Economic and financial developments in 2000 essay

ECONOMIC AND FINANCIAL DEVELOPMENTS IN 2000

The expansion of U. S. economic activity maintained considerable momentum through the early months of 2000 despite the firming in credit markets that has occurred over the past year. Only recently has the pace of real activity shown signs of having moderated from the extremely rapid rate of increase that prevailed during the second half of 1999 and the first quarter of 2000. Real GDP increased at an annual rate of 5-1/2 percent in the first quarter of 2000. Private domestic final sales, which had accelerated in the second half of 1999, were particularly robust, rising at an annual rate of almost 10 percent in the first quarter. Underlying that surge in domestic spending were many of the same factors that had contributed to the con-siderable strength of outlays in the second half of 1999. The ongoing influence of substantial increases in real income and wealth continued to fuel consumer spend-ing, and business investment, which continues to be undergirded by the desire to take advantage of new, cost-saving technologies, was further buoyed by an accel-eration in sales and profits late last year. Export demand posted a solid gain during the first quarter while imports rose even more rapidly to meet booming domestic demand. The available data, on balance, point to another solid increase in real GDP in the second quarter, although they suggest that private household and business fixed investment spending likely slowed noticeably from the extraordinary first-quarter pace. Through June, the expansion remained brisk enough to keep labor utilization near the very high levels reached at the end of 1999 and to raise the factory utilization rate to close to its long-run average by early spring.

Inflation rates over the first half of 2000 were elevated by an additional increase in the price of imported crude oil, which led to sharp hikes in retail energy prices early in the year and again around midyear. Apart from energy, consumer price inflation so far this year has been somewhat higher than during 1999, and some of that acceleration may be attributable to the indirect effects of higher en-ergy costs on the prices of core goods and services. Sustained strong gains in worker productivity have kept increases in unit labor costs minimal despite the per-sistence of a historically low rate of unemployment.

Consumer spending was exceptionally vigorous during the first quarter of 2000. Real personal consumption expenditures rose at an annual rate of 7-3/4 percent, the sharpest increase since early 1983. At that time, the economy was rebounding from a deep recession during which households had deferred discretionary pur-chases. In contrast, the first-quarter surge in consumption came on the heels of two years of very robust spending during which real outlays increased at an annual rate of more than 5 percent, and the personal saving rate dropped sharply.

Outlays for durable goods, which rose at a very fast pace in 1998 and 1999, accelerated during the first quarter to an annual rate of more than 24 percent. Most notably, spending on motor vehicles, which had climbed to a new high in 1999, jumped even further in the first quarter of 2000 as unit sales of light motor vehi-cles soared to a record rate of 18. 1 million units. In addition, households' spending on computing equipment and software rebounded after the turn of the year; some consumers apparently had postponed their purchases of these goods in late 1999 before the century date change. Outlays for nondurable goods posted a solid in-crease of 5-3/4 percent in the first quarter, marked by a sharp upturn in spending on clothing and shoes. Spending for consumer services also picked up in the first quarter, rising at an annual rate of 5-1/2 percent. Spending was quite brisk for a number of non-energy consumer services, ranging from recreation and telephone use to brokerage fees. Also contributing to the acceleration was a rebound in out-lays for energy services, which had declined in late 1999, when weather was unsea-sonably warm.

In recent months, the rise in consumer spending has moderated considerably from the phenomenal pace of the first quarter, with much of the slowdown in out-lays for goods. At an annual rate of 17-1/4 million units in the second quarter, light motor vehicles sold at a rate well below their first-quarter pace. Nonetheless, that level of sales is still historically high, and with prices remaining damped and auto-makers continuing to use incentives, consumers' assessments of the motor vehicle market continue to be positive. The information on retail sales for the April-to-June period indicate that consumer expenditures for other goods rose markedly slower in the second quarter than in the first quarter, at a pace well below the av-erage rate of increase during the preceding two years. In contrast, personal con-sumption expenditures for consumer services continued to rise relatively briskly in April and May.

Real disposable personal income increased at an annual rate of about 3 per-cent between December and May–slightly below the 1999 pace of 3-3/4 percent. However, the impetus to spending from the rapid rise in household net worth was still considerable, labor markets remained tight, and confidence was still high. As a result, households continued to allow their spending to outpace their flow of cur-rent income, and the personal saving rate, as measured in the national income and product accounts, dropped further, averaging less than 1 percent during the first five months of the year.

After having boosted the ratio of household net worth to disposable income to a record high in the first quarter, stock prices have fallen back, suggesting less impetus to consumer spending going forward. In addition, smaller employment gains and the pickup in energy prices have moderated the rise in real income of late. Al-though these developments left some imprint on consumer attitudes in June, house-holds remained relatively upbeat about their prospective financial situation, accord-ing to the results of the University of Michigan Survey Research Center (SRC) sur-vey. However, they became a bit less positive about the outlook for business condi-tions and saw a somewhat greater likelihood of a rise in unemployment over the coming year.

Housing activity stayed at a high level during the first half of this year. Homebuild-ers began the year with a considerable backlog of projects that had developed as the exceptionally strong demand of the previous year strained capacity. As a result, they maintained starts of new single-family homes at an annual rate of 1. 33 million units, on average, through April–matching 1999’s robust pace. Households’ demand for single-family homes was supported early in the year by ongoing gains in jobs and income and the earlier run-up in wealth; those forces apparently were sufficient to offset the effects that higher mortgage interest rates had on the affordability of new homes. Sales of new homes were particularly robust, setting a new record by March; but sales of existing units slipped below their 1999 high. As a result of the continued strength in sales, the homeownership rate reached a new high in the first quarter.

