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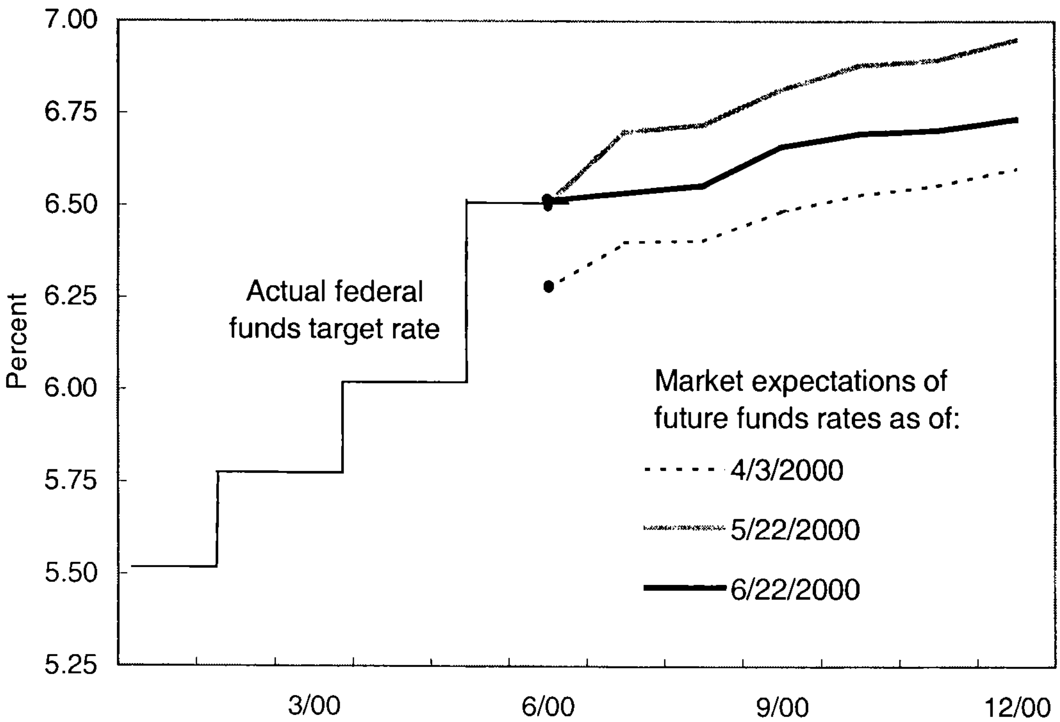
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 23, 2000

CHART OF THE WEEK

Market Expects Fed Rate Hikes Nearly Done for the Year



Market sentiment is that the Federal Open Market Committee will not make a move at next week's meeting, but will probably raise the federal funds target by one-quarter percentage point to 6.75 percent sometime later in the year. Recent data showing subdued inflation and slowing growth have soothed earlier concerns of further rate hikes.

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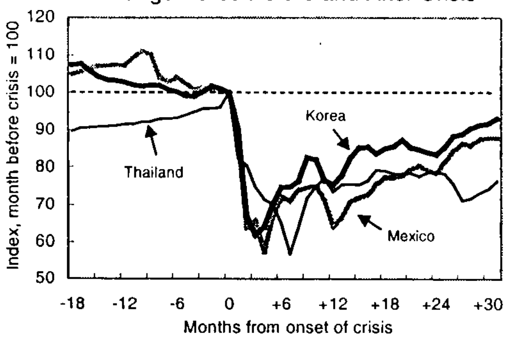
SPECIAL ANALYSIS

The Asian Rebound

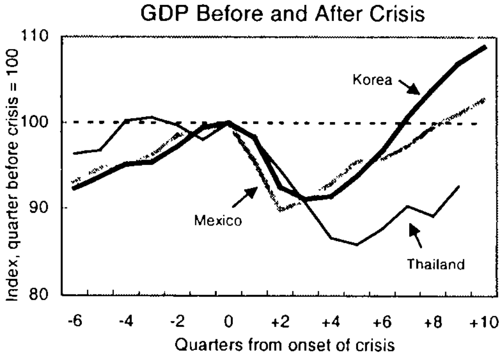
In contrast to the so-called "Tequila crisis" in Mexico in 1994-95, the Asian financial crisis that began in 1997 appeared to be rooted in private sector financial weaknesses rather than public sector financial problems. Nevertheless, the post-crisis responses of the economies have been remarkably similar, particularly in the cases of Mexico and Korea.

Real Exchange Rates Before and After Crisis



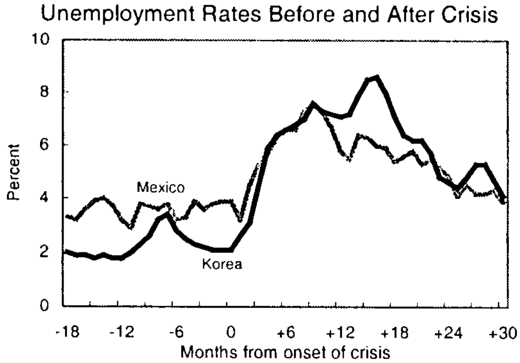
Exchange rates collapsed. The exchange rates of the Asian economies most affected by the crisis fell by around 40 percent at the onset of the Asian crisis, similar to the earlier Mexican experience (see upper chart). Real exchange rates remain well below pre-crisis levels in Korea and Thailand, as they did in Mexico.

GDP Before and After Crisis



Output fell sharply. The decline and subsequent rise in real GDP in Korea closely follows the pattern set by Mexico during its earlier crisis and recovery. In each case, output fell about 10 percent below its pre-crisis peak, and recovered fully within 2 years (see middle chart). Hong Kong and Malaysia have enjoyed rebounds similar to Korea's; in Thailand and Indonesia, however, the recoveries have shown considerably less bounce.

Unemployment Rates Before and After Crisis



Unemployment rose. Monthly unemployment data are available for Mexico and Korea, and show substantial increases after the onset of crisis (see lower chart). The unemployment rate rose more sharply in Korea than in Mexico, and peaked somewhat later. In both countries, unemployment gradually declined over the next few years. In the case of Mexico, the unemployment rate of 2.5 percent in April 2000 (4 1/2 years past the peak shown on the chart) was well below its pre-crisis level, while the Korean unemployment rate is still above its pre-crisis level but continues to decline.

A cautionary note. The policy response to the Mexican crisis 5 years ago is now generally viewed as having produced satisfactory results. Similarly, the rapid rebound enjoyed by some economies hard hit by the Asian crisis owes much to sound macroeconomic policy and structural reform measures—as well as to a global economic boom that has boosted demand for Asian exports. The reform agenda remains incomplete, however, and the pace of reform needs to be maintained in order to continue improving corporate governance and rehabilitating the financial sector. The ongoing rapid recovery heightens the risk of complacency. While structural reforms can be painful in the short run, without them Asia would remain vulnerable to future economic disruptions.

EYES ONLY

SPECIAL ANALYSIS

Measuring the Benefits of Pharmaceutical Innovation

Pharmaceutical research and innovation have been a key part of the increase in longevity discussed in last week's *Weekly Economic Briefing*. Antibiotics and vaccines, for example, have nearly eradicated major diseases like polio, measles, and diphtheria, and improved drug therapies have reduced the effects of epidemics such as AIDS.

Pharmaceutical innovations explain much of the fall in mortality. Today, people are living longer than ever. New drugs are constantly being developed and put to use to decrease mortality. A recent study finds that nearly two-fifths of the drugs in use in 1991 had been approved since 1980, highlighting the rapid rate of pharmaceutical innovation. The same study finds the use of new drugs (approved since 1970) explains over 40 percent of the variation in mortality reduction across 75 diseases between 1970 and 1991. In contrast to the impact of drugs, measures of non-medication therapeutic services, vaccines, and new surgical procedures appear to contribute little to the reduction in mortality from these diseases over this period.

Drugs reduce the need for hospitalization. A wide range of evidence supports the view that drug treatments have reduced the need for hospital care. For example, operations for peptic ulcers decreased by 80 percent from 1977 to 1987 after the introduction of H2 antagonists, thus saving hundreds of millions of dollars in annual medical costs. Similarly, one study found that the number of hospital bed-days declined most rapidly when the number of drug prescriptions rose. Data from patient visits, hospital use, and drugs prescribed between 1980 and 1991 show that there is a strong inverse relationship between hospital bed-days and drugs in use: a 10 percent increase in drug prescriptions is associated with a 6.4 percent reduction in hospital bed days. In contrast to the effect of drugs, the availability of new surgical techniques tends to increase hospital use.

Case study: drug treatment for heart attacks. The effects of new drug treatments in reducing mortality rates from heart attacks stands out as a particularly valuable example because, as noted in last week's *Weekly Economic Briefing*, improved cardiovascular care has been the dominant source of increased longevity in the United States. The heart attack mortality rate fell by about 30 percent between 1975 and 1995. During this period, several key drugs were introduced and widely adopted. For example, Heparin (a blood thinning drug) use rose quickly following its introduction in the 1980s to 53 percent of all cases, and settled at 70 percent by the mid-1990s. According to one estimate, improved medical treatment explains about half of the fall in heart attack mortality between 1975 and 1995, with virtually all of this attributable to pharmaceuticals. In fact, these numbers underestimate the total effect of drug therapy, because they do not include the effect of drugs in reducing the probability of having a heart attack in the first place.

EYES ONLY

The social return to research on pharmaceuticals. According to one estimate, the return to society in the form of increased longevity of pharmaceutical research and innovation is well above the rates of return to overall investment in the economy. Moreover, such estimates of the value of pharmaceutical research ignore the positive effect of new drugs on the quality of life, implying an even larger benefit to society.

ARTICLE

Wealth and Giving

Philanthropic giving is estimated to have reached a record $190.2 billion in 1999 and has grown faster than GDP since 1995. The strong stock market and substantial increases in income and wealth among the wealthiest Americans appear to be important reasons for the recent surge.

Trends in giving. Between 1975 and 1995, total charitable giving fluctuated in a range around 1.75 percent of GDP (see chart). Sharp increases in giving in 1995 and 1996 outpaced growth in GDP, and the AAFRC Trust for Philanthropy (the organization that compiles these data) estimates that giving continued to be strong in 1998 and 1999, based on growth in income and the stock market. As a result, giving as a share of GDP in 1999 is estimated to be back near the levels of the 1960s.

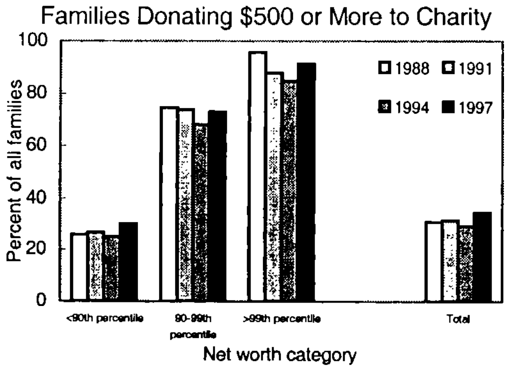
Economic determinants of giving. Individuals provide about three-fourths of all giving, with the rest coming from foundations, bequests, and corporations. Economists analyzing the determinants of individual giving focus on ability to give (income and wealth) and the "price" of giving (based on the marginal tax rate for those who itemize deductions).

- Income and wealth. The average contribution through most of the income range averages about 1½ to 2 percent of family income, but this percentage rises for the small share of families with incomes above $100,000. Thus, strong growth in income and wealth has probably contributed to the recent growth in individual giving and bequests. In addition, private foundations are required by law to distribute a minimum share of their assets to charity each year, and the rise in the stock market has boosted these assets substantially.

- Taxes. Cuts in income tax rates in the 1980s raised the after-tax cost of making tax-deductible charitable contributions, and this increase was only partly reversed by subsequent changes in tax law. Thus, tax changes are probably not the primary cause of recent increases in giving. However, economic studies generally find that giving is at least somewhat responsive to tax incentives, especially for higher income taxpayers. The Treasury estimates, for example, that repeal of the estate tax would reduce charitable giving by about $5-6 billion per year, partly through reduced bequests and partly through reduced lifetime giving.

Wealth effects. Evidence on how giving varies with wealth comes from the Federal Reserve's Survey of Consumer Finances (SCF), which gathers detailed information about wealth and also asks about charitable contributions of $500 or more. Because of the $500 exclusion, the SCF data do not reflect smaller contributions. While this exclusion may produce a distorted pattern of participation among less wealthy households, it appears to exclude only about 5-10 percent of total contributions.

