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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

November 12, 1999

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pg 6
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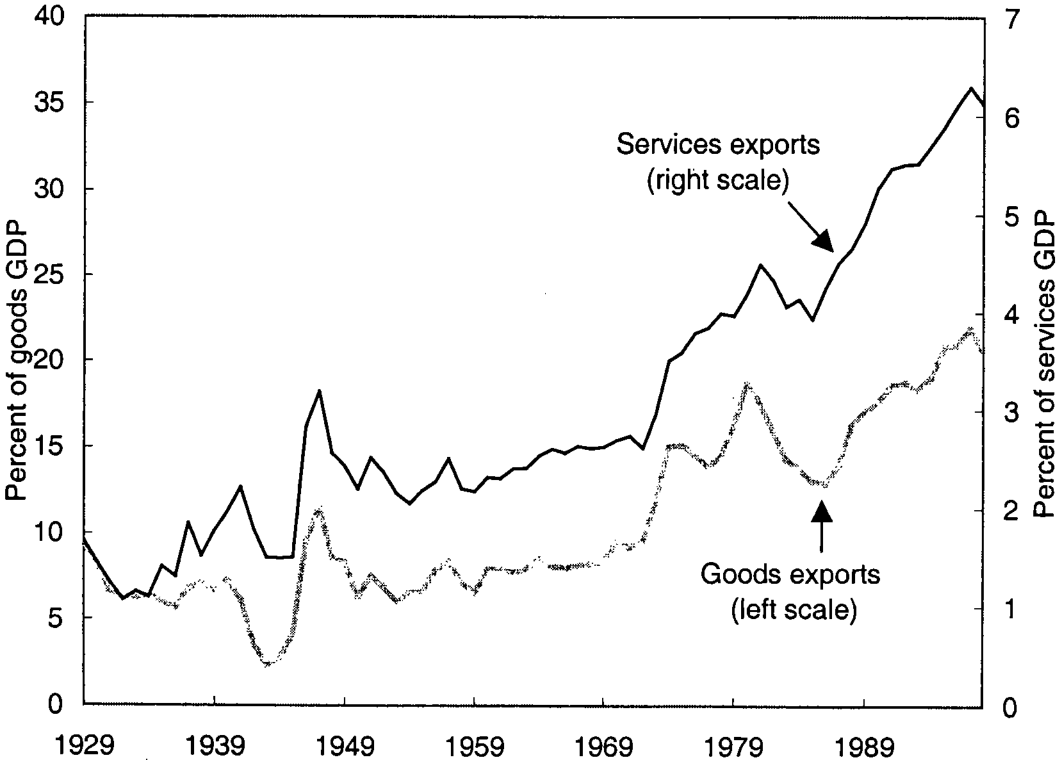
CHART OF THE WEEK

Goods and Services Exports as Share of Sector GDP



For both goods and services, exports have grown much faster than output, especially in the last decade. For services, which include travel and transportation, telecommunications, education, and a variety of financial and business services, exports were more than 50 percent greater as a share of services GDP in 1998 than they were in 1985.

