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12-9-96

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 6, 1996

CHART OF THE WEEK

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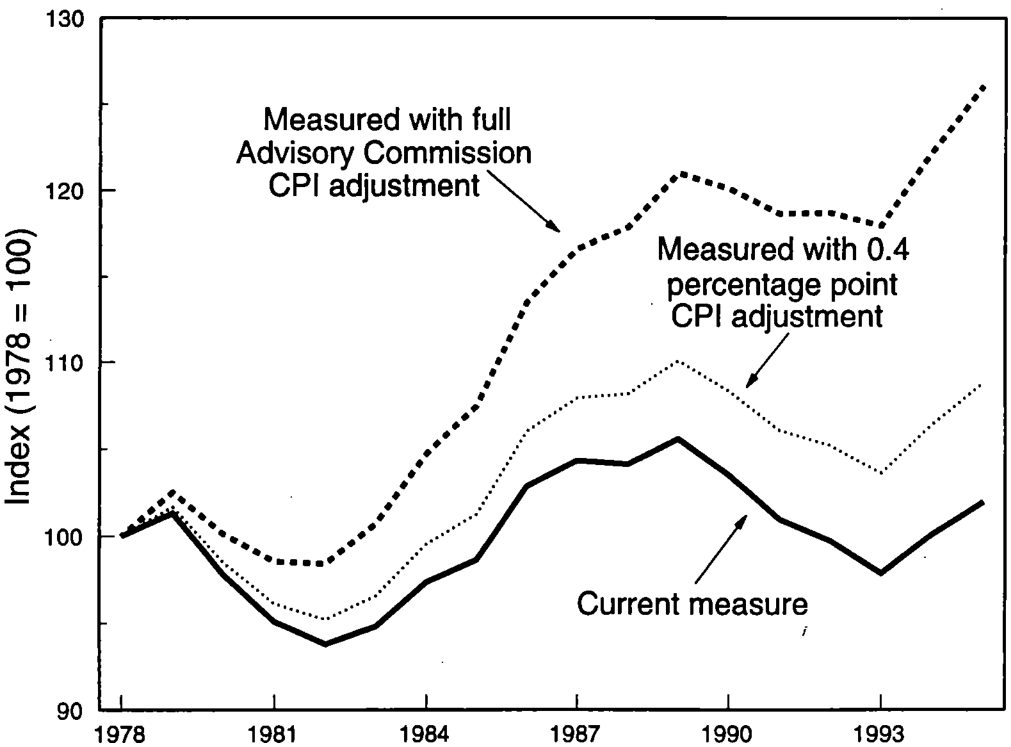
Real Median Family Income with Different CPI Adjustments



Median family income, after adjusting for inflation, was about 2 percent higher in 1995 than it was in 1978. If the Advisory Commission to Study the Consumer Price Index is correct, the CPI has overstated inflation by 1.3 percentage points per year for a considerable period of time in the past (and will continue to overstate it by 1.1 percentage points per year going forward). If inflation were this much lower, real income would have risen 26 percent since 1978. Even with a more modest assessment of the degree to which the CPI has overstated inflation, median family income since 1978 would show a 9 percent increase.

