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Weekly Economic Briefing Jun. 24, 1997

THE PRESIDENT HAS SEEN

1-27-97

Sumner

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

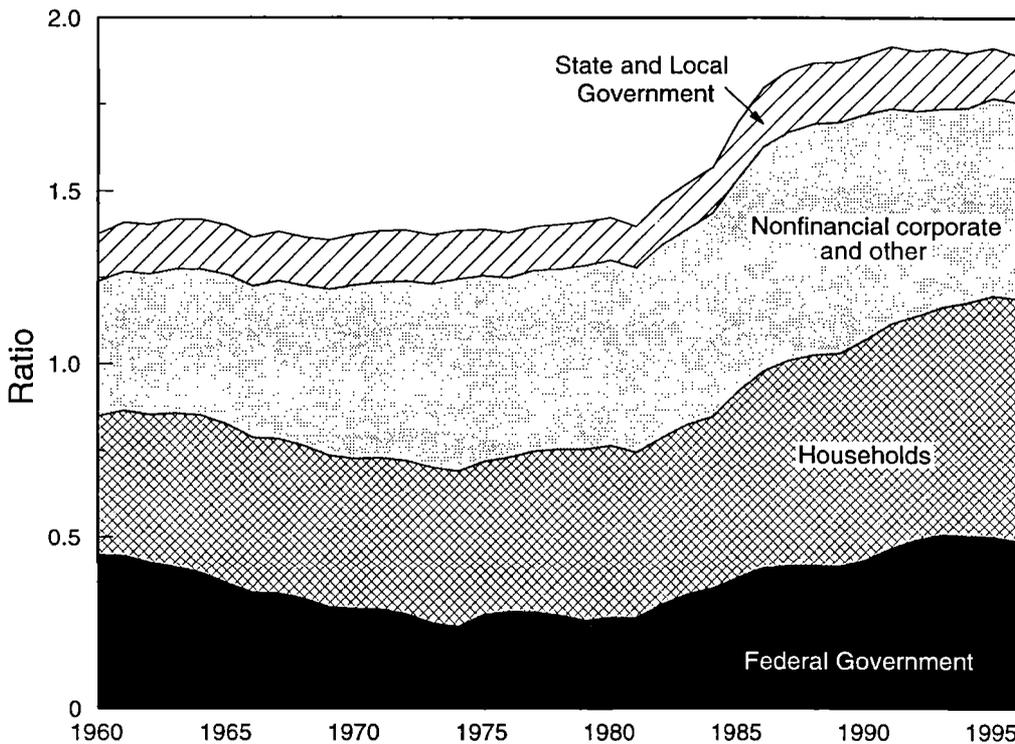
January 24, 1997

1-27-97

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w/notes)*

CHART OF THE WEEK

Domestic Debt-to-GDP Ratio



Taken together, borrowing by the Federal government, households, nonfinancial businesses, and state and local governments has remained constant as a share of GDP during this expansion. Thus, little evidence exists of a borrowing binge or financial imbalances that might threaten the expansion. Nevertheless, the sharp increase in the domestic debt-to-GDP ratio that occurred in the 1980s has not been reversed.

PHOTOCOPY
WJC HANDWRITING

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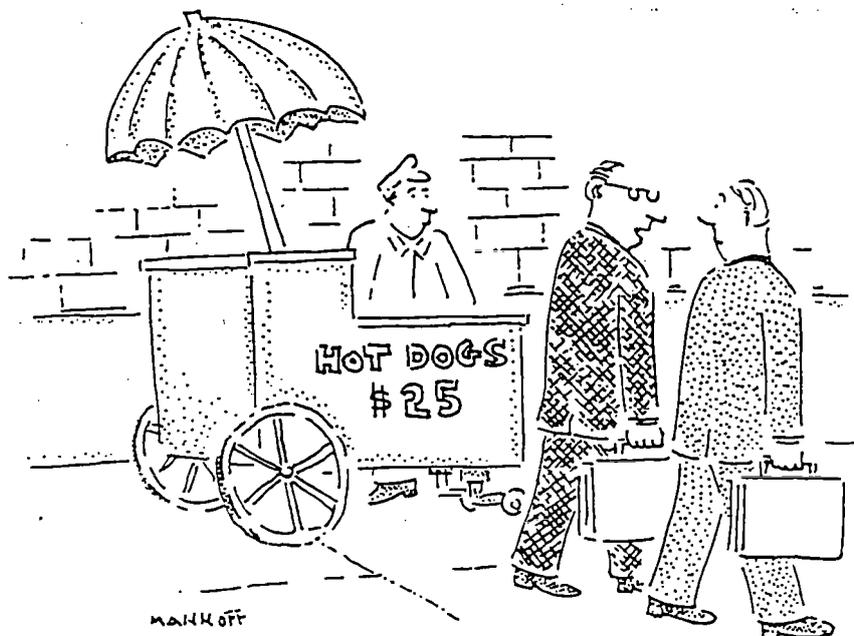
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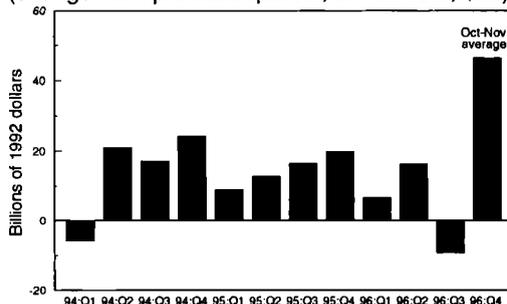
"I told you the Fed should have tightened."

