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THE PRESIDENT HAS SEEN

BE 10-23-96

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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

October 18, 1996

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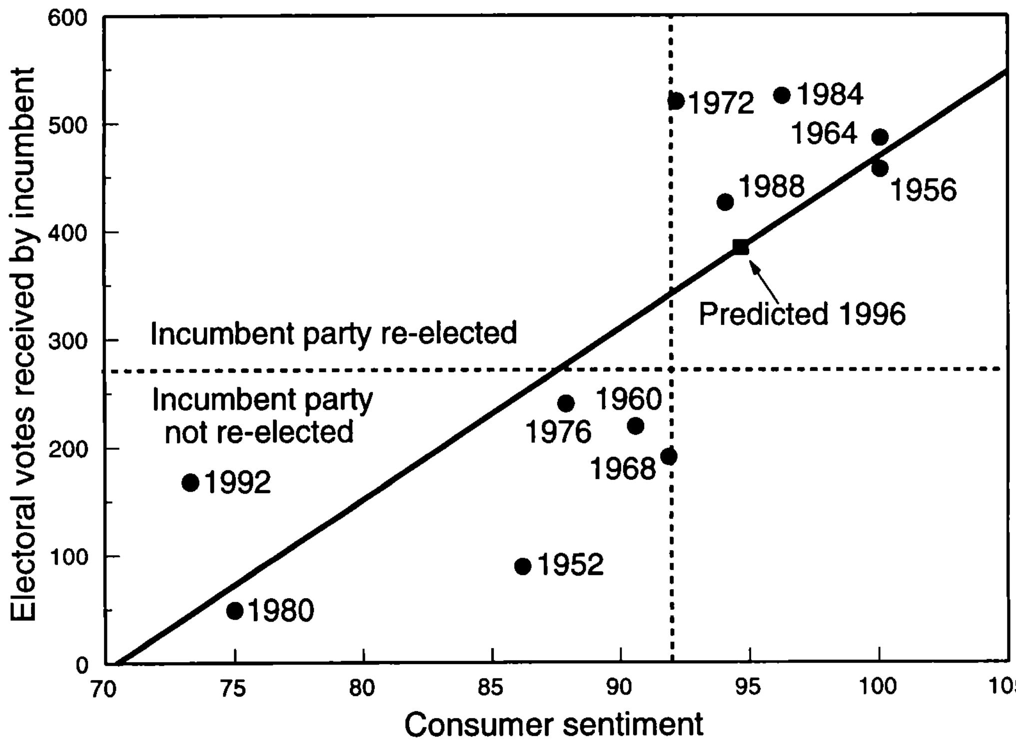
CHART OF THE WEEK

Consumer Sentiment and Electoral Votes



Since its inception in 1952, the University of Michigan's consumer sentiment index has turned out to be an infallible predictor of Presidential election winners. Higher levels of consumer confidence translate into more electoral votes for the incumbent (or his party's nominee). The incumbent party has won every election in which the consumer sentiment index in the month before the election was above 92. Consumer sentiment in September was 94.7 and will be about that in October as well.

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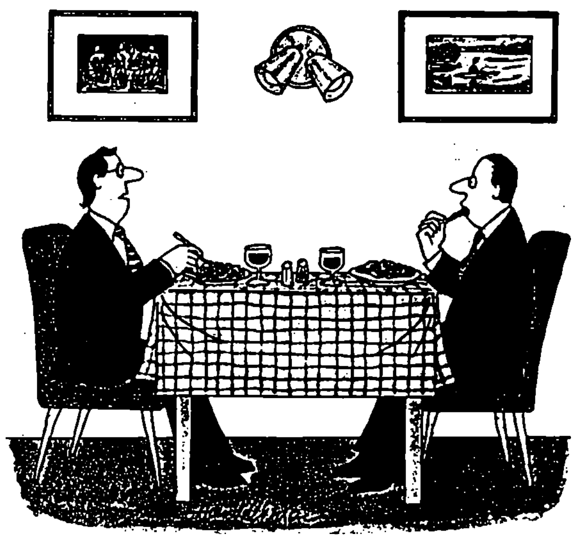


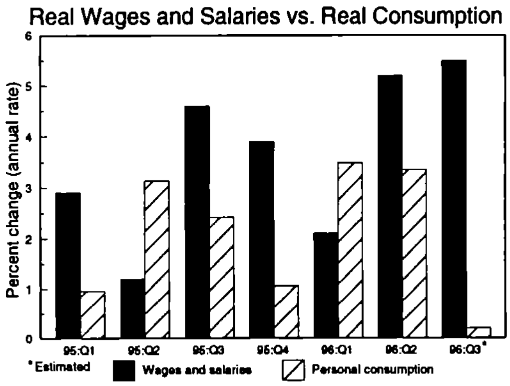
"As a nation, we may be spending our children's money, but at my house it's the other way around."

