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THE PRESIDENT HAS SEEN

7-24-96

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 19, 1996

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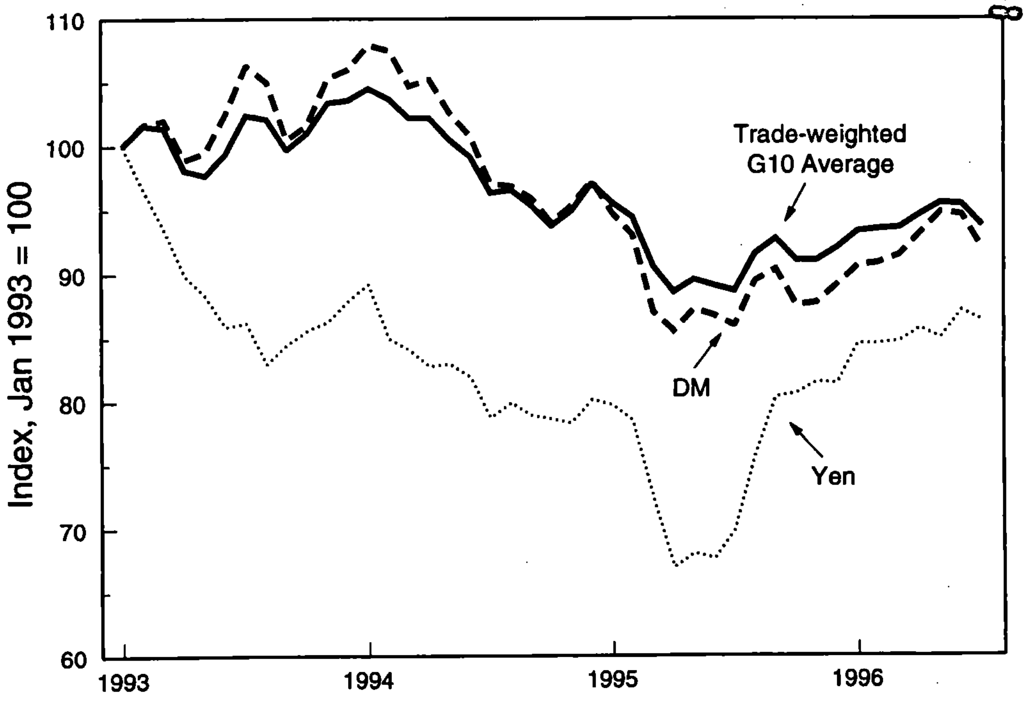
CHART OF THE WEEK