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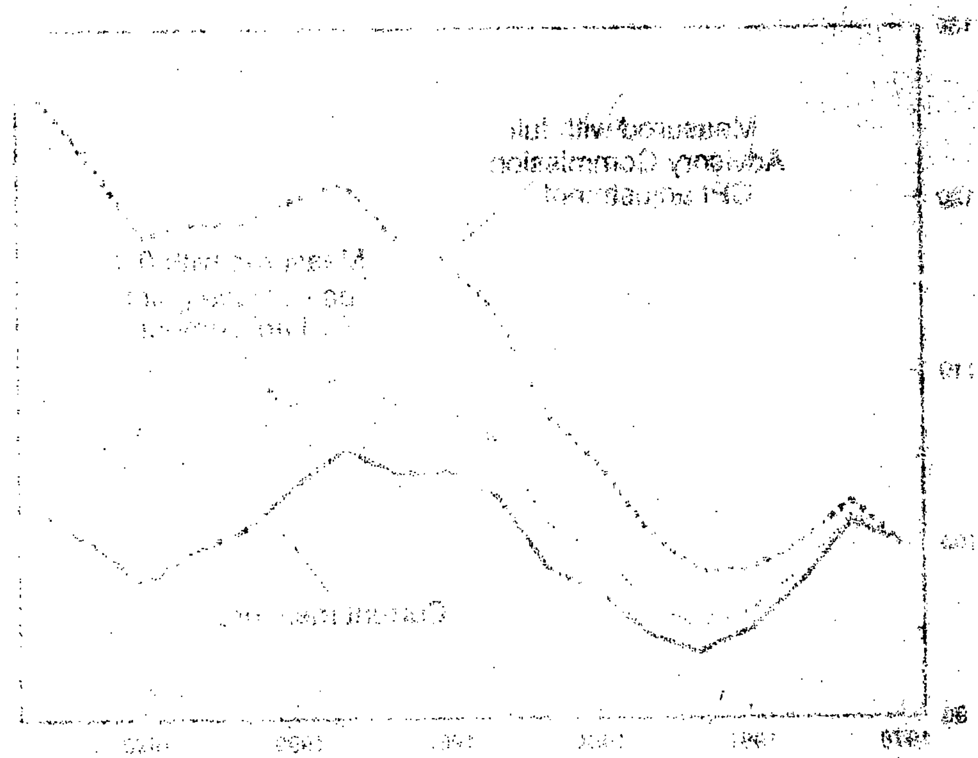

Median family income, after adjusting for inflation, was about [illegible] percent higher in [illegible] than it was in 1970. [illegible] Advisory Commission [illegible] is correct, the CPI has overstated inflation by 1.1 percentage points per year for a considerable period of [illegible] continue to overstate it by 1.1 percentage points per year going forward. [illegible] inflation were [illegible] lower, real income would have risen [illegible] percent since 1976. [illegible] adjustment of the degree to which the CPI has overstated inflation, median family income since 1976 would show a [illegible] percent increase.

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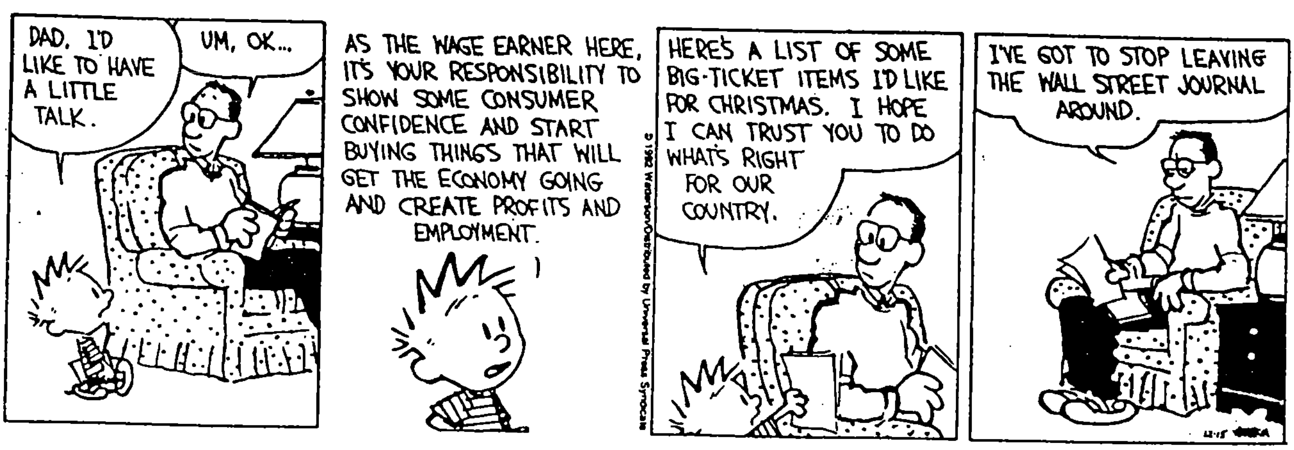

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CURRENT DEVELOPMENT

Commission Recommends a Cost-of-Living Index

The consumer price index (CPI) overstates changes in the cost of living by 1.1 percentage points a year, according to the report of the Advisory Commission to Study the Consumer Price Index. The box shows the components of the bias estimated by the Commission and assesses the strength of the supporting evidence.

