2.4% in 1998:IQ. Expectations of further declines in net exports and slower inventory accumulation generally underlie forecasts of weaker near-term growth. Domestic demand is likely to remain brisk. Moreover, 86% of the Blue Chip participants anticipate that real economic growth

for all of 1998 will exceed 2.5%, a rate associated with more sanguine estimates of the economy's long-term growth potential. Buoyed by strong gains in real disposable personal income, advances in net worth, and historical highs for favorable consumer sentiment, real consumer spending has continued at a brisk pace this year. On a year-over-year-basis, February saw real disposable personal income increase 4.3% and real consumer

spending increase 3.6%. Sales of automobiles and light trucks have maintained their 1997:IVQ level of 15 million units. Single-family housing starts progressed at an annualized 1.27 million units in February, well above last year's average. February sales of new and existing homes achieved new records of 893,000 and 4.75 million units, respectively. In addition to factors supporting consumer *(continued on next page)*

Economic Activity (cont.)

Industrial Production Index (Annual percent change)	1997		1998	
	IIIQ	IVQ	Jan.	Feb.
Total index	6.8	7.3	0.9	0.9
Manufacturing	6.0	9.0	3.7	0.0
Durables	9.0	11.0	3.2	0.8
Computer and office equipment	41.3	19.5	36.6	21.8
Motor vehicles and parts	26.5	15.4	-13.9	-25.7
Nondurables	2.9	5.7	5.3	-2.1
Excluding motor vehicles and parts	5.1	8.1	5.5	1.8
Utilities	15.1	-0.6	-37.6	10.8
Mining	3.0	-3.8	18.2	-3.4



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

spending in general, warm weather and low mortgage rates have boosted starts. The average 30-year fixed mortgage rate is currently 7.01%, down from 8.11% one year ago.

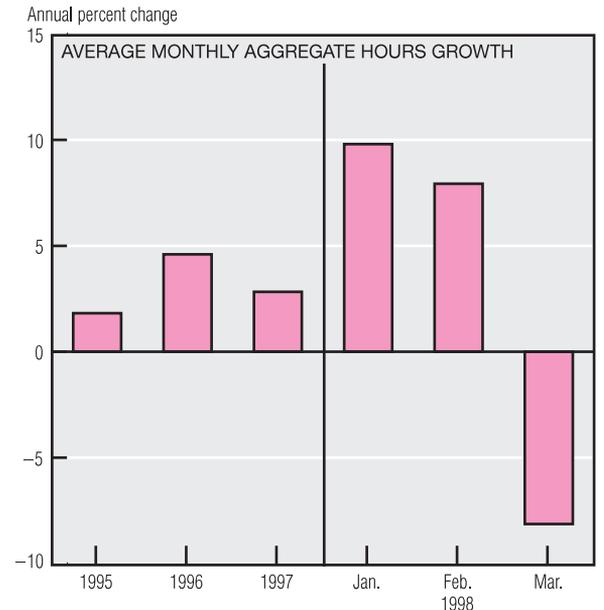
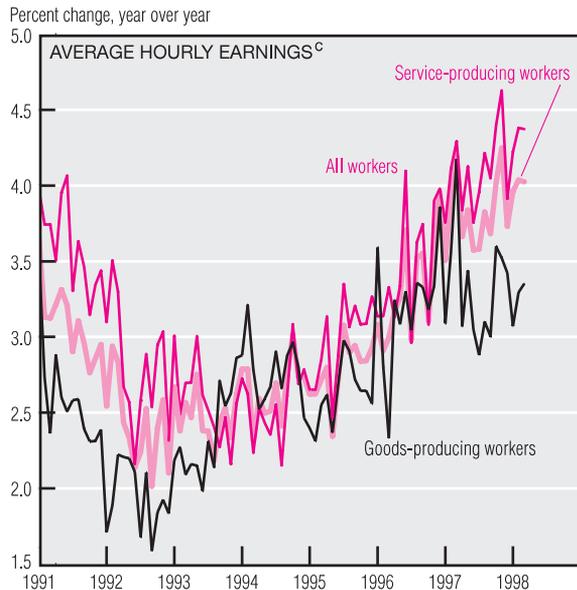
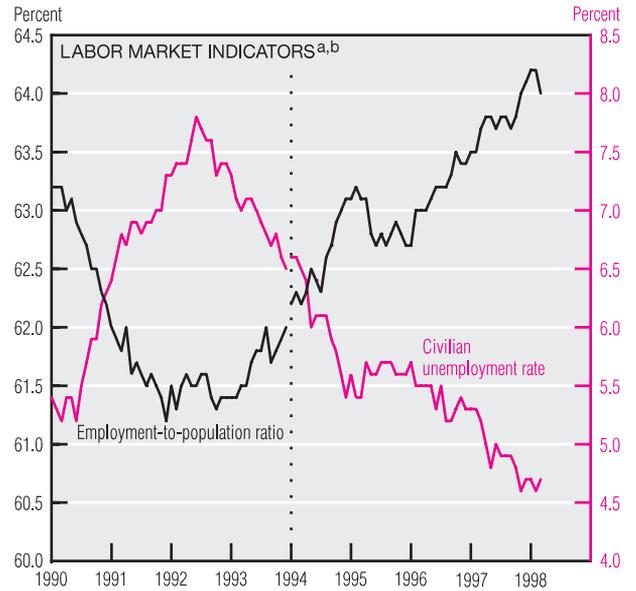
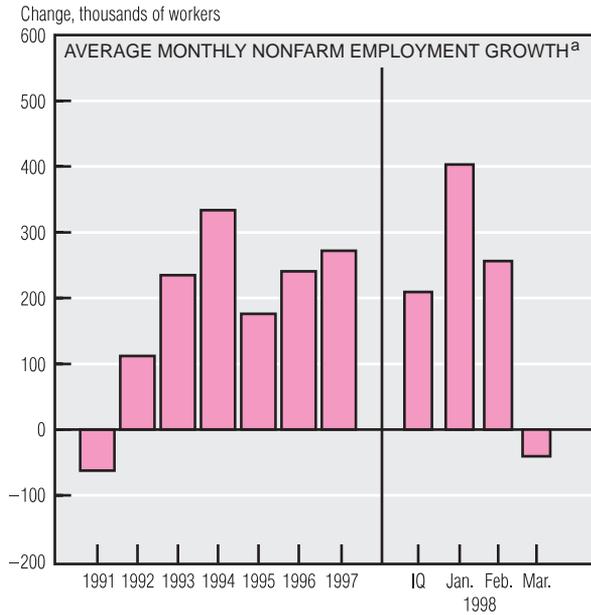
Industrial production slowed during the first two months of 1998 from its rapid pace in the second half of last year, largely because of a sharp weather-related decline in utility output and a drop in auto output. The weakness in manufacturing production, however, extended beyond

motor vehicles. Nondurable production fell in February, and the torrid pace of computer and office equipment cooled somewhat.

