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THE WHITE HOUSE
WASHINGTON

December 30, 1995

MR. PRESIDENT:

Attached are the materials CEA plans to discuss with you at the January 2 Weekly Economic Briefing:

- Stiglitz memo on CPI bias;
- December 15 weekly economic briefing packet;
- December 8 weekly economic briefing packet; and,
- December 1 weekly economic briefing packet.

Todd Stern
Helen Howell

Shelley: 6677464 12/29

This was sent over friday evening w/ attached note from Michele Jolin.

This is all old material & we usually don't get info in this form. (This is for Tuesdays 10:30 am Economic Weekly briefing. Check w/ H2 again. (call Michele) Deb

1/11

Todd OK to Send to RM?

Yes

S

Sharon

Never used

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

December 29, 1995

95 DEC 29 P 7:29

TO: Todd Stern

RE: Jan 2 WEB briefing w/the President

Attached is the material that CEA plans to discuss with the President at the January 2 Weekly Economic Briefing.

MJ

Michele Jolin
CEA Chief of Staff

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

THE CHAIRMAN

December 13, 1995

MEMORANDUM FOR THE PRESIDENT

FROM: JOSEPH STIGLITZ

SUBJECT: CPI Bias

You asked about the CEA's consensus on the bias in the consumer price index and about the effects that correcting for the bias would have on the budget deficit. We respond below to your questions.

Our view on the extent of bias in the CPI.

- There has been a range of estimates of the amount by which the CPI overstates inflation. In a preliminary review, Administration economists agreed that an estimate of 0.5 percentage point was a reasonable lower bound to the bias.

- After additional research and discussions, the CEA's best estimate is that the CPI has been overstating inflation about 1.2 percentage points per year. We are fairly certain that 0.7 percentage point of the bias comes from technical problems inherent in constructing the index, but we are less certain about the magnitude of the remaining bias that comes from hard-to-fix problems of accounting for quality changes in new and existing products. Our provisional estimate of this remaining bias is 0.5 percentage point.

- In January of 1995, the Bureau of Labor Statistics changed the treatment of housing, food, and prescription drugs, and estimated that these changes would lower the rate of increase in the CPI by about 0.1 percentage point per year. This change was incorporated into the economic assumptions for our budget forecast earlier this year.

- The correction of 0.1 percentage point leaves a bias of 0.6 of the total 0.7 that could be fixed by technical adjustments to current data. The BLS plans to make adjustments in the way the CPI is computed by January 1997 that would remove about 0.2 percentage point of this bias. These adjustments have been incorporated into our latest 7-year budget forecast as well as in the new CBO forecast. With this adjustment, however, 0.4 percentage point of this "fixable" bias would remain.

- As discussed in the Weekly Economic Briefing, December 8, a well-established alternative method for constructing price indexes (using geometric averaging) could be used to eliminate the entire 0.6 percentage point of bias that is fixable. BLS is developing an "experimental index" that in part uses this alternative method, but this experimental index would not encompass the complete set of technical corrections that are possible with the alternative method, and the correction accordingly would be smaller, in the range of 0.3 to 0.4 percentage point.

- The alternative method still would leave the "quality" bias of about 0.5 percentage point, but would go much further than the adjustments currently planned by BLS. While we believe that the estimate of 0.5 for the "quality" bias is reasonable, economists have a range of opinion. At the current time, the only way to address this part of the bias is through a legislated adjustment (for example, "CPI inflation minus 0.5").

The effects of CPI adjustment on the budget deficit.

- **The amount of actual budget savings depends on the timing and amount of the CPI adjustment. Changes in the construction of the index which occur beginning in 1997 would start to have budgetary impacts in fiscal 1998. Postponing the introduction of CPI adjustments would significantly reduce savings, both cumulatively over the 7 years and in 2002.**

- **According to CBO estimates (February baseline), a reduction in the CPI inflation rate of 0.5 percentage point per year (in addition to any change already incorporated in baseline) with effects beginning in fiscal year 1996, would yield a cumulative reduction in the budget deficit over the next seven years of $140 billion and a cumulative reduction over ten years of $317 billion (see table). The budget savings in each year grows over time, and reaches $70 billion a year in the year 2005. Starting the indexation in 1997 or 1998 leads to somewhat smaller effects on the deficit, as estimated by OMB and CEA (Mid-Session Review baseline). (Using the baseline just released by CBO would give slightly different estimates. The qualitative pattern, however, would remain.)**

Change in the Deficit from a 0.5 Percentage Point Reduction per Year in CPI Inflation with Initial Effects in Year Indicated (billions of dollars)

	Beginning in 1996 (CBO Estimates)	Beginning in 1997 (OMB Estimates)	Beginning in 1998 (OMB and CEA Estimates)
7-year cumulative	-140	-97	-65
10-year cumulative	-317	-256	-198
Effect in 2002	-41	-34	-26
Effect in 2005	-70	-64	-54

(Whether the budget savings come from scoring relative to a fixed baseline or from a change in the baseline depends on whether or not the adjustment is included in legislation.)

- Because of the large savings from introducing the CPI adjustment early, several proposals involve in part legislating a CPI adjustment for the years 1996 and 1997 equal to the magnitude of the bias that eventually would be corrected by technical adjustments.

How should we proceed?

A variety of alternative approaches have been proposed, ranging from legislating a fixed adjustment to CPI inflation (i.e., CPI inflation minus 0.5), to adopting BLS's "experimental" index, to instructing BLS to implement the more thorough revision of its methodology. And, these approaches can be combined in a variety of ways, all of which are consistent with the objective of ensuring that social security beneficiaries and taxpayers not be adversely affected by increases in the rate of inflation.

To avoid confusion between the traditional CPI and any of the proposed indexes, there have been suggestions that the new indexes be referred to as "cost-of-living indexes." Note that the CPI measures the cost of a fixed basket of goods, while a cost-of-living index attempts to measure the cost of maintaining the same living standard, taking into account changes in buying patterns, changes in quality, and the introduction of new products. Among the proposals that have been discussed in the press or in proposed legislation (Coalition proposal), some of which would use a new cost-of-living index, are the following (savings listed are in addition to CPI adjustments already incorporated in the June budget):

A. Simply accept and "score" the already announced adjustments in CPI methodology, scheduled for January 1997, and which therefore would affect CPI adjustments beginning in fiscal year 1998. We have incorporated this in our recent 7-year budget proposal, where these changes were scored at $32 billion for an adjustment of 0.24 percentage point.

B. Legislate a 0.5 percentage point initial adjustment to the increase in the CPI, but when the already announced methodological adjustments in the CPI occur, the "legislated" component would drop down to 0.3 percentage point. This has been scored at approximately $100 billion over 7 years. (Coalition Proposal.)

C. Develop a new cost-of-living index (using geometric averaging), ready for use beginning in January 1997, which would affect CPI adjustments beginning with fiscal year 1998. Preliminary estimates are that such an index would result in a 0.6 percentage point adjustment to the increase in the CPI, for a savings of $78 billion over 7 years.

D. Legislate a 0.6 percentage point adjustment to the increase in the CPI for 1997, followed by the methodological changes of alternative C for 1998 and beyond, for a savings of $116 billion over 7 years.

E. Legislate a 0.8 percentage point adjustment to the increase in the CPI for the year 1997, followed by the methodological changes of alternative C, plus a 0.2 "quality adjustment," for a savings of $155 billion over 7 years.

EYES ONLY

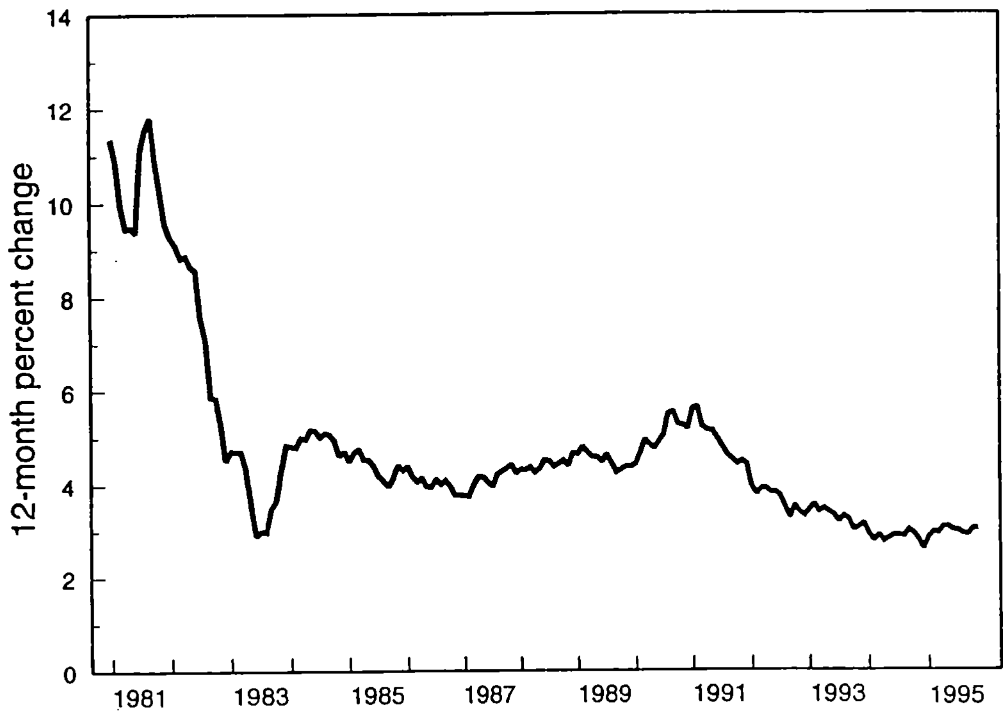
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 15, 1995

