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

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

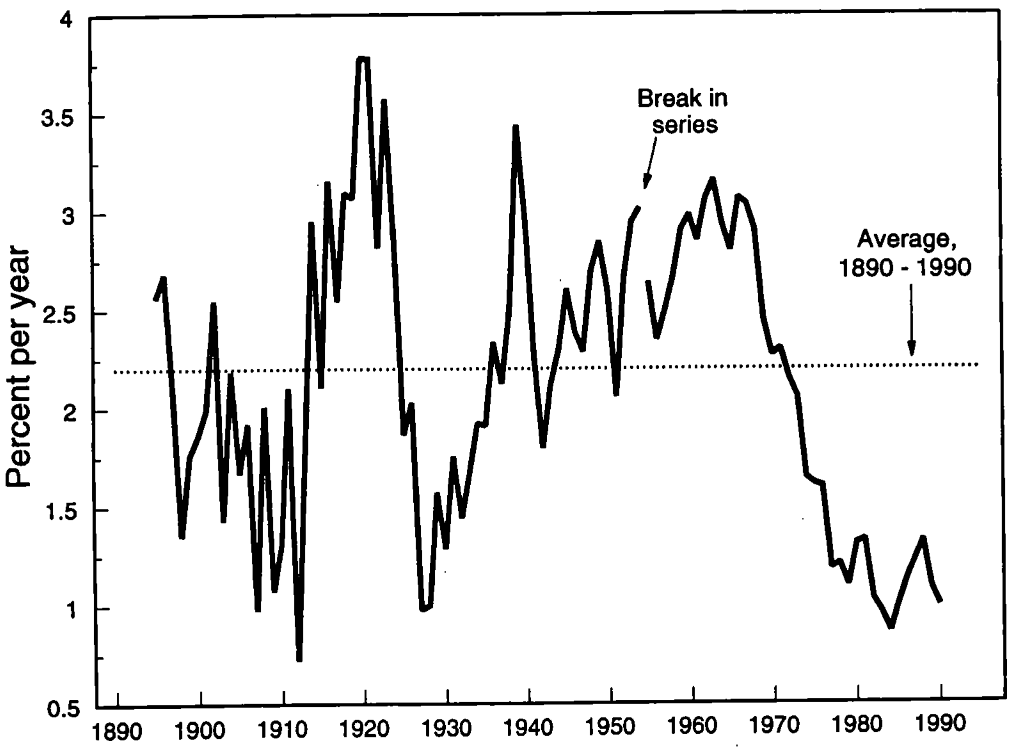
August 2, 1996

copy for
Stiglitz

pg. 9 Notes

CHART OF THE WEEK

Growth in Output Per Hour over the Past Century



Ultimately, growth in the Nation's standard of living depends on strong productivity growth. After above-average performance in the 1950s and 1960s, productivity growth slowed dramatically in the early 1970s and remains well below the long-term historical average. (Because year-to-year changes are quite volatile, the chart shows a centered moving average, hence data for the period 1985-95 are centered on 1990.) The slowdown in productivity growth has not been confined to the United States and cannot be reversed quickly. But deficit reduction and sound public investment programs can make a difference.

