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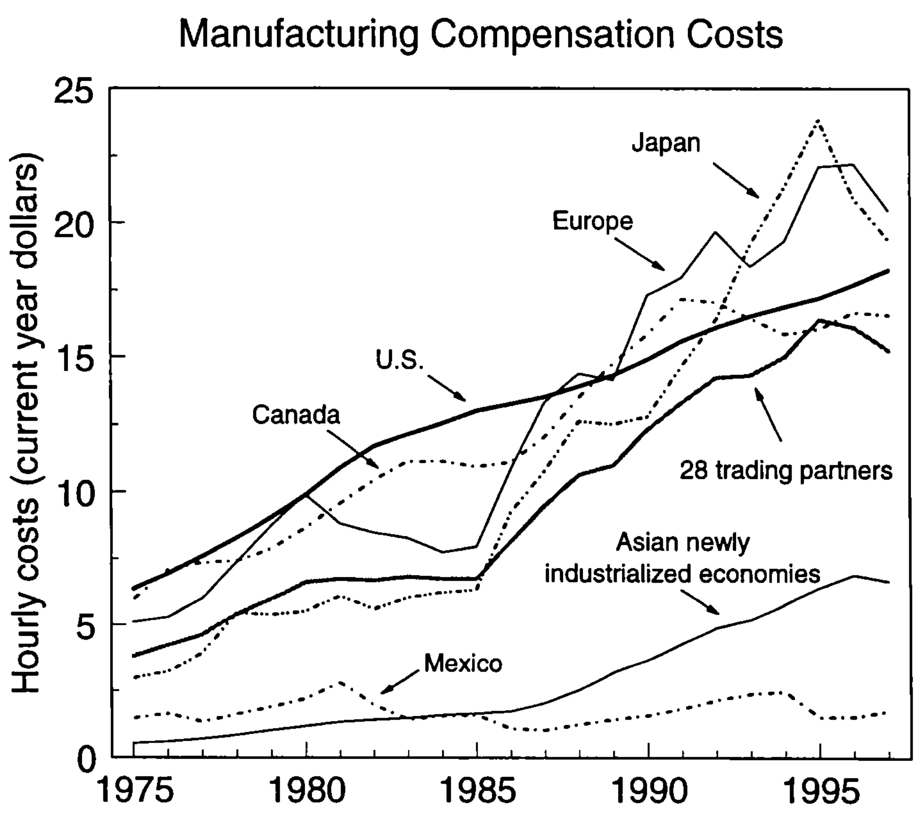
EYES ONLY

# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 25, 1998

CHART OF THE WEEK




The gap between the hourly labor compensation costs of U.S. manufacturers and those of a weighted average of 28 U.S. trading partners widened in 1997. The major reason was the strength of the dollar, according to the Bureau of Labor Statistics, which compiled the data. European and Japanese costs, by contrast, fell closer to U.S. levels.

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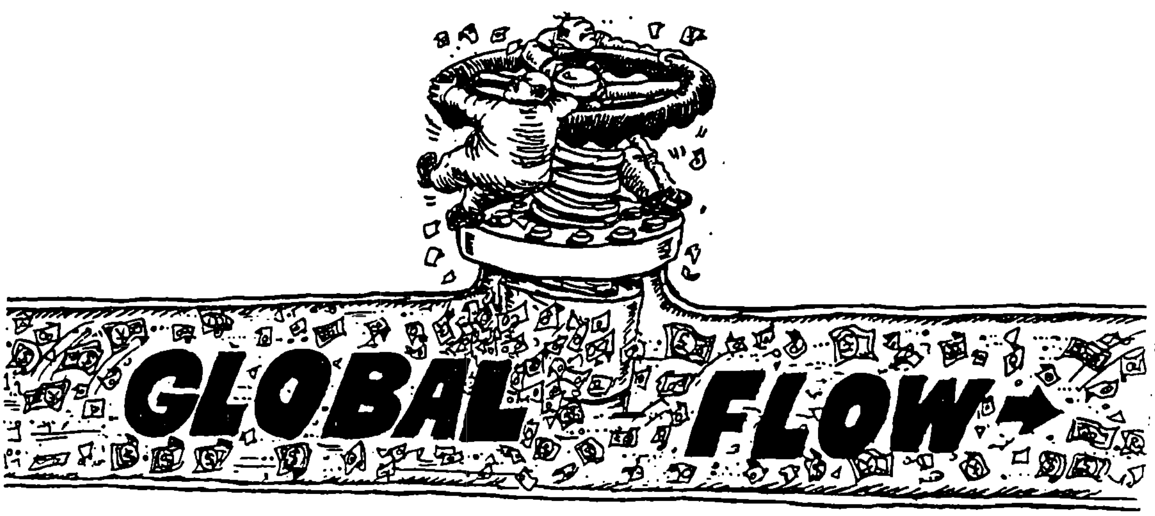

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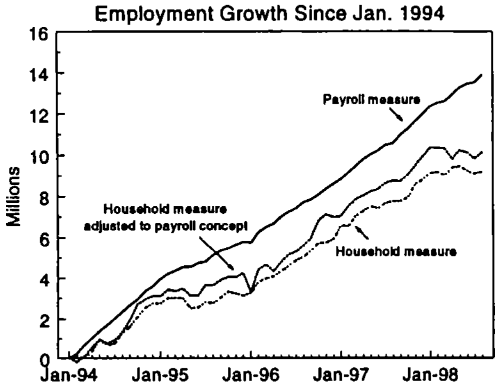
## CURRENT DEVELOPMENT

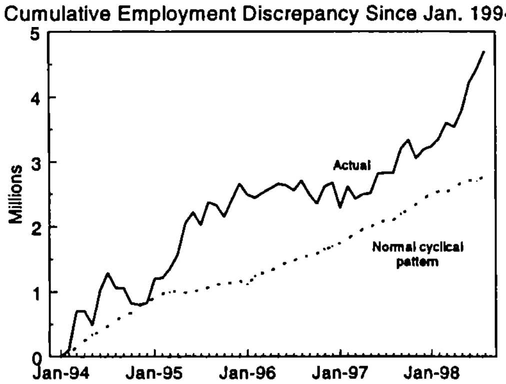
# How Many Jobs Have Been Created?

Firms report that they have added 13.9 million jobs since January 1994—4.7 million more than the employment growth reported by households over the same period (see upper chart). What accounts for this discrepancy?

Employment Growth Since Jan. 1994




Cumulative Employment Discrepancy Since Jan. 1994




**Methodology.** The payroll survey collects information from nonfarm employers, whereas the household survey interviews one person from each household about the activities of all the members of that household. Those who hold more than one job are counted once in the household survey but more than once in the payroll survey.

In addition, agricultural, self-employed, private household, and unpaid family workers are counted in the household but not in the payroll survey; and those under 16 are counted in the payroll but not in the household survey. The household survey includes auxiliary questions, including one on multiple jobholders, that can help reconcile the two surveys. But after converting the household survey to the payroll concept, the gap between the two surveys, at 3.8 million, remains wide.

**Cyclical differences.** The tendency of payroll job increases to outpace household employment growth during good times is nothing new, although the explanation for this cyclical pattern is not clear. It may be that the true number of multiple jobholders is increasing faster than what is implied by responses to the question on the household survey. Or it may have something to do with illegal immigration or some other factor. Whatever the explanation, once the cyclical pattern is removed, the discrepancy shrinks to 1.9 million (see lower chart).

**The last 12 months.** Neither the methodological differences nor the cyclical pattern explain the growth in the discrepancy over the past 12 months. Over this period, the payroll survey is still subject to revision because it has not yet been benchmarked to the unemployment tax system. The unexplained slower growth in household employment suggests a downward revision of payroll employment at the time of next year's benchmark.

EYES ONLY

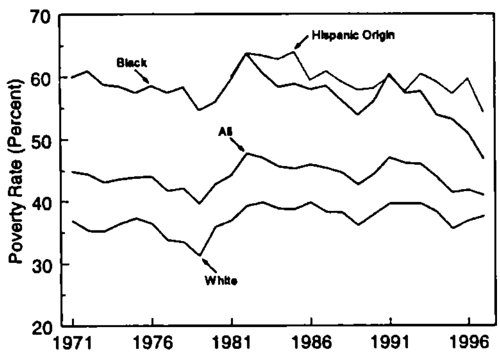
SPECIAL ANALYSIS

# Looking Beneath the Aggregate Income and Poverty Data

New data on income and poverty released this week show a rise in real median household income of 1.9 percent and a drop in the poverty rate to 13.3 percent. Gains among the traditionally disadvantaged were particularly noteworthy.

**Large gains for female-headed households with children.** Historically, the poverty rate has been extremely high for female-headed families with children, and the rate remained high in 1997 (41.0 percent compared with 15.7 percent for all families). But female-headed families with children have shown substantial improvements in recent years. The rate for all such families is the lowest it has been since 1979, and the rates for black and Hispanic families are the lowest on record (see chart). These are the families most likely to be affected by welfare reform, and it will be important to monitor their well-being in coming years.

Poverty Rates of Female-Headed Families with Children




**Issues in poverty measurement.** Problems with the official poverty measure that are currently under review by the Administration are particularly acute for female-headed families with children. Such families are disproportionately likely to receive the EITC, food stamps, Medicaid, or housing assistance, and they typically have work expenses, particularly child care costs. The National Research Council's recommended alternative poverty measure would reflect these additional sources of income and expenditure in measuring the well-being of families. This spring the Census Bureau is scheduled to release unofficial poverty estimates based on this alternative measure.

**Central cities share in the progress.** Poverty in the central city remained high at 18.8 percent (compared with 9.0 percent in metropolitan areas outside of central cities and 15.9 percent in non-metropolitan areas). The good news is that, although still high, the central city poverty rate fell nearly a full point in 1997 and economic gains were substantial in central cities within larger metropolitan areas. Median family income for central city residents grew by 3.9 percent within metropolitan areas of at least one million people and 2.0 percent for smaller metropolitan areas.

**Poverty continues to fall among foreign-born residents.** Data that are available only since 1994 show declines in the poverty rate from 22.6 percent in 1994 to 19.9 percent in 1997 for foreign-born residents (compared with a decline from 13.8 to 12.5 percent for the native-born). The rate among naturalized citizens was an even lower 11.4 percent in 1997.

**Income deficit remains high for most poor families.** Despite the fall in the poverty rate, the income of many poor families is substantially below the poverty threshold. Five percent of families needed only $500 of additional income to be lifted out of poverty in 1997, and 9.4 percent needed less than $1,000. However, over half of families in poverty needed at least $5,000 to reach the poverty line, and the average poverty gap was $6,602.

**The role of the economy.** Many factors have probably contributed to the recent gain in income and reduction in poverty, but one stands out—growth in the overall economy. The poverty rate tends to rise during recessions and fall during expansions. According to a simple model based on historical relationships, economic gains over the past year should have reduced the poverty rate by between 0.3 and 0.5 percentage point. The actual decline of 0.5 point was at the top of this range.

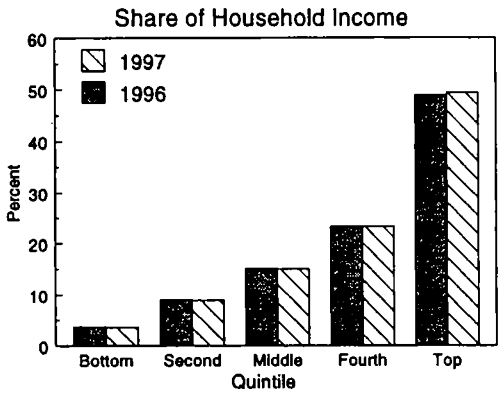
EYES ONLY

SPECIAL ANALYSIS

## Big Gains for Lower-Income Groups but No Less Inequality

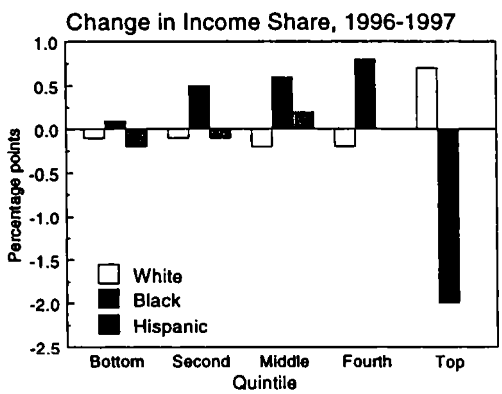
Low-income groups experienced particularly large income gains in 1997, yet measures of income inequality increased. What explains these divergent trends?

**Changes in 1997.** Real median household income rose by 4.3 percent for blacks and by 4.5 percent for Hispanics between 1996 and 1997, compared with a 1.9 percent increase in overall median household income. Other groups with median household incomes below the overall median of $37,005 also experienced disproportionate gains, including family households headed by single females and elderly households (both up 4.4 percent), Southern households (up 3.6 percent), and those in central cities of metropolitan areas with at least a million people (up 3.1 percent). Meanwhile, the share of household income received by each of the bottom four quintiles fell by 0.1 percentage point, while the share received by the top 20 percent grew by 0.4 percentage point (see upper chart).




**Analysis.** Three factors might explain why disproportionate gains for lower-income groups did not translate into reduced overall inequality.

- Share shifts. If the proportion of the population belonging to the lower-income groups were growing fast enough, the increasing weight attached to their below-average *level* of income could increase overall inequality. This cannot be a large part of the story, however, because 1-year shifts in population shares are quite small. For instance, Hispanic households went from 8.1 to 8.4 percent of all households between 1996 and 1997, and the South's share of households grew from 35.3 to 35.7 percent.




- Inequality within lower-income groups. If inequality increased *within* the lower-income groups, that would also tend to increase overall inequality. However, the little information we have suggests that this is probably not the explanation either. For blacks, inequality *decreased* between 1996 and 1997, with the share of income rising in the lower four quintiles and falling at the top (see lower chart on previous page). For Hispanics, there was some redistribution from the first and second quintiles to the middle quintile, but no change in the share of the top two quintiles.

- Inequality within higher-income groups. Increasing inequality in the *rest* of the population is probably the reason why overall inequality did not diminish. Published data do not exist for the relevant group (non-elderly, non-single mother, non-Hispanic white households living in smaller metropolitan areas and suburbs outside the South), which constitutes a considerable part of the population. But the change in the distribution for white households is suggestive, with the share of aggregate white household income *falling* for each of the bottom four quintiles and *rising* for the top.

**Conclusion.** Although lower-income groups experienced disproportionate increases in median household income between 1996 and 1997, large gains at the top for other groups contributed to a modest increase in overall inequality.

EYES ONLY

ARTICLE

## A New Deal for Russia?

Like the United States in the Great Depression, Russia currently faces a severe economic crisis with widespread distress. This makes it understandable that Prime Minister Primakov would draw parallels between his plans for increased state intervention in the Russian economy and the New Deal. But such comparisons should be approached cautiously.

**Different macroeconomic conditions.** The major macroeconomic problem facing the United States in the Great Depression was a sharp drop in aggregate demand. Output in 1933 was nearly 30 percent below its 1929 level, the unemployment rate was almost 25 percent, and prices were falling. In Russia, by contrast, the major macroeconomic problem is a breakdown of the supply side of the economy. The sharp drop in output after 1989 reflected a costly adjustment from a planned toward a market-oriented economy rather than a sharp drop in aggregate demand. There are idle and unpaid workers in Russia today, but the supply-side problems that continue to plague the economy suggest that aggressive demand stimulus would simply aggravate inflation.

**What happened during the New Deal?** The New Deal transformed America's view of the proper role of government in managing the economy. But modern economic historians question how much it contributed to pulling the economy out of the Great Depression.

- Overall macroeconomic stimulus. Because Russia's macroeconomic conditions are so different, there are few lessons from New Deal macroeconomic policy. It is worth noting, however, that even though Keynesian analysis was forged in the crucible of the Great Depression, U.S. fiscal policy did not really follow the Keynesian prescription until the onset of World War II. The Federal budget remained in surplus through 1930. The subsequent widening of the deficit mostly reflected falling economic activity rather than active fiscal expansion. (The structural balance may actually have been in surplus.)

- Public spending. Although growth in Federal outlays during the New Deal paled in comparison with the size of the output gap (and in comparison with subsequent wartime spending), it was nevertheless substantial. Spending included direct employment (such as the Civilian Conservation Corps and the Works Progress Administration), public investment (particularly for public power and rural electrification), and farm price supports. The Federal Government also took increased responsibility for the social safety net, creating national unemployment compensation, welfare, and social security programs. Whatever the merits of these policies, however, the unemployment rate remained well above 10 percent until 1941.

- Microeconomic intervention. The New Deal entailed substantial government intervention in specific industries and sectors, not always to good effect. For example, the *de facto* suspension of antitrust prohibitions against price fixing at the heart of the National Industrial Recovery Act of 1933 was almost surely misguided. In retrospect, extending existing price and entry regulation to trucking and airlines was probably unnecessary and inefficient. Thus, it would probably be a mistake for Russia to emulate elements of the New Deal that tried to "manage" competition.

- Banking and Financial reform. FDR took office amidst a wave of bank runs and bank failures. A bank holiday was declared in March 1933 and solvent national banks were subsequently reopened with temporary Federal deposit insurance. The Nation was effectively taken off the gold standard, and a number of financial and securities reforms were enacted. Like so many other New Deal policies, these actions represented a mixed bag of "try anything" emergency measures and longer-term reforms. Among the latter, the most enduring are probably ones like the creation of the Securities and Exchange Commission that created institutions to increase confidence in markets and make them work better.

**Conclusion.** The New Deal was neither a consistent nor a comprehensive plan. Neither did it pull the economy out of the Great Depression. But to judge it only on economic grounds is to miss its political and social significance. FDR's bold experimentation and balancing of conflicting interests kept the country together through a period of severe economic distress and laid the groundwork for the mixed economy that produced a doubling of living standards in the first generation following the end of World War II.

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Colleges Seen as Places to Learn about Diversity.** The major findings of the new book by Derek Bok and William Bowen, *The Shape of the River*, have been widely reported: blacks who graduate from elite colleges earn advanced degrees at the same rates as their white counterparts, and they tend to be more active than their white classmates in civic activities. An important finding that received less attention is the increased percentage of graduates who felt that their colleges contributed "a great deal" to their ability to work effectively and get along with people of different races and cultures—a 16 percentage-point increase between 1976 and 1989 for both black and white cohorts (to 46 percent in 1989 among blacks and to 34 percent in 1989 among whites). A similar increase was found for a question regarding the ability to have good rapport with people holding different beliefs. The authors posit that students may be increasingly aware of the importance of learning to get along with a wide range of people, and are taking better advantage of opportunities to learn this in college. The authors also suggest that colleges may be becoming more adept at creating an environment in which students can learn from classmates who are different from themselves.

**Traditional South Gets "All Shook Up."** The historically black/white, mostly Protestant, native-born South is rapidly becoming a multi-ethnic society, according to a new study. Whereas whites made up 76 percent of the population 20 years ago, that percentage is down to 68; meanwhile the percentage of Hispanics has jumped from 5 to 11. Although most Hispanics in the South live in Florida or Texas, the six counties with the most rapid growth in their Hispanic populations are in Georgia, North Carolina, Virginia, and Arkansas. Just from 1990 to 1997, the Asian population in the South increased 42 percent, from 1.2 to 1.7 million. The South also contains the five counties with fastest growing Asian populations in the country. The educational attainment of immigrants to the South has been bifurcated: the proportion of foreign-born immigrants with at least a bachelor's degree is higher than that of all Southerners, but the proportion lacking a high school diploma is also higher. The South has also become less rural: seven in 10 Southerners live in a metropolitan area, and three-quarters of the region's jobs are in those areas.

**Survey Examines Work-Related Trends.** Despite low unemployment and strong economic growth, many Americans are still concerned about their economic security, according to a new quarterly nationwide survey of workers or those actively looking for work. In particular, 59 percent of Americans reported that they were very concerned about job security for workers in general, although 55 percent reported being very satisfied with the security of their own job. Nearly four in ten (39 percent) rated the ability to balance work and family as an extremely important factor for a job, followed by health and medical insurance (38 percent), job security (33 percent), and income (33 percent). About 75 percent of respondents said that it is very or extremely important for the government to provide financial assistance for skills training, basic education, and college, and 88 percent think it is very or extremely important for government to improve the quality of education in schools.

EYES ONLY

## INTERNATIONAL ROUNDUP

**IMF Offers New Assessment of Capital Market Liberalization.** The International Monetary Fund expresses some support for controls on inward movements of capital in its latest annual report on international capital markets. This is noteworthy, considering the IMF's past strong support for open financial markets. The report also reveals that total net private inflows fell 28 percent in 1997, while inflows to Asia plummeted by 87 percent—the first decline in those inflows since 1992. (According to a press report, private capital may now even be flowing out of emerging markets.) The report draws three broad conclusions about financial liberalization. First, strong financial sectors are essential, particularly strong and sound banking systems. Second, despite the large potential benefits derived from global capital makets, critical preconditions need to be met before countries open their capital accounts, and the sequencing of liberalization must be carefully considered. Third, transparency and the timely availability of accurate information are crucial. One clear lesson drawn from the Asian crisis is that unique problems arise when domestic banks are the key intermediaries for volatile capital flows. The report identifies the combination of a weak banking system and an open capital account as "an accident waiting to happen." It also recognizes that restrictions on short-term capital flows, such as those established by Chile, might be necessary given that there are limits to the pace at which financial sectors can be strengthened. As the report notes, however, it can be difficult differentiating between short- and long-term capital flows, due to both data and conceptual problems. In addition, controls are not substitutes for reform of the underlying financial sector. In fact, certain capital controls might have contributed to the crisis (particularly those that discouraged foreign purchases of long-term securities) by channeling foreign investment through domestic banks.

**Blair Calls for Overhaul of the International Financial System.** In a speech Monday, British Prime Minister Tony Blair called for "a new Bretton Woods for the next millennium." He challenged heads of state, finance ministers, international financial institutions, and outside experts to develop the necessary reforms within one year, so that the new institutions would be in place by the year 2000. Blair proposed several measures to deal immediately with the financial crisis. He called on the world's major economies to coordinate macroeconomic policy to ensure that growth is sustained. He also emphasized the urgent need for fiscal action in Japan to boost domestic demand. Urging swift action to provide the IMF with resources to support countries pursuing sound economic policy, he concluded with an exhortation against short-term measures alone. In his view, the 54-year old Bretton Woods institutions, built for a world of fixed exchange rates, capital controls, and smaller international capital flows, are now outdated. Current conditions require greater transparency and improved information transfers among government, the private sector, and the international institutions themselves. Finally, Blair said, open world capital markets require an international lender of last resort, a role that the IMF currently does not and cannot play.

EYES ONLY

## RELEASES THIS WEEK

**Gross Domestic Product**

According to revised estimates, real gross domestic product grew at an annual rate of 1.8 percent in the second quarter.

**Advance Durable Orders**

Advance estimates show that new orders for durable goods increased 1.6 percent in August, following an increase of 1.9 percent in July.

## MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Leading Indicators (Wednesday)
NAPM Report on Business (Thursday)
Employment (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 | June 1998 | July 1998 | August 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.5 | 4.5 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 189 | 68 | 365 |
| increase since Jan. 1993 | | | | | 16682 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.1 | 0.2 | 0.2 |
| PPI-Finished goods | 5.0 | -1.2 | -0.1 | 0.2 | -0.4 |

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

New or revised data in **boldface**.

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | July 1998 | August 1998 | Sept. 24, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9097 | 8479 | 8002 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 4.96 | 4.90 | 4.44 |
| 10-year T-bond | 6.44 | 6.35 | 5.46 | 5.34 | 4.64 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 6.95 | 6.92 | 6.64 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level September 24, 1998** | **Percent Change from** | |
|---|---|---|---|
| | | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.678 | -0.4 | -5.5 |
| Yen-Dollar | 135.3 | 2.6 | 12.4 |
| Multilateral $ (Mar. 1973=100) | 96.40 | -0.0 | -1.4 |

| **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) | 4.5 (Aug) | 1.6 (Aug) |
| Canada | 3.1 (Q2) | 8.4 (Jul) | 1.1 (Jul) |
| Japan | -1.8 (Q2) | 4.2 (Jul) | -0.1 (Jul) |
| France | 3.0 (Q2) | 11.7 (Jul) | 0.8 (Jul) |
| Germany | 2.5 (Q2) | [2] 7.4 (Jul) | 0.9 (Jul) |
| Italy | 1.1 (Q2) | 12.4 (Apr) | 1.8 (Jul) |
| United Kingdom | 2.6 (Q2) | 6.3 (May) | 3.5 (Jul) |

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

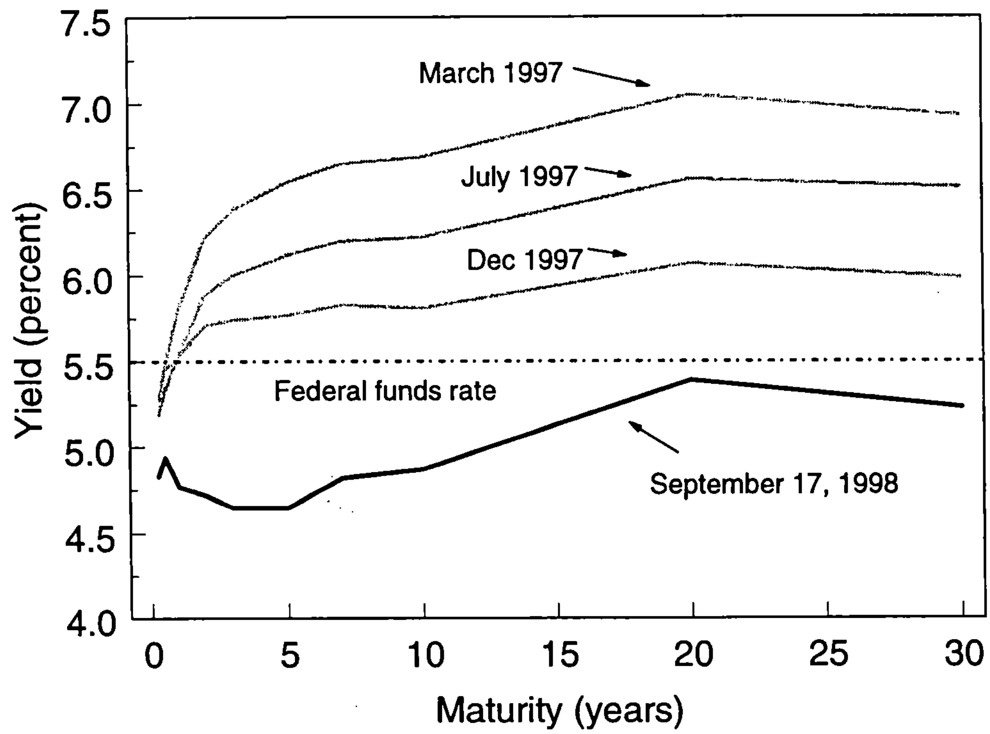
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 18, 1998

## CHART OF THE WEEK

The Flattening Treasury Yield Curve




Over the past 18 months, intermediate- and long-term interest rates have declined substantially, while short-term rates have declined much less. All Treasury issues now have yields below the Federal Reserve's target Federal funds rate. In the past, such conditions have often been indicative of Fed tightening to slow the economy, but a more likely explanation now is strong demand for Treasury securities stemming from the international financial crisis and very low inflation expectations.

