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EYES ONLY

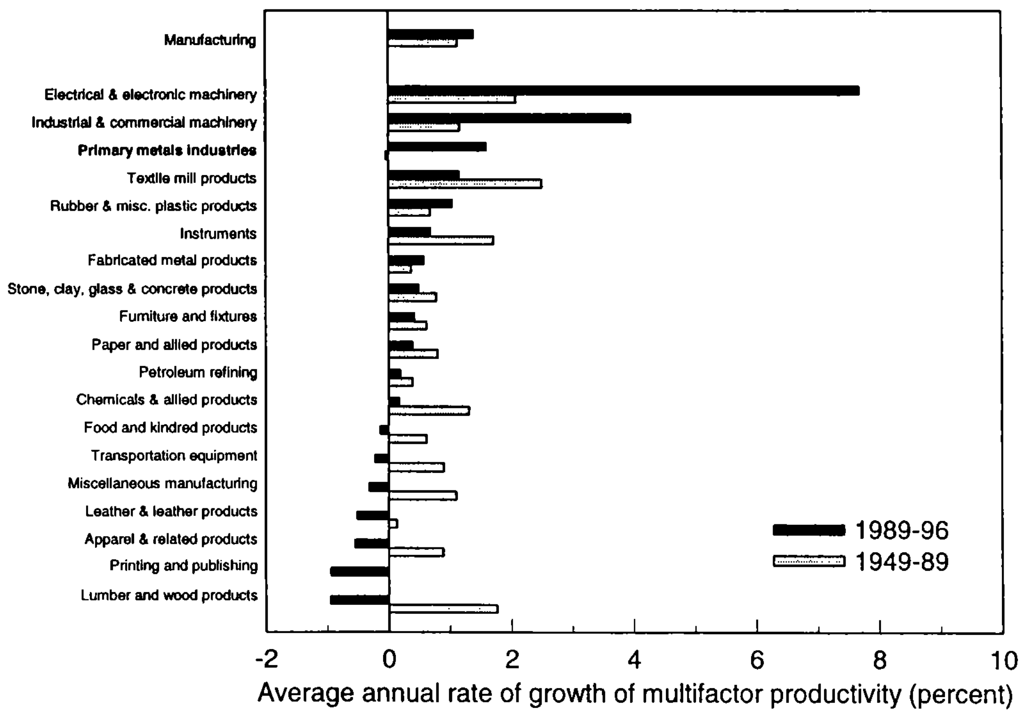
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

March 19, 1999

CHART OF THE WEEK

Technological Progress in Manufacturing Industries



Multifactor productivity growth measures the increase in output over and above what can be attributed to growth in capital and labor inputs. For the manufacturing sector overall, the average annual rate of growth of this measure of technological progress was higher between 1989 and 1996 than it was over the preceding four decades. Among individual manufacturing industries, primary metals (including steel) had a poor record over the earlier period but is the third-ranked performer in the 1990s.

EYES ONLY

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"Gimme a break. Being driven out of Ireland was the best thing that ever happened to you."

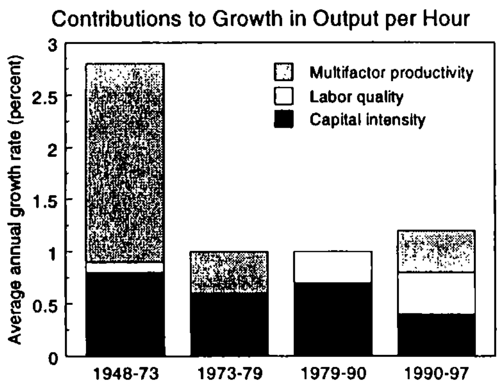
EYES ONLY

TREND

Contributions to Growth in Labor Productivity

Although investment growth has been strong in this expansion, the contribution of greater capital intensity to increases in labor productivity has been relatively modest, at least so far, according to the latest data from the Bureau of Labor Statistics.

Sources of productivity growth. Three factors contribute to growth in output per hour: increased capital intensity (more or better capital per hour), improvements in labor quality (education and experience), and residual efficiency gains (such as from new technology, economies of scale, or improved organization and management). The BLS calls this residual efficiency multifactor productivity (MFP).



Strong increases in MFP are the main reason why output per hour grew so rapidly between 1948 and 1973 (see chart). Capital has consistently contributed less than a percentage point to growth in labor productivity, and the post-1973 slowdown can be traced to sharply slower growth in MFP. In the 1990s, capital's contribution has been even smaller than previously.

Why so little from capital? One reason is that investment as a share of GDP started out from a very low base in this expansion, so that, although it has since grown rapidly, the average level has been relatively low. The average annual contribution of capital did, however, rise from -0.1 percentage point in 1992-95 to 0.5 percentage point in 1995-97.

More to come? Recent growth in labor productivity of about 2 percent per year reflects this increased contribution from capital as well as an average contribution of 0.9 percentage point from MFP in 1995-97. Arguably, much of this pickup in MFP reflects statistical and cyclical factors, but it also provides an intriguing hint of an improved long-term trend rate of growth in productivity.

EYES ONLY

SPECIAL ANALYSIS

Why Has Private Crop Insurance Failed to Blossom?

Currently most crop insurance is subsidized by the Federal government, suggesting it is difficult to provide actuarially sound policies. Economists have identified three reasons for this difficulty, which apply to private and government programs alike.

Asymmetric information. Farmers usually know more than the insurer about their individual yield distributions and individual farming practices. This creates two kinds of problems.

- Adverse selection. With insurance premiums based on observable risk characteristics, the farmers with the greatest unobservable risk characteristics will be the ones most likely to purchase insurance. As a result, the insurer's expected indemnity outlays will exceed total premium income, and, in the long run, the insurance operation will lose money.

- Moral hazard. Once they have acquired insurance, farmers have an incentive to minimize costs in ways that may jeopardize yields if these practices cannot be policed by insurers. This raises the costs to insurers and hence premiums.

Systematic risk. Systematic risk in agriculture arises primarily because weather events such as droughts or extreme temperatures extend across wide areas and affect large numbers of farmers simultaneously. Crop insurers therefore have much less ability than, say, automobile insurers to pool risks. Simulations indicate that U.S. crop insurer portfolios are 20 to 50 times riskier than they would be if crop-yield losses were independent across farms.

Ad hoc disaster relief. Ad hoc (unbudgeted) disaster relief is analogous to free catastrophic insurance that pays "indemnities" in the event of widespread losses. Such relief swamps government expenditures on insurance, and farmers have come to expect disaster payments during periods of catastrophic yield losses. For example, ad hoc disaster payments accounted for 76 percent of total USDA outlays for insurance and disaster-related programs during the 1980s. Otherwise-low-risk farmers have little reason to buy crop insurance when their major risk is likely to be covered by disaster payments.

Mitigating strategies. A number of strategies can be used to combat these problems. Deductibles encourage farmers to self-protect against yield loss. Contracts in which each period's indemnity schedule depends on past claims build memory into the insurance contract and increase the probability of detecting cheating. Some contracts address adverse selection by including yield discounts so that farmers with higher expected yields have lower rates. Area-yield insurance severs the link between individual yields and indemnities by setting indemnities equal to the difference between the area yield and some predetermined critical yield level, thus reducing problems of asymmetric information (area yield information is widely available). Area-yield reinsurance can address systematic risk. One study shows that area-yield reinsurance contracts would enable crop insurers to reduce their portfolio risk to levels comparable with other kinds of insurance, substantially reducing the cost of providing private crop insurance to farmers. One approach to the problem of incentives associated with ad hoc disaster relief is to condition receipt of disaster relief on participation in insurance programs.

Conclusion. Cost-effective strategies for encouraging greater use of crop insurance may reduce net payments to higher risk farmers. But adopting such strategies could free up resources for safety net programs focusing on low-income farmers.

ARTICLE

Comparable Worth and the Gender Pay Gap

Comparable worth policies aim to eliminate gender-based occupational pay differences by requiring firms to pay the same wage for comparable occupations. Examples that have been cited of comparable occupations where predominantly female jobs pay less than predominantly male jobs include nurses and tree trimmers, clerical workers and parking lot attendants, and social workers and probation officers. The Equal Pay Act of 1963 does not address these occupational pay discrepancies, as it guarantees equal pay for the same work, not equal pay for comparable work.

What is comparable worth? Comparable worth generally refers to job characteristics such as skill, effort, responsibility, and working conditions—dimensions along which *employees* would consider jobs comparable. This is the concept generally used in pay equity assessments. However, this set of considerations does not include other relevant market conditions such as the wages and availability of qualified workers and, on the demand side, the value to *employers* of the skills workers bring to the job.

Explanations and evidence. The most common explanation for gender-based occupational pay differences is that women are crowded into certain occupations because of discrimination and preferences for particular job characteristics. This depresses the wages in those occupations, so that the women as well as men who remain in them might be expected to have lower productivity, higher turnover, and less training, on average. Indeed, a study found that in 1993 the average woman's wage in an occupation that was 80 percent female was about 11 percent lower than in an occupation that was 80 percent male. However, this comparison ignores personal and job characteristics for which employers legitimately pay different wages. After controlling for these characteristics, the gap was closer to 3 percent.

Markets and comparable worth. Employers in competitive markets would be reluctant to pay more than the going wage for similarly productive workers, lest it raise their costs above the competition's. If market wages for an occupation are not considered by an employer, queues or shortages of applicants may occur. For example, the jobs of English professors and engineering professors require comparable skill, effort, and responsibility, and they have comparable working conditions, yet a university that equalized salaries would very likely face a shortage of engineering professors and a flood of candidates for English professorships.

Comparable worth in action: state and local government. Situations exist, however, particularly in the public sector, where market forces are not the sole determinant of wages. Often in the public sector, there is a formal point system for assigning pay grades to job titles, so that employers can implement a comparable worth policy by re-evaluating their point system and making adjustments when it undervalues certain jobs. Many states and localities have looked into occupational pay differences among their own heavily male and female government jobs. Twenty states have made actual pay adjustments, and eight have enacted comparable worth legislation covering state government employees.

A study of the effects of comparable worth in Minnesota found modest pay increases for women without pay losses for men (a 12 percent increase in women's relative pay), and negligible effects on employment. Iowa's particular way of implementing comparable worth helped junior employees disproportionately, in a few cases even resulting in workers being paid more than their supervisors. Most states incurred direct costs ranging from 3 to 4 percent of their total payroll in meeting the requirements of comparable worth laws. Impacts on taxpayers and private sector employers were not included in these assessments of costs.

Implications. Comparable worth in the public sector has not been particularly expensive or disruptive, but its implementation there has been modest. It is probably unworkable in the private sector, especially in smaller firms that do not use formal pay-setting systems. Although it might be more feasible in larger and more bureaucratic firms, comparable worth would increase production costs and could produce queues and shortages. Moreover, the difference in pay between heavily male and heavily female occupations seems to be quite small after controlling for relevant personal and job characteristics, leaving little scope for comparable worth policies to be effective.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Gains in Economic Activity, Prices Little Changed. In the latest summary of commentary on current economic conditions, the Federal Reserve districts reported some further gains in economic activity in January and February, despite weakness in agriculture and a few manufacturing industries. Consumer spending continued to display strength, aided by post-holiday price discounting and mild weather in some regions. Motor vehicle sales increased, led by light trucks, and furniture sales benefited from robust home sales. Manufacturing activity expanded in most districts, although foreign competition and low energy prices depressed textile, apparel, and energy-related industries. Commercial real estate and construction activity, already at a high level, grew at a brisk pace in most districts. Residential construction was strong in most regions. Several districts reported a pickup in business lending, and a few noted that lenders' standards were stable to slightly tighter. Agriculture continued to be plagued by low farm commodity prices, and an increasing number of farmers were under financial stress. Labor markets remained tight. Finding qualified workers has become more difficult in several districts, and reports of faster wage increases were more widespread than in recent months. Prices of most goods remained little changed, and several districts said that businesses remain reluctant to press for price increases.

Census Bureau Surveys Women's Economic Status. The percentage of wage and salary recipients who were women increased from 32 percent in 1947 to 48 percent in 1997, according to a Census Bureau release on the occasion of Women's History Month. A related measure shows a comparable increase: the proportion of year-round, full-time workers who were women rose from 29 percent in 1967 to 41 percent in 1997. The number of women-owned businesses reached 6.4 million in 1992, or 33 percent of all domestic firms. With more women in the labor force, child care needs have grown: the nation's employed mothers had 10.3 million children under age 5 in 1994; 43 percent of these children received primary care from their fathers, grandparents or other relatives, while 29 percent were cared for in an organized facility. Finally, in 1995, 55 percent of bachelors and masters degrees were awarded to women (compared with about 40 percent in the early 1970s).

Buffett Criticizes U.S. Accounting Practices. Legendary investor Warren Buffett used the annual report of his holding company, Berkshire Hathaway, to attack shady accounting at major U.S. corporations. Buffett focused his ire on the misuse of accounting practices such as restructuring charges. He contends that these charges are increasingly being used in the context of acquisitions to dump large costs into one quarter's earnings report, thereby inflating future earnings. Buffett lamented the lax ethical climate that has led "otherwise high-grade managers ... to the view that it's okay to manipulate earnings to satisfy what they believe are Wall Street's desires." Buffett praised SEC Chairman Arthur Levitt's efforts to end earnings management and other practices of questionable integrity.

EYES ONLY

INTERNATIONAL ROUNDUP

Latin America Faces Recession. A sharp reduction in external financing, low commodity prices, and relatively high interest rates will push Latin America into recession in 1999, according to new forecasts from the Institute of International Finance (IIF). The region's export revenues fell for the first time in a decade in 1998 as a result of declining world trade volumes and depressed commodity prices, and the prices of Latin America's main commodity exports are expected to fall further. Borrowing spreads should be lower than in 1998 though still high relative to 1996-97 levels, at least until the risk of further contagion from Brazil recedes. Net private capital flows are projected to fall dramatically, although this should be offset somewhat by increased official flows. (A more optimistic assessment of the outlook for capital flows came this week from the Inter-American Development Bank, which acknowledged that the region would continue to face difficulties but predicted that expansionary monetary policies and low interest rates in the developed world would prompt a recovery of capital flows to emerging markets.) The IIF predicts that the region's GDP will contract by 1.5 percent, with Brazil, Argentina, Venezuela and Ecuador suffering the largest contractions. Mexico's close links with the United States should help it achieve the region's highest growth rate (estimated at 2.5 percent); Chile's economy, whose 1980s reforms made it more resilient to external shocks and which lacks significant trade links with Brazil, should grow by 2 percent.

Reform Advances in Southeast Asia. Indonesia and Thailand both took important steps in the last week toward strengthening their financial systems. After 2 weeks of delay, Indonesia closed 38 insolvent banks, took over seven deemed too large to close and agreed to restructure nine weak but viable banks. The IMF, which had postponed approval of further disbursements of its $11.2 billion rescue package pending the successful resolution of the bank-closure issue, is expected to approve further disbursements. All the banks affected were private, leading the World Bank to call for further actions to restructure state banks (about half the banking system). Thailand's parliament passed several key bankruptcy reform bills, which should allow for easier settlement of loan disputes and defaults. The news helped push the Thai stock index to a 6-week high.

U.S. Third Lowest in Cost of Business among the G-7. Low labor and construction costs and a favorable exchange rate help give Canada the lowest average business costs among the G-7 nations, according to a new study by a private consulting firm. The United States ranks third, after Canada and the U.K. The study, which examined seven manufacturing sectors and two software industries, found Canada's costs to be nearly 8 percent below the U.S. average. Japan was last on the list, with costs nearly 22 percent higher than U.S. costs. Italy and France were closely grouped with costs just 4 percent higher than here, while Germany lagged behind all but Japan at 8 percent above U.S. costs. Costs in Germany and Japan were relatively more competitive in capital-intensive industries.

EYES ONLY

RELEASES THIS WEEK

Consumer Price Index

The consumer price index rose 0.1 percent in February. Excluding food and energy, consumer prices also rose 0.1 percent.

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $17.0 billion in January from $14.1 billion in December.

Housing Starts

Housing starts fell 1 percent in February to 1.799 million units at an annual rate.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 0.2 percent in February. Capacity utilization fell 0.1 percentage point, to 80.3 percent.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (Wednesday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.3	1.8	3.7	6.1
GDP chain-type price index	5.4	0.9	0.9	1.0	0.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.7	0.3	2.5	4.6
Real compensation per hour:					
Using CPI	0.6	2.5	2.2	2.3	1.7
Using NFB deflator	1.3	3.7	3.5	3.4	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	11.3
Imports	9.2	13.0	13.1	12.9	13.1
Personal saving	5.2	0.3	0.3	0.1	0.1
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Dec. 1998	Jan. 1999	Feb. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.3	4.3	4.4
Payroll employment (thousands)					
increase per month			314	217	275
increase since Jan. 1993					18108
Inflation (percent per period)					
CPI	5.8	1.6	0.1	0.1	**0.1**
PPI-Finished goods	5.0	-0.1	0.4	0.5	-0.4

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Jan. 1999	Feb. 1999	March 18, 1999
Dow-Jones Industrial Average	7441	8626	9346	9323	9998
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.34	4.44	4.39
10-year T-bond	6.35	5.26	4.72	5.00	5.11
Mortgage rate, 30-year fixed	7.60	6.94	6.79	6.81	7.01
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level March 18, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.099	0.5	N.A.
Yen (per U.S. dollar)	117.5	-1.7	-9.7
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	94.97	-0.7	-1.1

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	4.3 (Q4)	4.4 (Feb)	1.6 (Feb)
Canada	2.8 (Q4)	7.8 (Jan)	0.6 (Jan)
Japan	-3.0 (Q4)	4.5 (Jan)	0.2 (Jan)
France	2.8 (Q4)	11.4 (Jan)	0.5 (Jan)
Germany	1.8 (Q4)	[2/] 7.2 (Jan)	0.5 (Dec)
Italy	0.9 (Q4)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.3 (Q4)	6.2 (Nov)	2.5 (Jan)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics.
2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for January was 9.1 percent.

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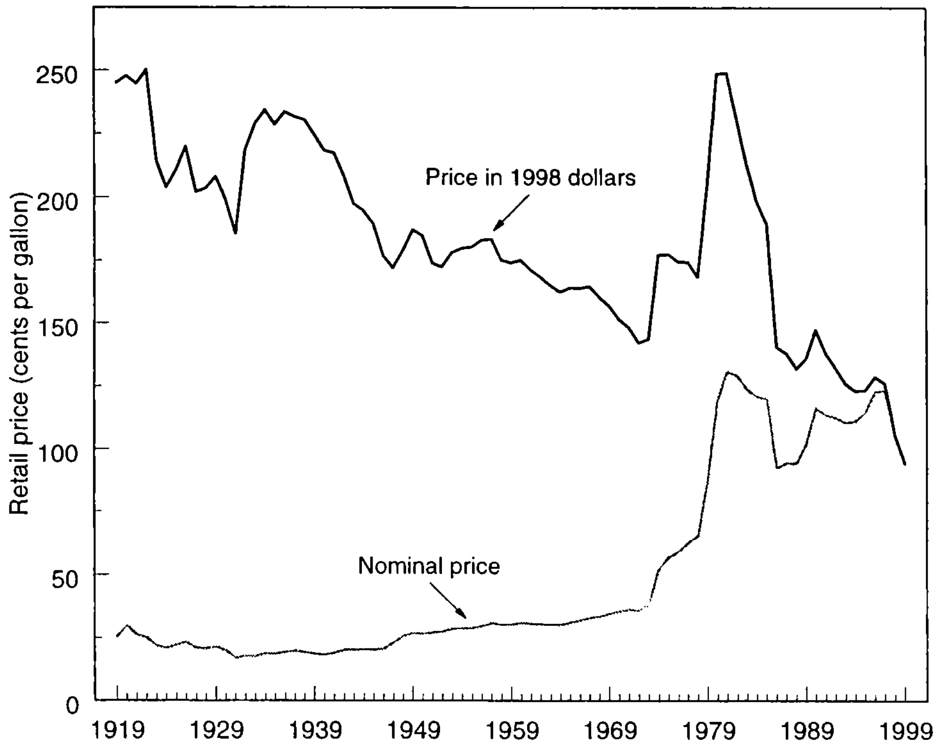
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

March 5, 1999

CHART OF THE WEEK

The Real Price of Gasoline



The retail price of gasoline (now under $1.00 per gallon) recently hit an all-time low relative to non-energy consumer prices. Declining crude oil prices and an apparent intensification of competition among refiners appear to be important reasons for plunging prices at the pump. The decline may be coming to an end, however, with prices expected to show a normal seasonal rise, peaking in the summer at levels close to last year's.

EYES ONLY

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CURRENT DEVELOPMENT

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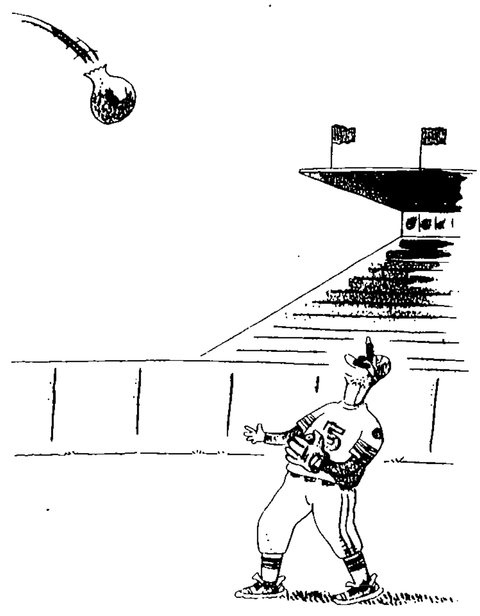
DEPARTMENTS



SPRING TRAINING

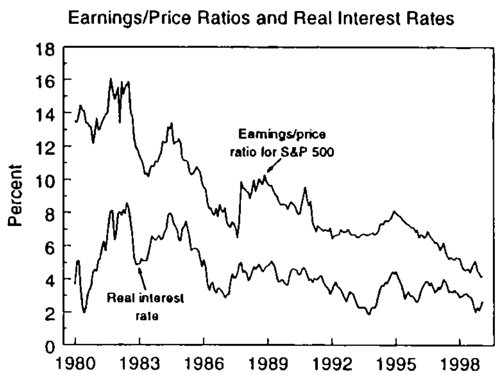
EYES ONLY

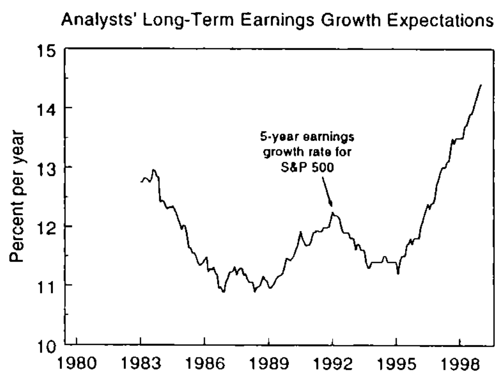
CURRENT DEVELOPMENT

The Stock Market: Still Crazy after All These Years?