CHART OF THE WEEK

The Core Rate of Inflation



The core rate of consumer price inflation (which excludes energy and food prices) has been steady at an average of 3.1 percent over the past 3 years, the lowest 3-year period since 1968. The monthly rate of core inflation for November was reported this week at an impressively low 0.1 percent, or 1.5 percent on an annual basis. With labor costs rising very slowly and retailers unlikely to raise profit margins given sluggish consumer spending, the good news on price inflation should continue.

EYES ONLY

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SPECIAL ANALYSES

ARTICLE

DEPARTMENTS

BY JIM BORGMAN FOR THE CINCINNATI ENQUIRER

"I INSISTED ON A REAL, OLD-FASHIONED TREE THIS CHRISTMAS — SO HAROLD LOCATED ONE ON THE INTERNET AND WE HAD IT FEDEXED FROM SINGAPORE."

EYES ONLY

SPECIAL ANALYSIS

Philanthropy and Deficit Reduction: Will States and Private Donations Provide a Social Safety Net?

The size of reductions in Federal spending on Medicaid, welfare, and other social safety net programs has become one of the most contentious issues in the current budget battle. Some advocates of reductions in such programs assert that cuts in Federal spending would be offset by increased private donations to charities as well as increased state and local government spending. Thus, they argue, Federal spending can be dramatically reduced with little adverse impact on the poor and disabled.

Private donations. Roughly three-quarters of American households contribute to charities (including religious charities), with an average annual contribution of about $900. Economists have studied how such private donations respond to changes in government spending on social programs. The studies generally suggest that for every dollar reduction in government spending, private donations increase by between zero and 35 cents. In other words, increases in private expenditure are not likely to significantly offset cuts in government expenditure.

State and local offsets. Reduced Federal spending on social programs could possibly be offset by higher state and local spending, so that overall government spending would not change. But the historical evidence suggests otherwise. Econometric studies generally find that state and local governments do not fully offset the behavior of the Federal Government.

Block grants. Turning AFDC and Medicare into block grants will make it even less likely that states will offset Federal spending cuts. These programs currently are funded through matching grants, which reduce the states' marginal cost of providing benefits. This is especially true for low-income states that receive more generous Federal matching. A move to block grants would therefore raise the marginal cost to state governments of providing the benefits. For example, an extra dollar in combined Food Stamps and AFDC benefits currently costs a low-income state only $0.35. But if AFDC is shifted to a block grant system, the net cost rises to $1.43, because Food Stamp benefits are reduced when AFDC payments are increased. The literature suggests that states cut benefits by 1 to 3 percent for every 10 percent increase in net cost.

Tax effects. Current tax rules make donations of appreciated assets particularly attractive: such donations are not subject to capital gains tax and are deductible at their appreciated value. The higher the capital gains tax rate, the more valuable the exemption from the capital gains tax and therefore the more attractive this option. Reductions in the capital gains tax rate would thus raise the net cost of donating appreciated assets.

EYES ONLY

Summary. The available evidence strongly suggests that private donations and state and local government spending are unlikely to offset reductions in Federal spending on the social safety net. Cuts in tax rates (including a capital gains tax cut) and a shift to block grants would strengthen—rather than attenuate—this conclusion.

EYES ONLY

SPECIAL ANALYSIS

CBO's Forecast, At Last!

The Congressional Budget Office (CBO) released its new forecast this week, showing a $288 billion reduction in its baseline deficit over 7 years compared with their previous forecast. Many of their revisions move their forecast in the right direction and some of the remaining problems involve hard to explain technical issues. Nevertheless, Administration economists believe the CBO forecast remains unduly pessimistic.

Where did the $288 billion improvement come from? Of the $288 billion decline in the baseline deficit, the bulk reflected updating for recent economic developments and a fuller accounting of the effects on the economy of balancing the budget. The remainder was attributable to lower anticipated growth for spending on Medicare and Medicaid, along with changes in other technical assumptions.

What are the problems with the new CBO forecast? Several of the economic assumptions used in the new CBO baseline continue to be pessimistic compared with other forecasts.

- **Nominal GDP growth is low.** Nominal GDP growth averages 4.9 percent over the next 7 years, and has been revised down by about 0.3 percentage point per year from the earlier forecast. Although forecasters are generally revising down nominal GDP in response to the low inflation, the new CBO number should be compared to our Mid-Session Review forecast of 5.4 percent and the Blue Chip consensus of 5.2 percent.
- **CPI inflation is too high.** Given CBO's projected low growth rate for nominal GDP, their CPI inflation projection is too high. This combination has an adverse impact on the budget, since low nominal GDP growth reduces tax revenues and high CPI inflation both reduces tax revenues and raises spending. The important flaw in the CBO forecast is not primarily their real GDP forecast but rather the difference between the GDP price index and the CPI.
- **Interest rates don't fall enough.** Long-term interest rates are now lower in the near term, but are actually higher in later years, as compared with the earlier CBO forecast. The net result of these two changes on the deficit is negligible. Nevertheless, the long-term 5.5 percent rate does not reflect the decline in inflationary expectations and produces too large a difference between long and short rates. Lowering the long-term rate to 5.0 percent (as in their earlier forecast) would help reduce the deficit.
- **The profit share should be higher.** For the first time, CBO has shown the effects of deficit reduction on the income distribution. The profit share, which is projected to increase early on, is assumed to fall back gradually in the later years. CBO argues that this is the result of higher depreciation which, in turn,

results from the higher investment spending expected to accompany deficit reduction. There is room to argue here.

The new figures create very little slack in the Republican budget. Despite the substantial change in the baseline estimates, CBO reports that the cumulative 7-year deficits under the Republican budget plan are reduced by only $135 billion. Moreover, the revisions have virtually no effect on the deficit projection in 2002. This means that the new figures create very little room for additional spending under the Republican plan. Spending even a small amount of the $135 billion pushes the budget into deficit in 2002 because of higher interest payments on a larger national debt.

Why does the deficit change so little under the Republican plan? In large part, this is a consequence of their reliance on spending caps to define their proposals. Take Medicaid, for example: Under the Republican proposals, Medicaid becomes a capped block grant to the states. When CBO projects lower baseline Medicaid spending, the cap saves less money. Overall, the new estimates reduce the proposed policy cuts under the Republican plan from $903 billion to $750 billion. With $153 billion in lower cuts, the original $288 billion reduction in the baseline deficit is scaled back to $135 billion ($288 billion - $153 billion) in lower cumulative deficits.

CBO has re-scored our 7-year plan. CBO has scored our 7-year proposal with a deficit of roughly $115 billion in 2002. While the new CBO numbers bring our plan closer to balance in 2002, they still leave a large gap. The Coalition proposal, which was in balance under the old CBO assumptions, will likely show a modest surplus with the new figures.

EYES ONLY

ARTICLE

Corporate Contributions to Reducing the Deficit

Observers across the political spectrum have proposed reducing or eliminating corporate subsidies that benefit particular industries or firms without commensurate benefits to society as a whole. Such subsidies are often referred to as "corporate welfare," but this term is sometimes viewed as pejorative and anti-business. Although estimates of the budget savings vary, some have argued that cutting these corporate subsidies could reduce the deficit by several hundred billion dollars over the next 7 years.

A yardstick for measuring corporate subsidies and tax breaks. At a time when average Americans are being asked to accept government cutbacks, supporters of reducing corporate subsidies emphasize that it is only fair to ask businesses to share in this sacrifice. Corporate subsidies can take the form of tax preferences, direct Federal payments, or more subtle provisions such as quotas, below-market prices, and implicit government guarantees. Economists also point out that corporate subsidies can interfere with the ability of markets to properly allocate resources, thereby reducing economic efficiency (see box on next page). A useful yardstick for examining such subsidies, therefore, is the extent to which they "distort" the efficiency of markets.

What are these distortions? Business subsidies have three general effects:

- They can lead to overinvestment in certain industries, depriving other industries of scarce capital and labor.
- They can insulate industries from competitive pressures that may be important for raising productivity.
- They sometimes directly or indirectly raise prices to consumers, thereby redistributing income from consumers to producers.

