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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

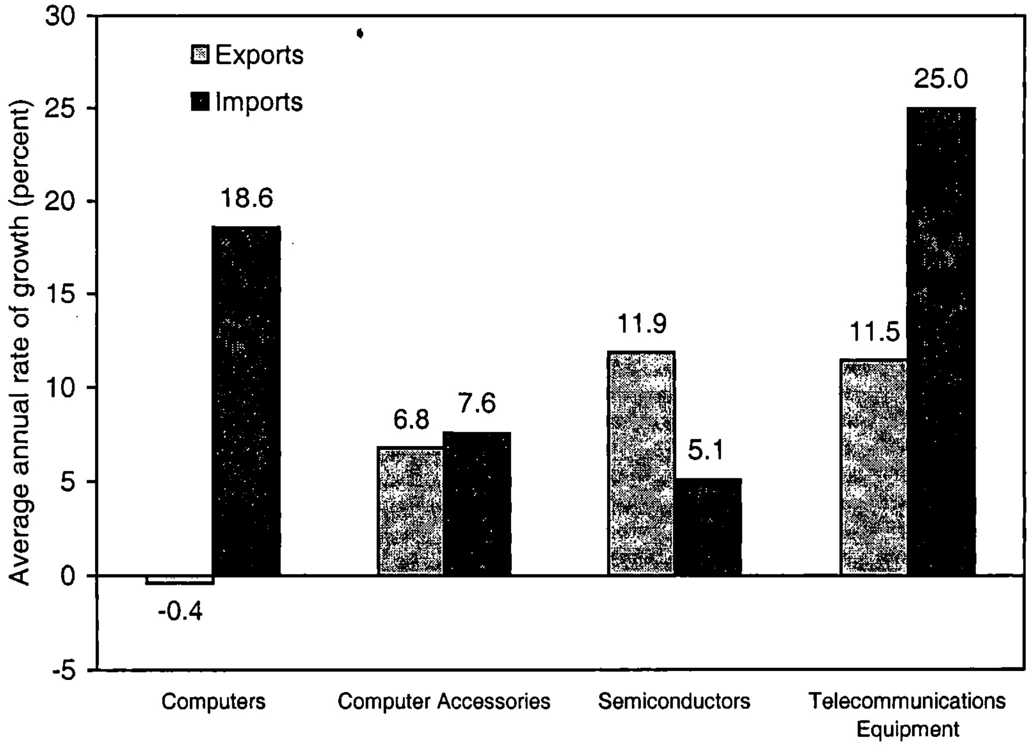
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

October 6, 2000

Copied
Entire Report:
Bailey
Podesta
Pg 6:
Sperling

CHART OF THE WEEK

Growth in IT Imports and Exports, 1996-2000



Since 1996, imports of information technology (IT) goods have grown particularly rapidly. Except for computers, export growth has also been fairly strong. However, an important share of the IT investment that has been driving growth and productivity has come from imports.

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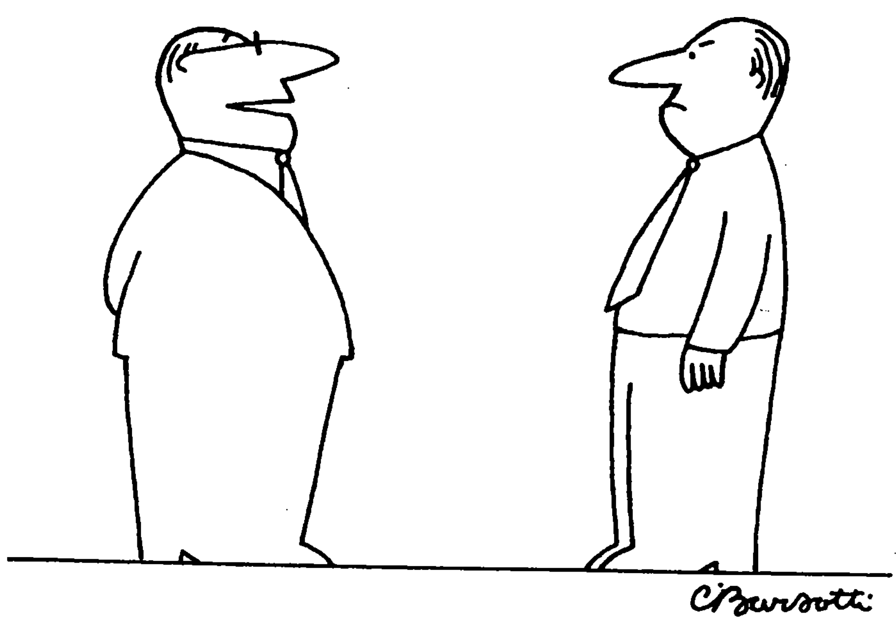
DEPARTMENTS