Advisory Commission Estimates of the CPI Bias

Type	Percentage Points Per Year	Strength of Evidence/ Degree of Consensus
Upper-level substitution	.15	Strong
Lower-level substitution	.25	Very good
Low-cost outlets	.1	Probable but debatable
New products and quality change	.6	Probable but debatable
Total bias	1.1	Plausible range (.8 to 1.6)

Substitution bias. The CPI prices a fixed market basket of commodities based on spending patterns in a base period (currently 1982-84). But when the relative prices of goods change, consumers substitute away from goods and services that have become relatively expensive toward those that have become relatively cheap. Increases in the CPI measure how much income a typical consumer would need to buy the base-period market basket at the new prices. A true cost-of-living index would measure how much more income a consumer would need to maintain the same level of economic well-being, taking into account the possibility of substitution to mitigate the effects of large relative price increases. By ignoring substitution, the CPI overstates increases in the cost of living.

Substitution bias takes place at two levels, given the way the CPI is constructed. The "upper-level" refers to substitution among the 207 basic categories in the overall CPI—for example, from apples to oranges. But these 207 categories are themselves made up of numerous individual items. Apples, one of the 207 categories, is a weighted average of Delicious, Granny Smith, Jonathan, and other varieties. "Lower level" substitution takes place when the price of Delicious apples increases and consumers shift to other varieties.

The Advisory Commission estimates the upper and lower level substitution biases separately and recommends separate solutions. At the upper level, the Commission recommends a "Tornqvist" index, which is superior to the current method in taking substitution into account. A problem is that calculation of a true Tornqvist index requires very up-to-date information and cannot be computed on as timely a basis as the current CPI. The Commission therefore recommends that the BLS compute an

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annual index, in addition to a revised CPI, that would use as up-to-date information as possible, but that would be revised periodically to incorporate new information.

Data are not available for computing a Tornqvist index at the lower level. Instead, the Commission recommends geometric weighting. This method makes assumptions about consumer behavior that are probably about right for most of the 207 categories, but may not be appropriate for all of them.

Quality and other biases. The BLS attempts to measure quality changes when it can. Some of these quality changes are easy to measure—such as the number of cookies in a box. Others are more difficult but straightforward (like sticker price increases that are judged to reflect quality improvements, like anti-lock brakes).

BLS does not adjust for other, more difficult problems. For example, cars and televisions nowadays are less likely to need repair. Surgery now is more likely to be successful than in the past. The Commission estimates that quality adjustments are most inadequate in medical care and electronic equipment.

New products, such as air conditioners in the 1950s or VCRs in the 1980s, usually decline in price during the first years that they are available for sale. But these products are usually not included in the CPI until years after their introduction, and so the CPI never records their initial price declines.

Over time, consumers may change their shopping patterns, shifting from high-priced to low-priced outlets such as Wal-Mart and K-Mart. Of course, the quality of service is often lower at the lower-priced outlets. Current methods assume that all of the difference in price between high- and low-priced outlets reflects the quality of service. But when this assumption is not appropriate, current methods omit one source of price decline.

The Commission did not have an immediate remedy for most of these problems, but suggested that "The President and Congress...should pass legislation adjusting indexing provisions." It also suggested a program of additional data collection, outside advice, and research that would help identify and eliminate these problems.

Criticisms. Different parts of the bias are based on varying degrees of evidence and judgement. With respect to substitution bias, most economists would agree that a methodology that reflects substitution is preferable to the current fixed-weight methodology. With respect to quality, however, the Commission has had to use a lot of judgement in its estimates. Although these judgements may be correct, they are much more debatable.

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SPECIAL ANALYSIS

How Much Currency is Abroad? And Does it Matter?

Recent studies suggest that a very large fraction of U.S. currency is held abroad. These holdings matter for the budget, for monetary policy, and for evaluating the impact of financial innovations.

Analysis. Nearly $400 billion of U.S. currency is now in circulation—enough for every woman, man, and child in America to hold about $1,500 in cash, $900 of it in $100 bills. Clearly, the typical American does not hold anywhere near this amount. Even taking into account business demand, money stuffed in mattresses, and the use of cash for illicit purposes like drug transactions and tax avoidance, domestic demand appears to fall well short of the outstanding supply.