MACROECONOMIC UPDATE

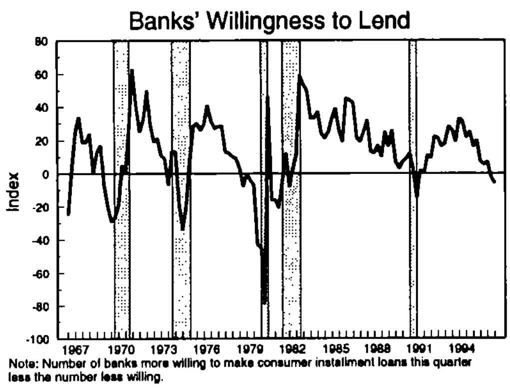
Slower Growth in Second Half of Year

Economic growth is slowing in the second half of the year—but it is not clear by how much.

Mixed signals. The third quarter shows a puzzling discrepancy between income growth (which is relatively strong) and spending (which is weak). Despite large gains in real wages and salaries, for example, consumption spending rose negligibly in the third quarter (see upper chart). Yet industrial production rose 4.4 percent. Where did this output go? Incomplete data point to a rebuilding of inventories, which had become excessively lean during the second quarter. Even so, the October 30 estimate of GDP growth is likely to be only 1½ to 2½ percent.



No clear reason for the abrupt slowdown in consumption is evident. Some observers have pointed to an increasing reluctance by banks to lend to consumers as reported in Federal Reserve surveys (see lower chart). Yet most of the fundamentals of consumption are still favorable: consumer confidence is high; income growth is robust; and the net-worth-to-income ratio of households is at its highest level since 1961. Thus, the recent slowdown in consumption is likely to be temporary.



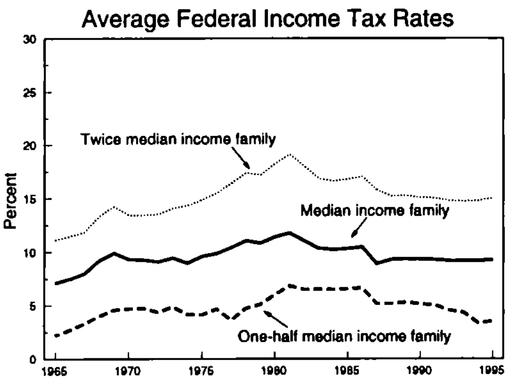
Motor vehicles. Thus far, damage to U.S. production from the Canadian autoworkers strike has been small. And parties said this week that they are making progress toward a settlement. Should talks collapse, however, the ripple effects of the strike could eventually shut down most of General Motors' U.S. operations by the end of October. Because GM sales account for about 1 percent of U.S. GDP, this could have a significant effect on fourth-quarter growth. Strike effects aside, schedules indicate that motor vehicle production will be a drag on fourth-quarter growth.

Next year. The economy is probably close to its non-inflationary capacity. If the economy grows much faster than its 2.3 percent potential growth rate, inflation probably will edge up. The consensus, however, expects real GDP growth to slow on its own to 2.0 percent in 1997, averting a rise in inflation.

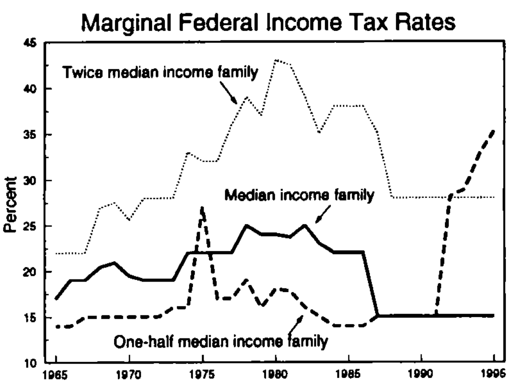
SPECIAL ANALYSIS

Are We Living in More Taxing Times?

