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WEEKLY ECONOMIC BRIEF OF THE PRESIDENT OF THE UNITED STATES

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

September 22, 2000

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Baily
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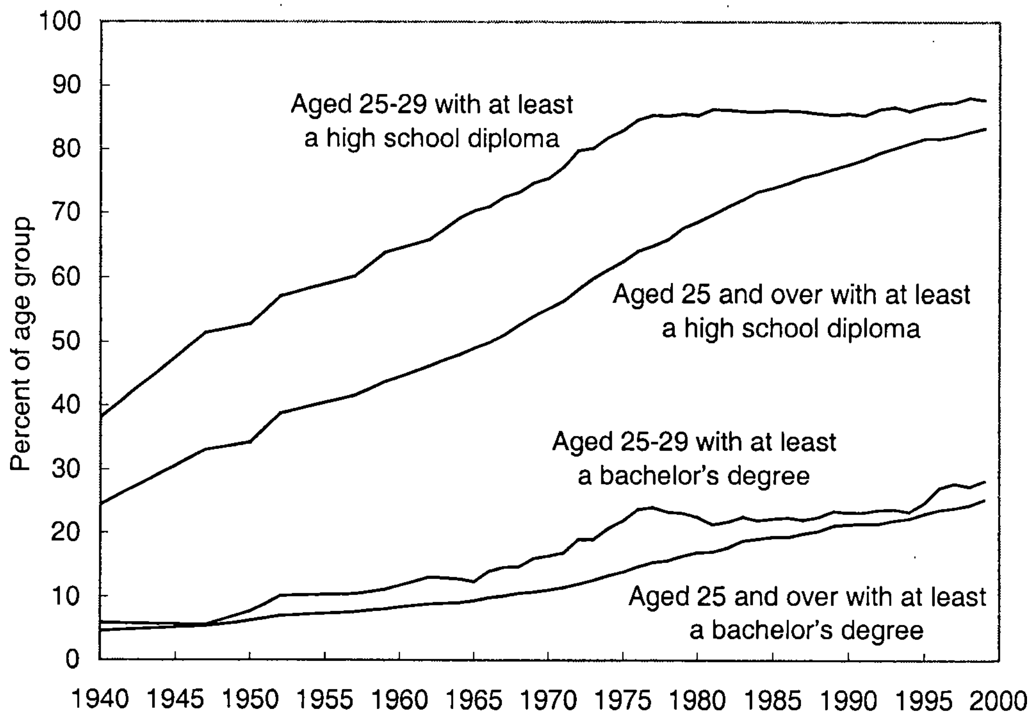
CHART OF THE WEEK

Educational Attainment of Adults



The share of Americans aged 25-29 with at least a high school diploma has exceeded 85 percent since 1977. As a result, the share of the population aged 25 and older with at least a high school diploma has increased steadily, reaching 83.4 percent in 1999. The share of young adults with a bachelor's degree or more exceeded its 1977 level in 1995 and reached an all-time high of 28.2 percent in 1999.

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"Anyway, who needs oil? We've got the internet."

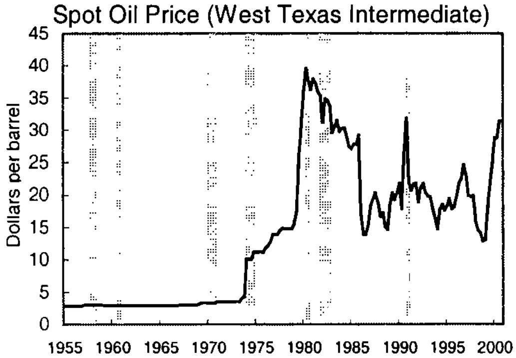
9-26-00

CURRENT DEVELOPMENT

Oil Prices and the Macroeconomy

Three of the past four recessions have been preceded by a sharp rise in oil prices (see chart), raising legitimate concerns about the possible impact of the latest surge in oil prices. While the economy today is less vulnerable to an oil price shock than it was in the past, a sharp enough rise in oil prices could be disruptive.