By the spring, higher mortgage interest rates were leaving a clearer mark on the attitudes of both consumers and builders. The Michigan SRC survey reported that households' assessments of home buying conditions dropped between April and June to the lowest level in more than nine years. Survey respondents noted that, besides higher financing costs, higher prices of homes were becoming a factor in their less positive assessment of market conditions. Purchases of existing homes were little changed, on balance, in April and May from the first-quarter average; however, because these sales are recorded at the time of closing, they tend to be a lagging indicator of demand. Sales of new homes–a more current indicator–fell back in April and May, and homebuilders reported that sales dropped further in June. Perhaps a sign that softer demand has begun to affect construction, starts of new single-family homes slipped to a rate of 1-1/4 million units in May. That level of new homebuilding, although noticeably slower than the robust pace that charac-terized the fall and winter period, is only a bit below the elevated level that pre-vailed throughout much of 1998, when single-family starts reached their highest level in twenty years. Starts of multifamily housing units, which also had stepped up sharply in the first quarter of the year, to an annual rate of 390, 000 units, settled back to a 340, 000 unit rate in April and May.

Fueled by robust spending, especially early in the year, the expansion of household debt remained brisk during the first half of 2000, although below the very strong 1999 growth rate. Apparently, a favorable outlook for income and employment, along with rising wealth, made households feel confident enough to continue to spend and take on debt. Despite rising mortgage and consumer loan rates, household debt increased at an annual rate of nearly 8 percent in the first quarter, and pre-liminary data point to a similar increase in the second quarter.

Mortgage debt expanded at an annual rate of 7 percent in the first quarter, boosted by the high level of housing activity. Household debt not secured by real estate–including credit card balances and auto loans–posted an impressive 10 per-cent gain in the first quarter to help finance a large expansion in outlays for con-sumer durables, especially motor vehicles. The moderation in the growth of house-hold debt this year has been driven primarily by its mortgage component: Prelimi-nary data for the second quarter suggest that, although consumer credit likely de-celerated from the first quarter, it still grew faster than in 1999.

Debt in margin accounts, which is largely a household liability and is not in-cluded in reported measures of credit market debt, has declined, on net, in recent months, following a surge from late in the third quarter of 1999 through the end of March 2000. There has been no evidence that recent downdrafts in share prices this year caused serious repayment problems at the aggregate level that might pose broader systemic concerns.

The combination of rapid debt growth and rising interest rates has pushed the household debt-service burden to levels not reached since the late 1980s. Nonetheless, with household income and net worth both having grown rapidly, and employment prospects favorable, very few signs of worsening credit problems in the household sector have emerged, and commercial banks have reported in recent Federal Reserve surveys that they remain favorably disposed to make consumer in-stallment and mortgage loans. Indeed, financial indicators of the household sector have remained mostly positive: The rate of personal bankruptcy filings fell in the first quarter to its lowest level since 1996; delinquency rates on home mortgages and auto loans remained low; and the delinquency rate on credit cards edged down further, although it remained in the higher range that has prevailed since the mid-1990s. However, delinquency rates may be held down, to some extent, by the surge in new loan originations in recent quarters because newly originated loans are less likely to be delinquent than seasoned ones.

The boom in capital spending extended into the first half of 2000 with few indica-tions that businesses' desire to take advantage of more-efficient technologies is diminishing. Real business fixed investment surged at an annual rate of almost 24 percent in the first quarter of the year, rebounding sharply from its lull at the end of 1999, when firms apparently postponed some projects because of the century date change. In recent months, the trends in new orders and shipments of nonde-fense capital goods suggest that demand has remained solid.

Sustained high rates of investment spending have been a key feature shaping the current economic expansion. Business spending on new equipment and software has been propelled importantly by ongoing advances in computer and information technologies that can be applied to a widening range of business processes. The ability of firms to take advantage of these emerging developments has been sup-ported by the strength of domestic demand and by generally favorable conditions in credit and equity markets. In addition, because these high-technology goods can be produced increasingly efficiently, their prices have continued to decline steeply, providing additional incentive for rapid investment. The result has been a signifi-cant rise in the stock of capital in use by businesses and an acceleration in the flow of services from that capital as more-advanced vintages of equipment replace older ones. The payoff from the prolonged period during which firms have upgraded their plant and equipment has increasingly shown through in the economy’s improved pro-ductivity performance.

Real outlays for business equipment and software shot up at an annual rate of nearly 25 percent in the first quarter of this year. That jump followed a modest increase in the final quarter of 1999 and put spending for business equipment and software back on the double-digit uptrend that has prevailed throughout the cur-rent economic recovery. Concerns about potential problems with the century date change had the most noticeable effect on the patterns of spending for computers and peripherals and for communications equipment in the fourth and first quarters; expenditures for software were also affected, although less so. For these catego-ries of goods overall, the impressive resurgence in business purchases early this year left little doubt that the underlying strength in demand for high-tech capital goods had been only temporarily interrupted by the century date change. Indeed, nominal shipments of office and computing equipment and of communication devices registered sizable increases over the April-May period.

In the first quarter, business spending on computers and peripheral equip-ment was up almost 40 percent from a year earlier–a pace in line with the trend of the current expansion. Outlays for communications equipment, however, acceler-ated; the first-quarter surge brought the year-over-year increase in spending to 35 percent, twice the pace that prevailed a year earlier. Expanding Internet usage has been driving the need for new network architectures. In addition, cable companies have been investing heavily in preparation for their planned entry into the markets for residential and commercial telephony and broad-band Internet services.

Demand for business equipment outside of the high-tech area was also strong at the beginning of the year. In the first quarter, outlays for industrial equipment rose at a brisk pace for a third consecutive quarter as the recovery of the manu-facturing sector from the effects of the Asian crisis gained momentum. In addi-tion, investment in farm and construction machinery, which had fallen steadily dur-ing most of 1999, turned up, and shipments of civilian aircraft to domestic custom-ers increased. More recent data show a further rise in the backlog of unfilled or-ders placed with domestic firms for equipment and machinery (other than high-tech items and transportation equipment), suggesting that demand for these items has been well maintained. However, business purchases of motor vehicles are likely to drop back in the second quarter from the very high level recorded at the beginning of the year. In particular, demand for heavy trucks appears to have been adversely affected by higher costs of fuel and shortages of drivers.

