

## *The Economy in Perspective*

*Rebooting Asia* ... History repeats itself in the Far East, having repeated itself not long ago in Latin America. Nations that seemed on a straight path of economic development have suddenly veered off, hurting their trading partners and inflicting tragedy on their citizens. What causes these calamities, and why do they seem to arise so suddenly? What can be done to cure or, better yet, prevent them? A general theory would be presumptuous, since each historical episode has its own context and nuances, but we can extract some common elements and lessons.

Economists have long attributed economic progress to capital accumulation and education. Standard growth theory says that a nation can accelerate its pace by augmenting its capital stock and attaining a more educated labor force. While it seems plausible (even likely) that worker education and capital differentials help explain inequalities of wealth among nations, economists have yet to fashion a theory in which these two factors alone can explain all observed disparities.

More recently, development economists have begun to appreciate that economies vary importantly in their openness to innovation. Educated labor and ample capital help up to a point, but the key is a nation's ability to deploy these resources to maximum advantage. Nearly 150 years ago, Ralph Waldo Emerson wrote that the wisdom of nations was shown in what they did with their surplus capital. The ones that grow rapidly for long periods may well be those that not only save and educate, but also excel at adopting new technologies and business practices.

How can nations create these conditions? With the crumbling of the Berlin Wall, history returned a verdict against totalitarian regimes whose comprehensive national planning systems effectively ration consumption and control investment. There was another model, based on a partnership between the state and concentrated industrial conglomerates, that seemed capable of producing significant gains in southeast Asia's living standards. In fact, some countries in the region made such dramatic wealth gains that their economic philosophies won American converts who saw in them a superior framework for broad-based competition.

Nothing succeeds like success, and there is no disputing what many rapidly industrializing na-

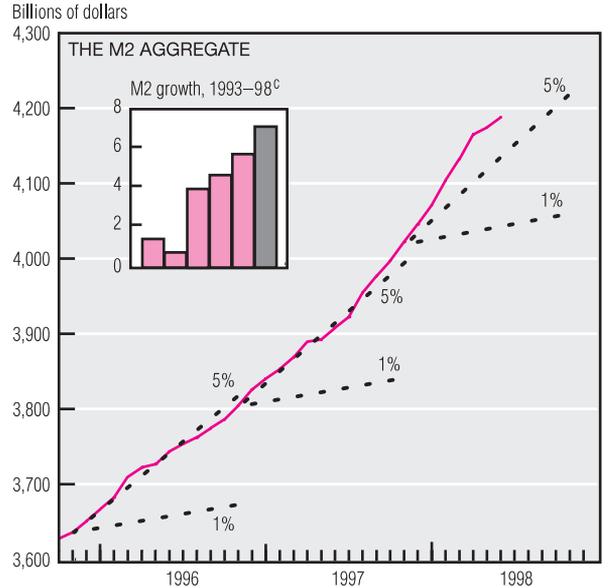
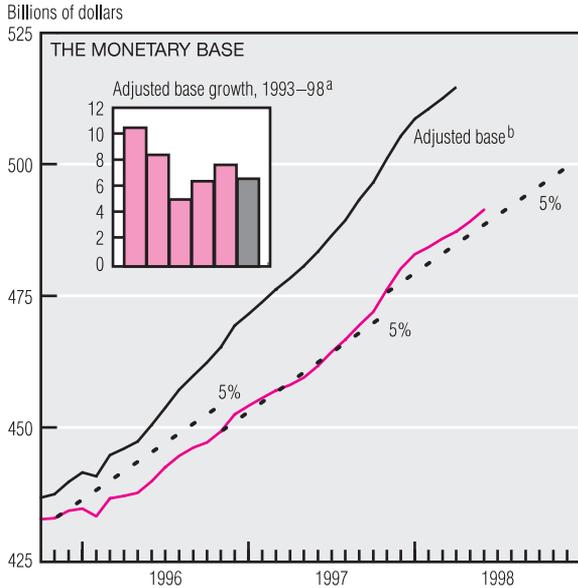
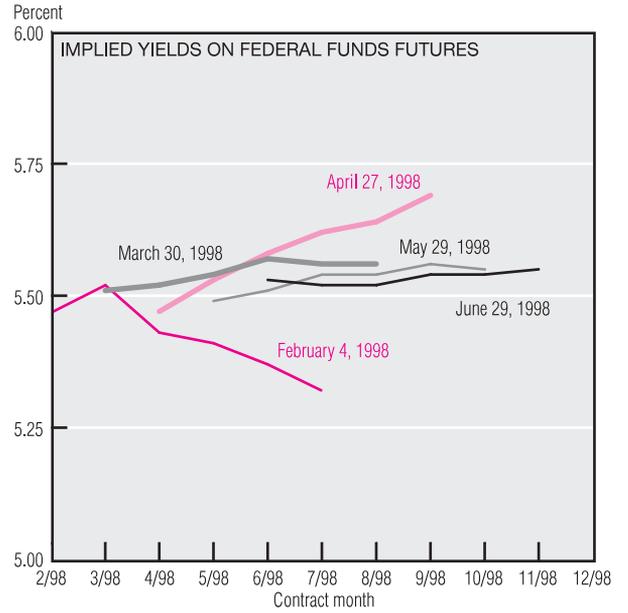
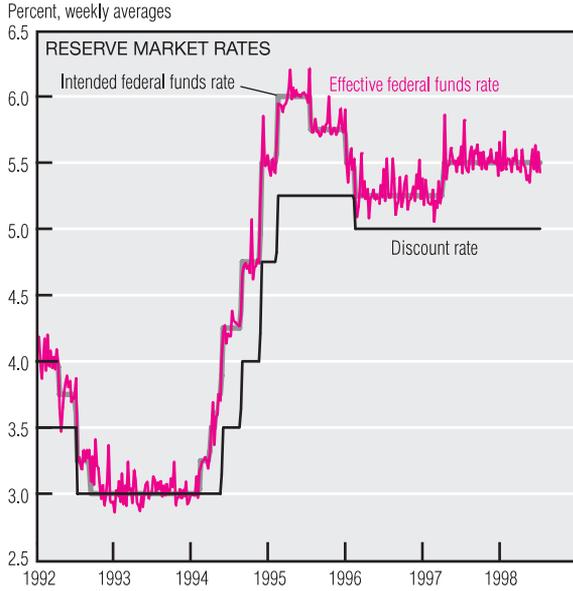
tions have achieved since the 1960s. According to one study, between 1960 and 1985, several southeast Asian countries roughly doubled their wealth position relative to the United States. These economies generated large increases in their capital stocks with high domestic saving rates and devoted sizable resources to education and training; small wonder that foreign capital followed. But hindsight reveals that the economic development models espoused by many of these countries contained a fatal flaw.

Their governments retained a considerable role in directing resource allocation through trade policies, tax and subsidy codes, and public expenditures. In particular, government practices favored a business structure featuring groups of interlocking firms that spanned many industries. Because these groups usually included banks, credit was often available on loose terms. Careless financing mattered little in the initial phase of economic development, because there were so many promising investment projects to fund. Later on, however, when world competition intensified and investment projects required closer scrutiny, inability or unwillingness to be more disciplined exacted a heavy toll.

As the afflicted nations scramble to restructure their economies and restart their growth processes, they will be tempted to assert that they need only resolve the bad debts and bankruptcies, and then life can resume. This is unlikely to be. As a Dickens character once remarked, "Change begets change. Nothing propagates as fast. ... The mine which Time has slowly dug beneath familiar objects is sprung in an instant; and what was rock before, becomes but sand and dust."

Daunting as the task of reanimating Asian economies may be, it does not begin quite from scratch. Their market orientation still exists, and their competitive instincts remain intact. Just consider how far these nations have come in the span of a single generation. While we cannot deny the difficulties lying ahead, at least there is a solid foundation to build on. The significance of the Asian crisis must not be ignored or downplayed. But in the decade-long units we should use to judge economic development, these nations have ample time to correct their problems and even to prosper.

# Monetary Policy



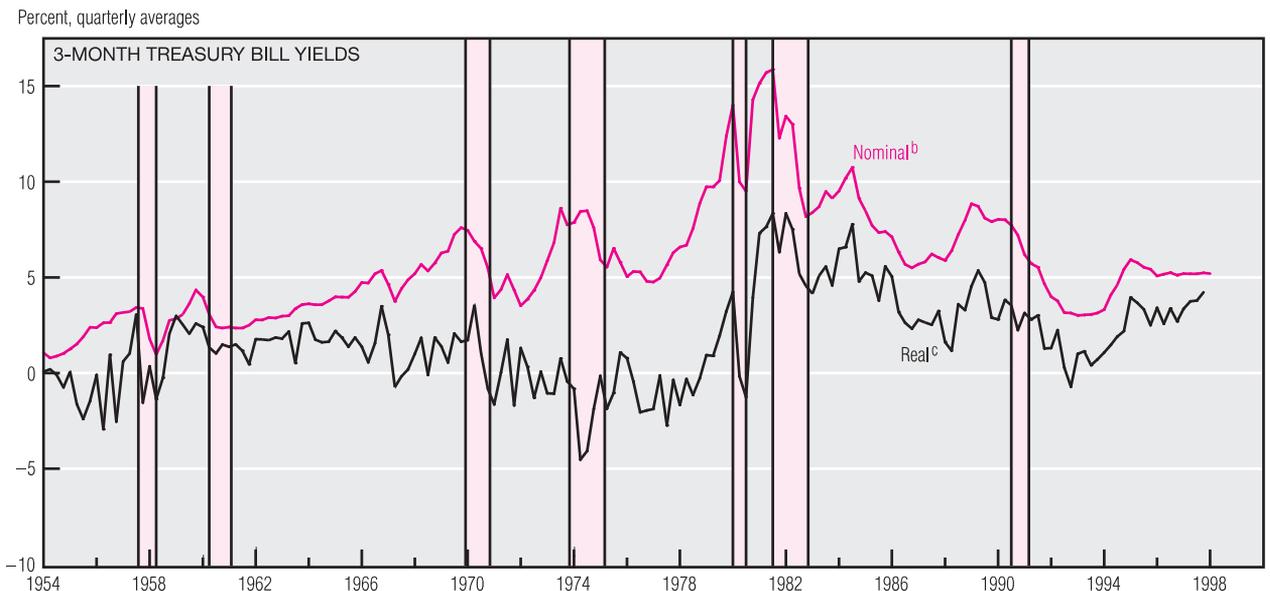
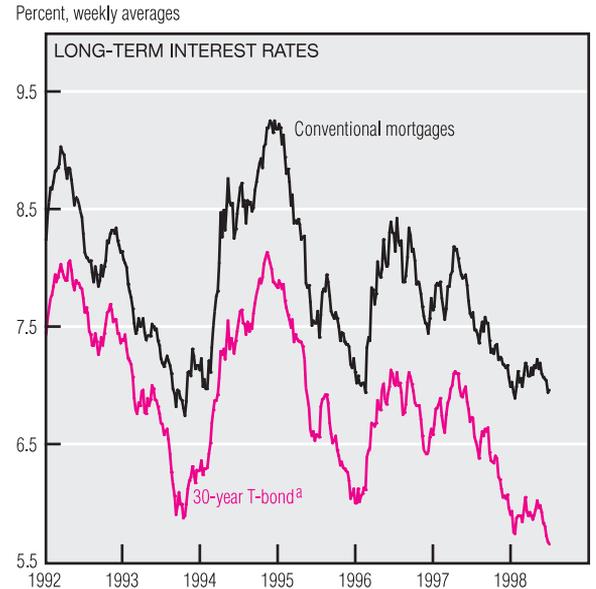
a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1998 is calculated on an April over 1997:IVQ basis.  
 b. Adjusted for sweep accounts.  
 c. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. Annualized growth rate for 1998 is calculated on an estimated June over 1997:IVQ basis.  
 NOTE: M2 and monetary base aggregates are seasonally adjusted. The last plots for M2 and the (unadjusted) monetary base are estimated for June 1998. For M2, dotted lines are FOMC-determined provisional ranges. For the monetary base, dotted lines represent growth rates and are for reference only.  
 SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

At its June 30 meeting, the Federal Open Market Committee (FOMC) left the 5.5% federal funds rate target unchanged, as it has since March 1997. (The next scheduled meeting is on August 18.) For most participants in financial markets, the committee's decision came as no surprise. The Reserve Banks' discount rates have remained unchanged at 5.0% over an even longer period, since February 1996. Market participants' expectations

for the direction of future monetary policy can be inferred from the implied yields on federal funds futures. The yields' downward slope as of early February reflected traders' belief that a rate decrease was more likely than a rate increase, while the upward-sloping yields as of late April suggested just the opposite. More recently, the implied yields have become quite flat, suggesting a market belief that rates will remain unchanged over the next several months.

