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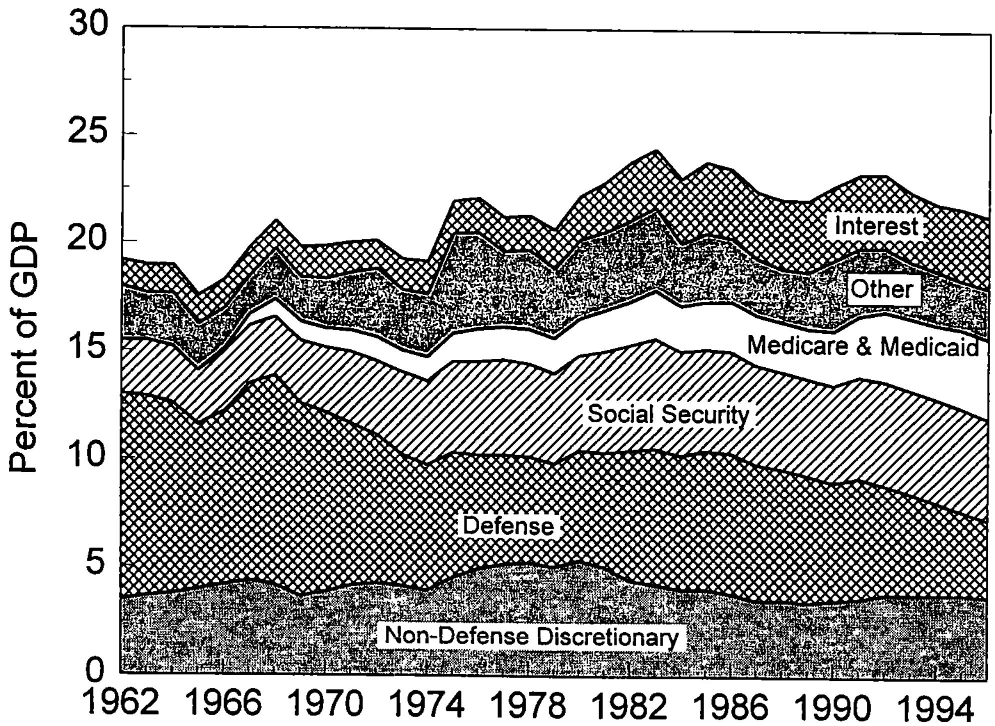
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 20, 1996

CHART OF THE WEEK

The Composition of Federal Spending



The composition of the Federal budget has changed markedly over the past 3 decades. Defense has come down sharply as a share of GDP. Social Security has remained about the same since the mid-1970s. Health care expenditures and interest on the debt have risen sharply relative to GDP.

198310

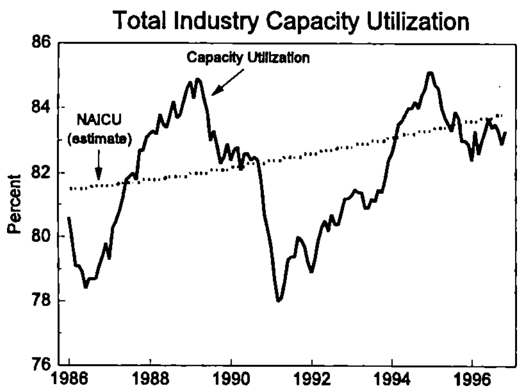
CONTENTS

"It's Christmas, Melanie. Have young Cosgrove go down to the street and give something back to the community."

CURRENT DEVELOPMENT

Capacity Utilization: An Alternative Indicator of Inflation?

Capacity utilization in U.S. industry, which is computed monthly by the Federal Reserve, helps to predict inflation. It can usefully supplement the more conventionally studied indicators, the unemployment rate and the output gap. Recently, capacity utilization indicates possible downward pressure on the inflation rate.



