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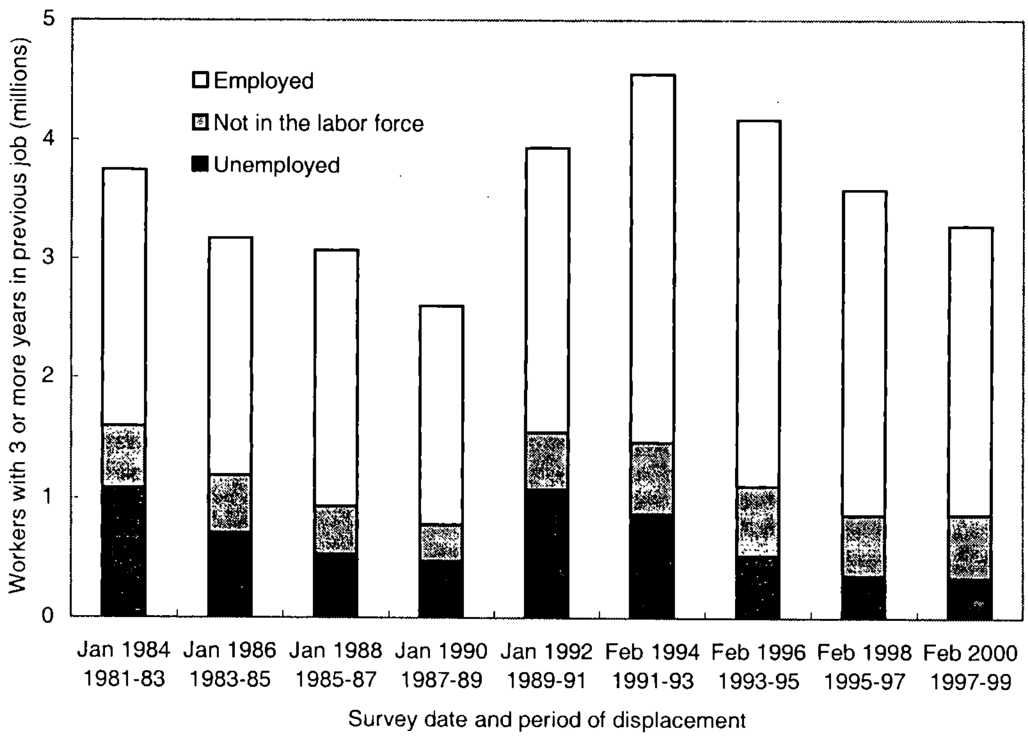
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 18, 2000

CHART OF THE WEEK

Displaced Workers and Subsequent Employment Outcomes



Displaced workers are those who lost their jobs because their plants or companies closed down or moved, their positions or shifts were abolished, or their employer did not have enough work for them. Biennial surveys since 1994 have shown a steady decline in the displacement of long-tenured workers. Although the level of displacement identified in the 2000 survey (for 1997-99) was higher than that in the 1990 survey (for 1987-89), the number of displaced workers who were still unemployed at the time of the survey was lower in 2000.

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"It's very, very important that you try very, very hard to remember where you electronically transferred Mommy and Daddy's assets."

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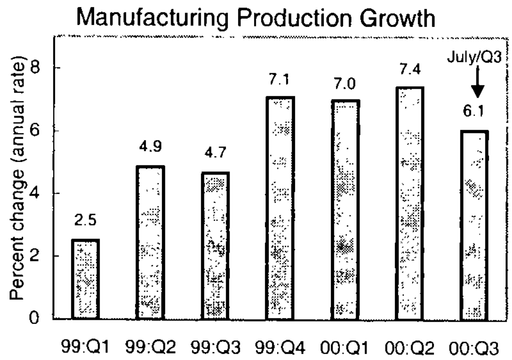
MACROECONOMIC UPDATE

The Economy Keeps Chugging Along

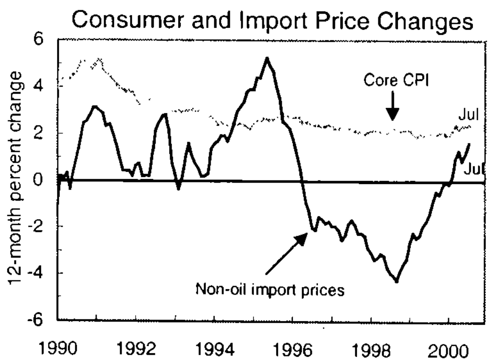
Economic activity appears to have been well-maintained into the third quarter, although at a reduced pace.

Concurrent indicators are still moving up. Production-worker hours are on track to increase at about a 1 percent annual rate in the third quarter—enough to support real GDP growth in the 3 to 4 percent range at an annual rate. Although initial claims for unemployment insurance (available through mid-August) have increased slightly so far this quarter, they remain at levels consistent with continued growth. July data show manufacturing production growing at a 6 percent annual rate thus far in the third quarter—down only slightly from its pace in the three previous quarters (see upper chart).



Household spending is slowing but exports are picking up. The composition of activity is moving away from consumption and residential construction. Both decelerated in the second quarter. And thus far in the third quarter, consumption growth appears moderate, while residential construction is falling. Consumption was fueled by the stock market gains of the past 5 years and may be expected to slow with a cooler stock market. (Thus far this year, the broadly based Wilshire 5000 index has been flat.) As consumption and residential investment slow, their contribution to GDP growth may be partially offset by the external account. Slowing consumption may slow imports. And the 8½ percent growth in exports during the past four quarters—reflecting the pickup in growth among our major trading partners—has been encouraging. Net exports are still likely to subtract from GDP growth, but by less than during the past 2 years.

Inflationary creep. Besides strengthening the market for U.S. exports, stronger foreign growth has also caused an acceleration in prices charged for our non-oil imports (see lower chart). Declines in these prices had been one of the factors restraining inflation, but now this restraining influence has vanished. This import-price acceleration—together with a rise in petroleum prices—is putting some upward pressure on inflation. Thus far, a very strong rise in productivity has largely offset these inflationary influences. Nevertheless, the risk of a slow upward creep of inflation is increasing.



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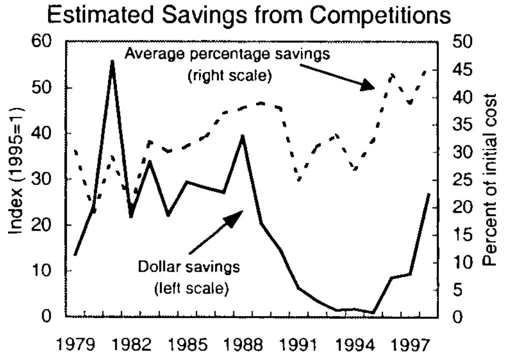
SPECIAL ANALYSIS

Public-Private Competition for DoD Commercial Activities

Over the past two decades, public-private competitions for the performance of commercial activities—tasks that could be obtained from the private sector—have generated substantial savings over initial costs for the Department of Defense. Average savings have been particularly large recently, and the numerous DoD tasks that remain available for competition represent significant additional potential savings.

Background. DoD completed over 2,000 public-private competitions (involving about 90,000 government positions) for the performance of commercial activities between 1979 and 1989, with estimated average weighted savings of over 30 percent of the initial cost. In the late 1980s and early 1990s, administrative and legislative constraints on the program led to relatively few competitions. But a renewed emphasis on competition since 1995, consistent with Reinventing Government initiatives, has been associated with average savings in excess of 40 percent and an increase in estimated total savings (see chart).

Estimated Savings from Competitions



The public-private competition process. Competitions apply to commercial activities; inherently governmental activities are exempt. The latter are defined as activities so intimately related to the public interest that they must be done by a Federal employee (such as directing or supervising government employees or administering contracts). Government employees have the opportunity to bid against the private sector after developing their "most efficient organization" to perform the specified work. The government has won about half of the competitions. Early competitions usually were awarded on a lowest bid basis, but changes in 1996 have allowed a "best-value" approach, evaluating bids on both quality and cost.

Recent results. Average savings on DoD contracts have been very high recently in part because some large competitions have resulted in exceptionally high savings. For example, a Navy competition completed in 1999 for base operating services in Guam had 2,300 baseline positions and estimated savings of about $91 million per year, or 68 percent of the baseline cost. Improved competition management has also played a role in achieving large savings. For example, DoD has been conducting larger competitions, which usually have higher percent savings. But even after controlling for factors like the size and scope of contracts, savings have been increasing recently. One possible explanation is that, in areas that had not yet faced competition, the gap between public and private sector efficiency had been widening.

Interpret with care. Estimated savings are based on the winning bid for the work compared with the initial estimated cost, but actual savings may differ from these estimates. For instance, actual costs may often increase as a result of changes from the projected workload. Furthermore, efficiency gains may not translate dollar-for-dollar into budget savings, if, for example, the military realigns personnel whose positions have been eliminated to fill empty positions elsewhere. In addition, because the workload might change over time (for example, because of a base closure and realignment), estimates of cumulative savings cannot be extrapolated from these initial estimates. Finally, these estimated savings omit transition costs, such as severance pay and early retirement incentives, as well as the cost of conducting the competition.

Potential savings. Even with these caveats in mind, additional potential savings may be substantial. Since 1998 Federal agencies have been required to identify personnel positions associated with tasks that can be competed, and DoD has identified over 240,000 such positions. Based on average savings of 30 percent and an average cost of $50,000 per position, this represents $3.6 billion per year in potential savings.

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ARTICLE

Are Free Trade Agreements Good for Free Trade?

Establishing a mandate for a new round of WTO negotiations is proving to be difficult, and the sense of momentum for trade liberalization in large regional groupings such as the Asia-Pacific Economic Cooperation (APEC) forum appears to have waned. However, interest in bilateral or smaller regional free trade agreements (FTAs) remains intense.

A recent WTO tally based on press reports identified 65 such arrangements at some stage of development. While these arrangements may prove to be stepping-stones to freer trade multilaterally, they do pose some potential transitional problems for the global economy. FTAs involving large economies like Korea or Japan may pose particular problems for the United States.

Motivations of small countries. Small countries such as Singapore or Chile, both of which are particularly active in these developments, generally have limited bargaining power in multilateral settings. But they may be able to exact more concessions and get more attention in bilateral settings. Such countries may be particularly interested in becoming export platforms for multinational corporations, a goal that can be achieved through preferential access to large foreign markets. At the same time, unlike complex multilateral arrangements, free trade agreements between unequally sized partners may present fewer political obstacles in both countries. Small economies generally do not pose major threats to their FTA partners' industries, while the smaller country typically has the most to gain from the FTA, ensuring domestic political support.

Motivations of Japan. For most of the postwar period Japan relied exclusively on multilateral trade arrangements such as the WTO or "open" regional arrangements such as APEC. But it has recently changed its strategy. There are reports that agreements with Mexico, Korea, and Singapore are at various stages of completion. The agreement with Mexico is clearly defensive, allowing Japan to dilute the U.S. preferences gained from NAFTA. (The EU has implemented a similar agreement with Mexico.)

The motives behind Japan's Asian initiatives are more complex. Japan has begun to explore bilateral arrangements partly out of frustration at the lack of progress in multilateral and APEC negotiations. Of course, one reason for these failures is Japan's own unwillingness to liberalize its agriculture and forest products. Japan's FTA initiatives have therefore centered largely on countries that are not major agricultural exporters, such as Singapore and Korea . However, precisely because Japan and Korea have very similar trade patterns, one study found only small economic gains for Japan from the proposed FTA. With so little commercial benefit from these agreements, it becomes clear that Japan's interest in pursuing these negotiations is motivated more by political than by economic considerations.

Implications for the global economy. The proliferation of FTAs poses some problems for the global economy. First, goods may no longer be exported from the lowest-cost producer if that producer lies outside of the relevant FTA. This trade diversion is a particularly important concern if, as it appears, countries choose partners that will not compete with their uncompetitive sectors. Second, overlapping FTAs and their "rules of origin" may create regulatory burdens, with different rules governing trade with different partners. On the positive side, however, FTAs can increase trade between the member countries. In addition, there may be a domino effect from regional trade initiatives. The presence of one agreement may act as a catalyst for other agreements, and these arrangements may over time aggregate into ever larger regional groupings that could then serve as stepping-stones to multilateral trade liberalization.

Implications for the United States. Preferential trading arrangements that exclude the United States will have a minor impact on U.S. exports and economic welfare as long as they involve small, relatively open economies such as Singapore. By contrast, the United States could experience greater competitive disadvantages from arrangements involving relatively large, protected economies like Korea and Japan. Moreover, American influence in East Asia could erode if we are left out of regional decisionmaking. Aggressive promotion of multilateral liberalization in the WTO and in broad regional forums such as APEC offers a possible antidote to these effects.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Finds Growth Moderating, Wages Up. Economic activity in all Federal Reserve districts continued to expand in June and July, but there were additional signs that the expansion was moderating in some sectors and the majority of districts. Seven districts—Atlanta, Boston, Chicago, Dallas, New York, Richmond, and San Francisco—reported slowing economic growth. The Cleveland, Kansas City, Minneapolis, and Philadelphia districts reported essentially no change in growth rates, and the St. Louis district reported accelerating economic growth. District reports suggest that consumer spending, manufacturing, and construction were slightly softer than in the last report in June. Easing demand appears to be restraining price increases. Energy prices remain high but may have peaked, and reports suggest that most of the indirect costs of rising energy prices have been absorbed by final goods producers for the time being. Labor markets continue to be very tight, with indications that the shortage of workers is limiting growth of activity in some areas. Many districts reported wage increases and the growing use of non-wage benefits.

Study Examines Sources of HMO Savings. In the treatment of certain conditions, about half of the difference between HMO and traditional indemnity health insurance costs comes from the fact that HMO patients are less likely to have such conditions, according to a new study. Most of the remaining cost difference comes from lower costs for the same courses of treatment. The study, drawing on data for the 200,000 state and local employees in Massachusetts, found that HMO patients were younger, on average, than patients in the indemnity plan. Even after adjusting for age and sex, however, HMO enrollees were cheaper to cover: the incidence of heart attacks, cancers, pregnancy, and diabetes was about 50 percent higher among people enrolled in the indemnity plan. For each condition, the course of treatment followed did not vary systematically between HMOs and the indemnity plan, but the HMOs paid less for such treatment. For example, about 13 percent of heart attack patients received bypass surgery and about 53 percent received no surgical intervention, irrespective of whether they were covered by the indemnity plan or an HMO. But the HMOs paid only $11,000 compared with the indemnity plan's $18,000 when there was no surgical intervention, and $52,000 versus the indemnity plan's $73,000 for bypass surgery.

Charting Older Americans' Well-Being. The Federal Interagency Forum on Aging Related Statistics recently released a chartbook, "Older Americans 2000: Key Indicators of Well-Being." These charts depict the increasing size and diversity of the American population aged 65 and older, and the increasing health and economic security of older Americans. A smaller proportion live in nursing homes now than in the mid-1980s, and the percentage with a chronic disability has fallen. The income of older Americans has been rising steadily for more than 20 years—older Americans are now less likely to be poor than any other age group. However, the poorest quintile of older Americans derive 80 percent of their income from Social Security.

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INTERNATIONAL ROUNDUP

Bank of Japan Abandons Zero-Interest Rate Policy. Arguing that Japan's economy was no longer in danger of damaging deflation, the Bank of Japan nudged interest rates up to 0.25 percent, ending an unprecedented year-and-a-half-long zero-interest rate policy. The move came after several months of signals that a rise was imminent, and the Bank indicated that it would maintain a relaxed, flexible policy. Characterizing the easing as in line with the improvement of the economy, the Bank said that innovations in communications and information technology, a resurgent world economy, and macroeconomic stimuli had sparked a gradual recovery that is likely to continue. International observers were less optimistic. The IMF, for example, noted that signs of growth were less certain and that other indicators pointed to a continuing threat of deflation and recession. The corporate sector also remained weak; bankruptcies rose 2.1 percent in June and are up 21.2 percent from a comparable period last year.

U.S. Usually Succeeds in WTO Dispute Settlements. Only one of the 17 cases brought against the United States before the World Trade Organization is likely to have a significant domestic commercial impact, according to a recent GAO analysis. That case, however, is the EU challenge to U.S. tax exemptions for exports of foreign sales corporations and is estimated to affect $152.3 billion in U.S. exports that benefited from the exemptions. Otherwise, the GAO found that most of the 25 U.S. complaints have produced changes in foreign regulations and practices that strengthened intellectual property protection and increased market access. The GAO also argues that the overall tenor of the settlements has upheld trade principles important to the United States, including equal treatment of foreign and domestic goods. The report found that WTO proceedings have yet to challenge U.S. sovereign trade law in any substantial manner; furthermore, the WTO has upheld the validity of long-standing U.S. provisions (including the controversial section 301 actions against unfair trade practices) as a method of addressing trade grievances.

Trade Opportunities Reduce Corruption. A country's "natural openness," as determined by its geography and demographics, has a significant effect on the level of corruption and the quality of governance, according to a new study. Greater natural openness (defined as the predicted sum of exports and imports as a share of GDP, based on remoteness, size, and language) implies a greater role for international trade and investment. Since international traders have more outside options than domestic ones, they tend to avoid operating in corrupt countries. Hence, a country that is naturally more open would find it optimal to devote more resources to building good institutions and fighting corruption. Based on a sample of over 60 countries, the study did find natural openness to be a significant explanatory variable for the different levels of corruption across countries, after controlling for income, ethnic fragmentation, and political institutions. Higher average income was also associated with lower corruption. A naturally more open economy also tended to pay a better relative salary to its civil servants, even after controlling for the level of development of the country.

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RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, August 18, 2000****

The goods and services trade deficit was $30.6 billion in June; it was $30.3 billion in May.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.4 percent in July following an increase of 0.2 percent in June. Capacity utilization rose 0.1 percentage point to 82.3 percent.

Consumer Price Index

The consumer price index increased 0.2 percent in July. Excluding food and energy, consumer prices also rose 0.2 percent.

Housing Starts

Housing starts fell 3 percent in July to 1.512 million units at an annual rate.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (Thursday)
Gross Domestic Product (Friday)

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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	5.2
GDP chain-type price index	5.2	1.6	1.6	3.3	2.5
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	8.0	1.9	5.3
Real compensation per hour:					
Using CPI	1.0	2.2	1.3	0.0	1.6
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	13.8
Residential investment	4.5	4.3	4.3	4.3	4.3
Exports	8.2	10.6	10.8	10.8	10.8
Imports	9.2	13.4	13.9	14.2	14.5
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	N.A.

	1970-1993	1999	May 2000	June 2000	July 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.0	4.0
Payroll employment (thousands)					
increase per month			171	30	-108
increase since Jan. 1993					22010
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.6	**0.2**
PPI-Finished goods	5.0	2.9	0.0	0.6	0.0

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

New or revised data in **boldface**.

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FINANCIAL STATISTICS

	1998	1999	June 2000	July 2000	Aug. 17, 2000
Dow-Jones Industrial Average	8626	10465	10583	10663	11056
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.96	6.09
10-year T-bond	5.26	5.65	6.10	6.05	5.81
Mortgage rate, 30-year fixed	6.94	7.43	8.29	8.15	7.96
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 17, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.915	0.8	-13.0
Yen (per U.S. dollar)	108.5	-0.2	-5.0
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	98.63	-0.5	4.4

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)	4.0 (Jul)	3.5 (Jul)
Canada	4.9 (Q1)	6.6 (Jun)	2.9 (Jun)
Japan	0.7 (Q1)	4.7 (Jun)	-0.7 (Jun)
France	3.4 (Q1)	9.8 (May) [2/]	1.7 (Jun)
Germany	2.3 (Q1)	8.3 (Jun)	1.9 (Jun)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jun)
United Kingdom	3.0 (Q1)	5.7 (Apr)	3.3 (Jun)

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.

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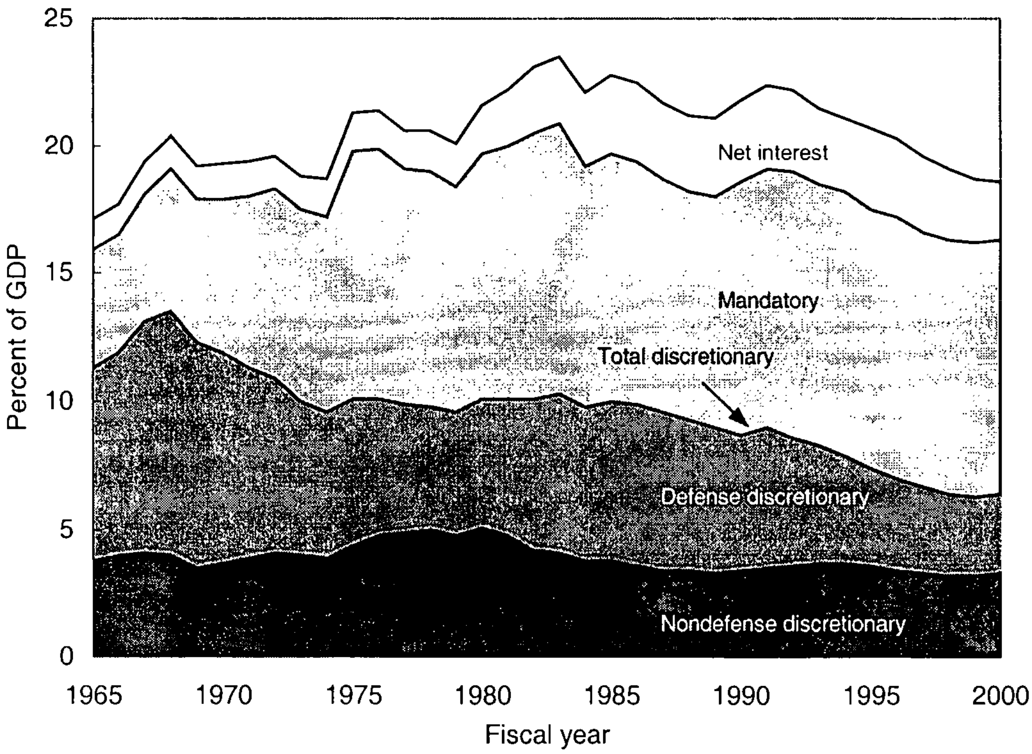
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 4, 2000

CHART OF THE WEEK

Federal Budget Outlays as Share of GDP



All budget enforcement act categories of Federal outlays fell as a share of GDP between 1992 and 2000, led by a drop of 1.9 percentage points in discretionary spending for national defense. Net interest fell 0.9 percentage points; mandatory spending fell 0.5 percentage points; and nondefense discretionary spending fell 0.3 percentage points. The total decline in Federal outlays as a share of GDP was 3.5 percentage points (reflecting rounding).

