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THE PRESIDENT HAS SEEN
9-23-96

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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

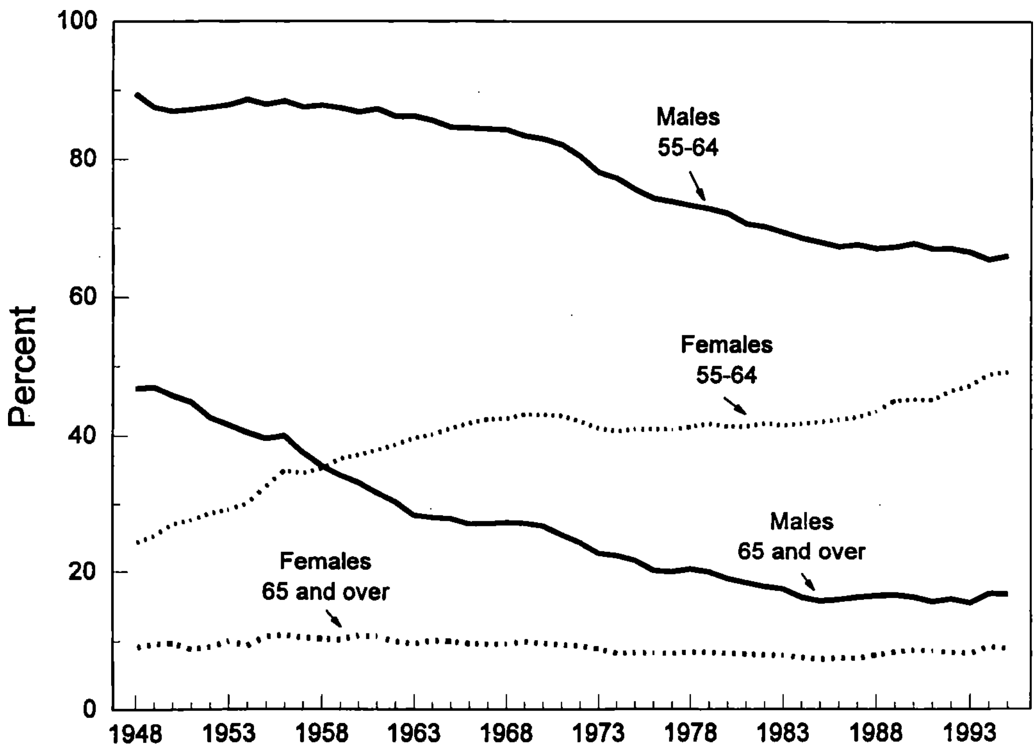
September 20, 1996

9/23

cc: Joe Stiglitz
copied

CHART OF THE WEEK

Labor Force Participation Rates of Older Americans



Labor force participation among men aged 55 and over has been declining at least since the end of World War II, suggesting a trend toward earlier retirement. But the trend has flattened recently, especially for men 65 and older. A Special Analysis in this Weekly Economic Briefing discusses this flattening. The long-term trend toward rising overall female labor force participation accounts for the rise among women 55 to 64. But both their rate and the rate for women 65 and older have flattened out.

Weekly Economic Briefing

The President of the ...

Prepared by the Council of Economic Advisers with the ...