Relatively rapid growth in the monetary aggregates continues to be a source of concern for at least some policymakers, because sustained high growth rates in money may signal an impending increase in the inflation rate. The growth rates of M2 and M3 continue to be substantially above the provisional ranges set by the FOMC, and growth in the monetary base adjusted for sweep accounts has remained strong. *(continued on next page)*

## Monetary Policy (cont.)



a. Constant maturity.  
 b. Secondary market 3-month T-bill yield.  
 c. Secondary market 3-month T-bill yield minus the change in the GDP deflator.  
 NOTE: Shaded areas indicate recessions.  
 SOURCE: Board of Governors of the Federal Reserve System.

Short-term interest rates have held fairly steady over the past several weeks, while long-term rates have declined. Both the 3-month and 1-year Treasury bill yields have fluctuated within a relatively narrow range since last summer. After declining sharply through the end of 1997, long-term rates increased somewhat through March, but have since fallen back. For the week ending June 26, the 30-year constant maturity yield reached the lowest level recorded since the series' beginning in 1977.

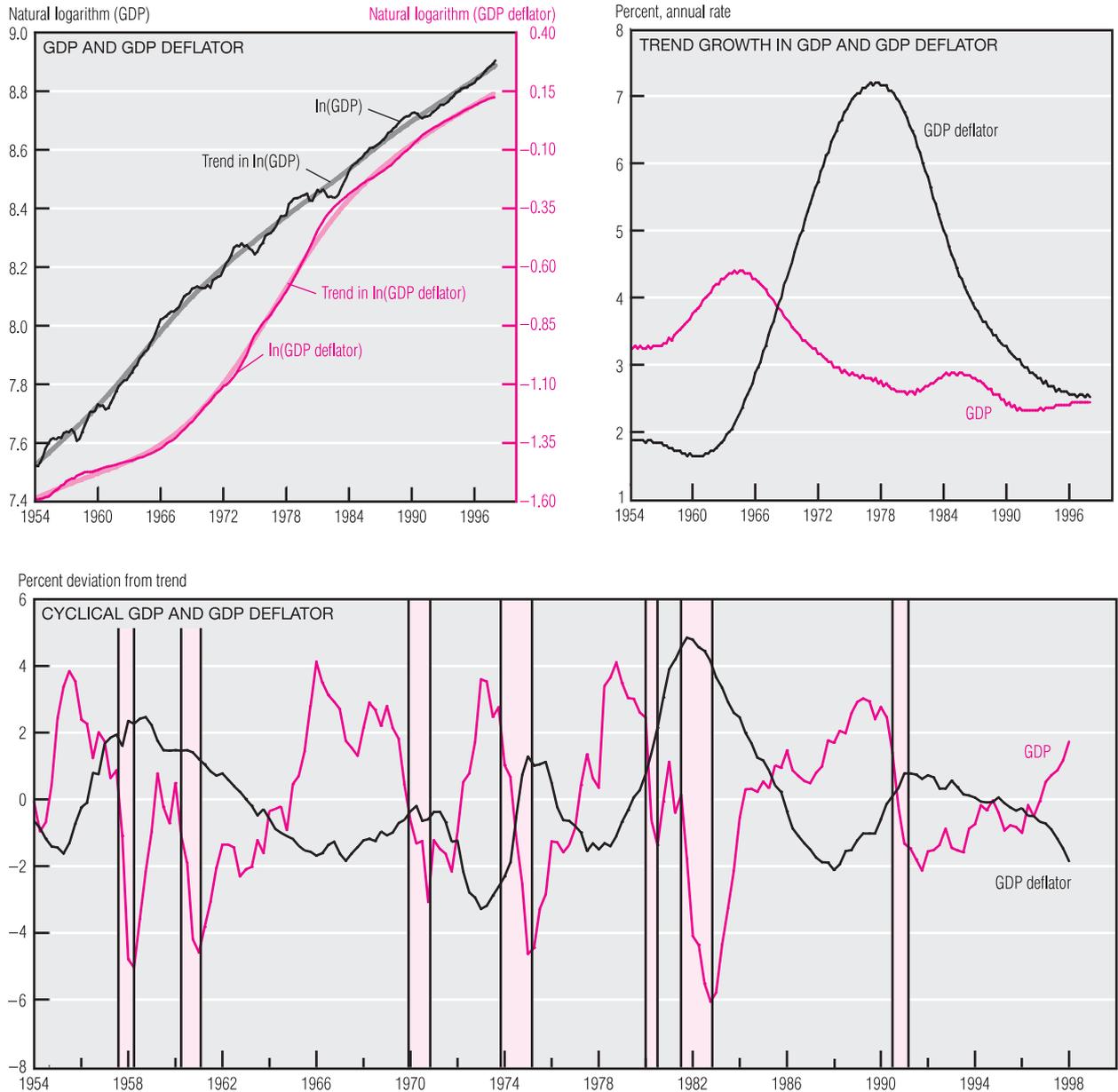
Looking over a longer horizon, the 3-month Treasury yield has remained below 6% since early 1991. One must go back to the 1960s to find a similar period of sustained low interest rates. It is no coincidence that one must also go back to the 1960s to find a comparable period of sustained low inflation.

While nominal interest rates have been relatively low in recent years, real interest rates have not. The ex post real interest rate, defined as the nominal 3-month Treasury bill yield minus inflation over the following

quarter, has stood between roughly 3% and 4% in recent years — somewhat higher than the real rates of the 1960s and considerably higher than the negative rates experienced during the 1970s. It is real rates of interest, rather than nominal rates, which are crucial to both firms and investors in making investment and savings decisions.

It is widely thought that strong growth during short-lived economic booms leads to higher prices and accelerated inflation. One method of  
*(continued on next page)*

## Monetary Policy (cont.)



NOTE: Shaded areas indicate recessions. GDP is in billions of chain-weighted dollars; GDP deflator is a chain-weighted implicit price deflator index 1992=10. Both are seasonally adjusted annual rates. Trend is calculated using the Hodrick-Prescott filter.  
SOURCES: Federal Reserve Bank of Cleveland; and DRI/McGraw-Hill.

exploring the price level's behavior over business cycles is to break down the historical path of the price level and output into two parts—a trend component and a cyclical component.

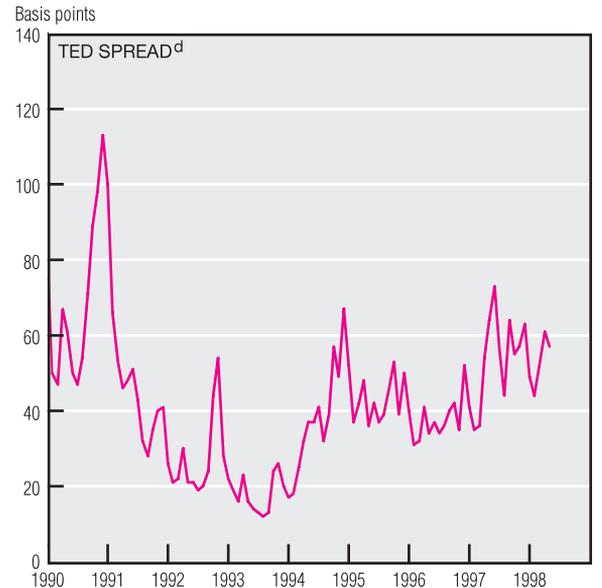
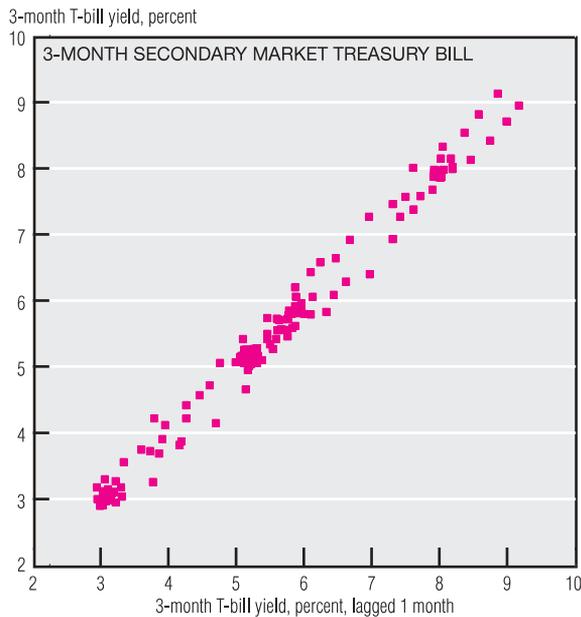
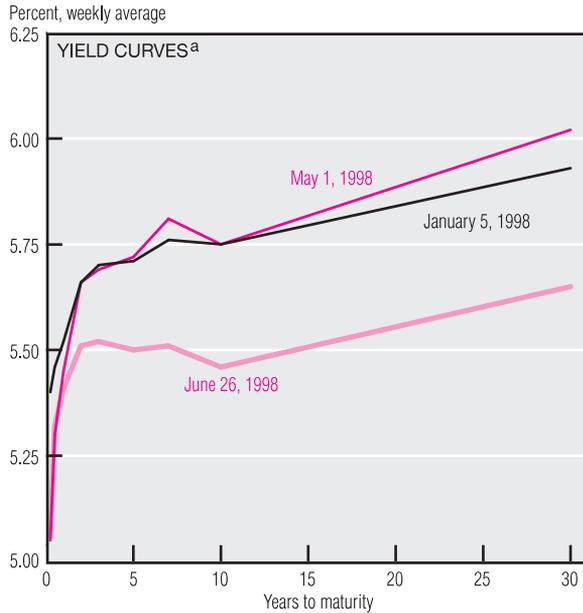
The trend in the price level and output can be interpreted as reflecting the underlying, or long-run, momentum in these variables. The changing trend in the GDP deflator clearly illustrates the steady increase in the underlying inflation rate from the early 1960s through 1980, and the deceleration in inflation which followed.

Cyclical components of the price level and output (that is, deviations from their respective trends) highlight the behavior of prices and output over the business cycle. Not surprisingly, the cyclical component of output falls sharply during recessions.

Contrary to a commonly held belief, however, the price level is not procyclical, but rather is clearly countercyclical. In other words, the cyclical component of the price level tends to be high when the cyclical component of output is low, and vice versa.

Furthermore, in terms of cyclical components, output growth is negatively associated with inflation, meaning that when output grows more rapidly, the price level rises less rapidly, and vice versa. To the extent that real output is currently above its long-run trend, this suggests that as output returns to its trend, inflation is likely to increase from the relatively low rate of the past year (1.5%) to a rate more in line with the underlying trend of the past few years (around 2.5%).

# 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. 3-month Eurodollar rate minus the 3-month secondary market Treasury bill rate.  
 SOURCES: Board of Governors of the Federal Reserve System; and Bloomberg information services.

In the past several months, the yield curve has flattened noticeably, with the benchmark 10-year, 3-month and 3-year, 3-month spreads decreasing from 70 to 40 basis points and from 64 to 46 basis points. The middle continues to show some inversions, where shorter rates exceed longer ones. The long bond rate, which as of May 1 had surpassed its early January level, has since dropped 37 basis points.