Real investment in private nonresidential structures jumped at an annual rate of more than 20 percent in the first quarter of the year after having declined in 1999. Both last year's weakness and this year's sudden and widespread revival are difficult to explain fully. Nonetheless, the higher levels of spending on office build-ings, other commercial facilities, and industrial buildings recorded early this year would seem to accord well with the overall strength in aggregate demand. However, the fundamentals in this sector of the economy are mixed. Available information suggests that property values for offices, retail space, and warehouses have been rising more slowly than they were several years ago. However, office vacancy rates have come down, which suggests that, at least at an aggregate level, the office sec-tor is not overbuilt. The vacancy rate for industrial buildings has also fallen, but in only a few industries, such as semiconductors and other electronic components, are capacity pressures sufficiently intense to induce significant expansion of produc-tion facilities.

The ratio of inventories to sales in many nonfarm industries moved lower early this year. Those firms that had accumulated some additional stocks toward the end of 1999 as a precaution against disruptions related to the century date change seemed to have little difficulty working off those inventories after the smooth transition to the new year. Moreover, the first-quarter surge in final demand may have, to some extent, exceeded businesses' expectations. In current-cost terms, non-auto manufacturing and trade establishments built inventories in April and May at a somewhat faster rate than in the first quarter but still roughly in line with the rise in their sales. As a result, the ratio of inventories to sales, at current cost, for these businesses was roughly unchanged from the first quarter. Overall, the ongo-ing downtrend in the ratios of inventories to sales during the past several years suggests that businesses increasingly are taking advantage of new technologies and software to implement better inventory management.

The swing in inventory investment in the motor vehicle industry has been more pronounced recently. Dealer stocks of new cars and light trucks were drawn down during the first quarter as sales climbed to record levels. Accordingly, auto and truck makers kept assemblies at a high level through June in order to maintain ready supplies of popular models. Even though demand appears to have softened and inventories of a few models have backed up, scheduled assemblies for the third quarter are above the elevated level of the first half.

The economic profits of nonfinancial U. S. corporations posted another solid in-crease in the first quarter. The profits that nonfinancial corporations earned on their domestic operations were 10 percent above the level of a year earlier; the rise lifted the share of profits in this sector's nominal output close to its 1997 peak. Nonetheless, with investment expanding rapidly, businesses' external financ-ing requirements, measured as the difference between capital expenditures and in-ternally generated funds, stayed at a high level in the first half of this year. Busi-nesses' credit demands were also supported by cash-financed merger and acquisi-tion activity. Total debt of nonfinancial businesses increased at a 10-1/2 percent clip in the first quarter, close to the brisk pace of 1999, and available information suggests that borrowing remained strong into the second quarter.

On balance, businesses have altered the composition of their funding this year to rely more on shorter-term sources of credit and less on the bond market, although the funding mix has fluctuated widely in response to changing market con-ditions. After the passing of year-end, corporate borrowers returned to the bond market in volume in February and March, but subsequent volatility in the capital market in April and May prompted a pullback. In addition, corporate bond investors have been less receptive to smaller, less liquid offerings, as has been true for some time.

In the investment-grade market, bond issuers have responded to investors' concerns about the interest rate and credit outlook by shortening the maturities of their offerings and by issuing more floating-rate securities. In the below-investment-grade market, many of the borrowers who did tap the bond market in February and March did so by issuing convertible bonds and other equity-related debt instruments. Subsequently, amid increased equity market volatility and grow-ing investor uncertainty about the outlook for prospective borrowers, credit spreads in the corporate bond market widened, and issuance in the below-investment-grade market dropped sharply in April and May. Conditions in the corpo-rate bond market calmed in late May and June, and issuance recovered to close to its first-quarter pace.

As the bond market became less hospitable in the spring, many businesses evidently turned to banks and to the commercial paper market for financing. Partly as a result, commercial and industrial loans at banks have expanded briskly, even as a larger percentage of banks have reported in Federal Reserve surveys that they have been tightening standards and terms on such loans.

Underscoring lenders' concerns about the creditworthiness of borrowers, the ratio of liabilities of failed businesses to total liabilities has increased further so far this year, and the default rate on outstanding junk bonds has risen further from the relatively elevated level reached in 1999. Through midyear, Moody's In-vestors Service has downgraded, on net, more debt in the nonfinancial business sector than it has upgraded, although it has placed more debt on watch for future upgrades than downgrades.

Commercial mortgage borrowing has also expanded at a robust pace over the first half of 2000, as investment in office and other commercial building strength-ened. Extending last year's trend, borrowers have tapped banks and life insurance companies as the financing sources of choice. Banks, in particular, have reported stronger demand for commercial real estate loans this year even as they have tightened standards a bit for approving such loans. In the market for commercial mortgage-backed securities, yields have edged higher since the beginning of the year.

The incoming information regarding the federal budget suggests that the surplus in the current fiscal year will surpass last year's by a considerable amount. Over the first eight months of fiscal year 2000–the period from

October to May–the uni-fied budget recorded a surplus of about $120 billion, compared with $41 billion dur-ing the comparable period of fiscal 1999. The Office of Management and Budget and the Congressional Budget Office are now forecasting that, when the fiscal year closes, the unified surplus will be around $225 billion to $230 billion, $100 billion higher than in the preceding year. That outcome would likely place the surplus at more than 2-1/4 percent of GDP, which would exceed the most recent high of 1. 9 percent, which occurred in 1951.

The swing in the federal budget from deficit to surplus has been an important factor in maintaining national saving. The rise in federal saving as a percentage of gross national product from -3. 5 percent in 1992 to 3. 1 percent in the first quarter of this year has been sufficient to offset the drop in personal saving that occurred over the same period. As a result, gross saving by households, businesses, and gov-ernments has stayed above 18 percent of GNP since 1997, compared with 16-1/2 percent over the preceding seven years. The deeper pool of national saving, along with the continued willingness of foreign investors to finance our current account deficit, remains an important factor in containing increases in the cost of capital and sustaining the rapid expansion of domestic investment. With longer-run projec-tions showing a rising federal government surplus over the next decade, this source of national saving could continue to expand.

The recent good news on the federal budget has been primarily on the re-ceipts side of the ledger. Nonwithheld tax receipts were very robust this spring. Both final payments on personal income tax liabilities for 1999 and final corporate tax payments for 1999 were up substantially. So far this year, the withheld tax and social insurance contributions on this year's earnings of individuals have also been strong. As a result, federal receipts during the first eight months of the fiscal year were almost 12 percent higher than they were during the year-earlier period.