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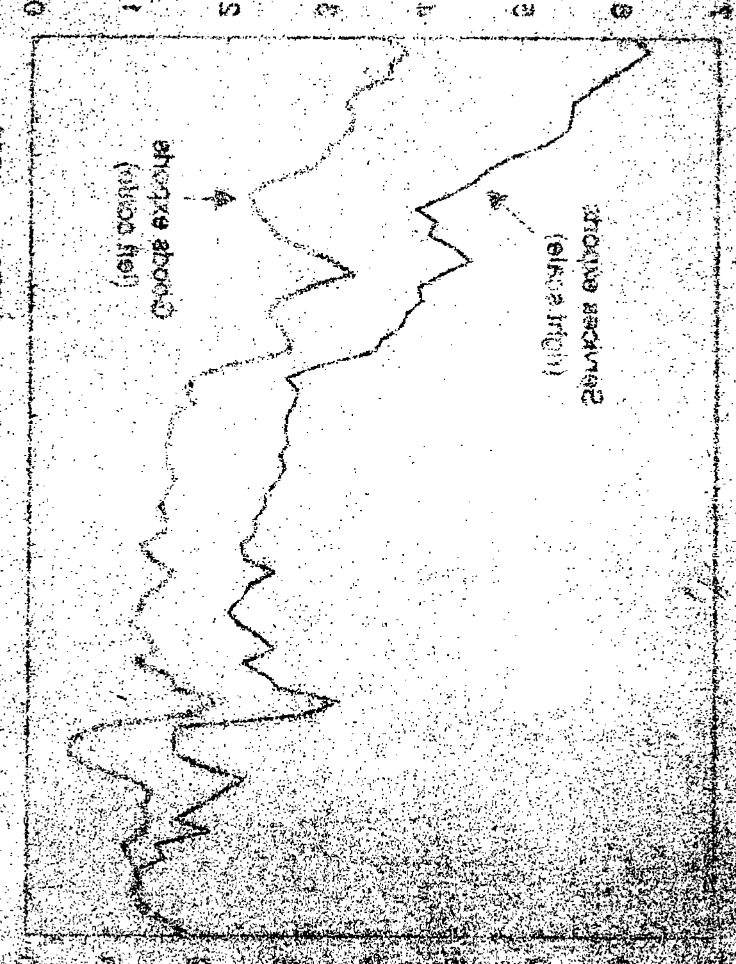
Goods and Services Exports as Shares of Sector GDP



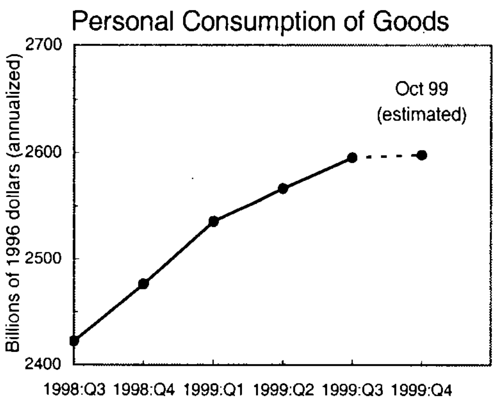
November 12, 1998

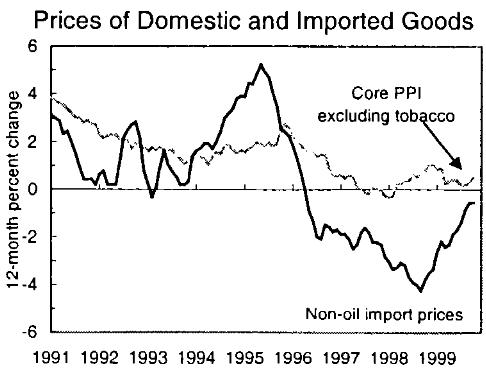
MACROECONOMIC UPDATE

Fourth Quarter Starts Out Strong

Macroeconomic forecasters (on average) are expecting the economy to grow at about a 4 percent annual rate in the fourth quarter. This rate is consistent with October's strong labor market and may reflect expectations of extra inventory accumulation aimed at creating a buffer against possible Y2K disruptions.

Jobs. The jump in payroll employment of 310,000 in October showed that the labor market remains very strong and that the anemic September job growth was probably attributable to Hurricane Floyd. Weekly data on initial claims for unemployment insurance suggest that demand for labor remained strong through the first week of November.





Spending. Personal consumption of goods thus far in the fourth quarter appears to have slowed substantially from the pace of earlier quarters (see upper chart). Motor vehicle sales dropped in October for the second consecutive month, but 1999 is still likely to be the best sales year on record. Spending on other goods has posted sizable gains in the past 3 months—though October's gain was smaller than that of the past 2 months

Inflation. Strong productivity growth and falling non-oil import prices have held inflation in check for the past 4 years. Productivity, which increased 2.9 percent over the past 4 quarters, remains as strong as ever. However, import prices are no longer falling sharply, possibly because of a resurgence of growth abroad. Prices of imported oil dropped sharply in 1998 but rebounded dramatically in 1999. Falling prices of non-oil imports had restrained the pricing power of domestic goods producers (illustrated by the core PPI excluding tobacco in the lower chart). Non-oil import prices fell through April but have been roughly flat since then.