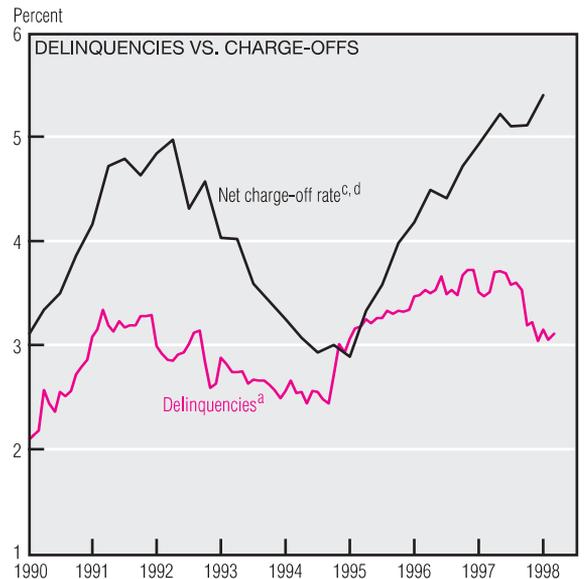
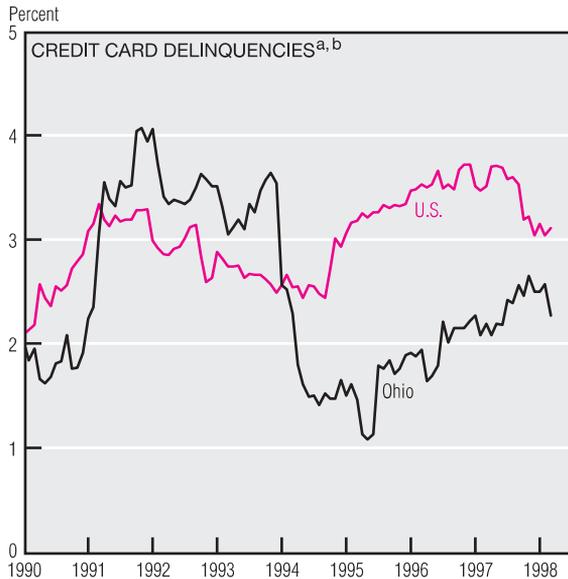
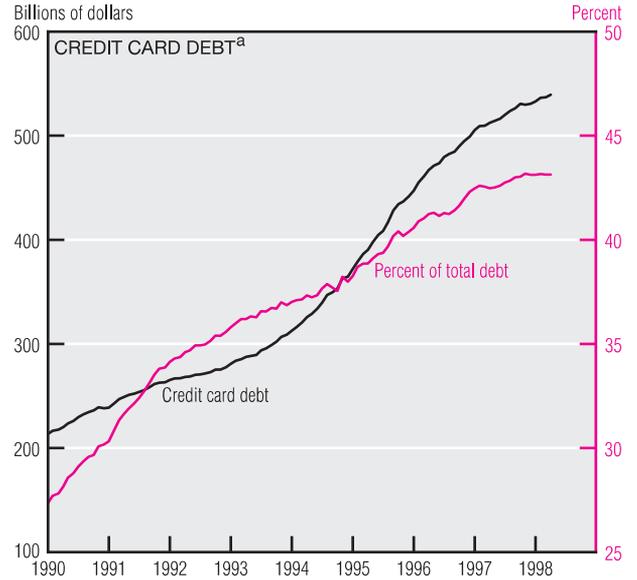
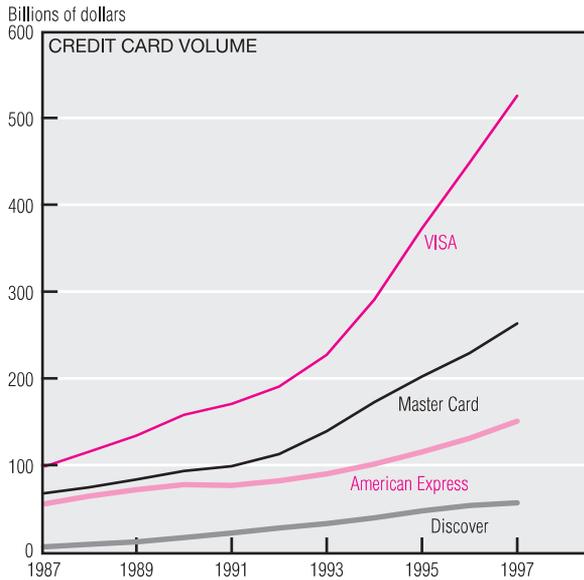
A controversy swirls around whether a flattening yield curve indicates slower economic growth or a new age of low inflation. One

measure of inflationary expectations (at least those of bond market participants) is the spread between the yield on nominal 10-year bonds and the yield on 10-year Treasury Inflation-Protection Securities, which has fallen 35 basis points since its recent peak in early May. This may indicate lower expected inflation, although the current 1.69 value is in line with January levels.

Interest rates' rather gradual movement can be pictured in a different way. Interest rates show strong persistence, or, in statistical jargon, high serial correlation: If

they are high today, they will probably be high tomorrow. Still, large movements can occur, especially in spreads, one of which is now being closely watched because of the Asian crisis: The Treasury-to-Eurodollar (TED) spread has been rising throughout most of 1998, although its most recent moves have been downward. The rise shows that investors demand a higher return for holding dollar-denominated assets overseas rather than as U.S. Treasuries, perhaps signifying greater worry over international considerations.

# Credit Card Activity



a. Seasonally adjusted annual rates.

b. Percent of credit card accounts that are 30 days past due.

c. Net charge-off rate is the percentage of total credit card debt that banks remove from their balance sheets because of uncollectibility, less amounts recovered on credit cards previously charged off, annualized.

d. All FDIC-insured commercial banks.

SOURCES: Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*; American Bankruptcy Institute; American Bankers Association, *Consumer Credit Delinquency Bulletin*; Credit Card Management, *Annual Report*, May 1998; and HSN Consultants, *The Nilson Report*, various issues.

People are using their credit cards more often, for larger amounts, and at a wider variety of places. The dollar amounts of purchases charged to nationally known, general-purpose credit cards has grown exponentially toward the \$1 trillion mark. In 1997, Americans had more than 564 million cards, and used them to finance 18% of their total \$5.5 billion in personal consumption expenditures. In the same year, the number of locations accepting cards

increased a hefty 7%. Besides convenience, special features like credits towards air mileage have fueled credit card use.

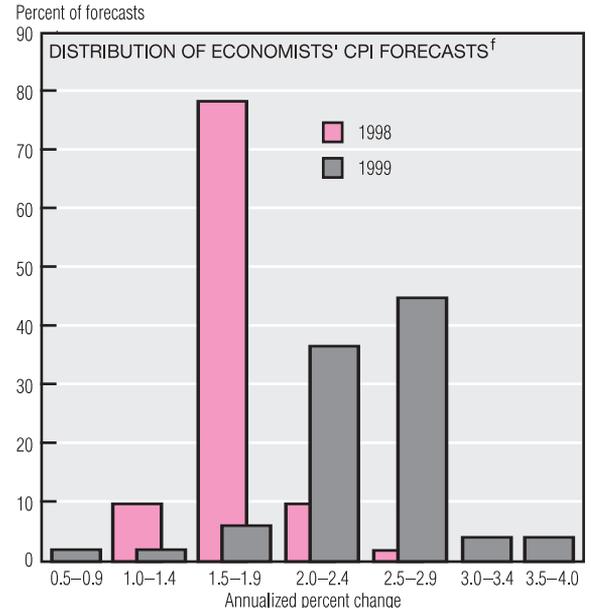
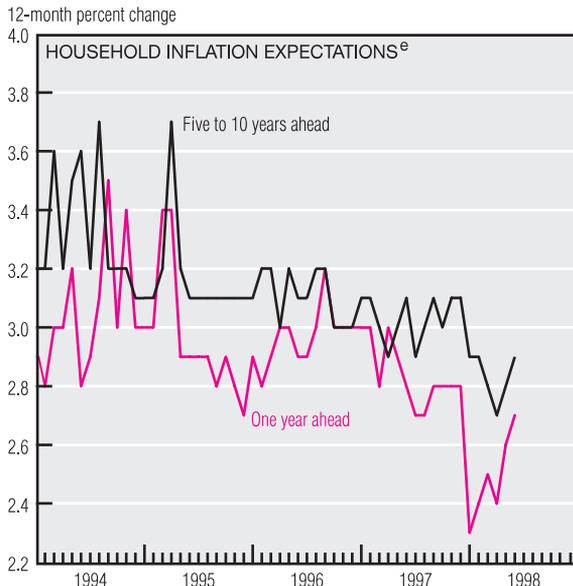
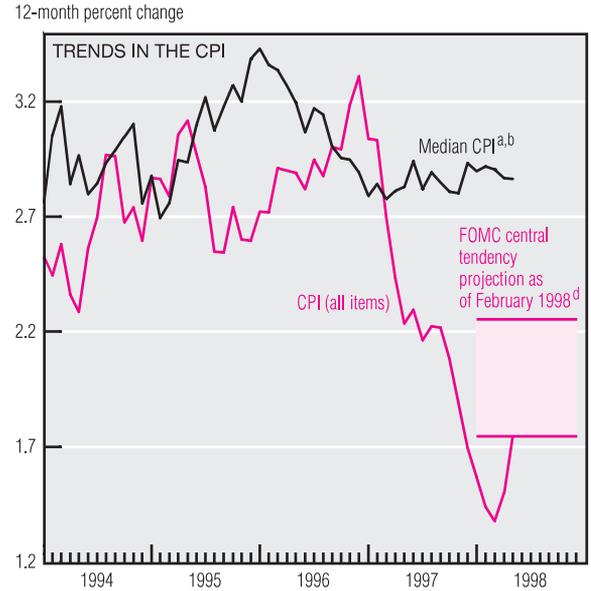
Along with heavier use, the volume of credit card debt outstanding has continued to rise. As percent of total debt outstanding, credit card debt has recently been hovering around 43%.

The disconcerting rise in credit card delinquencies nationwide since 1995 reversed itself in 1997. (In

Ohio, where the rate of delinquencies has been significantly lower than the national average since 1995, the drop in delinquencies was especially sharp in 1998:1Q.) Despite the recent decline in U.S. delinquencies, the charge-off rate continued to rise in 1997. This may reflect a delay between the time an account is first considered delinquent and the point at which the issuer begins to write it off.

# Inflation and Prices

May Price Statistics	Annualized percent change, last:				1997 avg.
	1 mo.	3 mo.	12 mo.	5 yr.	
<b>Consumer Prices</b>					
All items	3.8	2.2	1.7	2.5	1.7
Less food and energy	2.8	2.6	2.3	2.7	2.2
Median <sup>a,b</sup>	3.0	2.8	2.9	3.0	2.9
<b>Producer Prices</b>					
Finished goods	1.9	0.3	-0.9	0.8	-1.2
Less food and energy	2.6	1.7	0.6	0.9	0.0
<b>Commodity futures prices<sup>c</sup></b>					
	-36.0	-22.7	-12.6	0.7	-3.5



a. Calculated by the Federal Reserve Bank of Cleveland.

b. In May 1998, the median CPI component structure and market basket were updated, and the weighting scheme was revised.

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*, June 10, 1998.

