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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

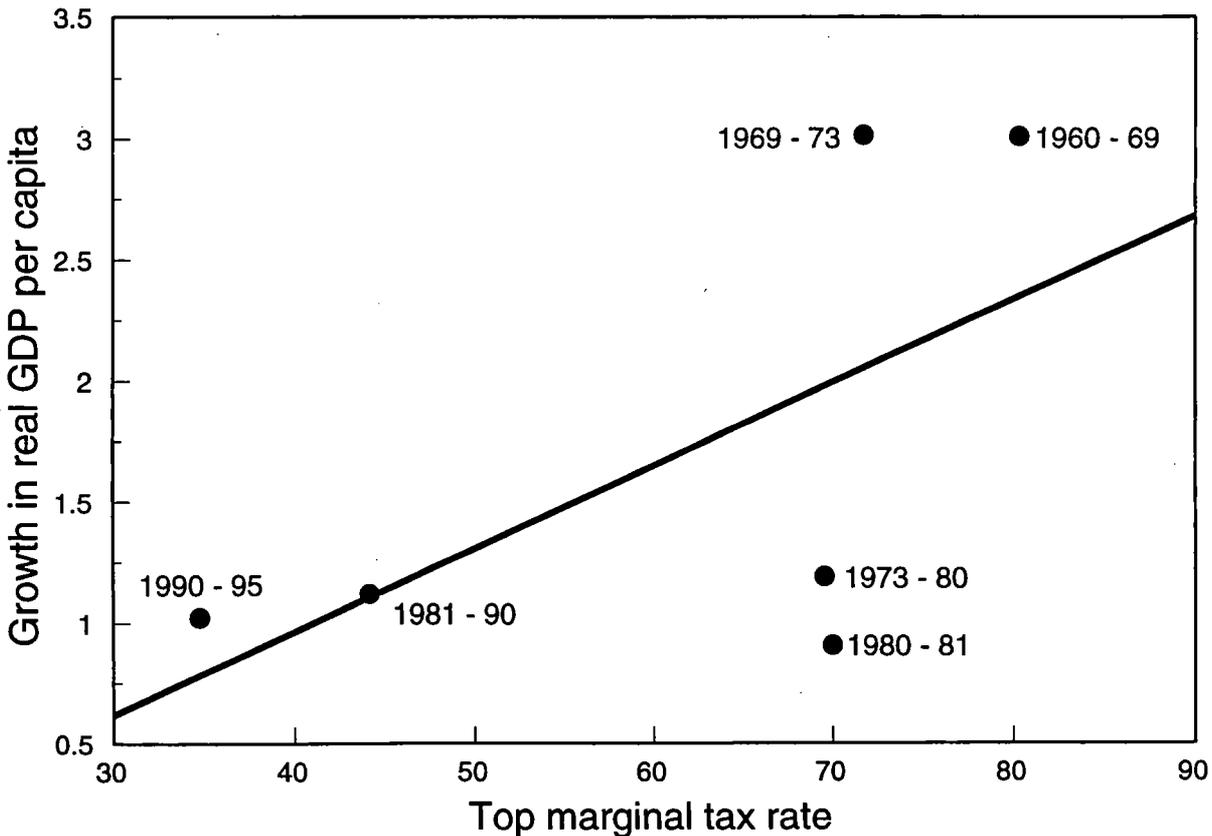
July 26, 1996

Copy sent to
Stiglitz

p. 4 sent to
Rahn

CHART OF THE WEEK

Any Relationship between Marginal Tax Rates and Growth?



Note: Data are averages over the business cycle.

Tax cut advocates sometimes use simple charts purporting to show that cutting taxes boosts economic growth. This simple plot of top marginal tax rates against per capita GDP growth suggests such "analysis" is hardly definitive. Taken literally, the upward-sloping line providing the "best fit" to these data suggests that a rise in the top tax rate has a mildly positive effect on economic growth (in fact, both growth rates and marginal tax rates have drifted down over time, without one necessarily causing the other). More to the point, simple correlations cannot prove how taxes affect growth.

