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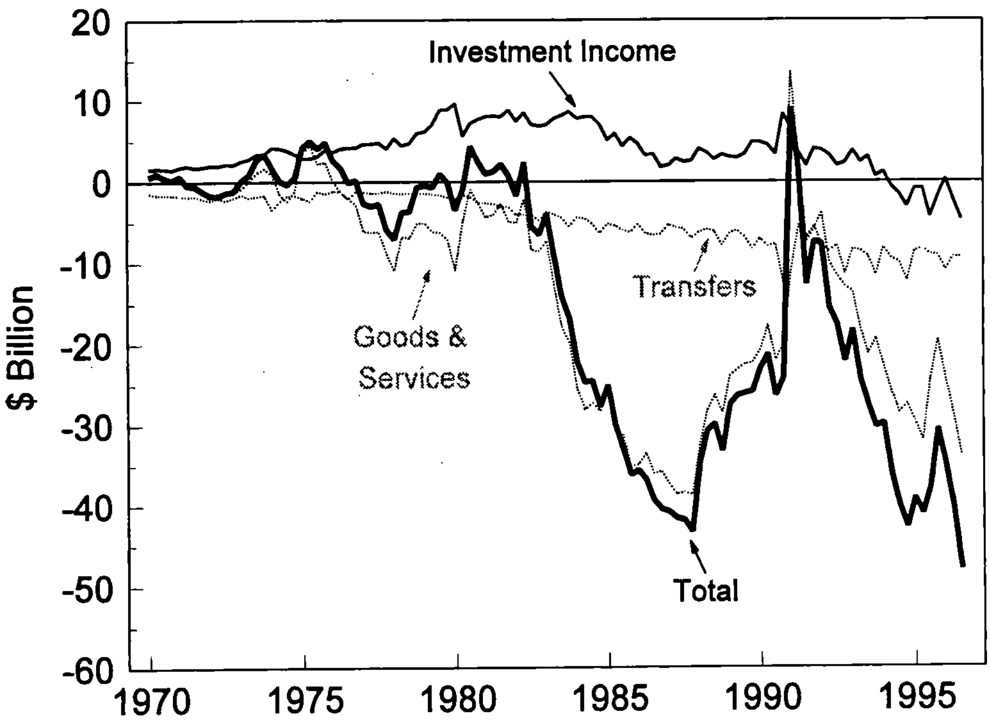
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 13, 1996

CHART OF THE WEEK

U.S. Current Account Balance



The U.S. current account balance showed a record deficit of $48 billion in the third quarter. The current account is the most comprehensive measure of the balance of payments. It includes not only goods and services, but also transfers and net investment income. In the 1970s, the United States' current account was in balance, on average. The cumulative effect of subsequent deficits has been to move the United States from being the world's largest net creditor to being its largest net debtor.

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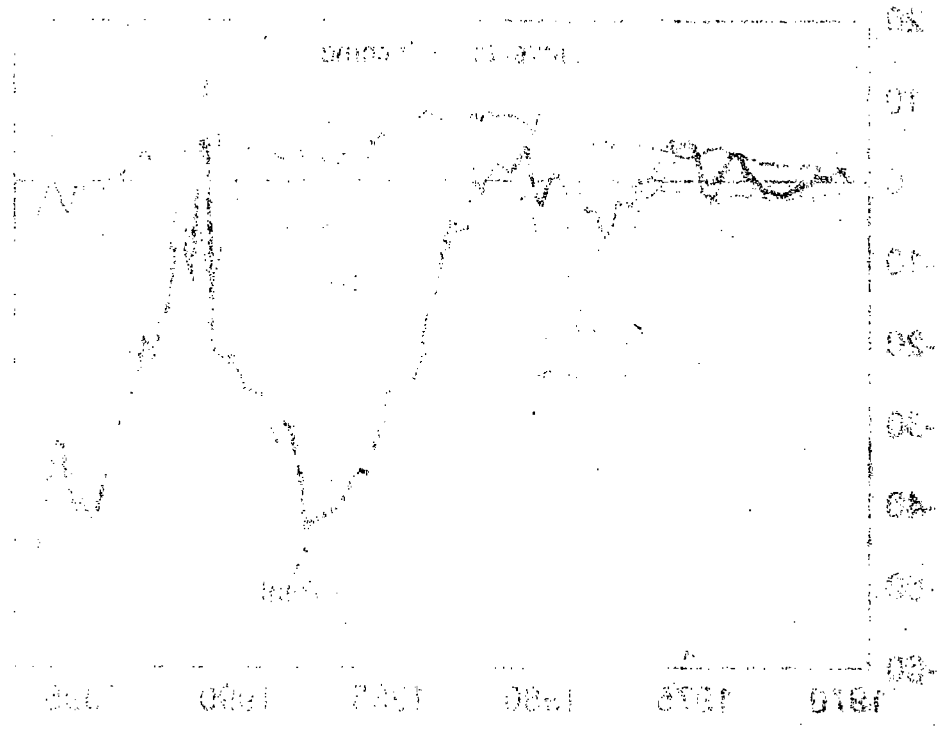


