Overview

The economy performed impressively in 1996. Solid advances in the real expenditures of households and businesses led to sizable gains in output. Employment rose briskly, and the unemployment rate edged down to its lowest level of the current expansion. Consumer price inflation increased because of the probably temporary effects of firmness in food and energy markets, but some broader price measures showed inflation holding steady or even declining. With the economy strengthening, intermediate- and long-term interest rates rose on net, but credit continued to be amply available to businesses and most households, and equity prices soared.

Several factors helped to restrain price increases in the face of high levels of resource utilization. Workers' concerns about job security helped limit, to some degree, the acceleration of wages, and further success in controlling health care costs helped to temper the rise in benefits. Moreover, significant declines in the prices of U.S. imports, resulting from low inflation abroad and appreciation of the dollar on foreign exchange markets, tended to hold down domestic prices. Damped inflation expectations probably contributed as well to the favorable price performance: A lengthening run of years during which inflation has been in a more moderate range, together with an understanding of the Federal Reserve's commitment to maintaining progress toward price stability, may have discouraged aggressive pricing behavior. Business firms continued to rely on cost control and gains in productivity, rather than on price increases, as the primary channels for achieving profit growth.

Still, the Federal Open Market Committee (FOMC) recognized the danger that pressures emanating from the tight labor market might trigger an acceleration of prices, which could eventually undermine the ongoing economic expansion. Consequently, although conditions were not deemed to warrant immediate policy action, the Committee's policy directives starting in mid-1996 reflected a perception that the most likely direction of any policy action would be toward greater restraint in the provision of reserves to the banking system. Forestalling a disruptive buildup of inflationary pressures in the near term and moving toward price stability over time remained central to the System's mission of promoting maximum sustainable growth of employment and production.

The Evolution of Policy in 1996

The FOMC eased the stance of monetary policy twice around the beginning of the year—in December 1995 and in January—lowering the federal funds rate ½ percentage point in total, to 5¼ percent. These actions were taken to offset the effect on the level of the real federal funds rate of declines in inflation and inflation expectations in the second half of 1995 and thereby to help ensure the resumption of moderate economic

NOTE. The discussion here and in the next three chapters is adapted from *Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1997). Data cited here and in the next four chapters are those available as of mid-March 1997.

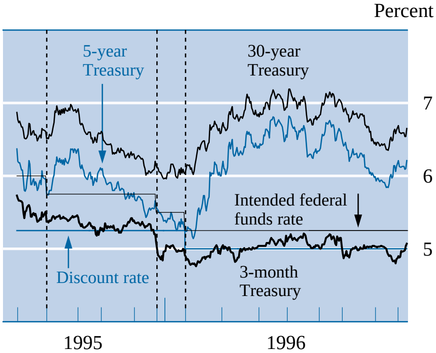
growth after the marked slowdown and inventory correction in late 1995.

By the spring, economic growth had become more vigorous than either the Committee or financial markets had foreseen. In response, intermediate- and longer-term interest rates as of mid-May were up around a full percentage point from the two-year lows reached early in the year. In combination with some softening of economic activity abroad and declines in interest rates in major foreign industrial countries, these developments contributed to a further appreciation of the dollar, building on the rise that had started in mid-1995. The Committee anticipated that the increase in the cost of credit, along with the higher exchange value of the dollar, would be sufficient to foster a downshift in economic expansion to a more sustainable pace and contain price pressures; thus, it left its policy stance unchanged at its spring meetings.

By early summer, however, the continued momentum in demand and pressures on labor resources that were being reflected in faster growth in wages were seen as posing a threat of increased inflation. Core inflation remained moderate, but in light of the heightened risk that it would turn upward, the Committee in its early July directive to the Manager of the Open Market Account indicated its view that near-term economic developments were more likely to lead to a tightening of policy than to an easing. Labor markets continued to be taut over the balance of the year, and this bias toward restraint was included in directives adopted at all of the Committee's remaining meetings in 1996.

After having peaked during midsummer, interest rates moved down on balance through the fall, as expansion of consumer spending and economic activity in general appeared to be moderating and markets saw less likelihood of a need for Federal Reserve firming action. Equity prices fell back for a time during the summer, reversing some of the substantial increase registered over the first half of the year, but by autumn they had reached new highs. Interest rates and dollar exchange rates turned back up late in the year when signs of rapid growth and more intense use of the economy's resources re-emerged.

Selected Interest Rates



NOTE. Small tick marks refer to dates in 1995 and 1996 on which the Federal Open Market Committee held scheduled meetings. Dashed lines indicate dates of meetings at which the Committee announced a monetary policy action: July 6, 1995; December 19, 1995; and January 31, 1996. The data are daily.

Debt and the Monetary Aggregates

For the nonfinancial business sector, the effect of the higher intermediate- and long-term interest rates on the overall cost of funds in 1996 was offset to some degree by an easing of lending terms at banks and a narrowing of yield spreads on corporate bonds over Treasuries, as well as by declines in the cost of capital in the equity market. Encouraged, perhaps, by the prospects of sustained economic expansion and low inflation, banks, market lenders, and equity investors displayed a strong appetite for business obligations and seemed willing to require less compensation for the possible risks entailed. Some households, by contrast, faced a tightening of standards and terms with respect to credit card debt and some other types of consumer debt as banks reacted to a rising volume of delinquencies and charge-offs on these instruments. However, credit availability under home equity lines increased, particularly from finance companies but also from banks. Overall debt growth was slightly above the midpoint of its 3 percent to 7 percent monitoring range. The growth rates of M2 and M3 edged up and, as was anticipated in the monetary policy reports to the Congress in February and July, both aggregates ended 1996 near or above the upper end of their growth ranges. Again in 1996, the growth of M2 relative to nominal income and interest rates was generally in line with historical relationships, in contrast to its behavior during the early years of the decade. ■

The Performance of the Economy in 1996

The economy turned in a remarkably favorable performance in 1996. Real GDP rose more than 3 percent, one of the larger gains of the past several years and appreciably more than the FOMC was expecting early in the year. Employment rose substantially, and the unemployment rate declined further. Tightness of the labor market led to a moderate pickup in wage increases in 1996. However, acceleration of prices was confined largely to the food and energy sectors; prices for other consumer products decelerated, as did prices paid by businesses for capital goods and materials.

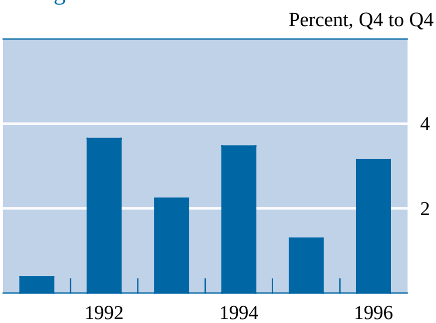
The Labor Market

The number of jobs on nonfarm payrolls rose more than 2½ million from December 1995 to December 1996, an increase of about 2¼ percent. At year-end, the job count was up more than 12½ million from the lows of the early 1990s.

Employment in the private service-producing sector, in which nearly two-thirds of all nonfarm workers are employed, increased about 3 percent during 1996. Moderate employment gains were posted in retail trade, transportation, and finance, and sizable gains in hiring continued in some other service-producing industries, such as data processing, computer services, and engineering and management. Job growth at suppliers of personnel—a category that includes temporary help agencies—was more than 6 percent, a touch faster than in 1995 but much slower than it had been over 1992–94; with the tightening of labor markets in the past couple of years, longer-lasting commitments in hiring may have come back into greater favor among some employers.

Employment changes among producers of goods were mixed in 1996. In construction, employment climbed about 5½ percent, to a new high that was almost 4 percent above the peak of the last business expansion. In manufacturing, increases in factory jobs through the latter part of 1996 were not sufficient to reverse declines that had taken place earlier in the year. On net, the loss of factory jobs amounted to about ½ percent, a shade less than the average rate of decline since 1979, the year in which manufacturing employment peaked. Manufacturers of durable goods boosted employment slightly last year, but many producers of nondurables implemented further job cuts. As in many other recent years, reductions in factory employment were accompanied by strong gains in worker productivity. Consequently, increases in output were sizable—the rise in the Federal Reserve's index of manufacturing production cumulated to more than 4 percent over the year.

Change in Real GDP



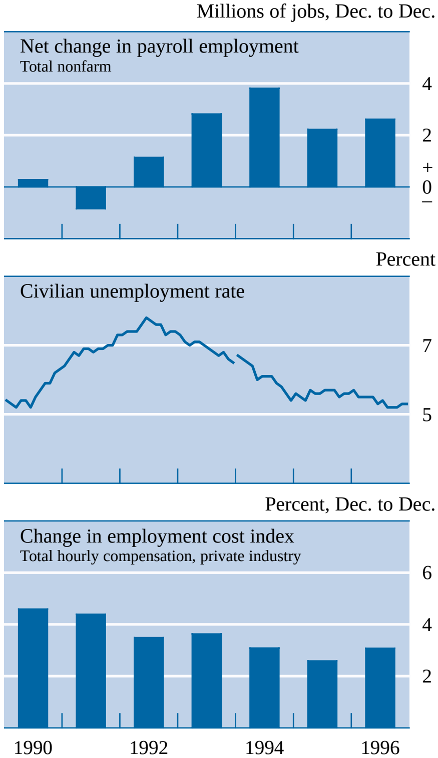
Note. The data are derived from chained (1992) dollars and come from the Department of Commerce.

