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6-12-00

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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

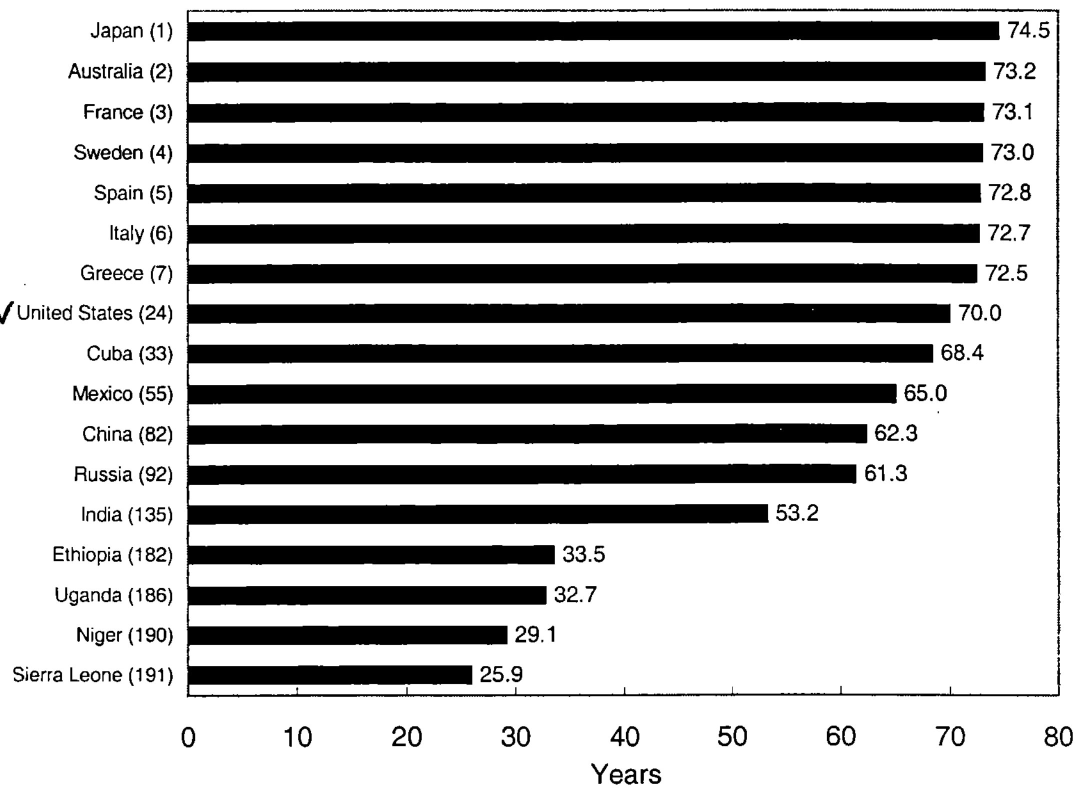
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

Copied
Baily
Podesta

June 9, 2000

CHART OF THE WEEK

Healthy Life Expectancy in Selected Countries



Japan ranks first and the United States 24th in a new World Health Organization (WHO) ranking of healthy life expectancy for babies born in 1999. In contrast to a measure based on mortality data alone, the WHO indicator uses a methodology that discounts years lived in poor health. The relatively low U.S. ranking reflects a number of factors, including the poor health of some groups (such as Native Americans) and the effects of AIDS and tobacco-related cancers.