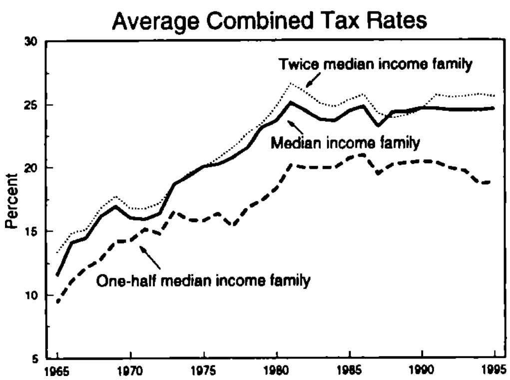
For a typical middle class family, average and marginal Federal income tax rates were the same or lower in 1995 than they were in most of the 1980s. The story is a little less clear, however, when payroll taxes are included in the analysis.



Income taxes. The upper chart shows trends in Federal income taxes as a percent of income for the median 4-person family ($49,687 in 1995). It also shows trends for families with half and twice this median income. Rates have been relatively constant for these middle and upper income families in the 1990s (the 1993 tax increases only affected families with more than 3 times median income). Expansion of the Earned Income Tax Credit (EITC) has substantially lowered average tax rates for lower income working families. Overall, the income tax system has been progressive.

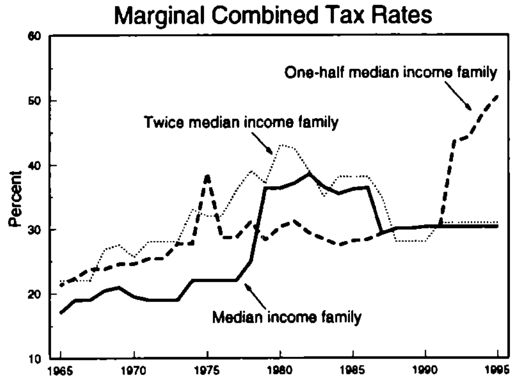


Higher income families tend to face higher marginal rates than lower-income families. In recent years, however, phase-out provisions in the EITC (which affect families of 4 whose income falls between 20 and 55 percent of median income) have resulted in high marginal tax rates on many lower income families (see middle chart). EITC phase-out considerations aside, marginal tax rates for typical families are as low as at any time during the 1980s.



Effects of including payroll taxes. A more comprehensive analysis incorporating both payroll taxes and income taxes shows higher average tax rates (see lower chart). Including both the employer and employee share of Social Security and Medicare payroll taxes, for example, raises the average tax burden on the half-median-income family from 3.5 percent to 18.8 percent. Because a worker's ultimate Social Security benefits are related to wages (and hence to the amount of taxes paid), it is unclear exactly how much should be considered as a current tax burden and how much a purchase of future Social Security benefits.

Marginal Combined Tax Rates



The marginal tax rate story is somewhat different when payroll taxes are part of the analysis. In recent years, marginal tax rates on wage income are nearly identical for median and twice-median income families, while marginal tax rates on half-median income families are quite a bit higher (see chart).

Implications. Average tax rates are indicators of progressivity, while marginal tax rates affect economic behavior. Therefore, lower income families may face greater disincentives for work and saving than many higher income families. This effect is exacerbated if phase-outs for transfer programs are added to the analysis.

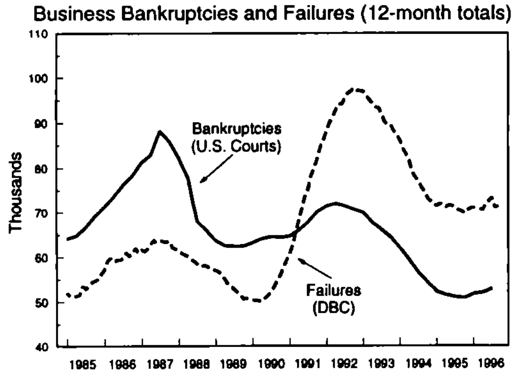
SPECIAL ANALYSIS

No Dangerous Trend in Business Bankruptcies

The personal bankruptcy rate has been rising (see *Weekly Economic Briefing,* July 19, 1996). But measures of business bankruptcies and failures remain relatively benign.

Filings. The number of business bankruptcy filings reported by the Administrative Office of the United States Courts declined ~~sharply between 1992 and~~ 1995, most ~~likely reflecting the economic recovery~~ and expansion (see upper chart). Despite a small rise over the past year, the level of business bankruptcies remains more than 25 percent below its 1992 peak. Moreover, the level of bankruptcies over the past 2 years has been lower than for any comparable interval over the previous dozen years.

