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EYES ONLY

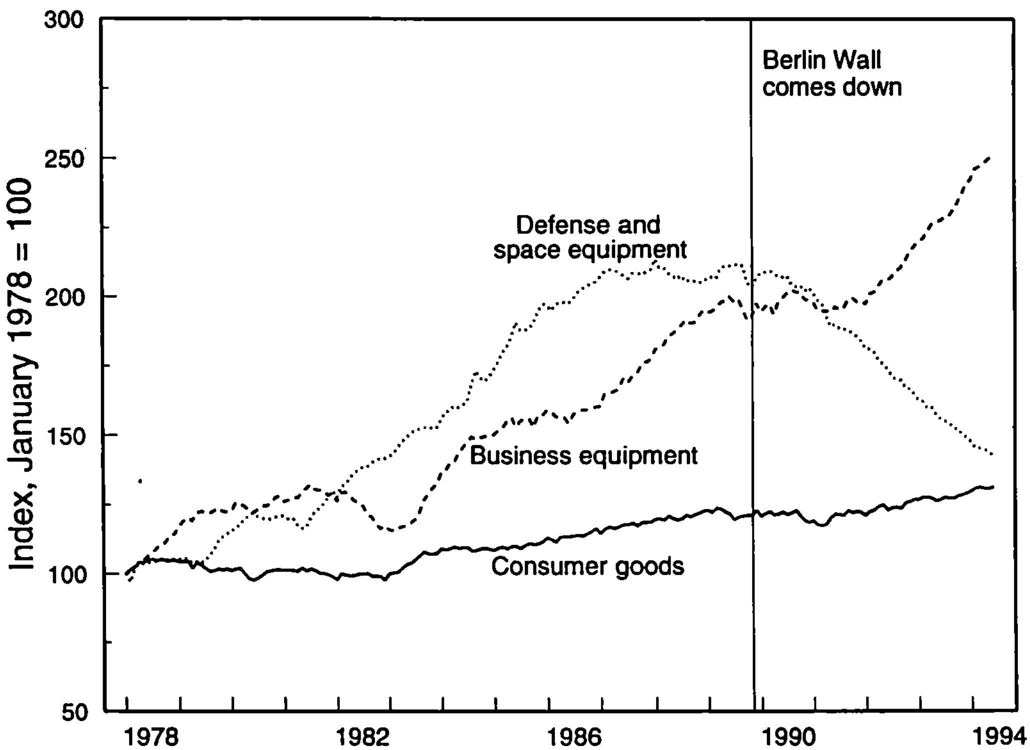
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 12, 1994

CHART OF THE WEEK

Industrial Production



Since 1989, the production of defense and space equipment has plunged about 30 percent, while the production of business equipment has surged by about the same amount. The output of consumer goods has increased 8 percent. These shifts represent a substantial reorientation of manufacturing capacity toward the production of civilian goods, especially for investment purposes, and away from the production of military goods.

EYES ONLY

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QUOTE OF THE WEEK

"There has never been a time when economic understanding was all encompassing, activity was measured with unerring precision, and forecasting was flawless."

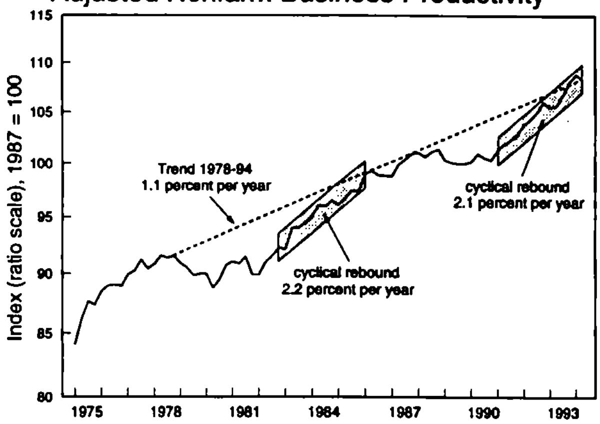
Alan Greenspan in testimony before Congress, August 10, 1994

TREND

Productivity Growth in the 1990s: *Plus Ça Change...?*

Since the trough of the most recent recession, productivity has increased 2.1 percent at an annual rate, nearly twice the trend rate of growth over the past 16 years (see chart). This has led some analysts to speculate that the United States has entered a new era of more rapid productivity growth.

Adjusted Nonfarm Business Productivity



Analysis. Productivity varies considerably over the business cycle. When the economy enters a recession, productivity typically falters. And when the economy begins to recover, productivity moves up rapidly. The recent rapid growth of productivity closely resembles the cyclical rebound that occurred during the early 1980s (see chart). Abstracting from cyclical effects, there is little evidence thus far that the long-run trend in productivity has improved. The experience of the next year or two should help decide whether productivity is on a faster trend.

An improvement in the *trend* growth of productivity would imply that the long-run growth potential of the economy had increased, paving the way to more rapid growth in living standards.

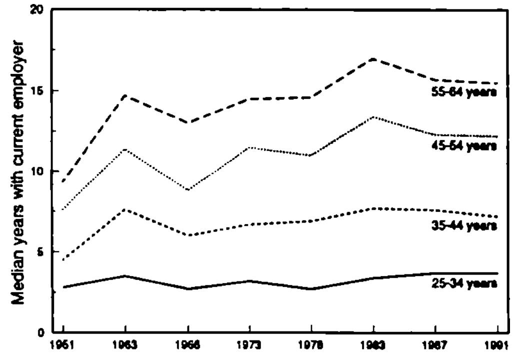
EYES ONLY

TREND

Job Tenure and the Accumulation of Pension Rights

Many commentators have suggested that the U.S. workforce has become increasingly mobile in recent years. If so, current workers may not accumulate adequate retirement benefits, because pension rules typically link the level of benefits paid to the years of service with a particular employer. Available evidence indicates, however, that this problem may have been overestimated.

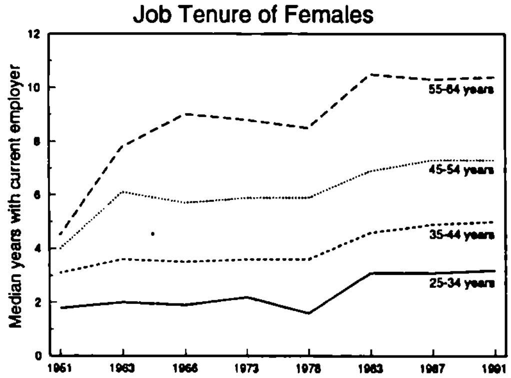
Job Tenure of Males



Analysis. The median job tenure of males may have declined slightly since the early 1980s, especially for older workers, but it remained higher in 1991 (latest year for which data are available) than in the 1960s or 1970s.

Moreover, there is no evidence of any decline in the median job tenure of females. Indeed, this indicator hit an all-time high in 1991. Over the post-war period, trends in the job tenure of females likely reflect not only trends in the mobility of women who remain in the labor force continuously, but also trends in the mobility of women in and out of the labor force. Other things equal, the increasing labor force participation of women has probably boosted the figures on their median job tenure.

Job Tenure of Females



Conclusion. Job tenure does not appear to have declined markedly in recent years. This suggests that labor mobility, by itself, is not impeding the efforts of today's workers to build retirement security. Recent evidence suggests that pension coverage rates for men and women in the private sector have nearly converged, with the rate for men declining from 55 percent in 1979 to 51 percent in 1993, and the rate for women rising from 40 percent to 48 percent over the same period.

EYES ONLY

CURRENT DEVELOPMENT

Doing Well, Thank You Very Much

Median total compensation (including bonuses and stock options) of the CEOs of 200 of the largest American companies was $2.8 million in 1993, 18 percent above the median for 1992, according to the results of a recent Fortune Magazine survey. In contrast, the employment cost index—a comprehensive indicator of overall compensation trends in private industry—increased only 3.6 percent in 1993.

This year, as a result of a provision contained in OBRA93, corporations face a "cap" of $1 million on the amount of executive compensation that is tax-deductible. Thus far, there is little evidence that the cap will restrain the growth in CEO compensation, in part because corporations are finding the restrictions fairly easy to circumvent. For one thing, amounts over the cap can be deducted if CEO pay is linked to objective performance goals approved by the stockholders. For another, compensation that is deferred until separation from the company (including after retirement) is not subject to the cap.

Analysis. Historically, the link between corporate performance and CEO compensation has not been very strong. One of the strongest predictors of whether a given CEO is highly paid is whether the members of the Compensation Committee themselves are highly-paid.

EYES ONLY

ARTICLE

What Could Go Wrong (or Right) in 1995 or 1996?

In its Mid-Session Review of the Budget, the Administration projected that real GDP will increase 3 percent this year and just under 2-3/4 percent in each of the next two years. The unemployment rate is expected to remain near 6 percent and payrolls are expected to expand by about 2 million jobs each year, realizing the Administration's goal of 8 million jobs over four years. But like all forecasts, this one is subject to myriad uncertainties.

What Could Go Wrong?

Collapse of consumer confidence. On occasion, consumer confidence seems to exert considerable influence on household spending. For example, sentiment fell a record amount in mid-1990 in the wake of Iraq's invasion of Kuwait. Consumer spending also fell sharply, contributing to the recession that began that August. If another crisis were to provoke a similar collapse of confidence today, growth of real GDP could be reduced 3/4 percentage point over the next year. However, growth in the following year would recover 1/2 percentage point as consumer spending rebounded.

Spike in oil prices. Oil prices have risen about $5 per barrel since mid-February due to strikes in Nigeria and to a weather-related temporary surge in demand in Japan and Europe. If the price were to rise another $5 per barrel before the end of this year and remain at the higher level, real GDP growth might be 1/3 percentage point lower both next year and in 1996.

Tightening by the Fed. Since February, the Fed has boosted the funds rate 125 basis points to 4-1/4 percent. Misjudgment about the amount of spare capacity in the economy and an overestimation of the risk of inflation could cause the Fed to tighten more than necessary. Or, a significant tightening by monetary authorities abroad might cause the Fed to hike rates to maintain the value of the dollar. If the Fed were to increase short-term interest rates another 150 basis points over the next year—100 basis points more than assumed in our forecast—real GDP growth might be 1/4 percentage point lower in each of the next two years.

What Could Go Right?

Decline in interest rates. Long-term interest rates have risen almost 200 basis points since last October. Part of this increase reflects the strengthening of the economy, but some observers believe that part may reflect the bond market's overreaction to inflation concerns. Indeed, the consensus 10-year inflation forecast has remained unchanged at 3.7 percent over this period. Thus, there may be room for long-term rates to fall. A decline of 50 basis points might add 1/8 to 1/4 percentage point to the growth rate of real GDP next year, but would have no

Effect on Real GDP Growth
(percentage point)

	First Year	Second Year
Collapse of consumer confidence	−3/4	+1/2
Spike in oil prices ($5 per barrel)	−1/3	−1/3
Tightening by the Fed (funds rate 100 b.p. higher)	−1/4	−1/4
Decline in interest rates (long rates 50 b.p. lower)	less than +1/4	none
Accumulation of inventories	up to +1	up to −1
Rebound in foreign economies (1 percentage point higher growth)	none	+1/4

discernable effect on growth in 1996. On the other hand, a financial market disruption—such as a sizeable "correction" in the stock market—could depress real GDP growth by reducing wealth and causing a further rise in long-term interest rates.

Accumulation of inventories. Inventories are lean relative to sales and there is growing evidence that business confidence is increasing. If this confidence translates into an increased willingness to hold inventories, real GDP growth might be boosted temporarily by as much as 1 percentage point. The effect would be short-lived, however. Indeed, growth would slow once firms had reached their desired inventory positions.

Rebound in foreign economies. So far this year, real growth in America's trading partners is estimated to have been about 1/2 percentage point higher than the consensus expectation as of January. Such a surprise is common when economies are emerging from recession, as has been the case this year. An additional 1 percentage point surprise in foreign growth over the next year would have little effect in 1995, but might raise growth in 1996 1/4 percentage point.

Assessment. The risks outlined above demonstrate that substantial uncertainty surrounds the Administration's outlook. At this point, we believe that the downside risks outweigh the upside risks, for the following reasons. First, an additional increase in oil prices is highly possible in light of current tensions in the oil market. Second, the Fed is more likely to err on the side on excessive restraint than on the side of excessive ease. Third, fiscal policy will be a drag on the economy in 1995, before moving to a more neutral stance in 1996. Finally, the expansion is likely in its mature phase. Already 40 months long, it is only 15 months shorter than the average post-war expansion.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Boeing Expands China Operations. The Boeing Company this week unveiled plans to spend $100 million in China on a new regional headquarters and parts center. Boeing's move is seen as an attempt to protect growing sales to China, which accounted for 14 percent of Boeing's worldwide sales in 1993. Boeing hopes to maintain or increase its current 65 percent share of the Chinese market despite actions by both McDonnell Douglas and Airbus this year to expand their Chinese operations. Boeing forecasts that the total Chinese market for commercial jet aircraft will be worth more than $40 billion by the year 2010, making it the third largest aviation market after the United States and Japan.

Latin American Countries Form Customs Union. Leaders of Argentina, Brazil, Paraguay, and Uruguay signed a series of trade agreements recently in preparation for the formation of the Mercosur customs union. By January 1, 1995, the countries plan to eliminate tariffs within the group, as well as to apply a set of common tariffs to countries outside the group. This customs union will create a common market of more than 190 million people, with $600 billion of economic activity. The agreement, which is GATT consistent, allows for the accession of other countries; membership talks with Chile and Bolivia have already begun.

Cray Computer Wins Japanese Sale. Cray Research, a U.S. supercomputer manufacturer, has won a Japanese public sector order for its C90 supercomputer. This is the first time Cray has been able to win such a sale while in direct competition with a Japanese computer company. The C90 supercomputer was bought by the Tokyo Institute of Technology, an institution funded by the Japanese government, for use as a host computer at its information processing center. While the amount of the sale has not been disclosed, supercomputers typically cost between $10 and $25 million.

From Musketeers to Mouseketeers? Question: What are you going to do now that you've won the Cold War? Answer: "I'm going to Disney World!" Indeed, nuclear weapons designers from Los Alamos and Sandia Laboratories in New Mexico recently visited Disney World in Orlando, Florida to demonstrate a remote-sensing device that could be used to test the structural integrity of rides at the Disney theme parks. Disney officials are also pondering the potential of other weapons lab offerings: specialized microchips to use as electronic timing devices for fireworks; computerized control systems to add lifelike movement to a mannequin of Abraham Lincoln; and laser remote sensing to help optimize the amount of moisture in the air of the hydroponics exhibit at Epcot Center. Although a cooperative research and development agreement has yet to be signed, laboratory officials are eager to discuss the possibility of a high-profile contract that would highlight the commercial relevance of their post-Cold War work.

EYES ONLY

RELEASES THIS WEEK

Consumer Price Index ****Embargoed until 8:30 a.m., Friday****

The consumer price index rose 0.3 percent in July. Excluding food and energy, consumer prices rose 0.2 percent.

Producer Price Index

The producer price index for finished goods rose 0.5 percent in July. Excluding food and energy, producer prices were up 0.1 percent.