Growth of output per hour in the nonfarm business sector as a whole picked up in 1996, rising about 1 percent over the year according to preliminary data. However, coming after a three-year period in which output per hour changed little, this rise left the average rate of productivity growth in the 1990s a bit below that of the 1980s and well below the average gains achieved in the first three decades after World War II. The sustained sluggishness in measured productivity growth this decade is difficult to explain, as it has occurred during a period when high levels of investment in new capital and extensive restructuring of business operations should have been boosting the efficiency of workers. Of course, measurement problems could be distorting the data. As a summary measure that relates aggregate output to aggregate input of labor, the nonfarm productivity index is affected by whatever deficiencies might be present either in adding up the nominal expenditures for goods and services in the economy or adjusting those expenditures for price change. A considerable amount of recent research suggests that growth of output and productivity is in fact understated, but whether the degree of understatement has been increasing over time is less clear.

In contrast to the experience of most other recent years, the 1996 rise in employment was accompanied by a sustained pickup in the labor force participation rate. The rise in participation boosted the labor supply and helped to relieve pressures on the labor market. Nonetheless, hiring during 1996 was sufficient to reduce the civilian unemployment rate from a December 1995 rate of 5.6 percent to a December 1996 rate of 5.3 percent.

Tightness of the labor market appears to have exerted some upward pressure on the cost of labor in 1996, even as some workers continued to express anxiety about job security. The employment cost index (ECI) for the private nonfarm sector of the economy showed compensation per hour moving up 3.1 percent over the year. The index had risen 2.6 percent in 1995. The step-up in hourly pay increases was to some extent the result of a hike in the minimum wage that took place at the start of October. More generally, however, businesses probably had to boost hourly compensation either to attract workers or to retain them at a time when alternative employment opportunities were perceived to be more widely available.

Labor Market Conditions



NOTE. The data are from the Department of Labor. The break in data for the unemployment rate at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with those of earlier periods.

As in 1995, increases in hourly compensation in 1996 came more as wage and salary increases than as increases in fringe benefits. According to the ECI, the rise in wage rates for workers in the nonfarm sector amounted to nearly 3½ percent after a rise of 2¾ percent in 1995. By contrast, the ECI measure of the hourly cost of benefits rose only 2 percent, slightly less than it did in 1995 and much less than it rose on average over the past decade. Increases in the cost of benefits have been held down in recent years by reduced inflation for medical services and by the actions that many firms have taken to shift employees into managed care arrangements and to require them to assume a greater portion of the cost of health insurance and other medical benefits.

Prices

The consumer price index rose more rapidly than in 1995, but the step-up was concentrated in the food and energy sectors—areas in which prices were affected by supply limitations that seemed likely to be of temporary duration. The CPI excluding food and energy—often called the "core" CPI—rose just a touch more than 2½ percent after having increased 3 percent during 1995. Both the total CPI and the core CPI have been affected in the past two years by technical improvements implemented by the Bureau of Labor Statistics that are aimed at obtaining more accurate readings of price change; the rise in the CPI in 1996 would have been somewhat greater if procedures used through 1994 had not been altered.

Other price indexes generally rose less rapidly than the CPI. Like the overall CPI, the chain-type price index for personal consumption expenditures (PCE) accelerated somewhat in 1996, but its rate of rise, shown in the accompanying table, was significantly lower than that of the CPI. The two measures of consumer prices differ to some degree in their weights and methods of aggregation. They also differ somewhat in their selection of price data, with the PCE measure relying on alternative data in some areas in which the accuracy of the CPI has been questioned. The chain-type price index for gross domestic purchases, which takes account of the prices paid by businesses and governments as well as those paid by consumers, moved up 2¼ percent during 1996, about the same as the percentage rise during 1995. By contrast, price measures associated with GDP decelerated in 1996 to thirty-year lows of around 2 percent or less. Conceptually, the GDP measures are indicative of price changes for goods and services that are produced domestically rather than price changes for goods and services purchased domestically—foreign trade accounting for the difference.

The 1996 outcomes for all these measures reflected an economy in which inflation pressures were muted. Sharp declines in non-oil import prices during the year lowered input costs for many domestic firms and likely caused other firms to restrain their product prices for

Alternative Measures of Price Change

Percent

Price measure	1995	1996
Fixed-weight		
Consumer price index	2.7	3.2
Excluding food and energy	3.0	2.6
Chain-type		
Personal consumption expenditures	2.1	2.5
Excluding food and energy	2.3	2.0
Gross domestic purchases	2.3	2.2
Gross domestic product	2.5	2.1
Deflator		
Gross domestic product	2.5	1.8

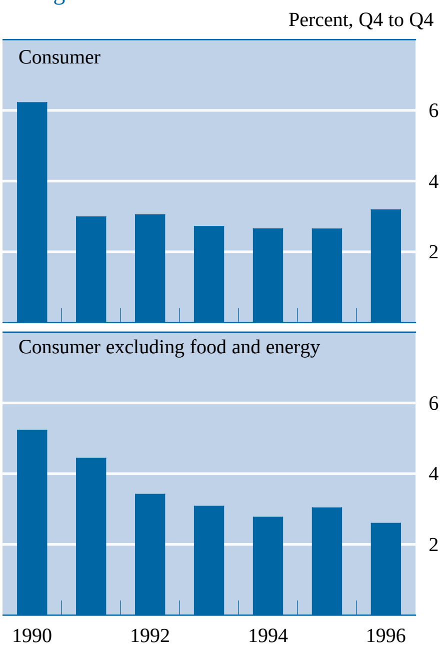
NOTE. Changes are based on quarterly averages and are measured to the fourth quarter of the year indicated from the fourth quarter of the previous year.

fear of losing market share to foreign competitors. Also important, in all likelihood, were the favorable imprints that several years of moderate and relatively stable rates of inflation have left on inflation expectations. Despite the uptick in hourly compensation and adverse developments in the food and energy sectors, survey data showed little change in consumers' expectations of inflation, and private forecasters' views of the prospects for prices held steady. Businesses commonly described the situation as one in which competitive pressures were intense and the "leverage" for raising prices simply was not present.

Food and energy prices were the exceptions. In the food sector, steep increases in grain prices in 1995 and the first few months of 1996 caused production adjustments among livestock farmers and substantial price increases for some livestock products. Later in the year, grain prices fell back, but livestock production could not recover in time to prevent significant price advances for some retail foods. Consumer prices for pork, poultry, and dairy products registered their largest increases in several years. Retail beef prices also rose but only moderately: Expansion of the cattle herd in previous years had laid the groundwork for a high flow of product to consumers, and herd reductions that occurred in 1996 augmented that flow. Elsewhere in the food sector, acceleration was reported in the price index for food away from home—a category that has a weight of almost 40 percent in the CPI for food; the rise in the minimum wage appears to have been an important factor in the acceleration. All told, the 1996 rise in CPI food prices amounted to 4¼ percent, the largest increase since 1990.

The energy sector was the other major part of the economy in which significant inflation pressures were evident in 1996. Crude oil prices, which had started firming in the latter part of 1995, continued on an upward course through much of 1996, rising more than 30 percent in total. Stocks of crude oil and petroleum products were tight during the year, even after allowing for an apparent downward trend in firms' desired inventories. Inventory building was forestalled by production disruptions at refineries, a string of weather problems here and abroad that boosted fuel requirements for heating or cooling, and a reluctance of firms to take on inventories that seemed likely to fall in value once renewed supplies from Iraq became available. Natural gas, too, was in tight supply at times, and its price surged. With retail prices of gasoline, fuel oil, and natural gas all moving up substantially, the CPI for energy rose

Change in Prices



NOTE. Consumer price index for all urban consumers. Based on data from the Department of Labor.

about 7½ percent over the four quarters of 1996, the largest increase since the Gulf War.

The CPI for goods other than food and energy rose 1 percent during 1996, one of the smallest increases of recent decades. As in 1995, price increases for new vehicles were moderate, and prices of used cars turned down after several years of sizable advances. Prices of apparel and house furnishings also fell; these prices, as well as the prices of vehicles, may have been heavily affected by the softness of import prices. Moderate increases were the rule among most other categories of goods in the CPI. In the producer price index, prices of capital equipment rose only ½ percent over 1996; computer prices continued to plunge, and the prices of other types of equipment rose moderately, on balance. Materials prices were weak: Prices of intermediate materials excluding food and energy declined about 1¼ percent from the fourth quarter of 1995 to the final quarter of 1996, and the producer price index for crude materials excluding food and energy dropped more than 6½ percent over that period. Productive capacity was adequate among domestic producers of materials, and supplies of many materials were readily available at competitive prices on the world market.

The CPI for non-energy services increased 3¼ percent in 1996. The rise was somewhat smaller than the increases of most other recent years. Prices of medical services decelerated for a sixth consecutive year, and increases in the cost of shelter were held down by another year of moderate advances in residential rent and owners' equivalent rent. Large increases were evident only in scattered categories: Airfares posted a large increase, and educational costs, maintaining a long-established trend, continued to rise quite rapidly relative to prices in general. ▪

Domestic Spending and Finance in 1996

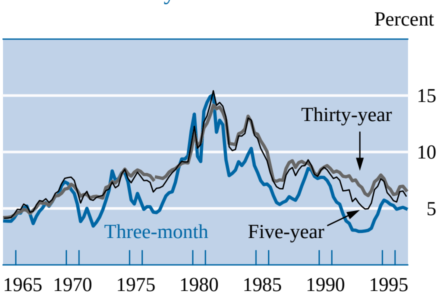
Aggregate spending of households, businesses, and governments recorded a sizable advance in 1996, rising a touch faster than real GDP. Household expenditures picked up, and business investment expenditures surged, the latter bolstered by increases in business profits and ready access to a variety of sources of finance on quite favorable terms. Government outlays for consumption and investment rose moderately in real terms.