Warnings that the stock market might be overvalued are not new. Alan Greenspan's famous observation that investors might be demonstrating "irrational exuberance" was made in December 1996, and the Standard and Poor's 500 index has gone up almost 70 percent since then. Is there a rational explanation?

Valuing equities. One way to analyze stock valuation is to ask what a rational investor would pay today for the stream of future dividends and capital gains likely to be generated by companies' future earnings. These future earnings would be discounted to reflect both the interest that could be earned by investing in an alternative safe asset and the additional risk incurred by investing in equities.





Interest rates. Longer term real interest rates have come down since Greenspan's remark (see upper chart). By itself, this would justify an increase in the price of stocks relative to current earnings, due to the lower return on competing safe assets. However, the rise in stock prices (and corresponding decline in the earnings-to-price ratio shown in the chart) have been greater than could be explained by interest rate movements alone.

Expected earnings. Faster growth in expected earnings could also contribute to an increase in stock prices. Analysts' earnings forecasts have indeed become more optimistic (see lower chart). Taken literally, the acceleration in earnings expectations shown here would imply an even larger increase in stock prices than we have seen. However, investors may not expect high earnings growth to continue forever (which would lead to an unprecedented share of capital income in GDP). They may also have become more risk averse and increased the premium they require for taking on risk, which would be consistent with increases in risk premiums in other financial markets.

Conclusion. Despite the sharp increase in stock prices since 1996, market participants may be less tolerant of risk than they were then. However, the focus of irrational exuberance in the stock market may simply have shifted to earnings expectations.

SPECIAL ANALYSIS

Dam Economics

Dams along the Columbia and Snake Rivers generate cheap hydroelectric power, but they have also contributed to the decline of salmon in the Columbia basin. Efforts to recover several salmon stocks currently listed under the Endangered Species Act (ESA) are anticipated to be expensive and will inevitably affect electricity prices.

Dams and endangerment. Snake River sockeye, steelhead, and spring/summer and fall chinook are all listed under the ESA. Dams in the upper Snake River basin have cut off salmon spawning habitat, and eight dams along the Columbia and Snake below Hell's Canyon impede the migration of Snake River salmon to and from the ocean. But other factors have also contributed to declining salmon populations, including fishing, adverse ocean conditions, and activities that damage spawning habitat and water quality (such as mining, logging, agriculture, and urbanization).

Recovery costs. The Bonneville Power Administration (BPA) anticipates costs ranging from $438 to $721 million per year between 2001 and 2006 for fish and wildlife management (mainly salmon-related). About $250 million per year represents direct costs for fish and wildlife programs and capital investments (such as fish ladders and hatcheries). Roughly $180 million per year represents reduced hydroelectric power generation. Additional expenses would be incurred if the earth embankments at four Snake River dams were removed, thereby restoring natural river conditions along a 140-mile stretch. These expenses would include a one-time capital cost in excess of $1 billion and power generation losses of $150 to $350 million annually. Other river uses such as navigation, irrigation, and recreation would also be affected.

Electricity prices. Without salmon recovery costs, hydropower is an inexpensive generation source, and electricity prices in the Pacific Northwest historically have been far lower than the national average. Efficient pricing of BPA electricity should reflect the portion of salmon recovery costs attributable to the generation of that electricity. BPA expects the strong cost advantage of hydroelectric power to keep its rates competitive, even after incurring the added salmon recovery costs. However, some potential combination of further escalation of fish and wildlife costs, falling market rates for electricity due to increased competition, and several years of drought leading to lower-than-expected hydroelectric power generation revenues could result in BPA's costs exceeding the revenues generated by competitive market electricity prices.

Who will pay? As long as BPA's costs remain below competitive market prices, consumers of BPA power will pay for the hydropower portion of salmon recovery costs. However, in the event that BPA cannot pay for its salmon recovery costs and remain competitive, the Administration intends to propose that BPA be able to charge transmission customers in the region, not all of whom are BPA generation customers, up to a maximum of $600 million. Beyond this amount, BPA would postpone repayment of its debts to the Treasury. The probability that a transmission surcharge or delayed Treasury payment will be required is low.

Resolution. The Administration is committed to restoring healthy salmon stocks and to maintaining a financially healthy BPA. Economic efficiency considerations call for BPA to take into account all costs, including the adverse effects of dams on salmon. Keeping BPA solvent, however, may expose taxpayers and consumers who buy from other generators to some of these costs.

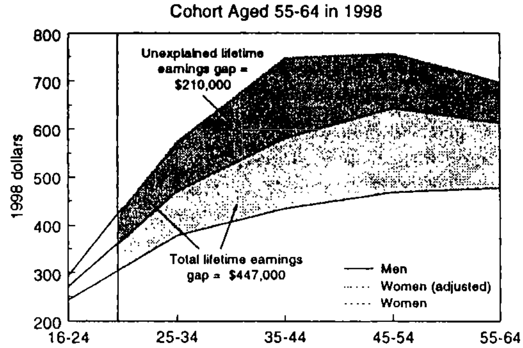
SPECIAL ANALYSIS

The Lifetime Gender Gap in Pay

For workers now nearing retirement who have been employed full time since they were 25 years old, the lifetime earnings gap between men and women is about $447,000 (measured in 1998 dollars). More than half of this gap reflects differences in observable factors like occupation or experience, but the rest remains unexplained.

Measuring the gap. The $447,000 figure is a CEA estimate of the accumulated difference in earnings between a male and a female aged 60 in 1998, assuming each worked full time, 50 weeks per year since they were 25 years old in 1963. Each is assumed to have earned the median full-time wage for their gender at each age during their lifetime (see chart). This estimate assumes a zero interest rate. If the men had invested their extra earnings at interest, the estimated gender gap would be larger.

Median Usual Weekly Earnings of Wage & Salary Workers
Cohort Aged 55-64 in 1998



How much can be explained? Although women's education and experience have increased and they have begun to enter higher paying occupations, remaining differences in these characteristics account for part of ongoing differences in pay. The best evidence (unfortunately 10 years old) suggests that about a third of the gender wage gap is due to differences in education and work experience, and a little over a quarter to differences in occupation, industry, and unionization of the jobs held by men and women. The remaining unexplained gap is due to some combination of unmeasured productivity-related factors and discrimination. CEA estimates that the unexplained part of the $447,000 lifetime earnings gap described above is $210,000.

Paid work time also differs. The gender gap in actual lifetime earnings is even larger than the gap for full-time workers, because women are more likely to have part-time jobs or to be out of the labor force, especially during the child-rearing years. In 1998 a woman was only 80 percent as likely to be employed as a man, and if she was employed, she was almost 2.5 times as likely to work part time.

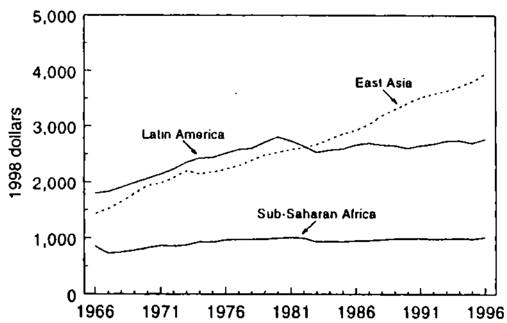
What the pay gap does *not* mean. A recent report by the AFL-CIO and the Institute for Women's Policy Research interprets pay gap figures as the amount by which family incomes would rise if women earned as much as comparable men. But this is not necessarily what closing the pay gap would do. Men's wages might fall; indeed, their decline over the past two decades has contributed to narrowing the gender gap. Only a sizeable increase in productivity, mostly going into higher wages for women, would eliminate the current unexplained pay gap without putting downward pressure on men's wages.

ARTICLE

Explaining Africa's Slow Economic Growth

While economic growth took hold in much of Asia and to a lesser extent in Latin America prior to the recent turmoil in the international economy, per capita GDP in Sub-Saharan Africa (hereafter, Africa) has hardly grown at all since the 1970s (see chart). With notable exceptions (such as Botswana, Lesotho, Mauritius, and, more recently, Ghana and Uganda), the poor performance has been widespread: 32 out of 42 countries had negative growth rates. Several new studies find that many standard explanations for three decades of economic stagnation are incomplete, and that poor domestic policies in Africa are the most important constraint on growth.

Per Capita GDP by Region



Note: Regional averages are population-weighted by country. Excludes countries where data are unavailable.

Reexamining previous explanations. Traditional explanations for Africa's chronic failure to grow (and reasons to question them) include the following:

- Inadequate attention to education. Many developing nations have experienced economic growth while making only limited investments in schooling, yet others have failed to progress despite substantial educational investments. Although most African countries have increased lower-level school enrollments rapidly, their economies retrogressed.

- Inequality. High levels of income inequality or extreme urban bias could substantially slow growth. Some African countries (such as Guinea Bissau and South Africa) have substantial inequality comparable to Latin American countries like Brazil, but others (such as Ghana, Niger, and Tanzania) have more equal distributions comparable to many East Asian countries.

- High ethnic diversity leading to poor policies and frequent conflict. Statistical studies find that growth rates are lower in non-democratic countries with high ethnic diversity but diversity does not hurt growth in democracies. Thus, the real problem may be a lack of political rights. Moreover, the peak danger of civil war generally occurs with low diversity—when a country consists of just two groups.

- Geography and high population growth. Africa's climate (with diseases such as malaria, and hostile conditions for livestock and agriculture) and landlocked locations are disadvantageous, but geography seems to explain little of Africa's poor growth record overall. Botswana, for example, has experienced the world's most rapid growth despite being landlocked and having a low population density.

Africa's continued high birth rate has also slowed growth in per capita income, but it may be a result of stagnation rather than a cause.

- Lack of openness to trade and foreign capital. Substantial trade restrictions have been an important obstacle to exports in the past; their recent reduction in most African countries can be expected to improve trade performance significantly. But simply lowering trade barriers or properly realigning exchange rates does not guarantee prosperity. Most intra-African variance in growth rates, for example, cannot be explained by different degrees of openness.

Policy matters. Geography, demography, and past high trade barriers have almost surely slowed growth in Africa. But the new studies argue that the lion's share of Africa's current stagnation can be explained by the direct constraints on firms' performance arising from the region's domestic policies, most notably poor delivery of public services. These constraints include the high costs of power due to monopolies and corruption; high transaction costs due to weak contract enforcement; high costs of information due in part to very poor telephone systems; and high levels of risk due to political uncertainty and an absence of property rights. Firms have responded by reducing risks (holding large inventories, investing in electricity generators, and restricting business relations to known enterprises) and by reducing investment, both of which have been costly to economic growth.

The beginnings of reform. Only during the 1990s have a significant number of governments seriously embarked on reform. In fact, among the 12 low-income African countries thought to have broadly satisfactory policy environments in 1995, subsequent annual growth in output per worker has been a respectable 4.7 percent. But serious challenges remain: Africa as a whole is still rated the worst policy environment in the world, according to the World Bank. Moreover, aid has not been successful in encouraging reform where the policy environment is poor. That is why the World Bank's new Highly Indebted Poor Countries debt relief initiative targets aid to countries that have an established and sustained record of policy reform. Finally, the reform of trade and exchange rate policies has proved much easier than the reform of infrastructure and institutions.

Conclusion. If African countries can improve public service delivery and establish a stable political environment that enables people to gain the rewards of investment in physical and human capital, the supposed barriers to growth—education, trade, inequality, and geography—may prove surmountable. For the people of Africa, 40 percent of whom live on less than $1 per day, an economic revival on the continent cannot come too soon.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

No Need for More UI Search Enforcement. Failure of unemployment insurance (UI) claimants to seek work actively has not been a cause of overpayments, according to a new study. The study reports the results of randomized trials intended to measure whether stricter enforcement and verification of work-search behavior decreases unemployment insurance claims and benefits. Past studies based on nonexperimental data found that the failure of claimants to seek work is a prime cause of UI overpayments, but the new study finds little evidence that verification of claimant search behavior or tighter checks on eligibility led to shorter claims or lower total benefit payments. The authors suggest that for UI the enforcement of sanctions is not worth the cost; they call for more experimentation to see if their results hold in different locations or under different labor market conditions.

No Boomer Bust for the Stock Market. Baby boomers' entry into their "peak saving years," and the associated increase in their demand for financial assets is one popular explanation for the rise in stock market values in the 1990s. This view is often accompanied by predictions that when boomers reach retirement age, their concerted decision to sell assets will result in declining—and perhaps sharply declining—asset values. A recent study finds little support for such a view. It argues, for example, that standard age-wealth profiles derived from a cross section of different households at a point in time appear to overstate the extent of asset accumulation and subsequent decumulation that typically takes place over time in individual households. In addition, households with substantial asset holdings appear to decumulate wealth slowly, if at all, after retirement. The study also finds no robust relationship between changes in demographic structure and asset returns in the historical data—though the amount of variation in demographic structure is relatively small in these data. The author speculates that factors such as forward-looking behavior by market participants could further weaken the relationship between age structure and asset returns. For example, efficient markets would not be surprised by the aging and eventual retirement of the boomers and would incorporate this effect into asset prices in advance.

Layoffs.com. In a study of layoffs over the last 6 years, a Chicago outplacement firm found that although the high-flying computer industry is often heralded for its rapid growth and job creation, it has also been one of the three largest job cutters. Between 1993 and 1998, firms in the computer industry announced more than 270,000 job cuts. This finding illustrates an important feature of the U.S. labor market: its dynamism, with large numbers of jobs being lost in one place and made up in another. The study found that aerospace and defense firms were at the top of the list, announcing more than 370,000 layoffs (not surprising, since net job creation was negative in these sectors over the period). Retail companies were second with 280,000 gross job reductions. The aforementioned industries, together with telecommunications, finance, industrial goods, and transportation industries, collectively accounted for over half of the 3.1 million gross job cuts announced in the 6-year period by the more than 30 industries tracked.

INTERNATIONAL ROUNDUP

"Seeds of Hope" in Central America. Four leading agricultural research centers have begun "Seeds of Hope for Central America," a 2-year, $2.5 million program designed to restore the food production capacity of Honduras' and Nicaragua's agricultural sectors. In the short run, the program aims to use "foundation seeds"—high-quality, disease-free seeds suitable for local growing conditions and diets—to produce large quantities of seeds for distribution to subsistence farmers. With half of the two countries' work force employed in the agricultural sector and up to 70 percent of basic food crops destroyed by Hurricane Mitch, swift restoration of food production is considered necessary to avoid nutrition and health problems and loss of jobs. Long-term goals include teaching environmentally appropriate agricultural and resource-management practices to reduce vulnerability to future disasters. The program, led by research centers from Colombia, Italy, Mexico, and Peru, builds on the successful Seeds of Hope program conducted in Rwanda in 1995.

Who Controls East Asian Corporations? Economists have pointed to weaknesses in the structure of corporate ownership and governance as a primary cause of the Asian crisis. However, little data exist on the nature and concentration of ownership in East Asia and its relation to performance. The environments in which corporations have operated—which are characterized by insufficient shareholders' rights, weak judicial systems, and corruption—are also likely to make these relationships different from those observed elsewhere. A recent World Bank study finds that in a sample of almost 3,000 corporations in 9 East Asian countries more than half are controlled by a single shareholder. Consistent with previous research, the study finds that raising ownership concentration from very low levels helps performance, but that greater concentration is detrimental when concentration is already high. This pattern holds irrespective of the category of shareholder (whether individual, financial institution, or corporate). One explanation is that governance is weak when no one is in charge but conflicts of interest among shareholders can develop as concentration increases. The study also finds that ownership tends to be more concentrated in less developed countries.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, March 5, 1999****

In February, the unemployment rate was 4.4 percent; it was 4.3 percent in January. Nonfarm payroll employment rose by 275,000.

Leading Indicators

In January, the composite index of leading indicators increased 0.5 percent.

NAPM Report on Business

The Purchasing Managers' Index rose to 52.4 percent in February from 49.5 percent in January.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.3	1.8	3.7	6.1
GDP chain-type price index	5.4	0.9	0.9	1.0	0.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.5	0.3	2.5	3.7
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.1	1.5
Using NFB deflator	1.3	3.6	3.5	3.4	3.0
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	11.3
Imports	9.2	13.0	13.1	12.9	13.1
Personal saving	5.2	0.3	0.3	0.1	0.1
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Dec. 1998	Jan. 1999	Feb. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.3	4.3	**4.4**
Payroll employment (thousands)					
increase per month			**314**	**217**	**275**
increase since Jan. 1993					**18108**
Inflation (percent per period)					
CPI	5.8	1.6	0.1	0.1	N.A.
PPI-Finished goods	5.0	-0.1	0.4	0.5	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, March 5, 1999**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Jan. 1999	Feb. 1999	March 4, 1999
Dow-Jones Industrial Average	7441	8626	9346	9323	9467
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.34	4.44	4.49
10-year T-bond	6.35	5.26	4.72	5.00	5.41
Mortgage rate, 30-year fixed	7.60	6.94	6.79	6.81	7.06
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level March 4, 1999**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	1.082	-2.2	N.A.
Yen (per U.S. dollar)	123.5	3.6	-2.6
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.93	2.1	1.6

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	4.3 (Q4)	**4.4** (Feb)	1.7 (Jan)
Canada	2.8 (Q4)	8.0 (Dec)	0.6 (Jan)
Japan	-3.5 (Q3)	4.4 (Dec)	0.2 (Jan)
France	2.8 (Q4)	11.4 (Dec)	0.5 (Jan)
Germany	1.8 (Q4)	[2/] 7.3 (Dec)	0.5 (Dec)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.3 (Q4)	6.2 (Oct)	2.5 (Jan)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, March 5, 1999.**

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for December was 9.5 percent.

EYES ONLY

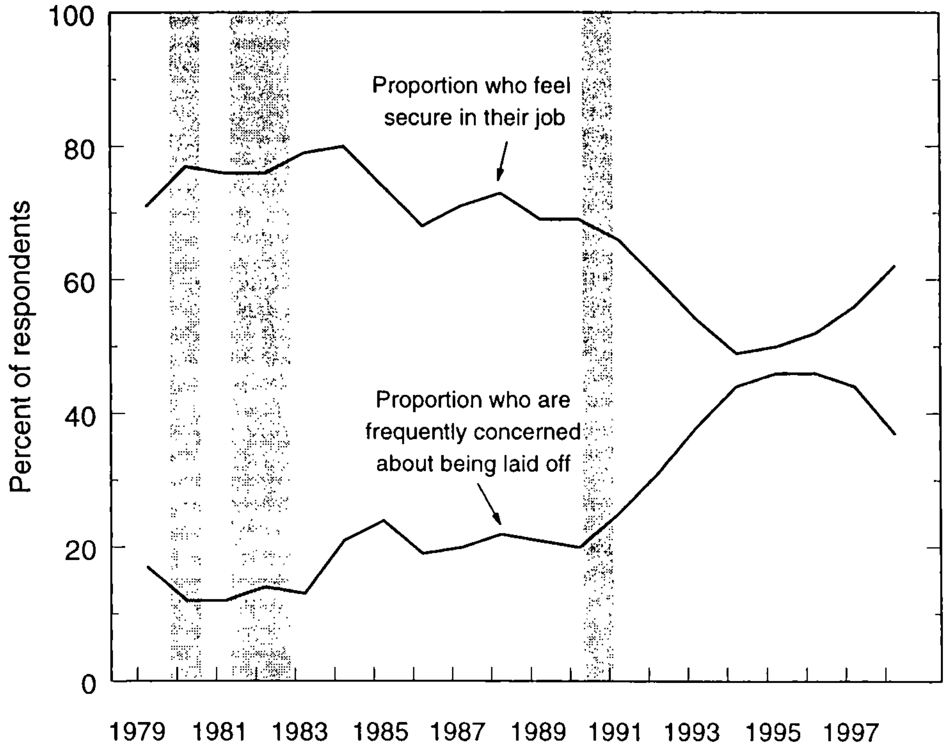
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

February 26, 1999

CHART OF THE WEEK

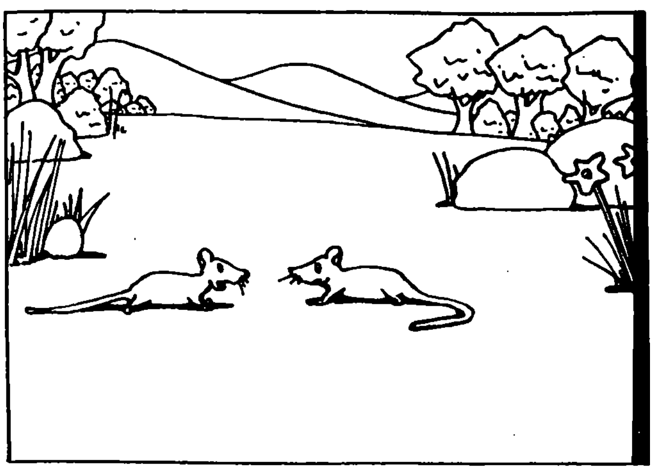
Survey Shows Job Insecurity Is Abating



In recent Congressional testimony, Federal Reserve Chairman Greenspan has argued that worker anxiety is probably no longer an important factor restraining wage inflation. In one private survey, the proportion of respondents who say they are frequently concerned about being laid off fell to 37 percent in 1998, while the proportion who say they can be sure of having a job with their company as long as they perform well rose to 62 percent. Neither measure, however, is back to pre-1990-91 recession levels.

EYES ONLY

CONTENTS

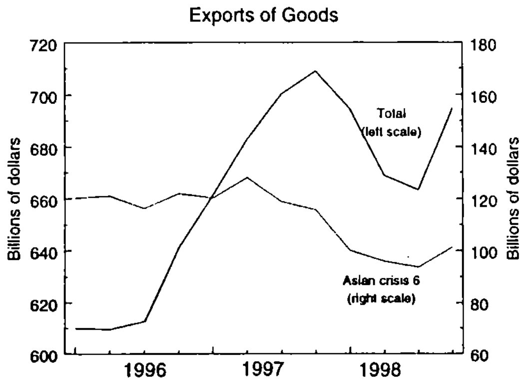


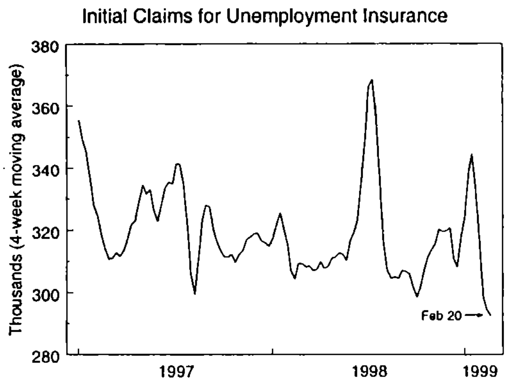
"I hear the streets are paved with garbage."

