

The Economy in Perspective

Keep on truckin'... If the Dow Jones index accurately forecasts future economic conditions, its surge past 9700 in early March signals a continuation of the U.S. boom. And why not be optimistic? The pace of aggregate activity continues to exceed the nation's long-term average—and estimates of the threshold beyond which inflation should accelerate. No wonder forecasters of all stripes are confused.

U.S. production of goods and services expanded more than 4% in real terms last year for the second year in a row, once more outstripping private forecasters' average projections by a wide margin. Indeed, as late as January 1999, analysts' average prediction of last year's fourth-quarter growth tallied 3%; now, as the Commerce Department's official estimates become available, it appears that last year's real growth rate ended at a 6% annual rate. It turns out that U.S. exports, which declined in each of the first three quarters of 1998, rebounded so strongly in the final quarter that exports actually increased for the year as a whole. This welcome turn of events for U.S. producers had not generally been anticipated. Partly because of the improved trade picture, private forecasters have boosted their 1999 growth predictions from an average of 2% to 2.5% (even so, these figures remain far below the pace of the last two years).

Nor did forecasters anticipate the strength of consumer demand. Household purchases of goods and services expanded more vigorously than did real GDP last year, by nearly a full percentage point. Although the first quarter of 1999 seems to have made a slow start, the Conference Board's Present Situation Index rose sharply in February and now stands at the highest level recorded since the survey began 32 years ago.

The continued brisk pace of business fixed investment has also caught forecasters by surprise. Investment spending has been a driving force throughout the expansion, registering real gains in the 10–15% range for many years. Last year's pace was no different, and 1998 ended with a solid 16% annual rate gain in the fourth quarter. Businesses continue to see opportunities for improving productivity through capital investments. Last year, productivity in the nonfarm business sector increased nearly 2.5%, while manufacturing productivity expanded about 4%.

Elevated productivity growth means that the economy can translate a given amount of labor-force growth into more output (and income) than it otherwise could. When sustained for several

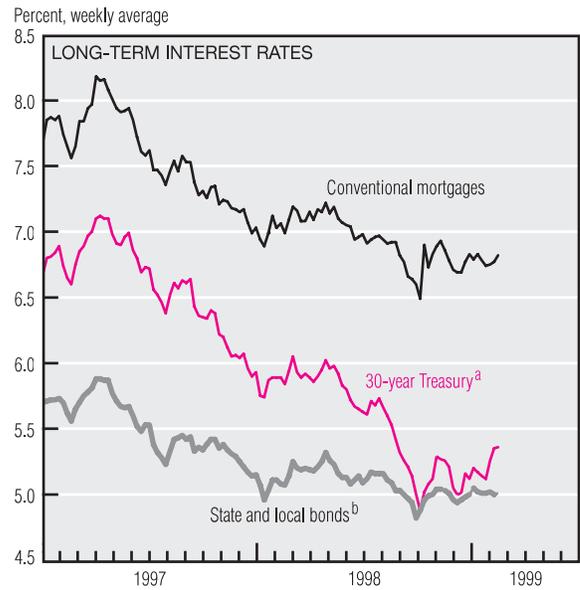
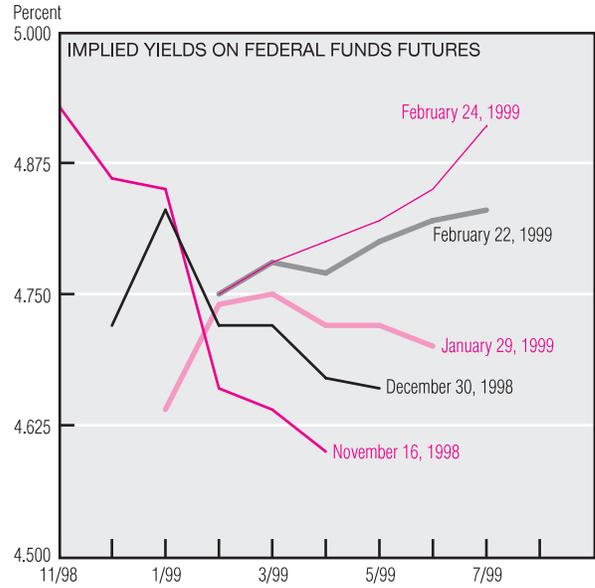
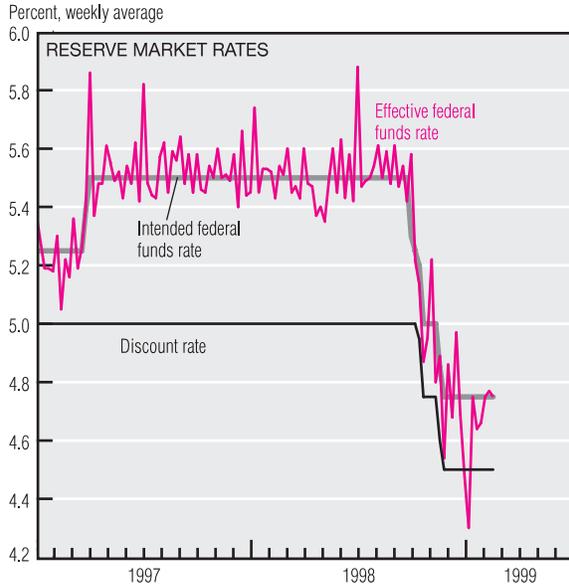
decades, seemingly small increments in productivity growth can amount to significant increases in living standards. For example, the difference between 2% and 3% productivity growth rates over a 20-year period cumulates into a 30% difference in real income levels.

Perhaps the most startling aspect of U.S. economic performance has been the price level: The Consumer Price Index rose a mere 1.6% in 1998. With the unemployment rate holding at levels not seen for nearly 30 years and the share of the working-age population actually employed hitting record highs, one might have expected that labor-market tightness would propel inflation forward. Although many analysts think that strong productivity growth accounts for inflation's present quiescence, the longer-term relationship is not obvious. Improved labor productivity makes each labor hour more valuable, which means that productivity gains should eventually translate into rising real wages and profits, not necessarily into lower-than-otherwise output prices. Prevailing inflation rates result from short-term productivity dynamics, falling import prices, and worldwide weakness in commodity and manufactured goods prices. It's likely that these conditions are already in the process of unwinding, but not so far as to push the U.S. inflation rate into the danger zone this year.

To be sure, there are risks to both the expansion's pace and the expansion itself. It is still possible that poor economic conditions in other parts of the world will damage the U.S. economy substantially. Already, certain industries such as steel, petrochemicals, and agriculture are suffering badly. In the past year, for example, soybean prices fell 25% and steel prices 40%. As for other risks, the phrase "equity markets" speaks volumes. Yet, despite widespread belief that these industry- and market-specific gales would tatter the economy's mainsails, the ship has held its course and maintained its speed.

Forecasting is an uncertain business for both private practitioners and central bankers. During such exceptionally good times as these, the downside potential appears so much greater than further upside gains. Monetary policymakers can take satisfaction from knowing that price stability can indeed be sought without compromising improvements in living standards. Indeed, the next time they are called upon to defend actions aimed at achieving price stability, central bankers can draw strength from that knowledge.

Monetary Policy



a. Constant maturity.
b. Bond Buyer Index, general obligation, 20 years to maturity, mixed quality.
SOURCES: Board of Governors of the Federal Reserve System; and the Chicago Board of Trade.

On February 23 and 24, Federal Reserve Chairman Alan Greenspan testified before Congress as part of the Federal Reserve's semiannual report on monetary policy. This testimony, along with a written report, summarizes the central bank's view of current economic conditions, monetary policy, and the economic outlook through 1999.

In his testimony, Chairman Greenspan lauded the economy's performance over the past year but warned of "considerable upside and downside risks to the economic

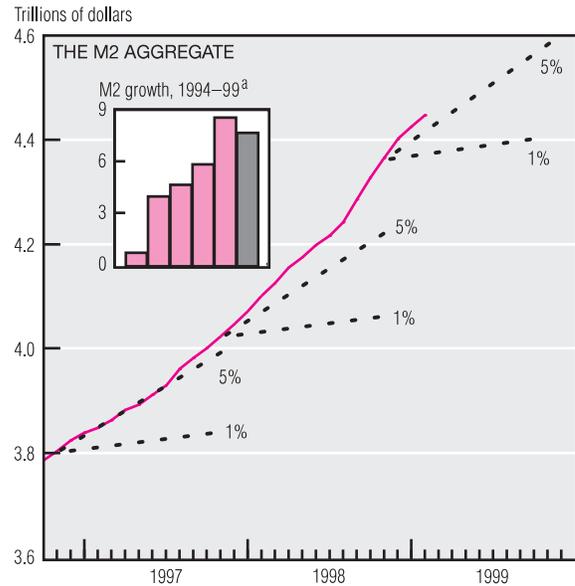
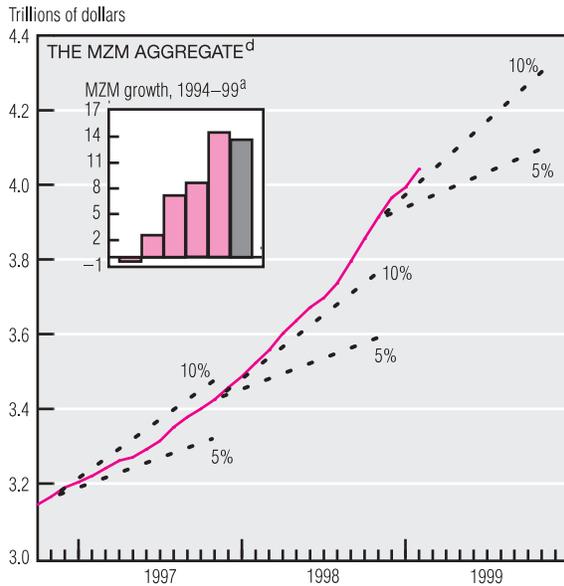
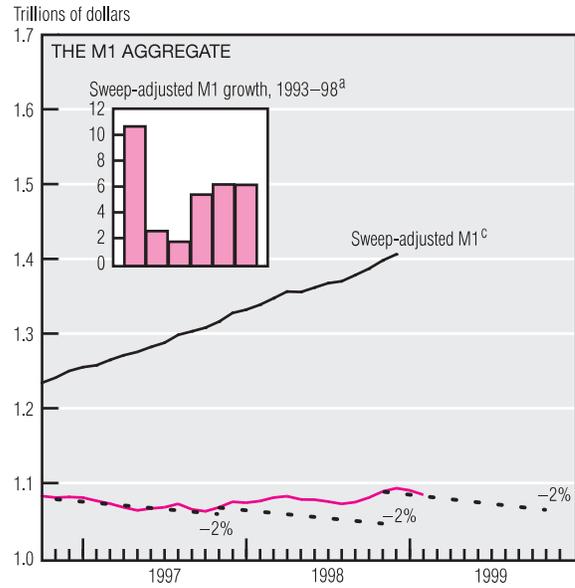
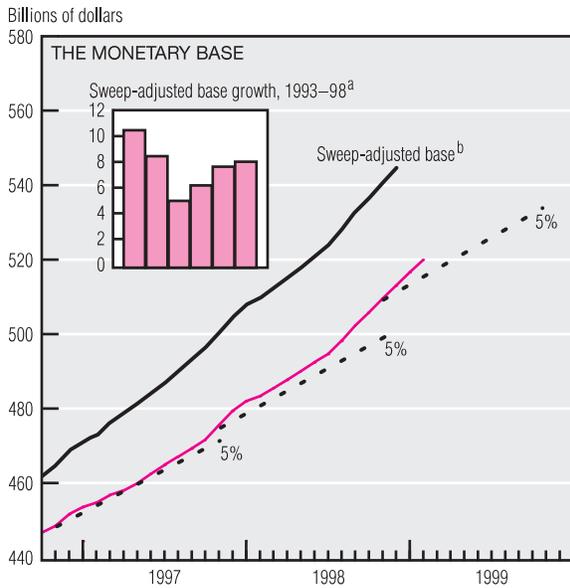
outlook." He noted that "in light of all these risks, monetary policy must be ready to move quickly in either direction should we perceive imbalances and distortions developing that could undermine the economic expansion." He also restated the Federal Reserve's commitment to maintaining price stability, saying, "We perceive stable prices as optimum for economic growth. Both inflation and deflation raise volatility and risks that thwart maximum economic growth."

As for 1999, most members of the Board of Governors and the Federal

Reserve Bank presidents expect that the economy will continue expanding moderately, with inflation increasing slightly over its 1998 rate. The central tendency of the forecasts for real GDP growth (from 1998:IVQ to 1999:IVQ) is 2½% to 3%, while the central tendency for inflation as measured by the Consumer Price Index is 2% to 2½%. The unemployment rate is expected to remain around 4¼% to 4½%.

The intended federal funds rate was unchanged at the February meeting of the Federal Open Market
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Monetary Policy (cont.)