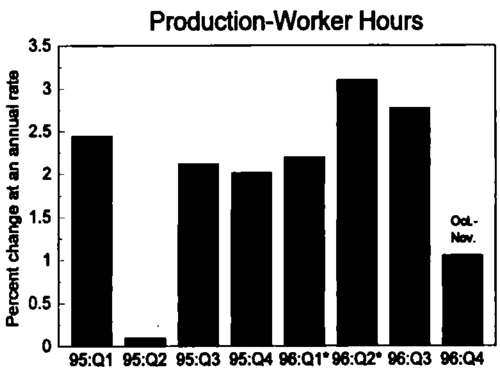
CONTENTS

"If it's so easy to assemble, why is there an emergency number for the Army Corps of Engineers?"

MACROECONOMIC UPDATE

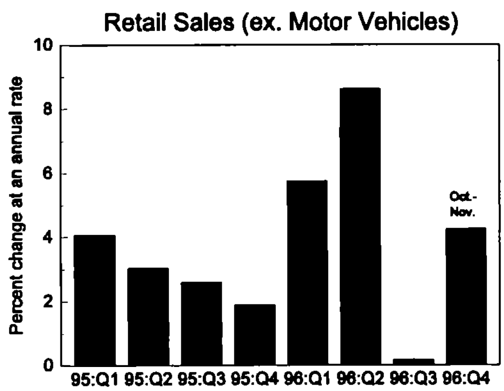
Economy Moving Forward at a Sustainable Pace

The economy appears to be settling into a period of steady and sustainable growth. Payroll employment has slowed to a 113,000 per month pace over the past 3 months, down from 240,000 per month during the first 8 months of the year. The recent pace is consistent with the 2¼ percent rate of real GDP growth that the Administration expects for 1997.

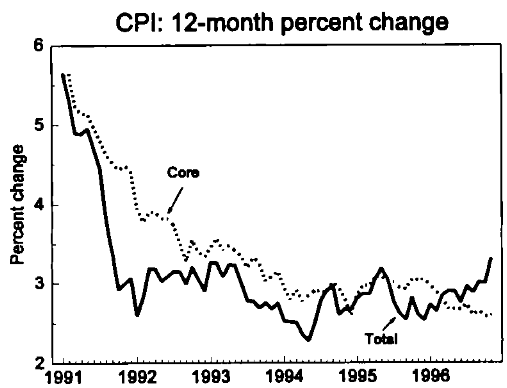


* Adjusted for bad weather effects in January 1996

Hours worked by production workers—a good indicator of current-quarter activity—have increased at a 1.1 percent annual rate thus far in the fourth quarter (upper chart). These hours, together with productivity growth of about 1 percent per year, can support GDP growth at about a 2 percent annual rate.



Consumer spending is growing moderately after a weak third quarter. Non-auto retail sales for October and November are up smartly (middle chart) while motor vehicle sales are flat. Even so, light vehicle sales in 1996 may turn out to be as strong as in any year since 1988. Consumer fundamentals remain strong. Wealth is very high relative to income, and confidence is in the top 20 percent of its historical range.



