FOIA Number: 2018-0275-F

FOIA MARKER

This is not a textual record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Collection/Record Group: Clinton Presidential Records

Subgroup/Office of Origin: National Economic Council

Series/Staff Member: Laura D'Andrea Tyson

Subseries:

OA/ID Number: 8926

FolderID:

Folder Title:
[Weekly Economic Briefing 1995] [2]

Stack:	Row:	Section:	Shelf:	Position:
S	18	4	2	2

EYES ONLY

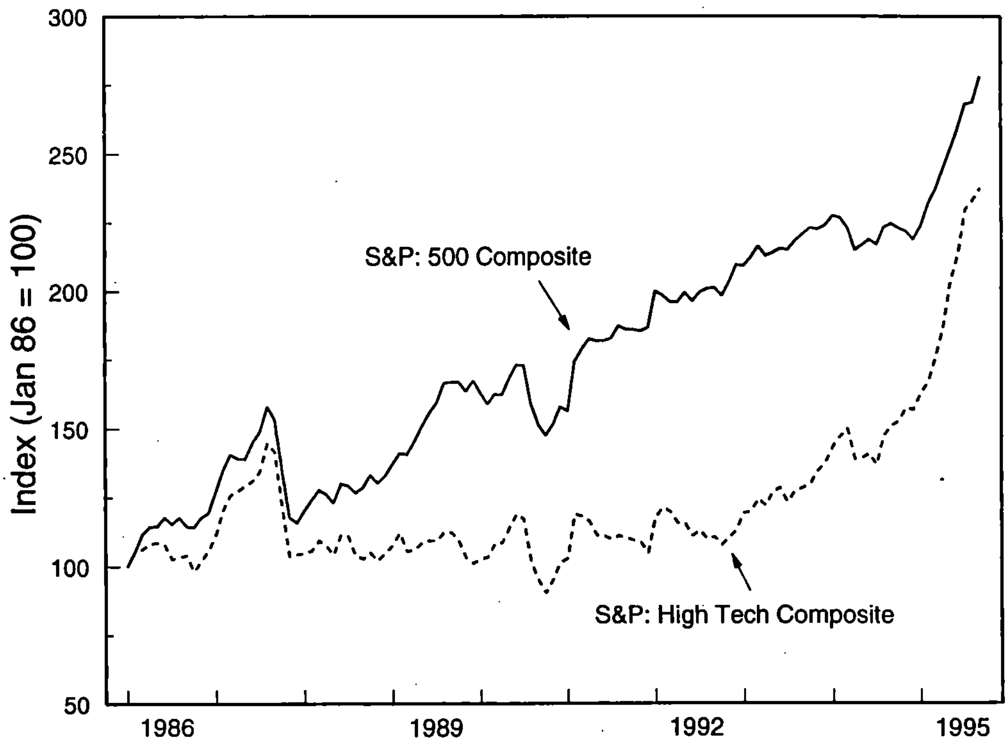
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 27, 1995

CHART OF THE WEEK

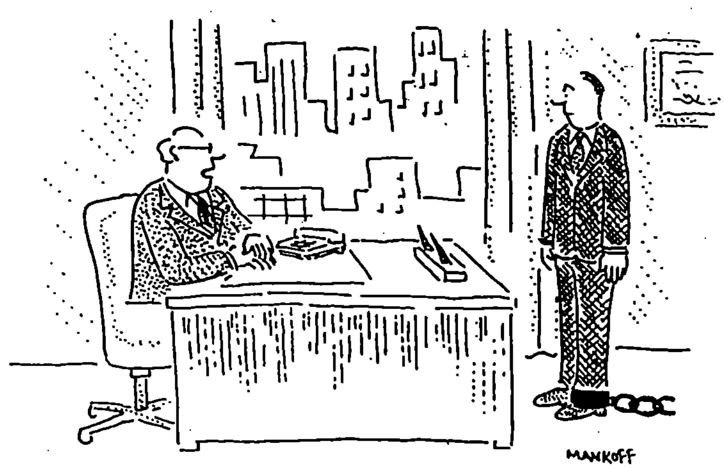
U.S. Stock Prices



The U.S. stock market has increased sharply in value since the end of last year, with most major indexes breaking through record levels. The increase in value has been broad-based, with nearly all major sectors experiencing substantial gains. Stocks of firms in the high technology sector have outpaced the market as a whole, reversing the pattern seen during the late 1980s and early 1990s when these stocks lagged the overall market. A Special Analysis in this issue of the Weekly Economic Briefing discusses recent developments in the stock market.

EYES ONLY

CONTENTS



"Why, Ferber, I'm surprised to find you away from your desk."

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Third Quarter 1995

Real GDP increased at an unexpectedly high rate of 4.2 percent in the third quarter of 1995, according to advance estimates of the Commerce Department. Although most forecasters very recently revised their growth projections upward, forecasts were still in the 2 to 3 percent range. The report indicated very balanced growth: consumption, investment, housing and—at long last—net exports all posted gains. The fixed-weight GDP price index rose at a 2.1 percent annual rate, below its pace earlier this year. The advance estimates are subject to substantial revision. Nevertheless, the estimates of growth and inflation are extraordinarily good, especially given the low level of slack in the economy.

Component	Growth*	Comments
Consumer expenditures on motor vehicles	10.7%	Excess inventories now have largely been worked off, so that cutbacks in auto production should no longer be a factor in restraining growth.
Total consumer expenditures	2.9%	Exceptionally strong expenditures on durable goods, owing in part to falling interest rates.
Producers' durable equipment	9.7%	Investment in equipment -- particularly high-tech equipment -- continues to be the backbone of the expansion.
Housing	10.9%	A robust turnaround in housing, reflecting declines in mortgage rates and a stable and low unemployment rate. This sector was a big factor in second-quarter weakness.
Nonresidential structures	3.5%	A slowing compared to recent rates of growth, but consistent with still-high vacancy rates for commercial buildings.
Inventories (change, billions of 1987$)	$35.3	About the same level of accumulation as in the second quarter; but, not particularly worrisome given strong final sales.
Government purchases	3.1%	An aberrant rebound in Federal purchases (despite a policy-induced downward trend) and steady growth in state and local purchases.
Exports	10.6%	A welcome surge, partly due to a pickup in exports to both Japan and Mexico.
Imports	8.6%	Import growth remained strong but was finally outpaced by export growth.

*Percent real growth in the third quarter at annual rates (except inventories). The advance estimate is subject to substantial revision.

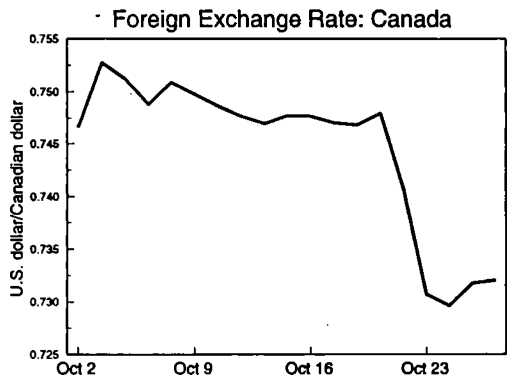
EYES ONLY

CURRENT DEVELOPMENT

Quebec's Referendum: The Economic Impact

Several recent polls indicate a close vote in next Monday's referendum on Quebec independence. Anxiety over the referendum has battered the Canadian stock market (which fell by about 3 percent on Monday), raised long-term interest rates (up 25 basis points from a week ago), and depressed the Canadian dollar (down 2 percent from last week against the U.S. dollar, see chart).

The national economy. Canada faces a variety of challenges in addition to the immediate turmoil surrounding the referendum. After strong growth last year, the economy has slowed significantly, and unemployment, though falling, remains high. The economic slowdown is complicating efforts to reduce the budget deficit, which was 5.3 percent of GDP last year. The withdrawal of Quebec from the union would be an additional disruption.



Budget woes. Quebec already runs a budget deficit of over 2 percent of GDP. The deficit is likely to expand if Quebec secedes (the Federal government transfers more to the province than the province pays to the Federal government). Of particular importance is that Quebec would probably have to assume some share of the Federal government's debt, which is roughly 75 percent of national GDP. If Quebec were assigned a one-quarter share of the Federal debt (roughly equal to its share in both population and output), the interest payments could push its budget deficit to more than 10 percent of GDP.

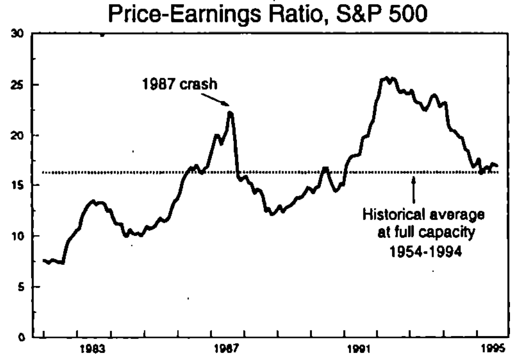
Trade deficit. Quebec's trade deficit (with other provinces and the rest of the world) amounted to 3 percent of GDP in 1990. Interest payments on former Federal debt and possible limits on access to the NAFTA market would magnify the external deficit.

SPECIAL ANALYSIS

How Vulnerable Are We to a Stock Market Crash?

The U.S. stock market has surged this year, increasing 27 percent as measured by the S&P 500 index for its best January-to-September performance since 1987. This rise has caused concern that the market is now overvalued and could drop suddenly by a substantial amount if the government were forced to default on its debt.

Analysis. A rough way to measure whether the stock market is overvalued is to check whether stock prices are high relative to earnings. As the chart shows, the price-earnings ratio for the S&P 500 companies remains well below values reached in 1987 prior to the market crash and about at its historical average for an economy operating at full capacity. At its current level of about 17, the price-earnings ratio is close to that for stock markets in other G-7 countries, except Japan, where it is much higher.



Although the stock market does not presently appear overvalued relative to earnings, fluctuations in stock prices ultimately depend on investor perceptions, which can change swiftly. Hence, some future event could trigger a major drop in the market. In this regard, the crash of 1987 teaches two important lessons:

- The Federal Reserve in 1987 quickly provided funds to financial institutions, supporting the financial system as it teetered near a precipice, thus preventing the market crash from becoming a "systemic" crisis. Although the Fed consistently has said it would act to limit the consequences of any future market collapse, there is always a small chance such a crisis could spread.

- The 1987 crash did not send the economy into recession, although it may have restrained economic growth a bit. The relatively small effects on the economy probably reflected the quick rebound of the stock market and the incipient overheating of the economy, which provided room for a slight drop in growth without causing a downturn. Today, with growth at a more moderate rate and Japanese banks in crisis, the economy likely is at somewhat greater risk from a market collapse, particularly one that spread abroad.

EYES ONLY

TREND

Economic Reform in France: Disappointing Thus Far

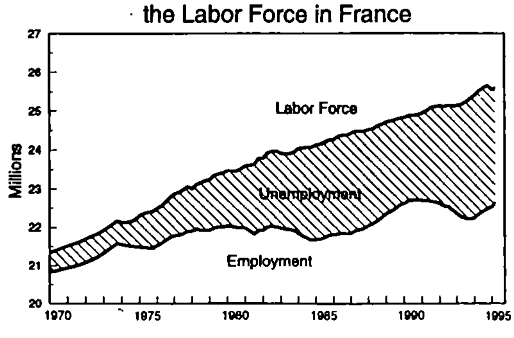
President Chirac, who makes a state visit in early November, has seen a precipitous decline in his government's popularity in its first 5 months in office. When he was elected last May many hoped that he would address the major structural problems that restrain the French economy—a high and potentially exploding budget deficit, very weak employment growth, and high unemployment. So far his government has not lived up to expectations. The substantial rise in value-added and other taxes in July repeated past French practice of responding to fiscal difficulties by raising taxes. The recent firing of his reform-minded finance minister roiled financial markets, and a proposal to freeze public sector salaries resulted in a huge 1-day public sector strike.

Analysis. In fact, Chirac has very little room to maneuver. He is hemmed in on fiscal policy by a budget deficit of 5 percent of GDP, and the need to meet the Maastricht deficit limit of 3 percent. Monetary policy is hostage to the "strong franc" policy of maintaining a stable exchange rate with Germany, which has required interest rates well in excess of German levels. And he has made a set of promises that are in large part contradictory.

The Budget. Increases in social welfare expenditure, a shortfall in tax receipts, and the growing use of tax exemptions to encourage employment have widened the budget deficit this year, but the pension and health-care systems pose the greatest long-term problems. Price controls have actually reduced the relative cost of health care over time, but quantities have risen steadily, leading to a large rise in total costs. Although France has taken some actions to rein in the growth of individual pensions, they are still generous by European standards.

Employment and Unemployment. Very weak employment growth—much of it through government jobs—and continued growth in the labor force has transformed France from a low- to a high-unemployment country (see chart). Unemployment is concentrated among young people, women, and the least-skilled. Generous unemployment benefits and income-support measures have reduced the incentive to seek and accept work, while the high minimum wage level (50 percent of the average wage, versus 37 percent in the United States) probably limits demand for low-skilled workers.

Employment, Unemployment and the Labor Force in France



France has taken some steps to reduce the generosity of its income-support schemes, but an attempt in 1994 to reduce the minimum wage for new entrants to the labor force sparked mass protests and was withdrawn. The government has instead focused on lowering employers' social security contributions for those at the bottom of the wage scale to reduce labor costs. So far, little has been done to modify the complex and rigid rules surrounding hiring and firing that many view as impeding job creation.

Conclusion. Those who had hoped for more ambitious reforms from a President whose political nickname is le bulldozer have so far been disappointed. However President Chirac in a recent speech affirming the sanctity of the social welfare system did stress that the system was in crisis and reform was necessary for its survival. Despite his slow start, he has the advantage of a 7-year term and an institutionally powerful presidency. But the French electorate seems to have little appetite for sweeping reform, and mass protest has recently been an effective blocking tool.

EYES ONLY

ARTICLE

Innovation and Investment: The Twin Sources of Growth

A recent article by Woody Brock examined the "productivity paradox" of the U.S. economy. The article pointed to comparisons of productivity in services and manufacturing that showed the United States in 1987-90 had a higher level of productivity than in Europe and Japan, despite the fact that saving and investment rates in the United States have been much lower than in these countries. In other words, innovation could substitute for investment in generating economic growth.

Innovation: A Key to Growth. The importance of innovation to economic growth has been well documented. Writing before World War II, Josef Schumpeter pointed to the importance of technological change and the "creative destruction" that it induces as new products and processes drive out old ones. In the 1950s, Robert Solow's Nobel-prize winning studies found that about 87 percent of U.S. growth in output per worker during the first half of this century was attributable to technological change and about 13 percent to capital deepening. Subsequent research has confirmed this result. Brock certainly is correct to identify the importance of innovation for productivity growth, especially new "general-purpose technologies" (like the computer) which spawn many subsequent innovations.

The Administration's technology policy is geared towards increasing innovation, particularly in general-purpose technologies. Historically, government funding channelled through the Defense Department has been crucial in many areas, notably the development of the computer and aircraft industries. More recently government funds have supported biotechnology, among the important general-purpose technologies of the future. Government support of basic and pre-commercial technologies helps open up whole new fields.

Investment Can Spur Innovation. While innovation is clearly important for economic growth, we believe investment plays a more important role than the Brock study indicates, especially in helping spur innovation. Productivity studies show that capital investment is usually <u>necessary</u> to achieve best-practice productivity levels. For example, the machine tool industry in Japan invested heavily in new production line equipment as its level of productivity overtook that of the machine tool industry in the United States. Similarly, the food processing industry in the United States is highly mechanized and has much higher productivity than the less-mechanized industry in Japan.

Although frequently a necessary ingredient for productivity improvements, <u>capital investment does not guarantee success</u>. The German metalworking industry in the 1980s invested heavily, but the investment did not pay off because companies did not use their workforces efficiently and did not innovate to take full advantage of the investment. The key point is that <u>innovation, training, and investment work</u>

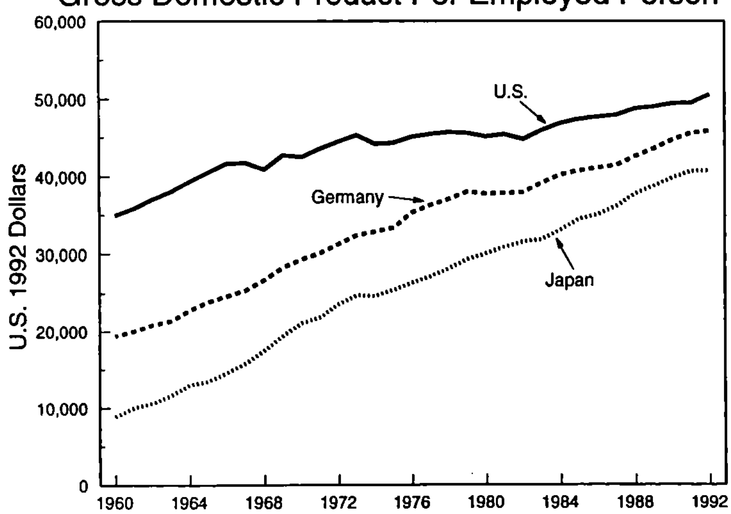
together. Simply adding more of the same type of capital leads to diminishing returns, but innovation often requires access to new capital—new technologies frequently are embodied in new capital equipment.

Investment and Productivity Growth. If capital investment really is important, what explains the paradox that Brock describes? Why does the United States look so good relative to other countries when it has invested so little?

The answer is that the United States got a head start in the race. It had a lot more capital per worker and a much higher level of productivity than other countries back in the 1950s. It has invested enough to stay ahead, but other countries have been catching up (see chart) because the growth of productivity in the United States has been slower than such growth in other countries. (See Weekly Economic Briefing, November 12, 1993 for further discussion of international comparisons of productivity.) If the United States is to maintain its productivity lead it will need to step up its rate of investment.

Looking ahead. Balancing the budget will lower interest rates and encourage investment, although other investment incentives may also be worth considering. In a recent meeting on economic growth between CEA and outside experts, Robert Solow suggested stimulating an investment blitz by incentives, such as a broad-based investment tax credit and accelerated treatment of depreciation for tax purposes. Such incentives would go a long way towards achieving the key to increased growth, which is to combine innovative products, services and production processes with the capital investment and skilled workers needed to take advantage of them.

Gross Domestic Product Per Employed Person



EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Survey Sheds Light on Corporate Job Creation. A study just released by the American Management Association shows that many firms that eliminate jobs also create other ones at the same time. More than half of all surveyed firms added jobs between July 1994 and June 1995, while exactly half eliminated jobs during the same period. However, the share that eliminated more jobs than were added was just 27.3 percent, down from the previous 2 years. The survey found that salaried workers in general, and middle managers in particular, bear the brunt of corporate reductions, at least relative to their shares of the corporate workforce. Unions seem to protect their members: while union members hold 39.5 percent of all jobs in surveyed companies with union shops, only 15.5 percent of eliminated jobs in these companies were union-held. Companies that increased training after downsizing were much more likely than those that did not report increased profits and productivity after 1 year.

Good News on Earnings. Reversing an 8-year trend of decreases, median weekly earnings for full-time male workers rose by 2 percent, according to the Bureau of Labor Statistics. However, median weekly earnings for full-time female workers declined 1.2 percent, causing the female-to-male earnings ratio to fall from 77.9 percent in the third quarter of last year to 75.6 percent in the same quarter this year. Overall, median real weekly earnings of full-time wage and salary workers (age 16 and over) rose to $479, an increase of 1 percent on a quarter-to-quarter basis. Real weekly earnings rose at the bottom of the wage distribution and were essentially unchanged at the top of the wage distribution. On average, the BLS report indicates some better news on the wage front, but the Department of Labor notes that a single quarter's trends should not be given too much weight.

Two Chip Firms Combine to Compete with Intel. In a merger of two leading makers of microprocessors, NexGen, Inc. of Milpitas, CA., has agreed to be acquired by Advanced Micro Devices (AMD) of Sunnyvale, CA. In 1991, AMD introduced a competitor to Intel's 386 chip. While it is difficult to determine the direct impact of competition, the price of 386 chips dropped quickly thereafter. Since then, Intel has introduced the newer and more powerful 486 and 586 (Pentium) chips, and the company is expected to ship its sixth generation chip (the Pentium Pro) next month. In developing ever newer chip generations, Intel has employed a strategy of having multiple production teams simultaneously working on a chip and its successor, while other, smaller firms have been unable to do so. Officials at AMD and NexGen expect their merger to allow them to take this multiple-stage approach, suggesting that the microprocessor industry may be in for greater competition in the years to come.