While receipts have accelerated, federal expenditures have been rising only a little faster than during fiscal 1999 and continue to decline as a share of nominal GDP. Nominal outlays for the first eight months of the current fiscal year were 5-1/4 percent above the year-earlier period. Increases in discretionary spending have picked up a bit so far this year. In particular, defense spending has been running higher in the wake of the increase in budget authority enacted last year. The Con-gress has also boosted agricultural subsidies in response to the weakness in farm income. While nondiscretionary spending continues to be held down by declines in net interest payments, categories such as Medicaid and other health programs have been rising more rapidly of late.

As measured by the national income and product accounts, real federal ex-penditures for consumption and gross investment dropped sharply early this year after having surged in the fourth quarter of 1999. These wide quarter-to-quarter swings in federal spending appear to have occurred because the Department of De-fense speeded up its payments to vendors before the century date change; actual deliveries of defense goods and services were likely smoother. On average, real de-fense spending in the fourth and first quarters was up moderately from the aver-age level in fiscal 1999. Real nondefense outlays continued to rise slowly.

With current budget surpluses coming in above expectations and large surpluses projected to continue for the foreseeable future, the federal government has taken additional steps aimed at preserving a high level of liquidity in the market for its securities. Expanding on efforts to concentrate its declining debt issuance in fewer highly liquid securities, the Treasury announced in February its intention to issue only two new five- and ten-year notes and only one new thirty-year bond each year. The auctions of five- and ten-year notes will remain quarterly, alternat-ing between new issues and smaller reopenings, and the bond auctions will be semi-annual, also alternating between new and smaller reopened offerings. The Treasury also announced that it was reducing the frequency of its one-year bill auctions from monthly to quarterly and cutting the size of the monthly two-year note auctions. In addition, the Treasury eliminated the April auction of the thirty-year inflation-indexed bond and indicated that the size of the ten-year inflation-indexed note of-ferings would be modestly reduced. Meanwhile, anticipation of even larger surpluses in the wake of the surprising strength of incoming tax receipts so far in 2000 led the Treasury to announce, in May, that it was again cutting the size of the monthly two-year note auctions. The Treasury also noted that it is considering additional changes in its auction schedule, including the possible elimination of the one-year bill auctions and a reduction in the frequency of its two-year note auctions.

Early in the year, the Treasury unveiled the details of its previously announced reverse-auction, or debt buyback, program, whereby it intends to retire seasoned, less liquid, debt securities with surplus cash, enabling it to issue more “ on-the-run” securities. The Treasury noted that it would buy back as much as $30 billion this year. The first operation took place in March, and in May the Treasury announced a schedule of two operations per month through the end of July of this year. Through midyear, the Treasury has conducted eight buyback operations, re-deeming a total of $15 billion. Because an important goal of the buyback program is to help forestall further increases in the average maturity of the Treasury's pub-licly held debt, the entire amount redeemed so far has corresponded to securities with remaining maturities at the long end of the yield curve (at least fifteen years).

In the state and local sector, real consumption and investment expenditures regis-tered another strong quarter at the beginning of this year. In part, the unseasona-bly good weather appears to have accommodated more construction spending than usually occurs over the winter. However, some of the recent rise is an extension of the step-up in spending that emerged last year, when real outlays rose 5 percent after having averaged around 3 percent for the preceding three years. Higher fed-eral grants for highway construction have contributed to the pickup in spending. In addition, many of these jurisdictions have experienced solid improvements in their fiscal conditions, which may be allowing them to undertake new spending initiatives.

The improving fiscal outlook for state and local governments has affected both the issuance and the quality of state and local debt. Borrowing by states and municipalities expanded sluggishly in the first half of this year. In addition to the favorable budgetary picture, rising interest rates have reduced the demand for new capital financing and substantially limited refunding issuance. Credit upgrades have outnumbered downgrades by a substantial margin in the state and local sector.

The deficits in U. S. external balances have continued to get even larger this year. The current account deficit reached an annual rate of $409 billion in the first quarter of 2000, or 4-1/4 percent of GDP, compared with $372 billion and 4 per-cent in the second half of 1999. Net payments of investment income were a bit less in the first quarter than in the second half of last year owing to a sizable increase in income receipts from direct investment abroad. Most of the expansion in the current account deficit occurred in trade in goods and services. In the first quar-ter, the deficit in trade in goods and services widened to an annual rate of $345 billion, a considerable expansion from the deficit of $298 billion recorded in the second half of 1999. Trade data for April suggest that the deficit may have in-creased further in the second quarter.

U. S. exports of real goods and services rose at an annual rate of 6-1/4 per-cent in the first quarter, following a strong increase in exports in the second half of last year. The pickup in economic activity abroad that began in 1999 continued to support export demand and partly offset negative effects on price competitiveness of U. S. products from the dollar’s past appreciation. By market destination, U. S. exports to Canada, Mexico, and Europe increased the most. By product group, ex-port expansion was concentrated in capital equipment, industrial supplies, and con-sumer goods. Preliminary data for April suggest that growth of real exports re-mained strong.

The quantity of imported goods and services continued to expand rapidly in the first quarter. The increase in imports, at an annual rate of 11-3/4 percent, was the same in the first quarter as in the second half of 1999 and reflected both the continuing strength of U. S. domestic demand and the effects of past dollar appre-ciation on price competitiveness. Imports of consumer goods, automotive products, semiconductors, telecommunications equipment, and other machinery were particu-larly robust. Data for April suggest that the second quarter got off to a strong start. The price of non-oil goods imports rose at an annual rate of 1-3/4 percent in the first quarter, the second consecutive quarter of sizable price increases follow-ing four years of price declines; non-oil import prices in the second quarter posted only moderate increases.