- Participation. The proportion of families making charitable contributions is much higher in the top 10 percent of the wealth distribution than in the bottom 90 percent (see chart). In 1997, 35 percent of all households made charitable contributions of $500 or more, a higher rate than in 1988, 1991, and 1994. The participation rate was 30 percent among the least wealthy 90 percent of families, and over 90 percent in the richest 0.5 percent of families.



- Amount given. About half of all contributions come from the wealthiest 10 percent of families, and a substantial fraction of that from the wealthiest 0.5 percent. Even so, giving as a proportion of net worth is higher in the bottom 90 percent of the distribution than it is at the top.

Conclusion. Strong growth in income and wealth, especially among richer families, appear to be important reasons why charitable giving has grown faster than GDP since 1995. There is some evidence that the rich are more likely to support education, health, and art and cultural institutions and less likely to support religious institutions and social services than the less wealthy. Thus changes in the distribution of wealth or changes in taxes that affect charitable giving may alter the composition of giving as well as its level.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Payroll and Income Taxes. Although average Federal income taxes have declined since 1979 across all income classes, payroll taxes have increased so that the average family's combined Federal income and payroll tax liability is roughly the same as it was in 1979, according to a recent study. As a result of the payroll tax increase of the early 1980s coupled with the expansion of the EITC in the late 1980s and early 1990s, payroll tax liabilities now exceed income tax liabilities for nearly two-thirds of all families, compared with 42 percent of families in 1979. Families with adjusted AGI below $10,000 have seen their total Federal tax liabilities decline by roughly one-third between 1979 and 1999. For families in all income categories between $10,000 and $200,000, the combined tax burden in 1999 was nearly unchanged from 1979, but, for the small set of families with adjusted AGI in excess of $200,000, the Federal tax burden has fallen.

Tightening Bank Lending Standards May Cut Down Loan Growth. Nearly a quarter of domestic banks reported tightening standards on commercial and industrial loans in the past quarter, according to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey. Recent research suggests that such a tightening in loan standards may lead to lower aggregate loan growth, supporting the view that bankers allocate loans not only by raising and lowering interest rates, but by changing non-price terms as well. Researchers at the Federal Reserve Bank of New York find that during the past two decades commercial lending by U.S. banks slowed substantially following reports of tighter standards, even after controlling for other factors. To the extent that credit availability depends on lenders' standards, a tightening of standards could cause a decline in spending by firms that depend on bank credit. A tightening of standards may also signal that lenders are reacting to other factors that cause the economy to slow.

Housing Vouchers Improve Outcomes for the Poor. Offering residents of distressed inner-city housing projects vouchers for private housing can improve their well-being, according to a recent study of the Moving to Opportunity program in Boston. Housing project residents were randomly offered either a restricted Section 8 certificate valid only in low-poverty areas (together with mobility counseling), unrestricted Section 8 assistance (and no counseling), or continued project residence. Those with restricted certificates were more likely to move to suburban, low-poverty neighborhoods than their counterparts. However, fewer families offered restricted certificates managed to move out of public housing as compared to those receiving unrestricted assistance (48 and 62 percent, respectively). Both types of movers experienced large improvements in personal safety, health, and a decline in behavior problems among boys, as compared to public housing residents offered no vouchers. The children of families that moved to the suburbs also experienced a decline in injuries, asthma attacks, and personal crime victimization.

EYES ONLY

INTERNATIONAL ROUNDUP

Study Links Civil Wars to Economic Factors. A new study finds that the occurrence of civil war is more strongly related to economic and geographical factors than to measures of objective grievance, such as lack of rights. The study analyzes the pattern of civil wars in 161 countries from 1965-99, covering 73 conflicts. It finds that greater geographical dispersion of the population, faster population growth, less access to education, and a lower rate of GDP growth are all associated with higher incidence of internal conflict. The most powerful risk factor, however, is having a substantial share of primary commodity exports in GDP, perhaps because they can be easily looted and thus provide a potential source of finance for rebellion. Surprisingly, inequality (of income or assets), does not have a discernible effect on the probability of conflict, nor does a lack of democratic rights. Statistical analysis also reveals that countries with *more diverse* religious and ethnic populations have a lower incidence of conflict, while countries with one dominant group have a higher risk of conflict.

WTO Says Trade Promotes Growth and Fights Poverty. A new WTO Secretariat study provides evidence that trade liberalization helps poorer countries catch up with richer ones and that this faster economic growth may help alleviate poverty. While income per capita in developing countries has in general *not* been catching up with that in developed countries, the report—looking at the experiences of various middle- to high-income countries—finds that a country that formally enacted trade liberalization policies did tend to close the income gap. Interestingly, countries that trade extensively with one another tend to converge in income, with both trading partners moving to higher and steeper growth paths. Of course, other factors beyond trade are also important for long-run growth. For the poorest countries, trade liberalization on its own may not have large effects in the absence of other changes that improve capacity to participate effectively in the global market.

WHO Ranks U.S Health System Performance 37th in World. Although the United States has the highest health expenditures per capita, it is only 15th best in terms of health goal attainment, placing it in 37th position for overall performance per health care dollar, according to a World Health Organization study of 191 countries. The report measured health system goal attainment using indicators of disability-adjusted life expectancy across the population, responsiveness to patients, and the distribution of the financial burden of health costs. Japan scored best in overall goal attainment and France was best in terms of performance per dollar spent. The United States ranked first in overall responsiveness of care, based on respect for patients and quality of service, but was 24th in average life expectancy and fared poorly on the equitable distribution of costs and responsiveness for different groups of society.

EYES ONLY

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RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $30.4 billion in April; the deficit was $30.6 billion in March.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 22, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10376
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.67
10-year T-bond	5.26	5.65	5.99	6.44	6.12
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.14
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 22, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.940	-1.4	-9.0
Yen (per U.S. dollar)	104.4	-2.0	-14.2
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.59	-0.1	0.1

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	4.1 (May)	3.1 (May)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.7 (Q1)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	3.0 (Q1)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

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

EYES ONLY

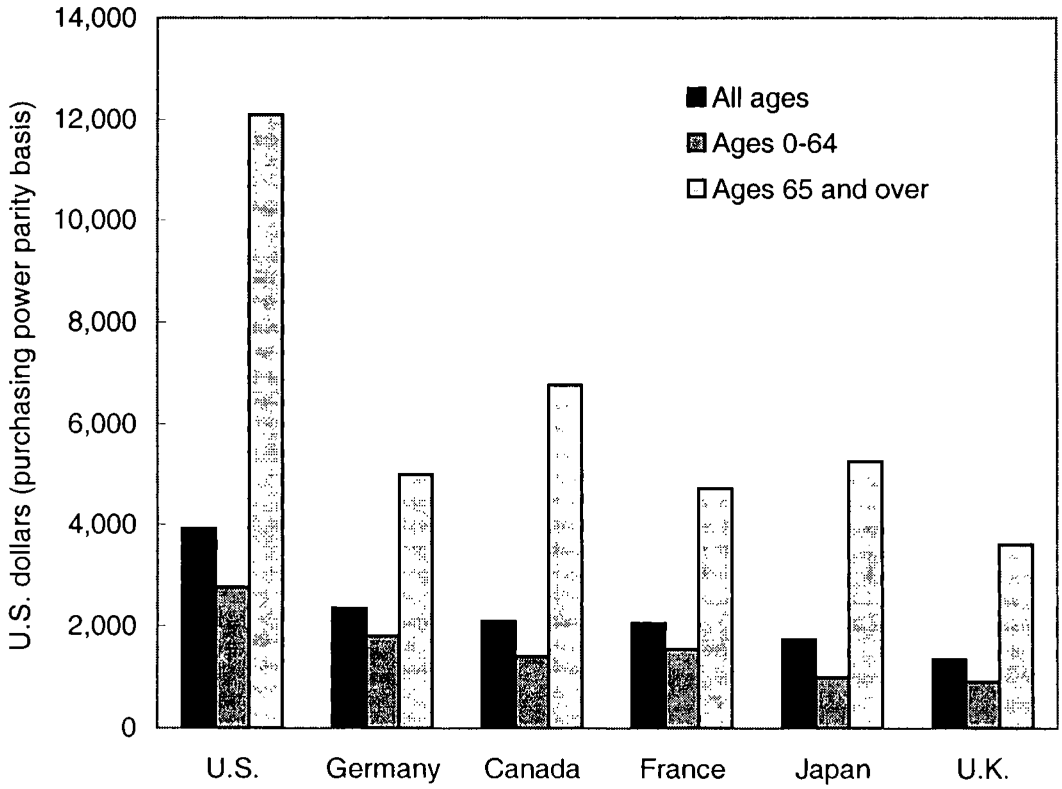
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 16, 2000

CHART OF THE WEEK

Per Capita Health Spending in Selected Countries, 1997



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

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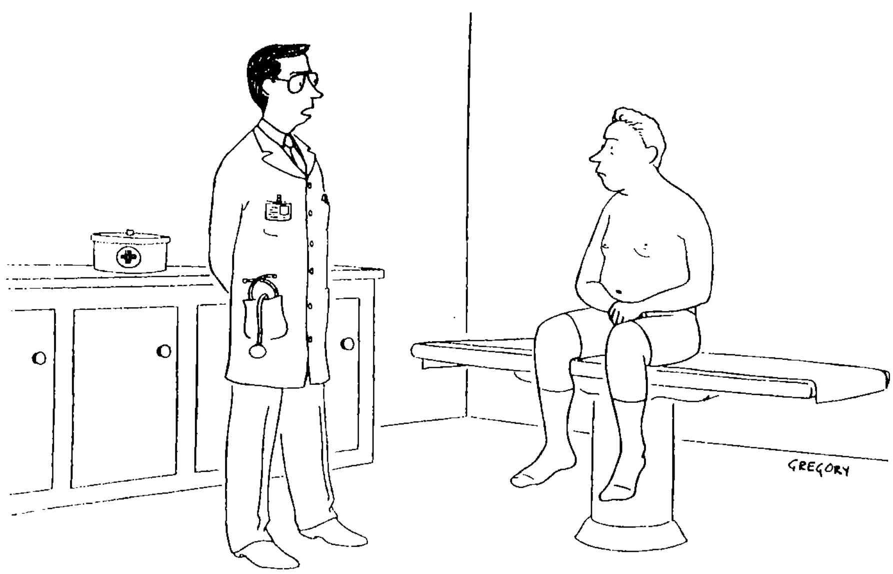
CONTENTS



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

EYES ONLY

SPECIAL ANALYSIS

The Costs of Reducing MTBE

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

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

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

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

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

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

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

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

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

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

SPECIAL ANALYSIS

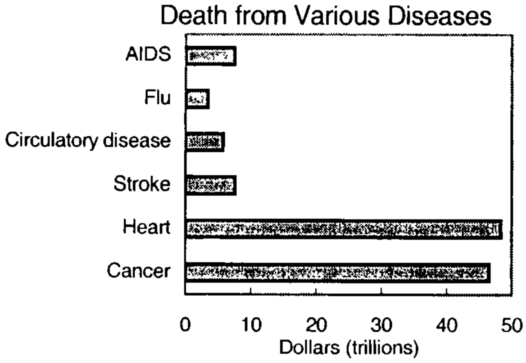
The Economic Value of Medical Research

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

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

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

Economic Value of Eliminating Death from Various Diseases



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

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

EYES ONLY

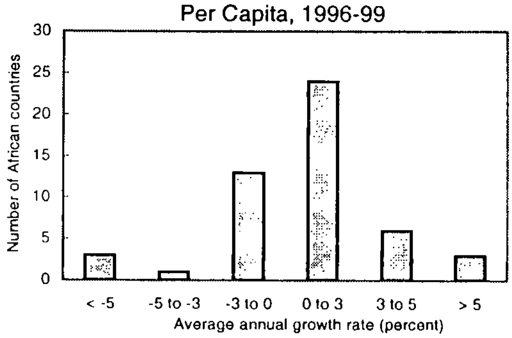
ARTICLE

Africa: A Glimmer of Hope

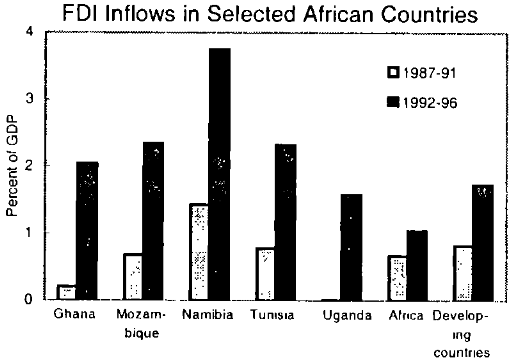
While parts of Africa are making headlines with wars and natural disasters—presenting observers like *The Economist* with an image of a "hopeless continent"—other parts are making headway reforming their economies, attracting more interest from domestic and foreign businesses, and attracting foreign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