Types of Corporate Subsidies. Each type of corporate subsidy (tax expenditures, direct government spending, and hidden subsidies) can produce some or all of these distortions. And the budgetary costs can be quite large. For example, estimates from the Progressive Policy Institute place the cost of selected tax subsidies at about $100 billion through the rest of this decade and the cost of selected spending subsidies at about $130 billion. The costs of hidden subsidies are more difficult to measure because they confer subtle benefits that are difficult to value. These subsidies, however, may be relatively straightforward to eliminate: user fees could be raised to cover full costs of providing services (timber sales, nuclear waste disposal, regulatory services) and auctions could transfer resources from the public sector to the private sector (broadcast spectrum, concessions at national parks, some agricultural quotas).

But will the sky fall if subsidies are eliminated? Some have argued that government subsidies are needed to prevent falling profits from threatening the existence of a "vital" industry. But this argument does not consider how:

- Markets usually adjust to reflect demand for vital products. If for some reason the market does not work, however, the issue is not the importance of the product, but whether the social benefit of the subsidy exceeds the cost.
- The ultimate beneficiaries are not always obvious. In some cases, the owners of assets at the time when the subsidy was introduced receive the bulk of the benefits. The value of subsidies is capitalized in the value of the assets used in the industry. New entrants into the industry do not benefit at all, since they have to pay more for their assets, and earn a lower net rate of return.
- Subsidies may induce additional firms to enter an industry, leading to increased production and lower prices, thereby limiting rates of return. Thus, the subsidies actually can lower before-subsidy returns.

Thus, eliminating subsidies need not turn profitable industries into unprofitable ones because economic forces will adjust rates of return to compensate for the loss of the subsidies.

Market Failures and Corporate Subsidies

The basic rationale for government intervention in the market is that sometimes markets fail to produce efficient outcomes: they produce too much of certain items (e.g., pollution) and too little of others (e.g., basic research). Subsidies to produce more of an underproduced item are thus designed to correct a market failure, and represent efficient subsidies. Programs to support research and development that because of market failures would not otherwise occur fall into this category. Subsidies that do not address (or are larger than necessary to address) a market failure should be viewed as inefficient and undesirable.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Improving Employment Situation For Recent College Grads. A recent survey of 527 businesses, industries, and governmental agencies projects a 4.7 percent increase in the hiring rate for new college graduates during 1995-96, according to the Career Services and Placement department at Michigan State University. This year is the third in a row for which surveyed employers predicted an increase in job openings for new college graduates. Nearly half of all new hires in surveyed organizations had career-related work experience, underscoring the importance of such experience to the competitiveness of labor market participants. Computer literacy and command of popular office technology continue to be much sought-after attributes in employees, making the capacity to adapt to changing technology an important qualification. Employers also stressed that new graduates should continue to keep current with the latest trends in their field, read trade journals, and update their skills.

Number of Black-Owned Firms Grows, but Most Are Small. The number of African American-owned businesses in the United States increased 46 percent (to about 621,000) from 1987 to 1992, compared to an increase of 26 percent for the country as a whole, according to a report the Census Bureau will publish later this year. While receipts per firm were $193,000 for all U.S. firms in 1992, black-owned businesses averaged just $52,000 in receipts. Moreover, the distribution of receipts among black-owned firms is highly skewed: while 56 percent of such firms had receipts under $10,000, only about 0.5 percent had receipts exceeding $1 million. The percentage of firms owned by African Americans was 29 percent in the District of Columbia, by far the most among the states (Maryland was next, with 11 percent), but these firms accounted for just 4 percent of all receipts in the District.

Mixed Reports on Holiday Shopping, Spending. Many retailers nationwide said sales for the period from Thanksgiving through the weekend ending December 10 were flat or down compared to last year's levels. According to anecdotal evidence, revenue rose only where stores promoted heavily with price-cutting or promotional gimmicks to lure bargain-hunting shoppers. The Commerce Department reported that retail sales grew strongly in November, but November included only 1 week of the holiday shopping season. On a positive note, the credit card-issuer Visa International reported that transactions at retail merchants through the first 16 days of this year's holiday shopping season were up nearly 25 percent over last year and the dollar volume of sales was up almost 20 percent.

INTERNATIONAL ROUNDUP

Discount Rates Fall in the UK and Germany. On December 13, the Bank of England lowered its discount rate by 25 basis points to 6.5 percent. The interest rate cut follows signs of slowing economic growth (GDP growth was sluggish in the third quarter) and lower-than-expected inflation. The Bank of England's move was followed on December 14 by a Bundesbank announcement of a 50 basis point cut in its discount and Lombard rates. Economic conditions remain relatively depressed in Germany, with no growth in real GDP between the second and third quarters. The market reaction in Germany was muted, as the anticipated rate cut had been widely anticipated.

Budget Balance by Extraordinary Means? Argentina's new Congress, which assumed office this week, is considering a controversial proposal which would temporarily allow President Menem to circumvent the Congressional approval process for future expenditure cuts and tax increases. Menem is seeking these extraordinary powers in order to scale back the bloated state sector and to reform the tax system. But Congress is not eager to surrender its recently enhanced powers, and passage of the extraordinary measure may therefore be difficult. In the midst of this power struggle, Argentina's economy seems to be strengthening after this year's estimated 2.5 percent fall in GDP. According to a household survey, unemployment in the greater Buenos Aires area dropped to 17.4 percent in October from 20.2 percent in May. And financial markets appear to be recovering from the aftershocks of the Mexican peso crisis: the Argentine stock market enjoyed a surge of 15 percent in the second half of November.

Structural Adjustment at the World Bank. World Bank President James Wolfensohn recently announced a reorganization of the financial institution's upper management as the first salvo in a restructuring of the development bank. In a memo released to staff on December 7, Wolfensohn outlined his plans to provide clear lines of authority for the main areas of World Bank business and to strengthen the World Bank Group's ability to address major issues. Five Managing Directors were appointed, and a new Executive Committee was set up. The World Bank, along with other international financial institutions, has been under increasing pressure to justify its use of contributions from member governments. The Bank is being encouraged to focus on its role as a mobilizer of resources essential to the development process—be they private or public, intellectual or financial—rather than on its role as a lender to governments.

EYES ONLY

RELEASES THIS WEEK

Consumer Price Index

The consumer price index was unchanged in November. Excluding food and energy, consumer prices increased 0.1 percent.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 0.2 percent in November. Capacity utilization declined 0.1 percentage point to 83.1 percent.

Retail Sales

Advance estimates show that retail sales increased 0.8 percent in November. Excluding sales in the automotive group, retail sales increased 0.9 percent.

Producer Price Index

The producer price index for finished goods increased 0.5 percent in November. Excluding food and energy, producer prices rose 0.4 percent.

MAJOR RELEASES NEXT WEEK

Gross Domestic Product (Tuesday)
Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)
Personal Income (Thursday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1995:1	1995:2	1995:3
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	2.7	1.3	4.2
Chain weights	2.7	3.7	1.7	0.7	3.0
GDP implicit price deflator:					
Fixed weights	5.5	2.3	2.2	1.6	0.6
Chain weights*	5.4	2.7	2.8	2.2	1.9
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	2.5	4.9	2.0
Chain weights	1.4	0.9	0.2	3.4	0.7
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.0	0.3	1.0
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.5	3.2
Chain weights*	1.2	0.7	1.8	1.4	1.8

* CEA estimates.

	1970–1993	1994	1995:1	1995:2	1995:3
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	14.1
Residential investment	4.7	4.3	4.2	4.0	4.1
Exports	8.0	12.3	12.9	13.1	13.3
Imports	9.2	14.4	15.1	15.4	15.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	3.1
Federal surplus	–2.8	–2.4	–2.1	–1.8	N.A.

