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THE PRESIDENT HAS SEEN
11-29-96

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

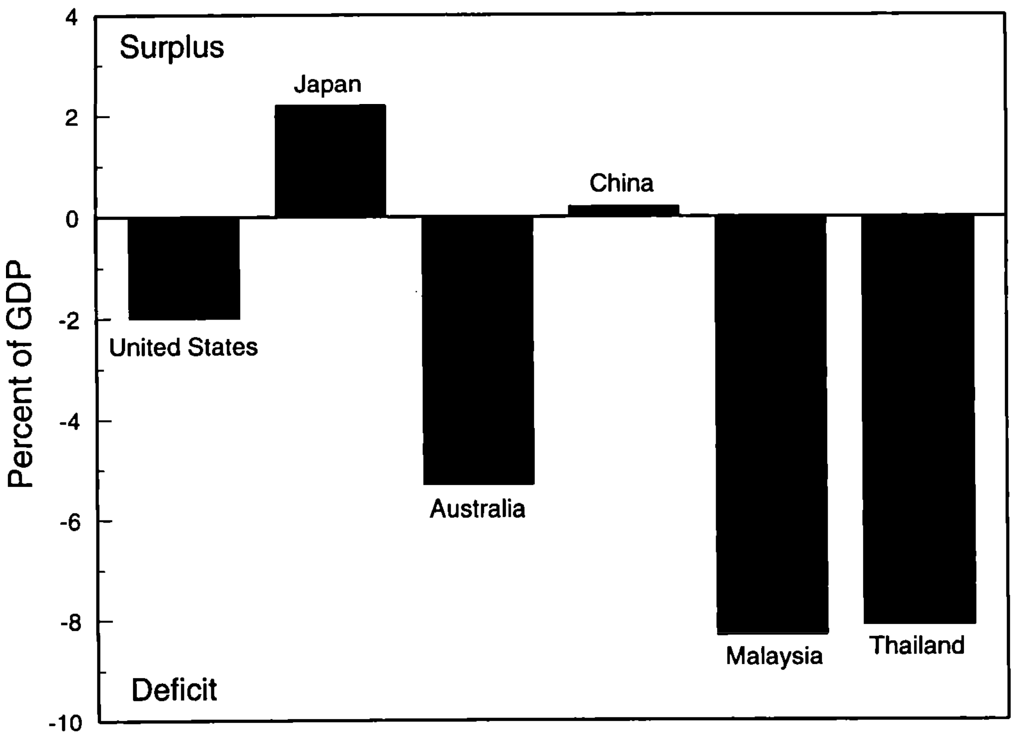
96 NOV 22 AM9:02

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

November 22, 1996

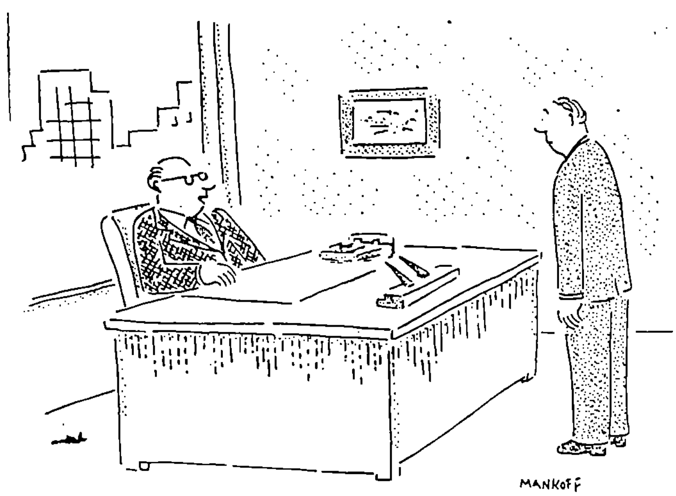
CHART OF THE WEEK

Current Accounts of Selected APEC Countries in 1995



A common rule of thumb is that countries with current account deficits in excess of 3 percent of GDP are vulnerable to a crisis, as was the case for Mexico and Argentina in 1994. Such deficits are less dangerous, however, when a country is borrowing from abroad to finance rapid investment and growth—the current situation in Malaysia and Thailand. Australia has borrowed from abroad for many years to develop its vast natural resources, with little evident problem.