The 1996 Rise in the Dollar in Perspective



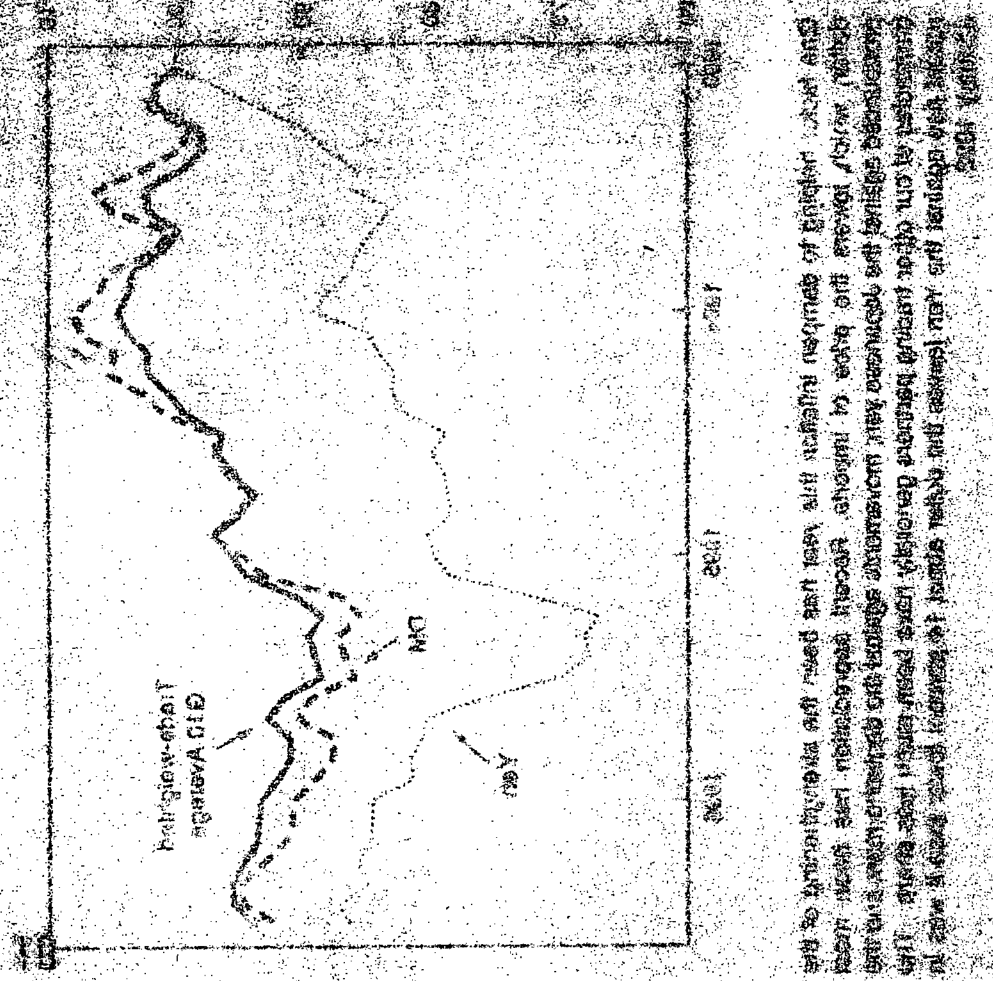
One factor helping to dampen inflation this year has been the strengthening of the dollar, which lowers the price of imports. Recent appreciation has been most pronounced against the Japanese yen; movements against the deutsche mark and the currencies of our other trading partners generally have been much less sharp. The recent rise against the Yen leaves the dollar about 14 percent lower than it was in January 1993.

Council of Economic Advisers

JUL 18 1990

THE WEEK

The 1990 Rise in the Dollar in Perspective



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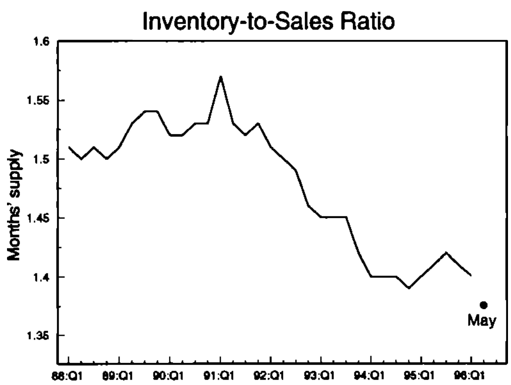
"On the other hand, it's great to be out of Washington!"

MACROECONOMIC UPDATE

Growth Likely to Moderate in Third Quarter

Second-quarter growth was probably about 3.5 to 4 percent at an annual rate. Strong growth in consumption and residential investment will be only partially offset by the increase in the trade deficit. Growth is likely to moderate in the third quarter, to about a 2.5 percent annual rate, somewhat stronger than previously estimated.

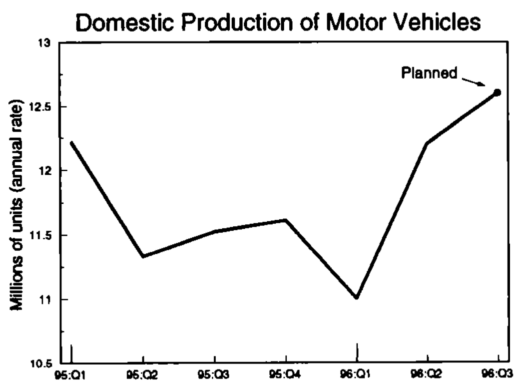


The economy continues to show momentum. Recent gains in employment are generating higher incomes that are likely to continue fueling consumption. Inventories are lean (see upper chart), implying increased production in order to rebuild them.

