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THE PRESIDENT HAS SEEN
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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

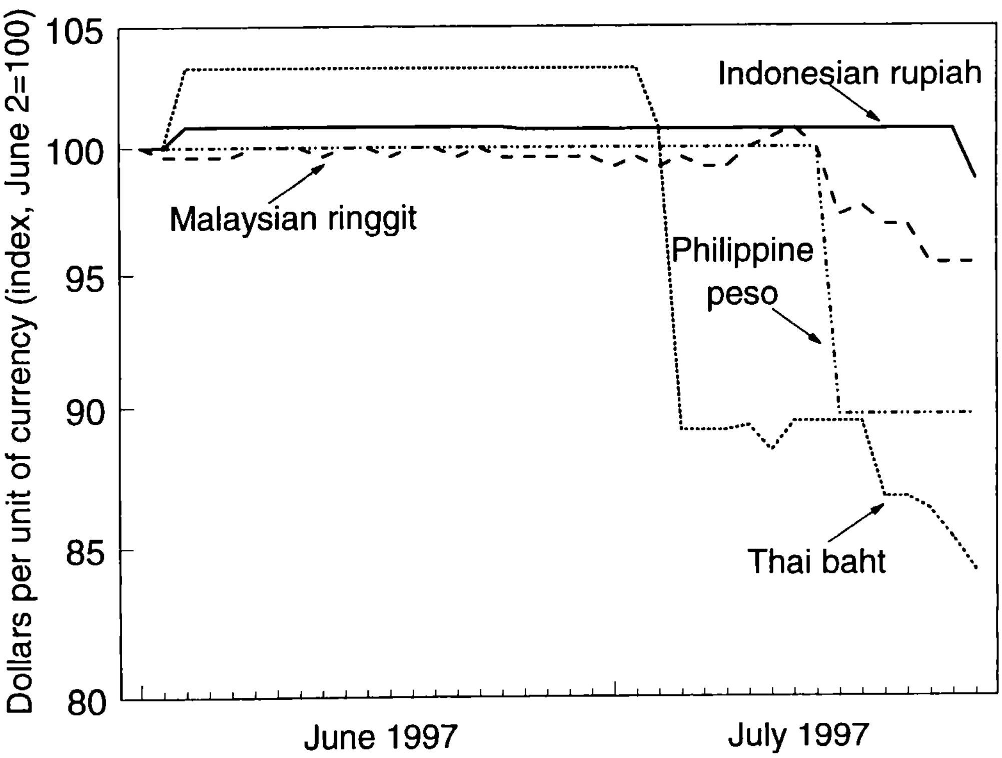
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

July 25, 1997

PHOTOCOPY
WJC HANDWRITING

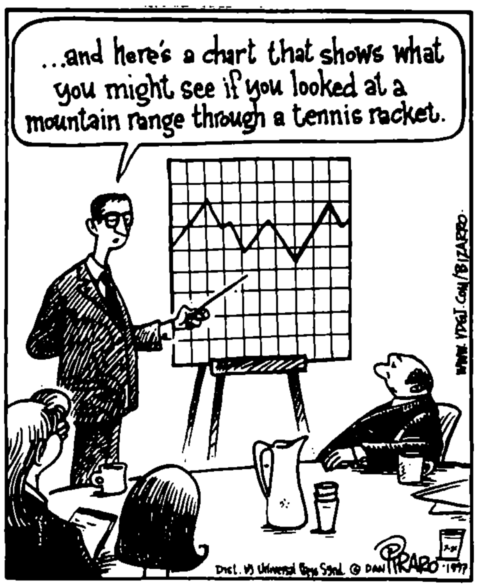
CHART OF THE WEEK

Turmoil in Southeast Asian Currency Markets



This month has seen turmoil in Southeast Asian currency markets. After Thailand's large devaluation, the Philippines and Malaysia followed suit. Even Indonesia has now widened the margins within which its exchange rate is allowed to fluctuate.