CONTENTS

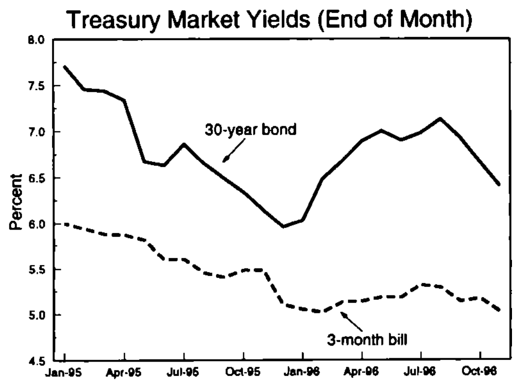


"Brodkin, now that the economy is creating jobs at a faster than expected clip, why don't you go out and find yourself one?"

CURRENT DEVELOPMENT

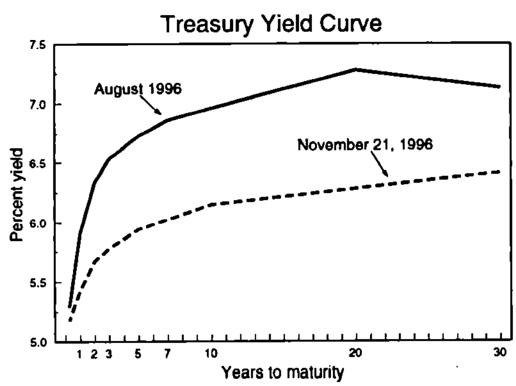
Long-term Interest Rates Experience Fall

Since the summer, the yield on 30-year Treasury securities has declined much more than the rate on 3-month bills (see upper chart). This decline has produced a "yield curve," which shows interest rates at various maturities, that is less steep and closer to its historical norm (see lower chart).



Analysis. The recent decline in long-term rates has reversed almost two-thirds of the rise earlier in the year. Changes in expectations of future inflation or real interest rates can cause shifts in the yield curve. Recent surveys have shown little change in expected inflation. Rather, the rise and subsequent decline in intermediate- and long-term interest rates this year appear to reflect movements in real interest rates.

At least three factors have affected real rates this year: perceptions about the strength of the economy, expectations about Federal Reserve policy, and the outlook for the Federal budget deficit.



The pickup in growth earlier this year produced expectations of increasing demand for funds and higher future interest rates. It also led market participants to believe the Fed would probably raise rates to prevent the economy from overheating. Finally, partisan discord may have increased pessimism about the outcome of the budget process.

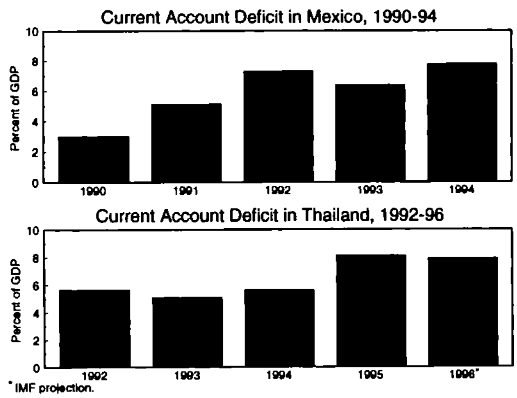
All these factors have turned around in recent months: the economy has slowed, the Fed shows no intention of tightening soon, and relations between the White House and the Congress have a more conciliatory tone. As a result, expectations of higher interest rates have abated as well.

SPECIAL ANALYSIS

Is Thailand the Next Mexico?