	1970–1993	**1994**	**Sept. 1995**	**Oct. 1995**	**Nov. 1995**
Unemployment Rate	6.7**	6.1**	5.6	5.5	5.6
Payroll employment (thousands)					
increase per month			94	66	166
increase since Jan. 1993					7687
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.3	**0.0**
PPI-Finished goods	5.0	1.7	0.3	–0.1	**0.5**

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	Oct. 1995	Nov. 1995	Dec. 14, 1995
Dow-Jones Industrial Average	3522	3794	4760	4936	5182
Interest Rates					
3-month T-bill	3.00	4.25	5.28	5.36	5.26
10-year T-bond	5.87	7.09	6.04	5.93	5.74
Mortgage rate, 30-year fixed	7.33	8.35	7.48	7.38	7.15
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 14, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.441	–0.2	–8.3
Yen-Dollar	101.5	+0.1	+1.2
Multilateral $ (Mar. 1973=100)	85.09	–0.1	–5.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q3)	5.6 (Nov)	2.6 (Nov)
Canada	1.9 (Q3)	9.4 (Oct)	2.4 (Oct)
Japan	–0.2 (Q3)	3.3 (Oct)	0.2 (Sept)
France	2.1 (Q3)	12.1 (Aug)	1.8 (Oct)
Germany	1.5 (Q3)	6.6 (Sept)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (July)	5.8 (Oct)
United Kingdom	2.0 (Q3)	8.6 (Oct)	3.2 (Oct)

EYES ONLY

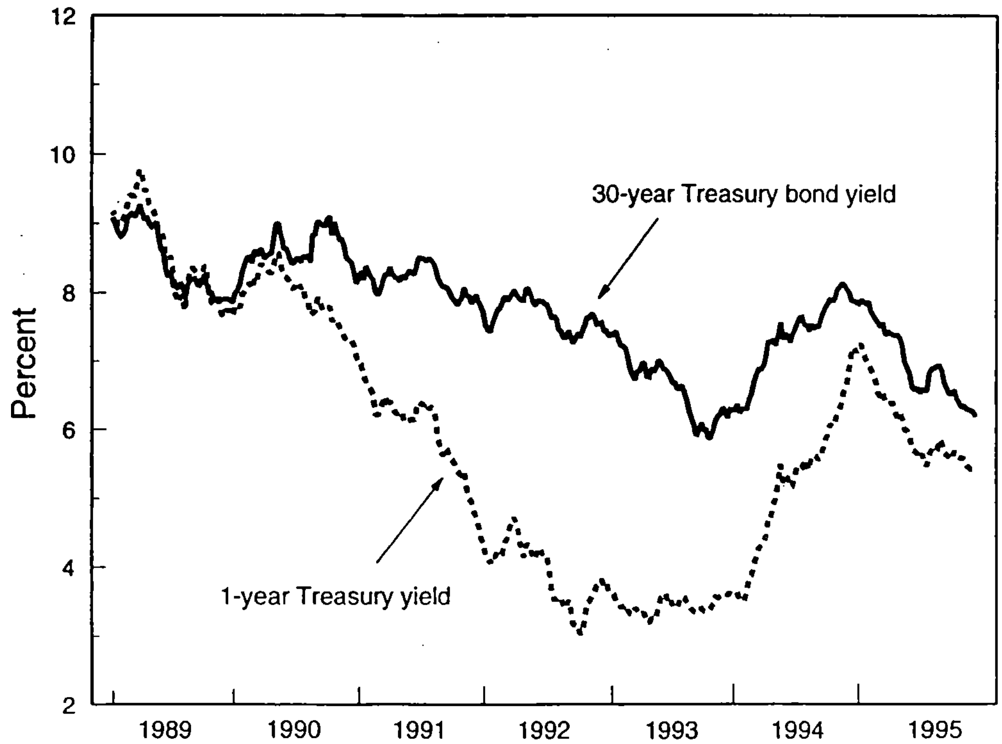
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 8, 1995

CHART OF THE WEEK

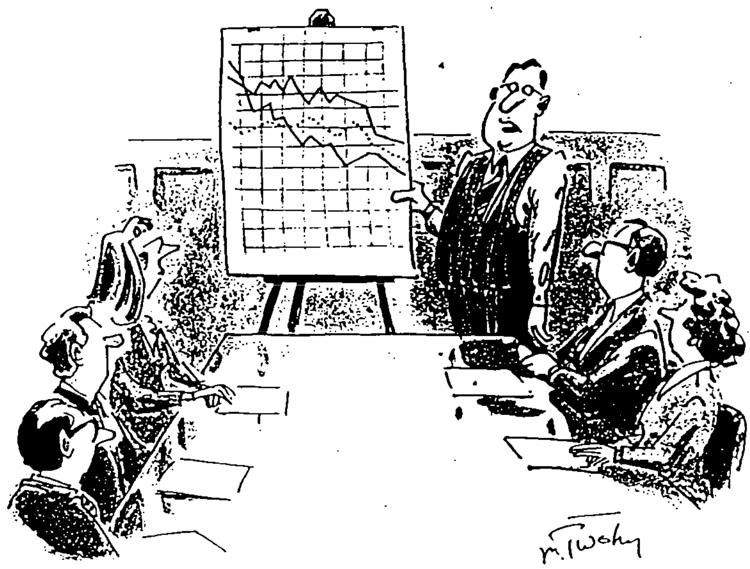
Interest Rates



The 30-year Treasury rate dipped below 6 percent this week for the first time in over 2 years. Since peaking late last year at just over 8 percent, the rate has fallen steadily. Although the 1-year Treasury rate also has fallen this year, the spread between the 30-year and 1-year rates is much smaller than the last time bond rate were this low. The narrowing of the spread, along with falling long-term r suggests that investors expect short-term interest rates to decline, possibly as later this month following the Federal Reserve's next Federal Op Committee meeting.

EYES ONLY

CONTENTS



"So, we look to the fourth quarter as a time of healing."

EYES ONLY

TREND

Labor Force Growth Projected to Slow

The Bureau of Labor Statistics has released revised projections showing the labor force will grow at an annual rate of 1.1 percent over the period 1994-2005, down from the 1.4 percent rate recorded during 1982-93. Growth in the labor force at this lower rate entails creating about 1.5 million new jobs per year to keep unemployment from rising, somewhat less than the 2.5 million pace of the past 3 years.

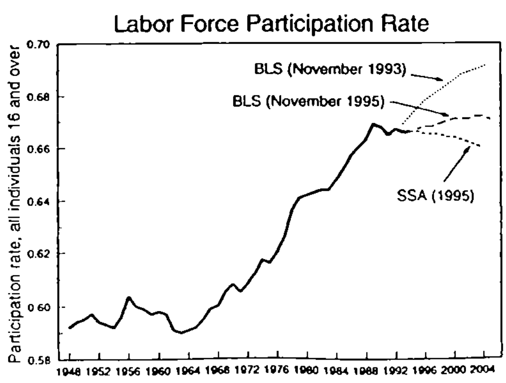
Analysis. The labor force is projected to grow more slowly because:

- Labor force participation is expected to rise more slowly, as the ongoing decline in participation by men accelerates and the ongoing increase in participation by women moderates (see table).
- The working-age population is expected to grow more slowly due entirely to a small decline in growth of men over the age of 16.

Growth in the Labor Force
(Average annual percent change)

1982-1993	All	Male	Female
Population 16 and over	1.1	1.2	1.0
Participation Rate	0.3	-0.2	0.8
Total Labor Force Growth	1.4	1.0	1.8
1994-2005	**All**	**Male**	**Female**
Population 16 and over	1.0	1.0	1.0
Participation Rate	0.1	-0.3	0.4
Total Labor Force Growth	1.1	0.7	1.4

The new BLS projections are significantly lower than those released previously, and are close to projections presently used by the Social Security Administration. They also are close to those used by the Council of Economic Advisers in developing our economic forecasts. The main reason for the downward revision is a lower projected rate of growth in labor force participation (see chart). The earlier BLS projections had assumed the drop in participation by men during the early 1990s would be reversed once the economic recession ended, but the new projections assume the drop is part of a long-term trend.



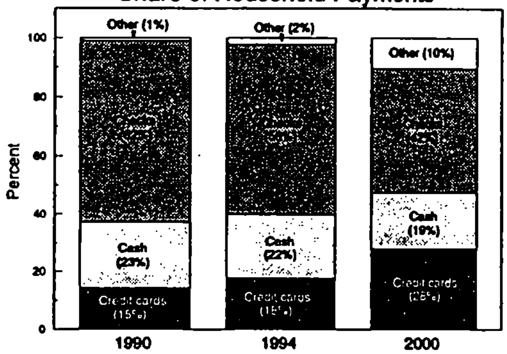
EYES ONLY

SPECIAL ANALYSIS

Credit Card Use Soaring

Credit card use by American households has skyrocketed in recent years, as the country moves toward a cashless economy. Close to 18 percent of payments by households were charged on credit cards in 1994, up from 15 percent in 1990, and this share is expected to grow to roughly 28 percent by 2000 (see chart). The dollar volume of these charges rose by 50 percent from 1990 to 1994, more than twice the rate of growth in overall consumer spending.

Share of Household Payments



About three-quarters of all households now have at least one major credit card, and roughly a third have three or more. In total, households have a combined national credit limit of just over $1 trillion dollars, double the limit of 5 years ago. This sharp increase in easily available credit and the rapid growth in charge volume have sparked concern that households could quickly face debt difficulties if the economy were to weaken.

