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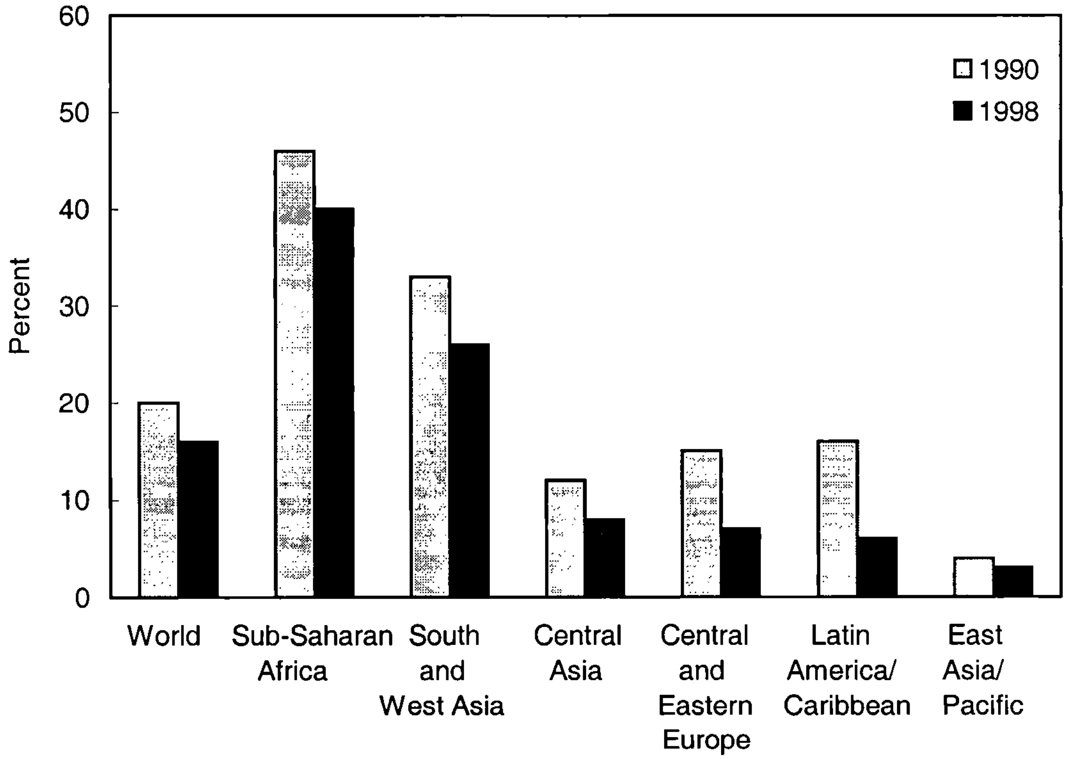
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 5, 2000

CHART OF THE WEEK

Primary-School-Aged Children Not Enrolled in School



The proportion of primary-school-aged children not enrolled in school has fallen worldwide and in all less developed regions since 1990. In 1998, 97 percent of the 113 million out-of-school children lived in less developed regions, and nearly 60 percent of them were girls.

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"What was it this time, old economy or new economy?"

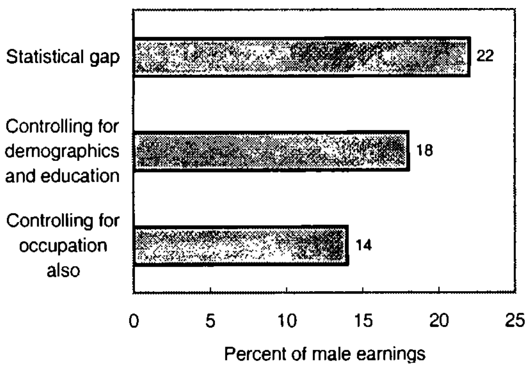
SPECIAL ANALYSIS

Gender Pay Differences in the IT Labor Market

In the U.S. labor market, women earn only about three-quarters as much as men. Gender pay differences in the rapidly expanding field of information technology (IT) provide one perspective on the sources of this pay differential.

Employment and earnings in IT. The IT field is characterized by both high-paying jobs and high employment growth. (IT is defined here to comprise the following five occupations: electrical and electronic engineering, computer systems analysts and scientists, operations and systems researchers and analysts, computer programmers, and computer operators). A CEA analysis finds that the median IT worker earns 74 percent more than the median worker in other occupations ($947 per week versus $544 per week). Employment in IT has grown by almost 23 percent over the past 10 years, to approximately 3.4 million workers, and projections by the Bureau of Labor Statistics suggest that this rapid growth will continue.

