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THE PRESIDENT HAS SEEN
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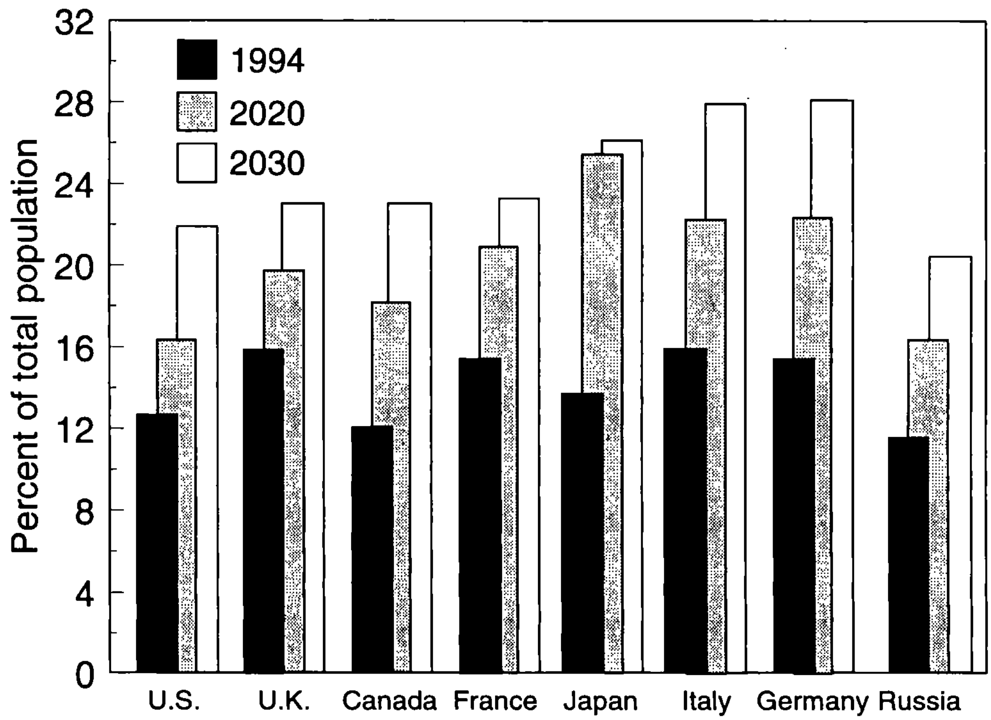
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

June 13, 1997

CHART OF THE WEEK

The Aging Eight: Share of Population Aged 65 and Over



Over the next generation, each of the countries at the Denver Summit can expect to see its population age substantially. However, the projected timing and extent of that aging will differ greatly across countries. The earliest and most dramatic population aging will occur in Japan, while the experience in the United States will be more gradual and more modest in extent. By 2030, Italy and Germany are projected to have the oldest populations among the Eight. (Projections for Russia are less reliable than the others.)

22.2.07

CONTENTS

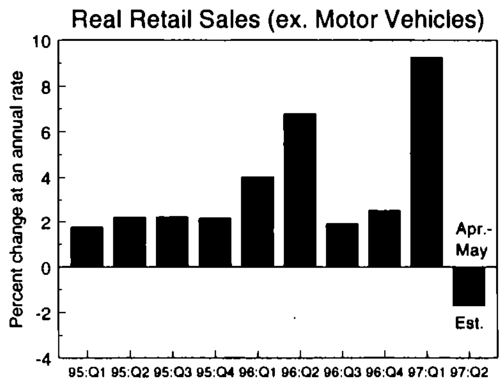
COUNCIL OF ECONOMIC ADVISORS
THAT'S IT?..OUR ADVICE TO THE PRESIDENT IS DON'T TAKE ANY WOODEN NICKELS?!