Thailand—like Mexico before the 1994 peso crisis—has been financing a rapidly expanding current account deficit with substantial short-term international borrowing. Thus, Mexican-style pressures could hit Thailand. But key differences between these economies make Thailand less vulnerable to a crisis.

Similarities. Until December 1994, when Mexico devalued the peso and was forced to let its currency float, increasing capital inflows had been financing an expanding current account deficit (see chart). The deficit hit 7.8 percent of GDP in 1994. In Thailand, the current account deficit has recently shown a similar pattern, reaching 8.1 percent last year.



Thailand has substantial short-term debt outstanding, as Mexico had before the crisis. In each case, the government's attempt to peg, or at least stabilize, the value of the currency contributed to the debt inflow.

Differences. Important macroeconomic indicators suggest Thailand has a healthier economy today than Mexico had in 1994. Recent Thai economic growth has been much higher and steadier than Mexican growth was in the early 1990s. Thai GDP grew 8.7 percent last year (although it is likely to slow this year). Mexican growth in the early 1990s peaked at only 3.6 percent in 1991. In common with other fast-growing Asian economies, Thailand has a high rate of gross domestic saving—36 percent of GDP last year. Mexican gross domestic saving, by contrast, was only 18 percent of GDP in 1994. This means both that the economy would suffer less if cut off from lending, and that investors, aware of this, are less likely to cut off lending.

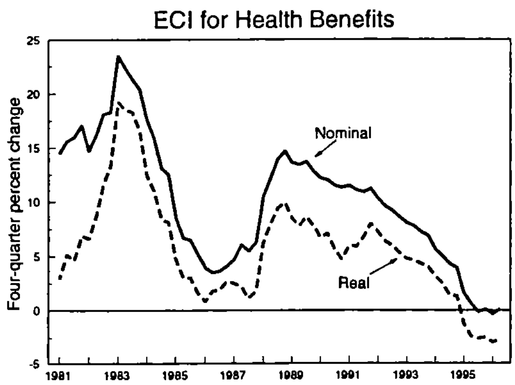
Mexico's current account deficits in the early 1990s were accompanied by a real appreciation of the peso. Mexican inflation was greater than that of Mexico's trading partners, leading to gradually increasing relative costs of Mexican goods. This, together with political instability in Mexico in 1994 and the increase in U.S. interest rates, caused speculation against the peso. Thailand's real exchange rate, by contrast, has been stable throughout the 1990s.

Conclusion. Thailand's reliance on short-term foreign capital inflows clearly poses dangers. But the underlying economy is strong, and international investors are less likely to lose confidence in it the way they sometimes have with Mexico.

ARTICLE

Why Have Increases in Employer Health Benefit Costs Slowed?

Employers have recently seen a marked slowdown in the rate of increase of health benefit costs. Over the last 4 years, the health benefit component of the employment cost index (ECI) has risen just 0.9 percentage point per year faster than the consumer price index. During the last 2 years, it has fallen in real terms (see upper chart).

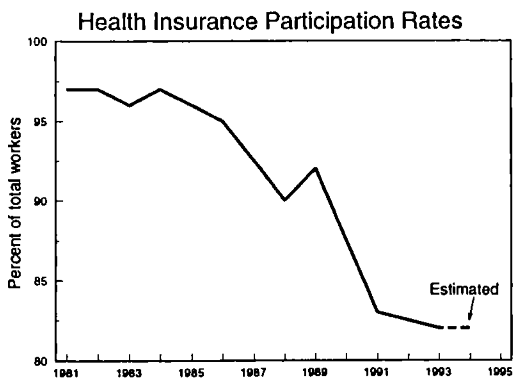


Two popular explanations—reductions in employer health insurance coverage and shifting of health costs to employees—do not work, because the timing is wrong. The direct and indirect impacts of managed care, however, may be an important part of the story.

Not necessarily same lag time

Wrong timing. Most of the decline in coverage and shifting of costs from employers to employees occurred in the late 1980s and early 1990s.