EYES ONLY

INTERNATIONAL ROUNDUP

A peace dividend for the Israeli economy? The prospects of lasting peace and strong economic growth are encouraging a surge in foreign investment into Israel. Last Friday, the Intel Corporation announced that it will build a new $1.6 billion facility in Israel. But capital inflows such as the Intel investment have complicated monetary policy, which is struggling to contain relatively high inflation without smothering rapid growth (6.5 percent in 1994). The balancing act is delicate, because growth is crucial to absorbing massive flows of immigrants without increasing unemployment. On this front, the Israeli economy has performed quite well: Immigrants have expanded the population by 13 percent since 1990, while the unemployment rate has fallen. The central bank remains worried, however, about high inflation (15 percent in 1994) and a large budget deficit (projected to be 5 percent of GDP this year). Such concerns apparently dominate thinking at the central bank: On Monday, it announced an increase in its discount rate.

Japan's banking-sector troubles continue. Early this week, Standard & Poor reduced Daiwa Bank's long-term credit rating from A minus to BBB. The agency argued that the $1.1 billion in trading losses revealed last month "represent a major setback to the bank." Daiwa's scandal is the most recent example of the problems facing the Japanese banking sector. Bad loans in the banking sector amount to at least 50 trillion yen (more than 10 percent of GDP), and Japanese banks are now generally forced to pay premiums on their international borrowing. The Federal Reserve has agreed to make secured loans to Japanese banks if they require emergency financial assistance. The Japanese government continues to examine ways of addressing the bad loans problem.

Moderate growth and budget intrigue in the UK. According to statistics released on Monday, the U.K. economy grew by an annualized 1.9 percent in the third quarter, in line with market expectations. Analysts continue to speculate over whether the government can afford to include tax cuts in its 1996-7 budget. According to media reports, Chancellor of the Exchequer Kenneth Clarke insists that he will not propose tax cuts unless spending is reduced sufficiently. The general government budget deficit is expected to be 4.9 percent of GDP this year, down from 6.8 percent in 1994.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, October 27, 1995****

According to advance estimates, real gross domestic product grew at an annual rate of 4.2 percent in the third quarter.

Advance Durable Orders

Advance estimates show that new orders for durable goods rose 3.0 percent in September, following an increase of 5.1 percent in August.

MAJOR RELEASES NEXT WEEK

Personal Income (Monday)
Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Leading Indicators (Wednesday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1995:1	1995:2	1995:3
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	2.7	1.3	**4.2**
Chain weights	2.7	3.7	1.7	0.7	**3.0**
GDP implicit price deflator:					
Fixed weights	5.5	2.3	2.2	1.6	**0.6**
Chain weights*	5.4	2.7	2.8	2.2	N.A.
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	2.5	4.8	N.A.
Chain weights	1.4	0.9	0.2	2.9	N.A.
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.0	0.1	N.A.
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.1	N.A.
Chain weights*	1.2	0.7	1.8	1.4	N.A.

* CEA estimates.

	1970–1993	1994	1995:1	1995:2	1995:3
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	**14.1**
Residential investment	4.7	4.3	4.2	4.0	**4.1**
Exports	8.0	12.3	12.9	13.1	**13.3**
Imports	9.2	14.4	15.1	15.4	**15.5**
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	**3.1**
Federal surplus	–2.8	–2.4	–2.1	–1.8	N.A.

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Unemployment Rate	6.7**	6.1**	5.7	5.6	5.6

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

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Payroll employment (thousands)					
increase per month			28	262	121
increase since Jan. 1993					7481
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.1	0.1
PPI-Finished goods	5.0	1.7	0.0	–0.1	0.3

New or revised data in **boldface**.
GDP and related data for third quarter 1995 **embargoed until 8:30 a.m., Friday, October 27, 1995.**

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	Aug. 1995	Sept. 1995	October 26, 1995
Dow-Jones Industrial Average	3522	3794	4639	4747	4704
Interest Rates					
3-month T-bill	3.00	4.25	5.40	5.28	5.22
10-year T-bond	5.87	7.09	6.49	6.20	6.06
Mortgage rate, 30-year fixed	7.33	8.35	7.86	7.64	7.45
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 26, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.403	−0.6	−6.2
Yen-Dollar	101.8	+1.2	+4.9
Multilateral $ (Mar. 1973=100)	83.95	0.0	−1.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**3.3 (Q3)**	5.6 (Sept)	2.5 (Sept)
Canada	2.5 (Q2)	9.6 (Aug)	2.3 (Sept)
Japan	0.6 (Q2)	3.2 (Jul)	−0.3 (Aug)
France	2.9 (Q2)	12.2 (Jul)	2.0 (Sept)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (Jul)	5.8 (Aug)
United Kingdom	2.8 (Q2)	8.7 (Aug)	3.8 (Sept)

U.S. GDP data **embargoed until 8:30 a.m., Friday, October 27, 1995.**

EYES ONLY

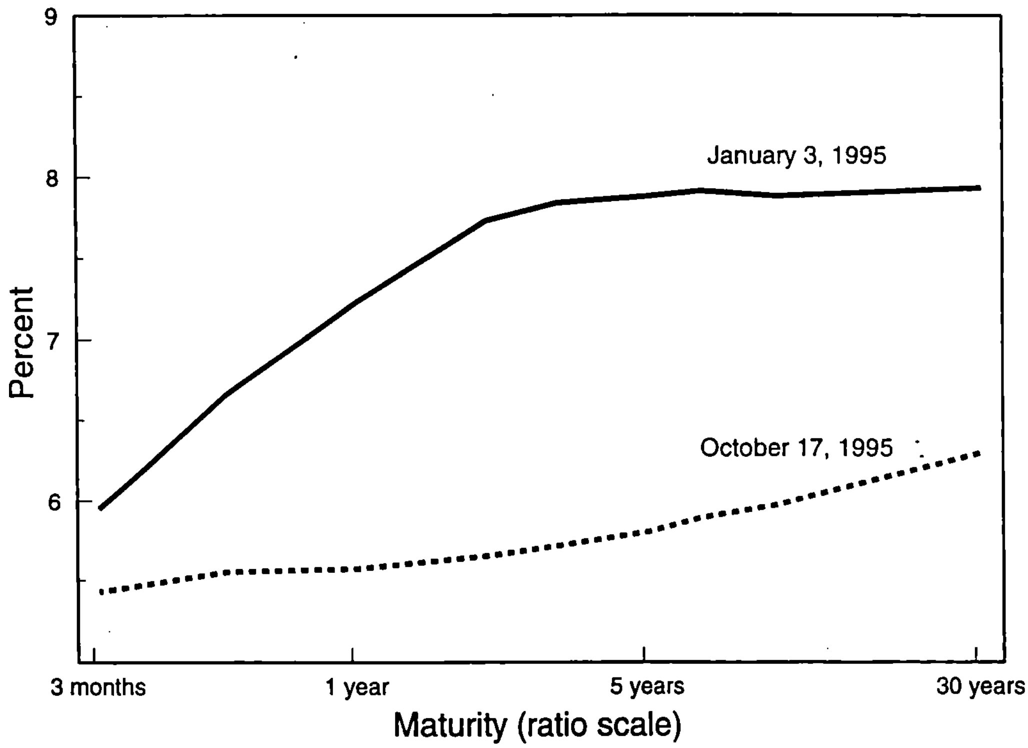
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 20, 1995

CHART OF THE WEEK

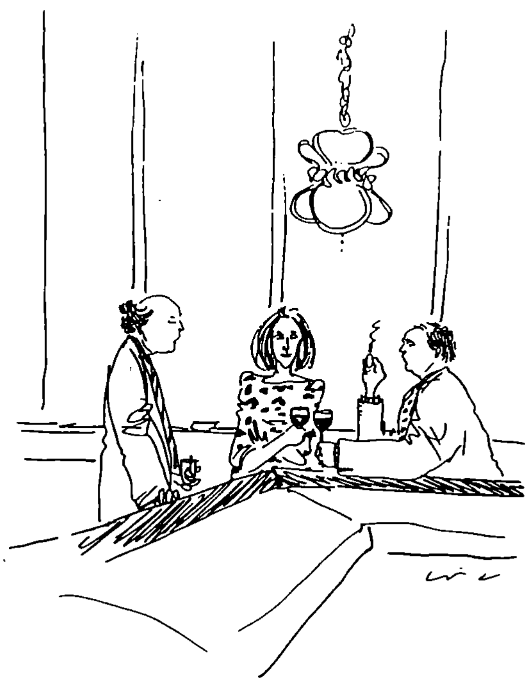
Interest Rates on Treasury Securities



The yield curve for Treasury securities has dropped considerably since the beginning of the year, with the long end falling by much more than the short end. The larger drop in long-term interest rates is consistent with the view that investors expect short-term interest rates to decline. A Special Analysis in this issue of the Weekly Economic Briefing discusses interest rates in more detail.

EYES ONLY

CONTENTS



"I bought on a dip, but there was another dip."

EYES ONLY

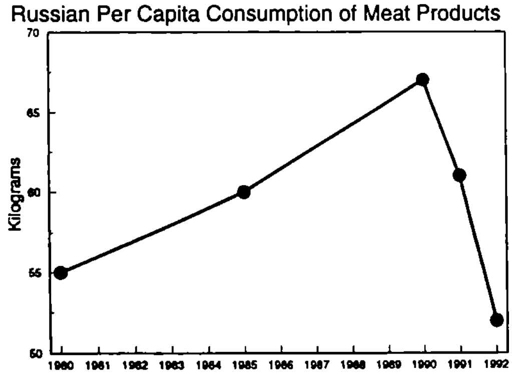
CURRENT DEVELOPMENT

Russian Wheat Production Falls....But So Does Demand

Russian wheat production this year fell 26 percent below last year's level as a result of one of the worst harvests in 30 years. For the states of the former Soviet Union as a whole, the harvest is projected to produce 60 million tons, down from the level of 100 million tons reached in 1990. Although this production shortfall might appear to represent a golden opportunity for U.S. wheat producers, it will not significantly boost U.S. wheat exports because it comes at a time when Russian agricultural reforms are reducing the demand for wheat.

Analysis. In Russia, wheat is used chiefly as a feed grain, so the demand for wheat is tied closely to livestock production. During the Soviet period, subsidies to producers and consumers encouraged overexpansion of the livestock sector. By 1990, per capita consumption of meat and dairy products reached levels as high as those in many Western countries, even though the Soviet Union had a per capita income only half as large. Price distortions were so acute that they encouraged Russian farmers to use bread as cattle feed.

Russian Per Capita Consumption of Meat Products



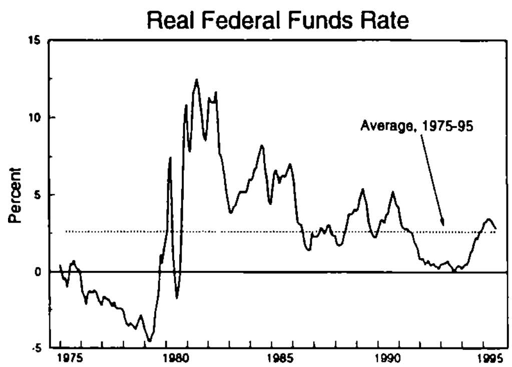
Price increases resulting from market reforms have led Russian consumers to substitute away from more expensive foods, like beef and pork, and toward cheaper foods, such as poultry, bread, and potatoes. Livestock inventories have fallen 20 percent since 1990, and per capita meat consumption fell 22 percent between 1990 and 1992 (see chart). As a result, grain imports have fallen over 70 percent since the late 1980s.

EYES ONLY

SPECIAL ANALYSIS

Are Short-Term Interest Rates Too High?

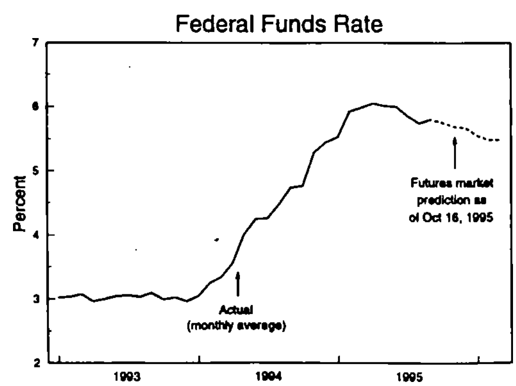
Some observers have argued recently that short-term interest rates are higher than justified by current economic conditions. They claim that high interest rates will constrain economic growth.



Short-term interest rates depend on the current and expected future values of the federal funds rate, which is the rate set by the Federal Reserve on overnight loans among banks. The funds rate, on an inflation-adjusted basis, rose sharply last year, but still remains below the level reached during the economic expansion of the late 1980s and close to its average level over the past twenty years (see chart).

Analysis. Whether or not the funds rate is too high depends on economic conditions. During 1994, as the economy grew rapidly and incipient inflationary pressures developed, some increase in interest rates may have been necessary to return growth to a sustainable pace. This year, with growth moderating and inflation low and stable, a drop in rates may be desirable to keep the economic expansion on track. The Fed did lower its target for the funds rate by 25 basis points in July, but has since held the rate steady. One economic model that relates the funds rate to recent economic conditions shows that the funds rate currently is about 75 basis points higher than predicted, leaving room for a further decline in the funds rate.

Indeed, participants in the futures market for federal funds are betting on a decline in the funds rate of 25 basis points from its current level by January of next year (see chart). Furthermore, some short-term rates have now fallen slightly <u>below</u> the funds rate because investors expect the funds rate to decline. The anticipated decline probably reflects the growing consensus that the Fed will lower rates following agreement by the Administration and Congress on a package to balance the budget. However, if the Fed chooses not to change the federal funds rate, short-term interest rates likely would move back up.



EYES ONLY

ARTICLE

Immigrants, Jobs, and Wages

Concerns about the effects of immigration on jobs and wages in part are driving the push in Congress for legislation to reduce legal immigration, particularly of unskilled workers. These concerns stand in sharp contrast to claims by employers that restricting immigration will exacerbate skill shortages.

Although immigrants accounted for a large share—38 percent—of the increase in the U.S. population over the 1980s, evidence provides little support for negative effects from increased immigration on wages and employment, even for the least-skilled. Nevertheless, any reevaluation of immigration policy should include consideration of favoring skilled immigrants because such individuals contribute valuable information and know-how to the U.S. economy.

Evidence provides little support for conventional wisdom. A majority of Americans—nearly two thirds, according to one poll—believe that new immigrants take jobs away from American workers and drive down wages. Indeed, economic theory asserts that an increase in the supply of labor, unmatched by an increase in demand, should reduce wages or raise unemployment. Numerous recent studies, however, reveal no significant negative impact of increased immigration on the wages and employment of U.S.-born workers at the local level.

A typical study finds that a 10 percent increase in the number of immigrants causes wages in the local area to fall only one to two tenths of a percent. In one particularly striking example, the 1980 Mariel boatlift increased Miami's labor force by 7 percent. Yet employment, unemployment, and wage trends in Miami were no different from those in Los Angeles, Houston, and Atlanta, despite the large influx of mostly-unskilled Cuban workers.

Even if increased immigration does not depress average wages, it might depress the wages of the least-skilled. Immigrants account for roughly 21 percent of the population with less than a high-school education, much higher than their share of the total population. Nevertheless, most evidence at the local level suggests that the wages of less-skilled U.S.-born workers are little affected by recent increases in immigration.

What explains the lack of evidence? A variety of explanations may account for the discrepancy between theory and evidence:

- Established residents may move away from local areas in response to large influxes of immigrants, mitigating downward pressures on local wages and limiting any rise in unemployment. Although the 1980 Census showed substantial outmigration, more recent evidence is mixed. Of course, if resident outmigration explained the absence of local labor-market effects, we might expect to see an impact on national employment and wages. (Although one study suggests that immigration has contributed to the widening of the wage gap between skilled and unskilled workers at the national level, the evidence here remains inconclusive.)

- Immigrants and natives may work in separate segments of the labor market. Studies in Florida show that even 6 years after arriving, 40 percent of Cuban immigrants are employed by Cuban Americans. The segments may be sufficiently different so that rather than competing for jobs, U.S.-born workers and immigrants actually may perform complementary work. Immigrant scientists may specialize in unique technologies and immigrant doctors may specialize in particular diseases, employing knowledge that is specific to their country of origin.

- The absence of adverse effects on employment and wages may reflect an expanding economy, with immigrants contributing to increased demand for goods and services as well as to increased supply of labor. Such an offsetting expansion of demand is completely consistent with economic theory.

Targeting skills to boost competitiveness. Even if immigration has little effect on the wages and employment of low-skilled U.S.-born workers, it may be beneficial to favor high-skilled immigrants because they bring abilities and knowledge that contribute to the growth of the U.S. economy. Indeed, some economists and employers contend that the United States is competing in an international market for immigrants, and our policies should be designed to attract immigrants with high levels of human capital to the U.S. economy.

- The average skill level of immigrants can be increased by favoring employment-based as opposed to family-based or refugee categories of immigrants. In 1980, 60 percent of employed immigrants admitted under employment preferences worked as professionals or managers, compared to 21 percent of employed immigrants admitted under family preferences.

- The skill mix also can be influenced by targeting particular education levels or professions within the employment preference category. Since 1967, Canada has used a point system to allocate immigration in favor of skill and educational attainment. Since Canada implemented this policy, the educational attainment and post-immigration earnings of Canadian immigrants have been higher relative to Canadian natives than have been the education and earnings of U.S. immigrants relative to U.S. natives.

Summary. Although evidence suggests immigrants have little, if any, negative effect on employment and wages of U.S.-born workers, pressure to reassess our immigration policy may persist. In that case, favoring higher-skilled immigrants may be a way to retain the major economic advantages of immigration.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Demographic Study Paints Picture of Single-Parent Families. The Census Bureau reports that single-parent families make up more than 30 percent of American households with children, with most such families headed by women. Single parenthood was particularly prevalent among African Americans: 65 percent of black families were headed by a single parent, compared to 25 percent for whites. These figures represent an enormous increase for both groups since 1970, when only 35 percent of black families and 10 percent of white families were headed by a single parent. About 38 percent of single parents in 1994 had never been married. More than one in five single parents neither owned nor rented their own home, but instead were living with relatives or other acquaintances.

New Product Touted for Prevention of 'Net Theft. A new security system now is available for electronic transactions, according to its manufacturer (Atalla Corp. of San Jose, CA). The large-scale commercial potential of the Internet can be realized only if reliable digital security can be assured. However, security for banks' ATM networks is based exclusively on hardware systems, while data encryption employed by Internet users is software-based. According to the company, the product will serve as a bridge between these systems, allowing sensitive data—like credit card numbers, electronic notarization, or authorization numbers—to be sent securely from any Internet user to any financial institution. The hardware approach allows all decoding to be done within the product's own processor, preventing hackers or electronic pirates from gaining access to a user's electronic keys.

Tight Wheat Stocks Drive up Prices. Wheat prices are predicted to rise above the $4 per bushel target price set under the Federal farm program. The main reason for the price rise is that production in the United States, other major exporting countries, and China, a major importer, is forecast to be much lower than last year. Worldwide stocks relative to demand for wheat are predicted to fall to their lowest level since the U.S. Department of Agriculture started keeping such records in 1960. If prices persist above target levels, USDA will not make $1.4 billion in deficiency payments next year, an unexpected budget savings. A by-product of the strong worldwide demand for wheat is that Canada will be able to find markets for its wheat crop outside of the United States, thereby easing trade tensions with the United States.

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production decreased 0.2 percent in September following a 1.1 percent increase in August. Capacity utilization decreased 0.4 percentage point to 83.8 percent.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $8.8 billion in August; it was $11.2 billion in July.

Housing Starts

Housing starts were basically unchanged in September at 1.39 million units at a seasonally adjusted annual rate. For the first 9 months of 1995, housing starts were down 8 percent compared with the same period a year ago.