Convenience use versus debt use. Credit cards are both a convenient means of payment and a readily available source of funds for borrowing:

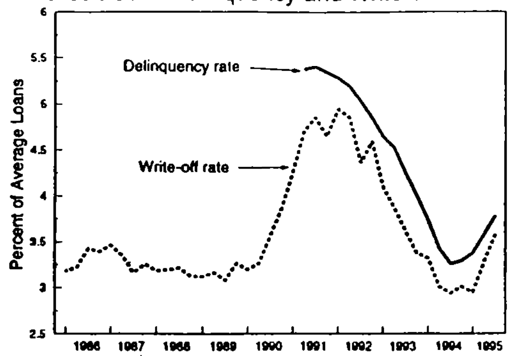
- The use of credit cards for convenience, where charges are paid off each month without interest, is growing more rapidly than debt use, where charges are not paid off each month and interest accrues.
- Convenience use has been propelled by the proliferation of rebates, frequent-flier miles, and credits toward auto purchase, and by the increasing acceptance of credit cards by supermarkets, health and dental clinics, college tuition offices, and even the postal service.
- Despite growth in convenience use, a survey this past July found roughly three-fifths of cardholders do not pay off their balances. On average, these cardholders carry a balance of about $3,200 and owe about $45 in interest each month.
- The share of total charges paid off each month is only about 25 percent. As a result, interest payments on credit card debt continue to be an important burden on consumers.

Will the holiday season be merry? Consumers generally load up on debt during the holiday shopping season. But this year rising delinquency rates on credit cards and increasing write-offs by banks of bad credit-card debts suggest that some

EYES ONLY

consumers may have stretched beyond their means (see chart). Although early returns indicate a mixed overall start to holiday shopping, some individual retailers of large ticket items like big screen televisions and computers are reporting strong sales. Thus, it is still too early to say whether rising consumer debt will restrain spending this holiday season.

Credit Card Delinquency and Write-off Rates



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ARTICLE

A Possible Fix for the CPI

Most economists now believe that changes in the consumer price index overstate changes in the cost of living. Part of this bias occurs because of difficulties accounting for new products and quality change in the index. Part of this bias occurs because the index does not adequately account for the way people substitute products whose prices are rising slowly for products whose prices are rising quickly—so-called "substitution bias." And the remainder of this bias occurs because of certain technical problems with the way the index is constructed—so-called "formula bias."

A method for simultaneously fixing substitution and formula bias has been developed, however, and would find broad support among economists and other experts. The new method is technically feasible and could be implemented with available data on a timely basis. We estimate that changes in such an index would be 0.6 percentage point lower per year compared to the current CPI.

What is the problem? It is helpful to think of the CPI as being put together in two stages representing two levels of aggregation. At the first level of aggregation, prices for individual items, such as McIntosh, Winesap, and Delicious apples, are collected and used to construct a price index for apples. The price index for apples is just a weighted average of the prices of individual varieties of apples. At the second level of aggregation, the price index for apples is combined with price indexes for other product categories (televisions, autos, etc.) to construct a price index for the entire market basket. Substitution bias occurs at the second level because the weight applied to each category is based on 1982 consumption patterns and therefore fails to account for the way consumers substitute products whose prices are rising slowly for products whose prices are rising quickly.

At the first level of aggregation (McIntosh-Winesap-Delicious), in addition to substitution bias, formula bias occurs. This formula bias arises because some of the data needed to construct the index at this level are not available and must be estimated, and the estimation procedure induces a built-in error that overweights rising prices (such as prices of items coming off of a sale) and underweights falling prices.

How would the new method work? The new method of computing the CPI would differ from the current method in two important ways:

- The new method would <u>use weights that are updated regularly</u> to combine prices of product categories (apples, televisions, autos) into a single index, rather than the current practice of constant weights held equal to their values in a base year. Continually updating the weights would directly account for the way consumers substitute toward products that experience relatively low inflation.

- The new method would use a geometric average rather than an arithmetic average both to combine the prices of individual items into prices for product categories, and to combine prices of product categories into a single index. The use of a geometric average would reduce substitution bias and eliminate formula bias.

Is the new method feasible? The new method requires data on household expenditure patterns to update the weights used in computing the CPI. Although BLS collects these data, they are available only with a lag of 3 to 6 months. It would be possible, however, to update weights each month by using statistical techniques to project trends in expenditure patterns. Accordingly, the new method of computing the CPI could be implemented using data presently collected by the BLS.

What is BLS doing? Beginning in 1997, BLS plans to make adjustments in how they calculate the CPI which would only partially address these problems. These adjustments should reduce the change in the CPI by about 0.2 percentage point per year. BLS currently is not planning the major revamping of the CPI entailed by using a geometric rather than an arithmetic average. In fact, they would regard such a change as altering the basic nature of the CPI. As a result, it might be easier to introduce a new separate cost-of-living index based on geometric weights, rather than fix the existing CPI, which could continue to be produced and used in labor contracts. The decision could be made at the policy level to ask BLS to produce a new index and then to use the new index for adjusting taxes and benefits.

Comparing Geometric and Arithmetic Averages

Suppose the price of a product increases from $1 to $1.50 this year, and then decreases to $1 next year. The price increase is 50 percent this year and the price decrease is 33 percent next year. An arithmetic average of the price change over the 2 years would equal 8.5 percent (0.5 x [50-33]). A geometric average of the price change over the 2 years would give 0 percent change (1 - [1+0.5]x[1-0.33]). The reason for this difference is that an arithmetic average weights each percentage change equally, whereas a geometric average weights larger changes proportionately less than smaller changes. And they say economics isn't interesting!

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Record Growth in Prison Population. The size of the U.S. prison population continues to soar, with the Bureau of Justice Statistics recently recording the largest 1-year prison population increase ever. The number of state and Federal inmates grew by 89,707 during the 12 months ending June 30, 1995, putting the prison population at 1,104,074. Large racial differences again were evident. For the first time ever, the number of blacks incarcerated (in both prisons and jails) actually surpassed the number of whites: 735,200 blacks were incarcerated in 1994, compared to 725,100 whites. In all, BJS reports that roughly 4.3 million adult males were in prison, jail, on probation or on parole in 1994—a number approximately equal to the average number of males who were unemployed in 1994.

Beige Book Indicates Moderate Growth, Little Price Pressure. The recent Current Economic Conditions survey published by the Federal Reserve indicates that the economy continues to expand, but at a somewhat slower pace than last month. Although retail sales picked up in November, early returns on sales for the holiday season were mixed, with some regions reporting lower-than-expected sales while others reported encouraging results for the day-after-Thanksgiving sales. Other indicators—such as manufacturing production and single-family home construction—were mixed as well. Continued tight labor markets for both skilled and unskilled workers in entry-level jobs appear to be contributing to some wage pressure, and some regions report employers are having difficulty filling temporary service positions.

The Rich and the Poor, Again. New statistics, based on unpublished data from the Congressional Budget Office, further document the large gains of the richest and the large losses of the poorest Americans since the late 1970s. In 1992, the wealthiest 1 percent of the population (2.5 million people) earned almost as much after-tax income as the bottom 40 percent of the population (100 million people). This contrasts sharply with 1977, when the total after-tax income of the top 1 percent was less than half that of the bottom 40 percent. In 1992, the top 20 percent of the population earned the same amount of after-tax income as the bottom 80 percent of the population. Between 1977 and 1992, the top 1 percent saw its average after-tax income increase 91 percent, while the poorest 20 percent saw its average after-tax income fall by 17 percent.

INTERNATIONAL ROUNDUP

Japanese Economy Continues to Stagnate. Japan's GDP expanded by a weak annualized rate of 0.6 percent in the third quarter, slightly above private sector expectations, as the banking-sector crisis and subdued confidence continued to suppress activity. Strong growth in personal consumption expenditure was offset by the continued weakness of capital spending and housing. Net exports declined dramatically, falling by 32 percent in the third quarter, in part reflecting a narrowing in the bilateral trade surplus with the United States. Deflation continued, as prices fell for the fifth consecutive quarter. Japan is unlikely to attain the 2.8 percent real growth rate forecast by the government for the 1995-96 (April-March) fiscal year. The government's Economic Planning Agency has recently suggested that growth of only 1 percent is more likely.

German Economy Sluggish. Real GDP in Germany was essentially unchanged in the third quarter, and was up only 1.5 percent over the same period in 1994. Unemployment (including the self-employed) rose to 9.3 percent during November from 9.2 percent in October. Labor market conditions differ significantly between the new and the old states of Germany: unemployment is 14 percent in the east and 8.2 percent in the west. The German government, engineering employers, and the influential union of metal-workers have agreed to reach consensus on a "jobs pact" by late January. The pact drafted by the union proposes wage freezes in return for job creation and security measures. Renewed growth in Germany and Japan—two of our top trading partners—would boost U.S. exports.