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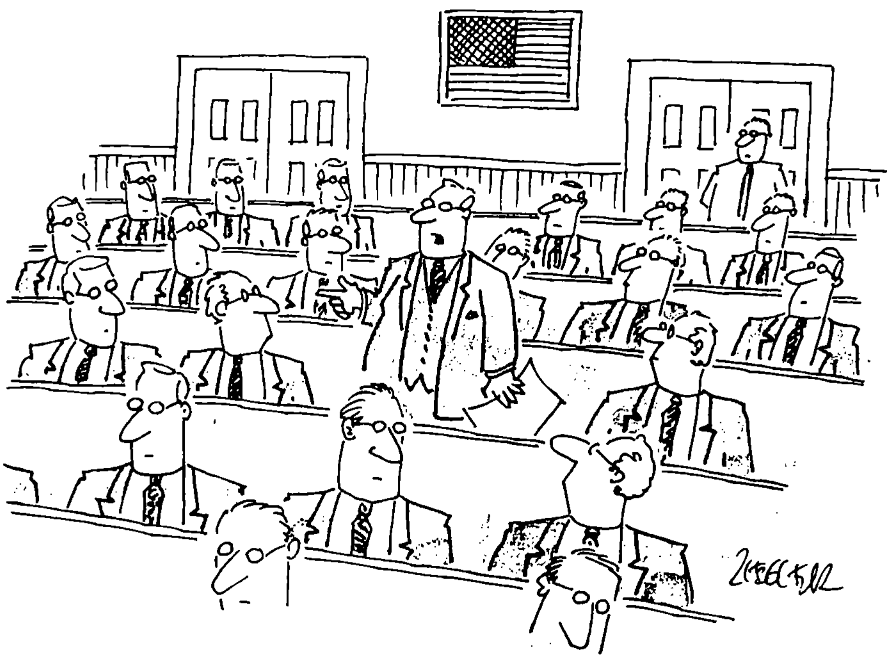

"The only solution I can see is to hold a series of long and costly hearings in order to put off finding a solution."

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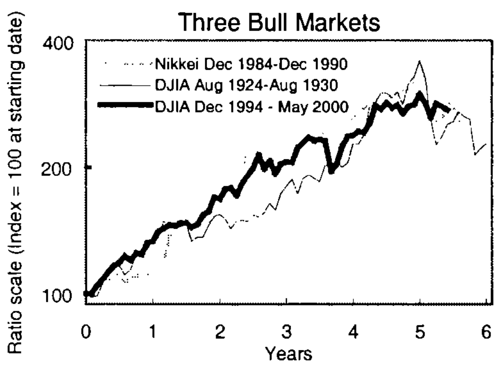
SPECIAL ANALYSIS

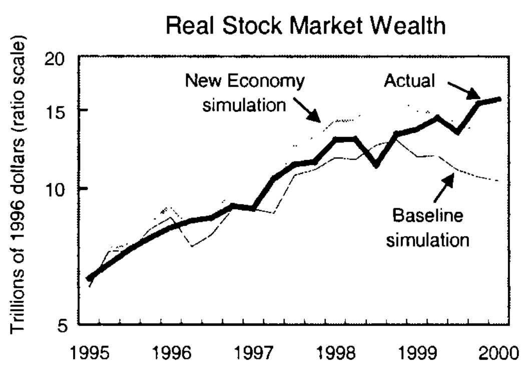
Irrational Exuberance?

The economist Robert Shiller has garnered considerable attention recently with his book arguing that excessive optimism and a herd mentality have led investors to bid stock prices to dizzying heights well above values justified by financial fundamentals. While it remains difficult to know whether the absolute *level* of stock prices is justified by the fundamentals, much of the *increase* in stock prices over the last 5 years could be explained by *changes* in fundamentals—including the acceleration in productivity.

Is it another speculative bubble? Shiller argues that changes in economic fundamentals can only explain a fraction of the runup in stock prices in the 1990s. He compares the atmosphere of the current bull market to those in the past, when media hype, widespread belief in the onset of a "new era" (often associated with the dissemination of technological innovations), and self-fulfilling expectations of stock returns during a bull market led to investor overconfidence. For example, over 90 percent of wealthy investors surveyed in 1999 agreed that the market would bounce back from a sharp contraction within a couple of years or so. Taken at face value, the stock market performance in the late 1990s looks strikingly like that of the ill-fated speculative bubbles of the late 1920s and the Japanese stock market boom of the late 1980s (see upper chart).



