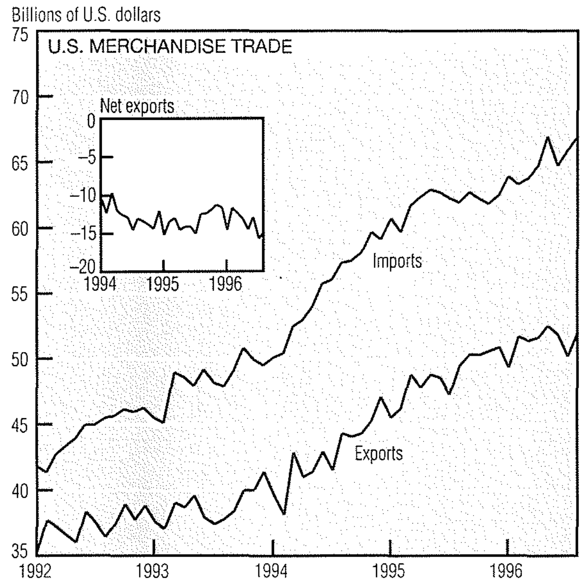
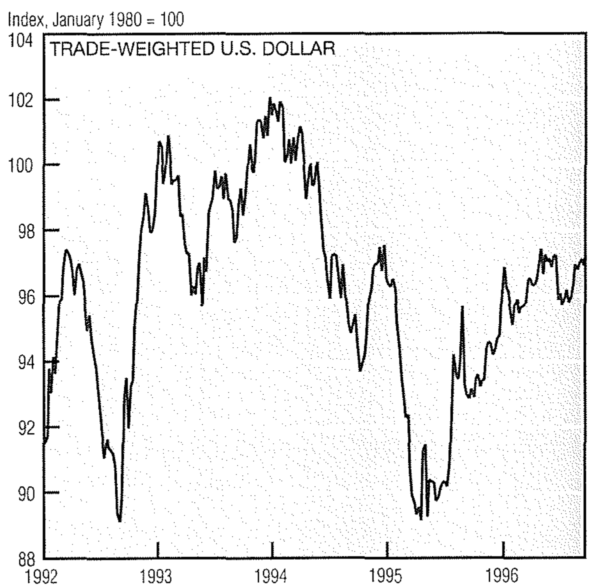
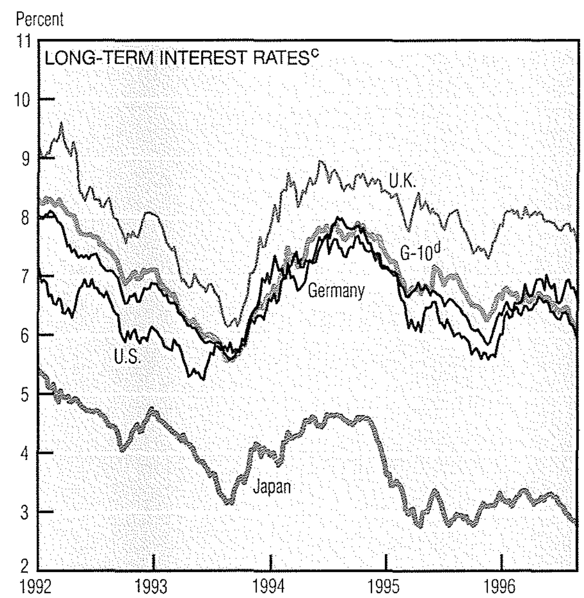
International Developments

Output and Inflation
(Percent change, s.a.a.r.[a])

	Real GDP: 1996:IIQ		CPI: August 1996	
	Year over year	Change from previous quarter	Year over year	Change from previous month
U.S.	2.7	4.7	2.8	0.2
Germany	1.2	6.1	1.8	−0.1
Japan	2.6	−2.9	−0.1	−0.1
Canada	1.2	1.3	2.2	0.1
U.K.	1.7	1.5	3.4	−0.4[b]
France	0.4	−1.5	1.7	−0.3







a. Seasonally adjusted annual rate.
b. Change from June to July 1996.
c. Weekly average of daily rates.
d. The foreign G-10 countries comprise Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the U.K.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; U.S.Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of New York; and Citibank.

The economies of the U.S., Canada, Japan, and their major European trading partners grew at a slow to moderate pace over the past year. The U.S. fared best with an annual growth rate of 2.7%, while France saw the slowest growth at 0.4%.

Consumer prices also appear to be increasing moderately in both the European and North American countries. Inflation over the past year ranged from 1.7% in France to 3.4% in the U.K. The bunching of long-term interest rates from 6% to 7% in these nations suggests that market participants expect long-term inflation to remain in the 3% to 4% range. Consumer prices in Japan were nearly unchanged, falling a slight 0.1% since last year. Japan's long-term interest rate is nearly three percentage points below that of its trading partners, suggesting that consumer price increases will remain relatively low there.

In August, the U.S. trade deficit fell by $0.7 billion, to $15.6 billion. This slight decline was caused by a surge in exports of nearly $1.8 billion. Imports continued their steady march upward, increasing nearly $1 billion. Despite the moderate narrowing in the trade deficit over the past month, the long-term trend toward ever-larger deficits continues. On a trade-weighted basis, the dollar appreciated slightly in mid-October (up 0.3%), remaining little changed from January.