EYES ONLY

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### CURRENT DEVELOPMENT



### SPECIAL ANALYSES



### ARTICLE



### DEPARTMENTS



*"Up a hundred and sixteen points! If only we'd had the foresight to invest ten minutes ago."*

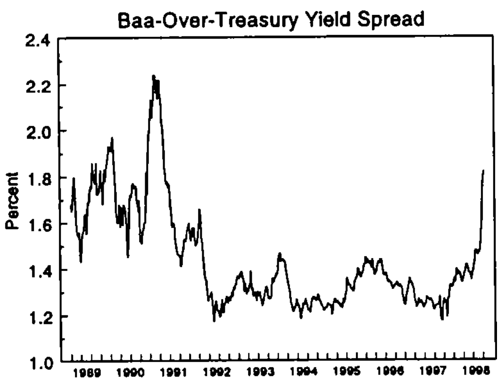
EYES ONLY

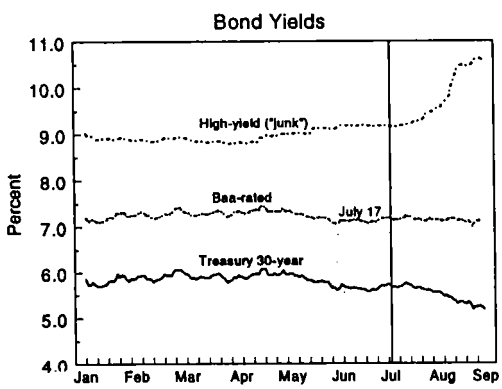
## CURRENT DEVELOPMENT

# Are Businesses Having Trouble Borrowing?

Some anecdotal accounts suggest that a "flight to quality" spurred by the international financial crisis has made it more difficult for U.S. businesses to borrow. What do the data show?

**Interest rate spreads.** Since mid-July, the yield spread between typical investment-grade corporate bonds and Treasury bonds has increased sharply, reaching its largest value since 1991 (see upper chart). Yet the recent widening of the spread arises *not* from an increase in the private yield but rather from a decline in Treasury yields (see lower chart). Thus, companies with a rating of Baa or higher can still borrow money at roughly the same cost as 2 months ago. Only high-risk companies seem to be having more trouble obtaining funds now, as yields on "junk" bonds have increased substantially. Indeed, new issuance of such bonds has come to a virtual halt.




**Why have spreads widened?** Apparently, shifts in preferences toward U.S. assets have focused on Treasury securities, which are extremely safe and liquid. Moreover, increased uncertainty about future economic conditions seems to have raised the risk premium that investors demand for holding private instead of government bonds. Both factors tend to push up Treasury prices—and push down their yields—relative to private securities. A larger risk premium may also have contributed to the drop in stock prices since July, if investors are now discounting expected future earnings at a higher (risk-adjusted) rate.

**Conclusion.** Interest rates have risen in the high-risk market of late. By contrast, rates have not increased for less-risky debt—nor have they fallen in line with Treasury yields.

EYES ONLY

## SPECIAL ANALYSIS

## Who Should Pay for Environmental Protection?

Although equity considerations are central to the discussion of who should pay for environmental protection, economists have tended to think that efficiency is largely unaffected by how this question is resolved. That view is changing, however, as an analysis of the Administration's "no surprises" policy with respect to endangered species protection illustrates.

**The Coase theorem.** The belief that who pays is unrelated to efficiency can be traced to analysis of Nobel laureate Ronald Coase showing that, under ideal conditions, an efficient amount of an environmental good can be provided regardless of who incurs the costs. If individuals are liable for any damage caused, they will take mitigating action up to the point where the cost of additional mitigation would exceed the benefits in terms of reduced damage payments. If individuals are not liable for damages, government (acting in society's interest) should be willing to pay individuals to take mitigating action up to the point where the additional benefits would fall short of the additional costs. In either case, according to Coasean logic, an efficient outcome is achieved.

**Future costs.** The ideal conditions necessary for the Coase theorem to hold are not often met. In particular, who pays affects efficiency as well as distribution when the issue is future environmental protection. Individuals who might face environmental costs in the future have an incentive to try to avoid those costs. For example, landowners fearful that they will face future land use restrictions aimed at protecting endangered species may make investments that are harmful to species conservation, rush to develop prior to regulation, or hide information about species on their land. Each of these actions, while harmful to species conservation, can result in lower expected future costs borne by the landowner.

**No surprises.** To reduce conflicts with private landowners, the Administration introduced a "no surprises" rule to the Habitat Conservation Plan provisions of the Endangered Species Act. Under the rule, a landowner with an approved HCP is assured that no additional land use restrictions will be required for species covered by the plan. This no surprise policy does not rule out surprises; rather, it shifts the cost of any surprises from the landowner to the government. Because surprises entail possible future environmental protection, it is important for efficiency reasons to shelter landowners from paying the costs. Having the government compensate landowners for future land use restrictions, but not necessarily for present land use restrictions, is thus consistent with sound economic efficiency principles.

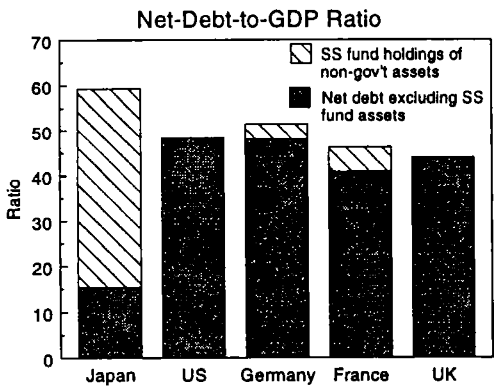
**Conclusion.** Deciding who should pay for environmental protection involves issues that go beyond efficiency, such as whether individuals have a duty to protect the environment or should be free to do as they please with their property. But as economists are starting to demonstrate, it involves questions of efficiency as well.

SPECIAL ANALYSIS

## Can Japan Afford Fiscal Stimulus?

One reason Japan has given for resisting international pressure to pursue a more expansionary fiscal policy is the country's large budget deficit and public debt. How persuasive is this concern?

**How large is Japan's fiscal imbalance?** Japan's budget deficit is expected to be 6.1 percent of GDP this year, compared with a U.S. budget surplus and deficits below 3 percent in the European countries forming the EMU. By some measures, Japan's public debt amounts to more than 80 percent of GDP. It is important to note, however, that the current budget deficit includes a large cyclical component. Moreover, the debt underlying the 80 percent calculation includes substantial government debt held by other government agencies. The OECD calculates that after netting out these assets, Japan's debt was equal to 59 percent of GDP in 1996, roughly in line with several other major OECD countries (see chart). Moreover, Japan's social security system holds a substantial amount of non-government assets. Netting these out reduces the debt-to-GDP ratio to 15.4, well below comparable figures for the other major OECD countries.




**The social security question.** As in all G-5 countries, Japan's population is aging, and social security issues color any assessment of the fiscal balance. The buildup of assets in the social security system reflects Japan's awareness of the future obligations it will face. However, Japan has a more serious aging problem than the rest of the G-5, as it has the highest average age, will have one of the largest dependency ratios in the next 50 years, and has the longest life expectancy. These factors and the amount of legislated benefits imply that Japan faces greater unfunded pension liabilities: 105 percent of GDP in Japan, compared with 25 percent in the United States, over 100 percent in Germany and France, and 5 percent in the U.K. These larger liabilities tend to counterbalance the greater assets of the Japanese system and imply a serious long-term problem both for pension liabilities and health care costs for the elderly.

**Implications.** Japan will eventually have to take further steps to prepare for the aging burdens that are ahead. In the meantime, however, Japan does not face a problem of exploding debt that would militate against a fiscal expansion. In fact, a fiscal expansion could have substantial benefits. First, of course, it could help spur the economy and avoid a worsening recession. Stronger growth would offset some of the immediate impact of fiscal stimulus on the deficit. Second, paradoxically, a larger deficit in the short term could produce a smaller deficit in the intermediate term. If the stimulus leads to a strong enough rebound in spending and a sustained recovery in growth, tax revenues might increase enough and countercyclical government spending might fall enough to improve the medium-run deficit picture. Just as a growing economy has helped shrink the U.S. budget deficit over the past several years, a strong resumption of growth in Japan should help to reduce its deficit over time.

EYES ONLY

## ARTICLE

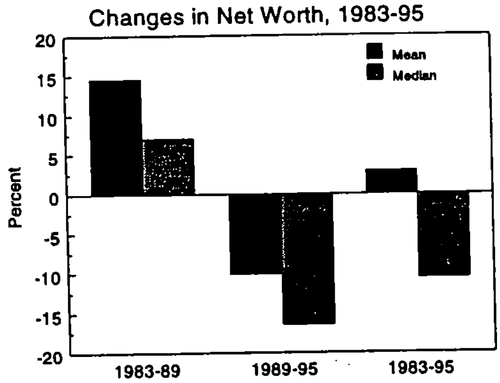
# The Distribution of Wealth

When the Census Bureau releases its latest report on money income and poverty next week, annual data on family income and its distribution will be available through 1997. By contrast, 1995 is the latest year for which we have data on wealth and its distribution. Nevertheless, it seems likely that the increase in stock prices since 1995 has produced a modest widening in what was already a highly unequal distribution.

**No wealth of data.** The best data for examining wealth and its distribution is the Federal Reserve's Survey of Consumer Finances (SCF) for 1983, 1989, 1992, and 1995 (the 1998 survey is now underway). The SCF consists of a core representative sample combined with a high-income supplement designed to provide a greater number of potentially wealthy respondents. The SCF is not only less frequent than the Current Population Survey used to produce the money income and poverty data, it is also substantially smaller (less than 5,000 respondents, compared with about 50,000 in the CPS).

**Levels and trends.** The average net worth of all households was a little over $200,000 in 1995. Taking out the net equity in owner-occupied housing, average financial wealth was about $157,000. Because the distribution of wealth is highly unequal, median wealth is substantially lower than average wealth: median net worth was roughly $50,000 in 1995, and median financial wealth was roughly $10,000. Both mean and median net worth rose between 1983 and 1989 and fell between 1989 and 1995 (see chart). In one study, mean net worth in 1995 was slightly higher than it was in 1983, as shown in the chart. But in another study, median net worth was also higher in 1995 than in 1983.

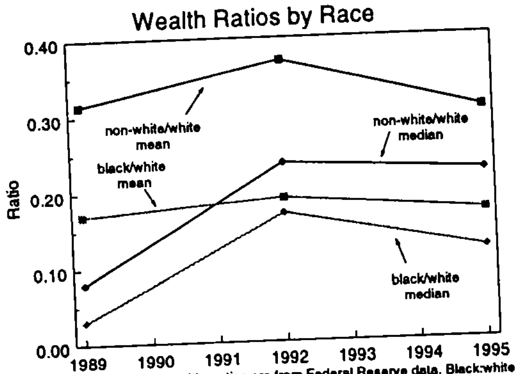
Changes in Net Worth, 1983-95




**Inequality.** Wealth is substantially more unequally distributed than income. For example, the share of net worth held by the wealthiest 1 percent of households was close to 40 percent in 1995, whereas the share of household income received by the richest 5 percent of households was 21 percent. In the wealth rankings, the bottom 80 percent accounted for just 16 percent of net worth; in the income rankings, the bottom 80 percent accounted for more than half of aggregate family income. The proportion of households with zero or negative net worth was 18.5 percent in 1995. Studies showing a sharp increase in wealth inequality between 1983 and 1989 have been called into question by a recent study, which finds no statistically significant change over that period. But wealth inequality does appear to have increased slightly between 1992 and 1995.

**Race.** Non-whites and Hispanics have substantially less wealth than non-Hispanic whites (see chart). The median wealth of black households was only 12 percent that of non-Hispanic whites in 1995. Although this represents an improvement over 1983's 7 percent, it represents a decline from 17 percent in 1992. Wealth ratios are substantially lower than the corresponding black/white income ratio. One reason may be inheritances: 24 percent of white households had received an inheritance (with an average value of $115,000) in 1995, compared with 11 percent of black households who had received an inheritance (with an average value of $32,000).

Wealth Ratios by Race



Note: Non-white:white ratios are from Federal Reserve data. Black:white ratios are from other sources.

**Age.** SCF data show the expected hump-shaped age-wealth profile, with wealth accumulation over early and middle adulthood and decumulation in old age. However, between 1983 and 1995, the shape of this profile shifted, with relatively large gains for the oldest age group and losses for the youngest groups.

**Who are the rich?** The rich (the 1 percent of households with net worth of more than $2.4 million in 1995) are different from everyone else not just because they have more money. Other differences include age (the wealthy are older, on average), education (69 percent college graduates compared with less than 30 percent for all household heads), race (95 percent non-Hispanic whites), and self-reported health status (55 percent excellent, compared with 30 percent for all household heads).

**Conclusions.** Ownership of wealth was highly concentrated in the United States in 1995 with the wealthiest 1 percent accounting for more than a third of net worth. The rise in stock prices since 1995 has probably increased concentration at the top even more, though the continuing economic expansion may have produced increases in wealth for all groups.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Beige Book Shows Moderate Growth but Deteriorating Expectations.** The latest summary of commentary on current economic conditions from the Federal Reserve districts shows all district economies continuing to expand at a moderate pace, although several districts indicated slowing in some sectors. The summary notes reports from the New York district that significant segments of its economy were slowing and from the Dallas district that economic activity decelerated in August as the manufacturing sector declined. While the strength and pattern of the business expansion appears to have changed only marginally since the August 5 report, several districts indicated a sharp deterioration in both business and household expectations regarding the economy in the fourth quarter and in 1999. A large number of districts continued to exhibit labor market tightness, which appears to be pushing wages up at a faster pace. Retail prices, by contrast, remain generally steady or are declining slightly in most districts, and falling import prices have helped push industrial commodity prices lower.

**EPI Offers Gloomy Assessment of Working America.** In its latest annual assessment of the *State of Working America*, the Economic Policy Institute concludes that most working families have not seen their standard of living recover from the recession of the early 1990s, despite 7 years of strong economic growth and increases in the minimum wage. This "glass is half empty" assessment finds that median family income was $1,000 (2.3 percent) less in 1996 than it was in 1989, although 1997 data (available next week) are likely to show a parity with 1989 levels. Income growth generated among middle-income families has been driven largely by increases in working hours—an additional 6 weeks annually for the typical family since 1989—to make up for stagnant or falling wages. Between 1989 and 1997, real hourly wages remained constant or fell for the bottom 60 percent of workers, except for low-wage workers, whose wages rose 1.4 percent during that period. However, this assessment does not reflect healthy increases in real wages that have occurred this year.

**Teacher Quality Drives Student Achievement.** A better understanding of ways to improve the quality of teaching is necessary to evaluate proposed changes in education policy, according to a new study. The study, which tracked one-half million elementary school students in Texas public schools over 3 years, concluded that differences in teacher quality explained variation in student achievement gains better than class size, overall school organization, leadership, or financial condition. However, measurable factors, such as experience or a master's degree, did little to explain differences in teacher quality. The study did find that reduced class size had a positive effect on the math and reading achievement of low-income children, but cautioned that resources devoted to reducing class sizes for low-income children might be better used to support preschool, after-school, or summer programs, for which spending is currently quite low.

EYES ONLY

## INTERNATIONAL ROUNDUP

**IMF Lowers Forecast for World Growth.** IMF Managing Director Camdessus acknowledged in a newspaper interview this week that the IMF is again lowering its projection for world growth this year. The forecast of 2.1 percent growth, which will be officially released in the forthcoming *World Economic Outlook*, represents a precipitous drop from the IMF's October 1997 forecast of 4.3 percent growth. More ominously, forecasted world growth for 1998 is now comparable to levels not seen since the pronounced world slowdowns of 1974-75, 1980-82, and 1990-91. Downward revisions are being driven by Asia. Japan's economy is expected to decline by 2.3 percent; the newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.4 percent; and the ASEAN-4 economies (Indonesia, Malaysia, the Philippines, and Thailand) are now expected to shrink by a staggering 10.4 percent. Closer to home, expected growth in the Western Hemisphere is now 2.7 percent, down from 5.1 percent actual growth in 1997.

**Falling Oil Prices Still Challenge a Diversifying Saudi Arabia.** Since the early 1980s, Saudi Arabia has been relatively successful at diversifying its economy. Non-oil activities (such as agriculture, manufacturing, and services) have increased from about 44 percent of GDP in the 1970s to about 65 percent recently. Government policies supporting this transition have included infrastructure investment, privatization, and reductions in many subsidies. The country has also maintained a favorable overall economic environment, with low inflation, competitive labor costs, a reduced fiscal deficit, and an open trade and exchange rate system. Nevertheless, oil revenues still account for nearly 90 percent of Saudi export earnings. This year's fall in oil prices of around $7 per barrel has caused a sharp reduction in oil revenues that will likely increase the budget deficit and cut GDP growth drastically—perhaps even causing a decline—after 4.4 percent annual growth over the last 2 years.

**World Bank Study Cites Role of Structural Flaws in Asia's Woes.** A recently released World Bank study applies standard financial-ratio analysis to determine what caused the crisis in Asia. The study points to a rapid build-up of fixed assets throughout Asia from 1992 to 1996, with particularly rapid growth in Indonesia and Thailand. With most of the growth financed with debt (especially in Thailand and Korea), high levels of corporate leverage were already prevalent in 1996. At the same time, moderate to low profitability severely impaired the ability of many Asian firms to meet their interest obligations. Banks were the main source of funds, channeling very high household savings to businesses. Most of the countries in the study that had poor returns on capital employed also have underdeveloped capital markets. At the same time, many of the countries had recently liberalized their financial sectors, but in an environment that lacked an adequate prudential framework. The study concludes that the lack of financial and institutional discipline, coupled with the recent financial sector liberalization is a plausible explanation for the mix of currency, corporate, and banking crises confronting the region.

EYES ONLY

## RELEASES THIS WEEK

### Housing Starts

****Embargoed until 8:30 a.m., Friday, September 18, 1998****

Housing starts fell 5 percent in August to 1.613 million units at an annual rate. During the first 8 months of this year, housing starts were 10 percent above the same period a year ago.

### Consumer Price Index

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

### U.S. International Trade in Goods and Services

The goods and services trade deficit was $13.9 billion in July; it was $13.6 billion in June.

### Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 1.7 percent in August. Capacity utilization rose 1.1 percentage points, to 81.7 percent.

### Retail Sales

Advance estimates show that retail sales increased 0.2 percent in August, following a decrease of 0.6 percent in July. Excluding sales in the automotive group, retail sales rose 0.3 percent, following an increase of 0.6 percent.

## MAJOR RELEASES NEXT WEEK

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

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 | 1.6 |
| GDP chain-type price index | 5.4 | 1.7 | 1.1 | 0.9 | 0.8 |
| 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 | 13.2 |
| Personal saving | 5.2 | 1.5 | 1.2 | 0.9 | 0.4 |
| Federal surplus | -2.7 | -0.3 | 0.0 | 0.7 | 0.9 |

| | 1970-1993 | 1997 | June 1998 | July 1998 | August 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.5 | 4.5 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 189 | 68 | 365 |
| increase since Jan. 1993 | | | | | 16682 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.1 | 0.2 | **0.2** |
| PPI-Finished goods | 5.0 | -1.2 | -0.1 | 0.2 | -0.4 |

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

New or revised data in **boldface**.

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | July 1998 | August 1998 | Sept. 17, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9097 | 8479 | 7874 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 4.96 | 4.90 | 4.58 |
| 10-year T-bond | 6.44 | 6.35 | 5.46 | 5.34 | 4.80 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 6.95 | 6.92 | 6.66 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level September 17, 1998** | **Percent Change from** Week ago | Year ago |
|---|---|---|---|
| Deutschemark-Dollar | 1.685 | -0.4 | -4.9 |
| Yen-Dollar | 131.9 | -1.8 | 9.0 |
| Multilateral $ (Mar. 1973=100) | 96.42 | -0.5 | -1.4 |

| **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) | 4.5 (Aug) | 1.6 (Aug) |
| Canada | 3.1 (Q2) | 8.4 (Jul) | 1.1 (Jul) |
| Japan | -1.8 (Q2) | 4.2 (Jul) | -0.1 (Jul) |
| France | 3.0 (Q2) | 11.7 (Jul) | 0.8 (Jul) |
| Germany | 2.5 (Q2) | [2] 7.5 (Jun) | 0.9 (Jul) |
| Italy | 2.5 (Q1) | 12.4 (Apr) | 1.8 (Jul) |
| United Kingdom | 2.6 (Q2) | 6.3 (May) | 3.5 (Jul) |

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 June 1998 is 9.7 percent.

EYES ONLY

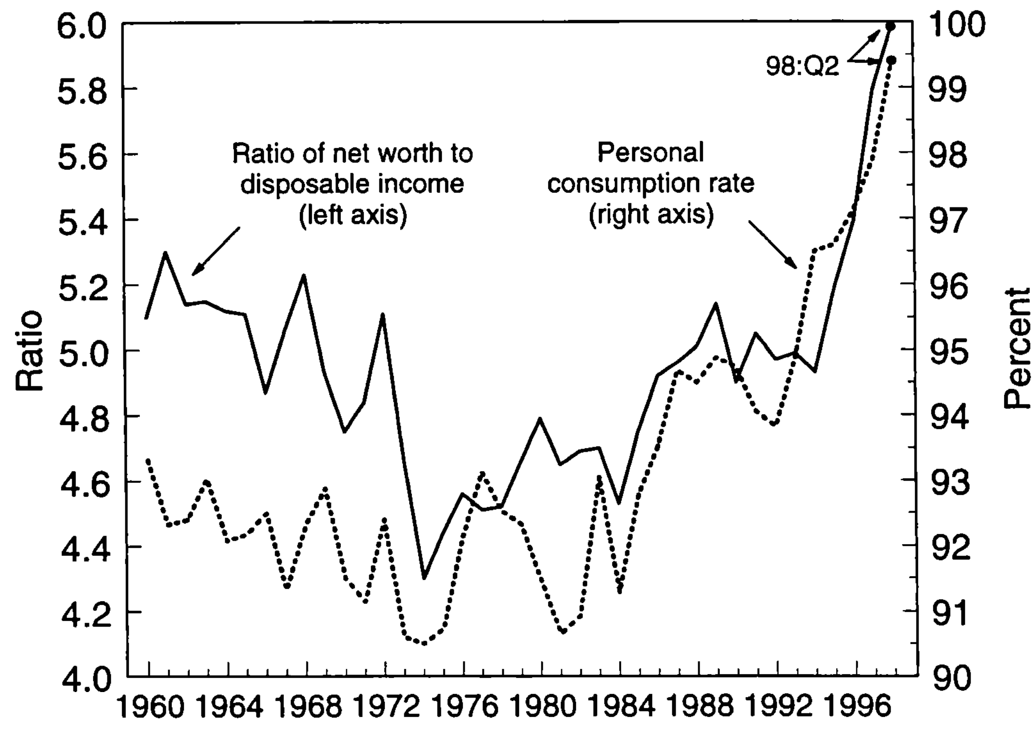
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 7, 1998

## CHART OF THE WEEK

Household Net Worth and the Personal Consumption Rate

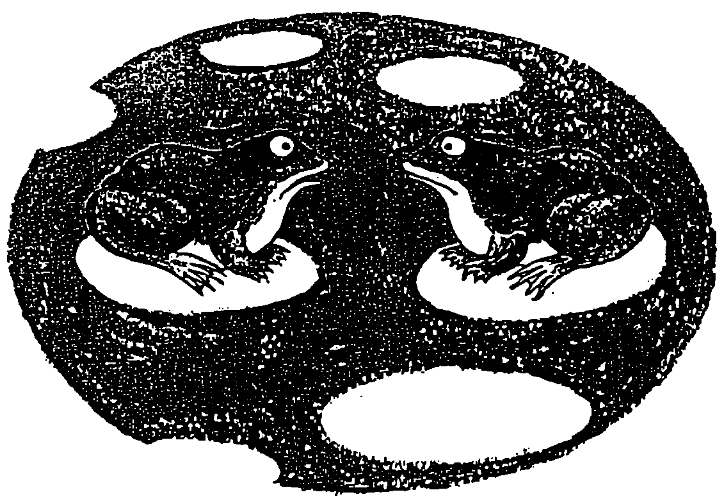



The rise in the stock market over the past few years has increased household net worth and boosted the ratio of net worth to disposable income. This increase in wealth has reduced the need to save out of current income. As a result the proportion of income going to consumption has risen (and the personal saving rate has fallen).

EYES ONLY

# CONTENTS





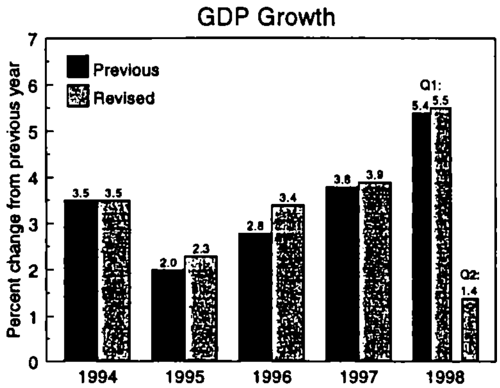
*"So they hold this conference to figure out why we're becoming extinct, and guess what they have for dinner."*

EYES ONLY

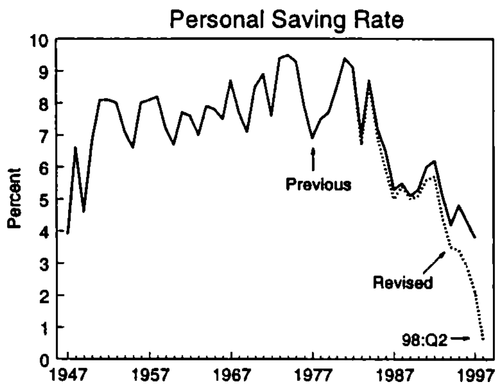
## CURRENT DEVELOPMENT

# GDP Revisions Show More Growth, Less Personal Saving

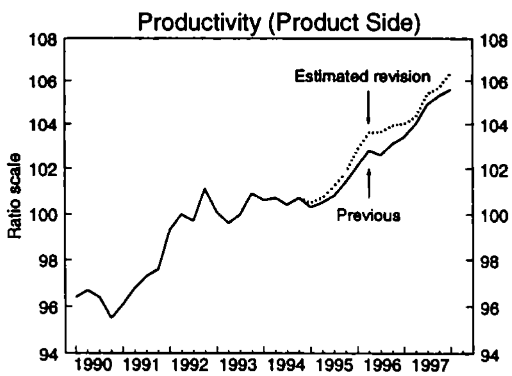
The latest annual revisions to the National Income and Product Accounts show that the economy grew faster than previously estimated over the past several years. The growth rate of real GDP was raised for each of the past 3 years (see upper chart); since 1993, real GDP has grown at a 3.4 percent annual rate—up 0.3 percentage point from the previous estimate.