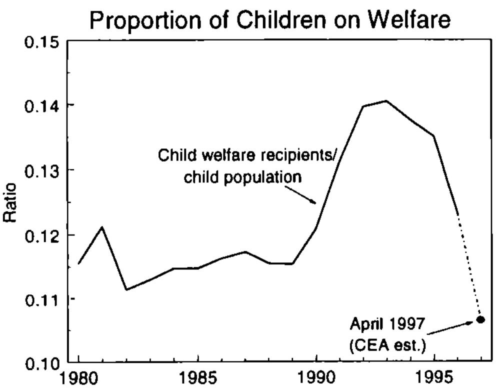
CONTENTS


...and here's a chart that shows what you might see if you looked at a mountain range through a tennis racket.
PIRARO 1997

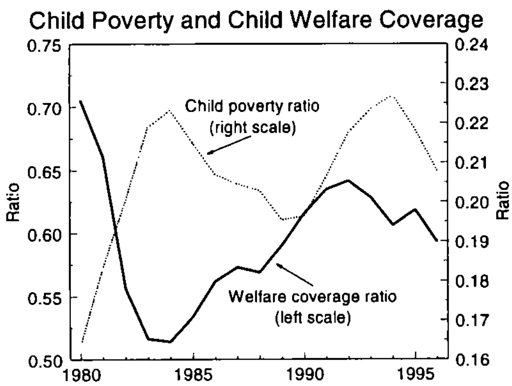
<u>CURRENT DEVELOPMENT</u>

Accounting for the Decline in Children on Welfare

As with the overall caseload, the number of children receiving welfare has fallen dramatically since 1993. The fraction of children on welfare now is smaller than at any time since the early 1970s (see upper chart).



Children in poverty and children on welfare. The ratio of child welfare recipients to all children is the product of two other ratios: The "welfare coverage ratio" (the ratio of children on welfare to all poor children), and the child poverty ratio (the ratio of poor children to all children). Each of these has trended down over the past few years (see lower chart). Data limitations preclude a precise decomposition of the contributions of these two trends to the decline in the ratio of children on welfare to all children. But a rough estimate assigns about 45 percent of the decline between 1993 and 1996 to lower child poverty and 55 percent to decreased welfare receipt among poor children.



Interpretation. It is tempting to attribute the reduction in poverty to the strong economy and the reduction in the welfare coverage ratio to welfare reform. But to the extent that welfare reform has reduced child poverty (for example, by encouraging mothers to work), it may also be responsible for part of the reduction in the caseload associated with falling child poverty. Also, reasons for the sharp drop in the caseload in 1997 remain to be examined (because data are not currently available). Either child poverty has dropped to levels not seen for many years, or welfare receipt among poor children has fallen sharply.

SPECIAL ANALYSIS

Is There a Free Lunch in the Refrigerator?

Economists are typically skeptical of the argument heard in energy policy debates that alternative energy-saving technologies are readily available at no extra cost to consumers. They recognize that people do not always take advantage of cost-effective, energy-efficient technologies that, in the long run, are good for both the pocketbook and the environment. At current energy and product prices, however, many consumers may not be willing to experiment with compact fluorescent light bulbs, improved thermal insulation, better heating and cooling systems, and energy-efficient appliances.

Consumer preferences. Although recent assessments of energy-savings opportunities based on engineering studies suggest that from 20 to 25 percent of existing greenhouse gas emissions could be eliminated at no additional costs, many people resist these new "green" technologies. Why? A reason is that people act as if they have a short time horizon, perhaps because they are uncertain about future energy prices and the reliability of the technology. Several studies have estimated that when consumers buy air conditioners, space-heaters, water-heaters, and refrigerators they implicitly apply a substantial discount to future cost-savings. Their time horizon appears to be much shorter than the time horizon reflected in market interest rates. Even when they are presented with estimates of the likely future cost savings, they pay more attention to immediate outlays.

Moreover, factors other than energy efficiency also matter to consumers. They care about quality and features, as well as the time and effort required to learn about a new technology and how it works. Consumers may perceive a risk that the energy savings will not be realized, and may be averse to such risks. Finally, even if a technology is cost-effective in its energy use on average, it may not be cost-effective for people who use little energy.

Environmental concerns. Why do we care whether people use energy-efficient technologies? A key reason is that the burning of coal and other fossil fuels results in environmental damage and global warming. Improved information about the benefits of buying energy-efficient technologies could affect consumer decisions. For example, the government requires appliance labels to include information about likely energy bills, which allows consumers to make informed choices. The evidence suggests, however, that many people still prefer conventional appliances—at least at current energy prices.

As our experience with the oil shocks of the 1970s shows, choices do change when prices rise. Thus, the economist's view is that the most effective way to curb energy consumption is to raise the price of energy to reflect the harmful effects on the environment of burning fossil fuels.