A measure of slack. At high levels of capacity utilization, bottlenecks start to develop and firms are more likely to raise prices than to continue expanding output. Analogously, low levels of capacity utilization imply downward pressure on inflation. The point at which capacity utilization starts to put upward pressure on the inflation rate is sometimes called the non-accelerating inflation rate of capacity utilization (NAICU) and is analogous to the non-accelerating inflation rate of unemployment (NAIRU).

Recent behavior of the NAICU. Statistical estimates show that the NAICU for total industrial capacity has recently been rising and is roughly 84 percent today (see chart). Actual capacity utilization has been slightly below the NAICU for the past year. In November it stood at 83.3 percent. Taken alone, this evidence suggests that the economy is operating below its sustainable level of production and utilization is putting slight downward pressure on inflation.

Qualification. Capacity utilization, however, should not be accorded too much weight in predicting inflation. This indicator is only calculated for the industrial sector, which is about one-fifth of the economy. Also, total capacity is very difficult to measure, and consequently estimates of capacity utilization are subject to more revision and uncertainty than the unemployment rate.

SPECIAL ANALYSIS

Does "America Works" Work?

America Works is perhaps the best known of the for-profit firms that place welfare recipients into jobs. Many find its market-based approach to reducing the welfare rolls appealing. But an examination of America Works suggests the costs may be higher than are generally recognized and the benefits uncertain.

What does America Works do? In part, America Works acts like an ordinary placement service, attracting workers who want to be placed in jobs and locating firms that are willing to offer employment. Because of its focus on long-term welfare recipients, however, it provides other services as well. Workers are required to attend a 5-to-6-week program that teaches them basic work skills, ~~including~~ how to write a resume and respond to interview questions. Once placed, workers become employees of America Works and are contracted out to firms for a probationary period of 4 months. During that period, America Works helps its workers solve any personal problems that interfere with their work, including a sick child, an abusive mate, or trouble finding transportation. It also helps them address work-related problems, like adapting to workplace norms that may be unfamiliar to new workers.

The costs. For these services, America Works derives revenue from four sources:

- a lump-sum payment made by the State welfare agency of about $5,000 for every successful job placement for those who stay on the job for at least 6 months;
- a wage premium during the 4-month probationary period equal to the difference between the wage payment America Works receives from the employer and the minimum wage America Works pays to the employee;
- available tax credits, including the Targeted Jobs Tax Credit that expired in 1995 and the new Work Opportunities Tax Credit;
- other lump-sum payments from State welfare agencies;

Altogether, America Works receives roughly $10,000 per placement. If for-profit, fee-for-service placement agencies were more widespread, these costs might well be lower due to greater competition.

The benefits. America Works has successfully placed thousands of long-term welfare recipients into productive employment in its three locations, including New York City. The number of successful placements, however, probably overstates the benefits America Works provides. The success of such a program does not depend on the total number of placements made, but rather on the number of placements made among those who would not have found jobs without the special efforts of America Works (a substantial number of long-term welfare recipients find jobs each year anyway, see *Weekly Economic Briefing*, December 13, 1996). No evaluation of America Works has assessed the benefits this way.

In fact, the design of the program appears to favor workers who would be successful finding jobs anyway. Recipients are placed in a queue and may have to wait as long as 6 months before training begins. Once training starts, anyone who arrives at class even 5 minutes late is thrown out of the training and placed at the end of the queue. Such sanctions help insure that those who complete the program are the people most willing to work. As discussed in last week's *Weekly Economic Briefing*, the fact that many of these workers have received welfare benefits for a long time is not by itself a good indicator that they are difficult to place.

Conclusion. Job placement agencies for welfare recipients may provide the basic work skills and employer contacts that low-skilled workers need to enter the labor market successfully. Unfortunately, the experience of America Works may be too limited to determine whether such an approach provides sufficient benefits to outweigh its costs.

SPECIAL ANALYSIS

Raising the Retirement Age: Who Could Get Hurt?

