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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

April 18, 1997

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Whole report: COS
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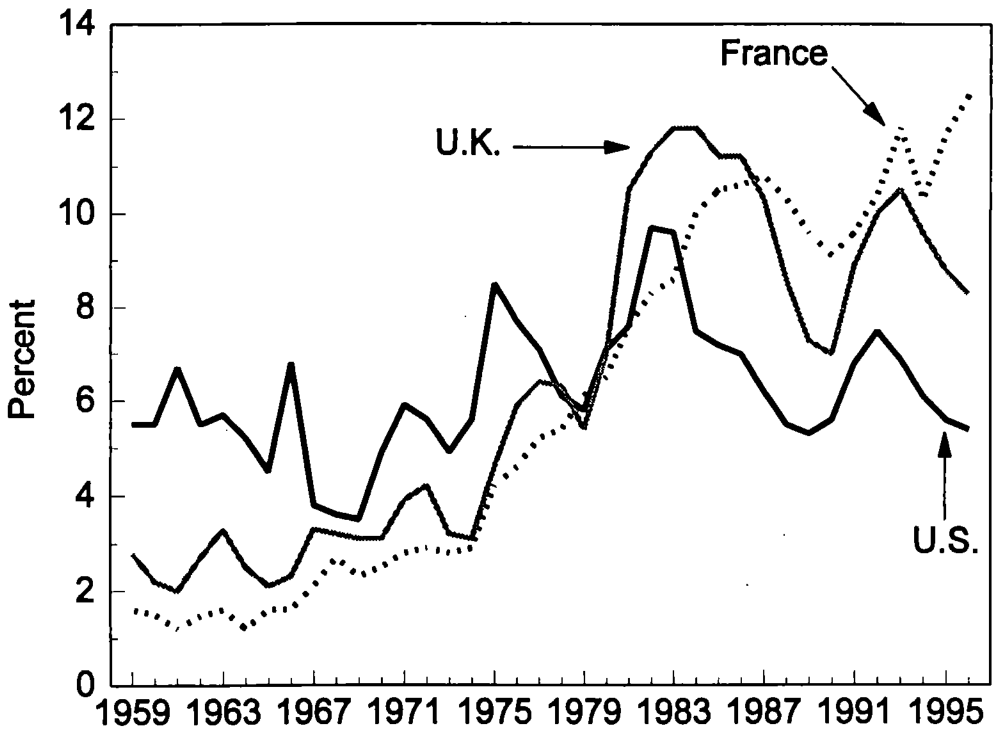
CHART OF THE WEEK

U.S. and European Unemployment Rates



The United States has a lower unemployment rate than nearly every European member of the OECD. The unemployment rate for OECD Europe as a whole now stands at 10.5 percent, and several countries—including France, Germany, Italy, Norway, and Sweden—have hit their highest level in at least 45 years during the past 12 months. Almost a quarter of the labor force is unemployed in Spain. A few countries that have instituted labor market reforms, including the UK, have seen their unemployment rate start to come down. An article in this *Weekly Economic Briefing* discusses why unemployment is so high in Europe.

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DEPARTMENTS

THE WALL STREET JOURNAL

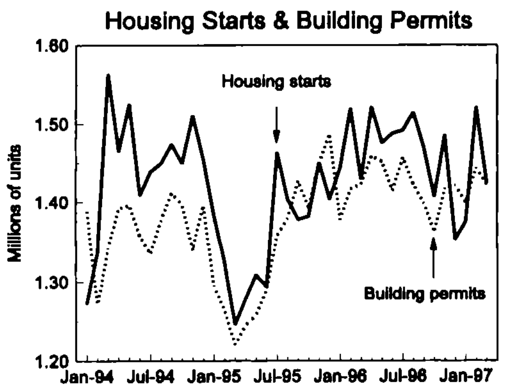
"I'm sorry I'm late for my audit ... I was abducted by aliens and they confiscated my records ..."