CHART OF THE WEEK

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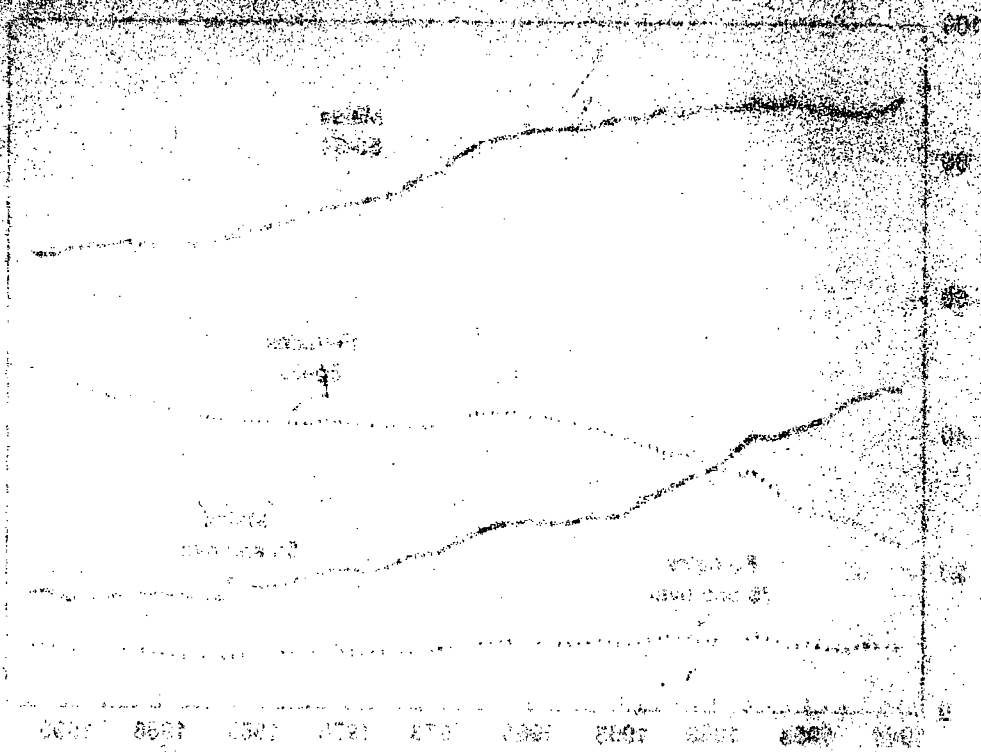

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"What's this I hear about you adults mortgaging my future?"

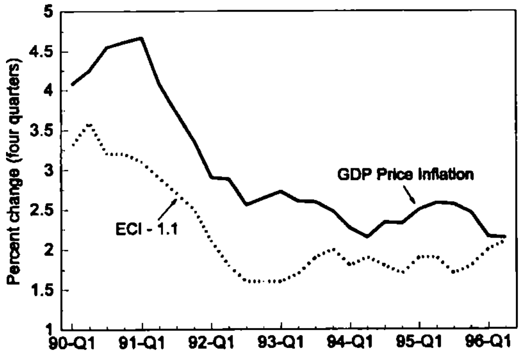
CURRENT DEVELOPMENT

Inflation Update

So far this year, price inflation remains subdued. Wages have begun to accelerate, but they do not yet pose a threat to price inflation.

Prices. Over the past 12 months, the CPI has increased 2.9 percent, 0.3 percentage point faster than its year-earlier pace. All of the rise, however, is due to increases in volatile food and energy components. The core CPI, which excludes food and energy, rose only 2.6 percent over the past 12 months, down from 2.9 percent the year before. The rise in food and energy inflation, which was anticipated in the Administration's last economic forecast, should reverse next year. The price index for GDP, a broader measure of inflation, also grew more slowly than it did a year ago (2.1 percent versus 2.6 percent).

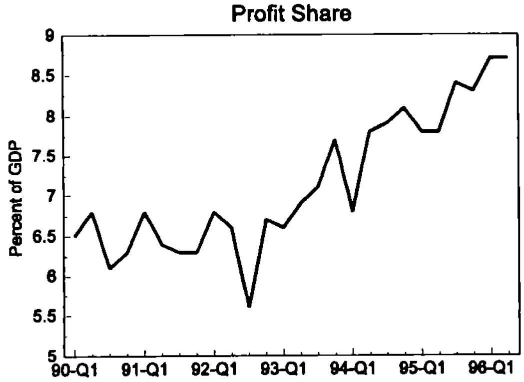
Inflation and Trend Unit Labor Costs



Wages and hourly compensation. In contrast to the stability in prices, wages have started to accelerate. The employment cost index (ECI) for wages and salaries rose 3.4 percent, 0.5 percentage point faster than it did in the year-earlier period. For several reasons, this pick-up in wages is not yet a threat to price inflation:

- Increases for non-wage benefits, especially medical insurance premiums, have been running below wage inflation, so that the ECI for total compensation increased only 2.9 percent.
- Trend unit labor costs are not rising faster than prices. Subtracting trend productivity of 1.1 percent per year from wage increases of 3.4 percent, prices could go up about 2.3 percent per year with no erosion of profit margins. This is about the current pace of GDP price inflation (see upper chart).
- Profits are currently high (see lower chart), so a further rise in wage inflation would not necessarily cause an immediate acceleration of prices.

Profit Share



Long-term outlook. Although inflation remains subdued, the consensus of economists is that maintaining unemployment at its current relatively low level may well cause inflation to start rising.

