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Clinton's Balancing Act

The Administration projects a balanced budget in 2002. This projection rests on assumptions regarding economic growth, employment, interest rates, etc., during the next 5 years. These are generally reasonable and in line with recent experience, but they could be thrown awry by another recession. Moreover, most of the projected deficit reduction is to occur in 2001 and 2002. Mr. Clinton is leaving much of the work of closing the current deficit to his successor, and his budget proposals do nothing about the major budget problems that we will encounter only a few years later.

In President Clinton's budget proposal for fiscal 1998, Federal outlays are projected to increase by 15 percent over the next 5 years and receipts are projected to increase by 25 percent. Gross Domestic Product (GDP) is projected to increase even more, and outlays and receipts are projected to decrease in relation to the U.S. economy. By 2002, outlays would fall to their lowest share of GDP since the mid-1970s. In addition, the budget deficit would be eliminated by 2002, and there would be a budget surplus for the first time since 1969, according to the Administration's projections.

If this were to happen, it would mark the continuation of a trend that began in the mid-1980s. Although it is often overlooked in discussions of the budget, Federal outlays and the deficit have decreased, as percentages of GDP, for most of the past 10 years (see Chart 1). During the early 1980s, outlays and the deficit increased to postwar highs relative to GDP, but, with the exception of a recession-related increase in 1990-92, they have declined since then. In fiscal 1996, which ended last September, outlays decreased to the smallest share of GDP since 1979. The deficit fell to 1.4 percent of GDP, the smallest percentage since 1974.

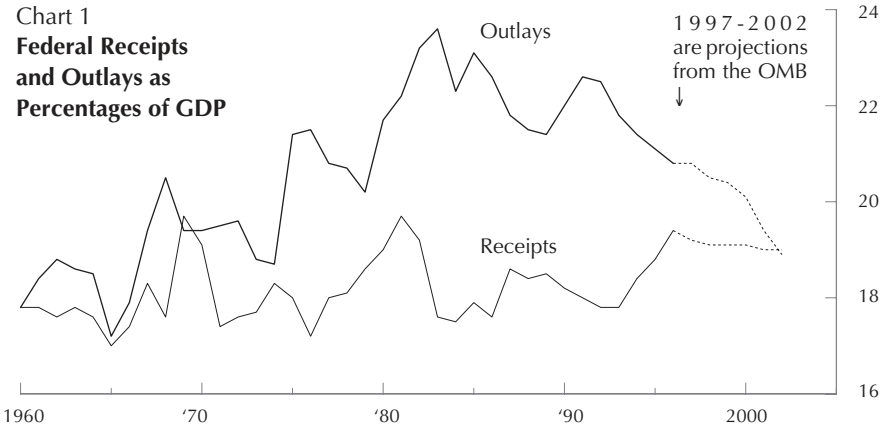
Economic growth is the major factor in this decrease, as output has increased during all but one of the past 10 years. Growth not only increases GDP but also boosts receipts, thus helping to reduce the deficit. Since 1993, when some tax rates were increased, the growth of receipts has accelerated, increasing from 17.8 to 19.4 percent of GDP in fiscal 1996, the highest percentage in 15 years.

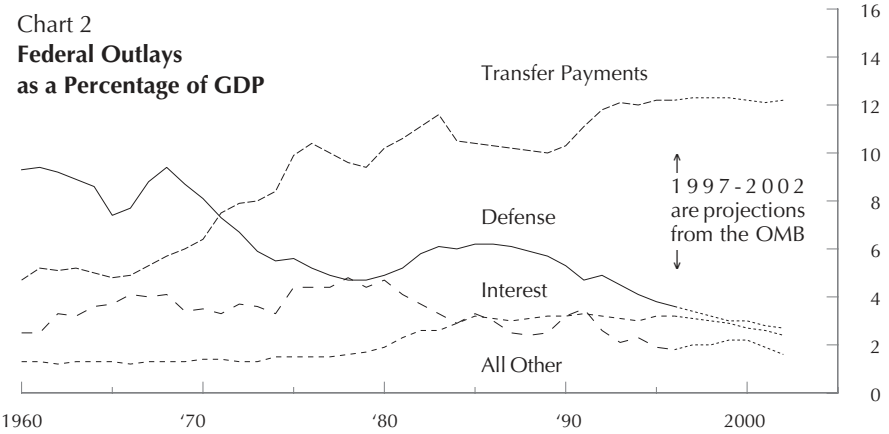
In addition, Federal spending has increased more slowly during the 1990s. After adjusting for price inflation, outlays have increased at about half the rate they did in the 1980s, and constant-dollar outlays actually declined in 1993. Most of this slowdown is due to sharp cuts in military spending.

