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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

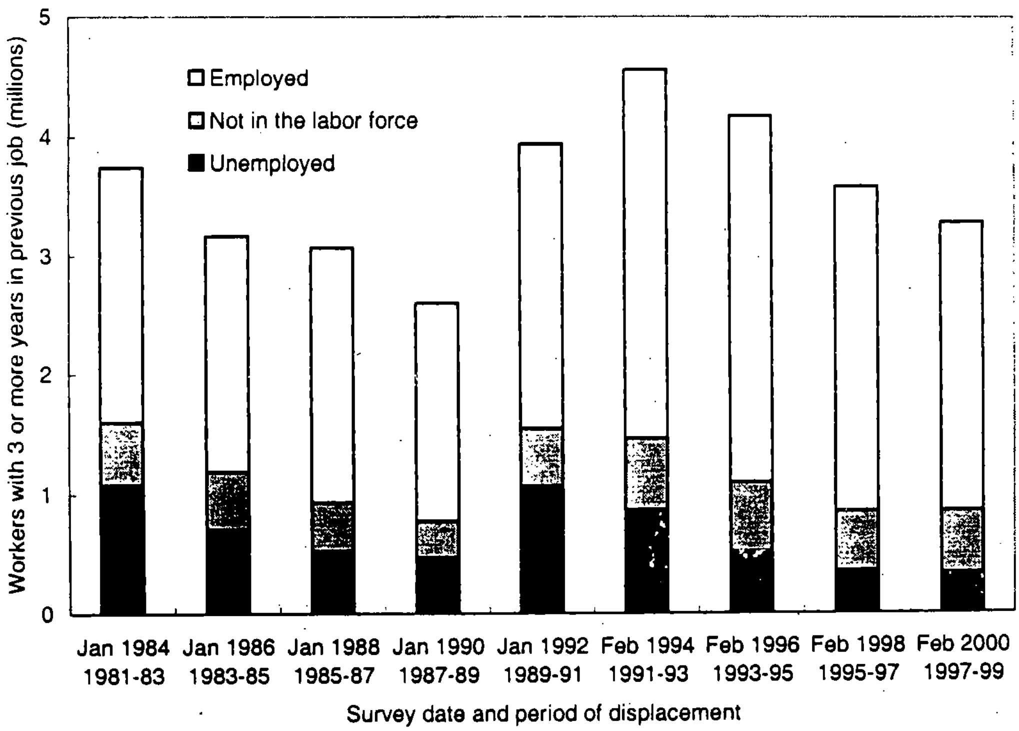
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

August 18, 2000

Copied
Baily
Podesta
page 2 to
Sec Cohen

CHART OF THE WEEK

Displaced Workers and Subsequent Employment Outcomes



Displaced workers are those who lost their jobs because their plants or companies closed down or moved, their positions or shifts were abolished, or their employer did not have enough work for them. Biennial surveys since 1994 have shown a steady decline in the displacement of long-tenured workers. Although the level of displacement identified in the 2000 survey (for 1997-99) was higher than that in the 1990 survey (for 1987-89), the number of displaced workers who were still unemployed at the time of the survey was lower in 2000.

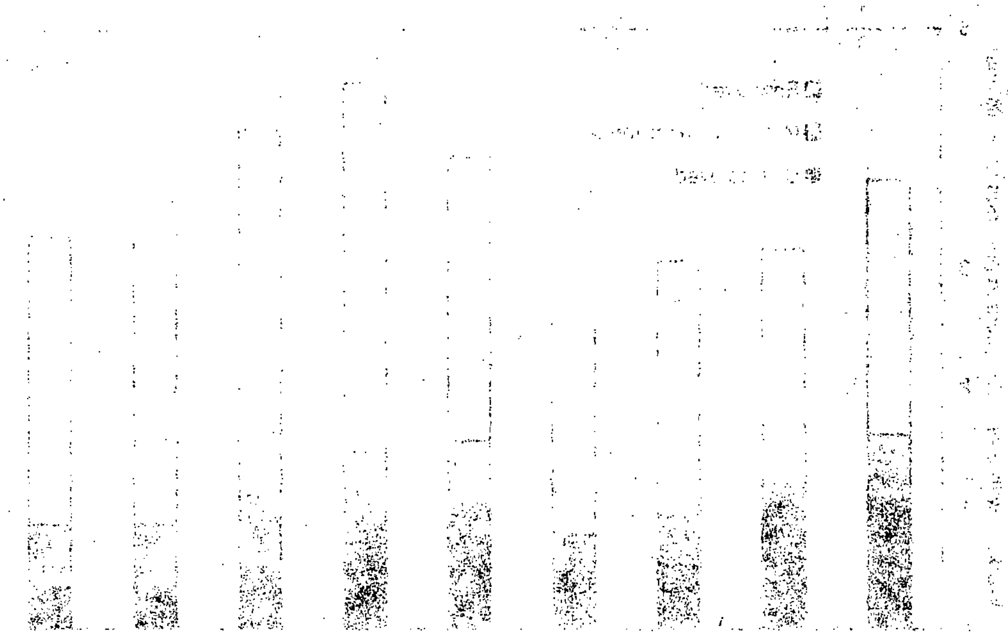
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 15, 2000