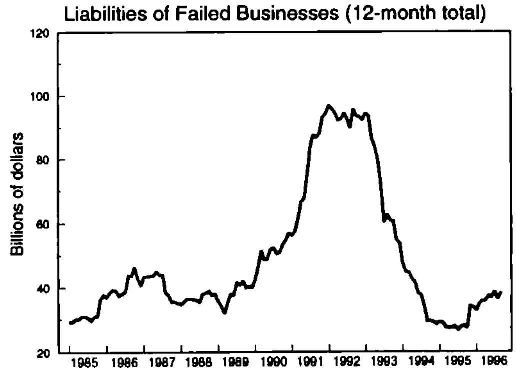
Business Bankruptcies and Failures (12-month totals)



Failures. Data on business failures and liabilities collected on a consistent basis since 1984 are published by the Dun and Bradstreet Corporation (DBC). They provide an alternative indicator of business stress. DBC defines failures to include all businesses that cease operations without paying creditors in full. Thus, DBC includes firms that go out of business without filing for bankruptcy but excludes firms that continue to operate after filing for bankruptcy.

The DBC data on the number of business failures show a pattern similar to that of business bankruptcies in recent years. In contrast to the bankruptcy data, however, the number of failures over the past 2 years has been higher than the levels that prevailed in the 1980s. In part, this difference may reflect improvements in coverage by DBC.

Liabilities of Failed Businesses (12-month total)

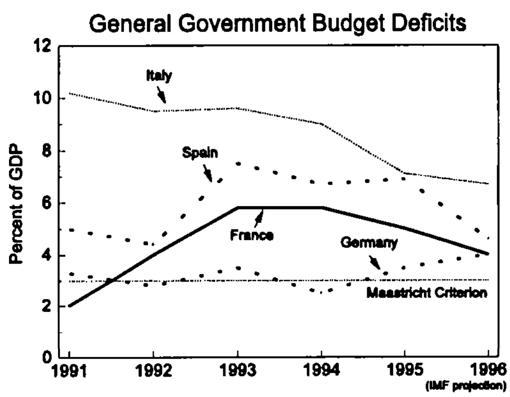


Liabilities. DBC data on the liabilities of failed businesses show a substantial rise since mid-1995 (see lower chart). However, this rise starts from a very low level—the liabilities of failed firms over the 12 months ending in June 1995 were the lowest on record. The increase in liabilities of failed businesses since that time reflects both a general up-trend and the effect on the 12-month total of a large ($6 billion) spike in the liability series in October 1995—possibly the result a large company's reorganization known to have occurred that month.

ARTICLE

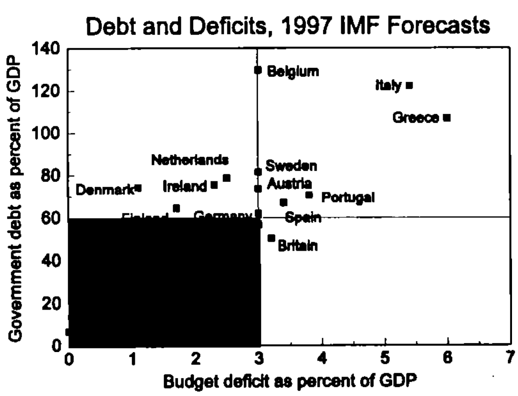
Monetary Union or Bust

Smoke and mirrors budget-making is more prevalent than usual in the 1997 budget plans introduced recently by some European governments hoping to be admitted into the European monetary union in 1999. The Maastricht budget criterion for EMU admission requires that a country's total budget deficit (including social insurance) for all levels of government not exceed 3 percent of GDP in 1997.



Deficits have been running higher than this in many countries (see upper chart). The Maastricht agreement also requires that the stock of debt be less than 60 percent of GDP (see lower chart), although high-debt countries that are making significant progress may get an exemption. Despite these debt and deficit concerns, tax cuts loom large in several budget plans.

France. Slow growth will prevent France from achieving its 1996 deficit target of 4 percent of GDP. Nevertheless, Prime Minister Juppé has announced a 1997 target equal to exactly 3 percent of GDP. Belatedly fulfilling a broken 1995 campaign promise of President Chirac, he has also announced plans to cut income tax rates while eliminating a host of special exemptions and deductions. To pay for the tax cut and meet the deficit target, total central government spending except social security will be frozen in nominal terms. Even this will not be sufficient, so the government will book an accounting transfer equal to 0.45 percent of GDP from France Télécom. This move is widely considered a gimmick, since the transfer is offset by the government's assumption of the obligation to pay the pensions of workers at the soon-to-be-partially-privatized telephone company. Deeper genuine cuts now would have been very difficult in France, which suffers from slow growth and 12.5 percent unemployment.