MACROECONOMIC UPDATE

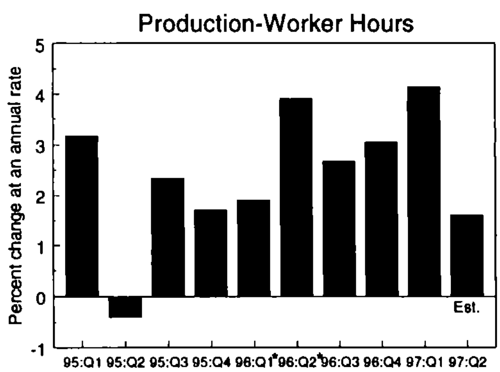
Economy Slows as Consumers Cut Back

Although the jobless rate continues to fall—dropping to 4.8 percent in May from 5.3 percent in the first quarter, evidence is accumulating that the economy has slowed from its blistering first-quarter pace.

Consumption. Consumer spending has been volatile and unpredictable during the past year. A slowdown in purchases of goods (excluding motor vehicles) in the second half of 1996 was followed in the first quarter by one of the fastest-ever growth rates (see upper chart). Preliminary data for April and May seem to indicate that consumption growth has stopped abruptly. No good explanation is at hand for this recent volatility. Looking ahead, consumer fundamentals remain positive: Consumer confidence is at one of its highest levels ever, and part of the gain in stock-market wealth over the past few years may not yet be reflected in consumption.



Investment. Considerable momentum remains in business investment. Inventory building was robust in the first quarter and this pace may be sustainable, at least in the short run, as inventories remain lean in relation to sales. Equipment investment is likely to post another strong quarter, as the backlog of unfilled orders for investment goods has increased in each of the past 4 months. And construction of business structures is expected to continue to grow as vacancy rates for office buildings continue to decline.



* Adjusted for bad weather effects in January 1996

The labor market. Production-worker hours appear to be rising at about a 1.6 percent annual rate in the second quarter (based on April and May)—noticeably slower than the growth rates over the past 4 quarters (see lower chart). Nevertheless, with expected growth in productivity at about 1 percent, this growth in hours would, on its own, point to real GDP growth at an annual rate of about 2 to 3 percent in the second quarter.

Putting it all together. Because of the anemic retail sales figures, however, summing the available spending data results in a weaker estimate of GDP than indicated by the labor market. Weighing all the evidence, our best guess is that real GDP is growing at about a 1¾ percent annual rate in the second quarter.

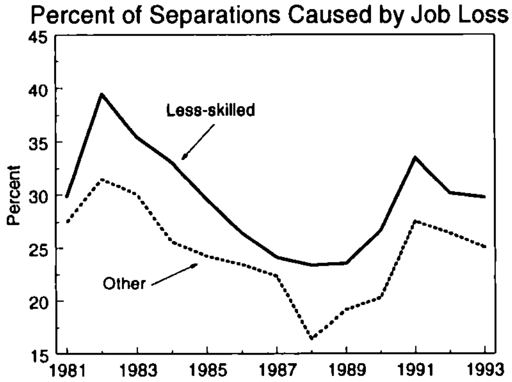
SPECIAL ANALYSIS

Less-Skilled Workers in the UI System: Empirical Evidence

To what extent will the unemployment insurance (UI) system fill in as a safety net for those who move from welfare to work? It should help some. But UI is generally paid only to those who lose their jobs (not those who quit), which may substantially limit eligibility.

Job separations and UI eligibility. If former welfare recipients are similar to other unskilled workers, they are likely to experience labor market difficulties (see *Weekly Economic Briefing*, April 18, 1997). Evidence from a survey of roughly 10,000 individuals from the 1957-64 birth cohort indicates that low-skilled workers—defined as high school dropouts or those who scored poorly on an aptitude/achievement test in their late teens or early 20s—were quite likely to become jobless. In 1993, for example, about 30 percent of the jobs held by these workers ended without the worker immediately taking up a new one.

