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EYES ONLY

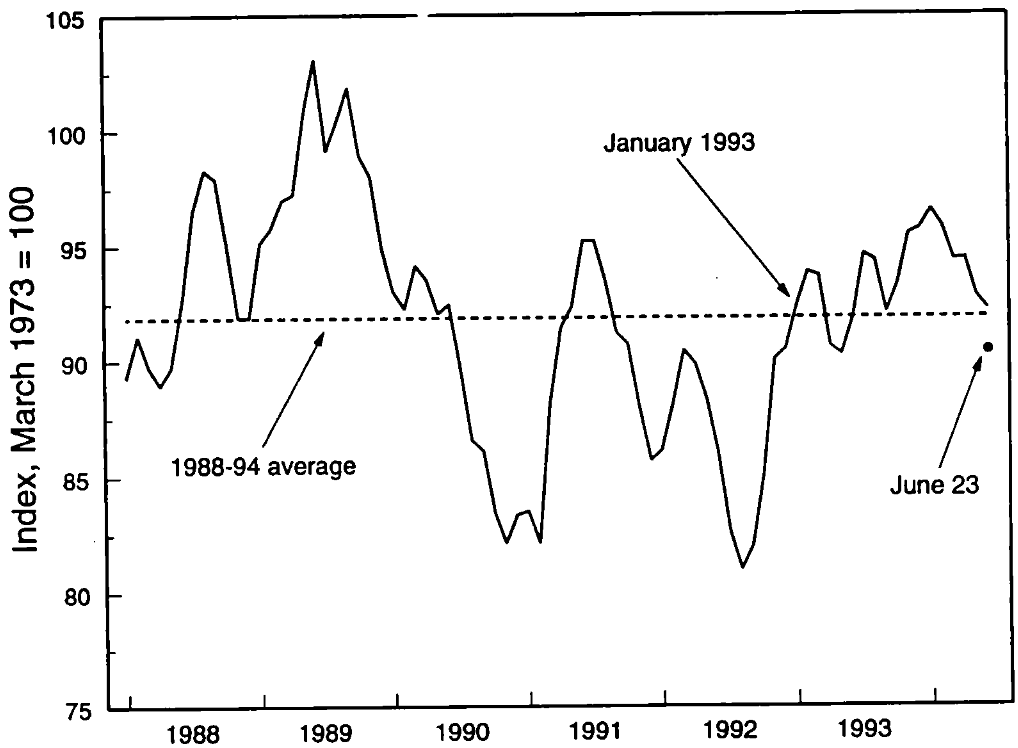
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 24, 1994

CHART OF THE WEEK

The Value of the Dollar (monthly)



The foreign exchange value of the dollar against the currencies of our major trading partners has fluctuated from 1988 to the present with no apparent trend. Since the beginning of this year, the value of the dollar has declined, but its current value is not low by recent historical standards: In mid-1992, for example, the value of the dollar against this basket of currencies was more than 10 percent lower than it is today.

EYES ONLY

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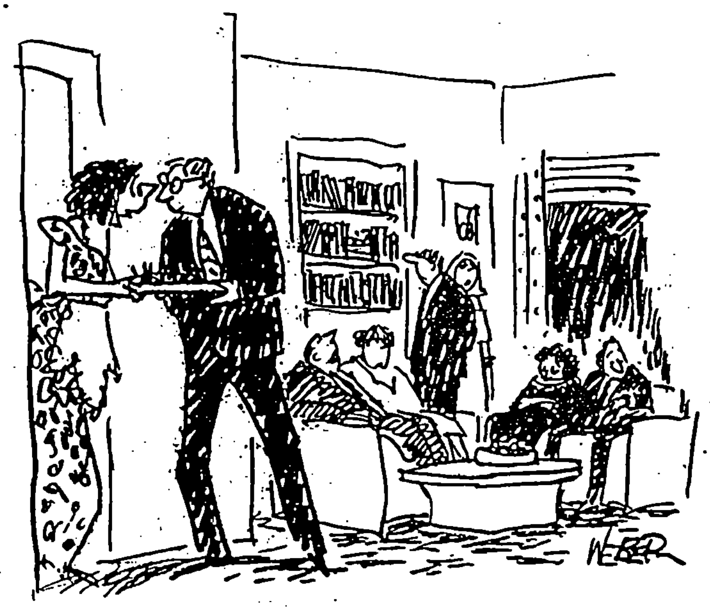


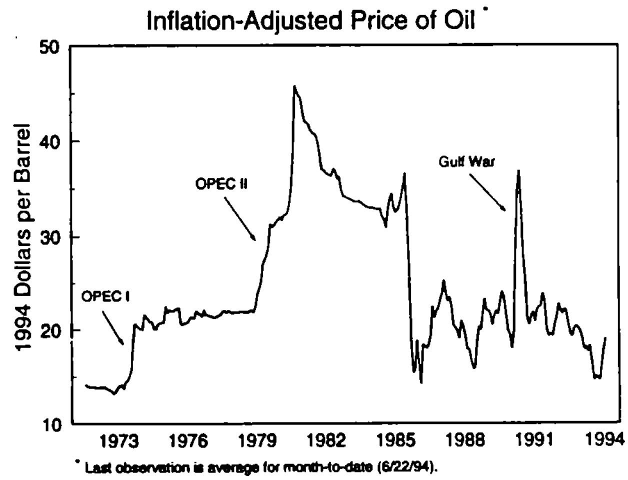
"Do something, quick. How about your cute little impersonation of Alan Greenspan?"

EYES ONLY

CURRENT DEVELOPMENT

Oil Prices Reverse Earlier Decline

Oil prices have rebounded from their turn-of-the-year lows, and now are about the same as they were a year ago. Despite the recent increases, oil prices in real terms remain near the low end of their range over the past 20 years (see chart).



Analysis. Several factors have contributed to the runup in oil prices. On the demand side, prospects for recovery in Japan and Europe have brightened. On the supply side, OPEC recently decided to hold production to current levels, and the U.N. has maintained restrictions on Iraqi shipments.

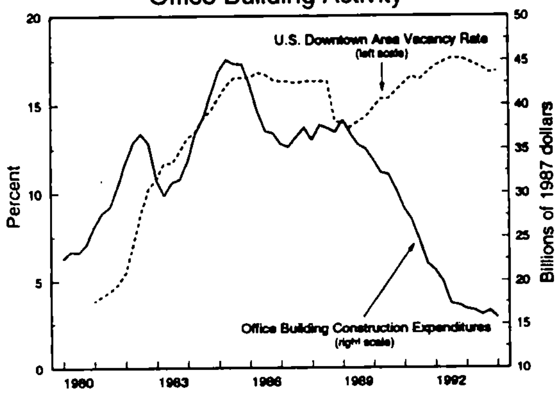
The recent runup in oil prices has left them higher than assumed in our mid-session budget review forecasts. If the recent rise is not reversed, it would reduce GDP growth about 0.2 percentage point below our forecast and raise CPI inflation about 0.3 percentage point above our forecast. Of course, if these recent price increases prove to be transitory, as was last autumn's decline, their impact on the economy will be much smaller.

CURRENT DEVELOPMENT

Market for Office Buildings Remains Weak

Construction expenditures for office buildings remain at very low levels (see first chart). The pace in the first quarter of this year, at $15 billion (in inflation-adjusted terms), was only about one-third of the peak rate realized in 1985.

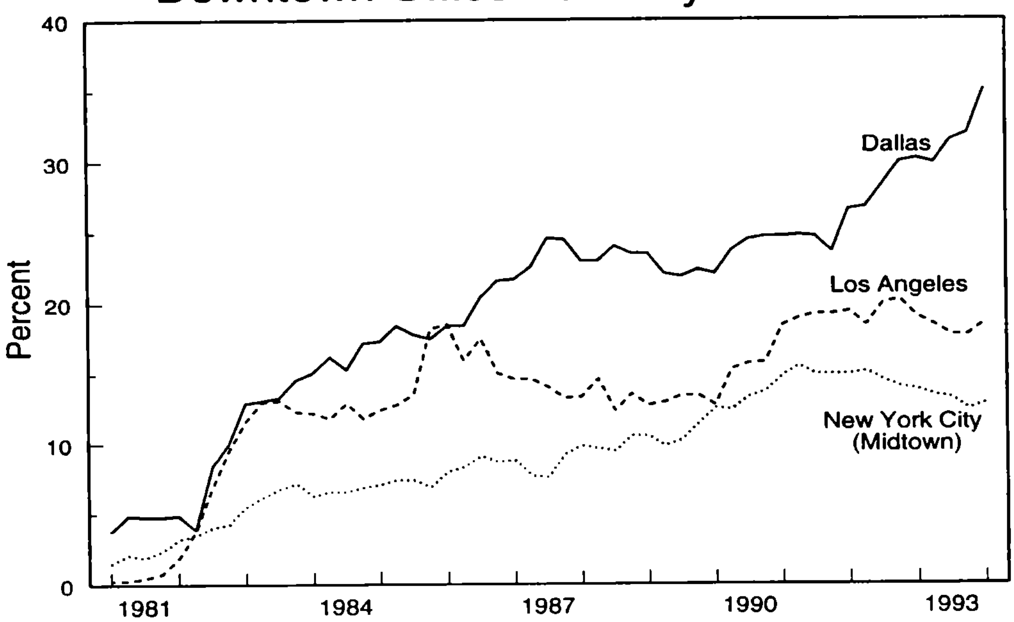
Office Building Activity



Analysis. The national vacancy rate for office buildings in downtown areas has barely declined from its 1992 high (also shown in the first chart). This indicator bodes ill for future construction activity.

Trends in vacancy rates differ widely across local markets (see second chart). Some downtown areas, including midtown Manhattan, Denver, and Boston, have seen a significant reduction in vacancy rates, while in other areas, including Dallas, Houston, and Detroit, the vacancy rate continues to rise. The vacancy rate in Los Angeles has been about flat for the last few years.

Downtown Office Vacancy Rates



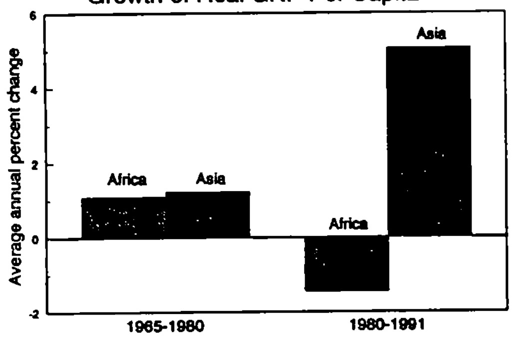
EYES ONLY

TREND

Living Standards in Africa: The "Lost Decade"

Per capita income in sub-Saharan Africa has fallen since 1980 (see chart). This decline stands in sharp contrast to the rapid growth in Asian countries that were about as poor in 1965.

Growth of Real GNP Per Capita



Note: Chart includes low-income countries only.

For example, per capita income in Nigeria in 1965 was 28 percent higher than in Indonesia. By 1980, Indonesia had closed the gap to 10 percent. And since 1980, Indonesia's per capita GNP has increased nearly 4 percent per year while Nigeria's has declined. Indonesia's per capita income now exceeds Nigeria's by nearly 80 percent.

Analysis. Declining prices for Africa's commodity exports—such as coffee and cocoa, whose prices have fallen by half since 1980—explain part of the difference between Asia's "miracle" and Africa's decline. But differences in economic policy have also been important. African countries have suffered from high inflation, large budget deficits, and overvalued currencies. In addition, they have been slow to privatize inefficient state enterprises, and have impeded agricultural productivity through policies such as price controls. Moreover, rampant population growth poses other economic challenges.

Perhaps most importantly, the Asian emphasis on education—especially primary schooling—helped raise economic growth. In Africa, in contrast, a smaller and declining fraction of school-age children received primary education during the 1980s.

Alternative Measures of Well-Being

Since 1960, low-income countries have achieved significant improvements in life expectancy and literacy, and low-income African countries are no exception. But African countries still lag behind other countries that were similarly poor in 1965. In Africa, 50 percent of adults are now literate and life expectancy is 52 years, but in East Asian developing countries, adult literacy is 76 percent and life expectancy is 68 years.

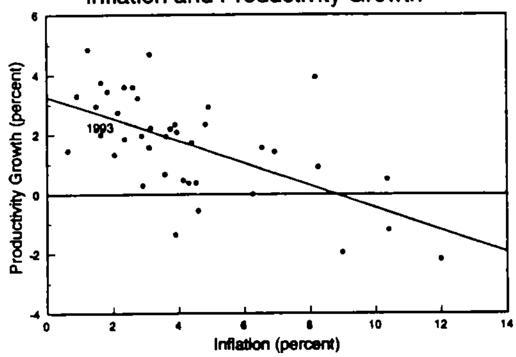
EYES ONLY

ARTICLE

Does Lower Inflation Raise Productivity?

In recent testimony to Congress and in other public statements, Fed Chairman Alan Greenspan has noted that productivity growth in the United States during the postwar period has been higher, on average, when inflation has been lower (see chart). A recent Fed study documents that inflation and productivity growth have indeed tended to move inversely in the United States throughout the postwar period—not just during the 1970s—and that the same link is evident in data for Canada and England, but not in data for Germany or Japan. Chairman Greenspan has interpreted the evidence for the United States as buttressing the case for keeping inflation low and perhaps even driving it lower.

Inflation and Productivity Growth



Why is this issue important? If lower inflation leads to faster productivity growth, then reducing inflation might be the best way to bolster living standards over time. Moreover, if the beneficial effects of low inflation are large, the short-run pain involved in getting inflation down will be recouped relatively quickly.

Why are inflation and productivity linked? The conventional view among economists has been that causation runs in the opposite direction: that high productivity growth leads to low inflation. After all, one reason why firms undertake productivity-enhancing investment is precisely to reduce their costs and thus to improve their ability to offer lower prices. On close examination, however, the data are not particularly friendly toward this hypothesis: Improvements in productivity do not precede reductions in inflation, as one might expect if productivity growth were the driving factor.

Another possible explanation for the inflation-productivity link focuses on the role of oil prices: An increase in the price of an imported input like oil will both raise prices and reduce output. While this explanation makes sense, it too is not supported by the evidence: The relationship between inflation and productivity growth was just as pronounced in the 1960s and 1980s as it was in the 1970s, when changes in oil prices were dramatic. So the question arises:

Does lower inflation really cause higher productivity? This is the question that has motivated much recent research. Thus far, the empirical results for the United States are inconclusive. This is not surprising because there is no obvious reason why inflation should adversely affect productivity. One possible reason is that, when inflation is high, managers divert their attention from productive to unproductive activities—spending too much time worrying about financial manipulations to "beat inflation" and not enough time "minding the store." This explanation appears to have some merit during periods of very high inflation when the benefits of actions to beat inflation may be quite large. But it is not particularly convincing for periods of moderate inflation like those characteristic of the U.S. economy during the postwar period.

Another possible explanation builds on the observation that, historically, inflation has been less predictable when it has been high. Unpredictable inflation leads to all kinds of mistakes: Businesses make the wrong products, they invest in the wrong types of equipment, and they focus too much on the short term. Lack of predictability also makes lenders nervous, so they add a risk premium to their loan rates—thus increasing the cost of capital and reducing the level of investment.

Like the two explanations reviewed earlier, neither of these stories about how low inflation leads to high productivity growth squares particularly well with the facts. Both hypotheses seem most plausible as explanations of long-run trends, not year-to-year fluctuations. But the evidence suggests that the correlation between productivity and inflation is mainly a short-run phenomenon.

Conclusion. Despite inconclusive empirical evidence and debatable analytical explanations, the idea that lower inflation causes higher productivity is becoming more important in policy debates about inflation. In the meantime, debate is sure to continue as Congressional staff, academics, and others weigh in on the matter.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More Hospital Mergers on the Horizon. A recent Deloitte & Touche survey of 1,200 hospital executives found that 81 percent expect their hospital to become involved in some sort of alliance, merger, or network within five years. Currently, only 24 percent are. The survey also found that hospitals are becoming more willing to work with HMOs. Of the hospitals surveyed, fewer than 50 percent had formal dealings with HMOs eight years ago; more than 80 percent have such relationships today. And 98 percent predict that they will have some sort of agreement with an HMO by 1996.

Callbacks Ringing Up Profits. A growing number of people around the world are escaping expensive international telephone rates by using callback services. To use a callback service, a customer dials a special number in the United States and then hangs up. This call triggers a return call to the customer, who gets a dial tone to make an international call. The customer is billed at the much lower U.S. rates. In the past year, the number of callback companies has increased fivefold to 100, and market volume has risen to $200 million. Although the industry has survived an earlier bid by AT&T to halt the practice, it still faces many legal challenges from abroad. As these services become even more common, they may begin to exert real downward pressure on the prices charged by less competitive foreign carriers.

Beige Book Indicates Continued Expansion and Moderate Inflation. On Wednesday, the Federal Reserve released the latest edition of its "beige book" survey of economic conditions. The survey paints a picture of continued economic expansion, though at a more measured pace. It also reports only moderate upward pressure on prices, generally favorable crop conditions, and strong home sales in most areas of the country. The San Francisco Fed reports that economic conditions are improving slowly in California. Higher crude oil prices have induced a slight increase in drilling activity in the Kansas City District; drilling activity in other districts, however, is reported to be about unchanged or even down a notch.

Catching Polluters on Film. In the future, cars that pollute may be captured on film by a sensing device known as a "green camera." The device, developed some time ago at Denver University and tested this week in the U.K., uses infrared and ultraviolet beams to measure the pollution emitted from passing cars. If it finds illegal levels, a photo of the car's license is then turned over to the police. Supporters of the "green camera" believe that it could drastically reduce carbon monoxide emissions from the worst polluters. California authorities will be testing the equipment next month.

EYES ONLY

RELEASES THIS WEEK

U.S. International Trade

The goods and services trade deficit rose to $8.4 billion in April from $6.9 billion in March.

Durable Goods

According to advance estimates, new orders for durable goods were up 0.9 percent in May, the third consecutive monthly increase.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Gross Domestic Product (Wednesday)
Personal Income and Expenditures (Thursday)
Leading Indicators (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	3.0
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.

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

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Apr. 1994	May 1994	June 23, 1994
Dow-Jones Industrial Average	3284	3522	3661	3708	3699
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	7.10
Mortgage rate, 30-year fixed	8.40	7.33	8.32	8.60	8.46
Prime rate	6.25	6.00	6.45	6.99	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 23, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.601	–1.8	–5.4
Yen-Dollar	101.1	–2.0	–7.1
Multilateral (Mar. 1973=100)	90.39	–1.6	–3.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.7 (Q1)	6.0 (May)	2.3 (May)
Canada	3.4 (Q1)	11.0 (Apr)	0.2 (Apr)
Japan	–0.0 (Q1)	2.9 (Mar)	1.4 (Mar)
France	1.0 (Q1)	12.4 (Mar)	1.7 (Apr)
Germany	1.6 (Q1)	6.7 (Feb)	3.2 (Apr)
Italy	0.3 (Q4)	10.6 (Jul)	4.1 (Apr)
United Kingdom	2.6 (Q1)	9.7 (Apr)	2.5 (Apr)

EYES ONLY

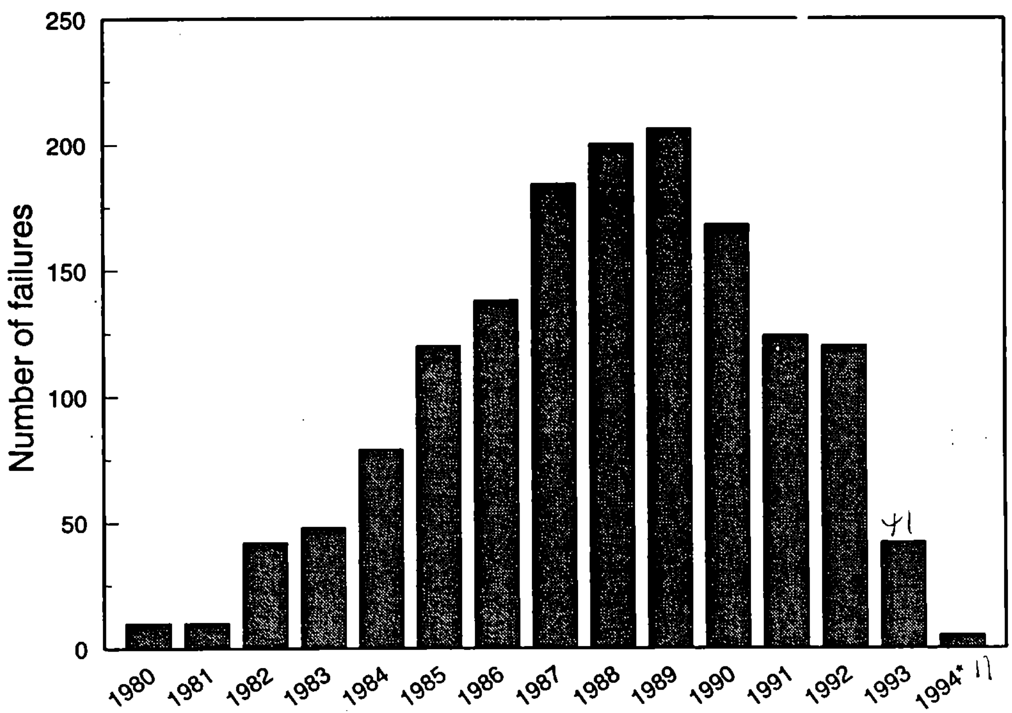
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 17, 1994

CHART OF THE WEEK

Bank Failures



* total through June 13, 1994

The chart shows the number of failed banks insured by the Bank Insurance Fund from 1980 through the present. Failures soared in the mid- and late-1980s, reflecting in particular the oil-related downturn in the Southwest and the end of the commercial real estate boom in the Northeast. More recently, failures have subsided dramatically as the economy has improved and bank profit margins have widened.