Venezuela Faces Tough Challenges. Problems faced by Venezuela's current government were highlighted this week when the opposition party won a majority of the regional governorships at stake. Poor economic performance has produced strong criticism of President Rafael Caldera's government: the budget deficit stands at 7 percent of GDP, inflation is expected to remain high at 50 percent for 1995, and more than 40 percent of Venezuelans live in abject poverty. The Venezuelan government is seeking an agreement with the International Monetary Fund (IMF) in order to bolster its foreign exchange reserves. But the IMF does not seem satisfied with the government's economic plan for 1996. In particular, the government is hesitant to meet the IMF requirement that gasoline prices be increased. Past attempts to reform the Venezuelan economy resulted in violent riots in February 1989 which left hundreds dead.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment
****Embargoed until 8:30 a.m., Friday, December 8, 1995****

In November, the unemployment rate rose to 5.6 percent from 5.5 percent in October. Nonfarm payroll employment increased by 166,000 in November.

Leading Indicators

The index of leading economic indicators fell 0.5 percent in October.

Domestic Auto Sales

Domestic autos were sold at an annual rate of 7.1 million units in November.

MAJOR RELEASES NEXT WEEK

Producer Prices (Tuesday)
Retail Sales (Wednesday)
Consumer Prices (Thursday)
Industrial Production and Capacity Utilization (Thursday)

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U.S. ECONOMIC STATISTICS

	1970–1993	1994	1995:1	1995:2	1995:3
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	2.7	1.3	4.2
Chain weights	2.7	3.7	1.7	0.7	3.0
GDP implicit price deflator:					
Fixed weights	5.5	2.3	2.2	1.6	0.6
Chain weights*	5.4	2.7	2.8	2.2	1.9
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	2.5	4.9	2.0
Chain weights	1.4	0.9	0.2	3.4	0.7
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.0	0.3	1.0
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.5	3.2
Chain weights*	1.2	0.7	1.8	1.4	1.8

* CEA estimates.

	1970–1993	1994	1995:1	1995:2	1995:3
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	14.1
Residential investment	4.7	4.3	4.2	4.0	4.1
Exports	8.0	12.3	12.9	13.1	13.3
Imports	9.2	14.4	15.1	15.4	15.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	3.1
Federal surplus	–2.8	–2.4	–2.1	–1.8	N.A.

	1970–1993	1994	Sept. 1995	Oct. 1995	Nov. 1995
Unemployment Rate	6.7**	6.1**	5.6	5.5	**5.6**
Payroll employment (thousands)					
increase per month			**94**	66	**166**
increase since Jan. 1993					**7687**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.3	N.A.
PPI-Finished goods	5.0	1.7	0.3	–0.1	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 8, 1995.**

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FINANCIAL STATISTICS

	1993	1994	Oct. 1995	Nov. 1995	Dec. 7, 1995
Dow-Jones Industrial Average	3522	3794	4760	4936	5159
Interest Rates					
3-month T-bill	3.00	4.25	5.28	5.36	5.34
10-year T-bond	5.87	7.09	6.04	5.93	5.72
Mortgage rate, 30-year fixed	7.33	8.35	7.48	7.38	7.18
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 7, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.444	−0.2	−8.2
Yen-Dollar	101.4	−0.4	+1.3
Multilateral $ (Mar. 1973=100)	85.15	−0.2	−4.8

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q3)	**5.6** (Nov)	2.8 (Oct)
Canada	1.9 (Q3)	9.2 (Sept)	2.4 (Oct)
Japan	0.6 (Q2)	3.2 (Sept)	0.2 (Sept)
France	2.1 (Q3)	12.1 (Aug)	1.8 (Oct)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (Jul)	5.8 (Oct)
United Kingdom	2.0 (Q3)	8.6 (Sept)	3.2 (Oct)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, December 8, 1995.**

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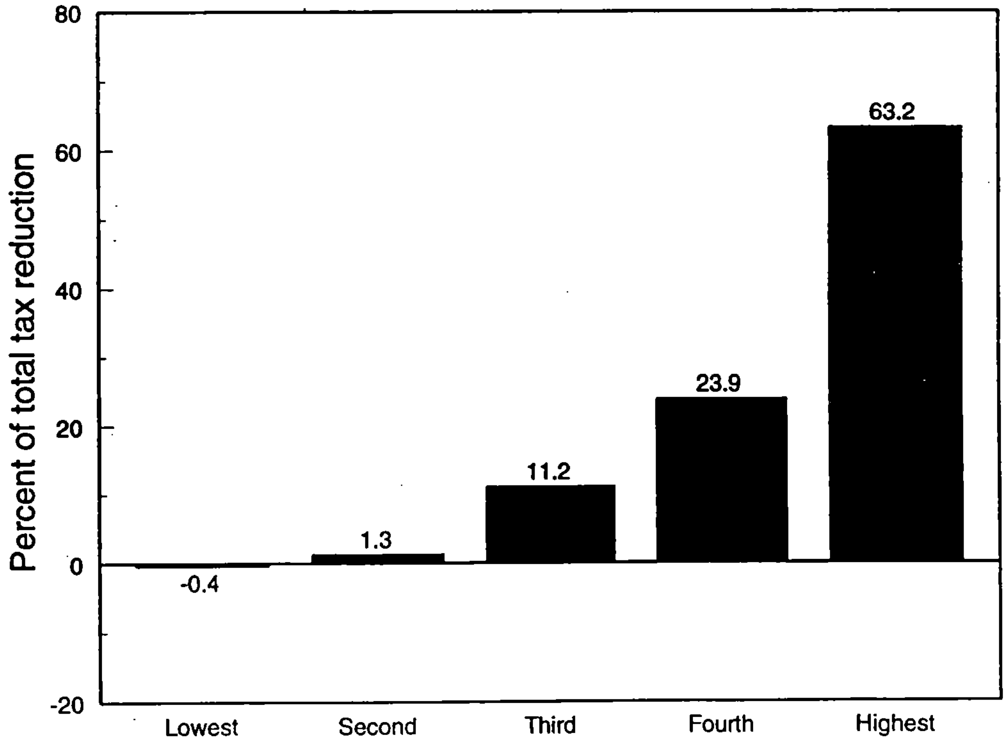
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 1, 1995

CHART OF THE WEEK

Tax Breaks By Family Income
Quintile Under the Republican Tax Plan



Treasury estimates that tax provisions in the Reconciliation Bill's Conference Agreement, if fully phased in, would give roughly two-thirds of all tax reductions to households with the highest incomes (over $79,000 in 1996 dollars), but would give only a minuscule share of the tax breaks to those in the second quintile, and actually would raise taxes for those with the lowest incomes. A Special Analysis in this issue of the Weekly Briefing discusses how the budgetary cost of tax breaks affecting mainly upper-income households rises sharply after the year 2002.

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CONTENTS

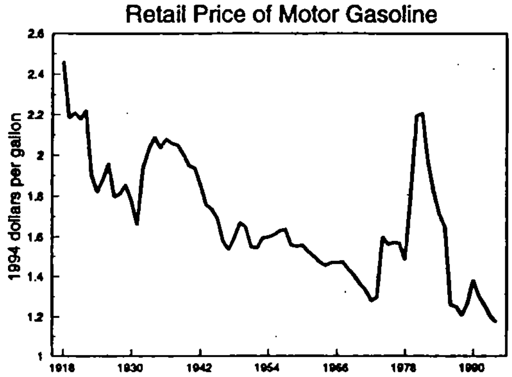
"We jacked up our prices to insure that you receive the same quality and service in the future."

CURRENT DEVELOPMENT

Gas Prices Lowest Since Model T

Gasoline prices have fallen to their lowest level in real terms in the entire 75-year history of recorded pump prices (see chart). After a slight increase during the first half of 1995 compared with a year earlier, gasoline prices plunged in August below their 1994 levels and have continued to fall since then. Last month, consumers paid an average of $1.19 per gallon of gasoline, compared to $1.25 (adjusted for inflation) one year ago. The fall in gasoline prices has occurred despite the small rise of 4 cents in the Federal gasoline tax in 1993.

Retail Price of Motor Gasoline



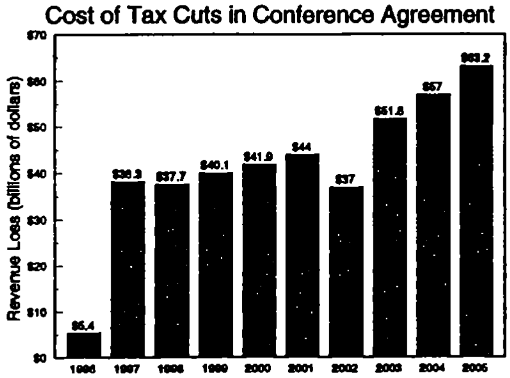
Fuel cost of travel at all-time low. The low gasoline prices, coupled with steadily increasing motor fuel efficiency, have made the cost of auto travel the lowest ever for consumers. The cost per mile driven was 5.4 cents in 1994, compared to 9.6 cents 10 years earlier, and 11.4 cents in 1950, all measured in 1994 dollars.