Defense outlays have fallen more than 25 percent, in constant dollars, since the end of the Cold War. As a proportion of GDP, defense spending is now lower than at any time since before World War II. Other government spending also has increased more slowly in the past few years. Transfer payments — those for which the Government receives no current goods and services in return, such as Social Security, welfare, and health care programs — have held steady as a share of GDP after rising in the early 1990s. Interest payments on the debt have also decreased relative to GDP, as well as total outlays on all programs other than defense, transfer payments, and interest on the debt (see Chart 2).

Will This Trend Continue?

Like all forecasts, the Administration's projected continuation of this trend rests heavily on assumptions about future eco-





Source: *Office of Management and Budget, Treasury Dept., Commerce Dept.*

nomic growth, price inflation, interest rates, etc. For example, it is assumed that real GDP will grow by 2.2 percent a year, on average, for the next 5 years. Given that this is close to the actual rate of growth in recent years, it may not be an unreasonable assumption. However, as even the Administration admits, it would be highly unusual for the economy to grow without interruption for the next 5 years. If it does, the current business expansion would become the longest in U.S. history.

If there is a recession between now and 2002, it is most unlikely that the President's spending and deficit targets would be met. Every recession in the postwar years has been accompanied by higher spending and bigger deficits, both nominally and in relation to GDP.

Even if there is no recession, relatively small errors in the Administration's economic and policy forecasts could have a big impact. A year ago, for example, the Administration was predicting that the deficit for fiscal 1996, which was already in progress, would be $146 billion. It turned out to be a much lower $107 billion, largely because receipts were higher than expected and outlays for health care programs increased less than expected. Even after Congress and the President agree on a budget, there is no certainty that outlays, receipts, and the deficit will follow the expected trends.

In any event, the President's plan relies largely on two areas of spending to achieve a balanced budget. First, it calls for maintaining current-dollar defense spending at roughly the same level it is now. If the economy grew as assumed, this would shrink defense spending to just 2.7 percent of GDP by 2002. Second, the plan projects that interest payments on the national debt will shrink in relation to GDP. Since interest on the debt is not a discretionary payment and is tied closely to fluctuations in market rates, this projection depends largely on the twin assumptions that interest rates will decrease over the next 5 years and that the deficit will continue to decrease, thereby slowing the increase in the national debt.

To a lesser extent, the plan would also restrain the growth of nondefense discretionary spending — that is, the domestic spending that the President and Congress must agree on every year through annual appropriations bills. Except during the recession, such spending has been decreasing as a percentage of the budget and of GDP since the early 1980s. President Clinton's plan would decrease it from 3.3 percent of GDP now to 2.8 percent in 2002.

No Change in Entitlements

On the other hand, the budget proposal would not reduce spending on the entitlement programs that have come to dominate the budget. Spending on these programs — Social Security, Medicare, and various means-tested programs such as Medicaid and food stamps — is largely determined by permanent law rather than annual appropriations. The President and Congress have to change the law to change the level of spending on them, and President Clinton does not propose any major changes. He does propose cutting an estimated $100 billion from Medicare over the next 5 years, but this represents less than 10 percent of what Medicare is expected to cost during this period. These savings would be partly or entirely offset by a separate plan to roll back some of the cuts included in last year's welfare reform legislation.

On the revenue side, the plan proposes a new tax credit for taxpayers with children under 13, new tax credits and deductions for college tuition, elimination of the capital-gains tax on home sales, and expanded IRAs. Although not included in the budget proposal, there are rumors that President Clinton might also agree to cut the capital gains tax. Despite these tax breaks, total receipts are projected to remain over 19 percent of GDP over the next 5 years. As can be seen in Chart 1, receipts have seldom been this high in the past.

Most of the proposed cuts in spending growth and the deficit are postponed until the years 2001 and 2002, after President Clinton leaves office. Over two-thirds of the projected reduction in the deficit occurs in those years. In contrast, the deficit is expected to *increase* in the current fiscal year, to $126 billion, and over the next two years it is projected to fall only to $117 billion. The Administration's failure to propose bigger spending and deficit cuts in the near term suggests that President Clinton is more interested in rearranging the current mix of programs — by using cuts in some areas (like the military) to pay for increased spending on other things (such as Head Start and "investing in renewable energy") — rather than smaller government. A year ago, the President's budget plan called for the deficit to drop by $40 billion in fiscal 1998. Had he stuck to this target this year, he would have had to find an extra $35 billion in spending cuts. Instead, he is using the bigger-than-expected drop in last year's deficit to justify a much smaller cut in next year's projected deficit. By leaving most of the balancing to his successor, he has missed an opportunity to make greater genuine progress on the budget. By not addressing the large demographically-driven entitlement programs, he has increased the likelihood that if the budget is balanced in the next 5 years, the achievement will be temporary. ❑

BUSINESS-CYCLE CONDITIONS

The outlook for business conditions remains favorable. The latest data on the leading indicators point to further expansion and all the coincident indicators continue to expand to new highs. With no indication of bottlenecks in the lagging indicators, the economy should continue to expand at least into the second quarter of 1997.

