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Weekly Economic Briefing of the President

THE PRESIDENT HAS SEEN
12-14-99

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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

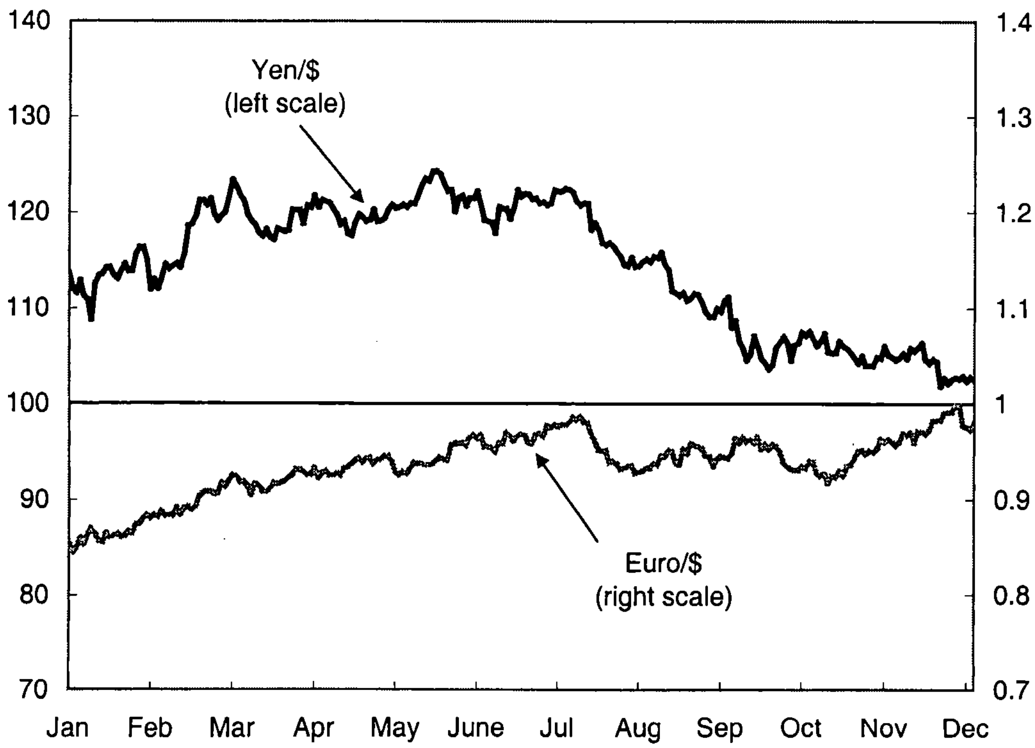
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

December 10, 1999

Copied
Baily
Podesta
p. 8 to
Frampton
Carol Browner
Podesta

CHART OF THE WEEK

Convergence of Exchange Rates in 1999



The euro is nearly at parity with the dollar while the yen is nearly at parity with the penny.

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THE PRESIDENT HAS SEEN

[illegible] ECONOMIC [illegible]

[illegible] PRESIDENT OF THE UNITED [illegible]