The Consumer Price Index (CPI) increased an annualized 3.8% in May, partly because energy prices rebounded after five months of decline. The CPI trend has now risen to the lower limit of the FOMC central tendency established in February 1998. Excluding its food and energy components, the CPI increased at 2.8% (annualized rate); along with the median CPI, this suggests that the underlying inflation trend is holding just under 3%. Interestingly, the median CPI, an alternative

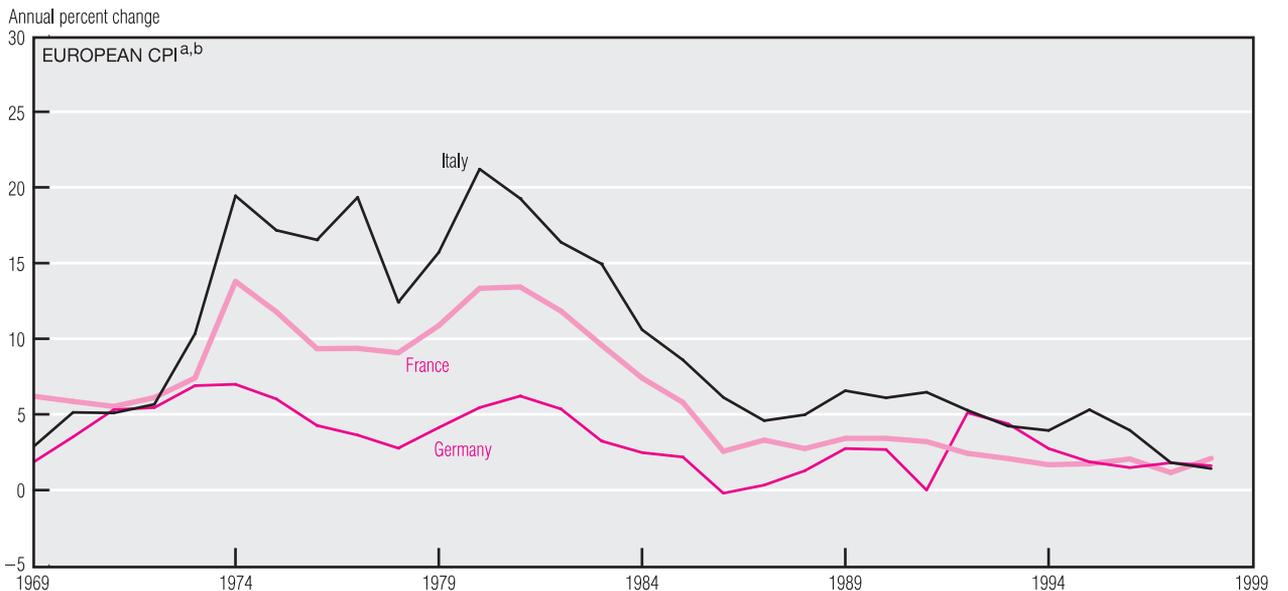
measure of core inflation, held steady at just below 3.0% this year and last, while the CPI and the CPI excluding food and energy initially drifted below that rate and recently returned to it.

Reflecting 1998 revisions by the Bureau of Labor Statistics, the median CPI now has a revised item structure and an updated consumer market basket. In addition, the revised median CPI incorporates a weighting technique based on a component's "relative importance."

Producer prices rose for the second straight month in May, increasing an annualized 1.9%. Excluding the food and energy components, the producer price index (PPI) increased 2.6% (annualized rate). Although there have been recent increases in the CPI and PPI trend growth rates, commodity futures prices continue to decline, and have dropped 12.6% since May 1997.

Households responding to the Michigan Survey of Consumers *(continued on next page)*

## Inflation and Prices(cont.)



a. Data not seasonally adjusted.

b. Data through May 1998.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and International Monetary Fund, *International Financial Statistics*, various issues.

reported slightly higher inflation expectations, although both long- and short-run expectations remain under 3.0%. Since May 1997, however, households' short- and long-run inflation expectations have diverged, suggesting that respondents believe the current low inflation environment is transitory and likely to become slightly less favorable within a few years. Economists predict CPI inflation for 1998 will be roughly the same as for 1997, with nearly 80% of respondents putting it in the range of 1.5%–1.9%. Forecasts

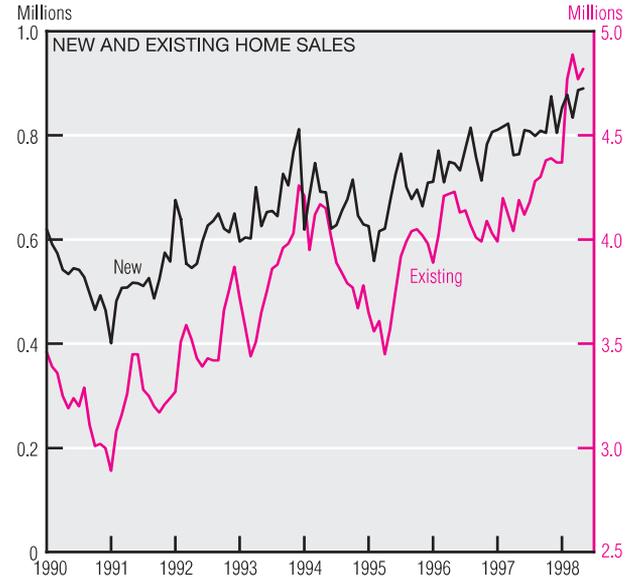
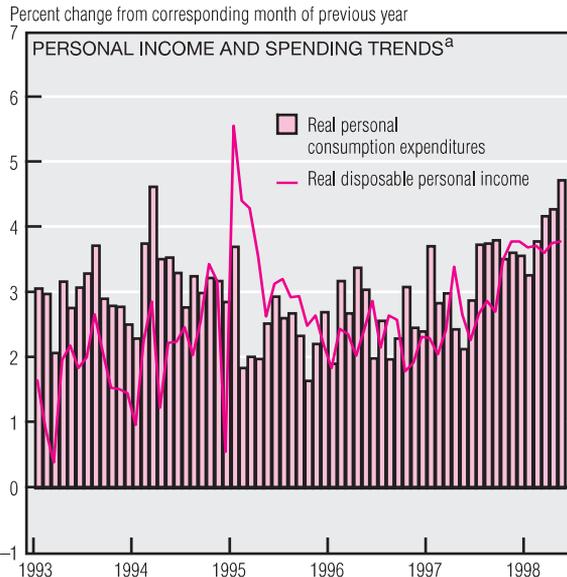
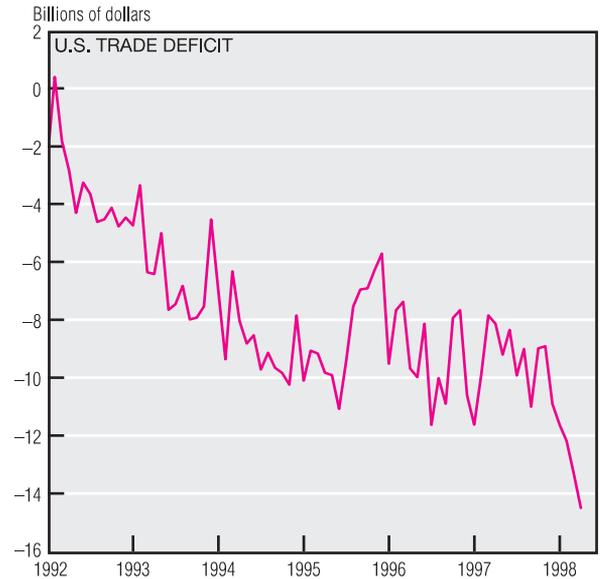
for 1999, however, suggest that CPI inflation will increase to the 2.0%–3.0% range. The distribution of CPI inflation forecasts for 1999 shows surprising variation, indicating considerable uncertainty about the future inflation environment.

Inflation among the major industrialized countries has converged to approximately 3% in recent years. In the mid-1970s, these countries experienced dramatic jumps in inflation. In 1974, for example, Japan saw prices rise more than 23%; a year later, the U.K. had a 24% increase.

The speed with which nations reduced the high-inflation trends of the 1970s varied. In France, Italy, and the U.K., double-digit inflation persisted well into the 1980s, while Japan and Germany were able to bring their rates down quickly. The overall moderation was assisted by two factors: Some countries—most notably Canada and the U.K.—adopted explicit inflation targets for their monetary policies, and inflation convergence became a criterion for membership in the European Monetary Union.

# Economic Activity

	Change, billions of 1992 \$	Percent change, last:	
		Quarter	Four quarters
Real GDP	95.7	5.4	3.9
Consumer Spending	72.6	6.0	3.7
Durables	23.4	15.0	7.0
Nondurables	23.5	6.6	1.8
Services	27.7	4.0	4.0
Business fixed investment	36.5	17.8	12.4
Equipment	41.3	26.4	17.8
Structures	-1.4	-2.8	-0.9
Residential investment	11.4	16.9	8.9
Government spending	-10.3	-3.2	0.3
National defense	-15.6	-18.6	-2.8
Net exports	-49.3	—	—
Exports	-3.1	-1.2	7.3
Imports	46.2	17.0	14.2
Change in business inventories	31.7	—	—



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

NOTE: All data are seasonally adjusted.

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

According to the Commerce Department's final estimate, real GDP grew 5.4% in 1998:IQ, a substantial upward revision from the previous estimate of 4.8%. Much of the difference results from a larger-than-expected buildup of inventories, and a smaller-than-anticipated decline in net exports. Despite this revision to net exports, foreign trade is still an area of concern. In April, the U.S. trade deficit in goods and services continued to increase, reaching a record \$14.5 bil-

lion, largely because of a deterioration in exports.

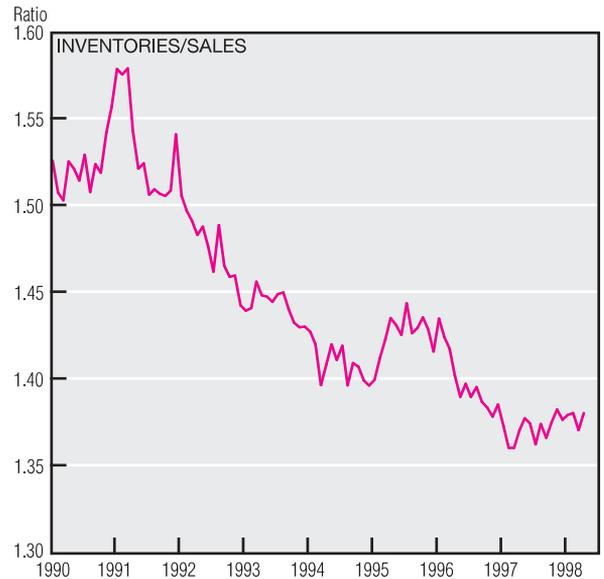
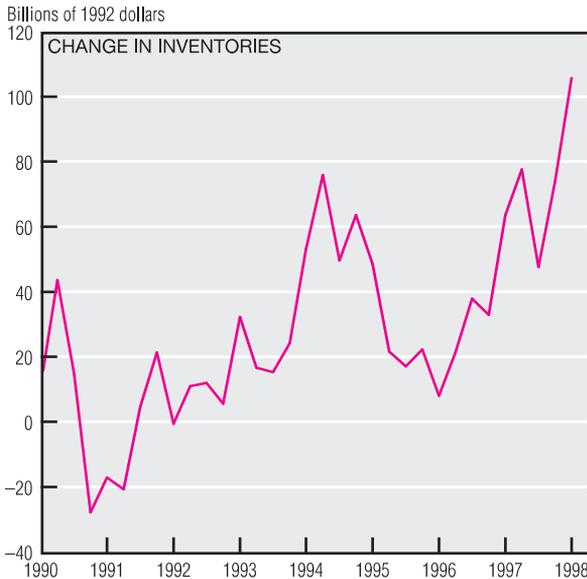
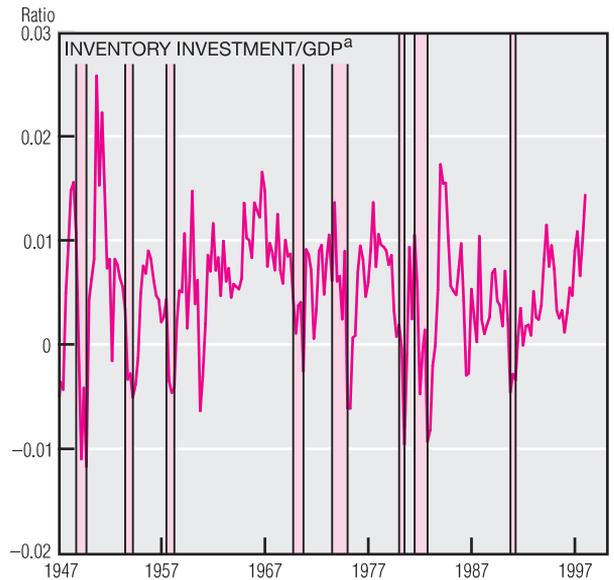
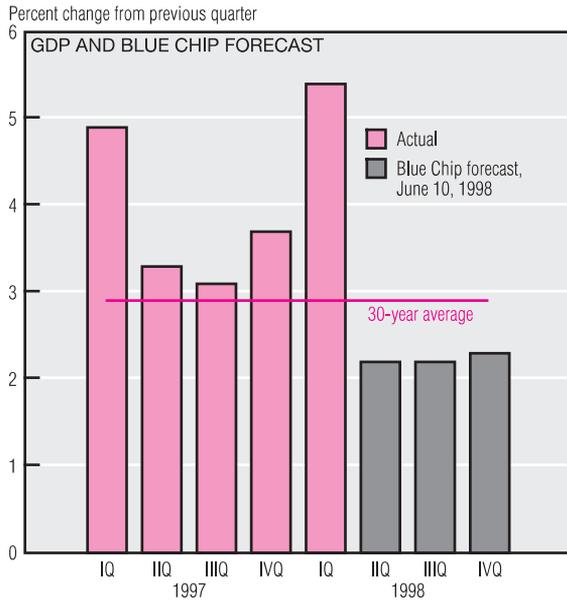
The consumer sector remains robust. Real personal consumption expenditures have jumped 4.7% since last May, while real disposable income has grown 3.8%. Consumers are generally optimistic that the economy will stay strong, as shown by vigorous sales of new and existing homes, which have also been buoyed by low interest rates and rising incomes.