Direct evidence on foreign holdings is lacking, but indirect measures suggest that perhaps as much as 70 percent of U.S. currency is held abroad. Very large shipments of currency to Latin America (especially Argentina) and to Eastern Europe and the former Soviet Union have been recorded in recent years. These shipments are consistent with reports of substantial substitution of dollars for domestic currency in some countries during and after periods of high inflation and financial uncertainty. The 70 percent estimate comes from recent research at the Federal Reserve comparing patterns of currency holding in the United States and Canada—on the assumption that foreign holdings of Canadian dollars are quite small. Alternative indirect measures presented in the Fed study show foreign holdings between one-third and two-thirds of the total, with an average of about 55 percent.

Implications. Foreign holdings of U.S. currency have implications in three areas:

- The budget. Foreign holdings of dollars are effectively an interest-free loan to the U.S. Government, worth an estimated $10 to $15 billion a year in interest savings. Much as American Express benefits from the float on travelers' checks, the United States benefits whenever people in Argentina or Russia hold dollars that do not pay interest instead of Treasury securities that do.

- Monetary policy. Currency outstanding is a component of the U.S. monetary aggregates. Fluctuations in foreign holdings of dollars, which reflect foreign economic conditions, will produce fluctuations in the U.S. aggregates. If monetary policy were based to a significant degree on the aggregates (as it was in the early 1980s), and if the effects of changes in foreign currency demand were not taken into account, fluctuations abroad could lead to policy errors here.

- Financial market innovations. Evaluations of the likely effects of financial market innovations (like the widespread adoption of electronic money) on the demand for U.S. currency need to take account of foreign demand. For example, an innovation expected to reduce currency demand by 10 percent would reduce currency outstanding by nearly $40 billion if all currency were held domestically, but by only about $12 billion if 70 percent of currency were held abroad.

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SPECIAL ANALYSIS

What Do We Know about the Welfare-to-Work Transition?

Several social experiments conducted during the 1970s and 1980s tested different approaches to helping welfare recipients make the transition to paid employment. Although many approaches improved employment prospects for some recipients, they had little success placing even a majority in long-term jobs. The recent welfare reform makes finding successful job placement strategies imperative.

Controlled experiments. A dozen or so evaluations have been based on controlled experiments in which welfare recipients are randomly assigned to control and treatment groups in order to guarantee that the only difference between the two is the policy treatment. Policies evaluated range from the very inexpensive, like job search assistance, to the very expensive, like subsidized employment and payments for education and training. Findings from these experiments include:

- Employment of those in the treatment group increased by statistically significant amounts, but the majority still did not work.
- AFDC spending fell for members of the treatment group.

min wage/EITC

- Earnings of those in the treatment group rose, but few recipients were lifted out of poverty.
- Low-cost programs produced larger earnings gains and welfare savings relative to the expenditure (a higher benefit-cost ratio), but those benefits were small in absolute terms.

The table summarizes the employment effects from a very low-cost treatment (in Arkansas), a very high-cost treatment (the National Supported Work Demonstration—NSWD), and the Riverside County, CA, program, which is generally regarded as the most successful welfare-to-work program. In all these experiments, employment among treatment group members was greater than among control group members. None of the experiments, however, placed a majority of recipients in long-term jobs.

Experiment	Cost per individual (1996 dollars)	Percent employed after one year		Percent employed after three years	
		treatment	control	treatment	control
Arkansas	$186	20.4	16.7	24.5	18.3
Riverside	$1,730	35.3	22.1	31.2	24.6
NSWD	$26,164	73.3	30.4	45.3	43.3

PHOTOCOPY
WJC HANDWRITING

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What can we learn? These experiments probably tell us very little about how successful a universal program (such as job search assistance) would be in the present environment. Welfare reform has led to significant changes in the incentives facing low-income job seekers. Long-term welfare receipt is no longer available as an option. Thus, policies designed to assist such workers in finding and maintaining employment may be considerably more successful than the experimental results suggest. On the other hand, if time limits provide enough incentive for low-income individuals to get jobs, additional support for job-finding may be superfluous.