Prepared by the Council of Economic Advisers
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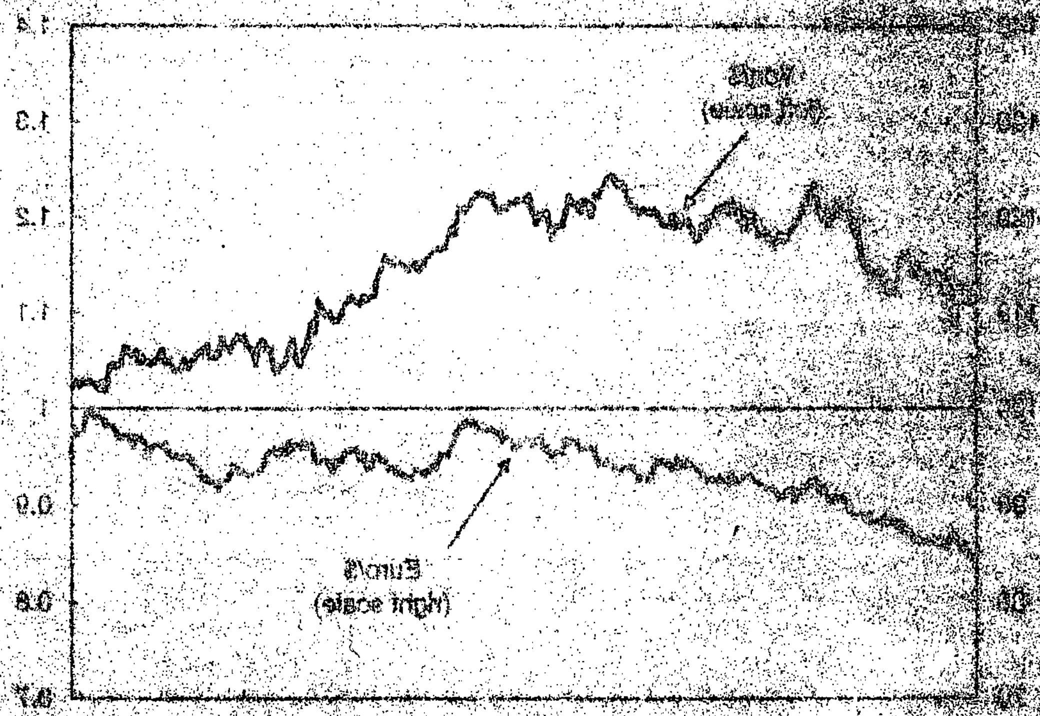
[illegible] OF THE WEEK

Convergence of Exchange Rates in 1999



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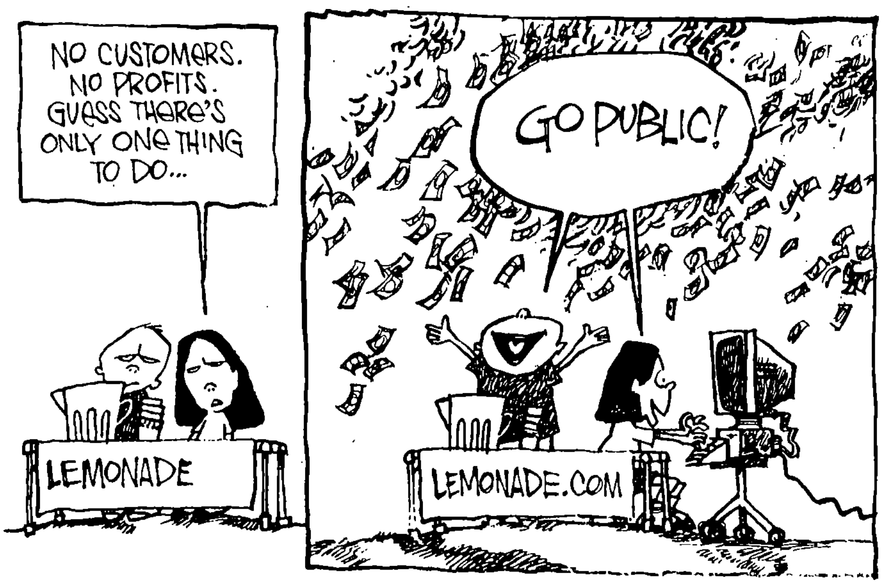
CONTENTS



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CURRENT DEVELOPMENT

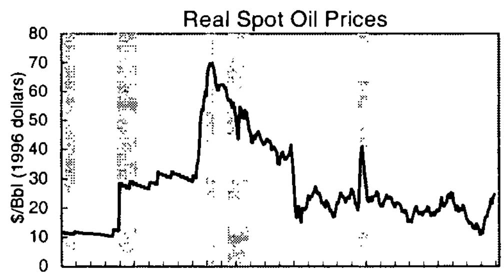
Have Oil Prices Reached their Peak?