EYES ONLY

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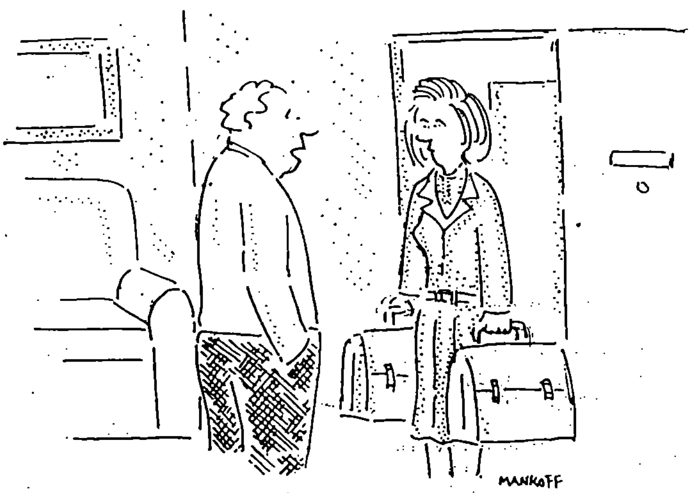


"My God, Ellen, I didn't think our relationship was so interest rate-sensitive."

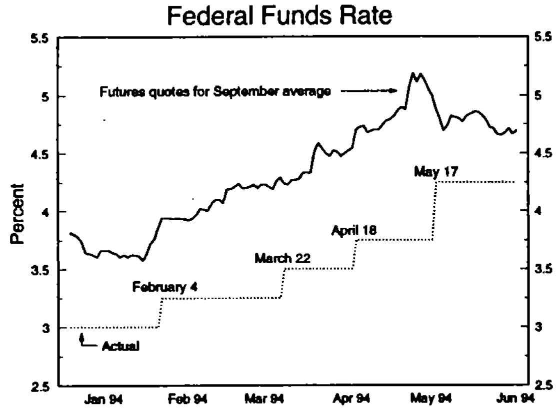
EYES ONLY

CURRENT DEVELOPMENT

Financial Markets Bet on More Fed Tightening

Financial market participants expect the Federal Reserve to increase the rate on federal funds further in the next month or two. Currently, prices in the federal funds futures market (see box) predict that the federal funds rate will average nearly 4-3/4 percent in September, or nearly 1/2 percentage point above its current level (see chart). Such a level could be reached, for example, if the Fed were to notch up the funds rate 1/4 percentage point at both its July and August meetings.

Federal Funds Rate



About a month ago, the market was expecting the funds rate to reach an even higher level by September, but developments since then, including the most recent action by the Fed on May 17, have apparently damped those expectations somewhat. At this point, both financial market participants and most economic forecasters predict a further increase in short-term interest rates during the second half of the year. But the former anticipate a larger increase than the latter.

Analysis. Expectations about future rate hikes are probably already reflected in current long-term interest rates. Therefore, if the Fed increases the funds rate in line with current market expectations, long-term interest rates probably would not change much from their current levels. If, however, the Fed were to move more aggressively than the market now expects, it is likely that long-term interest rates would increase further, exercising an additional contractionary influence on economic activity.

The Market for Federal Funds

The federal funds market allows banks to borrow and lend reserves at an interest rate known as the federal funds rate. The federal funds futures market allows banks to place bets on the future course of the federal funds rate.

EYES ONLY

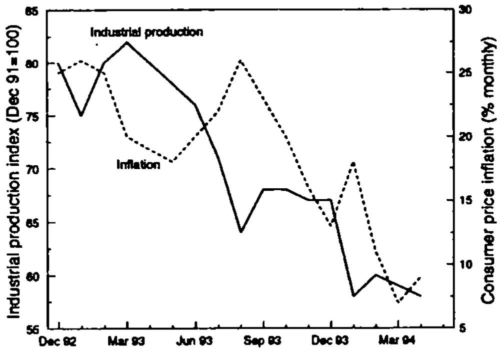
SPECIAL ANALYSIS

Chernomyrdin Leads Stabilization Effort in Russia

Confounding the predictions of both Western pundits and Russian reformers, Prime Minister Victor Chernomyrdin has been pursuing a tough stabilization policy since the reshuffling of the government last December.

Until recently, an extensive system of government subsidies in Russia was maintaining output at an unsustainable level and boosting the rate of inflation (see Weekly Economic Briefing, January 7, 1994). But Chernomyrdin has slashed those subsidies and promised to keep the budget deficit under 10 percent of GDP this year (down from more than 20 percent in 1992). He has also been promoting a tighter monetary policy to reduce inflation from more than 20 percent per month in 1993 to less than 10 percent per month by the end of this year.

Industrial Production and Inflation in Russia



Already, the effects of these restrictive policies are being felt. Both output and inflation are down significantly (see chart). And official unemployment—while still only about 2 percent—has been rising.

Analysis. Open unemployment in Russia has been suppressed largely by maintaining employment in wasteful and moribund industries. The experience of economic reform in other previously socialist economies suggests that if the Russian government continues to limit subsidies to state enterprises, a sharp increase in unemployment is likely. During Poland's stabilization period, for example, the unemployment rate jumped from 6 percent in 1990 to 15 percent in 1992. The creation of new jobs in the private sector will help ease the unemployment problem caused by cutbacks in state enterprises. An effective social safety net (providing job search, training, and transitional income assistance) would be helpful, but both financing and technical design difficulties impede its implementation.

Are Official Russian Data on Unemployment Reliable?

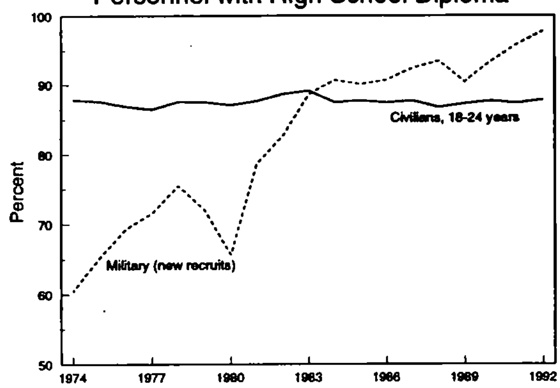
Official Russian data understate the extent of unemployment because people who are effectively no longer working may not be registering with the authorities. Unemployment benefits are meager (at about 10 percent of the average wage), and openly unemployed individuals lose the social benefits provided by many Russian firms. Independent researchers estimate that Russian unemployment is probably 2 to 3 times the officially reported rate of 2 percent.

TREND

Quality of Military Recruits Continues to Improve

The quality of new military recruits has been steadily improving since the establishment of the all-volunteer force in 1973. For example, the fraction of new recruits with a high school diploma has risen from about two-thirds in the mid-1970s to more than 95 percent in recent years (see chart). At the same time, there has been essentially no change in the fraction of young civilian workers with a high school diploma.

Personnel with High School Diploma



Analysis. The improving quality of recruits suggests that service in the Armed Forces remains an attractive opportunity for many potential volunteers, and that the current level of compensation paid to enlisted recruits is sufficient to allow the military to compete effectively in the labor market.

Meaningful comparisons of compensation between the military and civilian sectors are difficult to make for at least two reasons. First, the compensation package offered by the Armed Forces includes not only take-home wages but also free health care, PX privileges, housing allowances, and job training. In total, the non-wage benefits offered by the military are more generous than the non-wage benefits offered by civilian employers for comparable workers.

Second, the military employs mainly high school graduates in the enlisted ranks. Therefore, the compensation of newly enlisted personnel should be compared with the compensation of civilians with a similar level of education. Over the past decade or two, the relative wages of high school graduates in the civilian labor market have declined.

EYES ONLY

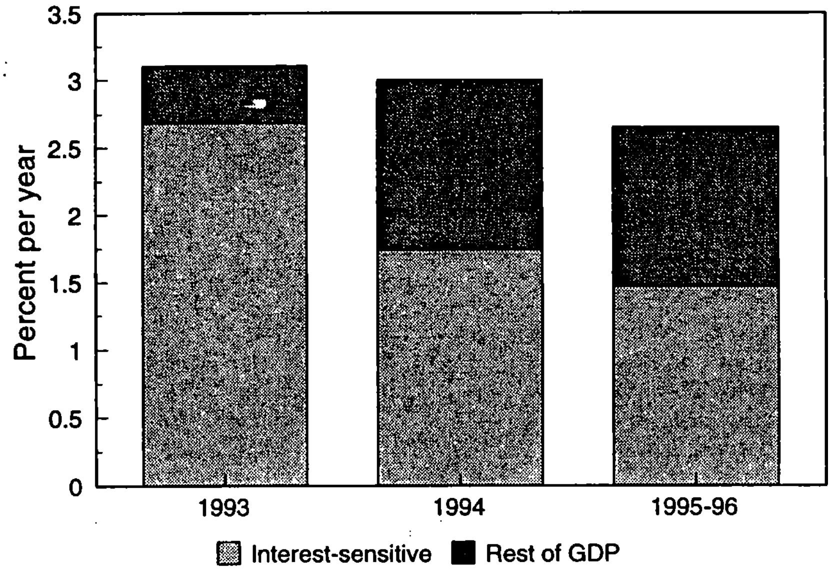
ARTICLE

Sources of GDP Growth as the Expansion Matures

To date, the economic expansion has been led by the interest-sensitive sectors of the economy—business investment, housing, and consumer purchases of cars and other durable goods. Spending in these sectors should continue to grow, although probably not as rapidly as in recent quarters.

As the expansion matures, other sectors will become more important sources of GDP growth (see chart). Shifts in the composition of growth away from the interest-sensitive sectors and toward the other components of GDP are typical in the middle stages of a business cycle.

Contributions to GDP Growth



In the near-term, there appears to be some scope for accumulation of inventories, which have been at low levels relative to sales (see Weekly Economic Briefing, May 6, 1994). In the longer term, net exports should become less of a drag on GDP growth. Export growth has been held down thus far in the recovery by the lackluster economic performance of many of our trading partners, especially continental Europe and Japan. Exports should accelerate, however, as those foreign economies strengthen. Growth of imports, which have been boosted noticeably by increased imports of capital equipment, should begin to taper off as business investment slows.

Investment will remain high. Despite the slowing in the rate of growth of investment spending, the level of investment (as a share of total GDP) will be high relative to historical experience. Investment relative to GDP was also high at a similar stage of the business cycle in the mid-1980s, although the composition of investment was quite different then: In that expansion, the mix of investment was more heavily weighted toward nonresidential structures. Such spending was stimulated by tax incentives, and much of it turned out to be relatively unproductive. In the current expansion, a larger share of investment spending has been devoted to business acquisition of equipment.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Japanese Government Limits Acceptance of American Rice. Cold, wet summer weather in Japan last year resulted in a catastrophically poor rice harvest, and forced Japan to open its rice market to a significant volume of imports for only the second time since 1968. California is a major foreign supplier of the medium-grain japonica rice favored by the Japanese. But the Japanese government-controlled rice marketing agency has taken steps to limit consumer acceptance of foreign rice, particularly American imports, by mixing japonica rice from the United States and Australia with long-grain indica rice from Thailand and labeling the result "American" rice. Because the two types of rice cook differently, the mixture is perceived to be of low quality.

Global Vital Signs Improve. A recent study by Worldwatch Institute reports signs of improving planetary health. The study says that global production of chlorofluorocarbons (CFCs) fell nearly 20 percent last year and is down 60 percent from its peak in 1988. This decline can be traced to a series of international agreements dating from the Montreal Protocol in 1987. The Copenhagen amendments signed in 1992 call for a complete ban on CFC production by the end of 1995. The EU nations have pledged to halt production by the end of this year. Estimates for global carbon emissions are essentially flat since 1989. However, this plateau masks soaring emissions in developing nations, especially in Asia.

Sprint Says Hello to European Partners. In a move to expand its global reach, Sprint announced this week that it will sell a 20 percent stake to the national carriers of France (France Telecom) and Germany (Deutsche Telekom) for $4.2 billion. The partnership plans to offer a wide variety of new services—voice, data and video services for multinationals, calling cards for consumers overseas, and a range of new wireless services. The Justice Department recently approved a similar agreement between MCI and British Telecommunications; approval from Justice will be required before the Sprint deal can proceed.

"Co-Provider" Marriages Bloom. A new study compares the contributions of young wives to family income in 1963 with their contributions in 1992. "Co-provider" marriages, in which the wife contributes between 30 and 70 percent of family income, have become increasingly common: Thirty years ago only about one-fifth of wives were in such marriages; today, more than two-fifths are. Marriages in which the wife provides more than 70 percent of family income have also become more common during this period, but still account for only about 5 percent of all marriages.

EYES ONLY

RELEASES THIS WEEK

Retail Sales

Retail sales declined 0.2 percent in May. Excluding sales at auto dealers, retail sales increased 0.3 percent.

Consumer Price Index

The consumer price index increased 0.2 percent in May. Excluding food and energy, the index was up 0.3 percent.

Industrial Production

The industrial production index increased 0.2 percent in May. Capacity utilization edged down to 83.5 percent.

Housing Starts

Housing starts increased 3 percent in May. Building permits decreased 2 percent.

MAJOR RELEASES NEXT WEEK

US International Trade in Goods and Services (Tuesday)
Durable Goods Manufacturers' Shipments and Orders (Thursday)

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	3.0
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.

			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 16, 1994
Dow-Jones Industrial Average	3284	3522	3661	3708	3811
Interest Rates					
3-month T-bill	3.43	3.00	3.68	4.14	4.11
10-year T-bond	7.01	5.87	6.97	7.18	7.07
Mortgage rate, 30-year fixed	8.40	7.33	8.32	8.60	8.33
Prime rate	6.25	6.00	6.45	6.99	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 16, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.631	–2.2	–1.7
Yen-Dollar	103.2	–0.8	–3.2
Multilateral (Mar. 1973=100)	91.87	–1.4	0.0

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.7 (Q1)	6.0 (May)	2.3 (May)
Canada	3.4 (Q1)	11.0 (Apr)	0.2 (Apr)
Japan	0.0 (Q4)	2.9 (Mar)	1.4 (Mar)
France	–0.3 (Q4)	12.4 (Mar)	1.7 (Apr)
Germany	1.6 (Q1)	6.7 (Feb)	3.2 (Apr)
Italy	0.3 (Q4)	10.6 (Jul)	4.1 (Apr)
United Kingdom	2.6 (Q1)	9.7 (Apr)	2.5 (Apr)

EYES ONLY

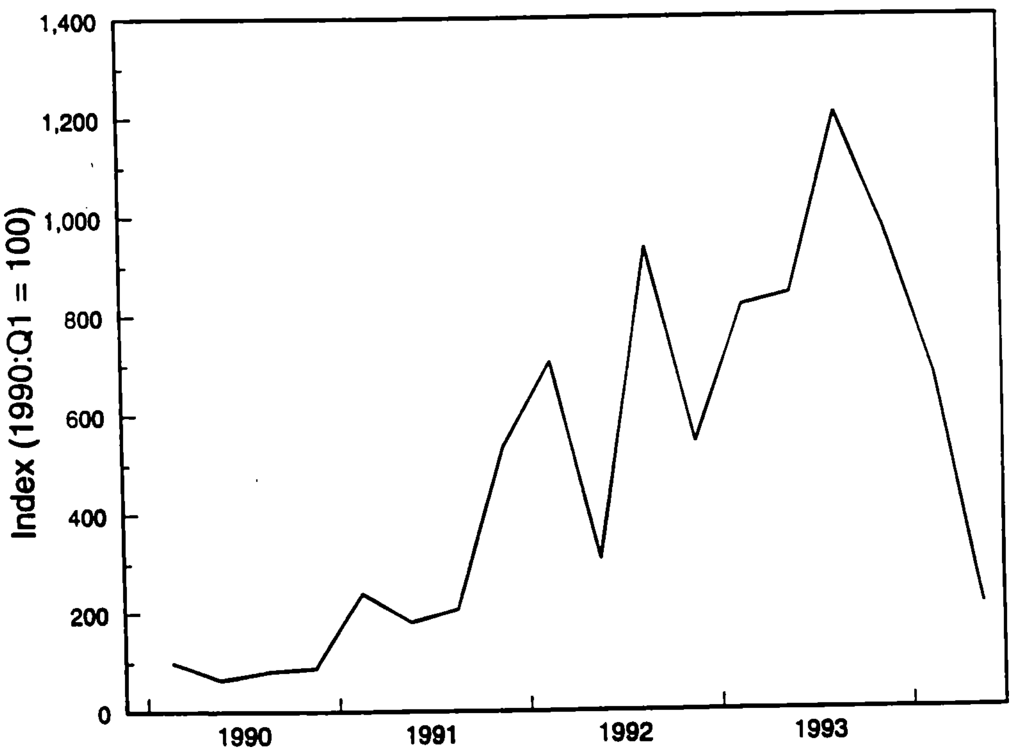
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 10, 1994

CHART OF THE WEEK

Volume of Applications for Mortgage Refinancing



The chart shows an index of the volume of applications for mortgage refinancing. Refinancing volume is generally high when interest rates are believed to be low or about to rise. The most recent peak in refinancing occurred in the second half of 1993. Since then, activity has dropped off markedly as mortgage rates have increased.

EYES ONLY

CONTENTS

"You'll always be much more than a commodity to me."

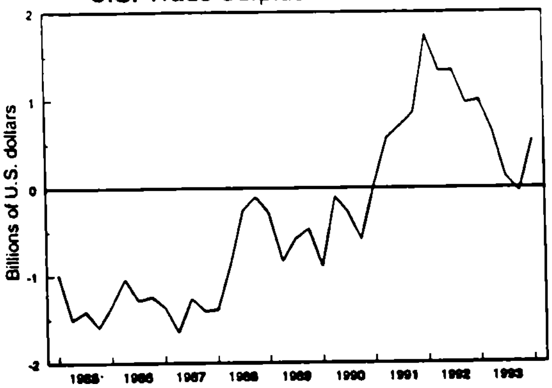
EYES ONLY

CURRENT DEVELOPMENT

U.S. Trade Surplus with Mexico Inches Up

NAFTA opponents often claimed that the Agreement would cause imports from Mexico to surge, and thus lead to substantial job losses in the United States. A press report earlier this week lent apparent support to this claim by noting that our trade surplus with Mexico in the first quarter of 1994 was only half as large as it had been in the same quarter 1 year earlier. But that report was misleading.

U.S. Trade Surplus with Mexico



Our trade surplus with Mexico did decline over the period mentioned in the press report—but that decline occurred entirely before NAFTA was implemented. Between the fourth quarter of 1993 and the first quarter of 1994, the surplus actually increased slightly (see chart).

Analysis. The decline in our surplus with Mexico during 1992 and 1993 is not surprising given that our economy was gathering strength while Mexico's economy was struggling. Indeed, Mexican GDP growth in 1993 was the lowest since 1986. With its political outlook uncertain, Mexico may continue to experience low economic growth in 1994. If so, our trade balance with Mexico may well deteriorate later this year.

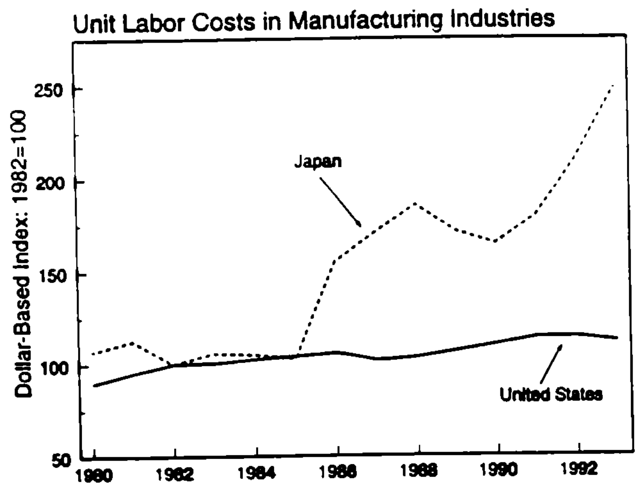
As discussed in previous Weekly Economic Briefings, the primary benefits of trade liberalization are enhanced productivity and living standards in the long run. It is these benefits—not the possibility of short-run increases in our trade surplus with Mexico—that will constitute the real gains from NAFTA.

EYES ONLY

CURRENT DEVELOPMENT

Toyota to Boost U.S. Auto Production

Toyota recently announced plans to cut the price of the redesigned Camry by 15 percent. Cost savings are to be realized by shifting more assembly to the United States, using more U.S.-made parts, and stepping up efforts to encourage U.S. parts suppliers to integrate their design and materials choices more effectively with Toyota's operations.



Analysis. Toyota's intention to boost the U.S. content of the Camry may owe in part to trade pressures, but exchange rate changes have been significant. When expressed in dollar terms, Japanese unit labor costs in manufacturing increased about 2-1/2 times between 1982 and 1993; more than 80 percent of this increase was due to a stronger yen. At the same time, U.S. unit labor costs increased only slightly, as 4 percent average nominal compensation gains were nearly offset by 3 percent average growth in productivity. Consequently, the relative cost of producing goods in the United States has decreased. This change in relative cost is encouraging companies like Toyota to shift to more U.S.-based production and should help reduce our bilateral trade deficit with Japan.

EYES ONLY

CURRENT DEVELOPMENT

State Tax Revenues Rise

State tax revenues for the first quarter of 1994 rose 6.7 percent (4.4 percent in real terms) from the same period last year. Revenue increases were especially strong in the Southwest (11 percent), the Great Lakes region (10 percent), and Arkansas (9 percent). Revenues in California, however, edged down slightly (0.1 percent) over the last four quarters, reflecting continued slow growth in the California economy.

