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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

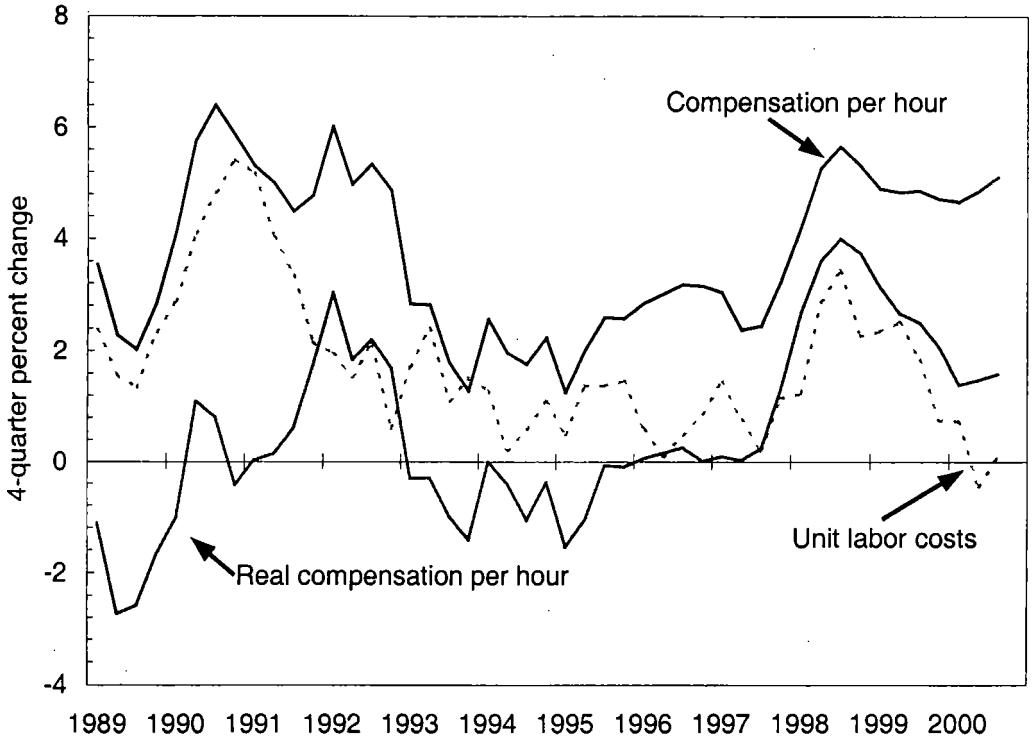
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