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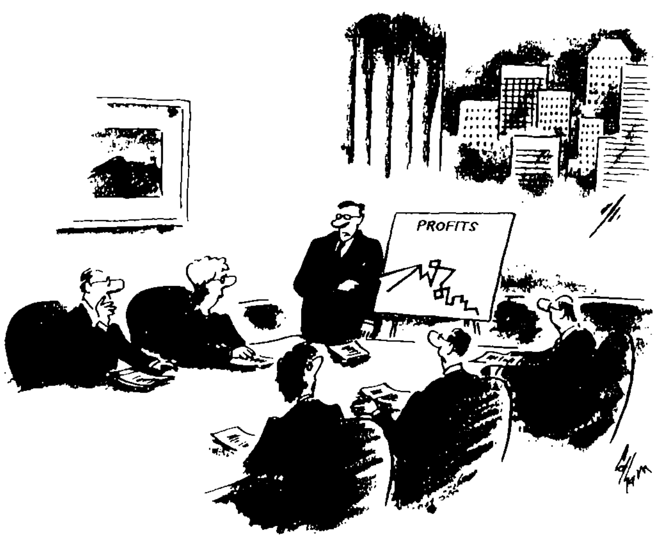

"This is where things started getting really weird."

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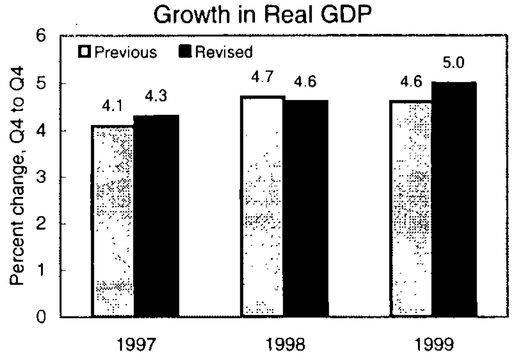
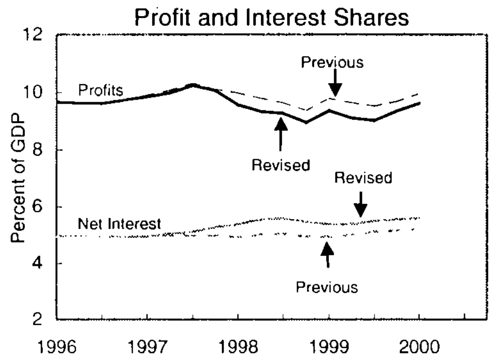
CURRENT DEVELOPMENT

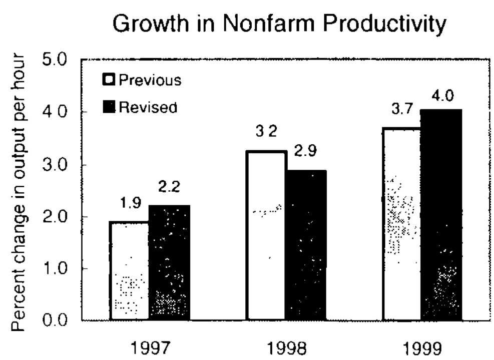
GDP Revisions Raise Output, Implying More Productivity

Last week the Commerce Department issued revised national income accounts for 1997 and beyond which showed slightly stronger growth in GDP. Official measures of productivity growth are likely to be revised upward as a result.

Growth in GDP. Revisions to real GDP growth for 1997 and 1998 were small and partially offsetting (see upper chart). But the 0.4 percentage point upward revision in 1999 (due to upward revisions to software investment and farm inventories) was substantial. Over the 1997-2000 period of the revisions, the average annual growth rate of GDP was revised up a little over 0.1 percentage point.







Income. Because real GDP measured on the income side of the accounts (gross domestic income) was not revised much, the increase in GDP reduced but did not eliminate the statistical discrepancy. Labor's share of income was reduced slightly reflecting a downward revision to employers' contributions to pensions and health insurance. The capital share was revised up slightly reflecting more depreciation. Estimates of capital income were reallocated as new IRS tabulations resulted in an upward revision to interest payments and an offsetting downward revision to profits (see middle chart). The profit share of GDP peaked in mid-1997.

Productivity. This upward revision to real GDP growth in 1999, together with changes in hours, is likely to result in a 0.3 percent upward revision to 1999 productivity growth (see lower chart).

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SPECIAL ANALYSIS

Coastal Erosion and National Flood Insurance

A significant and expanding number of Americans live in coastal areas at risk from both storm-related flooding and coastal erosion. The National Flood Insurance program (NFIP) was not designed to address coastal erosion, yet *de facto* it covers many kinds of erosion damage without incorporating erosion risk into its premium structure. As a result, it provides incentives to build or buy in areas subject to such erosion.

Down at the shore. Coastal areas are inherently dynamic and unstable, and most U.S. coastlines have historically contracted landward as a result of storms, currents, and geological processes. About 338,000 structures are located within 500 feet of an ocean or Great Lakes shoreline. An estimated 87,000 of these are located in areas that will be damaged by erosion in the next 60 years if current erosion rates continue. Estimated annual property losses from coastal erosion are about $500 million per year.

Risk and insurance. The National Flood Insurance Program administered by the Federal Emergency Management Agency (FEMA) was instituted in 1968 as a policy response to flood risk throughout the United States. While NFIP premiums are based on flood risk and do not take into account the risk of loss from erosion, a recent evaluation found that claims for erosion losses were almost always paid. As a result, the insurance premium tends to be too low for houses at high erosion risk—and therefore cross-subsidized by houses with lower erosion risk. Because individuals do not bear the full risk of building in erosion hazard areas, more building takes place and more houses are lost to erosion. A recent study found that development density in high-risk areas rose to a level closer to that in low-risk areas after the enactment of the NFIP. This suggests that the program has indeed increased the incentives to develop in risky areas.

Why does it matter? The current system effectively subsidizes a group of coastal property owners who build in risky areas. In addition, greater development in erosion hazard areas increases the pressure on all levels of government to provide protection through costly public works projects that attempt to prevent erosion. These include the construction and maintenance of shoreline engineering (seawalls, groins, and jetties) and the execution of beach nourishment projects (pumping or trucking sand onto the beach from other locations). Shoreline engineering detracts from the recreational and aesthetic experiences of visitors and can negatively affect coastal ecosystems; nourishment projects can increase erosion or siltation in areas used as the source of sand.

Policy challenges. Changes in the structure of NFIP premiums could provide better incentives for efficient coastal development. FEMA has the ability to develop and disseminate maps displaying the best available information on erosion risk by specific location at a cost of about $44 million over 10 years.

These maps can provide information to make NFIP premiums better reflect the risks they insure. This information can also help individuals to make more informed decisions about building or buying in erosion hazard areas. But these changes could make some homeowners worse off.

Impact on property owners. Recent research indicates that flood insurance rates in designated high-hazard coastal areas would have to roughly double to fully cover erosion risks, rising by about $0.90 per $100 of coverage. A survey of homeowners in erosion zones indicates that roughly half would voluntarily buy insurance against erosion losses at a cost of $1-2 per $100. This suggests that the necessary rate increase, while unlikely to be popular, would be tolerated. In addition to any impact on insurance premiums, developing better information could affect coastal property values. The market value of existing homes found to be at high erosion risk may decrease, while homes near the coast found to be at relatively low risk could see their value increase.

Implications. The interests of property owners in the coastal zone do not always coincide with the interests of the wider group of Americans who value beaches as recreational and environmental assets. Government policies that affect the density of coastal development and the direct management of coastal resources need to balance carefully the sometimes-competing needs of both groups. Providing accurate information on erosion hazards and using this information to set NFIP premiums to reflect both erosion and flood risks can help establish this balance.

EYES ONLY

ARTICLE

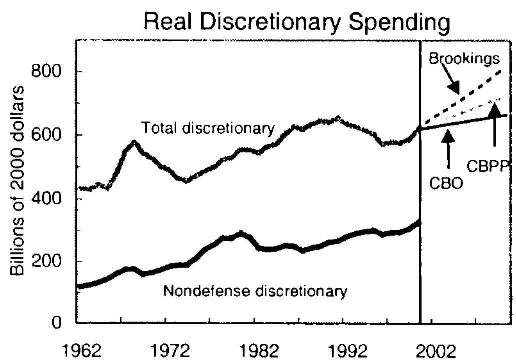
Carving up the Pie: How Big Is the Available Surplus?

CBO's latest estimate of cumulative non-Social Security baseline budget surpluses is $2.2 trillion over the next 10 years. Two recent studies from the Brookings Institution and the Center on Budget and Policy Priorities (CBPP) suggest, however, that only a fraction of these surpluses are realistically available for new initiatives, such as tax cuts or new spending programs. In part, these analyses make alternative assumptions about how policies should be measured in the baseline, but they also make judgments about policy priorities.

Assumptions about current policy. Both studies start with the CBO's $2.2 trillion baseline and then adjust it for certain spending and tax changes that they believe are already "built in" to the policy process.

- Discretionary spending. CBO's "inflated baseline" projection assumes that total discretionary spending increases with inflation but not with population growth. According to CBPP, the 10-year surplus would fall by about $350 billion if real per capita spending were maintained. The Brookings analysis observes that the cumulative surplus would be over $850 billion smaller if discretionary spending were kept constant as a share of GDP.

  How the Congress and the President will treat discretionary spending in the future is, of course, unknown. Discretionary spending has reached an historically low level as a share of GDP recently, due largely to a falling share for defense (see the Chart of the Week). However, its real level has grown at a 3.8 percent annual rate in the 1998-2000 period, compared with about 1 percent per year over the 1962-2000 period (see chart). This has led some to question whether CBO's baseline assumption of low real spending growth over the next 10 years is realistic.



- Expiring provisions. The official budget projections assume certain farm and tax provisions will decline or expire as scheduled. But farmers have received substantial emergency payments in recent years, and expiring tax credits have been regularly extended. Both studies use CBO's estimate that continuing tax provisions which would otherwise expire would cost more than $50 billion over the next 10 years. The CBPP study also adds $60 billion for farm aid.

- Alternative minimum tax. Under current law, more and more households, including middle-class families, will become subject to the alternative minimum tax (AMT), due to the effects of inflation. The CBPP and

EYES ONLY

Brookings studies argue that policymakers will not allow that to happen. Likely changes to the AMT would cost about $80-90 billion over 10 years.

In sum, these two forecasts of how current policy is likely to evolve would reduce the available non-Social Security budget surplus by about $600 billion in the CBPP analysis and by over $1 trillion in the Brookings analysis (these figures include increases in interest on the debt).

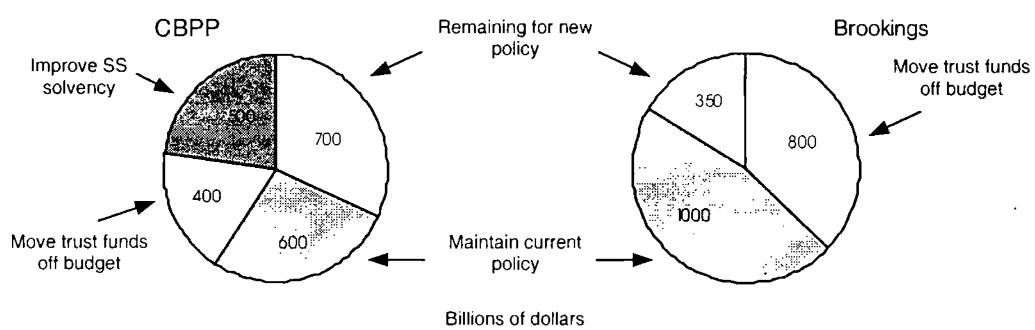
Accounting for longer-term policy needs. Echoing the Mid-Session Review, both studies also urge policy changes to help save Social Security and Medicare.

- <u>Setting aside the trust funds</u>. The CBO surplus projections account for Social Security's off-budget status but do not subtract the surpluses of other trust funds that remain on budget. The CBPP study estimates that excluding projected Medicare HI trust fund surpluses in line with the Administration's proposal would reduce the available surplus by about $400 billion over 10 years. Brookings additionally puts aside government military and civilian employee pension funds, reducing the surplus by another $400 billion.

- <u>Strengthening Social Security and Medicare</u>. The studies stress the importance of saving some general revenues now to prepare for future rainy days. Both observe that achieving longer-term Social Security and Medicare solvency will require substantial tax increases or general fund transfers. CBPP reduces the 10-year surplus by another $500 billion in recognition of this claim.

The bottom line. The CBPP analysis concludes that only $700 billion of CBO's 10-year, $2.2 trillion non-Social Security surplus is really available to fund changes in tax and program policies. The Brookings analysis concludes that even before addressing the long-term solvency problem, the 10-year surplus is reduced to $350 billion (see chart). These studies support the Administration's view that the latest surplus projections do not support large tax cuts. The argument is even stronger using OMB projections that the cumulative 10-year surpluses are a smaller $1.9 trillion.

Dividing Up CBO's 10-Year $2.2 Trillion Surplus



EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Individual Investors Who Trade More Earn Less. Individual investors who trade shares of stocks more often than the average investor earn similar gross returns, but they pay more each year in transaction costs, according to a new study based on 1991-96 data from a large discount brokerage house. The fifth of investors who traded most often (with an average monthly portfolio turnover of 21.5 percent) earned net annual returns in the stock market of 11.4 percent, after subtracting transaction costs. In contrast, the fifth of investors who traded least often (with an average monthly turnover of 0.2 percent) earned net annual returns of 18.5 percent per year. The average household buying and selling stocks through this discount broker earned a gross annual return of 18.7 percent and a net return of 16.4 percent, after paying transaction fees. Over this same period, the S&P 500 rose by about 17.9 percent annually. Related research found that men traded 45 percent more frequently than women, with the result that transactions costs subtracted 0.6 percentage point more from men's annual returns than from women's. These differences by sex were even larger among single people.

Tobacco Settlement Provides Health Benefits. The tobacco settlement between the states and the tobacco companies requires payments of about $87 billion (in present value) through 2025 to compensate for Medicaid spending arising from smoking-related illness. Most of these payments will be financed by higher cigarette prices. A recent study estimates that these higher prices will reduce smoking, benefiting society in two ways. First, Medicaid payments for smoking-related illnesses will be reduced. Second, and quantitatively far more important, reduced smoking will allow people to live longer and healthier lives. The study argues that smokers significantly undervalue the health risks of their actions, and thus benefit when higher cigarette prices discourage them from smoking (though continuing smokers bear the cost of higher prices). The study estimates that for each dollar of payments transferred from tobacco companies to the states there are $6 of benefits, mainly due to the longer and healthier lives enjoyed by those who are discouraged from smoking.

Are CEOs Rewarded for Luck? Economics suggests that the way to encourage CEOs to act in the shareholders' best interest is to tie CEO compensation to changes in the value of the firm that seem to have arisen from the CEO's actions. In this view, good firm performance that can be attributed to events outside the CEO's control (luck) should not affect pay. A recent study found, however, that among the 51 largest U.S. oil firms, CEO pay increased 0.8 percent for every 1 percent increase in general firm performance between 1977 and 1994, while it increased 2 percent for every 1 percent increase in performance attributable to worldwide oil prices (luck, presumably). The study also found that CEO pay in a broader set of industries responded more to good luck than to bad. Structuring CEO pay to provide the right incentives is difficult, but the study did find that firms with more effective and independent monitoring by shareholders rewarded CEOs less for firm performance that was attributable to luck than did other firms.

INTERNATIONAL ROUNDUP

Agreement May Lead to Higher Drug Prices in Developing World. The WTO agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) provides valuable incentives to innovate and protection for inventors. However, it could cause a price increase of 200-300 percent in patented medicines for developing countries, according to a recent analysis. Such an increase could have a drastic impact on nations where up to 66 percent of total health spending is on medicine and 50-90 percent of expenditures are out-of-pocket. Before TRIPS, many countries did not allow patents for medication; now most are members of the WTO, where TRIPS requires a patent term of 20 years. While the agreement only affects applications for new medicines made from 1995 onwards, drugs for diseases like AIDS fall within the jurisdiction of TRIPS. Developing countries have several options to reverse a price increase, including compulsory licenses, in which the patent holder licenses the invention to a third party in return for "adequate remuneration;" price controls; and generic drug approvals.

If You Think U.S. Stock Prices Are High... Broad indexes of U.S. stocks continue to trade near historically high price-to-earnings (P/E) ratios, and the P/Es of technology stock indexes are substantially higher than those of the broader indexes. But U.S. markets are not unique: major European stock markets are trading at P/Es similar to those in the United States, and European technology markets are experiencing substantially higher P/Es than those of comparable U.S. markets. For example, the Bloomberg European 500 Index, an index of the 500 most highly capitalized European companies, is trading at 27 times earnings, which is roughly comparable to the P/E of 29 for the S&P 500 and the P/E of 32 for the Wilshire 5000, one of the broadest indices of U.S. stocks. By contrast, the New Market, a pan-European grouping of regulated markets dedicated to high-growth stocks, is trading at 1,630 times earnings, substantially higher than the P/E of 126 for the NASDAQ Composite Index. Substantial national variation exists within the New Market however. While the Netherlands New Market is trading at 64 times earnings, the German is at 604, and the French has negative aggregate earnings. The EASDAQ, a unified European market dedicated mainly to technology companies and designed to be a European NASDAQ, also has negative aggregate earnings.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, August 4, 2000****

In July, the unemployment rate was unchanged from June at 4.0 percent. Nonfarm payroll employment decreased by 108,000.

Leading Indicators

The composite index of leading indicators was unchanged in June.

NAPM Report on Business

The Purchasing Managers' Index was unchanged in July at 51.8 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding.)

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Retail Sales (Friday)
Producer Prices (Friday)

EYES ONLY

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	5.2
GDP chain-type price index	5.2	1.6	1.6	3.3	2.5
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	6.9	2.4	N.A.
Real compensation per hour:					
Using CPI	1.0	1.7	0.9	0.2	N.A.
Using NFB deflator	1.5	2.9	1.8	1.8	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.0	13.4	13.8
Residential investment	4.5	4.3	4.3	4.3	4.3
Exports	8.2	10.6	10.8	10.8	10.8
Imports	9.2	13.4	13.9	14.2	14.5
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	N.A.

	1970-1993	1999	May 2000	June 2000	July 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.0	**4.0**
Payroll employment (thousands)					
increase per month			**171**	**30**	**-108**
increase since Jan. 1993					**22010**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.6	N.A.
PPI-Finished goods	5.0	2.9	0.0	0.6	N.A.

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

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, August 4, 2000**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	June 2000	July 2000	Aug. 3, 2000
Dow-Jones Industrial Average	8626	10465	10583	10663	10707
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.96	6.05
10-year T-bond	5.26	5.65	6.10	6.05	5.95
Mortgage rate, 30-year fixed	6.94	7.43	8.29	8.15	8.12
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 3, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.904	-3.1	-15.3
Yen (per U.S. dollar)	108.4	-0.7	-5.9
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.22	1.3	5.1

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)	**4.0** (Jul)	3.7 (Jun)
Canada	4.9 (Q1)	6.6 (May)	2.9 (Jun)
Japan	0.7 (Q1)	4.6 (May) [2]	-0.7 (Jun)
France	3.4 (Q1)	9.8 (May) [2]	1.7 (Jun)
Germany	2.3 (Q1)	8.3 (May)	1.9 (Jun)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jun)
United Kingdom	3.0 (Q1)	5.7 (Mar)	3.3 (Jun)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, August 4, 2000.**

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.

