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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

December 18, 1998

CHART OF THE WEEK

The relative importance of U.S. trade with Mexico has been growing, and that country is now our second largest trading partner, behind Canada. U.S. exports to Mexico fell after the financial crises of 1982 and December 1994. Nevertheless, exports have risen 91 percent in the 5 years since NAFTA went into effect in January 1994, while imports have risen 156 percent. The upward trend in U.S.-Mexico trade began after Mexico joined the GATT in 1986.

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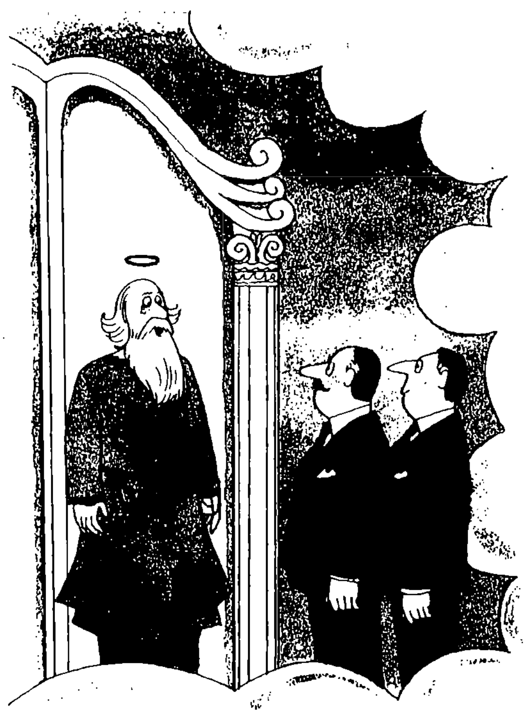

"You're saying that because of the merger I have to admit both of you?"

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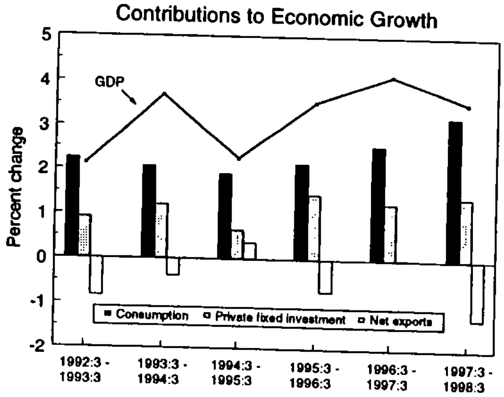
MACROECONOMIC UPDATE

The Energizer Economy Is...Still Going...

GDP grew by 3.5 percent between the third quarter of 1997 and the third quarter of 1998—slightly less than the year-earlier pace of 4.1 percent. Growth in the fourth quarter appears to be running in the 3 to 4 percent range. These rates of growth are higher than most analysts were expecting when they assessed the likely impact of the widening Asian crisis a year ago.

Changing contributors to growth. In the year leading up to the emergence of a serious Asian crisis in late 1997, consumer expenditures and private fixed investment were important contributors to growth, with little growth coming from other factors including net exports (see chart). Over the next 4 quarters, the widening international crisis had the expected effect of reducing net exports. However, rising consumer expenditures offset much of the drag on growth from declining net exports.



Current performance. Consumption continues to be strong in the fourth quarter as indicated by motor vehicle and other retail sales through November. Job growth has also been robust. Net exports are most likely to be a drag over the medium term, but the trade deficit in October was smaller than expected.

The future. Growth has continued to be faster than the long-run sustainable pace of 2.4 to 2.5 percent per year that is consistent with annual labor force growth of 1.2 percent and trend productivity growth of 1.3 percent. The Administration is forecasting that growth will slow to 2 percent in 1999 and 2000 as the waning effects of the stock market boom lead to lower consumption and excess industrial capacity slows the demand for industrial equipment. Private forecasters, too, are forecasting a significant slowing.

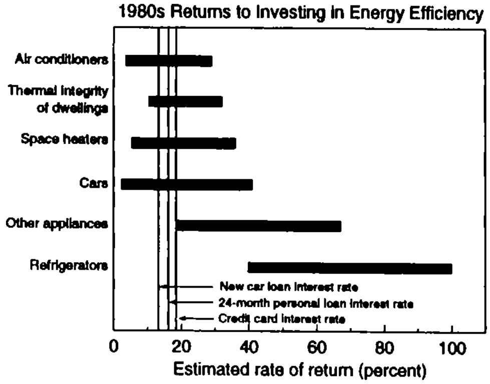
SPECIAL ANALYSIS

It's Getting Harder to Save Money by Being Green

Studies in the 1980s found an apparent "energy paradox" in which consumers were unwilling to invest in energy-efficient products such as improved insulation materials and energy-efficient appliances, even though such purchases might have saved them money. In the 1990s, the implementation of energy efficiency standards contributed to raising average energy efficiency, but, combined with lower energy prices, the tighter standards may have reduced the opportunities for *additional* investments that save both energy and money.

The 1980s. More energy-efficient products typically require a larger initial outlay than their less-efficient counterparts, but they result in lower energy bills through time. These energy-cost savings can be expressed as a rate of return on the extra cost of the more efficient product. The chart shows ranges of estimates of such rates of return from the 1980s for a number of products. In the most dramatic example of how a consumer could save money and energy, the rate of return on investing in a more energy-efficient refrigerator was estimated to be in the 39 to 100 percent range, compared with financing costs of less than 20 percent.

1980s Returns to Investing in Energy Efficiency



The 1990s. Two factors have reduced the rate of return from investing in energy efficiency in the 1990s. First, the relative price of electricity has fallen by about 27 percent since 1983, reducing the energy cost savings associated with more efficient products. For example, the rate of return on today's standard high-efficiency central air conditioner is 2.3 percent, but it would be 8.7 percent if electricity were still priced at its 1983 rate. Second, the implementation of energy efficiency standards for products such as refrigerators, washing machines, and florescent light bulbs reduced the difference in efficiency between more- and less-energy-efficient products, and hence the potential cost savings from investing in greater efficiency. Lower interest rates in the 1990s make energy efficiency investments more attractive, but this effect has been outweighed by the changes in prices and efficiency standards.

Implications. A substantial fraction of domestic greenhouse gas emissions comes from energy use, and reducing energy consumption will play a central role in reducing emissions. The energy paradox implies that opportunities exist for consumers to save energy *and* money by making energy-efficient investments and that at least some reduction in energy can be achieved costlessly. However, today's low energy prices and higher efficiency standards have eliminated some of the "low hanging fruit" and reduced opportunities for such money-saving investments in energy conservation.

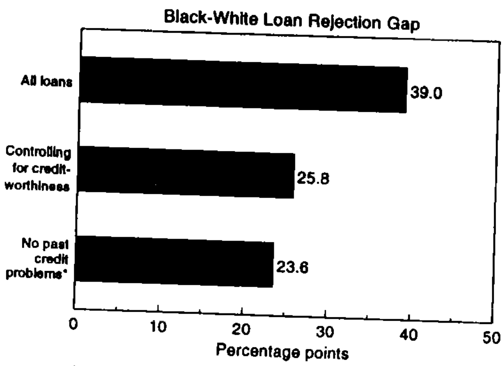
EYES ONLY

ARTICLE

Discrimination in the Small Business Credit Market

Black-owned small businesses are about twice as likely to have loan applications denied than are similarly credit-worthy white-owned businesses, according to a new study. Discrimination appears to be more prevalent in small business lending than in the high-profile mortgage loan market. Because of the demanding capital requirements for starting and running small businesses, racial discrimination in the credit market can be especially harmful for minority ownership.

The black-white loan rejection gap. The new study, which is based on the credit experiences of more than 4,600 small businesses surveyed in the early 1990s, found that 66 percent of loan applications from black-owned firms were rejected, compared with 27 percent of those from white-owned firms. This gap was due in part to black-white differences in financial background and previous loan delinquency, profitability and sales, experience and education of owner, and other factors relevant to credit-worthiness.



* Also controls for credit-worthiness

All things equal? Even after controlling for factors relevant to credit worthiness, the study found that black-owned firms still faced a loan denial rate about 25 percentage points higher than that of white-owned firms (see chart). The study found less bias in loan approvals against firms owned by other racial groups and none against those owned by women. The black-white rejection gap existed even among firms that had no past credit problems. Furthermore, black-owned firms also paid interest rates about 1 percentage point higher than their counterparts with similar credit-worthiness. Surprisingly, the difference was even greater (about 1.5 percentage points) for those with no past credit problems.

Minding one's own business. Because entrepreneurs are generally liquidity constrained and thus rely on existing personal assets, loans are critical to small business ownership and self-employment. For example, all else equal, workers are more likely to move from employment to self-employment when they have greater family assets or have received an inheritance or gift, that is, when they are less constrained by loan availability. Discrimination in small business lending would further disadvantage non-white entrepreneurs. Black men are only one-third as likely to be self-employed as white men; they move into self-employment at one-half the rate of whites and they move out at twice the rate.

More than mortgages. This evidence is consistent with inequities in other lending markets. In the mortgage market, for example, the most widely cited evidence shows

EYES ONLY

that lenders are about 8 percentage points less likely to approve loans for non-whites than for whites with similar characteristics. (Without controlling for any other characteristics, the data show non-whites being rejected 28 percent of the time and whites 10 percent.) One explanation for the larger black-white gap in small business lending is that lenders may feel a greater "distance" from the applicant in the mortgage market. Because about 50 percent of mortgage loans are traded in a secondary market (Fannie Mae, Freddie Mac, and Ginnie Mae), the original lender may have little intention of maintaining the loan relationship and hence less reason to discriminate.

How to discriminate with statistics. These gaps in loan rejection and interest rates among blacks and whites with similar characteristics may result from a number of unlawful practices. "Red-lining," or the denial of equal terms to applicants from different neighborhoods, may disproportionately harm non-white applicants. Also possible is "statistical discrimination," which is the use of race as an indicator of credit-worthiness. Finally, there is the simple personal prejudice of the lender. The reported gaps may overstate illegal discrimination if some lawful information that creditors use is missing from the survey; however, these gaps may understate discrimination if creditors discourage non-white entrepreneurs from applying in the first place. In short, despite the statistical evidence of bias against non-whites, the exact motivations and mechanisms for discrimination in credit markets remain unclear.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More Americans Will Pay Zero Federal Income Tax in 1998. The number of Americans who will pay no Federal income taxes is expected to rise in 1998. But the share of taxes collected from people earning more than $40,000 a year continues to grow, according to a new report from the Congressional Joint Committee on Taxation. Nearly 48 million Americans will owe no Federal income tax for this year, compared with 46 million in 1997. The increase was attributed in part to the new $400-per-child tax credit. Taxpayers with incomes above $40,000 will pay 96 percent of income taxes collected in 1998, up from 94 percent the year before. The 10.5 million taxpayers (8 percent of all returns) with incomes in excess of $100,000 will account for 62 percent of 1998 income taxes, compared with 56 percent last year. The report also estimates that only 36 million of the 87 million taxable returns in 1998 will itemize deductions.

Do Managers Have Discretion in Wage Setting? Economists have long recognized that managers do not always have the incentive to maximize profits. A recent study examines whether managers might exhibit non-maximizing behavior when they set wages. It uses states' passage of anti-takeover legislation as a source of independent variation in managers' discretion over wages. The study assumes that managers recognize that if they fail to maximize profits, they endanger themselves by risking takeover and subsequent job loss. Anti-takeover laws insulate managers from takeover pressures and may dull their incentives to maximize profits. The study looks specifically at business combination (BC) laws passed in 28 states during the middle and late 1980s that impeded highly leveraged takeovers. Using firm-level data from 1976 to 1995, the study finds that the passage of BC laws led to an increase in annual wages of 1 to 2 percent, or $500 per year. This increase in wages may have gone to existing workers in the form of above-market wages, or it may have stemmed from managers' preferences for hiring more qualified (and therefore higher paid) workers.

SO_2 Permit Prices Rise as Phase II Approaches. The price for SO_2 allowances in the EPA's Acid Rain Program increased 84 percent over 3 months this spring. The permits, which had been trading at around $100 per ton for almost a year, are now trading at approximately $189 per ton. The costs of Phase II of the program, which will begin in 2000, are expected to be much higher than those of Phase I, because Phase II calls for further reductions in emissions. But SO_2 permits can be banked and used in the future and one would not have expected such large price movements solely on the basis of this anticipated policy change. One possible explanation is that the approach of Phase II and the need to develop compliance strategies may have shocked firms out of their myopia. A second explanation is that legislation is pending that could effectively reduce the number of permits available in Phase II. If fewer permits are available for Phase II, prices in that phase will be much higher than previously anticipated.

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INTERNATIONAL ROUNDUP

Most Firms Are Not Ready for the EMU. The majority of European companies are not ready for the implementation of the EMU, according to a report by a major consulting firm. Nearly all survey respondents claimed they had a strategy regarding EMU implementation. Less than two-thirds had estimated adaptation costs, however, and less than half had budgeted for them. Some early estimates suggest that system adaptation alone might require one-and-a-half times the effort of Y2K compliance. Moreover, significant mismatches are likely in terms of when sectors and countries price and purchase in euro, when employees start being paid in euro, and when the euro becomes firms' core accounting currency. In addition, firms have identified broader implications of the single currency for pricing, marketing, and branding. According to the report, monetary union is expected to have an impact on everything from price points and packaging to supply chains and workforce and plant location.

And in One Respect, Neither Is France. In what might signal a more aggressive stance toward the liberalization of member countries' foreign ownership restrictions, the European Commission recently said France's "golden share" in its largest oil company was incompatible with Community law on the free movement of capital. So-called golden shares are those containing special ownership rights not accruing to ordinary equity holders. Many governments have retained such shares in privatized firms, establishing veto power over future changes in ownership deemed contrary to their national interest. Uncertainty surrounding government interference, however, is likely to impede the large-scale industrial consolidation expected ultimately to result from monetary union. Since 1997, the Commission has initiated similar cases against Portugal, Spain, Italy and Belgium for practices that infringe on the free movement of capital.

Disappointing Results in the "World's Largest Auction." Thailand's Financial Sector Restructuring Authority (FRA) closed bidding this week on what it claimed would be "the world's largest auction." It had hoped to sell loans with a total face value of $10.3 billion. Most of the loans were non-performing and backed by property collateral. Some hoped that the sale would return liquidity to the real-estate market by establishing a market-clearing price for the property collateral. It was expected that banks would be required to use this value to mark down the value of the property collateralizing their bad loans. In this way the auction results could also have shed light on the ultimate cost to the government of the bank bailout. Earlier this week, it seemed that the potential contribution of the sale to the restructuring process had won out over both political pressure to forestall the sale and nationalist concerns over potential sales of assets to foreigners. The only good news thus appears to be that the sale took place at all. The FRA accepted bids on only 8.6 percent of the loans, at an average of 37 percent of face value, only slightly higher than the minimum bid of 30 percent that was set to avoid triggering a further collapse in asset prices. The failure to amend bankruptcy and foreclosure laws was blamed by many for the poor results, with troubling implications for future restructuring.

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RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit decreased to $14.2 billion in October from $14.4 billion in September.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production declined 0.3 percent in November. Capacity utilization fell 0.6 percentage point, to 80.6 percent.

Housing Starts

Housing starts decreased 3 percent in November to 1.65 million units at an annual rate.

Consumer Price Index

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

MAJOR RELEASES NEXT WEEK

Gross Domestic Product (Wednesday)
Advance Durable Shipments and Orders (Wednesday)

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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	3.9
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
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	1997	Sept. 1998	Oct. 1998	Nov. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.6	4.6	4.4
Payroll employment (thousands)					
increase per month			172	145	267
increase since Jan. 1993					17273
Inflation (percent per period)					
CPI	5.8	1.7	0.0	0.2	**0.2**
PPI-Finished goods	5.0	-1.2	0.3	0.2	-0.2

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	Oct. 1998	Nov. 1998	Dec. 17, 1998
Dow-Jones Industrial Average	5743	7441	8164	9006	8876
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	3.96	4.41	4.35
10-year T-bond	6.44	6.35	4.53	4.83	4.58
Mortgage rate, 30-year fixed	7.80	7.60	6.71	6.87	6.69
Prime rate	8.27	8.44	8.12	7.89	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 17, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.666	0.7	-5.8
Yen-Dollar	116.3	-0.6	-8.4
Multilateral $ (Mar. 1973=100)	94.36	0.3	-4.0

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.5 (Q3)	4.4 (Nov)	1.5 (Nov)
Canada	2.3 (Q3)	8.1 (Oct)	1.1 (Oct)
Japan	-3.5 (Q3)	4.3 (Oct)	0.2 (Oct)
France	2.8 (Q3)	11.6 (Oct)	0.5 (Oct)
Germany	2.7 (Q3)	2/ 7.3 (Oct)	0.7 (Oct)
Italy	1.1 (Q2)	12.4 (Jul)	1.7 (Oct)
United Kingdom	2.3 (Q3)	6.2 (Aug)	3.1 (Oct)

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 October 1998 is 9.3 percent.

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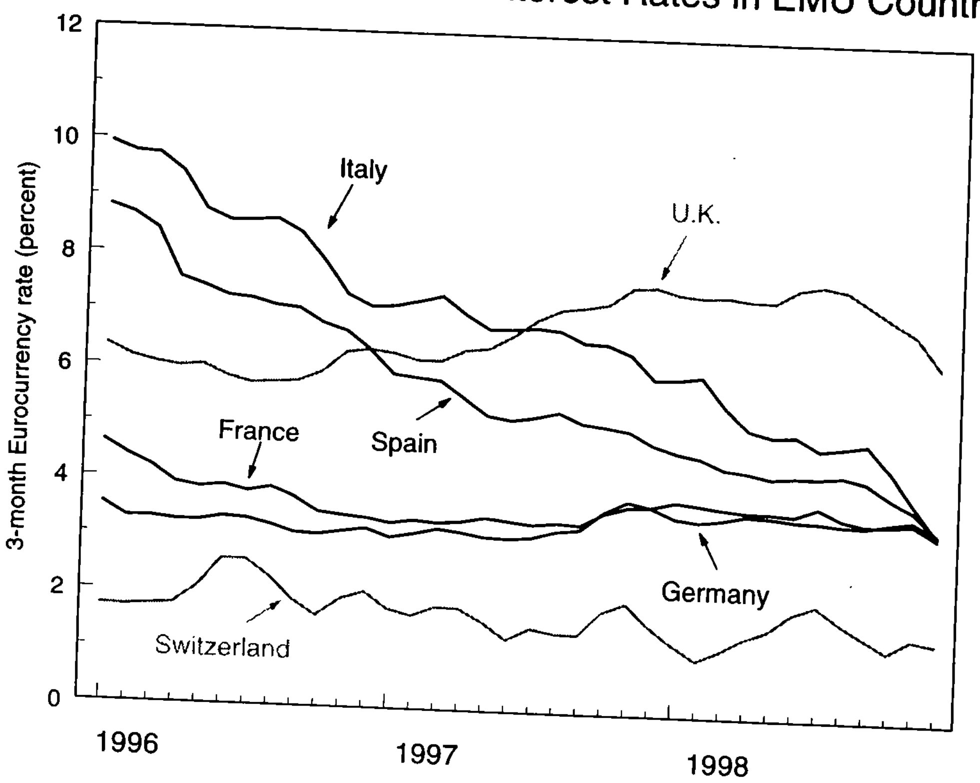
Weekly Economic Briefing of the President of the United States

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

December 11, 1998

CHART OF THE WEEK

Convergence of Short-Term Interest Rates in EMU Countries



Short-term interest rates have converged in EMU countries (illustrated by Italy, Spain, France, and Germany in the chart) preparatory to the introduction of the euro in January. Last week all 11 countries except Italy cut their official bank rates to 3.0 percent, producing the convergence to a single rate that will be required on January 1. By contrast, rates have not converged in non-EMU countries, as illustrated by Switzerland and the U.K. (even after it cut rates this week).

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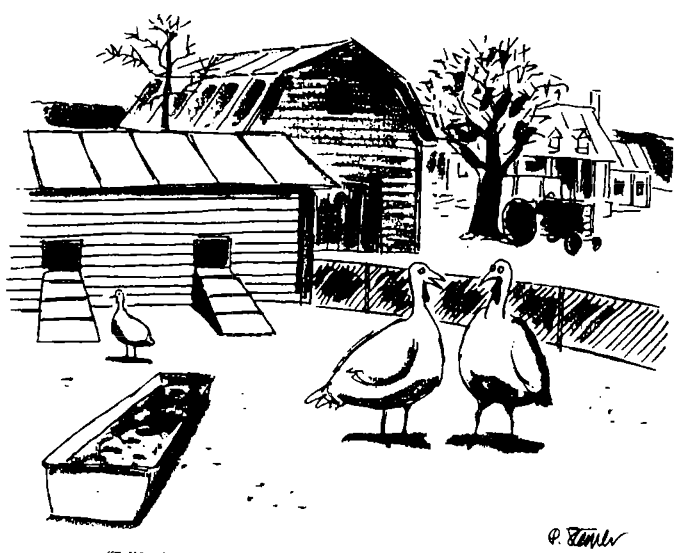


"I like it best after the holidays, when the crowds are gone."

EYES ONLY

CURRENT DEVELOPMENT

Is the Euro a Threat to the Dollar?

The dollar's role as the dominant international currency was described in last week's *Weekly Economic Briefing*. This analysis looks at whether the introduction of the euro threatens this status.

Characteristics of an international currency. How does the dollar stack up with respect to the attributes that analysts have identified as important in determining international currency status?

- Economic size. The currency of a country that has a large share in international output, trade, and finance has a natural advantage as an international currency. The U.S. economy is still larger than the euro-11 economies combined. If Britain and the other remaining EU members (Sweden, Denmark and Greece) join in the future, however, the two currency areas will then be very close in size.

- Strong financial markets. U.S. capital and money markets, more so than those on the European continent, meet the condition of being open, free of controls, well-developed, and liquid.

- History. A strong inertial bias favors using whatever currency has been the international currency in the past, and that is the dollar.

- Confidence in the value of the currency. An international currency should not be subject to wild fluctuations in value or doubts about its stability. The United States has enjoyed good inflation performance relative to other major countries recently—but it has not always. Furthermore, the United States' status as a large net international debtor with a substantial current account deficit might reduce the attractiveness of the dollar as an international currency.

Prognosis for the euro. On January 1, the euro will automatically inherit the international currency status now held by the ecu, DM, and French franc. Subsequently, the euro's share in reserve currency holdings and other measures of international use may rise gradually to be more consistent with the share of "euroland" in world output.

Despite the likely international importance of the euro, however, the odds are against its rapidly supplanting the dollar as the world's premier currency. The dollar will probably continue to be the world's favorite currency for holding reserves, pegging minor currencies, invoicing imports and exports, and denominating bonds and lending. Two of the four determinants of reserve currency status—liquid financial markets and historical inertia—support the dollar over the euro. A third, economic size, is a tie. The fourth determinant (confidence and stability) is an open question, which will depend in part on the track record of the new European Central Bank.

EYES ONLY

SPECIAL ANALYSIS

The Swedish Approach to Social Security Reform

Sweden made sweeping changes to its public pension system this summer. The most novel reform is the creation of defined-contribution individual accounts as part of a traditional pay-as-you-go (PAYGO) system.

The new program. Key aspects of the reforms include the following:

- Notional accounts. The lion's share of future payroll taxes will be used to finance contemporaneous benefits, as in the old PAYGO system. But these taxes will be recorded in individual "notional accounts" that will earn an imputed rate of return based on the growth of average covered earnings in the economy. Contributions will also be made to the notional accounts of some people without current market earnings (such as the disabled, the unemployed, and those caring for children). In addition, the system will maintain substantial redistribution through minimum guaranteed pensions financed by general revenue.

- Annuitization. Upon retirement, which can be at any age after 61, individuals' notional accounts will be automatically converted by the government into annuities. The size of the annuity will depend on the individual's account balance and the average life expectancy of men and women that age. With rising life expectancy, the monthly benefit associated with any given retirement age will decline over time. Put the other way around, successive cohorts will have to work longer in order to receive the same monthly benefit. Thus, the system may generate a naturally rising retirement age.

unisex life tables?
unless wages ↑ so accum ↑ faster than life expectancy

- Prefunded private accounts. A second and smaller arm of the system provides for individual accounts with claims on real assets. Taxes will be invested initially by the government in low-risk assets until precise individual pension rights can be tallied (about 18 months later, on average). At that point, individuals can direct their balances to any certified investment fund, or by default to a public fund. To reduce administrative costs, individuals will interact only with a central public agency; this agency will hold one account with each investment fund equal to the aggregate of all individuals' balances.

Analysis. The new system has several interesting implications:

- As a defined-contribution system, it will more closely link benefits to contributions than did the old system. This may be viewed as more fair, and the perception that payments are retirement contributions rather than taxes may reduce labor supply distortions. The unavoidable tradeoff is that redistribution will be more transparent.

- Individuals will bear limited financial-market risk. Officially, people will bear the full risk of their investment choices in the prefunded private accounts. However, if someone's total benefit from the notional and prefunded accounts falls below a given threshold, he or she will receive additional payments. Still, this minimum guarantee is indexed over time to inflation rather than wages, so it will decline in relative importance if real wages grow unless future changes are made.

- The system is less vulnerable to demographic shifts than traditional defined-benefit PAYGO systems. The key innovation is the way that annuitizing notional accounts *automatically* adjusts benefits to changes in life expectancy. At the same time, the chosen rate of return on notional accounts will not be sustainable if the Swedish labor force declines over a long enough period. Total contributions are determined by both average earnings and the number of workers making contributions, but the rate of return is indexed only to average earnings. Thus, a shrinking labor force would drain the system, while an expanding labor force would lead to surpluses. Swedish analysts recognize that changes in the rate of return may be necessary over time, but they expect that these changes can be buffered by the public pension trust funds.

EYES ONLY

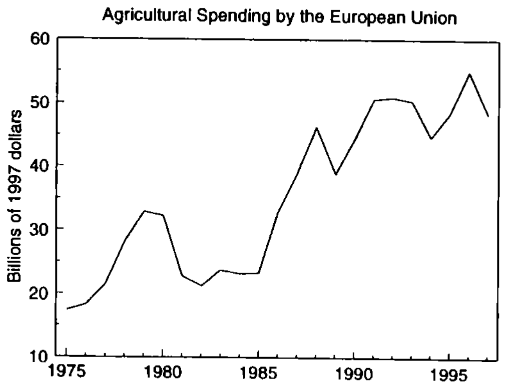
SPECIAL ANALYSIS

Common Agricultural Policy Problems

In 1958, the Treaty of Rome singled out agriculture as the cornerstone of the European Common Market, and a Common Agricultural Policy (CAP) was established in 1962. The CAP has subsequently become one of the EU's most expensive endeavors and, many analysts would say, one of its most inefficient. Current reform proposals, which are more serious than any introduced before, are meeting resistance from farm groups and agricultural ministers across the Union.

From cornerstone to millstone. The CAP is primarily a price management system that supports the income of EU farmers. Authorities buy surplus products when market prices threaten to fall below agreed minimum prices. Also, the CAP applies border measures such as tariffs so that imports of most price-supported commodities cannot be sold into the Community below the desired internal market price. Export subsidies are used to promote the sale of excess production in world markets.

Predictably, the CAP's system of guaranteed prices with few production limitations has led to excess agricultural production and a misallocation of resources. Since 1970, the EU has shifted from being a net importer of wheat, sugar, beef, pork, poultry, and dairy products, to being one of the world's largest net exporters. This turnaround has come at a high cost in terms of higher overall food prices for consumers and a strained EU budget. Real EU outlays for agriculture have grown from about $17 billion in 1975 to $48 billion in 1996 (see chart). And these figures do not include government spending on agriculture by individual EU member countries. The CAP currently accounts for about 55 percent of the EU budget, after requiring as much as 70 percent in earlier years.



Current CAP reform proposals. Impending EU enlargement, continued budget pressures, and WTO commitments to limit export subsidies have triggered renewed calls for CAP reform. In 1997, the European Commission proposed sharp cuts in guaranteed prices and the continued use of direct compensatory payments. These compensatory payments (first introduced in the 1992 reforms) are similar in spirit to U.S. AMTA payments and represent an effort to wean farmers from a system of guaranteed prices. They also entail substantial short-term budget commitments. The current proposal also includes options to reform CAP financing. The possibility of linking countries' payments more closely to benefits received has become a particularly contentious point of debate among EU members, with Germany, for example, expressing reluctance to continue subsidizing French farmers. The deadline for adopting any CAP reforms as part of the EU's "Agenda 2000" is March 1999.