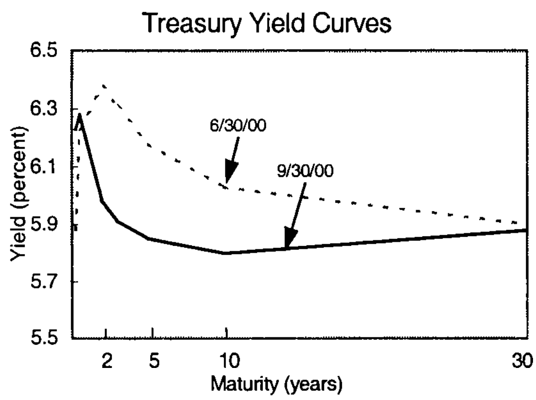


"No, no, your job's not going out of the country to some foreign bastard. We're just firing you."

FINANCIAL MARKET UPDATE

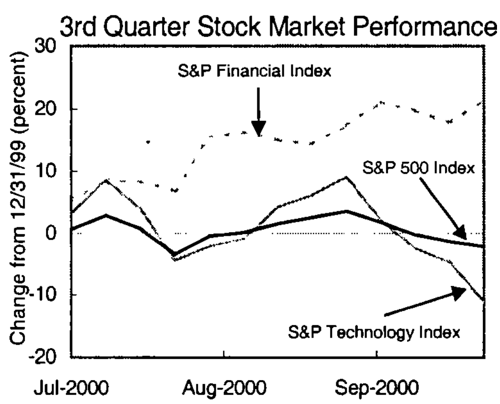
Markets Appear to Anticipate a Cooling Economy

Financial markets ended the third quarter anticipating, correctly, that the Federal Reserve would not raise interest rates at this week's FOMC meeting. Movements in interest rates and stock prices have been consistent with growing evidence that economic growth is moderating.



Interest rates. After peaking in May, when the Fed last increased its target Federal funds rate, yields on Treasury securities have come down across a broad range of maturities. The yield curve, which became inverted in January, remains so (see upper chart). The fact that long-term rates are lower than short-term rates generally implies that markets expect economic activity to be moderate and are not anticipating a pick-up in inflation.

Peculiarities with the 30-year bond. The perception that 30-year bonds will be in scarce supply as the Federal debt is repaid has pushed their yields down relative to those of other long-term securities and compromised their role as a benchmark for long-term interest rates. However, rates on 30-year Treasuries rose back to their June level in late September, while other long-term rates remained flat, possibly because of speculation as the election approaches that the Federal debt might not be repaid as fast as previously expected.



Stock prices. Lowered earnings expectations contributed to a decline in broad-based stock indexes like the Standard and Poor's 500 at the end of the quarter (see lower chart). Declines in technology stocks were particularly acute. By contrast, a moderating interest rate outlook appears to have contributed to strong growth in financial stocks.

Conclusion. Financial market developments in the third quarter point to a growing perception that economic growth is moderating. Rising energy prices may be contributing to this perception of slower growth, but they do not yet appear to be fueling inflationary expectations.

SPECIAL ANALYSIS

Worker Perceptions of International Trade

Recent protests at the IMF/World Bank meetings in Prague are the latest manifestation of a backlash against globalization that encompasses a variety of issues, including questioning the benefits of free trade. Survey evidence suggests that many Americans share concern about the effects of increased trade, but it also reveals that worker perceptions vary depending on their skill level.

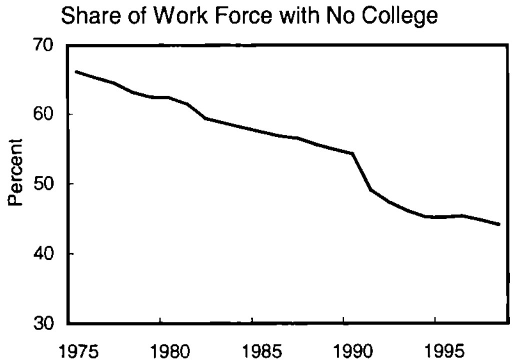
Americans recognize the good and bad. Extensive survey evidence suggests that a strong majority of Americans believe that international trade increases product variety (nearly 90 percent), reduces prices (over 60 percent), and fosters innovation (some 75 percent). However, a substantial majority also think that trade depresses wages (close to 70 percent), and many believe that trade destroys jobs (between 40 and 56 percent). Moreover, when asked to weigh the costs and benefits of free trade, about half of Americans emphasize the detriments, siding with protectionist policies. Survey responses also show an aversion to the job dislocation created by trade, even if new jobs pay more.