MAJOR RELEASES NEXT WEEK

Advance Durable Orders (Thursday)
Gross Domestic Product (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.3
Chain weights	2.7	3.7	4.0	1.7	0.7
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	–2.8	–2.4	–2.3	–2.1	–1.8

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Unemployment Rate	6.7**	6.1**	5.7	5.6	5.6

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

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Payroll employment (thousands)					
increase per month			28	262	121
increase since Jan. 1993					7481
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.1	0.1
PPI-Finished goods	5.0	1.7	0.0	–0.1	0.3

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	Aug. 1995	Sept. 1995	October 19, 1995
Dow-Jones Industrial Average	3522	3794	4639	4747	4802
Interest Rates					
3-month T-bill	3.00	4.25	5.40	5.28	5.25
10-year T-bond	5.87	7.09	6.49	6.20	5.98
Mortgage rate, 30-year fixed	7.33	8.35	7.86	7.64	7.38
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 19, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.411	–0.7	–6.1
Yen-Dollar	100.6	+0.3	+3.4
Multilateral $ (Mar. 1973=100)	83.95	–0.4	–2.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q2)	5.6 (Sept)	2.5 (Sept)
Canada	2.5 (Q2)	9.6 (Aug)	2.4 (Aug)
Japan	0.6 (Q2)	3.2 (Jul)	0.1 (Jul)
France	2.9 (Q2)	12.2 (Jul)	1.9 (Aug)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.8 (Q2)	12.0 (Jul)	5.8 (Aug)
United Kingdom	2.8 (Q2)	8.7 (Aug)	3.6 (Aug)

EYES ONLY

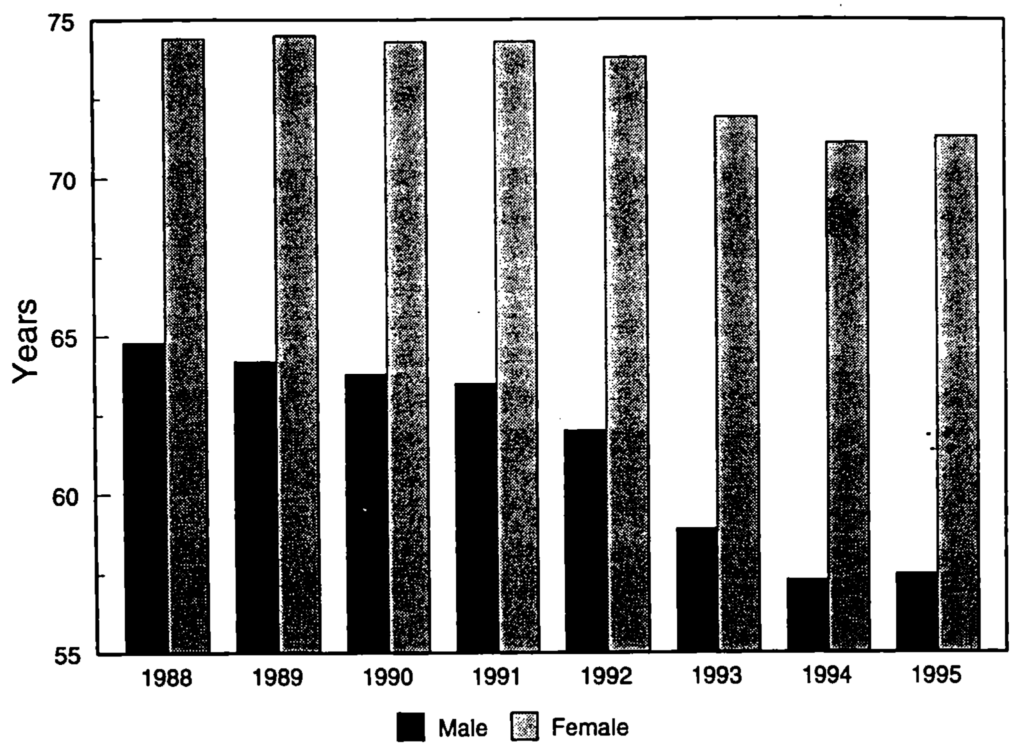
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 13, 1995

CHART OF THE WEEK

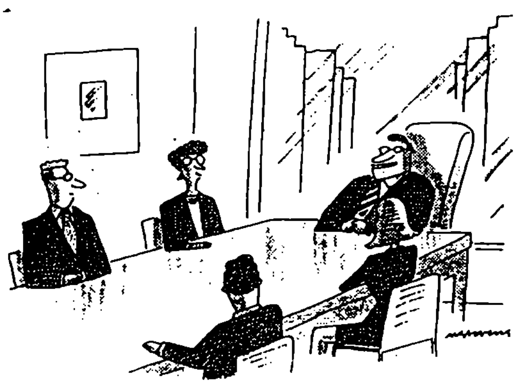
Life Expectancy in Russia



Life expectancy at birth for Russian men plummeted following the collapse of the Soviet Union, falling to just over 57 years by 1994, which was the male life expectancy in the United States in 1936. For Russian women the decline has been less dramatic, with life expectancy of a little over 71 years by 1994. Although the downward trend in life expectancy began during the late 1980s, the disruption of Russia's health care system after the breakup of the Soviet Union may have accelerated this trend. A rise in cardiovascular disease and violent deaths (accidents, murders, and suicides) are the main factors behind the fall in life expectancy.

EYES ONLY

CONTENTS



"We're still a Baby Bell, but now we're a really big Baby Bell."

EYES ONLY

CURRENT DEVELOPMENT

Default Today, Pay Forever

If Congress does not raise the $4.9 trillion debt limit, Treasury will not be able to roll over maturing debt securities and the United States could default on a portion of its debt.

Effect on interest rates. The United States has never defaulted, so estimating the effects is difficult. In cases where local governments have defaulted, there has been a spike in interest rates paid on that government's debt. When the local government has reorganized so that investors become more confident that they will be repaid, interest rates have declined to a level below the temporary spike but above the pre-default level. Analysts estimate that Orange County will pay between 25 and 75 basis points more in interest because of its recent default.

What is the possible cost? The penalty that the U.S. Government would have to pay likely would be less than that paid by a defaulting local government. For instance, Orange County investors doubted that they would ever be fully repaid. A delay in interest payments by the U.S. Government would not raise these same concerns. Nevertheless, given the size of U.S. debt, even a small interest rate increase could add up. For example, a 10 basis point increase on newly issued debt would cost the government about $42 billion in extra interest payments over 10 years.

Higher interest rates on U.S. debt also would increase costs for some homeowners with adjustable-rate mortgages. Of the approximately $800 billion of adjustable-rate mortgages outstanding, roughly half have interest rates tied to rates on Treasury securities. These mortgage rates would rise if Treasury rates were to increase.

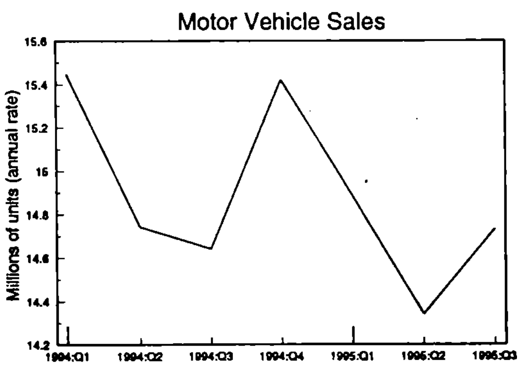
A default might also have adverse effects on other financial markets. In particular, foreign investor reaction to a default could increase volatility in currency markets in the short run.

MACROECONOMIC UPDATE

Economy Growing Moderately

The economy probably grew moderately in the third quarter at about a 1.5-2.0 percent annual rate—an increase compared with the second quarter, but well below the exceptional pace of 1994. (Since the Administration does not issue quarterly forecasts, our estimate of growth does not represent an "official" forecast.) Motor vehicle sales, housing starts, and spending on consumer goods all picked up in the third quarter, but the economy is still working off an excess of inventories. The unemployment rate, now at 5.6 percent, has been little changed since the beginning of the year. Core consumer price inflation remains stable at about 3 percent.

Data are not yet available on the fourth quarter, but GDP growth likely will be in the moderate range. Motor vehicle production schedules show that automakers plan no step-up in production over the quarter. Business investment spending has been strong so far this year, but orders for future delivery of capital goods fell in the third quarter and suggest that investment may slow in the near term. Export growth, which slowed in the first quarter as a result of the weak economic performance of our trading partners (especially Mexico), is likely to improve by the fourth quarter as these economies regain strength. But exports in the fourth quarter could be hurt by a prolonged strike at Boeing (whose exports total almost a billion dollars per month).



Note: Excludes heavy trucks

Inventories remain high. Sales of motor vehicles increased in the third quarter to 14.8 million units at an annual rate (see chart). The pickup in sales, together with a cut in production allowed the automakers to slim down their inventories during the second and third quarters. Even so, inventories remain somewhat higher than the industry's desired level.

Inventories in non-auto sectors also appear to be above desired levels, with producers and merchants cutting back on investment in inventories during July and August.

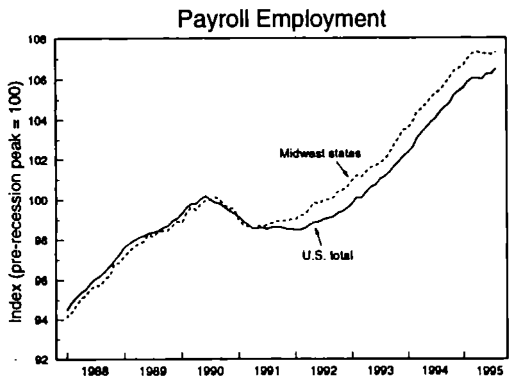
Housing is a bright spot. Housing starts, which had fallen sharply in the first half of the year, rebounded in the third quarter in response to the earlier decline in mortgage rates. The inventory of unsold new homes—which had restrained construction—has returned to normal levels, clearing the way for a pickup in housing construction over the rest of the year.

EYES ONLY

TREND

Midwest Economy: Continuing to Diversify

The Midwest—which for the upcoming Midwest Regional Economic Conference includes Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Ohio, West Virginia, and Wisconsin—recovered fairly rapidly from the 1990-91 recession, with the upturn in employment coming several months earlier than for the overall United States (see chart). Although employment growth in the Midwest since then has mirrored that across the country, it recently has leveled off and is projected to grow more slowly than the national average in the future, reflecting expected losses of manufacturing jobs due primarily to modernization of plant and equipment.



Currently, however, the labor market in the Midwest region is tight, with unemployment in many states approaching 20-year lows. The unemployment rate in August for each of the Midwest states—except for Illinois and West Virginia (which consistently posts higher rates)—was below the national average of 5.6 percent. Some states, including Iowa, Minnesota, and Wisconsin, had unemployment rates of about 3 percent.

Important factors influencing the future health of the regional economy include:

- Education. An educated and well-trained workforce is a key factor that will influence the Midwest's ability to continue to diversify away from traditional manufacturing and agricultural industries into high-tech and financial service industries. While the proportion of high school graduates in the Midwest is about the same as the national average, the proportion of college graduates is much lower. Given the increasing importance of higher education for jobs in emerging high-tech industries, efforts to encourage more Midwesterners to attend college could bolster future prospects for the region.
- Manufacturing. Manufacturing still is a mainstay of the Midwest economy, employing 20 percent of all workers, with the auto sector accounting for about two-thirds of automobile production in the United States. Following the downturn in the early 1990s, growth in manufacturing employment played an important role in the recovery in the Midwest, outpacing that in the United States overall. Although manufacturing employment is projected to decline in the future, this

decline reflects rapid gains in productivity, which represent the fruits of ongoing technological advances in manufacturing.

- Agriculture. Although the Midwest as a whole depends much less on agriculture than do the Plains states, agriculture continues to be an important sector. Of the 9 Midwest states, Iowa depends the most on agricultural employment, with around 25 percent of its workforce in farm or farm-related jobs (compared with a Midwest average of 17 percent). The number of farming-dependent counties in the region has declined significantly, as the trend toward consolidation and the disappearance of the family farm continues. The agricultural sector has largely recovered from its 1980s doldrums, and farm exports are projected to set a record next year.

- Concentration of elderly. Another factor affecting the future health of the Midwest economy is the relatively large concentration of elderly Americans living in that region. Ohio, Indiana, Wisconsin, Iowa, Missouri, and West Virginia all have average or higher-than-average concentrations of elderly. In fact, Iowa has the third highest concentration of elderly in the United States at 15.5 percent, behind only Florida at 18.6 percent and Pennsylvania at 15.8 percent. West Virginia has the fifth highest. Even Illinois, Michigan, and Minnesota are only slightly below the national average of 12.7 percent. Cutbacks in Federal programs affecting the elderly, such as Medicare, could therefore have a disproportionate impact on the region.

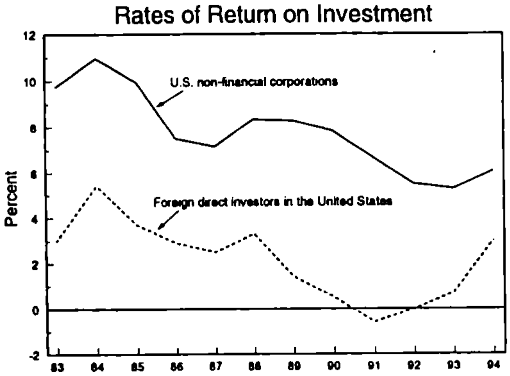
EYES ONLY

SPECIAL ANALYSIS

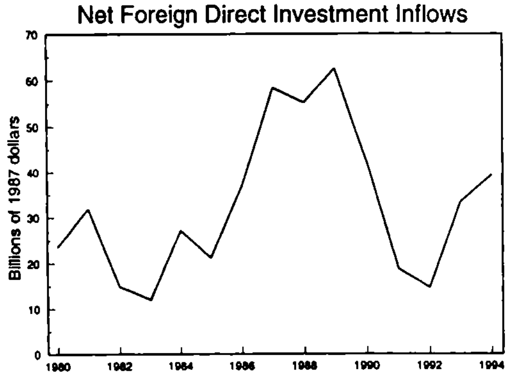
Why Do Foreign Investors Earn So Little?

The low reported earnings of foreign direct investors in the United States has been a longstanding puzzle (see left chart). How could foreigners, holding U.S. productive assets of over $500 billion, have had net losses for the 1990-92 period, when U.S. companies earned over 5 percent in each of those years? Are foreigners simply poor investors, or have they distorted their reported earnings to avoid paying American taxes?

Rates of Return on Investment



Net Foreign Direct Investment Inflows



Analysis. There appears to be truth in both explanations, although the timing and characteristics of foreign investment provide much of the explanation for the observed low returns. And, while the evidence suggests some tax evasion, the amount of additional revenue the U.S. Treasury could take in through full compliance is much smaller than the gap between rates of return might indicate.

Timing and characteristics. There was a huge increase in foreign direct investment during the late 1980s (see right chart). By 1990, over 60 percent of total foreign holdings in the United States had been acquired or established after 1985. Because the profit rates on newly acquired foreign investments are typically very low, the large inflow in the late 1980s depressed the average return. Similarly, the turnaround in average profitability in 1994 likely reflects both the maturing of these earlier investments and the relatively small inflow of foreign investment in the early 1990s.

The characteristics of foreign investment also account in part for the low rate of return. Over 80 percent of foreign direct investment has come through the purchase of existing firms. In general, foreign investors paid relatively high prices for firms with profit rates well below average, and often subsequently invested heavily in restructuring and upgrading. High purchase prices, post-acquisition expenses, and accounting charges relating to the takeovers all lowered profit rates in the period immediately following acquisition.

Poor investments? Many foreign investments simply do not work out. Heavy foreign investments in U.S. real estate in the mid to late 1980s (e.g., Rockefeller Center) were particularly ill-advised. The precipitous drop in U.S. commercial real estate values during the early 1990s inflicted losses on foreign investors that totaled $27 billion by 1993.

Tax evasion? A sophisticated multinational firm may be able to shift taxable income among affiliates by allocating expenses in order to minimize overall tax liability. The firm would try to lower its reported profit in high tax jurisdictions, but would also seek to avoid large losses, since such losses could otherwise be used to reduce reported taxable income elsewhere.

Tax evasion cannot be measured directly. However, a company evading taxes will arrange to keep its reported U.S. profit close to zero. And, in practice, reported profits of U.S. affiliates of foreign firms are more tightly clustered and nearer zero than are profits of domestic firms. Profits of foreign firms also tend to return towards zero more rapidly following a profitable year. Furthermore, reported profit rates are lower for firms that have the most to gain from tax evasion, such as firms whose home country does not tax income on a worldwide basis. All of these observations may be evidence of efforts to avoid U.S. taxes.

Conclusion. If foreign investors had earned the same return as domestic investors in 1994 they would have earned $24 billion more. However, applying the corporate tax rate to this additional income (yielding $8 billion) greatly overstates the revenues that could be generated by more stringent tax enforcement. For reasons explained above, foreign investors do earn a lower return than on U.S. investment. Furthermore, the Internal Revenue Service has strict rules on debt (and thus debt service) allocation, and monitors transfer pricing, limiting the most common methods of shifting taxable income. Thus, while it is surely possible to increase collections further through more stringent enforcement, the incremental returns may not be very large.

EYES ONLY

ARTICLE

AT&T's Voluntary Splitup: Benefits and Costs of Integration

In a dramatic move, AT&T recently announced that it would voluntarily split up into three new companies each focusing on different businesses. AT&T believed that the three companies—communication services, equipment manufacturing, and computers—would perform better separately than integrated, and investors agreed, bidding up AT&T's stock price by over 10 percent on the news for an increase of $9.5 billion in total stock value.

The AT&T splitup raises two broader issues. First, what are the benefits and costs of integration? Understanding these benefits and costs helps explain AT&T's decision to split up today. Second, what difference does regulation make? Understanding how regulation encourages companies to integrate helps explain: (1) why AT&T resisted the earlier 1984 court-ordered breakup; (2) why the regulated local Bell companies are clamoring to enter the unregulated long-distance telephone market; and (3) why the Administration opposes provisions in the pending telecommunications bills that would allow such Bell entry prematurely.

Benefits of integration.. At first blush, an integrated firm seemingly should always outperform separate firms. With selective intervention, the firm's CEO could let divisions operate mostly autonomously and intervene only in instances where it would increase the firm's overall profit. The CEO might order a division to sell to another at cost, help resolve disputes, and prod divisions to cooperate in offering seamless service to customers.

Costs of integration: incentives suffer. But intervention often cannot be confined to cases where it increases overall firm profit. A chronically weak division asks for "temporary" help claiming recovery is just around the corner; another asks for cheap financing for a questionable project which outside investors simply "don't appreciate." Unfortunately, such cross-subsidies reduce incentives: penalties for failure are attenuated, as are rewards for success. This incentive problem can plague both conglomerate firms (whose divisions are in unrelated businesses—see box on next page) and vertically integrated firms (where the product of one division is used as an input into another division).

Added concerns in vertical integration: Tensions in customer-rival relations. But vertically integrated firms can experience an additional problem: one division's competitors are another division's customers. Bell companies and foreign telephone companies reportedly have been reluctant to buy AT&T equipment, believing that AT&T's equipment unit would favor its own telephone unit over rivals.

AT&T's splitup should help the new equipment company compete for orders. The new telephone services company also should become a stronger competitor, because once other telephone companies are no longer its equipment customers, AT&T can take the gloves off. AT&T can thus be more aggressive in competing for customers in local service (where allowed), and in bargaining over access fees to local networks (to complete long-distance calls). In short, AT&T's splitup is likely to be good for it and, by increasing competition, good for consumers.

Regulation creates bias towards integration. Why then did AT&T in the early 1980s resist the Justice Department's ultimately successful effort to vertically separate local-telephone companies (the Bells) from the long-distance and equipment company (what is now AT&T)? Before the breakup, regulation played a major role. AT&T could use its affiliates in the less regulated markets for equipment and long-distance service to evade price regulation of its local-service monopoly. It allegedly paid inflated prices to its equipment subsidiary, which were passed on to local telephone rate-payers as higher "costs." And it allegedly discriminated against long-distance competitors like MCI by providing them with poorer-quality connections, in order to steer traffic towards its own long-distance business. In general, a firm that is regulated in one market has strong incentives to vertically integrate into other, less regulated markets so as to circumvent regulation, harming both rivals and consumers.