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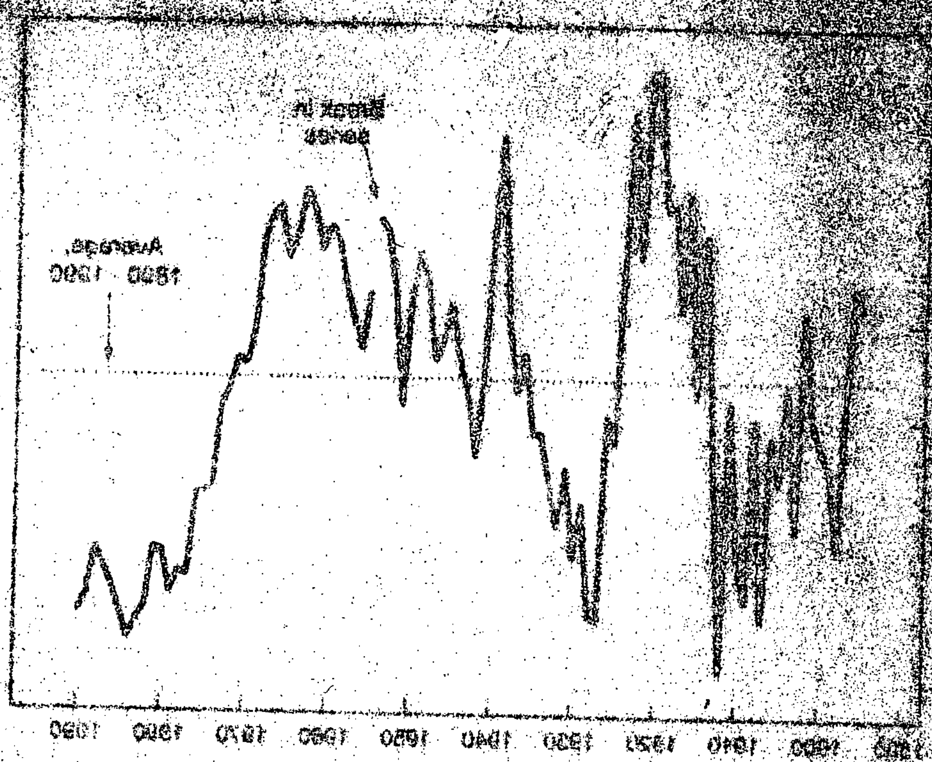
Growth in Output Per Hour over the Past Century



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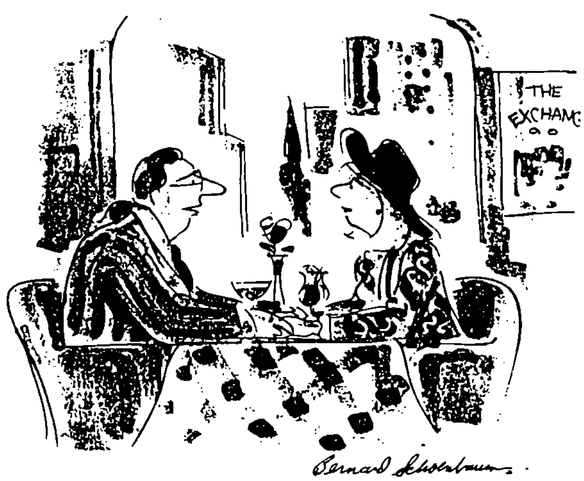


"It's only fair that I warn you, Margaret. I'm very subject to market fluctuations."

CURRENT DEVELOPMENT

GDP Scorecard: Second Quarter 1996

Real GDP rose at a 4.2 percent annual rate in the second quarter of 1996, somewhat faster than market expectations. All major components except nonresidential structures and net exports increased. The GDP price index rose at a 2.1 percent annual rate, about the same as over the previous four quarters. These estimates of growth and inflation are very good, especially given how little slack there is in the economy.

Component	Growth*	Comments
Total consumer expenditures	3.7%	Very strong growth in furniture and household equipment had been foreshadowed by robust reports on retail sales.
Producers' durable equipment	3.2%	Growth in equipment, especially computers, was extraordinarily strong in the first quarter. Second quarter investment edged up from this high level. Orders for investment goods point to a slowdown in the third quarter.
Nonresidential structures	-6.6%	June data were unavailable at the time of the release and a weak number was penciled in. We expect an upward revision in this category.
Housing	15.2%	Housing starts have been surprisingly strong, given the recent run up in mortgage rates. But sales trailed off towards the end of the second quarter.
Nonfarm inventories (change, billions of 1992 dollars)	$15.5	Inventory investment, which had been slow in the first quarter, picked up in the second. Nevertheless, inventories remain quite lean in relation to sales.
Federal purchases	8.4%	An aberrant increase in Federal purchases, despite a policy-induced downward trend
State & local purchases	6.3%	The school year was extended in many places to make up for snow days last winter.
Exports	5.2%	Exports are expanding to record levels.
Imports	12.9%	Strong growth is stimulating imports. The U.S. economy is growing faster than most of its trading partners, resulting in a deterioration of net exports.