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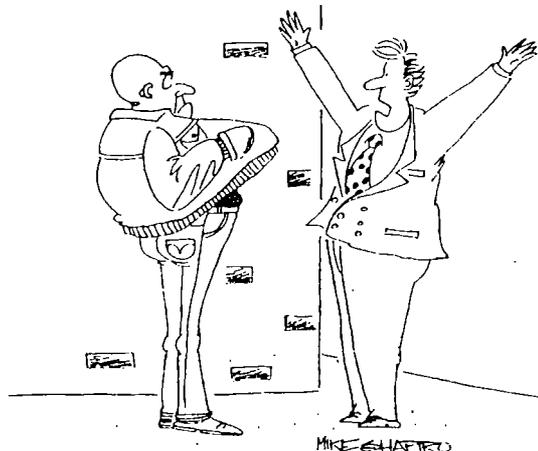
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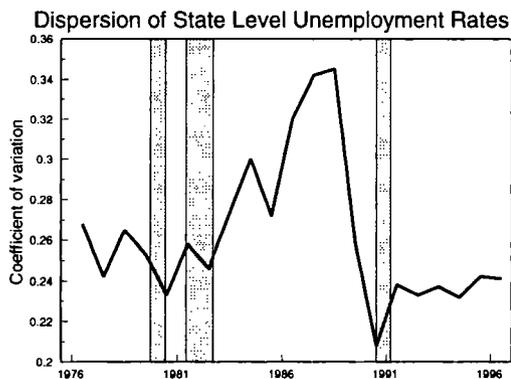


"Sorry, but I'm much too successful to carry cash."

CURRENT DEVELOPMENT

State Unemployment Rates Show Current Expansion Is Broad-Based

Economic expansions can sometimes show strong growth at the national level while masking pockets of regional weakness (this appears to have happened in the mid-1980s, for example). The current expansion appears to be broad-based, however, as evidenced by the narrowing of differences in unemployment rates across states.



Analysis. The chart shows how the coefficient of variation of state unemployment rates (including the District of Columbia) has varied over the past twenty years. The coefficient of variation is a measure of the relative dispersion of individual state unemployment rates around the average of all state unemployment rates. A higher coefficient of variation indicates greater divergence among individual state unemployment rates.

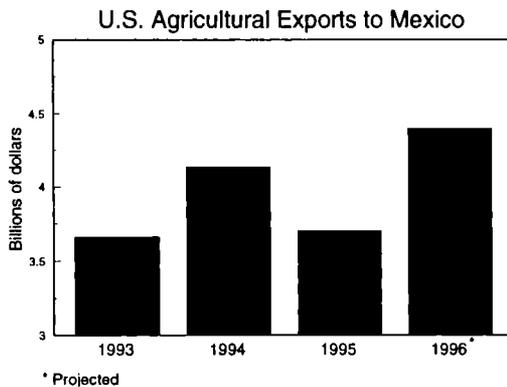
The dispersion of unemployment showed little trend before rising sharply in the mid-1980s. It fell sharply in 1989-90, following its 1984-88 rise. It has now leveled off near its pre-1983 level. The increased dispersion in the mid-1980s may be explained by regional factors like the "Massachusetts miracle" and prolonged oil-price-related recessions in Texas and Louisiana. These regional shocks ended by 1989-90.

Conclusion. In contrast to the economic recovery of the mid-1980s, the current economic recovery has been quite uniform across states, with the benefits of falling unemployment widely shared.

CURRENT DEVELOPMENT

USDA Projects Record Farm Exports to Mexico

U.S. agricultural exports to Mexico are projected to hit a record \$4.4 billion in fiscal 1996, surpassing the \$4.1 billion mark set in 1994 (see chart). The Department of Agriculture also projects a record \$60 billion in total U.S. farm exports in 1996.