A number of developments affecting world oil demand and supply led to a fur-ther step-up in the spot price of West Texas intermediate (WTI) crude this year, along with considerable volatility. In the wake of the plunge of world oil prices dur-ing 1998, the Organization of Petroleum Exporting Countries (OPEC) agreed in early 1999 to production restraints that, by late in the year, restored prices to their 1997 level of about $20 per barrel. Subsequently, continued recovery of world de-mand, combined with some supply disruptions, caused the WTI spot price to spike above $34 per barrel during March of this year, the highest level since the Gulf War more than nine years earlier. Oil prices dropped back temporarily in April, but in May and June the price of crude oil moved back up again, as demand was boosted further by strong global economic activity and by rebuilding of oil stocks. In late June, despite an announcement by OPEC that it would boost production, the WTI spot price reached a new high of almost $35 per barrel, but by early July the price had settled back to about $30 per barrel.

Capital flows in the first quarter of 2000 continued to reflect the relatively strong performance of the U. S. economy and transactions associated with global corporate mergers. Foreign private purchases of U. S. securities remained brisk–well above the record pace set last year. In addition, the mix of U. S. securities purchased by foreigners in the first quarter showed a continuation of last year’s trend toward smaller holdings of U. S. Treasury securities and larger holdings of U. S. agency and corporate securities. Private-sector foreigners sold more than $9 billion in Treas-ury securities in the first quarter while purchasing more than $26 billion in agency bonds. Despite a mixed performance of U. S. stock prices, foreign portfolio pur-chases of U. S. equities exceeded $60 billion in the first quarter, more than half of the record annual total set last year. U. S. purchases of foreign securities remained strong in the first quarter of 2000.

Foreign direct investment flows into the United States were robust in the first quarter of this year as well. As in the past two years, direct investment in-flows have been elevated by the extraordinary level of cross-border merger and acquisition activity. Portfolio flows have also been affected by this activity. For ex-ample, in recent years, many of the largest acquisitions have been financed by swaps of equity in the foreign acquiring firm for equity in the U. S. firm being ac-quired. The Bureau of Economic Analysis estimates that U. S. residents acquired $123 billion of foreign equities in this way last year. Separate data on market transactions indicate that U. S. residents made net purchases of Japanese equities but sold European equities. The latter sales likely reflect a rebalancing of portfo-lios after stock swaps. U. S. direct investment in foreign economies has also re-mained strong, exceeding $30 billion in the first quarter of 2000. Again, a signifi-cant portion of this investment was associated with cross-border merger activity.

Capital inflows from foreign official sources in the first quarter of this year were sizable–$20 billion, compared with $43 billion for all of 1999. As was the case last year, the increase in foreign official reserves in the United States in the first quarter was concentrated in a relatively few countries. Partial data for the second quarter of 2000 show a small official outflow.

The labor market in early 2000 continued to be characterized by substantial job creation, a historically low level of unemployment, and sizable advances in productiv-ity that have held labor costs in check. The rise in overall nonfarm payroll employ-ment, which totaled more than 1-1/2 million over the first half of the year, was swelled by the federal government’s hiring of intermittent workers to conduct the decennial census. Apart from that temporary boost, which accounted for about one-fourth of the net gain in jobs between December and June, nonfarm payroll em-ployment increased an average of 190, 000 per month, somewhat below the robust pace of the preceding four years.

Monthly changes in private payrolls were uneven at times during the first half the year, but, on balance, the pace of hiring, while still solid, appears to have mod-erated between the first and second quarters. In some industries, such as con-struction, the pattern appears to have been exaggerated by unseasonably high lev-els of activity during the winter that accelerated hiring that typically would have occurred in the spring. After a robust first quarter, construction employment de-clined between April and June; on average, hiring in this industry over the first half of the year was only a bit slower than the rapid pace that prevailed from 1996 to 1999. However, employment gains in the services industry, particularly in business and health services, were smaller in the second quarter than in the first while job cutbacks occurred in finance, insurance, and real estate after four and one-half years of steady expansion. Nonetheless, strong domestic demand for consumer dur-ables and business equipment, along with support for exports from the pickup in economic activity abroad, led to a leveling off in manufacturing employment over the first half of 2000 after almost two years of decline. And, with consumer spending brisk, employment at retail establishments, although fluctuating widely from month to month, remained generally on a solid uptrend over the first half.

The supply of labor increased slowly in recent years relative to the demand for workers. The labor force participation rate was unchanged, on average, at 67. 1 percent from 1997 to 1999; that level was just 0. 6 percentage point higher than at the beginning of the expansion in 1990. The stability of the participation rate over the 1997-99 period was somewhat surprising because the incentives to enter the workforce seemed powerful: Hiring was strong, real wages were rising more rapidly than earlier in the expansion, and individuals perceived that jobs were plentiful. However, the robust demand for new workers instead led to a substantial decline in unemployment, and the civilian jobless rate fell from 5-1/4 percent at the beginning of 1997 to just over 4 percent at the end of 1999.

This year, the labor force participation rate ratcheted up sharply over the first four months of the year before dropping back in recent months as employ-ment slowed. The spike in participation early this year may have been a response to ready availability of job opportunities, but Census hiring may also have temporarily attracted some individuals into the workforce. On net, growth of labor demand and supply have been more balanced so far this year, and the unemployment rate has held near its thirty-year low of 4 percent. At midyear, very few signs of a signifi-cant easing in labor market pressures have surfaced. Employers responding to vari-ous private surveys of business conditions report that they have been unable to hire as many workers as they would like because skilled workers are in short supply and competition from other firms is keen. Those concerns about hiring have per-sisted even as new claims for unemployment insurance have drifted up from very low levels in the past several months, suggesting that some employers may be mak-ing workforce adjustments in response to slower economic activity.

Reports by businesses that workers are in short supply and that they are under pressure to increase compensation to be competitive in hiring and retaining employ-ees became more intense early this year. However, the available statistical indica-tors are providing somewhat mixed and inconsistent signals of whether a broad ac-celeration in wage and benefit costs is emerging. Hourly compensation, as measured by the employment cost index (ECI) for private nonfarm businesses, increased sharply during the first quarter to a level more than 4-1/2 percent above a year earlier. Before that jump, year-over-year changes in the ECI compensation series had remained close to 3-1/2 percent for three years. However, an alternative measure of compensation per hour, calculated as part of the productivity and cost series, which has shown higher rates of increase than the ECI in recent years, slowed in the first quarter of this year. For the nonfarm business sector, compen-sation per hour in the first quarter was 4-1/4 percent higher than a year earlier; in the first quarter of 1999, the four-quarter change was 5-1/4 percent.