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

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



FDI Inflows in Selected African Countries



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

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

Morocco: Sustained Increase in FDI Inflows

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

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

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

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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

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

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

INTERNATIONAL ROUNDUP

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

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

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

EYES ONLY

RELEASES THIS WEEK

Housing Starts

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

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

Industrial Production and Capacity Utilization

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

Consumer Price Index

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

Retail Sales

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

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

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

INTERNATIONAL STATISTICS

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

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	4.1 (May)	3.1 (May)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.7 (Q1)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

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

EYES ONLY

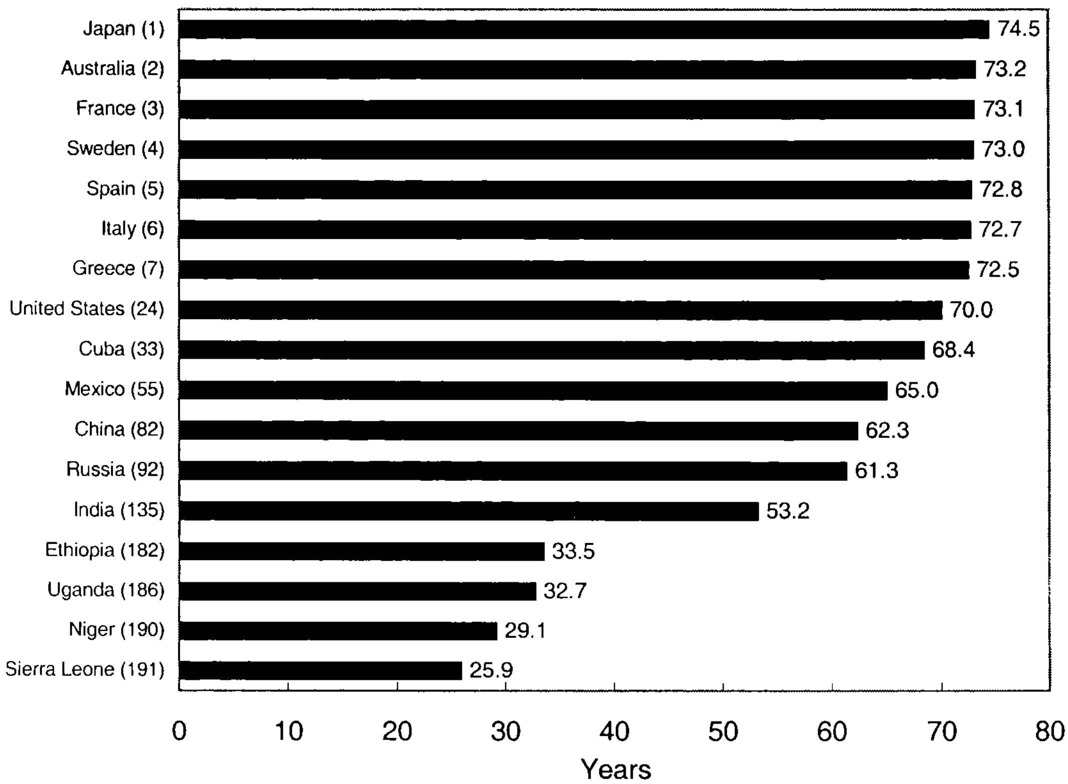
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 9, 2000

CHART OF THE WEEK

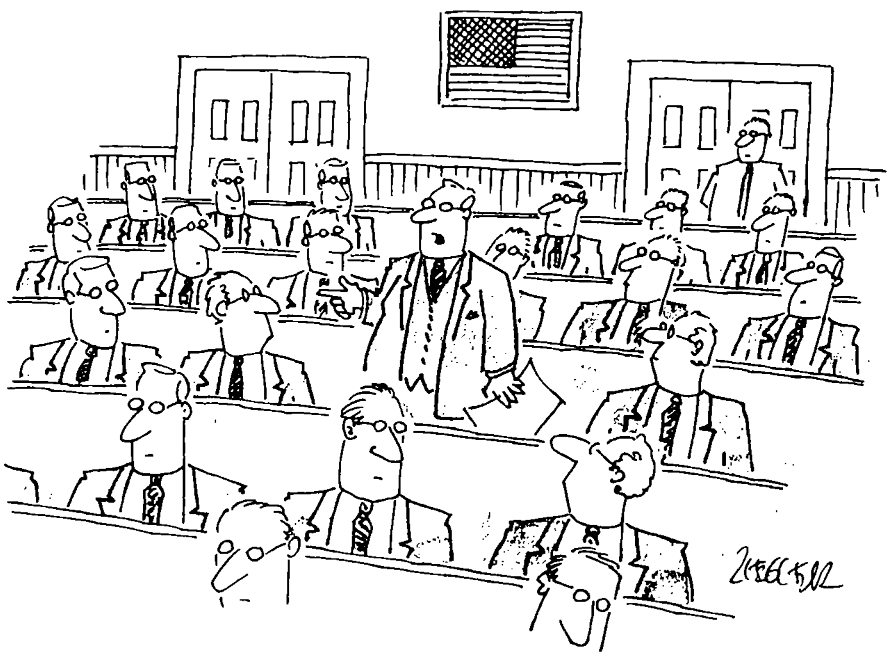
Healthy Life Expectancy in Selected Countries



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

CONTENTS

EYES ONLY



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

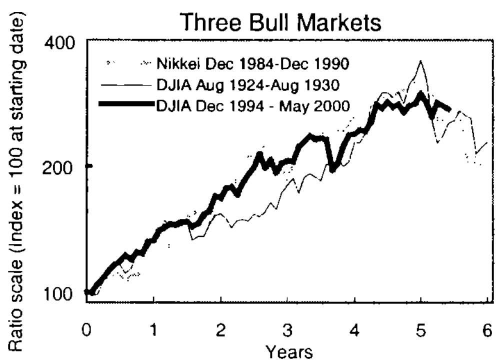
EYES ONLY

SPECIAL ANALYSIS

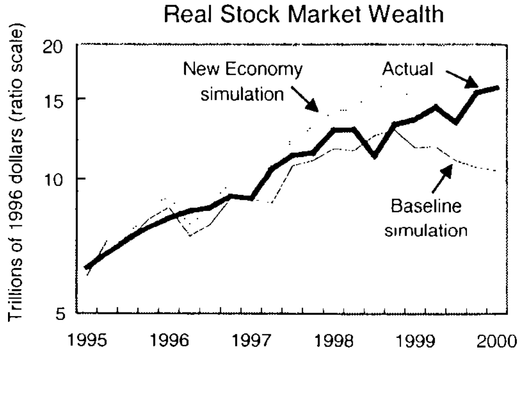
Irrational Exuberance?

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

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



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



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

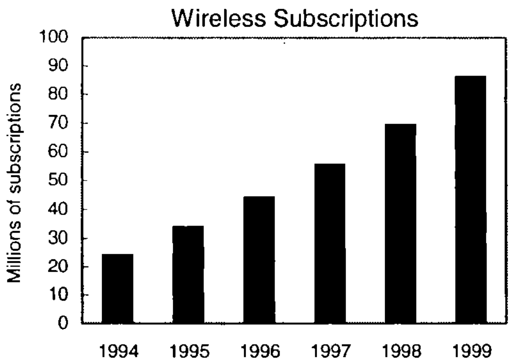
The first (baseline) simulation shows that nearly half of the actual increase in stock market wealth can be explained by fundamentals, assuming that investors' forecast of future growth stayed at a level consistent with the economy's performance during the previous two decades. Falling real interest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

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

SPECIAL ANALYSIS

Wireless Bandwidth

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



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

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

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

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

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

EYES ONLY

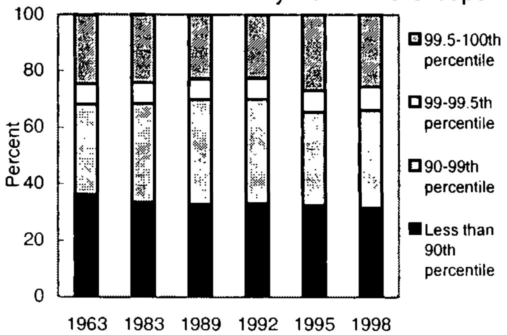
ARTICLE

The Distribution of Wealth Is Top Heavy—As Usual

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

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

Net Worth Distribution by Percentile Groups



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

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

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

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

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

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

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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

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

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

INTERNATIONAL ROUNDUP

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

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

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

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

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

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

Productivity

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

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, June 9, 2000**.

EYES ONLY

FINANCIAL STATISTICS

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

INTERNATIONAL STATISTICS

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

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	4.1 (May)	3.0 (Apr)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.0 (Q4)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