The Financial Backdrop: Interest Rates, Equity, and Debt

Declines in interest rates during the second half of 1996, elicited by evidence that economic growth had moderated, only partially reversed the increases over the first half. Longer-term Treasury rates rose on balance on the order of ½ percentage point over the year, and intermediate rates were up somewhat more. Spreads between most private rates and Treasuries narrowed markedly, reflecting the high quality of business balance sheets. Municipal rates moved up comparatively little over the first half of 1996, as earlier relative increases in these yields associated with discussions of fundamental tax reform were reversed when the likelihood of such changes to the tax code diminished. Movements in interest rates over the year appeared to be basically in their real component, as inflation expectations were little changed, according to surveys.

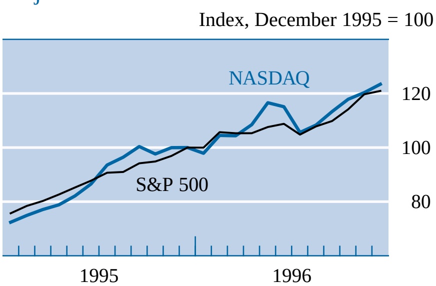
The substantial rise in equity prices in 1996 was only a bit below that registered in 1995. However, in contrast to 1995, when bond rates declined substantially, the equity gains came despite the net rise in bond rates. Corporate earnings were robust, but their advance fell short of share price increases, and price-earnings ratios rose to unusually high levels; dividend–price ratios were even more out of line with historical experience. Market participants appeared to be anticipating further robust earnings growth, and they also seemed to be requiring much less compensation for the extra risk of holding equities compared to, say, Treasury bonds. Such evaluations may have been based on a perceived environment of persisting low inflation and balanced economic growth

Selected Treasury Rates



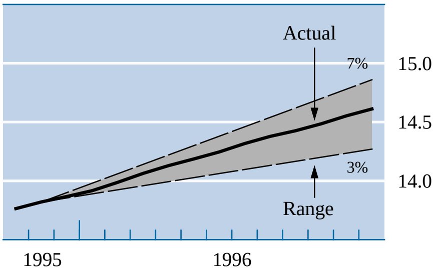
NOTE. The twenty-year Treasury bond rate is shown until the first issuance of the thirty-year Treasury bond, in February 1977.

Major Stock Price Indexes



NOTE. The data are monthly.

Total Domestic Nonfinancial Debt



NOTE. The range was adopted by the FOMC for the period from 1995:Q4 to 1996:Q4.

that would lower the odds of disruptions to economic activity.

Other asset prices were generally subdued. Commodity prices were flat to down. Commercial real estate prices, although no longer falling, rose at little more than the rate of inflation. Residential real estate prices increased moderately.

Growth of the debt of nonfinancial sectors in 1996, about 5½ percent, was similar to the rise in 1995. The growth of household sector debt dropped from 8¼ percent to 7¾ percent, a deceleration accounted for entirely by a sharp slowing of consumer credit. The expansion of business borrowing was held below its 1995 pace by an increase in internally generated funds, but at 4¾ percent it was faster than in any other year since 1989. Its strength reflected robust spending, extremely favorable credit conditions, and financing needs associated with a high level of mergers and acquisitions. Growth of federal debt slowed a bit further in 1996. State and local debt expanded slightly after two years of contraction.

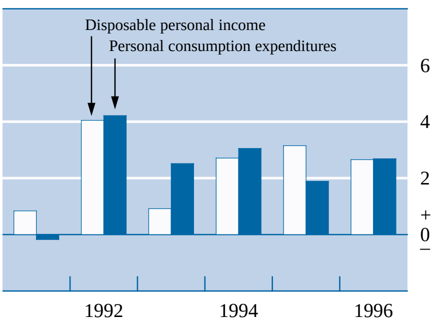
The Household Sector

Household expenditures picked up in 1996—both consumer spending and residential investment. Although debt problems arose with greater frequency in the household sector in 1996 and may have restrained spending in some instances, households also benefited from healthy increases in real income and another year of sizable gains in wealth. Consumers were relatively optimistic about prospects for the economy at the start of 1996, and they became more so as the year progressed. Given this upbeat view, households were willing to take on additional mortgage debt at a brisk pace, but they did cut back on expansion of consumer credit after very large increases in 1994 and 1995.

Spending, Income, and Saving

After having risen less than 2 percent in 1995, real personal consumption expenditures moved up 2¾ percent in 1996. Real outlays for consumer durables rose more than 5 percent after a gain of only 1¼ percent the previous year. As has been true for many years, real expenditures on computers and electronic equipment outpaced the growth of other household outlays by a wide margin in 1996. Sizable increases were also reported for most other types of consumer durables. However, real expenditures on vehicles changed little

Change in Real Income and Consumption



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

on net over the year, as gains achieved during the first half were reversed after midyear. Late in 1996, sales of light vehicles may have been constrained to some degree by supply shortages that arose during strikes in the United States and Canada. Consumer purchases of nondurables rose 1¾ percent in 1996 after having increased 1 percent during 1995. Spending for services rose nearly 2¾ percent, slightly more than the average gain in previous years of the expansion.

After-tax personal income increased 5 percent in nominal terms over the four quarters of 1996. Wages and salaries rose briskly, and the income of farm proprietors surged. Other types of income generally exhibited moderate gains. Given the low level of price inflation, the rise in nominal income translated into another significant advance in real disposable income—about 2¾ percent over the year.

As in 1995, strong cross-currents continued to shape individual households' willingness—and ability—to spend from current income. Huge increases in stock market wealth provided some households the wherewithal to boost spending at a pace considerably faster than the growth of disposable income. But a number of households were likely held back by the need to divert income to the servicing of debt, and according to some survey evidence, households have become more concerned about saving for retirement. Responding to these influences, the annual average of the personal saving rate was up slightly from that of 1995; however, it remained relatively low compared with its longer-run average.

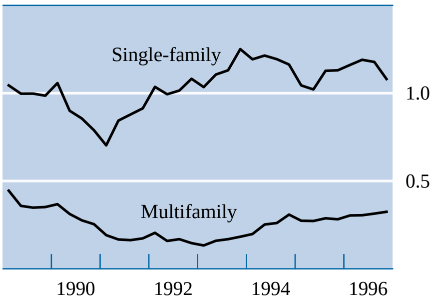
Residential Investment

Outlays for residential investment expenditures posted a gain of about 4 percent in real terms over the four quarters of 1996, more than reversing a small decline in the previous year. Demand for single-family housing was especially strong. Although interest rates on longer-term fixed-rate mortgage loans moved up considerably in 1996, a substantial number of homebuyers sidestepped at least the initial costs by using adjustable-rate loans that were available at lower rates. The effects of the rate increases on the single-family market were cushioned by other influences as well, most notably the growth of employment and income. Even for fixed-rate loans, mortgage financing costs held at a level that, by historical standards, was low relative to household incomes. All told, sales of new homes surged to the highest annual total of the current expansion, and sales of existing homes established a historical high. New construction of single-family dwellings also rose but not so dramatically as sales, as builders apparently chose to work off some of their inventories of unsold units, which had climbed in 1995.

Construction of multifamily units maintained a path of recovery from the extreme lows of the early 1990s, moving up about 14 percent in terms of annual totals. The number of multifam-

Private Housing Starts

Millions of units, annual rate



NOTE. The data are seasonally adjusted quarterly averages and come from the Department of Commerce.

ily units started—about 315,000—was double the number started in 1993, when construction of these units was at a low. However, compared with previous peaks, the 1996 total was less impressive—starts were twice as high in some years of the 1970s and 1980s. Although market conditions for multifamily properties varied considerably from city to city in 1996, the national average vacancy rate for multifamily rental units remained relatively high, and demographic influences were probably less supportive of multifamily housing than they were a decade or so ago. Also, manufactured houses have provided an increased number of families with an alternative to rental apartments in recent years.

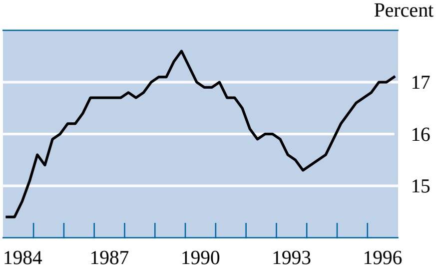
Household Finance

Consumer credit grew 8¼ percent in 1996, just a bit over half the pace of the preceding two years. The sharp retrenchment likely reflected the burdens associated with a substantial accumulation of outstanding consumer debt over recent years as well as some tightening of lending terms and standards by commercial banks, particularly with respect to credit cards.

The slowing in consumer credit growth also was associated with a shift toward increased use of home equity loans. These loans were marketed vigorously, particularly by finance companies, in part as a vehicle for consolidating credit card and other outstanding consumer debt. Some of the growth in home equity loans reflected moves by finance companies and banks into the "subprime" market—lending either to higher-risk customers or on terms entailing unusually high loan-to-value ratios, or both. The push to expand home equity lending offset to some degree the effect of tighter lending standards and terms on credit cards and other forms of consumer credit.