MACROECONOMIC UPDATE

Economy Picks Up Speed in the Fourth Quarter

Recent indicators show that the pace of aggregate demand picked up in the fourth quarter. Next week's advance estimate of real GDP growth for the fourth quarter probably will be in the 3½ to 4 percent range at an annual rate, up substantially from the 2.1 percent pace of the third quarter.

Exports of Goods and Services (BOP Basis)
(change from previous quarter, annual rate, \$92)

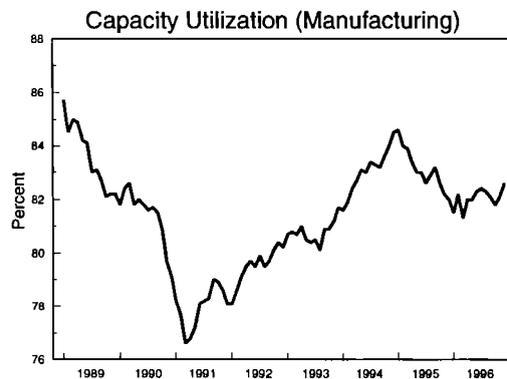


Note: Deflated by implicit export deflator (NIPA bases); Oct-Nov by BLS export price index.

Exports lead the way. Exports appear to have rebounded after anemic growth earlier in the year (see upper chart). This pickup may reflect an acceleration of foreign economic activity. A speedup in growth in the major European economies has been forecasted, in part because of lower interest rates.

Other signs of growth. Nonresidential construction and inventories also appear to have contributed to a rapid pace of U.S. fourth-quarter growth. Stronger demand is evident in the acceleration of employment growth to 217,000 per month in the fourth quarter, up from 171,000 per month in the third. Looking ahead, first-quarter

growth is likely to be strong as well. Motor vehicle production schedules indicate a significant pickup. And solid income growth seems likely to support further gains in consumption.



Price pressure? Core inflation remains stable and few reports of bottlenecks have surfaced. But the economy has less economic slack than a year ago. Over the 12 months of 1996, the unemployment rate fell 0.3 percentage

point; capacity utilization rose 0.6 percentage point (see lower chart); and more purchasing managers report delays in obtaining supplies. Next Tuesday's employment cost index—which probably will show a rise because of the recent increase in the minimum wage—will be closely watched for evidence of inflationary pressures.

SPECIAL ANALYSIS

No Big Revenue Echo Expected from Stock Boom

Capital gains tax revenues are projected to grow more slowly than the economy as a whole over the next decade, notwithstanding the surge in the stock market over the past 2 years.

Why so glum, chum? Several factors explain why a rise in average stock prices may have little impact on income tax revenues from capital gains:

- Stocks make up only a quarter of total asset holdings by households and much of these holdings are in tax favored forms, such as IRAs and pension funds.

| | Amount (trillion) | Share (%) |
|--|----------------------|--------------|
| Residential real estate | \$8.2 | 24.3 |
| Consumer durables and other tangible assets | 3.4 | 10.0 |
| Equity holdings | 8.4 | 25.0 |
| Other financial assets | 13.7 | 40.7 |
| Total | \$33.8 | 100.0 |

- Capital gains income is recognized for tax purposes only when an asset is sold, and taxpayers can match gains with offsetting losses to minimize tax liability.
- For assets held at the time of a taxpayer's death, no income taxes are owed on accumulated capital gains, and a new basis equal to market value at time of death is established for heirs. Each year, about \$25 billion escapes taxation through this "step up at death" loophole.
- New tax strategies, often involving financial derivatives, have been developed for high-income taxpayers to let them "lock in" capital gains without actually selling the underlying assets and incurring a tax liability. The pace of financial instrument innovation seems likely to outpace Congress' ability to close such loopholes.