Export trends since NAFTA. U.S. farm exports to Mexico rose 25 percent in 1994, the first year of NAFTA implementation. U.S. corn producers were major beneficiaries of reduced trade barriers as corn exports to Mexico rose 10-fold. Since NAFTA, Mexico's share of U.S. corn exports has risen to over ten percent. In 1995, a deep recession and peso devaluation reduced Mexico's demand for U.S. farm exports. Even so, U.S. exports to Mexico of corn, wheat, and about 40 other commodities continued to grow. In 1996, drought in Mexico coupled with general economic recovery have renewed the upward trend in demand for U.S. farm exports. The U.S. agricultural trade balance with Mexico has improved from a \$15 million deficit in fiscal 1995 to a \$480 million surplus through May of fiscal 1996.

Impacts on Mexico. Besides the impact of growing U.S. exports, Mexican producers have also been contending with major reforms of the Mexican farm price support program. Mexican consumers have gained to the extent that the rise in U.S. exports of corn and other commodities have kept food costs down.

CURRENT DEVELOPMENT

Costs of Changing Unemployment Insurance Eligibility

Recent judicial and legislative actions regarding Unemployment Insurance (UI) highlight the tension between greater eligibility and higher costs.

Current practice and judicial action. Like many other states, Illinois based UI eligibility on earnings in the first four of the previous five calendar quarters. Eligibility for a worker laid off in May of 1996 is determined from employment in 1995. If this worker had only been employed since December 1995, he or she would probably be ineligible. But a District Court has ordered Illinois to consider more recent work history as well now that improved data processing has made this possible.

Cost consequences. Use of more recent work history will increase the number of workers eligible for UI and raise expenditures. The costs of the change, however, may be different than projected based on increased eligibility alone. Research suggests that experienced workers' earnings start to decline well before they are actually laid off. These workers would actually receive smaller benefits. This effect may be alleviated if more up-to-date earnings records are used only for those who do not qualify under conventional methods, as dictated by the District Court. Cost estimates using a supplemental method may be less than projected as well. The newly eligible workers will have more intermittent work histories and lower earnings. They would be eligible for smaller UI benefits and, research suggests, would be less likely to take up their benefits than more experienced workers.

Conclusion: Basing UI eligibility on more up-to-date earnings will increase access to UI for workers with intermittent work histories. UI costs will go up if workers can qualify under either eligibility criterion. Moving exclusively to the new criterion will hurt experienced workers whose earnings are falling.

ARTICLE

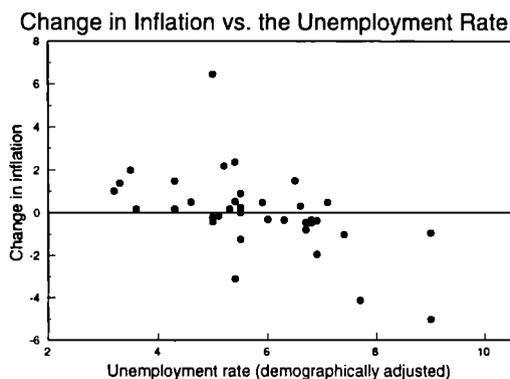
Is the Unemployment Rate Too Low?

At 5.3 percent, the unemployment rate is as low as it has been in this expansion. Some worry that it is too low to be sustained without a resurgence of inflation.

Conventional economic wisdom holds that once the unemployment rate falls below its “natural” rate, inflation begins to rise. Until recently, statistical estimates of this natural rate have tended to cluster around 6 percent. The fact that the unemployment rate has been below 6 percent for almost two years now and that inflation has remained tame has led economists to look again at the relationship between inflation and unemployment.

The NAIRU model. The non-accelerating-inflation rate of unemployment (NAIRU) is the name economists now commonly apply to the “natural” rate of unemployment. The standard model predicts a rise in inflation when markets are tight (a low unemployment rate) and a decline when they are slack (a high unemployment rate). So, for example, if the NAIRU is 6 percent, maintaining unemployment at 5.3 percent would produce rising inflation over time (for example, 3 percent this year, 3½ percent next year, 4 percent the following year, and so forth). Symmetrically, keeping the unemployment rate at 6.7 percent would produce falling inflation (5 percent this year, 4½ percent next year, and so forth). In principle, keeping inflation at the NAIRU would keep inflation constant.