Who stands where? Economic theory suggests two possible models to explain which workers are likely to support free trade and which are likely to oppose it. One is industry-based: to the extent that workers perceive that their economic well-being is tied to a specific industry, those working in import-competing industries will view free trade less favorably than those working in export industries. The other theory is skill-based. U.S. exports tend to use skilled labor more intensively than import-competing U.S. goods and services, suggesting that more-skilled workers might be more favorably disposed toward free trade than less-skilled workers.

A new study analyzing the survey evidence provides strong support for the latter view. On an industry basis, workers in trade-protected sectors were no more or less likely to support protectionist policies than those in exposed industries. However, less-skilled respondents were more likely to favor protection, while more-skilled workers leaned toward freer trade.

Motives for protectionism. Less-skilled workers may blame international trade for the slow wage growth and rising wage inequality that took place between the early 1970s and the early 1990s. They may even acknowledge that technological change is a more important cause of those wage problems but still expect the quickened pace of globalization to exacerbate the situation in the future. In addition, less-skilled workers may believe that technological change is not under government control, leaving protectionist policies on trade and immigration as the only way to combat wage problems.

Implications. As technology and policy continue to drive increased international trade, less-skilled workers could stiffen their opposition to trade liberalization. However, since the mid-1990s, real-wage growth has been widespread, and particularly strong among less-skilled workers. In addition, the share of less-skilled workers in the labor force has been declining, to the point where less than half of the labor force is now composed of workers with no college (see chart). Although anti-trade sentiment is still significant, the combination of a declining share of unskilled workers and rising economic prosperity even among the less-skilled may soften opposition in the coming years as the economic benefits of free trade become more apparent.



ARTICLE

Investing Government Surpluses

Although the United States is projected to run large and growing budget surpluses over the coming decade, current long-term projections show a return to deficits later in the century. In the meantime, investing surpluses could provide a buffer against higher Federal tax burdens in the future. The experience of other countries provides some insight into how such investment might take place.

State and local bonds—the example of Canada. With the creation of the Canadian Pension Plan (CPP) in 1966, the Canadian federal government chose to invest pension surpluses in provincial debt. In effect, the Federal government subsidized provincial borrowing by accepting an interest rate equal to the federal long-term bond rate prevailing at the time of purchase, rather than the higher rate at which the provinces would normally have to borrow.

A risk of this plan is that states or provinces may treat such debt purchases as transfers rather than as obligations. For example, although it never actually defaulted, Ontario flatly declared in the late 1970s that it would not repay its CPP debts. Subsequent reforms reduced the proportion of provincial debt in the CPP portfolio and required that such debts bear market interest rates. Recently, most of the outstanding 20-year government bonds held by the CPP were purchased in the early 1980s when interest rates were relatively high: the weighted average annual return of these securities in 1997 was over 11 percent. In the United States investing in state and local bonds might actually boost Federal income tax receipts, to the extent that Federal purchases crowded out purchases by individuals whose interest earnings are currently tax-exempt.

Mortgage company bonds—the example of Sweden. Starting in the 1960s the Swedish government used budget surpluses to buy the obligations of government-controlled mortgage companies. This subsidy may have supported the growth of investment in the housing market of 6 percent per year in the 1960s, compared with 3 percent in the United States and 2 percent in Germany. However, subsequent deregulation of the financial system led to a real estate bubble and forced the government to collect the "bad" loans in a special government-owned mortgage company.

In the United States, analogous purchases of the debt of government sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac would most likely increase these companies' activities in secondary mortgage markets, thereby expanding the amount of credit available for the construction of homes. This could lead to an increase in home-ownership rates (and perhaps put upward pressure on real estate prices). However, investing in GSEs is controversial. First, such obligations carry some risk. Second, Federal government ownership of GSE obligations could strengthen investors' perceptions of an implicit guarantee, even though

GSEs are not part of the Federal government and their securities are not federally guaranteed.

Equities—the example of Norway. In 1990 Norway created a fund, managed by the central bank, to invest petroleum revenues in foreign bonds and, after the 1997 reforms, equities. Various guidelines put limits on risk, the percentages to be invested in stocks and bonds, the amounts that can be invested in different regions, and the amount that can be invested in any one company (less than 3 percent). The government was also precluded from taking part in the management of any firm.