EYES ONLY

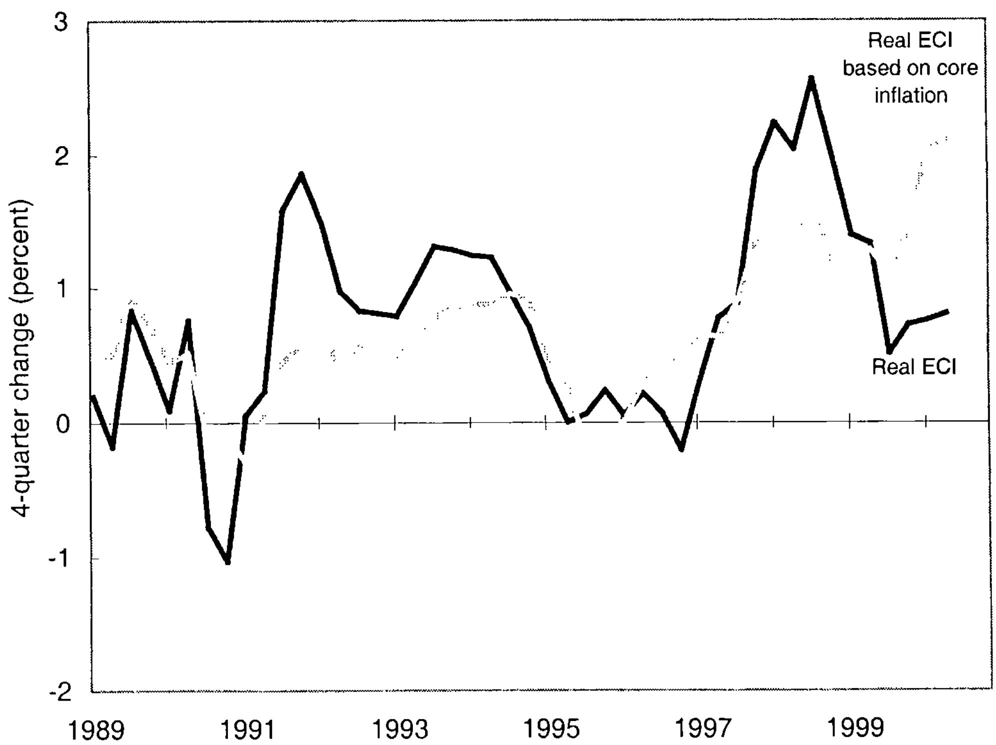
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 28, 2000

CHART OF THE WEEK

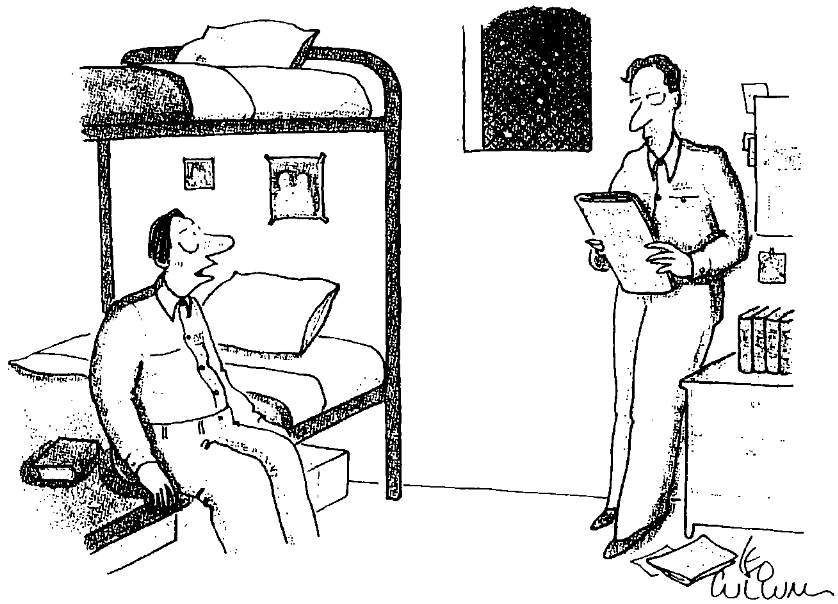
Growth in Compensation and Real Wages



Data released this week show that private compensation as measured by the employment cost index (ECI) rose 0.8 percentage points faster than inflation over the year ending in June. Fluctuations in consumer price inflation due to oil prices raised real wage growth in 1998 and lowered it in 1999 and this year. Growth in real ECI compensation measured using the core CPI (which excludes food and oil) generally shows an acceleration since 1995.

EYES ONLY

CONTENTS



"I never should have tried to take my accounting to the next level."

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Second Quarter 2000

Real GDP is estimated to have increased at a 5.2 percent annual rate in the second quarter. Consumption slowed significantly from its previous pace, and much of domestic demand was met by imports. Second-quarter growth was supported by strong gains in business investment and stockbuilding, as well as a rebound in Federal purchases. Inflation, as measured by the price index for GDP, was 2.5 percent at an annual rate in the second quarter, up from 1.8 percent during the previous four quarters.

Component	Growth*	Comments
Total consumer expenditures	3.0%	Consumption slowed from 6 percent growth during the previous four quarters. The slowdown was concentrated in goods, especially motor vehicles.
Equipment and software	21.0%	Business purchases of computers grew at a 63 percent annual rate. Other major categories of equipment and software investment grew at strong or solid rates.
Nonresidential structures	13.0%	Investment in structures has picked up in the first half of 2000 after stagnating in 1999.
Residential investment	3.9%	Growth in residential investment was accounted for by real estate brokers' commissions. Construction of residential structures was flat.
Inventories (change, billions of 1996 dollars)	$60.3	The pace of stockbuilding picked up in the second quarter, accounting for 1 percentage point of real GDP growth. Even so, inventories remain lean in relation to sales.
Federal purchases	17.5%	Defense purchases have been erratic, increasing sharply in the second half of 1999, crashing in the first quarter, and rebounding in the second.
State & local purchases	0.5%	Highway building, which had boomed in the previous two quarters, edged down in the second quarter.
Exports	7.3%	This was the fifth consecutive quarter of strong export growth, which suggests continuing expansion among our trading partners.
Imports	17.0%	Growth was especially strong for imports of capital goods.

*Percent real growth in the quarter at annual rates (except inventories). This advance estimate is subject to substantial revision—especially for exports, imports, and inventories, where the estimates are based on only 2 months of data.

EYES ONLY

SPECIAL ANALYSIS

Do Accounting Rules Matter?

A recent proposal by the Financial Accounting Standards Board (FASB) to change the way that accountants treat mergers and acquisitions has ignited a firestorm of controversy. The FASB argues that its proposal will make it easier for investors to interpret the balance sheet of merged firms; critics, often from high-tech New Economy firms, argue that it will hurt their ability to grow.

Everybody out of the pool? Under current practices, business combinations can be recorded either as "purchases," in which one firm acquires the assets of another, or "poolings of interest," in which assets are simply combined into a common balance sheet. Under the purchase method, any acquisition premium (the difference between the purchase price and the book value of the target firm) is typically recorded as an intangible asset called "goodwill," which is depreciated and charged against earnings over time. Because pooling allows the balance sheets of the two firms to be combined directly without any charges against earnings, acquirers can often report higher incomes by using this method.

According to one estimate, pooling accounting was used for only 5 percent of all acquisitions in 1999, but these acquisitions represented 36 percent of the total value of mergers and acquisitions during the year. Many of the largest recent U.S. deals were pooled, including Exxon-Mobil, Citicorp-Travelers, and Bell Atlantic-GTE. The FASB argues that pooling accounting allows firms to "hide" acquisition premiums from investors, and recommends that pooling be eliminated and all business combinations be treated as purchases.

Will high-tech firms be left high and dry? Critics swiftly charged that such a rule change would harm firms making acquisitions, particularly in the high-technology sector, and in March the Senate held a hearing where these concerns were aired. For companies with substantial intangible assets—human capital, technical blueprints, brand-name recognition, corporate culture, and the like—market value will substantially exceed book value. When such companies are acquired under the purchase method, this extra value must be treated as a cost that is then depreciated, resulting in significant charges against earnings over time. Such charges are not incurred under the pooling method, allowing reported earnings to be higher. This may be especially important for firms already struggling to achieve short-term profitability.

Are the critics of pooling all wet? The assumption behind the pooling method is that there has been no exchange of economic resources, but rather a combining of equity interests. Two firms have joined forces to better serve their combined clientele; neither has "purchased" the other. The FASB argues that few business combinations meet this criterion. Acquisitions are purchases, and any purchase—whether inventory or software or a patent—is recorded at the price paid and generally charged against earnings over its useful economic life. By this argument, acquisitions should be treated the same way, with goodwill premiums treated as intangible assets that depreciate over time. In cases where companies are purchased at share prices well above the market prices that prevailed prior to acquisition, the FASB is concerned that the pooling method effectively disguises these acquisition premiums from shareholders.

The FASB argues further that the coexistence of two accepted practices is confusing and can mislead investors. Additionally, firms that decide to use pooling must accept potentially harmful restrictive criteria (such as financing the merger with stock, rather than cash or debt) to achieve the perceived gains from higher reported earnings. Pooling may also impose a burden on regulators: the SEC Chief Accountant has said that his staff spends a large share of its time interpreting the complicated pooling-of-interests criteria. Finally, eliminating the pooling method would bring U.S. practices in line with those of most other countries and help harmonize accounting standards around the world.

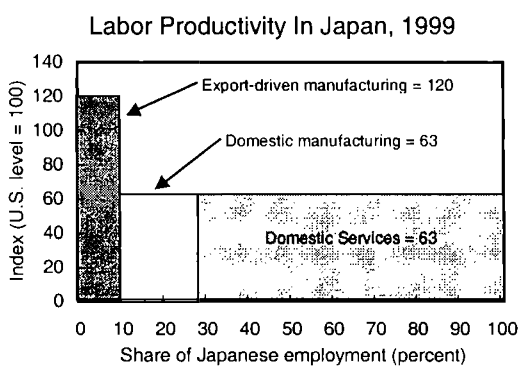
Does it really matter anyway? Economic reasoning suggests that the value of the firm should be determined by future cash flows, which are not affected by the accounting treatment of acquisitions. Indeed, despite many efforts, academic researchers have failed to find compelling evidence that investors can be systematically misled by accounting practices. It is thus difficult to explain the intensity of the reaction to the FASB recommendation. Some investors may be misled by accounting practices, but the evidence suggests that, as long as there *are* standards, the market as a whole is not.

ARTICLE

Achieving Healthy Productivity Growth in Japan

While most economists have focused on weakness in demand to explain Japan's sluggish growth in the 1990s, a new study by a large consulting firm looks at problems of productivity and supply. The study finds that the Japanese economy generates considerable employment, but outside the export-driven manufacturing sector productivity is low. Overall, hours worked per capita in Japan were 11 percent higher than in the United States in 1999, but GDP per hour worked was only 69 percent of the U.S. level, even with 13 percent more capital per worker.

Japan's dual economy. Although overall productivity is low in Japan, the export-driven manufacturing companies have become household names and fierce competitors around the world. Labor productivity in the Japanese automobile industry, for example, was 45 percent higher than in the U.S. auto industry in 1999. The study estimates that, on average, this competitive sector of the Japanese economy was 20 percent more productive than the same U.S. industries in 1999. However, this productive part of the economy represents only about 10 percent of employment. The part of manufacturing that competes only domestically and the service sector each had labor productivity of only 63 percent of the U.S. level in 1999 (see chart).



Why is productivity so low? The study finds that Japan is rife with protection for inefficient companies and even provides subsidies to help them stay in business. An example of a low-productivity service industry is retailing, which has 55 percent of employment in traditional mom-and-pop stores (the U.S. figure is 19 percent). Efficient large-scale retailers are prevented from expanding by local committees that must approve development. These committees include owners of the small stores that would be put out of business. In addition, loans and grants have been provided by the government to keep the small stores operating. The study argues that the lack of consolidation in retailing spills over into food processing—a large manufacturing industry that competes domestically. This industry is fragmented and operates plants with only a tenth of the scale of U.S. plants, on average, which results in much lower efficiency. Foreign competition is prevented by protective trade barriers.

Raising productivity: A deep dilemma. When evaluating how to increase productivity, the study confronts the serious dilemma that removing regulatory barriers and restructuring industries will lead to large-scale job losses in the short run. Even though the Japanese still work very long hours, labor input fell in the

1990s and unemployment rose. An important reason that Japan hangs on to its over-regulated economy is that it is afraid of worsening its already weakened labor market and scaring consumers who already are reluctant to spend.

Developing new opportunities. The study proposes a novel solution to this dilemma: generate a million new health care jobs. The study reaches this conclusion as a result of a detailed comparison of the U.S. and Japanese health care sectors. While Japan enjoys higher life expectancy, this appears to reflect factors such as diet and lifestyle differences; Japan's health care system provides inferior services. It is slow to use new technologies, provides far too little outpatient care, and overuses prescription drugs—a patient going to see a doctor waits in a long line, sees the doctor for 5 minutes, and comes out with a sheaf of prescriptions. Investment in improving service would seem to be worthwhile.

No panacea. If the Japanese economy is ever to achieve the combination of full-employment and high productivity that the United States enjoys, it will have to deregulate its markets in ways that both force restructuring and consolidation of old companies and encourage investment and job creation in new companies or lines of business. New jobs must be created to offset the inevitable job losses, and these potential jobs do exist, whether in health care or elsewhere. However, achieving sustained economic growth in Japan will require increases in both supply and demand, and the study is too dismissive of problems on the demand side arising from a fragile financial system and perceived constraints on monetary and fiscal policy.

The study may be correct, however, in suggesting that even if demand-increasing policies are successful, they may not be enough (after all, fiscal expansion did stimulate growth in 1996). Sustained growth will require restructuring to open up new productive investment and employment opportunities.

Conclusion. Japanese policymakers thus far have favored only incremental policy changes and seem content with a continuation of slow growth. Some Western economists have suggested more radical approaches on the demand side, such as monetizing part of the government debt. On the supply side, one can argue that deregulatory "shock therapy" may be needed to break the power of vested interests and open up new opportunities. Of course the experience of countries like Poland illustrate that shock therapy can be very painful along the way.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

The Cost of Superfund Exemptions. Most businesses with Superfund liability are small firms or firms that contributed only a very small share of the toxic waste at a particular site. A recent study assesses the cost of exempting such firms from their liabilities in order to cut short the sometimes slow process of determining shares of liability when there are many firms involved. Sites with multiple firms are called generator/transporter sites. They make up just over half of the total number of sites, but they involve about 99 percent of total firms with Superfund liability and about 75 percent of total Superfund cleanup costs. For such sites, the study found that transferring the liabilities of firms with 75 or fewer employees to the Superfund Trust would cost the government about $100,000-225,000 per firm, or a total of $6-12 billion. The study estimates that a blanket exemption for small businesses, which would include owner/operators with exclusive responsibility at some sites, would cost $3-6 million per firm at such sites, or another $1.2-1.7 billion. A different and perhaps complementary approach would be to exempt firms that contribute only a small amount to any site from liability at that site. The costs of any of these proposals would have to be weighed against their effectiveness in speeding up the cleanup process.

Crime Doesn't Pay (Enough). Improved labor market conditions over the past 7 years are an important reason for the decline in crime, according to a recent study. Offenders and ex-offenders are often low-wage workers with limited employment opportunities. Decreasing unemployment and strong economic growth have provided more jobs, and thus increased the opportunity cost of devoting time to crime. The study estimates that decreases in unemployment between 1992 and 1997 accounted for 30 percent of the decrease in crime over that same period. Therefore, policies promoting full employment, a higher minimum wage, improved educational and job-training opportunities, and expansion of work support (such as the Earned Income Tax Credit) may be valuable tools in lowering crime rates. Undoubtedly increased policing and "get tough" laws help to reduce crime. However, debates over crime reduction should not ignore the important link between crime and labor market opportunities.

Merchant Trafficking in Food Stamps Remains Small. About 3½ cents of every dollar of food stamps issued between 1996 and 1998 were illegally redeemed for cash instead of food, according to a recent USDA study. About 12 percent of stores illegally traffic in food stamps, but among the large groceries and supermarkets, which redeem 84 percent of food stamps, only 2 percent do so. Stores in poorer neighborhoods are more likely to redeem stamps for cash. As a result of increased activity since 1993, rural stores have become as likely as urban stores to traffic in food stamps. Overall, trafficking has decreased by ½ cent per food stamp dollar since 1993. The total number of households receiving food stamps has declined by 24 percent, the total amount of food stamps issued has declined by 11 percent, the number of retailers authorized to accept food stamps has declined by 16 percent, and half of food stamps issued have been converted from paper coupons to electronic benefit transfer cards.

INTERNATIONAL ROUNDUP

Preparation for Euro Is Slow. The European Commission reports that firms and individuals are slow in preparing for the euro launch on January 1, 2002. While use of the euro rose to 25 percent of the value of firm transactions, such payments were only 2.4 percent of transaction volume. Only 20 percent of large companies and 15 percent of small and medium enterprises reported having switched entirely to the euro, with a respective 40 and 25 percent expecting to change over by the end of 2001. Likewise, the first quarter of 2000 saw only 2.4 percent of transaction volume paid in euros by individuals. The Commission noted that while dual pricing was widespread in EU member countries, there appeared to be little effect on consumer knowledge of the euro. To aid implementation, the EC urged public administrations to ensure the adequacy of their own preparations and to intensify efforts to educate small and medium enterprises and the general public for the turnover.

Average Hospital Stays Are Falling in the OECD. Lengths of hospital stays have been falling in all OECD countries in the last two decades, but they have fallen faster outside the United States, which always had the shortest stays. This is the featured finding in the OECD's latest release of comparative health figures. Other countries appear to be converging gradually toward U.S. levels. Differences remain, however: the average stay for appendicitis in Germany is still almost 7 days (down from over 12 in 1980), while it is less than 4 days in the United States. OECD data provide a wide range of other findings. For example, people are generally becoming healthier in the OECD area; the share of health spending in GDP has stabilized, on average, since the early 1990s; the United States is still by far the largest spender on health care, both per capita and as a share of GDP; and the United States and Korea are the only two OECD countries in which private health care spending still exceeds public.

Undernourishment Should Decline Significantly by 2030. World per capita food consumption will grow significantly, from less than 2,800 calories per day in 1996 to 3,100 calories per day in 2030, according to the Food and Agriculture Organization of the United Nations. Above all, this change will reflect rising food availability for consumption in developing countries (the basis for calorie estimates). The proportion of the world's population living in countries with per capita consumption above 3,000 calories per day will rise to 75 percent, compared with only 21 percent in 1996. However, 412 million people (6 percent of the world's population) will still be living in countries with very low levels of food consumption in 2015. Sub-Saharan Africa will remain the most undernourished region. With the highest projected population growth rate, it should also experience the greatest growth in demand for agricultural products—a demand that is projected to exceed slightly the rate of growth of production in the region. Growth of both aggregate demand and production of agricultural products in industrial countries is projected to continue to slow.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product
****Embargoed until 8:30 a.m., Friday, July 28, 2000****

According to advance estimates, real gross domestic product grew at an annual rate of 5.2 percent in the second quarter of 2000.

Employment Cost Index

The employment cost index for private industry workers increased 4.6 percent for the 12-month period ending in June.

Advance Durable Orders

Advance estimates show that new orders for durable goods increased 10.0 percent in June, following an increase of 7.0 percent in May.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, rose 2.5 index points in July, to 141.7 (1985=100).

MAJOR RELEASES NEXT WEEK

NAPM Report on Business (Tuesday)
Leading Indicators (Wednesday)
Employment (Friday)

EYES ONLY

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**	**5.2**
GDP chain-type price index	5.2	1.6	**1.6**	**3.3**	**2.5**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	6.9	2.4	N.A.
Real compensation per hour:					
Using CPI	1.0	1.7	0.9	0.2	N.A.
Using NFB deflator	1.5	2.9	1.8	1.8	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	**12.9**	**13.0**	**13.4**	**13.8**
Residential investment	4.5	**4.3**	**4.3**	**4.3**	**4.3**
Exports	8.2	**10.6**	**10.8**	**10.8**	**10.8**
Imports	9.2	**13.4**	**13.9**	**14.2**	**14.5**
Personal saving	6.6	**1.6**	**1.1**	**0.1**	**0.2**
Federal surplus	-2.8	1.2	1.2	2.1	N.A.

Note.—Revised data for Federal surplus are not yet available.

	1970-1993	1999	April 2000	May 2000	June 2000
Unemployment Rate (percent)	6.7**	4.2**	3.9	4.1	4.0
Payroll employment (thousands)					
increase per month			410	171	11
increase since Jan. 1993					22099
Inflation (percent per period)					
CPI	5.8	2.7	0.0	0.1	0.6
PPI-Finished goods	5.0	2.9	-0.3	0.0	0.6

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

New or revised data in **boldface.**
GDP data **embargoed until 8:30 a.m., Friday, July 28, 2000**. **Data revised beginning 1997**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	May 2000	June 2000	July 27, 2000
Dow-Jones Industrial Average	8626	10465	10580	10583	10586
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.79	5.69	6.04
10-year T-bond	5.26	5.65	6.44	6.10	6.02
Mortgage rate, 30-year fixed	6.94	7.43	8.52	8.29	8.13
Prime rate	8.35	8.00	9.24	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 27, 2000**	**Percent Change from** Week ago	Year ago
Euro (in U.S. dollars)	0.933	0.4	-12.2
Yen (per U.S. dollar)	109.2	1.2	-6.1
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	97.94	0.0	2.8

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)	4.0 (Jun)	3.7 (Jun)
Canada	4.9 (Q1)	6.6 (May)	2.9 (Jun)
Japan	0.7 (Q1)	4.6 (May) [2]	-0.7 (May)
France	3.4 (Q1)	9.8 (May) [2]	1.7 (Jun)
Germany	2.3 (Q1)	8.3 (May)	1.9 (Jun)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jun)
United Kingdom	3.0 (Q1)	5.7 (Mar)	3.3 (Jun)

U.S. GDP data **embargoed until 8:30 a.m., Friday, July 28, 2000.**

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.