Dangers from Bell re-integration. Policing such misbehavior by AT&T through its affiliates in less-regulated markets proved difficult, and drove the Justice Department to seek AT&T's breakup and to keep the regulated local-service monopolies (the Bells) out of the potentially competitive markets for equipment and long-distance service. Today, the long-distance market is fairly competitive. But the Bells retain monopoly over local service, and their prices for local calls and for access to long-distance calls remain regulated. Permitting the Bells to re-integrate into long distance without real competition in their local markets thus raises the specter of abuses similar to those that prompted the 1984 breakup. For this reason, the Administration opposes provisions in the pending telecommunications bill that would allow the Bells into long distance while they retain monopoly over local service.

Conglomerate Mergers and Splitups

Many conglomerate mergers in the 1960s were touted as bringing "synergies." But synergies did not materialize. In fact, performance suffered as firms became less focused and as divisions' incentives weakened. The corporate takeover wave of the 1980s in large part served to undo these conglomerates: corporate raiders subsequently spun off divisions to other companies in the divisions' industry or as independent entities. Thus refocused, the new entities became more efficient. The last two years have again witnessed many splitups that significantly increased value to shareholders.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Criminal Supervision Reaches Astonishing Levels. The Sentencing Project last week released a study documenting the large and increasing number of persons in prison or on probation or parole. Of particular note is the study's estimate that over 30 percent of African American males between the ages of 20-29 (amounting to 787,692 men) were under criminal justice supervision on any given day in 1994, compared to 25 percent 5 years ago. Racial differences are striking: "only" 7 percent of white men and 14 percent of Hispanic men of similar age were under criminal supervision. Criminal supervision has also risen among women, with African American women experiencing the greatest rise in proportion of the population under criminal supervision of any demographic group. The study estimates that drug-related offenses are the largest contributor to the rise in criminal populations, with the number of incarcerated drug offenders rising by 510 percent between 1983 and 1993.

Companies and the Contingent Worker. A recent survey by The Conference Board (a business group) shows that the contingent workforce has been growing in recent years. While 75 percent of companies surveyed reported that contingent workers comprised 5 percent or less of their workforce 5 years ago, 58 percent predicted a continuing rise in their use of contingent workers. The most common forms of contingent labor used by the companies were workers supplied by staffing companies (90 percent) and independent contractors (85 percent). All but two of the 106 companies surveyed believe the advantages of using contingent employment outweigh the disadvantages, with many citing the need for flexibility in the face of changes in demand. Among the disadvantages cited were lack of skills and training, poor work quality, poor attitudes, and a lack of commitment to the organization. (See Weekly Briefing, September 22, 1995, for further discussion of contingent workers.)

U.S. Economist Nabs This Year's Nobel. This week Robert Lucas became the latest University of Chicago faculty member to win the Nobel Prize in Economics. Lucas was cited for his work on macroeconomics and his insight into the difficulties of using economic policy to control the economy. Lucas is best known for his efforts to renew interest among economists in the importance of expectations about the future for understanding economic behavior. Although many of the assumptions underlying his macroeconomic models have been seriously questioned, economists today routinely incorporate his insights about the role of expectations into many of their analyses.

EYES ONLY

RELEASES THIS WEEK

Consumer Price Index

****Embargoed until 8:30 a.m., Friday, October 13, 1995****

The consumer price index increased 0.1 percent in September. Excluding food and energy, consumer prices rose 0.2 percent.

Retail Sales

****Embargoed until 8:30 a.m., Friday, October 13, 1995****

Advance estimates show that retail sales increased 0.3 percent in September following a revised 0.5 percent increase in August. Excluding sales in the automotive group, retail sales increased 0.7 percent.

Producer Price Index

The producer price index for all finished goods increased 0.3 percent in September. Excluding food and energy, producer prices increased 0.2 percent.

MAJOR RELEASES NEXT WEEK

Industrial Production and Capacity Utilization (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)
Housing Starts (Thursday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.3
Chain weights	2.7	3.7	4.0	1.7	0.7
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	–2.8	–2.4	–2.3	–2.1	–1.8

	1970–1993	1994	**July 1995**	**Aug. 1995**	**Sept. 1995**
Unemployment Rate	6.7**	6.1**	5.7	5.6	5.6

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

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Payroll employment (thousands)					
increase per month			28	262	121
increase since Jan. 1993					7481
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.1	**0.1**
PPI-Finished goods	5.0	1.7	0.0	–0.1	**0.3**

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, October 13, 1995.**

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	Aug. 1995	Sept. 1995	October 12, 1995
Dow-Jones Industrial Average	3522	3794	4639	4747	4765
Interest Rates					
3-month T-bill	3.00	4.25	5.40	5.28	5.30
10-year T-bond	5.87	7.09	6.49	6.20	6.07
Mortgage rate, 30-year fixed	7.33	8.36	7.84	7.61	7.50
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 12, 1995**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.422	–0.4	–7.8
Yen-Dollar	100.3	0.0	+0.3
Multilateral $ (Mar. 1973=100)	84.28	–0.0	–4.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q2)	5.6 (Sept)	**2.5** (Sept)
Canada	2.5 (Q2)	9.6 (Aug)	2.4 (Aug)
Japan	0.6 (Q2)	3.2 (Jul)	0.1 (Jul)
France	2.8 (Q2)	12.2 (Jul)	1.9 (Aug)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.8 (Q2)	12.0 (Jul)	5.8 (Aug)
United Kingdom	2.8 (Q2)	8.7 (Aug)	3.6 (Aug)

U.S. CPI data **embargoed until 8:30 a.m., Friday, October 13, 1995.**

EYES ONLY

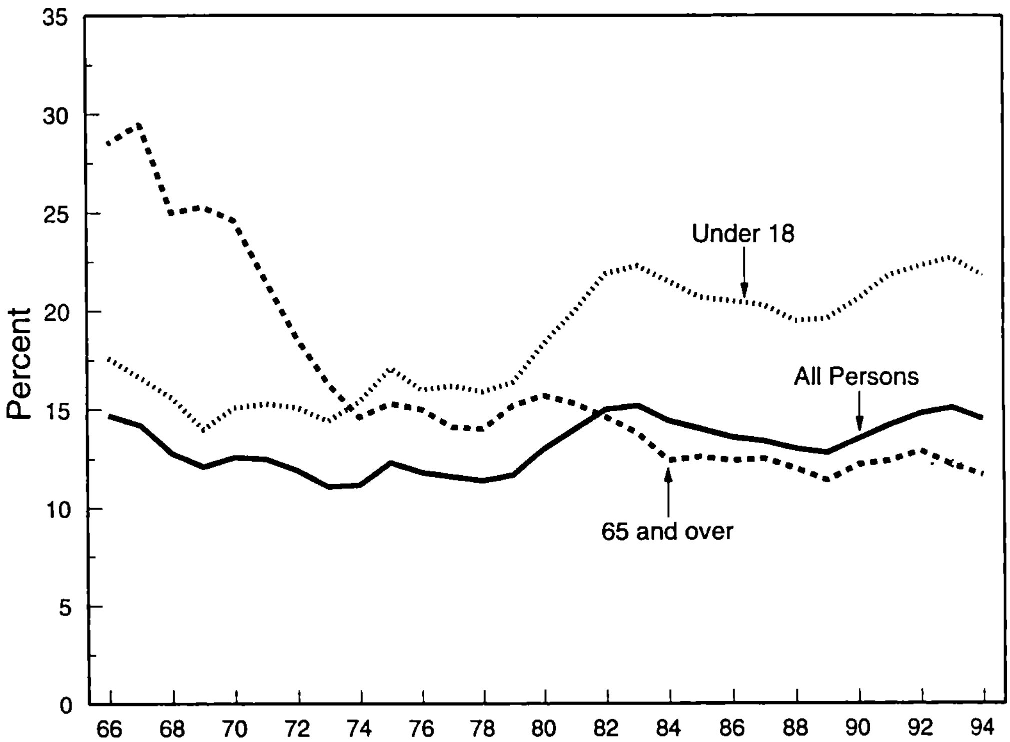
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 6, 1995

CHART OF THE WEEK

Poverty Rates in the United States



The poverty rate fell from 15.1 percent to 14.5 percent between 1993 and 1994. This was the first decrease since 1989. The largest drop in poverty was for African Americans, whose real median household income grew by 5.0 percent, compared to 0.7 percent for whites. A Current Development in this issue of the Weekly Briefing discusses the latest data on poverty.

EYES ONLY

CONTENTS

EYES ONLY

CURRENT DEVELOPMENT

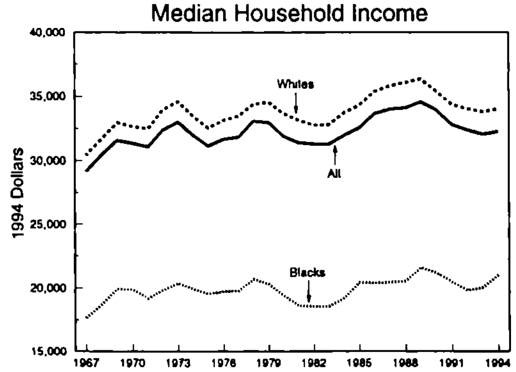
Good News on the Poverty Front

A Commerce Department report this week showed that the portion of the population living in poverty dropped from 15.1 percent to 14.5 percent between 1993 and 1994. This was the first decline since 1989, and meant that 1.2 million fewer people were living in poverty. The poverty rate for children under 18, which still remains higher than that in any developed country, dropped from 22.7 percent to 21.8 percent.

There also were some encouraging signs for African Americans. The poverty rate for blacks dropped from 33.1 percent to 30.6 percent. The real median income of black households was up 5.0 percent, compared to an increase of 0.7 percent for white households. Further, the tragically high poverty rate for black children fell from 46.1 percent to 43.8 percent.

Incomes remain stagnant. While the poverty rate improved, real median household income remained stagnant at $32,264 in 1994, compared to $32,041 in 1993 (see chart). Moreover, the trend toward inequality continued, albeit at a slow pace. The bottom quintile held its own, while the middle continued to lose income share to the top 20 percent—a pattern similar to recent years.

Median Household Income



Finally, although the "official" definition of poverty includes only money income, the report also presents a more comprehensive measure that reflects Federal taxes and non-cash transfers. Like other poverty figures, this more comprehensive poverty rate declined in 1994 to 12.4 percent from 13.1 percent in 1993. Unfortunately, if the extensive cuts aimed at the low-income population are enacted by Congress, we should expect to see an increase in this comprehensive poverty rate in the future.

EYES ONLY

SPECIAL ANALYSIS

The Short-Run Macroeconomic Effects of Deficit Reduction

The deficit reduction package that ultimately emerges from the budget reconciliation process is likely, by itself, to restrain economic growth for the next several years. The estimate of fiscal restraint associated with the Budget Resolution passed by Congress is roughly $41 billion for FY 1996 and $79 billion for FY 1997—a bit higher than the estimated first 2 years of fiscal restraint due to the Omnibus Budget Reconciliation Act of 1993.

Can a short-run reduction in growth be avoided? The path to a balanced budget involves cuts in numerous government programs that will directly reduce spending in the economy. The direct reduction in spending, in turn, will lower the incomes of people dependent on government programs, thereby inducing a further reduction in spending. Under these circumstances, growth in GDP can be maintained only if real interest rates decline.

A deficit reduction package should lead to a decline in real interest rates, as the expected drop in government borrowing eases pressures on credit markets. Whether real rates would fall by enough on their own to keep GDP growth from falling is less certain. The Congressional Budget Office recently reported that real interest rates would probably have to decline between 1 and 2 percentage points to approximately offset the restraint on growth from reducing the deficit. Some of this decline may have occurred already in long-term rates as market participants anticipate the gains from balancing the budget.

For a sustained decline in real rates of 1 to 2 percentage points, financial markets would likely want a commitment by the Federal Reserve to "accommodate" the fiscal restraint. It is reasonable to expect that the Fed would ease credit conditions if economic growth were slowed by fiscal restraint. The Fed has said as much. For instance, in his testimony on September 22 before the Senate Banking Committee, Fed Chairman Alan Greenspan said, "Clearly, the Federal Reserve, in appraising evolving developments, will continue to take the likely effects of fiscal policy into account." Of course, it may be a process of trial and error before financial markets and the Fed get interest rates at exactly the appropriate settings.

How would deficit reduction affect the composition of output? With a decline in real interest rates, the shares of investment (including housing construction) and net exports in GDP likely would increase. Estimates suggest that roughly two-thirds of the reduction in the budget deficit would show up in an increase in net exports and one-third in increased investment. Overall, the shift toward a smaller current account deficit and more investment would represent a marked improvement from the record of the 1980s, during which a consumption boom was paid for by crowding out investment and borrowing massively from abroad.

EYES ONLY

SPECIAL ANALYSIS

Has the Sustainable Level of Unemployment Fallen?

A debate is now underway over whether unemployment in the United States can be pushed below its current level without additional inflation. This is an important issue in the current discussion about whether the U.S. economy can grow faster (see Article in this issue of the Weekly Economic Briefing).

Some observers have argued that the minimum sustainable unemployment rate—the so-called NAIRU—has declined recently. If so, this leaves room for a drop in unemployment without sparking an inflationary spiral.

The sustainable rate has varied over time. The sustainable unemployment rate, as estimated by the Congressional Budget Office, has varied over the last three decades (see chart). This variation is the result of changes in labor market conditions and changes in the relationship between wages and prices.

Changes in labor market conditions. In the 1970s, the increased share of new entrants (women) and young people in the work force probably led to a higher sustainable unemployment rate. This is because new entrants and young people are more likely to move from job to job, and thus may more frequently be unemployed. More recently, the falling share of teenage entrants can account for much of the decline in the sustainable rate in the early 1990s. This trend, however, likely will not continue since the share of teenagers is expected to increase over the next 5 years.

The Sustainable Level of the Unemployment Rate

Changes in the relationship between wages and prices. During the 1970s, the drop in productivity took the nation by surprise. Some workers continued to demand and employers continued to pay real wage increases of 3 percent, even though productivity had dropped to 1 percent. To cover these costs, employers had to raise prices faster than they otherwise would have. As a result, the inflation rate associated with a given unemployment rate was higher than it would have been had productivity growth not slowed.

Why might the sustainable rate be falling now? Many explanations have been circulating recently as to why the sustainable rate of unemployment may have fallen during the past several years. These explanations focus on structural changes in the U.S. economy that may have restrained increases in wages and prices. For example, deregulation, computerized production-management techniques, increased international competition, a decline in the influence of labor unions, and increased job insecurity have all been given as reasons why wage and price pressures at current levels of unemployment have been restrained.

Sorting out the evidence. Given low rates of unemployment, the last couple of years have seen less upward pressure on wages and benefits than would be expected. Much of this slower growth in compensation has been due to slower growth in health care expenses, as firms have made vigorous efforts to rein in health costs. As a result of the slower growth in compensation, price inflation is a bit lower than what would have been expected at current unemployment rates. Hence, evidence to date is not inconsistent with a small downward shift in the sustainable level of the unemployment rate of about 0.1 to 0.2 percentage points.

EYES ONLY

ARTICLE

Can the U.S. Economy Grow Faster?

Some observers claim that the U.S. economy is capable of more rapid sustained economic growth without additional inflation, faster than the 2.5 percent growth rate projected in the Administration's budget forecast. Based on meetings with experts both inside and outside the Administration, we have reached a preliminary conclusion that for budget purposes existing data provide no support for projecting GDP growth greater than 2.5 percent.

The Administration's proposed growth-enhancing policies—including those concerning education, research, technology, and balancing the budget—are likely to have positive effects on growth over the long run, but given our commitments to credible forecasting, such benefits cannot be counted on in the near term. This article looks at the basis for the view that the economy can grow faster than 2.5 percent, and why we think these arguments in favor of more rapid U.S. growth are often misleading.

Short-Term Growth. In the short run, the major determinant of the economy's growth potential is whether it has excess capacity. If the economy starts out with slack (where real GDP is well below potential GDP), then it can grow rapidly without generating inflationary pressure. For example, one commentator lauded the record of growth from 1982-88. But the reason for rapid growth over this period was that the economy was in deep recession in 1982. Likewise, in 1993-94 we got a growth bonus with the recovery from the mild recession of 1990-91. But, today, the U.S. economy is close to capacity, so there is little possibility for a further bonus.

Is the U.S. Economy at Full Capacity? In our most recent budget forecast we assumed that economic slack had been eliminated by the end of 1994. However, because inflation has been surprisingly low and stable recently, it is possible some slack yet remains so that the economy could operate at lower levels of unemployment.

This possibility raises the following question: how much extra growth can we get in the short run if the economy has more slack than we thought? If unemployment were brought down from the current rate of 5.6 percent to 5.1 percent over the next year, this would add about an extra 1 percent to GDP growth for 1 year. If lower unemployment could be sustained, the level of GDP would be higher indefinitely. The increment to growth would be temporary, however, a point that is often missed in popular discussions. Moreover, given the Fed's concerns about inflation, it is unlikely that they would allow the economy to move to 5.1 percent unemployment in 1 year. Given this, our best estimate still is that the economy is currently operating at close to full capacity.

Why not higher sustained growth? Some critics of the Administration, and some supporters too, have pointed to much higher growth in the 1950s and 1960s and asked: if the economy could grow fast then, why not now? The reason has to do with a slowdown in the components that contribute to economic growth: productivity growth and labor force growth. This has had the effect of slowing potential GDP growth.

Slower productivity growth. The slowing of potential GDP growth is mostly due to slower productivity growth. Output per hour grew at 2 to 3 percent a year after World War II. But since 1973, it has grown about 1 percent a year. Economists have suggested many reasons for the slowdown in productivity—demographics, slower investment, less research and development, and more regulation. They have, however, reached no consensus about which are most important.

Many business people—especially those in manufacturing—are skeptical that U.S. productivity growth has slowed, and believe the U.S. economy can grow much faster than 2.5 percent. Indeed, productivity growth in U.S. manufacturing has remained rapid, but manufacturing is only 20 percent of the economy. Moreover, companies that have increased their productivity by laying off their least productive workers often ignore the fact that these workers may lower productivity at the jobs they move to. As for other sectors, such as services, economists have long been concerned about productivity growth and recognize the difficulties in measuring that productivity growth. More general problems with measuring productivity are discussed in the box on the next page.

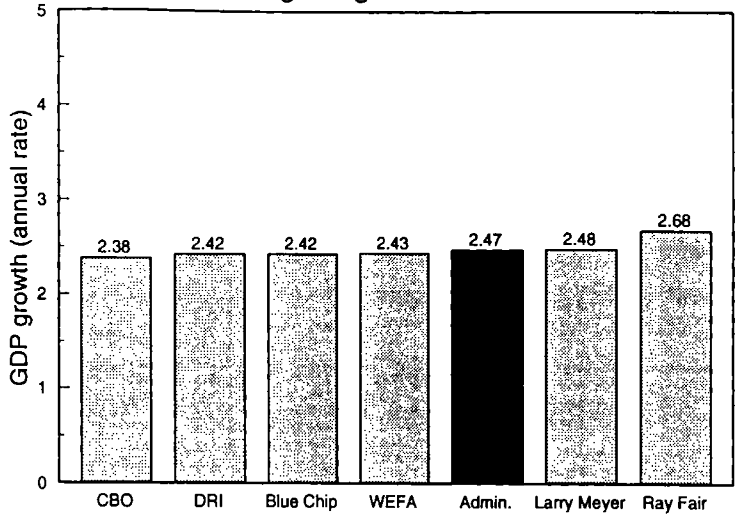
Slower labor force growth. A smaller contributor to the slowdown in potential GDP growth is the decline in growth rate of total hours worked. Even when productivity growth slowed in the 1970s, real GDP growth was partially sustained by rapid increases in labor force participation. This came from the entry of the baby-boomers and women into the workforce. In the last few years, these demographic changes have been running their course.

Our assessment is that long-run growth of 2.5 percent is the potential for the U.S. economy. As the chart on the next page shows, our forecast of long-run growth is in line with that of other forecasters.

Conclusion. We are still evaluating the growth issue. We will be meeting with proponents of the high potential-growth view to exchange ideas. At this stage, however, our assessment is that there is no basis to raise the projection of the growth rate above that in our budget forecast, especially since the forecast must be based on the most credible evidence. This does not mean we should be content with slow growth. The Administration should continue to pursue pro-growth policies, such as investment in education and technology, and we have reason to be optimistic about their long-term impact.