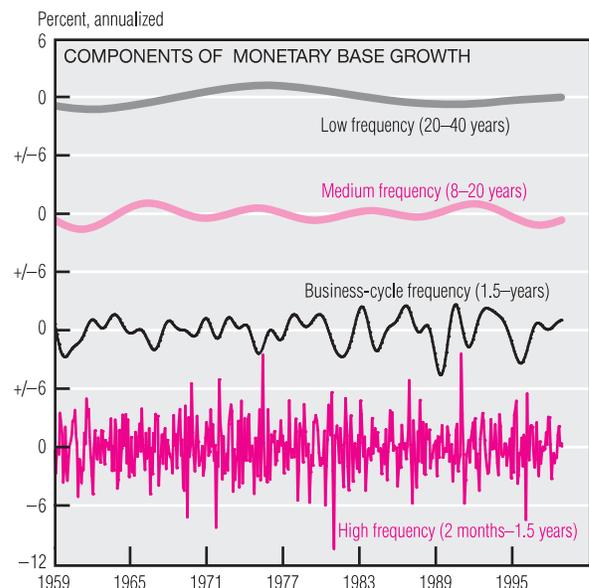
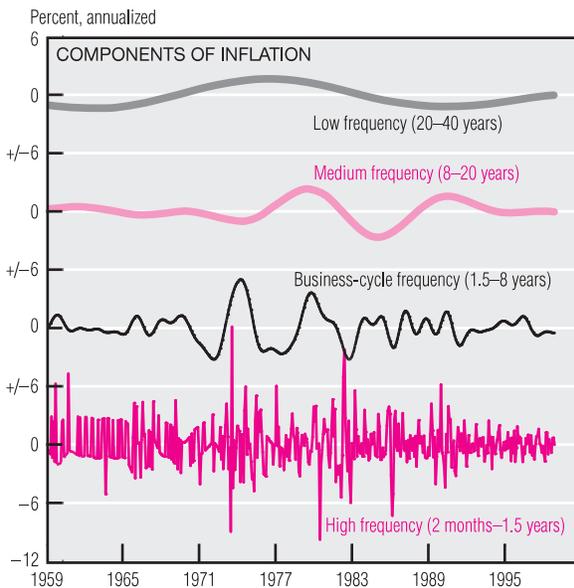
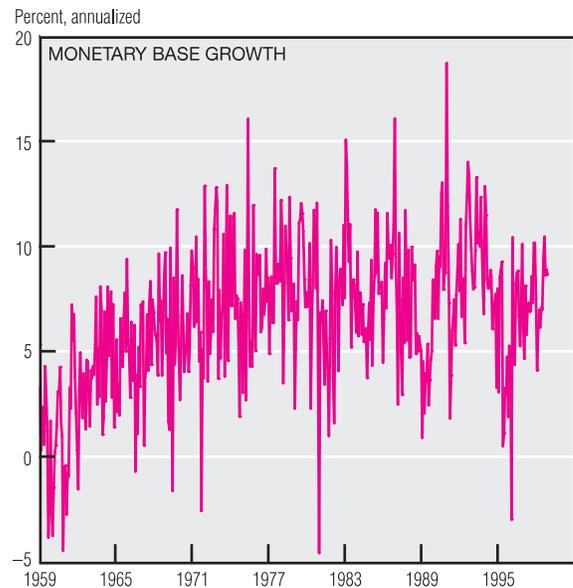
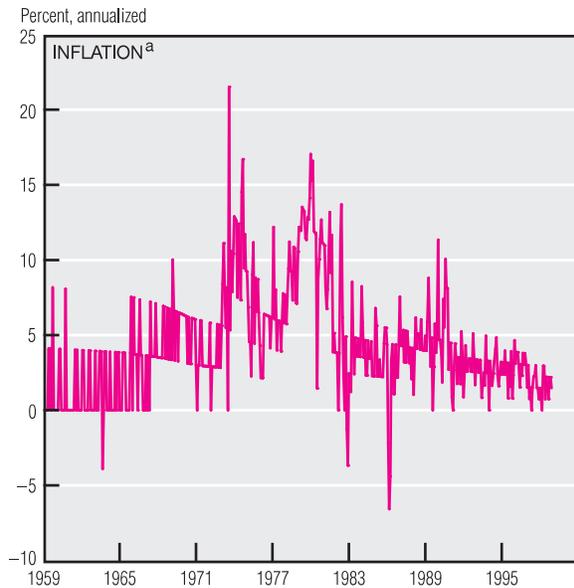
a. Growth rates are percentage rates calculated on a fourth-quarter over fourth-quarter basis. The 1999 growth rates for M2M and M2 are calculated on an estimated February over 1998:IVQ basis.
 b. The sweep-adjusted base includes an estimate of required reserves saved when balances are temporarily shifted from reservable to nonreservable accounts.
 c. Sweep-adjusted M1 includes an estimate of balances temporarily shifted from M1 to non-M1 accounts.
 d. M2M is an alternative measure of money that is equal to M2 plus institutional money market mutual funds less small time deposits.
 NOTE: Data are seasonally adjusted. Last plots for M1, M2, and M2M are estimated for February 1999. Dotted lines for M2 are FOMC-determined provisional ranges. All other dotted lines represent growth in levels and are for reference only.
 SOURCE: Board of Governors of the Federal Reserve System.

Committee (FOMC), remaining at 4¼%. Since then, market interest rates have increased somewhat, most notably long-term rates. The implied yield on federal funds futures has recently begun to tilt upward, indicating that anticipation of forthcoming decreases in the federal funds rate has largely diminished and that expectations now lean toward a rate increase as the next Fed move. In part, this may be a response to the Chairman's state-

ment that “[t]he Federal Reserve must continue to evaluate, among other issues, whether the full extent of the policy easings undertaken last fall to address the seizing-up of financial markets remains appropriate as those disturbances abate.” Growth in monetary aggregates remains strong, with year-to-date M2 and M3 growth well above the target range set by the FOMC. The Committee reaffirmed the 1999 monetary growth ranges that were set last July:

1%–5% for M2 and 2%–6% for M3. The report to Congress noted that “[g]iven continued uncertainties about movements in the velocities of M2 and M3 (the ratios of nominal GDP to the aggregates), the Committee would have little confidence that money growth within any particular range selected for the year would be associated with the economic performance it expected or desired.” However, the report *(continued on next page)*

Monetary Policy (cont.)



a. As measured by the Consumer Price Index.

NOTE: Data are monthly and seasonally adjusted. Data are filtered using a band-pass filter.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and Lawrence J. Christiano and Terry Fitzgerald, "The Band-Pass Filter," February 1999 (unpublished).

also states that "money growth still has some value as an economic indicator," and that "the Committee will continue to monitor the monetary aggregates as well as a wide variety of other economic and financial data to inform its policy deliberations."

As evidenced by comments in the report, the view that monetary aggregates are a valuable policy tool has largely diminished in recent years. This is a response to a well-documented breakdown in the short-run relationship between money, prices, and output

that occurred in the early 1990s. In contrast, there is a relatively close relationship between money growth and inflation over long-term horizons, giving credence to the view that inflation is, in fact, a monetary phenomenon.

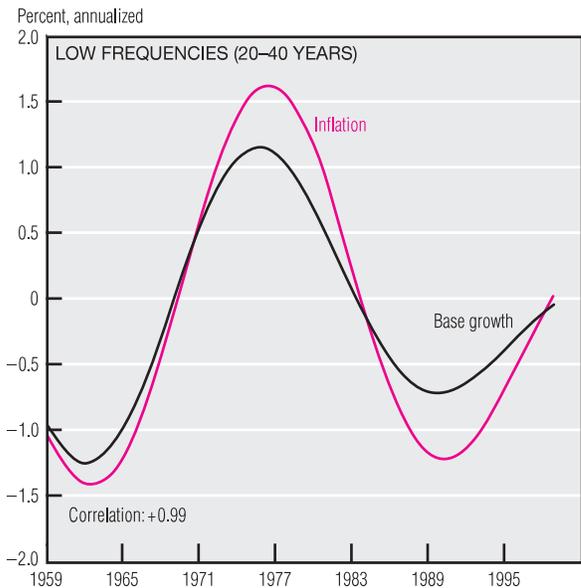
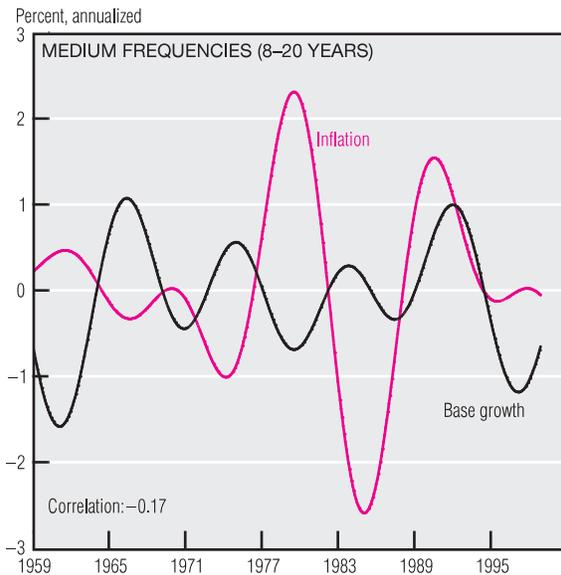
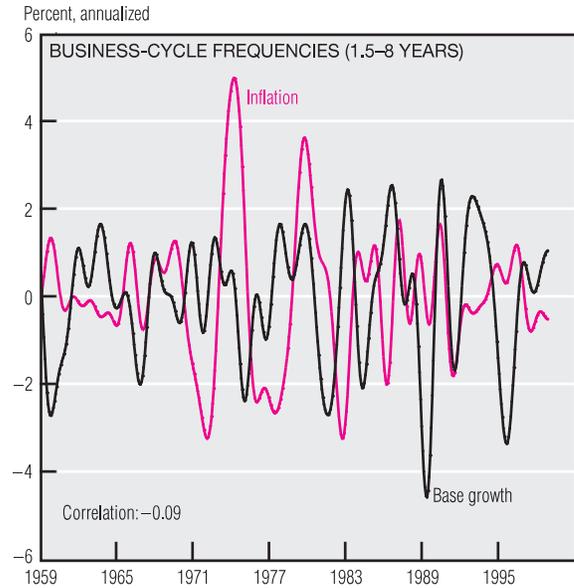
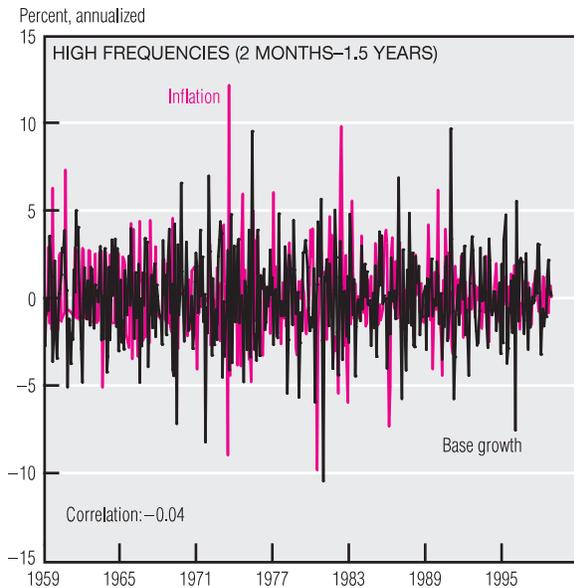
This contrast in the statistical relationship between money and inflation over short- and long-term horizons leads one to question the length of the long-term horizon at which money growth and inflation are closely associated. If "long" means three or four years, then one could argue that the monetary

aggregates provide clear guidelines for policy, despite the lack of a clear relationship over a month or quarter. However, if long is 40 years, it is less clear that the aggregates are useful for policy decisions that are made at roughly six-week intervals.

One strategy for addressing this question is to first break down the inflation and money-growth data into a set of components containing the variations in each series at different frequencies, as shown in the charts. The raw data on monthly inflation can be broken

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Monetary Policy (cont.)



NOTE: Data are monthly and seasonally adjusted. Data are filtered using a band-pass filter.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and Lawrence J. Christiano and Terry Fitzgerald, "The Band-Pass Filter," February 1999 (unpublished).

down into a component that captures high-frequency movements in the data, a component that captures business-cycle movements, and components that capture slower-moving aspects of the data. The same can be done for money growth. After doing this, we can look at the relationship between money growth and inflation for the different frequency components.