EYES ONLY

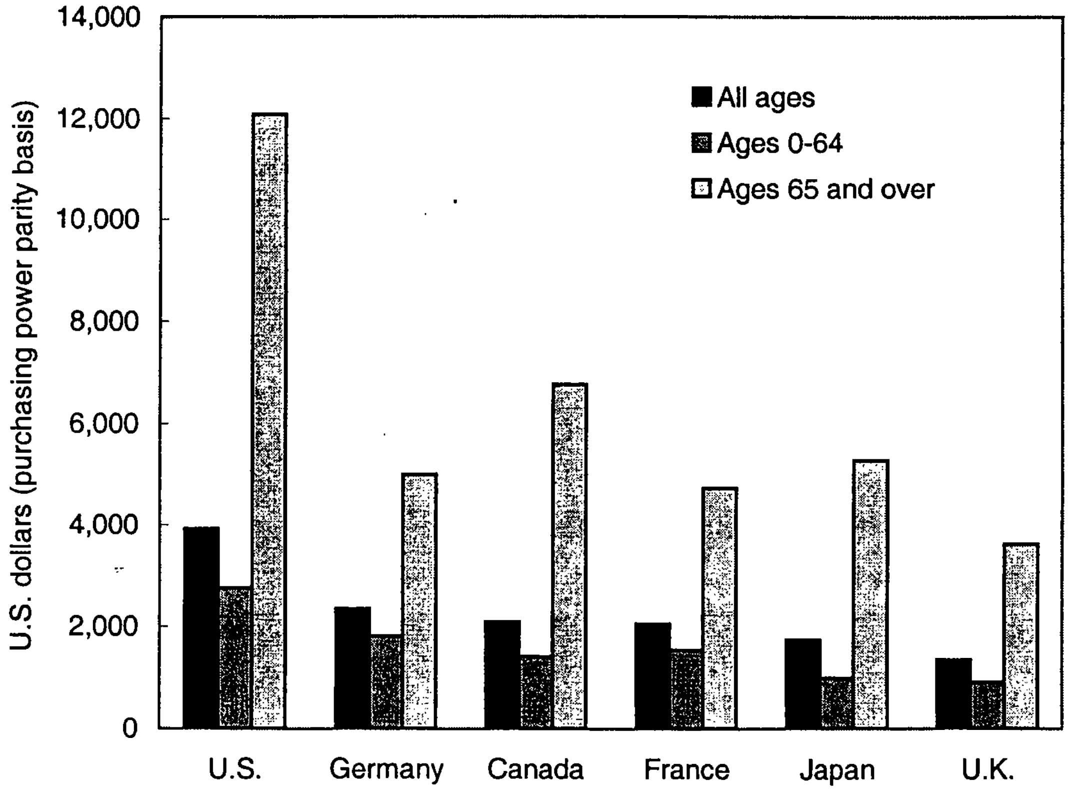
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 16, 2000

CHART OF THE WEEK

Per Capita Health Spending in Selected Countries, 1997



Calculations based on OECD data show that the United States spends considerably more per capita than other developed countries on health, both for the elderly and for the non-elderly. The United States spends 4.4 times as much on an elderly person as on a non-elderly person, which is not as high as Japan's 5.3 times or Canada's 4.8 times.

EYES ONLY

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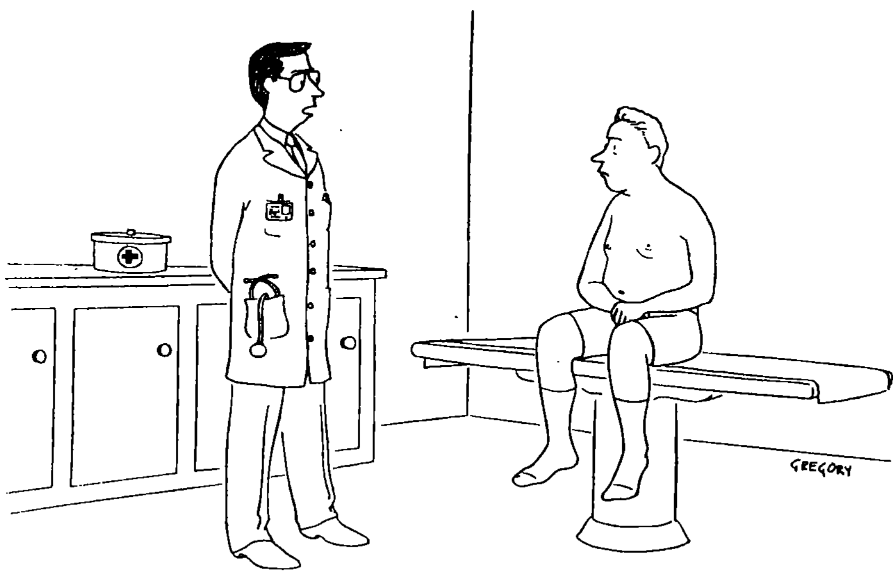


"Your infection may be antibiotic-resistant, but let's see how it responds to intensive litigation."

SPECIAL ANALYSIS

The Costs of Reducing MTBE

Last week the Administration sent the Congress a report that examined the economic consequences of reducing or eliminating the use of MTBE in gasoline. The report finds that reducing MTBE and maintaining the air quality benefits of the reformulated gasoline program could raise gasoline prices by about 2 cents per gallon.

You can breath the air... The 1990 Clean Air Act Amendments mandated cleaner burning gasoline for the most polluted urban areas through the reformulated gasoline (RFG) program. This program included an oxygenate mandate that at least 2 percent of each gallon must be oxygenates such as ethanol and MTBE. RFG makes up about a third of all gasoline sold in the country and 87 percent of RFG contains MTBE. Refiners have preferred MTBE because of its ease of transport and blending and the lower costs relative to ethanol for making RFG. Since 1995, RFG has achieved significant reductions in vehicle emissions of toxic and smog-forming pollutants.

...but don't go near the water. While MTBE has delivered air quality benefits, leaks from pipelines and underground storage tanks have contaminated drinking water supplies. Contamination at or above the EPA advisory range may make water smell and taste so bad that it becomes unusable for consumption. The risk of MTBE contamination has prompted California and New York to ban its use in gasoline effective in 2002 and 2004, respectively.

A new approach. The Administration has proposed to reduce or ban MTBE while maintaining the air quality benefits of the RFG program. To provide flexibility to refiners in continuing to meet the emissions standards, the Administration has also recommended repealing the oxygenate mandate. In addition, the Administration supports a flexible renewable fuel standard (requiring that a minimum percentage of all gasoline must contain renewable fuel, such as ethanol). A modeling assessment of a variety of policy scenarios consistent with these principles and based on a smoothly functioning national gasoline market found the following:

- Reducing MTBE use to its pre-1990 level by 2003, maintaining the air quality benefits of the RFG program, and repealing the oxygenate mandate is projected to increase the national average price of gasoline by about 2 cents per gallon.

- Banning MTBE in 2003, maintaining the air quality benefits of the RFG program, and repealing the oxygenate mandate is projected to increase the national average price of gasoline by about 3 cents per gallon.

- The costs of a renewable fuel standard vary with the level of that standard. A standard of about 1.7 percent in 2005 (60 percent above estimated 2000 use) would have negligible additional costs, since a policy of reducing MTBE to its pre-1990 level, maintaining air quality benefits of the RFG program, and repealing the oxygenate mandate is projected to increase ethanol consumption to this level anyway. However, a more aggressive renewable fuel standard would be more costly: a 2 percent standard in 2005 would add another 2 cents per gallon to the price of gasoline.

- In 2005, receipts to the Highway Trust Fund would fall by about $600 million to $900 million because of the tax-favored status of ethanol relative to gasoline.

Replacing the oxygenate standard. Banning MTBE without repealing the oxygenate mandate would be very expensive, because it would effectively require ethanol to be used in summer RFG, which would involve substantial costs in transporting and blending ethanol with gasoline. However, a renewable fuel standard that allowed refiners to buy and sell tradable ethanol credits would provide the flexibility needed to allow ethanol to be used in the least-expensive regions at the least-expensive time of the year, subject to meeting emissions requirements for conventional gas and RFG. Thus, midwest winter gasoline could contain ethanol well in excess of the renewable fuel standard and east coast summer gasoline could contain no ethanol under this approach. A renewable fuel standard that delivers the same amount of ethanol to market as the oxygenate mandate would cost refiners and consumers less.

Conclusion. Despite its value in reducing air pollution, MTBE has been found to contaminate drinking water. Reducing MTBE and repealing the oxygenate mandate could raise gasoline prices by 2 cents per gallon, while a renewable fuel standard could have a negligible impact or it could nearly double the gasoline price increase, depending on the level of the standard.

SPECIAL ANALYSIS

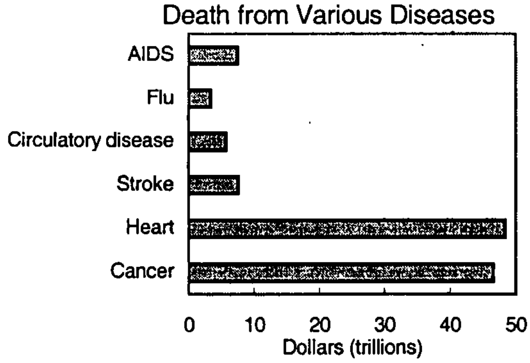
The Economic Value of Medical Research

Have the substantial investments in medical research made in the United States over the past few decades provided benefits sufficient to justify their cost? Yes, according to a soon-to-be-published collection of economic studies that find evidence of substantial returns to investments in medical research.

Valuing improvements in life expectancy. A goal of the new studies was to assess the value of medical research in terms of its impact on the length or quality of life and to quantify how research-related reductions in mortality can be valued in monetary terms. A central challenge in such an exercise is to estimate the monetary value of changes in life expectancy. Some of the studies do this by combining estimates of the economic value of life by age (based on economic research on individuals' willingness to take risks) with recent changes in life expectancy.

Dramatic benefits from longer life. One of the studies estimates that the social value of improvements in life expectancy between 1970 and 1990 is between $2.4 and $2.8 trillion per year (in 1992 dollars)—a value that is more than half of real GDP in 1980, a midpoint of the period. The reduction in deaths from heart disease generated a substantial share of this gain ($1.5 trillion annually). This research also finds that eliminating deaths from various diseases would have a large economic value. Eliminating death from heart disease, for example, (holding death rates from other diseases constant) would be worth $48 trillion to the U.S. population (see chart). Expressed more realistically, this finding implies that each 1 percent permanent reduction in mortality from this source is worth $480 billion.

Economic Value of Eliminating Death from Various Diseases



Making the link to medical research. A portion of increases in life expectancy is due to spending on medical research. But some improvements are due to other factors such as changes in life style and diet. One of the papers in the collection attempts to apportion the credit for longevity by focusing on cardiovascular disease, the source of the greatest gains since 1970. The authors provide evidence that one-third of the reduction in cardiovascular disease mortality can be explained by advances in acute medical technology and better pharmaceutical treatments. This suggests that if only one-third of the total economic value of reducing mortality from heart disease ($1.5 trillion annually between 1970-1990) is attributable to medical research, this research brought an annual return of $500 billion. This is considerably larger than the most recent estimate of total expenditures on medical research of $36 billion in 1995 ($33 billion, when measured in constant 1992 dollars to be consistent with the measure of annual return).

Conclusion. Recent studies provide evidence that past investments in medical research on some diseases have paid off handsomely. While these findings do not imply that future research would yield equally high returns, the large economic valuation assigned to the improvements in life expectancy over the last several decades suggests that research generating even modest advances against major killer diseases is a good economic investment.

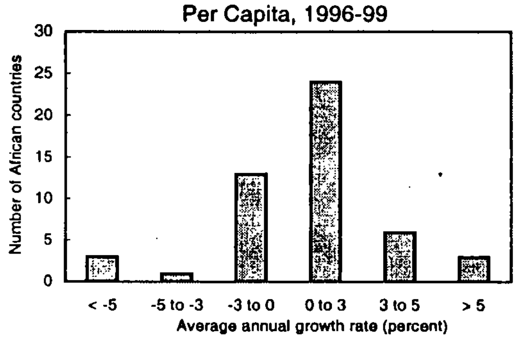
ARTICLE

Africa: A Glimmer of Hope

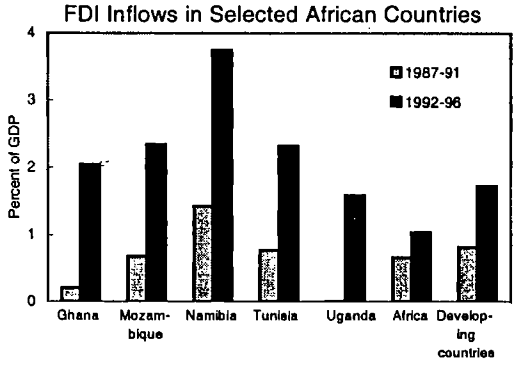
While parts of Africa are making headlines with wars and natural disasters—presenting observers like *The Economist* with an image of a "hopeless continent"—other parts are making headway reforming their economies, attracting more interest from domestic and foreign businesses, and attracting foreign direct investment (FDI). Even with respect to HIV/AIDS, several countries have made significant progress in controlling the spread of the epidemic.

Reform delivers progress. In sub-Saharan Africa, average income per capita remains lower today than it was at the end of the 1960s. However, economic performance has varied widely across African countries, both recently (see upper chart) and over the longer term. While Botswana and Mauritius provide examples of sustained longer-term growth, countries such as Mozambique and Uganda, which have recently made key economic reforms (liberalizing markets and trade, improving economic management, and promoting private sector activity) have seen faster growth, rising personal income, and reduced poverty. In fact, before Mozambique was hit by a devastating flood earlier this year, it was among the fastest growing economies in the world.

Distribution of Growth Rates in Real GDP Per Capita, 1996-99



FDI Inflows in Selected African Countries



Rising foreign investment. Africa's share in total FDI inflows to developing countries dropped significantly from more than 11 percent in 1976-80 to 4 percent in recent years. However, as with economic performance, aggregate FDI inflow data conceal a diverse picture.

While larger countries such as Nigeria and Egypt continue to claim the largest *volume* of FDI, a number of countries have experienced high *growth* of FDI inflows, especially relative to the size of their economies (see lower chart). Economic reforms, privatization, and efforts to improve the education levels of their citizens have all contributed to this rapid increase of FDI. And while rich natural resource reserves play an important role, FDI flows are increasingly going to the manufacturing and services sectors. Moreover, investment in Africa seems to be highly profitable for foreign companies. In the 1990s, rates of return on U.S. FDI in Africa hovered close to 30 percent and were consistently higher than those in other regions. The example of Morocco (see box) illustrates many of these trends in FDI flows to Africa.

Morocco: Sustained Increase in FDI Inflows

Morocco has established itself as one of the largest recipients of FDI in Africa. According to a UNCTAD report, broad economic reforms during the 1990s, including privatization programs and the liberalization of the FDI regime, have transformed the investment climate in Morocco. FDI inflows to Morocco increased from an annual level of around $200 million in the early 1990s to $1.1 billion in 1997. The petroleum sector received the largest share of FDI, with the energy sector and the banking sector capturing significant shares as well. Morocco also hosts one of the largest multinational corporations in the continent, Conserverie Chérifiennes, a food company. Prospects for sustained FDI inflows are promising, with the modernization of the Morocco stock exchange, reforms of the banking sector, and the establishment of export processing zones.

Confronting AIDS. Despite the devastating effects of the HIV/AIDS epidemic, political commitment to fight AIDS remains weak in some African countries. Where there has been political will, AIDS has been met head on. Uganda and Senegal provide excellent examples. Timely and aggressive national prevention campaigns have helped Senegal maintain one of the lowest HIV infection rates in Africa (1.8 percent) and have lowered infection rates in Uganda significantly. In 1992, the HIV prevalence rate among Uganda's teenagers was almost 30 percent, but by 1996, it had been brought down to 10 percent.

Conclusion. Africa's challenges remain enormous. However, it is important not to let the negative image of the continent as a whole mask the diversity of economic performance and opportunities in individual countries that provide grounds for hope.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book: Continuing Solid Growth but Some Signs of Slowing. Reports from the 12 Federal Reserve districts indicate that solid economic growth continued in April and May, but with signs of some slowing from the rapid pace earlier in the year. Economic activity remains "hot" in Minneapolis; growth is said to be strong in Chicago and Richmond and moderate or steady in most of the other districts. All but Minneapolis said scattered signs of cooling are in evidence or the pace of growth is slowing. Indications of worsening price inflation, while not widespread, were reported by several districts. Labor markets are tight across all districts, but the tightness does not appear to have intensified since the last report. Base wages of permanent employees are not said to be accelerating in most districts, but seasonal help and temporary workers are being recruited only with sizable raises. Similarly, some occupations experiencing severe shortages—such as skilled building trades in New York and Internet and other technical workers in the Boston and Atlanta districts—have seen larger pay increases.

Internet Economy Continues to Grow. The Internet economy performed well in 1999, with revenue growing by 62 percent and employment growing by 36 percent, according to a recent report. In 1999 annual revenue amounted to over $500 billion, and the report estimates that if present conditions continue, it will reach about $850 billion this year. This is 15 times the growth rate for the entire U.S. economy. The Internet economy, which includes the Internet-related activities of infrastructure companies (such as AOL), software companies (such as Microsoft), and e-commerce companies (such as amazon.com), now employs approximately 2.5 million workers. The report found that these employees are increasingly efficient, with revenue per employee jumping 19 percent from year-end 1998 to year-end 1999. And the vast majority of companies involved with the Internet respond that it increases productivity. For example, 73 percent of Internet economy companies report they saw gains in employee and equipment productivity, compared with only 29 percent of a sample of all firms.

Antitrust Trial of MasterCard and Visa Begins. The Department of Justice trial against MasterCard and Visa for antitrust violations began in New York this week. MasterCard and Visa have a combined share of about 75 percent of the U.S. charge card market, and the boards of both companies have representatives from many of the same banks. The government alleges that this joint board role by the banks has reduced competition between the two networks in developing new types of cards and services. In addition, the two networks have issued rules preventing member banks from issuing other types of cards (like American Express) even though the rules allow member banks to issue both MasterCard and Visa cards. MasterCard and Visa contend that there is a substantial amount of competition among member banks regarding the terms on which their cards are offered. Visa also notes that while its rules do restrict member banks in the types of cards they issue, the rules do not restrict consumer choice among competing card brands: with all of the solicitations sent out by card issuers, the rules do not prevent consumers from obtaining other companies' charge card products.

EYES ONLY

INTERNATIONAL ROUNDUP

United States Is #1 in "E-business Readiness." The United States is the world's most "e-business ready" country according to a new study that ranks economies according to their overall ability to support and encourage e-business. In assessing e-business readiness, the study weighs both the general business environment and "connectivity." Business environment indicators include the strength of the economy, the regulatory climate, taxation policies and openness to trade and investment. Connectivity factors include not only the state of the existing telephone network but other factors that affect Internet access such as dial-up costs and literacy rates. The Nordic countries (Sweden, Finland, and Norway) are ranked closely behind the United States by virtue of high scores on connectivity, while a poor score in the general business environment puts Japan at 21st overall, and last among the G-7. Some large countries (China, India, and Russia) are ranked very far down on the list as they suffer from infrastructure weakness. The study stresses that it is simplistic to say that the Internet is a borderless network that allows businesses to go global instantly, as the rankings show large differences between countries in readiness for e-business.

Costs of Agriculture Policies Are High in OECD Countries. A new OECD study estimates that the agricultural policies of its member countries cost $361 billion (1.4 percent of GDP) in 1999. U.S. support (an estimated $97 billion, or 1.1 percent of U.S. GDP) represents about 27 percent of the OECD total. Reform would not only reduce these considerable costs but also improve the efficiency of agricultural policies through more specific targeting of support to intended beneficiaries. The largest (and generally richest) farmers often receive the bulk of the support. The 25 percent of farms with the highest annual sales generally receive more than half—and in some countries as much as 90 percent—of support provided by governments (the U.S. figure is about 85 percent). In terms of producer support as a percentage of total producer receipts, however, the United States (at about 20 percent) is well below the OECD average of 40 percent and the EU average of more than half. Direct payments to farmers are relatively more important than price supports in the United States, hence the majority of U.S. support represents a transfer from taxpayers, while that in the OECD as a whole is a transfer from consumers. The study urges that the role of agriculture-specific policies be clarified and that damaging distortions be removed.

Drug-Resistant Diseases Threaten World Health. Curable diseases are in danger of becoming incurable as a result of increasing levels of drug-resistance, according to a new World Health Organization report. In poorer countries, underuse of drugs—patients who are unable to afford the full course of medicine—cause this antimicrobial resistance. In wealthy countries, by contrast, the overuse of drugs by patients and the overuse of antimicrobials in livestock is contributing to increased drug resistance. The report notes that the economic cost of antimicrobial resistance can be staggering. For example, the cost of treating a patient with multi-drug resistant TB is an estimated one hundred times greater than the cost of treating an unresistant strain.

EYES ONLY

RELEASES THIS WEEK

Housing Starts

****Embargoed until 8:30 a.m., Friday, June 16, 2000****

Housing starts fell 3.9 percent in May to 1.592 million units at an annual rate.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 0.4 percent in May. Capacity utilization was unchanged, at 82.1 percent.

Consumer Price Index

The consumer price index rose 0.1 percent in May. Excluding food and energy, consumer prices rose 0.2 percent.

Retail Sales

Advance estimates show that retail sales decreased 0.3 percent in May, following a decrease of 0.6 percent in April. Excluding sales in the automotive group, retail sales were unchanged, following a decrease of 0.4 percent.