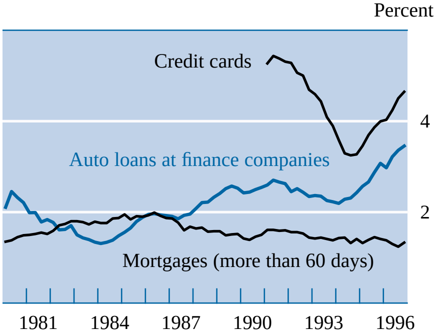
The shift toward home equity loans, along with a strong housing market, led to a pickup in mortgage debt growth in 1996 to a rate of 8¼ percent, the largest advance since 1990. Mortgage borrowing for home purchases was restrained surprisingly little by the increase in interest rates over the first half of the year. As noted previously, many borrowers were able to put off, at least for a time, much of the impact of the increase in rates by shifting to adjustable-rate mortgages, the rates on which rose much less than those on fixed-rate mortgages.

Household Debt-Service Burden



NOTE. As a percentage of disposable personal income. Debt is household mortgage and consumer debt, and debt service is the sum of required interest and principal payments on such debt. The data are quarterly.

Delinquency Rates on Household Loans



NOTE. The data for mortgages are from the Mortgage Bankers Association; for auto loans and credit cards, from the Federal Reserve. The data are quarterly.

Although the growth of household sector debt fell off a bit from the pace of recent years, it still exceeded that of disposable income. With loan rates up on average for mortgages and down only a little on consumer loans, debt-service burdens continued to rise, and some households experienced difficulties servicing certain kinds of debt. Delinquency rates on banks' consumer loans, particularly credit card loans, posted a second year of considerable increase, although they remained below levels in the early 1990s. At finance companies that are subsidiaries of automakers, auto loan delinquency rates rose to very high levels; but this rise apparently resulted in large part from a business strategy to compete in the vehicle market by easing lending standards. Auto loan delinquency rates at commercial banks also rose but remained well within historical ranges. Delinquency rates on residential mortgages turned up at some lenders but remained low overall.

Despite the rise in delinquencies on consumer debt, household balance sheets appeared healthy overall, as growth of household assets in 1995 and 1996 more than kept pace with the growth of debt. Household net worth, the sum of household financial claims and tangible assets less liabilities, rose approximately $5 trillion from the end of 1994 to the end of 1996, an amount that is equal to almost a full year's personal disposable income. Roughly two-thirds of that gain was accounted for by the surge in the prices of corporate shares, which lifted the value of a wide range of household investments, not only directly held stocks but also assets held in other forms such as pension plans. The ratio of household net worth to personal disposable income continued to climb in 1996, moving to its highest level in recent decades.

The Business Sector

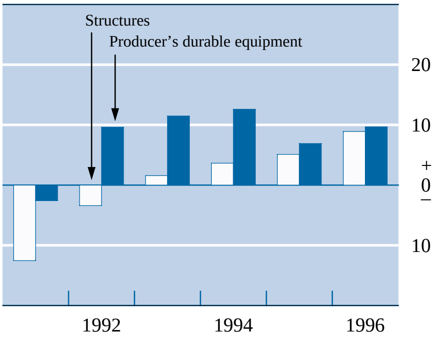
The performance of the business sector in 1996 was marked by continued rapid growth of fixed investment, a further increase in profits, and a conspicuous absence of serious imbalances. In these circumstances, businesses were able to obtain credit on exceptionally favorable terms. They also benefited from the rise in share values, which lowered the cost of obtaining finance through the equity markets.

Investment Expenditures

Business fixed investment recorded a fifth consecutive year of strong expansion in 1996, moving up about 9½ percent. As in other recent years, investment was driven by rising profits, favorable trends in the cost of capital, and the ongoing efforts of businesses to boost efficiency. Although much of the investment spending was to replace depreciated equipment, the net addition to the aggregate capital stock appears to have been substantial. The rate of rise in the stock has picked up over the past two or three years after subpar growth through the latter half of the 1980s and first few years of the 1990s; the result-

Change in Real Business Fixed Investment

Percent, Q4 to Q4



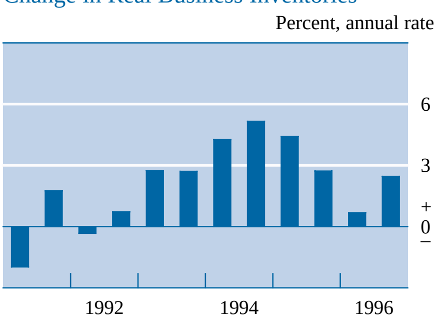
NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

ing rise in the level of capital per worker should enhance labor productivity and potential output.

Equipment outlays moved up almost 9¾ percent in real terms in 1996. Business purchases of office and computing equipment once again rose much faster than the outlays for other types of equipment. Computer purchases were propelled by many of the same forces that have been at work in other recent years—most particularly, the expansion of networks and the availability of new models of computers embodying substantially improved computing power at highly attractive prices. Outlays for communications equipment also rose quite rapidly in 1996. Gains for other types of equipment were generally more modest.

Investment in nonresidential structures also rose substantially over the four quarters of 1996, posting the largest advance in several years. Business spending on structures went through an extended contraction in the latter part of the 1980s and early 1990s, and until recently the subsequent recovery has been relatively slow. That the 1996 gain in nonresidential investment would be so large was not evident until late in the year, when incoming data began to trace out sizable increases in new construction for many types of buildings. Investment in office buildings scored an especially large gain over the year, amid widespread reports of firming market conditions and reduced vacancy rates, and real outlays for other commercial structures moved up for a fifth consecutive year. Financing appeared to be in ample supply for commercial construction, and according to reports from the District Reserve Banks, speculative office building projects—that is, those without pre-committed tenants—were becoming more common.

Change in Real Business Inventories



NOTE. Total nonfarm sector. The data are seasonally adjusted, derived from chained (1992) dollars, and come from the Department of Commerce.

Inventory investment was relatively subdued in 1996. The stock of nonfarm business inventories rose only 1½ percent over the four quarters of the year, the smallest increase since 1992. Businesses had been moving toward a reduced rate of stockpiling over much of 1995, and the rate of accumulation came almost to a halt in early 1996, when stocks of motor vehicles plummeted in conjunction with a strike at two plants that manufacture auto parts. Thereafter, inventory developments were relatively uneventful. Stocks of vehicles changed little on net over the final three quarters of the year, and accumulation of inventories by other nonfarm businesses was moderate on average. Stocks at year-end generally appeared to be at comfortable levels—or perhaps even a little tight—relative to trends in sales.

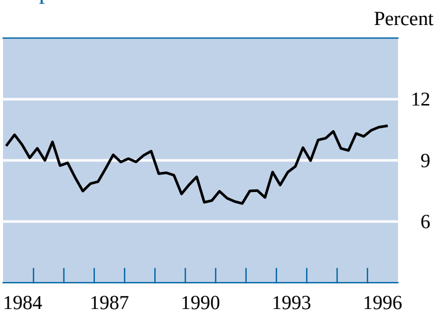
Corporate Profits and Business Finance

Business profits turned in another strong performance in 1996, building on the impressive gains of other recent years. Economic profits earned by foreign subsidiaries of U.S. corporations fluctuated from quarter to quarter but remained at high levels, and returns from domestic operations rose substantially for both financial and nonfinancial firms. Domestic profits of nonfinancial corporations, measured in proportion to the nominal value of these firms' output, reached the highest levels of the current expansion.

Although many interest rates rose in 1996, businesses continued to find credit readily available and at favorable terms. This accommodation likely resulted in part from the strong financial condition of firms, reflected in minimal delinquency rates on bank loans to businesses and very low default rates on corporate bonds, including those of low-rated issuers. With securitization of household debt instruments proceeding apace and with high levels of capital, banks appeared to have ample room on their balance sheets for business loans. This situation encouraged the development of a highly competitive lending environment in which banks further eased a variety of credit terms, such as covenants and markups over base rates. In capital markets, interest rate spreads of private debt instruments over Treasuries narrowed, particularly in the case of high-yield bonds. Surveys by the National Federation of Independent Business revealed a rising tendency of small businesses to borrow over 1996, with credit availability reported to be in a range more favorable than at any time in the current economic expansion.

On a gross basis, a pickup in bond issuance by nonfinancial firms in 1996 was accounted for mainly by speculative-grade offerings, likely in part a reaction to the improved pricing. In the fourth quarter, however, investment-grade issuance was substantial, responding to the decline in interest rates that began in late summer. Commercial paper declined in the final months of the year, primarily because of paydowns from bond proceeds, but bank lending to businesses was strong, in part because of robust merger activity. Despite a marked increase in gross stock issuance—with strong gains both for initial public offerings and for seasoned offerings—equity continued to be retired on net, as merger activity remained brisk and businesses used ample cash resources to repurchase their outstanding shares.

Corporate Profits before Taxes

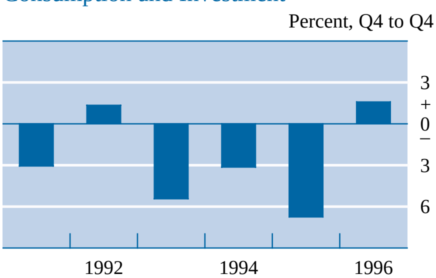


NOTE. Profits of nonfinancial corporations from domestic operations, with adjustments for inventory valuation and capital consumption, as a percentage of GDP of nonfinancial corporate sector. Last observation is 1996:Q3.