A report by the Center for the Study of the States attributes revenue increases in 1993 and 1994 almost entirely to strong economic growth. In contrast, revenue increases in 1992 were mostly due to legislated tax increases.

Increase in State Tax Revenue
(percent change, first quarter over first quarter)

	Total	Due to Legislation
1992	7.8	6.8
1993	5.8	0.1
1994	6.7	0.4

Source: Center for the Study of the States

Analysis. The pickup in state economies, with the consequent improvement in their fiscal positions, has enabled some states to cut taxes—although such adjustments generally have been small. Five states (Arizona, Georgia, Maryland, New Jersey, and New Mexico) have cut personal income taxes for 1994, one (Utah) has reduced its sales tax, and at least three others (Maine, Minnesota, and Washington) have reduced business taxes.

EYES ONLY

ARTICLE

Networks and Growth: From Railroads to the Information Superhighway

The development of the national railroad network during the 19th century spurred economic growth. Railroads brought people closer together and helped firms reach their customers and suppliers more quickly and cheaply. The development of a national communications network has already had similar effects, and the new technologies that are building the information superhighway will produce additional benefits.

The Railroad Network. At the dawn of the 19th century, rivers and oceans were the only inexpensive and reliable means of transportation in the United States. As a result, economic activity was concentrated near navigable rivers and along the eastern seaboard. The development of turnpikes and canals before 1850, and railways after 1850, transformed the economic landscape. By increasing productivity, these transportation networks made the Nation wealthier.

The net social return on the investment in railroads was very high. Indeed, the social return exceeded the return to those who invested in the railways because of "network externalities" that made the railroads more valuable as increasing numbers of people were connected to them.

The Communications Network. The developing broadband interactive communications network—the information superhighway—can be expected to <u>increase productivity throughout the economy in much the same way that the railways did in the previous century</u>. The new communications network will make it easier for firms to reach customers and suppliers, and will spur the development of new services.

Regulatory barriers now limit the rate at which the economy will achieve these benefits. The Administration's proposed legislation would <u>remove unnecessary regulatory restrictions</u>, <u>provide a way for other regulatory restrictions to wither away as effective competition arises</u>, and <u>reduce private sector uncertainty about the future course of regulation</u>. By encouraging private investment and accelerating the arrival of the information superhighway (see box), these legislative proposals have the potential to add more than $100 billion (in 1994 dollars) to GDP over the next decade.

The new regulatory environment should boost the output of the economy in three ways.

- Productivity will increase slightly throughout the economy.
- Jobs will shift into economic activities in which workers are more productive.

EYES ONLY

- Increased private sector investment in an advanced telecommunications infrastructure will accelerate the rate at which the economy approaches full employment.

Helpful as it is for understanding certain aspects of the transformation to the information economy, the railway analogy may not be useful in forecasting the effect of the advanced communications network on market structure. Whereas the railroads encouraged the development of large industrial firms, the communications network may encourage flexibility rather than scale. Some industries may actually become less concentrated, as small firms emerge to serve narrow market niches.

Growth in the Telecommunications and Information Services Sector

The Administration's legislation is expected to stimulate considerable growth in the economy's telecommunications and information services sector. This sector includes "conduit" (phone, cable, and wireless), "content" (such as broadcast programming, newspapers, books, recorded music, and video) and "computers" (hardware, software, and computing services). Much of the sector's growth will come from the development and deployment of new products and services, such as personal communications systems and tele-medicine. In addition, functions once considered part of the manufacturing sector may be relabeled as "information services." For example, payroll services performed in-house by manufacturing companies and heretofore included in measures of manufacturing output and employment increasingly are being outsourced to companies providing advanced data processing services.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Major U.S. Banks to Establish Subsidiaries in Mexico. By the end of the year, all seven of the largest U.S. banking companies plan to have separately capitalized subsidiaries in Mexico. (Currently, Citicorp is the only major bank with operations in Mexico.) NAFTA puts U.S. and Canadian banks on the same competitive footing as Mexican banks. Initially, the American banks plan to limit their activities mainly to foreign exchange trading and general advisory work; these services are expected to appeal mainly to the largest Mexican firms. Many in Mexico hope that the American banks will eventually enter the loan market as well and, by increasing the competitiveness of the banking sector in Mexico, possibly bring down borrowing costs for both large and small borrowers.

On-Line Financing. Many small businesses struggle to find capital, but new on-line computer services are expected to make the task of raising funds a little easier. One service links small businesses and potential investors: companies pay for a one-page listing, and investors pay to search the listings. Another service plans to list small-business share offerings to on-line investors. These new services will connect entrepreneurs—who often have difficulty acquiring financing—with a national pool of investors.

Strong Farm Equipment Sales Signal Industry Revival. Sales of tractors and combines in the U.S. were up 16 percent in the first 4 months of this year over the same period 1 year ago, boosted by still relatively low interest rates, low farm debt, high farm incomes, and the advent of new technology. Despite the upsurge in demand, the leading manufacturers—Deere, Case, and Ford New Holland—remain cautious about adding to their plants' productive capacity.

Pigs in Space. For the first time ever, the weekly feeder-pig auction in Iowa has gone live via satellite. Pre-registered bidders can participate by phone. Since the pigs are videotaped on the farm, buyers get to see the animals without having them exposed to infection from other herds or injury from transportation. The pig auctioneers received technical assistance from a firm that has 7 years of experience in video cattle auctions. Pork producers see these auctions becoming increasingly popular, maybe even having their own cable channel 1 day.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

**** FOR RELEASE Friday 8:30 a.m. ****

The producer price index for finished goods declined 0.1 percent in May.

MAJOR RELEASES NEXT WEEK

Retail Sales (Tuesday)
Consumer Price Index (Tuesday)
Industrial Production (Wednesday)
Housing Starts (Thursday)

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	3.0
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	2.0	4.0	6.4	0.5
Manufacturing (1978-93)	2.3	5.2	3.0	7.4	6.6
Real compensation per hour	0.6	0.1	1.8	–0.2	3.4
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**	**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.

	1970–1993	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	N.A.
PPI-Finished goods	5.0	0.2	0.2	–0.1	**–0.1**

PPI data **embargoed until 8:30 a.m., June 10 (Friday).**
New or revised data in **boldface.**

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Apr. 1994	May 1994	June 9, 1994
Dow-Jones Industrial Average	3284	3522	3661	3708	3753
Interest Rates					
3-month T-bill	3.43	3.00	3.68	4.14	4.12
10-year T-bond	7.01	5.87	6.97	7.18	6.98
Mortgage rate, 30-year fixed	8.40	7.33	8.32	8.60	8.25
Prime rate	6.25	6.00	6.45	6.99	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 9, 1994**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.667	0.8	1.9
Yen-Dollar	104.1	–0.8	–2.2
Multilateral (Mar. 1973=100)	93.14	0.3	2.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.7 (Q1)	6.0 (May)	2.4 (Apr)
Canada	3.0 (Q4)	11.0 (Apr)	0.2 (Apr)
Japan	0.0 (Q4)	2.9 (Mar)	1.4 (Mar)
France	–0.3 (Q4)	12.4 (Mar)	1.7 (Apr)
Germany	1.6 (Q1)	6.7 (Feb)	3.2 (Apr)
Italy	0.3 (Q4)	10.6 (Jul)	4.1 (Apr)
United Kingdom	2.6 (Q1)	9.7 (Apr)	2.5 (Apr)

BR|Bo|65|SM

EYES ONLY

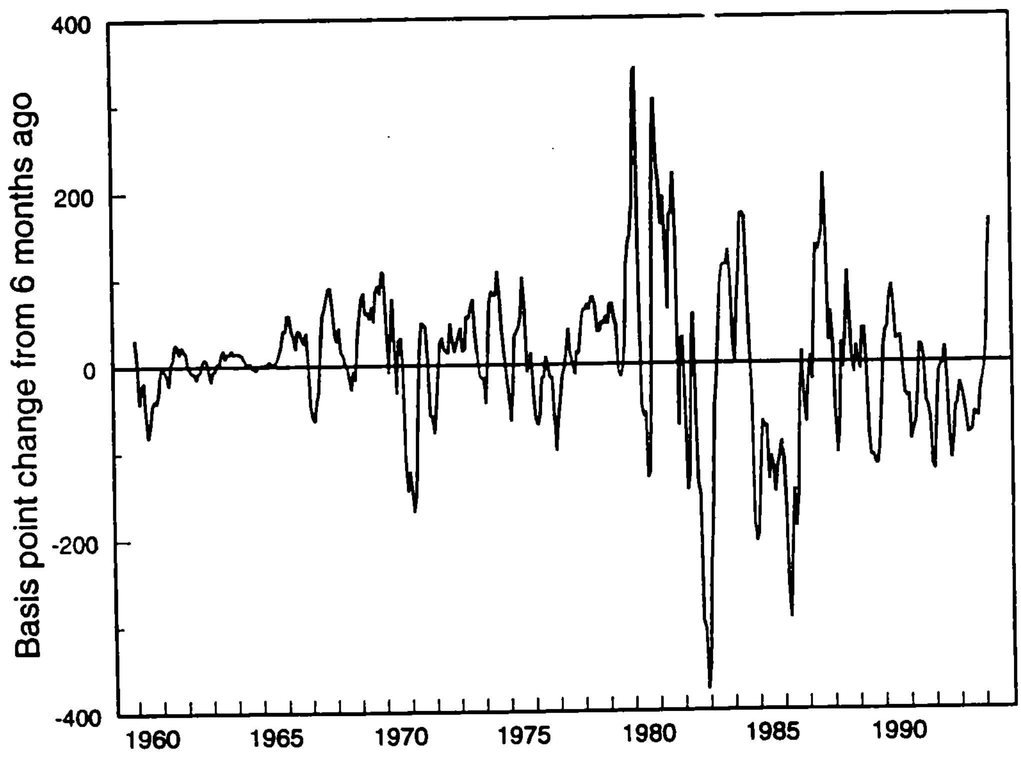
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 27, 1994

CHART OF THE WEEK

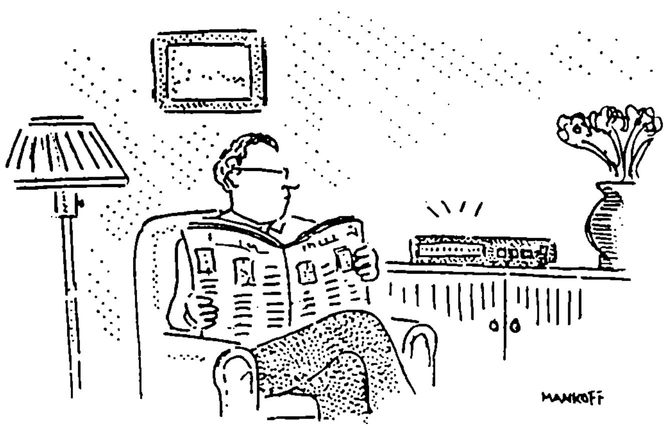
Changes in 10-Year Bond Yields



The jump in long-term interest rates that has taken place over the past 6 months is one of the steepest such increases of the past 35 years. Long-term interest rates became much more volatile in the late 1970s. Although volatility fell somewhat in the late 1980s, bond yields today remain more volatile than they were before 1979.

EYES ONLY

CONTENTS



"An increase in interest rates by the Federal Reserve board today sent the stock market down, but then the hope that this would lead to sustainable economic growth moved the market back up, until the realization that higher interest rates could stall the recovery sent it down again, before it ultimately rose on expectations that a sluggish economy would cause the Federal Reserve board to lower rates."

EYES ONLY

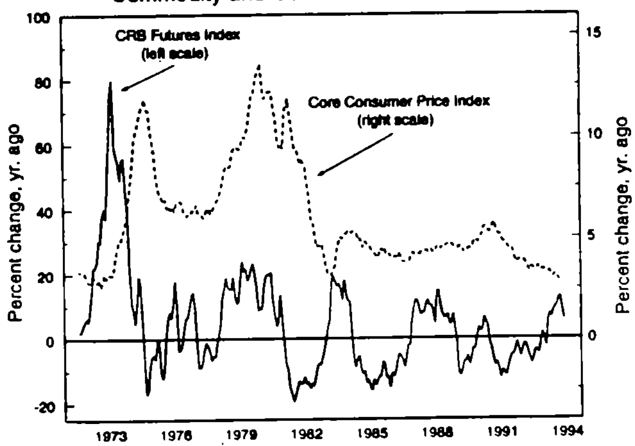
CURRENT DEVELOPMENT

Commodity Prices Rise, Will Inflation Follow?

Commodity prices have posted sharp increases over the past several months, leading some to argue that higher inflation is just around the corner.

Analysis. The claim that there is a close relationship between commodity prices and economy-wide inflation relies heavily on the experience of the 1970s. Between 1971 and 1982, commodity price inflation (measured here by the widely-watched CRB futures index) and subsequent core CPI inflation tended to move together (see chart). But this relationship appears to have fallen apart over the last decade: core CPI inflation remained quite flat despite wide swings in commodity price inflation.

Commodity and Consumer Price Inflation



Commodity prices react strongly to things like crop failures, weather, and the behavior of international producers and cartels. For example, last summer the CRB index rose sharply because of floods in the Midwest and drought in the Southeast, but overall inflation fell. Nevertheless, the fact that several different commodity price indexes are now all rising in tandem could be a harbinger of future inflationary pressures.

EYES ONLY

CURRENT DEVELOPMENT

Growth Prospects Improve in Europe

The prospects for economic growth in Continental Europe have brightened in recent months. After contracting in 1993, the economies of France, Germany, and Italy are expected to grow this year. As signs of recovery became clearer, forecasters raised their growth projections (see table).

Real GDP Growth Rates

	1993	**1994 Consensus Forecasts**		
		12/93	**5/94**	**Revision**
France	–0.8	0.8	1.3	0.5
Germany	–1.9	0.2	0.7	0.5
Italy	–0.7	1.0	1.1	0.1

Source: The Economist.

Analysis. Even these higher forecasted growth rates will be insufficient to reduce European unemployment in 1994.

Exports, spurred in part by strong growth in the United States, are forecasted to be an important engine of growth for Europe. The OECD, for example, expects that Germany's growth in 1994 will be entirely due to net export growth.

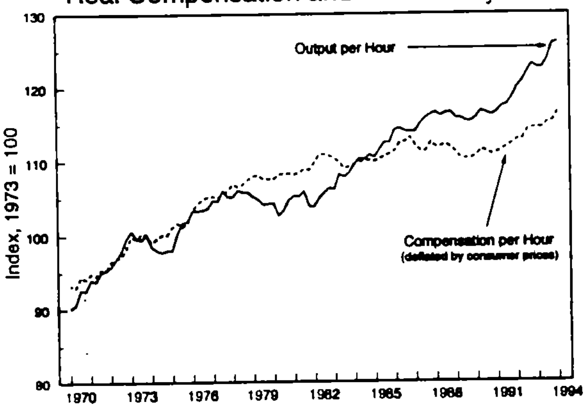
Faster growth in Europe should lead to a small rise in U.S. exports. The forecast revisions above, if actually realized, translate into $4.4 billion in additional U.S. exports in 1994.

EYES ONLY

TREND

Productivity and Real Compensation

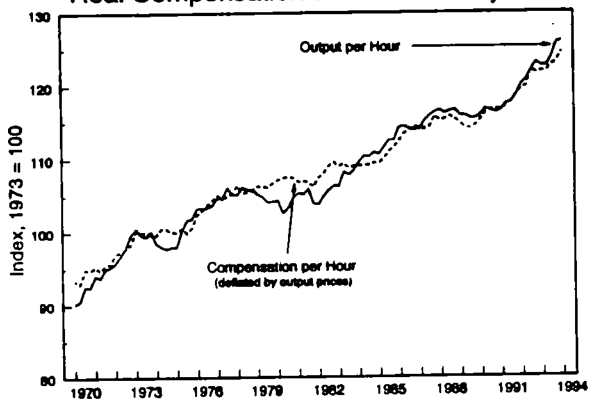
Real Compensation and Productivity



Economists say that productivity growth is the wellspring of real wage increases. Yet allegedly real compensation has lagged behind productivity in recent years. Has it?

The answer depends on how nominal compensation is deflated. If compensation is deflated by the buying prices paid by American households, a sizable gap has indeed opened between productivity and real compensation (see first chart). But if compensation is deflated by the selling prices received by American businesses, real compensation tracks productivity closely (see second chart).

Real Compensation and Productivity



The two alternatives give different answers because consumer prices have risen faster than output prices since the mid-1980s.

- The prices of investment goods, especially computers, have been rising very slowly. Most investment goods do not directly enter the consumer price index.

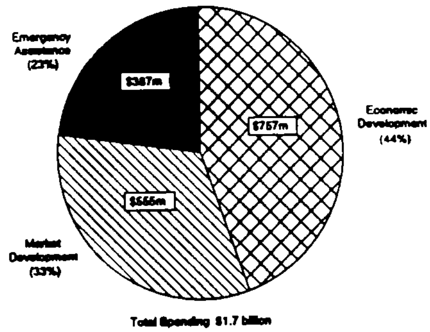
- The prices of housing, health care, and other consumer services, which are larger components of consumer prices than of output prices, have been rising relatively rapidly.

Analysis. Economists expect productivity to track compensation deflated by output prices, not consumer prices. The reason is that businesses deciding whether to expand their workforce compare compensation costs to the value of what additional workers will produce. This in turn depends on the productivity of workers and the prices that businesses receive when they sell their output. It is therefore not surprising that compensation deflated by output prices closely tracks productivity.

ARTICLE

Reinventing Food Aid

U.S. Food Aid Spending, 1993



The Rwanda tragedy—and the refugee crisis it has engendered—is a forceful reminder of the importance of humanitarian aid in general and food aid in particular. U.S. food aid programs, which account for about half of all world food aid, have three objectives: to develop markets for our products, to provide emergency assistance such as famine relief, and to encourage long-term economic development. Each of these objectives warrants scrutiny.

Who gains from market-development spending? One-third of U.S. food aid is aimed at developing markets for American agricultural products (see chart). Because they are targeted at middle-income countries, these funds might be better thought of as a farm support program rather than as food aid.

Export Subsidies and Food Aid

In principle, export subsidies for agricultural commodities under the Export Enhancement Program (EEP) are aimed at commercial sales, while food aid addresses needs that would not be met commercially. But reality is sometimes different. Some EEP recipients actually pay less for wheat than do some aid recipients. El Salvador, for example, recently requested a wheat EEP allocation for this reason.

Is famine relief effective? Poorly timed and inappropriately targeted famine assistance can actually do more harm than good. The Ethiopian famine of 1983-1984 provides a tragic example. Although it was known in late 1982 that Ethiopia would soon need large quantities of food aid, large-scale efforts did not begin until late 1984. Food promised in late 1984 arrived 6 months later, after the rainy season had begun and roads were impassable. Once the rainy season ended, a new crop was harvested. Food aid then was not only less needed, but also potentially counterproductive, because it forced food prices down and lowered the income of farmers, thereby exacerbating long-term adjustment problems.

In addition, distribution problems can result in too much aid going to urban areas and too little aid going to rural areas, where famine is often most severe. Too much aid to urban areas induces the rural population to migrate to cities, thereby perpetuating food shortages by reducing indigenous food production.

Paradoxically, a shortage of food is frequently not the principal cause of famine. Instead, crop failures or other problems cause severe losses of income for the poor, who then lack the income to buy food even though food production is sufficient to meet at least the subsistence needs of the entire population. Many regions in the grip of famine—such as Ireland during the potato famine and Bangladesh in 1974—actually exported food!

It therefore makes sense to target food aid toward those suffering income losses. Many countries have had success in using low-paying public works programs as vehicles for delivering aid. These programs assist recovery by keeping the rural population in the countryside while helping to improve rural infrastructure. For example, food-for-work programs in Bangladesh were used for irrigation, drainage, and flood-control projects that ultimately increased crop production by an estimated 27 percent.

Does food aid promote economic development? Nearly half of U.S. food aid spending goes for programs to promote long-term economic development by reducing malnutrition among children and nursing mothers, increasing school attendance, and alleviating poverty. The goals of these programs are laudable but little is known about their overall effectiveness. Program operators (including private voluntary organizations) are not required to collect data that would facilitate monitoring and evaluation. Development efforts could be made more effective in reducing hunger and malnutrition if the organizations delivering the aid were required to collect such data.

Does food aid impede sustainable agricultural development? Critics charge that donated food pushes food prices down and thus makes it more difficult for a viable farm sector to emerge. Recent studies find that such effects are often small, however, because food aid mostly displaces spending on <u>imported</u> food.
Is food aid spending efficient? The kinds of commodities provided as food aid are chosen because they are cheap for donors, not because they are highly valued by recipients. Thus a dollar's worth of donated food is frequently worth less than a dollar to recipients; examples include wheat in urban areas of China, cooking oil in China, or canned meat and fish in Bolivia and China.

The cost of U.S. food assistance has also been increased by provisions designed to satisfy domestic constituencies, such as requirements for shipping on U.S. flag carriers or processing in the United States prior to shipment.

Conclusion. Food aid is likely to remain an important vehicle for providing development assistance, since its political constituency makes it among the most acceptable forms of aid. Better targeting and improved delivery can make current spending levels much more effective.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

New Computer Price Index Shows Steeper Price Declines. Rapid technical improvements in computer processor speed, memory, and storage make measuring computer prices difficult. Changes in quality complicate price comparisons of even the same model in successive years. Using a quality-adjusted price index for personal computers, the authors of a recent NBER study find that price declines were almost 50 percent greater than estimates using conventional methods. By estimating the value of the characteristics of desktop models, the authors find that prices fell by an average annual rate of over 30 percent between 1989 and 1992. In contrast, conventional methods indicate a 19 percent decline.