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

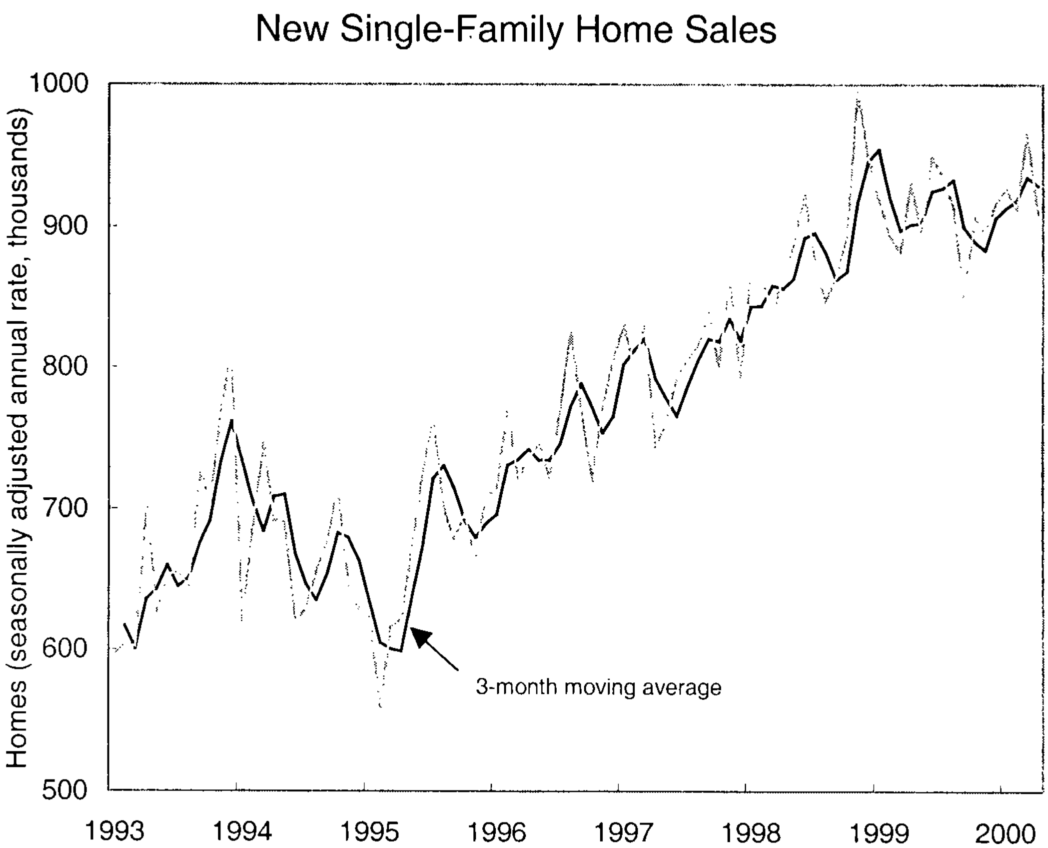
EYES ONLY

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 2, 2000

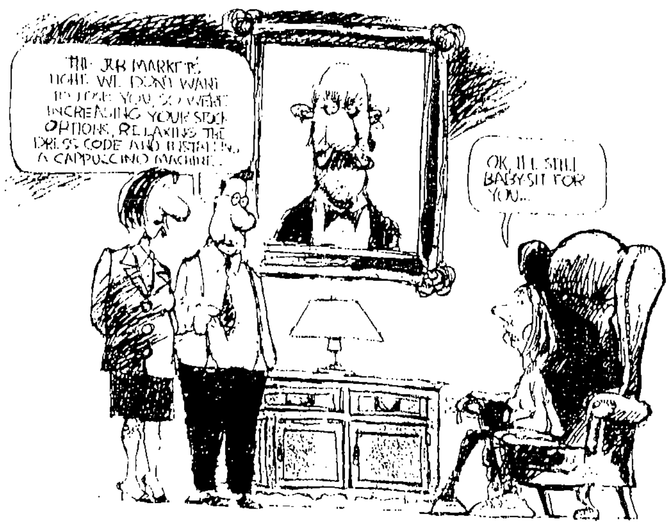
CHART OF THE WEEK



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

CONTENTS

EYES ONLY

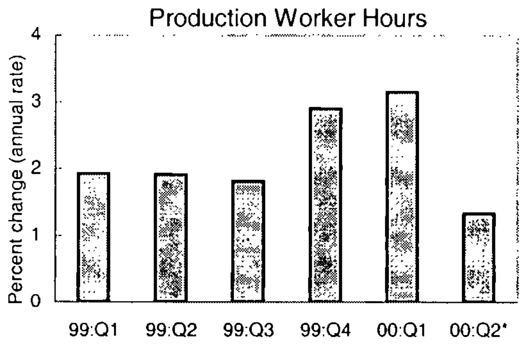


EYES ONLY

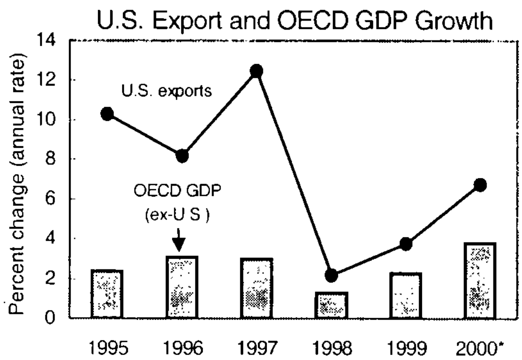
MACROECONOMIC UPDATE

Economy Likely to Slow in the Second Quarter

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



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



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

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

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

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

SPECIAL ANALYSIS

The Economics of Standards

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

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

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

Conclusion. As the HIPAA example illustrates, firms may not always have the incentive to develop standards that would generate cost savings to the entire

EYES ONLY

industry due to the costs of coordinating such a move. While government intervention can resolve this type of deadlock and increase economic efficiency, the imposition of standards by the government does carry some risks. For example, whenever the government chooses a standard, even one that is the best available at any point in time, the incentives to develop a better standard may be diminished. In addition, since government standards are typically slow to develop, government standards may sometimes take longer to develop than market-based solutions.

EYES ONLY

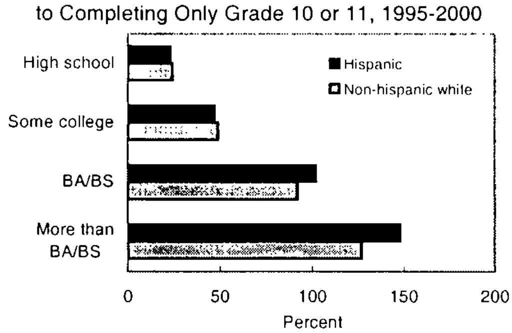
ARTICLE

Education and the Economic Success of Hispanics

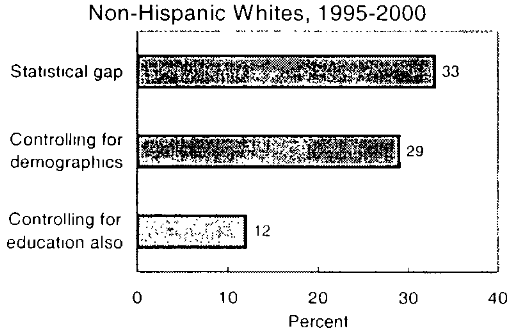
Hispanics are a growing segment of the U.S. population. In 20 years about one in six U.S. residents will be of Hispanic origin, and by the middle of this century—when today's young children are middle aged—this ratio will increase to about one in four. Given the current educational attainment gap between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

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

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



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



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

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

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

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

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

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

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

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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

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

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

INTERNATIONAL ROUNDUP

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

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

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

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

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

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

NAPM Report on Business

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

Leading Indicators

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

Consumer Confidence

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

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Producer Prices (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

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

EYES ONLY

FINANCIAL STATISTICS

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

INTERNATIONAL STATISTICS

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

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	**4.1** (May)	3.0 (Apr)
Canada	4.9 (Q1)	6.8 (Mar)	2.1 (Apr)
Japan	0.0 (Q4)	5.0 (Mar)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Mar)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.9 (Jan) [2/]	3.0 (Apr)

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

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

2/ Data from OECD standardized unemployment rates.

EYES ONLY

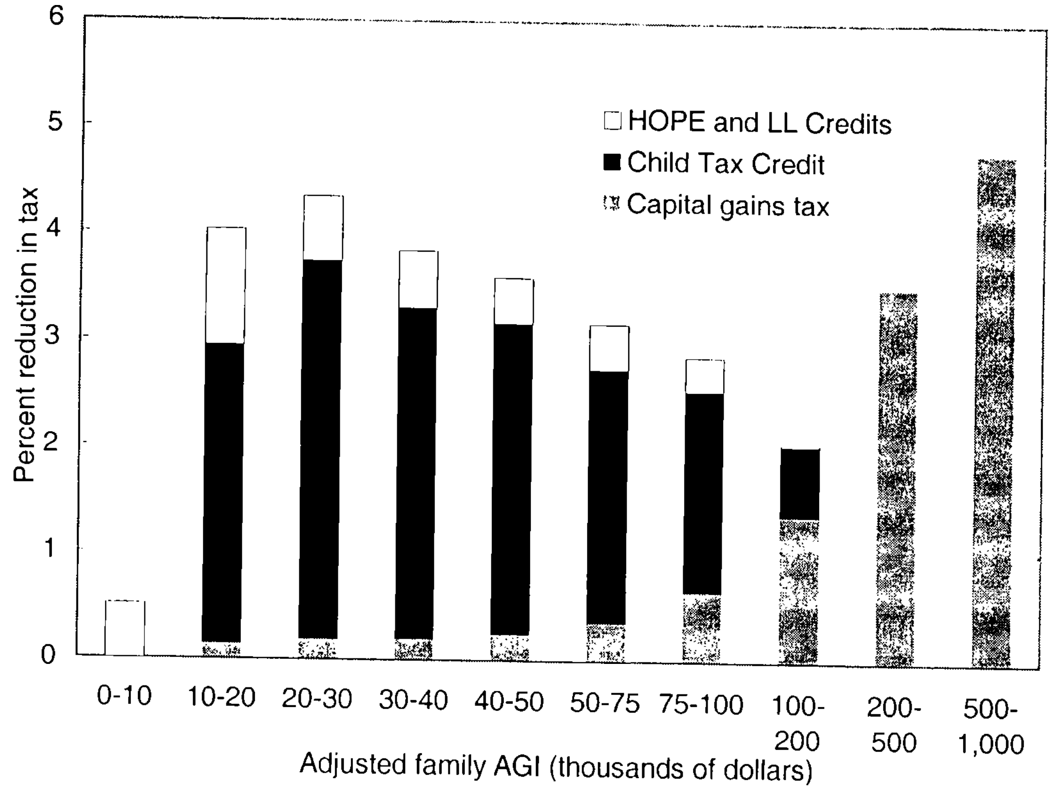
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 26, 2000

CHART OF THE WEEK

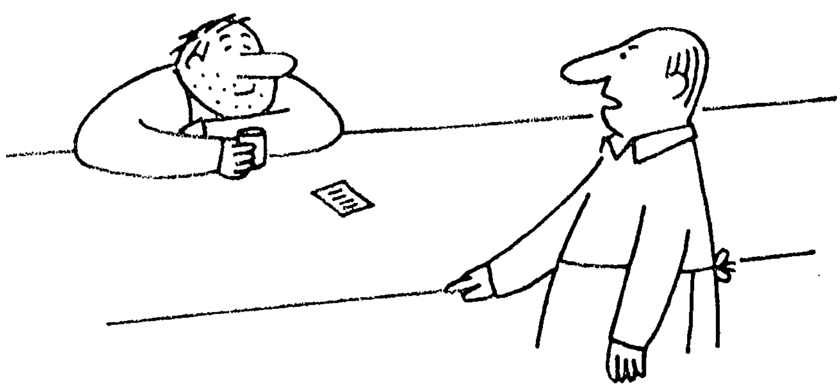
Effects of TRA-97 Provisions on Tax Burdens in 1999



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

EYES ONLY

CONTENTS



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

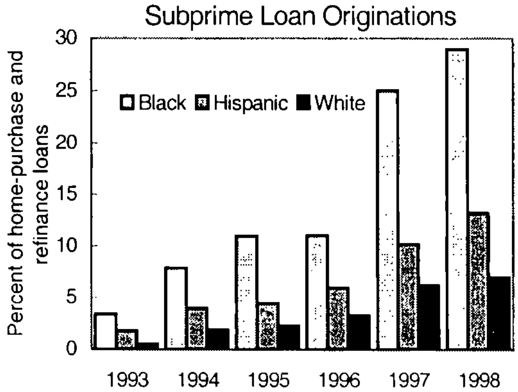
EYES ONLY

SPECIAL ANALYSIS

Keeping Predatory Lending at Bay

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

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



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

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

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

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

EYES ONLY

SPECIAL ANALYSIS

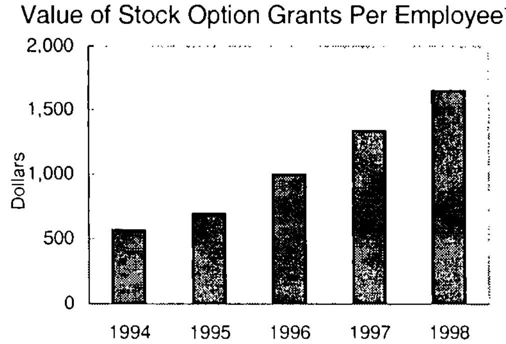
The Growing Importance of Employee Stock Options

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

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

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

Value of Stock Option Grants Per Employee*



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

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

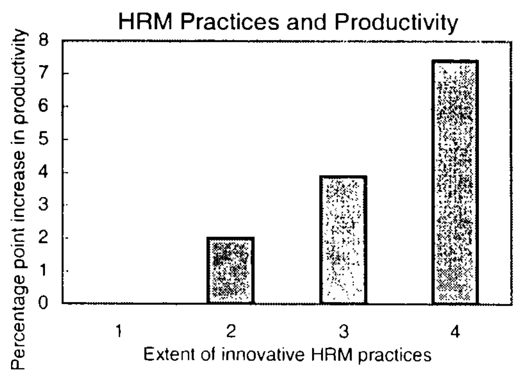
How should stock options be taxed? The taxation of stock options differs across types of option plans, both in terms of the corporate income tax paid by the employer and the personal income tax paid by the employee. Congress is currently considering the creation of a "super stock option." This new option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

ARTICLE

Innovative Human Resource Management Practices

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

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



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

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

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

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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

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

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

INTERNATIONAL ROUNDUP

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

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

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

EYES ONLY

RELEASES THIS WEEK

Advance Durable Orders

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

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

Gross Domestic Product

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

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

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

INTERNATIONAL STATISTICS

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

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	3.9 (Apr)	3.0 (Apr)
Canada	4.7 (Q4)	6.8 (Mar)	2.1 (Apr)
Japan	0.0 (Q4)	5.0 (Mar)	-0.5 (Mar)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q4)	8.4 (Mar)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.9 (Jan) [2]	3.0 (Apr)