Economists participating in the most recent Blue Chip survey expect economic growth to decelerate during the rest of the year from its recent dizzying pace. Concerns about excessive inventory accumulation and the worsening Asian economic climate underlie these lower projections.

Much of the worry about inventories centers on why they are growing and how companies will respond.

*(continued on next page)*

# Economic Activity (cont.)



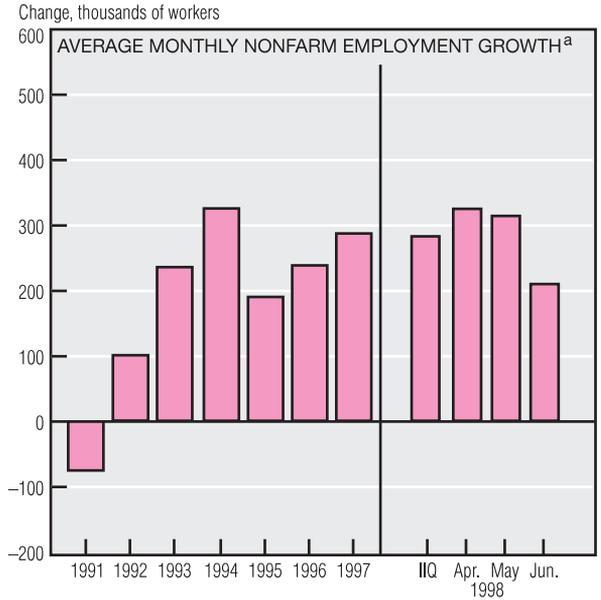
a. Shaded areas indicated recessions.  
 NOTE: All data are seasonally adjusted.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and *Blue Chip Economic Indicators*, June 10, 1998.

The traditional view is that a shock to aggregate demand leads to decreased sales and an accumulation of inventories. Then, if companies expect the slowdown in aggregate demand to continue, they will cut production accordingly. However, although inventories decline relative to GDP during a recession, high inventory levels do not necessarily precede a slowdown, because they may be

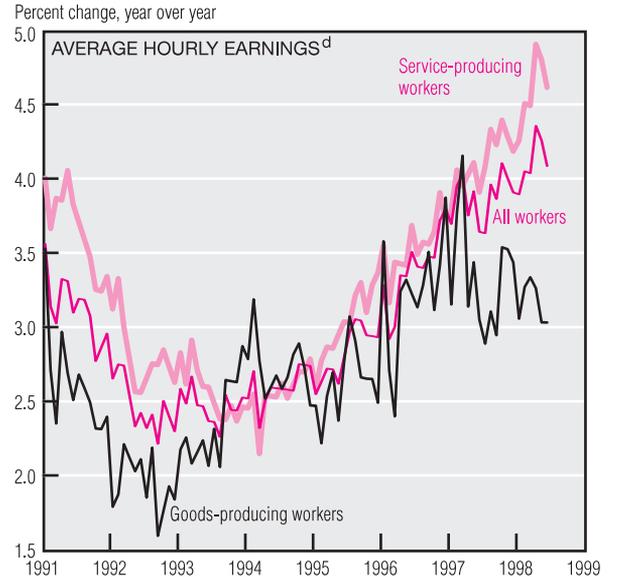
caused by other factors. For example, a firm could enjoy an unanticipated increase in productivity or a decrease in costs, leading to higher-than-expected production. Inventory investment could also rise because firms anticipate stronger demand. Both these scenarios support more optimism about the economy's future performance than does the traditional view.

Inventories grew by a record \$105.7 billion in the first quarter. It is not yet entirely clear what this increasing inventory investment means. Ratios of inventories to sales are still quite low, but this trend has been apparent for quite a while because of the shift to just-in-time inventories.

# Labor Markets



	Average monthly change (thousands of employees)				
	1994	1995	1996	1997	1998 to date
Payroll employment	320	185	233	282	243
Goods-producing	57	8	31	42	16
Manufacturing	33	-1	3	21	-3
Motor vehicles	8	2	0	3	-1
Apparel	0	-7	-4	-3	-6
Electronic	5	4	2	4	0
Service-producing	264	178	202	240	227
Services	135	112	117	142	115
FIRE <sup>c</sup>	-3	-1	14	17	24
	Average for period				
Civilian unemployment rate (%)	6.1	5.6	5.4	5.0	4.5
Manufacturing workweek (hours) <sup>d</sup>	41.9	41.6	41.6	42.0	41.8



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

The pace of jobs creation slowed in June, raising the unemployment rate to 4.5% from the 28-year low of 4.3% seen in April and May. This change is probably the labor market's reaction to Asian economic conditions and the General Motors strike. Even after the increase, however, unemployment remains well below the 5.0% rate that prevailed a year ago.

Nonfarm payrolls increased 205,000 in June, compared to more than 300,000 in each of the previous two months. Even so, the number of

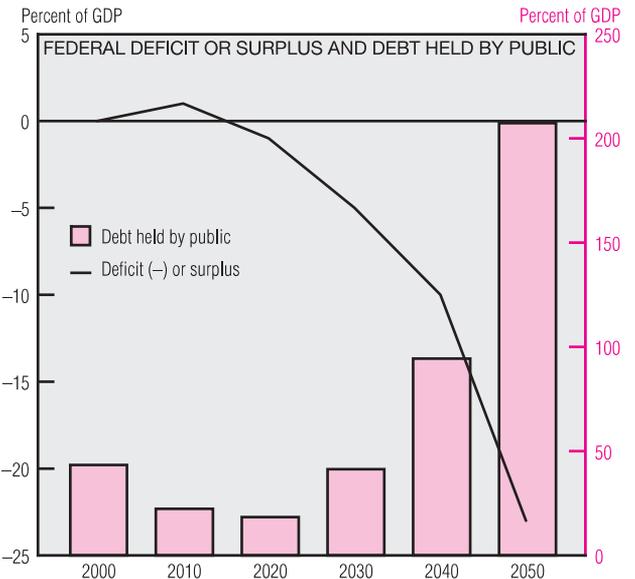
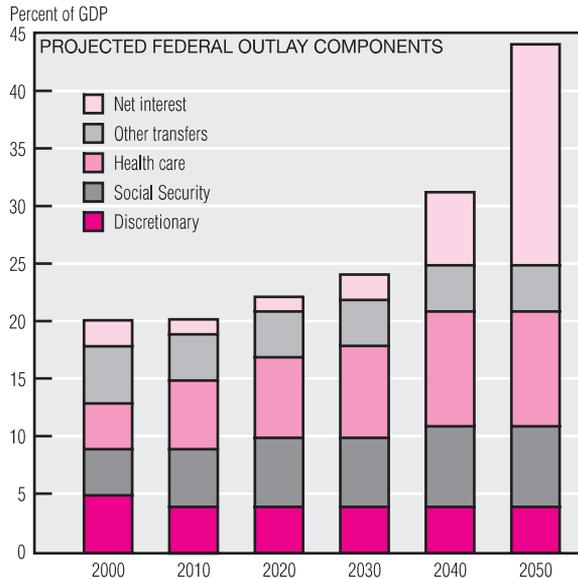
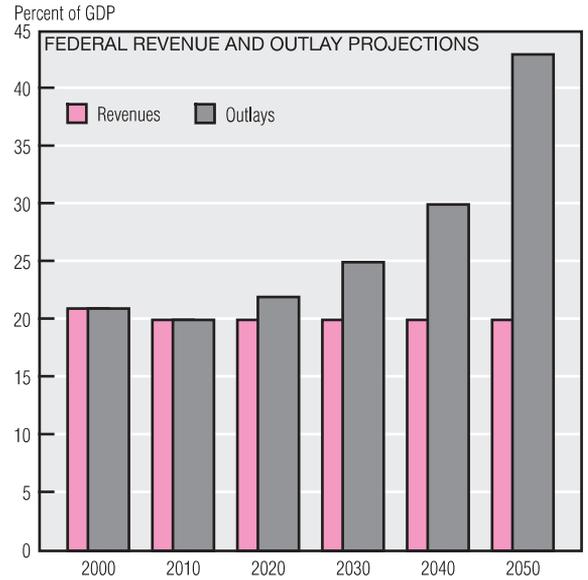
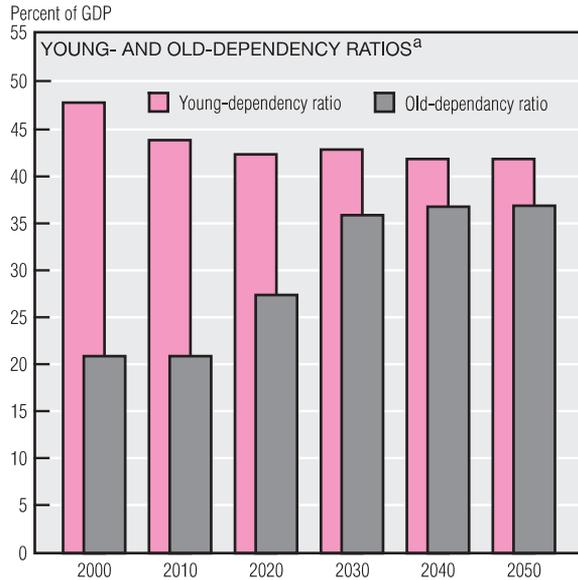
additional jobs created in June exceeded the average of 196,000 new jobs per month for the current expansion (since March 1991). In 1998:IIQ, payrolls increased an average of 278,000 per month, surpassing average jobs creation for the same period last year.

The number of jobs in the manufacturing sector decreased 29,000 in June, largely because of heavy competition from Asian imports such as apparel and electronics. For both these industries, moreover, June was the third straight month of payroll decreases. Motor vehicle mak-

ers cut 6,000 jobs last month, reflecting some of the effects of the June 5 strike at the GM stamping plant in Flint, Michigan, but available statistics do not yet show the strike's full impact.

Registering their smallest increase in over two years, average hourly earnings for private production workers rose just one cent, to \$12.74. Manufacturing workers' hourly pay also increased one cent, to \$14.28, while workers in service-producing industries showed a two-cent raise, to \$12.24 an hour.

# Demographic Change and the Long-term Budget Outlook



a. The young- and old-dependency ratios show the number of persons under 20 and over 64, respectively, to the number of persons aged 20–64.  
 NOTE: Budget data are reported on a National Income and Product Account basis.  
 SOURCES: Congressional Budget Office; and Social Security Administration.