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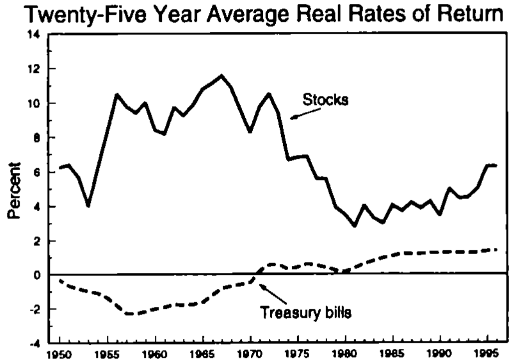
SPECIAL ANALYSIS

Stock Returns over the Long Term

Leading stock market indexes reached new highs this week. Over short periods of time, stock price movements can be highly volatile. But over longer periods, stocks have outperformed safer instruments, such as Treasury securities.

Twenty-Five Year Average Real Rates of Return



Note: 1996 data are projections. Years represent the end of a 25-year period.

High stock returns over long periods. Between 1926 and 1995, the total rate of return on stocks (as measured by the Standard and Poor's 500 stock index with dividends reinvested) averaged 10.5 percent per year, while that on Treasury bills was just 3.7 percent. These differences in return have an enormous impact on the long-term value of investments. A dollar invested in stocks in 1926 would have risen to more than $1,100 today, while a dollar invested in Treasury bills would have increased to only $13. In fact, for every 25-year period since 1926, an investor would have done better investing in stocks than in Treasury bills (see chart).

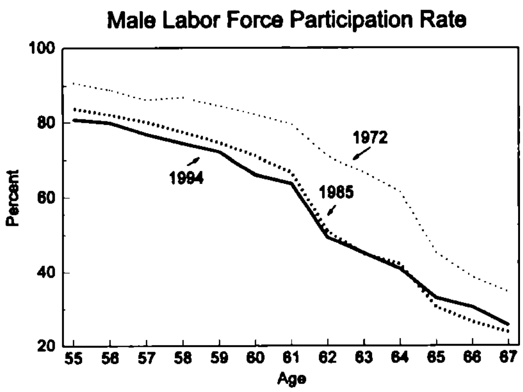
Relative performance over shorter periods. Over short holding periods, high stock price variability means returns on stocks can be very poor, often considerably below those on less volatile Treasury securities. Indeed, the standard deviation of the annual return on stocks since the mid-1920s has been over five times that of the 1-year return on Treasury bills. However, studies over the past decade have shown that the return on stocks has not been risky enough to explain the substantial premium earned relative to Treasury bills over shorter investment horizons, such as 1 year.

The future? Despite a recent uptick, the premium earned on stocks relative to Treasury bills over 25-year intervals ending after the early 1970s has been much lower than it was in the 1950s and 1960s. In part, high average stock returns in the earlier period may have reflected a high perceived riskiness of equities caused by the 1929 stock market crash. As the memory of that event faded from investors' minds, stock prices may have been bid up, reducing their rate of return. Two recent studies have found that the premium earned on stocks in the 19th and early 20th century was only 2 or 3 percentage points, more similar to that prevailing in recent years than to the very high differentials that prevailed in the 1950s and 1960s. Nonetheless, these studies confirm that while the size of the premium has varied, long-term returns on stocks have almost always significantly exceeded those on Treasury securities for a century or more. These results make it difficult to understand why investors would hold Treasury securities rather than stocks when investing for the long term, such as for retirement.

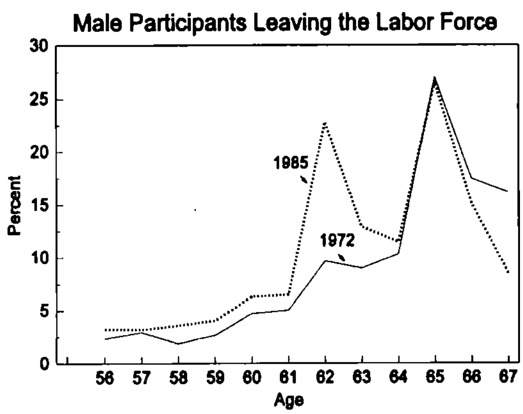
SPECIAL ANALYSIS

Has the Trend toward Earlier Retirement Ended?

The average age of retirement for men has been falling for most of the post-World-War-II era (see Chart of the Week). But recent evidence shows a slowdown in this trend and hints at a reversal.



Labor force participation rates. Data on labor force participation rates of older men at specific ages are available back to 1972. They show that these older men's labor force participation rates fell between 1972 and 1985, but have changed little since (see upper chart). In 1972, for example, 91 percent of 55-year-old men were in the labor force, but this participation rate fell to 84 percent in 1985 and has come down only a little since.