MACROECONOMIC UPDATE

Surprising Strength in Net Exports

Real GDP growth in the fourth quarter has been revised up to 6.1 percent at an annual rate. Preliminary labor market evidence suggests continued solid growth in the first quarter.





Net exports. Net exports accounted for about 0.5 percentage point of real GDP growth in the fourth quarter, the first positive contribution from this sector in 2 years. Partly reflecting lumpy airplane shipments, exports of goods rose substantially. The increase included exports to Japan and the five Asian countries most affected by the crisis (see upper chart). Although most forecasters expect the erosion of the trade balance to reassert itself over the next year, the prospects for exports now appear rosier.

Jobs. Monthly payroll employment gains have averaged a torrid 273,000 from November through January. Initial claims for unemployment insurance averaged just 293,000 for the 4-week period ending February 20th (see lower chart), the lowest 4-week average value during the current expansion.

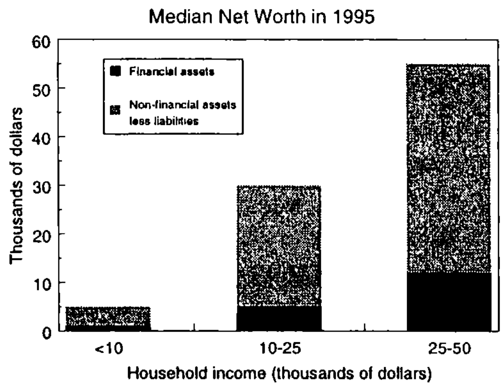
Output and demand. Fragmentary data for the first quarter point to a slower but still positive rate of growth. Motor vehicle production, which had contributed about 2 percentage points to fourth-quarter growth, will remain about flat in the first quarter according to manufacturers' schedules. Housing starts, however, have continued to increase.

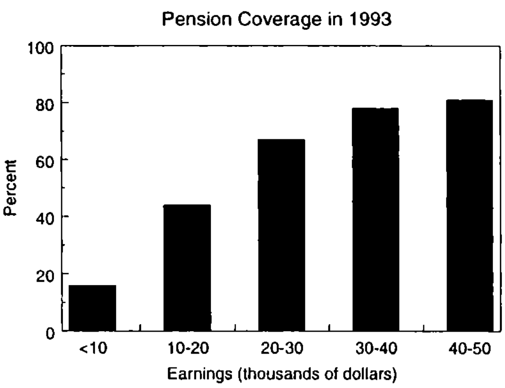
The outlook. The fundamentals of the near-term outlook remain positive: inflation remains low; inventories remain lean with respect to sales; and consumer confidence is high. One possible worry is import prices, which have stopped falling in recent months and may no longer be a restraint on inflation.

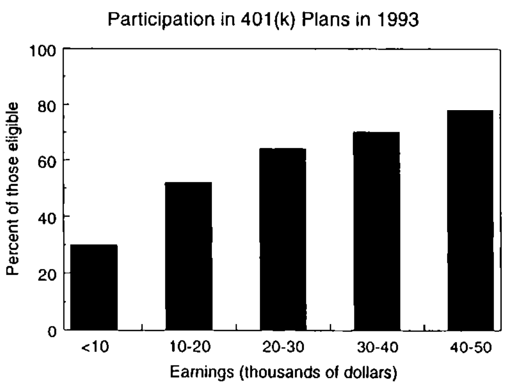
SPECIAL ANALYSIS

Encouraging Saving through USA Accounts

Many American families have very little savings. Federal tax policy currently offers the biggest saving incentives to higher income families, but universal savings accounts (USAs) would focus new saving incentives on lower income families.







Personal saving. Most Americans with low or middle income have small net worth—even relative to their income—and very few financial assets (see upper chart). In addition, workers with lower earnings are much less likely to be covered by a pension than workers with higher earnings (see middle chart). Even taking into account the progressive structure of Social Security, households with lower earnings appear to be less able to maintain pre-retirement levels of consumption after retiring.

401(k) plans. A key aspect of the tax code that encourages saving is 401(k) plans, in which employers typically match some share of worker contributions up to a limit, and both employee and employer contributions (again, within limits) are untaxed. However, many eligible workers do not contribute to 401(k) plans, and participation is significantly lower among workers with lower earnings (see bottom chart). The total tax loss on these plans is further skewed toward upper income workers, because those workers would otherwise pay higher tax rates on the additional income. Treasury estimates show that almost two-thirds of all tax expenditures on pension plans go to the top 10 percent of families by income.

Participation. Employers usually try to encourage wide participation in 401(k) plans, in part because nondiscrimination rules limit how much highly compensated employees may contribute relative to other employees. Intuition suggests that higher match rates would lead to more contributions. The available evidence seems to confirm that the *existence* of a match has an important effect on workers' participation in 401(k)s, but the evidence is ambiguous as to whether the *size* of a match is important.

USA accounts. The Administration's plan would provide an incentive for saving by matching workers' contributions to USAs or 401(k)s at a sliding rate. It would also put money into many workers' accounts even if those workers made no contributions out of their own incomes. The progressive nature of these subsidies increases savings the most for households that are least prepared for retirement. In addition to the government's flat contribution, the high match rate might help to overcome some people's natural reluctance to put their limited savings in an account that is relatively inaccessible before retirement. Progressivity also means that more of the funds in USAs will be new saving instead of a reshuffling of existing saving, because lower income households have few other assets that they could transfer into these accounts. Thus, the focus in the USA program on lower income people has advantages from both the distributional and aggregate saving perspectives.

EYES ONLY

SPECIAL ANALYSIS

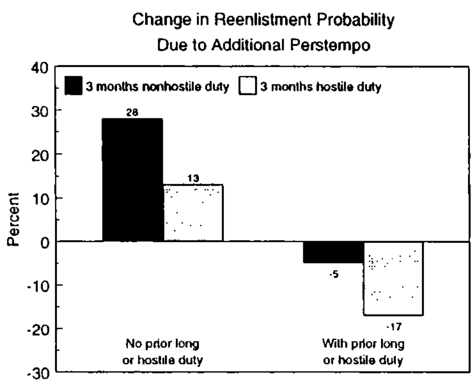
Compensation, Perstempo, and Reenlistment

Military pay is front page news, at least in part because of the implications of the recent strong labor market for the Department of Defense's ability to meet its personnel requirements. What are the economic factors affecting reenlistment?

Compensation. A rational determination of whether or not to reenlist would involve comparing the costs and benefits of entering the civilian sector with those of remaining in the military. According to one estimate, a 10 percent increase in civilian unemployment increases first-term retention by about 1.5 percent; a 1 percent increase in military pay relative to civilian pay increases first-term retention by 1.0 to 1.5 percent. Thus, an across-the-board pay increase in the 4 to 5 percent range would significantly increase reenlistment. Supplemental raises targeted to selected grades and enhanced retirement benefits would increase retention rates still more.

Perstempo. Another factor influencing service members' decision to reenlist is the extent to which they have long or hostile duty away from home—what is called "perstempo" (for personnel tempo) in inimitable military argot. Perstempo is higher than it was during the pre-Gulf War period, especially in the Air Force and Army. Greater perstempo increases separation from family and the risk of casualty, which would be expected to decrease retention. At the same time, many service members join the military out of a sense of adventure, travel, or service to their country.

A recent study found that among service members in their first term, a small amount of long or hazardous duty is associated with higher retention. After that, however, the effect diminishes, and, in fact, too much perstempo hurts retention. For example, among first-term Army personnel, an initial 3 months of *nonhostile duty* was estimated to increase retention by 28 percent relative to having no perstempo; the estimated effect of *hostile duty* is smaller but still positive (13 percent higher retention than with no perstempo). However, for those who have already had long or hostile duty, an additional 3 months of nonhostile duty reduces retention by 5 percent, and an additional 3 months of hostile duty reduces retention by 17 percent (see chart).



Implications. Just like a civilian worker's decision to leave a firm, a service member's decision to leave the military depends on a variety of factors. Empirical studies demonstrate that both compensation and non-monetary factors are important determinants of reenlistment.

EYES ONLY

ARTICLE

Can Cities Grow Forever?

The social costs of suburban sprawl and of inner city decay, as well as the so-called "death of distance" brought on by new communications technologies, have led some to suggest that cities may become less the economic engines and cultural Meccas they have historically been—if not virtually obsolete. Could the 21st century see a decline in urbanization as rapid as its rise in the 19th and 20th centuries?

Do cities make sense? Economists have long sought to understand the efficiencies of urban density. Adam Smith contrasted cities, with their division of labor, against "the Highlands of Scotland, [where] every farmer must be butcher, baker, and brewer for his own family." Alfred Marshall cited "economies of localized industry," such as readily available pools of labor and reduced transport costs for supplies. These observations about the benefits of agglomeration remain valid today for producers as well as consumers, who enjoy such efficiencies as shared public goods and nearby shopping malls. Moreover, concentrations of wealth and learning promote intellectual and cultural advance: about 95 percent of product innovations occur in metropolitan areas, for example, and 25 percent of the Kennedy Center lifetime achievement award winners were born in New York City.

Why Wall Street and Broadway... Though transport costs of manufactured goods have lost influence as a factor in urbanization since the Industrial Revolution, the costs of moving people are as important as ever. Empirical evidence shows that over the past 20 years, the ability to share a common labor pool has been the most important reason specific industries locate together. Anecdotal evidence points to the rise of intellectual-industrial oases like Silicon Valley and to "superstar" industries like show-business that seek to place the best performers in the largest market. Because much of the cost of transporting people is the opportunity cost of time, which rises with income, population density will probably grow in importance as incomes continue to grow.

...are both in New York. Economic benefits arise from both the density and the diversity of industries and populations in a city. Like a well-diversified stock portfolio, a city with many industries has reduced exposure to economic ups and downs, as some businesses hire while others lay off workers. Size and diversity together allow better matching of individuals' skills and needs to specific jobs and services. Large cities stabilize demand for medical specialists in rare diseases, as well as financial traders and comedians. Beyond general productivity advantages of larger cities (as reflected in earnings differences as high as 30 percent, even when controlling for education and occupation), the diversity of a city's industrial mix may have further, positive spill-over effects on its economic growth.

City limits. Despite their advantages, the largest cities do eventually stall in attracting population. The main forces that can halt urban growth are the long-standing costs of city living: high real estate prices, congestion, pollution, and crime. Land and housing prices increase with city size, as do average commute times and pollution. Today, moving to a city involves a larger increase in commuting costs than in pollution costs, due to improved emissions controls and environmental technology and to declines in urban manufacturing. Crime is arguably costlier than both. Though the connection between crime and cities has decreased since 1970, the rate of violent crime in cities with populations over 250,000 is still double that of places with fewer than 10,000 residents; for property crimes, the difference is 30 percent. Only 10 to 15 percent of the urban crime differential is due to lower probabilities of arrest; the remainder may result from weaker social sanctions, greater poverty, or stronger networks for criminals.

Virtually complements. Some futurists argue that information technology will make face-to-face contact, and therefore cities, obsolete. While e-mail and other advances are indeed substituting for other forms of communication, the history of the telephone bodes well for survival of the city: There has been no negative correlation between the rise in telephones and urbanization. Rather, people in cities are much more likely to use telephones, and people who are physically near are much more likely to call one another. Electronic communication may increase face-to-face contact, and vice versa; that is, the two may well be complements rather than substitutes.

Conclusion. As Mark Twain might say of cities, reports of their death are greatly exaggerated. Though the percentage of Americans living in the ten largest metropolitan areas fell from 23 to 21 percent between 1970 and 1990, the share living in urban areas with populations over 1 million rose from 41 to 48 percent. Assuming that government policies can continue to curb the costs of city living, the economic advantages of urban density and diversity are likely to balance out the disadvantages in years to come.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Greenspan Lauds the Economy's Performance but Cites Risks. In Congressional testimony presenting the Federal Reserve's semiannual report on monetary policy, Chairman Greenspan observed that the U.S. economy over the past year again performed admirably, despite the challenges presented by severe economic downturns in a number of foreign countries and episodic financial turmoil abroad and at home. Greenspan cited the many respects in which the underpinnings of this performance remain strong, including flexible markets and the shift to a Federal budget surplus. These are facilitating the build-up in cutting-edge capital stock, which in turn is spawning rapid advances in productivity that are helping to keep inflation well-behaved. But the Fed chairman also cited ways in which the economy had become "stretched" after a long expansion. These include the using up of spare labor resources (implying more inflationary pressure if productivity growth does not increase still further), possibly overvalued stock share prices, mounting household and business debt, increasing external debt of the country (reflecting the deepening current account deficit), and vulnerability to rapidly changing conditions overseas. Greenspan said monetary policy must be ready to move quickly in either direction. But he also noted that the Fed must continue to evaluate, among other issues, whether the full extent of the policy easings undertaken last fall to address the seizing up of financial markets remains appropriate as those disturbances abate.

Welfare-Induced Migration Found to Be Small. Welfare-induced migration does occur, according to a recent study, but it is modest in magnitude. The study examines the possible statistical biases of previous research on the topic and presents its own calculations using 1980 and 1990 Census data. It finds that the welfare population in high benefit states is increased by less than one percent through migration over a 5 year period. Migration effects were largest for high-school dropouts. The study concludes that state governors and legislators should be more worried about the effect of benefit levels on participation by their own constituents than about the effects of benefits on migration of single mothers.

More Evidence on Job Stability. Although media accounts of layoffs at large corporations may give a different impression, a new study finds no evidence of reduced job stability in large corporations in the 1990s. Based on 5 years of employment records beginning between 1990 and 1992 for over 700,000 employees from 51 firms, the study finds that mean tenure and the percentage of employees with 10 or more years of service did not decrease. Moreover, job duration in large corporations continues to be much longer than in the rest of the labor market. The study also finds no evidence that mid-career employees are being singled out in downsizing decisions: the retention rates for mid-career employees were virtually indistinguishable for growing or downsizing firms, and the impact of employment adjustment is still being borne by the most junior workers. These findings are roughly consistent with most previous research using nationally representative surveys (which finds only small changes in job mobility and employment tenure) as well as with employee survey responses (see the Chart of the Week).

EYES ONLY

INTERNATIONAL ROUNDUP

A Turnaround in Trade with East Asia? Recent trade data contain preliminary indications that the impact of the Asian crisis on the U.S. trade balance may have peaked. In the fourth quarter of 1998, seasonally adjusted exports to seven East Asian nations (China, Indonesia, Japan, Korea, Malaysia, the Phillippines, and Thailand) were just $22.8 billion below their level before the Asian crisis (compared with $33 billion in the third quarter). Exports to the five crisis nations (Indonesia, Korea, Malaysia, the Phillippines, and Thailand) grew by $8.3 billion, while imports from these five increased just $1.7 billion. Much of the improvement can be attributed to strong exports to Korea in December—in fact, the United States. ran its first trade *surplus* with Korea since October 1997. Although one quarter's data do not establish a new trend, these and other data signal that the effects of the crisis on exports may have bottomed out and economic recovery may be underway in some parts of East Asia.

New Study Ponders the Prevention of Financial Crises. A new Institute for International Economics study by Barry Eichengreen proposes a four-part program to help prevent and manage future monetary crises. Rejecting "pie-in-the-sky" overhauls of the international financial system that would involve a global currency, central bank, financial regulator, or bankruptcy court as politically impossible, the author urges "robust incrementalism"—substantial reforms that build on, rather than sweep away, existing institutions. First, the study recommends the adoption of new international standards for emerging market bank regulation, bankruptcy laws, corporate governance, auditing, and accounting. The IMF would provide enforcement by conditioning its lending on adherence to the standards. Second, it proposes Chilean-style taxation of all short-term capital inflows in countries with inadequate bank supervision, in order to limit debt buildups that could trigger crises. Third, it recommends that the IMF encourage majority voting, burden-sharing and collective representation clauses in loan commitments by offering more attractive interest rates to countries that incorporate such provisions in their securities. Finally, it argues that recent currency crises in fixed-rate regimes make indisputable the need for the vast majority of emerging markets to move to more flexible exchange rates.

European Union Directive Opens Electricity Sector. U.S. companies now have greater opportunities for expansion in Europe's electricity sector, thanks to recent EU liberalization. Last Friday, an EU directive freeing a minimum of 26 percent of its roughly $130 billion per year electricity market to international competition took effect. By 2003, 33 percent must be liberalized. Industry in nearly every EU nation pays substantially more for electricity than firms pay in this country. U.S. utilities already have a presence across the Atlantic, controlling 7 of England's 12 regional electricity distributors, and can therefore be expected to be active players in the EU market. European electric utilities seem to be just as interested in investing in the United States as they are in exploiting their domestic markets: European utilities accounted for a substantial part of the $19 billion invested by foreign firms in the U.S. electricity sector last year.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, February 26, 1999****

According to revised estimates, real gross domestic product grew at an annual rate of 6.1 percent in the fourth quarter.

Advance Durable Orders

Advance estimates show that new orders for durable goods increased 3.9 percent in January, following an increase of 3.4 percent in December.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, rose 3.2 index points in February, to 132.1 (1985=100).

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	**4.3**	1.8	3.7	**6.1**
GDP chain-type price index	5.4	0.9	0.9	1.0	**0.7**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.5	0.3	2.5	3.7
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.1	1.5
Using NFB deflator	1.3	3.6	3.5	3.4	3.0
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	**11.3**
Imports	9.2	**13.0**	13.1	12.9	**13.1**
Personal saving	5.2	0.3	0.3	0.1	**0.1**
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Nov. 1998	Dec. 1998	Jan. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.4	4.3	4.3
Payroll employment (thousands)					
increase per month			277	298	245
increase since Jan. 1993					17845
Inflation (percent per period)					
CPI	5.8	1.6	0.2	0.1	0.1
PPI-Finished goods	5.0	-0.1	-0.2	0.4	0.5

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

New or revised data in **boldface**.
GDP data **embargoed until 8:30 a.m., Friday, February 26, 1999**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Dec. 1998	Jan. 1999	Feb. 25, 1999
Dow-Jones Industrial Average	7441	8626	9019	9346	9366
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.39	4.34	4.51
10-year T-bond	6.35	5.26	4.65	4.72	5.32
Mortgage rate, 30-year fixed	7.60	6.94	6.72	6.79	6.89
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level February 25, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.107	-1.4	N.A.
Yen (per U.S. dollar)	119.3	-0.5	-7.3
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	94.95	0.9	-0.8

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	**4.3** (Q4)	4.3 (Jan)	1.7 (Jan)
Canada	2.3 (Q3)	8.0 (Dec)	1.0 (Dec)
Japan	-3.5 (Q3)	4.4 (Dec)	0.6 (Dec)
France	2.9 (Q3)	11.4 (Dec)	0.3 (Dec)
Germany	1.9 (Q4)	2/ 7.3 (Dec)	0.5 (Dec)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.6 (Q4)	6.2 (Oct)	2.8 (Dec)

U.S. GDP data **embargoed until 8:30 a.m., Friday, February 26, 1999.**

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for December was 9.5 percent.

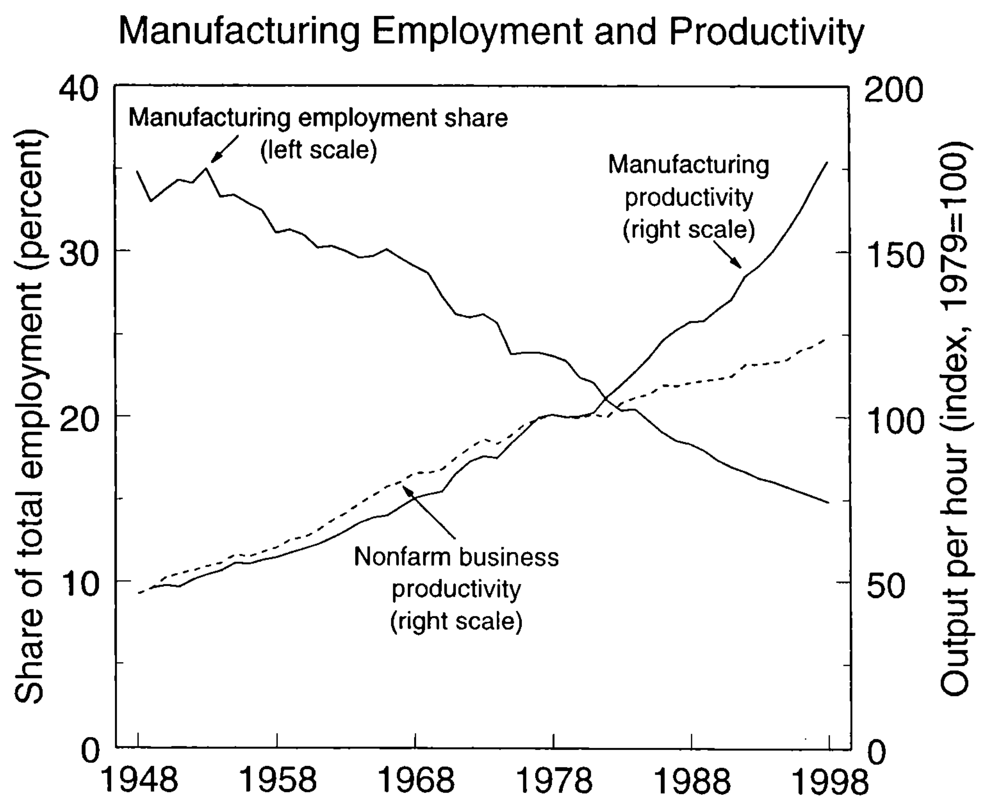
EYES ONLY

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

February 19, 1999

CHART OF THE WEEK



Manufacturing's share of nonfarm employment has been falling for decades. In part, this reflects the fact that rising incomes have led Americans to devote an increasing fraction of their consumption to services. But it also reflects strong growth in manufacturing productivity, which has allowed an increasing proportion of the labor force to produce other goods and services.