Although the pace of business fixed investment dipped in 1997:IVQ, economists generally expect it to remain strong throughout this year. Acquisitions of computer and other information processing equipment, which have accounted for most of the investment boom since 1992, should continue to be robust.

Many of the economists who project a slower rate of growth this year believe businesses will trim their pace of inventory accumulation. Although inventories typically drop relative to output during recessions, neither a high level of inventories nor an inventory correction necessarily presages a slowdown. Similarly, although inventory-to-sales ratios generally rise during a recession, high ratios do not seem to augur a recession.

# Labor Markets



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

Labor markets eased slightly in March. Nonfarm payrolls fell 36,000 for the month, the first decline in more than a year. The overall decrease was led by dips in construction (88,000), retail (48,000), and restaurant (43,000) employment. The drop in construction was due to unseasonably cold March weather. Monthly employment growth averaged 205,000 in 1998:IQ, down from 358,000 in 1997:IVQ.

A 136,000 increase in the number of people looking for work and a

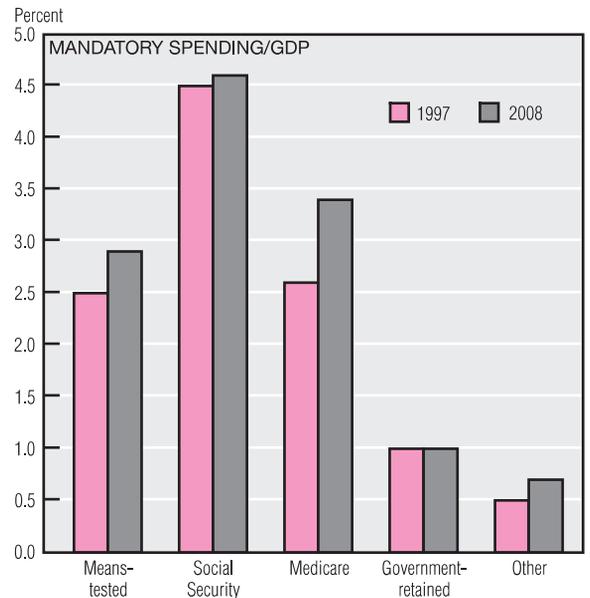
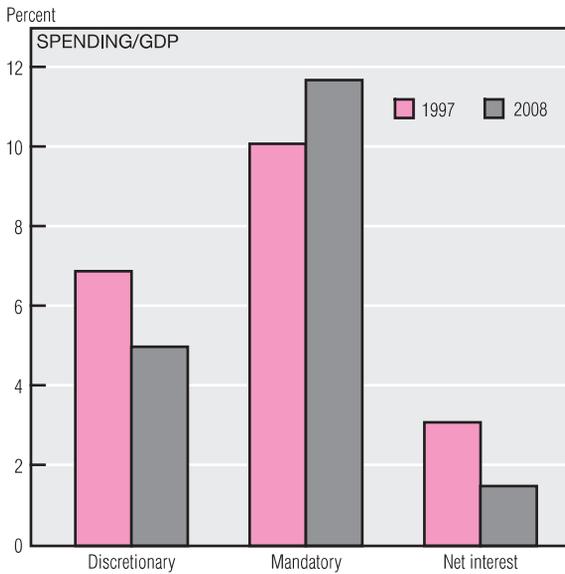
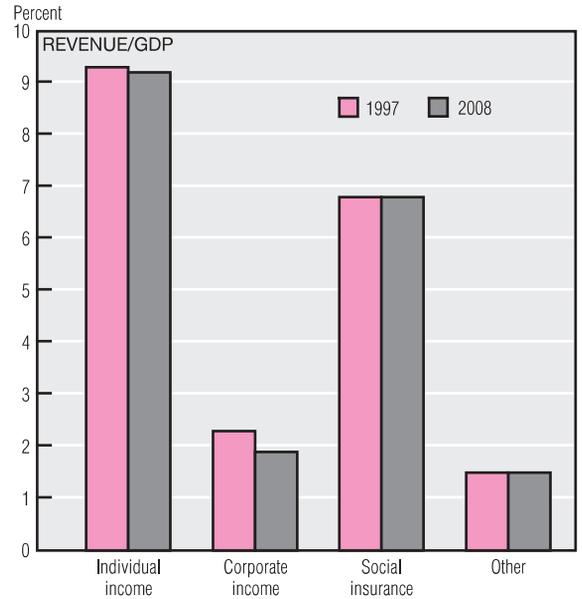
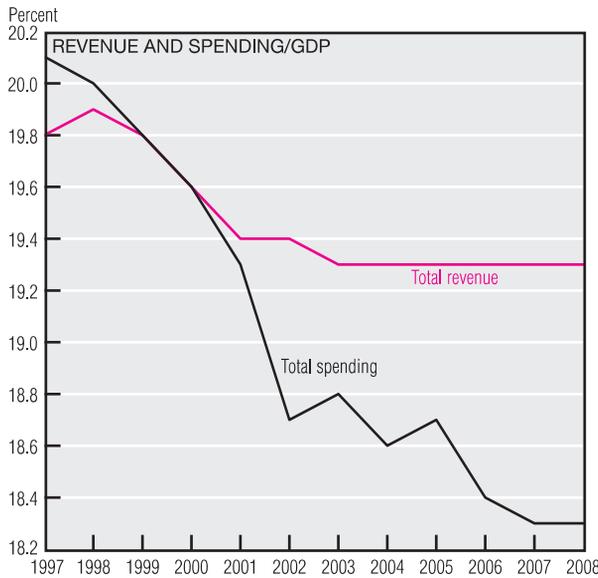
34,000 decrease in the labor force caused the unemployment rate for the month to inch up from 4.6% to 4.7%. March was the ninth straight month with an unemployment rate of less than 5.0%. The employment-to-population ratio also declined slightly, slipping to 64% from its record high of 64.2%

Even with the increase in available workers, average hourly earnings of nonfarm, nonsupervisory workers rose three cents (4%) in March, the second consecutive

month of 4% increases. Earnings for service workers held steady, while goods-producing workers' earnings went up slightly.