Two additional features of male retirement behavior are revealed in the lower chart, which shows the percentage of men who leave the workforce at any given age (for example, the percentage of men in the labor force at age 59 who have left the labor force by age 60). First, the retirement rates of 55-to 61-year-old men increased moderately between the early 1970s and middle 1980s. Second, males have become much more likely to retire at age 62.

The trend toward early retirement. The reduction in retirement age has occurred despite the elimination of mandatory retirement for almost all workers, the enactment of strict legislation banning age discrimination, and marked increases in life expectancy. Three sets of factors work to encourage earlier retirement:

- Higher incomes. Many Americans are retiring earlier because they can now afford to do so. Household incomes increased rapidly through the late 1970s as did Social Security and private pension benefits. Workers reaching age 65 in 1960 received Social Security benefits equal to about 33 percent of their pre-retirement earnings; by the mid-1980s this replacement rate was about 43 percent. Similarly, the proportion of persons 65 and over receiving employer-based pensions rose from less than a quarter in the early 1970s to almost a third in the middle 1980s.

- Incentives. Many private pension plans have changed in ways that encourage many workers to retire earlier. This explains a portion of the increase in retirement prior to age 62 and, in combination with the rise in Social Security benefit levels occurring during the 1970s, is likely to be responsible for the growing propensity of men to retire at 62.

- Job opportunities. Older job losers are now out of work longer and experience larger wage reductions than their younger counterparts, which could induce early retirements.

A trend toward later retirement? Economic factors help explain why participation rates have recently stopped declining and raise the possibility that the retirement age will begin rising. Social Security replacement rates have remained virtually unchanged since the mid-1980s, and the retirement age for collecting full benefits is scheduled to increase. The rapid growth of private pension coverage ended in 1970, implying a subsequent stabilization in the fraction of retirees receiving benefits. Moreover, firms have increasingly shifted from defined benefit to defined contribution pension plans. The latter do not contain the same incentives for early retirement. Finally, slow wage growth during the 1980s and early 1990s, possibly combined with more limited employer contributions to retiree health insurance benefits, may make it more difficult for future cohorts to afford retirement at young ages.

Educated Baby Boomers May Retire Later

A recent study focusing on the state of Wisconsin projects that the average educational attainment of older workers will increase rapidly as the highly educated baby-boomers age. At every age level, labor force participation increases with educational attainment. In 1993, for example, the labor force participation rate for those 55 and older was 56 percent for college graduates compared to 31 percent for high school graduates. By the year 2020, the study projects that the share of high school dropouts in the 55 and older cohort will fall to 15 percent from 40 percent in 1990, while the share with at least some college will climb from around 25 percent to nearly 50 percent. As a result, the state's older labor force participation rate is projected to increase 7 percent. The same trend holds true for the entire nation; older workers will be a lot better educated in the next quarter century. And, such workers tend not only to stay on the job longer but also to earn more and derive more satisfaction from using their skills.

ARTICLE

Implementing the Telecommunications Act of 1996: The Devil Must Be in the Details Because It's Hot Down Here

With deserved fanfare, the Telecommunications Act of 1996 became law in February, promising a competitive telephone industry unencumbered by the regulations and monopolies of the past century. But creating competition is not simply a matter of legislative declaration, especially when controversies regarding market power and dominance will persist for some time. The magnitude of the Federal Communications Commission's Order on interconnection with local telephone companies, and efforts by some of those companies to overturn the FCC's regulations in the courts, point out that translating the promise of competition into reality will be a long and arduous process.

Hefty orders for hefty issues. The First Report and Order implementing the local competition provisions of the Telecommunications Act–known as the "Section 251" proceeding–weighs in at over 700 pages, with over 3,200 footnotes. The length and complexity of the order are especially striking in light of the fact that the Act gives competitors the right to negotiate among themselves, subject only to state mediation and arbitration.

Much of the complexity arises because firms wishing to enter new markets to offer local telephone service in competition with the incumbent may do so in three ways:

- End-to-end providers. An entrant can build a network that allows its customers to make and receive local telephone calls without using the incumbent's facilities. Because a telephone system is more valuable if it can communicate with everyone who has a phone, these "end-to-end" entrants need to interconnect with the established telephone company, so that their customers and those who stay with the incumbent can talk to one another.