Annual rates of return have so far been strong (9 percent in 1998 and 12 percent in 1999 for the overall portfolio), but there has been substantial volatility in shorter time frames. For example, the equity portfolio fell nearly 16 percent in the third quarter of 1998, causing an overall loss in the total portfolio of 3.6 percent for that quarter. As was probably inevitable, the allocation and management of the Petroleum Fund has raised political questions. In particular, some of the companies in which the fund has invested have been criticized for their lack of environmental standards or abuses of human rights. Banning investments in tobacco companies has also been proposed. The government has responded by creating a second smaller fund that will invest in companies considered "environmentally sound."

Conclusion. These examples illustrate some of the pros and cons of different approaches to investing budget surpluses. While investing in state and local bonds could help boost federal tax revenues, the Canadian case raises concerns about debt repayment. Buying Fannie Mae or Freddie Mac obligations could boost homeownership but raises questions about risks and implicit government guarantees. Finally, an independently managed fund could achieve high rates of return over the long run by investing in a diversified portfolio of bonds and equities, but the Norwegian experience suggests the need for safeguards against politicization of the fund and its management.

10-9-00

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

A Majority of Prisoners are Parents. Fifty-five percent of state prisoners and 63 percent of Federal prisoners reported having a child under 18 in 1999, according to new report from the Bureau of Justice Statistics. These prisoners were the parents of an estimated 1.5 million children, more than 2 percent of all minor children in the United States in 1999. According to the report, 7 percent of black children had a parent in prison, much higher than the 1 percent of white children and the 3 percent of Hispanic children. However, more than half of imprisoned parents reported that they did not live in the same household as their children before their arrests, possibly softening the impact on those children of having imprisoned parents. Female prisoners were slightly more likely than male prisoners to have minor children, although the greater number of men in prison means that most imprisoned parents were male. About 90 percent of imprisoned fathers reported that their children were being cared for by the child's mother, while half of the imprisoned mothers reported that their children were being cared for by grandparents. About 2 percent had a child in a foster home, agency, or institution.

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Elderly Women and Poverty. The latest data on income and poverty are full of good news, but the plight of elderly women remains a concern. The poverty rate for all unrelated women aged 65 and over was 21 percent in 1999. But the rate for blacks in this group was 44 percent and the rate for Hispanics was 59 percent. Moreover, these rates have not shown any substantial improvement over the past decade, and the poverty rate for elderly unrelated Hispanic women is higher than it was in 1989. Social security and SSI are especially important sources of income for this group. In 1998 only 22 percent of unmarried elderly women had pension income, compared with 40 percent of married couples. Only 8 percent of elderly unmarried Hispanic women received private pension income.

Gene

[illegible]

Incentive Effects of the Social Security Earnings Test. Despite the recent removal of the Social Security Earnings test for beneficiaries at or below the normal retirement age, younger beneficiaries remain subject to a provision that reduces their current benefits when their earnings exceed a certain threshold. Although these reductions are subsequently restored in a roughly actuarially fair manner once a beneficiary reaches normal retirement age, the earnings test is seen by some as a disincentive to paid work. A recent study notes that sentiment to remove the remaining earnings test could mount as the baby boom approaches retirement age and examines the likely effects of such a change. Using 1973-98 data to examine the effects of past changes in the earnings test, the study found no strong evidence that an earnings test affects aggregate employment, hours of work, or earnings for men. While it did find some suggestive evidence of a labor supply effect for women, the authors conclude that removing the remaining earnings test would probably not have much of an effect on the labor supply of older Americans. It did find, however, that removing the earnings test could increase the number of people claiming benefits early.

10-9-00

INTERNATIONAL ROUNDUP

Direct Investment Continues to Boom Worldwide. Worldwide outflows of foreign direct investment (FDI) may surpass one trillion dollars in 2000, according to the latest *World Investment Report* by the United Nations Conference on Trade and Development. FDI rose 16 percent to $800 billion in 1999, driven largely by mergers and acquisitions. Cross-border M&A activity rose 35 percent, with some 6,000 deals valued at $720 billion. While developing ~~countries received a record high~~ $208 billion in FDI inflows in 1999, the majority of FDI continued to flow to developed nations, foremost the United States. FDI flows to most of East and Southeast Asia, particularly Japan, surged after the 1998 financial crisis, although China saw an 8 percent decline. However, UNCTAD predicts that China's accession to the WTO could boost FDI inflows from 1999's $40 billion to over $60 billion in the next several years.