CHART OF THE WEEK

Displaced Workers and Subsequent Employment Outcomes



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CONTENTS

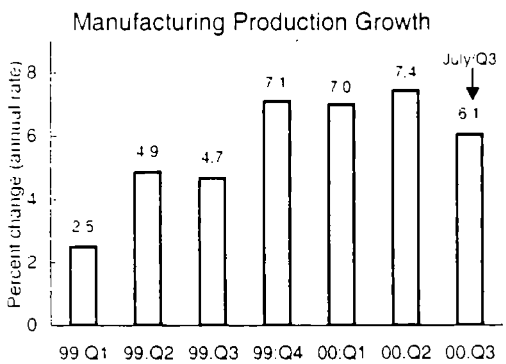
"It's very, very important that you try very, very hard to remember where you electronically transferred Mommy and Daddy's assets."

MACROECONOMIC UPDATE

The Economy Keeps Chugging Along

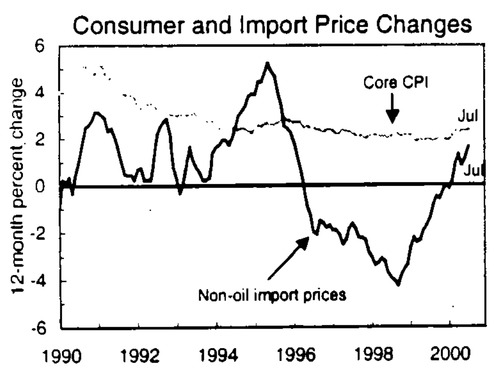
Economic activity appears to have been well-maintained into the third quarter, although at a reduced pace.

Concurrent indicators are still moving up. Production-worker hours are on track to increase at about a 1 percent annual rate in the third quarter—enough to support real GDP growth in the 3 to 4 percent range at an annual rate. Although initial claims for unemployment insurance (available through mid-August) have increased slightly so far this quarter, they remain at levels consistent with continued growth. July data show manufacturing production growing at a 6 percent annual rate thus far in the third quarter—down only slightly from its pace in the three previous quarters (see upper chart).



Household spending is slowing but exports are picking up. The composition of activity is moving away from consumption and residential construction. Both decelerated in the second quarter. And thus far in the third quarter, consumption growth appears moderate, while residential construction is falling. Consumption was fueled by the stock market gains of the past 5 years and may be expected to slow with a cooler stock market. (Thus far this year, the broadly based Wilshire 5000 index has been flat.) As consumption and residential investment slow, their contribution to GDP growth may be partially offset by the external account. Slowing consumption may slow imports. And the 8½ percent growth in exports during the past four quarters—reflecting the pickup in growth among our major trading partners—has been encouraging. Net exports are still likely to subtract from GDP growth, but by less than during the past 2 years.

Inflationary creep. Besides strengthening the market for U.S. exports, stronger foreign growth has also caused an acceleration in prices charged for our non-oil imports (see lower chart). Declines in these prices had been one of the factors restraining inflation, but now this restraining influence has vanished. This import-price acceleration—together with a rise in petroleum prices—is putting some upward pressure on inflation. Thus far, a very strong rise in productivity has largely offset these inflationary influences. Nevertheless, the risk of a slow upward creep of inflation is increasing.



8.23.00

cc Sec, Bill Cohen

SPECIAL ANALYSIS

Public-Private Competition for DoD Commercial Activities

Over the past two decades, public-private competitions for the performance of commercial activities—tasks that could be obtained from the private sector—have generated substantial savings over initial costs for the Department of Defense. Average savings have been particularly large recently, and the numerous DoD tasks that remain available for competition represent significant additional potential savings.