November 10, 2000

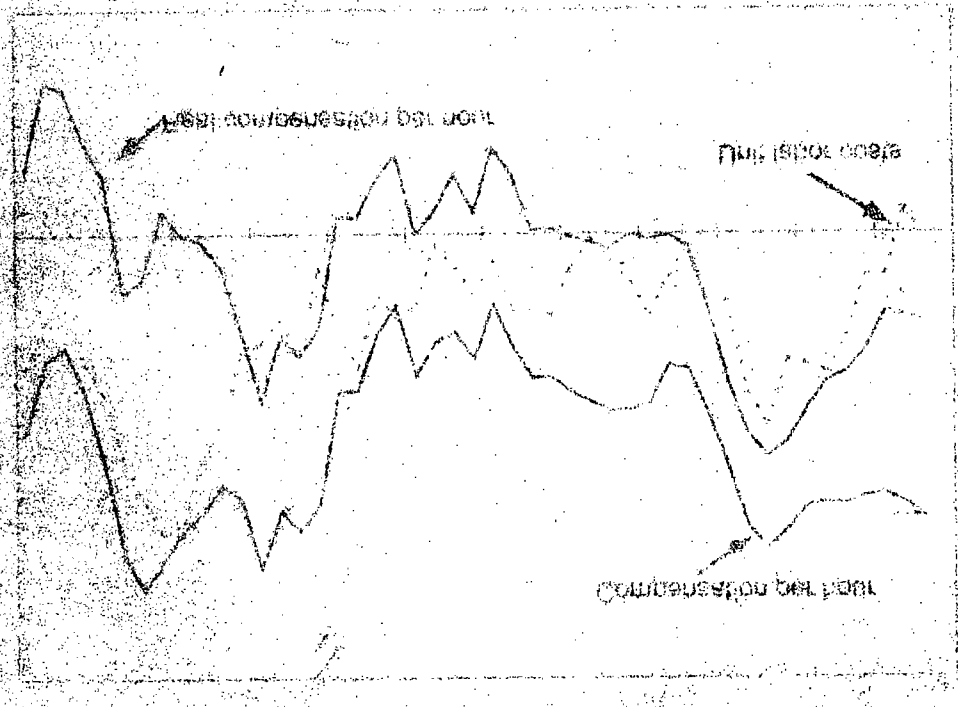
Copied
Baily
Podesta

CHART OF THE WEEK

Employee Compensation and Labor Costs



Wages and compensation increased solidly in nominal terms in the past four quarters. From the standpoint of businesses, however, these wage increases were offset by strong productivity gains, with the result that unit labor costs did not put upward pressure on product prices. From the standpoint of workers, increases in the consumer price index associated with higher energy prices have restrained increases in real compensation.



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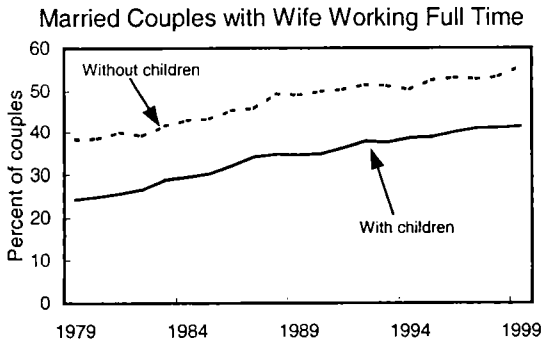
"Working at home has been a mixed blessing."

SPECIAL ANALYSIS

Combining Work and Motherhood

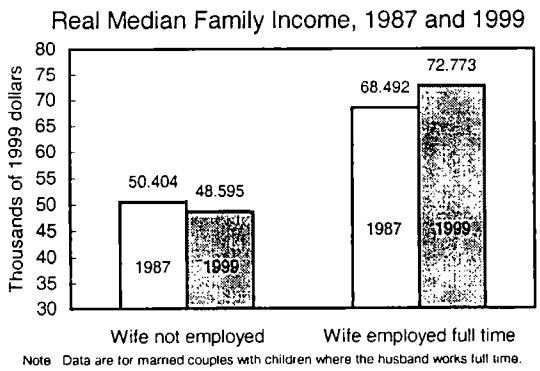
As noted in a recent Chart of the Week, the American family passed a milestone in 1999, when more than half of married women of childbearing age were both working for pay and rearing children. These mothers make an important contribution to family income, but new data show that dual-earner families may face additional stress associated with their high child-care needs.

More women are working, including more mothers. The increase in labor force participation among married women with children is part of a general pattern of rising labor force participation among women. Impressive increases in the 1970s and 1980s have persisted in the 1990s, probably reflecting a combination of factors such as an increase in flexible work schedules; higher wages associated with increased female educational attainment—which raises the rewards from work while making child care relatively more affordable; and a strong economy that has generated numerous job opportunities. Married women with children are still less likely to work full time compared with married women without children. But in percentage terms, the increase in full-time work among mothers has exceeded that for all married women, and full-time work is as common among mothers now as it was for married women without children in the mid-1980s (see upper chart).



Note: Data are for married couples where the husband works full time.