Taxing Alcoholic Beverages. Recent research compares estimates of the social costs of alcohol-related traffic accidents to existing excise taxes on alcoholic beverages. One study states that "the rest of society collectively pays $0.63 in crash costs each time someone takes a drink." Current alcohol taxes, which average less than $0.10 per drink, are well below these social costs.

Compaq Takes Lead in World PC Market. Compaq Computer seized the lead in world market share for personal computers shipped in the first quarter of this year. This is the first time that Compaq has outpaced perennial leaders IBM and Apple. Compaq also leads the U.S. market with a 12.4 percent share. Compaq initially focused on the corporate market, but has recently expanded its retailer network.

A Hidden Cost of Hyperinflation. For decades, Argentina's hyperinflation rapidly reduced the value of coins, making vending machines impractical. At inflation's peak in 1989, a candy bar purchased for 50 centavos would have cost about 1000 centavos 6 months later. Now that inflation averages only 0.1 percent per month, vending machines are becoming practical. As a result, Vendor Argentina, a joint venture between Argentine investors and an American group of vending machine manufacturers is beginning to see its business grow.

EYES ONLY

RELEASES THIS WEEK

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

According to the preliminary report, gross domestic product rose 3.0 percent (annual rate) in the first quarter.

Durable Goods

According to the advance report, durable goods orders rose 0.1 percent in April.

MAJOR RELEASES NEXT WEEK

Personal Income (Tuesday)
Consumer Confidence (Tuesday)
Leading Indicators (Thursday)
Employment (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	**3.0**
GDP deflator	5.6	2.2	1.6	1.3	**2.6**
Productivity					
Nonfarm business	1.2	2.0	4.0	6.4	0.5
Manufacturing (1978-93)	2.3	5.2	3.0	7.4	6.6
Real compensation per hour	0.6	0.1	1.8	−0.2	3.4
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	N.A.

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

*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	Feb. 1994	Mar. 1994	Apr. 1994
Payroll employment (thousands)					
increase per month			278	464	267
increase since Jan. 1993					2853
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	0.1
PPI-Finished goods	5.0	0.2	0.5	0.2	−0.1

GDP **embargoed until 8:30 a.m., May 27 (Friday).** New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Mar. 1994	Apr. 1994	May 26, 1994
Dow-Jones Industrial Average	3284	3522	3817	3661	3753
Interest Rates					
3-month T-bill	3.43	3.00	3.50	3.68	4.16
10-year T-bond	7.01	5.87	6.48	6.97	7.09
Mortgage rate, 30-year fixed	8.40	7.33	7.68	8.32	8.53
Prime rate	6.25	6.00	6.06	6.45	7.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 26, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.649	–0.5	1.2
Yen-Dollar	104.6	0.3	–3.6
Multilateral (Mar. 1973=100)	92.65	–0.1	2.2

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**3.7** (Q1)	6.4 (Apr)	2.4 (Apr)
Canada	3.0 (Q4)	10.6 (Mar)	0.2 (Apr)
Japan	0.0 (Q4)	2.8 (Feb)	1.4 (Mar)
France	–0.3 (Q4)	12.3 (Feb)	1.7 (Apr)
Germany	–0.8 (Q4)	6.7 (Feb)	3.2 (Apr)
Italy	0.3 (Q4)	10.6 (Jul)	4.1 (Apr)
United Kingdom	2.6 (Q1)	9.8 (Mar)	2.5 (Apr)

GDP **embargoed until 8:30 a.m., May 27 (Friday).**

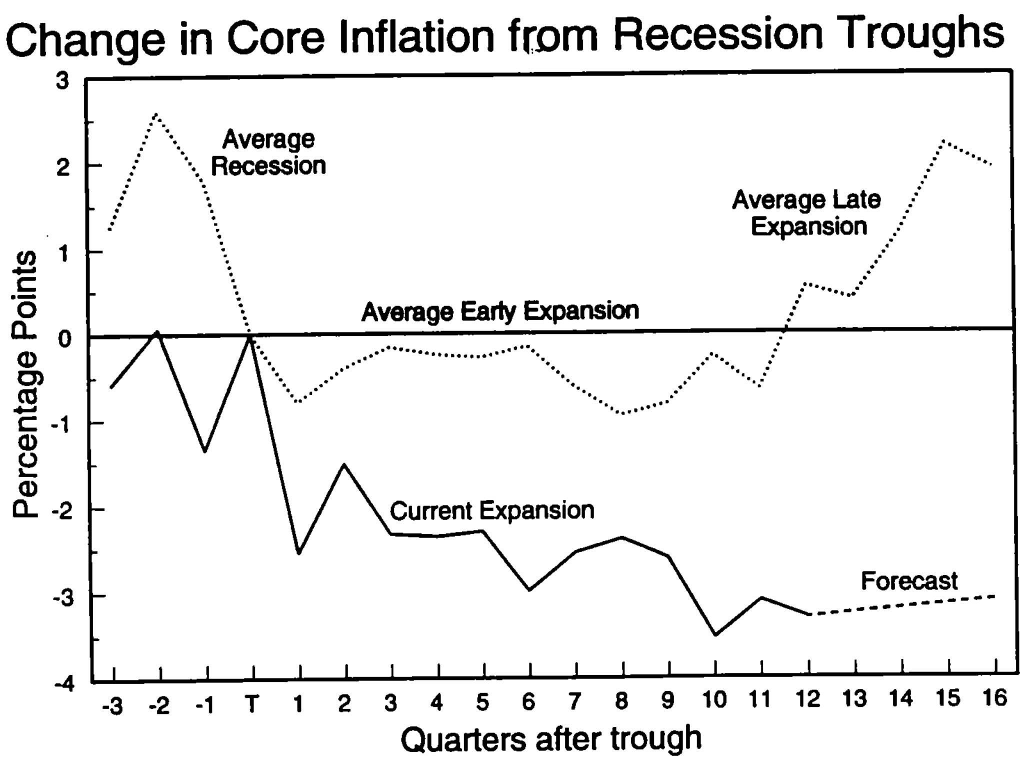
EYES ONLY

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

May 13, 1994

CHART OF THE WEEK



The chart compares the <u>change</u> in core CPI inflation during the current economic expansion to the average of previous expansions. Inflation tends to be fairly stable during the first 3 years of economic expansions, but has fallen in this one. Inflation typically increases in the fourth year. (See <u>Current Development</u>, page 2, for a discussion of inflation in the current expansion.)

EYES ONLY

CONTENTS

QUOTATION OF THE WEEK

"Bond people are perverse. We never react in the way people expect."

Senior Portfolio Manager
(Wall Street Journal, April 29, 1994)

EYES ONLY

CURRENT DEVELOPMENT

Bundesbank Cuts Key Interest Rates, Others Follow

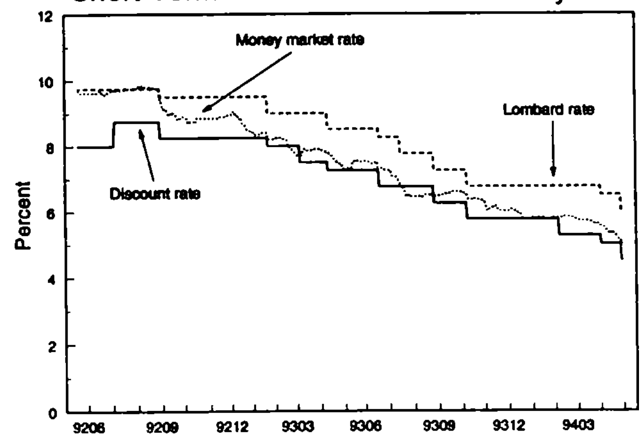
The Bundesbank lowered its key interest rates by 50 basis points on Wednesday. The discount rate—the cheapest rate at which banks can borrow from the Bundesbank and the effective floor on money market interest rates—was set at 4.5 percent. The Lombard rate—the most expensive rate at which the Bundesband lends to banks and the effective ceiling on money market rates—was set at 6.0 percent.

As has been the pattern recently, other European central banks responded with cuts of their own. The central banks of France, Italy, Denmark, Belgium, the Netherlands, Portugal, and Austria all followed the Bundesbank.

Analysis. The Bundesbank has been cutting interest rates slowly since mid-1992. Money market interest rates have declined along with the official rates (see chart). Since inflation has been declining steadily, real interest rates have not fallen as quickly as nominal rates. With inflation currently running at 3.1 percent, short-term real interest rates are 2 percent—down from 5.5 percent in mid-1992 and slightly below their average over the past 20 years.

The German economy is projected to grow slowly this year. Declining interest rates should help provide a much-needed stimulus.

Short-Term Interest Rates in Germany



EYES ONLY

CURRENT DEVELOPMENT

Inflation Update

In April consumer prices rose 0.1 percent and producer prices (for finished goods) fell 0.1 percent. Consumer price inflation so far this year is running below last year's rate (see table). Producer price and GDP inflation, although somewhat higher than last year's very low rates, remain very moderate. So far this year, both consumer and GDP inflation are running slightly below the Administration's forecast.

Analysis. Given the excellent recent record, why is there so much fear of increasing inflation?

- The perception that GDP is growing faster than expected raises fears that it will soon exceed its noninflationary "potential" (see Article, page 3).
- Typically, inflation begins to increase after 11 quarters of expansion (see Chart of the Week). Market participants might fear that the U.S. economy will repeat this pattern.

But the historical pattern of substantial increases in inflation as an expansion progresses is not inevitable. Economic policy in this expansion reduces the probability of an inflationary overheating of the economy.

- The Administration's restrained fiscal policy promotes sustainable, noninflationary growth.
- The Fed's move to raise interest rates will restrain economic growth and therefore further reduce the risk of inflation.

Inflation Rates	1993	1994 To Date*	Administration Forecast for 1994
CPI	2.7%	2.3%	3.0%
PPI (finished goods)	0.2	2.7	—
GDP Deflator	2.2	2.6	2.7

*Annual rate.

Note: CPI embargoed until Friday 8:30 a.m.

EYES ONLY

ARTICLE

How Close is the Economy to Capacity?

As the economy approaches capacity, concerns about increasing inflation are mounting. How large is the current gap between GDP and "potential" output? And how fast is potential output growing? The answers to these two questions are critical for assessing the risk of increased inflation.

There seems to be widespread agreement that potential is growing at about 2.4 or 2.5 percent per year. But there are substantial differences in estimates of the size of the current GDP gap (see table). The size of the current gap determines how much GDP can grow before fueling inflation.

- DRI has a relatively pessimistic estimate of potential output. With its GDP gap of 0.9 percent and potential growth rate of 2.4 percent per year, the economy could grow 8.1 percent (0.9 + 2.4 + 2.4 + 2.4) over 1994, 1995, and 1996.

- Even with the most optimistic estimate by WEFA (another private forecasting firm), the economy could grow 8.7 percent (1.8 + 2.3 + 2.3 + 2.3) over these 3 years.

- The Administration's January forecast projected 8.4 percent total growth over these 3 years, right in the middle of these two numbers.

Estimates of Potential GDP

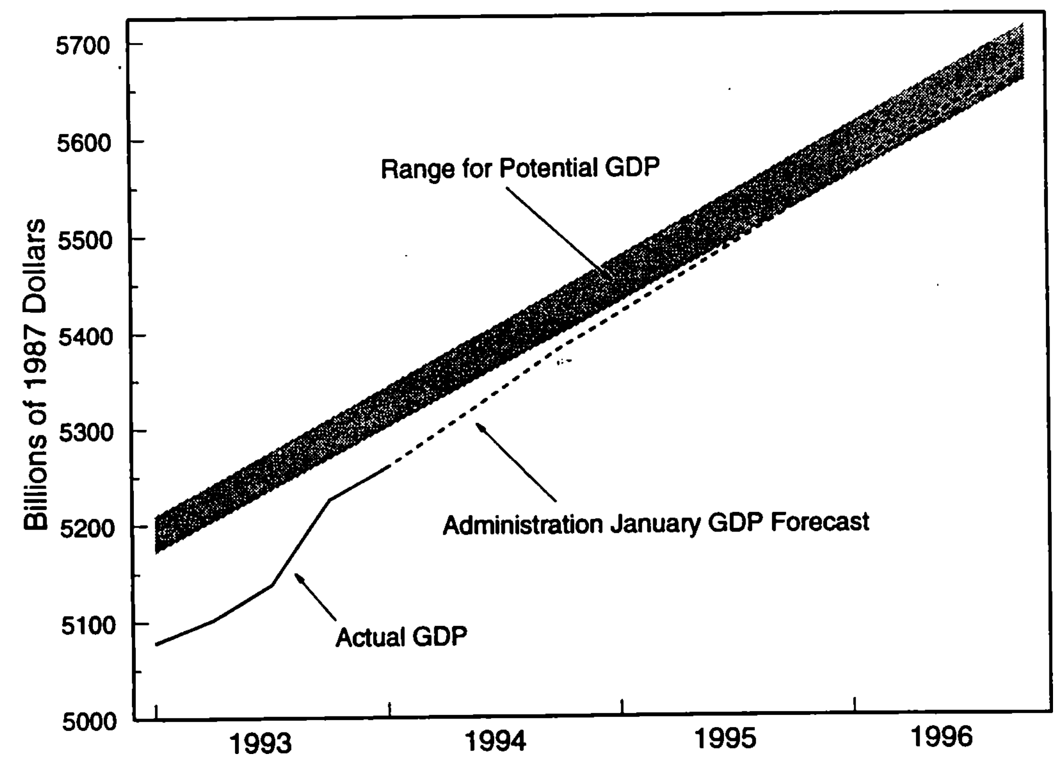
Source	Gap between Actual and Potential GDP (1994:1)	Growth of Potential GDP
DRI	0.9%	2.4%
Meyer and Associates	1.0	2.5
Federal Reserve*	1.2	2.4
Congressional Budget Office	1.3	2.4
WEFA	1.8	2.3

*Unofficial. Estimate based on data published in Business Week.

For several reasons, the Administration makes its projections based on a range for potential GDP. First, there is some uncertainty about the level and growth of potential (as seen in the table). Second, potential output is not an absolute ceiling. The amount of inflationary pressure depends on by how much and for how long the economy temporarily exceeds potential.

The chart compares the current Administration forecast of GDP with this range for potential. The range reflects the estimates in the table. In the first quarter of 1993, the gap between actual and potential GDP was between 2 and 2-1/2 percent. But faster economic growth in the second half of 1993 narrowed the gap. As of the first quarter of 1994, it was between 3/4 and 1-1/2 percent. Our current forecast calls for growth slightly faster than potential through 1996.

Potential and Actual GDP



Analysis. If the forecasted path for GDP does not exceed estimates of potential for the next few years, why is there so much concern about inflation?

- GDP is close enough to potential that one or two strong quarters of growth could push output above potential, thereby creating inflationary pressures.

- Some analysts believe that output is now growing somewhat faster than we forecast.

- There is uncertainty about the level of potential. Under our forecast, GDP reaches the lower bound of the range of sensible estimates of potential next year.

Therefore, even though a reasonable forecast suggests that it will be 3 years before the economy reaches potential, it is certainly possible that output could get there much sooner.

EYES ONLY

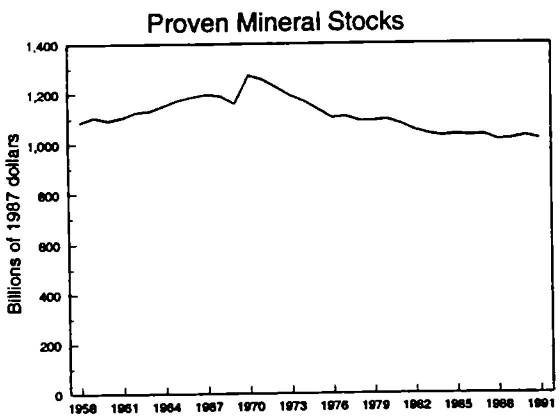
SPECIAL ANALYSIS

Commerce Takes First Step Towards Green GDP Accounts

This week the Commerce Department presented its conceptual basis for estimating "green GDP," its integrated economic and environmental satellite accounts (IEESA). It also presented the first phase of this effort: estimates of mineral resources in the United States from 1958 to 1991. Future phases will provide similar estimates for renewable resources, such as fisheries and forests, and environmental resources, such as air and water.

The IEESA treats natural and environmental resources as productive assets, analogous to the treatment of business capital. Like industrial equipment, natural and environmental assets help produce flows of goods and services. Just as capital depreciates, resources can lose their productivity through depletion or degradation. And the stock of resources can be augmented through discoveries of new deposits and cleanup efforts—just as investment augments the capital stock.

Initial estimates for minerals. The value of proven reserves of mineral resources adds 3 to 7 percent to the value of the country's private capital stock. Additionally, depletion of proven reserves has been offset by additions, leaving the stock of proven reserves down only slightly over the last 33 years (see chart). Thus, the United States has not been "running out" of proven mineral reserves. Because of this, adding mineral depletion to the standard national accounts would have little net effect on GDP.



Analysis. In a purely physical sense, the United States must be running down its endowments (proven plus unproven) of minerals. In a practical sense, these endowments are continually expanding as technological improvements make it economically feasible to recover minerals from more hostile environments, from deeper deposits, and from deposits with lower concentrations of minerals. Using proven reserves as a measure of the country's mineral stock does not fully take into account either this ultimate scarcity or these future technological improvements.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Global Foreign Direct Investment Declines. Based on international balance of payments figures, global foreign direct investment fell about 14 percent in 1992. This was the second consecutive year of decline. The main factors behind the decrease were the continued long-term decline of direct investment by Europe and a sharp drop in direct investment by Japan. Direct investment by the United States rose nearly 20 percent, making the United States the world's leading investor for the first time since 1986. Investment in industrialized countries was down, while East Asian countries, especially China, continued to experience sizable investment increases.

New Report Recommends Investment Budget. In its third report, the Competitiveness Policy Council focuses on the need for greater investment in infrastructure and human capital. The Council recommends that the Federal Government establish an investment budget to highlight the share of Federal spending that goes into public investment. It envisions the budget process incorporating a "soft target" for the share of the total budget that should go to Federal investment. The Council suggests a non-defense investment target of 12 percent of total non-defense outlays, which in FY 1995 would shift an additional $16 billion into public investment.

GM Wins Approval for Pension Funding Plan. This week, the Pension Benefit Guarantee Corporation endorsed a General Motors plan to contribute an extra $10 billion in cash and stock over the next 2 years to its pension fund for its hourly workers. GM has the nation's largest unfunded pension liability, estimated at over $20 billion (see Weekly Economic Briefing, December 3, 1993). GM also expects to make its regular pension contributions of about $8 billion through 1996.

EYES ONLY

RELEASES THIS WEEK

Consumer Prices ** FOR RELEASE Friday 8:30 a.m. **

Consumer prices rose 0.1 percent in April.

Producer Prices

Producer prices for finished goods fell 0.1 percent in April.

Retail Sales

According to the advance report, retail sales fell 0.8 percent in April.

MAJOR RELEASES NEXT WEEK

Industrial Production and Capacity Utilization (Monday)
Housing Starts (Tuesday)
Balance of Payments (Thursday)

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	2.6
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	2.0	4.0	6.4	0.5
Manufacturing (1978-93)	2.3	5.2	3.0	7.4	6.6
Real compensation per hour	0.6	0.1	1.8	–0.2	3.4
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	11.5
Imports	9.2	13.1	13.2	13.5	13.5
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.8
Federal surplus	–2.8	–3.5	–3.3	–3.2	N.A.