**Lower prices.** About three-fourths of the upward revision to real GDP resulted from price revisions. The experimental geometric indexes scheduled to be incorporated into the consumer price index next January were used to deflate most parts of nominal personal consumption back to 1995.




**A smaller statistical discrepancy.** About one-fourth of the upward revision to output resulted from the use of more complete source data, which raised nominal GDP by $31 billion in 1997. Gross domestic income, by contrast, was little changed, and the statistical discrepancy between income and spending was trimmed by $30 billion.




Note: Revised productivity figures are estimated from revised output and hours data.

**Saving reallocated.** Capital gains distributions by mutual funds, which had been erroneously included in personal dividend income, were shifted to undistributed corporate profits. This reduced personal saving by $60 billion in 1997 but increased business saving by the same amount—with no net effect on national saving. Meanwhile the personal saving rate fell to just 0.6 percent in the second quarter (see middle chart).

**Higher productivity.** Because the upward revision to real output exceeds the upward revision to hours (announced 2 months ago by the Bureau of Labor Statistics), productivity is likely to be revised up (see lower chart). Since the last business-cycle peak, productivity appears to have grown at a 1.3 percent annual rate—0.1 percentage point higher than previously estimated.

EYES ONLY

SPECIAL ANALYSIS

## Conserving Species without Breaking the Bank

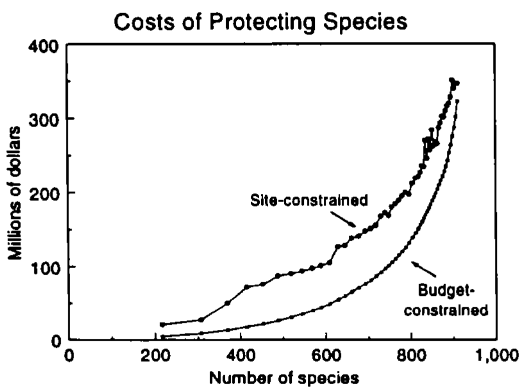
The Endangered Species Act prohibits actions that may lead to the extinction of species and requires the government to implement recovery plans that will restore healthy populations. However, protecting all species is currently beyond the means of both public and private conservation agencies. What is the best way to use limited resources to achieve conservation benefits?

**Selecting priority areas.** A recent study by conservation biologists indicates that the vast majority of domestic species on the endangered species list can be protected by targeting a small number of high-priority areas. This study implicitly assumes that the cost of setting aside land for conservation is the same in all areas. The priority areas that were selected, however, include some of the most expensive land in the United States (including Hawaii and much of coastal California). The same number of species could be protected at lower cost by taking land costs into account.

**A cost-effective conservation strategy.** A recent economic study illustrates this point. It treats a listed endangered species as protected if it occurs in at least one county where a biological reserve site is established. For simplicity, reserve sites in all counties are assumed to be the same size. Using data on the occurrence of listed species and the per acre land value by county, the study assesses the number of species protected and the total cost of choosing different sites for biological reserves under two different protection strategies:

- site-constrained, where the objective is to choose sites that cover the maximum number of species, given that a fixed number of sites will be chosen.
- budget-constrained, where the objective is to choose sites that cover the maximum number of species given a fixed budget.

**Findings.** The chart shows that the budget-constrained strategy protects listed species at far lower cost than the site-constrained strategy. (Costs are illustrative and assume 1,000 acres are set aside for each protected site.) For example, the costs of covering approximately half of the listed species under the budget-constrained approach are about a third those under the site-constrained approach. By choosing sites that are one-sixth as expensive, on average, the budget-constrained approach has twice as many reserve sites, protects as many species, and still costs far less than the site-constrained approach. The chart also illustrates how the total costs of species protection rise slowly at first under the cost-effective strategy, but eventually rise very sharply.



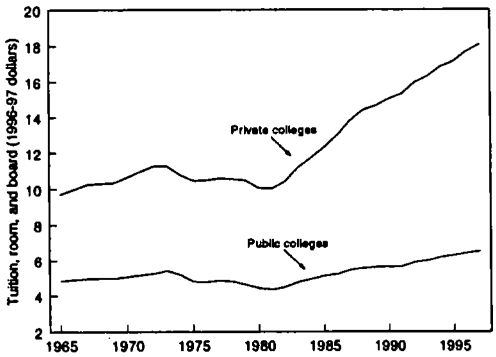
EYES ONLY

SPECIAL ANALYSIS

## College Quality and Earnings

Increased educational quality (in the form of smaller class size) appears to improve educational outcomes among young children. Two recent studies suggest that quality matters at the other end of the educational spectrum as well: attending a high-quality 4-year college enhances graduates' earnings over and above effects related to students' individual characteristics.

Public and Private Tuition, Room, and Board




**College tuition is high and variable.** Tuition (including room and board) varies substantially among 4-year colleges, averaging roughly $7,300 at public institutions and $18,000 at private colleges. Many of the elite schools cost $25,000 or more. College costs have been increasing since 1980, especially among private institutions (see chart).

**Quality matters.** A new study of 3,100 men finds that attending a higher-quality college leads to greater earnings than attending a lesser-quality institution. The study measured school quality using indicators such as SAT scores of incoming students, share of faculty with Ph.D.s, applicant rejection rate, faculty-to-student ratio, and spending per student. It found that after adjusting for individual characteristics (such as performance on standardized tests, parental education, parental family structure, and various characteristics of the student's high school), men who attended colleges in the top fifth of the quality ranking earned 13 percent higher hourly wages than those who attended colleges in the bottom fifth.

These results were confirmed by a second study, which found that attending elite private colleges increases wages. Moreover, this study found that around age 24, the wage advantage associated with attending an elite private college was lower for students who graduated in the late 1970s (a 9 percent wage advantage relative to attending a bottom-ranked public school) than in the mid- to late 1980s (a 20 percent wage advantage). This finding is consistent with earlier studies showing that disparities in wages have risen over this period among workers with the same years of education, experience, and race.

**Implications.** The effectiveness of educational spending continues to be debated. Although more spending *per se* may not improve student performance, new studies have demonstrated that smaller class sizes and other quality improvements are associated with better academic performance and future labor market outcomes. In the case of colleges, however, a question remains whether improved school quality raises graduates' wages because it raises their productivity or simply because employers *assume* that graduates with prestigious degrees are worth more.

EYES ONLY

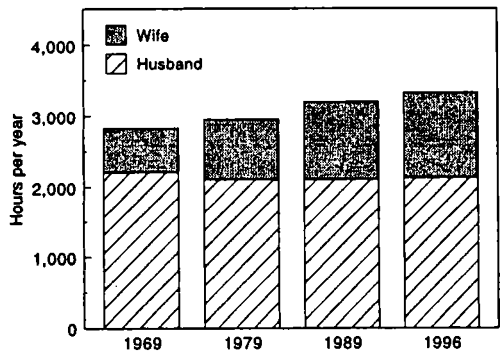
## ARTICLE

# More Work for Mom

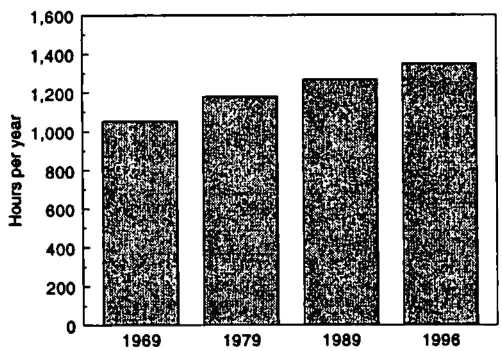
Many American families spend more time working for pay than their counterparts did 30 years ago. All of the increase is due to increased hours among women—wives and single mothers.

**Trends.** Average annual hours of work increased for both married-couple and single-parent families between 1969 and 1996. The increase was 496 hours (18 percent) for two-parent families (see upper chart) and 297 hours (28 percent) for single-parent households (see lower chart). In 1996, wives in married-couple families worked almost twice as many hours as their 1969 counterparts, and their increase more than accounted for the rise in hours worked among such couples. (To put these numbers in context, a person working full-time year-round would work about 2,000 hours per year.)

Annual Hours of Work, Married-Couple Families




Annual Hours of Work by Single Parents




**More weeks or longer weeks?** For wives and single parents, the increase in annual work hours reflects both more weeks worked per year (including fewer women not working at all) and more hours of work per week. For husbands, the number of weeks worked has declined slightly, while the usual number of hours worked per week has remained relatively constant.

**Where are the effects greatest?** Although the basic trends are similar across a wide range of family types, the following two groups experienced especially large effects:

- The highly educated. For married couples with a college-educated husband, average annual hours of work increased 644 hours (23 percent)—more than twice the increase for couples in which the husband had a high school diploma or less. In both cases, the increase came from the wives. For single parents with a college degree, annual hours of work rose by 321 hours (20 percent), compared with 165 hours (16 percent) for single parents with a high school diploma or less.

- Parents of young children. For single parents with a child under age 3, annual hours of work increased by 405 hours (55 percent), compared with 260 hours

(23 percent) for single parents without a young child. For married couples, hours of work increased by 557 hours (21 percent) for families with a child under age 3, compared with 467 hours (16 percent) for families without a young child. This result is not surprising, since mothers of young children worked less than mothers of older children 30 years ago and therefore had more room to increase their hours.

**Implications.** More work in the market means fewer total hours available for child care, work in the home, and leisure. Changes in family size and structure complicate any assessment of how this change in work hours has affected the amount of time parents have available to spend with each child. On the one hand, a rising share of single-parent families and increased time in the labor market among married-couple families may mean less *total* time available for child care. On the other hand, a reduction in the average number of children per family would tend to increase parental time *per child*. In addition, working parents may spend less time on housework and leisure in order to reclaim time with their children.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Housing Affordability Index Remains High.** Despite a small drop in the second quarter, housing affordability conditions remain near their highest sustained levels since the early 1970s, according to the National Association of Realtors (NAR). The NAR composite Housing Affordability Index stood at 131.1 in the second quarter, 6.1 points higher than a year ago. The index measures housing affordability factors (mainly home prices and mortgage rates and terms) relative to median family income. The current level means that half the nation's households have at least 131.1 percent of the income needed to afford a median-priced resale home (costing, coincidentally, $131,100). The NAR calculates that families with $30,000 of income can afford a house priced at $115,000 and those with $60,000 can afford a house priced at $230,000. In the second quarter, an increase in the median existing-home price offset a modest increase in family income and a slight decline in mortgage interest rates.

**CBO Assesses Impact of Generic Drugs.** Between 1984 and 1996, the proportion of prescription drugs sold in the United States accounted for by generic drugs rose from 19 to 43 percent, according to a recent study by the Congressional Budget Office. Switching to generics saved consumers $8 to $10 billion at pharmacies in 1994. CBO found three main causes for the growth in generic sales. First, the 1984 Hatch-Waxman Act made it easier and less costly for manufacturers to market generic drugs. Second, drug-substitution laws have allowed pharmacists to dispense a generic drug when a brand-name drug is prescribed. Third, government and private health plans have substituted generic for brand-name drugs. The Hatch-Waxman Act also contained patent-extension provisions to address the issue of incentives to develop new brand-name drugs, which could be eroded by increased generic entry. The CBO study concludes that since 1984, the expected returns from marketing a new drug have declined by about 12 percent, or $27 million in 1990 dollars. Although probably not enough to make drug development unprofitable on average, this decline may have made some specific projects unprofitable. Although some pharmaceutical industry representatives have called for further patent-term extensions, CBO concludes that policies to speed up the FDA drug approval process without sacrificing the safety and efficacy of drugs would be much more beneficial to both the pharmaceutical industry and consumers, because that would bring new drugs to market sooner rather than delay the introduction of a generic.

**Infants' Health Is Now Less Dependent on Family Income.** The intergenerational transmission of health inequality has been reduced over the twentieth century, according to a new study. The relationship between a newborn's weight and its parents' income has weakened, as has the relationship between a mother's height, which is dependent on her own nutritional status during her growing years, and her newborn's weight. Although birth weights at the turn of the century were quite similar to today's birth weights, turn-of-the-century infants quickly lost ground relative to today's infants, as their risk of death in the first 10 days of life was much higher. The author attributes the change to improved obstetrical and medical knowledge, particularly in infant nutrition.

EYES ONLY

## INTERNATIONAL ROUNDUP

**New Study Compares Public Pension Systems among the G-5.** A recent study concludes that the cost of public programs for the elderly is expected to increase significantly as a share of GDP in every G-5 country except the United Kingdom, as the proportion of the population over 65 continues to grow relative to the population aged 15 to 64. Several factors make the United Kingdom different. Over time, the basic flat rate pension of their two-tier pension system has declined, and workers now have the option of switching out of the earnings-based second tier into private pension programs. In addition, public health care costs in the United Kingdom are expected to increase less than in other G-5 countries, in contrast to the United States, which has the largest projected increase in such costs. As a result of this reduction in public spending on pension and health care programs, the United Kingdom will not face the same financing problems as the other G-5 countries. Despite the impact of privatization on the U.K.'s pension costs, the study notes a number of problems. If large numbers of workers suffer low or negative returns on their investments, for example, democratically elected governments may face pressure to compensate them for their losses.

**Do High Asian Saving Rates Reflect Cultural Differences?** Economists remain unsure exactly why some countries save so much more than others. Most explanations based on differences in the economic environment (such as social security systems, tax incentives, and land and housing prices) have been largely unsuccessful at explaining the observed variation. As a result, many have suggested that saving differences stem in part from cultural differences rather than strictly economic differences. But a recent study of U.S. immigrants found that although the saving patterns of immigrants differed substantially by country of origin, immigrant saving patterns did not match up with the country-of-origin saving patterns. In particular, immigrants from countries with high national saving rates, such as Japan, Korea, and Taiwan, did not seem to have higher saving rates than the other immigrants in the authors' sample. Of course, immigrants may differ in important ways from those who remain at home.

**Southeast Asian Governments Undertake New Measures to Support Recovery.** The governments of Malaysia and Thailand have each formulated plans to support their weakening financial systems and promote economic recovery. Malaysia's plan calls for a $5 billion bond issue for the purposes of bank recapitalization, stabilizing the currency within a band set by a trade-weighted basket of currencies, increasing foreign reserves, reducing dependence on the dollar for trade, and adopting a balanced interest rate policy. The government has also recently announced several fiscal and monetary measures to revive the Malaysian economy, which local analysts expect to contract by 3 percent this year. Such measures include a $1.25 billion infrastructure fund to revive infrastructure projects that were deferred last year and the reduction of statutory reserve requirements by the Central Bank of Malaysia, from 10 percent to 8 percent. Details of the Thai plan are being withheld pending the outcome of ongoing negotiations with the IMF.

EYES ONLY

## RELEASES THIS WEEK

**Employment and Unemployment**

****Embargoed until 8:30 a.m., Friday, August 7, 1998****

In July, the unemployment rate was unchanged from June at 4.5 percent. Nonfarm payroll employment rose by 66,000.

**Leading Indicators**

In June, the composite index of leading indicators decreased 0.2 percent following a decrease of 0.1 percent in May.

**NAPM Report on Business**

The Purchasing Managers' Index decreased to 49.1 percent in July from 49.6 percent in June.

## MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Retail Sales (Thursday)
Industrial Production and Capacity Utilization (Friday)
Producer 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 | 1.4 |
| GDP chain-type price index | 5.4 | 1.7 | 1.1 | 0.9 | 0.8 |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 1.4 | 1.1 | N.A. |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 3.1 | 3.7 | N.A. |
| Using NFB deflator | 1.3 | 2.5 | 3.9 | 3.5 | N.A. |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.6 | 10.7 | 11.0 | 11.1 |
| 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 | 13.2 |
| Personal saving | 5.2 | 1.5 | 1.2 | 0.9 | 0.4 |
| Federal surplus | -2.7 | **-0.3** | **0.0** | **0.7** | N.A. |

| | 1970-1993 | 1997 | May 1998 | June 1998 | July 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.3 | 4.5 | **4.5** |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | **328** | **196** | **66** |
| increase since Jan. 1993 | | | | | **16322** |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.3 | 0.1 | N.A. |
| PPI-Finished goods | 5.0 | -1.2 | 0.2 | -0.1 | 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, August 7, 1998.**

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | June 1998 | July 1998 | Aug. 6, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 8873 | 9097 | 8578 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 4.98 | 4.96 | 4.90 |
| 10-year T-bond | 6.44 | 6.35 | 5.50 | 5.46 | 5.44 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.00 | 6.95 | 6.94 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level August 6, 1998** | **Percent Change from** | |
|---|---|---|---|
| | | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.768 | -0.5 | -5.9 |
| Yen-Dollar | 144.6 | 1.5 | 21.9 |
| Multilateral $ (Mar. 1973=100) | 101.1 | 0.2 | -0.3 |

| **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 (Q2) | **4.5** (Jul) | 1.7 (Jun) |
| Canada | 3.8 (Q1) | 8.4 (May) | 1.1 (Jun) |
| Japan | -3.7 (Q1) | 4.2 (Apr) | 0.1 (Jun) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (Jun) |
| Germany | 3.0 (Q1) | [2] 7.6 (Apr) | 1.2 (Jun) |
| Italy | 2.5 (Q1) | 12.4 (Apr) | 1.8 (Jun) |
| United Kingdom | 2.6 (Q2) | 6.4 (Mar) | 3.7 (Jun) |

U.S. unemployment data **embargoed until 8:30 a.m., Friday, August 7, 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 April 1998 is 10.0 percent.

EYES ONLY

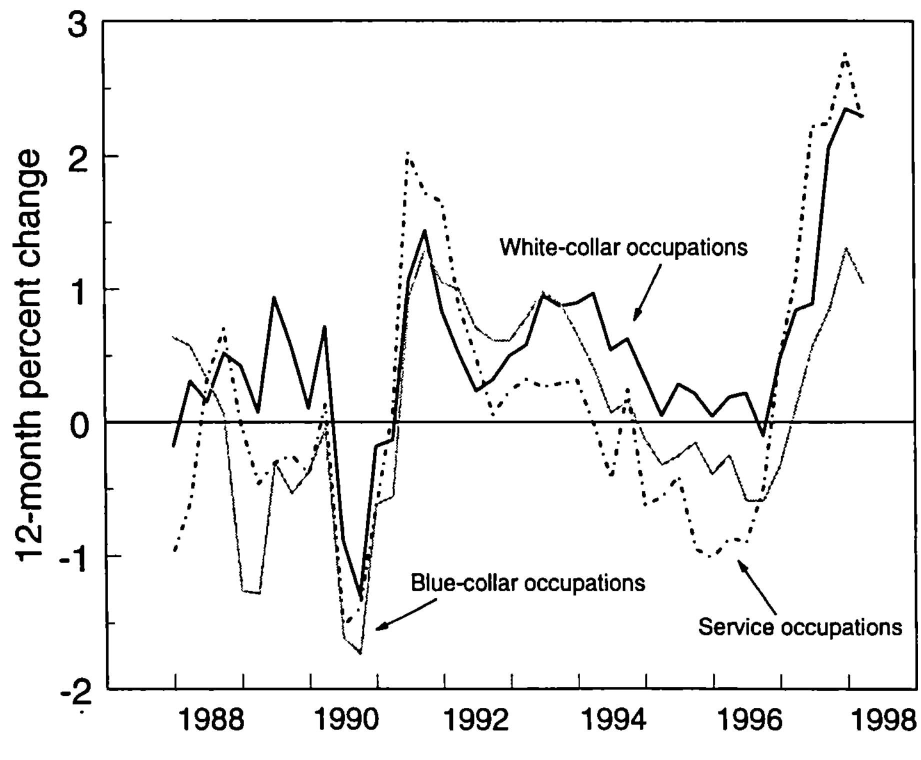
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 31, 1998

CHART OF THE WEEK

Growth in Real ECI Compensation




Employee compensation as measured by the employment cost index (ECI) has been rising faster than inflation recently. White-collar (managerial, administrative, and professional) and service occupations have seen larger increases than blue-collar occupations.

EYES ONLY

## CONTENTS



*"The economy's never been better. Here's another potato!"*

EYES ONLY

## CURRENT DEVELOPMENT

# GDP Scorecard: Second Quarter 1998

Real GDP is estimated to have increased at a 1.4 percent annual rate in the second quarter—a dramatic slowdown from the 5.5 percent rate in the first quarter. Three factors took a bite out of second-quarter output: a decline in net exports; slower growth in stockbuilding after an extraordinary first-quarter pace; and the strike at GM, which cut second-quarter growth by about 0.6 percentage point at an annual rate. The price index for GDP increased only 0.8 percent at an annual rate in the second quarter and 1.0 percent over the past year.

| Component | Growth* | Comments |
|---|---|---|
| Total consumer expenditures | 5.8% | Motor vehicle purchases increased sharply, driven at least in part by generous incentive programs. Increases in spending on nondurables and services were also large. |
| Producers' durable equipment | 17.8% | Increases in transportation equipment and information-processing equipment were large. |
| Nonresidential structures | -4.5% | These have been down in the last two quarters. In part, this may reflect a drop in oil well drilling due to a drop in oil prices. |
| Residential structures | 13.2% | The large increase in single-family home construction reflects solid income gains over the past year as well as declines in mortgage rates in the second half of 1997. |
| Inventories (change, billions of 1992 dollars) | $44.7 | After heavy stockbuilding in the first quarter, inventory investment dropped sharply in the second, as expected. |
| Federal purchases | 7.0% | Defense outlays bounced back after a drop last quarter. |
| State & local purchases | 2.0% | Second-quarter growth is similar to the pace of growth over the previous 4 quarters. |
| Exports | -8.0% | This is the second consecutive quarter of decline and most likely reflects a drop in exports to the Asian crisis countries. |
| Imports | 11.9% | Strong growth in final sales, together with a 3 percent drop in prices of non-petroleum imported goods over the past year, has encouraged imports. |

*Percent real growth in the second 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

## What Do We Know about High Performance Workplaces?

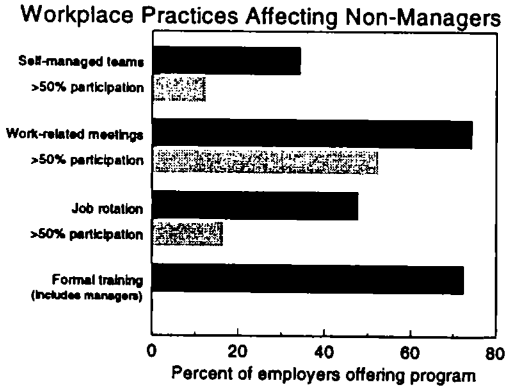
In the past decade, the role of workplace organization, human resource practices, and compensation schemes in determining firms' performance has received increasing attention. The evidence is mixed as to whether these practices do indeed enhance performance.

**What are high-performance work practices?** Human resource practices designed to improve performance fall into five broad categories:

- employee involvement in the work process, such as through self-managed teams or regular meetings to discuss work-related issues;
- skill building through formal and informal job training and job rotation;
- reward systems, including individual and group incentive-based compensation;
- explicit or implicit commitments by employers to provide long-term employment relationships;
- rigorous recruitment and selection systems.

**How prevalent are these practices?** The 1997 National Employer Survey (NES) provides the most recent and most representative data on employer practices. Many employers reported using high-performance practices, such as self-managed teams, work-related meetings (also known as quality circles), and job rotation with their non-managerial staff (see chart). While many employers use these practices with at least some of their employees, far fewer apply them to more than half of their employees. Firms also reported high rates of formal training.

Workplace Practices Affecting Non-Managers




**The package matters.** According to a recent review of research findings, firms that implement multiple work practices designed to enhance flexibility and worker participation can improve business productivity. However, isolated changes in individual work practices were generally found not to improve performance. For example, employee involvement may not encourage workers to share ideas if they do not perceive that the rewards from higher productivity will be shared, or if productivity gains are followed by worker layoffs. In light of these findings, it is noteworthy that few firms in the NES reported implementing a strategy that combined a number of practices.

**ESOP fables?** Employee stock ownership plans (ESOPs) and profit sharing plans have been the subject of growing interest, in large part because workers may respond to these incentives with improved performance. Research combining the results from many individual studies indicates that average productivity increases by 4 to 5 percent following the adoption of either ESOPs or profit sharing plans. However, the individual studies themselves show that, although many firms experienced increased productivity after instituting ESOPs, many other firms experienced little or no change. For profit sharing, the individual studies yielded more consistently positive results.

**Implications.** Evidence on the effectiveness of high-performance work practices should be interpreted cautiously. While employee ownership and profit sharing plans appear to help productivity and profitability, the mechanism through which they operate effectively remains elusive. The positive relationship between multiple work practices and outcomes may signal synergies within systems of practices. But it could arise because firms that are more serious about improving performance in general also implement more of these specific practices than firms that are less committed. It is also possible that more-profitable firms are more willing to undertake these strategies in the first place.

EYES ONLY

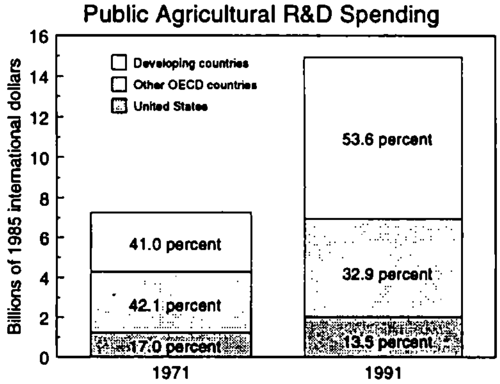
SPECIAL ANALYSIS

## International Spillovers in Agricultural Technology

Expanded global capacity in agricultural research has increased the rate at which new food and agricultural technology flows across national borders. The United States remains the world's largest investor in agricultural research, but foreign sources of scientific and technological innovations have become increasingly important to us.

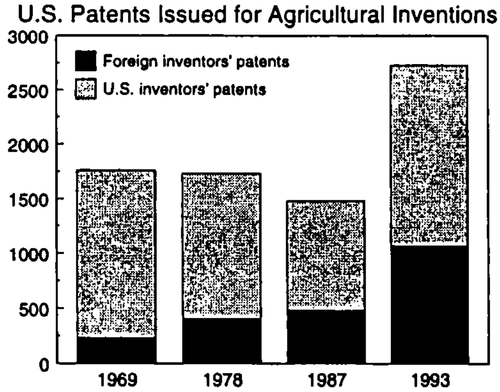
**Global investments in agricultural research.** Between 1971 and 1991, global public expenditures for agricultural research more than doubled, from $7.3 billion to $15.0 billion in constant 1985 dollars. While the U.S. share fell from 17 percent to 13.5 percent (see upper chart), that of developing countries rose to more than half the total by 1991. Along with these increases in public expenditures, multinational food and agricultural companies have stepped up their investments in agricultural research and technology transfer.

Public Agricultural R&D Spending




**U.S. imports of agricultural technology.** One indicator of U.S. imports of technology is the share of patents awarded to foreigners who want to market their inventions here. For agricultural inventions, this share increased steadily from 13 percent in 1969 to 39 percent in 1993 (see lower chart), indicating a growing reliance on imported technology in this sector. The United States also relies heavily on foreign plant genetic material to breed higher yielding crop varieties: most crops grown here originated elsewhere, and most genes needed to increase biodiversity come from foreign locations. The use of plant genetic material from international agricultural research centers has led to significant economic benefits for U.S. agriculture (see box on next page).