At the end of last year, real oil prices hit their lowest point in over 25 years. Since then, rising demand and falling supply have pushed crude oil prices back up. As of yesterday, the price stood at $26 per barrel for West Texas Intermediate crude oil. Prices of refined products, like gasoline, have followed the same general trend. A key issue for the United States economy in the next year is whether oil prices have peaked or whether further increases are expected.

Supply. One of the reasons for the increase in oil prices is a reduction in supply. After oil prices fell below $12 a barrel at the end of last year, the major OPEC countries agreed to production targets to limit the supply of oil and thereby increase the price. Analysts generally believe that the major OPEC countries have stuck to the agreed upon limits. In addition, Iraq cut off oil exports in November, reportedly to protest a shortening of the renewal period of the "Oil-for-Food" program from 6 months to 2 weeks.

Demand. Shifts in demand have also influenced oil prices. The Asian crisis and slow world growth dampened demand for oil last year. Since then, economic recoveries in Asia and in parts of Europe have combined with the booming U.S. economy to push up world oil demand this year. In addition, there is some anecdotal evidence of stock building of oil and refined products in preparation for possible Y2K-related disruptions. Demand is expected to remain strong next year.

Outlook. Futures prices for oil imply that markets expect oil prices will fall next year. Two factors support this view. First, most Administration experts agree that the New Year will not generate widespread disruptions in the flow of oil. Moreover, Mexico, Venezuela, and Saudi Arabia recently announced that they would make up any Y2K-related shortfalls. Second, there are reasons to suspect that OPEC desires lower prices than those seen today. High oil prices encourage non-OPEC high-cost suppliers to increase production, cutting into OPEC's profits. In addition, high prices threaten the integrity of the cartel by making production in excess of agreed upon targets more profitable.



Notes: Price is West Texas Intermediate
The gray bars represent U.S. recessions.
October-December 1999 data are estimates.

Interestingly, none of the Blue Chip forecasters expect that rising oil prices will seriously threaten the current economic expansion, despite the experiences of the 1970s and early 1990s when oil price hikes were associated with economic downturns (see chart). This view seems justified because, relative to overall prices, the price of oil is much lower today than the peaks reached in the 1970s and the early 1990s. Unlike past oil price increases, this one was preceded by a decline in oil prices. Moreover, the energy intensity of the economy has fallen steadily for the last 50 years, suggesting that the U.S. economy may be less vulnerable to oil price shocks. Arguably, only a precipitous spike in oil prices would pose a significant risk to the economy.

ARTICLE

A Closer Look at Skill-Biased Technical Change

One common explanation for the increase in wage inequality in the United States from 1979 to the early 1990s is technical progress that has shifted labor demand toward more highly skilled workers relative to the less skilled–so called "skill-biased technical change." Research is beginning to provide insights into how information technology (IT) affects the workplace and the demand for skills.

Findings. Case studies of individual firms have shown how companies use IT to change the way they conduct business. These studies find that successful IT investment is often coupled with changes in business strategy and organizational structure. A recent study provides broad supporting evidence based on survey data on about 400 large U.S. firms during the mid-1980s to the mid-1990s. The two key findings are:

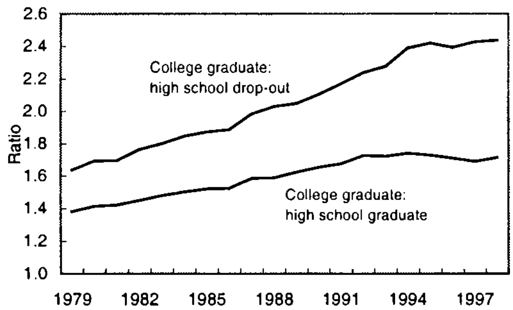
- IT interacts with organizational structure and worker skills. Controlling for industry and firm size, firms that invest more in computer equipment also tend to have a decentralized workplace organization (including broader job responsibilities for line workers, more decentralized decisionmaking, or more self-managing teams) and employ higher-skilled or more educated workers. One reason for combining IT and a decentralized workplace may be that IT can put greater information in the hands of front-line workers who may be better able to make day-to-day decisions than upper-level managers. This increased role for front-line workers in turn may raise the importance of skills and education for job performance.