Retail Sales

Retail sales declined 0.1 percent in July. Excluding sales in the automotive group, retail sales were up 0.4 percent.

Productivity

Nonfarm business productivity declined 1.2 percent at an annual rate in the second quarter. Manufacturing productivity increased 3.8 percent.

MAJOR RELEASES NEXT WEEK

Industrial Production (Monday)
Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Thursday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:4	1994:1	1994:2
Percent growth (annual rate)					
Real GDP	2.5	3.1	6.3	3.3	3.7
GDP deflator	5.5	1.8	1.3	2.9	2.9
Productivity					
Nonfarm business	**1.2**	**1.9**	**4.9**	**2.9**	**–1.2**
Manufacturing (1978-93)	**2.3**	**4.8**	**7.9**	**6.8**	**3.8**
Real compensation per hour	**0.6**	**–0.2**	**–0.6**	**3.9**	**–1.9**
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	12.0	12.2	12.4
Residential investment	4.7	4.1	4.3	4.4	4.4
Exports	8.0	11.7	12.0	11.8	12.0
Imports	9.2	13.2	13.6	13.8	14.1
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	2.9	2.7	2.9
Federal surplus	–2.8	–3.8	–3.4	–2.7	N.A.

		1993	May 1994	June 1994	July 1994
Unemployment Rate	6.7*	6.8*	6.0	6.0	6.1

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

Payroll employment (thousands)					
increase per month			252	356	259
increase since Jan. 1993					4076
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.3	**0.3**
PPI-Finished goods	5.0	0.2	–0.1	0.0	**0.5**

New or revised data in **boldface.**
CPI data **embargoed until 8:30 a.m., August 12, 1994 (Friday).**

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	June 1994	July 1994	Aug. 11, 1994
Dow-Jones Industrial Average	3284	3522	3738	3718	3751
Interest Rates					
3-month T-bill	3.43	3.00	4.14	4.33	4.34
10-year T-bond	7.01	5.87	7.10	7.30	7.36
Mortgage rate, 30-year fixed	8.40	7.33	8.43	8.62	8.57
Prime rate	6.25	6.00	7.25	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 11, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.562	−1.5	−9.3
Yen-Dollar	100.4	.0	−3.1
Multilateral (Mar. 1973=100)	89.26	−0.9	−6.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q2)	6.1 (Jul)	**2.8** (Jul)
Canada	3.4 (Q1)	10.3 (Jun)	0.0 (Jun)
Japan	−0.0 (Q1)	2.9 (Jun)	0.8 (May)
France	1.2 (Q1)	12.4 (May)	1.7 (Jun)
Germany	1.6 (Q1)	6.6 (Jun)	2.9 (Jun)
Italy	0.6 (Q1)	11.9 (Apr)	3.8 (Jun)
United Kingdom	3.3 (Q2)	9.6 (Jun)	2.6 (Jun)

CPI data **embargoed until 8:30 a.m., August 12, 1994 (Friday).**

EYES ONLY

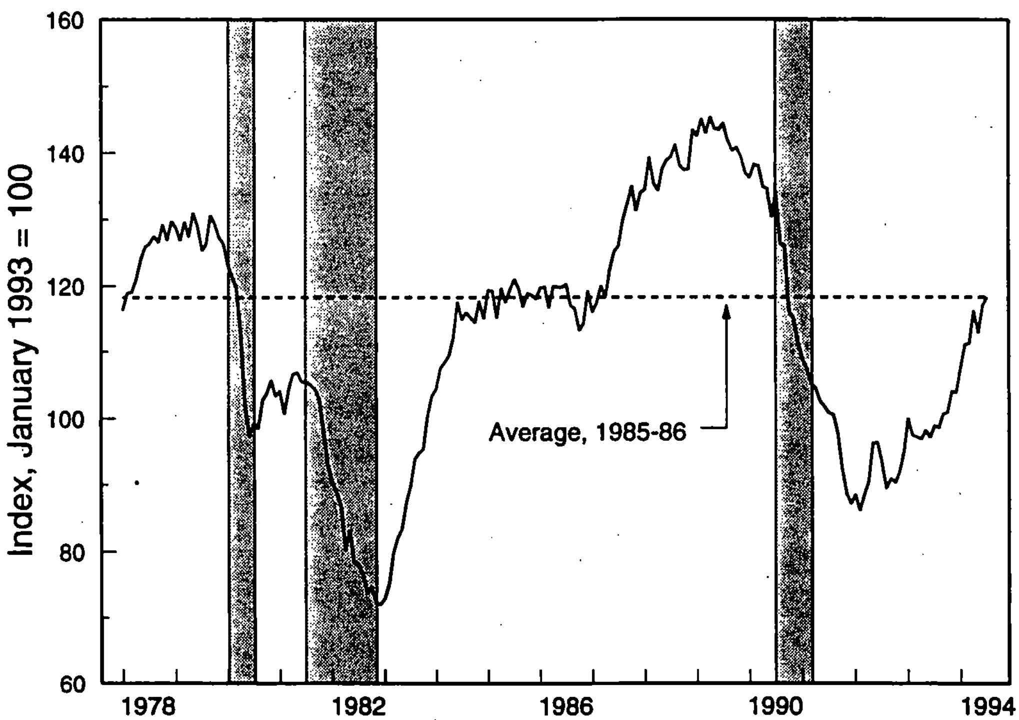
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 5, 1994

CHART OF THE WEEK

Household Perceptions of Job Availability



Note: Shaded regions indicate recessions.

The graph shows data from Conference Board surveys on the share of U.S. households reporting that "jobs are plentiful" minus the share reporting that "jobs are hard to find," indexed to January 1993. Perceptions of job availability sagged in the early stages of the current recovery, but began to move up decisively in 1993. The latest readings finally put this series into the range observed during the mid-1980s. The failure of job-market perceptions to improve more promptly may help explain why more individuals have not joined the labor force since the beginning of the recovery.

EYES ONLY

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QUOTATION OF THE WEEK

" ... [the Federal Reserve has] no intention of setting artificial limits on employment or growth. Indeed, the Federal Reserve would be pleased to see more rapid output growth and lower unemployment than projected by forecasters such as the CBO and the Administration—provided they were sustainable and consistent with approaching price stability. I should note, however, that most Federal Reserve policymakers would not regard the inflation projections of these other forecasters, which generally do not foresee further progress toward price stability over the medium term, as a desirable outcome."

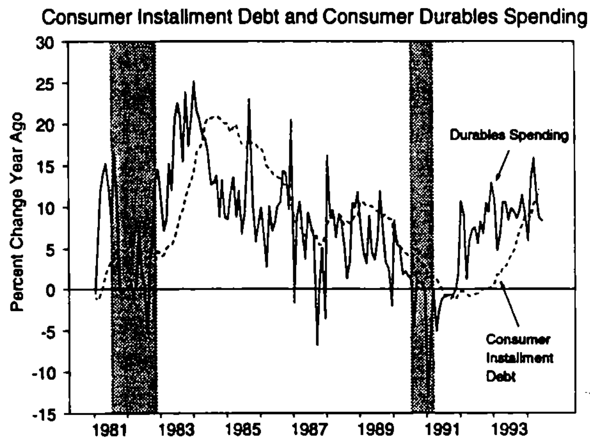
Alan Greenspan in testimony before Congress, July 20, 1994

EYES ONLY

CURRENT DEVELOPMENT

Consumers' Appetite for Borrowing Improves

Over the 12 months ending in May, consumer installment borrowing (including auto loans and credit card debt) grew more than 12 percent (see chart).



Note: Shaded regions indicate recessions.

Analysis. The surge in installment borrowing is unsurprising in light of the recent strength of household spending on durable goods, especially cars and trucks. Data scheduled for release later today will show whether the trend continued into June.

<u>Despite the recent run-up in borrowing, household balance sheets have improved over the last few years.</u> For example, installment debt-service payments as a share of disposable income have declined over the past year to 10.2 percent in the first quarter, down from a peak of more than 11 percent in 1989.

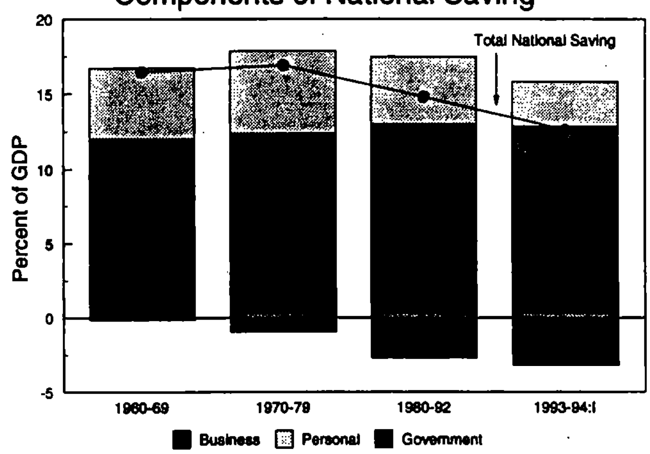
EYES ONLY

TREND

Business Saving: The Pillar of U.S. National Saving

Business saving constitutes a large fraction of overall saving in the U.S. economy. Since 1980, American businesses have saved about three times as much as U.S. households. And because governments dissaved about as much as households saved in recent years, business saving today accounts for all of national saving (see chart).

Components of National Saving



Throughout the postwar period, business saving has been remarkably stable relative to the size of the economy, amounting to between 11 and 13 percent of GDP, and seems not to have been affected much by either the strength of the economy or changes in tax provisions.

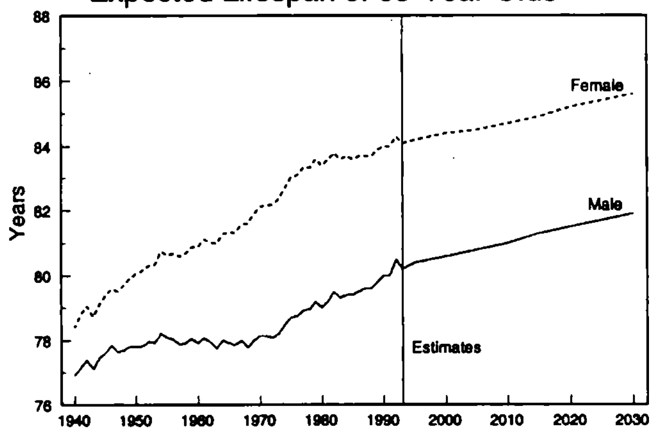
The decline in the national saving rate since the 1970s reflects a decline in household saving and a sizable increase in government deficit spending, not a reduction in the rate of business saving.

TRENDS

What's Wrong with Americans Living Longer?

Americans are living longer. In 1940, when the first social security benefit check was paid, a 65-year-old woman could expect to live to age 78-1/2 (see chart). Today, a 65-year-old woman can expect to live to age 84. For men aged 65, life expectancy has increased from 77 years in 1940 to 80 years today.

Expected Lifespan of 65-Year-Olds



Source: Social Security Administration.

Analysis. Although the increase in expected lifespan is good news, it puts additional financial stress on the social security system. Such stress can be reduced or eliminated by increasing social security taxes, reducing benefits, boosting retirement ages, or taking other actions to improve the balance between income and outlays.

Current law increases the normal retirement age for full social security benefits from 65 to 67 over a 22-year period starting early in the next century. By the time this phase-in begins, the life expectancy of men aged 65 will have risen 3-1/2 years since 1940, and the life expectancy of women aged 65 will have risen 6 years. In other words, the slated increase of 2 years in the normal retirement age will only partly offset the increases in life expectancy realized since 1940.

EYES ONLY

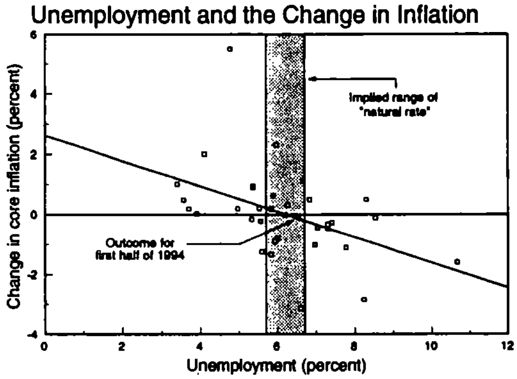
ARTICLE

Has Inflation Reached Its Low-Water Mark?

Over the twelve months ending in June, the consumer price index (CPI) rose just 2.5 percent. Only rarely during the past 30 years has inflation reached comparably low levels.

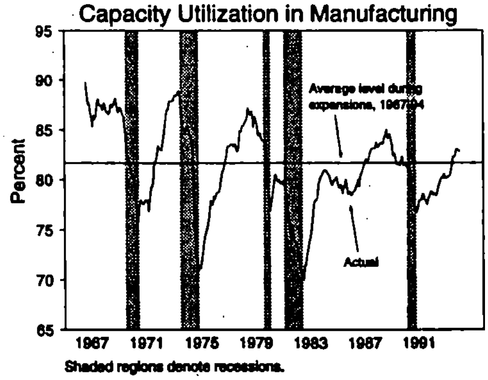
But what of the future? It now seems more likely that the next movement in inflation will be up rather than down. The Administration (in its Mid-Session Review of the Budget), the Federal Reserve, and the Blue Chip economic forecasters all anticipate an uptick in inflation over the remainder of 1994 and in 1995. It is not surprising that concerns about inflation have intensified as the economy has continued to expand. Several factors have contributed to these concerns.

Unemployment and the Change in Inflation



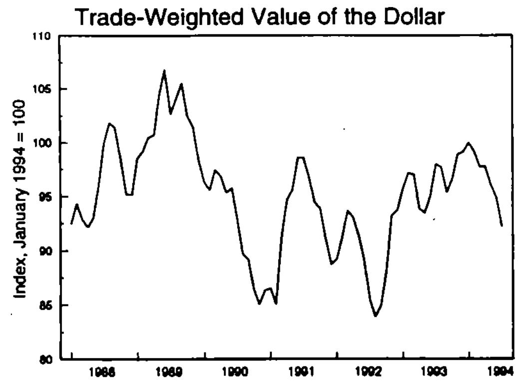
Labor market developments. Labor markets have tightened considerably recently, and are unlikely to exert much further downward pressure on inflation. According to today's report from the Labor Department, the unemployment rate in July was 6.1 percent. Past experience suggests that when the unemployment rate is high, inflation tends to decline. Conversely, when the unemployment rate is low, inflation tends to rise (see chart). The interpretation of the current level of unemployment is complicated by the redesign of the household employment survey. However, as best we can tell, the current rate of unemployment falls in an intermediate zone—not clearly associated in the past with either an increase or a decrease in inflation.

Capacity Utilization in Manufacturing

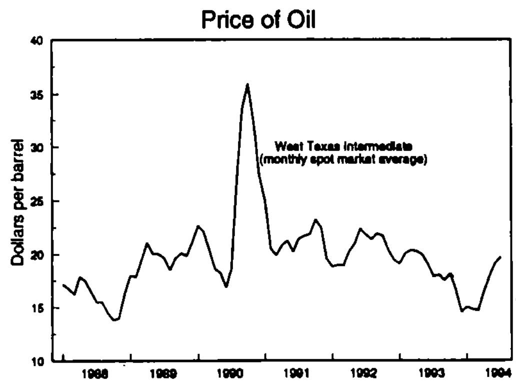


Shaded regions denote recessions.