TREND

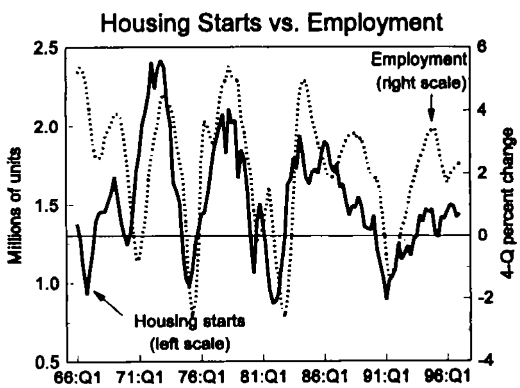
The Housing Market

Homebuilding is a highly cyclical sector, accounting for a disproportionate share of GDP fluctuations. It is also one of the key interest-sensitive sectors affected by monetary policy.

Which measure? Each month brings a flurry of housing statistics, including permits, starts, sales of new homes, and sales of existing homes. Of these, permits are the most reliable short-run indicator. They are more stable, less affected by bad weather, and more forward-looking than starts. Housing starts, however, directly affect the pace of construction and hence GDP. They also have broader geographic coverage than permits. Housing starts in the first quarter rose to a 1.45-million-unit annual pace, about the same as for 1996 as a whole (see upper chart). Although new home sales may be the clearest expression of demand for housing, initial estimates are subject to substantial revision. Sales of existing homes have little effect on GDP.



Analysis. Over the short and intermediate run, housing demand and economic activity are closely related (see lower chart). Interest rates also matter, but the correlation is weaker. Over periods of decades, demographic factors like the rate of household formation tend to assert themselves. Many experts believe that these factors argue for a pace of housing starts of about 1.3 to 1.4 million units per year, slightly below the current pace.



Conclusion. In the near term, solid rates of growth of employment and income are likely to support homebuilding activity near recent levels. Interest rates, however, have risen recently and may start to exert a damping influence.

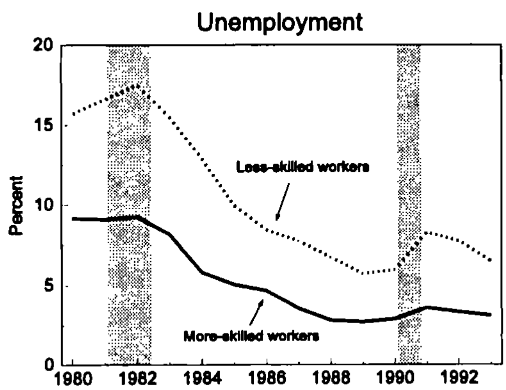
SPECIAL ANALYSIS

Welfare Reform and the Unemployment Insurance System

With hundreds of thousands of less-skilled workers likely to enter the workforce under welfare reform, the unemployment insurance (UI) system will take on increased importance as a safety net program.

Employment prospects for welfare recipients. The new welfare law has put time limits on receipt of benefits—2 years for a single spell without work and 5 years for lifetime receipt. States have some discretion, however, and many have chosen narrower limits. Thus, many people who may have relied on welfare in the past will now have to find work.

The employment experiences of similar less-skilled workers may provide a useful indicator of how former welfare recipients will fare when they enter the labor market. Like other low-skilled workers, welfare recipients are more likely to be high school dropouts and to score relatively poorly on standardized tests compared with other workers. For example, in a sample of roughly 10,000 individuals from the 1957-1964 birth cohort, almost half of those who received welfare for 3 or more years between 1980 and 1993 fell in the bottom 25 percent of the distribution on a standardized exam of aptitude/achievement.



The chart shows the unemployment rate between 1980 and 1993 for less-skilled and more-skilled workers from the 1957-1964 birth cohort. Both groups saw their unemployment rate drop over time as they gained work experience. But the unemployment rates of the less-skilled were both higher and more sensitive to recessions. This evidence suggests that welfare recipients could exhaust their lifetime benefits over the course of one lengthy recession.

Welfare reform and UI. The UI system could provide additional protection. UI benefits are available to job losers with a sufficient work history (job leavers are generally not eligible). Although the specific rules differ among states, the minimum work requirements are not that stringent. For instance, a minimum-wage worker who had been employed 30 hours per week for 6 to 9 months would be eligible in most states. The amount and duration of benefits also vary among states, but such a worker would typically receive about $75 a week for up to 6 months (potentially longer in a recession). These benefits are roughly comparable to the maximum monthly welfare benefit for a family of three in many states.