MAJOR RELEASES NEXT WEEK

U.S. International Trade in Goods and Services (Tuesday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.2
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	13.0
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.9
Imports	9.2	13.5	13.8	14.0	14.3
Personal saving	6.6	1.7	1.5	1.3	0.4
Federal surplus	-2.8	1.2	1.4	1.2	1.9

	1970-1993	1999	March 2000	April 2000	May 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	4.1
Payroll employment (thousands)					
increase per month			527	414	231
increase since Jan. 1993					22152
Inflation (percent per period)					
CPI	5.8	2.7	0.7	0.0	**0.1**
PPI-Finished goods	5.0	2.9	1.0	-0.3	0.0

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 15, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10715
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.67
10-year T-bond	5.26	5.65	5.99	6.44	6.05
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.22
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 15, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.953	-0.2	-8.5
Yen (per U.S. dollar)	106.5	0.6	-11.7
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.66	0.0	0.9

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	5.0 (Q1)	4.1 (May)	3.1 (May)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.7 (Q1)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics.

EYES ONLY

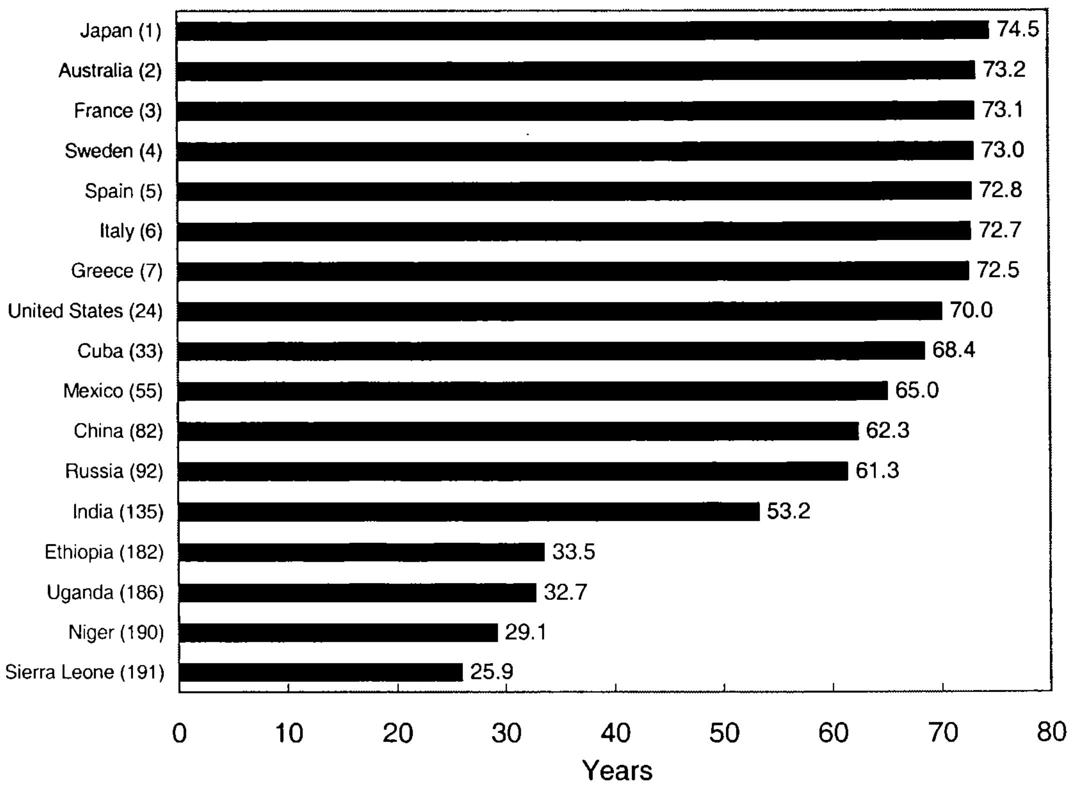
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 9, 2000

CHART OF THE WEEK

Healthy Life Expectancy in Selected Countries



Japan ranks first and the United States 24th in a new World Health Organization (WHO) ranking of healthy life expectancy for babies born in 1999. In contrast to a measure based on mortality data alone, the WHO indicator uses a methodology that discounts years lived in poor health. The relatively low U.S. ranking reflects a number of factors, including the poor health of some groups (such as Native Americans) and the effects of AIDS and tobacco-related cancers.

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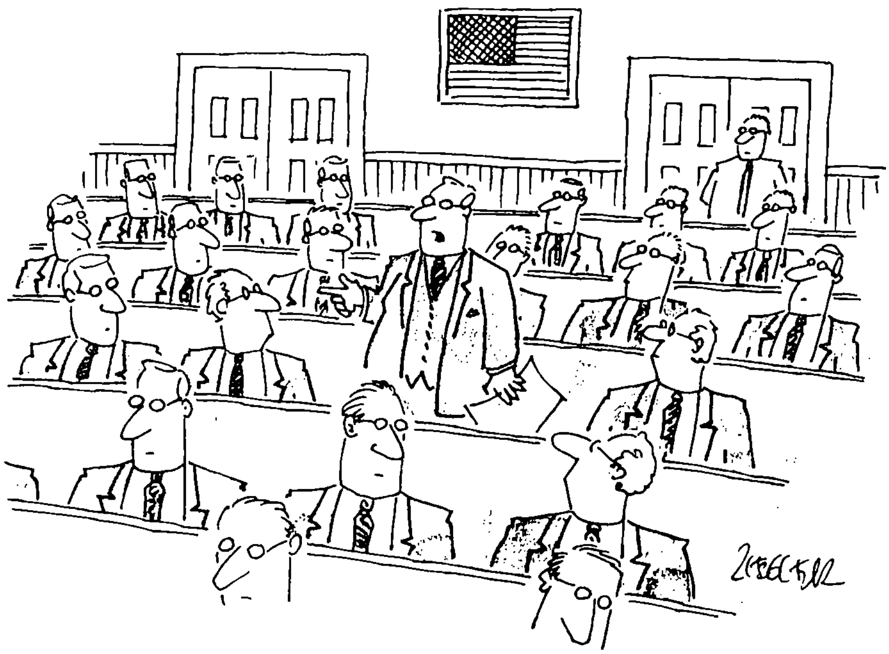
EYES ONLY

SPECIAL ANALYSES

ARTICLE

DEPARTMENTS



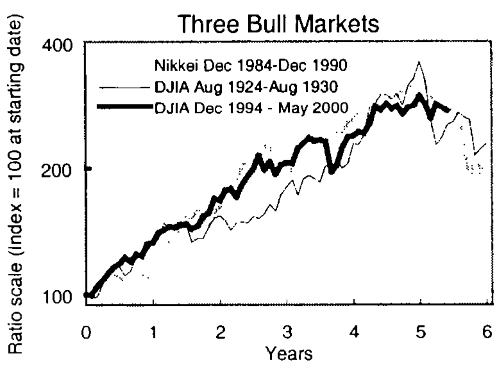
"The only solution I can see is to hold a series of long and costly hearings in order to put off finding a solution."

SPECIAL ANALYSIS

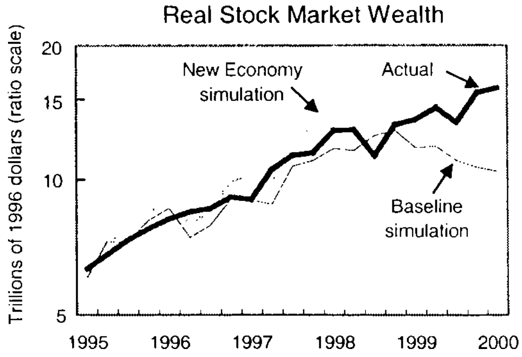
Irrational Exuberance?

The economist Robert Shiller has garnered considerable attention recently with his book arguing that excessive optimism and a herd mentality have led investors to bid stock prices to dizzying heights well above values justified by financial fundamentals. While it remains difficult to know whether the absolute *level* of stock prices is justified by the fundamentals, much of the *increase* in stock prices over the last 5 years could be explained by *changes* in fundamentals—including the acceleration in productivity.

Is it another speculative bubble? Shiller argues that changes in economic fundamentals can only explain a fraction of the runup in stock prices in the 1990s. He compares the atmosphere of the current bull market to those in the past, when media hype, widespread belief in the onset of a "new era" (often associated with the dissemination of technological innovations), and self-fulfilling expectations of stock returns during a bull market led to investor overconfidence. For example, over 90 percent of wealthy investors surveyed in 1999 agreed that the market would bounce back from a sharp contraction within a couple of years or so. Taken at face value, the stock market performance in the late 1990s looks strikingly like that of the ill-fated speculative bubbles of the late 1920s and the Japanese stock market boom of the late 1980s (see upper chart).



Or is it the New Economy? Shiller does not give much credence to the idea that there have been fundamental changes in the real economy of late. But that may not be correct. After all, the recent surge in stock prices has coincided with an apparent acceleration in trend productivity since 1995, suggesting the possibility that the two are related. A sustained acceleration in productivity can lead to higher future profits, raising the value of shares today. Abstracting from the issue of whether the stock market was "correctly" valued at the start of the productivity acceleration, it is of interest to measure the relative contribution of the rise in productivity growth to the rise in stock prices.



To illustrate the effect of an increase in expected growth on stock prices, the lower chart shows simulations of a model that relates stock prices to economic fundamentals—dividend payments and stock repurchases, the real interest rate, and expected future growth in payouts to shareholders (dividends plus stock repurchases). The chart compares two simulations of the growth in real (inflation adjusted) stock market wealth from the end of 1994 to the end of March this year with the actual increase over the same period of about 170 percent.

The first (baseline) simulation shows that nearly half of the actual increase in stock market wealth can be explained by fundamentals, assuming that investors' forecast of future growth stayed at a level consistent with the economy's performance during the previous two decades. Falling real interest rates in 1998 contributed to some of the strength shown in this simulation in 1998, and the subsequent rise in interest rates causes the fall in stock prices in 1999 and early 2000. The second simulation shows that if investors raised their forecast of the future growth of dividends by one percentage point over the last 5 years—a reasonable "New Economy" estimate—then fundamentals explain about three-quarters of the increase in stock prices. A 1.6 percentage point increase in trend growth would be required to explain fully the actual increase in stock market wealth.

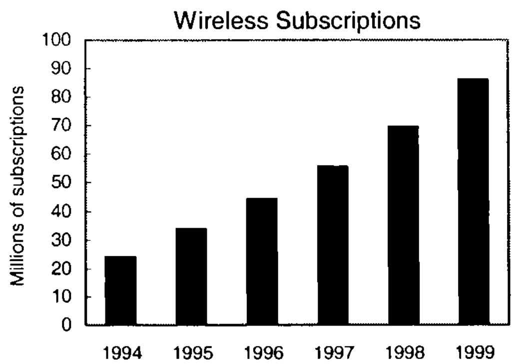
Conclusion. The performance of the stock market has led Shiller to believe that investor psychology may have created a stock market bubble. An alternative explanation for the recent surge in stock prices is that investors have recognized that economic fundamentals have significantly improved, with a sustained period of faster economic growth before us. Of course, both irrational exuberance and fundamental change may be at work.

EYES ONLY

SPECIAL ANALYSIS

Wireless Bandwidth

With more than 86 million subscribers, wireless phones have become commonplace in many households (see chart). Indeed, wireless technology and services are growing so rapidly and promising so much that the chairman of the FCC has focused attention on the question of whether the demand for additional spectrum is outpacing supply. One way to help resolve this problem might be through the use of new technologies that bridge the gaps between incompatible standards and allow the creation of a "marketplace" for spectrum, much like that for any other commodity.



New spectrum and new entrants. The rapid growth of wireless subscribers has been driven in part by the entry of new digital wireless PCS (Personal Communications Services) systems. Using spectrum acquired through FCC auctions, PCS systems have increased wireless competition in many markets. One study found that prices fell 10 percent when the first PCS entrant started service, and prices fell an additional 25 percent when a second PCS entrant launched service. To keep prices low as demand for additional services rises, however, other alternatives to expanding capacity may need to be explored.

New technology may make better use of existing spectrum. Rather than allocating additional bandwidth, new technologies may make it possible to use existing capacity more efficiently. Traditional wireless handsets use hardware to transmit and receive radio signals over specific bandwidths that may employ very different transmission standards. Recent developments in software defined radio (SDR) will allow a handset to be programmed to operate across a broad range of frequencies and transmission standards. With access to multiple networks, these new SDR handsets make it possible to develop a market mechanism to allocate the available bandwidth among users.

Spot markets for bandwidth. To take advantage of this new technology, one company proposes conducting an ongoing private auction among cellular providers. With such a system, one network that had excess spectrum capacity could offer to sell its available bandwidth to users of another network that had excess demand at a particular moment.

Spot markets and PCS investment. Although PCS providers are operating in many large markets, PCS is not yet available in some areas. Since entrants must raise capital both to build their systems and to run marketing campaigns to attract new customers, spot markets might provide an additional incentive to develop unused capacity. If these PCS providers were able to make their spectrum available to subscribers of existing incumbents (who may be capacity-constrained on their older systems), then entrants may have incentives to build out their systems more rapidly over the next several years.

Long-run implications. While a spot market for bandwidth can reallocate capacity among providers to resolve uneven usage problems, it does not provide a long-term solution to shortages spurred by higher demand for new wireless services. If companies are using all their capacity at prevailing prices, they will be more likely to increase price. To keep prices low in the face of increasing demand, the FCC will need to consider other options, such as the forthcoming auction for the spectrum currently occupied by TV channels 60 through 69. With the transition to high definition television, these stations will be relocating to a new portion of the spectrum. As a result, more wireless spectrum should become available, allowing wireless companies to provide new services over their phones.

EYES ONLY

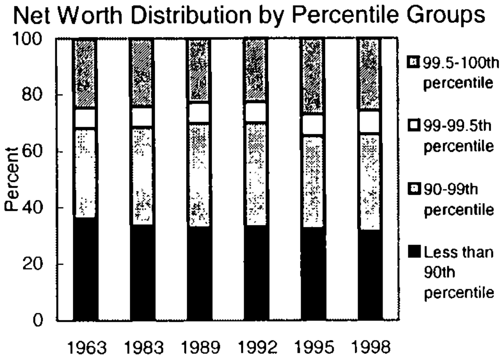
ARTICLE

The Distribution of Wealth Is Top Heavy—As Usual

Among the many favorable trends in the current long expansion have been the halt to rising income inequality, the decline in poverty, and the improvement in living standards for a wide variety of demographic groups. At the same time, however, the expansion has generated large amounts of financial wealth that are concentrated at the top of the distribution. Nevertheless, median wealth has also increased, the increase in overall wealth inequality in the 1990s has been modest, and the distribution of wealth looks about as it has since the early 1980s.

Trends in the concentration of wealth. Real (inflation-adjusted) median net worth rose 18 percent between 1995 and 1998 and increases occurred over a fairly broad range of the wealth distribution. Nevertheless, wealth remains much more unequally distributed than income. In the distribution of household income, the top 20 percent received just under half of aggregate money income in 1998. In the distribution of wealth, the top 10 percent had more than two-thirds of aggregate net worth, and the top 0.5 percent had more than a quarter. This inequality is not new, however (see chart). In 1998, the share of net worth held by the top 10 percent was 68.7 percent compared with 67.0 percent in 1992 and 66.6 percent in 1983.

Net Worth Distribution by Percentile Groups



The composition of net worth. In 1998, the bottom 90 percent of households held 37 percent of aggregate assets and 70 percent of aggregate liabilities (mainly principal residence debt). These percentages are roughly the same as in 1995. While ownership of stocks has become more widespread in recent years, stocks are still disproportionately held by those at the top of the wealth distribution: the bottom 90 percent of households held only 18 percent of all stocks in 1998 (up from 16 percent in 1995). By contrast, they held 65 percent of principal residence wealth and 75 percent of vehicle wealth. Since the major assets of most households are their houses and their cars rather than stocks, it is perhaps not surprising that the sharp increase in stock market wealth between 1995 and 1998 was concentrated at the top of the distribution and that wealth inequality increased somewhat.

Income and poverty. Since most households are not wealthy, trends in income and poverty remain key indicators of economic inequality. Analysis in previous *Weekly Economic Briefings* and the 2000 *Economic Report of the President* has provided encouraging evidence that the rise in inequality since the early 1970s has been arrested in recent years:

- Gini index. The Census Bureau's Gini index of household income inequality was only 0.4 percent higher in 1998 than it was in 1993. This compares with an increase of 0.7 percent between 1989 and 1992, and 6.7 percent between 1979 and 1989. (The Gini index jumped between 1992 and 1993 when a change in methodology increased measured income at the top of the distribution by more than actual income rose.)

- Income shares. The share of income received by the top 20 percent of families was a high 49.2 percent in 1998, but it was already 48.9 percent in 1993 and had risen from 44.0 percent in 1979 to 46.9 percent in 1992. Similarly, the share of the bottom 20 percent was a low 3.6 percent in 1998, but this was the same as in 1993, and the share of the bottom 20 percent had already fallen from 4.2 percent in 1979 to 3.8 percent in 1992.

- Poverty rate. The poverty rate has fallen sharply since 1993, and the decline has been even faster for an alternative measure reflecting improvements proposed by a National Academy of Sciences panel (such as including the EITC). Nevertheless, the poverty rate remains higher than it was in the 1970s, in part because of the increased proportion of single mothers in the population.

Conclusion. Increases in stock market wealth in the 1990s have produced a modest increase in the concentration of wealth. But real median net worth has also increased substantially. This, together with a variety of other income and poverty indicators, point to an expansion whose benefits have been shared broadly among the population.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

EIA Raises Forecast of Gasoline Prices. The national average price for regular unleaded gasoline reached $1.56 per gallon this week, and the latest monthly forecast from the Department of Energy's Energy Information Administration (EIA) has gasoline prices this summer averaging about 5 to 10 cents more per gallon than in last month's forecast. Assuming relatively smooth operating conditions for refineries and pipelines, EIA forecasts gasoline prices will peak in July, and then fall to $1.38 per gallon by the end of the year. The higher prices for the summer driving season reflect faster growth in petroleum demand, which has contributed to crude oil prices rising back into the $30 per barrel range. Low gasoline inventories are another major contributor to the high gasoline prices. Finally, reformulated gasoline (RFG)—fuel with lower emissions of air pollutants that represents one-third of all gasoline consumption—has averaged about 11.5 cents more per gallon than conventional gasoline over the past 10 weeks as the RFG program has transitioned into more stringent emissions standards.

The Changing Tax Cost of Marriage. While some couples paid a marriage tax penalty and others received a marriage tax subsidy, on average marriage was subsidized by the Federal tax code over the 1984-97 period, according to a recent study. However, the tax cost of marriage has been steadily rising and married couples today are more likely to face a tax penalty than they were in 1984. By 1997, about 55 percent of couples faced an average marriage tax penalty of $1,300 and 34 percent received an average subsidy of $2,200. The study finds that changing tax laws and demographics reinforced each other to increase the tax cost of marriage. Changing tax laws explain 55 to 60 percent of the increase, while the increased labor force attachment of married women also played a large role, since two-earner couples pay a marriage tax penalty, while single-earner couples receive a bonus. Families in which the wife earned more than a quarter of family earnings were found to pay the largest marriage tax.

New Evidence on Job Creation and Destruction in Manufacturing. The fact that U.S. labor markets are characterized by high rates of gross job creation and gross job destruction has been well-documented by researchers. But previous research did not distinguish between job reallocation among different firms versus job flows among different plants of the same firm. A new study addressing this question found that small manufacturing firms with only one plant created jobs at nearly twice the rate of large firms with multiple plants, but they also destroyed jobs at a much higher rate than large firms. Much of this job creation and destruction at small firms was due to startups and shutdowns. For large firms, approximately half of the job reallocation was among plants owned by the same firm. In the aggregate, approximately one-quarter of the reallocation of jobs among manufacturing plants occurred among the plants of one firm. The study also found that net employment at single-plant firms expanded over the past two decades, while employment at large multi-plant firms shrank.

EYES ONLY

INTERNATIONAL ROUNDUP

OECD Calls for Stronger Action against International Cartels. Further action to enhance the effectiveness of anti-cartel enforcement is vital to member country economies, according to a recent OECD report. The report argues that most government officials, legislators, and citizens are not aware of the extent of the harm done by cartels, and fines in some countries are too low to possibly deter collusion. While precise quantification is impossible, the report does offer some examples of serious harm from recent cases. In one, nearly every major worldwide producer of graphite electrodes recently pled guilty to participating for 5 years in a cartel that affected over $1.7 billion of U.S. commerce alone and raised prices of electrodes by 60 percent. In addition to the direct harm to consumers caused by artificially high prices, these cartels have also created economic waste and inefficiency. The report stresses that international cooperation is particularly important for effective action against cartels. Currently, however, most countries' laws prevent their competition authorities from sharing information with foreign authorities, which has seriously hindered the prosecution of international cartels.

Brussels Pushing to Revise VAT on E-Commerce. The European Commission proposed this week to modify its rules for applying the value added tax (VAT) to certain electronically supplied services, such as software, computer, and radio and television broadcasting services. Currently, digitally delivered services originating within the EU are subject to the VAT (whether or not they are consumed in the EU), while those produced outside the EU are not. The proposed amendments would ensure that only services supplied for consumption within the European Union were subject to the EU VAT, as is now the case for physical goods purchased over the electronic network. The United States has previously urged the Commission to hold off on this proposal given its complicated and potentially damaging implications, and to support the multilateral OECD discussions rather than proceed unilaterally.