- Coverage. Insurance coverage for persons in permanent full-time jobs with medium or large employers fell from 97 percent in 1985 to 83 percent in 1991. The last official data are from 1993, but it appears that this participation rate has not changed much since 1991 (see lower chart). Similarly, coverage rates of all wage and salary workers have actually increased slightly since 1991. In recent years, employers have cut back on coverage for retirees, but the number affected is too small to explain the recent slowdown.



- Cost shifting. Employers can shift cost by raising premiums or increasing deductibles and co-payments. Between 1988 and 1992, the percentage of workers whose employers fully financed family health insurance fell from 37 percent to 29 percent, with corresponding decreases for single coverage. Since then, this percentage has changed little. Moreover, the size of employee contributions has not increased markedly in recent years; neither have deductibles and co-payments. As with coverage, the timing of cost-shifting is inconsistent with the timing of the slowdown in health benefit cost increases.

Managed care. Although the causes of slower growth in health care costs are not fully understood, the move to managed care probably helps explain a lot. More is going on, however, than just a switch from expensive indemnity plans to cheaper managed care providers, because cost increases have also slowed in fee-for-service plans. Competition from HMOs may well be causing traditional plans to become more efficient.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Decline in Purchasing Power of Welfare Checks Documented. Average monthly AFDC benefits have declined by nearly 50 percent when adjusted for inflation over the past 25 years, according to the latest edition of the House Ways and Means Committee's *Green Book*. In the median state, the maximum welfare payment for a 3-person family in January 1996 was $389, down from $728 (constant 1996 dollars) in 1970. For some states, the reduction has been even more dramatic. For example, the maximum benefit of $188 in Texas in 1996 is 68 percent lower than its 1970 value of $586. Food stamp benefits have risen to offset part of the decline in real AFDC benefits. But even so, combined maximum AFDC-food stamp benefits for a 3-person family dropped by more than a quarter in real terms, from $962 in July 1972 to $699 in January 1996. The *Green Book*, a widely used compendium of background material and data on social programs—including Medicare, Social Security, and welfare—is back in publication after a year lapse.

Communication Boosts 401(k) Participation. Employees who receive targeted communications and specific advice about their company's 401(k) plan save 2 percentage points more of their income than those who do not get such information, according to a new study. Targeted communications raise saving and participation levels just as much as an increase in the employer match rate from 25 percent to 100 percent, but at a fraction of the cost to the company. A targeted approach is necessary to get non-highly compensated employees, who generally have lower participation rates in 401(k) plans, to enroll. And, given "non-discrimination" rules for pensions, greater participation among low-paid workers often permits higher-paid managers to contribute greater tax-deferred amounts to their own pension plans.

Effects of U.S. Cigarette Exports on Smoking in Asia. A recent study reports that, between 1975 and 1994, U.S. cigarette consumption fell more than 20 percent in response to a variety of public health policies. During the same period, U.S. cigarette production increased 11 percent. Why the difference? Domestic producers increased their exports to several Asian markets in the mid- to late 1980s under Section 301 of the 1974 Trade Act. The study finds that in 1991 per capita cigarette consumption was nearly 10 percent higher in recently opened Asian markets than it would have been if the markets had remained closed to U.S. cigarettes. One explanation is that U.S. imports introduced competition into cigarette industries that were formerly government-run monopolies. (These government monopolies charged higher prices—the economic equivalent of cigarette taxes levied in the United States. One difference is that these government monopolies discriminated against imports, which excise taxes do not.) Price reductions induced by competition would be expected to increase smoking. Another reason for the increase could be the competition-induced expansion of marketing campaigns, which some say were aimed at recruiting new smokers, primarily women and teenagers.