Developments in the manufacturing sector. Activity in the manufacturing sector has picked up noticeably. An estimated 100,000 manufacturing jobs have been added on net since the beginning of the year. At last reading, 82.8 percent of manufacturing capacity was utilized, compared with an average of 81.7 percent during expansion periods since 1967 (see chart). This higher level of activity may possibly generate upward pressure on prices.



The decline of the dollar. Between mid-1992 and the end of 1993, the strength of the dollar helped keep inflation down. Since the beginning of the year, however, the dollar has depreciated about 6 percent relative to the currencies of our major trading partners (see chart). A depreciation of the dollar contributes to inflation in the United States because it tends to drive up not only the prices of imported goods but also the prices of competing domestic goods. Roughly speaking, a sustained 10 percent depreciation of the dollar against the currencies of our major trading partners may boost the level of the CPI about 1 percent after a year or so.



Commodity prices. The prices of a number of industrial and agricultural commodities have risen in the last few quarters. In particular, oil prices have rebounded from the lows reached last winter (see chart). Energy prices were a moderating influence on the overall CPI from 1991 through the first half of this year. The recent run-up in oil prices already has caused higher prices for gasoline and other energy items. If oil prices were to remain in the $20 per barrel range, overall consumer price inflation would be about 3/4 percentage point higher over the second half of this year and in 1995.

Expectations. According to surveys, household expectations of inflation have been running above actual rates for several consecutive years. Stubborn expectations are important because they may become self-fulfilling. For example, businesses make pricing decisions and workers negotiate wage contracts in part on the basis of their expectations of inflation.

Summary. The outlook for inflation is more guarded than at the beginning of the year. The economy has gathered strength faster than many expected, commodity prices have moved up, and the dollar has weakened. These developments are cited by market observers as possibly being sufficiently serious to motivate the FOMC to raise the funds rate another notch at its August meeting. For at least some members of the FOMC, the fact that most inflation forecasters anticipate no further reduction in inflation—and perhaps some increase—is a compelling reason to raise interest rates (see "Quotation of the Week").

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beijing Parks Satellite in Tow Zone. China launched a satellite recently, achieving the dubious distinction of becoming the first nation to ignore the international convention for parking satellites. Typically, the International Telecommunication Union, a U.N. agency, registers satellites and ensures that all satellites are positioned so that they do not interfere with each other. Although this registration process can take up to four years, all previous launchers have complied. The placement of the Chinese satellite may interfere with both the operations of a satellite owned by Rimsat, a U.S. company, and the operations of a Japanese telecommunications satellite. Ironically, the Chinese satellite itself may not function well in its current position, thus hindering the Asian strategies of international broadcasting companies, such as Turner broadcasting and HBO, who had signed up to use it. However, the Chinese insist that they will complete the coordination process with operators of neighboring satellites, and that a satisfactory solution can be reached.

Beige Book Reports Moderate Expansion. On Wednesday, the Federal Reserve released the July edition of its "beige book" survey of economic conditions. The survey shows continuing expansion of business activity, although there were some scattered signs of slowing. Retail markets are particularly strong after a slow spring. There are some reports of tighter labor markets, particularly in the Atlanta and Minneapolis districts, but so far there has been little upward pressure on wages. Price increases have been more widespread than in previous months, though competitive pressures are holding prices down at the retail level. Lending activity is growing in most areas of the country, including California.

Tax Code Penalizes Marriage. A new study released by the National Bureau of Economic Research shows that 52 percent of all couples filing joint returns in 1994 paid greater individual income taxes than if they had simply filed as single individuals.. The average "marriage penalty" paid by these couples was an estimated $1244. At the same time, about 38 percent of joint filers paid less individual income tax because they filed a joint return. These couples received an estimated average "marriage subsidy" of $1399. For all taxpayers, OBRA93 resulted in a shift from an aggregate annual marriage <u>subsidy</u> of about $7-1/2 billion to an aggregate annual marriage <u>penalty</u> of roughly $6-1/2 billion. This change primarily reflects that the individual income tax rate schedules enacted in OBRA93 are more progressive.

Striking Out. Six major league baseball players now have 35 or more home runs. If the season is not interrupted by a strike, the CEA estimates that there is a 51 percent chance that one or more will break Roger Maris's record of 61 home runs in a 162 game season. San Francisco's Matt Williams has an estimated 35 percent chance of breaking the record, and Seattle's Ken Griffey, Jr. has a 15 percent chance.

EYES ONLY

RELEASES THIS WEEK

Personal Income and Expenditures

Personal income rose 0.1 percent in June (monthly rate). Disposable personal income also rose 0.1 percent. Personal consumption expenditures rose 0.4 percent.

Leading Indicators

The index of leading economic indicators rose 0.2 percent in June.

Auto Sales

Domestic autos sold at an annual rate of 6.5 million units in July.

Employment and Unemployment **FOR RELEASE FRIDAY at 8:30 a.m.**

In July, the unemployment rate rose to 6.1 percent from 6.0 percent in June. Nonfarm payroll employment increased 259,000 in July.

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Producer prices (Thursday)
Retail sales (Thursday)
Consumer prices (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:4	1994:1	1994:2
Percent growth (annual rate)					
Real GDP	2.5	3.1	6.3	3.3	3.7
GDP deflator	5.5	1.8	1.3	2.9	2.9
Productivity					
Nonfarm business	1.2	1.7	6.1	1.3	N.A.
Manufacturing (1978-93)	2.3	4.8	7.9	6.9	N.A.
Real compensation per hour	0.6	–0.3	–0.5	3.1	N.A.
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	12.0	12.2	12.4
Residential investment	4.7	4.1	4.3	4.4	4.4
Exports	8.0	11.7	12.0	11.8	12.0
Imports	9.2	13.2	13.6	13.8	14.1
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	2.9	2.7	2.9
Federal surplus	–2.8	–3.8	–3.4	–2.7	N.A.

	1970–1993	1993	May 1994	June 1994	July 1994
Unemployment Rate	6.7*	6.8*	6.0	6.0	**6.1**

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

	1970–1993	1993	May 1994	June 1994	July 1994
Payroll employment (thousands)					
increase per month			**252**	**356**	**259**
increase since Jan. 1993					**4076**
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.3	N.A.
PPI-Finished goods	5.0	0.2	–0.1	0.0	N.A.

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

EYES ONLY

August 5, 1994 (Friday).

FINANCIAL STATISTICS

	1992	1993	June 1994	July 1994	Aug. 4, 1994
Dow-Jones Industrial Average	3284	3522	3738	3718	3766
Interest Rates					
3-month T-bill	3.43	3.00	4.14	4.33	4.32
10-year T-bond	7.01	5.87	7.10	7.30	7.12
Mortgage rate, 30-year fixed	8.40	7.33	8.43	8.62	8.38
Prime rate	6.25	6.00	7.25	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 4, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.586	−0.3	−7.3
Yen-Dollar	100.3	+0.3	−4.3
Multilateral (Mar. 1973=100)	90.04	−0.2	−4.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q2)	**6.1** (Jul)	2.5 (Jun)
Canada	3.4 (Q1)	10.7 (May)	0.0 (Jun)
Japan	−0.0 (Q1)	2.8 (May)	0.8 (May)
France	1.0 (Q1)	12.4 (Apr)	1.7 (Jun)
Germany	1.6 (Q1)	6.6 (Apr)	2.9 (Jun)
Italy	0.6 (Q1)	11.2 (Oct)	3.8 (Jun)
United Kingdom	3.3 (Q2)	9.6 (May)	2.6 (Jun)

Unemployment data **embargoed until 8:30 a.m., August 5, 1994 (Friday).**

EYES ONLY

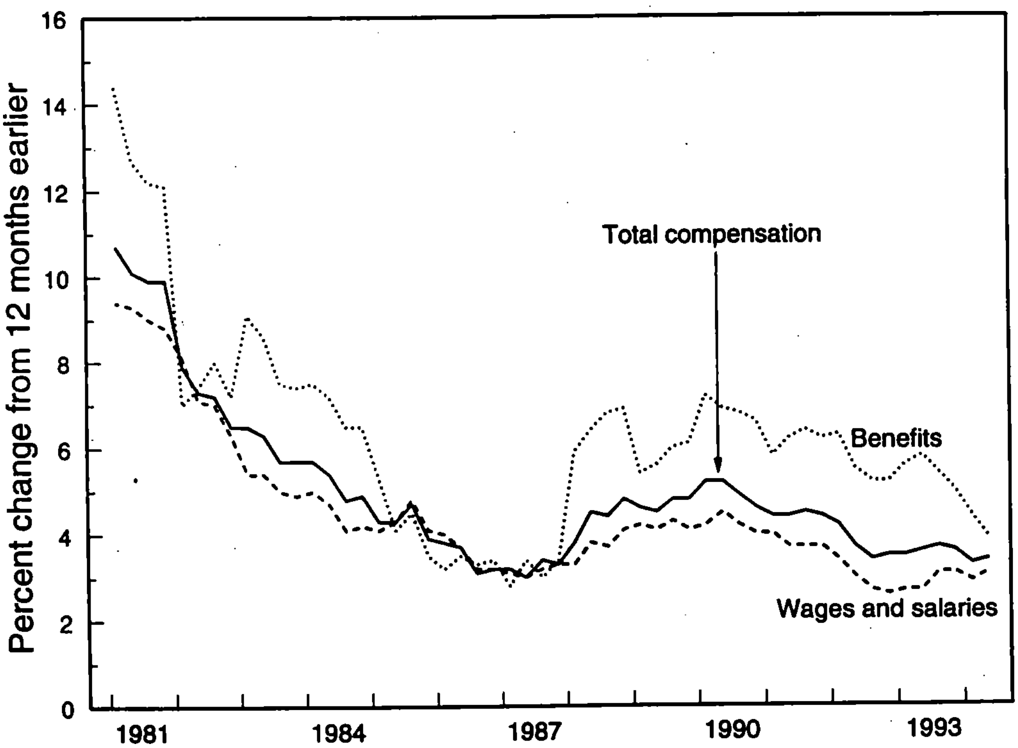
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 29, 1994

CHART OF THE WEEK

Employment Cost Index



Total compensation in private industry increased 3.4 percent over the twelve months ending in June. Growth in benefit costs slowed to just 3.9 percent—down nearly 2 percentage points from a year ago and the slowest rate of increase since late 1987. The moderation in benefit costs reflected continuing deceleration in insurance costs for health and workers' compensation. <u>Overall, compensation data suggest that labor costs continued to exert only moderate upward pressure on prices through the middle of this year.</u>

EYES ONLY

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"Are you the one with the preëxisting condition or the one with just the existing condition?"

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Second Quarter of 1994

Real GDP grew at an annual rate of 3.7 percent during the second quarter. Strong inventory accumulation accounted for more than half of the growth. Real final sales (real GDP less inventory accumulation) grew at an annual rate of only 1.5 percent, as the pace of consumer spending slowed.

The following scorecard gives the growth of major GDP components during the second quarter and indicates factors affecting their recent performance or outlook.

Component	Growth*	Comments
Consumer expenditures on motor vehicles	−8.7%	After posting strong gains during the past two quarters, purchases of new cars and trucks declined.
Other consumer expenditures	1.9%	Consumers took a break from their spending spree of the past 4 quarters, and used some of their income to rebuild savings.
Producers' durable equipment	7.7%	A healthy gain but less than half the pace of the past year.
Housing	7.0%	Housing investment remained strong, but expanded more slowly than in the previous 2 quarters.
Nonresidential structures	18.4%	Nonresidential construction bounced back following its weather-related decline in the first quarter.
Inventories (change, billions of 1987$)	$54	The largest quarterly gain since 1987. A key question is whether producers have overstocked their shelves and may cut back on future production.
Government purchases	−0.5%	Federal purchases fell almost 5 percent at an annual rate. A modest increase in State and local purchases offset much of the decline at the Federal level.
Exports	11.1%	Exports appear to have snapped back after a decline in the first quarter.
Imports	15.1%	The import surge continues. Are imports winding up on warehouse shelves?

*Percent real growth in second quarter at annual rate (except inventories). These preliminary figures are subject to substantial revision.

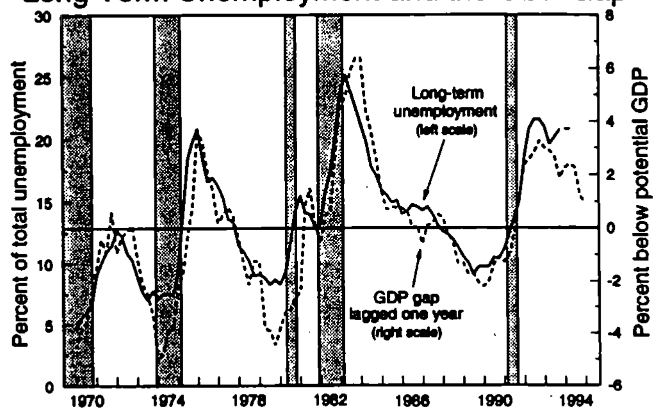
EYES ONLY

CURRENT DEVELOPMENT

Long-term Unemployment Remains Stubbornly High

The share of long-term unemployment in total unemployment has hovered around 20 percent during the current recovery (see chart).

Long-Term Unemployment and the GDP Gap



Note: Shaded regions indicate recessions.
1994 employment data come from the revised CPS.

Analysis. In the past, the share of long-term unemployment in total unemployment has mirrored closely the overall strength of the economy—with a lag of about a year or so. To date, the persistence of long-term unemployment appears to be primarily a result of the unusually slow pace of the early stages of the current recovery. If history is any guide, long-term unemployment should diminish in importance over the rest of 1994 and into 1995. If long-term unemployment remains high, it would be a sign that a larger fraction of long-term unemployment is structural than in previous recoveries.

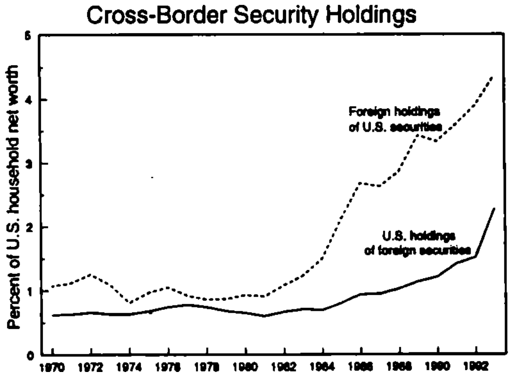
TREND

American Investors Add a Cosmopolitan Touch

American investment in foreign financial markets has mushroomed during the last few years. For example, according to financial market participants, pension funds now hold about 8 or 9 percent of their portfolios in foreign securities—up from about 5 percent just two years ago. Because many pension fund advisers are recommending a target portfolio share of 12 percent or more, the trend toward international diversification seems likely to continue.

Individuals also are increasing their holdings of foreign securities. This trend has been facilitated by the increased availability of mutual funds that invest in foreign securities. In 1993, Americans put $27 billion of net new money into mutual funds invested exclusively in foreign markets, nearly 3 times as much as in 1992.