Gender Difference in Earnings in IT, 1997-1999



The IT gender pay gap. Women working full time in IT earn about 22 percent less than men—about the same difference as in the labor market generally. Part of this gap reflects gender differences in demographic characteristics such as age and race and in educational attainment. After controlling for these factors, women were found to earn 18 percent less than men (see chart). Differences in the number of hours worked appear to have little effect.

The importance of occupation. Controlling for occupation within the IT sector explains another large part of the pay gap. Only about a fifth of workers in the two most highly paid IT occupations (electrical engineering and computer systems analysts and scientists) are women. By contrast, women account for two-fifths of workers in the other three occupations. In the CEA's statistical model, the gender earnings gap in IT fell to about 14 percent once differences in occupational composition were taken into account.

How much is discrimination? It is tempting to conclude that the impact of gender discrimination is captured by the 14 percent gap that remains after controlling for occupation, education, and demographic characteristics. Some might even argue that the statistical gap is an "upper bound" that would be reduced still further if data were available that would allow an even finer division of occupations. Even with such data, however, it would be difficult to resolve more fundamental concerns about the underlying reasons for the substantial gender differences in occupation composition. First, some women may choose to pursue career paths that provide increased flexibility for devoting time to their families but that also pay less. Second, systematic gender discrimination may exist in hiring and promotion. For example, women may be less likely than men to be hired as systems analysts or may have lower mobility from programming positions to systems analyst positions. Third, women may respond rationally to perceived discriminatory practices by reducing the investments they make in their own careers and thus achieve less.

Conclusion. A statistical analysis of the gender pay gap in IT finds that the raw gap of 22 percent falls to 14 percent once differences in occupation, age, race, and education are taken into account. To the extent that women choose to sacrifice pay for flexibility or other advantages, the gap might be even smaller than this. However, to the extent that discrimination pushes women into lower paying occupations, this statistical analysis—which focuses on the average of gender wage differences observed within occupations—understates the true gap.

SPECIAL ANALYSIS

Instant Messaging Disconnect

With network goods, where the value to each user rises as the number of connections increases, the firm with the largest network has an advantage. The instant messaging (IM) market provides an interesting test case of how a dominant firm reacts to competition, and whether consumers' ability to switch services—even at a relatively low cost—is sufficient to preserve competition.

What is IM? Instant messaging services provide a way to send short messages among individuals in pre-established groups using the Internet. Users of the service are notified when other users in their group are online and able to exchange messages with them. America Online has become a leading supplier of this technology, and it claims that it has 90 million registered users. AOL's software can be downloaded at no charge from the Internet, enabling anyone with an Internet connection to send instant messages to other users of AOL's software.

Interconnection and competition. IM is one element of the bundle of services Internet access providers use to compete for customers and advertising revenue. For a dominant firm like AOL (which some claim has a 90 percent market share), there is very little incentive to give away that advantage to rivals by allowing interconnection. Microsoft, which provides its own instant messaging service for users of its network, wanted to interconnect its customers to those using AOL's services. Rather than reaching an agreement with AOL, however, Microsoft devised software that would create the linkage. AOL, in turn, blocked Microsoft's repeated attempts to interconnect to AOL customers.

Creating a standard. One possible solution that could help create more network connections is to establish a standard for IM services. The Internet Engineering Task Force has solicited proposals for a protocol that would allow interconnection among IM services. Creating a standard, however, is different from implementing a standard. In particular, AOL might see little advantage to making its system compatible with any other standard that emerges.

Competition and standards. AOL's smaller rivals are likely to implement the standard because the alternative of remaining a small, isolated network is not a viable long-term strategy. Once all of AOL's rivals are interconnected, the standard will create a larger pool of users that its own customers would want to be able to access. Although AOL could still just say no to standardization, customers who desire such connections could download a rival firm's software anyway, thereby becoming users of both networks.

Implications. In the particular case of instant messaging, where the costs of switching between networks appear to be low, AOL may find that inconveniencing its customers only leads them to defect to rival suppliers. If, however, AOL is able to maintain its position without connecting to other networks that adopt a common standard, that would suggest that first mover advantages are strong. Such an outcome would raise questions about whether competitive forces could erode a dominant position in other markets where network effects are present and switching costs are high.