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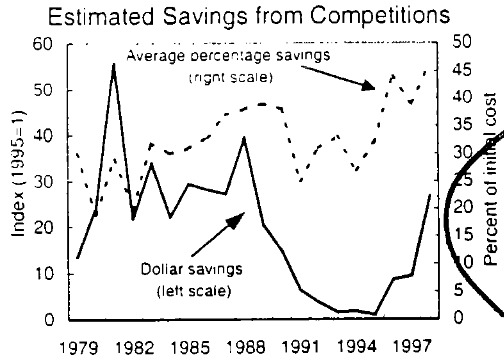
Background. DoD completed over 2,000 public-private competitions (involving about 90,000 government positions) for the performance of commercial activities between 1979 and 1989, with estimated average weighted savings of over 30 percent of the initial cost. In the late 1980s and early 1990s, administrative and legislative constraints on the program led to relatively few competitions. But a renewed emphasis on competition since 1995, consistent with Reinventing Government initiatives, has been associated with average savings in excess of 40 percent and an increase in estimated total savings (see chart).

Estimated Savings from Competitions



The public-private competition process. Competitions apply to commercial activities; inherently governmental activities are exempt. The latter are defined as activities so intimately related to the public interest that they must be done by a Federal employee (such as directing or supervising government employees or administering contracts). Government employees have the opportunity to bid against the private sector after developing their "most efficient organization" to perform the specified work. The government has won about half of the competitions. Early competitions usually were awarded on a lowest bid basis, but changes in 1996 have allowed a "best-value" approach, evaluating bids on both quality and cost.

Recent results. Average savings on DoD contracts have been very high recently in part because some large competitions have resulted in exceptionally high savings. For example, a Navy competition completed in 1999 for base operating services in Guam had 2,300 baseline positions and estimated savings of about $91 million per year, or 68 percent of the baseline cost. Improved competition management has also played a role in achieving large savings. For example, DoD has been conducting larger competitions, which usually have higher percent savings. But even after controlling for factors like the size and scope of contracts, savings have been increasing recently. One possible explanation is that, in areas that had not yet faced competition, the gap between public and private sector efficiency had been widening.

Interpret with care. Estimated savings are based on the winning bid for the work compared with the initial estimated cost, but actual savings may differ from these estimates. For instance, actual costs may often increase as a result of changes from the projected workload. Furthermore, efficiency gains may not translate dollar-for-dollar into budget savings, if, for example, the military realigns personnel whose positions have been eliminated to fill empty positions elsewhere. In addition, because the workload might change over time (for example, because of a base closure and realignment), estimates of cumulative savings cannot be extrapolated from these initial estimates. Finally, these estimated savings omit transition costs, such as severance pay and early retirement incentives, as well as the cost of conducting the competition.

Potential savings. Even with these caveats in mind, additional potential savings may be substantial. Since 1998 Federal agencies have been required to identify personnel positions associated with tasks that can be competed, and DoD has identified over 240,000 such positions. Based on average savings of 30 percent and an average cost of $50,000 per position, this represents $3.6 billion per year in potential savings.

ARTICLE

Are Free Trade Agreements Good for Free Trade?

Establishing a mandate for a new round of WTO negotiations is proving to be difficult, and the sense of momentum for trade liberalization in large regional groupings such as the Asia-Pacific Economic Cooperation (APEC) forum appears to have waned. However, interest in bilateral or smaller regional free trade agreements (FTAs) remains intense.

A recent WTO tally based on press reports identified 65 such arrangements at some stage of development. While these arrangements may prove to be stepping-stones to freer trade multilaterally, they do pose some potential transitional problems for the global economy. FTAs involving large economies like Korea or Japan may pose particular problems for the United States.

Motivations of small countries. Small countries such as Singapore or Chile, both of which are particularly active in these developments, generally have limited bargaining power in multilateral settings. But they may be able to exact more concessions and get more attention in bilateral settings. Such countries may be particularly interested in becoming export platforms for multinational corporations, a goal that can be achieved through preferential access to large foreign markets. At the same time, unlike complex multilateral arrangements, free trade agreements between unequally sized partners may present fewer political obstacles in both countries. Small economies generally do not pose major threats to their FTA partners' industries, while the smaller country typically has the most to gain from the FTA, ensuring domestic political support.

Motivations of Japan. For most of the postwar period Japan relied exclusively on multilateral trade arrangements such as the WTO or "open" regional arrangements such as APEC. But it has recently changed its strategy. There are reports that agreements with Mexico, Korea, and Singapore are at various stages of completion. The agreement with Mexico is clearly defensive, allowing Japan to dilute the U.S. preferences gained from NAFTA. (The EU has implemented a similar agreement with Mexico.)