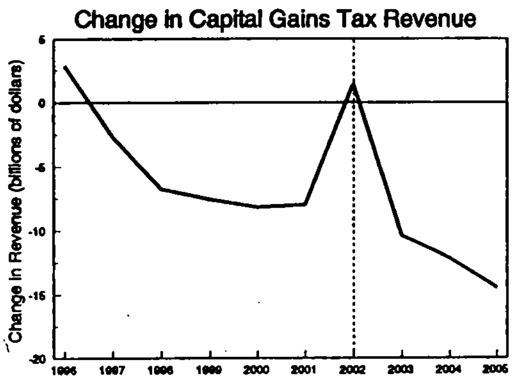
Analysis. The recent drop in pump prices is somewhat puzzling, given the apparent tight supplies of producers and strong demand by households and businesses in conjunction with growth in the economy. This is even more surprising given that motorists in nine large cities have been required to use a new and more expensive cleaner-burning gasoline starting this year.

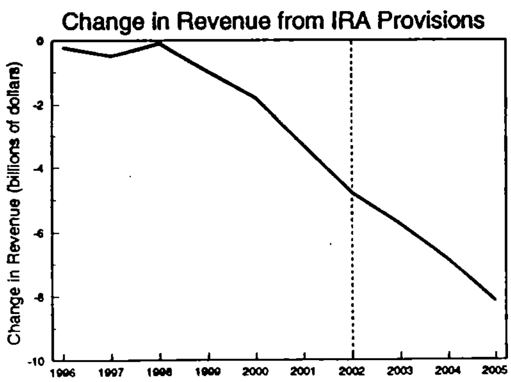
SPECIAL ANALYSIS

Budgetary TNT: Exploding Costs of the Republican Tax Plan

Some of the tax cuts in the Reconciliation Bill's Conference Agreement limit revenue losses through the year 2002, but result in an explosion in revenue loss in subsequent years. Such "backloading" makes it easier to balance the budget by 2002, but more difficult to maintain balance afterwards.







Analysis. According to Joint Tax Committee estimates, the budgetary cost of the tax cuts generally rises between 1997 and 2001, declines in 2002, and then rises steeply (see top chart). Several provisions in the bill contribute to this pattern; two are discussed below.

Capital gains income would be taxed at one-half the rates on ordinary income. In addition, assets purchased on or after January 1, 2001 would be indexed for inflation. Taxpayers with existing assets could treat them as "new" provided they pay tax on the gain through that date. This feature increases taxes in fiscal year 2002, when tax returns for calendar year 2001 are filed (see middle chart). The temporary increase primarily represents taxes the government would have collected anyway when the assets are sold. (Treasury estimates show a much smaller revenue spike in 2002.)

A new form of individual retirement account would be created, with contributions not deductible but with earnings on such accounts completely free of tax. Owners of existing IRAs can convert to the new type of account if tax is paid on the accumulated funds. This feature limits the loss of revenue over the next several years, but the losses grow progressively larger after 1998 (see bottom chart). The Administration's IRA proposal contains similar accounts, but, with income limits on participation, fewer people will take advantage of them, so the revenue loss grows less steeply.

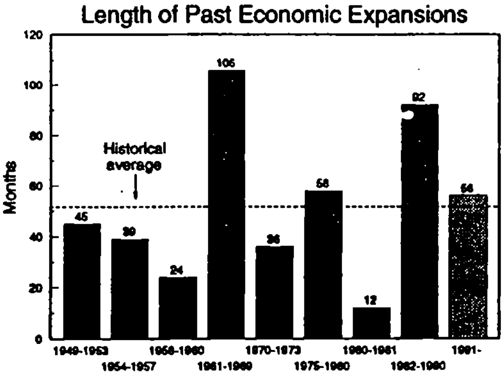
SPECIAL ANALYSIS

Is the Economic Expansion About to End?

The current economic expansion has run for 56 months, a little beyond the 52-month average for post-war expansions. As the expansion lengthens, analysts increasingly have raised the possibility that it might soon falter, with the economy dipping into recession. Although the current expansion is typical of other expansions in many ways, the current expansion will not end simply because it has gone on for a long period of time. Rather, economic indicators at present suggest that the expansion will continue into the foreseeable future.

The length of expansions has varied. Post-war economic expansions have varied substantially in length, with the shortest (1980-81) lasting only 12 months, and the longest (1961-69) lasting 106 months (see chart). Such large differences in the actual length of past expansions make the 52-month average a relatively uninformative guide to the life expectancy of the current expansion. The likelihood of the expansion ending depends on whether economic developments that typically precede an economic downturn—increasing inflation, rising interest rates, financial imbalances, and inventory buildup—have begun to appear.

Length of Past Economic Expansions



- **Core inflation.** Most post-war downturns have been preceded by a rise in the core rate of inflation—the rate of inflation after eliminating the effects of volatile food and energy prices. The rise sometimes has been precipitated by external events—such as increased oil prices—and sometimes by overly stimulative fiscal or monetary policies. Although core inflation jumped up earlier this year, it since has moved down and stabilized at about 3.0 percent. Inflation remains firmly under control.

- **Interest rates.** Another feature preceding economic downturns is rising interest rates, typically because the Federal Reserve tightens credit policy in response to an increase in the rate of inflation. During 1995, however, interest rates have fallen, especially during the last part of the year, unlike the pattern usually seen prior to a downturn. Furthermore, as interest rates have fallen, the housing and auto sectors have recovered from the slowdown earlier in the year, so that these sectors should not develop overcapacity problems as they did early in 1995.

- **Bank problems.** Unlike the late 1980s and early 1990s, when the savings and loan crisis and general weakness of the banking sector represented a strong downside risk, the banks today are on a more stable footing. The better financial situation of the banks means that the system should be able to adapt more easily today to any adverse shift in interest rates or real estate values, thereby limiting the consequences for the overall economy.

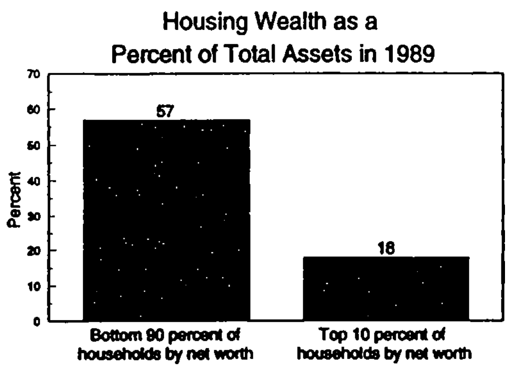
- **Business inventories.** The inventory buildup in the auto and housing sectors that was evident earlier this year has now been mostly worked off, primarily as a result of the slowdown in the second quarter. Accordingly, the possibility in the near future of a downturn due to an inventory overhang appears remote.

- **Financial imbalances.** The recession of 1990-91 was preceded by a period during which the financial balance sheets of households became burdened by debt. These debt loads became unmanageable when interest rates increased and the real estate market weakened sharply, sending delinquency rates and personal bankruptcy filings soaring. Even though debt loads of households today have reached historic highs, lower interest rates presently are allowing households to manage their debts with a bit more ease. Given current debt levels, however, a rise in the average interest rate on outstanding household debt of about two percentage points could push the debt service burdens to the levels in the late 1980s. Although continuing goods news on inflation should keep interest rates low, an impasse on the budget, if it persisted, could raise interest rates sharply.

ARTICLE

House Rich and Cash Poor: Reverse Mortgages Can Help

The largest component of wealth for most Americans is, by far, the value of their homes. Housing wealth made up almost 60 percent of household assets in 1989 for homeowners below the 90th percentile of net worth, compared with a much smaller share for the richest homeowners (see chart). Although home-equity loans have made borrowing against this wealth possible for many working-age Americans, such loans have not been an option for retired Americans who cannot meet the associated income qualification standards. Soon, however, as many as 3 million retiree households may be able to turn the equity in their homes into cash under a new program offered by the Federal National Mortgage Association (Fannie Mae).



Reverse mortgages. The new program, dubbed the "Home Keeper Mortgage," will set national standards for reverse mortgages, which differ from conventional mortgages by having no payments due until the homeowner dies or moves from their home. Fannie Mae will purchase reverse mortgages meeting these national standards from its network of lenders, bundle them together, and sell them to investors. In this way, Fannie Mae will create a national market for this type of mortgage, similar to the role it plays in conventional mortgage markets.

How will these mortgages work? Fannie Mae's Home Keeper Mortgage will allow people 62 or older to convert equity in their home into a lump-sum payment or a monthly income payment (or a mixture of both). Interest accrues on the mortgage but no payments are due until the homeowner dies, moves out of the home, or transfers ownership to another person. If a homeowner lives so long that total payments plus interest exceed the value of the home, the amount owed remains at most equal to the value of the home. Fannie Mae will use fees paid by the borrower to purchase insurance from mortgage insurance companies to cover this possible shortfall. The amount homeowners can borrow will depend on their life expectancy, marital status, and the value of their home. In addition, the amount available for borrowing depends on interest rates and origination fees.