Cross-Border Security Holdings



Analysis. Investors diversify their portfolios—across borders as well as across types of assets—in order to reduce risk. Diversification across borders by both U.S. and foreign residents has been on the upswing for about a decade, but the pace has accelerated recently (see chart).

As financial markets have become more global, borrowers have had to compete on a wider stage as they seek to raise capital. If American and foreign investors perceive that foreign securities are more attractive than U.S. securities, either U.S. borrowers must offer more attractive terms or the dollar will weaken.

EYES ONLY

ARTICLE

Globalism versus Regionalism: Choosing the Path toward Trade Liberalization

Policymakers have traditionally preferred to liberalize trade through global arrangements such as the GATT. This preference reflects an underlying belief that the most certain way to secure the full gains of trade liberalization is through global liberalization.

The argument for regionalism. Lately, however, the traditional preference for globalism has given way to greater interest in regional and other sub-global trading arrangements. In part, this change in focus reflects a recognition of the importance that geography continues to play in determining trade flows. In addition, it reflects the presumption that the ability of negotiators to secure agreements is likely to decline as the number of participants increases and as participants become more diverse economically and socially. Such considerations suggest that sub-global—i.e., regional or "plurilateral"—agreements may represent the most efficient path toward trade liberalization under some circumstances. Yet economists traditionally have been skeptical of such arrangements because of the preferential relationships they create.

How might regional trade agreements go wrong? Part of the answer is that they can divert as well as create trade.

Trade creation. Joining a preferential trading bloc can make a country better off if it leads to new trade. Suppose, for instance, that all countries' tariffs on apparel were such that the United States initially chose to produce its own apparel despite being a high-cost producer. And assume that a NAFTA-like agreement leads the United States to begin buying cheaper apparel from Mexico, a medium-cost producer. In this scenario, the United States and Mexico are better off after joining the preferential bloc. This scenario would be an example of "trade creation."

Trade diversion. On the other hand, suppose world tariffs on apparel were such that the United States initially bought its apparel from the Dominican Republic, the low-cost producer. As before, the formation of a preferential North American bloc through NAFTA leads the United States to buy its apparel from Mexico (reduction of tariffs within North America makes medium-cost Mexican apparel cheaper than low-cost apparel from the Dominican Republic, which still faces a higher U.S. tariff). In this scenario, the United States is simply replacing purchases of low-cost apparel from the Dominican Republic with medium-cost apparel from Mexico. This scenario would be an example of "trade diversion." In this case, the preferential trading bloc proves beneficial to Mexico and the United States, but makes the Dominican Republic worse off.

EYES ONLY

Persistent concerns about this sort of trade diversion in light industries such as apparel have led countries like the Dominican Republic—which are part of the Caribbean Basin Initiative (CBI) but not part of NAFTA—to demand the same preferential access to the U.S. market that NAFTA has afforded Mexico.

The globalist accommodation to regionalism. The framers of GATT were well-acquainted with the notions of preferential trade blocs and their attendant trade diversion. As a consequence, GATT rules forbid countries from increasing external barriers when forming a preferential agreement, and require that members of preferential trade agreements eliminate all protection (not just barriers in some sectors). These rules insure that preferential arrangements meet a test of true integration and are not simply beggar-thy-neighbor schemes. In order to be GATT-consistent, the NAFTA agreement had to include difficult-to-liberalize sectors such as agriculture as well as sectors, such as manufactures, that were politically easier to liberalize.

One more potential pitfall of the regional approach. When analyzing which countries win and which countries lose from a regional trading arrangement, it is necessary to look beyond the question of whether the arrangement results in trade creation or only trade diversion. One also must gauge the likelihood that non-member countries will form their own competing preferential blocs. For example, some have expressed a concern that Europe might respond to U.S. regional initiatives in the Western Hemisphere and in Asia by becoming more inward-looking, by erecting more trade barriers, and by cooperating less with the United States.

How do we move forward? One possibility would be to require that all sub-global arrangements include "accession clauses"—explicit rules guaranteeing membership for any non-member country willing to match the degree of liberalization achieved by the agreement. Another suggestion—though probably a less realistic one—is that GATT rules be amended to allow compensation for non-members hurt by regional liberalization agreements.

The Administration's view is a pragmatic one: The United States should pursue both regional and global liberalization simultaneously, ensuring that any regional arrangements are GATT-consistent and using them, where appropriate, as leverage to encourage further global liberalization.

BR — What do you think about this

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Going, Going, Gone. On Monday, the Federal Communications Commission began its first auction of segments of the communications spectrum. The licenses on the auction block were for 10 nationwide narrow-band segments that probably will be used for two-way advanced paging and messaging. The 27 approved bidders have been entering secret bids via computer since Monday. The bids have been higher than the FCC expected. As of 7:00 p.m. Thursday, the leading bids totalled nearly $590 million dollars, including a bid of more than $80 million for one piece of the spectrum. On Thursday, the FCC began to sell 594 wireless interactive video licenses. By day's end, 300 licenses had been sold for a gross value of approximately $195 million, but after accounting for small-business and minority discounts, the total collected was about $167 million.

State Budgets Aided by Resurgent Economy. According to a preliminary report released this week by the National Conference of State Legislatures, the financial condition of most states continues to improve. State general fund outlays are projected to increase 4.1 percent on average during the fiscal year ending June 30, 1995, while general revenues are expected to increase 4.2 percent [see Weekly Economic Briefing, June 10, 1994, for a review of state revenues]. Although outlays for Medicaid and corrections continue to grow more rapidly than spending in most other program areas, increases in these two categories have slowed, giving states latitude to redirect resources to other programs, especially education. States will increase K-12 spending 7.3 percent including Michigan, and 4.2 percent excluding Michigan. (Michigan's large influence on the overall figures reflects its switch from local- to state-level financing of public education.) Higher education also will receive more new state dollars than will corrections for the first time in four years.

Union Settlements Continue on a Moderate Trend. Major collective bargaining settlements reached during the second quarter of this year called for wage rate increases averaging 2.4 percent per year over the life of the new contracts, compared with 3.0 percent under the contracts being replaced, the Labor Department reported. Most of the 627,000 workers covered under the 143 new agreements are in construction, trucking, apparel production, food stores, and real estate. The Labor Department also reports that coverage under cost-of-living clauses has declined markedly in recent years. As of June 30, 1994, only 24 percent of workers under these contracts had COLA coverage, compared with about 40 percent during the late 1980s.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product ****FOR RELEASE FRIDAY at 8:30 a.m.****

According to the advance estimate, real GDP grew at a 3.7 percent annual rate in the second quarter.

Employment Cost Index

The employment cost index for private industry workers rose 3.4 percent for the 12-month period ending in June.

Durable Goods

Advance estimates for June show that new orders for durable goods rose 1.3 percent, the fourth consecutive monthly increase.

MAJOR RELEASES NEXT WEEK

Personal income (Monday)
Leading indicators (Wednesday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:4	1994:1	1994:2
Percent growth (annual rate)					
Real GDP	**2.5**	**3.1**	**6.3**	**3.3**	**3.7**
GDP deflator	**5.5**	**1.8**	**1.3**	**2.9**	**2.9**
Productivity					
Nonfarm business	1.2	1.7	6.1	1.3	N.A.
Manufacturing (1978-93)	2.3	4.8	7.9	6.9	N.A.
Real compensation per hour	0.6	–0.3	–0.5	3.1	N.A.
Shares of Real GDP (percent)					
Business fixed investment	**11.0**	**11.5**	**12.0**	**12.2**	**12.4**
Residential investment	**4.7**	**4.1**	**4.3**	**4.4**	**4.4**
Exports	**8.0**	**11.7**	**12.0**	**11.8**	**12.0**
Imports	**9.2**	**13.2**	**13.6**	**13.8**	**14.1**
Shares of Nominal GDP (percent)					
Personal saving	**4.9**	**3.0**	**2.9**	**2.7**	**2.9**
Federal surplus	**–2.8**	**–3.8**	**–3.4**	**–2.7**	N.A.

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Unemployment Rate	6.7*	6.8*	6.4	6.0	6.0

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Payroll employment (thousands)					
increase per month			401	252	379
increase since Jan. 1993					3840
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.3
PPI-Finished goods	5.0	0.2	–0.1	–0.1	0.0

New or revised data in **boldface**.

EYES ONLY

GDP data **embargoed until 8:30 a.m., July 29, 1994 (Friday).**

FINANCIAL STATISTICS

	1992	1993	May 1994	June 1994	July 28, 1994
Dow-Jones Industrial Average	3284	3522	3708	3738	3731
Interest Rates					
3-month T-bill	3.43	3.00	4.14	4.14	4.42
10-year T-bond	7.01	5.87	7.18	7.10	7.29
Mortgage rate, 30-year fixed	8.40	7.33	8.60	8.43	8.57
Prime rate	6.25	6.00	6.99	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 28, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.590	–0.0	–7.4
Yen-Dollar	100.1	+0.9	–4.9
Multilateral (Mar. 1973=100)	90.24	+0.3	–4.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**4.0** (Q2)	6.0 (Jun)	2.5 (Jun)
Canada	3.4 (Q1)	10.7 (May)	0.0 (Jun)
Japan	–0.0 (Q1)	2.8 (May)	0.8 (May)
France	1.0 (Q1)	12.4 (Apr)	1.7 (Jun)
Germany	1.6 (Q1)	6.6 (Apr)	2.9 (Jun)
Italy	0.6 (Q1)	11.2 (Oct)	3.8 (Jun)
United Kingdom	2.9 (Q1)	9.6 (May)	2.6 (Jun)

GDP data **embargoed until 8:30 a.m., July 29, 1994 (Friday).**

BR/GS/SM

THE PRESIDENT HAS SEEN 7/25

VP / Rubin / Tyson — please comment on 2 articles —

Please see commen on 2 article

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

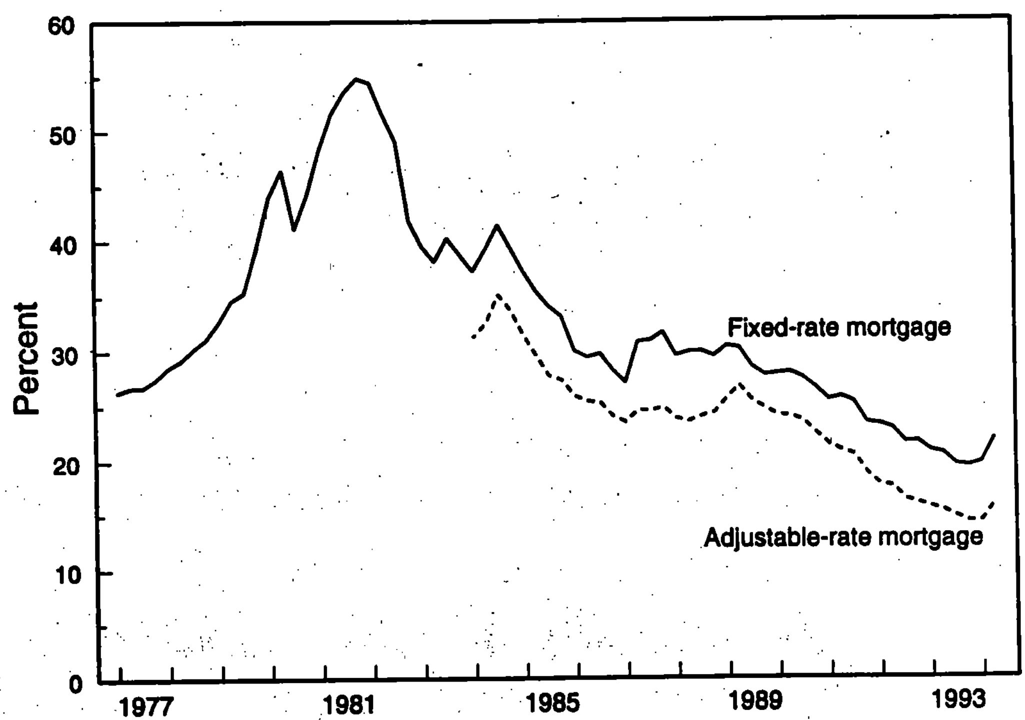
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

July 22, 1994

94 JUL 21 P9:41

CHART OF THE WEEK

Home Mortgage Payments as a Fraction of Income



Note: Figures for 1994:Q2 are estimates.

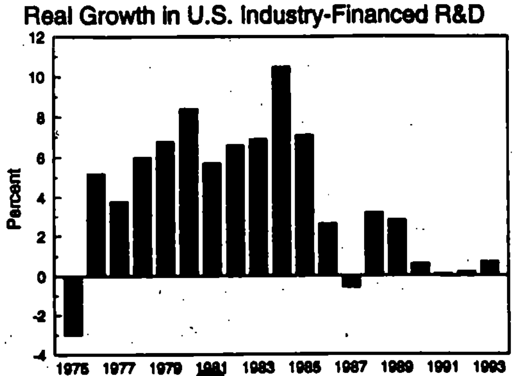
The chart shows the ratio of the mortgage payment on a new home of constant quality (the typical home sold in 1987) relative to disposable personal income. Although the recent increase in mortgage rates has caused the cash-flow burden of homeownership to move up, it is still near its 1993 low and remains far below its 1980s average.

CURRENT DEVELOPMENT

Private R&D Spending Continues to Grow Slowly

A new survey reports continued slow growth in spending on research and development. According to the Council on Competitiveness, R&D spending by U.S. industry increased just 0.7 percent last year in real terms (see chart). This extends a pattern of slowing growth that has been evident since the mid-1980s and intensified during the 1990s.

Real Growth in U.S. Industry-Financed R&D



No

International comparisons. The United States is not alone. All G-7 countries other than Germany report slower growth in total (public plus private) R&D after 1985 than during the first half of the 1980s.

Analysis. A number of factors probably underlie the recent slowdown in the growth of private R&D spending in the United States, including:

- The recent recession: A business-cycle downturn generally is bad news for R&D spending. The 1990-91 recession was no exception.
- Corporate cost-cutting drives: As private industry has become more cost conscious, it has cut back on basic research and targeted its R&D spending on development of technologies that are closer to commercialization.
- The end of the Cold War: Between 1979 and 1985—the period of the last defense buildup—private R&D spending rose more than five times faster than its current rate. In part, the higher spending during the buildup reflected both private matching of Pentagon funding, and private initiatives undertaken in order to win defense contracts.

CURRENT DEVELOPMENT

Microsoft Charges Leveled—And Settled

The Department of Justice charged software titan Microsoft with monopolization this week, and simultaneously announced a settlement.

Part of the settlement dealt with the method Microsoft often used to license MS-DOS and Windows software to hardware manufacturers. Frequently, Microsoft based royalties on the number of computers that a manufacturer sold rather than the number of copies of software it actually installed. Thus, if a manufacturer wanted to sell a machine with a competitor's program in place of MS-DOS or Windows, it had to pay royalties both to Microsoft and to the competitor. Effectively, this arrangement raised the rival's price and reduced competition. Under the settlement, Microsoft agreed to collect royalties based on the number of copies of its software actually installed.

A similar agreement with the European Commission was announced simultaneously—an unprecedented instance of international coordination in antitrust enforcement.