Working mothers boost married-parent family incomes. The gap between the incomes of two-earner and single-earner married families with children has widened since the late 1980s. Real median income for families with full-time working mothers rose over 6 percent between 1987 and 1999, while that for families where the mother was not employed actually fell (see lower chart). Among married couples, the share of families with wives' earnings greater than husbands' earnings has risen from about 16 percent in 1981 to 22-23 percent in the 1996-99 period (with most of the increase occurring over the 1980s). Some evidence suggests that working mothers may contribute particularly large amounts to family incomes near the top of the distribution: more-highly educated mothers have higher labor force

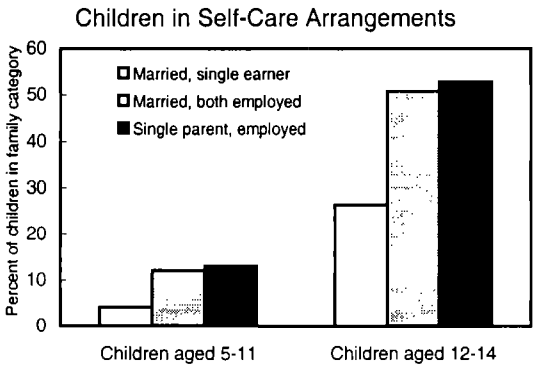


Note Data are for married couples with children where the husband works full time.

PHOTOCOPY
WJC HANDWRITING

participation rates than other mothers, and they tend to be married to more-highly educated men.

Who will watch the kids? The typical two-earner family has a higher income than the typical one-earner family, but that income gain comes with challenges. One is the need to make child care arrangements. Flexible job arrangements can help. However, barely more than a quarter of working mothers have such flexibility. Evidence that some families may struggle to find day care arrangements comes from a recent Census Bureau report showing that dual-earner families are more likely than single-earner families to rely on "self care" for their school-aged children (see chart). (Self care is a situation in which children are home alone for some period of time "on a regular basis," although not necessarily as a primary arrangement.) Indeed, the prevalence of self care in dual-earner families is quite similar to that of single-parent families.



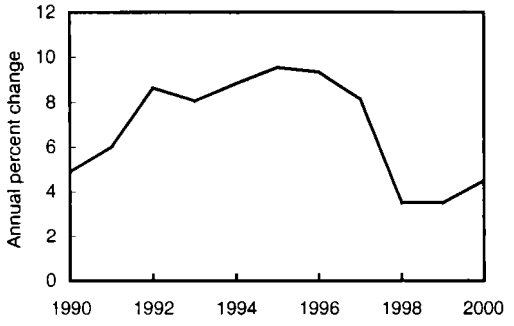
Conclusion. The continued increase in labor force participation of married mothers means families have more income and enjoy the benefits associated with greater financial well-being. However, families may have a difficult time substituting for the child care role more traditionally filled by mothers. Moreover, other recent data indicate that two-earner families have less time for home activities, including time with children and housework; although two-parent, higher-income families still report lower stress than other families, the gap has begun to close recently.

SPECIAL ANALYSIS

Prospects for Reform and Growth in Vietnam

Even with an expected uptick this year, economic growth in Vietnam is likely to remain well below the 8-10 percent annual rates achieved from 1992 to 1997 (see chart). It is unclear whether reforms undertaken this year will be adequate to restore the earlier high growth rates.

Vietnam: Growth in GDP



The power of reform. Vietnam's "doi moi" reforms begun in 1986 are generally believed to have been central to the subsequent strong growth in real GDP. These reforms terminated the cooperative agricultural system, encouraged private enterprise, lifted price controls, and opened the economy to foreign investment. The private sector accounted for over 90 percent of employment and 60 percent of GDP in 1999. The agricultural sector—now overwhelmingly private—accounts for nearly 70 percent of employment and 25 percent of GDP.

Slowing reforms and the Asia Crisis. By the time the Asian crisis hit in late 1997, the pace of reform had begun to slow. The combination of foreign investors' perceptions that the business climate in Vietnam had turned hostile and a general reticence over new investment in emerging markets is seen as leading to the abrupt decline in the inflow of foreign capital. Prior to the crisis, Vietnam had experienced only limited inflows of short-term portfolio investment, and was thus not affected by capital flight during the crisis. But the longer-term foreign direct investment that is a key driving force behind growth fell from around $2 billion per year in 1995-97 to $700-800 million per year in 1998-99. The value of foreign investment approved through May 2000 is reported to be 40 percent below that of the first 4 months of 1999.