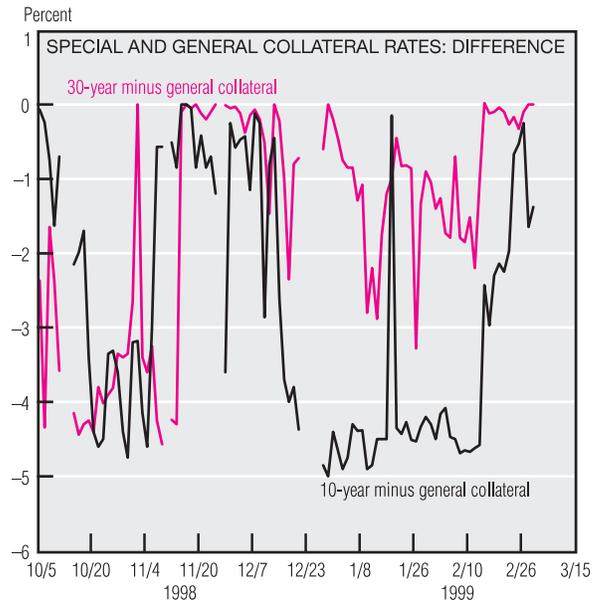
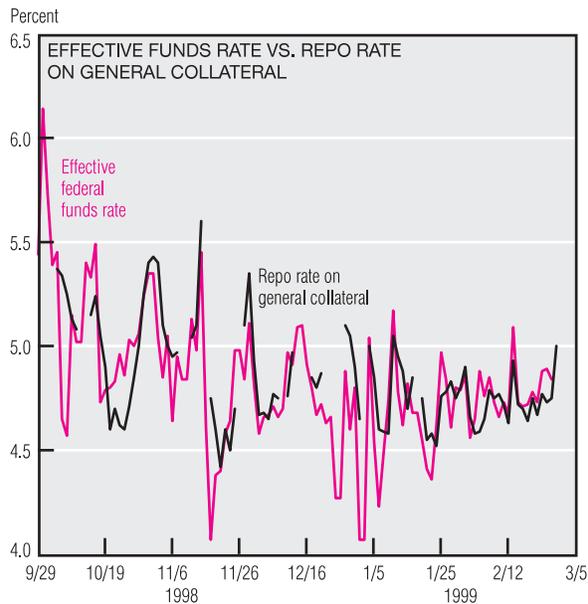
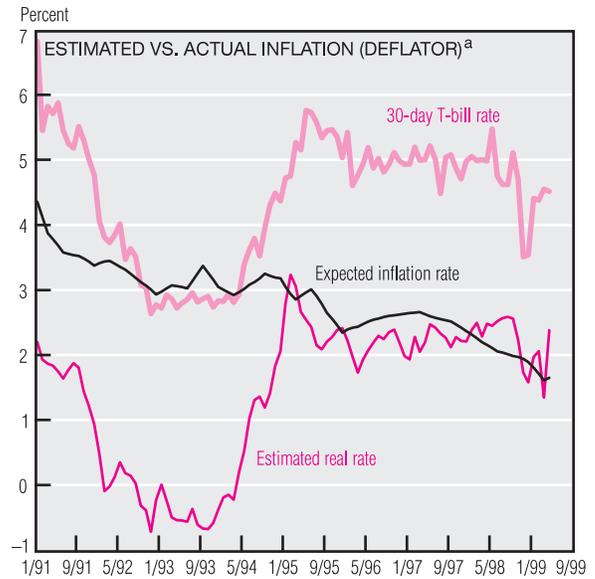
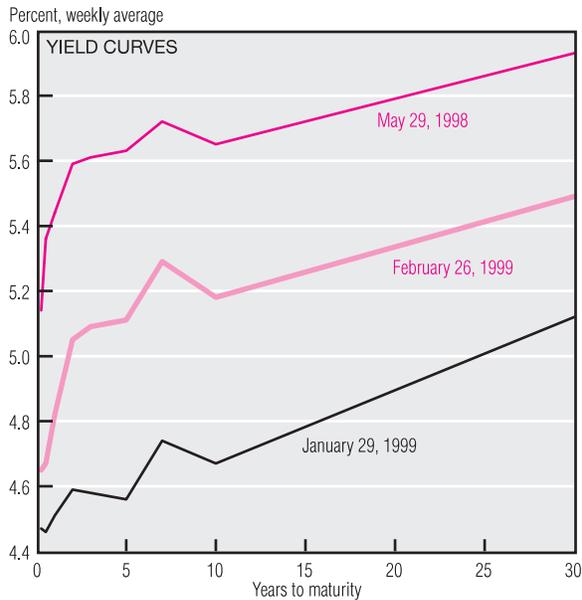
Not surprisingly, there is little correlation between inflation and the high-frequency components of money growth. Furthermore, the

observation that money growth and inflation are closely associated over long horizons is dramatically demonstrated by the data component associated with 20- to 40-year fluctuations. The correlation between these series is almost one. However, this relationship does not hold up when we look at the business-cycle component of the data, or even the component that captures fluctuations of eight to 20 years. For these components, the correlation between money growth and inflation is slightly negative.

Of course, money growth today is thought to influence inflation in

the future, so the fact that these variables do not move contemporaneously is not so surprising. In fact, the correlation between money growth and future inflation is somewhat positive in all four components. However, as the charts indicate, there is no clear, consistent relationship between money growth and future inflation in the business-cycle and medium-frequency components of the data. That is, the correlation between current money growth and future inflation is not particularly strong for any lag length in these components.

Interest Rates



a. The expected inflation rate and the estimated real rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; and *Dow Jones Capital Markets Report*.

Interest rates at all maturities have moved up sharply since last month. Some of the increase can be traced to speculation that the Federal Reserve will increase the federal funds rate. If the market expects such an increase to be delayed several months, this may explain the pronounced steepening at the short end of the yield curve—the 3-year, 3-month spread increased from 11 to 44 basis points. But such short-term expectations about policy should not have a pronounced effect on longer rates, which also increased substantially. A greater

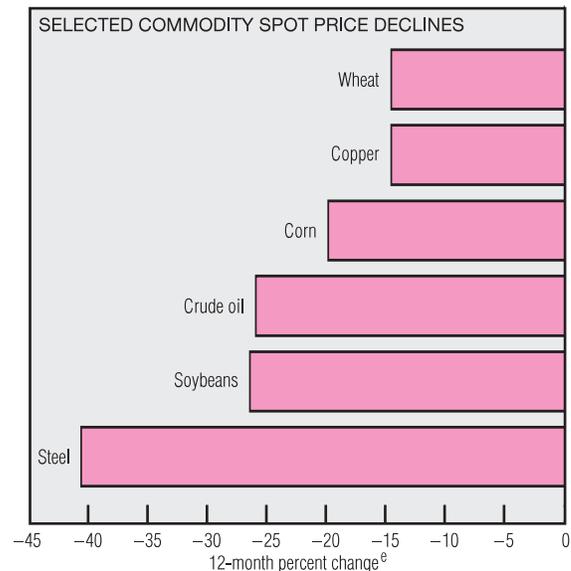
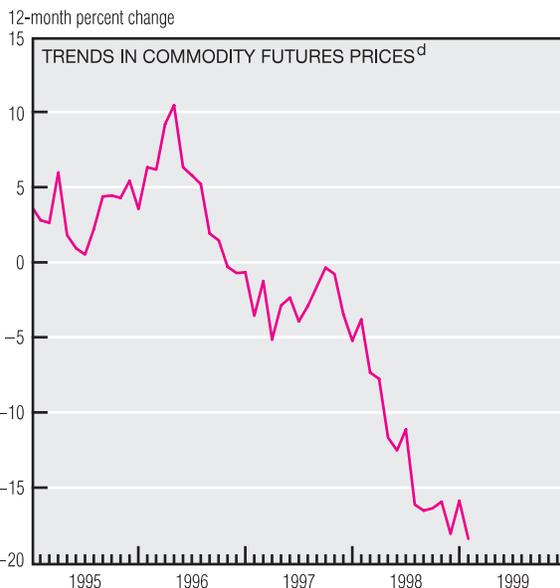
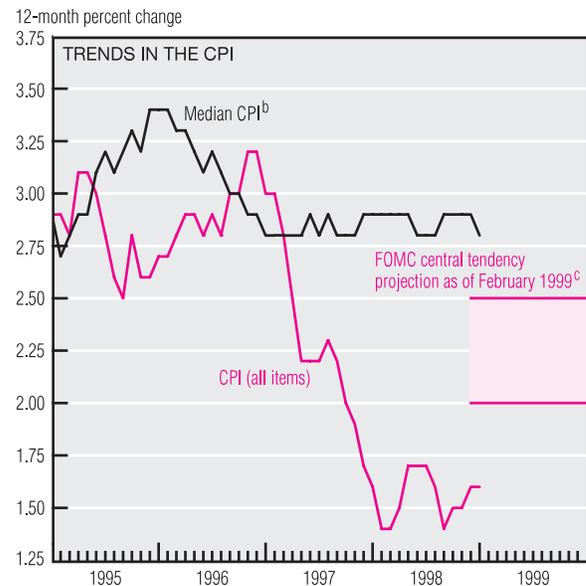
worry might be the possibility of higher inflation. One admittedly short-term measure, however, which combines nominal rates with professional forecasts of inflation, indicates only a minuscule upturn in inflationary expectations.

The market for repurchase agreements ("repos" or RPs) is an important arena for short-term borrowing and lending. It is also the market most frequently used by the Open Market Desk of the Federal Reserve Bank of New York to implement monetary policy directives from the FOMC. A bank will borrow money

by selling a Treasury security and agreeing to repurchase it later, usually the next day, at a given rate. This rate closely tracks the federal funds rate. The exact Treasury security that is repurchased generally doesn't matter, but often certain securities are in greater demand (or lesser supply) than the general collateral. This leads the repo to go "on special," allowing anyone owning such collateral to borrow at relatively low rates. Recently, both the 30-year and the 10-year bond have been on special by substantial amounts.

Inflation and Prices

	Percent change, last:				1998 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
January Price Statistics					
Consumer Prices					
All items	1.5	1.7	1.6	2.4	1.6
Less food and energy	0.7	2.1	2.3	2.6	2.5
Median ^b	1.3	2.2	2.8	3.0	2.9
Producer Prices					
Finished goods	6.6	2.8	0.9	1.1	-0.2
Less food and energy	-0.8	4.5	2.3	1.4	2.4



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Upper and lower bounds for CPI inflation path as implied by the central tendency growth ranges issued by the FOMC and nonvoting Reserve Bank presidents.

d. 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.

e. February 1998–February 1999.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; the Commodity Research Bureau; and DRI/McGraw-Hill.

Consumer prices showed little movement in January, as the Consumer Price Index (CPI) inched up an annualized 1.5%, with much of the increase caused by higher food prices. After exclusion of the volatile food and energy components, the CPI showed even less movement, rising a mere 0.7% (annualized). The median CPI, an alternative measure of inflation, showed little change in January, rising an annualized 1.3%.

At its February meeting, the Federal Open Market Committee (FOMC) left the central tendency

projection for the CPI unchanged at 2%–2.5% for 1999. The CPI is currently tracking nearly ½ percentage point under the lower bound of the central tendency, an indication that the FOMC expects consumer price pressure to increase significantly this year.

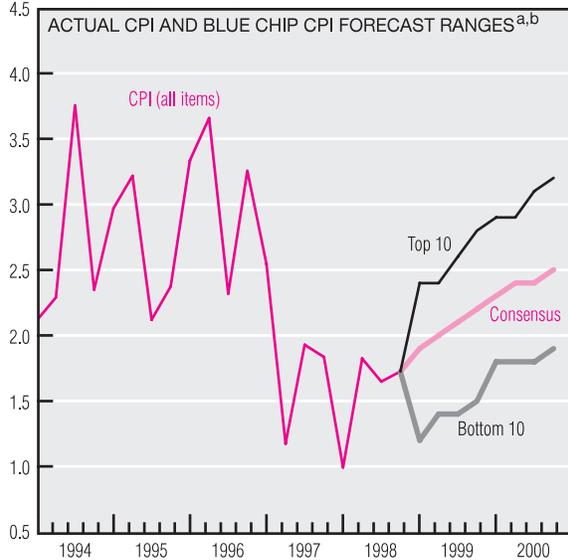
The futures price index of the Commodity Research Bureau (CRB) recently hit lows not seen since February 1975; the 12-month percent change in the index has been negative since November 1996, and its downward trend has accelerated during the past several years.

Economic weakness in Asia and Russia has reduced foreign demand for U.S. products while also creating fierce competition for the U.S. market. Since February 1998, the bushel spot price of soybeans has fallen 25%. Other agricultural products whose prices have dropped include corn (down more than 20%) and wheat (down 15%). Steel spot prices have been hit the hardest, as a flood of imported steel has driven the price down more than 40% in 12 months.