EYES ONLY

Comparison of Long-range Forecasts of Real GDP



Measurement Issues

As difficult as it is to gauge the economy's true prospects for economic growth, matters are exacerbated by measurement problems. For instance, in some sectors of the economy, productivity is growing, but deficiencies in measuring the impact of new goods and services may understate growth in other sectors. For example, the "quality" measurement problems which bias the consumer price index upwards have an analogous effect in biasing downward estimates of GDP and productivity growth.

The adoption in December of chain-weighted GDP will remove a bias that currently overstates GDP growth. Current-price weights will replace out-of-date ones—a recalibration that will lower the projected growth of potential output to 2.0 percent from 2.5 percent per year. The primary reason is the more accurate but smaller weight given to business investment in computers. Changes in our statistical measures, of course, do not alter what is really going on in the economy, and fortunately, these changes should have little impact on our projection of the budget deficit.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Fed Minutes Suggest Intent to Ease in Event of Fiscal Restraint. Minutes released from the August 22 meeting of the Federal Open Market Committee indicate that they see Federal budget developments as the major factor likely to affect economic performance in the near term. While the minutes cited the potential drag on the economy from reducing the deficit, participants noted that economic conditions also would play a part in shaping future Fed policy decisions. At this time, the FOMC finds economic conditions to be generally favorable and has not changed interest rate policy since it cut rates in early July. But, according to the minutes, members generally believed that adjusting the Committee's policy stance might be warranted if substantial fiscal restraint were to be enacted.

European Union Reaffirms Move to Single Currency. Last week European central bankers and finance ministers agreed that the EU should not postpone monetary integration from its scheduled date of January 1, 1999. Despite deep public skepticism in some member nations, participants insisted the single-currency process was fully on track. They emphasized that the economic situation was encouraging and progress was being made with convergence in deficits and inflation, despite the arguments of some member states for a delay of a year or two. Participants in the meeting agreed that aspiring members of the currency bloc would have to meet a series of "strict" criteria on deficits, inflation, and interest rates. One possible outcome is that monetary union will be formed initially by "hard core" states (like Germany), while countries (like Italy) unable to meet such requirements would join in later rounds of membership. Of particular concern is France's ability to meet the membership qualifications due to its large budget deficit. Moreover, only Germany and Luxembourg currently meet all of the criteria for integration.

IMF Growth Projections Shows Solid European Picture, Bad News for Japan. The International Monetary Fund has released its latest World Economic Outlook, which includes forecasts of output growth around the world. According to the report, relatively strong growth now is forecast for the European Union: the report projects growth of 2.9 percent for 1995 and 2.8 percent for 1996. These predictions are reductions, respectively, of 0.3 and 0.2 percentage points from the IMF's May projections. The most serious deterioration in economic performance and prospects among industrial countries has occurred in Japan, for which the IMF has reduced the growth forecast by 1.3 percentage points in each of 1995 and 1996. These downward revisions leave the Fund's current projections for Japanese growth in 1995 and 1996 at 0.5 percent and 2.2 percent, respectively.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, October 6, 1995****

In September, the unemployment rate was unchanged at 5.6 percent. Nonfarm payroll employment increased by 121,000.

Personal Income and Expenditures

Personal income was about unchanged in August (it increased less than 0.1 percent at a monthly rate), following increases of 0.6 percent in July and 0.5 percent in June. Disposable personal income also increased less than 0.1 percent in August. Personal consumption expenditures increased 1.0 percent.

Leading Indicators

The index of leading economic indicators increased 0.2 percent in August.

Domestic Auto Sales

Domestic autos were sold at an annual rate of 7.5 million units in September.

MAJOR RELEASES NEXT WEEK

Producer Prices (Thursday)
Retail Sales (Friday)
Consumer Prices (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.3
Chain weights	2.7	3.7	4.0	1.7	0.7
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	−2.8	−2.4	−2.3	−2.1	−1.8

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Unemployment Rate	6.7**	6.1**	5.7	5.6	**5.6**

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

	1970–1993	1994	July 1995	Aug. 1995	Sept. 1995
Payroll employment (thousands)					
increase per month			**28**	**262**	**121**
increase since Jan. 1993					**7481**
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.1	N.A.
PPI-Finished goods	5.0	1.7	0.0	−0.1	N.A.

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, October 6, 1995.**

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	Aug. 1995	Sept. 1995	October 5, 1995
Dow-Jones Industrial Average	3522	3794	4639	4747	4763
Interest Rates					
3-month T-bill	3.00	4.25	5.40	5.28	5.28
10-year T-bond	5.87	7.09	6.49	6.20	6.06
Mortgage rate, 30-year fixed	7.33	8.36	7.84	7.61	7.57
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 4, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.433	+0.4	-7.6
Yen-Dollar	100.7	+0.6	+1.1
Multilateral $ (Mar. 1973=100)	84.50	+0.1	-4.0

(Latest available data for multilateral dollar is October 4; exchange rate data shown are also for October 4.)

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q2)	**5.6** (Sept)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.4 (Aug)
Japan	0.6 (Q2)	3.2 (Jun)	0.1 (Jul)
France	2.8 (Q2)	12.4 (Apr)	1.9 (Aug)
Germany	2.1 (Q2)	6.5 (May)	2.0 (Aug)
Italy	2.8 (Q2)	12.2 (Apr)	5.8 (Aug)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.6 (Aug)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, October 6, 1995.**

WEB Oct. 1995

EYES ONLY

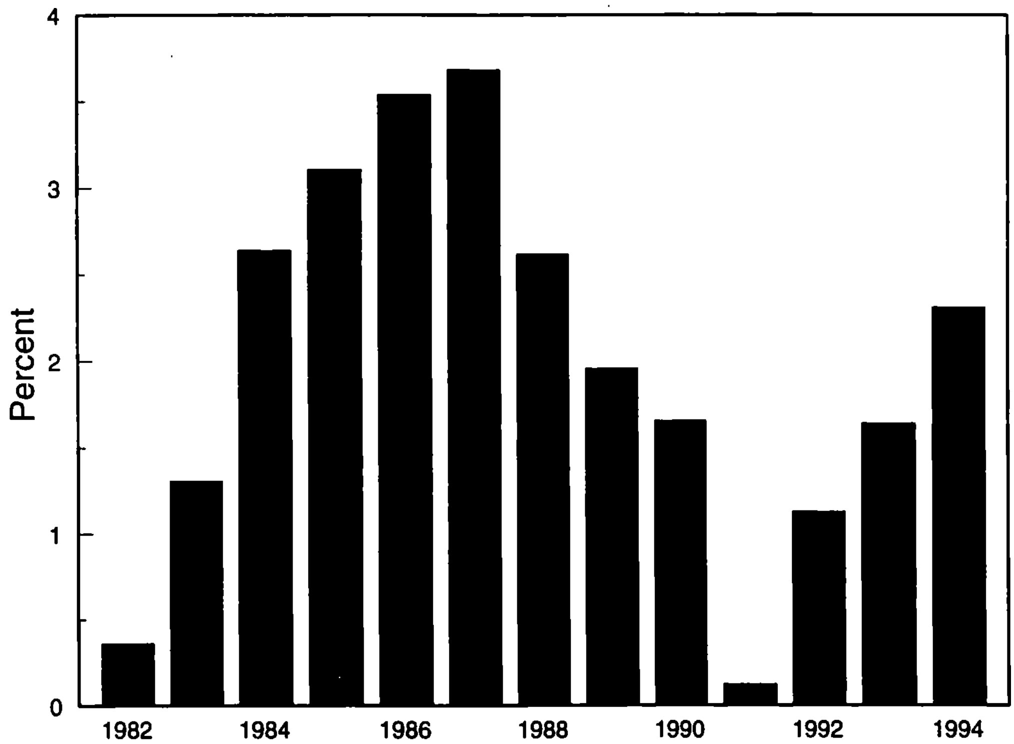
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 29, 1995

CHART OF THE WEEK

U.S. Current Account Deficit as a Percent of GDP



The U.S. current account deficit (the broadest measure of our international trade) has increased over the past several years. In dollars, the deficit has approached the record level reached in 1987. Put in perspective, however, the current account deficit today is a smaller share of GDP than during the mid-1980s.

EYES ONLY

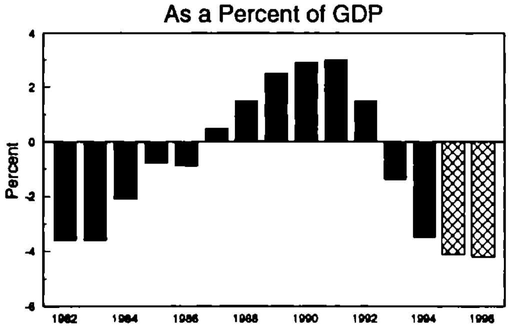
CONTENTS

CURRENT DEVELOPMENT

Japan Announces New Fiscal Package

Last week, the Japanese government announced a fiscal stimulus package totaling ¥14.2 trillion ($140 billion). The economic effects of the package likely will be smaller than the announced total because some expenditures represent transfers of assets (as with land purchases) and some may displace private market sources of credit (as with loan programs). Even so, the package should provide a direct stimulus of over 1 percent of GDP.

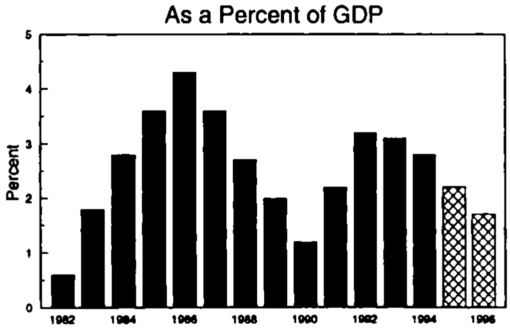
Japan's Government Budget Balance
As a Percent of GDP



Note: 1995 and 1996 are estimates

As part of the U.S.-Japan Framework Agreement concluded in 1993, Japan agreed to adopt fiscal measures to promote economic growth by expanding government spending. Since then, Japan has announced five fiscal stimulus packages totaling over ¥50 trillion. These measures have pushed the Japanese government's budget sharply into deficit (see top chart). In fact, the budget deficit for 1995 will be over 4 percent of GDP—more than twice that of the United States.

Japan's Current Account Surplus
As a Percent of GDP



Note: 1995 and 1996 are estimates

These increases in government spending have led to a decline in Japan's current account surplus (see bottom chart). Because a country's current account surplus is the difference between its domestic savings and domestic investment, policies that reduce government savings and stimulate domestic investment narrow this gap and lower the current account surplus.

Since effects from the stimulus packages will play out over the next few years, Japan's current account surplus should continue to decline. Indeed, analysts now predict that the current account surplus will fall to under 2 percent of GDP in 1996, a significant correction from the levels reached in the mid-1980s and early 1990s.

EYES ONLY

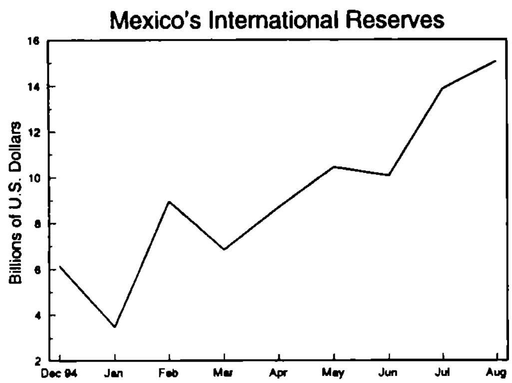
TREND

Mexico: Hints of Economic Growth Ahead

President Zedillo of Mexico will visit Washington in 2 weeks. His government, with the assistance of the United States and the I.M.F., has adopted a forceful set of adjustment policies in response to the recent peso crisis. Partly as a result of these policies, conditions seem to have stabilized and the stage may be set for renewed growth in 1996. But there are some lingering risks.

Adjustment to the peso crisis. The peso devaluation in December 1994 sparked an acute financial crisis that led to a severe recession early this year. Interest rates on 1-month Mexican treasury bills shot up from 14 percent in mid-December to 82 percent in mid-March. Real GDP fell 3.6 percent in the first quarter, and an additional 7.2 percent in the second quarter.

The Mexican authorities have responded to the crisis with a sharp tightening of both credit and fiscal policies. The budget surplus rose to 2 percent of GDP in the first half of this year, well above last year's level.



The results of these policies are slowly becoming evident. Monthly inflation has fallen from 8 percent in April to under 2 percent in August. Access to international credit markets has been at least partly restored, and international reserves have risen from $3 billion in January to $15 billion in August (see chart). Meanwhile, the stock market has increased almost 80 percent (in peso terms) from its low in late February. But the banking sector is still plagued by bad loans, which amounted to 12 percent of the total value of loans at the end of June.

Impact on U.S. exports. The depreciation of the peso and the contraction in output have hurt U.S. exports to Mexico, which were 18 percent lower in July than a year earlier. Nevertheless, exports have once again surpassed pre-NAFTA levels, and they should expand as the Mexican economy rebounds.

Outlook. Mexico's finances have recovered much more rapidly than anyone would have predicted last February. Private sector analysts expect growth of about 2 percent next year—which would increase demand for U.S. exports. However, setbacks are still possible. There is continued weakness in the banking sector, and the profound political transformation that Mexico is undergoing could pose some risks.

EYES ONLY

SPECIAL ANALYSIS

A Consumer Price Index for the Elderly?

While the recent clamor over the consumer price index (CPI) has focused mostly on its potential overstatement of inflation, there is also concern about how well the CPI measures changes in the cost of living for different demographic groups. In particular, some have suggested that price increases may affect the elderly disproportionately.

How would a price index for the elderly compare to the overall CPI? Elderly people devote a greater fraction of their total expenditures to medical care. Because medical care has been the fastest growing component of the CPI for many years, elderly Americans have faced a slightly more rapid rise in prices than the rest of the population. According to an experimental price index for the elderly developed by the Bureau of Labor Statistics (BLS), prices faced by elderly consumers increased between 1988 and 1993 by roughly 0.4 percentage point more per year than prices measured by the CPI for Urban Wage Earners and Clerical Workers (which is used to index Social Security benefits). Most of this difference was due to medical costs.

How accurate are these numbers? There are several reasons why the experimental index should be viewed with caution:

- The medical care component of the CPI likely overstates medical cost inflation. Some of the problems that lead the broad-based CPI to be biased upward are likely to be particularly severe in the medical cost component. In particular, much of the rise in health care costs may reflect increased quality and a wider range of services, rather than only increases in price. Fully adjusting the medical component of the CPI for such quality improvements could reduce or even eliminate the difference between the elderly CPI and the overall CPI.
- The elderly CPI does not account for differences in where the elderly shop or in "senior-discounts" received by the elderly. If the elderly are more likely to shop at discount stores (or receive discounts) than the general population, and if discount stores have become increasingly common, then the BLS estimates will overstate the price increases faced by the elderly.

Summary. It is possible that the elderly have experienced more rapid increases in the cost of living than the general population. The magnitude of the difference, however, may be small when compared to the biases affecting the overall CPI (see Weekly Economic Briefing, September 22, 1995). Price changes may also differentially affect other demographic groups. BLS is currently evaluating how price changes affect the poor, and expects to have preliminary results in the near future.

EYES ONLY

ARTICLE

Measuring the Progressivity of Alternative Tax Proposals

One aspect of the upcoming debate on tax reform will involve how proposed changes affect the fairness of the Federal tax system. This controversy may center on how to measure progressivity, as well as on whether one proposal is more progressive than another. (A progressive tax system is one where the rich pay a greater share of income in taxes than the poor.) For example, a broad-based consumption tax is thought by many to be unfair to those with lower incomes who consume a larger share of their income and would thus pay a larger share of income in taxes than those with higher incomes. When tax burdens are viewed over a person's lifetime, however, the tax base of a comprehensive consumption tax will be identical to the tax base of a comprehensive earnings tax.

Measuring tax burdens. The usual method for assessing the fairness (or progressivity) of a tax system starts by dividing taxes paid in a given year by an individual's income in that year. Then, this ratio is compared across individuals with different incomes to see if tax burdens are progressively distributed. This method, based on single-year snapshots of economic circumstances, may be misleading because incomes and deductions vary from year to year. Therefore, many economists believe that a better way to assess fairness is to compare the present value (i.e., after discounting future cash flows into today's dollars) of an individual's lifetime tax payments with the present value of their lifetime income.

Consumption versus income. Consider two individuals who expect to have the same earnings over their lifetime, but one (a young person just starting work) presently has a low annual income, whereas the other (a person in mid-career) has a high annual income. If there are no gifts, bequests, or inheritances, the present value of lifetime earnings would equal the present value of lifetime consumption for both individuals. Thus, it would make no difference if the government imposed a proportional tax (of, say, 20 percent with no exemptions or deductions) on lifetime earnings or on lifetime consumption.

In any given year, of course, the two taxes likely would differ markedly. The person in mid-career, with high current income and planning for retirement, may salt away a large fraction of earnings. The young worker struggling to support a family likely will save a much smaller share of earnings. Thus, when compared to this year's income alone, a tax imposed on consumption may appear to be quite regressive, since the higher-income individual will tend to consume a relatively small fraction of income and therefore pay a relatively small share of income in taxes. The young worker with lower income will pay a higher share of current income in taxes. On a lifetime basis, however, each individual pays the same share of lifetime earnings in taxes under both tax schemes.

EYES ONLY

Comparing progressivity. While a consumption tax may appear to be more regressive than an earnings tax when viewed in terms of annual incomes, on a lifetime basis both schemes levy tax on a similar tax base. Therefore, the distributional consequences would be similar.

In general, the assumptions under which the two tax systems have similar tax bases may not adequately describe the U.S. economy. Nevertheless, characterizing the two tax systems as similar may provide a useful policy framework. <u>However, both types of taxes may be less progressive than the current income tax</u>, which has a progressive rate schedule and which includes capital income in the tax base.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Planning the 2000 Census. The Census Bureau is currently planning its strategies for the decennial census set for the year 2000, hoping both to increase participation and to reduce the cost of administration. Census is considering using sampling and estimation methods to compile data about non-respondents to avoid costly attempts to locate each household physically through multiple visits. Furthermore, Census anticipates employing the records of the U.S. Postal Service and local governments to develop a master address file and to enumerate people in population groups often missed in the past. Census is currently examining possible objections to the new sampling methods based on arguments about the constitutionality of using sampling in lieu of the "actual Enumeration" specified in the Constitution. The House of Representatives has proposed cuts of $67 million in the Census Bureau budget that, if enacted, likely would limit Census's ability to improve its survey techniques.

Supervising By Risk. The Office of the Comptroller of the Currency (OCC), which is responsible for chartering, regulating and examining America's 3,000 national banks, recently announced a new supervision program for banks. This program will take into account a bank's risk exposure by assessing its vulnerability to fluctuations in interest rates and exchange rates, along with other factors influencing the value of its assets and liabilities. Furthermore, the new program also will evaluate the quality of a bank's internal management systems, including the ability of these systems to identify and adequately deal with fluctuations in a bank's financial position. The new guidelines lay out nine specific categories of risk which OCC examiners will use to evaluate a bank's safety and soundness. The new program represents a shift from the traditional "count the cash" approach to bank supervision that focused on measuring the value of assets, liabilities, and capital but did not assess underlying exposure to sudden changes in market conditions.

NASD Adopts Committee's Principles. Reports circulated in the media during 1994 alleging that member firms of the National Association of Security Dealers (NASD) were colluding to set excessive fees paid by investors. These reports led to the appointment of an oversight committee that recently presented its recommendations. The NASD has agreed to adopt the set of Principles of Effective Governance proposed by the committee. These Principles would require a majority of public representatives on the NASD board and would also separate oversight of the Nasdaq market from regulation of brokers and dealers, creating a new organization to be known as NASD Regulation. Separately, the Securities and Exchange Commission and the Department of Justice are investigating the allegations.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, September 29, 1995****

According to revised estimates, real gross domestic product grew at an annual rate of 1.3 percent in the second quarter.

Advance Durable Orders

Advance estimates show that new orders for durable goods rose 4.9 percent in August, the first monthly increase since May.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, fell 5.0 index points in September, to 97.4 (1985=100).