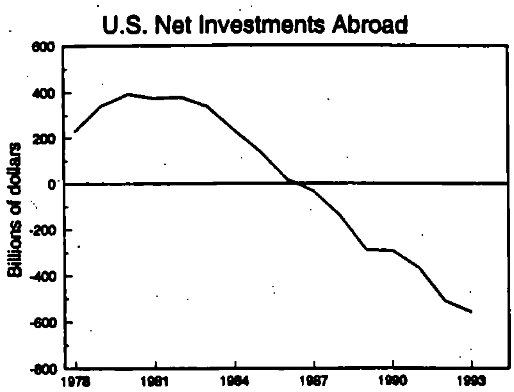
Analysis. MS-DOS and Windows have become the dominant operating system software for IBM-compatible personal computers. A firm that owns the property rights to an "industry standard" has a considerable advantage in its market. This advantage can be difficult for a competitor to overcome, even for a competitor with a technically superior product.

The agreement between Microsoft and the Justice Department did not seek to limit the market power that Microsoft wields merely as a result of owning an industry standard. Instead, the agreement focused on curbing practices that allegedly were being used to augment that power.

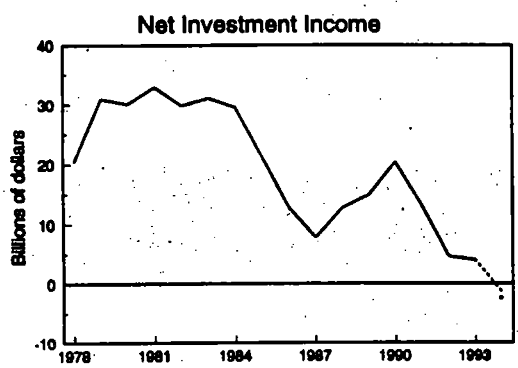
We need to discuss this & how we might need to explain this to others.

TREND

U.S. Borrowing Abroad Erodes Investment Income



America has been spending more than its income since the early 1980s. As a result, the United States has moved from a net creditor position to a net debtor position (see chart). Foreigners have purchased bonds, stocks, real estate, and companies from U.S. residents, and have invested in new or expanded production facilities in the United States. By 1987, the value of U.S. assets owned by foreigners was larger than the value of foreign assets owned by American residents, and the gap has continued to grow since then.



* 1994 observation reflects data for first quarter only.

We are now paying for that borrowing. Our payments of interest, dividends, and profits to foreigners on their American investments have increased dramatically and have recently begun to exceed our earnings on investments abroad (see chart).

In the past, a positive net income balance with the rest of the world helped reduce our current account deficit. Now, a negative net income balance will increase our current account deficit and add to our foreign borrowing needs (see box). The prospect of larger current account deficits is considered by some to be one of the "fundamentals" contributing to a weaker dollar.

The U.S. Current Account
(billions of dollars)

	1983	1993
Balance on Goods and Services	–57.8	–75.7
Net Investment Income	31.1	4.0
Grants and other Transfers	–17.7	–32.1
Current Account Balance	–44.4	–103.8

ARTICLE

Does the CPI Overstate Increases in the Cost of Living?

Many analysts have asserted recently that the consumer price index (CPI) overstates the true rate of increase in the cost of living. Several possible sources of such overstatement have been identified, but the associated magnitudes are still being hotly debated.

- **Substitution bias.** As the prices of goods and services change, consumers tend to shift their spending away from items that have become relatively more expensive. But such shifts are not reflected in the CPI, because it is derived from the prices of a fixed basket of goods and services. Substitution bias is estimated to cause the CPI to overstate the average annual increase in the cost of living about 0.2 percentage point. Substitution bias is thought to become more important as the standardized CPI market basket becomes increasingly outdated. Because the current market basket is based on spending patterns in 1982-1984 (and hence is very outdated), substitution bias may be contributing as much as 0.4 percentage point of the increase in the CPI this year.

- **Outlet bias.** Over time, consumers may change their shopping patterns, shifting from one type of retail outlet to another. For example, if shoppers become more price conscious and care less about customer service, they may shift more of their purchases to discount stores. Current methods would not correctly capture such a shift as a decline in the cost of living. Outlet bias is estimated to cause the CPI to overstate the annual increase in the cost of living by perhaps 0.1 percentage point.

- **Quality-adjustment bias.** The quality of many goods and services changes over time. The Bureau of Labor Statistics (BLS) attempts to correct for some of these quality changes; for example, automobile sticker-price increases that are judged to reflect quality improvements (e.g., airbags or anti-lock brakes) are not passed through into the CPI. However, the BLS does not attempt to correct for quality improvements in many other areas. Medical care services are a leading case in point: We know that the quality of an appendectomy today is better than ever before, but by how much? Quality adjustment is a real wild card. Some analysts estimate that it may account for an overstatement of cost-of-living changes by as much as 0.8 percentage point per year, while others say it amounts to nothing.

Overall, these and other factors may add between ¼ and 1-½ percentage points to the measured increase in the cost of living each year.

Maybe we should get the Kerrey Commission to consider doing this or part of it before '98 — it would mean a lot —

Maybe we should get the Kerrey Commission to consider doing this or part of it before '98 - it would mean a lot.

Why does this matter? The fact that CPI inflation may overstate increases in the cost of living is important because many elements of the Federal budget are indexed to the CPI. For example:

- On the outlays side, some transfer payments, including social security benefits and supplemental security income benefits, are indexed to the CPI.
- On the receipts side, several items related to personal taxes are indexed to the CPI, including personal exemption and standard deduction amounts, tax brackets, and the maximum amount of earned income on which the EITC may be claimed.

The objective of indexation is to insulate both the beneficiaries of social security and other transfer programs and taxpayers from the effects of inflation. Absent indexation, inflation would erode the purchasing power of benefits (unless an increase in benefits were enacted) and cause taxpayers to "creep" into higher tax brackets and hence increase their tax burden (unless a tax cut were legislated).

If CPI inflation does overstate the rate of increase in the true cost of living, then social security beneficiaries are enjoying a rising standard of living because the purchasing power of their benefits is increasing. And taxpayers are bearing a lighter burden than they would if the cost of living were properly measured.

Implications for the Federal budget. The fiscal stakes are large. Removing an ongoing upward bias in the CPI of just 0.1 percentage point per year starting in FY1995 would reduce outlays for social security benefits about $300 million that year and $1.9 billion in FY1999. And revenues from the personal income tax would be about $200 million higher in FY1995 and $1.7 billion higher in FY1999.

The cumulative effect of mismeasurement since the last major revision of the index (in 1986) could be sizable: Even assuming a total bias from all sources of only 0.2 percent per year—the lower end of the range of most analysts' estimates—CPI mismeasurement could be causing as much as $4 billion in excess social security benefit payments in FY1994.

What might be done? One possible course of action would involve indexing items such as social security benefits and personal tax brackets only partially rather than fully. For example, social security benefits might be moved up each year by some amount less than the increase in the CPI over the relevant period. Such an action would require statutory change.

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Cross-Border Traffic Steers Rail Industry. NAFTA may be driving some recent developments in the railroad industry. Although overall rail traffic to Mexico has increased only modestly thus far, certain goods have seen some immediate southbound traffic increases—feed grains, soybean meal, wood pulp, forest products, soda ash, and finished automobiles. And several railroads are considering projects along the border to relieve developing congestion. The recent merger of Burlington Northern and Sante Fe Pacific was partially NAFTA driven —BN's network did not serve Mexico and the Sante Fe network did not serve Canada.

Humphrey-Hawkins Highlights. In his semi-annual report to the Congress on monetary policy, Federal Reserve Board Chairman Alan Greenspan said "...it is an open question whether our actions to date have been sufficient to head off inflationary pressures." He noted that there are some signs of inflationary pressures—shortages of certain types of labor and higher prices for manufacturing materials—but that they are not widespread. He said that the Fed will "...be particularly alert to these emerging signs in considering further adjustments to policy in the period ahead." Greenspan said the FOMC forecasts real GDP growth of 3 to 3¼ percent for 1994 and 2½ to 2¾ percent for 1995, with inflation of around 2¾ to 3 percent for this year and the same or slightly higher for next year. These projections are quiet similar to the forecast underlying the Administration's Mid-Session Review of the Budget.

RELEASES THIS WEEK

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The goods and services trade deficit rose to $9.2 billion in May from $8.5 billion in April.

Housing Starts

Housing starts dropped 10 percent in June to 1.35 million units at an annual rate. Starts during the first 6 months of this year were 18 percent above their level during the same period in 1993.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Durable Goods (Wednesday)
Gross Domestic Product (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:3	1993:4	1994:1
Percent growth (annual rate)					
Real GDP	2.5	3.1	2.9	7.0	3.4
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	1.7	3.5	6.1	1.3
Manufacturing (1978-93)	2.3	4.8	2.6	7.9	6.9
Real compensation per hour	0.6	–0.3	1.2	–0.5	3.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	11.6	12.0	12.1
Residential investment	4.7	4.2	4.1	4.3	4.4
Exports	8.0	11.6	11.5	11.9	11.7
Imports	9.2	13.1	13.2	13.5	13.7
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.6
Federal surplus	–2.8	–3.5	–3.3	–3.2	–2.5

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Unemployment Rate	6.7*	6.8*	6.4	6.0	6.0

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Payroll employment (thousands)					
increase per month			401	252	379
increase since Jan. 1993					3840
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.3
PPI-Finished goods	5.0	0.2	–0.1	–0.1	0.0

FINANCIAL STATISTICS

	1992	1993	May 1994	June 1994	July 21, 1994
Dow-Jones Industrial Average	3284	3522	3708	3738	3732
Interest Rates					
3-month T-bill	3.43	3.00	4.14	4.14	4.33
10-year T-bond	7.01	5.87	7.18	7.10	7.27
Mortgage rate, 30-year fixed	8.40	7.33	8.60	8.43	8.52
Prime rate	6.25	6.00	6.99	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 21, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.591	+2.4	–6.4
Yen-Dollar	99.2	+0.9	–8.6
Multilateral (Mar. 1973=100)	89.93	+1.8	–4.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.8 (Q1)	6.0 (Jun)	2.5 (Jun)
Canada	3.4 (Q1)	10.7 (May)	–0.2 (May)
Japan	–0.0 (Q1)	2.8 (May)	0.8 (Apr)
France	1.0 (Q1)	12.4 (Apr)	1.7 (May)
Germany	1.6 (Q1)	6.6 (Apr)	3.0 (May)
Italy	0.6 (Q1)	11.2 (Oct)	4.0 (May)
United Kingdom	2.9 (Q1)	9.6 (May)	2.5 (May)

BR|Bo|GS/SM

EYES ONLY

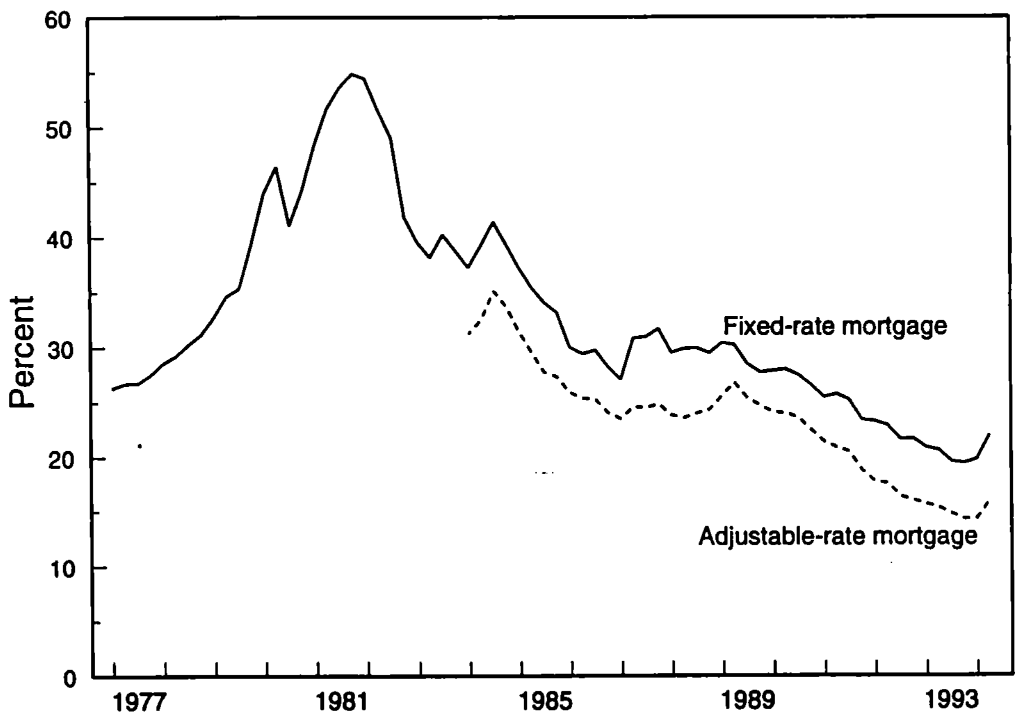
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 22, 1994

CHART OF THE WEEK

Home Mortgage Payments as a Fraction of Income



Note: Figures for 1994:Q2 are estimates.

The chart shows the ratio of the mortgage payment on a new home of constant quality (the typical home sold in 1987) relative to disposable personal income. Although the recent increase in mortgage rates has caused the cash-flow burden of homeownership to move up, it is still near its 1993 low and remains far below its 1980s average.

EYES ONLY

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"NOW I KNOW I'VE ARRIVED. THE COMPANY HAS BEEN ACCUSED OF AN ANTI-TRUST VIOLATION."

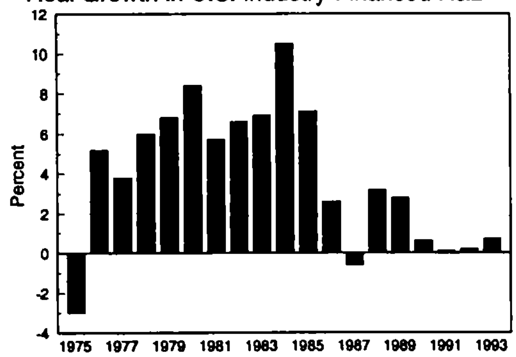
EYES ONLY

CURRENT DEVELOPMENT

Private R&D Spending Continues to Grow Slowly

A new survey reports continued slow growth in spending on research and development. According to the Council on Competitiveness, R&D spending by U.S. industry increased just 0.7 percent last year in real terms (see chart). This extends a pattern of slowing growth that has been evident since the mid-1980s and intensified during the 1990s.

Real Growth in U.S. Industry-Financed R&D



International comparisons. The United States is not alone. All G-7 countries other than Germany report slower growth in total (public plus private) R&D after 1985 than during the first half of the 1980s.

Analysis. A number of factors probably underlie the recent slowdown in the growth of private R&D spending in the United States, including:

- The recent recession: A business-cycle downturn generally is bad news for R&D spending. The 1990-91 recession was no exception.
- Corporate cost-cutting drives: As private industry has become more cost conscious, it has cut back on basic research and targeted its R&D spending on development of technologies that are closer to commercialization.
- The end of the Cold War: Between 1979 and 1985—the period of the last defense buildup—private R&D spending rose more than five times faster than its current rate. In part, the higher spending during the buildup reflected both private matching of Pentagon funding, and private initiatives undertaken in order to win defense contracts.