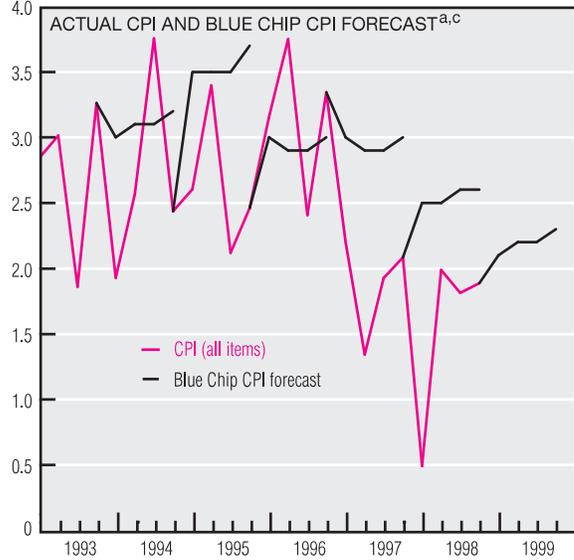
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Inflation and Prices (cont.)

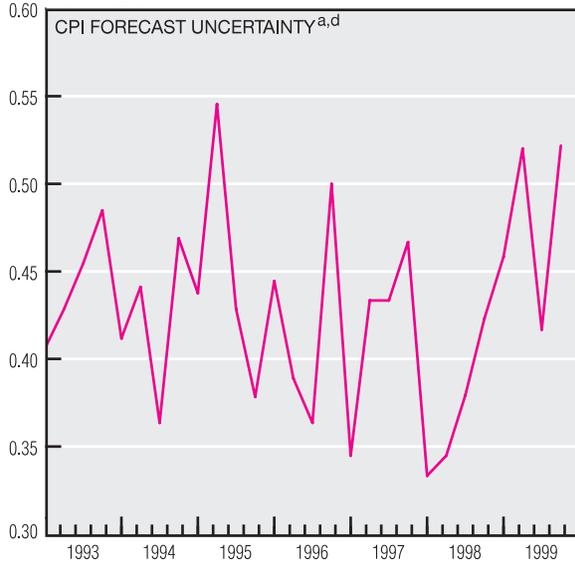
Annualized quarterly percent change



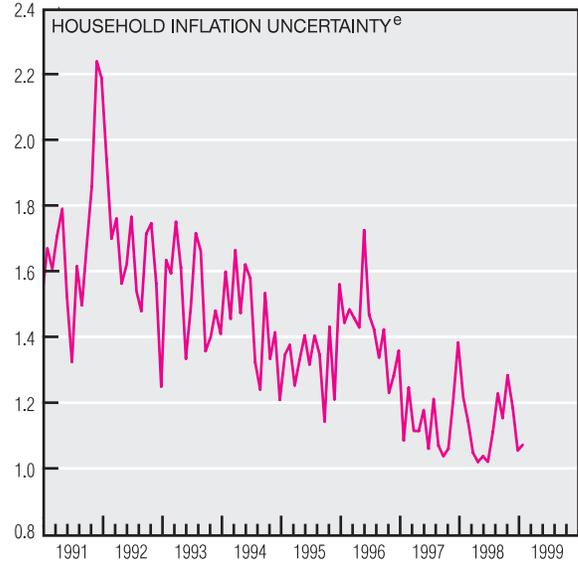
Annualized quarterly percent change



Relative percentage points



Coefficient of variation



- a. Blue Chip panel of economists.
 b. Forecast data represent annualized quarterly percent change.
 c. December 10 forecast.
 d. Top 10 forecast minus bottom 10 forecast, divided by the consensus forecast.
 e. Standard deviation of monthly responses divided by the response mean.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; *Blue Chip Economic Indicators*, various issues; and the University of Michigan's Survey Research Center.

Although the growth trend of the CPI has moderated rather sharply in the past two years, economists are calling for a pickup in CPI increases this year and next. The consensus forecast calls for consumer price increases of 2.2% by the end of 1999 and around 2½% by the middle of 2000.

However, economists have over-predicted the rise in consumer prices a disproportionate number of times in the past six years, and their inflation projections were especially far off the mark for the past two

years. In fact, economists' current inflation projections cover a wide range of opinions, with optimists seeing inflation holding around its current modest level and pessimists anticipating an inflation resurgence above 3% late next year.

The maintenance of price stability requires the central bank to provide for a stable price level *and* the expectation of its continued stability in the future. Economists' uncertainty over the price level has grown in the past year or so, presumably as they attempt to ascertain the staying

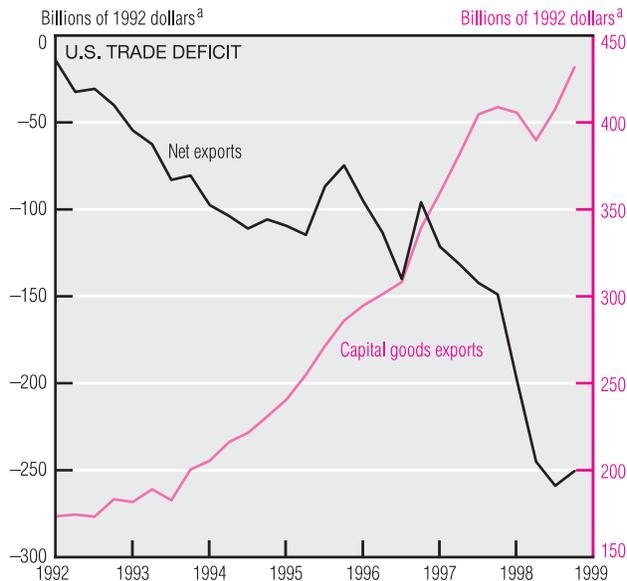
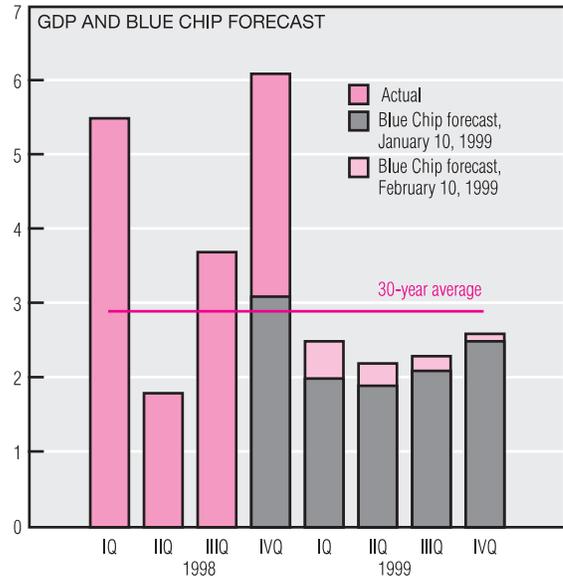
power of the recently improved inflation trend.

In contrast to economists' uncertainty, households' expectations about future inflation appear to be narrowing—a positive sign for policymakers. The amplitude of variation in households' inflation expectations (relative to the mean) has decreased markedly with their inflation projections since 1996, indicating that households have increased confidence in the persistence of a moderate inflation trend.

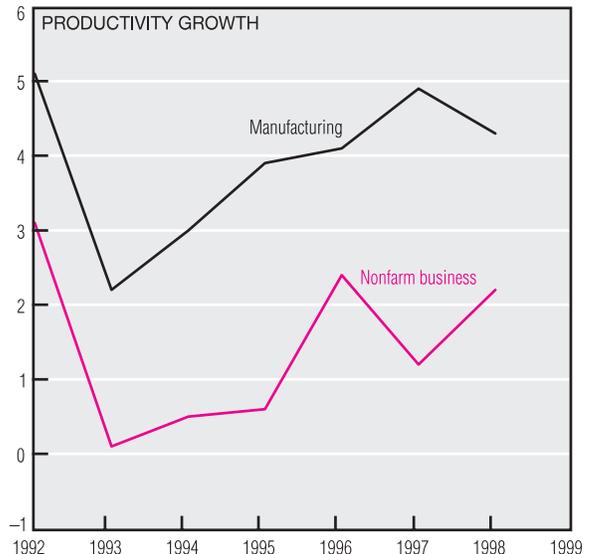
Economic Activity

Real GDP and Components, 1998:IVQ ^{a,b} (Preliminary estimate)	Change, billions of 1992 \$	Percent change, last:	
		Quarter, annual rate	Four quarters
Real GDP	112.0	6.1	4.3
Consumer spending	57.7	4.5	5.2
Durables	34.3	20.1	12.1
Nondurables	15.4	4.0	4.7
Services	12.5	1.7	4.0
Business fixed investment	36.1	15.9	12.3
Equipment	34.5	19.2	17.1
Structures	3.7	7.5	0
Residential investment	8.0	10.5	12.7
Government spending	12.1	3.8	1.7
National defense	1.0	1.3	-1.4
Net exports	8.5	—	—
Exports	45.3	20.1	1.2
Imports	36.8	12.6	9.9
Change in business inventories	-7.9	—	—

Annualized percent change from previous quarter



Annual percent change



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

b. Components of real GDP need not add to totals because current dollar values are deflated at the most detailed level for which all required data are available.

NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of Labor Statistics; and *Blue Chip Economic Indicators*, January 10 and February 10, 1999.

In early January, the Blue Chip consensus forecast of GDP for 1998:IVQ was a solid annualized growth rate of 3.1%. The advance estimate, released soon after, more than exceeded that expectation with a remarkably strong 5.6% growth rate, which may be one reason for February's upward revision in the Blue Chip consensus forecasts of GDP for every quarter of 1999.

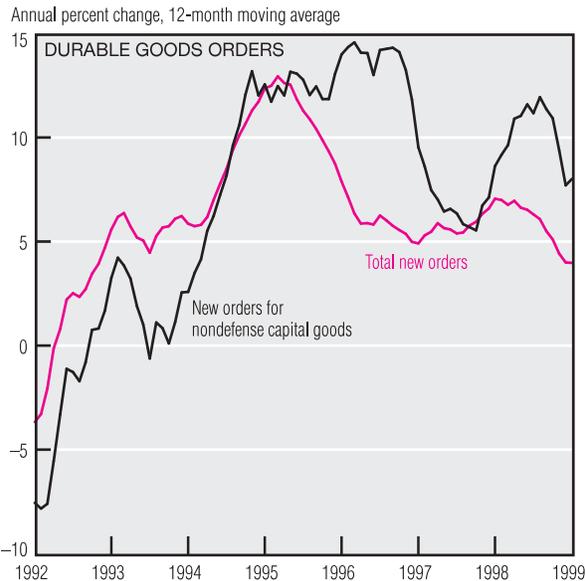
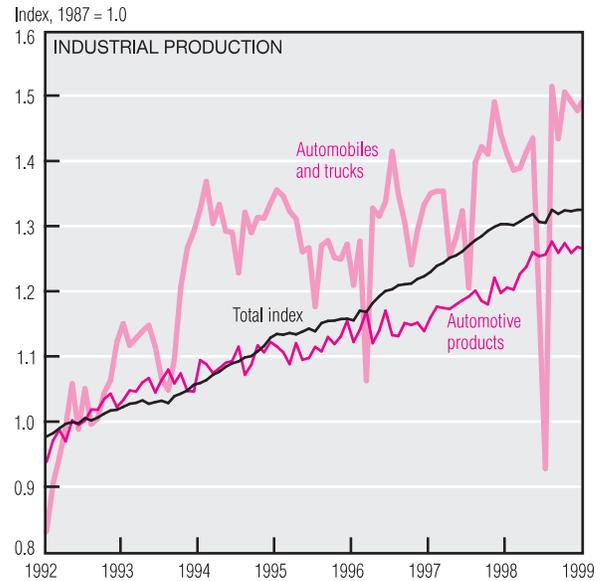
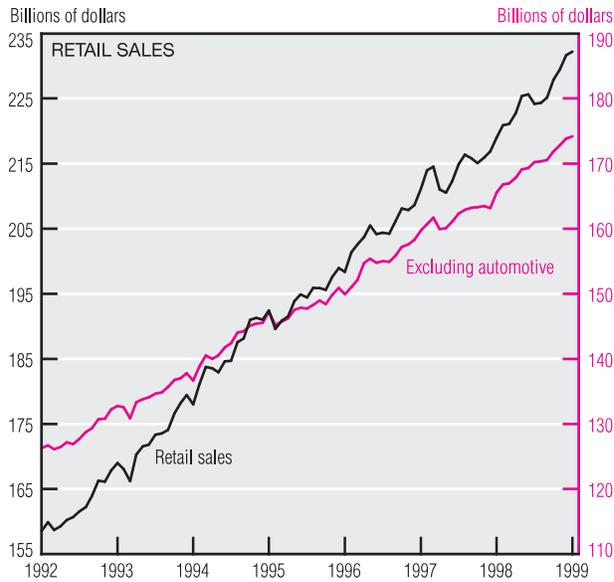
By February, the preliminary estimate of GDP growth in 1998:IVQ was an even higher 6.1%, largely because of a much lower trade-deficit estimate. While the level of imports

was revised downward only slightly, a surprising uptick in exports far surpassed expectations. U.S. exports declined in each of the first three quarters of 1998; however, that entire 3.4% drop was erased in 1998:IVQ, when exports reached a height that exceeded their 1997:IVQ level by 1.2%. Moreover, most of the jump in exports came from nonautomotive capital goods, which were 5.6% higher than the previous year's level. It remains to be seen whether this increased demand for U.S.-made equipment reflects an improvement in economic conditions abroad or a depreciation of the dollar in 1998.