- These interactions affect productivity. Firms with high levels of IT investment, workplace decentralization, and more highly skilled workers tend to have higher productivity than those with lower levels. Moreover, firms that use IT intensively without instituting organizational changes often experience little if any productivity gains. This helps explain the apparent lag (during the 1980s and early 1990s) in the effect of IT on productivity in the United States, since it has taken time for firms to redesign their organizations to take advantage of their IT investments.

Other evidence. Trends in the economy over the last 25 years dovetail with the case-study and firm-level evidence. Impressive advances in the underlying science and engineering of IT have increased the capabilities and reduced the costs of this technology. As a result, real investments in IT have grown at double-digit rates for several decades. Meanwhile, decentralized workplaces appear to have become more common. The skill levels of the work force have also been rising, at least according to measures such as the proportion of college graduates in the work force. Until 1994, the demand for more educated workers outpaced supply, raising the wages of more-skilled workers relative to less-skilled workers (see chart). Earnings growth since 1994 has been much more evenly distributed.

Implications and conclusion. Based on evidence from large firms, IT and IT-enabled organizational change appear to be important factors in raising the demand for skilled workers. Of course, IT can reduce the demand for skills in some cases. For example, computer-assisted scanning devices for final sales or inventory control may require lower average skills by retail clerks, and an automated teller machine may completely replace a bank teller. Nonetheless, it seems apparent that new technology and organizational change are making the acquisition of education and skills increasingly important for getting and keeping well-paying jobs. This highlights the importance of ensuring that students learn the basic skills needed in the information economy: higher-level math, reading, and writing skills, personal skills such as the ability to work effectively in groups, and a knowledge of computers.

Ratio of Full-Time Year-Round Weekly Median Earnings by Educational Attainment



ARTICLE

Saving the Planet while Cutting Taxes

The Administration has proposed a domestic greenhouse gas tradable permit program for 2008 to 2012 subject to the ratification of the Kyoto Protocol. Recent analysis indicates that how the program is implemented will affect energy company shareholders and taxpayers, and could also affect the costs to society of achieving the Kyoto target.

Effects of the tradable permit program on energy prices. Implementing a tradable permit program would require industries covered by the program to restrict their greenhouse gas emissions to comply with the Kyoto Protocol emissions target. Abating greenhouse gas emissions involves costs associated with investing in new technologies, fuel-switching, and other ways to reduce emissions. As the energy sector becomes more competitive over the next decade, the costs of controlling emissions will be reflected in consumer prices. For example, the Administration's economic analysis of the Kyoto Protocol found that a tradable permit price of $23 per ton of carbon would increase energy prices to consumers by about 5 percent in 2010, but this increase could be largely offset through the implementation of the Administration's electricity restructuring proposal.

To "grandfather" or to auction? A key question in implementing a tradable permit system is the allocation of permits. For example, the government could give away permits to firms ("grandfathering"); alternatively, the government could sell permits to firms through auctions. Importantly, the price of energy paid by consumers is likely to be the same in either case. Permits will be scarce, and the price of energy will reflect the cost of buying a permit or taking abatement measures regardless of how the permits were originally distributed. Producers who receive free permits will be like owners of particularly low-cost oil wells when oil prices go up: they will sell at the market price and reap windfall profits. In contrast, an auction allows the government to capture the value of the permits, because competition should lead companies to bid away almost the full value of any potential windfall profits from owning the permits.

Grandfathering would result in the giving away of permits valued in the tens to hundreds of billions of dollars annually. Because these firms can pass on most of the cost of reducing emissions to consumers, the grandfathering of permits would provide these firms with significant windfall profits, and allow them to enjoy higher profits under climate policy than without climate policy. However, if the government sells permits it would receive revenues in the tens to hundreds of billions of dollars annually. While energy firms would have lower profits under an auction, the permit revenues could be recycled back into the economy through tax cuts. Recent research has found that such revenue recycling could reduce the costs to society resulting from the use of greenhouse gas permits by up to 80 percent.