Spot Oil Price (West Texas Intermediate)



Swings in oil prices. At about $31 per barrel, crude oil prices in August were roughly $10 higher than they were a year earlier. Prices this month have surged to $37 per barrel. Oil prices had fallen sharply during the Asian economic crisis in 1998. But over the past 2 years, prices have risen as world economic growth (at 3.6 percent per year) has outpaced growth in world oil production capacity (at 0.9 percent per year). Current high prices should encourage growth in capacity, and futures markets expect prices to fall about $4 by January. Still, uncertainty about how much surplus production capacity can come online and about Iraqi intentions suggest the possibility of further price increases in the near future.

Energy prices and inflation. A $10 per barrel increase in oil prices like the one we experienced through August directly boosts the CPI by 0.6 percentage point. Natural gas prices would also be pushed up as a result of utilities and industry substituting away from oil. The price *level* could be pushed up a bit more in the longer run when higher energy costs feed through to other goods. But if oil prices stabilize, the post-shock *inflation rate* should recede toward earlier levels.

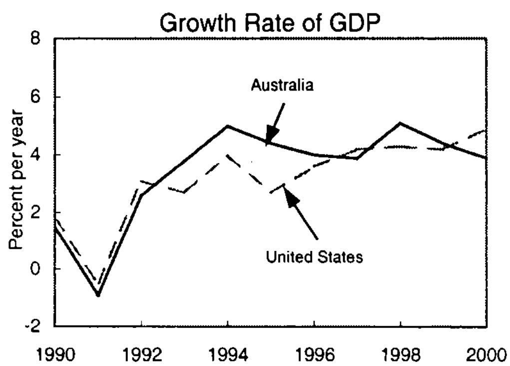
Macroeconomic effects. A $10 per barrel increase in oil prices costs domestic oil consumers about $71 billion annually. Roughly $35 billion of this is a transfer to domestic oil producers, but the remaining $36 billion is transferred to foreign oil producers. Transfers to foreigners represent a drain on purchasing power that reduces aggregate demand. Monetary policy would face a hard choice between supporting aggregate demand and fighting inflation.

Conclusion. This analysis suggests that recent high oil prices will have a moderating effect on U.S. economic growth. However, the economy today is remarkably strong, with high employment, low inflation, and strong productivity growth. In addition, oil is less important to the economy than it once was: the United States consumes only 52 percent as ~~much oil per dollar of real~~ GDP as it did in 1973. Nevertheless, the calculations above suggest that a sustained increase in oil prices to over $40 per barrel, if it should happen, would further increase the danger of some combination of weaker growth and higher inflation. *

SPECIAL ANALYSIS

Australia's Olympian Economy

As the eyes of the world turn to Sydney for the Olympic Games, it appears that the United States and Australia share more than athletic prowess in swimming. Like the United States, Australia is experiencing a remarkable and long-lasting economic boom, with growth averaging 4 percent per year over the past 7 years (see chart). Growth continues to be robust this year. This rapid growth stands in stark contrast to the plodding 2.8 percent per year experienced during the 1980s.



Some similarities. Durability is not the only attribute that the Australian expansion shares with ours. Like us, Australia has experienced a drop in its unemployment rate, a shrinking government debt-to-GDP ratio, and low inflation. Moreover, productivity growth has remained high even as the expansion has matured. Australia also has a declining household saving rate and a large current account deficit (nearly 6 percent of GDP).

But some differences. Despite these similarities, Australia has some way to go before attaining the American standard of living: per capita income in 1999 was only 74 percent that of the United States. Some features of Australia's expansion are also different from ours. Perhaps most notably, Australia's surge in productivity and economic growth is not concentrated in the production of information technology equipment, which only accounted for 0.7 percent of GDP in 1997 (compared with 3.1 percent in the United States). Taken together, however, value added in IT and communication equipment production, software, and communications services was not too far away from U.S. levels (3.3 percent of GDP in Australia compared with 4.4 percent in the United States). In other words, Australia does not produce much IT equipment, but it does appear to be a fairly intensive user of the technology.

Policy foundations. Macroeconomic and structural policy changes have been important sources of renewed productivity growth in Australia. The Labour Party undertook extensive reform of the economy during the 1980s, when the financial sector was deregulated and tariff rates were reduced. In the 1990s, state-owned enterprises were privatized, extensive labor market reforms were enacted, and tariffs were reduced further. Over the 1990-97 period, the value of proceeds from privatizations was second only to that of the UK among OECD countries. For instance, the major telecommunications company Telstra is now partially privatized, and Australia is home to a number of vigorously competing mobile telephone companies. The average tariff rate on imports was 4 percent in 1998, down from over 12 percent in the mid-1970s. Floating the Australian dollar proved to be a key macroeconomic policy change, particularly during the East Asian financial crisis. With a floating exchange rate and a sound banking sector, the Australian economy was scarcely affected. even though 57 percent of exports went to East Asia in the quarter before the collapse of the Thai baht.