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

EYES ONLY

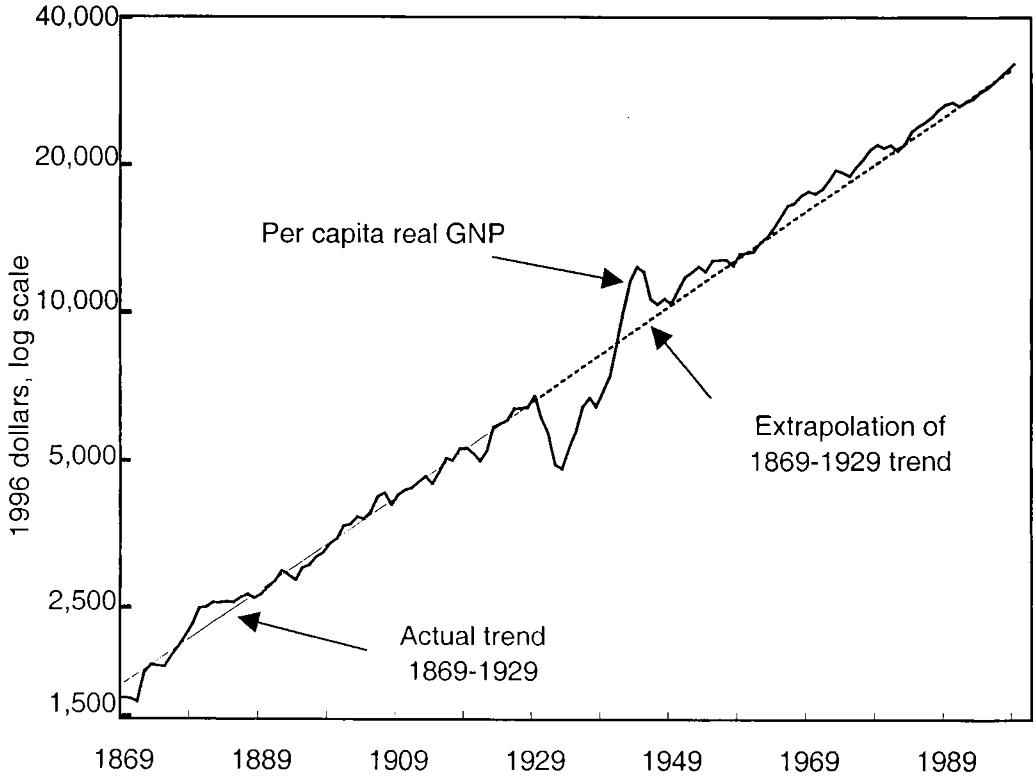
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 19, 2000

CHART OF THE WEEK

The Long-Run Trend in Per Capita Real GNP



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

EYES ONLY

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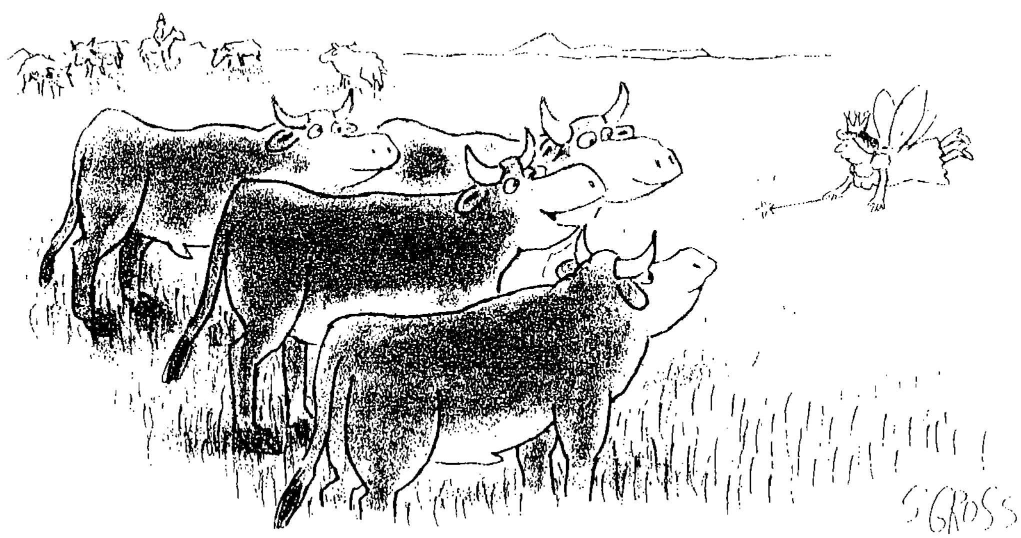


"We would like to be genetically modified to taste like Brussels sprouts."

EYES ONLY

SPECIAL ANALYSIS

South Africa: The Employment Struggle

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

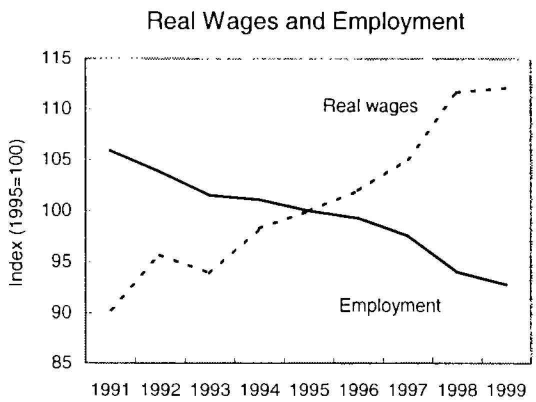
Working. Since assuming power in 1994, the African National Congress (ANC) has made progress in several dimensions. Budget policy has been disciplined. The consolidated general government deficit has been brought down from 5.6 percent of GDP in 1994/95 to 2.4 percent in 1998/99. At the same time, spending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

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

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

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

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



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

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

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

EYES ONLY

ARTICLE

Competitive Effects of B2B Exchanges

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

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

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

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

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

EYES ONLY

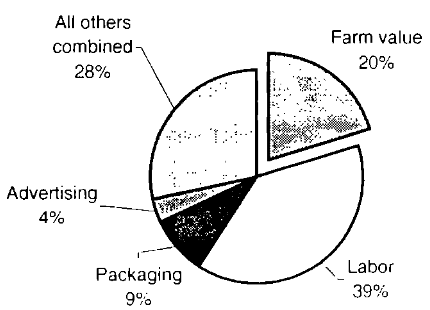
ARTICLE

Desire for Convenience Eats up Food Expenditures

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

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

What a Dollar Spent for Food Paid for in 1998



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

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

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

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

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

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

EYES ONLY

INTERNATIONAL ROUNDUP

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

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

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

EYES ONLY

RELEASES THIS WEEK

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

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

Consumer Price Index

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

Housing Starts

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

Industrial Production and Capacity Utilization

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

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

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

INTERNATIONAL STATISTICS

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

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	3.9 (Apr)	3.0 (Apr)
Canada	4.7 (Q4)	6.8 (Mar)	3.0 (Mar)
Japan	0.0 (Q4)	5.0 (Mar)	-0.5 (Mar)
France	3.1 (Q4)	9.8 (Mar)	1.5 (Mar)
Germany	2.3 (Q4)	8.4 (Mar)	1.9 (Mar)
Italy	2.1 (Q4)	11.3 (Jan)	2.5 (Mar)
United Kingdom	3.0 (Q4)	5.9 (Jan) [2/]	2.6 (Mar)

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

EYES ONLY

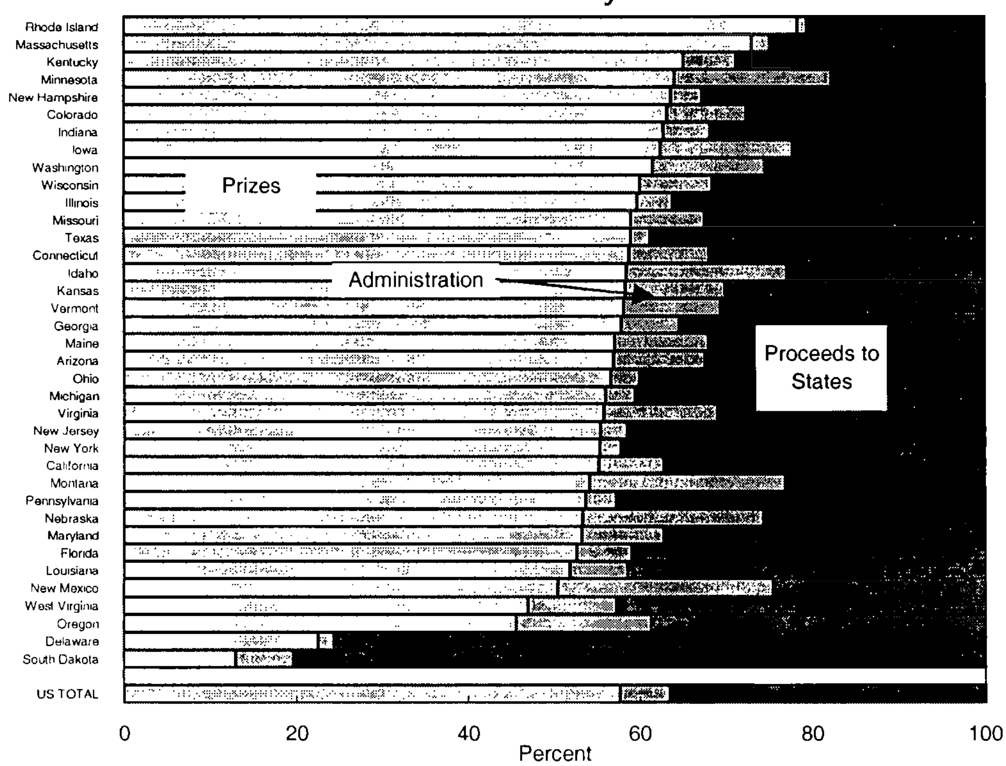
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 12, 2000

CHART OF THE WEEK

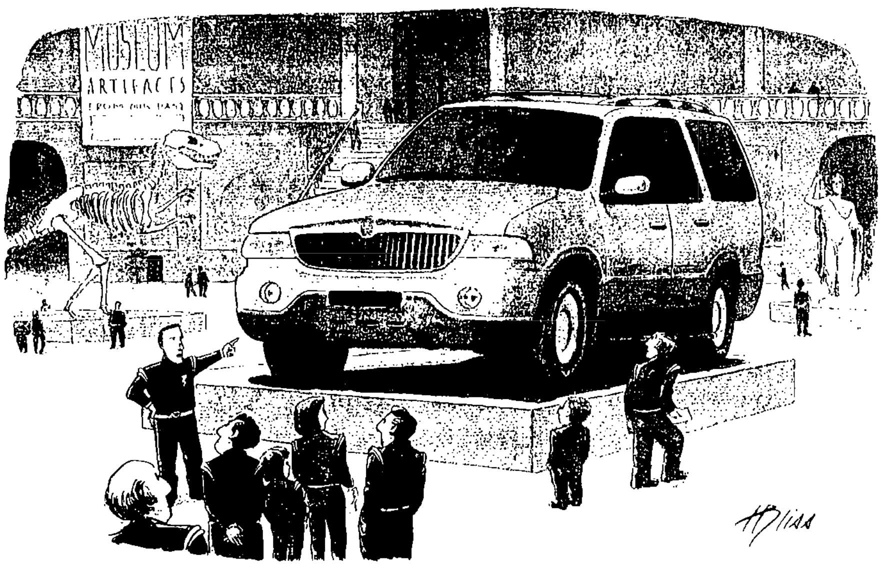
Allocation of State Lottery Collections



Thirty-seven U.S. states have lotteries. In 1998, aggregate ticket sales were $33.3 billion: 57.7 percent of this total was paid out in prizes, 5.8 percent went for administration, and 36.5 percent represented proceeds to the states. Rhode Island and Massachusetts paid out the largest percentage of ticket sales in prizes; South Dakota and Delaware paid out the least.

EYES ONLY

CONTENTS



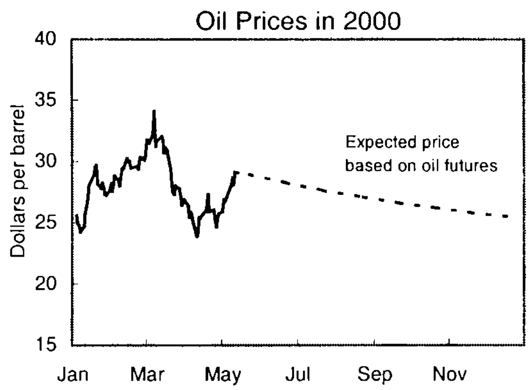
"We're not certain why they disappeared, but archeologists speculate that it may have had something to do with their size."