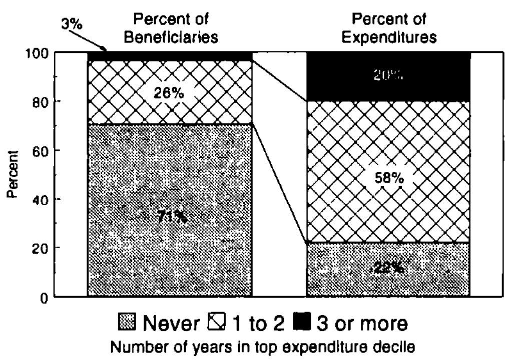
SPECIAL ANALYSIS

Medicare Expenditure Concentration: A Longer-Term View

In any year, Medicare expenditures are highly concentrated among a small group of very high-cost recipients. But the same beneficiaries do not occupy the upper end of the spending distribution year after year, according to a recent study. Many patients either die or recover after receiving high-cost treatment.

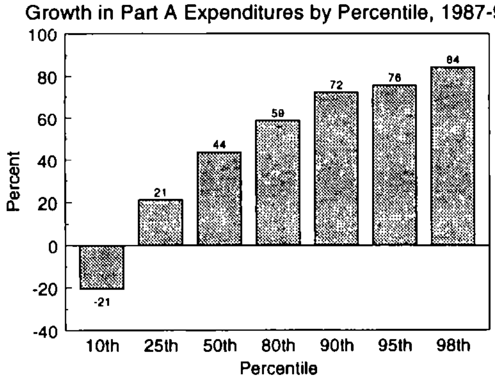
Multi-year evidence. Those few who do stay in the top of the distribution for a number of years (probably because they are chronically ill) use a disproportionate share of services when measured on a multi-year basis. For example, only 3 percent of beneficiaries were in the highest expenditure decile for 3 or more years between 1987 and 1995, but they accounted for about 20 percent of total expenditures over that period. More than half of spending over this period was accounted for by individuals who had high expenditures in only 1 or 2 years (see upper chart).

Concentration of 1987 to 1995 Medicare Expenditures



Growth in expenditures is concentrated at the top. Overall Medicare reimbursements for patients receiving some services rose by about 37 percent between 1987 and 1995. High-cost beneficiaries accounted for a disproportionate share of this increase. Growth at the top of the distribution is particularly striking for Part A (hospital) outlays, reflecting increasing intensity of care and rising costs per hospital admission. Even though the prospective payment system was in place and hospital utilization declined overall, annual expenditures at the 98th percentile of those receiving some Part A services grew 84 percent in real terms between 1987 and 1995, from about $34,000 to almost $63,000 (see lower chart).

Growth in Part A Expenditures by Percentile, 1987-95



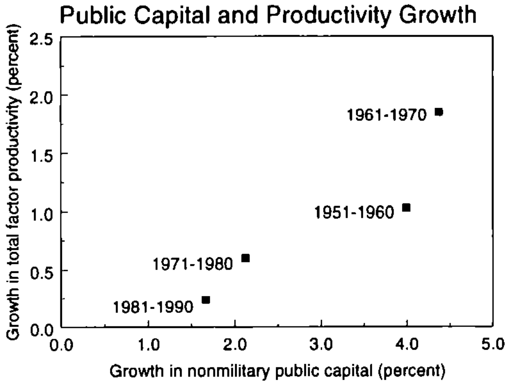
Implications. Although Medicare spending is clearly skewed toward high-cost recipients even over several-year periods, individuals who have very high costs year after year are not responsible for the bulk of spending. As Medicare managed care expands, special attention might be warranted to ensure that this group has access to care without being exposed to unreasonably high financial burdens over many years. Since the majority of spending is for "short-term" high-cost beneficiaries, that may be the best place to look for savings.

ARTICLE

Public Capital and Productivity: Some New Evidence

Historically, periods that have seen faster growth in the stock of nonmilitary government-owned capital have been associated with higher rates of productivity growth (see chart). Two recent studies confirm the relationship between productivity and government capital, finding a significant effect of "core" infrastructure capital—roads, waterworks, and sewers—on private productivity.

Public Capital and Productivity Growth



The first study analyzes whether greater amounts of infrastructure in a state reduce the cost of production for manufacturing firms located in the state. Estimates differ by region but imply that $1 million in infrastructure investment reduces manufacturing costs by $160,000 to $180,000 in most areas.

The second study estimates productivity differences across cities and relate them to cities' stocks of infrastructure capital. It finds that a 1 percent increase in infrastructure raises output by one-tenth of one percent, with road and highway capital providing much of the benefit.

Answering the critics. Virtually all previous research tried to relate a measure of public capital to measures of economic performance such as output or productivity. The new studies seek to address two problems that are associated with this sort of approach. The first is causality. If wealthier communities demand more government spending, then faster productivity and output growth might induce more investment by government, not the other way around. The second is measurement. Previous analyses have had difficulty measuring and controlling for other sources of productivity, such as private capital. The new studies address these problems in different ways and still find relatively significant effects of infrastructure capital on productivity.