- Using the incumbent's facilities. An entrant into local exchange service may find it useful to provide some facilities on its own (for example, a switch that can direct incoming calls to its customers), but it may still wish to use "network elements" provided by the incumbent (for example, the copper wire loops that connect an individual telephone to the rest of the system).

- Reselling the incumbent's service. Finally, an entrant may wish to purchase the ability to provide local telephone service from the established carrier on a wholesale basis, and then "resell" the service to final customers. A long-distance company like AT&T, MCI, or Sprint, for example, might want to offer its customers "one-stop shopping" for both long distance and local service in advance of or instead of building its own local network.

The following table summarizes some of the disputed issues and the FCC's resolution:

Entrant type	*Entrant concern*	*Incumbent position*	*FCC decision*
End-to-end	Incumbent preserves monopoly by refusing to interconnect	Act provided for negotiation between entrants and incument; FCC intervention will undermine process	Sets standards for negotiating interconnection agreements between existing local telephone companies and new end-to-end providers
Use "network elements"	Incumbent offers too few elements at too high a price	Entrants demand inefficient slicing of network; forward-looking incremental cost rules will not pay for past investments	Determines what "network elements" (loops, switches, and other discrete components) incumbent carriers should make available; specifies cost-based methods for setting their prices
Reseller	Obtain service at wholesale rates that permit profitable retail competition	Inadequate compensation; grants resellers rights to buy residential service at subsidized, below-cost rates	Sets a default discount of 17-25% based on estimates of incumbents' "avoided costs" related to retailing

The tip of the iceberg. Despite its size and scope, this Order represents only a small fraction of the regulatory effort necessary to implement the Act fully:

- State regulators will still have to mediate and arbitrate interconnection negotiations between incumbent local telephone companies and new entrants.
- The FCC will have to make contentious decisions regarding whether the local telephone companies have met the Act's conditions for being allowed to offer long distance service.
- The FCC still ~~has to determine a long-term~~ mechanism for ~~funding "uni~~versal service" subsidies for telephone service to ~~low-income or~~ high-cost (generally ~~rural) areas~~, Those services have traditionally been funded through "access charges" paid by long distance carriers to local telephone service providers. The current charge is 6¢ per minute; long distance carriers such as AT&T argue that the cost is less than a penny. Even the incumbent local telephone companies concede that the costs are only about 1.5¢ per minute, but they claim that the additional revenues are necessary to provide subsidies that hold down local telephone rates. Their opponents claim that the incumbents are merely "lining their pockets."

The road to competition is long and potholed. State and FCC decisions in all of these matters are unlikely to be the final word. This interconnection Order has already wound up in the courts, and according to the FCC Chairman, "almost every communications company will have sued" the Commission by the time it finishes its work on universal service and access charges. The years of debate prior to passage of the Telecommunications Act likely presage the years of regulation and litigation necessary to realize its goals. The lesson in this industry, as in others that have been or will be deregulated, is that the issues are complex and will require active policy oversight to ensure a proper outcome.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Older Residents Invest Less in Local Schools. A recent study confirms what many in suburban towns have already suspected: elderly residents are more likely to vote against increasing school spending. The study shows that states with a relatively large elderly population tend to spend considerably less per pupil, after adjusting for regional differences. Over the long run, this could have a major impact on education, as the elderly share of the population is projected to rise from 12.5 percent to nearly 19 percent in 2030. The study predicts that this aging will lead to a 10 percent decrease in per-student spending.

Credit Card Delinquencies Up. The rate of late payments on credit cards rose to a record high in the second quarter, according to the American Bankers Association's latest figures. Delinquencies–loans past due 30 days or more–were reported on 3.66 percent of credit card accounts, up from 3.53 percent in the first quarter. The rate of the increase, however, has slowed from the first quarter's large jump. The report attributes the increase to looser lending standards used by banks 18 to 24 months ago. Although banks have been tightening lending standards, it will take time before this is translated into lower delinquency rates.

Blizzard-Inspired Baby Boom. When calculating the cost of the $500 per child tax credit, the Congressional Budget Office left a factor out of its budget estimate–the weather forecast. Now, nearly 9 months after the blizzard of 1996 dumped 3 feet of snow on Washington and kept residents confined to their homes for days, hospitals and doctors are preparing for what could be the busiest baby season in years. Eight area hospitals report that the number of women registering for September or October deliveries is up 20 to 25 percent over last year. Hospitals report they are preparing extra facilities and hiring more nurses for what they expect to be a record-breaking month. Other East Coast cities are likely to show similar effects from "The Week the Streets Turned White."