The prospect of slower growth in the third quarter is based primarily on two considerations:

- planned motor vehicle production shows only a slight pickup in the third quarter, in contrast to the steep rise in the second (see lower chart). Still, the third quarter assembly plans represent an upward revision from earlier plans.
- housing starts are likely to be constrained by rising mortgage rates, although starts remained robust through June as rates rose.

At this time, price data show no rising inflation. The core CPI increased 2.7 percent during the 12 months ending in June, down from 3.0 percent during the year-earlier period. Wage growth has picked up, but not to a level that threatens an increase in inflation. Trend unit labor costs are growing at about 2¼ percent (3½ percent growth in wages less 1¼ percent growth in trend productivity), which is no higher than recent increases in prices.



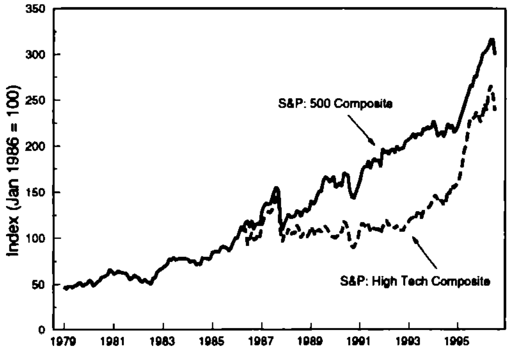
Although inflation remains in check, the last time the unemployment rate was 5.3 percent (at the end of the 1980s), inflation crept up.

CURRENT DEVELOPMENT

Implications of Recent Stock Market Movements

Recent stock market gyrations have fueled debate over whether the stock market is overvalued and headed for a fall. A "correction" cannot be ruled out, but recent events have barely dented the impressive gains turned in over the past 18 months or so (see upper chart).

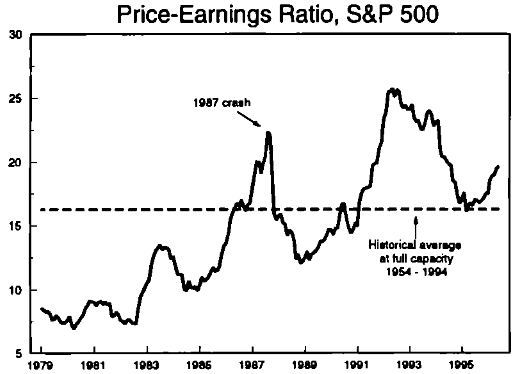
U.S. Stock Prices



Analysis. Fluctuations in stock prices depend on investor perceptions, which can change quickly. The two key fundamentals are expected earnings and expected interest rates. Fear of disappointing earnings appears to have put downward pressure on stock prices earlier this week, but some better-than-expected company earnings reports have since exerted a calming influence. A strong jobs report created interest rate fears earlier this month, but those fears too seem to have abated recently.

A rough way to measure whether the stock market is overvalued is to compare stock prices to current earnings. Today's price-earnings ratio is above its historical average for an economy operating at full capacity, but still below its level preceding the October 1987 crash (see lower chart). Ideally, one would like to look at the expected rate of return on equity (stocks) relative to the expected rate of return on bonds (the interest rate), but this is not easily calculated. One attempt shows a narrowing of the differential during 1996, suggesting a possible substantial market correction.

Price-Earnings Ratio, S&P 500



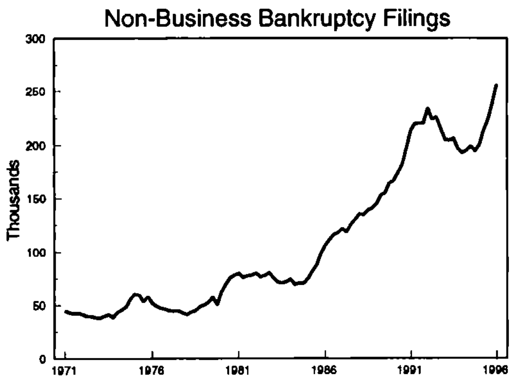
Implication. Some question whether a stock market drop would affect the economy. Econometric models indicate that recent market gains have not yet affected consumer spending. This suggests that a market drop should have relatively little effect on the economy.