EYES ONLY

SPECIAL ANALYSIS

Macroeconomic Implications of the Y2K Problem

One Wall Street analyst has put the chance of a serious global recession due to the Year 2000 computer problem at 70 percent. Given the central role that computer technology plays in today's economy, it is impossible to rule out serious unexpected consequences from the Y2K problem. But is the prospect as dire as this forecast? Will Y2K even show up in macroeconomic indicators such as GDP?

Possible effects. Macroeconomic effects of the Y2K problem, beyond the widely discussed effects on individual firms or households, include the following:

- Direct spending on computers. Efforts to address the Y2K problem should increase the demand for computer hardware, software, and programming services prior to the year 2000. One study estimates that $50 billion has been spent on the Y2K problem, based on a sample of 10-K reports filed by Fortune 500 firms. However, this spending may *reduce* GDP to the extent that it represents a diversion of firms' computer spending from other, presumably more productive purposes. Thus, the study estimates that Y2K computer spending will subtract a tenth of a percent or two per year from U.S. productivity growth in 1998 and 1999.

- Inventories. Uncertainty over the performance of information and delivery systems might lead firms to stockpile inventories prior to January 2000. The Y2K inventory effect, if it takes place, would provide a boost to GDP in 1999, offset by a corresponding negative effect in 2000. Given the intrinsic uncertainty created for firms by the Y2K problem, this is an appropriate market response.

- The demand for money. Risk-averse people may wish to withdraw more than the usual amount of cash from the automatic teller machine on the way to their New Year's Eve parties next year. An unexpected increase in the demand for money is contractionary, but the Federal Reserve has already made arrangements to ensure that banks have the cash they need to satisfy a surge in demand. Thus, the demand for money is one part of the macroeconomic equation that need not be a source of concern.

- Supply-side and financial effects. Disruptions to particular sectors that connect the rest of the economy—such as transportation, power distribution, telecommunications, or finance—are much harder to predict, and are the source of the more alarming scenarios. There is no way to evaluate, for example, whether Y2K glitches in the financial sector will give enough substance to irrational end-of-millennium unease that the result will be self-confirming volatility in securities markets. More concretely, banks have reported that Y2K compliance is already an important factor in their decisions whether to extend credit in certain foreign countries, particularly in Asia and Eastern Europe. A tightening of bank lending in these regions could accentuate the capital scarcity arising from the recent flight to quality.

A Y2K recession? The odds that the Y2K problem will lead to a recession in the year 2000 are not easy to assess by formal modeling. Indeed, those who issue pessimistic forecasts of the effects admit freely that these are purely subjective judgments. However, one can look at possible historical precedents to see if anything is to be learned about the macroeconomic spillover effects of disruptions to infrastructure. The last three decades have seen numerous instances of natural disasters in which the adverse impacts on buildings and property were large, even leaving aside the human toll. In economic terms, these damages represent a loss in future consumption—resources are diverted to replace or repair the capital stock that has been lost or damaged. Yet in most cases, the disruption was not sufficiently great to show up in the year's statistics on output, income, or employment. The same is true of strikes, even those that affected the communications or transportation infrastructure. The UPS strike of 1997, for example, in the end had little discernible impact on GDP, in part because firms and individuals found other ways to deliver their packages.

To be sure, it could be dangerous to generalize from these precedents. A disruption that affected the entire country, or that lasted more than a few weeks, would offer less scope for substitution. But even the 2-month power outage suffered earlier this year in the central business district of Aukland, New Zealand's largest city, is now estimated to have had only a small impact on the country's GDP.

Conclusion. A recent survey of 33 professional forecasters showed an average expectation that the Y2K conversion problem would add 0.1 percentage point to economic growth in 1999 and subtract 0.3 percentage point in 2000. Even if Y2K disruptions turn out to be on the serious side, they are most likely to show up primarily as inconveniences and losses in individual sectors, and not in substantial macroeconomic losses. Moreover, the huge efforts underway to address the Y2K problem, both in the government and in the corporate sector, represent valuable precautionary steps against a serious disruption. Nevertheless, it is impossible to rule out a more unpleasant surprise.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Indicate Continuing Growth. All 12 Federal Reserve district economies continued to expand in November, despite contraction in export industries, according to the Fed's latest summary of commentary on current economic conditions. Consumer spending was up, but several districts said sales were weaker than expected. Manufacturing activity was generally softer, largely because of output declines in export-related industries. Overall, construction activity increased. Stronger consumer confidence and lower interest rates spurred homebuilding, refinancing, and a rebound in commercial construction activity in some areas. Loan demand was strong in most districts, but bankers reported generally tighter credit standards. Low prices and weak exports continued to hurt the natural resource and agricultural industries, and several districts noted sizable losses incurred by many agricultural producers. Labor markets remained tight in nearly all districts, although wage pressures may have subsided.

U.S. Purchasing Executives Expect Further Growth in 1999. The Nation's purchasing executives expect continued growth in both manufacturing and non-manufacturing industries in 1999, according to new semiannual surveys from the National Association of Purchasing Managers. Manufacturing purchasers expect a 5.2 percent net increase in overall revenues, compared with a 7.0 percent increase reported for 1998. Non-manufacturing purchasers expect a 6.2 percent increase, compared with a 4.2 percent increase expected for 1998. Only 1 percent of manufacturing purchasers and 2.5 percent of non-manufacturing purchasers expected to have major problems with Y2K compliance.

Canadian Welfare Experiment Shows Promise. Complete 18-month results from the Self-Sufficiency Project (SSP), a demonstration running in two Canadian provinces, show that participants worked more, had higher earnings and income, and received less welfare than a control group. These results confirm preliminary findings discussed in a Special Analysis in the April 24, 1998, *Weekly Economic Briefing*. SSP offers a generous earnings supplement to former welfare recipients for up to 3 years, as long as the client continues to work full-time and remains off welfare. (The supplement roughly doubles the earnings of many low-wage workers.) With the supplement, participants' income was typically $2,500 to $4,000 per year higher in 1997 U.S. dollars than if they had worked the same amount and remained on welfare. The complete results show that SSP doubled the full-time employment rate of participants (to 29 percent) and reduced welfare receipt by 13 percentage points relative to the control group. Researchers note, however, that the additional employment generated by SSP occurred primarily at low wages. It remains to be seen, therefore, whether the positive results continue after the supplement ends.

Current Account Deficit Widens. The U.S. current account deficit widened to $61.3 billion in the third quarter as the deficit on investment income increased, the surplus on services fell, and net unilateral transfers increased. The deficit on goods was virtually unchanged from the second quarter.

INTERNATIONAL ROUNDUP

World Bank Forecasts Slow Growth for Developing Countries. Growth in per capita income in developing countries is expected to slow from 3.2 percent in 1997 to 0.4 percent this year, according to the World Bank's latest annual *Global Economic Prospects of the Developing Countries.* This would be the slowest growth for these countries since the 1980s debt crisis. Countries that account for nearly half of the developing world's GDP and more than a quarter of its population are expected to experience a decline in per capita income. The press conference accompanying the release of the report generated controversy when it was reported that the Bank was critical of the International Monetary Fund and the United States for their handling of the Asian crisis. The Bank has disavowed such criticism. The report does argue, however, that the response to the crisis failed to recognize its profound social cost and its disproportionate impact on the poor.

WTO Forecasts Less Trade. Growth in the volume of real merchandise exports in 1998 is expected to fall to 4 to 5 percent from an historically high level of 10 percent in 1997, according to the World Trade Organization's annual report on trade. Even at the slower pace, however, growth in trade will continue to outpace growth in GDP. The report cites the decrease in overall economic activity precipitated by the international financial crisis, the Japanese recession, and slow growth in the United Kingdom and Latin America. Two major risk factors are identified as a result of the slower trade growth: the possibility of a sharp correction in "historically high-priced" Western European and North American stock markets and a significantly weaker dollar.

Is FDI Good for the Environment? In the next 30 years, developing countries will become the leading source of greenhouse gas emissions. Yet these countries may be inhibited in their ability to reduce emissions by weak public sectors and other pressing concerns, such as reducing poverty. A new study examining the impact of foreign direct investment (FDI) in the Chinese electricity generating sector suggests that FDI offers promise as a way of achieving important energy efficiency gains in these countries and thereby reducing emissions. China opened its power sector to FDI in the early 1990s, and the study finds that average coal consumption per kilowatt hour of electricity generated is substantially lower in American wholly owned and joint venture plants than it is in new Chinese plants of similar scale. However, the gains may not be all that they could be. To avoid the lengthy approval process for large plants and to minimize risk, early FDI tended to be in small-scale plants that are generally less energy-efficient than large-scale plants. Also, international investors' early enthusiasm may be waning in the face of persistent uncertainties regarding FDI approval, electricity sector regulation, and the ongoing risk of default on power purchase contracts.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, December 11, 1998****

The producer price index for finished goods decreased 0.2 percent in November. Excluding food and energy, producer prices increased 0.1 percent.

Retail Sales

****Embargoed until 8:30 a.m., Friday, December 11, 1998****

Advance estimates show that retail sales increased 0.6 percent in November following an increase of 1.2 percent in October. Excluding sales in the automotive group, retail sales rose 0.4 percent following an increase of 0.8 percent.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
Housing Starts (Wednesday)
Industrial Production and Capacity Utilization (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	3.9
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
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	1997	Sept. 1998	Oct. 1998	Nov. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.6	4.6	4.4
Payroll employment (thousands)					
increase per month			172	145	267
increase since Jan. 1993					17273
Inflation (percent per period)					
CPI	5.8	1.7	0.0	0.2	N.A.
PPI-Finished goods	5.0	-1.2	0.3	0.2	**-0.2**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, December 11, 1998.**

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	Oct. 1998	Nov. 1998	Dec. 10, 1998
Dow-Jones Industrial Average	5743	7441	8164	9006	8842
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	3.96	4.42	4.37
10-year T-bond	6.44	6.35	4.53	4.83	4.53
Mortgage rate, 30-year fixed	7.80	7.60	6.71	6.87	6.69
Prime rate	8.27	8.44	8.12	7.89	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 10, 1998**	**Percent Change from** Week ago	Year ago
Deutschemark-Dollar	1.655	-1.0	-7.3
Yen-Dollar	117.1	-1.4	-9.3
Multilateral $ (Mar. 1973=100)	94.10	-0.8	-5.1

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.5 (Q3)	4.4 (Nov)	1.5 (Oct)
Canada	2.3 (Q3)	8.1 (Oct)	1.1 (Oct)
Japan	-3.5 (Q3)	4.3 (Oct)	0.2 (Oct)
France	2.8 (Q3)	11.6 (Oct)	0.5 (Oct)
Germany	2.7 (Q3)	2/ 7.3 (Oct)	0.7 (Oct)
Italy	1.1 (Q2)	12.4 (Jul)	1.7 (Oct)
United Kingdom	2.3 (Q3)	6.2 (Aug)	3.1 (Oct)

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 October 1998 is 9.3 percent.

EYES ONLY

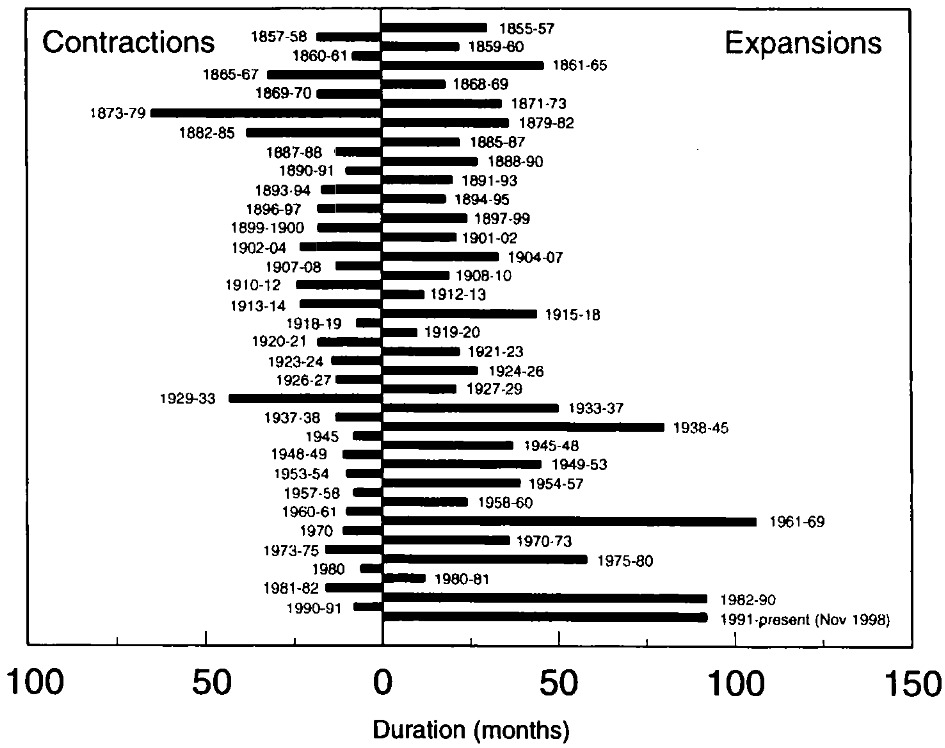
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 4, 1998

CHART OF THE WEEK

Duration of Business Cycles Since 1855



With today's news that payroll employment grew another 267,000 in November, it appears very likely that the current expansion entered its 93rd month in December. This would make it the longest peacetime expansion on record, based on National Bureau of Economic Research reference dates, which go back to 1854. The Kennedy-Johnson expansion of 1961-69 lasted 106 months.

EYES ONLY

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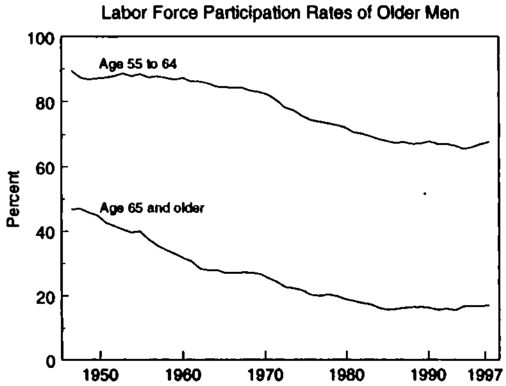
"I'm sorry, sir, but I don't believe you know us well enough to call us the Fed."

EYES ONLY

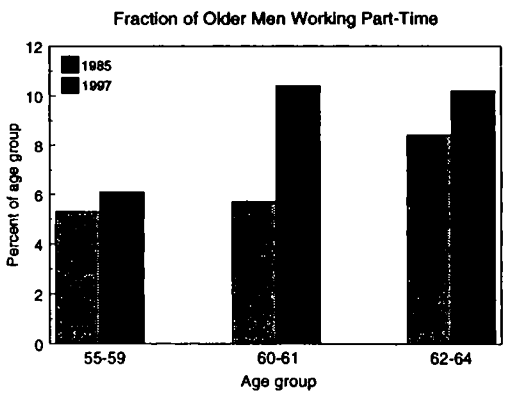
TREND

Labor Force Participation at Older Ages

It has been widely recognized that the labor force participation rates of older men have largely leveled off, after a long downward drift (see upper chart). Less widely recognized is the fact that the trend toward less work by older men continues, as more of them are now working part time rather than full time.



Male participation rates. Between 1948 and 1984 the labor force participation rate of men aged 65 and older dropped from 46.8 percent to 16.3 percent. The rate in 1997 was a slightly higher 17.1 percent. Among men aged 55 to 64, the decline began later, but shows a similar flattening out, with the rate in 1997 (67.6 percent) roughly the same as it was in 1985 (67.9 percent).



The changing character of participation. Although the fraction of men aged 55 to 64 in the labor force has been roughly constant, the proportion of this age group working part time has increased, especially among those in their early 60s (see lower chart). The population of men aged 55 to 64 also contains a rising share of pension recipients who continue to work after "retiring."

Factors encouraging part-time work. The part-time wages of older men have risen relative to those of younger men since 1980. In addition, the growth of the service sector, where jobs are less physically demanding and have more flexible schedules than in manufacturing, makes work at older ages more attractive than in the past. Employers also may be more willing to hire older workers in today's tight labor market. Finally, the shift away from defined-benefit pensions, which often provide strong incentives to retire at a certain age, and changes in Social Security rules that liberalized the earnings test and increased the payoff to postponing retirement beyond age 65 have removed many of the incentives to withdraw from the labor force abruptly and completely.

Factors encouraging pensioners to work. Those who were displaced or took early retirement buyouts during the recession of 1990-91 may now feel an income squeeze. In addition, employers have reduced retiree health insurance, increasing pensioners' out-of-pocket health care expenses. Workers are more able now than in the past to spend their pension funds for other purposes in advance of or at retirement. The shift to defined-contribution pension plans means that benefits are received in the form of lump-sum distributions upon termination of a job instead of as annuities, as in defined-benefit plans. In 1993, a fifth of those aged 55 to 64 who received lump-sum distributions spent the entire amount, and the percentage was much higher at younger ages.

What about women? Long-term trends in the labor force participation rates of older women show a much different pattern from those of men. During the past 50 years the rate for women aged 55 to 64 has doubled from 25 to 50 percent. This is largely due to the replacement of older cohorts in which fewer women worked outside the home by younger cohorts with higher labor force participation rates throughout their adult lives. Among women aged 65 and older, participation rates have hovered in roughly the 8 to 10 percent range for the past 50 years.

EYES ONLY

BOOK REVIEW

The Crisis of Global Capitalism by George Soros

Soros' new book is breathtaking in its intellectual scope. Ranging far beyond a mere analysis of the international financial system, it offers many thought-provoking observations. The author opines at one point that readers are probably attracted only by his success as an international investor. But the reader may in fact be most interested in the book for the information it provides about the inter-relationship between this role and Soros' other roles, as philanthropist and public intellectual.

Introspections of a speculator. To see this inter-relationship, consider the question of how Soros the philanthropist thinks about the social or moral implications for a country when Soros the speculator helps force its currency into crisis and devaluation. At least four possible answers seem to fit at one point or another.

- *Stop me before I speculate again.* The author, as intellectual analyst, makes clear his view that, at the end of the 20th century, market values have grown undesirably prominent compared with social values; that financial markets have become excessively volatile due to positive feedback from price movements to speculators' expectations; and that some sort of government intervention is appropriate. But the book in fact contains no specific proposal for a policy measure to slow down excitable financial markets (such as turnover taxes). Soros' proposal for an International Credit Insurance Corporation receives little explanation here and sounds more like a device to increase capital flows than like one to slow them down.

- *My investment positions generally work to push the markets in desirable directions. It is the activities of many others that I view as pot entially harmful.* Soros could plausibly defend this claim. Hedge funds in general, and Soros in particular, tend to make bets based on economic fundamentals and arbitrage opportunities, rather than on simple trend-following behavior. His fund's short-sales of sterling in 1992 arguably helped move Britain's exchange rate toward its proper equilibrium, and its short-sales of the Thai baht in early 1997 should have signaled a coming problem of the same nature, if the Thai authorities had paid attention. But the author never comes out and says explicitly that everything would be fine with financial markets if other investors operated as he does.

- *Because I devote a large share of my profits to charitable activities, I make up morally for any possible negative effects of my speculative activities.* This claim too could be sustained were he to make it. Soros' "Open Society" philanthropic activities in Eastern Europe and elsewhere tend to be innovatively and efficiently conceived. But he does not attempt this sort of self-justification for his investment operations, perhaps to his credit.

- *My speculative self is completely divorced from my philanthropic self.* This seems to be the author's preferred answer. These two personalities operate independently. "I try to be a winner as market participant and serve the common interest as a citizen and human being." But elsewhere he claims to have undertaken the synthesis: "I have made a conscious effort to integrate the various aspects of my existence [business, socially responsible and private personalities], and I am happy to report that I have been successful." How the personalities view each other remains a puzzle.

An experiment in the ruble. The section of the book that will be most fascinating to those following recent developments in emerging markets is titled "A Real-Time Experiment" and concerns Russia. The author, on August 9, 1998, interrupts his work on the manuscript and—in effect—turns to the reader and confides: *I see things are heating up in Russian markets. Let me take time out to show you how it is done.* He relates to the reader developments in Russia and his real-time phone conversations over the next 2 weeks with various key participants in both governments. Frustrated that his views on how to save Russia are not eliciting sufficient reaction from top policymakers, he publishes a letter in the *Financial Times* that includes the recommendation that Russia introduce a currency board after a modest devaluation of 15 to 25 percent.

Then the world's speculators, reading over their morning coffee that the financial wizard thinks the ruble is overvalued, and perhaps also inferring that Soros himself must have a large short position in rubles, flee from the Russian currency. (Such "market manipulation" is perfectly legal in international currency markets, though it would be illegal in domestic securities markets. Soros' fund was in fact long in ruble assets, in any case, as he takes pains to explain to the reader. One wishes he had included in the book a description of his next phone conversation with his fund manager!) To the author's horror, he has precipitated the very crisis he set out to prevent. On August 26—with the ruble devalued, Russian debts in default, and Prime Minister Kiriyenko having been fired—Soros in effect admits that his real-time experiment is a failure, and returns to writing the next chapter of his book (on how to reform the IMF so that it won't continue to make mistakes).

The lesson? The book's real lesson may be that it is difficult for an individual to try to buck trends that carry everyone else in the wrong direction. It is of little use for a speculator to diagnose correctly that a currency is overvalued and to take a short position accordingly, if simplistic trend-following behavior by other speculators leaves the currency even more overvalued when the time comes to close out his position. The author also laments that enlightened thinking is no more likely to predominate in the political process than it does within the market process. Policymaking is afflicted by problems of unintended consequences, self-interest, voter disaffection, money-dominated politics, and trend-following candidates promising what voters want to hear. Indeed, ultimately, "the political process is less effective than the market process in correcting its own excesses."

EYES ONLY

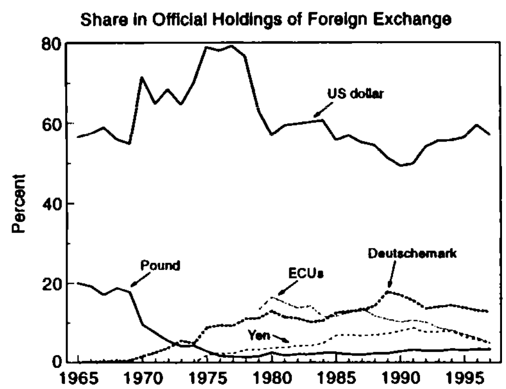
ARTICLE

The Buck Doesn't Stop Here: International Use of the Dollar

Although some measures show a gradual decline in its use, the dollar remains the world's pre-eminent international currency. This article discusses some of the advantages of this status. A follow-up in a future *Weekly Economic Briefing* will analyze how the emergence of the euro after January 1 might affect the dollar's standing.

What is an international currency? An international currency is one that is used outside its home country. Official uses include the holding of foreign exchange reserves by central banks ("reserve currency" use) and the pegging of minor currencies. Private-sector uses include invoicing imports and exports, denominating financial transactions, and serving as a medium of exchange in foreign countries (called "vehicle currency" use in the case of foreign exchange trading).

Official use of the dollar. The dollar's share of central bank reserve holdings declined from 72 percent in 1970 to 56 percent in 1990, as central banks gradually shifted their portfolio shares into marks and yen (see chart). It has been relatively stable since. Of minor currencies that peg, 39 percent peg to the dollar. The French franc ranks second in importance (29 percent of peggers, mainly in Africa). Only three currencies are pegged to the mark (those of Estonia, Bosnia, and Bulgaria). And no currencies anywhere are pegged to the yen.



Private-sector use of the dollar. More than half of funds raised in international capital markets are denominated in dollars. As of April 1998, 87 percent of foreign exchange transactions involved the dollar. Almost four times as much cash circulating among citizens abroad takes the form of dollars rather than DM, the nearest competitor. Wherever hyperinflation or social disorder undermine the public's faith in the local currency, the American dollar is the preferred alternative. (The drug trade and other illegal activities is another source of demand, of course.)

Benefits. Should a country care whether its currency is used internationally? The following are some of the advantages conferred on the United States by the dollar's status as an international currency:

- Convenience for residents. It is more convenient for a country's exporters, importers, borrowers, and lenders to be able to deal in their own rather than foreign currencies. The global use of the dollar, as with the global use of the

English language, is a natural advantage that American businessmen tend to take for granted.

- More business for banks and other financial institutions. There need be no tight connection from the currency in which banking is conducted to the nationality of the banks. Nevertheless, it stands to reason that U.S. banks have a comparative advantage at dealing in dollars.

- Seignorage. This may be the most important of the benefits. Just as American Express reaps profits whenever people hold its travelers' checks, which they are willing to do without receiving interest, so the United States profits whenever people in Argentina or Russia hold dollars that do not pay interest. A simple calculation suggests that the United States now derives about $13 billion a year in seignorage from foreign holdings of U.S. currency.

- Political power and prestige. These are decidedly nebulous. Nevertheless, historians sometimes identify key currency status and international creditor status, along with such non-economic factors as colonies and military power, as trappings of great powers. When the pound sterling lost key currency status, the end of the British Empire was not far behind.

- A strong dollar is good for America. Increased international use can be associated with an increase in demand for a currency, and thus an appreciation in its foreign exchange value. A strong dollar has positive effects on real income.

Disadvantages? In the past, some countries have been reluctant to have their currencies used widely abroad. One reason is potential instability from an increased variability of demand that might result from having one's currency held by a wide variety of people around the world. Central banks are sometimes concerned that internationalization will result in greater variability of the money supply or exchange rate. In the 1960s and 1970s, the Japanese and German governments were particularly worried about the possibility that if assets were made available to foreign residents, an inflow of capital would cause the currency to appreciate and render exporters uncompetitive in world markets. Some Europeans today are worried that international currency status for the euro might lead to a loss in export competitiveness for European firms.

Conclusion. The dollar is currently the dominant international currency. Overall, this probably entails some small benefits for the United States. A future analysis will examine whether the euro will pose a challenge to the dollar in this role.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Trends in Employer-Provided Health Insurance. The fraction of private-sector workers covered by their employers' health insurance plans declined from 72 percent in 1979 to 65 percent in 1997, with most of the drop occurring between 1988 and 1993, according to a recent study. The study found that the decline was driven primarily by declines in takeup for core (long-term, full-time) workers and declines in eligibility for peripheral (newly hired or part-time) workers. It found little change in the fraction of workers whose employers offered health insurance coverage to at least some workers. The authors conclude that these findings are consistent with the view that employers are continuing to make health insurance available to their core employees but are restricting it for peripheral employees. In 1997, for example, 98 percent of private-sector core workers in firms that offered health insurance were eligible for that coverage, while only 70 percent of peripheral workers were eligible.

What Do We Know about Life After Welfare? Serious data problems make it difficult to analyze what has happened to single mothers who have left the welfare rolls since welfare reform. But a recent study pulls together information from past studies of AFDC and a few recent geographically targeted surveys, to paint a likely (though speculative) picture. The study suggests that about two-thirds of those who left the welfare rolls in the past few years continued to receive some form of benefit (such as Medicaid or Food Stamps) in the first year after leaving, with the fraction declining to 35 to 45 percent after a few years. About two-thirds worked after leaving the rolls—most part-time, with hours worked per year rising over time. Wages were generally in the $6.50 to $7.00 per hour range. Growth in both wages and especially hours worked led to annual earnings increases of 6 to 10 percent. On average, family income of leavers without a spouse or cohabiting mate was between $14,000 and $17,000 (and was a few thousand dollars higher for those with a spouse or mate). Poverty rates fell over time as earnings and the number of leavers with partners increased. About 40 percent of the leavers remained poor a few years out.

Study Examines Effects of School Finance Reform. Funding for low-income school districts increased in the 1980s in states where the school financing system was earlier declared unconstitutional, according to a new study. Among the 12 states with adverse rulings, five switched to school-finance systems aimed at promoting greater equality. Increased state funding led to greater spending on education by poorer districts, with each additional dollar of state funding boosting district spending on education by between 50 cents and $1.00. Nevertheless, inequality in local revenues per student between richer and poorer districts widened in many states over the 1980s, partially offsetting the equalizing effects of changes in state aid formulas. The study also found some weak evidence of a modest equalizing effect of school-finance reforms on the test-score outcomes of children from different family backgrounds. The authors note that adverse court rulings did not necessarily have much effect on the general trend among states toward more "equalizing" funding formulas. For example, even among the 15 states whose systems were found to be constitutional, nine switched to more equal school financing between 1975 and 1991.