Conclusion. The economy appears to be growing strongly in the fourth quarter. With continued tight labor markets and the change in the import price environment, continued strong productivity growth appears to be the key to keeping inflation tame in the coming year.

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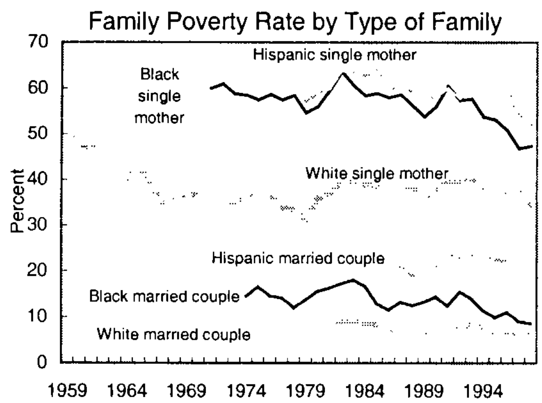
SPECIAL ANALYSIS

Poverty and Family Structure

The good news is that in 1998 the poverty rate among female-headed families with children under age 18 was the lowest it has been in data that go back to 1959. The bad news is that it was still 38.7 percent. This rate stands in marked contrast to the 6.9 percent poverty rate among married-couple families with children. The question naturally arises whether encouraging families to form and stay together could significantly reduce the overall poverty rate.

Trends. Whether white, black, or Hispanic, married-couple families with children under age 18 have much lower poverty rates than single-mother families (see chart). Although black and Hispanic rates have come down in recent years, they remain higher than those of whites in each family type. Nevertheless, it is noteworthy that the poverty rate for black married-couple families with children (about 40 percent of all black families with children) fell to 8.6 percent in 1998. This rate is close to the rate for whites of 6.6 percent.



Why are single-parent rates higher? A one-parent family typically has less earning capacity than a two-parent family simply because it has fewer potential adult earners. Moreover, single mothers who work often earn less than adult men in married-couple families, because less-skilled women typically have much lower earnings than less-skilled men. Single parents might also be seriously limited by parental responsibilities and child-care availability as to when and how much they can work. Finally, married-couple families can benefit from economies of scale in living costs. For example, the income required to keep two single-parent-with-one-child families out of poverty is almost $6,000 greater than the income required to keep a married couple with two children out of poverty, according to the current official poverty thresholds. *

Selection issues. People who become single parents may also have different characteristics from those who marry and stay married, and these differences may increase the likelihood of adverse economic outcomes. In the case of teenage mothers (the majority of whom are unmarried), for example, recent evidence suggests that factors other than the disruptive effects of having a child at a young age (such as family background) may explain a large portion of why teenage mothers fare worse economically than young women who delay their childbearing.

Race differences. Racial and ethnic differences in the proportion of single mothers who have never been married or are divorced can explain some of the disparity in poverty rates across racial and ethnic groups. In particular, 63 percent of black female family heads have never been married, compared with 28 percent for whites; only 17 percent are divorced, compared with 44 percent for whites. This means they are likely to receive fewer resources from fathers. In 1993, for example, never-married mothers were less likely to have a child support award than divorced mothers (44 percent versus 73 percent) and, if they actually received support, it was a much smaller amount ($1,700 versus $3,600).

Policy implications. The benefits of marriage and raising children with two parents are clear and can be seen in this comparison of poverty rates. Unfortunately, research suggests that the reasons for high poverty rates among single mothers reflect more than just the absence of a spouse. Addressing these underlying problems would seem to be an important complement to policies aimed at discouraging out-of-wedlock births and encouraging families to stay together. That said, efforts to improve paternity establishment and child support enforcement can play an important role in providing greater resources to single-parent families.

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ARTICLE

What Comes Next in the Microsoft Case?