The Government Sector

Real federal expenditures on consumption and gross investment—the part of federal spending that is included in GDP—rose about 1½ percent, on net, from the fourth quarter of 1995 to the fourth quarter of 1996, but the rise was

Change in Real Federal Expenditures on Consumption and Investment

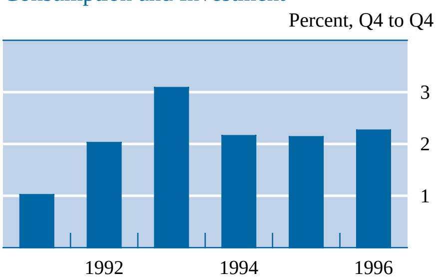


NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

mostly an artifact of late-1995 real purchases having been pushed to especially low levels by government shutdowns. The underlying trend of federal consumption and investment expenditures is probably better represented by the 2¾ percent annual rate of decline from the fourth quarter of 1994 to the final quarter of 1996. Reductions were apparent over this period both in real defense purchases and in real nondefense purchases.

Federal expenditures in the unified budget increased about 3 percent in nominal terms in fiscal 1996 after having increased 3¾ percent in fiscal 1995. Slower growth was recorded across many budgetary categories in fiscal 1996, and outright declines were reported in some. Combined expenditures on health, social insurance, and income security—items that account for more than half of all federal outlays—moved up 4½ percent, the smallest increase this decade. Defense spending was down about 2¼ percent in nominal terms, and net interest outlays rose much less rapidly than in fiscal 1995. Measured relative to the size of nominal GDP, total outlays in fiscal 1996 were the smallest since 1979. Legislative restraint has led to cuts in a number of discretionary programs in recent years, and the

Change in Real State and Local Expenditures on Consumption and Investment



NOTE. The data are derived from chained (1992) dollars and come from the Department of Commerce.

expanding economy has relieved pressure on those outlays that tend to vary inversely with the strength of activity.

Federal receipts increased about 7½ percent in fiscal 1996, the third year in which growth of receipts outpaced growth of nominal GDP by a significant margin. Receipts from individual income taxes climbed more than 11 percent in the most recent fiscal year, in conjunction with healthy increases in households' taxable earnings from capital and labor. Taxes on corporate profits also continued to rise rapidly, more or less in step with the growth of business earnings. The rapid growth of receipts, coupled with the restrained growth of expenditures, brought the unified budget deficit down to $107 billion in fiscal 1996 from almost $165 billion in fiscal 1995. The deficit as a share of nominal GDP was 1.4 percent, the smallest in more than twenty years.

Federal government debt grew 3¾ percent, the lowest rate in more than two decades. The growth of federal debt was held down in 1996 by legislative constraints on spending and by the boost to tax receipts from both the stronger economy and a booming stock market.

The aggregate consumption and investment expenditures of state and local governments rose slightly more than 2 percent in real terms over 1996. This gain was about the same as those of the two previous years. Outlays for services, which consist mainly of employee compensation and account for more than two-thirds of all state and local purchases, rose roughly 1½ percent in real terms. Investment expenditures, which make up the next biggest portion of state and local purchases, rose about 4½ percent, according to preliminary data. In the aggregate, the budget picture for state and local governments was relatively stable in 1996, as the surplus of nominal receipts over nominal current expenditures changed little from the positive readings of other recent years.

Two years of contraction of state and local government debt ended in 1996. The declines had occurred as issues that were pre-refunded earlier in the decade, when interest rates were unusually favorable, matured or became eligible to be called. Pre-refunded debt continued to be called in 1996, albeit at a reduced pace, but this decline was just offset by gross issuance, which picked up. ■

Depository Credit and the Monetary Aggregates

The growth of credit supplied to the economy by depository institutions slowed in 1996, in part because of a shift to greater caution in making loans to consumers but also because of favorable conditions for selling loans in the securities markets. Shifts in the way that banks financed their credit growth in 1996 translated into an increased rate of expansion of M3. Growth of M2 also picked up, rising at a pace close to that of nominal GDP, but M1 contracted as sweep arrangements continued to expand.

Depository Credit

The slower expansion of depository credit in 1996 entirely reflected a slower advance in bank credit. Growth at thrift institutions picked up, benefiting from strong demand for residential mortgages and improved capital positions. Growth of commercial bank loans moderated, as loans to businesses and, especially, consumers decelerated from elevated rates of growth in 1995. Bank portfolio expansion also appears to have been damped somewhat by a faster pace of asset securitization, likely spurred by receptive capital markets. For example, real estate loan growth at banks was a subdued 4 percent, despite a robust housing market and a pickup in commercial real estate. At the same time, outstanding securities backed by mortgage pools expanded nearly $200 billion in 1996, well above the pace of the preceding year. Commercial banks are a major source of securitized mortgages. The outstanding amount of consumer credit that had been securitized by banks also rose at a brisk pace in 1996, although not so rapidly as in 1995. As a result of the slowing of bank credit, the share of the 1996 advance in nonfederal debt that ended up on the books of depositories fell to about 38 percent, down from around 44 percent in the preceding two years.

Banks encountered an increased incidence of repayment problems on loans to consumers in 1996, and charge-off rates on these loans rose to around the peak levels of the last recession, in 1990–91. According to Federal Reserve surveys of senior loan officers, banks had anticipated some deterioration in the quality of their consumer loan portfolios, but they were surprised by its extent. These surveys also showed that banks considered the rate of charge-offs to be high relative to the level of delinquencies and that the credit-scoring models most banks use to evaluate consumer lending decisions have tended to be too optimistic. An important reason for the high level of charge-offs and the apparent shortcomings of the credit-scoring models was a 30 percent increase in personal bankruptcies. This surge stemmed in part from changes in the bankruptcy code that became effective at the beginning of 1996 against a backdrop of an apparently reduced stigma associated with this method of dealing with financial problems. Banks responded to the deterioration in their consumer loan portfolios by tightening standards and terms, especially on credit cards. In contrast, banks eased terms and conditions on home equity loans.

Despite the rise in repayment problems on consumer loans, the balance sheets and operating results of depositories remained strong in 1996. Bank profits were at historically high levels for the fourth consecutive year, a record reflecting the maintenance of relatively wide interest rate margins, further loan growth, and substantial fee income related to sales of mutual funds as well as to securitization and other off-balance-sheet activities. At year-end, almost 99 percent of commercial bank assets were held at banks classified as well capitalized. Underlying thrift profits were also stronger. However, profits at thrift institutions and at banks with deposits insured by the Savings Association Insurance Fund (SAIF) were held down temporarily by a special assessment on deposits to recapitalize SAIF. (Some bank deposits are SAIF-insured because of mergers with thrift institutions or acquisitions of them.)

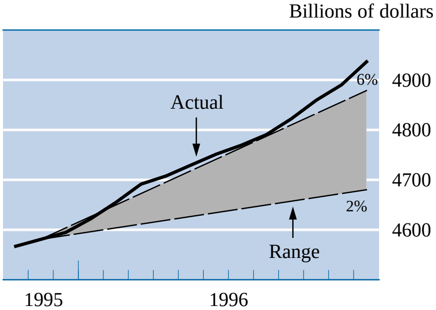
The Monetary Aggregates

The slowing of depository credit notwithstanding, growth of the broader monetary aggregates strengthened in 1996: M3 expanded almost 7 percent, up from the pace of 1995 and above the upper end of its 2 percent to 6 percent annual range. M2 grew 4½ percent, up ½ percentage point from 1995 and in the upper portion of its 1 percent to 5 percent range. The ranges for monetary growth in 1996 had been chosen to be consistent with approximate price stability and a sustainable rate of real economic growth, rather than as indicators of the range of money growth rates likely to prevail under expected economic conditions.

The acceleration of M3 was caused partly by a shift in the way banks financed their credit—specifically, substituting issuance of large time deposits for borrowings from offices abroad. Both foreign and domestically chartered banks paid down net borrowing from foreign head offices and branches in 1996. For domestic banks, this paydown may have been related to the reduction to zero of insurance assessments on deposits, beginning with the last quarter of 1995. In addition, the greater growth of M3 relative to that of M2 reflected the need to fund particularly strong loan growth at U.S. branches and agencies of foreign banks, which do not offer the retail accounts that dominate deposits in M2.

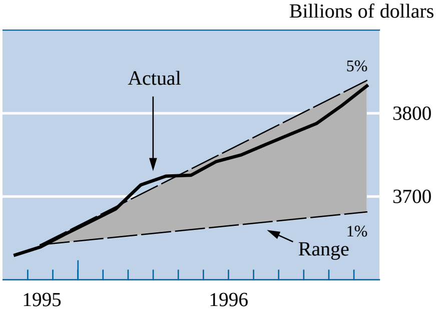
Growth of both M2 and M3 was supported again in 1996 by continuing robust advances in money market

Stock of M3



NOTE. The range was adopted by the FOMC for the period from 1995:Q4 to 1996:Q4.