For policymakers, it may be important to know not only the NAIRU but also how fast inflation is likely to change when the economy deviates from the NAIRU. For example, policymakers might be more inclined to push down the unemployment rate if the evidence suggests that any resulting inflation would be mild and easily checked rather than virulent and difficult to rein in.



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Empirical evidence. The chart provides a representative plot of the change in inflation against the unemployment rate.

The NAIRU is the point where a line fitted to these data crosses the horizontal axis. Recent empirical investigations of this relationship suggest the following:

- The NAIRU may have fallen some over the past several years. Changes in labor market conditions and changes in the relationship between wages and prices can cause the NAIRU to change. Recent estimates lend support to the idea that it may have fallen below 6 percent. Reasons that have been cited include changes in the demographic composition of the labor force, deregulation, increased

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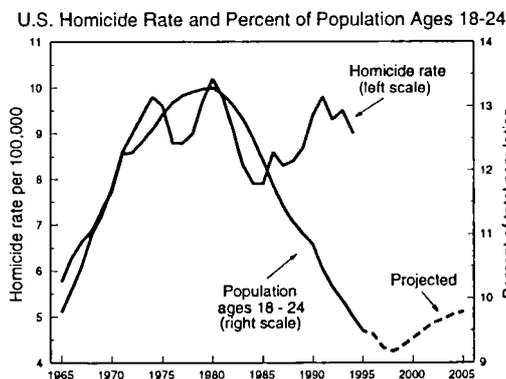
C. Rahm

TREND

Youth and Crime

Although the national crime rate has shown a welcome downward trend recently, trends in serious crime among youth are disturbing.

Analysis. Violent crime appears to be an activity of the young. The homicide rate, for example, tracked the proportion of the population aged 18-24 quite closely between the mid-1960s and the mid-1980s (see chart). It even showed a modest downward trend as the baby boom matured and the proportion of 18-24 year olds fell in the first part of the 1980s.



This trend led many to conclude that a decline in the number of young adults, particularly males, would lead to a decline in crime rates overall. In 1985, however, the homicide rate began to rise rapidly even as the proportion of young people continued to fall. A rough estimate suggests this deviation from trend produced about 65,000 additional homicides between 1986 and 1994.

Juvenile crime and its causes. Homicides committed by 14 to 24 year-olds jumped sharply between 1985 and 1991. Moreover, handgun-related homicides by juveniles have nearly quadrupled since 1985, while the number of homicides using other forms of weapons has remained relatively constant.

Although researchers have identified declines in economic opportunity for inner-city youths, increased financial benefits from crime, lack of supervision, and family histories of child and substance abuse as contributors to this problem, it is unlikely any of these changed dramatically around 1985. But the widespread introduction of crack cocaine beginning about 1985 could be a cause. Some criminologists point to crack dealing and the protection of turf by local drug cartels as bringing about an increase in armed youth gangs and a greater propensity to act violently.

Implications. Even if the rate of violent crime by young people does not rise further, the crime rate may go up as the baby "boomerang" enters their crime-prone years (see chart). A continuing worsening in the violent crime rate among youth would aggravate this demographic effect. Although hard evidence is limited, promoting economic opportunity and reducing the profits from illegal conduct appear to be a necessary component of any policy to ameliorate this trend.

**PHOTOCOPY
WJC HANDWRITING**

international competition, computerized production-management techniques, and a decline in the influence of labor unions.

- The precise value of the NAIRU is uncertain. One study, for example, reports an estimate of 6.2 percent, plus or minus more than a point, for the 1990 NAIRU. Another estimates the 1996 NAIRU to be as low as 5.2 percent using one inflation measure and as high as 5.7 using another.
- Inflation responds noticeably but not explosively when the unemployment rate goes below the NAIRU. Models typically show that when the unemployment rate drops one percentage point below the NAIRU inflation rises between one-half and three-quarters of a percentage point for each year that the unemployment rate stays below the NAIRU.
- Moderate inflation can be reduced with a moderate rise in unemployment above the NAIRU. Models typically show that the inflationary effects of going a certain amount below the NAIRU for a year can be undone by staying the same amount above the NAIRU for a year (assuming such fine tuning were possible).
- Supply shocks can create inflation that is costly to reduce. Oil and other adverse supply shocks can raise the inflation rate irrespective of whether unemployment is high or low. Reducing such inflation can be costly because it requires accepting economic slack (high unemployment and lost output).