EYES ONLY

CURRENT DEVELOPMENT

Microsoft Charges Leveled—And Settled

The Department of Justice charged software titan Microsoft with monopolization this week, and simultaneously announced a settlement.

Part of the settlement dealt with the method Microsoft often used to license MS-DOS and Windows software to hardware manufacturers. Frequently, Microsoft based royalties on the number of computers that a manufacturer sold rather than the number of copies of software it actually installed. Thus, if a manufacturer wanted to sell a machine with a competitor's program in place of MS-DOS or Windows, it had to pay royalties both to Microsoft and to the competitor. Effectively, this arrangement raised the rival's price and reduced competition. Under the settlement, Microsoft agreed to collect royalties based on the number of copies of its software actually installed.

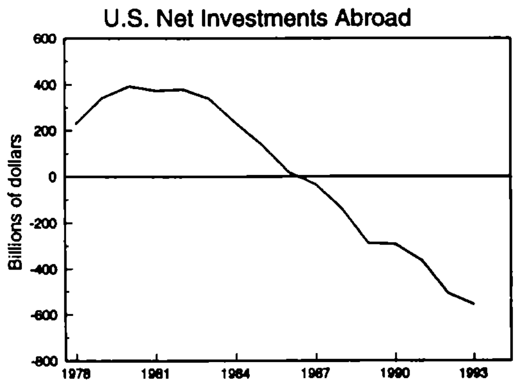
A similar agreement with the European Commission was announced simultaneously—an unprecedented instance of international coordination in antitrust enforcement.

Analysis. MS-DOS and Windows have become the dominant operating system software for IBM-compatible personal computers. A firm that owns the property rights to an "industry standard" has a considerable advantage in its market. This advantage can be difficult for a competitor to overcome, even for a competitor with a technically superior product.

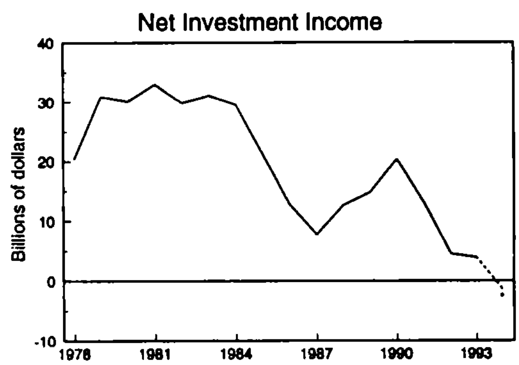
The agreement between Microsoft and the Justice Department did not seek to limit the market power that Microsoft wields merely as a result of owning an industry standard. Instead, the agreement focused on curbing practices that allegedly were being used to augment that power.

TRENḌ

U.S. Borrowing Abroad Erodes Investment Income



America has been spending more than its income since the early 1980s. As a result, the United States has moved from a net creditor position to a net debtor position (see chart). Foreigners have purchased bonds, stocks, real estate, and companies from U.S. residents, and have invested in new or expanded production facilities in the United States. By 1987, the value of U.S. assets owned by foreigners was larger than the value of foreign assets owned by American residents, and the gap has continued to grow since then.



* 1994 observation reflects data for first quarter only.

We are now paying for that borrowing. Our payments of interest, dividends, and profits to foreigners on their American investments have increased dramatically and have recently begun to exceed our earnings on investments abroad (see chart).

In the past, a positive net income balance with the rest of the world helped reduce our current account deficit. Now, a negative net income balance will increase our current account deficit and add to our foreign borrowing needs (see box). The prospect of larger current account deficits is considered by some to be one of the "fundamentals" contributing to a weaker dollar.

The U.S. Current Account
(billions of dollars)

	1983	1993
Balance on Goods and Services	–57.8	–75.7
Net Investment Income	31.1	4.0
Grants and other Transfers	–17.7	–32.1
Current Account Balance	–44.4	–103.8

EYES ONLY

ARTICLE

Does the CPI Overstate Increases in the Cost of Living?

Many analysts have asserted recently that the consumer price index (CPI) overstates the true rate of increase in the cost of living. Several possible sources of such overstatement have been identified, but the associated magnitudes are still being hotly debated.

- **Substitution bias.** As the prices of goods and services change, consumers tend to shift their spending away from items that have become relatively more expensive. But such shifts are not reflected in the CPI, because it is derived from the prices of a fixed basket of goods and services. Substitution bias is estimated to cause the CPI to overstate the average annual increase in the cost of living about 0.2 percentage point. Substitution bias is thought to become more important as the standardized CPI market basket becomes increasingly outdated. Because the current market basket is based on spending patterns in 1982-1984 (and hence is very outdated), substitution bias may be contributing as much as 0.4 percentage point of the increase in the CPI this year.

- **Outlet bias.** Over time, consumers may change their shopping patterns, shifting from one type of retail outlet to another. For example, if shoppers become more price conscious and care less about customer service, they may shift more of their purchases to discount stores. Current methods would not correctly capture such a shift as a decline in the cost of living. Outlet bias is estimated to cause the CPI to overstate the annual increase in the cost of living by perhaps 0.1 percentage point.

- **Quality-adjustment bias.** The quality of many goods and services changes over time. The Bureau of Labor Statistics (BLS) attempts to correct for some of these quality changes; for example, automobile sticker-price increases that are judged to reflect quality improvements (e.g., airbags or anti-lock brakes) are not passed through into the CPI. However, the BLS does not attempt to correct for quality improvements in many other areas. Medical care services are a leading case in point: We know that the quality of an appendectomy today is better than ever before, but by how much? Quality adjustment is a real wild card. Some analysts estimate that it may account for an overstatement of cost-of-living changes by as much as 0.8 percentage point per year, while others say it amounts to nothing.

Overall, these and other factors may add between ¼ and 1-½ percentage points to the measured increase in the cost of living each year.

Why does this matter? The fact that CPI inflation may overstate increases in the cost of living is important because many elements of the Federal budget are indexed to the CPI. For example:

- On the outlays side, some transfer payments, including social security benefits and supplemental security income benefits, are indexed to the CPI.
- On the receipts side, several items related to personal taxes are indexed to the CPI, including personal exemption and standard deduction amounts, tax brackets, and the maximum amount of earned income on which the EITC may be claimed.

The objective of indexation is to insulate both the beneficiaries of social security and other transfer programs and taxpayers from the effects of inflation. Absent indexation, inflation would erode the purchasing power of benefits (unless an increase in benefits were enacted) and cause taxpayers to "creep" into higher tax brackets and hence increase their tax burden (unless a tax cut were legislated).

If CPI inflation does overstate the rate of increase in the true cost of living, then social security beneficiaries are enjoying a rising standard of living because the purchasing power of their benefits is increasing. And taxpayers are bearing a lighter burden than they would if the cost of living were properly measured.

Implications for the Federal budget. The fiscal stakes are large. Removing an ongoing upward bias in the CPI of just 0.1 percentage point per year starting in FY1995 would reduce outlays for social security benefits about $300 million that year and $1.9 billion in FY1999. And revenues from the personal income tax would be about $200 million higher in FY1995 and $1.7 billion higher in FY1999.

The cumulative effect of mismeasurement since the last major revision of the index (in 1986) could be sizable: Even assuming a total bias from all sources of only 0.2 percent per year—the lower end of the range of most analysts' estimates—CPI mismeasurement could be causing as much as $4 billion in excess social security benefit payments in FY1994.

What might be done? One possible course of action would involve indexing items such as social security benefits and personal tax brackets only partially rather than fully. For example, social security benefits might be moved up each year by some amount less than the increase in the CPI over the relevant period. Such an action would require statutory change.

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EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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Durable Goods (Wednesday)
Gross Domestic Product (Friday)

EYES ONLY

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Nonfarm business	1.2	1.7	3.5	6.1	1.3
Manufacturing (1978-93)	2.3	4.8	2.6	7.9	6.9
Real compensation per hour	0.6	–0.3	1.2	–0.5	3.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	11.6	12.0	12.1
Residential investment	4.7	4.2	4.1	4.3	4.4
Exports	8.0	11.6	11.5	11.9	11.7
Imports	9.2	13.1	13.2	13.5	13.7
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.6
Federal surplus	–2.8	–3.5	–3.3	–3.2	–2.5

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Unemployment Rate	6.7*	6.8*	6.4	6.0	6.0

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

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increase since Jan. 1993					3840
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.3
PPI-Finished goods	5.0	0.2	–0.1	–0.1	0.0

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	May 1994	June 1994	July 21, 1994
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10-year T-bond	7.01	5.87	7.18	7.10	7.27
Mortgage rate, 30-year fixed	8.40	7.33	8.60	8.43	8.52
Prime rate	6.25	6.00	6.99	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 21, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.591	+2.4	–6.4
Yen-Dollar	99.2	+0.9	–8.6
Multilateral (Mar. 1973=100)	89.93	+1.8	–4.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.8 (Q1)	6.0 (Jun)	2.5 (Jun)
Canada	3.4 (Q1)	10.7 (May)	–0.2 (May)
Japan	–0.0 (Q1)	2.8 (May)	0.8 (Apr)
France	1.0 (Q1)	12.4 (Apr)	1.7 (May)
Germany	1.6 (Q1)	6.6 (Apr)	3.0 (May)
Italy	0.6 (Q1)	11.2 (Oct)	4.0 (May)
United Kingdom	2.9 (Q1)	9.6 (May)	2.5 (May)

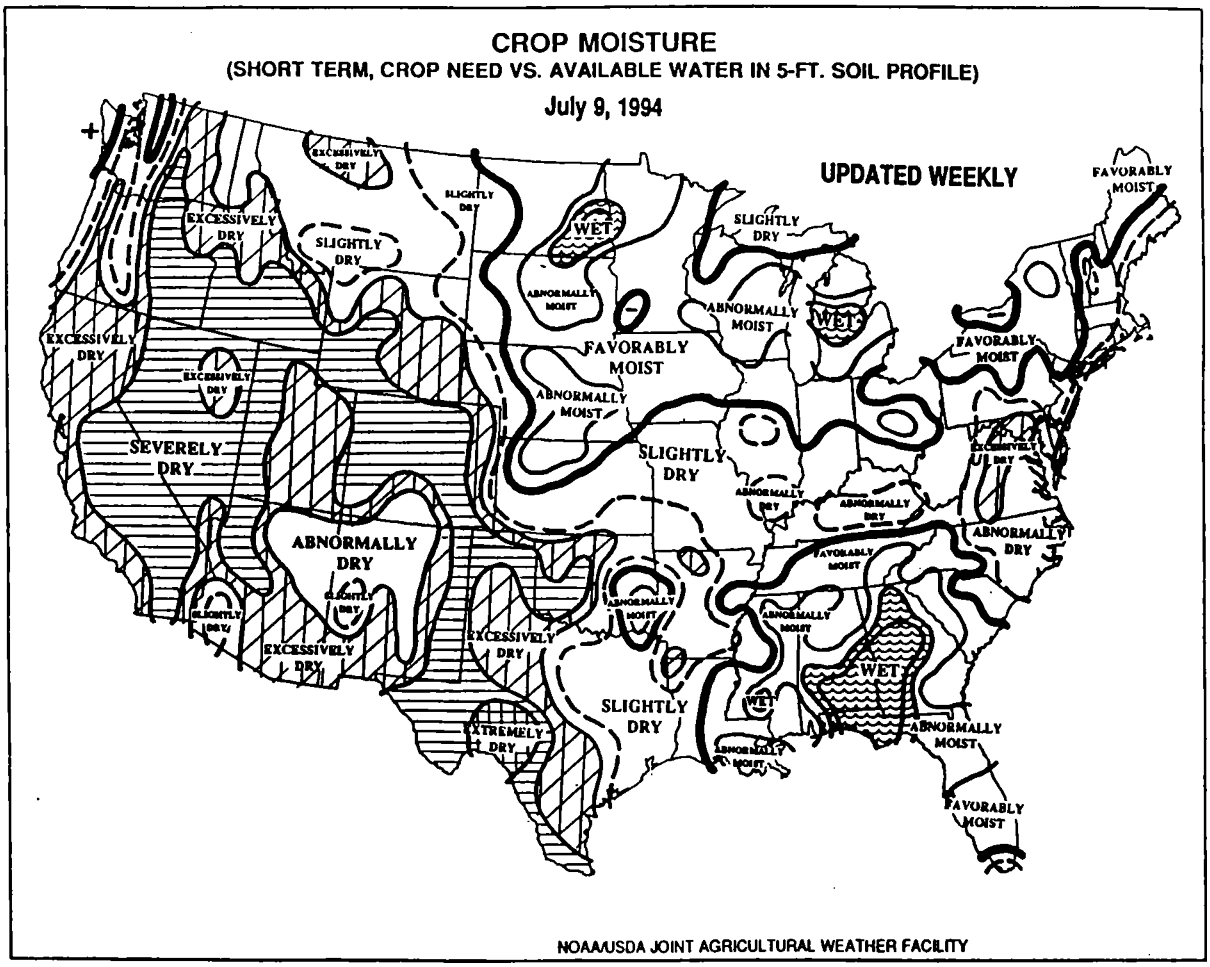
EYES ONLY

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 15, 1994

CHART OF THE WEEK



Crop moisture is good throughout much of the Midwest. In contrast, most of the West and Southwest is dry, in some places severely so. The main concentrations of excessive moisture are in the Southeast and some parts of the upper Midwest. USDA is predicting a good harvest this year, especially for corn and other feed grains. Production appears to be recovering nicely from the effects of last year's flooding in the Midwest.

EYES ONLY

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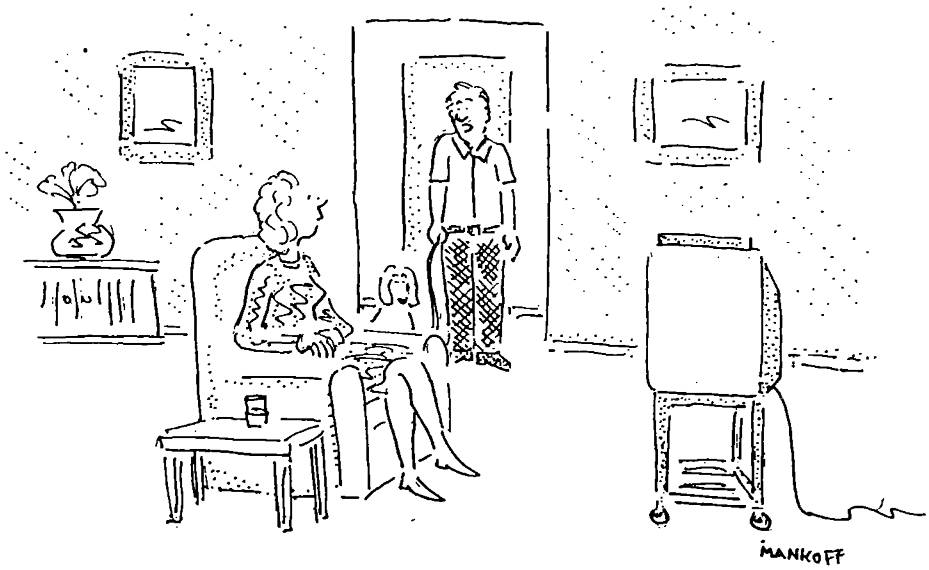


"The Fed take any recovery-fighting measures while we were out?"

