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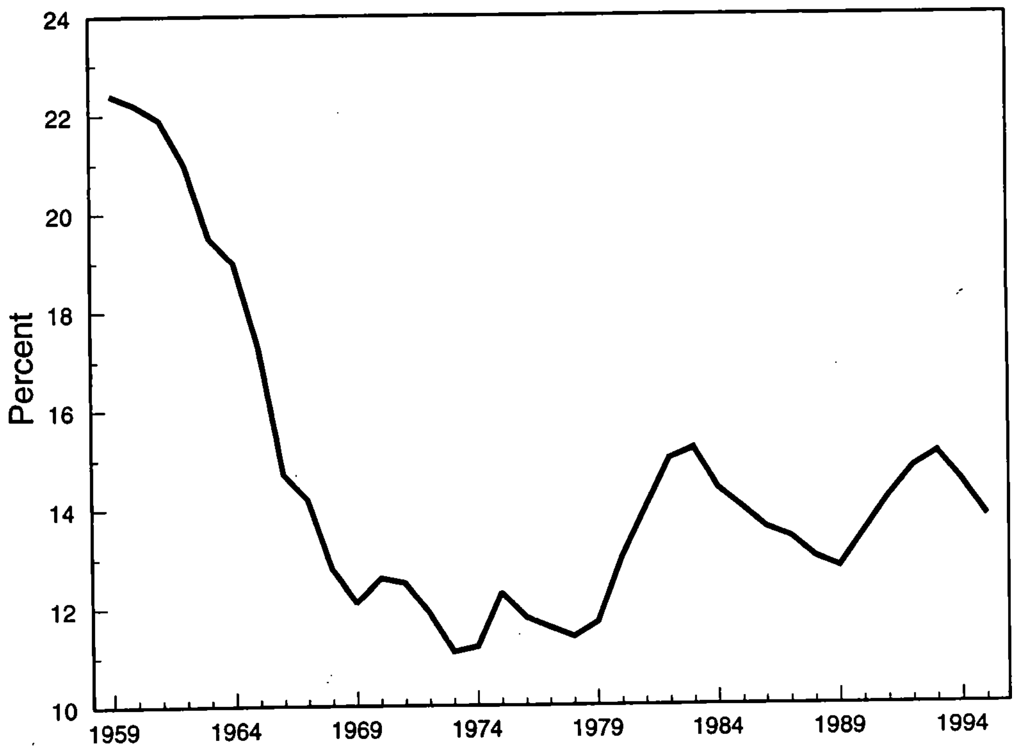
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 27, 1996

CHART OF THE WEEK

The Poverty Rate



The percentage of Americans with incomes below the poverty threshold fell in 1994 and 1995 and was a full point lower in 1995 than it was in 1992. Taking a longer perspective, the poverty rate fell sharply during the 1960s and was below 12 percent in every year but one between 1971 and 1979. But it has not been below 13 percent since 1979.

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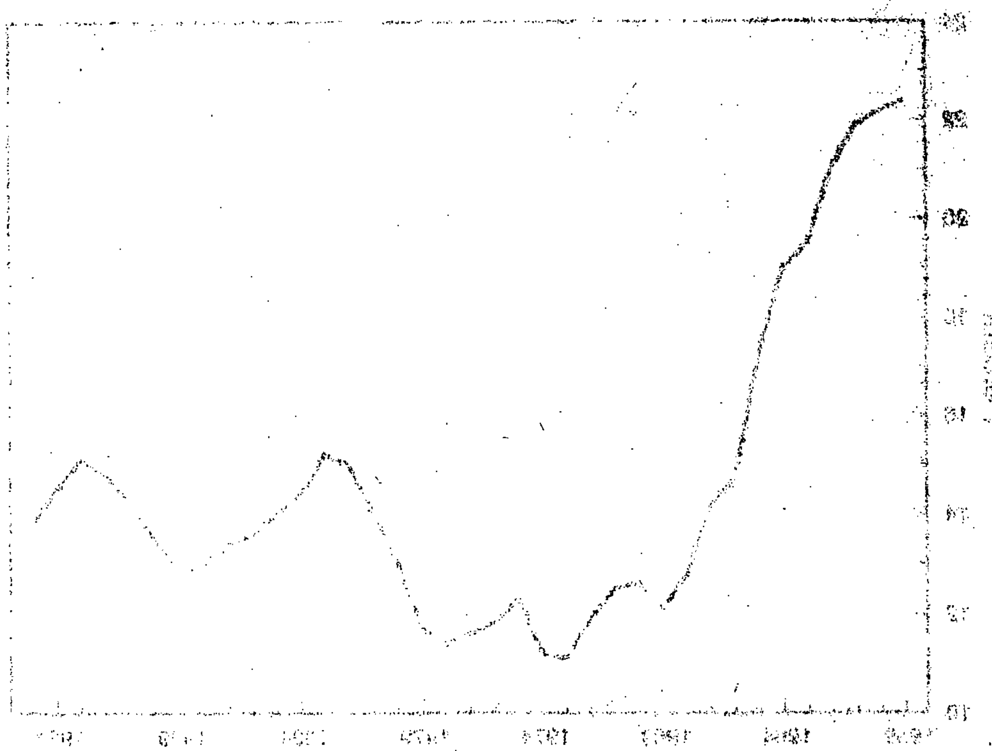