The normal Social Security retirement age is scheduled to rise gradually from 65 to 67 during the first 3 decades of the next century. And some have proposed raising it farther and faster. Those who retire at age 62 now receive 80 percent of the normal-age benefit; raising the retirement age would require reducing this fraction to 70 percent to keep lifetime benefits equivalent for early and normal retirement. Further increases in the retirement age would lower the age-62 benefit still further. An important policy question is: Who would be adversely affected by such reductions?

62- and 63-Year-Old Men Classified by Health/Wealth Status

	in labor force	not in labor force
healthy and wealthy	25 percent	18 percent
healthy and not wealthy	20 percent	15 percent
not healthy but wealthy	2 percent	4 percent
not healthy and not wealthy	4 percent	11 percent
total	52 percent	48 percent

Notes: "Healthy" means respondent reports himself in excellent, very good, or good health; "not healthy" means respondent reports himself in fair or poor health. "Wealthy" means having more than $150,000 in assets (including homes). Figures may not add to total due to rounding.

Preliminary evidence. New data on the wealth and health status of men who were 62 or 63 years old in 1994 or 1995 provide some information. The table shows that 11 percent of 62- and 63-year-old men are 1) out of the labor force; 2) not healthy—that is, they report themselves in fair or poor health; and 3) not wealthy—that is, their net worth is less than $150,000. This is a potentially vulnerable group, although how vulnerable depends on what other sources of income they have. Those on Social Security Disability Insurance, for example, would be unaffected by a change in the retirement age. Recipients of means-tested Supplemental Security Income (SSI) benefits would also be unaffected. Federal SSI payments bring the income of recipients up to 77 percent of the poverty line for single individuals and 92 percent for married couples. A number of States provide some additional benefits.

People at risk are those who depend primarily on Social Security, have few assets, and are in poor health. These people might find themselves with a marginally adequate retirement income or be forced onto the SSI rolls. This raises two types of issues. The first is the desirability of a substantially larger proportion of the elderly being dependent on a means-tested program. The second is the adequacy of means-tested support. If the retirement age were increased, should the levels of SSI benefits be adjusted? Should SSI benefits for the non-disabled—currently available only for those 65 and over—be available earlier? Should the Social Security disability program play a greater role?

The pressure to resolve these issues will depend, in part, on the size of the vulnerable population. Other information is needed, however, before it is possible to determine the size of the group at risk. Such information includes the health and wealth status of men aged 64 and some assessment of how many additional men would fall into the vulnerable category as the retirement age increases from 65 to 67. A comparable analysis also needs to be done for women.

ARTICLE

Saving, Investment, and the Current Account

The current account balance is the international bottom line on the Nation's income statement. When it is negative, as it has been in most recent years, our expenditure exceeds our income and we are borrowing from the rest of the world. The good news about the recent current account deficit is that the reason we have had to borrow more is that national investment has been rising. The bad news is that national saving is still low.

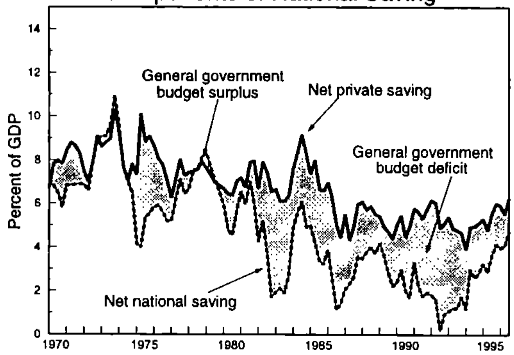
Net borrowing from abroad. The current account balance is the sum of the trade balance (goods and services), the investment income balance, and net transfers. It can be expressed, equivalently, as the rate at which U.S. residents are accumulating claims on foreigners, net of the claims foreigners are accumulating on domestic residents. Here, "claims" include direct investment (factories and real estate), equities, bonds, bank loans, deposits, checks, and cash. The fact that the current account deficit and capital inflows must equal each other is important, but the intuition as to why may be elusive.