Percent of Separations Caused by Job Loss



Although spells of joblessness are common among workers in the survey, most were not eligible for UI because, in general, only job losers may collect benefits. Typically, workers who quit their jobs are not eligible, even if they leave because of family illness, loss of day care, or transportation problems. The share of separations due to job loss is higher for less-skilled workers than for others. But even in recessions, job loss accounts for less than half of these separations (see chart).

UI eligibility among job losers. To collect UI benefits, a job loser must satisfy not only this job-loss test but also minimal job-tenure and earnings requirements. For example, a minimum wage worker who had been employed 30 hours per week for 6 to 9 months would generally be eligible. Analysis of the 1957-64 birth cohort shows that about 9 out of 10 job losers qualify for UI. This percentage is roughly the same among less-skilled workers as it is among others in the survey.

Conclusion. Many less-skilled workers stop working for reasons other than job loss and are therefore not eligible for UI. Most job losers already satisfy the experience and earnings requirements for collecting UI benefits, hence these requirements are not a major barrier to eligibility. On balance, the UI system can provide additional income support for some of those who move from welfare to work, but many will experience significant gaps in their income streams.

<u>SPECIAL ANALYSIS</u>

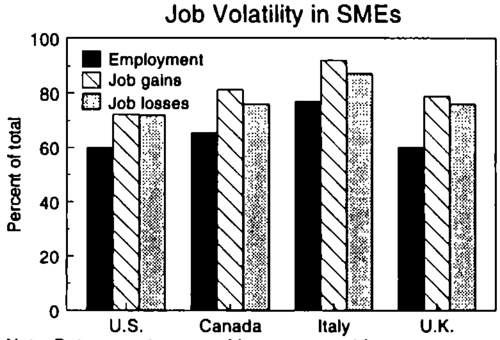
Small Business in the G7

Small businesses make important contributions to job creation and productivity growth in every G7 country. But, compared with large businesses, small businesses tend to offer less secure jobs at somewhat lower wages.

Net job creation. More than 99 percent of businesses in the G7 employ fewer than 500 employees, the conventional definition of small and medium-sized enterprises (SMEs). The share of total employment in these firms ranges from about 50 percent in the United States to around 80 percent in Italy and Japan. It is probably not surprising that a majority of net job creation in G7 countries is attributable to small and medium-sized enterprises, given their large job base. But no systematic relationship appears to exist between business size and the <u>rate</u> of job creation. This has been demonstrated in a number of studies and is consistent with the fact that the share of employment in small and medium-sized enterprises has stayed fairly constant in G7 countries. Evidence for the United States indicates that although the size of the firm is unimportant, <u>young</u> establishments seem to be disproportionate job creators (see *Weekly Economic Briefing*, March 7, 1997).

Turbulence. In all G7 countries, the proportion of gross job gains occuring in small and medium-sized enterprises is larger than their share of total employment. So, too, however, is the proportion of gross job losses (see upper chart). Such turbulence can create hardship for individual workers, but recent research from the United States shows that the process whereby workers move from less-productive to more-productive firms is vital to overall productivity growth.

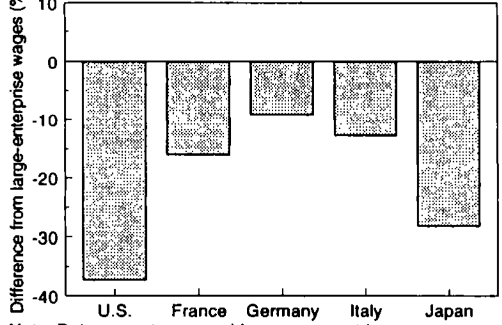
Job Volatility in SMEs



Note: Data are not comparable across countries.
U.S. data for manufacturing only.

Wages. On average, wages paid by small and medium-sized enterprises are 10 to 40 percent lower than wages paid by large enterprises (see lower chart). The gap in benefits is also large. Much of the premium paid by large enterprises arises because workers there tend to be in higher-wage occupations, tend to be more experienced, and are more likely to be members of unions. But at least in the United States, even after adjusting for these factors, newly hired workers in large firms earn roughly a 10 percent premium.