EYES ONLY

INTERNATIONAL ROUNDUP

Mitch Batters Central American Economies. Before being hit by Hurricane Mitch, both Honduras and Nicaragua appeared to have turned their economies around. Honduras had initiated policies in the 1990s that reversed a decade of economic decline in the wake of the debt crisis of the 1980s, and growth topped 4 percent in 1997. However, a lack of infrastructure has always been a major impediment to growth in Honduras, and Mitch is reported to have damaged roughly 60 percent of primary roads. Some estimates indicate that Honduras also lost nearly its entire banana crop and that total damage was equal to 40 percent of GDP. The storm damage is expected to take 2 percentage points off GDP growth in 1998 and produce a 2 percent contraction in 1999. The damage was less severe in Nicaragua, which emerged in the 1990s from war-torn economic chaos and began laying the foundations for economic growth. However, as the second poorest nation in the Americas, Nicaragua can ill afford any economic setback. Both countries depend upon storm-damaged agricultural exports for a large portion of their income and are likely to experience external imbalances in the short to medium term. Considerable damage to coffee trees might also entail longer-term consequences for exports.

OECD Holds Workshop on Modeling Climate Change. The proceedings of an OECD workshop on the economic consequences of climate change policies were released at the recent Buenos Aires Conference of Parties. The workshop was held with modelers from around the world as the OECD prepares to renew its own modeling efforts. Some key results were consistent across all models, including those from European and Japanese teams. One was the importance of emissions trading—and of including developing countries in trading—in order to lower the costs of meeting greenhouse gas emissions targets. This finding reinforces the conclusions drawn from American models, including the one used by the Administration. (All models assume that emissions trading is fully efficient and frictionless.) The conference also highlighted the need to incorporate specific features of the Kyoto Protocol, such as non-CO_2 greenhouse gases and carbon sinks, into future modeling work. The OECD has made the issue of climate change a priority and will continue to support economic analysis of this issue.

EC Criticizes U.S. Trade Policy, Again. As it has in the past few years, the European Commission in its *1998 Report on United States Barriers to Trade and Investment* cites extraterritoriality and unilateralism as two tendencies in U.S. trade policy that are of particular concern. The report extolls the strength of the Transatlantic economic relationship. But it also expresses EU opposition on grounds of law and principle to U.S. legislation that seeks to regulate non-U.S. companies and EU trade with third countries. The Commission also believes that the use of unilateral U.S. sanctions or retaliatory measures casts doubt on American support for the multilateral WTO-based trading system—though it admits the United States has resorted to unilateralism less in recent times and made greater use of WTO procedures. The report also criticizes various non-tariff barriers such as government procurement procedures, regulatory restrictions, and direct and indirect subsidies.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, December 4, 1998****

In November, the unemployment rate fell to 4.4 percent from 4.6 percent in October. Nonfarm payroll employment rose by 267,000.

Productivity

Nonfarm business productivity rose 3.0 percent at an annual rate in the third quarter. Manufacturing productivity rose 5.2 percent.

Leading Indicators

In October, the composite index of leading indicators increased 0.1 percent.

NAPM Report on Business

The Purchasing Managers' Index fell to 46.8 percent in November from 48.3 percent in October.

MAJOR RELEASES NEXT WEEK

Retail Sales (Friday)
Producer Prices (Friday)

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	3.9
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
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	**1997**	**Sept. 1998**	**Oct. 1998**	**Nov. 1998**
Unemployment Rate (percent)	6.7**	4.9**	4.6	4.6	**4.4**
Payroll employment (thousands)					
increase per month			172	145	267
increase since Jan. 1993					17273
Inflation (percent per period)					
CPI	5.8	1.7	0.0	0.2	N.A.
PPI-Finished goods	5.0	-1.2	0.3	0.2	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, December 4, 1998.**

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	Oct. 1998	Nov. 1998	Dec. 3, 1998
Dow-Jones Industrial Average	5743	7441	8164	9006	8880
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	3.96	4.42	4.34
10-year T-bond	6.44	6.35	4.53	4.83	4.58
Mortgage rate, 30-year fixed	7.80	7.60	6.71	6.87	6.71
Prime rate	8.27	8.44	8.12	7.89	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 3, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.673	-1.8	-5.5
Yen-Dollar	118.8	-2.5	-7.7
Multilateral $ (Mar. 1973=100)	94.88	-1.7	-3.3

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	3.5 (Q3)	**4.4** (Nov)	1.5 (Oct)
Canada	2.3 (Q3)	8.3 (Sept)	1.1 (Oct)
Japan	-3.5 (Q3)	4.4 (Sept)	0.2 (Oct)
France	2.8 (Q3)	11.6 (Sept)	0.5 (Oct)
Germany	2.7 (Q3)	[2/] 7.3 (Sept)	0.7 (Oct)
Italy	1.1 (Q2)	12.4 (Jul)	1.7 (Oct)
United Kingdom	2.3 (Q3)	6.3 (Jul)	3.1 (Oct)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, December 4, 1998.**

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 September 1998 is 9.5 percent.

EYES ONLY

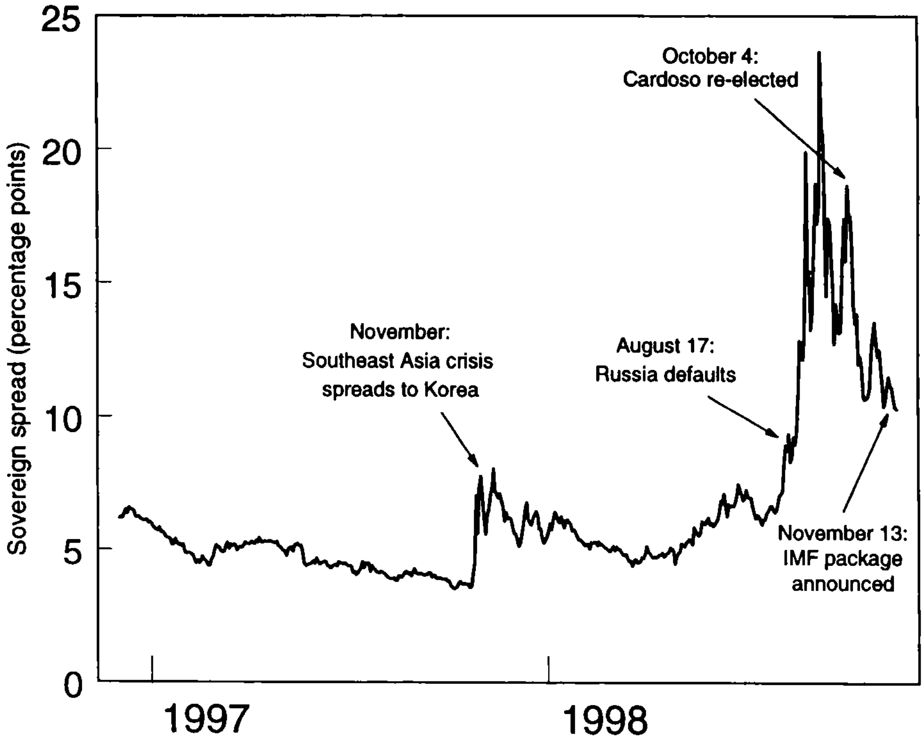
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 20, 1998

CHART OF THE WEEK

The Risk Premium on Brazilian Debt



The difference between yields on Brazilian Brady bonds and those on comparable U.S. Treasury notes reflects conditions specific to Brazil, but it also reflects international investors' attitudes toward risk more generally. The recent drop in the spread may indicate a somewhat improved outlook. The spread remains high, however.

EYES ONLY

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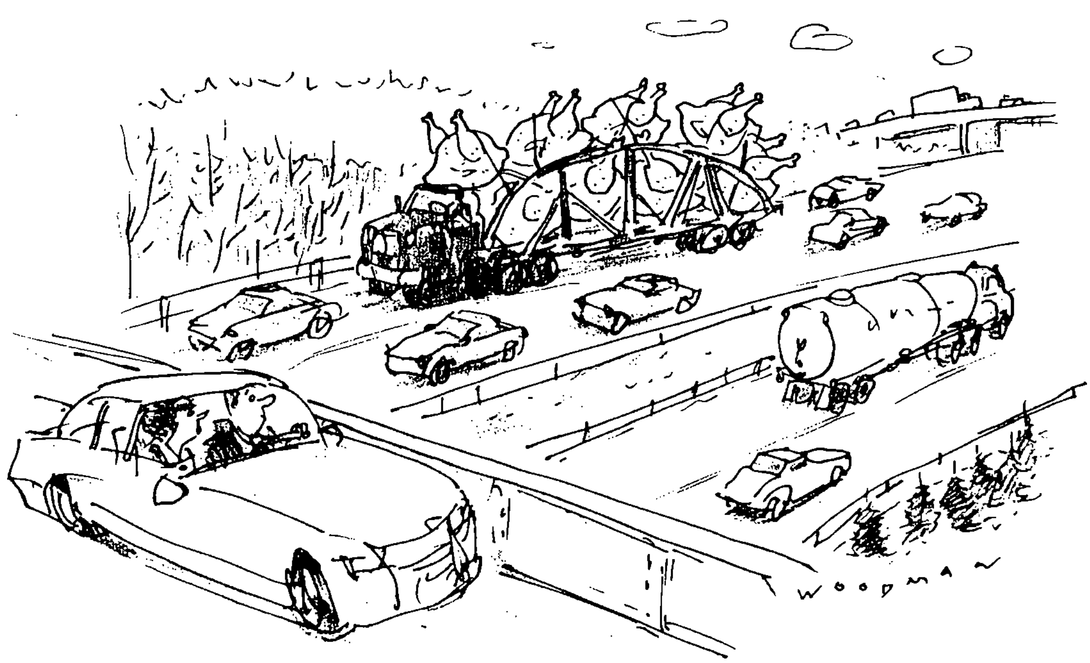
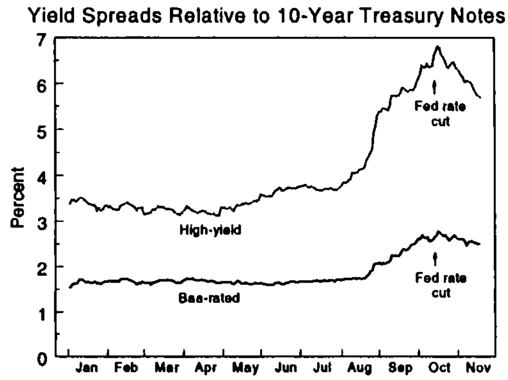


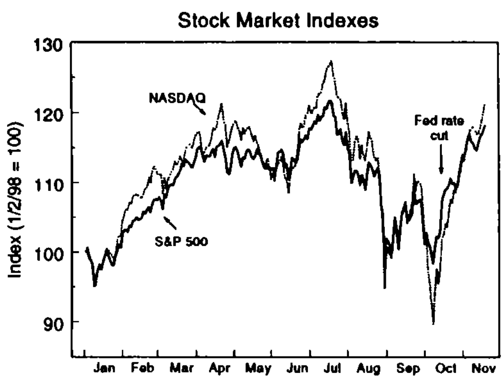
EYES ONLY

CURRENT DEVELOPMENT

Financial Market Conditions Are Improving

The Federal Reserve cut interest rates on Tuesday, explaining that conditions in financial markets have settled down since their last rate cut but "unusual strains" remain.





Risk spreads. Between mid-July and mid-October, spreads between yields on corporate bonds and Treasury notes widened dramatically, with an especially large increase for riskier corporate debt (see upper chart). Investment-grade spreads are little changed since the Fed's October 15th rate cut, but high-yield spreads have fallen noticeably.

Stock prices. Most major stock market indexes hit record highs in mid-July and then lost roughly a fifth of their value by the end of August (see lower chart). They have moved up sharply since early October.

Less market stress. Other indicators have also improved since mid-October. Bid-ask spreads have narrowed. The yield spread between more- and less-liquid Treasury securities, which rose substantially in September and early October, has now diminished. Corporate debt issuance, which was virtually nil in the first part of October, has picked up. Also, business borrowing from banks has risen rapidly, even though banks report tightening credit terms and standards.

Is the Fed on hold? The Fed seemed to signal that further rate cuts should not be expected, noting that "with the 75 basis point decline in the Federal funds rate since September, financial conditions can reasonably be expected to be consistent with fostering sustained economic expansion." Still, prices of Federal funds futures contracts indicate that market participants put roughly even odds on a further ¼ percentage point reduction by February.

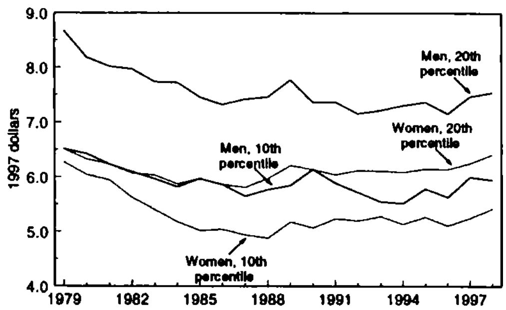
EYES ONLY

SPECIAL ANALYSIS

Labor Market Gains for Low-Wage and Minority Workers

Recent CEA analysis provides hopeful signs of wage and employment gains for low-wage and minority men over the past 2 years. Though long-term trends differ for women, they too have shared in the recent gains.

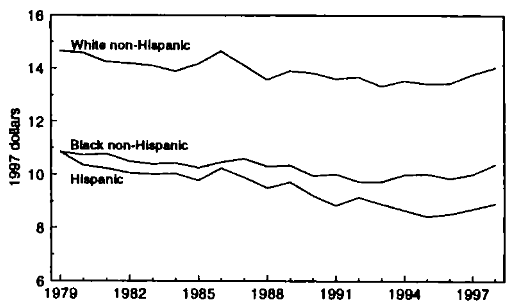
Hourly Wages of Low-Wage Workers by Sex
1979-1998



Note: 1998 estimate is average of first 8 months.

Low-wage workers. After two decades of decline, the real wages of low-wage men bottomed out in the mid-1990s (see upper chart). Since 1996, the real hourly wage at the 10th percentile of the men's distribution has increased an estimated 5.7 percent, while that at the 20th percentile has risen 5.3 percent.

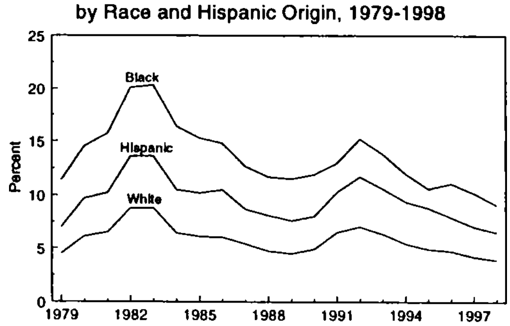
Hourly Wages of Men Aged 16 and Over by Race
1979-1998



Note: 1998 estimate is average of first 8 months.

Race. Black, Hispanic, and white men have all achieved wage gains recently (see middle chart). The gain for black men in 1998 may turn out to be the largest single-year improvement in the last two decades. Nevertheless, the wage gap between these minorities and white workers remains large: the median wage of whites is 35 percent higher than that of blacks and 58 percent higher than that of Hispanics.

Unemployment Rates of Men Aged 16 and Over
by Race and Hispanic Origin, 1979-1998



Note: 1998 estimate is average of first 10 months.

Unemployment. Unemployment rates have fallen to very low levels for blacks, Hispanics, and whites (see bottom chart). The average unemployment rate for black men aged 16 and over has averaged 9.1 percent thus far this year, pointing toward an annual rate that would be the lowest since 1973. For Hispanic men aged 16 and over, the rate has averaged 6.5 percent this year, compared with a previous low of 6.7 percent in 1973.

A new trend? Recent wage and employment gains for low-wage and minority workers are impressive. With only a few years of data, however, it is too soon to tell whether the gains achieved in the current exceptionally strong labor market represent the long-term reversal of a sustained period of declining real wages for those at the bottom of the wage distribution or just short-term cyclical effects.

EYES ONLY

ARTICLE

Another Challenge for Telecommunications Regulation

An important goal of the Telecommunications Act of 1996 was to spur new entry into the market for local telephone service. While little competition has emerged as yet in the market for basic service, the Act has sparked rivalry in the provision of advanced telecommunications services to businesses. This new market has created both large consumer benefits and difficult regulatory issues.

The new competition. Competing providers are now vying to provide high-speed Internet access and data transport to firms (and individuals) that value the ability to find and retrieve information quickly. New entrants lease customer lines and other essential facilities from the incumbent local phone company in order to provide their services. New providers of "digital subscriber line" (DSL) service, for example, place special equipment in an incumbent's switching office and use that equipment to transport information at high-speed through the existing copper lines that link the incumbent's switching office to subscribers.

Threats to competition. Incumbent local phone companies ("ILECs") not only provide necessary inputs to the new competing local carriers ("CLECs") but also offer advanced services themselves. As a result, new competitors argue, the incumbent can put them in a "price squeeze" by charging them more for necessary inputs than it charges itself. Moreover, a competitor would have to charge a price that includes both the cost of the line and the cost of the advanced service, whereas the incumbent is already recovering its line costs in the price it charges for basic voice service and could price enhanced services at their incremental cost. Thus, incumbents might offer low-priced service bundles that benefit consumers in the short run but deter competition in advanced services in the long run.

Is regulation necessary? One policy response is simply to let ILECs provide advanced services on an unregulated basis and exploit complementarities between lines of business—what economists call economies of scope—regardless of the impact on competitors. This might make sense, for example, if scope economies are sufficiently large or competition from outside the phone network—perhaps from cable systems that have already entered the advanced-services market—is sufficiently strong. The Federal Communications Commission is currently investigating whether the incumbents' advanced-service businesses should be regulated in order to protect competition. (No position is being taken here on the proper outcome of the FCC's proceeding or on the implications of these issues in other legal or regulatory forums.)

Regulatory tradeoffs. FCC regulation would most likely entail a choice between rules for direct monitoring of the prices and terms of incumbents' advanced-service offerings and rules requiring that incumbents offer advanced services only through separate subsidiaries that deal at arm's length with their parent firms. The goal would be to ensure that the price for ILEC data services includes the same costs for lines and other inputs that the CLECs must pay, in principle removing the potential for a price squeeze. One risk of either direct or structural separation is loss of beneficial economies of scope. A further practical difficulty—though one that has been surmounted in other contexts—is in drawing the line between parent and subsidiary. Economic logic requires that all inputs to advanced services over which the ILEC has a monopoly be assigned to the regulated parent, while only competitive functions reside in the subsidiary. Of course, distinguishing competitive and monopoly elements will be challenging in a fast-changing, high-technology industry like telecommunications.

Conclusion. The 1996 Telecommunications Act anticipated that new market developments would raise regulatory issues that could not be addressed in advance by statute. It accordingly left such unforeseen problems to the FCC for resolution. The nascent market for advanced, local telecommunications services provides a test case for this approach. Rules to protect new competitors might reduce economies of scope, but the lack of such guidelines might lead to an extension of market power from basic to advanced services. Where lies the long-run balance of consumer benefits is the question to be resolved.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Steel Imports Decline in September. Steel imports fell 8 percent in September, to $2.1 billion. This returns them to their June level, but they remain 18 percent higher than in September 1997. The net tonnage of imports declined 13 percent, even more than the dollar value. Tons imported from Brazil fell, those from Russia remained essentially flat, and those from Japan increased. All remain higher than a year ago.

Import Prices Level Out in October, but Export Prices Continue to Fall. Non-oil import prices were unchanged last month and have fallen 3.9 percent over the past year. Export prices were down 0.1 percent, bringing the 12-month decline to 4.0 percent. The favorable effects of lower import prices on U.S. inflation have been widely noted, as have the pressures put on competing U.S. producers. The analogous effects of declining export prices have been less widely noted. Prices of agricultural exports were up slightly in October but still showed a decline of 11.5 percent over the last year. Asian deflation and past dollar appreciation have contributed to the declines in both import and export prices.

A Case of Productivity-Enhancing Pollution Abatement. Oil refineries in the Los Angeles (South Coast) air basin increased their productivity between 1979 and 1992, despite increased air quality regulation and unprecedented pollution abatement expenditures. In fact, according to a recent study, rising productivity among South Coast refiners occurred at the same time refinery productivity was falling in other regions, suggesting that the abatement investments contributed to the productivity growth. The study concludes that estimates of the cost of regulation that rely on gross abatement costs without netting out productivity gains could be substantially overstated. The authors also confront an obvious puzzle: why did it require regulation for companies to adopt new technology that was truly more productive? One possibility is that the capital costs associated with the new technology are high enough that plants in other regions not subject to regulation as strict as that in the South Coast district would not find it profitable to adopt the technology voluntarily. A second, somewhat related explanation is that the costs of abatement are sufficiently high that plants outside the South Coast district would prefer to wait and see how successful the new technology is before adopting it. The authors found support for both hypotheses in discussions with environmental engineers.

Thanksgiving Economics. Turkey consumption in the United States has taken flight, rising 80 percent since 1980. But some of this increased demand has been gobbled up by foreign producers. In 1997, the United States ran a $7.2 million trade deficit in live turkeys (all live turkey imports came from Canada). Despite an additional, $6.2 million deficit in cranberries, the U.S. trade balance was not entirely squashed by the traditional turkey-and-trimmings Thanksgiving dinner—we did enjoy a $3.6 million surplus in sweet potatoes. North Carolina has carved out roughly a fifth of the market for domestically produced turkeys, followed by Minnesota, Missouri, and Arkansas. Wisconsin is the top cranberry producer, followed by Massachusetts and New Jersey.

EYES ONLY

INTERNATIONAL ROUNDUP

OECD Trims Its Growth Forecasts. The latest *OECD Economic Outlook* projects cumulative growth for 1998-99 that is a full percentage point lower than the March forecast. Growth is now expected to be 2.2 percent in 1998 and 1.7 percent in 1999 in the OECD. It is expected to slow to 1.5 percent in 1999 in the United States and to 2.2 percent in the EU. It is expected to reach 0.2 percent in Japan.

Falling Prices in Europe. Germany's consumer price index dropped 0.2 percent in October and the press is reporting provisional estimates of a possible small decline in France. These reports have triggered fears that the core of the European economy might be on the verge of deflation.

Brazilian Interest Rates Decline. Brazil raised interest rates to nearly 50 percent in September to prevent capital flight, and the economy has begun to show the effects of these high rates. For example, industrial production in September was 6 percent lower than it was a year ago. The official interest rate was lowered just prior to last Friday's announcement of the international support package for Brazil. Since the announcement, the government has been expected to target further substantial reductions in domestic interest rates. Given the size of domestic debt outstanding, the government saves nearly $1.5 billion in annual interest payments for every 100 basis point decline. Spreads on Brazil's international debt have also declined by nearly 80 basis points since Friday's announcement (see the Chart of the Week).

World Bank Approves $3 Billion in Loans to Argentina. In order to safeguard Argentina's social and economic advances from the adverse impact of unsettled financial markets, the World Bank recently approved two loans to that country totaling $3 billion. The loans aim to improve domestic finance, credit, and capital markets and to safeguard social protection programs. A Special Repurchase Facility was given $500 million to provide the central bank with funds to finance short-term liquidity support for domestic banks. Because of its currency board system, the Argentine banking sector is particularly exposed to shortfalls in capital flows.

EU Gets a Poor Competitiveness Report Card. Europe lags behind the United States in virtually all measures of competitiveness, according to a new report submitted to the European Commission. Faster productivity growth in the EU than in the United States since 1970 has been offset by slower employment growth and an inability to move quickly into promising new industries. As a result, the EU standard of living remains 33 percent lower than that of the United States, and its employment rate trails significantly as well. The report cites rigidities in labor markets, high costs of basic services (such as energy, transportation and communication), and lack of adequate risk capital as major reasons for Europe's sluggishness. The report recommends eliminating structural and regulatory barriers in financial, labor, and product markets—in order to spur innovation and entrepreneurship—and warns against "picking winners," that is, providing subsidies or trade protection to particular industries.

EYES ONLY

RELEASES THIS WEEK

Housing Starts

Housing starts rose 7 percent in October to 1.695 million units at an annual rate. During the first 10 months of this year, housing starts were 10 percent above the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $14.0 billion in September; it was $15.9 billion in August.

Consumer Price Index

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

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production declined 0.1 percent in October. Capacity utilization fell 0.4 percentage point, to 80.6 percent.

MAJOR RELEASES NEXT WEEK

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

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	3.3
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	3.5	0.3	2.3
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	3.4
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	13.0
Personal saving	5.2	1.5	0.9	0.3	0.1
Federal surplus	-2.7	-0.3	0.7	0.9	N.A.

	1970-1993	1997	August 1998	September 1998	October 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.6	4.6
Payroll employment (thousands)					
increase per month			322	157	116
increase since Jan. 1993					16962
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.0	**0.2**
PPI-Finished goods	5.0	-1.2	-0.4	0.3	0.2

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	September 1998	October 1998	Nov. 19, 1998
Dow-Jones Industrial Average	5743	7441	7910	8164	9056
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.61	3.96	4.35
10-year T-bond	6.44	6.35	4.81	4.53	4.85
Mortgage rate, 30-year fixed	7.80	7.60	6.72	6.71	6.86
Prime rate	8.27	8.44	8.49	8.12	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 19, 1998**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.685	-0.5	-2.9
Yen-Dollar	119.7	-2.5	-6.0
Multilateral $ (Mar. 1973=100)	95.49	-0.8	-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	3.4 (Q3)	4.6 (Oct)	1.5 (Oct)
Canada	2.9 (Q2)	8.3 (Sept)	0.9 (Sept)
Japan	-1.8 (Q2)	4.4 (Sept)	-0.2 (Sept)
France	3.1 (Q2)	11.6 (Sept)	0.6 (Sept)
Germany	2.5 (Q2)	[2] 7.3 (Sept)	0.8 (Sept)
Italy	1.1 (Q2)	12.4 (Jul)	1.8 (Sept)
United Kingdom	2.5 (Q3)	6.3 (Jul)	3.2 (Sept)

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 September 1998 is 9.5 percent.

EYES ONLY

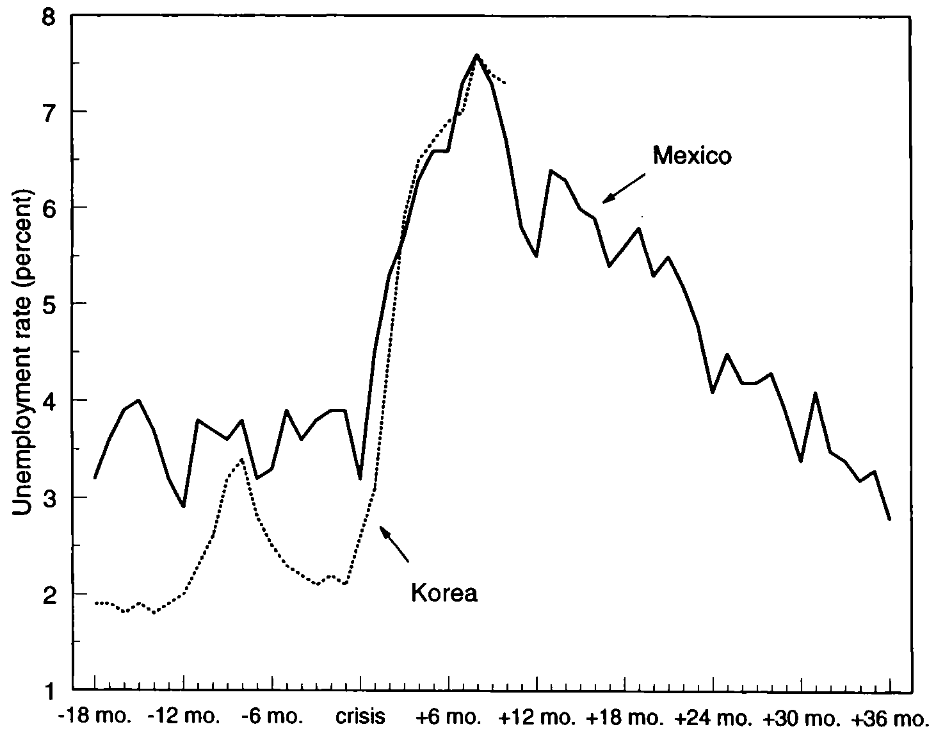
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 13, 1998

CHART OF THE WEEK

A Turnaround in Korea?



Korean unemployment appears to have peaked 8 months after the country was hit by the East Asian crisis. Remarkably, unemployment in Mexico also peaked 8 months after it was hit by the peso crisis of December 1994. The correspondence in timing (and level) is to some degree coincidental, and Korea's economic future is uncertain. Nevertheless, the pattern is consistent with other evidence that an economic recovery may have begun in Korea, much as it did in Mexico in 1995.