Inflation remains under control. Although energy prices have accelerated, the core CPI increased 2.6 percent over the 12 months ending in November—down from its year-earlier rate (lower chart). With the economy at about its non-inflationary capacity, the slowing of GDP is just what the Fed wanted, hence the Open Market Committee is unlikely to change rates at next Tuesday's meeting.

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12-16-96

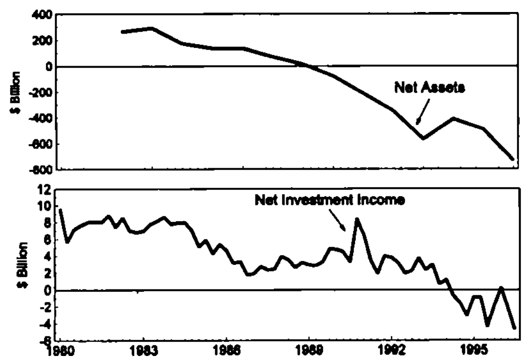
CURRENT DEVELOPMENT

Balance on Investment Income Shows a Record Deficit

Investment income paid to foreign owners of U.S. assets exceeded income earned on U.S.-owned assets abroad by a record $4.7 billion in the third quarter. The investment income balance—which includes interest payments, dividends, and profits repatriated by multinational corporations—has been trending down for some time now (see chart).

From creditor to debtor. The balance on investment income reflects trends in the U.S. net international investment position. The United States was a net creditor from World War I—when the country lent heavily to Britain to sustain its war effort—all the way into the 1980s. Indeed, in 1981 this country was the world's largest international creditor. But borrowing abroad to finance large deficits in the 1980s quickly wiped out that creditor position. At the end of 1995 the value of U.S. obligations to foreigners exceeded the value of U.S. assets abroad by $774 billion.

Net Assets and Investment Income



Paying the piper. The income balance actually remained positive for 5 years after the investment position turned negative. This is because the United States enjoys special advantages. Much U.S. debt takes the form of Treasury securities—prized for their liquidity and absence of default risk, hence able to pay a low interest rate. The bulk of U.S. overseas assets take the form of direct investments that tend to earn a high rate of return, on average. By 1994, however, U.S. foreign debt had become so large that payments going out exceeded those coming in.

A key component of the deterioration in the third-quarter investment income balance was an increase of $1.7 billion in interest payments to foreigners on their holdings of U.S. Treasury securities. This highlights a relationship between budget deficits and current account deficits that will be discussed in an upcoming *Weekly Economic Briefing*.

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12-16-96

SPECIAL ANALYSIS

Balanced Budget Requirements and the States

The fact that many States have balanced budget requirements is often used to justify a balanced budget amendment to the Constitution. But State balanced budget rules are quite different from those proposed for the Federal Government, and generally less restrictive. Nevertheless, the potential for balanced budget rules to aggravate economic fluctuations is evident at the State level.

What States do. State requirements for a balanced budget may be expressed either in State Constitutions (about 40 States) or in statutes. A recent report by the Government Accounting Office indicates that:

- 43 States require governors to submit a balanced budget.
- 36 States require legislatures to pass a balanced budget.
- 27 States require that the final totals for the fiscal year must show the budget in balance (this is the toughest anti-deficit rule).
- Only two States (Vermont and Wyoming) have none of these requirements.

Balanced budget requirements typically apply only to general funds (operating expenses). Capital funds, enterprise funds (State-run businesses), and pension funds—which together account for almost half of State spending—are generally excluded.

Other tools for imposing fiscal restraint often accompany balanced budget requirements. For example, 40 governors have line-item veto authority and 36 governors can reduce spending without legislative approval. (Line-item veto provisions, however, do not appear to reduce State spending levels substantially, see *Weekly Economic Briefing*, December 19, 1994.) Twenty-one States impose limits on overall spending, 7 limit the amount of revenue that can be raised, and 3 do both. Ten States place limits on issuing debt.

Analysis. Recent research that tries to distinguish between more and less restrictive budget constraints indicates that tight budget rules can have a discernible effect on the size of a State's general fund deficit. In the short run, these tighter provisions often lead to spending reductions and accounting gimmicks. Over the longer term, however, tax levels are often adjusted upward and spending downward to comply with strong anti-deficit rules. The combination of tight limits on debt issuance and strong anti-deficit rules show the largest effects on general fund deficits.