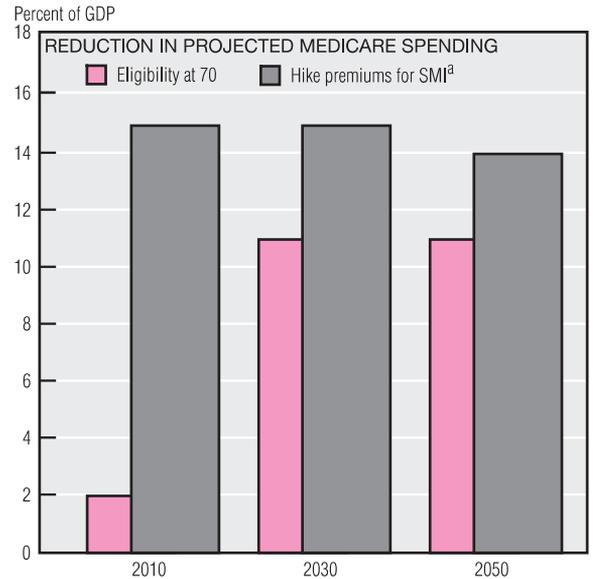
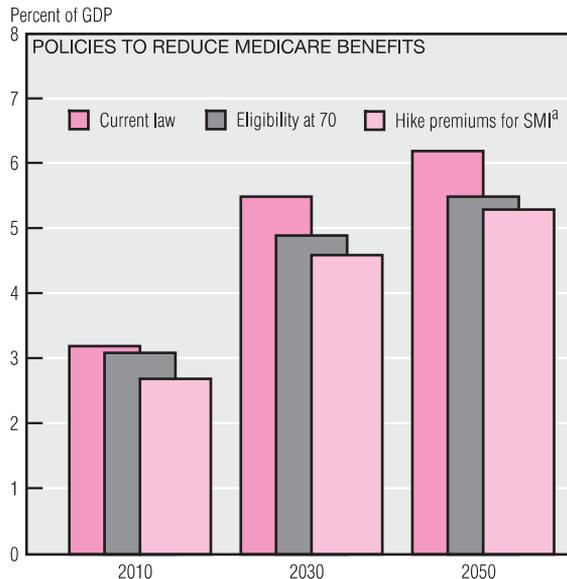
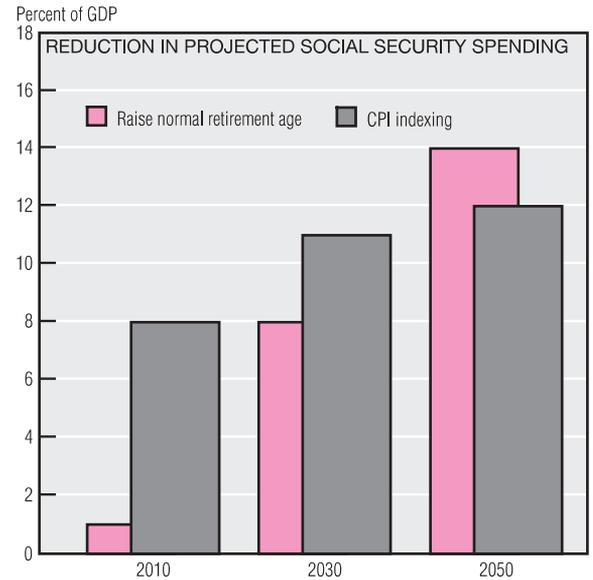
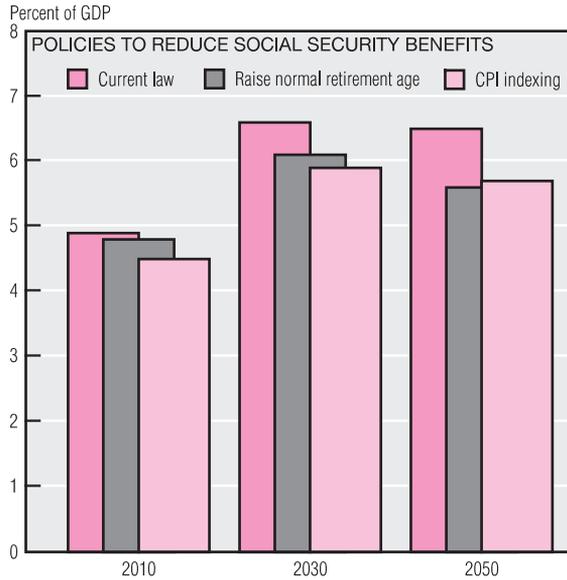
Demographic change will be the main determinant of budget allocations over much of the next century. Low birth rates, an aging population, and increasing survival rates promise to swell the “old-dependency ratio” —the number of those over 65 as a share of those aged 20–64—from 21% today to 37% by the year 2050. The fiscal burden of supporting the elderly through greater Social Security and health care outlays will be eased somewhat by the declining “young-dependency ratio” —the number of those under 20 as

a share of those aged 20–64—which is projected to fall from 48% today to 42% by 2050. These figures are subject to uncertainty, especially for years far in the future, mostly because of unpredictable future fertility rates.

Under current fiscal policy, total federal revenues as a share of GDP are expected to remain relatively constant at about one-fifth through 2050. However, the Congressional Budget Office expects total outlays as a share of GDP to increase from 22% in 1997 to 25% by 2030, then to surge to 43% by 2050.

Federal discretionary spending is projected to decline from 5% of GDP in 1997 to 4% by 2050. However, by the year 2050, Social Security outlays will take up 7% of GDP, and health care 10%, more than double their current levels of 3% and 4%, respectively. As spending outstrips revenue, federal deficits and debt held by the public will grow, forcing a steep increase in net interest payments, which will leap from 3% to 19% of GDP by 2050—almost as large a share as the entire federal budget today.

# Policies to Reduce Entitlement Spending



a. Supplementary Medical Insurance.  
SOURCE: Congressional Budget Office.

Four frequently cited methods to trim federal entitlements are: increasing the normal retirement age for Social Security (SS); adjusting the inflation indexing of SS benefits; raising the age for Medicare eligibility; and hiking Medicare premiums. These proposals differ in both the magnitude and the timing of their impacts.

One proposal would complete the scheduled transition to 67 as the normal SS retirement age by 2011, instead of by 2025, and increase it gradually to 70 by 2029. After that, the retirement age would rise with

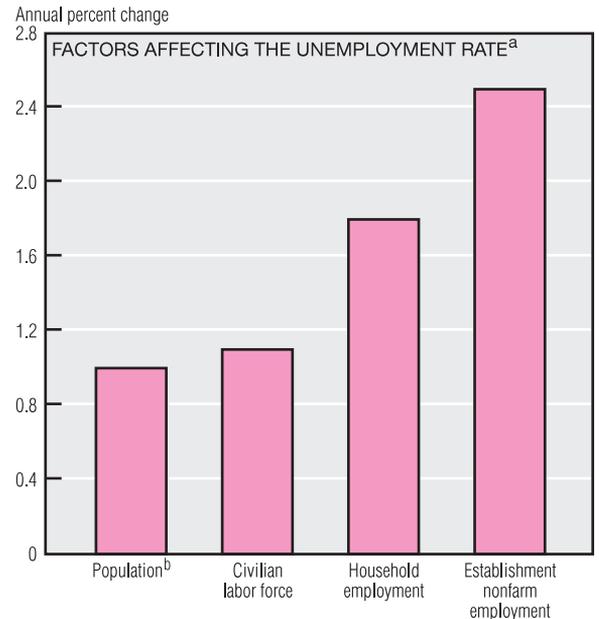
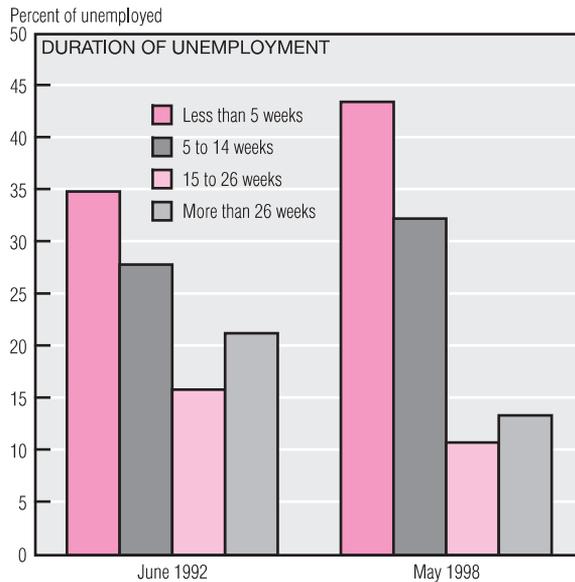
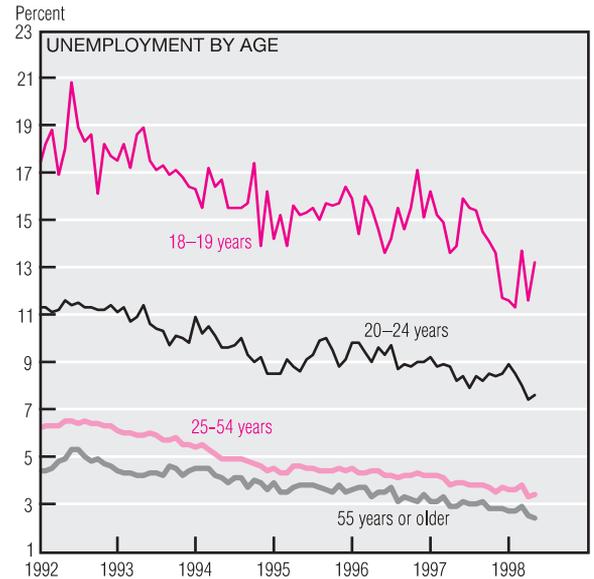
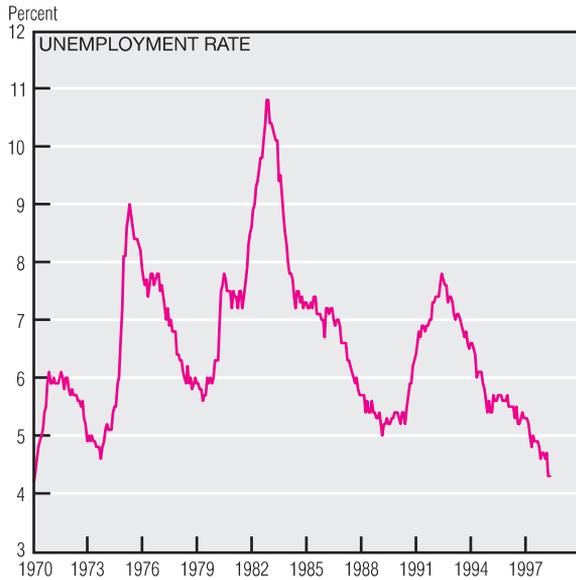
life expectancy. This approach would cut SS outlays to 5.6% of GDP in 2050 from 6.5% under current law, which equals a reduction of 14% in SS outlays for that year.

Cutting the inflation adjustment for benefits by one percentage point would also lower total outlays, but only to 5.7% of GDP. Because it would affect all benefits immediately, however, this method would have a more immediate impact on SS outlays than increasing the retirement age.

A policy of gradually raising the

eligibility age for benefits from 65 to 70 by 2032 could trim Medicare outlays to 5.5% of GDP in 2050 from 6.2% under current law, which equals a savings of 11% in that year. Alternatively, hiking the premium for Supplementary Medical Insurance (SMI), widely known as Medicare Part B, to cover 50% of its costs by the year 2000 could reduce Medicare spending to 5.3% of GDP in 2050. Because this policy would affect all Medicare beneficiaries, not just new ones, it could trim outlays by 15% as early as 2010.

# Labor Market Strength



a. Change from June 1992 to May 1998.  
 b. Not seasonally adjusted.  
 NOTE: Data are seasonally adjusted unless otherwise specified.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

The strong current recovery has been exceptional in many ways, perhaps most remarkably in producing the lowest unemployment rate since early 1970. The historical comparison is probably even better: Survey procedure changes in 1994 raised measured unemployment by approximately 0.5%, suggesting that today's rate is comparable to a pre-1994 rate of 3.8%.