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CONTENTS

CURRENT DEVELOPMENT

Could the Market for Heating Oil Get Hot? 1

SPECIAL ANALYSES

Some Mechanics of Federal Reserve Policy 2

What Do We Know about School Vouchers? 3

ARTICLE

Good News on Income and Poverty: More Than Just a Cyclical Recovery 4

DEPARTMENTS

Business, Consumer, and Regional Roundup 6

International Roundup 7

Releases 8

U.S. Economic Statistics 9

Financial and International Statistics 10

"Well, so long Eddie, the recession's over."

Nanc
Fyi -
Bc

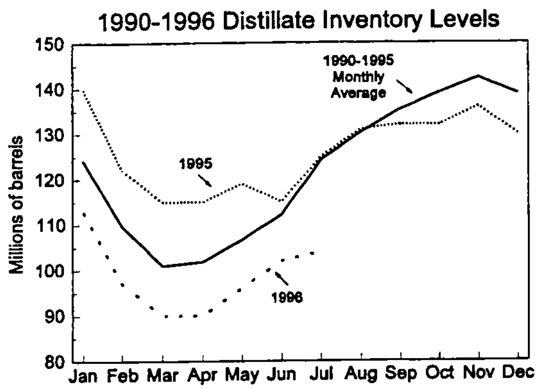
THE PRESIDENT HAS SEEN
9-29-96

CURRENT DEVELOPMENT

Could the Market for Heating Oil Get Hot?

Lean inventories appear to have been one cause of the spike in gasoline prices this spring. Some worry that it may be "deja vu all over again" this winter with distillates (which include home heating oil, diesel fuel, and some types of boiler fuels).

Analysis. Distillate inventories in 1996 have shown their normal seasonal pattern, but at levels below those of earlier years (see chart). The most likely reason for these low inventories—and for low inventories of crude oil and other refined products as well—is market expectations through most of the year that crude prices would be lower in the near future. Although 1996 distillate inventories might be adequate to cover demand in a normal winter heating season, a colder winter than usual could produce a price shock.



Demand for distillates is determined primarily by two factors: the level of economic activity (which affects demand for diesel fuel from the trucking industry and is currently strong) and the severity of winter weather (especially in the Northeast where heating oil demand is concentrated). With inventories low, an early cold snap could strain supply. Although rising prices might elicit some incremental domestic production and imports, this supply response is likely to be limited.

Price prospects. The Department of Energy estimates that heating oil prices, which averaged about 93 cents per gallon last winter, will be about 9 cents per gallon higher this winter (reflecting higher crude oil prices this year). But if the weather is 10 percent colder than normal, an additional 7 to 8 cents a gallon could be tacked on.