INTERNATIONAL ROUNDUP

UK and EU Clash Once Again. After a bitter debate over the banning of British beef following the mad cow disease scare, the UK and the EU are at loggerheads once again. Last week, the European Court of Justice dismissed a British challenge to a European directive that limits working time to 48 hours per week and entitles every worker to paid annual leave of at least 3 weeks. The British government has threatened to hold up all progress on further European integration until the ruling is changed. In response, senior EU officials have reportedly characterized Britain as favoring a sweatshop economy. As the UK did not sign the social chapter of the 1992 Maastricht Treaty, it has remained outside the purview of most European regulations on working conditions. The British government has repeatedly pointed out that Europe can learn from its flexible, deregulated labor market. In the EU as a whole, 18 million people are currently out of work, nearly 11 percent of the labor force. The average unemployment rate for youth (under 25) is 21 percent. Britain's unemployment has fallen to 8.1 percent overall, and 15 percent for young people.

International Bankers Report on Policy Implications of Electronic Money. Electronic money—or "e-money," like the "smart cards" promoted at the Atlanta Olympics, could potentially affect the demand for money and the formulation of monetary policy, according to a recent study by the Bank for International Settlements (BIS). The study finds that if households substituted e-money for other monetary assets, the usefulness of the monetary aggregates as policy targets or indicators could be temporarily reduced. The report also noted that, to the extent e-money substitutes for reservable bank deposits, the resulting decline in the volume of reserves could affect the procedures used by central banks to set money market interest rates.

International Oil Consortium To Sign Long-Awaited Deal on Kazak Pipeline Project. Last week in Moscow, negotiators concluded a major international agreement to build a $1.5 billion pipeline. The so-called Caspian Pipeline Consortium (CPC) is composed of the governments of Russia, Kazakstan, and Oman in addition to Chevron, Mobil, the Russian giant Lukoil, and other international oil companies. The pipeline will connect the huge Kazak oil fields in Tengiz on the Caspian Sea with a new terminal to be built on the Black Sea near the Russian city of Novorossiysk. Its ultimate capacity is estimated at 67 million tons of oil per year. The new pipeline will help clear a bottleneck that has discouraged the development of Kazakstan's significant oil reserves. Chevron's partnership with the Republic of Kazakstan was formed in 1993 as a 40-year, $20 billion joint venture; it is one of the largest joint ventures in the former Soviet Union.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $11.3 billion in September from $10.3 billion in August.

Housing Starts

Housing starts decreased 5 percent in October to 1.37 million units at an annual rate. For the first 10 months of 1996, starts were up 10 percent compared with the same period a year ago.

MAJOR RELEASES NEXT WEEK

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

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	2.2
GDP chain-type price index	5.3	2.5	2.3	2.2	1.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	1.7	0.5	0.2
Real compensation per hour:					
Using CPI	0.6	1.4	0.0	0.0	1.6
Using NFB deflator	1.3	2.1	2.0	2.0	2.7
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.4	10.3	10.5
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	12.6
Personal saving	5.1	3.4	3.6	3.2	4.0
Federal surplus	–2.7	–2.2	–2.1	–1.7	N.A.

	1970–1993	1995	Aug. 1996	Sept. 1996	Oct. 1996
Unemployment Rate	6.7**	5.6**	5.1	5.2	5.2
Payroll employment (thousands)					
increase per month			280	–35	210
increase since Jan. 1993					10703
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	0.3
PPI-Finished goods	5.0	2.3	0.3	0.2	0.4

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

FINANCIAL STATISTICS

	1994	1995	Sept. 1996	Oct. 1996	Nov. 21, 1996
Dow-Jones Industrial Average	3794	4494	5804	5996	6418
Interest Rates					
3-month T-bill	4.25	5.49	5.09	4.99	5.04
10-year T-bond	7.09	6.57	6.83	6.53	6.15
Mortgage rate, 30-year fixed	8.35	7.95	8.23	7.92	7.53
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Nov. 21, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.498	–0.7	6.3
Yen-Dollar	111.4	0.1	9.6
Multilateral $ (Mar. 1973=100)	86.27	–0.6	2.9