Or is it the New Economy? Shiller does not give much credence to the idea that there have been fundamental changes in the real economy of late. But that may not be correct. After all, the recent surge in stock prices has coincided with an apparent acceleration in trend productivity since 1995, suggesting the possibility that the two are related. A sustained acceleration in productivity can lead to higher future profits, raising the value of shares today. Abstracting from the issue of whether the stock market was "correctly" valued at the start of the productivity acceleration, it is of interest to measure the relative contribution of the rise in productivity growth to the rise in stock prices.



To illustrate the effect of an increase in expected growth on stock prices, the lower chart shows simulations of a model that relates stock prices to economic fundamentals—dividend payments and stock repurchases, the real interest rate, and expected future growth in payouts to shareholders (dividends plus stock repurchases). The chart compares two simulations of the growth in real (inflation adjusted) stock market wealth from the end of 1994 to the end of March this year with the actual increase over the same period of about 170 percent.

The first (baseline) simulation shows that nearly half of the actual increase in stock market wealth can be explained by fundamentals, assuming that investors' forecast of future growth stayed at a level consistent with the economy's performance during the previous two decades. Falling real interest rates in 1998 contributed to some of the strength shown in this simulation in 1998, and the subsequent rise in interest rates causes the fall in stock prices in 1999 and early 2000. The second simulation shows that if investors raised their forecast of the future growth of dividends by one percentage point over the last 5 years—a reasonable "New Economy" estimate—then fundamentals explain about three-quarters of the increase in stock prices. A 1.6 percentage point increase in trend growth would be required to explain fully the actual increase in stock market wealth.

Conclusion. The performance of the stock market has led Shiller to believe that investor psychology may have created a stock market bubble. An alternative explanation for the recent surge in stock prices is that investors have recognized that economic fundamentals have significantly improved, with a sustained period of faster economic growth before us. Of course, both irrational exuberance and fundamental change may be at work.

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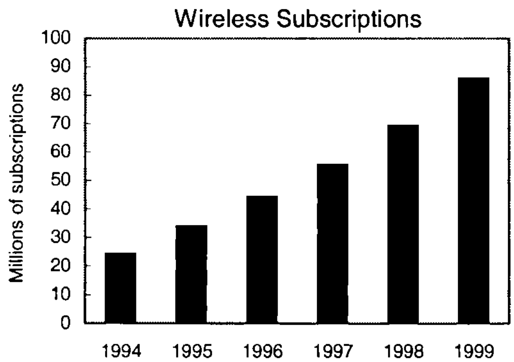
SPECIAL ANALYSIS

Wireless Bandwidth

With more than 86 million subscribers, wireless phones have become commonplace in many households (see chart). Indeed, wireless technology and services are growing so rapidly and promising so much that the chairman of the FCC has focused attention on the question of whether the demand for additional spectrum is outpacing supply. One way to help resolve this problem might be through the use of new technologies that bridge the gaps between incompatible standards and allow the creation of a "marketplace" for spectrum, much like that for any other commodity.



New spectrum and new entrants. The rapid growth of wireless subscribers has been driven in part by the entry of new digital wireless PCS (Personal Communications Services) systems. Using spectrum acquired through FCC auctions, PCS systems have increased wireless competition in many markets. One study found that prices fell 10 percent when the first PCS entrant started service, and prices fell an additional 25 percent when a second PCS entrant launched service. To keep prices low as demand for additional services rises, however, other alternatives to expanding capacity may need to be explored.

New technology may make better use of existing spectrum. Rather than allocating additional bandwidth, new technologies may make it possible to use existing capacity more efficiently. Traditional wireless handsets use hardware to transmit and receive radio signals over specific bandwidths that may employ very different transmission standards. Recent developments in software defined radio (SDR) will allow a handset to be programmed to operate across a broad range of frequencies and transmission standards. With access to multiple networks, these new SDR handsets make it possible to develop a market mechanism to allocate the available bandwidth among users.