	1970–1993	1993	Feb. 1994	Mar. 1994	Apr. 1994
Unemployment Rate	6.7*	6.8*	6.5	6.5	6.4

*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	Feb. 1994	Mar. 1994	Apr. 1994
Payroll employment (thousands)					
increase per month			278	464	267
increase since Jan. 1993					2853
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	**0.1**
PPI-Finished goods	5.0	0.2	0.5	0.2	**–0.1**

CPI **embargoed until 8:30 a.m., May 13 (Friday).** New or revised data in **boldface.**

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Mar. 1994	Apr. 1994	May 12, 1994
Dow-Jones Industrial Average	3284	3522	3817	3661	3653
Interest Rates					
3-month T-bill	3.43	3.00	3.50	3.68	4.13
10-year T-bond	7.01	5.87	6.48	6.97	7.36
Mortgage rate, 30-year fixed	8.40	7.33	7.68	8.32	8.77
Prime rate	6.25	6.00	6.06	6.45	6.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 12, 1994**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.668	0.1	3.4
Yen-Dollar	104.4	1.6	-6.5
Multilateral (Mar. 1973=100)	93.24	0.2	2.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.6 (Q1)	6.4 (Apr)	**2.4 (Apr)**
Canada	3.0 (Q4)	10.6 (Mar)	0.2 (Mar)
Japan	0.0 (Q4)	2.8 (Feb)	1.1 (Feb)
France	-0.3 (Q4)	12.3 (Feb)	1.5 (Mar)
Germany	-0.8 (Q4)	6.7 (Feb)	3.2 (Mar)
Italy	0.3 (Q4)	10.6 (Jul)	4.2 (Mar)
United Kingdom	2.6 (Q1)	9.8 (Mar)	2.3 (Mar)

CPI **embargoed until 8:30 a.m., May 13 (Friday).**

EYES ONLY

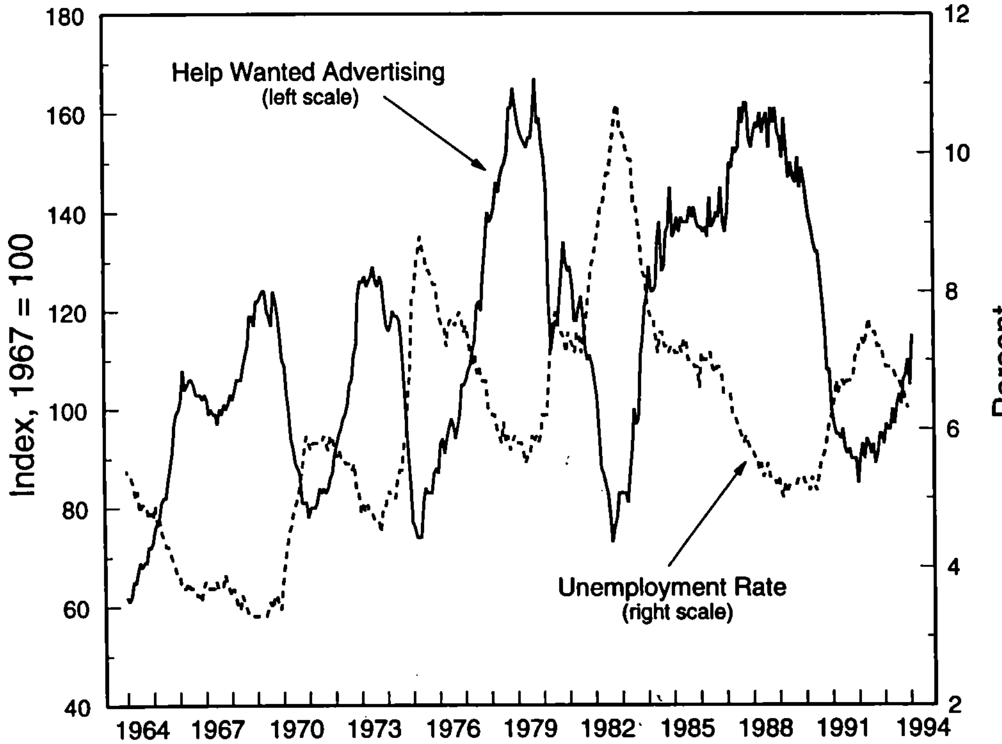
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 6, 1994

CHART OF THE WEEK

Help Wanted Advertising and the Unemployment Rate



Increases in help wanted advertising and decreases in the unemployment rate are highly correlated. This year, help wanted advertising has increased sharply, but remains well below its previous two business-cycle peaks.

EYES ONLY

CONTENTS

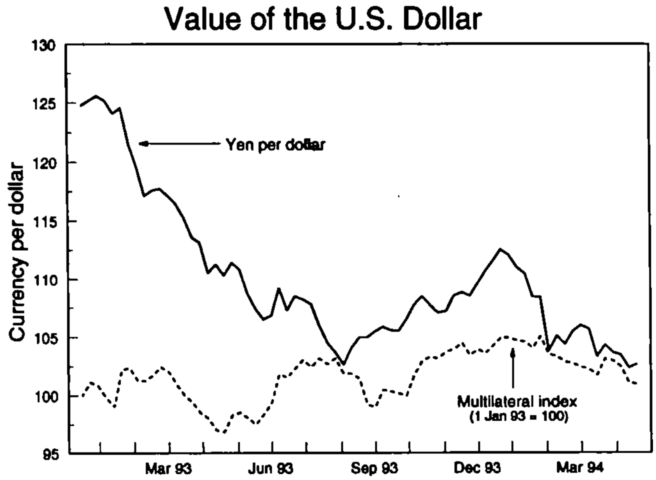
"Once again, how many of you think we should tinker with the economy?"

EYES ONLY

CURRENT DEVELOPMENT

Central Banks Intervene to Support the Dollar

The United States, joined by Germany, Japan, and at least 12 other countries intervened in foreign exchange markets Wednesday to support the dollar. This was the second time in a week that the United States intervened.



Analysis. As the chart shows, the multilateral exchange rate is approximately where it was 15 months ago. So why is the dollar perceived to be weak?

- The recent decline of the dollar relative to the mark switched the story from a strong yen to a weak dollar.
- The dollar's approach to the psychologically important 100 yen barrier raised expectations of further declines were that barrier to be breached.
- Short-term interest rates have risen here and declined abroad—especially in Europe. Normally, the dollar would have risen in response to such changes in interest rates. Therefore, the dollar's weakness is puzzling given the increased return on U.S. interest-bearing assets. Expectations of increased U.S. interest rates cannot explain the puzzle, but expectations of higher foreign interest rates could.

EYES ONLY

CURRENT DEVELOPMENT

First Quarter Profits Report

Major corporations reported operating profit increases of 11 percent for the first quarter of 1994 compared to the first quarter of 1993. In the fourth quarter of 1993, profits increased a remarkable 38 percent from the fourth quarter of 1992.

Recent high profits are partially attributable to modest wage increases and continued corporate restructuring. Higher profits are good news for investment because firms often finance their projects from their earnings.

Sector	Net Operating Profit*	Comments on Selected Industries
Basic Materials	+7%	Winter weather hurt steel, but demand is strong. Aluminum losses continue. Chemicals show surprising strength.
Energy	–5%	Low oil prices hurt many large oil companies; those with refinery and chemical businesses fare better.
Industrial and Transport	+22%	Heavy equipment manufacturers have a good quarter. Transportation equipment makers benefit from strong heavy truck sales. Trucking companies hurt by weather, but see traffic improving. Air-freight carriers report strong earnings growth, especially overseas.
Consumer, Cyclical	+11%	Autos, homebuilders, furnishings and appliances all have good quarter. Newspapers gain on ad growth.
Consumer, Noncyclical	+3%	HMOs report good earnings from increased enrollments and cost moderation. Food retailers see gains. Tobacco profits better than expected.
Technology	+29%	Computer manufacturers, chipmakers, and software developers are strong. Aerospace earnings fairly flat despite slow defense and commercial orders. Communications firms report solid profit growth.
Financial Services	+13%	Money center banks have good operating profits despite a sharp decline in trading revenues. Eastern regional banks especially strong. Property insurers hit by earthquake and storms. Securities firms still growing but slower than last year; those targeting retail investors fare best.
Utilities	+15%	Electric companies were virtually flat. Telephone companies performed better than expected, boosted by cellular operations and steady growth in core business.

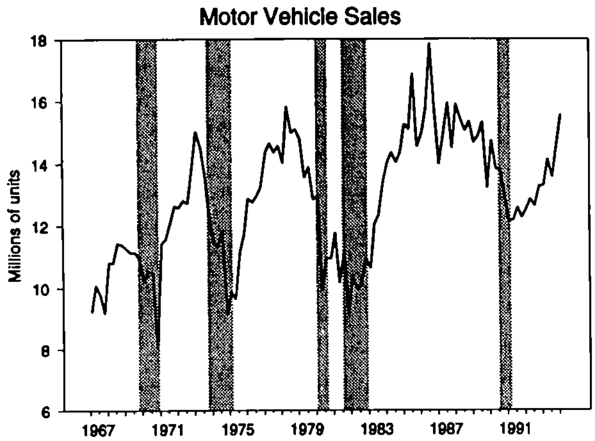
*The percent change in net operating profit from the first quarter of 1993 to the first quarter of 1994.

EYES ONLY

CURRENT DEVELOPMENT

Will the Auto Rebound Last?

Strong sales of cars and light trucks have helped to power the current economic expansion and have been responsible for buoyant Big Three profits. But how much more growth can be expected?



Shaded bars denote recessions

Motor vehicle sales are highly cyclical (see chart). In the last three expansions, sales almost doubled from trough to peak.

Low car purchases during the recession led to an increase of the average age of cars on the road to its current record value of 8.1 years. This pent up demand to replace the aging stock of cars gives momentum to automobile demand.

Analysis. Two factors might moderate the outlook for autos. First, higher interest rates will reduce affordability. Each 100 basis point increase in interest rates cuts vehicle sales by about half a million units (3 percent of current sales). Second, automobile makers announced higher prices this week. With imported car prices rising faster than U.S. inflation, will Detroit revert to its 1980s practice of going for higher prices and short-term profits, or will it keep prices down and go for market share?

If future interest rate increases are modest and Detroit only increases prices in line with general inflation, the odds favor an auto expansion that should run at least another year. Sales could increase by another million units and peak around 17 million units.

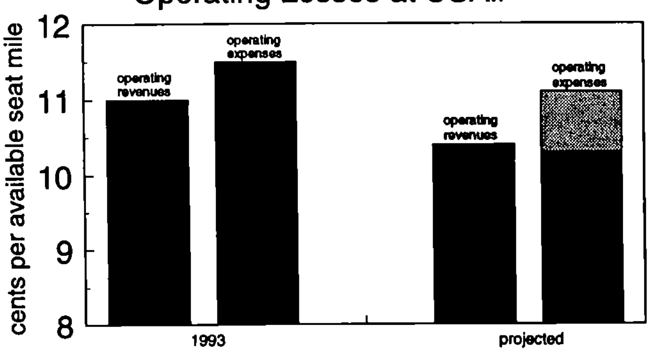
CURRENT DEVELOPMENT

USAir Insolvency Threatened

USAir, the sixth largest U.S. air carrier, reported an operating loss of $131 million for the first quarter of 1994. Although most other carriers began to earn operating profits (or narrowed their losses) as the economy strengthened, USAir saw its highest quarterly loss since 1992.

Absent a boom in air travel, USAir may seek bankruptcy protection in 1994 or 1995. Two warning signs suggest that USAir might file under Chapter 11 this year rather than next. First, USAir raised cash through selling its accounts receivable at the end of 1993. This expensive method of borrowing makes sense only when firms are shut out by banks and the financial markets. Second, minority owner British Airways announced in March that it would not invest more until USAir engages in major cost cutting.

Operating Losses at USAir



Operating expenses are projected to fall because of new operating procedures, but without wage and work rule concessions proposed by management (shaded area), USAir will still show a loss.

Analysis. With its current cost and route structure, USAir is probably not viable in the long run. New operating procedures will save costs by shortening aircraft turnaround time, but increased competition from Continental and Southwest will depress revenues (see chart).

But USAir wage levels are now among the industry's highest. To become profitable, USAir probably also needs major wage and work rule concessions from its unions, which account for half of its 48,000 employees (see shaded area in chart). The unions are unlikely to agree unless they obtain a substantial ownership interest in exchange.

EYES ONLY

ARTICLE

Inventories Send Mixed Signal for Growth

Real GDP grew at a 2.6 percent annual rate during the first quarter of this year, but final sales—GDP minus inventory accumulation—grew at only a 0.9 percent annual rate. Thus inventory accumulation added 1.7 percentage points to the annual growth rate of GDP in the first quarter. The strong inventory accumulation last quarter can be either good or bad news for growth during the second quarter of this year.

Bad news for second quarter growth? Normally, the combination of high inventory accumulation and slow growth in final sales would lead analysts to lower their short-run forecast for GDP growth. If the high first quarter inventories resulted from goods piling up as a result of disappointing sales, firms would limit increases in output this quarter. Rather than producing more, they could simply sell from inventories.

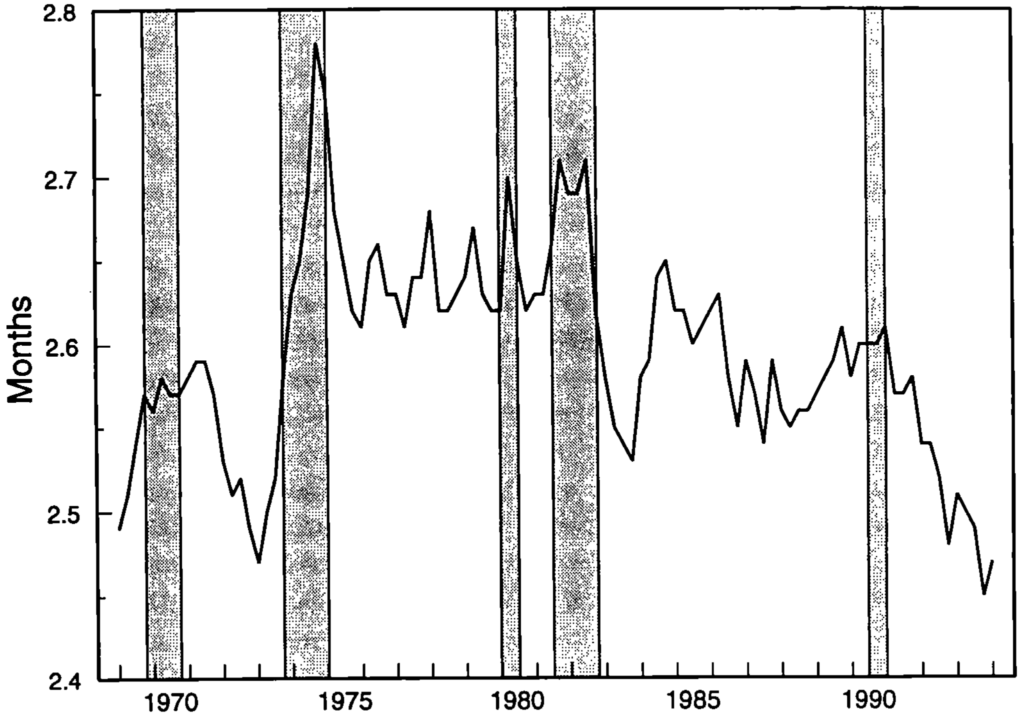
Good news for second quarter growth? But several factors support a more optimistic analysis—that the strong inventory accumulation signals good news for growth over this quarter.

- If inventories were being stocked deliberately to prepare for strong expected future sales, the burst of inventory accumulation would indicate a potential for stronger GDP growth in the second quarter. Although there is little direct evidence on expected future sales, consumer demand remains solid. And the weakness in last quarter's final sales was attributable to large dips in exports and government purchases that are likely to be temporary. Therefore, the outlook for sustained growth in sales looks good.

- Inventories remain low. The inventory-sales ratio has fallen sharply since the recession. (See chart on the next page). The rebuilding of inventories that has occurred during many previous expansions has yet to kick in. Last quarter's strong inventory accumulation resulted in only a slight uptick in the inventory-sales ratio. If inventory rebuilding is sustained, it could be an important positive factor in the later phases of the current expansion. This rebuilding might have begun, but it is too soon to tell.

EYES ONLY

Inventory-Sales Ratio



Note: Shaded areas are recessions.

"Just in Time" and the Trend in Inventories

There is no downward trend in inventories. Some analysts have suggested that the current low level of inventories is caused by improved management of production and inventories—especially "just-in-time" inventory management. But the chart shows that the inventory-sales ratio has no downward trend, particularly since the mid-1980s when just-in-time inventory management began to be practiced in the United States.

With just-in-time inventory management, firms do not stockpile parts and materials. Rather, they rely on suppliers to make deliveries as needed. Just-in-time inventories may not reduce the total amount of inventories held in the economy. Firms using the parts and materials in production will hold smaller inventories. But, to assure just-in-time delivery, suppliers might need to hold larger inventories.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Inflation Concerns Rise. In its most recent survey, NAPM reported that the most mentioned economic concern was inflation. The purchasing executives ranked environmental and regulatory costs second and interest rates third. In the December 1993 survey, inflation ranked sixth among economic concerns, and interest rates were eighth. The increased concern about inflation occurred even though respondents currently expect prices to increase in 1994 by less than they reported in December's survey.

JEC Report: Higher Interest Rates Pose Risk for Economic Growth. The Joint Economic Committee's annual report gives credit to the Administration's economic plan for turning around the economy in 1993 and for addressing the deficit problem. But it states that the continuing fiscal restraint will limit economic growth, leaving a greater role for monetary policy. It notes, however, "The interaction of financial leverage [e.g. hedge funds] with interest rate increases by the Fed may be the single biggest danger to the continued economic recovery." It also observes, "Instead of calming the financial market's [fears of inflation], the Fed's actions seem to have made them more nervous."

Solid Economic Growth Reported Throughout the Country. The economic expansion continues in most areas of the country, according to the Federal Reserve's survey. California is showing signs of recovery, with increased loan demand and an improving market for homes. Manufacturing activity continues to expand—except for aerospace. Production of automobiles, vehicle parts, steel, and building materials is near capacity.

Electronic Filing of Tax Returns Gains. The IRS reports that overall filings for the 1994 season so far are running slightly behind returns for this time last year. But a record number of electronic filings have been received so far, including nearly a half a million over the phone in the TeleFile pilot program. The average refund of returns processed so far is $1026, up almost 5 percent from this time in 1993.

The Hidden Costs of Spring. For the estimated 40 million Americans with allergies, this spring has been a miserable one. High pollen counts will probably mean an estimated 3 million days of work lost. In addition, many sufferers may have another 2 weeks of work impaired by allergy symptoms and drowsiness from medication. Spending on treatment will exceed $2 billion on medications, plus the cost of millions of boxes of tissues.

EYES ONLY

RELEASES THIS WEEK

Employment ** FOR RELEASE Friday 8:30 a.m. **

Payroll employment rose by 267,000 jobs in April. The unemployment rate fell 0.1 percentage point to 6.4 percent.

Leading Indicators

The composite index of leading indicators rose 0.7 percent in March.

Productivity

Productivity in nonfarm business increased at a 0.5 percent annual rate in the first quarter.

MAJOR RELEASES NEXT WEEK

Producer Prices (Thursday)
Retail Sales (Thursday)
Consumer Prices (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	2.6
GDP deflator	5.6	2.2	1.6	1.3	2.6
Productivity					
Nonfarm business	1.2	**2.0**	4.0	**6.4**	**0.5**
Manufacturing (1978-93)	2.3	**5.2**	3.0	**7.4**	**6.6**
Real compensation per hour	0.6	**0.1**	1.8	**–0.2**	**3.4**
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	11.5
Imports	9.2	13.1	13.2	13.5	13.5
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	2.8
Federal surplus	–2.8	–3.5	–3.3	–3.2	N.A.

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

*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.

			Feb. 1994	Mar. 1994	Apr. 1994
Payroll employment (thousands)					
increase per month			**278**	**464**	**267**
increase since Jan. 1993					**2853**
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	N.A.
PPI-Finished goods	5.0	0.2	0.5	0.2	N.A.

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

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Mar. 1994	Apr. 1994	May 5, 1994
Dow-Jones Industrial Average	3284	3522	3817	3661	3696
Interest Rates					
3-month T-bill	3.43	3.00	3.50	3.68	4.03
10-year T-bond	7.01	5.87	6.48	6.97	7.11
Mortgage rate, 30-year fixed	8.40	7.33	7.68	8.32	8.53
Prime rate	6.25	6.00	6.06	6.45	6.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 5, 1994**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.666	0.1	5.6
Yen-Dollar	102.7	1.1	–6.8
Multilateral (Mar. 1973=100)	93.03	0.3	4.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.6 (Q1)	**6.4** (Apr)	2.5 (Mar)
Canada	3.0 (Q4)	11.1 (Feb)	0.2 (Mar)
Japan	0.0 (Q4)	2.8 (Jan)	1.1 (Feb)
France	–0.3 (Q4)	11.7 (Dec)	1.5 (Mar)
Germany	–0.8 (Q4)	6.6 (Jan)	3.2 (Mar)
Italy	0.3 (Q4)	10.6 (Jul)	4.2 (Mar)
United Kingdom	2.4 (Q4)	10.0 (Jan)	2.3 (Mar)

Unemployment rate **embargoed until Friday, 8:30 a.m.**

EYES ONLY

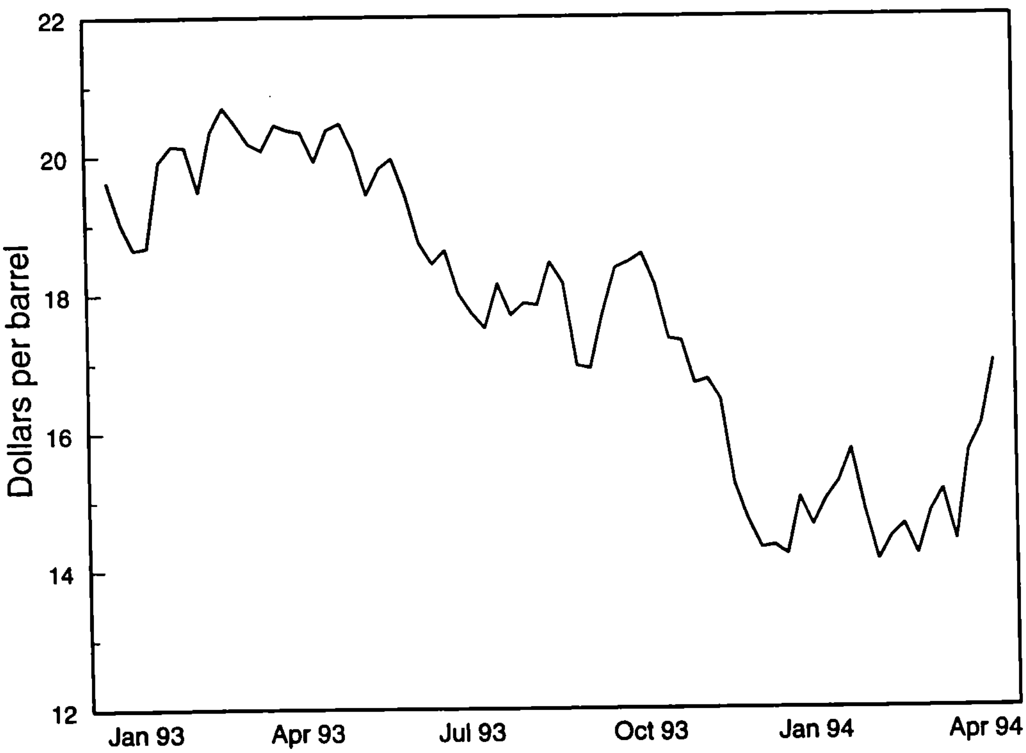
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

April 29, 1994

CHART OF THE WEEK

Crude Oil Prices Rebound



Oil prices have rebounded sharply this month to their mid-1993 level. Market participants suggest that the following factors might account for the recent change in prices: OPEC members are staying within their production quotas, the prospect for increased sales by Russia and Iraq has diminished, and demand—especially from the United States—has increased.