Our latest review of business-cycle conditions indicates that the economy will continue expanding in the months ahead. This month, two of the primary leading indicators reached new highs. Not surprisingly, the *index of common stock prices* (stock prices and all other dollar-based series are reported in constant dollars) rose to a new high, and despite the recent strong growth in inventories, the *ratio of manufacturing and trade sales to inventories* reached another new high as well. Both series are appraised as clearly expanding.

The *M2 money supply* continues to increase, as does the highly volatile *3-month percent change in sensitive materials prices*. The *average workweek in manufacturing* is unchanged at 41.8 hours per week. These three series are all clearly expanding as well.

The appraisals for both *new orders for consumer goods and materials* and *initial claims for state unemployment insurance* were downgraded this month to probably expanding from clearly expanding. Several months of decline in the data for these series raised doubt about their cyclical trends, and with the base data continuing to decrease in both series we can no longer confidently assert that the two series are expanding.

Contracts and orders for plant and equipment increased this month, despite a drop in the base data. However, this series is still slightly below its peak level of $47.8 billion in January 1996. Until the

series increases above $47.8 billion, it is likely to remain appraised as probably rather than clearly expanding.

Although at any given time a series is either expanding or contracting, sometimes its cyclical status does not become evident until more data are available. This is the case for *vendor performance*. As the historical chart on page 20 suggests, this series is subject to rather large fluctuations. In recent months, however, the data have been relatively "flat" with no discernible trend. Therefore, vendor performance remains cyclically indeterminate.

New housing permits increased slightly, but not enough to indicate a reversal in the series' probable trend. This series, which increased sharply through 1995 but levelled off in 1996, remains appraised as probably contracting.

Two of the leading indicators are clearly contracting: the *M1 money supply* and the *3-month percent change in consumer debt*. A large portion of the slowdown in the growth of consumer debt reflects slower growth in credit card debt. If this trend continues, the change in consumer debt could turn negative in the months ahead.

Overall, 73 percent (8 out of 11) of the leading indicators with apparent cyclical trends are expanding. This is unchanged from last month. AIER's cyclical score, however, increased to 70 from a revised score of 66. Unlike the percentage of leaders expanding, the cyclical score is revised to reflect revisions to the economic data. Last month we reported the score as 64, but revisions to the data increased last month's cyclical score to 66. Historically, both the score and the percent of leading indicators expanding have signaled turning points in the economy 3 to 6 months in advance. Thus, we expect the economy to continue expanding at least into the second quarter of 1997.

All six of the primary roughly coincident indicators are at new highs. *Nonagricultural employment* increased by 271,00 new jobs in January. Fully 88 percent of these were created in the service sector. The *index of industrial production* was unchanged this month at 117.7. Industrial production was rebased this month from 1987 to 1992. Thus the latest data signifies that since 1992, the volume of output from manufacturing, mines, and electric and gas utilities has increased 17.7 percent.

Personal income in manufacturing, the annualized wages and salaries earned in the manufacturing sector, adjusted for price inflation, increased by $3.9 billion to $433.8 billion.

Manufacturing and trade sales continue to expand as does *civilian employment as a percentage of the working-age population*, which is now 63.5 percent. The preliminary estimate for *gross domestic product* (GDP) indicates that it increased at an annual rate of 4.7 percent in the last quarter of 1996. Although this estimate is subject to revision over the next two months, GDP is still clearly expanding.

Overall 100 percent (6 out of 6) of the coinciders with apparent cyclical trends are expanding. At the end of March, the current expansion will be six years old. It already is the third longest in postwar history; if it lasts until December, it will become the second longest, surpassing the 1982-90 expansion. To date, the longest expansion occurred from February 1961 to December 1969. There is no telling how long this expansion will last, but it does not appear probable that it will end soon.

There were two new highs among the six primary lagging indicators: the *average duration of unemployment* (inverted) and *manufacturing and trade inventories*. There was no change from last month's high in the average duration of unemployment. It remains 15.9 weeks. Both series are appraised as clearly expanding.