Spot markets for bandwidth. To take advantage of this new technology, one company proposes conducting an ongoing private auction among cellular providers. With such a system, one network that had excess spectrum capacity could offer to sell its available bandwidth to users of another network that had excess demand at a particular moment.

Spot markets and PCS investment. Although PCS providers are operating in many large markets, PCS is not yet available in some areas. Since entrants must raise capital both to build their systems and to run marketing campaigns to attract new customers, spot markets might provide an additional incentive to develop unused capacity. If these PCS providers were able to make their spectrum available to subscribers of existing incumbents (who may be capacity-constrained on their older systems), then entrants may have incentives to build out their systems more rapidly over the next several years.

Long-run implications. While a spot market for bandwidth can reallocate capacity among providers to resolve uneven usage problems, it does not provide a long-term solution to shortages spurred by higher demand for new wireless services. If companies are using all their capacity at prevailing prices, they will be more likely to increase price. To keep prices low in the face of increasing demand, the FCC will need to consider other options, such as the forthcoming auction for the spectrum currently occupied by TV channels 60 through 69. With the transition to high definition television, these stations will be relocating to a new portion of the spectrum. As a result, more wireless spectrum should become available, allowing wireless companies to provide new services over their phones.

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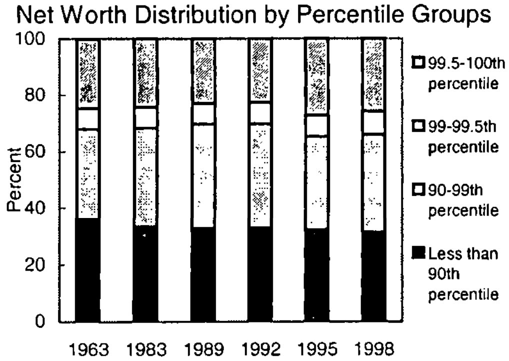
ARTICLE

The Distribution of Wealth Is Top Heavy—As Usual

Among the many favorable trends in the current long expansion have been the halt to rising income inequality, the decline in poverty, and the improvement in living standards for a wide variety of demographic groups. At the same time, however, the expansion has generated large amounts of financial wealth that are concentrated at the top of the distribution. Nevertheless, median wealth has also increased, the increase in overall wealth inequality in the 1990s has been modest, and the distribution of wealth looks about as it has since the early 1980s.

Trends in the concentration of wealth. Real (inflation-adjusted) median net worth rose 18 percent between 1995 and 1998 and increases occurred over a fairly broad range of the wealth distribution. Nevertheless, wealth remains much more unequally distributed than income. In the distribution of household income, the top 20 percent received just under half of aggregate money income in 1998. In the distribution of wealth, the top 10 percent had more than two-thirds of aggregate net worth, and the top 0.5 percent had more than a quarter. This inequality is not new, however (see chart). In 1998, the share of net worth held by the top 10 percent was 68.7 percent compared with 67.0 percent in 1992 and 66.6 percent in 1983.

Net Worth Distribution by Percentile Groups



The composition of net worth. In 1998, the bottom 90 percent of households held 37 percent of aggregate assets and 70 percent of aggregate liabilities (mainly principal residence debt). These percentages are roughly the same as in 1995. While ownership of stocks has become more widespread in recent years, stocks are still disproportionately held by those at the top of the wealth distribution: the bottom 90 percent of households held only 18 percent of all stocks in 1998 (up from 16 percent in 1995). By contrast, they held 65 percent of principal residence wealth and 75 percent of vehicle wealth. Since the major assets of most households are their houses and their cars rather than stocks, it is perhaps not surprising that the sharp increase in stock market wealth between 1995 and 1998 was concentrated at the top of the distribution and that wealth inequality increased somewhat.