EYES ONLY

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SPECIAL ANALYSES

ARTICLE

DEPARTMENTS

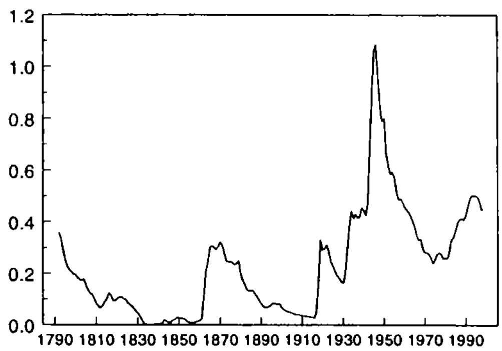
"The social conservative in me tells me to pay for dinner, but the fiscal conservative thinks we should split it."

EYES ONLY

SPECIAL ANALYSIS

Life after Debt

Under the Administration's framework for Social Security reform, Federal debt held by the public is projected to be completely eliminated by 2018. What would be the implications of such a drastic reduction in debt?



Debt history. Federal government debt in the United States has tended to rise as a share of GDP during wars and economic downturns and to fall during peacetime economic expansions. Federal debt has never been zero, although it did fall to just $38,000 (less than half of one percent of GDP) in 1835. The largest debt-to-GDP ratio was 1.09 in 1946 (see chart).

Macroeconomic effects. Reducing the debt would boost national saving and private investment, thereby reducing interest rates and raising productivity, real wages, and incomes. Productive capital would replace government debt in private portfolios, although probably not dollar-for-dollar, because private saving might be somewhat diminished by reduced interest rates or greater confidence in the government's ability to provide current-law retirement benefits. Most of the extra flow of national saving would be invested in the United States; the remainder would be invested overseas, with future earnings raising U.S. national income.

In early 1993, budget deficits were projected to grow as far as the eye could see. The Administration's proposed debt reduction would lower interest rates by 2½ or more percentage points by 2014 compared with what they would have been under this dismal deficit outlook. Even compared with a more optimistic alternative in which policymakers had been able to muddle through and keep debt held by the public at 50 percent of GDP from 1992 on, the current projections imply a substantial improvement in macroeconomic conditions. Rough calculations suggest that, with the debt eliminated by 2018, GDP would be 3½ to 4½ percent higher and interest rates would be 1 to 1¼ percentage points lower.

Effects on financial markets. U.S. Treasury securities are widely viewed as valuable risk-free assets in financial portfolios. Eliminating the debt would leave investors looking for an alternative. In addition, Treasury debt plays numerous roles in financial markets, both domestic and foreign. For example, it serves as an ideal hedging instrument and is frequently used as collateral for short-term lending. Finally, the primary channel through which the Federal Reserve currently conducts monetary policy is the purchase or sale of Treasury securities in order to create or remove liquidity from the banking system.

The debt of other well-regarded governments would be one alternative for investors seeking a relatively safe asset, as would securities of government-sponsored enterprises like Freddie Mac or high grades of corporate debt. The Federal Reserve could either forego the use of open market operations or elect to deal in some other asset. Possible obstacles to the latter choice include the Fed's statutory requirements and relatively thin markets for other instruments. Another possibility is that the Federal government would elect to buy other assets in lieu of paying down its debt entirely. In other words, the Federal government could continue to issue gross debt even after becoming a net creditor.

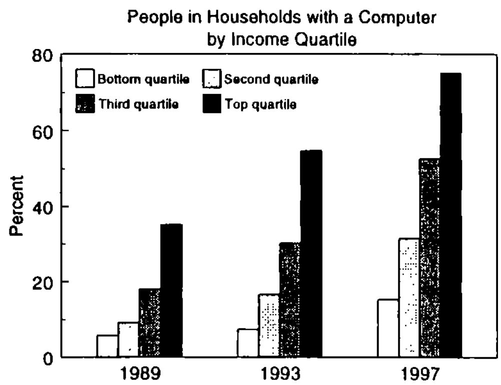
Conclusion. Eliminating the Federal debt would produce substantial benefits by increasing saving and private investment. Any problems from reducing the debt are fairly small and easily avoided.

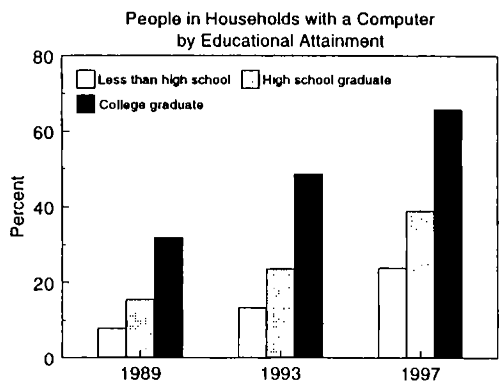
SPECIAL ANALYSIS

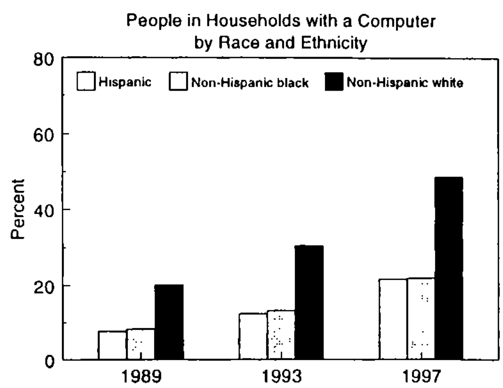
Socio-Economic Status and Home Computers

Access to a computer within the home and use of the Internet have risen rapidly among all socio-economic groups since 1993. However, minorities and people with lower income and less education remain much less likely to be connected.

Computer access is on the rise. Special supplements to the Current Population Survey (CPS) in 1989, 1993, and 1997 show that the share of the population who have a computer in their home has been rising. After rising from 18 percent to 27 percent between 1989 and 1993, this share rose to 43 percent in 1997.







Socio-economic differentials. Gaps in access to home computers and use of network services among socio-economic and demographic groups have persisted since 1989. In 1997, people in the top income quartile were nearly five times as likely to have a home computer as those in the bottom quartile (see top chart). Non-college graduates, especially high school dropouts, were much less likely to have home computers than college graduates (see middle chart). Differences among racial and ethnic groups (see lower chart) partly reflect gaps in education and income, but even after adjusting for these factors, whites are nearly 50 percent more likely to have a home computer than blacks or Hispanics.

Implications. Computers and the Internet are becoming an integral part of many workplaces, and studies have shown that among workers with similar education and background, those who use a computer at work are in jobs that pay higher wages. Persistent gaps in home computer ownership and Internet use are disturbing to the extent that they reflect a more general isolation of some groups from today's increasingly information-intensive economy.

SPECIAL ANALYSIS

New Evidence Gives GED a Better Grade

Past studies have found that acquiring a General Educational Development (GED) high school equivalency credential does not raise earnings. But a new study suggests more positive results, at least for less skilled whites.

The conventional wisdom: no learning, no effect. Workers with a GED earn more than other high school dropouts. Studies have found, however, that once observable differences (such as years of schooling) between GED holders and other dropouts are taken into account, the GED has no significant effect on earnings. Its main benefit was seen as coming through access to post-secondary education and training, both civilian and military. Since obtaining the GED does not significantly change a person's knowledge or skills (median preparation time for the GED is a relatively inconsequential 30 hours), it might not be expected to have much effect, by itself, on labor market outcomes.

New evidence: a valuable signal. The more recent study finds that having the GED *does* improve earnings for less skilled white recipients, when the effect is properly measured with controls for cognitive ability and motivation. This result suggests that the GED credential has significant value as a signal to employers.

Unobservables observed. Cognitive ability and personal motivation are important determinants of labor market outcomes, and GED recipients may differ from other high school dropouts in both motivation and cognitive skill. If so, the effects of these differences on wages may be confused with the effect of the GED itself. The new study uses interstate differences in the minimum score for passing the GED to compare persons with the same GED score (a proxy for cognitive ability), some of whom obtain the GED and some of whom do not (since the same score will pass in a state with lower standards but fail in a state with higher standards). Since all persons in the sample have attempted the GED, motivation is also better controlled for than when comparing GED holders with high school dropouts who did not even attempt the GED exam. The pure "credential" effect of the GED is thus isolated from cognitive ability and motivation. Once these factors are controlled for, acquiring the GED results in an estimated earnings increase of 10 to 19 percent after 5 years for young white dropouts.

Reconciling the apparent contradiction. The implication of the new GED study is that the GED credential helps the least skilled recipients—those who barely pass the exams—but not necessarily those with higher cognitive ability. This finding is supported by another recent study, which found that GED holders earned more than other dropouts scoring in the lowest quartile of a math test, but that there were no differences in earnings in the highest three quartiles. Earlier studies, which found no effect from the GED, estimated its average effect across all skill levels, suggesting that the significant effect for the least skilled got lost in the overall average.

Why doesn't the signal work for nonwhites? The new research continues to find no earnings effect from the GED for nonwhites. The authors speculate that employers may find English fluency a better signal of productivity than the GED for nonwhite dropouts overall (their nonwhite sample contains more Hispanics than blacks). Another possible explanation is that employers may distinguish among GED-holders, discounting the GED for those who obtained it while participating in a "welfare training" program such as the Job Corps, the Job Training Partnership Act, or AFDC. The authors make a rough estimate that 44 percent of all nonwhites who took the GED test in 1990 did so in conjunction with one of these programs, whereas the comparable figure for whites was only 11 percent.

EYES ONLY

ARTICLE

Broadband to the Home

The speed of communications networks can shape how much people use the Internet and even how they use it. While businesses have a number of broadband (high speed, high capacity) options to choose from, broadband is still unavailable to most residences and, where it is available, it is only just beginning to become affordable to a broad range of citizens.

Residential fiber links are scarce. The existing telephone network consists overwhelmingly of old copper lines that have much less carrying capacity than fiber optic cable. Although millions of miles of fiber have been installed for transporting traffic between carriers' switching offices, the cost of extending that fiber over the "last mile" to customers is very high. Recent data show that at most, only about 20 percent of channels connecting customers with switching offices are fiber, and most of those are business links in urban areas. As a result, traffic that moves at high speed between switching offices slows to a crawl when it is handed off to most residential customers' copper lines. Using these lines and the best conventional modem operating at 56 kilobytes per second (kbps), images download slowly and a 3½ minute video clip takes more than 20 minutes to download.

Better options exist, but still for the few. Given the time and cost required to build-out new fiber networks on a broad scale, any short-run solution for bringing broadband service to residential customers must work over existing telephone or cable networks. Today, three technologies that meet that constraint are beginning to enter the market at affordable prices: integrated services digital network (ISDN) line service and digital subscriber line (DSL) service over the telephone network, and cable modem service over cable systems.

- ISDN allows transmission rates up to 128 kbps over the existing circuit-switched voice network (twice as fast as with a standard modem). About 40 percent of local telephone company central offices are currently capable of providing such service. Residential ISDN line prices have recently fallen to as low as $25 per month, but additional charges for usage, Internet access, and necessary equipment make the actual cost to consumers much higher.

- DSL service can achieve substantially faster downloads than ISDN over conventional copper lines. Subscribers currently number only in the tens of thousands, but availability is increasing. By the middle of 1998, DSL service was available to at least some consumers in most states. Incumbent local exchange companies have announced plans to serve between 20 and 70 percent of their customers by 2000, and competitive local exchange carriers focusing on data services have entered a number of markets. Prices for DSL have accordingly started to fall, to as low as $49 per month (including Internet access) for speeds that would cut the download time for the above-mentioned 3½ minute video to under 4 minutes.

- Cable systems currently provide high-speed data services to about 300,000 customers, but are expanding aggressively. Prices are competitive with DSL offerings, and a customer connected to the Internet through a 4 megabyte per second (mbps) cable modem could download the 3½ minute video in a mere 20 seconds.

Higher availability and lower prices are needed. Although current developments in the broadband market are promising, there is no assurance that deployment targets will be reached or that, if they are, prices will be accessible to a broad range of Americans. Indeed, future new purchasers of Internet access may be increasingly cost-conscious. The latest Pew Center survey shows that the fastest growing groups of new Internet users are those with much lower income and educational levels than in the past (though these groups remain less likely to be users than those with higher incomes or more education). The survey finds that 23 percent of new users have annual household incomes below $30,000—which is less than median household income. This is a healthy development, but it also suggests that, over time, customers will be increasingly hard to attract at a given access price.

Policy initiatives. To help the spread of residential broadband, an interagency task force led by the White House is currently developing initiatives to remove artificial impediments to entry into the market for high speed data services. With increased competition and innovation, both availability and affordability of broadband should grow. The task force is similarly working to ensure the equitable availability of such services to the growing range of Americans who own computers and use the Internet, as well as to those who have yet to take advantage of new and powerful information tools that are becoming increasingly important in day-to-day life.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More Evidence on Cigarette Prices and Youth Smoking. A new study finds further evidence that higher cigarette prices would result in substantial reductions in both smoking participation and average cigarette consumption among young adults. The study uses a nationally representative survey of high school seniors conducted annually between 1976 and 1993, with up to seven bi-annual follow-up surveys of each sample member. It estimates that a 10 percent increase in the real price of cigarettes would decrease cigarette consumption by approximately 8 percent. (Given estimates that the 1998 tobacco settlement will raise cigarette prices by 35 to 50 cents per pack—a 17.5 to 25 percent increase—this means that smoking among young adults could be reduced by about 14 to 20 percent as a result.) The study also examines the effect of smoking restrictions in public places and private work sites and finds that they are also effective ways to reduce cigarette consumption among young adults. The study concludes that cigarette price hikes have the potential to decrease aggregate smoking levels and smoking-related health problems dramatically within a few decades. In 1998, the incidence of smoking among high school seniors fell for the first time since 1992, to 35 percent, although this figure is still 7 percentage points higher than in 1991.

"Rust Belt" Regains Its Shine. In a recent report, the Census Bureau examines one of the most striking demographic trends of the 1990s: the comeback of the "Rust Belt," the stretch of Midwestern cities traditionally identified with heavy industry, autos, and steel. During the late 1970s and early 1980s, many metropolitan areas in the Rust Belt suffered as heavy manufacturing experienced major downturns in domestic and international markets. However, in the 1990s, as many Rust Belt metro areas have followed the rest of the Nation in shifting from a mostly goods-related economy to a service-based economy, unemployment is down (to below the national average), as are welfare rolls and crime, while wages and population are up or stable. According to the report, the Detroit/Ann Arbor/Flint area stands out as a tremendous success, while other areas (such as Steubenville, Ohio/Weirton, West Virginia; Wheeling, West Virginia; Decatur, Illinois; and Benton Harbor, Michigan) have not shared in the region's turnaround.

Effects of the Proposed 10 Percent Tax Cut. If the 10 percent income tax cut proposed by House and Senate leaders were enacted and went into effect at the beginning of next year, Federal revenues would decline by more than a trillion dollars over the next decade, according to analysis by Citizens for Tax Justice. In addition, the group estimates that over 60 percent of the proposed tax cuts would go to the 10 percent of taxpayers with the highest incomes; the one percent of taxpayers with annual incomes above $300,000 would receive an average tax cut of almost $21,000; and the 60 percent of all taxpayers with annual incomes of less than $38,000 would receive an average tax cut of just $99.

INTERNATIONAL ROUNDUP

OECD Anti-Bribery Convention Enters into Force. The *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* went into force this week after 5 years of development. The Convention permits coordinated action to adopt national legislation making it a crime to bribe foreign public officials, thus creating a level playing field for companies competing for business contracts. It provides a broad definition of bribery, requires bribery of foreign officials to be treated like domestic bribery, and commits countries to provide mutual legal assistance. Under OECD auspices, rigorous multilateral surveillance will monitor compliance with the Convention and assess countries' implementation efforts. Signatories include all 29 OECD member countries as well as Argentina, Brazil, Bulgaria, Chile, and the Slovak Republic.

Japanese Bond Market Should Overtake Treasuries. This year, the Japanese government bond market should become the world's largest, as an indirect result of Japan's efforts to revive its economy. According to J.P. Morgan, Japan's net debt will increase by an estimated $352 billion, increasing the value of outstanding government bonds to about $2.6 trillion, as the central government runs a $450 billion deficit. At current exchange rates, this would surpass the value of outstanding U.S. Treasury bonds, which are expected to fall by $112 billion. Japan will account for about 90 percent of net government bond issuance (new debt minus redemption of maturing bonds) among the leading 18 developed countries in 1999. The surging supply of bonds had pushed up long-term interest rates, which threatened any potential recovery. In an effort to bring interest rates back down, the finance ministry this week reversed course and announced that its Trust Fund Bureau would resume purchases of government bonds. Yields on Japanese government bonds and the value of the yen both fell sharply as a result of the announcement.

International Patent Applications Rise. The number of international applications filed with the World Intellectual Property Organization increased by 23 percent last year to 67,007. The United States, Germany, Japan, and the United Kingdom account for most of the applications (42.3, 13.6, 9.1, and 6.5 percent, respectively), but several developing countries, including Brazil, Cuba, Indonesia, Poland, and Turkey have increased their use of the system. Since 1978 the Patent Cooperation Treaty (PCT) system has offered inventors and industry a simpler route for obtaining patent protection internationally. The filing of one "international" patent application under the PCT seeks protection for an invention simultaneously in 98 countries.

UN Agrees to End Ban on Ivory Trade. The Standing Committee of the Convention on International Trade in Endangered Species of Wild Fauna and Flora (administered by the United Nations Environment Programme) agreed last week to allow Namibia and Zimbabwe each to make one ivory shipment to Japan of 13.8 and 20 metric tons, respectively. Money from the sales will support conservation and community development projects in the two countries.

EYES ONLY

RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, February 19, 1999****

The goods and services trade deficit decreased to $13.8 billion in December from $15.3 billion in November. For 1998, the goods and services trade deficit was $168.6 billion; for 1997, the deficit was $110.2 billion.

Consumer Price Index
****Embargoed until 8:30 a.m., Friday, February 19, 1999****

The consumer price index increased 0.1 percent in January. Excluding food and energy, consumer prices also rose 0.1 percent.

Producer Price Index

The producer price index for finished goods rose 0.5 percent in January. Excluding food and energy, producer prices decreased 0.1 percent.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production was unchanged in January following an increase of 0.2 percent in December. Capacity utilization fell 0.3 percentage point, to 80.5 percent.

Housing Starts

Housing starts rose 4 percent in January to 1.80 million units at an annual rate.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.1	1.8	3.7	5.6
GDP chain-type price index	5.4	0.9	0.9	1.0	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.5	0.3	2.5	3.7
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.1	1.5
Using NFB deflator	1.3	3.6	3.5	3.4	3.0
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	11.2
Imports	9.2	13.1	13.1	12.9	13.2
Personal saving	5.2	0.3	0.3	0.1	-0.0
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Nov. 1998	Dec. 1998	Jan. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.4	4.3	4.3
Payroll employment (thousands)					
increase per month			277	298	245
increase since Jan. 1993					17845
Inflation (percent per period)					
CPI	5.8	1.6	0.2	0.1	**0.1**
PPI-Finished goods	5.0	-0.1	-0.2	0.4	**0.5**

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

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, February 19, 1999.**

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Dec. 1998	Jan. 1999	Feb. 18, 1999
Dow-Jones Industrial Average	7441	8626	9019	9346	9299
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.39	4.34	4.42
10-year T-bond	6.35	5.26	4.65	4.72	5.04
Mortgage rate, 30-year fixed	7.60	6.94	6.72	6.79	6.82
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level February 18, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.122	-0.7	N.A.
Yen (per U.S. dollar)	119.8	4.5	-5.2
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	94.14	1.3	-1.6

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	4.1 (Q4)	4.3 (Jan)	**1.7** (Jan)
Canada	2.3 (Q3)	8.0 (Dec)	1.0 (Dec)
Japan	-3.5 (Q3)	4.4 (Dec)	0.6 (Dec)
France	2.9 (Q3)	11.4 (Dec)	0.3 (Dec)
Germany	2.7 (Q3)	[2] 7.3 (Dec)	0.5 (Dec)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.6 (Q4)	6.2 (Oct)	2.8 (Dec)

U.S. CPI data **embargoed until 8:30 a.m., Friday, February 19, 1999.**

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for December was 9.5 percent.

EYES ONLY

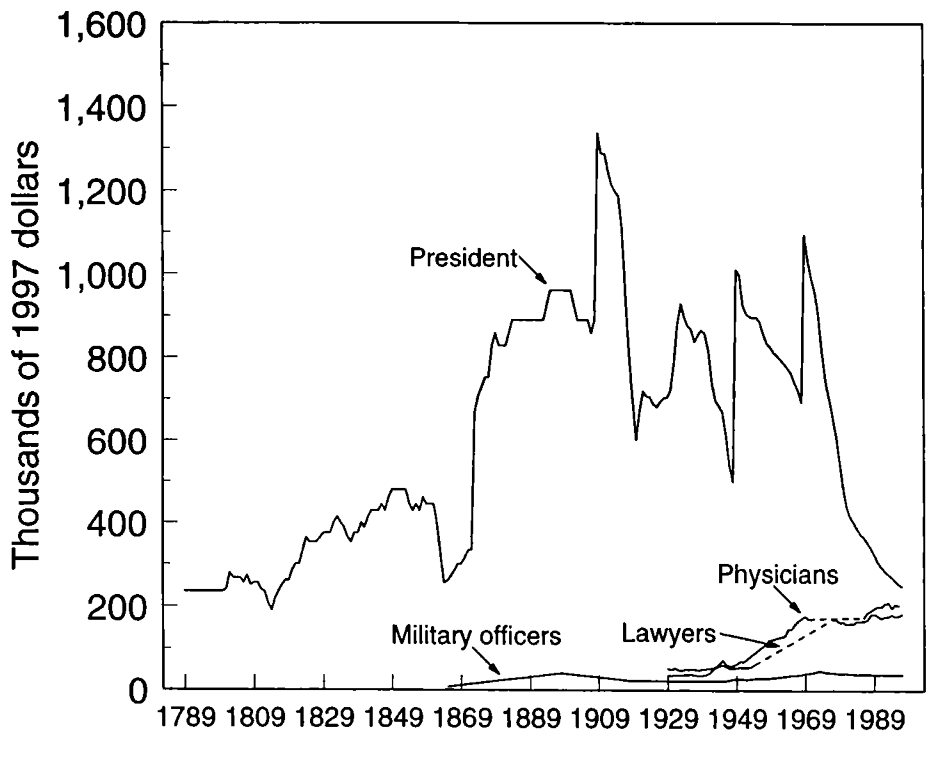
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

February 12, 1999

CHART OF THE WEEK

A Presidents' Day View of Salaries



The nominal annual salary of the President of the United States has been raised in five discrete jumps (the last in 1969), from George Washington's $25,000 to the current $200,000 (plus $50,000 of expenses). Between adjustments, the real value of the President's salary has fluctuated with the general price level and is now about the same as it was in 1789. It has declined relative to other professions such as doctors and lawyers. The Commander-in-Chief's salary has fallen from 35 times that of military officers in Lincoln's time to an all-time low of 7 times that of officers in 1997.