Implications for policy. Most economists continue to believe that unemployment cannot be pushed down forever. Eventually, the economy will overheat and inflation will begin to rise. Many argue for slowing the economy now to prevent the emergence of inflation. Others note the absence of evidence that dropping below the NAIRU produces an explosive inflationary shock. They find it hard to justify slowing the economy prematurely and sacrificing jobs and output when inflation remains tame and we do not know precisely where the NAIRU is.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Post-Olympics, Atlanta Economy Continues to Look Peachy. Like the athletes themselves, the city of Atlanta has been preparing for the 100th Olympic games for years. Atlanta was chosen as the sight of this year's games in 1990, and construction of sports and lodging facilities, increased tourism, and other Olympic spending are expected to generate \$5.1 billion in spending and 70,000 additional jobs in Georgia. When the games come to a close, however, much of this increased economic activity will end as well. But forecasters predict that Atlanta will not suffer from the post-Olympic employment slump that plagued Los Angeles in 1984. Because of the strong regional economy and already-tight job market in the South, the displaced workers should be readily absorbed into new jobs.

"Smart Cards" Hot in Atlanta. Visa is hoping to cash in during the Olympics by convincing visitors to use less cash. Instead of fumbling with rumpled bills or searching for correct change, visitors can pay for meals, gasoline, pay-phone calls, and public transportation using a new "Visa Cash" smart-card. The plastic cards have an embedded microchip and function as electronic cash. They are faster and easier than credit or debit cards because the value is stored directly on the card and accessed by a PIN, bypassing the time-consuming approval process required for the other cards. Two types are being sold via card-dispensing machines in Atlanta: disposable cards in \$10 to \$100 denominations, and reloadable cards that can be replenished at ATMs. Visa's trial run in Atlanta should provide insight into whether Americans want smart cards, which are already being used in Europe, South America, and Australia. So far, the cards have been well received, with nearly 50,000 transactions logged during the first 6 days of the games.

Seniors Seen as Cause of Savings Slump. In trying to explain the decline in the already-low U.S. saving rate, economists have tried to blame government or consumption-happy baby boomers. A new study instead points the finger at the Nation's elderly population. Two major factors have contributed to the fall in the savings rates since 1960, according to the study. First, Social Security and Medicare have redistributed resources to the elderly. Second, today's elderly spend a higher percentage of their incomes than past generations. It is not that the elderly are buying more Winnebagoes or wintering more in Florida. The biggest culprit is increased spending on personal health care.

INTERNATIONAL ROUNDUP

Despite Closure of Large Russian Banks, Fears of Systemic Collapse Are Overblown. This week the Central Bank of Russia revoked the license of Tveruniversal Bank, the 17th largest bank in the country. The failure of this high-profile bank, in addition to the closure of hundreds of other banks since 1991, has raised concerns that Russia's banking system is on the verge of collapse. The Russian banking system's financial weaknesses, which include a troublesome bad loans problem, reflect difficulty adjusting to the more stable macroeconomic environment in which recent appreciation of the rouble has greatly reduced bank profits. Despite these weaknesses, there are several factors mitigating what otherwise might be a disaster. First, loans account for only about 20 percent of the banking system's assets. Second, the banking system is small relative to the overall economy. Third, the vast majority of Russian banks are small, and two-thirds of household deposits are held by the state-controlled savings bank.

New Indian Budget Tries to Balance Poverty Reduction and Deficit Reduction. India's new coalition government just presented a budget for 1996-97 that calls for a modest reduction of its budget deficit to 5 percent of GDP. Although the previous Indian government was accused of sacrificing the plight of the poor on the altar of economic reform, the new left-of-center government has put forward a number of measures that aim to improve the lot of those previously left out. "Basic minimum services," which include access to safe drinking water, universal primary education, health care coverage, and public housing assistance are targeted for a 25 percent spending increase. Farmers will benefit from a doubling in the flow of credit to agriculture over the next five years. In order to meet these and other new financing pledges, the government intends to introduce a minimum corporate tax. Observers have expressed concern that the government's revenue projections are too optimistic. They warn that rising interest payments on India's debt, reported to account for 47 percent of government revenue currently, might lead India into a debt trap like the one experienced in 1991.