Another highlight of the economy's performance in 1998:IVQ was a 3.7% increase in productivity. As compensation levels have risen more rapidly, faster productivity growth has allowed the economy to motor along at a brisk pace with minimal inflation—the deflator increased at an annual rate of only 0.7%. Productivity gains occur when output increases faster than hours worked. Through the 1990s' expansion, annual productivity growth rates have varied from 0.1% (1993) to a strong 3.4% (1992). In 1998, nonfarm business productivity grew at a rate of

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Economic Activity (cont.)



NOTE: All data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of the Census; Board of Governors of the Federal Reserve System; National Association of Purchasing Management; and The Conference Board, Inc.

2.3%, while manufacturing productivity grew at 4.3%.

The important question is whether the GDP strength shown late in 1998 was merely ephemeral or was sustained by strong monthly data early in 1999. Preliminary measures of the current dollar value of January retail sales seemed weak. Their increase of only 0.2% from December lagged 1998's 0.5% average monthly increase. Substantial outright declines were registered at both food stores and gasoline service stations, where weak prices may have compounded any drop in sales volume. However, these declines were offset by very strong increases at general merchan-

dise, apparel, and drug stores. Industrial production was unchanged from December to January, below the 0.2% average monthly increases of the past year. Small increases in manufacturing and utilities production were offset by another substantial decline in mining output.

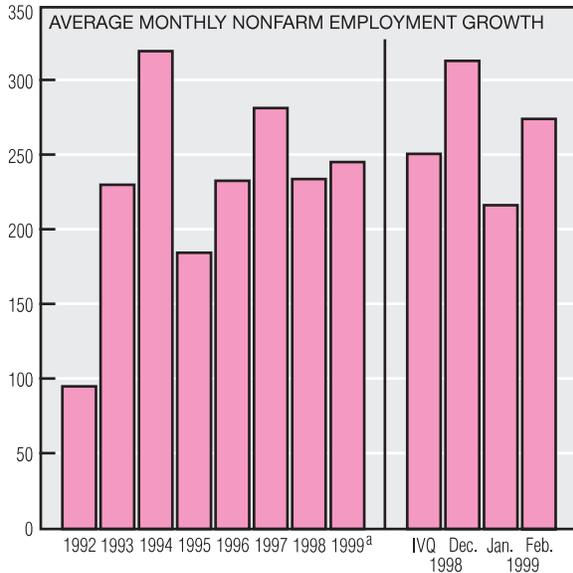
On the other hand, durable goods orders rose 3.9% in January, the seventh increase in the last eight months and the biggest jump since November 1997's 4.4% increase. Nondefense capital goods orders, which might serve as an indicator of investment spending, rose 11.2% in January.

February polls of consumer confidence also seemed to reflect economic strength. The Present Situation

Index (from surveys of consumer sentiment about present economic conditions) rose 5.5 points to reach the highest level observed since the Conference Board began its survey 32 years ago. The Expectations Index (from surveys of sentiment about future conditions) rose 1.6 points, continuing the recovery from last year's precipitous decline. Similarly, the February composite Purchasing Managers' Index of new orders, production, supplier deliveries, inventories, and employment rose 2.9 points. This raised its level to 52.4, breaking 50 for the first time since May 1998 and signaling a general expansion in manufacturing.

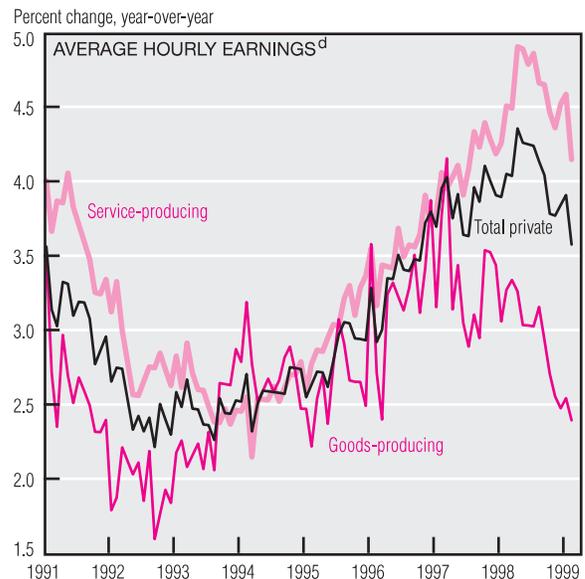
Labor Markets

Change, thousands of workers



Labor Market Conditions

	Average monthly change (thousands of employees)				
	1996	1997	1998	1999 YTD ^a	Feb.
Payroll employment	233	282	234	246	275
Goods-producing	31	42	6	-1	12
Mining	1	1	-3	-10	-10
Construction	28	20	29	43	72
Manufacturing	3	21	-19	-34	-50
Durable goods	10	22	-10	-17	-24
Nondurable goods	-7	-1	-9	-17	-26
Service-producing	202	240	229	247	263
Retail trade	42	34	39	80	123
FIRE ^b	14	17	22	15	7
Services	117	142	113	94	87
Household employment	228	235	157	309	-252
Civilian unemployment	Average for period (percent)				
	5.4	4.9	4.5	4.4	4.4



a. Year to date.
 b. Finance, insurance, and real estate.
 c. Vertical line indicates break in data series due to survey redesign.
 d. Earnings data for production and nonsupervisory workers on private nonfarm payrolls (approximately four-fifths of total private nonfarm employees).
 NOTE: All data are seasonally adjusted.
 SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

Labor markets' vigorous growth showed no sign of abating in February. Nonfarm payrolls grew at a better-than-average rate, with industry gains and losses that reflected strong consumer spending, a healthy building market, favorable weather, and international economic turmoil. The unemployment rate rose slightly amid moderate growth in average hourly earnings.

Nonfarm payrolls increased 275,000 for the month. With January's downward revision (217,000 instead of 245,000), the year-to-date

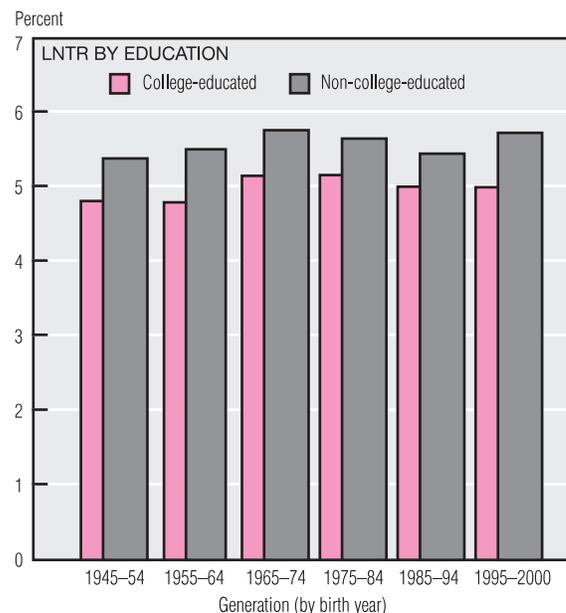
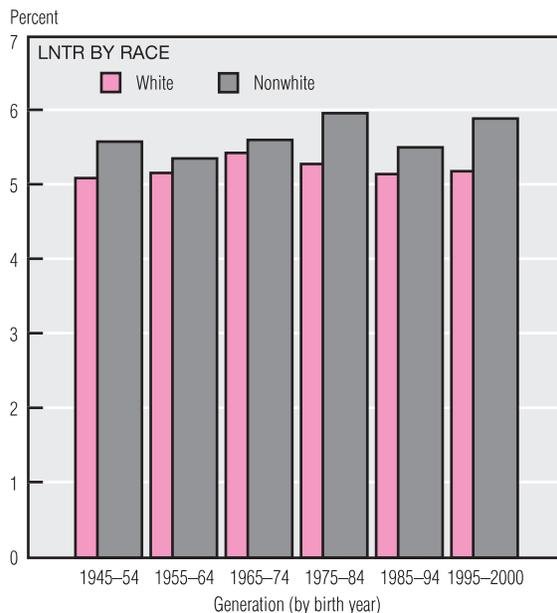
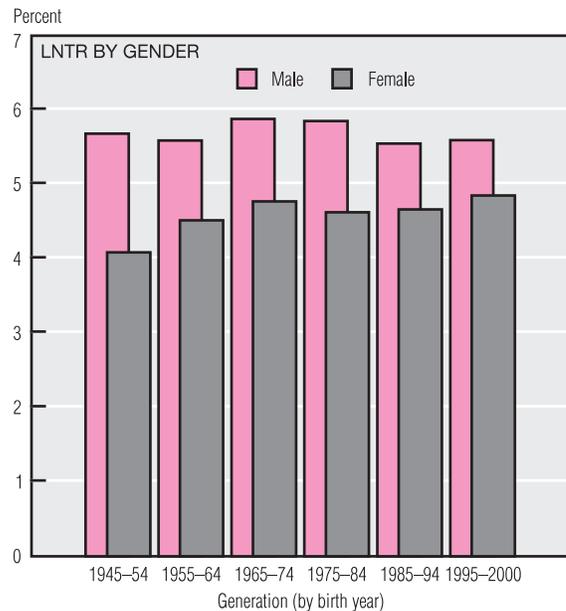
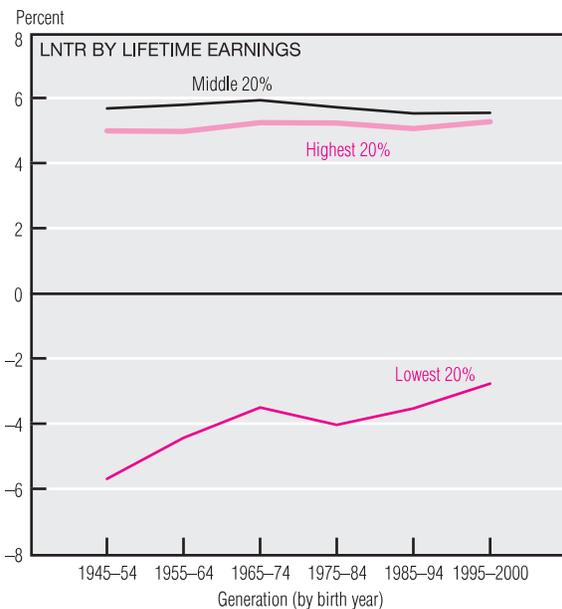
average is little changed at 246,000. Payrolls in service-producing industries expanded by 263,000, led by employment increases in restaurants, department stores, and miscellaneous retail establishments. The pace of jobs growth in the construction industry surged as 72,000 jobs were added to payrolls. Manufacturing lost 50,000 jobs in its sixth consecutive month of contraction, bringing the number of jobs lost in the past six months to 201,000.

A decrease in household employment slightly outweighed a de-

crease in the labor force, causing the unemployment rate to creep up one-tenth of a percent to 4.4%. The employment-to-population ratio fell to 64.4%.

Since February 1998, hourly earnings have risen 3.6%, slightly more than the current expansion's year-over-year average growth rate of 3.1%. Total earnings growth has recently been tempered by slower-than-average growth in goods-sector wages. Wages for service-sector jobs increased a solid 4.1%.

Social Security



SOURCE: Steven Caldwell, Melissa Favreault, Alla Gantman, Jagadeesh Gokhale, Thomas Johnson, and Laurence J. Kotlikoff, "Social Security's Treatment of Postwar Americans," in James Poterba, ed., *Tax Policy and the Economy*, vol. 13. Cambridge, Mass.: National Bureau of Economic Research (forthcoming).

The tax treatment of different demographic groups varies considerably under Social Security, also called Old Age and Survivors Insurance (OASI). The lifetime net tax rates (LNTR), rates of return (RR), and age-65 net payment (NP-65) charted above are based on the assumption that current tax and benefit rules will prevail throughout the lifetimes of postwar generations—those born after 1945. The calculations draw on a large-scale simulation of the U.S. economy and a sophisticated Social Security benefit calculator.

LNTRs show the number of cents paid per dollar of lifetime earnings

through participation in OASI. Generations with the lowest lifetime earnings receive more benefits in present value than they contribute in payroll taxes. Those in the middle quintile face LNTRs of almost 6 cents in present value, while those in the highest quintile surrender just over 5 cents per dollar of their lifetime earnings.