Last Friday Judge Thomas Penfield Jackson released findings of fact in the antitrust case against Microsoft. The next scheduled step is the issuance of conclusions of law, followed if necessary by the determination of appropriate remedies. It is possible that the parties could negotiate a settlement at any time in the process.

Findings of fact. Judge Jackson found that Microsoft had monopoly power in the manufacture of operating systems and that it used that power to preserve its position by forestalling competition. He found that an operating system, such as Windows 98, includes a collection of programs called Application Product Interfaces (APIs), designed to provide other programs with a means of interacting with the computer's hardware. He concluded not only that Microsoft was the major supplier of these APIs but also that the company tried to prevent other companies from developing their own APIs or programs that might perform similar functions.

Effects on competitors. Judge Jackson cited numerous instances in which Microsoft leveraged its monopoly status to the detriment of competitors, including ones involving Sun's Java, Netscape's Navigator, IBM's OS2, and Intel. In the mid-1990s, for example, Intel developed new PC microprocessor features that it felt Microsoft's Windows did not fully support. Intel decided to write its own interface programs to allow software developers to access these advanced features. The Judge found that Microsoft, in order to prevent Intel's entry into the API market, pressured major computer manufacturers not to install the software and threatened not to support Intel processors in subsequent versions of Windows unless Intel stopped developing interface software. Faced with such pressure, Intel relented.

Effects on consumers. Judge Jackson found that Microsoft's actions had serious and far-reaching impacts on consumers besides limiting access to new hardware features. First, by unnecessarily tying its Web browser Explorer to Windows, Microsoft forced all manufacturers to ship computers with this browser. This forced businesses and consumers who did not want to use Explorer to incur the cost of using an operating system that was unnecessarily slow and took up more storage space than one without a browser. Similarly, the Judge concluded, Microsoft forced consumers to use overly complicated technology by preventing software manufacturers from adding software that eased consumers' introduction to their new computers. What the judge found most problematic, however, was that Microsoft deterred other companies from producing any software that could intensify competition against one of its core products by developing a reputation for punishing such efforts.

Next steps. Judge Jackson has ordered the parties to file memoranda of law with respect to the conclusions of law that the Court should draw. He further ordered that these memoranda should *not* address the subject of remedy, or injunctive relief, which will be addressed in a separate briefing if warranted. The current schedule calls for the Judge to have these memoranda of law by January 31, 2000.

The issue of remedy thus remains speculative at this point. However, remedies in antitrust cases typically fit into two basic categories:

- <u>Structural remedies</u> such as the AT&T divestiture try to eliminate monopoly by breaking firms with monopoly power into pieces. In the case of AT&T, the settlement separated the long-distance company from the local telephone companies, removing any ability for AT&T to use monopoly control of the local market to limit competition in the long-distance market. Some have argued that a break-up of Microsoft might not resolve the underlying competitive problem identified by the Court, because separation of the applications segment of the company (word processors and spreadsheets) from the operating system market would not end the monopoly in the latter.

- <u>Behavioral remedies</u> would require Microsoft to abandon problematic business practices without changing the structure of the company. Behavioral remedies in the Microsoft case might include providing universal access to technical specifications, requiring uniform pricing, or separating the browser functions from the operating system. It remains a question, in light of the findings of fact, whether such behavioral remedies would work if Microsoft is allowed to retain its monopoly in the operating system market, because the company would still have an incentive to deter future entry and because no list of prohibited activities could ever be exhaustive. In fact, in the consent decree from Justice's previous suit against Microsoft, Microsoft agreed to avoid specific contractual relationships with manufacturers and to avoid using other exclusionary practices that achieve similar effects.