The value of additional public investment. Studies indicating a positive relationship between public capital and productivity need to be interpreted carefully. For example, the cost of raising funds for public investment might outweigh any realized productivity gains. In addition, if infrastructure investment in one region causes firms to migrate to that region, then this will reduce the investment's overall benefit once the loss of industry in other regions is taken into account.

On the other hand, it is also possible that existing estimates understate the benefits of public capital. For instance, more and better public capital might improve quality of life, and this is not measured in the national accounts. (One of the new studies does attempt to measure the impact of infrastructure on quality of life—but finds little effect.) In addition, more public capital could actually reduce measured GDP. Suppose, for example, that more potholes mean more broken car axles, and thus more expenditures on auto repairs. Then fixing potholes might actually lower GDP.

Summing up. On balance, existing research indicates that public capital raises private productivity. However, the benefits from public capital are probably smaller than those implied by the earliest, very optimistic studies. It is worth noting, though, that much of the existing literature deals with traditionally defined investment in physical capital, not public investment in a broader sense (for example, government investment in education). In addition, most current research does not assess the efficiency with which infrastructure is used. One recent cross-country study finds that maintaining infrastructure in good condition has a profound impact on the benefits that obtain from its use. This raises the possibility that small investments in upkeep could potentially generate large rewards.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Some State Parks Adopt Business Strategies. Some state parks are turning to business practices as a solution to their financial woes, according to a recent study. Between 1980 and 1994, state park systems experienced a 2.2 percent annual increase in visitation while their total budgets fell 1.5 percent per year in real terms. In 1994, the Texas park system, faced with drastic reductions in state funding, moved to allow parks to keep revenues that exceeded a target amount. Since that time, the number of parks in the Texas system making more than they spend has increased from 6 to 22. Other park systems are experimenting with tactics such as different user fee structures, central reservation systems for camping, and per-person entry fees rather than per-vehicle fees. Currently, 16 state park systems earn at least half their operating funds from fees, and two of those (Vermont and New Hampshire) fund their entire operations out of park-generated revenues.

Will Federal Computers be Ready for the Year 2000? Many computer systems are able to recognize only the last 2 digits of years and will read "00" as 1900 rather than 2000. Last month, the Office of Management and Budget released its first quarterly "Getting Federal Computers Ready for 2000" report, designed to track Federal Government efforts to address this "Year 2000" problem. The report shows that of the approximately 7,500 "mission critical" Federal Government computers that need repair—which include those that handle defense, air traffic control, and income taxes—59 percent are being repaired, 17 percent are being replaced or retired, and 21 percent are already year-2000 compliant. Most government agencies are on schedule, with no mission critical systems being reported behind schedule. Nevertheless, the schedule is very tight with 18 of the 25 agencies with mission critical systems not expected to complete their conversion until the last 3 months of 1999. Total costs of this effort to upgrade computers are estimated at $2.8 billion, although this figure is expected to rise as agencies conclude their internal reviews.

Counterfeit U.S. Money in Abundance Overseas. The stability and worldwide acceptance of U.S. currency have made it a target for international counterfeiters. The Federal Reserve estimates that counterfeit currency may account for up to $30 million of the $215 to $265 billion held abroad at the end of 1996. Of this amount, approximately three-quarters can be accounted for by counterfeit $100 notes. The Treasury Department has begun audits of U.S. currency flows in 18 countries and plans to perform similar audits at 3-year intervals through April 2006. U.S. currency held abroad effectively reduces the need for the government to borrow and thus may lower the government's interest costs by an estimated $10 billion or more annually (see *Weekly Economic Briefing*, December 6, 1996). If confidence in the dollar were undermined, individuals might switch to other currencies, which would reduce this benefit to the United States.

INTERNATIONAL ROUNDUP

Floods Wreak Havoc in Central Europe. Poland, the Czech Republic, Hungary, Slovakia, and Romania continue to suffer from severe flooding. Preliminary reports estimate that the flooding has caused $2.5 billion of damages to Poland, the equivalent of roughly 2 percent of GDP. Flood damage in the Czech Republic could run to as much as $1.5 billion, equivalent to about 3.7 percent of GDP. In response, the European Commission has offered about $568,000 in humanitarian aid to central and eastern European countries.