Income and poverty. Since most households are not wealthy, trends in income and poverty remain key indicators of economic inequality. Analysis in previous *Weekly Economic Briefings* and the 2000 *Economic Report of the President* has provided encouraging evidence that the rise in inequality since the early 1970s has been arrested in recent years:

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- Gini index. The Census Bureau's Gini index of household income inequality was only 0.4 percent higher in 1998 than it was in 1993. This compares with an increase of 0.7 percent between 1989 and 1992, and 6.7 percent between 1979 and 1989. (The Gini index jumped between 1992 and 1993 when a change in methodology increased measured income at the top of the distribution by more than actual income rose.)

- Income shares. The share of income received by the top 20 percent of families was a high 49.2 percent in 1998, but it was already 48.9 percent in 1993 and had risen from 44.0 percent in 1979 to 46.9 percent in 1992. Similarly, the share of the bottom 20 percent was a low 3.6 percent in 1998, but this was the same as in 1993, and the share of the bottom 20 percent had already fallen from 4.2 percent in 1979 to 3.8 percent in 1992.

- Poverty rate. The poverty rate has fallen sharply since 1993, and the decline has been even faster for an alternative measure reflecting improvements proposed by a National Academy of Sciences panel (such as including the EITC). Nevertheless, the poverty rate remains higher than it was in the 1970s, in part because of the increased proportion of single mothers in the population.

Conclusion. Increases in stock market wealth in the 1990s have produced a modest increase in the concentration of wealth. But real median net worth has also increased substantially. This, together with a variety of other income and poverty indicators, point to an expansion whose benefits have been shared broadly among the population.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

EIA Raises Forecast of Gasoline Prices. The national average price for regular unleaded gasoline reached $1.56 per gallon this week, and the latest monthly forecast from the Department of Energy's Energy Information Administration (EIA) has gasoline prices this summer averaging about 5 to 10 cents more per gallon than in last month's forecast. Assuming relatively smooth operating conditions for refineries and pipelines, EIA forecasts gasoline prices will peak in July, and then fall to $1.38 per gallon by the end of the year. The higher prices for the summer driving season reflect faster growth in petroleum demand, which has contributed to crude oil prices rising back into the $30 per barrel range. Low gasoline inventories are another major contributor to the high gasoline prices. Finally, reformulated gasoline (RFG)—fuel with lower emissions of air pollutants that represents one-third of all gasoline consumption—has averaged about 11.5 cents more per gallon than conventional gasoline over the past 10 weeks as the RFG program has transitioned into more stringent emissions standards.

The Changing Tax Cost of Marriage. While some couples paid a marriage tax penalty and others received a marriage tax subsidy, on average marriage was subsidized by the Federal tax code over the 1984-97 period, according to a recent study. However, the tax cost of marriage has been steadily rising and married couples today are more likely to face a tax penalty than they were in 1984. By 1997, about 55 percent of couples faced an average marriage tax penalty of $1,300 and 34 percent received an average subsidy of $2,200. The study finds that changing tax laws and demographics reinforced each other to increase the tax cost of marriage. Changing tax laws explain 55 to 60 percent of the increase, while the increased labor force attachment of married women also played a large role, since two-earner couples pay a marriage tax penalty, while single-earner couples receive a bonus. Families in which the wife earned more than a quarter of family earnings were found to pay the largest marriage tax.

New Evidence on Job Creation and Destruction in Manufacturing. The fact that U.S. labor markets are characterized by high rates of gross job creation and gross job destruction has been well-documented by researchers. But previous research did not distinguish between job reallocation among different firms versus job flows among different plants of the same firm. A new study addressing this question found that small manufacturing firms with only one plant created jobs at nearly twice the rate of large firms with multiple plants, but they also destroyed jobs at a much higher rate than large firms. Much of this job creation and destruction at small firms was due to startups and shutdowns. For large firms, approximately half of the job reallocation was among plants owned by the same firm. In the aggregate, approximately one-quarter of the reallocation of jobs among manufacturing plants occurred among the plants of one firm. The study also found that net employment at single-plant firms expanded over the past two decades, while employment at large multi-plant firms shrank.