Conclusion. The Court found that Microsoft has monopoly power, which it has used to forestall competition. If the Court subsequently rules that Microsoft has violated the antitrust laws, the design of appropriate remedies will involve complicated economic and legal considerations.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Study Examines Medicaid Enrollment Decline. National Medicaid enrollment for low-income children and their parents declined by 2 percent in 1996 and by an estimated 3 percent in 1997, despite program eligibility expansions in many states and enhanced Federal funding through the Children's Health Insurance Program (CHIP). A recent study investigated these declines by examining Medicaid eligibility policies and operations in five states—California, Colorado, Florida, Minnesota, and Wisconsin. The study found that policy changes from Federal legislation, state decisions, and litigation have created complicated Medicaid eligibility rules that are often difficult for applicants, beneficiaries, and staff to understand. States' automated eligibility determination systems (which handle applications for Medicaid, welfare, and food stamps) were also found to be inadequate because they were designed to meet welfare, not Medicaid, needs. The study concludes that, along with better outreach, states should reassess their Medicaid eligibility requirements and systems to make them more efficient, accessible, and understandable. It also urges better coordination between welfare and Medicaid systems so that families who leave welfare understand the availability of Medicaid coverage.

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to do more
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Racial Differences in Sources of Small Business Financing. According to a recent study examining small businesses in two ethnic Chicago neighborhoods, the start-up capital in black-owned businesses was an estimated 46 percent less than that in comparable Hispanic-owned businesses. However, the amount of personal funding used to start businesses was roughly the same for black and Hispanic owners after adjusting for business and individual characteristics other than race. Although they were unable to estimate precise numbers for other sources of funding, the authors inferred from their data that the smaller amount of start-up capital for black owners may reflect a lack of access to informal capital (such as loans and gifts from family, friends, and business associates). The authors argue that the apparent importance of informal sources of funding suggests that it is worth exploring ways to combine the presumed flexibility and informational advantages of informal networks with the formal sector's ability to raise capital—perhaps through community development financial institutions and micro-lending pools.

Economic Conditions Have Helped Lower Juvenile Crime. According to a new study, declines in the unemployment and poverty rates between 1993 and 1996 explain 28 percent of the reduction in juvenile crime during the period. The study uses nationally representative data on over 16,000 high school students in 1995 to estimate the effect of personal, family, and neighborhood characteristics—as well as deterrence measures such as police spending and arrest rates by county—on juveniles' propensities to commit crime. It then uses these results to estimate how the decline in unemployment and poverty rates have affected juvenile crime. The study concludes that juveniles respond to both incentives and sanctions, and that employment opportunities, increased family income, and more strict deterrence are effective tools to reduce juvenile crime.

INTERNATIONAL ROUNDUP

Europe Tightens Monetary Policy. Amid signs that European growth is strengthening, the European Central Bank (ECB) raised interest rates by 0.5 percentage point last week, bringing the main refinancing rate to 3 percent. This was accompanied in London by the Bank of England's raising rates by 0.25 percentage point to 5.5 percent. The ECB's decision reversed the rate reductions made in April and reflected a view that the balance of risks had shifted toward higher inflation—though it is worth noting that the euro-zone unemployment rate was 10 percent in September and consumer prices were only 1.2 percent higher than a year earlier. The rate hike appears to be motivated by a desire to keep inflation expectations safely below the ECB's target ceiling of 2 percent per year.

New Venture Launched to Fight Malaria. In a first for international public health, public agencies and the private sector recently joined together to create a unique organization to develop anti-malarial drugs that would not otherwise be brought to market. The World Health Organization (WHO), the International Federation of Pharmaceutical Manufacturers Associations, and the World Bank are among the sponsors of the partnership—dubbed the Medicines for Malaria Venture (MMV). The MMV aims to register, on average, one new anti-malarial drug every 5 years. According to the WHO, about $150 million will be required to bring each new drug to market and make it accessible. The pharmaceutical industry will complement this financial outlay with "in kind" support, such as access to chemical libraries. An estimated 300 to 500 million malaria cases are contracted worldwide each year, resulting in one million deaths. The direct and indirect costs of malaria in sub-Saharan Africa exceed $2 billion per year, according to one estimate.