Current conditions. Weak consumption and investment in a slowing economy led to a 4 percent current account surplus in 1999 and an expected 2 percent surplus in 2000. The government budget deficit is expected to widen to 3.5 percent of GDP after averaging around 1 percent since 1995, with the larger deficit driven by increased civil service wages and spending on infrastructure projects. Inflation fell to zero at the end of 1999, and prices actually fell through mid-2000. Strong growth reduced the poverty rate from 58 percent in 1993 to 37 percent in 1998, but further progress will require renewed high growth. In 1999, per-capita GDP was around $1,800 on a purchasing power parity basis.

The need for further reform. Restoring normal trade relations with the United States can play a role in fostering stronger growth in Vietnam (see box on next

page). But reforming state-owned firms and encouraging the private sector are critical.

- State-owned firms. These industrial enterprises are largely unprofitable and not subject to market discipline. They are the recipients of the bulk of bank credit; non-performing loans are estimated to be about 35-40 percent of total bank assets. A program to bail out banks and restructure state-owned enterprises is estimated to have a price tag equal to about 12 percent of GDP over 2000-03. Current reform efforts are focused on selling off smaller state-owned enterprises, with measures aimed at larger firms yet to be formulated.

- The private sector. Most private enterprises are small, including some 600,000 household ventures. Fewer than 500 of the more than 5,600 registered manufacturing enterprises have over 100 employees. Licensing requirements and regulations on small business were relaxed this year, resulting in a sharp increase in private business formation. But red tape and corruption continue to hold back the private sector. This year's changes to the foreign investment law make it easier for public and private enterprises with foreign investors to borrow abroad, but it will still be necessary to convince foreign investors that such investment is attractive. The recently opened stock market in Ho Chi Minh City could eventually become a source of funds for investment, but right now only four securities are listed.

Reform prospects. Reforms that improve the allocation of credit and force industrial firms to face competition should improve efficiency and growth. But such reform typically comes with dislocation, including substantial labor shedding by state-owned enterprises. Further policy efforts are thought to be unlikely in advance of the March 2001 Communist Party Congress.

The U.S.-Vietnam Bilateral Trade Agreement

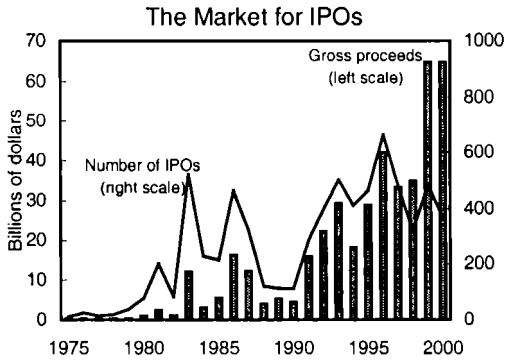
This agreement provides Vietnam with normal trade relations, though not permanently until Vietnam is ready for WTO entry in several years. Upon ratification, goods from Vietnam will face average U.S. tariff rates of around 5 percent rather than the current average of around 35 percent. But the Senate may require quotas on apparel exports before approving the treaty. Vietnam agrees to provide improved access for U.S. goods and services, including lower tariff and non-tariff barriers; protection of intellectual property rights; more hospitable treatment of U.S. investment; and a guarantee to U.S. firms of transparency and the rule of law in dispute settlement. A World Bank study predicts that the lower U.S. tariffs will lead to at least a doubling of Vietnam's exports to the United States, with a 0.9 percent increase in per-capita income in Vietnam. Modest benefits are predicted for the United States.