Women have smaller LNTRs than men because of Social Security's progressive benefit structure (on average, women receive lower paychecks). They also are the majority recipients of dependent and survivor benefits because of their lower earnings and greater long-

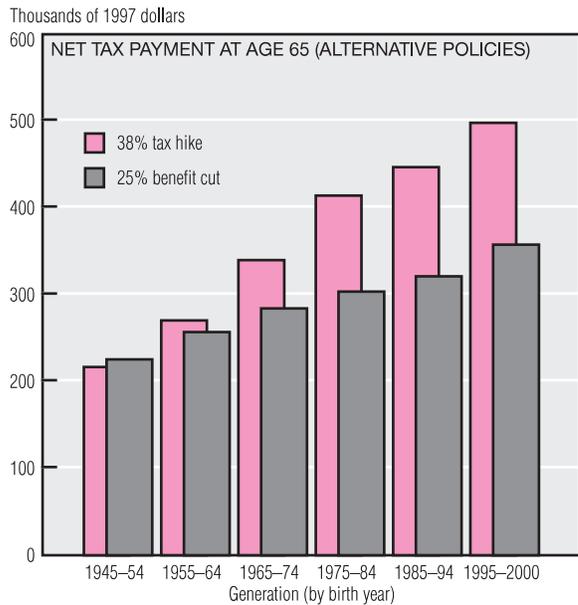
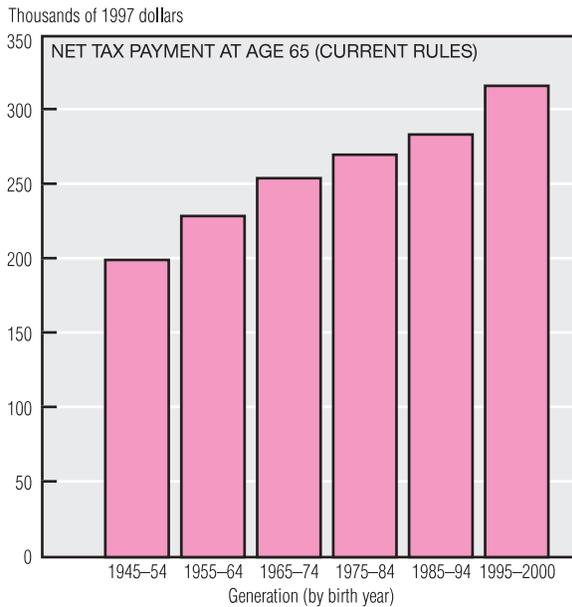
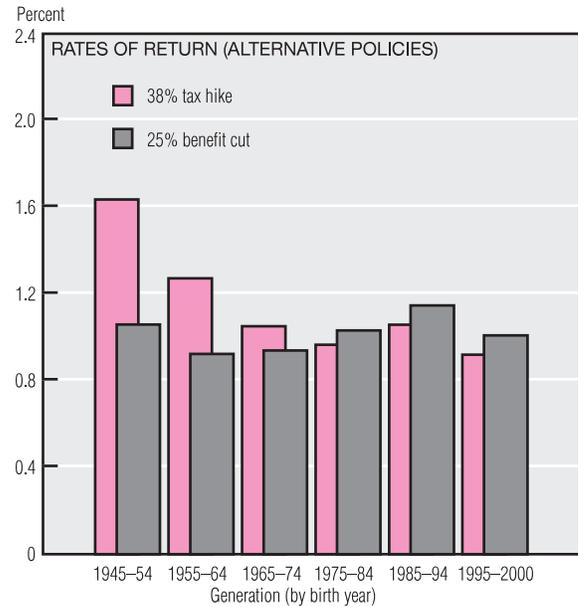
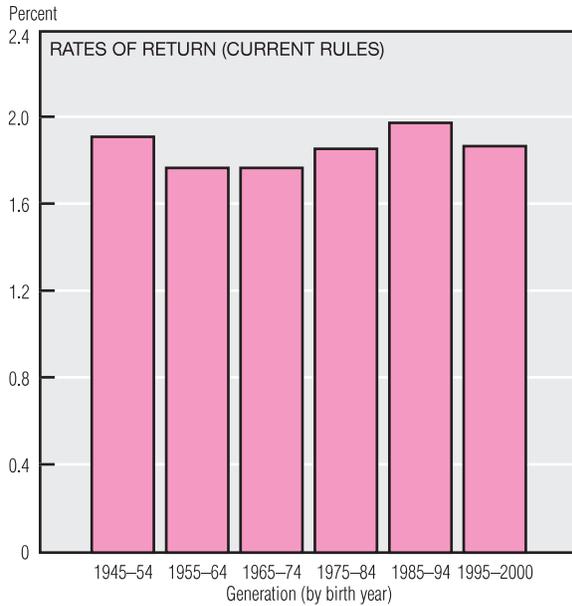
evity. These benefits are Social Security's insurance against dependency, widowhood, and poverty at very old ages.

In some instances, Social Security is kinder to better-off groups: Whites and the college-educated, for example, face lower LNTRs than do nonwhites and those without a college education. Despite the fact that better-off groups earn more, they collect more benefits because they live longer.

If we view payroll contributions as "investments" that generate a return in the form of future OASI benefits, we can evaluate the rate of

(continued on next page)

Social Security (cont.)



SOURCE: Steven Caldwell, Melissa Favreault, Alla Gantman, Jagadeesh Gokhale, Thomas Johnson, and Laurence J. Kotlikoff, "Social Security's Treatment of Postwar Americans," in James Poterba, ed., *Tax Policy and the Economy* vol. 13. Cambridge, Mass.: National Bureau of Economic Research (forthcoming).

return (RR) that is implicit in this transaction. Under current rules, all postwar generations receive RRs of just under 2%. These rates are risky because participants do not know how or when taxes or benefits will be altered to correct OASI's long-term insolvency. These RRs compare unfavorably with returns on 10-year Treasury inflation-protection securities (TIPS), which yield much higher returns (greater than 3.5%) and are considered to be almost perfectly safe. OASI participants forgo investment in much safer and higher-yielding assets.

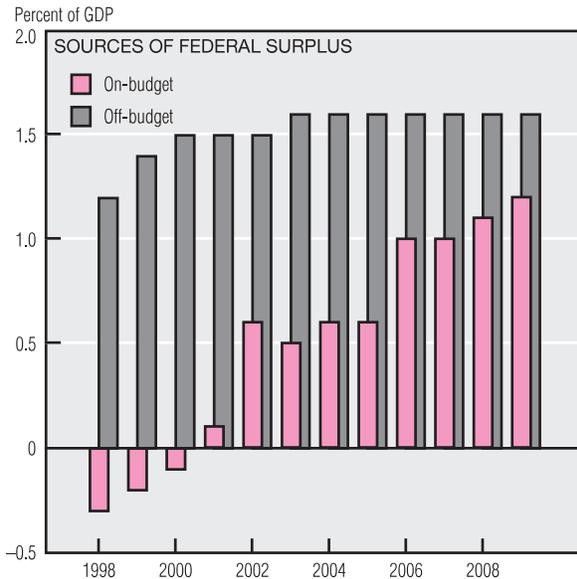
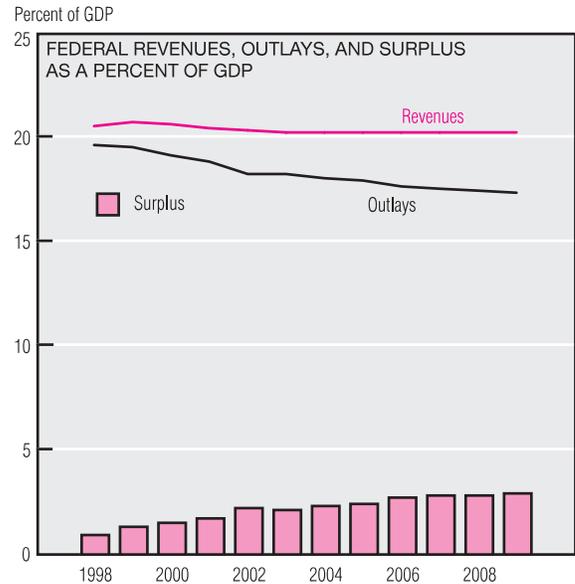
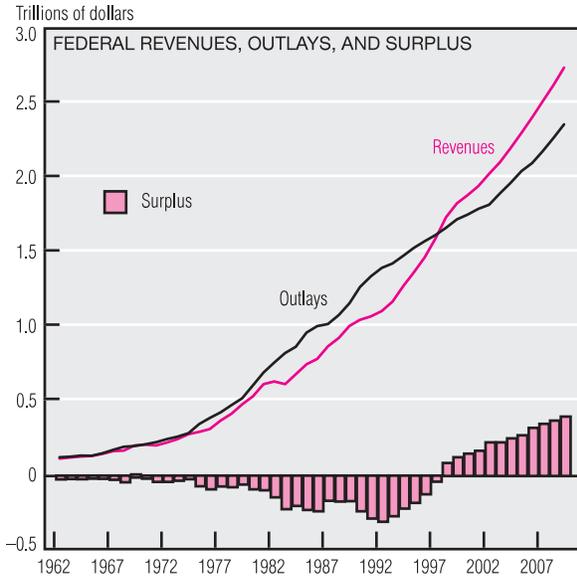
By one estimate, restoring OASI

to long-term solvency would require an immediate, permanent hike of about four percentage points in the payroll tax rate (currently at 10.6%). Alternatively, OASI benefit levels would have to be reduced 25% immediately and permanently. Under the payroll-tax-hike option, generations born earlier would see only slight drops in RR, but those born later would suffer larger declines because most of their tax-paying years would occur after the tax hike. Cutting OASI benefits would impose a uniform reduction in the RRs of postwar generations. This option, however, would be likely to impose

significant burdens on today's retirees and pre-retirees—those born before 1945.

For those born soon after World War II, participating in OASI means having \$200,000 less, on average, at age 65 than they would have gained from contributions placed in private capital markets and earning a 5% rate of return. For those born in the late 1970s and early 1980s, the sacrifice amounts to \$270,000. These burdens would be even higher under the tax-hike and benefit-cut options for restoring OASI's long-term financial health.

The Federal Budget



Summary Budget Proposals (Trillions of dollars, fiscal year 2000)		
	On-budget	Off-budget
Sources of funds		
Own surplus	2.1	2.7
Grant from on-budget ^a		2.8
Total sources	2.1	5.5
Uses of funds		
Grant to off-budget ^a	2.8	
Pay off debt held by the public		2.7
Spending and financing costs	1.4	
Medicare spending	0.7	
Total uses	4.9	2.7
Sources less uses	-2.8	2.8

a. Grant in the form of IOUs from the Treasury to the Social Security trust fund.
 NOTE: All data are for fiscal years.
 SOURCES: Congressional Budget Office; and Majority Staff, Senate Budget Committee.

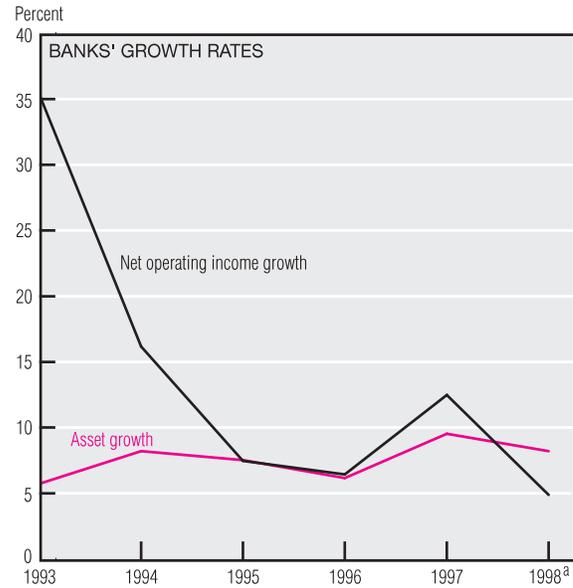
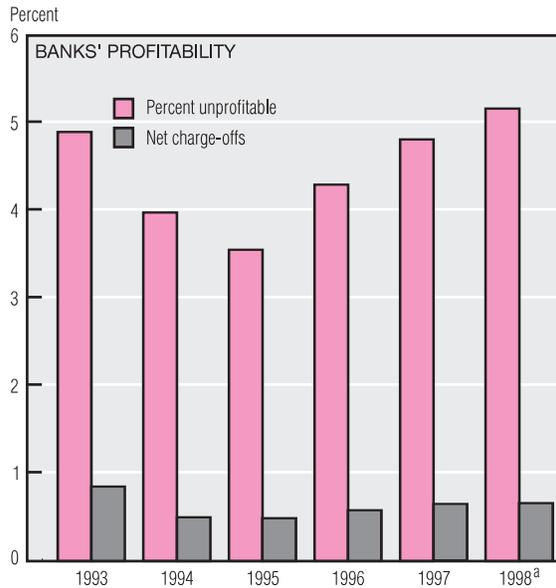
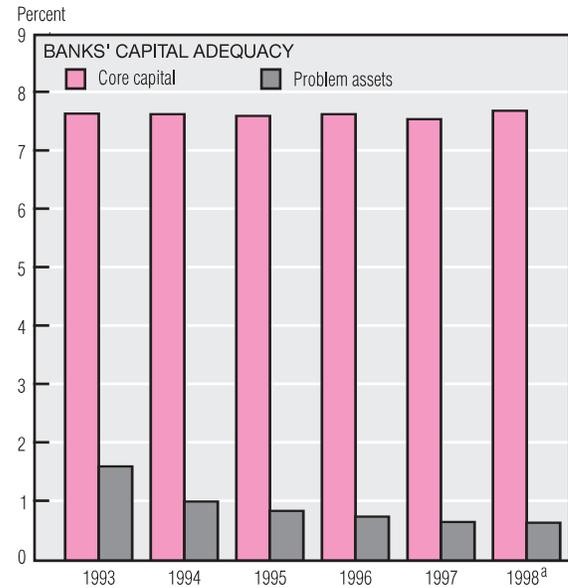
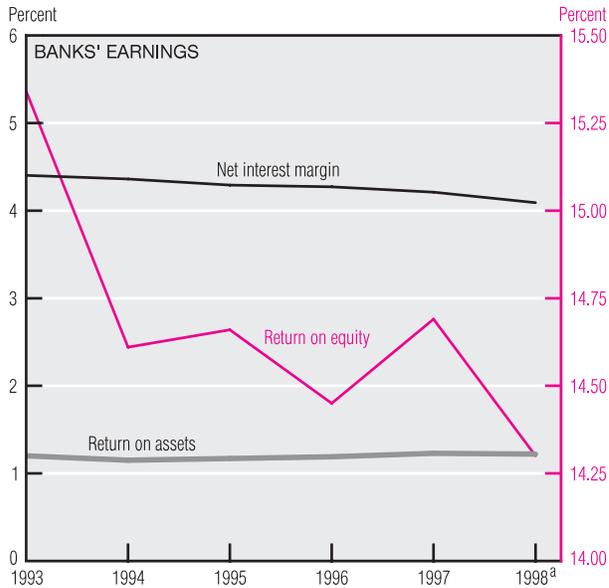
At the end of fiscal year 1998, there was a surplus on the books of the federal government—the first in 28 years. The latest Congressional Budget Office projections indicate that federal surpluses will accumulate during the next decade to the tune of \$2.7 trillion. Over the short term, most of the surplus is expected to occur on the off-budget side of the ledger—in the Social Security plus Postal Service account. The on-budget side will not register a surplus until 2001. As a percent of GDP, revenues are at a postwar