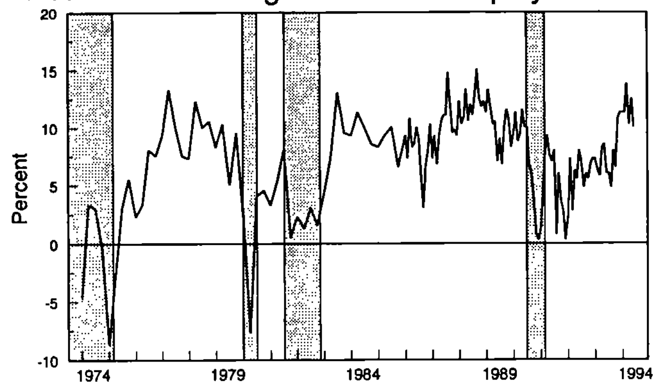
EYES ONLY

CURRENT DEVELOPMENT

Small Business Hiring Plans Remain Strong

Small businesses will continue to hire workers aggressively, according to a June survey of members of the National Federation of Independent Business. Eighteen percent of the firms in the survey plan to increase employment during the next three months, while only 8 percent intend to trim employment. The net reading of 10 percent remains well within the range that prevailed during the expansion of the 1980s, and considerably above the levels recorded during the early phases of the current recovery (see chart).

Net Firms Planning to Increase Employment*



Note: Shaded areas indicate recessions.

* Firms planning an increase in employment minus firms planning a decrease, as a percent of total firms responding to survey.

Analysis. <u>These results reinforce other recent indications of continuing strength in the labor market</u>. For example, a recent survey by Manpower, Inc. of employers' hiring plans was similarly upbeat. More importantly, payroll employment rose more than 1 million in the second quarter.

EYES ONLY

CURRENT DEVELOPMENT

Job Growth Can Go Hand in Hand with Productivity Gains

Labor productivity in the manufacturing sector rose rapidly during the 1980s, while employment fell. Modern-day Luddites have used that fact, and high-visibility news accounts of corporate layoffs, to argue that productivity growth inevitably comes at the expense of employment. A recent study published by the National Bureau of Economic Research, however, refutes that argument.

Reviewing the experience of 140,000 manufacturing plants, the study finds that plants where productivity rose during the 1980s were more likely to add jobs than shed jobs (see box).

Plants with Growing Productivity
(percent of total)

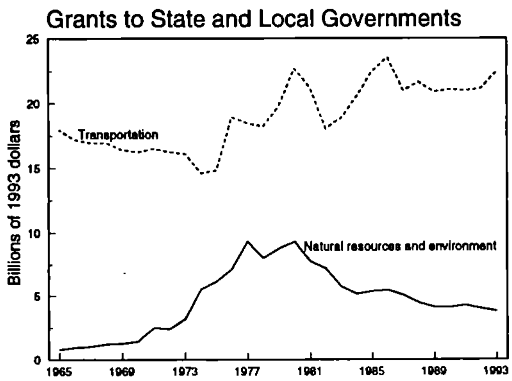
Plants adding workers:	55 percent
Plants shedding workers:	45 percent

Analysis. Any well-functioning market economy continually redirects workers toward their most valuable uses. As a result, "downsizing" at some firms is to be expected. But downsizing is not the only cause of productivity gains. Technological innovation—which can yield both productivity gains and job growth—is also important.

SPECIAL ANALYSIS

How Much More Infrastructure Does One Federal Dollar Buy?

The Federal government spent more than $25 billion in 1993 on highways, mass transit systems, water treatment facilities, and other infrastructure projects undertaken by State and local governments (see chart for trends in spending for transportation projects and natural resources and environment projects).



Much of this money was funnelled to the State and local governments through grant programs that require the recipient government to match Federal dollars with money of their own. For example, the Federal highway program requires State governments to contribute 20 percent of total project costs. Typically, grant programs also cap the annual amount of Federal support a government can receive from a given program.

Does Federal spending really cause State and local governments to undertake more infrastructure investment? The answer is yes, but the short-run effects of Federal grants for State and local infrastructure investments are considerably larger than the long-run effects. In the first year of a new or expanded program, additional Federal spending increases infrastructure investment substantially. But in the long run, each additional dollar of Federal spending generates only 30-40 cents of additional infrastructure investment. Other earmarked Federal grant programs have similar long-run effects.

Why is the long-run impact so low? Once the cap on Federal grants is reached, State and local governments must bear the full cost of additional infrastructure projects. Therefore, the Federal program does not really reduce the cost of additional infrastructure to a State or local government; it simply represents a source of funding. If instead the Federal grant programs reduced the cost of additional infrastructure, they would have a greater impact on State and local infrastructure investment. Evidence from the Federal highway program is germane. Most States spend more than the amount required to receive the maximum allowable Federal highway grant.

How could we get more bang for the buck? An NEC working group is exploring issues related to Federal financing of infrastructure investment. Changes in the structure of grant programs could increase the impact of Federal outlays and boost the level of spending by State and local governments for infrastructure. One method for accomplishing this goal would be to ensure that Federal grant programs focus on reducing the cost of incremental infrastructure investment.

EYES ONLY

ARTICLE

The Double Dividend from Taxing "Bads"

Some individuals and businesses engage in activities that impose costs on others in society. For example:

- Each individual rush-hour driver slows the progress of everyone else wanting to use the same roadway at the same time. Congestion costs, including excess commuting time and wasted fuel, have been estimated at more than $30 billion per year nationwide.
- Smokers require additional health care that they do not always pay for themselves, and subject others to the hazards and discomforts of second-hand smoke. They also drive up group life insurance premiums, take extra sick leave, and cause property loss from fires. On net, excluding the cost to smokers themselves (which are much higher), the various costs that smokers impose on others have been estimated at roughly 33 cents per pack of cigarettes.
- Similarly, drinkers require extra medical care that they do not always pay for themselves, and drunk drivers pose a great danger to others who use the roadways. (45 percent of all traffic fatalities in 1992 were alcohol-related.) Overall, the external costs of alcohol consumption have been estimated at about 70 cents per ounce of alcohol, or about $2.20 per six-pack of beer.

Provided they are set at an appropriate level, taxes are one way to discourage private activities that impose substantial costs on others. They achieve this objective by making individuals and businesses confront the "all-inclusive" cost of such activities.

Getting the tax right. From a purely economic perspective, taxes on such activities should be calibrated to offset their social costs. For example, highway tolls should be set to recoup the monetary cost that each driver imposes on others through increased congestion and pollution. And alcohol taxes should be set to confront each drinker with the full cost of his/her behavior, including health, insurance, and property damage consequences. But it can be difficult to choose the right tax rate and to administer and ensure compliance with the tax.

The "double dividend." The revenues generated by taxing "bads" can be used in ways that yield additional benefits. For example, revenues from an increased tax on pollution could be used to fund new public investment. Or, they could be used to fund reductions in tariff rates or other taxes with no net loss of government revenues.

Recent initiatives. Taxes on "bads" have attracted considerable attention recently in the American environmental community. This week, a conference sponsored

EYES ONLY

jointly by the Environmental Protection Agency and the Council of Economic Advisers focused on the possible role of "greenfees" or "ecological taxes" in reducing the "externalities" polluters impose on the rest of society.

Greenfees are also a hot topic in Europe. For example, the recent White Paper on Employment issued by the European Commission proposes to shift part of the tax burden away from payroll taxes—which the Commission views as excessively high in some countries—toward greenfees such as pollution taxes.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Bretton Woods Report Calls for Reform. The Bretton Woods Commission, chaired by Paul Volcker, issued a report last week calling for changes in the role of the International Monetary Fund (IMF) and the World Bank Group. The report encouraged the World Bank Group to focus on long-term development issues, giving special attention to areas in which the private sector has failed, such as investment in infrastructure and human resources, relief of poverty, and support of environmentally sustainable development. In contrast, the report recommended that the IMF concentrate its attention on the international monetary system and macroeconomic adjustment issues, including exchange-rate volatility and macro policy coordination.

Exports of Autos to Mexico Surge. During the first six months of the North American Free Trade Agreement, exports of automobiles and trucks from U.S. and Canadian subsidiaries of the "Big Three" to Mexico increased dramatically. In January through June of 1994, these exports totalled 23,275 vehicles—more than 6 times the number of units that were exported during the same period last year.

Employees Gain Control of United Airlines. The shareholders of UAL Corporation, the parent of United Airlines, approved a buyout that will make UAL the second largest employee-owned company in the United States. The workers received a 55 percent stake in the company in exchange for wage and work-rule concessions valued at $4.9 billion spread over 6 years. Even though the company currently is showing an operating profit, United sees the restructuring as necessary to ensuring its future ability to compete with low-cost rivals. The negotiated change in work rules will allow the creation of "an airline within an airline," called the United Shuttle (see Weekly Economic Briefing July 1, 1994), that will be able to go head-to-head against Southwest.

Heavy Truck Sales Set Record. Sales of heavy trucks set an all-time record in June of 17,247 units. Deliveries for the first half of 1994 are up more than 19 percent over the first half of 1993, and are on track to approach the record level of 173,000 units set in 1979. Major truck makers have been working near capacity to keep up with demand, and order books are filled into the first part of next year for the heaviest class of trucks. The industry sees no signs of a slowdown in demand, but the UAW walkout at Caterpillar might have some impact on supply.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

The producer price index for finished goods was unchanged in June. Excluding food and energy, the index edged down 0.1 percent.

Consumer Price Index

The consumer price index rose 0.3 percent last month. Excluding food and energy, consumer prices also rose 0.3 percent.

Retail Sales

Retail sales increased 0.6 percent in June. Excluding sales in the automotive group, retail sales were up 0.4 percent.

Industrial Production

The index of industrial production rose 0.5 percent in June. Total capacity utilization was up 0.3 percentage point to 83.9 percent.

MAJOR RELEASES NEXT WEEK

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

Industrial production and capacity utilization data **embargoed until 9:15 a.m., July 15, 1994 (Friday).**

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:3	1993:4	1994:1
Percent growth (annual rate)					
Real GDP	2.5	3.1	2.9	7.0	3.4
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	1.7	3.5	6.1	1.3
Manufacturing (1978-93)	2.3	4.8	2.6	7.9	6.9
Real compensation per hour	0.6	–0.3	1.2	–0.5	3.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	11.6	12.0	12.1
Residential investment	4.7	4.2	4.1	4.3	4.4
Exports	8.0	11.6	11.5	11.9	11.7
Imports	9.2	13.1	13.2	13.5	13.7
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.6
Federal surplus	–2.8	–3.5	–3.3	–3.2	–2.5

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Unemployment Rate	6.7*	6.8*	6.4	6.0	**6.0**

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

	1970–1993	1993	Apr. 1994	May 1994	June 1994
Payroll employment (thousands)					
increase per month			**401**	**252**	**379**
increase since Jan. 1993					**3840**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	**0.3**
PPI-Finished goods	5.0	0.2	–0.1	–0.1	**0.0**

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	May 1994	June 1994	July 14, 1994
Dow-Jones Industrial Average	3284	3522	3708	3738	3739
Interest Rates					
3-month T-bill	3.43	3.00	4.14	4.14	4.30
10-year T-bond	7.01	5.87	7.18	7.10	7.25
Mortgage rate, 30-year fixed	8.40	7.33	8.60	8.43	8.72
Prime rate	6.25	6.00	6.99	7.25	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 14, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.553	−1.3	−9.5
Yen-Dollar	98.2	−0.6	−8.4
Multilateral (Mar. 1973=100)	88.33	−1.3	−6.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.8 (Q1)	6.0 (Jun)	2.5 (Jun)
Canada	3.4 (Q1)	10.7 (May)	−0.2 (May)
Japan	−0.0 (Q1)	2.8 (May)	0.8 (Apr)
France	1.0 (Q1)	12.4 (Apr)	1.7 (May)
Germany	1.6 (Q1)	6.6 (Apr)	3.0 (May)
Italy	0.3 (Q4)	11.2 (Oct)	4.0 (May)
United Kingdom	2.9 (Q1)	9.6 (May)	2.5 (May)

EYES ONLY

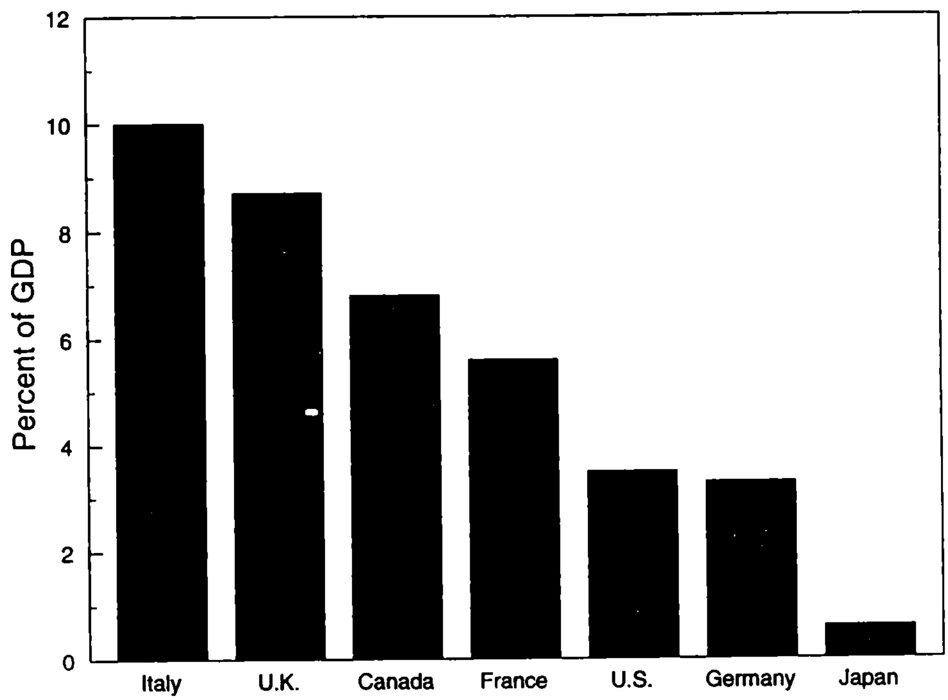
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 1, 1994

CHART OF THE WEEK

Government Budget Deficits in 1993
(all levels of government, calendar-year data)



Budget deficits differ widely across G-7 countries. For the most part, these discrepancies reflect differences in structural deficits, not just differences in cyclical position. Among G-7 countries, only Germany and Japan have a smaller deficit than we do.