CURRENT DEVELOPMENT

Why Are Personal Bankruptcies Soaring?

Personal bankruptcies rose to a new high in the first quarter (see chart). This development fuels the concerns of those who worry that households are overextended.

Analysis. Personal bankruptcies have been soaring for more than a decade, possibly because changes in bankruptcy laws in 1978 and 1994 made it less financially burdensome to declare bankruptcy by increasing the value of assets that could be protected from creditors. With more assets protected, bankruptcy is easier and the bankruptcy rate may be higher than it used to be for the same underlying economic conditions.



Rising bankruptcies may also be linked to efforts by banks to issue credit cards to less creditworthy customers and expand consumer loans. As less creditworthy customers become overextended they may choose bankruptcy to escape their debts. The stigma may also be less now that bankruptcy is easier and more widespread.

Although rising consumer debt probably contributes to the rising bankruptcy rate, debt alone is not the problem. Bankruptcies appear to result from the interaction of high debt and calamities like job loss, divorce, medical emergencies, and auto accidents. A recent study, for example, shows that Hawaii has high per capita debt but a low bankruptcy rate. This may be because Hawaiians have a low divorce rate and enjoy above-average protection against financial catastrophes through good medical insurance coverage and strict auto insurance requirements.

Conclusion. Although the rising personal bankruptcy rate may be discomforting, it seems to be partly a response to changes in law, rather than a major financial development.

SPECIAL ANALYSIS

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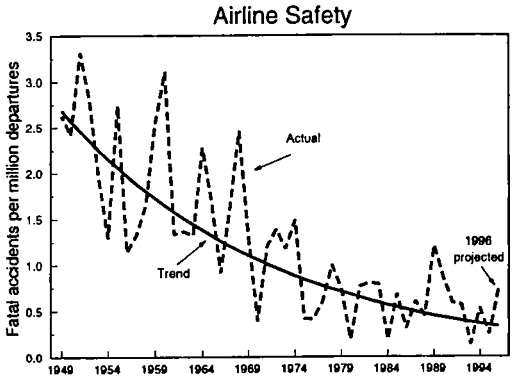
Regulating Safety in a Deregulated Airline Industry

Recent tragic airline crashes have revived concerns about airline safety. Critics of airline deregulation and competition often claim that flying has become more hazardous. In fact, by virtually any measure, airline safety has improved throughout the history of commercial aviation. Still, a review of the record and of the economics of airline safety is in order.

A record of improvement. The number of fatal accidents per departure has shown a persistent downward trend from 1949 to 1995, according to data from the Air Transport Association (see chart). Unfortunately, as the chart shows, some years exhibit well-above-average accident rates. On average, however, in the years 1949 to 1958, the rate of fatal accidents was 2.1 per million departures; by the 1986-95 period this accident rate had fallen to 0.6 per million departures (see table). In other words, in recent years the chance of a fatal airplane crash has been just a little more than half the proverbial one-in-a-million.



The average decline in fatal accidents is somewhat more pronounced when measured on a per-aircraft-mile-traveled basis. The data in the table show a tenfold reduction between the 1949-58 and 1986-95 periods, to less than 1 per billion aircraft miles. Data from the National Highway Traffic Safety Administration, by contrast, show about 16 fatal highway accidents per billion miles traveled by car during 1992-93.

Airline Fatality Rates

Measure	Average Annual Change 1949-95	Average Rate 1949-58	Average Rate 1986-95
fatal accidents per departure	-4.5%	2.1 per million	0.6 per million
fatal accidents per traffic mile	-7.3%	9.9 per billion	0.9 per billion

The disasters of 1996. Barely halfway into the year, we have had three fatal plane accidents. Simple projections of numbers of departures indicate that, at this rate, 1996 could be an unusually severe year. The last point on the chart above indicates how much higher this rough projection of the 1996 "fatal accidents per departure" ratio is compared to the trend.