Gender Equality Enhances Development. A new World Bank report, "Engendering Development," surveys a wide range of studies and finds that countries that discriminate by gender pay a high price in terms of economic growth, health, and other development goals. For example, cross-country studies show that controlling for the effects of per capita income and other factors on child mortality, a 10 percentage point increase in the female primary school enrollment rate reduces the infant mortality rate by 4.1 deaths per 1,000 births. Countries where girls are only half as likely to go to school as boys have 21 more infant deaths per 1,000 live births than countries with no school gender gap. Another study finds that in Brazil, the positive impact on children's nutritional indicators of additional income in mothers' hands is 4 to 8 times larger than the impact of additional income in fathers' hands. Analysis of Burkina Faso shows that agricultural output could be increased by between 6 and 20 percent simply by reallocating fertilizer and other inputs more equitably between husbands and wives, who typically operate separate plots.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, June 9, 2000****

The producer price index for finished goods was unchanged in May. Excluding food and energy, producer prices rose 0.2 percent.

Productivity

According to revised estimates, nonfarm business productivity rose 2.4 percent at an annual rate in the first quarter of 2000. Manufacturing productivity rose 7.3 percent.

MAJOR RELEASES NEXT WEEK

Retail Sales (Tuesday)
Consumer Prices (Wednesday)
Industrial Production and Capacity Utilization (Thursday)
Housing Starts (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	**0.2**
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	13.0
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.9
Imports	9.2	13.5	13.8	14.0	14.3
Personal saving	6.6	1.7	1.5	1.3	0.4
Federal surplus	-2.8	1.2	1.4	1.2	1.9

	1970-1993	1999	March 2000	April 2000	May 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	4.1
Payroll employment (thousands)					
increase per month			527	414	231
increase since Jan. 1993					22152
Inflation (percent per period)					
CPI	5.8	2.7	0.7	0.0	N.A.
PPI-Finished goods	5.0	2.9	1.0	-0.3	**0.0**

**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 9, 2000**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 8, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10669
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.74
10-year T-bond	5.26	5.65	5.99	6.44	6.13
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.32
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 8, 2000**	**Percent Change from** Week ago	Year ago
Euro (in U.S. dollars)	0.955	2.6	-8.5
Yen (per U.S. dollar)	105.9	-2.6	-11.7
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.65	-1.9	1.0

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	5.0 (Q1)	4.1 (May)	3.0 (Apr)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.0 (Q4)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics.

EYES ONLY

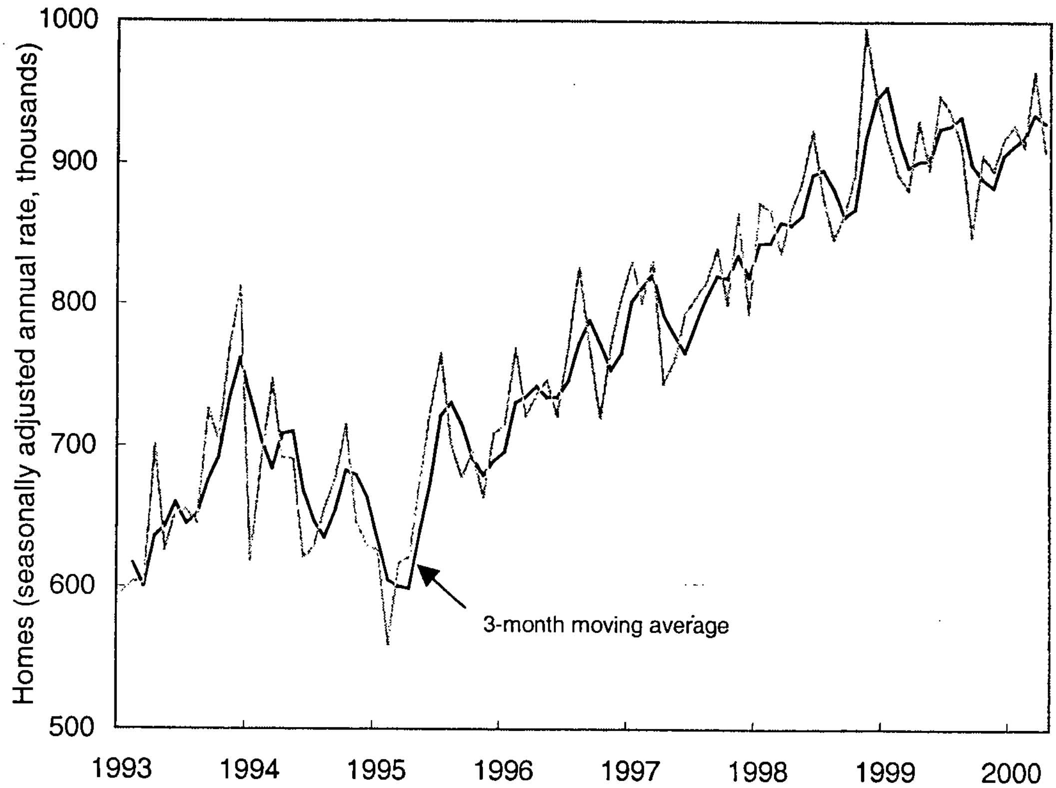
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 2, 2000

CHART OF THE WEEK

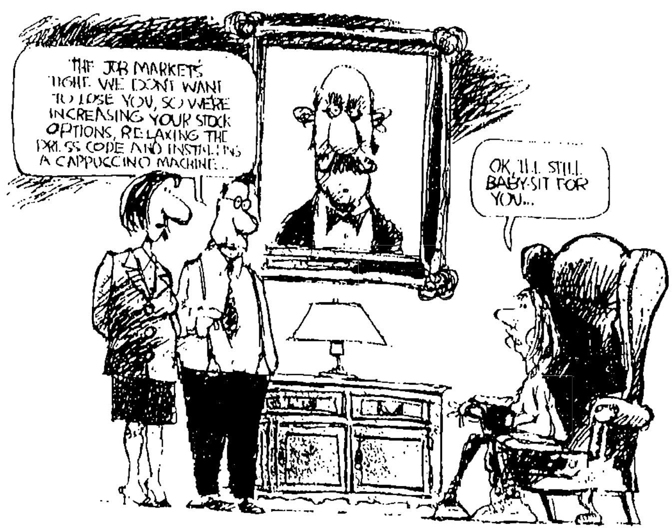
New Single-Family Home Sales



This week's data on new home sales in April showed a sharper-than-expected monthly drop of 5.8 percent. Although the level of new home sales remains high, the drop in April is consistent with other data on housing starts and existing home sales which suggest that the Federal Reserve's tightening of monetary policy may be beginning to affect the housing market.

CONTENTS

EYES ONLY

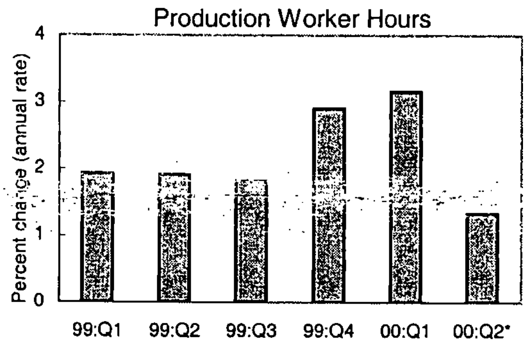


EYES ONLY

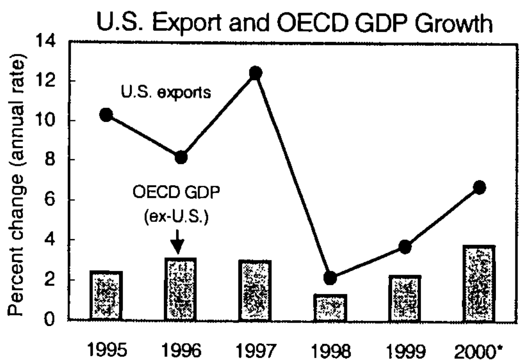
MACROECONOMIC UPDATE

Economy Likely to Slow in the Second Quarter

The decline of 116,000 in private payroll employment in May indicates a slowing of labor demand in the second quarter. Hours worked by production workers appear to be up about 1¼ percent at an annual rate from the second quarter, a slowing from their earlier pace (see upper chart). This growth in hours could support real GDP growth in the 3 to 4 percent range.



* Second-quarter estimate based on April and May data.



* 2000 figures for export and GDP growth are first-half estimates.

The shape of demand. Domestic demand has grown faster than domestic production for most of the past 4 years, with imports growing faster than exports. But domestic demand may have moderated in the second quarter according to fragmentary data on consumption, housing, and equipment investment.

Exports. Prospects for U.S. export growth in 2000 are improving. GDP growth in the rest of the OECD, which had averaged only 1.8 percent in 1998 and 1999, is now expected to increase at a 3¾ percent annual rate in the first half of 2000. The acceleration in foreign GDP may account for a pickup in U.S. exports to about a 7 percent annual rate (see lower chart).

Inflation. After years of low and stable inflation, it appears that price inflation has edged up—but only slightly. The four-quarter change in the GDP price index—at 1.8 percent—was 0.5 percentage point above its year-earlier rate, although the core CPI has shown only a 0.2 percentage point acceleration. One measure of hourly compensation, the Employment Cost Index, has accelerated much more (1.5 percentage points). Thus far, these wage increases have been largely offset by higher productivity growth.

EYES ONLY

SPECIAL ANALYSIS

The Economics of Standards

One goal of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) was to reduce health care costs and administrative burdens by setting standards for the electronic transmission of many administrative and financial transactions between insurers, providers, and other health care institutions. This month the Department of Health and Human Services is expected to issue its first final rule to begin establishing such standards. In this particular case, standards may result in substantial cost reductions. But across industries, the question of when or whether the government should intervene to set standards can pose serious policy challenges.

Are market forces enough? Developing a standard requires solving a coordination problem among a potentially diverse set of consumers and producers. At times, a standard can emerge as a result of technological or market dominance. In some areas of today's economy, firms may seek an advantage by encouraging the adoption of their own technology rather than that of others. As firms compete to improve their products, new technologies may lead to better designs that then supplant the prevailing market standard. To the extent, for example, that a large majority of video cassette recorder consumers decided that they preferred the properties of VHS technology to those of Betamax, no explicit coordination was required for a de facto standard to emerge. Another way that firms may be able to overcome coordination issues is to use industry-based standard setting bodies. In other cases, however, the distribution of costs and benefits may be sufficiently uneven that voluntary coordination is not achievable. Even where the total industry-wide benefits exceed costs, some participants may incur net costs and be unwilling to switch to a new standard voluntarily. Government intervention may be necessary for a standard to be adopted.

The case of HIPAA. Insurance companies, health care plans, and providers currently use many different types of forms to transmit similar information. To receive payment, hospitals must support each insurance company's forms. Although hospitals may benefit on balance from reducing this administrative burden by having one standard way of transmitting information, each insurance company would also have to incur the costs of switching to a new system. Studies suggest that the long-run savings from adopting a standard might greatly exceed the additional costs imposed by requiring a common form. The uneven distribution of costs and benefits may have hindered the development of a voluntary industry-wide standard. The HIPAA legislation breaks this deadlock by requiring all firms to adopt a standard format for transferring information. An early industry analysis estimated annual savings for the transactions covered by HIPAA to range between $8.9 and $20.5 billion.

Conclusion. As the HIPAA example illustrates, firms may not always have the incentive to develop standards that would generate cost savings to the entire industry due to the costs of coordinating such a move. While government intervention can resolve this type of deadlock and increase economic efficiency, the imposition of standards by the government does carry some risks. For example, whenever the government chooses a standard, even one that is the best available at any point in time, the incentives to develop a better standard may be diminished. In addition, since government standards are typically slow to develop, government standards may sometimes take longer to develop than market-based solutions.

EYES ONLY

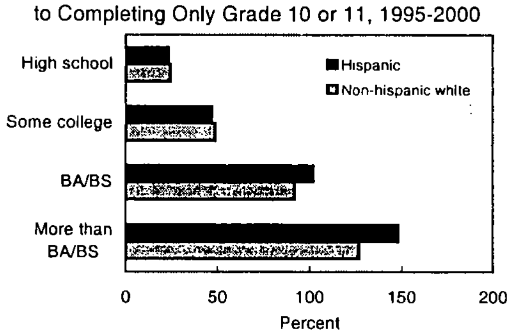
ARTICLE

Education and the Economic Success of Hispanics

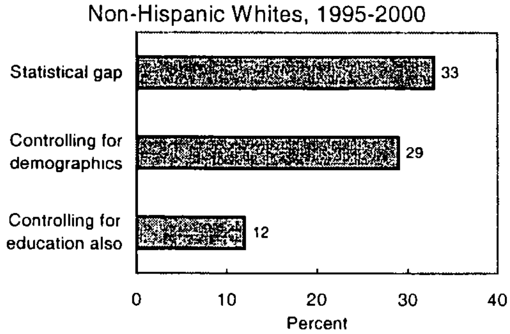
Hispanics are a growing segment of the U.S. population. In 20 years about one in six U.S. residents will be of Hispanic origin, and by the middle of this century—when today's young children are middle aged—this ratio will increase to about one in four. Given the current educational attainment gap between Hispanics and other groups, a key to the future productivity of the U.S. labor force will be our ability to raise education levels among this expanding pool of workers. A forthcoming CEA analysis of Hispanics in the rapidly growing information technology (IT) sector illustrates the potential payoff to such an effort.

Educational lags among Hispanics. Compared with non-Hispanic groups, there are now substantial education gaps at all levels. The high school graduation rate for Hispanics aged 25 to 29 is about 63 percent—compared with about 90 percent for non-Hispanics (both black and white). The fraction of Hispanics who graduate from 4-year colleges is less than half that of non-Hispanic whites. Part of this education gap is attributable to low educational attainment of immigrants, but native-born Hispanics also drop out of high school at much higher rates than non-Hispanic whites.

Earnings Premium by Education Level Relative to Completing Only Grade 10 or 11, 1995-2000



Difference in Earnings between Hispanics and Non-Hispanic Whites, 1995-2000



Consequences for economic success. For Hispanics and non-Hispanics alike high school and college educated individuals have far higher earnings than those who complete 10 or more years of education, but fail to graduate from high school (see upper chart). However, analysis of data from 1995 to 2000 indicates that Hispanics earn 33 percent less than non-Hispanic whites.

A very small part of this gap is due to differences in gender and age composition; after adjusting for these demographic factors the gap is 29 percent (see lower chart). Rather, most of the earnings disparity is due to differences in educational attainment. After controlling for educational attainment, the gap declines to 12 percent.

Information technology: A case study. Analysis of employment and earnings in IT provides a vivid illustration of the importance of education in the new economy. (IT is defined here to comprise the following five occupations:

electrical and electronic engineering, computer system analysts and scientists, operations and systems researchers and analysts, computer programmers, and computer operators.) IT is an important sector of the U.S. economy, characterized by both high employment growth and relatively high pay.

- Earnings. CEA analysis indicates that in IT Hispanics earn only slightly less than non-Hispanic whites (about 7 percent less after controlling for age, education, and gender), and that earnings of individuals in both groups are far higher than in other occupations. While the differential in median hourly earnings between the IT and non-IT occupations is 62 percent for non-Hispanic whites, it is 100 percent for Hispanics—reflecting the low earnings of Hispanics in non-IT jobs.

- Employment. While earnings are similar, there is a striking digital divide in the IT workforce, with Hispanics significantly underrepresented (4 percent of workers in IT occupations, compared with 11 percent of the full-time labor force). This Hispanic digital divide in IT does not reflect a marked lack of success of well-educated Hispanics who take IT jobs. Rather, it is indicative of a lack of the education needed to prepare Hispanics for these occupations. In particular, the digital divide in IT employment seems to stem from the low levels of college attendance among Hispanics.

Improving outcomes for Hispanics. Research has established that the gap in educational achievement between Hispanics and non-Hispanics begins at young ages. Research also indicates that ultimate educational outcomes are determined to a considerable extent by educational success at young ages. Programs aimed at older disadvantaged youth—for example, policies that lower economic barriers to higher education—may well be helpful for improving prospects of Hispanics. However, it is particularly crucial that educational policies address the ethnic, racial, immigrant-status, and economic-based education gaps that exist for young children.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Don't Rain on My Parade. Most states are currently enjoying the best fiscal health they have had in years. Annual budget surpluses have been substantial in many states, and some states have accumulated growing fund balances. Budget reserves and "rainy day funds" can serve an important function in protecting state budgets against the need to raise taxes or cut spending sharply in a downturn, limiting the kind of pro-cyclical fiscal policy that has often characterized state budgets in the past. However, the Center on Budget and Policy Priorities found that in fiscal 1999 only eight states had enough savings to maintain services through a 3-year recession without raising taxes. Since then, five of those states have enacted tax cuts. The shortfalls in these five states are now projected to range from 2.7 percent of general fund expenditures in Massachusetts to 10.4 percent in Michigan. Other states start out in an even less favorable position.

Changes in New Home Inventories. For much of the last four decades, the stock of unsold new homes has tracked new home sales very closely, including rising in boom years. But a recent study finds that since 1995 inventories have fallen behind rapidly rising sales. In part, the study argues, this decline reflects longer-term trends toward building larger and higher quality homes that require longer construction times (thereby slowing the response of inventories to cyclical fluctuations in sales and reducing desired inventories). For example, average square footage for new single-family homes rose from 1,700 in 1980 to 2,170 in 1998, and new homes are more likely to have extras such as central air conditioning, fireplaces, and multi-car garages. A second longer-term trend is the growing practice of selling homes before construction has begun. The study also notes that very strong demand in the current expansion may be straining industry capacity. The study concludes that the current low level of inventories offers some assurance that the homebuilding sector could weather a slowdown in sales without the dramatic decline in construction activity that has been seen in the past.

Unmarried Parents Are Not Necessarily Single, at Least at First. Most new unmarried parents agree substantially with the view that marriage and father involvement are important, according to a recent study. And despite not being married, about half of all such parents live together, and another 30 percent are romantically involved at the time of their child's birth. More than two-thirds believe that their chances of marrying are 50 percent or better and that it is better for children if their parents are married. The study argues that public policies and programs should build upon and maintain this commitment that exists at the "magic moment" of a child's birth. However, other findings suggest that this may be difficult. When asked about the qualities of a successful marriage, 90 percent of parents in Austin and more than three-quarters of parents in Oakland rated "husband having a steady job" as very important. Yet the study found that unmarried fathers had an average income of only $12,500 and about half lacked a high school degree, suggesting that increases in human capital and employment could play critical roles in the development and maintenance of stable families.

EYES ONLY

INTERNATIONAL ROUNDUP

OECD Economic Prospects Bright. OECD-wide output growth for this year is projected to be 4 percent, the fastest pace in a decade, according to the June 2000 *OECD Economic Outlook.* Aggregate unemployment is expected to decline by more than 2 million between 1999 and 2001, falling to 6.1 percent of the labor force. The euro area should see a particularly strong decrease in unemployment, from 10.1 percent in 1999 to 8.5 percent in 2001. This reflects projected real GDP growth of 3.5 percent this year and 3.3 percent in 2001. Japan is expected to grow 1.7 percent this year and 2.2 percent next year. The report warns that the recent strength of domestic demand in the United States is not sustainable and points to signs of inflationary pressure and the deterioration of the current account and net international investment position. OECD projections for U.S. growth are 4.9 percent this year slowing to 3.0 percent in 2001.

The Poor Suffer More from Inflation. The poor are more concerned about inflation than the rich, and inflation tends to reduce the relative income of the poor and increase poverty, according to a recent study co-authored by IMF First Deputy Managing Director Stanley Fischer. These findings complement those of World Bank researchers described in a recent *Weekly Economic Briefing*. Survey data for over 30,000 households in 38 countries—19 industrialized and 19 developing—show that within a country, the poor and less educated are more likely than the more advantaged to mention inflation as a top national concern. This is probably because the poor tend to hold relatively more cash, be less aware of or have less access to financial instruments that hedge against inflation risk, and depend more heavily on income that is not fully indexed to inflation. In addition, the study shows that several more direct indicators of the well-being for the poor—their share of national income, poverty rates, and real minimum wage—tend to deteriorate with high inflation.

Healthy Foreign Banks Can Be Stabilizing. A new study of the experiences of Mexico and Argentina in the 1990s finds that diversity of bank ownership contributed to greater stability of credit in recent crises and times of financial system weakness. In both countries, foreign banks had stronger loan growth rates than their domestically owned counterparts, with lower associated volatility contributing to greater stability in overall financial system credit. Importantly, the study found that bank health—not national ownership *per se*, has been the critical determinant of the growth, volatility, and cyclicality of bank credit. In Mexico, banks with higher impaired loan ratios (ILRs) had lower and more volatile rates of portfolio expansion than banks with less problematic portfolios. While the banking system overall showed a small contraction in credit during the 1995-99 period following the Tequila crisis, both domestic and foreign banks with low ILRs continued to extend credit steadily during this period, though their share of total lending was small. The study concludes that healthy foreign banks have emerged as an important source of funding for local investment and growth opportunities without raising the volatility of the financial system.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment
****Embargoed until 8:30 a.m., Friday, June 2, 2000****

In May, the unemployment rate was 4.1 percent; it was 3.9 percent in April. Nonfarm payroll employment increased by 231,000.

NAPM Report on Business

The Purchasing Managers' Index decreased 1.7 percentage points in May to 53.2 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding.)

Leading Indicators

The composite index of leading indicators declined 0.1 percent in April.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, rose 6.7 index points in May, to 144.4 (1985=100).