EYES ONLY

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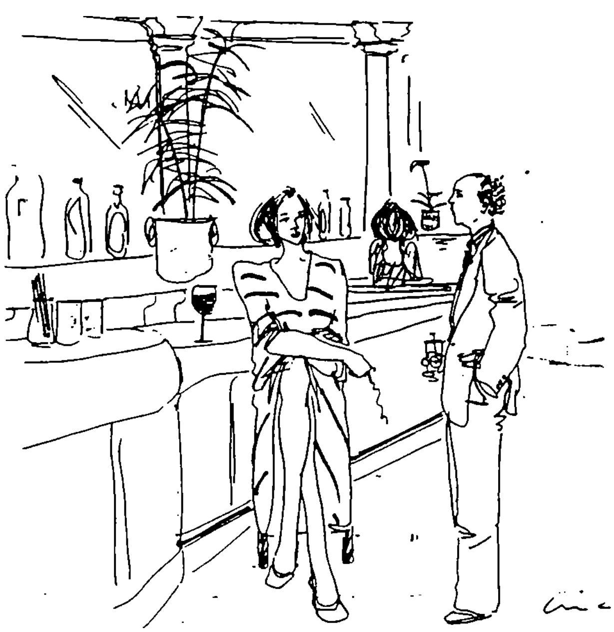


"I thought I had the flu last weekend, but it was my hedge fund."

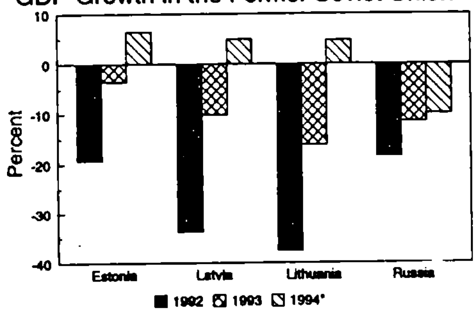
EYES ONLY

CURRENT DEVELOPMENT

Economic Stabilization in the Baltics

Throughout the former Soviet Union (FSU), output slumped and inflation erupted when the old order collapsed. The first signs of economic growth and a slowdown in inflation are more apparent in Estonia, Latvia, and Lithuania than in any of the other successor states of the FSU (see charts).

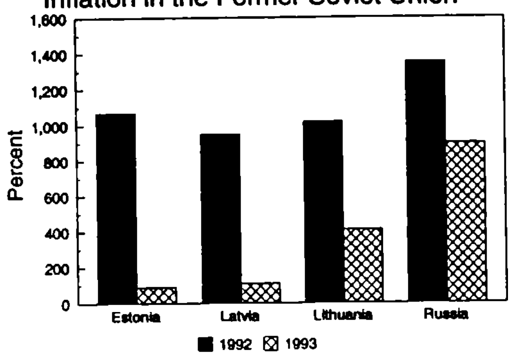
GDP Growth in the Former Soviet Union



*IMF projections

The Baltics have some advantages relative to the other countries of the FSU: They are close to Western Europe and blessed with good ports. They are also small, and can therefore benefit significantly even from modest amounts of foreign aid.

Inflation in the Former Soviet Union



But sound economic policies have also contributed to the relative success of the Baltics, and their experience is serving as an example elsewhere —particularly in Russia. All of the Baltic nations have established stable and credible monetary policies, slashed the size of their governments, kept their budgets roughly in balance, liberalized trade, and begun the process of privatization.

Analysis. The adjustment process has not been painless. Output fell sharply until mid-1993. Employment has also dropped significantly. In Estonia, for example, employment fell 15 percent between 1991 and 1993. And although inflation is down and GDP growth has resumed, much remains to be done. The Baltics must still establish a framework for private economic activity, including well defined private property rights and rules of corporate governance. Investment is likely to be impeded until the legal framework is strengthened.

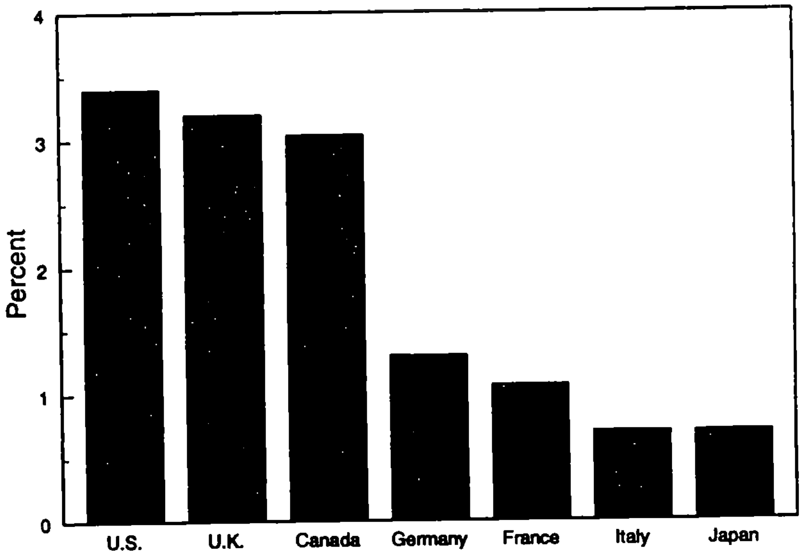
EYES ONLY

SPECIAL ANALYSIS

Business Conditions in the G-7 Countries

The G-7 economies are moving forward at different speeds. The American, British, and Canadian economies are expanding steadily. But the continental European and Japanese economies are only in the early, tentative, stages of recovery (see chart).

Annualized GDP Growth Since Tokyo Summit



Is Japan reviving? Real GDP grew at a strong 3.9 percent annual rate in the first quarter. However, real GDP also surged in the first quarters of 1992 and 1993 only to decline subsequently, mainly in response to declining investment spending. And industrial production has fallen in both April and May of this year. Even if recovery does take hold this year, it is unlikely to be robust.

Prospects for economic growth in continental Europe have improved. The French, German, and Italian economies are expected to grow this year, but not sufficiently rapidly to bring down unemployment rates (see Weekly Economic Briefing, May 27, 1994). Exports, spurred in part by strong growth in the United States, are expected to be an important engine of growth for Europe. Fiscal and monetary policy, however, are unlikely to provide much additional stimulus:

- Budget deficits are seen as severely constraining fiscal policy (see Chart of the Week). Germany and Italy are tightening fiscal policy even at the risk of slowing their recoveries.

- The Bundesbank has been cutting interest rates slowly since September 1992. The discount rate has been notched down six times since the end of June 1993—from 7-1/4 percent to 4-1/2 percent. Improved growth prospects and rapid monetary growth,

EYES ONLY

however, reduce the likelihood of additional cuts by the Bundesbank. Other countries in the Exchange Rate Mechanism of the European Monetary System have been following Germany's lead on interest rates. So further cuts in interest rates elsewhere in Europe have also become less likely.

The dollar and G-7 growth. A stronger dollar would make American goods less competitive in world markets. This would help the continental European countries achieve their goal of export-led growth and reduce the squeeze on Japanese exporters. Both higher U.S. interest rates and lower European interest rates would contribute to a strengthening of the dollar. But higher U.S. interest rates would also tend to slow U.S. growth, thereby dampening the beneficial effects of a stronger dollar on European exports to the United States. In contrast, lower European interest rates would contribute both to a strengthening of the dollar and to a strengthening of the European recovery.

EYES ONLY

ARTICLE

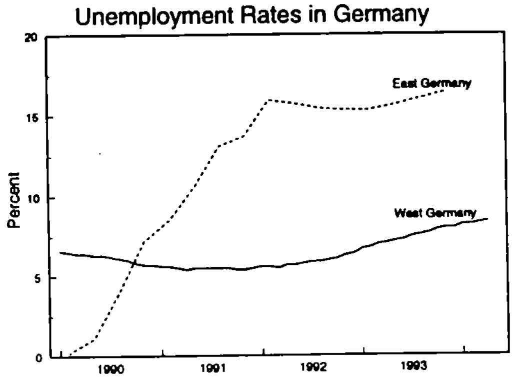
Update on Germany: Legacies of the Decision to Unify at Par

A crucial economic issue in German re-unification was how to set the terms of conversion between East German ostmarks and West German deutsche marks. Productivity in West Germany was about 3 times as high as productivity in East Germany at the time of unification, suggesting that the ostmark was "worth" less than the deutsche mark. But policymakers feared that conversion at less than par—at less than one ostmark for one deutsche mark—would unleash a huge population migration from east to west. So they decided to convert at par. At the same time, they also decided to extend the generous West German social safety net to the East German population. The consequences of these decisions are still reverberating through the German and world economies today.

Conversion at par meant that production costs measured in deutsche marks were much higher in the east than in the west after re-unification, and this caused a sharp contraction of output and employment in the east. The extension of the West German social safety net to the east meant a huge transfer of resources from the west to maintain the incomes of citizens in the east. In 1991, transfers amounted to nearly 70 percent of East German GDP, or nearly $5,000 per East German citizen.

- **Consequences for the labor market.** To limit the initial dislocation caused by reunification and reform, subsidies were funnelled into enterprises operating in the east. Nonetheless, the unemployment rate in the East soared from virtually zero at the start of 1990 to more than 15 percent by the beginning of 1992, and an estimated 38 percent of East German jobs have been lost since 1989. As employment has contracted and new investment has been undertaken, worker productivity in the east has risen rapidly but convergence to the level in the west is far from complete.

Unemployment Rates in Germany



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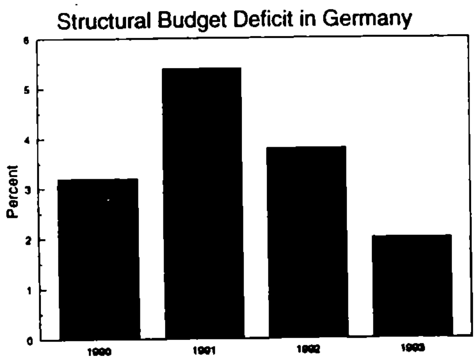
- **Budgetary consequences.** The transfers from west to east caused the German federal budget deficit to worsen sharply (see chart).



The huge borrowing needs of the government, interacting with relatively restrictive monetary policy, caused real interest rates to rise.

Prospects for the future. The Germans have been trying to bring their deficit down, and further fiscal restraint is scheduled to be applied next year, with the reinstatement of the "solidarity surcharge" on income tax. Meanwhile, unemployment in Germany is still rising, interest rates are still high, and transfers from west to east remain a huge drain on the federal budget.

Implications of German Unification for the DM/$ Exchange Rate

The massive fiscal expansion associated with unification supported the deutsche mark against the dollar. To combat the inflationary impetus of the government spending, the Bundesbank has kept interest rates relatively high in real terms, making German securities attractive to international investors. Some observers have noted a parallel between the appreciation of the deutsche mark over this period and the appreciation of the dollar during the early and mid-1980s. In the U.S. case, dollar appreciation was caused by the interaction of the Reagan fiscal expansion with relatively tight monetary policy.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Frost in Brazil Heats Up Coffee Prices. Following an unexpected weekend frost in the coffee-growing regions of Brazil, coffee futures prices rose this week to their highest levels since 1986. Since last Friday, short-term coffee futures prices have risen 50 percent. Brazil is the world's largest coffee grower, currently producing about a quarter of the world supply and specializing in the high quality Arabica coffees that U.S. coffee drinkers prefer. The frost is not expected to affect Brazil's crop for this year, which is already being harvested, but some early estimates predict damage to 20 percent of next year's crop. The damage could be worse: Low coffee prices for the past four years encouraged growers to reduce spending on fertilizer; as a result, the plant stock is extremely vulnerable to frost. Higher prices are already filtering through to the consumer level.

New Low Cost Airline Ready to Take Off. UAL Corp., the parent of United Airlines, announced last week that its new low-cost, short-flight airline will begin operations in October. The new airline, known for now as U2, will emulate the quick-turn model of the profitable Southwest Airlines but with a few extras including assigned seats, a first class section, and frequent-flier miles. Initially, U2 will fly in the West, where United already has a strong presence. But it will face stiff competition from Southwest, which plans a vigorous defense of its command over the California market.

U.S. Auto Makers Gaining in Japan. Sales in Japan of U.S.-made cars have been strong thus far this year, and the Big Three expect to reach a 35,000 unit total for the year as a whole—an 80 percent increase over 1993. While this is a dramatic increase, American-made cars still account for less than 1 percent of the Japanese market (indeed, total foreign imports account for only about 6 percent). Better quality, competitive prices, and increased availability of right-drive vehicles are the basic reasons behind the increase in sales of U.S. vehicles.

EYES ONLY

RELEASES THIS WEEK

Consumer Confidence—Conference Board

Consumer Confidence, as measured by the Conference Board, rose 3.1 index points in June, to 92.0 (1985=100).

Gross Domestic Product

The growth of GDP during the first quarter of this year was revised up 0.4 percentage point, and now is estimated at 3.4 percent at an annual rate.

Personal Income and Expenditures

Personal income rose 0.6 percent in May (monthly rate), while disposable personal income (personal income less taxes and other adjustments) rose 1.2 percent. Personal consumption expenditures rose 0.4 percent in May (monthly rate).

Leading Indicators*

The index of leading economic indicators was unchanged in May.

MAJOR RELEASES NEXT WEEK

Employment for June (Friday)

***Leading indicators data embargoed until 8:30 a.m., Friday, July 1.**

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1993	1993:3	1993:4	1994:1
Percent growth (annual rate)					
Real GDP	2.5	3.1	2.9	7.0	**3.4**
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	1.7	3.5	6.1	1.3
Manufacturing (1978-93)	2.3	4.8	2.6	7.9	6.9
Real compensation per hour	0.6	−0.3	1.2	−0.5	3.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	11.6	12.0	12.1
Residential investment	4.7	4.2	4.1	4.3	4.4
Exports	8.0	11.6	11.5	11.9	11.7
Imports	9.2	13.1	13.2	13.5	13.7
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.6
Federal surplus	−2.8	−3.5	−3.3	−3.2	−2.5

		1993	Mar. 1994	Apr. 1994	May 1994
Unemployment Rate	6.7*	6.8*	6.5	6.4	6.0

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

		1993	Mar. 1994	Apr. 1994	May 1994
Payroll employment (thousands)					
increase per month			379	358	191
increase since Jan. 1993					3357
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.1	0.2
PPI-Finished goods	5.0	0.2	0.2	−0.1	−0.1

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Apr. 1994	May 1994	June 30, 1994
Dow-Jones Industrial Average	3284	3522	3661	3708	3625
Interest Rates					
3-month T-bill	3.43	3.00	3.68	4.14	4.15
10-year T-bond	7.01	5.87	6.97	7.18	7.34
Mortgage rate, 30-year fixed	8.40	7.33	8.32	8.60	8.57
Prime rate	6.25	6.00	6.45	6.99	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 30, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.586	–0.9	–7.0
Yen-Dollar	98.6	–2.4	–7.9
Multilateral (Mar. 1973=100)	89.67	–0.8	–4.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**3.8** (Q1)	6.0 (May)	2.3 (May)
Canada	3.4 (Q1)	11.0 (Apr)	–0.2 (May)
Japan	–0.0 (Q1)	2.9 (Mar)	0.8 (Apr)
France	1.0 (Q1)	12.4 (Mar)	1.7 (May)
Germany	1.6 (Q1)	6.7 (Feb)	3.0 (May)
Italy	0.3 (Q4)	10.6 (Jul)	4.0 (May)
United Kingdom	2.9 (Q1)	9.7 (Apr)	2.5 (May)