U.S. Patents Issued for Agricultural Inventions




**U.S. exports of agricultural technology.** Innovations in this country, such as applying biotechnology to develop genetically modified crops, are also spreading quickly to other countries via private multinational seed companies. Although agricultural biotechnology is facing consumer resistance in Europe, genetically modified crops are currently being grown commercially in Canada, Mexico, South America, China, and Australia, as well as in the United States.

EYES ONLY

**Implications.** Growth in global public and private agricultural research implies that new agricultural technology will spread more quickly across countries. Further, the United States may increasingly look to foreign sources of new agricultural technology for domestic agricultural productivity growth. Expanded cooperation in international agricultural science and technology can improve U.S. access to foreign agricultural innovations.

**Benefits from International Agricultural Research**

For nearly three decades, the United States has been an important player in international agricultural research through its investments in the work of the Consultative Group on International Agricultural Research (CGIAR), a network of 16 agricultural research centers around the world. CGIAR research centers helped produce the "green revolution" in the 1960s and 1970s. While the main goal of U.S. support for the CGIAR is to enhance global food security and alleviate poverty, we also enjoy direct spillover benefits from this effort. A recent study found that by using improved plant genetic material developed at CGIAR centers, U.S. crop breeders were able to increase U.S. yields of wheat and rice significantly. By the early 1990s, about one-fifth of U.S. wheat acreage and 73 percent of U.S. rice acreage were sown with varieties having some CGIAR ancestry. The total benefits to the U.S. economy between 1970 and 1993 were estimated to have been between $3 and $15 billion. This compares with a total U.S. investment of $134 million in international wheat and rice research at CGIAR centers between 1960 and 1993.

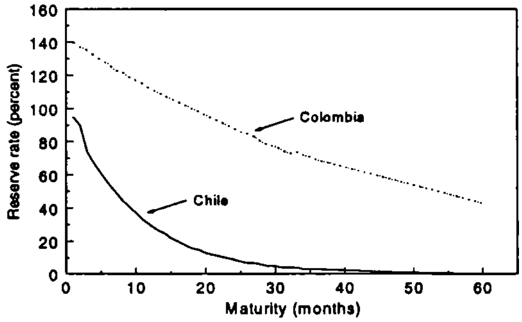
EYES ONLY

ARTICLE

## Controls on "Hot-Money" Inflows in Chile and Colombia

The Asian currency and financial crisis has rekindled a broad debate over whether controls on short-term capital inflows, such as those implemented by Chile and Colombia in the 1990s, have helped them withstand international currency crises.

Effective Reserve Requirement Rate on Short-Term Capital Inflows According to Maturity (1994)




**How do controls work?** Countries have adopted numerous methods to limit short-term capital inflows. Chile and Colombia require borrowers to put funds on deposit in non-interest-bearing accounts against their foreign borrowing—in effect "taxing" those borrowings. The implicit tax rate declines with the maturity of the amount borrowed (see chart), with very short- term inflows taxed at a steep rate.

**"Hot money" can burn you.** A (controversial) view is that large inflows of short-term capital, or "hot money," can be destabilizing. For example, large money inflows may cause a country's currency to appreciate, ultimately eroding competitiveness and widening its current account deficit. Growing reliance on foreign debt to finance such a deficit can lead to crisis, especially if the liabilities are short-term, foreign-currency denominated, and bank-related. When optimism about a country's economic prospects turns to pessimism, the money can quickly flee.

**You should not play with fire if you are not a grown-up.** Is there evidence that short-term debt can make a country more vulnerable to a crisis? Yes, but with an important caveat: fundamentals matter too. A number of recent studies suggest that countries with weak economic fundamentals are the ones where a high level of short-term liabilities noticeably increases the probability or severity of a crisis. Danger signs include real currency appreciation and large current account deficits, excessive bank lending booms, and weak financial systems. In other words, strong economic fundamentals are the best protection against crises.

**If it feels too hot, should you take a cold shower?** In contrast to short-term portfolio flows, longer-term capital inflows (such as foreign direct investment, long-term bonds, and equities) are generally thought to be stabilizing. Chile and Colombia designed their controls in part to avoid boom-and-bust cycles of capital flows by discouraging short-term inflows. Recent studies suggest that such controls have affected the composition of capital inflows but have not reduced their overall level.

**Can you turn the hot water on and off?** The Asian flu has recently caught up with both Chile and Colombia. Their monetary authorities have been forced to defend falling currencies by depleting foreign reserves and raising interest rates. Both countries have recently trimmed their controls on short-term inflows because they now need all the money they can get. Some argue that this policy reversal shows that the rationale for controls was weak to begin with. Others suggest that a case remains if the controls are intended to address a problem of excessive short-term inflows at one stage of the cycle, followed by excessive reversal at another stage.

**Arguments for free capital flows.** Although capital controls have garnered substantial attention since the Asian crisis, several strong arguments have been raised against them. First, controls may raise domestic borrowing costs, diminishing investment. Second, they may be unnecessary if a solid bank supervision system is in place. In fact, some think Chile and Colombia have been sheltered from speculative attack due to the strength of their financial sectors and not as a result of their controls. Third, capital controls tend to become ineffective as investors find ways around them. Finally, approval of targeted restrictions could lead countries to use capital controls indiscriminately, thus insulating unsound policies from the discipline of the marketplace.

**Limiting controls to banks.** Taking into account these arguments against controls, some have proposed penalizing only *banks*' short-term borrowing from abroad. Such regulations fall well within the kind of enhanced prudential banking supervision that the United States and the IMF have for some time urged on developing countries.

**Conclusion.** Arguably, capital controls served a limited purpose in Chile and Colombia. In general, however, free capital mobility is necessary for the market to allocate saving to the best investment opportunities, and countries should pursue capital account liberalization as their long-term goal.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Telecom Merger Mania Continues; Wall Street Cool.** Bell Atlantic and GTE Corp. have announced a "merger of equals" between the two telecommunications companies that would create the nation's largest local exchange carrier, with combined annual revenues of over $53 billion in 1997. The deal, valued at over $50 billion, adds another large telecommunications merger to this year's record-setting pace of proposed mergers and acquisitions. The Bell Atlantic-GTE merger announcement highlighted four key businesses in which the merged company expected to enjoy a leadership position: data and advanced Internet services, cellular services, local telephone service, and international service. Unlike many mergers, however, where the acquisition price represents a premium over the current market valuation, the price in this merger was based on the recent stock market value of the two companies. The day of the announcement, the prices of both companies' stock fell, as did a more general index of telephone prices. One reason may be concern that the wave of recent telecommunications mergers may lead to increased regulatory scrutiny by the antitrust authorities and the Federal Communications Commission.

**Mexican Immigrants Face Special Challenges.** Mexicans represent a large share (22 percent in 1990) of the foreign-born population in the United States—and an even larger share of the children of foreign-born. Roughly one-third of the children of immigrants have at least one Mexican-born parent. A recent study identifies an education gap that separates Mexican immigrants from other immigrant groups and puts them at particular economic risk in today's economy. Thirty percent of second-generation non-Mexicans lived in a household where the head had a college degree (7 percentage points higher than the rate for all natives); for second-generation Mexican households the figure was only 4 percent.

**Do Official Measures Underestimate U.S. Investment?** According to standard measures of investment, the United States has devoted a smaller share of its GDP to investment than many other developed countries. A recent study suggests that the U.S. investment record is, in fact, better than these figures suggest. The authors argue that international comparisons using domestic prices for capital goods are not meaningful, since they measure consumption sacrificed rather than real investment gained. The authors use measures based on world prices to account for the fact that capital goods are generally cheaper in the United States. Furthermore, the national accounts measure only physical capital investment: business and non-military government construction and purchases of plant and equipment, as well as purchases of owner-occupied housing. The study argues for an accounting more compatible with the economic notion of investment as an activity that yields income beyond the present period. This broader definition would include education, research and development, consumer durables, and military capital formation as investment goods. Because the United States devotes a greater share of GDP to these areas than do most other developed countries, a change in accounting methods would boost the U.S. position in international comparison of investment-to-GDP ratios.

EYES ONLY

## INTERNATIONAL ROUNDUP

**New President Looks to Put Colombia Back on Track.** Markets welcomed the victory in June of President-elect Andres Pastrana, who has said that fiscal reform will be a priority of his new administration when it takes office August 7. Colombia had a long history of prudent economic management (a fact not widely known in the United States). However, rising fiscal deficits under the current administration have put upward pressure on interest rates and the already- appreciating real exchange rate. This led to increasing capital inflows and a widening of the current account deficit. These worsening fundamentals, together with general emerging-market turbulence, led to reduced capital inflows this year and pushed the exchange rate toward the bottom of its support band. Political uncertainty leading up to the election fueled speculative pressure on the exchange rate, forcing the government to raise interbank interest rates to nearly 80 percent and spend nearly $1 billion in reserves. After the election the peso recovered somewhat against the dollar, but interest rate premiums on Colombian debt still exceed those of Mexico, despite Colombia's better credit rating. Failure by the new administration to address the growing current account and fiscal imbalances could well result in a further depression of investor confidence and a downgrade of the country's credit rating.

**It's the Economy, Dummkopf.** According to a recent poll, unemployment is the single most important issue to German voters, who are generally dissatisfied with the performance of the current government. Thus the centerpiece of the economic platform of the opposition Social Democrats (SPD) is a proposal to boost demand-led growth through a tax restructuring that will lower tax rates while expanding the tax base. The SPD candidate for Chancellor, Gerhard Schroeder, is the current front-runner for the September election, in part, some think, because his campaign rhetoric promotes a policy approach that bridges traditional liberal-conservative differences. The Schroeder approach integrates market-based economic reforms, an emphasis on investment and new technologies, and the traditional progressive social policy of his party. Schroeder, however, has not managed to reshape his party's economic policy agenda, which has formally retained many of its traditional interventionist and redistributional goals under the leadership of party chairman Lafontaine. So although Schroeder himself has voiced support for market-based structural reforms, the need for consensus building within the coalition government makes it unlikely that actual SPD policies will represent a radical departure from current policies.

EYES ONLY

## RELEASES THIS WEEK

### Gross Domestic Product
****Embargoed until 8:30 a.m., Friday, July 31, 1998****

According to advance estimates, real gross domestic product grew at an annual rate of 1.4 percent in the second quarter.

### Employment Cost Index

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

### Advance Durable Orders

Advance estimates show that new orders for durable goods decreased 0.2 percent in June, following a decrease of 3.3 percent in May.

### Consumer Confidence

Consumer confidence, as measured by The Conference Board, decreased 2.8 index points in July, to 135.4 (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 | 1997:4 | 1998:1 | 1998:2 |
|---|---|---|---|---|---|
| **Percent growth** (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | **3.8** | **3.0** | **5.5** | **1.4** |
| GDP chain-type price index | 5.4 | **1.7** | **1.1** | **0.9** | **0.8** |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 1.4 | 1.1 | N.A. |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 3.1 | 3.7 | N.A. |
| Using NFB deflator | 1.3 | 2.5 | 3.9 | 3.5 | N.A. |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | **10.6** | **10.7** | **11.0** | **11.1** |
| 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 | **13.2** |
| Personal saving | **5.2** | **1.5** | **1.2** | **0.9** | **0.4** |
| Federal surplus * | -2.7 | -0.4 | -0.1 | 0.6 | N.A. |

*Based on unrevised GDP data.

| | 1970-1993 | 1997 | April 1998 | May 1998 | June 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.3 | 4.3 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 320 | 309 | 205 |
| increase since Jan. 1993 | | | | | 16246 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.2 | 0.3 | 0.1 |
| PPI-Finished goods | 5.0 | -1.2 | 0.2 | 0.2 | -0.1 |

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

New or revised data in **boldface.**
GDP data **embargoed until 8:30 a.m., Friday, July 31, 1998.**

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | May 1998 | June 1998 | July 30, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9080 | 8873 | 9027 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 5.00 | 4.98 | 4.94 |
| 10-year T-bond | 6.44 | 6.35 | 5.65 | 5.50 | 5.50 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.00 | 6.97 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level July 30, 1998** | **Percent Change from Week ago** | **Percent Change from Year ago** |
|---|---|---|---|
| Deutschemark-Dollar | 1.776 | -0.9 | -3.3 |
| Yen-Dollar | 142.5 | 0.7 | 20.4 |
| Multilateral $ (Mar. 1973=100) | 100.9 | -0.4 | 1.2 |

| **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 | **3.5** (Q2) | 4.5 (Jun) | 1.7 (Jun) |
| Canada | 3.8 (Q1) | 8.4 (May) | 1.3 (May) |
| Japan | -3.7 (Q1) | 4.2 (Apr) | 0.5 (May) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (May) |
| Germany | 3.0 (Q1) | [2] 7.6 (Apr) | 1.3 (May) |
| Italy | 2.5 (Q1) | 12.4 (Apr) | 1.7 (May) |
| United Kingdom | 2.6 (Q2) | 6.4 (Mar) | 4.2 (May) |

U.S. GDP data **embargoed until 8:30 a.m., Friday, July 31, 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 April 1998 is 10.0 percent.

EYES ONLY

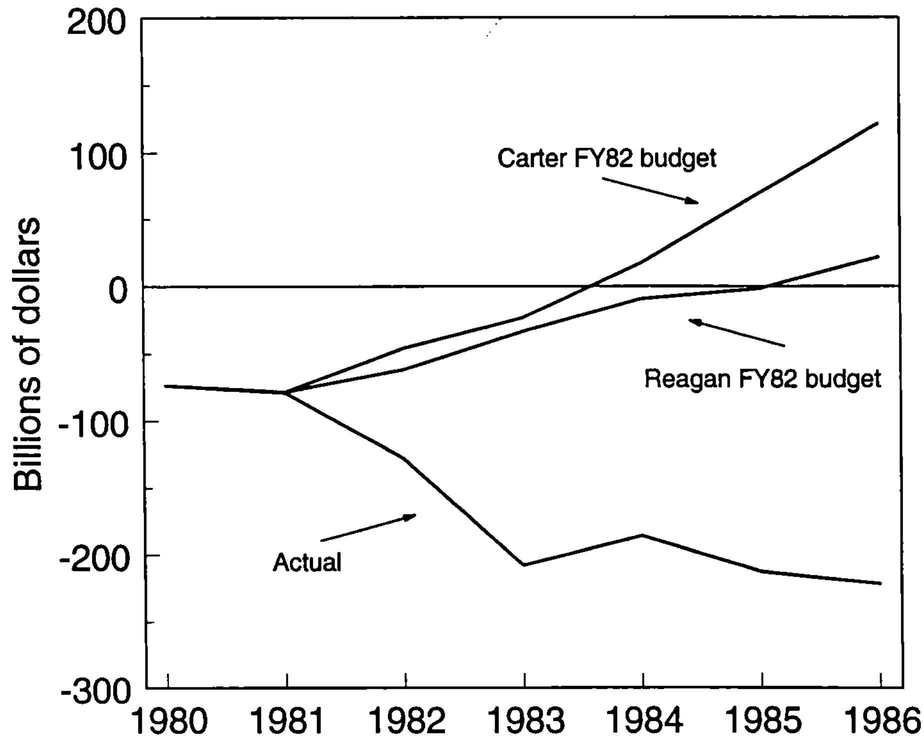
# Weekly Economic Briefing of the President of the United States

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

July 24, 1998

## CHART OF THE WEEK

Tax Cuts and Budget Surpluses: A Look Back




The budget history of the early 1980s illustrates how quickly projected surpluses can become large deficits. The FY 1982 budget submitted by President Carter in January 1981 projected rapidly declining deficits, turning into a surplus of $121 billion by 1986. The large tax cuts and other changes in the Reagan FY 1982 budget ate into this surplus, but, based on optimistic economic assumptions, this budget still projected a surplus for 1985 and 1986. In fact, of course, the combination of large tax cuts and a severe recession produced massive deficits.

EYES ONLY

## CONTENTS

### SPECIAL ANALYSES



### ARTICLE



### DEPARTMENTS



EYES ONLY

SPECIAL ANALYSIS

# Estimating the Costs of Keeping Cool

The Administration is about to release an economic analysis showing that the costs to the United States of meeting its Kyoto Protocol emissions target can be modest.

**Effective flexibility matters.** The key to keeping costs modest is effective flexibility. The Kyoto Protocol provides several market-based approaches for achieving lower emissions—most importantly the trading of emissions permits among countries that accept emissions targets (and among firms in those countries). However, the rules for implementing trading still need to be negotiated. The Administration's economic analysis follows the U.S. position and presumes that trading will be implemented in an effective manner. Actions by other countries to restrict the use of trading or otherwise increase transaction costs could significantly increase the cost of compliance to the United States and other developed countries.

**Model-based results.** The CEA drew on a wide range of evidence to reach the conclusion that compliance costs can be modest. For illustrative purposes, the report contains simulation results from one long-term economic model of the United States and 11 other regions of the world—the Second Generation Model. Several different trading scenarios were examined (see box on next page). Key results include the following:

- Trading among the industrialized countries could reduce compliance costs by nearly 60 percent relative to a strategy of achieving all emissions reductions domestically.
- Cost reductions would rise to about 80 to 90 percent if developing countries adopted targets and participated in international trading.
- If China, India, Mexico, and Korea were all to adopt emissions targets based on 2010 business-as-usual emissions levels and sell permits to developed countries, the world price for a greenhouse gas permit would be $14 to $23 per ton.

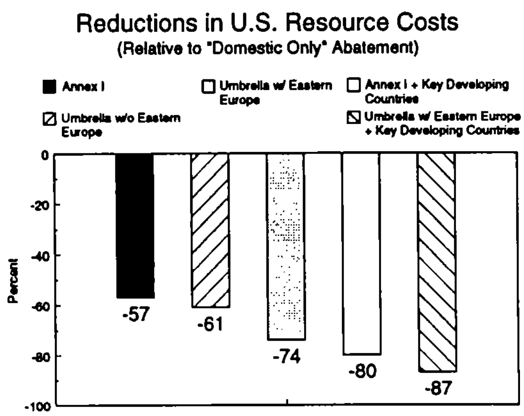
Such prices would result in modest increases in the price of fuels (about 5 cents per gallon for gasoline) that would cost the average household about $70 to $110 per year. The Administration's electricity restructuring proposal would generate cost-savings roughly offsetting this increase.

**Batteries not included.** The Administration's analysis focuses on compliance costs, assuming effective flexibility. It does not attempt to quantify the effects of Kyoto on climate change or assess the payoffs from our domestic initiatives.

EYES ONLY

## Cost Reductions from Alternative Trading Scenarios

The ability to purchase international emissions permits reduces the total cost to the United States of meeting its Kyoto emissions targets. The chart shows the percentage reduction in resource costs (domestic abatement plus purchases of permits abroad) under various trading scenarios, relative to a "domestic only" scenario in which the target is met through domestic abatement alone. Scenarios differ according to what groups of countries participate in trading: Annex I (industrialized) countries, which include Russia and other Eastern European countries; key developing countries (here taken to be China, India, Mexico, and Korea); "umbrella" countries (the United States, Japan, Australia, Canada, Russia, and Ukraine); and Eastern Europe.



EYES ONLY

SPECIAL ANALYSIS

## More Guns, Less Crime?

A recent book by a scholar at the University of Chicago has garnered considerable attention for its claim that "right-to-carry" concealed-handgun laws reduce crime. However, several analysts have questioned the validity of this claim.

**Background.** Right-to-carry laws require local law enforcement authorities to issue permits to carry concealed handguns to any applicant who meets a set of specified criteria related to age, criminal history, and mental illness. Thirty-one states have enacted such laws; an additional nine states have considered them.

In theory, the effect of right-to-carry laws on crime is ambiguous. Increasing the number of guns may increase both the frequency and the severity of crime: guns may be substituted for less lethal weapons in hostile confrontations, and higher rates of gun carrying among potential victims may cause criminals to arm themselves with greater frequency. However, right-to-carry laws may also deter crime to the extent that criminals are unwilling to attack potential victims who may be armed.

**A flawed study.** The recent book is based on research that examined the crime rates of all U.S. counties from 1977 to 1992. After controlling for other factors such as arrest rates, personal income, and demographic characteristics, right-to-carry laws were associated with declines of 5 to 10 percent in the rates of murder, rape, and aggravated assault.

Several critics have noted that these results do not necessarily indicate any causal relationship between right-to-carry laws and crime. Instead, they may reflect the presence of other factors that are correlated with both crime rates and right-to-carry laws. For example, if right-to-carry laws are enacted in conjunction with other anti-crime measures, the Chicago study would attribute all of the subsequent crime reduction to right-to-carry laws even if such laws had no effect on crime.

**Another look.** A new study addresses this deficiency by taking advantage of the fact that many right-to-carry states also have a minimum-age requirement (ranging from 18 to 21) for obtaining a concealed-carrying permit. If right-to-carry laws actually deter crime, they should—because of the minimum-age requirement—reduce crimes against adults more than crimes against juveniles. Contrary to the deterrence hypothesis, however, adult victimization rates have not fallen relative to juvenile victimization rates in states that have passed right-to-carry laws. This suggests that factors other than right-to-carry laws are behind the reductions in crime in these states.

**Implications.** Pro-gun advocates have used the Chicago study to support right-to-carry proposals in states without such laws. However, the defects of the Chicago study render it an inappropriate guide to public policy towards guns.

EYES ONLY

## SPECIAL ANALYSIS

# New Evidence That Class Size Matters

A new evaluation of an important educational experiment has found promising evidence that smaller classes improve children's academic achievement.

**Problems with previous studies.** Studies using non-experimental data on school characteristics and student performance have tended to find little relationship between expenditures and outcomes. But these studies are potentially flawed to the extent that they have not controlled adequately for underlying factors, such as innate ability or family resources, that also affect student outcomes. Moreover, reverse causality may have been present if resources were directed toward the schools with the greatest problems. An experimental approach, in which students are randomly assigned to classes receiving different amounts of school resources, offers a way around these methodological problems. Random assignment serves to remove underlying differences in the average characteristics of students in each type of class.

**STAR pupils.** Although the experimental approach has been widely used in other areas, such as welfare and training, it has rarely been used to evaluate education outcomes. The Tennessee Student Teacher Achievement Ratio (STAR) experiment is a notable exception. In this study, students in kindergarten through grade three were randomly assigned to either a small class (with an average of about 15 students), a regular-size class of about 22 students, or a regular-size class with a teacher's aide and about 23 students. For the most part, students remained in their original class-size assignment until the third grade.

**The results.** Promising evidence from the STAR experiment includes the following:

- Large initial effects. At the end of the first year, test scores of students assigned to small classes exceeded those of other students by about 5 to 8 percentile points. By contrast, the presence of a teacher's aide made little or no difference in the scores of students in regular-size classes. Evidence on how additional years in a small class affect subsequent relative test scores is inconclusive.

- Larger effects for disadvantaged students. Both minority students and students participating in the reduced-price lunch program tended to show larger relative test score improvements from being assigned to a small class.

- Lasting effects. A study that followed students for 4 years after they had left the experiment found that those who had been assigned to small classes maintained their achievement gains.

**Implications.** These results suggest that judiciously applying additional resources in order to reduce class size can improve students' academic achievement. However, it is important to note that this study was conducted only in one state and only among very young students.

## ARTICLE

# Back to the Future: Japan's Banking Crisis of 1927

In 1927 Japan faced a banking crisis similar in many ways to its current one (see box on next page). In both episodes, banks' fragility was exacerbated by subsequent deflationary shocks and a weak and delayed policy response that led to the accumulation of bad loans. In what may be a lesson for the 1990s, however, an expeditious cleanup of the banks after the formation of a new government in 1927 solved the banking crisis and ushered in a period of sustained economic growth.

**Prelude to crisis.** The banking crisis of 1927 resulted from excessive bank lending and poor bank supervision in an economy hit by negative shocks, including the 1923 Tokyo-Yokohama earthquake. The banking system was already fragile when the earthquake hit, due to excessive lending during the World War I boom period. In the aftermath of the quake, many borrowers had trouble meeting their loan obligations, and the Bank of Japan adopted a very easy credit policy in order to relieve the pressure on financial institutions. In 1925, however, the Japanese government tried to balance the budget by raising taxes and reducing expenditures. This had deflationary effects and further hurt borrowers' ability to repay their bank loans.

**Overlending, bad loans, and poor supervision.** Among the main holders of bad loans was the Bank of Taiwan, a Japanese institution in what was then a Japanese colony. This bank had grown aggressively, venturing outside Taiwan to lend excessively in Japan itself. It funded this loan expansion, not with stable deposits, but with short-term call loans from other banks that could be, and eventually would be, quickly withdrawn. While the bank borrowed short, it lent long. Banks were not closely supervised in Japan and the law imposed no limit on how much a bank might lend to a single borrower. Also, there were many small banks undiversified as to both assets and liabilities, and there was no government deposit insurance.

**Panic and bank runs.** Confidence in the banking system was seriously shaken in 1927 by a Diet debate that revealed the unsoundness of many banks. The government then resigned in April to protest a court rejection of its plan to rescue the Bank of Taiwan. Public reaction to uncertainty about that bank's rescue led to withdrawal of deposits, and when the Bank of Taiwan could not accommodate the subsequent run, it collapsed. With no deposit insurance, contagion and panic spread; other banks began to experience runs. Twelve banks failed in one 4-day period in what was the worst crisis in Japanese financial history.

**Resolution through rapid cleanup and recapitalization.** A new government began to reform the financial system by recognizing and dealing with losses and bad loans that had been covered up for years. The 18 months after June 1927 were a period of consolidation, during which the number of ordinary banks was reduced from 1,359 to 1,030. The corporate sector also went through restructuring. Weak firms were closed or placed under new and more efficient control.

EYES ONLY

**Japan fared well in the Great Depression.** The rapid cleanup of the financial and corporate system after the 1927 crisis is one of the reasons why Japan experienced a period of sustained economic growth (at a 6 percent average annual rate) in the 1930s while the rest of the world went through the Great Depression. A very large fiscal expansion beginning in 1931, when Japan also abandoned the gold standard and depreciated the yen, further contributed to the successful growth experience of the 1930s.

**Implications.** Japan's current banking situation is similar in many ways to the one leading up to the 1927 crisis. In the 1990s, the cleanup of the banking system was significantly delayed after the asset bubble of the 1980s burst, and bad loans built up in the financial system. The plight of the financial sector and a tightening fiscal policy have contributed to the protracted stagnation of the economy in the 1990s. However, the experience of the 1920s suggests that sound policies can restore financial stability and economic growth.