Effects of a rate cut. A capital gains tax rate reduction could increase revenue in the short run by accelerating sales that otherwise would have taken place later. But a simple acceleration of sales due to a rate cut would produce a net revenue shortfall over the long run. While some permanent increase could occur if these sales involve assets that might otherwise have been held until death, the economic literature suggests that such an effect is likely to be small compared to the direct revenue loss from lower rates. Thus a capital gains rate cut most likely would make it more difficult to achieve and maintain a balanced budget in future.

SPECIAL ANALYSIS

THE PRESIDENT HAS SEEN

1-27-97

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The Impact of Medicaid Expansions

Until 1984, the close historical tie between Medicaid eligibility and participation in Aid to Families with Dependent Children (AFDC) limited Medicaid to single-parent households with very low incomes. Since 1984, eligibility has been expanded substantially. The increased coverage associated with these expansions has improved the health of infants and children. But the net increase in coverage was far less than the increase in eligibility.

Medicaid expansions and health outcomes. The period from 1984 to 1987 saw incremental increases in Medicaid eligibility to populations with circumstances similar to AFDC families. For example, coverage was extended to children of two-parent families meeting the AFDC income criteria and pregnant women who would become eligible for the program once their children were born. After 1987, Medicaid and AFDC eligibility were virtually decoupled. By 1992, states were required to provide Medicaid coverage to all children under the age of 6 living in households with incomes no more than 133 percent of the poverty line and to all pregnant women in such households.

These expansions produced important health improvements. For instance, making expectant mothers eligible for Medicaid greatly increased their chances of receiving prenatal care in the first trimester of pregnancy. Increased eligibility between 1984 and 1992 was associated with roughly a 1.6 percent decline in low-birthweight babies, a 7.3 percent decline in infant mortality and an 8.8 percent decline in child mortality.

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Effects on Medicaid eligibility and coverage. Although eligibility expanded greatly, take-up rates in means-tested programs like Medicaid are relatively low and many of the newly eligible already had private health insurance. Hence, the net increase in Medicaid coverage was much smaller than the increase in eligibility. Between 1984 and 1992, the fraction of children eligible for Medicaid rose from 16 to 31 percent while the proportion actually covered by Medicaid increased from 13 to 21 percent. Among women, an increase in eligibility of more than 25 percentage points led to an increase in coverage of only about 2 percentage points for some types of expenses.

*

The net increase in health insurance coverage is even smaller, because the Medicaid expansions also decreased private health insurance coverage. Some families may have replaced costly private insurance with free Medicaid coverage, even though some family members who were not eligible for Medicaid may have lost coverage altogether as a result. Some employers may have reduced their coverage because they thought more of their employees would be eligible for Medicaid coverage.

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Don Baer*

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1-27-97

| <u>Group</u> | Change in Millions of Persons Covered | |
|-------------------|---------------------------------------|--------------------------|
| | <u>Medicaid</u> | <u>Private Insurance</u> |
| Children | 1.5 | -0.6 |
| Women, aged 15-44 | 0.7 | -0.8 |
| Other Adults | -- | -0.3 |
| Total | 2.2 | -1.7 |

A recent study examining the extent of such "crowding-out" estimated that the Medicaid expansions occurring over the 1987-1992 period added 2.2 million individuals to the program but reduced private health insurance coverage by 1.7 million people (see table). These figures probably overstate the extent of crowding out, because some persons who have not signed up for Medicaid may end up receiving coverage anyway. For example, hospitals frequently enroll eligible pregnant women and children who show up without coverage.

* **Impact of targeting.** Medicaid expansions between 1984 and 1987 were narrowly targeted, expanding coverage among very low-income households. Expansions between 1987 and 1992 included households with higher incomes that were more likely already to have private insurance. Not surprisingly, improvements in health outcomes were larger and less costly for the very low-income population targeted by the earlier expansions. The higher cost for those covered by the later expansions raises the hard question of how to extend coverage to categories of people where some have health insurance and others do not without causing large reductions in private insurance coverage.