Some of the increased foreign claims against the United States represent deliberate financial transactions, as when a foreign bank buys U.S. securities for its portfolio, or a foreign resident buys Treasury bills. But what happens if these deliberate capital inflows are inadequate to finance the current account deficit? In such a case more dollars flow out to pay for U.S. purchases of foreign goods, services, and assets abroad than flow back to pay for foreign purchases here, and foreigners necessarily end up accumulating dollars; these accumulated dollars are also claims on the United States.

The budget deficit and the national saving rate. A third way of looking at the current account balance—as the difference between saving and investment—brings home the importance of macroeconomic factors. The net national borrowing represented by a current account deficit has two components: government borrowing to finance its budget deficit and private borrowing to finance the difference between private saving and private investment. If national saving is too low to finance national investment, the difference must be made up by borrowing from abroad.

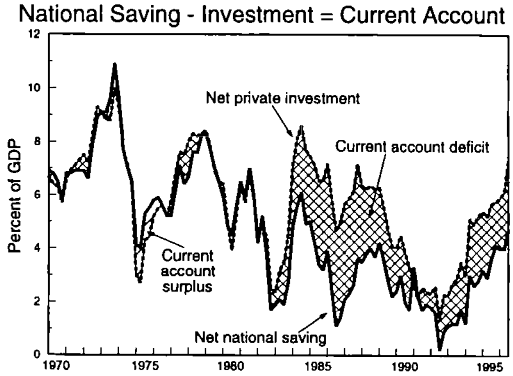
The upper chart on the next page shows that the large budget deficits that emerged in the 1980s compounded the effect of falling private saving in reducing national saving. It also shows that national saving has risen in the 1990s due to higher private saving and smaller budget deficits. The lower chart shows that, in the 1980s, national saving fell faster than domestic investment, which necessitated borrowing from abroad and produced a large current account deficit. In the past few years, saving has gone up, but it remains below investment.

Components of National Saving



Thus, the source of the U.S. current account deficits of the last 15 years is high budget deficits and low saving. The deficits are a problem not because of the trade deficits per se, but because they reflect low national saving, and because they leave us with high international indebtedness. We are borrowing from abroad to finance much of our domestic investment. Equivalently, one can say we are borrowing from abroad to finance our budget deficit. In an economic sense, it does not ultimately matter if the Treasury borrows from American residents who then turn around and borrow from abroad, or if the Treasury sells its bonds directly to foreigners.

National Saving - Investment = Current Account



An investment boom. The good news is that the national saving rate has been improving since 1992. As the general government budget deficit has declined from 4.4 to 1.5 percent of GDP, the private saving rate has risen from 5.5 to 6.3 percent of GDP. Why then has the current account not yet improved? Because of more good news: the investment rate has risen even more strongly than the saving rate in the current expansion. Financing this stronger investment has required all of the increase in domestic saving, plus an increase in borrowing from abroad. Hence the increased current account deficit. (This pattern is typical of the expansion phase of the business cycle.) The 5.1 percentage point increase in investment, minus the 3.6 percentage point increase in total national saving, gives a 1.5 percentage point increase in the current account deficit, to 2.5 percent of GDP.

We should not lament that the recent improvement in national saving is working to improve investment rather than to improve the current account. Either way, we leave our children in a better position; investment adds to the physical capital stock, which pays future dividends in much the way that our international financial investments do. Similarly, rates of investment that fail to keep up with depreciation work to subtract from the physical capital stock, analogously to the way that borrowing from abroad subtracts from our international investment position.

The bottom line. The recent increase in the current account deficit can be viewed as good news: it reflects an investment boom. But the origin of the record deficits of the last 10 years was a bad thing: the sharp fall in national saving. We now need to continue recent progress at resurrecting national saving, whether we wish to boost investment or to improve the current account.

A Cross-Country Comparison

The role of national saving and investment in determining the current account is illustrated dramatically by the differing experience of various countries:

Greece has a high current account deficit because of a high budget deficit—a classic twin deficits problem.