Trade and the Environment. Conventional wisdom may not accurately reflect the academic literature on the relationship between freer trade and the environment, according to a recent assessment by the International Trade Commission. In contrast to the popular perception that trade will concentrate pollution-producing sectors in the developing world, empirical evidence indicates that freer trade does not move production into polluting industries in the developing world, and in fact can shift production toward cleaner sectors. And even when it does not, trade puts pressure on firms to adopt environment-friendly techniques that more than offset the small negative effect. Empirical evidence is ~~ambiguous as to~~ whether or not trade liberalization will degrade global environmental quality.

Need more aggressive int'l global measures re pollution climate change.

Crony Capitalism and Currency Crises. Corruption indicative of crony capitalism alters the structure of capital inflows, which in turn raises the probability that a country will have a currency crisis. This is the conclusion of a recent study, which finds that corrupt countries receive less foreign ~~direct~~ investment, but may not be disadvantaged in obtaining bank loans. As a result, corruption in a capital-importing country tends to tilt the composition of its capital inflows away from FDI and toward foreign bank loans. This may be because those making direct investments are more likely than international banks to have repeated interactions with local officials (for permits, taxes, health inspections, and so on), making local corruption more detrimental to FDI than to other forms of capital flows. This finding is robust against three different measures of corruption. Several studies have shown that the composition of capital inflows is correlated with the incidence of currency crises. In particular, the lower the share of FDI is in total capital inflow the more likely a country is to experience a currency crisis.

PHOTOCOPY
WJC HANDWRITING

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, October 6, 2000****

In September, the unemployment rate fell to 3.9 percent from 4.1 percent in August. Nonfarm payroll employment rose by 252,000.

Leading Indicators

The composite index of leading indicators decreased 0.1 percent in August following a decrease of 0.2 percent in July.

NAPM Report on Business

The Purchasing Managers' Index rose 0.4 percentage point to 49.9 percent in September, the second consecutive month below 50 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent that it is generally declining.)

MAJOR RELEASES NEXT WEEK

Producer Prices (Friday)
Retail Sales (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:4	2000:1	2000:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	8.3	4.8	5.6
GDP chain-type price index	5.2	1.6	1.6	3.3	2.4
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	8.0	1.9	5.7
Real compensation per hour:					
Using CPI	1.0	2.2	1.3	0.0	1.7
Using NFB deflator	1.5	3.3	2.9	1.1	2.9
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.0	13.4	13.7
Residential investment	4.5	4.3	4.3	4.3	4.2
Exports	8.2	10.6	10.8	10.8	11.0
Imports	9.2	13.4	13.9	14.2	14.6
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	2.4

	1970-1993	1999	July 2000	August 2000	September 2000
Unemployment Rate (percent)	6.7**	4.2**	4.0	4.1	**3.9**
Payroll employment (thousands)					
increase per month			**-40**	**-91**	**252**
increase since Jan. 1993					**22266**
Inflation (percent per period)					
CPI	5.8	2.7	0.2	-0.1	N.A.
PPI-Finished goods	5.0	2.9	0.0	-0.2	N.A.

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

New or revised data in **boldface.**
Employment and unemployment data **embargoed until 8:30 a.m., Friday, October 6, 2000.**

FINANCIAL STATISTICS

	1998	1999	August 2000	September 2000	Oct. 5, 2000
Dow-Jones Industrial Average	8626	10465	11015	10968	10725
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	6.09	6.00	6.07
10-year T-bond	5.26	5.65	5.83	5.80	5.87
Mortgage rate, 30-year fixed	6.94	7.43	8.03	7.91	7.83
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 5, 2000**	**Percent Change from Week ago**	**Year ago**
Euro (in U.S. dollars)	0.869	-1.6	-18.8
Yen (per U.S. dollar)	109.3	1.6	2.2
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	101.5	0.9	10.3

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	6.1 (Q2)	**3.9** (Sep)	3.4 (Aug)
Canada	5.3 (Q2)	6.8 (Jul)	2.5 (Aug)
Japan	0.8 (Q2)	4.7 (Jul)	-0.7 (Aug)
France	3.4 (Q2)	9.6 (Jul) [2/]	1.7 (Aug)
Germany	3.6 (Q2)	8.3 (Jul)	1.8 (Aug)
Italy	2.6 (Q2)	10.8 (Apr)	2.6 (Aug)
United Kingdom	3.2 (Q2)	5.5 (May)	3.0 (Aug)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, October 6, 2000.**

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

2/ Data from OECD standardized unemployment rates.