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Producer Prices (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.3
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	13.0
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.9
Imports	9.2	13.5	13.8	14.0	14.3
Personal saving	6.6	1.7	1.5	1.3	0.4
Federal surplus	-2.8	1.2	1.4	1.2	1.9

	1970-1993	1999	March 2000	April 2000	May 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	**4.1**
Payroll employment (thousands)					
increase per month			**527**	**414**	**231**
increase since Jan. 1993					**22152**
Inflation (percent per period)					
CPI	5.8	2.7	0.7	0.0	N.A.
PPI-Finished goods	5.0	2.9	1.0	-0.3	N.A.

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

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, June 2, 2000**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 1, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10652
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.57
10-year T-bond	5.26	5.65	5.99	6.44	6.20
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.54
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 1, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.931	2.6	-10.9
Yen (per U.S. dollar)	108.7	1.2	-9.9
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	98.52	-1.0	2.5

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	5.0 (Q1)	**4.1** (May)	3.0 (Apr)
Canada	4.9 (Q1)	6.8 (Mar)	2.1 (Apr)
Japan	0.0 (Q4)	5.0 (Mar)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Mar)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.9 (Jan) 2/	3.0 (Apr)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, June 2, 2000.**

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.

EYES ONLY

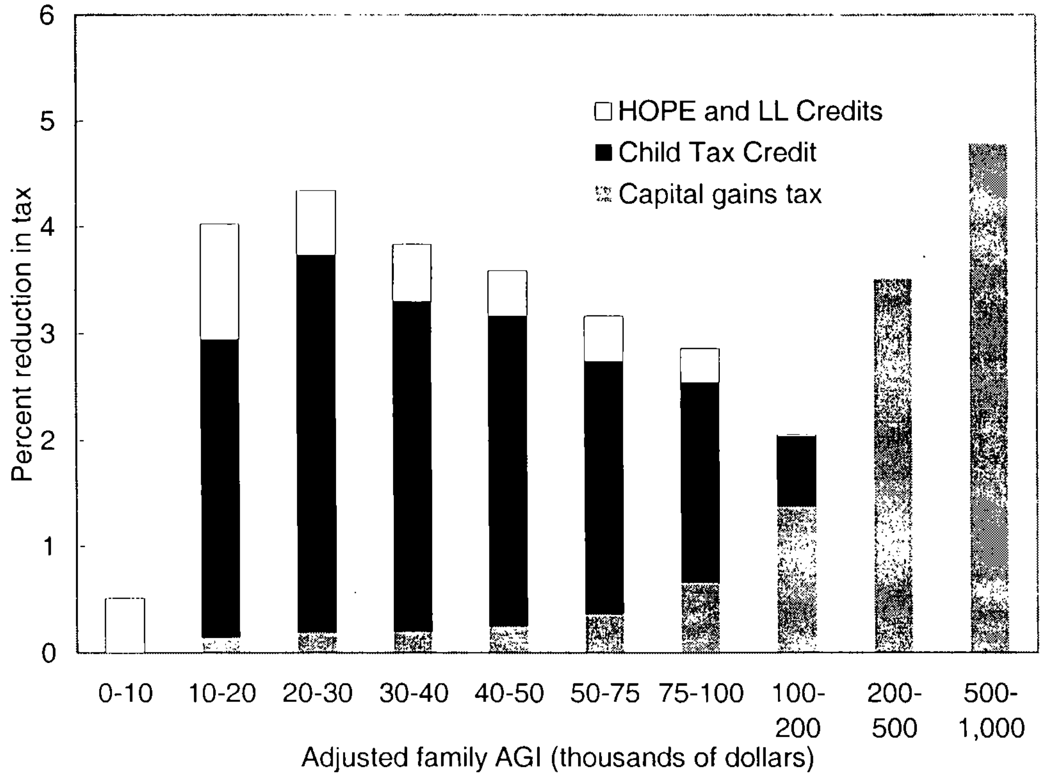
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 26, 2000

CHART OF THE WEEK

Effects of TRA-97 Provisions on Tax Burdens in 1999



Three major tax reduction provisions of the Tax Relief Act of 1997 (TRA-97) lowered federal income taxes for all income groups. Based on a tax simulation model, the HOPE, Lifetime Learning, and Child Tax Credits significantly reduced taxes—measured by the sum of payroll and individual income taxes—for low to middle income families, while the capital gains tax reduction primarily benefited higher income families.

EYES ONLY

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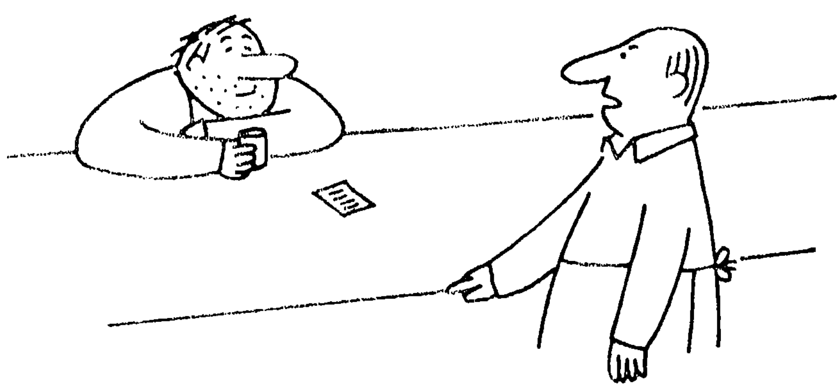


"I don't want stock options. I want you to pay your tab."

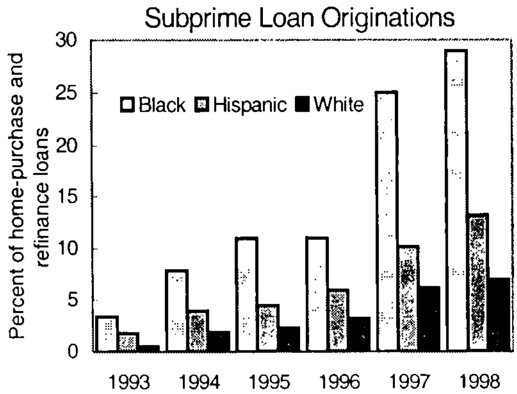
EYES ONLY

SPECIAL ANALYSIS

Keeping Predatory Lending at Bay

Increased access to mortgages for people with less-than-perfect credit has contributed to the rise in the share of American households who own homes, which at 67 percent is the highest on record. Unfortunately, this expanding "subprime" market may also be providing fertile ground for the growth of predatory practices by some lenders that can rob borrowers of hard won equity in their homes—often their only significant asset.

The subprime market. The mortgage market is divided between prime loans for those borrowers with unblemished credit and subprime loans for those with poorer credit. About one-quarter of all subprime loans in 1998 were for home purchases and the other three-quarters were for home refinance. Subprime lenders—typically finance or mortgage companies not subject to routine regulatory compliance audits—face higher screening costs and greater default risk in making these loans and therefore charge fees and interest rates above those of the prime market. Racial and ethnic minorities are more likely than whites to be subprime borrowers. In 1998, subprime loans accounted for 29 percent of all home purchase and refinance loans issued to African Americans, 13 percent to Hispanics but only 7 percent to whites (see chart).



Growth in subprime lending. The number of subprime loan originations has increased over 15-fold since 1993. Subprime home-purchase loans have helped to make mortgage credit and homeownership more widely available. Between 1993 and 1998, the total number of home-purchase loans to African American borrowers increased 95 percent (as compared to 40 percent for whites), with nearly one third of that increase accounted for by subprime loans.

Predatory lending practices. Anecdotal evidence of abusive and predatory lending practices, particularly in low-income urban areas, have accompanied the growth of the subprime market. In addition to outright fraud, predatory practices include the steering of prime borrowers into subprime loans, excessive interest rates and fees, prepaid credit insurance, and the making of short-term or unaffordable loans. This last practice, often referred to as loan "flipping," ensures that the loan will have to be refinanced in a short time, providing the creditor with additional origination fees and prepayment penalties, which are then financed out of homeowners' equity. This is akin to a securities broker "churning" a customer's stock portfolio, with fees eating into the principal with each successive purchase and sale.

Market imperfections may facilitate predation. The combination of consumers with limited credit experience and the absence of standardized loan products creates an environment in which these abusive practices, despite being so damaging, are not driven out by market forces. For example, a recent survey found that only 49 percent of African American respondents with "good" credit records self-assess their own records as either "good" or "very good" (compared to 72 percent of white respondents), which may make them more likely to rely on subprime and predatory lenders than necessary. In addition, the lack of standardized loans has limited competition in subprime lending.

Possible remedies. Low-income and minority borrowers have increasingly benefited from a rapidly growing subprime market, but this has come at the cost of an apparent expansion in predatory lending practices. A HUD-Treasury Joint Task Force and the House Banking and Financial Services Committee are considering proposals to limit abuses. The prohibition of particularly abusive practices such as single premium credit life insurance and restrictions on the ability of the secondary market to securitize predatory loans could improve consumer welfare. Improved financial education, tightened disclosure rules and enforcement, and the encouragement of the increased entry of regulated financial institutions into the subprime market are other potential ways to combat abusive lending.

EYES ONLY

SPECIAL ANALYSIS

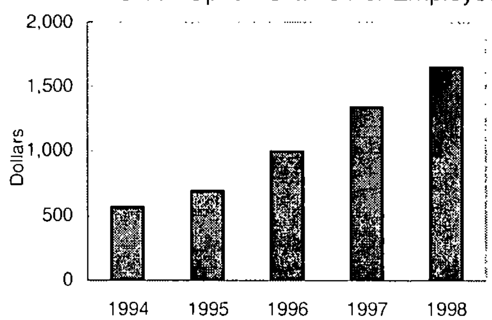
The Growing Importance of Employee Stock Options

Employee stock option plans have rapidly become an important form of compensation for employees and a powerful recruiting tool for companies, especially in technology industries. The rapid expansion of such compensation has created new challenges in measuring corporate profitability and has stimulated a debate regarding the appropriate tax treatment of stock options.

Stock option plans. A variety of stock option plans exist, but the most common type of option allows an employee to buy a predetermined number of shares at a fixed price, often the market price at the time the option is granted. If the market price subsequently rises above the fixed price, the option holder can exercise the option by purchasing the stock. The stock can be sold for an immediate profit or held in anticipation of future gains. Employers favor stock option plans because they provide workers with a stronger incentive to improve company performance and because they are treated more favorably than ordinary salary expenses under current accounting rules. For employees, stock options may represent a potentially lucrative opportunity to share directly in the fortunes of their employers. However, they may also increase the uncertainty and variability of workers' income.

Rapid growth. Stock option plans have spread quickly. A Fed study covering the 125 largest nonfinancial firms in the S&P 500 found that the value per employee of annual stock options grants nearly tripled between 1994 and 1998 (see chart). Another survey found that these plans are not reserved exclusively for executives. The informal survey found that 34 percent of businesses offered stock option plans to nonexecutives. But fewer than 10 percent had programs available to employees below the managerial and professional level. This extraordinary growth suggests that businesses have been shifting the compensation mix toward option-based pay and away from traditional salaries. According to a recent study, the growth in stock options may have increased the actual annual growth rate of economy-wide employment costs in the range of 0.25 to 0.75 percentage point between 1994 and 1998—a figure not counted in the official Employment Cost Index.

Value of Stock Option Grants Per Employee*



* For 125 largest nonfinancial firms in the S&P 500

Are stock options expenses? This rapid growth in stock options has created new challenges in measuring the profitability of companies. Although stock options represent a cost of doing business, current financial accounting rules do not require firms to report the cost of the most common type of option as an expense on their income statement. As a result, earnings reported on the income statement understate the true cost of their operations and hence overstate their profitability. This discrepancy is not trivial: at the 125 S&P 500 firms discussed above, the value of stock options granted could have represented as much as 8 percent of reported profits in 1998. The Financial Accounting Standards Board (FASB) has encouraged firms to report stock option costs as a compensation expense—a convention that would conform more closely to the economic definition of labor costs. However, the FASB has continued to allow companies to omit most stock option transactions from the income statement, provided they make pro forma disclosures of net income with the cost of these options treated as an expense.

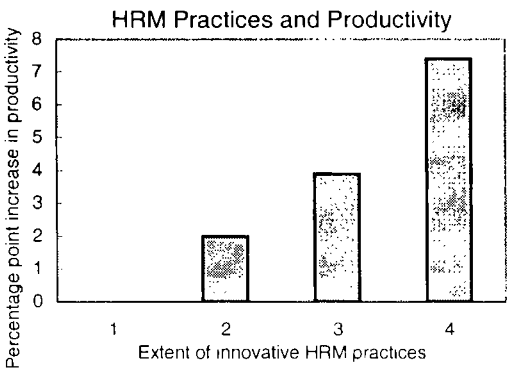
How should stock options be taxed? The taxation of stock options differs across types of option plans, both in terms of the corporate income tax paid by the employer and the personal income tax paid by the employee. Congress is currently considering the creation of a "super stock option." This new option would combine the most favorable tax treatment of existing option plans for both employers and employees. Employers would be able to deduct stock option costs from taxable income when the options were granted or exercised. Workers, on the other hand, would only pay taxes at the capital gains rate (assuming certain requirements are met) and the tax would be deferred until the resulting shares are sold. This approach would create a further tax-based incentive to substitute option-based compensation for standard salary income, but there is no clear economic rationale for subsidizing this particular form of compensation.

ARTICLE

Innovative Human Resource Management Practices

Firms have increasingly introduced innovative human resource management (HRM) practices that are aimed at greater employee involvement in decision making. It is estimated that about half of all establishments have adopted some form of employee involvement program, and that the vast majority of these programs were introduced since 1987. To what degree do these innovative HRM practices raise workers' productivity, and how do these practices change the demand for less-skilled workers?

HRM effects on productivity. One recent study examined productivity differences among 41 comparable steel finishing lines in the United States and Japan. In this study, the HRM practices are divided into four groups, with the lowest group (#1) having no innovative practices and the top group (#4) having a comprehensive set of innovative practices. Innovative practices include extensive communications with workers, off-site training, worker rotation across jobs, extensive participation by production workers on problem-solving teams, and pay that is a function of multiple attributes of performance. Based on monthly production data from steel production lines, productivity rises as the extent of innovative HRM practices increase from the lowest to highest HRM groups (see chart). The very high returns to adopting the comprehensive innovative HRM practices suggest that individual HRM practices are particularly successful when they are adopted in unison; for example, problem-solving teams are most likely to be productive when used with other innovative practices.



Where do innovative HRM practices have the greatest impact? Evidence from another study of steel mills suggests that innovative HRM practices are most valuable in plants that produce higher-quality products or that use more sophisticated production processes—and therefore require a greater degree of problem-solving on the part of operators. These are also likely to be the plants that pay the highest wages. Plants that produce commodity products and emphasize low-cost production are less likely to gain from the investment in innovative HRM practices.

Plants that invest in innovative HRM practices are also more likely to have extensive IT investments, and evidence suggests that innovative HRM practices enhance the return to IT. In manufacturing, IT puts more minute-by-minute production information in the hands of front-line operators who are running the production lines from the computerized pulpits. Innovative HRM practices that enable operators to use this new information to make decisions can produce higher productivity outcomes.

Problem-solving skills for high-school educated workers. As innovative HRM and IT are combined in the workplace, there is a much greater need for the development of analytical problem-solving skills among the high-school educated workers who are empowered with more decision-making on the production line. These workers need to be fluent in basic skills—reading, math, and basic computer use—but their key to higher performance and higher wages lies in their ability to solve problems on the job.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Smoking and the Relationship Between Socioeconomic Status and Health. While it is well-known that women of lower socioeconomic status (SES) are more likely to have infants with poor health, a recent study finds that a key reason for this is maternal health habits, particularly smoking. Babies born to women over age 20 without a high school diploma are nearly twice as likely to die before their first birthday as babies born to college graduates. While this strong association between health and SES has been well-documented, the fundamental causes of the relationship are poorly understood. The study finds that in 1988, maternal health habits during pregnancy explain about half of the correlation between SES and low birth weight (low birth weight babies are 20 times as likely to die as other infants). In particular, smoking significantly increases the likelihood of low birth weight. The author stresses that because many health habits begin early in life, policies should target these harmful health behaviors among youth.

Supply and Demand Jointly Determine Marijuana Use. The price of marijuana has a substantial impact on its use by youth, as do teenagers' perceptions of the harms associated with regular marijuana use, according to a recent study. A 10 percent increase in price is associated with approximately a 3 percent decline in use. Similarly, a 10 percentage point increase in the number of teens who believe regular marijuana use is harmful lowers annual participation by about 5 percentage points. The percent of high school seniors who report smoking marijuana in the previous year fell from about 45 percent in 1982 to a low of 22 percent in 1992. During this time, changes in price explain 55 percent of the decline while changes in perception of harm explain 40 percent. In 1992, the trend reversed and marijuana use started to increase, reaching 38 percent in 1998. Falling perceptions of harm are the dominant explanation of the increase, accounting for 80 percent, while changes in price had little effect.

Why Aren't There More Women in Business School? Female enrollment at top business schools has plateaued at 30 percent, compared with peaks of 44 percent in law and medical schools. While an equally high percentage of male and female graduates from 12 of the nation's top business schools report being satisfied with the business school experience and their post-MBA careers, female MBA graduates are less satisfied than their male counterparts with business school culture, according to a recent study. In particular, women are less likely to feel they could relate to the people in case studies and somewhat more likely to feel the environment was overly aggressive. While the study does not provide a comparative analysis of different professions, several results suggest why this difference may exist. For example, focus groups of women who chose to pursue professional degrees other than an MBA considered the business world intolerant of diversity, male dominated, and overly focused on financial gain rather than social improvement.

EYES ONLY

INTERNATIONAL ROUNDUP

More Sub-Saharan African Women Want to Limit Births. The percent of women who want no more children has risen steadily since the 1970s in sub-Saharan Africa, according to a new study, reaching levels ranging from 20 to 40 percent in many countries by the late 1990s. One dramatic example is Kenya, where this proportion rose from 15 percent in 1977 to 46 percent in 1998. These levels, however, remain far below those seen in Asia and North Africa (40-60 percent) and in Latin America (where the proportion exceeds 60 percent in five of 11 countries studied). But not all of the women in Sub-Saharan Africa who want to limit births are using contraception. The share of fecund married women who would like to limit births but do not use contraception increased fairly uniformly in the region. In contrast, in Asia, North Africa, and Latin America the number of those who wish to stop having children but do not practice contraception has fallen sharply over the last two decades.

Swiss Voters Agree to Bilateral Agreements with EU. In a referendum last Sunday, Swiss voters overwhelmingly approved a set of seven bilateral agreements between Switzerland and the European Union which would allow gradual opening of transit, labor, and goods and services markets on a reciprocal basis. Although the EU is Switzerland's main trading partner—with more than 60 percent of Swiss exports going to the EU and nearly 80 percent of its imports coming from the EU—the traditionally independent Swiss have stayed out of the EU and the European Economic Area. The current agreements do not represent a step towards EU membership, and will only take effect once they are also ratified by the 15 EU member states.

Unemployment Low, but Lasts a Long Time in Portugal. Unlike other European countries with relatively inflexible labor markets, Portugal's unemployment rate remained low in the 1980s and 1990s. Portugal and the United States have had the same average unemployment rate over the past 15 years and their current unemployment rates are both about 4 percent. A new study, however, finds that—as in many other European countries—the unemployment pool in Portugal is much more stagnant than in the United States. The average duration of periods of unemployment is three times longer in Portugal than in the United States. The study argues that the stagnancy in the flow of workers into and out of employment in Portugal is due to excessively strong employment protection laws; the OECD consistently ranks Portugal as the country with the highest degree of employment protection among OECD countries. Legislation on collective dismissals has an uncertain effect on the unemployment rate: it can lead to lower layoffs because it imposes a long and costly process on employers, but it can also lead to a reluctance to hire new workers. The authors point out that although labor market inflexibility does not necessarily increase unemployment, in their model it unambiguously reduces overall economic efficiency because it inhibits the sorting process of the labor market.

EYES ONLY

RELEASES THIS WEEK

Advance Durable Orders

****Embargoed until 8:30 a.m., Friday, May 26, 2000****

Advance estimates show that new orders for durable goods decreased 6.4 percent in April, following an increase of 4.5 percent in March.