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Effects of permit allocation on energy industries. One paper evaluated the effects of grandfathering and auctioning on energy industries. Giving away permits to energy industries would significantly increase equity values while selling permits would lower equity values. An alternative is to follow a hybrid approach that combines elements of grandfathering and auctions. It is estimated that grandfathering 5 to 15 percent of the permits to energy firms while auctioning the remaining permits would be sufficient to ensure that these firms' equity values would be the same under climate policy as they would be without climate policy. Furthermore, since most of the permits would be auctioned, such an approach would still provide significant revenues to the government.

Conclusion. The type of permit allocation does not affect energy prices. It can however, significantly influence the impact of climate policies on energy industries as well as the costs to society. A hybrid system of grandfathering and auctioning permits could preserve energy industries' profits and equity values while providing sufficient government revenues to finance tax cuts or for other purposes.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Midwest Feels the Heat of a Strong Economy. After suffering from a weak labor market during the 1970s to early 1990s, labor market conditions in the Midwest have improved significantly. In fact, the Midwest's unemployment rate (3.4 percent in October of this year) has been the lowest among the four regions for every month since April 1991. As a result, business executives in the Midwest report that their most difficult problem is "finding good help at current wage offers." A recent study by the Federal Reserve Bank of Chicago suggests that the region's tight labor market will continue. One reason the study cites is slow work force growth caused by continued net-migration out of the Midwest. Another reason is the region's strong economy, which has propelled growth in labor demand, particularly for workers with high levels of education and skills. The study mentions possible public policy responses including encouraging migration to the region, improving education and training, continued welfare-to-work efforts, improving access to transportation and information about jobs for inner-city residents, and encouraging businesses to move to the central cities, where labor markets are typically not as tight.

The Gains from Telecommuting. In May 1997, more than 21 million Americans did some work at home as part of their primary job, according to a recent report. Lower prices and expanding access to mobile phones, laptops, e-mail, and the Internet have made it easier for people to work at home. The report finds that telecommuting provides benefits both to employees and businesses. Workplace flexibility reduces time spent commuting and may help workers balance work and family responsibilities. Not surprisingly, working parents take advantage of telecommuting more than childless workers; in fact, married women with children under the age of 6 had the highest home work rate at nearly 24 percent. Evidently, employers find that offering the option of telecommuting is a way to attract and retain employees and reduce absenteeism. In a 1998 study of large companies, 33 percent allowed employees to work off-site on a regular basis and another 14 percent said they were considering it.

Beige Book Reports Continued Growth. Reports from most Federal Reserve Districts indicated continued moderate to strong economic growth in October and November. Consumer spending picked up over the Thanksgiving weekend, after being hampered by warm weather earlier in November. Manufacturing activity continued to advance in most Districts. Commercial real estate markets remained strong in most parts of the country. Home sales have slipped. Agricultural conditions were mixed, and low prices persist for grains and some other commodities. Oil and gas drilling has increased. Bank lending has declined for residential mortgages but risen for consumer loans. Labor markets remain tight in all Districts. The pace of wage and salary increases did not appear to be accelerating generally, although there were some reports of larger recent salary increases in some industries and regions. Prices appear to be mostly steady at the retail level. Although prices of industrial goods were reported to be mostly steady in a majority of Districts, prices of some goods have been on the rise.

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INTERNATIONAL ROUNDUP

€1 = $1 = ¥100? Last week, the yen soared to its strongest level against the dollar in 4 years despite interventions by the Japanese government, while the euro tumbled to its weakest level since its introduction at the beginning of the year, briefly dropping below parity with the dollar. Economic statistics released this week may help curb these trends in the yen and the euro. After growing soundly in the first half of the year, the Japanese economy contracted at an annual rate of nearly 4 percent in the third quarter, according to data released on Monday. Indicators suggest that the outlook for the fourth quarter is similarly dismal, which should dampen upward pressure on the yen. Turning to the euro, unemployment and other indicators released this week indicated improved economic prospects in Germany, suggesting a brighter outlook for the Euro-region. The euro has climbed back above parity and is currently at around $1.02.