MAJOR RELEASES NEXT WEEK

Personal Income (Monday)
Leading Indicators (Wednesday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	**1.3**
Chain weights	2.7	3.7	4.0	1.7	**0.7**
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	−2.8	−2.4	−2.3	−2.1	−1.8

	1970–1993	1994	June 1995	July 1995	August 1995
Unemployment Rate	6.7**	6.1**	5.6	5.7	5.6

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

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.1
PPI-Finished goods	5.0	1.7	−0.1	0.0	−0.1

New or revised data in **boldface**.
GDP and related data for second quarter 1995 **embargoed until 8:30 a.m., Friday, September 29, 1995.**

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 28, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4788
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.28
10-year T-bond	5.87	7.09	6.28	6.49	6.28
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.62
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	Sept. 28, 1995	**Week ago**	**Year ago**
Deutschemark-Dollar	1.422	−0.9	−8.2
Yen-Dollar	99.73	−0.4	+1.0
Multilateral $ (Mar. 1973=100)	84.18	−0.7	−4.2

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**3.3** (Q2)	5.6 (Aug)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.4 (Aug)
Japan	0.6 (Q2)	3.2 (Jun)	0.1 (Jul)
France	2.8 (Q2)	12.4 (Apr)	1.9 (Aug)
Germany	2.1 (Q2)	6.5 (May)	2.0 (Aug)
Italy	4.0 (Q1)	12.2 (Apr)	5.8 (Aug)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.6 (Aug)

U.S. GDP data for second quarter 1995 **embargoed until 8:30 a.m., Friday, September 29, 1995.**

EYES ONLY

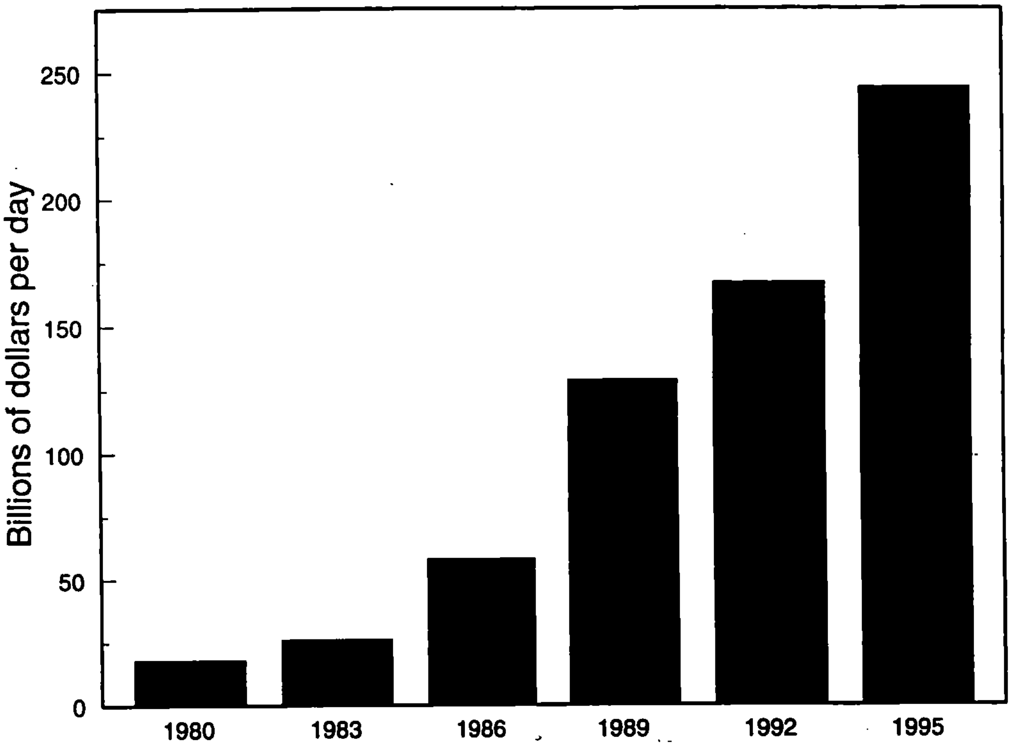
WEEKLY ECONOMIC BRIEFING
OF THE PRESIDENT OF THE UNITED STATES

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

September 22, 1995

CHART OF THE WEEK

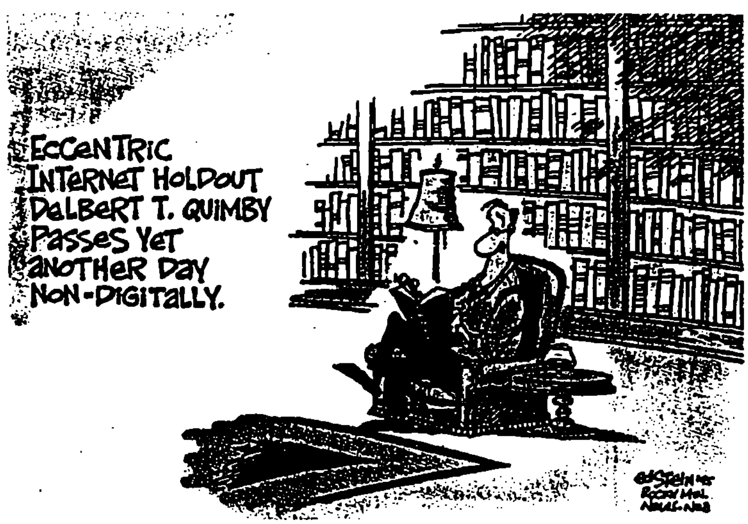
Daily Turnover in the U.S. Foreign Exchange Market



Major central bank reports on foreign exchange trading, released this week, indicate much stronger growth in the volume of trading over the past 3 years than many analysts had expected. London remains the world's largest foreign exchange market, with daily trades over $460 billion, followed by New York. The reports also show that transactions in the forward market have grown in importance.

EYES ONLY

CONTENTS



EYES ONLY

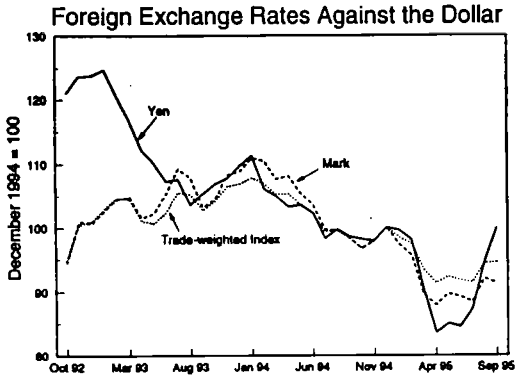
CURRENT DEVELOPMENT

The Rebound of the Dollar

Since early July, the U.S. dollar has rallied strongly on world currency markets. Its rise has been sharpest against the yen, where the gain is about 20 percent, but the dollar has also risen against the deutsche mark and on average against the currencies of our major trading partners (see chart).

Reasons for the dollar's ascent include large interest rate differentials in favor of the dollar. Recent Treasury Department intervention, in coordination with foreign central banks, has been particularly successful in catching traders off-guard, producing relatively large short-run movements.

Foreign Exchange Rates Against the Dollar



Effects on the U.S. Economy. The rebound in the dollar reverses its sharp depreciation early this year, and largely restores exchange rates to December 1994 levels. An exchange rate cycle lasting only 9 months would be expected to have only limited short-run effects on the U.S. economy, and essentially no net effects after 1 year. Manufacturers' planning horizons typically extend over a much longer period and are based on longer-term trends in real exchange rates. Thus, little of the depreciation earlier this year showed up in import prices before the dollar rebounded: between December 1994 and July 1995 the prices of imports from Japan rose only 4.8 percent, while those from the European Union rose by 3.7 percent.

Despite the recent appreciation of the dollar, the United States remains a highly competitive economy. U.S. real exchange rates based on unit labor costs today are back to early 1990 levels, while Germany and Japan have seen their costs rise relative to their competitors.

EYES ONLY

SPECIAL ANALYSIS

Contingent Workers

As reported recently in the New York Times, employers' use of contingent workers is growing, but is not as widespread as some estimates have suggested. Unfortunately, there is no common definition for "contingent worker," and estimates of the number of such workers have varied widely.

In 1995, the Bureau of Labor Statistics established a measure of the number of these workers that includes wage and salary workers who believe their jobs are temporary, as well as self-employed workers and independent contractors who do not expect to be with their client for more than one additional year. Using this definition, the BLS survey in February 1995 found that 4.6 percent of the labor force and 4.9 percent of all employed persons were contingent workers. In other words, in addition to the 5.4 percent of the labor force that were unemployed in that month, another 4.6 percent believed that their jobs were only temporary. Contingent workers were more likely to be young, female, black or hispanic, and part-time workers. They also were less likely to have health insurance.

Is the number growing? The BLS does not have historical data on trends in contingent employment since the new measure was added just this year. But other evidence suggests that the number of contingent workers has grown considerably over time. For instance, the number of persons employed at temporary help agencies—one component of the contingent workforce—grew from 0.9 percent to 1.4 percent of private nonfarm payroll employment between 1985 and 1990 and to 2.2 percent in 1995.

Should we be concerned? Economists disagree as to whether growth in the number of contingent workers signals a weakness or a strength of the U.S. labor market. On one hand, greater uncertainty about future employment is one way in which jobs at the bottom of the labor market have deteriorated. On the other hand, contingent workers can provide greater flexibility for management to tailor its workforce to its needs.

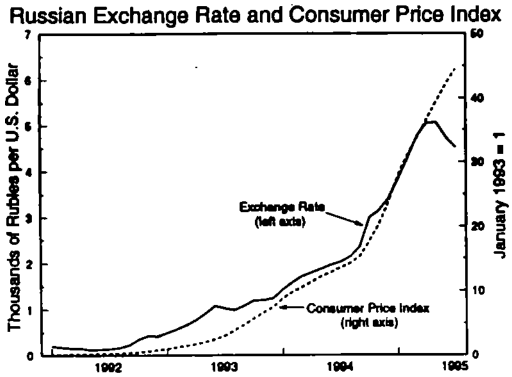
TREND

The Resurgent Russian Ruble

Inflation in Russia averaged 17 percent per month (about 550 percent per year) between January of 1992 and January of this year. This high inflation—the result of monetary credits used to finance large budget deficits—battered the Russian ruble, which fell in value from 180 rubles per dollar in early 1992 to about 4,500 per dollar in the middle of this year (see chart).

Policy measures. In March of this year, the Russian government and central bank announced a new program to combat inflation. The program, which was devised with the assistance of the International Monetary Fund, limits the budget deficit and credit growth. It seems quite successful thus far. The Federal budget deficit in the first half of this year was 3.2 percent of GDP, down from 9.2 percent a year earlier. And monthly inflation fell from 18 percent in January to 5 percent in July.

Russian Exchange Rate and Consumer Price Index



Building on their initial success in reducing inflation, the authorities issued a promise in July to maintain the exchange rate within a zone of 4,300 to 4,900 rubles to the dollar. Since then, the demand for rubles has surged: the Central Bank has been forced to sell rubles (and buy dollars) in order to ensure that the ruble does not gain too much value. As a result, Russia's foreign exchange reserves rose from $2 billion in January to $10 billion in June.

Analysis. Very high inflation causes significant and often unexpected costs. A target for the exchange rate can help to reduce high inflation by anchoring some domestic prices to those abroad and by serving to bolster the government's credibility. Many stabilization programs (such as the ones implemented by Israel in 1985 and Argentina in 1991) have used exchange rate targets.

Pegging the exchange rate is not a panacea. The exchange rate target is likely to collapse relatively quickly unless it is accompanied by other fundamental policy changes, such as reductions in the budget deficit. And maintaining an exchange rate target for a long time—even if it were feasible—might not be desirable. Unless inflation falls rapidly, exporters will be squeezed between rising domestic costs (driven up by the domestic inflation rate) and roughly constant revenues (held down by the fixed exchange rate). While policymakers must ensure that these costs do not become excessive, temporarily pegging the exchange rate can be an important tool in stopping very high inflation and its associated distortions.

EYES ONLY

ARTICLE

The Advisory Commission on the CPI: Interim Report

The Advisory Commission to Study the Consumer Price Index last week released its interim report, in which it estimates that the CPI as presently calculated overstates changes in the true cost of living by about 1.5 percentage points per year. Of this bias, the Commission believes 0.5 percentage point will be eliminated by changes in the formula used to compute the CPI when its next update occurs in 1998. The remaining bias of 1.0 percentage point, which actually may range from 0.7 to 2.0, will be more difficult to eliminate. The Commission, which was appointed earlier this year by the Senate Finance Committee, consists of five experts in the fields of economics and statistics. All of these experts were on record prior to appointment as believing that the bias in the CPI is large. The Commission will present its final report in June 1996.

Analysis. Although the CPI is a good measure of the price of a fixed market basket of consumer goods and services over time, it tends to overstate changes in the cost of living. Both the Bureau of Labor Statistics and the Commission have identified the reasons for this bias.

- **Technical problems.** The CPI suffers from problems in the way it combines the prices of thousands of products and services into the aggregate index. For example, its formula exaggerates the effect of price increases after a sale. The BLS is aware of these problems and will reduce them when the CPI is updated in 1998. These corrections are estimated by the Commission to account for a 0.5 percentage point overstatement of the cost of living.
- **Substitution toward low-priced products.** Because the market basket used to create weights for constructing the CPI is updated only about once every 10 years, the fixed weights do not allow for substitution by consumers away from those goods and services whose prices are rising faster than others. For this reason, the CPI overweights products whose prices are rising rapidly and underweights products whose prices are rising more slowly, biasing the overall index upward. This bias tends to increase slightly over time as the base period recedes further into the past. The Commission estimates that substitution bias causes the CPI to overstate changes in the cost of living by about 0.3 percentage point per year.
- **Substitution toward discount outlets.** In recent years, consumers have been shopping more and more at discount warehouse stores. The BLS presently attributes the lower prices at these new discount stores primarily to differences in the quality of service compared with older traditional retail outlets, and not to an actual decline in price. While some of the price differences may well be due to the lower level of service at discount stores, these stores are gaining market share, indicating that consumers do

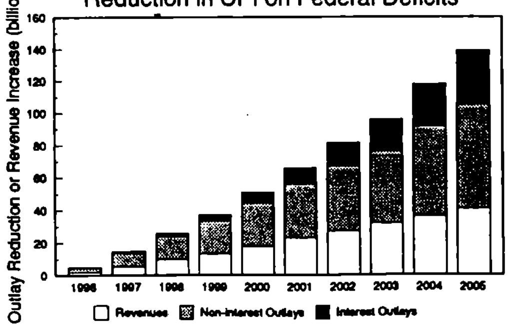
not believe the price differences are offset entirely by differences in the quality of service. The Commission estimates that outlet bias causes the CPI to overstate changes in the cost of living by about 0.2 percentage point per year.

- **Changes in the quality of products.** An increase in the price of a product that reflects an increase in quality should not be recorded as a rise in the cost of living. The BLS accounts for some of these quality changes; for example, automobile price increases that are judged to reflect improvements in quality (e.g., airbags or anti-lock brakes) are not passed through into the CPI. But BLS does not attempt to correct for quality improvements in many other areas. The reason, in part, is that methods for measuring changes in quality require large amounts of data that often cannot be collected and analyzed within the monthly time frame for producing the CPI. The Commission estimates that quality-change bias causes the CPI to overstate changes in the cost of living by about 0.2 percentage point per year.

- **New products.** The BLS includes new products in the index only with a substantial time lag. For example, the microwave oven was first included in 1978, and the VCR and personal computer in 1987, several years after these products first appeared in the marketplace. Thus, much of the usual rapid decline in the price of new products, particularly electronic ones, is missed because of the delay in introducing new products into the market basket. The Commission estimates that new-product bias causes the CPI to overstate changes in the cost of living by about 0.3 percentage point per year.

Assessment. Most economists agree about the significance of the first two types of bias, but there is wide disagreement about the magnitudes of the three other types. For instance, difficulty in estimating the value of quality changes is one reason that such changes frequently are not reflected in the CPI. Recent budget cuts proposed in the Republican-sponsored appropriation bill funding the BLS likely will limit on-going efforts to improve the CPI.

Effect of a One Percentage Point Reduction in CPI on Federal Deficits



Budgetary Implications. According to estimates from the Congressional Budget Office, a reduction of 1 percentage point in the annual rate of inflation used to index Federal government programs and the income tax system starting in fiscal 1996 would reduce the deficit for fiscal year 2005 by $140 billion (see chart). Roughly $41 billion of this reduction would come from higher Federal revenues, $64 billion from lower outlays, and $34 billion from lower

EYES ONLY

interest payments. The cumulative reduction in the Federal deficit amounts to $634 billion by the end of fiscal year 2005, which is more than half of the total in the Administration's 10-year plan to balance the budget.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Study Finds EITC Increases Labor Force Participation. A recent National Bureau of Economic Research study finds that the 1987 expansion of the Earned Income Tax Credit, together with other features of the Tax Reform Act of 1986, increased the rate of labor force participation among female household heads from 73.1 percent to 74.5 percent. The increase was statistically significant and largest among low-educated and low-income women with children. Interestingly, the study found no evidence of reduced hours of work among people whose incomes were in the phase-out range and thus were subject to positive marginal tax rates, even though economic theory would predict that such people would respond to the EITC expansion by working less. The study's authors conclude that compared to other government antipoverty efforts, the EITC appears to produce little distortion of work incentives. While these findings are encouraging, it is important to keep in mind that the 1987 expansion was significantly smaller than the 1993 expansion, and data allowing similar study of that expansion are not yet available.

Survey Examines Americans' Views on Retirement and Savings. In a new survey of full-time workers aged 25 to 64, Merrill Lynch reports that about half of respondents fear they will outlive their nest eggs. While about seven in ten expect to be better off in the next 5 years, most believe they will have to stretch their savings further in retirement than their parents did. Few Americans believe that Social Security benefits will be sufficient for their retirement years, yet Merrill Lynch reported in April that baby-boomers (ages 31-49) currently save too little to meet their retirement goals. Moreover, 86 percent believe that Social Security and Medicare will be cut back. At the same time, 85 percent of respondents believe the government does not do enough to encourage Americans to save for the future.

New Book Touts Empowering of Employees. A recently released book, titled <u>Open-Book Management: The Coming Business Revolution</u> and written by a senior writer at <u>Inc</u>. magazine, argues that a company can tap the creativity and intelligence of its workforce by giving employees the information they need to understand the company's overall performance and their own contribution to it. According to the author, numerous companies have found that employees who are informed and aware of the company's financial situation are motivated to seek solutions to problems and assume a greater degree of responsibility for the company's performance. The author points to several principles of open-book management: timely sharing of crucial financial information with employees; educating employees to understand that information and empowering them to apply it to their own work; and offering employees a stake in the successful implementation of their ideas. The book has received favorable reviews from readers in business and academia.