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Implications for the UI system. The additional inflow of low-skilled workers into the UI system resulting from welfare reform raises issues regarding program funding and design. The system is funded by a tax on employers that is imperfectly experience-rated. Firms that lay off more workers pay more into the system, but only up to a point. To the extent that welfare recipients get hired by firms that are already paying the maximum tax rate, the number of potential UI recipients will go up, but no additional funding will be generated. Other issues of program design—including the relatively high UI tax on low-wage workers and the adequacy of the trigger for extending benefits during a recession—will be addressed in a future *Weekly Economic Briefing*.

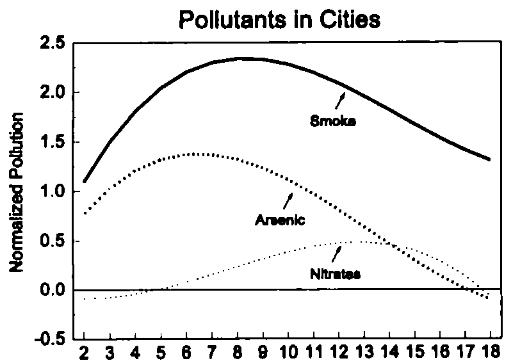
SPECIAL ANALYSIS

Economic Growth and Environmental Quality

Does an ever-richer economy create an ever-poorer environment? Evidence suggests not; with the right policies, environmental quality can improve even as growth continues.

An inverted U. Several recent statistical studies have found that, for many environmental indicators, the relationship between economic growth and environmental quality seems to have an inverted-U shape. For low levels of income, environmental quality deteriorates as income rises, but, beyond a certain point, further increases in growth are associated with improving environmental quality. These improvements presumably do not occur spontaneously. As a nation gets richer, it imposes tighter environmental regulations because its citizens demand more environmental quality. To a much lesser extent, richer nations may also reduce their own pollution by importing "pollution-intensive" goods rather than producing them at home.

One study found this pattern in cross-country data for a number of air and water quality indicators, including smoke, arsenic, and nitrates. The exact turning point varied from one environmental indicator to another, but it tended to be at a per capita income of about $6,000 to $13,000 (see chart). Other studies have revealed a similar pattern for sulfur dioxide, particulate matter, oxides of nitrogen, carbon monoxide, and deforestation.



In 1994 Chile, Malaysia, and Mexico were countries with per capita incomes in the $6,000 to $13,000 range where pollution stops rising and starts turning down. China, Indonesia, and Turkey had lower per capita income. Some richer nations over the hump included Australia, Canada, and the United States.

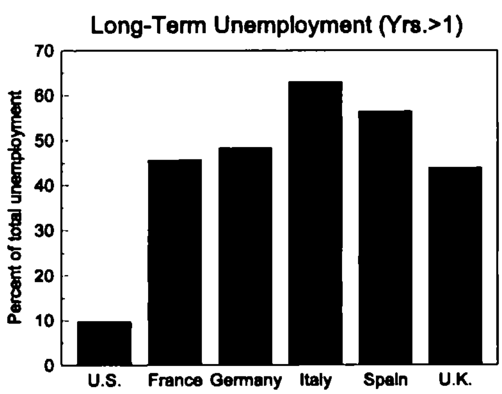
What about greenhouse gases? Greenhouse gas emissions do not yet show an inverted-U pattern. Emissions are still worsening with economic growth even in many prosperous countries. This may be a case where the effects of emissions are not felt directly enough by the emitters to call forth a response. Since each country alone can do little because of the classic free-rider problem in the global commons, all nations will have to work together as they reconsider their development strategies.

ARTICLE

Why Is Unemployment So High in Europe?