The motives behind Japan's Asian initiatives are more complex. Japan has begun to explore bilateral arrangements partly out of frustration at the lack of progress in multilateral and APEC negotiations. Of course, one reason for these failures is Japan's own unwillingness to liberalize its agriculture and forest products. Japan's FTA initiatives have therefore centered largely on countries that are not major agricultural exporters, such as Singapore and Korea . However, precisely because Japan and Korea have very similar trade patterns, one study found only small economic gains for Japan from the proposed FTA. With so little commercial benefit from these agreements, it becomes clear that Japan's interest in pursuing these negotiations is motivated more by political than by economic considerations.

Implications for the global economy. The proliferation of FTAs poses some problems for the global economy. First, goods may no longer be exported from the lowest-cost producer if that producer lies outside of the relevant FTA. This trade diversion is a particularly important concern if, as it appears, countries choose partners that will not compete with their uncompetitive sectors. Second, overlapping FTAs and their "rules of origin" may create regulatory burdens, with different rules governing trade with different partners. On the positive side, however, FTAs can increase trade between the member countries. In addition, there may be a domino effect from regional trade initiatives. The presence of one agreement may act as a catalyst for other agreements, and these arrangements may over time aggregate into ever larger regional groupings that could then serve as stepping-stones to multilateral trade liberalization.

Implications for the United States. Preferential trading arrangements that exclude the United States will have a minor impact on U.S. exports and economic welfare as long as they involve small, relatively open economies such as Singapore. By contrast, the United States could experience greater competitive disadvantages from arrangements involving relatively large, protected economies like Korea and Japan. Moreover, American influence in East Asia could erode if we are left out of regional decisionmaking. Aggressive promotion of multilateral liberalization in the WTO and in broad regional forums such as APEC offers a possible antidote to these effects.

8 23-00

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Finds Growth Moderating, Wages Up. Economic activity in all Federal Reserve districts continued to expand in June and July, but there were additional signs that the expansion was moderating in some sectors and the majority of districts. Seven districts—Atlanta, Boston, Chicago, Dallas, New York, Richmond, and San Francisco—reported slowing economic growth. The Cleveland, Kansas City, Minneapolis, and Philadelphia districts reported essentially no change in growth rates, and the St. Louis district reported accelerating economic growth. District reports suggest that consumer spending, manufacturing, and construction were slightly softer than in the last report in June. Easing demand appears to be restraining price increases. Energy prices remain high but may have peaked, and reports suggest that most of the indirect costs of rising energy prices have been absorbed by final goods producers for the time being. Labor markets continue to be very tight, with indications that the shortage of workers is limiting growth of activity in some areas. Many districts reported wage increases and the growing use of non-wage benefits.

Study Examines Sources of HMO Savings. In the treatment of certain conditions, about half of the difference between HMO and traditional indemnity health insurance costs comes from the fact that HMO patients are less likely to have such conditions, according to a new study. Most of the remaining cost difference comes from lower costs for the same courses of treatment. The study, drawing on data for the 200,000 state and local employees in Massachusetts, found that HMO patients were younger, on average, than patients in the indemnity plan. Even after adjusting for age and sex, however, HMO enrollees were cheaper to cover: the incidence of heart attacks, cancers, pregnancy, and diabetes was about 50 percent higher among people enrolled in the indemnity plan. For each condition, the course of treatment followed did not vary systematically between HMOs and the indemnity plan, but the HMOs paid less for such treatment. For example, about 13 percent of heart attack patients received bypass surgery and about 53 percent received no surgical intervention, irrespective of whether they were covered by the indemnity plan or an HMO. But the HMOs paid only $11,000 compared with the indemnity plan's $18,000 when there was no surgical intervention, and $52,000 versus the indemnity plan's $73,000 for bypass surgery.

Charting Older Americans' Well-Being. The Federal Interagency Forum on Aging Related Statistics recently released a chartbook, "Older Americans 2000: Key Indicators of Well-Being." These charts depict the increasing size and diversity of the American population aged 65 and older, and the increasing health and economic security of older Americans. A smaller proportion live in nursing homes now than in the mid-1980s, and the percentage with a chronic disability has fallen. The income of older Americans has been rising steadily for more than 20 years—older Americans are now less likely to be poor than any other age group. However, the poorest quintile of older Americans derive 80 percent of their income from Social Security.