Germany. The Germans plan to make the target without resorting to such gimmicks. Chancellor Kohl's budget calls for $45 billion in spending cuts next year, or 2 percent of GDP, although details still depend on negotiations with the opposition Social Democrats. Key proposals include reductions in the transportation and defense ministry budgets, and reduced spending on unemployment benefits, despite

Germany's 10.4 percent unemployment rate. Taxes will also fall, mainly at the Länder (state) level. The target is for a general government deficit of 2.5 percent of GDP, down from 4 percent this year. Income tax reform similar to that of France is also in the cards, but not until 1999. The government, if it stays in power after the 1998 elections, plans to cut Germany's high marginal income tax rates and eliminate tax breaks such as deductions for depreciation of housing.

Italy. Hamstrung by interest payments on its high government debt, Italy is likely to turn in a deficit of 6.7 percent this year, but it appears determined not to be left behind at the start of the EMU. The government has set off on a forced march designed to bring the deficit down to the Maastricht target next year. Part of the government's strategy is a special income tax, called the "pro-Europa tax," that is supposed to bring in $8.5 billion. Spending cuts, including welfare, and French-style financial gimmicks are also in the plan.

Spain. Like Italy, Spain has not been considered a prime candidate for early inclusion in monetary union, but the Spanish government is also making a serious effort to qualify for entry. It plans to bring the deficit down from this year's level of 4.4 percent through spending cuts, tax increases, and creative accounting.

Conclusion. To guard against backsliding after the start of the EMU, European ministers have informally agreed to a system of fines if members of monetary union run persistent deficits above the 3 percent level. If such a mechanism is added to monetary union, European countries will be gaining fiscal probity, but they will be sacrificing their ability to use either monetary or fiscal policy to combat high levels of unemployment that currently exist in most European countries.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

ADM Receives Largest Antitrust Fine In History. This week the agribusiness giant Archer Daniels Midland announced that it is pleading guilty to criminal price fixing charges and paying a fine of $100 million. The pleas and fines involved collusion to fix prices of lysine, an additive in animal feed, and citric acid, a preservative and common component of soft drinks. Charges involving high-fructose corn syrup (a market that may well owe its existence to Federal sugar quotas) were dropped. And ADM's ethanol production (a market in which it has a near-monopoly) was not part of the case. The ADM fine is reported to be approximately 7 times the previous record fine in an antitrust case. Evidence in the case included taped conversations of agreements to raise price and reduce supplies of these products. Cases involving price fixing among large companies are relatively rare. But whether that is because price fixing does not happen or because it is difficult to detect—with ADM a fortuitous exception—is an open question.

Looking for Reasons for Increased Personal Bankruptcies. Personal bankruptcies have been rising sharply over the past decade. A recent survey investigated the factors that influenced individuals who had filed for bankruptcy in the past 12 months. The number one reason, cited by 29 percent of these debtors, was simply—and uninformatively—overextension. Other major reasons cited include medical expenses, divorce, unemployment, and collection tactics. The majority of respondents believed they had no alternative, and less than half sought professional debt counseling before deciding to file for bankruptcy. Most respondents had never filed before, but a substantial minority were repeat filers. Although conventional wisdom holds that today bankruptcy carries less stigma than it once did, this does not seem evident in the responses. The majority of filers had been unable to re-establish credit, over half reaffirmed at least some of their outstanding debt, and nearly a quarter still owed income tax after filing.

Productivity Boosted by Pollution Laws. Critics of environmental regulations claim these rules are a major factor in the productivity slowdown since the 1970s. A new study argues that such a view is based on a faulty measure of productivity. Total productivity as it is currently measured reflects the difference between the growth of output and the growth of inputs (mainly labor and capital). But it ignores negative effects of pollution like health problems, corrosion and environmental degradation. In the conventional measurement, when extra inputs are employed to reduce environmental harm, they reduce productivity growth. In terms of living standards, however, a kilowatt hour of electricity or a ton of paper produced without pollution is qualitatively different from one that pollutes the environment. When differences in environmental outcomes are factored into productivity estimates for the electric-power industry, for example, total productivity grows by at least 0.38 percent per year between 1970 and 1991, compared with the 0.35 percent per year decline over the same period computed using standard methods.