There are no apparent trends in *commercial and industrial loans*, the *ratio of consumer debt to personal income*, or the *composite of short-term interest rates*. Commercial and industrial loans had been appraised as probably contracting, but this month's uptick raised further doubts about the series' trend. The ratio of consumer debt to income had been clearly contracting, but revisions to the consumer debt data show that it has levelled off at roughly 18 percent of income. The composite of short-term interest rates, which is the average of the 1-month dealer-placed commercial paper rate and the 3-month top rated bankers' acceptance rate, still has not developed a clear trend. Its cyclical status remains indeterminate.

Despite recent upticks in the data, the 12-month *change in labor cost per unit of manufacturing output* remains appraised as probably contracting. Prior to a recession we would expect this series to rise above zero for several months. That it currently is below zero is further evidence that the economy will continue expanding into at least the second quarter of 1997.

Overall, 66 percent (2 out of 3) of the lagging indicators with apparent cyclical trends are expanding. This is slightly higher than last month's 60 percent ex-

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Oct.	*Nov.*	*Dec.*	*Jan.*	***Primary Leading Indicators***	*Dec.*	*Jan.*	*Feb.*
-	-	-		M1 money supply	-	-	-
-	+	+		M2 money supply	+?	+	+
+[r]	-	-		Change in sensitive materials prices	+	+	+
+	-	-		New orders for consumer goods	+	+	+?
-	-	-		Contracts and orders for plant and equipment	+	+?	+?
-	+	+		Index of new housing permits	?	-?	-?
+[r]	+			Ratio of manufacturing and trade sales to inventories	+	+	+
+	+	nc[r]	-	Vendor performance	?	?	?
+	+	+	+	Index of common stock prices (constant purchasing power)	+	+	+
nc	nc	+	-	Average workweek in manufacturing	+?	+	+
+	-[r]	-		Initial claims for unemployment insurance (inverted)	+	+	+?
-	-[r]	+		Change in consumer debt	-	-	-
				Percentage expanding cyclically	80	73	73
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+[r]	+	+	nc	Index of industrial production	+	+	+
+[r]	+	+		Personal income in manufacturing	+	+	+
+	+			Manufacturing and trade sales	+	+	+
+	-	+	+	Civilian employment to population ratio	+	+	+
+	+	+		Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	100	100
				Primary Lagging Indicators			
+	+	+	-	Average duration of unemployment (inverted)	+?	+	+
+	+			Manufacturing and trade inventories	+	+	+
-	-	+		Commercial and industrial loans	+	-?	?
+	-[r]	-		Ratio of consumer debt to personal income	+?	+	?
-	-	+		Change in labor cost per unit of output, manufacturing	?	-?	-?
-	nc	+	-	Composite of short-term interest rates	?	?	?
nc No change.	[r] Revised.			*Percentage expanding cyclically*	100	60	66

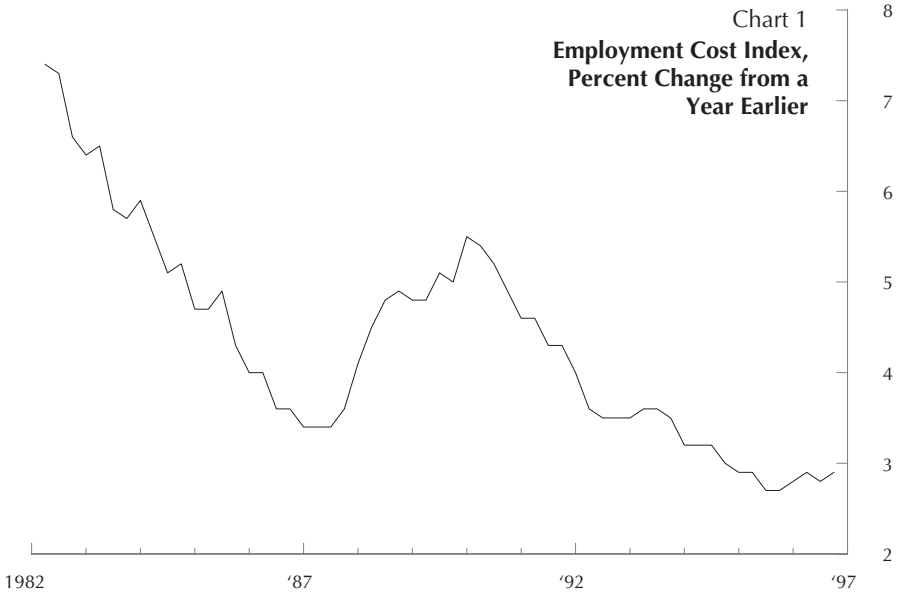
Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