**Comparisons between the 1920s and the 1990s**

| 1920s | 1990s |
|---|---|
| Tokyo-Yokohama earthquake in 1923 | Kobe earthquake in 1995 |
| Yen appreciation in 1925 | Yen appreciation until 1995 |
| Contractionary fiscal policy in 1925 | Contractionary tax increase in 1997 |
| Excessive lending and poor bank supervision in boom years | Excessive lending and poor bank supervision in 1980s and early 1990s |
| Slow reaction of the political system to the accumulation of bad loans until 1927 | Slow reaction of the political system to the accumulation of bad loans until 1998 |
| Bank run and crisis in 1927 | Implicit and explicit bankruptcy of financial institutions in 1997-98 |
| New government in 1927 undertook rapid closures and clean up of the banks | New government in 1998...? |

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Greenspan Calls Economic Performance Impressive, Assesses Risks.** In presenting the Federal Reserve's mid-year report on monetary policy to the congressional banking committees, Fed chairman Alan Greenspan observed that, overall, the performance of the American economy continues to be impressive. He noted that so far this year, the economy has continued to enjoy a "virtuous cycle" in which economic performance has strengthened as inflation has subsided. Greenspan reported that monetary policymakers foresee a reasonably smooth transition to a slower and more sustainable rate of growth—but with significant risks attending that outlook. Given the current tightness in labor markets, Fed policymakers see the potential for accelerating inflation as probably greater than the risk of protracted, excessive weakness in the economy.

**Does Crime Pay for Gang Members?** The distribution of wages in gangs is highly skewed, with gang leaders reaping large rewards, while low-level drug dealers earn surprisingly low wages for highly risky work. This is the implication of a recent study based on 4-years' worth of detailed financial information from a now-defunct gang—though it is unknown whether these results generalize beyond this single case study. Average wages, which ranged between roughly $6 and $11 per hour in different years of the study, conceal a sharp disparity between the gang leader's wage, which ranged between $32 and $97 per hour, and the average wage of a "foot-soldier," which ranged between $2.50 and $7.10 per hour. This disparity invites a "tournament" interpretation—which has also been applied to corporate compensation structures—in which participants choose to vie for large awards that only a small fraction will ultimately attain. The gang members in the study, on average, earned income only slightly above wages in legal jobs. This income difference implies a compensation for increased "occupational" risk among gang members that is more than 10 times lower than estimates typically found in the economics literature.

**BEA Releases First Travel and Tourism Satellite Accounts.** Travel and tourism spending by U.S. residents and by nonresidents traveling in the United States accounted for 5 percent of GDP in 1992, according to the newly developed travel and tourism satellite accounts (TTSAs) recently released by the Commerce Department's Bureau of Economic Analysis (BEA). These accounts show that travel and tourism spending accounted for about 3 percent of total employment. Of the approximately $300 billion in travel and tourism spending, the largest single expenditure was for airline fares ($81 billion), followed by lodging ($56 billion) and meals and beverages (approximately $50 billion). Satellite accounts are rearrangements of information from the national economic accounts and other sources for the purpose of analyzing specific economic activities more completely than is possible within the structure of the basic accounts. For example, development of the TTSAs arose out of a 1995 White House Conference on Travel and Tourism that had highlighted difficulties with existing measures of travel and tourism. BEA has also developed transportation services, environmental, mineral resources, and R&D satellite accounts.

## INTERNATIONAL ROUNDUP

**Moody's Threatens To Downgrade Japanese Credit Rating.** Yesterday, Moody's announced that it will consider downgrading Japan's credit rating, citing the ineffectiveness of current policy to address structural problems in the Japanese economy, lack of consensus over economic strategy, a worsening fiscal outlook, and signs that Japan's external position is weakening. The yen dipped temporarily following Moody's announcement. It had been depreciating throughout the week, which press reports attribute in part to investor skepticism that front-runner Keizo Obuchi will undertake serious reforms to address Japan's economic problems if he becomes Prime Minister.

**Wall Street Firm Urges Asian Debt Relief to Avert Further Crisis.** Asian governments must move quickly to shore up their banking systems, according to a recent Goldman Sachs report. The report suggests that public sector balance sheets of the crisis countries are sufficiently robust and the long-term growth outlook is sufficiently strong that the banks can be recapitalized without generating an unsustainable debt position. It goes on to argue for immediate government action to alleviate credit crunch conditions. Goldman Sachs has lowered its macroeconomic forecasts, predicting deeper real contraction this year for the crisis economies (Indonesia, Korea, Malaysia, and Thailand), with negative or near-zero growth extending into 1999.

**ILO Reports That Violence on the Job is a Global Problem.** France, Argentina, Romania, Canada, and England have reported the highest rates of assaults and sexual harassment on the job, according to a worldwide survey of violence in the workplace issued this week by the International Labor Organization. While acknowledging the difficulties of comparing rates of violence among countries, the ILO report draws on a 1996 survey of workers in 32 countries and their perceptions of what had occurred to them on the job. Of those surveyed, taxi drivers, health care workers, teachers, and those working alone were among those facing the greatest risk of violence. The ILO also reports that in the United States roughly 1,000 killings take place each year in job settings, and that homicide has become the leading cause of death on the job for U.S. women. One survey found that U.S. employers incurred costs from workplace violence of more than $4 billion in 1992.

**Nigerian Fuel Crisis Intensifies, with Renewed Violence.** Nigeria's longstanding fuel shortage has grown even more acute in the wake of violence sparked by the death of Moshood Abiola. Over 30 oil tanker trucks have reportedly been destroyed and several drivers killed; many other drivers have now refused to drive their tankers from the fuel depots. Shortages of aviation fuel have required the cancellation of some domestic flights. Although the oil sector generates a third of national output, inefficiency and the poor economic performance of many of these enterprises have helped generate fuel and power shortages that have depressed economic activity and forced Nigeria to import fuel to meet domestic requirements. Many of Nigeria's refineries have been shut down or are operating below full capacity.

EYES ONLY

## RELEASES THIS WEEK

### Housing Starts

Housing starts increased 6 percent in June to 1.62 million units at an annual rate. During the first six months of 1998, housing starts were 8 percent above the same period a year ago.

## MAJOR RELEASES NEXT WEEK

Consumer Confidence—The 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 | 1997:3 | 1997:4 | 1998:1 |
|---|---|---|---|---|---|
| **Percent growth** (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | 3.7 | 3.1 | 3.7 | 5.4 |
| GDP chain-type price index | 5.4 | 1.8 | 1.4 | 1.4 | 1.2 |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 3.6 | 1.4 | 1.1 |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 1.8 | 3.1 | 3.7 |
| Using NFB deflator | 1.3 | 2.5 | 2.7 | 3.9 | 3.5 |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.5 | 10.7 | 10.6 | 10.7 |
| Residential investment | 4.5 | 4.1 | 4.1 | 4.1 | 4.2 |
| Exports | 8.2 | 11.8 | 11.9 | 11.9 | 11.5 |
| Imports | 9.2 | 13.1 | 13.3 | 13.2 | 13.1 |
| Personal saving | 5.3 | 2.8 | 2.6 | 2.9 | 2.6 |
| Federal surplus | -2.7 | -0.4 | -0.1 | -0.1 | 0.6 |

| | 1970-1993 | 1997 | April 1998 | May 1998 | June 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.3 | 4.3 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 320 | 309 | 205 |
| increase since Jan. 1993 | | | | | 16246 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.2 | 0.3 | 0.1 |
| PPI-Finished goods | 5.0 | -1.2 | 0.2 | 0.2 | -0.1 |

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

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | May 1998 | June 1998 | July 23, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9080 | 8873 | 8933 |
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| 3-month T-bill | 5.01 | 5.06 | 5.00 | 4.98 | 4.96 |
| 10-year T-bond | 6.44 | 6.35 | 5.65 | 5.50 | 5.45 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.00 | 6.96 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level July 23, 1998** | **Percent Change from** | |
|---|---|---|---|
| | | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.792 | 0.1 | -1.7 |
| Yen-Dollar | 141.5 | 0.9 | 22.2 |
| Multilateral $ (Mar. 1973=100) | 101.3 | 0.2 | 2.9 |

| **International Comparisons** [1] | **Real GDP growth** (percent change last 4 quarters) | **Unemployment rate** (percent) | **CPI inflation** (percent change in index last 12 months) |
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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 April 1998 is 10.0 percent.

EYES ONLY

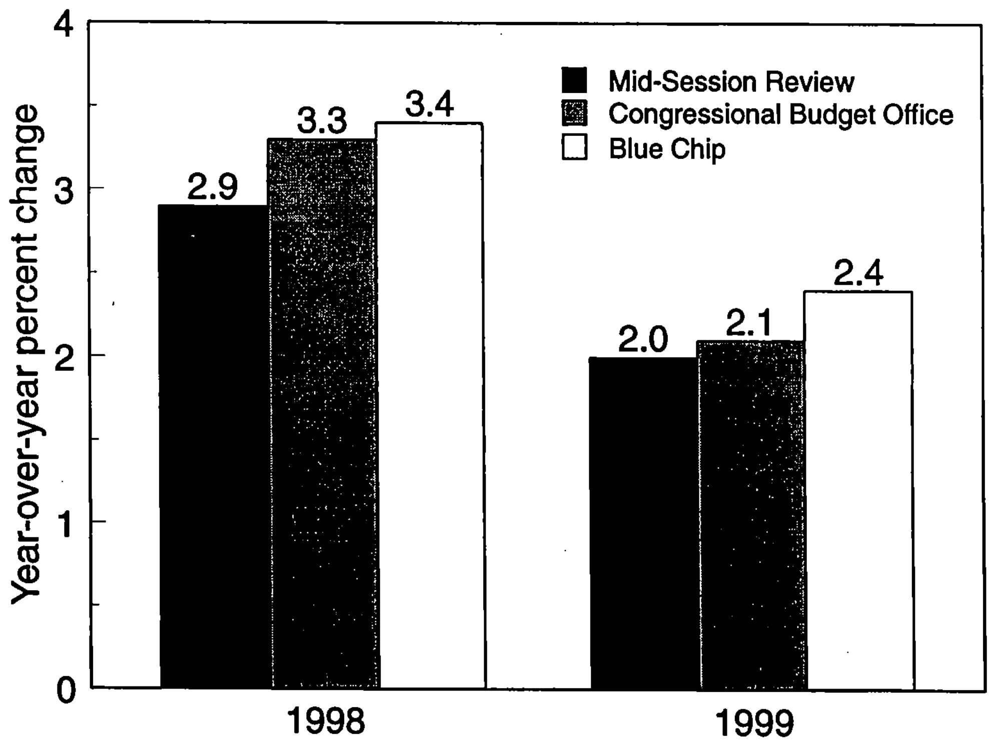
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 17, 1998

CHART OF THE WEEK

Real GDP Growth Forecasts

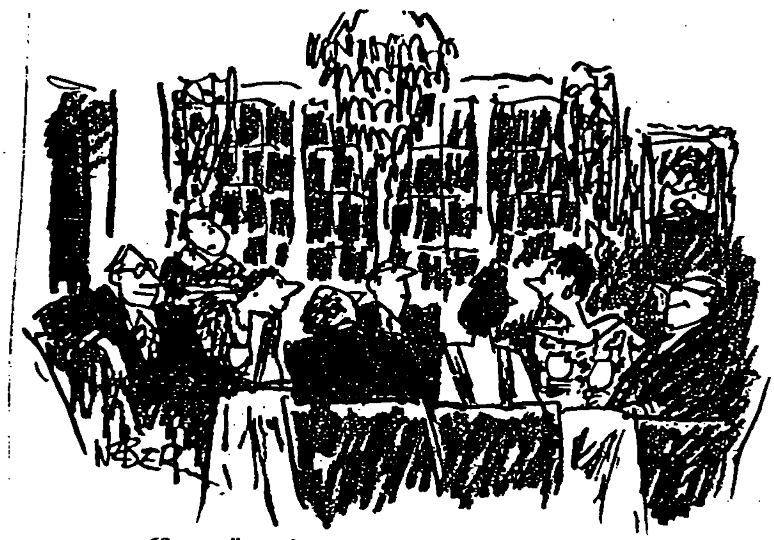



This week the Congressional Budget Office (CBO) released its updated economic forecast. CBO raised its forecast for real growth in 1998 to 3.3 percent (up from 2.7 percent in its January forecast). Like the private Blue Chip forecast, the new CBO forecast is higher than the Administration's most recent forecast and reflects the particularly strong first quarter. All three forecasts show slower growth in 1999.

EYES ONLY

# CONTENTS






*"Steve tells me that when he was in Beijing he discovered a rather good little Chinese restaurant."*

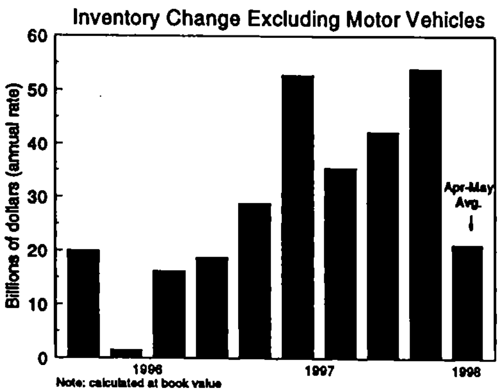
EYES ONLY

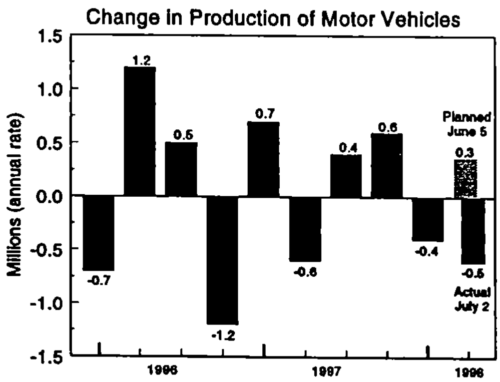
## MACROECONOMIC UPDATE

# A Slowdown, for Sure

Evidence continues to mount that the long-anticipated slowdown has arrived. Growth in real GDP may well have been less than 1 percent at an annual rate in the second quarter, and a decline in GDP is conceivable.

Production worker hours rose at only a 0.8 percent annual rate in the second quarter—the smallest increase since the second quarter of 1995. Spending weakness is concentrated in inventory investment and net exports; domestic final demand continues to perk along.



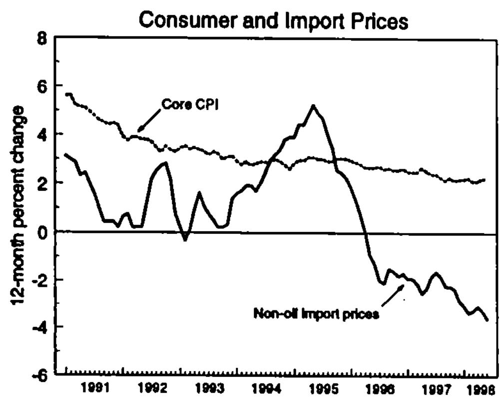




**Inventories.** Nonfarm inventory investment (excluding motor vehicles) was exceptionally—and unsustainably—strong in the first quarter, adding almost 2 percentage points to GDP growth. Preliminary data for April and May indicate a sharp drop in the second quarter (see upper chart)—enough to subtract 2 percentage points from GDP growth. In addition, the GM strike will produce a huge drop in motor vehicle inventories. Motor vehicle production in the second quarter fell well short of plans (see lower chart), largely because of the strike. CEA estimates that the strike reduced real GDP growth by about 0.6 percentage point in the second quarter.

**International trade.** Net exports, which subtracted more than 2 percentage points from first-quarter growth, appear to have fallen further in the second quarter. April and May data show a continued erosion of exports—especially to the Asian crisis countries—while imports continue to rise.

**Domestic spending.** In sharp contrast to inventories and net exports, domestic final spending remains exceptionally strong. Buoyed by large increases in real disposable income, real consumption appears to have increased at a blistering 5½ percent annual rate in the second quarter. Housing investment continues to make solid gains, and business equipment investment is likely to show another sizable increase in the second quarter.

**Inflation.** Core CPI inflation seems to have stopped falling, but it remains at a very low 2.2 percent, as measured over the past 12 months. Inflation pressures are being contained, at least in part, by the continued drop in non-oil import prices, which have fallen 3.6 percent over the past 12 months (see chart).




**What next?** The economy may now be moving toward the 2 percent average annual rate of growth anticipated in the Administration's forecast (though the fourth quarter could be boosted as GM makes up for production lost during the strike). Inventories remain lean relative to sales, hence the adjustment to a slower pace of inventory investment may have already been completed. In other respects, however, the shape of aggregate demand may be qualitatively similar to the second quarter, with weak net exports offsetting solid growth rates for consumption and business investment.

EYES ONLY

<u>SPECIAL ANALYSIS</u>

## Who Owns Guns?

Surveys indicate that approximately 40 percent of U.S. households have at least one gun. A recent study based on a nationwide survey of almost 21,000 people between 1973 and 1994 provides evidence on the characteristics of gun owners.

**Demographic and socioeconomic characteristics.** The study provides evidence on the effects of different characteristics on the probability of owning a gun, holding all other characteristics constant. Findings include the following:

- <u>Sex and age</u>. The likelihood of owning a gun is 8 percentage points higher for men than for women, and people over the age of 40 are about 8 percentage points more likely to own guns than are those under 30.
- <u>Family structure</u>. People who are married are 9 percentage points more likely to be armed. Families with teenagers are 2 percentage points more likely to own guns, but also slightly less likely to own handguns.
- <u>Location of residence</u>. Living in a rural area increases the probability of owning a gun by over 60 percentage points. People in the South are almost 20 percentage points more likely to own a gun than people in the East.
- <u>Education and income</u>. Graduating from college reduces the probability of owning a gun by about 10 percentage points. Income is positively correlated with gun ownership, perhaps because guns are expensive or because high-income individuals have more property to protect. Interestingly, gun ownership is also higher among those who did not respond to the survey's income question, which may indicate general mistrust.

**Private or public justice?** Other factors affecting gun ownership include attitudes about crime and justice. People who fear crime in their neighborhood are more likely to own handguns (although those who report being robbed in the past year are not any more likely to own guns). Gun ownership appears to be associated with a belief in private justice: Gun owners report less confidence in the courts and public officials and are more likely to approve of violent retribution. Gun ownership is also higher in states with fewer police per square mile.

**The effect of gun-control laws.** Waiting periods do not seem to reduce gun ownership generally, but they do appear to be successful in reducing gun ownership among people who have been arrested. No strong connection was found between other gun-control laws and gun ownership.

**Conclusion.** Those who own guns are more likely to be middle-aged, married, male, living in a rural area, and living in the South. Gun ownership also appears to be linked to the idea that private enforcement of property rights is needed to supplement public enforcement.

EYES ONLY

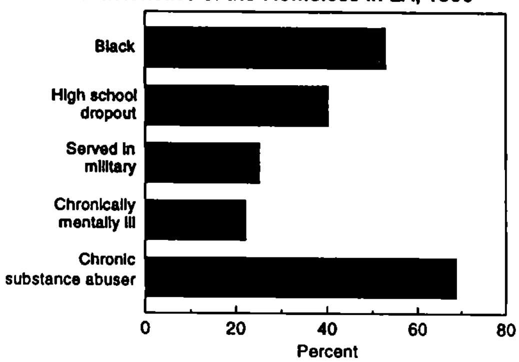
SPECIAL ANALYSIS

## Evidence on Homelessness from Los Angeles

The problem of homelessness became more apparent in the past two decades. New information from Los Angeles provides some evidence on the characteristics of the homeless and their sources of income and assistance.

**How many people are homeless nationally?** Estimating the number of persons who are homeless is difficult. Estimates from 1987 suggest that in a given week 496,000 to 600,000 people in the nation were "literally" homeless in the sense that they were living in temporary shelters or on the streets. But homelessness is dynamic, with many people moving in and out of homelessness. Evidence from 1995 suggests that nationally at least 12 million people have been homeless at some point in their lives.

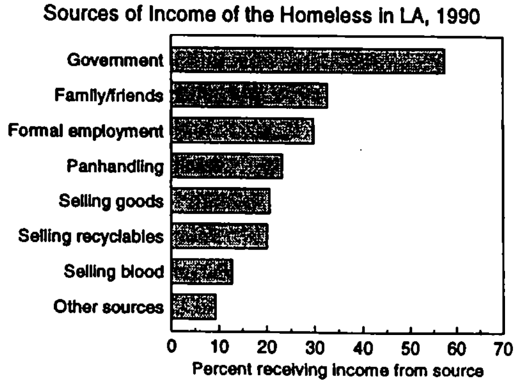
Characteristics of the Homeless in LA, 1990




**Who are they?** A survey of 1,548 homeless persons in Los Angeles in 1990 provides evidence on the needs and abilities of the homeless. The vast majority (83 percent) of them were men, and one-quarter had served in the military (see upper chart). Blacks, who accounted for 11 percent of the total population of Los Angeles in 1990, accounted for 53 percent of the city's homeless.

Although the homeless were less educated than the population as a whole, 60 percent had at least a high school degree, and 29 percent had some schooling beyond high school. Many may have had the formal education to be normal labor market participants, but 22 percent were chronically mentally ill, 69 percent were chronic substance abusers, and 17 percent exhibited both characteristics.

Sources of Income of the Homeless in LA, 1990




**How do they get by?** The Los Angeles study found that total income from all sources (including food stamps) averaged $387 per month in 1990. The most common source of income was government assistance—received by nearly 60 percent of those surveyed (see lower chart). Government assistance represented 45 percent of all income in the 30 days prior to the interview. A third of those surveyed received assistance from family members and friends; 30 percent had formal employment. Panhandling, selling recyclables, and selling other goods were also fairly common. Thirteen percent had sold their blood as a source of income.

**How adequate is public assistance?** Despite the overall importance of public assistance, 42 percent of the homeless were not receiving government transfers even though they presumably met the financial eligibility requirements for food stamps and General Relief (GR). The fact that 84 percent said they received some form of assistance in the past suggests that most homeless people knew that aid existed.

The most common form of government cash assistance received by the homeless in Los Angeles was GR, which is the county-run and state-mandated welfare program of last resort. GR provided aid to 76,281 persons in Los Angeles County in May 1998 (this number is greater than the number of persons receiving TANF in each of 28 states). California currently permits counties to place time limits on GR receipt, and Los Angeles decided to limit participation to no more than 5 months out of every 12. On June 30, 6,500 GR participants were the first to hit the time limit, and debate exists about what will happen to these people.

**Implications.** Although families and friends are an important source of assistance, for some people this support is insufficient to prevent homelessness in the first place. In addition, addressing the problem of homelessness is complicated by its dynamic nature. For example, solutions that help people become housed must also try to keep them from falling back into homelessness. They must also guard against undermining other sources of support, such as families and friends.

EYES ONLY

ARTICLE

## Converting Surplus Military Real Estate

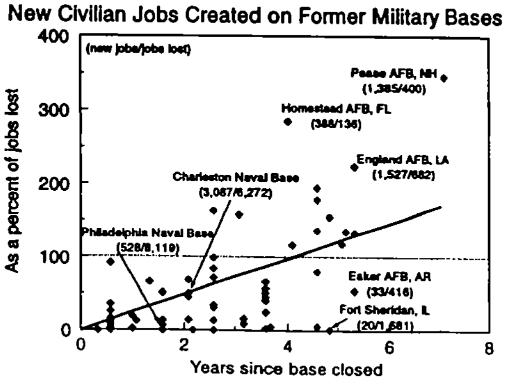
Between 1988 and 1995, the Department of Defense announced the closure or realignment of 261 military bases and facilities, to be completed by 2001 under the Base Realignment and Closure (BRAC) process. What do we know about how well this process is working?

**Selecting bases for closure: the BRAC process.** In the past, efforts to close individual military bases or facilities were often blocked by Congress to protect jobs and Federal expenditures within a state or Congressional District—even though the general public interest would be served by the closings. The BRAC process addressed this common policy dilemma by creating an independent commission to select domestic facilities to be closed or realigned. Congress could accept or reject the entire list of actions, but could not make changes to the commission's recommendations.

**Assessing economic impacts.** Besides the loss of civilian jobs, base closures and the redeployment of substantial numbers of military personnel can adversely affect local economies through reduced sales at businesses, depressed real estate values, lower public school enrollments, and a diminished tax base. Potential impacts can be exaggerated, however, since some bases may not be closely integrated into the local economy and civilian workers can often find new jobs in other sectors—especially when the national economy is strong. While reemployment of displaced workers is one of the most important indicators of successful conversion, communities are also concerned with finding new uses for the former base facilities themselves. The speed at which base-use conversion takes place depends on several factors, including the commercial value and condition of the facility, local economic conditions, and the degree of assistance provided by Federal and state governments to local redevelopment authorities.

**Civilian conversion to date.** The list of announced closures includes 98 major bases (defined as ones where 300 or more civilian and/or military jobs are lost). Most of the closed facilities are converting to nonmilitary uses, and civilian job loss at the facilities is gradually being made up. By March 1998, an estimated 47,682 jobs had been created on 58 former major military bases closed so far, replacing the 100,635 civilian jobs lost at these facilities due to closure and realignment.

New Civilian Jobs Created on Former Military Bases




Of the 58 major bases that have already been closed, 14 have at least as many new civilian jobs as were lost due to closing. Moreover, job creation improves with time (see chart) as facilities are refurbished and new tenants are found. An important factor in the success of base conversion to nonmilitary uses is the commercial value of base facilities. For example, many former Air Force bases located near metropolitan areas have rapidly converted to civilian uses, probably because communities have found it relatively easy to establish needed new civilian airports at former military airfields. Surprisingly, the speed of new job creation at former bases does not appear to be closely correlated with either local job growth or unemployment rates in the affected communities.

**Strengthening the base conversion process.** The recent rounds of base closings have provided important lessons in finding new uses for the surplus facilities as well as evidence of learning over time. For example, preliminary results from an MIT assessment of military base redevelopment found that conversion milestones were reached more quickly in each successive round of base closings (1988, 1991, 1993, and 1995). The study also examined techniques used by organizations other than the military (state and local governments and corporations) to convert surplus or obsolete sites to new uses. (Cases studied included former state mental hospital campuses, contaminated industrial sites known as "brownfields," and former industrial facilities owned by private corporations.) The following were identified as key elements of successful conversion:

- Infrastructure. Most surplus facilities required varying degrees of public intervention, such as infrastructure improvements, to create developable and thus commercially valuable sites.
- Capital. Successful developers usually had a source of ready capital that either did not require repayment or that could be repaid in the long term.
- Expertise. Corporations tended to make greater use of outside experts and consultants in developing conversion plans than did government authorities, and corporate real estate people discovered that out-sourcing to obtain needed skills and experience may be preferable to building up a large in-house staff.

**Conclusion.** The Department of Defense recently proposed another round of base closings. While closing military bases can have adverse local economic impacts, conversion to civilian uses can eventually lead to significant growth opportunities for these communities. Lessons from the recent public and private experiences with facility conversion suggest that further improvements can be made in the conversion process.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Corporate Charity Increases with Corporate Profits.** Many of America's largest companies plan to give more to charity this year than in 1997, according to a study published in the *Chronicle of Philanthropy*. Among 66 big companies that reported their giving plans for 1998, cash donations are expected to rise to $1.3 billion. This 11 percent increase in giving follows a 14 per cent increase by the same companies from 1996 to 1997. The increase can be attributed to the companies' increased profits, rather than to a higher rate of giving. Companies that provided income figures averaged 11 percent growth in profits from 1996 to 1997, but their average rate of giving remained constant at 0.8 percent of pre-tax profits. Some charities fear that increased merger and restructuring activities will reduce corporate generosity as corporations become less local, but the study cites several cases in which mergers led to no change or an increase in the level of giving. Among 65 business that provided figures, employees' contributions through matching gift programs are expected to increase 12 percent to $190 million from 1997 to 1998.