Wage Differential in SMEs



Note: Data are not comparable across countries.

ARTICLE

Liability Law: Who Should Pay, When, Why?

Lawsuits over who should pay for the costs of accidents and product defects have received considerable attention in the press and among policymakers. An economic perspective can help explain how liability rules can lead those involved in accidents—both injurers and victims—to control risk in an appropriate manner.

Deterrence or compensation? The economic perspective on liability focuses primarily on deterring careless or negligent conduct. Compensation, while important, need not require elaborate rules or costly litigation to determine who is at fault when accidents occur. For example, health insurance could pay the bills when a homeowner is injured while using a lawnmower, without having to go through a court proceeding to decide whether the accident was caused by poor product design, misuse by the consumer, or both.

What liability rule works best? Over the centuries, courts have evolved a variety of legal rules for determing when injurers should pay in accident situations. From an economic perspective, the choice of a rule depends upon who should be taking care to reduce the chances of an accident or the severity of a loss.

- Only the victim's care level matters: no liability. The onus should be on victims when they can control the risk of an accident at lower costs than others can. A driver who damages his car by hitting a tree should generally not be able to hold the owner of the tree liable if no action by the tree owner could have prevented the collision. Losses from natural disasters are another setting where "no liability" is the appropriate rule, because no apparent injurer is responsible for the loss. In cases like these, insurance can compensate for any loss, but no one should be sued for damages.

- Only the injurer's care level matters: strict liability. Under no liability, potential injurers lack any incentive to take care—an inefficient outcome if the benefits of taking care exceed the costs. A strict liability rule can promote efficiency when harm is fully in the control of the injurer, as when an uncut dead tree on one person's property falls onto a neighbor's roof. Strict liability gives injurers an incentive to factor expected costs into their decisions, which should lead them to take care up to the point where the benefits of making accidents less likely or less severe just cover the costs in time, effort, and resources of being more careful.

- Both the injurer's and the victim's levels of care matter: negligence rules. Under strict liability, victims have no incentive to take care, even when it would be efficient for them to do so. If a lawnmower manufacturer were held strictly liable when someone loses a toe by cutting the grass in bare feet, consumers would have less incentive to take reasonable steps to protect themselves (such as wearing shoes). If, by contrast, manufacturers were absolved of all liability, they would have less incentive to take cost-effective safety-design measures (such as adding foot guards).

Negligence rules, in which potential injurers are liable only if they fail to exercise "due care," can solve this problem. Injurers would take appropriate care to avoid being found negligent and thus liable for damages. Victims, being exposed, would have an incentive to take care as well. A rule with the same effect that shifts the cost to injurers would be to have strict liability, but where an injurer could avoid having to pay damages if the victim failed to take appropriate care.

Just a taste. The economic analysis of legal rules recognizes numerous "real life" effects including litigation costs, liability insurance, settlement alternatives, imperfect information, multiple injurers, insolvent defendants, incorrect "due care" standards, and punitive damages for intentional harms. But very simple cases can illustrate how one can justify liability law as a way to encourage efficient amounts of care, rather than as a type of insurance against accidental losses.

The Economics of Law

The attention of economists to legal issues largely began with a classic 1960 article by Nobel laureate Ronald Coase. In that article, Coase proposed the then-novel idea that, when property rights are well defined, liability rules do not matter for achieving efficiency, if—and it is a big "if"—people can costlessly negotiate solutions to potential conflicts. For example, if smokers have the right to smoke—a no liability rule—nonsmokers could pay them not to smoke if the costs imposed on them by the smoking exceeded the benefits to the smokers from continuing to smoke. But if nonsmokers had the right to be protected—a strict liability rule—smokers could go ahead if the benefits to them from smoking exceeded the costs to the nonsmokers (as reflected in their willingness to pay a judgment for harm done to nonsmokers).