Stock of M2



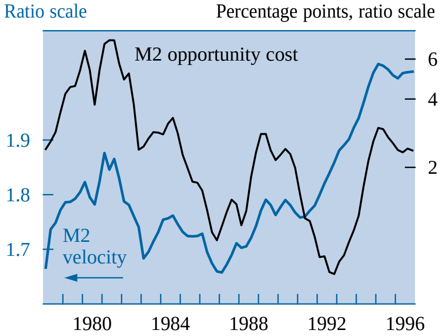
NOTE. The range was adopted by the FOMC for the period from 1995:Q4 to 1996:Q4.

mutual funds (MMMFs). Because the yields on these funds are based on the average return earned on their assets, they lag changes in yields on new market instruments; thus, the funds tend to attract additional inflows when market rates are falling. Accordingly, MMMFs advanced rapidly in the early part of the year, when the monetary easings of December and January pulled down short-term rates, and also later in the year, when short-term rates were again declining. However, these instruments expanded briskly even in the third quarter, when short-term rates were rising, suggesting that part of the attractiveness of MMMFs is the convenience they offer those investors engaged in moving funds in and out of stock and bond mutual funds, which expanded at a record pace last year. In addition, institution-only funds seemed to have considerable success in marketing cash management programs that capture excess cash of corporations and municipalities. Likely reflecting the attractiveness of money market and capital market mutual funds, deposits in M2 actually showed little growth in 1996. Retail deposit growth also may have been damped by a lack of aggressive pricing of deposits on the part of banks, as demand for their loans slipped and they apparently found it cheaper to finance a larger share of loan originations through securitizations and large time deposits.

The behavior of M2 relative to income, as summarized by its income velocity, again bore a fairly systematic relationship to M2's opportunity cost—the return on M2 assets relative to yields available on alternative instruments. The relationship of velocity to opportunity costs was reasonably stable historically, but it broke down in the early 1990s, a period characterized by extensive restructuring of balance sheets by households, businesses, and banks. In the process, M2 velocity rose substantially and, apparently, permanently. Since 1993, velocity no longer appears to be shifting higher, and M2 velocity and opportunity costs are moving together about as they did before 1990. However, the recent period of relative stability in this relationship has been too short for the Federal Reserve to place increased reliance on M2 as a guide to policy.

M1 contracted 4½ percent in 1996, as the pace at which new arrangements were established to sweep reservable retail transactions deposits to nonreservable nontransaction accounts accelerated. The initial amounts removed from transaction accounts by sweep arrangements established during the year amounted to $116 billion, compared with $45 billion in 1995. M1 continued to be supported by currency growth, as foreign demands, which were depressed earlier in the year partly in anticipation of the new $100 bill, picked up in the second half. Adjusted for the initial amounts removed from transaction accounts by sweep arrangements, M1 grew 5¼ percent in 1996. The sweeping of transaction deposits contributed to

M2 Velocity and M2 Opportunity Cost



NOTE. The velocity of M2 is the ratio of nominal gross domestic product to the stock of M2. The opportunity cost of M2 is a two-quarter moving average of the three-month Treasury bill rate less the weighted average return on assets included in M2.

Annual Rate of Change in Reserves, Money Stock, and Debt Aggregates

Percent

Item	1993	1994	1995	1996				
				Year	Q1	Q2	Q3	Q4
Depository institution reserves[1]								
Total	12.2	–1.2	–4.9	–11.4	–7.9	–6.4	–16.4	–16.9
Nonborrowed plus extended credit	12.2	–1.5	–4.9	–11.4	–6.5	–7.6	–17.6	–16.0
Required	12.5	–1.1	–5.2	–11.7	–8.5	–5.7	–16.6	–18.3
Monetary base[2]	10.4	8.4	4.1	3.8	1.5	3.0	5.4	5.1
Concepts of money[3]								
M1	10.6	2.5	–1.6	–4.6	–3.5	–1.4	–6.5	–7.3
Currency	10.2	10.2	5.4	5.7	2.7	4.4	7.6	7.7
Demand deposits	13.5	.7	1.4	2.7	8.6	8.7	–.9	–5.5
Other checkable deposits	8.6	–1.8	–10.5	–23.1	–23.1	–19.5	–29.8	–29.4
M2	1.3	.6	4.0	4.6	5.3	4.5	3.4	5.0
Non-M1 components	–2.6	–.3	6.7	8.8	9.3	7.0	7.7	10.2
Savings (including MMDAs)	2.9	–4.3	–3.2	11.7	13.9	10.4	8.4	12.1
Small denomination time deposits	–10.6	2.4	15.4	1.3	1.2	–1.8	2.2	3.8
Retail money market mutual funds	–.8	7.6	18.7	17.1	14.6	16.3	16.3	17.2
M3	1.1	1.7	6.2	6.9	6.6	6.4	5.4	8.4
Non-M2 components	*	6.6	15.3	15.5	11.7	13.9	12.7	20.4
Large-denomination time deposits	–6.5	7.3	16.1	17.6	9.9	14.7	16.4	25.5
Institution-only money market mutual funds	–2.4	–4.9	24.0	19.8	21.4	12.1	20.6	19.8
Repurchase agreements	23.4	13.4	5.7	4.1	2.8	16.2	–4.7	2.1
Eurodollars	–1.6	23.4	12.2	17.4	11.8	11.0	8.7	34.7
Domestic nonfinancial sector debt	5.2	5.2	5.5	5.4	5.0	5.8	5.3	5.0
Federal	8.4	5.7	4.4	3.8	3.0	4.7	3.8	3.2
Nonfederal	4.0	5.1	5.9	6.0	5.7	6.2	5.8	5.6

NOTE. Changes for quarters are calculated from the average amounts outstanding in each quarter. Changes for years are measured from Q4 to Q4. Based on seasonally adjusted data.

1. Data on reserves and the monetary base incorporate adjustments for discontinuities associated with regulatory changes in reserve requirements.

2. The monetary base consists of total reserves; plus the currency component of the money stock; plus, for all quarterly reporters, and for all weekly reporters without required reserve balances, the excess of current vault cash over the amount applied to satisfy current reserve requirements. For further details, see the Federal Reserve's H.3 Statistical Release.

3. M1 consists of currency in circulation excluding vault cash; travelers checks of nonbank issuers; demand deposits at all commercial banks other than those due to depository institutions, the U.S. government, and foreign banks and official institutions, less cash items in the process of collection and Federal Reserve float; and other checkable deposits, which consist of negotiable orders of withdrawal and automatic transfer service accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions.

M2 is M1 plus savings deposits (including money market deposit accounts); small-denomination time deposits (including retail repurchase agreements), from which have been subtracted all individual retirement accounts (IRAs) and Keogh accounts at commercial banks and thrift institutions; and balances in taxable and tax-exempt retail money market mutual funds (money funds with minimum initial investments of less than $50,000), excluding IRAs and Keogh accounts.

M3 is M2 plus large-denomination time deposits at all depository institutions other than those due to money stock issuers; balances in institution-only money market mutual funds (money funds with minimum initial investments of $50,000 or more); wholesale RP liabilities (overnight and term) issued by all depository institutions, net of money fund holdings; and Eurodollars (overnight and term) held by U.S. residents at all banking offices in Canada and the United Kingdom and at foreign branches of U.S. banks worldwide, net of money fund holdings. For further details, see the Federal Reserve's H.6 Statistical Release.

* In absolute value, greater than zero and less than 0.05 percent.

a contraction of almost 12 percent in required reserves—twice the rate of decline of the previous year. The monetary base decelerated only a little, however, as growth of its major component, currency, was little changed between 1995 and 1996.

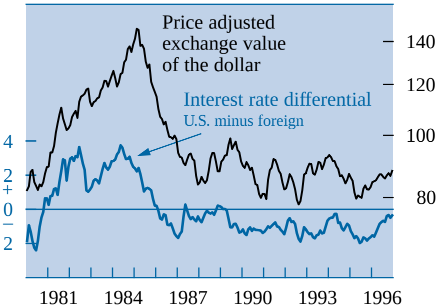
The Federal Reserve continued to monitor sweep activity closely, as persistent declines in the levels of required reserves have the potential to impinge on the Federal Reserve's ability to exert close day-to-day control over the federal funds rate—the overnight rate on reserves traded among depository institutions. Depositories hold balances at Reserve Banks to meet daily clearing needs in addition to satisfying statutory reserve requirements. At low enough levels, reserve balances may provide inadequate protection against adverse clearings, and banks' attempts to avoid overdrafts could generate highly variable daily demands for balances at the Federal Reserve and a volatile federal funds rate. Through 1996, however, no serious problems had emerged, in part because the substantial drop in depositories' required reserve balances attributable to sweeps was partially offset by increases in their holdings of required clearing balances—an arrangement whereby depositories pay for services provided by the Federal Reserve through the holding of specified amounts in reserve account balances. In addition, advances in banks' techniques of monitoring balances at the Federal Reserve and gauging their clearing needs have enabled them to operate efficiently and smoothly at relatively low levels of balances. Sweeps have had an effect on Federal Reserve earnings and the amounts it remits to the Treasury. The decline in reserve balances of about $12 billion attributable to sweeps must be matched by an accompanying lower level of Treasury securities on the books of the Reserve Banks. ■

International Developments

Economic activity picked up in most major foreign industrial countries in 1996, but the pace of expansion, while brisk at times, was generally uneven over the course of the year. Output remained significantly below estimated potential in most countries, and unemployment remained high or even rose in much of Europe and in Canada. These conditions helped keep inflation in check; by the end of the year, the average inflation rate in the major foreign industrial countries was below 2 percent.