EYES ONLY

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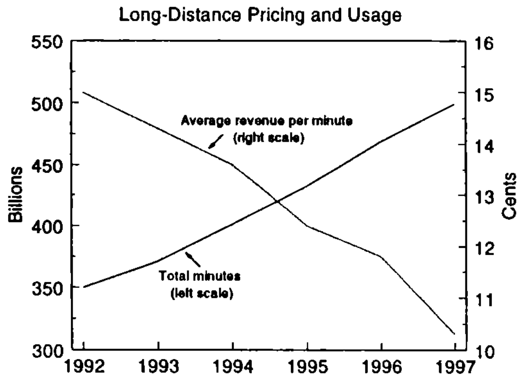
EYES ONLY

TREND

Competition Is Growing as the Telecom Act Turns Three

This week the Council of Economic Advisers marked the third anniversary of the Telecommunications Act of 1996 by releasing a progress report on the U.S. telecommunications industry since 1993. The report cites the direct creation of 200,000 new jobs, on net, the entry of hundreds of new firms, tens of billions of dollars worth of new investment, and benefits to consumers from expanded services and declining prices.

Cataloging the benefits. The benefits of the Administration's focus on increasing competition in the telecommunications industry can be seen sector-by-sector:



- Long-distance telephone services. Competition has eroded AT&T's market share to about 50 percent and increased the availability of low-cost calling plans for a broad range of consumers. Average revenue per minute earned by carriers has been declining steadily for several years, and long-distance usage has increased substantially (see chart).

- Wireless telephone service. Over 60 million Americans now subscribe to mobile service, four times as many as in 1993. Since 1996, median prices per minute have fallen, depending on usage levels, by as much as 30 to 40 percent for residential users and 30 to 50 percent for business users. Wireless carriers directly created over 100,000 new jobs between 1993 and 1998. Wireless service revenues have grown by an average of 24 percent per year since 1993, to $30 billion. Capital investment has reached a cumulative $50 billion.

- Local telephone services. Employment has risen by about 50,000 since 1996, and capital investment has increased by $30 billion, not counting debt or private venture financing. Critics of the 1996 Act have focused on this market, where the market share of new entrants is relatively small, and underlying economic and regulatory factors have created incentives for new entrants to serve mainly the more profitable business customers rather than residential customers. The Supreme Court's affirmation of the FCC's authority to implement market-opening provisions of the 1996 Act should encourage increased competition for all customers in the future.

- Equipment. Estimated total telecommunications equipment revenues were $120 billion in 1998, a three-fold increase since 1993. A growing proportion of manufacturing consists of innovative equipment for integrated voice and data communications over digital networks. Annual U.S. telecommunications equipment exports doubled from 1993 to 1998, to over $25 billion.

- Infrastructure and the information sector. The telecommunications industry provides the infrastructure for fast and reliable transport of information. As Internet usage surged over the past 5 years, the number of Internet "hosts" (individual sources of information) grew from fewer than 3 million to over 30 million, and electronic commerce has become a multi-billion dollar industry. High-speed data services have spread as cable and telephone firms have invested in advanced facilities: deployment of high capacity fiber grew by at least 16 percent in 1997, and usage of innovative data networking equipment is growing. Household demand for additional phone lines has also increased with data traffic, from about 9 million lines in 1993 to about 18 million lines in 1997.

Conclusion. In some telecommunications markets, such as long-distance, growth reflects more than a decade of competition. In others, such as local telephone service, the regulatory and legislative changes that opened the market to entry occurred much more recently. While more remains to be done for entry to occur in parts of the local market, notably residential service, the lesson from markets with a longer history of entry is that, with opportunity and the passage of time, greater competition can emerge.

SPECIAL ANALYSIS

Farm Revenue Insurance

Traditionally, Federally subsidized crop insurance has helped to reduce farm income variability by providing farmers with protection against yield shortfalls due to any number of occurrences, including poor weather conditions and pest damage. An alternative approach to stabilizing farm income is direct revenue insurance.

Federal and private programs. Revenue insurance contracts make indemnity payments when crop revenues fall short of insured levels, whether because of low prices, low yields, or a combination of the two. The three primary types of crop revenue insurance plans now available to farmers are income protection (IP), crop revenue coverage (CRC), and revenue assurance (RA). The IP program grew out of a since-abandoned attempt by the Federal Crop Insurance Corporation to develop a cost-of-production form of crop insurance. CRC is a privately developed program and RA was developed by the Iowa Farm Bureau as a pilot program for corn and soybean farmers in that state. All three plans guarantee a minimum level of revenue. All have developed complex methodologies to assess price and yield risk. And all are subsidized by the Federal government, which pays an average of 40 cents of each dollar of producers' premiums and agrees to absorb a significant share of any losses incurred by insurance companies.

More risk reduction. Simulations for corn revenue show that revenue insurance is more effective than yield insurance in reducing farm income risk. In South Dakota, a relatively high-risk corn state, the probability that corn revenue will fall to less than 70 percent of expected levels is reduced to around 15 percent with a yield insurance contract and to around 2 percent with a revenue insurance contract. The fact that revenue insurance contracts, unlike yield insurance, cover decreases in crop revenue due to downward swings in commodity prices increases their effectiveness. The cost-effectiveness of revenue insurance contracts is further enhanced by the natural hedge (the fact that prices and yields typically move in opposite directions in major producing areas). Unlike yield insurance, revenue insurance plans such as IP and RA do not pay indemnities when yield and price variations offset each other to stabilize farm revenues. In simulations for an Iowa corn family, for example, the General Accounting Office estimates that in the case of a 30 percent yield shortfall accompanied by a 30 percent price increase, yield insurance (actual production history) would pay $14.70 per acre while IP and RA would make no payments.

Participation. Participation in revenue insurance programs has been significant despite limited availability. In Iowa, a state that offers all of the three principal types of coverage, these products accounted for 38 percent of insured acres and 53 percent of total premiums recently. Nevertheless, further participation and development of revenue insurance programs may be limited to the extent that farmers reasonably expect their income to be protected by Federal disaster payments (in effect, no-fee revenue insurance) in the event of an emergency.

EYES ONLY

SPECIAL ANALYSIS

The Economic Impact of Michael Jordan's Retirement

The NBA lock-out has ended, and the shortened season tipped off last Friday. However, the league will be without its most valuable commodity. Michael Jordan (MJ) retired for the second and apparently final time, on January 13th. The financial impact is likely to be substantial.

Salary. Last season MJ was paid $33 million by the Chicago Bulls, though his reported total income, including endorsements, was substantially higher (about $80 million). Jordan's salary was phenomenal, but eight other players earned at least $10 million, and 64 made $4 million or more last season. The NBA minimum salary was $242,000 for the 1997/98 season. (Babe Ruth justified the fact that he earned more than President Hoover by saying that he had had a better year, but can the players "riding the pine" at the end of the bench today make a similar claim?)

Externalities. NBA teams do not share revenues from gate receipts and local TV contracts, so when MJ played on the road, the host team reaped the benefits from increased attendance and local TV viewership. However, the league shares evenly the revenues from national TV contracts and sales of NBA paraphernalia such as jerseys and hats, so that all teams benefited equally from MJ's effect on these revenue streams. A recent econometric study found that, for the rest of the teams in the league, Michael Jordan was responsible for roughly 10 percent of their revenue from gate receipts, TV contracts, and NBA merchandise sales. Comparing Nielsen ratings for games in which Jordan and the Bulls played with those of games in which they did not play (and adjusting for other factors such as the month, day, and time of the game, the number of other All-Stars playing in the game, and competing TV programing), the study found that Jordan increased viewership by 20 to 50 percent. Gate attendance was estimated to be roughly 25 percent higher in games in which the Bulls played. Finally, items associated with MJ have accounted for roughly 20 percent of gross retail sales of NBA merchandise, which totaled $3 billion last year.

Other economic effects. MJ endorses several products, and his image appears to create significant value in terms of stock prices. Between the time that rumors of MJ's return to basketball from baseball began to surface and the official announcement of his return, stock prices for MJ-endorsed Nike and McDonald's rose 3.4 percent and 6.5 percent, respectively (compared, for example, with 2.5 percent and 3.2 percent, respectively, for non-MJ-endorsed competitors Reebok and PepsiCo). Jordan's products have been tremendously popular. His sports videos are reported to have generated total revenues of $80 million and his cologne $155 million. Sales of his line of underwear are expected to exceed $10 million annually, and his movie *Space Jam* grossed $230 million at the box office and another $209 million in video sales. But Jordan's most profound impact has probably been on Nike, with sales of his "Air Jordan" shoes totaling $130 million in the brand's first year. Amazingly, Jordan's products overall have grossed about $2.6 billion for Nike.

EYES ONLY

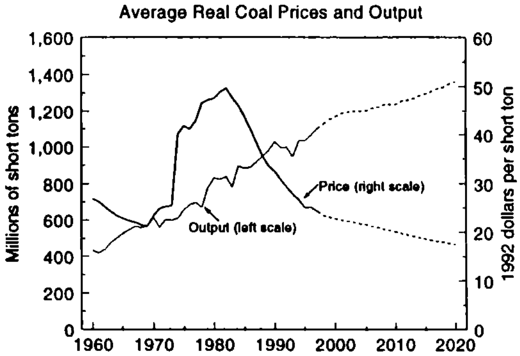
ARTICLE

Coal and Climate Change: Employment Effects

Efforts to address climate change will need to include substitution out of carbon-intensive fuels such as coal and into carbon-lean and carbon-free fuels, such as natural gas and renewables. How will this affect the coal industry relative to its current trajectory?

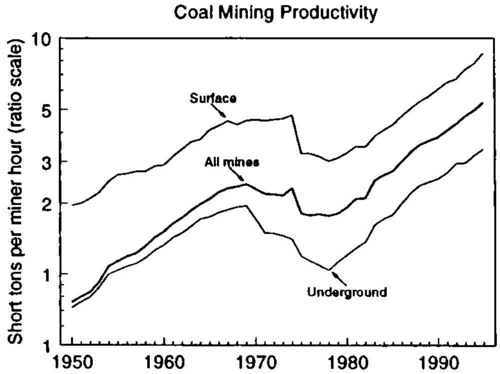
Price and productivity trends. After spiking up substantially during the energy crisis of the 1970s, coal prices have since fallen to near the lowest levels in 40 years (see upper chart). They are projected to fall further through 2020 under business-as-usual conditions, while coal output continues to grow. Much of the decline reflects improvements in productivity. Following a slide in the 1970s, coal mining productivity rose at an average annual rate of 7 percent between 1980 and 1995 (see middle chart). Surface mining operations, which tend to be more prevalent in the west, have higher *levels* of productivity, but productivity *growth* over this period was actually a little bit faster in underground mining.

Average Real Coal Prices and Output

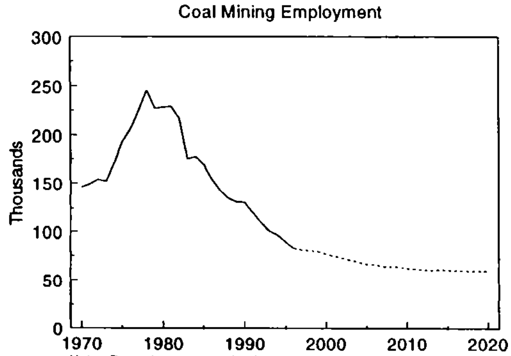


Note: Data after 1996 are business-as-usual projections.

Coal Mining Productivity



Coal Mining Employment



Note: Data after 1996 are business-as-usual projections.

Job trends. Increased demand for coal in the 1970s caused a temporary spurt in coal mining employment. But the last two decades have witnessed a steady decline (see lower chart). Strong productivity growth allowed output to grow at a 1.6 percent annual rate from 1980 to 1996, even as employment fell at a 6.1 percent annual rate. By 2010, coal mining employment is projected to be 62,000—a 2.1 percent annual rate of decline from 1996 levels. Some have claimed that the rapid decline in the 1990s reflected the effects of Clean Air Act rules, such as the SO_2 trading program.

The impact of Kyoto. Recent studies by the United Mine Workers and the Environmental Protection Agency have assessed the impact of the Kyoto Protocol on coal industry employment. The UMW study includes one case in which the energy sector bears a substantial amount of the effort in reducing emissions and the price of a carbon dioxide permit is high (about $110 per ton of carbon). The study estimates that the coal mining industry would lose more than one-third of its workforce under such conditions. However, if policies such as international emissions trading can keep permit prices low, the effects on the coal industry would be much smaller. For example, the EPA study found that at permit prices of $14 to $23 per ton of carbon, employment losses in coal mining would range between 5 and 10 percent.

Conclusion. Employment in the coal mining industry has been declining over the past two decades and is projected to decline further under business-as-usual conditions. The size of any further decline associated with meeting the Kyoto Protocol emissions targets will depend on how much of the required emissions reductions must occur in the energy sector, especially electricity generation. Implementing efficient international emissions trading, pursuing opportunities to abate non-carbon dioxide greenhouse gas emissions, and promoting sink activities would all contribute to keeping the impact on coal industry employment relatively modest.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

A New Landscape for Nonprofits. The entry of for-profit firms (such as Lockheed Martin and America Works) into social services raises fundamental questions about the future of nonprofits, according to a recent article in the *Harvard Business Review*. One message is that nonprofits must reexamine their missions in light of a market that rewards performance and emphasizes organizational capacity irrespective of profit status. The article attributes the growth of for-profits in social services to a new public sector attitude toward business, and to the specific advantages of many for-profits: larger size (and accompanying economies of scale, risk management, and ability to perform a wider range of services), greater access to capital, greater geographic mobility, and possibly greater responsiveness to government clients. The article predicts that resourceful nonprofits, especially larger ones, will probably get the requisite capital and technology to meet the new demands of government contracts. But it warns that nonprofits may be forced to reconfigure their operations in ways that could compromise their missions. The article notes two key challenges: for nonprofits to win contracts while remaining responsive to their clients and communities, and for governments to design contracts that promote efficient services while protecting the individual client's need for humane and high quality service.

LTCM Hedge Fund Bounces Back. Long-Term Capital Management (LTCM), the highly leveraged hedge fund that was saved from collapse last September by a consortium of firms brought together by the Federal Reserve Bank of New York, appears to have weathered its crisis. Relative to pre-bailout levels, the value of LTCM's holdings had increased roughly 11 percent, after fees, by the end of the year. Equity capital had grown to about $4.5 billion, up from $2.3 billion in August and down only about 5 percent from its level a year earlier. Some members of the bailout group, which has a 90 percent controlling stake in LTCM, were said to be considering cashing out their position, now that they have earned a small profit. News reports also suggest that LTCM's partners have been actively seeking new capital in order to buy out the consortium.

Valentine's Day Economics. What do hard-nosed economists know about flowers, candy, and romance? Well, over 26,000 florists plied their trade in 1996, employing about 125,000 people. Americans consumed 27 pounds of candy per person in 1997, and almost $13 billion worth of candy and other confectionary goods were produced in 1996, according to unfudged Census estimates. Candy prices reflect the U.S. sugar quota system, which has elevated the domestic sugar price to 22 cents per pound, compared with a world price of about 7 cents per pound. (Thus, it is little wonder that countries like Mexico are pushing for greater access to the U.S. market.) On the romance front, 1996 saw 2.3 million marriages and 1.2 million divorces. The estimated median age at first marriage is 25.0 years for women (as high as it has been this century) and 26.7 years for men (down slightly from its 1996 peak). Nevada is the nation's marriage capital, with 88 marriages per thousand of population. But while many try their hand at hearts, the gamble does not always pay off: Nevada is also the divorce capital, with 8 divorces per thousand of population.

INTERNATIONAL ROUNDUP

U.S. Manufacturing FDI Seeks Mature Markets. U.S. manufacturers allocated 65 percent of their foreign direct investment (FDI) to high-wage and mature labor markets in 1997 in preference to low-wage developing countries. These findings, compiled by a major international management consulting firm, counter the usual suspicion that U.S. manufacturers seek in their foreign operations to benefit primarily from low wages. Instead, the stability of high-wage markets attracted many businesses at a time when developing markets were volatile. Well-developed infrastructure, large market potential, and skilled labor were other elements cited as having made high-wage markets prime targets for U.S. investors. Europe received the largest amount of U.S. direct investment, with the UK accounting for Europe's largest share. Geography also seemed to play a role, as Canada received the second largest amount of U.S. manufacturers' FDI (tripling its 1996 figure), and Mexico registered its first increase in such investment since 1994.

OECD Reports Falling Transfers. Aggregate public and private net resource flows from OECD countries to aid recipients fell in 1997 for the first time this decade, according to the OECD's latest *Development Co-operation Report.* These flows include not only government sources such as official development finance and export credits but also private resource transfers such as commercial bank and bond market lending, equity flows, and private non-governmental grants. Thus, these flows reflect all resources that developing countries receiving aid can use to finance their external deficits. Overall, the more than 10 percent drop in net resource flows between 1996 and 1997 reflected the Asian financial crisis, and projections for 1998 indicate an even larger decline. Though total private direct investment was up, little went to those countries most in need. At the same time, official development assistance (ODA) from OECD members fell to its lowest level of the decade. Since 1992 real ODA from G7 countries has fallen by nearly 30 percent.

France Proposes Exchange Rate Stability Plan. At a meeting of euro 11 finance ministers this week, the French finance minister proposed enhanced co-operation within the G7 to promote greater exchange rate stability among the dollar, the euro, and the yen. The plan would involve closer surveillance of exchange rates, especially the dollar-euro rate, based on a periodic IMF assessment of exchange rates that would reflect economic fundamentals and business cycle developments. The French plan also called for strengthened co-operation on macroeconomic policies and a framework for organized monetary relations with emerging countries. The plan did not call for target zones for currencies, in contrast to the controversial ideas attributed to the new German finance minister last year. It is thus closer to the calls for policy "coordination" Japanese Prime Minister Obuchi reportedly advanced during his recent trip to Europe.

Canada's Job Market Improves. Canada's unemployment rate fell to 7.8 percent in January—its lowest level since June 1990. The drop took Canadian economists by surprise. January marked the seventh consecutive month of employment gains.

EYES ONLY

RELEASES THIS WEEK

Retail Sales

Advance estimates show that retail sales increased 0.2 percent in January following an increase of 1.0 percent in December. Excluding sales in the automotive group, retail sales rose 0.2 percent following an increase of 0.6 percent.

Productivity

Nonfarm business productivity rose 3.7 percent at an annual rate in the fourth quarter. Manufacturing productivity rose 5.6 percent.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.1	1.8	3.7	5.6
GDP chain-type price index	5.4	0.9	0.9	1.0	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	**2.5**	0.3	**2.5**	**3.7**
Real compensation per hour:					
Using CPI	0.6	**2.5**	2.0	**2.1**	**1.5**
Using NFB deflator	1.3	**3.6**	**3.5**	**3.4**	**3.0**
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	11.2
Imports	9.2	13.1	13.1	12.9	13.2
Personal saving	5.2	0.3	0.3	0.1	-0.0
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Nov. 1998	Dec. 1998	Jan. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.4	4.3	4.3
Payroll employment (thousands)					
increase per month			277	298	245
increase since Jan. 1993					17845
Inflation (percent per period)					
CPI	5.8	1.6	0.2	0.1	N.A.
PPI-Finished goods	5.0	-0.1	-0.2	0.4	N.A.

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Dec. 1998	Jan. 1999	Feb. 11, 1999
Dow-Jones Industrial Average	7441	8626	9019	9346	9363
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.39	4.34	4.39
10-year T-bond	6.35	5.26	4.65	4.72	4.93
Mortgage rate, 30-year fixed	7.60	6.94	6.72	6.79	6.77
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level February 11, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.130	-0.0	N.A.
Yen (per U.S. dollar)	114.7	2.4	-7.1
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	92.89	0.5	-2.3

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	4.1 (Q4)	4.3 (Jan)	1.6 (Dec)
Canada	2.3 (Q3)	8.0 (Dec)	1.0 (Dec)
Japan	-3.5 (Q3)	4.4 (Dec)	0.6 (Dec)
France	2.9 (Q3)	11.4 (Dec)	0.3 (Dec)
Germany	2.7 (Q3)	[2] 7.3 (Nov)	0.5 (Dec)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.6 (Q4)	6.2 (Oct)	2.8 (Dec)

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for November was 9.4 percent.

EYES ONLY

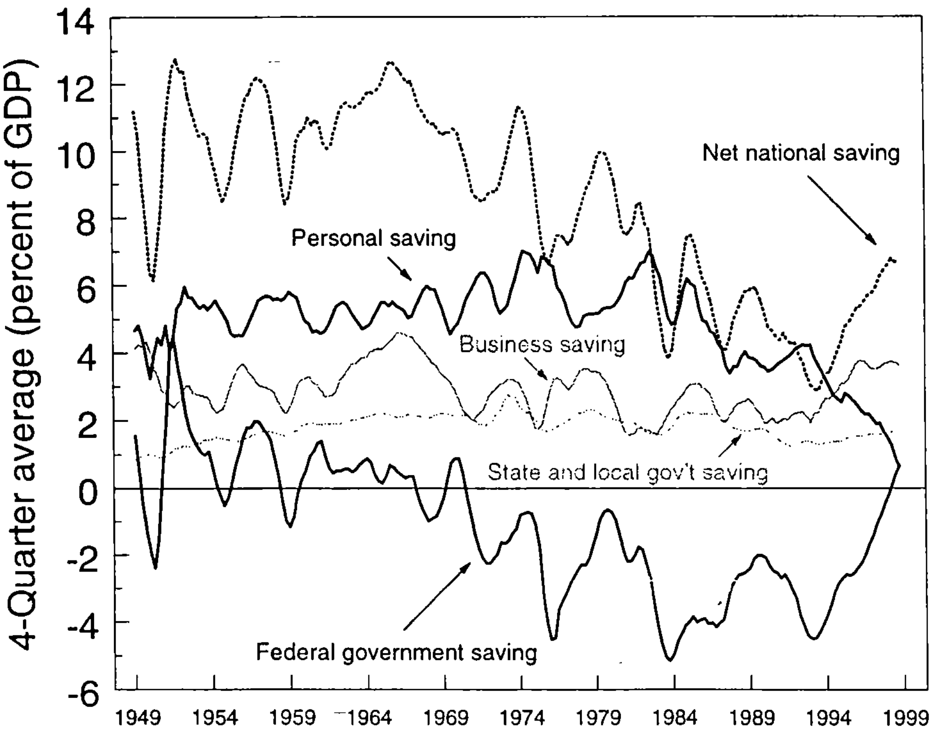
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

February 5, 1999

CHART OF THE WEEK

Net National Saving and Its Components



Personal saving has evaporated in recent years, yet net national saving has increased sharply as a share of GDP, to levels last seen in the mid-1980s. The main source of improvement in the national saving rate has come from the rapidly improving Federal government budget balance. Net business saving (largely undistributed corporate profits) has increased modestly and state and local government surpluses have been relatively stable. (Net saving equals gross saving less the consumption of fixed capital.)