Implications. Better evidence for evaluating future policies should come from carefully evaluated experiments at the local level conducted under waivers and, in the future, under local variation that occurs as a result of Temporary Assistance for Needy Families (TANF). To give welfare reform the best chance to succeed, innovative strategies need to be developed to employ hard-to-place welfare recipients. These strategies may be too expensive for states to finance under their existing TANF grants. Additional resources would be needed to support and evaluate work-based systems for the hard-to-employ.

ARTICLE

Dealing with Risk under the New Farm Act

The 1996 Farm Act eliminated deficiency payments and thus removed the government-created floor on commodity prices. Although some feared that farmers would be exposed to greater risk under the new Act, exposure to risk is limited by a number of factors.

Price volatility versus family income volatility. Farm income is only one component of family income, which is what ultimately matters to farm families. This is especially true for young farm families, for whom farm income represents only 20 to 30 percent of total income. Thus, the continuing diversification of the rural economy helps protect against farm income fluctuations.

The 1996 Act itself helps with risk management by increasing total payments to farmers. Contract payments to farmers are expected to be $25 billion higher between 1996 and 2002 than deficiency payments would have been under the old program. This large fixed payment reduces the chance that farm income will fall below some target level.

Basic market forces also mitigate the impact of price changes. Farm income is the product of price and yield, which frequently move in opposite directions. This negative correlation between prices and yields produces a "natural hedge" that reduces the impact of price fluctuations on farm income.

Traditional risk management strategies. In addition to income diversification and natural hedges, forward contracting and the purchase of futures contracts are two important ways to manage price risk. Forward contracting entails selling a portion of expected output to another party—often the operator of a local grain elevator—at the time the crop is planted, thereby locking in a price and guaranteeing an outlet. Purchasing futures contracts is another way to insure against price risk, but is less commonly used than forward contracting because it requires a cash or credit investment to begin and maintain the process.

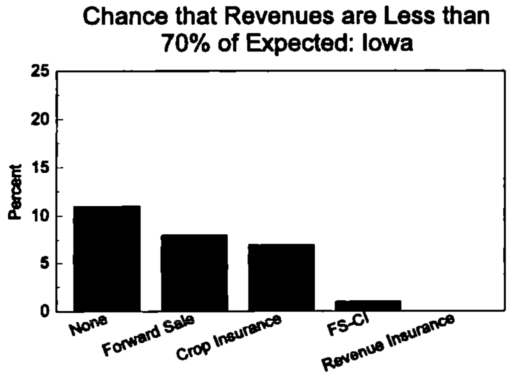
Yield risk is frequently controlled through the use of government-subsidized crop insurance. Farmers can purchase basic coverage against "catastrophic" yields at highly subsidized rates, and they can purchase additional coverage with a declining percentage subsidy. In 1996, participation in these programs was high—67 percent of corn acres nationwide and 84 percent of cotton acres.

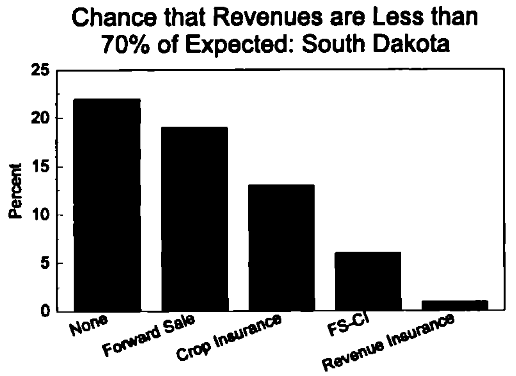
New tools for reducing risk. Further opportunities for risk reduction emerged in the spring of 1996, when two pilot revenue insurance programs were introduced.

- Income Protection (IP) offers a revenue guarantee based on the crop's expected harvest-time price and the farmer's expected yield. The farmer receives an indemnity if actual revenue falls below the guarantee.

- Crop Revenue Coverage (CRC) is a private sector initiative comprising two components. First, the contract offers a revenue guarantee based on price expectations and the farmers' expected yields. Second, CRC offers "replacement coverage" whereby coverage can increase during the season if prices rise.