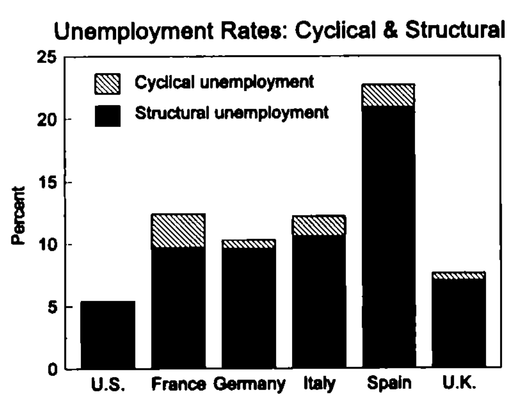
The trends in European unemployment discussed in the Chart of the Week are not just a business cycle phenomenon. They reflect underlying structural problems. In a few countries, improvements in employment creation following major structural reforms suggest, however, that rising unemployment is not inevitable.

Background. The contrast between job creation in Europe and in the United States is stark. Between 1980 and 1995, employment grew by more than 25 million in the United States, with most of the new jobs in the private sector. Over the same period, employment in OECD Europe grew by only 10 million, almost all of which came from the public sector. Three features of European unemployment are particularly troubling:

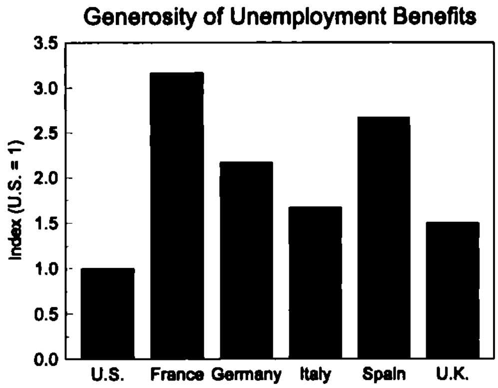


- Dispersion. Unemployment is spread very unevenly, with high unemployment rates for young workers and large regional disparities.
- Duration. Long-term unemployment is substantially larger for many European countries than it is for the United States (see upper chart). Even countries with unemployment rates not much higher than ours have substantially larger fractions of long-term unemployment.
- Participation. Compared with the United States, a larger fraction of the working-age population is not even in the labor force in Europe. In France, for example, the labor force participation rate was 55 percent in 1995, 11 percentage points lower than that of the United States.

Structural unemployment. Several episodes of contractionary macroeconomic policy, most recently the tight monetary and fiscal policies undertaken to meet the Maastricht criteria for monetary union, have contributed to rising unemployment. But the bulk of European unemployment is structural (see lower chart). Compared with the United States, where the unemployment rate falls relatively quickly once contractionary policies are relaxed, unemployment in Europe tends to persist



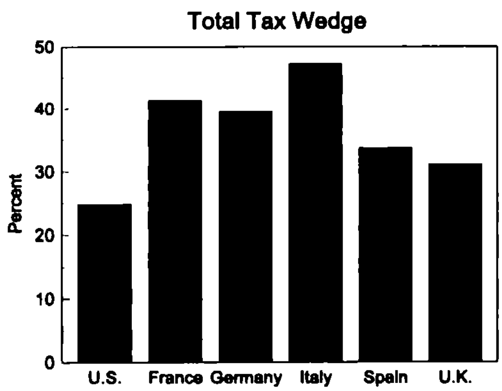
even after macroeconomic policy becomes looser. Three impediments to labor market flexibility may be at work:



- Insider protection. Employment-protection legislation and strong labor unions provide "insiders" with long-term contracts that protect against wage erosion and dismissal. This discourages firms from hiring workers in the first place. And it concentrates the costs of adjustment among young, immigrant, and part-time workers, as well as others who lack insider protection.

- Generous unemployment benefits. Unemployment benefits are substantially more generous than they are here in terms of amount, coverage, and duration (see upper chart). This not only creates a disincentive for unemployed workers to look hard for jobs, but it also increases the bargaining power of insiders by strengthening their fall-back position. The duration of unemployment benefits may be one of the most important determinants of aggregate unemployment.

- Employment costs. The statutory minimum wage and taxes (social insurance and income) are higher in many European countries than they are in the United States. In France, for example, the statutory minimum wage is 55 percent of the average manufacturing wage. This compares with about 40 percent in the United States once the latest increase is fully phased in. The tax wedge measuring the difference between the compensation paid by the firm and the after-tax wage received by the worker is also substantially higher in Europe than it is here (see lower chart).