The ubiquity and diversity of the ways people can make arrangements among themselves through contracts, organizations, and ordinary market transactions, illustrate one lesson of the "Coase Theorem." But economists have also been inspired by Coase's analysis to consider how legal rules matter when negotiation or "transaction costs" keep people from making mutually beneficial arrangements. Liability rules are needed precisely because people cannot work everything out in advance in matters such as how much care to take in manufacturing products and putting others at risk of accidental loss.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Insurance Plan Influences Cataract Surgery Rates. A recent study examining a large sample of California Medicare patients found that managed care enrollees were significantly less likely to undergo cataract surgery than those in the traditional fee-for-service program. After controlling for age, sex, and diabetes status, fee-for-service beneficiaries were twice as likely as managed care beneficiaries to have the elective procedure. Within the fee-for-service sector, women were twice as likely as men to have the procedure. Because they did not have information about the results of the surgery, the authors caution that they cannot determine whether the surgery is performed too often in fee-for-service or not enough in managed care. They call for further research to assess the appropriateness of cataract surgery by evaluating use compared to clinical need.

Does Parents' Income Matter for Their Children's Future Earnings? Many researchers have found a correlation across generations between parents' and children's incomes. But this correlation does not necessarily mean that it is the money *per se* that matters. The persistence of economic status across generations might, for example, reflect abilities or values transmitted by parents to their children through genes, culture, or education. A recent study tests for the importance of money *per se* by trying to isolate observable determinants of parental income that arguably represent luck—union status, industry, and involuntary job loss due to plant shutdowns or closings. The author concludes that changes in fathers' incomes due to these factors have at best a negligible impact on children's incomes, suggesting that much of the measured intergenerational correlation between parents' and children's incomes may be related to the transmission of other traits that are related to income (including particular skills or abilities as well as attitudes and behaviors, like low expectations). However, the study found that for a sample of lower-income parents, money does matter. One explanation for this finding is credit constraints: Low-income parents may have difficulty borrowing and may therefore under invest in their children's human capital.

What Central Bankers Could Learn from Academics—and Vice Versa. Drawing on his experiences as Vice Chairman of the Federal Reserve Board, former Council of Economic Advisers member and current Princeton economics professor Alan Blinder concludes that central banking in practice is as much art as science, but that the Federal Reserve and other central banks could profit from more disciplined and systematic thinking. They need to specify their ultimate goals and their long-run plans to achieve them rather than focusing solely on current data and the near-term outlook. He argues that academic researchers need to train their powerful tools on real-world issues instead of chasing intellectual will-o'-the wisps. For example, many academic papers are based on the assumption that central bankers will always yield to inflationary impulses. Blinder argues that he never once witnessed nor experienced this temptation.

INTERNATIONAL ROUNDUP

France Calls for More Time to Examine EMU Stability Pact. The new Socialist goverment in France called for more time to study the effects of the EMU "Stability Pact" on job creation, a move that puts France at odds with its European partners. The Stability Pact was negotiated last year in Dublin as a means of enforcing continuing fiscal discipline on EMU countries after they satisfy the Maastricht criterion for entry. According to the pact, countries that run deficits in excess of 3 percent of GDP would have 10 months to correct the situation before facing possible fines. A failure to ratify the agreement at next week's Amsterdam summit would be likely to upset financial markets once again, perhaps encouraging more short-term assaults on the deutsche mark and the franc.

Uganda Launches New Stock Exchange. Uganda's new stock exchange opened for business last week in Kampala. The new stock exchange is another step in the direction of encouraging private markets in a country that is already showing considerable economic promise. In the last few years, Uganda has undergone a series of fiscal reforms, and, as a result, the public deficit has fallen from 8.9 percent of GDP in the 1995 fiscal year (running from July 1994 to June 1995) to 6.8 percent in 1996. The deficit is expected to fall to 5.8 percent in 1997. The Ugandan government has pushed through reforms in a number of sectors. It privatized 20 companies in 1996, and an accelerated privatization agenda has been proposed for 1997. These policies appear to be paying off in terms of economic performance. Real GDP grew 8.5 percent in the 1996 fiscal year. Annual inflation over the same period was 5.3 percent. Growth in real GDP is expected to increase to more than 7 percent in 1997.