How effective are these risk management tools? The effectiveness of these old and new tools varies by region, but in general they provide substantial protection.





The charts compare the performance of five insurance strategies for corn farmers in Iowa and South Dakota. In Iowa, both revenue insurance and the forward-sale-combined-with-crop-insurance (FS-CI) strategies essentially eliminate the possibility that corn revenues will be less than 70 percent of expected levels. These are superior strategies in South Dakota as well, but to a somewhat lesser extent, because corn farming is generally riskier in South Dakota than in Iowa.

Policy implications. Although crop and revenue insurance are potentially effective risk management tools for farmers, they have drawbacks. Crop insurance, IP, and CRC are all farm-specific, which creates potentially serious incentive problems. Because these contracts indemnify farmers against their own yields, they may not take all appropriate steps to protect and maximize their output. One alternative would be to key insurance to subpar regional performance. Farmers resist this approach, however, because fluctuations in individual farm yields are not always well correlated with fluctuations in regional yields (the difference is called "basis risk"). The tradeoff between basis risk and incentive problems is a fundamental issue in the farm insurance debate.

Conclusion. Farmers are insulated from price fluctuations by their off-farm employment, by the high fixed payments provided by the 1996 Farm Act, and by the natural hedge. Existing and new risk management strategies can dispense with much of the remaining risk.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Consumers Upbeat. Retailers and consumers are generally upbeat, according to the latest Federal Reserve regional survey. Retail sales have increased recently. After slow sales last year, retailers are modestly optimistic about sales during this holiday shopping season, despite a shortened shopping period (five fewer days than last year between Thanksgiving and Christmas). Regions continue to report moderate economic growth, and prices are stable. Most districts report tight labor markets, but wage pressure is generally not rising except in some technical occupations and for some skilled workers.

Quality Gains in Services Under-Counted. A new study by DRI/McGraw-Hill concludes that quality improvements in health care, finance, and business services have been significantly underestimated. One implication is that service sector productivity is mismeasured by about three-quarters of a percentage point. DRI expects annual productivity growth as currently measured to increase to about 1.3 percent over the next five years, which suggests true productivity growth of about 2 percent per year, given their estimate of the service sector bias. This conclusion does not mean, however, that growth in productivity has not slowed since the 1960s. DRI finds that it was also understated in those years (though by less than it is now).

Children Born to Teenage Mothers More Likely to Repeat a Grade. Repeating a grade in school has been linked to future problems; children who have repeated a grade are more likely to be high school dropouts and generally have lower cognitive achievement. A recent study finds, after taking into account other influences such as family income, that children born to teenage mothers are more likely to repeat one or more grades than other children. In fact, children of teenage mothers repeat at over twice the rate of the entire population of enrolled children. This holds true even among siblings. A child born when the mother is a teenager is more likely to repeat than a younger sibling born when the mother is older. The study also examined child disabilities, and found no significant relationship between mother's age and child disability.

Better Jobs: Half the Problem is Getting There. A recent survey of fast-food restaurants in Atlanta finds that although the suburbs have more job openings and higher pay, few inner-city dwellers pursue suburban jobs. The black share of fast-food employment is 97 percent in the central city, compared to just 55 to 73 percent in the various suburbs. The researchers find that 36 percent of the difference between black employment shares in the suburbs and the city occurs because the suburban restaurants are not accessible by public transportation. An additional 33 percent reflects commuting distance from the central city. These findings may be explained either by lack of access to or lack of information about these jobs. The study implies that car and van pools to provide transportation for reverse commuters could pay off for both prospective employees and employers.

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INTERNATIONAL ROUNDUP

Japanese Economic Growth Remains Weak in Third Quarter. Data released this week indicate that Japanese GDP grew at an annualized rate of 0.4 percent in the third quarter. Although weak, this growth is an improvement over the revised rate of -1.1 percent for the second quarter. Domestic demand—especially of the public sector—was anemic, contracting at an annualized rate of 0.6 percent. Residential investment, which grew at an average annual rate of roughly 29 percent over the previous three quarters, fell 2.1 percent. Non-residential investment, by contrast, continued to grow at a strong pace, increasing by 6.4 percent. In the public sphere, investment fell almost 8 percent, the first decline since early 1995. Growth during the third quarter was sustained by strong exports, which expanded at an annualized rate of 6.1 percent. Imports of goods and services fell 2.8 percent. GDP growth was within expectations. Some analysts are concerned, however, that weak domestic demand threatens Japan's precarious recovery, especially because a consumption tax hike is planned for April 1997.