Growth in most of the major economies of Latin America rebounded in 1996 as the drag associated with the collapse of the Mexican peso in late 1994 and early 1995 dissipated. Asian countries generally continued to enjoy strong growth, although not as strong as in 1995. While output continued to decline in Russia and Ukraine, the pace of contraction slowed further; most of the other republics of the former Soviet Union showed signs of growth. The countries of Central and Eastern Europe recorded moderate growth in line with the recent average for these economies. In Africa, growth for the region as a whole reached 5 percent, significantly higher than in recent years. Economic activity picked up a bit in the Middle East after several years of relatively slow growth there.

Exchange Value of the Dollar
and Interest Rate Differential



Note. The exchange value of the U.S. dollar is its weighted average exchange value in terms of the currencies of the other G-10 countries using 1972–76 total trade weights. Price adjustments are made using relative consumer prices.

The interest rate differential is the rate of long-term U.S. government bonds minus the weighted-average rate on comparable foreign securities, both adjusted for expected inflation; expected inflation is estimated by a thirty-six month moving average of consumer price inflation using staff forecasts of inflation where needed.

The data are monthly.

The U.S. trade deficit in goods and services widened to $114 billion in 1996 from $105 billion in 1995. Recent movements in the exchange value of the dollar had partly offsetting effects on net trade flows during the year. The appreciation of the dollar that began in 1995 and continued during 1996 began to boost imports and hold down exports of services as the year progressed. Meanwhile, lagged effects of the 1994–95 depreciation of the dollar continued to give a boost to merchandise exports. In addition, with U.S. income growth in 1996 close to the average for the country's major trading partners, U.S. imports increased more than exports, as is typical when increases in income among these countries are similar.

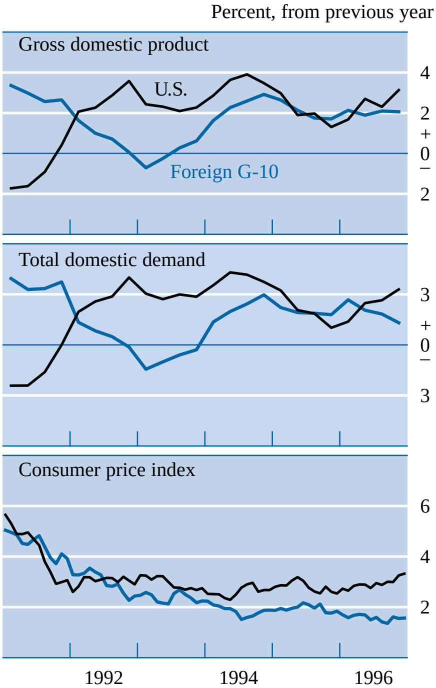
The current account deficit expanded to $165 billion from its 1995 level of $148 billion. As in 1995, a substantial portion of the balancing net capital inflows represented accumulations of foreign official assets in the United States. Recorded holdings of assets in the United States by private foreigners also increased rapidly in 1996, and recorded U.S. private holdings of foreign assets likewise rose substantially. The analysis of capital flows in 1996 is complicated, however, by the statistical discrepancy's wide swing from positive to negative.

The foreign exchange value of the dollar rose about 4 percent on balance in 1996 in terms of a trade-weighted average of the other G-10 currencies.[1] The dollar's appreciation was consistent with the divergence in trends in economic activity in 1996 between the United States and most other major industrial countries. Relatively strong growth here combined with moderate and uneven growth abroad was also reflected in a widening differential between long-term interest rates in the United States and foreign countries. U.S. rates rose about ½ percentage point, while a weighted average of ten-year rates in foreign G-10 countries declined about ¾ percentage point on balance. Generally lower short-term interest rates plus fiscal consolidation, especially in Canada and some parts of Europe, also contributed to the fall in foreign long-term rates.

Foreign Economies

In Germany, domestic demand remained fairly subdued during 1996, but net exports made a strong contribution to growth. Economic activity turned down early in the year because frigid winter weather restricted construction activity; the pace of activity rebounded temporarily in the spring but then slowed sharply at the end of the year. In the United Kingdom, France, and Italy, growth increased after midyear; but late in the year, activity slowed in France and declined in Italy. In Switzerland, economic activity again contracted over the course of the year. Growth remained sluggish in Canada over the first half of the year but increased substantially thereafter, partly in response to robust U.S. growth. In Japan, an exceptionally strong first quarter was followed by two quarters of stagnation, but in the fourth quarter, activity accelerated again. Stimulated by the easy stance of monetary and fiscal policies in recent years, private investment strengthened,

Changes in GDP, Demand, and Prices



Note. Data for the foreign G-10 countries are from national sources. The data are weighted by the countries' 1987–89 GDP as valued after adjusting for differences in the purchasing power of their currencies; GDP and domestic demand are in constant prices.

Data for the United States are from the Departments of Commerce and Labor. GDP and domestic demand are derived from chained (1992) dollars.

For GDP and domestic demand, the data are quarterly; for consumer prices, the data are monthly.

1. The Group of Ten consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

contributing to a rise in domestic demand over the year.

Weak growth in continental Europe contributed to increased slack in the labor market. The unemployment rate rose to post–World War II records in Germany, France, and Switzerland; unemployment also remained high in Italy and Belgium. By contrast, the rate of unemployment continued to decline steadily in the United Kingdom, where expansion has been under way for several years. In Canada, unemployment rose slightly after falling a bit in 1995; labor market conditions appeared to be improving near the end of the year. Japan's unemployment rate rose to a postwar high of 3.5 percent in the second quarter and fell only slightly over the rest of the year.

The deterioration of labor market conditions in several of the major foreign industrial countries reflected sustained or worsened shortfalls of actual output from estimated potential output. With growth at or slightly below its potential rate in Germany, Canada, and France, existing gaps were not narrowed; the discrepancy widened in Italy, where growth was significantly below its potential rate. Persistent output gaps continued to exert downward pressure on inflation rates. On average, consumer price inflation in the foreign G-10 countries continued to decline gradually, reaching about 1¾ percent by the last quarter of 1996. In Italy, the rate of consumer price inflation at the end of the year, 2½ percent, was less than half the year-earlier rate. An exception was the United Kingdom, where growth exceeded the rate estimated to be sustainable, and the underlying inflation rate rose slightly above 3 percent. In Japan, consumer prices were unchanged on balance over the year; the yen's depreciation raised import prices, offsetting ongoing domestic price deflation.

General government budget deficits narrowed further in Canada and the United Kingdom, partly as a result of rising economic activity but also because of fiscal policy changes aimed at reining in structural budget deficits. France also experienced some improvement in its deficit. Despite the Maastricht objective, budget deficits widened in Germany in 1996 to nearly 4 percent of GDP and in Italy to 6¾ percent, mainly as a result of slow growth.[2] In Japan, expansionary fiscal policy continued to widen the deficit significantly.

Long-term interest rates declined in all foreign G-10 countries except the United Kingdom. The drop was consistent with generally subdued economic growth and related downward pressure on inflation rates; fiscal consolidation also contributed where it occurred. Short-term interest rates fell as monetary policy eased in many countries in response to slowing economic activity and declining inflation. In Japan, the rate on three-month certificates of deposit remained at ½ percent to maintain support for economic recovery and to facilitate restructuring in the Japanese financial sector.

The current account surplus in Japan fell to a six-year low, in part because of lagged effects on exports from the yen's appreciation in 1995, but also because higher oil prices and the depreciation of the yen in 1996 raised the cost of imports denominated in dollars. Italy's current account surplus widened; weak domestic demand curbed imports, while exports received a boost from the restraints on labor costs that have improved Italy's international com-

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2. According to the Maastricht Treaty, only those countries that had a general government deficit of 3 percent of GDP or less in 1997 may participate in the European Monetary Union upon its scheduled commencement at the start of 1999.

petitiveness over the past few years. Canada's deficit was almost eliminated, in part because of strong exports to a healthy U.S. economy. The U.K. current account deficit also declined significantly, mostly on account of rising income from British investment abroad.

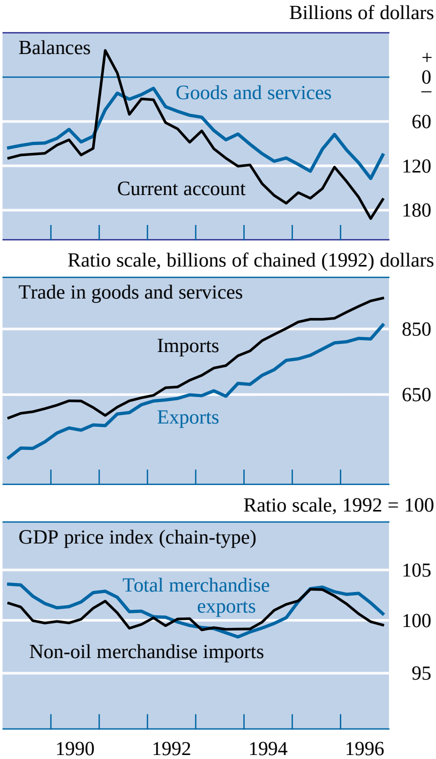
Mexico's economy bounced back from the sharp decline in output associated with the crisis that followed the December 1994 devaluation of the peso. By the end of the year, economic activity had regained the pace achieved before the crisis. With the currency stable and inflation much lower than in 1995—albeit at just under 30 percent—interest rates fell, helping investment and other elements of domestic demand take over from net exports as the driving force in the recovery. Mexico's trade balance remained in moderate surplus, declining somewhat in the second half of the year as imports accelerated and the expansion of non-oil exports slowed. The Argentine and Brazilian economies, which had been adversely affected in 1995 by spillovers from the Mexican crisis, grew at fairly rapid rates in 1996. Monetary tightening and a decline in copper prices slowed growth in Chile from the high rate recorded in 1995. Inflation in Venezuela exceeded 100 percent and, as noted, inflation remained high in Mexico; elsewhere in Latin America, it ranged from zero to 10 percent.