EYES ONLY

CONTENTS

QUOTATION OF THE WEEK

"If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage."

—Adam Smith

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: First Quarter of 1994

Real GDP grew at an annual rate of 2.6 percent during the first quarter. Declining exports and government purchases were major negatives. Inventory accumulation added substantially to growth.

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

Component	Growth*	Comments
Consumer expenditures on motor vehicles	26.3%	Purchases of autos and light trucks continued to be very strong.
Other consumer expenditures	2.6%	All other consumer spending stayed on track for a solid, but not spectacular, expansion.
Producers' durable equipment	13.5%	Business investment continued to be a key source of strength. Purchases of computers and information processing equipment grew at about the same rate as total equipment.
Housing	9.1%	Housing investment was slowed from its stunning 30 percent growth rate in 1993:4 by bad weather. But it remained strong.
Nonresidential structures	–16.1%	Weather depressed nonresidential construction.
Inventories (change, billions of 1987$)	$30.5	Inventory investment gave a major boost to GDP growth. Real GDP less inventory accumulation grew at only a 0.9 percent rate in the first quarter.
Government purchases	-6.2%	Federal purchases fell at a sharp 12 percent rate. State and local purchases were also down, probably again due to bad weather.
Exports	–9.3%	Exports are very volatile. They pulled down GDP growth in 1994:1, but they were a major positive factor in 1993:4's strong growth. Over the last 4 quarters, real exports have increased 2.9 percent.
Imports	2.8%	The import surge moderated. But, like exports, imports are subject to large quarter-to-quarter fluctuations.

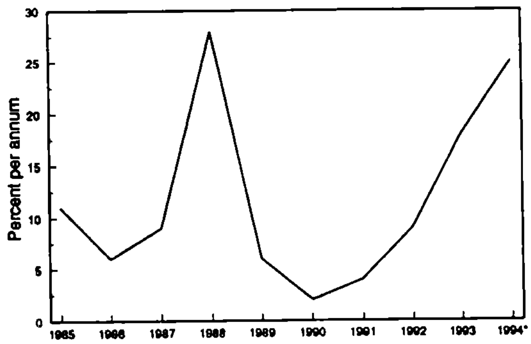
*Percent real growth in first quarter at annual rate (except inventories). These preliminary figures are subject to substantial revision.

CURRENT DEVELOPMENT

China's Economy Booms, Inflation Surges

Sweeping economic reforms begun in 1978 have spurred an explosion of economic growth in China. Real GDP growth has averaged about 10 percent over the past 10 years. Growth has been especially rapid outside the state-owned sector, and state enterprises now account for less than half of industrial output. In 1993, for example, industrial production grew by more than 20 percent, but the output of state enterprises rose by only about 2 percent.

Chinese Inflation



* 1994 figure is for February.

After reaching nearly 20 percent in 1993, inflation for the 12 months through February exceeded 25 percent (see chart). The Chinese authorities tried to restrict credit to restrain inflation in July 1993. But these restrictions were short-lived. State-owned enterprises and some local governments hurt by lack of credit successfully lobbied the authorities to ease monetary policy. State-owned enterprises remain an obstacle to tighter money since about half are unprofitable and rely on loans to meet operating expenses.

Analysis. Tight credit has led some state-owned enterprises to lay off workers and cut pay. These dislocations, along with changes engendered by rapid growth and concerns about rising inflation, have led to social unrest and demonstrations by displaced and laid-off workers.

In 1989, similar economic conditions—rapid growth, rising inflation, and government attempts to restrain inflation—contributed to the social pressures that culminated in the Tiananmen Square uprising. Ironically, these pressures may lead the Chinese to clamp down politically just when we are asking them to be more forthcoming. But some analysts believe that after 4 years of rapid economic growth, popular support for the regime is quite strong.

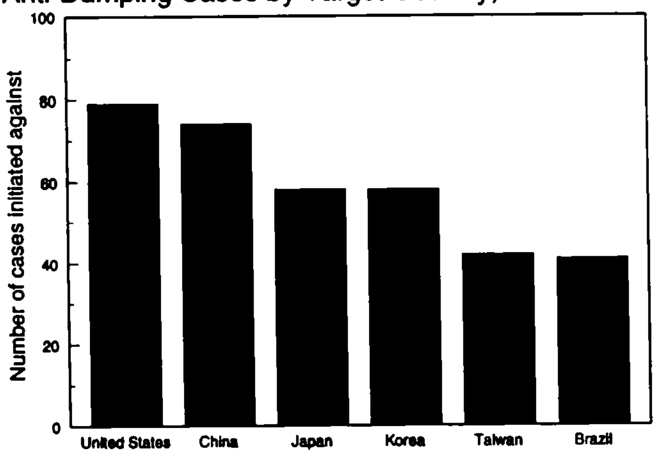
EYES ONLY

CURRENT DEVELOPMENT

Anti-Dumping: U.S. Industry Is the Most Frequent Target

Anti-dumping laws aim to protect American business from "unfair" competition from imports. However, foreign anti-dumping laws affect our exports. In fact, over the past 5 years, U.S. industries have been the most frequent target of anti-dumping cases initiated worldwide (see chart).

Anti-Dumping Cases by Target Country, 1989-1993



The use of anti-dumping laws is spreading. As recently as 1990 about 2 dozen countries had anti-dumping laws. More than 40 do now, and several others are expected to adopt such laws once the Uruguay Round is ratified.

GATT implementing legislation. The implementing legislation for the Uruguay Round will not only reshape our anti-dumping laws but will help determine how similar laws are written abroad, because foreign anti-dumping laws often mimic U.S. practice. Several countries (including the EU, Australia, and Mexico) automatically link their anti-dumping procedures used against U.S. exporters to those we use against their exporters.

Moreover, foreign anti-dumping cases are sometimes initiated to retaliate against cases initiated here. For example, Mexico and Canada initiated anti-dumping cases against the U.S. steel industry in response to cases filed against them in June 1992.

EYES ONLY

ARTICLE

What Is "Neutral" Monetary Policy?

According to recent comments by several Federal Reserve officials and according to minutes of FOMC meetings, the goal of the Federal Reserve is a so-called neutral policy stance. But what does the Fed mean by neutral? A possible definition of a neutral monetary policy is one that allows the economy to grow at its "potential" growth rate, which is the sum of the rate of growth of the labor force and the rate of growth of labor productivity. (Most economists believe that the potential growth rate of the U.S. economy is about 2-1/4 to 2-1/2 percent.)

Since the 1990 recession, there has been substantial slack in the economy. And until this year, the Fed said it was pursuing an expansionary policy, that is one that allowed the economy to grow faster than "potential." Given the slack in the economy, the expansionary monetary policy aided the recovery without creating substantial inflationary pressure. Since February, the Fed claims it has been moving toward a neutral policy. Nonetheless, we believe there is still slack in the economy. Why would the Fed move to tighten before all the slack in the economy disappeared?

The Fed's control over the economy works with substantial lags. It takes between 6 and 18 months for changes in interest rates to affect real activity. Hence, to avoid an inflationary overshooting, the Fed might have felt it necessary to act well in advance of reaching full employment.

Implementing a neutral monetary policy. Given that the Fed does not directly control the growth of the economy, how would the Fed implement a neutral monetary policy? In particular, what indicators could it use to judge that it is actually pursuing a policy that is neutral for growth?

In the past, the Fed often relied on the rate of growth of money as an indicator of monetary policy. But in recent years the relationships among money, output, and prices have become extremely unstable. Consequently, the money aggregates are no longer very useful for monetary policy.

Some analysts have suggested the real short-term interest rate as a policy indicator. Chairman Greenspan has stated repeatedly that the nearly zero real short-term rates that the economy enjoyed from late 1992 through early 1994 were unsustainably low. The Fed apparently attaches some importance to this indicator.

Is there a neutral real short-term interest rate? The table on the next page shows real short-term interest rates—the 3-month Treasury bill rate minus a forecast of 3-month inflation—for selected periods. The 0.3 percent rate in 1993 was well below the historical average. But the real short-term rate exhibits large and persistent swings over time. Only the 1960s and (so far) the 1990s look close to the "average."

Real Short-Term Interest Rates	
Period	**Percent**
1955-93	1.3
1955-59	-0.7
1960-69	1.1
1970-79	-0.3
1980-89	4.0
1991-93	1.0
1993	0.3

- In the 1970s, high inflation led to negative real interest rates.
- The large budget deficits of the 1980s pushed real rates of interest to unprecedentedly high levels.
- In 1993, a combination of expansionary monetary policy, fiscal restraint, and an economy only beginning to recover from recession kept real rates of interest low.

As these cases suggest, the real short-term interest rate depends on the state of the economy and also on both fiscal and monetary policy. Hence, what is a neutral real interest rate for one period might not be neutral for another. In particular, a shift toward smaller fiscal deficits should lower the neutral real rate of interest. There is no single real short-term interest rate that is neutral for all times and in all circumstances.

With the recent 75 basis point increase in nominal short-term interest rates and the current 3 percent rate of expected inflation, the real short-term interest rate is now about 0.75 percent—slightly below its 1955 to 1993 historical average.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Recycling Plant Out of Sorts. Better than expected curbside recycling has produced financial problems for San Diego County's new $134 million trash-sorting plant. Given the willingness of residents to sort their garbage, a curbside recycling program is proving to be a more cost-effective means of diverting waste from landfills than operating the plant. The plant is losing money because it does not have enough trash to process.

New Consortium to Develop Plastic Fiber Optical Networks. A group of leading manufacturers and researchers has formed the High Speed Plastic Network Consortium to develop and market networks based on plastic optical fiber technology. Glass fiber optics are not currently used in short and medium distance applications because of high cost and user-unfriendly connection systems. But the new plastic fibers will be able to compete with copper-wired systems in a variety of applications. With the assistance of an ARPA grant, the consortium will develop applications for aircraft, automotive, and data communication networks as well as for computer and office equipment wiring.

New Tribal Casino Agreement. Connecticut Governor Weicker has reached a new agreement with the Mohegan tribe that allows it to operate casinos in exchange for at least $80 million a year in payments to the state. This agreement means that the Mashantucket Pequots, who currently have a casino monopoly in the state, will now share the gambling business with the Mohegans. By allowing two tribes this right, the state is guaranteed $160 million in payments from the tribes, who as sovereign nations cannot be taxed. If the Legislature opens up the casino business to others, the payments could be in jeopardy.

GM Parts Makers Join Toyota Group. Three General Motors subsidiaries have joined Toyota's auto parts association. This is the first time that affiliates of a Big Three auto maker have been offered membership in the group. Other independent American parts manufacturers are already members.

Diet Centers Report Losses. Jenny Craig reported a loss for the most recent quarter. The loss includes a charge for reducing the number of centers the company operates, part of an ongoing commitment to a leaner structure. The company's profits have been trimmed over the past year, as Americans seem to be cutting down on diets and exercise.

EYES ONLY

RELEASES THIS WEEK

GDP

Real GDP grew at a 2.6 percent annual rate in the first quarter. The GDP fixed-weight price index increased 2.9 percent.

Personal Income ** FOR RELEASE Friday 8:30 a.m. **

Real disposable income rose 0.3 percent in March. Real consumption expenditures rose 0.1 percent.

Durable Goods

According to the advance estimate, durable goods orders increased 0.4 percent in March.

Employment Cost

Compensation in private industry increased 0.7 percent in the first quarter of 1994 according to the employment cost index.

MAJOR RELEASES NEXT WEEK

Leading Indicators (Tuesday)

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	**2.6**
GDP deflator	5.6	2.2	1.6	1.3	**2.6**
Productivity					
Nonfarm business	1.2	1.9	4.0	6.1	N.A.
Manufacturing (1978-93)	2.3	5.2	3.0	7.2	N.A.
Real compensation per hour	0.6	0.1	1.8	–0.1	N.A.
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	**11.5**
Imports	9.2	13.1	13.2	13.5	**13.5**
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	2.8	3.0	**2.8**
Federal surplus	–2.8	–3.5	–3.3	–3.2	N.A.

		1993	Jan. 1994	Feb. 1994	Mar. 1994
Unemployment Rate	6.7*	6.8*	6.7	6.5	6.5

*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	Jan. 1994	Feb. 1994	Mar. 1994
Payroll employment (thousands)					
increase per month			–31	198	456
increase since Jan. 1993					2498
Inflation (percent per period)					
CPI	5.8	2.7	0.0	0.3	0.3
PPI-Finished goods	5.0	0.2	0.2	0.5	0.2

New or revised data in **boldface.**

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Feb. 1994	Mar. 1994	Apr. 28, 1994
Dow-Jones Industrial Average	3284	3522	3906	3817	3668
Interest Rates					
3-month T-bill	3.43	3.00	3.25	3.50	3.89
10-year T-bond	7.01	5.87	5.97	6.48	7.04
Mortgage rate, 30-year fixed	8.40	7.33	7.15	7.68	8.32
Prime rate	6.25	6.00	6.00	6.06	6.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Apr. 28, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.664	−1.6	5.2
Yen-Dollar	101.6	−2.0	−9.3
Multilateral (Mar. 1973=100)	92.71	−1.5	3.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.6 (Q1)	6.5 (Mar)	2.5 (Mar)
Canada	3.0 (Q4)	11.1 (Feb)	0.2 (Mar)
Japan	0.0 (Q4)	2.8 (Jan)	1.1 (Feb)
France	−0.3 (Q4)	11.7 (Dec)	1.5 (Mar)
Germany	−0.8 (Q4)	6.6 (Jan)	3.2 (Mar)
Italy	0.3 (Q4)	10.6 (Jul)	4.2 (Mar)
United Kingdom	2.4 (Q4)	10.0 (Jan)	2.3 (Mar)

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EYES ONLY

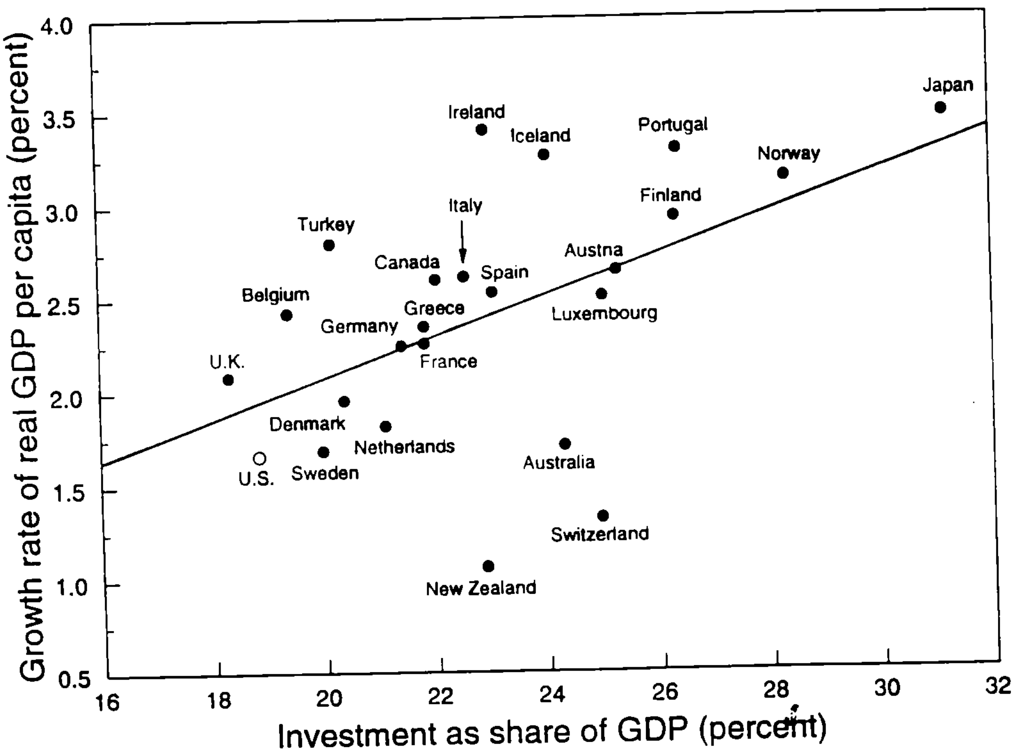
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

April 22, 1994

CHART OF THE WEEK

Investment Rates and Productivity Growth



The chart compares the average annual growth rate of GDP per capita to the average investment rate by country for the 1970 to 1990 period. Countries that invest a high fraction of their output have high rates of productivity growth. During the past year, the United States investment rate has increased by about one percentage point. Over time, this could increase GDP growth by 0.1 to 0.2 percentage point.

EYES ONLY

CONTENTS

QUOTATION OF THE WEEK

"Please keep interest rates low for me and high for my mother."

Private communication received by Alan Blinder (April 1994)

EYES ONLY

CURRENT DEVELOPMENT

Fed Raises Interest Rates Again

The Federal Reserve Board announced Monday that it was increasing interest rates for the third time this year. Although it did not specify the size of the increase, it is widely believed to be another 25 basis points, leaving the target Federal Funds rate at 3.75 percent. On Monday and Tuesday, major banks raised their prime rate by 50 basis points to 6.75 percent.

Chairman Greenspan made the decision to raise rates following telephone consultation with members of the FOMC, but without a specific vote. The next regularly scheduled meeting of the FOMC is May 17.

Long-term Rates. Long-term rates continue to ratchet up with each hike in the Federal Funds rate. Since the first FOMC move in February, the rate on 10-year Treasury bonds has increased over 100 basis points—a surprisingly large amount.

- Long-term and short-term interest rates usually move in the same direction. But there have been occasions—notably when the Fed moved to monetary restraint in 1973 and 1988—when increases in short-term rates were accompanied by declines in long-term interest rates. Long-term rates could decline following a Fed tightening if it caused or were accompanied by a substantial reduction in inflationary expectations.
- On average, when short-term interest rates change, long-term interest rates change by only about 1/3 as much. But since the Fed's move in February, long-term rates have increased much more than short-term interest rates.
- The Administration's January forecast projected that short-term interest rates would rise somewhat over the next 2 years, but that long-term interest rates would not change. (The Blue Chip consensus had a similar forecast.) Our reasoning was that the gap between short-term and long-term interest rates was unusually large, implying that the projected increase in short-term interest rates had already been built into long-term interest rates.

Why have long-term interest rates moved so dramatically and unexpectedly? As we have argued in previous editions of the Weekly Economic Briefing, the markets are either overreacting to the increases in short rates that we have already seen or they are expecting further increases in short rates in the future. Additionally, some market observers suggest that bond rates rose sharply in response to sales of bonds that had been purchased on margin.

Increase in Discount Rate Likely

The Federal Reserve's discount rate, the rate charged to banks for borrowing directly from the Fed, has been 3.0 percent since July 1992. The Fed is likely to raise the discount rate soon to bring it into line with the Federal Funds rate, the rate banks charge each other for overnight loans. Although an increase in the discount rate is likely to make headlines, it would be largely symbolic. Few transactions actually take place at the discount rate.

EYES ONLY

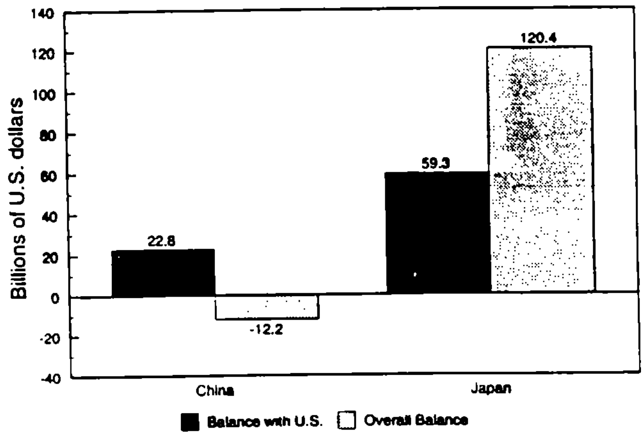
SPECIAL ANALYSIS

China's Development Strategy

Our February bilateral trade deficit with China ($1.7 billion) was, once again, second in magnitude only to our deficit with Japan. But this does not mean that China is following a protectionist development strategy.

China does not regularly run an overall trade surplus. Despite its large surplus with the United States, China ran an overall trade deficit of more than $12 billion last year. Japan's trade surplus, on the other hand, exceeded $120 billion (see chart). As is common for a developing country, China has run current account deficits for 5 of the past 10 years.

1993 Trade Balances



Our increased bilateral deficit with China reflects a shift of production away from Hong Kong and Taiwan. In recent years, producers of running shoes, toys and garments have moved from Hong Kong and Taiwan to mainland China, where labor costs are lower. Our combined deficit with these three jurisdictions has changed little over the same time period.

China is relatively open to foreign investment. Although the United States has problems with some of China's policies toward foreign investment, international capital flows are less regulated in China than they were in Japan until recently.

Foreign direct investment in China reached $20 billion in 1993. U.S. firms account for just under 10 percent of foreign direct investment in China, in large part because they have not been as active as firms from Hong Kong and Taiwan.

China has begun to liberalize. Special Economic Zones encourage foreign investment and liberalize international trade. The success of the "open door" policies in these zones has made them a laboratory for the reforms that have spread to other areas of China. Although substantial non-tariff barriers remain, the role of giant state trading companies has been reduced, import controls have been rationalized, and export subsidies have been largely eliminated in China. As a result, China is relatively open compared to other low-income countries.