EYES ONLY

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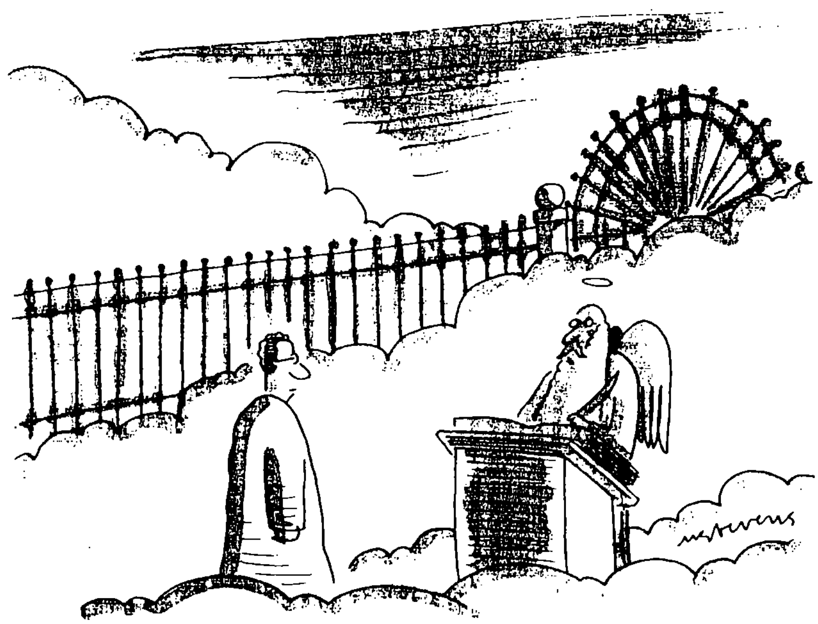


"Any fruits or vegetables?"

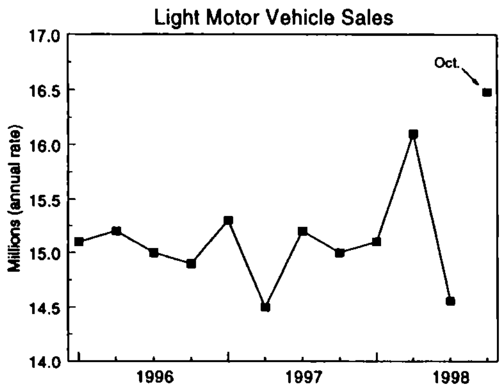
EYES ONLY

MACROECONOMIC UPDATE

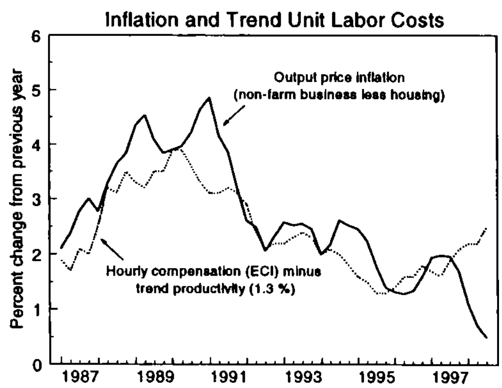
Solid Performance Continues into the Fourth Quarter

Real GDP grew at a 3¼ percent pace in the third quarter, and early indications are that growth in the fourth quarter will be similar.

Production and sales. Production-worker hours jumped in October to well above their third-quarter average, and sales of light motor vehicles rebounded (see upper chart). The strength in motor vehicle sales partly reflected generous price incentives, but automakers responded by increasing fourth-quarter assembly schedules. The planned increase in motor vehicle production will add more than a percentage point to fourth-quarter GDP growth. Although consumer confidence has declined from earlier lofty levels, the latest retail sales figures point to continued growth in non-auto consumer expenditures as well.



Prices and wages. Prices in the nonfarm business sector rose less than 1 percent over the past year. At the same time, hourly compensation in private industry, as measured by the employment cost index, rose 3.8 percent. This gap between prices and wages is unusually large. Until recently, trend unit labor costs (defined as hourly compensation less a 1.3 percent productivity trend) have tended to match the rate of increase of business prices (see lower chart). Part of the reason wage increases have not put more pressure on prices is that productivity has grown faster than its longer-term trend over the past year. In addition, profits as a share of GDP are very high by historical standards and some wage increases have been offset by reduced profits. Over time, however, continued strong wage growth without inflation will require even faster productivity growth or a further erosion of profits.



EYES ONLY

SPECIAL ANALYSIS

Genetically Engineered Foods and Consumer Choice

Genetically engineered foods are currently being produced and eaten in the United States. Nevertheless, there is little empirical evidence that genetically engineered foods have been widely accepted by Americans.

What is genetic engineering? Genetic engineering is the biochemical manipulation of genes or DNA. It is just one type of biotechnology, though the two terms are often used interchangeably. Examples of genetically engineered crops include Flav'r Sav'r tomatoes and New Leaf Superior potatoes. Other genetically engineered products include chymosin for cheese making and bovine somatotropin (rBST) for promoting milk production. Foods such as "broccoflower" are not genetically engineered, though they do involve hybridization, a form of biotechnology.

American attitudes. A summary of the results of a number of consumer surveys regarding attitudes toward one type of genetic engineering (rBST) found that 57 percent of the survey respondents were negatively inclined toward its use. Ten percent stated that they would stop purchasing milk if rBST were introduced. An auction study in which participants used real money revealed similar results: 47 percent of the participants were willing to pay something to move from rBST milk to non-rBST milk, and 15 percent were willing to pay a substantial amount. In other studies, an overwhelming majority of adults indicated a desire to be informed about whether genetic engineering had been used in producing their food.

To label, or not to label? These survey results suggest that at least some consumers would value information about whether the food they buy is genetically engineered. Mandatory labeling of genetically engineered foods for safety reasons is considered unnecessary in the United States because the regulatory process requires that only foods that are safe for consumption be made available to consumers. However, voluntary labeling of non-engineered foods could increase consumer welfare. Many labels cater to specific consumer concerns. Examples include "kosher" or "organic" labels, or labels that provide information about "dolphin-safe nets" or "no animal testing." The advantage of voluntary labeling is that consumers who place a value on knowing that their food is non-engineered would pay the premium for the labeling (as well as the extra costs associated with the production process). Problems with the voluntary labeling of non-engineered foods arise in assuring the accuracy of the claim.

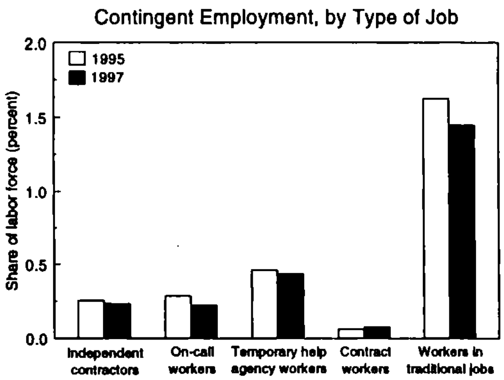
A first step? The first step toward establishing a voluntary "not genetically engineered" label may already have been taken (though perhaps inadvertently). The Department of Agriculture has announced that its revised proposed rule on organic standards will not allow foods produced with genetic engineering to bear the organic label. If this proposed rule is adopted, the voluntary organic label will thus also signify non-engineered food.

SPECIAL ANALYSIS

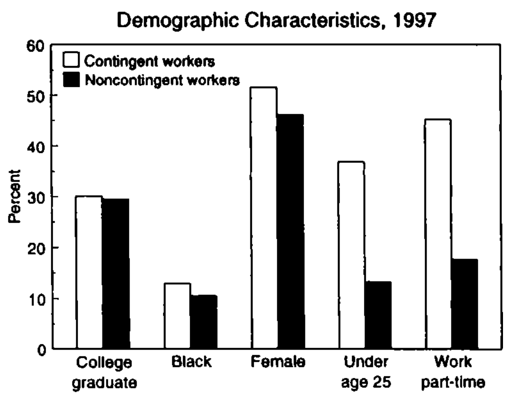
No Trend in Contingent Work

Are employment patterns shifting toward more temporary work arrangements that might result in lower paying and less stable jobs? No, at least according to the most recent data on contingent employment.

A small share of total employment. Contingent employment is defined by the Bureau of Labor Statistics as employment without an implicit or explicit long-term contract. The BLS has conducted two surveys of such employment. The first, in 1995, found that the share of contingent employment was relatively small. The second, in 1997, found that it was not increasing. About 2.4 percent of the labor force (3 million workers) was in contingent work in February 1997, a slightly smaller share than in February 1995. Forty percent of contingent workers in 1997 were in alternative work arrangements, including independent contractors, on-call workers, temporary help agency workers, and workers provided by contract firms. None of these categories of contingent workers comprised more than 0.5 percent of the labor force (see upper chart). A majority of contingent workers were in traditional jobs.



A diverse set of workers. Contingent and noncontingent workers were strikingly similar in terms of educational attainment and race (see lower chart). Also, contingent workers were employed in a wide variety of occupations, belying the view that all contingent jobs are low-skilled. The most fundamental difference was age: persons under age 25 made up 37 percent of contingent workers but only 13 percent of noncontingent workers.



Hours and earnings. Forty-five percent of contingent workers were employed part-time, compared with only 18 percent of noncontingent workers. Contingent workers also earned less, with median weekly earnings that were only 69 percent as large as those of noncontingent workers—though differences in age and hours worked appear to account for much of the earnings gap. Regardless of age, however, contingent workers were less likely to be offered health insurance or a pension plan by their employers.

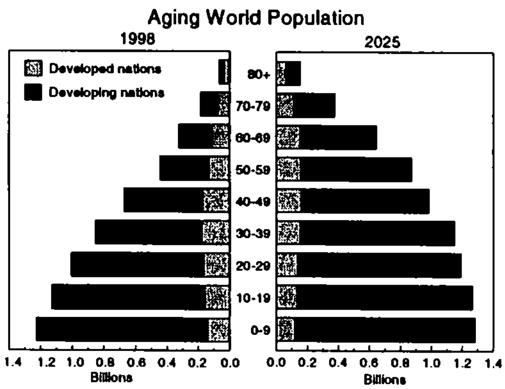
A matter of choice? The majority of contingent workers would have preferred noncontingent jobs, though more than one-third preferred their current arrangements. More specific data from 1995 show that half of contingent workers accepted their contingent jobs for personal reasons such as wanting a flexible work schedule or being in school or training. Thus, even though contingent work is not a preferred choice for many people, it may allow them to balance their work and their non-labor-market activities.

ARTICLE

Population Aging: A Global Phenomenon

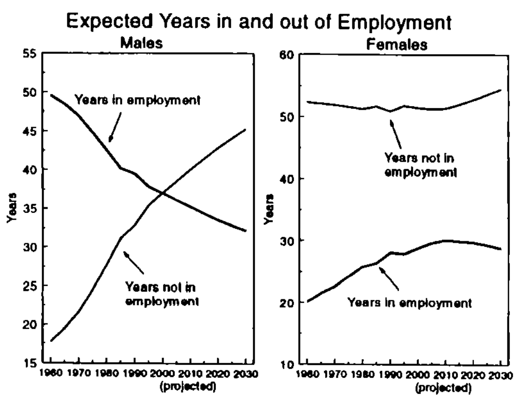
Just as vast improvements in health and longevity characterized the early 1900s, declining fertility rates have shaped the world's populations during the latter half of the century. Moving into the 21st century, the confluence of these two global trends will make population aging a dominant demographic phenomenon—and a major challenge to policymakers—around the world.

Aging naturally. Worldwide population aging (the rising share of older people) is a natural result of better health and nutrition and of lower fertility and infant mortality rates. While life expectancies have grown, fertility rates in some developing nations have fallen as much as 50 percent in the past 30 years. By 1996, 28 developing nations including China had rates below the 2.1 live births per woman required for population replacement.



Middle-aged bulge. The result of these trends in life expectancy and fertility is a shift toward the older ages across the world's populations. Over the next 30 years this will show up as a bulge in the number of middle-aged men and women (see upper chart). The developed nations are aging sooner, due to earlier changes in longevity and fertility, but the elderly population will grow faster in the developing world.

Lives of leisure? One challenge developed societies will face is the changing work and retirement choices of the elderly. An OECD study of 26 member countries predicts that, in the absence of policy changes, the number of working years in a man's lifetime will be surpassed by years not working (see lower chart). For women, the number of working years is projected to level out. These changes in part reflect the strong incentives to retire in many European countries. For example, between 1960 and 1995, the average age of male retirement fell more than 6 years in Spain, the Netherlands, and Finland. In the United States, by contrast, where more of the elderly have been choosing part-time or part-year work rather than abrupt retirement, the decline was only 2.9 years.



Who will care? Another global challenge will be caring for the rapidly growing "oldest old" (those aged 80 and above), who use disproportionate shares of health and long-term care. In many cases, they will be cared for by adult children themselves nearing retirement age, or even by an elderly spouse. (A 1992 survey found that 22 percent of those aged 75 and older in the United States were givers of care, typically to spouses in poor health.) Between today and 2025, the parent support ratio (the number of oldest old per 100 persons aged 50 to 64) will rise from 19 to 27 in developed countries as a group and to 42 in Japan. The relative shortage of available kin will hit East Asia especially hard, due to cultural expectations of filial support and the traditional absence of state involvement. In South Korea, for example, as the parent support ratio doubles from 7 to 15, the share of elderly widows with no surviving son will also double from 15 to 30 percent.

Conclusion. Never before have so many people in so many societies lived for so long. As much as population aging is a blessing of increased longevity and survival in all age groups, it also represents a fundamental shift in social structure that may affect labor markets, family structures, and even the social contract among generations. Many societies will face the difficult tasks of overturning tradition and redefining the roles of family and government in caring for their elders.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Employee Absenteeism Jumps to 7-Year High. Unscheduled absenteeism by American workers has reached its highest level in 7 years, according to a new survey of human resources executives. The overall average unscheduled absenteeism rate (defined as total paid sick hours divided by total paid productive hours) was estimated to be 2.9 percent this year, up from 2.3 percent last year. For the first time, "family issues" replaced "personal illness" as the most frequently cited reason for unscheduled absences, with "personal needs" third. Although employers acknowledged that more flexible time-off programs had a positive effect in reducing last-minute no-shows by employees, these programs have not been widely instituted. Paid time-off programs, which provide employees with a bank of hours to be used for various purposes instead of traditional separate accounts for sick, vacation and personal time, were seen as the most effective means for controlling unscheduled absences, but only 25 percent of organizations surveyed reported having implemented such a program, most within the last 2 years.

New Study Examines Non-Financial Corporations' Use of Derivatives. About half of the non-financial corporations surveyed in a recent study used derivatives (forwards, futures, options, or swaps). Although the proportion of companies using derivatives showed little trend between 1994 and 1998, companies that used derivatives appeared to be increasing their intensity of use. More than 80 percent of the large firms surveyed used derivatives, compared with just 12 percent of the small firms. By industry, primary product firms were the most likely users (68 percent). This is probably not surprising in light of the fact that futures exchanges were originally established to help manage commodity risks. Use of derivatives was less prevalent in manufacturing (48 percent) and services (42 percent). In those industries, use was most likely driven by the growing need to manage foreign exchange exposure, according to the report. In fact, foreign exchange exposure was the risk most commonly managed with derivatives, and 83 percent of all firms that used derivatives reported foreign exchange risk management as one of their uses. At the time of the survey, in early 1998, 27 percent of the firms ranked market risk (defined as unforseen changes in the market value of derivative positions) as their most serious concern.

Front Office Millionaires. CEO total compensation packages of more than $1 million were quite prevalent in 1997, according to the Conference Board's latest annual survey of executive compensation. The survey, which covered 1,711 companies in 14 major industries, looked at both current compensation (salary plus bonus) and total compensation (which includes the annual value of stock options and other long-term incentives). Median CEO total compensation was more than $1 million in five industries: insurance, communications, telecommunications, energy, and financial services. Median CEO total compensation was a mere $600,000 or so in construction and retail trade.

EYES ONLY

INTERNATIONAL ROUNDUP

Japanese Interest Rates: Less Than Zero. Last week some Japanese nominal interest rates were negative, implying that lenders received fewer yen back than they lent. This highly unusual situation is perhaps the most dramatic reflection yet of concern about the health of Japanese banks. Analysts note that Japanese banks seeking to increase their year-end overseas dollar assets have faced increasingly unfavorable terms on direct dollar loans. As a result, the banks have obtained local yen financing and then exchanged yen deposits with foreign banks for dollars of comparable maturity (in transactions called "currency swaps"). Foreign banks, however, face few attractive alternatives for investing their yen deposits. Concern over the health of the banking sector makes it undesirable to hold yen deposits with Japanese banks, and withdrawing massive amounts in cash is not a practical option. As a result, many have turned to short-term Japanese treasuries, and prices of 6-month bills rose so high last week (relative to their par redemption value) that yields dipped into negative territory. Accordingly, foreign banks have begun to offer even more negative rates to the Japanese banks.

Fire Sales for Asian Assets? In what may be the world's biggest-ever 1-day asset sale, Thailand announced that it will auction off more than $10 billion of loans seized from bankrupt finance companies last year. This was good news for those worried that the sale would be postponed, thwarting progress on corporate restructuring. But some Thai bankers and politicians would still prefer that the sale be delayed, because they are hopeful of an economic recovery and a rebound in asset prices. Meanwhile, Indonesian banks were given a reprieve from a possible fire sale when the government announced that it would allow central bank loans made earlier this year to be paid back over a multi-year period. President Habibie had pushed for complete cash reimbursement within a year, but domestic and IMF concerns over political and economic repercussions led to the adoption of a more flexible repayment schedule.

Good News from Canada, but Doubts Linger. Canada reported an unemployment rate of 8.1 percent in October, its lowest level in 8 years. This better-than-expected report followed an earlier announcement that Canadian GDP had risen 0.7 percent in August after 4 months of decline—though some analysts worried that the statistics reflected a rebound from the GM strike rather than more meaningful improvements.

UN Reports Continued Growth in FDI. Global foreign direct investment (FDI) continued to grow in 1997 despite the emergence of the Asian crisis, according to the 1998 *World Investment Report* from the United Nations. Inflows increased 19 percent to reach a new record of $400 billion. The sum of inward and outward FDI stocks is now equal to 21 percent of global GDP; foreign affiliate exports are one-third of world exports; and the production of foreign affiliates accounts for 7 percent of world GDP. Liberalization of FDI policies in developing countries does not seem to have been impeded by the Asian crisis, according to the report. The proliferation of bilateral treaties and the creation of new regional markets and investment areas have contributed to this liberalization.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, November 13, 1998****

The producer price index for finished goods increased 0.2 percent in October. Excluding food and energy, producer prices increased 0.1 percent.

Retail Sales

****Embargoed until 8:30 a.m., Friday, November 13, 1998****

Advance estimates show that retail sales increased 1.0 percent in October following an increase of 0.3 percent in September. Excluding sales in the automotive group, retail sales rose 0.5 percent following an increase of 0.1 percent.

Productivity

Nonfarm business productivity rose 2.3 percent at an annual rate in the third quarter. Manufacturing productivity rose 3.7 percent.

MAJOR RELEASES NEXT WEEK

Industrial Production and Capacity Utilization (Monday)
Consumer Prices (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)
Housing Starts (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	3.3
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	3.5	**0.3**	**2.3**
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	**3.4**
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	13.0
Personal saving	5.2	1.5	0.9	0.3	0.1
Federal surplus	-2.7	-0.3	0.7	0.9	N.A.

	1970-1993	**1997**	**August 1998**	**September 1998**	**October 1998**
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.6	4.6
Payroll employment (thousands)					
increase per month			322	157	116
increase since Jan. 1993					16962
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.0	N.A.
PPI-Finished goods	5.0	-1.2	-0.4	0.3	**0.2**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, November 13, 1998.**

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	September 1998	October 1998	Nov. 12, 1998
Dow-Jones Industrial Average	5743	7441	7910	8164	8830
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.61	3.96	4.37
10-year T-bond	6.44	6.35	4.81	4.53	4.77
Mortgage rate, 30-year fixed	7.80	7.60	6.72	6.71	6.93
Prime rate	8.27	8.44	8.49	8.12	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 12, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.693	2.1	-1.8
Yen-Dollar	122.8	4.5	-2.6
Multilateral $ (Mar. 1973=100)	96.24	2.4	0.2

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	3.4 (Q3)	4.6 (Oct)	1.5 (Sept)
Canada	2.9 (Q2)	8.3 (Sept)	0.9 (Sept)
Japan	-1.8 (Q2)	4.4 (Sept)	-0.2 (Sept)
France	3.1 (Q2)	11.6 (Sept)	0.6 (Sept)
Germany	2.5 (Q2)	[2] 7.4 (Aug)	0.8 (Sept)
Italy	1.1 (Q2)	12.4 (Jul)	1.8 (Sept)
United Kingdom	2.5 (Q3)	6.3 (Jul)	3.2 (Sept)

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 August 1998 is 9.6 percent.

EYES ONLY

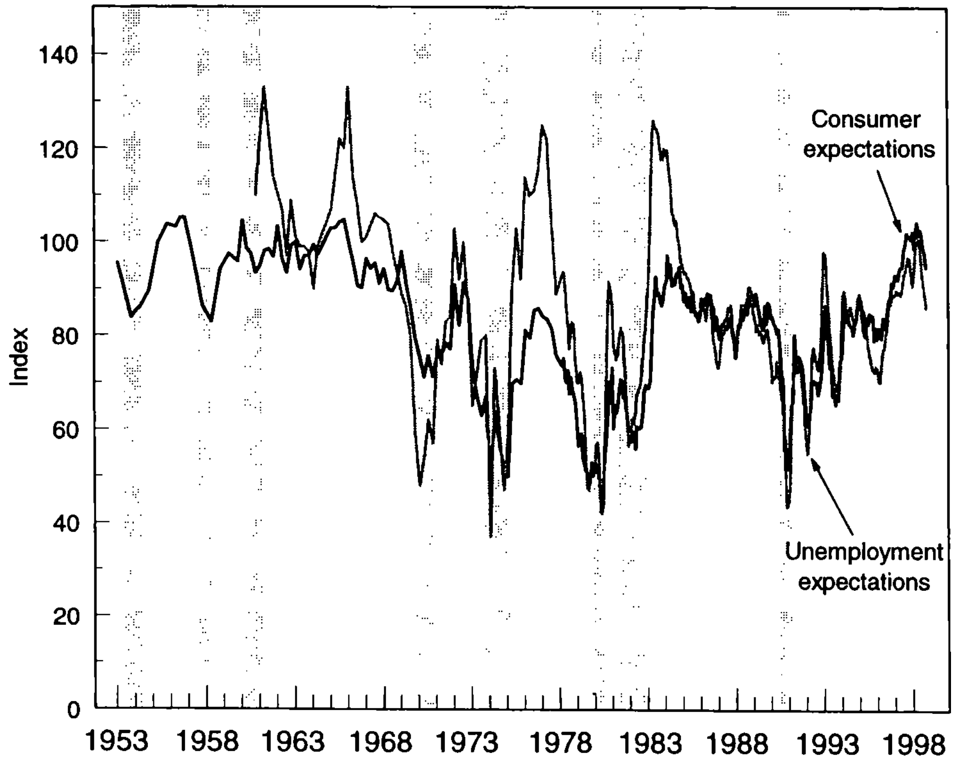
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 6, 1998

CHART OF THE WEEK

Consumer Expectations and the Business Cycle



Consumer confidence remained high in October, though its level fell. The University of Michigan's index of consumer expectations is a component of the index of leading economic indicators, but researchers have found that an index of unemployment expectations, also based on the Michigan survey, is much more robustly correlated with most measures of spending. The index's average reading of 86 for the 3 months ending in October reflects the fact that 14 percent more respondents expected unemployment to rise than expected it to fall.

EYES ONLY

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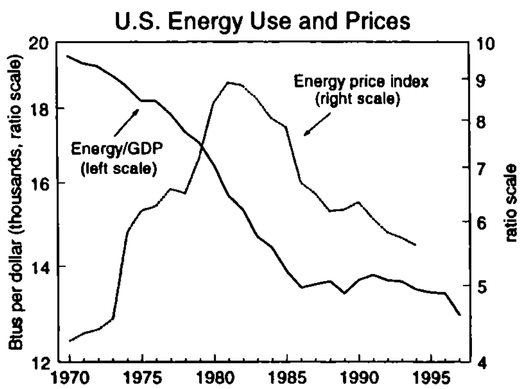
"Why, these are nothing but a lot of tax-and-spend proposals!"

EYES ONLY

SPECIAL ANALYSIS

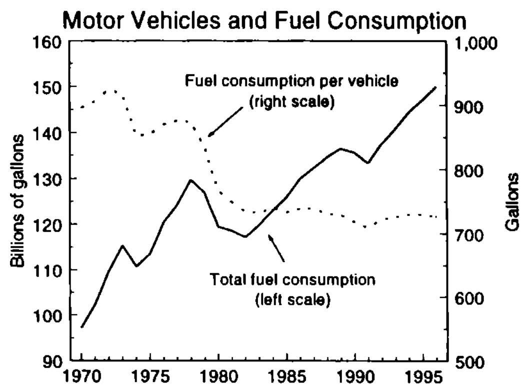
Energy Consumption: Low Prices Offset Efficiency Gains

Energy efficiency is much greater now than it was at the time of the first oil shock 25 years ago. Nevertheless, total U.S. energy consumption is greater than it was then.



Trends. The ratio of energy use to GDP (in Btus per dollar) fell rapidly in the 1970s and early 1980s, though it has remained relatively flat in the 1990s (see upper chart). Despite the efficiency gains, total energy use rose by 27 percent between 1973 and 1997, stimulated by population growth and rising per capita GDP. The entire increase came after 1986, a period of relatively low energy prices. Before 1986, relatively high energy prices had kept energy use flat.

Motor vehicles. One of the most dramatic increases in energy use was in motor vehicle transportation, where annual consumption rose 51 percent between 1970 and 1995. The average fuel efficiency of new passenger cars doubled between 1973 and 1996, from 14.2 to 28.5 miles per gallon. These efficiency gains were partially offset, however, by an increase in miles traveled per vehicle and a shift toward more powerful vehicles. Average horsepower, for example, increased from 137 in 1975 to 166 in 1996. The net effect was a small decline in fuel use per vehicle (see lower chart) but a large increase in total fuel consumption due to an increase in the number of vehicles.



Residential. Energy consumption in the residential sector, by contrast, was about the same in the early 1990s as it was in the 1970s. Efficiency gains kept pace with increases in the number of households, average house size, and average number of appliances per household. For example, the efficiency of the average new refrigerator improved 192 percent from 1972 to 1996. Per household energy use declined rapidly in the late 1970s and early 1980s but has been stable since.

Conclusion. Changes in energy use are a race between efficiency gains and increases in population and income, with shifts in consumer behavior the "swing voter." Lower energy prices have shifted demand toward energy-intensive goods and services and resulted in higher energy use.

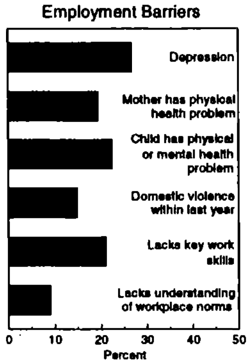
SPECIAL ANALYSIS

Potential Barriers to Work among Welfare Recipients

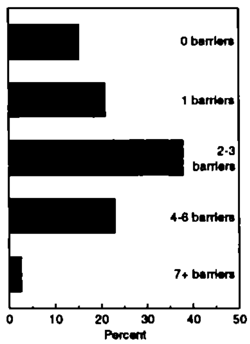
Most discussions of welfare and work have focused on how education, work experience, child care, and transportation limit welfare mothers' employment and wages. However, other potential barriers to employment, such as mental and physical health problems, substance abuse, and domestic violence, also affect welfare mothers disproportionately and make employment difficult.

Prevalence of potential barriers. Two recent surveys of welfare recipients in San Bernardino County, California, and in an urban county in Michigan indicate that the vast majority of welfare recipients face at least one potential employment barrier. Most face multiple barriers (see upper chart). In one study, for example, over 20 percent lacked key job skills, and roughly one in ten misunderstood workplace norms on issues such as punctuality, absenteeism, and lines of authority in the workplace. Mental health problems were quite common: the proportion diagnosed with depression was at the low range of previous surveys of low-income mothers but about twice as high as among all women. About one in five had a physical health problem, and respondents were twice as likely to report physical limitations as women nationally. The share that reported severe physical abuse by a husband or partner in the last year was about four to five times the national average—though similar to rates reported in other welfare studies. Previous research has also found that 25 to 35 percent of recipients had a learning disability.