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What about deregulation? Since deregulation's inception, critics have claimed that it threatens the safety of air travel. The allegation is that improved technology, better airplanes, and continued safety regulation might have led to even better performance, but for deregulation. According to this criticism, competition in airline service makes it more difficult to monitor airline safety practices because it increases the ease with which new carriers can enter the industry and decreases prices, which in turn increases air travel. A further point is that because competition reduces carrier profits below the levels previously protected by regulation, it reduces the financial penalty borne by unsafe airlines if regulatory enforcement or consumer resistance were to put them out of business.

Simple statistical tests fail to reveal any effect on airline safety that can be attributed to deregulation of the industry in 1978. The data suggest a slight improvement in safety since deregulation, but this is not a statistically significant finding. The fortunate fact that fatal accidents are unusual events makes it difficult to garner much information beyond basic trends.

The role of safety regulation. In principle, market forces should reward airlines that provide the level of safety consumers demand. Among other factors, however, the unusual nature of airline accidents makes it virtually impossible for travelers to assess the safety of particular airlines or aircraft. Because the costs of an uninformed decision could be so high, government has an important role in monitoring and regulating airline safety.

But reduction in the risk of air travel is not without cost. Increased regulation almost inevitably requires increasing the budget of the regulatory agencies. Ticket prices inevitably rise as more stringent safety regulation–requiring newer planes and advanced technology, more thorough maintenance, and perhaps reductions in the availability of flights at certain times and places–increases the cost of air travel.

Paradoxically, requiring greater airline safety beyond some point could make travel in general more risky. For example, higher air fares could lead people to drive instead. One study estimates that by luring people out of cars, lower air fares from deregulation save between 90 and 140 lives per year, on balance.

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ARTICLE

Legalized Gambling: A Sure Fire Winner?

Between 1992 and 1994 annual legalized-gambling wagers jumped 46 percent, from $330 billion to $482 billion. This has attracted the attention of the Congress, and steps are underway to establish a national commission to study the impact of gambling.

The table shows gambling activity by type; it indicates that Nevada and New Jersey casino gambling activities represented more than half of gross wagers and that state-sponsored lotteries were the single largest source of gross profits. Moreover, as measured by the percentage of wagers retained (an indicator of gross profitability), state lotteries are the most profitable of all the listed gambling activities.

Legalized Gambling Activity: 1994 Wagers and Revenues

	Wagers (billions)	Gross Revenue (billions)	Profit Rate (percent)
Nevada/NJ casinos	$283.9	$10.2	3.6
Cruise ships and riverboats	68.9	3.6	5.3
Indian reservations	41.1	3.4	8.3
State lotteries	34.5	14.1	41.0
Horse and greyhound racing	17.1	3.6	20.9
All other	36.7	5.0	13.6
Total	482.1	39.9	8.3

Notes: Wagers are the total amount bet for each gambling activity. Gross Revenue is wagers minus payouts. Profit Rate is revenue divided by wagers. Source: *International Gaming and Wagering Business*, August 1995.

The extent of gambling. Gambling is ubiquitous:

- Only two states (Utah and Hawaii) have no legalized gambling activity.
- Thirty-seven states and the District of Columbia sponsor lotteries.
- Casino activity is legalized in 10 states (the largest amount of casino activity is in Nevada and New Jersey).
- Riverboat and Indian reservation casinos appear to be among the fastest-growing segments of the gambling industry. Five states had riverboat gambling in 1994, and others are poised to follow. The Bureau of Indian Affairs has approved gambling compacts with 130 tribes, almost one-fourth of all Indian tribes.

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- Gambling has also appeared on the Internet in the form of "virtual" casinos. No good estimates of the size of this activity exist. Although currently thought to be small, Internet gambling may become far more important in the future.

The economics of gambling. Gambling is a form of entertainment, where participants obtain enjoyment from participating in the activity (and in the hope of winning money). As such, gambling competes with other entertainment industries like movies, television, music, and sports. In other words, gambling creates value in much the same way as other leisure time pursuits.