8·23·00

INTERNATIONAL ROUNDUP

Bank of Japan Abandons Zero-Interest Rate Policy. Arguing that Japan's economy was no longer in danger of damaging deflation, the Bank of Japan nudged interest rates up to 0.25 percent, ending an unprecedented year-and-a-half-long zero-interest rate policy. The move came after several months of signals that a rise was imminent, and the Bank indicated that it would maintain a relaxed, flexible policy. Characterizing the easing as in line with the improvement of the economy, the Bank said that innovations in communications and information technology, a resurgent world economy, and macroeconomic stimuli had sparked a gradual recovery that is likely to continue. International observers were less optimistic. The IMF, for example, noted that signs of growth were less certain and that other indicators pointed to a continuing threat of deflation and recession. The corporate sector also remained weak; bankruptcies rose 2.1 percent in June and are up 21.2 percent from a comparable period last year.

U.S. Usually Succeeds in WTO Dispute Settlements. Only one of the 17 cases brought against the United States before the World Trade Organization is likely to have a significant domestic commercial impact, according to a recent GAO analysis. That case, however, is the EU challenge to U.S. tax exemptions for exports of foreign sales corporations and is estimated to affect $152.3 billion in U.S. exports that benefited from the exemptions. Otherwise, the GAO found that most of the 25 U.S. complaints have produced changes in foreign regulations and practices that strengthened intellectual property protection and increased market access. The GAO also argues that the overall tenor of the settlements has upheld trade principles ~~important to the United States, including~~ equal treatment of foreign and domestic goods. The report found that WTO proceedings have yet to challenge U.S. sovereign trade law in any substantial manner; furthermore, the WTO has upheld the validity of long-standing U.S. provisions (including the controversial section 301 actions against unfair trade practices) as a method of addressing trade grievances.

Trade Opportunities Reduce Corruption. A country's "natural openness," as determined by its geography and demographics, has a significant effect on the level of corruption and the quality of governance, according to a new study. Greater natural openness (defined as the predicted sum of exports and imports as a share of GDP, based on remoteness, size, and language) implies a greater role for international trade and investment. Since international traders have more outside options than domestic ones, they tend to avoid operating in corrupt countries. Hence, a country that is naturally more open would find it optimal to devote more resources to building good institutions and fighting corruption. Based on a sample of over 60 countries, the study did find natural openness to be a significant explanatory variable for the different levels of corruption across countries, after controlling for income, ethnic fragmentation, and political institutions. Higher average income was also associated with lower corruption. A naturally more open economy also tended to pay a better relative salary to its civil servants, even after controlling for the level of development of the country.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, August 18, 2000****

The goods and services trade deficit was $30.6 billion in June; it was $30.3 billion in May.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.4 percent in July following an increase of 0.2 percent in June. Capacity utilization rose 0.1 percentage point to 82.3 percent.

Consumer Price Index

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

Housing Starts

Housing starts fell 3 percent in July to 1.512 million units at an annual rate.

MAJOR RELEASES NEXT WEEK

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

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:4	2000:1	2000:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	8.3	4.8	5.2
GDP chain-type price index	5.2	1.6	1.6	3.3	2.5
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	8.0	1.9	5.3
Real compensation per hour:					
Using CPI	1.0	2.2	1.3	0.0	1.6
Using NFB deflator	1.5	3.3	2.9	1.1	2.9
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.0	13.4	13.8
Residential investment	4.5	4.3	4.3	4.3	4.3
Exports	8.2	10.6	10.8	10.8	10.8
Imports	9.2	13.4	13.9	14.2	14.5
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	N.A.

	1970-1993	1999	May 2000	June 2000	July 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.0	4.0
Payroll employment (thousands)					
increase per month			171	30	-108
increase since Jan. 1993					22010
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.6	**0.2**
PPI-Finished goods	5.0	2.9	0.0	0.6	0.0

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1998	1999	June 2000	July 2000	Aug. 17, 2000
Dow-Jones Industrial Average	8626	10465	10583	10663	11056
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.96	6.09
10-year T-bond	5.26	5.65	6.10	6.05	5.81
Mortgage rate, 30-year fixed	6.94	7.43	8.29	8.15	7.96
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 17, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.915	0.8	-13.0
Yen (per U.S. dollar)	108.5	-0.2	-5.0
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	98.63	-0.5	4.4

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	6.0 (Q2)	4.0 (Jul)	3.5 (Jul)
Canada	4.9 (Q1)	6.6 (Jun)	2.9 (Jun)
Japan	0.7 (Q1)	4.7 (Jun)	-0.7 (Jun)
France	3.4 (Q1)	9.8 (May) 2/	1.7 (Jun)
Germany	2.3 (Q1)	8.3 (Jun)	1.9 (Jun)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jun)
United Kingdom	3.0 (Q1)	5.7 (Apr)	3.3 (Jun)

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