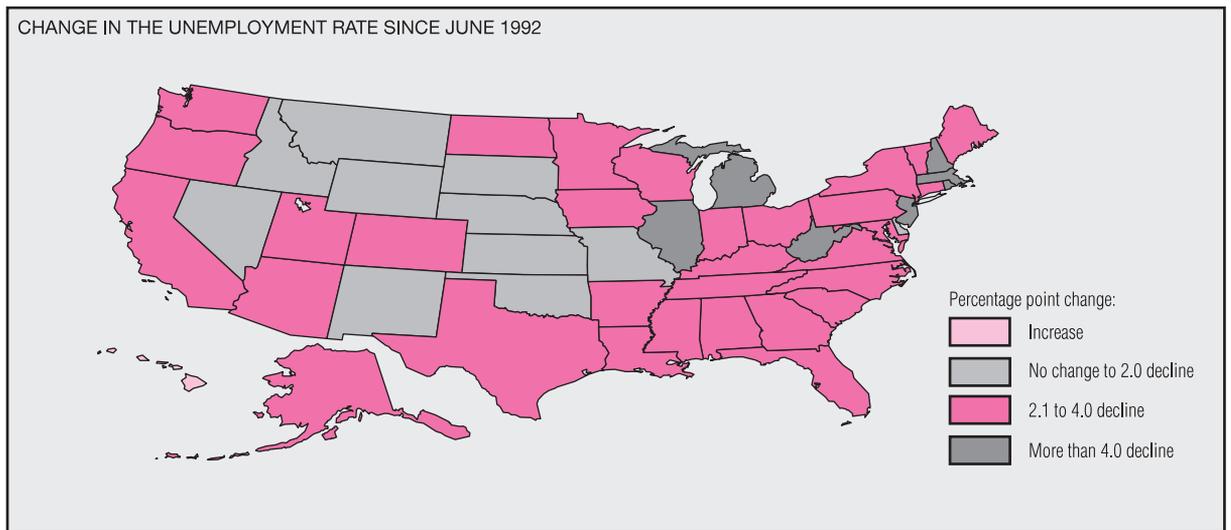
All age groups have experienced the unemployment decline, al-

though more than 10% of early career workers (18-19 years old) are unemployed. In addition, jobless people are spending less time on the unemployment rolls, with a median spell of less than six weeks this May, compared to nearly nine weeks in June 1992.

How did the unemployment rate get so low? The rate depends on the availability of jobs and on the size of the potential workforce. The latter rises largely with the growth of the

adult U.S. population (1.0% per year during this recovery), but that is not the only factor. Rising participation rates have also expanded the civilian labor force. Since June 1992, when the unemployment rate reached its recent peak of 7.9%, the participation rate has risen from 66.7% to 67.0%. Without higher participation, the unemployment rate would have fallen even farther, to 3.8%. According to either the household or the  
*(continued on next page)*

# Labor Market Strength (cont.)



a. Nonfarm employment.  
 b. Transportation and public utilities.  
 c. Finance, insurance, and real estate.  
 NOTE: Data are seasonally adjusted.  
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

establishment survey of employment, jobs growth has outstripped labor force growth, leading directly to a lower unemployment rate. The growth rate in the establishment measure of jobs exceeds the household count of workers, a sign that moonlighting (a worker holding more than one job) has increased.

Employment gains have occurred in every sector of the economy except mining. Of course, sectors have not expanded evenly. Over eight million workers were added by serv-

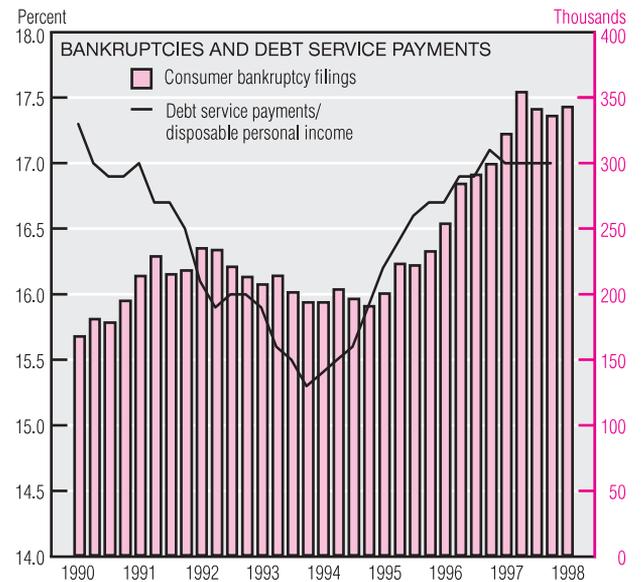
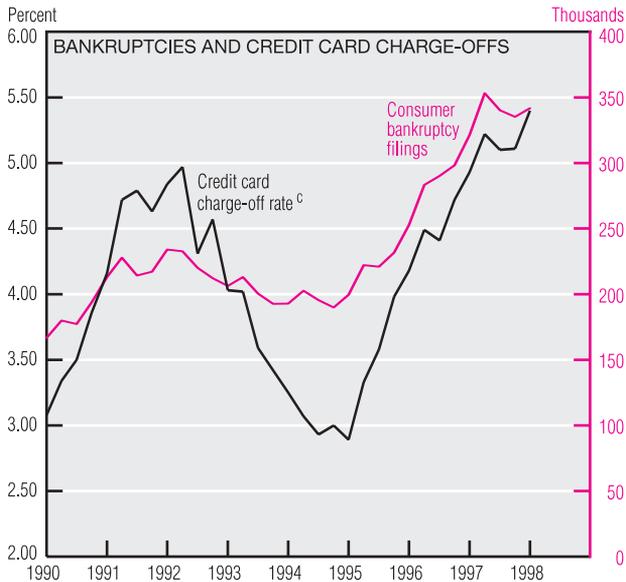
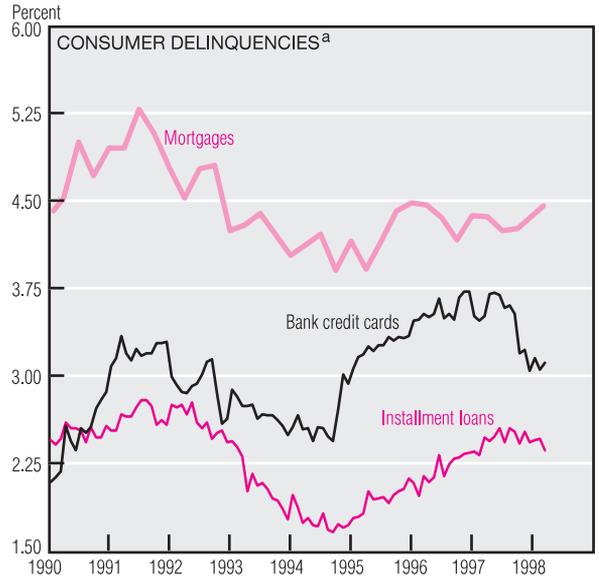
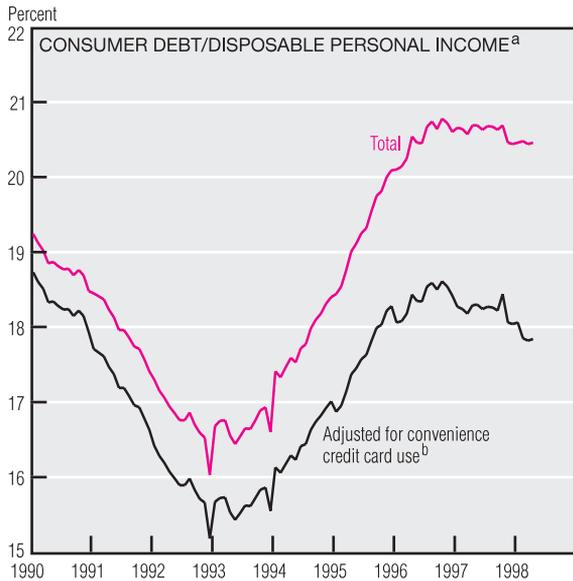
ice firms, making the largest major industry also the fastest-growing. Construction work has boomed too, undoubtedly stimulated by some of the lowest long-term interest rates in decades.

The picture is similarly bright for most states. Those that struggled during the last recession, notably several eastern states, have enjoyed the largest declines in their unemployment rates. The midwestern states with the smallest unemployment rate declines were those that did not experience very high unem-

ployment rates in the 1990-91 recession. The exception to all this positive news is Hawaii, tightly linked to Japan through tourism and construction funding, which has been hurt by the slowing of the Japanese economy.

Can the heartening trend to lower unemployment rates persist? Jobs growth has continued unabated into 1998, but further unemployment rate reductions at the post-1992 pace would push joblessness to unprecedented lows.

# Consumer Debt and Bankruptcy



a. Seasonally adjusted.  
 b. Adjusted consumer debt as a fraction of disposable personal income is calculated using an estimate of bank card debt actually accruing finance charges.  
 c. Net charge-off rate is the percentage of total credit card debt that banks remove from their balance sheets because of uncollectibility, less amounts recovered on credit cards previously charged off, annualized.  
 SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Administrative Office of the U.S. Courts; American Bankers Association, *Consumer Credit Delinquency Bulletin*; Federal Deposit Insurance Corporation, *Quarterly Banking Profile*; Mortgage Bankers Association of America, *National Delinquency Survey*; and Ram Research Group, *Bankcard Update/Bankcard Barometer*.

After rising at a breakneck pace early in the current economic expansion, total consumer debt burdens seem to have leveled off and even to have dropped over the last couple of years. Furthering this impression that household financial conditions are more stable than in the recent past, credit card delinquency rates have dropped sharply over the last 12 months, while delinquency rates on mortgages and other consumer installment loans have stayed relatively constant.

Despite these encouraging trends,

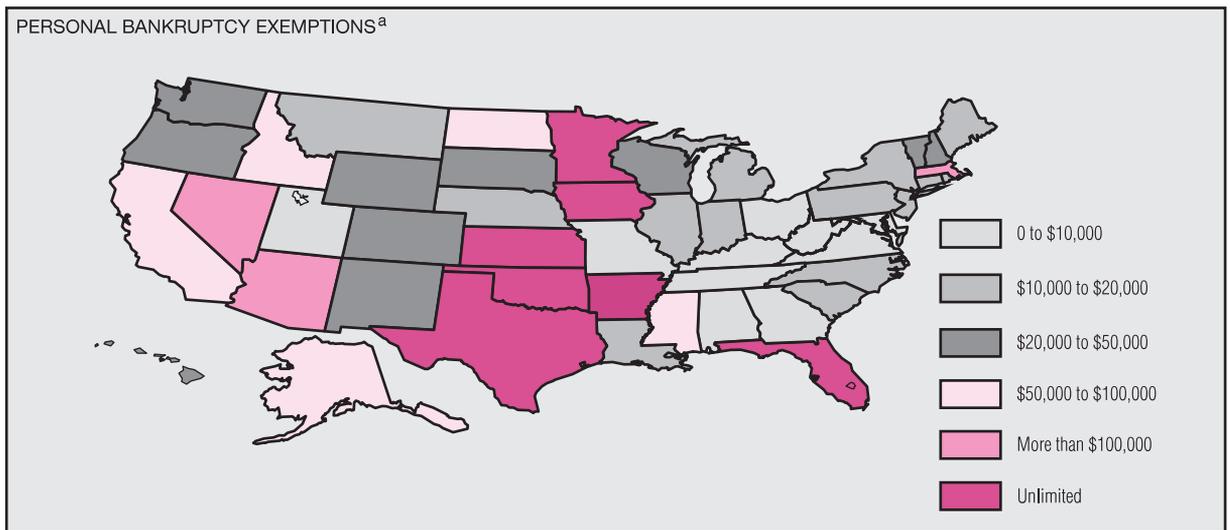
record numbers of individuals have continued to file for bankruptcy, nearly 1.35 million of them last year alone (up 20% from 1996). Recently released figures show that consumer filings in the first three months of 1998 were up more than 6% from the same period last year. Following historical patterns, the percentage of credit card balances that lenders write off as uncollectible rose in lockstep with bankruptcy filings, to 5.4% of outstanding balances in the first quarter of this year.