Prospects. It remains to be seen whether the Australian experience over the past decade signals the beginning of a new era of accelerated growth, or merely a transitional phenomenon associated with the efficiency gains arising from previous policy reforms. However, recent studies conclude that trend productivity growth has risen relative to its lows during the 1980s, suggesting that the recent gains could prove to be enduring.

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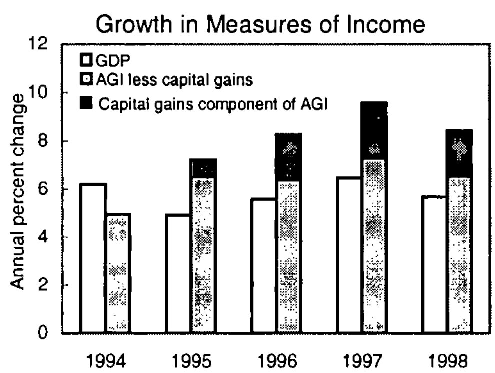
ARTICLE

The Sustainability of the Revenue Boom

Recurring revenue "surprises" have been an important feature of the fiscal landscape in recent years. Personal income tax receipts, in particular, have surged from less than 8 percent of GDP in 1994 to nearly 10 percent most recently, with the "excess" growth contributing an additional $141 billion to deficit reduction over the 1994-98 period, according to Congressional Budget Office calculations.

The faster growth in revenue relative to GDP reflects two main factors: faster growth in taxable income than in income generally; and an increase in effective tax rates (the percentage of income paid in taxes). Uncertainty about how much of this increase is sustainable introduces uncertainty into future surplus estimates.

Strong growth in taxable personal income. CBO estimates that 60 percent of the excess growth in individual income tax receipts arose from rapid growth in adjusted gross income (AGI) relative to GDP. About 17 percentage points of this excess growth occurred because personal income grew faster than the other income components of GDP. The rest reflects strong growth in sources of AGI that are not included in GDP (because they are not earned as a result of current production), such as capital gains realizations and retirement benefits—with capital gains being particularly important (see chart).



A rise in the effective tax rate. Statutory individual income tax rates have not increased since 1993, and some fell as a result of the 1997 Taxpayer Relief Act. Nevertheless, the overall effective tax rate on non-capital gains AGI has increased, accounting for the remaining 40 percent of excess growth in individual income tax receipts. Two factors account for most of this increase in effective tax rates, in roughly equal measure:

- Real bracket creep. For taxpayers in general, income has grown faster than the inflation-indexed adjustments to tax brackets. Because of this, more aggregate taxable income is now taxed at the higher rates.

- More taxable income at the top. Especially strong growth at the top of the income distribution also increased the proportion of aggregate income subject to the top tax rates. Tax return data indicate that the share of taxpayers with AGI above $200,000 (in 1998 dollars) rose over the 1994-98 period, and those taxpayers experienced higher-than-average growth in income. Incomes grew even more for taxpayers with more than $1 million in AGI. As a result, the share of taxes paid by these highest-income groups rose; of course, their after-tax incomes rose substantially as well.

Will excess revenue growth continue? CBO expects that growth in overall real income will continue and that taxable retirement income will pick up in the future, but it anticipates that capital gains relative to GDP will level off. However, revenue estimation remains an inexact science. In January, the CBO forecast that the net effect of these factors would be a slowing in individual tax receipts relative to GDP over the next 5 years, followed by a pick-up that would bring individual income taxes as a share of GDP back to about 10 percent by 2010. By the July update, however, another surprise had raised the 2000 forecast to 10.2 percent, which was projected to remain roughly level before rising slightly in 2009. Thus, the CBO forecast now assumes that the rise in individual income tax revenues as a share of GDP to its current, historically high level was not due to unusual factors that will soon be reversed. But it is fairly conservative in assuming that these revenues cannot grow faster than GDP indefinitely.