ARTICLE

The Underpricing of Initial Public Offerings

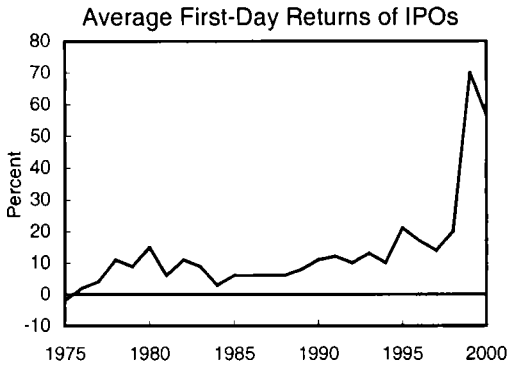
Initial Public Offerings (IPOs)—sales of equity shares to the public by privately owned firms—are an important source of capital in the new economy. But a peculiarity of IPO pricing suggests that companies may not be raising as much money as they could. In particular, the closing price of an IPO on the first day of trading frequently is substantially higher than the initial offering price (which determines the firm's proceeds).

The role of IPOs. Between 1993 and the end of October 2000, private firms going public raised $316 billion through IPOs (see chart). Even after adjusting for inflation, this amount is more than twice that raised in the prior 20 years. The funds raised by an IPO may be used for investment and expansion or to reduce debt. They may also allow certain owners to sell their stakes in the firm. Cross-country evidence suggests, for example, that an active IPO market may be necessary for venture capital to flourish. After an IPO, a firm's stock is traded on the open market. The visibility and liquidity provided by publicly traded stock may also enhance the value to the firm of using stock or stock options to compensate employees. In a typical high-tech IPO, between 5 and 20 percent of a firm's shares are sold. If the firm subsequently needs additional capital, it may be obtained through issuing debt or undertaking additional equity offerings.



Benefits and costs to the firm. An IPO allows firms to raise substantial funds quickly without having to make specific commitments to repay the providers of those funds. For instance, United Parcel Service's 1999 IPO offered about 10 percent of the company to the public and raised $4.3 billion. Raising funds through an IPO entails both one-time and on-going costs. Underwriters—mainly investment banks—typically receive 7 percent of the proceeds raised from the IPO. In return for this fee, the underwriter makes the complex determination of the offering price (using a variety of valuation methods and its own knowledge of the capital markets) and finds buyers for the IPO shares. Becoming a publicly-traded firm then obligates the company to disclose financial information on a regular basis in accordance with SEC rules.

The underpricing phenomenon. Frequently, demand for an IPO at the initial offering price outstrips supply, and the price for an IPO stock at the end of its first day of trading is significantly higher than the initial offer price. This suggests that the offer price could have been higher and that the firm could have obtained more capital or sold fewer shares to raise the same amount of capital. Strong demand



also means that the underwriter must ration the shares, and it is likely that the underwriter's preferred clients will receive the majority of the rationed shares. Underpricing (measured as the percentage increase in the first-day closing price over the initial offering price) was particularly dramatic in 1999 (see chart). In 1999, an estimated $36 billion was "left on the table" by firms issuing IPOs, while individuals and institutional investors lucky enough to be allocated the IPO shares of these firms earned substantial returns.

Explanations for underpricing. The very substantial underpricing in 1999 and early 2000 may turn out to be an anomaly related to an exuberant stock market. Large first-day returns garner significant attention from the business press. With more individual investors following the stock market on a daily basis, it is possible that firms underprice their shares to obtain publicity and attention, which may improve their business prospects or may provide a non-monetary reward to the firm's managers.

Possible reasons for the more persistent longer-term underpricing include the following:

- Signaling quality. In their initial public offerings, shares of high-quality firms may be underpriced if the firms expect to undertake a later secondary offering. Low-quality firms are unlikely to be able to make a successful secondary offering, so they must try to obtain as much capital as possible in the IPO. On average, this combination leads to underpricing.