INTERNATIONAL ROUNDUP

OECD Calls for Stronger Action against International Cartels. Further action to enhance the effectiveness of anti-cartel enforcement is vital to member country economies, according to a recent OECD report. The report argues that most government officials, legislators, and citizens are not aware of the extent of the harm done by cartels, and fines in some countries are too low to possibly deter collusion. While precise quantification is impossible, the report does offer some examples of serious harm from recent cases. In one, nearly every major worldwide producer of graphite electrodes recently pled guilty to participating for 5 years in a cartel that affected over $1.7 billion of U.S. commerce alone and raised prices of electrodes by 60 percent. In addition to the direct harm to consumers caused by artificially high prices, these cartels have also created economic waste and inefficiency. The report stresses that international cooperation is particularly important for effective action against cartels. Currently, however, most countries' laws prevent their competition authorities from sharing information with foreign authorities, which has seriously hindered the prosecution of international cartels.

Brussels Pushing to Revise VAT on E-Commerce. The European Commission proposed this week to modify its rules for applying the value added tax (VAT) to certain electronically supplied services, such as software, computer, and radio and television broadcasting services. Currently, digitally delivered services originating within the EU are subject to the VAT (whether or not they are consumed in the EU), while those produced outside the EU are not. The proposed amendments would ensure that only services supplied for consumption within the European Union were subject to the EU VAT, as is now the case for physical goods purchased over the electronic network. The United States has previously urged the Commission to hold off on this proposal given its complicated and potentially damaging implications, and to support the multilateral OECD discussions rather than proceed unilaterally.

Gender Equality Enhances Development. A new World Bank report, "Engendering Development," surveys a wide range of studies and finds that countries that discriminate by gender pay a high price in terms of economic growth, health, and other development goals. For example, cross-country studies show that controlling for the effects of per capita income and other factors on child mortality, a 10 percentage point increase in the female primary school enrollment rate reduces the infant mortality rate by 4.1 deaths per 1,000 births. Countries where girls are only half as likely to go to school as boys have 21 more infant deaths per 1,000 live births than countries with no school gender gap. Another study finds that in Brazil, the positive impact on children's nutritional indicators of additional income in mothers' hands is 4 to 8 times larger than the impact of additional income in fathers' hands. Analysis of Burkina Faso shows that agricultural output could be increased by between 6 and 20 percent simply by reallocating fertilizer and other inputs more equitably between husbands and wives, who typically operate separate plots.

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, June 9, 2000****

The producer price index for finished goods was unchanged in May. Excluding food and energy, producer prices rose 0.2 percent.

Productivity

According to revised estimates, nonfarm business productivity rose 2.4 percent at an annual rate in the first quarter of 2000. Manufacturing productivity rose 7.3 percent.

MAJOR RELEASES NEXT WEEK

Retail Sales (Tuesday)
Consumer Prices (Wednesday)
Industrial Production and Capacity Utilization (Thursday)
Housing Starts (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	**0.2**
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	13.0
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.9
Imports	9.2	13.5	13.8	14.0	14.3
Personal saving	6.6	1.7	1.5	1.3	0.4
Federal surplus	-2.8	1.2	1.4	1.2	1.9

	1970-1993	1999	March 2000	April 2000	May 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	4.1
Payroll employment (thousands)					
increase per month			527	414	231
increase since Jan. 1993					22152
Inflation (percent per period)					
CPI	5.8	2.7	0.7	0.0	N.A.
PPI-Finished goods	5.0	2.9	1.0	-0.3	**0.0**

**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 9, 2000**.

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 8, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10669
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.74
10-year T-bond	5.26	5.65	5.99	6.44	6.13
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.32
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 8, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.955	2.6	-8.5
Yen (per U.S. dollar)	105.9	-2.6	-11.7
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.65	-1.9	1.0

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	5.0 (Q1)	4.1 (May)	3.0 (Apr)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.0 (Q4)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	2.1 (Q4)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

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