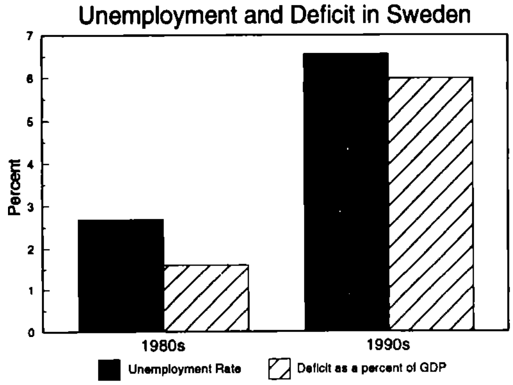
*Percent real growth in the second quarter at annual rates (except inventories). The advance estimate is subject to substantial revision.

SPECIAL ANALYSIS

Does Sweden Have to Give Up on the Welfare State?

For years, Sweden was admired for its ability to promote social welfare and create wealth. For a long time its income distribution has been more equal than that of the United States. In 1970, Sweden's per capita income (calculated on a purchasing power parity basis) ranked fourth in the world.

Unemployment and Deficit in Sweden



Over the past two decades, however, Sweden has experienced relatively poor economic growth. By 1990 it had fallen to 8th place in the income rankings. And in 1991, Sweden was hit by its worst recession since the 1930s, driving up unemployment and the budget deficit (see chart). By 1995, Sweden had fallen to 16th place in the income per capita rankings.

Reasons offered to explain this deterioration in economic performance include:

- Lack of competition. Three-quarters of the economy is sheltered from foreign competition, which has deprived corporations in these sectors of the incentives to adopt global best practice and to innovate. By contrast, those Swedish industries with few regulatory barriers and intense competition, such as heavy trucks and buses and computer software, exhibit best practice performance.

- Large public sector. Mainly as a result of generous welfare-state arrangements, total public sector expenditures have fluctuated between 60 and 70 percent of GNP since the late 1970s. Of this, transfers have usually accounted for 35 to 40 percentage points, compared with 11 percentage points in the United States. High taxes and generous benefits create incentive problems and give rise to tax evasion, tax avoidance, and benefit cheating.

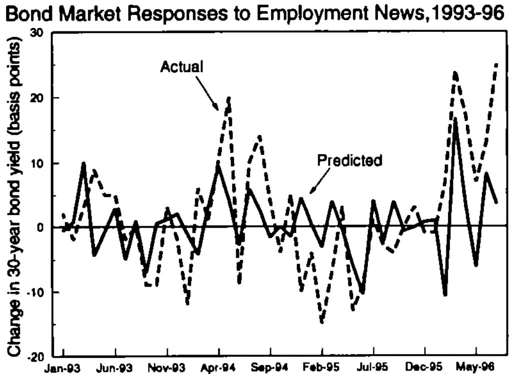
Policy responses. Sweden has tried to address some of its serious incentive problems with tax reforms in 1983 and 1991 and benefit reforms in the early 1990s. A program of fiscal retrenchment was launched in 1994 to reduce the deficit. Although Sweden began growing again in 1994, roughly 13 percent of workers remain unemployed or in government training programs. To beat unemployment, Sweden will probably have to continue liberalizing its product and labor markets.

SPECIAL ANALYSIS

The Bond Market and the Monthly Employment Report

Traders in the bond market watch the monthly employment release closely because it provides clues about inflationary pressures and Federal Reserve strategy. They respond primarily to the unexpected movement in the employment and earnings data, since the expected changes are already reflected in current bond prices and yields. An unexpectedly strong employment report raises the likelihood of higher interest rates in the future, explaining why traders react adversely to rapid job growth. While such a response is understandable, it is difficult to tell whether the size of the response is appropriate.

Bond Market Responses to Employment News,1993-96



Analysis. A recent study quantified the bond market response, finding that each 100,000 increase in employment above expectations is associated with an increase in the 30-year bond yield of about 4 basis points. The chart illustrates how well such predictions have worked since the beginning of 1993. Last month, the bond market responded more strongly than usual to the employment numbers for June (perhaps because of the unexpectedly rapid growth in wages). The bond market should not respond strongly to today's news of employment and earnings for July, since the numbers are roughly consistent with expectations. The study also found:

- The employment figures are subject to substantial and predictable revision. Between 1979 and 1995, the average absolute change between the initial release and the final benchmark was 88,900. In two-thirds of the cases where the initial report was above what markets expected, job growth was subsequently revised downward; in two-thirds of the cases where it was lower than expected it was subsequently revised upward. Since the employment data released today were what the market had anticipated, we would not expect them to be revised.

- Growth in the number of firms sampled (from about 68,000 in 1979 to about 239,000 now) has increased the reliability of the data in the initial employment report. Revisions–although still substantial–are smaller than they used to be. Although the bond market might have been expected to respond more to unexpected job movements as the reliability of the initial estimate improved, the data do not show any such rise in responsiveness.

Conclusion. The bond market responds to the employment figures because they contain news about the economy. But contrary to what casual observation may suggest, the bond market has not become any more sensitive to the jobs numbers.

SPECIAL ANALYSIS

No Supply-Side Miracle in an Across-the-Board Tax Cut

A 15 percent across-the-board tax cut would increase the budget deficit and hurt macroeconomic performance, according to simulations from two different econometric models.

Analysis. Evidence on saving and labor supply provides little support for supply-side assertions that people's economic behavior is highly responsive to tax cuts (see Weekly Economic Briefing, June 28, 1996, and July 12, 1996). This is confirmed in simulations using two leading econometric models that differ in their treatment of supply-side responses. The Washington University Macro Model (WUMM) has supply-side responses at the upper end of the plausible range, while the Data Resources, Inc. (DRI) model contains more modest responses.

A 15 percent across-the-board tax cut introduced at the beginning of 1997 has the following effects (relative to baseline) over the 1997-2005 simulation period:

- Roughly 1.2 million more jobs are created, on average, in the WUMM, and roughly 300,000 more in the DRI model.

- Output goes up in each model and interest rates rise (the Federal Reserve is assumed to react to the tax cut stimulus with monetary restraint).

- The budget deficit goes up substantially in each model (by about $150 billion a year), reducing national saving and increasing foreign borrowing. Even with a strong supply-side response, increased growth offsets only about 15 percent of the revenue loss from the tax cut in the WUMM. DRI shows a negligible offset.

- Investment falls in the DRI model and rises modestly in the WUMM (because output grows enough to offset higher interest rates). In each case, however, reduced national saving means more investment is foreign-financed.

Macroeconomic performance improves some if the tax cut is fully offset by spending cuts. Simulations of such a tax cut produce some additional output growth, lower interest rates, and increased investment. Of course, the required spending cuts are huge (the equivalent of at least a 50 percent cut in domestic discretionary spending). If poorly chosen, they might well hurt investment and growth. And these models do not take into account the possible financial market response if the cuts are not seen as credible.

Conclusion. Simulations of large-scale econometric models confirm research findings that supply-side responses to tax cuts are too modest for the tax cuts to "pay for" themselves. A 15 percent across-the-board cut in marginal tax rates would add substantially to the deficit and hurt economic performance.

SPECIAL ANALYSIS

Unemployment and Inflation: The Lessons of 1988-90

So far this year, unemployment is low and inflation is tame. This is a substantial achievement, but experience from the late 1980s teaches that maintaining such conditions can be difficult.

Inflation and unemployment in 1988. In late 1987, the unemployment rate dropped below 6 percent, which at the time was generally thought to be the "natural", or non-accelerating-inflation rate of unemployment (NAIRU). (Recent research suggests the NAIRU was indeed about 6 percent at the time but has fallen some since, see Weekly Economic Briefing, July 26, 1996). Although monetary policy turned somewhat restrictive in 1988, as evidenced by a 2 percentage point rise in the Federal funds rate, the jobless rate continued to edge lower, reaching 5¼ percent in the fourth quarter of 1988.

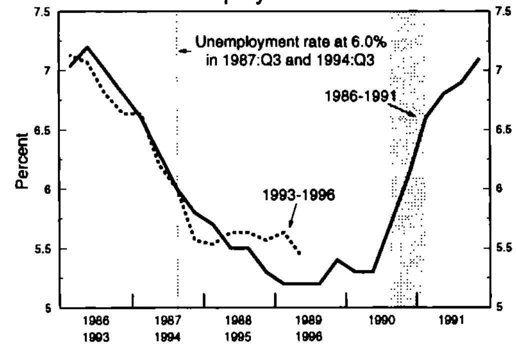
Rising consumer price inflation was barely perceptible in 1988. Wage inflation, by contrast, was signaling that the economy might be starting to overheat.

Fed tightening, an oil shock, and the 1990-91 recession. As rising inflation became more evident towards the end of 1988, the Federal Reserve responded aggressively, raising interest rates more than 2 percentage points. Monetary policy affects the economy with long lags, however, and it was not until the second half of 1990 that the unemployment rate began to edge up. By this time, the Fed had already begun to ease back on rates in hopes of achieving a "soft landing." Instead, the Iraqi invasion of Kuwait in August 1990 appears to have unsettled markets by reminding people of the disruption to the economy from previous oil price shocks. The economy dipped into recession, with unemployment rising to more than 7½ percent by mid-1992.

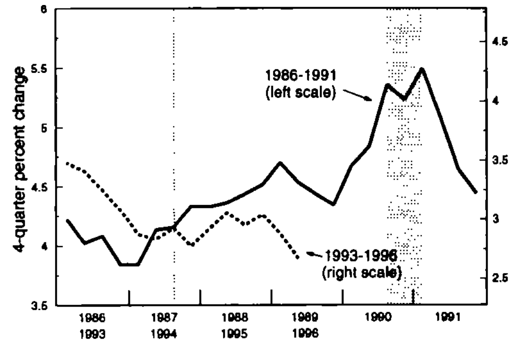
Some believe that if the Fed had acted sooner and more forcefully in 1987 and 1988, it would not have had to apply the brakes so hard in 1989. Sharp swings in interest rates in 1989 made the economy difficult to control, much like a fishtailing car when the steering wheel is turned too abruptly.

Lessons. As in 1988, the unemployment rate has dropped to where the economy runs some risk of rising inflation, although actual inflation remains stable (see charts on next page). Unlike 1988, however, trend growth in unit labor costs (growth in compensation less trend growth in productivity) is still below the rate of inflation. Despite the current good behavior of unit labor costs, some fear that increases in the Employment Cost Index (ECI) over the past two quarters presage future increases in inflation.

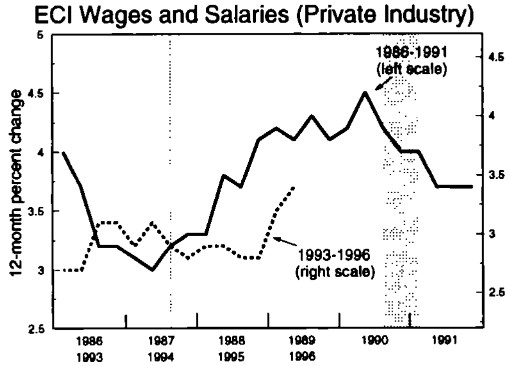
Unemployment Rate



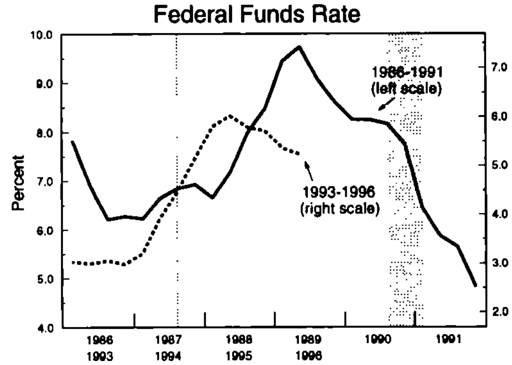
Core CPI Inflation



ECI Wages and Salaries (Private Industry)



Federal Funds Rate



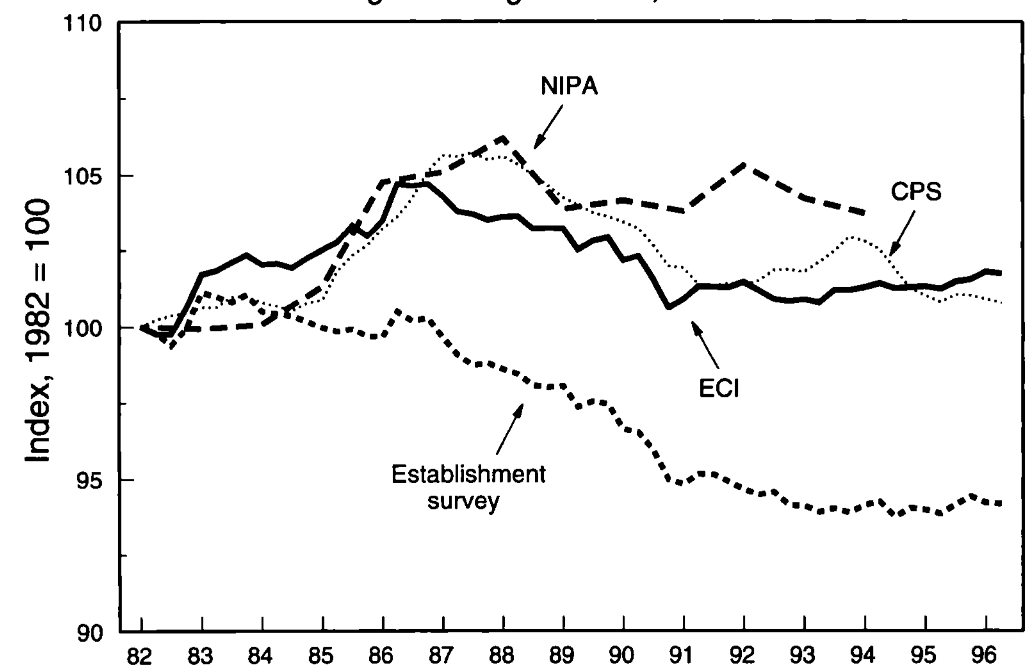
ARTICLE

Trends in Real Wages

A puzzling feature of the current recovery is that most indicators of earnings growth have been essentially flat despite the strong pace of job growth. Changes in the composition of the labor force over the business cycle may provide part of the answer.

Trends in alternative wage series. The chart shows trends in wages and earnings from four major sources (see table on next page).

Real Wage/Earnings Indices, 1982 - 1996



Note: Series deflated by CPI-U. To the extent that the CPI-U overstates inflation, it understates gains in real wages.

The first three series have moved in a roughly similar pattern since 1982; only the last shows a different pattern. Adjusted for inflation, median weekly earnings of full-time workers have fluctuated in a narrow range since 1982. The ECI and NIPA average hourly wage have behaved similarly over the period even though they measure average rather than median wage changes, compute hourly wages rather than weekly earnings, and include part-time as well as full-time workers.

Establishment Survey data, by contrast, fell through much of the 1980s and early 1990s before finally leveling off in 1993. Unlike the other wage series, however, this one covers only production and nonsupervisory workers, who suffered relative wage declines in the 1980s.

Sources of Wage Data

Source	Measure	Covered Workers	% Change, 1993-96
Current Population Survey (CPS)	median weekly earnings	full-time	-1.4*
Employment Cost Index (ECI)	index of hourly wages	all private industry	0.8
National Income and Product Accounts (NIPA)	average hourly wage	all	N.A.
Establishment Survey	average hourly wage	production and nonsupervisory	0.1

*Represents 1994-96 change because of 1994 CPS redesign.

Real wages over the business cycle. Two factors affect the pattern of real wages observed over the business cycle. The first is the experience of individual workers who keep their jobs. The second is the changing composition of the labor force. During recessions lower skilled workers are more likely to lose their jobs. When the economy recovers, they get their jobs back. Therefore, during an expansion the labor force is likely to include more low-earnings workers, reducing the average wage of the labor force. Some research supports this hypothesis. Workers with strong employment histories appear to receive a 1 to 1½ point rise in wages for each percentage point drop in the unemployment rate.

Conclusion. The current economic expansion has not led to a noticeable increase in the standard measure of real wages. This may be misleading, however, to the extent that cyclical compositional changes in the workforce that occur over the business cycle may be masking the wage gains of the continuously employed.

Several other issues remain, however. First, this discussion has focused on wages, but total compensation, including fringe benefits, may be a better measure for some purposes. Second, this article has focused on wage growth from the perspective of worker welfare, deflating nominal wages by the consumer price index. An equally important issue is the cost of labor to producers. Deflating by producer prices would show higher wage costs because producer prices have risen more slowly than consumer prices recently. These issues will be addressed in future Weekly Economic Briefings.

THE PRESIDENT HAS SEEN
8-6-96

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More Adults Return to the Classroom. More adults are heeding the call to lifetime learning and are taking formal steps to further their education, according to the Department of Education's newest Condition of Education report. In 1995, 40 percent of adults took part in adult education courses, up from 32 percent in 1991. About equal proportions of these adult students enrolled in work-related courses (21 percent) and classes for personal development (20 percent), while a much smaller number studied toward a diploma, degree or certificate (6 percent). The report notes that, while more workers are learning new skills, those who do not are finding that their opportunities are limited.

States Doing Well, Cut Taxes. The favorable national economic climate has allowed states to cut taxes, according to a report issued by the National Conference of State Legislatures. After cutting taxes by $3.3 billion in 1995, states cut taxes even more–by $3.6 billion–in 1996. Most of the reduction has come from personal income tax cuts. This is the first time since the late 1970s that states have adopted back-to-back tax cuts. Twenty-three states ended fiscal 1996 with general fund balances exceeding 5 percent, and many states have well-endowed rainy-day funds.

Decreasing Share of Wealth for the Most Affluent. A recent New York Times article reported that wealth became more concentrated between 1989 and 1994. This statement was based on preliminary results from a University of Michigan study that analyzed changes in families' net worth (assets like stocks, bonds, bank accounts, houses and cars, less debts like mortgages and credit card balances). The original results showed that the wealthiest 10 percent of households held 61 percent of total wealth in 1989 and 67 percent in 1994. Upon further review and prompted in part by the Council of Economic Advisers' skeptical reaction to the original results, the University of Michigan now reports that the top 10 percent of households held only 59 percent of total wealth in 1994, down from 1989.

*

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THE PRESIDENT HAS SEEN
8-6-96

INTERNATIONAL ROUNDUP

Indonesia's Financial Markets Shaky As Country is Rocked by Political Violence. Indonesia's stock market dropped 5 percent on Monday following a weekend standoff between the government and the opposition Indonesia Democracy Party–the country's worst episode of political violence in 20 years. Indonesia's currency, the rupiah, lost value as well, although the fall was less pronounced. Despite the current financial market turmoil, confidence remains that the fundamentals of the Indonesian economy are solid. Over the last 25 years, Indonesia has transformed itself into one of the faster growing economies in East Asia, with output growth averaging 8 percent in the 1990s. Still, 25 million people remain below the country's poverty line (itself quite low) and more than a third of all children are malnourished. Child labor and unequal opportunities for schooling remain serious problems. Other challenges faced by the government include inflation, persisting at 10 percent, and the current account deficit, which runs on the order of 4 percent of GDP (roughly twice that of the United States).

Unpopular Argentine Economy Minister Ousted as Nation Protests Budget Cuts. On July 26, Argentine President Menem dismissed Economy Minister Domingo Cavallo, who had come to be identified as the architect of Argentina's austerity measures. The economic reform program introduced in 1991 reduced inflation dramatically (from nearly 200 percent in 1991 to less than 2 percent last year) and delivered 4 years of strong growth between 1991 and 1994. Last year, however, Argentina suffered a 4 percent drop in output and unemployment surged to 18 percent. Although the recession was partly a result of the events in Mexico in 1994, Argentina's fiscal position had become cause for concern. In order to meet this year's deficit target, Economy Minister Cavallo announced 3 weeks ago that further cutbacks in social spending were required. This announcement was met by widespread opposition and demands for Cavallo's resignation. As rumors of Cavallo's dismissal spread on July 26, the stock market in Buenos Aires tumbled 4 percent. The financial situation appears to be stabilizing, as the new Economy Minister, the former president of the Central Bank, is unlikely to waver from the reform program.

Women Break New Ground In Traditional Male Occupations, But Also Swell the Ranks of the Working Poor. Across the globe, women work longer hours and are paid 25 percent less than men, on average, according to a report released this week by the International Labor Organization. Representation of women in managerial and technical jobs has shown a strong upward trend especially in industrialized countries, but women still hold less than 6 percent of senior management jobs in the world. On the whole, however, women's economic activities continue to be highly concentrated in low-wage, low-productivity and precarious forms of employment. Lack of access to education is considered one of the main causes of female poverty and unemployment. Women account for nearly two-thirds of the world's one billion adult illiterates, and nearly 70 percent of the world's poor.

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, August 2, 1996****

In July, the unemployment rate rose slightly to 5.4 percent from 5.3 percent in June. Nonfarm payroll employment rose by 193,000.

Gross Domestic Product

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

NAPM Report on Business

The Purchasing Manager's Index declined to 50.2 percent in July from 54.3 percent in June.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, rose 7.1 index points in July, to 107.2 (1985=100).

Employment Cost Index

The employment cost index for private industry workers increased 2.9 percent for the 12-month period ending in June.

MAJOR RELEASES NEXT WEEK

Leading Indicators (Monday)
Producer Prices (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	**0.3**	**2.0**	**4.2**
GDP chain-type price index	5.3	**2.5**	**2.1**	**2.3**	**2.1**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	–0.8	2.1	N.A.
Real compensation per hour:					
Using CPI	0.6	1.0	0.5	0.1	N.A.
Using NFB deflator	1.3	1.7	2.0	2.4	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	**10.2**
Residential investment	4.5	4.0	4.0	4.1	**4.2**
Exports	8.2	11.1	**11.4**	**11.3**	**11.3**
Imports	9.2	**12.4**	**12.3**	12.5	**12.7**
Personal saving	5.1	**3.4**	**3.8**	**3.6**	**3.2**
Federal surplus	–2.7	–2.2	–2.1	–2.1	N.A.

	1970–1993	1995	May 1996	June 1996	July 1996
Unemployment Rate	6.7**	5.6**	5.6	5.3	**5.4**
Payroll employment (thousands)					
increase per month			**407**	**220**	**193**
increase since Jan. 1993					**10224**
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.1	N.A.
PPI-Finished goods	5.0	2.3	–0.1	0.2	N.A.

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

New or revised data in **boldface.**
Employment and unemployment data **embargoed until 8:30 a.m., Friday, August 2, 1996.**

FINANCIAL STATISTICS

	1994	1995	June 1996	July 1996	August 1, 1996
Dow-Jones Industrial Average	3794	4494	5672	5496	5595
Interest Rates					
3-month T-bill	4.25	5.49	5.09	5.15	5.11
10-year T-bond	7.09	6.57	6.91	6.87	6.65
Mortgage rate, 30-year fixed	8.35	7.95	8.32	8.25	8.23
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	August 1, 1996	**Week ago**	**Year ago**
Deutschemark-Dollar	1.474	−0.4	+6.7
Yen-Dollar	106.8	−1.5	+20.7
Multilateral $ (Mar. 1973=100)	86.01	−0.4	+5.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.6 (Q2)	**5.4** (Jul)	2.8 (Jun)
Canada	0.6 (Q1)	9.4 (May)	1.4 (Jun)
Japan	5.5 (Q1)	3.6 (May)	0.0 (Jun)
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 (Q2)	8.3 (May)	2.2 (Jun)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, August 2, 1996**.