Balanced budget provisions at the State level are generally less restrictive or more flexible than proposed balanced budget amendments:

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12-16-96

- Many States grant the chief executive the ability to adjust expenditures during the fiscal year in order to meet deficit targets. Such a rule makes budget balance easier to achieve, but Congress is unlikely to shift this degree of control over expenditures to the executive branch.

- States are required to balance only the operating budget; capital investments (like roads, schools, and other infrastructure) can be financed by debt outside the anti-deficit constraints. A Federal balanced budget amendment would require the government to balance the unified budget, which includes capital expenditures.

- Many States have established "rainy day" funds that can be drawn down to smooth fiscal fluctuations. If the Federal budget had to be balanced each and every year, a fund of this sort would not be available as a smoothing device, even on the modest scale of the States.

- Many States merely require that a balanced general fund budget be submitted or enacted. Proposals for a balanced budget amendment typically require the stricter condition that the unified budget be in balance at the end of every year.

Implications. Even with greater flexibility than the Federal Government would have under a balanced budget amendment, State budget actions are pro-cyclical. During the 1990-91 recession, for example, 37 States raised taxes to address budget shortfalls. For similar reasons, State expenditures often fall just as the economy enters a recession. A balanced budget requirement at the Federal level would produce the same type of pattern. Currently, the government can smooth fluctuations through discretionary fiscal policy, and more importantly, through automatic stabilizers like unemployment insurance and progressive income tax rates that cushion the decline in private spending during economic downturns. Disabling these counter-cyclical tools would mean that the economy would suffer more severe recessions.

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12-16-96

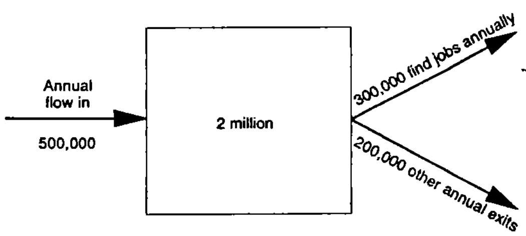
SPECIAL ANALYSIS

Job Placement of Long-Term Welfare Recipients

Even under welfare as we knew it, a substantial number of long-term recipients left the rolls each year because they found a job. To be judged successful, new policies will have to increase the rate of job placement beyond what is already taking place or reduce the flow of new welfare recipients.

Welfare dynamics. The pool of long-term welfare recipients is subject to considerable outflow and replenishment each year (see chart). Based on historical patterns, about a quarter of the 2 million people who have been on welfare for more than 2 years will go off—about half because they take a job. Although recidivism among those leaving the rolls is high, an annual rate of 300,000 people taking jobs translates into almost a million long-term welfare recipients finding jobs with no further intervention over a 3-year period. Unfortunately, their spots in the long-term population will be taken by those who remain on the rolls beyond their second year (from among the 750,000 or so who have been on welfare between one and 2 years).

Long-Term Welfare Recipients



Effective targeting. Because resources are scarce, it is important to direct additional services to those who would not find jobs without such services. The dynamic nature of the welfare rolls, even among long-term recipients, makes identifying the hard-to-place difficult. How long someone has received benefits does not appear to be a good measure of whether they are hard to place. For instance, some less-skilled women who lack affordable day care and may receive welfare for a number of years while their children are of pre-school age may nevertheless face no substantial obstacles to finding employment once their children enter school. Programs that define all long-term welfare recipients as hard to place run the risk of spending substantial resources on those who would have found a job anyway.

Research points to two types of welfare recipients who may have difficulty finding a job: high school dropouts and those with no work experience. Unfortunately, neither characteristic is readily usable as a screen for targeting services. A substantial fraction of welfare recipients are of school age. Hence, providing additional services to high school dropouts (other than assistance for degree completion) provides a perverse incentive for potential welfare recipients to cut their education short. As for work experience, self-reports may be inaccurate; recipients may have an incentive to report no experience to be eligible for maximum services. Coordination with other agencies, such as the Social Security Administration, would be required to verify such claims.