SPECIAL ANALYSIS

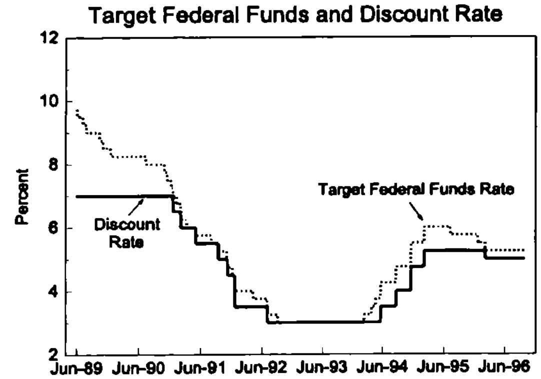
Some Mechanics of Federal Reserve Policy

The Federal Reserve took no action to change monetary policy this week. But speculation that it would tighten, and a press leak suggesting a majority of regional Reserve bank presidents wanted higher rates, focused attention on the mechanics of monetary policy and raised issues that may come up again prior to the next scheduled meeting on November 13.

The federal funds rate. Monetary policy is made by the Federal Open Market Committee (FOMC), which consists of the 7 Federal Reserve Board members, the president of the Federal Reserve Bank of New York, and 4 of the other 11 regional bank presidents. The FOMC sets policy primarily by its choice of a target level for the federal funds rate, the rate charged by banks and other depository institutions on overnight loans of their reserve deposits held at Federal Reserve banks.

Had the FOMC chosen to tighten at this week's meeting, it most likely would have voted to raise its target for federal funds by ¼ percentage point, to 5½ percent. The Fed does not rigidly peg the rate at its target level. Rather it uses "open market operations" (the purchase and sale of government securities) to vary the supply of reserve deposits in order to ensure that the rate remains near the desired level.

Target Federal Funds and Discount Rate



Movements in the federal funds rate are reflected in other interest rates as well. These subsequent movements in broader market interest rates affect the level of economic activity by changing the cost to households and businesses of financing spending. Economists believe it takes 1 to 2 years before such effects are fully realized.

The discount rate. Last week's leak involved the setting of the discount rate, which is the rate charged by Federal Reserve banks on loans to banks. While the Reserve banks can request changes in this rate, the Board of Governors (not the FOMC) must approve them. Although the discount rate is a potential instrument of monetary policy, the Fed in recent years has focused instead on the federal funds rate. On some occasions in the past, however, the Fed changed the discount rate as a way of emphasizing a policy move. In the past few years, the discount rate has been moved less frequently than the federal funds rate, although its path has been fairly similar otherwise (see chart). Other countries with less developed money markets rely more heavily on discount rate changes to implement monetary policy.

SPECIAL ANALYSIS

What Do We Know about School Vouchers?

Debate over school vouchers that would cover expenses at private schools is heated. But scant evidence exists for deciding whether such vouchers work.

The Milwaukee program. What little we know about private school vouchers comes primarily from a single pilot program operating in Milwaukee since 1990. This program provides lower income children with a voucher equal to the city's per-pupil expenditure (currently between $3,000 and $4,000) to pay for tuition at local nonsectarian private schools. Participation has been limited in each year but enrollment has never reached the maximum allowed. Nevertheless, some private schools had more voucher applicants than they were willing to accept and randomly chose whom to admit. Given the available supply of schools, the voucher program was not overwhelmingly popular.

On the one hand... An initial academic study comparing the educational experiences of students who used the voucher to those who remained in Milwaukee public schools found that many parents who took advantage of the plan reported greater satisfaction with their children's education. But attrition rates among voucher students were high, and educational achievement among program participants grew no more rapidly than among public school students.

This finding should be interpreted with caution, however, because students participating in the voucher program were more likely to be underachievers, with below-average academic performance in public school prior to participation even though the educational attainment of their parents was above-average. If their academic performance equaled that of the typical Milwaukee public school student, they may have benefitted from their private school experience.

On the other... A second study made a different comparison. It looked at voucher students and otherwise qualified students who failed to gain admission to oversubscribed schools and remained in the Milwaukee public school system. The study found that after 3 years, voucher students performed better than rejected students. But these results may exaggerate the success of the voucher program. First, attrition rates were high, suggesting that students who stayed in the voucher program for 3 years might have been those who did better. Second, the study did not follow students who left the Milwaukee public school system, and some of the most motivated students who applied to the program but were rejected may have moved to better suburban school districts or paid full tuition at private schools. Rejected students who enrolled in a Milwaukee public school were probably poorer academic performers.

Conclusion. Advocates on one side or the other in the voucher debate are on shaky ground when they definitively cite evidence from Milwaukee.