Not surprisingly, the record rise in

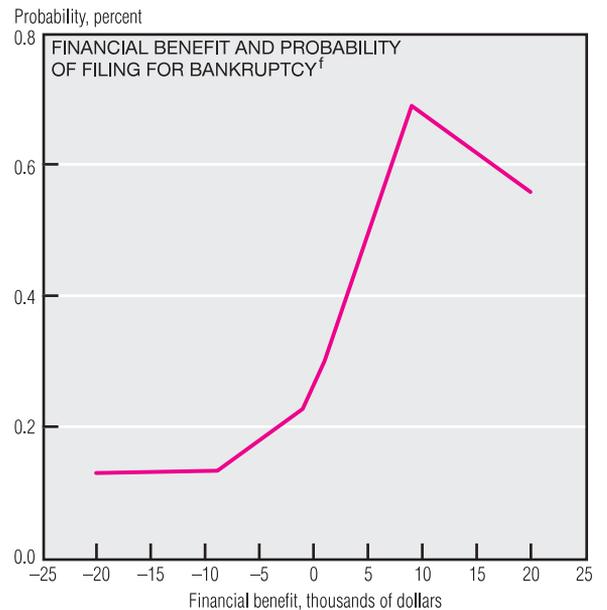
personal bankruptcy filings has fueled interest in reforming bankruptcy laws. Just last month, the U.S. House of Representatives passed the Bankruptcy Reform Act of 1998; the Senate is scheduled to debate its own reform bill later this summer.

During these debates, many analysts have cited record levels of consumer debt as the driving factor in the recent rise in bankruptcy filings. Research by Professor Michelle White at the University of Michigan, however, suggests that borrowers  
*(continued on next page)*

# Consumer Debt and Bankruptcy (cont.)



State	Total allowed exemptions <sup>a</sup>	Percent of households that would benefit <sup>d</sup>	Median net benefit of filing <sup>e</sup>
California	\$76,600	16	\$1,700
Florida <sup>b</sup>	Unlimited	14	\$1,950
Illinois	\$10,700	14	\$1,500
Louisiana	\$15,000	10	\$1,720
Massachusetts	\$101,675	18	\$1,770
Michigan <sup>c</sup>	\$12,850	14	\$1,650
Mississippi	\$85,000	30	\$1,650
New Jersey <sup>c</sup>	\$12,850	14	\$1,650
New York	\$14,900	16	\$1,400
Ohio	\$6,800	11	\$1,585
Texas <sup>b</sup>	Unlimited	32	\$1,680
U.S.	\$12,850	17	\$1,650



a. Total allowed state or federal exemptions, from White (1998).  
 b. State law permits residents to retain unlimited equity in a personal residence.  
 c. State law permits the more generous federal exemption.  
 d. Proportion of U.S. households for which the value of debt discharged would exceed the value of assets forfeited in bankruptcy.  
 e. Median net benefit of filing for bankruptcy among those for which this benefit is positive.  
 f. "Average" household's probability of filing for bankruptcy as the benefit from doing so varies.  
 SOURCES: Michelle J. White, "Why It Pays to File for Bankruptcy: A Critical Look at Incentives under U.S. Bankruptcy Laws and a Proposal for Change," *University of Chicago Law Review*, forthcoming, tables 1, 3, and 4; and Erik Hurst, Scott Fay, and Michelle J. White, "The Bankruptcy Decision: Does Stigma Matter?" University of Michigan, Department of Economics Working Paper 98-01 (1998), figure 5.

base the decision to file for bankruptcy on their overall financial benefit from doing so, not just their debt levels.

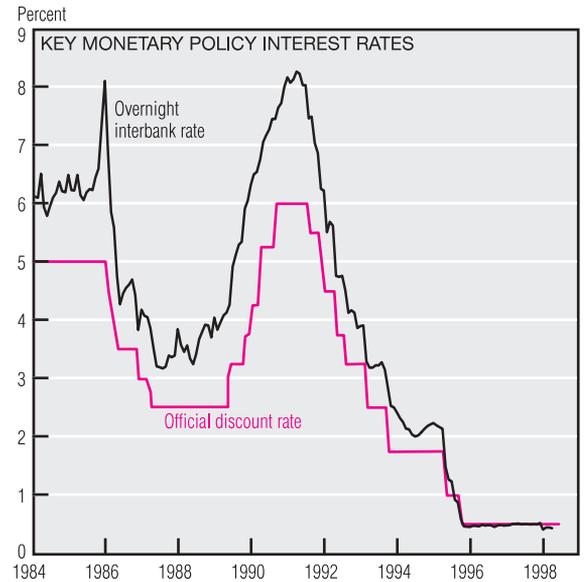
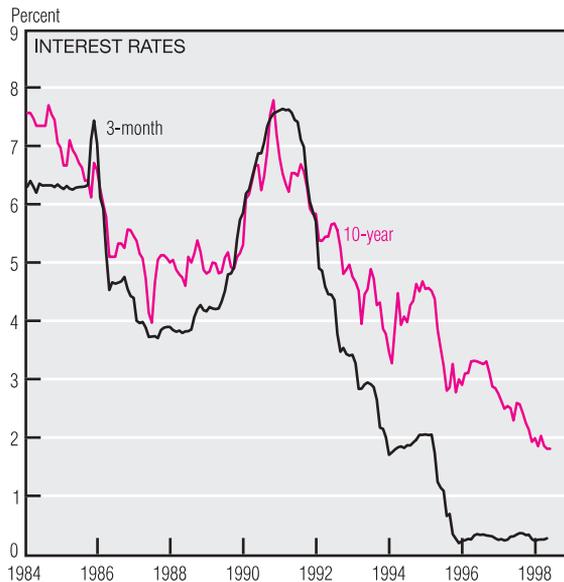
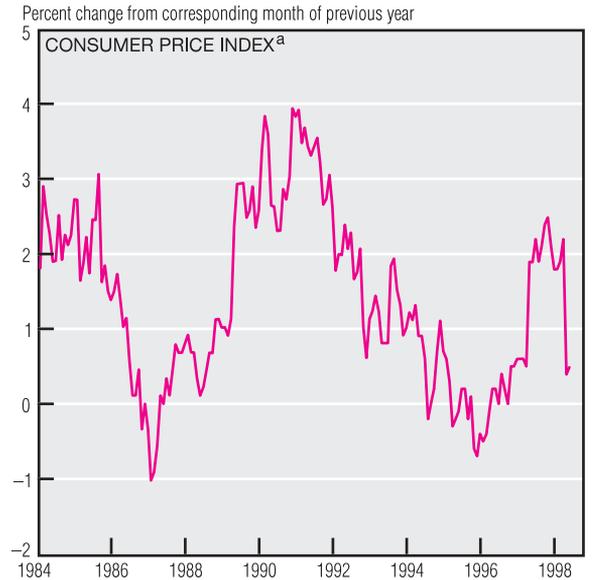
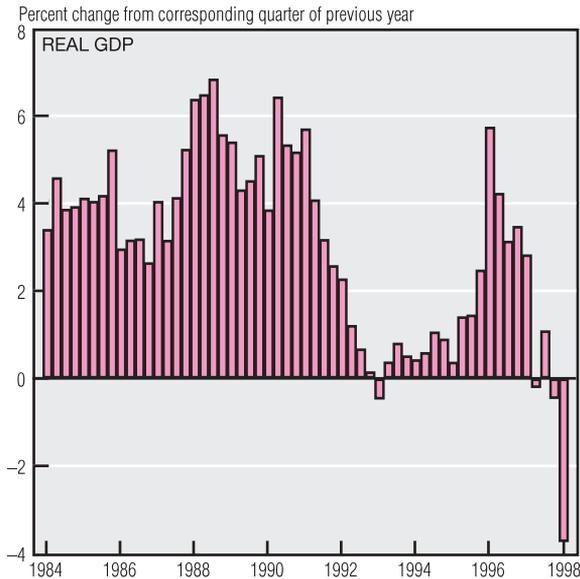
A borrower's financial benefit from filing is simply the value of any debt that would be discharged in bankruptcy minus any assets that would be forfeited. In bankruptcy, borrowers are allowed to retain some assets, even as their debts are erased. The permitted level of these personal exemptions varies from

state to state, with some allowing an unlimited "homestead exemption" for a residence. As a result, an individual's total financial benefit from filing for bankruptcy varies not only with his level of debt, but also with the amount of personal exemptions his state allows.

Professor White calculates that, while these incentives vary substantially across states, roughly 17% of all U.S. households could benefit financially from filing for bankruptcy;

within that group, the median reduction in debts compared to lost assets would be \$1,650. Clearly, not every borrower with a financial incentive actually files for bankruptcy, but separate research has shown that borrowers who stand to gain a strong financial benefit are substantially more likely to do so. This suggests that to understand recent trends in filing levels, we must consider personal exemptions as well as consumer debt burdens.

## International Aspects of Japan's Business Cycle



a. Sales taxes account for the year-over-year jump in prices between April 1997 and April 1998.  
SOURCES: Bank of Japan; Statistical Bureau of the Prime Minister (Japan); and DRI/McGraw-Hill.

Rocked by Southeast Asia's economic crisis, Japan sank deeper into recession during 1998:1Q. Some economists believe the country's modest inflation rate and corresponding low interest rates have actually hampered its recovery by eliminating a key channel through which monetary policy affects aggregate demand. Since it cannot force nominal interest rates below zero, an expansionary Japanese monetary policy might not affect consumption, investment, and savings decisions.

In these circumstances, fiscal initiatives coupled with monetary ease may be effective, but such policies raise important questions about prospective debt burdens and about the public's response to implied future taxes. The uncertainty surrounding these questions may explain Japan's reluctance to deploy a stronger fiscal stimulus. Alternatively, monetary policy might still affect aggregate demand through exchange rate channels, but this could raise the ire of Japan's trading partners, notably U.S. trade protectionists.

Independent of monetary policies, however, currencies often depreciate during economic downturns and appreciate during expansions. Since 1995, the yen has depreciated 59% in nominal terms and 66% in real terms against the dollar. When global business cycles are nonsynchronous, as in the 1990s, such countercyclical exchange rate movements can have moderating effects, especially for countries with close trade ties. The yen's real depreciation against the  
*(continued on next page)*

# International Aspects of Japan's Business Cycle (cont.)



**U.S. Interventions against Japanese Yen, January 1985–March 1997**

	Total number	Percent successes <sup>a</sup>	Percent virtual successes <sup>b</sup>	Forecast value <sup>c</sup>
<b>Appreciation/depreciation</b>				
Purchases	180	46	48	No
Sales	82	41	50	No
<b>Change direction</b>				
Purchases	180	28	24	No
Sales	82	29	25	No
<b>Smooth movements</b>				
Purchases	180	49	41	Yes
Sales	82	65	41	Yes

a. Days on which exchange rate movements corresponded to the criteria in column 1 and intervention occurred.  
 b. Days on which exchange rate movements corresponded to the criteria in column 1 whether or not intervention occurred.  
 c. Based on a statistical comparison of actual and virtual successes.  
 SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of New York; and Federal Reserve Bank of Cleveland.

dollar should expand Japanese exports and aggregate demand. Of course, lower exports will have the opposite effect in the U.S.

Considering the countercyclical benefits of a yen depreciation, the recent intervention may seem odd. On June 17, the U.S. and Japan bought a substantial number of yen in a concerted attempt to support the sagging currency. Most countries routinely neutralize the monetary implications of their interventions, so the yen purchase probably did

not shrink Japan's monetary base. Studies suggest that intervention does not alter the fundamental determinants of exchange rates, but sometimes may influence market perceptions and expectations of those fundamentals. It is possible that the U.S. and Japan intended the June 17 intervention as a signal that the yen's depreciation was too rapid or too large.

If monetary authorities routinely had better information than the market about underlying fundamentals, interventions would have posi-

tive value to traders as forecasts of future exchange rate movements. Between January 1985 and March 1997, U.S. intervention against the yen had positive value only as a forecast that a recent movement of the yen-dollar exchange rate would moderate. This country's purchases and sales of yen could not predict dollar depreciations or appreciations against the yen, nor could its intervention anticipate changes in the direction of the yen-dollar exchange rate.