Conclusion. Of course, the tremendous uncertainty surrounding economic forecasts and predictions about real GDP, stock market values, and other variables affecting taxable income feeds directly into uncertainty about these revenue forecasts. Since 1986, CBO revenue forecasts for the upcoming budget year have been off by absolute amounts averaging 4 percent of revenues (and 0.8 percent of GDP), with overestimates occurring in the 1986-92 period, and underestimates since then. Moreover, forecast errors grow larger as the forecast horizon lengthens. Nevertheless, the apparent connection of economic growth with higher tax revenues, and hence with higher national saving and lower interest rates, suggests another channel through which a strong economy can be self-sustaining.

THE PRESIDENT HAS SEEN

9-26-00

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Shows Moderating Economy. Economic activity expanded at a moderate pace in August and early September, according to the latest reports from the Federal Reserve districts. Most districts characterized economic conditions as strong, and several said that economic growth continued to be solid. However, reports from Atlanta, Chicago, St. Louis, and Minneapolis indicated a softened overall pace of growth. Consumer spending was flat to modestly higher in most districts in August compared with late spring and early summer. Home sales and construction continued to soften, but several districts reported that commercial real estate activity was robust. In agriculture, crop prices remained low, and yield prospects dimmed in areas of the Southeast and Midwest experiencing prolonged drought conditions. Labor markets remained tight in most districts. Nevertheless, there were few indications that higher wages were being passed to consumers as higher productivity and competitive pressures held prices in check.

Educational Attainment Gaps Remain among Young Adults. As has been the case for about a decade, women aged 25-29 are more likely than men in that age group to hold high school diplomas and bachelor's degrees, according to new Census tabulations of 1999 data. The 1999 data are also broadly consistent with past evidence on racial and ethnic differences: the share of blacks aged 25-29 with high school diplomas (89 percent) is just a little below that of whites (93 percent), but the share of Hispanics is a much lower 62 percent. While 51 percent of Asians and 34 percent of whites aged 25-29 have bachelor's degrees, the shares are just 15 percent for blacks and 9 percent for Hispanics. Particularly low educational attainment among the foreign-born Hispanic population pulls down that group's overall attainment. Among all Hispanics aged 25 and over, 44 percent of the foreign-born hold high school degrees, compared with 71 percent of the native-born. The native-born are also more likely than the foreign-born to hold college degrees. This pattern contrasts with that of non-Hispanics aged 25 and over, among whom the foreign-born are more likely than the native-born to hold bachelor's degrees.

Effects of Public School Choice in Chicago. Allowing Chicago high school students to attend a public school other than the one in their neighborhood has not achieved its objective of greater racial integration, according to a recent study. But it has increased the amount of segregation by ability. It also appears to have boosted graduation rates. Overall, the study found that high-ability students were most likely to leave their neighborhood schools. White students were more likely to travel to attend high-achieving schools, while black students were more likely to travel to attend career academies. Controlling for pre-high-school test scores, the study found that students who traveled were more likely to graduate. School characteristics explained the higher graduation rates of those attending career academies, while unobservable characteristics of the students themselves seemed to be most important for those traveling to high-achieving academic high schools. The authors found no evidence that school choice lowered the probability of graduation for the students who remained in their neighborhood schools.

THE PRESIDENT HAS SEEN

9-26-00

INTERNATIONAL ROUNDUP

IMF Projects Strong World Growth. World GDP is projected to grow 4.7 percent in 2000 and 4.2 percent in 2001, according to the latest IMF *World Economic Outlook.* U.S. growth is projected to slow from 5.2 percent in 2000 to 3.2 percent in 2001. The Euro area recovery should continue, with growth of 3.5 and 3.4 percent in 2000 and 2001 respectively, up from 2.4 percent in 1999. Differences in growth rates within the Euro area are projected to narrow. The IMF is somewhat optimistic for Japan, claiming that a modest recovery is gathering momentum and should produce growth rates of 1.4 and 1.8 percent in 2000 and 2001 respectively. Latin America and East Asia are continuing to recover from the 1997-98 crises, with projected growth rates of more than 4 percent in 2000 and 2001 for Latin America and over 6 percent for East Asia. Growth in Africa is expected to rise to 4.5 percent in 2001, spurred by the recovery in South Africa and the oil-exporting countries. However, the poorest countries in Africa have been hit hard by both higher oil prices and declining prices for their commodity exports.