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.3 (Q3)	5.2 (Oct)	3.0 (Oct)
Canada	1.2 (Q2)	9.9 (Sept)	1.5 (Sept)
Japan	3.9 (Q2)	3.3 (Sept)	0.0 (Sept)
France	0.5 (Q2)	12.3 (Aug)	1.6 (Sept)
Germany	1.1 (Q2)	7.3 (Sept)	1.4 (Sept)
Italy	0.7 (Q2)	11.9 (Jul)	3.4 (Sept)
United Kingdom	2.4 (Q3)	8.0 (Sept)	2.1 (Sept)

THE PRESIDENT HAS SEEN
11-27-96

THE WHITE HOUSE
WASHINGTON

November 22, 1996

Mr. President:

We are holding your weekend reading here for your return, but thought you might like to see this portion of CEA's "Weekly Economic Briefing."

Phil Caplan

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'96 NOV 22 AM 9:02

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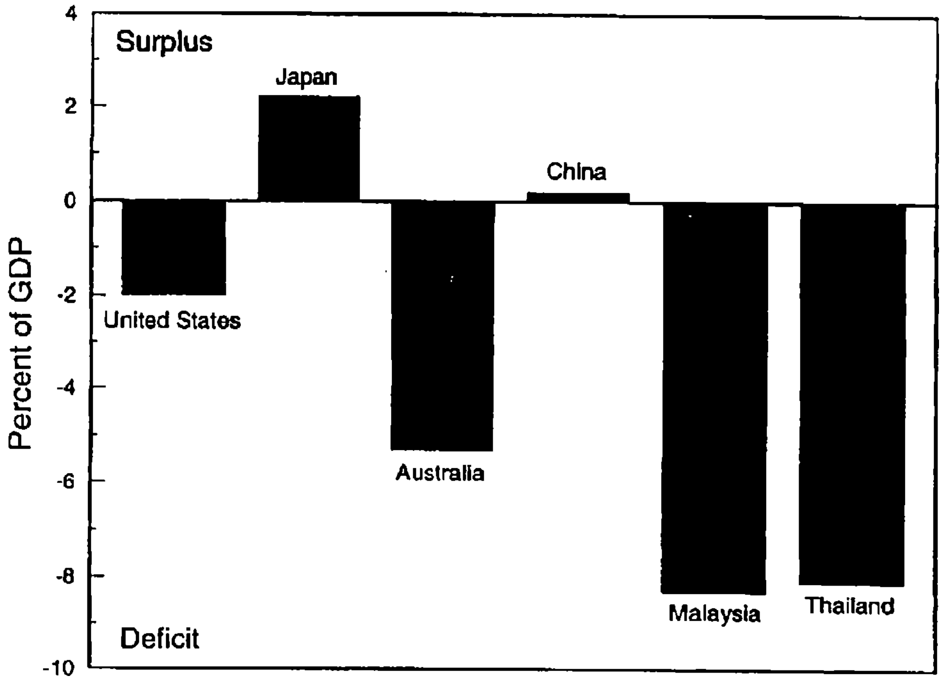

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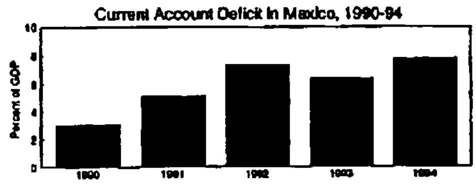

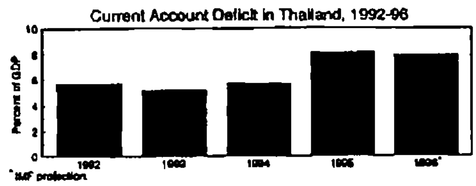

*IMF projection

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MESSAGE DESCRIPTION: CEA Weekly Economic Briefing

TO (AGENCY)	DELIVER TO	DEPT/ROOM NO.	PHONE NUMBER
	Stephen Goodin (Information - For the President)		
	Evelyn Lieberman		

REMARKS:

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NOV 22 AM9:02

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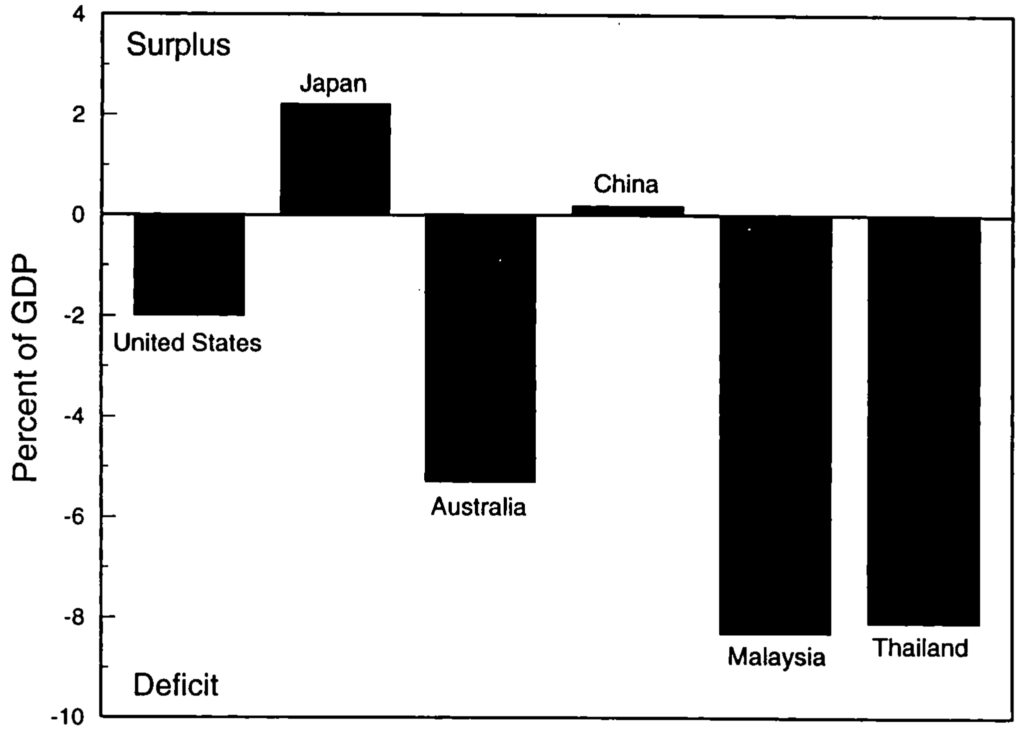

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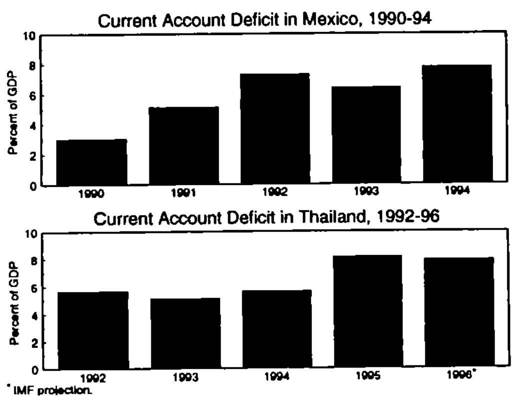

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8:15 am -SAF

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'96 NOV 22 PM4:35

MESSAGE NO.: SA710 **CLASSIFICATION:** Unclassified **TOTAL:** 4 **PAGES INCLUDING COVERS**

FROM: Phil Caplan (NAME) 62702 (PHONE NUMBER) Gd Fl WW (ROOM NO.)