ARTICLE

Good News on Income and Poverty: More Than Just a Cyclical Recovery

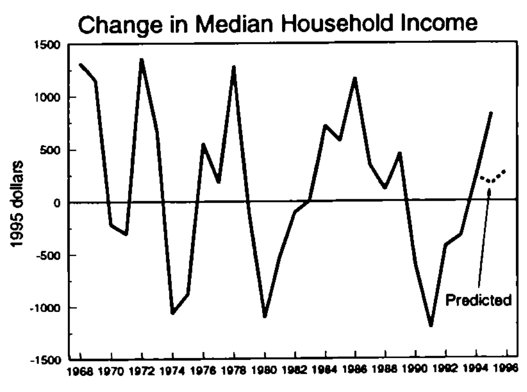
Just-released Census data on money income and poverty show stronger income gains in 1995 and a sharper reduction in the poverty rate than would have been predicted from cyclical factors alone.

Broad economic gains observed. Incomes rose and poverty rates fell over broad economic groups, particularly among many that have been historically disadvantaged. Highlights of the report include:

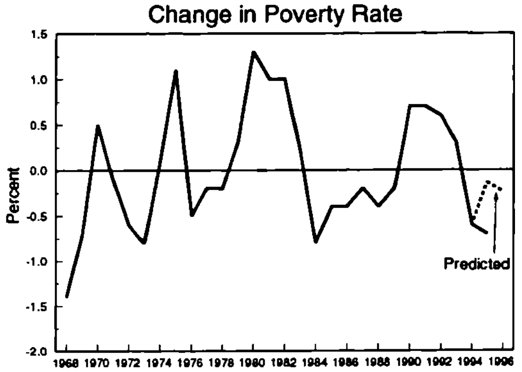
- Median household income grew by 2.7 percent (almost $1,000) overall and by 3.6 and 4.5 percent for blacks and female-headed households, respectively.
- The poverty rate fell by 0.7 percentage point overall and by 1 point and 1.3 points for children and blacks, respectively.

Business cycles and income growth. A stronger economy should logically provide the foundation for income growth and poverty reduction. In fact, median household income and poverty rate statistics do show a strong cyclical component over time. For instance, the long expansion of 1983-89 led to about a $3,000 increase in median family income and a reduction in the poverty rate of more than 2 points. In contrast, the 1990-93 recession and subsequent slow growth virtually wiped out that income gain and drove the poverty rate to a near-three-decade high.

Last year the economy grew, but at a moderate pace, implying only slight improvements in income and poverty statistics (it will take another year before we have poverty and income statistics that reflect the strong growth of the first half of 1996). For instance, economic performance in 1995 was similar to that in 1979 and 1987. GDP grew about 2 to 3 percent and the unemployment rate was about 6 percent. In 1979 and 1987, median household income changed only slightly. The poverty rate fell 0.2 percentage point in 1987, and actually rose 0.3 percentage point in 1979.

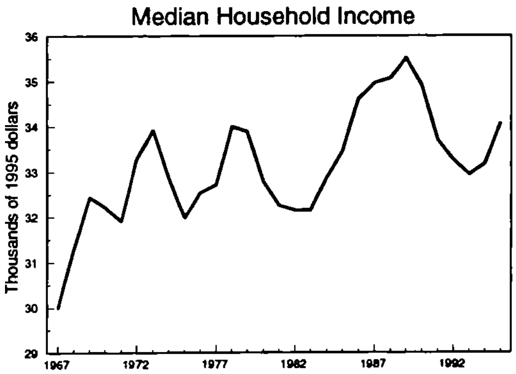


Based on a formal statistical estimate of the effect of changes in economic activity on median income between 1967 and 1994, median household income would have been expected to rise about $150 in 1995, given economic activity in that year (see chart). In fact, it rose $900. Similarly, the poverty rate would have been expected



to fall about 0.1 percentage point instead of the 0.7 percentage point it actually fell (see upper chart). These results suggest the growth in median family income and the decline in the poverty rate reflect more than just the gains that normally accompany a cyclical expansion. Given somewhat stronger economic performance in 1996 compared to 1995, the current model would forecast a rise in median household income of about $250 and a decline in the poverty rate of about 0.2 percentage point.