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12-16-96

The "Wisconsin Works" approach. An alternative to such mechanistic approaches is to place more autonomy in the hands of case workers. That is what Wisconsin does in its Wisconsin Works (W-2) program, implemented statewide earlier this year. W-2 requires all able-to-work welfare recipients to work, and it offers them different levels of employment services, including subsidized employment, community service jobs, and "vocational rehabilitation" (treatment for drug or alcohol addiction, for example) at the case worker's discretion. This approach creates a potential problem, however, because the case worker may have an incentive to underprovide intensive services to those who are hardest to employ. It is too soon to evaluate the success of W-2.

Conclusion. A large number of long-term welfare recipients find jobs each year under existing policies. The challenge in developing new policies is to improve job-finding success among the truly hard-to-place.

THE PRESIDENT HAS SEEN
12-16-96

ARTICLE

Risk-Based Pricing in Insurance Markets

In policy contexts ranging from health insurance to entry into Japanese insurance markets, the desire for efficient pricing of insurance may conflict with moral objections to separating people into different risk categories. Choices we have made in balancing these competing objectives often appear puzzling.

Competition implies risk-based premiums. In a competitive insurance market, the premium for insuring a particular risk is determined by the amount insurers will have to pay out on average for that risk. If a person faces a 1-in-5,000 chance of a $100,000 loss, for example, the average or expected loss will be $100,000/5,000 or $20. As competition in any market drives price to cost, competition among insurers will force premiums down to $20 (plus administrative costs). The rub is that premiums set equal to expected losses will rise when the chance or magnitude of the loss becomes greater. In the above example, if an insurer learns that an individual belongs to a group for whom the chances of this loss are 1-in-500 instead of 1-in-5,000, the premium for that group will be $200 not $20.

Because the cost of insurance is based on the expected average payout, insurers have an economic incentive to gather and use the best available information for predicting risk and loss. Younger drivers, males in particular, have to pay substantially greater premiums for auto insurance than other drivers. Drivers who live in areas where accidents or auto theft are frequent also have to pay higher premiums.

Conflicts with social considerations. Risk-based rates run counter to a common view that insurance is society's method for having all of us share burdens borne when economic, natural, or health disasters strike an unfortunate few. Moreover, we as a society have decided that some risk classifications are improper. We do not allow race-based premiums for health and life insurance, for example, despite lower life expectancy among African Americans.

Sometimes our values appear contradictory. We generally allow gender-based premiums for life insurance—because women outlive men on average, but we do not allow employers to have separate gender-based contributions to pension plans—even though, by living longer, women would collect more pension benefits. Age is usually regarded as a proper factor for life insurance, but a couple of state "community rating" programs attempt to eliminate age as a factor in rates for health insurance.

Implementation of social objectives poses problems. Requiring insurers to charge the same premium to both high- and low-risk persons subsidizes the former at the expense of the latter. Consequently, insurers could have an incentive to refuse to insure high-risk individuals. They might also look for proxies for disallowed classifications, such as using geographic location as a substitute for race.

THE PRESIDENT HAS SEEN
12-16-96

Restrictions on risk classification are likely to entail complex efforts to ensure that insurance companies are not refusing to serve high-risk customers.

A perfectly competitive insurance industry, with perfect information, will inevitably base premiums on risk. Discerning social values and deciding when they warrant sacrificing efficiency by proscribing particular risk classifications can be difficult.

Market Failure in Insurance

Recognizing the relationship between competition and risk-based premiums in insurance markets does not imply that insurance markets always work perfectly. Two particularly significant problems may warrant public intervention.

Adverse selection takes place when purchasers of insurance know their risks better than insurance companies know them. Those who expect to incur losses are more likely to buy insurance than those who do not. The consequent increase in premiums discourages relatively less-risky persons from buying insurance. A cycle of increasing premiums and decreasing participation could make this insurance unavailable. This is one justification for public provision of health insurance to the elderly, who may have a better sense of their personal health risk than private insurers (or younger persons).

Moral hazard involves taking advantage of insurers after the purchase of insurance—for instance, by acting carelessly or refusing to take appropriate action to mitigate risk. An example is buying fire insurance and then smoking in bed. A variant in health care is the "third-party payment" problem, when doctors and patients may overspend on tests and procedures because the insurer is paying for them. Moral hazard may explain why unemployment insurance is publicly provided. Private firms may be unwilling to offer it because someone who purchases it may become less concerned with being fired and, consequently, a less reliable or diligent employee.