The hours worked by all private workers fell sharply in March, countering large increases in the first two months of the year. The average monthly increase for the first quarter was 3.2%. This implies either that productivity (output per hour) will drop or that the predicted 2.4% gain in first-quarter GDP is too low.

# The Federal Budget



NOTE: All data are for fiscal years.  
SOURCE: Congressional Budget Office.

The Congressional Budget Office's latest revenue and expenditure projections indicate a movement from deficit to surplus in the unified federal budget, despite a decline in revenue as a percent of GDP. The shift is expected to occur in the year 2001, with the surplus amounting to 1% of GDP by the year 2008. The cumulative surplus between 1998 and 2008 is estimated at \$655 billion.

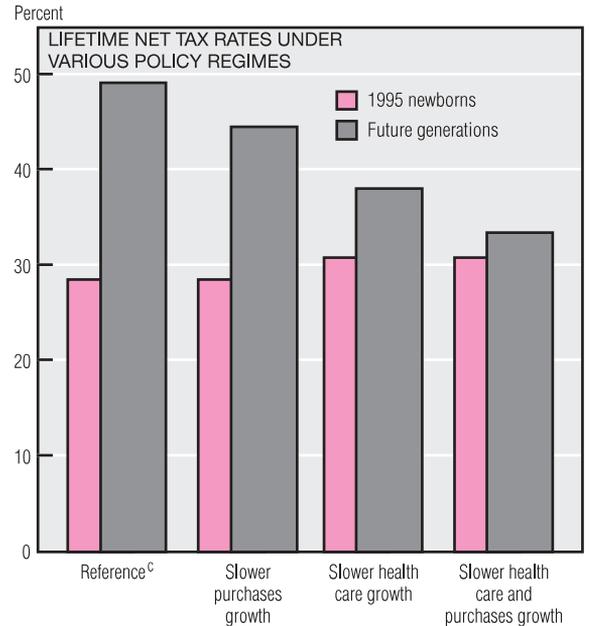
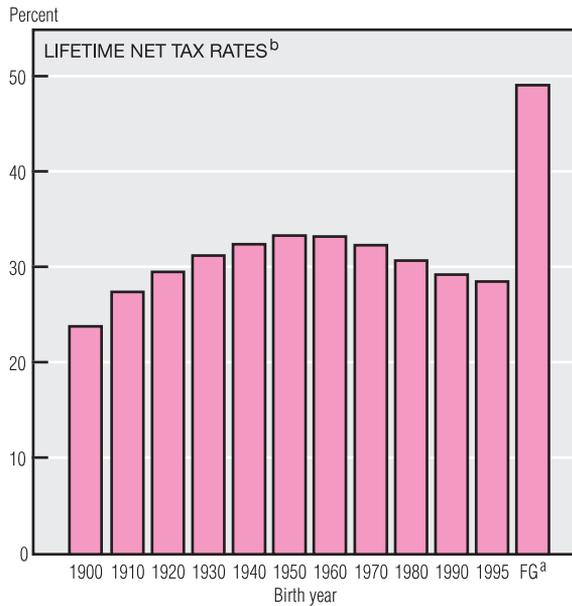
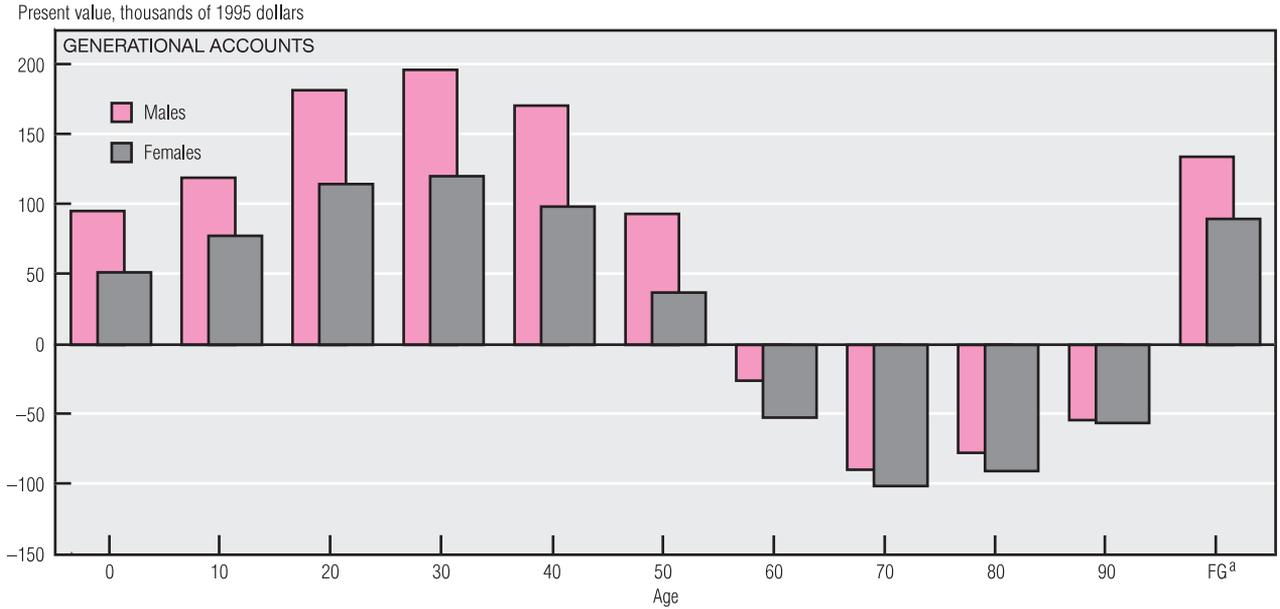
Revenue as a percent of GDP is expected to fall from 19.8% to 19.3%, primarily because of a projected reduction in corporate in-

come taxes from 2.3% of GDP in 1997 to 1.9% in 2008. Most of this decline is expected to occur by 2002 because of an anticipated drop in taxable corporate profits. Throughout the projection horizon, it is expected that individual income taxes will continue accruing at just above 9% of GDP, social insurance contributions will remain steady at 6.8%, and other taxes will hold constant at 1.5%.