MESSAGE DESCRIPTION: CEA Weekly Economic Briefing

TO (AGENCY)	DELIVER TO	DEPT/ROOM NO.	PHONE NUMBER
CAIRNS	Stephen Goodin (Information - For the President)		
	Evelyn Lieberman		

REMARKS:

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THE PRESIDENT HAS SEEN
11-29-96

TO
EBS | COS/BReed/NEC

This is another compelling argument for every state making wage subsidies available for at least 1 year —
BC

SPECIAL ANALYSIS

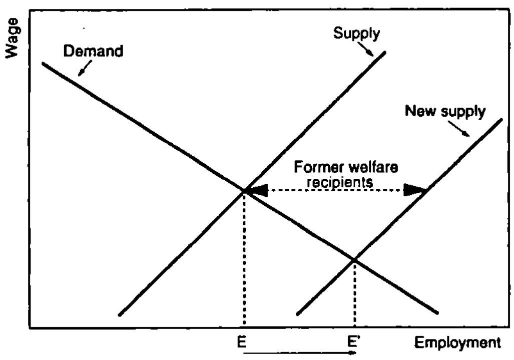
Will There Be Enough Jobs for Welfare Recipients?

An important concern following the enactment of welfare reform is whether those who leave the welfare rolls because of work requirements and time limits will be able to find jobs. Supply and demand analysis suggests many will, but their entry may reduce wages in the less-skilled labor market. Moreover, these jobs are likely to be highly sensitive to cyclical fluctuations.

Impact on jobs and wages. Millions of jobs are created during economic expansions—far more than the number of new job seekers who will be coming off welfare. But welfare recipients have fewer skills than the typical worker and they will have to compete in the more limited market for less-skilled workers.

The main impact of welfare reform will be to increase the number of less-skilled people looking for work at any given wage (an outward shift in the supply curve). Because firms do not find it profitable to hire more workers at the prevailing market wage, the wage will have to fall to induce more hiring. But some workers will no longer wish to work at a lower wage. Thus, the net increase in employment will be smaller than the outward shift in the supply curve (see chart).

Effect of Welfare Reform on Less-Skilled Labor Market



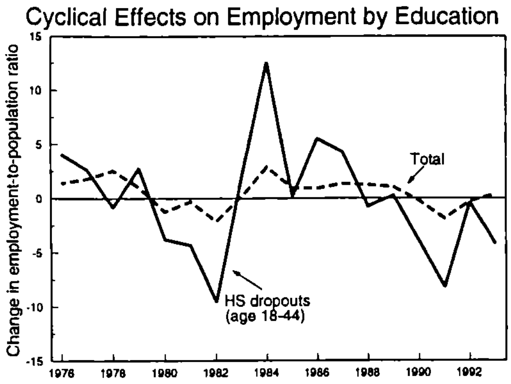
That's why ~~must~~ [illegible] wage subsidies

The actual outcome will depend on the slopes of the supply and demand curves. If, for example, employers are very willing to hire more workers when the wage drops just a little (a relatively flat demand curve), most of the new job seekers will be successful and wages will not drop much. But if employers are reluctant to hire more workers even in the face of a substantial lowering of the wage (a relatively steep demand curve), employment will not increase much even as wages fall. The magnitude of the supply response of workers matters as well.

Simulations based on plausible demand and supply curves suggest that if 2 million additional less-skilled, welfare recipients seek work, employment in the less-skilled labor market would increase by over 1 million and wages for less-skilled workers would fall by about 11 percent. Under assumptions that are more optimistic about job growth—but still within an empirically plausible range—employment would increase by 1.8 million and wages would fall by 12 percent.

[illegible] to do it

Cyclical sensitivity of employment. Because roughly half of all welfare recipients are younger high school dropouts, their employment is likely to be highly cyclical, much more so than that of the workforce as a whole. For instance, the share of



younger high school dropouts with a job fell almost 10 percent in the recessionary years of 1982 and 1991, compared to about 2 percent for the population as a whole (see chart). These employment losses were reversed in the subsequent economic expansions.

Job loss following employment spells as short as 9 months to a year may qualify many of these former welfare recipients for unemployment insurance. These benefits would reduce some of their income loss but could put additional strains on the unemployment insurance system.

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TO
EOB / COS / Breed / NEC
This is another compelling
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BC

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