EYES ONLY

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SPECIAL ANALYSES

ARTICLE

DEPARTMENTS

"The very survival of our society depends upon the just compensation of our professional athletes."

EYES ONLY

SPECIAL ANALYSIS

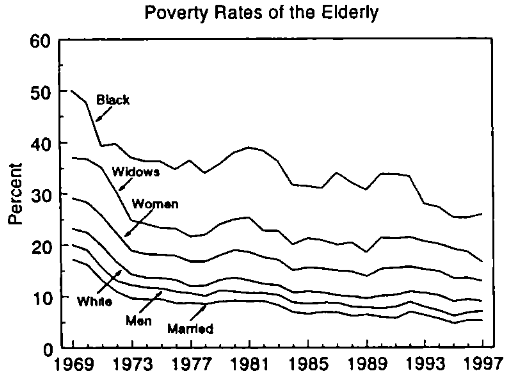
Elderly Poverty

One of the great successes of Social Security has been its contribution to the sharp decline in the elderly poverty rate in the last three decades. However, poverty still remains very high for some groups of older Americans.

Trends. The poverty rate among people aged 65 and older dropped from 35.2 percent in 1959 to 10.5 percent in 1997. Some of this progress came from the double-digit increases in Social Security benefits in the late 1960s and early 1970s. Even since these expansions, however, the elderly poverty rate has continued a steady decline, with a drop from 12.2 to 10.5 percent from 1993 to 1997.

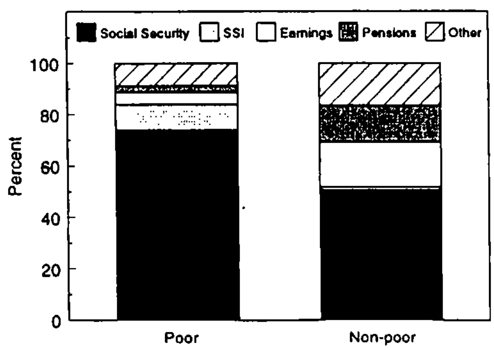
Some groups lag behind. While poverty has declined across demographic groups—men and women; whites and blacks; older and younger elderly; widows and married persons—large gaps persist (see upper chart). High rates of poverty exist among women (13.1 percent), especially widows (17.9 percent), and blacks (26.0 percent). At the intersection of these groups are black widows, with a disturbingly high poverty rate of 34.7 percent (not shown on chart). By comparison, 7.0 percent of men, 9.0 percent of whites, and 5.2 percent of married elderly live in poverty. As a result of these disparities, nearly three-quarters of poor elderly are female, just under one-half are widows, and one-fifth are black.

Poverty Rates of the Elderly



Implications. These data suggest that a policy aimed at reducing elderly poverty should focus on women, especially widows. These groups have high rates of poverty, and they represent the vast majority of all poor elderly. Social Security benefits are key, accounting for 74 percent of total family income among elderly living in poverty, on average. Income from the Supplemental Security Income (SSI) program accounts for an additional 10 percent (see lower chart). The Federal maximum guaranteed income under SSI can bring an elderly person who lives alone to 75 percent of the poverty line. This rises to 86 percent of the poverty line when Food Stamps and the Social Security benefits an SSI recipient is allowed to keep are included.

Income by Source for Poor and Non-Poor Elderly, 1997



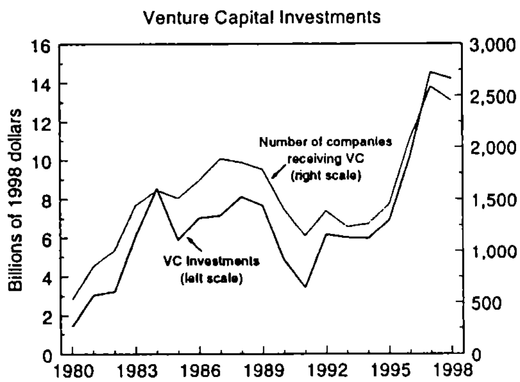
EYES ONLY

SPECIAL ANALYSIS

Venture Capital and Innovation

Investments by venture capital (VC) firms rose dramatically in the United States over the past 4 years, from $6.9 billion in 1995 to $14.2 billion in 1998 (see chart). Although these sums are much smaller than conventional R&D investments ($63 billion by governments and $133 billion by corporations in 1997), new research finds that venture capital plays a disproportionate role in innovation.

Funding patently good ideas. The rise to prominence in the 1990s of venture-backed firms such as Microsoft, Genentech, and Federal Express, provides casual evidence that VC successfully spurs innovation. A recent study provides more systematic evidence using data spanning the 1965-92 period for 20 U.S. industries. It finds that more VC funding in an industry is associated with more patenting. The study suggests that VC accounted for about 15 percent of industrial innovations in recent years, even though it amounted to less than 3 percent of total R&D investment.



Cause and effect? Why might VC be more closely associated with innovation than other types of investment? The study does not examine this question, but industry experts point to at least two factors.

- Picking winners. Ironically, very little VC actually goes toward funding basic innovation. Instead, VC investors seek out firms and individuals who already have good ideas. In fact, about 90 percent of VC is follow-on funding for projects developed through R&D expenditures by governments and corporations. One currently fertile area is the information technology sector (including the Internet), which received over half of all VC funding in 1997.

- Active governance. Managerial incompetence and the inability to identify the most valuable commercial use of a product appear to be as likely to derail a start-up firm as technological difficulties. To avoid these pitfalls, VC investors usually play a significant role in strategic decisions and in choosing or dismissing management. Thus, venture-backed entrepreneurs can finance the development of new ideas outside the confines of a large corporation without losing access to professional management skills and strategic guidance.

Implications. To the extent that VC spurs innovation, the jump in VC investments since 1995 bodes well for innovation in the near future. The role of VC in innovation may also explain why many major corporate research facilities appear to be restructuring their traditional R&D spending toward investments that resemble VC, such as joint ventures with smaller firms and strategic investment programs.

EYES ONLY

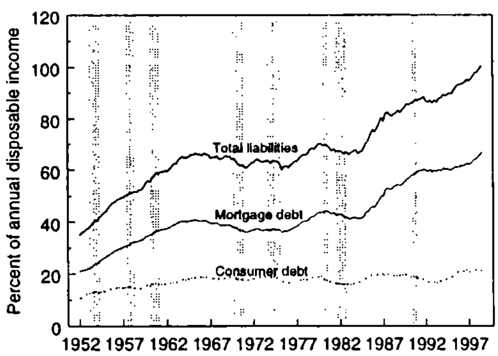
ARTICLE

The Financial Condition of Households

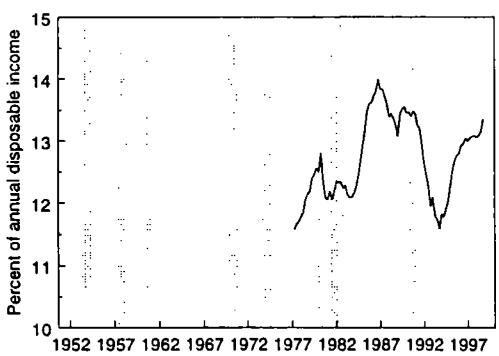
The decline in the personal saving rate to zero in the fourth quarter has raised questions about whether households are so financially strapped that they are unable to save. Aggregate data show that household liabilities and debt service burdens are high, but so are assets. A *rise* in household net worth appears to be an important reason for the decline in saving.

Liabilities. Household liabilities have trended up relative to income for most of the postwar period (see top chart). A particularly sharp increase over the past 5 years raised liabilities to more than 100 percent of income by 1998. Most of the recent increase has been in mortgage debt. Consumer debt, which rose in 1994 and 1995, has changed little as a share of income over the past 2 years. Interest rate declines have kept debt service from rising as fast as liabilities, and debt service as a share of income remains below its 1987 peak (see middle chart).

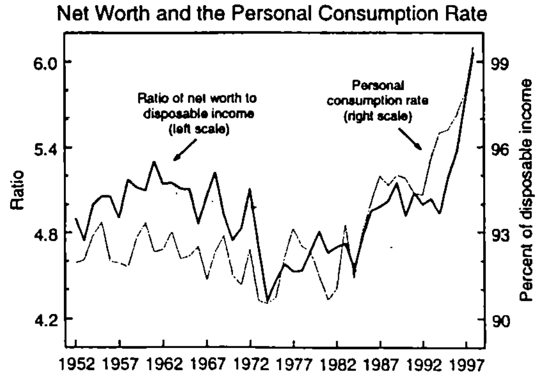
Household Liabilities



Household Debt Service Burden



Net Worth and the Personal Consumption Rate

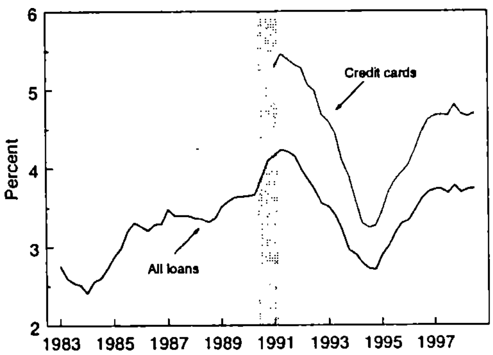


Assets and net worth. Fueled by strong stock market gains, assets have been increasing even faster than liabilities. Household net worth, the difference between assets and liabilities, is now about 600 percent of household income, its highest multiple on record.

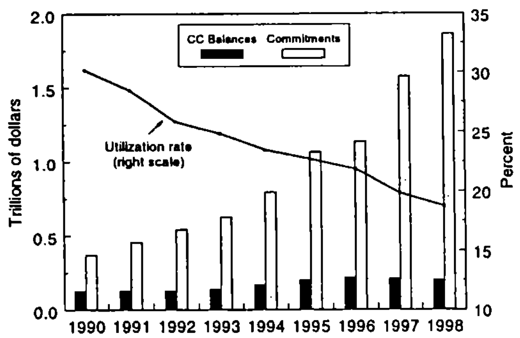
Consumption effects. Consumption has increased faster than income in each of the past 6 years, driving the saving rate to zero. The consumption rate tends to move together with the wealth-to-income ratio (see bottom chart) and statistical models that include wealth have tracked the recent growth in consumption rather well. Thus, the increase in wealth associated with a rising stock market seems to have caused a major part of the recent rapid increase in the consumption rate.

Credit quality. Rising aggregate net worth does not mean that there is no financial distress, especially if the rise in assets and the rise in liabilities are experienced by different segments of the population. Unfortunately, we have little up-to-date information about differences among households by income. Data from the 1995 *Survey of Consumer Finances* show more financial distress at the lower end of the income distribution, but this stress was no worse in 1995 than in earlier years.

Consumer Loan Delinquency Rates



Credit Card Balances and Commitments



Note: Data are third-quarter values for each year.

At the aggregate level, the various measures of financial distress do not show a major deterioration in credit quality. For example, the delinquency rate of consumer loans at commercial banks, one of the broadest measures of household financial distress, increased between 1995 and 1997, but it has flattened out in the past 2 years and is below its 1991 peak (see top chart). The rise in personal bankruptcies, another measure of distress, is probably at least partly the result of changes in bankruptcy law and greater societal acceptance of bankruptcy.

Credit card proliferation. Credit line commitments available to households rose rapidly in the 1990s with the proliferation of credit cards (see lower chart). However, the balances maintained on the credit lines have grown much more slowly. Hence the utilization rate on credit card lines—the average balance as a proportion of the available credit— has declined dramatically.

Conclusion. The recent decrease in household saving does not appear to be a symptom of increasing financial distress among households. The statistical evidence suggests that a cooling off of the stock market would most likely be associated with a return of the consumption rate to more normal levels and an increase in household saving. Nevertheless, household liabilities and debt burdens are at high levels. A sharp drop in the stock market or a rise in interest rates could lead to a serious deterioration in household net worth and an increase in financial distress.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Alliances' Effects on Consumers Are up in the Air. Alliances between domestic airlines may provide consumer benefits in the form of better route options and more flexible frequent flyer programs, according to a new report from the General Accounting Office. But the report also finds that consumers could suffer if the airlines do not compete vigorously along shared routes. Of the three recent alliances analyzed in the report, only the one between Northwest and Continental provides for "code-sharing," which allows an airline to sell seats on its partners' planes as if they were its own, enabling the airline to expand its network without adding any planes or flights. All three alliances establish reciprocal frequent flyer programs, allowing members to earn and redeem their miles on either carrier. The GAO acknowledged the benefits to consumers from such arrangements but found that the benefits were likely to be smaller than airline executives have claimed. The report noted that reduced competition would be a concern in those markets where the alliance gives the partners a dominant market share.

More Evidence Against *The Bell Curve*. The link between education and income is well documented, but the relationship is not necessarily causal. A new study reviews recent research on whether education provides skills (human capital) that raise people's productivity (and hence their income), or whether inherent individual ability is what matters, and naturally brighter individuals receive more education and more income. The evidence comes from studies that compare income and education differences within families or use exogenous determinants of schooling (such as geographical distance to the nearest college). The results are surprisingly consistent: the return to schooling is not caused by an omitted correlation between ability and schooling, nor does the return differ significantly by race, ethnicity, socio-economic status, or measured ability. The study concludes that educational policies, by increasing the skills and incomes of individuals, have the potential to decrease income inequalities, and that criticism of programs aimed at low-achieving students is misguided in arguing that brighter students benefit more from schooling.

Study Examines Child Care Costs and Labor Supply. How much bang can the child care buck deliver in moving welfare mothers into the workforce? A new study of how access to kindergarten affects mothers' labor supply decisions suggests that free child care can significantly improve mothers' labor market outcomes. The study uses 1980 Census data (the most recent with quarter-of-birth statistics needed to determine kindergarten eligibility) and the fact that public schooling is a form of free child care. The study shows that among female heads whose youngest child is five, access to public schooling for the 5-year-old significantly increased labor supply while reducing public assistance receipt. On the other hand, female heads with a 5-year-old and a younger child did not respond to the 5-year-old's schooling. The results suggest that direct provision of child care may be an efficient way of redistributing resources and increasing labor supply of single mothers.

EYES ONLY

INTERNATIONAL ROUNDUP

Are Developing Countries Ready for Y2K? A World Bank survey of Y2K preparedness in 139 developing countries worldwide indicates that only 54 have initiated national Y2K policies: 21 are taking concrete remedial steps to safeguard their computer systems; 33 have medium to high awareness of the problem, but they are not currently taking action. The Bank has recommended that those countries without remedial efforts underway develop contingency plans to protect essential national systems, and has approved loans of $30 million to Argentina and $29 million to Sri Lanka to provide assistance developing such plans. It is also discussing a $100 million loan to Malaysia, and has added Y2K funds to loans in process for Turkey and the Ukraine. The Bank's *InfoDev* department, which has received donations from the United States, the United Kingdom, Canada, and Italy, has received Y2K-related grant requests from more than 60 countries for nearly $10 million. Thus far, three-quarters of the requests have been approved.

Health Canada Rejects Lactating Cattle Hormone. Health Canada, the country's official health agency, recently denied approval for Canadian use of rbST, a bovine growth hormone intended to increase milk production in lactating cows. Though Health Canada's nearly 10-year-long review found no significant risk to human safety through ingestion of products from rbST-injected animals, it identified various risks to animal health. The European Union will have to reassess its moratorium on the sale of rbST, which is scheduled to lapse in 1999. Health Canada's decision will probably strengthen EU support for continuing the ban. Such a decision could exacerbate U.S.-European friction over the use of growth hormones in beef cattle.

Basle Committee Criticizes Banks' Risk Management. The Basle Committee on Banking Supervision last week released a report examining the interactions between mainstream financial institutions, such as banks and securities firms, and highly leveraged institutions (HLIs), such as hedge funds. The report, prompted in part by the near-collapse of Long-Term Capital Management, criticized banks' lack of effective policies and guidelines for managing exposures to HLIs. The report concluded that many of the risks raised by these funds could be addressed by improving standards for the banks that deal with them. The Federal Reserve Board echoed this conclusion in a letter it sent this week to bank management and supervisors. In any case, this approach to the issues posed by HLIs may be the only one available, because many operate in offshore financial centers and are therefore subject to little or no regulatory oversight.

EU's Farm Commissioner Warns of Grain and Meat Surpluses. EU Farm Commissioner Franz Fischler has predicted that failure to reform the EU's Common Agricultural Policy would result in stocks of 50 million tons of cereals and 1.5 million tons of beef by 2005. Though negotiations to reform the roughly $50 billion-per-year farm subsidy program have been progressing, recent market weakness has stiffened farmer opposition to reform.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, February 5, 1999****

In January, the unemployment rate was unchanged from December at 4.3 percent. Nonfarm payroll employment rose by 245,000.

Leading Indicators

In December, the composite index of leading indicators increased 0.3 percent.

NAPM Report on Business

The Purchasing Managers' Index rose to 49.5 percent in January from 45.3 percent in December.

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Retail Sales (Thursday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.1	1.8	3.7	5.6
GDP chain-type price index	5.4	0.9	0.9	1.0	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	N.A.	0.3	3.0	N.A.
Real compensation per hour:					
Using CPI	0.6	N.A.	2.0	2.2	N.A.
Using NFB deflator	1.3	N.A.	3.4	3.8	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.2	10.9	11.1
Residential investment	4.5	4.3	4.3	4.4	4.5
Exports	8.2	11.3	11.3	11.0	11.2
Imports	9.2	13.1	13.1	12.9	13.2
Personal saving	5.2	0.3	0.3	0.1	-0.0
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Nov. 1998	Dec. 1998	Jan. 1999
Unemployment Rate (percent)	6.7**	4.5**	4.4	4.3	**4.3**
Payroll employment (thousands)					
increase per month			**277**	**298**	**245**
increase since Jan. 1993					**17845**
Inflation (percent per period)					
CPI	5.8	1.6	0.2	0.1	N.A.
PPI-Finished goods	5.0	-0.1	-0.2	0.4	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, February 5, 1999**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Dec. 1998	Jan. 1999	Feb. 4, 1999
Dow-Jones Industrial Average	7441	8626	9019	9346	9305
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.39	4.34	4.38
10-year T-bond	6.35	5.26	4.65	4.72	4.89
Mortgage rate, 30-year fixed	7.60	6.94	6.72	6.79	6.75
Prime rate	8.44	8.35	7.75	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level February 4, 1999**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	1.131	-0.8	N.A.
Yen (per U.S. dollar)	112.0	-3.7	-9.5
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	92.40	-1.3	-2.7

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	4.1 (Q4)	**4.3** (Jan)	1.6 (Dec)
Canada	2.3 (Q3)	8.0 (Nov)	1.0 (Dec)
Japan	-3.5 (Q3)	4.5 (Nov)	0.6 (Dec)
France	2.9 (Q3)	11.5 (Nov)	0.3 (Dec)
Germany	2.7 (Q3)	[2] 7.3 (Nov)	0.5 (Dec)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Dec)
United Kingdom	1.6 (Q4)	6.2 (Sep)	2.8 (Dec)

U.S. unemployment data **embargoed until 8:30 a.m., February 5, 1999.**

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for November was 9.4 percent.

EYES ONLY

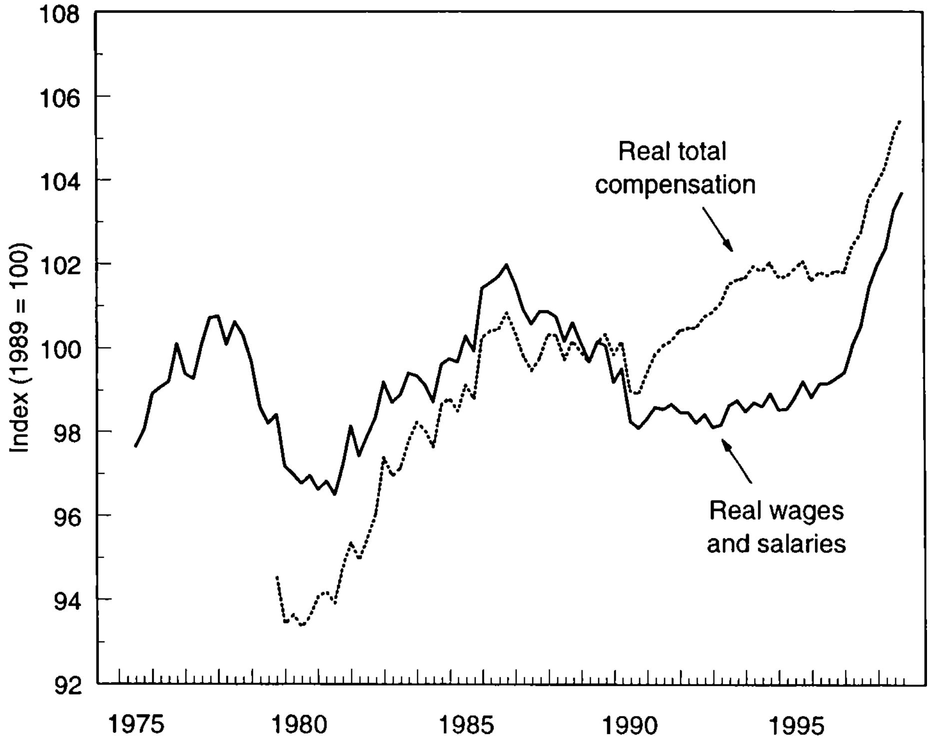
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

January 29, 1999

CHART OF THE WEEK

The Employment Cost Index for Private Industry



On an inflation-adjusted basis, the employment cost index (ECI) for private industry wages and salaries stands at its highest level in the history of the series, which goes back to 1975. The 4.4 percent increase in this measure of real wages over the past 2 years is also the largest 2-year gain on record. Benefits have grown more slowly than wages recently, but real ECI compensation is also up substantially.

EYES ONLY

CONTENTS

CURRENT DEVELOPMENT

ARTICLE

DEPARTMENTS

"And they say electric cars aren't practical."

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Fourth Quarter 1998

Real GDP is estimated to have increased at a 5.6 percent annual rate in the fourth quarter. A rebound in motor vehicle production after a strike that held down output in the second and third quarters accounted for 2.1 percentage points of GDP growth. The jump in output appears to have been produced with only a modest 2.4 percent gain in production-worker hours, implying a surge in productivity.