But gambling generates at least two distinct social costs that other entertainment industries do not: the financial toll that compulsive gambling takes on affected families; and the indirect costs when some gamblers undertake illegal activities to finance their gambling. Because of this, it is understandable why society might intervene and attempt to regulate gambling activities to lessen the economic burden on affected parties.

Raising government revenues from gambling may also have negative distributional effects. Because state lotteries face no competition, they tend to pay only about half of the gross revenues in prizes. A large fraction of the remaining funds are retained by the sponsoring state, as profits. These lottery profits are analogous to a state excise tax on the activity of gambling via a state-sponsored lottery. Since lower-income individuals spend a higher proportion of their income on lotteries, this "lottery tax" is a very regressive source of revenue.

Conclusion. Some social commentators view gambling solely as a moral issue. Economists, however, view gambling as similar to other leisure-time pursuits, with two important differences: (1) gambling can impose costs on non-participants and (2) legalized gambling is generally an instance where the state uses its regulatory powers to restrict output and keep prices artificially high. Concern for the economics of legalized gambling can help frame a policy discussion over its social desirability.

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Where were we Life exp? '92?

INTERNATIONAL ROUNDUP

United Nations Reports on State of Human Development. The United States placed second, just behind Canada, in the U.N. Human Development Index rankings for 1996. The index, which was released in a new U.N. report on the state of human development, combines three components of national well-being: life expectancy at birth, educational attainment and adjusted real income. The United States ranked second in real GDP per capita and education, but 18th among industrial nations in life expectancy and in preventing maternal deaths. In another human development index that takes into account gender differences in literacy, education, and share of earned income, the United States ranked fourth, after Sweden, Canada, and Norway.

Israeli Financial Markets in Turmoil As Nation Protests Planned Budget Cuts. On July 16, one day before a planned nationwide strike, the Israeli stock market dropped nearly 5 percent, its tenth straight day of losses. An important factor behind the stock market's weakness has been a steady upward drift in long-term interest rates. Pressure is mounting–from both the public and private sectors–for a cut in rates as a confidence-boosting measure. The Bank of Israel, however, appears reluctant to do so in the face of rising inflation. The stock market tumble was followed by a general strike on Wednesday, in which some 400,000 public sector workers–roughly one-fifth of the workforce–closed the stock market, banks, public companies and government offices across the country. The work stoppage also crippled hospitals, public utilities and transportation services. The strike was launched to protest the government's planned budget cuts, which would hit social services particularly hard.

Inter-Korean Trade Still Low, but Growth Is Steady. Trade between North Korea and the Republic of Korea (ROK) has grown steadily since the reestablishment of economic ties in 1988. Bilateral trade was $287 million last year, up from only $19 million in 1989. Imports from North Korea nevertheless accounted for less than 1 percent of the ROK's total imports in 1995. Since the resumption of trade between the two countries, goods flowing south have represented the bulk of bilateral trade. Reasons include North Korea's scarcity of hard currency with which to pay for imports and the political sensitivity in North Korea over goods identifiably from the ROK. North Korea's exports to the ROK are overwhelmingly primary products. Due to the political sensitivities associated with intra-peninsular trade, most shipments go through third countries. Originally this was primarily Hong Kong, but now most inter-Korean trade flows through China.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $10.9 billion in May from $9.6 billion in April.

Housing Starts

Housing starts increased 1 percent in June to 1.48 million units at an annual rate. For the first 6 months of 1996, starts were up 14 percent compared with the same period a year ago.