South Africa's Pension System Benefits the Elderly and Children. With the end of apartheid, the South African pension system was reformed to allow Africans to participate. A recent study examined the effect of the resulting large cash transfers to the African elderly. The "pension" system in South Africa is particularly interesting because the transfers to the poor do not depend on past contributions to the system and are also very large—about twice the size of median per capita income in African households. The study finds that because young children commonly live with an elderly person, they are also likely to benefit from the elderly person's pension. Also, the fraction of children living with a pensioner is highest among children whose household per capita incomes are the lowest, so that the pension not only reaches the households in which children live, but disproportionately reaches children in poverty.

Poverty in Chile Declines. Progress towards combating poverty in Chile has continued with the poverty rate falling to 23.2 percent in 1996, down 4.3 percentage points from 1994. (In Chile, the poverty threshold for a family of five is less than $5,000 per year.) In 1987, the poverty rate in Chile was over 45 percent, and it has steadily fallen in each survey year since. The fraction of the population classified as "indigent" also fell in 1996 to 5.8 percent from 7.6 percent in 1994. Income inequality, however, has changed little over the past 30 years. President Frei credits the poverty reduction to social programs aimed at the poor and also to government policies that have supported economic growth and job creation. The government's strategy for continued poverty eradication is to maintain current policies and to reform primary and secondary education.

IMF Extends Loans to the Philippines. The IMF approved a request by the Philippines to extend about $1 billion in loans to help stabilize the peso, which fell about 12 percent after it was floated on July 11. The loans to the Philippines mark the first time the IMF has used the Emergency Financing Mechanism (EFM). The IMF adopted the EFM after the Mexican peso crisis to insure that it could respond quickly to the needs of a member country facing an external financial crisis.

RELEASES THIS WEEK

Advance Durable Orders

****Embargoed until 8:30 a.m., Friday, July 25, 1997****

Advance estimates show that new orders for durable goods rose 2.3 percent in June, following a decrease of 0.4 percent in May.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Gross Domestic Product (Thursday)
NAPM Report on Business (Friday)
Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1996	1996:3	1996:4	1997:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.1	2.1	3.8	5.9
GDP chain-type price index	5.4	2.1	2.0	1.9	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.9	-0.2	1.3	2.6
Real compensation per hour:					
Using CPI	0.6	0.4	0.8	0.3	2.8
Using NFB deflator	1.3	2.2	2.4	2.8	2.7
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.4	10.6	10.6	10.6
Residential investment	4.5	4.1	4.1	4.1	4.1
Exports	8.2	11.3	11.1	11.5	11.5
Imports	9.2	12.6	12.7	12.6	12.8
Personal saving	5.3	3.6	3.9	3.8	3.5
Federal surplus	-2.7	-1.7	-1.6	-1.4	-1.0

	1970-1993	1996	April 1997	May 1997	June 1997
Unemployment Rate	6.7**	5.4**	4.9	4.8	5.0
Payroll employment (thousands)					
increase per month			327	166	217
increase since Jan. 1993					12538
Inflation (percent per period)					
CPI	5.8	3.3	0.1	0.1	0.1
PPI-Finished goods	5.0	2.8	-0.6	-0.3	-0.1

**Figures beginning 1994 are not comparable with earlier data.

FINANCIAL STATISTICS

	1995	1996	May 1997	June 1997	July 24, 1997
Dow-Jones Industrial Average	4494	5743	7242	7600	8117
Interest Rates					
3-month T-bill	5.49	5.01	5.05	4.93	5.09
10-year T-bond	6.57	6.44	6.71	6.49	6.16
Mortgage rate, 30-year fixed	7.95	7.80	7.94	7.69	7.43
Prime rate	8.83	8.27	8.50	8.50	8.50

INTERNATIONAL STATISTICS

Exchange Rates	Current level July 24, 1997	Percent Change from Week ago	Year ago
Deutschemark-Dollar	1.830	2.1	22.8
Yen-Dollar	116.0	-0.2	7.1
Multilateral $ (Mar. 1973=100)	98.77	1.3	13.9

International Comparisons	Real GDP growth (last 4 quarters)	Unemployment rate	CPI inflation (last 12 months)
United States	4.1 (Q1)	5.0 (Jun)	2.3 (Jun)
Canada	2.8 (Q1)	9.5 (May)	1.4 (May)
Japan	2.6 (Q1)	3.6 (May)	1.9 (May)
France	1.1 (Q1)	13.0 (Mar)	0.9 (May)
Germany	2.8 (Q1)	7.8 (Apr)	1.5 (May)
Italy	-0.4 (Q1)	12.3 (Jan)	1.6 (May)
United Kingdom	3.1 (Q1)	6.9 (May)	2.6 (May)