Total expenditures are projected to fall from 20.1% of GDP in 1997 to 18.3% by 2008, mainly because of lower discretionary spending

and a drop in net interest payments as a percent of GDP. Discretionary spending will decline as a percent of GDP if it is contained within its statutory caps through the year 2002 and then grows with inflation. Declining net interest payments will follow, as debt falls relative to GDP. Mandatory spending, however, will be higher as a fraction of GDP and is expected to continue rising after 2008. The largest contributor to higher mandatory spending is Medicare, followed by means-tested programs that include Medicaid.

# Generational Accounts



a. Future generations.  
 b. Average of males and females in the same year.  
 c. Cuts base purchases and health care outlays by the same amounts as under the Balanced Budget and Taxpayer Relief Acts of 1997.  
 SOURCE: National Bureau of Economic Research.

Generational accounts—the present values of future taxes minus prospective transfers (net taxes) per capita by age and sex—tell us how the burden of paying for government purchases is distributed across generations. For example, the account of 30-year-old males is \$196,800. It is positive because, in present value, this group’s tax payments during working years exceed post-retirement Social Security and Medicare benefits. In contrast, 70-year-old males’ generational account is –\$89,200 because they pay

low taxes but receive large Social Security and health care benefits.

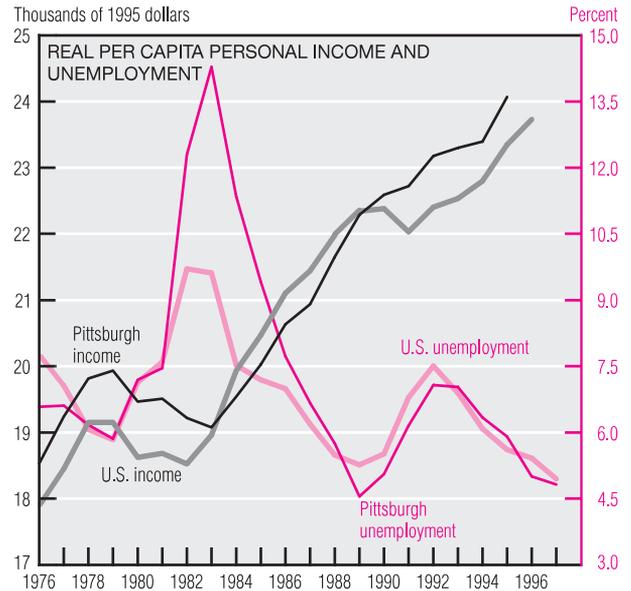
Lifetime net tax rates, which show what fraction of lifetime labor income is paid as net taxes, have increased from just under 24% for those born in 1900 to about 28.6% for those born in 1995. They are highest for the children of the 1950s and 1960s, but decline for later generations—a reflection of growth in Social Security and public health care programs.

If living generations continue to be treated as they are under current fiscal policies, future generations

will have to bear a much higher lifetime net tax rate—49.2% on average—if all projected purchases are to be paid for. The rate for future generations is more than 70% larger than that for 1995 newborns, a clear indication that current fiscal policy is unsustainable. If it is kept in place, each new generation will pay at a 28.6% rate—far too little to balance the government’s books in the long run. The unsustainability persists, even with optimistic projections of future purchases or health care outlays.

# Regional Update: Pittsburgh

Industry Share of Total Nonfarm Employment (Percent)	Pittsburgh MSA		U.S.	
	1997	1979	1997	1979
	Mining	0.4	1.4	0.5
Construction	4.6	5.1	4.6	5.0
Manufacturing	12.8	24.6	15.2	23.4
Durables	9.1	19.8	8.9	14.2
Nondurables	3.7	4.8	6.2	9.3
TPU <sup>a</sup>	6.1	6.4	5.3	5.7
Trade	23.9	22.3	23.5	22.5
FIRE <sup>b</sup>	5.8	4.9	5.8	5.5
Services	34.6	22.6	29.1	19.1
Government	11.7	12.8	16.1	17.8



Largest Employers in Pittsburgh MSA <sup>c</sup>					
1997		1979			
Share of MSA employment (percent)	Industry	Share of MSA employment (percent)	Industry		
University of Pittsburgh Medical Center	1.1	Services	United States Steel	4.4	Durables mfg.
US Airways	1.1	TPU <sup>a</sup>	Westinghouse	3.1	Durables mfg.
Allegheny Health, Education and Research Foundation	0.9	Services	Jones and Laughlin Steel	2.4	Durables mfg.
University of Pittsburgh	0.8	Government	Allegheny Ludlum Steel	0.7	Durables mfg.
Mellon Bank Corp.	0.8	FIRE <sup>b</sup>	Bell Telephone Co.	0.7	TPU <sup>a</sup>
Westinghouse Electric Corp.	0.7	Services	Crucible Steel	0.7	Durables mfg.
PNC Bank Corp.	0.6	FIRE <sup>b</sup>	Babcock and Wilcox	0.6	Durables mfg.
USX Corp.	0.6	Durables mfg.	University of Pittsburgh	0.6	Government
McDonald's Corp.	0.5	Services	PPG Industries, Inc.	0.5	Durables mfg.
Eat 'n Park Restaurants, Inc.	0.5	Services	Wheeling-Pittsburgh Steel	0.5	Durables mfg.

a. Transportation and public utilities.  
 b. Finance, insurance, and real estate.

c. Excludes local education and unspecified local, state, and federal government employment.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Pennsylvania Department of Labor and Industry; and "50 Largest Pittsburgh-area Employers," *Pittsburgh Business Times*, 1998 Book of Lists, December 30, 1997, p. 72.