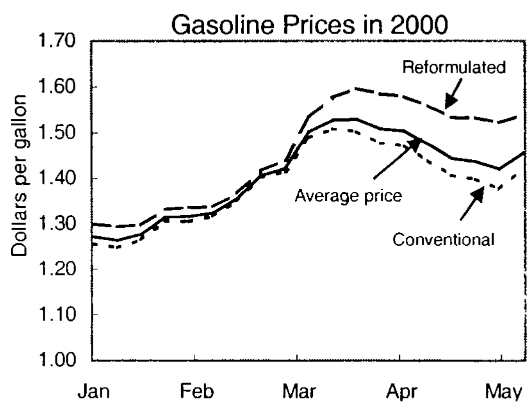
EYES ONLY

CURRENT DEVELOPMENT

Over the Hill on Oil and Gasoline Prices?

After falling nearly $10 per barrel from its early March peak, the price of crude oil has moved up some. Gasoline prices also rose last week after declining for 6 straight weeks. Nevertheless, further large increases are not expected this year.





Oil. West Texas Intermediate crude closed Thursday at $29.13 per barrel, 15 percent below its 2000 peak on March 7, but 22 percent above its 2000 trough on April 11 (see upper chart). The market expects prices to fall slightly over the next few months, but low stocks in the United States and other OECD countries, and increased demand from refiners after the spring maintenance season may support or pull prices up. Some OPEC ministers' comments suggest that the cartel may not increase production at its June meeting.

Gasoline. After falling 11 cents per gallon between March 20 and May 1, the average cost of gasoline rose 3½ cents last week to $1.46 per gallon (see lower chart). The Energy Information Agency's forecast projects gasoline prices to stay between $1.40 and $1.45 through the summer. Gasoline inventories remain lean, however, as we approach the zenith of the summer driving season—a combination that could support higher prices.

Regulatory impacts. Average gasoline prices mask the difference between conventional and reformulated gasoline (RFG). The latter, which has been required since 1995 in areas with severe smog problems, has averaged 2.5 cents more per gallon than conventional gasoline. More stringent RFG standards effective this year were expected to increase this spread to 4 cents per gallon. However, this gap had widened to as much as 14 cents before narrowing to 11 cents in the past week. Transient refinery problems could have caused the spread, but analysts also may have underestimated refining costs, especially since royalties might be required on an RFG patent that was recently upheld in court.

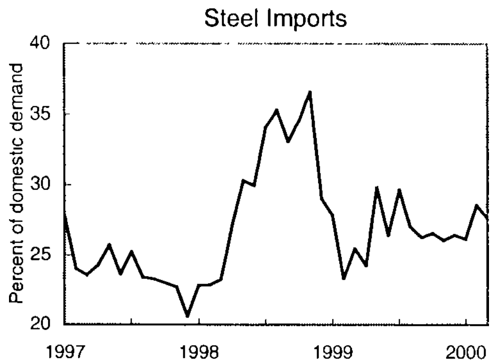
Conclusion. Oil and gasoline prices are expected to remain stable through the summer, but OPEC decisions, lean stocks, and strong demand in the upcoming driving season are risk factors for higher prices.

SPECIAL ANALYSIS

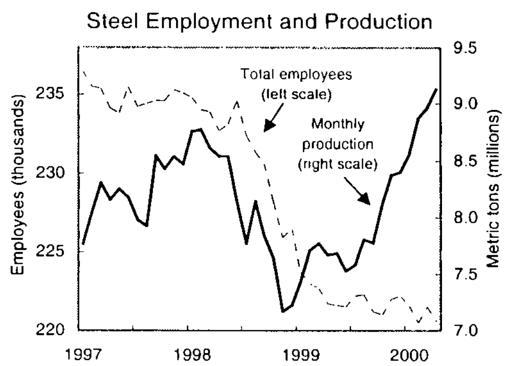
Is Steel Still in Trouble?

November 1998 marked a nadir for the U.S. steel industry; imports accounted for 37 percent of the domestic market while nearly a quarter of domestic production capacity lay idle. Fortunately, the industry has recovered substantially since then.

Fewer imports. Imports now meet just over a quarter of domestic steel demand, up slightly from the 1997 average of 24 percent (see upper chart). Imports in recent months have been led by semi-finished products, which are then processed further by domestic firms. In part, the scaling back of imports reflects the anti-dumping and countervailing measures imposed in 1999, and also the recovery of demand in other steel consuming countries. Declines in imports from Japan and Russia were particularly sizable.



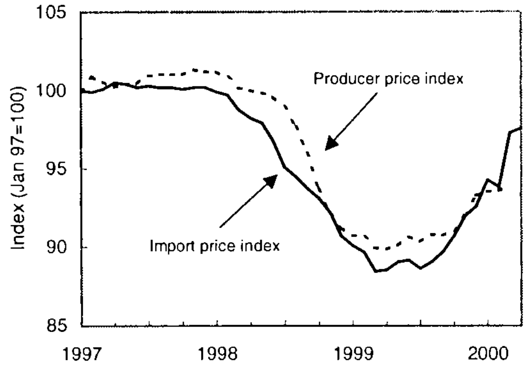
More domestic production. While production and employment dropped sharply in tandem during the 1998 crisis, the booming U.S. economy has facilitated a swift recovery in production since then (see lower chart). Domestic raw steel production in April approached a high annual rate of 110 million metric tons, with demand growth especially strong in the construction sector and in the oil and gas drilling and transportation sector. U.S. steel producers are now operating at over 90 percent of capacity, and the inventory buildup during the crisis has been reversed as new orders and shipments have picked back up.



Employment and productivity. The increase in production has not been accompanied by an increase in employment. The number of employees in the blast furnaces and basic steel products sector remains around 220,000, with increased productivity accounting for the increased output. This pattern is consistent with longer-term trends: steel industry employment has declined steadily since the 1980s to less than half its level then, while greater production efficiency has allowed output to grow.

Prices, profits, and prospects. Prices have also begun to climb back to earlier levels (see chart on next page). Available (but incomplete) earnings results confirm that a recovery is underway. They also show that mini-mills have

Iron and Steel Product Prices



weathered the crisis far better than integrated mills. The OECD Steel Committee predicts that in 2000, imports to the United States should fall by 8 percent, as demand continues to recover in other steel consuming countries. Increased production, along with higher prices, should lead to improved performance in 2000 for the main steel enterprises after a difficult period in 1998-99.

Conclusion. The steel industry appears to have bounced back from its 1998 crisis. Nevertheless, longer-term trends of declining employment and the importance of mini-mills are likely to continue.

ARTICLE

Is Japan Becoming More Open?

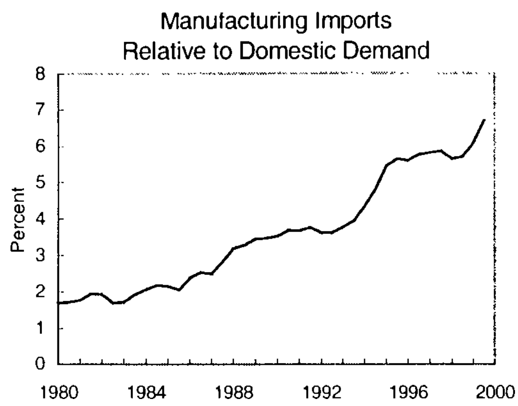
Japan has long appeared relatively closed to foreign goods and investment. Although official barriers to goods, such as tariffs, are low, observers have pointed to a wide range of potential "invisible" barriers. Foreign investors have also faced numerous hurdles. Recent reforms are helping to ease these barriers, and quantitative indicators show some signs of increasing openness. Nevertheless, Japan remains much more closed than other industrial countries.

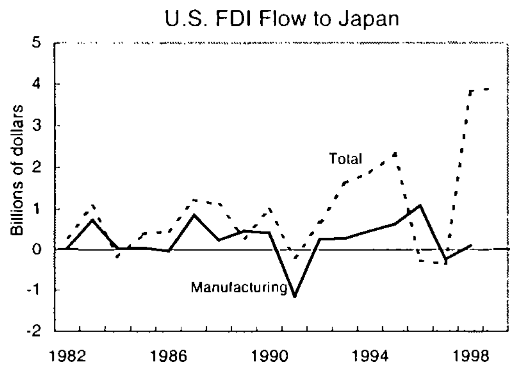
Structural reforms should ease barriers to foreign access. In the 1990s, Japan began a program of structural reforms to create a more efficient and competitive domestic economy. Financial liberalization is creating a more competitive and open financial environment. New accounting standards are improving corporate governance and transparency by making it easier to evaluate the performance of Japanese companies. These standards could also make foreign firms more willing to merge or acquire Japanese companies because they can better evaluate what they are buying. Japan has made some (albeit incomplete) progress at reducing regulation in areas such as telecommunications, energy, distribution, and auto repair. Japan itself is the major beneficiary of these reforms, but foreign providers of goods and capital are also likely to benefit.

Challenges to the *keiretsu*. One indicator of structural change in Japan is that the *keiretsu* system of affiliated firms (often centered around a lead bank that provides financial support to the group) is now under attack. Cross-shareholding appears to be falling; mergers of weak Japanese lead banks may also attenuate the sometimes cozy ties between banks and companies. A breakdown of the *keiretsu* system should benefit foreign firms. In the past, members of a *keiretsu* may have preferred to purchase inputs from affiliated suppliers, even if foreign suppliers were cheaper; *keiretsu* members may even have colluded to keep potential competitors (including foreign firms) out of the market.

Auto alliances. A second indicator of structural change is that foreign auto companies have now taken major ownership stakes in Japanese auto companies. Renault, for example, is allied with Nissan; Ford is allied with Mazda; General Motors has alliances with Isuzu, Subaru, and Suzuki; Daimler-Chrysler has announced an alliance with Mitsubishi. The president of Nissan was born in Brazil and educated in France, and the president of Mazda is American. These alliances may help further the breakdown in the traditional *keiretsu* system.

Trade and FDI flows. In addition to these qualitative indicators, quantitative evidence suggests some progress. Manufacturing imports showed particularly sharp gains relative to domestic demand in the early 1990s (see upper chart on next page). Nevertheless, the Japanese figure remains about half that of the United States and about a quarter that of the EU.





Inflows of foreign direct investment have also risen, driven in part by surging mergers and acquisitions (M&A) related to restructuring. U.S. direct investment in Japan, for example, reached record levels of about $4 billion per year in 1998 and 1999, after essentially no investment in 1997 (see lower chart). Cross-border M&A in Japan rose from $4 billion in 1998 to $16 billion in 1999. While these changes are dramatic, for both FDI inflows and cross-border M&A activity, Japan accounted for only about 2 percent of developed-country totals in 1999, up from less than 1 percent in 1998. By contrast, the roughly similar U.S. and EU shares together accounted for around 90 percent of direct investment inflows and cross-border M&A activity to developed countries in 1998 and 1999.

Progress may be slow. Even after Japan fully implements reforms, it will take time for the full quantitative effects to be apparent. In addition, Japan's prolonged recession and the relative strength of the dollar tend to restrain Japan's imports of U.S. goods. For example, despite some steps taken under the 1995 U.S.-Japan Agreement on Autos and Auto Parts that opened up the Japanese distribution system and auto-repair regime—and despite the ownership stakes of U.S. auto companies in Japanese firms—sales of U.S. autos and auto parts have plummeted in recent years, largely reflecting the adverse macroeconomic environment.

Conclusion. Despite nascent signs of increasing openness, import penetration and inflows of foreign direct investment relative to GDP in Japan remain well below the rates in other industrial countries, which have also been making substantial changes to open their economies. To the extent that structural reforms continue, Japan is likely to open further in the future. Nevertheless, reforms still have a long way to go, and they face domestic political opposition, so that continued progress is not assured.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

The Power of Suggestion in Saving Behavior. How a company presents its savings plan to employees affects their enrollment decision. A recent study examined data from a large U.S. corporation that changed its 401(k) plan from one requiring employees to affirmatively opt into the plan to one automatically enrolling employees unless they made a negative election to opt out of the plan. Although none of the economic features of the plan changed, this switch to automatic enrollment dramatically changed the saving behavior of employees. When they were automatically enrolled, 401(k) participation was significantly higher. Additionally, the default contribution rate and investment allocation chosen by the company under automatic enrollment had a strong influence on the saving behavior of 401(k) participants. This "default" behavior appears to result both from participant inertia and from many employees interpreting the default as investment advice from the company. Automatic enrollment in 401(k) plans also appears to even out differences that previously existed between men and women and between racial and ethnic groups.