Unrealized Hopes in Transition Economies. Hopes that privatization in transition economies would create the foundation for improved governance and transform the ties between the state and firms have not been fully realized, according to the European Bank for Reconstruction and Development's *Transition Report 1999.* Rather, enterprises in these economies spend considerable resources lobbying state officials, paying bribes, and adjusting to state interference. In return, enterprises receive benefits in the form of subsidies, soft finance, preferential tax treatment, and the tolerance of arrears. A survey of 3,000 firms in 20 transition economies confirms that corruption is a major problem in these countries, particularly for small businesses. Thirty-seven percent of small enterprises report paying bribes frequently, compared with only 16 percent of large enterprises. The average bribe paid by small firms is also higher, absorbing 5.4 percent of annual revenues, nearly double the 2.8 percent paid by large firms. New firms also tend to pay higher bribes. The average "bribe tax" is generally higher in the Commonwealth of Independent States (5.7 percent of company revenues), than in central and eastern Europe (3.3 percent). The report also finds that privatized firms pay a bribe tax similar to that paid by state-owned firms.

RELEASES THIS WEEK

Productivity

Nonfarm business productivity rose at an annual rate of 4.2 percent in the third quarter. Manufacturing productivity rose 3.4 percent.

Retail Sales

Advance estimates show that retail sales were unchanged in October following a decrease of 0.1 percent in September. Excluding sales in the automotive group, retail sales rose 0.5 percent following an increase of 0.6 percent.

Producer Price Index

The producer price index for finished goods fell 0.1 percent in October. Excluding food and energy, producer prices rose 0.3 percent.

MAJOR RELEASES NEXT WEEK

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

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1999:1	1999:2	1999:3
Percent growth (annual rate)					
Real GDP (chain-type)	3.0	4.6	3.7	1.9	4.8
GDP chain-type price index	5.2	1.1	2.0	1.3	1.0
Nonfarm business (NFB) sector:					
Productivity (chain-type)	N.A.	**3.1**	**2.7**	**0.6**	**4.2**
Real compensation per hour:					
Using CPI	N.A.	**3.9**	**2.8**	**1.2**	**2.2**
Using NFB deflator	N.A.	**4.7**	**2.9**	**2.9**	**4.4**
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.5	12.6	12.6	12.8
Residential investment	4.5	4.2	4.4	4.5	4.4
Exports	8.2	11.0	10.7	10.7	10.9
Imports	9.2	12.7	12.9	13.4	13.9
Personal saving	6.6	2.6	2.2	1.8	1.5
Federal surplus	-2.8	0.5	1.1	1.3	N.A.

	1970-1993	1998	August 1999	September 1999	October 1999
Unemployment Rate (percent)	6.7**	4.5**	4.2	4.2	4.1
Payroll employment (thousands)					
increase per month			129	41	310
increase since Jan. 1993					19794
Inflation (percent per period)					
CPI	5.8	1.6	0.3	0.4	N.A.
PPI-Finished goods	5.0	0.0	0.5	1.1	**-0.1**

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1997	1998	September 1999	October 1999	Nov. 10, 1999
Dow-Jones Industrial Average	7441	8626	10714	10397	10598*
* The close on Nov. 11 was 10595					
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.68	4.86	5.05
10-year T-bond	6.35	5.26	5.92	6.11	6.00
Mortgage rate, 30-year fixed	7.60	6.94	7.82	7.85	7.67
Prime rate	8.44	8.35	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 10, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.044	-0.0	N.A.
Yen (per U.S. dollar)	104.6	0.1	-14.9
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	92.56	0.2	-1.8

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	4.1 (Q3)	4.1 (Oct)	2.6 (Sep)
Canada	3.7 (Q2)	7.5 (Sep)	2.5 (Sep)
Japan	0.9 (Q2)	4.7 (Sep)	-0.2 (Sep)
France	2.1 (Q2)	11.0 (Sep)	0.7 (Sep)
Germany	0.6 (Q2)	9.1 (Sep)[2]	0.6 (Sep)
Italy	0.8 (Q2)	12.1 (Apr)	1.8 (Sep)
United Kingdom	1.8 (Q3)	5.9 (Jul)	1.1 (Sep)

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 unified Germany.