Component	Growth*	Comments
Total consumer expenditures	4.4%	A big increase in motor vehicle sales was partly in response to factory incentives. The gain in total consumption may also reflect stock-market gains.
Producers' durable equipment	21.0%	Computer purchases grew 60 percent, while much of the pickup in motor vehicle sales found its way into investment in transportation equipment.
Nonresidential structures	5.5%	The first notable increase in this sector after four quarters of stagnation reflects a pickup in office construction. Industrial building continues to slump.
Residential Investment	10.1%	The fifth consecutive quarter of rapid growth had been foreshadowed by recent strength in housing starts.
Inventories (change, billions of 1992 dollars)	$48.9	Despite this high pace of inventory accumulation, inventories remain lean with respect to sales.
Federal purchases	7.9%	In the third quarter, the sale of the U.S. Enrichment Corporation was recorded as a negative purchase. Fourth-quarter purchases rebounded to a more normal level.
State & local purchases	2.1%	Fourth-quarter growth was at the same pace as over the previous four quarters.
Exports	18.8%	This strong increase after three quarters of decline was completely unanticipated even 2 months ago.
Imports	16.0%	The growth in imports likely reflects the strength in domestic demand.

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

EYES ONLY

ARTICLE

The 1999 *Economic Report of the President*

The 1999 *Economic Report of the President* will be released February 4. This article summarizes and highlights the seven chapters of the accompanying annual report of the Council of Economic Advisers.

Chapter 1: Meeting Challenges and Building for the Future

This chapter provides the customary overview of the entire report and the economic policies and accomplishments of the past year. This year the chapter marks the attainment of the longest peacetime expansion on record and describes important challenges for the next century, including preserving fiscal discipline and meeting the international challenge. The chapter also discusses the following:

- Comparing three long expansions. The current expansion is only the third on record that has lasted at least 7 years. Compared with the long expansions of the 1960s and the 1980s, inflation has remained tame even as the unemployment rate has reached low levels. In addition, productivity growth has remained strong (relative to the post-1973 trend) rather than slowing down as is often the case in the mature stage of expansions. Finally, more than a third of the increase in real GDP has come from fixed investment—a substantially higher fraction than in the other two long expansions—while the contribution of government spending has been negligible.

- Embracing change while promoting fairness. Difficult choices must be made when confronting change that confers broadly distributed gains while imposing smaller but more concentrated costs. Increases in our standard of living over the longer term require that we embrace change, but considerations of fairness require that we ensure that no part of our society bears disproportionate losses. The general principle that it is desirable to address the disruption caused by positive change rather than block the change itself is illustrated with a discussion of three areas of current policy concern—agriculture, corporate mergers, and international trade.

Chapter 2: Macroeconomic Policy and Performance

This chapter traditionally provides a review of macroeconomic developments in the past year, as well as the Administration's economic forecast and the near-term outlook for the economy. This year it also analyzes financial market volatility in 1998, the strength of business investment in this expansion, and the macroeconomic implications of the Y2K computer problem.

- Another strong year. By a number of different measures, the U.S. economy performed very well last year. Robust growth in business investment and household spending, combined with vital contributions from fiscal and monetary policy, fueled strong growth and created 2.9 million jobs. The unemployment rate of 4.5 percent was the lowest since 1969; the 1.6 percent rise in the consumer price index was the second smallest increase since 1964, and other measures of inflation were even more muted. The turmoil in foreign economies showed up in the sharp decline in net exports, but the economic expansion maintained considerable momentum.

- Financial markets. Markets finished the year solidly up by most measures, after a worldwide flight to quality and liquidity in the late summer and early fall temporarily reduced some businesses' access to capital and raised the cost of borrowing for others. The near collapse of the hedge fund Long-Term Capital Management raised questions about the proper regulatory stance toward hedge funds and other institutions that actively trade securities and derivative instruments—institutions that are currently relatively lightly regulated.

- Robust business investment. Rapid output growth, strong corporate profits, plunging computer prices, and increased national saving due to improving Federal Government balances have all contributed to strong growth in investment during this expansion. Equipment investment has contributed more than twice as large a share of GDP growth during this expansion as during previous postwar expansions.

- Y2K. The chapter concludes that even if Y2K disruptions turn out to be on the serious side, they will most likely show up primarily as inconveniences and losses in some particular sectors—not in substantial macroeconomic terms.

- The Administration forecast. The Administration projects GDP growth over the long term at roughly 2.4 percent per year—a figure consistent with the experience so far during this business cycle as well as with reasonable growth rates of the economy's supply-side components. A moderation in output growth to 2.0 percent is projected for the next 3 years, in line with private forecasts, but the outcome could be even better, as indeed it has been for the past 3 years.

Chapter 3: Benefits of a Strong Labor Market

This chapter examines conditions in the labor market during this expansion and discusses the Administration's education and training initiatives. It finds that the Nation's labor market is performing at record levels: the number of workers employed is at an all-time high, the unemployment rate is at a 30-year low, and real (inflation-adjusted) wages are increasing after years of stagnation.

- Progress for disadvantaged groups. Groups whose economic status has not improved in past decades are now experiencing progress. The real wages of blacks and Hispanics have risen rapidly in the past 2 to 3 years, and their unemployment rates are at long-time lows; employment among male high school dropouts, single women with children, and immigrants, as well as among blacks and Hispanics, has increased; and the gap in earnings between immigrant and native workers is narrowing.

- A strong employment relationship. Job displacement—job losses due to layoffs, plant closures, and the like—has declined substantially since the 1993-95 period, and among those who have been displaced, the share that have found new work has increased. These reemployed workers still typically earn less on the new job than at the job they lost, but these wage losses are at record lows. Moreover, the popular assertion that secure lifetime jobs are disappearing appears to be overstated. This is not to suggest that the picture is entirely benign: some groups have experienced declines in job tenure since the 1980s, and the rate of job displacement remains relatively high given current labor market strength.

- Reduced welfare use and crime. Besides spreading the benefits of economic growth more widely, the robust labor market has generated other, less obvious benefits. It has contributed to a decrease in welfare caseloads, allowing states and localities to focus increased resources on designing and implementing welfare reform. In addition, low unemployment and, especially, the rise in average wages may have contributed to a reduction in crime. Several studies have demonstrated an inverse relationship between labor market opportunities and criminal behavior: the better the options in legal employment, the less likely are potential criminals to commit crimes.

Chapter 4: Work, Retirement, and the Economic Well-Being of the Elderly

Today, more than one out of every eight Americans are over 65. It is projected that by the time the youngest baby-boomers hit age 65, in 2029, almost 20 percent of Americans will be elderly. This chapter assesses the work decisions and economic well-being of the current and the soon-to-be elderly as America anticipates this phenomenal demographic change.

- Labor force participation. Long-term trends in the labor force participation of older Americans, both male and female, are changing. The century-long decline in male labor force participation at older ages has leveled off since 1985. More men aged 55-64 are continuing to work, often part time or in a different occupation, after "retiring." Meanwhile the share of women aged 55-64 participating in the labor force has increased by almost 10 percentage points in the past 15 years.

- Pensions and health insurance. Employer-provided pensions and health insurance are also undergoing rapid change. The share of participants in defined-contribution pension plans, such as 401(k) plans, is growing, and the share in defined-benefit plans is shrinking. Employer-provided health insurance coverage for retirees has also become less widespread, less generous, and more expensive. These developments have many ramifications, both for retirement incentives and for the incomes and living standards of retirees.

- Less poverty. The economic status of the elderly as a group has improved remarkably during the past three decades. Their poverty rate has fallen to less than half what it was in 1970. In that year the elderly were more than twice as likely to live in poverty as the nonelderly, but today poverty is less prevalent among the elderly than it is among younger persons.

- Disparities in well-being. Although most elderly groups—men and women, blacks and whites, older and younger elderly, single as well as married persons—have enjoyed economic progress, large disparities in well-being prevail among these groups. Just 4.6 percent of elderly married men, but 28.8 percent of elderly black women and 17.9 percent of elderly widows, live in poverty. And whereas Social Security benefits account for at least 80 percent of income for 38 percent of all elderly households, another 9 percent rely on Social Security for less than 20 percent of their income. Moreover, among those now approaching retirement age, over 10 percent have no financial savings whatsoever, and 30 percent have less than $1,200, whereas the top 10 percent have at least $200,000 in financial assets. Over half of all blacks and Hispanics aged 51-61 have no financial holdings.

Chapter 5: Regulation and Innovation

Because innovation—the development and adoption of new technology—is essential to U.S. economic performance over time, regulation that interferes with innovation, however justifiable on other grounds, comes at a cost. This chapter examines Administration efforts in three areas to ensure that regulation not only does not interfere with innovation, but indeed fosters beneficial technological change and adapts itself to such change as well.

- Competition policy. Antitrust policy in recent years has broadened its conventional focus on the price and output benefits of competition to incorporate consideration of the long-run benefits of innovation. New technologies often have significant consequences for markets and consumers, while market and industry characteristics can affect the incentive and ability to innovate. The antitrust authorities have met the resulting challenges through careful enforcement decisions. In evaluating mergers, they look not only at conventional effects on prices and competition but also, increasingly, at evidence of a merger's likely effects on research and development, as the FTC did in a recent biotechnology merger. Antitrust policy has also addressed the relationship between competition and innovation in "network industries." Enforcement actions in the credit card and software industries as well as consent decrees in the telecommunications sector have highlighted the challenges enforcement agencies face—and their ability to meet those challenges—of balancing long-run encouragement of innovation with short-run concerns about competition.

- The environment. Environmental regulation can reduce pollution and increase the net value of economic activity (the value of goods and services produced after deducting all costs of production, including the social costs of environmental damage). The design of environmental regulation can also have a significant impact on innovation, and the ultimate costs of efforts to address important environmental concerns, such as climate change, will depend importantly on the pace at which such innovation occurs. The use of incentive-based regulation, such as the recently introduced tradable permits system to reduce nitrogen oxides emissions, not only achieves environmental goals at lowest possible cost given existing technology, but also gives firms proper incentive to search for more environmentally friendly technology.

- Electric power restructuring. The electric power industry is in the midst of technological and profound regulatory change. The Administration's Comprehensive Electricity Competition Plan provides an excellent example of how an enlightened regulatory approach can remove barriers to private innovation, resulting in both economic and environmental benefits.

Chapter 6: Capital Flows in the Global Economy

What began in the summer of 1997 as a regional currency crisis in Southeast Asia spread in 1998 to Russia, Brazil, and elsewhere. Coming as it did after years of increasing worldwide financial integration, the crisis shook the faith of some in globalization. This chapter describes these issues and the policy steps that ensued.

- Global integration and financial crises. Enhanced financial integration has allowed investors to tap the benefits of international diversification, while enabling borrowers to draw on a broad pool of world savings to finance investment and growth. But these trends have also been associated with recurrent financial crises, three in this decade: the European Monetary System crisis in 1992-93, the Mexican peso crisis of 1994-95, and now the 1997-98 Asian crisis.

- Origins of the Asian crisis. After years of breakneck growth, Asia might have been heading for a slowdown in any case. Adverse external developments (terms of trade shocks, recession in Japan and yen weakness) played a role. More important were structural weaknesses in the crisis countries' financial systems. Directed-lending, connected-lending, crony capitalism, and moral hazard led financial institutions to borrow too much abroad and to lend too much at home for investment projects that were not always profitable. The financing of large current account deficits led to a buildup of foreign debt that was largely short-term, in foreign currency, and unhedged. Capital account liberalization in an environment of lax supervision of the financial system also played a role.

- Contagion. While the crisis was triggered by such fundamental vulnerabilities, investors may have overreacted. Large capital reversals occurred; currencies and asset prices probably fell more than justified by fundamentals. The chapter also discusses the channels of contagion across countries, and the role Japan, with its own deteriorating economy, played in the crisis.

- The policy response. The chapter details the U.S. leadership role in addressing the crisis and discusses the IMF's approach, particularly its emphasis on financing that is conditional on countries' adjusting their policies. A relatively novel feature is that the policies on which the IMF programs are conditional are not solely macroeconomic, but also structural (dealing for example with banking regulation and corporate governance). The chapter also analyzes some of the criticisms that have been lodged against the IMF.

- Implications for the United States. The crisis has led to an expanding trade deficit, but the chapter refutes the view that this deficit has hurt the U.S. economy. Paradoxically, trade deficits are often associated with strong growth, and surpluses with recessions. The increased U.S. deficit has been driven by an investment boom. The crisis has heightened the need to embrace economic openness on a global scale; a retreat to protectionism would be dangerous.

Chapter 7: The Evolution and Reform of the International Financial System

This chapter describes how the recurrence of currency and financial crises in the world economy poses a challenge to policymakers and how the international financial architecture can be reformed so as to strengthen financial systems and make such crises less frequent and less severe in the future.

- Consensus for reform. Some consensus now exists for reforming the global financial system to 1) increase 'transparency,' namely to improve the availability of information; 2) strengthen and reform banks and other domestic financial institutions; and 3) improve the mechanisms available to resolve crises that do occur. Three G-22 working group reports addressed these respective concerns.

- Proposals for reform. In its October 30 statement, the G7 committed to a number of reforms consistent with both the recommendations of the G22 working groups and other analysis and research. The G7 also stressed the need to widen efforts to strengthen the international financial system in the following areas:

  - Examining the scope for strengthened prudential regulation in industrial countries.
  - Further strengthening prudential regulation in emerging markets and promoting orderly capital account liberalization. Proposals to slow the fraction of capital inflows that take the form of short-term bank inflows merit further investigation.
  - Developing new ways to respond to crises, including new structures for official finance and new procedures for greater private sector involvement in crisis resolution (for example, "bailing in" investors).
  - Assessing proposals for further strengthening of the IMF.
  - Seeking to minimize the human cost of financial crises and encouraging the adoption of policies that better protect the most vulnerable in society.
  - Consideration of the elements necessary for the maintenance of sustainable exchange rate regimes in emerging markets.

The chapter discusses several key issues associated with these new areas of study.

- The euro. The European Economic and Monetary Union represents an historic reform of the monetary system. The chapter outlines the history that led up to the January 1999 adoption of a common currency. It outlines criteria for an "optimal currency area" and argues that Europe currently has too little labor market flexibility and insufficient ability to transfer funds between regions. The prospects for the euro as an international currency are also considered. The introduction of the euro instantly created an international currency that potentially rivals the dollar. There may be some small associated costs for the United States. But there is no reason to expect the euro to surpass the dollar anytime soon, nor for the costs from the U.S. viewpoint to outweigh the political and economic advantages of a successful EMU.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

States Continue to Move on Electricity Restructuring. On January 1, Pennsylvania became the latest state to introduce retail electricity competition, following California, Massachusetts, Montana, and Rhode Island. The move, which followed a series of successful pilot programs over the past year involving nearly 2 million customers, will extend choice to all of the state's 5.4 million customers. A further 13 states have passed regulatory orders or legislation to allow retail competition in the future, and still more are considering legislation. Recent research indicates that those states that have moved most quickly to allow competition are also those that stand to benefit the most from retail competition. The limited experience to date also bears out several predictions about the industry. For example, it was thought that retail competition, by making it easier to bundle electricity supply with efficiency services, would foster the growth of companies that "manage" a client's energy needs in return for a portion of the energy cost savings. In California, for example, many supply contracts for commercial and industrial customers include an energy-management component. Furthermore, numerous "green power marketers" are active in nearly every state offering retail competition.

Brookings to Examine National Priorities. The Brookings Institution has offered an advance look at its annual report, *Setting National Priorities*, to be released in May. The report will focus on Medicare and Social Security, tax reform, and foreign policy spending, plus topics not typically included such as education, urban problems, the environment, trade, government renewal and reform, crime and drugs, and families. Some of the report's policy ideas will include using Head Start as a testing ground for high educational standards; resisting—and in some areas reversing—the trend toward Federal crime prevention and control; increasing defense spending to replace worn-out Reagan-era equipment, and for pay, spare parts, and base upkeep; and making a basic package of subsidized health insurance available to all children and young adults in order to improve well-being and make work pay. The report also argues that further gains from trade can be achieved by negotiating additional international trade agreements and suggests an approach to winning significant negotiating authority on trade issues.

"Steeling" an Advanced Peak at the Trade Numbers. This week the Commerce Department took the unprecedented step of releasing preliminary data on steel imports in December, as part of the Administration's plan to respond to the 1998 surge. They showed that the dollar value of imports decreased by more than one-fifth and the quantity fell by nearly one-third from the preliminary November totals. A drop in imports from Japan of 47 percent in quantity terms (32 percent in value) were a key factor. In the case of bilateral trade with Japan, it has always been possible to get an advance estimate, because Japan reports all its provisional trade numbers a month ahead of the United States. The Japanese numbers provide a rough check on the new preliminary U.S. steel numbers. Earlier in the week Tokyo announced that the volume of its steel exports to the U.S. fell 21 percent in December, so it appears that the surge from Japan might be peaking, regardless of what statistics are used.

INTERNATIONAL ROUNDUP

Once Again, Korea Makes the Investment Grade. Last week Fitch IBCA returned Korean sovereign debt to investment grade. Standard and Poor's did the same on Monday of this week. And other credit-rating agencies are expected to follow suit. Growth in Korean central bank reserves to $52 billion and the recent strengthening of the won have no doubt contributed to the unprecedented recovery in external liquidity that Fitch credits for the upgrade. According to Fitch, this return to liquidity should not mask remaining sources of uncertainty. Korea's financial system remains poorly supervised and its corporate sector severely indebted. It remains to be seen how businesses will fare absent heavy government intervention and how banks will function in a commercially driven environment.

Nigeria Negotiates for an IMF Economic Program. Nigeria's military government has reportedly ended its long-standing rift with the International Monetary Fund and is negotiating a Fund-monitored economic program. The proposal, expected to be approved by the IMF in mid-February, would not directly provide financing, but would help Nigeria establish a positive record of economic reform that could lead to financial assistance later this year. Nigeria is seeking foreign assistance to help close its budget financing gap, which could be as high as $2.3 billion in 1999. It is hoped that the IMF agreement would also pave the way for rescheduling negotiations as early as April with Nigeria's Paris Club creditors, estimated to hold roughly two-thirds of its $29 billion in external debt. Although this timetable is ambitious, many donors are reportedly anxious that the incoming civilian administration—scheduled to take office in May—start out on sound financial footing.

IMF Defends Its Response to the Asian Crisis but Concedes Errors. In a new report, the International Monetary Fund acknowledged that it made some mistakes in its response to the Asian crisis, but rejected criticism that its policy recommendations were too restrictive. The report noted that the Fund, like most observers, failed to anticipate the severity of the recessions that struck Indonesia, South Korea, and Thailand, and that large downward revisions in its optimistic projections hurt the Fund's credibility. The report also conceded that the initial targets for fiscal adjustment, which assumed that the slowdown in growth would be modest, became inappropriate as the economic situation deteriorated. However, it noted that fiscal programs became more accommodating in response to the worsening situation: during the course of 1998, fiscal targets in all three countries were revised to provide a greater stimulus. The report also defended the Fund's recommendations for monetary policy: although monetary tightening in Korea and Thailand did have real costs, the alternative—a depreciation and inflation spiral—would have been more costly; Indonesia's failure to stay on track led to spiraling inflation, rising risk premiums, continued capital flight, and a dramatic collapse of economic activity.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, January 29, 1999****

According to advance estimates, real gross domestic product grew at an annual rate of 5.6 percent in the fourth quarter.

Employment Cost Index

The employment cost index for private industry workers rose 3.5 percent for the 12-month period ending in December.

Advance Durable Orders

Advance estimates show that new orders for durable goods increased 1.9 percent in December, following an increase of 0.3 percent in November.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, rose 0.9 index point in January, to 127.6 (1985=100).

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:2	1998:3	1998:4
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	**4.1**	1.8	3.7	**5.6**
GDP chain-type price index	5.4	**0.9**	0.9	1.0	**0.8**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	N.A.	0.3	3.0	N.A.
Real compensation per hour:					
Using CPI	0.6	N.A.	2.0	2.2	N.A.
Using NFB deflator	1.3	N.A.	3.4	3.8	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	**11.0**	11.2	10.9	**11.1**
Residential investment	4.5	**4.3**	4.3	4.4	**4.5**
Exports	8.2	**11.3**	11.3	11.0	**11.2**
Imports	9.2	**13.1**	13.1	12.9	**13.2**
Personal saving	5.2	**0.3**	0.3	0.1	**-0.0**
Federal surplus	-2.7	N.A.	0.9	1.1	N.A.

	1970-1993	1998	Oct. 1998	Nov. 1998	Dec. 1998
Unemployment Rate (percent)	6.7**	4.5**	4.5	4.4	4.3
Payroll employment (thousands)					
increase per month			164	251	378
increase since Jan. 1993					17654
Inflation (percent per period)					
CPI	5.8	1.6	0.2	0.2	0.1
PPI-Finished goods	5.0	-0.1	0.2	-0.2	0.4

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

New or revised data in **boldface**.
GDP and related data **embargoed until 8:30 a.m., Friday, January 29, 1999**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Nov. 1998	Dec. 1998	Jan. 28, 1999
Dow-Jones Industrial Average	7441	8626	9006	9019	9281
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.41	4.39	4.38
10-year T-bond	6.35	5.26	4.83	4.65	4.67
Mortgage rate, 30-year fixed	7.60	6.94	6.87	6.72	6.74
Prime rate	8.44	8.35	7.89	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level January 28, 1999**	**Percent Change from**	
		Week ago	**Year ago**
Euro-Dollar	1.140	-1.6	N.A.
Yen-Dollar	116.4	2.3	-7.1
Major currency index (Mar. 1973=100) (trade-weighted value of the U.S. $)	93.62	1.3	-2.1

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	**4.1** (Q4)	4.3 (Dec)	1.6 (Dec)
Canada	2.3 (Q3)	8.0 (Nov)	1.3 (Nov)
Japan	-3.5 (Q3)	4.5 (Nov)	0.8 (Nov)
France	2.9 (Q3)	11.5 (Nov)	0.3 (Nov)
Germany	2.7 (Q3)	[2] 7.3 (Nov)	0.7 (Nov)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Nov)
United Kingdom	1.6 (Q4)	6.2 (Sep)	3.0 (Nov)

U.S. GDP data **embargoed until 8:30 a.m., January 29, 1999**.

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for November was 9.4 percent.