Historical Perspective. Although substantial progress has been made over the last 2 years in raising household income and reducing poverty, the advances have yet to overcome the sharp reversals of the 1989-93 period. In fact, despite the strong gains made in 1994 and 1995, median household income is at roughly the same level it was in 1978 (see lower chart). In terms of poverty, there has never been a complete recovery from the dramatic upward trend in poverty between 1980 and 1982, when the poverty rate rose by one point or more per year (see Chart of the Week).



Conclusion. The recent data show that households' economic status has risen dramatically over the past 2 years, beyond what would have been predicted by cyclical factors. Although these results are very encouraging, it is too soon to tell whether the longer term trends of stagnating incomes and rising poverty have been reversed.

Why Is Mean Income Growing Faster than Median Income?

Real (inflation-adjusted) median household income is about the same now as it was in 1978, but real mean household income is about $5,000 higher. This discrepancy reflects the two-decades long trend toward greater income inequality. The median household is the one at the halfway point in the distribution when households are ranked by income. Income gains that occur mainly in the upper half of the distribution pull up the mean but have little effect on the median.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Do Prestigious Colleges Pay Off? As many high school seniors make college plans, families are deciding between sending their kids to tuition-friendly state universities and enrolling them in prestigious but high-priced private schools. A recent study of the effect of college quality on wages using female identical twins finds that a student's choice between schools could result in a differential of tens of thousands of dollars in lifetime earnings. It appears that prestige does pay off: individuals who attend colleges that grant PhDs, are private, have well-paid faculty and have small enrollments tend to earn significantly higher lifetime wages than they otherwise would have. Women in the study who graduated from major private research universities (such as Harvard) had the highest earnings, followed in decreasing order by those who attended small private colleges (such as Wellesley), those who attended large public research universities (such as the University of Michigan), and those who went to big public colleges (such as Mankato State College in Minnesota).

NYC Union Chief Repays Welfare Debt. Having grown up on welfare, Willie James, the leader of New York City's transit workers' union, went to bat for welfare workers in recent contract negotiations with the Mass Transit Authority. While New York City is already putting thousands of welfare recipients to work cleaning up parks and picking up trash, and participants may have difficulty moving into permanent jobs. Through the new MTA contract, James hopes to improve welfare workers' prospects of finding permanent positions. He agreed to allow the transit authority to hire welfare workers only if they are given credit for their experience should they apply for permanent jobs. James says that he is simply repaying his debt: "The reason I am where I am is because someone gave me a chance. I feel a duty to pass that on." The new contract awaits approval by both parties.

Counterfeiters Try to Get "Smart". The newly redesigned U.S. currency, with enhanced security features such as color-shifting ink and a watermark, promises to make counterfeiting much more difficult. New research shows, however, that counterfeiters may find a new market niche in duplicating the electronic-cash "smart cards" that are widely used in Europe ~~and are being tested~~ by banks and credit card companies in the United States. The cards, which store bits of electronic money on reloadable microchips, are touted as being as easy to use as cash. Although no smart card counterfeiting has been discovered yet, computer scientists warn that a counterfeiting method exists that would allow criminals to capture authentication information from a legitimate card and make a copy.

INTERNATIONAL ROUNDUP

Further Progress in Establishing European Monetary Union. European Union ministers met in Dublin last weekend to continue preparations for economic and monetary union. The most important issue was how to ensure that once EMU has started, members will stick to their pledge of not exceeding a budget deficit equal to 3 percent of GDP. Ministers agreed that enforcement of the deficit limit will be beefed up by fines. These will be levied on EMU states with persistent deficits above 3 percent. Fines would take the form of a non-interest bearing deposit, not to exceed 0.5 percent of GDP. Critics worry that if all countries try to reduce their deficits simultaneously, and monetary authorities do not respond appropriately, European growth will be slowed, and deficits actually increased. Fines would exacerbate these deficits. At the end of 1995, only three countries (Denmark, Ireland, and Luxembourg) had met the Maastricht deficit criterion for EMU.

UK Economy Registers Moderate Growth in First Half of 1996. The British economy grew at a 2.2 percent annual rate in the second quarter, up somewhat from its 1.9 percent growth rate in the first quarter, according to data released this week. The UK posted its first current account surplus since early 1995. Unemployment in July was still a relatively high 8.1 percent, although this is an improvement from 1993's 10.5 percent. Whether Britain will eventually join the European Monetary Union remains unclear—the pound will most probably not be included in the first stage. To date, however, the UK is one of the several countries that have not yet met the Maastricht criteria for monetary union. For example, the government deficit was 5.8 percent of GDP in 1995, and is likely to remain above 3 percent in 1996. Although the government has hinted that it wants a tax cut, this large a deficit leaves little room for one in November's budget—the last before the election.