Trade Barriers In Developed Countries Exacerbate African Poverty. In the 1997 Human Development Report, the United Nations has called on industrial countries to open their home markets, "especially for Africa's agricultural exports." The reportfinds that agricultural subsides in industrial nations and those countries' barriers to textile imports cost the developing world about $60 billion a year. It also states that average tariffs on industrial country imports from the least developed countries are 30 percent higher than the global average. The main purpose of the report is to detail the state of human poverty around the world. It finds that Sub-Saharan Africa has a larger fraction of people in poverty than any other region in the world. The report warns that by the year 2000, 50 percent of Sub-Saharan Africans could be living in poverty. (The UN definitionof poverty is based on a lower income threshold than is the U.S. poverty rate.)

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, June 13, 1997****

The producer price index for finished goods fell 0.3 percent in May. Excluding food and energy, producer prices also fell 0.3 percent.

Retail Sales

Advance estimates show that retail sales decreased 0.1 percent in May following a decrease of 0.9 percent in April. Excluding sales in the automotive group, retail sales also decreased 0.1 percent in May following a decrease of 0.5 percent in April.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
Industrial Production and Capacity Utilization (Tuesday)
Housing Starts (Tuesday)
Productivity (Wednesday)
U.S. International Trade in Goods and Services (Thursday)

U.S. ECONOMIC STATISTICS

	1970-1993	1996	1996:3	1996:4	1997:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.1	2.1	3.8	5.8
GDP chain-type price index	5.4	2.1	2.0	1.9	2.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.9	0.0	1.1	2.0
Real compensation per hour:					
Using CPI	0.6	0.4	0.7	0.2	2.3
Using NFB deflator	1.3	2.2	2.0	2.7	2.3
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.4	10.6	10.6	10.6
Residential investment	4.5	4.1	4.1	4.1	4.0
Exports	8.2	11.3	11.1	11.5	11.5
Imports	9.2	12.6	12.7	12.6	12.9
Personal saving	5.3	3.6	3.9	3.8	3.5
Federal surplus	-2.7	-1.7	-1.6	-1.4	-1.0

	1970-1993	1996	March 1997	April 1997	May 1997
Unemployment Rate	6.7**	5.4**	5.2	4.9	4.8
Payroll employment (thousands)					
increase per month			182	323	138
increase since Jan. 1993					12289
Inflation (percent per period)					
CPI	5.8	3.3	0.1	0.1	N.A.
PPI-Finished goods	5.0	2.8	-0.1	-0.6	**-0.3**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, June 13, 1997**.

FINANCIAL STATISTICS

	1995	1996	April 1997	May 1997	June 12, 1997
Dow-Jones Industrial Average	4494	5743	6658	7242	7711
Interest Rates					
3-month T-bill	5.49	5.01	5.16	5.05	4.84
10-year T-bond	6.57	6.44	6.89	6.71	6.48
Mortgage rate, 30-year fixed	7.95	7.80	8.14	7.94	7.72
Prime rate	8.83	8.27	8.50	8.50	8.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 12, 1997**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.725	-0.3	12.3
Yen-Dollar	114.0	-1.5	4.1
Multilateral $ (Mar. 1973=100)	95.36	-0.4	7.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.1 (Q1)	4.8 (May)	2.5 (Apr)
Canada	2.8 (Q1)	9.6 (Apr)	1.7 (Apr)
Japan	3.1 (Q4)	3.4 (Apr)	1.9 (Apr)
France	1.0 (Q1)	12.8 (Mar)	0.9 (Apr)
Germany	2.8 (Q1)	7.8 (Apr)	1.3 (Apr)
Italy	0.1 (Q4)	12.3 (Jan)	1.8 (Apr)
United Kingdom	3.0 (Q1)	7.0 (Apr)	2.4 (Apr)