Nationally, the proportion of workers in the manufacturing sector is declining, while employment in the service industries is on the upswing. Nowhere is this trend more apparent than in the Pittsburgh metropolitan statistical area (MSA).

In 1979, the MSA's unemployment rate was low at 5.8%; its per capita personal income exceeded the national rate by 4%. A quarter of the workforce was engaged in manufacturing, and eight of the metropolitan area's 10 largest employers were manufacturers of

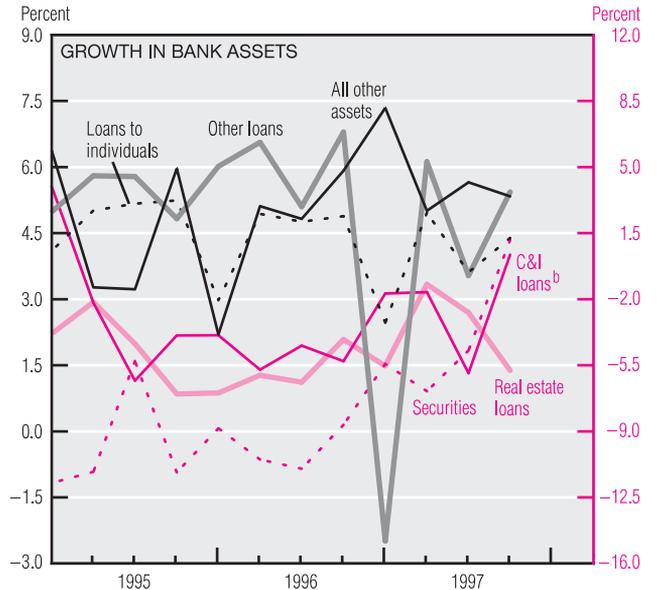
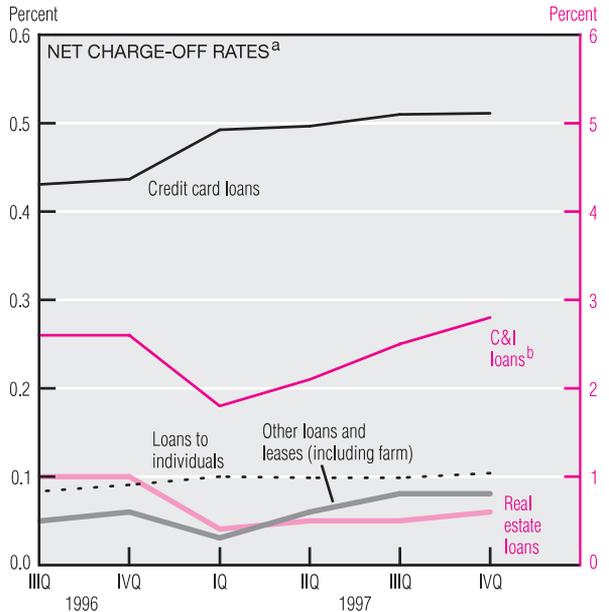
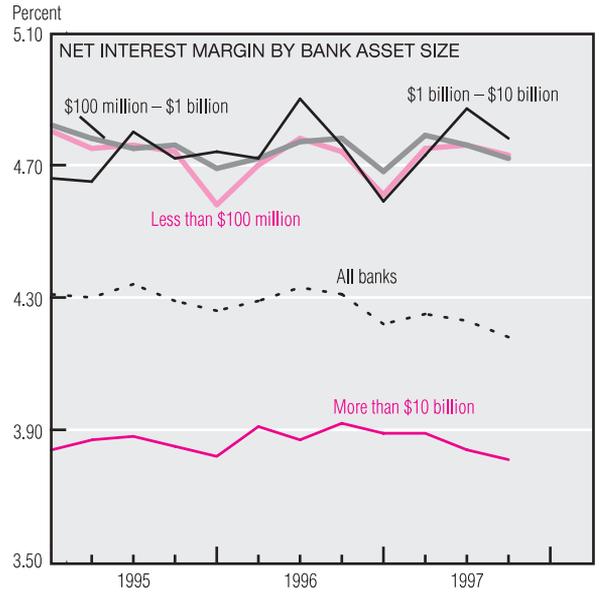
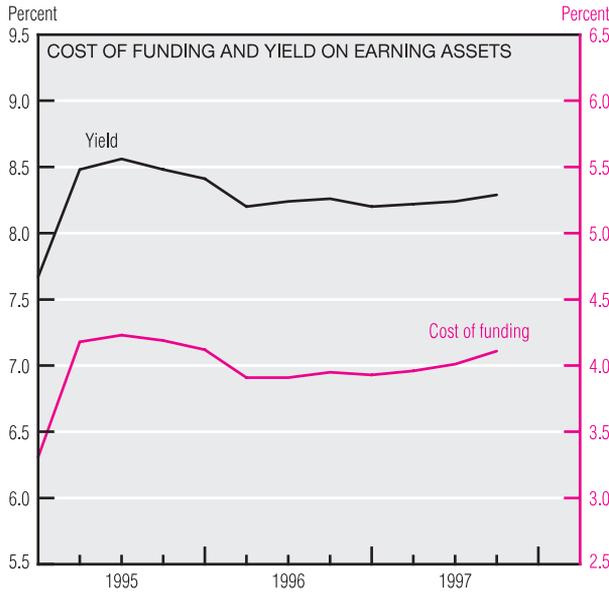
durable goods. The top two utilized 7.5% of the area's total workforce—a considerable share. The health of Pittsburgh's economy was heavily dependent on steel production.

During the early 1980s, its formerly prosperous economy faltered, primarily because of shocks to the steel industry and competition from more efficient mills elsewhere. In 1983, the jobless rate for the MSA reached a historical high of 14.3% (compared to 9.6% for the U.S.) and its real per capita personal income declined 4.3% from four years earlier

(compared to the U.S. drop of 0.3%).