Consumer Prices

The consumer price index increased 0.1 percent in June. Excluding food and energy, consumer prices increased 0.2 percent.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.5 percent in June, following a similar increase in May. Capacity utilization increased 0.1 percentage point in June to 83.2 percent.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (Thursday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:3	1995:4	1996:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	3.6	0.5	2.2
GDP chain-type price index	5.3	2.6	2.2	2.2	2.4
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	1.7	−0.8	2.1
Real compensation per hour:					
Using CPI	0.6	1.0	2.1	0.5	0.1
Using NFB deflator	1.3	1.7	2.0	2.0	2.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.2	10.4
Residential investment	4.5	4.0	4.0	4.0	4.1
Exports	8.2	11.1	11.1	11.3	11.2
Imports	9.2	12.5	12.5	12.4	12.5
Personal saving	5.1	3.3	3.2	3.6	3.4
Federal surplus	−2.7	−2.2	−2.2	−2.1	−2.1

	1970–1993	1995	April 1996	May 1996	June 1996
Unemployment Rate	6.7**	5.6**	5.4	5.6	5.3
Payroll employment (thousands)					
increase per month			191	365	239
increase since Jan. 1993					10008
Inflation (percent per period)					
CPI	5.8	2.5	0.4	0.3	**0.1**
PPI-Finished goods	5.0	2.3	0.4	−0.1	0.2

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	May 1996	June 1996	July 18, 1996
Dow-Jones Industrial Average	3794	4494	5617	5672	5464
Interest Rates					
3-month T-bill	4.25	5.49	5.02	5.09	5.11
10-year T-bond	7.09	6.57	6.74	6.91	6.72
Mortgage rate, 30-year fixed	8.35	7.95	8.07	8.32	8.23
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 18, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.486	−2.3	+7.1
Yen-Dollar	107.9	−2.0	+22.2
Multilateral $ (Mar. 1973=100)	86.60	−1.6	+5.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	1.7 (Q1)	5.3 (Jun)	2.8 (Jun)
Canada	0.6 (Q1)	9.4 (May)	1.5 (May)
Japan	5.5 (Q1)	3.6 (May)	0.3 (May)
France	0.9 (Q1)	12.6 (Mar)	2.4 (May)
Germany	0.4 (Q1)	7.1 (May)	1.5 (May)
Italy	1.6 (Q1)	12.5 (Apr)	4.3 (May)
United Kingdom	1.9 (Q1)	8.3 (May)	2.2 (May)

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Smoking Bans Help Workers Kick the Habit. Company policies that forbid smoking on the job are effective at getting workers to stop smoking altogether, according to a recent study released by the National Bureau of Economic Research. Workplace bans designed to reduce employees' exposure to passive smoke covered more than two-thirds of the indoor work force in 1993–up from only one-quarter in 1985. The study found that quitting altogether is the easiest way to adjust when it becomes inconvenient to smoke during the day. As a result, indoor workers quit smoking at a faster rate than others. In 1993 only 26 percent of indoor workers smoked, down from 31 percent in 1985. Even workers who failed to kick the habit reduced their daily cigarette intake by 10 percent.

More College Drop-ins Results in More College Drop-outs. A rising number of first-year college students fail to return to campus for their sophomore years, according to numbers recently released by American College Testing (ACT). The dropout rate at 4-year institutions rose to 26.9 percent this year, its highest level since ACT began gathering data in 1983. Several explanations suggest themselves. First, to the extent that college enrollment increases have reflected relaxed admissions requirements, more students may be finding the college workload much harder than they expected. Second, a strong economy and increased job opportunities can lure students into employment and away from campus. Third, more students are enrolling in private colleges, where the dropout rate has been rising more rapidly. Finally, the growing number of non-traditional students–more than 40 percent of enrollment by some estimates–may be more likely to study in a start-and-stop fashion.

Greenspan Testifies. Federal Reserve Chairman Alan Greenspan presented his Humphrey-Hawkins testimony to the Congress on Thursday. Greenspan said that he did not see any direct evidence of rising inflation and that the Fed did not have any firm judgments on the level of output that would engender economic strains. Rather the Fed would respond to evidence that those strains themselves are developing. Greenspan noted that current levels of slack, measured in terms of either the unemployment rate or capacity utilization, have often been associated with rising inflation. Greenspan said two transient–not permanent–factors are holding down inflation: because of worries about job security, workers are accepting smaller compensation increases, and globalization is promoting greater specialization and efficiency. Long-term interest rates fell about 0.1 percentage point during Greenspan's testimony.

cc to Higher dollar

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