Red Tape for Start-ups Is Severe in Many Countries. A recent study of 75 countries finds substantial variation in the number of procedures that must be followed and the time and costs involved before a new business can open its doors. The number of required procedures varies from a low of 2 in Canada to a high of 20 in Bolivia, with a worldwide average of about 10. The minimum time required to complete these procedures ranges from 2 to 174 business days, with a worldwide average of 63 days. The payments required for a single firm to complete these procedures can surpass 2.6 times per capita GDP. The United States requires 4 procedures that take an average of 7 days to complete at a cost of a little under 1 percent of per capita GDP. The study found that countries with heavier regulation frequently exhibit greater corruption and a larger unofficial economy. Even after controlling for the costs associated with corruption and bureaucratic delay, the study found that starting a business is expensive, especially in poor countries. Moreover, stricter regulation of business start-ups was not found to be associated with higher quality products, less pollution, or more favorable health and safety outcomes.

Who Is the Most Corrupt of Them All? Nigeria is perceived to be the most corrupt economy in the world and Finland the least corrupt, according to Transparency International's latest corruption perceptions index. The index, which ranks countries from least to most corrupt, is calculated using 16 separate surveys from eight independent institutions and gauges the level of corruption perceived by business people, country analysts, and the general public. The United States was ranked 14th least corrupt, trailing several European countries, Singapore, Australia, New Zealand, and Canada. Nigeria received its poor ranking despite recent anti-corruption efforts, but survey respondents were optimistic about future efforts. By contrast Zimbabwe, Ukraine, and the Philippines registered considerable drops from last year. Recent political scandals in Ireland and Germany were also associated with a decline in their rankings.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $31.9 billion in July; the deficit was $29.8 billion in June.

Housing Starts

Housing starts were unchanged in August at 1.53 million units at an annual rate.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
Median Income and Poverty Reports (Tuesday)
Advance Durable Shipments and Orders (Wednesday)
Gross Domestic Product (Thursday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:4	2000:1	2000:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	8.3	4.8	5.3
GDP chain-type price index	5.2	1.6	1.6	3.3	2.6
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	8.0	1.9	5.7
Real compensation per hour:					
Using CPI	1.0	2.2	1.3	0.0	1.7
Using NFB deflator	1.5	3.3	2.9	1.1	2.9
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.0	13.4	13.7
Residential investment	4.5	4.3	4.3	4.3	4.2
Exports	8.2	10.6	10.8	10.8	11.0
Imports	9.2	13.4	13.9	14.2	14.6
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	2.4

	1970-1993	1999	June 2000	July 2000	August 2000
Unemployment Rate (percent)	6.7**	4.2**	4.0	4.0	4.1
Payroll employment (thousands)					
increase per month			57	-51	-105
increase since Jan. 1993					21989
Inflation (percent per period)					
CPI	5.8	2.7	0.6	0.2	-0.1
PPI-Finished goods	5.0	2.9	0.6	0.0	-0.2

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

FINANCIAL STATISTICS

	1998	1999	July 2000	August 2000	Sept. 21, 2000
Dow-Jones Industrial Average	8626	10465	10663	11015	10766
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.96	6.09	5.98
10-year T-bond	5.26	5.65	6.05	5.83	5.88
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.03	7.90
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level September 21, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.856	-0.7	-18.2
Yen (per U.S. dollar)	106.5	-0.7	1.6
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	101.3	-0.0	9.5

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	6.0 (Q2)	4.1 (Aug)	3.4 (Aug)
Canada	5.3 (Q2)	6.8 (Jul)	2.5 (Aug)
Japan	0.8 (Q2)	4.7 (Jul)	-0.5 (Jul)
France	3.4 (Q2)	9.6 (Jul) [2]	1.7 (Aug)
Germany	3.6 (Q2)	8.3 (Jul)	1.8 (Aug)
Italy	2.6 (Q2)	10.8 (Apr)	2.6 (Aug)
United Kingdom	3.1 (Q2)	5.5 (May)	3.0 (Aug)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics, except as noted in footnote 2.
2/ Data from OECD standardized unemployment rates.