**Medicare HMOs Target Healthiest Seniors.** Medicare HMOs attempt to attract healthy, active senior citizens rather than people with costly medical problems, according to a new study of the marketing strategies of Medicare HMOs by the Kaiser Family Foundation and the marketing and public relations firm Porter Novelli. The study examined a sample of ads and marketing materials from Cleveland, Los Angeles, Miami, and New York to reach five key conclusions: 1) advertising emphasizes lower costs and more generous benefits than the traditional Medicare program; 2) ads target physically and socially active seniors, rather than beneficiaries in poor health; 3) non-elderly disabled Medicare beneficiaries are not targeted by ads; 4) marketing seminars are not consistently accessible to beneficiaries with physical disabilities; 5) a great deal of the important information included in ads is in fine print that is difficult for older people to read. The study noted that, without a reimbursement system that pays HMOs more if they enroll members with high costs, plans are financially disadvantaged if they enroll high-cost members, such as seniors in poor health or non-elderly disabled.

**OCC Weighs in on Bank Lending Practices.** In a recent speech, the Acting Comptroller of the Currency echoed concerns raised by the Federal Reserve about possible future problems arising from current bank lending practices. At roughly yearly intervals since 1995, the Office of the Comptroller of the Currency (OCC) has conducted a survey of examiners-in-charge at a sample of its largest banks. Concern arose from the continued deterioration in credit underwriting standards evident in the most recent survey. On the consumer lending side, the survey found improved credit card standards but easing standards for loans and credit backed by home equity. On the commercial side, the survey found more serious problems, with banks increasing their downside risk while also reducing their ability to cover potential losses. This view of commercial lending is more pessimistic than the Fed's and prompted the OCC to initiate a series of steps to give bankers the opportunity to make appropriate risk management assessments and halt the perceived slide in credit standards.

## INTERNATIONAL ROUNDUP

**Calculating the Bilateral Trade Balance with China.** The trade balance between the United States and China is one of the most contentious economic issues between the two countries. Even the size of the deficit is in dispute. According to U.S. statistics, the bilateral deficit was $40 billion in 1996, but Chinese data put it at less than $11 billion. This discrepancy is largely due to differences in the treatment of goods shipped through Hong Kong. Chinese goods that have been re-exported from Hong Kong are generally treated as imports from China in U.S. trade statistics, but many U.S. goods that are re-exported to China from Hong Kong are not recorded as exports to China. Thus, resolving the discrepancy between the U.S. and Chinese figures requires both an accurate accounting of bilateral trade shipped through Hong Kong and proper measurement of the value added by Hong Kong traders to these goods. These adjustments are not generally required under standard trade accounting practices, but a recent academic study that made them found a "true" bilateral trade deficit in the range of $15 to $20 billion in 1994 and $16 to $22 billion in 1995, a little more than half the recorded U.S. bilateral deficit. Like both sets of official balances, these estimates suggest that the bilateral deficit is widening over time. Exploring the determinants of the deficit, the authors found that this widening reflected the same evolving national saving and investment behavior in each country that has increased the overall trade deficit of the United States and created an overall trade surplus for China, as well as the general shift in the production of U.S.-imported goods to mainland China from elsewhere in East Asia.

**IMF Study Analyzes Capital Taxation in a Globalized Economy.** With globalization intensifying and vast amounts of capital instantly mobile across borders, the ability of governments to tax financial capital appropriately and effectively is a growing concern. Communication innovations like the Internet have eased access to and the anonymity of international financial transactions, while the rapid growth in the volume and complexity of financial instruments such as derivatives has complicated traditional notions of securities income. Intensifying tax competition among national governments seeking to attract capital has also eroded the effectiveness of traditional tax collection. In a recent study, IMF economists discuss possible solutions to these problems. Capital is now generally taxed according to the country of residence of the income recipient, rather than the country generating the capital income. One approach has been to adapt current tax policies to close existing loopholes. Ultimately, however, residence-based arrangements presuppose that the income recipients can be readily identified: The effectiveness of these policies is dependent upon the availability of relevant information on resident activities in tax haven countries. The IMF study concludes that since most interest and dividend payments are made by easily identifiable entities such as governments, corporations, and financial institutions, the simplest and most direct means of combating tax evasion is a shift toward source taxation of cross-border flows of interest and dividends. Such a move could be implemented through a multilateral tax treaty that would set minimum source withholding tax rates on those entities generating capital income in a given country.

EYES ONLY

## RELEASES THIS WEEK

### U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, July 17, 1998****

The goods and services trade deficit was $15.7 billion in May; it was $14.3 billion in April.

### Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production fell 0.6 percent in June. Capacity utilization fell 0.8 percentage point, to 81.6 percent.

### Retail Sales

Advance estimates show that retail sales increased 0.1 percent in June, following an increase of 1.2 percent in May. Excluding sales in the automotive group, retail sales also increased 0.1 percent in June, following an increase of 0.9 percent in May.

### Consumer Price Index

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

## MAJOR RELEASES NEXT WEEK

Housing Starts (Tuesday)

EYES ONLY

## U.S. ECONOMIC STATISTICS

| | 1970-1993 | 1997 | 1997:3 | 1997:4 | 1998:1 |
|---|---|---|---|---|---|
| **Percent growth** (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | 3.7 | 3.1 | 3.7 | 5.4 |
| GDP chain-type price index | 5.4 | 1.8 | 1.4 | 1.4 | 1.2 |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 3.6 | 1.4 | 1.1 |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 1.8 | 3.1 | 3.7 |
| Using NFB deflator | 1.3 | 2.5 | 2.7 | 3.9 | 3.5 |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.5 | 10.7 | 10.6 | 10.7 |
| Residential investment | 4.5 | 4.1 | 4.1 | 4.1 | 4.2 |
| Exports | 8.2 | 11.8 | 11.9 | 11.9 | 11.5 |
| Imports | 9.2 | 13.1 | 13.3 | 13.2 | 13.1 |
| Personal saving | 5.3 | 2.8 | 2.6 | 2.9 | 2.6 |
| Federal surplus | -2.7 | -0.4 | -0.1 | -0.1 | 0.6 |

| | 1970-1993 | 1997 | April 1998 | May 1998 | June 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.3 | 4.3 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 320 | 309 | 205 |
| increase since Jan. 1993 | | | | | 16246 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.2 | 0.3 | **0.1** |
| PPI-Finished goods | 5.0 | -1.2 | 0.2 | 0.2 | -0.1 |

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

New or revised data in **boldface.**

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | May 1998 | June 1998 | July 16, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9080 | 8873 | 9328 |
| | | | | | |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 5.00 | 4.98 | 5.03 |
| 10-year T-bond | 6.44 | 6.35 | 5.65 | 5.50 | 5.50 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.00 | 6.94 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level July 16, 1998** | **Percent Change from** | |
|---|---|---|---|
| | | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.790 | -2.2 | -0.5 |
| Yen-Dollar | 140.3 | -0.7 | 20.6 |
| Multilateral $ (Mar. 1973=100) | 101.1 | -1.5 | 3.5 |

| **International Comparisons** 1/ | **Real GDP growth** (percent change last 4 quarters) | **Unemployment rate** (percent) | **CPI inflation** (percent change in index last 12 months) |
|---|---|---|---|
| United States | 3.9 (Q1) | 4.5 (Jun) | 1.7 (Jun) |
| Canada | 3.8 (Q1) | 8.4 (May) | 1.3 (May) |
| Japan | -3.7 (Q1) | 4.2 (Apr) | 0.5 (May) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (May) |
| Germany | 3.0 (Q1) | 2/ 7.6 (Apr) | 1.3 (May) |
| Italy | 2.5 (Q1) | 12.4 (Apr) | 1.7 (May) |
| United Kingdom | 2.9 (Q1) | 6.4 (Mar) | 4.2 (May) |

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 April 1998 is 10.0 percent.

EYES ONLY

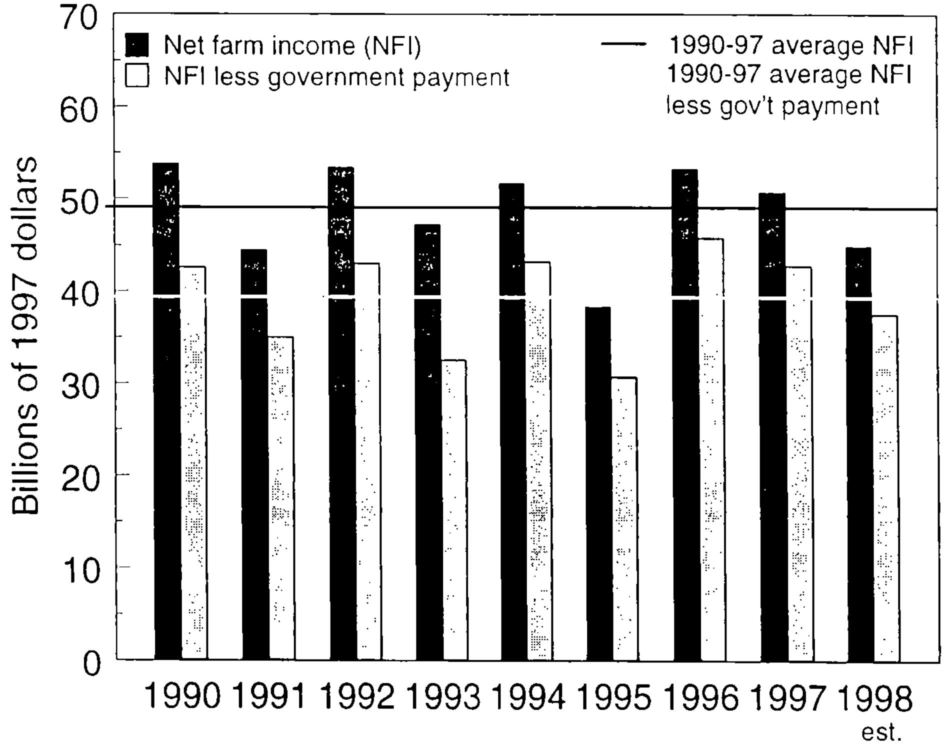
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 10, 1998

## CHART OF THE WEEK

Net Farm Income in the 1990s




The last 2 years were good ones for farmers, with both strong prices and large fixed support payments from the 1996 Farm Act. The latest USDA projections suggest that 1998 will not be so strong a year—though it should be within the range experienced in this decade. Some regions, particularly the upper Great Plains, are likely to experience more severe distress.

EYES ONLY

CONTENTS

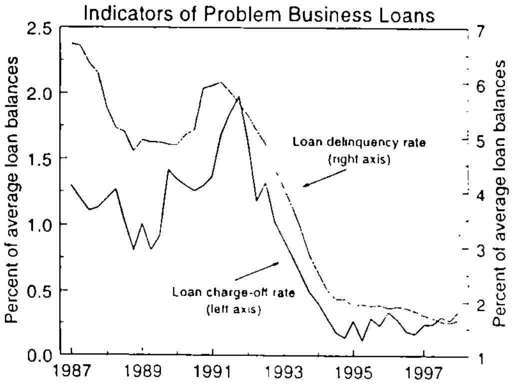


EYES ONLY

## CURRENT DEVELOPMENT

# Are Bank Lending Standards Too Lax?

Financial imbalances sometimes presage the end of expansions. As a precaution against the emergence of such imbalances, the Federal Reserve recently told bank examiners that this is a critical time for banks to maintain lending discipline.




**Background.** Aggregate statistics for the banking industry show problem business loans to be at historically favorable levels. Both delinquency rates and charge-off rates are low (see chart). Nevertheless, the Fed has been hearing complaints from both industry and supervisory officials that lending terms and standards have become too lax.

Because its normal supervisory process was not indicating any unusual amount of underwriting weakness, the Fed conducted a special intensive study of domestic commercial and industrial loans. This study verified that competition appeared to be encouraging banks to offer more favorable loan pricing, longer maturities, and other favorable loan conditions. However, these tendencies towards easing lending standards were mostly offset by improved (current) financial performance among many borrowers. On balance, the examiners found no evidence of significant deterioration in the credit quality of loans made in 1997 compared with those made in 1995.

**Why the warning?** The Fed's concern is that banks are not sufficiently forward-looking in their loan assessments. In particular, the current strength of the economy has contributed to the strong cash flow and solid balance sheets presented by borrowers. Without adequate attention to what might happen under more adverse circumstances, lending could become too risky. In other words, the Fed does not see a major problem now but worries that many of today's loans could become problems if the economy were to weaken.

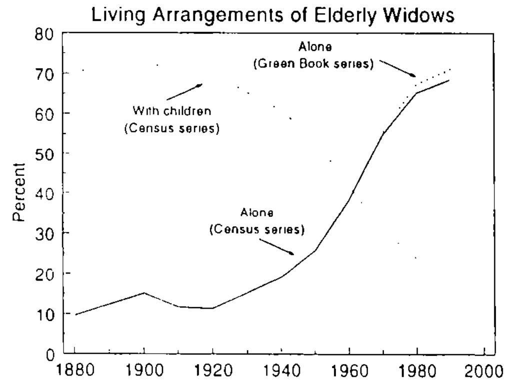
EYES ONLY

## SPECIAL ANALYSIS

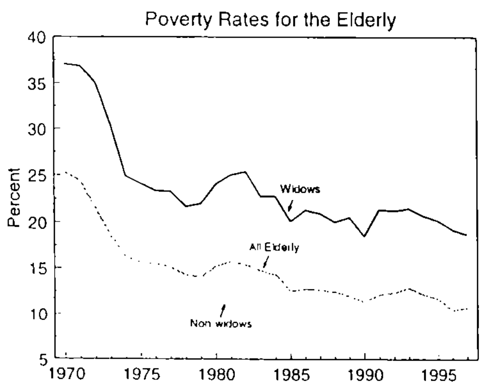
# Living Arrangements of Elderly Widows

Today 79 percent of unmarried elderly women are widows. Surveys indicate that a majority of elderly widows would prefer to live alone rather than move in with their children, and a recent study shows that the proportion of elderly widows living by themselves has increased dramatically over the past century. The main cause has been improvements in economic status. Nevertheless, the poverty rate of elderly widows remains substantially higher than that of elderly persons in general.

**Trends.** The share of (noninstitutionalized) elderly widows living alone stayed roughly constant at a low level (10 to 15 percent) for several decades prior to the enactment of Social Security in 1935 (see upper chart). But between 1940 and 1980, the share living alone increased sharply, while the share living with adult children fell. By 1980, 65 percent were living by themselves, and only 24 percent shared a home with their children. This strong upward trend ended in 1980, and living arrangements in 1995 were fairly similar to those in 1980.




**What caused the change?** The study found that rising economic status, primarily due to greater coverage and higher benefits from Social Security, accounted for 62 percent of the increase in the share of elderly widows living alone between 1940 and 1990. About 9 percent of the change was explained by a decline in the number of children available for widows to move in with.




**Poverty status.** Widows, like elderly people generally, have seen their poverty rate decline substantially over the past three decades (the longest period for which consistent data are available). However, the poverty rate for widows (who account for 27 percent of all elderly persons) was a relatively high 19 percent in 1997—more than twice the rate for all other elderly persons (see lower chart).

**Implications.** The primary source of income for most widows is Social Security. In 1990, two-thirds of widows derived at least half their total income from Social Security benefits. Thus, Social Security reform, including changes in survivor's benefits, will be particularly important for this population.

## SPECIAL ANALYSIS

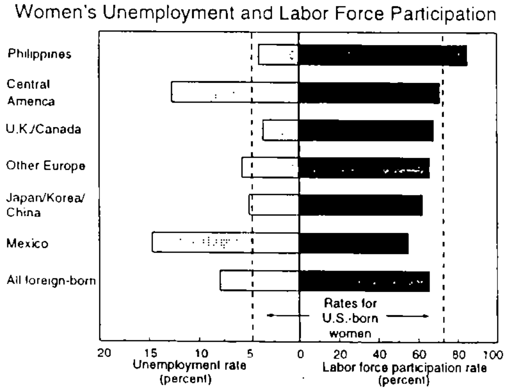
# Foreign-Born Women in the U.S. Labor Market

Several studies have examined the labor market performance of male immigrants, but almost half of all immigrant workers are women. A recent study that does look at women found substantial differences in labor force participation, unemployment, and wages among immigrants born in different countries. These differences are highly correlated with disparities in education among immigrant groups.

**Immigration trends.** The share of the population that is foreign-born rose from 4.8 percent in 1970 to 9.7 percent in 1997. At the same time, the importance of different countries as sources of immigrants has been changing. Whereas 31 percent of U.S. immigrants were from Europe in 1970, the share from Europe fell to 18 percent by 1995, with 37 percent coming from Asia and 12 percent from Mexico.

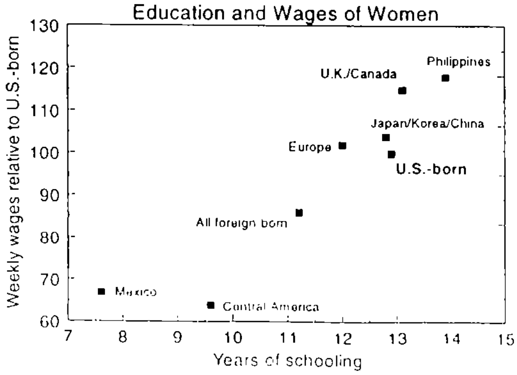
**Women's labor force participation and unemployment.** In 1990, 66 percent of working-aged (25 to 60-year old) female immigrants participated in the labor force, compared with 73 percent for U.S.-born women (see upper chart). Unemployment was more common among foreign-born women. Their unemployment rate was 7.9 percent, compared with 4.8 percent for U.S.-born women. (These estimates are from the 1990 census; more recent surveys do not provide large enough samples for accurate estimation.)

Women's Unemployment and Labor Force Participation




Although foreign-born women as a whole have relatively high unemployment rates, immigrants from some countries do very well. As shown in the chart, most groups' labor force participation rates are very similar to that of U.S.-born women, and their unemployment rates are comparable. However, immigrants from Mexico and Central America, who accounted for 19 percent and 6 percent, respectively, of all immigrant women in 1990, faced double-digit unemployment rates in 1990.

Education and Wages of Women




**Education and earnings.** In 1990, working-aged foreign-born women had, on average, 1.7 fewer years of schooling than U.S.-born women (see lower chart). Thus, it is not surprising that immigrant women earned wages that were 14 percent lower. The wage gap was particularly high for Mexican women, who earned just 67 cents on the dollar relative to U.S.-born women. This large difference reflects very low levels of schooling among Mexicans: in 1990, average education was just 7.6 years for Mexican women, while U.S.-born women averaged 12.9 years. The study found that the differences in completed years of schooling explained 87 percent of the earnings gap for Mexicans.

At the same time, some women have performed very well. On average, immigrants from the U.K. and Canada, the rest of Europe, Japan, Korea, and China, and the Philippines earned wages that were higher than those earned by U.S.-born women. Again, education is the key factor. As shown in the chart, foreign-born women with higher wages have completed more schooling.

**Implications.** Women account for 42 percent of all foreign-born workers. Many immigrant women are doing quite well in the labor market, earning wages comparable to those of U.S.-born workers soon after arriving in the United States. However, Mexican and Central American women earn much less due to their relatively low levels of schooling, and they have high unemployment. These two groups accounted for only 10 percent of all foreign-born women living in the United States in 1970. But by 1990 this share had increased to 25 percent, and immigration from these countries has continued to grow in the 1990s. This suggests that aggregate gains among women in the labor market in the last decade were somewhat attenuated by the increasing share of foreign-born workers with lower levels of education.

EYES ONLY

## ARTICLE

# Time As Money: A Perspective on Productivity

The average manufacturing worker earned less than $9 *per week* in 1897, compared with more than $13 per hour in 1997. Of course, a substantial amount of the increase in manufacturing wages between 1897 and 1997 reflects a rise in the overall price level. But productivity advances kept the prices of a large number of goods from increasing as fast as wages, with the result that the purchasing power of the money earned from an hour's work increased substantially.

**Productivity, prices, and purchasing power.** Analytically, changes in the real wage are calculated by comparing changes in the money wage with changes in a weighted average index of prices for a wide variety of goods and services. A new study from the Dallas Federal Reserve takes a more colorful (but more impressionistic) approach by calculating long-term changes in the amount of time it would take a typical manufacturing worker to earn enough to buy a wide variety of individual items. This approach is easily implemented for some items (a 3-pound fryer chicken is a 3-pound fryer chicken), but in other cases the issue of quality change is important. A 1997 Ford Taurus might be compared with a 1908 Model T, for example, or today's 1/5-pound Big Mac might be compared with the 1/8-pound burgers served by the McDonald brothers in 1940.

**Food.** Looking at basics, the report calculates the work time required to buy a 12-item food basket containing staples like a half-gallon of milk, a dozen eggs, a pound of bread, 5 pounds of sugar, and a pound of ground beef. In 1919 it would have required a long day's work (9.5 hours) to buy such a basket; this fell to 3.5 hours in 1950 and only 1.6 hours in 1997. A 3-pound fryer chicken, which was relatively expensive at $1.23 in 1919, was relatively cheap at $3.15 in 1997. This shows up in the dramatic drop in time cost—from 2 hours 37 minutes to just 14 minutes.

**Shelter.** The median price of a house in 1920 was $4,700. This rose to $14,500 in 1956 and $140,000 in 1996. This increase is larger than the increase in wages. But houses have gotten bigger. (The average new home in 1996 had the equivalent of two additional 12x15 foot rooms than the average new house in 1970; it had almost twice the number of square feet as the average new home in 1920.) The labor time required per square foot of housing fell from 7.8 hours per square foot in 1920 to 5.6 hours per square foot in 1996. Although the time cost today is slightly higher than it was in 1970, today's home is more likely to come with central heat, air-conditioning, and other amenities included in the basic price.

**Clothing.** In 1927 Charles Lindberg toured the country in a $42.95 suit provided by Hart Schaffner & Marx. In 1997, the company's suits cost about $525. But a man would have had to work 79 hours to afford the 1927 suit, compared with 40 hours in 1997. At the other end of the clothing spectrum, the work-time cost of a pair of Levis jeans has fallen to about a third of what it was in 1900. Today's work-time cost is somewhat higher than its all-time low in 1971, but the report argues that jeans have moved from being designed for work to being designed with fashion, fit, and comfort in mind (which it identifies with higher quality).

**The automobile.** The Ford Model T was one of the country's first affordable cars. The 1908 model cost $850, or over 4,500 hours of work for the typical factory worker (almost 2 years, given the average work week of about 50 hours). A 1997 Ford Taurus costing about $18,000 required about 8 months of work (at 40 hours per week). Paying for a gallon of gasoline required about a half hour's work in 1920 but only about 5 minutes' work in recent years.

**New products.** The report illustrates how dramatic productivity and price improvements can be following the introduction of a new product. In 1972 a VCR cost about $1,400 (365 hours of work); in 1997 a VCR cost about $200 (15 hours of work). IBM's Mark I computer cost about $200,000 to build in 1944 and could do about 3 calculations per second. In 1997, a $1,000 PC could do 166 million instructions per second (MIPS). Between 1984 and 1997 alone, the work-time cost per MIPS fell from 52 hours to 27 minutes.

**What's up?** Not everything has come down in price. Medical costs have, of course, increased. And tuition and fees at public colleges and universities have roughly doubled in terms of work time since the mid-1970s. (The increase has been even greater at private institutions). However, the medical and educational dollars also appear to be buying more than they used to. The report points out, for example, that the wage premium associated with a college degree has also increased since the mid-1970s.

**Conclusions.** Looking at long-term changes in the amount of work time it takes to purchase a wide variety of goods and services illustrates in a more colorful way many of the issues involved in formal analyses of productivity, price changes, and the cost of living. For example, reductions in the time-cost of purchasing many specific items have flattened out considerably since the early 1970s, reflecting the general productivity slowdown at that time. (To be sure, productivity and price improvements are still dramatic in areas like computing and home electronics.) In addition, education and medical services illustrate the lack of measured productivity growth and the difficulty in accounting for quality changes in key service sectors.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Mergers and Acquisitions Reach Record Level in the First Half of 1998.** Announced domestic merger and acquisition (M&A) activity reached an unprecedented $973 billion, from over 5,300 deals, in the first half of 1998. This value already exceeds 1997's record total of $920 billion (though merger activity in the mid-1980s was larger as a share of the market value of U.S. companies than last year's dollar-record level). Triggering this surge was an unprecedented volume of activity during the second quarter of 1998. Nearly $700 billion in announced domestic deals occurred in the past 3 months, more than double the previous quarterly record for domestic M&As set during the fourth quarter of 1997. Commercial banking was the leading sector for announced activity in the first half of 1998 with nearly $216 billion from 212 deals, followed by the telecommunications sector with about $122 billion from 137 transactions, and the radio and television industry with over $86 billion from 138 deals.

**Marginal Tax Rates Remain Low.** Marginal Federal income tax rates, which fell dramatically over the 1980s, have remained low for the vast majority of taxpayers, according to a recent study by economists at the Urban Institute, the Brookings Institution, and the Congressional Budget Office. In 1980, three-quarters of taxpayers faced statutory tax rates above 15 percent, but by 1995 less than one-quarter of taxpayers were in that situation. The proportion of taxpayers facing rates of 28 percent or less rose from 57 percent in 1980 to 96 percent in 1995. The study shows that the higher tax brackets introduced in the 1990 and 1993 reforms affected very few taxpayers. Only 3 percent faced marginal rates of 31 or 36 percent, while just one-half of 1 percent were in the highest bracket of 39.6 percent. The results suggest that growing prosperity, not higher rates, is responsible for the recent increase in total personal tax payments. The study considers only Federal personal income taxes and not other Federal or state and local taxes.

**States Refocus Welfare Systems toward Work.** While the Nation's welfare caseload fell by more than a quarter between 1996 and 1998, overall state spending on welfare decreased by less than 10 percent, and state spending on child care and job readiness training rose sharply. According to the National Governors' Association's *Fiscal Survey of States*, state spending on child care increased by more than 50 percent during the period (from 15 percent of total welfare expenditures to 23 percent), and spending on services that promote self-sufficiency—training, education, job placement, and subsidized employment—increased by more than 30 percent (from 5 percent of total expenditures to 7 percent). The welfare-to-work program of Portland, Oregon, may be a model of the refocused welfare system. According to an HHS-sponsored study, the program was strongly employment-focused—emphasizing job search for "good" jobs—though it utilized a mixed service strategy, including short-term education, vocational training, work experience, and life-skills training. The program raised employment levels by 11 percentage points over 2 years (relative to a control group), increased earnings by 35 percent, and reduced welfare expenditures by 17 percent.