high of 20.9%, while outlays have hit a 25-year low of 19.6%. If discretionary spending after 2002 adheres to the real level set for that year, outlays are expected to reach a low point of 17.3% of GDP by 2009.

The Clinton Administration projects a total surplus of \$4.8 trillion over the next 15 years, of which \$2.1 trillion emerges on-budget. Contingent on “saving” Social Security, the President’s proposal sets aside \$1.4 trillion for additional discretionary spending, establishing Universal Saving Accounts, and

meeting the associated financing charges. In addition, \$0.7 trillion is allocated to bolstering the Medicare trust fund. The off-budget surplus of \$2.7 trillion would be used to pay down part of the debt held by the public. The proposal “saves” Social Security by having the Treasury issue additional nonmarketable securities to the Social Security trust fund in the amount of \$2.8 trillion. This manner of saving Social Security seems to involve committing on-budget revenues beyond a 15-year horizon.

Banking Conditions



a. Data are through 1998:IIIQ.

NOTE: All data are for FDIC-insured commercial banks.

SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, September 1998.

Commercial banks' balance sheets showed continued signs of health through the third quarter of 1998. Despite a slowdown in profits relative to 1997, earnings remained strong, with the net interest margin remaining above 4%. Return on equity for the first nine months of 1998 was 14.3%. Moreover, nearly 95% of all commercial banks posted positive profits through the third quarter of 1998.

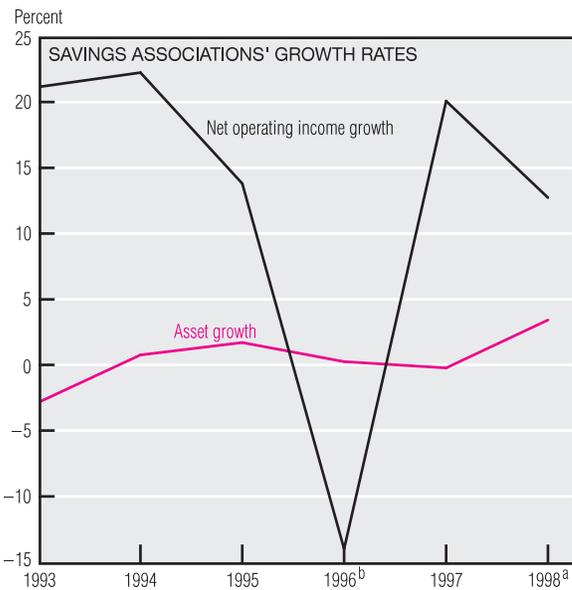
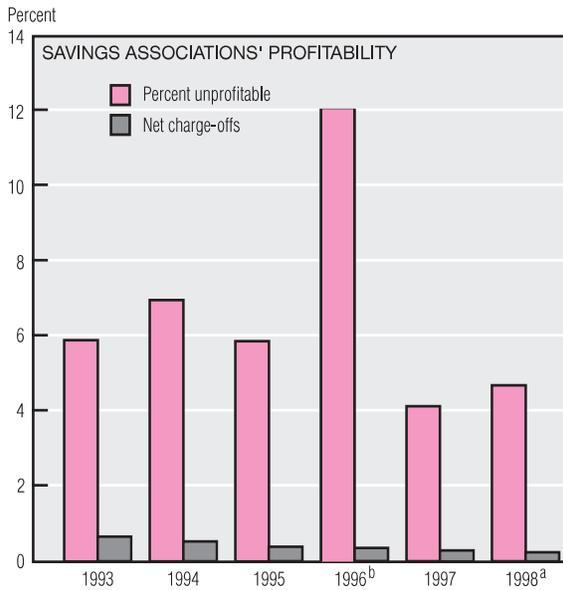
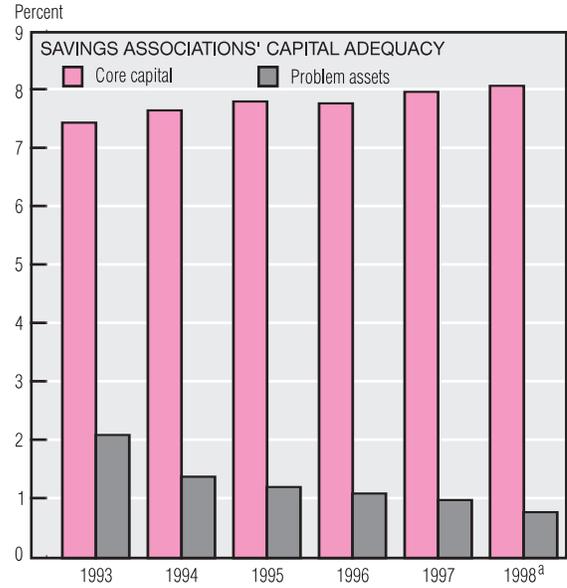
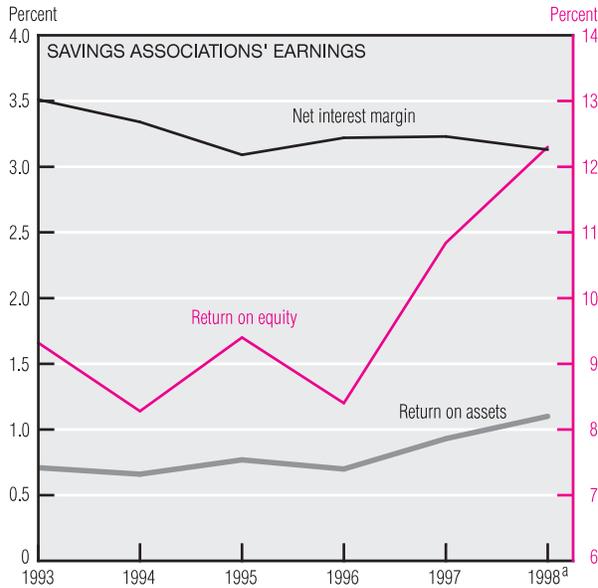
Strong bank balance sheets are

reflected in core bank capital, which is at 7.7% of assets, its highest level in 47 years. Asset-quality problems are not yet evident, as nonperforming assets fell to 0.65% of assets. One sign of potential weakness is the increased level of net charge-offs to 0.66% of loans. However, while net charge-offs have reached their highest level in five years, they remain well below 1% of total loans and do not merit concern at this time.

Finally, the banking sector's growth showed signs of a moderate slowdown during the first nine months of 1998. Net operating income growth fell below 5%, its lowest level in five years. Bank asset growth, however, remained above 8% through the third quarter of 1998. Overall, the banking sector could continue to grow at current rates without compromising the recent trend in profitability or, more importantly, the quality of its assets.

(continued on next page)

Banking Conditions (cont.)



a. Data are through 1998:IIIQ.
 b. The sharp decline in operating income growth in 1996 was driven, in part, by a special insurance assessment on the deposits of savings associations.
 NOTE: All data are for FDIC-insured savings associations.
 SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, September 1998.

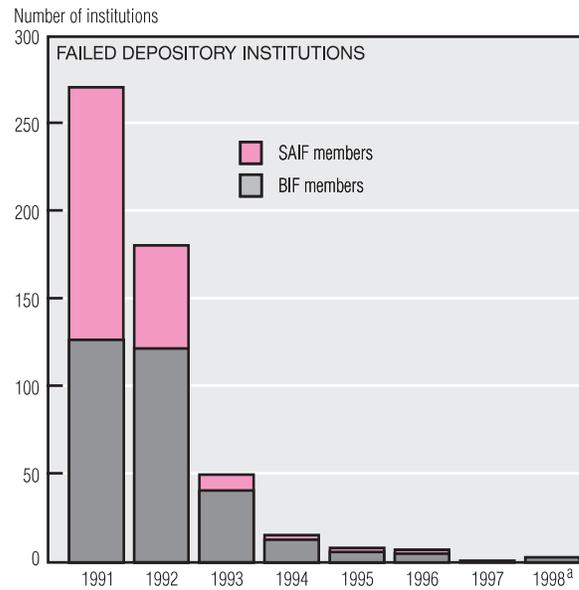
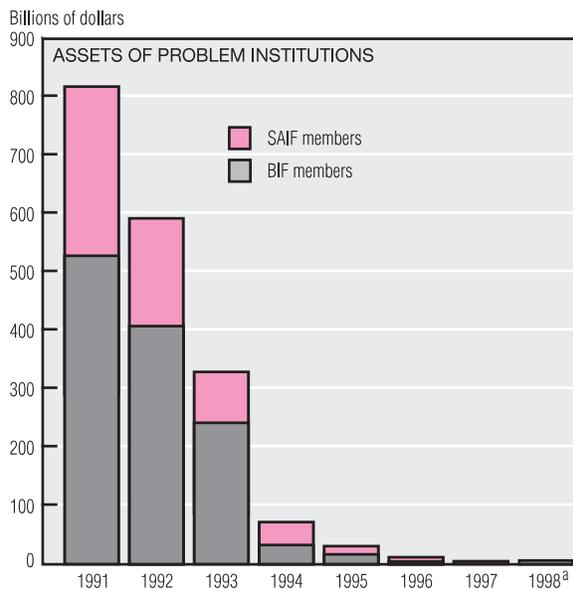
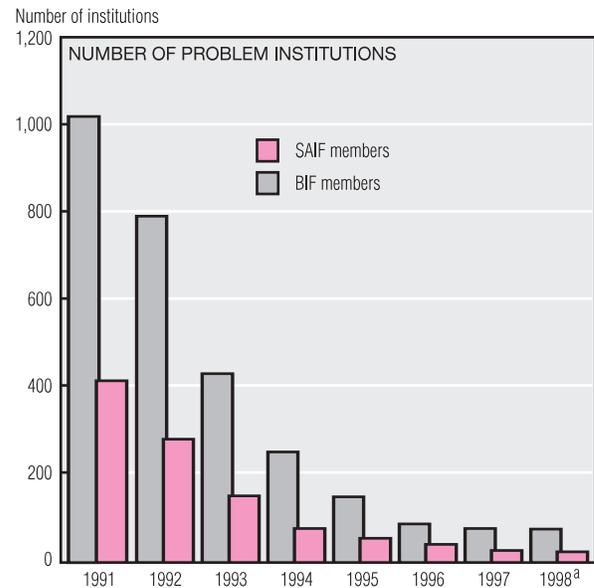
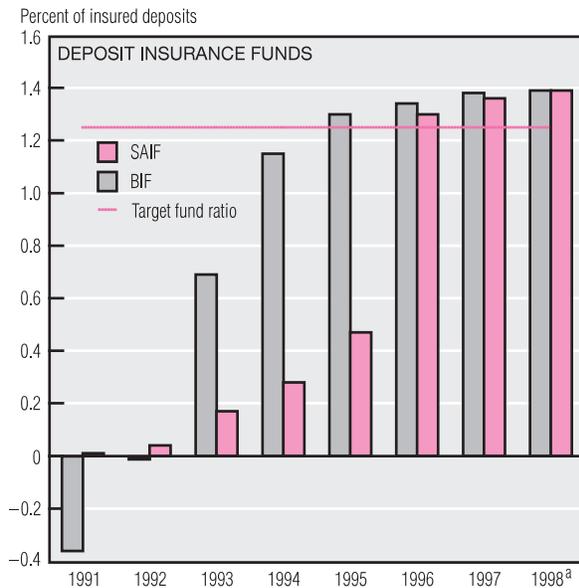
Savings associations' performance continued to be strong during the first nine months of 1998. A return on equity of 12.3% was the highest level since 1985. However, unlike that of 1985, this return on equity was generated by a return on assets of 1.1%—the highest level since 1955—and a steady net interest margin of 3.13%. Moreover, less than 5% of savings associations reported losses through the third quarter of 1998.