EYES ONLY

RELEASES THIS WEEK

Housing Starts

Housing starts rose slightly in August to 1.40 million units at a seasonally adjusted annual rate. For the first 8 months of 1995, housing starts were down 8 percent compared with the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $11.5 billion in July; it was $11.3 billion in June.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Orders (Wednesday)
Gross Domestic Product (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.1
Chain weights	2.7	3.7	4.0	1.7	0.5
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	–2.8	–2.4	–2.3	–2.1	–1.8

	1970–1993	1994	June 1995	July 1995	August 1995
Unemployment Rate	6.7**	6.1**	5.6	5.7	5.6

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

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month*			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.1
PPI-Finished goods	5.0	1.7	–0.1	0.0	–0.1

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 21, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4767
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.24
10-year T-bond	5.87	7.09	6.28	6.49	6.21
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.57
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 21, 1995**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.435	–3.4	–7.3
Yen-Dollar	100.1	–2.4	+2.2
Multilateral $ (Mar. 1973=100)	84.74	–2.5	–3.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.2 (Q2)	5.6 (Aug)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.5 (Jul)
Japan	0.6 (Q2)	3.2 (Jun)	0.3 (Jun)
France	2.8 (Q2)	12.4 (Apr)	1.4 (Jul)
Germany	2.1 (Q2)	6.5 (May)	2.3 (Jul)
Italy	4.0 (Q1)	12.2 (Apr)	5.7 (Jul)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.5 (Jul)

EYES ONLY

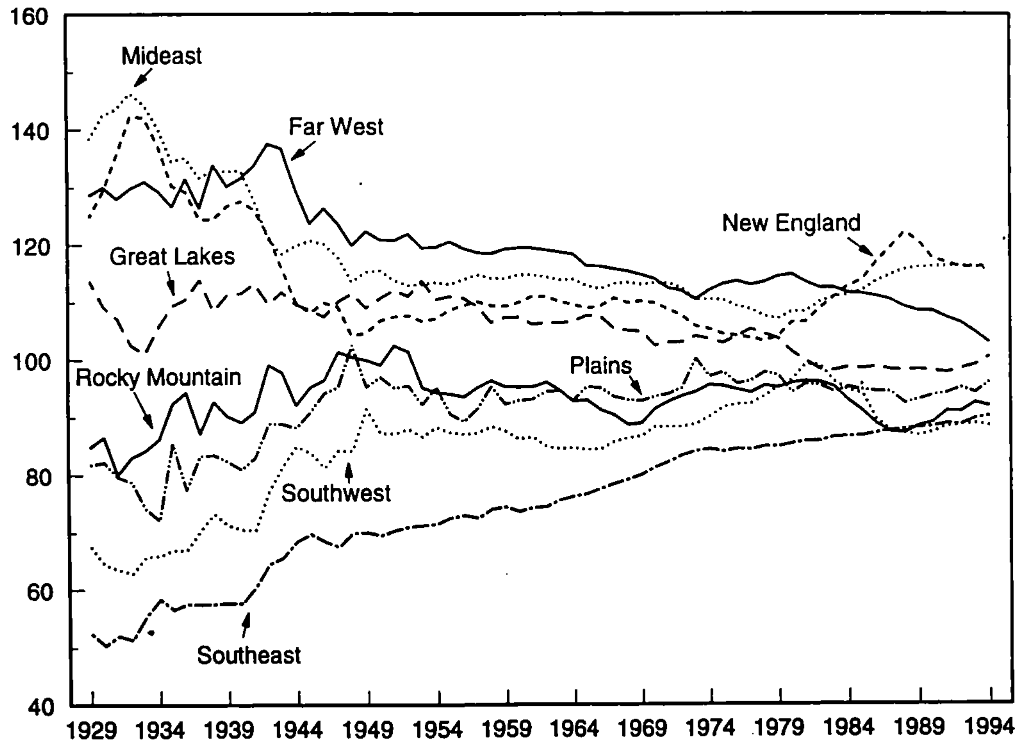
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 15, 1995

CHART OF THE WEEK

Per Capita Personal Income as a
Percentage of U.S. Average by Region

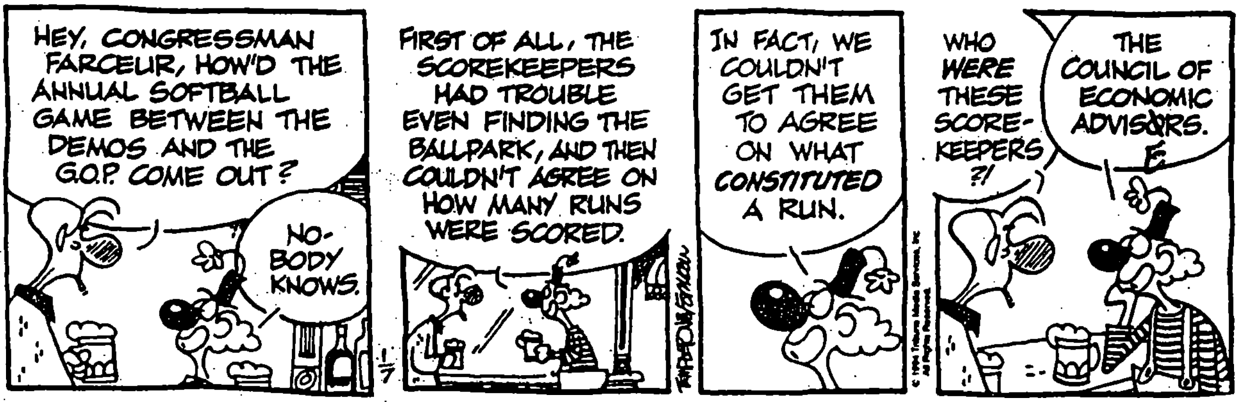


Regional differences in per capita personal income have narrowed considerably since the Great Depression. The trend toward regional convergence, however, stalled in the 1980s, as per capita income across regions began to diverge. Since the early 1990s, regional differences have begun to stabilize, and in some cases regional incomes have resumed their trend toward convergence. California has driven the pattern of convergence for the Far West region. Over the years, its per capita income has fallen from a level 150 percent of the national average to a level in 1994 only slightly above the national average.

EYES ONLY

CONTENTS

MOTLEY'S CREW



EYES ONLY

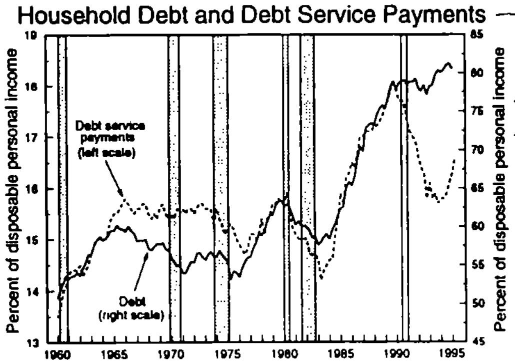
CURRENT DEVELOPMENT

Household Debt Rising, But Still Manageable

American households continue to take on debt, though the pace has eased somewhat in recent months. Rising debt has sparked some concern that consumers may soon cut back their spending, contributing to an economic slowdown.

Analysis. Debt recently has been growing roughly twice as fast as wages and salaries. Although the ratio of debt to income remains near its all-time high, the share of income devoted to servicing that debt is still well below the levels of the late 1980s (see top chart). Likewise, delinquency rates on mortgage and consumer installment loans are still far below the levels reached in the 1980s, and remain close to 20-year lows (see bottom chart). These indicators suggest that Americans are managing their debt effectively and that the increase in debt would not be expected to restrain spending.

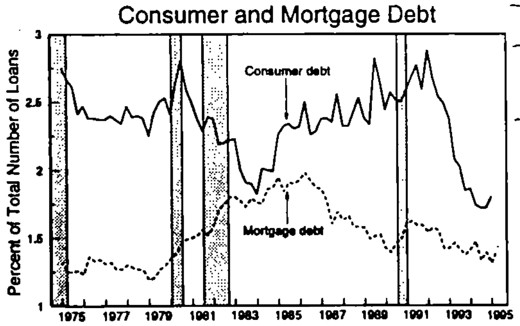
Household Debt and Debt Service Payments



Note: Shaded regions indicate recessions.

Debt service as a share of income has risen slightly over the past year, primarily as a result of increases in interest rates on home mortgages and consumer loans during 1994. The drop since January of about 1.5 percentage points in interest rates on fixed-rate mortgages, along with similar declines for adjustable-rate mortgages, should help moderate the recent uptick, keeping future debt burdens manageable. Because debt as a share of income remains close to its historical high, though, an unexpected move back up in interest rates could raise the debt burden quickly.

Delinquency Rates on Consumer and Mortgage Debt



Note: Shaded regions indicate recessions.

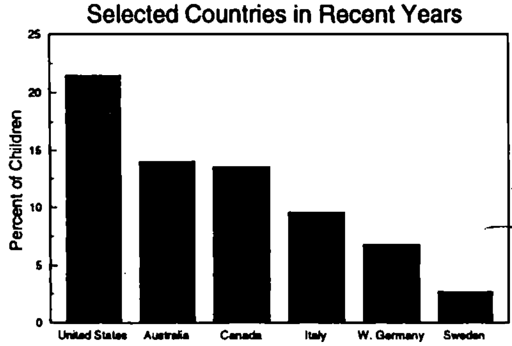
EYES ONLY

TREND

The State of Our Poorest Children

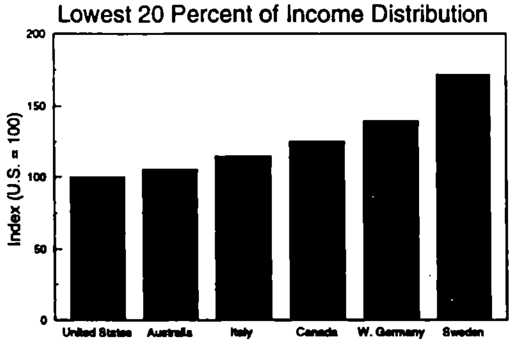
The recently released Luxembourg Income Study of children in 18 nations finds that poor children in the United States fare far worse than their counterparts in other countries. Using a relative measure of poverty—defined as the percent of children in families with incomes less than 50 percent of the country's median income—the United States has the highest child poverty rate, at 21.5 percent (see top chart). Australia comes in a distant second, with a child poverty rate of 14.0 percent.

Child Poverty Rates of Selected Countries in Recent Years



The reported high U.S. poverty rate would be less of a concern if our poorest children were still better off in absolute terms than the children of other countries. However, when comparing real spendable incomes of families with children, the study finds that, while children in our high- and middle-income families do extraordinarily well relative to those in other countries, children in our low-income families fare far worse (see bottom chart). Children in families in the poorest 20 percent of households in the United States are worse off than those in all other countries studied except for Israel and Ireland.

Income of Families With Children in the Lowest 20 Percent of Income Distribution



Analysis. The Luxembourg study's definition of income differs from official U.S. poverty statistics in that the study uses after-tax income, which includes the Earned Income Tax Credit and food stamps, whereas the official U.S. rate is based on before-tax income. As such, the Luxembourg poverty rate is closer in definition to that recommended by the National Research Council (see *Weekly Economic Briefing*, May 15, 1995). Accordingly, cuts proposed by the Republicans in the EITC and in welfare programs likely would raise U.S. poverty as measured in the Luxembourg study, worsening our already dismal international ranking. Moreover, the study's calculations do not include government-provided health care or other in-kind benefits; the inclusion of these benefits would likely exacerbate the relative standing of the poorest U.S. children.

EYES ONLY

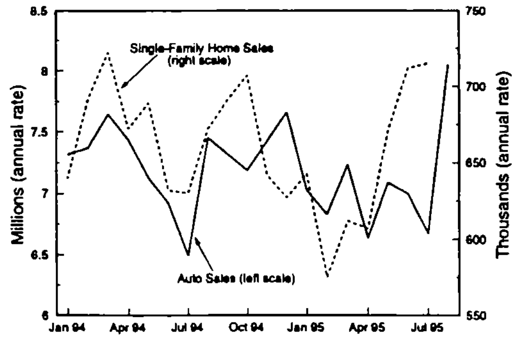
MACROECONOMIC UPDATE

Expansion Regaining Momentum

The Department of Commerce recently revised upward its estimate of second-quarter growth in real GDP to 1.1 percent, so that growth over the first half of the year is now about one-half of a percentage point below potential. Sales of motor vehicles in August were sufficiently strong that the auto sector should no longer be a drag on GDP growth. Thus, GDP is likely to expand at a 2 to 2.5 percent rate over the second half of this year. An added bonus is that inflation has been quite low, in fact surprisingly so compared to most analysts' forecasts of inflation.

Analysis. Many factors have contributed to the slowdown in the economy during the first half of the year, including repercussions from the crisis in Mexico. But the slowdown in autos and housing was especially pronounced, due in large part to the interest rate hikes in 1994 through February of this year. Sharp declines in sales of autos and houses led to a build up in inventories and then to significant cutbacks in auto production and housing construction, depressing second-quarter growth. The declines in interest rates in recent months, which have boosted demand for autos and homes (see chart), as well as the production cutbacks, have allowed both sectors to work off their excess inventories. As a result, housing starts have been increasing of late, rising close to 7 percent in July, and residential construction is now poised to add to GDP growth for the first time this year. Similarly, recently announced auto production schedules suggest that this sector will no longer significantly restrain growth.

Home and Auto Sales



Risks to the forecast. Upside and downside risks to the forecast are fairly well balanced. On the upside, recent data show the manufacturing sector is finally rebounding at an impressive rate. This should boost incomes and generate additional spending throughout the economy. The major concern on the downside is the possibility of an impasse with respect to the appropriations bills or the failure to raise the debt ceiling. Although their direct impacts on growth are likely to be marginal, their repercussions in financial markets could be substantial (see Weekly Economic Briefing, August 4, 1995). Extreme reactions in debt or equity markets—markets where valuations have been known to deviate from economic fundamentals for sustained periods—could seriously impair consumer and business willingness and ability to spend.

EYES ONLY

ARTICLE

Tax Reform and the Tax Treatment of Housing

Recent proposals to reform the U.S. income tax system could have effects on many sectors of the economy. An important aspect of these effects are the costs associated with the transition to a new tax system. Transition costs must be carefully weighed against any benefits of proposed reforms. As an example of these transition costs, this article focuses on the impact of proposed changes in the tax treatment of housing. In particular, we consider the effects of eliminating the tax preference for housing, a change that is implicit in Representative Armey's proposed flat tax and other consumption tax proposals.

Current Tax System. Many people believe that the tax subsidy provided to owner-occupied housing derives solely from the deductibility of mortgage interest. More accurately, the subsidy also stems from the fact that the implicit rental income homeowners receive from their investment in housing is untaxed. Even taxpayers who have paid off their mortgages receive a substantial subsidy.

> <u>Example</u>. Consider an investor who buys a house for $100,000 that could be rented for $8,000 per year. Excluding tax considerations, that investor would be equally well off purchasing a $100,000 bond that paid $8,000 per year in interest, and renting a similar house for $8,000. However, the investor who purchases the house pays no tax on the return to the investment (the $8,000 in implicit rent), whereas the investor who rents and purchases a bond pays tax on the $8,000 of interest.
>
> <u>Deductibility of mortgage interest</u>. If the investor borrowed the $100,000, interest on that borrowing would be deductible regardless of whether the investor purchased a bond or purchased a house. Eliminating the deductibility of mortgage interest would, of course, wipe out the tax subsidy provided to homeowners with a mortgage, but would still leave a subsidy for homeowners without a mortgage.

The current tax system provides additional subsidies to housing by its preferential treatment of capital gains on housing and the deductibility of property taxes.

What is to be gained from reform? Proponents of changing the tax treatment of housing point to two benefits:

- **Efficiency effects.** The current tax system encourages people to become homeowners, but also encourages people to buy more costly houses. This biases investment toward housing at the expense of other potentially more productive investments, like plant and equipment investment. Eliminating this bias could, in the long run, increase the nation's productive capacity.

EYES ONLY

- **Distributional Effects.** The subsidy to housing primarily benefits middle- and upper-income households. For example, while less than 10 percent of all taxpayers have incomes of $100,000 or more, these taxpayers receive almost 50 percent of the total tax benefits associated with the deductibility of mortgage interest.

What is the cost of reform? Even if eliminating the tax subsidy to housing would have long-term beneficial effects, it could create significant transition costs:

- **Value of housing.** Eliminating the preferential tax treatment of housing most likely would cause the value of residential real estate to fall. Assessing the magnitude of the fall is difficult, and could vary substantially across different types of houses and across regions of the country. Nevertheless, a recent study concluded that replacing the current tax system with a flat tax (which would eliminate the tax preference to housing) would result in a 15 percent decline in home values.

- **Banking spillovers.** It is possible that the elimination of the mortgage interest deduction would make servicing mortgages more difficult for many homeowners, and could result in some increase in mortgage defaults. If the removal of the tax preference to housing were done in the context of a tax reform that generally lowered income taxes, the additional costs of mortgage payments might be offset by lower taxes on other income, and defaults might not pose a significant problem.

- **Macroeconomic effects.** Reducing the tax subsidy provided to owner-occupied housing would reduce the amount of wealth people devote to housing. This reduction in demand could result in a severe short-term contraction in the housing industry, which could spill over to other sectors of the economy. Again, the exact effects would depend on the other provisions of the tax reform.

Summary. Many people believe that the current tax system subsidizes investment in housing at the expense of investment in other forms of capital, such as factories and equipment. As a consequence, capital may be misallocated and economic growth may be lower than otherwise. Removing this subsidy, however, would generate significant transition costs. Incremental reductions in the subsidy provided to housing, however, might improve efficiency without causing severe disruptions in the housing market. Balancing long-term benefits against transition costs should be central to any consideration of tax reform.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

World Bank Report Focuses on Inequality within Families. A recently released World Bank policy paper finds that, while the past two decades have seen progress in the treatment of women worldwide, inequalities nonetheless persist between men and women. According to the report, unequal treatment of the sexes can result in a vicious circle in which households invest less in girls' education than in boys', perpetuating inequality. For example, if educated females earn less than similarly educated males, households will have an incentive to provide boys with more education than girls. This decision, however, can affect social outcomes for future generations because there is a strong correlation between women's education and the number of children they have, as well as the education and health of their children. Therefore, the report stresses that the government must play an important role by encouraging investment in women's education and health.

Fed Survey Suggests Stable Economy. The Federal Reserve's latest district-based Current Economic Conditions survey cites further expansion in economic activity with no clear change in underlying price pressures. After the last report suggested a slowdown in manufacturing, this one finds that industrial activity has stabilized and in some areas may now be strengthening. Many districts also report a pickup in construction. While business conditions appear soft in some sectors, like retailing and agriculture, the hot, dry summer weather commonly is blamed. Increases in consumer prices are somewhat restrained and suggest little acceleration in retail price pressures over the near term. Reinforcing this fact, the demand for labor is seen as growing moderately, with little unusual pressure on wage gains. Tourism and construction each appear to have performed favorably throughout the country.

$14,000 A Vote?!? A recent National Bureau of Economic Research working paper takes a novel approach to computing the effects of Federal spending in Congressional elections. While it is widely believed that bringing Federal expenditures to their districts helps incumbent Representatives get reelected, empirical evidence has been extremely weak. One explanation is that incumbents who anticipate a tough campaign may exert greater effort to obtain spending for their districts. Hence statistical analyses will be clouded by the fact that we observe greater Federal spending in districts whose incumbents are likely (for other reasons) to get a smaller share of the vote. Controlling for this problem, the paper shows that the effect of non-transfer spending (e.g., construction projects) is five times that measured with less adequate statistical techniques. An additional $100 per capita in non-transfer spending is worth as much as 2 percent of the popular vote—which can work out to as much as $14,000 a vote!

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

****Embargoed until 9:15 a.m., Friday, September 15, 1995****

The Federal Reserve's index of industrial production rose 1.1 percent in August. Capacity utilization rose 0.6 percentage point to 84.3 percent.

Retail Sales

Advance estimates show that retail sales rose 0.6 percent in August following a 0.4 percent decline in July. Excluding sales in the automotive group, retail sales were basically unchanged in July and August.

Consumer Price Index

The consumer price index increased 0.1 percent in August. Excluding food and energy, consumer prices rose 0.2 percent.

Producer Price Index

The producer price index for all finished goods decreased 0.1 percent in August. Excluding food and energy, producer prices increased 0.1 percent.