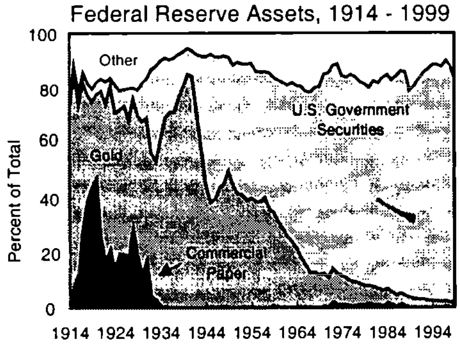
ARTICLE

What Is the Fed to Do when the T-Bills Run Out?

The prospective elimination of all publicly held debt by 2013 poses a practical problem for the Federal Reserve System, which conducts monetary policy primarily through transactions in Treasury securities. In the distant past, the Fed conducted monetary policy using commercial paper, and it could return to this practice. A better alternative, however, would be to find a replacement that has the key characteristics of Treasury securities: liquid and transparent markets and very low credit risk.

What the Fed owns. Except in unusual circumstances, the Fed can own only the following types of financial assets: gold, certain types of short-term private commercial paper, U.S. Treasury and agency securities, foreign sovereign debt, and some securities issued by state and local governments. It has no express authority to purchase corporate equities or bonds, mortgages, or land (other than Federal reserve premises). During its early history, the Federal Reserve's main assets were gold and commercial paper (see chart). Beginning in the 1930s, however, it greatly increased its holdings of Treasury securities, which now make up about 80 percent of Fed assets. The Fed currently holds—either directly or in repurchase agreements—about one-seventh of all Federal debt held by the public.

Federal Reserve Assets, 1914 - 1999



The conduct of monetary policy today... The Fed affects short-term interest rates by manipulating the supply of reserves held by member banks. Banks hold reserves to fulfill reserve requirements on certain types of deposits and to cover claims on their accounts made during the day. When the Fed increases reserves, their price—the federal funds rate—falls. The current practice is to raise or lower reserves principally through the purchase or sale of government securities to member banks in exchange for reserves. In several important ways, Treasury securities represent an ideal instrument for monetary policy. First, Treasury markets are generally very liquid, so that the Fed can easily purchase and sell securities at market prices. Second, price information is widely available, making these markets highly transparent. Third, Treasury securities are backed by the full faith and credit of the U.S. government; hence, the Fed takes on no credit risk in owning them.

...and in the future. With all publicly held Federal debt (which includes Federal Reserve holdings) projected to be retired by 2013, the Fed will need to change its asset portfolio and its conduct of monetary policy. The best option would be to find financial instruments that closely approximate the desirable characteristics of

Treasury securities. Unfortunately, some of the kinds of securities that the Fed is currently allowed to own fail this test. For example, use of foreign government securities would expose the Fed to exchange rate risk. Moreover, the regular use of foreign bonds to adjust reserves could impinge on the Treasury Department's responsibility for foreign exchange policy. Similarly, large-scale direct ownership and discounting of short-term commercial paper—a standard Fed practice in the 1920s—would imply a much more active role for the Fed in pricing risk and potentially interfering with the normal functioning of financial markets with respect to the allocation of credit and risk. One solution might be the creation of new securities by the private sector (see box)—though it might be necessary to broaden the Federal Reserve's power to own private securities to take advantage of such new securities.

A Triple-A Plus Solution

Private institutions could provide a solution to the Fed's problem of replacing Treasury securities in the conduct of monetary policy by creating new, very low-risk securities constructed from a pool of private debt securities. Such securities would be similar to mortgage-based securities currently issued by government-sponsored enterprises like Freddie Mac and Fannie Mae. For example, a financial institution, perhaps called the Triple-A Plus Fund, would buy a set of high-quality corporate bonds. It would then offer to sell a coupon bond called the Triple-A Plus bond that pays a fixed annual interest rate of, say 7 percent, for the life of the bond. The Triple-A Fund would put up its equity capital and take on the default risk of the underlying corporate bonds. Although not completely risk-free, bonds like the Triple-A Plus bond would entail very little credit risk and would be close substitutes for Treasury securities. Liquid and transparent markets should develop, given markets' and the Fed's appetite for such a low-risk security.