Savings associations' balance-sheet strength improved, with core capital exceeding 8% of total assets at the end of the third quarter. Asset quality continues to improve, as nonperforming assets fell to 0.75% of total assets and net charge-offs fell to 0.21% of loans.

While the industry shrank slightly in 1997, it rebounded in 1998, its assets growing at a rate of 3.42% through the end of the third quarter. This asset growth was accom-

panied by growth in operating income of nearly 13%, suggesting that asset growth in 1998 did not come at the expense of profit margins. Overall, recent industry performance suggests that savings associations will continue to play an important role in the economy, albeit a smaller one than they have played in the past.

Federal Deposit Insurance



a. Data are through 1998:IIIQ.

NOTE: All data are for FDIC-insured banks and savings associations.

SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, September 1998.

Buoyed by the strong performance of the depository institutions sector in the mid-to-late 1990s, the Federal Deposit Insurance Corporation's bank insurance fund (BIF) and savings association insurance fund (SAIF) continued to grow during the first nine months of 1998. At the end of the third quarter, reserves of the BIF and SAIF stood at 1.41% and 1.39% of insured deposits, respectively, well in excess of the 1.25% target fund

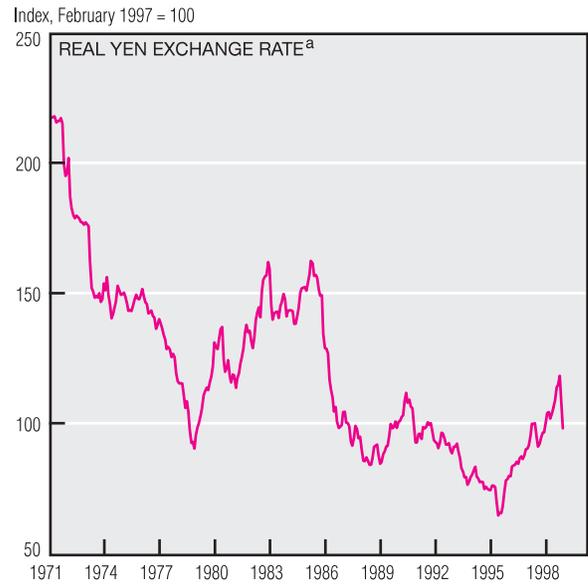
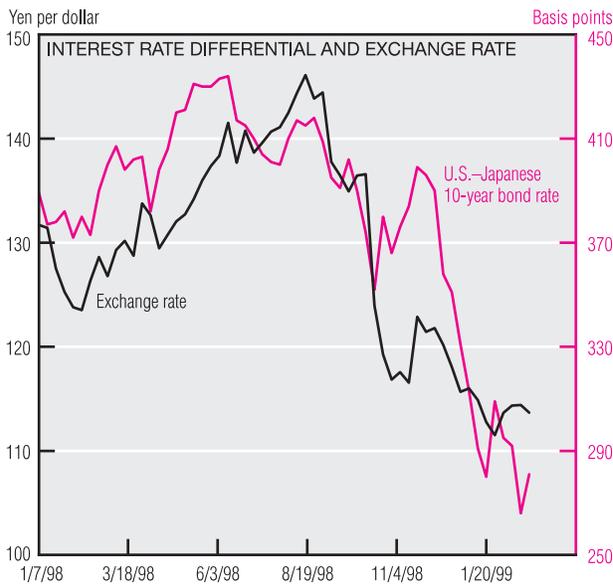
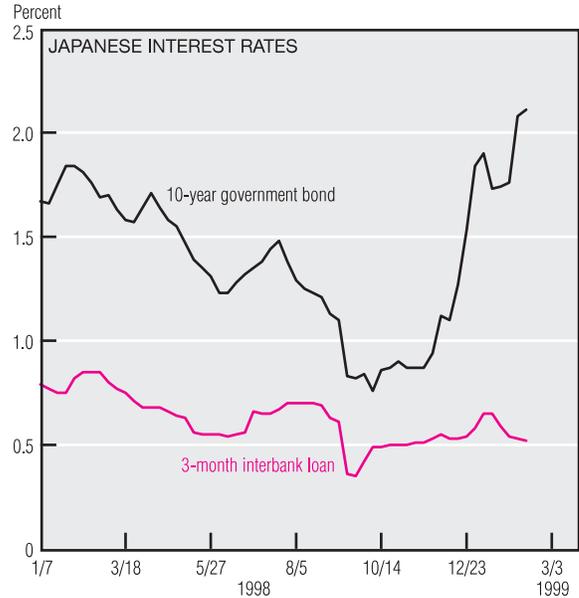
ratio mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

The high reserves in BIF and SAIF mean that well-capitalized banks and savings associations with satisfactory examination ratings will not be assessed deposit insurance premiums for 1998. This group of institutions includes nearly 95% of BIF members and more than 92% of SAIF members. Despite this, the funds are likely to grow as the in-

vestment income from the reserves of BIF and SAIF is likely to exceed expenses for the next several years.

Given the small and declining number of problem banks and savings associations, the number of depository institution failures is likely to remain low in the foreseeable future. Moreover, the relatively small asset size of these problem institutions suggests that any failures that do arise will cause only modest losses to the funds.

The Rising Yen



a. The real exchange rate adjusts the nominal exchange rate for inflation in both countries. A decline (rise) represents a real appreciation (depreciation) of the yen against the dollar.

SOURCES: Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

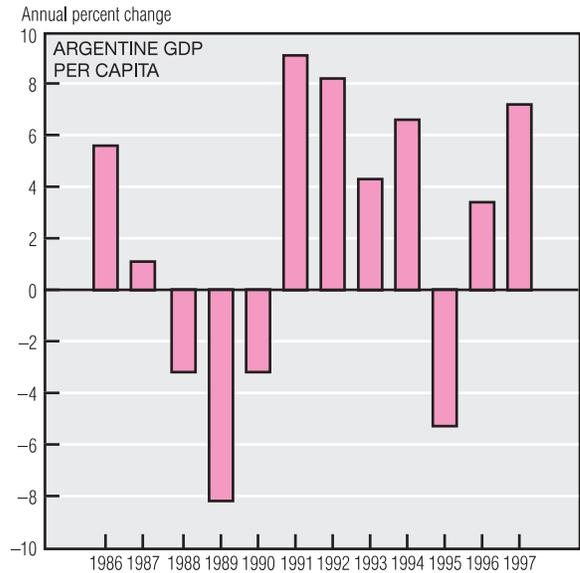
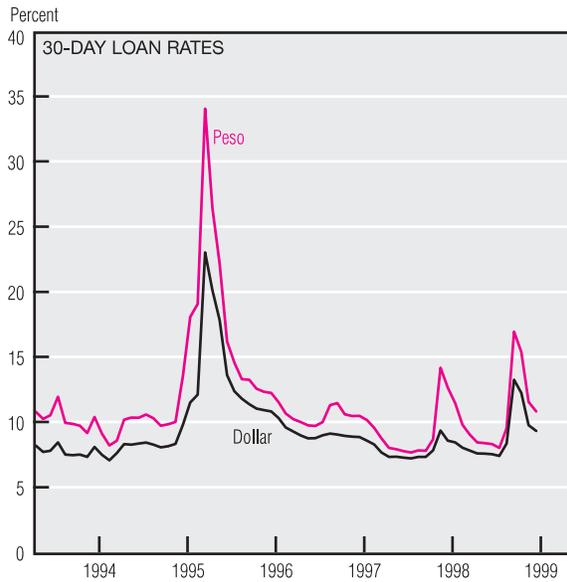
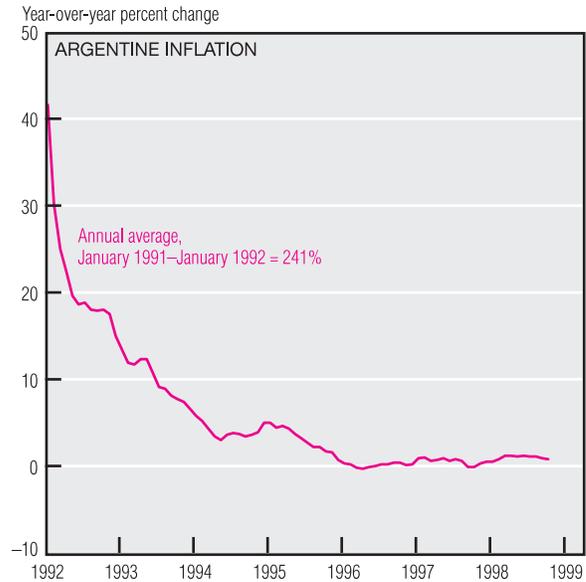
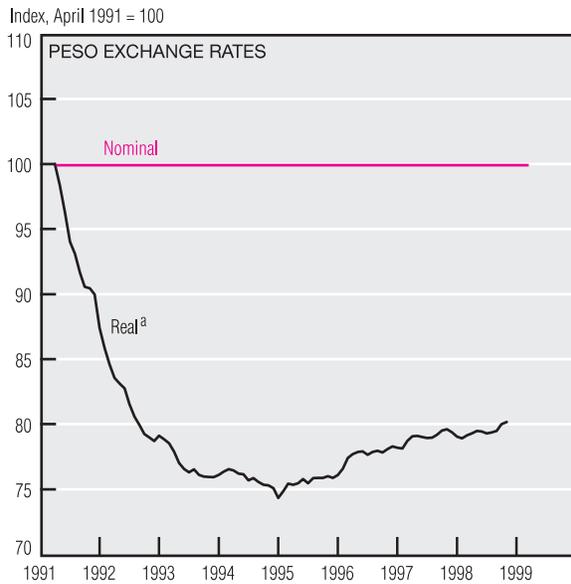
The U.S. dollar has depreciated 18% against the Japanese yen since August 1998. More than half of the decline occurred in late October, as hedge funds and other international investors scrambled to stop losses on short yen positions. Investors' swift actions, while increasing market volatility, were a response to emerging news of changes in Japanese fiscal policy.

Last summer, as its economy slipped deeper into recession, Japan

announced a series of fiscal initiatives. The market, however, was not impressed with the initiatives' overall size or the lack of permanent tax cuts, and remained unconvinced of Japan's willingness to tolerate large budget deficits. An additional installment in November seemed to add credibility, and yields on long-term government bonds rose sharply. In contrast, U.S. long-term bond yields fell. The narrowing rate differential seems to explain the yen's appreciation since August.

Dollar movements against the yen since 1995—its initial appreciation and its more recent depreciation—have tended to offset inflation differentials between the two countries. Upward and downward movements in the real exchange rate confer a competitive advantage on Japan and the U.S., respectively—especially deviations from an index value of 100, which is consistent with purchasing power parity. Opposite movements eliminate these gains.

Dollarizing Argentina



a. The real exchange rate adjusts the nominal exchange rate for inflation in both countries. A decline (rise) represents a real appreciation (depreciation) of the peso against the dollar resulting from higher (lower) inflation in Argentina than in the U.S.

SOURCE: International Monetary Fund, *International Financial Statistics*.

In April 1991, Argentina established a currency board to cure its chronic inflation. Because the currency board issues only pesos for dollars at a fixed rate of one-for-one, dollar reserves back Argentina's monetary base. The currency board cannot undertake open-market operations or make loans. Tying the peso to the dollar protects the peso's purchasing power by linking Argentina's monetary policy to the U.S. Since 1994,

Argentina has maintained an inflation rate similar to that of the U.S.

With the peso fixed to the dollar, however, Argentina's exchange rate cannot act as a buffer against economic shocks. Adjustments, which rely on domestic price movements, often entail unemployment and lost output. Argentina's growth rate fell in 1995 after the Mexican crisis; it will probably slow this year because of Brazil's predicament.

The credibility of the peso-dollar peg rests on Argentina's ability to ride out these adjustments. A recent rise in the differential between peso and dollar loan rates in Argentina suggests that confidence ebbed following the Brazilian real's depreciation. Calls for complete dollarization in Argentina seem to have alleviated these concerns somewhat; dollarization would prevent Argentine policymakers from breaking the peg and returning to their inflationary past.