China's Economy Continues to Expand Rapidly in 1996. Earlier this week, the Minister of China's State Planning Commission announced that China's economy had grown rapidly in the past six months while successfully keeping inflation in check. From January through June, real GDP grew at a 9.8 percent annual rate while consumer price inflation was 9.2 percent at an annual rate—the lowest level in three years. The agricultural sector, where many of China's economic reforms were first implemented, continues to experience significant gains, with output of summer grains reaching a record high. Moreover, China's growth is translating into gains in real income, particularly in the coastal areas: in the first six months of this year the real income of farmers in one eastern province increased by an astounding 27.6 percent to just over 1600 yuan. Still, incomes remain low by any standard—this represents just \$200 at current exchange rates and roughly \$900 on a purchasing power parity basis.

RELEASES THIS WEEK

Advance Durable Orders

Advance estimates show that new orders for durable goods decreased 0.8 percent in June, following an increase of 4.2 percent in May.

MAJOR RELEASES NEXT WEEK

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

U.S. ECONOMIC STATISTICS

	1970– 1993	1995	1995:3	1995:4	1996:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	3.6	0.5	2.2
GDP chain-type price index	5.3	2.6	2.2	2.2	2.4
<u>Nonfarm business (NFB) sector:</u>					
Productivity (chain-type)	1.5	0.3	1.7	-0.8	2.1
Real compensation per hour:					
Using CPI	0.6	1.0	2.1	0.5	0.1
Using NFB deflator	1.3	1.7	2.0	2.0	2.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.2	10.4
Residential investment	4.5	4.0	4.0	4.0	4.1
Exports	8.2	11.1	11.1	11.3	11.2
Imports	9.2	12.5	12.5	12.4	12.5
Personal saving	5.1	3.3	3.2	3.6	3.4
Federal surplus	-2.7	-2.2	-2.2	-2.1	-2.1
<hr/>					
	1970– 1993	1995	April 1996	May 1996	June 1996
Unemployment Rate	6.7**	5.6**	5.4	5.6	5.3
Payroll employment (thousands)					
increase per month			191	365	239
increase since Jan. 1993					10008
Inflation (percent per period)					
CPI	5.8	2.5	0.4	0.3	0.1
PPI-Finished goods	5.0	2.3	0.4	-0.1	0.2

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

FINANCIAL STATISTICS

	1994	1995	May 1996	June 1996	July 25, 1996
Dow-Jones Industrial Average	3794	4494	5617	5672	5422
Interest Rates					
3-month T-bill	4.25	5.49	5.02	5.09	5.15
10-year T-bond	7.09	6.57	6.74	6.91	6.87
Mortgage rate, 30-year fixed	8.35	7.95	8.07	8.32	8.19
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	Current level	Percent Change from	
	July 25, 1996	Week ago	Year ago
Deutschemark-Dollar	1.480	-0.4	+6.1
Yen-Dollar	108.4	+0.4	+23.3
Multilateral \$ (Mar. 1973=100)	86.37	-0.3	+5.2

International Comparisons	Real GDP growth (last 4 quarters)	Unemployment rate	CPI inflation (last 12 months)
United States	1.7 (Q1)	5.3 (Jun)	2.8 (Jun)
Canada	0.6 (Q1)	9.4 (May)	1.4 (Jun)
Japan	5.5 (Q1)	3.6 (May)	0.3 (May)
France	0.9 (Q1)	12.6 (Mar)	2.3 (Jun)
Germany	0.4 (Q1)	7.1 (May)	1.3 (Jun)
Italy	1.6 (Q1)	12.5 (Apr)	4.0 (Jun)
United Kingdom	1.9 (Q1)	8.3 (May)	2.2 (Jun)