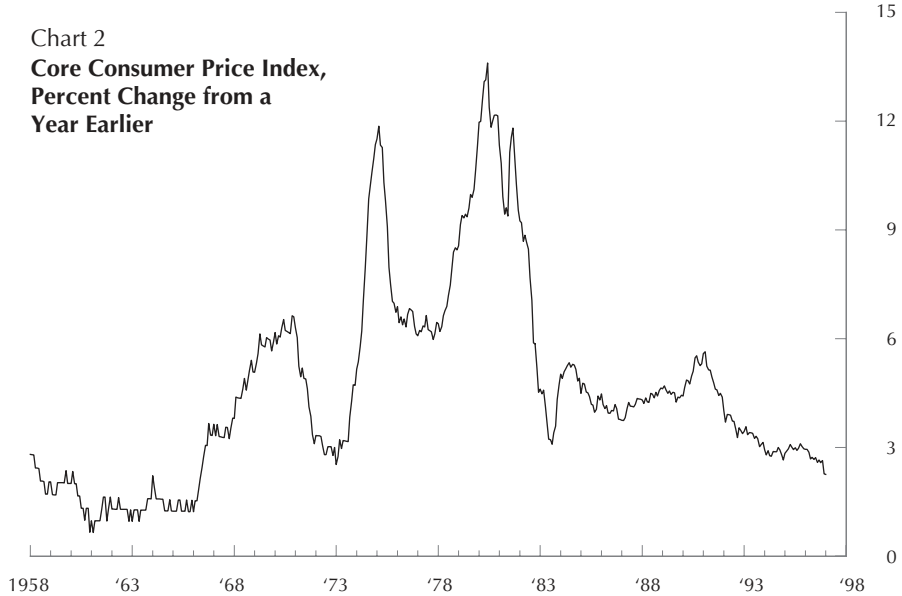
panding. Still, it does not suggest that bottlenecks are developing. Unit labor costs are decreasing and short-term interest rates remain low. The duration of unemployment (inverted) is also quite low, especially this late in the expansion. Although inventories have increased recently, sales have increased even more. These are all favorable conditions for the economy that point to further expansion.

Looking to the Labor Market for Signs of Price Inflation

Through increases in wages, tight labor markets usually create upward pressure on price inflation. However, thus far in this expansion, despite some increase in wages, there has been little evidence of increased price inflation. Over the past year, hourly wages have increased 3.2 percent in the manufacturing sector and 3.7 percent in the services-producing sector (or $0.41 an hour each). Chart 1 shows the 12-month percent change in the employment cost index, another measure of labor costs. This series takes into account both wages and benefits. As the chart indicates, the rate of increase in employment costs has expanded only slightly in the past year. Chart 2 shows the 12-month percent change in the "core" consumer price index (the CPI less prices for food and energy, which are often volatile). As the chart suggests, the increase in the growth rate of employment costs has not been accompanied by an increase in price inflation. Among other possible factors, labor productivity has increased along with labor costs, thus offsetting some of the cost pressures. This is suggested by the chart on page 22 showing the 12-month percent change in labor cost per unit of output in manufacturing. As can be seen, unit labor costs in this sector have decreased recently and have declined during most of this business expansion. Since output is difficult to measure in the service sector, there are no comparable data on productivity and unit labor costs in the service sector.

However, as long as increases in productivity offset increases in wages and benefits, there is little reason to expect labor costs to trigger an increase in price inflation — more especially given the current strength of the dollar on forgien exchange. The stronger dollar makes imports more attractive because consumers can get more "bang for the buck" on purchases of foreign products. This outside competition gives domestic producers an incentive to keep their prices lower and to push instead for productivity increases to maintain profits. Overall, despite the slightly accelerating growth of employment costs, at this point there is little to suggest that producers will pass all of this increase along in the form of higher prices for their products. If any of these trends change, and unit labor costs begin to increase, then it would be more likely that the Federal Reserve would tighten its monetary policy. (Fed Chairman Alan Greenspan often cites labor costs as a useful indicator of price pressures.) At present, the available data offer little evidence to warrant any action by the Fed. ❑





Source: *Department of Commerce, Bureau of Labor Statistics.*

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	Feb. 16	*Feb. 15*	*Feb. 13*	*Feb. 20*
Final fixing in London	$376.75	$404.60	$342.65	$345.00

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