Italy Takes Steps to Meet Criteria for European Monetary Union. On November 25, the Italian lira re-entered Europe's Exchange Rate Mechanism (ERM), the monetary arrangement that commits its members to maintaining the values of their currencies within a fixed range set in terms of the *ecu*. Speculative attacks on the lira had forced it out of the ERM in 1992. (The United Kingdom, Sweden and Greece are the only EU countries still outside the ERM.) Money markets responded favorably to the lira's re-entry, with T-bill yields falling to their lowest levels since the 1970s. This has pressured the Central Bank again to lower the discount rate, which has already fallen 150 basis points since July. In order to meet the fiscal criterion for monetary union—this year's deficit is projected at almost 7 percent of GDP—the Prodi government has included a special $8 billion "Eurotax," equivalent to 0.6 percent of GDP, in its 1997 budget proposal. Eurotax revenues will come primarily from a new income tax, plus early payment of taxes on lump-sum retirement benefits and accelerated collection of overdue taxes. The government plans a partial rebate of the 1997 Eurotax in 1999.

British Government Shuns Major Tax Cuts in Last Budget Before Elections. On November 26, Britain's Chancellor of the Exchequer unveiled the last budget before parliamentary elections, which must be held by May 1997. The government announced its GDP growth projections of 2.5 percent for this year and 3.5 percent for 1997, slightly above the consensus forecasts of 2.3 and 3.3 percent, respectively. Modest new tax cuts were announced that are aimed at the lower end of the income scale and at small businesses. In order to reduce the higher-than-expected deficit, a number of measures to stem tax leakage and secure the tax base were introduced. Other revenue-raising measures include the privatization of student loans and increases in excise duties on tobacco and gasoline by 5 percentage points above inflation. Although total spending is set to fall from last year's plan, public expenditure has been reallocated to increase funding for education, law and order, and the national health service.

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, December 6, 1996****

The unemployment rate rose slightly in November to 5.4 percent from 5.2 percent in October. Nonfarm payroll employment rose by 118,000.

Productivity

Nonfarm business productivity decreased 0.3 percent at an annual rate in the third quarter of 1996. Manufacturing productivity increased 6.3 percent.

Leading Indicators

The composite index of leading indicators increased 0.1 percent in October.

NAPM Report on Business

The Purchasing Managers' Index rose to 52.7 percent in November from 50.2 percent in October.

MAJOR RELEASES NEXT WEEK

Producer Prices (Wednesday)
Consumer Prices (Thursday)
Retail Sales (Thursday)

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	N.A.
PPI-Finished goods	5.0	2.3	0.2	0.4	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, December 6, 1996.**

FINANCIAL STATISTICS

	1994	1995	Oct. 1996	Nov. 1996	Dec. 5, 1996
Dow-Jones Industrial Average	3794	4494	5996	6318	6437
Interest Rates					
3-month T-bill	4.25	5.49	4.99	5.03	4.91
10-year T-bond	7.09	6.57	6.53	6.20	6.22
Mortgage rate, 30-year fixed	8.35	7.95	7.92	7.62	7.44
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Dec. 5, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.553	1.6	8.0
Yen-Dollar	112.4	-0.9	10.8
Multilateral $ (Mar. 1973=100)	88.72	1.3	4.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.2 (Q3)	**5.4** **(Nov)**	3.0 (Oct)
Canada	1.6 (Q3)	9.9 (Sept)	1.7 (Oct)
Japan	3.9 (Q2)	3.3 (Sept)	0.0 (Sept)
France	1.4 (Q3)	12.3 (Aug)	1.7 (Oct)
Germany	1.9 (Q3)	7.3 (Sept)	1.5 (Oct)
Italy	0.7 (Q2)	11.9 (Jul)	3.0 (Oct)
United Kingdom	2.4 (Q3)	8.0 (Sept)	2.7 (Oct)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, December 6, 1996.**