Prevalence of Certain Potential Employment Barriers

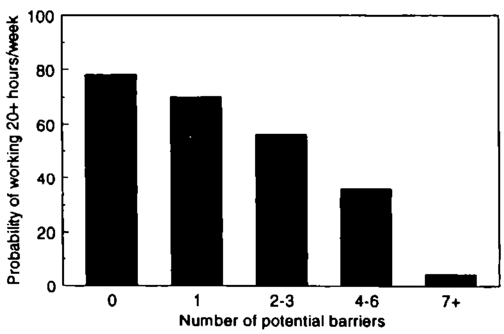


Frequency of Multiple Barriers



Employment. The studies find that these barriers do in fact affect employment. In one study, for example, the probability of working at least 20 hours per week decreased steadily with increases in the number of potential barriers faced by an individual (see lower chart). Even so, many people who faced barriers were able to work, and in some cases the differences in work participation were not large between those with and without a particular barrier. In San Bernardino, for example, just over one quarter of recipients with health problems met the 1998 California work requirement of 26 hours per week, a level similar to the 30 percent with no health problems who met the requirement.

Employment Probabilities by Number of Potential Barriers



Overcoming barriers. Why are certain people able to overcome potential barriers to employment while others are not? The surveys do not examine this question, but previous research points to the confluence of "special circumstances" that help poor women work. These include co-residence with relatives or supportive boyfriends (and its associated economies of scale), free child care provided by relatives or friends, receipt of regular and substantial child support, access to transportation, and employer tolerance while new workers adjust to their jobs.

Implications. Overcoming barriers to employment will be a key component of recipients' success under the new welfare system. New findings confirm that recipients differ in the number and severity of the barriers they face. For those with few or no barriers, providing job search assistance may be enough. For those with multiple barriers, more intensive, coordinated services may be required if they are to achieve economic self-sufficiency.

EYES ONLY

ARTICLE

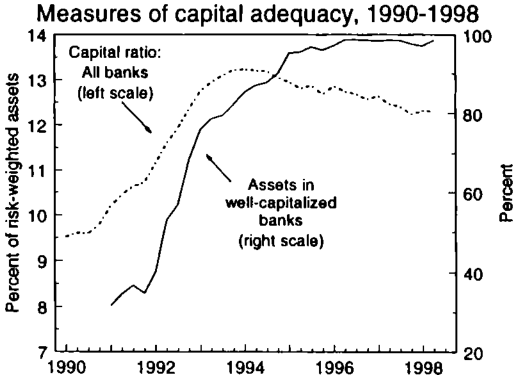
Modernizing Bank Capital Standards

In 1989 Federal regulators adopted minimum risk-based capital (RBC) requirements for banks. RBC ratios have since come to play an important role in bank regulation and supervision. But these requirements may not be a reliable guide to the capital adequacy of large, global banks. Insuring that "regulation remains as modern as the markets" may require some updating of the standards.

The role of capital requirements. A bank's capital acts as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause it to fail. The public policy interest in setting appropriate capital requirements arises because deposit insurance and other aspects of the Federal safety net (such as "too big to fail" intervention) provide incentives for excessive risk-taking by banks. Capital requirements provide a counterbalance by assuring that bank shareholders are exposed to a certain percentage of potential losses. The most commonly used measure of bank capital adequacy is the total risk-based capital ratio, defined as the ratio of a bank's total capital to its risk-weighted assets. The 1988 Basle Accord, a G-10 agreement applying to internationally active banks, determined risk-weights by placing all assets in four risk categories. Cash, at one extreme, receives a risk weight of zero. Most non-mortgage loans receive a risk weight of 100 percent.

Our well-capitalized banks. Judged by their RBC ratios, U.S. banks are in very sound condition (see chart). Capital ratios of all banks have increased substantially since 1990, averaging 12.3 percent in the second quarter of 1998—well above the Basle minimum of 8 percent. In fact, the share of bank assets at "well-capitalized" banks stood at 98.5 percent in the second quarter of 1998, up from just over 30 percent in 1991. ("Well-capitalized" banks are those that meet a number of conditions, including having a total capital ratio greater than 10.)

Measures of capital adequacy, 1990-1998



Are capital adequacy standards adequate? Critics question whether the Basle capital requirements provide an adequate measure of banks' risk positions.

- One big bucket. Most bank assets—ranging from a secured loan to a triple-A borrower to an unsecured loan with a junk bond rating—are assigned the identical 100 percent risk weight and 8 percent capital requirement to cover credit risk.

- Diversification does not count. Although theory and practice prove that it is highly risky to put all of one's eggs in a single basket, a portfolio consisting entirely of agricultural loans to California farmers is treated identically with respect to risk as a diversified portfolio of loans across businesses and regions.

Regulatory arbitrage. The "one-size-fits-all" nature of the Basle capital regulations affords banks the chance to game the system. Through securitization and other financial innovations, a sophisticated bank can increase the riskiness of its portfolio to a preferred level while meeting or exceeding the regulatory capital requirements. One technique is cherry-picking, which involves shifting low-risk assets with unduly high regulatory capital requirements off the regulated banking book while retaining higher risk assets. This regulatory arbitrage might explain why no major U.S. bank holding company's parent corporate debt is rated AAA, and, in fact, the parent corporate debt of almost 80 percent of the top 50 U.S. banking companies is rated below AA-.

Alternatives to RBC requirements. One alternative to the Basle Accord's rule-based measures of credit risk entails increased reliance on the mathematical models now used by globally active banks to measure and manage risk as a matter of "best business practice." A recent amendment to the Basle Accord permits banks to use their own Value-at-Risk (VaR) models for calculating RBC requirements against specific risks within their trading portfolios (bonds, swaps, derivatives). U.S. regulators are studying the feasibility of extending this approach and using banks' internal models to estimate the economic capital required to support credit activities on the banking book. However, the collapse of Long-Term Capital Management—a firm that appears to have relied heavily on such a model-based approach to determine acceptable risks—serves as a cautionary tale. An even more radical alternative than internal models is to base a bank's capital requirement on its own pre-commitment to a maximum loss exposure over a designated horizon, with appropriate penalties for non-compliance.

Conclusion. As the activities undertaken by sophisticated banking organizations have become more complex, the difficulty for examiners in evaluating bank capital adequacy using traditional capital tools has increased. The challenge is to protect the public interest in a safe and sound banking system while allowing banks adequate scope to pursue sophisticated profit-maximizing strategies.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Cautious Views about the Economic Outlook. The latest summary of commentary on current economic conditions from the Federal Reserve districts suggests that the pace of economic expansion moderated in the past 2 months, amid signs of slowing in some sectors. Retail sales were mostly at or below merchants' expectations, but there were only scattered reports of involuntary inventory accumulation. Real estate and construction activity remained generally robust, especially in residential markets, but most districts reported that more stringent credit standards were a factor slowing commercial and real estate activity. Manufacturing activity, though continuing at relatively high levels, was the sector most often cited as showing signs of softening. Labor markets remained very tight in most districts, although demand for workers in manufacturing industries was softening in some areas. Upward pressure on most wages remained subdued, prices at the retail level were little changed, and producers' prices for intermediate inputs were generally flat or down. Low commodity prices and adverse weather conditions in some areas were causing increasing concern among farmers and agricultural banks. Virtually all districts reported that businesses and consumers remained cautious about the economic outlook.

New Jersey Family Cap Lowers Birth Rate. Since 1992, New Jersey has precluded welfare recipients from receiving additional cash benefits for children conceived while on welfare. A new study tracks a sample of recipients subject to the family cap, as well as a control group exempt from the cap, over a 4-year period. While the immediate impact was to increase abortions among those subject to the cap relative to the control group, the study also found a growth over time in the use of family planning services among those subject to the cap. The net result was a decline in births that was larger for those just entering the rolls (12 percent) than for those already part of the caseload (9 percent). The decline in the birth rate among new cases was related both to increased use of contraception and to abortion, while the decline in the birth rate among ongoing cases was associated with more sterilizations and increased use of family planning services. A large majority of those subject to the cap said that the family cap was a fair rule that promoted individual responsibility.

Study Says Layoffs Do Not Lead to Higher CEO Pay. Firms that announce layoffs in the previous year pay their CEOs more and give them larger percentage raises than firms that do not have at least one layoff announcement in the previous year. However, a new study finds that the likelihood of announcing a layoff varies along other dimensions, such as firm size, that are also correlated with CEO pay. Taking into account these other effects, the CEO pay premium for laying off workers disappears. In addition, the study found a small negative share price reaction to layoff announcements.

EYES ONLY

INTERNATIONAL ROUNDUP

Developing World Gets in on the Anti-Dumping Act. Developing countries have become major users of anti-dumping policies, according to a forthcoming study. Developing countries have initiated over half of all dumping investigations since 1993, and they accounted for two-thirds of the total in 1996. The United States has initiated the most anti-dumping cases since 1987. Mexico, Argentina, and Brazil are the three most active new users. In fact, relative to the size of their imports, they are more active initiators than the United States and collectively initiated a fifth of all investigations between 1987 and 1997. Intense foreign competition brought on by accelerating trade liberalization might explain the growing use of anti-dumping policies among developing countries. However, the rise in the share of all cases brought by developing countries also reflects a decline in recent years in the number of cases brought by anti-dumping's past heavy users, particularly the United States and Canada. The study argues that this decline is probably temporary. Nevertheless, the study concludes that discussions of anti-dumping should no longer portray it as the exclusive domain of developed countries.

Signs of Life for Emerging Market Bonds. Just weeks ago, the market for emerging market bonds seemed closed. New issues from developing countries had virtually ceased, and prices for existing securities demonstrated strong investor reluctance to hold emerging market risk without a very high expected return. Sovereign spreads—the excess yield offered by emerging market bonds over comparable-maturity U.S. Treasury securities—had increased to levels unseen for most of the last decade. However, signs of life have recently reappeared, at least in the eyes of some market participants. Last week, Argentina became the first emerging market borrower to place a new issue since the Russian devaluation in August. Venezuela followed shortly thereafter. Improved investor sentiment has also become evident in declining sovereign spreads. Spreads for bonds included in JP Morgan's Emerging Markets Bond Index have fallen by over 650 basis points since September 10. Despite this decline, however, private borrowing costs remain substantially higher for emerging market countries than those prevailing even in early August.

More Declining Interest Rates in Europe. Spain and Portugal announced interest rate cuts this week, surprising many observers. Among countries shifting to the euro, only Ireland continues to maintain significantly higher interest rates than the rest. Once the single currency is established, short-term interest rates will have to be essentially the same in all member countries.

Britain Hopes to Close Productivity Gap. A recent report by the McKinsey Global Institute identified a significant British productivity gap when UK companies were benchmarked against global top performers in key market sectors. This may have colored the pre-budget report of the Chancellor of the Exchequer, Gordon Brown, who asserted that improving Britain's competitiveness was essential for it to remain at the forefront of the coming knowledge-driven international economy.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment
Released 1:30 p.m., Thursday, November 5, 1998

In October, the unemployment rate was unchanged from September at 4.6 percent. Nonfarm payroll employment rose by 116,000.

Leading Indicators

In September, the composite index of leading indicators was unchanged for the second consecutive month.

NAPM Report on Business

The Purchasing Managers' Index fell to 48.3 percent in October from 49.4 percent in September

MAJOR RELEASES NEXT WEEK

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

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	3.3
GDP chain-type price index	5.4	1.7	0.9	0.9	0.8
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	3.5	0.1	N.A.
Real compensation per hour:					
Using CPI	0.6	1.9	4.1	2.0	N.A.
Using NFB deflator	1.3	2.0	4.3	3.4	N.A.
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	13.0
Personal saving	5.2	1.5	0.9	0.3	0.1
Federal surplus	-2.7	-0.3	0.7	0.9	N.A.

	1970-1993	1997	August 1998	September 1998	October 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.6	**4.6**
Payroll employment (thousands)					
increase per month			**322**	**157**	**116**
increase since Jan. 1993					**16962**
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.0	N.A.
PPI-Finished goods	5.0	-1.2	-0.4	0.3	N.A.

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	September 1998	October 1998	Nov. 5, 1998
Dow-Jones Industrial Average	5743	7441	7910	8164	8915
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.61	3.96	4.47
10-year T-bond	6.44	6.35	4.81	4.53	4.82
Mortgage rate, 30-year fixed	7.80	7.60	6.72	6.71	6.89
Prime rate	8.27	8.44	8.49	8.12	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 5, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.657	0.2	-3.8
Yen-Dollar	117.5	0.1	-4.2
Multilateral $ (Mar. 1973=100)	93.97	0.0	-1.9

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.4 (Q3)	4.6 (Oct)	1.5 (Sept)
Canada	2.9 (Q2)	8.3 (Aug)	0.9 (Sept)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Sept)
France	3.1 (Q2)	11.7 (Jul)	0.6 (Sept)
Germany	2.5 (Q2)	2/ 7.4 (Aug)	0.8 (Sept)
Italy	1.1 (Q2)	12.4 (Apr)	1.8 (Sept)
United Kingdom	2.5 (Q3)	6.2 (Jun)	3.2 (Sept)

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 August 1998 is 9.6 percent.

EYES ONLY

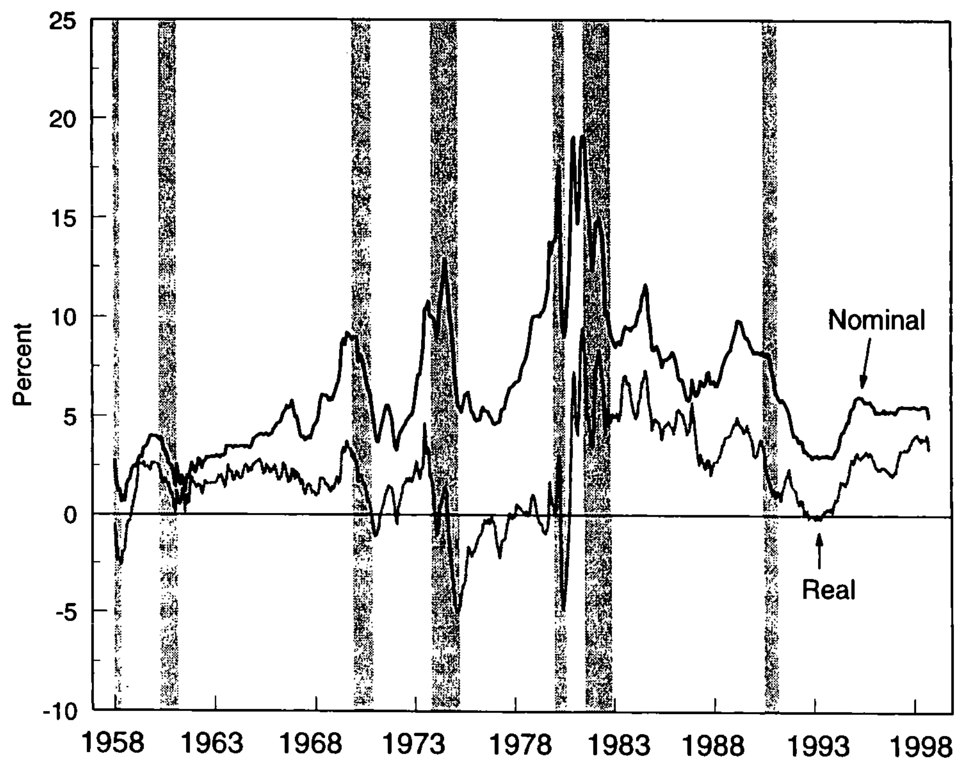
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 30, 1998

CHART OF THE WEEK

Real and Nominal Federal Funds Rate



Often in the past, the Federal funds rate would increase sharply just prior to a recession—though 1990-91 was an exception. No such rise is evident at present. Between March 1997 and the most recent rate cuts, the nominal Federal funds rate had remained near the Federal Reserve's target rate of 5.5 percent, although the real rate had crept up as inflation dropped.

EYES ONLY

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EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Third Quarter 1998

Real GDP is estimated to have increased at a 3.3 percent annual rate in the third quarter, with almost all of the growth accounted for by household spending on consumption or homebuilding. The personal saving rate fell to only 0.1 percent. Business fixed investment fell slightly, and net exports again declined. Price inflation remained subdued.

Component	Growth*	Comments
Total consumer expenditures	3.9%	Most of the growth was in services. Motor vehicle sales fell sharply, reflecting the termination of major incentive programs in the second quarter.
Producers' durable equipment	1.1%	A large drop in motor vehicle purchases offset continued large gains in computer investment.
Nonresidential structures	-6.5%	This was the third consecutive quarter of decline. A sharp drop in contracts points to further decreases in building construction, while low oil prices may slow oil drilling.
Residential structures	6.8%	The gain had been foreshadowed by strong housing starts through July, but a drop in the past 2 months suggests that homebuilding may have peaked.
Inventories (change, billions of 1992 dollars)	$57.2	Automakers rebuilt their stocks after depleting them during the GM strike and sales promotions last quarter.
Federal purchases	-1.7%	These were held down by the sale of the United States Enrichment Corporation. The sale of USEC had no effect on GDP because offsetting adjustments were made to business investment.
State & local purchases	3.2%	Stronger construction accounts for the pickup from the recent trend.
Exports	-2.9%	The third consecutive quarter of decline most likely reflects weak foreign growth.
Imports	3.4%	This was the smallest increase in several years.

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

EYES ONLY

SPECIAL ANALYSIS

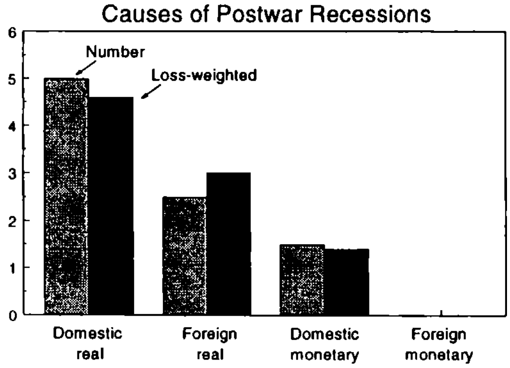
Does the Fed Kill Expansions?

Research shows that the probability that an economic expansion will end in the next month does not rise appreciably with the length of the expansion. This may have prompted the observation attributed to one economist that none of the expansions of the past 40 years died in bed of old age; every one was murdered by the Federal Reserve. But is the Fed guilty as charged?

Identifying monetary policy shocks. Common sense suggests that, when the Federal Reserve shifts to a contractionary stance and the economy subsequently goes into a recession, the Fed "caused" the recession. But a more subtle question is what caused the Fed to embark on the contractionary policy in the first place. If, for example, the Fed responds in a characteristic (and predictable) way by raising interest rates following an oil price shock that triggers a rise in inflation, and if the economy then goes into a recession, it seems reasonable to blame the contraction on the oil shock. The Fed would be implicated, however, if it pursued an exceptionally aggressive anti-inflationary stance.

A taxonomy of shocks. A recent study addresses the question of what causes expansions to end by analyzing the economic history literature covering the last hundred years of business cycles. It separates shocks into four categories: domestic real (DR, such as an unexpected drop in consumption); domestic monetary (DM, such as an exceptional contraction in the money supply); foreign real (FR, such as an oil shock); and foreign monetary (FM, such as the "contagion" following Britain's abandonment of the gold standard in 1931—which the author argues is a distinct shock that turned the 1929-31 downturn into the Great Depression).

Causes of Postwar Recessions



Note: 1981 treated as 1/2 FR, 1/2 DM.

The postwar record. Of the nine contractions since the end of World War II, the study finds the most common cause to be domestic real shocks; domestic monetary shocks are responsible for just 1½ contractions (see chart). Weighted by an index of lost output, foreign and domestic real shocks were by far the most important. Briefly, the shocks associated with recent recessions are as follows:

- 1969 (DR). The study identifies the cause as a decline in government spending attending the winding down of Vietnam War expenditures. (Real defense expenditures, which were contributing 1.2 percentage points to GDP growth in 1967, were subtracting 0.5 percentage points by 1969.) This shock came at the same time the Fed was trying to restrain rising inflation.

- 1973 (FR). Sharp oil price increases led to rising inflation. Faced with an unhappy choice between even more inflation or an even greater reduction in real output, the Fed responded characteristically by tightening monetary policy.
- 1980 (FR). Sharp increases in oil prices preceded this, the shortest recession.
- 1981 (FR, DM). Effects of oil price increases continued to be felt. In addition, the Fed pursued a more aggressive anti-inflationary policy under Paul Volcker than would have been expected based on past behavior.
- 1990 (DR). Expectations changed for some reason ("animal spirits" is the best explanation one prominent macroeconomist could adduce), and consumption fell. Iraq's invasion of Kuwait has been cited as a shock that discouraged consumption. Monetary policy had been easing for more than a year.

Implications. The analysis of factors that cause expansions to end has not settled on a single explanation. International monetary shocks, though found to be important in the Great Depression, have not been identified as the cause of any postwar decline. The Fed, though often at the scene of the crime, is generally not seen as the perpetrator. At this point in the current expansion, Fed actions do not appear threatening (indeed, the most recent rate cut might be viewed as a positive monetary shock). Unexpected changes in domestic spending (consumption or investment) or a worsening of the global economic environment appear to be the more serious risks.

EYES ONLY

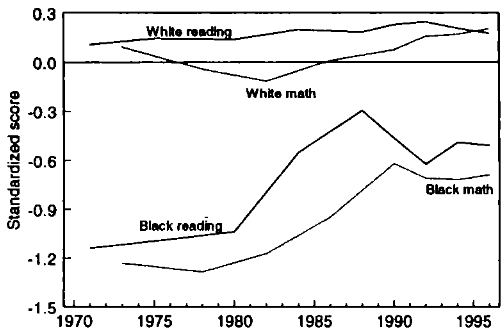
ARTICLE

Why Do Blacks Still Score Worse on Tests?

The public firestorm sparked by *The Bell Curve*, which espouses genetics as the primary source of racial differences in IQ, has ignited research into the relative test performance of blacks and whites. Refuting the biological theories, a new set of studies strongly reasserts the impact of social environment on the black-white test-score gap, a disparity that has endured despite decades of educational reforms.

Why test scores matter. According to the new studies, closing the test-score gap may be a necessary and effective way to fight inequality in other educational and economic outcomes. For example, earnings for blacks and whites with similar test scores are much more similar today than they were 30 years ago. Another study finds that blacks are more likely to graduate from college than whites with similar scores on a test of vocabulary, math, and reading.

National Assessment of Educational Progress
Reading and Mathematics Scores for 17-year-olds



The chasm narrows. Although still large, the test-score gap has narrowed substantially since the 1970s (see chart). This narrowing has been most noticeable among those with the lowest test scores. Nevertheless, the typical black student still scores lower than 75 percent of white test-takers on most standardized tests. Moreover, the gap remains largest at the top, where even in 1992, white high school seniors were about 10 times more likely than blacks to place in the top 5 percent of composite academic scores.

Why "gap genes" don't fit. One of the new studies surveys the literature that most directly tests links among race, heredity, and IQ. It finds no systematic genetic contribution to cognitive gaps between blacks and whites. Instead, the new studies reveal stronger effects from social environment, race perceptions, and school experiences than previously found. For example, traditional measures of socioeconomic status such as parental education and income explain only one-third of the typical test-score gap, but a larger set of environmental factors including parenting practices accounts for two-thirds of the gap between black and white 5- and 6-year-olds. These studies strongly suggest that environmental factors, not genetics, are the most important factors contributing to the test-score gap.

Less-than-great expectations. Once students are in school, teacher expectations may help sustain or expand the gap in test scores. The Great Expectations demonstration program in Oklahoma offers evidence that teacher biases can be changed through professional development, but the effects on the test-score gap remain to be seen. How students view themselves also matters: controlled experiments at a top-notch private university show that merely reminding black students of their race before an exam depresses their test scores.

Beyond desegregation. The effects of a school's racial composition on test scores remain uncertain. Studies find that desegregation raised the test scores of younger black students in the newly desegregated Southern schools of the 1970s and that attending a "whiter" school may have increased black students' reading scores in the early grades. Unfortunately, these improvements still leave a significant gap even in mixed schools, and racial composition seems to matter very little for scores beyond elementary school.

Class size matters. Experiment and history indicate that reducing class size can help narrow the gap. The Tennessee class-size experiment showed that cutting average class sizes from 23 to 15 in grades K-3 raised black children's scores by one-third of a standard deviation, twice the change for whites. Furthermore, as class sizes fell between the 1960s and 1990s, reading scores improved more for black 9-year-olds than for white.

Conclusion. The black-white test-score gap appears in the early years of schooling and may have lasting damaging effects well into later life. Narrowing the gap may be a particular benefit of the Administration's targeted K-3 education initiatives.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Slow but Steady Increases in Women on Boards. More than four-fifths of the Fortune 500 companies have at least one woman director, and more than one-third have multiple women directors, according to a recent survey. Even so, women hold only 11 percent of Fortune 500 board seats, up 23 percent since 1994. Women directors are least likely to chair executive committees (where only 2 percent of chairs are women) and most likely to chair social/corporate responsibility committees (21 percent). Based on an average rate of growth in the percent of women directors since 1993, women would not reach boardroom parity until 2064. Only one Fortune 500 board (Golden West Financial Corporation) currently has gender parity.

New York City: If You Live by the Big Board.... New York City's economy is more dependent than ever on the fortunes of Wall Street, according to a recent report by the state comptroller. Since the recovery from the 1990-91 recession, the Wall Street boom has fueled the city's growth. The study estimates that the securities industry directly accounted for 56 percent of growth in real earnings between 1992 and 1997 and 12 percent of net new job creation between 1995 and 1997. Wall Street may have been responsible for well over half of all new jobs created over the same 2-year period, once its impact on related industries and the effect of increased consumer spending are taken into account. The Wall Street boom has also helped bring the city government out of its worst period of fiscal distress since 1975: securities and finance firms accounted for 51 percent of the growth in personal and business income taxes from 1992 to 1998. However, the comptroller expressed concern at the city's vulnerability to a market downturn, and urged diversification of its economic base. The revitalized Times Square entertainment district and the downtown and Flatiron District "Silicon Alleys" were cited as models.

Board of Education Alert: Benign Findings on Special Education. A new study sheds light on important but neglected issues in the debate over special education: is it effective in raising achievement, and how does it interact with the provision of regular education? The study, which tracked over 200,000 Texas elementary students in over 3,000 schools during the mid-1990s, found that a year in special education raised test scores, particularly in math, of physically or mentally disabled students above what would be expected in regular education classes. The effects were strongest for those with learning disabilities. The study also found no evidence that mainstreaming special education students detracted from the performance of nonspecial education students. (The general thrust of mandated special education programs has been to provide regular classroom instruction where possible—mainstreaming—along with specialized instruction to deal with specific needs.) The authors note that their analysis ignores any negative impacts of special education common to all schools in Texas, such as reduced state aid for regular education. Nationally, 12 percent of public school students in grades K-12 had disabilities in 1996, up from 8 percent in 1977.

INTERNATIONAL ROUNDUP

Banks Nervous about Future of Chinese ITICs. International investors have lent billions of dollars to China's International Trust and Investment Corporations (ITICs), most likely on the belief that these obligations were backed by the state. This belief has been called into question by the recent high-profile closure of Guangdong's ITIC and claims that Prime Minister Zhu ordered it. Subsequent official statements have done little to ease the confusion, since they have left the status of unregistered foreign borrowings unclear. Reliable estimates of the size of these unregistered liabilities are elusive, but the amount may be in the low tens of billions of dollars. Since the Guangdong closure, many foreign banks have refused to roll over loans and extend new credit to other ITICs. Two additional ITICs in Guangdong have defaulted and another shows signs of distress. Other ITICs could well fail as a result of illiquidity if foreign banks continue to withdraw credit. The news this week that the Fujian ITIC intends to sell its stake in the regional airline and local bank has reinforced concerns about liquidity and suggested that the financial turmoil might be spreading beyond Guangdong.

Slovenia Makes Short List for EU, but Challenges Remain. Last year, Slovenia was chosen as one of five former communist countries to initiate talks on European Union membership. Its presence on this short list of transition economies reflects both its relatively strong starting point and its track record of sound economic policies. Slovenia enjoyed the highest standard of living among the Yugoslav republics, and continues today to be the most prosperous country in Central and Eastern Europe, with a per capita GNP almost twice that of the Czech Republic and up to three times that of the other transition economies being considered for EU membership. Slovenia achieved independence in October 1991. Like its sister republics, Slovenia's economic performance had been suffering due to the structural weaknesses of Yugoslavia's system of enterprise self-management. Following initial reforms aimed at fighting inflation, introducing a new currency, and maintaining fiscal balance, the country's economic turnaround began in early 1993 with a comprehensive program of enterprise and banking sector reform. Subsequent results have been mixed. Growth has averaged 4 percent per year since 1993—steady progress, but less impressive than some other transition economies vying for EU membership. Some observers have expressed concern that Slovenia's growth reflects its overall attitude toward reform. They point to insufficient progress in privatization, pension reform, and financial-sector liberalization as remaining constraints to the creation of a truly modern market economy. Many hope that the push for EU membership will reinvigorate Slovenia's structural reform agenda.