Part of the acceleration in the ECI in the first quarter was the result of a sharp step-up in the wage and salary component of compensation change. While higher rates of straight-time pay were widespread across industry and occupational groups, the most striking increase occurred in the finance, insurance, and real es-tate industry where the year-over-year change in wages and salaries jumped from about 4 percent for the period ending in December 1999 to almost 8-1/2 percent for the period ending in March of this year. The sudden spike in wages in that sec-tor could be related to commissions that are tied directly to activity levels in the industry and, thus, would not represent a lasting influence on wage inflation. For other industries, wages and salaries accelerated moderately, which might appear plausible in light of reports that employers are experiencing shortages of some types of skilled workers. However, the uptrend in wage inflation that surfaced in the first-quarter ECI has not been so readily apparent in the monthly data on aver-age hourly earnings of production or nonsupervisory workers, which are available through June.

Although average hourly earnings increased at an annual rate of 4 percent be-tween December and June, the June level of hourly wages stood 3-3/4 percent higher than a year earlier, the same as the increase between June 1998 and June 1999.

While employers in many industries appear to have kept wage increases mod-erate, they may be facing greater pressures from rising costs of employee bene-fits. The ECI measure of benefit costs rose close to 3-1/2 percent during 1999, a percentage point faster than during 1998; these costs accelerated sharply further in the first quarter of this year to a level 5-1/2 percent above a year earlier. Much of last year's pickup in benefit costs was associated with faster rates of increase in employer contributions to health insurance, and the first-quarter ECI figures indicated another step-up in this component of costs. Private survey information and available measures of prices in the health care industry suggest that the upturn in the employer costs of health care benefits is associated with both higher costs of health care and employers' willingness to offer attractive benefit packages in order to compete for workers in a tight labor market. Indeed, employers have been reporting that they are enhancing compensation packages with a variety of benefits in order to hire and retain employees. Some of these offerings are included in the ECI; for instance, the ECI report for the first quarter noted a pickup in supple-mental forms of pay, such as overtime and nonproduction bonuses, and in paid leave. However, other benefits cited by employers, including stock options, hiring and re-tention bonuses, and discounts on store purchases, are not measured in the ECI. The productivity and costs measure of hourly compensation may capture more of the non-wage costs that employers incur, but even for that series, the best es-timates of employer compensation costs are available only after business reports for unemployment insurance and tax records are tabulated and folded into the an-nual revisions of the national income and product accounts.

Because businesses have realized sizable gains in worker productivity, com-pensation increases have not generated significant pressure on overall costs of pro-duction. Output per hour in the nonfarm business sector posted another solid ad-vance in the first quarter, rising to a level 3-3/4 percent above a year earlier and offsetting much of the rise in hourly compensation over the period. For nonfinancial corporations, the subset of the nonfarm business sector that excludes types of businesses for which output is measured less directly, the 4 percent year-over-year increase in productivity held unit labor costs unchanged.

With the further robust increases in labor productivity recently, the average rise in output per hour in the nonfarm business sector since early 1997 has stepped up further to 3 percent from the 2 percent pace of the 1995-97 period. What has been particularly impressive is that the acceleration of productivity in the past several years has exceeded the pickup in output growth over the period and, thus, does not appear to be simply a cyclical response to more rapidly rising demand. Rather, businesses are likely realizing substantial and lasting payoffs from their investment in equipment and processes that embody the technological advances of the past several years.

Rates of increase in the broader measures of prices moved up further in early 2000. After having accelerated from 1 percent during 1998 to 1-1/2 percent last year, the chain-type price index for GDP–prices of goods and services that are produced domestically–increased at an annual rate of 3 percent in the first quar-ter of this year. The upswing in inflation for goods and services purchased by con-sumers, businesses, and governments has been somewhat greater: The chain-type price index for gross domestic purchases rose at an annual rate of 3-1/2 percent in the first quarter after having increased about 2 percent during 1999 and just 3/4 percent during 1998.

The pass-through of the steep rise in the cost of imported crude oil that be-gan in early 1999 and continued into the first half of this year has been the princi-pal factor in the acceleration of the prices of goods and services purchased. The effect of higher energy costs on domestic prices has been most apparent in indexes of prices paid by consumers. After having risen 12 percent during 1999, the chain-type price index for energy items in the price index for personal consumption ex-penditures (PCE) jumped at an annual rate of 35 percent in the first quarter of 2000; the first-quarter rise in the energy component of the CPI was similar.

Swings in energy prices continued to have a noticeable effect on overall measures of consumer prices in the second quarter. After world oil prices dropped back temporarily in the spring, the domestic price of motor fuel dropped in April and May, and consumer prices for energy, as measured by the CPI, retraced some of the first-quarter increase. As a result, the overall CPI was little changed over the two months. However, with prices of crude oil having climbed again, the bounce-back in prices of motor fuel led to a sharp increase in the CPI for energy in June. In addition, with strong demand pressing against available supplies, consumer prices of natural gas continued to rise rapidly in the second quarter. In contrast to the steep rise in energy prices, the CPI for food has risen slightly less than other non-energy prices so far this year.

Higher petroleum costs also fed through into higher producer costs for a number of intermediate materials. Rising prices for inputs such as chemicals and paints contributed importantly to the acceleration in the producer price index for intermediate materials excluding food and energy from about 1-3/4 percent during 1999 to an annual rate of 3-1/2 percent over the first half of this year. Upward pressure on input prices was also apparent for construction materials, although these have eased more recently. Prices of imported industrial supplies also picked up early this year owing to higher costs of petroleum inputs.

Core consumer price inflation has also been running a little higher so far this year. The chain-type price index for personal consumption expenditures other than food and energy increased at an annual rate of 2-1/4 percent in the first quarter compared with an increase of 1-1/2 percent during 1999. Based on the monthly es-timates of PCE prices in April and May, core PCE price inflation looks to have been just a little below its first-quarter rate. After having risen just over 2 percent be-tween the fourth quarter of 1998 and the fourth quarter of 1999, the CPI exclud-ing food and energy increased at an annual rate of 2-1/4 percent in the first quar-ter of 2000 and at a 2-3/4 percent rate in the second quarter. In part, the rise in core inflation likely reflects the indirect effects of higher energy costs on the prices of a variety of goods and services, although these effects are difficult to quantify with precision. Moreover, prices of non-oil imported goods, which had been declining from late 1995 through the middle of last year, continued to trend up early this year.