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ARTICLE

Preserving Genetic Crop Diversity

Food production in the first two decades of the next century will be as large as total production since the beginning of agriculture. To sustain this trend in the face of increasing scarcity of arable land, advances in genetics that produce new, higher-yielding crop varieties will be crucial. So too will be the conservation of the tropical "centers of genetic diversity" that make these advances possible.

Genetic diversity versus monoculture production. Virtually all of the raw material for developing new crop varieties comes from centers of genetic diversity that are typically located far from centers of actual crop production. Generally, centers of diversity are mountainous areas, usually near the tropics, where small, isolated populations have established and maintained agriculture with relatively sporadic outside contact.

Most crop production worldwide occurs as monoculture in relatively gene-poor ecosystems. For example, most corn production occurs in the United States and China, far from its center of diversity in Latin America. Yields are often higher when a plant is grown in the absence of its close genetic relatives, which tend to be its natural competitors. Removal of a crop to a gene-poor environment frequently is an effective, economical, non-chemical means of achieving high yields.

Private versus social incentives. From a private producer's perspective, growing a single variety makes economic sense. Farmers have an incentive to select the crop variety with the greatest yields and lowest cost of production on an individual field. Marketers and consumers prefer a uniform raw product, and legal restrictions often reinforce these desires. In the United States, for example, marketing orders frequently stipulate size and color limitations based on old varieties, and a number of States have "one variety laws" severely restricting the types of plants that can be commercially produced.

From a social perspective, crop genetic uniformity can be dangerous. The Irish potato famine demonstrates the magnitude of human suffering that can result from a lack of genetic diversity (see box on next page). In 1970 the Southern corn leaf blight epidemic caused a 15 percent drop in U.S. corn output. A study by the National Academy of Sciences around this time found that major U.S. crops were "impressively uniform and impressively vulnerable."

In situ conservation. Biologists agree that the best method for preserving genetic resources is in situ preservation, as occurs, for example, in farmers' gardens and their weedy margins. This method preserves the whole complex of life forms, known and unknown, and allows them to continue to evolve together.

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Continued in situ preservation of most major crops requires continued active human participation in traditional farming methods, especially in genetically diverse environments. Unfortunately, maintaining crops in such areas is not generally consistent with traditional forms of economic development. Thus, it is unlikely that farmers in centers of diversity will provide an optimal degree of crop genetic diversity. Economists have suggested subsidizing traditional farming methods as a way to conserve the agricultural gene pool. A more controversial proposal is to compensate indigenous people for flows of genetic material out of high-diversity areas.

Gene banking. Gene banks can complement in situ preservation. In the past two decades, the number of gene banks worldwide has increased from 53 to 133. The largest holdings are in the United States, China, and Russia.

Good gene banking requires more than simple collection and preservation of genetic material; indeed, many biologists warn about the danger of gene banks becoming “seed morgues.” Varieties must be economically available to breeding enterprises on a timely basis. If breeders’ needs change rapidly and unpredictably, as is often the case with respect to genes for disease resistance, good communication and ready availability of seed stocks become critical.

Conclusion. Government has more incentive to preserve crop genetic diversity than do individual farmers and plant breeders. Preserving diversity, as opposed to simply growing the highest-yielding variety, increases society’s ability to deal with unanticipated disease or pest problems in the future. In situ conservation is the best option, but may conflict with continuing economic development. External gene banks are a valuable complement to in situ preservation, and are effective when they provide timely access to needed genetic material in a crisis.

The Irish Potato Famine

The Irish potato famine of 1845-49 dramatically illustrates the damage that can result from relying on a genetically uniform food plant introduced from outside. Many varieties of potato occur in their natural region of origin in the Andes. Ireland had become very dependent on one particular variety for its food supply by the middle of the 19th century. The infestation that struck then might have caused little problem if resistant varieties were available. As it was, however, it devastated the Irish potato crop, leading to widespread hunger and heavy outmigration.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Moderate Growth Across Regions. Economic growth in December and early January was moderate in most parts of the country according to the latest Federal Reserve regional survey. Holiday sales were in line with retailers' expectations and manufacturing activity continued to grow, with significant strength coming from capital equipment and materials manufacturers. Bank loan activity continued at high levels, with mixed growth across Districts. Residential real estate markets remained stable or improved in most areas; commercial real estate markets were almost uniformly tight. District reports provided scattered evidence of increasing wage pressures, particularly for skilled workers, but in general did not indicate significant price pressures other than for energy items.