Over the last 18 years, Pittsburgh has been transformed. Employment in manufacturing has decreased almost 12 percentage points, with service industry jobs increasing by the same amount. The MSA's unemployment rate is currently lower than the nation's, and since 1983, its real per capita income growth has topped the U.S. average. Nine of the area's 10 largest employers are currently service producers, and there is no dominant employer.

# Banking Conditions



a. The net charge-off rate is the percentage of total loans that banks remove from their balance sheets because of uncollectibility, less amounts recovered on loans previously charged off, expressed as an annual rate.  
 b. Commercial and industrial.  
 NOTE: All data are for FDIC-insured commercial banks.  
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

Insured commercial banks reported net income of \$15.3 billion for 1997:IVQ, surpassing the previous quarter's record high. Net interest income was a major contributor to the record-breaking net income and to quarterly earnings that were 11.5% higher than a year earlier.

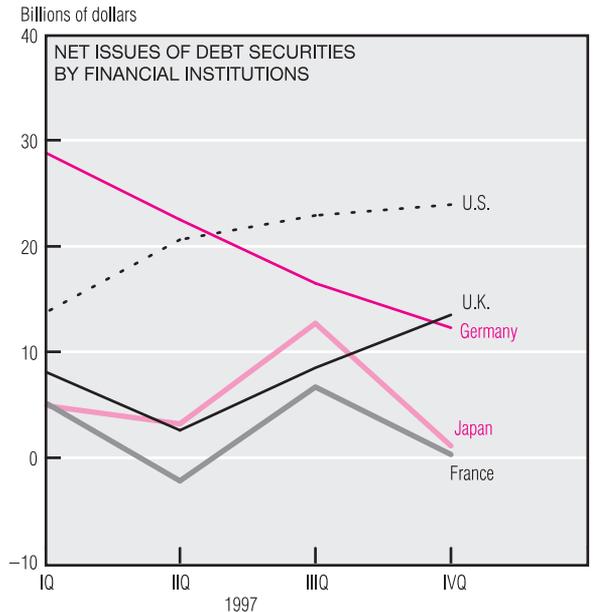
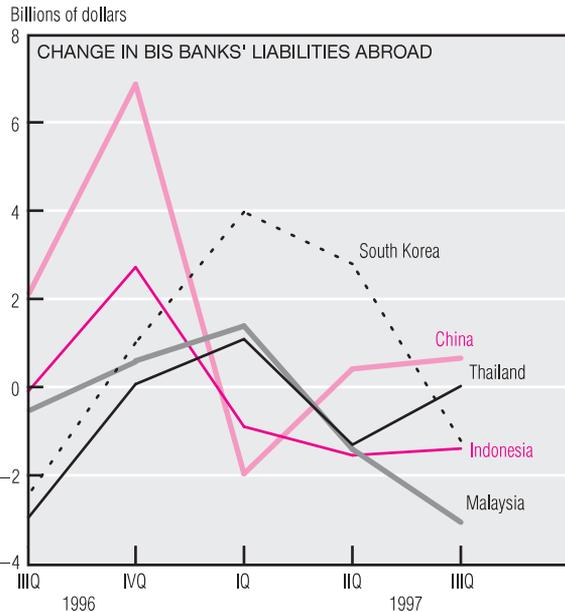
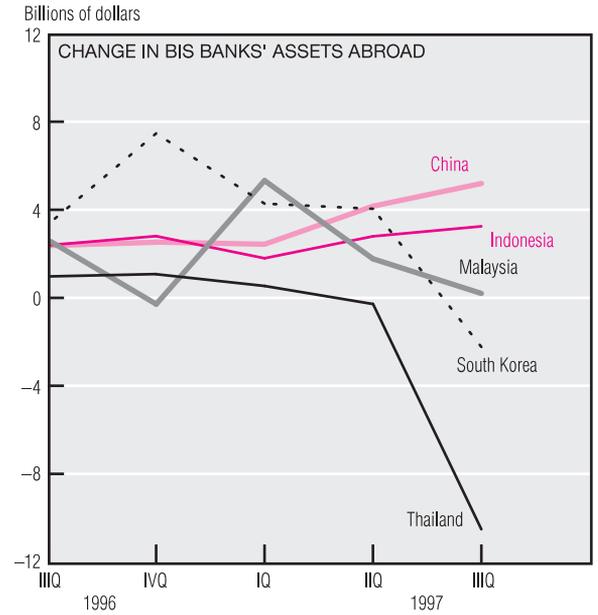
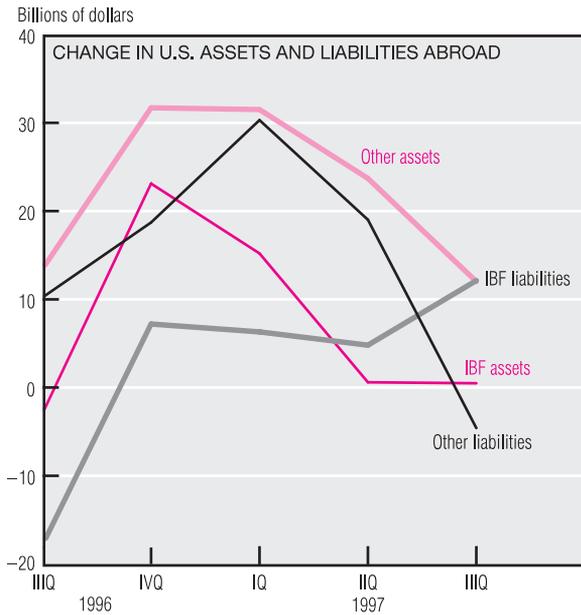
Despite a narrower margin between the yield on earning assets and the cost of funding such assets, growth in earning assets fueled the

rise in net interest income. In 1997:IVQ, margins narrowed for all asset-size classes of banks. In the two previous quarters, banks with assets between \$1 billion and \$10 billion saw widening margins. For the industry as a whole, 1997 was the fifth consecutive year of declining net interest margins.

Net charge-off rates for 1997 increased from a year earlier. In the fourth quarter, charge-off rates rose

on commercial real estate loans and consumer loans other than credit cards. According to some measures, the credit risk of bank asset portfolios has risen while loan portfolios have shifted toward higher-risk loans and lower-risk securities have been replaced by higher-risk loans. Overall, bank asset quality is neither improving nor deteriorating.