The pickup in core inflation, as measured by the CPI, has occurred for both consumer goods and services. Although price increases for nondurable goods excluding food and energy moderated, prices of consumer durables, which had fallen between 1996 and 1999, were little changed, on balance, over the first half of this year. The CPI continued to register steep declines for household electronic goods and computers, but prices of other types of consumer durables have increased, on net, so far this year. The rate of increase in the prices of non-energy consumer services has also been somewhat faster; the CPI for these items increased at an annual rate of 3-1/2 percent during the first two quarters of this year compared with a rise of 2-3/4 percent in 1999. Larger increases in the CPI measures of rent and of medical services have contributed importantly to this acceleration. Another factor has been a steeper rise in airfares, which have been boosted in part to cover the higher cost of fuel.

In addition to slightly higher core consumer price inflation, the national in-come and product accounts measure of prices for private fixed investment goods shows that the downtrend in prices for business fixed investment items has been interrupted. Most notably, declines in the prices of computing equipment became much smaller in the final quarter of last year and the first quarter of this year. A series of disruptions to the supply of component inputs to computing equipment has combined with exceptionally strong demand to cut the rate of price decline for computers, as measured by the chain-type price index, to an annual rate of 12 per-cent late last year and early this year–half the pace of the preceding three and one-half years. At the same time, prices of other types of equipment and software continued to be little changed, and the chain-type index for nonresidential struc-tures investment remained on a moderate uptrend. In contrast, the further upward pressure on construction costs at the beginning of the year continued to push the price index for residential construction higher; after having accelerated from 3 percent to 3-1/2 percent between 1998 and 1999, this index increased at an annual rate of 4-1/4 percent in the first quarter of 2000.

Although actual inflation moved a bit higher over the first half of 2000, in-flation expectations have been little changed. Households responding to the Michi-gan SRC survey in June were sensitive to the adverse effect of higher energy prices on their real income but seemed to believe that the inflationary shock would be short-lived. The median of their expected change in CPI inflation over the com-ing twelve months was 2. 9 percent. Moreover, they remained optimistic that infla-tion would remain at about that rate over the longer run, reporting a 2. 8 percent median of expected inflation during the next five to ten years. In both instances, their expectations are essentially the same as at the end of 1999, although the year-ahead expectations are above the lower levels that had prevailed in 1997 and early 1998.

Conditions in markets for private credit firmed on balance since the end of 1999. Against a backdrop of continued economic vitality in the United States and a tighter monetary policy stance, private borrowing rates are higher, on net, particu-larly those charged to riskier borrowers. In addition, banks have tightened terms and standards on most types of loans. Higher real interest rates–as measured based on inflation expectations derived from surveys and from yields on the Treas-ury's inflation-indexed securities–account for the bulk of the increase in interest rates this year, with short-term real rates having increased the most. Rising mar-ket interest rates and heightened uncertainties about corporate prospects, espe-cially with regard to the high-tech sector, have occasionally dampened flows in the corporate bond market and have weighed on the equity market, which has, at times, experienced considerable volatility. Through mid-July, the broad-based Wilshire 5000 equity index was up approximately 3 percent for the year.

As the year began, with worries related to the century date change out of the way, participants in the fixed-income market turned their attention to the signs of con-tinued strength in domestic labor and product markets, and they quickly priced in the possibility of a more aggressive tightening of monetary policy. Both private and Treasury yields rose considerably. In the latter part of January, however, Treasury yields plummeted, especially those on longer-dated securities, as the announced de-tails of the Treasury's debt buyback program and upwardly revised forecasts of federal budget surpluses led investors to focus increasingly on the prospects for a diminishing supply of Treasury securities. A rise in both nominal and inflation-indexed Treasury yields in response to strong economic data and tighter monetary policy in April and May was partly offset by supply factors and by occasional safe haven flows from the volatile equity market. Since late May, market interest rates have declined as market participants have interpreted the incoming economic data as evidence that monetary policy might not have to be tightened as much as had been previously expected. On balance, while Treasury bill rates and yields on shorter-dated notes have risen 15 to 80 basis points since the beginning of the year, intermediate- and long-term Treasury yields have declined 5 to 55 basis points. In the corporate debt market, by contrast, bond yields have risen 10 to 70 basis points so far this year.

Forecasts of steep declines in the supply of longer-dated Treasuries have combined with tighter monetary policy conditions to produce an inverted Treasury yield curve, starting with the two-year maturity. In contrast, yield curves else-where in the U. S. fixed-income market generally have not inverted. In the interest rate swap market, for instance, the yield curve has remained flat to upward sloping for maturities as long as ten years, and the same has been true for yield curves for the most actively traded corporate bonds. Nonetheless, private yield curves are flatter than usual, suggesting that, although supply considerations have played a potentially important role in the inversion of the Treasury yield curve this year, in-vestors' forecasts of future economic conditions have also been a contributing fac-tor. In particular, private yield curves are consistent with forecasts of a modera-tion in economic growth and expectations that the economy will be on a sustainable, non-inflationary track, with little further monetary policy tightening.

The disconnect between longer-term Treasury and private yields as a conse-quence of supply factors in the Treasury market is distorting readings from yield spreads. For instance, taken at face value, the spread of BBB corporate yields over the yield on the ten-year Treasury note would suggest that conditions in the corpo-rate bond market so far in 2000 are worse than those during the financial market turmoil of 1998. In contrast, the spread of the BBB yield over the ten-year swap rate paints a very different picture, with spreads up this year but below their peaks in 1998. Although the swap market is still not as liquid as the Treasury secu-rities market, and swap rates are occasionally subject to supply-driven distortions, such distortions have been less pronounced and more short-lived than those affect-ing the Treasury securities market of late, making swap rates a better benchmark for judging the behavior of other corporate yields.