Gross Domestic Product

According to revised estimates, real gross domestic product grew at an annual rate of 5.4 percent in the first quarter of 2000.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
Leading Indicators (Wednesday)
NAPM Report on Business (Thursday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.3
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	**13.0**
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	**10.9**
Imports	9.2	13.5	13.8	14.0	**14.3**
Personal saving	6.6	1.7	1.5	1.3	**0.4**
Federal surplus	-2.8	1.2	1.4	1.2	**1.9**

	1970-1993	1999	February 2000	March 2000	April 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.1	3.9
Payroll employment (thousands)					
increase per month			27	458	340
increase since Jan. 1993					21615
Inflation (percent per period)					
CPI	5.8	2.7	0.5	0.7	0.0
PPI-Finished goods	5.0	2.9	1.0	1.0	-0.3

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	March 2000	April 2000	May 25, 2000
Dow-Jones Industrial Average	8626	10465	10483	10944	10324
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.66	5.68
10-year T-bond	5.26	5.65	6.26	5.99	6.39
Mortgage rate, 30-year fixed	6.94	7.43	8.24	8.15	8.62
Prime rate	8.35	8.00	8.83	9.00	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 25, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.907	1.3	-14.3
Yen (per U.S. dollar)	107.5	-1.1	-12.5
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.53	-0.5	4.1

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	5.0 (Q1)	3.9 (Apr)	3.0 (Apr)
Canada	4.7 (Q4)	6.8 (Mar)	2.1 (Apr)
Japan	0.0 (Q4)	5.0 (Mar)	-0.5 (Mar)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q4)	8.4 (Mar)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.9 (Jan) [2]	3.0 (Apr)

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

EYES ONLY

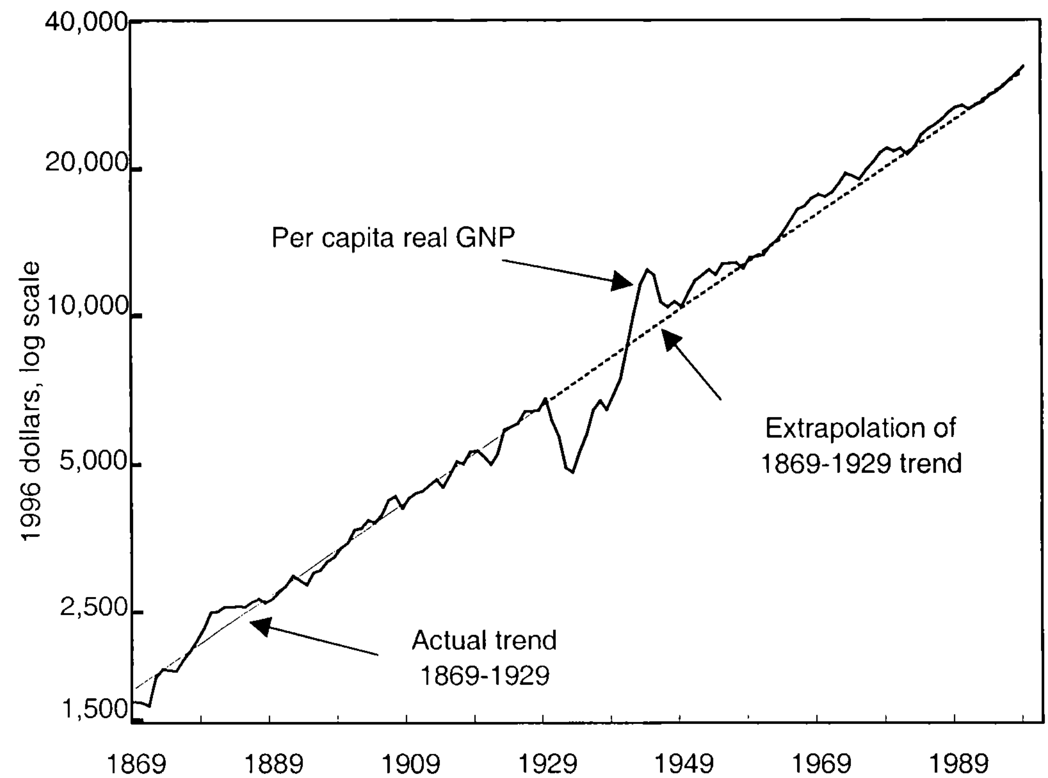
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 19, 2000

CHART OF THE WEEK

The Long-Run Trend in Per Capita Real GNP



The BEA recently released revised estimates of GNP going back to 1929. The long-run trend in per capita real GNP growth has been amazingly constant at 2.2 percent per year over the last 130 years. In fact, if one simply extrapolates the trend from 1869 to 1929—shown by the dashed line in the chart—the error in predicting per capita real GNP in 1999 is only 2 percent. Of course, the economy has veered off this long-run trend for extended periods, the pronounced examples being the Great Depression and World War II.

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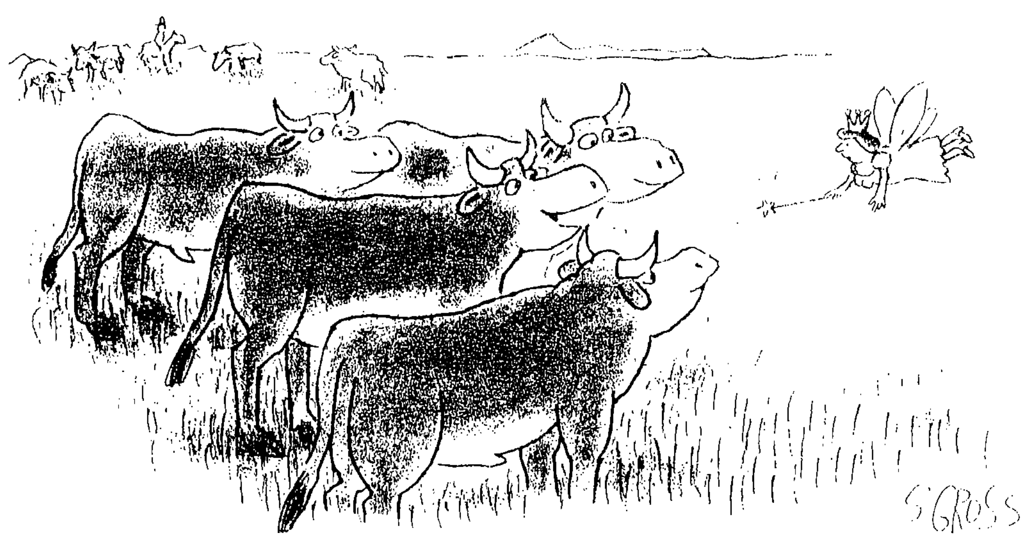


"We would like to be genetically modified to taste like Brussels sprouts."

EYES ONLY

SPECIAL ANALYSIS

South Africa: The Employment Struggle

The South African government has taken vital steps in improving its economy, including establishing fiscal discipline and reducing import barriers, but the abysmal performance of the labor market remains the economy's Achilles heel. Without a dramatic increase in economic growth, unemployment will remain stubbornly high.

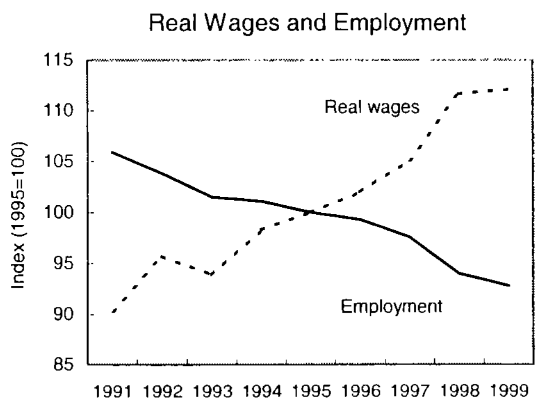
Working. Since assuming power in 1994, the African National Congress (ANC) has made progress in several dimensions. Budget policy has been disciplined. The consolidated general government deficit has been brought down from 5.6 percent of GDP in 1994/95 to 2.4 percent in 1998/99. At the same time, spending has been reoriented away from defense towards social needs such as education, health, and justice. In addition, tariff reductions have opened up the economy. Economic restructuring has boosted productivity growth, and GDP growth has averaged 2.5 percent per year—a marked contrast from the stagnation that characterized the final years of apartheid. Assuming recent problems in Zimbabwe do not have adverse effects, growth this year is expected to be between 3 and 4 percent.

Not working. But even growth rates of 4 percent are likely to be associated with higher unemployment. The South African labor force is growing at about 2.7 percent per year. This implies that if output per worker rises at 4 percent per year, as recorded between 1993 and 1998, output must grow at almost 7 percent annually simply to keep the unemployment rate from rising. But it has not done so. The result has been declining employment under ANC rule, continuing a worrying trend that has led to a 16 percent overall reduction in non-agricultural employment since 1990. The ratio of employment to population in South Africa is now just 21 percent, compared with 44 percent in Brazil and 61 percent in Mexico.

South Africa's official unemployment rate of 22 percent in 1997 understates the problem by not counting discouraged workers. An official census survey, which did count discouraged workers, placed the unemployment rate at 37 percent. As with most economic issues in South Africa, the burden has been borne along racial lines; while unemployment was a fairly modest 4.3 percent for white men, it was as high as 55 percent for black women! Even relatively more educated black South Africans with a high school diploma had unemployment rates of 50 percent. Since employment has continued to fall since 1997, today's unemployment rate is even higher.

It goes without saying that the social consequences of such unemployment levels are dire. Workers, particularly those who are young and without skills, must fend for themselves in the informal economy by scrounging a living as hawkers, receiving largesse from others, or turning to crime.

Remedies. Despite several major initiatives, the ANC has yet to find a compelling growth strategy. To grow more rapidly, South Africa clearly needs to stimulate more investment. With a domestic saving rate of about 15 percent—far lower than is common in economies with rapid growth—the government is particularly eager to attract foreign capital. But foreign investors remain leery, citing high crime rates and labor laws that add to costs.



Notwithstanding the high levels of unemployment, workers continue to receive significant increases in real wages (see chart). Labor remains militant: In 1998 there were 520 strikes and work stoppages involving 321 thousand workers. Moreover, the South African labor movement continues to call for even tougher labor market regulations and slower privatization.

A third way? A hands-off policy which depends on even higher unemployment to reduce costs is unlikely to work. Similarly, an effort to break the power of the unions is not viable (and not desirable) given the close links between the ANC and the unions that were forged on the anvil of fighting apartheid. Nonetheless, increased labor-market flexibility in both work rules and wages—particularly those for less-skilled workers—is clearly called for. The key challenge, therefore, lies in formulating a tri-partite grand bargain in which each social partner brings something to the table. One approach would have labor agree to permit increased flexibility in return for a business commitment to increase investment in skills and affirmative action, while government agrees to provide macroeconomic stimulus.

Conclusion. The reconciliation phase following apartheid has gone surprisingly smoothly. What is now needed is a much more decisive approach to labor market problems so that Africa's leading economy, which is richly endowed with human and natural resources, can realize its full potential.

EYES ONLY

ARTICLE

Competitive Effects of B2B Exchanges

Using the Internet, new Business-to-Business (B2B) electronic exchanges are being established where multiple buyers and sellers can negotiate contracts. For example, the big three automakers—Ford, GM, and Daimler-Chrysler—are planning to create a joint e-commerce exchange for automobile parts. Unlike a stock market where securities regulations govern transactions, these new exchanges are not heavily regulated. Antitrust laws still govern these businesses, however, and a reported antitrust inquiry into the automakers' operations has raised the issue of what type of oversight should be established in these new electronic marketplaces.

The growth of B2B exchanges. Many different industries are establishing Internet-based B2B exchanges for a variety of goods and services. In areas as diverse as paper, steel, aerospace, and defense, new B2B marketplaces are being announced. One major advantage of using electronic links to create these new marketplaces is that they lower the costs of reaching multiple buyers and sellers, creating deeper markets for many basic commodities. Where before specialized brokers were needed to match buyers and sellers in transactions, new websites today allow multiple buyers and sellers to find each other and enter into transactions for both commodity products and products needing more detailed specifications.

The automakers' joint venture. GM, Ford, and Daimler-Chrysler are planning to move a major portion of their procurement activity onto this new exchange. Together the three companies hope to move 60,000 suppliers and $250 billion worth of orders to the Internet and lower their supply costs. In addition to the automakers themselves, many of their suppliers may also use the site to obtain bids for items they need, adding as much as $500 billion in potential transactions to this new marketplace. Although they compete for automobile sales, each automaker would benefit from a more efficient and competitive purchasing system. GM has begun doing some electronic auctions for parts, and reports price reductions of 10 to 40 percent on some components.

Antitrust concerns. The Federal Trade Commission is said to be examining the automakers' joint venture. One potential concern is that if information on enough transactions between an automaker and its suppliers is available to competitors, that information could be used to facilitate coordination on output or pricing decisions. Paradoxically, having more information available in a concentrated industry can help a cartel raise prices. For example, airlines have long used electronic systems to convey information about airfares to consumers. These systems, however, also allow competitors to monitor each other's prices. In 1994, the Justice Department contended that major airlines used some types of information in this joint electronic fare system to increase fares and discourage discounting. A settlement with the airlines allowed them to continue to disseminate fares electronically, but prohibited some of the ancillary information that they used to communicate with each other about future prices for airline tickets.

Analysis. B2B exchanges are likely to become an increasingly important part of the supply chain in many industries. Where these exchanges enhance efficiency and lower prices, existing antitrust guidelines state that such cooperative ventures among competitors are fully consistent with the agencies' interpretations of antitrust law. Indeed, the likelihood of having a positive, efficiency enhancing outcome in the automaker case is suggested by the reaction of sellers to the new exchange. Many suppliers are concerned that their profit margins may decline due to the greater competition that these B2B exchanges are designed to promote. However, those competitive pressures should benefit consumers by holding down the cost of new cars.

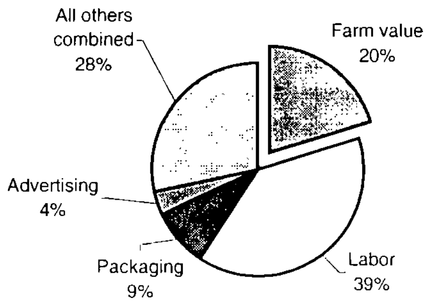
ARTICLE

Desire for Convenience Eats up Food Expenditures

Since 1980, the share of total personal consumption expenditures allocated to food in the United States has dropped from 18 percent to 13 percent, continuing a long-term trend downward. At the same time, more of America's food spending goes to convenience, both in the form of prepared foods and foods consumed away from home. This is one reason why the value of purchases from farmers is a diminishing fraction of the food dollar.

The farm value share has fallen... The USDA estimates that consumer spending on food originating on U.S. farms (including purchases at stores, restaurants, and other eating places) amounted to about $585 billion in 1998. Of that total, the farm value—the amount that U.S. farmers received—accounted for roughly 20 percent (see chart), down from about 30 percent two decades ago. The rest—what the USDA calls the marketing bill—represents all the major functions of the food industry, including processing, wholesaling, transporting, and retailing.

What a Dollar Spent for Food Paid for in 1998



...while the labor share has risen. Rising labor costs have largely replaced declining farm value. Labor costs are the largest component of the marketing bill, and they have increased from 31 percent of a food dollar in 1980 to about 39 percent in 1998. More food consumed away from home and greater demand for labor-intensive convenience foods prepared by supermarkets have likely contributed to this increase. (In fact, the USDA reports that expenditures for eating out accounted for 47 percent of total food spending in the United States in 1998, up from 39 percent in 1980.) The next largest component of the marketing bill is packaging, at about 9 percent of the food dollar. Somewhat surprisingly, advertising's share is relatively small—4 percent.

Implications. The quest for convenience is shaping consumer food expenditures. Away-from-home food expenditures are rising more rapidly than at-home food expenditures, and the farm value share of the food dollar is declining. In addition, some recent evidence suggests that greater convenience may, at times, result in poorer health. For example, when eating out, people often eat more or eat higher calorie foods and, according to the USDA, this tendency appears to be increasing.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Young Men Put Family First. Most young men highly value having a job schedule that allows for family time, with far fewer emphasizing money, power, or prestige, according to a new study. Eighty-two percent of men aged 21-39 said family time was very important, nearly the same percentage as women in that age group (85 percent). Breaking ranks with their fathers and grandfathers on the important issue of work-family integration, 71 percent of men aged 21-39 said they would give up some of their pay for more time with their families. While young men today are focusing on integrating work and family life, older generations of men tend to be more concerned with job satisfaction and status. The survey also showed that practically all young men claim to want to take an active role in raising their children.

Rural Health Woes. Residents of rural areas, in particular those not adjacent to metropolitan areas, are less likely to have health insurance or to have visited a doctor or health care professional, and are more likely to report fair or poor health. Much of these differences are probably linked to higher rates of poverty in rural areas. Only 63 percent of residents in rural counties not adjacent to urban areas had private insurance, well below the rates for residents of rural counties adjacent to urban areas (72 percent) and urban residents (75 percent). Public insurance coverage rates were higher in rural areas, but public coverage was not sufficient to overcome the private insurance gap: 22 percent of those living in rural areas not adjacent to urban areas were uninsured, compared to 18 percent of those in rural areas adjacent to urban areas and 14 percent in urban areas. Rural residents report worse health than urban residents on average, and they get less professional medical attention than their urban counterparts.

Health Insurance Tax Subsidy May be Costly. The continued rise in the number of Americans without health insurance has led to considerable interest in tax-based policies to raise the level of insurance coverage. A recent study estimates that a relatively generous tax subsidy—a refundable tax credit for health insurance spending capped at $1000 for single filers and $2000 for joint/head of household filers—would decrease the ranks of the uninsured by about 4 million, nearly 10 percent of the uninsured population. The average cost to government per newly insured person is estimated to be $3,300, which is 50 percent more than the cost of a typical non-group policy. The reason for the high cost is that most of those receiving the subsidy already have insurance. The policy would also induce a substantial shift from group to non-group insurance (the study estimates that 25 percent of those who would take the subsidy were previously covered by their employer). Moreover, almost one-half of those taking up the subsidy would be persons who are currently already purchasing non-group insurance.

EYES ONLY

INTERNATIONAL ROUNDUP

War and Uncertainty Mar Prospects for African Economic Integration. African leaders gathered in Mauritius this week to discuss the prospect of a Common Market for Eastern and Southern Africa (COMESA) Free Trade Area. The 21 member states of COMESA—with a total population of 385 million— had committed themselves in 1992 to the gradual elimination of all internal tariffs by October of this year. Nevertheless, progress remains slow and intra-COMESA trade remains paltry at $4.2 billion in 1998, compared to total foreign trade of over $60 billion, two-thirds of which are imports. A mechanism has been arranged to compensate qualifying members for the loss of government revenues associated with regional tariff removal, and COMESA is promoting numerous measures to appease protectionist sentiments that oppose exposing domestic industries to foreign competition. Wars and instability, however, continue to scar the continent and threaten progress on establishing the free trade area. More than half of COMESA members are either at war with each other or are fighting internal rebellions. Six are involved in the war in the Democratic Republic of the Congo, and Ethiopia and Eritrea last week resumed their border conflict.

College Enrollment Rising in OECD. While the United States continues to enjoy relatively high rates of university-level attainment, enrollment in other OECD countries appears to be catching up. According to new OECD data, enrollment in university-level programs grew by more than 50 percent between 1990 and 1997 in eight countries and by more than 20 percent in all but five OECD countries. At today's enrollment rates, 40 percent of young people in the OECD will enter bachelor degree or higher programs at some point in their lives, nearly equal to the 44 percent enrollment rate in the United States. While the percentage of students who enter these programs is increasing, not everyone completes a degree. On average, one-third of university-level entrants in the OECD drop out (the drop-out rate in the United States was 37 percent). The United States is one of the few countries where the private sector participates significantly in funding college and university education: 49 percent of funds for tertiary institutions come from private sources, more than twice the OECD average of 23 percent.

Developing Countries to Receive Free Genetically Modified Rice. The inventors of rice genetically modified to combat Vitamin A deficiency have struck a deal with the pharmaceutical company AstraZeneca that will give farmers in developing countries free access to the grain. This "golden rice" is a genetically altered grain fortified with beta-carotene that converts to Vitamin A. Vitamin A deficiency afflicts an estimated 124 million people worldwide and results in the deaths of up to 2 million children each year. Under the new agreement, the rice will be distributed free to national and international research organizations in developing countries. Local farmers will be permitted to earn up to $10,000 annually growing this rice, without paying royalties. AstraZeneca will market the rice in developed nations for profit. The company said that the earliest date of availability for local planting and consumption would be 2003.

EYES ONLY

RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, May 19, 2000****

The goods and services trade deficit was $30.2 billion in March; the deficit was $28.7 billion in February.

Consumer Price Index

The consumer price index was unchanged in April. Excluding food and energy, consumer prices rose 0.2 percent.

Housing Starts

Housing starts rose 3 percent in April to 1.663 million units at an annual rate.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 0.9 percent in April. Capacity utilization rose 0.4 percentage point to 82.1 percent.

MAJOR RELEASES NEXT WEEK

Gross Domestic Product (Thursday)
Advance Durable Shipments and Orders (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.3
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	12.9
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.8
Imports	9.2	13.5	13.8	14.0	14.2
Personal saving	6.6	1.7	1.5	1.3	0.5
Federal surplus	-2.8	1.2	1.4	1.2	N.A.

	1970-1993	1999	February 2000	March 2000	April 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.1	3.9
Payroll employment (thousands)					
increase per month			27	458	340
increase since Jan. 1993					21615
Inflation (percent per period)					
CPI	5.8	2.7	0.5	0.7	**0.0**
PPI-Finished goods	5.0	2.9	1.0	1.0	-0.3

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	March 2000	April 2000	May 18, 2000
Dow-Jones Industrial Average	8626	10465	10483	10944	10777
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.66	5.75
10-year T-bond	5.26	5.65	6.26	5.99	6.56
Mortgage rate, 30-year fixed	6.94	7.43	8.24	8.15	8.64
Prime rate	8.35	8.00	8.83	9.00	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 18, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.895	-0.8	-16.1
Yen (per U.S. dollar)	108.7	0.2	-11.8
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	100.1	0.7	5.0

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	5.0 (Q1)	3.9 (Apr)	3.0 (Apr)
Canada	4.7 (Q4)	6.8 (Mar)	3.0 (Mar)
Japan	0.0 (Q4)	5.0 (Mar)	-0.5 (Mar)
France	3.1 (Q4)	9.8 (Mar)	1.5 (Mar)
Germany	2.3 (Q4)	8.4 (Mar)	1.9 (Mar)
Italy	2.1 (Q4)	11.3 (Jan)	2.5 (Mar)
United Kingdom	3.0 (Q4)	5.9 (Jan) [2]	2.6 (Mar)

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.