EYES ONLY

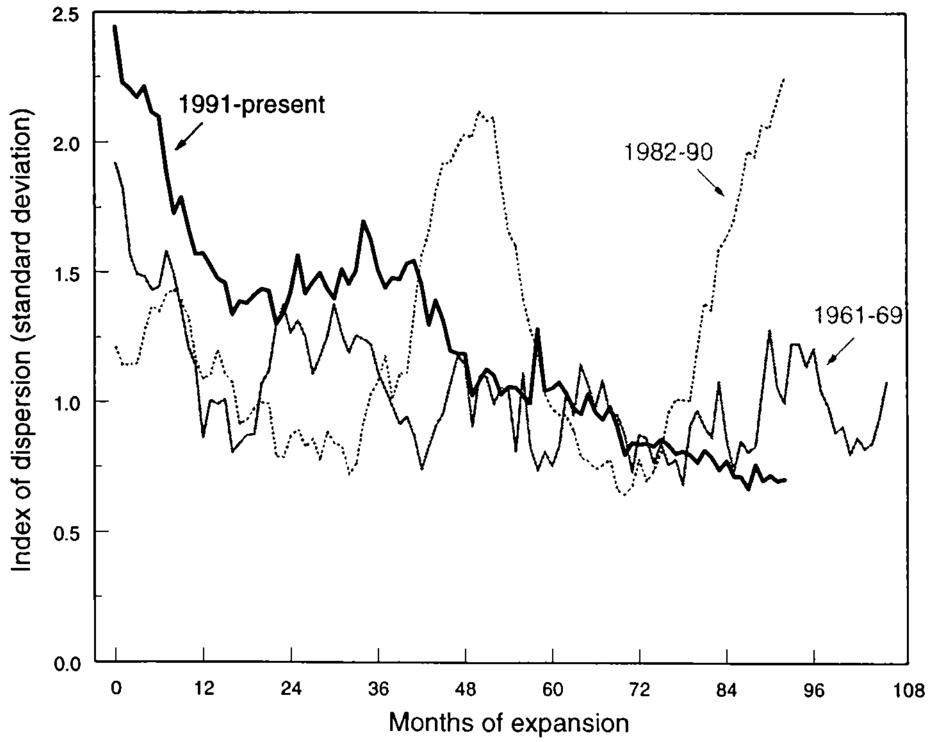
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

January 15, 1999

CHART OF THE WEEK

Regional Dispersion of Job Growth in Three Expansions



Job creation has become fairly balanced across regions in this expansion. This is shown in the chart by the decline to relatively low levels of the standard deviation for the distribution of the 12-month percentage change in job growth by region. The 1980s, by contrast, had periods of more unbalanced growth (reflected in the much larger standard deviations).

EYES ONLY

CONTENTS

"How many times do I have to beep you?"

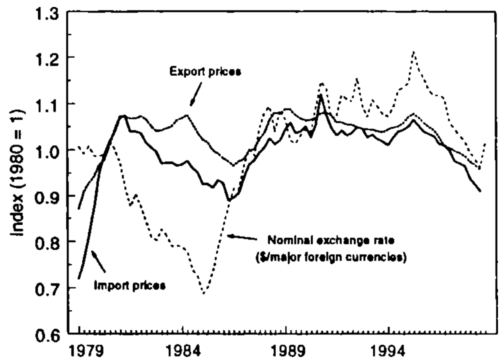
EYES ONLY

CURRENT DEVELOPMENT

Implications of the Decline in Import *and* Export Prices

Prices of U.S. goods imports fell 6.1 percent over the course of 1998 (3.1 percent excluding petroleum). Prices of U.S. goods exports fell 3.5 percent (2.8 percent excluding agricultural products). The effect of the 1995-98 appreciation of the dollar and the East Asia crisis on U.S. import prices and inflation has been widely recognized. Analogous effects through export prices have gotten much less attention.

Import and Export Prices and the Exchange Rate



The dollar and export prices. Because of the increased openness and competitiveness of the U.S. economy, the sensitivity of export prices to changes in the dollar has increased and become close to that of import prices (see chart). Export prices fell 11 percent when the dollar rose 21 percent against major foreign currencies in 1995-98. In 1980-85, by contrast, export prices did not fall at all in the face of an even greater 30 percent appreciation of the dollar.

Effects on inflation. Goods exports are about 8 percent of GDP, and the decline in export prices over the past 3 years has directly shaved about 0.3 percentage point per year off the price index for GDP. But the total effect may be greater. In some sectors, low export prices have put downward pressure on the prices of U.S. goods even when they are sold domestically. Agriculture is perhaps the strongest example. In addition, the drop in import prices has held down CPI inflation by about 0.7 percentage point. Again, there may be an additional competition effect. Low inflation has in turn allowed interest rates to be lower and domestic demand higher than they would otherwise be. This is one reason why residential construction, for example, has boomed. With the depreciation of the dollar since September, however, this help on the inflation front is unlikely to continue in 1999. Indeed, export prices were flat in the last quarter, and so were non-oil import prices.

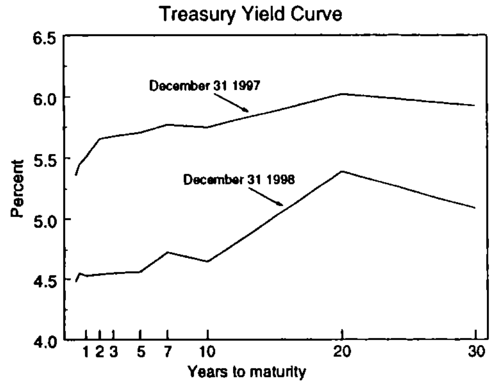
Traded goods: winners and losers. Declines in prices of internationally traded goods lower inflation. However, lower prices place pressure on all sectors that are exposed to international competition, whether they compete against imports or export to overseas markets. Producers respond to the lower prices by cutting back output. Export industries such as industrial machinery and agriculture have suffered losses as much as have import-competing industries such as steel.

FINANCIAL MARKET UPDATE

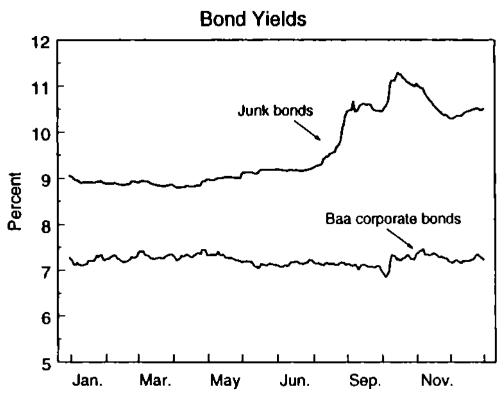
Wrapping up 1998

Financial markets ended 1998 on a positive note after a wild ride during the late summer and early fall. Treasury interest rates reached historically low levels while stock prices soared to record highs.

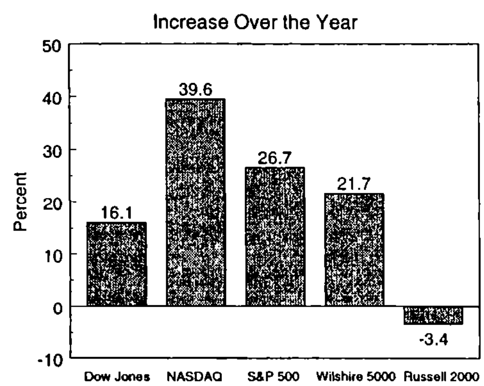
Treasury yields. A worldwide flight to safety and liquidity pushed the yields on Treasury securities sharply downward between mid-August and mid-October. Three rate cuts by the Federal Reserve then helped restore calm in financial markets. Yields on U.S. government securities at most maturities finished the year almost a full percentage point below their levels at the end of 1997 (see upper chart). The 10-year note reached its lowest level since the 1960s, and the 30-year bond (which was introduced in 1977) reached an all-time low.



Private yields. Spreads between Treasury and corporate securities widened sharply in 1998. In fact, the average yield on high-yield or "junk" bonds finished the year more than a percentage point above its 1997 close (see middle chart). By contrast, the yield on Baa-rated corporate bonds, the median rating in terms of outstanding value, ended the year about where it started.



Stock prices. After hitting record highs in mid-July, most stock indices endured a sharp downturn in late summer before jumping to new highs by year-end. Most major indices showed strong gains for the year (see lower chart), and stock prices remain very high according to standard measures of valuation. Soaring technology stocks boosted the NASDAQ in particular. Smaller stocks did not fare nearly so well: the Russell 2000 index peaked on April 21 and was down 3 percent for the year as a whole.



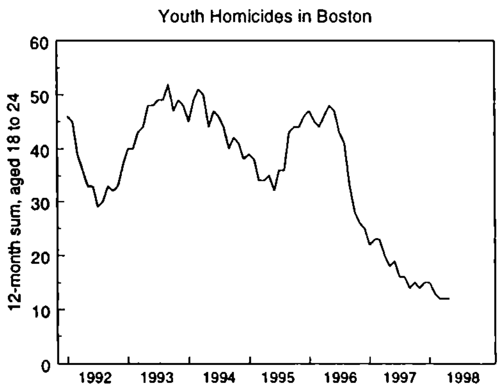
EYES ONLY

SPECIAL ANALYSIS

Youth Violence and Operation Ceasefire in Boston

Boston has shown remarkable success in curbing youth violence. Operation Ceasefire, which was the outcome of a problem-solving process engaged in by a wide variety of agencies, began in the spring of 1996 and is credited with much of this success.

Sharp drop in youth homicides in Boston. Violent crime nationally has been on the decline since 1991. Boston is no exception, especially in terms of youth violence.



In the early 1990s an average of about 43 youth under age 25 were murdered each year, and about 160 youth were assaulted by someone with a gun. Beginning around May 1996, the youth homicide rate declined substantially, to an annual average of about 16, representing roughly a 60 percent drop that has been sustained (see chart). Other violent activities (such as adult homicides, gun assaults, and reports of gun shots fired) also declined sharply over this period.

Operation Ceasefire. A recent study credits much of this remarkable decline to Operation Ceasefire. This set of interventions had two primary objectives: to create a focused deterrent against violence and to reduce gun trafficking. Ceasefire focused on violence; reducing gang activity or drug trafficking *per se* were not the principal goals. In addition, efforts were directed towards reducing trafficking in makes and calibers of guns most used by gangs and those that were used in crimes shortly after being purchased. It also focused on traffickers in the guns typically used by the city's most violent gangs. Other key ingredients included delivery of a direct and explicit message to gangs regarding the new focus on violent offenses, continuous communication with gangs to relate the seriousness of Ceasefire, participation by a wide variety of agencies, and focusing traditional prevention activities on gangs.

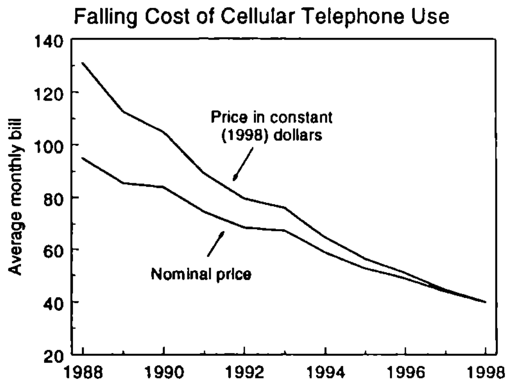
Lessons for other communities? It is unclear whether Boston's recipe for success can be replicated in other communities where the nature of youth violence (such as the number of gangs, the size of the city, and the market for guns and drugs) may be quite distinct. A key component of Ceasefire was a progressive law enforcement leadership that was willing to engage in a problem-solving process that included generating new knowledge about youth violence in the community, working collaboratively with various local agencies, and developing and implementing a new intervention strategy.

ARTICLE

Cell Phones Sell

Wireless telephone prices have dropped substantially over the past 10 years. In fact, for a surprisingly broad range of consumers, prices and service offerings have improved sufficiently for mobile phones to replace conventional telephones.

Success of competition in the wireless industry. This development is quite recent. Ten years ago the average monthly bill for wireless phone service was nearly $100 (see chart) for usage levels far lower than routine phone use. Since the first personal communication service (PCS) broadband spectrum auctions in 1995, however, many new competitors have entered the wireless market (originally consisting of two providers per market) pushing prices down. Today, over half of all Americans live in areas served by at least three new competitors beyond the original two cellular services, and the average monthly bill has declined steadily, to just under $40 in June 1998. At the same time, subscribers have been calling more on their mobile phones: wireless usage increased from an average of 100 minutes per month in 1996 to over 140 minutes per month in 1998.



Selling free time. Wireless prices appear to have become even more competitive in the second half of 1998. Wireless companies using digital technology had substantial excess capacity and were able to offer very high minutes of use at low prices. Several now offer package deals that provide a maximum number of minutes—whether local or long-distance, from anywhere in the country—for a fixed price. For example, packages at $90, $120, and $150 per month offer, respectively, 600, 1000, and 1400 minutes per month of calling. If a customer originates calls only from a single calling area, prices are as low as $50 for 400 minutes.

How the bills stack up. These pricing plans stand in contrast to conventional, land-line telephone service, which is typically divided between flat-rate local calling and usage-based toll calling. The average monthly bill for residential local service in urban areas is roughly $20 per month, including applicable taxes and regulatory fees. Long-distance costs average roughly an additional $30 per month. Altogether, using a conservative estimate, a middle-income American household spends about $50 per month on home telephone service. At these rates, who is likely to substitute wireless service for a conventional telephone?

If you bill it, they will come. Besides those heavy travelers targeted by the one-rate plans, who may have little use for a fixed residential phone, the substitution may also make sense for other callers such as those calling mostly long-distance or those requiring a second phone line. For example, a family using about 400 minutes of long-distance per month from home pays roughly $60 per month. For $10 *less*, this family can have the convenience of a wireless phone and all its pre-billed, bundled services (such as call waiting, voicemail, and some paging) under the $50, 400-minute wireless plan.

A solution for teenagers. Single people who do not share a phone with others are better candidates for wireless phone substitution than families who share a phone service at home. But larger families who need more than one line may also find wireless to be a cost-effective substitute for a second line, especially since second lines can entail more fixed fees than primary lines. Moreover, Internet usage that takes up time on one conventional phone line could also drive adoption of wireless as the "voice" option, leaving the conventional line dedicated to data transmission.

Will the bargains last? One caveat: prices for the one-rate packages may have to rise if more subscribers than expected use the maximum allotted time. Increased competition, excess network capacity, and advances in digital compression technology, however, will probably keep prices low, if not falling, for years to come. Furthermore, by promoting these one-rate plans, wireless companies are hoping that callers will learn to use and appreciate wireless service. If they do, any remaining price difference over conventional phone lines may matter less. Finally, if the prices of mobile phone handsets drop, if premium services such as data messaging come to be included in the package deals, or if connection quality simply becomes more robust, then the substitution of wireless for wireline could become yet more worthwhile.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

States Report Moderate Growth in Spending, Tax Cuts. State governments are continuing to enjoy a fiscal dividend during this expansion, and they are using it for moderate increases in spending as well as tax cuts, according to the latest report of the National Governors' Association and the National Association of State Budget Officers on the financial condition of the states. States estimate an increase in general fund spending of 5.7 percent in fiscal 1998 and 6.3 percent in fiscal 1999, a rate slightly lower than the 6.5 percent average annual increase over the last 20 years (of course inflation is lower now too). At the same time, states continue to respond to public support for modest tax cuts: in fiscal 1999, it is projected that net tax and fee changes will lower revenues by $7.0 billion, the largest decrease yet in 5 consecutive years of reductions. Most of the tax reductions have been for personal income taxes—29 states reduced personal income taxes by reducing rates, increasing deductions and exemptions, lowering taxes for the elderly, and providing tax credits for higher education.

Internet Shopping Takes off, Sending Internet Stocks into Orbit. Online retailers experienced very rapid revenue growth in 1998, according to a recent consulting group study. With a very strong holiday season on top of rapid growth in the first half of the year, 1998 revenues are estimated to have exceeded $13 billion—triple those of 1997. Sales of computer goods, books, consumer electronics, music, and videos currently account for about 42 percent of online retail revenues and discount brokerages are responsible for another 32 percent. The surge in electronic commerce has led large traditional retailers and established financial services firms to enter the online market. However, skeptics note that even with such rapid growth, the market still amounts to less than 1 percent of total retail revenue. For example, Wal-Mart Stores had sales of $118 billion in 1997, more than 9 times the estimate of total online retail revenues for 1998. Nevertheless, these sales results have exceeded expectations. Another new study suggests that much of the revenues in e-commerce result from the lack of sales taxes on online purchases. The study provides evidence that people from areas with high sales taxes are significantly more likely to buy things over the Internet (controlling for heterogeneity across cities) and argues that applying existing sales taxes would reduce Internet spending by more than 30 percent.

Banks Take Big Third-Quarter Hit on Derivatives. Turmoil in world financial markets in the third quarter of 1998 caused U.S. banks to suffer their worst losses from derivatives on record, according to a recent report from the Office of the Comptroller of the Currency (OCC). Banks had to write off $445 million in credit losses on derivatives in the third quarter, nearly five times the $94 million written off in the second quarter. Despite the poor third-quarter performance, derivatives remained less of a credit risk for banks than consumer and commercial loans, according to OCC officials. In addition, financial market conditions settled down in the fourth quarter.

EYES ONLY

INTERNATIONAL ROUNDUP

Why Did the Yen and Japan's Long-Term Interest Rates Rise? The yen appreciated almost 10 percent against the dollar between early December and January 11, bringing the total rise to 20 percent since September. Meanwhile, long-term interest rates have risen from 1.1 percent in early December to 1.8 percent this week. Some observers have found these movements puzzling, since the Japanese economy remains in recession. But there is a natural textbook interpretation. To finance its fiscal stimulus, the Japanese government has issued bonds. Absent a decision by the central bank to purchase them (that is, if the bank does not "print money" to finance the deficit), private investors must be persuaded to. This drives up interest rates, which, in turn, encourages international investors to purchase more Japanese assets. The purchase of Japanese assets strengthens the yen. After the yen reached 108.8 to the dollar on January 11, the Bank of Japan intervened to buy dollars; the exchange rate bounced back 4 percent over the next 3 days.

EMU takes flight. Europe's new single currency enjoyed a relatively painless birth, proving wrong at least those who feared significant computer failures. The euro enjoyed an initial surge, closing at $1.18 against the dollar after its first day of trading, up from $1.17. This strength might have provided some initial support for those economists expecting international portfolio rebalancing out of dollars and into euros. However, any such effect was quickly overtaken by other events. A strong U.S. employment report together with unexpectedly weak employment data for Germany reversed the euro's rise.

European Manufacturing Activity Appears to Be Slowing. Amid confidence about the launch of the euro, press reports indicate that the first release of a purchasing managers' index (PMI) for the euro-11 showed declining manufacturing activity in the fourth quarter and a steady slide in new orders in the second half of 1998. The overall index, which analysts believe to be an accurate assessment of business activity, covers some 82 percent of manufacturing activity in the euro-zone. It fell from 49.3 in October to 46.9 in December (a reading of 50 indicates no change in activity), suggesting that the euro may have been launched under less ideal economic conditions than originally thought. Recent forecasts have European growth slowing to 2.2 percent in 1999, from 2.8 percent in 1998.

Foreign Direct Investors Are Back in Korea. Though Foreign Direct Investment was already known to be the category least affected by the Asian crisis, recently released estimates for Korea showed surprisingly strong gains. In 1998, FDI grew 27 percent compared with 1997, reaching nearly $9 billion. Investment in December alone was nearly $2 billion, up 87 percent from the previous year. Seoul attributes the increase to FDI promotion programs and economic reforms.

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

****Embargoed until 9:15 a.m., Friday, January 15, 1999****

The Federal Reserve's index of industrial production increased 0.2 percent in December. Capacity utilization fell 0.1 percentage point, to 80.9 percent.

Consumer Price Index

The consumer price index increased 0.1 percent in December. Excluding food and energy, consumer prices rose 0.3 percent. For the 12-month period ending in December, consumer prices rose 1.6 percent. Excluding food and energy, consumer prices rose 2.4 percent.

Retail Sales

According to advance estimates, retail sales rose 0.9 percent in December following an increase of 0.6 percent in November. Excluding sales in the automotive group, retail sales rose 0.4 percent following an increase of 0.6 percent.

Producer Price Index

The producer price index for finished goods rose 0.4 percent in December. Excluding food and energy, producer prices rose 1.0 percent. For the 12-month period ending in December, producer prices decreased 0.1 percent. Excluding food and energy, producer prices rose 2.4 percent.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1997	1998:1	1998:2	1998:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	5.5	1.8	3.7
GDP chain-type price index	5.4	1.7	0.9	0.9	1.0
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	3.5	0.3	3.0
Real compensation per hour:					
Using CPI	0.6	1.9	4.1	2.0	2.2
Using NFB deflator	1.3	2.0	4.3	3.4	3.8
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	11.0	11.2	10.9
Residential investment	4.5	4.0	4.2	4.3	4.4
Exports	8.2	11.9	11.6	11.3	11.0
Imports	9.2	13.1	13.1	13.1	12.9
Personal saving	5.2	1.5	0.9	0.3	0.1
Federal surplus	-2.7	-0.3	0.7	0.9	1.1

	1970-1993	1998	Oct. 1998	Nov. 1998	Dec. 1998
Unemployment Rate (percent)	6.7**	4.5**	4.5	4.4	4.3
Payroll employment (thousands)					
increase per month			164	251	378
increase since Jan. 1993					17654
Inflation (percent per period)					
CPI	5.8	**1.6**	0.2	0.2	**0.1**
PPI-Finished goods	5.0	**-0.1**	0.2	-0.2	**0.4**

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	Nov. 1998	Dec. 1998	Jan. 14, 1999
Dow-Jones Industrial Average	7441	8626	9006	9019	9121
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.41	4.39	4.29
10-year T-bond	6.35	5.26	4.83	4.65	4.63
Mortgage rate, 30-year fixed	7.60	6.94	6.87	6.72	6.83
Prime rate	8.44	8.35	7.89	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level January 14, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro-Dollar	1.169	0.1	N.A.
Yen-Dollar	113.3	1.4	-13.8
Major currency index (Mar. 1973=100) (trade-weighted value of the U.S. $)	92.24	0.6	-4.7

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	3.5 (Q3)	4.3 (Dec)	1.6 (Dec)
Canada	2.3 (Q3)	8.0 (Nov)	1.3 (Nov)
Japan	-3.5 (Q3)	4.5 (Nov)	0.8 (Nov)
France	2.8 (Q3)	11.5 (Nov)	0.3 (Nov)
Germany	2.7 (Q3)	[2] 7.3 (Nov)	0.7 (Nov)
Italy	1.2 (Q3)	12.4 (Oct)	1.5 (Nov)
United Kingdom	2.2 (Q3)	6.2 (Sep)	3.0 (Nov)

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for November was 9.4 percent.