# International Banking Developments



NOTE: All data series have been adjusted for exchange rate changes.  
 SOURCES: Bank for International Settlements, *Banking and Financial Market Developments*, various issues.

According to data released by the Bank for International Settlements (BIS), 1997:IIIQ saw a sharp decline in U.S. banks' external assets. BIS-reporting banks as a whole have been decreasing their external asset position since 1997:IQ. Liabilities, however, have been increasing for international banking facilities (IBFs), but decreasing for other U.S. banks. (The Federal Reserve System made IBFs possible in December 1981 to enable U.S. banks to conduct Euro-currency business at

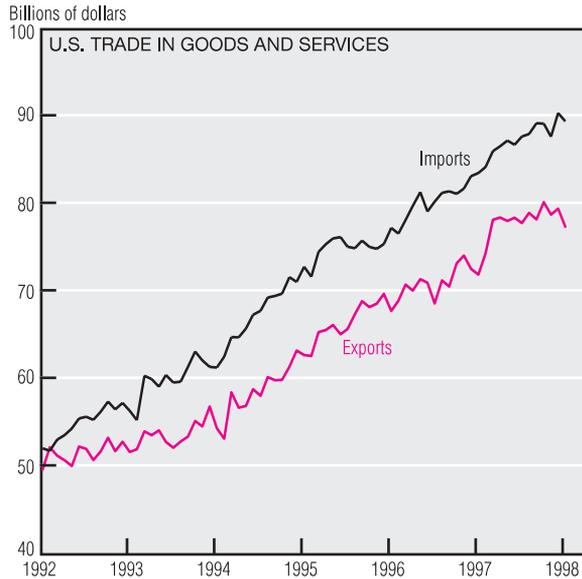
home without being subject to various domestic banking regulations.) Overall, external liabilities for BIS-reporting banks have decreased sharply since 1997:IIQ.

The third quarter of 1997 was the first time in six years that BIS banks' outstanding claims decreased on Asia as a whole, although claims on China and Indonesia grew. The sharpest decline in BIS banks' assets occurred in Thailand, as the result of a Japanese withdrawal. BIS banks' liability positions increased in Thailand, Indonesia, and

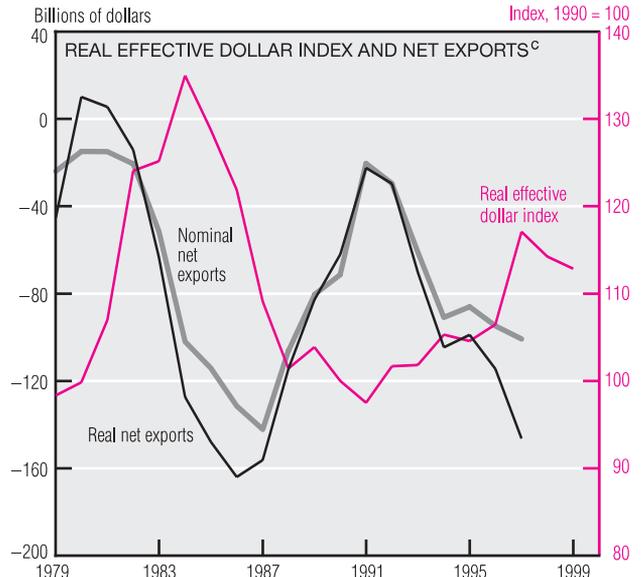
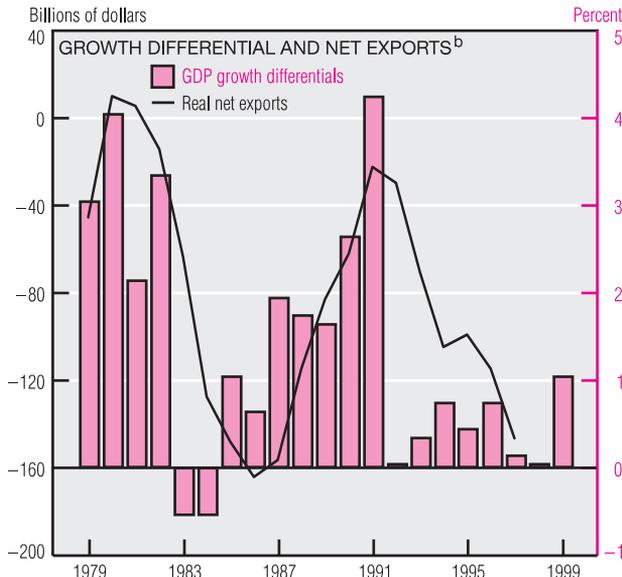
China, but decreased in South Korea and Malaysia.

Net issues of international debt securities by U.S. and U.K. financial institutions increased in 1997:IVQ, bucking the trend set by France, Germany, and Japan. Repayments of past issues reached a new high for BIS banks as a whole, contributing to a decline in net issues. New issues of lower-rated securities and subordinated debt declined dramatically as a result of difficulties in Southeast Asian financial markets.

# The Balance of Trade



Major Trading Partners <sup>a</sup>			
(Trade balance, millions of dollars)			
	1997	1998	Change
Canada	-1,696	-1,663	33
Japan	-4,294	-4,357	-63
Mexico	-1,241	-799	442
Germany	-1,237	-1,287	-50
U.K.	-85	345	430
Taiwan	-1,070	-1,106	-36
China	-3,723	-4,241	-518
Korea	181	-856	-1,037
France	-228	-235	-7
Singapore	-53	-287	-234
Italy	-679	-780	-101
Hong Kong	159	63	-96
Netherlands	905	1,115	210
Belgium	566	581	15
Malaysia	-618	-515	103



a. Order reflects total trade (exports and imports) with the U.S. between 1990 and 1995.  
 b. Growth differential equals the trade-weighted average growth rate for the 15 countries listed in the table minus the U.S. growth rate. Estimates for 1997 through 1999 are from various sources.  
 c. Real effective dollar index includes countries shown in table. Data include estimates of inflation for 1997 and earlier years in many cases. Forecasts for 1998 and 1999 utilize various sources.  
 SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; International Monetary Fund, *International Financial Statistics*; Organisation for Economic Co-operation and Development, *Economic Outlook*; DR/McGraw-Hill; and *Blue Chip Economic Indicators*, March 10, 1998.