Bankers Express Concerns About Official Bailouts of Developing Countries. In a recent letter to the IMF, a group representing the world's largest bankers argued for limiting the role of the IMF and the World Bank in managing financial crises in emerging markets. As the private sector accounts for roughly 90 percent of total financial flows to emerging markets, the banks do not consider official bailouts a realistic or desirable alternative in times of financial difficulty. Instead, the banks call for strong and convincing policy action by countries to rebuild market confidence and restore market access. Although banks have benefitted from official bailouts, by having the value of their loans to crisis economies somewhat protected, their call for an end to such bailouts may reflect their wish for more financial discipline in emerging economies. By virtually eliminating the possibility of the IMF coming to their rescue, these countries might take greater pains to avoid financial crises in the first place.

RELEASES THIS WEEK

Gross Domestic Product
****Embargoed until 8:30 a.m., Friday, September 27, 1996****

According to revised estimates, real gross domestic product rose 4.7 percent in the second quarter.

Income and Poverty Report for 1995

In 1995, real median family income increased to $40,611 from $39,881 in 1994 (income in 1995 CPI-U-X1 adjusted dollars). The poverty rate for persons declined to 13.8 percent in 1995 from 14.5 percent in 1994.

Advance Durable Orders

Advance estimates show that new orders for durable goods fell 3.1 percent in August, following an increase of 1.4 percent in July.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, declined 0.2 index point in September to 111.8 (1985=100).

MAJOR RELEASES NEXT WEEK

Leading Indicators (Tuesday)
NAPM Report on Business (Tuesday)
Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	0.3	2.0	**4.7**
GDP chain-type price index	5.3	2.5	2.1	2.3	2.2
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	–1.1	1.8	0.5
Real compensation per hour:					
Using CPI	0.6	1.4	1.6	0.0	-0.1
Using NFB deflator	1.3	2.1	2.8	2.0	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	10.3
Residential investment	4.5	4.0	4.0	4.1	4.2
Exports	8.2	11.1	11.4	11.3	**11.3**
Imports	9.2	12.4	12.3	12.5	12.6
Personal saving	5.1	3.4	3.8	3.6	3.2
Federal surplus	–2.7	–2.2	–2.1	–2.1	–1.7

	1970–1993	1995	June 1996	July 1996	August 1996
Unemployment Rate	6.7**	5.6**	5.3	5.4	5.1
Payroll employment (thousands)					
increase per month			219	228	250
increase since Jan. 1993					10508
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	0.1
PPI-Finished goods	5.0	2.3	0.2	0.0	0.3

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

New or revised data in **boldface**.
GDP and related data for 1996:2 **embargoed until 8:30 a.m., Friday, September 27, 1996.**

FINANCIAL STATISTICS

	1994	1995	July 1996	Aug. 1996	Sept. 26, 1996
Dow-Jones Industrial Average	3794	4494	5496	5686	5869
Interest Rates					
3-month T-bill	4.25	5.49	5.15	5.05	4.85
10-year T-bond	7.09	6.57	6.87	6.64	6.66
Mortgage rate, 30-year fixed	8.35	7.95	8.25	8.00	8.16
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 26, 1996**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.523	0.6	5.9
Yen-Dollar	110.5	1.0	9.5
Multilateral $ (Mar. 1973=100)	87.89	0.2	3.8

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	5.1 (Aug)	2.9 (Aug)
Canada	1.2 (Q2)	9.8 (Jul)	1.2 (Jul)
Japan	3.9 (Q2)	3.4 (Jul)	0.0 (Jun)
France	0.4 (Q2)	12.2 (Jun)	2.2 (Jul)
Germany	1.1 (Q2)	7.1 (Jun)	1.3 (Jul)
Italy	1.6 (Q1)	12.5 (Apr)	4.0 (Jun)
United Kingdom	2.2 (Q2)	8.1 (Jul)	2.2 (Jul)

U.S. GDP data **embargoed until 8:30 a.m., Friday, September 27, 1996.**