New Alliance to Produce Global Framework for E-business. The United Nations and the world's leading computer and software companies have joined together to unify technical standards for the exchange of electronic business information, a move that may revolutionize business on the Web. Currently, most Web documents are stored and transmitted in a computer language known as HTML (Hypertext Markup Language). HTML is easy to learn and is adequate for simple data display, but it limits the types of information that can be represented. A new, more sophisticated language known as XML (Extensible Markup Language) holds the promise of broadening how the Internet can be used. For example, standardized XML specifications would allow an emergency room physician to transfer a wider variety of patient records from distant hospitals into a local database. The public-private alliance aims to create a single global XML standard so that firms in different industries can exchange electronic business data, thereby lowering the barrier of entry to electronic business, particularly with respect to small and medium-size enterprises and developing countries.

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Better Ways to Cut Pollution. Developing countries are cutting industrial pollution by combining the power of local communities, markets, and the media to police discharges from private companies, according to a recent World Bank report. The report argues that controlling pollution through traditional regulations entails high enforcement costs and often yields disappointing results. The report presents evidence suggesting that market incentives and public information may provide much better outcomes. Seven highly populated regions in Colombia, for example, instituted a system that charges a flat levy for every ton of specified pollutants discharged into the nation's waterways. In the first 6 months of the plan, discharges of biochemical oxygen demand (BOD) into the Rio Negro River fell 52 percent, and discharges of total suspended solids fell 16 percent. The Indonesian PROPER program, in which regulators publish ratings of plants based on their environmental performance, provides an example of the power of public information disclosure. In an 18-month period, PROPER induced the pilot group of factories to reduce their water pollution by 40 percent.

cc Geo Frampton
Carol Browner

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RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, December 10, 1999****

The producer price index for finished goods rose 0.2 percent in November. Excluding food and energy, producer prices were unchanged.

Productivity

Nonfarm business productivity rose 4.9 percent at an annual rate in the third quarter. Manufacturing productivity rose 3.9 percent.

MAJOR RELEASES NEXT WEEK

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

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	5.5
GDP chain-type price index	5.2	1.1	2.0	1.3	1.1
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.1	2.7	0.6	**4.9**
Real compensation per hour:					
Using CPI	1.0	3.9	2.8	1.2	**2.1**
Using NFB deflator	1.5	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	13.8
Personal saving	6.6	2.6	2.2	1.8	1.5
Federal surplus	-2.8	0.5	1.1	1.3	1.4

	1970-1993	1998	September 1999	October 1999	November 1999
Unemployment Rate (percent)	6.7**	4.5**	4.2	4.1	4.1
Payroll employment (thousands)					
increase per month			103	263	234
increase since Jan. 1993					20043
Inflation (percent per period)					
CPI	5.8	1.6	0.4	0.2	N.A.
PPI-Finished goods	5.0	0.0	1.1	-0.1	**0.2**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, December 10, 1999**.

FINANCIAL STATISTICS

	1997	1998	October 1999	November 1999	Dec. 9, 1999
Dow-Jones Industrial Average	7441	8626	10397	10810	11135
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.86	5.07	5.10
10-year T-bond	6.35	5.26	6.11	6.03	6.14
Mortgage rate, 30-year fixed	7.60	6.94	7.85	7.74	7.84
Prime rate	8.44	8.35	8.25	8.37	8.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 9, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.016	1.4	N.A.
Yen (per U.S. dollar)	102.6	-0.1	-13.1
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	93.05	-0.8	0.1

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	4.2 (Q3)	4.1 (Nov)	2.6 (Oct)
Canada	4.2 (Q3)	7.2 (Oct)	2.3 (Oct)
Japan	1.0 (Q3)	4.7 (Oct)	-0.7 (Oct)
France	3.0 (Q3)	11.0 (Sep)	0.8 (Oct)
Germany	1.2 (Q3)	9.0 (Oct)[2]	0.8 (Oct)
Italy	0.8 (Q2)	12.1 (Apr)	1.8 (Oct)
United Kingdom	1.8 (Q3)	5.9 (Aug)	1.2 (Oct)

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.