Sweden has a low saving rate, both public and private. Yet it has a current account surplus because its investment rate is especially low and can be financed entirely at home.

Japan is an example of a country with a high investment rate, but a strong current account. The explanation is a very high private saving rate, which is more than sufficient to finance domestic investment and thus spills over into investments overseas.

Malaysia has an even higher investment rate, so that it does run a large current account deficit—heavy borrowing from abroad—despite good private and public saving rates. Developing countries like Malaysia buy a lot of capital goods equipment (including machine tools, transportation equipment, and earth-moving equipment) from abroad on credit, rendering the link between investment and the current account deficit particularly tangible.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Ending Welfare with a Carrot. The current approach to reforming welfare in the United States stands in contrast to experimental programs currently underway in Canada. Starting in 1992, some 6,000 long-term welfare recipients—mainly single mothers—in two provinces were randomly assigned into a control and a treatment group to test the effects of an employment subsidy given to full-time job-holders. The subsidy was equal to half the difference between an earnings target ($21,600 or $27,000 per year in U.S. dollars, depending on the province) and the individual's actual earnings. A worker in British Columbia earning roughly $5.10 per hour for 30 hours per week and 50 weeks per year would receive a subsidy of close to $10,000 per year, far more generous than any wage subsidies available or proposed in the United States. Preliminary results indicate that after 18 months, close to 25 percent of those eligible for the subsidy had found full-time work compared with about 10 percent of the control group. The very low rate of full-time employment among members of the control group may be explained by the generosity of Canada's standard welfare system, which offers maximum benefits of $7,500 to $10,000 (depending upon the province) per year to a poor women with one child and an implicit 100 percent tax rate on any labor earnings. Even though employment increased roughly 2.5 times, about 75 percent of welfare recipients eligible for the subsidy still did not have full time jobs. Because many of the benefits may come about in the form of long-term reductions in the welfare rolls, it is too soon to tell whether the benefits of the program are greater than the costs.

Medicaid for Poor Mothers and Children Saves Lives. Eligibility for Medicaid coverage expanded dramatically over the past decade or so among poor children and pregnant women who do not receive welfare. Between 1984 and 1987, the program expanded to provide benefits to low income mothers who were ineligible for AFDC for non-income related reasons, like family structure. From 1987 to the present, eligibility was expanded to those with somewhat higher incomes. In both periods, however, the expansion of coverage did not occur simultaneously across all states, creating a "natural experiment." This has made it possible to compare health outcomes in states that expanded eligibility earlier with those in states that expanded later. Evidence from a number of studies indicates that utilization of preventive care rose substantially and infant and child mortality fell. For instance, the 30 percentage point rise in eligibility that took place between 1979 and 1992 was associated with an 8.5 percent decline in the infant mortality rate.

INTERNATIONAL ROUNDUP

OECD *Economic Outlook* Sees Balanced Non-Inflationary Growth. Annual growth across all OECD countries is expected to be 2.5 percent in 1996 and 1997 and 2.75 percent in 1998, with inflationary pressures held in check, according to the recent OECD *Economic Outlook.* The U.S. outlook is less positive, because the OECD expects tight monetary policy to restrain GDP growth to 2.0 percent in 1997—slightly lower than the most recent Congressional Budget Office estimate of 2.3 percent. Projections for Japan, by contrast, show growth rising to 3.7 percent by 1998, supported by low interest rates and a weaker yen. Although growth in Europe is expected to pick up as well, unemployment rates in excess of 10 percent will remain a problem across continental Europe. The report also expresses skepticism about the ability of France and Germany to reduce their budget deficits enough to meet the criteria of the Maastricht treaty. For OECD countries as a whole, strong profits, a slowdown in the rate in inventory accumulation, and exchange rate movements have all contributed to the generally positive outlook.