Economies in Asia slowed a bit on average in 1996 after booming in 1995. Earlier monetary tightening in some countries had its intended effect of moderating strong growth. In addition, exports were dampened in many economies by strong appreciation in their exchange rates in terms of the yen and by a generally weak global electronics market. Inflation remained low, ranging from 2 percent in Singapore to 7 percent in China.

U.S. International Transactions

Real imports of goods and services in the United States rose rapidly over the four quarters of 1996, increasing slightly more than 8 percent after expanding about 4 percent in 1995. The pickup in U.S. economic activity boosted the demand for imports, and further impetus came from the dollar's appreciation, which put downward pressure on prices of imported goods other than oil in 1996. Most major categories of merchandise trade showed sizable increases in the volume of imports; oil and semiconductors were the notable exceptions. While rising faster than in

U.S. International Trade



NOTE. The data are from the Department of Commerce; they are quarterly and seasonally adjusted. Data for trade are at annual rates.

1995, imports of services grew less in 1996 than imports of merchandise.

Real exports of U.S. goods and services expanded 7½ percent over the year, about the same pace as in 1995. Merchandise exports were stimulated by the pickup in growth in some important U.S. trading partners and by lingering effects of the dollar's depreciation in 1995. Exports to Mexico accounted for most of the expansion, but exports to Canada, South America, and Asia also increased. Exports to Western Europe were about the same in the fourth quarter of 1996 as they were a year earlier. Receipts from services exports grew more slowly in 1996. Much of the slowdown was in fees and royalties and in receipts from travelers to the United States, spending that was dampened in part by the appreciation of the dollar.

Foreign official assets in the United States increased $122 billion in 1996. A number of countries gained dollar reserves as they attempted to counter the domestic effects of large private capital inflows. In addition, exchange market intervention early in the year increased

U.S. International Transactions

Billions of dollars, seasonally adjusted

Transaction	Year		Quarter				
			1995	1996			
	1995	1996 p	Q4	Q1	Q2	Q3	Q4 p
Goods and services, net	–105	–114	–19	–25	–29	–34	–26
Exports	787	836	204	205	209	206	216
Merchandise	576	612	149	150	153	150	158
Services	211	224	54	55	56	56	57
Imports	892	950	223	230	238	240	242
Merchandise	749	799	187	193	200	202	204
Services	142	150	36	37	37	38	38
Investment income, net	–8	–8	–2	*	–2	–4	–2
Direct investment, net	57	64	15	17	15	15	18
Portfolio investment, net	–65	–73	–17	–16	–17	–19	–21
Unilateral transfers, private and government, net	–35	–42	–9	–11	–9	–9	–13
Current account balance	**–148**	**–165**	**–30**	**–35**	**–41**	**–48**	**–41**
Private capital flows, net	17	89	–10	–21	37	38	36
Bank-related capital, net (outflows, –)	–44	–90	25	–34	2	–34	–23
U.S. net purchases (–) of foreign securities	–99	–105	–33	–34	–20	–23	–27
Foreign net purchases (+) of U.S. securities	195	285	29	48	60	78	99
Treasury securities	99	154	2	12	31	43	67
Corporate and other non-Treasury bonds	82	120	17	33	23	33	31
Corporate stocks	13	12	10	3	6	2	1
Direct investment flows, net (outflows, –)	–35	–4	–29	5	–9	12	–13
U.S. direct investment abroad	96	88	44	23	26	9	30
Foreign direct investment in United States	60	84	15	29	17	21	17
Other corporate capital flows, net	*	3	–3	–6	4	5	n.a.
Foreign official assets in United States (increase, +)	110	122	11	52	14	24	33
U.S. official reserve assets, net (increase, –)	–10	7	*	*	–1	7	*
U.S. government foreign credits and other claims, net	*	–1	*	*	*	*	*
Total discrepancy	32	–53	29	5	–9	–22	–27
Seasonal adjustment discrepancy	0	0	1	7	*	–8	2
Statistical discrepancy	32	–53	28	–2	–9	–13	–29

NOTE. Components may not sum to totals because of rounding.

* In absolute value, greater than zero and less than $500 million.

n.a. Not available. p Preliminary.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

the holdings of certain industrial countries, and higher oil prices boosted the reserves of oil producers.

Recorded foreign private assets in the United States expanded even more rapidly than the record pace of 1995. Private entities abroad made net purchases of U.S. Treasury securities amounting to $154 billion, well in excess of purchases in any other year. Net purchases of U.S. government agency and corporate bonds also surpassed previous sums, reaching $120 billion, much of which represented U.S. borrowing in the Eurobond markets. In contrast, foreign net acquisitions of U.S. stocks were relatively restrained.

U.S. net purchases of foreign securities were also very strong in 1996, but stocks were favored over bonds. Net purchases of stocks in Japan were particularly large in the first half of the year. Equities of firms in Central and South America and in Asia also attracted U.S. investors in 1996, but net purchases in both these regions were still below the peak reached in 1993.

Net capital outflows occurred through banks and security dealers in 1996. With credit issued by banks in the United States slowing, lenders relied less on foreign sources of funds. Repurchase agreements with securities dealers in the United States were used by foreign investors to finance part of their very large net purchases of U.S. Treasury securities, contributing to the outflow.

Foreign direct investment in the United States, swelled by mergers and acquisitions, reached $84 billion in 1996, surpassing the previous record of $68 billion, reached in 1989. U.S. direct investment abroad was also strong although somewhat lower than in 1995. Investments in formerly state-owned enterprises in some foreign countries, along with mergers and acquisitions, contributed to the large outflows.

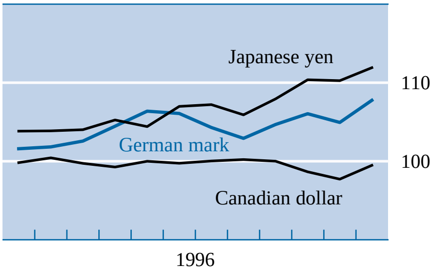
The large negative statistical discrepancy in 1996 contrasts sharply with the sizable positive figure of 1995. A negative discrepancy indicates net omissions or understatements of capital outflows and current account payments.

Foreign Exchange Developments

The dollar appreciated about 7 percent in terms of the mark and the other currencies that were in the European exchange rate mechanism (ERM) throughout the year.[3] The rebound was consistent with growth in the United States exceeding that in continental Europe and with the associated widening of the differential between long-term interest rates in the two regions. Downward pressure on the mark may also have been related to uncertainties stemming from the scheduled introduction in 1999 of a single currency among the initial members of the European Monetary Union. Nonetheless, the prospects of a successful launch seemed to

3. The ERM linked the currencies of Austria, Belgium, Denmark, France, Germany, Ireland, the Netherlands, Portugal, and Spain throughout 1996. In October, the Finnish markka was added, and in November the Italian lira rejoined the ERM after an absence of about four years.

Exchange Value of the Dollar
versus Selected Currencies



NOTE. Foreign currency units per dollar. The data are monthly.

improve in the eyes of market participants, judging by the narrowing of long-term interest rate differentials between Germany and other prospective EMU members.

By contrast, the dollar declined in value versus the pound and the Italian lira. Solid growth in the United Kingdom led to a tightening of monetary policy in late October, which in turn boosted sterling 9 percent. The lira strengthened 4 percent. Inflation in Italy fell to its lowest rate in more than twenty-five years, and prospects emerged for a substantial improvement in the country's fiscal deficit.

With weakness in economic activity persisting in Japan, the yen depreciated 12 percent versus the dollar. Switzerland's recession likewise depressed the Swiss franc, which fell 16 percent in terms of the dollar. The Canadian dollar moved only slightly compared to the U.S. currency over the year.

Adjusted for changes in consumer prices, the dollar declined about 1 percent on average measured against the currencies of eight newly industrializing countries in Latin America and Asia that are major U.S. trading partners.[4] The dollar appreciated 2½ percent in terms of the Mexican peso on a nominal basis, but adjusted for the inflation differential, the dollar depreciated 17 percent. This move was largely offset by the dollar's appreciation of 8 percent versus the Korean won in inflation-adjusted (and nominal) terms.

4. The countries are Chile, Hong Kong, Korea, Malaysia, Mexico, the Philippines, Singapore, and Taiwan.

Foreign Exchange Operations

U.S. authorities did not intervene in foreign exchange markets in 1996. Reported net purchases of dollars by major foreign central banks were $46 billion in 1996, about $20 billion less than in the year before. In January the Bank of Mexico made a final payment of $650 million on its 1995 Federal Reserve swap drawing.

At the end of the year, the System held $19,264 million of marks and yen valued at current exchange rates. With the dollar's appreciation versus both currencies in 1996, the cumulative valuation gains on System foreign currency holdings declined $1,668 million. In the absence of transactions in foreign currency, the System realized no gains or losses. ■