Through the first two quarters of 1996, the U.S. current account deficit was running at a $147 billion annual rate. A country running a current account deficit essentially borrows output from the rest of the world to finance its own consumption and investment. To finance its

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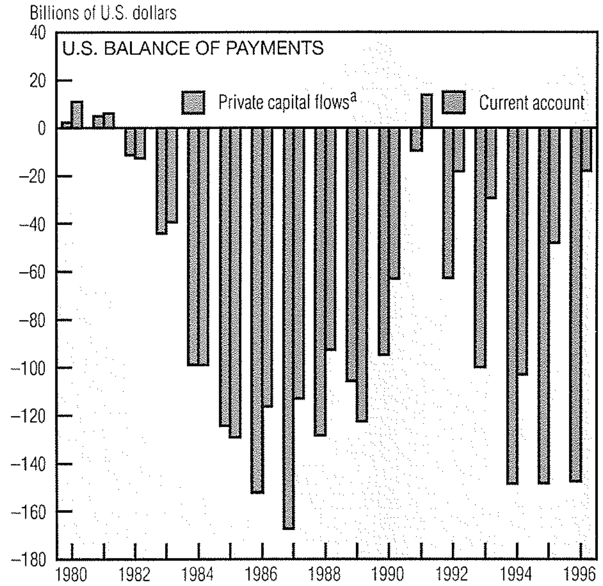
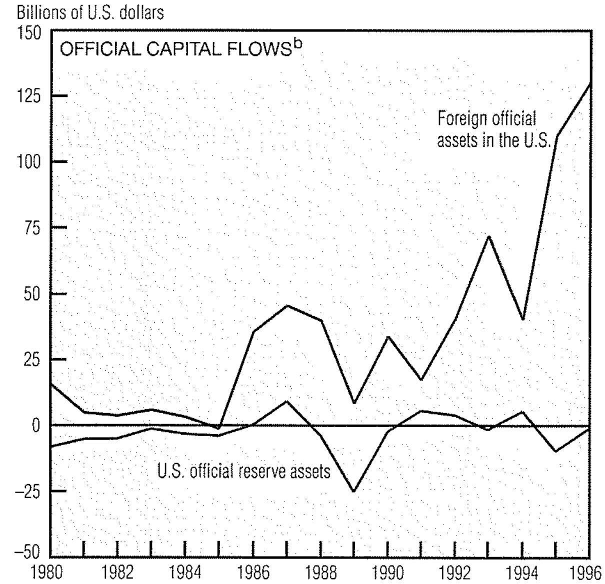
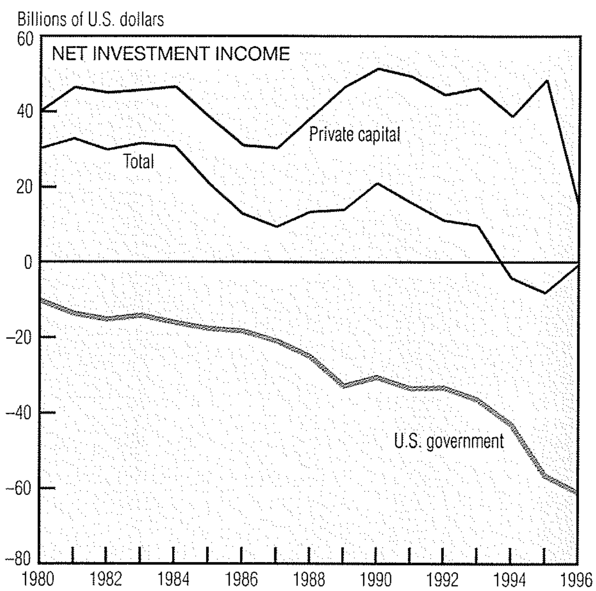
International Developments (cont.)





U.S. Current Account: Saving and Investment
(Percent of GDP)

	1993	1994	1995	1996
Gross saving	14.3	15.2	15.6	16.4
Private	14.7	14.5	14.5	15.1
Government	−0.4	0.7	1.1	1.4
Foreign capital inflow[c]	1.5	2.1	2.0	2.0
Gross domestic investment	16.5	17.7	17.4	17.6
Statistical discrepancy	−0.7	−0.4	0.2	0.8



a. Private capital flows have signs reversed and include the statistical discrepancy as unrecorded capital flows. Positive values represent a capital outflow.
b. Positive values represent a capital inflow.
c. Foreign capital inflows are the current account deficit with the sign reversed.
NOTE: All 1996 data are annualized averages of the first two quarters.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and the Federal Reserve Bank of New York.

imports, the U.S. must export financial assets—claims on our nation's future productivity—resulting in a net inflow of foreign capital. Indeed, a net private capital inflow of $17.8 billion has accompanied this year's buildup in the current account deficit. However, the majority of the requisite net capital inflow has occurred as foreign governments have added $130 billion (annualized) to their official holdings.

A country's ability to service these future claims without suffering a decline in its own standard of living depends on whether it borrows to finance consumption or investment. The dramatic difference between the current account deficit and private capital inflows suggests that our current account deficit is not supporting higher U.S. private investment. Instead, the rate at which foreign governments have added to their holdings of U.S. government securities indicates that our trade deficit is primarily supporting domestic government spending. Whether this results in a decline in our future living standard hinges on whether the increased government borrowing is financing government consumption or investment, such as public infrastructure.

Despite years of increased borrowing from abroad, total net investment income was positive prior to 1994; that is, we earned more from our offshore investments than foreigners earned from their investments in the U.S. Recently, however, the long-awaited payback has started, as total net investment income has turned slightly negative.