## INTERNATIONAL ROUNDUP

**Can A New Central Bank Chief Halt the Slide of the Rand?** In the wake of renewed turbulence in emerging markets, South Africa's rand has come under pressure. Since May 1, the rand has lost about 20 percent of its value. Perhaps hoping to restore market confidence, the government announced the successor to the central bank governor this weekend, 1 year before the appointment is due to take effect. The nominee is the current labor minister, an ANC politician with no banking experience. The initial market reaction to the appointment was adverse. On Monday the rand fell to a new low against the dollar, but it has since recovered somewhat. Although there are signs of some deterioration in fundamentals, many feel the rand may have overshot its "fair value" (although they also expect it may continue to fall in the short term under continuing speculative pressure). Investors seem to be keeping close watch on South Africa's thin reserves, which fell to about $5.5 billion at the end of June. Net reserves may be even lower, as the reported gross figures include about $3 billion in foreign borrowing and ignore central bank commitments made in forward market operations to support the rand. The bank's foreign exchange liabilities in forward markets now exceed current reserves by $22.5 billion, up sharply from $12.8 billion 2 months ago.

**Romanian Reform Goes Back to the Future.** Romania's private sector produces less than 60 percent of national output. This is one of the lowest shares in Central and Eastern Europe and a testament to the trouble the country has had achieving privatization and economic reform. Popular dissatisfaction with the pace of reform led to a new government with a new reform program in 1996, but coalition wrangling over tough political decisions stalled those efforts. The new government that took office earlier this year inherited an economy that had shrunk 6.6 percent last year while experiencing inflation of over a 150 percent. Pledges by Prime Minister Visile to push through privatization have renewed the promise of reform, but recent reports suggest that little has changed in the basic political landscape. A $410 million financing agreement with the IMF was put on hold after Romania's program started to go off track last fall, but the IMF is ready to negotiate a new program if it sees credible commitments to bring the budget deficit under control and restart the structural reform process. IMF officials remain skeptical, however.

**As Goes MERCOSUR, So Goes Uruguay.** After a recession in 1995, Uruguay has recorded two consecutive years of rapid growth (5 percent in 1996 and 6 percent in 1997). This growth was largely attributable to buoyant demand from its major trading partners and fellow MERCOSUR members, Argentina and Brazil. Between 1990 and 1996, the share of Uruguayan exports to MERCOSUR countries increased from one-third to almost one-half. Although events in Asia have had no significant direct impact on Uruguay to date, both Brazil and Argentina are in vulnerable positions, and it is likely that either devaluations or the protracted defense of the currency in one or both of these countries could cripple Uruguay's expansion.

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## RELEASES THIS WEEK

### Producer Price Index

****Embargoed until 8:30 a.m., Friday, July 10, 1998****

The producer price index for finished goods fell 0.1 percent in June. Excluding food and energy, producer prices rose 0.2 percent.

## MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
Retail Sales (Tuesday)
Industrial Production and Capacity Utilization (Thursday)
U.S. International Trade in Goods and Services (Friday)

EYES ONLY

## U.S. ECONOMIC STATISTICS

| | 1970-1993 | 1997 | 1997:3 | 1997:4 | 1998:1 |
|---|---|---|---|---|---|
| **Percent growth** (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | 3.7 | 3.1 | 3.7 | 5.4 |
| GDP chain-type price index | 5.4 | 1.8 | 1.4 | 1.4 | 1.2 |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 3.6 | 1.4 | 1.1 |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 1.8 | 3.1 | 3.7 |
| Using NFB deflator | 1.3 | 2.5 | 2.7 | 3.9 | 3.5 |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.5 | 10.7 | 10.6 | 10.7 |
| Residential investment | 4.5 | 4.1 | 4.1 | 4.1 | 4.2 |
| Exports | 8.2 | 11.8 | 11.9 | 11.9 | 11.5 |
| Imports | 9.2 | 13.1 | 13.3 | 13.2 | 13.1 |
| Personal saving | 5.3 | 2.8 | 2.6 | 2.9 | 2.6 |
| Federal surplus | -2.7 | -0.4 | -0.1 | -0.1 | 0.6 |

| | 1970-1993 | 1997 | April 1998 | May 1998 | June 1998 |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.3 | 4.3 | 4.5 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 320 | 309 | 205 |
| increase since Jan. 1993 | | | | | 16246 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.2 | 0.3 | N.A. |
| PPI-Finished goods | 5.0 | -1.2 | 0.2 | 0.2 | **-0.1** |

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, July 10, 1998**.

EYES ONLY

## FINANCIAL STATISTICS

| | 1996 | 1997 | May 1998 | June 1998 | July 9, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9080 | 8873 | 9090 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 5.00 | 4.98 | 4.94 |
| 10-year T-bond | 6.44 | 6.35 | 5.65 | 5.50 | 5.41 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.00 | 6.91 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | Current level July 9, 1998 | Percent Change from Week ago | Percent Change from Year ago |
|---|---|---|---|
| Deutschemark-Dollar | 1.831 | 0.4 | 3.9 |
| Yen-Dollar | 141.3 | -0.1 | 25.1 |
| Multilateral $ (Mar. 1973=100) | 102.7 | 0.5 | 6.9 |

| **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 | 3.9 (Q1) | 4.5 (Jun) | 1.7 (May) |
| Canada | 3.8 (Q1) | 8.4 (May) | 1.3 (May) |
| Japan | -3.7 (Q1) | 4.2 (Apr) | 0.5 (May) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (May) |
| Germany | 3.0 (Q1) | 2/ 7.6 (Apr) | 1.3 (May) |
| Italy | 2.5 (Q1) | 12.4 (Apr) | 1.7 (May) |
| United Kingdom | 2.9 (Q1) | 6.4 (Mar) | 4.2 (May) |

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 April 1998 is 10.0 percent.

EYES ONLY

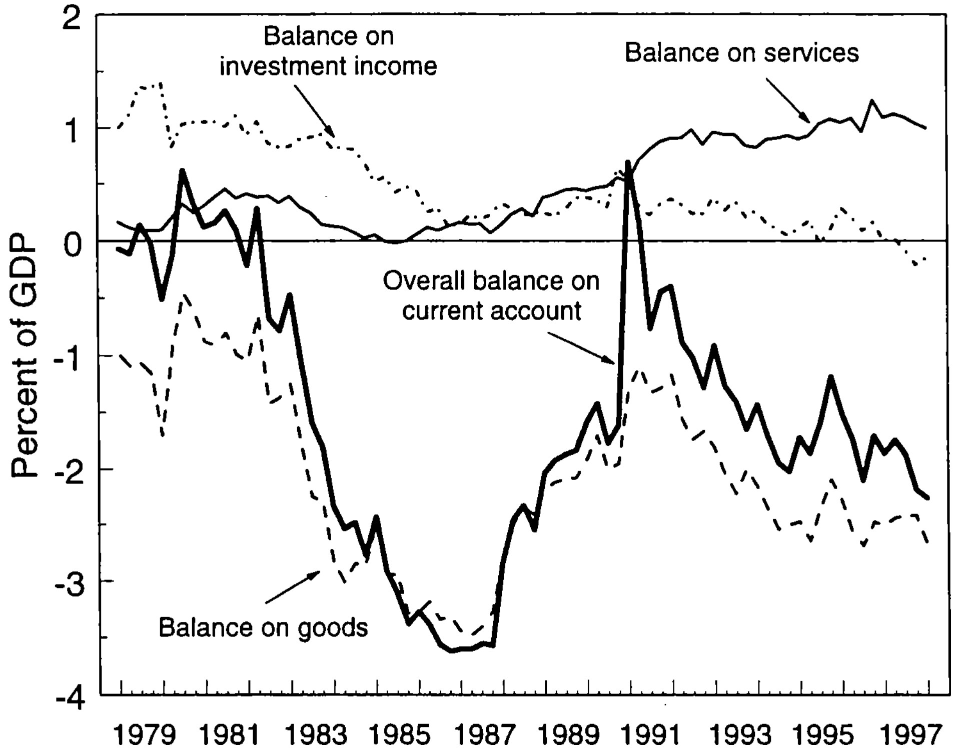
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 19, 1998

## CHART OF THE WEEK

The Current Account Balance




The current account deficit widened again, to $47.2 billion in the first quarter. In dollar terms, this is the second record quarterly deficit in a row—though deficits were much larger as a share of the economy in the mid-1980s. The current account deficit reflects the rate at which U.S. residents must borrow from abroad to finance spending in excess of income. In addition to trade in goods and services, which is reported monthly, the current account deficit includes investment income and unilateral transfers (public and private remittances).

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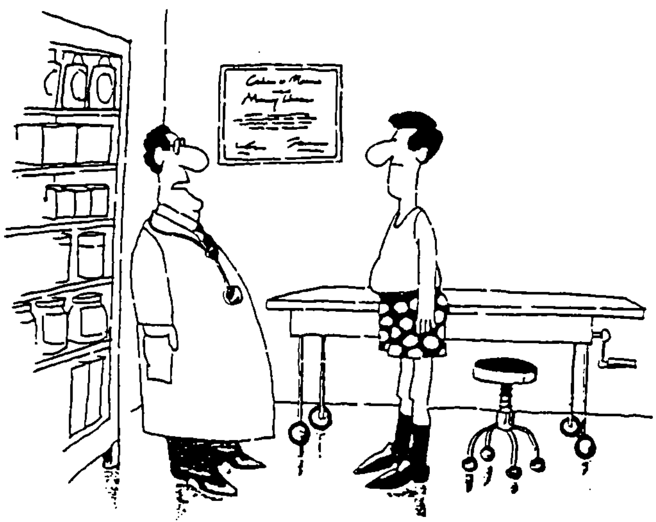


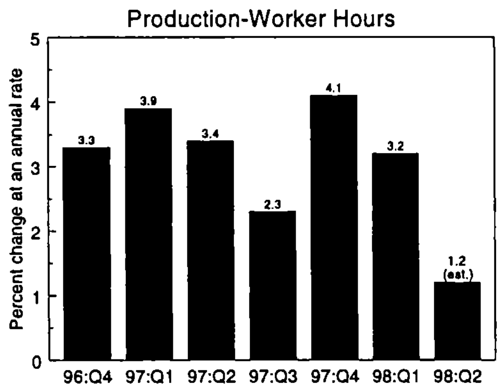
*"Sure, we doctors make a lot of money. But, don't forget, we spend a heck of a lot, too."*

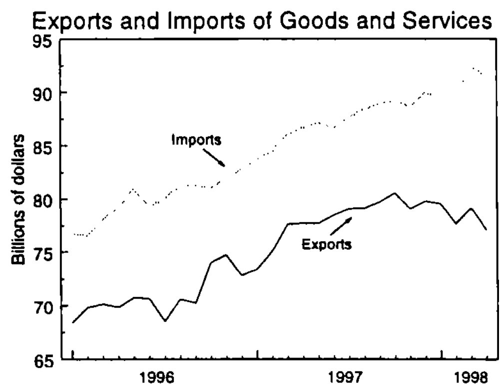
## MACROECONOMIC UPDATE

# Growth May be Moderating

The supercharged pace of growth over the past year may be moderating.

**Employment and output.** Increases in production-worker hours appear to have slowed to a 1¼ percent annual rate in the second quarter (see upper chart). In addition, unemployment insurance claims have edged up recently—though they remain very low. Consistent with the high and rising dollar, the slowdown in production is most notable in manufacturing, where output has grown more slowly than in the economy as a whole so far this year.




**Demand.** Available data hint that inventories and net exports are the components of demand that are slowing. Inventory investment was very high in the first quarter, and second-quarter stock building is likely to fall back towards a more normal pace. Retail sales in May show that consumption continues to grow at full throttle—with particularly rapid spending on motor vehicles. But to the extent that consumers are buying goods produced abroad, import growth may partly offset the boost from consumption—as it did in the first quarter. Weakness in the Asian economies appears to be reducing exports as well (see lower chart).

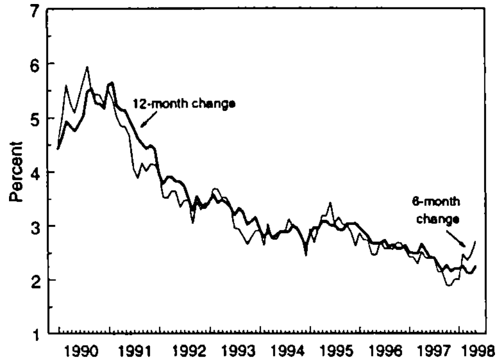
**The GM strike.** The ripple effects of the strike by two United Auto Workers locals are expected to shut down almost all of General Motors' production by the end of this week. Without a strike, real GDP might have grown at around a 3 percent annual rate in the second quarter. But with a strike continuing through the end of the quarter, the CEA estimates that real growth would be about 0.6 percentage point less. Unless the strike is prolonged well beyond the end of June, these output losses could be recouped later in

EYES ONLY

the year so that the net effect would simply have been to shift output from one quarter to another.

**Prices and wages.** Inflation has picked up slightly in recent months. Although core CPI inflation has fallen 0.3 percentage point over the past year, the core CPI increased at a 2.7 percent annual rate in the 6 months ending in May—up from a 1.9 percent annual rate during the preceding 6-month period (see chart). Nevertheless, inflation remains relatively low and under control. As a result, increases in nominal wages have translated into healthy increases in real wages, which are up 2.8 percent over the past 12 months.

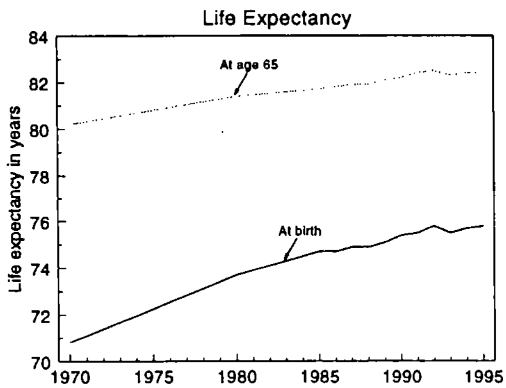
Core CPI Inflation



SPECIAL ANALYSIS

## Placing a Value on Improvements in Health

Increases in expenditures for health care have been substantial over the past three decades, but have they been "excessive"? The answer depends on the value of health benefits that have flowed from these expenditures. A definitive assessment is impossible, but a recent study finds very large increases in the value of total improvements in health between 1970 and 1990, suggesting that increases in health expenditures may well have been cost effective, on average.




**Health improvements.** From 1970 to 1990, the health of the population improved markedly. Life expectancy at birth rose from 70.8 to 75.4 years, and life expectancy at age 65 rose from 80.2 to 82.2 (see chart). The quality of health at a given age has also improved. Although, the prevalence of chronic conditions has increased because people are living longer, improved medical technology lets those with many of these conditions enjoy a better quality of life.

**Valuing longevity and health.** Attaching a dollar value to changes in health and longevity is inherently difficult and likely to result in a wide range of estimates. One strategy pursued in several studies is to look at how much individuals are willing to pay for technologies—such as smoke detectors—that reduce their mortality risk, or how much additional pay individuals demand to work in riskier jobs. Another approach is to use evidence from surveys that ask individuals directly how much they would pay for hypothetical health improvements. The new study uses a central estimate from this literature of $100,000 per additional year of life in perfect health. The authors then adjust this value to reflect the prevalence and impact of several chronic diseases. An individual's "health capital" is the present discounted value of expected future "quality-adjusted" years of life. The authors construct estimates of health capital for newborns and 65 year-olds in 1970 and 1990. Changes over time in the value of health capital provide a measure of the value of health improvements.

**Results.** The study estimates that health capital for an individual born in 1990 was about $95,000 greater than that for an individual born in 1970. The value of health improvements were even greater for older people; for a 65 year-old, the value of health capital was about $170,000 greater in 1990 than in 1970. To compare the costs and benefits of medical spending, the change in health expenditures must be measured in comparable present discounted value terms at birth and at age 65. The study estimates that the present discounted value of expected lifetime medical spending at birth rose $25,000 between 1970 and 1990, and the present discounted value of remaining health spending at age 65 rose by $45,000 over the same period.

**Is medical care worth the cost?** In addition to advancements in medical technology, many factors including smoking, diet, exercise, and environmental quality influence the health of the population. The authors compare changes in health capital to changes in expected lifetime health spending. The cost and health estimates imply that the additional medical spending was, on average, worth it if advancements in medical care were responsible for at least 30 percent of the observed improvements in health. Since these are estimates of the average cost-effectiveness of medical care, they do not imply that every treatment or procedure has been cost-effective.

**Conclusion.** There are signs that health expenditures may have begun rising more quickly after several years of slow growth—though growth rates recently still do not approach the double-digit growth rates of the 1980s. But it is important to bear in mind the health improvements that additional spending may provide, even though estimating the value of those potentially large health benefits is difficult.

SPECIAL ANALYSIS

## Life Insurance: Profiles in Coverage

A recent *New York Times* article suggested that people are forgoing the life insurance coverage that once protected families in the event of the death of a policyholder. In fact, life insurance coverage has declined only modestly: 78 percent of households owned life insurance in 1992, compared with 83 percent in 1960. What *has* declined is usage of those types of life insurance that can also serve as tax-deferred savings shelters or tax-exempt bequests.

**Types of life insurance.** Term life insurance provides life insurance for a specified period of time, with annual premiums increasing with the life of the policyholder. Cash value life insurance policies (such as whole life), in contrast, charge a constant annual premium throughout the life of the policy. The premium charged in the early years is higher than the actual cost of the insurance coverage; the excess amount of the premium is held in reserve as the policy's cash value, and this cash value grows over time from investment earnings. A policyholder who surrenders a cash value life policy receives the cash value contained in the policy at the time of surrender. Over the last 15 years, there has been a trend in life insurance purchases away from cash value polices and toward term policies.

**Why buy life insurance?** Both term and cash value policies provide insurance for dependents of the policyholder against financial hardship in the event of the policyholder's death. But cash value life insurance also serves as a savings vehicle. Because the assets in a cash value policy earn interest that is not taxed as it is accumulated, a cash value policy serves as a tax-deferred way of saving. In addition, Federal income and estate taxes can be avoided on money received under a life insurance contract paid by reason of the death of the insured—including the investment income earned on the accumulated cash value. Thus, families with substantial wealth can use cash value life insurance to reduce Federal estate taxes.

**Explaining changing patterns of life insurance.** There do not appear to be any careful studies of why the demand for the savings features of whole life may have decreased. Lower tax rates may have diminished the attractiveness of tax-deferred savings vehicles. In addition, the development of other attractive tax-deferred savings vehicles, such as IRAs (which were not widely available until 1981) and variable annuities, may have reduced demand for cash value life insurance. Consumer awareness about alternative savings vehicles that offer better returns than cash value life insurance may also have increased.

**Conclusion.** Life insurance has traditionally served multiple functions, offering not only insurance in the event of death but also a tax-deferred savings vehicle and a tax-exempt bequest vehicle. Americans are covered by insurance against death in roughly similar proportions as always, but they appear less willing than in the past to buy policies that bundle other features together with basic insurance.

EYES ONLY

ARTICLE

## The Malthusian Economics of Easter Island

Thomas Malthus warned in 1798 that the tendency for growth in population to outstrip growth in the means of subsistence could end in disease, famine, and poverty. Two centuries of impressive gains in living standards, accompanied by rapid population growth and stability (or even decline) in the relative prices of resources and primary commodities have left most economists skeptical of the Malthusian logic. But an intriguing new analysis of the rise and decline of Easter Island suggests that a Malthusian outcome can occur when natural resource degradation occurs gradually, when the payoff from taking action is long-deferred, and when cooperation on a large scale is required.

**The mystery of Easter Island.** At the time of its discovery by Europeans in 1722, Easter Island was a Polynesian island with a "late stone age" culture. Enormous carved stone statues, resting on large platforms around the island, bore witness though, to a past in which the island was both richer and more populous. The statues had been moved substantial distances from the island's lone quarry to their destinations; but observers estimated the population of the island at 3,000 in 1722—far too small to have transported the larger statues without appropriate tools. Moreover, the island had no trees suitable for making such statue-transport equipment. Local residents believed that the statues had walked to the platforms under the influence of a spiritual power.

**What happened?** A variety of theories have been advanced to explain the Easter Island mystery, but recent archaeological evidence suggests that after perhaps a thousand years of peace and prosperity, Easter island suffered a Malthusian fate. Its population rose above a sustainable level, the environment was degraded to the point it could no longer support its population, the social order disintegrated, and the civilization crashed.

**The depletion of the palm forest.** Easter Island was apparently settled around 400 A.D., at a time when great palm forests flourished. These forests were a nesting place for birds, a source of food. The palms also likely provided the wood needed for tools and for canoes used to fish. With abundant food, the population had ample time for artisan activities including carving and moving statues. As Malthus would predict, population grew rapidly. The statues appear to have been carved between 1100 and 1500 A.D.

The pollen record points to noticeable forest reduction by about 900 A.D., although the pace of forest loss was probably gradual enough to have been imperceptible to the typical Easter Island resident over his 30-year expected lifespan. By 1400 the palm forest was gone. Diet changed for the worse (less fish and hence less protein) with the depletion of the forests, and soil erosion lowered agricultural yields. With falling food consumption, carving activity declined and ultimately ceased. The islanders developed dagger-like weapons and began inhabiting caves and fortified dwellings, suggesting violent internecine conflict. By 1774, some statues that were still standing in 1722 had been knocked over, statue worship had disappeared, and the population had further declined in size.

**Why Easter Island?** If the Malthusian theory applies to Easter Island, how did other Polynesian islands, with similar demographics, culture and technologies, escape the same fate? A likely explanation relates to the particular species of palm tree (Chilean Palm) indigenous to Easter Island but found nowhere else in Polynesia. The Easter Island palms are particularly slow-growing, requiring 40 to 60 years to bear fruit. In contrast, the palms found elsewhere in Polynesia reach fruit-growing age in 7 to 10 years. More rapid forest growth implies a greater likelihood that regeneration of a shrinking resource base can occur, which would contribute to other islands' being able to avoid the dramatic collapse suffered on Easter Island. Depletion on Easter Island, once it occurred, would not quickly be reversed. Moreover, the investments needed to rebuild Easter Island's resource base would have produced payoffs for the island's descendants but not for the inhabitants themselves.

**Other Malthusian episodes?** Recent archaeological evidence suggests that the Easter Island experience was probably not unique. Environmental decline may have precipitated the collapse of the Mayan, Mesopotamian and Chaco Anasazi (southwestern United States) cultures. In each case, decline of the resource base, particularly soil degradation, precipitated a population crash and the decline of a complex civilization. More recently, the violent Rwandan conflict between Hutus and Tutsis could also have been related to resource competition. Between 1950 and 1994, advances in health care and agricultural practice raised real incomes but also increased fertility, resulting in a quadrupling of the population in Rwanda. By the 1980s conflicts over land had increased in severity, and may have precipitated civil war.

**Implications.** In modern times, technological progress, reduced fertility in the face of rising income, and the evolution of more effective resource management institutions—including well-defined property rights and international agreements to prevent "overgrazing of the commons"—have normally short-circuited the Malthusian dynamic. However, adaptive responses become more difficult when environmental degradation occurs gradually, when the payoff from environmental protection is long-deferred, and when cooperation on a large scale is needed—conditions that are all present, for example, in the case of global warming. Thus, Easter Island provides a cautionary tale about the possibility of Malthusian outcomes in the absence of appropriate institutions and effective policy responses.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Beige Book: U.S. Economy Continues Its Excellent Performance.** The economy continued to grow in all Federal Reserve districts and across most sectors, according to the Fed's latest summary of commentary on current economic conditions. The pace of growth varied across Federal Reserve districts, ranging from quite strong in the Northeast, much of the Midwest and the West Coast, to somewhat more modest in the Southeast and in the Dallas district. Growth was fueled by liberal consumer spending and by business investment in plant and equipment. The construction sector was very strong. Manufacturing was robust in several districts, notably Chicago, St. Louis, and Kansas City, but somewhat weaker in an arc from Dallas through Atlanta and Richmond. In agriculture, crop conditions were generally favorable, but prices were low. Oil and gas drilling continued to be slack, while output in other natural resource industries was generally stable. Seven districts reported some adverse effects from economic problems in Asia.

**New Evidence on Family Structure and Educational Attainment.** Numerous studies have found that living outside a traditional two-parent family has a negative effect on high school completion. However, a new study has found that the lower probability of high school graduation among children living with a divorced, separated, or widowed mother stems primarily from the reduced level of economic resources available to these families. (There were not enough never-married mothers in the sample to evaluate such families.) After taking economic status into account, living in with a divorced, separated, or widowed mother had little or no effect on the high school graduation rates of white males, white females, or black males. Such a family structure did have a slight negative effect on the educational attainment of black females, however, even after economic status was taken into account. Finally, the study found evidence that living in a mother-stepfather family slightly reduced the probability of high school graduation among all groups studied except black males. The author suggests that this effect may be attributable to the increased stress frequently associated with remarriage.

**Homeownership Encourages Good Citizenship.** Homeownership is strongly correlated with variables associated with good citizenship, according to a recent study. Controlling for factors such as age, race, gender, income, marital status, and having children, homeowners in the United States are 10 percent more likely than renters to work to solve local problems or know their local congressman by name. They are also more likely to know the identity of their school board head, vote in local elections, attend church, and join nonprofessional organizations. The study warns, however, that any judgment about the appropriateness of policies to encourage homeownership (including current tax policy) would require quantitative estimates of these homeownership benefits (which the study does not provide) as well as their costs, both in absolute terms (homeownership reduces mobility in the face of economic shocks) and relative to alternative policies to promote good citizenship.

EYES ONLY

## INTERNATIONAL ROUNDUP

**CBO Assesses Antidumping Actions Here and Abroad.** U.S. antidumping law imposes duties on imports that are sold here below their estimated cost of production, or below their price in the seller's domestic market, when such "dumped" imports cause "material injury" to the competing U.S. industry. A recent study by the Congressional Budget Office finds that the United States has taken antidumping action against other countries far more than they have against us and that, unlike other industrialized countries, the United States substantially increased its antidumping activity over the 1979-95 period covered by the study. However, U.S. antidumping policy may be coming back to haunt U.S. exporters. Many developing countries that now find their protectionist policies increasingly restricted by WTO discipline are starting to follow the U.S. lead in imposing antidumping duties. However, evidence suggests that in general U.S. firms are not singled out in foreign antidumping cases: In 16 of the 18 countries for which data were available, the share of U.S. imports was higher than the share of antidumping actions taken against the United States. The report also concludes that the application of antidumping duties to upstream goods (those used as inputs in the further production of other goods) is high enough in some cases to disrupt markets and create a significant disadvantage to downstream users. In the United States, two-thirds of the products covered by active antidumping measures are upstream goods, with average duties ranging from 32 percent on intermediate goods to 52 percent on raw and processed materials.