Italian Interest Rates Drop. This week the Italian central bank announced a large 100 basis point cut in its discount rate, to 4.0 percent. Although a cut in short-term rates might have been expected as EMU approaches, the behavior of long-term rates is surprising. At 4.5 percent, the yield on Italy's 10-year bond is only slightly higher than Germany's 4.1 percent; it is lower than the U.S. rate and significantly below that of the U.K.

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, October 30, 1998****

According to advance estimates, real gross domestic product grew at an annual rate of 3.3 percent in the third quarter.

Employment Cost Index

The employment cost index for private industry workers rose 3.8 percent for the 12-month period ending in September.

Advance Durable Orders

Advance estimates show that new orders for durable goods increased 0.9 percent in September, following an increase of 2.0 percent in August.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, fell 9.1 index points in October, to 117.3 (1985=100).

MAJOR RELEASES NEXT WEEK

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

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	**3.3**
GDP chain-type price index	5.4	1.7	0.9	0.9	**0.8**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	3.5	0.1	N.A.
Real compensation per hour:					
Using CPI	0.6	1.9	4.1	2.0	N.A.
Using NFB deflator	1.3	2.0	4.3	3.4	N.A.
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	**13.0**
Personal saving	5.2	1.5	0.9	0.3	**0.1**
Federal surplus	-2.7	-0.3	0.7	0.9	N.A.

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	4.6
Payroll employment (thousands)					
increase per month			118	309	69
increase since Jan. 1993					16745
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	0.0
PPI-Finished goods	5.0	-1.2	0.2	-0.4	0.3

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

New or revised data in **boldface**.
GDP and related data for 1998:3 **embargoed until 8:30 a.m., Friday, October 30, 1998.**

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	August 1998	September 1998	Oct. 29, 1998
Dow-Jones Industrial Average	5743	7441	8479	7910	8495
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.90	4.61	4.22
10-year T-bond	6.44	6.35	5.34	4.81	4.54
Mortgage rate, 30-year fixed	7.80	7.60	6.92	6.72	6.83
Prime rate	8.27	8.44	8.50	8.49	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 29, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.654	0.8	-4.8
Yen-Dollar	117.3	-0.5	-2.7
Multilateral $ (Mar. 1973=100)	93.93	0.6	-2.2

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	**3.4** (Q3)	4.6 (Sept)	1.5 (Sept)
Canada	3.1 (Q2)	8.3 (Aug)	0.9 (Sept)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.1 (Q2)	11.7 (Jul)	0.6 (Sept)
Germany	2.5 (Q2)	[2/] 7.4 (Aug)	0.8 (Sept)
Italy	1.1 (Q2)	12.4 (Apr)	1.8 (Sept)
United Kingdom	2.5 (Q3)	6.2 (Jun)	3.2 (Sept)

U.S. GDP data **embargoed until 8:30 a.m., Friday, October 30, 1998.**

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 August 1998 is 9.6 percent.

EYES ONLY

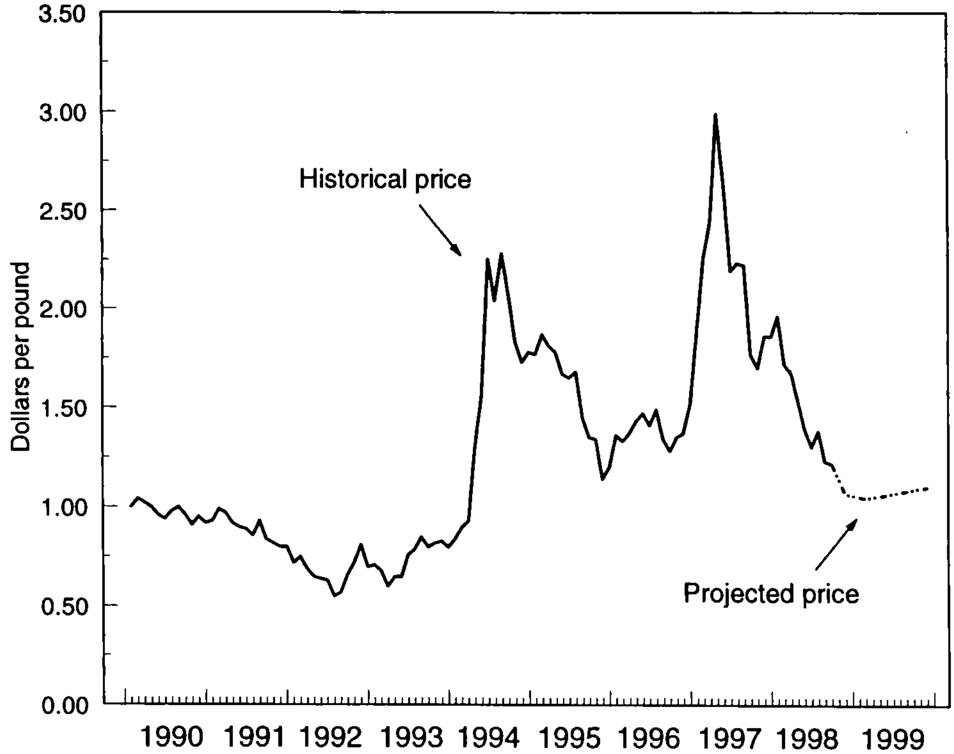
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 23, 1998

CHART OF THE WEEK

Colombian Coffee Prices



The price of Colombian coffee is down about 60 percent from its peak of almost $3.00 per pound in May 1997 and futures markets expect coffee prices to remain around current levels over the next year. (The projected price is based on coffee produced in several countries; Colombian coffee trades at a slight premium.) An international roundup discusses the role of coffee in the Colombian economy.

EYES ONLY

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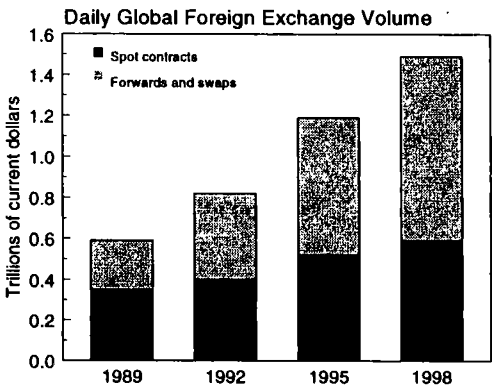
"I love the convenience, but the roaming charges are killing me."

EYES ONLY

CURRENT DEVELOPMENT

Daily Trading in Foreign Exchange Reaches $1.5 Trillion

The Bank for International Settlements in Basle, Switzerland, has just released its triennial compilation of 43 central bank surveys of foreign exchange markets. It shows that global foreign exchange trading has continued to grow substantially—to a daily volume of $1.5 trillion in April 1998 (see upper chart).

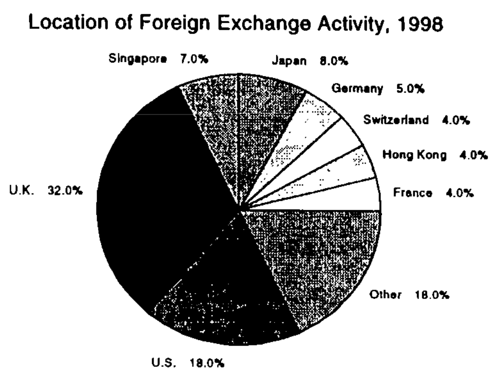


Growth in volume. Measured in current dollars, the growth rate between 1995 and 1998 was 26 percent. The volume of foreign exchange trading is roughly 100 times greater than the volume of global merchandise trade.

What is traded? Spot market purchases amounted to 40 percent of foreign exchange transactions, down from 44 percent in 1995. Forward instruments (contracts to buy or sell foreign exchange at a future date) continued to grow in importance relative to spot sales.

Who trades? Most trades take place between professional traders at banks and other financial institutions; only a fraction of foreign exchange sales and purchases directly involve those who ultimately import and export goods, services, and securities. In the most recent U.S. survey, the share of total transactions involving non-financial customers was 20 percent of all turnover. Though this proportion has increased substantially, it still suggests that each foreign exchange dollar is passed along five times before ultimately finding its way to someone willing to hold it.

Where does trading take place? Trading tends to be focused in major centers. Arguably, there is a natural equilibrium consisting of one major center in each of three 8-hour time zones. London continues to handle the greatest volume of foreign exchange transactions, with the U.K. share of world turnover increasing to 32 percent (see lower chart). New York is the main center in the Western Hemisphere, with U.S. volume now accounting for 18 percent of world turnover. Tokyo's turnover has fallen off recently, and its dominance in the Asian time zone is being threatened by Singapore.

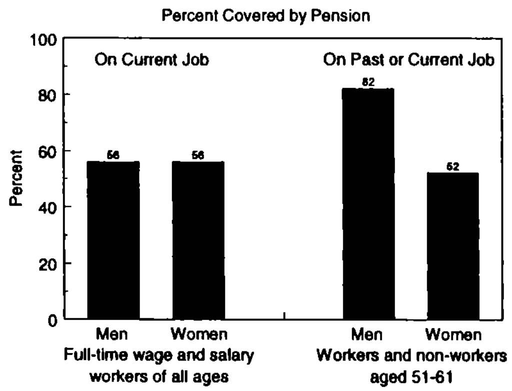


SPECIAL ANALYSIS

Gender Differences in Pension Wealth

Among those approaching retirement age, a smaller proportion of women than men have pension coverage, and the women's accumulated pension benefits are smaller. However, the increasing prevalence of defined contribution plans is likely to reduce the pension gender gap at retirement somewhat.

Coverage and vesting. In 1993 (the most recent year for which data are available) 56 percent of both male and female full-time wage and salary workers were covered by a pension on their current job (see chart). When part-timers are included, 51 percent of men and 46 percent of women were covered (coverage rates are lower for part-timers generally, and a larger fraction of women work part-time). Among full-time workers in the private sector only, 39 percent of men and 36 percent of women reported that they were vested in a pension plan. The gap in prospective pensions between women and men nearing retirement age is much larger, however, because of women's lower lifetime labor force participation and shorter job durations. An analysis of Health and Retirement Survey (HRS) data for men and women aged 51 to 61 in 1992 shows that 82 percent of men but only 52 percent of women expected to receive a pension from *some* job.



Wealth. The gender gap is larger for pension wealth than it is for pension coverage, because pension amounts increase with earnings and job tenure and women are at a disadvantage in both. For example, in the HRS survey of people approaching retirement, men's median pension wealth from their current job was 1.8 times what it was for women.

DB versus DC plans. Pension coverage has been shifting rapidly from defined-benefit (DB) to defined-contribution (DC) plans. Between 1975 and 1992, the share of active participants who were in DC plans rose from 29 to 60 percent. This shift is likely to narrow the gender gap in retirement wealth, because DC plans have advantages for those who change jobs frequently (such as women). Typically, when workers leave a job after being vested in a DB plan, their benefits are frozen in nominal terms. With a DC plan, by contrast, accumulations continue to earn a rate of return after the worker moves on. Thus, a succession of jobs with DC plans is likely to produce a larger lifetime pension benefit accumulation than a succession of jobs with DB plans. Among the 51-61 year olds in the HRS who had DB plans, women's median pension wealth was 45 percent of men's; but among those who had DC plans, women's pension wealth was 60 percent of men's.

Conclusion. The difference in employer pension wealth is even larger than the earnings difference between men and women. But the shift away from DB plans toward DC plans should reduce the pension disparity for future cohorts—especially if women "roll over" their DC and 401(k) pension funds when they change jobs.

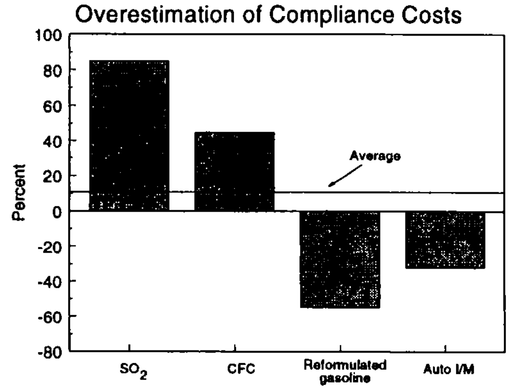
EYES ONLY

SPECIAL ANALYSIS

Evaluating Environmental Compliance Cost Estimates

Estimates of what it will cost to comply with new environmental regulations are subject to considerable uncertainty. But are these estimates biased, as some critics claim, in the direction of overestimating costs and hence discouraging stricter environmental standards that would in fact confer net economic benefits?

The record. Comparisons between pre-implementation estimates of compliance costs and reported post-implementation costs have been done for four EPA regulations. In two cases, reported costs were underestimated (automobile inspection/maintenance and reformulated gasoline); in the other two (the SO_2 program and the CFC phaseout) they were overestimated (see chart). For the four cases taken together, the average discrepancy was a modest 11 percent overestimate of actual costs.



Changes in technology and market conditions. Forecasting future costs is a difficult task that involves predicting future technologies and market conditions. Changes in market prices may either raise or lower the costs of compliance. In the case of reformulated gasoline, for example, costs may have been underestimated because the EPA did not foresee that methanol prices would increase. In the case of SO_2, declines in rail costs allowed utilities to abate more cheaply by switching to low-sulfur western coal. To the extent that cost estimates do not adequately incorporate future technological advances, the costs of compliance will be overstated. For example, the installed costs of scrubbing sulfur from utility smoke stacks has fallen nearly 40 percent since implementation of the acid rain program. Early cost estimates did not foresee this dramatic drop in scrubbing costs.

Compliance. Cost estimates are typically based on the assumption of 100 percent compliance with regulations. Since firms with the highest compliance costs tend to be those who do not comply, actual costs calculated from data that include only complying firms will tend to be lower than estimates based on perfect compliance.

Policy changes. Another reason why actual compliance costs differ from pre-implementation estimates is that policies tend to change between the proposal and the implementation stages. In phase 1 of the SO_2 program, for example, additional allowances were allocated to firms that installed scrubbers. Further, other firms were allowed to opt into the program and receive permits. Firms would only do so if they expected to sell permits. Both of these changes expanded the supply of permits and lowered the permit price.

Conclusion. While estimates of compliance costs for specific environmental programs are inherently subject to considerable uncertainty, they do not seem to be systematically overestimated. Though the total number of cases studied is small, it is interesting to note that the two cases of overestimated costs occurred with market-based policies. These policies give firms the flexibility to take advantage of unexpected circumstances, such as declining rail costs in the SO_2 case, which may result in lower-than-predicted costs.

EYES ONLY

ARTICLE

Competition in Markets for Network Products

Underlying the Microsoft trial that began this week are questions about competition in network markets.

Network externalities. A "network externality" arises when a product's value to consumers increases with the number of users. Each new telephone subscriber is an additional person current and future subscribers can call. Each new buyer of a word-processing system is another person with whom earlier purchasers can exchange documents. Products displaying network externalities are generally called "network goods." In the competition among network products, an early lead can reinforce itself: new customers buy the more popular good because of the larger externality, which then grows and makes the product yet more attractive to additional purchasers. This dynamic makes network markets prone to "tipping" toward monopoly.

Risks and benefits of dominance. A network monopoly has benefits not generally found in conventional markets because dominance can maximize the network externality for consumers. But network dominance also poses hazards that compound the usual concerns about monopoly. First, the best product will not always win. Because consumers want the good that will have the largest externality, expectations of a product's success can be at least as important to buyers as price and quality. No one wants a Betamax video system, even if it might be superior to VHS. Second, network markets can be particularly hard for new competitors to enter. Once customers invest in learning a system from which they derive large network benefits, they face high costs in switching to a different standard. And third, a network monopolist may have advantages in selling complementary goods—for example software for an operating system—that allow it to extend dominance from one market to another.

The challenge for antitrust. Even if an inferior standard dominates or if dominance results from anticompetitive tactics, it may be impractical or undesirable to remedy network monopolies. Innovation incentives diminish if honestly earned dominance can be second-guessed by regulators. And once customers have adopted a standard, it is costly to reduce the accrued network externality no matter how it has come about. Hence, the reduced feasibility of after-the-fact remedies makes early injunction of anticompetitive practices in network markets essential. Such quick action can be difficult, however, because competitive strategies that are inherently suspect in a conventional goods market may be reasonable given the winner-take-all potential of network rivalry. Pricing below cost, for example, is usually presumed to be predatory and undesirable because its intention is to drive rivals from the market and create a monopoly. But in network markets, the intention may be simply to gain customers quickly and raise expectations about a product's network externality. Antitrust authorities must decide if such low prices are a legitimate competitive strategy or if they instead undermine competition.

Similarly, authorities must determine whether a network monopolist's advantage in markets for complementary products stems from genuine efficiencies or from anticompetitive arrangements. A Federal appeals court, for example, recently ruled that Microsoft's joint provision of the Windows operating system and Explorer web browser was a legitimate integration rather than an anticompetitive bundling or tying strategy against rival browsers. In the trial starting this week, the court will examine other allegations that Microsoft abused its monopoly in operating systems to foreclose competition in the browser market. Did Microsoft use legitimate competitive tactics, regulation of which will reduce innovation incentives and consumer welfare? Or, has Microsoft engaged in predatory and exclusionary conduct that forecloses competition and innovation to the ultimate detriment of consumers? Where the boundary lies is the difficult question to be explored in court.

Conclusion. Network monopolies offer benefits when they maximize network externalities to consumers. They can also be very costly when barriers for new entrants into network markets are high and the potential for leveraging market power into complementary markets exists. Network markets thus pose a continuing challenge for antitrust enforcement.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Study Analyzes Who Is Leaving the District of Columbia. The conventional wisdom on the decline of central cities is that population losses have been especially heavy for middle- and upper-income households. But a recent case study of income and population in the DC metropolitan area found that it was the District's lowest- and moderate-income taxpayers who were leaving, as well as two-earner couples of relatively modest means. Higher-income households have generally stayed. The study finds that substantially more Federal tax filers who leave DC move to Maryland than move to Virginia. Between 1987 and 1995 about 7,000 Federal tax filers per year moved from DC to Montgomery County, MD, and between 3,000 and 4,000 per year moved to Prince George's County, MD; whereas fewer than 2,000 per year have moved Arlington County, VA, and even fewer to Fairfax County, VA. The author speculates that because overall taxes are considerably lower in Virginia than they are in the District, whereas Maryland taxes are more comparable, factors other than taxes are probably determining the pattern of out migration.

Home Care Increases for the Seriously Ill. Medicare policy changes in the 1980s provided incentives for increased use of home health services rather than prolonged hospital stays. The result, according to a new study, has been a dramatic increase in hospice and home care for the seriously ill and a modest decrease in hospital care—generally the most expensive form of health care. Growth in hospice and home care also increased Medicare utilization. The study finds that the percent of recipients who died in hospice care rose from about 2 percent to 10 percent during the 1989-95 period; those dying in an acute care hospital fell from 42 to 35 percent over a similar period. Meanwhile, the percentage of recipients who died without any Medicare services fell substantially, from 40 to 25 percent, and monthly Medicare expenditures before death rose from about $5,500 in 1988 to more than $7,000 in 1995 (in 1995 dollars). The study concludes that the growth of non-hospital care may have improved the well-being and satisfaction of dying patients and their families, but it does not appear to have slowed the growth of Medicare expenditures.

Surviving Shoe Companies Eschew Piece Rates. A tradition of piece-rate methods of pay was once a distinguishing characteristic of the American shoemaking industry. But companies that have survived in an industry that has shrunk dramatically in the face of import competition have turned increasingly to time rates of pay. A new study finds that establishments in which labor costs were a large share of total costs were disproportionately likely to close down over time. Looking at detailed internal data for a single firm that survived, the study found that the shift to time rates was part of a move toward continuous-flow methods of production, with job rotation and rapid changes in work tasks to introduce new styles and "just-in-time" products to retail stores. Although the change to time rates reduced labor productivity, it appears to have lowered costs even more through mechanisms such as lower workers' compensation insurance costs, smaller inventories, lower monitoring costs, lower wages and fewer grievances over wages during the labor contract, and the ability to produce an increased number of new styles of shoes.

EYES ONLY

INTERNATIONAL ROUNDUP

Coffee Contributes to Colombia's Highs and Lows. Like other developing countries, Colombia has been under pressure recently from international financial markets. The surprise devaluation of the peso in September took little pressure off the currency and had to be supplemented by successive increases in interest rates. In addition, President Pastrana's fiscal reform proposals pledge to reduce the deficit to 2 percent of GDP by 1999. Nonetheless, the peso has continued to trade at a value near the lower edge of its exchange band. Colombia's difficulties have been compounded by changing global prices of primary commodities, particularly coffee, which accounts for one-fifth of the country's exports. In August exports were a third off the pace of a year earlier, and coffee prices have continued to decline (see Chart of the Week). Historically, Colombia has exhibited a classic commodity price cycle. During the phase of high world coffee prices—most recently in 1997—Colombia's increased export revenues have tended to increase foreign exchange reserves, thereby putting upward pressure on the money supply, and, in turn, domestic prices. The danger is that rising wages and production costs affect all Colombian exporters and impair competitiveness in the non-commodity sector. (Sometimes the effect can come more directly, via upward pressure on the currency, but either way it is a "real appreciation.") This economic phenomenon is widely known as "Dutch Disease," after an earlier natural gas boom in the Netherlands. With the recent decline in coffee prices and uncertain financial market conditions, Colombia is squarely in the down-phase of the cycle, featuring an outflow of reserves and a tightening of monetary conditions at home.

Hyundai Wins Bid for Kia, Faces Challenges of Corporate Restructuring. The fate of the Korean car maker Kia illustrates some of the problems underlying the Asian crisis and the challenges that remain. Arguably, the magnitude of Kia's troubles resulted from an extreme case of "connected" lending. Kia's former chairman was sentenced earlier this week for embezzlement and he reportedly used the money for bribes to obtain preferential bank loans and keep Kia afloat. Since defaulting on an estimated debt of about $9 billion, Kia has been put on the auction block three times. The first two failed over the issue of whether the bidders would assume Kia's large debt. Hyundai's winning bid in the most recent auction this Monday awaits creditor approval. Press reports indicate that Hyundai is currently demanding that about 60 percent of the debt be written off, including some that will be swapped for equity. Even if its creditors approve, Hyundai will face an uphill battle to return Kia to viability. Redundant investments in saturated industries like autos are generally thought to have been the fundamental factors underlying the Korean crisis. To be successful, companies must strengthen their financial structure and redeploy their productive assets. Although Kia's labor union, which has a reputation for toughness, is likely to resist any large-scale layoffs, some analysts think that Hyundai has the necessary clout to rationalize production. Moreover, if Samsung ceases automobile production in the wake of its failed bid for Kia, as some analysts think it will, some of the excess capacity that has plagued the Korean car industry may well be eliminated.

EYES ONLY

RELEASES THIS WEEK

Housing Starts

Housing starts fell 2 percent in September to 1.576 million units at an annual rate. During the first 9 months of this year, housing starts were 9 percent above the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $16.8 billion in August; it was $14.5 billion in July.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1997	1997:4	1998:1	1998:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	3.0	5.5	1.8
GDP chain-type price index	5.4	1.7	1.1	0.9	0.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	0.9	3.5	0.1
Real compensation per hour:					
Using CPI	0.6	1.9	2.8	4.1	2.0
Using NFB deflator	1.3	2.0	3.9	4.3	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	10.7	11.0	11.2
Residential investment	4.5	4.0	4.1	4.2	4.3
Exports	8.2	11.9	12.0	11.6	11.3
Imports	9.2	13.1	13.2	13.1	13.1
Personal saving	5.2	1.5	1.2	0.9	0.3
Federal surplus	-2.7	-0.3	0.0	0.7	0.9

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	4.6
Payroll employment (thousands)					
increase per month			118	309	69
increase since Jan. 1993					16745
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	0.0
PPI-Finished goods	5.0	-1.2	0.2	-0.4	0.3

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

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	August 1998	September 1998	Oct. 22, 1998
Dow-Jones Industrial Average	5743	7441	8479	7910	8533
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.90	4.61	3.90
10-year T-bond	6.44	6.35	5.34	4.81	4.62
Mortgage rate, 30-year fixed	7.80	7.60	6.92	6.72	6.73
Prime rate	8.27	8.44	8.50	8.49	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 22, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.641	0.9	-8.0
Yen-Dollar	117.9	0.3	-2.3
Multilateral $ (Mar. 1973=100)	93.41	0.5	-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	3.6 (Q2)	4.6 (Sept)	1.5 (Sept)
Canada	3.1 (Q2)	8.3 (Aug)	1.0 (Aug)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.1 (Q2)	11.7 (Jul)	0.7 (Aug)
Germany	2.5 (Q2)	[2] 7.4 (Aug)	0.7 (Aug)
Italy	1.1 (Q2)	12.4 (Apr)	1.9 (Aug)
United Kingdom	2.6 (Q2)	6.2 (Jun)	3.3 (Aug)

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 August 1998 is 9.6 percent.

EYES ONLY

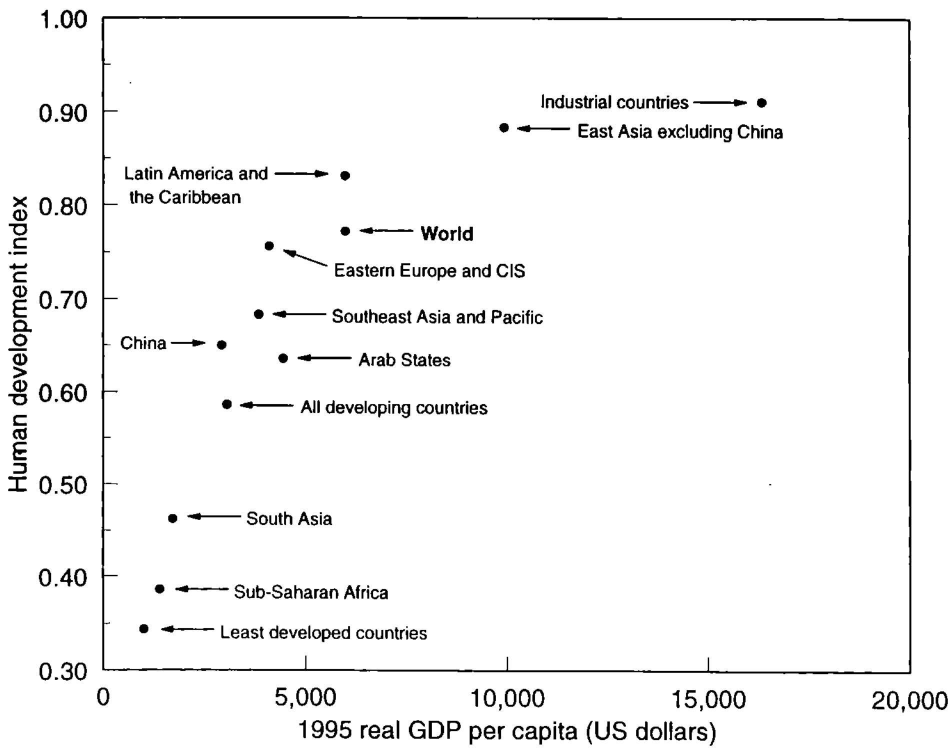
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 16, 1998

CHART OF THE WEEK

The UN Human Development Index and Income



This year's Nobel Prize winner in economics, Amartya Sen, has argued that although income is a key determinant of welfare because of the opportunities it creates, actual opportunities, or capabilities, depend on a number of other factors as well. The UN human development index reflects the spirit of Sen's views: it averages indexes of real per capita GDP, life expectancy, and education. It is correlated with income, but not perfectly.

EYES ONLY

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"I give you a fifty-fifty chance. Pay me up front, and I'll make it sixty-forty."

EYES ONLY

CURRENT DEVELOPMENT

Sen Awarded Nobel Prize in Economics

This year's Nobel Prize in economics was awarded to Amartya Sen of Trinity College, Cambridge, U.K. Sen, an Indian citizen who taught at Harvard from 1989 to 1997, was awarded the prize for his contributions to welfare economics. These contributions range from highly theoretical analyses of social choice to empirical studies of famine.