Aware that distortions to Treasury yields are likely to become more pro-nounced as more federal debt is paid down, market participants have had to look for alternatives to the pricing and hedging roles traditionally played by Treasuries in U. S. financial markets. In addition to interest rate swaps, which have featured prominently in the list of alternatives to Treasuries, debt securities issued by the three government-sponsored housing agencies–Fannie Mae, Freddie Mac, and the Federal Home Loan Banks–have been used in both pricing and hedging. The three housing agencies have continued to issue a substantial volume of debt this year in an attempt to capture benchmark status, and the introduction in March of futures and options contracts based on five- and ten-year notes issued by Fannie Mae and Freddie Mac may help enhance the liquidity of the agency securities market. None-theless, the market for agency debt has been affected by some uncertainty this year regarding the agencies’ special relationship with the government. Both the Treasury and the Federal Reserve have suggested that it would be appropriate for the Congress to consider whether the special standing of these institutions contin-ues to promote the public interest, and pending legislation would, among other things, restructure the oversight of these agencies and reexamine their lines of credit with the U. S. Treasury.

The implementation of monetary policy, too, has had to adapt to the antici-pated paydowns of marketable federal debt. Recognizing that there may be limita-tions on its ability to rely as much as previously on transactions in Treasury securi-ties to meet the reserve needs of depositories and to expand the supply of cur-rency, the FOMC decided at its March 2000 meeting to facilitate until its first meeting in 2001 the Trading Desk’s ability to continue to accept a broader range of collateral in its repurchase transactions. The initial approvals to help expand the collateral pool were granted in August 1999 as part of the Federal Reserve’s ef-forts to better manage possible disruptions to financial markets related to the century date change.

At the March 2000 meeting, the Committee also initiated a study to consider alternative asset classes and selection criteria that could be appropriate for the System Open Market Account (SOMA) should the size of the Treasury securities market continue to decline. For the period before the completion and review of such a study, the Committee discussed, at its May meeting, some changes in the management of the System’s portfolio of Treasury securities in an environment of decreasing Treasury debt. The changes aim to prevent the System from coming to hold high and rising proportions of new Treasury debt issues. They will also help the SOMA to limit any further lengthening of the average maturity of its portfolio while continuing to meet long-run reserve needs to the greatest extent possible through outright purchases of Treasury securities. The SOMA will cap the rollover of its existing holdings at Treasury auctions and will engage in secondary market purchases according to a schedule that effectively will result in a greater percent-age of holdings of shorter-term security issues than of longer-dated ones. The schedule ranges from 35 percent of an individual issue for Treasury bills to 15 per-cent for longer-term bonds. These changes were announced to the public on July 5, replacing a procedure in which all maturing holdings were rolled over and in which coupon purchases were spread evenly across the yield curve.

Major equity indexes have posted small gains so far this year amid considerable volatility. Fluctuations in technology stocks have been particularly pronounced: Af-ter having reached a record high in March–24 percent above its 1999 year-end value–the Nasdaq composite index, which is heavily weighted toward technology shares, swung widely and by mid-July was up 5 percent for the year. Given its surge in the second half of 1999, the mid-July level of the Nasdaq was about 60 percent above its mid-1999 reading. The broader S&P 500 and Wilshire 5000 indexes have risen close to 3 percent since the beginning of the year and are up about 10 percent and 13 percent, respectively, from mid-1999.

Corporate earnings reports have, for the most part, exceeded expectations, and projections of future earnings continue to be revised higher. However, the in-crease in interest rates since the beginning of the year likely has restrained the rise in equity prices. In addition, growing unease about the lofty valuations reached by technology shares and rising default rates in the corporate sector may have given some investors a better appreciation of the risks of holding stocks in general. Reflecting the uncertainty about the future course of the equity market, expected and actual volatilities of stock returns rose substantially in the spring. At that time, volatility implied by options on the Nasdaq 100 index surpassed even the ele-vated levels reached during the financial market turmoil of 1998.

Higher volatility and greater investor caution had a marked effect on public equity offerings. The pace of initial public offerings has fallen off considerably in recent months from its brisk first-quarter rate, with some offerings being can-celed or postponed and others being priced well short of earlier expectations. On the other hand, households' enthusiasm for equity mutual funds, especially those funds that invest in the technology and international sectors, remains relatively high, although it appears to have faded some after the run-up in stock market vola-tility in the spring. Following a first-quarter surge, net inflows to stock funds mod-erated substantially in the second quarter but still were above last year's average pace.

The total debt of the U. S. household, government, and nonfinancial business sectors is estimated to have increased at close to a 5-1/2 percent annual rate in the first half of 2000. Outside the federal government sector, debt expanded at an annual rate of roughly 9-1/2 percent, buoyed by strength in household and business bor-rowing. Continued declines in federal debt have helped to ease the pressure on available savings and have facilitated the rapid expansion of nonfederal debt out-standing: The federal government paid down $218 billion of debt over the first half of 2000, compared with paydowns of $56 billion and $101 billion in the first six months of calendar years 1998 and 1999 respectively.

Depository institutions have continued to play an important role in meeting the strong demands for credit by businesses and households. Adjusted for mark-to-market accounting rules, credit extended by commercial banks rose 11-1/2 per-cent in the first half of 2000. This advance was paced by a brisk expansion of loans, which grew at an annual rate of nearly 13 percent over this period. Bank credit increased in part because some businesses sought bank loans as an alterna-tive to a less receptive corporate bond market. In addition, the underlying strength of household spending helped boost the demand for consumer and mortgage loans. Banks' holdings of consumer and mortgage loans were also supported by a slower pace of securitizations this year. In the housing sector, for instance, the rising in-terest rate environment has kept the demand for adjustable-rate mortgages rela-tively elevated, and banks tend to hold these securities on their books rather than securitize them.

Banks have tightened terms and standards on loans further this year, espe-cially in the business sector, where some lenders have expressed concerns about a more uncertain corporate outlook. Bank regulators have noted that depository insti-tutions need to take particular care in evaluating lending risks to account for possi-ble changes in the overall macroeconomic environment and in conditions in securities markets.

Growth of the monetary aggregates over the first h

Bibliography: