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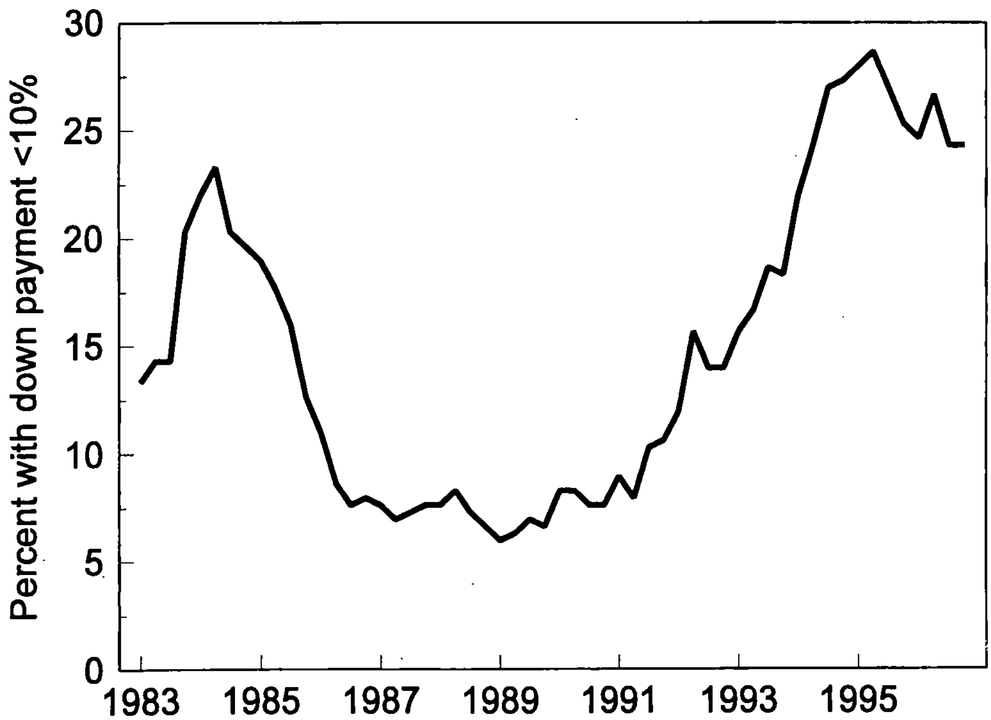
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

February 21, 1997

CHART OF THE WEEK

Proportion of Home Buyers with Low Down-Payments



Since 1994, about a quarter of those purchasing houses have been able to make their purchases with a down-payment of less than 10 percent of the value of the house. In part, this may reflect low mortgage rates, which make it possible to buy more house for the same monthly payment. At the same time, lenders appear more willing to lend to lower-income home buyers. It remains to be seen how safe these new loans will turn out to be, but mortgage delinquency rates have remained low in recent years. (Data since 1991 are more reliable than and not strictly comparable to those for earlier years.)

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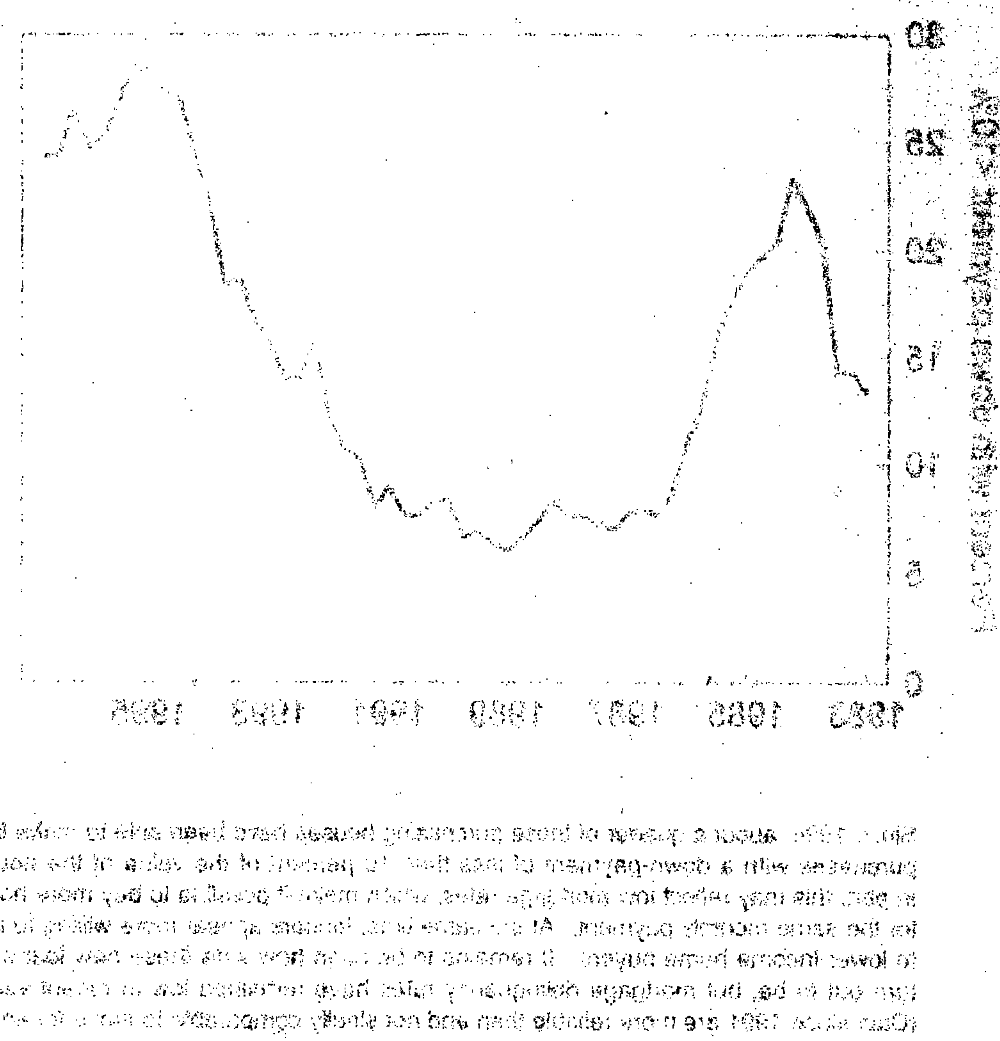

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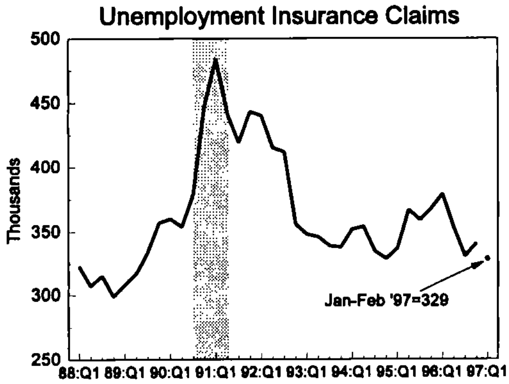
"Dad, the dean has gone over your financial statement, and he doesn't think you're working up to your full potential."

MACROECONOMIC UPDATE

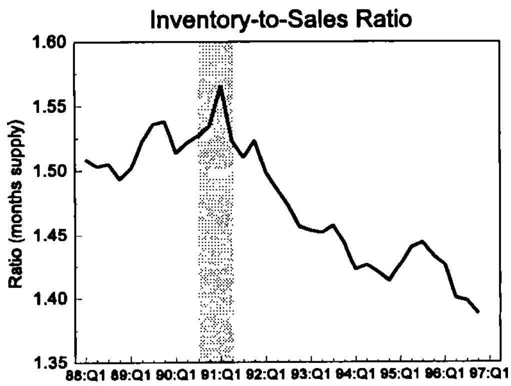
Economy Moves Forward, but Maybe at a Slower Pace

The torrid pace of GDP growth in the fourth quarter is unlikely to be repeated in the first quarter. (Nor is it likely to stand; new data imply it will be revised down from 4.7 to 4.0 percent.) Nevertheless, the economy is moving forward with considerable momentum.



Signs of slowing. Some volatile indicators point to a slower first quarter (retail sales, housing starts, and the workweek). First-quarter GDP growth may also be depressed by exports, which are likely to return to trend after a surge in the fourth quarter.

Signs of strength. Despite some slowing in the first quarter, the most reliable data show that the economy continues to make solid gains: Motor vehicle sales increased in January; 271,000 new jobs were added to payrolls; and initial claims for unemployment insurance (the most up-to-date indicator) are as low as they have been at any time during the current expansion (see upper chart). The near-term fundamentals remain positive. Inflation remains low and stable. The vacancy rate for office buildings continues to fall. Inventories are more lean relative to sales than at any time since the Korean war (see lower chart).



Stock market bears watching. Although the stock market has been one of the economy's recent strengths, it might present a risk if the market were overvalued relative to earnings prospects (see *Weekly Economic Briefing*, November 1, 1996). Consumption spending might be curtailed following a substantial market decline. But because consumption has not fully reflected stock-market gains on the way up, it probably would not fully respond to the stock market on the way down.

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SPECIAL ANALYSIS

Can a Pension Plan Be a Tax Trap?

A few high-income savers may find that they have fallen into a tax trap, according to a recent study. Because some academic economists have accumulated large sums in their defined-contribution pension plans, this study was a hot topic of conversation at the recent American Economic Association meeting.

What's the hubbub? Pension plans are tax-favored because generally no income tax is collected on either qualified contributions to the plan or accrued earnings. Withdrawals from plans are then included in taxable income and taxed at rates up to approximately 40 percent for the Federal income tax and 10 to 12 percent for State and local income taxes.

If very large withdrawals (over $155,000 in a year) are made from a pension plan, a non-deductible 15 percent excise tax is imposed. Similarly, if pension assets in an estate are excessively large, the same 15 percent excise tax is imposed on the pension portion of the estate. These excise taxes are intended to limit the tax subsidy for pension savings so that it supports only reasonable levels of retirement income. (In the Small Business Job Protection Act of 1996—the minimum wage bill—Congress temporarily suspended the excise tax on excess distributions through 1999.)

When assets are passed on to heirs, an estate tax may be imposed on the transfer. Spousal transfers are tax-exempt, but transfers greater than $600,000 to other heirs may be subject to tax. Estate tax rates range from 37 percent to 55 percent on the largest estates (those in excess of about $21 million).

When these three layers of taxes are combined, the tax burden on the transfer of pension assets can be 90 percent or more. To some, tax rates this high seem confiscatory.

But these tax rates are misleading. First, relatively few taxpayers are affected. Less than 1.25 percent of taxpayers face marginal income tax rates of 36 percent or higher, and fewer than 2 percent of all decedents have estates subject to taxation. Furthermore, the 15 percent excise tax on excess withdrawals applies only to the small fraction of people (substantially less than 5 percent of the population) who have more than $155,000 of income.

Second, the tax benefit provided to pension saving is tax deferral, not tax forgiveness. Hence, income tax rates on withdrawals must be viewed in the context of "settling up" tax liability. Simply adding up the income, excise, and estate taxes misses the point that the income tax component reflects tax collections that otherwise would have been due years earlier if not for the special tax treatment of pensions.

Third, the excise tax on excess distributions and accumulations may be a blunt instrument, but it does serve as a signal that the Congress has deemed that the tax subsidy for pension savings should be targeted to middle-class taxpayers and used to encourage retirement savings not bequests.

In short, although tax rates of 90 percent or more on pension transfers seem alarming, few people are affected and good policy rationales exist for the taxes involved.

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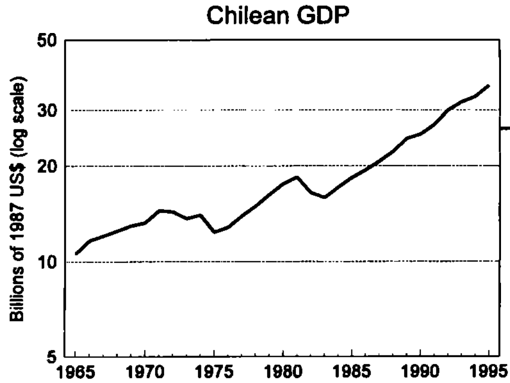
ARTICLE

Free Markets Plus Pragmatic Intervention Equals Economic Success for Chile

Chile is the economic superstar of Latin America. Riding free-market policies, the country has achieved strong economic growth averaging more than 7 percent per year since 1983 (see chart). Some of Chile's success, however, seems to have come from tempering predominantly free-market policies with occasional pragmatic government intervention. This blend had provided important lessons on successful growth strategies for other developing countries around the world.



Economic reform. After the military seized power in 1973, Chile instituted a host of structural economic reforms that put it in the forefront of Latin America's move away from the inward-looking government-directed policies most countries had pursued in the 1950s and 1960s. Chile's reforms included

- deregulation of financial markets and the liberalization of interest rates
- liberalization of international trade, with tariff reductions and the lifting of nontariff barriers
- liberalization of some restrictions on international financial transactions, including the removal of restrictions on direct investment from abroad
- sharp cuts in the government budget deficit
- elimination of domestic price controls and subsidies
- a rapid and broad privatization program

An early stumble followed by success. Initially, these reforms lacked the regulatory structures needed to prevent excesses. Economic problems eventually followed, culminating in the debt and financial crisis of 1982. This crisis was due to unsupportable external borrowing, coupled with an overvalued exchange rate and a failure to supervise the liberalized banking system.

After a deep recession in 1982-83, Chile began a strong, export-based economic recovery. Policies to prevent the overvaluation of Chile's real exchange rate encouraged export industries. Although exports fell last year, they grew at more than 9 percent per year between 1983 and 1995. This growth rate is better than those for other Latin American countries, but still below that of the Asian tigers (see chart on next page). Inflation has slowed in the last few years and is now below 10 percent.

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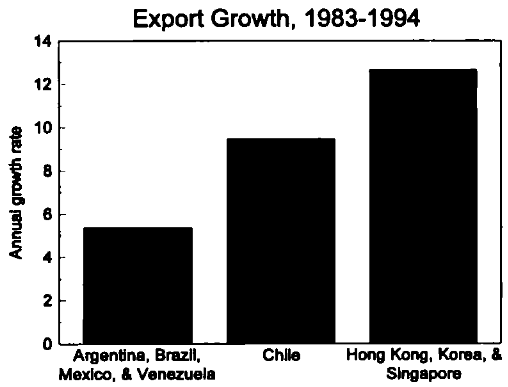

This inflation rate is moderate by the standards of some of Chile's Latin American neighbors.

Capital controls. Chile has departed from pure market principles in its approach to international capital movements. While other Latin American countries experienced surging capital inflows in the early 1990s, Chile restricted such inflows, not only to prevent an appreciation of the peso that would have slowed the growth of exports but also to preclude a repetition of its earlier experience with overindebtedness. The primary restriction, which has been in place since 1991, is a requirement that foreign providers of investment funds must deposit a percentage of those funds in a non-interest-bearing account for one year. This requirement acts as a tax that discourages short-term financial transactions and favors long-term investment in the country.

Along with its high saving rate and strong copper prices, Chile's relatively limited reliance on short-term capital may have been a factor that insulated the country from the financial pressures felt by Mexico, Argentina and Brazil when the Mexican peso crisis hit in early 1995. The restrictions on capital inflows have also allowed Chile to maintain a stable real exchange rate.

The pension system. No discussion of the Chilean economy would be complete without a discussion of its pension system. In 1981, Chile began to transform its public pension system into a fully funded system that relied on privately managed funds investing in Chilean stocks and bonds. The system has been heralded as a major contributor to raising the country's saving rate. As a pension program, however, it has been plagued by very high administrative costs (almost 20 times those of the U.S. Social Security system as a fraction of benefits) and limited participation (about half of workers). The system also subjects pensioners to the risk of adverse movements in Chilean stock and bond markets, although a minimum pension paid out of general government revenues is guaranteed in the event of a shortfall. In 1995 the funds, on average, had a negative return.

Conclusion. Chile has pursued economic policies that rely heavily on the benefits of free markets. But, as the willingness to impose controls on capital inflows demonstrates, Chile's approach is far from being one of complete *laissez faire*.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Economists Weigh In on Climate Change. More than 2,000 U.S. economists, including six Nobel laureates, have endorsed a statement on climate change recognizing that global climate change carries with it significant environmental, economic, social, and geopolitical risks, and that preventive steps are justified. According to the statement, use of market-based mechanisms, such as the auction of emissions permits or carbon taxes, is the most efficient approach to slowing climate change. The economists also call for a cooperative approach among nations, such as an international emissions trading agreement. Finally, they contend that market-based policies to limit greenhouse-gas emissions could ultimately prove beneficial to the U.S. economy by improving productivity in the longer run.

Baby Bell's Entry into Long-Distance Will Have to Wait. Last week, Ameritech (a Regional Bell Operating Company) withdrew its application to the Federal Communications Commission to provide long-distance service in Michigan. The application was the first one filed since enactment of the 1996 Telecommunications Act, which lifted the antitrust decree that kept RBOCs from providing long-distance service. In order for a Baby Bell like Ameritech to offer long-distance service in its local telephone markets, it must, among other things, show that it has agreed to deliver calls to and from other local service competitors. In its application, Ameritech offered as evidence a proposed agreement that would have allowed AT&T to offer local service in Michigan. The FCC, however, determined that this proposed agreement, which had not been signed by either party, was not binding. Ameritech says it intends to refile once the status of its contract with AT&T in Michigan is resolved.

Pilot Welfare-to-Work ProgramWorks in New York. New York's welfare reform initiative, the Child Assistance Program (CAP), has helped move able welfare recipients to work since it was implemented in 1988, according to a recently released study. CAP is a voluntary alternative to AFDC, designed to motivate recipients to take steps toward financial self-sufficiency by allowing them to retain more of their earnings. Although the initial payment to CAP recipients is lower than AFDC, CAP benefits are reduced by only 10 cents per dollar on the first several hundred dollars of monthly earnings and 67 cents thereafter (compared to nearly a dollar for dollar reduction in AFDC benefits). As a result, more CAP households worked and those employed earned more. The per-household administrative outlay is higher for CAP than for AFDC, but that additional expense is more than recouped through lower assistance payments and increased Social Security, Medicare, and sales tax revenues.

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INTERNATIONAL ROUNDUP

Surge in Unemployment Makes Maastricht Target Tougher for Germany. The unemployment rate in Germany rose to 12 percent in January, its highest level since at least 1960. Normally, a weakening economy is associated with a rising budget deficit as transfer payments increase and tax revenues fall. The Finance Ministry stated, however, that Germany is prepared to introduce spending controls and other corrective measures if revenues fall short of projections. Fiscal austerity in a weak economy is difficult, however, and could have adverse social consequences. Thus, many economists are now openly speculating about whether Germany will meet the Maastricht deficit target of 3 percent of GDP in 1997, a question that seemed unimaginable when the treaty was initially crafted. If monetary union is not delayed, a German failure to meet the treaty provisions could make it more difficult to keep countries with weaker macroeconomic fundamentals out of the single currency. In response to these concerns, Germany recently reaffirmed its commitment to taking the actions necessary to achieve the Maastricht deficit target. This case provides an illuminating example of how a deficit constraint (or balanced budget amendment) can interfere with other economic policies.