The theory of social choice. A fundamental question in social choice theory is whether individual preferences can be aggregated into social preferences that allow for rational collective decision making. According to Nobel laureate Kenneth Arrow's impossibility theorem, they cannot be, under fairly general conditions. For example, consider three sets of voters: one prefers a balanced budget (B) to more education spending (E), and more education spending to a tax cut (T); a second prefers E to T, and T to B; a third prefers T to B, and B to E. Collectively, a majority prefers B to E and a (different) majority prefers E to T. But a (third) majority prefers T to B, hence the choices cannot be ranked by majority voting. Such intransitivity illustrates the difficulty in aggregating individual preferences into social preferences that allow rational choices among policies. Sen did not refute Arrow's impossibility theorem, but his research helped refine and enrich understanding of fundamental social choice issues in normative economics and moral philosophy.

Indexes of welfare and poverty. Sen applied the theory of social choice to the construction of theoretically sound indexes to measure differences in income and welfare. For instance, in contrast to the standard measure of poverty (the share of the population with income below a predetermined poverty threshold), Sen developed a measure that also takes into account the distribution of income within the poor population. Such an index is not calculated explicitly for U.S. poverty data, but the related poverty gap is reported (the amount of income needed to raise the entire poor population to the poverty threshold). Sen also emphasized the importance of factors other than income when measuring welfare (see the Chart of the Week, for example).

Analysis of famine. Sen's applied work deals with development economics and often the welfare of the poorest people in society. His analysis of poverty and famines challenged the common view that a shortage of food is the most important explanation of famine. His analysis of a number of catastrophes in India, Bangladesh, and Saharan countries showed that famines have occurred even when the supply of food was not significantly lower than during previous non-famine years, and that famine-stricken areas have sometimes exported food. Part of his explanation for the Bangladesh famine of 1974 is that flooding throughout the country that year significantly raised food prices, while work opportunities for agricultural workers declined drastically. As a result, the real incomes of agricultural workers declined sharply and that group was disproportionately stricken by starvation.

Conclusion. The awarding of the Nobel Prize to Amartya Sen recognizes a body of work that combines the highly theoretical (social choice theory) with the eminently practical (how to prevent famine). Its unifying theme is a concern for social choice and distributional issues generally, with special emphasis on the welfare of the most impoverished members of society.

EYES ONLY

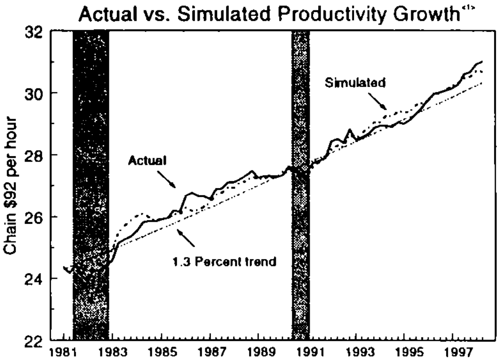
SPECIAL ANALYSIS

Has Trend Productivity Growth Increased?

The official measure of productivity in the nonfarm business sector has grown at a 1.9 percent annual rate over the past 3 years, substantially faster than the 1.1 percent average annual growth rate between the business cycle peaks of 1973 and 1990. Is it reasonable to conclude that the trend rate of productivity growth has picked up?

A methodological change. Part of the increased rate of growth of productivity observed over the past 3 years reflects the official decision to switch to using the geometric consumer price index to deflate consumption. This change, which was implemented beginning with the July revisions to the national income and product accounts, raised the annual growth rates for output and productivity by about 0.2 percentage points per year for 1995 and subsequent years. If the same methodology were applied to earlier years, the average annual rate of productivity growth since 1973 would be 1.3 percent rather than the 1.1 percent growth now officially reported.

Actual vs. Simulated Productivity Growth<1>



<1> Productivity has been adjusted for methodological changes and is defined as the average of the income and product-side measures.

Income- versus product-side measures. Since 1993, the average annual growth rates of the income-side measures of output and productivity have been 0.5 percentage point higher than the official product-side measures. The CEA believes that both measures contain useful information. The data in the chart and the following analysis are based on an average of the two measures.

Cyclical behavior. In the long term, productivity increases with training, technology, and capital accumulation. But productivity growth also shows considerable variation over the business cycle, falling below its trend during recessions, then growing faster than trend during the mid-expansion, and finally falling again in advance of the business-cycle peak. The behavior of productivity between the business cycle peaks in 1980 and 1990 is typical. This cyclical behavior can be captured by a model in which firms adjust towards their desired employment, but only partially in any quarter because hiring and firing are costly. As shown in the chart, a simulation from this model reproduces the above-trend behavior of productivity in recent years.

Conclusion. The most straightforward explanation of these results is that trend productivity growth has not changed over the post-1973 period and that recent productivity growth reflects purely cyclical factors. But those looking for a more optimistic interpretation might conclude from the rapid growth in productivity since 1994 that the U.S. economy entered a new period of higher trend productivity growth starting in that year.

EYES ONLY

SPECIAL ANALYSIS

Does More Competition Lead to More Innovation?

Under static conditions, competitive markets usually benefit consumers by producing more output at lower prices than do concentrated markets. But competition may not always be best for promoting the R&D and innovation that over time bring new products and technologies into the marketplace.

Theoretical considerations. A firm trying to increase or defend its market share from rivals has the incentive to develop new products and processes. Returns to innovation may, however, be short-lived in a highly competitive market. Even if intellectual property rights give the innovator a temporary monopoly, rivals may develop similar or better advances. Moreover, firms in truly competitive markets have lower cash-flow margins to invest in R&D. Monopoly, by contrast, probably provides more cash and lower risk for R&D. Monopolists, however, already have the market share for which competitive firms strive and thus have less incentive to innovate in the first place. Economic intuition suggests innovation will be most intense in firms with a mix of competitive incentives and supra-competitive returns.

Empirical studies. The foregoing intuition is borne out by empirical analyses finding that the correlation between market structure and innovation follows an "inverted-U" pattern: innovation is observed to be low at high levels of competition, to reach its peak at intermediate levels of oligopoly (where the four leading firms control roughly half the market), and then to fall off as market structure approaches monopoly. Several studies question whether there is an optimal market structure for promoting innovation, but they too find little evidence that either particularly high levels of competition or pure monopoly correlate with high levels of innovation.

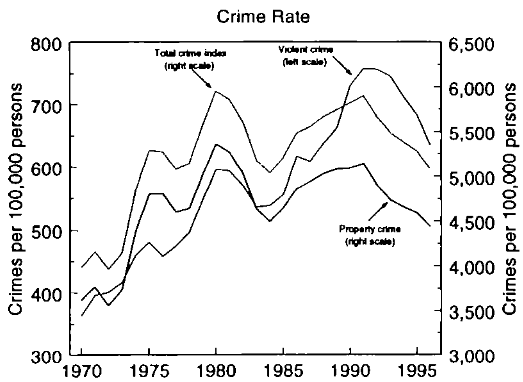
More than market structure matters. One cannot, however, rely on the above correlations to predict R&D activity in a given case. Industry-specific characteristics of products and technologies are also significant determinants of innovation. Thus, fierce competition may yield R&D: as many as 45 firms are racing to develop new anti-obesity drugs. And so might monopoly: Microsoft, the dominant maker of computer operating systems, often introduces new products. But in each case factors independent of market structure are important. The market for anti-obesity drugs is new, and the rewards for successful R&D are huge—an estimated $5 billion per year in sales. The market for operating systems software contains technological opportunities that make complacency risky for even a dominant firm.

Conclusion. Market structure is a potential, but ambiguous and relatively weak, driver of innovation. Studies suggest that neither heavy competition nor pure monopoly is likely to encourage R&D effort. But even in those polar cases, the evidence shows that market structure alone cannot be relied on to predict innovation levels.

SPECIAL ANALYSIS

Crime and the Labor Market

Two new studies suggest that the decline in wages among unskilled workers that began in the 1970s had a significant upward effect on crime rates. Recent wage gains may therefore bode well for the crime rate.



Trends. Crime rates rose substantially in the 1970s and started to decline in the early 1980s (see chart). Although it was thought that rates might continue to drop with the maturing of the baby boom and a decline in the number of young people (those most likely to commit crimes), rates started to rise again through the late 1980s. Until a pickup in 1997, wages for men aged 16 to 24 had declined significantly over the past three decades.

A new methodology. Most studies of the relationship between crime and the labor market have used the unemployment rate as their measure of labor market conditions. Such studies have typically found modest evidence that unemployment rates are positively linked to crime. The new studies argue that potential criminals are more likely to be influenced by longer-term prospects in the mainstream economy than by shorter-term conditions and that wages are a better measure of these longer-term prospects than the unemployment rate.

The effect of wages on crime. The new research shows that young men are responsive to wage incentives. First, declining real wages appear to have played an important role in influencing crime rates. In particular, the decline in wages of low-skilled men between 1979 and 1995 is estimated to have increased property crimes by 10 to 13 percent and increased violent crimes by about half that amount. These findings are consistent with the idea that monetary incentives play a larger role for economically motivated crimes such as burglary and robbery than they do for crimes like murder and rape. Second, the black-white wage gap explains about one-quarter of the racial differential in the probability of committing a crime. Third, one study found that the age distribution of crime is largely a labor market phenomenon, with the growth in market opportunities as they move into their early twenties largely responsible for the concomitant decrease in crime.

Implications. Falling wages provide at least a partial explanation for why property crimes have not fallen much over the last 20 years along with the proportion of 18-to-24 year olds in the population. However, the correlation between wages and crime suggests that recent efforts to "make work pay" through the minimum wage and the EITC may have added benefits by reducing crime.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Financial Services Industry Is Feeling the Pinch. Global financial turmoil and exposure to troubled hedge funds may be having their effect on Wall Street firms and money center banks. For example, Merrill Lynch announced plans on Tuesday to cut 3,400 employees, about 5 percent of its global work force, after third-quarter profits fell sharply from a year ago. The company cited financial market turbulence and diminished profit opportunities in emerging markets as leading reasons for the cost-cutting move. Earnings were also down at other Wall Street firms. In addition, BankAmerica announced Wednesday that its third-quarter earnings were 50 percent lower than a year ago, owing in part to a $372 million writedown of a credit to a single trading and investment firm. Bank stocks, especially those of money center banks, have fallen more sharply than the market as a whole in recent months. But the news was not all bad for banks. First Union posted record quarterly profits, while Wachovia reported a 13 percent jump in operating income. Both are regional banks and are therefore not so vulnerable to global troubles.

Study Throws Cold Water on Supply Siders. The 1986 Tax Reform Act lowered marginal tax rates substantially, with the top bracket falling from 50 to 28 percent. Research has shown that, subsequent to the rate cut, incomes of wealthy taxpayers generally rose. Some have presumed that the lower rates increased work incentives among the affluent, leading them to work more and thereby increase their incomes. But a recent study of 500 men surveyed both before and after the tax act (in 1983 and then again in 1989) finds no evidence of a labor supply response (measured by hours worked) among the affluent (or for that matter among those with low or middle incomes). Economic theory allows for offsetting effects from the wage incentive to work more hours and the income incentive to take more leisure, but the authors also note that most affluent men were already working more than 2,500 hours per year before the act, which might have limited their opportunity to increase their work hours. Full-time work is generally considered to be 2,000 hours per year.

Automobile Anti-Pollution Devices to Be Treated as a Cost in the CPI. The Bureau of Labor Statistics has decided that, beginning in 1999, it will no longer treat modifications to goods and services that are made solely to meet air quality standards as quality improvements in the consumer price index. Price increases associated with such modifications will be treated as increases in the index. The new policy will have its most significant effect on the motor fuel and new and used motor vehicle components of the CPI. The rationale for the decision is that price changes deriving from mandated product changes that affect only public goods (like clean air) are properly treated in the CPI as pure price changes, because the benefits do not accrue to the individual purchaser. By contrast, mandated changes that also entail a change in product characteristics for which consumers would ordinarily pay (like increased safety) should continue to be treated as a quality improvement. BLS estimates that the CPI would have risen an additional 0.7 percent (0.025 percent per year) between 1968 and 1997 if the proposed procedures had been in effect.

EYES ONLY

INTERNATIONAL ROUNDUP

Flexible Monetary Strategy Set for EMU. This week, the Governing Council of the European Central Bank (ECB) shed light on two questions: (1) whether they would target the inflation rate or some other variable when they begin operations in January, and (2) the initial level of interest rates. On the first question, the ECB agreed on the three main elements of its monetary policy strategy. First, the maintenance of price stability will be the primary objective of the European System of Central Banks. Price stability has now been defined as a year-over-year increase of below 2 percent in the Harmonized Index of Consumer Prices for the euro area. Second, quantitative reference values for the growth of a broad monetary aggregate will be announced, a decision that shows the influence of Bundesbank thinking. However, the concept of a reference value is not meant to imply a commitment to correct deviations mechanistically over the short term. Third, a broadly based assessment of the price outlook using a wide range of economic indicators will play a major role in the monetary policy strategy. Much uncertainty remains, however, regarding the second question: exactly how interest rates will converge in the various countries involved. In remarks following the announcement, ECB officials rejected calls for world-wide interest rate cuts, citing expected reductions as all member countries' rates converge downward to French and German levels. It has been argued that the ECB would like to start off with a reputation for monetary discipline.

Japanese Bank Bill Is Moving through the Diet. A rescue package for Japan's weakest banks may emerge from the parliament as early as Friday. The release of official details is pending the expected passage, but the likely enactment of a 60 trillion yen (about $500 billion) package came as a pleasant surprise to many observers who had expected a much smaller amount. It appears that roughly 30 percent will be committed to protecting depositors, 40 percent to recapitalizing banks, and 30 percent to purchasing the shares of nationalized banks. Questions remain, however, about the bailout's overall effectiveness. Strict conditions on management responsibility are imposed on banks receiving public funds. This, along with the stigma associated with state support, has some analysts questioning whether banks will voluntarily apply for injections of public capital. Such concerns led Prime Minister Obuchi's chief cabinet secretary to suggest that the government retain the option to force public recapitalizations at its discretion. Even so, uncertainty about the economic future might prevent even well-capitalized banks from lending, which could prolong Japan's credit crunch.

UN Study Analyzes Consumption for Human Development. Despite a dramatic surge in global consumption, with real expenditures doubling over the last 25 years, more than a billion people still lack the opportunity to consume in ways that meet their basic needs, according to The United Nations' *1998 Human Development Report*. The report also argues that many people, especially in industrial countries, are consuming in ways that cannot be long sustained environmentally or socially.

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization
****Embargoed until 9:15 a.m., Friday, October 16, 1998****

The Federal Reserve's index of industrial production declined 0.3 percent in September. Capacity utilization fell 0.5 percentage point, to 81.1 percent.

Consumer Price Index
****Embargoed until 8:30 a.m., Friday, October 16, 1998****

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

Producer Price Index

The producer price index for finished goods increased 0.3 percent in September. Excluding food and energy, producer prices increased 0.4 percent.

Retail Sales

Advance estimates show that retail sales increased 0.3 percent in September. Excluding sales in the automotive group, retail sales rose 0.1 percent.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1997	1997:4	1998:1	1998:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	3.0	5.5	1.8
GDP chain-type price index	5.4	1.7	1.1	0.9	0.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	0.9	3.5	0.1
Real compensation per hour:					
Using CPI	0.6	1.9	2.8	4.1	2.0
Using NFB deflator	1.3	2.0	3.9	4.3	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	10.7	11.0	11.2
Residential investment	4.5	4.0	4.1	4.2	4.3
Exports	8.2	11.9	12.0	11.6	11.3
Imports	9.2	13.1	13.2	13.1	13.1
Personal saving	5.2	1.5	1.2	0.9	0.3
Federal surplus	-2.7	-0.3	0.0	0.7	0.9

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	4.6
Payroll employment (thousands)					
increase per month			118	309	69
increase since Jan. 1993					16745
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	**0.0**
PPI-Finished goods	5.0	-1.2	0.2	-0.4	**0.3**

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

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, October 16, 1998**.

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	August 1998	September 1998	Oct. 15, 1998
Dow-Jones Industrial Average	5743	7441	8479	7910	8299
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.90	4.61	4.05
10-year T-bond	6.44	6.35	5.34	4.81	4.58
Mortgage rate, 30-year fixed	7.80	7.60	6.92	6.72	6.90
Prime rate	8.27	8.44	8.50	8.49	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 15, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.626	1.3	-7.0
Yen-Dollar	117.5	-1.1	-3.1
Multilateral $ (Mar. 1973=100)	92.90	0.8	-4.1

International Comparisons 1/	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.6 (Q2)	4.6 (Sept)	**1.5** (Sept)
Canada	3.1 (Q2)	8.3 (Aug)	1.0 (Aug)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.0 (Q2)	11.7 (Jul)	0.7 (Aug)
Germany	2.5 (Q2)	2/ 7.4 (Jul)	0.7 (Aug)
Italy	1.1 (Q2)	12.4 (Apr)	1.9 (Aug)
United Kingdom	2.6 (Q2)	6.2 (Jun)	3.3 (Aug)

U.S. CPI data **embargoed until 8:30 a.m., Friday, October 16, 1998**.

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 July 1998 is 9.6 percent.

EYES ONLY

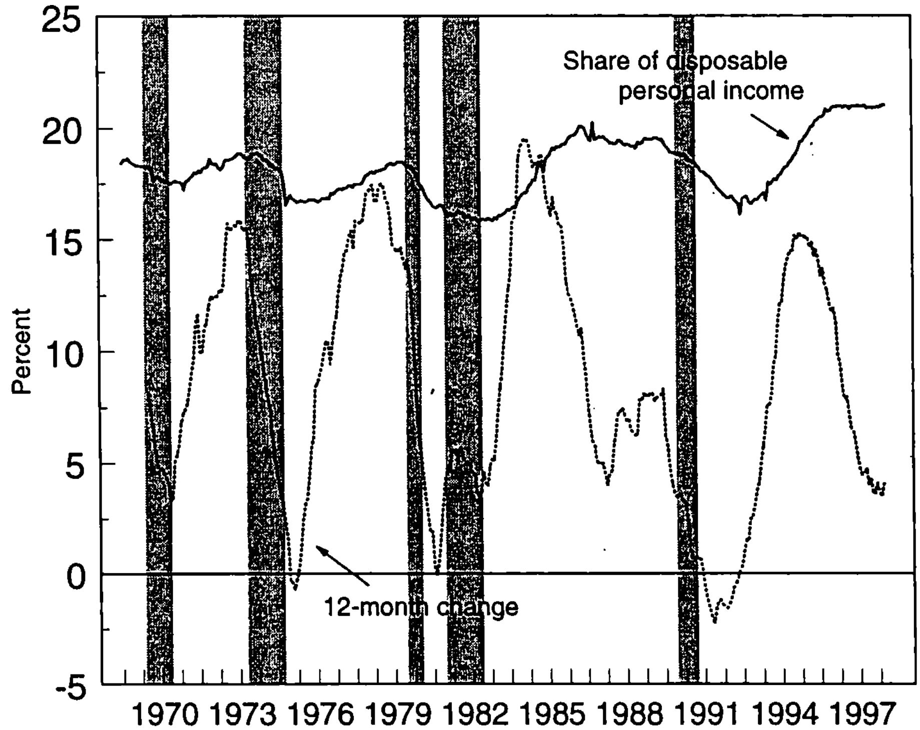
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 9, 1998

CHART OF THE WEEK

Trends in Consumer Credit



Data released this week show that consumer credit increased at a relatively modest 4.1 percent pace over 12 months ending in August. Nevertheless, consumer credit as a share of disposable personal income remains high at 21.0 percent. Consumer credit covers most short- and intermediate-term credit extended to individuals, such as car loans and credit cards; it excludes loans secured by real estate.

EYES ONLY

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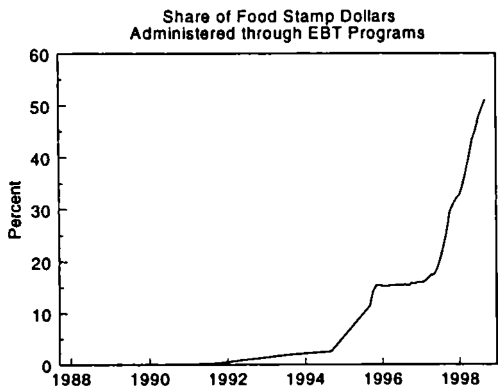
"I'm looking for a hedge against my hedge funds."

EYES ONLY

SPECIAL ANALYSIS

Electronic Benefits Cross 50 Percent Mark for Food Stamps

The latest estimates indicate that more than half of food stamp benefits were distributed through an electronic benefits transfer (EBT) system in September (see chart). By October 1, 2002, all states must replace the paper coupon system with an EBT system. Thus far, 20 states have a statewide system, and another 14 have an EBT system in some areas.



Preliminary evaluations indicate a favorable response to EBT from recipients, food retailers, and financial institutions. It remains an open question, however, whether the move to EBT will change people's behavior.

What is EBT? In the EBT system, recipients are issued plastic electronic benefit cards and a personal identification number for verification. Benefits are electronically credited to a recipient's account each month and grocery purchases are debited from the account through the EBT card. The primary goals of the EBT system are to reduce administrative costs and curtail food-stamp fraud.

Participation effects. The switch to an EBT system could increase participation by reducing participation costs and stigma. For many of the 30 percent of those who are eligible for food stamps but do not now participate, the level of available assistance may be too small to justify the time and effort required to register for and participate in the program. To the extent that the automatic monthly crediting of recipients' EBT accounts reduces these costs, it could make participation more worthwhile. In addition, because transactions conducted with an EBT card are identical to those conducted with a standard grocery store debit card, the EBT system could reduce embarrassment that might be associated with food-stamp use.

Food purchase effects. Although the EBT system might increase participation, it could reduce food consumption per participant. Research has found that an additional dollar of food stamps increases the typical recipient's net food expenditure by between 17 and 47 cents, compared with an increase of between 5 and 10 cents from an additional dollar of cash income. One reason might be that households spend more on food at the beginning of the month when their coupons arrive and then, after the coupons run out later in the month, they buy additional food with cash. Another possibility is that, within a household, the use of food stamps is more under the control of women, who tend to spend relatively more on food. Like food stamps, EBT cards are distributed to the heads of recipient households. But to the extent that recipients come to regard EBT cards as more like cash than like coupons, the switchover to EBT might lead to expenditure patterns more like those associated with cash income.

The "no change" effect. One aspect of EBT might lead to greater food consumption per participant. Under the paper coupon system, recipients could receive up to 99 cents in change for a given transaction. This money could then be spent on anything. The EBT system, by contrast, eliminates cash change by deducting the exact amount of the transaction from the recipient's account. This reduces the amount of food-stamp dollars that can be diverted to nonfood consumption and could result in an increase in food consumption.

Conclusion. The switchover to an EBT system for food stamps is now underway. Early evaluations suggest that the move is a popular one. But it will be some time before we know how participation and food consumption will be affected.

EYES ONLY

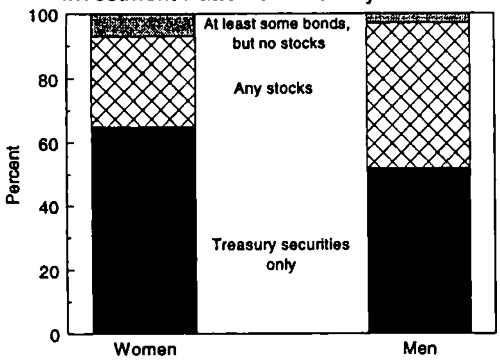
SPECIAL ANALYSIS

Gender Differences in Retirement Investments

Women appear to make more conservative retirement investments than men. As a result they are likely to end up with less wealth to finance their retirement.

Evidence from the TSP. Federal employees participating in the Thrift Savings Plan (TSP) can allocate their savings among three funds: one consisting of special short-term U.S. Treasury securities issued only to the TSP; a fixed-income index fund of government and corporate bonds; and a stock fund indexed to the Standard and Poor's 500 index. A study based on the 2 million participants in TSP in 1990 found that 65 percent of women and 52 percent of men invested *only* in the special Treasury securities fund—the one providing the least risk but also the lowest expected return (see chart). Only 28 percent of the women, but 45 percent of the men, participated in the common stock index fund.

Investment Patterns in TSP by Gender



Gender-specific differences. Virtually all studies of portfolio choice that are able to control for income and wealth find that lower-income and less-wealthy individuals invest more conservatively than those who are better off. Thus, some of the gender differences found in the TSP study may reflect the fact that women typically have lower earnings and less wealth than men. However, the TSP study found that men were more likely than women to invest in the stock and government/corporate bond index funds, even after controlling for salary, other family income, age, and marital status. Married women as a group made the most conservative choices while single men were least conservative. Married men and single women made similar choices.

The TSP study was not able to control for other assets. Some studies have found that women are *not* more conservative in their portfolio choices than men, once wealth as well as other determinants of investment behavior are taken into account. But these studies are not definitive. To the extent that there are gender-specific differences, one reason might be that the high divorce rate makes it risky for women to "invest" in their husbands' careers instead of in their own earning power, which leads them to choose more conservative financial investments in order to balance their overall "portfolios."

Implications. The (adjusted) gender-specific difference between the percentages of men's and women's contributions invested in the stock fund was estimated to be 14 points in the TSP study. As a result of women's more conservative choices, the men's accumulation was predicted to be 8 percent larger after 20 years and 16 percent larger after 35 years.

EYES ONLY

ARTICLE

Should All NO_X-ious Emissions Be Treated the Same?

The damage caused by some pollutants such as nitrogen oxides (NO_X), which contribute to the formation of ozone both locally and in downwind areas, depends upon where the emissions occur. For example, NO_X emissions from Ohio contribute to violations of ozone standards in heavily populated downwind areas including Pennsylvania and New York, while emissions from Florida do not.

New Environmental Protection Agency regulations to reduce NO_X emissions across 22 states plus the District of Columbia allow trading on a one-for-one basis between any sources in the region regardless of location. In principle, intelligent policy would aim to reduce emissions more from sources that cause greater harm, but practical implementation issues may justify EPA's decision to treat emissions from all sources equally.

Accounting for different damages. Permit trading encourages cost-effective pollution control by equalizing the incremental cost of reducing emissions across all sources. When the environmental damages caused by a unit of pollution are the same across all sources (as is the case with CO_2 emissions, for example), permit trading can minimize the cost of achieving any given level of environmental quality. The situation is more complicated, however, in the case of pollutants like NO_X, where the environmental damage per unit of emissions depends on where the emissions occur. In such cases, minimizing damages in a cost-effective manner requires weighing the relative damages caused by a unit of emissions from two sources in order to calculate a permit-trading ratio between the sources.

Practical difficulties. While desirable in theory, damage-weighted trading may be difficult to implement. In particular, it is often difficult to measure damages from specific sources objectively. For example, the contribution of NO_X emissions to ozone formation depends on the combination of wind patterns, temperature, sunshine and complex and incompletely understood air chemistry. Uncertainty over objective measures, combined with the lack of an easily applied principle like equal treatment of all sources, may create intense lobbying pressure. Even with full scientific understanding, basing trading prices on formulas that depend in part on weather conditions will subject sources to considerable uncertainty. In addition, the complexity of weighting trades according to damages will increase administrative costs.

Policy experience. For the most part, regulators have adopted simple rules that allow one-for-one trades among all sources, even when the location of emissions matters. Nevertheless, experience to date in the national SO_2 program indicates that trading has not increased emissions from places that cause higher damages, such as the Ohio River Valley. A similar outcome is anticipated for NO_X trading. One program that has taken the location of emissions into account is the RECLAIM trading program in Southern California, where the trading region is divided into a coastal and an interior zone. Because of the larger potential damages caused by emissions in the coastal region, a source in the interior region cannot trade the right to emit to a source in the coastal region.

Conclusion. For pollutants for which the location of emissions matters, it is potentially important to account for the difference in damages from different emissions sources. The trick in practice is to account for such differences in a workable, flexible, and simple regulatory scheme. One possibility that could account for large differences in damages while still being simple enough to implement might be to establish trading regions within which trades take place on a one-for-one basis (like the RECLAIM program), but to extend the idea by allowing trades between regions at a specified ratio that reflects relative damages.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Large Firms Face Tighter Credit. In mid-September, the Federal Reserve conducted a special Senior Loan Officer Opinion Survey to assess the impact of recent financial turbulence on the bank loan market. The study found a fairly widespread tightening of standards and terms for loans to larger firms. For domestic banks, this tightening represented a shift from surveys as recent as mid-August; for foreign banks operating here it was a continuation of recent trends. The survey revealed little change in standards and terms for loans to small firms or in banks' willingness to provide consumer installment loans—though even this stability marks a modest departure from the tendency toward some easing shown in August. Banks that reported having tightened lending standards cited a less favorable economic outlook and worsening of industry-specific problems, as well as a reduced tolerance for risk. Despite this tightening of standards and terms, the volume of commercial and industrial loans issued increased in September, perhaps because weak demand for junk bonds has led companies to seek out more bank loans. With investors behaving more cautiously as a result of economic problems in Russia, Japan, and other Asian countries, only $21 billion of high-yield bonds were issued in the third quarter, compared with $100 billion in the first 6 months of the year.