Benefits of imports from China. The United States imports low-cost consumer goods such as toys, dolls, sneakers, other shoes, and apparel from China. These products are bought primarily by the poor and middle class, who enjoy lower prices and greater variety as a consequence. U.S. firms that buy Chinese electrical machinery and office equipment are able to lower their costs and increase their competitiveness. In addition, by obtaining goods cheaply from abroad, the United States is able to specialize in areas where its productivity advantages over other countries are greatest. This specialization raises our overall productivity and our living standards. These benefits are tangible. If we were to revoke China's MFN status, the annual cost to U.S. purchasers of Chinese imports would be around $5 billion. The cost to the United States would rise if we were to lose markets for our specialized exports (such as aircraft) to Chinese retaliation.

EYES ONLY

ARTICLE

Designing Spectrum Auctions

Last year, Congress required the Federal Communications Commission (FCC) to conduct auctions for radio spectrum allocated for personal communications services (PCS)—an advanced type of cellular telephone service. As with radio and television licensees, PCS licensees will have the right to use a portion of the spectrum within a region. Over 500 regions have been designated.

Auctioning off public assets can help the government raise revenue and help place assets in their most valuable uses (see Weekly Economic Briefing, April 8, 1994). But the details of auction design matter.

Uncertainty and Royalty Payments. The ultimate value of PCS licenses is highly uncertain. PCS licenses could become extremely valuable if wireless transmission replaces telephone and cable television service. But PCS licenses could instead have little value—if PCS technology turns out to be more expensive than currently hoped, if competition with existing cellular service lowers revenues more than is now expected, or if alternative technologies such as fiber optic lines turn out to be cheaper than currently believed.

Such large uncertainties can make bidders less willing to pay high prices to the government. To reduce this problem, the FCC could seek royalty payments (a percentage of gross revenues, for example) instead of up-front cash payments for the license. The FCC will soon decide whether to use a royalty-based auction scheme for selling PCS licenses, or just to sell licenses for an up-front fee.

Royalties would probably increase the long-run revenues to the government.

- Royalty payments let bidders share the risk of future value of the license with the government. (If the license ultimately has little value, royalty payments will be correspondingly small.) Risk-averse bidders will in consequence bid more for the license.

- When bidders have different beliefs about the ultimate value of a license, to avoid the "winner's curse" (see box) they tend to bid less than their private views would warrant. Royalty-based auctions reduce the importance of differences in bidders' beliefs.

- If potential bidders have trouble raising the capital necessary for up-front license payments, a royalty-based auction may increase the number of bidders. Greater competition generally leads to higher bids.

EYES ONLY

Spectrum auctions based on royalties also have disadvantages.

- A licensee that must share revenues with the government will not reap the full benefits of its investments, and in consequence may invest less.

- The government must develop an administrative machinery for monitoring licensee revenues.

The "Winner's Curse"

When competing bidders have different beliefs about the ultimate value of an object being sold at auction, the winner of the auction may actually overpay. This occurs because the winner of the auction is likely to have the most optimistic beliefs about the value of the object being sold.

For example, suppose three oil companies are bidding on an offshore tract. The firms are uncertain about the value of the oil they might find. Because the firms have different geological information about the area, their best estimates differ. The first firm believes the tract is worth $90, and the second and third firms believe the tract is worth $100 and $110, respectively. If each firm bids what it thinks the tract is worth, the third firm will win at a price of $110. In fact, the tract is probably worth only $100—this is the best estimate of tract value using the information possessed by all three firms.

If bidders are aware of this problem, they may reduce their bids. The third firm might bid only $95, even though it believes the tract is worth $110, because it recognizes that if it wins the auction, that could mean it has overly optimistic beliefs about the tract's value.

Oil companies found that they had repeatedly overestimated the reserves in the offshore oil leases that they won at auction. Therefore, they now routinely take into account the "winner's curse" by shaving their bids.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Home Builders' Sales Outlook Moderates. According to the National Association of Home Builders survey, the outlook for home sales deteriorated for the fifth straight month in April. Only 38 percent of those surveyed expect home sales for the next 6 months to be "good," compared with 48 percent in March.

Margin Loan Activity Continues to Grow. The New York Stock Exchange reports that margin loans outstanding to all investors were $62 billion at the end of March, down slightly from their record peak in February. This represents about a 40 percent increase from a year earlier. With margin loan rates fairly low (8.5 percent for a $5000 loan at Merrill Lynch, for example), more individuals are using margin loans to pay off high-cost credit cards and other debts.

New Energy-Efficient Lamp Introduced. This week in Europe, GE Lighting introduced a new lamp, called Genura, that uses a high-frequency magnetic field to produce light. This bulb combines the long life and energy efficiency of a fluorescent with the aesthetic qualities of an incandescent. In the United States the 23-watt Genura bulb will produce light similar to a 75-watt bulb. Initially it will sell for about $20, but it should produce energy savings of $40 over its lifetime. The bulbs should be available commercially later this year, and to consumers sometime next year.

World Economic Growth Outlook Improving. The IMF projects that world economic growth will be 3.0 percent in 1994 and 3.7 percent in 1995. Industrial economies are expected to expand at 2.4 percent this year, twice the rate of last year. The IMF forecast shows the United States leading the industrial economies this year with 3.9 percent growth. Developing countries will continue to experience strong growth of 5.5 percent this year. Economies in transition, especially the former Soviet States, will continue to experience deteriorating conditions, but growth should improve in 1995.

EYES ONLY

RELEASES THIS WEEK

Housing Starts

Housing starts increased 12.1 percent from February to March, to an annual rate of 1.47 million units.

Trade Deficit

The trade deficit (goods and services) increased to $9.7 billion in February from $6.6 billion in January.

MAJOR RELEASES NEXT WEEK

Durable Goods (Wednesday)
GDP (Thursday)
Personal Income (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1993	1993:2	1993:3	1993:4
Percent growth (annual rate)					
Real GDP	2.5	3.1	1.9	2.9	7.0
GDP deflator	5.6	2.2	2.3	1.6	1.3
Productivity					
Nonfarm business	1.2	1.9	–0.4	4.0	6.1
Manufacturing (1978-93)	2.3	5.2	6.0	3.0	7.2
Real compensation per hour	0.6	0.1	–1.2	1.8	–0.1
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	11.5	11.6	12.0
Residential investment	4.7	4.2	4.0	4.1	4.3
Exports	8.0	11.6	11.6	11.5	11.9
Imports	9.2	13.1	13.1	13.2	13.5
Shares of Nominal GDP (percent)					
Personal saving	4.8	3.0	3.3	2.8	3.0
Federal surplus	–2.8	–3.5	–3.5	–3.3	–3.2

		1993	Jan. 1994	Feb. 1994	Mar. 1994
Unemployment Rate	6.7*	6.8*	6.7	6.5	6.5

*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	Jan. 1994	Feb. 1994	Mar. 1994
Payroll employment (thousands)					
increase per month			–31	198	456
increase since Jan. 1993					2498
Inflation (percent per period)					
CPI	5.8	2.7	0.0	0.3	0.3
PPI-Finished goods	5.0	0.2	0.2	0.5	0.2

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Feb. 1994	Mar. 1994	Apr. 21, 1994
Dow-Jones Industrial Average	3284	3522	3906	3817	3653
Interest Rates					
3-month T-bill	3.43	3.00	3.25	3.50	3.74
10-year T-bond	7.01	5.87	5.97	6.48	6.91
Mortgage rate, 30-year fixed	8.40	7.33	7.15	7.68	8.49
Prime rate	6.25	6.00	6.00	6.25	6.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Apr. 21, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.692	−1.1	+5.8
Yen-Dollar	103.65	−0.5	−6.4
Multilateral (Mar. 1973=100)	94.11	−0.8	+4.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	+3.1 (Q4)	6.5 (Mar)	2.5 (Mar)
Canada	+3.0 (Q4)	11.1 (Feb)	0.2 (Feb)
Japan	0.0 (Q4)	2.8 (Jan)	1.2 (Jan)
France	−0.1 (Q4)	11.7 (Dec)	1.8 (Jan)
Germany	−0.8 (Q4)	6.6 (Jan)	3.4 (Feb)
Italy	0.3 (Q4)	10.6 (Jul)	4.2 (Feb)
United Kingdom	+2.4 (Q4)	10.0 (Jan)	2.4 (Feb)

EYES ONLY

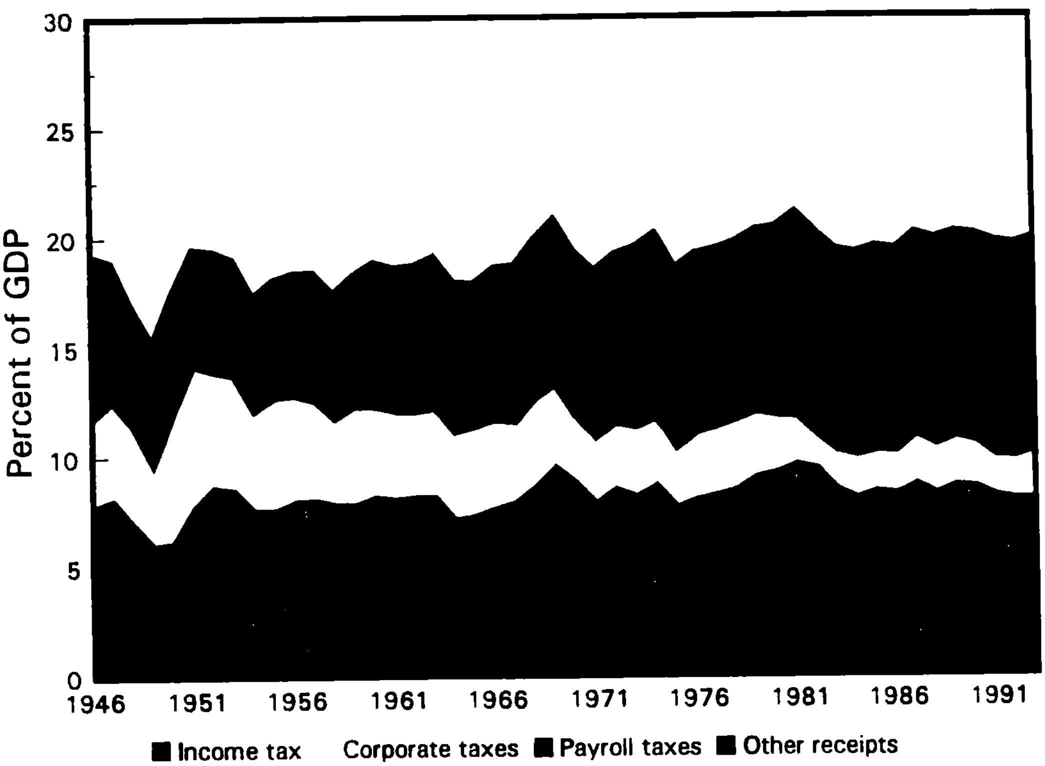
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

April 15, 1994

CHART OF THE WEEK

Federal Receipts as a Share of GDP



Federal receipts have been about 20 percent of GDP since World War II. The share of revenue raised by personal income taxes has also been roughly constant. Declines in the share of corporate income taxes and other taxes (excises, duties) have been offset by increased reliance on payroll taxes as a source of revenue.

EYES ONLY

CONTENTS

CURRENT DEVELOPMENTS

ARTICLE

DEPARTMENTS

QUOTATION OF THE WEEK

"The public interest is closely aligned with that of bondholders."

Former Fed Governor Wayne Angell, commenting on maintaining the Fed's independence to tighten monetary policy (Wall Street Journal, April 11, 1994)

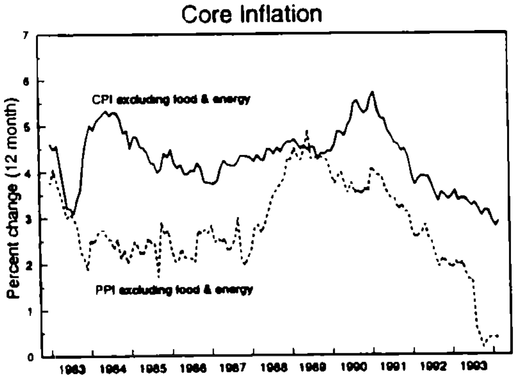
EYES ONLY

CURRENT DEVELOPMENT

Inflation Is Moderate, But Up Slightly from Last Year

This week's reports on consumer and producer prices continue to show moderate inflation. Core consumer price inflation (CPI excluding food and energy) was 2.9 percent at an annual rate over the first 3 months of the year, the same rate of increase as over the last 12 months. Core producer price inflation (PPI for finished goods excluding food and energy) was 3.3 percent over the first 3 months of the year, compared to 0.4 percent over the last 12 months.

Core Inflation



How does a core CPI inflation rate of 3 percent look in the light of recent economic history? Beginning in 1985, core CPI inflation was between 4 percent and 4-1/2 percent. When it increased in the late 1980s, the Fed moved to a restrictive policy. With a lag, the 1990-91 recession steadily reduced CPI inflation to below 3 percent last year. (Core PPI inflation showed a similar pattern in the same period, although its changes led CPI changes and were larger.)

Analysis. In retrospect, the period from mid-1993 through early 1994 is likely to appear to be one of unusually low inflation. Indeed, the Administration forecasts an increase in inflation as a consequence of a strengthening economy.

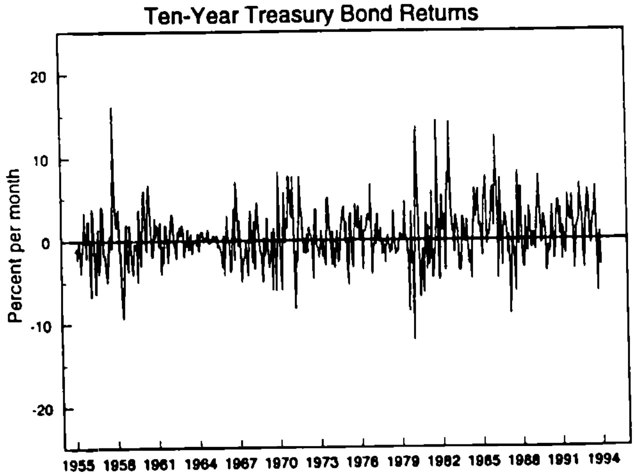
- Even if oil prices stay low, the downward pressure they have been exerting on inflation has about run its course. As economies around the world recover, upward pressure on the price of oil and other commodities is likely.
- The 3.3 percent rate of increase of the core PPI so far this year might herald the beginning of a slight increase in CPI inflation.
- For those, such as Wayne Angell, who would like to see inflation decline to zero, seeing the trough in inflation is a disappointment.

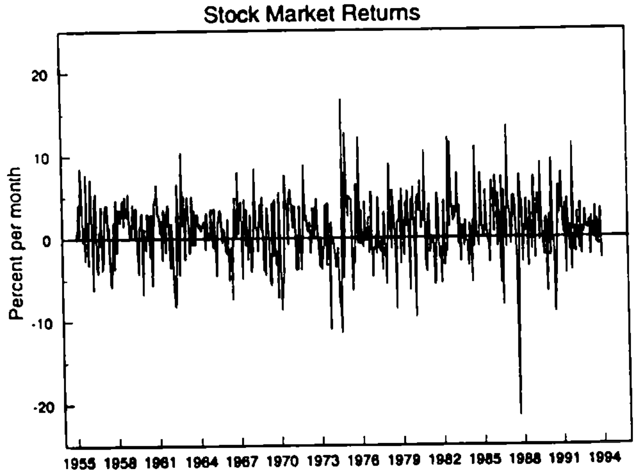
...YES ONLY

CURRENT DEVELOPMENT

No Trend in Financial Market Volatility

In recent months, there has been growing concern that the expansion of derivative securities and hedge funds may have increased the volatility of financial markets. This echoes the concern about program trading activities expressed a few years ago.





The charts show the month-to-month returns from holding bonds and stocks. There has been no discernable increase in the volatility of either bond or stock returns.

Bond returns have periodic changes in their volatility. They were particularly volatile in the 1979 to 1982 period, when the Fed was making no effort to stabilize interest rates. But the recent period has not been particularly volatile.

Stock market volatility has been fairly constant over the last 30 years. Volatility has been relatively low over the last year.

EYES ONLY

CURRENT DEVELOPMENT

Truck Strike Has Little Impact on Overall Economy

Although it has been almost 2 weeks since 75,000 Teamsters went on strike against 22 freight carriers, shippers and consumers have noticed little disruption. In contrast, the trucking strike in 1979 significantly disrupted freight traffic. It affected 300,000 workers at 350 firms.

Analysis. Although total employment in trucking has grown 20 percent since 1979, the unionized sector of the industry has shrunk dramatically. The main reason is the 1980 legislation that partially deregulated the trucking industry and that allowed a large number of non-union firms to enter the market.

In 1979, negotiations between the Teamsters and the trucking industry were closely watched as the first major test of the Carter Administration's wage guidelines. Today, there is little concern that a generous new union contract will set the stage for economy-wide wage increases, for several reasons:

- The striking union has many fewer workers than previously.
- The strike is not mainly over wage levels. The key issue is management's demands for rule changes that would allow firms to make greater use of part-time workers and rail transport. This emphasis reflects the Teamsters' weakened bargaining position since trucking was deregulated.
- Unions in other industries have become less likely to base negotiations on the provisions of wage agreements signed in key industries such as trucking and steel.

ARTICLE

The Odds Have It: Gambling in the U.S.A.

Gambling is a large and growing business in the United States. In 1992, Americans made legal wagers of $330 billion and, after covering payouts of winners, the gambling industry earned $30 billion in revenues. This dwarfs the revenues earned by other entertainment industries—for example, movie ticket sales are only about $5 billion per year.

Gambling Activity: Annual Wagers and Revenue

	Wagers (billions)	Revenue (billions)
State lotteries	$24.4	$11.5
Nevada/NJ casinos	237.7	9.0
Horse racing	14.1	2.9
Indian reservations	15.2	1.5
Charitable games	4.8	1.3
Bingo	4.3	1.0
Greyhound racing	3.3	0.7
Card rooms	8.4	0.7
Cruise ships and riverboats	11.6	0.7
Other casino activities	3.6	0.5
Jai alai	0.4	0.1
Legal bookmaking	2.1	0.1
Total	$329.9	$29.9

Notes: Figures are for 1992. Wagers are the total amount bet for each gambling activity. Revenue is wagers minus payouts. Source: *International Gaming and Wagering Business*, August 1993.

Gambling is becoming ubiquitous.

- 9 states have authorized casinos (including riverboat gambling).
- 37 states and the District of Columbia have lotteries.
- Over 100 Indian reservations have some form of gambling (casinos or high-stakes bingo, for example).
- 43 states permit some form of parimutuel betting (horse or greyhound racing, or jai alai, for example).
- Only 2 states (Hawaii and Utah) have no legalized gambling.

The uses of gambling revenue. To stay in business, the gambling industry's receipts must exceed its payouts to winning gamblers. Accordingly, gamblers lose money on average. The industry's revenues must be large enough to cover its costs, its profit margin, and any taxes that may be assessed by state, local, or Federal governments.

States use two basic methods to raise revenues from gambling:

- Casino games and parimutuel betting are taxed by levying an excise tax on gambling revenues. For example, New Jersey assesses an 8 percent excise tax on the amount retained by casinos. The casinos use the remaining 92 percent to cover wages and other costs and to provide a net profit.
- When states sponsor gambling, such as a lottery, they typically retain a much higher fraction of the proceeds (see table on previous page). For instance, the average state-run lottery pays out only 50 percent of gross wagers as prizes. Other costs, such as advertising and fees paid to merchants, consume part of revenues. The balance—close to half of wagers—is retained by states as a tax.

What is the scope for raising further tax revenue from gambling? Economic analysis indicates that gamblers are not very responsive to the "price" of gambling. That is, when the winning payoffs change but the odds stay constant, the overall amount wagered changes only slightly. This observation indicates that an excise tax on the entire gambling industry would not significantly discourage gambling, and therefore would not erode the tax base provided by the gambling industry. If only a segment of the gambling industry is subject to tax, however, there is a large potential for consumers to shift gambling activity to untaxed segments of the industry, causing the tax base to shrink.

Who bears the burden of taxes on gambling? The typical gambler at casinos is from the middle class. Patrons of lotteries tend to have lower incomes than average. Hence, taxes on gambling are regressive. The implicit tax on state lotteries is especially so.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Mortgage Loan Fees at 20-Year Low. Initial fees and charges on conventional mortgages that closed in February averaged 0.99 percent of the loan balance. This is the first month since December 1973 that initial fees and charges have averaged less than 1 percent of the loan balance. The downward trend in fees, which began in 1982, likely reflects three factors: the popularity of "no point" loans among households refinancing their homes, a more competitive mortgage market where lenders often compete with lower fees, and accounting rules adopted several years ago that limit the amount of initial fees and charges that a lender may recognize as current income.

Top-Rated Ideas to Boost Productivity Growth. Blue Chip forecasters recently rated 15 ideas to improve U.S. productivity growth on the basis of political feasibility and economic soundness. The top-ranked suggestion was, "Increase the quality of education, including appropriate financial support for job training and retraining." The second most popular idea was, "Avoid protectionism and let the dollar seek competitive levels."

Spain Offers Old Car Bounty. The Spanish government is offering a cash incentive to owners of older cars to trade them in for newer models that pollute less. Cars over 10 years old that are turned in for scrap will be eligible for a $720 discount on the 13 percent licensing tax on new cars. Automakers have also announced their own incentives of up to $1445. The government incentive, which will last for 6 months, is an attempt to revive a struggling auto sector. France announced a similar scheme in February that quickly boosted new car sales. There is speculation that the new Italian government may make a similar offer.