INTERNATIONAL ROUNDUP

Nicaraguans Go To the Polls with Economy Improving Yet Fragile. This Sunday, Nicaraguans will vote in a presidential election that analysts are describing as too close to call. Economic issues shaping the campaign include how to implement the economic reforms needed to encourage growth and how to combat Nicaragua's extreme poverty. With income per capita (in purchasing-power-adjusted terms) of $2,280 in 1994, Nicaragua is the second poorest nation in the Western Hemisphere (Haiti is the poorest). But conditions are improving. Inflation, which had raged at an annual rate of 13,500 percent in 1990, was reduced to 11 percent in 1995. After more than a decade of decline, real GDP began rising again in 1994 and has grown at an average annual rate of 4 percent since then. Unemployment, however, is still a relatively high 18 percent. One hotly contested issue in the campaign affects U.S. investors—how to deal with properties confiscated during the Sandinista regime. So far, roughly $390 million in compensation bonds have been issued to previous owners.

France and Germany Gradually Introduce Competition to Telecommunications. Both France and Germany are planning to privatize a substantial share of their state telecommunications companies. In Germany, this fall's flotation of shares in Deutsche Telekom, which are valued at roughly $9.8 billion, is reportedly the largest initial public offering ever held in Germany. In France, the government is set to sell a 20 percent share in France Télécom, worth roughly $5.3 billion. Both countries have also recently introduced laws that go some way towards bringing competition to their telecommunications sectors. But the new French law has already been criticized by companies, including AT&T France, who argue that the law leaves out too many key issues and does not provide sufficient separation between regulation and operations. Full competition in telecommunications services by the beginning of 1998 is mandated by the European Union.

Republic of Korea to Become 28th Member of the OECD. Last Friday, the terms of Korea's accession to the OECD were finalized. A ceremony marking the formal invitation is scheduled for October 25. Korea will become the second Asian economy to join the OECD. Economic development in Korea over the past 30 years has been among the most rapid and sustained in the world. Since 1963, real GDP has increased by a factor of 12. Per capita income has risen 7-fold, from 14 percent of the OECD average, to 40 percent today. Outward-oriented development policy has helped Korea increase its share in world exports from virtually zero to 2.5 percent, making it the 11th largest exporter in the OECD. Growth in exports has been accompanied by a progressive liberalization of trade, with the average import tariff rate falling from 41 percent in 1978 to 6 percent in 1994. Nevertheless, some trade friction remains. U.S.-Korean trade has increased dramatically in recent years. Between 1992 and 1995 U.S. exports to Korea have grown nearly 75 percent—to $25.4 billion, while U.S. imports from Korea rose 45 percent—to $24.2 billion.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, October 18, 1996****

The goods and services trade deficit declined to $10.8 billion in August from $11.6 billion in July.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.2 percent in September. Capacity utilization edged down 0.1 percentage point to 83.3 percent.

Housing Starts

Housing starts decreased 6 percent in September to 1.44 million units at an annual rate. For the first 9 months of 1996, starts were up 11 percent compared with the same period a year ago.

Consumer Price Index

The consumer price index rose 0.3 percent in September. Excluding food and energy, consumer prices also increased 0.3 percent.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (Friday)

U.S. ECONOMIC STATISTICS

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

	1970–1993	1995	July 1996	Aug. 1996	Sept. 1996
Unemployment Rate	6.7**	5.6**	5.4	5.1	5.2
Payroll employment (thousands)					
increase per month			235	241	-40
increase since Jan. 1993					10466
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.1	**0.3**
PPI-Finished goods	5.0	2.3	0.0	0.3	0.2

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	Aug. 1996	Sept. 1996	Oct. 17, 1996
Dow-Jones Industrial Average	3794	4494	5686	5804	6059
Interest Rates					
3-month T-bill	4.25	5.49	5.05	5.09	4.98
10-year T-bond	7.09	6.57	6.64	6.83	6.51
Mortgage rate, 30-year fixed	8.35	7.95	8.00	8.23	7.88
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Oct. 17, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.544	0.9	9.1
Yen-Dollar	112.2	0.8	11.9
Multilateral $ (Mar. 1973=100)	88.56	0.6	5.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	5.2 (Sept)	3.0 (Sept)
Canada	1.2 (Q2)	9.4 (Aug)	1.4 (Aug)
Japan	3.9 (Q2)	3.4 (Aug)	0.2 (Aug)
France	0.5 (Q2)	12.2 (Jul)	1.6 (Aug)
Germany	1.1 (Q2)	7.2 (Aug)	1.4 (Aug)
Italy	0.7 (Q2)	11.9 (Jul)	3.4 (Aug)
United Kingdom	2.2 (Q2)	8.1 (Aug)	2.2 (Aug)