Survey Finds Firms Take Minimum-Wage Hike in Stride. The latest minimum-wage hike, from $4.75 to $5.15 per hour, affected hiring or employment decisions at just 6 percent of small businesses, with 89 percent reporting no effect, according to a survey of 568 commercially and geographically diverse small businesses conducted by the Jerome Levy Institute. Among firms reporting that they were affected by the increase, 17 percent reduced new hires and 6 percent required layoffs. According to the survey, an increase to $6.00 per hour would affect hiring at 21 percent of small businesses and lead to layoffs at only 3 percent. Among firms paying entry-level wages at or near the minimum wage ($5.15 to $6.00 per hour), 87 percent reported no effect on hiring or employment from the most recent increase, and 60 percent predicted no effect from an increase to $6.00. Retail sales and trade, service, and food service industries were found to be most sensitive to wage increases.

Free Trade Can be Good for the Environment. A recent study of sulfur dioxide concentrations using data from 44 countries spanning the years 1971-1996 identifies three distinct channels through which freer trade affects the environment. The first is a *composition* effect: pollution will go up in countries in which trade shifts the pattern of production towards pollution-intensive goods and down in countries in which trade shifts it away from pollution-intensive goods. However, the study finds these composition effects to be small. The other two effects—*scale* and *technique*—stem from the increase in output and income that are likely to be stimulated by freer trade. The study finds that if trade liberalization raises GDP per person by 1 percent, the resulting increased scale of production raises sulfur dioxide concentrations by 0.3 percent, but the resulting higher income encourages cleaner production techniques that reduce concentrations by about 1.4 percent. Thus, on balance, freer trade improves the environment.

EYES ONLY

INTERNATIONAL ROUNDUP

Surge in Yen May Be Evidence of Irrationality. This week the yen went from over 135 per dollar to 112 at one point, before coming back to about 120. IMF Managing Director Michel Camdessus is reported to have said that this reflected the irrationality gripping global markets. The appreciation of the yen came in the wake of a number of developments in Japan. Last week, Bank of Japan's quarterly survey of corporate sentiment (the "tankan") showed a disappointingly large drop in corporate morale. This week the Economic Planning Agency downgraded its forecast for this fiscal year from 1.9 percent growth to a 1.8 percent contraction, and the Ministry of Trade and Industry publicly called for 10 trillion yen in new spending. Perhaps in response, Prime Minister Obuchi instructed his cabinet to devise effective stimulus steps quickly. The biggest news, however, appeared to be a plan submitted to the Diet on Wednesday to use public money to recapitalize banks. Optimism that the plan might pass appeared to be behind a rare and dramatic 6.2 percent advance for the slumping Nikkei. Market enthusiasm waned Thursday, however, and the Nikkei gave back most of its gains. Few credited improved prospects for the Japanese economy for the sharp appreciation of the yen over these 2 days. Traders pointed instead to massive dollar sales by hedge funds seeking to liquidate risky bets against the yen and to protect against further losses.

Corruption Index Now Covers 85 Countries. A large number of countries scored poorly in the 1998 Corruption Perception Index recently published by the independent organization Transparency International. The index, which was instituted in 1995, now covers 85 countries. It draws upon numerous distinct surveys of expert and general public views of the extent of corruption in many countries around the world. Seven of the 10 least corrupt countries are European, with Denmark leading the list. The most corrupt country is Cameroon, followed by Paraguay and Honduras. The United States is ranked 17th, tied with Austria.

21st Annual World Development Report Analyzes the Role of Knowledge. The global explosion of knowledge now underway may lift hundreds of millions of the world's poor out of poverty—or it may create a widening knowledge gap, in which poor countries lag further and further behind. This is the challenge posed by *Knowledge for Development*, the 1998/99 World Development Report from the World Bank. The report focuses on two types of knowledge problems that are critical for developing countries: inadequate *how-to knowledge* in areas such as nutrition, birth control, engineering, and accounting; and inadequate *information* about such things as the quality of a product or the creditworthiness of a small firm, which could limit the effective working of markets. The report recommends that developing country governments adopt policies to close the knowledge gap that separates them from rich countries, including investing in education (especially of girls) and maintaining an open trading regime. The latter is important for a variety of reasons, including exporters tend to invest more in knowledge, and valuable knowledge spillovers are associated with direct foreign investment by multinational investors.

EYES ONLY

RELEASES THIS WEEK

No major releases.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1997	1997:4	1998:1	1998:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	3.0	5.5	1.8
GDP chain-type price index	5.4	1.7	1.1	0.9	0.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	0.9	3.5	0.1
Real compensation per hour:					
Using CPI	0.6	1.9	2.8	4.1	2.0
Using NFB deflator	1.3	2.0	3.9	4.3	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	10.7	11.0	11.2
Residential investment	4.5	4.0	4.1	4.2	4.3
Exports	8.2	11.9	12.0	11.6	11.3
Imports	9.2	13.1	13.2	13.1	13.1
Personal saving	5.2	1.5	1.2	0.9	0.3
Federal surplus	-2.7	-0.3	0.0	0.7	0.9

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	4.6
Payroll employment (thousands)					
increase per month			118	309	69
increase since Jan. 1993					16745
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	N.A.
PPI-Finished goods	5.0	-1.2	0.2	-0.4	N.A.

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

EYES ONLY

FINANCIAL STATISTICS

	1996	1997	August 1998	September 1998	Oct. 8, 1998
Dow-Jones Industrial Average	5743	7441	8479	7910	7732
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.90	4.61	3.80
10-year T-bond	6.44	6.35	5.34	4.81	4.56
Mortgage rate, 30-year fixed	7.80	7.60	6.92	6.72	6.49
Prime rate	8.27	8.44	8.50	8.49	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 8, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.606	-2.7	-8.4
Yen-Dollar	118.9	-12.4	-1.8
Multilateral $ (Mar. 1973=100)	92.14	-3.5	-4.9

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.6 (Q2)	4.6 (Sept)	1.6 (Aug)
Canada	3.1 (Q2)	8.3 (Aug)	1.0 (Aug)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.0 (Q2)	11.7 (Jul)	0.7 (Aug)
Germany	2.5 (Q2)	[2] 7.4 (Jul)	0.7 (Aug)
Italy	1.1 (Q2)	12.4 (Apr)	1.9 (Aug)
United Kingdom	2.6 (Q2)	6.2 (Jun)	3.3 (Aug)

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 July 1998 is 9.6 percent.

EYES ONLY

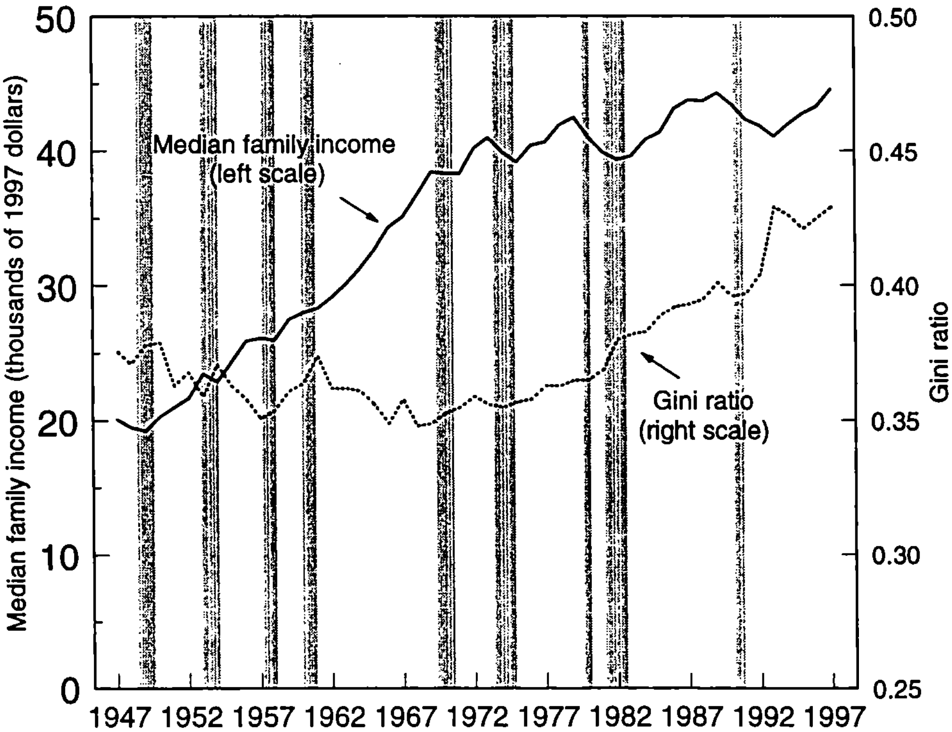
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 2, 1998

CHART OF THE WEEK

Family Income over the Past Fifty Years



Median family income doubled between 1947 and 1973, after adjusting for inflation. Growth since then has been much more modest and more subject to cyclical fluctuations (the gray bars in the chart represent recession periods). Slower growth in real median family income over the past two decades has also been accompanied by increasing inequality in the distribution of income, as measured by the Gini ratio.

EYES ONLY

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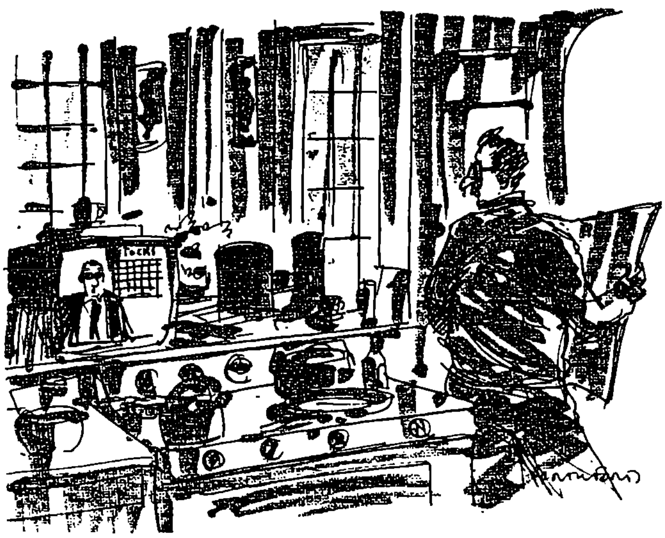


"And now, if you don't want to know today's Dow Jones closing, look away from your set until the music stops."

EYES ONLY

CURRENT DEVELOPMENT

Hedge Fund Gets Clipped

Last week, a group of large financial institutions urgently invested $3.5 billion in the hedge fund Long-Term Capital Management (LTCM) in order to prevent its collapse. What is a hedge fund and what got LTCM in trouble?

Funds for the sophisticated. The label "hedge fund" is usually applied to investment funds that are unregulated because they restrict participation to a relatively small number of wealthy investors. No precise figures are available, but the amount invested in hedge funds appears to be in the $200-300 billion range. These funds often make combinations of transactions—including the use of derivatives—that allow them to hedge some kinds of risk (see box).

What went wrong at LTCM? According to press accounts, LTCM gambled that yield spreads between Treasury bonds and many riskier types of debt would narrow. Instead, the recent "flight to quality" sharply widened risk spreads, causing many of LTCM's bets to fail at the same time. In addition, LTCM had financed many transactions by borrowing. By leveraging its relatively small amount of equity capital, the fund raised profits when its investment decisions were correct, but reduced its margin for error.

What is the role for government? If LTCM had gone bankrupt and been forced to liquidate its large and somewhat illiquid portfolio quickly, financial markets might have been seriously disrupted. To avoid this outcome, the New York Federal Reserve Bank brought LTCM's principal creditors together, but it did not set the terms of the rescue or invest public money. Still, analysts have noted that even the appearance of government assistance might encourage greater risk-taking by investment firms in the future.

Why Are They Called Hedge Funds?

By engaging in specific combinations of transactions, hedge funds protect their portfolios against all risks except the ones they choose to take. For example, if a hedge fund believes that the yield spread between mortgage-backed securities and U.S. Treasuries is likely to decline, it can buy mortgage-backed securities and sell Treasuries short. Then, changes in the yield spread will generate gains or losses for the fund, but common movements in the yields will be a wash. Such a "pure play" focuses risk exposure but does not eliminate it.

EYES ONLY

SPECIAL ANALYSIS

Are Large Firms More Technologically Innovative?

Joseph Schumpeter conjectured more than 50 years ago that large enterprises, by virtue of their superior ability to attract capital and brain power, bear risk, and recoup investments, were superior innovators to small firms. Empirical studies have provided both limited support and important challenges to Schumpeter's claim.

Innovative input: research and development. Studies consistently find that bigger enterprises are more likely than smaller ones to undertake at least some R&D. In addition, among those firms that do undertake R&D, bigger firms tend to make larger R&D investments. But are these investments *proportionately* larger? Early studies found that the intensity of R&D varied somewhat by industry. For example, large firms were found to spend proportionately more on R&D in the chemicals industry, but proportionately less in pharmaceuticals. But in most industries and in most cross-industry studies, size did not prove to be a good predictor of R&D investment per dollar of sales volume or other measures of firm scale. More sophisticated recent research has led to a consensus that, in general, R&D rises only proportionately with firm size. These results suggest that large firms have no particular tendency—nor any notable reluctance—to engage in innovation.

Innovative output: patents. Although evidence based on R&D investment is instructive, several scholars have argued that it would be better to test Schumpeter's conjecture by looking at innovative output. Here several studies spanning the 1960s through the 1990s have found that small firms account for a disproportionately large share of patents—though once again with some variation across industries. Studies that have explicitly matched R&D investment with patent output have found that smaller firms produce more innovations per R&D dollar than do large firms.

These results do not necessarily imply a negative assessment of large firms' innovative efforts. First, there may be diminishing returns to R&D, and large firms may simply be more willing to invest in projects with less prospect of success. Second, not all patents or other innovative outputs are equivalent in value. So simply counting patents and dividing by R&D investment is an imperfect measure of innovative productivity. Third, large firms may earn higher returns on R&D than small ones because of their ability to deploy innovations across a broader array of products or take advantage of process cost savings over a larger production volume. So even though a large firm might produce fewer patents per R&D dollar, it may earn more per patent, perhaps explaining why large firms continue to invest in R&D even after their proportionate patent yield drops below that of smaller firms.

Conclusion. The relationship between firm size and innovation is complex. Available evidence calls into question Schumpeter's conjecture that large firms are superior innovators, but it does not lead to the contrary view that large firms are bad for technological progress and economic growth.

EYES ONLY

SPECIAL ANALYSIS

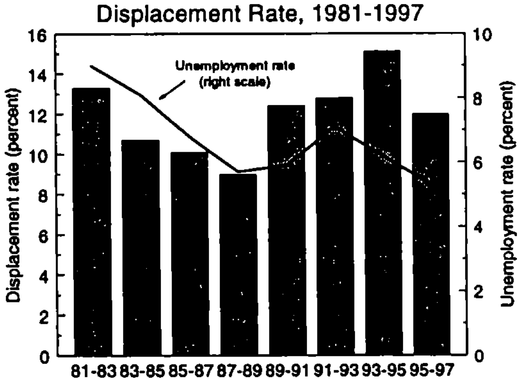
Conditions Improve Substantially for Displaced Workers

Based in part on data from the 1996 survey of displaced workers, which showed job displacement to be unusually high given the overall strength of the labor market, some analysts argued that the employer-employee relationship had changed and job instability was on the rise. But new data showing a substantial decline in job displacement and a record low loss in workers' earnings associated with displacement suggest that this interpretation may have been premature.

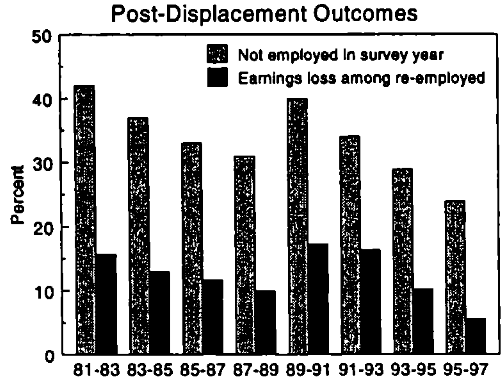
The displaced worker survey. Since 1984, the Department of Labor has conducted a biennial survey of workers who have been displaced from their job sometime in the 3 years prior to the survey. Displacement is defined as job loss due to a plant closing, insufficient or slack work, abolishment of a position or shift, or some other similar reason.

Displacements on the decline. The 1996 survey was cause for concern because it indicated that the number of workers who reported being displaced at some time between 1993 and 1995 was equivalent to 15.1 percent of the workforce—up from 12.8 percent in 1991-93, despite a drop in the overall unemployment rate (see upper chart). The 1998 survey is more encouraging, showing a drop in the displacement rate to 12.0 percent for the 1995-97 period. Moreover, declines were evident for all major groups of workers: men and women, younger and older workers, high school dropouts and college-educated workers, and workers in manufacturing as well as professional services. Nevertheless, the rate of job displacement in 1995-97 was 20 percent higher than it was in 1987-89—when the unemployment rate was roughly the same.

Displacement Rate, 1981-1997



Post-Displacement Outcomes



Costs of displacement. Historically, 30 to 42 percent of displaced workers were not re-employed 1 to 3 years after losing their jobs. Thus it is encouraging that this rate has fallen to 24 percent in the latest survey (see lower chart). In addition, re-employed workers typically earn less than they did in their previous jobs. For example, one study of workers with at least some earnings in the years after displacement found an average earnings decline of 29 percent in the year of displacement that subsequently shrank to an average loss of 10 percent. The latest data, by contrast, show that the loss in weekly earnings among those who were re-employed was at a record low of 5.7 percent overall in 1995-97. Losses are at or near record lows for workers of all education levels, with workers at higher education levels now experiencing particularly small losses.

Conclusion. The latest data on job displacement goes a long way toward laying to rest the most serious concerns raised by the 1996 results. Nevertheless, job displacement remains more common than it was in the 1980s, which will continue to fuel the discussion of employment insecurity.

EYES ONLY

ARTICLE

Climate Forecast: Increasing Sun and Wind

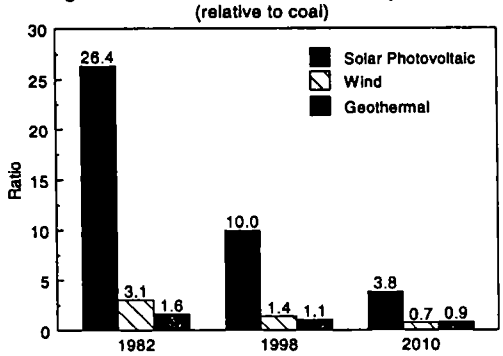
Improvements in (non-hydropower) renewable energy technologies have substantially reduced the costs of these technologies over the past two decades, and some analysts have expressed enthusiasm for the opportunities for such renewable energy to replace significant amounts of fossil fuel-based power. However, the weight of the evidence suggests that these renewable energy sources will most likely supply only a small fraction of total U.S. energy over the next two decades.

Trends and projections. Renewable energy has long been a significant component of U.S. electricity generation. In 1950, hydropower was about 30 percent of total electricity generation—second only to coal as a source of electricity. In the late 1960s, new generation came from non-hydro renewable sources, traditionally defined as wind, solar, biomass and waste combustion, and geothermal power. Non-hydro renewable generation increased through the 1970s and 1980s, in part due to R&D devoted to alternative energy sources spurred by the 1973 and 1979 oil shocks.

By 1996, the share of hydropower had fallen to about 10 percent, while non-hydro renewable generation had climbed to 2.2 percent of total electricity generation. The share of hydropower generation is projected to fall further between 1996 and 2020, while other renewables are projected to edge up to 2.6 percent of total electricity generation. Since most good opportunities for hydropower development have already been employed, growth in renewable power will likely depend on the development of these other sources. Although their costs are projected to decline further, use of non-hydro renewable energy sources is not likely to increase much in the face of low coal prices.

Costs are coming down. While hydropower has long been a cheap source of energy, non-hydro renewables have historically had much higher generation costs. In 1982, solar photovoltaic power cost more than 25 times as much as coal while wind power was about 3 times as expensive (see chart). But continued technological advances, together with cost reductions arising from greater economies of scale in production, have lowered generation costs. Wind is now competitive in some areas, while the costs of solar photovoltaics have fallen 70 percent. In addition, geothermal is now competitive in those limited areas where it is feasible.

Average Cost of Renewable Electricity Generation
(relative to coal)



Renewables and climate change. Non-hydro renewable energy that generates electricity without carbon dioxide emissions can help address the risks of climate change. The economics of renewables become more attractive, for example, when coal and natural gas prices include the cost of a greenhouse gas permit. Several modeling simulations indicate, however, that the cost of a greenhouse gas permit would need to be relatively high for non-hydro renewables to increase significantly by 2010. In one simulation, for example, the permit price had to be about $350 per ton for the share of electricity generation from non-hydro renewables to double; at a price as high as $65 per ton non-hydro renewables displaced less than 0.5 percent of fossil fuel-based electricity generation in 2010. These results indicate that during the first "budget period" established under the Kyoto Protocol, electricity generators would more likely switch over to natural gas than to non-hydro renewable sources.

Conclusion. Electricity generation costs from non-hydro renewable sources have fallen significantly over the past two decades. Drawing from this experience, one recent analysis even suggests that solar photovoltaic power could cost-effectively replace fossil fuels midway through the next century. Over the next 20 years, however, these renewables most likely will continue to account for only a small share of electricity generation.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Fed Eases; Markets Unimpressed. A week ago financial markets reacted favorably when Federal Reserve Chairman Greenspan signaled that a rate cut was imminent. But the cut in the Federal funds target rate from 5½ to 5¼ percent seemed to disappoint markets, which apparently were hoping for a stronger move by the Fed—either a larger rate cut or an accompanying cut in the discount rate (the rate the Fed charges banks who borrow reserves from it). The Fed funds futures market implies that investors expect a further 0.5 percentage point cut by year-end.

FCC Thwarts Bell Operating Companies on Long Distance—Again. This week the Federal Communications Commission ruled that business agreements entered into by Ameritech and U S WEST to provide long distance service to their local customers violate the Communications Act because the companies have not yet demonstrated that their local telephone markets are open to competition. Both companies had agreements with a third firm, Qwest Communications Corp., to offer Qwest's long distance service as part of a package of services they offered customers under their own brand name. Section 271 of the Telecommunications Act is meant to prevent Bell Operating Companies (BOCs) from leveraging their bottleneck control of local telephone markets into the long distance market and to provide an incentive to open their local market to competition. In 1997, Ameritech made the first of several BOC efforts to try to enter the long distance market, but it withdrew its application when the FCC determined that it had not yet opened its local markets to competition.

Program for Poor Fathers Shows Poor Results. The Parents' Fair Share Demonstration, conducted at seven sites since 1994, offered a quid-pro-quo to low-income noncustodial fathers: in return for their cooperation with the child support system, participants received employment and training services as well as peer support focused on responsible parenting. An experimental evaluation found no increases in employment, earnings, or average child support payments during the first 18 months. The percentage of fathers who made any child support payment during the period showed a modest increase, from 69 to 73 percent. The participants were a disadvantaged group, with the majority in poverty and with little access to public assistance. Half lacked a high school diploma and 70 percent had an adult arrest record.

Census Documents 50 Years of Economic Change Using the CPS. This week the Census Bureau released a chart book chronicling a half century of measuring income in America using the Current Population Survey (see the Chart of the Week, for example). Highlighted trends include a 150 percent increase in the real median income of married-couple families between 1947 and 1997 (due in part to an increase in the number of married women in the labor force); a rise in the ratio of female-to-male earnings to a record high; and a continuing three-decade-long increase in the number of children in poverty. The March supplement to the CPS provides the data for Census' annual income and poverty estimates.

INTERNATIONAL ROUNDUP

IMF Staff Urges Looser Monetary Policy. The International Monetary Fund staff is recommending that monetary policies be eased or that accommodative monetary policies be retained in countries accounting for 90 percent of world GDP, according to IMF chief economist, Michael Mussa. Tighter fiscal policies are being recommended for countries accounting for only about 10 percent of world GDP. Speaking at a press conference on the release of the latest *World Economic Outlook*, Mussa attacked the popular impression that the Fund staff has nothing to recommend but tighter monetary and fiscal policies. Recommendations for easier policies reflect the latest IMF expectation that world GDP will grow only 2 percent this year and 2.5 percent next year.

Pessimism about Global Economy Increases. Private sector concerns regarding the fallout from the Asian crisis are building. For instance, Goldman Sachs recently reported that securities prices are consistent with a 40 percent probability of recession in the next 12 months. WEFA states that the likelihood of a global meltdown is now "significant," assessing its probability at 30 percent. Noting the recent occurrence of key elements of its worst-case scenario, Standard & Poor's DRI also increased its subjective probability of a world recession to 30-35 percent. Included among its concerns are the potential for policy mistakes such as foot-dragging on IMF funding and rising protectionist pressures.

Hungary Stays on Growth Path, Aims for EU Integration. Like other transition economies, Hungary at first suffered a sharp drop in GDP (17 percent between 1990 and 1993). But the stabilization and reform program introduced in 1995 led to a strong recovery, with 4.4 percent GDP growth in 1997. Sustained growth now seems achievable, fueled by exports and investment and supported by comprehensive structural reforms. Privatization and regulatory reform have occurred in infrastructure sectors (such as electricity, gas, telecommunications, and transportation), and regulatory agencies have been created and strengthened in the financial sector. The newly elected center-right government has declared its intent to continue the reform process, and achieving integration into the EU has become the most important issue on the economic agenda. Budget deficits and inflation have been reduced, but progress must continue and the enforcement capacity of the country's legal institutions must be improved.

IIF Forecasts Substantial Fall in Emerging Market Capital Flows. Net private capital flows in 1998 are expected to fall to just over half of their 1996 levels, according to the Institute of International Finance, a global association of private sector financial institutions. The IIF predicts that portfolio equity flows will decline much more than direct investment, which should hold firm. Contraction in commercial bank lending, however, largely accounts for the overall decline. Data for Indonesia, Malaysia, South Korea, Thailand, and the Philippines indicate an expected net private outflow of $25 billion this year. Reduced bank lending more than accounts for this total; $30 billion in loans will be withdrawn in 1998.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment
****Embargoed until 8:30 a.m., Friday, October 2, 1998****

In September, the unemployment rate was 4.6 percent; it was 4.5 percent in August. Nonfarm payroll employment rose by 69,000.

NAPM Report on Business

The Purchasing Managers' Index was unchanged in September at 49.4 percent.

Leading Indicators

In August, the composite index of leading indicators was unchanged, following an increase of 0.5 percent in July.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, fell 7.1 index points in September, to 126.0 (1985=100).

MAJOR RELEASES NEXT WEEK

There are no major releases scheduled for release.

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1997	1997:4	1998:1	1998:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	3.0	5.5	1.8
GDP chain-type price index	5.4	1.7	1.1	0.9	0.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	0.9	3.5	0.1
Real compensation per hour:					
Using CPI	0.6	1.9	2.8	4.1	2.0
Using NFB deflator	1.3	2.0	3.9	4.3	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	10.7	11.0	11.2
Residential investment	4.5	4.0	4.1	4.2	4.3
Exports	8.2	11.9	12.0	11.6	11.3
Imports	9.2	13.1	13.2	13.1	13.1
Personal saving	5.2	1.5	1.2	0.9	0.3
Federal surplus	-2.7	-0.3	0.0	0.7	0.9

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	**4.6**
Payroll employment (thousands)					
increase per month			**118**	**309**	**69**
increase since Jan. 1993					**16745**
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	N.A.
PPI-Finished goods	5.0	-1.2	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, October 2, 1998.**

EYES ONLY

FINANCIAL STATISTICS

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Dow-Jones Industrial Average	5743	7441	8479	7910	7633
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Prime rate	8.27	8.44	8.50	8.49	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 1, 1998**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.650	-1.6	-7.0
Yen-Dollar	135.8	0.3	12.4
Multilateral $ (Mar. 1973=100)	95.52	-0.9	-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	3.6 (Q2)	**4.6** (Sept)	1.6 (Aug)
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Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.0 (Q2)	11.7 (Jul)	0.7 (Aug)
Germany	2.5 (Q2)	2/ 7.4 (Jul)	0.7 (Aug)
Italy	1.1 (Q2)	12.4 (Apr)	1.9 (Aug)
United Kingdom	2.6 (Q2)	6.3 (May)	3.3 (Aug)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, October 2, 1998.**

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 July 1998 is 9.6 percent.