Many analysts fret that the U.S. trade balance will deteriorate significantly over the next year or so. This seems a safe bet. Many of the same analysts predict that further declines in net exports must slow overall economic growth, but while slower growth is likely, the connection to the trade deficit seems misguided.

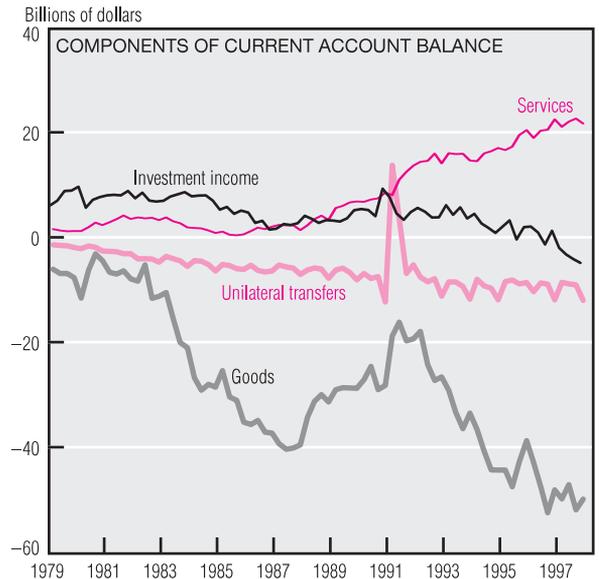
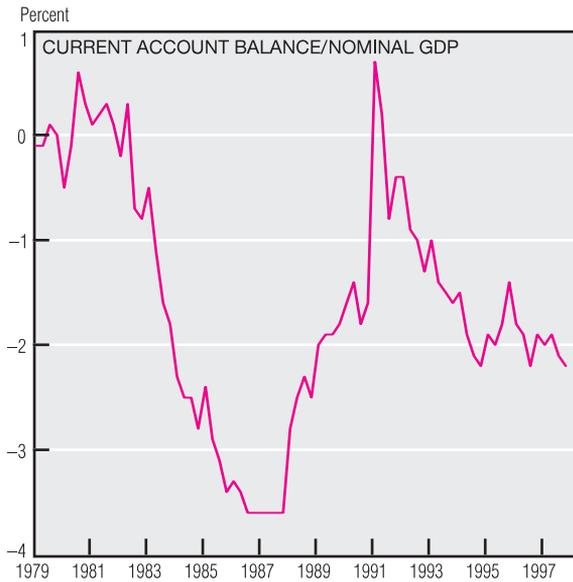
U.S. net exports have deteriorated since 1991, largely *in response* to relatively fast economic growth at home. Since 1991, growth abroad has averaged 3.2% per year, while

U.S. growth has averaged 2.3%. Typically, the growth differential must approach two percentage points (in favor of our trading partners) before the U.S. trade deficit begins to narrow. Recent forecasts of growth here and abroad anticipate a rather narrow differential over the next two years, implying no improvement in the trade balance because of relatively slower U.S. growth.

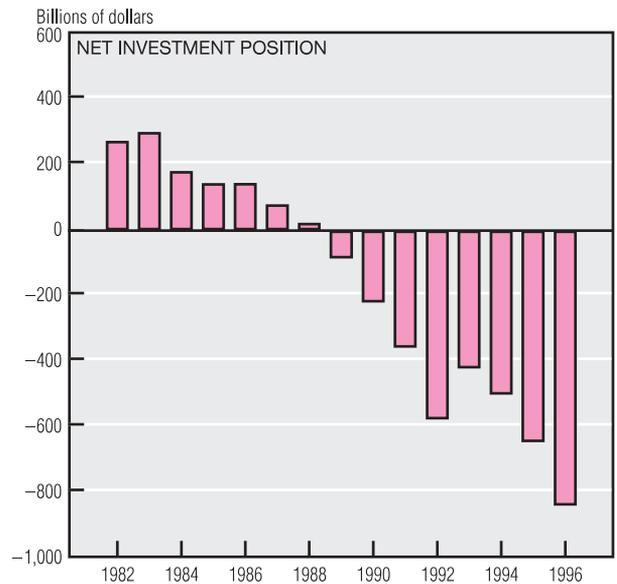
Since 1991, the dollar has appreciated approximately 20% on a real effective basis against our 15 major

trading partners. Any such rise reflects either a nominal appreciation of the dollar, a higher inflation rate in the U.S. than abroad, or both. As the dollar appreciates on a real effective basis, the foreign price of U.S. goods rises and the U.S. price of foreign goods declines. Recent forecasts of exchange-rate movements (notorious for their inaccuracy) and global inflation rates suggest that the real effective dollar will depreciate 3.6% over 1998 and 1999.

# The U.S. Current Account



	1991	1997	Change
Gross private savings	14.2	14.3	0.1
Gross government savings	0.1	2.8	2.7
Foreign capital inflow	-0.1	1.9	2.0
Gross domestic investment	14.3	16.1	1.8
Statistical discrepancy	-0.2	2.9	3.1



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

The U.S. current account, a broad measure of our trade position, showed a \$166.4 billion deficit in 1997. Most analysts expect the current account deficit to widen this year and next, for the reasons suggested on the previous page.

Our current account deficit indicates that through consumption, investment, and government spending, the U.S. is absorbing more output than it is producing and is

satisfying its excess demand by importing. This situation also implies that our private and government savings are not sufficient to finance our gross private domestic investment. An inflow of foreign capital makes up the difference. If all transactions are properly measured, the capital inflow exactly matches our current account deficit. In other words, we finance our net imports by exporting financial claims on our future output.

As a consequence of our persistent current account deficits, the U.S. has become a debtor nation. This is not necessarily a bad situation. Since 1991, the inflow of foreign capital has financed additional investment, not additional private and government consumption. If this investment enhances productivity, the U.S. should be able to service its debts without any diminution in its standard of living.