MAJOR RELEASES NEXT WEEK

Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.1
Chain weights	2.7	3.7	4.0	1.7	0.5
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	–2.8	–2.4	–2.3	–2.1	–1.8

	1970–1993	1994	June 1995	July 1995	August 1995
Unemployment Rate	6.7**	6.1**	5.6	5.7	5.6

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

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	**0.1**
PPI-Finished goods	5.0	1.7	–0.1	0.0	**–0.1**

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 14, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4802
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.28
10-year T-bond	5.87	7.09	6.28	6.49	6.08
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.60
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 14, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.485	+0.6	–3.5
Yen-Dollar	102.6	+4.0	+3.5
Multilateral $ (Mar. 1973=100)	86.88	+0.9	–1.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.2 (Q2)	5.6 (Aug)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.5 (Jul)
Japan	0.1 (Q1)	3.2 (Jun)	0.3 (Jun)
France	2.9 (Q2)	12.4 (Apr)	1.4 (Jul)
Germany	2.1 (Q2)	6.5 (May)	2.3 (Jul)
Italy	4.0 (Q1)	12.2 (Apr)	5.7 (Jul)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.5 (Jul)

EYES ONLY

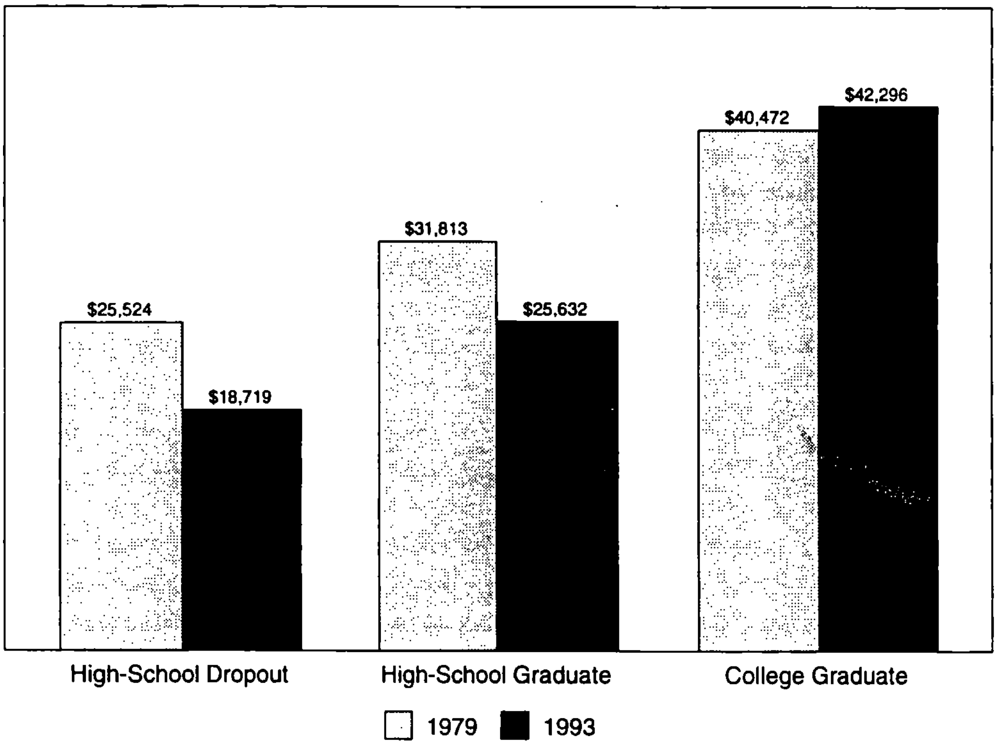
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 8, 1995

CHART OF THE WEEK

Average Annual Earnings by Educational Attainment
(25-34 year-old male working full time, 1993 dollars)



Average annual earnings of 25-34 year-old males declined between 1979 and 1993 for those with a high school education or less, while earnings increased slightly for those with a college education. Over this 15-year period, the payoff from a college degree relative to a high school diploma has about doubled, largely because of the decline in the earnings prospects of the less-educated. A Special Analysis in this issue of the Briefing highlights the disparities in college enrollment rates for youth of differing family backgrounds.

EYES ONLY

CONTENTS

SPECIAL ANALYSES

TREND

ARTICLE

DEPARTMENTS

"Son, they say your generation doesn't have as much to look forward to as my generation did. Do you want to talk about it?"

EYES ONLY

SPECIAL ANALYSIS

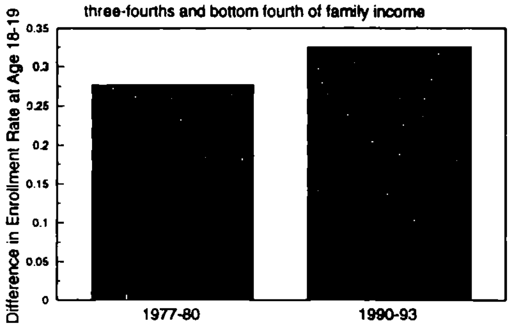
Widening Gaps in College Enrollment

At a time when the value of a college education has increased dramatically, gaps in college enrollment rates between income and racial groups are widening. In 1979, the average 25-34 year-old male college graduate earned 27 percent more than a similar high-school graduate. By 1993, the average male college graduate earned 65 percent more than a high-school graduate.

Uneven gains in enrollments. Not all youth have responded similarly to the rising value of a college education. College enrollment rates have been rising primarily among those in the top three-fourths of the family income distribution. As a result, the gap in enrollment rates between the top three-fourths and the bottom fourth of the family income distribution has been growing (see top chart).

Gap in College Enrollment by Family Income

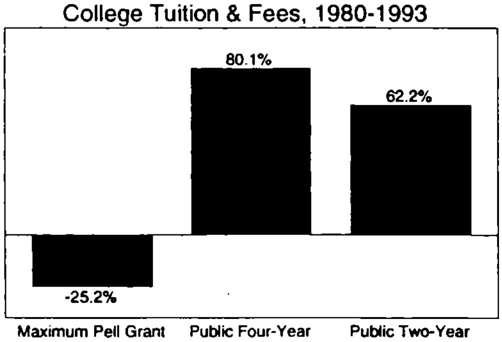
Difference in enrollment rate between top three-fourths and bottom fourth of family income



Largely because blacks on average have lower family incomes than whites, this growing disparity has been reflected in a growing racial gap in college enrollment rates. In 1980, white youth were 18 percentage points more likely than blacks to be attending college. By 1993, that gap had risen to 22 percentage points.

Why have these gaps widened? One potential cause of these widening gaps in college enrollment between groups is the rising cost of a public university education (see bottom chart). As more youth seek to attend college, the states have been unable to keep up their historical commitment to pay the majority of the costs of public higher education. As a result, they have increasingly resorted to public tuition hikes. The maximum Pell Grant that a low-income youth can receive has not kept pace with these rising costs. The Administration is seeking to increase the maximum Pell Grant to $2,620 (from its current level of $2,340) which will have the effect of making 200,000 more students eligible next year. Legislation passed by Republicans in the House of Representatives would set a lower maximum award of $2,440, as well as eliminate 360,000 students from eligibility.

Real Change in Maximum Pell Grant and College Tuition & Fees, 1980-1993



EYES ONLY

Outlook. Differences in families' ability to respond to the rising payoff to schooling does not augur well for the future. To the extent that the problem is financial, continued support for financial aid policies targeted at lower-income youth is one way to curb this disturbing trend. To the extent that poor preparation serves as a deterrent, Head Start and such programs as Goals 2000 are important longer-term strategies.

Students Spending More Time on Homework

Since a college education has become relatively more valuable, high-school students now spend more time on homework to improve their prospects for acceptance into college. The proportion of 13-year-olds reporting that they had no homework or that they had not done their homework declined from 37.6 percent in 1980 to 21.5 percent in 1988. The proportion reporting that they spent more than 2 hours on their homework increased from 7.2 percent to 10.7 percent over the same period. Similarly, the number of students taking Advanced Placement courses grew by 138 percent relative to the number of 11th and 12th grade students between 1984 and 1992.

EYES ONLY

SPECIAL ANALYSIS

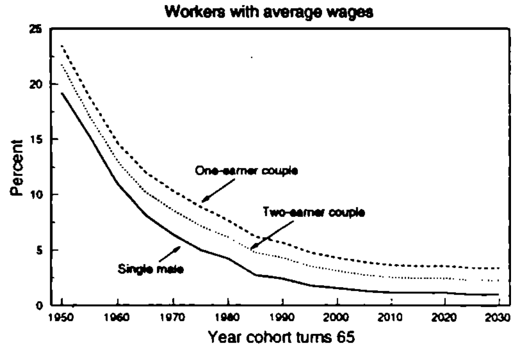
Declining Returns to Social Security

Rates of return to Social Security contributions have declined dramatically for all workers retiring since 1950 and are projected to continue to decline to relatively low levels (see chart and Weekly Economic Briefing, August 4, 1995).

Future Returns. The low rates of return expected on Social Security contributions in the future may erode some of the political support currently enjoyed by the program. A single male with average wages retiring in 2010, for example, can expect a real rate of return of 1.2 percent. A high-income two-earner couple can expect a return of 1.45 percent. Political tensions may also arise because the rates of return vary so much with family circumstances (for example, a one-earner couple retiring in 2010 with average earnings will still receive a 3.6 percent rate of return).

Real Rates of Return on Social Security Contributions

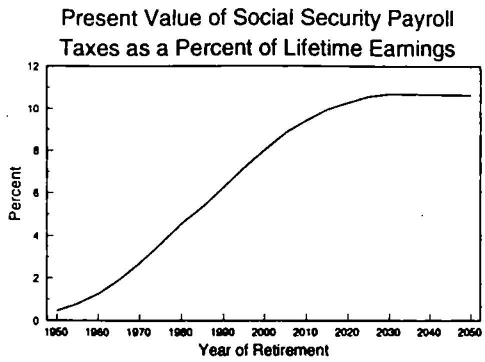
Workers with average wages

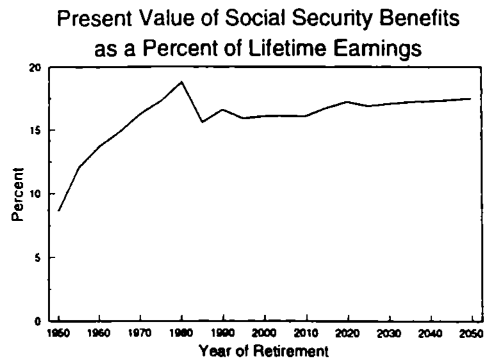


This problem of low returns is distinct from the problem of the anticipated deficit in the Social Security trust fund. Relatively small changes in benefits or taxes would restore the fiscal viability of the system. These modifications would actually slightly exacerbate the significant political problem stemming from the low rates of return.

Why have rates of return fallen? The two charts on the next page illustrate the present value of taxes and benefits for an average two-earner couple, assuming that the real opportunity cost of funds is 2 percent. They show that the decreasing rate of return is a consequence of increasing taxes with stable (and in one period, declining) benefits.

Increasing tax payments. The increase in taxes is primarily a consequence of two factors: the maturation of the system, and increases in tax rates. Workers retiring in the early years of the Social Security program had only a few years worth of wages subject to the Social Security payroll tax. Over time, retirees had more and more years of wages subject to taxation, substantially increasing their lifetime tax payments. Furthermore, the rate of Social Security tax also increased over time, so that later generations of retirees not only paid taxes over a longer time horizon, but also paid taxes at higher rates.





<u>Changes in benefits.</u> In the early years of the program, a combination of statutory changes as well as changes in productivity and substantial increases in life expectancy led to rapid increases in benefits relative to income. (Average remaining life expectancy for men at 65 climbed from 12.7 years in 1940 to 15.3 years in 1990, and is projected to increase to 18 years by 2050. The increase in life expectancy was even greater for women.)

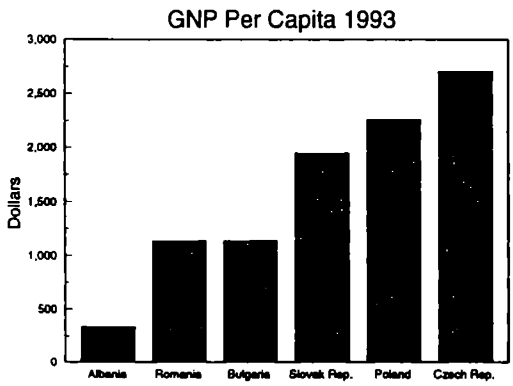
In the future, these factors likely will have only small and roughly offsetting effects, so that the ratio of benefits to lifetime income is expected to climb only modestly over the next few decades. In particular, increases in life expectancy will be roughly offset by a scheduled increase in the retirement age from 65 to 67.

Analysis. The U.S. Social Security system is a pay-as-you-go system, with benefits of retirees at any date largely paid for by taxes on workers at that time. When the system was established, benefits were conferred on retirees that far exceeded their contributions—hence the high rates of return. As the system matures, however, each generation pays the benefits for its parents and, in return, receives benefits based on taxes on its children's wages. The higher the growth of real wages, the higher the benefits. Because population and productivity growth rates are anticipated to be relatively moderate, future returns to Social Security contributions will be low.

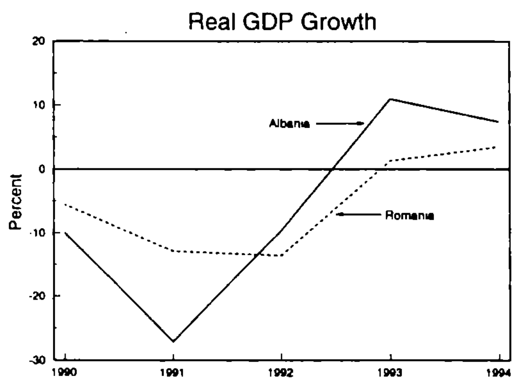
TREND

Albania and Romania: Turning the Corner?

President Berisha of Albania and President Iliescu of Romania, each of whom will visit Washington this month, head nations that lag far behind the rest of Eastern Europe in per capita GNP (see top chart). Although economic performance in both countries has improved during the past two years, with lower rates of inflation (still high by western standards) and modest economic growth (see bottom chart), the transition to market economies has been painful for most residents of these countries, who endured a rise in unemployment and skyrocketing inflation after the first reforms were implemented in the early 1990s. Both governments are considering additional reforms, including large-scale privatization programs that would entail a public offering of stock in most remaining government enterprises.



Foreign aid helping to support economic reform. Romania and Albania are relying on multilateral and bilateral foreign aid and investment to support economic reforms. For example, financial assistance from foreign governments and international agencies (for public investment) in Albania is over twice the expenditure of the government itself. Much assistance is contingent upon economic reforms, including reduction of budget deficits, stabilization of currencies, and privatization of state enterprises. While Albania has largely complied, opposition within the government has stalled reform in Romania, where only 35 percent of GDP is generated by the private sector. As a result, $500 million in loan disbursals from the IMF and World Bank have been delayed. The inadequate state of infrastructure in these countries has hindered foreign investment. But as positive effects of foreign aid on macroeconomic stabilization and better infrastructure become apparent, both nations, particularly Romania, will likely see increased interest from foreign corporations. Although it remains insubstantial relative to most other East European nations, foreign investment in Albania tripled to $60 million in 1994 over 1993 and jumped five-fold in Romania to $650 million.



ARTICLE

Competition in Satellite Services: Restructuring INTELSAT

The Clinton Administration is attempting to increase competition in telecommunications markets both domestically and internationally. One such effort involves how to restructure INTELSAT, an international consortium of 132 countries that provides satellite services for global communications. The Administration and others charge that INTELSAT's special status as a quasi-governmental organization gives it unfair advantages and inhibits free competition in the rapidly growing market for satellite services, and that these obstacles to free competition harm some innovative U.S. companies and consumers worldwide. The Administration advocates reducing INTELSAT's artificial advantages and role. It supports INTELSAT's original goal of ensuring that all countries are provided access to international telecommunications, but believes that competitive private providers can largely meet this goal, and that any remaining shortfall can be addressed more effectively through other means.

Background. When INTELSAT was created in 1964, an international telecommunications consortium may have been necessary, but technological developments in the last 30 years have dramatically altered matters. Private companies now provide many of the services that once only INTELSAT offered. For instance, sub-marine fiber optic cables now carry a large share of international telephone traffic, and some independent satellite operators recently have emerged. But critics have long worried that further growth of independent satellite operators (still dwarfed by INTELSAT) is being stifled by INTELSAT's artificial advantages.

INTELSAT'S Advantages. INTELSAT has privileges and immunities concerning taxation and antitrust laws. Moreover, its members, usually government-owned telecommunications monopolists, are well placed to restrict access of satellite competitors to national markets by pressuring national licensing authorities or through their control of interconnection to key ground facilities. At the same time, INTELSAT finds its ability to expand into new services limited by its awkward governing arrangement; it would like to restructure to gain the organizational flexibility of a private company while preserving all of its special advantages.

The U.S. position. The Administration opposes such restructuring, having consistently argued that deregulation or privatization alone are not necessarily desirable if they lead to unrestrained monopoly. We fear that granting INTELSAT more flexibility while preserving all its artificial advantages would increase the danger that INTELSAT would monopolize important emerging services such as satellite video broadcasts. The Administration seeks a structure that places INTELSAT on an equal footing with private competitors, assures continued and expanded communication links to all countries, and preserves as much as possible any genuine efficiencies, such as economies of scale, that INTELSAT might possess.

A possible way to restructure. One approach is to separate INTELSAT into two or more entities. One entity (the "residual INTELSAT") would retain the current INTELSAT organizational structure and privileges, the other(s) would be organized along private lines and enjoy no special status. The United States favors confining the residual INTELSAT to core "lifeline" services, such as basic telephone links to all countries, and making it independent of the other entities, which would be free to provide any services. Most other countries prefer letting the residual INTELSAT provide all services and, more importantly, making the other entities its wholly-owned subsidiaries.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Gender Disparity Lowers U.S. Ranking. A recent study by the U.N. Development Programme found that although the United States ranks second in overall "Human Development"—a measure designed as an alternative to GNP and composed of measures of average life expectancy, income, and education—the United States falls to fifth among the 130 countries studied when gender disparities in the same indicators are taken into account. If calculated in 1970, the United States would have ranked first in the "Gender Development Index," but has since been overtaken by Sweden, Finland, Norway, and Denmark. This drop in ranking can be accounted for primarily by the small share of earned income going to U.S. women relative to women in these other countries. Only 35 percent of total earned income in the United States goes to women, compared to 42 percent in Sweden. The report also estimates that women in the United States work 5.8 percent more hours than men, with 63 percent of that time in paid work and 37 percent in unpaid work. For U.S. males, the shares are exactly the reverse.

U.S. Wins "Competitiveness" Title. For the second straight year, the International Institute for Management and Development in Switzerland ranked the United States as the world's most "competitive" nation. Singapore ranked second, followed by Hong Kong, Japan, Switzerland, and Germany. The first-place ranking for the United States was attributed to aggressive deregulation, strength in innovative technologies, and tight control over labor costs. The biggest jump in ranking was by Taiwan, which moved from 18th to 11th place. Japan continued to decline in the ranking, after leading the competitive league for nine years until 1993.

States Balance of Payments. There are wide regional disparities in the balance of payments between states and the Federal government. A new report, produced jointly by Harvard's JFK School of Government and Sen. Pat Moynihan, finds that the 10 states with the highest tax payments relative to Federal subsidies were concentrated in the Northeast and Midwest. Residents in Connecticut, New Jersey, Delaware, Illinois, New Hampshire, Minnesota, Michigan, New York, Wisconsin, and Nevada paid an average of $1,347 more in taxes than the government spent. States with higher Federal expenditures relative to taxes tended to be poorer and less populated, and were located primarily in the South and Southwest. In all, 20 states paid more in Federal taxes than they received in Federal outlays in fiscal 1994. While high-income states may appear to benefit disproportionately from any particular Federal program, on balance the Federal government tends to redistribute money from high-income to low-income states.

EYES ONLY

RELEASES THIS WEEK

Productivity

Nonfarm business productivity increased 4.8 percent at an annual rate in the second quarter. Manufacturing productivity increased 2.6 percent.

Domestic Auto Sales

Domestic autos were sold at an annual rate of 8.1 million units in August.

MAJOR RELEASES NEXT WEEK

Producer Prices (Tuesday)
Consumer Prices (Wednesday)
Retail Sales (Thursday)
Industrial Production and Capacity Utilization (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP	2.5	4.1	5.1	2.7	1.1
GDP deflator	5.5	2.3	1.3	2.2	1.6
Productivity					
Nonfarm business	1.2	1.8	4.3	2.5	4.8
Manufacturing (1978-93)	2.1	4.2	3.7	3.5	2.6
Real compensation per hour	0.6	0.6	1.5	1.0	0.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	–2.8	–2.4	–2.3	–2.1	–1.8
			June 1995	**July 1995**	**August 1995**
Unemployment Rate	6.7*	6.1*	5.6	5.7	5.6

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	N.A.
PPI-Finished goods	5.0	1.7	–0.1	0.0	N.A.

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 7, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4670
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.34
10-year T-bond	5.87	7.09	6.28	6.49	6.21
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.63
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 7, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.476	+0.6	–4.7
Yen-Dollar	98.58	+0.8	–0.7
Multilateral (Mar. 1973=100)	86.09	+0.4	–2.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.2 (Q2)	5.6 (Aug)	2.8 (Jul)
Canada	2.5 (Q2)	9.8 (Jul)	2.5 (Jul)
Japan	0.1 (Q1)	3.2 (Jun)	0.3 (Jun)
France	2.9 (Q2)	12.4 (Apr)	1.4 (Jul)
Germany	2.1 (Q2)	6.5 (May)	2.3 (Jul)
Italy	4.0 (Q1)	12.2 (Apr)	5.7 (Jul)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.5 (Jul)

WEB Sept. 1995