Defense Technology to End Tailgating? The latest defense-conversion technology for cars is a palm-sized, radar-like device designed to smooth traffic flow and prevent collisions by beeping when something gets too close. The company developing the device, Amerigon, used technology originally created at Lawrence Livermore National Laboratory for laser experiments in nuclear fusion. Motorists can use sets of these devices to help parallel park, back up, and change lanes. The devices can also trigger an air bag and create an "intelligent" cruise-control system to keep cars at a fixed distance. The components of the device cost only about $10. Amerigon hopes to have the devices installed in cars by 1997.

Trust Funds Running Out. A recent trustees' report estimates that the Medicare hospital trust fund is expected to run out of money by 2001. The report notes that the Medicare program is not sustainable in its present form. The outlook for the other Social Security trust funds is also gloomy. The disability fund will be exhausted next year if there are no changes in the law, and the retirement fund will run out in 2036, 8 years sooner than last year's report predicted.

RELEASES THIS WEEK

Consumer Prices

The consumer price index rose 0.3 percent in March.

Producer Prices

The producer price index for finished goods rose 0.2 percent in March.

Retail Sales

According to the advance report, retail sales rose 0.4 percent in March.

Industrial Production **** FOR RELEASE FRIDAY 9:15 A.M. ****

Industrial production rose 0.5 percent in March. Capacity utilization increased 0.2 percentage point to 83.6 percent.

MAJOR RELEASES NEXT WEEK

Housing Starts (Wednesday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1992	1992	1993	1993:3	1993:4
Percent growth (annual rate)					
Real GDP	2.5	3.9	3.1	2.9	7.0
GDP deflator	5.7	2.8	2.2	1.6	1.3
Productivity					
Nonfarm business	1.2	3.6	1.9	4.0	6.1
Manufacturing (1978-92)	2.1	4.8	5.2	3.0	7.2
Real compensation per hour	0.7	2.1	0.1	1.8	–0.1
Shares of Real GDP (percent)					
Business fixed investment	10.9	10.6	11.5	11.6	12.0
Residential investment	4.8	4.0	4.2	4.1	4.3
Exports	7.9	11.6	11.6	11.5	11.9
Imports	9.0	12.3	13.1	13.2	13.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	4.0	3.0	2.8	3.0
Federal surplus	–2.8	–4.6	–3.5	–3.3	–3.2

	1970–1992	1992	1993	Feb. 1994	Mar. 1994
Unemployment Rate	6.7*	7.4*	6.8*	6.5	6.5

*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.

	1970–1992	1992	1993	Feb. 1994	Mar. 1994
Payroll employment (thousands)					
increase per month			168	198	456
increase since Jan. 1993					2498
Inflation (percent per period)					
CPI	5.9	2.9	2.7	0.3	**0.3**
PPI-Finished goods	5.2	1.6	0.2	0.5	**0.2**

Newly released data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Feb. 1994	Mar. 1994	Apr. 14, 1994
Dow-Jones Industrial Average	3284	3522	3906	3817	3663
Interest Rates					
3-month T-bill	3.43	3.00	3.25	3.50	3.58
10-year T-bond	7.01	5.87	5.97	6.48	6.97
Mortgage rate, 30-year fixed	8.40	7.33	7.15	7.68	8.26
Prime rate	6.25	6.00	6.00	6.25	6.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Apr. 14, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.710	–0.4	+7.4
Yen-Dollar	104.2	–0.6	–8.4
Multilateral (Mar. 1973=100)	94.86	–0.4	+4.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	+3.1 (Q4)	6.5 (Mar)	2.5 (Mar)
Canada	+3.0 (Q4)	11.1 (Feb)	0.2 (Feb)
Japan	0.0 (Q4)	2.8 (Jan)	1.2 (Jan)
France	–0.1 (Q4)	11.7 (Dec)	1.8 (Jan)
Germany	–0.8 (Q4)	6.6 (Jan)	3.4 (Feb)
Italy	–0.5 (Q3)	10.6 (Jul)	4.2 (Feb)
United Kingdom	+2.4 (Q4)	10.0 (Jan)	2.4 (Feb)

BR|BO|GS|SM

EYES ONLY

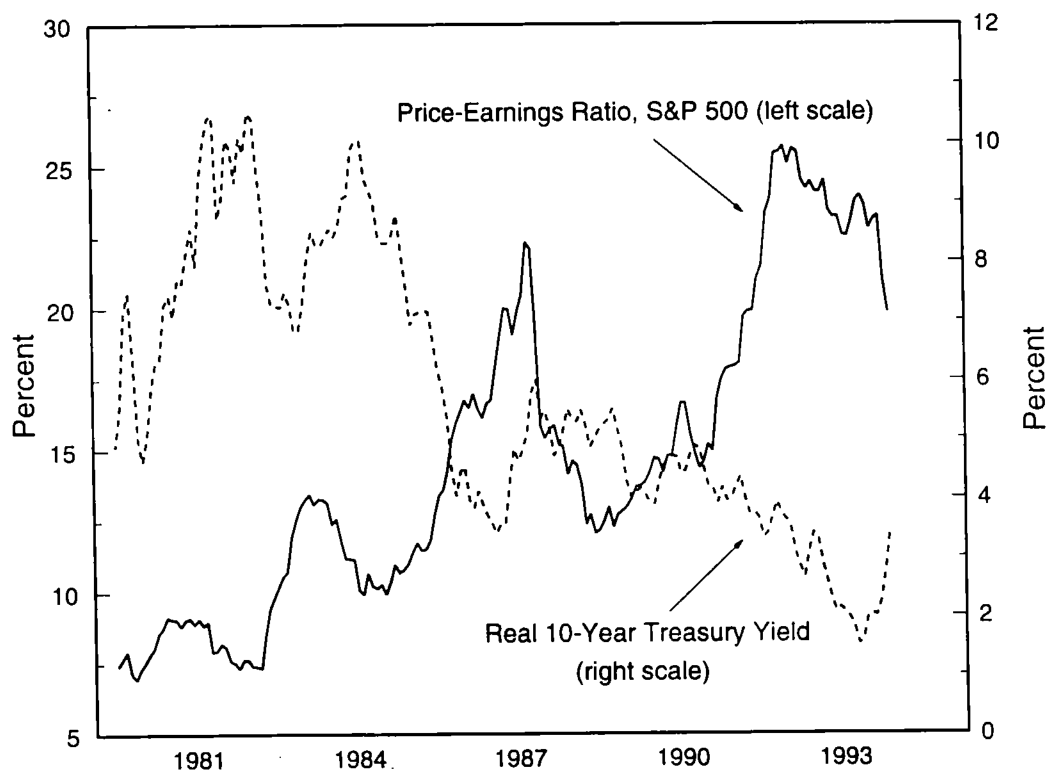
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

April 8, 1994

CHART OF THE WEEK

Stock Prices versus Long-Term Interest Rates



Stock prices and interest rates tend to move in opposite directions. When interest rates increase, stock prices decline as investors try to sell stock and move into money market funds, bonds, and other interest-bearing assets.

EYES ONLY

CONTENTS

PEANUTS CHARLES M. SCHULZ

Cereal and pet food exports from the United States to Canada have increased dramatically under the free trade agreement between the two countries (see Current Development, page 4).

EYES ONLY

SPECIAL ANALYSIS

The Stock Market and Economic Activity

The stock market has been extremely volatile recently. As of Monday, the Standard and Poor's composite stock price index was down 8.9 percent from its peak on February 2. By Thursday, it had recovered somewhat, but was still down 6.5 percent from its peak.

While stock market declines often do signal lower economic activity, the recent decline must be viewed in the context of the volatility of stock prices.

- Despite its recent decline the stock market remains high relative to earnings (see Chart of the Week). Moreover, the recent decline is not large compared to those that have occurred during the last 25 years (see table).

- A decline in the stock market is sometimes followed by a slowdown or a recession in economic activity, but this is not always the case. As the table shows, there is truth in the old saw, "The stock market has predicted nine out of the last five recessions."

Stock Market Declines

Date of Peak	Date of Trough	Price Decline	Followed by Recession?
Jul. 1959	Oct. 1960	-10.1%	Yes
Dec. 1961	Jun. 1962	-22.5%	No
Jan. 1966	Oct. 1966	-17.3%	No
Dec. 1968	Jun. 1970	-29.0%	Yes
Jan. 1973	Dec. 1974	-43.4%	Yes
Sep. 1976	Mar. 1978	-15.8%	No
Nov. 1980	Jul. 1982	-19.4%	Yes
Aug. 1987	Dec. 1987	-26.8%	No
Jun. 1990	Oct. 1990	-14.8%	Yes
Feb. 1994		-6.5%	No (CEA forecast)

Note: Percent decline in Standard and Poor's composite stock price index from peak to trough in stock price. The February 1994 figure is the decline from February 2 through April 7.

. . . continued

The stock market's links to the real economy. The stock market has two direct effects on real economy activity.

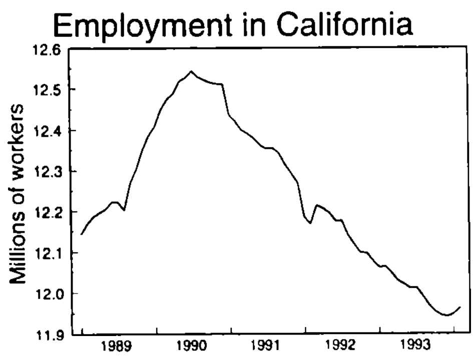
- **Wealth Effect.** Corporate equity is about 17 percent of private net worth. Consumption depends on wealth, so a decline in the value of the stock market reduces spending. A 10 percent, sustained reduction in the value of stock market wealth would depress consumption, leading to a 0.4 percent decline in GDP.

- **Cost of capital effect.** The stock market is a source of finance for firms' investment spending. The higher the market, the cheaper it is to finance investment by selling new equity. A 10 percent decline in the stock market would lead to a reduction in investment of about 4 percent, resulting in a further 0.6 percent decline in GDP.

EYES ONLY

CURRENT DEVELOPMENT

Good News, Bad News California Recovery



After a 4-year barrage of bleak economic news, California's long-awaited economic recovery appears to have begun. California added payroll jobs in January and February—the first consecutive 2-month gain since mid-1990. As the chart shows, however, this increase is too small to offset the sharp decline in employment that began in 1990. Moreover, it will take time before we know if the recent uptick is the beginning of a sustainable upward trend.

Other indicators also show improvement. California housing sales in January were 20 percent above a year ago while California business failures declined by 23 percent. Consumer confidence in the Pacific region jumped a healthy 6.8 percent from February to March.

Despite these promising signs, it is likely that California's jobless rate will exceed the nation's throughout the 1990s as the aerospace squeeze continues. Over the next few years, more unemployed people will leave the State, drop out of the labor force, or settle for jobs that pay less than the ones they have lost.

Short-Term Unemployment Rate Movements After Natural Disasters

The January 17 earthquake may have helped to revive the California economy in the short run. Changes in regional unemployment rates following Hurricane Andrew, Hurricane Hugo, and the San Francisco earthquake of 1989 suggest that regional unemployment rates usually decline in the 3 to 6 months following a major natural disaster.

- The biggest decline (about 2 full percentage points) occurred in Miami after Hurricane Andrew. The unemployment rate there was over 10 percent before the hurricane hit.
- A smaller decline followed the 1989 San Francisco earthquake—arguably because the region was already at full employment.

Based on this pattern, it is likely that the recent LA earthquake will cause a noticeable reduction in the region's high unemployment rate in the coming months.

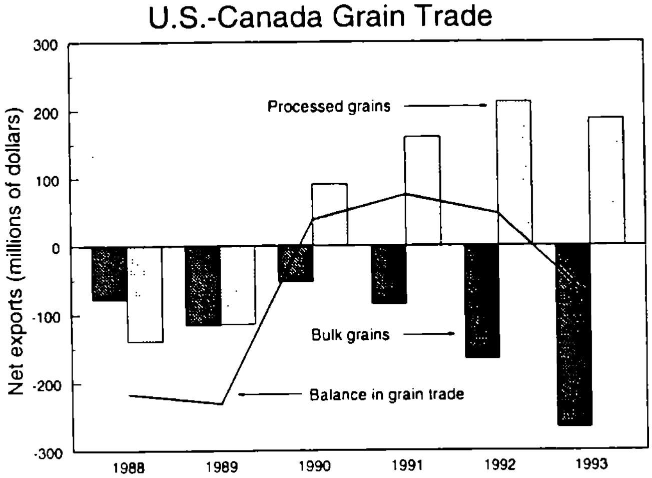
EYES ONLY

CURRENT DEVELOPMENT

Grain Trade with Canada Grows Under Free Trade Agreement

The recent surge in imports of wheat from Canada has created the impression that the U.S.-Canada Free Trade Agreement (CFTA) has hurt American farmers. But that impression is misleading. The CFTA has been good for U.S. agriculture in general and for the grain sector in particular.

Since the CFTA took effect, the U.S. agricultural trade balance with Canada has moved from a deficit of about $408 million in 1987 to a surplus of $625 million in 1993. The balance in grain trade with Canada has also improved as net exports of processed products (such as breads, pasta, cereals, and pet foods) have outstripped net imports of bulk grain commodities (see chart).



Last year, the trade balance in grain deteriorated as imports rose sharply. But 1993 was an unusual year. Heavy rains and flooding led to poor U.S. harvests, while aggressive subsidization of exports through the Export Enhancement Program (EEP) diverted part of the smaller U.S. production overseas, driving up domestic prices and attracting imports.

Analysis. As farm trade with Canada has expanded, the United States has been importing more bulk agricultural commodities and exporting more intermediate and finished agricultural goods. The market for processed goods such as breakfast cereals is more stable than the market for basic wheat or barley. Imports from Canada are therefore likely to fluctuate more than exports to Canada. Temporary import surges in a year of bad harvests are thus neither surprising nor a cause for concern.

EYES ONLY

ARTICLE

Auctioning Public Assets

The government controls many public assets. When the private sector can utilize those assets more effectively than the government, the government often allows private firms to do so. Public assets used by private firms include:

- Licenses to use parts of the radio spectrum for radio and television broadcasting or wireless communication
- The right to produce oil and gas from offshore tracts
- Licenses to dam rivers to generate hydroelectric power
- Military bases that will be converted to civilian use
- The right to cut timber in national forests.

These public assets are often extremely valuable. The government earned nearly $1 billion from timber harvests in 1993; the government earns about $3 billion annually from oil and gas auctions and royalty payments; and upcoming auctions for the radio spectrum allocated to personal communications services (PCS)—an advanced type of cellular telephone service—are expected to bring more than $10 billion to the U.S. Treasury. In one extreme example, the government sold 17,000 acres of land for $42,000. Weeks later, these lands were resold to a major oil company for $37 million.

Methods of Allocating Assets. A number of methods can be employed to decide which private firms will be permitted to use public assets.

- Licenses can be given away randomly, as was done for some cellular telephone licenses.
- A license can be awarded without charge to the best applicant, as chosen through a hearing. This was the traditional method for choosing licensees for radio and television stations and for hydroelectric projects.
- Licenses can be sold for a fixed price, as is done with grazing rights.
- Licenses can be auctioned to the highest bidder. Offshore oil and gas production rights have historically been auctioned.

Recent legislation authorizes the Federal Communications Commission (FCC) to conduct auctions for the electromagnetic spectrum allocated to PCS.

Advantages of Auctions. In choosing among these alternatives, the government typically has several objectives. It seeks revenue from the use of public assets, seeks to ensure that the assets are used efficiently, and seeks to ensure that other social objectives are satisfied as inexpensively as possible. Using auctions to allocate rights to use public assets has advantages in satisfying each of these objectives.

- Auctions will maximize the revenues to the government because competition among bidders raises the price the government receives. This is important when the rights being allocated are worth billions of dollars, as is the case for the examples above.
- Of all the methods for choosing licensees, auctions are the most likely to place the asset in its most economically efficient use. The private firm that can create the most wealth out of the asset is most likely to make the highest offer. Other methods of allocating assets to private firms will be less successful at achieving this outcome unless the market for resale of government assets works well. But buyers may have less interest in acquiring the asset on the second go-round. For example, buyers may worry that an oil tract is being offered for resale because the seller discovered too late that the geography is unfavorable for oil production, or because the tract would be expensive to utilize for buyers that did not purchase adjoining tracts.
- Auctions can be designed to accommodate other social objectives. For example, the government can set-aside some timber tracts for auctions limited to minorities or small businesses. Alternatively, the government can impose conditions on licensees. For example, the government can auction broadcast spectrum for television, and require a successful licensee to devote certain program hours to news or public interest programming.

Despite these advantages, auctions have historically been more the exception than the rule in allocating public assets to the private sector—but their use is rising.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Agricultural Export Subsidies: Spending Up, Volume Down. A recent USDA report shows a decline in subsidized agricultural export volume for the first half of fiscal 1994 despite increased spending on subsidies. The tonnage of subsidized wheat was down 25 percent over the previous year. But subsidies per ton averaged almost 50 percent higher than during the first half of fiscal 1993, so total spending on subsidies rose. Subsidized tonnage of flour, barley malt, and vegetable oils was similarly lower than in the previous year despite significant increases in subsidy rates. Barley sales were 13 percent higher, but at a cost of a more than 80 percent increase in the subsidy per ton.

Medicare Payment Gap Widening. This week, the Physician Payment Review Commission estimated that Medicare pays doctors 59 percent of what private insurance companies pay. In 1989, doctors received 68 percent of what private insurance companies paid. The Commission noted the success in limiting the reimbursement of doctors by Medicare, but raised concerns about a potential shortage of doctors willing to treat Medicare patients at reduced fees. Additionally, the Commission found a 50 percent increase in the volume of doctors' services per Medicare beneficiary from 1986 to 1993.

Second Major Telco-Cable Deal Falls Apart. Cox Enterprises, a cable system operator, and Southwestern Bell recently called off their proposed partnership arrangement. In February, Bell Atlantic and TCI cancelled the largest proposed telco-cable merger. Many smaller deals are also in trouble. For example, Canada's BCE Telecom is renegotiating its investment in Jones Intercable.

NAPM Price Index Falls in March. Increases in the National Association of Purchasing Managers' (NAPM) price index survey received a lot of attention early in the year and "moved markets." The price index was 64.2 in March, down from 67.0 percent in February. This could have been interpreted positively by the markets—a sign of some moderation of inflation pressures. But its announcement Monday was accompanied by a 17 basis point jump in long-term interest rates.

Small Businesses Report Strong Demand for Workers. According to a survey of small businesses by the NFIB, 29 percent of small firms plan to expand employment and only 5 percent plan to reduce it. Nearly a quarter of firms also reported having difficulty filling job openings.

EYES ONLY

RELEASES THIS WEEK

Leading Indicators

The index of leading indicators fell 0.1 percent in February.

Automobile Sales

Domestically produced automobiles sold at a 7.7 million unit annual rate in March, an increase of 4 percent from February.

MAJOR RELEASES NEXT WEEK

Producer Prices (Tuesday)
Consumer Prices (Wednesday)
Retail Sales (Wednesday)
Industrial Production and Capacity Utilization (Friday)

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U.S. ECONOMIC STATISTICS

	1970-1992	1992	1993	1993:3	1993:4
Percent growth (annual rate)					
Real GDP	2.5	3.9	3.1	2.9	7.0
GDP deflator	5.7	2.8	2.2	1.6	1.3
Productivity					
Nonfarm business	1.2	3.6	1.9	4.0	6.1
Manufacturing (1978-92)	2.1	4.8	5.2	3.0	7.2
Real compensation per hour	0.7	2.1	0.1	1.8	-0.1
Shares of Real GDP (percent)					
Business fixed investment	10.9	10.6	11.5	11.6	12.0
Residential investment	4.8	4.0	4.2	4.1	4.3
Exports	7.9	11.6	11.6	11.5	11.9
Imports	9.0	12.3	13.1	13.2	13.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	4.0	3.0	2.8	3.0
Federal surplus	-2.8	-4.6	-3.5	-3.3	-3.2

	1970-1992	1992	1993	Feb. 1994	Mar. 1994
Unemployment Rate	6.7*	7.4*	6.8*	6.5	6.5

*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.

	1970-1992	1992	1993	Feb. 1994	Mar. 1994
Payroll employment (thousands)					
increase per month			168	198	456
increase since Jan. 1993					2498
Inflation (percent per period)					
CPI	5.9	2.9	2.7	0.3	N.A.
PPI-Finished goods	5.2	1.6	0.2	0.5	N.A.

No new data this week.

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FINANCIAL STATISTICS

	1992	1993	Feb. 1994	Mar. 1994	Apr. 7, 1994
Dow-Jones Industrial Average	3284	3522	3906	3817	3693
Interest Rates					
3-month T-bill	3.43	3.00	3.25	3.50	3.53
10-year T-bond	7.01	5.87	5.97	6.48	6.86
Mortgage rate, 30-year fixed	8.40	7.33	7.15	7.68	8.47
Prime rate	6.25	6.00	6.00	6.25	6.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Apr. 7, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.718	+2.8	+6.1
Yen-Dollar	104.9	+2.3	−7.7
Multilateral (Mar. 1973=100)	95.24	+2.1	+3.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	+3.1 (Q4)	6.5 (Mar)	2.5 (Feb)
Canada	+3.0 (Q4)	11.1 (Feb)	0.2 (Feb)
Japan	0.0 (Q4)	2.8 (Jan)	1.2 (Jan)
France	−0.1 (Q4)	11.7 (Dec)	1.8 (Jan)
Germany	−0.8 (Q4)	6.6 (Jan)	3.4 (Feb)
Italy	−0.5 (Q3)	10.6 (Jul)	4.2 (Feb)
United Kingdom	+2.4 (Q4)	10.0 (Jan)	2.4 (Feb)