Recent Survey Shows Net Worth Rises. The Federal Reserve has just released its Survey of Consumer Finances, which provides information on the income, net worth, assets, and liabilities of U.S. families in 1995. Both median family income and net worth rose in constant dollars since 1992, the last time the survey was conducted (in 1995, median family wealth was \$56,400). Stock ownership and its importance in families' wealth rose over this period. In 1995, more than 41 percent of families owned stock, compared with about 37 percent in 1992. These assets accounted for about 40 percent of their total financial assets, compared with 34 percent in 1992. The survey provided little evidence of a serious rise in debt payment problems between 1992 and 1995, even though both the share of families with debt and the median amount of their debt rose. Looking at the longer-term trend, net worth returned to its 1989 level in 1995, while median family income remained lower in 1995 than it was in 1989. (This is similar to the trend in Census median family income).

What Children Need to Know about Economics. How are prices of candy bars and compact disks determined? A recently released report indicates that students should be taught that these and other prices are determined by the interaction of supply and demand. The report by the National Council on Economic Education responds to Goals 2000: The Educate America Act of 1994, which listed economics as one of nine core subject areas in which teaching standards should be developed. The Council's report identified 20 concepts that students should understand along with benchmarks for expected achievement in grades 4, 8, and 12. Aside from price determination, these concepts include: (1) scarcity of productive resources requires people to choose some things and give up others; (2) effective decision-making requires weighing the costs and benefits of particular actions; (3) federal government budgetary and monetary policy influence the overall levels of employment, output, and prices.

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INTERNATIONAL ROUNDUP

Korean Unrest Nearing Resolution? In an effort to resolve a 3-week-old labor strike that could impose substantial costs on the South Korean economy, President Kim Young Sam agreed this week to enter discussions on a controversial new labor law and suspend arrest warrants for strike leaders. The controversial labor law, which was passed last month in a dawn meeting of the National Assembly to which opposition leaders were not invited, introduces a flexible work hour system, allows managers to dismiss workers in order to facilitate company restructuring, and restricts union activity. Previously, President Kim had refused to change the new labor law, which management argues is necessary to increase labor market flexibility and international competitiveness in an economy stifled by companies providing lifetime employment. In a review of the legislation, the OECD Committee for Employment, Labour and Social Affairs complained that the law does not meet commitments on freedom of association and collective bargaining made by Korea when it joined the OECD last month.

Priorities Set for Bosnian Reconstruction. Meeting for 2 days in Brussels, officials from over 50 countries and 30 international institutions stressed infrastructure development, fiscal reforms, employment creation, and return of refugees as top priorities for Bosnian reconstruction in 1997. Over this past year, strong donor support has already facilitated significant economic progress. Unemployment fell, wages rose almost threefold while prices remained fairly stable, and GDP grew an estimated 35 percent. Yet reconstruction remains far from complete, with industrial production at only 10 to 15 percent of its pre-war level, unemployment hovering between 50 and 60 percent, and the only social safety net provided by international donors. The situation is worse in neighboring Serbia where growth is stagnant and inflation high as the country emerges from internationally imposed economic sanctions. Donors estimate financing needs at \$2.5 billion for 1997-98, to be allocated both to the Federation of Bosnia and Herzegovina and to Serbia.

Belgian Ministers Remain Optimistic While Struggling to Meet Maastricht Criteria. Belgium's 1996 budget deficit came in at 3.4 percent of GDP, which was higher than predicted and higher than the 3 percent criterion under Maastricht. With slow economic growth (1.4 percent) contributing to lower-than-expected revenues and higher-than-expected unemployment benefits and health care expenditures, the desired 3 percent deficit was unattainable. Belgium also continues to run a cumulative debt of over 130 percent of its GDP, well above the 60 percent requirement. Yet, Belgian ministers remain optimistic, pointing out that although the budget deficit was higher than initially forecasted, expenditures had fallen during a time of slow economic growth. They predict that the deficit will continue downward to meet the 3 percent criterion in 1997, the crucial year for EMU admission. It is widely believed that Belgium will be exempted from the virtually impossible criterion of reducing its debt to 60 percent of GDP.