Implications. Although many countries in Continental Europe have taken some steps to liberalize their labor markets, most have not addressed any of the three fundamental impediments to labor market flexibility. (France, for example, has reduced employment protection for part-time workers and tightened rules governing eligibility for unemployment benefits.) The unemployment rate has come down, however, where countries have pursued more sweeping reforms—reducing employment protection legislation (the UK), cutting the level or duration of unemployment benefits (Ireland, the Netherlands, and the UK), substantially reducing the minimum wage (the Netherlands and the UK), and reducing the tax wedge (the Netherlands).

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Birth Rate is Lowest Since 1978. The birth rate fell 2 percent, to 15.2 per thousand total population in 1994. This is the lowest rate since 1978, and provisional National Center for Health Statistics (NCHS) data indicate that the rate fell by about 2 percent in 1995 as well. The falling birth rate is attributable to declining fertility rates, as well as demographic shifts. The proportion of women aged 20 to 34—the ages when more than three-quarters of births occur—has been falling. Both the birth and abortion rates for teenagers continued to fall. (The falling birth rates, however, are not enough to offset growth in the number of teenaged women, hence total births to teenagers are rising). The report also showed that use of pre-natal care increased among all age and racial and ethnic groups, with the largest increases among those with the lowest levels of care. Unfortunately these increases were not enough to reverse the upward trend in the incidence of low birthweight babies, although this incidence did improve somewhat among black mothers. Finally, babies continue to prefer to enter the world on Tuesdays.

Another Baby Bell Tries to Be the First to Enter the Long-Distance Market. SBC, the Oklahoma-based company formerly known as Southwestern Bell, is trying to become the first Regional Bell Operating Company (RBOC) to be allowed into the long-distance market under the 1996 Telecommunications Act. To be allowed in the long-distance market, Baby Bells must submit an application to the FCC and show that they have agreed to "interconnect" with other providers in their local market (a prerequisite for more competitive local-telephone-service markets). Earlier this year, another RBOC (Ameritech) withdrew its application after the FCC determined that it had not provided adequate evidence that it had the necessary interconnection agreements. Similar allegations have surfaced regarding SBC. If the company's application overcomes this hurdle, the telecommunications world will be watching to see how much discretion the FCC has under the Telecommunications Act in determining whether a Baby Bell's entering the long-distance market is in the "public interest."

Women-Owned Businesses Flourish. Over 15 percent of U.S. businesses with employees are owned by women, and women own another 19 percent of such businesses jointly with men, according to recent results from the Census Bureau's Survey of Business by Gender of Ownership—the first survey focusing on women-owned businesses. The report also suggests that the proportion of businesses owned by women has been growing. Nearly 20 percent of firms established between 1991 and 1994 were women-owned, compared to 12 percent of those established before 1980. Not surprisingly, businesses owned by women tended to be younger than the average business. The survey did not confirm worries that the expansion of such businesses is thwarted by poor access to credit. Compared with male-owned businesses having similar characteristics, women-owned businesses had no more difficulty gaining access to credit and tended to use the same sources of credit. In addition, they had similar plans for expansion.

INTERNATIONAL ROUNDUP

Business Confidence Rises Among Japanese Manufacturers. For the first time since late 1991, the Bank of Japan TANKAN survey shows that principal manufacturing companies regard Japanese business conditions as "favorable." Nonmanufacturing and small manufacturing enterprises, by contrast, continue to rate business conditions as "unfavorable." In fact, the business confidence of nonmanufacturing industries was lower in the most recent (March) survey than it was in November 1996. A possible explanation for the division within the Japanese business community is that principal manufacturing enterprises are more export-oriented and expect to benefit from a weaker yen.