- Underwriters' incentives. Underwriters receive a fixed fraction of the overall proceeds of an IPO, generally 7 percent. Thus, a higher offer price generates more proceeds for the underwriter. However, underwriters often earn commission revenues when investors trade shares. Underpricing guarantees that investor demand will exceed the supply of shares, and that many shares will change hands on the first day of trading. The allocation of shares to preferred clients may also solidify relationships and lead to future profits. Regulations that somewhat constrain underwriters' pricing flexibility create some risk for the underwriter and may also play a role.

Conclusion. An active IPO market has been an important feature of the new economy. Underpricing is likely to continue to be a feature of a well-functioning market, although probably not at the dramatic levels seen in recent years.

11-13-00

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Moderate Growth, Some Signs of Slowing. Reports from the Federal Reserve Districts generally described their regional economies as growing at a moderate pace in September and early October, but with some additional signs of slowing growth in some areas. Manufacturing activity was generally steady, but some reports noted continuing problems because of labor shortages, higher fuel prices, and competition from imports. Retail spending softened slightly in some districts, and the outlook was a little less positive for the tourism sector. Residential housing sales and construction activity continued to slow in most of the country. Commercial real estate markets remained generally healthy, but some reports indicated that activity might be slowing. Reports on agriculture were mixed, while the energy sector strengthened considerably. Labor markets remained stretched, and some districts indicated increasing wage pressures. Reports also noted higher oil-based manufacturing input costs, although strong competition among producers continued to prevent most firms from passing on much of the cost increases to their customers.

Computers, Innovative Work Practices, and Wages. A new study using data from 1994 and 1997 links higher wages with computer usage and high performance work practices. In particular, computer use in manufacturing was found to be associated with significantly higher wages for front-line workers. High performance practices like teams, employee involvement, and total quality management (TQM) were also found to be associated with higher wages. In non-manufacturing industries, computer usage was associated with higher wages, but innovative practices were not. Studies like these face the difficult task of trying to disentangle the effects on wages of computers, workplace practices, and the higher wages earned by skilled workers, when all three tend to be present in innovative establishments. In this study, a wage premium associated with computer usage persisted after controlling for the presence of innovative work practices. A positive relationship between computer usage and wages also persisted for front-line employees in manufacturing, after controlling for measurable differences in human capital and other individual characteristics based on 1990 Census data.

Heading South. In every year since 1980, more Americans have moved into the South than have moved out, and more have moved out of the Northeast than have moved in, continuing long-term trends. Net movements into and out of the Midwest and the West have varied from year to year since 1993—in contrast to earlier years in which the net movement was, by and large, out of the Midwest and into the West. Between March 1998 and March 1999, one-sixth of the population moved, although 60 percent of movers stayed within the same county. About 8 percent of movers changed regions. While overall moving rates are largest for those aged 20-29 and decline steadily with age thereafter, the people most likely to move to another region are those aged 65 and older. Overall, non-Hispanic whites were the least likely racial or ethnic group to move, but among movers, they were the most likely to move to another region.

INTERNATIONAL ROUNDUP

International Business Alliances Surge. The number of new strategic alliances between companies in different countries grew from around 860 in 1989 to 4,400 in 1999, and these international agreements accounted for 68 percent of the 62,000 alliances formed in the 1990-99 period, according to OECD tabulations. The significant growth in cross-border arrangements is similar to the increase seen in transnational mergers and acquisitions. Through 1995, the bulk of strategic alliances were formed for three major purposes: joint sales and marketing, manufacturing and production, and R&D. Since then other kinds of alliances (such as those to provide business services) have become more important. While U.S. firms formed about two-thirds of all alliances in the 1990s, they accounted for only 43 percent of international ventures. About 60 percent of U.S. cross-border alliances were made with firms in Japan, the U.K., Canada, Germany, and China. Worldwide, the information and communication technologies sector accounted for 37 percent of total R&D alliances in 1980-96, with pharmaceuticals accounting for an additional 28 percent.