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RELEASES THIS WEEK

Housing Starts

Housing starts decreased 12 percent in December. For the year 1996, 1.474 million housing units were started, up 9 percent over 1995.

MAJOR RELEASES NEXT WEEK

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

U.S. ECONOMIC STATISTICS

| | 1970- 1993 | 1995 | 1996:1 | 1996:2 | 1996:3 |
|--|-----------------------|-------------|----------------------|----------------------|----------------------|
| Percent growth (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | 1.3 | 2.0 | 4.7 | 2.1 |
| GDP chain-type price index | 5.3 | 2.5 | 2.3 | 2.2 | 2.0 |
| <u>Nonfarm business (NFB) sector:</u> | | | | | |
| Productivity (chain-type) | 1.5 | -0.1 | 1.9 | 0.6 | -0.3 |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 1.0 | 0.2 | 0.1 | 1.1 |
| Using NFB deflator | 1.3 | 1.7 | 2.0 | 2.0 | 2.0 |
| Shares of Nominal GDP (percent) | | | | | |
| Business fixed investment | 10.9 | 10.2 | 10.4 | 10.3 | 10.6 |
| Residential investment | 4.5 | 4.0 | 4.1 | 4.2 | 4.1 |
| Exports | 8.2 | 11.1 | 11.3 | 11.3 | 11.1 |
| Imports | 9.2 | 12.4 | 12.5 | 12.6 | 12.7 |
| Personal saving | 5.1 | 3.4 | 3.6 | 3.2 | 3.9 |
| Federal surplus | -2.7 | -2.2 | -2.1 | -1.7 | -1.6 |
| <hr/> | | | | | |
| | 1970- 1993 | 1996 | Oct. 1996 | Nov. 1996 | Dec. 1996 |
| Unemployment Rate | 6.7** | 5.4** | 5.2 | 5.3 | 5.3 |
| Payroll employment (thousands) | | | | | |
| increase per month | | | 261 | 127 | 262 |
| increase since Jan. 1993 | | | | | 11176 |
| Inflation (percent per period) | | | | | |
| CPI | 5.8 | 3.3 | 0.3 | 0.3 | 0.3 |
| PPI-Finished goods | 5.0 | 2.8 | 0.4 | 0.4 | 0.5 |

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

FINANCIAL STATISTICS

| | 1995 | 1996 | Nov. 1996 | Dec. 1996 | Jan. 23, 1997 |
|-------------------------------------|------|------|--------------|--------------|------------------|
| Dow-Jones Industrial Average | 4494 | 5743 | 6318 | 6436 | 6756 |
| Interest Rates | | | | | |
| 3-month T-bill | 5.49 | 5.01 | 5.03 | 4.91 | 5.04 |
| 10-year T-bond | 6.57 | 6.44 | 6.20 | 6.30 | 6.60 |
| Mortgage rate, 30-year fixed | 7.95 | 7.80 | 7.62 | 7.60 | 7.85 |
| Prime rate | 8.83 | 8.27 | 8.25 | 8.25 | 8.25 |

INTERNATIONAL STATISTICS

| Exchange Rates | Current level | Percent Change from | |
|---------------------------------|----------------------|----------------------------|-----------------|
| | Jan. 23, 1997 | Week ago | Year ago |
| Deutschemark-Dollar | 1.641 | 2.8 | 10.7 |
| Yen-Dollar | 119.7 | 2.7 | 13.1 |
| Multilateral \$ (Mar. 1973=100) | 92.68 | 2.7 | 6.5 |

| International Comparisons | Real GDP growth | Unemployment rate | CPI inflation |
|----------------------------------|--------------------------|--------------------------|-------------------------|
| | (last 4 quarters) | | (last 12 months) |
| United States | 2.2 (Q3) | 5.3 (Dec) | 3.3 (Dec) |
| Canada | 1.6 (Q3) | 10.0 (Nov) | 2.0 (Nov) |
| Japan | 3.2 (Q3) | 3.3 (Nov) | 0.5 (Oct) |
| France | 1.4 (Q3) | 12.8 (Oct) | 1.6 (Nov) |
| Germany | 1.9 (Q3) | 7.5 (Nov) | 1.5 (Nov) |
| Italy | 0.7 (Q3) | 11.9 (Jul) | 2.7 (Nov) |
| United Kingdom | 2.4 (Q3) | 7.4 (Nov) | 2.7 (Nov) |