WTO Report Indicates World Trade Slowdown in 1996. Last year, the volume of world merchandise trade grew about 4 percent, after growing 8.5 percent in 1995 and about 10 percent in 1994. The deceleration last year was much greater than was forecast by any of the leading analysts. Substantially lower growth in both Asian exports and Asian imports were a significant contributing factor. In many Asian countries (including China and Japan), growth in trade lagged behind growth in GDP—a striking reversal of the usual pattern. In Japan, export growth was negative in 1996. In the United States, by contrast, merchandise export and import growth exceeded the world growth rate in 1996. In nominal dollar terms, U.S. merchandise exports grew 6.8 percent, while imports grew 6.1 percent.

Emerging EU Rift over New Central Bank. Reports that the French government may propose its own candidate for the presidency of the European Central Bank (ECB) are reported to have received a cool reception from German and Dutch officials. The current front-runner for the ECB post is Wim Duisenberg of the Netherlands, who will take over the Presidency of the European Monetary Institute this summer. The Institute is the precursor organization to the proposed ECB. French officials have publicly criticized the statutory independence of the ECB, and Duisenberg's perceived devotion to conservative banking principles and central bank independence may make him unpalatable to France. Some German media reports claim that the French will propose Michel Camdessus, the managing director at the IMF, instead of Duisenberg. Meanwhile, the current President of the European Monetary Institute, Alexandre Lamfalussy of Belgium, warned against any delay of monetary union.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

According to revised estimates the goods and services trade deficit declined to approximately $10.4 billion in February from $12.7 billion in January.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.9 percent in March. Capacity utilization increased 0.5 percentage point to 84.1 percent.

Housing Starts

Housing starts decreased 6 percent in March to 1.43 million units at an annual rate.

Consumer Price Index

The consumer price index increased 0.1 percent in March. Excluding food and energy, consumer prices increased 0.2 percent.

MAJOR RELEASES NEXT WEEK

There are no major releases scheduled for release.

U.S. ECONOMIC STATISTICS

	1970–1993	1996	1996:2	1996:3	1996:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.1	4.7	2.1	3.8
GDP chain-type price index	5.3	2.1	2.2	2.0	1.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.9	0.6	0.0	1.1
Real compensation per hour:					
Using CPI	0.6	0.4	0.5	0.7	0.2
Using NFB deflator	1.3	2.2	2.0	2.0	2.7
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.4	10.3	10.6	10.6
Residential investment	4.5	4.1	4.2	4.1	4.1
Exports	8.2	11.3	11.3	11.1	11.5
Imports	9.2	12.6	12.6	12.7	12.6
Personal saving	5.1	3.6	3.2	3.9	3.8
Federal surplus	–2.7	–1.7	–1.7	–1.6	–1.4

	1970–1993	1996	Jan. 1996	Feb. 1997	Mar. 1997
Unemployment Rate	6.7**	5.4**	5.4	5.3	5.2
Payroll employment (thousands)					
increase per month			259	293	175
increase since Jan. 1993					11926
Inflation (percent per period)					
CPI	5.8	3.3	0.1	0.3	**0.1**
PPI-Finished goods	5.0	2.8	–0.3	–0.4	–0.1

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1995	1996	Feb. 1997	Mar. 1997	April 17, 1997
Dow-Jones Industrial Average	4494	5743	6917	6901	6659
Interest Rates					
3-month T-bill	5.49	5.01	5.01	5.14	5.15
10-year T-bond	6.57	6.44	6.42	6.69	6.86
Mortgage rate, 30-year fixed	7.95	7.80	7.65	7.90	8.16
Prime rate	8.83	8.27	8.25	8.30	8.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level April 17, 1997**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.725	0.4	14.5
Yen-Dollar	126.1	0.1	16.4
Multilateral $ (Mar. 1973=100)	96.85	0.2	10.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.1 (Q4)	5.2 (Mar)	2.8 (Mar)
Canada	2.3 (Q4)	9.7 (Feb)	2.2 (Feb)
Japan	3.1 (Q4)	3.4 (Feb)	0.7 (Feb)
France	2.1 (Q4)	12.8 (Dec)	1.6 (Feb)
Germany	2.2 (Q4)	7.6 (Dec)	1.7 (Feb)
Italy	0.1 (Q4)	12.3 (Jan)	2.4 (Feb)
United Kingdom	2.0 (Q4)	7.2 (Feb)	2.7 (Feb)