**Will Europe Be a Locomotive of Growth?** Economic growth in the EU was 3.1 percent over the last four quarters, an increase from the 2.9 percent registered at the end of 1997, and not too far below the U.S. growth rate of 3.7 percent, according to preliminary estimates of first quarter GDP released this week by the EU Statistical Office. Inflation edged up slightly in April but remained low (1.6 percent at an annual rate). Some European commentators have suggested that these trends are an encouraging sign that a broad recovery is underway, but such proclamations may be premature. Almost half of this growth occurred between the first and second quarters of 1997 (growth in the second quarter was 5.7 percent at an annual rate). For the last three quarters, output in the EU has consistently grown at a pace closer to 2 percent at an annual rate, suggesting that a plateau has been reached. April unemployment numbers support this interpretation—unemployment stands unchanged from March at 10.2 percent, down only slightly from the April 1997 rate of 10.7 percent.

**Oil Producers Make New Attempt to Raise Prices.** Reacting to weak market conditions, the oil ministers of the three producers that initiated cuts this March in Riyadh—Saudi Arabia, Mexico, and Venezuela—agreed to further reductions of 450 thousand barrels per day in Amsterdam earlier this month. Estimates of global demand for the second quarter have been revised downwards by 510 thousand barrels per day to 73 million, due to weak demand among the OECD countries and in Asia. Since last October, there has been a cumulative downward revision of Asia's projected demand for 1998 of 750 thousand barrels per day due to the regional crisis.

EYES ONLY

## RELEASES THIS WEEK

### U.S. International Trade in Goods and Services

The goods and services trade deficit was $14.5 billion in April; it was $13.2 billion in March.

### Housing Starts

Housing starts decreased 1 percent in May to 1.53 million units at an annual rate. During the first five months of 1998, housing starts were 6 percent above the same period a year ago.

### Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production rose 0.5 percent in May following an increase of 0.3 percent in April. Capacity utilization rose 0.1 percentage point, to 82.2 percent.

### Consumer Price Index

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

## MAJOR RELEASES NEXT WEEK

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

EYES ONLY

## U.S. ECONOMIC STATISTICS

| | **1970-1993** | **1997** | **1997:3** | **1997:4** | **1998:1** |
|---|---|---|---|---|---|
| **Percent growth** (annual rate) | | | | | |
| Real GDP (chain-type) | 2.7 | 3.7 | 3.1 | 3.7 | 4.8 |
| GDP chain-type price index | 5.4 | 1.8 | 1.4 | 1.4 | 1.0 |
| Nonfarm business (NFB) sector: | | | | | |
| Productivity (chain-type) | 1.5 | 2.1 | 3.6 | 1.4 | 1.1 |
| Real compensation per hour: | | | | | |
| Using CPI | 0.6 | 2.2 | 1.8 | 3.1 | 3.7 |
| Using NFB deflator | 1.3 | 2.5 | 2.7 | 3.9 | 3.5 |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.5 | 10.7 | 10.6 | 10.7 |
| Residential investment | 4.5 | 4.1 | 4.1 | 4.1 | 4.2 |
| Exports | 8.2 | 11.8 | 11.9 | 11.9 | 11.5 |
| Imports | 9.2 | 13.1 | 13.3 | 13.2 | 13.1 |
| Personal saving | 5.3 | 2.8 | 2.6 | 2.9 | 2.7 |
| Federal surplus | -2.7 | -0.4 | -0.1 | -0.1 | 0.6 |

| | **1970-1993** | **1997** | **March 1998** | **April 1998** | **May 1998** |
|---|---|---|---|---|---|
| **Unemployment Rate** (percent) | 6.7** | 4.9** | 4.7 | 4.3 | 4.3 |
| **Payroll employment** (thousands) | | | | | |
| increase per month | | | 82 | 302 | 296 |
| increase since Jan. 1993 | | | | | 16010 |
| **Inflation** (percent per period) | | | | | |
| CPI | 5.8 | 1.7 | 0.0 | 0.2 | **0.3** |
| 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 | April 1998 | May 1998 | June 18, 1998 |
|---|---|---|---|---|---|
| **Dow-Jones Industrial Average** | 5743 | 7441 | 9037 | 9080 | 8813 |
| **Interest Rates** (percent per annum) | | | | | |
| 3-month T-bill | 5.01 | 5.06 | 4.95 | 5.00 | 5.05 |
| 10-year T-bond | 6.44 | 6.35 | 5.64 | 5.65 | 5.50 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.14 | 6.94 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level June 18, 1998** | **Percent Change from** | |
|---|---|---|---|
| | | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.793 | -0.6 | 3.5 |
| Yen-Dollar | 137.6 | -3.9 | 21.2 |
| Multilateral $ (Mar. 1973=100) | 100.5 | -1.2 | 5.2 |

| **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 | 3.7 (Q1) | 4.3 (May) | 1.7 (May) |
| Canada | 3.8 (Q1) | 8.4 (Apr) | 1.0 (Apr) |
| Japan | -3.7 (Q1) | 4.2 (Apr) | 0.3 (Apr) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (Apr) |
| Germany | 3.0 (Q1) | 2/ 7.6 (Mar) | 1.3 (Apr) |
| Italy | 2.8 (Q4) | 12.1 (Jan) | 1.8 (Apr) |
| United Kingdom | 2.9 (Q1) | 6.5 (Feb) | 4.0 (Apr) |

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 March 1998 is 10.0 percent.

EYES ONLY

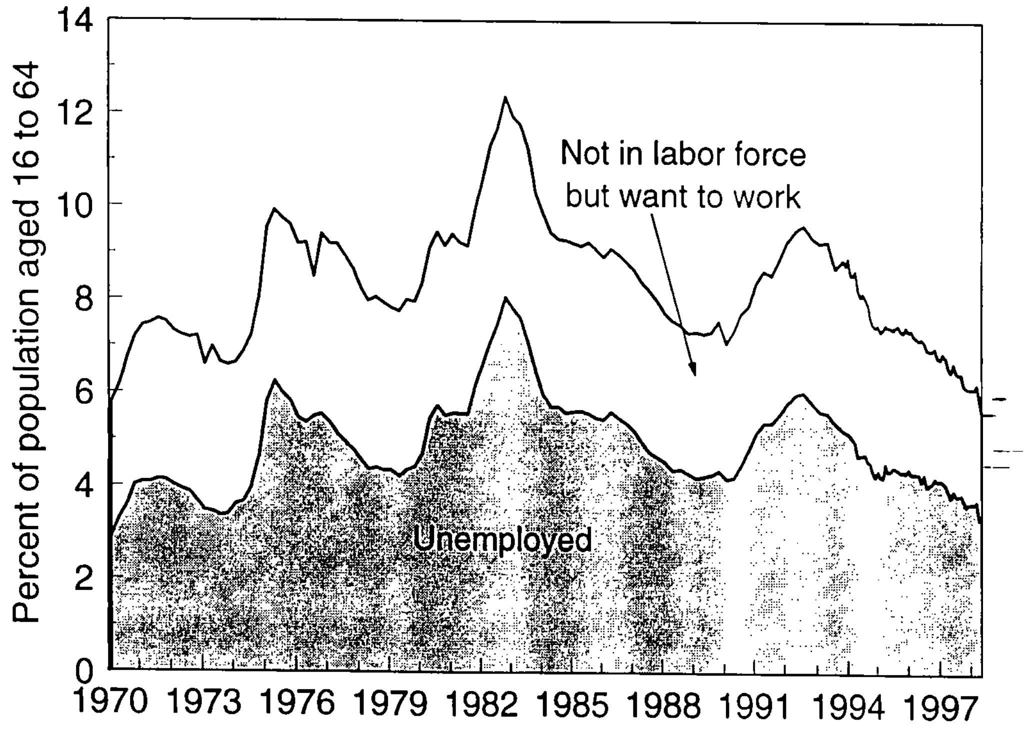
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 12, 1998

CHART OF THE WEEK

People Without Jobs Who Want to Work




In congressional testimony this week, Federal Reserve Chairman Greenspan noted that the percentage of persons aged 16 to 64 who wanted to work but did not have jobs had fallen to slightly more than 5½ percent—a record low for this series, which first became available in 1970. This statistic, which includes both the unemployed and those who wanted a job but had not looked for work (and were therefore treated as not in the labor force) is a measure of how tight labor markets have become.

EYES ONLY

## CONTENTS



*"All I'm saying is now is the time to develop the technology to deflect an asteroid."*

EYES ONLY

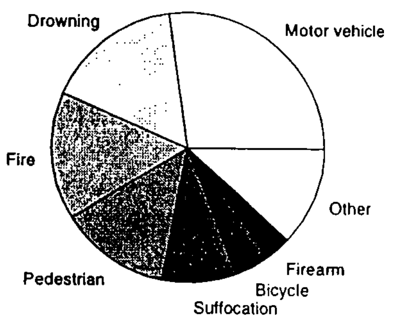
## TREND

# Growing-up Risks Are Going Down

Until about 1970, the main reason for reductions in child mortality was progress against infectious disease and other medical conditions. Since then, a large part has come from reductions in deaths due to injuries.

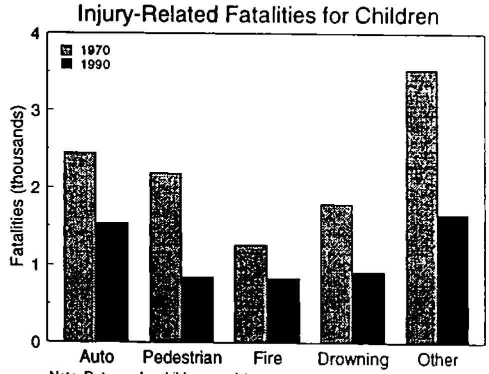
**Current levels.** Unintentional injuries represent the number-one cause of death for children aged 1 to 14. The major causes of these injuries are accidents affecting motor vehicle passengers, pedestrian accidents (which often involve collisions between cars and pedestrians), drowning, fires, suffocation, bicycle accidents, and firearm accidents (see upper chart). Causes of death vary by age; for example, while firearm accidents represent only 3 percent of injury-related deaths for all children under age 14, they represent 24 percent of all injury-related deaths for children aged 10 to 14.

Causes of Childhood Deaths Due to Unintentional Injury, 1995




Note: Data are for children aged 14 and under.

Injury-Related Fatalities for Children




Note: Data are for children aged 1 to 12.

**Reasons for decline.** The number of deaths due to unintentional injuries for children aged 1 to 14 declined by 53 percent from 1970 to 1995, accounting for half of the total reduction in child mortality over this period. The decline in child-injury fatalities in the 1970s and 1980s occurred across a broad range of injury categories (see lower chart). Hence, it is unlikely that it was driven by a small number of specific interventions.

Rather a combination of factors was probably responsible, including the following:

- Increased regulation, such as drug-packaging requirements, seat belt and automobile safety seat requirements, and safety standards for toys and other products likely to be encountered by children.

- More information due to increased research and development in child safety and greater coverage of child-safety issues in the press and in popular child-rearing books. For example, the number of pages devoted to child-safety issues in the best-selling child-rearing book by Dr. Spock more than quadrupled between the 1957 and the 1992 editions.

- Demographic/lifestyle factors probably had mixed effects on child safety. For example, the increase in the number of working mothers and single-parent families may have reduced the amount of parental time available for child supervision. But these effects may have been offset by decreases in the average number of children per family.

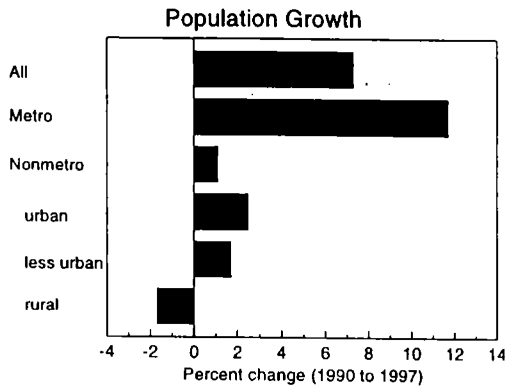
- Enhanced trauma care probably led to improvements in outcomes for accident victims, particularly for victims of burns and motor vehicle accidents.

**Policy initiatives.** Because unintentional injuries remain a major cause of death and disability for children, the Children's Environmental Health and Safety Task Force has made further reductions in unintentional injuries one of its main priority areas. It will consider a range of approaches to reducing unintentional injuries, including education and outreach, subsidies for safety devices such as fire alarms and bicycle helmets, and enhanced technical support to promote state and local interventions.

SPECIAL ANALYSIS

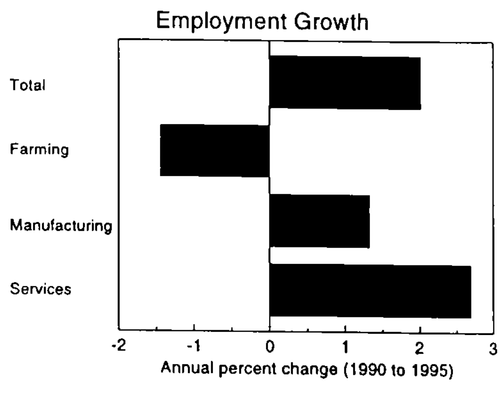
# Economic Change in the Great Plains

The tough economic times currently facing farmers in the northern Great Plains may revive arguments that the region is losing population and is no longer economically viable. In fact, however, a recent study shows that population growth in the Great Plains has been roughly comparable to overall U.S. population growth. Farm jobs are disappearing, but the population is growing in metropolitan areas, and new job opportunities are opening up in manufacturing and services.




**Population growth.** Between 1990 and 1997, population in the Great Plains grew by 7.3 percent (see upper chart), compared with 7.5 percent for the United States as a whole. Almost all of this growth occurred in metro areas (cities of 50,000 or more). While the total population in nonmetro counties also grew slightly, over half of Great Plains counties lost population. Most of these are sparsely populated, isolated from urban centers, and highly dependent on agriculture.

**Economic change.** Total employment in the Great Plains grew by an average of 2.0 percent per year between 1990 and 1995 (see lower chart), compared with 1.0 percent for the nation as a whole. Like the rest of the U.S. economy, most employment growth occurred in wholesale and retail trade and services. Jobs in manufacturing grew more rapidly than the U.S. average, although from a relatively small base. Employment in primary industries (farming and mining) declined, but total agricultural output from the 10 Great Plains states increased during this period due to productivity gains. Nevertheless, counties highly dependent on agriculture lost population. Rural communities that have been successful in maintaining population and jobs are those that have been able to diversify their economies, are connected to urban centers, or offer natural amenities that attract new residents or tourists.



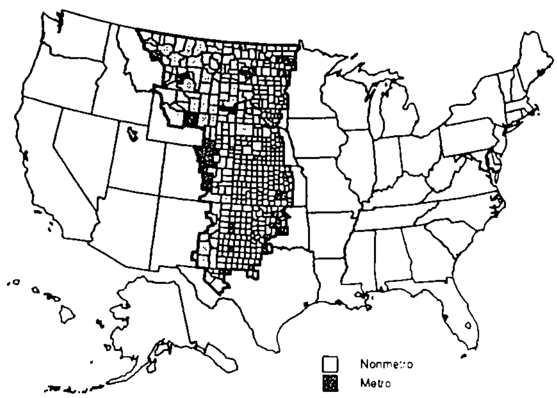

**Farming the Great Plains.** Few crops are well-adapted to the Great Plains climate. Dryland agriculture emphasizes wheat and rangeland for cattle, while irrigation is

EYES ONLY

generally required to support corn and cotton. Farm numbers have been declining in the region, and many farmers rely on government farm program payments and off-farm jobs to supplement farm earnings. Further consolidation of farms is expected, and without growth in nonfarm job opportunities, continued population decline is likely in many rural, isolated counties.

**What is the Great Plains?**

The Great Plains is the continental slope of the west central United States, east of the Rocky Mountains. In general, the Plains have sparser population, lower and more erratic rainfall, and less forest land than areas to the east. The eastern boundary often lacks a sharp visible physical border. As defined here it includes 478 counties, about one-fifth of the land area of the continental United States.



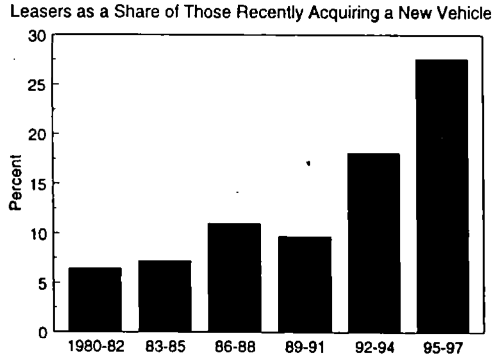
EYES ONLY

## ARTICLE

# Vehicle Leasing Takes Off

The popularity of leasing new cars and trucks has increased sharply since the early 1980s (see chart). Under a typical lease contract, the consumer puts up a modest down payment, then makes monthly payments for a fixed period (often 3 years), at the end of which the consumer can choose to purchase the vehicle for a price specified in the original lease contract or return the vehicle. Some might be concerned that leasing is diminishing one of the traditional channels of wealth accumulation in the United States: the "forced saving" imposed by a monthly car payment.

Leasers as a Share of Those Recently Acquiring a New Vehicle




Note: Data represent percent of those recently acquiring a new vehicle who have at least one leased vehicle.

**Leasing pros.** Industry analysts cite several reasons consumers might prefer to lease rather than buy. For a given vehicle, leases entail a lower down payment and much lower monthly payments, making it possible for consumers to drive a nicer car than they could afford to buy. For high-income consumers who want a new car every few years, leasing can be a way to avoid the inconvenience and cost of repeatedly disposing of used vehicles. Leasing can also provide "lemon insurance," because a consumer with a problem car probably will not choose to buy it when the lease ends. Similarly, leasing is a convenient way to experiment with an unfamiliar vehicle type, such as a sport utility vehicle, with the option to return the vehicle at the end of the lease if it turns out not to fit the consumer's needs.

**Leasing cons.** Because lease contracts are necessarily very complex, some consumers may not fully understand the terms of the deal to which they commit themselves when they agree to lease. Indeed, the upsurge in leasing in the early 1990s was accompanied by complaints from consumers charging that they had been misled in various ways about the terms of their leases. The worst abuses involved down payments, trade-in values, and rebates that were not credited to the consumer in the terms of the lease—effectively disappearing into the dealer's or lessor's pocket, in ways that unsophisticated consumers might find difficult or impossible to detect amid the complexity of the lease contract. Another problem was that some contracts did not contain enough information for consumers to be able to verify or understand how their monthly payment was calculated. Finally, many consumers reportedly did not understand that there are often hefty penalty charges for terminating a lease early.

**The Fed to the rescue.** In response to these problems, the Federal Reserve Board, which writes the regulations for the leasing industry, implemented an updated set of guidelines in January 1998 that require lessors to specify clearly all terms of the lease in a standard format designed to make comprehension and comparison of lease contracts simpler.

**Meet the leasers.** So who is the typical leaser? Perhaps surprisingly, data from both 1992 and 1995 show that leasers of new vehicles tend to have considerably higher household incomes and greater liquid assets than consumers who choose to finance their new vehicle with a loan (and both owners and leasers of new vehicles are considerably more affluent than the average household). Furthermore, leasing is more prevalent at the luxury end of the auto market than in the middle or economy parts of the market.

**Conclusions.** Leasing rather than buying new vehicles can be attractive to consumers for a variety of reasons. Surveys have found higher levels of satisfaction among consumers who have leased vehicles than among those who have financed their purchase. Surveys also find that a large proportion of current leasers intend to lease their next vehicle as well. While leasers do not build equity in their vehicles over the course of the lease, they may simply prefer to pursue wealth accumulation more directly in such forms as tax-favored retirement accounts. So long as the recent changes in regulations and in leasing procedures succeed in making consumers informed purchasers, there appears to be little reason for concern about the remarkable rise in the proportion of vehicles that are leased.

EYES ONLY

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Greenspan Calls Current Economic Performance "Impressive."** In testimony to Congress on Wednesday, Federal Reserve Chairman Alan Greenspan stated, "The current economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy." However, Greenspan expressed his continuing concern that economic growth will run into constraints as the reservoir of unemployed people available to work is drawn down (see Chart of the Week). Greenspan said the Fed remains watchful for signs of potential inflationary imbalances, but his testimony appeared to ease many investors' concern that the Fed was likely to raise interest rates at its next meeting, and the bond market rallied.

**Study Finds Differences by Race in Application of Death Penalty.** A new study released by the Death Penalty Information Center (DPIC) finds evidence of significant racial disparities in the application of the death penalty. The study, conducted in Philadelphia, examined a large sample of the murders there between 1983 and 1993 in which the death penalty could be applied. Even after controlling for a variety of case differences such as multiple victims, the deliberate infliction of pain, and the background of the accused, blacks were almost four times as likely to receive a death sentence as whites. The racial combination most likely to result in a death sentence was a black defendant with a non-black victim, followed by a black defendant with a black victim and a non-black defendant with a non-black victim. Non-blacks who killed blacks were least likely to receive a death sentence. These findings accord with most previous research on the subject. Another recent study, also released by the DPIC, finds that nearly 98 percent of the chief District Attorneys in death penalty states are white, though the study offers no direct evidence on differences between white and non-white DAs in seeking the death penalty.

**Behavior Alone Does Not Explain Socioeconomic Differences in Mortality.** Differences in health along socioeconomic lines have been recognized as a persistent public health problem. A prominent hypothesis about these differences suggests that they arise from the higher prevalence of risky behaviors, such as smoking, drinking alcoholic beverages, and being overweight, among those with lower levels of education and income. However, a new study has found that socioeconomic differences in mortality would persist even with improved health behaviors among the disadvantaged. The study investigated the degree to which education, income, and four behavioral risk factors (cigarette smoking, alcohol drinking, sedentary lifestyle, and relative body weight) affected mortality risk over a period of seven and a half years. The study found that, although behavioral differences explained a modest portion of the mortality differences across socioeconomic groups, the risk of dying was still significantly greater for the lowest income groups even after these risky behaviors were taken into account.

## INTERNATIONAL ROUNDUP

**Sinking Yen Pulls Down Pacific Rim Currencies.** On Monday the yen fell below 140 to the dollar for the first time in 7 years; it then fell further later in the week. Monday's drop helped trigger a fall in the Australian dollar the same day. Despite intervention by the central bank, Australia's currency fell to a 12-year low against the U.S. dollar. Trade links to Asia have contributed to weakening in both the Australian and the New Zealand dollars over the past 18 months, and each country faces a difficult choice between letting the currency fall (which would increase inflationary pressure) and raising interest rates (which would risk recession). New Zealand—which is experiencing rising unemployment, falling stock prices, and a current account deficit approaching 8 percent of GDP—has already eased monetary policy several times in recent months. In Japan, new data are likely to show that the economy contracted again in the first quarter, producing the two consecutive quarters of decline that conventionally signify a recession. On Wednesday, the Diet extended its session to June 18 to allow time to pass the supplementary budget, which is necessary for implementing the economic stimulus package announced April 24.

**Is Russian Tax Reform Finally on the Way?** Despite long-standing recognition that effective tax reform is central to Russia's recovery from its current economic troubles, little progress has been realized. One response was the formation last week of Russia's newest political movement, the "Union of Russian Tax Payers," on the platform of rational and effective budget and tax policies for Russian citizens. Sensing, perhaps, the growing grass-roots pressure for movement on tax reform, the Russian government made the unprecedented move Monday night of arresting the head and several managers of Goskomstat, the state statistical agency, for systematically understating the actual production of large firms to facilitate tax evasion among Russian companies. The arrests raise questions about the accuracy of Russian economic accounting, which could contribute to the shaky confidence of international investors even though the implication is that true economic production is higher than officially declared. (In general, including black market activity would add an estimated 25 to 35 percent to Russian GDP.) Russian financial markets remained relatively stable early this week, despite defaults on several regional government agribonds. According to Russian news reports, legislation is now being drafted by the Finance Ministry that would prohibit borrowing at the regional level.

**Repression of Union Activities Increasing.** Repression of trade union activities is increasing around the world, according to the annual report on trade union rights published this week by the International Confederation of Free Trade Unions (ICFTU), which represents 125 million workers in 141 countries. In 1997, 299 trade unionists were killed, more than half of these in Colombia. In addition, 1,681 were tortured or ill-treated, 2,329 were detained, and there were 3,369 cases of intimidation. "Fifty years after the adoption of the ILO Convention on Freedom of Association...trade unionists are still having to fight for the right to organize," commented the ICFTU General Secretary, introducing the report.

EYES ONLY

## RELEASES THIS WEEK

### Producer Price Index

****Embargoed until 8:30 a.m., Friday, June 12, 1998****

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

### Retail Sales

Advance estimates show that retail sales rose 0.9 percent in May following an increase of 0.7 percent in April. Excluding sales in the automotive group, retail sales rose 0.4 percent in May following an increase of 0.5 percent in April.

## MAJOR RELEASES NEXT WEEK

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

EYES ONLY

## U.S. ECONOMIC STATISTICS

| | 1970-1993 | 1997 | 1997:3 | 1997:4 | 1998:1 |
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| Using NFB deflator | 1.3 | 2.5 | 2.7 | 3.9 | 3.5 |
| **Shares of Nominal GDP** (percent) | | | | | |
| Business fixed investment | 10.9 | 10.5 | 10.7 | 10.6 | 10.7 |
| Residential investment | 4.5 | 4.1 | 4.1 | 4.1 | 4.2 |
| Exports | 8.2 | 11.8 | 11.9 | 11.9 | 11.5 |
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| Personal saving | 5.3 | 2.8 | 2.6 | 2.9 | 2.7 |
| Federal surplus | -2.7 | -0.4 | -0.1 | -0.1 | 0.6 |

| | 1970-1993 | 1997 | March 1998 | April 1998 | May 1998 |
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| increase per month | | | 82 | 302 | 296 |
| increase since Jan. 1993 | | | | | 16010 |
| **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, June 12, 1998**.

EYES ONLY

## FINANCIAL STATISTICS

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| | | | | | |
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| 10-year T-bond | 6.44 | 6.35 | 5.64 | 5.65 | 5.44 |
| Mortgage rate, 30-year fixed | 7.80 | 7.60 | 7.14 | 7.14 | 7.04 |
| Prime rate | 8.27 | 8.44 | 8.50 | 8.50 | 8.50 |

## INTERNATIONAL STATISTICS

| **Exchange Rates** | **Current level** | **Percent Change from** | |
|---|---|---|---|
| | **June 11, 1998** | **Week ago** | **Year ago** |
| Deutschemark-Dollar | 1.804 | 2.2 | 5.1 |
| Yen-Dollar | 143.3 | 3.5 | 28.6 |
| Multilateral $ (Mar. 1973=100) | 101.8 | 2.1 | 7.3 |

| **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 | 3.7 (Q1) | 4.3 (May) | 1.4 (Apr) |
| Canada | 3.8 (Q1) | 8.4 (Apr) | 1.0 (Apr) |
| Japan | -0.2 (Q4) | 4.2 (Apr) | 0.3 (Apr) |
| France | 3.4 (Q1) | 12.0 (Apr) | 1.0 (Apr) |
| Germany | 3.0 (Q1) | [2] 7.6 (Mar) | 1.3 (Apr) |
| Italy | 2.8 (Q4) | 12.1 (Jan) | 1.8 (Apr) |
| United Kingdom | 2.9 (Q1) | 6.5 (Feb) | 4.0 (Apr) |

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 March 1998 is 10.0 percent.