Who will benefit? Among American seniors, over 62 percent own their home outright and thus could qualify for the program. Another 21 percent have a home with a remaining mortgage balance, but could qualify if the balance were paid off with proceeds of the reverse mortgage. The funds can be used for any purpose, and are seen as making it possible for seniors to stay in their homes and remain independent.

How important could this be? One way to gauge the potential importance of reverse mortgages is to compare the size of the monthly payment or lump-sum payment for which a borrower can qualify to their income or wealth. A recent Federal Reserve Bank study performed these calculations using Census Bureau data to estimate that:

- The monthly payment would equal at least 20 percent of other monthly income for about a quarter of homeowners 62 or over, while for about a tenth of such homeowners the share would be over half of their other income.
- The lump-sum payment would equal at least half of liquid wealth (checking accounts, stocks, bonds, etc.) for about 60 percent of homeowners age 62 or over.

These estimates suggest that for a significant portion of senior homeowners, availability of reverse mortgages may represent an important way for them to supplement their income and wealth.

But will seniors want to borrow against their homes? In the end, of course, reverse mortgages may not be a solution that seniors embrace. The limited experience with reverse mortgages to date suggests strong reluctance on the part of many seniors to "re-mortgage" their homes after working for so many years to pay off the original mortgage. Also, lenders often have charged high loan fees in the past. The new Fannie Mae program, however, should make reverse mortgages more widely available and more competitively priced, perhaps getting seniors to take a second look. With the number of senior households projected to increase sharply in the next 25 years, lenders likely will find this a market worth pursuing.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More on Education and Racial Wage Inequality. In a recent study by the Economic Policy Institute cited in the Washington Post, the average black male aged 25-34 continued to earn only about 80 percent of the average wage for whites, despite gains in educational attainment. Two facts nullified their gains. First, an increase in the payoff to education made the remaining racial difference in educational attainment even more glaring. Despite progress, blacks continued to be less likely to graduate from high school or college. As the payoff to education grew, such differences became even more important. Second, mean wages for blacks fell relative to whites even among those with similar levels of education. This latter trend seems to have reversed since 1989 for male college graduates. (Black women continued to lose ground relative to white women with the same educational attainment.) Given current trends in college enrollment rates for blacks and whites, the outlook for racial equity in the future may be more gloomy. The racial gap in college enrollment among 18-24 year-olds, which began to close during the Seventies, actually widened during the 1980s and 1990s.

Christmas Price Index Takes A Swan Dive. The cost of "The 12 Days of Christmas" dropped sharply this year, according to PNC Bank of Pittsburgh, keeper of this seasonally adjusted "CPI". PNC says the cost of giving a partridge in a pear tree, two turtle doves, etc., has dropped to just $12,482, down 22 percent. The decrease was driven by a first-ever 50 percent drop from last year's $7,000 price tag for seven swans-a-swimming. The PNC report confirms the Administration's view of troubling wage distribution trends: while the unchanged minimum wage of $4.25 kept the cost of eight maids-a-milking at $34, the index's only increase was due to a 6 percent uptick in the cost of 10 Lords-a-leaping.

"Murphy Brown Syndrome" Documented. While much of the welfare reform debate has focused on out-of-wedlock births among poor women, unmarried women (particularly whites) in their thirties have displayed a growing trend toward having babies. The birth rate for white unmarried women in their thirties grew by 100 percent between 1983 and 1993. The growth in birth rates for black unmarried women was slower, at 26 percent, although the birth rate for unmarried black women in their thirties was still 1.7 times higher than for white women in their thirties. Also, the teen birth rate seems to be leveling off after a prolonged period of increase. After rising by 50 percent between 1983 and 1991, the birth rate for teens has been 45 per thousand for three consecutive years.

INTERNATIONAL ROUNDUP

Czech Republic Joins OECD. On November 28, the Czech Republic became the first post-communist economy to join the 26-member OECD (Organization for Economic Cooperation and Development). The Czech Republic has made significant progress since its "Velvet Revolution" six years ago. After experiencing a contraction of roughly 20 percent between 1989 and 1993, the economy is now growing again: It expanded by 2.6 percent in 1994, and is expected to grow by 4 percent this year. Other signs are also encouraging. The private sector accounts for roughly 70 percent of national output. The government budget has been in surplus since 1993, and inflation has fallen to an annual rate of 10 percent. And, unlike many other transition economies, the Czech Republic has managed to enjoy strong economic growth without high unemployment. The registered unemployment rate in 1994 was 3 percent.

French Transport Workers Strike to Protest Budget Cuts. Public transportation in France has come to a standstill as rail workers protest the Juppé government's plans to cut welfare spending and reform the pensions system. The national rail service has been on strike since November 24. Virtually all public transport across the country remained out of service on November 30, forcing many commuters to walk, hitchhike, and even rollerblade to work. In Paris 10,000 students protested on Thursday against underfunding of higher education; in Toulouse as many as 30,000 students took to the streets. The government's spending cuts are part of its effort to reduce the budget deficit from 5 percent of GDP to the limit of 3 percent required for participating in the European Union's move to a single currency.

U.K. Announces Budget Package. Chancellor of the Exchequer Kenneth Clarke unveiled the United Kingdom's 1996-7 budget on November 28. The budget deficit is currently 5 percent of GDP, but the new package nevertheless includes a small reduction in taxes. The basic income tax rate will be lowered from 25 to 24 percent, and the tax rate on investment income will fall from 25 to 20 percent. The income tax exemption level will also be raised, relieving an estimated 220,000 low-income people from having to pay income tax. The budget also includes some spending cuts, with increases in real expenditure on social insurance and welfare programs, the single largest budget item, restricted to 1 percent per year, by eliminating benefit eligibility for illegal immigrants and by reducing housing benefit for single people under 25. The government has also pledged to reduce the share of public spending from 42 percent of GDP to below 39 percent within the next three years.

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RELEASES THIS WEEK

Advance Durable Orders

Advance estimates show that new orders for durable goods decreased 1.0 percent in October, following increases of 2.9 percent in September and 5.1 percent in August.

Housing Starts

Housing starts declined 4 percent in October to 1.34 million units at an annual rate.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, increased 5.1 index points in November, to 101.4 (1985=100).

MAJOR RELEASES NEXT WEEK

Leading Indicators (Wednesday)
Employment (Friday)
GDP Benchmark Revisions for
1959-92 (Friday)

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U.S. ECONOMIC STATISTICS

	1970–1993	1994	1995:1	1995:2	1995:3
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	2.7	1.3	4.2
Chain weights	2.7	3.7	1.7	0.7	3.0
GDP implicit price deflator:					
Fixed weights	5.5	2.3	2.2	1.6	0.6
Chain weights*	5.4	2.7	2.8	2.2	1.9
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	2.5	4.9	2.0
Chain weights	1.4	0.9	0.2	3.4	0.7
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.0	0.3	1.0
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.5	3.2
Chain weights*	1.2	0.7	1.8	1.4	1.8

* CEA estimates.

	1970–1993	1994	1995:1	1995:2	1995:3
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	14.1
Residential investment	4.7	4.3	4.2	4.0	4.1
Exports	8.0	12.3	12.9	13.1	13.3
Imports	9.2	14.4	15.1	15.4	15.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	3.1
Federal surplus	–2.8	–2.4	–2.1	–1.8	N.A.

	1970–1993	1994	Aug. 1995	Sept. 1995	Oct. 1995
Unemployment Rate	6.7**	6.1**	5.6	5.6	5.5
Payroll employment (thousands)					
increase per month			263	50	116
increase since Jan. 1993					7527
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.1	0.3
PPI-Finished goods	5.0	1.7	–0.1	0.3	–0.1

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

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FINANCIAL STATISTICS

	1993	1994	Sept. 1995	Oct. 1995	Nov. 30, 1995
Dow-Jones Industrial Average	3522	3794	4747	4760	5074
Interest Rates					
3-month T-bill	3.00	4.25	5.28	5.28	5.30
10-year T-bond	5.87	7.09	6.20	6.04	5.76
Mortgage rate, 30-year fixed	7.33	8.35	7.64	7.48	7.33
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 30, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.447	+2.9	−7.8
Yen-Dollar	101.8	+1.3	+2.9
Multilateral $ (Mar. 1973=100)	85.31	+2.2	−4.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q3)	5.5 (Oct)	2.8 (Oct)
Canada	1.9 (Q3)	9.2 (Sept)	2.4 (Oct)
Japan	0.6 (Q2)	3.2 (Sept)	0.2 (Sept)
France	2.1 (Q3)	12.1 (Aug)	1.8 (Oct)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (Jul)	5.8 (Oct)
United Kingdom	2.0 (Q3)	8.6 (Sept)	3.2 (Oct)