Deterrence or Vengeance? The economic approach to optimal punishment suggests that differences in sentence length should be related to their effect on incapacitating criminals and deterring crime. A new paper analyzing sentences for murders finds some support for this hypothesis: sentences are higher when the expected apprehension rate for murderers is lower, for types of murder that respond less to deterrence, and for murderers with higher expected recidivism rates. Victim characteristics also play a role. Consistent with other studies, murderers were found to receive shorter sentences if the victim was black or male. This pattern was observed even in the case of vehicular homicides, where the victim was most likely random and different sentences would be unlikely to have deterrence effects: drivers who killed women got 56 percent longer sentences, while those who killed blacks got 53 percent shorter sentences. These striking effects lead the authors to conclude that sentence lengths may also be driven, in part, by a taste for vengeance.

Just the Facts, Mom. The nation has 35 million mothers aged 15 to 44 to honor this Mother's Day. About a third of these mothers have one child, 40 percent have two, and 9 percent have four or more. Alabama, Alaska, Idaho, Mississippi, and Wyoming have the highest percent of women who are mothers (about 64 percent of women aged 15-44). In contrast, only 38 percent of women in the District of Columbia have ever given birth. In June 1998, nearly 120,000 (3 percent) of women who had given birth during the previous year were in their 40s, compared with fewer than 60,000 (2 percent) in 1980. Mothers are working more and returning to work sooner after giving birth. In 1998, the majority (59 percent) of women aged 15-44 who had given birth in the previous year had returned to the labor force, a 50 percent increase since 1980. As more mothers enter the workforce to help support their families, we are also paying them greater tribute: in 1997, the nation's greeting card publishers shipped $212 million worth of Mother's Day cards, up from $148 million in 1992.

INTERNATIONAL ROUNDUP

Internet Prices Falling in the OECD. The cost of accessing the Internet is falling in OECD countries, and a trend toward "unmetered" access bodes well for electronic commerce, according to a new OECD study. The average cost of 20 hours per month of Internet access fell by 15 percent between October 1999 and March 2000. The United States, Australia, Canada, New Zealand, and Mexico have unmetered plans in which the Internet access charge does not vary with connection time. For peak-time, the monthly access charge averages $44 in these five unmetered countries, compared with an average of $256 for 150 hours in metered countries. Since countries with unmetered access have six times as many servers designed for e-commerce, unmetered access appears to facilitate e-commerce. The study also reports that the Internet Service Provider fee has fallen as a share of Internet access costs from 63 percent in 1995 to 23 percent in March 2000 (while the share of telephone service costs has increased).

East Asian Nations Coordinate to Defend Currencies. The governments of East Asian nations have decided to move forward with a proposal to establish a regional financing arrangement to supplement the existing international facilities. This "Chiang Mai Initiative" was launched last weekend by the finance ministers of Japan, China, and the Republic of Korea, along with the ten finance ministers of the Association of South East Asian Nations. The proposal is meant to strengthen the economic defenses of these nations against the sort of speculation that instigated the 1997 Asian economic crisis. Specifically, the proposal involves a network of bilateral currency swaps and repurchasing agreements. The Ministers expressed general agreement over the course of the meetings on the importance of further cooperation among Asian nations in response to the region's growing interdependence.

Growth Does Not Worsen Inequality. Using data for 80 countries covering four decades, a new study by World Bank researchers finds evidence that when a country grows, the income of the poor grows as well. Analyzing growth in per capita GDP and in the average income of the poorest 20 percent of the population the study found that the two tended to grow approximately one-for-one, suggesting that the poor share proportionally in overall growth. The study also investigated whether different sources of economic growth might have differential impacts on the poor. For instance, it found that openness to trade had no effect on the incomes of the poor after controlling for the effect of growth in overall per capita GDP, suggesting that trade does not have negative effects on the poor. The results do indicate that inflation has a disproportionately higher negative effect on the income of the poor, suggesting that measures to control inflation are in fact "super pro-poor" policies. Additionally, the study found that public spending on health and education did not have systematic effects on the incomes of the poor, which might suggest that such spending has been poorly targeted.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, May 12, 2000****

The producer price index for finished goods fell 0.3 percent in April. Excluding food and energy, producer prices rose 0.1 percent.

Retail Sales

Advance estimates show that retail sales decreased 0.2 percent in April following an increase of 0.5 percent in March. Excluding sales in the automotive group, retail sales were unchanged, following an increase of 1.2 percent.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

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

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

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, May 12, 2000.**

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	March 2000	April 2000	May 11, 2000
Dow-Jones Industrial Average	8626	10465	10483	10944	10546
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.66	5.96
10-year T-bond	5.26	5.65	6.26	5.99	6.43
Mortgage rate, 30-year fixed	6.94	7.43	8.24	8.15	8.52
Prime rate	8.35	8.00	8.83	9.00	9.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 11, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.902	1.3	-15.8
Yen (per U.S. dollar)	108.5	0.3	-10.3
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.42	-0.2	5.1

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	3.9 (Apr)	3.7 (Mar)
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Germany	2.3 (Q4)	8.4 (Mar)	1.9 (Mar)
Italy	2.1 (Q4)	11.3 (Jan)	2.5 (Mar)
United Kingdom	3.0 (Q4)	5.9 (Dec)	2.6 (Mar)

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

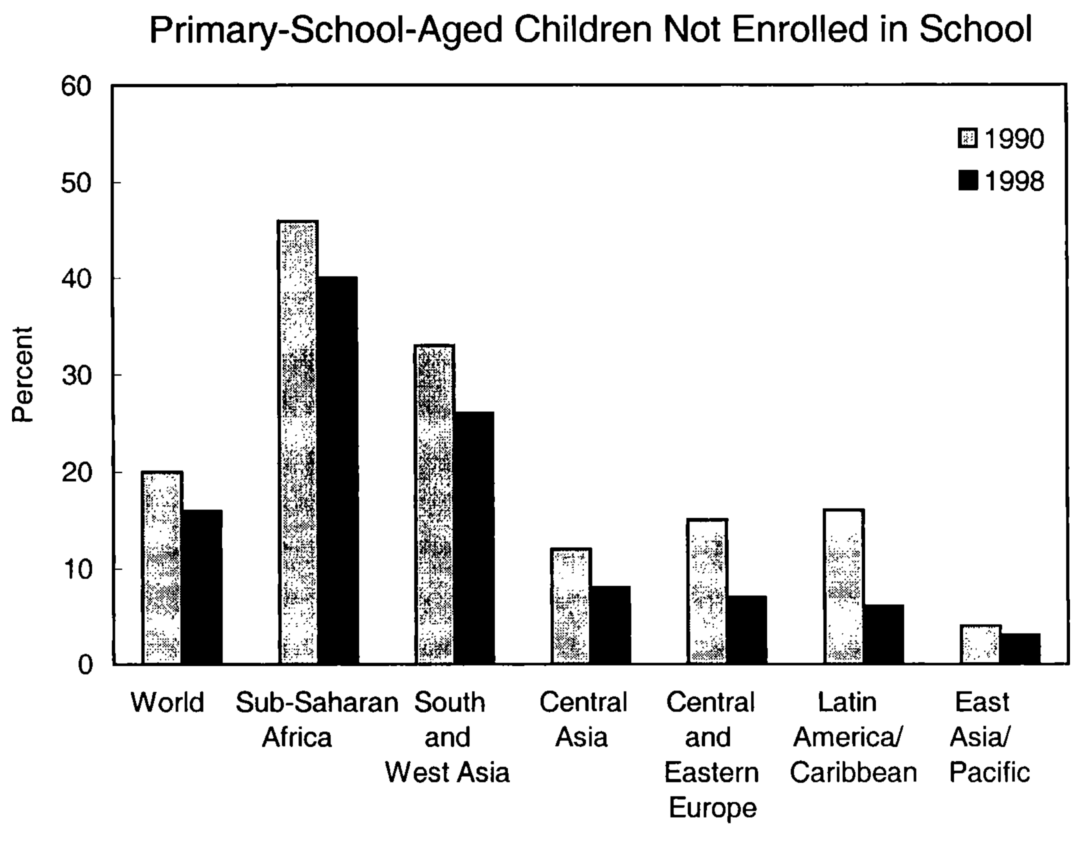
EYES ONLY

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 5, 2000

CHART OF THE WEEK



The proportion of primary-school-aged children not enrolled in school has fallen worldwide and in all less developed regions since 1990. In 1998, 97 percent of the 113 million out-of-school children lived in less developed regions, and nearly 60 percent of them were girls.

EYES ONLY

CONTENTS

"What was it this time, old economy or new economy?"

EYES ONLY

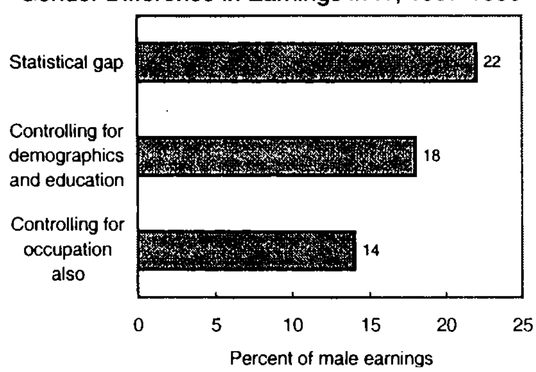
SPECIAL ANALYSIS

Gender Pay Differences in the IT Labor Market

In the U.S. labor market, women earn only about three-quarters as much as men. Gender pay differences in the rapidly expanding field of information technology (IT) provide one perspective on the sources of this pay differential.

Employment and earnings in IT. The IT field is characterized by both high-paying jobs and high employment growth. (IT is defined here to comprise the following five occupations: electrical and electronic engineering, computer systems analysts and scientists, operations and systems researchers and analysts, computer programmers, and computer operators). A CEA analysis finds that the median IT worker earns 74 percent more than the median worker in other occupations ($947 per week versus $544 per week). Employment in IT has grown by almost 23 percent over the past 10 years, to approximately 3.4 million workers, and projections by the Bureau of Labor Statistics suggest that this rapid growth will continue.

Gender Difference in Earnings in IT, 1997-1999



The IT gender pay gap. Women working full time in IT earn about 22 percent less than men—about the same difference as in the labor market generally. Part of this gap reflects gender differences in demographic characteristics such as age and race and in educational attainment. After controlling for these factors, women were found to earn 18 percent less than men (see chart). Differences in the number of hours worked appear to have little effect.

The importance of occupation. Controlling for occupation within the IT sector explains another large part of the pay gap. Only about a fifth of workers in the two most highly paid IT occupations (electrical engineering and computer systems analysts and scientists) are women. By contrast, women account for two-fifths of workers in the other three occupations. In the CEA's statistical model, the gender earnings gap in IT fell to about 14 percent once differences in occupational composition were taken into account.

How much is discrimination? It is tempting to conclude that the impact of gender discrimination is captured by the 14 percent gap that remains after controlling for occupation, education, and demographic characteristics. Some might even argue that the statistical gap is an "upper bound" that would be reduced still further if data were available that would allow an even finer division of occupations. Even with such data, however, it would be difficult to resolve more fundamental concerns about the underlying reasons for the substantial gender differences in occupation composition. First, some women may choose to pursue career paths that provide increased flexibility for devoting time to their families but that also pay less. Second, systematic gender discrimination may exist in hiring and promotion. For example, women may be less likely than men to be hired as systems analysts or may have lower mobility from programming positions to systems analyst positions. Third, women may respond rationally to perceived discriminatory practices by reducing the investments they make in their own careers and thus achieve less.

Conclusion. A statistical analysis of the gender pay gap in IT finds that the raw gap of 22 percent falls to 14 percent once differences in occupation, age, race, and education are taken into account. To the extent that women choose to sacrifice pay for flexibility or other advantages, the gap might be even smaller than this. However, to the extent that discrimination pushes women into lower paying occupations, this statistical analysis—which focuses on the average of gender wage differences observed within occupations—understates the true gap.

EYES ONLY

SPECIAL ANALYSIS

Instant Messaging Disconnect

With network goods, where the value to each user rises as the number of connections increases, the firm with the largest network has an advantage. The instant messaging (IM) market provides an interesting test case of how a dominant firm reacts to competition, and whether consumers' ability to switch services—even at a relatively low cost—is sufficient to preserve competition.

What is IM? Instant messaging services provide a way to send short messages among individuals in pre-established groups using the Internet. Users of the service are notified when other users in their group are online and able to exchange messages with them. America Online has become a leading supplier of this technology, and it claims that it has 90 million registered users. AOL's software can be downloaded at no charge from the Internet, enabling anyone with an Internet connection to send instant messages to other users of AOL's software.