12-16-96

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

CPI Understates Christmas Inflation. True loves will have to spend more this year to do right by "The Twelve Days of Christmas." The total cost of the gifts included in the song—from drummers drumming to a partridge in a pear tree—is up 5.7 percent this year to $13,196 according to PNC Bank's annual Christmas Price Index. (The index is based on a fixed market basket and does not take quality change into account.) Increasing labor prices for hiring performing dancers, pipers and drummers accounted for most of the cost hike. Nine ladies dancing now command $3,259 for their performance, up 25 percent from last year due to the first salary increase in 4 years at the Philadelphia Dance Company. Eight maids-a-milking fetch $38 this year (cows not included), up 12 percent due to the increased minimum wage. The other items' prices remained flat. Three French hens are the least expensive gift at $15, and one partridge in a pear tree comes in at $28. For purists, the song's "true cost of Christmas" is $54,479, up 5.2 percent from 1995 (when all 12 verses are sung, 364 presents are mentioned—12 partridges in a pear tree, 22 pipers piping, and so forth).

Hispanics Helped by Head Start. One-quarter of the over 700,000 children enrolled in Head Start are Hispanic, many of whom have special needs particularly in regard to language skills. A recent study finds that Latino children in Head Start fare significantly better than siblings who attend other pre-school programs and those who attend no program at all. Although the educational performance of Latinos as a group lags behind that of both blacks and whites, Head Start closes at least one-quarter of the gap in test scores between Latinos and non-Hispanic whites, and two-thirds of the gap in the probability of repeating a grade. The Latino population is quite diverse, and the benefits from Head Start are not evenly distributed. Mexican-origin children reap the largest gains, and Puerto Rican children receive little benefit.

Poverty Among Young Children Has Grown. Although poverty rates for children have fallen since 1993, the longer-term trend has been upward; a recent study shows this is particularly true for children under age 6. The poverty rate for those under age 18 rose from 17.1 percent to 21.8 percent between 1975 and 1994, but it increased from 18.2 percent to 25.1 percent for those under age 6. The poverty rate for all Americans was 12.3 percent in 1975 and 14.5 percent in 1994. Among the younger children, substantial increases have occurred in demographic groups generally less susceptible to poverty, such as suburban children, white children, and children in two-parent families with a full-time worker. Nevertheless, the increase in child poverty may be overstated; the official poverty rate does not include in-kind transfers, such as Food Stamps, which have expanded over time. These transfers are largely targeted at households with young children.

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12-16-96

INTERNATIONAL ROUNDUP

WTO Reports Growth in World Trade Slowing. Growth in world merchandise trade is slowing to 5 percent this year, down from 8 percent in 1995 and 10 percent in 1994, according to the World Trade Organization. The slowdown represents a return to more typical trade patterns after 2 years of exceptional growth. Despite the slowdown, world trade continues to expand faster than world output (projected to grow 3 percent this year). WTO economists forecast that future expansions in world trade will be fueled by developing countries, with Asia in the lead. Asian economies are predicted to increase exports and imports by 9 percent and 10 percent, respectively. Intra-regional exports among Asian developing economies are rapidly catching up with these countries' combined exports to North America and Western Europe. The current slowdown in the overall rate of trade expansion is attributed to sluggish demand in the West for consumer goods. Developing countries are projected to grow 6 percent in 1996; industrialized countries, only 2 percent.

Consensus on Economic Reform Evident in Ghana. With an average annual growth rate of 4.3 percent from 1990 to 1994—compared to a regional average of 0.9 percent—Ghana is one of sub-Saharan Africa's few stars. Boosted by adequate rains and a good harvest, GDP growth is predicted to reach 5 percent this year, inflation should fall to 40 percent from last year's 70 percent, and the fiscal deficit decrease to between 2.5 and 3 percent of GDP from 4 percent of GDP in 1995. The fiscal shocks that jolted the Ghanaian economy due to a spending spree prior to the last elections in 1992 have been avoided this year. But challenges remain as the re-elected Rawlings government seeks to lower still-high inflation, reduce the fiscal deficit, encourage private investment, and raise the extremely low per capita income—less than one-twelfth that of the United States in 1994. A broad consensus on the need to continue market-oriented reforms meant that economic issues were virtually ignored in the presidential and parliamentary elections held last Saturday in Ghana.

