



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 5, 1997

To: The Secretary
The Deputy Secretary

From: Jon Gruber *JG*

Re: Economic Policy Weekly Report

Key News

DC Economic Development: While the Congress rejected the Administration's proposal to establish a D.C. economic development corporation, the functions that would have been performed by the corporation are vital to the city's economic vitality over the longer term. Staff is exploring whether some of these critical functions might be performed by existing or new entities without the level of federal support envisaged for the development corporation.

Tobacco settlement: We continue to evaluate the tobacco settlement, in preparation for a Principals meeting this week. We have refined our analysis of the lookback provision, suggesting a number of alternatives which offer stronger incentives to reduce youth smoking. We have also developed a series of options for capturing more of the surplus that the tobacco companies will earn from this settlement relative to a future of legal uncertainty.

Climate Change: We have been engaged in discussions of climate change policy on several fronts. We are critiquing excessively optimistic work by DOE and OMB on the benefits of technology subsidies for reducing the costs of climate change controls. We are working with EPA to produce a report which accurately assesses the lessons of past cap and trade systems, and which carefully explores the feasibility of an auction system. And we are working with CEA to evaluate the appropriate role of developing countries in an international emissions control regime.

Electricity Restructuring: We will brief the Deputy Secretary in preparation for a Deputies meeting on Thursday on three key DOE proposals: that the government should mandate competition, with an opt out for states that wish to remain regulated (which we support, so long as it is not tied to heavy-handed intervention on the stranded cost problem); that there should be a tax on electricity consumers to support a "public benefits fund" (which we strongly oppose); and that generators of electricity in a deregulated environment be required to purchase a certain percentage of their energy from renewable sources (which we would support only if the percentage is justified by careful cost/benefit analysis).

Disaster Insurance: We are preparing a briefing for the Deputy Secretary in anticipation of a meeting with academic experts on the topic. We have had a fruitful series of conversations with some outside experts at the staff level, which has generated a series of topics that can form the agenda for this meeting. In particular, we need to explore approaches which can navigate the tradeoff between fixing the failure in existing markets and crowding out future private sector initiatives.

Higher Education Financial Aid: As part of the Savings Initiative, we have been having conversations with the Department of Education (ED) about reducing the taxation of assets in their financial aid formula. Our conversations have borne some fruit, as ED is proposing a revised formula that replaces the taxation of assets with additional taxation of income, an efficiency enhancing shift. We are working with ED to provide analytical support for this approach, which is likely to face substantial opposition from the financial aid community.

Child Care: The administration is beginning an interagency process on child care policy, in anticipation of an October White House conference on the topic. We will work with Tax Policy and CEA to provide economic analysis for this effort, in particular focusing on the most efficient means of expanding access to child care, and quantifying the tradeoffs between increasing quality and maintaining affordability.

Health: The children's health initiative in the budget deal was an excellent outcome from our perspective, balancing the tendencies of Republicans for block grants with no accountability and of Democrats for expansions of the overly generous Medicaid program: the result was a compromise that requires net new state spending on children's health insurance, but that does so in a manner which gives states flexibility to offer less generous benefits to more children. There are a number of important implementation issues with this approach, however, and we will work with HHS to lend expertise on this front. We will also work with HCFA on some issues regarding implementation of changes to the Medicare program, particularly those to do with MSAs.

Major Economic Indicators Released in Past Week (Through August 5)

As expected, GDP growth slowed in the second quarter but early data for July showed considerable strength.

Employment increased by 316,000 in July, more than expected and above the 233,000 average increase over the first half of the year. Some of the jump reflected seasonal adjustment problems in the government sector, but private sector jobs also exhibited strength. The **unemployment rate** fell back to 4.8 percent in July, the same as in May and the best since the early 1970's. The average workweek eased, however, leading to a decline in the index of aggregate hours worked. Hourly earnings were unchanged at \$12.23, and over the past twelve months have increased 3.6 percent.

The July index of the **National Association of Purchasing Management** increased to 58.6 percent from 55.7 percent in June, indicating considerable forward momentum in the manufacturing sector at the start of the third quarter. Measures of price and capacity pressures also rose.

Growth in **real GDP** in the second quarter slowed to 2.2 percent at an annual rate from a revised 4.9 percent in the first quarter. The slowdown was led by weak consumer spending and little change in inventory investment after a large accumulation in the previous quarter. Business fixed investment was very strong, especially for equipment expenditures which rose at more than a 20 percent annual rate. The GDP price index grew 1.4 at an annual rate while the index of prices paid by U.S. residents (which excludes exports and includes imports) edged up just 0.6 percent.

Personal income in nominal terms grew by 0.6 percent in June following smaller gains in the previous two months. In real terms, disposable income (after taxes) was up by 0.4 percent in June and 3.0 percent at an annual rate over the entire second quarter. This was slower than growth in the first quarter when wage and salary growth was faster and cost-of-living adjustments to social security and other programs boosted income. **Real consumer spending** edged up 0.1 percent in June and rose at only a 0.8 percent annual rate in the second quarter. The **personal savings rate** was 4.4 percent in June. Revisions lowered the personal savings rate in 1996 but raised it in the years 1993-95, leaving the average over the four years unchanged at 4.6 percent.

Consumer confidence rose even higher in July, according to the Michigan survey. Their index increased to 107.1 from a preliminary figure of 106.4 reported earlier in the month. The July reading was the highest in the history of the series, which dates back to 1952.

Construction expenditures in real terms softened in June but figures for May were revised higher. Residential and private nonresidential construction spending was down sharply but real expenditures by the public sector improved. Residential construction may pick up in future months as new home sales are currently quite strong and the inventory of new homes on the market is extremely low. Single-family **home sales** rose by 6.1 percent in June to 819,000 units at a seasonally-adjusted annual rate, almost matching the cyclically-high pace of the first quarter.

New orders for **manufactured goods** increased by 1.2 percent in June, led by a 2.4 percent surge in durable goods orders (revised up slightly from the advance report). Orders for nondurables declined by 0.3 percent. Inventories in the manufacturing sector rose by 0.3 percent in June following a gain of 0.4 percent in May.

The **index of leading economic indicators** was unchanged in June after increasing by 0.3 percent in May. Increases in five of the ten components of the leading index offset declines in the other five components. The behavior of the index over recent months is consistent with continued economic growth.

Indicators Scheduled for Next Week (Through August 12)

New Car and Light Truck Sales, July (August 6)

Wholesale Trade Inventories, June (August 7)

Consumer Installment Credit, June (August 7)

Productivity and Labor Costs, Q-II (August 12)

EP Schedule (Robert Gillingham and Jon Gruber)

Monday, August 4

- Education (@DOE)
- Working Group on Child Care (@OEOB)
- Climate Change w/CEA (@Treas.)

Tuesday, August 5

- Climate Change w/EPA (@Treas.)

Wednesday, August 6

- Tobacco w/CEA (@OEOB)
- Climate Change w/CEA, EPA, & others (@Treas.)

Thursday, August 7

- Weekly Health Care Strategy w/Bruce Reed
- Climate Change (@OEOB)

Friday, August 8

- No external meetings scheduled

The Week Ahead:

Monday, August 11

- No external meetings

Tuesday, August 12

- Health Issues (@OEOB)

Wednesday, August 13

- No external Meetings Scheduled

Thursday, August 14

- Weekly Health Care Strategy w/Bruce Reed

Friday, August 15

- No external meetings scheduled