Telecom Agreement Marks End to Successful U.S. Negotiations. The global telecommunications agreement just clinched in Geneva represents a spectacular success for U.S. negotiators, for U.S. industry, and for economic efficiency around the world. The agreement will open up the $600 billion dollar world telecom industry to U.S. companies who are among the most competitive in the world. Meanwhile, the enhanced competition should encourage better service, lower prices, and more innovation. In addition to being an important victory for U.S. trade policy, the telecom agreement contrasts sharply with the conventional wisdom in political economy that only multi-sector negotiations can be successful. The conventional argument is that while the United States, a net exporter in this market, may favor liberalizing world telecommunications, a country that imports these products or services would oppose liberalization. In addition, consumers in the foreign country would be too diffuse to organize and lobby for a freer market, hence the foreign country's position would be dictated solely by the import-competing industry. By this reasoning, the only way for the United States to achieve telecom liberalization would be to offer liberalization of its own market in some other sector of interest to its trading partners. The telecom agreement did not use this multi-sector "bundling" approach yet still succeeded admirably. It is possible that because telecommunications goods and services are an input into nearly every industry in every country, export industries abroad lobbied in favor of liberalizing their domestic telecom market to lower their own costs and enhance their international competitiveness. In this sense the problem of organizing diffuse consumers is overcome.

RELEASES THIS WEEK

Housing Starts

Housing starts rose 2 percent in January to 1.35 million units at an annual rate.

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $10.3 billion in December from $7.9 billion in November. The deficit for 1996 was $114.2 billion compared with a deficit of $105.1 billion for 1995.

Consumer Price Index

The consumer price index increased 0.1 percent in January. Excluding food and energy, consumer prices also increased 0.1 percent.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Thursday)
Gross Domestic Product (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1996	1996:2	1996:3	1996:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.4	4.7	2.1	4.7
GDP chain-type price index	5.3	2.1	2.2	2.0	1.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.2	0.6	0.0	2.2
Real compensation per hour:					
Using CPI	0.6	0.4	0.1	1.0	0.4
Using NFB deflator	1.3	2.1	2.0	2.0	2.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.4	10.3	10.6	10.5
Residential investment	4.5	4.1	4.2	4.1	4.0
Exports	8.2	11.3	11.3	11.1	11.5
Imports	9.2	12.6	12.6	12.7	12.7
Personal saving	5.1	3.6	3.2	3.9	3.8
Federal surplus	–2.7	N.A.	–1.7	–1.6	N.A.

	1970–1993	1996	Nov. 1996	Dec. 1996	Jan. 1997
Unemployment Rate	6.7**	5.4**	5.3	5.3	5.4
Payroll employment (thousands)					
increase per month			181	261	271
increase since Jan. 1993					11500
Inflation (percent per period)					
CPI	5.8	3.3	0.3	0.3	**0.1**
PPI-Finished goods	5.0	2.8	0.2	0.6	–0.3

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1995	1996	Dec. 1996	Jan. 1997	Feb. 20, 1997
Dow-Jones Industrial Average	4494	5743	6436	6707	6927
Interest Rates					
3-month T-bill	5.49	5.01	4.91	5.03	4.97
10-year T-bond	6.57	6.44	6.30	6.58	6.38
Mortgage rate, 30-year fixed	7.95	7.80	7.60	7.82	7.56
Prime rate	8.83	8.27	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Feb. 20, 1997**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.686	−0.0	16.1
Yen-Dollar	122.8	−1.2	15.8
Multilateral $ (Mar. 1973=100)	95.07	0.1	10.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.4 (Q4)	5.4 (Jan)	3.0 (Jan)
Canada	1.6 (Q3)	9.7 (Dec)	2.2 (Dec)
Japan	3.2 (Q3)	3.3 (Dec)	0.5 (Nov)
France	1.4 (Q3)	12.8 (Oct)	1.7 (Dec)
Germany	1.9 (Q3)	7.5 (Nov)	1.4 (Dec)
Italy	0.7 (Q3)	11.9 (Jul)	2.6 (Dec)
United Kingdom	2.6 (Q4)	7.8 (Dec)	2.4 (Dec)