Bulgaria Calls for U.S. Assistance in Latest Round of Financial Crises. In the wake of the recent run on the state savings bank, the Bulgarian government has asked for technical assistance from the United States in restructuring its embattled financial system. Bulgaria has ambled erratically toward a market economy, and in recent years its banking sector has been under considerable liquidity and solvency pressure. An economic crisis in 1994 led to better macroeconomic policies in 1995 and real GDP growth of nearly 3 percent. But the underlying weaknesses of Bulgaria's financial institutions led to recurring runs on bank deposits in late 1995. With output projected to contract 10 percent this year, and inflation running at over 200 percent, Bulgaria has plunged into a steep economic decline. The Bulgarian lev has lost three-fourths of its value since the beginning of the year, and interest rates have risen dramatically. The government is considering the introduction of a currency board in order to stop the free-fall of the currency.

RELEASES THIS WEEK

Consumer Price Index

The consumer price index increased 0.3 percent in November. Excluding food and energy, consumer prices increased 0.2 percent.

Retail Sales

Advance estimates show that retail sales decreased 0.4 percent in November following an increase of 0.3 percent in October. Excluding sales in the automotive group, retail sales increased 0.3 percent.

Producer Price Index

The producer price index for finished goods increased 0.4 percent in November. Excluding food and energy, producer prices increased 0.1 percent.

MAJOR RELEASES NEXT WEEK

Industrial Production and Capacity Utilization (Monday)
Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Thursday)
Gross Domestic Product (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1996:1	1996:2	1996:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	2.0	4.7	2.0
GDP chain-type price index	5.3	2.5	2.3	2.2	1.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	–0.1	1.9	0.6	–0.3
Real compensation per hour:					
Using CPI	0.6	1.0	0.2	0.1	1.1
Using NFB deflator	1.3	1.7	2.0	2.0	2.0
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.4	10.3	10.6
Residential investment	4.5	4.0	4.1	4.2	4.1
Exports	8.2	11.1	11.3	11.3	11.1
Imports	9.2	12.4	12.5	12.6	12.7
Personal saving	5.1	3.4	3.6	3.2	3.9
Federal surplus	–2.7	–2.2	–2.1	–1.7	–1.6

	1970–1993	1995	Sept. 1996	Oct. 1996	Nov. 1996
Unemployment Rate	6.7**	5.6**	5.2	5.2	5.4
Payroll employment (thousands)					
increase per month			–2	224	118
increase since Jan. 1993					10868
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.3	**0.3**
PPI-Finished goods	5.0	2.3	0.2	0.4	**0.4**

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

New or revised data in **boldface.**

FINANCIAL STATISTICS

	1994	1995	Oct. 1996	Nov. 1996	Dec. 12, 1996
Dow-Jones Industrial Average	3794	4494	5996	6318	6304
Interest Rates					
3-month T-bill	4.25	5.49	4.99	5.03	4.84
10-year T-bond	7.09	6.57	6.53	6.20	6.40
Mortgage rate, 30-year fixed	8.35	7.95	7.92	7.62	7.57
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Dec. 12, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.544	–0.5	6.6
Yen-Dollar	113.6	1.1	11.5
Multilateral $ (Mar. 1973=100)	88.40	–0.4	3.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.2 (Q3)	5.4 (Nov)	3.3 (Nov)
Canada	1.6 (Q3)	10.0 (Oct)	1.7 (Oct)
Japan	3.2 (Q3)	3.4 (Oct)	0.5 (Oct)
France	1.4 (Q3)	12.8 (Sept)	1.7 (Oct)
Germany	1.9 (Q3)	7.4 (Oct)	1.5 (Oct)
Italy	0.7 (Q2)	11.9 (Jul)	3.0 (Oct)
United Kingdom	2.4 (Q3)	7.9 (Oct)	2.7 (Oct)