European Software Developers Neglect Patents. A report to the European Commission finds that small to medium enterprises and independent software developers in Europe make little use of patents, compared with large companies and U.S. software developers. The analysis argues that the wording of the European Patent Convention (EPC) fosters a widely held misperception by smaller firms that inventions related to computer programs are not patentable. Although the EPC specifically excludes "schemes, rules and methods for performing mental acts, playing games, or doing business, and programs for computers," court rulings have interpreted this language not as a blanket exclusion but simply as requiring that such inventions make a technical contribution. But misperceptions have remained, leading to proposals in the EU for a revision of the patent law governing software.

Many Countries Post Higher Scores on Economic Freedom Index. Global economic freedom is on the rise, according to the Heritage Foundation's latest calculations of its economic freedom index for 155 countries. The index is calculated as an average of a broad array of factors such as corruption, barriers to trade, fiscal burden of government, and regulatory burdens. The index does not purport to measure democracy or political freedom. In North America and Europe 24 of 43 countries improved their scores over last year. Although Sub-Saharan Africa is still by far the least economically free region, 18 countries experienced gains, and only 11 posted losses. Hong Kong and Singapore held on to the top two spots, with Ireland jumping to third as a result of tax cuts, an openness to foreign investment, and a competitive banking system. The United States placed fifth, with the report noting the strong protection of property rights, open trade policy, and the substantial 1999 deregulation of the financial system. As in previous years, North Korea was rated the most economically repressive country, with the worst possible scores in all measures. Vietnam also fared poorly, ranking 144th.

RELEASES THIS WEEK

Producer Price Index

The producer price index for finished goods rose 0.4 percent in October. Excluding food and energy, producer prices declined 0.1 percent.

MAJOR RELEASES NEXT WEEK

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

U.S. ECONOMIC STATISTICS

	1970-1993	1999	2000:1	2000:2	2000:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	4.8	5.6	2.7
GDP chain-type price index	5.2	1.6	3.3	2.4	2.0
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	1.9	6.1	3.8
Real compensation per hour:					
Using CPI	1.0	2.2	-0.2	2.2	3.2
Using NFB deflator	1.5	3.3	1.1	4.0	4.3
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.4	13.7	13.8
Residential investment	4.5	4.3	4.3	4.2	4.1
Exports	8.2	10.6	10.8	11.0	11.3
Imports	9.2	13.4	14.2	14.6	15.0
Personal saving	6.6	1.6	0.1	0.2	-0.2
Federal surplus	-2.8	1.3	2.4	2.4	N.A.

	1970-1993	1999	August 2000	September 2000	October 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	3.9
Payroll employment (thousands)					
increase per month			-79	195	137
increase since Jan. 1993					22358
Inflation (percent per period)					
CPI	5.8	2.7	-0.1	0.5	N.A.
PPI-Finished goods	5.0	2.9	-0.2	0.9	**0.4**

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

New or revised data in **boldface.**

FINANCIAL STATISTICS

	1998	1999	September 2000	October 2000	Nov. 9, 2000
Dow-Jones Industrial Average	8626	10465	10968	10441	10834
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	6.00	6.11	6.21
10-year T-bond	5.26	5.65	5.80	5.74	5.82
Mortgage rate, 30-year fixed	6.94	7.43	7.91	7.80	7.79
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level** November 9, 2000	**Percent Change from** Week ago	Year ago
Euro (in U.S. dollars)	0.857	-0.2	-17.6
Yen (per U.S. dollar)	107.4	-0.9	2.4
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	102.8	0.2	10.7

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	5.3 (Q3)	3.9 (Oct)	3.5 (Sep)
Canada	5.3 (Q2)	6.8 (Sep)	3.2 (Sep)
Japan	0.8 (Q2)	4.6 (Aug)	-0.8 (Sep)
France	3.4 (Q2)	9.7 (Aug)	2.2 (Sep)
Germany	3.6 (Q2)	8.2 (Sep)	2.5 (Sep)
Italy	2.6 (Q2)	10.6 (Jul)	2.6 (Sep)
United Kingdom	2.9 (Q3)	5.3 (Jul)	3.3 (Sep)

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