INTERNATIONAL ROUNDUP

U.S. Oil Giant Launches Russian Joint Venture. On Thursday, ARCO and LUKoil, Russia's largest oil company, announced the creation of LUKARCO, which is being described as Russia's largest joint venture to date. Investment in the joint venture could total up to $5 billion over the next 18 years, with ARCO, which will hold a 46 percent stake, providing most of the financing. LUKoil has been Russia's leader in overseas investments in oil projects, and the new joint venture is expected to participate in LUKoil's projects in Azerbaijan, Kazakhstan and western Siberia. The pr~~ivatization~~ of Russia's oil industry is relatively well-advanced, with three-quarters ~~of the country~~'s oil-producing units and four-fifths of all enterprises in the fuel and energy complex now owned or controlled by private interests. Nevertheless, foreign investors ~~were banned from initial~~ offerings in this sector, and legal hurdles have further discouraged foreign investment. Overall, foreign investment in Russia has been quite weak, cumulating to only $5.5 billion by the end of 1995. Hungary, by contrast, attracted $4.5 billion in 1995 alone. According to Russian official statistics, total investments worth $2 billion make the United States the most significant foreign investor in Russia.

Mixed Signals in the Second Quarter for Japan's Recovery. Following double-digit growth in the first quarter, real GDP in Japan contracted in the second quarter at a seasonally adjusted annual rate of 2.9 percent. The second quarter number, however, is influenced by some anomalies. For example, observers speculate that some of the 1.3 percent decline in private consumption is attributable to declining food purchases following the food poisoning scare. Also, public investment fell 66 percent at an annual rate, in the aftermath of an extended period of fiscal stimulus. Net exports of goods and services also reduced growth, as Japan's ~~trade~~ surplus continued to decline in the second quarter. Adding to growth, residential investment was up 3.7 percent, and private non-residential investment was up 1.6 percent.

RELEASES THIS WEEK

Housing Starts

Housing starts increased 4 percent in August to 1.53 million units at an annual rate. For the first 8 months of 1996, starts were up 11 percent compared with the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $11.7 billion in July from $8.2 billion in June.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.5 percent in August. Capacity utilization increased 0.2 percentage point to 83.5 percent.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Thursday)
Income and Poverty Report for 1995 (Thursday)
Gross Domestic Product (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	0.3	2.0	4.8
GDP chain-type price index	5.3	2.5	2.1	2.3	2.2
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	–1.1	1.8	0.5
Real compensation per hour:					
Using CPI	0.6	1.4	1.6	0.0	-0.1
Using NFB deflator	1.3	2.1	2.8	2.0	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	10.3
Residential investment	4.5	4.0	4.0	4.1	4.2
Exports	8.2	11.1	11.4	11.3	11.2
Imports	9.2	12.4	12.3	12.5	12.6
Personal saving	5.1	3.4	3.8	3.6	3.2
Federal surplus	–2.7	–2.2	–2.1	–2.1	–1.7

	1970–1993	1995	June 1996	July 1996	August 1996
Unemployment Rate	6.7**	5.6**	5.3	5.4	5.1
Payroll employment (thousands)					
increase per month			219	228	250
increase since Jan. 1993					10508
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	0.1
PPI-Finished goods	5.0	2.3	0.2	0.0	0.3

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

FINANCIAL STATISTICS

	1994	1995	July 1996	Aug. 1996	Sept. 19, 1996
Dow-Jones Industrial Average	3794	4494	5496	5686	5868
Interest Rates					
3-month T-bill	4.25	5.49	5.15	5.05	5.11
10-year T-bond	7.09	6.57	6.87	6.64	6.87
Mortgage rate, 30-year fixed	8.35	7.95	8.25	8.00	8.14
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 19, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.515	−0.0	2.0
Yen-Dollar	109.4	−0.8	5.0
Multilateral $ (Mar. 1973=100)	87.70	−0.2	0.8

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	5.1 (Aug)	2.9 (Aug)
Canada	1.2 (Q2)	9.8 (Jul)	1.2 (Jul)
Japan	3.9 (Q2)	3.4 (Jul)	0.0 (Jun)
France	0.4 (Q2)	12.2 (Jun)	2.2 (Jul)
Germany	1.1 (Q2)	7.1 (Jun)	1.3 (Jul)
Italy	1.6 (Q1)	12.5 (Apr)	4.0 (Jun)
United Kingdom	1.8 (Q2)	8.1 (Jul)	2.2 (Jul)