New Free Trade Agreements Threaten U.S. Exports to Chile. With the recent signing of the Canada-Chile Free Trade Act, over 80 percent of trade between Chile and Canada will be duty-free starting in mid-1997. Already close to nine-tenths of Mexican exports to Chile are tariff-free, and since October 1, the Mercosur countries (Argentina, Brazil, Uruguay, and Paraguay) have enjoyed expanded access to the Chilean markets. U.S. exporters, by contrast, are subject to an average tariff of 11 percent and complain that they cannot compete with duty-free goods exported from other trade partners. Already, Goodyear and McDonald's have begun to source intermediate products and food processing equipment out of Mexico as opposed to the United States. The rate of growth of U.S. exports to Chile was only 8.5 percent in the first 3 quarters of 1996 compared with 38 percent in the first 3 quarters of 1995, and the U.S. share of the Chilean market is expected to decline slightly in 1996. In preparation for President Frei's February 1997 visit to Washington, the Chilean Minister of Finance has repeatedly emphasized Chile's desire to gain NAFTA accession soon—and hinted that the Chilean administration will consider new trade possibilities in the Asia-Pacific region.

NAFTA Seen as Aiding Mexico's Recovery. Trade liberalization, spurred in part by the implementation of NAFTA, has been credited with softening the blow of the economic crisis in Mexico. The 31 percent increase in exports in 1995, which led Mexico's recovery, would have been impossible without investments in export industries made prior to 1995, according to a high level official of Mexico's Central Bank. Export growth has continued in 1996, up 19 percent for the first 3 quarters of 1996, with over 80 percent of exports sent to the United States. Yet, import growth continues to outstrip export growth (U.S. exports to Mexico are up 24 percent for the first 3 quarters of 1996), turning Mexico's current account surplus into a deficit. Concern has been expressed that the target growth rate of 5 percent for 1998 will not be met. Problem areas include weak retail sales, depressed construction activity, and lack of credit expansion. GDP growth is predicted to be 4 percent for 1997.

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, December 20, 1996****

According to revised estimates, real gross domestic product rose 2.1 percent at an annual rate in the third quarter.

U.S. International Trade in Goods and Services

The goods and services trade deficit fell to $8.0 billion in October from $11.4 billion in September.

Housing Starts

Housing starts increased 9 percent in November to 1.51 million units at an annual rate. For the first 11 months of 1996, starts were up 10 percent compared with the same period a year ago.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.9 percent in November. Capacity utilization increased 0.4 percentage point to 83.3 percent.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (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	**2.1**
GDP chain-type price index	5.3	2.5	2.3	2.2	**2.0**
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**.
GDP data for 1996:3 **embargoed until 8:30 a.m., Friday, December 20, 1996.**

FINANCIAL STATISTICS

	1994	1995	Oct. 1996	Nov. 1996	Dec. 19, 1996
Dow-Jones Industrial Average	3794	4494	5996	6318	6474
Interest Rates					
3-month T-bill	4.25	5.49	4.99	5.03	4.88
10-year T-bond	7.09	6.57	6.53	6.20	6.36
Mortgage rate, 30-year fixed	8.35	7.95	7.92	7.62	7.74
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	Dec. 19, 1996	**Week ago**	**Year ago**
Deutschemark-Dollar	1.557	0.8	8.2
Yen-Dollar	114.0	0.4	11.9
Multilateral $ (Mar. 1973=100)	89.00	0.7	4.7

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)	2.0 (Nov)
Japan	3.2 (Q3)	3.4 (Oct)	0.5 (Oct)
France	1.4 (Q3)	12.8 (Sept)	1.6 (Nov)
Germany	1.9 (Q3)	7.4 (Oct)	1.5 (Nov)
Italy	0.7 (Q2)	11.9 (Jul)	2.7 (Nov)
United Kingdom	2.4 (Q3)	7.9 (Oct)	2.7 (Nov)

U.S. GDP data **embargoed until 8:30 a.m., Friday, December 20, 1996.**