Interconnection and competition. IM is one element of the bundle of services Internet access providers use to compete for customers and advertising revenue. For a dominant firm like AOL (which some claim has a 90 percent market share), there is very little incentive to give away that advantage to rivals by allowing interconnection. Microsoft, which provides its own instant messaging service for users of its network, wanted to interconnect its customers to those using AOL's services. Rather than reaching an agreement with AOL, however, Microsoft devised software that would create the linkage. AOL, in turn, blocked Microsoft's repeated attempts to interconnect to AOL customers.

Creating a standard. One possible solution that could help create more network connections is to establish a standard for IM services. The Internet Engineering Task Force has solicited proposals for a protocol that would allow interconnection among IM services. Creating a standard, however, is different from implementing a standard. In particular, AOL might see little advantage to making its system compatible with any other standard that emerges.

Competition and standards. AOL's smaller rivals are likely to implement the standard because the alternative of remaining a small, isolated network is not a viable long-term strategy. Once all of AOL's rivals are interconnected, the standard will create a larger pool of users that its own customers would want to be able to access. Although AOL could still just say no to standardization, customers who desire such connections could download a rival firm's software anyway, thereby becoming users of both networks.

Implications. In the particular case of instant messaging, where the costs of switching between networks appear to be low, AOL may find that inconveniencing its customers only leads them to defect to rival suppliers. If, however, AOL is able to maintain its position without connecting to other networks that adopt a common standard, that would suggest that first mover advantages are strong. Such an outcome would raise questions about whether competitive forces could erode a dominant position in other markets where network effects are present and switching costs are high.

EYES ONLY

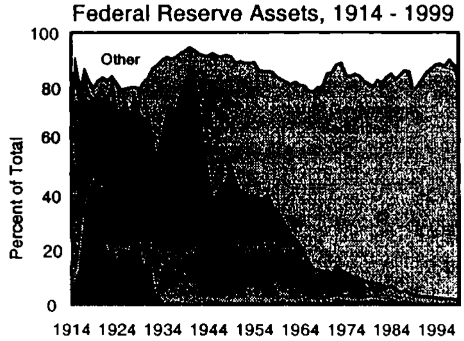
ARTICLE

What Is the Fed to Do when the T-Bills Run Out?

The prospective elimination of all publicly held debt by 2013 poses a practical problem for the Federal Reserve System, which conducts monetary policy primarily through transactions in Treasury securities. In the distant past, the Fed conducted monetary policy using commercial paper, and it could return to this practice. A better alternative, however, would be to find a replacement that has the key characteristics of Treasury securities: liquid and transparent markets and very low credit risk.

What the Fed owns. Except in unusual circumstances, the Fed can own only the following types of financial assets: gold, certain types of short-term private commercial paper, U.S. Treasury and agency securities, foreign sovereign debt, and some securities issued by state and local governments. It has no express authority to purchase corporate equities or bonds, mortgages, or land (other than Federal reserve premises). During its early history, the Federal Reserve's main assets were gold and commercial paper (see chart). Beginning in the 1930s, however, it greatly increased its holdings of Treasury securities, which now make up about 80 percent of Fed assets. The Fed currently holds—either directly or in repurchase agreements—about one-seventh of all Federal debt held by the public.

Federal Reserve Assets, 1914 - 1999



The conduct of monetary policy today... The Fed affects short-term interest rates by manipulating the supply of reserves held by member banks. Banks hold reserves to fulfill reserve requirements on certain types of deposits and to cover claims on their accounts made during the day. When the Fed increases reserves, their price—the federal funds rate—falls. The current practice is to raise or lower reserves principally through the purchase or sale of government securities to member banks in exchange for reserves. In several important ways, Treasury securities represent an ideal instrument for monetary policy. First, Treasury markets are generally very liquid, so that the Fed can easily purchase and sell securities at market prices. Second, price information is widely available, making these markets highly transparent. Third, Treasury securities are backed by the full faith and credit of the U.S. government; hence, the Fed takes on no credit risk in owning them.

...and in the future. With all publicly held Federal debt (which includes Federal Reserve holdings) projected to be retired by 2013, the Fed will need to change its asset portfolio and its conduct of monetary policy. The best option would be to find financial instruments that closely approximate the desirable characteristics of

Treasury securities. Unfortunately, some of the kinds of securities that the Fed is currently allowed to own fail this test. For example, use of foreign government securities would expose the Fed to exchange rate risk. Moreover, the regular use of foreign bonds to adjust reserves could impinge on the Treasury Department's responsibility for foreign exchange policy. Similarly, large-scale direct ownership and discounting of short-term commercial paper—a standard Fed practice in the 1920s—would imply a much more active role for the Fed in pricing risk and potentially interfering with the normal functioning of financial markets with respect to the allocation of credit and risk. One solution might be the creation of new securities by the private sector (see box)—though it might be necessary to broaden the Federal Reserve's power to own private securities to take advantage of such new securities.

A Triple-A Plus Solution

Private institutions could provide a solution to the Fed's problem of replacing Treasury securities in the conduct of monetary policy by creating new, very low-risk securities constructed from a pool of private debt securities. Such securities would be similar to mortgage-based securities currently issued by government-sponsored enterprises like Freddie Mac and Fannie Mae. For example, a financial institution, perhaps called the Triple-A Plus Fund, would buy a set of high-quality corporate bonds. It would then offer to sell a coupon bond called the Triple-A Plus bond that pays a fixed annual interest rate of, say 7 percent, for the life of the bond. The Triple-A Fund would put up its equity capital and take on the default risk of the underlying corporate bonds. Although not completely risk-free, bonds like the Triple-A Plus bond would entail very little credit risk and would be close substitutes for Treasury securities. Liquid and transparent markets should develop, given markets' and the Fed's appetite for such a low-risk security.

Conclusion. Under current projections for the elimination of publicly held Federal debt, the Fed's reliance on Treasury securities for its conduct of monetary policy will have to end. Although not discussed here, a related issue is how the Treasury Department should invest future Federal surpluses once the publicly held debt is paid off. Alternatives exist and the staffs at the Federal Reserve and the Treasury Department are actively evaluating the various options.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Shows Expansion Continuing. The latest reports from the 12 Federal Reserve districts indicated that the economy continued to expand during March and the first 3 weeks of April. The majority of districts reported moderate to strong economic growth, with only Richmond and Chicago noting some signs of slight slowing. Consumer spending was strong. Commercial construction activity generally remained robust, while several districts noted softening residential demand. Factories were running near capacity in some areas, as overall manufacturing activity was strong. Dry soil conditions were reported in many areas, but spring planting proceeded at a rapid pace. Oil drilling activity was up from a year ago. There were more frequent reports of intensifying wage pressures as shortages of workers persisted in all districts. Increasing input prices were noted in nearly every region. Many districts cited wider use of fuel surcharges by shipping firms and other transportation companies. Manufacturers in several areas also reported higher prices for petroleum-related inputs. However, there were only a few reports that increases in input costs were resulting in higher prices at the retail level.

Explaining the Decline in Unionization. While some observers argue that the lack of legal and political support for organizing new workers is an important reason for the decades-long slide in union membership rates in the private sector, a recent study concludes that changes in the economy are far more important. In particular, the study found that between 1973 and 1998, employment in non-unionized establishments and new establishments that were not organized (the non-union sector) grew by an average of 2.8 percent per year. By contrast, employment in unionized establishments (including organization of previously non-unionized workers) shrank by 2.9 percent annually. The authors argue that this divergence in growth rates is related to the structural shift in the U.S. economy away from sectors in which unions were strongest such as manufacturing, transportation, and communications (and within manufacturing to a shift in new capacity to regions that have historically not been favorable to unions). The study suggests that a very large increase in union organizing activity would be required to have a significant influence on the union membership rate in the private sector.

INTERNATIONAL ROUNDUP

ECB Raises Rates but Euro Keeps Falling. Amid concerns that the euro's low value may be contributing to inflationary pressures in the euro area, the European Central Bank announced last week that it would raise its benchmark interest rate by 0.25 percentage points, the fourth increase since November. Nevertheless, the euro continued to slide this week, reaching a record low of 89.0 cents. The value of the euro has fallen 24 percent against the dollar and 27 percent against the yen since its introduction in January 1999. The strength of the U.S. economy relative to Europe's and the prospect of further interest rate increases by the Federal Reserve are seen as reasons for the euro's weakness against the dollar. Some commentators have also suggested that capital markets are skeptical of the pace of labor market and tax reforms by European governments.

Education for All. Representatives from 181 countries at the World Education Forum (WEF) in Dakar last week renewed pledges made in 1990 to pursue education for all, particularly girls. Significant progress has been made in the past decade, with 84 percent of primary-school-aged children enrolled worldwide in 1998, up from 80 percent in 1990. The illiteracy rate among young adults aged 15-24 declined from 26 percent in 1970 to 14 percent in 1998, with evidence that countries are giving higher funding priorities to primary education. Nevertheless, more than 113 million children still have no access to primary education, 880 million adults remain illiterate, and gender discrimination continues. In Africa, the Arab States, and South and West Asia, primary school enrollment rates for school-age girls are about 10 percentage points lower than those of boys. WEF participant countries pledged that by 2015, all children, especially girls and minorities, would have free and compulsory primary education of good quality. In addition, donor countries and institutions promised that lack of resources will not stand in the way of achieving this goal.

New Pan-European Stock Exchange to be Created. The London Stock Exchange and Germany's Deutsche Boerse announced plans to merge this week, combining Europe's two largest stock markets into a new exchange called iX. The two exchanges currently provide the primary listing for 45 percent of Europe's top 300 companies and account for 53 percent of trade volume. In addition, iX said that it has signed a memorandum of understanding with NASDAQ to create a pan-European high-growth market. This new joint venture would represent Europe's biggest high-growth market, accounting for about 80 percent of volume in these stocks. Companies listed will include several hundred from Germany's Neuer Markt, London's techMARK, the NASDAQ 100, and other major U.S. and non-European securities and index funds. NASDAQ's stated goal is eventually to link this venture to other NASDAQ-branded markets around the world, creating a global, 24-hour trading platform. The boards of Deutsche Boerse and the London Stock exchange likewise believe that the merger will provide the basis for developing a global securities market, and talks for including the Milan and Madrid exchanges have already begun.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment
****Embargoed until 8:30 a.m., Friday, May 5, 2000****

In April, the unemployment rate was 3.9 percent; it was 4.1 percent in March. Nonfarm payroll employment rose by 340,000.

Productivity

According to preliminary estimates, nonfarm business productivity rose 2.4 percent at an annual rate in the first quarter of 2000. Manufacturing productivity rose 6.9 percent.

Leading Indicators

The composite index of leading indicators increased 0.1 percent in March.

NAPM Report on Business

The Purchasing Managers' Index decreased 0.9 percentage point in April to 54.9 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding.)

MAJOR RELEASES NEXT WEEK

Retail Sales (Thursday)
Producer Prices (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

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

	1970-1993	1999	February 2000	March 2000	April 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.1	**3.9**
Payroll employment (thousands)					
increase per month			**27**	**458**	**340**
increase since Jan. 1993					**21615**
Inflation (percent per period)					
CPI	5.8	2.7	0.5	0.7	N.A.
PPI-Finished goods	5.0	3.0	1.0	1.0	N.A.

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

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, May 5, 2000**.

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FINANCIAL STATISTICS

	1998	1999	March 2000	April 2000	May 4, 2000
Dow-Jones Industrial Average	8626	10465	10483	10944	10412
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.66	5.73
10-year T-bond	5.26	5.65	6.26	5.99	6.46
Mortgage rate, 30-year fixed	6.94	7.43	8.24	8.15	8.28
Prime rate	8.35	8.00	8.83	9.00	9.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 4, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.891	-1.9	-15.9
Yen (per U.S. dollar)	108.2	1.7	-10.6
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.62	1.6	4.9

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	**3.9** (Apr)	3.7 (Mar)
Canada	4.7 (Q4)	6.8 (Feb)	3.0 (Mar)
Japan	0.0 (Q4)	4.9 (Feb)	-0.5 (Mar)
France	3.1 (Q4)	10.0 (Feb)	1.5 (Mar)
Germany	2.3 (Q4)	8.6 (Feb)	1.9 (Mar)
Italy	2.1 (Q4)	11.2 (Jan) [2]	2.5 (Mar)
United Kingdom	3.0 (Q4)	5.9 (Dec)	2.6 (Mar)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, May 5, 2000.**

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

2/ Data from OECD standardized unemployment rates.