Conclusion. Under current projections for the elimination of publicly held Federal debt, the Fed's reliance on Treasury securities for its conduct of monetary policy will have to end. Although not discussed here, a related issue is how the Treasury Department should invest future Federal surpluses once the publicly held debt is paid off. Alternatives exist and the staffs at the Federal Reserve and the Treasury Department are actively evaluating the various options.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Shows Expansion Continuing. The latest reports from the 12 Federal Reserve districts indicated that the economy continued to expand during March and the first 3 weeks of April. The majority of districts reported moderate to strong economic growth, with only Richmond and Chicago noting some signs of slight slowing. Consumer spending was strong. Commercial construction activity generally remained robust, while several districts noted softening residential demand. Factories were running near capacity in some areas, as overall manufacturing activity was strong. Dry soil conditions were reported in many areas, but spring planting proceeded at a rapid pace. Oil drilling activity was up from a year ago. There were more frequent reports of intensifying wage pressures as shortages of workers persisted in all districts. Increasing input prices were noted in nearly every region. Many districts cited wider use of fuel surcharges by shipping firms and other transportation companies. Manufacturers in several areas also reported higher prices for petroleum-related inputs. However, there were only a few reports that increases in input costs were resulting in higher prices at the retail level.

Explaining the Decline in Unionization. While some observers argue that the lack of legal and political support for organizing new workers is an important reason for the decades-long slide in union membership rates in the private sector, a recent study concludes that changes in the economy are far more important. In particular, the study found that between 1973 and 1998, employment in non-unionized establishments and new establishments that were not organized (the non-union sector) grew by an average of 2.8 percent per year. By contrast, employment in unionized establishments (including organization of previously non-unionized workers) shrank by 2.9 percent annually. The authors argue that this divergence in growth rates is related to the structural shift in the U.S. economy away from sectors in which unions were strongest such as manufacturing, transportation, and communications (and within manufacturing to a shift in new capacity to regions that have historically not been favorable to unions). The study suggests that a very large increase in union organizing activity would be required to have a significant influence on the union membership rate in the private sector.

INTERNATIONAL ROUNDUP

ECB Raises Rates but Euro Keeps Falling. Amid concerns that the euro's low value may be contributing to inflationary pressures in the euro area, the European Central Bank announced last week that it would raise its benchmark interest rate by 0.25 percentage points, the fourth increase since November. Nevertheless, the euro continued to slide this week, reaching a record low of 89.0 cents. The value of the euro has fallen 24 percent against the dollar and 27 percent against the yen since its introduction in January 1999. The strength of the U.S. economy relative to Europe's and the prospect of further interest rate increases by the Federal Reserve are seen as reasons for the euro's weakness against the dollar. Some commentators have also suggested that capital markets are skeptical of the pace of labor market and tax reforms by European governments.

Education for All. Representatives from 181 countries at the World Education Forum (WEF) in Dakar last week renewed pledges made in 1990 to pursue education for all, particularly girls. Significant progress has been made in the past decade, with 84 percent of primary-school-aged children enrolled worldwide in 1998, up from 80 percent in 1990. The illiteracy rate among young adults aged 15-24 declined from 26 percent in 1970 to 14 percent in 1998, with evidence that countries are giving higher funding priorities to primary education. Nevertheless, more than 113 million children still have no access to primary education, 880 million adults remain illiterate, and gender discrimination continues. In Africa, the Arab States, and South and West Asia, primary school enrollment rates for school-age girls are about 10 percentage points lower than those of boys. WEF participant countries pledged that by 2015, all children, especially girls and minorities, would have free and compulsory primary education of good quality. In addition, donor countries and institutions promised that lack of resources will not stand in the way of achieving this goal.

New Pan-European Stock Exchange to be Created. The London Stock Exchange and Germany's Deutsche Boerse announced plans to merge this week, combining Europe's two largest stock markets into a new exchange called iX. The two exchanges currently provide the primary listing for 45 percent of Europe's top 300 companies and account for 53 percent of trade volume. In addition, iX said that it has signed a memorandum of understanding with NASDAQ to create a pan-European high-growth market. This new joint venture would represent Europe's biggest high-growth market, accounting for about 80 percent of volume in these stocks. Companies listed will include several hundred from Germany's Neuer Markt, London's techMARK, the NASDAQ 100, and other major U.S. and non-European securities and index funds. NASDAQ's stated goal is eventually to link this venture to other NASDAQ-branded markets around the world, creating a global, 24-hour trading platform. The boards of Deutsche Boerse and the London Stock exchange likewise believe that the merger will provide the basis for developing a global securities market, and talks for including the Milan and Madrid exchanges have already begun.